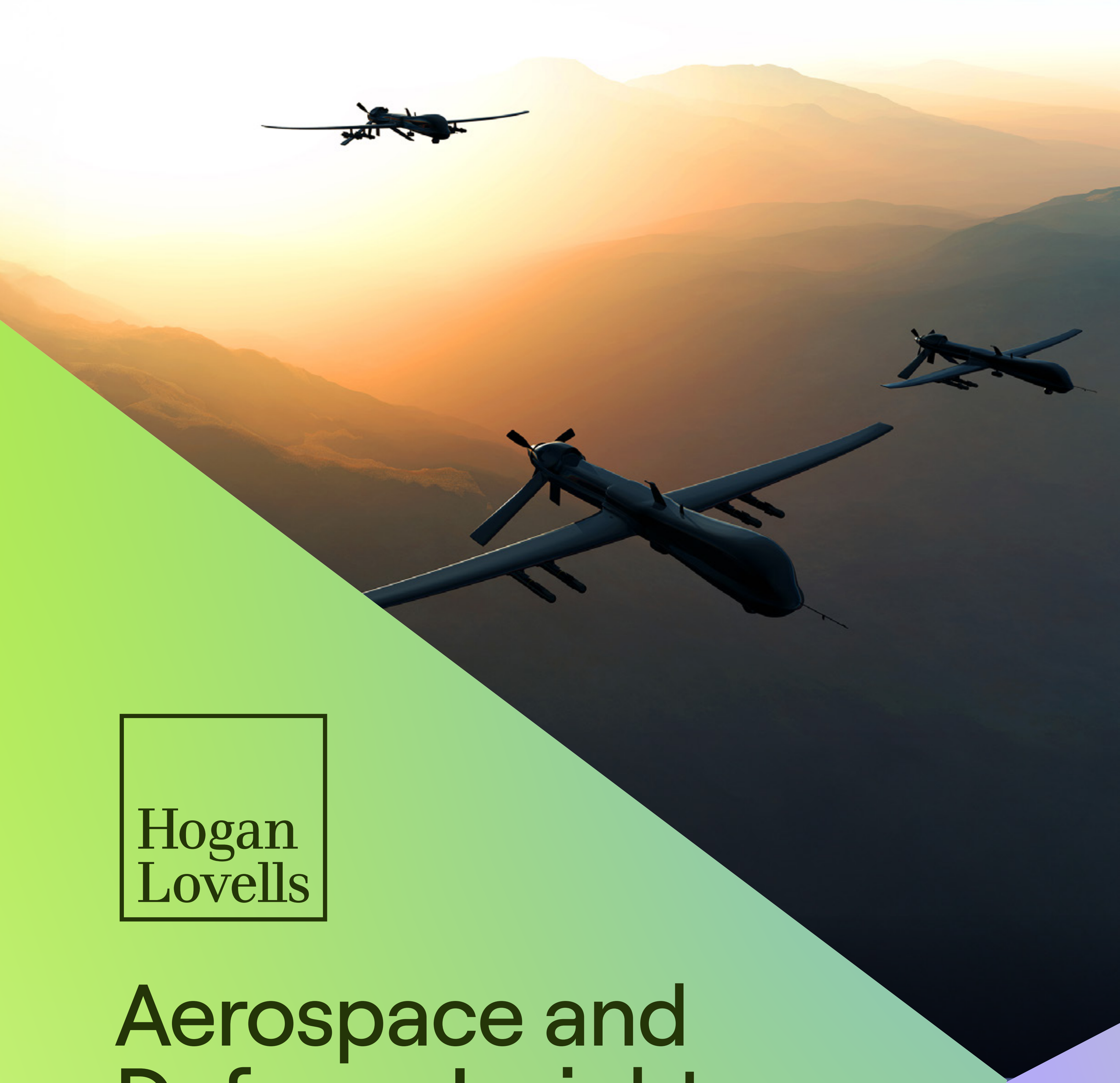

Hogan Lovells

Aerospace and Defense Insights

Increasing European defense budgets: What are the implications for government contractors and investors?

Through Aerospace and Defense Insights, we share with you the top legal and political issues affecting the aerospace and defense (A&D) industry. Our A&D industry team monitors the latest developments to help our clients stay in front of issues before they become problems, and seize opportunities in a timely manner.

Introduction

At a time of marked geopolitical uncertainty, governments around Europe are committing to meaningful increases in defense spending, whilst also looking to private capital and investment to supplement public funds. This in turn will have a significant impact on both investment activity in the defense supply chain and how these products and services are procured. In this article we examine recent developments in Europe's largest economies including the UK, Germany, and France where significant changes in defense activity are underway including a strategic defense review, the introduction of unlimited borrowing for defense spending, and the bolstering of nuclear weaponry.

