



The Family
Office Association

THE ROLE OF FAMILY OFFICE CAPITAL IN NATIONAL SECURITY

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The Role of Family Office Capital in National Security

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Context

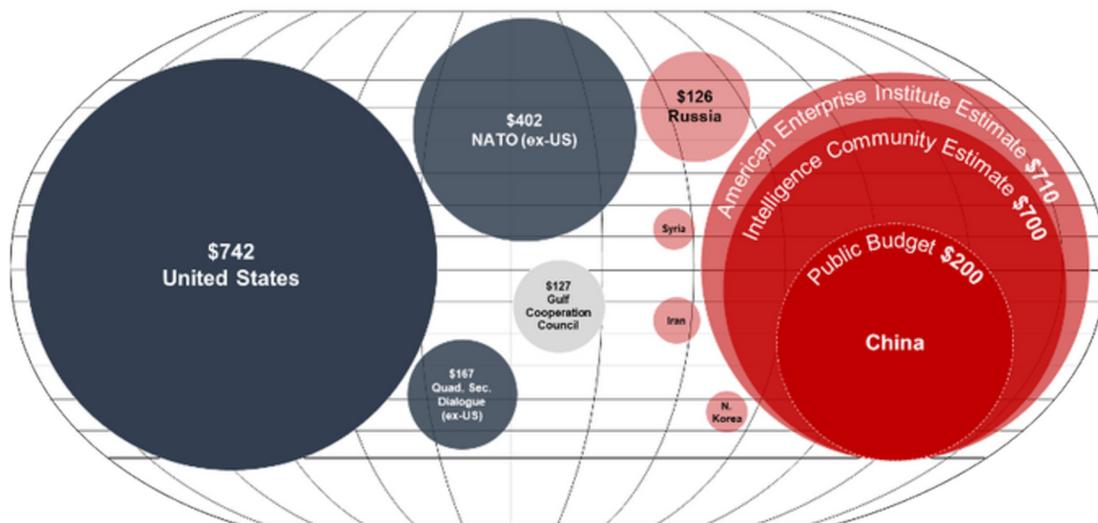
This white paper outlines the strategic importance of private capital investment in the US and Western defense and national security sectors and invites family office investors to consider the significant impact and potential returns of such investments.

"The last man lives in a world without conflict or danger, without passion or excitement, without love or hate. He lives in a world without history."
 - Francis Fukuyama, *The End of History and the Last Man*

Executive Summary

In today's rapidly evolving geopolitical landscape, the United States and her Western Allies face an imperative need to enhance the collective Defense Industrial Base (DIB). While government funding plays a crucial role, it alone cannot sustain the significant expenditures required to maintain a robust and innovative defense and national security sector, notably at this juncture of history with increasing geopolitical challenges and emerging budgetary constraints. To that end, a significant generational opportunity exists for family office private capital to bridge this gap, providing a strategic advantage to the US and Allies in strengthening the 'Arsenal of Democracy'.

Global National Defense Spending (\$ Billion)



Source: Eagen, Mackenzie. Keeping Up with the Pacing Threat: Unveiling the True Size of Beijing's Military Spending. American Enterprise Institute, April 2021.
 Note: Figures for all countries adjusted for US\$ 2022, excluding US and China.
 Note: Gulf Cooperation Council countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.
 Note: Quad. Sec. Dialogue countries include Australia, Japan, and India.

Current challenges in defense and national security funding include:

- *Capital Market Constraints:* Environmental, Social, and Governance (ESG) guidelines have limited access to critical funds. Furthermore, the consolidation of capital markets and a lack of defense sector-specific knowledge has restricted investment in related sectors.
- *Economic Volatility:* Recent economic disruptions, such as the collapse of Silicon Valley's primary lender, and rising interest rates, have led to a retrenchment in the venture capital ecosystem, negatively impacting funding availability.
- *Chinese Military Civil Fusion (MCF):* China has successfully integrated civilian innovations into military applications at a rapid pace, leveraging fewer barriers between civilian and defense sectors. This strategy has given China a competitive edge in developing advanced military capabilities.

