

Midsized contractors look to M&A to avoid getting squeezed

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In the eyes of the US Small Business Administration, government contractors come in two sizes - small and large. And once they're large, they had better get a lot larger, according to sector advisors and investors.

Small businesses enjoy startup stimulus such as special contracts set aside that large companies can't touch. There is no such perk for being medium sized. So companies that graduate beyond small-business status are often "orphaned to no man's land," said an investor in the space.

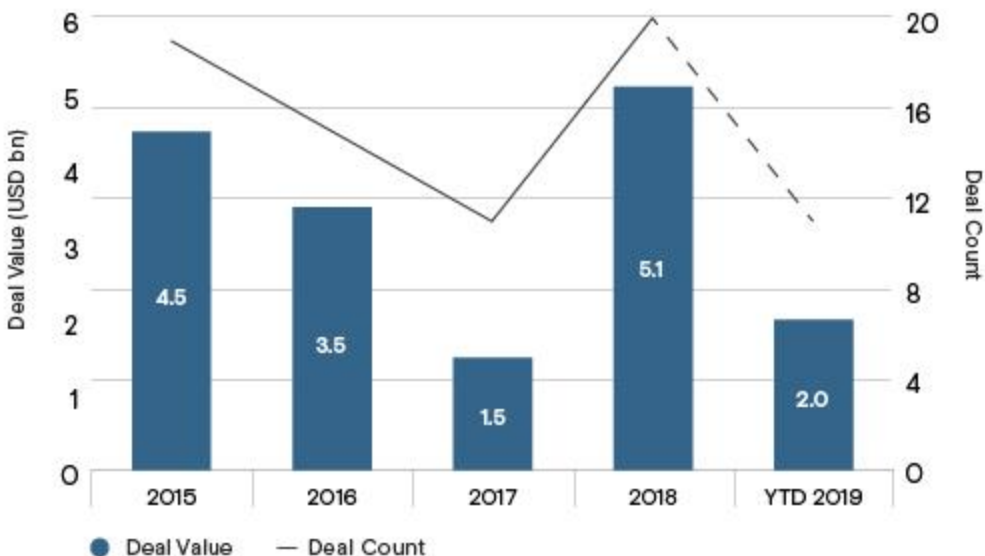
These "orphans" - generally in the USD 20m to 100m annual revenue range - divest assets to return to being "small," merge with similarly sized companies or find tuck-ins to grow quickly, the investor added.

"Most companies in that USD 20m-100m revenue range still have a lot of set-aside revenue," the investor said. "When combined with the fact that there are now many companies with more than USD 2bn of revenue, the new 'mid-tier' is really USD 100m to USD 1 bn of revenue."

The challenge of being stuck in the middle is one reason why M&A activity for 2019 in the middle tier of the aerospace, defense and government services (ADG) markets remains robust, he and the sector advisors said.

"There might not be a lot of banks involved in these deals or a lot of press releases, but there is a lot of action there," the investor said.

US Aerospace & Defense Activity (2015 - YTD 2019)



All data run from 01-Jan-2015 to 08-Aug-2019. Data correct as of 08-Aug-2019.
Deals with a total disclosed value between USD 30m and USD 1 bn.

Source: Mergemart

The challenge these smaller contractors face is how to transition from competing against similarly sized firms to suddenly taking on multibillion-dollar industry giants, said Greg Woodford, senior managing director of The McLean Group's ADG practice. "Because for that next step, you need to be USD 500m to 1bn [in revenue] to compete, and that's very hard to do," he said.

The unintended consequence of SBA regulations is that it puts companies at a significant disadvantage when they graduate. The SBA defines 'small' based on different factors, such as employee headcount, the type of work a company does, or annual revenue. Typically, professional service contractors cease being defined as 'small' once they reach USD 27.5m in revenue and sustain that average over a three-year period, referred to as a firm's 'look-back.'

Woodford said companies that reach USD 50m to 100m in revenue often decide to find buyers or "shrink" back to small-business size. "Increasingly, business owners who struggle to grow are choosing to manage their businesses to stay under the small business size standards," he said.

Another option is to scale up through a tuck-in. For example, in June defense contractor METIS Solutions acquired defense contractor Pluribus International Corporation for an undisclosed amount.

According to the investor, who is familiar with that deal, METIS wanted to grow out of its 'small' status and didn't want to sell or divest assets, so it found a target that

already had unrestricted contract vehicles and different capabilities that would help it scale.

John Allen of Bluestone Investment Partners said the rules about size are arbitrary. "I do not think that the definition of small is anywhere near relevant to where the market is today," Allen said, adding that this gap makes being small "a blessing and a curse."

Small businesses need to have a plan early in their life cycle that leverages SBA programs and positions them for unrestricted work, he added.

To help small companies as they grow, the Small Business Runway Extension Act of 2018 changed the look-back time a small business must use to measure its annual revenue from three years to five. It became US law in December but has yet to be completely implemented by the SBA.

Both Woodford and Allen agreed the new law might not help the middle tier much, though.

"I think a lot of contractors are excited about it because it provides them a longer runway to grow," Woodford said. "But in some ways, it is only extending the same problem because eventually they are going to have to make that jump."

Allen said "graduation should not mean the end of work or the end of contracts or the risk of losing contracts."

The investor said a system of special preferences for middle tier contractors in the USD 500m to USD 1bn revenue range is something he doesn't see coming anytime soon.

"It's hard to look at US taxpayers in middle America and say here's a poor, disadvantaged, half-a-billion or billion-dollar company," the investor said.

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