EightAdvisory

Financing the defense industry

Options for tackling the financing difficulties faced by the defense technology industrial base

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8 EIGHT INTERNATIONAL

Introduction

After years of budget constraints and downsizing of Europe's armed forces, the defense sector is faring better. Since first Ukrainian crisis in 2014, the governments of the five main European powers (France, Germany, the UK, Italy and Spain) have all unveiled increased defense budgets. The invasion of Ukraine in 2022 also served as a trigger for a historic increase in NATO member countries' equipment budgets - with Germany and Poland leading the way. Of course, the challenges posed by government budget constraints, inflation, recruitment difficulties and the need to adapt supply chains to keep pace with increased production rates cast a more mixed light on the dynamics of the defense industry. But there is one constant that few can overlook, and which is causing concern among governments and parliaments in Europe: despite robust order books, access to financing remains problematic, not only due to regulatory constraints, but above all to the reputational risk that the banking sector is often reluctant to bear.

Major contractors, whose activities are generally dual-purpose, are largely unaffected by bank financing difficulties. The situation is quite different for the SMEs and mid-tier companies belonging to the European Defense Technological and Industrial Base (EDTIB). The origins of these difficulties are many and varied: normative inflation within the European Union, credit risk, regulatory constraints, influence peddling and pressure from governments and NGOs, but most of all, reputational risk. This network of small and mid-tier companies plays a crucial role in the value chain, and financing difficulties are hampering their growth and that of the industry. It should be noted that these difficulties are shared across Europe: all the representative bodies of the defense industries report the same difficulties, from the GICAT, the Group of French Industries for Land and Air-land Defense and Security to the BDSV, the Association of German Security and Defense Industries.

Can *Private Equity* funds provide a solution for defense financing problem? Although they are not very active in this field in Europe, they are by no means the only option, but they could be part of the solution. In fact, the sector's specific characteristics - namely, an illiquid market with few potential buyers, the heavy involvement of the State, and unusual cooperation arrangements between manufacturers (consortia, shared industrial programmes, etc.) hamper the involvement of *Private Equity* funds. Nevertheless, the sector has a number of key selling points: visibility and regular cash flow, an attractive technological dimension, and high entry barriers. While the M&A market has been slowing down over the past few quarters, the SME and mid-tier sector remains buoyant, driven mainly by two underlying factors: i) safeguarding supplies, and ii) acquiring technological building blocks. These transactions are mainly aimed at preserving margins, developing new skills in niche markets, and bolstering the supply chain. The combination of these external growth strategies enables the emergence of more resilient players with more diversified revenues. Because over and above the financing aspects, *Private Equity* funds bring their expertise in structuring and streamlining operational and economic performance to the EDTIB.

Key features of the aerospace, security and defense sector, including the United Kingdom

More than **4 000 companies** in Europe

Ttl revenues of approx. **€240 bn** in Europe in 2023

879 000 jobs within the EDTIB

Global leaders: Thales, Safran, Airbus, Rolls-Royce, Saab, Naval Group, Leonardo, Dassault Aviation, BAE Systems, Rheinmetall, Knds

Approx. 50% of revenues generated from exports

Approx. €18 billion in R&D per year

Summary

Positive momentum across the entire EDTIB

A buoyant macro-economic and geopolitical backdrop

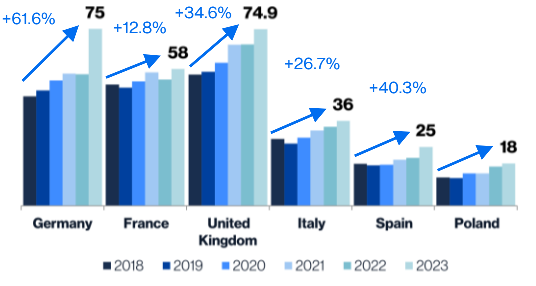
As a result of the weaknesses exposed in European societies by the COVID-19 epidemic and the outbreak of war in Ukraine, the notion of strategic autonomy and resilience has become widely accepted. The defense industry has undeniably benefited from this and is now confronted with the problem of increasing production rates (for example, Nexter and its CAESAR gun, production of which is ramping up at Bourges), or more to the point, the commercial success of the Rafale. In fact, the defense sector has substantially increased its contribution to the trade balance. In Europe, exports are necessary to ensure the long-term viability of the EDTIB, as domestic orders are generally insufficient to ensure programmes make even and manufacturing companies remain profitable.

