PERSPECTIVES **Viewpoint** Equity

Time to act: Europe's possible Defence Initiative

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Key takeaways

- In order to quickly become capable of defending itself, while reducing the trade surplus with the U.S., Europe will have to rely on U.S. supplies in the short term. At the same time, Europe needs to consolidate and develop its own defence sector. According to the European Commission, at least 50% of all military procurement is to take place within the EU by 2030 and 60% by 2035.
- According to the Kiel Institute for the World Economy, debt-financed investments in domestic defence technology research and development, and in the production of state-of-the-art military equipment, can increase productivity. Short-term economic stimulus could enable higher long-term economic growth and via positive spillover effects this could lead to increased potential growth.
- European defence stock prices have increased by around 46% in the past twelve months and are no longer cheaply valued. Nevertheless, they are likely to have upward potential in the medium term under a European Defence Initiative. However, investors should also consider sector-specific characteristics when selecting single stocks.

Turning point

On 27 February 2022, Chancellor Olaf Scholz's "Zeitenwende speech" to the German Bundestag attracted international attention. Three days earlier, Russian troops had invaded Ukraine. Since then, the issue of European defence has been at the centre of political debate. After the new U.S. administration under President Donald Trump and Vice President J.D. Vance signalled the end of U.S. defence guarantees for Europe, confidence in the U.S. as a reliable partner alongside Europe appears to be severely damaged.

The pressure on Europe to significantly increase its defence spending has increased noticeably. The need to strengthen European defence should not remain a one-off effect. For too long, many European states have been relying on the U.S. as a protector. Now change is afoot. Not only has Germany set up a special fund, but the Draghi report also recommends increasing funding at a European level. European defence spending is expected to remain high in the coming years.

British Prime Minister Keir Starmer recently announced the largest increase in British defence spending since the end of the Cold War. Three years ahead of schedule, the defence budget is projected to rise to 2.5% of the UK GDP by 2027, and 3% by 2034. German politics is also on the move after the early Bundestag elections on 23 February this year. Among other things, the increase of the "special funds" for infrastructure and Bundeswehr of up to EUR400bn each will be discussed.

Possibilities of an EU Defence Initiative

Statements by various European politicians also indicate a growing willingness to develop a coherent European strategy, including greater acceptance of joint defence financing.

The European Commission has already responded by proposing a relaxation of European debt rules. While proposals of up to 5% of GDP were circulating for defence, the new NATO strategy could amount to 3-4%. In 2023, the GDP of the NATO countries excluding the U.S. was almost EUR23tn. So defence spending of 3.5% of GDP would amount to more than EUR800bn per year.

While national resources have been the main source of defence spending, many Member States are financially constrained by high public debt and deficits. One way to circumvent the "3% deficit rule" under EU rules would be to consider defence spending as a "relevant factor." In addition, the national escape clause allows Member States to derogate from EU fiscal rules in exceptional cases.

In the longer term, a sustainable defence strategy can only be ensured through common European financial instruments. The debate on adjusting EU debt rules is likely to gain momentum, especially in the event of a geopolitical spike.

