EUROPEAN VALUATIONS

# MARKET SECTOR INSIGHTS - OCTOBER 2020

## Aerospace Market

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### Global Outlook

The major determinant of aircraft parts demand is investment activity in the end-user industries for aircraft equipment such as the defence industry or civil aircraft industry. Moreover, demand depends both on the demand for replacement parts as well as demand for new equipment. In general, both are stimulated by economic growth.

According to the Netherlands' Ministry of Foreign Affairs, global air travel is set to increase over 50% in the next 10 years. This scenario is expected to create global demand for an additional 8,000-10,000 helicopters; 25,000-30,000 large civilian aircraft; 20,000-25,000 business jets and 4,000-6,000 regional jets by 2030.

In addition to the expected growth of global air travel, another market driver is the number of airplane retirements and replacements. It is estimated in the next few decades, some 2,000 airplanes will be replaced by new ones.

### Boeings Effect on the EU Aeropsace Industry

The Boeing 737 Max has been grounded since March 2019, following two deadly crashes in five months in 2019 that killed 346 people. The now more than year-long crisis has put orders and deliveries of many of the company's jets on hold. Boeing reported its first annual loss in more than 20 years, posting a net loss of $636 million in 2019. In June 2020, Boeing reported that although it logged orders for new freighter planes in May, cancellations continued to outpace new business as the coronavirus impacted the air travel industry.

In December 2019, Boeing decided to temporarily suspend the production of its 737 Max airliners. This had a ripple effect on the company's EU suppliers which faced significant losses. According to the Financial Times, shares of France's Safran, the world's third-largest aerospace supplier, saw one of the steepest drops on the Stoxx 600 aerospace and defence index, declining about 3%. The Paris-based company had already warned in September 2019 that the grounding of the 737 Max would hit its cash flow by about €300 million a quarter, up from the €200 million that it estimated in the first quarter of the year. The timetable for when regulators will allow the 737 Max to return to service remains unclear, with some speculations about the 737 Max getting EU clearance by the end of 2020.

Meanwhile in the UK, Senior, an engineering company that counts Boeing as one of its top customers, was the biggest decliner among suppliers, falling 9%. The FTSE 250 group had warned in August 2019 that margins at its aerospace business were going to be squeezed by the prolonged grounding of the Max 737. Furthermore, there are a number of other smaller suppliers in Boeing's 737 Max supply chain that have been affected. The halting of 737 Max production has had a considerable effect on the bottom-line of these companies as well.

Boeing's problems have had an effect on EU aircraft parts manufacturing companies; however, it is important to keep in mind that EU aircraft parts manufacturers and suppliers have significantly more exposure to Airbus than to Boeing, which mitigates the loss to the overall EU aerospace industry. Moreover, the grounding of 737 Max has also resulted in an increase in demand for Airbus aircraft, which might actually bode well for EU aircraft parts companies.

Also, the fact that the aerospace industry has perhaps the toughest entry barriers compared to all other industries cannot be overlooked. This is the

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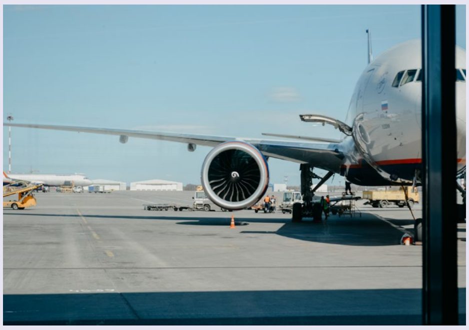

> *The EU is the single largest export market for the UK representing 35% of all UK aerospace exports. This is followed by the US & Canada with a 21% share and China with 20%.*

reason why the commercial aerospace industry has been a duopoly for such a long time, with no change to it expected in the near future. This means that in spite of its current problems, Boeing will probably overcome this period of turbulence, which undoubtedly would be good news for its suppliers in the EU.

### Forecast for Aerospace Manufacturers

Although the long-term outlook of the aviation industry is good, there are some expected headwinds in the short term, which will be further exacerbated by the COVID-19 pandemic. Industry growth rates are expected to drop in the next couple of years. In the face of this development, OEMs are cutting costs, doing more in-house and shoring up their supply chain, clipping the wings of manufacturers in the process. The predictable result for manufacturers is overcapacity and downward pressure on margins.

