The next generation of defense primes with Matt Steckman and Trae Stephens

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[00:00:28] **Eric Lofgren:** I'm pleased to be speaking with Matt Stackman, chief Revenue Officer at Anduril Industries, and Trae Stephens, co-founder and executive chairman of Anduril Industries. Trae is also a partner at Founders Fund. Guys, thanks for joining me on Acquisition Talk. Thanks, Eric. Good to be here. So I wanna start out here with some Anduril news, cuz you guys have been making some big acquisitions including Dive and Area i, so this is making, and Earl a much more hardware rich company. Can you guys just talk about what you've learned in that

[00:00:58] **Matt Steckman:** process? Yeah, I'll take the first crack at that and then Trey would obviously love to hear your thoughts as well. So just as a quick reminder to the audience the super fast version of Anduril is we build advanced command and control software as well as autonomous systems software for both full autonomy operations as well as, manned-unmanned teaming operations.

[00:01:20] We take that software and, put it into our own hardware in some cases, as well as uh, third party hardware through a set of open interfaces and sort of basic standards that exist out there for doing this stuff. So that's us in a nutshell. We're about 1300 people now, spanning both us and allied, nations and doing, starting to do some pretty cool stuff.

[00:01:42] So in terms of the hardware acquisitions, it really goes to the broader philosophy of the company. Make exceptionally compelling modern software platforms and find the absolute best hardware to create vertical stacks of, either again, autonomously deployed or manned, unmanned team deployed systems.

[00:02:03] And so, when we find a company that has a unique play in the hardware space, but also in the software space for that matter, we get real excited about it. And we think about if our teams come together, what else are we gonna be able to do? Our software, their hardware, their software, our hardware doesn't really matter to us as long as, we ultimately can create a pretty compelling set of capability.

[00:02:28] Anything else to add, Trey?

[00:02:29] **Trae Stephens:** Yeah, I would say we have long had a strategy that at some point in our company's history, it will make a lot of sense for us to pursue some interesting acquisitions. There, there are hundreds of really interesting technologies that have been created by, everything from like mom and pop shops to small private equity backed businesses, bootstrap technology companies started by academics, things like that.

[00:02:55] And a lot of those companies are building cool things, but they don't really have the understanding of how the system works to be able to ramp an effective sales engine. And so we have the opportunity to step in and partner with these organizations through the acquisition process to not only add fire power to their ability to sell into the government customer, but also do that in a way that allows them to continue building their own tech, their own company in the way that they would've wanted to with a capital infusion that comes from Anduril.

[00:03:27] So we've done this three times. You named Dive and Area I, we also acquired a company called Copious Imaging that builds passive radar systems. And uh, we're constantly kind of on the prowl for other companies that fit into that model that Matt just described.

[00:03:39] **Eric Lofgren:** what do you guys, I guess, bring, you said that you have some of the expertise of the go to market with government. What do you guys bring in that space and how is it different in the US versus Australia there? Because you guys have won a pretty major program under unmanned submarine program for Australia.

[00:03:55] So what's that? What does that look like in the US and then how is it different in Australia? Yeah.

[00:04:01] **Matt Steckman:** So just to catch the audience up we won a program with the Royal Australian Navy to build extra large autonomous underwater vehicles. So think sort of school bus size and larger, underwater submarines.

[00:04:14] It's a very ambitious program. We are attempting to get three builds out in three years and then scale from there. The Royal Navy has been an exceptional partner. Maybe the more interesting observation is not US versus Australia. I think that's probably a false comparison.

[00:04:32] I think there are pockets of greatness everywhere you go within the national security community. I think it's what makes a good partner is actually fundamentally what's at hand here. And we have great partners in the US as well. I think we'll probably get into this later, but our partnership with US SOCOM on their counter uua s work, is exceptional.

[00:04:51] And I think all of these great partnerships, the Australian partnership included, are defined by a lot of characteristics that shouldn't be all that surprising. A willingness to move fast, a willingness to experiment together, a willingness to work as partners when new technology inevitably hits some roadblocks or some hiccups.

[00:05:10] I think if you treat it as a learning experience as opposed to something that can end up more punitive or one-sided in a lot of relationships, you actually end up accelerating coming out of those learning experiences as opposed to decelerating. And then sort of concentration of focus and concentration of budget, which is also a big thing in, in terms of getting technology to scale quickly.

[00:05:31] So we're experiencing all of that in spades with the Australian government. We also experience it with the US and other countries. I think the more that we can have programs across the board, have sort of these good partnership principles connected to them, the better we're all gonna do. And I wouldn't necessarily think, again, it's like it's not really one country versus another.

[00:05:50] It's where do you find partners and champions that want to get things done?

[00:05:54] **Eric Lofgren:** Still Australia did take a pretty big leap with you guys. It almost feels like that's a pretty large program. Is there something comparable going on in, in SOCOM that is kind of like a major program of record that you guys are doing?

[00:06:06] **Matt Steckman:** Sure, yeah. So the SOCOM Systems Integration Partnership program that we're working on is certainly comparable.

[00:06:13] It's it's working against what is one of the most challenging problems facing, special forces, but also ultimately conventional forces as well, which is the counter drone threat. We're seeing this play out, in a pretty serious way in, in Ukraine. You don't have to be an expert to realize what's going on right now in terms of drone warfare between Russia and Ukrainians.

[00:06:32] So this is a tier one problem. This is top of mind to everyone in the us and that program is treated with, the same amount of focus, dedication, partnership, which includes experimentation, which includes both new technologies, but also scaling, traditional technologies that work.

[00:06:49] And being SOCOMs partnering in this, is obviously a privilege that we don't take lightly. And we put a lot of our own fire power and capital against this to make sure it works as well.

[00:06:58] **Eric Lofgren:** So we recently had um, the undersecretary for acquisition sustainment Bill Plant at one of our conferences, the George Mason d a u conference.

[00:07:07] And he said something to the effect that I got a little bit of Twitter play, right? It was, I don't really care if it has AI or quantum, what matters if it's fielded at scale. And he also said the tech bros aren't helping in Ukraine. What's just your reaction to those lines? What's

[00:07:22] **Matt Steckman:** Twitter again? Eric

[00:07:23] **Eric Lofgren:** It's something Elon Musk took over pretty recently.

