

## Talking Heads podcast with George Ferguson

**Andy Craig:** Hello, and welcome to this week's BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis on the topics that really matter to investors.

In this episode, we'll be discussing investing in European defence companies that are focused on developing new technologies to keep pace with advancements in the changing threats, and in particular, suitable for a passive investment approach in the European defence sector via a benchmark constructed and administered by Bloomberg Intelligence.

I'm Andy Craig, Co-head of the Investment Insights Centre, and I'm joined today by George Ferguson, Senior Analyst for Aerospace, Defence and Airlines at Bloomberg Intelligence, the research group at Bloomberg LP. Welcome, George, and thank you for joining us today.

**George Ferguson:** Thank you very much for having me.

**AC:** George, let's start by reviewing [the] performance of the European defence sector. Have developments over the last year in the sector kept pace with expectations?

**GF:** I think since the start of the year, we've seen defence shares actually dip a bit. In both Europe and the US, there was some conjecture in the investment community that we'd hit peak defence – that defence budgets were rising in Europe, rising in the US and maybe this was really as good as it gets.

So, in recent months it's lagged a bit, although I would say since then, we've seen continued geopolitical unrest. I think that reminds everyone this is really a long-term investment opportunity because 1) the world is not becoming safer, and 2) there's a heavy amount of investment that needs to occur in Europe, especially in a world where the US might be distracted – engaged in other parts of the world.

So, I think the opportunity is still there, even though we've seen some of the share prices come down since the beginning of the year. We always knew this investment in defence would come in fits and starts. It's typically a heavy industrial business.

Heavy industrial businesses take time to invest in capex so you can build the product that you're being contracted to build. You collect an order from your biggest customer, which is typically a government. Sometimes they don't move as fast as investors would be used to or like. Those are some of the items that have slowed progress – receiving contracts, building product and seeing the increased revenues and profits.

So things have come off a little bit since the beginning of the year. Some of the reasons why are understandable and short-term in nature. I think this is really a long-term requirement for Europe to invest in defence and therefore a long-term opportunity.

**AC:** And as you say, there has been absolutely no let-up in geopolitical tensions – if anything, there's been a heightening – and as a result, the commitments by European governments to strengthen their independent defence capability have been continuous.

And there's been no doubt that it's now up to Europe to reinforce its defence capability. Do you think that the valuations now accurately reflect the outlook at the moment and the fact that this is a long-term opportunity?

**GF:** Yes, like I said, when we saw some of this decline in the share price recently some of the valuations have come nicely in line with their US counterparts. So I would say the valuations look appropriate for the industry that has a long-term opportunity to build defence equipment.

I think people, investors, even citizens, don't always understand that governments are going to have to set aside a certain level of budget. We're looking for 3.5% of budget out of European countries to build their defence establishments up. And this is something that has to happen every year into perpetuity, right? It's not a short-term event where you buy all this equipment, put it in warehouses and then don't use it, don't train with it and don't need to replace it for 20 or 30 years.

So when we see what's developing in Europe, this is a change in where some of the monies these governments are going to spend is going. And it's a big amount of money, in the \$500 to \$600 billion range this year. Again, as you see the US engaged globally and other problems around the world, Europe is really going to have to posture [position] itself to be able to manage any problems on the continent with less US support.

That means that this \$500 - \$600 billion level is probably not a place that European governments are going to be able to stop [at]. They're going to have to continue to increase the amount of spend and persistently spend year over year. I think that's what creates this this opportunity.

And if valuations are settling in close to where the US peers are, which is the next largest defence industry in the world, that's a pretty good positive for folks that want to invest in the defence business.

**AC:** Let's talk about the European defence sector – about how the Bloomberg Europe Defence Select Index reflects the investment universe for a passive approach to the European defence sector? How does it provide investors with exposure to the sectors that are likely to matter in the future?

**GF:** What we typically see inside the defence world is that the US is potentially the model for how Europe would develop its defence sector, and so far the developments we've seen indicate that that would be true.

You'll typically find companies called prime contractors, and those prime contractors get a large majority of the contracting from the government to build products, build defence systems, right? So the contractor essentially buys the components from a supply chain, assembles them into a system that works, and then delivers it to the government for payment.

As we see that grow in Europe, one of the other big key trends is that a lot of these governments are spending a lot more money on defence than they had a decade ago, and they're trying to spend as much of it as possible in the[ir] home country so they can enjoy any economic multipliers from that increased employment inside the country.

Which also brings revenue back to the government in taxes and things like that. But they want to build up their own industries. Europe's going to have to stay more efficient as they build their defence industry out.

So, as we think about investing in the defence sector in Europe, we think you need to be closest to the largest governments, the largest budgets. And we all know the Big Five – Germany's the largest, and then you've got France, [the] UK, Spain and Italy.

Those are key countries to be investing around. Each has a go-to defence prime that you want to be invested around. One of the constraints on defence investment clearly is going to be these countries' capacity to spend, and Europe has varying degrees of capacity to spend.

And a lot of times what we find is in southern Europe – Italy, Spain and France – there's more challenges around the budget. It's a little more difficult to wedge in that defence spending with existing commitments, so that may take a little more time to develop.

We think the growth is a bit slower in those regions. And what we're finding as well is that in Central Europe and Northern Europe, where there's more capacity inside these budgets to spend – Germany, Scandinavia and Poland – we're seeing faster spending.

And therefore maybe the opportunity is coming sooner to those countries. We also note that this mirrors some of the risk that we're seeing inside Europe. Central Europe to Northern Europe sees a lot more of the immediate risk, with the biggest threat right on their doorstep. That incent[ivise]s them to spend faster.

One of the other big things we note is that Germany is a special case in the middle of this whole increase in defence spending, because Germany is the largest economy on the continent, and has underspent since the end of the Berlin Wall, even before then.

So, we're seeing Germany spend a lot of money and that's going to create even more opportunity. It's going to come in fits and starts – nothing goes up on a straight line – but that's how we think about the opportunity around Europe for investing in defence.

I would also note that the index includes some level of tech spending, but not a huge amount. We think the tech side of defence is super important. We've seen it in fighting around the world, where drones and unmanned systems are becoming more and more important.

They're not overtaking the big manned systems – the fighters or the armoured personnel carriers or the tanks – so you want to be invested around that big, heavy equipment because there's still a lot of opportunity in that part of the industry. But you also want some proportion – not an overloaded proportion – of investment in the tech companies that are going to build these AI-managed drones on the battlefield that help improve visibility on the battlefield through sensors and things like that.

That's the way we think about [our] construction of investment in the defence industry in Europe or even in other regions of the world.

**AC:** Clearly this is a very long-term project in nature, and it represents significant potential for investors via the passive investment approach that we're proposing, using the benchmark that you've constructed and will be administering for us.

Thank you very much, George, for talking us through the situation and the outlook today.

**GF:** Yeah, I enjoyed it. Thank you.

**AC:** That's it for this week's episode of Talking Heads. If you'd like to learn more about our investment insights or about our passive investment approach to investing in European defence stocks, please reach out to your BNP Paribas Asset Management contact, or check out Viewpoint, our website for investment insights, at [viewpoint.bnpparibas-am.com](http://viewpoint.bnpparibas-am.com).

You've been listening to the BNP Paribas Asset Management Talking Heads podcast with me, Andy Craig, and George Ferguson, Senior Analyst for Aerospace, Defence and Airlines at Bloomberg Intelligence.

Please do join us again next week. Until then, take care.