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EUROPE'S DEFENSE COMPANIES FACE CONFLICTING SPENDING OUTLOOK

The AlixPartners A&D Minute

While the European defense industry has thus far escaped most of the direct effects of COVID-19, the outlook for defense budgets on the Continent is not completely clear. Unlike commercial aviation's crushing collapse under the pandemic, the defense side has only experienced increased costs and delays, necessitated by workplace safety measures, supply chain disruptions, and travel restrictions. The top European players—Airbus, BAE Systems, and Leonardo—are all hopeful that their defense business will at least partly compensate for losses on the commercial side. At the same time, the burden of economic recovery and other myriad conflicting factors complicate the landscape.

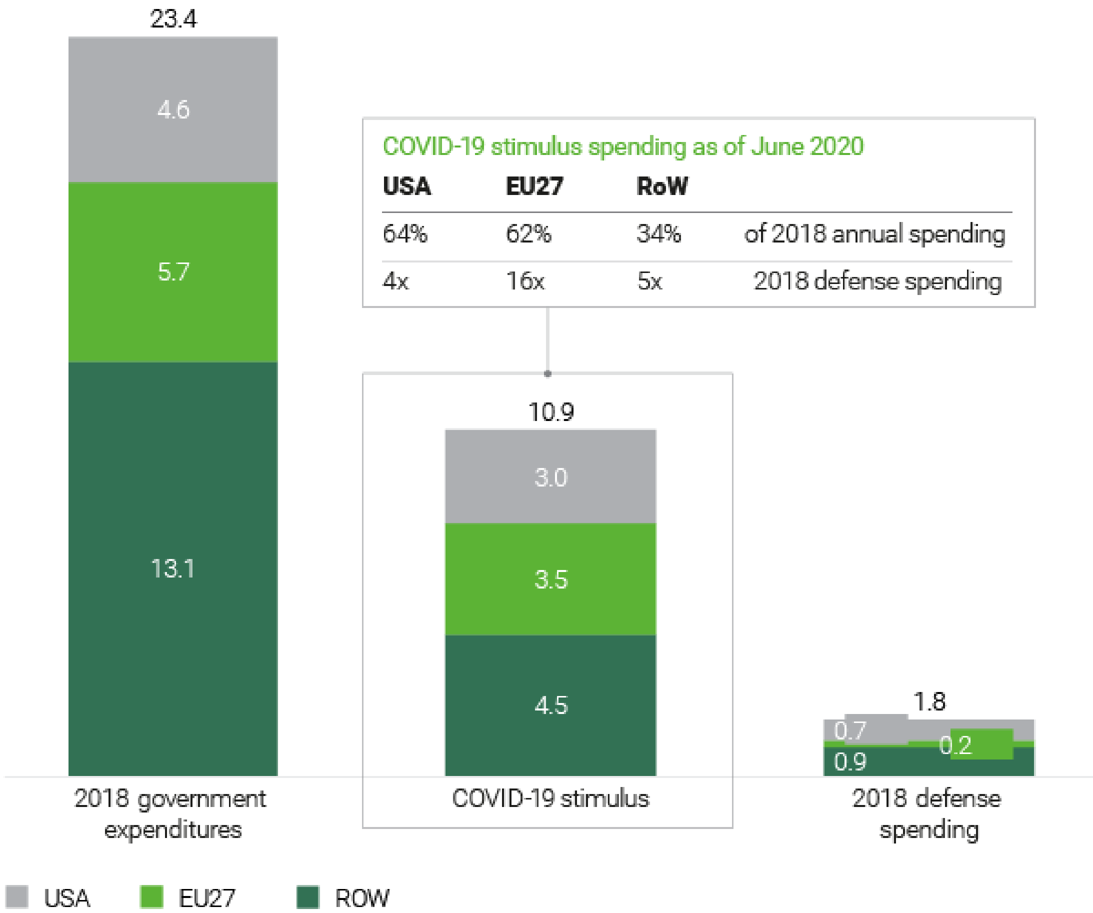
Europe's defense market is growing, with budgets increasing steadily over the last five years. The Continent makes up 16% of global defense spending, with a compound annual growth rate of 3.4% between 2015 and 2019. However, its arms exports are flattening, while the US is increasing its export share. With about 20% to 30% of export share, Europe is the runner-up to the US' 30% to 40%. Lack of collaboration and weaker confidence in the European defense industry continue to shrink the domestic export business and allow the US to make export gains.

Meanwhile, defense budgets in the region appear stable with the biggest European customers signaling increases in the near term. Germany and France are both looking to continue increases or remain steady, and the UK is in the midst of its largest defense budget increases since the Cold War. Italy announced a major boost even as the country spends heavily to battle COVID-19. Each country has its own ambitions, but the threats they face will not subside with the pandemic or with a potential Brexit resolution.

The competitions on key weapons systems to fulfill requirements or upgrade and replace over the next decade bode well for the industry—Germany's recently confirmed €5.5 billion contract with Airbus for 38 Eurofighters is one notable example. Investment in disruptors such as cybersecurity, space command, and the hypersonic missile threat also gives a boost. So, too, do major collaboration programs for next-generation systems such as the Future Combat Air System as well as Tempest, Main Ground Combat System, and the recently announced Next-Generation Rotorcraft Capability. The extent of the procurement and research and development required for these investments make a strong argument that defense expenditures could go far to support economic recovery.

