

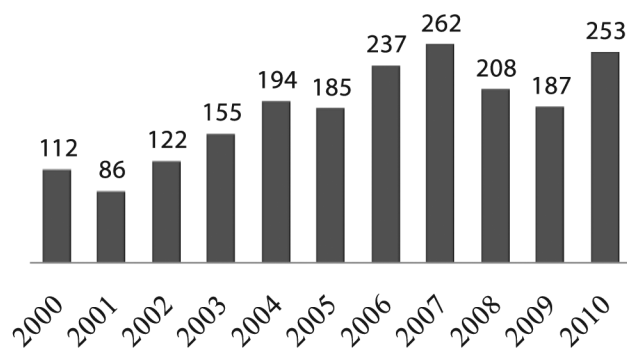
Dynamic Defense and Government Services Market Creates Opportunities for Valuation Practitioners

By Mitch Martin and Geoff Nattans

The defense and government services sector faced an uncertain climate in early 2010, but by the end of the year, the levels of M&A activity had risen to a level not seen since the 2006-2007 peak. Increasing M&A activity always drives demand for business valuation practitioners and at the same time provides significant opportunity. Both buyers and sellers require valuation professionals to perform such services as transaction fairness opinions, purchase price allocations, goodwill impairment tests, and general equity appraisals

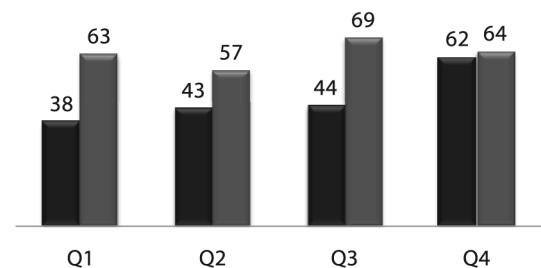
Based on data from The McLean Group, Info-Base, and Capital IQ, 2010 saw 253 reported M&A transactions in the defense and government services marketplace, up more than 35% from 2009 (see Figure 1). Transaction multiples for federal contractors generally declined in many subsectors in 2010 compared to their mid-decade highs, but the industry has held up remarkably well in light of the continuing global economic, political, and financial challenges.

Figure 1. Defense & Government Services Sector, Number of Deals (Annually)



Building on the momentum of 2009's second half, first quarter 2010 deals rose to 63 transactions, slowed a bit to 57 in the second quarter, and steadily picked up in the third quarter to 69 and to 64 in the fourth (see Figure 2). Disclosed transaction valuation multiples also increased in 2010: the median EV/EBITDA (trailing) multiple was 11.9x compared with 8.2x in 2009, and EV/Revenue (trailing) was 1.5x vs. 1.1x in 2009.

Figure 2. Defense & Government Services Sector, Number of Deals (2009 vs. 2010)



M&A Analysis

Of the 253 disclosed transactions, 70% were less than \$250 million in enterprise value, 19% fell between \$250 million and \$1 billion in enterprise value, and 11% exceeded \$1 billion in enterprise value. Among buyers, public and private companies accounted for 54% and 46% of these transactions, respectively. Public and private *sellers* accounted for approximately 5% and 95% of transactions, respectively.

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Private equity activity increased in 2010 year-over-year on an absolute basis with 66 reported deals versus 60 in 2009, while decreasing on a relative basis with private equity buyers accounting for 25% of total 2010 deals (including both direct platform investments and bolt-ons to existing portfolio companies) vs. 32% in 2009. Strategic buyers maintained the lion's share of 2010 deal activity (75%). Notably, financial sponsors also were active 2010 sellers, with 41 exits. Foreign buyers also played a prominent role, driving 28% of 2010 deals.

With ample "dry powder" available for acquisitions—from both cash reserves and better access to financing—larger public companies played a major role as buyers in 2010. BAE Systems, SAIC, ITT, and Ametek each completed five transactions, leading the sector. By dollar value, TransDigm Group led with a total aggregate transaction value of \$2 billion in enterprise value,¹ with BAE Systems, Triumph Group, Honeywell, and ITT rounding out the top five.

While many drivers influenced this highly dynamic market, five of the most prominent macroeconomic and industry-specific trends stimulating defense and government services M&A activity in 2010 were these:

1. The U.S. fiscal environment;
2. The public market recovery;
3. The middle-market crunch;
4. Asymmetric warfare; and
5. Organizational conflicts of interest.

(1) The U.S. Fiscal Environment: In 2010, U.S. officials and the American public shifted focus from the financial and mortgage turmoil of the prior three years to the ballooning federal

¹ HP's \$2.2 billion acquisition of 3Par was excluded from this calculation.

