Defense Industry Working Capital Insights: *Scaling Up Production in a Dynamic Environment*

Introduction

As geopolitical tensions rise globally, the defense sector and its supply chain are experiencing a significant increase in demand as governments are accelerating their defense spending. Today's world is marked by geopolitical division and escalating conflicts – as of 2023, there were 59 armed conflicts globally, the highest number worldwide since 1946[1].

In response to this global instability, governments around the world, from Australia and South Korea to the UK and the EU, are investing to strengthen their defense capabilities, and develop next generation technologies. Global defense spending reached $2.44 trillion in 2023[2], up 37% from $1.77 trillion in 2014[3]. A further increase is anticipated in 2025 with the North Atlantic Treaty Organization (NATO) alliance pledging to raise defense spending to 5% of GDP by 2035[4], which would unleash hundreds of billions of dollars into the sector.

Amid this rise in geopolitical tensions and subsequent increase in defense orders, there lies a challenge for defense companies. Scaling up production to match the surge in demand for defense products presents financial and working capital challenges along with supply chain pressures that require innovative solutions across the sector.

In this article, we will explore the specific challenges faced by the defense industry and examine the benefits of efficient working capital management, including traditional trade finance, accounts receivables finance and supply chain finance, in addressing these challenges.

[1] Urdal, Herik. "Can We Award a Prize for Peace in a World Full of War?" *Peace Research Institute Oslo (PRIO)*, 9 October 2024, https://www.prio.org/blogs/1146.

[2] Boffey, Daniel. "Global defence budget jumps to record high of $2440bn." *Courtesy of Guardian News & Media Ltd*, 21 April 2024, https://www.theguardian.com/world/2024/apr/22/global-defence-budget-jumps-to-record-high-of-2440bn.

[3] "SIPRI Yearbook 2015." *Information from the Stockholm International Peace Research Institute (SIPRI)*, 2015, https://www.sipri.org/yearbook/2015/09.

[4] Foy, Henry et al, "Nato promises historic rearmament shift in bid to win over Donald Trump", *Financial Times*, 25 June 2025, https://www.ft.com/content/b9109961-a05c-4052-9d6e-63b320e802a0

1. The Challenges in Scaling up Defense Production

Defense companies often encounter hurdles in scaling up their production when entering a wartime economy whereby production speed and volumes become crucial, adapting from a decades long structure where spending on defense was a much lower percentage of Gross Domestic Product (GDP). These challenges arise from factors such as the costs of expansion and constrained supply chains. Additionally, the industry's strict compliance requirements can further intensify issues in scaling up production through supplier diversification.

Order backlogs can rapidly grow for defense companies while they invest in increasing production. An order placed today for some types of equipment can already take up to seven years for delivery[5]. The orders of the eight largest European defense companies increased by 15% in 2024, and their combined backlogs grew by 19%, reaching a record €291 billion, up from €177 billion at the start of 2022[6].

In most cases, increasing production capacity will be a multi-year journey, whether expanding current premises, taking over repurposed facilities or building new factories. There is hesitation in the sector to invest in new production facilities until governments commit to long-term deals. Defense companies are concerned about the risks of expanding capacity over a 1–3-year period without certainty beyond the initial contract period which can last for 6-10 or more years.

Given the defense sector's production constraints, companies from other manufacturing sectors (e.g. mobility and aerospace industries) are evaluating potential roles in entering defense manufacturing. For example, Italy's Industry Minister has proposed converting automotive factories to defense production[7] while one of the arms manufacturers is actively considering taking over idle automotive factories in Germany in the search for extra production capacity[8].

The investment required to increase production (e.g. new factories and facilities) combined with increased research and development (R&D) is likely to result in a strain on defense companies capital reserves, impacting their working capital requirements. Consequently, managing balance sheets effectively will become a critical priority.

Based on Citi's research, median Days Sales Outstanding (DSO), the number of days that it takes for a company to collect payment after a sale has been made, for the aerospace and defense sector is higher than its top performing peers. The aerospace and defense sector takes 86 days to have its invoices settled (Figure 2), compared to its top performing quartile which only take 52 days and the S&P Global 1200 median which takes 67 days[9]. Cash Conversion Cycle (CCC), or the time that it takes a company to disburse and collect cash, has lengthened for the sector from 131 days in 2018 to 163 days in 2024 (Figure 1) – considerably higher than the S&P Global 1200 median of 57 days and the top quartile of aerospace and defense companies at 92 days.

[5] Abboud, Leila. Pfeifer, Sylvia. "Missile maker MBDA hits snags in effort to re-arm Europe." *Financial Times*, 13 April 2025, https://www.ft.com/content/2b68c3a2-f7df-4755-b83d-d559d4149c88.

[6] "European Defence Companies' Record Backlogs Boost Cash Flow Generation." *Fitch Ratings*, 20 March 2025, https://www.fitchratings.com/research/corporate-finance/european-defence-companies-record-backlogs-boost-cash-flow-generation-20-03-2025.

