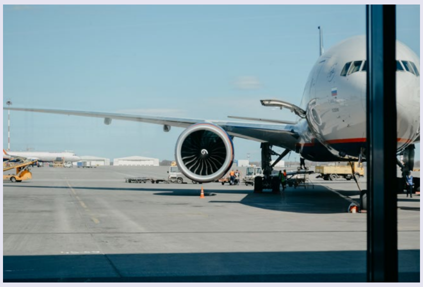
EUROPEAN VALUATIONS

MARKET SECTOR INSIGHTS – JUNE 2023 (Q2)

Aerospace Market



“Domestic traffic levels registered about 81% of the pre-pandemic 2019 levels (in September 2022), and international traffic levels have shown strong growth with easing travel restrictions worldwide.”

Global Outlook

According to Deloitte’s 2023 aerospace and defence industry outlook, with the global economy gradually recovering from the COVID-19 pandemic, the aerospace and defence (A&D) industry has shown signs of a strong rebound in 2022, but supply chain and talent issues continue to limit the industry’s growth. According to Deloitte’s outlook survey, supply chain disruptions and talent shortages may be the biggest risks or challenges for A&D organizations in 2023. Furthermore, the Russian invasion of Ukraine (the invasion) disrupted global supply chains, especially for critical metals and rare earth elements, and exacerbated fuel price volatility. Inflation remains a challenge for the entire industry—54% of respondents in Deloitte’s outlook survey report that price increases are one of the key risks in 2023.

As demand for passenger travel is correlated to ticket prices, which, in turn, depend on jet fuel prices, a quick and sustained rise in jet fuel prices can affect traffic and increase market volatility. To address this challenge, aircraft manufacturers are investing in aircraft and engine design to make them more fuel-efficient, lower operating costs, and explore lower- and zero-emissions commercial aircraft for the future. The strong recovery in air travel is leading to increased aircraft orders and aftermarket activity. Domestic traffic levels registered about 81% of the pre-pandemic 2019 levels (in September 2022), and international traffic levels have shown strong growth with easing travel restrictions worldwide. Leading global commercial aerospace original equipment manufacturers (OEMs) estimate that global passenger traffic will return to 2019 levels by the end of 2023 or early 2024. This could, in turn, result in production ramp-ups to remediate the growing backlog and drive industry revenue in 2023.

The defence segment remained stable through 2022 and is expected to outperform the commercial aerospace segment as an increase in defence budgets in the wake of the invasion is boosting demand for military equipment globally. The US defence budget for FY2023 emphasizes perceived strategic threats from China and Russia, with a key focus on electronic warfare and cybersecurity. European nations are modernizing armed forces with a planned increased budget to address rising geopolitical tensions. These nations have announced an increase of about $204 billion in the defence budget in the first three months of the invasion focusing primarily on future military technologies.

Aerospace Parts Market

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.

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"Cargo continues to outperform domestic and international passenger markets."

According to a report by Grand View Research, the global aerospace parts market size was estimated at USD 899.48 billion in 2022 and is expected to grow at a compound annual growth rate (CAGR) of 4% from 2023 to 2030. The market is growing on account of growing passenger traffic, especially in Asia Pacific and the Middle East & Africa, which is expected to drive the demand and production of aerospace parts, over the coming years. Moreover, the increasing demand for light weighted and fuel-efficient aircrafts to reduce greenhouse gas emission is positively influencing the demand for aerospace parts manufacturing in the market.

Forecast for the Global Airline Industry

In December 2022, the International Air Transport Association ("IATA") released a forecast according to which, traffic continues to be driven mostly by pandemic-related travel restrictions which are still dampening the recovery, notably in China P.R. Even so, global passenger numbers are forecast to reach the 2019 level in 2024.

Cargo continues to outperform domestic and international passenger markets. While CTKs have moderated, the related revenue will likely exceed 2019 results going forward, in spite of pressure on yields as belly capacity returns.

The air transport industry will likely post a loss of nearly USD 7 billion in 2022 and deliver a profit of USD 4.7 billion in 2023. This is a remarkable performance given the USD 138 billion loss seen in 2020.

All regions will see their finances get better in 2023. The North America region is in the lead and likely was profitable already in 2022. In 2023, Europe and the Middle East are expected to deliver a profit as well, while Latin America, Africa, and Asia Pacific will have to look to 2024 or beyond to join their ranks.

There are numerous risks to the outlook, many of which are tilted to the downside, but if achieved, this net profit outcome would be a remarkable performance, following the disruption COVID-19 wrought on the airline industry and the associated massive financial loss of almost USD 140 billion in 2020.

UK

According to figures from ADS, a trade organisation for the UK aerospace and defence sectors, Q1 2023 might prove more difficult than businesses would like, following a challenging 2022. The continuation of difficult circumstances especially for the supply chain with the rising cost of doing business against a backdrop of rising demand. The UK continues to experience double-digit inflation and although there have been some government interventions, rising energy prices continue to be a cause of concern for both households and businesses.

