COMMERCIAL AEROSPACE STILL OPTIMISTIC BUT REORGANIZING

AUDIO TRANSCRIPT

Michael: Hello and welcome to Aviation Week's Check Six with Accenture. I'm Michael Bruno, senior business editor at Aviation Week.

Program management in aerospace and defense used to be focused on the good, old-fashioned boring stuff, like schedule, scope and scorecards. For decades before the COVID-19 pandemic, what dominated executives' minds were product iterations, process improvements and operating profit. Supplier issues existed, of course – does anyone remember airliner seats being the culprit last decade? – but it was generally a good problem to have as industry labored toward record production rates. Fears of a grey tsunami of retiring workers faded with each year.

Well, that was then and this is now. At a recent closed-door event hosted by Aviation Week, program management leaders from OEMs and Tier 1 suppliers decried a litany of nontraditional concerns, that ambush their everyday. Long-lead times have grown exponentially for some parts, including the most basic elements such as capacitors.

Once upon a time, parts like those were some of the most reliable components but now they too are a chokepoint for making delivery schedules. Meanwhile, companies find they have to give "microlearnings" to leaders about inflation and its corrosive nature on margins if not properly managed. Above all, industry is losing the war for talent, at least at the moment it is hard to describe it as anything but a struggle. Attrition rates are double historic averages, and companies complain that not enough new entrants want to join, or even rise into management.

The good news is the darkest period of Covid-19 is behind industry and a recovery is underway, no matter how haltingly it occurs. According to the new Commercial Aerospace Insight Report from Accenture, most executives are cautiously optimistic, a sentiment confirmed by Aviation Week in our own reporting. The bad news however is that the recovery may not come any sooner than hoped because of supplier restraints, including workforce shortages and inflation.

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Accenture's Commercial Aerospace Insight Report, the latest installment in what is probably industry's most consistent survey of C-suite sentiment, provides insight into the business dilemmas facing aerospace and defense today. Here to parse the latest findings are two seasoned experts and longtime friends of Aviation Week, John Schmidt, Accenture's global A&D lead, and Jeff Wheless, global A&D research leader. John, Jeff, it's good to be back with you two, welcome.

John and Jeff: Thank you Michael it is good to be back.

Michael: Gentlemen, I want to start with the Accenture Commercial Aerospace Insight Report's latest findings. Jeff, what did respondents say about their 2022 expectations?

Jeff: Well Michael, the darkest period for aerospace companies seems to be behind us. Strong consumer demand, I mean all you can say is wow to RPKs being twice that of 2021, load factors reaching over 80%, international borders reopening. We expect aircraft deliveries this year to be about 1,175, that is about 11% YoY and just shy of 2019 deliveries. With airlines expecting to finally turn profitable, starting in North America, the aerospace industry has reached recovery mode. After polling executives and updating our economic model, our outlook for this year predicts global commercial aerospace company revenues to grow at about 13%, which is solid but overall revenues would still be 20% down versus 2019.

Michael: John, a lot of goods new there that we are almost back to 2019 levels, I hear in some sense. That's great, but the survey spotlights several clouds on the horizon. Executives sound wide-eyed to challenges, what did they tell you?

John: Well Michael there is certainly no shortage of things that can keep an aerospace executive awake at night these days. While the pandemic effects are waning, there are a number of aftershocks that continue. Supply chain disruptions and labor shortages which are top of mind in both aerospace and the broader economy. We look at turmoil in financial markets and central bank actions. OPEC moves and energy concerns – especially in Europe. Regional conflict is an ongoing tragedy that is cemented as an ongoing concern these days. Despite these potential headwinds, the sentiment from the executives we surveyed is positive – I think it is a testament to the strength and resilience of the companies in our industry.

Michael: John, we just finished the traditional third quarter at the end of September, but of course we won't know until at least the end of October or early November when top-tier companies start reporting financial results. But we do have a really good idea of what happened in the first half of 2022 and there was a definite slowdown from what was expected just at the beginning of the year. Has that cut into optimism at all?

