

BARON INSIGHTS

Mission Ready: Unlocking Value in Aerospace & Defense



Rebecca Ellin
VP, Research Analyst



Neil Parekh
Research Analyst

Key Takeaways

- We are in an environment of increasing demand for the aerospace and defense (A&D) industry.
- While the major A&D players continue to face supply chain and other challenges, select smaller players offer exceptionally promising opportunities for long-term growth, in our view.
- The aftermarket segment is poised for continued expansion due to the need to keep older planes in service longer.
- The industry is also leaning into innovative technologies to develop new and improved products, drive efficiencies, and save on costs, another area where select companies can excel.

*Note: For an in-depth discussion of **Space Exploration Technologies Corp.** (SpaceX), you can watch a replay of our recent Thought Leadership Forum on SpaceX or read our Baron Insights piece on SpaceX by visiting our website.*

Industry Overview

The aerospace and defense industry consists of manufacturers of civil or military aerospace and defense equipment, parts, or products, including defense electronics and space equipment. The industry is dominated by big, well-known companies such as The Boeing Company, General Dynamics Corporation, and Lockheed Martin Corporation, which manufacture commercial and military aircraft and defense systems. Smaller, more specialized players supply components and aftermarket products and services for these platforms.

Although there is overlap in the companies that supply the industry, the end markets for aerospace and defense are distinct. The commercial side is somewhat cyclical, although less cyclical than Industrials overall, as air travel is a consumer discretionary category that follows a more modest cycle than the industrial/business capex cycle. Typically, defense stocks are considered defensive in the market due to the underpinning of long-term contracts combined with steady after-market/replacement revenue.

Increasing demand

We are currently in an environment of increasing demand for both categories. Air travel was strong in 2024, having more than recovered from the pandemic dip. Traffic (as measured by revenue passenger kilometers) increased 10.4% from 2023. This was 3.8% higher than pre-pandemic levels and a record high both internationally and domestically.¹ With the rising middle classes in countries like China and India and more than 75% of people overall never having flown, we believe growth will continue at a mid-single digit rate for the foreseeable future.

U.S. defense spending has been on an upward trend following the 2015 bottom a decade ago.² The FY 2025 budget is \$842 billion. The increase in spend is being driven by a new era of competition with China and Russia. This new era is evident in a 2018 U.S. National Defense Strategy document -- the first instance since the Cold War in which the Department of Defense shifted its focus to the “great powers” as opposed to regional adversaries or terrorism. Wars in the Middle East and Ukraine have added to incentives to increase spend. Looking ahead, we believe defense spending in the U.S. will grow in concert with GDP or slightly higher. The EU’s recent endorsement of a plan to unlock \$866 billion in military spend in a bid to decouple from its reliance on the U.S. signals increased defense spend in that region as well.

¹ Source: IATA - Global Air Passenger Demand Reaches Record High in 2024, 1/30/2025.

² Source: U.S. Department of Defense.

Aerospace Industry

Surging Demand, Restricted Supply

5.85 billion

Total passenger seats³

16,783 planes

Global aircraft order backlog⁴

13.8 years

Estimated time needed to fill existing orders⁴

Supply challenges

The major A&D players continue to face challenges ranging from supply chain issues to talent and production shortages. The industry is characterized by a highly complex supply chain with multiple tiers of suppliers. For instance, an average U.S. commercial aerospace manufacturer has more than 200 Tier 1 suppliers and 12,000 Tier 2 or Tier 3 suppliers.⁵ Consolidation over the past decade, especially among Tier 2 and Tier 3, has reduced the diversity of supply sources and heightened the risk of shortages.⁶ While many companies have started working to balance supply chain resilience with efficiency, parts shortages and delivery delays, shipping costs, and sourcing concerns appear likely to continue, at least for the near term, driven by global labor shortages and increasing geopolitical tensions.

The key players developing and building core defense technologies have had difficulty expanding margins, as fixed cost contracts continue to plague the space, while a strained defense supply chain and limited workforce are driving costs higher. Commercial aviation faces challenges to profitability as well, due to high operating costs, intense competition, fuel price volatility, and evolving industry dynamics, including the need for sustainable practices.

For these reasons, we prefer to focus on smaller players operating within pockets of higher-than-average growth. We also like companies that are disrupting their markets through innovative technologies.

