Drivers of Value in Government Contracting M&A Transactions

The McLean Group
Investment Bankers to the Middle Market

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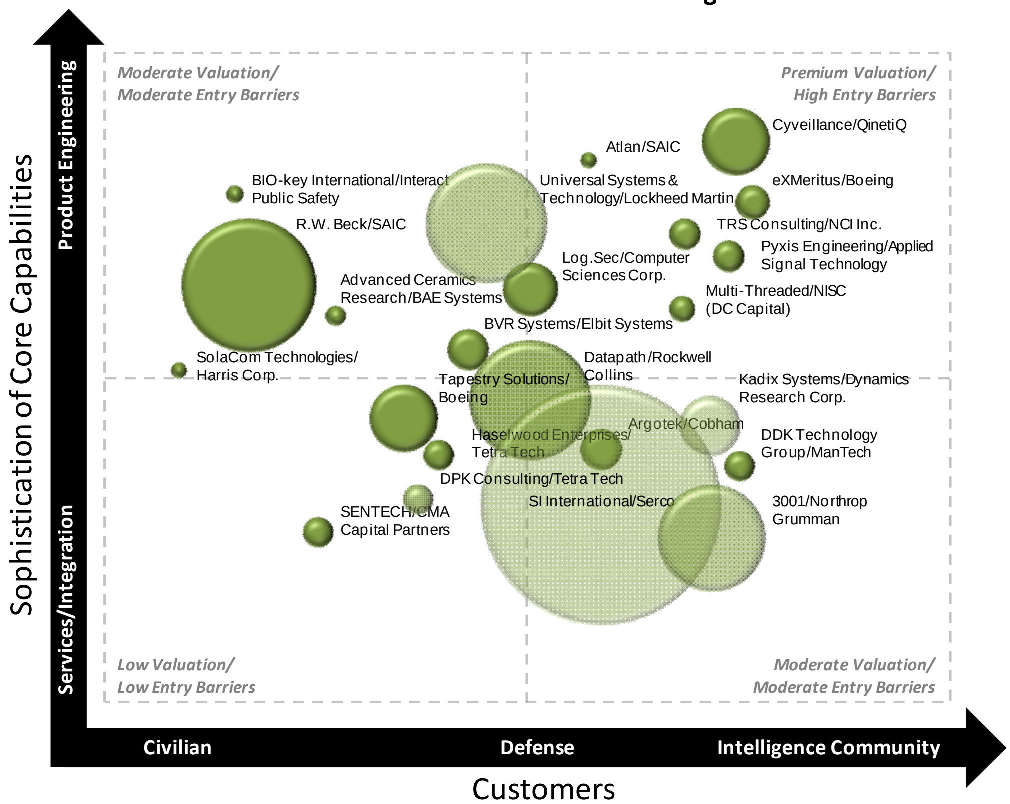
Overview

Private company valuations most often are derived from two key concepts: intrinsic value and relative value. Intrinsic value is a measure of quantitative and qualitative factors internal to a company that generally is determined by calculating the net present value of the company's future cash flows. Also indicative are such factors as revenue growth rates, profitability, core capabilities and management depth—qualitative characteristics that ultimately impact the quantitative analysis. Relative value, on the other hand, is determined by market forces and is measured by applying valuation multiples from recent M&A transactions for comparable private companies and trading multiples for comparable public companies.

M&A Transaction Analysis

Government services M&A valuations in the lower middle market—loosely defined as transactions valued at between $10 million and $200 million—typically are a function of company-specific value drivers (qualitative intrinsic characteristics) combined with the level of demand for a target company's capabilities and/or customers (relative valuation). The figure below presents theoretical relative valuations for selected recent lower middle market government contracting M&A transactions. Since official transaction multiples are unavailable for most recorded transactions, we made assumptions based on alternative value drivers and market intelligence to deduce financial metrics (i.e. number of employees, contract values, information in 10-K filings, etc.). Each acquisition is plotted according to its customer base and core capabilities, with the bubble size denoting estimated relative transaction size.

