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Top 10 Trends in the Defense and Government Services M&A Markets

By Mitch Martin, MBA, MPA

During the first half of 2012, we tracked 76 transactions that closed in the defense and government services sector, a number below historical norms. However, given the expected increase in capital gains taxes at the end of the year, we might now see a spike in transaction volume similar to what we saw in 2010. That said, it is unclear exactly how budget pressures and sequestration risk will impact transaction activity for the remaining two quarters. Continued economic uncertainty has created a disconnect with respect to valuation expectations. That is, who bears the risk if a company isn't making its numbers or contracts are delayed, the buyer or the seller? In light of these uncertainties, here are 10 trends we are currently watching in the defense and government services M&A market.

1. Use of capital. Automatic, across-the-board federal budget cuts (sequestration) now pending will continue to place downward pressure on government spending, making organic growth challenging. Buyers continue to have substantial cash reserves and debt capacity, but there's a threshold for the return demanded by shareholders. If companies think they can get beyond a certain return with cash investments, then they make those investments. Otherwise, companies should give the cash reserves back to shareholders. Currently, a lot of government contractors—including primes such as Lockheed and General Dynamics—are repurchasing their own shares, granting special dividends, or giving cash back to their shareholders. This is an indication that many of the organic and inorganic growth opportunities they are seeing do not provide the risk-adjusted expected financial return necessary to justify the investment.

2. Reconsidering cost of capital. If a company wants to grow, it can make investments in organic growth—hire business development personnel, spend money on proposals, etc.—or the company can acquire businesses. To the extent that the pie is getting smaller, organic growth is much tougher and more expensive. As a result, companies in certain instances think M&A might be cheaper than it was a year or two ago. Buying market share looks attractive given the increased organic growth expense—more companies chasing fewer opportunities.

3. Sticking to knitting. In previous downturns in defense and government spending, we saw government contractors try to diversify into commercial markets. Historically, this has not worked out well for these companies because they underestimate how different the government market is from commercial. This move often requires a very different sales force, new business capture and time frame, different accounting systems, etc. With the exception of healthcare information technology, some cyber work, and a few other selected sectors, we aren't seeing the attempted diversification into commercial markets this time around. Many companies are divesting noncore businesses and returning to their core business model. Many of the smarter companies are saying, "We're going back to markets where we're very good and efficient, and we'll wait out the downturn."

4. Year-end close. A big driver for M&A in any market, but certainly government contracting, is what's going to happen with tax policy. The projected capital gains tax increase at the end of 2012 is contributing to strong sell-side activity. However, while the seller is strongly incentivized to close a deal by year end to pay the current 15% federal capital gains rate, the buyer is largely indifferent with respect to this timing. As a result, as due diligence and deal negotiations enter into November and December of this year, the buyer starts to gain considerable leverage on the smaller issues that could potentially drag the deal out. The buyer really doesn't care when the deal closes, but the seller has a very real economic reason to close it before the end of the year. We saw a similar dynamic in 2010,

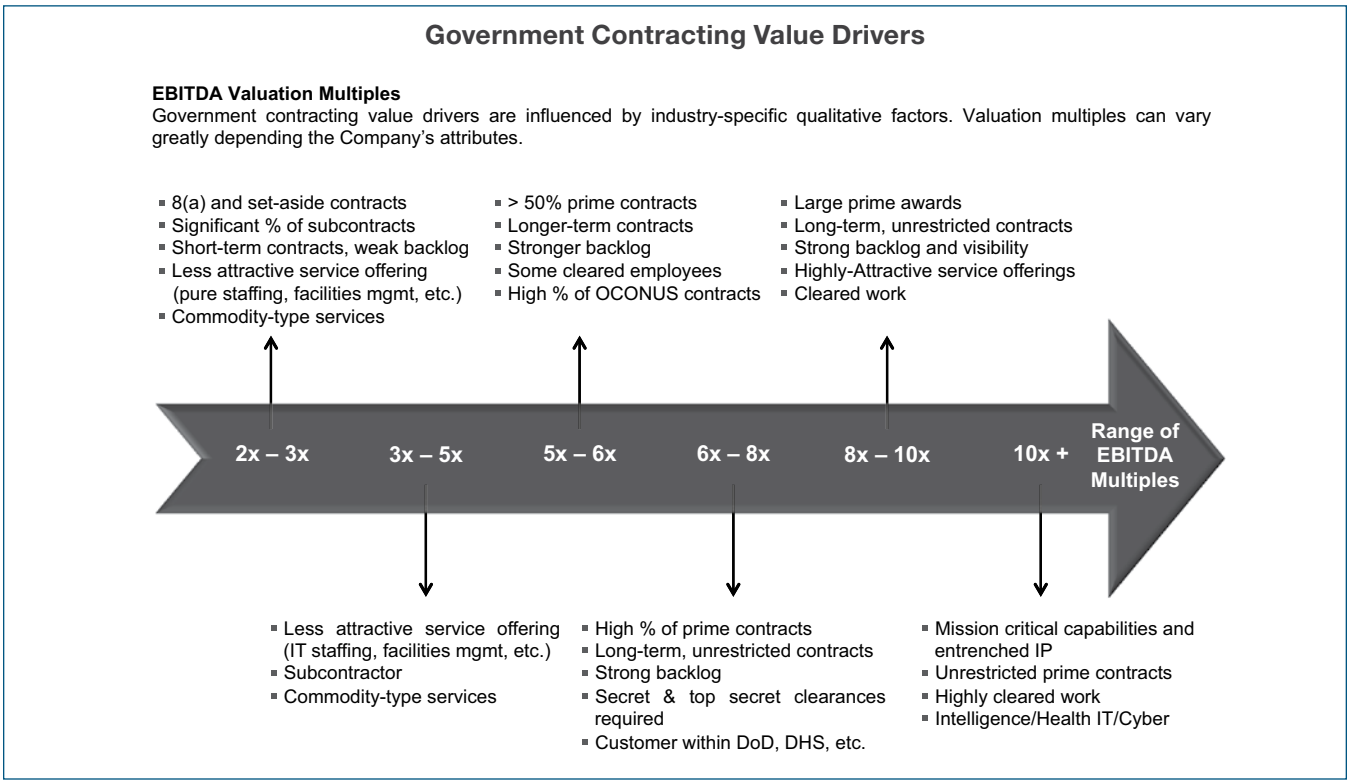
when people thought the Bush tax cuts would get rolled back.

