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Capital

BRIEFING

FUNDING THE FRONTLINE

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THE DEFENCE FINANCE LANDSCAPE

Defence differs from most other sectors in relation to finance. It is capital-intensive, contracts and payments are irregular, and the certainty of future business is influenced by government priorities as much as market demand. A company can be a world leader in defence capability but still face constraints due to cash flow, long payment terms, or the complexity of procurement.

The United Kingdom's defence industrial base is highly specialised, characterised by a handful of major primes and systems integrators who, in turn, are supported by a network of highly capable but heavily resource-constrained small and mid-sized enterprises ("SMEs"). These SMEs often deliver the most agile innovation across a wide range of disciplines, from sensors, AI, autonomy, propulsion, and materials science, and beyond. Yet, they face persistent challenges in accessing finance, scaling production, and competing for long-cycle government contracts.

When it comes to financial institutions investing in or financing defence, security and resilience ("DSR") companies, traditional financiers are cautious, influenced by ESG policy, compliance restrictions, or limited internal expertise in defence. However, the landscape is slowly shifting in a positive direction. Recent years have seen a gradual increase in interest from private-credit funds, venture capital organisations, and private-equity firms, who have begun to enter the sector. With NATO spending rising and sovereign capability back on the agenda, capital is starting to flow into the sector. This surge could lead to the risk of misallocation and short-termism if not guided by informed judgment.

This briefing outlines the typical stages of a defence company's financial journey, the funding options that may be available, when to consider using them and a few practical ideas.

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STAGES OF A DEFENCE COMPANY

Most defence companies follow a similar pattern towards maturity, progressing from concept validation through design, manufacture, and ultimately delivery of orders and scale.

Early Stage – Turning Ideas into a Business

- Funding tools include founder capital, friends-and-family investments, angel investors, early-stage venture capital (e.g., Enterprise Investment Scheme), and grants.
- Financiers need proof of concept, demonstration of customer demand and market size, and a path to revenue.
- Success at this stage depends on demonstrating technical credibility and an investable management team.
- Typically associated with pre-Seed and seed funding rounds.

Growth Stage – Building Capability

- Funding tools include venture debt, contract finance, bridging loans, invoice discounting, asset finance, revolving facilities, export finance, and venture capital.
- Financiers care most about contract quality, forecasting accuracy, governance standards and a long-term product roadmap.
- Working-capital management becomes critical as contracts scale and delivery cycles lengthen.
- Typically associated with seed and series A & B funding rounds.

Maturity and Expansion – Past the Valley of Death

- Funding tools: a blend of debt and venture capital or private equity investment to scale or consolidate.
- Financiers focus on profitability, scalability, and exit options, whether through acquisition or long-term partnership.

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- Product delivered and contracts secured.
- Effective preparation for this stage requires strong accounting, clear intellectual property ownership, and defined customer contracts.
- Often linked to late-stage investment rounds.

Each stage brings its own funding logic and risk profile, and understanding where your company sits on this path is essential before approaching the appropriate investors or lenders.

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TYPES OF FUNDING AND THEIR BALANCE SHEET IMPACT

Funding comes in two broad forms: equity (ownership) and debt (borrowing). Choosing the right mix determines cost, control, risk, and ultimately, the pace of growth.

Key Differences at a Glance

	Debt	Equity
What it is	Borrowed money to be repaid with interest	Sale of shares in your company
Cost	Interest and fees	Ownership dilution
Control	Retained – you keep controlling the company and benefit from any upside over the interest costs	Shared or restricted– investors influence or control key strategic decisions
Best for	Working capital, equipment, contract mobilisation	R&D, market expansion, long runway
Main sources	Banks, private credit, leasing	Angels, venture capital, private equity, strategic partners

Most defence SMEs succeed with a blended path: equity as the core financing instrument, then debt to scale the business without equity dilution once contracts are won and the balance sheet improves.

Position on the Balance Sheet

The balance sheet can be visualised with three key positions.

Position	Section	Meaning
Top	Assets	What you own – cash, equipment, IP, contracts
Middle	Liabilities	What you owe – loans, leases, creditors
Bottom	Equity	What's yours – capital and retained profits

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Forms of Equity Capital

In practice, equity isn't a single instrument. The Companies Act 2006 permits multiple share classes, each of which may carry different rights and economic interests.

