

Japan Capital Goods

Defense spending back in spotlight

Industry Overview

Defense spending firmly back in spotlight

On the back of the events rapidly unfolding in Europe, alongside comments made by Elbridge A. Colby – nominee for US Under Secretary of Defense for Policy – suggesting Japan should raise defense spending to at least 3% of GDP, the defense theme was firmly back in the spotlight last week. Mitsubishi Heavy Industries (MHI) – Japan’s largest defense-related name – saw its share price rise 25% last week (vs. TOPIX +1%). On page 3, we estimate the potential upside to MHI’s defense business if the spending rises.

Debate about Japan’s defense spending likely to rise

As evident from announcements this week from the European Commission on its €800bn defense plan and the next likely German government (see [Euro Area Watch: Germany: game changer](#)), the discussions around defense spending are intensifying in Europe. On the other hand, Japan’s defense spending is currently set at 2% of GDP by FY27. However, we believe the potential pressure from the US, plus the rising spending in Europe, are likely to raise questions/debates around whether Japan needs to spend more for defense.

S-T status quo, but M-T defense spending could rise ¥9tn

Prior to this week, there were already some questions being asked whether Japan needs to raise the defense budget. However, based on government commentary, we do not get the impression of any near-term shift in spending. However, as we look beyond the current five-year plan, the bias of risk seems skewed to the upside. In fact, we note the current five-year plan was pulled forward by one year. Therefore, if the circumstances call for it, spending could rise before the current plan ends in FY27. We calculate that if Japan raises spending to 3% of GDP, defense spending could rise by ¥9tn to ¥20tn.

Economics: Upside risks for the fiscal and trade deficits

The Japanese government has put off the debate on funding the increase in defense spending and will likely remain reluctant to raise personal income taxes to cover additional defense spending. This will not only complicate the discussions around raising defense spending but could result in more debt issuance if the government ends up raising it. Meanwhile, higher defense spending means more imports to Japan. The result will be a marginally higher trade deficit, but not enough to materially shrink the trade surplus with the US, suggesting continued diplomatic pressures from the US administration.

Decision on Australia’s frigate bid likely in 2H 2025

In November 2024, the Australian government selected MHI’s Mogami-class ship as one of the two final contenders for its new general-purpose frigates, worth AUD10bn. According to media reports (e.g., NHK, 17 Feb), the final selection may come as early as 2H CY25. We see this as a potential catalyst for MHI in 2025, and also noteworthy from the point of exports, which is a theme that has been lacking in Japan.

10 March 2025

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AD&S: Aircraft, Defense & Space
GDP: Gross domestic product
GTCC: Gas turbine combined cycle
S-T: Short-term
M-T: Medium-term
JGB: Japanese government bonds

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Refer to important disclosures on page 7 to 10. Analyst Certification on page 5. Price Objective Basis/Risk on page 5.

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Where we stand on defense spending in Japan

Globally, Japan is the ninth largest spender on military, and it is expected to spend about US\$56bn in FY25. Japan's military spending over the past five years has seen 11% CAGR, as it increases spending towards 2% of GDP. The government has also introduced a new pricing scheme, which makes it more profitable for companies to take on defense-related works.

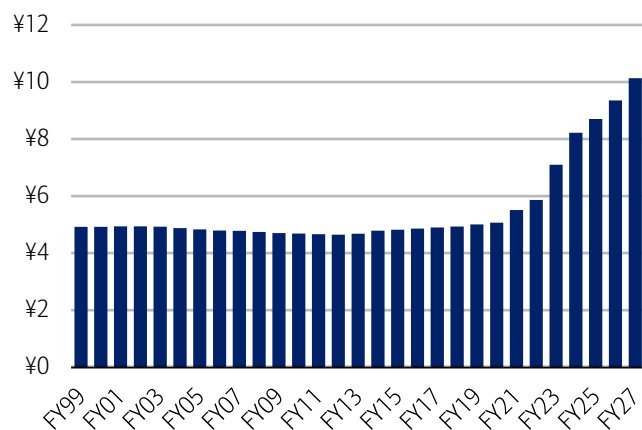
The proposed defense budget for the next fiscal year is ¥8.5tn. The spending proposed for FY25 is in line with the government's plans to spend ¥43tn over a five-year period, or c.2% of GDP. Given the weaker yen and cost inflation, there does seem to be some debate on whether Japan should raise the spending further. However, for now, the government seems fairly stubborn on sticking with its plan of spending ¥43tn. So, near term, any rise in spending beyond what has already been planned seems unlikely.

