Growing military expenditure and air travel fuels soaring M&A in aerospace, defense, and government services

- US$4.3 billion in cross-border deal value registered in Q1
- Quarterly deal value 221% above average since 2010
- Commercial air travel growing 6.5% annually

As the demand for air travel rises and defense expenditures grow globally, M&A in the aerospace, defense, and government services (ADG) sector has sky-rocketed in the first three months of 2019. ADG registered US$4.3 billion in cross-border deal value in Q1, far above the US$1.3 billion quarterly average over the last nine years.

Global military expenditures began to increase in 2017, after several flat years. The United States’ national defense budget has risen to US$750 billion for fiscal year 2020, up from US$582.7 billion for 2017, while China has set a 7.5% growth target for its 2019 defense budget. In Europe, Germany’s 2018 defense spending went up by 10% year-on-year to US$50.2 billion. Taken together, NATO’s European members’ defense spending leapt to a five-year high in 2018. As Western countries shift away from a focus on terrorism back towards “great power competition,” defense firms are looking to gain scale and access to the latest technologies through M&A in order not to miss out.

Meanwhile, demand for commercial air travel is taking off. Over the course of 2018, revenue passenger kilometers (RPKs) — an industry metric measuring the distance traveled by paying passengers — rose 6.5%. This demand has led to a seven- to ten-year backlog of orders at the two dominant original equipment manufacturers
(OEMs), Airbus and Boeing, respectively, although it is unclear whether that will change given the recent events regarding Boeing.

Over the past two years, Airbus and Boeing also entered into joint ventures. In January, Boeing struck a US$4.2 billion deal for an 80% stake in Brazil’s Embraer’s commercial aviation business. The deal was widely seen as a response to Airbus’ joint venture with Bombardier in 2017, which saw the European champion take a 50.1% stake in Bombardier’s C Series unit for US$2.6 billion.

OEMs like Airbus and Boeing are striking M&A deals to gain access to new technologies and markets. This consolidation wave could affect their suppliers, who feel increased pressure to consolidate between themselves and gain scale to improve their negotiating power against the OEMs.

PE dips into ADG

In December 2018, Carlyle Group acquired aerospace and defense services firm StandardAero in a secondary buyout from Veritas Capital. While the deal value was not disclosed, Veritas acquired the company in 2015 for US$2.25 billion. In 2018, Veritas also acquired PricewaterhouseCoopers’ U.S. public sector business for an undisclosed amount.

With vast levels of capital to deploy, PE is increasingly looking at sectors they previously avoided, including ADG. (See our Q1 2019 PE Market Insight for more info.)

Some funds, like Veritas and Arlington Capital, have always specialized in government services and regulated industries, but the sector’s high margins and high multiples are certain to attract general interest firms such as Carlyle and TowerBrook. Compared to strategic players, however, PE funds face certain disadvantages, especially compared to domestic U.S. trade buyers.

When it comes to U.S.-based targets, PE bidders may come under Foreign Ownership, Control or Influence (FOCI) scrutiny from the Department of Defense, which is designed to monitor government contractors that have access to sensitive information. PE funds wishing to acquire any firms that have contracts with the U.S. government must report any foreign ownership, no matter how small.

Moreover, foreign buyers are subject to increasing scrutiny not just by the Committee on Foreign Investment in the United States (CFIUS), but by other government bodies around the world.

Growing suspicions

The United States, the United Kingdom, France, and Germany all took steps last year to strengthen their review process for foreign investment into strategic industries. For example, in August 2018, U.S. President Trump signed the Foreign Investment Risk Review Modernization Act (FIRRMA) into law to strengthen CFIUS. FIRRMA expands and closes gaps in CFIUS around minority investments and real estate transactions and requires mandatory declarations in certain cases. In the past, only acquisitions of controlling stakes would be subject to CFIUS scrutiny.

FIRRMA is widely seen as a move against China and concerns about intellectual property and sensitive data access. The ongoing trade talks between the world’s two largest economies similarly have focused in part on technology transfers.

These regulatory concerns will weigh on potential cross-border bidders for ADG targets, but given how in demand targets are in the sector, such regulatory hurdles
are unlikely to significantly slow down ADG M&A.

Cyber worries

The growing reach of CFIUS and other countries’ governmental bodies regulating inbound investments reflect shifting approaches to issues around technology and data.

Under the EU’s General Data Protection Regulation (GDPR), which came into effect in May 2018, violators could be fined up to 4% of annual worldwide revenues, but data breaches concern more than privacy watchdogs. In December, The New York Times reported that U.S. government investigators had found evidence that the cyberattack on the Marriott hotel chain, which compromised as many as 500 million account details, was carried out by Chinese state-backed agents intent on tracking U.S. government officials.

News of massive data breaches and potentially serious security flaws only make growing cybersecurity threats more visible. As new types of cyber-related threats emerge, interest in acquiring innovative firms with effective solutions will only increase, especially from companies in sensitive areas such as defense. For example, while U.S.-based defense contractor L3 Technologies’ US$18.4 billion merger with Harris Corporation attracted more media attention, the company’s US$184 million acquisition of two IT security firms, Australia-based Azimuth Security and Canada-based Linchpin Labs, was one of the largest ever cross-border acquisitions of IT security firms by a defense contractor in recent years.

Outlook

ADG’s high growth and high margins will continue to attract investors, both old and new. Sub-sectors, including health care, NASA services, and IT, will be in particular demand. While regulatory issues may be a cause for concern among some dealmakers, appetite for deals in the ADG space should remain strong — cross-border deals included.

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