



Europe's Sharpened Focus on Defense Creates M&A and Investment Opportunities

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Key Points

- The war in Ukraine has prompted a historic surge in European defense spending.
- Governments in the EU and U.K. are stressing the need for innovation. They are increasingly turning to investment in small and medium-sized businesses — including startups — to drive rapid technological advances, rather than relying exclusively on large, established defense firms.
- This creates opportunities for private equity and venture capital investors, who are increasingly active in the defense sector, and it will likely generate M&A activity.
- Understanding the focus on sovereign capability, innovation and dual-use technologies will be essential for capitalizing on this dynamic market.

The European defense landscape is undergoing a profound transformation. Governments are urgently increasing procurement in response to the growing need for European sovereign capability highlighted by the war in Ukraine, and they are focused on the role of innovation in an increasingly technology-driven battlefield.

With private investors actively looking to expand their horizons, there is a compelling environment for investment and M&A activity, especially for small and medium-sized enterprises (SMEs) at the forefront of emerging defense technologies.

A Surge in European Defense Expenditure

There has been a dramatic increase in current and planned European defense spending, with expenditure across the continent surging by 17% to \$693 billion in 2024, pushing beyond Cold War levels, according to the Stockholm International Peace Research Institute (SIPRI).

A significant portion of this growth is from preexisting commitments. For instance, Germany's 28% increase in defense spending in 2024 is largely attributed to its €100 billion special defense fund announced in 2022, according to SIPRI. Similarly, Poland's robust increase

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to 4.2% of gross domestic product (GDP) in 2024 reflects sustained dedication to defense spending that began over a decade ago.

However, substantial new commitments are also driving this surge. The European Commission's "ReArm Europe Plan/Readiness 2030" aims to mobilize €800 billion, including a €150 billion loan instrument. The U.K.'s recent commitment to raising defense spending to 2.5% of GDP by 2027, and 3% by the mid-2030s, underscores a similar upward trajectory.

The European Commission has also proposed a number of regulatory measures to attract private investment flows alongside increased government expenditure. These include adding "defence readiness" as a positive consideration when reviewing mergers and acquisitions, and clarifying that environmental, social and governance (ESG) rules do not exclude all defense investment.

Opportunities for Investors and SMEs

Traditionally, defense procurement has been dominated by large, established prime contractors. With a shift toward innovation in cyber, artificial intelligence (AI), quantum and software-defined warfare, SMEs are increasingly well positioned for success. Unlike traditional defense hardware, these product areas are characterized by rapid development cycles, iterative innovation and a reliance on specialized software engineering and data science expertise.

With the lessons from the Ukrainian battlefield in the forefront of the leaders' minds, European governments are increasingly looking to invest directly in innovation by SMEs. The U.K.'s recent Strategic Defence Review (SDR) emphasizes that the U.K. "must embrace its role in seeding innovation and growth" and proposes a new Defence Research and Evaluation organization to act as a gateway to academia and research institutions.

Similarly, the NATO Innovation Fund is designed to invest in deep tech startups developing disruptive technologies. Other national innovation hubs and accelerator programs with comparable strategies are emerging across Europe. The U.K.'s Ministry of Defence "Tech Scaler" marketplace and the Defence and Security Accelerator are explicitly designed to cut contracting times and inject capital into cutting-edge projects from SMEs.

Private capital is also a rapidly growing source of investment. In Europe, sustained high levels of dry powder among private equity investors, strong competition for good quality assets and a changing conception of ESG policies to lift the taboo on defense investment are combining to create meaningful momentum.

M&A and Investment Opportunities

Increased direct defense procurement opportunities alongside private investment are critical for SMEs looking to escape the pre-revenue "valley of death." Rather than be left to be acquired at lower pre-revenue valuations by prime contractors, SMEs are able to mature and potentially attract better exit premiums from strategic acquirers when backed by defense revenue.

However, defense investment is not just for defense players. The U.K.'s SDR highlights the role of commercial solutions, including dual-use technologies, in delivering military advantage. Governments are increasingly looking to existing, readily adaptable commercial solutions with a shorter runway to operational readiness than early-stage technologies.

By understanding where their solutions may have defense use cases, commercial innovators in key emerging technology sectors such as AI, cyber, quantum computing and advanced materials can also benefit from this "defense dividend" in Europe.

Final Thoughts

The European defense market is experiencing a profound resurgence. Increased governmental expenditure coupled with a strategic emphasis on innovation is creating a dynamic environment for M&A and investment.

For SMEs specializing in the next generation of defense technologies or commercial solutions with potential dual-use applications, there is a novel window for growth, maturation and strategic partnerships, potentially shaping the future of sovereign European security.

Understanding the defense landscape, including current priorities for governments, will be key for investors looking to deploy capital successfully, as well as for SMEs looking to take advantage of this window.

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