GLOBALIZATION AND THE AEROSPACE INDUSTRY: LOW-COST & THE DOLLAR ZONE

INSIGHTS FROM THE 3RD ANNUAL MEETING OF THE MAZARS AERO CLUB
New growth engines, reduced exposure to fluctuations in the U.S. currency, and lower production costs: these are just some of the many opportunities that international development strategies offer players in the aerospace industry.

While developing business activities on the international scene offers several undeniable advantages, there are also a large number of risks inherent in such a strategy that need to be anticipated. These include, notably, rapid salary inflation, political instability, an under-qualified workforce, additional costs related to non-quality, uncertainty regarding regulatory changes, transfer of know-how, and the protection of intellectual property. Against the backdrop of the globalization of markets, players in the aerospace industry, who are subject to more rigorous product safety requirements, must be able to meet their clients’ needs as closely and as cost-effectively as possible, while continuing to provide risk management and ensure quality in their programs.

How should these players approach foreign markets, given this context? What are the key factors for success? What are the primary risks that must be taken into account? How can businesses protect themselves against such risks? Can SMEs develop internationally as easily as large industrial groups?

To try to answer these questions, Mazars organized a round table on Thursday, November 15, 2012, as part of the third annual meeting of the Mazars Aero Club. The theme of this meeting was ‘Globalization and the Aerospace Industry: Low-cost and the Dollar Zone’. The aim was to identify best practices by comparing feedback and opinions from the recognized industry players who were kind enough to take part, including Aerolia, Aerospace Valley, Airbus, Latécoère and Safran.

At the meeting, which was moderated by Gil Bousquet, Business and Aerospace journalist with La Dépêche du Midi, some fifty manufacturers, subcontractors, service providers, financiers and investors from the Midi-Pyrénées region, all specialized in the aerospace industry, heard from representatives of large industrial groups, the Aerospace Valley Competitiveness Cluster, and Mazars experts.

Below you will find a summary of the views expressed during this meeting.
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MODERATOR: Gil Bousquet, Business and Aerospace Journalist, La Dépêche du Midi

Left to right: Kamal Mokdad, Florence Pinot, Laurent Inard, André Guiraud, Marc Pere, Eric Zanin, François Bertrand et Raphaël Duflos
In 2011, almost 80% of the activities of aerospace industry manufacturers were conducted abroad. Fueled by the boost in air traffic in Asia and the Middle East in particular, this international development continues to grow. In the words of Julie Laulusa\(^{(1)}\), Mazars Partner from the Shanghai office, “…the middle class population in China is set to triple in the next ten years”, with China “likely to become the primary aerospace market in the world, overtaking the United States.”

To protect themselves from fluctuations in the exchange rate, some players, such as Airbus, have transferred part of their production to the dollar zone. Likewise, certain manufacturers, including Latécoère, have also set up part of their production in low-cost countries whose currency is tied to the U.S. dollar, not only to protect against the risks of fluctuating exchange rates, but also as a way of reducing costs.

These few examples are a perfect illustration of the opportunities available abroad. “Globalization is absolutely essential for manufacturers in the aerospace industry,” said Eric Zanin, Member of the International Commission of the Toulouse Chamber of Commerce. Thanks to globalization “it is possible to access low-cost or dollar bases, find new engines for growth, and reach new markets via major industrial groups or aerospace contractors.”

But beyond the advantages offered by globalization, expanding outside the domestic market can lead to difficulties that need to be anticipated: political instability, additional costs related to non-quality, lack of qualified workers, etc.

\(^{(1)}\) Comments made at the previous meeting of the Aero Club in September 2011.
Low labor costs are one of the factors quoted by aerospace manufacturers when deciding to establish themselves and begin production abroad. This decision is even more relevant in the global marketplace with the appearance of new players from emerging countries, such as Comac in China and Embraer in Brazil.