[00:07:27] **Matt Steckman:** Trae, you wanna take the first swing at

[00:07:27] **Trae Stephens:** that one? Yeah. In many ways he is not wrong. There's a kind of a premium that needs to be put on scaling, manufacturing, delivering things into the field rapidly. And a lot of the stuff that we sent over to Ukraine early in the conflict were things that we already had in inventory, obviously.

[00:07:45] And so part of that is like kind of a self-critique in a way that maybe he wasn't expecting, which is they haven't been buying things from new entrants to the market. So there was nothing in inventory. So obviously when it came time to start shipping things to. There was nothing from tech companies to send, which is a critique of their, the approach that they've taken for many years.

[00:08:07] On the other hand, I think that there are a lot of critiques that you can make of the tech community and their interest in and ability to engage with the do d on things that matter deeply to the dod. If you look at the kind of dual use strategy that we've taken for many years what we've essentially done is we've said, look, if you have a commercial market for a technology, you've sold a bunch of that stuff.

[00:08:30] You are a mature business. It has the ability to build like a federal business unit to then turn those commoditized technology products over into a federal sales pitch. Then we are a willing buyer and that's how we buy, Microsoft Office applications. That's how we buy cloud compute capacity.

[00:08:47] That's how we buy. , Dell computer monitors and PCs. But it's hard. It's much harder, I would say, for a startup a seed stage series, a series B company to have a thriving private sector market, commercial market for their tech as well as a thriving federal market. And so you end up having these, very defense specific problem sets and only legacy players that are interested in working on them.

[00:09:12] Because if you're a startup, it's much easier to sell into the private sector than it is public sector. And so you tend to just lean more in that direction. That said we have had tech Anduril tech that has been deployed in Ukraine since the very beginning of the conflict. And is it at a scale that would rise to the Bill LA plant level?

[00:09:31] Probably not. We're not like orchestrating multi-billion dollar arms deals as part of, aid packages or anything like that. But as I said, I think that critique goes in both directions. Yeah, I

[00:09:43] **Matt Steckman:** couldn't agree more. And just sort of one add or one spin on it is you of go into a conflict with what you have, right?

[00:09:49] There's never been a conflict where you're like, oh, I'm gonna take this new thing with me that I've never trained on or I don't understand the characteristics of and, that's what I'm gonna use. That's just not a thing. And so I think the challenge in front of us is how do you take these new technologies and weave them into the fabric of what we do, such that you almost assume it away.

[00:10:10] It's just a background piece of technology that exists. Everybody knows it exists, and that's what you take with you. And so take AI as an example. If we had. Production level at scale, take drone ISR available. You sh you better bet we would send that over to the Ukrainians, right? If it existed. Now it was trained on, it was understood, but it's not yet it's not trained on is not understood.

[00:10:34] It's not at scale. And the thing we need to do very quickly the next year, two, five years, is get these things at scale where we're not talking about ai, we're talking about automated ISR as a capability. And no one even talks about the underlying technologies that power it.

[00:10:49] And can

[00:10:50] **Eric Lofgren:** you guys go just a little bit deeper, like what exactly did you send over to Ukraine and any thoughts on how it's performing or what the reaction from the field is?

[00:10:59] **Matt Steckman:** Yeah, so we've publicly released that our Ghost Group two VTOL, ISR drone has been deployed. So far it's performing well.

[00:11:08] We're learning a lot just like everybody else is. Everything else is hard to talk about at this point, as you could well imagine. But we are engaged with partner government and directly with the Ukrainians to figure out what more can we do to help them.

[00:11:20] **Trae Stephens:** I think that one, one thing that I would say is more based on the rhetoric piece of the under secretary's comment is, this referencing tech bros.

[00:11:29] The closer I find myself engaging with senior D O D officials. It seems like what they're really trying to signal is that people that have found success in the tech industry by implementing new technologies in new sectors are like in some way reprehensible. It's like we don't like seeing commercial success because it says something about our industry, it says something about our sector.

[00:11:53] It says something about the creation of wealth. And what they're really saying is that we like working with the traditional defense industry because we have total control over their economics. , like we we give them tiny margins. They're basically just like an index fund for the defense budget.

[00:12:11] It's they just track directly with the increase in the defense budget. We can pair them off against each other to allow each of them to grow in a very predictable way. And in many ways they're just subsidiaries of the United States government, like most of these big legacy primes are basically government agencies.

[00:12:27] And so I think when they say things like, the tech bros aren't helping in Ukraine, what they're really saying is the defense industry is the defense industry. And people that sit outside of that, that might be new entrants, that could in theory be able to help us. We don't trust them and we don't like them because they are unpredictable and because they are potentially unreliable.

[00:12:48] And because we don't like the idea that people could break into this and make money while saving money for the taxpayer. It's like it's destabilizing in some way. And I think that they really don't like that. And that this comes out in all of these different ways. It comes out in like calling the tech community tech bros.

[00:13:04] It comes out in critiques of the venture capital industry. It comes out in like critiques of patriotism of tech companies. But really it's like a tremendous distrust in the allowing the capitalist system to work in the way that it should with an industry that desperately needs capitalism.

[00:13:20] **Eric Lofgren:** Yeah. I wanna double tap on that and do a deep dive into what you're talking about here, Trey, because. , you know, of course after World War I, we had the profiteers, right? And never again will we pay, large margins or have big profits in defense was the feeling that kind of pervaded through after World War II as well.

[00:13:38] And, it seems that, one of the things here is what you've said in the past, right? You've mentioned that d o d officials have a moral aversion to paying software margins to companies. But I wanted to just step, take a step back here and get you to explain why should software companies tend to receive higher margins in the commercial marketplace in the first place relative to a Lockheed Martin that year, in year out's gonna make 10, 12, maybe 15%. I looked at this over time.

[00:14:07] I, I tried to compare all these different industries in their financial state. Just like the defense industry was remarkable in terms of its consistency year over year and the lack of volatility in the profits that it is receiving. But when you look at healthcare, retail, other types of sectors, lots of winners, losers, lots of volatility, high margins, low margins.