Looking ahead, if the government raises defense related spending to 3% of GDP by FY32, we estimate that defense spending may rise to about ¥20tn in FY32. However, even if the government keeps the target at 2% of GDP, FY32 defense spending will increase to around ¥13tn from around ¥11tn in FY27 (Exhibit 2).

Note: The FY27 defense related spending 2% of GDP is calculated using FY22 GDP to keep it consistent with government calculations. For the FY32, we have applied FY27 GDP estimates (source: International Monetary Fund).

Exhibit 1: Domestic defense spending (¥tn)

Japan's spending has been growing rapidly

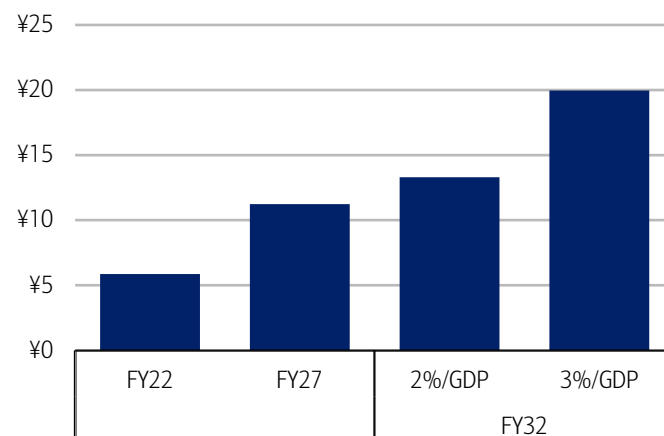


Source: Ministry of Defense (MoD), BofA Global Research estimates

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Exhibit 2: Domestic defense spending (¥tn)

Japan's spending may rise to c.¥20tn by FY32 under 3% GDP scenario



Source: MoD, BofA Global Research estimates

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High hurdle to secure funding

As noted, the Japanese government has increased defense spending since FY2023 under the Defense Buildup Program that it drew up in 2022 but has thus far put off the debate on funding it and used JGB issuance to cover the shortfall.

Specifically, it has stated that ¥3tn of the ¥4tn per year in funding for the increase in defense spending will come from 1) spending cuts, 2) upswing in tax revenues and budget surpluses, and 3) gains on the sale of state-owned assets, with the remaining ¥1tn to be covered by raising corporate, income, and tobacco taxes. The government approved increases in corporate and tobacco taxes (from April 2026) at the end of last year, but has pushed back the debate on raising the income tax to the end of 2025 at the earliest.



The Japanese government has been reluctant to discuss income tax hikes, given its low approval rating, and we think it will remain cautious until it can build stronger political capital. This likely means it will be unable to secure the roughly ¥200bn in planned funding from income tax hikes for the time being.

The issue of funding will also be a key theme for the potential increase in defense spending from FY2028. As noted, if the government plans to increase spending to 3% of GDP, this would require an additional ¥7tn per year in funding. Given the recent debate around the FY25 initial budget, the government will likely remain cautious about increasing fiscal spending significantly (see [Amended FY25 budget should not require more JGB issuance 2025-02-27](#)).

If the government still decides to expand Japan's defense spending despite the high hurdle to secure funding, the political obstacles to raising taxes by around ¥7tn (equivalent to an 3ppt increase in the consumption tax) could result in more debt issuance.

Higher defense spending will slightly increase trade deficit

On the trade front, higher defense spending means more imports to Japan. Former prime minister Fumio Kishida said during a 6 February 2024 Diet session that foreign military sales (FMS) and general imports make up 10-20% of defense spending¹.

If Japan boosts defense spending to 3% of GDP, with imports making up 20% of the ¥9tn in additional spending, spending on defense equipment would increase goods imports by ¥1.8tn (1.6% of the nominal 2024 total). Combined with the expected increase in defense-related imports in the current plan, this works out to around ¥4tn, which is not especially large compared with imports of mineral fuels such as oil and liquefied natural gas (¥25.5tn in 2024).

