European defence: rearmament orders to test R&D, supply chains, short-term funding

Surge in orders promise strong cashflows for contractors but policymakers must deliver on commitments

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The rearmament of Europe will raise demand for the region's defence companies but test the sector's fragmented production capabilities, research and development (R&D), supply chains, and access to capital.

Sharp shifts in the United States' foreign and defence policy under the new Trump administration have forced Europe to reassess its defence strategies, transforming the European industry's outlook, with the focus on building up military self-sufficiency as Russia's war in Ukraine continues.

European defence contractors are well positioned to benefit from continued growth. Share prices have risen sharply in recent months reflecting market expectations of a surge in new orders. In addition, many contractors are generating free operating cashflow which creates financial headroom for new investment. This is notable among the larger firms such as UK's BAE Systems PLC, Italy's Leonardo SpA, Germany's Rheinmetall AG and aircraft-maker Airbus SE's defence units.

However, the sector does face structural challenges related to the peculiarities of the European sector: the relatively modest size of individual firms, fragmented procurement processes across multiple different defence ministries, in addition to supply-chain, staffing and funding constraints.

It may take some time before the European industry more closely resembles that of the US, where large contractors such as Lockheed Martin Corp., RTX Corp. and Northrop Grumman Corp. have the advantage of serving a single Department of Defence. Unless there is further consolidation in the European industry, the region's smaller and more specialised firms, with fewer economies of scale, are less well placed for ramping up output, leading to slower, costlier procurement.

Another constraint is the European industry's relatively limited investment in research and development (R&D) which hampers innovation and blunts its competitive edge in defence technologies.

Table 1. European defence market characteristics – opportunities and challenges

⊕	**Defence budgets to rise:** Most NATO allies agree on raising defence spending to 3% of GDP from current 2% commitment. EU studies EUR 150bn defence fund and mobilising EUR 800bn for 2030 Readiness plan.
⊕	**Increasing equipment demand:** Defence procurement in the EU is set to rise to more than EUR 100bn in 2025, up more than 10% from EUR 90bn in 2024, and up 64% from EUR 61bn in 2023.
⊕	**Strategic autonomy:** Centralising EU arms procurement through mechanisms like the European Military Sales Mechanism could bolster domestic arms makers and reduce reliance on external parties.
⊕	**Enhanced funding:** Strong order flow, greater government fiscal support, better access to capital markets should provide ample financial headroom for investing in new capacity.
⊕	**Spare capacity:** Defence contractors could take advantage of spare capacity elsewhere in European manufacturing. Volkswagen AG has proposed unused facilities for military output.
⊖	**Fragmented market:** European defence firms operate in fragmented national procurement systems, limiting economies of scale. US peers benefit from a unified domestic market, helping optimise R&D, output.
⊖	**R&D investment disparities:** European defence firms' R&D investments lag those of US companies.
⊖	**Supply-chain vulnerabilities:** Dependence on non-EU suppliers for critical components exposes the European sector to geopolitical risks and potential disruptions, limiting resilience and self-sufficiency.
⊖	**Financial constraints:** Lingering regulatory, ethical considerations may still limit European firms' ability to raise funds on capital markets in contrast with US peers.
⊖	**Skills shortages:** With military budgets run down over and the size of the armed forces reduced over many years, the industry faces a shortage of skilled staff which could impede scaling up production.

Table of content

Promise of cashflow surge leaves some funding questions unanswered

Even allowing for improved cashflow, the new phase of heavy capital expenditure may strain the finances of smaller companies. Anticipated cash inflows might not materialise immediately without government support. Staffing shortages and supply-chain bottlenecks may further exacerbate these challenges so fulfilling orders will require careful management of inventory (working capital) and longer-term funding for adjusted production capacity.

The working-capital question is critical, despite optimistic cashflow projections. European defence firms, particularly small and medium-sized enterprises (SMEs), have had restricted access to bank and capital-market funding due to regulatory and ethical concerns as the EU Commission and some investors prioritised environmental, social and governance (ESG) considerations.

