Global Defence

NATO moves to 5% of GDP - FAQ

Industry Overview

NATO moves to 5% of GDP - FAQ

The NATO allies have agreed to a 5% of GDP defence spending target by 2035. Of that figure, 3.5% is allocated towards core defence capabilities and 1.5% will be invested in defence related outlays. In this note we provide an FAQ for investors to navigate the key impacts on the Defence sector over the coming years.

(1). If NATO countries all increase their military spending to 5% of GDP what does this do to the underlying growth rate of A&D companies?

Based on 2024 GDP estimates we see c.$371bn of incremental Defence spending if all NATO members (ex US) were to spend 3.5% of GDP on core defence, vs $507bn in 2024. NATO members (ex US) ramping defence spending from c.2.1% in 2024 on core defence spending to c.3.5% by 2035 would mean a 2024-35e CAGR of c.>5% in budgets.

We see the underlying growth of the European Defence companies at >12.5% CAGR 2024-28 as we see the % of procurement increasing from c.32% in 2024 to c.40% through 2030. However, the 3.5% core defence journey won't be homogenous in our view (we expect countries to ramp defence spending at a different rate), and companies with high exposure to Defence budgets that will ramp earlier to 3.5% will likely grow the most. For instance, if Germany spends 3.5% in core defence by 2029, this will mean >€150bn in defence. The government spending c.40% of this on procurement would mean c.€60bn to be spent on equipment by 2029 (which compares to c.€26bn in 2024) implying a 2024-29 CAGR of c.20% in equipment.

(2). What % of NATO spend will go to US vs European vs ROW companies?

Whether European or US companies will benefit the most from the rearmament of Europe has become one of the key points of discussion with investors. We expect most of the incremental defence investments to go to European companies. For instance, Indra highlighted at the Paris Air Show that c.80% of the >€10bn of incremental defence spending that Spain will invest in 2025 to reach 2% will be allocated to Spanish Defence companies. We also believe that countries like France have a strong enough Defence industry to be almost 100% self-sufficient and independent from the US.

In our view, there are 3 core capabilities (HIMARS, Patriot & F35) where Europe will likely still be reliant on the US mid-term. We see scope for the US companies to participate in the European defence investment cycle through JVs like the recently announced JVs of Lockheed Martin (missiles) and Anduril (drones) with Rheinmetall or from business units domiciled in Europe such at GD Land Systems.

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HIMARS: High Mobility Artillery Rocket System

NATO: North Atlantic Treaty Organization

ROW: Rest of world

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(3). Which areas of defense spending will increase the most?

Defence electronics (radar, sensors) and air defence systems (integrated air, missile defence and precision strike) will be a corner stone of the NATO capability review. We believe these will be the areas with significant growth well beyond 2030, and as a result, we see the market shifting to prefer names with significant electronics/air defence exposure. Shorter cycle & more heavily exposed land portfolios will still see significant growth across their portfolios as a result of the increasing budgets, but we likely see the rate of growth slow beyond 2030.

We believe investors will start to shift towards portfolios and companies with exposure to end markets with growth visibility well beyond 2030 into the second half of the year where valuations are more attractive right now.

Alongside the 3.5% of GDP to be spent on core defence, NATO is targeting c.1.5% of GDP on defence 'related' outlays. We see exposure to Cyber & Space as key areas of exposure here. Cyber will likely increase in importance in defence applications mid to long term and Space is clearly seen as a strategic capability at the European level.

(4). Which companies are best positioned to benefit from this increased spending?

In the US, we see Lockheed, Raytheon, General Dynamics as best positioned across the prime contractors, and DRS on the subsystem's suppliers.

(5). How firm do we think this 5% commitment is?

The NATO allies agreed to a 5% of GDP defence spending target by 2035. Of that figure, 3.5% is allocated towards core defence capabilities and 1.5% will be invested in defence related outlays. NATO members will commit to annual plans to reach the 5% goal and a NATO review will take place in 2029. We have seen most countries in Europe now articulate a plan on how they are going to achieve these higher levels of defence spending, and their commitment to the higher 5% targets. We see the 5% as a firm commitment that will stick.

