Hosking Partners®

Babcock International

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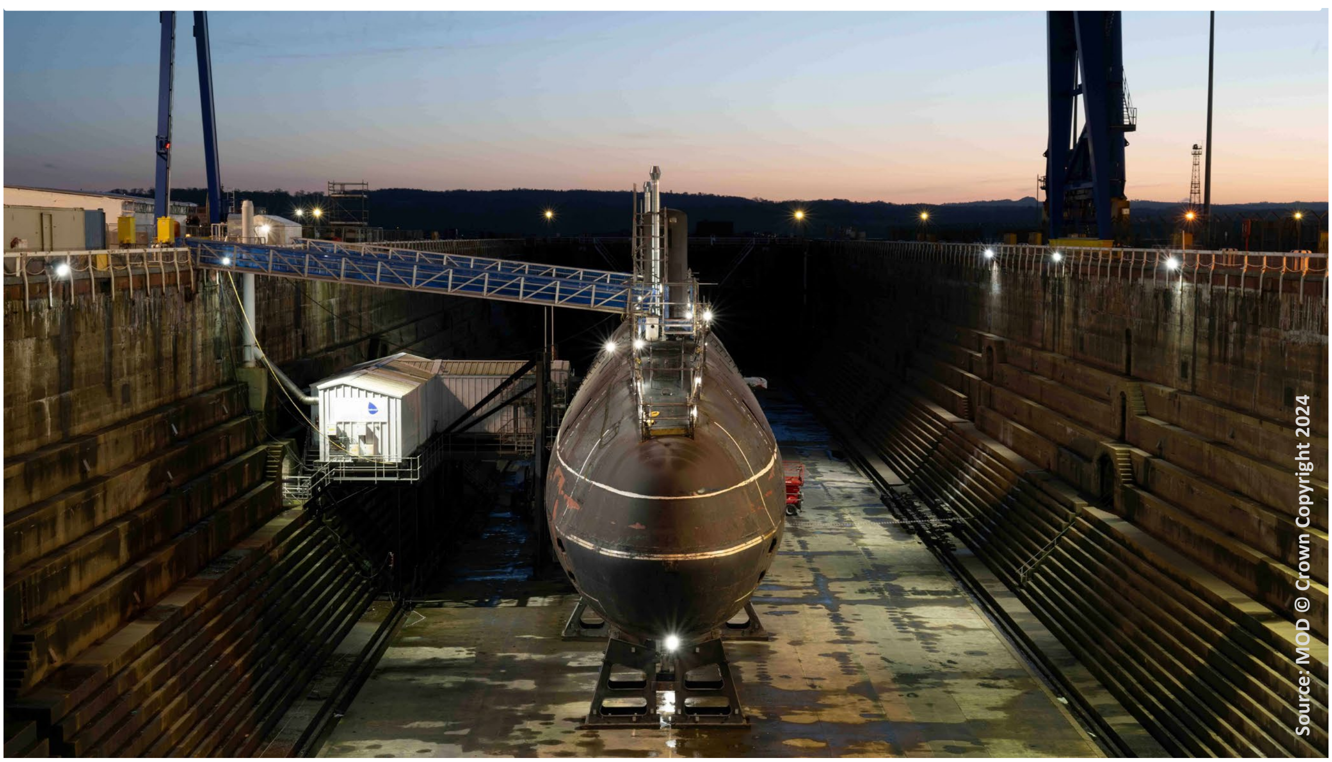
www.hoskingpartners.com | info@hoskingpartners.com | +44 (0) 20 7004 7850 | 11 Charles II Street, London, SW1Y 4QU

A focus on… Babcock International

- Rising geopolitical tensions around the world have prompted the Hosking Partners team to re-examine a long-held underweight to the Defence sector.
- Under new management since 2020, Babcock is a well-positioned turnaround tale built on the foundations of unique strategic assets and a revamped revenue model.
- Meanwhile, tight governance and clear alignment with democratic Western governments provide confidence in the company's broader impact.

The Hosking Partners portfolio is – and has historically remained – underweight the Defence and Aerospace sector (as of the end of Q3, the portfolio holds 94bps in Aerospace & Defence versus 179bps in the benchmark, based on the Hosking Representative Portfolio and MSCI ACWI respectively). This is a result of our bottom-up, capital cycle approach. Valuations amongst the large US Defence companies have been high, while we have been cautious that they are overearning as beneficiaries of inefficient state procurement systems. The direction of government spending is hard to predict at the best of times, and the US Defence industry is doubly difficult to penetrate due to the scaffold of complex and opaque lobbying relationships. Meanwhile, although the Defence megacaps have maintained a theoretically attractive oligarchic hold on 'big bits of kit' (think aircraft carriers), the relevance of this sort of technology seems increasingly challenged by non-conventional military competitors. In short, the market for delivering Defence effect has seemed oversupplied, while the future character of conflict remained unclear.