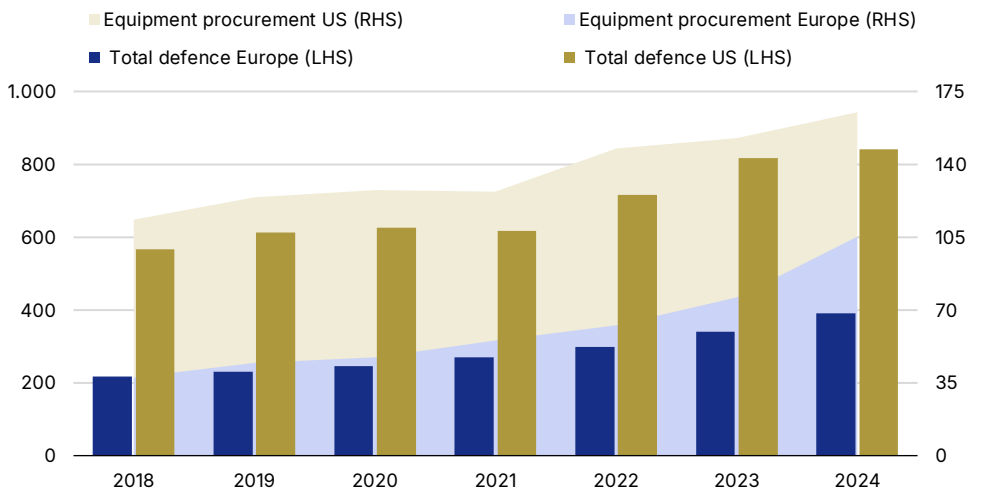
1. Spending gap with US highlights potential for European firms

EU eyes EUR 800bn boost to defence expenditure

EU member states are on course to spend more than EUR 100bn in defence procurement (purchases of new equipment) this year, a sharp rise from EUR 90bn spent in 2024. This increase reflects just one aspect of the growing government defence budgets – EU states spent an estimated EUR 326bn on defence (about 1.9% of EU GDP) in 2024 – as support for Ukraine continues and pressure grows for Europe to be more responsible for its own defence.

Amid discussions for an extra EUR 800bn in EU defence spending over the next few years under the ReArm Europe Plan/Readiness 2030, European defence contractors are looking forward to a surge of new orders even though the region's combined defence spending remains approximately half of that of the US despite recent increases prompted by Russia's full-scale invasion of Ukraine.

Figure 1: Europe-US comparison of total defence expenditure gap (EUR bn)



Sources: US Department of Defence's National Defence Budget Estimates, UK Ministry of Defence's Departmental Resources 2024, European Council / EDA – EU defence spending, Scope Ratings.
Notes: Europe refers to euro area and UK; shaded beige area refers to amount of US procurement in excess of Europe's (shaded blue area).

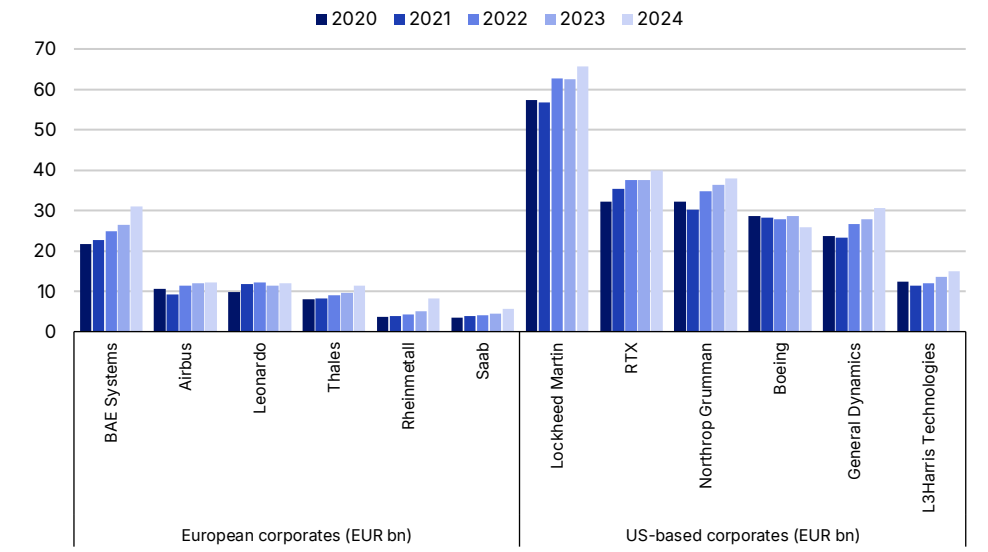
Europe's defence industry is several years into a cyclical upswing, driven by heightened geopolitical tensions and reflected in the strong order intake and revenue growth of the region's largest firms, particularly since the escalation of the war in Ukraine in 2022.

