

# A “Special Operation”? Nyet: Implications of Ukraine Invasion on the Global Defense Industry

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## “When the Facts Change, I Change My Mind. What Do You Do, Sir? – John Maynard Keynes

As the world was watching the 2022 Winter Olympics during February, Russia was not-so-quietly building up an invasion force directed at Ukraine. At the conclusion of the Winter Games, Russian President Vladimir Putin ordered the invasion, which he has consistently referred to as a “special operation” and not a war. Ukraine and the rest of the world view this attack as a true long-term threat – and anything but a “special operation”. Although the conflict is concentrated in southeastern Europe, we view this event as a huge wake-up call to not only the nearby eastern European countries in the former Soviet-bloc, but to all countries around the world. This event has clear and sustainable implications for countries, alliances, and regional partners around the world for years to come.

We believe a dominant driver of defense spending over the long-term is the *perceived* threat level. With the Ukraine invasion fast becoming the largest military action in Europe since WW2, it has permanently raised the threat levels both locally and around the world. Although it is difficult to predict with precision, we note that defense spending cycles have historically been elongated, spanning multi-year periods. By using history as a guide, and putting the Ukraine invasion in the context of prior conflicts, we believe the direction of global defense spending in the coming years has a high likelihood of being sustainably higher than recent levels. While it is nearly impossible to predict the timing or terms of a resolution to the current conflict, we think the damage has already been done. A new era of re-prioritizing resources and efforts on defense and security has been irreversibly placed upon the world.

Given the Ukraine situation, we thought it would be helpful to scope the medium-term possibilities for the global defense industry. There are more unknowns than knowns at this point, but we wanted to share a few observations and try to quantify potential outcomes.

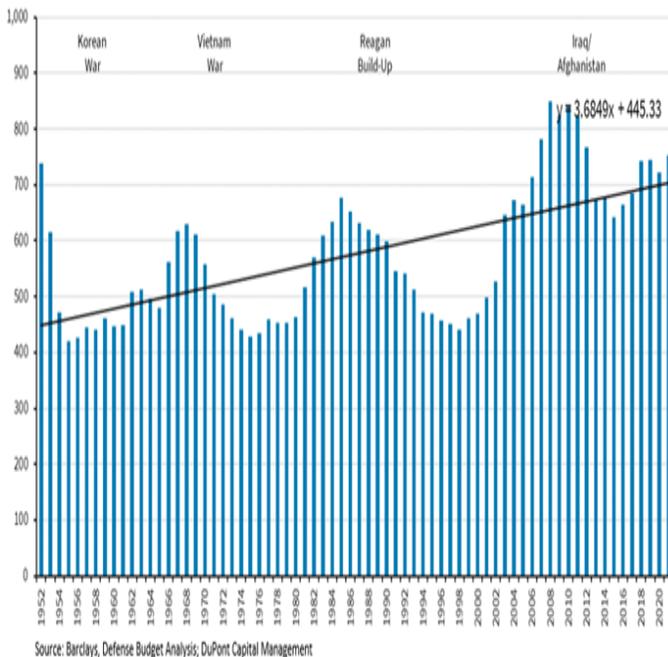
### A few points:

1. The West’s response to Russia’s aggression in Ukraine has fundamentally changed, especially in Europe.
2. Historically, defense spending has been more driven by the perceived threat level – even if war calms down tomorrow, the damage is likely done and the threat environment unlikely to change.
3. We used history as a guide to arrive at a range of possible spending changes for US defense spending going forward. Here are the data.

Era	Years	Type	Approx. Change in US Defense Spending, dollars	Approx. Change in US Defense Spending, %
Vietnam	1966-1970	Hot	from ~\$475b (on trend) to \$575b in 5 yrs	+21%
Reagan	1981-1990	Cold	from ~\$500b (below trend) to \$625b in 9 yrs	+25%
Afghan/Iraq	2003-2011	Hot	from ~\$525 (well below trend) to \$700b in 9 yrs	+33%
Ukraine	2022-202?	Cold?	From ~\$740 (slightly above trend) to ??	+??%

Source: Barclays DuPont Capital Management

Based on these data, a reasonable range of possibilities could be a 10-20% increase in broader US defense spending. This could then trickle down to individual defense companies' earnings power by a similar amount.



