



SUPPLIER CONFIDENCE REACHES NEW LOW

AUDIO TRANSCRIPT

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Aviation Week Check 6 podcast with Accenture on December 10, 2021

Michael: Welcome to Aviation Week's Check 6 podcast with Accenture. I'm Michael Bruno, senior business editor at Aviation Week.

2022 can't come fast enough for the commercial aerospace industry. With widespread hopes of being the most normal year since 2018 – normal being quote-unquote – industry leaders are voicing hope for the future while keeping clear-eyed about the challenges ahead.

At the end of 2021, the situation is mixed. Commercial passenger traffic is still down from 2019 levels and varies greatly depending on the region of the world. Domestic travel has largely returned in some countries, while overall international travel remains low. IATA forecasts a net loss of \$52 billion for global airlines this year, and another \$12 billion in 2022. Omicron is the newest coronavirus variant of concern, and travel restrictions on travelers from southern Africa are being reintroduced in the U.S., Europe and Asia. Meanwhile, publicly traded global A&D stocks are up 7% year-to-date, but down 13% relative to benchmarks like the S&P 500.

As if Covid-19 was not enough to deal with, the whole aerospace and defense sector is embracing a new sense of urgency when it comes to environmental, social and governance concerns, or ESG. Chief among them is the new industry pledge to become a so-called net-zero emitting business by 2050,

a mere three decades away. While that may seem like plenty of time, in the aerospace world it's equivalent to a single generational change of new airliners. That means to get the goal, hard work must be put in now. So where does all of that all leave commercial aerospace, and what are executives thinking heading into the new year? The latest Accenture Commercial Aerospace Insight Report offers details thanks to an exclusive survey of industry leaders. The polling was completed in September, before the Omicron variant emerged, but it still reflects the best expectations that industry leaders have as they finalized their 2022 business plans. Joining me to talk about the results of the survey are two veterans of the Check 6 podcast, John Schmidt, Accenture's global A&D lead, and Jeff Wheless, global A&D research leader.

John, Jeff, welcome back!

John: Thanks Michael! It's good to be with you.

Jeff: Thanks Michael. Great to be here again.

Michael: John, tough year, and better only in comparison to 2020. Commercial aerospace has proven itself resilient once again, but to be honest, the recovery has not been as fast as most of us hoped at the start of 2021. Airlines as a whole are making it through, but that is thanks to \$240 billion or so in government aid. What did Accenture's

survey tell you about when industry leaders expect a full recovery now?

John: Michael, our results from surveying the c-suite of the commercial industry indicate 24-36 months to globally recover to 2019 levels. Having said that, in the near term, Boeing and Airbus have combined deliveries through third quarter are a 51% increase YoY and we estimate 5% YoY growth for global aerospace in 2021 with 13% YoY growth for 2022. According to IATA, the Airline industry is forecast to support this uplift as well, with global RPKs up 18% this year and a predicted 51% increase in 2022.

Michael: You know that's kind of amazing to think about for a moment. A 51% increase in RPKs that would be great any other year but considering where we are coming from everybody would like a little bit more than that.

Jeff, one of the unique aspects of Accenture's survey that I always look forward to reading about is the "up at night" question – as in what keeps respondents up at night. So, hearing about potential recovery, what has Accenture heard about what's keeping people up at night now?

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Jeff: Well Michael, certainly the pandemic and economy is top of mind in the short-term and we're seeing that concern realized with Omicron driving the border tightening and stock market gyrations right now. That said, there is certainly a lessening of concern over geopolitical, economic risk and even about the pandemic in the longer term in 12-18 months. When we ask folks about their business cycle stance and production outlooks; the expected margin improvements in the short-term, we are

beginning to see those gains. If you look at Boeing and Airbus and their commercial operations, Airbus is even turning their margin positive again. Production volumes are anticipated to increase in the 12-month time horizon, which bodes well for all.

