BABCOCK INTERNATIONAL: THE NEXT LINE OF DEFENCE

MARCH 2026

Rising geopolitical tensions over the past several years have prompted a reassessment of long-standing assumptions around defence spending and national resilience, and particularly in the UK, the role of affordable and dependable energy.

Against this backdrop, Hosking Partners' portfolio holding in leading defence company Babcock International has emerged as a critical player in the UK, specifically for maintaining the nation's nuclear and naval capabilities. The tailwinds behind the company's recent growth resurge is expected to continue as Europe strengthens its defence amongst an ever-increasing volatile geopolitical future.

Jeremy Hosking first initiated a holding in Babcock in March 2023, following a “single stock pitch idea” from then-analyst Omar Malik, establishing a small position following a reassessment of the defence sector in light of these evolving geopolitical realities. Babcock presented itself as an operational turnaround story under a new management team that joined in 2020, with significant progress made in restructuring the balance sheet, improving contract economics, and refocusing the business on core engineering competencies. The shares also traded at a significant discount to the replacement value of the asset base, a phenomenon we often see at the bottom of a cycle. Here, we explore why we have continued to build out our exposure since first entering the position and look at the importance of our ongoing engagement activity with the management team.

Babcock International is one of the UK’s most strategically essential engineering services companies, specializing in the management of complex defence and nuclear assets. Its responsibilities include maintaining the UK’s continuous at sea nuclear deterrent and managing three of four key dockyard assets in the UK – HMNB Devonport, HMNB Clyde, and Rosyth. In the case of Devonport and Rosyth, they directly own these irreplaceable assets. It remains one of two operators capable of performing nuclear submarine refits, upgrades, and life extension work at scale. This unique positioning has only grown in importance since Russia’s invasion of Ukraine, which reignited cross-party support in the UK for strengthening the deterrent with a particular focus on submarines.

With public perceptions shifting, defence companies such as Babcock have increasingly been categorised by investors less as controversial investments and more as essential companies for continued national security.

The shift of Babcock’s largest contract, managing the submarine fleet, towards a cost-plus model in early 2024 represented a material de risking of the business. We could see a clear path towards a more stable, long cycle business operation aligned with the UK government’s renewed focus on availability and readiness, rather than cost minimisation.

As a result, two additional portfolio managers added Babcock to their holdings. This is the typical lifecycle of a position in the Hosking Partners portfolio and shows the benefits of our multi-counsellor approach. An idea is surfaced and initiated by one portfolio manager, leading to increased conviction over time as the idea is monitored and discussed internally, followed by purchases by other portfolio managers at opportunistic price points.

Part of our investment approach also involves active, constructive engagement with management on capital allocation and governance matters, which has certainly been the case with Babcock. We have maintained a consistent dialogue with Babcock's leadership regarding operational priorities, financial discipline, and shareholder returns.

In late 2024, we sent a letter advocating for the company to pursue a share buyback program in order to opportunistically take advantage of the undervaluation of Babcock's shares. Despite four years into the turnaround and significant improvements across operations, culture, and financial strength, we felt the shares remained stubbornly depressed at 8x operating profits. We also expressed our desire to engage with the board regarding the management incentive scheme, which we felt was inadequate in highlighting the long-term opportunity at Babcock. Six months after our correspondence, the company announced the launch of a £200m share buyback programme.

More generally, throughout our ownership we have found Babcock's management team to be open, engaged, and strategically aligned with long-term investors. This receptiveness to shareholder input stands in contrast to the historical perception of defence contractors as opaque, overly bureaucratic entities. Babcock's new leadership has demonstrated a willingness to modernise both operations and capital allocation policies, which has been instrumental in restoring confidence across the investor base.

Since our initial investment in March 2023 and our last piece written on Babcock in the Q3 2024 AOR, shares in the company have risen +447% and +214%, respectively, reflecting fundamental improvements made at Babcock in the last three years. Accelerating revenue growth and consistent margin expansion are having significant impacts on the bottom line with Babcock reporting record underlying operating profits in the last 12 months.

A de-levered balance sheet and the emergence of new growth opportunities following increased defence spending in Europe has also had a meaningful impact. It is worth noting the shift in investor perceptions around defence companies, with companies across the board having seen their valuations increase, including Babcock's.

The post Ukraine environment has redefined defence companies as essential contributors to national and allied security. The public continues to recognise the importance of deterrence, cyber security, and the maintenance of vital infrastructure.

One of the potentially most promising and least appreciated business areas within Babcock is the company's civil nuclear engineering division. While it remains early days, given the UK government's explicit intention to accelerate nuclear power deployment, there is a credible argument that we could be at the beginning of a new cycle.

After a period of consolidation during the downturn, Babcock is the only surviving British company with the capabilities to service nuclear power stations and to take advantage of the emerging opportunities in advanced and small modular reactors. Given the sensitive security concerns around nuclear the government is likely to favour domestic incumbent with the correct regulatory credentials and high levels of trust. The nuclear division is one of the group's highest-margin areas and could become a meaningful driver of future profit growth if the government is serious about addressing the UK's high energy costs. Despite the exciting opportunity ahead, management is clear that the scale of the opportunity will depend on the economic terms of the contracts offered to the private sector. An important discipline to avoid repeating the mistakes Babcock made in defence a decade ago.

From an ESG angle, owning defence and nuclear companies carries inherent complexity, requiring far more nuance than simplistic ESG frameworks often allow. At Hosking Partners, we employ a holistic approach to ESG and assess each company and its particular circumstances on a fundamental case-by-case basis.

We see Babcock playing a necessary and stabilising role in maintaining credible military deterrence for NATO nations. Its blend of irreplaceable national infrastructure assets, specialised engineering known-how, improved financial discipline, and renewed growth tailwinds continue to make it an attractive investment opportunity in the defence sector at Hosking Partners.

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