BAE Systems, Italy's Leonardo, and Germany's Rheinmetall reported compound annual growth rates (CAGR) ranging from 6% to 23% during 2020-24.

European defence contractors have benefited from large-scale military aid deliveries to Ukraine and the resulting need to replenish national stockpiles, increased procurement across Europe as rearmament efforts gained momentum, and rising export demand from non-European markets.

However, the positive top-line effect from increased defence spending is more significant for US-based corporations, largely driven by their greater economies of scale (**Figure 2**).

Figure 2: Rising tide raises all boats: defence spending boosts contractors' revenues, but more so in US than Europe
Revenues at selected US, European defence contractors 2020-24



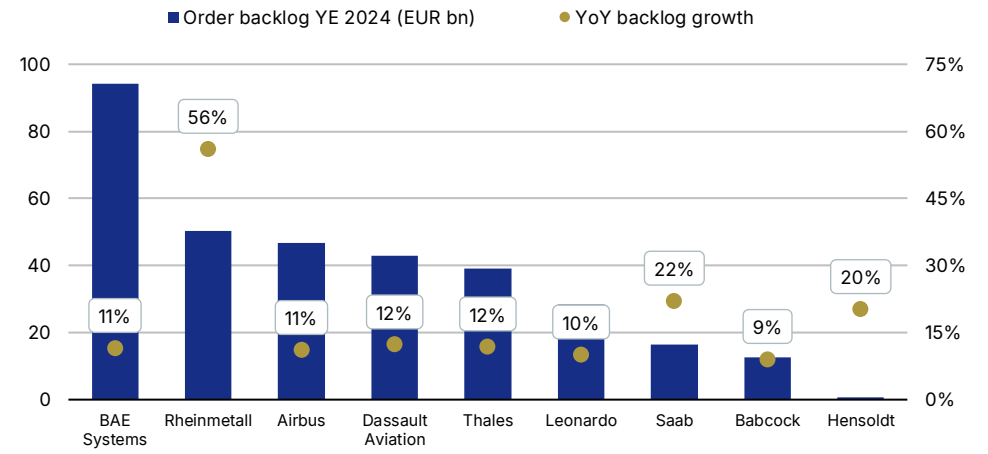
Sources: Annual reports, Capital IQ, Scope Ratings.
Note: Group revenues for companies such as Airbus, Leonardo, Thales, Rheinmetall, RTX, Boeing, General Dynamics and L3Harris Technologies have been adjusted to reflect only their defence/military segment sales.

2. Expanding order backlogs indicate long-term demand

European defence firms benefit from ballooning order backlogs

One of the strongest indicators of sustained growth in Europe's defence sector is the record-high multi-year order backlogs across leading firms, totalling EUR 330bn at end-2024 **(Figure 3**). Companies like BAE Systems (EUR 94bn order book at end-2024) and fighter-jet maker Dassault Aviation SA (EUR 43bn) have secured multi-year orders that extend beyond the current budget cycles. Rheinmetall – a key supplier of munitions, military vehicles, and air defence systems – reported the most substantial year-over-year backlog growth of 56% reflecting the persistent demand across European markets.

