CREDO WEALTH

An attractive defensive play

The USA is the largest military spender in the world. It thus stands to reason that seven out of the ten largest defence companies in the world are also American. The US Department of Defence's (DoD) decision on how much to spend, is therefore a driving factor for both allies' and foes' military budgets as well as the performance of defence stocks.

Since President Biden's election, concerns that he will choose to cut funding have been hanging over the sector. There are multiple reasons for this, including the precedent set during the Obama-Biden administration. In the aftermath of the Global Financial Crisis, as Congress had just passed a stimulus package sending federal spending soaring, a law was signed which capped the defence budget for a period of ten years. At the time, it was believed that this would wreak havoc on the defence industry, affecting more than a million US jobs and undermining any prospects for growth in the industry.

A decade later, Biden pledged to maintain the US military's superiority on the campaign trail, but with a caveat that this must be done affordably (criticizing President Trump's consistent increase in spending in the process). Seemingly in a similar situation to the one in 2009, with a growing fiscal deficit as a result of the Covid-19 pandemic, the thought has been that cuts will need to be made by the DoD to effectively fund the stimulus spending. As a result, the defence sector has been trading at the lowest absolute valuation in multiple years and the lowest relative valuation in decades.

Out of favour sectors can often contain attractive opportunities if the risks are priced in. In this case, we considered that the risk of a cut to the defence budget was both well-known and priced in. Within the sector, we see an opportunity specifically in Raytheon Technologies (RTX), providing us with exposure to both defence and commercial aviation, and in Northrop Grumman (NOC), a pure-play defence prime. We own both stocks in the Credo Global Equity Fund and RTX in our managed equity portfolios.

We like defence companies for several reasons. Firstly, they benefit from structural tailwinds. While a defence budget cut might be on the cards for an incoming administration, continuously growing geopolitical tensions are sure to offset possible cuts in one area with a heavy investment in another in order to keep up with the capabilities of the enemy.

Moreover, certain sectors of military spending are either monopolies or operate in an oligopolistic environment where two contractors could divide the projects among themselves. Participating successfully in tenders is a skill in itself, allowing the defence primes to leverage their expertise and cross-sell, thereby capturing a larger share of the budget. Hence, barriers for new entrants are extremely high while rewards are sticky as it is expensive to switch suppliers. Government programs could span across decades, and given they are agreed on a certain level of profitability, stable margins and returns on capital are ensured. We are thus presented with quality stocks that have resilient business models and return cash to shareholders on a regular basis. ▶▶

Apart from their solid positioning, we believe RTX and NOC will also benefit from idiosyncratic factors. RTX is a product of the 2020 merger of aircraft engine manufacturer, United Technologies, and missile specialist, the Raytheon Company. The stock offers exposure to a mix of a cyclical, commercial aerospace business and a stable defence contractor. As the pandemic halted flying, it wiped out a significant portion of the company's earnings which is derived from its civil engines and aftermarket sales. Aerospace peers suffered the same consequences. However, the defence division proved more resilient, allowing RTX to continue investing in the business, ultimately creating opportunities for market share gains.

NOC, on the other hand, as a prime US defence contractor, has spent the past few years repositioning itself in the most important segments of defence. Its high exposure to space (the fastest growing field of modernisation) as well as unmanned systems ensure an offset even in the case of budget cuts. Furthermore, the company is involved in two of the three legs of modernisation of US nuclear defences, which are contracts that will span over multiple decades and provide visible growth throughout changing administrations. As a consequence of its favourable positioning and stable earnings, NOC consistently returns cash to shareholders, paying out $4bn in dividends and having done approximately $7bn worth of share repurchases in just the last five years, for example.

Both RTX and NOC have strong financial metrics and are highly profitable as measured by returns on invested capital. They are also highly cash generative and have low balance sheet leverage.

We see the potential for a rerating in both companies should market sentiment around the defence budget improve. However, in the meantime we are getting access to steady and attractive earnings growth, boosted by excess free cash flow being deployed into shareholder returns. Sitting at the cross-section of value and quality, we believe that these companies represent attractive opportunities at the current time. ■

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