Defining the Value of a Government Contracting Business – Science, Art or Alchemy?

When a shareholder of a small- or mid-size government contracting business initially considers an exit strategy, the first-order issue inevitably involves setting the business’ value. Valuing a business is not an exact science, but it is not purely an art either. It is a little bit of both—a kind of an alchemy. For centuries, alchemy was used to define elements that appeared combine forces to create an outcome. Elements of science, like chemistry, with art and astrology were used together to define the physics and behaviors of ancient world. Today, we can quantify a business’ value with industry conventions or approaches, methods and formulas, but the price that a business is sold for depends on fundamentals that are inherent aspects of the business, as well as aspects that are not directly tied to the business’ economic value. The business’ future economic capacity as seen through the acquirer’s eyes is the determinant of value that sets the price. Capturing those future intangibles is the art of alchemy.

Elements known as value drivers, which are specific to a business or industry, have a marked impact on value. These value drivers are where a shareholder can focus his or her resources to best prepare the businesses for sale. The value drivers that any particular government contracting business possesses are where acquirers conduct most of their analyses.

The questions acquirers will attempt to answer in their analyses include:

· What financial, operational or strategic benefit will we gain by making a particular acquisition (these are the financial and operational synergies that an acquirer will project to see a return on investment [ROI])?

· What is the company worth? What is it worth to us?

· What is the top-end price we will pay at our requisite hurdle rate (required ROI)? What’s our low-end?

· What are the risks associated with the acquisition? Are the target company’s services a commodity? Is the target company a “body shop”? Does the target company have a defensible position, technology or service in the market? How long can it maintain its competitive foothold?

· If in a competitive bidding situation, and the cost to acquire is at or above the indicated requisite hurdle rate’s top-end value, is there a strategic advantage (i.e.: gain in market share, lock-out of competition) that can be gained through the acquisition that supersedes initial hurdle rate guidelines?
The value of a government contracting business is driven by several identifiable value drivers that are grouped into the following five factors:

1. Financial Performance
2. Growth
3. Contracts and Customer Relationships
4. Management and Human Resources, and
5. Market Differentiators

We will look at how each of these value drivers impact value. Some are probably obvious. Some may not be as imperative for current operations, from a shareholder’s perspective. Keep in mind that when preparing a business for sale, your target is: to look through the potential buyer’s viewpoint.

Financial Performance
An acquirer will first review a company's financial statements, accompanying sales data, and industry and market metrics. Cash flow is the biggest determinant to value in all but the very rarest of deals. Size does have an impact on value as larger companies usually have lower supply costs and lower costs of capital and therefore often garner higher multiples. Market share also has an impact to value but the impact of market share is different depending on government sector (see also Contracts and Customer Relationships). The value of a government contractor as tied to its profitability can be relative to size, market sector, types and size of contracts, types of services, etc. Leverage and liquidity are often of lesser importance as debt is most often not assumed but paid off in a transaction. Where this comes into play is when debt or capital structure is to be assumed or needs to be refinanced or when highly leveraged companies do not leave much for the current shareholders after debt is paid off. If the current company’s credit rating can affect an acquirer’s overall ability to access affordable capital, that can become an issue that could be a detractor in a sale and could negatively affect value.

Growth
Demonstrating a strong, consistent, positive growth-track over a number of years is a valuable attribute. A good track record of renewing expiring contracts also adds substantial value. Backlog is evidence of a definitive revenue stream and backlog which is fully funded is more valuable.

The future growth that a company has projected is often an issue that is hotly debated. How much is to be realized? And, who gets the credit? Negotiations for future revenues are won with a combination of many things. Know what is happening and be up-to-date on within your industry. Be prepared to defend growth projections with analysis and research. Backlog and funding issues aside, possessing good, solid research and having intimate knowledge of your client agency’s future demands will raise your credibility and lead credence to your forecasts. A likely buyer will be an industry strategic buyer and will have access to this information. You don’t want to be caught off guard during negotiations with information that could negatively impact value or derail the process.

Contracts & Customer Relationships
Special mention should be made of the restricted nature of 8(a) and Small Business set-aside contracts. On June 30, 2007, the SBA issued a new regulation affecting mergers and acquisitions of small businesses. The effect is that if, during the term of a contract, a business grows out of its "small" size (i.e., they are acquired and need to be recertified), that although terms and conditions of the original contract may still apply, the buying
agency no longer gets credit for contracting with that small business. If this is an issue with an acquiring company, it will affect the value that a small business has. An 8(a) firm has similar limitations due to the value of contracts that were awarded based on their 8(a) status. Both of these “set-aside” contract issues may limit the value of the contracts that a government contractor holds as the acquirer may not be able fulfill the contracts. This is now an issue for some acquirers but some deals are still getting done with companies that hold restricted contracts. For many acquirers the jury is still out as to the long term affect that the new SBA ruling will have on M&A transactions.