Figure 3: Order books bulge at European defence contractors



Sources: Annual reports, Scope Ratings
Note: BAE Systems, Saab, Babcock figures converted at GBP/euro, SEK/euro rates 31.12.24

Yet, even with this expansion, European firms remain significantly smaller than their American counterparts - a crucial factor that influences their long-term competitiveness. Lockheed Martin,

the world's largest defence contractor, reported USD 71.0bn (EUR 65.7bn) in revenue in 2024, equivalent to more than double BAE Systems and four times Leonardo's revenue. RTX (formerly Raytheon) and Northrop Grumman also operate at a larger scale.

This differential has strategic consequences. Larger companies can afford to invest in multiple large-scale projects simultaneously, secure bigger government contracts, and absorb economic shocks more effectively. In contrast, many European firms often rely on fragmented national procurement systems, forcing them to compete for smaller, country-specific contracts rather than leveraging the potential of a more integrated European defence market.

3. Capacity expansion accelerating but more will be needed

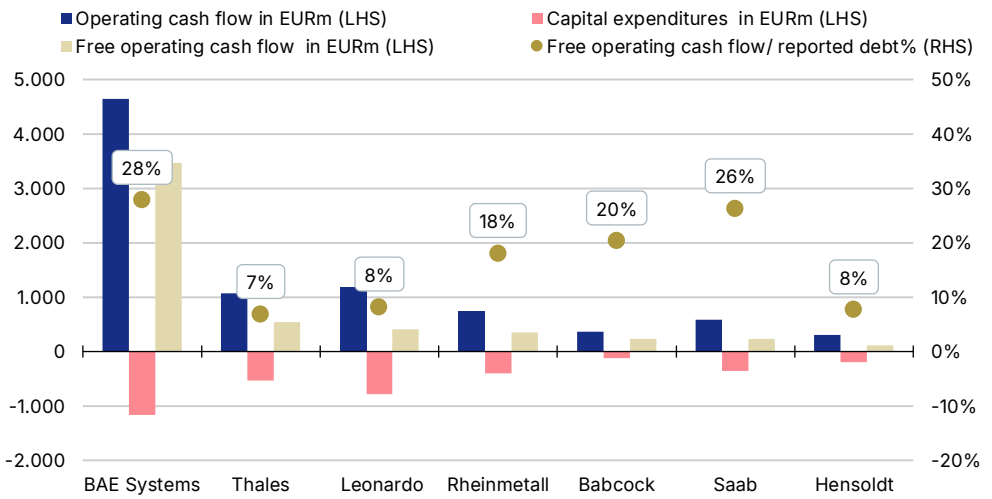
The recent surge in budgets and orders has started to significantly boost European defence contractors' financial position. Higher revenues and growing order backlogs are strengthening balance sheets, enabling reinvestment and providing capital for expansion.

Bulging order books leading to investment in new capacity

With orders booming, companies have been investing heavily in capacity even before receiving firm contracts, taking on more business risk than usual. Rheinmetall, for example, is considering converting idle automotive parts plants into ammunition factories, BAE Systems is also ramping up artillery shell output with a new facility in the UK.

Governments are also playing a key role providing subsidies and grants to eliminate bottlenecks, despite ongoing concerns about subsidising already profitable firms. Notably this defence driven expansion has reversed previous employment declines with the aerospace and defence sector creating 47,000 jobs in 2023 marking a sharp turnaround after years of contraction.

Figure 4: Cash flush: rising orders translated into strong cashflow performance in 2024



Sources: Annual reports, Capital IQ, Scope Ratings.
Note: While the cashflow of these companies are not adjusted specifically for cash generated from defence contracts, most of them have more than 70% exposure to the sector.