Despite these challenges, private capital markets in the US, with \$4.5 trillion in private funds (McKinsey Global Private Markets Review 2023), hold immense potential to enhance defense and national security capabilities. Strategic deployment of these resources can address capability shortfalls, fund technological advancements, and support transformation efforts across the sector. Family offices have a key role to play here by funding projects with flexible, patient, and sophisticated capital.

Key investment areas where family office capital can have the greatest impact include:

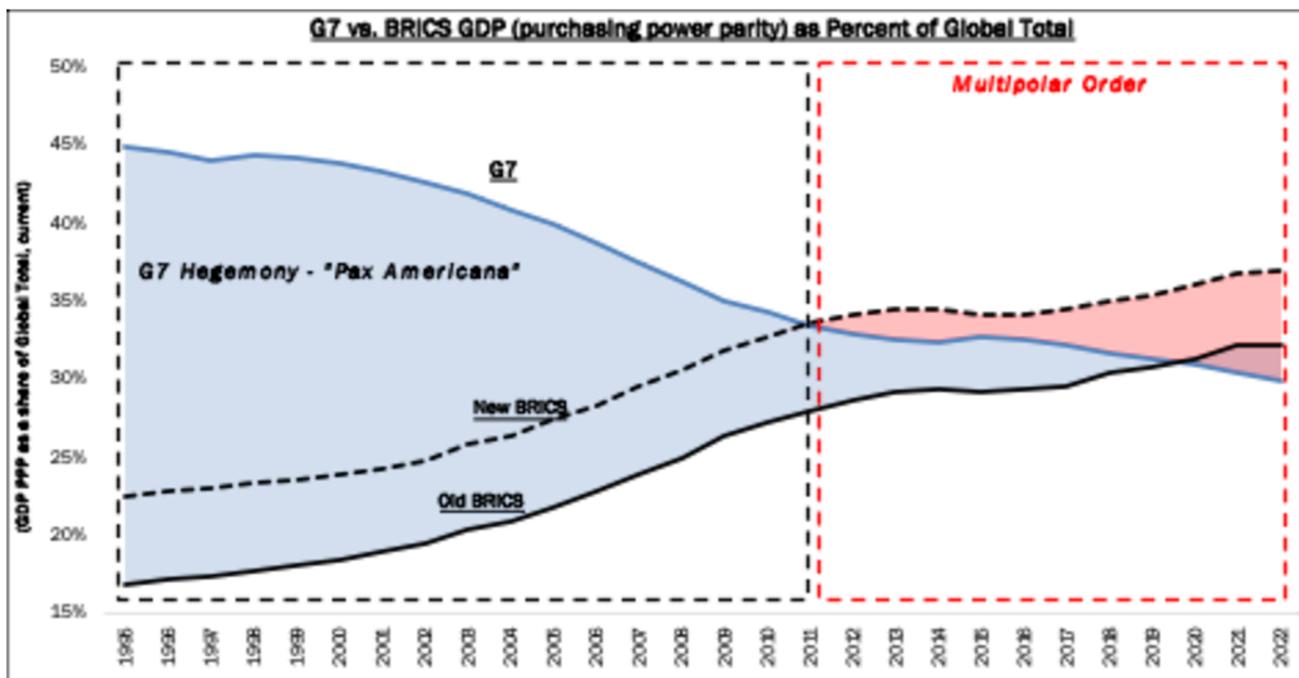
- *Technological Innovation:* Funding cutting-edge technologies that can be quickly integrated into defense applications and fielded with the warfighter.
- *Dual-Use Technologies:* Investing in commercial technologies with military applications, such as drones and satellites.
- *Early-Stage and Lower Middle Market Enterprises:* Supporting critically underfunded sectors that drive commercialization of innovation and enable fielding of new capabilities. This is particularly relevant to hardware manufacturing businesses ranging from sensors and weapons systems to energy storage and advanced materials.

The intersection of current geopolitical, capital markets, government, and investor conditions present a clear opportunity for family office capital to play a transformative role in defense and national security. By providing the necessary funding, private investors can support critical innovations, enhance the US's strategic capabilities, and achieve attractive returns.