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deficits and the commensurate interest expense to service the national debt. Keeping in mind lessons learned from the economic downturn, many in Congress and the media called on the federal government to rein in spending and balance the budget. Continuing fiscal imbalance was compounded by the expiring Bush-era tax cuts at year-end 2010 and potential repercussions of extending capital gains (and other) tax cuts for middle and upper income taxpayers. Concerned about an imminent capital gains tax once Bush-era tax cuts expired in 2010, many middle-market business owners pursued sell-side M&A options when they otherwise might have deferred an exit or liquidity event. However, in the wake of the 2010 elections, political compromise led to the extension of tax cuts passing Congress and being signed by the president in December 2010.

Fiscal austerity drove lawmakers and federal planners to evaluate annual budget items that could be trimmed or deferred. In short order, the Department of Defense budget came under scrutiny. While defense spending as a percentage of GDP has declined during the last several decades and stayed relatively flat since 9/11 (at 4% to 5% of annual GDP), U.S. military spending on a relative and absolute basis remains larger than that of such key allies as Germany, Britain, and France.² The global role and responsibilities of the United States are far more significant than those of its allies, but the U.S. budget deficit has forced lawmakers to closely evaluate global military operations to determine which efforts are sustainable and which must be curtailed or eliminated.

During 2010, the government prioritized base relocation and consolidation (BRAC) to cut costs and maximize efficiency wherever possible. It also sought to in-source top contractor talent as a way to (theoretically) reduce contractor expenses on “inherently governmental functions” and help solve a “brain drain” arising as retirements of baby boomer government workers accelerate. While in-sourcing received a great deal of attention in the media and federal community, by year-end 2010,

it had become apparent that the actual net impact of in-sourcing likely had been overestimated.

Finally, budget austerity and a cheap U.S. dollar drew attention from foreign buyers during that year. Foreign firms, most having an established U.S. government presence, jumped at the chance to win greater penetration with one of the world’s largest and most reliable customers.

(2) The Public Market Recovery: U.S. equity markets closed 2010 on an upswing, driving the Dow Jones Industrial Average up 10%, the S&P 500 up 13%, and the NASDAQ up 17%. The McLean Group’s Defense index tracked the S&P through the first half of the year before falling behind in the third and fourth quarters to finish slightly below January levels. While McLean’s Middle Market Contractor and Government Services indices outperformed benchmark indices throughout 2009 as investors came to appreciate the federal sector’s steady growth and transparent cash flows, 2010 brought a number of global challenges, including the European debt crisis, slower-than-expected jobs and housing recoveries, and such unexpected shocks to the system as May 2010’s “flash crash,” where the Dow sank 1,000 points in minutes (though it wound up recovering most of those losses during that same trading day). Such events gave investors pause, triggering a mid-year overall market correction. Reassurances from Federal Reserve chairman Ben Bernanke and aggressive quantitative easing helped bring the markets back in line to finish the year strong. The Defense index finished below the S&P on a relative basis for the year, while the Middle Market and Government Services indices closed the year roughly in line with the benchmark indices.

Trading valuations across the sector indices were adversely affected by uncertainties surrounding prospective Obama administration budget cuts. While mean EV/EBITDA multiples (trailing) are historically low (6.0x for Defense and 6.5x for Government Services), the Defense and Government Services companies completed initial cost-cutting measures, and resulting improvements likely will be reflected in increased

2 SIPRI research and *Christian Science Monitor*, “Cuts to US Defense Budget Look Inevitable,” June 2010.

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2011 profit margins and valuation metrics. (See Figures 3 and 4.)

Figure 3. EV/EBITDA Trading Multiples (2002-2010)

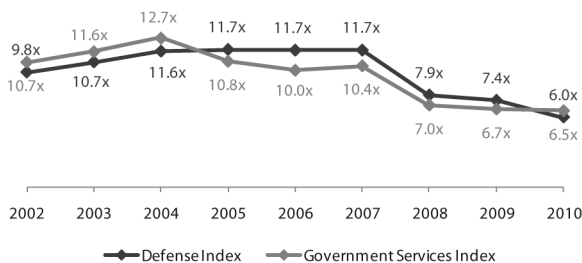
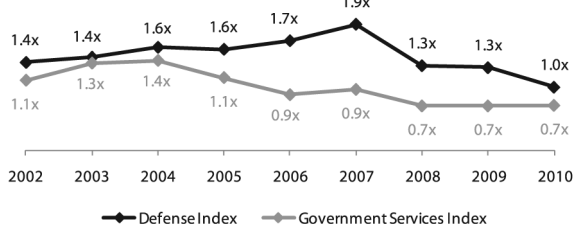


Figure 4. EV/Revenue Trading Multiples (2002-2010)



(3) The Middle-Market Crunch: The trend of mid-tier federal contractor consolidation continued in 2010. Middle-market firms generating between \$100 million and \$1 billion in annual revenue account for fewer than 5% of all federal contractors. Companies generating more than \$1 billion in annual revenue constitute less than 1% of all federal contractors. Thus, the overwhelming majority (~95%) of federal contractors is made up of lower-middle-market firms and small businesses. Middle-market contractors are squeezed on the one hand by large prime contractors (wielding substantially more human capital, financial resources and past performance qualifications) and on the other by small businesses leveraging very strong customer relationships and, in many cases, eligibility for Small Business Administration (SBA) set-aside advantages unavailable to mid-tier firms. Accordingly, middle-market firms often are forced to become buyers or sellers in the pursuit of strategic growth or an eventual exit. Mid-tier firms routinely acquire smaller companies to gain scale, key capabilities and/or customers while making themselves

more attractive acquisition candidates for larger firms seeking transformative acquisitions that will “move the needle”.