That said, we would expect Japan's trade deficit (based on customs data) to widen slightly versus ¥5.3tn in 2024, unless Japan ramps up its exports of defense equipment, as we discuss below.

We would note that Japan had an ¥8.6tn (US\$57bn) trade surplus with the US in 2024, which is unlikely to shrink appreciably even if it spends all of the above ¥1.8tn on defense-related imports from the US. The US government wants to eliminate its trade deficit with Japan (i.e., Japan's trade surplus with the US), but an increase in Japan's defense spending will not be enough by itself.

Thus, even if Japan were to commit to higher defense spending, we expect the US to continue pressuring the Japanese government via 1) threats of higher tariffs, 2) demands to increase direct investment in the US; 3) or ramp up its imports of US products, particularly in politically important areas such as agriculture.

Where is money being spent

For FY25, some examples of key areas of spending include the deployment of defense communication satellites (¥135.3bn), next-generation fighter jet development (¥112.7bn), and the building of new FFMs (three ships: ¥314bn), etc. The top areas of spending are sustainability & resiliency (¥295.2bn); cross-domain capabilities (¥157.9bn); and stand-off defense capabilities (¥970.0bn).

¹ Mr. Kishida indicated that 80-90% of defense spending goes on personnel costs, domestically manufactured equipment, procurement, and military bases. Foreign military sales (FMS) refer to the US's paid provision of military equipment to alliance partners under its national security strategy.

Exhibit 3: Breakdown of defense spending in Japan

Defense spending to remain high

	FY3/24	FY3/25	FY3/26	Implied annual FY3/27- FY3/28	Total 5 Years	% of total	Average previous	Average current
7 Major Programs								
Stand-off Defense Capabilities	1,413	713	970	952	5,000	11%	40	1,000
Integrated Air and Missile Defense Capabilities	983	1,228	537	126	3,000	7%	200	600
Unmanned Defense Capabilities	179	115	103	302	1,000	2%	20	200
Cross-domain Operation Capabilities	1,566	1,640	1,636	1,579	8,000	18%	600	1,600
Command and Control/Intelligence-related Functions	305	425	407	-69	1,000	2%	60	200
Mobile Deployment Capabilities/Civil Protection	240	565	448	374	2,000	5%	60	400
Sustainability and Resiliency	2,479	2,942	2,952	3,313	15,000	34%	1,200	3,000
Reinforcing Defense Production Base	97	83	101	59	400	1%	200	80
Research & Development	232	226	234	154	1,000	2%		200
Improvements to Bases	515	514	536	518	2,600	6%	880	520
Training Costs, Fuel, Others	944	912	808	668	4,000	9%		800
Total	8,953	9,363	8,733	8,226	43,500		3,440	8,700

Source: MoD, BofA Global Research estimates

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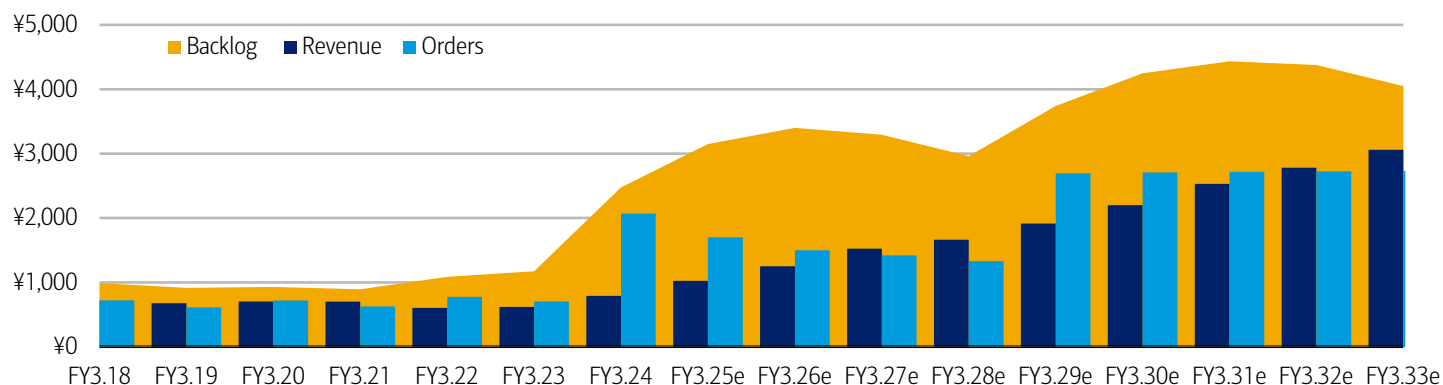
Potential impact on MHI's outlook if spending rises