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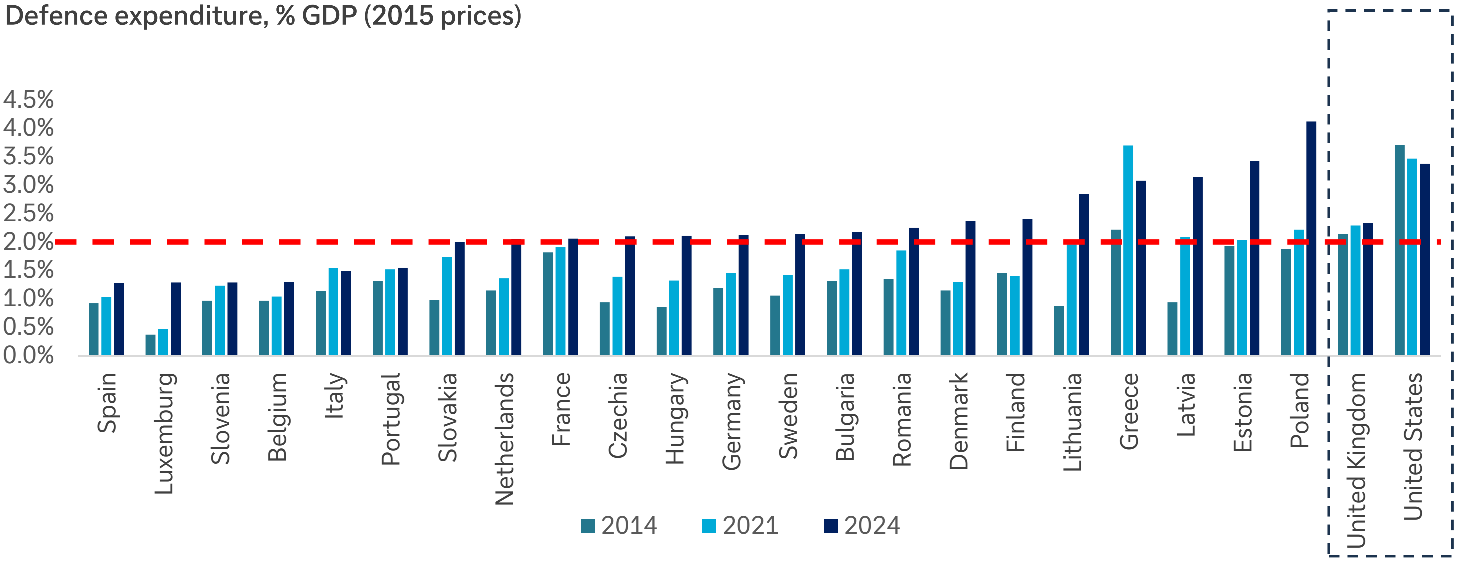
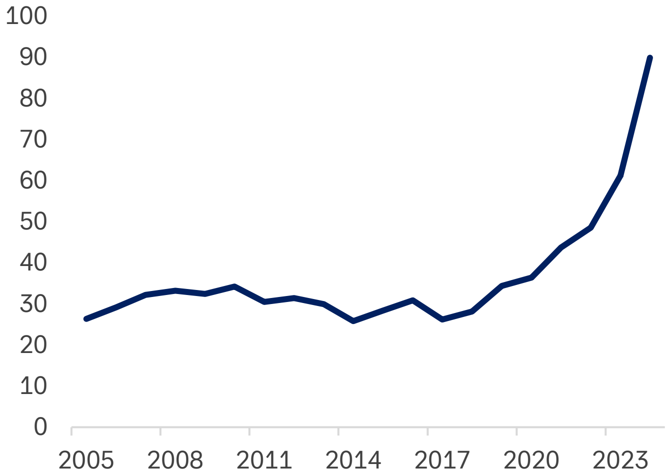
Figure 1: NATO: EU-States + United Kingdom + U.S.
Defence expenditure, % GDP (2015 prices)



Source: NATO, Deutsche Bank. Data as of February 28, 2025.

Figure 2: Defence Equipment Procurement , EUR bn (2023 prices)



Source: European Defence Agency, Deutsche Bank. Data as of February 2025.

Various options are under discussion, including whether they involve repurposing existing funding programs or creating new ones:

Figure 3: Financing under existing facilities

EU-Cohesion Fund Up to EUR60bn	RRF EUR95bn	NGEU EUR100bn (for 7 years)
Reassignment of existing funds	Reassignment of unused funds of the Recovery and Resilience Facility (RRF)	Reassignment of the long-term NextGenerationEU-programme (2028-2034)
Policy refinement via the EU commission	unanimous decision of the EU Council	unanimous decision of the EU Council

Source: Deutsche Bank. Data as of February 28, 2025.

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Figure 4: Financing via new facilities

„SURE 2.0“ Up to EUR100bn	„RRF 2.0“ Open	ESM EUR240bn	SPV Up to EUR500bn
Funds for defence expenditure, similar to the existing EU program SURE (Support to mitigate Unemployment Risks in an Emergency) to support national social expenditure,	New EU debt for defence	Creation of a new ESM credit line (**European Stability Mechanism**)	Establishment of an intergovernmental fund (**Special Purpose Vehicle**) to which the participating EU countries pay directly
Issuance requires unanimous decision of the EU Council Issue requires all EU members to guarantee	Unanimous decision of the EU Council and ratification by all national parliaments	Unanimous decision of all EU countries, with a possible extension to non-EU countries	Voluntary participation, possible extension to non-EU countries

Source: Deutsche Bank. Data as of February 28, 2025.