John: Well Michael, let's start with the half-year revenue results. They were certainly subdued; however, OEMs did record improved operating margins, demonstrating steady recovery of profitability. Boeing cut their operating margin losses almost in half and Airbus increased their operating margin to just over 14% in the first half of the year as two examples. Looking at the 2H of the year, 94% of executives we polled expect their commercial aerospace product deliveries to remain the same or increase, compared with to 2021. And if we look at announced production rates and executive sentiment point to increases in both narrow and wide body customer deliveries. As Jeff said earlier, utilization is up, and this also sets the stage for MRO activity this year which is confirmed in our report where 80% of the executives expect MRO growth in the next year.

Michael: Well gentlemen, I'm stuck by optimism and there seemed to be optimism all the way through the pandemic that things would eventually recover and so in the one sense not surprised to hear this, but we do know executives are acknowledging deeper challenges in the supplier base. CEOs from Airbus, Boeing and Raytheon have all forecast it could take through 2023 to get through supply chain issues alone, and let's not even mention workforce challenges, which we'll talk about in a couple of minutes. There is growing confidence in suppliers but also sobriety it seems over problems coming in the next year or so. Jeff, what did executives tell Accenture in the latest survey?

Jeff: Well, whether it be for aircraft or equipment, there are a lot of moving pieces in production, and I think that is an understatement. We look at that through two lenses, one is cost and then availability. In terms of costs for the back half of this year, executives we surveyed are split right down the middle in terms of rising or stable costs, for everything, raw materials, subsystems and labor. I think that is very much a reflection of when price increases will hit the system, based on escalation clauses in contracts or when catalog pricing gets released. It's pretty much the unanimous sentiment from executives we polled that for the next couple of years, cost increases in every category are expected. Let's move to availability or supply chain. Availability is perhaps as an analogy the Wild West of aerospace and it is all over the place. For sure executives were significantly more positive when we surveyed last month with 88% saying they had confidence in their supply chain, vs. 64% last year, which was an all-time low, but the situation changes fast based on breaking events. As but one example of the risks at play, the European winter may not be kind to some companies with limited production capacity and possibly site closures a distinct possibility rising from energy rationing. It is pretty hard to manufacture parts when the plant is closed.

Michael: Alright, cautious optimism with some definite challenges it sounds like certainly on labor, inflation, and energy costs. We are going to go deeper into those subjects 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 latest findings from the Accenture Commercial Aerospace Insight Report. Gentlemen, there are two areas I want to drill down into from the Accenture findings. One is supplier challenges, and another is labor availability. John, before the break Jeff was telling us about stubborn or growing production input costs. I have reported how CEOs have changed their tune this year, originally predicting they thought they could get a hold of supply chain issues as soon as this year, but now saying it could take until 2024 in some instances– and those are the top-tier companies. Who knows how bad it is deeper down in the supply chain. John, have you seen as a volatile a time as now when it comes to forecasting? Does it make your job any harder?

John: Not in my memory. These days it seems we have a new black swan event every month or at least a threat of it. Ukraine uncertainty. Energy security, or lack thereof, the Federal Reserve changing its own tune about inflation. We see OEM deliveries YTD are lower than OEMs projected. And while Tier 1 suppliers are seeing growing demand from OEMs, they are experiencing difficulties in meeting expectations as Jeff was describing. Aerospace companies are getting creative on how to mitigate these challenges. For example, Rolls-Royce is focusing on consolidating its supplying companies by making direct acquisitions of its best performers. We also see Airbus evaluating how to reduce the titanium content in their aircraft by 30%. Michael, there is no silver bullet here, but we will continue to see ideas that originate to help deal with these adversities and that is what gives me some of that cautious optimism.

Michael: Jeff, these problems are certainly coming through in measures of business activity. What did Accenture find when it comes to the expected North American and European commercial aerospace indices?

