Divest to invest: Portfolio shaping in aerospace and defense

Introduction

Aerospace and Defense (A&D) companies find themselves at a potentially risky yet rewarding crossroads, facing dual challenges of portfolio simplification and a strategic pivot toward advanced defense systems. How companies choose to address these imperatives can fundamentally transform their approach toward divestiture and portfolio management and fortify their commitment to better align with the industry's current and future priorities.

Many organizations have pursued growth through extensive mergers and acquisitions (M&A) in an active deal market over the last few years, embracing the conventional belief that adding to their portfolios and expanding their capabilities invariably bolstered shareholder value. Yet, an emerging perspective advocates for shifting away from this expansive approach to a more discerning and focused model that better aligns with strategic defense priorities and technological frontiers: consider the selective divestiture of non-core assets paired with targeted acquisitions to enhance long-term shareholder value and drive outperformance.

Holding onto disparate but nonessential segments tends to drive a diversification discount—limiting investment opportunities elsewhere and risking company undervaluation or overextension. KPMG LLP (KPMG) research shows that having financially disparate growth and margin businesses within a portfolio is linked to much higher diversification discounts. With many A&D companies prioritizing acquisitions of emerging technologies and domains, such as hypersonic, space, quantum, and artificial intelligence, this disparity will likely become more pronounced. Investing in these areas is crucial to align with current and future defense priorities, maintain technological leadership, and achieve a competitive advantage.

We advocate for a strategic shift driven by divesting noncore assets. By selectively shedding these assets, A&D companies can streamline operations, sharpen management focus, and unlock unique opportunities for growth and innovation. This approach helps enable leadership to concentrate efforts on areas with the greatest potential for technological advancement and market leadership, and represents a pivotal step in shifting core competencies to meet the new mission needs and participate in emerging high-growth opportunities.

The transformation of nonaligned assets into capital for reinvestment in strategic areas is exemplified by RTX's ongoing sale of its actuation and flight control programs out of its Collins Aerospace business unit to France's Safran for $1.8 billion. This deal refined RTX's focus and allowed it to invest in higher-growth areas more closely aligned with its strategic objectives, and helped position Safran as a fully integrated player with an end-to-end actuation and flight control product portfolio.[1] Similarly, the sale of Triumph Group Inc.'s Product Support Business—a provider of maintenance, repair, and operations services for structural components, engine and airframe accessories, interior refurbishment, and wheels and brakes—to AAR for $725 million[2] demonstrates the benefits of focusing on core businesses and expanding capabilities.

[1] "Safran to Acquire Collins Aerospace's Actuation and Flight Control Business," Safran, July 21, 2023

[2] "Triumph announces sale of Product Support business to AAR," Triumph, December 21, 2023

These examples underscore the value of strategic divestitures in creating shareholder value and positioning for future growth. Furthermore, in the long run, organizations that master the successful divestiture of noncore assets to the market are positioned for sustained stock market outperformance over time.

Strategic divestitures not only monetize nonaligned assets but also offer a unique pathway to create shareholder value and futureproof businesses. According to academic and KPMG research, diversified companies are on average worth 13 percent to 15 percent less than what their individual businesses would be worth if valued on a stand-alone basis.[3] Moreover, our research indicates that companies with segments demonstrating multiple disparate financial characteristics—differing significantly in capital intensity, growth rates, and profit margins—face a diversification discount that may surpass 30 percent.[4] We believe that limiting financial disparity (high- and low-growth businesses, high profit and low profit businesses, asset intensive and asset light businesses) is crucial to maximizing value.

Our research (see "Think Like an Activist") demonstrates that when companies announce divestitures, their market valuations tend to be higher 12 months after the transaction. Further, the market actually extracts a penalty for not selling as evidenced by successful activist investor campaigns that drive simplification and release value. Market data shows that companies on average create more value through divestitures than through acquisitions. A year after a transaction, shares in companies that divested businesses had 3.4 percent excess returns versus the overall market, compared with only 2.2 percent for companies that made acquisitions. The data rebuts the commonly held notion among top executives that acquisitions are the better route to higher valuation.[5]

Exhibit 1: Costly myths – CEOs still believe that acquisitions create more value than divestitures and that markets penalize companies that divest assets

Note(s): Compounded monthly returns after12 months, estimates based on research by E. Feldman; Average of manufacturing and services industry; In a CEO survey (n=50) conducted by KPMG with GLG, 72 percent of CEOs agree that acquisitions have created more value than divestitures over their careers and will do so in the future.
Source(s): Research by E. Feldman, based on KPMG analysis, KPMG CEO survey and CEO discussions.