[00:14:30] so back it, back up. Why should software companies, or why do they, when we look at the commercial market, why do they tend to get higher margins?

[00:14:38] **Trae Stephens:** Yeah, I mean, there's, a bunch of variables and we could go into each of them in great detail if you wanted, but at its core the cost of delivering software and scaling it into multiple customers is very low.

[00:14:49] If you're Microsoft and you build Microsoft, , you can sell Microsoft Office and people can just download it, install it on their computer, and then they get into a cycle of, in the case of Office 365, they're paying you on an

annual basis for the usage of the, of that software. And so the marginal cost of deployment is really low.

[00:15:09] Now, the upfront cost of developing that is potentially very high. The, there's a lot of r and d that goes into building a piece of software. And so if you as a software company have spent tens or hundreds of millions of dollars building something, when you go to sell it, you're trying to look for being compensated for the value that you're providing.

[00:15:28] So let's say that I'm a software company. I'm gonna sell a piece of software for a million dollars a year. I can't sell that software for a million dollars a year. The value that I'm providing to the business is not a million dollars a year, but let's say that I'm providing $10 million of value to the company that I'm selling my software to.

[00:15:45] And I'm just asking for 10% of the upside that they're generating, whether that's like reduction of risk for their business or indi additional productivity efficiencies that I might be adding to the business. The company, the buyer of that software will have no problem paying that 1 million to get 10 million of ROI on, on that sale.

[00:16:05] But for me, deploying that software and selling it to the customer, my marginal cost of deployment is like basically zero. It's like the cost of hosting for the data that they're then downloading to do the installation. Maybe like marginal, some amount of services and support that I would need to charge.

[00:16:21] But if I'm doing a good job, like my margins are gonna be north of 80%, for every time that I sell that to a new customer. Now the trick here is that if you are looking at this in a really perverse kind of way, you say, wow, if it doesn't cost you very much to sell this, then I should be paying.

[00:16:40] Like a tiny margin on top of what it costs. So if it costs you a thousand dollars for you to serve Microsoft Office 365, certainly I should pay close to a thousand dollars, right? No you shouldn't because you're generating 10 bill $10 million a year of value, and someone needs to be able to monetize the value that they're adding to that system.

[00:16:58] And so this is where things get really messed up in the DOD context, is that if you're paying for all the research and development costs as the government, sure you should be able to realize a really low margin on that. But if someone else is owning the risk in someone else is owning the cost of

building that software they should be able to get a portion of the upside for the value that's being.

[00:17:20] And that's not the way that our defense acquisition system works. We don't reward people for taking risk. We don't reward people for reinvesting their money into research and development. The primes are all in the like low single digit percentage of irad, whereas tech companies tend to be in the like mid double digit percentages for Irad.

[00:17:41] They're spending hundreds of millions or billions of dollars a year on reinvesting their profits into building new products. And that's something that's like inherent in tech that's very different in the way that the defense community works. Yeah.

[00:17:53] **Matt Steckman:** I'm I'm gonna pile on here. Eric, as this is a topic near and dear.

[00:17:56] We've spoken about this a lot in the past. But I'll add a couple of more juicy bits here. So we need to get to the point where profit is not considered predatory. Um, I think your example, you used to lead off this segment world War I, world War II being taken advantage of. There are many examples of profit equal equally predatory tactics.

[00:18:17] It doesn't actually work that way anymore in pretty much every other sector in the world, because if you're not taking the profits and reinvesting them smartly back into your business, someone's gonna come in and eat you. It only doesn't exist in the defense sector because there's no competition for someone to come and gobble up your work.

[00:18:35] And you can go on with a 10, 12, 15%, profit margin and you can just keep, keep winning those contracts keep growing slowly. but suddenly if a new type of company comes along, that because they're investing their own capital to great degree into creating capability. And are commanding higher margins because of it and can work with the government to figure out a structure to get paid back for that nra, which is also very complicated and something we can dig into.

[00:19:03] Suddenly you can take a healthier operating margin or profit margin and you can reinvest that back into the innovations that the defense department needs in the first place. It just so happens to be that it's not directly controlled by the Department of Defense. The company gets to, I'll say choose where to make those r and d investments, but it's not really a choice.

[00:19:25] We and or are we, the rest of the tech community are exceptionally thoughtful around where we actually put these dollars based on what our customers are telling us about the challenges that they are facing now and the challenges they're facing 10 and 20 years from now. And then because of our unique position within the tech community, we're able to offer unique solutions because we can control and we can direct.

[00:19:47] I think if you're in a world where it's all. Directed by a single payer, there's a lot of risk that you run. And you're seeing that risk bear out now.

[00:19:55] **Eric Lofgren:** Yeah, there was definitely a lot to react to there. It reminds me in the 1950s, the aerospace industry actually put 19% of their total revenue back into self-funded research and development. And one of the things that the department was looking at was how do we get rid of all this competition and lost leaders?

[00:20:14] We don't want industry to take all these lost leaders and then make their profits in production. We'll just pay them, you know, a consistent profit rate and choose the one single thing that actually works. So we got this requirements process and so the department kind of defines what they want and then they basically pay contractors for butts and seats to build that thing.

[00:20:32] So you guys are taking a little bit of a different approach where you're building it yourself, but you're also saying that it's based on interactions with the customer requirements in the first place, right? But you're not like taking their own specification, just building to that. And because of that risk and because of that self-funded effort you need a margin structure which reimburses you for that return on investment.

[00:20:55] So it's a little bit of a different thing here but for the, again, getting back to value, I want to get your view on this because you said we want to get reimbursed for the value of what we're bringing to the department. A company might be willing to pay that kind of margin because they can see the revenue coming in and there, there's like a profit loss signal, whereas the government won their tax, they have taxpayer funded money, but two, it's amorphous, right?