Below is a simple illustration on the potential impact to MHI's orders, revenue, and backlog for Aircraft, Defense & Space Systems, if we assume defense spending rises from 2% to 3% of GDP during the next five-year plan. We estimate the segment revenue to reach ¥3tn in FY3/33, or 15% CAGR over the next eight years. Moreover, based on our business profit margin assumption in FY3/28 of around 12%, business profit could reach c.¥380bn. In comparison, we estimate FY3/27 business profit of c.¥200bn. While there are a lot of assumptions made in this analysis, it nonetheless helps to demonstrate the potential upside to MHI's defense business under a 3% scenario.

However, we note that MHI has a more cautious view on the upside from any further increase in spending beyond current plans, largely owing to potential constraints in Japan (e.g. ability to produce, labor force in production and the military, etc). It noted that if spending were to increase, a larger part may go towards purchasing equipment from the US.

Exhibit 4: Aircraft, Defense & Space Systems orders backlog, revenue and orders (¥bn)

If Japan raises defense spending to GDP of 3%, MHI should see steady double-digit revenue growth out to FY3/33.



Source: Company data, BofA Global Research estimates

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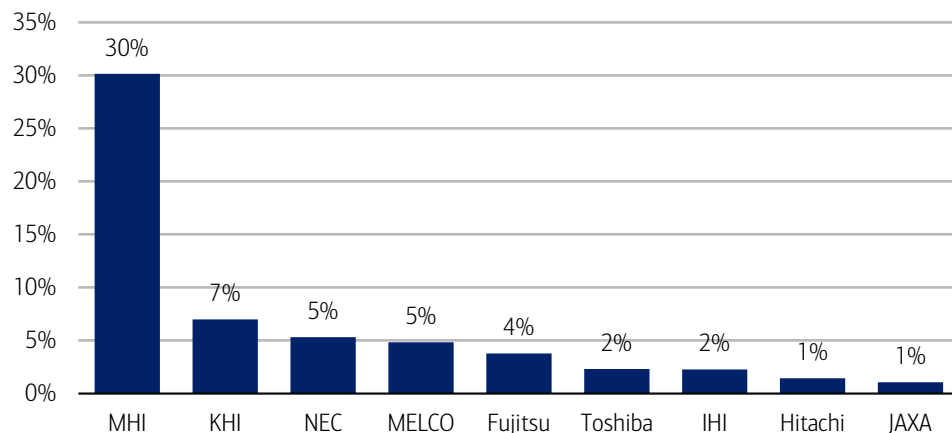
Manufacturing base keeping up for now

We believe keeping up to demand from a production point of view could become more of a pressing issue going forward, given the rise in defense spending. Currently, we do not get the impression from speaking to companies such as MHI of any severe production bottlenecks. However, MHI did allude to the difficulty in hiring (though it did say it was on target), which was something we heard during our recent visit to the Acquisition, Technology & Logistics Agency (ATLA) of the Ministry of Defense (MoD). ATLA also indicated that a lot of the production machinery used by the industry is old. However, we note the government does help to fund investment requirements.

Key domestic defense-related companies

Exhibit 5: Japan's defense procurement (FY3/24)

MHI is the largest, followed by KHI, NEC, and Mitsubishi Electric



Source: MoD

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Price objective basis & risk

Mitsubishi Heavy Industries (7011 / MHVYF / C-1-7 / Buy / 7 March close

¥2,708.59)

Our PO of ¥2,800 is based on applying a EV/EBITDA of 14x to the average of our FY3/26-27 earnings forecasts. The EV/EBITDA multiple is based on applying a premium to the peer average EV/EBITDA multiple of 13x. However, we believe applying a premium is warranted, given our expectations that MHI will report the highest revenue growth out of its peer group over the next few years, alongside improving returns.