[3] "Can your valuation be improved" KPMG, and analysis in conjunction with Emilie Feldman at Wharton Business School, 2021

[4] KPMG research, op cit

[5] Think Like an Activist, KPMG, 2020

A fresh review of noncore assets can lead to long-term outperformance

It's common for A&D companies to be composed of many components—some of which may be outside of the organization's core business strategy or are poorly aligned with evolving defense priorities. Given the changing market conditions, a careful review of these noncore assets is needed with an eye toward divestiture.

The assets under review should not be confined to poorly performing businesses or outdated technologies. Greater value can be found in better performing businesses that are no longer prioritized by defense agencies, businesses with strong outlooks that no longer represent the capabilities the organization wants to invest in, or even businesses that don't require significant capital investment but still take time, focus, and funding that could be redeployed elsewhere.

When reviewing, ask yourself whether your organization is the best owner for those assets—do you have the time, focus, and capital, and how does it fit with the rest of your priorities, goals, and capabilities? If the answer is no, it may be more valuable to sell those assets than to hold onto them. Note: One good way to test if you are the best owner is to reverse the thought process. If provided with the capital, is there a business combination that you believe would drive significant synergies? If so, now consider yourself the seller instead of the buyer—the deal logic should still hold.

The good news is that your noncore assets may be of great interest to another organization. Indeed, many of these recently divested businesses have significant market interest commanding high multiples. The A&D sector can be attractive to both strategic and financial buyers due to reliance on long-term government contracts and relative insulation from macroeconomic trends.

Divesting noncore assets that may no longer align with the organization's strategy or new market priorities offers a number of benefits:

- Divestiture puts dormant assets to work by reinvesting in the core business and incubating nascent technologies that are better aligned with defense priorities at a time when the cost of capital is high.
- It allows management to focus what is typically its scarcest resource—great leaders—on higher-growth assets, i.e., new technologies, as opposed to lower growth assets. In other words, money flows to the opportunities.
- Getting rid of nonessential businesses fosters efficiency, and allows the organization to focus on performance, not just topline growth.

Case study: L3Harris

L3Harris Technologies Inc., a defense contractor, technology company, and information-technology provider, was looking to implement the company's strategy of divesting non-core assets, a move that would return value to shareholders.

Working with KPMG, L3Harris successfully divested its consumer end-market weapons sight and sporting goods manufacturer. The EOTech division is the leading designer and manufacturer of mission-critical holographic weapon sights and magnified sporting optics and was L3Harris' only division with consumer end-markets. The division is the premier provider of battle-proven, electro-optical and applied optics solutions and the products are standard equipment in the special operations community and have a strong following among law-enforcement officers.

The execution team ran a targeted sale process that approached only the highest likelihood strategic and financial acquirers. The deal was signed at the height of the COVID-19 pandemic, highlighting the team's ability to leverage competitive tension to execute during high market volatility and uncertain times.

KPMG also assisted in the sale of two noncore L3Harris divisions of market-leading radio frequency (RF) applications solutions for space, electronic warfare, radar, medical, and industrial end markets.

The team packaged the assets as one combined entity that drove buyer interest in establishing a new RF defense technology platform. KPMG worked with L3Harris corporate and divisional leadership to create a combined project model and identify synergies between the two business units to present a cohesive business providing long-life, legacy RF solutions to a wide variety of end markets.

The combined entity received interest from both strategic and financial buyers looking to expand RF capabilities or establish a new RF defense technology platform for further consolidation. The separated company employed 800 workers across three facilities and resulted in a new Arlington Capital Portfolio company known as Stellant Systems.

Geopolitical pressures drive A&D portfolio reevaluation

For the past several decades, A&D companies have been focused on developing technologies and systems designed to counter unconventional, asymmetrical warfare tactics employed by insurgent and guerrilla forces, mostly in the Middle East. Today, however, defense priorities are changing to focus on near-peer competitors[6] that demand different tactics. Defense agencies are now asking companies to shift to domains like low-orbit space, and new technologies such as AI, quantum computing, hypersonic missiles and aircraft, drones, and domains.

To put it bluntly, the scale of recent investments demonstrates the importance of cutting-edge technology in maintaining strategic and tactical advantages. For example, the US Army recently awarded a $756 million contract to Lockheed Martin to develop additional capabilities to a hypersonic missile program.[7] Palantir Technologies secured a $480 million contract to begin work on the Army's AI-enabled battlefield analyzer.[8] And last year, SpaceX received a $70 million contract from the US Space Force for its new Starshield satellite constellation.[9]

Agencies are also looking for contracts that are more capability-focused, rather than program- or departmentally-focused—that is, firms that are known for a doing a certain thing that can be scaled across programs and agencies.