5. Small company burden. Budget pressures are contributing to sell-side activity, which makes it tough for privately held, lower-middle-market companies to diversify risks. This small company burden is something we see quite a bit with the volatile federal budget. A company such as Lockheed Martin or General Dynamics can more easily weather the storm because its risk of losing work is spread over many contracts. These cuts could hit the smaller contractors in the middle market and lower-middle market because they have a smaller basket of contracts. One cut program could be a devastating loss for a small company.

The impact and the potential risks in the market going forward create different considerations for the smaller government contractors, most of which are privately owned. For example, if businesses serve as the owners' retirement plans and they've counted on selling for a certain price, they make different decisions than a large publicly traded company, such as SAIC, does, with a board of directors, a very senior and experienced management team, numerous stakeholders, and a very different time horizon.

6. Not over 'til it's over. In this environment, many sellers are missing their numbers, and buyers are deeply scrutinizing the sellers' projections. When it becomes very clear during due diligence that the sellers aren't going to make their numbers, buyers will want to renegotiate the deal price and terms. Furthermore, in this year more than others, projecting the timing for new business wins and when they will translate into revenue has been especially difficult. Contracting officers simply aren't letting new work; they are awarding contracts but delaying task orders; and they are even recompeting some existing work early on a low-cost, technically acceptable basis. While there are limits to what sellers can do in this environment, taking their "eye off the ball" and not continuing to perform during due diligence can be disastrous.

7. Finding opportunities. Government contracting value drivers are influenced by industry-specific qualitative factors. Valuation multiples can



vary greatly depending on the seller's attributes. Some companies are getting very high valuations—8x, 9x, and 10x-plus—in markets such as cyber, intelligence, healthcare IT, intelligence contractors, and data analytics. These are areas where funding will most likely stay constant or increase.

On the other hand, some companies are getting low valuations—3x, 4x, 5x EBITDA (see the exhibit). We're not seeing much in the middle as we used to. As a result, we are seeing more opportunities in the sector to make acquisitions at a substantial discount to historical comparables of companies that have strong cash flows and fundamentals but are in out-of-favor subsectors.

8. ESOPs and leveraged recaps on the rise. As a result of all this turmoil, we're seeing a lot of deals that aren't getting done. Sellers are looking at fallback options and asking questions such as, "What can I do to still take advantage of capital gains rates at their current level?" One alternative is ESOPs. The decreasing delta between market M&A and ESOP values is driving increased ESOP activity. Also, an ESOP is a natural transition for some of the many good-size companies that have limited liquidity options due to small business set-aside contracts. For similar reasons, we are also seeing an increase in leveraged recaps and the payment of special dividends.

9. Active financial buyers. We continue to see very strong private equity group activity, much of this focusing on systems engineering and technical assistance (SETA) contractors with organizational conflicts of interest (OCI) constraints. Government contractors cannot be on both sides of the fence. A company can advise the government about a program, for example, but cannot sell products and services to the government on the same program. Substantial government scrutiny over this exists, and companies often divest business units to avoid the scenario.

Primes such as Lockheed Martin and Boeing often won't bid for the advisor-type projects because this could potentially preclude them from much larger opportunities on the vendor side. However, many smaller companies do bid on these advisor projects because they do not have to compete against the primes. Many private equity groups have realized they can acquire these small companies at a good price (because they are not competing with strategic buyers), integrate them, and build something of scale and increased value in a relatively short time frame.

10. Financing. Sequestration and general economic uncertainty could lead to significant financing issues during the second half of 2012 when sellers are rushing to get deals done. We are currently seeing quite a bit of pushback from banks with lending to government contractors. Currently interest rates are very attractive, but we're just not seeing the amount of debt put on deals that we did in the past.

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