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COMMENTARY

Success Hard To Tell From Panic

European aerospace suppliers face huge risks despite booming order books

With a combined backlog of more than 10,000 commercial aircraft worth close to $1 trillion, Boeing and Airbus have never been in stronger positions, in particular when it comes to negotiating with their suppliers. They can pretty much promise them 10 years of recurring orders on such programs as the Boeing 737 and 787 or Airbus A320 and A350. In exchange, the airframers expect significant investments, cost reductions, improved quality and close to 100% on-time delivery. Only the largest suppliers have the ability to push back and manage their businesses on their own terms, if only to some extent. For the rest, it is more like "take it or leave it." In Europe in particular, the weight of Airbus in the aerospace sector is such that its loss as a customer is simply not an option.

AIRBUS

This predominance is clearly a two-edged sword for Airbus. On one hand, it gives the company incredible leverage on its suppliers, as it can make or break almost any of them. No consolidation operation in the European supply chain today can happen without the blessing of Airbus, be it directly by acting as a "broker" of a deal or indirectly by bringing in some "friendly" investors, such as ACE Management, an investment firm that is majority funded by the Airbus Group and has been involved in most merger and acquisition deals in the French aerospace supply chain for the last few years.

But the downside of such dominance is that Airbus has no choice but to take responsibility for every one of its suppliers, however small. For historical reasons, OEMs like Airbus have been relying on very small companies as single sources for some key parts and sub-assemblies. When such small players are asked at the same time to invest in new capabilities and share the risks for a brand-new program like the A350, increase their production rates by up to 25% for the ongoing and booming A320 family, and take their businesses global to diversify their supplier and customer bases, they become overstretched both financially and operationally. Such companies can spin out of control quickly—and run out of cash—forcing Airbus to intervene in firefighting mode, even if it is only a $10 million company producing one small part for a single program.

Ideally, this job of managing the supply chain should be performed by the Tier 1 suppliers, but they are too vulnerable themselves to do it. Latecoere, for example, was identified six years ago as a potential consolidation platform in the European aerostructure sector. Airbus even considered selling the company two of its flagship factories that would have transformed it into a world leader, in particular with a major breakthrough role on the A350 (see photo).

But then Latecoere overstretched itself and became so undercapitalized that it almost went bankrupt in 2010. Even today, its debt-to-capital ratio is 180% and the company has a huge €300 million debt that comes due next year. Nobody knows how the company will manage it.

So beyond the glamorous and unprecedented backlogs of Airbus and the likes, the business reality down the supply chain actually displays a very different picture: too much fragmentation, too much debt, antiquated governance models, lack of international presence as well as undercapitalization, to list a few. In a nutshell, too many weaknesses are embedded in the system that are not being addressed properly. This is simply because, as orders keep pouring in, OEMs have just one obsession: to keep the system running, faster and faster, like a steam engine being fueled with more coal than it can consume and therefore overheats dangerously.

Yet, in the middle of all this, some suppliers are riding high. Figeac Aero for example, a French aircraft parts company with €140 million in annual sales, is growing at 20% per year and generating a 20% EBITDA (earnings before interest, taxes, depreciation and amortization) margin, recently raised €15 million when it was listed on the Paris stock exchange. A few weeks later, the company was valued at close to €350 million and its founder and CEO became an instant star in the French aerospace community. Never mind that the company's debt-to-capital ratio is 180% and that the founder still owns 94% of the company, therefore making the market cap rather meaningless. The story is appealing enough to make all other owner-CEOs in the sector believe they are sitting on piles of gold—and their bankers are more than happy to tell them just that.

Rather than a pile of gold, it looks more like a minefield to me. As the painter Edgar Degas once said, "There is a kind of success that is indistinguishable from panic." That seems to describe quite well what is happening in the European aerospace supply chain right now.