However, encouragingly, demand for travel continues to recover as well, with UK flights and arrivals data towards the end of March 2023 just 11% below the same day in 2019. Travel to visit friends and relatives leads the recovery.

Led by countries such as Australia, India and South Korea, the market in Asia-Pacific is forecast to reach $13.7 billion by 2026, while Latin America will expand at 6.3% CAGR through the forecast period.

The backdrop that the Chancellor delivered his Spring Budget against saw both households and businesses crave certainty about the future of rising costs. At the same time, the UK needs to be seen as the place to invest, especially for long term decarbonisation targets to be met and delivered upon, this is especially important in response to the US' Inflation Reduction Act.

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“Companies still recovering from the Covid-19 pandemic face new headwinds of inflation and rising interest rates”

Elsewhere, Russia’s war on Ukraine has persisted for over a year, the UK has continued its commitment to help support Ukraine and the Spring Budget saw an increase of £11bn in defence spending over the next five years. Which highlights the need as well to ensure UK national security.

In February of Q1, ADS surveyed its members on their outlook and intentions for 2023. The ADS Industry Outlook 2023: Q1 Survey found encouraging responses, that the majority of members expect this year to see increased turnover compared to 2022, with only 4% expecting a decrease.

Takeovers

According to the Financial Times, Britain’s aerospace and defence sector has been a rare bright spot, defying the shrinking trend of the country’s manufacturing base for more than 30 years, with a core group of heavyweights such as BAE Systems and Rolls-Royce surrounded by a cluster of key suppliers.

But in the past three years, several of these suppliers — Cobham, Meggitt and Ultra Electronics — have fallen to bids from overseas suitors. Ultra and Meggitt delisted from the London market last year. In September 2022, another stalwart — privately owned Pearson Engineering, based in Newcastle — was sold to an Israeli company.

The contracting British ownership of a vital industrial sector has renewed debate about its long-term prospects. Companies still recovering from the Covid-19 pandemic face new headwinds of inflation and rising interest rates.

Kevin Craven, chief executive of ADS, the aerospace industry trade group, said he expected more UK companies to draw interest from overseas.

Sir Nigel Rudd, who as chair sold Boots and Meggitt, said he expected successful companies to remain vulnerable. He added that there were two big issues driving the rush of takeovers across UK markets: the valuations of similar companies in the US were typically 20-30 per cent higher than those of UK peers and British investors “hate debt”.

Aluminium Prices

According to data from the London Metal Exchange, aluminium prices have declined over the past one year. Prices have declined from US$ 3,490 per tonne in April 2022 to US$ 2,336 per tonne at the end of March 2023.

Aluminium prices will likely rule firm in 2023 on supply constraints and rising demand, especially with China easing Covid-19 curbs, analysts say. Fitch Solutions Industry Research and Country Risk, a research unit of the Fitch Group, sees prices ruling at elevated levels but not rallying to the highs seen in 2022.

The development comes amidst data from the International Aluminium Institute showing the metal’s production in January 2023 increased by 3.3 per cent to 5.83 million tonnes (mt) from 5.64 a year ago. However, production in 2022 was up by a mere 2 per cent at 69 mt.

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“Up to 62% of surveyed global consumers already feel like they’re living in a recession...”

-Economic Outlook-

Over the past three years, the world has been faced with many unprecedented situations ranging from pandemic health crises to record-setting inflation, rising interest rates, falling global wage growth, extreme weather events and geopolitical conflicts. This has resulted in economic volatility and fears of an impending recession.

UK Manufacturing Outlook

Make UK’s Q1 2023 Manufacturing Outlook report, in partnership with BDO, finds that manufacturers have unexpectedly improved on their performance compared to the previous quarter following months of slowing activity.

However, whether the latest survey findings signal a resurgence of growth and investment or a one-time blip in the data remains to be seen. Due to this, the latest forecasts remain cautious in their predictions and expect manufacturing output may still decline overall this year relative to 2022.

Consumer Demand

According to the Consumer Outlook 2023 survey by Nielsen IQ, the global state of consumers in 2023 is unsettled. Unsure about the future and bracing for extremes, consumers are in a constant state of scepticism. And with the looming prospect of further disruption down the road, consumers remain cautious with all forms of spending, signalling a year of safeguarding, action-planning, and hopeful strategizing around socio-economic hurdles.

According to the survey, 39% of consumers self-identify as “cautious” spenders, or those who have not been impacted financially by recent events but remain cautious with spending. Nearly two in five global consumers feel they are in a worse financial position this year. And of those consumers, 74% say that increased costs of living are to blame for their recent financial struggles. Up to 62% of surveyed global consumers already feel like they’re living in a recession, with 48% of these consumers expecting this economic downturn to last for 12 months or more. This will have dramatic implications to the way in which wallet spending is allocated — with prevailing cautiousness looming heavily over the hotspot areas of recessionary intentions across the world.