[1] Swiss Life Global Solutions - "Risk and the Family Office: How Life Insurance Can Help" (May 18, 2022)

The Current State

The United States and Western allies, in particular the UK and Australia (AUKUS trilateral agreement), are engaged in a strategic competition on a global scale that threatens Western hegemony. The post-WW2 and Cold War peace dividends that delivered relative stability throughout the second half of the 20th century and much of the first quarter of the 21st century have been exhausted. The West has now re-entered a period of geopolitical instability where peer or near peer competitors struggle for dominance over their desired spheres of influence. The emerging global landscape, driven in large part by changing economic and demographic conditions, underscores the end of ‘Pax Americana’ unipolarity established in the wake of World War II and the shift to multipolarity global power dynamics.



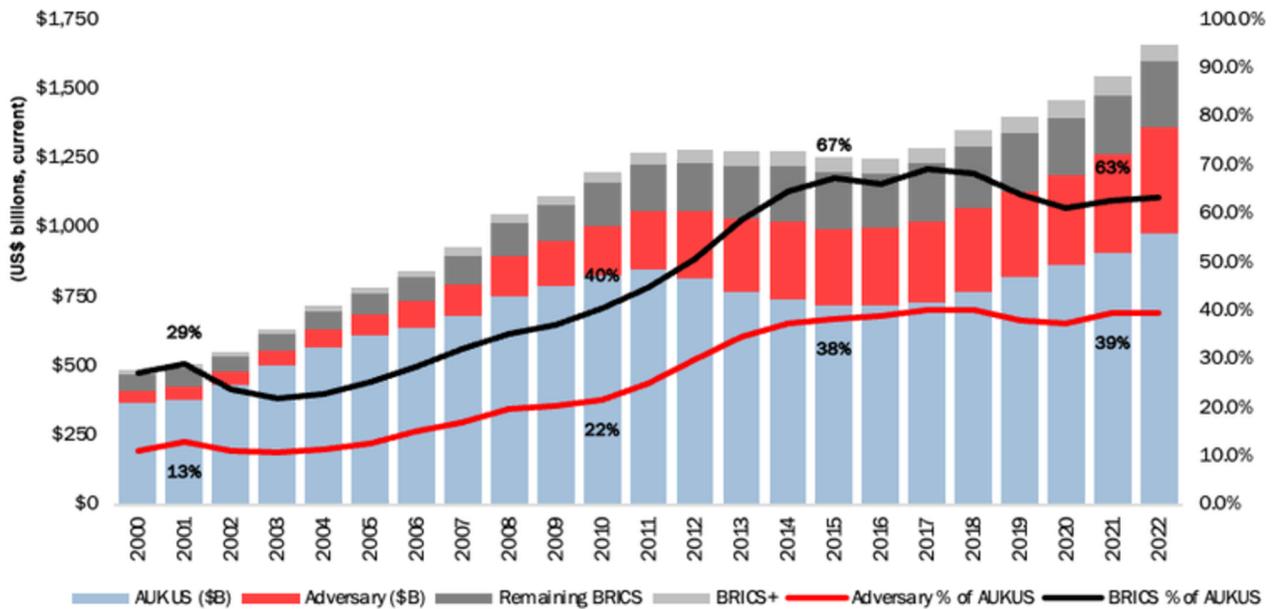
Note: G7 includes United States, United Kingdom, Canada, France, Germany, Italy, Japan

Note: Old BRICS includes Brazil, Russia, India, China, and South Africa

Note: Remaining BRICS includes Russia, China, Iran, India, Brazil, South Africa, Argentina, Saudi Arabia, Egypt, Ethiopia, and United Arab Emirates Source: The World Bank. (2023, February 8). GDP, PPP (current international \$)

While, for a variety of geopolitical, sociological, societal, and economic reasons, this is unlikely to result in a direct kinetic conflict between the main protagonists, it is of critical importance to our collective national security that we are prepared to deter and, if necessary, defend against the threats posed.

