M&D Watch
Aerospace
Cleared for Takeoff
2015 - Issue IV

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As we approach the holiday season, organizations in the aerospace industry have much to celebrate. An expanding middle class and emerging global infrastructure have powered commercial aircraft orders to record levels. In response, aircraft manufacturers have been trading production increase announcements over the past few years:

- October 2013: Boeing announces plans to increase production of its 737 aircraft from 42 per month to 47 per month in 2017.
- February 2014: Airbus announces plans to increase production of its A320 aircraft from 42 per month to 46 per month in 2016.
- October 2014: Boeing announces plans to increase production of its 737 aircraft to 52 aircraft per month in 2018.
- October 2015: Airbus announces plans to increase production of its A320 aircraft to 60 aircraft per month in 2019.

Both manufacturers have at least seven years of backlog according to their websites – giving suppliers a tremendous opportunity to succeed in the intermediate future. The most important question is how can suppliers keep pace with this tremendous demand while increasing quality and decreasing cost?

<u>Geographic Expansion</u>

Manufacturing facilities for Boeing and Airbus are based in only a few countries: the United States (both), France (Airbus), Germany (Airbus) and China (Airbus now, Boeing in the future). Suppliers located near these plants have a competitive advantage in terms of lower transportation costs and more opportunities for inter-company collaboration. However, labor costs in the United States and France, where a majority of the manufacturing occurs, are some of the highest in the world. So how can suppliers minimize their transportation and labor cost at the same time?

Bienvenidos and Bienvenue to Mexico and Morocco

Foreign direct investment in these two countries has significantly increased over the past few years as suppliers look to reduce both transportation and labor costs, while maintaining a close link to Boeing and Airbus. The questionable skill level of the labor in these countries is being solved with continued reinvestment in their aerospace infrastructure. The greater manufacturing income has also allowed both countries to invest in education, so as to better leverage their current economic gains into sustained, long-term progress. Morocco, for example, has created the Trades Institute of Aeronautics and Mexico the Aerospace University of Queretaro.

Despite the ability to decrease costs without compromising quality, suppliers outsourcing to Morocco and Mexico must still be aware of the differing social dynamic and the foreign currency exchange rate risk. It is important that outsourcing organizations get help from local firms who understand the local customs and culture and can identify the proper organizational structure so as to maximize cost savings.

Industry Consolidation

The M&A activity in the aerospace industry is as strong as ever. In order to manage huge backlogs and production increases, suppliers must find ways to increase their own production while cutting costs to remain competitive. One of the best ways to do this is to align with a competitor or adjacent organization to help achieve superior economies of scale. Additionally, consolidation allows enhanced collaboration and innovation between two entities who may previously have been competitors, increasing synergy.

One of the main risks of industry consolidation in such a transparent market is overpayment. The current robust sales and production levels make any supplier to Boeing and Airbus a palatable choice for acquisition, but the price must be right. Private equity firms have shown the willingness to pay a higher premium than in the past. Similarly, strategic organizations could substantiate a higher multiple due to prospective synergies. Financial advisory services are imperative as suppliers look to link with other organizations in order to determine the best price for a transaction.

Technological Innovations

The aerospace industry is currently focusing on producing the most energy efficient aircraft possible. These have a high impact on commercial airlines' cost structure because fuel costs comprise one third of operating expenses. Most aircraft are now being built to the highest energy efficiency standards, meaning suppliers must meet related demands to compete. Carbon fiber fuselages, geared turbofan engines, and blended winglets are just some of the technologies that help increase the fuel efficiency of an aircraft.

But how can a supplier that is trying to reduce costs to compete in the short term rationalize an increase in research and development expenses?

Other than understanding that incurring these costs now will help drive business in the future, suppliers can utilize tax credits to help reduce tax expenditures in the short term. Research and development tax credits are ubiquitous throughout the world. Many countries utilize them as a way to incentivize organizations to develop new technologies within the country, giving that nation a competitive advantage. Understanding the precise amount to be saved from these tax credits is extremely important when evaluating a prospective business plan.

Geographic expansion, strategic M&A activity, and technological innovation are all necessary elements keeping pace with production increases while enhancing quality and lowering costs. Considering all three areas will help suppliers work through the intermediate future of the commercial aircraft boom.

WeiserMazars in the USA, along with its global Mazars connections in France, Germany, the United Kingdom, Mexico, Morocco, and elsewhere, can be your trusted advisor as you look to navigate the turbulence that may flare up due to a significant production increase. Our experience in audit, assurance, advisory and tax can help resolve questions on multiple continents with one coordinated team.

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