Despite these signs, the pressure on governments to focus on overall recovery is undeniable. This pandemic and its economic fallout are unprecedented, but we can look to the Great Recession of 2008 for pointers. That financial crisis was not as deep as the current situation, but it's worth noting that Europe and the US reduced defense budgets in favor of bailing out economies. Meanwhile, China and Russia maintained steady growth in their defense spending. Thus far, the COVID-19 stimulus spending for Europe and the US represents 60% of 2018 government spending, whereas for the rest of the world it's at 34%. Looked at in terms of defense spending, Europe's pandemic stimulus spending is 16 times that of its 2018 defense spending (Figure 1). Given those numbers and how long it will take to control the pandemic, US and European defense budgets will almost certainly come under pressure, while China and Russia may not see the same effect.

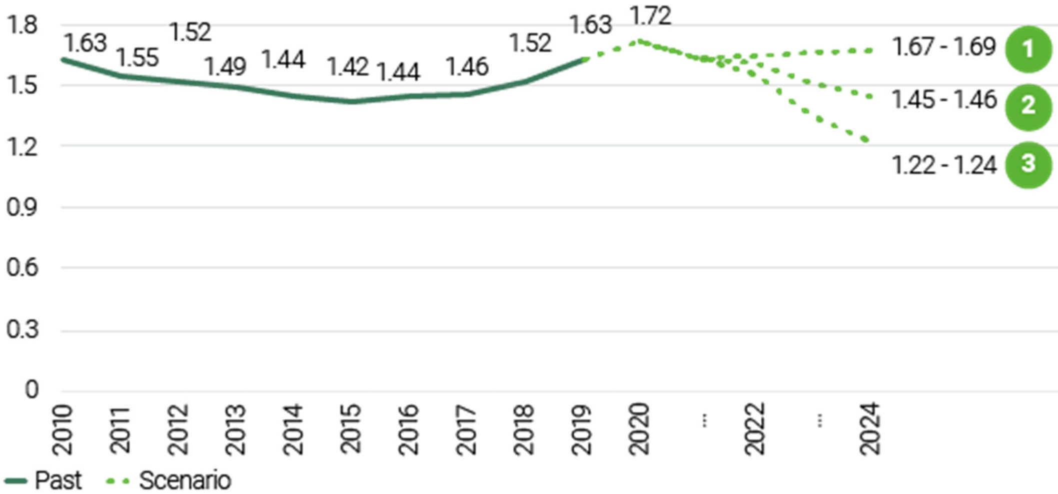
FIGURE 1: COVID-19 STIMULUS IN DOLLAR TRILLION COMPARED WITH OTHER GOVERNMENT EXPENDITURES



Source: SIPRI Military Expenditure Database, The World Bank, IMF June 2020 Fiscal Monitor; AlixPartners analysis

The European NATO countries' defense spending has come closer to the target of 2% of GDP recently, but still remains on average below it, at 1.63%. In 2019, only eight countries met or exceeded the target. With GDP expected to decline under the pandemic's economic toll, more countries are likely to get closer to 2% this year. But even if defense budgets increase after the pandemic, reaching the target is still a stretch. Assuming slight variations in GDP growth, the potential for the average share of GDP for defense spending would range between 1.22% and 1.69% in 2027 (Figure 2).

FIGURE 2: MILITARY EXPENDITURES OF EUROPEAN NATO COUNTRIES AS A PERCENTAGE OF GDP, INCLUDING POTENTIAL DEVELOPMENT SCENARIOS FOLLOWING COVID-19



Scenario analysis considering slight variations of GDP and defense budgets expected

1. Growing (average growth rate pre-crisis)
2. Staying constant at 2020 levels
3. Decreasing (comparable to the aftermath of 2008 financial crisis)

Source: NATO, IMF, SIPRI Military Expenditures Database; AlixPartners analysis

While the US market faces similar conditions, the landscape is more complex and fragile in Europe. At the same time, there is opportunity. The European defense industry should defend and increase its strong positioning while preparing for an uncertain future as economies, governments, and commercial aviation recover from the pandemic. These actions fall into four buckets:

- Actively manage the topline and undertake cost reduction measures required to maintain profitability. If necessary, this can extend to adjusting the cost base in both fixed and variable costs for all operating functions, including engineering, supply chain, and production.
- Observe disruptions in the supply chain and actively manage suppliers. Offer support to smaller suppliers that are more susceptible to fluctuations or already in trouble from the commercial air crisis.
- Actively support collaboration and consolidation nationally and across Europe. Fighting for success in pan-European programs and exploring additional opportunities will be critical, for example in the naval business where large joint programs have yet to evolve and consolidation is urgently needed to stay competitive.

- Ensure competitiveness and exportability of newly developed platforms. Make optimizing requirements and managing complexity a key lever and pair it with digital design capabilities, where the Europeans still lag US rivals. Digital tools help manage complexity, ensure robustness, and control cost in design, manufacturing, and operation in an industry with complex products and multi-decade cycle times. Such tools include:
  - Integrated digital twins to simulate design and manufacturing while fully incorporating supplier data
  - Augmented and virtual reality in both the design office and on the shop floor
  - Integrated systems to create full transparency and run risk simulations for materials and supply chain management

Regardless of the outcome of today's unprecedented conditions, it's unquestionable that companies that can incorporate flexibility into long-range planning will emerge from the pandemic positioned for growth and further success. Much depends on the large development programs, especially over the medium term. They offer great potential, but come with high risk, which demands still greater collaboration by governments and industry players. The success of such cooperation will significantly influence European defense sovereignty and the players that currently make up the industry.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.