BOEING USES ITS CLOUT TO CONTROL SUPPLIER CONSOLIDATION

News / Manufacturer

Berkshire Hathaway Inc's $37 billion deal for aerospace supplier Precision Castparts Corp is encouraging investors to consolidate the fragmented aircraft components industry, even as Boeing Co uses its clout as the world's biggest plane maker to put a check on some deals.

Berkshire chief Warren Buffett isn't alone in seeing potential for profits from rising demand for commercial aircraft. Private equity and strategic buyers have been pouring into the sector, and foreign companies such as China's AVIC and Senior PLC of the UK have recently been prowling for deals, bankers and company executives said.

Potentially standing in their way, though, is Boeing, these people said. Boeing is the biggest customer of most aerospace suppliers, and is slowing some acquisitions by using its power to

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approve the transfer of its supply contracts from one owner to another.

Boeing can act like as an unofficial regulator on aerospace mergers and acquisitions because of the "assignability clause" inserted in most of its contracts with suppliers. The clause allows Boeing to refuse to transfer the contracts to the new owners, giving it a de facto veto over deals.

Boeing said it hasn't changed the process it uses to scrutinize mergers and acquisitions among suppliers, and that the time taken depends on the size and complexity of the deal. Chief Executive Dennis Muilenburg, who took over July 1, is continuing predecessor Jim McNerney's policy of "de-risking."

"We have an ability to have our voice heard in the M&A process and we use that ability," said Kent Fisher, vice president and general manager of suppliers at Boeing Commercial Airplanes.

But bankers and company owners said approvals from Boeing that used to take a couple of weeks now take much longer, putting deals at risk, with no explanation from Boeing for the delay.

"Any time you have a pause in a transaction, it increases the risk that it won't get across the finish line," said Brian Murphy, a managing director at Meridian Capital, an investment bank based in Seattle.

For example, Boeing took four months to approve the purchase of a small supplier by Liberty Hall Capital Partners, a New York private equity firm focused on aerospace and defense.

LaCroix Industries, which has 45 employees and was founded in Kent, Washington, in 1977, has long supplied parts directly to Boeing for the 737, 777 and 787 jets. It earned awards from Boeing for near-perfect quality the last seven years, co-founder Philip LaCroix said.

The company began talks with Liberty Hall last September, and sought Boeing's blessing in April, he said. Boeing took until July to consent, and the deal closed that month.

MAJOR SLOWDOWN

"The approvals from Boeing were the major slowdown" and Boeing wouldn't say what was causing the delay, LaCroix said in an interview.

"That part of it was frustrating," he said. "You could lose a deal over something like that, where the acquirer says, 'Hey, I'm out of this.'"

Liberty Hall declined to comment. It plans to integrate LaCroix into its Irving, Texas-based Accurus Aerospace Corp subsidiary, which also supplies Boeing.

LaCroix had already agreed to give Boeing 15 percent price cuts on existing contracts, starting in 2016. The alternative was slow death by losing the right to bid on future work, LaCroix said.

"Staying in business with Boeing was much preferable," he said, "and still had plenty of profit for us."

Some bankers say they routinely exclude potential bidders for a company if they know those won't pass muster with Boeing, which looks at financial strength, track record and investment intentions of prospective buyers. Some also see the logic of talking with Boeing about meeting assignability

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requirements, and understand Boeing's need to minimize supply chain risk.

"Reviewing the companies that would acquire their suppliers is part of that," said Jet Wales, a managing director at Moss Adams Capital in Seattle.

MORE INVESTMENT, MORE RISK

North American aerospace and defense deals shot up 17 percent last year and their value nearly doubled to about $12 billion, Thomson Reuters data show. Private equity buyers are involved in an increasing number of transactions, according to data from PitchBook, a Seattle firm that tracks transactions, fueling competition for choice targets.

The big attraction: Boeing's eight-year backlog of commercial jet orders worth $431 billion. Investors see an assured revenue stream and have bid up the prices of supplier companies to lofty levels.

Ownership changes can increase risk, however. A stumble by a key supplier can disrupt Boeing's carefully orchestrated factories and run up hefty costs.

When Zodiac Aerospace of France failed to deliver premium seats earlier this year, it delayed delivery of 787s to American Airlines and hit Boeing with what analysts said were several hundred million dollars in added costs. Boeing said those estimates are overstated.

Many experts expect Buffett's aerospace purchase will spur even more consolidation, and likely will prompt Boeing to look even more closely at deals that affect its suppliers.

Precision Castparts, a 60-year-old firm based in Portland, Oregon, locked up key aerospace products and production capabilities by doing its own strategic acquisitions. It is now an integral supplier of parts for commercial and military aircraft and engines.

"Boeing woke up to the fact after the fact," said Christian Schiller, a managing director at Cascadia Capital investment bank in Seattle, referring to Precision's success in achieving vertical integration. "They couldn't undo it, so they're making sure they can exert more control over the M&A process to make sure a PCC doesn't happen again."

He and other bankers said Boeing has a legitimate need to protect its interests and avoid the rise of another powerful supplier.

"But Boeing should make it easier for the smaller deals to go forward," Schiller said. "There's no need to take really hard looks at $10 million to $100 million deals."

Boeing subjects even small deals to detailed scrutiny, such as the 2013 purchase by Kidd & Co and Centerfield Capital Partners of Imaginetics Inc, then a 120-person precision machining shop in Auburn, Washington, a top supplier to Boeing. Approval took more than a month, said a source familiar with the deal. Imaginetics declined to comment.

"Boeing has turned up the heat on who is the buyer and is taking longer to decide that a deal is OK," said Michael Black, a principal at Zachary Scott, an investment bank in Seattle.

"They've got a pretty tough filter and it's gotten tougher and I don't see that changing."

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