[7] Kazmin, Amy. "German defence splurge could revive Italy's manufacturers, says minister." *Financial Times*, 23 March 2025, https://www.ft.com/content/12dbf839-1889-4810-89ba-44a30b38a14d.

[8] Nilsson, Patricia. "Rheinmetall says it could take over idle Volkswagen plants to produce tanks." *Financial Times*, 12 March 2025, https://www.ft.com/content/f4bb94b3-afba-4661-812b-bbba26d0f7ec.

[9] S&P Capital IQ, Citi Services (2025)

Figure 1: Cash Conversion Cycle for Aerospace and Defense, S&P Global 1200 Index

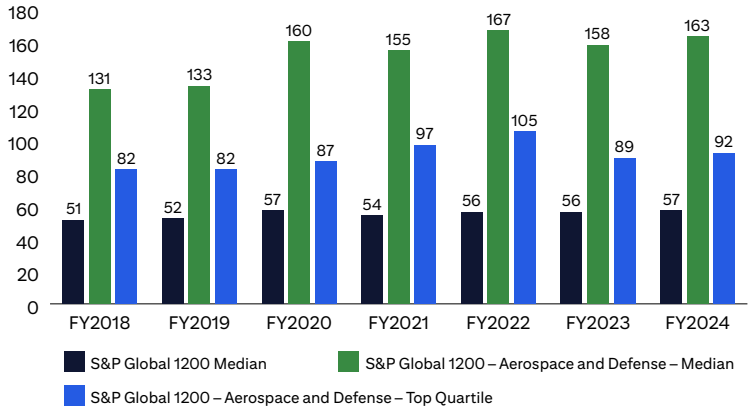
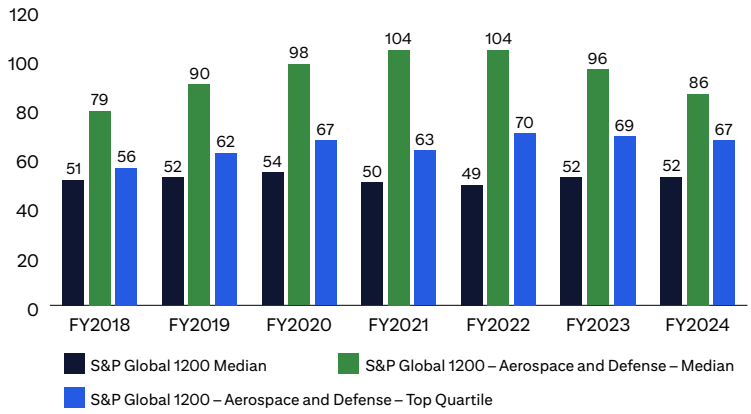


Figure 2: Days Sales Outstanding for Aerospace and Defense, S&P Global 1200 Index



As government contracts make up a large portion of defense companies' receivables, the investment grade worthiness of many sovereigns can make monetizing government receivables a viable path to accelerated low-cost liquidity.

This environment should give defense companies treasurers reasons to consider how they accelerate liquidity and the solutions available to enable this. As government contracts make up a large portion of defense companies' receivables, the investment grade worthiness of many sovereigns can make monetizing government receivables a viable path to accelerated low-cost liquidity. Conversely for suppliers, they have the opportunity to monetise their receivables against their Original Equipment Manufacturers (OEM) customers in exchange for an efficient source of liquidity that can simultaneously improve their DSO and CCC.

2. Supply Chain: Resilience remains a priority

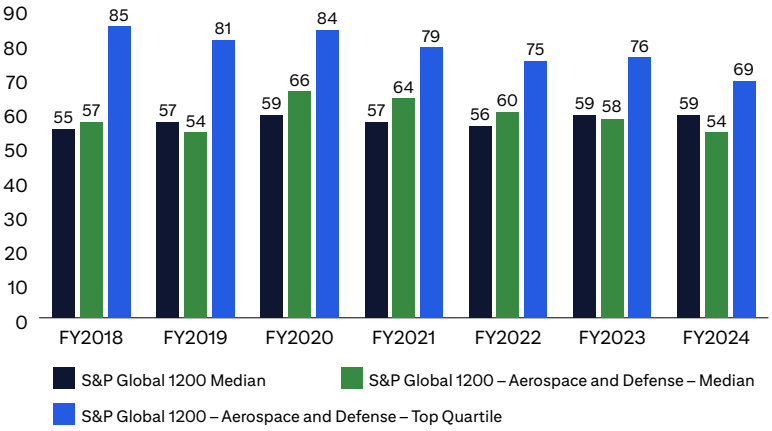
Scaling up production is particularly challenging for the defense industry due to its highly complex, multi-tiered supply chain. Defense companies typically have a very large network of tier-2 and tier-3 suppliers, a single tier-1 supplier can have hundreds and even thousands of tier-2 and tier-3 suppliers. Disruptions in the supply chain can have significant consequences, affecting production schedules and overall operations.