The aftermarket segment

The aftermarket segment, which is also known as maintenance, repair, and overhaul (MRO), is one of these pockets of higher growth. Demand is being driven by a surge in global travel coupled with ongoing supply constraints, necessitating that older aircraft stay in service longer. Despite overcapacity issues, there has been no meaningful change in aircraft order or delivery patterns in the past year or so. Both Boeing and Airbus remain in a holding pattern on producing and delivering new units due to manufacturing quality and labor issues in the case of Boeing and supply chain challenges in the case of Airbus.⁷ The global backlog of new aircraft orders reached a record total of 16,738 as of the end of 2024, which is estimated will take 13.8 years to fill.⁴

TRANSDIGM
GROUP INC.

This ongoing shortage of new planes plays directly into the hands of **TransDigm Group, Inc.**, which specializes in highly engineered parts for original equipment manufacturers (OEM) and the aftermarket. Its parts are custom designed and approved at the pre-production stage. The stringent approval process and typically low cost (<\$1000) of each part make it impractical for competitors to knock off its catalog, and TransDigm is the sole source for 80% of its products. This leads to stability and visibility of revenues as aircraft models tend to be in service for decades. It uses the cash flow from its highly profitable portfolio to make accretive acquisitions, creating efficiencies through economies of scale. While TransDigm earns a modest return on OEM parts, it earns large margins in the aftermarket. In recent years, management has focused the latter, and around 90% of its 2023 sales came from this segment.

Since its founding two decades ago, TransDigm has been one of the most reliable performers in the A&D industry. Over the past 10 years, the stock has appreciated nearly 843%. We see plenty of runway ahead, given TransDigm's leading position within its markets, reputation for engineering excellence, emphasis on innovation, and mission-critical nature of its products.

³ Source: Global Aviation Sets a Passenger Seat Record in 2024 - AVSN

⁴ Source: Global aircraft order backlog: another new record at 14 years. Airbus outsells Boeing, again | CAPA

⁵ Source: 2025 Aerospace and Defense Industry Outlook | Deloitte Insights, 10/23/2024.

⁶ Source: Overcoming challenges in aerospace procurement | McKinsey, 7/17/2024.

⁷ Source: <http://finance.yahoo.com/news/why-transdigm-group-tdg-among-192412443.html>

HEICO

HEICO Corporation, a manufacturer of aircraft parts and electronic system sub-components, has a business model similar to TransDigm centered on acquiring specialized manufacturers of critical niche parts with limited competition. This model allows HEICO to focus on delivering value to the customer (it sets prices below the OEM provider and seek to keep prices reasonable).

The similarity extends to both companies' emphasis on innovation and engineering excellence to maintain their competitive edge. With more than 70 operating companies, HEICO is the largest independent provider of FAA-approved aircraft replacement parts.

HEICO's share price has appreciated roughly 768% over the past decade. As with TransDigm, we see a long growth runway ahead. While both companies are leaders in their niche markets, the aftermarket segment is still highly fragmented, with tens of thousands of Tier 2 and 3 companies as potential acquisition candidates.

TransDigm and HEICO are what we call continuous compounders – companies that consistently generate incremental wealth for shareholders through a combination of profitable operations and effective capital deployment. While the end markets of continuous compounders may vary, they have a number of features in common. The continuous compounders we favor operate a diverse portfolio of niche businesses serving high-growth specialized markets. They focus on high-quality products with minimal commoditization, which offers the potential for pricing power and faster growth than their end markets. The products are key to customer operations while representing a low percentage of overall costs, which reduces the potential for switching. They generate substantial free cash flow. And they are managed by experienced leadership who emphasize continual improvement in cost structure and the use of free cash flow to acquire and integrate companies to generate additional growth.

The recent IPOs of **Loar Holdings Inc.**, an alliance of a dozen companies specializing in niche products; and **StandardAero, Inc.**, a provider of MRO to the aerospace industry, underscore the strong investor conviction in the aftermarket. With estimated annual growth in global airline travel of 5.6%⁸ and the projected acceleration in government defense budgets, we think the growth engine for both TransDigm and HEICO will continue to hum.

Disruptive growth companies

Another avenue where we have found outsized growth within A&D is with companies disrupting existing markets or creating their own market opportunities through differentiated technologies and/or products and services.