Selected Lower Middle Market Government Contracting M&A Transactions



Firms receiving the highest valuation multiples generally are located in the upper right quadrant—those that provide highly sophisticated engineering services (unique hardware/software "solutions") to the coveted US Intelligence Community (IC). These valuation premiums reflect acquirers' confidence that the IC will continue to receive substantial federal budget appropriations supporting current and future domestic and global security priorities. Firms that engineer proprietary hardware and software – to be licensed and resold as buyers see fit – often are more valuable in the marketplace than pure services and integration firms. Not surprisingly, competitors of companies found in this quadrant face the highest barriers to entry. The intellectual and financial capital necessary to engineer sophisticated products far outweighs the hurdles to be overcome to start a consulting or services firm. Furthermore, the US Intelligence Community poses significant barriers of its own, requiring contractors to pass extensive security clearances, maintain approved secured facilities and demonstrate a clear track record of successful past project performance.

The lower left quadrant includes firms that provide somewhat commoditized IT consulting/integration services primarily to civilian agencies. While this quadrant historically has generated lower valuations, it likely will benefit greatly from the new administration's focus on environmental services and healthcare IT—both of which are driven by civilian agency spending.

Companies in the lower right quadrant historically have enjoyed moderate valuations as firms providing mainstream IT services to the most restricted areas of the DOD and US Intelligence Community. Large and mid-sized prime contractors (Serco, Cobham, Northrop Grumman, ManTech, etc.) have been especially active in this quadrant, acquiring valuable agency relationships that smaller targets developed from successful project performance. With a "foot in the door," these large primes initiate market development strategies to cross-sell existing high margin products and capabilities.

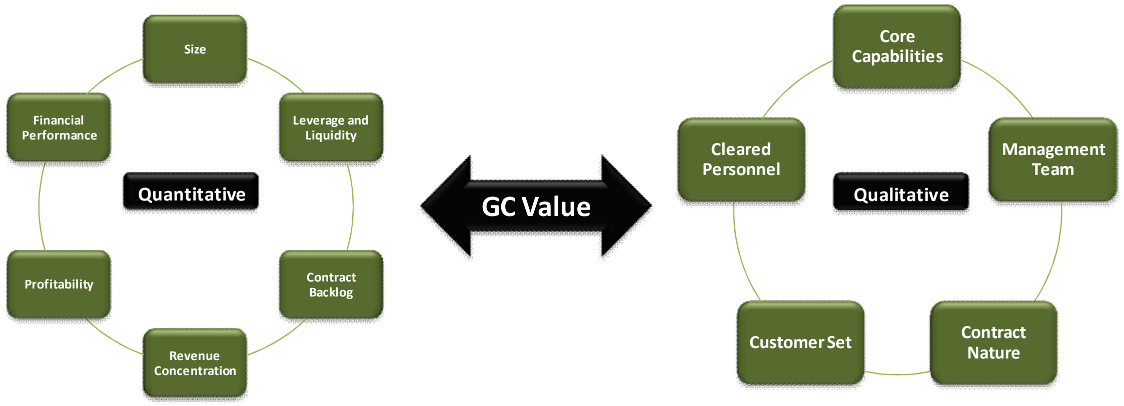
Acquisition targets in the upper left quadrant provide sophisticated product development and engineering services to civilian agencies. Valuations tend to be moderate, but they increase with the level of intellectual property incorporated in their hardware/software products, while declining in the face of the low barriers to entry common among civilian agencies. Acquirers tend to avoid buying into heavily saturated markets. However, evolving US federal priorities have positioned companies in the upper left quadrant to generate some of the largest valuation multiples in the next several years. For example, health care IT and environmental remediation firms having proprietary methods will become particularly attractive to prospective acquirers looking to grow inorganically through acquisition.

