## UP FRONT

# STEVE GRUNDMAN

# Back to the Future

### What the **proposed UTC-Raytheon tie-up** tells us about the industry

**THE MIGHTY CONSOLIDATION WAVE** that swept over the aerospace and defense industry after then-Deputy U.S. Defense Secretary William Perry's "Last Supper" in 1993 is taking another turn. The next inflection in the restructuring story is the proposed merger of United Technologies Corp. (UTC) and Raytheon to form what would be the third-largest global aerospace company by revenue, Raytheon Technologies. It is a stunning deal, marking a sharp change in our outlook on the markets and establishing a bellwether of new corporate-development plot lines to motivate the next chapter in the saga.

Announcement of the merger is a trailing indicator of several important changes in the industry's outlook. First, it underscores beliefs that U.S. defense spending is at or near its cyclical peak. Against an outlook for sustained defense market growth, Raytheon would be well positioned to prosper by its existing structure and capitalization; alternatively, the company might have commanded a substantial premium for its shareholders while the going remained good. Instead, Raytheon' sought out a merger of equals, and its stock has been largely unperturbed by the announcement.

Second, the merger reinforces indications that the so-called super-cycle in the commercial aircraft business is winding down. At both Airbus and Boeing, new orders are not keeping pace with deliveries, and backlogs are beginning to decline. Pratt & Whitney and Collins Aerospace, the residual UTC businesses that will combine with Raytheon, are overexposed to the cycle of commercial aircraft. The merger with Raytheon diversifies that exposure with putatively counter-cyclical military sales, resulting in a company deriving roughly half its revenues from each sector.

Third, the capital deployment strategies of aerospace and defense firms are weaning themselves of their overreliance on share buybacks. While the companies recommitted to having Raytheon Technologies continue returning substantial capital to shareowners, the value story of the transaction is all about investing in new franchise technology platforms, as Pratt & Whitney previously has done with its geared turbofan family of engines and Raytheon with its gallium-nitride radars.

The merger also is a leading indicator of how the business of aerospace and defense will change over the next decade.

UTC

Greg Hayes
UTC Chairman/CEO

RAYTHEON

Tom Kennedy
Raytheon Chairman/CEO

Sustaining competitive advantage in the U.S. defense market will require more private investment alongside government-funded R&D. The business model favoring pure-play defense firms is under threat, and the Raytheon Technologies merger is a response: The scale of the company's balance sheet and cash flow can accommodate big-bet investments on breakthrough innovations. This was the dominant message of the two CEOs' pitch for the merger, and it rings true against the backdrop of recent Pentagon awards in which the winner's up-front investments or willingness to bear back-end risk proved decisive.

Commercial aircraft suppliers will no longer abide bet-the-company projects, and diversification of end markets will form another line of defense against cost-cutting and risk-sharing imperatives. The ability to walk away is the ultimate leverage in any negotiation, and the merger with defense-focused Raytheon buttresses the hefty scale and scope UTC attained by acquiring Rockwell Collins, further strengthening its posture toward new projects like Boeing's new midmarket airplane.

In an era of worrisome macroeconomic indicators, the uses of corporate development to shore up balance sheets will come into vogue. While the complementarity of the two companies' capabilities and markets is being featured, it is the pairing of their capitalizations that as powerfully drives this transaction. As UTC Chief Financial Officer Akhil Johri put it in response to an equity analyst's question about debt, "That's the big benefit of this merger as well, where the shareholders can see some immediate benefits without having to focus on deleveraging, which would otherwise have been the case for the [the residual businesses of] UTC."

The UTC-Raytheon merger is a salutary throwback to an era before 1993 when the capabilities and assets of commercial aerospace and defense firms were combined under iconic brands like Lockheed, British Aerospace, Goodrich, Hughes and even Raytheon itself. Raytheon Technologies expresses a back-to-the-future story line that begins to reintegrate our industry and reclaim the financial, technological and economic synergies that a more diversified portfolio can exploit.

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