(6). How will countries finance this increase spending, will other expenditures be cut or will this all be debt financed?

The financing of the defence budget increases in Europe will be a significant focus of the market in the next few years. In the UK, the government has cut the aid budget to provide some additional flexibility to increase defence spending, and the UK has committed to the 5% of GDP target by 2035, and it is likely more budget savings will need to be found to support the higher spending. In Germany, the budget announcement last week highlighted a commitment to get to 3.5% on core defence by 2029, which in our view was ahead of expectations, the financing of the budget will be through debt. In France, there is a big question mark about their ability to finance a significant increase in defence spending above the currently approved Military Programming Law.

In their recent report, the BofA European Economists highlight that post the 5% commitment (3.5% on hard expenditure), the focus turns now to the credibility of that shift, particularly in Europe, where limited fiscal space, little appetite for mutualisation, and distance to Russia are all key ingredients for a lack of more aggressive efforts in some countries. That political conundrum will eventually, but not quickly, need to be resolved, since a slow move towards 3-3.5% is part of our base case.

(7). Could this commitment lead to an arms race in other regions other world, specifically Asia-Pacific?

We see sovereignty becoming a global investment theme mid-term and believe core capabilities around air defence and precision strike are key investment areas in the defence landscape to protect and reinforce the sovereignty of countries. We believe most of the incremental defence investment from European NATO members will focus on the significant capabilities shortages of Europe (missiles, air defence, radar, defence electronics). We also see strong growth in defence budget in Asia (Japan, Australia) as well as the Middle East, as these governments also look to underpin their security with these key capability areas.

(8). Which ETFs would we buy to take advantage of this increased defense spending?

In our view, the Global X Defense Tech ETF (SHLD) is the best fund to own for diversified exposure to rising global defense spending. Approximately 40% of the ETF is allocated to companies in Europe and the UK, with large stakes in firms like BAE Systems, Rheinmetall AG, Thales SA, and Leonardo SpA. In addition to providing global access, the fund invests in both defense primes and new technology companies, with industry allocations to software, research, and electronics. SHLD ranks highest among its ETF peer group because of its strong risk-adjusted returns, the liquidity of its holdings, and the high ratio of companies with Buy ratings from BofA analysts. SHLD has rallied 59% YTD, outperforming other defense industry ETFs by 30ppt or more. For more details, see our report "Exchange Traded Funds: The new era of defense tech".

(9). Are the defense service companies, such as BOOZ, positively impacted by this development?

Compared to the defense primes, the national security services names are relatively less impacted by the 5% NATO target. Their primary customer is the US Government (USG). The USG represents 80%+ of their government solutions portfolios. KBR is the US defense services company with largest exposure to NATO defense build-up, in our coverage universe. See details on KBR, Leidos and Palantir below.

That said, given increased NATO spending we do see opportunities for these names to expand their presence overseas.

KBR significantly increased their exposure to UK's national security applications through the acquisition of Frazer-Nash (2021) and VIMA Group (2022). Direct sales to EU (excluding the support to the US EUCOM though LOGCAP V) represents around 15% of Government Solutions sales (or 10%+ of total sales). They support UK's Ministry of Defence (MOD) and European Space Agency (ESA). Unlike NASA, ESA has more flexibility to operate on military missions.

Leidos has a strong presence in the UK supporting MOD, Metropolitan Police Service, and National Air Traffic Services. Key programs include the MOD Logistics Commodities & Services transformation (LCST) program and border security solutions. They employ around 1.3k people (or ~3% of total headcount). Total sales outside of the US to non-US customers is less than 10%.