Michael: Not a horrible list of things keeping people up at night, but there's always something that does it.

John, Jeff was just talking about OEM-level outlook, maintaining for the next year. But the Accenture Commercial Aerospace Insight Report has some staggering results, in my opinion, when it comes to the supply chain. What did you find?

John: What we found was that 69% of executives reported moderate to severe supply chain disruption – I think we all knew there were challenges, but that is an extraordinarily high number. On top of that, only 45% were confident their supply chain could deliver on-time and on quality. We thought 65% level of confidence in the supply chain we saw 6 months ago was shocking. Over the years, we have typically seen this measure much more at 90% confidence. So, yes, staggering is a good description.

Michael: I want to go back to that and not brush by it too quickly. You've been taking the survey for several years all the way going back to pre-pandemic when there were supply chain issues there, but the confidence level was not as low as what was being reported in the latest Insight report. That's pretty amazing to me. The pandemic has really caught up, it seems, with the supply chain.

John: Yes. I think it has indeed and that's what the survey results show.

Michael: Boeing has talked about narrow body production rate increases being driven by supplier readiness more than anything else. Meanwhile, Airbus has said that supply chain management will be the most challenging aspect of its recovery over the next 12-18 months. Jeff, when it comes to suppliers, when do they finally meet or exceed expectations again, according to the report?

Jeff: Well, I think that's changed a bit from prior editions, we would see that well we're going to change in 6 months and we're right around the corner. We're seeing that lengthen now a little bit if we look at the majority saying it's going to take 12 months to meet and 18 months to exceed expectations. As you mentioned, it's an all-time low from a survey perspective, but we do see that turning a corner. Supply chain is such a critical element for lack of a humble bearing, engines can't ship, now planes are a lot smarter than they were 10 years ago, semiconductors are beginning to become unobtainium and it's not easy to change designs in aerospace, so it's a front and center issue for everyone.

Michael: Right, and I will just remind listeners that one of the facts of the aerospace industry is 2/3 of the spend of any given aircraft program is found actually in the supply chain. And it's the supply chain that winds up helping you make the aircraft in the end.

Michael: That gives us a lot to chew over there but that's not all we've got out of the latest Commercial Insight Report. There are factors beyond the aerospace industry's control that are affecting the recovery. We're going to get into those and discuss the broader sustainability pivot next, but first let's hear a word from our sponsor.

MIDROLL BREAK

Michael: We're back with John Schmidt and Jeff Wheless of Accenture, talking about the results of the latest Commercial Aerospace Insight Report. Jeff, before the break we were talking about the sobering supply chain outlook, but there is just so much that is not in the control of the A&D industry when it comes to business factors.

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Inflation it's the bugaboo these days I hear about at all of the conferences I go to. Accenture's survey illustrates a direct line into aerospace leaders' thinking when it comes to costs like labor and raw materials. What did you find?

Jeff: Well, we found that inflation and costs is not a matter of if, but when. So, in the short-term, over the next 12 months or so, 60% of folks were saying they expect raw material increases and subsystem and parts cost to increase, but labor was going to be fairly stable. Case in point on that is looking at aluminum. If you look at it versus this same time frame two years ago, it's 50% higher on the commodity market. Labor looks to follow, and we see expectations of payroll increases and that's also being reflected in general business press as well. That's something that aerospace will have to face and the challenge on that most of the industry is on cost take out, oriented long-term contracts, so these are difficult trends to digest commercially.

Michael: As you literally just mentioned, long-term agreements so the aerospace industry may not see some of the effects until far long after the consumer industries see them and that's going to play in it too I think making it that much more difficult.

Jeff: Exactly

Michael: John, on the passenger traffic side of industry, it has really been a tale of two cities – or actually more like four or five regions. In some real instances, airline customers are flying again at levels not far from where they were in 2019. But it differs depending on where you look around the world. What does the Accenture Commercial Aerospace Insight Report say when it comes to the outlook around the world?