Furthermore, dwindling market shares and the need to streamline operations and innovate will also prompt a wave of consolidation in the market for aerostructures. Manufacturers must make sure they end up where the business is and the profits are. Aerostructure suppliers that plot a clear strategy and proactively shape the wave of consolidation ahead can turn the coming changes to their own advantage.

### UK

According to figures from ADS, a trade organisation for the UK aerospace and defence sectors, UK aerospace is present in over 80 countries worldwide and exports 95% of the goods it produces. The EU is the single largest export market for the UK representing 35% of all UK aerospace exports. This is followed by the US & Canada with a 21% share and China with 20%. UK aerospace output has grown by 45% since 2010 with annual turnover of £35.9 billion. Although growth for the UK aerospace sector was forecasted at 2.2% owing to COVID-19, ADS has recently said that the UK aerospace sector needs urgent and long-term support.

### Brexit Update

The growth in rate of consumption of processed and convenience food products, primarily in the emerging markets such as countries in the Asia Pacific region, is contributing significantly to the rising sales of malt ingredients. Various factors such as rise in consumer awareness regarding the health benefits of malt ingredients and the wide range of applications in food industry are driving market growth. Going forward, experts expect this trend to gain further prominence, opening up additional opportunities for players in this industry.

On 31 January 2020, the UK left the European Union and has entered a standstill transition period with the EU until 31 December 2020. A recent statement from ADS stated, "The UK and EU are currently negotiating what the future relationship will look like. ADS continue to work on behalf of the aerospace, defence, security and space sectors to identify and clearly explain how a negotiated deal with the EU is the best possible outcome for our sectors. It remains a priority of ADS to ensure any future arrangement with the EU is as close as possible.

Key priorities listed by ADS in the Brexit and future relationship negotiations are:

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*"Data from the London Metal Exchange ("LME") shows the aluminium market saw prices drop significantly in the first four months of 2020 before rebounding and seeing a consistent increase since then."*

- A stand-alone aviation deal that keeps the UK in EASA & protects Europe's connectivity
- Access to and influence in the European Chemicals Agency and the EU REACH regime
- A customs union with the EU that minimises additional costs for just-in-time supply chains
- A comprehensive Defence and Security partnership with the EU
- Inclusion in collaborative European Space and R&D programmes
- Access to the skilled EU labour required to maintain the UK's global competitiveness.

### Aluminium Prices

Data from the London Metal Exchange ("LME") shows the aluminium market saw prices drop significantly in the first four months of 2020 before rebounding and seeing a consistent increase since then. Aluminium prices declined from $1,771 per tonne in January 2020 to a low of $1,421 per tonne in April 2020, before rebounding and increasing to reach $1,737 per tonne in September 2020. As such, aluminium prices are currently hovering around where they were at the start of 2020.

## Economic Impact of Coronavirus

Undoubtedly, coronavirus is a black swan event – something that happens once in a century. Its spread has left businesses around the world counting costs, with many investors fearing the spread of coronavirus will pose an insurmountable challenge to the economic growth of all major countries across the globe. Almost every industry has been affected, with governments scrambling to somehow arrest the economic decline. Central banks in more than 50 countries, including the US Federal Reserve and the Bank of England have cut interest rates to try to strengthen their economies. Furthermore, most countries have announced unprecedented stimulus packages in the hopes of reviving their economy.

### Manufacturing and Services Have Been Massively Hit

In China, where the coronavirus first appeared, industrial production, sales and investment all fell in the first two months of the year, compared with the same period in 2019. China makes up a third of manufacturing globally and is the world's largest exporter of goods. Like China, factories in many other economic powerhouses like the US, UK and Germany were shut, resulting in a decline in manufacturing output at perhaps unprecedented levels.

Likewise, services sectors around the world including IT, IT enabled Services ("ITeS") and banking have also taken a hit, and perhaps the biggest hit has been the travel sector, with many companies in this sector now facing an existential crisis.

### Effect on Global Demand

Restaurants, cinemas and shops around the world have emptied, while flights, road traffic and energy use have fallen steeply. Oil prices have plummeted leading to oil producers slashing outputs.