Since the invasion of Ukraine, we have begun to reexamine this position. While overall the sector remains a difficult one with which to get fully comfortable, if the world is indeed entering a period of geopolitical multipolarity then opportunities should exist at the right price. In March 2023, we initiated a position in British Defence engineering services company



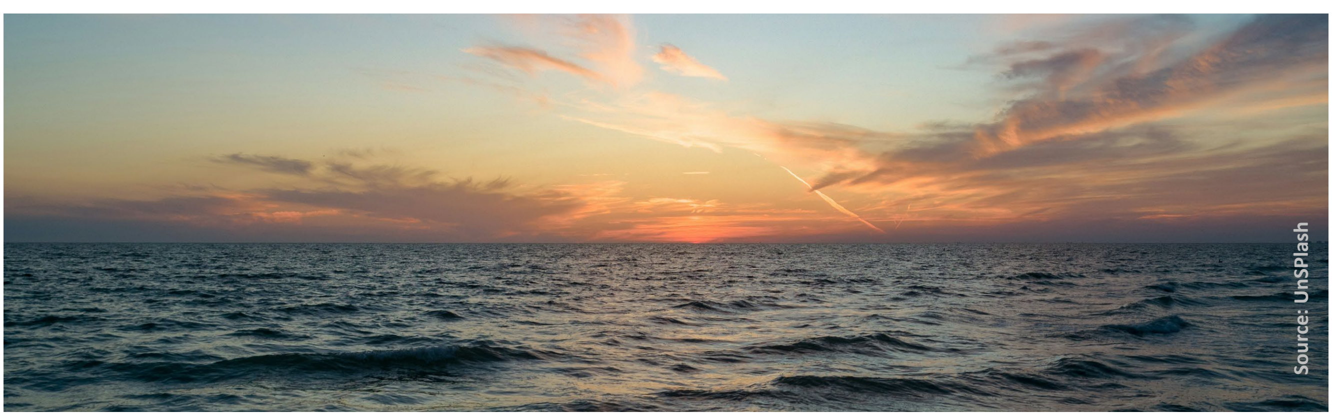
Babcock International Group Plc. The thesis is predicated on the idea that maintaining a continuous at-sea nuclear deterrent – and the naval hardware that supports it – will remain critical for the UK and is in fact seeing increased cross-party government support after years of uncertainty. International treaties like AUKUS, with other Western allies, further entrench this trend. Due to high technical and security-related barriers to entry, the companies that can deliver this service are few.

After years of mismanagement, Babcock International is a turnaround story. The new executive team, who joined in 2020, has focused on operational streamlining, including cleaning the balance sheet and resolving a pension drag, both of which are running ahead of target. The most interesting change, however, has been the renegotiation of submarine maintenance work to something close to a cost-plus model, as government priorities have shifted to maintaining availability rather than cost containment. Refitting the fleet of 20-year-old submarines caused Babcock major issues in the past, as the work is difficult to price before the submarine is dry-docked and works begin. As Babcock's largest contract, accounting for 20-30% of sales, one could now think of the new cost-plus model as providing a fixed 20-year annuity stream, which significantly de-risks the group and should justify a rerating.

Meanwhile, the British government remains fiscally constrained, and so outlays on new submarine hardware are likely to be delayed with extended maintenance of existing capability instead prioritised. Babcock's part-ownership of Devonport and Rosyth dockyards means it is the only company in the UK that can conduct most of the UK's surface fleet refits and upgrades, as well as maintain its nuclear submarines, which provides a tangible moat against competition. This position is being further entrenched via the £750m construction of Dock 10 at Devonport, providing an additional nuclear submarine drydock, an essentially irreplaceable strategic asset for the UK.

Any investment in Defence also requires consideration of the target company's role within the broader military-industrial complex, where the mixture of a profit incentive with the occurrence of conflict demands careful appraisal. The frequency and severity of conflict is an emergent property of a multitude of geopolitical, economic, and sociocultural factors. Despite fluctuations over time, conflict has never truly disappeared from the global stage. Nuclear weapons are intended to act as a stabilising force by deterring large-scale interstate conflicts but come at the cost of the perpetual threat of their use. Meanwhile, the concurrent emergence of the digital age with the rise of growing powers like China and India means multipolarity is the increasingly dominant geopolitical paradigm. Pulling apart whether Defence companies benefit passively from the occurrence of conflict, actively contribute to it, or help prevent it, is no simple task.