John: Michael, it's very uneven, with growth accelerating in North America catching up to 2019 levels in 2022, but even more so in Asia Pacific where they are expected to exceed levels 2019 by over 4% this year and are on track for more growth next year. The growth story is not as strong in Europe where they will be 29% lower than 2019 levels this year. It's a challenging situation they have to dig out of there. And in the Middle East where I was just asked this question a lot while attending the Dubai Air Show, they're poised for a 2022 rebound. The region is dependent on international traffic as I'm sure you know with the FIFA World Cup in Qatar in 2022 and the Ongoing Expo 2020 in Dubai, we've got two key drivers for both airlines and corresponding (?) demand in the region.

Michael: That's really interesting to me because I hear from my friends here in America and family obviously about how they go to the airport and things look crowded again. It always takes me a few minutes to explain that internationally, it's a very different outlook when it comes to recovery and how it's going across the globe.

I want to turn to sustainability because the latest survey results illustrate both how significantly that issue has become the leading factor in business planning, but also how far the industry has to go. Jeff, industry seems more clear-eyed than it was a just a few years ago, based on the results in your survey from what I can tell. What are executives worried about now?

Jeff: Well, we saw sustainability as very much top of mind as we surveyed and increasingly so over the next 5 years. So certainly, from an industry perspective, executives are putting are focus on it. But a lot of it is behind the scenes and not visible to passengers which is a challenge for everyone. Executives certainly recognize the need to transform not just aircraft technologies that are on board, but how their products are designed, manufactured, and serviced. And all that folds into sustainable operations and sustainable products. Executives in the survey identified three key challenges that were standing in the way in terms of their transformation and that was the ability to certify new technologies and designs, and then going back to the challenge of supply chain we talked about earlier. We've got new components, new technologies, batteries, and different areas coming out and the ability of the supply chain to meet that demand. And as well as government policy objectives being very challenging in the shorter terms. That said, there were certainly some tailwinds that they mentioned, as well that were helping them. One was collaboration with new and different technology partners and then higher revenues fueling additional R&D investments. So those were the two tailwinds mentioned the most in terms of helping them achieve new objectives.

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Michael: John, I want to turn to you because Aviation Week had a couple of really interesting conversations with you a couple of years ago, I think, at the Paris Airshow. We were all there coming out of it and everybody was a bit shocked at how important environment and sustainability was becoming just at the airshow and fast forward now after the pandemic I'm struck at how dominant sustainability is the driving issue right now in aerospace across the board. This is literally getting driven into five-year business plans now.



John: Michael, it absolutely is. I was just at the AIA Board of Governors meeting and it was a big topic there. In the survey, 70% of executives see sustainability as a critical focus over the next 5 years and understand that it will need to be addressed at every stage of the supply chain. Already, 24% believe sustainability is ‘very important’ to their business and 58% of executives believe that environmentally sustainable products and services will be essential for delivering differentiated offerings to their customers. The takeaway: To transform into a sustainable operation, aerospace companies will need to embed sustainability into their overall strategy, those five-year business plans you’re talking about, and into every stage of the manufacturing and delivery of products and services from their internal operations to their supply chain partners. We’ve also have identified “evangelizing” progress as a key component of every company’s strategy. We simply need to do better at sharing the progress this industry is making.

Michael: There sounds like there is a lot of agreement on what the big issue is and sounds like there’s agreement that there is a whole lot of work to do. There is so much more to talk about. Sustainability in aviation could be a whole podcast by itself, but we’ve run out of time on this episode of Check 6 with Accenture. John, Jeff, thanks for joining me today and providing the first glimpse into the latest Accenture Commercial Aerospace Insight Report.

John: Thank you Michael. It’s a pleasure to be with you always.

Jeff: Thank you for having us Michael.

Michael: Join us at Aviation Week again soon for another edition of Check 6, which is available for download on iTunes, Google Play, Spotify and Stitcher. Have a great rest of your day.

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