Defense, Diplomacy and Development

Opportunities for Federal Contractors Resulting from Cooperation Initiatives Amongst the US Departments of Defense, State and the Agency for International Development

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BACKGROUND
In the wake of the increasingly dynamic and irregular conflict environments following 9/11, the US military found itself deploying resources simultaneously across multiple engagements. Unexpectedly, Department of Defense (DoD) warfighters were playing front-line diplomatic roles by interacting directly with the local populace or providing humanitarian aid and assistance while restoring infrastructure in war-torn areas. Pre or post-conflict, these roles traditionally had been filled by a combination of the diplomatic efforts of the US Department of State (State) and the development and capacity building support provided by direct foreign assistance from the US Agency for International Development (USAID). As a result, the DoD had begun to step outside its core mandate of “provid[ing] the military forces needed to deter war and to protect the security of our country”¹ and actively embarked on strategies to establish secure and stable in-country environments—encompassing traditional objectives of both State and USAID. Recently, leadership at every level of the US government have taken steps to better coordinate programs and efforts amongst these groups to ensure that our national security and strategic interests are protected by deploying its best resources with the requisite experience in every case.

In 2010, this cooperative strategy has become a top priority. In its paper “A New Way Forward on Global Development”, leaked in early May 2010, the White House indicated its intent to “elevate development as a central pillar of our national security strategy, equal to diplomacy and defense; strengthen coordination between State and USAID; establish mechanisms for ensuring coherence in US development policy across the US Government; reestablish the US as the global leader on international development; and foster the integration of capabilities needed to address complex security environments.”

Although the United States is the world’s single largest donor of official development assistance (ODA), expenditures traditionally have been completed independent of other federal government efforts overseas—particularly military actions and engagements. Current inter-agency cooperation efforts mark the first time that the federal government has seriously tackled questions regarding US strategic investment in intertwined efforts that support and enhance national security and international diplomacy objectives. For example, joint task forces have been set up across DoD, State and USAID to promote better communication and cooperation, and State and USAID representatives have been embedded into DoD international commands (e.g. CENTCOM and AFRICOM). These initiatives are at the forefront of programs that continue to provide myriad federal contracting opportunities representing the convergence of Defense, Diplomacy and Development, or the “Three D’s”.

CURRENT COOPERATIVE ENVIRONMENT
Evolving strategies to protect America’s security and her interests overseas have gained traction at the highest levels of government. In its May 2010 policy paper, the White House reinforced its support of these initiatives and the benefits of integrating “all the tools of American power” to operate within complex security environments. The administration also indicated that it would provide strong incentives for the design of common programs to harness the expertise of specialized agencies in pursuit of US national security. While similar approaches have been explored for years, the Obama administration served as a catalyst to bring them into a more public forum. One year

¹ DoD Website. www.defense.gov/admin/about.html
ago, in July 2009, Secretary of State Clinton spoke at a town hall meeting about State's Quadrennial Diplomacy and Development Review (QDDR):

“The QDDR will help us create short-term and long-term blueprints for advancing our foreign policy objectives and enhancing coordination between USAID and the State Department, a crucial element of exercising smart power. Through this process, we will be working closely with the White House to harmonize the activities of USAID and the State Department with the goals and actions of the entire government... We see, in the Obama Administration, development as one of the most powerful tools we have for advancing global progress, peace, and prosperity. The President and I believe that it therefore must be a vital part of our country's foreign policy. And when I became Secretary of State, here in this great space, I pledged to elevate development to its rightful place alongside diplomacy and defense as we tackle the many global challenges and seize the opportunities facing us.”

Placing the “Three D’s” philosophy in the national limelight elevated humanitarian assistance to a prominence level equal to more traditional political and military solutions. The underlying theory is that marrying economic, trade, investment and security policies, the US can better assist struggling nations recover more quickly from crises and avoid sliding back into turmoil post-engagement. State’s QDDR initiative was adapted from the DoD’s Quadrennial Defense Review (QDR) process. In the DoD’s latest QDR, released in February 2010, DoD leadership explicitly expressed its intent to encourage “Three D” convergence:

“Preventing the rise of threats to US interests requires the integrated use of diplomacy, development, and defense along with intelligence, law enforcement, and economic tools of statecraft, to help build the capacity of partners to maintain and promote stability.”

In its QDR, DoD proceeded to publicly reinforce its commitment to build and execute “whole-of-government” approaches to national security challenges—a process which begins with improved cooperation with State and USAID. As the largest and best-funded of the three, DoD has acknowledged its charge to develop and execute upon a collaboration strategy to engage the agencies’ diverse, yet complementary capabilities most effectively. Secretary of Defense Gates has said, “One of the most important lessons from our experience in Iraq, Afghanistan, and elsewhere, has been the decisive role reconstruction, development, and governance play in any meaningful long-term success.”