Political and organisational challenges are considerable:

- Not least the political constellations in France and Germany make it difficult to imagine joint finance solutions at EU level that require qualified parliamentary majorities. But a sustained strengthening of the common deterrent capability requires more than the acceptance of sustainable financing.
- Equally important are forward planning and coordination of defence spending and, in the medium term, the establishment and development of appropriate production infrastructure throughout the European continent. Otherwise, there is a risk of inefficient use of funds for more expensive, less effective and poorly integrated systems, with the risk of cost inflation.

Spillover effects

If a European alliance is successful, targeted defence spending could not only contribute to strategic security as the basis of economic prosperity but could also contribute to the long-term potential growth of European economies beyond short-term economic effects, provided that the funds are channelled into infrastructure, research and development (R&D) and production from European sources.

Europe is still a long way away from that. Since the start of the Russia-Ukraine war in 2022, the EU states have awarded a large proportion of their defence contracts to manufacturers outside the EU – according to calculations by the IRIS think tank, around 78% by June 2023 (with a significant proportion of U.S. companies). Little will change in the short term. In order to become defendable quickly and at the same time reduce the trade surplus with the U.S., Europe will first have to continue to rely primarily on U.S.-produced armaments. At the same time, however, the European defence sector needs to be consolidated and developed as soon as possible.

In March 2024, the European Commission presented a new strategy for the defence industry with the aim of strengthening the European defence industry and reducing dependence on non-European suppliers. According to this, at least half of all military procurement is to take place within the EU by 2030. By 2035, this proportion is set to rise to 60%.

The efficiency of future defence depends to a large extent on the level of investment in new capabilities, i.e. research and technology (R&T). According to the European Defence Agency (EDA), investment in R&T increased significantly between 2008 and 2016 after a period of insufficient spending. According to EDA, total expenditure on defence R&T in 2023 amounted to EUR4bn, which represents a real increase of 8% compared with 2022. In 2023, 61 military R&D projects were launched under the European Defence Fund (EDF), with a total volume of EUR1.15bn.

In a recent study, the Kiel Institute for the World Economy (IfW) examines the economic impact of increasing defence spending in Europe. The experts argue for debt-financed rather than tax-financed increases in defence spending, and disagree with the classic "gun-or-butter" argument that higher defence spending is bound to come at the expense of private consumption and the civilian economy.

If more investment were made in domestic R&D and in the production of state-of-the-art military equipment, an increase of defence spending by 1% could increase the economy's productivity by 0.25 percentage points according to the IfW. This could add to potential growth and thus enable a higher growth path in the long run. In addition, there may be investment in infrastructure that can be used both by militarily and civilians, such as railways, roads and ports. A stronger industrial base is also expected to reduce dependence on international supply chains, thereby strengthening Europe's overall economic resilience. Under these conditions, a debt-fuelled increase in defence spending from 2% to 3.5% of GDP could boost economic growth by 0.9%-1.5% per year, according to IfW.

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Defence industry specifics

From an investor perspective, the selection of defence industry companies shall include other aspects of the assessment, in addition to the financial analysis of the company data.

- **High barriers to entry**: The defence sector has high barriers to entry compared to other civilian sectors. This is due, among other things, to the close integration with state institutions, the strict regulatory requirements and the complex development processes for military technologies.
- **Concentrated customer base and policy drivers**: Compared to many civilian industries, the number of potential customers for defence products is very limited, increasing defence contractors' dependence on large orders. In addition, strategic and defence policy decisions of the respective governments must be taken into account.
- **Technology as a key competitive factor:** The defence industry is one of the most technologically demanding industries in the world. From armored vehicles to the latest generation of fighter jets, almost all military systems are equipped with state-of-the-art technology. Without continued investment in R&D, defence companies risk losing touch with technological competition.
- **Cooperations and joint ventures:** Cooperations and joint ventures are commonplace in the defence industry. Companies are not only competitors, but often also mutual suppliers. Within the framework of cooperation, R&D resources can be pooled and used more efficiently. This could create opportunities for the more fragmented European market compared to the U.S. After all, FCAS (France, Spain, Germany) and Tempest (United Kingdom) have joined two consortia to develop the next generation of military aircraft. The MGCS project is also a consortium for the development of a European tank. Further cooperation is expected.
- **Regulatory and legal complexity:** Unlike in civilian industries, defence companies typically receive monthly advance payments for ongoing projects. While this ensures liquidity, it also increases the burden of regulatory control and management of these funds. The organization of the EU in nation states and the associated regulatory and legal diversity increase the complexity of transnational armament projects. In particular, in the case of long-term government contracts, price adjustment clauses are not uncommon and can have a significant impact on the profitability of defence companies in individual cases.
- **Long product lifecycles:** From an investor's perspective, the product lifecycles of many military systems are likely to be particularly interesting, in some cases exceptionally long compared to the civilian manufacturing industry. Learning effects can be better exploited in long-running productions, reducing manufacturing costs and increasing profit margins. Established companies benefit from comparatively stable and reliable cash flows. However, defence companies that are not included in key tenders risk being forced out of the market in the absence of adequate procurement programs in place in a timely manner.