Yet the defense sector has come a long way. Although NATO member states are collectively committed to keeping their defense budgets at 2.0% of GDP, most European countries have significantly reduced the size of their armed forces since the 1990s. The rapidly evolving geopolitical situation is prompting an in-depth review of military programming laws, and in particular equipment budgets. The conflict in Nagorno-Karabakh had already generated a growing awareness of the technological issues at stake and new demands of high-intensity conflicts (drones and their operating procedures, for example). With Ukraine just one step away from the European Union, governments are now seeing the need to expand the size of their armed forces and gradually move away from a "flow-based" approach to one based on stockpiling equipment.

The two facets of the defense industrial base

Against this broadly favourable backdrop for the sector, investors on publicly-traded markets have tended to be attracted to large industrial groups with dual activities (civil and military), who have little difficulty in raising debt, and obtaining relatively low spreads. These large groups are only slightly affected by financing difficulties. But they are, however, the exception in the EDTIB, where less than 5.0% of companies are publicly listed. In Europe, the sector's vitality is due, in no small part, to its network of SMEs and mid-tier companies, whose access to credit is much harder than that of large groups with diversified revenues.

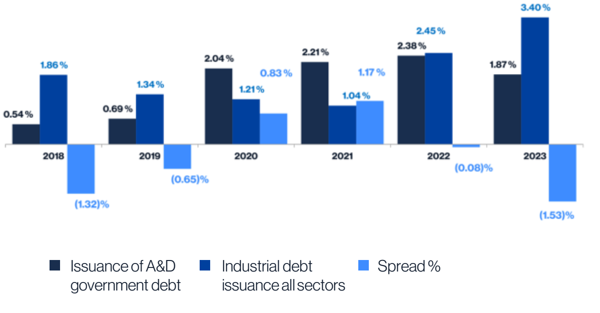
Defense spending in Europe (billions Euros)



Sources: World Bank & SIPRI, French Ministry of defense. Analysis by Eight Advisory

Note: defense budgets in European countries have risen significantly, even in 2023. However, there are disparities between countries, with Germany and Poland leading the way in increased spending (in relative terms). The majority of budget increases will go to equipment purchases.

An improving credit spread for the A&D sector



Source: Capital IQ. Publicly issued debt coupon of the twenty largest European A&D companies vs. debt issued by industry, all sectors combined, with the same rating.

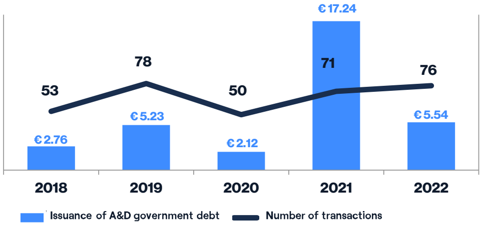
Note: After a period when the spread between defense companies and industry in general was unfavourable to the A&D sector (2020-21), the spread reversed to 1.53% in 2023. One of the reasons for this reversal is the fall in the sector's leverage ratios since the end of the COVID-19 epidemic. However, this spread applies only to larger listed corporations, whereas the majority of the sector is made up of unlisted companies, who are finding it harder to secure bank financing.

The strength of Europe's major defense groups

A more favourable position

The EDTIB's group of major contractors is comprised of companies with a wide range of revenues and dual activities (with military and civilian divisions); the credit taps are not closed for these industrial giants. The balance and diversity of their revenues, the strength of their balance sheets and their status as net contributors to foreign trade all play in their favour with credit institutions and financial markets.

M&A in Aerospace and Defense in developed Europe



Source: Capital IQ. Analysis by Eight Advisory.
Note: M&A transactions in the A&D sector are increasing slightly in volume, with more than 70 deals in 2021 and 2022, mostly under €100m.

