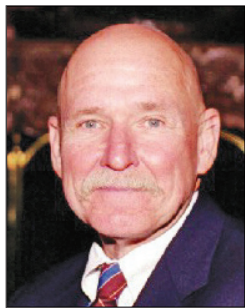


Should I sell now? How Long Will the Current Valuation Bubble for Government Contractors last?

An Investment Bankers View

It is no secret to anyone in the government contractor (GC) industry that for several years there have been unprecedented valuations placed on acquired companies. No one, who is not blessed with a crystal ball, can exactly predict the length of any high valuation merger and acquisition (M&A) cycle. There are however, certain factors



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that are known about M&A cycles that if carefully considered, can help owners make informed decisions as to the timing of their exit strategies in order to maximize the value of their ownership interests. The current bubble in the GC world has some unique factors going for it, but it is not unique to the GC world that all high valuation cycles have a finite life.

Recent Industry Cycles

The temporary staffing industry valuation bubble occurred in the middle 90's, as domestic outsourcing of technology needs was growing at a torrid pace. This bubble resulted in acquisition multiples as high as 11 to 12 times trailing earnings being paid by strategic buyers. At the end of a three year cycle, the industry valuations reverted back to multiples of 4 to 5 times trailing earnings.

There were the "roll ups" of the 1990's, when it was popular to buy and roll up fragmented privately owned middle market companies and resell them as IPO's. The

valuations for the acquired companies were very high and the bubble lasted for about three years. Everyone remembers the ridiculously high valuations of the internet and telecom industries, which came to a screeching halt, again after about three years in early 2000.

What We Can Learn From the Past

It is important to understand that historically the higher valuation middle market M&A cycles consist of four important elements:

- **Duration:** M&A cycles driven by the macro economy typically last for periods of up to 3 years, followed by a much lower valuation cycle (return to normal) of similar duration.
- **Drivers:** The robustness of the U.S. economy, changes in business processes and/or industry specific growth factors are the primary drivers of high valuation cycles.
- **Multiples:** In down cycles, valuations typically revert back to a range of 4 to 5 times trailing earnings. In up cycles, valuation multiples rise to whatever multiple is supported by the industry growth rate. Once the growth has peaked, the higher valuation multiples will come to an abrupt end. Buyers buy future earnings and they pay multiples higher than 5 only if earnings are growing.
- **Buyer characteristics in high valuation cycles:** Middle market M&A is a food chain with the big fish (public or well financed private companies) gobbling up the smaller fish, eating all they can, getting satiated and then typically spending several years dealing with the digestive disorders (integration) that resulted from their earlier bingeing.

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So What Does the Future Bode?

Most M&A experts estimate that we are slightly more than two years into the current cycle and that the current cycle is good for perhaps another twelve to eighteen months.

There is no question that the current bubble in GC valuations got its big push in early 2002 following the tragic events of the previous year. In terms of Government spending, which has floated all GC boats higher since 9/11, it is important to note that coming off a \$400 billion record setting deficit last year Congress is already looking at spending cuts and Agency spending, even in defense and security, is showing some signs of a decline in the rate of increase as well. It isn't necessary that government spend less to end the boom, it is merely necessary that it lower the rate of increase in spending. It is the rate of increase, as opposed to absolute spending, that drives growth in the industry and allows the very high valuation multiples.

As to buyer characteristics, again *deja vu* sets in. The last two to three years have seen a relative plethora of capital raises and IPO's, initiated by the larger (buyer) contractors which have been used to make acquisitions of middle market GC companies. The usual questions arise regarding satiation and integration. Inevitably the acquirers simply slow down in order to integrate what they have already acquired or because they have depleted the capital available for acquisitions. These are recent signs that that we may be approaching the end of the very high valuation cycle in the GC world.

Some of us will remember that until around 2000, GC acquisition multiples were nothing to brag about, ranging usually between 4 and 5 times trailing earnings. In the last two years we have seen multiples range as high as 8 to 11 times trailing earnings. This is very reminiscent of the staffing industry bubble of the mid 1990s and again is driven by a very rapid industry growth rate. Even civilian agency contractors have been basking in the glow of their non-civilian counterparts.

If history repeats itself, these high multiples are likely to recede in the near future, followed by lower or consider-

ably more moderate valuation multiples for at least three years and in some sectors, permanently lowered multiples. The commercial M&A slump of 2000 to 2003 witnessed a severe decline in valuation multiples and a 50% decline in the number of transactions. Of course there will be some exceptions for certain highly motivated strategic acquisitions, but these will be relatively fewer and further between.

I believe almost all decisions to sell middle market companies are life decisions first and economic decisions second. Life decisions cover the whole gambit from illness, to tiredness or just a desire to retire due to age. It is important that these life motivated decisions be made in an informed way

Those who are not students of the economic cycles of the M&A world, or believe that M&A investment bankers speak from kind of transaction hungry bias would do well to take to heart Joseph DeLevaga's observation written in the 17th century in "Confusion de Confusiones": "Take every gain without having the remorse of missed profits". This classic text about bubbles (rational and irrational), and the strong psychological compulsion to imagine them to be something else, is usually published in combination with Charles McKay's equally famous treatise "Extraordinary Popular delusions and the Madness of Crowds" (McKay 1841) on the same subject. We can learn from the ideas and the histories in these texts that even the duration of a legitimate bubble is almost always overestimated. But each generation and each industry seems to need to relearn the same lesson. I could describe a number of personal stories of clients who have lost substantial wealth by relying on the assumption that what was going on in the market place was permanent and that history would not repeat itself.

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