Clifford Chance

BRIEFING

Financing European defence: how can Europe address the fiscal and capital challenges?

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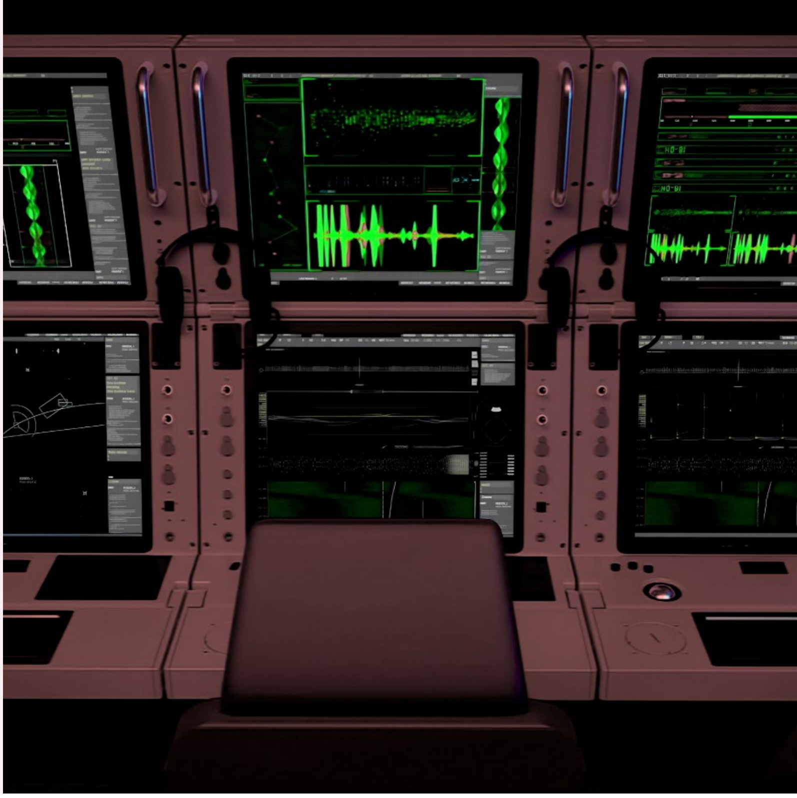

Against a backdrop of geopolitical, strategic uncertainty, Europe is progressing plans to rearm and shoulder more responsibility within NATO. In June 2025, NATO allies made a clear commitment to invest 5% of GDP annually by 2035, including at least 3.5% on core defence spending. However, three concrete questions remain unresolved: (i) how this commitment can be delivered given national budgetary constraints, (ii) how to plug the funding gap for the defence supply chain composed of small and medium-sized enterprises (SMEs), innovative tech companies and start-ups which do not have the same access to finance as the defence primes, and (iii) can new funding instruments, new institutions and a new approach close this gap, leverage public investment and create a virtuous circle which crowds in private capital to meet our needs?

This briefing highlights emerging financing options which may help address these challenges and which complement initiatives taken by the European Union, such as the SAFE programme. We describe below:

- new financial products which can help direct private capital to finance the defence and security sectors;
- intergovernmental and multinational initiatives which can complement SAFE, create capacity to raise debt in the capital markets which is not consolidated into national debt figures but which, when combined with the palette of instruments used by development and promotional banks, create a multiplier or leveraged effect that crowds in private capital into funding the defence and security sectors;
- recent market trends which demonstrate that defence, resilience and security could be the new "green" and can attract private capital in the form of both debt and equity.

European Defence Bonds

Whilst War bonds have been an historical capital markets instrument, a recent innovation in the French and European market has been the emergence of European Defence Bonds.

A European Defence Bond label was published by Euronext in 2025. One of its stated objectives is the channelling of private capital towards eligible defence and security projects in Europe. In July 2025, Bpifrance, the French state-owned promotional bank, issued its European Defence Bond Framework. In September 2025, BPCE issued its inaugural issue of European Defence Bonds of €750m and, in January 2026, Bpifrance made its inaugural issuance of €1 billion. Both issues were significantly oversubscribed and generated orders from a range of investors including banks, asset managers, pension funds and central banks.