Palantir – from a less traditional defense solutions angle – could also benefit from a ramp in NATO spending. They recently received an award to build the Maven Smart System for the Allied Command operations. This AI-platform is aimed to analyze data from drones, sats, and intel databases to improve battlefield awareness, targeting, and decision making. Palantir's software is also supporting several EU countries with their defense & intel missions, with Europe being a strong contributor to Palantir's ~$400mn sales related to International Governments (~10% of total sales

Exhibit 1: Stocks mentioned
Prices and ratings for stocks mentioned in this report

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
GD	GD US	General Dynamics	US$ 290.74	A-1-7
SHLD	SHLD US	Global X Defense	US$ 59.18	1-FV
KBR	KBR US	KBR	US$ 48.2	B-1-7
LDOS	LDOS US	Leidos Holdings	US$ 155.68	B-1-7
DRS	DRS US	Leonardo DRS	US$ 45.04	B-1-7
LMT	LMT US	Lockheed Martin	US$ 458.59	B-2-7
PLTR	PLTR US	Palantir	US$ 130.74	C-1-9
RTX	RTX US	RTX	US$ 144.66	B-1-7

Source: BofA Global Research

BofA GLOBAL RESEARCH

Price objective basis & risk

General Dynamics (GD)

Our PO of $310 is derived using a 1.1x relative multiple to the S&P 2026e EV/EBITDA. We think a premium to the market fairly considers the strength of the defense portfolio, the recovery expected in Aerospace, and improving Tech operations.

Downside risks to our PO are 1) a downturn could occur in business jets, due to an exogenous factor, 2) given that business jets are priced in dollars, an unexpected devaluation in the dollar could significantly impact order activity, 3) poor execution on defense programs could adversely impact margins, 4) defense budget cuts could limit growth in the medium and long term.

KBR (KBR)

Our PO of $70 is based on a 0.8x relative EV/EBITDA multiple to the defense primes on 2026 estimates. This equals a 11x EV/EBITDA multiple. We think the lower relative multiple fairly accounts for risks to NASA budget and slower-than-expected HomeSafe ramp, partially offset by opportunities on LNG within the STS segment.

Downside risks: cuts to the US government budget vs. anticipated, increased competition from non-traditional players, problems integrating M&A, hiring the right personnel, containing costs, executing on fixed price contracts, sustaining reputational risk and earning future awards. On Sustainable Technologies, risks are slower-than-expected adoption of sustainable technologies, or higher-than-expected competition, and thus, lower-than-expected profitability.

Upside risks: better-than-anticipated budget allocated to innovative technologies and modernization, inexpensive and well-integrated M&A activity, unexpected capital return to shareholders in the form of dividends or share buybacks, market share gains, and better-than-expected margin expansion. On Sustainable Technologies, upside risks are faster-than-expected adoption of sustainable technologies, market share gains, and higher-than-expected profitability.

Leidos Holdings (LDOS)

Our PO of $185 is based on a 0.9x relative EV/EBITDA multiple to the defense primes on 2026 estimates. We think a multiple slightly below the primes fairly reflects the near-term pricing pressure from transitioning some managed services programs to more commercial-terms and the opportunities at border security, healthcare, and defense systems. This equals a 12.5x EV/EBITDA multiple

Downside risks to our PO are: cuts to the US Government budget vs. anticipated, increased competition from non-traditional players, problems integrating M&A, hiring the right personnel, containing its costs, estimating costs and executing on fixed price contracts, sustaining reputational risk and future awards.

Upside risks to our PO are: a better than anticipated federal budget allocated to innovative technologies and modernization, inexpensive and well integrated M&A activity, unexpected capital return to shareholders in the form of dividends or share buybacks, market share gains, better than expected margin expansion.

Leonardo DRS, Inc. (DRS)
We derive our $50 PO based on a 25x EV/EBITDA multiple on 2026e. This implies a 1.8x relative multiple to the S&P 500 on 2026 estimates and to the defense primes on 2026 estimates. A multiple above the broader market and in line with SMID cap defense peers alludes to the company's high growth profile and exposure to long term programs with strongly predictable schedules and funding.

