Perspectives Podcast

“Aerospace, Defense and Tariff Turbulence”

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Bentley Kaplan

Hello and welcome to the weekly edition of Sustainability Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode. On today's show, we are going to get into aerospace and defense, an industry that has enjoyed a long period of rising share prices, but it's also one that may come under pressure from rising tariffs and trade barriers. We'll take a look at how things might shape up for two very different corners of this industry, defense and commercial aerospace, and how a long history of demanding regulators and public scrutiny may play into the favour of commercial aerospace companies.

Thanks for sticking around, let's do this. Now, we featured the defense industry pretty recently on the podcast, and with good reason, as an industry that has garnered a lot of attention in recent months as long-standing geopolitical relationships fracture, and governments, particularly those in the EU, look at strengthening their defense capabilities. Defense companies have seen their share prices on the rise, with the MSCI World Aerospace and Defense Index showing strong art performance relative to its MSCI World benchmark.

That's going back to around the middle of 2022 when I was still a young man. Now, in early April of this year, Mike sat down with our colleague Olga Emelianova to discuss the argument that sustainable investing was hindering capital inflows to defense, as some governments feel increasing pressure to rearm. In the episode, Mike explained that our ESG ratings as an opinion of how well a company is managing its financially relevant sustainability risks are not necessarily impacted or affected by the types of weapons a company produces or whether they produce weapons at all. It's much more a signal about how well the company is managing its workforce, its product quality and its efforts in clean tech and governance relative to other aerospace and defense peers.

Olga also gave a helpful breakdown of how investors can choose to screen out broad or specific defense-related products from their portfolios. That's things like cluster munitions, anti-personnel mines, chemical weapons, and or nuclear weapons, but that such screens very much depend on investment mandates. That is a very brief precis. If you're wanting to understand more about sustainability generally and the defense industry more broadly, that's an episode that will give you a very helpful starting point. To hear more, just search for it. It's called Can Bombs and Bullets Be Sustainable.

On today's show, we are looking at an emerging challenge for aerospace and defense companies, namely, a shake-up of global trade agreements. A shakeup that stems from the announcements of new and steep tariffs by the Trump Administration in early April. Because, if like an aerospace and defense company, your product relies on long and complex supply chains, tariffs present a considerable challenge.

In this episode, we're going to look at how this challenge will play out for two different sides of the same industry, commercial aerospace, and defense. You see, quickly finding new suppliers or rejigging your supply chain is always going to be a headache, but not always for the same reason. For commercial aerospace, it's all about quality oversight, a critical part of making commercial airliners, but for defense companies, it's much more to do with national security restrictions, which means you can't exactly shop around for new supplier.

Let's not get too far ahead of ourselves. Let's start with the differences between commercial aerospace and defense, how these different business segments operate and how their products are put together, because most companies in the aerospace and defense industry do a bit of both, but some lean more heavily towards commercial aerospace, like Embraer or Airbus, others like Boeing have slightly larger defense segments, and then others still, like Lockheed Martin or Northrop Grumman lean much more towards defense. To find out more about these differences, I flipped the tables on our show's very own, Mike Disabato, who covers the industry and pointed my mic in his direction.

Mike Disabato

It's just really complicated, the aerospace and defense supply chain because you also have to bifurcate it into these two camps. You have commercial aerospace, and then you have defense, which also includes the aerospace industry, but it's for military, think fighter jets and attack helicopters and stuff like that. While there are companies like Boeing and Airbus and Embraer that do both, they are really two different animals when it comes to company structure and supply chains and operations and all that.

For commercial aerospace, we're talking about an incredibly precise manufacturing process that has to be done over and over and over again, and the planes are all flown in different types of weather and they need to be able to handle any condition for 20 to 30 years of their lifespan, or people die inadvertently. Anyway, this means that airplane manufacturers need to be certain that everything down to the exact type of powdered metal is certified and up to the right standards.

This supply chain for this industry can be four or five, six levels deep, so suppliers of suppliers, of suppliers, of suppliers. It's this massive web of a supply chain. What we do is, we make sure that for all these companies, they're actually watching their suppliers in some way, whether that be through audits of the suppliers themselves or the facilities, or we ensure their suppliers themselves have a quality management system in place for their own production process, and they ensure that the suppliers of their suppliers have sort of a system in place, and then the main company verifies that. Anyway, it's a web.

At least with commercial aerospace, there are so many regulations and regulators theoretically watching the build process, and airlines do all these structured tests on their aircraft to ensure nothing is wearing down sooner than it's supposed to, and they notify everyone if it is, and the aerospace companies have to deal with that. Now, what about defense? Defense is a much different animal. It's a much different animal because not only are there so many more products in defense where you have missiles and submarines and tanks and attack helicopters and massive guns, but also because a lot of these products are state secrets. It's not like the government wants anyone to understand how they build some of their weapons, which might then be used against them.

There's even strict controls around allies when a company sells its weapons to a foreign entity. As far as investors are concerned with this whole process, things are done a bit more in the dark. There's classified builds, there's technically controlled manufacturing processes, the supply chain is a bit more opaque, but luckily you do have some pretty public announcements of who is awarded contracts for these massive weapons by governments because there has to be a bit of oversight by the public. Spends can get into an insane areas. As an investor, you kind of see who is making what. While the details are sparse and opaque, the structure of the supply chain for defense can be sussed out in some ways, like you can do for aerospace and commercial aerospace itself.

Bentley Kaplan

Okay, so clearly two very different dynamics at play here. Commercial aerospace means heavy regulation and tremendous pressure on quality controls. These companies really want to know where their parts are coming from and how well they are being manufactured. Defense is under a different kind of pressure.

