

A strong appetite for acquisition

Conditions still good for deals in the government market

- By James Schultz
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In the spicy stew that is the government mergers-and-acquisitions market, one ingredient consistently bubbles to the top: profit.

As the government's fiscal 2008 begins, the hunger for outsourced information technology services appears unquenched, despite an ongoing budget drain to pay for the Iraq war. On the civilian side, agencies continue to modernize in an attempt to save money and find ways to manage, deploy and deliver resources more efficiently. On the military side, the need remains for sophisticated IT systems related to intelligence and intelligence gathering, networks, logistics and modernization.

Taken as a whole, and despite lagging organic growth for the largest IT players, M&A activity continues with no indication of a slowdown, experts say. IT companies large and small are keenly aware that providing services to government is, by any calculation, both lucrative and a dependable revenue stream.

"IT consolidation isn't likely to subside at any point in the near term. There's a great deal of buyer interest and the ability to afford the deals," said Kevin DeSanto, co-founder and director at KippsDeSanto and Co., an investment banking firm in Vienna, Va. "One, the customer base is attractive. Two, the government is a good long-term customer."

In the past five years and through late August of this year, 488 M&A defense and government contracts-related transactions valued at \$49 billion have occurred, said Rick Knop, senior managing director and co-head at the Defense and Government Services Group at BB&T Capital Markets/Windsor Group in Reston, Va., and a columnist for Washington Technology. That's in all government sectors and includes not only IT and IT services but also platforms, hardware and IT-dependant defense technologies.

The Windsor Group has been the midwife for 54 deals since the beginning of 2005, valued at \$7 billion.

"The last two or three years have been very active," Knop said. "The literal numbers of transactions [this year] are about the same ? but that's at an all-time high. It's been fueled by a significant amount of capital. Government is outsourcing more and more to private contractors."

Perpetual privatizing

Recent estimates, said Larry Davis, managing partner at Aronson Capital Partners LLC, put growth of the federal IT budget at an average of roughly 6 percent per year during the next five years, from \$77 billion in 2007 to \$99 billion in 2012.

"There is still a lot of money to be made," Davis said, especially in mission-critical systems for both the military and civilian sectors of government.

Outsourcing remains a strong and persistent driver. Federal-sector buyouts and retirements have led to the erosion of institutional skills and subject-matter expertise within the agencies. Depletion of in-house know-how is a boon for IT firms with strong bench strength ? including, in many cases, part-time consultants who recently left federal jobs. What's more, privatizing remains a virtue throughout government with no end in sight, thanks to an expanding list of essential tasks and critical projects.

William Loomis, a managing director at the St. Louis-based Stifel, Nicolaus and Co., said the momentum for IT services comes from a continued emphasis on homeland security and ongoing modernization of an aging government IT infrastructure. Should Democrats capture the White House or retain control of Congress in 2008, or both, there will likely be renewed support for civilian-agency programs in health and human services, environment and education, Loomis said.

Figures compiled by Loomis indicate that, governmentwide, civilian agencies' IT budget requests are an aggregate 3 percent higher in fiscal 2008 than those sought in the 2007 budget, with some ? like the Treasury Department ? seeking increases in the double digits. Actual amounts may be higher, if budget acrimony between Congress and the White House results in a continuing resolution, Loomis said.

As the Iraq war continues, the Defense Department also is pursuing IT outsourcing as a way to move more uniformed personnel to core warfighting roles and cut costs. The military continues to retool, looking for ways to consolidate and more efficiently work across formerly insular commands. IT expertise remains in high demand, helping the armed forces with everything from military-base closings to the communications particulars necessary to joint operations across a multitude of previously unconnected systems.

"Piece by piece, the federal government is being privatized," said Tom Peltier, managing

director at Stifel, Nicolaus and Co.'s Aerospace, Defense and Government Services investment banking group. "That trend isn't going away."

A competitive ecology

According to Peltier, IT companies follow a predictable cycle in the hunt for growth and prosperity. First comes one or two contract wins for a smallish firm with a desired expertise. People are added, projects successfully completed, and reviews are favorable. More contracts follow, and additional employees sign on.

Ultimately, as the small company becomes midsize, it is faced with one of two choices: find a buyer or become a buyer. The bottom line: For a pure-play IT services firm to compete successfully the new annual revenues standard is \$1 billion.

The situation is becoming more difficult lately because of the government's turn to contract bundling: the practice of making awards to several companies that then compete for task orders. No one is guaranteed specific work, but the winners generally stand to do well during the life of the contract.

"It does get tougher each year," Peltier said. "It's a big market. It's growing, but there are many more competitors. And the defense primes, like Lockheed [Martin Corp.], are active with billions in revenue from federal IT contracts."

Expertise matters

No matter how large, the biggest players in the market are always on the hunt for additional capability. And despite being on the M&A radar, smaller companies can be successful by advertising strengths such as the ability to be nimble and responsive to customer needs.

"You'll never run into a situation where there's a lack of competition," DeSanto said. "There are just too many companies across the country that support IT work. It's not a capital-intensive business. It's bodies: more employees to work on more contracts for more customers."

For those wanting relatively dependable long-term gains, government-related IT remains a strong draw. Revenues and profit aren't going away. That guarantee continues to engage the interest and checkbooks of outside investors.

"Private-equity groups are still very interested in this sector," said Paul Serotkin, president at M&A advisory firm Minuteman Ventures LLC, based in Boston. "They're in it to fully maximize shareholder value. Between consolidation and private-equity interest, there will be a sustained number of M&A deals."

Key deals in 2007

Here are some major acquisitions that either closed or were announced in 2007.

| Buyer | Target | Value |
|-------------------------------|-----------------------------|----------------|
| ITT Corp. | EDO Corp. | \$1.7 billion* |
| Carlyle Group | Arinc Inc. | N/A* |
| Harris Corp. | Multimax Inc. | \$400 million |
| Madison Dearborn Partners LLC | CDW Inc. | \$7.3 billion* |
| Honeywell Inc. | Dimensions International | \$230 million |
| CACI International Inc. | Athena Innovative Solutions | \$200 million* |
| ManTech International Inc. | SRS Technologies Inc. | \$170 million |
| SI International Inc. | Logtec Inc. | \$59 million |

**Deal still pending*

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