Different financing challenges

While financing operations involving publicly listed entities inevitably attract increased public attention, reported by associations and specialised media, it appears that, for large contractors, the main financing issue is not so much access to bank credit, which is generally facilitated by the robustness, relative transparency and high quality of *reporting* of large groups. Instead, the main challenge lies in bond issues, where the investor base is much more limited. This can lead to less favourable financing conditions, and a divergence in interest rate spreads that is sometimes out of line with the level of risk borne by the bank. This situation is exacerbated by the defense industry's particular circumstances, where national security issues, strict regulations and, above all, reputational risks can curb investor appetite and make financing structures more complex.

Companies	2022 revenues (Global)	2022 revenues (Defense)	Sectors	
Airbus SE	58.8	11.3	Civil and military aviation, space and defense.	
Bae Systems	24.9	24.9	Aerospace, defense and cyber technology.	
Safran SA	19.7	7.5	Propulsion systems and components for civil, military and defense aviation.	
Thales SA	17.6	9.5	Aerospace, transportation, security and defense.	
ROLLS-ROYCE	15.9	4.3	Engines, propulsion systems for airplanes, ships and submarines.	
Leonardo SpA	14.7	12.2	Airplanes and helicopters and defense and security.	
Dassault Aviation	6.9	4.8	Military airplanes, private jets and space systems.	
Rheinmetall AG	6.4	4.8	Automotive components and defense equipment.	
Naval Group	4.3	4.3	Submarines and ships. Underwater weapons and cyber systems.	
Saab AB	4.0	3.5	Civil and military aviation, weapons, submarines. Security and surveillance.	

Source: Capital IQ and 2022 Annual Reports, in Billion Euros. A partial list of some of the sector's leading companies in Europe

Bank financing difficulties: the plight of SMEs and mid-tier companies

Europe
AIRBUS MBDA KNDS

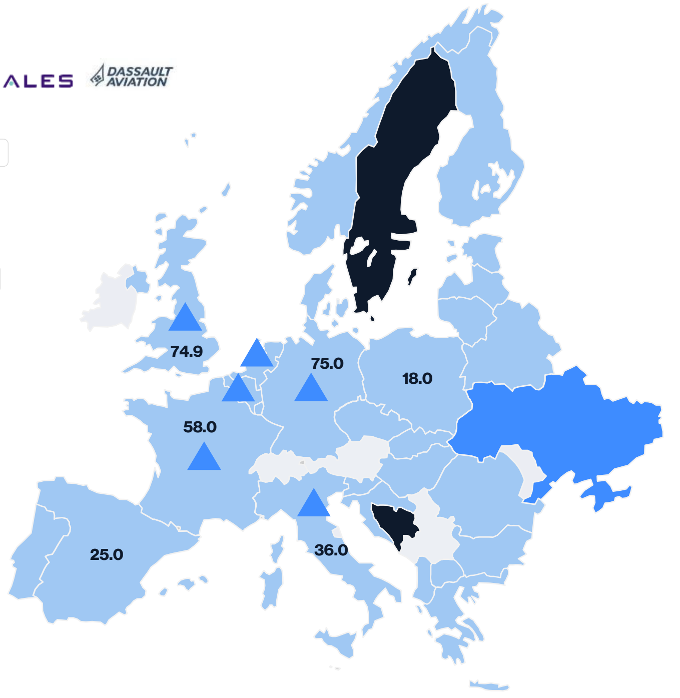
France +450 SME/ mid-tier
SAFRAN NAVAL GROUP THALES DASSAULT AVIATION

UK +400 SME/ mid-tier
BAE SYSTEMS Rolls-Royce

Germany +250 SME/ mid-tier
RHEINMETALL

Italy +200 SME/ mid-tier
LEONARDO

Sweden +50 SME/ mid-tier
SAAB



Number of SMEs or mid-tier firms classified as strategic (source: ADS, GICAT, GICAN, AIAD, BDSV).
NATO members
Countries in the process of accession
Countries seeking accession
Countries not seeking accession
Nuclear-armed or hosting US nuclear weapons
50.3 2023 defense budget (billion €)

01. The greatest difficulties faced by mid-tier businesses

When it comes to access to finance, the economic reality looks very different for major contractors and the rest of the EDTIB. SMEs and mid-tier companies, which are the backbone of Europe's industrial skills base, are experiencing serious financing constraints due to limited access to bond financing, the low number of publicly traded groups capable of raising capital and, most importantly, the banks growing reluctance to lend, which has become more acute in recent years. Even though the reality of the situation is often downplayed by the banks, it is the financial criteria that are cited. As far as the manufacturers are concerned, the main issue brought to the fore is the reputational risk which the banks are trying to avoid.