Investors and defense contractors alike will need to carefully consider how best to develop their defense related offerings, with an increased focus on more localised supply chains and what is meant by 'national security', a term which remains undefined in many jurisdictions.

Whether defense related contracts will be awarded to contractors, or whether investments and M&A activity will be permitted by governments, will be subject to ever increasing scrutiny and uncertainty. Having a clear narrative to present to authorities, and clarity over areas of uncertainty in the supply chain and risk areas relating to investors, will be crucial to navigating how best to take advantage of the increased government spending.

Increase in defense spending and activity

Major European economies, including the UK, France and Germany have recently publicly committed to an increase in defense-related spending. The geopolitical backdrop to this is multifaceted, with the U.S. Government renewing pressure on NATO members to meet or exceed the 2% of GDP defense spending target. U.S. demands have been as high as 5% of GDP for defense spending, with the U.S. Government suggesting that the U.S. may not defend a fellow NATO member if the country fails to meet the defense spending threshold. Additionally, the on-going conflict in Ukraine and uncertainty from within Europe about relations with the U.S. has led European governments to bolster military readiness and support for NATO.

Until recently, EU member states would spend slightly less than 2% of its GDP on defense but European leaders are now actively considering levels nearly twice that high. While the figure has been rising over recent years, European governments are now facing the prospect that a step-change in spending is likely required. And with the war in Ukraine showing that the efficacy period for new frontline technology is measured in weeks, not years, procurement practices will need to be revised to ensure they can deliver against that increased tempo.

In the **UK**, the government introduced plans to increase the country's defense spending to 2.5% of its GDP by 2027, at a time when the British Army has been at its smallest size in two centuries. This means an increase of £13.4bn each year, starting in two years' time. It is suggested that significant sums will be used for acquiring munitions and funding military programs and is expected to be the largest investment into the sector since the Cold War.

Additionally, the Chancellor has announced that the remit of the £27.8bn National Wealth Fund would be adjusted to allow its funds to be spent on defense, increasing the availability of fiscal resources for defense spending and investment into the UK's domestic defense sector.

In **Germany**, we similarly see a significant change of pace furthered and introduced by the country's chancellor-in-waiting, Friedrich Merz. Germany pledged to achieve and maintain NATO's 2% GDP defense spending target, a major shift from previous policies. The Bundeswehr, as the British Army, is currently at its smallest size in decades, and the €100bn Special Defense Fund (Sondervermögen) allocated in 2022 as part of the Zeitenwende is already used and could only cover the most pressuring shortcomings after decades of underspending. On 21 March 2025, Germany overhauled its "debt brake" and with it years of limited borrowing based on constitutional restrictions. What has now been approved is a €500bn fund for infrastructure plus unlimited borrowing for defense spending to bolster German and European defense efforts. Receiving over two-thirds majority support of the constitutional change in the Bundestag, this marks a revived approach to military reform in Germany.

In **France**, the French president Emmanuel Macron vowed to increase military and defense spending to 3.5% GDP, an increase of 1.5% to its current commitment, which amounts to €30bn more each year. However, hints of even higher contributions have also been suggested and statements have been made to order larger amounts of fighter jets and to invest €1.5bn into the latest nuclear technology for its military bases.

Increased European cooperation

At the EU level, the President of the European Commission Ursula von der Leyen has proposed a new €150 billion Security Action For Europe (SAFE) fund to support member states in bolstering their military capabilities. The SAFE fund is a proposal by the European Commission aimed at significantly enhancing the European Union's defense capabilities in response to escalating security threats, particularly from Russia. The funds will be raised on capital markets and disbursed to interested member states upon demand, based on national plans. The scheme encourages joint procurement and projects should involve at least two eligible countries.

Importantly, the funding available to member states could only be spent on items from EU nations, countries that are member of EFTA and the EEA (Norway, Liechtenstein, Iceland), Ukraine and countries in the EU accession process. Arms companies from other third countries such as the U.S. and UK are excluded unless their governments enter into Security and Defense Partnerships with the EU (although these could just relate to the programme in question). Notably, Japan and South Korea have such partnerships, while the UK and Canada are currently just 'in discussion'. Another key aspect of the proposal is a ban on using the funds to acquire advanced weapon systems that are subject to third-country restrictions on manufacturing, component usage, or operational deployment. This may especially be problematic for U.S. companies in light of typical ITAR restrictions.

