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Aerospace, Defense and Government Services

July 2019

Government contractors strive for bigger awards with PE backing

24 JUL 2019

- Drawn by counter-cyclical nature of government services sector
- M&A for aerospace and defense on pace for highest level in five years

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Private equity firms are pouring more cash into the aerospace, defense and government services sector, where small businesses need the help of deep pocketed financial sponsors so they can compete for larger contracts, PE executives and sector advisors said.

According to Mitchell Martin, a senior managing director of **The McLean Group**'s ADG investment banking practice, PE has been especially interested in companies with high amounts of set-asides — portions of federal government contracts that must be awarded to small businesses.

Martin said the set-asides represent an "extremely important dynamic" in the middle and lower middle markets because they can disappear following M&A transactions.

When a large strategic buyer acquires a small firm with set-asides, it often means those contracts will go away, if not at the time of the acquisition then certainly when it's time to re-compete for them, said Kevin Robbins, a partner with PE firm **Blue Delta Capital Partners**.

"It is up to the contracting officer's discretion as to whether or not they want to continue that work," Robbins said.

Exposure to these contracts lowers a firm's EBITDA multiple in the event of a sale to a strategic buyer, while also putting a "big damper" on enterprise value, he said. "If you are a majority small or majority (subcontractor) you are gravitationally constrained in terms of what people will pay," Robbins said.

"Buyers are always going to shy away from set-aside contracts, and that's always going to have a negative impact on valuations," Martin said.

But selling to a PE does not trigger that process. With a financial sponsor, the company gets to remain small in the short term, while also receiving capital that allows it to become more competitive over time. The idea is to grow and eventually win larger and unrestricted "full and open" contracts.

Once a firm gets those full and open contracts, Martin said, the PE usually exits and the large strategic players make their acquisitions.

Two examples of the trend occurred in April. PE firm **Arlington Capital Partners** became the majority investor of **Octo Consulting**, while **Enlightenment Capital** made an investment in **Trowbridge & Trowbridge**. The financial details of both deals were undisclosed, but *Mergermaket* deal data reported Octo generates around USD 15m in EBITDA and was expected to fetch an EBITDA multiple of around 10x.

Hogan Lovells partner Carine Stoick, who heads the firm's ADG M&A group, served as legal counsel for contractor **By Light Professional IT Services** when it was acquired by PE firm **Sagewind Capital** in May 2017 for an undisclosed amount. She agreed there has been more PE involvement overall and said one reason is the "robust government budget."

She mentioned specifically **Veritas Capital** and Arlington Capital as two PEs that have made multiple acquisitions and been very active participants in the ADG sector.

According to *Mergermarket* data, the number of M&A deals in the AD sector, excluding government services, is on pace to be the highest it has been in the last five years, with 46 deals recorded so far through July 15. That's the highest since 2015 when 80 deals were reported and 2018 when 78 were tallied. With the number of PEs in those M&A deals numbering 12 this year, or 26%, PE involvement is on pace to be the greatest in the last five years. The previous high was in 2016 when the sector saw 22 PEs, or 37%, involved in 59 deals.

PE Share of Aerospace & Defense Deals Rising Again

Source: Mergermarket

Last month, Arlington Capital raised its fifth fund. At a hard cap of approximately USD 1.7bn, it was oversubscribed. Less than three years prior, the firm raised USD 700m for its fourth fund.

Blue Delta received a similar reception from investors in raising money for its recently announced USD 125m, ADG-focused strategy and growth fund, the firm's second, because the sector is a “very safe place” to park money during a downturn, Robbins said.

Because the fundraising is ongoing, Robbins could not disclose an exact amount raised to date.

“We can debate how much of a correction there will be, but we cannot debate that there will be a correction,” Robbins said. “And when there is a correction, the government services market tends to behave counter-cyclically. It flourishes during a recession.”

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