Supply chain structure

Due to the high level of technology and the strategic importance of the sector, the supply chains of the sector are characterized by high technological requirements, strict regulatory requirements and geopolitical factors. Many military technologies have civil applications and vice versa ("dual-use"). Companies in the supply chain are therefore subject to strict export controls.

At the same time, defence companies and governments are seeking to reduce their dependencies by relying more on domestic production and suppliers. Similar to the automotive industry, the industry is characterized by a limited number of large companies (so-called "prime contractors") and a large number of highly specialized suppliers (so-called "tier 1, tier 2 and tier 3 suppliers"):

- **Governments and public procurement authorities** are the main customers and often determine the development of new weapons systems and award contracts for military platforms in direct consultation with the prime contractors.
- **Prime Contractors** are the prime contractors for large defence projects, coordinating R&D, production, and maintenance and service of complex weapons systems.
- **Tier 1 suppliers** are typically larger companies (often prime contractors) that supply core components for larger and more complex weapons systems, such as engines, avionics, radar systems, and gearboxes for armored vehicles.
- **Tier 2 and Tier 3 suppliers** often manufacture smaller, highly specialized (sub)components or materials such as cable systems, titanium alloys, semiconductors or optical devices.
- **Suppliers of raw materials** supply the defence industry with various industrial metals, such as steel, aluminium, titanium, lithium and cobalt and rare earths.

Market reactions and outlook

While the prices of U.S. defence companies have tended to consolidate recently, the prices of European defence equipment manufacturers are increasing. Recent statements by the new U.S. Secretary of Defence, Pete Hegseth, and the austerity measures imposed by Elon Musk's Department of Government Efficiency (DOGE) in other areas have recently raised concerns among investors that future defence assets could also come under the spotlight.

With regards to the European defence industry, the extent to which companies specialise in defence or offer a wider range of products must be taken into account. Moreover, the European market is more fragmented than the U.S. market, which is dominated by some large companies.

In principle, the chances for European defence companies seem to be good, even if the industry index "STOXX Europe Total Market Aerospace and Defence" is currently quoted at an all-time high after a performance of 46% in the last twelve months and is not rated cheaply by historical comparison. The price-to-earnings ratio of 21.8 (based on expected earnings for the next twelve months) is about 10% above its own ten-year average of 19.7.