High-level support for this inter-agency cooperation began despite USAID’s lack of an official top administrator. Dr. Rajiv Shah was sworn in as head administrator of the Agency on January 7th, 2010, marking the end of a nearly one year period following President Obama’s inauguration and significant uncertainty as to USAID’s priorities going forward. In his acceptance remarks, Dr. Shah stated that: “We find ourselves at a unique moment of opportunity. A powerful consensus has formed across this government, at the highest levels, that development is vital to both our national security and the shared interests of an interconnected world.”

Dr. Shah will seek to rehire and retain more expertise directly within the Agency and to utilize that experience to support contracting with a “partnership” rather than a “patronage” focus. The White House’s policy paper supported this strategy to rebuild USAID as the country’s lead development agency by attracting and retaining

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quality talent and bolstering its development capabilities across the board. Additionally, the White House indicated its intent to include the USAID administrator in National Security Council (NSC) meetings when appropriate to help assess the “development impact” of security policies, threats and engagements under review.

Each component of the three-pronged approach—DoD, State and USAID—contributes capabilities and invaluable experience that can complement and empower the others. For instance, while DoD’s in-country engagements by mandate have been military-to-military, it invariably retains a role in post-conflict security and can benefit greatly from USAID’s expertise in development, monitoring/evaluation and local knowledge; and from State’s experience in post-conflict reconstruction and stabilization operations. Providing the kind of assistance that “wins the hearts and minds” of civilian populations is critical to installing effective local security measures. At the same time, familiarity with—and providing input into—DoD’s regional peacekeeping capabilities are no less essential for USAID and State to operate effectively pre or post-conflict. Security and peacekeeping resources are vital to establish and maintain stability and enable rule of law initiatives to gain footholds in hostile environments, as well as support other humanitarian development efforts (e.g. agricultural, economic, communications, educational).

Although DoD, State and USAID often conflict with regard to the scope and timeframe of their respective objectives—they intersect in their common mission of furthering the interests of the US abroad. Using all three tools of defense, diplomacy, and development as elements of a cohesive and proactively managed strategy will accelerate the United States’ ability to achieve and protect its security and development objectives worldwide. This shifting landscape has created new demand for large federal contractors to create centers of integrated knowledge and experience across the “Three D’s”—whether defense, engineering, or management consulting-focused firms. To establish this expertise, many large contractors have turned to mergers and acquisitions (M&A) to add essential capabilities.

**Recent M&A Activity**

Several large and mid-sized defense and engineering federal contractors have positioned themselves well through M&A activity to capitalize on new budget priorities and contract opportunities resulting from the convergence of the Three D’s. Inorganic growth through acquisition has been, and continues to be, a primary strategy to sustain revenue growth and diversify amidst slowing growth in defense spending in coming years. The figure below identifies several selected M&A transactions during the last three years, indicative of the trend of larger defense and engineering contractors acquiring smaller diplomacy and development firms.

Overlapping defense and development programs create opportunities for DoD, USAID and State contractors alike. However, mid-sized and large contractors with the scale and experience to bid on larger opportunities requiring expertise in a diverse set of capabilities are best situated to benefit from increasing agency convergence. Furthermore, smaller contractors that have developed niche capabilities and particularly strong relationships with one or more of these agencies will continue to be attractive acquisition targets for their larger peers.
AECOM, one of the federal government’s largest engineering and infrastructure contractors, formed AECOM International Development by acquiring development firm The Services Group (TSG) in January 2008 and combining it with PADCO, an existing subsidiary acquired in 2004. AECOM International Development is positioned to provide fully integrated government services—from planning and capacity building to implementation and process management.

Coffey International, an Australian firm providing engineering, scientific, project management and strategic advisory services globally, announced two small acquisitions in March 2010. The large, publicly traded firm acquired Australia-based Global Justice Systems (GJS) for $4.5 million and U.K.-based Libra Advisory Group for approximately $3.4 million in a mix of cash and stock. The acquisitions strengthen Coffey’s presence in several areas of international development, including: stabilization and conflict prevention, rule of law and justice sector reform. Although relatively small firms, both GJS and Libra had developed niche specialties which were critical to executing the shifting defense, diplomacy and development strategies for their respective governments and international organizations. Furthermore, Coffey’s recent acquisitions complement its February 2008 purchase of Management Systems International (MSI), a Washington DC-based international development firm specializing in democracy and governance, economic growth and capacity building. Coffey paid approximately $25 million for MSI. With the

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4 Transaction data provided by Capital IQ
combined platform, Coffey has positioned itself as a prominent international development firm with a truly global reach and entrenched relationships with many of the world’s best-funded development agencies.

DynCorp International, a large DoD prime contractor, acquired Casals & Associates in January 2010 to expand its presence in the international development space. Casals specialized in implementing global programs promoting governance, accountability and rule of law and was prime contractor on several highly coveted USAID contract vehicles. DynCorp’s CEO William Ballhaus said, “This acquisition addresses our goal of creating value through continued growth and business diversification, and furthers our alignment with the Obama Administration’s emphasis on the application of ‘smart power’ to global challenges. We support defense, diplomacy, and development initiatives around the globe.” In April 2010, DynCorp announced that it would be acquired by private equity firm Cerberus Capital for approximately $1 billion or $17.55 per share. The Casals acquisition was a cornerstone in DynCorp’s management’s strategy to continue rebuilding their company into the leading provider of “soft power” services to the federal government. Cerberus’ subsequent acquisition is indicative of increasing interest in the federal contracting sector from financial buyers— who are attracted by the industry’s prevalence of long-term contracts and steady, transparent revenue streams.

