ClearBridge
A Franklin Templeton Company

Smaller Companies Step Up in Global Defense Cycle

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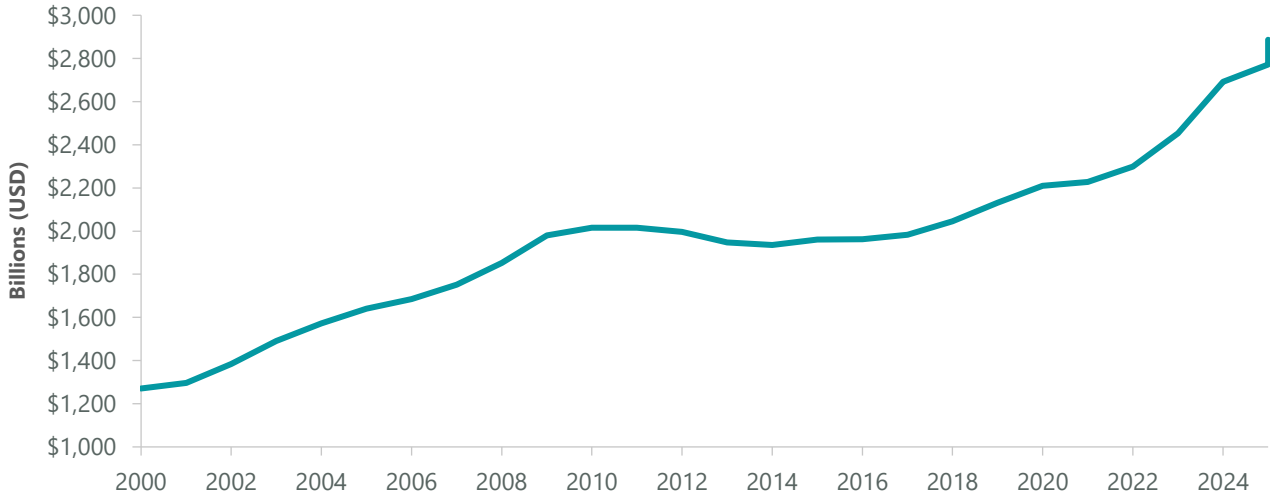
Key Takeaways

- A new global defense investment cycle is extending beyond the largest primary defense contractors to include nimbler high-tech defense businesses, and Europe is emerging as a key driver of rising defense spending.
- Defense priorities are shifting from legacy platforms toward faster, more autonomous and more software-enabled unmanned systems, defense electronics and aerospace capabilities.
- We believe compelling opportunities exist in smaller, specialized companies that form crucial links in the defense supply chain, can create new platforms faster and offer more diversified exposure to defense spending.

Defense Reinvestment No Longer the Purview of Primes

Global defense spending has entered a sustained upcycle as governments respond to a more contested geopolitical backdrop and a shifting role in U.S. security priorities. According to the Stockholm International Peace Research Institute (SIPRI), world military expenditure reached $2.887 trillion in 2025, rising 2.9% in real terms and marking the 11th consecutive year of growth (Exhibit 1). From 2016 through 2025, global military spending increased 41%, underscoring that the current cycle is not a short-lived reaction but a multiyear shift in national security priorities.