Downside risks to our PO are continued supply chain challenges pertaining to microelectronics, lumpiness of Columbia-class revenues, poor execution on fixed-price programs, continued fixed-price contract awards, poor award activity in the international market, potentially diminished funding for land systems in which DRS supports, and volatility from potential parent company secondary offering.

Upside risks to our PO are even higher-than-expected growth in defense spending, accelerated margin ramp on the Columbia-class program, more cost-plus contract awards, continued strength in the international market, continued funding for land systems, and the gradual reduction in Leonardo SpA's ownership stake.

Lockheed Martin (LMT)
Our $495 PO is based on a 12.5x 2026e EV/EBITDA multiple versus the S&P 500 of 12x. We see a premium to the market (above historical average of 0.9x) as justified given the defensive nature of LMT's defense exposure, partially offset by questions over the Aeronautics business and uncertainty in our terminal value.

Downside risks: as LMT derives nearly 30% of revenue from the Aeronautics division, should the company run into any execution issues on the F-35 program, we believe this could materially affect the company's financials in addition to posing headline risks. Execution risk on defense programs could result in cost overruns and margin contractions. Unexpected cancellations to programs in both commercial and military could materially impact Lockheed Martin as a result. Orders from international programs are difficult to time due to the complexity of the process. Thus, we could see some lumpiness with regard to international orders.

Upside risks: F-35 program performs better than anticipated, defense spending is higher than expected, and LMT continues to buy back more shares than we forecast, driving higher EPS growth.

Palantir Technologies (PLTR)
Our PO of $150 is based on a 15x EV/EBITDA on 2035E. We use a longer-term valuation methodology to reflect sustained high-growth and profitability profile of the company. We think this valuation fairly captures the beneficial position to national security and US government/allies' digital modernization efforts, a leading role in artificial intelligence (AI)-powered platforms, opportunistic partnerships, strong balance sheet and strong profitability.

Downside risks to our PO are lower-than-expected AI-platforms market growth, faster than expected commoditization, higher success from competitors to catch up with technologies, and/or stronger than expected resistance from government customers to use commercial off the shelf solutions.

Upside risks to our PO are stronger-than-expected growth of the AI-platforms market, higher-than-expected PLTR penetration, better-than-expected profitability, and/or successful agreements and investments.

RTX Corp (RTX)
Our $150 PO is based on 2026E EV/EBITDA 14x multiple vs. the S&P500 of 12x. We think a multiple slightly above the market fairly reflects RTX turning the corner of the recent GTF issue, strong demand tail winds, and defense exposure entering a period of reignited growth.

Upside risks to our PO are if the GTF issues are fixed faster and smoother than anticipated, if the commercial aero and bizjet recoveries are better than expected, if margins fare better than we are forecasting, if the company executes on existing programs better than expected, or if gains share in the international market or makes a materially accretive acquisition.

Downside risks to our PO are a downturn in commercial aviation due to the natural business cycle or an exogenous event such as a terrorist attack or a pandemic, additional complications related to the GTF powder-metal issue present further risks, a severe global economic slowdown affecting top-line growth as 45% of sales are generated outside the US, execution risk on defense programs or unexpected cancellations to programs, and uncertain timing around orders from international programs.