European defence companies possess the financial capacity to manage growth as displayed by the financial headroom provided by solidly positive free operating cash flow (**Figure 4**), but their ability to satisfy local and international demand will depend on successful scaling up of operations and the degree of coherent national and EU-level support and decision-making. Additionally, the sector faces significant workforce shortages, particularly in skilled labour, which impedes efforts to scale operations and meet increasing demand.

ESG lending, investment criteria restrict bank, market funding

Another point to scale operation is access to funding as Europe's defence sector has long been constrained by regulatory and/or ethical barriers, limiting firms' ability to scale despite strong demand. One EU study found that 44% of defence-sector SMEs struggled to obtain bank loans, due to strict ESG criteria labelling arms manufacturing as high risk.

The sub-optimal access to external funding is also largely displayed by the very limited aggregated bond issuing activities of European aerospace and defence companies compared to their US counterparts (**Figure 5**). While US-based A&D corporates provide a steady flow of bonds, making it an important sector of the debt capital market, European counterparts are only selectively tapping the market, with bond placements from the sector accounting for only around 1% of total bond placements over the past five years.

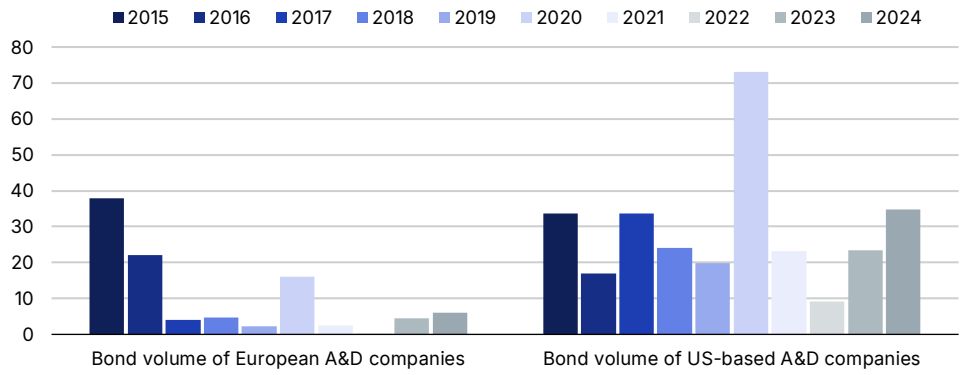
EIB eases defence lending criteria as EU reassesses sector funding

However, the tide is turning. In May 2024, the European Investment Bank (EIB, rated by Scope AAA/Stable) eased its defence lending policies[1].

The EU is now exploring joint funding tools like "European Defence Bonds" to improve capital-market access. For instance, the EU has proposed a EUR 150bn ReArm Europe funding plan exclusively for EU defence companies and those from third countries that have signed defence agreements with the EU.

We believe that bond investors will increasingly change their view on the funding of European defence companies. This shift is driven by heightened geopolitical tensions, a re-evaluation of ESG investment criteria and a stronger confidence in issuing entities whose credit quality will be supported by more supportive and stable regulatory and fiscal frameworks.

Figure 5: Aerospace and defence (A&D) bond market activities in past 10 years (EUR bn)



Source: Bloomberg, Scope Ratings

Significant sector consolidation through M&A may be coming

Ultimately, for European defence contractors to achieve more US-like economies of scale will necessitate industry-wide strategic consolidation through mergers and acquisitions (M&A).

For the larger firms with the financial and operational capacity to absorb smaller contractors, success will depend on identifying targets that complement existing technological capabilities and market positions, ensuring that consolidation efforts lead to sustainable growth and enhance the sector's global competitiveness.

At least Europe does have one role model in Airbus, the product of Franco-German-UK collaboration, which over time has rivalled Boeing as one of the world's two largest aircraft manufacturers. Airbus is itself an important defence contractor. Its defence and space unit's revenues rose 5% to EUR 12.1bn in 2024 from the year before.