Another very likely outcome of this conflict revolves around European NATO members' defense spending. In 2021, only eight European countries actually fulfilled the stated NATO target of 2% of GDP. As shown in the table below, if all members plus up their budgets to achieve the target, this would represent an approximate 24% increase in European NATO defense budgets. And, while it is difficult to quantify exactly how this would impact US defense companies' revenues, it would very likely provide a further tailwind. Additionally, there is now serious discussion of Sweden and Finland joining the NATO alliance. While both already have robust defense spending, this only provides a further opportunity for US defense companies to strengthen relationships in the region.

Country	Defense spending (\$ bn)				Defense spending as a % of GDP				Additional spend if 2% of GDP	Potential upside if 2% of GDP
	2018	2019	2020	2021	2018	2019	2020	2021		
<b>NATO members in Europe (1)</b>										
UK	58.0	59.2	61.5	71.6	2.0%	2.1%	2.3%	2.3%		
France	53.2	52.1	54.9	59.3	1.9%	1.9%	2.1%	2.0%		
Germany	45.5	48.4	52.1	56.1	1.2%	1.3%	1.4%	1.3%	28.5	51%
Italy	28.7	27.0	29.7	33.8	1.4%	1.4%	1.6%	1.6%	8.6	25%
Netherlands	11.3	12.1	12.6	14.8	1.2%	1.3%	1.4%	1.5%	5.4	36%
Spain	15.1	12.9	12.7	13.8	1.1%	0.9%	1.0%	1.0%	15.0	109%
Poland	11.9	11.8	12.8	13.4	2.0%	2.0%	2.1%	2.0%		
Turkey	14.1	14.0	13.4	11.9	1.8%	1.8%	1.9%	1.5%	4.0	34%
Greece	4.9	4.8	5.0	7.7	2.2%	2.3%	2.6%	3.6%		
Norway	6.8	6.7	6.5	7.5	1.6%	1.7%	1.8%	1.7%	1.5	20%
Belgium	4.8	4.8	5.3	6.4	0.9%	0.9%	1.0%	1.1%	5.2	82%
Romania	4.4	4.9	5.2	5.6	1.8%	2.0%	2.1%	2.0%	0.1	2%
Denmark	4.6	4.6	4.9	5.4	1.3%	1.3%	1.4%	1.4%	2.5	46%
Czech Rep.	2.7	2.9	3.3	4.0	1.1%	1.2%	1.3%	1.4%	1.6	40%
Portugal	2.6	2.7	2.9	3.0	1.1%	1.1%	1.3%	1.2%	2.1	70%
Hungary	1.7	1.8	2.0	2.6	1.1%	1.1%	1.3%	1.5%	1.0	38%
Slovakia	1.3	1.9	1.9	2.0	1.2%	1.8%	1.8%	1.7%	0.3	16%
Bulgaria	1.0	2.1	1.3	1.3	1.5%	3.0%	1.8%	1.6%	0.3	22%
Lithuania	1.1	1.1	1.2	1.3	2.0%	2.0%	2.1%	2.0%		
Croatia	1.0	1.1	1.0	1.1	1.6%	1.7%	1.8%	1.7%	0.2	19%
Estonia	0.6	0.7	0.7	0.8	2.1%	2.2%	2.3%	2.2%		
Latvia	0.7	0.7	0.8	0.8	2.1%	2.1%	2.3%	2.2%		
Slovenia	0.6	0.6	0.6	0.7	1.1%	1.2%	1.1%	1.1%	0.5	82%
Albania	0.1	0.1	0.2	0.2	0.9%	0.9%	1.5%	1.5%	0.1	37%
<b>NATO - Europe</b>										
only	275	279	292	325	1.51%	1.56%	1.69%	1.67%	77.0	24%
US (2)	631	685	775	754	3.1%	3.2%	3.7%	3.3%		
Canada	19	19	20	23	1.1%	1.1%	1.2%	1.1%	17.2	74%
<b>NATO - Total</b>	<b>925</b>	<b>983</b>	<b>1,087</b>	<b>1,102</b>	<b>2.28%</b>	<b>2.40%</b>	<b>2.73%</b>	<b>2.49%</b>	<b>94.2</b>	<b>9%</b>

Source: The Military Balance, 2019-2022 editions, J.P. Morgan

The investment narrative for defenselated businesses has certainly taken a dramatic twist since the start of the year. Despite the recent appreciation in shares, we believe a compelling long-term opportunity exists within the segment.

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DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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