

Restructuring in the aviation sector:

What does the future hold?

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Synopsis

The aviation industry in the UK is both highly valuable and highly fragmented. Civil aviation alone has a total turnover of £34 billion, with defence adding a further £24 billion. These two sectors directly employ around 250,000 people, and a large proportion of the workforce is employed by SMEs, including parts manufacturers, engineers and those providing overhaul and maintenance services.

The sector is no stranger to challenges, but the pandemic is unlike any event experienced before. The sheer speed of the cessation of around 80 per cent of global civil air travel at the start of the pandemic has tested all businesses in the industry, regardless of size.

Here, we explore the specific challenges the industry is facing, and immediate and long-term priorities for businesses operating in the space.



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What is the current state of play?

For civil aviation, these are turbulent times. Recent events have hit the sector hard, with border closures and travel restrictions forcing leading manufacturers like Rolls-Royce and Boeing to suspend operations, close production sites and cut thousands of jobs worldwide.

Major cutbacks and demands for price reductions from the big players have had wider ramifications for the supply chain, such as *Rolls-Royce demanding price reductions of between five and 15 per cent from 700 global suppliers in May 2020. Manufacturers, engineers and suppliers of all sizes, already operating on low margins, have faced significant challenges in recent months. Companies are operating in crisis mode and we have started to see cost cutting and cash preservation measures, including deferral of capital expenditure projects, deferred maintenance and, unfortunately, a series of redundancy programmes across the industry.

The financial strength and liquidity of many businesses will be severely tested across the supply chain with the fall-off in orderbooks for new aircraft and the reduced engine-hours of existing aircraft. Companies are depleting existing stocks and suspending projects in progress, while many employees have been furloughed. Additionally, the significant over-supply in the marketplace is driving many order cancellations or order delays, frequently in excess of a year.

Businesses are already putting measures in place to address the issues they're facing; be that looking at headcount or deferring capital expenditure but, for some, the main concern will be about their ability to win replacement work for next year and further ahead.

How has the COVID-19 pandemic impacted the sector?

The COVID-19 pandemic has had an unprecedented impact on the aviation industry. Whilst civil aviation has seen a partial recovery in demand from its initial post-COVID low point it remains at only 50-60 per cent of pre-COVID demand, and the expectation is that the

recovery will be prolonged, with analysts predicting it will take until at least 2024 before the industry rebounds to pre-COVID levels.

But it's not all doom and gloom. The defence sector has so far not been affected in the same way as civil aviation, with the government continuing to invest in defence procurement programmes, albeit there have been calls from the industry for these plans to be accelerated. Added to this, the freight sector has seen growth during the pandemic, partially due to the fact that passenger flights would have normally carried a proportion of global freight business and the luxury private jet market is seeing growth both in demand for new aircraft and charter of private jets.

How are these challenges affecting the wider industry?

The speed and size of the contraction in civil aviation has sent shockwaves through the supply chain, with large manufacturers unable to cushion the lower tier suppliers, due to their own liquidity pressures. In recent months, we've seen cost savings, redundancies and strengthening of balance sheets at global businesses including Airbus, Boeing, Rolls-Royce and Safran among many others.

This sudden drop-off in requirements, coupled with the inevitable post-Brexit changes to the UK's global trading relationships, will inevitably impact the entire sector. The aviation industry is heavily regulated and inherently risk-averse. Requisite industry and customer accreditations take time and significant investment to achieve. Therefore any changes in the supply chain, no matter how small, are generally undesirable.

Plans are afoot to introduce rapid result testing at airports. However, until this is in place, ongoing uncertainty of where people can travel to and from without having to quarantine, will continue to keep demand low for an extended period of time. The combined impact of these factors may lead to a future characterised by Darwinian theory, particularly as government support measures fall away.

Notes

* Financial Times, Rolls-Royce increases price-cuts pressure on suppliers <<https://www.ft.com/content/cdb0aa8c-3476-4871-b9c9-a8907c6f592e>>, 25 May 2020.

How could changes in the restructuring industry impact the sector?

There have been a number of recent developments in the UK restructuring and insolvency industry, partly as a response to COVID-19. Insolvency reforms in the Corporate Insolvency and Governance Bill 2020 have provided new tools – in particular a Restructuring Plan – which provides far greater scope than previous restructuring tools to compromise, liabilities and shareholders. This could mean that restructurings cut debt 'deeper' and/or tackle a wider range of stakeholders and, possibly, ownership structures. Lenders will have a close eye on debt levels and will want to see a sustainable capital structure.

Additionally, we have seen the use of 'light touch' administrations, where administrators delegate certain responsibilities back to directors in order to achieve a more collaborative, effective and lower cost insolvency process.

How do you think this will impact the future of the industry?

With the economic impact of the pandemic on the aviation industry, there may be further sector consolidation in a drive for scale. Supply chain consolidation has been happening for some time, as customers push for lead time reductions and cost savings. This activity will likely gather pace, as acquisitive companies take advantage of underperforming companies at discounted valuations. This in turn will allow them to increase their capabilities, customer base and technologies, meaning they emerge much stronger, more diversified and valuable as growth returns.

What does the future hold for businesses in the aviation industry?

We expect further distress in the aviation sector into 2021. The market challenges facing many smaller and financially weaker companies in the supply chain means that they will face existential challenges over the next 12 months, with pressures mounting as the current backlog of work runs out.

It is important that companies map out potential risks and put in place robust contingency plans. Having the courage and vision to explore options to streamline a business if appropriate is critical. Businesses should focus on conserving cash, find ways to reduce costs and be competitive on price.

The ability to challenge and re-examine every aspect of the business is paramount, and it's worth noting a simple reduction approach may not always be best.

A man in a blue flight suit and red headphones is working on an aircraft engine. He is looking down at a tablet device. The background is a blurred view of an aircraft hangar.

34

The total turnover of civil aviation is £34bn

40-50

Percentage that civil aviation demand has dropped

2024

The year analysts predict the aviation industry will rebound



Restructuring in the aviation industry

The ability to identify risks, scenario plan and maximise the runway for change, through cash management, is a key starting point. This is what all management teams are focused on, and they should continue to keep a close eye on operations.

As demand in civil aviation slowly bounces back, businesses that were operating at the cutting-edge of aerospace, dealing in the latest materials and technologies before the pandemic hit, should then expect to see a gradual resurgence in demand.

Conclusion

While we expect deeper aviation restructurings and an inevitably higher level of insolvencies in this cycle, there are a number of options for businesses to consider.

Management teams in this sector are aware of these issues and many have been working hard to address them. What they need is continued support in contingency planning in order to help them ride out the months ahead.

The aviation industry has always been a truly global industry, with various parts of aircraft being designed, tested, and manufactured worldwide. Careful thought and strategic planning carried out now will provide the best chance, not only of its survival, but also future strength and growth opportunities.

FRP have undertaken a number of assignments in the sector both pre and post-COVID helping clients assess options, and have lead successful negotiations with global customers such as Rolls-Royce and Safran. For businesses currently facing challenges, our team work closely with sector specialist interim and turnaround experts to ensure we deliver both operational and financial turnaround solutions. Options might include Company Voluntary Arrangements (CVAs) which can offer a route to rehabilitate companies while optimising value and outcomes for stakeholders. FRP have also advised businesses in the sector seeking acquisition opportunities.

→ Restructuring advisory

→ Corporate restructuring

→ Corporate advisory

→ Contentious insolvency

→ Solvent restructuring



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