Investment Value

While intrinsic and relative valuation methods can provide an accurate range of value for a business, true worth can be determined only by "investment value"—the actual market price paid by an acquirer—which takes into account the full value of synergies, cost savings and growth potential. For example, firms with established distribution channels and customer relationships relevant to an acquisition target often are more confident in achieving revenue and profitability targets as a result of an acquisition and therefore are willing to apply higher valuation multiples. Investment value, therefore, ultimately is a function of a specific acquirer's short and long term strategic objectives—factors which can be uncovered only during a true market auction process.

Government Contracting Value Drivers

Valuations for government contractors within a particular quadrant in the aforementioned figure can vary widely, driven by certain qualitative and quantitative company-specific factors. A seller's relative strengths and weaknesses across these value driver characteristics ultimately will determine its ability to obtain a premium transaction multiple.



Size

Company size is an indicator of stability, successful track record, and depth of customer relationships. Valuation multiples tend to be lowest in the sub $5 million range and somewhat discounted in the $5 million to $50 million range. Above $50 million, discounts usually are taken if the business processes are not in place to support further growth or easy integration. Currently, the average transaction size when looking at government contracting acquisitions under $300 million in size is approximately $50 million.

Financial Performance

A company's growth rate is tied very closely to achieving a premium transaction valuation. High historical growth rates support the case for continued growth. Valuation multiples correlate directly with a company's future growth projections and an acquirer's payback calculations. In addition, revenue is the first measure of a business and reflects a company's market share. Future growth rates and assumptions often are driven by unique service differentiation and opportunities within particular market segments. Currently, market expectations for higher value companies reflect interest in acquisitions that are growing faster than the public companies' organic growth rates. Historical and projected growth rates of 10% are viewed as neutral while rates of upwards of 20% typically generate premiums. Furthermore, the value of a business often is grounded in its expectations of future cash flow and its growth prospects. In other words, the higher the growth expectations, the higher the valuation multiple.

Profitability

Profitability reflects the value proposition that a company provides its customers. Profitability also reflects financial stability and a company's ability to invest internally as required to support further growth. Currently, public government contractors' average profitability ranges from 7% - 11%. Those companies at the higher end of this range have the highest multiples.

Revenue Concentration

High revenue concentration with particular agencies or procurement offices carries with it an increased risk of non-renewals and a major drop in revenue. Conversely, companies that do not generate sufficient revenue with a particular agency may be found to have non-meaningful customer relationships with those agencies.

Contract Backlog

Contract backlog denotes revenue stability while providing acquirers greater visibility into company projections. Backlog is measured in many different ways, but is most effectively presented as funded backlog and minimum work value. Typically, acquirers like to see six to nine months of funded backlog. When evaluating total contract backlog, acquirers usually discount IDIQ values in order to focus on guaranteed levels of work. Acquirers also tend to discount projected work if there is no history to support the expected levels. To be a successful, highly valued government contractor, a proven track record of developing business over a long period of time and the ability to renew or replace expiring contracts are critical.

Leverage and Liquidity

Leverage ratios are used to calculate a company's indebtedness, evaluate the company's financing methods and/or determine its ability to meet financial obligations. The debt-to-equity ratio is the most widely used leverage ratio. The quick ratio also is used frequently to provide a conservative measure of a company's liquidity by expressing the degree to which its current liabilities are covered by its most liquid current assets. A quick ratio of less than one may reflect an over-dependency on inventory or other current assets to fund current liabilities.

Core Capabilities

A Company's core capabilities will define the market, competition and growth opportunities. High growth, mature and/or declining markets are found within the general IT industry and affect valuations. The value of a business often is a function of the nature of the services it provides to the government. Highly sophisticated and/or specialized services command higher market valuations. In addition, developing and maintaining unique proprietary solutions can provide significant barriers to entry while serving as a strategic differentiator and competitive advantage.

