

BUSINESS 2.0

The Business of Fear

In this era of color-coded terror alerts, everyone from big-name VCs to tiny tech startups is scrambling to get a piece of the homeland security action. Is this the next big trend in technology, or just the start of another bubble?

By Jack Hitt, June 2003 Issue

Steve Longoria's resume isn't what you'd expect from a man whose title is CEO. He was a master sergeant in the U.S. Air Force. He was trained by the Israeli Defense Force. He calls himself a certified counterterrorism planner. "My training," he explains, "was a unique convergence of antiterrorism, which develops protective strategies, and 'after-terrorism,' which tries to control and minimize a situation."

Today, however, Longoria is running a company called Aanko Technologies. Its main product is an anthrax detector "designed for public areas such as convention centers, shopping malls, and airports." But it's only a matter of time, he says, before a high-quality anthrax detector is ready to be mounted in your stairwell, right next to your fire alarm, your carbon monoxide sensor, and your radon detector. "Eventually," Longoria says, "every residential homeowner could have one."

Like a lot of entrepreneurs in the homeland security sector, Longoria believes that the new market for safety will begin with commercial clients and grow as it reaches out to individual consumers. Longoria calls what he does "turning risk into revenue," and it's as good a description as any of the market that's emerging right now.

In the aftermath of 9/11 and with each subsequent threat -- from anthrax to dirty bombs to fear of reprisals from the war with Iraq -- firms large and small have responded in an effort to capitalize on the nation's growing sense of insecurity. New venture capital funds are underwriting companies whose technologies now come wrapped in antiterror sales pitches. Trade councils and lobbyists devoted to this new market are appearing. And in the consumer market, sales are increasing on items ranging from "nuke pills" to al Qaeda-proof bomb shelters actually called Apocalypse Houses (see "Be Afraid. Be Very, Profligately Afraid"). The store is open. Call it the business of fear. Ka-ching.

Among the first to jump into the fear business was Mark Thaller, a former naval officer and general partner at Zero Stage Capital, who in July 2001 launched Patriot Venture Partners, a VC fund devoted to the security sector. His decision to start the fund seems prescient, coming two months before 9/11, but Thaller would have you define the market in a somewhat different way than we did. "I have been very careful to avoid using the word 'fear,'" Thaller says. "Fear and paranoia might be the potential causes of action, but the real underlying need is to be a little more at ease. The truth is, the threats now are much less than they were two years ago, yet the demand is greater." Thaller has his own working formula for the new market: "The way I define it is this: Whatever it takes to make a corporation or an individual spend an extra nickel for better well-being."

In the short time since 9/11, the dimensions of this market of "better well-being" have taken shape. According to Thomson Venture Economics, there are at least 50 VC funds now active in the sector -- not just new arrivals like Patriot, which is still in the fund-raising stage and has yet to announce any investments, but also established heavyweights like New Enterprise Associates and Kleiner Perkins Caufield & Byers. A trade association -- the Homeland Security Leadership Alliance (HSLA) -- was formed this January. And there are plenty of market analysts trying to locate the new opportunities. "Thinking Outside the (Mail) Box ... The Mail -- A Terrorist's Disruptive Favorite," reads the headline on one newsletter addressing the potential of the "antiterrorism industry." According to HSLA executive director Sean Spence, the size of the market is already about \$100 billion a year.

"It's not just the federal spending -- President Bush's homeland security bill authorized \$36 billion in spending," Spence explains, "but you have to realize that there are also state expenditures and local governments. There is also private enterprise and the individual consumer market." Spence's figures are confirmed by another, independent source, market research firm Provizio, which says total homeland security expenditures this year will range from \$98 billion to \$114 billion.

Some venture capitalists see an even bigger opportunity looming. "When most people use the phrase 'homeland security,' they have what I call a 'fences-and-locked-door' sense," says Lt. Gen. Ken Minihan, a former director of the National Security Agency and a principal of the new Paladin Capital Group Homeland Security Fund. "You need to have a wider aperture."

Paladin, whose founding team also includes former CIA director James Woolsey, had a first closing in December on a reported \$300 million fund

and will have a final closing next December. A look at the companies already in the fund's portfolio suggests that information security and biochemical protection are two main areas of focus: ClearCube is a small software company that specializes in "blade computing" technology, a system that puts the data and processing guts of desktop computers into rack-mounted PCs locked safely inside a central server room. Another firm, Agion, has developed antimicrobial substances that are used to line refrigerators and other common appliances.

All of the companies Paladin is underwriting existed before 9/11. ClearCube's blade technology used to be sold purely on claims of efficiency and cost savings. Now it's also being positioned as IT security. With Agion, the principle is similar. Its product already touches on some aspect of biochemical protection. The company's hope is that the technology will now be expandable into a world concerned with anthrax and other biological weapons. In brief, Paladin is not looking to underwrite new ideas. But Minihan bristles at the suggestion that it's simply using the new fear to reposition old products. "I will not cede the point," Minihan says. "New ideas have emerged in exotic new startups, but most of the firms we are interested in should have been around for some time. The fund is primarily looking for equity growth investments."

