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# Financing Europe's Defence Build-Up:

The Role of Hybrid Capital





## A Spending Challenge of Historic Proportions

Europe is rearming at a speed and scale not seen since the Cold War. EU Member States' combined defence budgets have already risen from around €218 billion in 2021 to an estimated €381 billion in 2024 prices for 2025. McKinsey estimates that European defence spending could rise from approximately €470 billion in 2025 to around €800 billion per year by 2030, and that under a more aggressive scenario aligned with NATO's 3.5% of GDP target, it could approach €1 trillion annually.<sup>1</sup>

The political architecture to support this is already in place. The EU's "ReArm Europe/Readiness 2030" plan aims to leverage up to €800 billion in total defence investment to 2030, including a €150 billion EU-backed loan instrument (the Security Action for Europe, or "SAFE").<sup>2</sup>

The UK, outside the EU but a central player in European security, is on a similarly steep trajectory. The 2025 Spending Review confirmed defence expenditure will rise from £62.2 billion in 2025/26 to £73.5 billion by 2028/29.<sup>3</sup> The UK's Strategic Defence Review, published in June 2025, explicitly called for private finance to be "crowded in under new funding models", including PPPs, and for the establishment of a Defence Investors' Advisory Group drawing on venture capital and private equity expertise. Bloomberg has reported that the MoD is drawing up options to attract private capital in part to address an estimated £28 billion funding shortfall in its defence investment plan.<sup>4</sup>

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## Overcoming This Challenge: Private Capital to the Rescue

Government ambition alone cannot bridge the gap. SAFE's €150 billion is significant, but it represents less than 20% of the headline target; the remaining funding must come from national budgets still under real pressure, or from the private sector. The European Commission has been explicit: it wants to mobilise private capital so that the European defence industry is "not reliant on public investment alone."

For companies in the defence and defence-adjacent space, including prime contractors and dual-use technology firms as well as logistics, cyber and infrastructure businesses, this creates a real and pressing need for non-traditional financing solutions. Traditional senior debt financing is not always available or optimal for these situations, and raising new common equity can be commercially unpalatable or raise other issues, such as filings or approvals.

### What Is Hybrid Capital?

Hybrid capital – encompassing instruments such as junior debt, payment-in-kind (PIK) notes, convertible instruments, preferred equity and other structured solutions – sits between senior secured lending and ordinary equity. It typically offers providers higher returns than traditional senior debt, and it gives borrowers access to flexible, patient capital without immediate significant equity dilution (or in some cases, no dilution at all).

Examples we have deployed on deals in this space include preferred equity with a PIK dividend feature and step-up rights, warrants which crystallize upon exit (for equity upside sharing) but confer immediate governance rights, and other quasi-equity and junior debt solutions.

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## Enforcement, FDI and National Security: A Complex Web

Hybrid capital providers in the defence sector face a structuring challenge that has no real parallel in conventional sectors: the significant risk that enforcement rights may be compromised or severely constrained by foreign investment screening or national security regimes, or other similar regulations.

Across Europe, virtually every country operates some form of foreign investment screening or national security regime that subjects acquisitions of interests in defence and defence-adjacent businesses to governmental review. Defence supply chains, dual-use technology, critical infrastructure and related sectors face heightened scrutiny.

The practical consequence for a hybrid capital provider is that enforcement action (or the exercise of similar “downside protection” rights) which results in the provider acquiring an interest in or control rights over a borrower may trigger a mandatory prior notification or review. In some jurisdictions, completing such a transaction – such as exercising share pledges, step-in rights or debt-to-equity conversions – without clearance is a criminal offence.

Structuring hybrid capital transactions in this space therefore demands careful thought at the outset, including understanding the interplay of relevant regulatory regimes, realistic timelines for any required clearances, and how all of this interacts with enforcement mechanics, including any relevant standstill periods.

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## Navigating ESG

Another common challenge for hybrid capital deals in this space is navigating the highly fragmented landscape of ESG policies across capital providers. Some institutional investors have historically applied blanket exclusions to the defence sector. Others draw lines only around controversial weapons (cluster munitions, landmines, biological or chemical weapons), while treating conventional defence as acceptable. Still others have recently changed their policies in response to the geopolitical environment.

The UK's Financial Conduct Authority clarified in March 2025 that nothing in its sustainability rules prevents investment or finance for defence companies, emphasising that the decision rests with individual institutions.<sup>5</sup> But inconsistent interpretations of dual-use technologies (where a product has both civil and military applications) can create uncertainty.

For deal counsel, this means up-front mapping of any ESG constraints on each prospective capital provider, (which can impact representations and undertakings in documentation), and often tailored reporting frameworks allowing the borrower to comply with potentially differing investor requirements simultaneously.

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## How Willkie Can Help

Our team has deep experience advising hybrid capital providers and borrowers on complex, multi-jurisdictional financings in regulated and strategically sensitive sectors. We work closely with clients to navigate the unique structural and practical challenges inherent to investments of this type in the defence and defence-adjacent sectors, including guiding clients through regulatory considerations and incorporating these into deal structuring.

Through our market-leading Hybrid Capital practice (which includes partners from our Private Equity, Finance, Anti-Trust & Competition and Restructuring teams), Willkie has a unique track record in this space in Europe, and we know how to structure and deliver these deals.

We would welcome the opportunity to discuss how we can support your team in this exciting and rapidly evolving space.

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### Key Contacts



**Daniel Gendron**  
Co-Chair of the Hybrid Capital Practice Group

Partner, Finance  
London  
+44 20 3580 4902  
dgendron@willkie.com



**Sarah C. Kessler**  
Co-Chair of the Hybrid Capital Practice Group

Partner, Finance and Asset Management  
Chicago  
+1 312 728 9144  
skessler@willkie.com

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### Sources & Notes

- <sup>1</sup> McKinsey & Company, From Investment to Impact – Using Private Capital to Accelerate Defence Tech (2025/2026).
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- <sup>3</sup> House of Commons Library, UK Defence Spending (2025/2026); HM Treasury, Spending Review 2025.
- <sup>4</sup> UK Government, Strategic Defence Review (June 2025); Bloomberg, UK Looks to Private Capital to Help Fill Defense Spending Gap (January 2026).
- <sup>5</sup> PLG ESG, Is ESG Failing Defence? Rethinking Ethics, Investment and National Security (March 2026); FCA Statement, March 2025

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