

Perspectives Podcast

“Aerospace, Defense and Tariff Turbulence”

Transcript, 9 May, 2025

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 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.

The MSCI ESG Research podcast is provided by MSCI ESG Research LLC, a registered investment advisor under the Investment Advisors Act of 1940, and a subsidiary of MSCI Inc, except with respect to any applicable products or services from MSCI ESG Research, neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products, or instruments or trading strategies. An MSCI's products or services are not intended to constitute investment advice or recommendation to make or refrain from making any kind of investment decision and may not be relied on as such. The analysis discussed should not be taken as an indication or guarantee of any future performance, forecast or prediction. The information contained in this recording is not for reproduction in whole, or in part, without prior written permission from MSCI ESG Research. Issues mentioned or included in any MSCI ESG Research materials may include clients of MSCI or suppliers to MSCI and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in any MSCI ESG indexes or other products, have not been submitted to, nor received approval from the United States Securities and Exchange Commission or any other regulatory body. The information provided here is as is, and the user of the information assumes the entire risk of any use it may make or permit to be made of the information. Thank you.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit www.msci.com.

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. or its subsidiaries (collectively, "MSCI"), or MSCI's licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the "Information Providers") and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or disseminated in whole or in part without prior written permission from MSCI. All rights in the Information are reserved by MSCI and/or its Information Providers.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, "Index Linked Investments"). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investible assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. The calculation of indexes and index returns may deviate from the stated methodology. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on www.msci.com.

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.'s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.'s company filings on the Investor Relations section of msci.com.

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI's products or services are not a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such, provided that applicable products or services from MSCI ESG Research may constitute investment advice. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been

submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body. MSCI ESG and climate ratings, research and data are produced by MSCI ESG Research LLC, a subsidiary of MSCI Inc. MSCI ESG Indexes, Analytics and Real Estate are products of MSCI Inc. that utilize information from MSCI ESG Research LLC. MSCI Indexes are administered by MSCI Limited (UK).

Please note that the issuers mentioned in MSCI ESG Research materials sometimes have commercial relationships with MSCI ESG Research and/or MSCI Inc. (collectively, "MSCI") and that these relationships create potential conflicts of interest. In some cases, the issuers or their affiliates purchase research or other products or services from one or more MSCI affiliates. In other cases, MSCI ESG Research rates financial products such as mutual funds or ETFs that are managed by MSCI's clients or their affiliates, or are based on MSCI Inc. Indexes. In addition, constituents in MSCI Inc. equity indexes include companies that subscribe to MSCI products or services. In some cases, MSCI clients pay fees based in whole or part on the assets they manage. MSCI ESG Research has taken a number of steps to mitigate potential conflicts of interest and safeguard the integrity and independence of its research and ratings. More information about these conflict mitigation measures is available in our Form ADV, available at <https://adviserinfo.sec.gov/firm/summary/169222>.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and S&P Global Market Intelligence. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and S&P Global Market Intelligence.

MIFID2/MIFIR notice: MSCI ESG Research LLC does not distribute or act as an intermediary for financial instruments or structured deposits, nor does it deal on its own account, provide execution services for others or manage client accounts. No MSCI ESG Research product or service supports, promotes or is intended to support or promote any such activity. MSCI ESG Research is an independent provider of ESG data.

Privacy notice: For information about how MSCI collects and uses personal data, please refer to our Privacy Notice at <https://www.msci.com/privacy-pledge>.