Shifting defense priorities, as well as the unpredictable geopolitical environment, drove increases in defense spending funding that surpassed $2.44 trillion globally

in 2023.[10] Meanwhile, in the US, the proposed 2024 Department of Defense budget reached $842 billion, an increase of $26 billion over FY 2023 levels and $100 billion more than FY 2022.[11] These significant increases in defense budgets reflect the commitment of governments to invest in acquiring and maintaining a technological edge and enhancing national and global security in an era of complex and evolving threats.

[6] Jim Garamone, "General Says Deterring Two 'Near Peer' Competitors Is Complex," DOD News, August 17, 2023

[7] Natalie Venegas, "Hypersonic Weapons Get a Boost," Newsweek, May 21, 2024

[8] Joe Saballa, "Palantir Awarded $480M to Prototype US Army's 'Maven' AI Battlefield Analyzer," The Defense Post, May 30, 2024

[9] Brett Tingley, "SpaceX wins Space Force contract for Starshield military satellites," Space, October 2, 2023

[10] Dr. Nan Tian, Dr. Diego Lopes da Silva, Xiao Liang, Lorenzo Scarazzato, "Trends in World Military Expenditure," Stockholm International Peace Research Institute, April 2023

[11] "Department of Defense Releases the President's Fiscal Year 2024 Defense Budget," U.S. Department of Defense, March 13, 2023

Strategic next steps for companies to consider

Determining what assets are truly noncore and, therefore, candidates for divestment will require A&D companies to take a comprehensive look at their business portfolio in light of market factors, shareholder value, and what will position the organization well for the future.

Deconstructing your portfolio into "salable units" (businesses that can be divested) rather than reporting segments or current operating structures requires creative judgment and systematic analysis. Too often, business leaders have the tendency to view the portfolio through the same lens in which the businesses are organized, operated, and managed today, burying noncore assets within otherwise core units—in other words, it's not the most strategic perspective to be making decisions about selling or developing assets. This is where some of the art comes in—using the assessment to pinpoint assets with significant market potential rather than merely divesting the underperformers. The idea is to focus not just on getting rid of the least successful parts of the business but on recognizing and investing in those with promising prospects for growth and profitability.

The process is more about discerning the intrinsic value within your portfolio that holds substantial worth in the broader market even though it may not align perfectly with your core operations. This strategic segmentation is crucial to refine your asset base and ensures that you can capitalize on potential divestiture opportunities to enhance shareholder value and streamline your focus toward your primary strategic objectives.

As your A&D company begins the process of evaluating your portfolios for potential divestitures, you should consider following this roadmap:

First, **decompose your portfolio differently** (for example, by markets, customers, capabilities, programs, products, and profitability) to break down the "business-as-usual" mindset, then adjust your lens to focus on the unique value of the business' component parts to your organization and to others.

Next, **complete performance/ outlook assessments and strategic evaluations** for the business components you've identified: Evaluate the program or business unit based on financial and operational performance metrics. Then, prioritize programs or business units by strategic fit and contributions to the overall portfolio.

Finally, **evaluate your options:** The completion of these assessment will result in a list of non-core assets that do not align with the future of the company and can be sold to support further investment in core assets.

While each organization's experience will be unique, noncore assets typically meet some of the following criteria:

1. They are no longer aligned with the strategic objectives and long-term goals of the company.
2. They have limited prospects for improving financial performance.
3. They hinder the company's ability to invest in core operations.
4. They carry a higher or lower risk compared to the company's overall portfolio.
5. They no longer tie back to a strategic capability or customer.
6. They are more valuable to another owner, suggesting a misalignment with the company's strategic direction.
7. Their divestiture helps deconflict the portfolio ahead of strategic pursuits, clearing the path for focused growth.

A key part of the analysis is to remember that the goal isn't just selling off assets that are problematic. It's also about selling assets that have a limited growth impact for your organization but may be valuable to others. It can make more sense to sell a cash cow and reinvest the proceeds than to milk it.

Conclusion

Many of today's A&D companies already know they're standing at a critical juncture—they acknowledge their need to strategically reassess and realign their business portfolios in response to a rapidly evolving industry landscape. They also recognize the jeopardy. Organizations that are adept at effectively divesting noncore assets stand to achieve enduring superior performance in the stock market and can strengthen how they lead and innovate. However, the pitfalls and consequences of failure are very real. Getting it wrong could lead to a future of playing catch-up.

The decision-making that lies ahead isn't just about numbers and financial calculations; it demands deeper insight into which segments of their business will power sustainable growth and keep them relevant in the years to come. It's the kind of thoughtful consideration that not only shapes companies, but also the future they're aiming to build.

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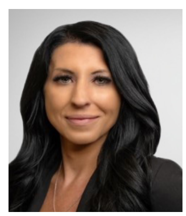

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We would like to thank our contributors:
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DASD-2024-15656