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*"According to a recent report by IATA, airline revenues could drop by $314 billion in 2020."*

The retail industry has been hit hard. Lockdowns in many major economies until the middle of May 2020, with only essential shops being allowed to open has meant huge losses for retailers, leading to many retailers shutting up shop."

It is clear now that the spread of coronavirus has led to a decline in global consumer spending, the heart of global economic activity. Moreover, employee layoffs in various industries are becoming increasingly common, in many cases on a large scale. This will lead to further pullback in consumer spending, at least in the near future, exacerbating the economic impact of coronavirus.

### Impact on the Aerospace Industry

According to a report in Deloitte, due to COVID-19 and the resulting lockdowns, commercial aviation companies experienced disruption in production and slowing demand as workers went home, passengers stopped traveling and customers deferred delivery of new aircraft. Demand for spare parts also went down since less maintenance was required. Aircraft manufacturers are capital intensive by nature, thus raising short-term concerns about cash flow and liquidity. Longer term, aircraft makers will continue to face cash-flow shortages, production challenges and cascading effects throughout the supply chain that may weaken the industrial base that supports complex manufacturing. Furthermore, the risk of critical program failure is likely to rise and key suppliers and specialised providers may become financially stressed and require support.

### Impact on the Travel Industry

COVID-19 has challenged the travel industry in unprecedented ways, triggering mass cancellations and affecting providers' ability to generate sales. According to a recent report by IATA, airline revenues could drop by $314 billion in 2020. From flight suspensions to border closures, the massive shutdown has cost countries billions of dollars, airlines are running out of money and millions of people have lost their jobs — turning the travel industry into one of the largest casualties of the coronavirus outbreak.

According to the World Economic Forum, due to restrictions imposed in March when the coronavirus started spreading rapidly around the world, international travel came to a screeching halt in April and May, resulting in international tourist arrivals that trailed last year's total by almost 60 percent through the first five months of 2020. Depending on when travel restrictions will be fully lifted, the World Tourism Organization expects international tourism receipts (i.e. spending by international tourists) to drop between $910 billion and $1.2 trillion this year, which has the potential to set the global tourism industry back by 20 years.

### Pace of Recovery Losing Momentum

According to the latest OECD Interim Economic Outlook report, after an unprecedented collapse in the first half of the year, economic output recovered swiftly following the easing of containment measures and the initial re-opening of businesses, but the pace of recovery has lost some momentum more recently. New restrictions being imposed in some countries to tackle the resurgence of the virus are likely to have slowed growth, the report says.

Uncertainty remains high and the strength of the recovery varies markedly between countries and between business sectors. Prospects for inclusive, resilient and sustainable economic growth will depend on a range of factors

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including the likelihood of new outbreaks of the virus, how well individuals observe health measures and restrictions, consumer and business confidence and the extent to which government support to maintain jobs and help businesses succeeds in boosting demand..

### Global Economic Forecast

The OECD Interim Economic Outlook projects global GDP to fall by 4.5% this year, before growing by 5% in 2021. The forecasts are less negative than those in OECD's June Economic Outlook, due primarily to better than expected outcomes for China and the United States in the first half of this year and a response by governments on a massive scale. However, output in many countries at the end of 2021 will still be below the levels at the end of 2019, and well below what was projected prior to the pandemic.

If the threat from COVID-19 fades more quickly than expected, improved business and consumer confidence could boost global activity sharply in 2021. But a stronger resurgence of the virus, or more stringent lockdowns could cut two to three percentage points from global growth in 2021, with even higher unemployment and a prolonged period of weak investment.

The report warns that many businesses in the service sectors most affected by shutdowns, such as transport, entertainment and leisure, could become insolvent if demand does not recover, triggering large-scale job losses. Rising unemployment is also likely to worsen the risk of poverty and deprivation for millions of informal workers, particularly in emerging-market economies.

The rapid reaction of policymakers in many countries to buffer the initial blow to incomes and jobs prevented an even larger drop in output. The Interim Outlook says it is essential for governments not to repeat mistakes of past recessions but to continue to provide fiscal, financial and other policy support at the current stage of the recovery and for 2021. Such measures should be flexible enough to adapt to changing conditions and become more targeted.

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