[00:21:19] It's like they don't have a profit and loss signal necessarily, maybe unless they're in a war itself. How do you think about, demonstrating and proving to the government, Hey, we have this price because we're generating this value for you. . What does that conversation look like? There are all

[00:21:35] **Trae Stephens:** sorts of measurements of. Productivity. There are all sorts of measurements of the cost of development, the cost of maintenance and sustainability and things like that. Like one of the, one of the things with autonomous systems is that oftentimes when they do cost comparisons between competing approaches to a problem that has, like humans in the loop, a lot of humans in the loop or something that's more autonomous is they'll look at the cost of development and they'll look at the cost of maintenance on that hardware, but they don't account for the difference in the number of humans that are required for labor behind a less autonomous system.

[00:22:12] So if you're gonna spend a hundred million in labor to do something and if you have an autonomous solution, 10 million a year all in they, they wouldn't be able to do like a side-by-side cost analysis of those two things. And so I think, the goal of any.

[00:22:26] Like smart new entrant that's trying to leverage cutting edge technology with the defense department is how can we reduce the need for the, 800 plus billion defense budget so that we can have better capabilities. We have better support for the war fighter, that meeting the needs and the requirements that they're being articulated and doing that at way less cost.

[00:22:49] And I think that we have a tendency to get into this. Like we can either do more with more, or we can do less with less mentality when literally the definition of technology is doing more with less. We should have better capabilities at lower costs. And yet we're not talking about that.

[00:23:04] We're just talking about like this, perverse more with more or less, with less thing. And it just doesn't make any sense. It's not the way that anyone evaluates the value of new technology.

[00:23:14] **Matt Steckman:** I don't think there's any silver bullet here, but the closest you come is competition. So if you are looking a, b, C across a series of competitors and you've set up your competition correctly, you've done outcome-based requirements, you've done actual field testing of prototypes in order to demand or push upon risk to the vendor community, your competition has been run in a fast way, you will ultimately get to an ab comparison of value.

[00:23:43] And you'll look at how these companies are performing and what their prices are. And now the thing that we need to allow for, and the thing that I still believe and, maybe I'm increasingly less of a believer, but let's just go with it for now, is. , we need to get to the point where you can win a competition.

[00:23:58] Let's say it's a hundred million dollars. You can win a competition charging a hundred million dollars at a 50% margin, versus a competitor that's charging $500 million at a 10% margin. That feels like the current paradigm, which I think gets to some of Trey's, really expressed frustration in his comments because it just appears that competitions seem to work out this way.

[00:24:21] But if you structure the competitions correctly, and it's actually an ab you can get to a value comparison. truly believe that.

[00:24:28] **Eric Lofgren:** On the value comparison, does IP play a role? It seems like sometimes, a defense contractor might say, I will give you G P R on this government purpose rights, where your company might want to keep some of those rights for one reason or another.

[00:24:42] Do you feel that's a big play in the competition space?

[00:24:45] **Matt Steckman:** I'm not sure. I think I'm increasingly of the belief that it's sort of a red herring in all of this. And what it actually is does the deal make sense? If a company is coming to a competition having invested hundreds of millions of dollars in the background intellectual property, and the contract is for $2 million, of course it doesn't make sense to really exchange IP at that point.

[00:25:07] The government isn't really a payer into ultimately that application or that system. They're just a user of it. But as things scale and as things become fundamentally pieces of weapons systems that are driving peer competition as an example, there is a level and there is a scale where these sorts of hybrid structures or full GPR structures absolutely make sense.

[00:25:30] We're engaged in a couple of them. But again it's about the. The deal in the opportunity itself it's not a one size fits all black, white. Do we need ip? Do we, do we not need it? It's for the particulars of the situation we're dealing with. Does it make sense for the government to be an owner based on a lot of different variables?

[00:25:49] I think investment on both sides is a big one. And I think, of the fundamentals of what the thing is doing is another big part of it. And I think uniquely, maybe as a new entrant into the defense community we've been very willing to engage in all types of structures if and when it makes sense.

[00:26:03] And we will continue to do so.

[00:26:04] **Eric Lofgren:** the IP thing, or intellectual property is interesting from this perspective that we've just been talking about because my perspective, I came as a cost estimator in the Department of Defense, when we estimated the cost of a system. It's cost per pound, the more pounds it is, the more capability it has, or it's the source lines of code.

[00:26:25] The more code lines it has, the more we're gonna pay you, the more capability it has. But it almost feels I want like a fighter that's , has zero weight, right? But has infinite , capability. So I hear what you and Trey were saying in terms of we can do more with less.

[00:26:39] That's the whole purpose of technology. But sometimes our models don't really work that way.

[00:26:44] **Trae Stephens:** oftentimes brilliant software engineers will say they'll judge some how good someone is at writing code by their efficiency in writing code.

[00:26:53] And so you could have a true artist, like a brilliant software engineer. , that writes one third the lines of code of a very average software engineer, just because they're super, super efficient. But the government doesn't seem to have any uh, they obviously don't have any ability to do a qualitative evaluation of talent.

[00:27:13] And so they lean into all of these quantitative versions of talent evaluation instead, which are almost backwards in, in certain cases. And I think this is why we've gotten ourselves into some of these problems on next generation technology is that we don't even know how to evaluate them anymore.

[00:27:29] **Eric Lofgren:** Yeah. . And one of the things that's coming out in the Department of Defense, we call it consumption-based solutions. That's something that came out of Section 8 0 9 and we have pilot programs for it now from Congress, but I've heard that you guys with SOCOM have been looking at counter u a s as a service.

[00:27:47] Can you just discuss what does that model look like and is it happening now?

[00:27:51] **Matt Steckman:** Sure. It's absolutely happening now with us Ocom and other partners of ours both in the US and abroad. It's a weighted set of words, so I'll just describe it. Where, we believe that a capability which includes

both software and hardware elegantly integrated to actually go and do something is never done.

[00:28:09] Counter Drone is a great, sort of case study for this where, I mean, almost weekly at this point you're seeing new types of threats, counters to our counters and so on and so forth and the depth of that challenge just continues to grow. And so if you're unable to continuously release, continuously develop, continuously upgrade both software and hardware, you've almost.

[00:28:32] You almost declare that you wanna lose. It's almost that simple. And so we came up with this sort of phrasing as a service which really just means for a fixed fee, we are going to make sure that hardware and software stack is continuously developed against and upgraded to whatever the nature is of the next threat that's coming down the pipe.