Comparative Defense Spending



Note: Adversary includes China, Russia, and Iran.
 Note: See above prior graphics for constituent definitions of AUKUS, Remaining BRICS, and BRICS+.
 Source: Stockholm International Peace Research Institute (SIPRI). "Trends in World Military Expenditure, 2022." SIPRI, 2022

Leaving aside issues of root secular causes, the Russian invasion of Ukraine, alongside the Iranian instigated and backed proxy war in Gaza that threatens to spread into Lebanon, all concurrent to the growing tensions in the South China Sea, clearly highlight the multi-theatre challenges faced by the West. The strategic purpose of these actions reaches far beyond the apparent tactical objectives. While Vladimir Putin may portray himself as a modern-day Katherine the Great, emulating the second partition of Poland (1793) and reincorporating something akin to the 9th Century Kyivan Rus territory into the Russian Federation. In reality, his “Special Military Operation” represented to him a seemingly low risk opportunity to test the resolve of the West by applying pressure to NATO and the EU.

Similarly, the Iranian backed proxy war in the Middle East, notably bringing together previously adversarial Shia (Hezbollah) and Sunni (Hamas) factions in a common cause of attacking Israel, has less to do with securing a homeland for the Palestinian people and more to do with stress testing the resolve of the Western leaning Gulf Cooperation Council (GCC), discrediting Israel in the eyes of Western allies, and derailing the strategically important Abraham Accords.

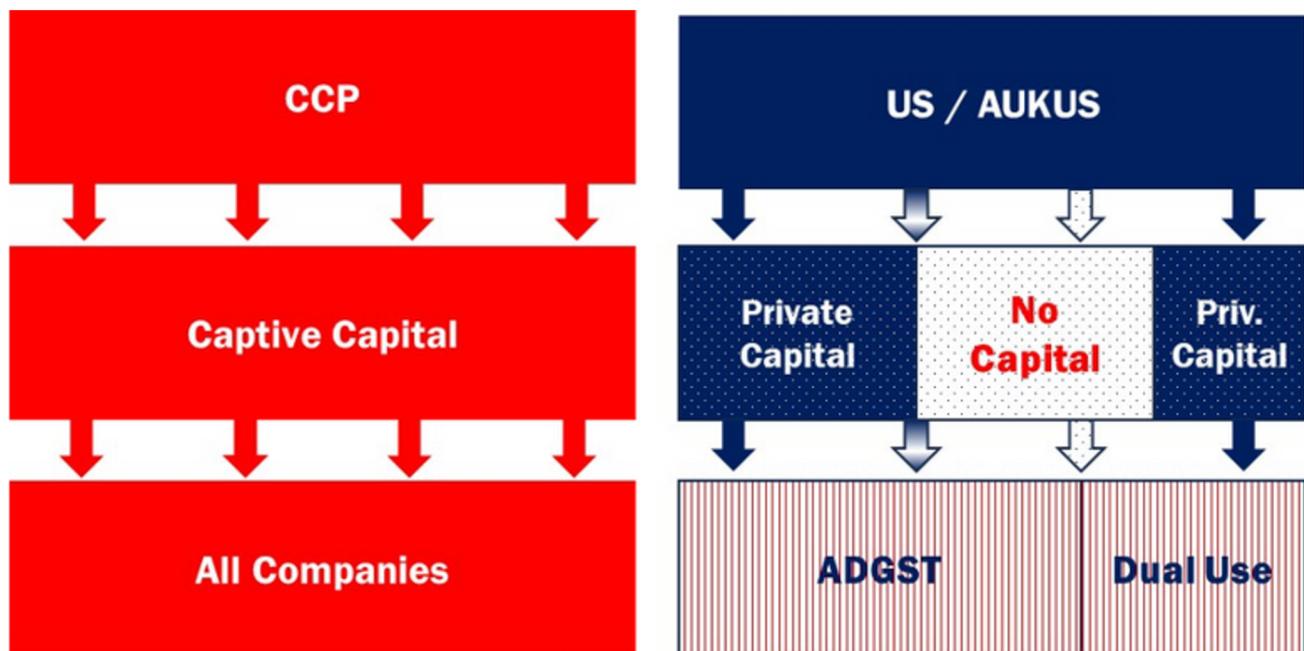
Beyond these kinetic conflicts, and arguably of greater significance, is the Chinese led low intensity probing and challenging of Western influence that can be seen across the globe. These activities range from deniable actions, such as deployment of adversarial capital

into Western innovation ecosystems, cyber-attacks and influence operations, to more overtly state sponsored acts of economic warfare and saber rattling (e.g., Spratly Islands, Papua New Guinea, Solomon Islands, etc.) in their attempts to subjugate their near abroad.

