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Increasing Federal M&A by Nontraditional Strategic Buyers

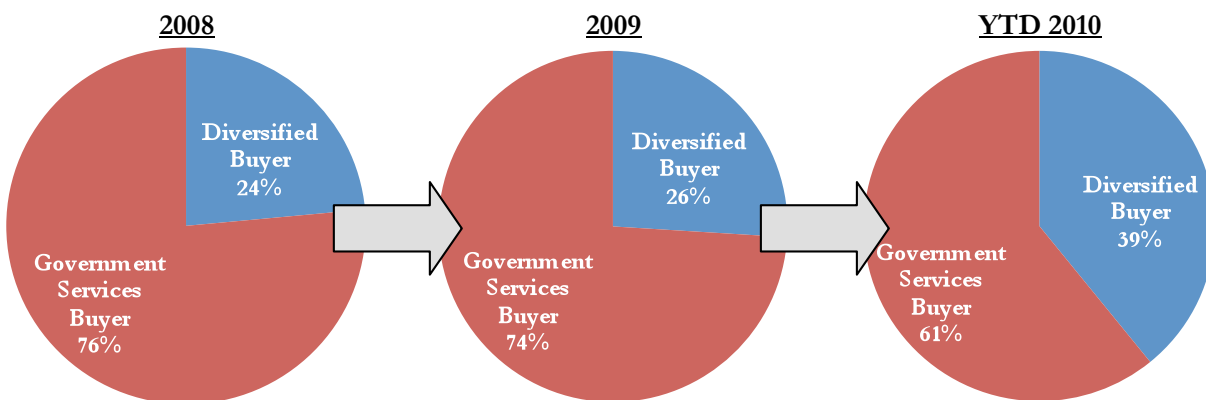
By Marc Marlin and Jon Yim

While somewhat below the radar, the federal market is receiving renewed attention from traditionally more commercially oriented technology, consulting, and engineering and construction companies (“Diversifieds”), a trend last experienced around 2002. In the aftermath of the dot.com bubble burst and reaction to the attacks of September 11th, many technology and other professional services companies looked to the federal market as a means of survival. These companies are again rethinking their portfolios in the aftermath of the 2008 market meltdown and economic slowdown. While these nontraditional government contractors have always been somewhat active in defense and technology M&A, we have witnessed a significant uptick in activity. Recent examples include the Jacobs Engineering Group’s acquisition of Tybrin Corporation and Deloitte’s acquisition of BearingPoint’s federal contracts.

Similar to their defense and federal pure play peers, the federal / commercial diversified buyers are very focused on the hottest market areas such as CyberSecurity, Intelligence, C4ISR, and healthcare information technology. This is especially true for the highest technology companies for which there exist crossover technologies that can be exploited in both the federal and commercial markets, such as in the case of Informatica’s acquisition of Agent Logic, Symantec’s acquisition of Gideon Technologies Inc., or TrustWave’s acquisition of Intellitactics. IBM’s acquisition of National Interest Security Company (NISC) is another example of a larger such Intel services deal, at a premium valuation. Heavy buyer demand (that meaningfully outstrips supply in the hottest areas) by federal and defense pure plays and financial sponsors, augmented by the Diversifieds, presents attractive alternatives for the well positioned, smaller and mid-sized firm. Understanding the motivators of the nontraditional government contractor’s acquisition interest and appealing to its desires can ultimately enhance value.

Government Services Acquisitions

2007 – April 2010



1. Thirst for Acquisitions

Many commercial companies spent the back-half of 2008 and most of 2009 cutting operating expenses, rationalizing capital expenditures, and dropping dividends to maintain or increase earnings and preserve cash despite revenues declines. As a result, these firms built significant cash reserves. Entering 2010, the economy appears to have turned and the financial engineering of the past year has been fully utilized. With modest near term expectations for broader economic growth, Companies are looking to supplement their organic growth through acquisitions. The combination of a slightly bullish near-term growth outlook and distinct advantages makes the federal space ripe with opportunity. The size, breadth of capabilities, and public market perception can enable nontraditional firms to pay-up and outbid the pure play federal and defense technology companies and still drive strong returns on investment given, (1) they have multiple avenues to drive growth post acquisition by cross-selling an even larger combined capabilities set or leveraging technologies in both the commercial and federal markets, and; (2) deals remain accretive to earnings at higher prices due to, in many cases, their premium public valuation metrics relative to the federal and defense players. Thomson Reuters, for example, acquired healthcare analytics firm Discovery Logic, affording the cross-usage of each company's respective solutions across the government, non-profit and commercial markets. The aforementioned public valuation differential and acquisition arbitrage opportunity is especially true when it comes to commercial software companies that trade northwards of 2x revenue.