François Bertrand, Chairman of the Board of Directors at Latécoère, began by stating that outsourcing production to a so-called low-cost country is an ongoing initiative, and that companies who wish to establish themselves globally must have sufficient growth potential for the long term. To illustrate his comments, Mr. Bertrand reminded participants that the implementation of ‘risk sharing’ contracts by Airbus for the launch of the A330 in 1988 paved the way towards globalization for Toulouse-based Latécoère, a specialist in aerostructure, wiring and embedded systems. Under this type of contract, the two companies were considered to be true partners, which guaranteed a workload for Latécoère for several years down the line. This allowed the Group to benefit from sufficient long-term

“A COMPANY WISHING TO ESTABLISH ITSELF ABROAD MUST HAVE CONSIDERABLE LONG-TERM GROWTH POTENTIAL”
FRANÇOIS BERTRAND
growth potential to begin outsourcing part of its production to South Korea. This successful experience encouraged Latécoère to start outsourcing to more and more foreign providers. In the mid-1990s, the Group reached a new milestone in its globalization policy by establishing a presence abroad in order to reduce production costs, while at the same time remaining in control of its processes and know-how, in particular with respect to its state-of-the-art technologies.

Mr. Bertrand also pointed out that the decision to set up a presence abroad was often made out of necessity, for reasons relating to cost, responsiveness, and quality, but was not directly related to specific requests from aircraft manufacturers. Having an international presence close to a contractor is in line with the principle of industrial efficiency as it optimizes production time and reduces logistics costs, especially for large components. Latécoère has therefore established production facilities in the Toulouse area for Airbus and Dassault, and in Brazil for Embraer. It is for these same reasons, for each potential move abroad, that the company considers the possibility of associating its suppliers and subcontractors in its expansion.

Laurent Inard, Mazars Partner from the Financial Advisory Services department, stated that caution is needed when invoicing for services outsourced to other countries, due to the sometimes sizeable tax deductions at source. In these cases, an in-country presence may prove necessary.

André Guiraud, Safran Regional Representative, explained more about globalization, pointing out that the term ‘relocation’ is inappropriate. In his view, there is no natural location for business activities, as a location should be assessed according to the particular situation. For example, 70% of Safran’s production
takes place in Europe, with over 50% in France, although Europe only accounts for 30% of the Group’s turnover. The question of where to locate assets is an important one, because there are clear advantages to being located close to clients. This can result in a decision to establish either a local presence or a partnership in the form of a joint venture. A local presence is sometimes unavoidable in order to ensure certain activities such as engine after-sales service and operational support, in particular for MRO activities.

In addition, Mr. Guiraud stated that operating internationally allows companies to acquire technological expertise via external growth operations and thus provides opportunities for more advanced research and development.

The benefits of a presence abroad also include the opportunity to develop new drivers for growth. Mr. Bertrand reminded those present that the crisis in the 1990s highlighted the aerospace industry’s vulnerability and the need to diversify its client base by turning to other countries. This trend has picked up momentum since the 2000s as aircraft manufacturers have begun to accept that first-rank suppliers might also work with their competitors. In this way, Latécoère works today with Airbus, Boeing and Embraer, thereby reducing its dependence on just one manufacturer.

Mr. Guiraud explained that, in addition to geographical diversification, it is necessary to implement long-term strategies by turning to activities currently under development, because the sector is expected to experience significant changes. As an example, he said that Safran has thus diversified into markets that are dynamic but very different from the Group’s core business, which is safety. While cost may be an important factor, the decision to develop activities abroad cannot be based on this criterion alone. Mr. Bertrand pointed out that the aerospace industry operates at a slow pace, and is less automated than other industries. The quality of the workforce is crucial, especially for complex business lines. To remain competitive when faced with falling prices in the sector, it is necessary to “diversify facilities according to the degree of complexity of the activities in question.” Some activities require very specific high-cost skills, while other, less technical procedures can be performed in low-cost countries. It is a matter of optimizing the ratio between the cost of the work and its complexity. This is why Mr. Bertrand prefers to talk about “best-cost” rather than “low-cost” production.

Although access to international markets provides plenty of opportunities, it is also accompanied by a number of risks, which companies must learn to foresee. Laurent Inard, Mazars Partner from the Financial Advisory Services department and the author of a study on the risks and opportunities associated with emerging countries, pointed out that the primary problem is a poor understanding of financial considerations, especially with respect to acquisitions.