The SAFE fund is part of the broader ReArm Europe Plan, which seeks to unlock €800 billion of additional public funds for defense, as well as mobilising private capital including by accelerating the Savings and Investment Union and through the European Investment Bank. This initiative would involve suspending the EU's fiscal deficit rules specifically for military expenditure and reallocating existing budgetary resources towards defense projects. The plan follows previous steps to greater coordination via, amongst other things, the appointment of the EU's first Defense Commissioner and initiation of the European Defense Industry Strategy (EDIS) in 2024.[1]

Major European nations have also taken active steps to expand the cooperation between their defense industries, with the aim of decreasing their reliance on U.S. defense manufacturing. These include a renewed focus on pre-existing programmes, including those developing sixth-generation fighter jets in the frameworks of the Future Combat Air System (FCAS / Germany, France, Spain) and Global Combat Air Programme (GCAP / UK, Japan, Italy).

Furthermore, recent strategic moves such as Finland and Sweden joining NATO are reshaping European defense priorities, significantly influencing procurement decisions and collaborative defense projects. Concurrently, the EU's intensified focus on indigenous defense technological capabilities and supply chains, demonstrated by recent commitments under the EDIS, emphasises the strategic drive towards technological sovereignty, especially in sectors such as artificial intelligence and quantum computing.

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[1] *For further background on European defense programmes and cooperation, please see our latest Aerospace and Defense Insights: European Defense Sector Outlook 2025: https://www.hoganlovells.com/en/publications/aerospace-defense-insights-european-defense-sector-outlook-2025.*

M&A, investment and government procurement – what is the impact?

With the increase in spending comes increased regulatory considerations for M&A, investment and government procurement generally.

It is of little surprise that European and UK defense company stocks have been performing well over the last months. Although generally only the larger "prime" contractors are listed, this is an encouraging indication for investors and others in the defense supply chain. This may attract new entrants to the industry (e.g. investors from other sectors such as technology, or an increase in commercial lending as banks relax their investment criteria) and it will be important to be aware of and plan for potential regulatory hurdles which may delay, impose conditions or otherwise scupper deals.

Foreign Direct Investment (FDI) regimes are increasingly active in the area of defense, and governments have shown themselves prepared to require remedies or otherwise block transactions in this sector. For example, in the UK the Secretary of State has used powers under the National Security and Investment Act to block or impose conditions (by way of a 'Final Order') on over 30 transactions to date, with around a third of these being the sector of defense. It would also be a misnomer to think Final Orders are only imposed from countries viewed as potentially hostile to the UK's national interests, with several such Final Orders being imposed on investors from countries traditionally considered 'friendly' to the UK – including the U.S., France and even the UK.

While specific cases in Germany are not publicly detailed, the country has a stringent FDI screening process, particularly concerning the defense sector. In France, authorities prohibited a U.S. company's proposed acquisition of a defense supplier in 2020 due to national security concerns. In 2022, France conditionally approved a U.S.-backed acquisition, imposing a "golden share" to retain state influence over strategic decisions, while in 2023, it blocked a proposed acquisition of a Canada-based leading provider of industrial steel valves whose French subsidiary manufactures and supplies valves for nuclear submarines nuclear power plants. The acquisition of relatively small stakes (e.g. 10% or even lower) can be sufficient for a government to review an investment. Even in Spain, a country with one of the lowest defense budgets in the EU, the government imposed various conditions on the sale of ITP Aero in 2022, including requiring shares to be reserved for Spanish companies and the Basque Government.

M&A, investment and government procurement – what is the impact? (continued)

Where defense companies are seeking to merge, or otherwise enter into joint ventures, it is also possible that antitrust and merger control rules become engaged and therefore need to be carefully considered to ensure any potential transactions do not fall foul of these rules. There may also be export control or sanctions to consider, particularly if software or products being produced or researched are dual-use.

Where public bodies or authorities spend money, they and the companies receiving it should also be thinking about whether and how the state aid/subsidy control rules apply. For example, in March 2025, the UK Chancellor committed to spending a minimum of 10% of the UK Ministry of Defense's kit budget on novel equipment (like drones and AI-enable tech) as part of broader efforts to make the UK a "defense-industrial superpower". Transactions which involve public authorities dealing with enterprises on market terms do not entail subsidies. But if public authorities want to support companies to do things like develop innovative technologies (e.g. with funding through grants, guarantees or low interest loans), then they will need to consider the application of the subsidy control rules. Part of this will involve weighing up whether the subsidy (if there is one) is exempt e.g. because it was for the "purposes of safeguarding national security".

Further, while the UK new procurement rules introduced at the beginning of 2025, should enable improved and more streamlined procurements, the introduction of 'national security' as a mandatory and discretionary ground for excluding bidders may be concerning for some. A new National Security Unit for Procurement (NSUP) has been established within the Cabinet Office to help assess the exclusions and debarment of suppliers on national security grounds. As a result, as government departments seeking to spend this increased investment, there will need to be a focus on how this procurement is carried out, particularly defense procurement where national security considerations around ownership and supply chains of would-be contractors will become increasingly relevant.

