European defence: fragmentation is binding constraint, not funding; consolidation pressure rising

Dispersed procurement and R&D gap with the US are pushing consolidation

Analysts

Jihwan Kim

+49 69 6677389-15

j.kim@scoperatings.com

Business Development

Florian Stapf

+49 69 6677382-95

f.stapf@scopegroup.com

Editorial/Press

Matthew Curtin

+33 7 88 89 78 09

m.curtin@scopegroup.com

Table of Contents

1. Some consolidation is underway; modest further activity appears likely

2. Issuer-specific balance sheet capacity could support further M&A

3. Execution risks may limit pace, benefits of consolidation

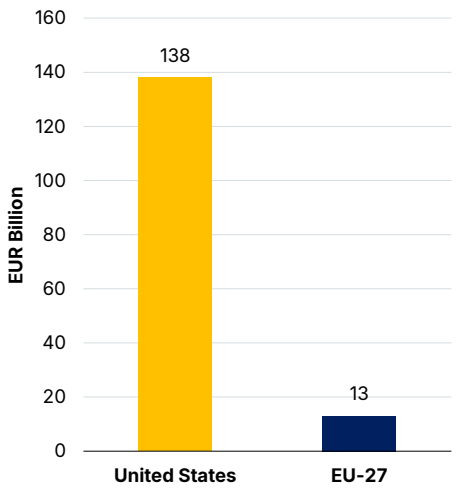
4. Credit implications are likely to vary considerably by issuer

Europe's fragmented but fast-expanding defence sector is ripe for consolidation, yet regulatory uncertainty, industrial complexity and high valuations might lead to only incremental deal-making by the few contractors without financial constraints. This leaves the industry at a deep structural disadvantage to the US unless European governments back pledges to spend more on defence with reforms. Without more coordinated procurement, clearer EU-wide merger regulations, looser state influence over domestic contractors and a less nationalist approach to multi-government projects, issuer-specific M&A is more likely than valuation-transforming sector consolidation.

Europe's defence industry has expanded rapidly since Russia's invasion of Ukraine. However, EU member states continue to procure defence equipment and services through separate national channels and maintain parallel weapons programmes which limits economies of scale and cross-border technology transfer. Unlike the US, where the Department of Defense coordinates R&D and procurement centrally, European investment is spread across 27 national budgets. The result is a spending gap — USD 149bn of US defence R&D in 2024 versus roughly EUR 13bn in the EU — and a lack of coordination that higher budgets alone are unlikely to close.

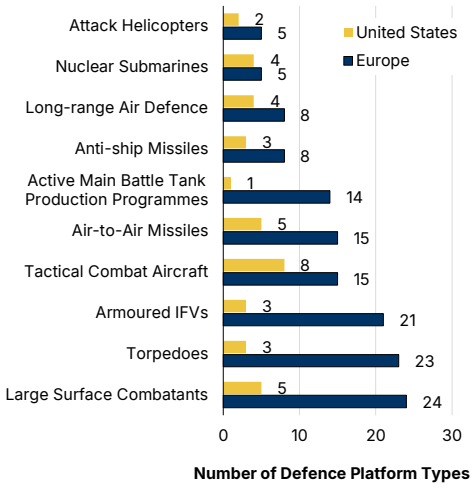
Fragmentation imposes material economic cost. The European Parliamentary Research Service estimates the annual cost of non-consolidation at EUR 18bn to EUR 57bn through duplicated procurement, foregone economies and lost innovation capacity. EU member states operate more than 170 weapons systems versus around 40 in the US, including three parallel fighter aircraft programmes compared with US standardisation around the F-35. Unless Europe's procurement becomes much better coordinated, inefficiencies are likely to persist even as nominal budgets rise.

Figure 1: Annual military R&D spend (2024, EUR bn)



Source: European Defence Agency, Scope

Figure 2: Europe's fragmented defence industry compared with the US



Source: McKinsey, Scope

1. Some consolidation is underway; modest further activity appears likely

Full order books provide cashflow for deal making

Record order backlogs – worth EUR 330bn at end-2024 - are translating into multi-year revenue visibility, strengthening the business case for consolidation – with several deals in the past 18 months. European defence M&A reached USD 2.3bn in H1 2025, more than in full-year 2024, but this falls wells short of fully developed consolidation cycle.