Key to countering these threats is the clear national strategic imperative to develop a robust and broad DIB across the Western allies but, in particular, domestically in the US. The current DIB has proven to be insufficient to meet the equipment, technology, and munitions needs required for a potentially protracted conflict across multiple theaters. Western government funding simply cannot sustain ever increasing expenditure needs and therefore suitable private capital resources are needed to amplify government spending, increase manufacturing capacity and foster innovation.

Military Civil Fusion (MCF)

In China, and to a lesser extent Russia and Iran, the government is scaling proven ideas into deployable systems at lower cost and with a velocity that is orders of magnitude faster than the US and other Western allies (which are bound by the conventions of traditional defense procurement). China, in particular, is actively utilizing Military Civil Fusion (MCF) programs and strategies to develop the most technologically advanced military in the world. A key part of MCF is the elimination of barriers between civilian R&D, commercial activities, capital markets, the military, and the defense industrial sectors.



China is implementing this strategy, not only through its own R&D efforts, but also by acquiring and diverting the world's cutting-edge technologies, including through nefarious means, to achieve commercial and military dominance. To further enable this strategy, China has deployed ever increasing quantities of state funds to rapidly establish and develop its industrial base more broadly. In doing so, China has aggressively secured raw materials from primary industries across the Global South and allies of convenience, such as Russia, Iran, and North Korea, creating a vast sphere of influence, controlled largely by the creation of financial dependency on the Chinese State. Chinese, or Chinese proxy, control of a large proportion of the world's natural resources, combined with a disproportionate concentration of processing capabilities in China, has created a significant advantage for Chinese manufacturers with the added benefit of creating market control and supply chain dependencies that adversely impact many Western industries, including our critical defense sector.

MCF is key to China's developing a "world class military" by mid-21st century while also deploying commercial technologies globally that provide unrivaled information and actionable intelligence on competitors and adversaries critical to advancing its regional and global ambitions¹. China is systematically reorganizing Chinese industry to ensure that new innovations simultaneously advance economic and military development, leveraging its growing GDP to expand its defense industrial sector.

Conversely, over the past thirty years US and broader AUKUS policies led to boom-bust cycles of defense spending and drastic consolidation of the largest defense contractors, which has impaired the legacy of Western military innovation.

The Counterbalance, a Critical Need for Private Investment

Key industry insiders are aware of the need for private capital to address US and AUKUS objectives and have become increasingly frustrated with the lack of progress and the persistent funding gap. "VCs are critical to this," Joseph Felter, director of the Gordian Knot Center for National Security Innovation at Stanford University urged recently, before suggesting commercial investment in US defense was "incomparable" to that of China. Thomas Tull, founder, and chairman of the US Innovative Technology Fund, has said, "We can stand around and complain, but every day we do nothing, we are losing ground on our adversaries." David Spirk, senior counselor at Palantir and former USSOCOM Chief Data Officer added, "If we can't slow them down, we can accelerate ourselves." At the AUKUS level this sentiment was echoed and emphasized by former Australian Prime Minister and incumbent Ambassador to the United States, Dr. Kevin Rudd, who in October 2023 publicly called for the Australian superannuation funds to begin investing a portion of their \$2.5 trillion to support the expansion of the defense space across the AUKUS alliance, stating to a joint US Australian defense centric audience in Washington, D.C., that "the time for seminaring (sic.) is over, the time for action is now!"