As the UK, Germany reformed bureaucratic procedures to speed up procurement, relaxing previously stringent tender and approval processes, allowing quicker decisions, particularly for urgently needed equipment. Since 2022, the German government already expedited the purchase and deployment of critical military systems, such as F-35 fighter jets, heavy transport helicopters (CH-47 Chinooks), ammunition stockpiles, and advanced air-defense systems including the IRIS-T and Patriot missile systems.

How can Hogan Lovells help?

Hogan Lovells' multidisciplinary cross-border team across defense contracting and procurement, M&A and joint ventures, FDI, antitrust, export control and sanctions are exceptionally well placed to guide clients through early stage considerations of transaction planning all the way to securing the right outcome as seamlessly as possible.

Whether it's negotiating some of the largest defense contracts ever, or advising clients on navigating the risks and intricacies of merger control and FDI regimes, we routinely help clients achieve the results that matter to their business. Please get in touch if we can help.

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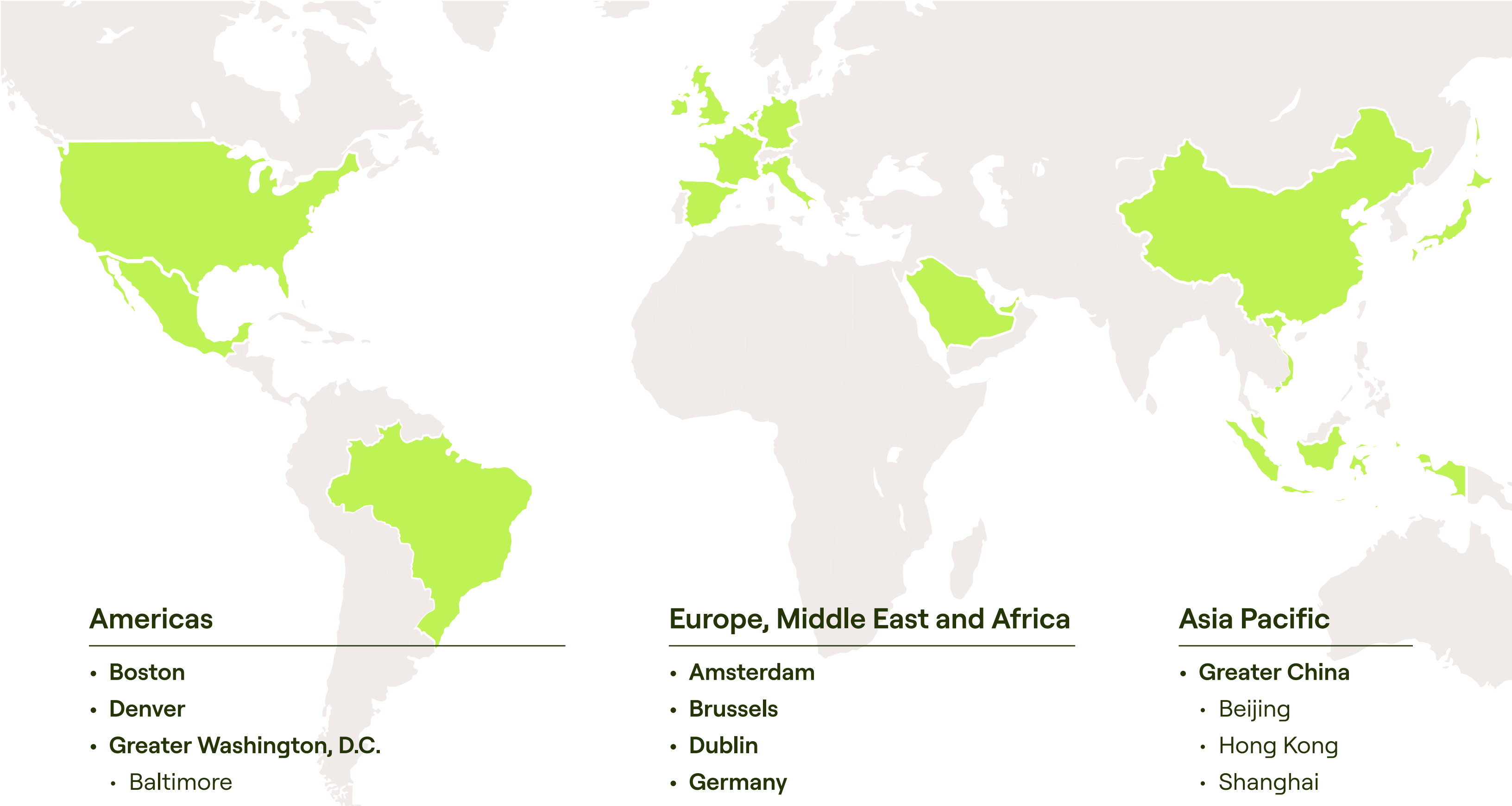

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