These companies are much more entangled in geopolitical dynamics, in relationships between different governments. As Mike says, there may well be less public scrutiny of quality controls, less that has to be made public because operations and products fall under national security or proprietary technology umbrellas. As Mike would tell me, because of their differences, these two parts of the industry might report very differently when it comes to insights on their supply chains.

Mike Disabato

If you think about this on the company level, if you're an investor assessing this on the company level, you want to ensure that these companies have great oversight of their suppliers. For commercial aerospace, you want this because you don't want to have, for example, a door plug blow out at 15,000 feet, which leads to the grounding of the fleet of airplanes that you made, costing you a lot of money and a lot of other things, which as we know happened with Boeing. Or find out that the powdered metal used in the aircraft engines that you made wasn't correctly manufactured, which leads to a lot of questions and grounding and cost, which happened to Pratt and Whitney engines.

For defense, you as a company probably want to be pretty transparent because you want to show government contractors that you can make weapons quickly and accurately, so you can win as many contracts as possible, you want to say to this government contractor, we have the quality control systems in place, we know where our supply chain is, we can deal with shifts and all that. How do these companies actually stack up then if we look at them in detail? Let's use the F-35 made by Lockheed Martin as the subject here. Lockheed Martin uses a number of suppliers to build its F-35.

This isn't an exhaustive list, but you have Rolls-Royce, you have MBDA, have BAE systems, you have BKN Aerospace, you have Leonardo, you have GKN Aerospace, Norway, you have Terma. These are a lot of the suppliers of Lockheed Martin Tier One products for its F-35. Now, they all use parts from their own suppliers, which are their Tier Two suppliers, and then all these parts together, they have raw material supplies, which we consider their Tier Three suppliers.

Lockheed has good disclosure around how it audits and ensures its Tier One suppliers are following good quality management protocols, but it doesn't disclose much on its Tier Two or Tier Three suppliers. That might be because Lockheed doesn't really have that much exposure to commercial aerospace and they think they don't need to disclose in the same way commercial aerospace does, because if you look at the top five aerospace and defense companies by market cap, you have GE, RTX, Boeing, Lockheed Martin, and Airbus, and you see the two major aircraft manufacturers in that list, Airbus and Boeing, they disclose on how they audit and ensure all their suppliers are following good quality management protocols.

That's Tier One, Tier Two and Tier Three, but GE, RTX and Lockheed who are much more exposed to the defense sector, they only disclose on their Tier One suppliers and how they assess their quality management systems. If you look broadly at the aerospace and defense industry, you see that Boeing and Airbus are more or less the outliers, and there's not that many that make commercial aerospace, so that kind of makes sense, because around 75% of companies in our aerospace and defense coverage disclose on their Tier One supplier's oversight, but that number drops to 25% for the Tier Two and Tier Three suppliers, which makes a pretty opaque industry.

Bentley Kaplan

Right. Mike was able to leverage the data that we collect on aerospace and defense companies, specifically under our product safety and quality key issue. In terms of supplier traceability, the data here tells a story of two very different business types. For commercial aerospace, because companies operate in a highly regulated environment, they do have oversight of their suppliers. They not only know where their upstream suppliers are based, but they monitor their quality controls and their performance.

For defense companies, the picture is very different. They aren't compelled to report publicly on these statistics, which is not to say that they don't collect the data or monitor their suppliers and supply chains closely, but our data shows that investors in these companies generally don't have that kind of insight, at least based on public disclosures. My last question to Mike was, okay, so you have commercial aerospace and you have defense, and one side of this industry has good supplier data, at least they're reporting it, and one may or may not, we just can't be sure, so what are some early markers that investors will be watching? Is there any early sign that commercial aerospace is in a better place to respond to new tariffs? It turns out that, well, it's still very much wait and see.

Mike Disabato

Tariffs have created a greater risk around this lack of disclosure because it's hard for investors to know if these companies are actually able to prepare for increased costs in their supply chains. If you listen to the earnings calls from any of these companies, they sort of run the gamut on how they're preparing for the impact of tariffs in 2025. Embraer downplayed the impact. Howmet Aerospace threatened to pull a force majeure on their contracts to get out from under adverse contracts due to tariffs. The details of that are so lawyer specific, it doesn't matter, they're just trying to get out of the way of contracts that are bad because of tariffs. Airbus said they didn't even want to predict anything because things are changing so quickly and in any time. Each company there seems to be taking its own root on how things are going to unfold.

It's hard, right now, to be certain, each really understands exactly where their costs may creep in because it's hard to us to know if these companies have the strongest oversight over their vast supply chains. You might be thinking, Mike, come on, just because your data says this, and just because they don't disclose, that doesn't mean they don't know where everything is coming from. I would point you to Philadelphia where a major fire on February 17th at a factory owned by SPS technologies, which make these highly specialized and vital punch for aircrafts, all sorts.

When this happened, Boeing had to send a letter to its suppliers where they said, do you regularly use parts from SPS because we need to know, and can you explain the impact of SPS could not ship the parts that were ordered? This is from a report that Reuters saw and reported on. You can go review that if you want. What that says is that Boeing needs to ensure from its suppliers that its suppliers actually understand where their supply chain is. It's a opaque and mysterious supply chain at times in this very important and complex industry.

Bentley Kaplan

That is it for the week. A massive thanks to Mike for his take on the news with a sustainability twist. I also want to say thank you very much for tuning in. If you like what we're doing, then let us know. Drop us a review, rate the show on your platform of choice and tell a friend or colleague about this episode. Thanks again, and until next time, take care of yourself and those around you.

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