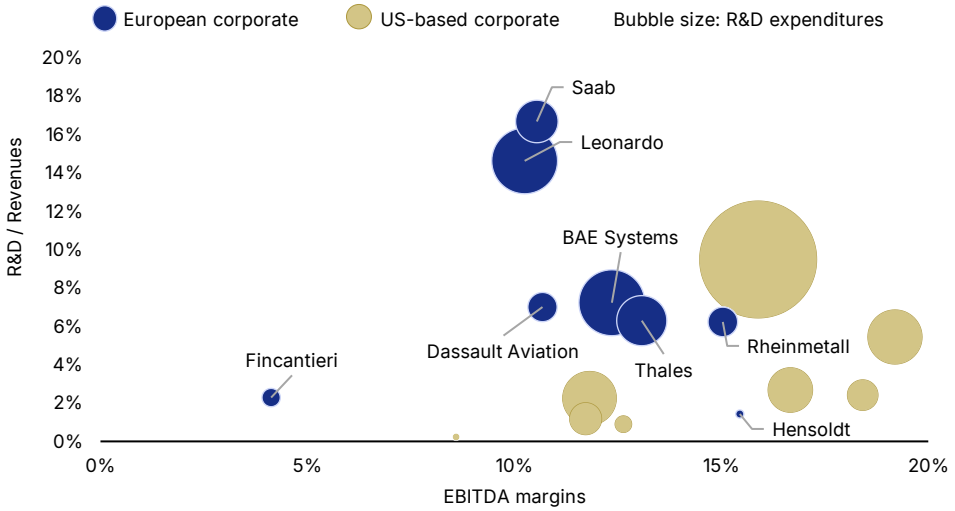
4. European R&D spending is rising, but still trails the US

Question of increasing R&D spending looms large

While financial growth is essential, long-term competitiveness in the defence sector depends heavily on R&D. Europe is investing more than ever, but its efforts are still tiny by the standards of the US. European firms like Leonardo and Saab invest a higher percentage of revenue into R&D activities, but US firms receive far more government-funded R&D, enabling them to dominate cutting-edge technology development (**Figure 6**).

[1] Investments in the defence and security sectors are subject to dual-use requirements and exclusion criteria for weapons and ammunition.

Figure 6: Making R&D count in the defence sector
Spending, profitability compared between European and US defence companies



Sources: Annual reports, Capital IQ, Scope Ratings
Note: Corporate data reflects company-wide R&D spending, profitability, not just that related to defence sector.

For example, the US Department of Defence allocated USD 141bn[2] to R&D in 2024—compared with just EUR 13bn for all EU countries combined. This disparity means American companies have far greater access to state-funded technology development, allowing them to lead in fields like hypersonic weapons, AI-driven combat systems, and autonomous drones.

More joint-funded projects likely to take shape

To compete with US firms, European companies must scale up joint R&D efforts under EU-funded projects. The Future Combat Air System (FCAS) – a trilateral programme between France, Germany, and Spain to develop a next-generation fighter jet – is one example of how Europe might collaborate more in the future.

However, unless European governments commit to long-term, sustained R&D funding mechanisms, there is a high risk that European firms will fall further behind their US competitors in critical next-generation warfare technologies.