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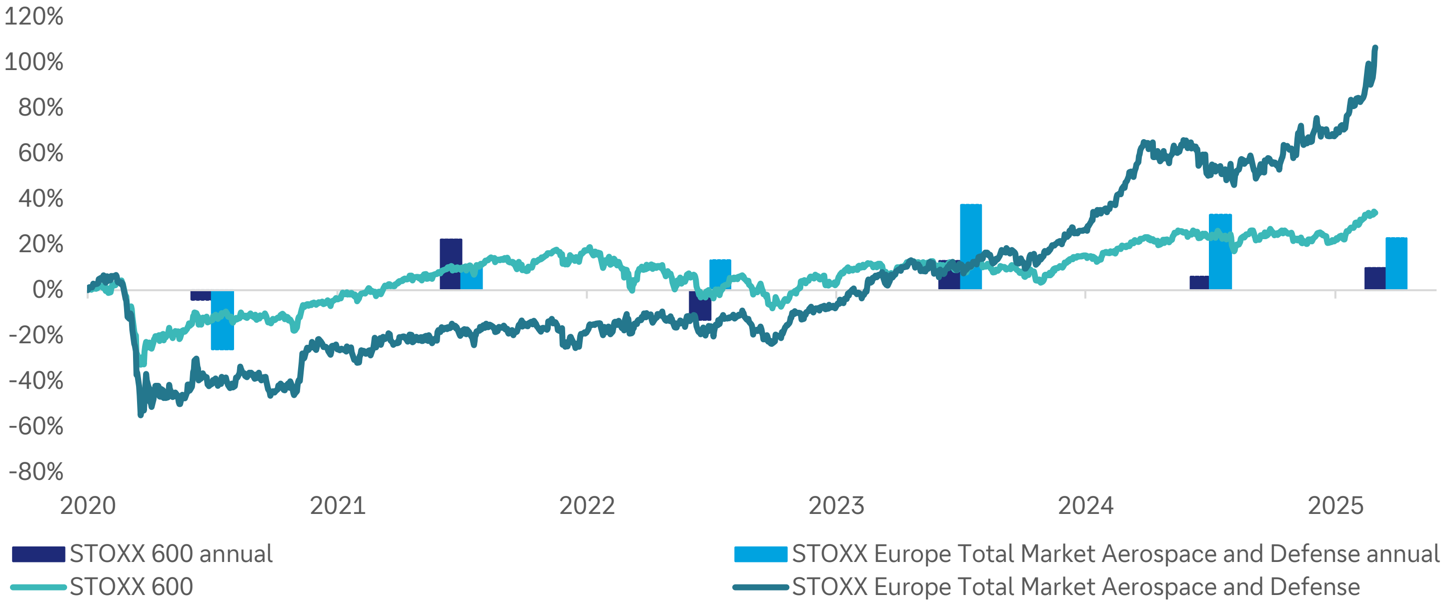
In the case of an increase in European defence spending, analysts have already begun to adjust their sales and profit forecasts for European defence companies from 2% to 3%. For 2025, the consensus currently expects sales and profit increases of 14% and 22% respectively, for the following years 2026 (12% / 20%) and 2027 (11% / 18%) with a slightly declining momentum.

Potential non-European markets could also play a role in the future. In the ten years from 2014 to 2024, defence spending in India, Japan, South Korea, and Australia grew cumulatively by almost 6% per year. For these countries, analysts expect a growing momentum in the coming years, as well as for the Middle East.

Last but not least, expected investments in infrastructure (including ports, roads, railways) should also benefit civil industrial assets.

Figure 5: Outperformance of European defence stocks

Price performance of European aerospace and defence stocks in EUR, excluding dividends, indexed 0=01.01.2020



Source: LSEG Datastream, Deutsche Bank. Data as of March 3, .2025.

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Glossary

The **Department of Government Efficiency (DOGE)** is formed in the second Donald Trump administration aimed to reduce federal spending.

The **EU Cohesion Fund** helps EU Member States with a per capita gross national income of less than 90 per cent (EU-27 average) to strengthen the EU's economic, social and territorial cohesion.

EUR is the currency code for the euro, the currency of the Eurozone.

The **European Commission (EC)** is the executive body of the European Union (EU) representing the interests of the EU as a whole.

The **European Defence Agency (EDA)** supports the development of military resources in the 27 Member States.

The **European Defence Fund (EDF)** supports Community efforts and cross-border cooperation between public and private bodies such as enterprises (including small and medium-sized enterprises), universities and research and technology organizations in the EU.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

NATO (North Atlantic Treaty Organization) is a defence alliance with a total of 31 European and North American member states.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings.

The **Recovery and Resilience Facility (RRF)** is a tool within the **NextGenerationEU program** to provide financial assistance and loans for reforms and investments in EU Member States. These funds are performance-based, i.e. they are only issued when the Member State concerned has achieved milestones and targets in the implementation of the planned reforms and investments.

SPV (Special Purpose Vehicle) are a sort of investment instruments set up for a specific purposes.

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Appendix

Historical performance

Performance	3.3.2020 - 3.3.2021	3.3.2021 - 3.3.2022	3.3.2022 - 3.3.2023	3.3.2023 - 3.3.2024	3.3.2024 - 3.3.2025
STOXX Europe 600	8.5%	5.8%	6.2%	7.2%	12.0%
STOXX Europe Total Market Aerospace and Defence	-12.8%	8.0%	26.1%	38.6%	39.7%

Source: Deutsche Bank AG, Bloomberg Finance L.P., LSEG Datastream; Data as of March 03, 2025.

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