Cleared Personnel

The market's focus on the largest federal government budgets – those that support mission-critical DOD and Intelligence Community applications –has put a premium on maintaining high concentrations of skilled workers with high-level security clearances. This trend has been compounded in recent years by a security clearance requests backlog and resulting delays experienced by people seeking clearances.

Customer Set

Federal government customers fall into three distinct categories: civilian (DOC, DOE, DOT, GSA, EPA, OPM, etc.) defense (DOD and DHS), and the Intelligence Community. However, recent convergence among civil, defense and intelligence agencies has blurred demarcations among traditionally defined federal government agencies. Most notably, the increasing use of civilian contractors to provide nation building services overseas—including governance, security and education training as well as communications, transportation and other infrastructure services—incorporates critical objectives from each agency vertical.

In addition to considering *WHICH* agencies constitute a target firm's customers, buyers also consider *WHEN* they are being served. The US' annual federal budget appropriation, like the domestic and global priorities upon which it is based, is constantly in flux. Accordingly, contractor valuations become a function of this dynamic funding environment. The early- and mid-2000s—following 9/11—were a time of ballooning defense and intelligence spending to: hunt down and disable Middle East terrorist networks; to arm and organize ourselves with the necessary tools to prevent another such atrocity, and support our ongoing operations in Iraq, Afghanistan and Pakistan. Acquirers apply premium valuations to firms providing mission-critical services to the DOD and Intelligence Community, agencies whose budgets grew substantially during post-9/11. Firms with strong contract backlog and opportunity pipelines with high probabilities of success provide transparent, reliable revenue streams—features which strategic and financial buyers alike find worthy of premium multiples.

The FY2010 federal budget, the first under the new administration, has made no secret of its intent to reduce spending on traditional weapons-related defense programs and shift focus and funding toward cyber security, environmental services and healthcare IT, among other initiatives. As a result, much of the lower middle market government services M&A activity to date has involved firms operating in these high priority areas. Large and mid-sized prime contractors have rushed to acquire smaller firms that can provide an entrée into new agency customers through existing relationships and, equally important, to bring best-in-class capabilities to increase market share and penetration going forward.

Contract Nature

Companies that perform large portions of work as prime contractors typically maintain closer—and therefore less risky—relationships with customers. A company's ability to win, manage and perform on prime contracts provides acquirers confidence that it will be able to continue to win business – including larger contracts – in full and open competition in the future. Contract quality also can impact value significantly. A company's reliance upon special designation contracts, such as 8(a) or small business contract programs, ultimately can diminish value. Contracts awarded as 8(a) or small business set-asides are viewed to be of limited duration and value to buyers that do not have proper transition plans.

Management Team

Most acquirers want to see a strong management team in place, particularly at the project manager level. Buyers do not want to see former owners walk out the door on Monday with their former companies' direct customer relationships in tow. Commitment to employment agreements, non-competes and an integration time frame by key members usually is required.

Corporate Infrastructure

Achieving growth projections usually requires additional infrastructure investment in a company. To the extent that a smaller company already has made investments in management, financial and accounting systems, HR, ISO, increased facilities, and business development, the buyer may assign premium value to the firm.

Capitalization and Corporate Structure

Simple capitalization tables and corporate structures are preferred because the overwhelming majority of acquisitions are completed through equity purchases. Clear title and ownership history and simple stock class structure, visibility into option pools, and multi-year histories as "C" or "S" corporations are positives.

Other

Because the vast majority of government services transactions are completed as stock purchases, a buyer's comfort with legal and liability issues is important. Corporate records, tax filings, BOD minutes, contracts, leases, and past and current litigation records should all be in electronic and easily accessible form if possible. These considerations rarely constitute positive or premium drivers, but negative issues in this area easily can kill transactions.

