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NEWSLETTER

View From Our Clients: Current State of M&A Activity in the Government Contracts Market

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View From Our Clients is a new feature in the *Government Contracts Issue Update* that we are excited to introduce. The articles will cover various topics of interest to the government contracts community based on non-attribution interviews with clients and friends of the firm. The purpose is simple—to find out more about the issues that "keep you up at night" and to get your insights on the hot topics of the day. Going forward, we hope to use this feature as another way to engage with you on the issues you care about most, and to allow us to serve as a clearinghouse for you to exchange information and insights with our readers and clients. If you are interested in participating in a future *View From Our Clients* article, or have suggestions or requests for topics, please contact us. We welcome your input.

This article addresses mergers and acquisitions (M&A) activity in the government contracts market. Although dealmaking has been somewhat tempered in recent years as a result of budget pressures and sequestration, some commentators have predicted a resurgence of activity in the near term as large, established companies look to put excess cash to use and achieve growth by entering emerging markets. We interviewed clients with significant M&A experience on both the buy and sell side, and in a variety of roles, including in-house counsel and business and finance executives. These are the five issues on the top of their minds.

Budget and Revenue Uncertainty

A consistent theme we heard is the difficulty in valuing government contractors in light of the current budget situation. Although the absolute dollar figures in play can be huge, there is still significant

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uncertainty in the market. For instance, the President's budget for Fiscal Year 2016 provides $561 billion in base discretionary funding for national defense, but that figure is $38 billion above sequestration levels. No one knows from where the $38 billion in sequester cuts will come.

In addition to (or perhaps, because of) the continuing budget uncertainty, there appear to be two new norms in government procurement, at least for the time being—delay and LPTA [Low Price Technically Acceptable procurements]. Agencies are taking even longer than usual to develop requirements and get RFPs on the street, and evaluations and source selections drag on longer than expected. Even in "hot" areas, like cybersecurity and health IT, risk-averse government buyers often delay acquisitions to avoid making a premature choice with scarce dollars on the "wrong" technologies that may soon be overtaken by newer or better options. Some contractors have been fortunate to maintain or even grow top line revenues in recent years, but the increased use of LPTA competitions (plus a growing trend in "best value" procurements awarded to the lowest bidder) has increased pressure on bottom-line margins.

As a result of these issues, government contractors that also have a foot in the commercial market, like multi-industrials, have become much more attractive targets, as their broader and more diverse revenue base can help withstand the uncertainties of the government market.

Rising Valuations

One industry veteran we spoke with likened the current transactional market to "house flipping," where buyers are interested in acquiring instant growth through acquisitions, and are also willing to take risks in segments of the industry (particularly IT) where it is possible to disrupt the market with emerging technologies. This appetite for risk is coupled with historically low interest rates that make debt financing appealing, especially for strategic acquisitions. The consequence has been a sharp rise in valuations, with companies trading at higher multiples above EBITDA. For income-oriented investors, this increases pressure on profitability, even at a time when overall revenues may be declining. Many whom we spoke with wondered whether the steadily increasing valuations would lead to a "course-correction" featuring a rapid decline in valuations over a short period, especially if profitability stalls and short-term income investors leave the market for higher returns elsewhere. They anticipated an opportunity for a flurry of dealmaking involving strategic buyers with large cash reserves.

Regulatory Considerations

The regulatory approvals process is always an unpredictable obstacle that can inject unplanned delays and transaction costs into a deal. One criticism that we heard was the "surprise" that is part of various approval processes—such as Hart-Scott-Rodino pre-merger notifications and approvals, CFIUS and DSS FOCI reviews regarding foreign investment, and even the novation process—where there seems to be little rhyme or reason for why the government expresses significant concerns in some transactions that seem low-risk, but comparatively little interest in others. The absence of clear trends makes it difficult to predict where the problems or delays will occur and increases the risk that cost and schedule impacts could arise in transactions that seem relatively low-risk. Clients shared their frustration at the lack of transparency by the

government in these areas, which often forces them to incorporate unnecessary contingencies into the deal timeline. We also heard concerns about the motivating factors for government resistance to deals, based on perceptions that government regulatory interest in a transaction can be ratcheted up by third-party complaints from industry competitors, suppliers, or other (non-governmental) customers of the parties to a deal.

Extended Dealmaking and Due Diligence Timeline

There is a perception that deals are taking longer to consummate because buyers are more averse to risk that a seller's contract backlog will erode, or that valuable product lines could fall prey to the "creative destruction" process and be overtaken by a better, emerging technology. From a seller's perspective, these longer transaction periods place more stress on the seller's revenue projections and the integrity of the contract backlog. One contributing factor to the extended timeline may be the entry of new investment capital into the government contracts space, where investors may lack depth or experience in government contracts due diligence issues and proceed more cautiously. One client suggested that all of these factors are particularly prevalent in the market for software and IT products, where competition is fierce and endless product and technology evolution leads to an aggressive natural selection process.

Post-Deal Integration

Finally, an often overlooked—but absolutely critical—aspect of dealmaking is post-deal integration. Many good deals on paper have quickly turned sour in practice as a result of poor planning or execution of the integration process. Long before the deal is closed, the principals have to assess how the post-deal organization is going to fit together and operate going forward. Communication and transparency with incumbent employees are also key. Transition periods are challenging and stressful at the human level, and in the absence of information about a post-transaction integration process, employees may assume the worst and default to self-preservation mode. While outside consultants and FAQs can be used to provide some limited communication benefit, there is no real substitute for engaging employees on the division or factory level to ensure they understand what the transaction means for them.