

Boeing, Airbus Look to Land Profits by Making Their Own Aircraft Parts

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The world's largest plane makers are testing a seemingly simple formula to smooth production, cut costs and fatten profits: Make more of the parts that go into their jets themselves. In the wake of United Technologies Corp.'s proposed \$23 billion deal to buy Rockwell Collins Inc., that push is taking on more urgency. The deal is the latest in a round of consolidation among the world's biggest suppliers of aviation parts -- something Boeing Co. and European rival Airbus SE have eyed warily. Earlier this week, Boeing said it might cancel some of its parts contracts if the deal undermines competition further in the aerospace supply chain. Airbus had previously expressed its skepticism over it. Worried about getting squeezed by the consolidation, Boeing and Airbus have moved to protect themselves by building more of their parts in-house. This month, Boeing will start construction of a new production facility in Sheffield, England, that will make some of its own actuation equipment -- motors that help move a wing's flaps. Airbus, meanwhile, is planning to build some of its own nacelles, the metal casings that house a plane's engines. United Technologies is one of the world's largest nacelle suppliers.

"We are constantly revisiting our 'make or buy' decisions," said Fabrice Brégier, Airbus chief operating officer and head of commercial planes. Boeing decided two years ago to make some of its own nacelles after years of buying them. In July, the company also said it is planning to develop and build some aircraft electronics, a market dominated by companies such as Rockwell Collins and Honeywell International Inc. The wings for a revamped version of Boeing's new 777 jetliner also will be built at a new plant near Seattle rather than bought from a supplier. Boeing bought the wings from a supplier for its last big project, the 787 Dreamliner. "The opportunity ahead of us, in terms of transforming how we design and build, how we manufacture, is even greater than some of the product innovation that we're going to bring to the table," said Boeing Chief Executive Dennis Muilenburg. Boeing and Airbus are slated to deliver new planes worth more than \$100 billion this year. Both have order-book backlogs that stretch years and, combined, are worth almost another \$1 trillion. But parts that represent more than half the value of each of those planes are mostly made by dozens of suppliers such as United Technologies, Spirit AeroSystems Holdings Inc. and General Electric Co.

Boeing and Airbus, under pressure to deliver all those planes, have pressed their suppliers for cost savings and deadline commitments. Plane makers' leverage, though, has lessened as the circle of suppliers has shrunk in recent years. United Technologies snapped up rival Goodrich Corp. in 2012. Its deal with Rockwell Collins will make it the world's biggest plane-parts providers. Another big tie-up is in the works: Plane parts maker Safran SA is haggling to buy cabin-interior specialist Zodiac Aerospace SA.

Bringing production in-house helps level the playing field. Those parts makers have also traditionally been able to suck out more profit for their components than plane makers like Boeing and Airbus can extract for selling whole aircraft. Profit margins for plane and

engine makers have averaged 9% over the past two years, compared with 14% for so-called "tier one" suppliers such as United Technologies and Rockwell Collins, which make finished parts directly for plane makers. Margins come in at 17% for tier 2 suppliers, which provide smaller components for those parts, according to Boston Consulting Group.

Boeing and Airbus executives have said they now aim to capture some of that extra margin for themselves. They also hope to get a larger share of the lucrative business servicing those parts once the plane is sold to a customer, usually an airline or an aircraft leasing company.

That service revenue -- from routine maintenance to repair work -- is more profitable still. For parts makers, the shift by Boeing and Airbus threatens to reduce their own slice of those service sales. Consultant Oliver Wyman estimates that commercial-aviation service business is worth roughly \$76 billion a year. Take the airplane manufacturers' recent entry into nacelle production. The parts typically cost roughly \$1 million per plane on a narrowbody jet, and \$4 million to \$5 million for long-range jets. Airlines -- which buy or lease Boeing and Airbus jets for their fleets -- spend \$1.5 billion to \$2 billion annually to service nacelles, said Kevin Michaels, managing director at AeroDynamic Advisory LLC, a consulting firm. By making the nacelles in-house, Airbus and Boeing save on the parts and may get to hold on to the servicing revenue for the life of the part.

Boeing wants to double annual services sales to \$50 billion in five years, a figure analysts consider ambitious. The plane maker opened a new unit in July to oversee the effort.

Analysts at Canaccord Genuity Inc. figure Boeing's current service-related revenue makes up nearly 20% of its overall aerospace and defense revenue. At Airbus, the figure is 15%. That compares to 56% at GE and 52% at engine maker Rolls-Royce Holdings PLC, two of the industry's biggest suppliers. The Airbus and Boeing moves are still in their early stages and have yet to affect either their earnings or those of parts suppliers. The incumbent parts makers say they aren't yet worried about getting squeezed out, given all the work to go around from the two makers' big backlogs.

"They've looked at some of the components within the aircraft, and think that they need to have more control on that," Kelly Ortberg, Rockwell Collins' chief executive, told investors recently, before announcing the United Technologies deal. "In fact, there's probably opportunities for us to maybe support them in different ways than we have in the past."

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