02. Reputational risk

Securing bank financing for the delivery of equipment to certain countries can prove to be a challenge. The equipment financed may end up in a war zone, or even be used against civilians, depending on the political climate, a situation that European banks are eager to avoid. In recent years, several associations have emerged with the aim of analysing the behaviour of major groups with a view to denouncing them (name & shame). The BankTrack network, for example, identifies the 'defense' exposure of European banks and draws public attention to their practices. However, reputational risks are not always backed up by documents, facts or quantifiable performance indicators. Nevertheless, these risks are perceived as being both significant and difficult to control.

Bank financing difficulties: the plight of SMEs and mid-tier companies

03. Compliance risk

In May 2020, the European Commission adopted an action plan to tackle money laundering, the implementation of which in Member States' legislation has significantly toughened the granting of credit to companies in the defense sector. This stricter legal framework may lead to non-compliant deals, for the smaller players in the EDTIB, who are less equipped than large groups to meet the transparency requirements.

A study published in November 2021 by the NGO, *Transparency International*, estimates that 62% of the world's countries are highly exposed to corruption in the defense and security sector, and only 12% of defense companies have implemented robust and convincing measures to combat corruption. Considering the significance of compliance risk for banks, this lack of clarity is bound to be detrimental to the EDTIB's industry.

04. Lack of qualified interlocutors

Part of the reason why EDTIB players find it difficult to obtain finance is that they lack specialised contacts in the banking world. The major banks do not always have dedicated teams to cover the sector, or if they do, they often only focus on export/trade finance. EDTIB subcontractors are generally handled by regional business centers, which are generic in most banks. Overall, the "defense culture" is not very prominent in civil society, which is a source of misunderstanding.

05. Sector-specific banking policies

The EDTIB's banking difficulties are mainly related to the financing of working capital requirements, as well as innovation and export financing. Access to such financing is constrained by the sector-specific policies of Europe's major banks, which more or less expressly curtail the financing of defense industries. It should be noted that these sectoral policies are not devoid of ambiguity: the banks willingly use broad terms, without precise definitions, such as prohibiting the financing of "controversial armaments", in order to maintain some flexibility when it comes to deciding whether to finance certain transactions.

However, this situation could well change, as French banks have always maintained an open attitude to the defense industry. Elsewhere in Europe, some banks previously very reticent banks have since adjusted their positions. NordLB, Hamburg Commercial Bank, Deutsche Bank and Commerzbank have stated that they are now open to considering a relaxation of their policy. The most visible example of an actual change comes from Imarquanta Landesbank Baden Württemberg. This regional bank has departed from its previous policy and announced that it is extending its scope to include the financing of all armaments for which a delivery permit has been issued by the competent German federal office.

> *There can be no prosperity, inclusiveness and sustainable development without stability and security.*
>
> Patrice Caine, Thales CEO

Financing difficulties: the role of non-financial criteria

01. European taxonomy

Ultimately, though, it is probably the non-financial criteria that lie at the heart of the problem of gaining access to bank financing. The primary reason is the growing importance of ESG requirements. The regulatory framework developed by the European Union to promote sustainable finance is complicating the financing of the EDTIB. The proposal put forward by the European Commission in 2021 to exclude arms from the eco-label as soon as the 5% revenue threshold for conventional arms is reached, poses direct threat to defense industry financing.