European Defence Bonds are "use of proceeds bonds" where the issuer undertakes to invest the proceeds in eligible projects which finance, refinance or guarantee loans or other exposures to the defence or wider resilience or security sectors. The mechanism is comparable with those used for Green Bonds or ESG bonds with transparent reporting on how the proceeds are used, including an audit and regular reporting to investors. The regime is more flexible than comparable ICMA rules for sustainable bonds, with no requirement for an independent third-party opinion and the ability for an audit to be conducted by an internal body of the issuer where appropriate.

Whilst the issuers of European Defence Bonds recognise that their bonds cannot be labelled as ESG or sustainability bonds, they usually include filters which reconcile the use of proceeds with the issuer's own ESG investment policies. They also have exclusion criteria which prohibit investment of proceeds in chemical, nuclear or biological weapons, landmines or fragmentation arms, or financing exports to embargoed countries. This reflects an approach which mirrors international treaty prohibitions.

It is too early to confirm whether European Defence Bonds will be a permanent new asset class. However, it is notable that in France, Credit Agricole Group has published its own Defence Bond Framework and BNP Paribas has issued European Sovereignty Bonds. There have now been six separate issuances of defence bonds in France.

In addition, in February 2026, Luxembourg issued a sovereign defence bond: a use of proceeds bond where the proceeds could be invested in both loans and equity investments in the defence and security sector. An innovative feature was a tax incentive whereby coupons on the bonds are not subject to income tax for Luxembourg residents. The issue was also made available to retail investors.

In practice, we understand that the main beneficiaries of the proceeds of European Defence Bonds, including those issued by Bpifrance and BPCE, have been SMEs, rather than prime defence companies which are not short of liquidity. By building investor trust and enhancing transparency, the European Defence Bond label could prove to be an important innovation for opening new routes for private capital and other funding sources to invest in opportunities in the European defence sector.

Supranational and multinational initiatives

Germany has changed its constitution to raise its capacity to issue sovereign debt to finance defence. The EU has relaxed its fiscal rules on excessive deficit procedures to facilitate defence expenditure. However, in practice, many European nations have limited real capacity to issue additional sovereign debt to finance defence expenditure. This has resulted in discussions on whether one or more supranational entities should be set up to raise funds in the capital markets, the debt of which is not consolidated into that of its sovereign shareholders.

A model for such proposals has been the structures of the European Stability Mechanism (ESM) or multinational development/promotional banks. Whilst such entities could be structured as a private company (for example, the European Financial Stability Fund (EFSF) is incorporated as a Luxembourg *société anonyme*), the more usual structure is a multinational public law entity created by treaty or charter, with its creditworthiness backed by a combination of paid-in capital and legally binding capital commitments from creditworthy sovereign shareholders. These shareholders would permit the entity's bond issues to achieve a high-quality credit rating (ideally AAA), a risk weighting of 0% for CRR purposes, access to ECB and/or other central bank liquidity, and qualification as high-quality liquid assets for LCR purposes. The credit rating and access to liquidity should permit such an entity to obtain financing at a cost below the average funding cost of its lower rated members, while the capacity to issue debt which is not consolidated into national sovereign borrowing figures to finance additional defence expenditure could be attractive even to its higher rated shareholders.

One proposal had been either to use the ESM or to use the structure of the ESM as a model for a new European Defence Mechanism which would both raise debt in the capital markets and decide on how the funds raised should be spent, by way of loans to its member states or direct loans or credit support for investments in defence projects. Whilst the ESM has its membership restricted to Eurozone member states, such an entity could potentially open membership to member states of the EU which do not have the euro as their currency. The EU has or is negotiating defence partnership agreements with several nations including European countries such as Norway and the United Kingdom, and non-European countries such as Japan, Korea, Australia and Canada, opening the possibility of cooperation with non-EU countries. In practice, there has not been the appetite to pursue this concept at an EU level, but parallel initiatives have emerged which are now taking form.

Defence Security and Resilience Bank

At the NATO Summit in July, nine countries (Albania, Belgium, Canada, Greece, Latvia, Luxembourg, Romania, Türkiye and Ukraine) announced their shared intention to establish the Defence Security and Resilience Bank (DSRB). The bank's headquarters will be in Canada, while Luxembourg will host the European hub. Its stated goal is to begin operations in 2027. It is expected that other countries will join in due course, but the founders and early members will have an advantage in determining the DSRB's strategy, orientation and governance.