Most accounting systems in emerging countries are structured according to local standards, which tend to focus very little on the economy, and are very different from standard international practice. With respect to acquisitions, the commonly observed aggregates such as EBITDA and EBIT are not fully understood. Different...
THE LOW-COST BUSINESS MODEL: MYTH OR REALITY?

accounting systems can also coexist within different departments of the same company: tax, legal, accounts management, etc. In external growth operations, it is also necessary to closely examine factors related to liabilities, off balance sheet commitments, and guarantees undertaken with third parties. To secure their operations, companies mainly protect themselves by placing part of the price in an escrow account, to which the liability guarantees will then be charged. Finally, Mr. Inard urged the same level of caution for asset ownership. “For example, we had a situation in Indonesia where two property deeds had been drawn up for the same piece of property!”

The second substantial risk involves staff and labor costs. According to Mr. Inard, careful attention must be paid to hidden costs, especially those relating to undeclared employees or wage increases triggered by turnover or legislation. In Vietnam, for example, the minimum wage varies depending on whether or not the shareholders are foreign.

Eric Zanin, Member of the International Commission, Airbus Senior Vice-President and Head of Procurement, stated that within the aerospace industry, the price differences observed between European companies and Asian or Russian companies in calls for tender are less significant than in other consumer product industries. Productivity associated with so-called low-cost countries does not apply in high-tech industries like the aerospace sector in the same way as in industries that rely on mass production with more repetitive, standardized procedures.

Raphaël Duflos, Purchasing and Supply Chain Director, Aerolia, emphasized that with external growth initiatives, companies need to look at the full cost of acquisition, including the potential surpluses created by restoring product quality. He also explained that savings or gains in productivity can
be achieved by implementing industrial optimization initiatives such as lean management between the various partners, rather than relying solely on reduced labor costs.

For André Guiraud, Safran Regional Representative, successful low-cost production requires the right balance between three essential parameters: political stability, a culture that can adapt to the business activity, and trained workers. The benefit lies, naturally, in reduced labor costs, but also in the responsiveness of the organization.

Regarding political stability, François Bertrand, Chairman of the Board of Latécoère, gave the example of Tunisia, where the Group has been established for over 15 years and its activity considerably impacted since the Arab Spring of 2011. For more than a year, these protests have been complicating the industrial environment, with repeated strikes, in particular within the transportation sector, resulting in significant increases in absenteeism. To protect itself against such risks, the Latécoère Group has diversified its production, notably by transferring high-speed production to Mexico. As Mr. Duflos explained, his company has also been present in Tunisia since 2009, and these recent political events have led to delays in staff training, causing the Group to scale back its plans for this growing market.

On the topic of political risk, Laurent Inard’s opinion was that there is no single solution, as it all depends on the nature of the instability. For countries known to be unstable, businesses must remain vigilant by using monitoring tools in collaboration with embassies and the public authorities. He added that certain companies, because of their particular business and market, are driven to establish a presence in ‘at-risk’ countries and have therefore incorporated this requirement into their business model. Expected profitability is higher in these countries in order to offset the higher risk involved. For the most unpredictable events, the decisions taken depend on the

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RAPHAËL DUFLOS
THE LOW-COST BUSINESS MODEL: MYTH OR REALITY?

extent of the impact. As already mentioned by all of the speakers, Mr. Inard emphasized that an international presence must reflect a long-term plan that should not be solely based on cost, but also serve other goals (business advantages, proximity to a client, etc.). In this way, an unexpected event will usually have limited impact over time, and will not necessarily jeopardize the company’s presence in a given country.

Mr. Duflos pointed out that when establishing a presence abroad, this ‘risk’ factor is integrated into the overall production costs, which specifically include the cost of implementing alternative solutions, such as resorting to stand-by manufacturing chains located in non low-cost areas, in order to guarantee production.

"COMPANIES WORKING IN COUNTRIES WITH SIGNIFICANT POLITICAL INSTABILITY TAKE THIS RISK FACTOR INTO ACCOUNT. IN THESE COUNTRIES, A HIGHER LEVEL OF PROFITABILITY IS REQUIRED."
LAURENT INARD

IF YOU WOULD LIKE A COPY OF OUR STUDY SETTING OUT THE PRIMARY RISKS AND OPPORTUNITIES ASSOCIATED WITH EMERGING COUNTRIES, PLEASE E-MAIL LAURENT INARD AT THE FOLLOWING ADDRESS: laurent.inard@mazars.fr
Marc Péré, General Director of the Aerospace Valley Competitiveness Cluster, started by pointing out that, compared to large groups, the issues relating to international expansion for SMEs and Mid Caps are very different. According to Mr. Péré, it is difficult for SMEs to develop their exports without the assistance of public authorities and large groups, even for those companies offering innovative or differentiating solutions that are likely to find an export market. Such projects must therefore be backed by close collaboration and general consensus among all players.