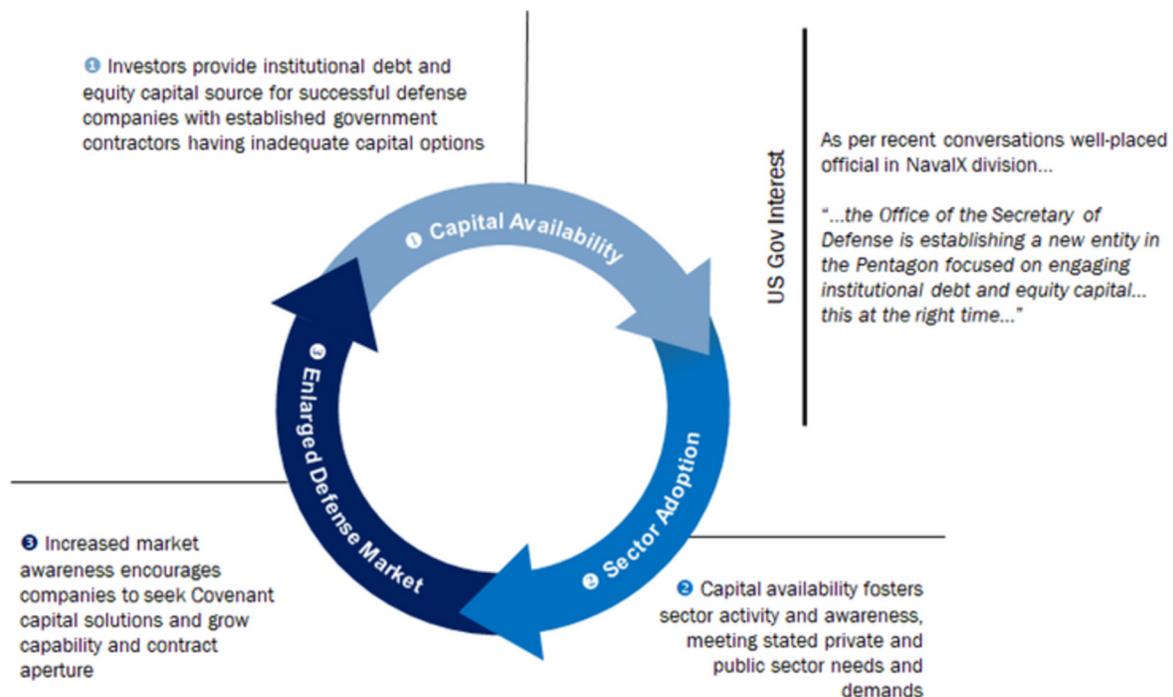
[1] Chinese Communist Party ("CCP") articulated goals during 19th National Congress of the CCP, held on October 2017

"A dollar can do more damage than a bullet."

- Major General Gary Harrell, Former Delta Force Commander

Recent initiatives, such as the formation of the Office of Strategic Capital within the Pentagon to ensure that the US maintains its technological superiority and secures its DIB against current and future threats, have helped define the capital need; however sufficient sources of capital continue to lag.

Notwithstanding the urgent and growing demand for capital, with expected asymmetric returns, private capital, in addition to credit capital, are simply not proceeding apace in providing adequate funding to the landscape. In part, this is due to idiosyncrasies in government contracting structures; confounded by expanding and restrictive investing promulgations prohibiting most institutional investors (which practically includes all investment funds, private equity, and venture capital sources) from investing in many defense asset classes. These circumstances, when taken together with the shifting global conflict matrix, the evolution of warfighting to increasingly be reliant on technology, the profound increase in the deployment of dual-use commercial technologies, and lessons learned in recent conflicts, have created a unique market window for family offices to step in and take a leading position.



While limited sources of investment and liquidity are available to large, well-established players in the target markets, early-stage and lower middle market enterprises represent a critical, severely capital starved element of the defense and national security ecosystem. Combined, these factors catalyze an opportune investing environment with an established prime contractor landscape providing viable exit opportunities. Considering the historical and prevailing geopolitical, market, government, and investor conditions, there exists a clear and present opportunity to provide deeply needed private capital with reasonably predictable attractive investor returns. Knowledgeable investors working closely with government (US / AUKUS) and understanding the needs and the landscape, can deliver flexible private capital to mitigate the identified challenges and generate attractive investor returns.

Government Response and Opportunity Landscape

The US, along with its AUKUS partners, is implementing significant changes to its defense acquisition processes to address critical needs and maintain technological superiority. These efforts aim to modernize, diversify, and build resilience into the DIB while attracting new commercial partners to the Department of Defense (DoD).