Form	Key Features	Typical Use & Effect
Ordinary Shares	Voting rights, variable dividends	Standard ownership; full risk and control
Preference Shares	Fixed dividends, priority in distribution, often non-voting	Income-seeking investors; viewed by lenders as quasi-debt
Redeemable Shares	Can be bought back by company later	Employee schemes or temporary capital
Convertible Instruments	Debt that converts to equity later	Attract funds without immediate dilution
Deferred/Non-Voting Shares	Limited rights until trigger event	Founder or employee retention tools

All forms appear within shareholders' funds (equity) on the balance sheet. Rights vary by class, as set out in the articles of association. Lenders generally view strong ordinary equity as a buffer against solvency, while heavy use of convertible instruments (debt-like funding that may convert into equity) can increase perceived risk.

Forms of Debt Finance

Debt can take many forms, differing mainly by term, security, and purpose. Each has distinct implications for cash flow and the balance sheet.

Form	Key Features	Typical Use & Effect
Term loans	Fixed amount repaid over a set period with interest; may be secured on assets or contracts	Predictable financing for capital expenditure or major projects; Increases long-term liabilities
Revolving credit facilities (RCFs)	Flexible credit line drawn down and repaid as needed	Smooths working-capital cycles; increases eligibility for tenders; sits within current liabilities
Invoice financing/ factoring	Advances cash against receivables	Improves liquidity without taking on long-term debt; shows as current liability
Asset finance/ leasing	Lender retains title until fully paid; may include equipment leases or hire-purchase	Preserves cash while acquiring equipment; recorded as debt or lease liability

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Bridging or contract finance	Short-term loan secured against expected receipts or contract milestones	Common in defence contracts with delayed MoD payments; increases short-term gearing
Trade credit/ supplier terms	Credit extended by suppliers	Informal debt source; sits within creditors on balance sheet

Debt instruments appear as liabilities on the balance sheet, divided into current (due within a year) and non-current (due greater than one year). High-quality secured debt can improve operational flexibility, but excessive leverage erodes equity ratios and can limit further borrowing capacity. Banks and private credit funds prioritise security, cash flow coverage, and management competence, valuing predictable contract income and clear asset ownership while viewing excessive short-term borrowing as a sign of financial stress.

Understanding this balance between risk capital and borrowed capital is the foundation for choosing the right funding at the right time.

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WHEN TO USE WHAT?

Choosing the right funding strategy at the right stage of your company's growth can be the difference between success and failure. While debt and equity are the available funding tools, understanding when to use each and how to balance them is critical. This section provides a framework for selecting the appropriate financing tools for your company at each stage of development, based on the unique challenges, funding needs, and growth goals that arise.

At the early stage of a company, funding is often about validating the business concept. In this phase, equity and grants are commonly used to build credibility and attract initial investment. In the growth stage, companies often turn to more structured debt products to manage working capital and accelerate expansion. Finally, the maturity stage sees a blend of debt and equity to consolidate, scale, or pursue acquisitions without further diluting ownership. Understanding when and how to combine these tools is essential for strategic growth and long-term financial stability.

Decision Matrix

Stage	Funding Tools	Key Considerations	Why to Use This
Early Stage	Equity (Founder, Friends & Family, Angel, Venture Capital), Grants	Proof of concept, developing a viable business model, limited revenue or contracts	Equity provides the runway to develop the product without the burden of repayment.
Growth Stage	Venture Debt, Invoice Discounting, Asset Finance, Contract Finance, Revolving Credit Facilities	Need for working capital, managing cash flow, bridging funding gaps, scaling operations	Debt preserves ownership while providing liquidity for scaling and contract fulfilment. Venture debt allows scaling without heavy equity dilution.
Maturity Stage	Term Loans, Private Equity, Mezzanine Finance, Asset Finance, Revolving Credit	Scaling operations, consolidating, acquiring new contracts or businesses, managing risk and leverage	Debt and equity work together to consolidate and scale operations. A mix of debt (for flexibility) and equity (for growth) supports larger ambitions.

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FURTHER THOUGHTS AND THINGS TO BEAR IN MIND

This section highlights alternative funding opportunities and practical strategies that defence SMEs may consider. These options can help alleviate pressure on working capital, improve financial flexibility, and unlock hidden value, all without necessarily seeking additional external funding.

R&D Tax Credits

- Recover 10-15% of eligible R&D expenditure.
- Defence firms are underclaiming by approximately 30%, creating an untapped opportunity to boost cash flow.
- Consult with specialists to maximise claims and ensure compliance with HMRC guidelines.

Leasing and Asset Finance

- Leasing enables a company to purchase essential equipment or infrastructure without significant upfront expenditure.
- It converts capital outlay into predictable operating costs, thereby easing working capital requirements.
- For defence SMEs, leasing is often an efficient route to acquire test facilities, vehicles, or manufacturing equipment when cash flow is tight or debt capacity is limited.