On this topic, Mr. Péré explained that within the framework of the Ayrault pact, the French government has introduced measures to facilitate access to international markets. These measures include personalized support for exports for 1,000 companies, closer connections between large companies and SMEs via the implementation of a ‘sectoral contract’, and the development of the VIE program. While international development remains a priority for the Competitiveness Cluster, Mr. Péré stressed that above all, we must remember that SMEs are faced with a wide variety of situations. Many of them have to deal with more immediate concerns such as access to financing, or recruitment difficulties. Furthermore, he said that the role of Aerospace Valley is not to interfere in decision making or endanger the local industrial fabric.

On this point, André Guiraud, Safran Regional Representative, stated that globalization does not necessarily lead to a loss of value within France. Since 2010 the Safran Group has established several sites abroad, while at the same time significantly stepping up activities in France, primarily via investments in technologies related to its core business, innovations and key industrial processes.

For SMEs and Mid Caps hoping to expand abroad, Mr. Péré explained that the goal of the Competitiveness Cluster is to create coherent, homogeneous groups of innovative companies, establishing a locally recognized source of innovation targeting specific markets and based on the idea that when expanding internationally, “there is strength in numbers.” The Competitiveness Cluster recently carried out some awareness activities with aircraft manufacturers, equipment manufacturers, subcontractors and suppliers at the Aéromart Summit held on December 4 in Toulouse, demonstrating that Aerospace Valley would be a good ‘host’ for creating such groups.

(1) The VIE (Volontariat International en Entreprise, or International Business Volunteer) program allows French companies to send a young person under the age of 28 on an assignment abroad. Regional and national support is available for VIE contracts: import-export credit and a COFACE marketing insurance contract, as well as subsidies for a significant portion of the VIE expenses in many French regions.
To conclude this topic, Eric Zanin explained that it was important to capitalize on feedback both from French nationals and from companies that have had an established local presence for many years. Globalization raises a certain number of questions concerning training, competition, ownership of property assets, and accounting and financial issues. It is therefore important to be both vigilant and pragmatic, because so-called low-cost countries do not necessarily constitute an El Dorado for the aerospace industry.

Mr. Zanin recommended that companies take a cautious approach, and only consider international expansion if it is of real benefit to them.

“So-called low-cost countries are not necessarily an El Dorado. Companies should be cautious and only expand if they are sure that it will be of real benefit to them.”

ERIC ZANIN
This meeting on the subject of globalization provided an opportunity to highlight the characteristics and future prospects of two rapidly expanding ‘low-cost’ markets: Russia and Morocco. By way of introduction, Kamal Mokdad, Mazars Partner from the Casablanca office, reminded participants that Morocco has long had ambitions in the aerospace industry. These ambitions were first described in the 2005 ‘National Pact for Industrial Emergence’, whose goal was to identify the industries where Morocco had a definite competitive advantage. Today, Morocco focuses on component production, sub-system assembly, and maintenance. All of the major aerospace players are present in the country, including Boeing, EADS, Safran, Bombardier and Zodiac.

Morocco has experienced rapid growth in recent years and the number of companies has increased tenfold, totaling around one hundred today. Sixty-five percent of production takes place in Casablanca, which boasts the largest Integrated Industrial Platform (Plateforme Industrielle Intégrée, P2I) and the majority of the training schools.

Mr. Mokdad pointed out that training is a decisive factor in the credibility of the products and services offered. Consequently, the national plan indicates that there are currently 9,000 qualified employees, and targets 15,000 by 2015 and 23,000 by 2017. To make this happen, an institute for the aerospace professions was created in 2011 and is chaired by GIMAS(1), which has already trained 600 workers and aims to train an additional 1,200 per year starting in 2017. At the same time, a public-private partnership has been set up between the State and the various private players in education, to reach the goal of 15,000 qualified employees by 2015.