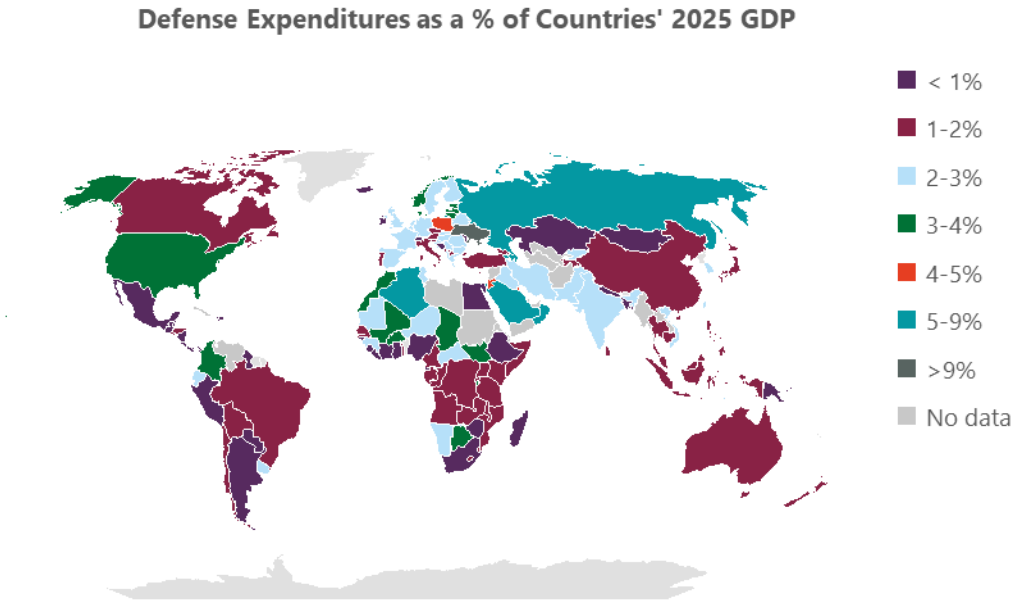
Exhibit 1: Global Military Expenditure Has Risen for 11 Consecutive Years



Data as of April 27, 2026. Source: The Stockholm International Peace Research Institute.

The growth is increasingly global. While the U.S. remains the world's largest defense spender on a total dollar basis, spending outside the U.S. rose 9.2% in 2025. Europe was the clearest example of accelerating rearmament, with military expenditure rising 14%, while Asia and Oceania rose 8.1%. NATO policy commitments also point to further runway: at the 2025 Hague Summit, allies committed to investing 5% of GDP annually by 2035, including at least 3.5% for core defense requirements and up to 1.5% for defense- and security-related spending.

Exhibit 2: Defense Spending is at Historic Highs and Rising



As of April 27, 2026. Source: The Stockholm International Peace Research Institute.

That spending is flowing not only to just the largest defense contractors, such as Lockheed Martin in the U.S. or BAE Systems in the U.K. The drone-dominated Russia-Ukraine war and the Middle East conflict illustrate how modern defense priorities increasingly emphasize faster, more distributed, more autonomous and more software-enabled systems — areas where smaller companies with narrower specialization can play an outsize role. As procurement shifts toward capabilities such as space systems, drones, propulsion, defense electronics, nuclear technologies and highly engineered aerospace components, these smaller specialists are becoming increasingly important contributors to the broader defense spending cycle.

Faster, More Flexible Technologies for Modern Defense

The character of defense spending is changing. Conflicts in Ukraine and the Middle East have reinforced the importance of unmanned systems, missile defense, lower-cost expendable platforms, rapid production capacity and technologies that can be fielded more quickly than traditional large platforms. This is especially relevant for European governments, many of which are seeking to replenish inventories, strengthen air defense, expand domestic industrial capacity and accelerate procurement timelines.

This environment favors companies with focused engineering expertise, flexible manufacturing models and exposure to high-priority areas of defense budgets. For example, Kratos Defense & Security Systems is positioned across several priority defense categories, including unmanned aerial drone systems, hypersonic and missile defense, missile propulsion and space capabilities. Its partnership with Airbus Defence and Space to pursue an uncrewed collaborative combat aircraft for the German Air Force highlights how smaller defense technology suppliers can support European capability needs alongside established regional primes. We believe Kratos's focus

on lower-cost, rapidly fielded systems, combined with proactive capacity investments, can support growth and margin expansion as defense budgets increasingly prioritize speed, scale and autonomy. Karman Holdings provides another example through its approach as a merchant supplier across numerous high-priority investment categories, including the production of critical parts and systems that go into missiles and missile defense, and the submarine program, all of which are tied to evolving national security priorities.

These companies are aligned with a broader shift toward faster, more flexible defense procurement. In the U.S., Replicator and the Defense Innovation Unit's Commercial Solutions Openings are helping expand the Pentagon's supplier base beyond traditional primes, while the European Defence Fund, the EU Defence Innovation Scheme and NATO's Defence Innovation Accelerator for the North Atlantic are supporting defense innovation, SMEs and dual-use technologies across the alliance. Together, these efforts reflect the growing need for distributed, autonomous and adaptable systems — from drones and sensors to precision technologies — that can be produced and deployed at scale. For smaller companies with differentiated technology and manufacturing know-how, this can create a more direct path to participation in defense modernization than the traditional prime contractor model. Without the large bureaucracies and lower growth of major defense primes, smaller and newer defense technology companies can also be positioned to deliver these critical capabilities at more attractive price points.