Analyst Certification

We, Benjamin Heelan, Jared Woodard, Mariana Perez Mora and Ronald J. Epstein, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Aerospace and Defense Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	AerCap Holdings N.V.	AER	AER US	Ronald J. Epstein
	Axon Enterprise Inc	AXON	AXON US	Jordan Lyonnais
	Boeing	BA	BA US	Ronald J. Epstein
	Bombardier	BDRBF	BDRBF US	Ronald J. Epstein
	Bombardier Inc.	YBBD B	BBD/B CN	Ronald J. Epstein
	Booz Allen Hamilton	BAH	BAH US	Mariana Perez Mora
	BWX Technologies, Inc.	BWXT	BWXT US	Ronald J. Epstein
	CACI International	CACI	CACI US	Mariana Perez Mora
	Crane Co.	CR	CR US	Ronald J. Epstein
	Embraer	ERJ	ERJ US	Ronald J. Epstein
	GE Aerospace	GE	GE US	Ronald J. Epstein
	General Dynamics	GD	GD US	Ronald J. Epstein
	HEICO Corporation	HEI	HEI US	Ronald J. Epstein
	Howmet Aerospace Inc.	HWM	HWM US	Ronald J. Epstein
	KBR	KBR	KBR US	Mariana Perez Mora
	L3Harris	LHX	LHX US	Ronald J. Epstein
	Leidos Holdings	LDOS	LDOS US	Mariana Perez Mora
	Leonardo DRS, Inc.	DRS	DRS US	Ronald J. Epstein
	Northrop Grumman	NOC	NOC US	Ronald J. Epstein
	OSI Systems	OSIS	OSIS US	Mariana Perez Mora
	Palantir Technologies	PLTR	PLTR US	Mariana Perez Mora
	Parsons Corporation	PSN	PSN US	Mariana Perez Mora
	Rocket Lab	RKLB	RKLB US	Ronald J. Epstein
	RTX Corp	RTX	RTX US	Ronald J. Epstein
	Teledyne Technologies Inc	TDY	TDY US	Ronald J. Epstein
	TransDigm Group Inc.	TDG	TDG US	Ronald J. Epstein
NEUTRAL				
	Amentum	AMTM	AMTM US	Mariana Perez Mora
	Cadre Holdings Inc	CDRE	CDRE US	Ronald J. Epstein
	CAE Inc.	YCAE	CAE CN	Ronald J. Epstein
	CAE Inc.	CAE	CAE US	Ronald J. Epstein
	Lockheed Martin	LMT	LMT US	Ronald J. Epstein
	RBC Bearings Inc	RBC	RBC US	Ronald J. Epstein
	StandardAero	SARO	SARO US	Ronald J. Epstein
	Textron	TXT	TXT US	Ronald J. Epstein
	V2X	VVX	VVX US	Mariana Perez Mora
UNDERPERFORM				
	Air Lease Corporation	AL	AL US	Ronald J. Epstein
	Albany International	AIN	AIN US	Ronald J. Epstein
	Garmin	GRMN	GRMN US	Ronald J. Epstein
	Hexcel Corporation	HXL	HXL US	Ronald J. Epstein
	Huntington Ingalls Industries	HII	HII US	Ronald J. Epstein
	Intuitive Machines	LUNR	LUNR US	Ronald J. Epstein
	Mercury Systems	MRCY	MRCY US	Ronald J. Epstein

Disclosures

Important Disclosures

Equity Investment Rating Distribution: Aerospace/Defense Electronics Group (as of 31 Mar 2025)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	34	64.15%	Buy	28	82.35%
Hold	10	18.87%	Hold	6	60.00%
Sell	9	16.98%	Sell	8	88.89%

Equity Investment Rating Distribution: Engineering & Construction Group (as of 31 Mar 2025)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	12	52.17%	Buy	8	66.67%
Hold	7	30.43%	Hold	4	57.14%
Sell	4	17.39%	Sell	3	75.00%

Equity Investment Rating Distribution: Technology Group (as of 31 Mar 2025)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	207	53.08%	Buy	102	49.28%
Hold	92	23.59%	Hold	49	53.26%
Sell	91	23.33%	Sell	24	26.37%

Equity Investment Rating Distribution: Global Group (as of 31 Mar 2025)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	1867	54.40%	Buy	1108	59.35%
Hold	774	22.55%	Hold	466	60.21%
Sell	791	23.05%	Sell	368	46.52%

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Exchange-Traded Funds Investment Rating Distribution: Global Group (as of 31 Mar 2025)

Coverage Universe	Count	Percent	Inv. Banking Relationships R2	Count	Percent
Buy	131	23.19%	Buy	86	65.65%
Hold	423	74.87%	Hold	311	73.52%
Sell	11	1.95%	Sell	7	63.64%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster R3
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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