Gil Bousquet, Business and Aerospace journalist with La Dépêche du Midi, pointed out that 75% of the 350 million euros invested in the sector came from France. France’s interest in Morocco is primarily explained by the two countries’ geographical, linguistic and cultural proximity. In addition, Morocco offers considerable advantages: a stable regime largely unaffected by the events of the Arab Spring, a relatively strong social policy, and a long-term vision backed by the National Pact for Industrial Emergence. Various measures have also been set up to attract foreign investors. For example, the introduction of a P2I in Casablanca means that manufacturers can focus on their core business and benefit from assistance with their logistical and administrative procedures, as well as a choice of equipped or semi-equipped factories to rent. The free trade zone also has several tax advantages: exemption from corporate tax for the first five years, an 8% tax rate over the next 20 years, exemption from customs duties and value-added tax on operations, and guaranteed …
THE BOOMING AEROSPACE INDUSTRY IN MOROCCO

repatriation of invested funds and profits for as long as the company remains in the country.

Speaking as the Head of Procurement for Airbus, Eric Zanin agreed with Mr. Mokdad’s comments regarding the appeal of the area, and the satisfaction expressed by those industrialists who have established a presence there. All of the speakers were in agreement on the need for caution regarding Morocco’s political situation, given the unpredictable nature of recent events in the area. André Guiraud, Safran Regional Representative, felt however that Morocco’s stability in the area is real, even if no-one can know what the future holds.

“THE NATIONAL PLAN INDICATES THAT THERE ARE CURRENTLY 9,000 QUALIFIED EMPLOYEES, WITH A GOAL OF 15,000 BY 2015 AND 23,000 BY 2017”

KAMAL MOKDAD
THE REVIVAL OF THE AEROSPACE INDUSTRY IN RUSSIA

To discuss the situation in Russia, Florence Pinot, Mazars Partner from the Moscow office, started by pointing out the geographical advantage of this immense country for the aerospace industry: a surface area 31 times larger than that of France, with 40% of it only accessible by air. With 65 million passengers a year, the aerospace industry faces little competition from road or rail transportation. To manage the increasing number of passengers, the Russian State has made significant investments in airport infrastructures, restructuring and modernizing the network, as well as expanding the capacity of its international airports. The country now totals around 200 airports, following the closure of 900 smaller ones.

Ms. Pinot stressed that the Russian government has a genuine desire to attract foreign investors, particularly in the aerospace industry; an industry in which the Russians were themselves pioneers. However, the country operated entirely independently for many years, and while it has significant industrial capacity and genuine expertise in the sector, it is need of modernization. Since 1991, privatizations have gradually made it possible to update the previously State-owned industrial facilities. This trend is set to accelerate with the launch of the fourth phase of the opening up of industrial capital in Russia to foreign investors, to the tune of around 8 billion dollars.

However, access to capital for foreign investors is limited in this sector, which is considered a strategic industry. The Russian State retains over 50% of the shares, and requires investors to provide technology offsets.

Eric Zanin specified that the country has a very substantial engineering capacity, mainly focused on military rather than civil aviation, the latter lagging behind, especially as regards propulsion systems and avionics. He also mentioned that the question of partnerships remains complex because of this limited access to capital. Mr. Zanin did not feel that Russia had a strong desire for development in aerostructures, unlike Mexico and Morocco.

André Guiraud acknowledged that the country has a strong technological culture, but was less optimistic about its economic and industrial culture, responsible, in his opinion, for slowing down development. Nonetheless, Safran is very keen to work in partnership with the Russians and to assist them in their development, as the Group is convinced that Russia, along with China, India and South America, will become a major player in the future.
This mention of future industry players led to a comparison of Russia with another large industrialized country—China. While Russia has traditionally invested in the aerospace industry, even if it was mostly focused on defense within the context of the Cold War, this was not the case in China. From a cultural point of view, however, the two countries have shown the same desire for autonomy, “although discussions about technology transfers have started taking place,” as Laurent Inard explained. Manufacturers are reluctant to establish themselves in China because of the many questions raised by such a move, in particular regarding the protection of proprietary know-how.

Eric Zanin was keen to point out the specific issues related to intellectual property in China, a problem that Airbus discusses with suppliers and equipment manufacturers. Mr. Zanin said that a cautious approach is necessary, and the potential benefits of projects in China need to be evaluated pragmatically.