Highly Engineered Components are Mission Critical

Modern defense systems are increasingly defined by precision engineering, advanced sensing and specialized components. Whether the application is an aircraft engine, missile defense system, drone, satellite or space platform, the need for highly engineered inputs continues to grow. This creates opportunities for smaller companies that occupy specialized niches within the broader aerospace and defense supply chain.

RBC Bearings and Teledyne Technologies illustrate how specialized suppliers can participate across multiple defense-related end markets. RBC Bearings supplies highly engineered bearings and components into aerospace, defense and industrial markets, with exposure to defense programs, missile replenishment demand and aerospace OEM build rates. Teledyne, meanwhile, provides enabling technologies for industrial growth markets, including monitoring and control instruments, electronic test and measurement equipment, visible-spectrum sensors used in surveillance and targeting, defense electronics and aviation equipment, with exposure that spans military, defense, drone and space applications.

The common thread is specialization. These businesses are not prime contractors building entire platforms; they provide difficult-to-replicate technologies and components that help make advanced platforms function. As defense systems become more complex, connected and precise, companies supplying highly engineered components are increasingly critical to the modernization of aerospace, defense, drone and space capabilities. Importantly for many of these component manufacturers, like RBC Bearings and Teledyne Technologies, their critical solutions are specifically designed in high-budget platforms, require aftermarket replacement and allow for pricing power which, in turn, supports a robust margin profile.

Space Becomes a New Front Line

Space has moved from a specialized frontier market to a central pillar of modern defense architecture (with future commercial opportunities likely over time). Communications, surveillance, navigation, missile warning and battlefield coordination increasingly depend on satellite networks that can operate reliably in contested environments. This has become particularly important as governments seek greater strategic autonomy, more resilient communications and improved surveillance capabilities in response to broader geopolitical uncertainty.

That shift is creating opportunities for smaller companies that can move quickly and specialize in targeted parts of the space ecosystem. York Space Systems manufactures and services satellites for aerospace and defense customers, with exposure to U.S. space-based defense programs as well as emerging commercial use cases. We believe York's rapid growth in core programs and potential expansion into Golden Dome-related applications

underscore how new defense priorities are broadening the opportunity set for smaller satellite specialists. Rocket Lab sits in a related part of the ecosystem, providing spacecraft, satellite components and launch services for commercial, government and classified customers. The company offers exposure to the broader need for space systems manufacturing as satellite constellations become more important to national security.

Karman Holdings extends this theme into the component and subsystem layer, supplying key systems tied to space with critical components that support launch and propulsion, thermal protection and even space craft assembly. Together, York, Rocket Lab and Karman show how space-related defense spending can flow not only to large prime contractors, but also to smaller specialists building the satellites, launch capabilities and mission-critical components that support the next generation of military architecture.

Smaller Companies Can Provide Differentiated Defense Exposure

We believe some of the most compelling opportunities in a potentially generational defense and space investment cycle reside outside the largest defense primes. As defense spending broadens — particularly in Europe, where governments are rapidly increasing budgets and rebuilding capabilities — smaller specialists are supplying increasingly essential capabilities across unmanned systems, defense electronics, engineered aerospace components, nuclear technologies and space infrastructure.

The current rearmament cycle is not simply about producing more legacy aircraft, ships or vehicles; it is about modernizing defense architecture for a world defined by contested airspace, autonomous systems, electronic warfare, missile defense, resilient infrastructure and space-based communications. These priorities are increasing demand across the defense supply chain, where specialized smaller companies can play a crucial role.

For investors looking to participate in global defense beyond the largest contractors, the Franklin ClearBridge US Smaller Companies UCITS ETF targets this broader defense supply chain. The Fund invests in smaller growth businesses with durable competitive advantages across the technologies, components and infrastructure enabling military modernization; these companies offer more diversified exposure to a sustained defense and security-related capital expenditure cycle.

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