

Best Practices For Defense Tech Startup Financing

By **Stephanie Evans, Gary Schall and Jason Chipman** (November 21, 2023)

Navigating the expanding defense technology subsector of the emerging company ecosystem requires careful planning and execution.

Beyond putting together a trusted team and developing a uniquely marketable product, defense tech startups should carefully consider their potential investors, who may also become their commercial partners. This article covers the recent growth of the defense tech market and discusses best practices for various financing sources.

Growth in Defense Tech Market

The growth in defense tech startup funding is readily apparent.

For instance, PitchBook calculates that:

- From 2022 to 2027, the U.S. defense tech market is projected to grow to nearly \$185 billion at a compound annual growth rate of 15.9%;
- From 2016 to 2022, the defense tech sector saw \$135 billion invested across 4,744 deals, with acquisitions accounting for 71% of defense-tech venture capital exits; and
- U.S. venture investment in defense startups surged from less than \$16 billion in 2019 to \$33 billion in 2022, with an additional \$14.5 billion in Q1 2023.[1]



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Many factors contributed to the defense tech market boom. Geopolitically, Russia's aggression in Ukraine, the recent attack by Hamas on Israel, and the risk of conflicts between China and Taiwan have driven up demand for innovative defense tech.

The arms race with China, among others, to develop the best defense technology translates to bipartisan support for increased defense spending. The end users, such as the U.S. military and its allies, increasingly understand the value of emerging defense tech and are pushing for its adoption.

Defense tech is broader than merely defense, and much of the technology has commercial attributes. Historically, the U.S. military's contributions to dual-use technological innovation have been significant. For instance, the U.S. military funded the development of the

internet, GPS, self-driving cars, advanced drone technology, robotics, lasers and satellite technology.

Emerging dual-use technologies include artificial intelligence, renewable energy generation and storage, semiconductors and microelectronics, and advanced computing and software. Established institutional venture investors see the potential. For example, Sequoia Capital invested in Mach Industries, a startup developing hydrogen-powered weapons and defense systems,[2] while Andreessen Horowitz invested in Anduril Industries, a weapons systems developer.[3]

Best Practices for Defense Tech Startups

Prepare for the Foreign Investor Issue

Defense tech companies should pay attention to regulatory issues earlier in their development cycle than other types of startups, particularly with regard to foreign investment. The defense market is highly regulated and politically sensitive.

Even though foreign investors can help grow the business, the U.S. regulatory and political environment is more complicated than ever before. There is a strong, bipartisan sensitivity around foreign investment, especially for companies that operate with a close nexus to the defense sector.

The presence of foreign investors on a startup's capitalization table can have regulatory consequences and can complicate future business with government customers.

Perhaps more significant, the Committee on Foreign Investment in the United States has significant power to review certain types of foreign investment in U.S. companies. Once jurisdiction is asserted, CFIUS can clear the transaction, demand mitigation to resolve perceived national security concerns, or recommend that the president of the U.S. prohibit the transaction.

Because CFIUS authorities are so potentially far-reaching, it is important to forecast whether a prospective investment will trigger CFIUS review and whether the review is likely to be navigated smoothly or present difficult obstacles.

Choose Your Funding Source

Defense tech startups should consider all potential sources of funding and evaluate potential investors thoroughly. As discussed above in the context of foreign investors, the source of financing can be mission-critical. Beyond determining the financing instruments for raising capital — including debt, equity, simple agreements for future equity and convertible notes — defense tech startups should seek investors experienced with the government customer.

Such ideal investors include traditional venture capital funds, private equity funds, strategic investors, government funding and defense-specific lending.

Venture Capital Funds, Private Equity Funds and Strategic Investors

When considering investment from venture capital funds, private equity funds and strategic investors, there are three factors to consider: (1) experience with government customers, (2) reputation of the investor and (3) motivation of the investor.

Government Customer Experience

When a defense tech startup has alternatives, it should focus on investors with experience working with government customers and knowledge of the regulatory hurdles. It is desirable that the investor understand the federal acquisition process, the challenges associated with it, and the patience required to grow despite that process and related challenges.

As discussed further below, an investor with the requisite experience is vital to bridging the proverbial valley of death, the challenging place between research and development and government program funding.

Investor Reputation

Ideally, the startup prefers an investor reputable with government customers, lenders, other investors, other entrepreneurs, and such investors' portfolio companies.

For example, investors can attract government contractors with whom their other portfolio companies previously transacted or facilitate commercial arrangements with portfolio companies of investors in complementary areas.

Furthermore, if a company wishes to raise capital via venture debt or a new equity investor, often the lead investor of the company's most recent financing round will be instrumental in providing comfort to that financing source.

Investor Motivation

In assessing motivation, a defense tech startup should consider whether the investor seeks purely financial returns or has strategic interests as well.

With many venture capital funds and private equity funds, the motivation will be purely financial. However, motivations may be complicated in situations where another portfolio company of the investor is developing a competing product or technology.

Financing from strategic investors can have many benefits, including immediate credibility with the government customer and investment community, along with access to the strategic investor's knowledge, technology and assets.

However, strategic investors often have inherently complicated intentions because the main purpose of the strategic involvement typically is engaging in a commercial arrangement, which is often more important than realizing investment gains from their investment.

For companies considering an investment from a strategic investor, they should think through the consequences that may arise if the commercial arrangement goes sideways.