Downside risks to our PO are (1) the improvements in defense related margins materialize at a slower pace than expected, (2) a slowdown in GTCC related orders, and (3) delays in nuclear restarts in Japan.

Analyst Certification

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	Ayala Corporation	AYYLF	AC PM	Russ Toribio
	Centre Testing International	XCTEF	300012 CH	Yikai Liu, CFA
	Daifuku	DAIUF	6383 JP	Kenjin Hotta
	Daikin Industries	DKILF	6367 JP	Kenjin Hotta
	Daikin Industries	DKILY	DKILY US	Kenjin Hotta
	Fanuc	FANUF	6954 JP	Kenjin Hotta
	Fanuc	FANUY	FANUY US	Kenjin Hotta
	Goldwind	XJGWF	002202 CH	Gary Tsang
	Goldwind	XJNGF	2208 HK	Gary Tsang
	GTCAP	GTHOF	GTCAP PM	Jojo Gonzales
	Hangcha Group	XXCLF	603298 CH	Summer Wang, CFA
	Hangzhou Great Star	XNZLF	002444 CH	Summer Wang, CFA
	Hankuk Carbon	HKUCF	017960 KS	KJ Hwang
	Hanwha Aerospace	SSASF	012450 KS	KJ Hwang
	HD Hyundai Electric	XPELF	267260 KS	Joon-Ho Lee
	HD Hyundai Mipo	HYAIF	010620 KS	KJ Hwang
	Jiangsu Hengli Hydraulic Co., Ltd	XHDCF	601100 CH	Ming Hsun Lee, CFA
	Jingda	XJINF	600577 CH	Joey Yang, CFA
	Keyence	KYCCF	6861 JP	Kenjin Hotta
	Korea Aerospace	XAQHF	047810 KS	KJ Hwang
	LS Electric	LGXSF	010120 KS	Joon-Ho Lee
	LT Group, Inc.	XLTGF	LTG PM	Philip Albert Felix
	Makita	MKEWF	6586 JP	Kenjin Hotta
	Mingyang Smart Energy	XLARF	601615 CH	Charlotte Xia
	Mitsubishi Heavy Industries	MHVYF	7011 JP	Kenjin Hotta
	Nabtesco	NCTKF	6268 JP	Kenjin Hotta
	NARI Technology	XLODF	600406 CH	Matty Zhao
	Samsung Heavy Industries	SMSHF	010140 KS	KJ Hwang
	Sany Heavy Industry Co., Ltd	SHVYF	600031 CH	Ming Hsun Lee, CFA
	SATS Limited	SPASF	SATS SP	Nathan Gee, CFA
	SCG Packaging PCL	XAFLF	SCGP TB	Narumon Ekasamut
	Shanghai Bochu Electronic	XWUTF	688188 CH	Summer Wang, CFA
	SK Bend	SUKWF	014620 KS	KJ Hwang
	SM Investments Corporation	SVTMF	SM PM	Russ Toribio
	SMC	SMECF	6273 JP	Kenjin Hotta
	SMC	SMCAY	SMCAY US	Kenjin Hotta
	Suzhou Maxwell Technologies	XSMTF	300751 CH	Gary Tsang
	THK	THKLF	6481 JP	Kenjin Hotta
	Weichai Power Co. Ltd	WEICF	2338 HK	Fiona Liang
	Weichai Power Co. Ltd	XWPEF	000338 CH	Fiona Liang
	XCMG Construction Machinery Co Ltd	XVPZF	000425 CH	Ming Hsun Lee, CFA
	XJ Electric	XJECF	000400 CH	Matty Zhao
	Zhejiang Supcon Technology	XDFFF	688777 CH	Ming Hsun Lee, CFA
	Zoomlion Heavy Industry	XLRYF	000157 CH	Ming Hsun Lee, CFA
	Zoomlion Heavy Industry	ZLIOF	1157 HK	Ming Hsun Lee, CFA
NEUTRAL				
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	Han's Laser	XHQTF	002008 CH	Summer Wang, CFA
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	Kubota Corp	KUBTY	KUBTY US	Kenjin Hotta
	OMRON Corporation	OMRNF	6645 JP	Kenjin Hotta
	OMRON Corporation	OMRNY	OMRNY US	Kenjin Hotta
	Sinotruk Hong Kong Ltd	SHKLF	3808 HK	Fiona Liang
	TGOOD	XQGDF	300001 CH	Yikai Liu, CFA
	Zhuzhou CRRC Times Electric	ZHUZF	3898 HK	Yikai Liu, CFA
	Zhuzhou CRRC Times Electric	XWCTF	688187 CH	Yikai Liu, CFA
UNDERPERFORM				
	Alliance Global Group, Inc.	ALGGF	AGI PM	Russ Toribio
	CKD	CKDOF	6407 JP	Kenjin Hotta
	D&L Industries, Inc.	DALQF	DNL PM	Philip Albert Felix
	ESTUN Automation	XNJNF	002747 CH	Ming Hsun Lee, CFA