**Customer or contract concentration** can also be a detractor that can negatively affect value. Buyers like diversification. For obvious reasons, too much customer concentration or contract concentration will negatively affect value. Although there is the rare exception where concentration is not a detractor, the acquirer must be very motivated to build a relationship with a particular agency.

**Holding more prime versus sub contracts** is regarded as being more valuable because the prime contractor has control and typically has better relationships with the agency. Outside of the obvious benefits of owning the contract relationship, the holder of the prime relationship has a higher probability of contract renewal and the possibility of expansion of the scope of contract awards with the agency where the contract is held.

**Management and Human Resources**

**Certain types of clearances (Top Secret, Q-Cleared), etc., can be very valuable to acquirers** who have a defined need to conduct business with specific agencies. The goal of a strategic acquirer is not just to procure additional manpower but to obtain access to new agencies or qualify for new contract bids that require cleared, experienced or certified personnel. Clearances aside, top technical talent experienced with certain types of programs, software or experience with specific agencies, are highly desirable and valuable assets.

**The depth and breadth of management** can be a critical factor in an acquisition, especially if the acquirer cannot or does not plan to parachute new management into the seller’s operations. For most acquisitions that take place in the government contracting space: in the lower third of the mid-market, defined as businesses with values between $10 million and $100 million, management in-place at the time of the acquisition are a very important part of the acquisition and integration (post acquisition). Current company management hold most of the key internal and external company relationships; they have tenured experience with the current company’s processes and procedures. They have a great deal of impact on the company culture: they are the glue that holds a company together and the grease that keep it running smoothly. Managers that can bridge the gap between the old and the new company culture can be invaluable in a transition.

**When too much responsibility is held by one person** (or by a small group relative to the size of a company), that can be a detractor and result in a reduction in the value of a business. When the exiting shareholders own all or the majority of the key supplier, external or internal customer relationships, this becomes an issue; one often ignored until the shareholders are ready to retire: They have run the business for 30 years; have met or exceeded their goals, are burned out and are ready to head out the door. But, they want a fair price for their business. The problem becomes obvious too late. They have worked in the business too long and not taken the proper time to take a step back for a few years before retirement and work on it. Transferring those key relationships and responsibilities throughout the company—as far down the organization as is practical, builds value in an acquirer’s eyes. It also frees up the key share holders to build strategically versus working in their business to only accomplish day-to-day tasks, and thus should pay additional dividends. These could come in the form of additional cash flow, retirement savings, less stress and a better price in the market when the business is sold.
Market Differentiators

As in any industry, the more a company can differentiate product or services (or create barriers to replication or market entry), the more valuable a company is to an acquirer. Developing proprietary technology, systems (patented, defensible or hard to replicate), or knowledge can be a significant value driver. One note here is that technology by itself is hard to sell. A business built around technology from which revenues are derived is what strategic acquirers look for. Custom solutions for industry software that require integration into client specific applications are one step away from a proprietary technology. Depending on the software, the degree of customization (minimal adaptation versus customized programming), and the application or solution, or the agency where the application is being implemented—the value of the services or solutions being rendered can be seen as a valuable asset to an acquirer. The question is whether the solution is a commodity or a unique product or service. Highly technical or specialized services that can generate added value and revenues are highly sought after.

In summary, experience tells us that in most cases it is best to plan for an exit as far in advance as is feasible. Art, science and alchemy aside, if you can be critical but honest, and can make changes in your operations to bolster your potential value as potentially seen through the eyes of a buyer, you will have a much higher probability of selling your business at the price, terms and conditions you desire. Three years of advanced planning is recommended. If there are not market, industry or lifestyle conditions dictating an earlier withdrawal, a strategic exit strategy developed and implemented over time is the best method to build value.

Oh, and don’t forget, there are Deal Drivers and Risk Drivers that also affect value. Get a valuation from an experienced valuation group that offers valuation services as its primary business and can show you their depth of knowledge and experience, and can talk to all of the drivers that can affect value. As a last note, assembling a deal team (consultants, legal and accounting council, M&A advisors, etc.) that can assist you is crucial in developing and executing an exit plan.