5. Using fewer non-EU subcontractors to strengthen supply chains

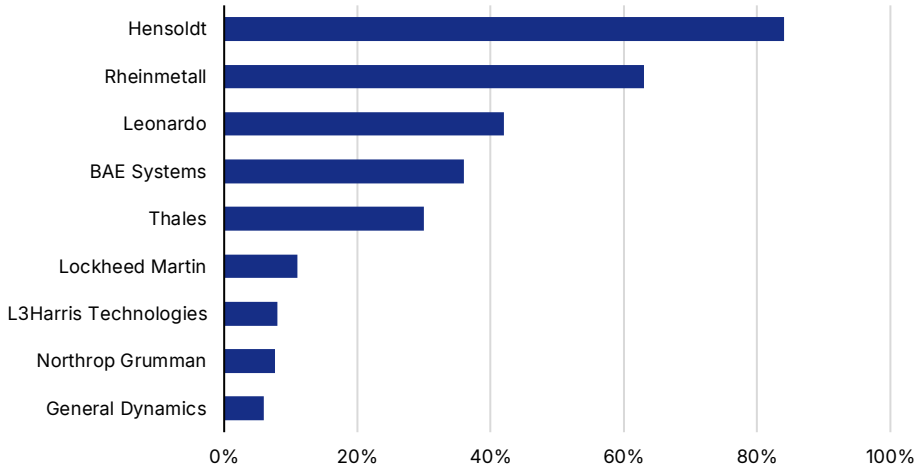
A major structural weakness exposed in recent years is Europe's reliance on non-EU suppliers for critical defence materials and components. Some European defence companies have substantial sales exposure to European defence spending (**Figure 7**), but EU suppliers accounted for only 22% of total procurement between mid-2022 and mid-2023, while U.S. firms alone made up 63%.

Such external dependence poses serious risks, as recent global disruptions in semiconductor supply chains and raw materials shortages have highlighted. A lack of domestic production capacity leaves European defence firms exposed to geopolitical uncertainties, trade restrictions and supply-chain bottlenecks which could undermine military readiness and industrial competitiveness.

The F-35 fighter jet programme is a prime example. Despite European nations producing capable alternatives like BAE System's Eurofighter Typhoon and Dassault Aviation's Rafale, several EU countries have opted to purchase the American F-35, citing its advanced networking and stealth capabilities. However, this choice increases reliance on US-controlled maintenance, training, and software updates, reducing Europe's strategic autonomy. Since Trump's return to power, Canada and Portugal are two NATO allies to have questioned the future role of the F-35 in their air forces.

[2] This represents about 15% of the total national defence budget of $892.5 billion approved by Congress for that fiscal year.

Figure 7: Exposure to European defence spending (% of total revenues)



Sources: DEFCON: Brave New World, Scope Ratings

Reliance on US technology like F-35 fighter jet presents challenge

Even when European nations procure locally, their supply chains are not truly independent. The reliance on US microelectronics, missile propulsion systems, and stealth coatings means that in a crisis scenario, Europe might not be able to ramp up production in a crisis without US approval.

On the other hand, American defence firms also face dependencies. Lockheed Martin and Northrop Grumman, for example, source critical raw materials like rare earth metals from China, a supply-chain vulnerability that could prove costly in the event of escalating U.S.-China tensions.

6. Europe's strategic autonomy requires more than just defence

Defence is just one crucial part of improving Europe's resilience

The future for European defence companies is promising but heavily dependent on the broader execution of Europe's rearmament plans in tandem with other measures to enhance the region's strategic autonomy, including investment in energy, transport and digital infrastructure facilitated by completing the capital markets union.

The biggest challenge for European firms will be ramping up output without long-term guarantees. Unlike their US counterparts, which benefit from multi-decade procurement programmes, European firms are often reliant on shorter-term government contracts. This uncertainty makes it difficult for companies to justify large scale capital investments or sustained capacity expansion.

Political will, private-sector funding key for self-sufficient defence

So, making Europe's defence sector more self-sufficient depends on political commitment. European policymakers will need to enforce local procurement and commit enough funding for industrial expansion. Without this commitment, reliance on US and non-EU suppliers will likely persist.

If defence budgets remain high, European firms will see sustained revenue and order growth in the medium-to-long term. To sustain it, private-sector funding commitments will also be important, particularly for R&D which remains below US levels. Without better coordination and more innovation, European companies risk falling behind technologically.

That said, with more predictable demand, companies can invest in new production lines, hire more staff and upgrade workers' skills. This should stimulate R&D and innovation in cutting-edge technologies (radar, aerospace, cyber etc.), given that 88% of EU defence investments already go to procurement.

By ensuring a large share of this investment is spent on European-made equipment rather than imports, the EU's 2030 Readiness programme could drive growth among prime defence contractors and a web of smaller subcontractors to build a more robust and integrated industrial base.

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