Guideline Public Company Comparables

When possible, evaluating a business based on valuations of similar public companies can provide useful market multiples. In determining whether guideline public companies are comparable to a company, and whether their market multiples represent a reasonable proxy for that company, it is important to analyze such business characteristics as: size, business activities, growth, leverage, liquidity and profitability. A sample analysis of guideline public companies in the government IT services industry is provided below:

(in millions, except per share data and ratios)

Date as of: 9/30/2009

Market Capitalization

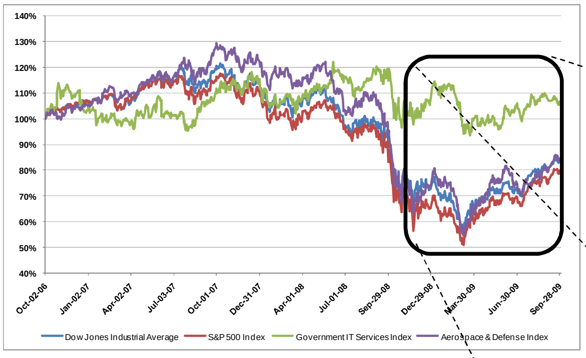
Company Name	Ticker	Stock Price	Annual Return	Standard Deviation	Daily Value Traded	Market Capitalization	Net Debt	Enterprise Value
CACI International Inc.	CACI	$47.27	-5.6%	39.7%	$8.1	$1,418.9	$429.1	$1,848.0
ICF International Inc.	ICFI	30.32	53.8%	54.1%	2.0	464.4	217.3	681.7
ManTech International Corp.	MANT	47.10	-20.6%	38.9%	17.4	1,680.0	(13.4)	1,666.6
NCI, Inc.	NCIT	28.66	0.6%	63.3%	1.2	386.2	24.6	410.8
SAIC, Inc.	SAI	17.54	-13.3%	22.5%	53.6	6,974.7	155.0	7,129.7
SRA International Inc.	SRX	21.59	-4.6%	60.8%	6.1	1,237.6	0.7	1,238.3
Stanley, Inc.	SXE	25.72	-30.3%	54.3%	3.0	617.3	159.9	777.2
Dynamics Research Corp.	DRCO	13.02	71.8%	57.0%	0.2	127.9	27.4	155.2
Low		*$13.02*	-30.3%	22.5%	$0.17	$127.86	($13.44)	$155.23
Mean		***28.90***	**6.5%**	**48.8%**	**11.43**	**1,613.36**	**125.06**	**1,738.43**
Median		***27.19***	**-5.1%**	**54.2%**	**4.53**	**927.43**	**91.19**	**1,007.72**
High		*47.27*	71.8%	63.3%	53.57	6,974.70	429.10	7,129.70

Implied Multiples

	Trailing Twelve Months				2009		2010	
Company Name	Revenue	Gross Profit	EBITDA	Free Cash Flow	Revenue	EBITDA	Revenue	EBITDA
CACI International Inc.	0.68x	2.15x	7.57x	13.21x	0.66x	7.76x	0.62x	7.31x
ICF International Inc.	1.02x	2.75x	9.93x	NA	1.02x	11.22x	0.93x	9.52x
ManTech International Corp.	0.86x	4.99x	8.69x	13.67x	0.81x	8.33x	0.73x	7.58x
NCI, Inc.	0.99x	7.28x	10.81x	14.12x	0.91x	10.22x	0.80x	8.77x
SAIC, Inc.	0.68x	4.94x	7.05x	19.24x	0.65x	7.27x	0.61x	6.62x
SRA International Inc.	0.80x	2.97x	8.88x	17.67x	0.79x	9.11x	0.74x	7.81x
Stanley, Inc.	0.95x	5.76x	8.48x	29.85x	0.92x	9.20x	0.85x	8.56x
Dynamics Research Corp.	0.58x	3.37x	5.96x	8.00x	0.55x	6.14x	0.53x	5.66x
Low	0.58x	2.15x	5.96x	8.00x	0.55x	6.14x	0.53x	5.66x
Mean	**0.82x**	**4.28x**	**8.42x**	**16.54x**	**0.79x**	**8.66x**	**0.72x**	**7.73x**
Median	**0.83x**	**4.16x**	**8.59x**	**14.12x**	**0.80x**	**8.72x**	**0.73x**	**7.70x**
High	1.02x	7.28x	10.81x	29.85x	1.02x	11.22x	0.93x	9.52x