[00:28:51] We think this has been quite successful. We've been able to keep, really keep up with the pacing threat. And I would argue that moving forward for these types of contracts, the velocity that you can get after the problem is actually the measure of success. Not necessarily, what's happening today or tomorrow or the next day, but how fast can I keep up with the pacing threat should almost be the measure of value to some of these systems.

[00:29:21] And then a, the next logical leap from there. And I'll show my biases here, is the way you keep velocity up against a pacing threat is by having a generic computing platform, a generic software platform that gives you tools so you can solve a lot of the problem from the get-go and just focus on the new thing coming at you.

[00:29:43] I think that's the beauty of focusing on software as a platform, focusing as on capability as a service, is you get this massive acceleration and velocity against things that you otherwise might not. Yeah. You

[00:29:55] **Eric Lofgren:** guys uh, Trey, you of talked about this in the past where, Anduril is based in software, but by virtue of being able to rat metal around it, it simplifies the sales process to the government.

[00:30:06] Can you just talk a little bit about how does that fundamentally actually solve this margins problem? Are the margins just hidden somewhere in the price? Which looks like a hardware thing or are you so much more cheap, like it's, you have a much cheaper capability that you can win those competitive contracts and the margins are still built in?

[00:30:24] Or where are those margins hidden?

[00:30:26] **Trae Stephens:** I wouldn't say that the margins are necessarily hidden anywhere. It's just because we are building the products ourselves and we're not generally speaking, or as Matt said, we'll pursue any business model that allows us to, to do the work that we're looking to do at the defense department.

[00:30:43] But if we are owning the cost and the risk for the research and development of a. We will charge for that product what we think the value is that we are generating for the customer. And so instead of all of that being tied back to the cost that is, that we are taking on to build something we are pricing it so that we can stay competitive with the alternative.

[00:31:04] And so that we can realize margins that allow us to reinvest our profits back into the business. And, there's all sorts of different ways that people look at this for different har types of hardware companies versus software companies. We're not looking to get software margins on our sales.

[00:31:19] Like we're not targeting 80 plus percent margins. But we are targeting something in like a healthy margin profile that would align with how people would do this exact sort of thing in commercial industry, which, for a lot of hardware companies is somewhere in like the 40 to 50% range. And so I think we know that the, the software that we're building is the thing that's critical.

[00:31:38] To sell to the United States government. That's the thing that they really need. But I also know that they don't know how to buy that. And so you have to figure out some way to sell them the thing that they know how to buy while still building a business model that allows you to succeed and continue to reinvest your profits.

[00:31:52] It is a bit of a balancing act.

[00:31:53] **Eric Lofgren:** It seems like it's not the margins per se, but what do you do with the margins, right? I mean, You could probably even show this to government with some kind of disclosure. We are reinvesting this in research and development, but when I look at a lot of these prime contractors, They're returning an awful lot of cash flow right back to their shareholders and the like.

[00:32:11] **Trae Stephens:** Yes, they're issuing dividends. They're re they're rebuying stock. This is not an exaggeration. In 2021, we spent almost a quarter

of what the top five primes spent on research and development by yourself, by ourself. So our business model is incredibly different from theirs. Like we aren't reinvesting one, one and a half, 2%, something like that.

[00:32:36] Like we are spending a hundred percent of our revenue every year on reinvesting in, in research and development. And that certainly won't continue in perpetuity. In theory, like by the time that we go public and, the business is much larger. We'll be, Less than a hundred percent, but will certainly never be as low as one, one and a half percent.

[00:32:56] Like it is incredibly important for us to continue dumping money back into the development

[00:33:01] **Matt Steckman:** of new products.

[00:33:02] **Eric Lofgren:** one of the issues there also seems to be, it's not this, that you guys are spending more on irad than traditional contractors.

[00:33:09] The traditional contractors get their independent research and development costs, as well as their bid in proposal costs directly reimbursed by Department of Defense through their overhead or their general administrative rates. And so they're actually, there's like a zero risk factor for them to invest.

[00:33:26] And they could actually, by selling like the same capability, the same irad. To the government at the same price, they would get a much higher r o ROI relative to you guys who need to make a return on that roi. Can you just talk a little bit a about that, but also what about the long term future?

[00:33:44] If you guys actually scale up and start making, significant profits to return to investors, is that a hard conversation to start having with government relative to we're just sinking everything back into you?

[00:33:54] **Matt Steckman:** I think it all comes back to is the government getting a good deal, it's kind of silly to say, but the fundamentals here are always come back to am I delivering a better capability at a reasonable or less expensive price than the alternative. And I was reflecting on what a good competition looks like, and it's worth repeating and it's worth just drum beating.

[00:34:16] I have outcome-based requirements. , I'm fielding prototypes to force investment in the competitors. I'm doing it quickly. And then you get your AB comparisons that you need and you can figure out, is this company actually

going to deliver me the capability that I need at the value that I want it, that I wanna pay for it?

[00:34:34] And as long as you continue to do that, you will never have a problem growing your business and you will never have a problem commanding margins that allow for you to approach the defense department in the way that Andel as a product company approaches. It's very challenging and it takes a lot of thought.

[00:34:50] It takes a tremendous amount of capital. It takes a team that is absolutely excellent at everything that we do. Engineering, hardware, software, as well as our approach to government. I am not worried whatsoever if we can continue to build better capability at a reasonable price that will ever have a problem with the government thinking that.

[00:35:10] Again, we're being predatory or whatever because they'll know through good competition, they'll know they're getting the better value, the better deal, and the better capability of the war fighter. I'm not worried about it at all.

[00:35:19] **Eric Lofgren:** I want to dive in just for a second on the as a service, what does that actually look like?

[00:35:24] Do you have just like an installation of Lattice and some sensors and other systems and it's just here's a license price for this base defense or something? Or what's the basis upon which you have asset service?

[00:35:36] **Matt Steckman:** Yeah, I'll give you a basic example, but it, it's very complicated cuz these things are complicated as you could well imagine.

[00:35:42] But yeah, take defending a base whether that's counter intrusion. So I care about my the ground around me or the maritime environment around me, or I care about the air environment around me if I'm in some sort of air defense mode. , it's a fixed fee to defend that installation and then keep that defense up with whatever the pacing threats are that are outlined in the agreements that we have with the government.