For example, if the strategic investor does not live up to its commitments yet remains on the cap table and retains a board seat or observer rights, a defense tech startup may have been better off with funding from venture capital funds. Further, the company should be sure to safeguard and protect its technology and intellectual property from a strategic investor whose motivation may shift from helping the startup to developing a competing technology.

Lastly, a strategic investor may preclude other potential strategic investors in a future financing or commercial partners in a future manufacturing or development agreement, or

request rights that a purely financially driven investor would not request, such as having a right of first offer in an exit scenario.

Such a right can complicate obtaining the highest value for the company by chilling interest from other potential acquirers.

Government Funding

In general, when receiving funding directly from the government, a defense tech startup should consider what they will want in return. Because the funds derive from taxpayers, there will be specific guidelines to ensure the funds are being deployed prudently in accordance with budgetary guidelines and the law.

Further, if the startup receives research and development funding from the government, the company should consider how that may affect ownership and use of intellectual property generated from those efforts. While not an exhaustive list, defense tech startups may want to consider the following government funding programs.

Small Business Innovation Research

A research and development program that facilitates opportunities for U.S.-owned and controlled businesses with 500 or fewer employees to propose new concepts to federal agencies. The SBIR program issues over \$3 billion in awards per year^[4] and entails three phases starting from technical merit, feasibility and commercial potential in phase I to commercialization in phase III.^[5]

Small Business Technology Transfer

A federal program which partially funds cooperative research and development between small businesses and research institutions, built on a three-phase structure similar to SBIR's program.^[6]

Other Transaction Agreements

These agreements are research and prototype development arrangements designed to invite the participation of nontraditional government contractors. Other transaction agreements are not subject to many of the statutory and regulatory requirements that apply to federal procurement contracts, with the U.S. Department of Defense as the primary government agency that uses this authority.^[7]

DOD's Defense Innovation Unit

This unit is the only DOD organization focused exclusively on fielding and scaling commercial technology across the U.S. military at commercial speeds. The Defense Innovation Unit partners with organizations across the DOD to rapidly prototype and field dual-use capabilities that solve operational challenges at speed and scale.^[8]

NATO's Defense Innovation Accelerator for the North Atlantic

This is an accelerator program providing companies access to grants to support technology development and demonstration, among other benefits. The program has a competitively selected first stage lasting six months and, for companies selected from the first stage, a second six-month stage with additional grants and support.^[9]

NATO Innovation Fund

This is a €1 billion (~\$1.094 billion) investment fund in which participating NATO countries have made capital commitments. The fund will focus on long-term investments in the innovation ecosystem of the alliance's deep tech startup communities. Note that neither the U.S. nor Canada committed capital to the fund, which means, per the limited partnership agreements, the fund cannot focus its investments on companies headquartered in either country.[10]

Defense-Specific Lending

As the defense tech market grows, industry-specific lending models have emerged, including government invoice factoring and government contract financing.

Government invoice factoring is a type of financing option that allows government contractors to sell their unpaid invoices to a third party at a discount. Essentially, the factoring company advances the company a portion of the invoice amount and then collects payment from the government agency on the company's behalf.

As a result, the factoring company takes on the risk of nonpayment and the company gets access to funds quicker.

Government contract financing is a specialized form of financing that is specifically designed for government contractors. Unlike invoice factoring, this type of financing is not based on the value of the unpaid invoices. Rather, it is based on the value of the company's current and upcoming approved government contracts.

A government contract financing company will review the company's government contracts and provide financing based on the estimated revenue generated by those contracts.

Carefully Manage Available Funds

Running out of cash is a concern for all startups, but it is particularly important for defense tech companies that are generating little or no revenue from the commercial market.

It can take a long time before a company receives substantial recurring revenue from government contracts, which can land a defense tech startup in the valley of death. Startups should therefore carefully manage available funds and consider avenues to bridge the proverbial valley.

As mentioned above, the valley of death is a term for the challenging place between research and development and government program funding. Many startups targeting the DOD fail to bridge the gap between conducting a pilot project and the procurement of their product for a program of record with a budget.

The typical startup operates on shoestring financing, and the government procurement process frequently lasts far longer than most startups' cash runways. Many across the startup ecosystem often lack the cultural understanding and historical expertise of working in government procurement environments, which tend to be more bureaucratic and slower than commercial markets.

In crossing the valley, one of the most important hurdles to overcome is time. Startups and their investors, who are used to working at lightning speed, should accept that the federal

government moves at a slower pace. If a company has an innovative product that truly will be valuable to the DOD, patiently laying the groundwork can yield a long-term payoff.

Understandably, newcomers will default to commercial sales mentalities and techniques, so they should learn how to sell to the DOD. This means they should become proficient in the authorities, policies, contract vehicles and roles involved in the DOD buying process.

Startups also need to understand some practical constraints the DOD must manage, such as avoiding being in a sole-source purchasing situation, the need to maintain certain types of data and intellectual property rights and the unique legal constraints to their contract agreements.

Proven commercial use cases will help support DOD decision making about sourcing risk. In the end, the key is matching the company's stage of development with the investor who has the right experience given this unique market.

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[1] <https://pitchbook.com/news/reports/2023-vertical-snapshot-defense-tech>.

[2] <https://www.reuters.com/technology/sequoia-makes-first-defense-tech-investment-mach-industries-2023-06-15/>.

[3] <https://www.cnbc.com/2019/09/11/anduril-valued-at-1-billion-in-round-including-andreessen-horowitz.html>.

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[7] <https://www.gao.gov/products/gao-22-105357>.

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