The DSRB will be structured as a multinational financial institution, established by charter. Its shareholders will be sovereign states which will both contribute fully paid-in capital and grant binding capital commitments to subscribe for additional capital when needed to achieve an overall high AAA rating for its debt. The funds raised will be used to fund loans, guarantees and portfolio guarantees to banks which provide financial support to enterprises in the defence and wider security and resilience sectors. The intention is to use a wide range of the financial products used by promotional and development banks so that the public funds invested have a multiplier effect and "crowd-in" private investment with a view to having a leveraged impact on the volume of financing to the defence sector. One of its key missions is to close the funding gap to the SME and supply chain sectors of the defence industry.

Multinational Defence Mechanism – Finland, the Netherlands, Poland and the United Kingdom

On 17 March 2026, Finland, the Netherlands and the United Kingdom announced in a joint communique that between themselves and other partners they were exploring the creation of a joint multinational initiative called the Multinational Defence Mechanism (MDM). This would both finance defence and aggregate demand, drive joint procurement, accelerate defence investment and increase the availability of critical capabilities – such as munitions – as the member states step up shared defence and security commitments. At the NATO Summit in Ankara, it was announced that Poland will join this initiative. The precise form that the MDM will take and whether it gives rise to a new supranational entity is not yet clear.

There is already active political debate on how best to co-ordinate the efforts of the DSRB and the MDM and whether these projects should be consolidated or even merged in the future, albeit that their membership and functions are slightly different. Ideally these new agencies should support expenditure which is complementary to the strategy of the European Commission including the SAFE programme.

Equity and investment products

Defence investment funds

Whilst certain investment funds have always had a particular interest in investing in the broader defence sector, there has been increased focus on the defence sector given the wider geopolitical context. A recent innovation by Bpifrance has been the establishment of its Bpifrance Defence Fund – a retail fund which permits high street investors to obtain access to investing in the equities of unlisted companies in the defence and strategic autonomy sectors.

The European Investment Fund itself established the Defence Equity Fund and recently announced the Defence Equity Fund 2. This shows the willingness of the European Union to promote long-term equity investment in defence. In addition, the European Investment Fund's €30 million commitment (made under the InvestEU Defence Equity Facility) to Sienna Hephaistos Private Investments, a private credit vehicle in Europe dedicated to providing debt finance to SMEs and mid-cap companies within the defence industry, illustrates its multifaceted approach for mobilising private capital in the European defence sector.

More broadly, we are also seeing growing venture capital interest in the sector. For example, Lakestar recently raised US$300 million for Europe's largest dedicated defence and dual-use technology fund (Resilience I). The fund is focused on supporting founders developing critical technologies for Europe and NATO allies, including advanced autonomous systems, AI-driven defence software, sovereign drone manufacturing, missile technologies, space capabilities and maritime platforms.

Equity markets and capital raises

Whilst IPO activity in Europe's defence sector was muted between 2022 and 2025 compared with historic levels, there is continuing interest amongst equity investors, particularly as a result of the defence funding gap and NATO rearmament push. This extends to both government and private defence sector players.

An upswing in defence IPOs began in February 2024 with the €500 million IPO and Frankfurt listing of Renk, a German manufacturer of high-performance propulsion and drivetrain solutions, including transmissions, gear units, hybrid power packs, suspension systems and slide bearings. The Renk IPO involved strong support from cornerstone investors, with approximately €150 million of the €500 million offer size being taken up by Franco-German land systems producer KNDS and Wellington Management, a leading global asset manager. Also during February 2024, Theon, a leading developer and manufacturer of night vision and thermal imaging systems for defence and security applications, completed its IPO and listing on Euronext Amsterdam, raising approximately €154 million. In June 2024, Exosens, a French technology company specialising in electro-optical detection and imaging systems for defence and industrial applications, completed its IPO and listing on Euronext Paris, raising approximately €350 million. The successful execution of these IPOs over a short period of time underscored renewed investor interest in the defence sector.