[00:36:04] There's a lot of variability there, and I'm not gonna get into all of that, but yeah, that, that's the basics of it, is you are paying to defend this sized installation from group one, two, and three drone threat. And we are guaranteeing that occurs to some amount of SLAs and to some amount of KPIs.

[00:36:23] Again, super simplified version of a very complex set of relationships. But that's it in a nutshell. And we're finding that our customers, gravitate towards it, right? Because it's almost pull this lever and make it happen. And then we're putting our own, again, capital and funds on the line to make sure that technology stays at the cutting edge.

[00:36:40] **Eric Lofgren:** And do you guys let's just say the Department of Defense gets into a war. Do you guys have surge pricing or is it contractor owned and operated and like, how would that work? Oh, it's

[00:36:49] **Matt Steckman:** all government. It's all government owned and operated. And yeah, there's a lot of different variables and permutations around war reserves and deployments and things like that, that are all dealt with.

[00:36:59] And you would think, oh, this is like hard to get done, but it's not. If you have a strong partner on the other side of the table that understands ultimately the outcome that everybody is shooting for and why that outcome is both aligned government and vendor, you get to the answers to all these questions.

[00:37:15] And so we're pretty excited about the current structures that exist. It's working really well. And we have no reason to believe that won't work. As the threats continue to scale and the challenges continue to scale.

[00:37:25] **Eric Lofgren:** So Enduro also talks about, becoming the next generation prime.

[00:37:29] And I just wanna ask you guys, how do you get there in d o d, this proc recurring revenue at scale without entering this kind of far 15 sole source world, which comes with all these business regulations? I talked to you a couple years ago, I was like would you guys ever take a cost plus contract?

[00:37:46] Cause that comes with all these regulations too. And you're like maybe it, it depends, right? But for now, probably not, but at some point, but far 15, even if you are in a firm fixed price contract world, it still comes with a lot of the cost accounting systems the estimating systems, the purchasing systems, all these types of things.

[00:38:04] What's your guys' view on that and strategy?

[00:38:07] **Matt Steckman:** the, The reality is if you want to play at the top tier level, you have to have the capability to create that spectrum of contractual

structure, accounting structures, cost structures that, that the government transacts against.

[00:38:23] And now, yes, we will through conversation, try and, convince the government that some of those structures are a better value to them and ultimately allow us to work in a more flexible and fast way.

[00:38:38] We're not gonna be completely and always successful at making those arguments, and that's fine. In which case we'll do something else on that sort of spectrum of choices you can make in contracts and structures. We are doing, pretty much every type of of structure you, you can think of at this point in the game.

[00:38:53] You have to, as you start to scale and as you start to grow. I think though the. I'll go back to some of my earlier comments. It's just more about the individual opportunity and piece of work that you're focused on that then suggests how you want to go and approach that work. And ultimately, again, if there's a champion and a partner on the other side of the table, you can get to the answer that, that both sides agree too, and you can go and do good work together.

[00:39:17] And so I think as Andal the next great defense prime. It would be hard to think in any

[00:39:22] **Eric Lofgren:** other terms.

[00:39:23] Yeah. The definition of non-traditional defense contractor, of course is, has not performed on any contracts or subcontracts subject to the cost accounting standards. And again, like cost accounting standards come with these sole source contracts that are relatively larger. I saw that you guys were competing, for example, on the ops.

[00:39:43] Fighting vehicle as a subcontractor on one of the teams. But if your team won that and you got into a high rate production, manufacturing, that stuff is flowing down to you, right? Like you have no choice to become ca at that point. Or you just let go of the contract or have a very non-traditional structure that you have to force the government to change what they do.

[00:40:04] So will you guys be a cast cover contract? Will you guys actually get out of non-traditional land at some point now? Of course, O M F V, that could be many years from now, but are you, are you guys like charting that path? You

[00:40:15] **Matt Steckman:** know, I guess I would use your, do you use your own words? We have no choice but to do these contracts if we want to be a player in major defense programs, which we do and which we are in some cases.

[00:40:26] We have to do these things. , we're never going to move the government completely off of approaches, especially on these very large, ACAT 1 23 type programs that would be silly of us and naive of us to think about. And so again as the opportunities come up where it makes sense, we're gonna pursue them with the full resources of the company behind it.

[00:40:46] **Eric Lofgren:** Not to belabor this point but once you get into this world with cost accounting standards it forces like the measurement of your price background to inputs. So you have a firm fixed price, so source contract, you get certified costs or pricing data, and they say, what is the labor and materials to deliver this thing?

[00:41:05] Not, I don't care about what you put in the past, I don't care about your sunk investment. I care about your audible costs on this one specific contract. that seems like it would present to you guys a. A problem because it's like we need to make a 40, let's just say 40% margin for this to even make business sense, but you're gonna give me, with the profit rate in far 15.4, you're gonna give me 10% profit on top of my marginal costs.

[00:41:31] So is that a dis like a discussion that you can work within this paradigm as long as they understand here are marginal costs, but this is why we're pricing it here and this is why the profit should be here and not look like a defense con, like a traditional defense contractor, or how do you think about that?

[00:41:47] Sure.

[00:41:48] **Matt Steckman:** Yeah. We, first we have worked with some excellent contracting officers that we work with to explain our business model, why it is different, where the dollars flow to how we do work, and for the most part we're able to get to terms that absolutely make sense for our business, whether that's.

[00:42:05] These types of payback models, cost plus models, things like that where we can be successful, we can know that yeah, maybe in certain circumstances we're taking a hit on a margin. But for these very large programs, the upside that is then at the proverbial end of the rainbow is massive. And so

from an roi, from an investment and from a business risk perspective where it makes sense, we engage.

[00:42:29] And I think you find in a lot of these larger programs that the ROI is there if you approach it correctly. I think maybe just to take a different spin on the question as well. You have to ensure that your teams continue to work like Andel and not maybe a more traditional company where we're focused on outcomes.

[00:42:47] We're focused on speed of delivery, we're focused on quality. , and not necessarily on, billing every hour that's on the contract. That's not actually important to us. I harkening back to some of the earlier comments. If we build better product and they're less expensive, we will always grow our company and we will always win.