02. Less effective government support

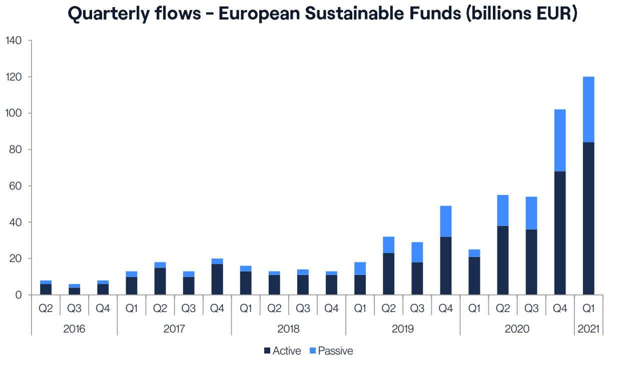
In France, the export license issued by the Inter-ministerial Commission for the Study of War Materiel Exports (CIEEMG) is an essential but an inadequate prerequisite for securing bank loans. Each bank conducts its own risk analysis and the CIEEMG's decision is not binding. Furthermore, in some European countries - Italy, Belgium and the UK - the legality of granting an export license has been challenged in the lower courts. This is diametrically opposite to the situation faced by the American defense industry, where some states have a totally different take on security issues: indeed, in 2022, Texas passed a law to exclude banks from certain bond issues, if they refuse to finance the defense industry. Admittedly, the defense industry is particularly important in Texas, as it is in Florida, Washington and California.

03. Competing regulatory standards

The norms and rules governing business law and international relations are not solely based on official documents. In the grey areas of international law, pressure and influence are brought to bear. The United States has strengthened its enforcement powers and uses the extra-territoriality of its law to deny access to sensitive material and dollar-denominated transactions. This is a real hindrance for investors and credit institutions, who are confronted with a major compliance risk. Moreover, several European banks have already suffered from the Office of Foreign Assets Control's (OFAC) case law reversal and have been forced to pay heavy fines, which heightens their perception of the risk. Over the last four years, if we focus solely on the most significant cases, OFAC has penalised around thirty banks with cumulative fines of around $2 billion.

04. Investment shift

With the European Sustainable Finance Disclosure Regulation (SFDR) coming into force in March 2021, many asset managers have placed a large proportion of their funds in the more demanding 'green' categories. These funds now account for a third of the investment products available on the European market, and almost half of assets under management. Faced with such a strong momentum, it is proving difficult to gain access to financing without complying with ESG fund investment rules. While these criteria are open to interpretation, the application of quantitative filters on ESG criteria often results in the exclusion of defense-related issues.



Source: Morning Direct, Manager Research, data to March 2021

Private Equity, a low profile player within the EDTIB

Investment funds are already active in the EDTIB

A number of investment funds are already present in the EDTIB. Leading asset managers are already among the main shareholders of major defense groups: Vanguard, Blackrock, Amundi, etc. invest in listed companies in the sector through mutual funds. n the United States, these institutional investors are the major shareholders in Lockheed Martin, Raytheon, Boeing, Northrop Grumman, General Dynamics, etc. However, these asset managers are passive shareholders who, with a few exceptions, have no role in influencing the companies' strategic moves.

Private Equity funds, on the other hand, are mainly active in SMEs and mid-tier companies. Venture Capital investment is modest, although there are signs of growing interest from early stage funds in start-ups that are developing dual technologies. The key players in the sector are predominately Anglo-Saxon LBO funds: the European ecosystem is relatively underdeveloped (although a few names stand out, such as Tikehau Ace Capital, HLD, Weinberg Capital Partners and Expansion, as far as private European players are concerned). *Private Equity* funds, and in particular LBO specialists, are key drivers of growth and consolidation in the industry, particularly among aerospace subcontractors. More specifically, *Private Equity* funds specialise in bringing their expertise to companies (management support, connections and familiarity with prime contractors, etc.). National public-sector bodies are also involved, notably Bpifrance through its Definvest fund, and the European Investment Bank (EIB). Finally, manufacturers also have their own funding vehicles (Airbus Ventures, Safran Corporate Ventures, SAAB Ventures, etc.).

Moving towards innovative financing solutions?

In light of the difficulties encountered in cooperation programmes between manufacturers, the industry is looking at different ways of strengthening the EDTIB. While the development of a *Private Equity* ecosystem in Europe is part of the solution, it does not prevent the industry from considering alternative financing solutions to maintain the EDTIB's robustness and capacity for innovation. NATO, for example, has considered using its status as a supranational organisation to assist Member States' DTIBs, by levying debt and making the resulting room for manoeuvre available to the defense industry in the form of loans. A more easily implemented scheme would be to redirect part of household savings towards financing defense industries through a dedicated savings account. In France, several scenarios are being explored, including the creation of a "sovereignty savings account" originally proposed by the French National Assembly's Foreign Affairs Committee, or the earmarking of the Livret A savings deposits to finance the EDTIB. The Swedish bank SEB recently reversed its decision to exclude arms from its investment universe. It now believes that investing in the defense industry is important for "defending democracy, freedom, stability and human rights".

