Suppliers of Aircraft Manufacturers Shooting for the Stars: Safran to acquire Zodiac Aerospace for €9.7bn

Safran S.A. (EPA: SAF) - market cap as of 03/03/2017: €28.61bn
Zodiac Aerospace S.A. (EPA: ZC) - market cap as of 03/03/2017: €8.03bn

Introduction

On January 19, 2017, the French multinational plane engine manufacturer Safran announced that it had entered into an agreement to acquire the aircraft seat supplier Zodiac Aerospace in a transaction valued at €9.7bn.
The deal will give rise to the third largest global aerospace supplier, following General Electric and Pratt & Whitney. The French Prime Minister Francois Hollande described the transaction as a "beautiful industrial operation" and is optimistic about future growth.

About Safran S.A.

Safran was initially established through a merger between SNECMA and SAGEM in 2005. Today, the company is headquartered in Paris and operates in three core market segments: aerospace, defence and security.
Safran places great emphasis on innovation and indeed invested €1.7bn in R&D in 2016. Through a joint venture with GE, the firm developed the LEAP (Leading Edge Aviation Propulsion) Engine, which reduces fuel consumption and CO2 emission levels by 15%. Other products include biometrics and explosive detection systems, as well as X-ray diffraction technologies. In FY2016, the firm announced revenues of €15.78bn, which represents a substantial increase compared to €15.53bn of the previous year. The company's operating income also increased, growing 5.3% from €2.28bn in 2015 to €2.40bn in 2016.

About Zodiac Aerospace

Zodiac Aerospace was founded in 1896 and supplies interior furnishing and control systems for aircrafts and helicopters. The firm operates in 100 sites and employs more than 35,000 individuals across the globe.
In 2011, the firm formed the IAEG (International Aerospace Environmental Group), which aims to reduce greenhouse gas emissions and to limit the irresponsible disposal of diverse chemical products. Furthermore, Zodiac Aerospace recently engaged in cost cuttings to limit labour inefficiencies.
In FY2016, Zodiac Aerospace reported total revenues of €5.21bn, a 5.1% increase compared to the €4.95bn figure in the previous year. Net income, however, has decreased from €185m in 2015 to €108m in 2016 (mainly due to impairment charges).

Industry Overview

The aircraft manufacturing industry is dominated by two key players, Boeing and Airbus. Their demand is closely tied to the health of the airlines sector and, in turn, the financial position of the plane makers affects their suppliers: Safran and Zodiac Aerospace are two of them.

Both deliveries and new orders of aircrafts are crucial to the financial success of plane manufacturers and their suppliers. As a matter of fact, while the largest chunk of the payments from airlines and lessors comes at delivery, new orders brings with them pre-delivery cash transfers which are crucial for the aircraft manufacturers to sustain current operations.

For the aerospace industry, 2015 was an outstanding year: low oil prices saved the industry billions of dollars and key metrics such as capacity and Revenue Passenger Kilometers (RPK) were up by 6.7% and 7.4% respectively.

Therefore, it was of course a good year for airplane manufacturers too: 1,400 jets were delivered and 2,400 were ordered in 2015.

However, in 2016 an unexpected slowdown occurred and the industry has not yet recovered from it. Boeing reported net income of $4.9bn in FY2016, down 5% with respect to the previous year and revenues are expected to decline even more in 2017. Part of the slowdown in production is attributable to the fact that manufacturers are transitioning to new aircraft models, which should support growth in the future. In addition to that, other factors causing such a slowdown can be traced back into the surplus in second-hand aircrafts delaying airlines' needs to upgrade their fleet and all the economic and geopolitical issues which have caused plane tickets bookings to dry up.

Overall, despite the slowdown in growth that airlines are experiencing (and the consequent decrease in orders), plane deliveries are keeping Boeing and Airbus in a relatively good shape. Aircraft manufacturers and their suppliers are indeed accelerating production in order to meet record backlogs and to deliver the already ordered planes.

Figure 3: History and forecast for large commercial aircraft orders and production (1981 to 2020F)

Source: Deloitte analysis of the following data: The Boeing Company, "Order and deliveries," accessed in November, 2016 http://active.boeing.com/commercial/orders/index.cfm; Airbus Group, "Orders and deliveries," accessed in November, 2016, http://www.airbus.com/company/market/orders-deliveries/; UBS, US Aerospace and Defense Playbook, 14 October 2016; and Credit Suisse, Global Aerospace and Defense, 27 May 2016.