[00:43:03] And if we can maintain that focus even in more traditional structures and traditional competitions, I think we'll end up being better off for it.

[00:43:10] **Eric Lofgren:** Yeah. Let's talk a little bit about the competitions. You guys had a nice document that came out recently rebooting the arsenal of democracy. You had a bunch of recommendations in there as well, but one of 'em really talked to the competitive contract process that wasn't rewarding merit and outcomes.

[00:43:27] And now of course there's all these laws, right? Competition and contracting act. The d o d has to be fair to everybody. Get everyone a chance on these things and maximize the number of competitive contracts. , are these processes unfair to non-traditionals like yourself, or is fairness the wrong measure?

[00:43:42] What needs to happen? I

[00:43:44] **Trae Stephens:** mean, I would argue that the fairness is mostly just a farce. It's like the system is obsessed with fairness and not with outcomes. And so when you're doing like a fairness assessment, what the ultimate outcome is participation trophies for all the players, what we really need to do is we need to pick winners which no one wants to say because it feels bad to say that out loud, but it is the right thing to do.

[00:44:08] And if we were to say we are going to reward outcomes, we'll reward the best player with a victory then we wouldn't get so caught up in this

crazy participation trophy practice where we never fully commit to anyone. We drag the process out for way longer than it needs to.

[00:44:25] We allow everyone to protest until, the thing that we initially set out to do is no longer even relevant because we've now gone past the timeline of relevance for that thing. And then once we've finally worked out all of those protests we now will have a 10 plus year timeline where we're going to let that player.

[00:44:42] what we should really be doing is moving much faster having more frequent competitions and actually just saying, look, we picked this winner. This is what we're gonna do for two years, three years. And if somebody comes out of the woodwork and beats them and proves better performance we'll switch.

[00:44:57] And we need to have the flexibility to do that. And the fairness thing is kind of a disease in my mind. It doesn't actually get you what you want. It just rewards people that are better at playing the game than anyone else. And the people that are best at playing the game are oftentimes not going to be the people that are best at actually building the thing that gives you the outcome that you want.

[00:45:15] **Eric Lofgren:** is the way that you just described it, is that how commercial companies buy sass? Or like how does the commercial world think about competitions? Or do they just do more kind of single sourcing to those who they just believe in?

[00:45:26] **Trae Stephens:** Well, I mean, It's certainly not perfect. I don't want to pretend that like our.

[00:45:31] Capitalist system in the private sector works flawlessly and without error. But generally speaking, like the best performer wins. And there, there isn't like a multi-stage gate for protests and, all that stuff that goes in. There's not like a revolving door between Walmart and its vendors

[00:45:48] That's just not the way that any of this works. And I think at its best, the way that our the private sector acquires technology is the way that the DOD should acquire technology, which is evaluate the options, pick your thing, and be open to changing if that's no longer the right strategy, at some point in the future,

[00:46:05] **Eric Lofgren:** our request for proposals kind of part of that problem.

[00:46:09] I saw one study where it was like a normal solicitation put out on the street requires like a master's or a PhD. reading level even to be able to decipher this. Does d o D need to do more market research, just straight up and then go with who who's the best and do demos and that kind of stuff?

[00:46:26] **Trae Stephens:** I think a lot of times we reward white papers. It's like totally crazy that we reward the ab the ability to write a really good white paper or like a research proposal. And we don't reward people that are building the actual products. And I think that's what we try to lean into suggesting that we make changes around is, look, look, you can articulate the problem statement to us, like we wanna understand the problem that you're facing.

[00:46:50] But we want some flexibility in being able to go out and build a solution for that problem, maybe in a way that no one else has thought about. And, that's what innovation is. It's disrupting the normal way of doing business. But if you're just rewarding people for how well they write white papers, , you're probably not gonna get the outcomes that you're looking for.

[00:47:07] Yeah. A lot

[00:47:08] **Matt Steckman:** of our a lot of our discussion with government or briefing on our technology stacks, it's not let's avoid competition and sole source it to us. It's not that at all. A lot of the later stage conversations simply end up being, run the competition, but hey, here are some ideas for how you can actually get to that ab comparison that you want, that we want, because we think we're gonna be better off in that comparison.

[00:47:36] But run it in such a way where you get to the end of it and you can actually make a choice that you have conviction behind. And then let's go perform together. And so endless numbers of conversations, both formal and informal, around just how do you run good competitions to get to that choice.

[00:47:52] **Eric Lofgren:** it strikes me, you know, like, is testing evals some of the problem here? Because most of the time you have a competition in research and development where everything is still a paper plan and then it goes through testing, eval and then you're into procurement. Whereas it seems like you guys are saying, we just need to a competition for the procurement slash production fielding stage because we feel like we've already done that de-risking, we don't need all this technology maturation, risk reduction stuff.

[00:48:20] We need, actual production contracts and the let the best person win. Cuz a lot of this stuff, a lot of the commercial technologies for example, you

don't need to de-risk, AI necessarily itself or advanced communications. It's just like the application and the adoption into the military.

[00:48:37] So how would you think about changing that?

[00:48:40] **Matt Steckman:** I think if the government and you're seeing this I'll give you an example in a minute. If the government spends a little bit more money upfront on running competitions by fielding prototypes against actual operational objective, they will ultimately get to a faster decision with a better set of companies and teams that will deliver them a production capability that can scale and can do what they need them to do.

[00:49:03] The example we're very excited about right now internally, is we're within the throes of a competition, with Army, p e o i e w, and s the Army's Ground TITAN vehicle program, which is a ground control station for army operations FMTV and JLTV based. To, to their credit, they are running this like a structured set of prototyping competitions.

[00:49:24] So starting with your paper plans and, a bunch made it through. , through prototyping, through fielding operational testing. And then what's even more exciting is they're saying that this is the prize at the end of the rainbow. Here's how many vehicles we're gonna build and roughly what they're gonna cost.

[00:49:41] And so every competitor knows that the return on investment is there, and you can put your own dollars in if you need to, or, the government's paying for a little bit as well. And these are the types of competitions we need because there's no hiding in it, right? Your vehicle either does the job or it doesn't.