At Hosking Partners, we believe the consideration of such issues should be about embracing complexity, rather than simplifying or reducing it. As the world moves towards a period of heightened tension and instability, the importance of transparency and accountability in the governance of the companies that produce weapons rises. Whether nuclear, conventional, or otherwise, we believe these companies should be publicly owned entities with shareholders who take an active interest in their management. This governance structure promotes greater oversight and ethical responsibility. In our view, companies like Babcock, who work overwhelmingly with Western governments whose procurement strategies are backed by a democratic mandate, represent the most responsible and long-term way to access this opportunity.



Appendix I

VOTING PROCESS

Hosking Partners has subscribed to the 'Implied Consent' service feature under the ISS Agreement to determine when and how ISS executes ballots on behalf of the funds and segregated clients. This service allows ISS to execute ballots on the funds' and segregated clients' behalf in accordance with ISS recommendations. Hosking Partners retains the right to override the vote if it disagrees with the ISS recommendation. In practice, ISS notifies Hosking Partners of upcoming proxy voting and makes available the research material produced by ISS in relation to the proxies. Hosking Partners then decides whether or not to override any of ISS's recommendations. A range of factors are routinely considered in relation to voting, including but not limited to:

- **Board of Directors and Corporate Governance**. E.g. the directors' track records, the issuer's performance, qualifications of directors and the strategic plans of the candidates.
- **Appointment / re-appointment of auditors**. E.g. the independence and standing of the audit firm, which may include a consideration of non-audit services provided by the audit firm and whether there is periodic rotation of auditors after a number of years' service.
- **Management Compensation**. E.g. whether compensation is equity-based and/or aligned to the long-term interests of the issuer's shareholders and levels of disclosure regarding remuneration policies and practices.
- **Takeovers, mergers, corporate restructuring and related issues**. These will be considered on a case by case basis.

In certain circumstances, instructions regarding the exercise of voting rights may not be implemented in full, including where the underlying issuer imposes share blocking restrictions on the securities, the underlying beneficiary has not arranged the appropriate power of attorney documentation, or the relevant custodian or ISS do not process a proxy or provide insufficient notice of a vote. The exercise of voting rights may be constrained by certain country or company specific issues such as voting caps, votes on a show of hands (rather than a poll) and other procedures or requirements under the constitution of the relevant company or applicable law.

The decision as to whether to follow or to override an ISS recommendation or what action to take in respect of other shareholder rights is taken by the individual portfolio manager(s) who hold the position. In circumstances where more than one portfolio manager holds the stock in question, it is feasible, under the multi-counsellor approach, that the portfolio managers may have divergent views on the proxy vote in question and may vote their portion of the total holding differently.

ENGAGEMENT PROCESS

Hosking Partners recognises that ESG considerations are important factors which affect the long-term performance of client portfolios. ESG issues are treated as an integral part of the investment process, alongside other relevant factors, such as strategy, financial risk, capital structure, competitive intensity and capital allocation. The relevance and weighting given to ESG and these other issues depends on the circumstances relevant to the particular investee company and will vary from one investee company to another. Whilst Hosking Partners may consult third-party ESG research, ratings or screens, Hosking Partners does not exclude any geographies, sectors or stocks from its analysis based on ESG profile alone. The multi-counsellor approach, which is deliberately structured so as to give each autonomous portfolio manager the widest possible opportunity set and minimal constraints to making investment decisions, means that ESG issues and other issues relevant to the investment process are evaluated by each portfolio manager separately, with the support of the Head of ESG.

Interaction with management and ongoing monitoring of investee companies is an important element of Hosking Partners' investment process. Hosking Partners does however recognise that its broad portfolio of global companies means that the levels of interaction are necessarily constrained and interaction will generally be directed to those investee companies where Hosking Partners expects such involvement to add the most value. Monitoring includes meeting with senior management of the investee companies, analysing annual reports and financial statements, using independent third party and broker research and attending company meetings and road shows.

Hosking Partners looks to engage with companies generally, and in particular where there is a benefit in communicating its views in order to influence the behaviour or decision-making of management. Engagement will normally be conducted through periodic meetings and calls with company management. It may include further contact with executives, meeting or otherwise communicating with non-executive directors, voting, communicating via the company's advisers, submitting resolutions at general meetings or requisitioning extraordinary general meetings. Hosking Partners may conduct these additional engagements in connection with specific issues or as part of the general, regular contact with companies.

Some engagements highlighted in this publication are part of an ongoing two-way dialogue, and as such Hosking Partners may not always publish the specific details of engaged firms. Where this is the case, further information about the engagements is available to clients upon request.

Appendix II

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