Firms having a clear organic growth strategy and able to articulate specific ways - capabilities to pull-through, crossover technologies to exploit, or larger prime opportunities to chase - that could accelerate their growth as part of a larger platform can confirm the Diversified's investment thesis and motivate them to push the edge on valuation.

2. Good Offense Sometimes Starts With Defense

The federal market is a defensive investment in the Diversifieds' business portfolios. The importance of diversification to delivering consistent performance over the long term can be quickly forgotten when times are good. However, when market conditions trend south, defensive investments receive urgent attention. In this spirit, as the commercial customers slowed or halted technology spending in 2009, the federal markets remained fertile, spurred by a multitude of nondiscretionary initiatives (e.g., CyberSecurity threats / responses, healthcare reform, stimulus programs etc.). According to Input, the government spent approximately \$73 billion on technology in 2009, an increase of 8.3% from 2008. This investment was in stark contrast to a decline in the commercial technology market. Although government technology spending is unlikely to increase significantly in any given year, the stability of a federal presence is in high demand as the broader economy and commercial markets remain cautious.

Sustainable growth is key. The more your contract portfolio and revenue stream looks like an annuity, the lower the perception of risk, and higher attraction as the defensive play. Take advantage of opportunistic situations, but invest business development resources for long term value creation, specifically, full & open contracts in support of less discretionary, mission critical programs.

3. Dilemma of Build vs. Buy Strategy

The federal market is difficult to crack from the outside. A common pitfall is thinking of the government as a vertical market in the same sense as financial services or healthcare. The federal market is a mosaic of

various agencies with different missions, needs and personalities. As a result, to effectively navigate the federal market, the commercial companies often spend years trying to understand this unique ecosystem. Still, even after significant time and capital have been devoted to these efforts, they are faced with additional barriers such as contract vehicles, past performance credentials, lack of cleared employees, and prolonged sales cycles. As a result, these companies are more inclined to acquire federal players to participate in the government game, and especially those with depth and longevity. As an example, General Physics (GP) acquired training firm PerformTech in December of 2009. This acquisition meaningfully expanded GP's overall federal footprint and especially at DHS, bought it a prime OPM TMA contract vehicle, and presented significant opportunity to provide services and leverage technologies beyond the scope of work that each could provide separately.

While access is a function of people, it's important that the customer relationships or subject matter expertise are institutionalized within the Company, and not only in the hands of a select few individuals. Contract vehicles and competitive differentiators in Intellectual Property, such as technology, processes, procedures, or knowledge management can make the difference between a market vs. premium valuation.

4. Need for Public and Private Collaboration

The government is becoming more open to public and private collaboration. Neither the government nor the private sector can address future IT contingencies alone, especially in the areas of CyberSecurity around systems interoperability, mobile applications, and migration to the cloud. Today's digital enablement of practically all business artifacts continues to fuel the technology reliance and interlace between public and private infrastructure. Nevertheless, most developmental work is done on the commercial side outside of the federal market, and the need for both sides to work together to fulfill the government's mission is publicized more than ever. Furthermore, most technologies change faster than the requirements and the budget processes can keep up, and the legacies of the public procurement cycle and process will likely need to be changed to accommodate the new IT world. As a result, the companies that are positioned to provide innovation from the industry side and understand the government game will outperform in the years to come. In fact, this ability to provide a hybrid solution is also catching on amongst the federal system integrators, as these service providers seek out technology acquisitions to differentiate themselves, and meet growing, constantly changing technology demands.

Know what your customers need, and show how you can help the larger more diversified partner deliver it. Commercially oriented technology companies often invest significantly in internal research and development and rely on scale distribution to drive returns. Being able to leverage the commercial solutions / approach is a win-win for all stakeholders.

The federal space continues to receive increased attention from the nontraditional contractor; however, if history is a predictor of the future, this renewed focus may soften as the economy improves. That said, we anticipate diversified players to remain formidable players in federal and defense focused M&A activity for the foreseeable future.