OEMs and their tier-1 suppliers are relatively shielded from the financial challenges in scaling up productions. Generally, as part of government contracts, OEMs typically receive advance payments from the government to cover purchases and source materials, often up to 10% of the contract value. On a large government contract, this can amount to a significant cash injection.

However, smaller tier-2 and tier-3 suppliers typically miss out on this significant cash injection, making them more vulnerable. As demand grows, these suppliers will require funding and additional working capital to scale their operations and meet production needs. One of the most pressing concerns in the sector is ensuring adequate financing across the wider supply chain. Without sufficient financial support, smaller suppliers may struggle to keep up with the increased demand, potentially causing delays and disruptions in production.

Median Days Payable Outstanding (DPO), a measure of the median number of days that it takes for a company to make payment to suppliers after a purchase, has declined in recent years in the sector as a result. The S&P Global 1200 index for Aerospace and Defense showed DPO declined from 66 days in 2020 to 54 days in 2024, signifying that these companies are now paying their suppliers 12 days faster[10]. This goes against the trend of many other corporate treasury departments where companies have been able to increase their payment terms with suppliers while offering them the facility of a Supply Chain Finance (SCF) program to liquidate its receivables and increase working capital resilience.

Figure 3: Days Payable Outstanding for Aerospace and Defense, S&P Global 1200 Index



3. The Role of Trade Finance and Working Capital Solutions

At Citi, we are acutely aware of the current working capital challenges facing the defense sector. We have been working with defense companies to advise on the different tools available to help mitigate these challenges on their working capital.

It is important for defense companies to have a strong, comprehensive knowledge of the working capital solutions available and a strategy in place to ensure access to a diversification of solutions. There are a variety of traditional and new trade and working capital financing solutions available to support companies throughout the defense industry supply chain:

1. **Adding Resilience to the Supply Chain:** Raising production levels for the defense sector can add strain to the supply chain, it is therefore imperative for OEMs to support their suppliers with access to liquidity. **SCF** programs can provide resilience throughout the supply chain by giving suppliers early payments and favourable payment conditions, improving their working capital and the security of their balance sheets while improving OEMs' DPO metrics. Governments or OEMs with surplus liquidity might consider using their own liquidity to provide support for suppliers using a tool such as **Dynamic Discounting (DD)**. Alternatively, **Purchase Order (PO) financing** provides financing to suppliers during the production stage prior to the good being shipped and invoiced. Injecting liquidity into the suppliers early can help to reduce the capital required during manufacturing.
2. **Building up Working Capital:** In order to increase production to meet the heightened demand for defense products, it is important for defense companies to proactively build up their working capital levels. As payment cycles are typically long for defense companies, **Accounts Receivables (AR) finance** is an efficient path that can accelerate cash flow and help to secure well priced liquidity for their balance sheet. For tier-2 and tier-3 suppliers, their receivables from tier-1 customers can be monetized to improve cash flow generations which can be redeployed into business expansion.

[10] S&P Capital IQ, Citi Services (2025)

3. **Core Trade:** Core trade instruments, such as **guarantees**, can provide an effective and efficient solution for defense companies in performing a government contract. For example, at the bidding stage of a government contract, defense companies may need to issue **bid bonds**. Once the contract is awarded **performance guarantees** and **advance payment guarantees** may be required. If the contract contains any offset provisions, these may also need to be covered by an **offset guarantee**. Finally post-delivery, **warranty bonds** are often required for the contracts. Separately, some governments are looking to balance their budget asks and are seeking **standby Letters of Credit (LCs)** to replace advance payments to suppliers.
4. **Investments to Increase Production:** Obtaining finance to support the construction of new manufacturing capabilities is vital for defense companies, **Export Credit Agency (ECA) finance** plays a significant role in supporting this expansion of manufacturing. ECA financing can help governments obtain financing for their procurement obligations in defense. Similarly, OEMs may be able to seek support to finance the constructions of new onshore defense manufacturing capabilities. For example, the UK recently increased UK Export Finance's direct lending capacity for defense from £8 billion to £10 billion[11], to facilitate additional opportunities for UK defense exports such as missiles, aircraft and armoured vehicles.

Conclusion

As a sector going through its most heightened demand in decades, defense companies face multiple challenges in working capital management as their order books grow and production scales up. Efficient working capital management is critical for defense companies to be able to meet their growing demands and optimize their cash flow. It is crucial for defense companies to explore these trade finance and working capital solutions to position themselves for success in the current dynamic environment.

At Citi, we are keen to support defense companies to assess their working capital requirements and help them determine a strategy that is supportive of their overarching working capital goals. We understand the unique financing and treasury challenges that companies in the defense sector face. Our extensive defense industry experience within Treasury and Trade Solutions (TTS) - combined with comprehensive working capital solutions - can help guide companies in the sector in this period of consequential change as they ramp up production, helping them assess how working capital management can best position them for long-term growth.

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[11] "£2 billion boost for defence sector to unlock orders from allies." GOV.UK, 14 March 2025, https://www.gov.uk/government/news/2-billion-boost-for-defence-sector-to-unlock-orders-from-allies

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