Strategic positioning as much as capacity optimisation has driven the vertical integration pursued by Rheinmetall with its acquisitions of Loc Performance (2024) and Naval Vessels Lürssen (2026) to address supply-chain bottlenecks and broaden exposure across land and sea platforms. The NVL transaction strengthens the company's control over naval production at a time of strained European shipbuilding supply. In contrast, Safran's EUR 220m purchase of AI earth observation firm Preligens addresses gaps in technology capability which constrained organic R&D budgets may not close quickly enough.

Encouragingly, accelerating venture capital investment in European defence – up 24% to USD 5.2bn in 2024 – creates a growing pool of technology-focused acquisition targets for prime contractors finding it hard to match innovation in autonomous systems, AI through organic R&D.

JVs are less financial onerous but only partial route to consolidation

Meanwhile, in the increasingly competitive space segment, Airbus, Thales and Leonardo have agreed to combine their satellite divisions under Project Bromo which will jointly be owned (Airbus 35%, Leonardo and Thales 32.5% each) to form the largest European space entity by revenue.

From a credit perspective, joint ventures offer lower-leveraged consolidation as issuers can expand capability and pool R&D without the step-up in debt typically associated with acquisitions. JVs are also well suited to situations where government co-ownership constrains cross-border M&A or valuations are elevated. However, JVs leave much of the underlying production and procurement fragmentation intact, so they are unlikely on their own to close the multibillion-euro annual cost gap between Europe and the US.

Political pressure for higher European defence spending remains

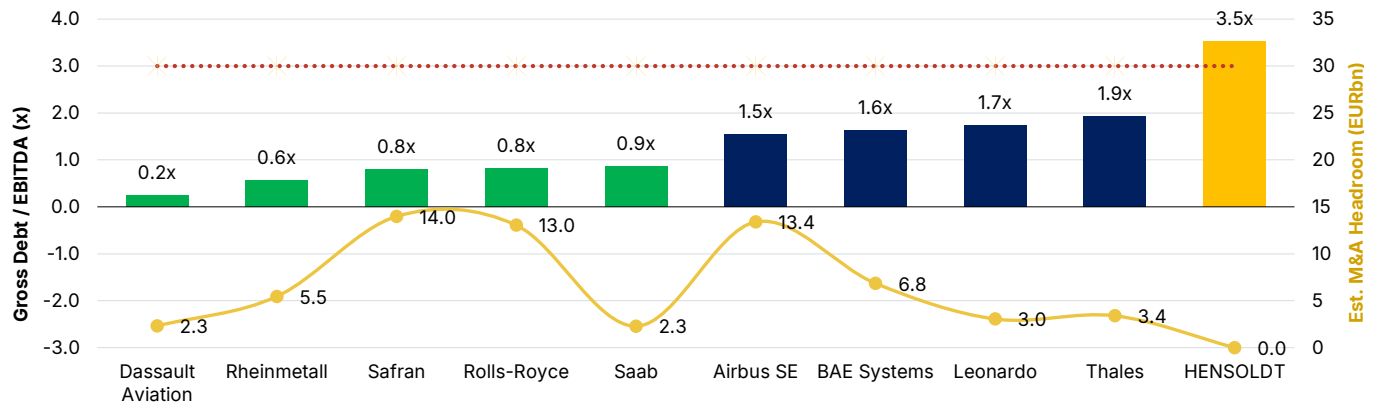
Other factors suggest further consolidation is likely long term. With full order books pointing to robust free operating cashflow, hence less need for external financing in M&A, the political pressure from the US for Europe to contribute more to NATO – recently intensified amid the US and Israeli war with Iran – provides longer-term visibility for European contractors.

2. Issuer-specific balance-sheet capacity could support further M&A

Gross, not net, leverage is good indicator for defence-sector M&A

Reassuring as headline cash balances are, they overstate the European sector's true capacity for transformative M&A. Much of reported cash is encumbered by customer advances linked to record order backlogs and is absorbed by working capital as production ramps up (**Figure 3**).