Jeff: Well Michael, North America was boosted by strong 737 MAX deliveries. We see 16% growth this year and similar growth next year. Driven by product ramp ups and delivering on the 787 backlog. In Europe, we see 14% growth this year, but supplier challenges hampered yet stronger growth and this will be a headwind as you said earlier, going into 2023. All eyes will be on European suppliers this winter to see how the energy situation plays out. And that situation in Europe is not just a European issue, since aerospace is fundamentally a very, very global industry.

Michael: Jeff, these forecasts matter because companies are trying to adjust to expected conditions. I was struck that one of the findings in the latest Accenture survey is how likely respondents are to undertake large-scale reorganization or operating model changes in the coming months and years to boost their performance. What did you find, and can you tell us a little more about that?

Jeff: For all its high tech dimensions, aerospace is still fundamentally a people business. As John said earlier, new ideas and bringing things to tackle new problems and volatility. People bring relationships, talent, and absolutely brilliant ideas. That said, 89% of executives said that a lack of people with digital talent impacted their ability to meet customer obligations this year. That's huge. Digital talent spans from sophisticated equipment operators on the production line to engineers that know the latest model-based engineering methods. I think this mismatch will drive a rethink on how functions are structured and drive further pushes for advanced tech such as AI, to mitigate where it can. To that point, 83% of executives in our poll believe it is likely that they will redesign their companies in the next 24 months to better capture opportunities and drive performance. This certainly fits with what we are seeing in companies across all industries around the world, in terms of greater concurrent change and continuous change in order to bolster their businesses.

Michael: John I'm going to put you on the spot here with a quick question, 83% saying they are going to reorganize maybe or look at different model changes. Do you remember that high in a survey result?

John: No, not in my experience. You can see what is driving it though Michael, you guys report this stuff that the structural changes in the number of companies that play in our industry, and now with Covid coming in and recognizing the power of these digital tools and what they can do in having a digital core of master data that can be deployed and leverage with some of the tools we have out there with AI. You can see why companies are thinking now is the right time to start thinking about it. We at Accenture call it total enterprise reinvention.

Michael: John, let me stick with you with a last question here. You and I, we have long talked, and often with Jeff, talked about workforce issues on this podcast all the time, maybe more than any other issue. But it has always been about Silicon Valley attracting new talent, or upskilling current talent, or how to augment with new technology such as virtual reality or bringing AI into the operations. The conditions are a lot worse now, according to reports – the Great Resignation is pushing institutional knowledge out the door while Work from Home issues threatening company cultures, from what I'm told. Has this changed the need for attracting digital talent, upskilling workers or adopting to new tech?

John: Actually, in my view, these drivers have really not changed the fundamental need for digital talent at all. However, they have dramatically accelerated the timeline for that need. Executives in our poll confirmed the widening gulf between need, the workers they need blue collar or white collar, vs. capability of those workers to fill those needs. In fact, just over 72% of executives said they were confident in their engineering digital talent mix, but that dropped off significantly when we asked about other critical areas. For instance, only 32% were confident in their digital manufacturing skills mix dropping off to 17% for MRO and only 8% confident in their supply chain digital skills mix.

That is incredible, because if you compare that to the challenges facing our industry, the largest digital skills mismatch is in the area causing most challenge to generating growth which is the supply chain. The industry is working to address this overall digital skills gap. Airbus is hiring 6,000 people focused on digital transformation and decarbonization. Boeing is creating a digital innovation hub in Virginia for security, autonomous operations, and quantum science. Certainly, these are steps in the right direction, but they have a long way to go.

Michael: Well, I look forward to talking about some of that progress and probably more of these challenges the next time we get together but for now that's a wrap for this edition of Check 6 with Accenture**.** **Jeff, John,** thank you for joining me today.

John & Jeff: Thanks Michael

Michael: Be sure to check out the new Accenture Commercial Aerospace Insight Report, and 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. Thank you for listening, have a great rest of your day.