ICF International acquired Macro International from Opinion Research Corp. for approximately $157.6 million in cash, plus $56.6 million in net assumed liabilities in March 2009. This represented an EV/revenue multiple of 1.4x and an EV/EBITDA multiple of approximately 12x. Macro provided research, evaluation and consulting services for federal agencies, including: HHS, State, Department of Education, and Veterans Affairs. The Company had more than 700 full-time employees. The acquisition brought scale to ICF’s international health programs and added key customers and capabilities. Macro had special expertise in research and evaluation surrounding HIV/AIDS, chronic disease prevention, behavioral health and health communication. At the time of transaction, Macro had a contract backlog worth approximately $452 million.

L-3 Communications, a large federal prime contractor providing C4ISR and other technology products and services primarily to the defense and homeland security markets, acquired the International Resources Group Ltd. (IRG) for $58.0 million in December 2008. L-3 is among many large defense contractors that undoubtedly will experience slowing organic growth in coming years due to heavy reliance on defense spending. As a prominent player in the international development community, IRG bolstered L-3’s capabilities surrounding governance, stability operations and reconstruction, economic growth and infrastructure development. Further, the acquisition provides a foot in the door at numerous federal agencies poised to receive increasing budget appropriations— particularly USAID.

Lockheed Martin spent approximately $700 million to acquire Pacific Architects and Engineers, Inc (PAE) in August 2006. Los Angeles-based PAE supported nation-building, training, disaster relief and military readiness efforts and had more than 6,000 employees. It provided State, DoD and other US and foreign agencies with facilities operations and maintenance, logistics and related services. By acquiring PAE, Lockheed built upon its focus of balanced, profitable growth and

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6 Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance
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complemented its existing capabilities, while adding a nation-building and development component. In partnering with Lockheed, PAE gained access to greater resources, more operational flexibility and a broader spectrum of services to provide its customers. Lockheed was among the first large prime defense contractors to step into the development space in 2006, recognizing the early stages of convergence and attempting to position with an integrated set of capabilities.

RTI International acquired MasiMax Resources in March 2009. Based in Rockville, MD, MasiMax strengthens RTI’s toolkit in the health communications field; its core services include: media and public relations, marketing, conferences and exhibits, and research and analysis. MasiMax’s marketing and communications expertise complements RTI’s more technical strengths. At the time of transaction, MasiMax had approximately 70 employees and $15 million in annual revenue. As of January 2010, MasiMax had been fully integrated into RTI’s Social, Statistical and Environmental Services Group.

Tetra Tech had built a thriving resources management consulting and engineering business but lacked international exposure and direct access to reliable revenue streams like those arising from civilian government contracts. Accordingly, the Company acquired ARD, Inc. in October 2007—gaining valuable global experience, technical capabilities and an established relationship with USAID. One year later, ARD, Inc. acquired DPK Consulting to bolster its presence in rule of law and government accountability programs, while also positioning itself to compete for upcoming larger-scale contract opportunities.

LOOKING FORWARD – OPPORTUNITIES FOR CONTRACTORS
Myriad opportunities exist for federal contractors with integrated government service capabilities across the spectrum of the “Three D’s”. In his FY 2011 budget proposal, the President expressed a commitment to, “using all of the tools of American power”—civilian and military—to advance US national security interests world-wide. The proposed FY 2011 budget for State, USAID and other international programs, released in February 2010, includes a significant 7.5% increase from its FY 2010 allotment—following unprecedented growth in FY 2010 figures, where State and USAID were allotted YOY budget increases of 13.1 percent and 88.9 percent, respectively.7

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7 FedSources, Inc.
As the US shifts from military to civilian presence in Iraq and focuses on executing a regional stabilization strategy in Afghanistan and Pakistan—missions for which it has budgeted $10.7 billion in FY 2011—there will be tremendous demand for contractor support in each of the three areas. The civil-military plan to build institutional capacity in Afghanistan, for instance, will require contractor expertise in anti-corruption, trade, agriculture, energy, communications and other areas. This combined effort will seek to improve regional stability by drawing insurgents away from the battlefield while providing the military with the tools necessary to execute an effective counterterrorism campaign.

US defense and foreign policy objectives continue to adapt to the demands of a dynamic global theatre, and DoD, State and USAID objectives overlap more frequently—ultimately resulting in both minor and significant conflicts of mission, scope and mandate. Disagreements involving agency philosophy and resource allocation, for example, present significant obstacles, but are inconsequential when compared to the immense opportunity for furthering US interests aboard by increasing the cooperation between defense, diplomacy and development initiatives.

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\[8\] FY 2011 Department of State Budget Proposal