Figure 3: European defence firms' leverage points to M&A debt capacity (FY2025)



Source: Annual reports, Scope

BAE Systems, Thales, Rheinmetall best placed pure-play firms

Based on gross rather than net leverage, Safran, Airbus SE and Rolls-Royce show the highest absolute capacity (**Table 1**) but with an important caveat. A large part of their balance sheet headroom is attributable to civil aerospace operations – so more of a reference that an indication of potential for large-scale M&A.

Table 1: Ranking of European aero-defence contractors by estimated M&A capacity

Company	Revenue FY2025	Net Debt / EBITDA (x)	Gross Debt / EBITDA (x)	Est. M&A Capacity (€bn)*
Safran	€31.2bn	-0.3x	0.8x	14.0
Airbus SE	€73.4bn	0.0x	1.5x	13.4
Rolls-Royce	€24.4bn	-0.4x	0.8x	13.0
BAE Systems	€34.1bn	0.9x	1.6x	6.8
Rheinmetall	€9.9bn	-0.2x	0.6x	5.5
Thales	€22.1bn	0.5x	1.9x	3.4
Leonardo	€19.5bn	0.4x	1.7x	3.0
Dassault Aviation	€7.4bn	-11.0x	0.2x	2.3
Saab	€7.4bn	-0.4x	0.9x	2.3
HENSOLDT	€2.5bn	1.5x	3.5x	-0.2

* Estimated M&A capacity reflects the additional debt an issuer could theoretically raise before reaching 3.0x gross leverage, assuming no immediate EBITDA contribution from acquisitions. It provides a simplified view of balance-sheet headroom for debt-funded M&A.

Among predominantly defence-oriented contractors, BAE Systems and Thales carry moderate gross leverage with significant, if limited, headroom for M&A.

Rheinmetall's modest gross leverage and rapidly growing EBITDA continues to widen financing capacity as acquisitions are executed. The company's recent NVL acquisition was largely funded by newly raised debt, supported by up to EUR 1.5 billion syndicated bridge financing arranged in early March 2026

HENSOLDT may prove near-term acquisition target

In contrast, HENSOLDT sits at the constrained end of the deal-making spectrum based on gross leverage – closer to its ceiling than the net position implies – and is not set for debt-funded M&A of meaningful scale in the near term. Its negative estimated capacity makes it more credibly a consolidation target than an acquirer.

In practice, acquisitions in this environment are more likely to be funded through incremental debt than through cash deployment, preserving liquidity.

Take BAE Systems which acquired Ball Aerospace with debt, so leverage has risen materially from FY2024 levels, yet the company retains capacity for further bolt-on activity as earnings growth helps the company carry the extra debt.

3. Execution risks may limit pace, benefits of consolidation

Structural obstacles stand in way of transformational M&A

If the strategic rationale for deeper industrial consolidation is clear, the ability of European defence companies to translate this impetus into completed deals with good financial outcomes is limited by structural obstacles. The constraints will shape how fast consolidation takes place.

Regulatory uncertainty in the EU is one constraint. Reforms intended to support defence industrial scale-up remain incomplete and uneven. The Defence Readiness Omnibus (June 2025) and the EUR 150bn SAFE facility signal support for cross-border cooperation, but they do not yet provide a predictable or harmonised merger framework. Formal revisions to the EU Merger Guidelines incorporating defence-readiness criteria are unlikely before late 2026 or early 2027, leaving transactions agreed in the interim subject to case-by-case interpretation.

Regulatory layers stand in way of rush of new deals

Parallel regimes such as the Foreign Subsidies Regulation and national FDI screening add procedural complexity, particularly where government shareholdings are involved. High-profile cases like Project Bromo will test whether the European Commission's emerging stance translates into predictable outcomes.

Complex ownership in Italy, Spain show consolidation challenge

The complexity of the European defence sector compared with other industries is another impediment to consolidation, notably the extent of government co-ownership. Italy's Ministry of Economy holds approximately 30% of Leonardo, France retains effective strategic influence over Thales, and KNDS operates under joint Franco-German governance.