APR - Industrials Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	HD Hyundai Heavy Industries	XHZXF	329180 KS	KJ Hwang
	Hitachi CM	HTCMF	6305 JP	Kenjin Hotta
	Hiwin Technologies	HITF	2049 TT	Ming Hsun Lee, CFA
	Hongfa Technology	XQXAF	600885 CH	Fiona Liang
	Komatsu	KMTUF	6301 JP	Kenjin Hotta
	Komatsu	KMTUY	KMTUY US	Kenjin Hotta
	L.K. Technology	XBQXF	558 HK	Joey Yang, CFA
	Leader Harmonious Drive Systems	XLHNF	688017 CH	Yikai Liu, CFA
	OPT Machine Vision	XOTVF	688686 CH	Yikai Liu, CFA
	Shenzhen SC New Energy	XENYF	300724 CH	Yikai Liu, CFA
	Yaskawa Electric	YASKF	6506 JP	Kenjin Hotta

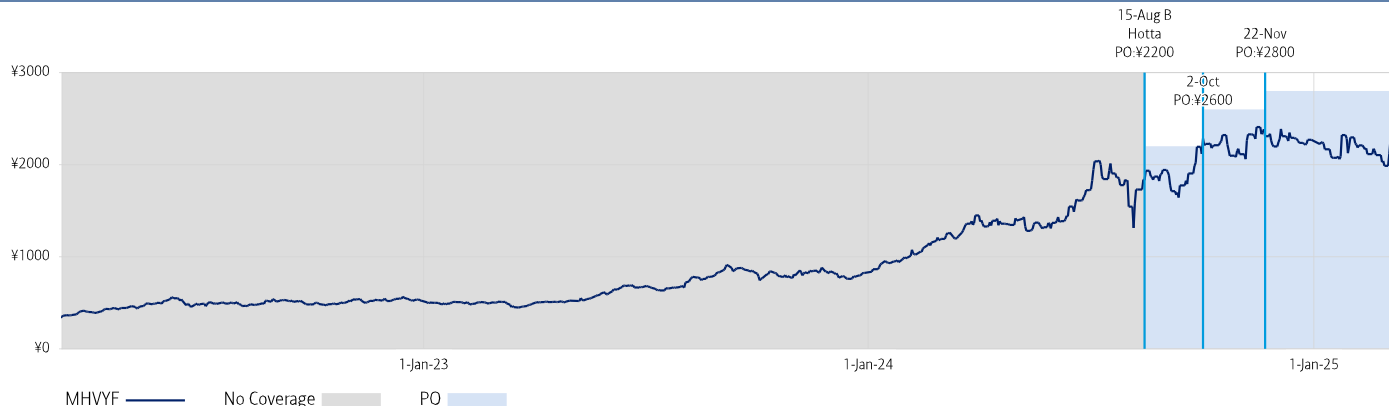
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	Jingce Electronic	XCKBF	300567 CH	Fiona Liang
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Mitsubishi Heavy Ind (MHVYF) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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Buy	31	48.44%	Buy	11	35.48%
Hold	12	18.75%	Hold	6	50.00%
Sell	21	32.81%	Sell	13	61.90%

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Sell	801	23.31%	Sell	370	46.19%

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