The Government IT Services and Aerospace & Defense industry performance for both one and three year periods is summarized below. The Government IT Services industry underperformed the NASDAQ Composite Index and the S&P 500 Index from October 2006 to May 2008, but has significantly outperformed the benchmark indices during the trailing twelve month period ending September 30, 2009. Conversely, the Aerospace & Defense industry outperformed the benchmark indices for the two years ending May 2008, but has underperformed during the trailing twelve month period.

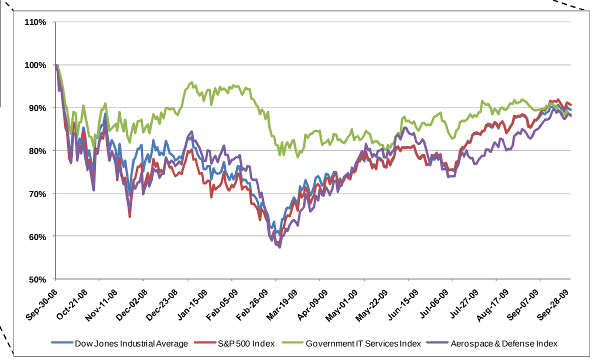
3 Year Relative Performance



Government IT Services Index: CACI International Inc., Dynamics Research Corp., ICF International Inc., ManTech International Corp., NCI, Inc., SAIC, Inc., SRA International, Inc., Stanley, Inc.

Aerospace & Defense Index: United Technologies Corp., Lockheed Martin Corp., Boeing Co., General Dynamics Corp., BAE Systems plc, Honeywell International, Inc., Raytheon Co., Northrop Grumman Corp.

1 Year Relative Performance



Guideline Public Company Discount

Public company valuations reflect the readily marketable nature of publicly held securities: a significant characteristic affecting the value of public securities. Applying a discount for lack of marketability to a public company valuation allows one to adjust public company valuations to align more closely with those of privately held companies. Several empirical studies have quantified the most appropriate discount to convert public company multiples to implied values applicable to private companies. The average discount derived from these studies falls between 25% and 45%. For most government contractors, a mid-range discount of 35% is appropriate.

Guideline Public Company Valuation Multiples - Government IT Services (Includes 35% Transformational Discount)								
	Trailing Twelve Months				2009E		2010E	
	Revenue	Gross Profit	EBITDA	Free Cash Flow	Revenue	EBITDA	Revenue	EBITDA
Low	0.37x	1.40x	3.88x	5.20x	0.36x	3.99x	0.34x	3.68x
Mean	**0.53x**	**2.78x**	5.47x	**10.75x**	**0.51x**	**5.63x**	**0.47x**	**5.02x**
Median	**0.54x**	**2.70x**	5.58x	**9.18x**	**0.52x**	**5.67x**	**0.48x**	**5.00x**
High	0.66x	4.73x	7.03x	19.40x	0.66x	7.29x	0.61x	6.19x

As of September 30, 2009, the mean discounted trading multiple for the selected group of guideline public government IT services companies was 5.47x trailing EBITDA.

Conclusions

To determine an accurate estimate of value for government contractors, one must analyze qualitative and quantitative characteristics using a combination of Discounted Cash Flow analysis, private M&A comparable transactions, discounted guideline public company trading multiples and company-specific value drivers.

While these methods can provide an accurate estimate value, true “investment value”—or the price/premium that an acquirer pays based on the presence of competing bids and the full value of synergistic growth and cost reductions—can be determined only by launching a true market auction.

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