KRATOS®

Kratos Defense & Security Solutions, Inc. is a technology company that is a significant player in the military drone market, particularly with its XQ-58 Valkyrie. Its stock price has more than doubled in five years, although it took a beating along the way. In recent months, however, we think Kratos may have reached an inflection point with a path to strong, sustainable, long-term growth.

In January 2025, Kratos won a \$1.45 billion contract from the Department of Defense to develop testing capabilities for hypersonic drones, marking the largest award in the company's history. The contract, along with collaborations with partners such as RocketLab and Leidos, should help solidify Kratos' place in the defense technology landscape. Kratos' growth potential could also be bolstered by the growing importance of autonomous military vehicles, which are expected to see faster production cycles and lower costs than traditional legacy defense projects. Despite some concern that defense budgets will be reduced under Trump, the push for efficiencies may, in fact, increase demand for innovative and cost-effective technologies such as drones. Kratos' "Loyal Wingman" project is another possible growth driver. This AI-driven military drone offers significant cost savings and operational advantages compared to traditional manned aircraft.

With increasing defense spending and Kratos' strong position in emerging sectors like hypersonic vehicles, we see substantial upside potential driven by defense innovation and government contracts.

AXON

Axon Enterprise, Inc., which makes tasers, body and vehicle cameras, and software for law enforcement, is another excellent example of a disruptive growth company in A&D. The company was the first to successfully market the taser, a non-lethal electric weapon, to police, and now has a near monopoly in that market. Its body and vehicle cameras have been equally as successful, and Axon has an estimated 85% share of that market. The company has built on its success with software linked to its devices that range

⁸ Source: Air Travel Demand Outlook 2025: Growth Persists | BCG

from digital evidence services and storage to AI-driven report writing capabilities.

Axon has stayed ahead of the curve with innovative software products that build on its near-monopoly in hardware, providing multiple vectors of growth. As a one stop shop for public safety systems, Axon is well positioned to benefit from growing spend by law enforcement agencies. Other avenues of expansion include various federal agencies and correctional facilities; international markets, especially in the Anglosphere and Continental Europe; and new products such as DFR (Drone as First Responder).

Conclusion

While aerospace & defense has a reputation as a relatively lower-growth market, over the years, we have found this sector to be a fruitful hunting ground for fast-growing, under-the-radar companies. Like many industries, A&D is also leaning into innovative technologies to develop new and improved products, drive efficiencies, and save on costs. While the outlook for the industry overall is a mix of positives and negatives, we continue to see opportunities for the selective investor.

Investors should consider the investment objectives, risks, charges, and expenses of the Fund carefully before investing. The prospectus and summary prospectus contain this and other information about the Fund and can be obtained from the Fund's distributor, Baron Capital, Inc., by calling 1-800-99-BARON or visiting BaronCapitalGroup.com. Please read them carefully before investing

Performance data quoted represents past performance. Past performance is no guarantee of future results. Current performance may be lower or higher than the performance data quoted above.

Risks: All investments are subject to risk and may lose value.

Portfolio holdings as a percentage of net assets as of March 31, 2025 for securities mentioned are as follows: **Space Exploration Technologies Corp.** - Baron Asset Fund (5.3%), Baron Fifth Avenue Growth Fund (1.6%), Baron Focused Growth Fund (11.3%), Baron Global Advantage Fund (11.9%), Baron Opportunity Fund (5.2%), Baron Partners Fund (18.1%*); **TransDigm Group Incorporated** - Baron Durable Advantage Fund (2.4%), Baron Small Cap Fund (3.7%); **HEICO Corporation** - Baron Durable Advantage Fund (3.0%), Baron Partners Fund (0.8%*); **Loar Holdings Inc.** - Baron Discovery Fund (1.2%); **Kratos Defense & Security Solutions, Inc.** - Baron Discovery Fund (3.8%), Baron Small Cap Fund (2.0%); **Axon Enterprise, Inc.** - Baron Asset Fund (0.7%), Baron Technology Fund (1.4%).

As of March 31, 2025, our funds did not hold shares of **StandardAero, Inc.**, **The Boeing Company**, **General Dynamics Corporation**, and **Lockheed Martin Corporation**.

* Percentage of long positions

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on management expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

Free Cash Flow (FCF) represents the cash that a company generates after accounting for cash outflows to support operations and maintain its capital assets.

BAMCO, Inc. is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Baron Capital, Inc. is a broker-dealer registered with the SEC and member of the Financial Industry Regulatory Authority, Inc. (FINRA).