Raphaël Duflot, Purchasing Director, Aerolia, said that Russia is keen to re-energize its civil aviation sector. To illustrate his point, he described how Aerolia has been manufacturing the same product, landing gear housing, for around ten years in both China and Russia. He explained that the product supplied by Russia had started to become less and less competitive, to such an extent that the Group was considering ending the business relationship. However, to hold onto their client, the Russians made a considerable effort to streamline their civil aviation industry, implementing lean manufacturing processes to improve the cost base and shorten production cycles. Thanks to this new industrial organization and proven commitment, the Aerolia Group today enjoys a strong partnership with Russia.
ANY FUTURE OUTSIDE THE DOLLAR ZONE?

The dollar has a significant impact on the aerospace industry. European players produce goods in euros that are primarily sold in dollars, resulting in an exchange rate risk. The future Airbus plant in Alabama will allow the company to level the playing field with its primary competitor, Boeing, by reducing the exchange rate risk while also cutting production times by assembling its aircraft in the United States. The new plant will also give suppliers and subcontractors an opportunity to set up a presence in the dollar zone, thus protecting themselves from fluctuating exchange rates.

To illustrate the impact of the U.S. currency, Raphaël Duflos explained that almost all of Aerolia’s turnover is generated in dollars, while the Group’s procurements have traditionally been made in euros. To protect itself from this kind of risk, the company has implemented a ‘dollarization’ system for its procurements, without however automatically resorting to contract flow-downs which would simply transfer the risk to its suppliers rather than removing it completely. The company distinguishes between short-term and long-term hedging. For short-term contracts, the possibility of hedging in dollars is analyzed with respect to the potential benefit to the Group and the relevant partner. For long-term contracts, it is more advantageous for the Group to use the dollar. For some contracts in euros, it is worth analyzing the currencies used across the entire manufacturing chain. Certain raw materials, such as aluminum, can be purchased in dollars, processed and then sold in euros to an equipment manufacturer who in turn sells its products in dollars. The goal is to minimize the impact of the exchange rate by using one single currency throughout the entire chain.

François Bertrand, Chairman of the Board of Directors of Latécoère, pointed out that the Brazilian real has recently experienced inflation rates of over 10%, resulting in an exchange rate risk. On the other hand, opening a factory in Mexico has reduced the Group’s exposure to such risks, as the peso is closely tied to the dollar.

On the topic of the expansion strategies of the larger American equipment manufacturers, Eric Zanin explained that their business model is similar to the French one. For example, in 2009 Spirit AeroSystems, Inc. established a site in Malaysia to strengthen its presence there and benefit from a hub in the Asia-Pacific region. “This model is universal,” Mr. Zanin remarked. The core activity stays in the home country, while local offices are set up both to work on programs alongside local manufacturers and to identify complementary resources. He went on to explain that, while the tangible portion of this sector is considerable, the intangible aspect is steadily growing, creating a need for partnerships with service providers, engineering firms and software companies.
CONCLUDING REMARKS

Luc Kempenich, Mazars Partner from the Toulouse office and one of the founders of the Aero Club, concluded the discussion by thanking the various speakers, representatives from large manufacturing groups, the Aerospace Valley Competitiveness Cluster, and Mazars experts, for their comments. The discussion had given the various players from the aerospace industry present at the round table a clear vision of both the best practices to be implemented and the traps to be avoided in their international expansion strategies.

In conclusion, Mr. Kempenich invited manufacturers, subcontractors, service providers, institutions, financiers and investors specializing in the aerospace industry to the next meeting of the Aero Club, to be held during the second half of 2013 in the Midi-Pyrénées region.
THE MAZARS AEROSPACE AND DEFENSE DIVISION

In its role as statutory auditor or consultant to many of the players in the aerospace and defense industry, including both SMEs and Mid Caps, as well as large industrial groups (listed or unlisted on the stock exchange), Mazars is a passionate observer of the challenges faced by the sector, and is fully committed to providing assistance to manufacturers.

As a result, Mazars launched its Aero Club in 2009, on the initiative of Mazars Partners specializing in the aerospace and defense industries in Toulouse and Paris.

The Aero Club holds regular conferences/debates, drawing on Mazars’ ability to bring together speakers on current topics from a variety of backgrounds, to exchange complementary and innovative points of view.

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