In 2010, middle-market firms experienced increased pressure from the top as the government pursued a more cost-effective procurement process by making bundled contracts much more commonplace. Agencies rolled numerous contracts with similar scopes of work into larger indefinite delivery, indefinite quantity (IDIQ) solicitations, often worth hundreds of millions of dollars. This caused difficulties for mid-tier firms lacking both inherent advantages of SBA set-asides and the business development/program management expertise of larger firms. In addition, the federal government made public its preference for firm fixed price (FFP) contracts versus time and materials (T&M) awards that in prior years were more prevalent.

Pressure from the bottom continued in 2010 for middle-market companies as well. Small businesses with access to SBA set-aside contracts have a significant competitive advantage in the marketplace over their mid-tier competitors, who often face-off against much larger contractors in “full and open” procurements. Government agencies are required by law to award a percentage of contracts to small and/or disadvantaged businesses annually (usually in the area of 25% of all contract spending).

(4) Asymmetric Warfare: Despite much uncertainty throughout 2010, one thing became clear: the manner in which the U.S. and the world historically addressed military and social conflict no longer was an effective deterrent. Since 9/11 in particular, the rise of asymmetric warfare has required the U.S. and its allies to reassess military and homeland security strategies and tactics—both offensive and defensive—to develop new approaches. Counterinsurgency (COIN) doctrine was not new in 2010 when it was resurrected for use in Afghanistan following its success under Gen. David Petraeus in Iraq.

Asymmetric warfare was a key theme of 2010, driving significant defense and government

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services M&A activity. Large and mid-tier contractors targeted firms with leading technologies, capabilities, and customers to reposition themselves strategically within well-funded areas of the federal budget (e.g., cyber security, intelligence analysis, data analytics, physical security, secure communications, and soft power). In McLean's full report, *2010 Defense & Government Services M&A Year in Review*, we plotted a selected group of key 2010 transactions by core capability and estimated deal size. Collectively, these transactions demonstrate the essential role contractors play in support of mission critical defense and intelligence programs and the "ripple effect" of geopolitical events and policies on private industry.

(5) Organizational Conflicts of Interest: During 2010, government regulators scrutinized many of the U.S. government's massive weapons and IT systems and contractors for potential organizational conflicts of interest (OCI). Government regulators paid particular attention to contractors providing systems engineering and technical assistance (SETA) services to design or recommend systems for which they subsequently performed integration work or supplied technology.

Large prime contractors reacted to 2009 rumblings that preceded the OCI April 2010 announcement by rushing to divest business units that potentially could raise conflicts with higher priority divisions. In nearly every case, this involved SETA business divestitures, creating an interesting marketplace dynamic. Although often substantial in size and attractive in capabilities and customers, these SETA divisions had a very limited buyer universe. Larger units such as Northrop Grumman's TASC division and Lockheed Martin's EIG division were too big a bite for peers while other large primes could not acquire them without confronting the very issues their competitors were trying to mitigate.

Private equity firms, on the other hand, found these businesses incredibly attractive platform investments. With ample size and critical mass,

transparent government contract backlog revenue streams, and strong relationships with the world's largest customer, these businesses fit the financial sponsor model perfectly. The only potential setback would be limited exit opportunities, since a sale to a strategic buyer after a five- to seven-year holding period (on average) would be unlikely unless the OCI climate changes dramatically. By default, then, IPOs constitute the most likely exit option, and one that would be attractive to Wall Street investors and analysts for the same reasons financial sponsors liked these deals in the first place.

Conclusion

M&A activity in the Defense and Government Services sector historically has been a leading indicator of market direction. Large and mid-tier contractors reevaluated their short-term and long-term objectives during 2010 in response to increasing marketplace uncertainty and turned to M&A to complement organic growth initiatives. Looking forward, the ultimate outlook for the sector remains to be seen, but the dynamic environment is likely to favor certain firms and become even more challenging for others.

Editor's Note: This article was developed from topics in The McLean Group's larger 2010 Defense & Government Services M&A Year in Review. You can obtain a complimentary version of the full report at www.mcleanllc.com/pdf/GCwhitpaper2010.pdf.

Mitch Martin is a senior managing director in the The McLean Group's Defense & Government Services Practice and can be reached via email at mmartin@mcleanllc.com. Geoff Nattans is a senior associate in The McLean Group's Defense & Government Services Practice and can be reached via email at gnattans@mcleanllc.com.

The McLean Group is a middle-market investment bank based in the Washington, D.C., area providing merger and acquisition advisory, corporate finance, and business valuation services.

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