Key initiatives include:

- **Small Business Focus:** The DoD is required to award at least 23% of its contracts to small businesses, with prime contract awards to small businesses now exceeding \$80 billion annually. Other agencies involved in these efforts include the Department of Energy, Department of Homeland Security, and various other agencies/branches.
- **Innovation Programs:** The DoD has established various innovation hubs and programs, such as the Rapid Defense Experimentation Reserve, Defense Innovation Unit, AFWERX, SOFWERX, NavalX, Army Futures Command, and the Chief Digital and Artificial Intelligence Office.
- **SBIR/STTR Programs:** These programs stimulate technological innovation by directing contracts to small businesses for R&D, promoting commercialization of technology beyond core defense markets. They offer a beneficial structure allowing companies to retain commercial ownership of developed technologies.
- **New Funding Initiatives:** Recently introduced programs include:
 - **Office of Strategic Capital (OSC):** Provides financial assistance to critical defense technology companies for scaling up operations.
 - **Defense Innovation Unit (DIU):** Identifies and supports the development of commercial technologies with defense applications.
- **Established Programs:**
 - **Defense Advanced Research Projects Agency (DARPA):** Focuses on innovative technologies for national security.
 - **In-Q-Tel:** The Intelligence Community's venture capital arm, investing in innovative technologies.
 - **DoD Manufacturing Technology Program (DMTP):** Supports US defense companies in adopting new manufacturing technologies.



Source: National Defense Industrial Association (NDIA), Department of Defense (DoD), Small Business Administration (SBA)

These initiatives create various direct and comingled investment opportunities that offer attractive prospective returns for family office investors within the defense and dual-use sectors. Focus areas include:

- **Seed / Venture:** Over the past decade a robust ecosystem of defense and national security technology centric venture firms have emerged, many led by Veterans, seeking to deliver innovative capability into the hands of the warfighter on an expedited basis. These range significantly in scale and focus from the deeply technical (e.g., Razors Edge), to the highly sector specific (e.g., Veteran Ventures), and the more generic but with an interest in the sector (e.g., Crosslink).
- **Venture Debt:** A multitude of non-sector specific venture debt providers operate in this sector (e.g., SVB) alongside a variety of factoring businesses, however a gap exists in the market for the provision of government contract underwritten credit solutions aimed at providing non / less dilutive capital options to high growth, venture backed technology companies scaling to deliver against government needs.
- **Late Venture / Early Growth Equity:** A small number of DoD centric late-stage venture / early-stage growth funds operate in the market (e.g., Shield Capital) and are largely focused on emerging technologies graduating from specific DoD funded initiatives such as DIU. Opportunities also exist to invest alongside the government through equity and convertible debt placements into companies benefiting from scale up SBIR Phase III awards designed to bring capital intensive technologies into service. Beyond this there is a value-added follow-on investment need to bring capital paired with sector specific acquisition expertise in support of companies that have made initial inroads into the DoD but are yet to scale, this is the domain of a number of niche funds.
- **Credit:** At the larger end of the market credit funds alongside traditional banks are active but in the lower middle market there is a significant opportunity for contract-backed financing, with an estimated \$20B private credit market capital gap supporting recipients of \$335B in US government prime contract awards to small businesses. A number of new funds are seeking to fill this void.

Despite these efforts, there remains an insufficient amount of private capital addressing strategic national security initiatives. The defense ecosystem represents a significant opportunity for family offices to fund high-growth investments in companies that have secured early government contracts and are looking to scale.

Nick Fisher is a Principal with Anzu Partners and a Fellow with the Australian Strategic Policy Institute. Over the past 25 years Nick has gained significant experience across the defense, national security and government contracting sectors of the US, UK, Australia and other allied nations. During this period, he has seen service as a Commissioned Officer in the Royal Navy, has acted as an advisor to government departments on the matter of private capital participation in the national security related innovation ecosystem and has undertaken corporate roles globally ranging from government sector business development to venture capital and lower middle market investment banking focused on the aerospace, defense and the government sector.

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*Chairman & Founder
The Family Office Association*

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