Be that as it may, it seems clear that many early-stage technology companies are repositioning themselves to take advantage of the sector's momentum. BroadWare Technologies, for instance, has jumped all over the homeland security market. Founded in 1996, the company developed software and hardware to take thousands of distinct digital video feeds and distribute and manage them for offsite viewing. Before 9/11, BroadWare was broadcasting video for Sun Microsystems (SUNW) and selling its services to day-care centers so working parents could monitor their kids. It had also developed one-off video networks for NASA and the Argonne National Laboratory so scientists could share video images.

The company's growth plans called for releasing its technology as a stand-alone server that could be packaged with the offerings of large systems integrators, companies like EDS (EDS) and Northrop Grumman (NOC) that bid on huge corporate and government contracts. But BroadWare didn't have the money to develop its server, let alone to deploy a sales team that could convince tech integrators that there was a need for what it had to offer. Then came 9/11. "You had an instantaneous change in priorities," says BroadWare CEO William Stuntz. "Budgets were being shifted to take advantage of technologies that could be applied to homeland security. Now, all of a sudden, the government is asking for video systems to be a part of what the big integrators offer."

UNCLE SAM WANTS TECH Matrics's RFID chip (on fingertip) intrigues the Pentagon. BroadWare went looking for a new round of funding, and in December it landed \$7.5 million -- a respectable chunk of change in the postbubble VC world. Recent funding stories from other startups are similar. Maryland-based Matrics has developed tiny, powerful radio-frequency identification tags. Touted as the next-generation replacement for bar codes, RFIDs are most visible today in the windshield-mounted toll passes that allow drivers to cruise through booths without stopping.



Matrics's RFID chips are much smaller (the size of a grain of table salt) and cheaper to manufacture than those used at the tollbooth. Most of the early interest came from retailers considering the tags for use in theft deterrence and inventory control. Now, however, Matrics chips are getting looks from airline security companies wanting to track luggage and passengers, and from the feds for use in ID cards for border control. The military wants RFID tags with global positioning capabilities to track its equipment and people. Since its founding in late 1997, Matrics has banked \$17 million in venture capital, the bulk of it -- \$15 million -- raised just one month after 9/11.

Still, many in the VC community argue that all this repositioning is not mere opportunism but rather a natural shift moving in lockstep with national priorities, both governmental and personal. "I saw a deal the other day for cars equipped with global positioning systems and cell phones," Patriot's Thaller says. "And just look at the cell-phone industry in general. Why is it exploding? It's not because we feel like talking, but because we want immediate access to Mom, Dad, and the kids -- that sense of well-being is worth the extra nickel. It's not about personal add-ons but about a personal inner desire for connectivity. Not paranoia, not keeping the thieves at bay. It's just the way Americans are. We dig a little deeper."

One place these Americans are sure to be digging is into the pockets of Uncle Sam. Given the new Department of Homeland Security's \$36 billion budget, everyone from kindergartners like Agion and BroadWare to the granddaddy of all tech companies is angling for a piece of the action. "Microsoft (MSFT) recently announced a new position, a director for homeland security," Spence says. "Look at the Fortune 500 companies. HP (HPQ), 3M (MMM), Honeywell (HON), Boeing (BA), EDS -- they all have one now."

Some of this, of course, is a matter of survival: With corporate IT budgets in the doldrums, many firms are shifting strategies to capitalize on the fact that

the government is one of the few outfits spending any money. But as important as this source of revenue is to the tech industry, just as important is the shifting role of the government in the public-private partnership. No longer do the feds seem content to sit back and wait for the technology to come to them. Increasingly, the government is looking to fill the role of VC, pumping money into startups with an eye toward developing security technologies.

In-Q-Tel, for instance, is a venture capital fund started by the CIA (according to legend, the Q refers to the gadgeteer in the old James Bond movies). The CEO of the fund, Gilman Louie, is also the guy who introduced Tetris to the United States. Launched in 1999 as a five-year experiment in helping the CIA identify startups with products that might be useful to spooks in the field, In-Q-Tel has primarily backed companies in the knowledge management sector, such as Palo Alto's Tacit Knowledge Systems, which produces software that helps people solve specific problems by scouting company databases to find other people working on the same problem.

Not surprisingly, few people expect In-Q-Tel to fold its tent when its initial funding runs out next year. Quite the opposite. "In fact, other agencies are looking at In-Q-Tel as a model," says Gayle von Eckartsberg, vice president for strategy at the fund. The 2003 budget for the U.S. Army, for instance, included a venture capital line of \$25 million to explore private investment in new technologies to provide energy support for the field soldier. According to Spence, there's talk that the FBI and the NSA may also be planning to underwrite VC funds dedicated to security startups.

So, with all this pork being brought to the table, the question is, Are we looking at another dotcom-style frenzy or a market that's here to stay? Though he admits it smells suspiciously like the former, the industry's official mouthpiece says he wouldn't bet against the latter. "We're at a point where it's obvious there's an evolution in the market," Spence says. "Yes, there's a bandwagon, and a lot of people will fall off -- but it will keep rolling. Just like the Net didn't go away after the dotcom crash, this market is here to stay. There will be a bubble, and it will contract at some point. But for now, everybody is getting in." ♦

Additional reporting by Michael V. Copeland.