Europe leading the way

The European Union has created the framework for several initiatives, such as Permanent Structured Cooperation (PESCO) and the European defense Fund, both of which serve as platforms for collaborative action and funding for European industrial and operational defense programmes.

In addition, there are other projects in the pipeline based on agreements between French, German and Italian manufacturers, such as the SCAF (next-generation combat aircraft), the MGCS (new-generation tank) and the Euromale RPAS (drone). The most common approach is for some manufacturers to contribute technological building blocks in exchange for partial financing of development costs. This type of cooperation is an alternative to the off-the-shelf equipment procurement for countries lacking the time or technological know-how to develop their own programmes

The role of investment funds

A wide range of financing tools

When it comes to financing, *Private Equity* funds have several instruments at their disposal, such as equity contributions and shareholder loans. Numerous debt instruments can also be deployed, such as convertible bonds or a whole spectrum of debt, from *plain vanilla* to more complex instruments, including subordinated debt.

Transformation strategy and implementation

Private Equity funds support the management team in identifying and implementing new development strategies:

- Innovation and a shift in positioning towards high value-added products;
- New commercial goals (such as participation in large-scale programmes);
- Geographical diversification: the funds sometimes have in-depth knowledge of certain external growth opportunities, with the aim of de-risking the business portfolio by striking a balance between civil and defense activities, a greater variety of customers and diversification of the product and service portfolio.
- The modernisation of production equipment, in particular to meet the challenges of the major industrial transformations already underway (AI, digitisation, etc.).

Mobility and capital allocation

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Critical size

Some of the difficulties faced by SMEs and mid-sized companies in the EDTIB stem directly from the relatively small size of the players involved. The equipment suppliers to the major principals therefore have a vested interest in participating in the sector's consolidation, to i) gain greater visibility with banking institutions and prime contractors, and above all ii) to diversify their sources of revenue and iii) to dilute their fixed costs and increase their margins.

Sector expertise

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Financing start-ups

Start-ups in the defense ecosystem appeal to a particular category of Private Equity fund – those specialising in early-stage development or Venture Capital. The latter generally take minority stakes, possibly alongside private individuals (founders, business angels, etc.). Corporate venture funds are also actively taking stakes in certain start-ups, such as Safran Corporate Ventures, which has invested in Cailabs and Electric Power Systems.

How Eight Advisory can provide support to the EDTIB

01. Acquisition Due Diligence

Financial *due diligence* enables potential buyers to have greater visibility and confidence in the target's financial performance. It focuses on the risks and opportunities associated with the acquisition, while ensuring the accuracy of the financial aggregates used to determine the target price.

02. Fiscal Due Diligence

Likewise, fiscal *due diligence* identifies the tax opportunities and risks associated with external growth transactions. It also outlines the appropriate acquisition structure (debt allocation and financial burdens, and fiscal treatment of acquisition expenses).

03. Strategic Transformation

To support the business case developed by the Transaction Services teams, we identify and quantify potential synergies across the value chain (commercial, production, procurement, overheads).

In the run-up to the transaction closing, we define the new integration strategy and develop the target operating model and provide management with support and action plans.

04. Valuation

Based on our business plan prepared in conjunction with the *Transaction Services* teams, our valuation consultants model the target's disposable cash flows and determine the valuation metrics. Our analysis is based primarily on the discounted cash flow (DCF) valuation method. These findings will be corroborated by the observed multiples in similar listed companies and non-listed peers. Analyses are conducted to heighten awareness of business value based on several key parameters.

05. Purchase Price Allocation

Depending on the company's size and its jurisdiction, a purchase price allocation (PPA) exercise may be necessary, to comply with IFRS 3. As part of a PPA exercise, intangible assets may be recorded in the balance sheet if they meet three criteria (identifiable, capable of generating future earnings and if they are effectively controlled by the buyer).

Contact our experts and see how we can help you!

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