In fact, consumers plan to spend less on most discretionary spending categories, where out-of-home dining (44%), out-of-home entertainment (41%) and clothing (40%) are leading the list of where consumers plan to trim their wallet allocation.

Instead, consumers will shift that spending towards maintaining contributions to future-focused mainstays like financial services (47%) and paying off debt (41%), while also increasing their spending on grocery and household items (36%) and contributing more to education for themselves or their families (29%).

Inflation is Declining but Remains Elevated

According to IMF’s latest World Economic Outlook, Update, global headline inflation has been declining since mid-2022 at a three-month seasonally adjusted annualized rate. A fall in fuel and energy commodity prices, particularly for the United States, euro area, and Latin America, has contributed to this decline. To dampen demand and reduce underlying (core) inflation, the lion’s share of central banks around the world have been raising interest rates since 2021, both at a faster pace and in a more synchronous manner than in the previous global monetary tightening episode just before the global financial crisis. This more restrictive monetary policy has started to

Aerospace Market

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show up in a slowdown in new home construction in many countries. Inflation excluding volatile food and energy prices has been declining at a three-month rate—although at a slower pace than headline inflation—in most (though not all) major economies since mid-2022.

Even so, both headline and core inflation rates remain at about double their pre-2021 levels on average and far above target among almost all inflation-targeting countries. Moreover, differences across economies reflect their varying exposure to underlying shocks. For example, headline inflation is running at nearly 7 percent (year over year) in the euro area—with some member states seeing rates near 15 percent—and above 10 percent in the United Kingdom, leaving household budgets stretched.

UK Economic Forecast

The British economy will avoid falling into recession this year, according to upgraded growth forecasts from the IMF. In its latest assessment of the U.K. economy, the IMF said domestic demand had proven more resilient than anticipated in the face of the surge in energy costs.

The IMF said UK GDP now looks set to grow by 0.4% in 2023 rather than contracting by 0.3% as it had predicted in April. The earlier forecast was the weakest for any major economy this year, but the new growth projection would see Britain edge ahead of some rich world peers including Germany.

The IMF said Britain's improved outlook reflected the unexpected resilience of demand, helped in part by faster than usual pay growth, higher government spending and improved business confidence. The fall in energy costs after sharp rises last year and the normalisation of global supply chains also helped, it said.

Despite the more upbeat assessment, the IMF also said inflation is likely to remain stubbornly high over the coming years and only return to the Bank of England’s target of 2% in mid-2025, six months longer than it predicted earlier this year.

Global Economic Forecast

According to the IMF’s latest World Economic Outlook update, the baseline forecast is for global output growth, estimated at 3.4 percent in 2022, to fall to 2.8 percent in 2023, 0.1 percentage point lower than predicted in the January 2023 World Economic Outlook update, before rising to 3.0 percent in 2024. This forecast for the coming years is well below what was expected before the onset of the adverse shocks since early 2022.

Compared with the January 2022 World Economic Outlook forecast, global growth in 2023 is 1.0 percentage point lower, and this growth gap is expected to close only. gradually in the coming two years. The baseline prognosis is also weak by historical standards. During the two pre-pandemic decades (2000–09 and 2010–19), world growth averaged 3.9 and 3.7 percent a year, respectively.

For advanced economies, growth is projected to decline by half in 2023 to 1.3 percent, before rising to 1.4 percent in 2024. Although the forecast for 2023 is modestly higher (by 0.1 percentage point) than in the January 2023 World Economic Outlook update, it is well below the 2.6 percent forecast of January 2022. About 90 percent of advanced economies are projected to see a decline in growth in 2023. With the sharp slowdown, advanced economies are expected to see higher unemployment: a rise of 0.5 percentage point on average from 2022 to 2024.

For emerging market and developing economies, economic prospects are on average stronger than for advanced economies, but these prospects vary more widely across regions. On average, growth is expected to be 3.9 percent in 2023 and to rise to 4.2 percent in 2024. The forecast for 2023 is modestly lower (by 0.1 percentage point) than in the January 2023 World Economic Outlook update and significantly below the 4.7 percent forecast of January 2022.

Aerospace Market

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Risks to the outlook are heavily skewed to the downside, with the chances of a hard landing having risen sharply. Financial sector stress could amplify, and contagion could take hold, weakening the real economy through a sharp deterioration in financing conditions and compelling central banks to reconsider their policy paths. Pockets of sovereign debt distress could, in the context of higher borrowing costs and lower growth, spread and become more systemic. The war in Ukraine could intensify and lead to more food and energy price spikes, pushing inflation up. Core inflation could turn out more persistent than anticipated, requiring even more monetary tightening to tame.

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