

On defense

Cashing in on the homeland security boom is proving difficult

by Vyvyan Tenorio

Not long after Sept. 11, homeland defense became the buzzword in venture circles. Faced with a looming war against terrorism, arms contractors began salivating over a \$37.7 billion defense budget and a sprawling new U.S. Department of Homeland Security. Early-stage startups rustled up financing for an array of security technologies, angling for a piece of the Pentagon pie.

The trouble is that no one then or now knows how large this market will be for technology providers. Congress has yet to approve the \$37.7 billion budget first proposed by the administration in January 2002.

Moreover, while VCs have shelled out money for promising new products over the past year, it still isn't clear how early-stage startups can build long-term businesses on homeland security.

"There's been a fair amount of hype," says Jeffrey Hamon, a principal at Boston investment boutique **RCW Mirus Inc.** "Everybody assumed that after Sept. 11 the government would make urgent changes in light of the terrorist threats and that the changes would happen overnight. But obviously it will take far longer than expected."

A recent analysis by RCW Mirus of venture financing for security technologies showed that overall funding levels for the U.S. security and defense industry actually declined to \$1.25 billion in 2002 from \$1.5 billion in 2001. If data, network and Internet security technologies are excluded, only an estimated \$450 million went to physical security systems such as identification and surveillance systems and biological and chemical defense technologies. But that number includes private placements for public companies, so funding

for private companies is even less.

Meanwhile, the creation of the Homeland Security Department caused a monumental upheaval as tens of thousands of employees were shifted from various agencies. "That means your relationships with procurement agents may no longer exist because that agent is no longer in charge of a certain area," Hamon says.



Levine: *no feeding frenzy*

Still, even many VCs who have traditionally eschewed companies that relied on the government as a major customer have been lured to the security sector. Many venture-backed businesses have expanded to enter the security market, according to Jeanne Metzger of the National Venture Capital Association.

For instance, Kline Hawkes & Co., a Los Angeles VC, traditionally has tried to reorient portfolio companies away from government and toward commercial clients. But today at least three companies have a significant homeland security slant.

"It's an attractive area," says Klaus Koch, a Kline Hawkes principal. "The companies with a government angle to them have actually performed better than most, despite the very difficult technology environment."

But VCs find that it's easier to get a commercially focused company to target the government than to recast one that started off catering to the government.

Kline Hawkes portfolio company **Sensor Systems Inc.**, a Sterling, Va.-based developer of advanced im-

age visualization, was launched in 1993 to develop commercial software for medical product applications. Since then its offerings have been expanded to include products to analyze satellite data transmissions, with government agencies in mind as customers. Kline Hawkes, the sole investor, recently sold Sensor to management for a four- to five-times return on its original \$3 million investment.

Going the other way can be a recipe for disaster for small companies. Mark Levine, a managing director at **Core Capital Partners** in Washington, warns that the government could be a "great customer but a pretty demanding" one. "When your initial sales comes from the government, the company's culture by nature responds to that and positions itself in such a way that it becomes difficult to transition to the commercial sector," he says.

Levine spent many years with a privately held government contracting company. "We found it was very hard to distract our staff to go after potentially more lucrative commercial contracts when the phone rings and the government customer says, 'We need to talk to you tomorrow,'" says Levine. "Everything else gets dropped."

Moreover, even if government agencies are looking for technologies offered by early-stage startups, that won't necessarily translate into contracts. "Large government agencies look to large contractors to not only bring the technology but also provide the systems and services to solve the problem," he says.

The more viable business model, he adds, is to develop technologies that **Lockheed Martin Corp.** or other large contractors are interested in.

Ultimately, as Levine says, the defense and security buildup "isn't a feeding frenzy for startups." ■