[00:49:58] It's very obvious. Once you're out on a range, once you're in an osteo environment, what's occurring? I think if you can, look at that as one of several positive case studies occurring, and continue to try and do that across the board. But by the way, omf V is similar in this context, right?

[00:50:12] It's just a bigger scale. you will ultimately get to faster and better outcomes.

[00:50:17] **Eric Lofgren:** Any other? Cuz we, we often don't give kudos to good things. Any other good things going on that we should hear about?

[00:50:24] **Matt Steckman:** Yeah, a absolutely. I think a lot of the counter drone stuff that we're involved with has been dealt with in a similar way through competition, through, come to this base and you're just gonna defend it for a couple of days type of competitions.

[00:50:36] Again, you can't hide the counter intrusion work we do the border security work, we do some of the air launched effects stuff that we do. You're seeing this more and more I think because ultimately program executive offices are seeing better outcomes, right? And so they're gonna follow what's working.

[00:50:51] And these types of structures are working. .

[00:50:53] **Eric Lofgren:** So there's a new acronym out there, I believe it's called like Sharp, which is all the new era defense companies that kind of reached a billion dollars in valuation. What does this kind of signal to you, and also should these companies in your company, start engaging in lobbying in dc?

[00:51:10] Like how do you think about that presence in DC because we know the traditionals have a pretty big one.

[00:51:15] **Trae Stephens:** Yeah. For what it's worth, like if you were to add the revenues of all of the companies in SHARPE together, it would equal like, maybe 2% of Lockheed Martin's revenue for last year.

[00:51:28] So it's, this isn't like a significant win for the government to be able to celebrate that they've created this massive industry. But yeah, I think, There are certain lessons that all of these companies have learned from the SpaceX's and Palantir's of the world that kind of are 10 years are senior.

[00:51:46] That. You actually can't do this without having a really effective government affairs engine , there is no version of becoming a credible competitor to the legacy defense industry without having lobbyists, without having consultants, without having people that are helping you navigate the internal system.

[00:52:05] So yeah, this is advice that we would give to any company that was planning on enter, entering the spaces plan on spending time and. Getting good at at government affairs. So yes, that, that definitely is the case. But I also wanna reiterate that that there seems to be this idea that like hitting these valuation goals, like suddenly being treated very seriously by the private capital community somehow indicates that you've made it.

[00:52:28] N none of us have made it. None of these companies are like, the air apparent for the next multiple decades. It's it's still very early innings. We still have a ton of work to do. We are going to try to work as hard as we can, not only on the product side, but also in helping figure out a business development model that allows us to retain and attract the talent that we need to build the things the Department of Defense needs. And I think it's in many ways, very exciting that we've been able to make the progress that we've made. And I think that goes for all the companies that are in that sharp index. But it's certainly not quite yet a a cause for celebration.

[00:53:00] There's still a lot of work to be done.

[00:53:01] .

[00:53:01] **Eric Lofgren:** One of the things I would invite you guys to potentially push on is this idea of P B B E reform, planning, programming, budgeting, execution. You guys had in your, in the rebooting the democracies arsenal, you guys actually talked about this history, right? McNamara came in, he brought this system that was very different than what had gone on before it.

[00:53:20] And in many ways it turns its back on, American values in my view of, Markets and, individual responsibility and it pushes this like central planning notion into d o d. There's a P B B E commission now that they're looking at this thing?

[00:53:36] What would you tell them? Or what is just like your kind of larger narrative of the structure of this industry and where it might need to go?

[00:53:43] **Matt Steckman:** I'll say we are Trey and I, we are no experts at ppv. We have spoken to the commission both formally and informally which is great that they're solicit.

[00:53:51] Inputs from our style of company. I think from my perspective me, Matt Stackman the one thing I care most about is flexibility of budget and the ability to, capitalize wins within the same year of execution. I think from a from a sort of a tech company perspective, that's one of the biggest challenges to our business is doing something that is great and sometimes eye watering if it's really great.

[00:54:20] And being able to reap the reward from that excellence within that same fiscal year. But that's a really hard thing for new companies and new tech companies to sustain. It takes. , a lot of knowledge and creative horsepower to,

it's tried at this point, but to leap the valley of death which we've been, I think, pretty good at doing so far.

[00:54:41] And if there's one ad to make, from, again, my personal perspective, it's flexibility in your funds and being able to move quickly against what's working within the st fiscal.

[00:54:49] **Eric Lofgren:** What's next on the roadmap for Anduril?

[00:54:52] **Matt Steckman:** Our advanced command and control software and our autonomy stack it's kind of getting scary.

[00:54:58] Good it's pretty exciting. Customers are starting to be pretty blown away by both, what those two pieces of software can do with our own hardware in some cases, but also increasingly with, much, much larger much more sophisticated, theater level. , hardware, both sensing affecting, vehicle platforms, things like that.

[00:55:17] We are very excited to be increasingly pulled in those directions where you are both, enabling existing technology to perform and do things more effectively and more efficiently than it otherwise could. At the same time actually allowing for different ways of, deterring competing using new technologies and new experimental platforms.

[00:55:40] Some of which we know, some of which we don't at this point. Very, it'll be a very exciting 2023 for Andrew in a lot of different directions. I will say for anybody listening, we are hiring like crazy. The the sort of the macro economic downturn, It's not affecting us like it is a lot of other tech companies that you're seeing layoffs in our community, which which we're just not seeing.

[00:56:00] And so if you're interested in coming and working on national defense and putting some of your time, your energy and your brain power against solving some of these problems hit us up. There's a lot of ways to find us.

[00:56:10] **Eric Lofgren:** Any final thoughts you'd like to leave our audience with

[00:56:13] **Matt Steckman:** okay. All I would say, Eric, is we gotta flip the script here and someone's gotta interview you at some point.

[00:56:18] **Eric Lofgren:** All right. Cool. Matt Stackman, Trey Stevens, thanks for joining me on Acquisition Talk. Thanks, Eric.

[00:56:24] **Matt Steckman:** Thanks Eric.

[00:56:25] **Trae Stephens:** Take care.

[00:56:26]