Moreover, long-run forecasts look positive: over the next 20 years, Boeing estimates a need for over 39,600 airplanes for a total value of $5.9T. Single-aisle airplanes, which are going to represent c. 71% of those future deliveries, are expected to drive growth for low cost carriers and thus provide replacement for older, less efficient aircrafts.

Deal Structure

The €9.7bn-EV transaction comprises two different phases. Initially, Safran will launch a cash tender offer on all Zodiac's outstanding shares priced at €29.47/share, valuing the target's equity at c. €8.17bn - a 26.4% premium on its closing price on the day before the announcement. If at least 50% of Zodiac's shares are tendered, the tender offer will be considered successful and Safran and Zodiac Aerospace will merge by means of a stock swap: for each of their shares, Zodiac's shareholders will indeed get 0.485 Safran shares.

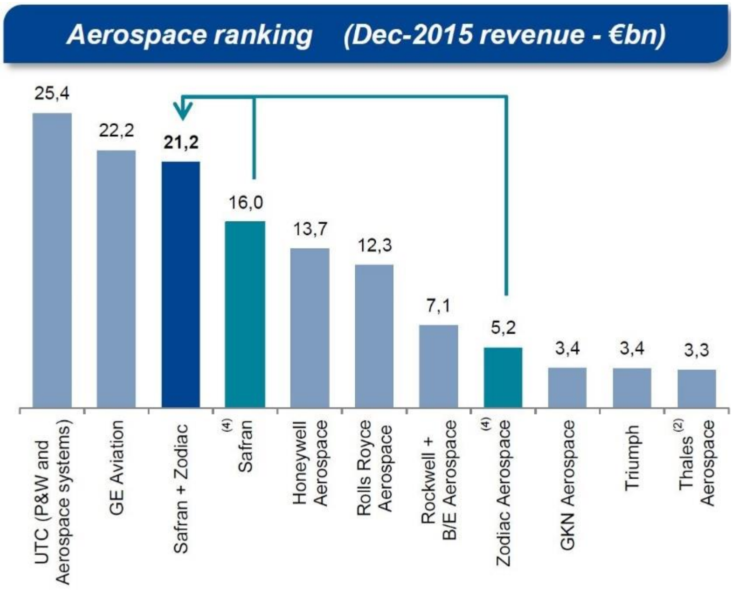
Furthermore, conditional on the success of the tender offer and on the respective shareholders' approval of the tie-up, Safran would distribute €2.3bn to its shareholders in the form of a €5.5/share special dividend.

Zodiac's largest shareholders, who approximately hold a 22% stake in the company, have decided not to tender their shares. However, they will give them up for Safran's shares during the merger phase, signalling the intention to share in the potential upside of the merged entity.

The deal will be financed with a mix of cash on hand and a €4bn underwritten bridge loan.

Deal Rationale

The merger will create the third largest player in the aerospace industry worldwide with c. €21.2bn in adjusted LTM pro-forma revenues. The complementarity of the two companies' core businesses – engine production and aircraft interiors production for Safran and Zodiac Aerospace respectively – will let the merged entity achieve significant synergies. Firstly, the significant economies of scope generated will let the firm offer a broader set of products to key clients. At the same time, this move will alleviate concerns brought up by Airbus on Zodiac's ability to deliver in time all the necessary items for the aircraft maker's new A350 wide-body plane. Moreover, the deal will generate an estimated €200m in annual pre-tax cost synergies, fully realized by the third year after the merger.



The acquisition of Zodiac Aerospace will also give a meaningful contribution to Safran's technology portfolio. In the words of Safran CEO Philippe Petitcolin, "the technological complementarities will ensure that [Safran] accelerate[s] domains as strategic as critical systems and the more electrical aircraft, which make up 40% of Zodiac Aerospace's activities".

Finally, the deal has been welcomed by the French government as a "beautiful industrial operation". This hints at a subtle political rational, whereby the deal is a way for the two parties to remain independent from foreign competitors. If the merger hadn't occurred, non-French players in the aerospace industry might have tried to increase their market share by bidding for one of the companies.

Market Reaction

On the date of the announcement, Safran's stock price fell by 5.4% from €67.27. It has since then increased by 7.8%, surpassing pre-deal levels. Zodiac shares, on the other hand, jumped by 22.9% on January 19, 2017 reaching €28.65, and have been trading at similar prices since then.

Advisors

Safran was advised by Bank of America Merrill Lynch and Lazard, whereas BNP Paribas and Rothschild advised Zodiac Aerospace. Furthermore, Bank of America Merrill Lynch provided financing by acting as bridge underwriter.