In January 2026, Czechoslovak Group (CSG), one of Europe’s leading privately held defence groups, which designs, manufactures and supplies a broad range of defence products, including military vehicles, ammunition and weapons systems, undertook its €3.8 billion IPO and Amsterdam listing. It is the largest defence IPO in the world to date and the largest European IPO since 2022 and marked a very important milestone in defence capital raising, demonstrating that the equity markets are a strong and viable route to access capital for European defence businesses with a compelling investment case. The success of the CSG IPO, which was heavily oversubscribed, was also a result of investors' strong and growing appetite for investing in the European defence sector. The CSG IPO also involved strong interest and eventual commitment from investors looking to act as cornerstone investors, with €900 million of the €3.8 billion offer size covered by three cornerstone investors in equal proportions – two financial investors and one sovereign wealth fund.

The CSG IPO has further paved the way for more European defence sector IPOs. In March, Vincorion, a leading developer and manufacturer of mission-critical power and mechatronic solutions for defence platforms and advanced aviation systems, undertook its €345 million IPO and Frankfurt listing, signalling that the markets continue to be receptive to defence sector IPOs.

More recently, listed European defence sector players have experienced volatility and drops in their share prices. KNDS consequently elected to defer its IPO plans (previously announced at the end of June). Despite this, it is expected that European defence sector companies will continue to pursue IPOs.

A key consideration for defence companies when embarking on an IPO is the market expectation in the defence sector that the relevant company will provide reasonably extensive forward-looking guidance on EBIT, EBIT margin and/or some other form of profit measure/metric to investors as part of the IPO process. To do this, the company and the underwriters acting on its IPO, together with their other advisers, will need to work through the company's projections to ensure that the guidance is compiled on the basis of robust and thorough procedures and due diligence. The company must have a high degree of confidence of being able to achieve the guidance post-listing. Whilst practice varies across jurisdictions within Europe, it would be customary for the underwriters to require the company's accountants to undertake some work independently to help support the forward-looking guidance.

Elsewhere across the sector, we are also seeing companies adopt innovative approaches to the traditional IPO process. In April, Toulouse-based ST Group, a high-tech manufacturer of composite materials for the aerospace and defence sectors, launched France's first tokenised IPO, issuing shares via blockchain through the Lightning Stock Exchange (LISE). The transaction represents the world's first fully tokenised IPO.

Alongside IPOs, several other equity transactions have taken place in the defence sector. For example, in November 2025, Theon undertook a €150 million rights issue and used the proceeds to acquire a 9.8% stake in Exosens. In May 2026, KNDS undertook a €262 million sell-down of a portion of its shareholding in Renk via an accelerated bookbuild, demonstrating strong secondary market demand for listed defence sector equities. Companies have also continued to access equity markets to finance growth and acquisitions, with Hensoldt completing a €241 million capital increase in 2023 through an equity placing partially to fund its acquisition of ESG Elektroniksystem- und Logistik-GmbH, demonstrating that the equity markets can help support M&A and consolidation activities.

The NATO rearmament push, accelerated by initiatives such as ReArm Europe (which aims to mobilise private capital alongside public funds), has also spurred growth in private fundraising by defence tech start-ups, with European DSR (defence, security and resilience) start-ups having secured a record US$8.7 billion in venture capital in 2025. Most notably, Helsing, a Munich and London-based defence AI company, raised €600 million in a Series D funding round in 2025, one of the largest private financings in the European defence space, backed by a combination of global venture capital firms and strategic investors. In May 2025, Quantum Systems, a German developer of AI-powered reconnaissance drones, secured a €160 million Series C round to invest in its AI research and development, while Portugal-based UAV specialist Tekever raised approximately €70 million from strategic investors to increase its production capacity and fund innovation. Also in May 2025, Arondite, a defence software platform in the UK focused on enabling "human-machine teaming", completed a US$12 million seed round fundraise. The successful execution of private financings like these, with a combination of early-stage and mature-stage funding rounds, further reflects investors' appetite for European defence technology businesses and the growing willingness of financial and strategic investors to deploy private capital into the defence sector.

Taken together, these transactions illustrate that European equity markets are facilitating IPOs and, at the same time, providing ongoing liquidity for shareholder exits and a reliable source of capital for strategic acquisitions, growth initiatives and development across the defence sector.

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