A recent example is Spain's Indra Sistemas (defence revenues of around EUR 1.4bn in 2025, below the scale of the large European defence primes shown in the table), where intermittent merger talks with privately owned Grupo Escribano illustrate how governance conflicts and the Spanish state's 28% shareholding can slow execution even in relatively contained, domestic transactions.

FCAS shows difficulties of cross-board, cross-company ventures

Cross-border transactions touching these entities require navigating multiple and simultaneous sovereign approval processes, leading to delays and political compromises that undermine potential cost savings and revenue gains.

This problem extends to new ventures such as Europe's Future Combat Air System, delayed by competing French, German and Spanish industrial priorities and tensions between Airbus and Dassault Aviation. FCAS illustrates how state influence and co-ownership can complicate even broadly shared strategic objectives.

Frothy stock-market valuations deter debt-financed M&A

Market valuations are another issue as investors have anticipated the growing order books for European firms, marking up share prices. European prime contractors are trading at EV/EBITDA multiples above 20x, up from around 13x in 2021. At such elevated valuations, acquisitions require substantial debt relative to the EBITDA acquired, making it difficult for issuers to pursue deals without materially increasing leverage. High purchase multiples compress financial headroom and constrain the scale of debt-funded consolidation across the sector.

A longer-dated risk is that growth in demand tails off if today's geopolitical urgency for increases in defence expenditure subsequently fades. Peace in Ukraine and the Middle East or unbearable fiscal pressures on those European NATO members behind on their spending commitments could moderate demand and future returns on investments. Issuers with revenues concentrated in Europe and with limited dual-use commercial exposure look most sensitive to such a scenario.

4. Credit implications are likely to vary considerably by issuer

The credit implications of consolidation are likely to diverge considerably across the issuer landscape. Balance-sheet health is only one dimension of that divergence. Execution risk, integration complexity and the strategic coherence of individual transactions will matter as much as the capacity to fund them.

For Rheinmetall, the primary credit question is whether it can smoothly integrate a growing set of acquisitions spanning land systems, naval platforms and autonomous technologies. At BAE Systems, the more relevant variable is how leverage evolves if management pursues more deals.

Sector faces consolidation, financial-flexibility trade-offs

More broadly, more indebted issuers face a sharper trade-off between strategic participation in consolidation and maintaining the financial flexibility that underpins their current ratings. At the most constrained end, HENSOLDT's credit trajectory may be shaped more by whether it becomes a consolidation target than by any strategic initiative of its own.

Leonardo and Thales illustrate a broader pattern of constrained headroom or leverage-adverse management likely to favour JVs to limit upfront borrowing while establishing shared capabilities and profit sharing.

Monitoring consolidation-related developments — including joint venture progress, the pace of EU Merger Guideline reform expected in 2026–27, and issuer-specific M&A activity — will remain essential to credit assessment of the European defence sector.

Related research and references

Scope Ratings: European defence: rearmament orders to test production, R&D, supply chains, short-term funding March 2025
Herbert Smith Freehills Kramer — Antitrust guidance for defence industry cooperation December 2025
European Centre for International Political Economy — Openness and Fragmentation in EU Defence Procurement Dec 2025
A&O Shearman — Rising geopolitical tensions ignite European defense M&A July 2025
EU Commission — Defence Readiness Omnibus June 2025
Freshfields — Roadmap for EU Defence Consolidation: M&A and state aid under the Omnibus June 2025
ASD Europe — Facts and Figures 2025
Draghi Report on European Competitiveness September 2024
European Defence Agency — EU Defence Data 2024-25

Scope Ratings GmbH

Lennéstraße 5, D-10785 Berlin
Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scoperatings.com

Scope Ratings UK Limited

1 King William Street
UK, London, EC4N 7AF
Phone: +44 20 3059 1051
info@scoperatings.com

Bloomberg: RESP SCOP
Scope contacts
scoperatings.com

Disclaimer

© 2026 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Ratings UK Limited, Scope Fund Analysis GmbH, Scope Innovation Lab GmbH and Scope ESG Analysis GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5, D-10785 Berlin.