Leasing as a Product

- Leasing can also be a commercial model offered by defence companies to their customers, particularly in export markets.
- It allows partner nations or agencies, especially those in small and medium-income economies, to obtain defence capability without the complexities of sovereign procurement, large capital budgets and often with a reduced maintenance and repair burden.

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- In essence, it reframes defence export as a service rather than a one-off sale.
- Often delivered in partnership with a specialist finance provider.

Export Finance

- Use UK Export Finance (UKEF) guarantees to facilitate contract financing and performance guarantees.
- Particularly valuable for defence and security firms with export contracts or overseas customers.
- Either obtained through a UKEF scheme lender or directly. But the process can be lengthy and complex, so it's best to engage with UKEF as early as possible.

Asset Refinancing

- Release value from existing equipment, property or intellectual property (IP).
- This can serve as an alternative to new debt financing while preserving equity.

Collaboration & Consortia

- Share financial load and reduce risk through collaboration.
- Partnering in consortia improves eligibility for larger grants and joint ventures, enhancing access to funding.
- Pooling resources also increases the chances of winning larger defence contracts.

Preventing Financial Stress

- Plan your working capital effectively and ensure there’s a buffer.
- Avoid situations where you only have a month to keep the lights on. Approaching lenders or investors in this scenario will reduce your chances of securing capital, regardless of how strong your product or IP is.

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- Pre-emptive financial management is critical for maintaining control and ensuring your business's financial stability.

Be Cautious with Niche Equipment

- Niche equipment can be difficult to resell if a loan is not repaid, which means the cost of capital for this equipment is often higher.
- For lenders, resale value is key. If assets are hard to liquidate, the risk profile increases, leading to higher interest rates or less favourable terms.

Intellectual Property (IP) as Collateral

- IP is difficult and costly to value.
- Lenders generally only lend a percentage of the independently assessed value of IP.
- This can limit your financing options if your assets are mainly intangible.

Clean Shareholder Register (Cap Tables)

- Ensure your cap table is clear and not fragmented across multiple small shareholders.
- A messy ownership structure can discourage investors, especially venture capital firms, from engaging early on.
- Ensure the equity structure is simple and easy to understand.

Key Takeaways

- Financial flexibility is key. Don't wait until you are at a crisis point; planning ahead can give you access to a wider range of funding options, whether through R&D tax credits, leasing, or asset refinancing.
- When you are proactive in managing your working capital and seeking out alternative financing options, you'll be in a much better position to attract the right investors and lenders.

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GLOSSARY

- Working Capital – the funds available for day-to-day operations, such as the cost of staff, suppliers, and bills.
- Venture Capital – equity investment in early-stage or high-growth companies with strong potential but limited trading history. Investors take ownership stakes in exchange for high-risk, long-term growth perspectives.
- Venture Debt – a loan typically for a Venture Capital-backed company, and which may include granting the lender a form of equity. Typically, it is repaid from future funding rounds and/or contracted revenue.
- Blending – structuring a mix of equity and debt investment to suit a company's stage and risk profile.
- Bridging Loans – short-term loans used to cover temporary funding gaps until longer-term finance or revenue is received. Commonly used for liquidity ahead of investment, contract drawdown or asset sale.
- Contract finance – a specific type of loan where capital is advanced against a confirmed customer or government contract, before or during delivery. Repaid directly from contract proceeds.
- Invoice Discounting – a form of short-term finance where a lender advances cash against cash flow from an issued invoice. Repaid when the invoice is paid.
- Asset Finance – a loan secured against equipment, property or machinery. The asset itself serves as the security for the loan.
- Revolving Facilities – a specifically allocated line of credit that a business can draw down, repay, and utilise again. Helps with working capital and demonstrates to contracting authorities that the company has the financial resources to deliver, often opening up more tenders for the company to bid for.
- Export Finance – finance for businesses selling goods or services overseas. Often, loans are used to cover production and shipping costs while waiting for

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payment. Reduces the impact of a foreign buyer delaying or failing to pay through insurance or guarantee funding.

- Receivables - money owed to a business by its customers for goods or services provided on credit. In simple terms, they represent outstanding payments that the company expects to receive in the future.
- Mezzanine Finance – a form of funding that is between senior debt and equity.
- Capitalisation Table (often called Cap Table) – a list of the company ownership detailing shareholders, share classes, and percentage holdings.

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ABOUT US

We provide advisory services and liquidity to companies in the defence, security and resilience industries.

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