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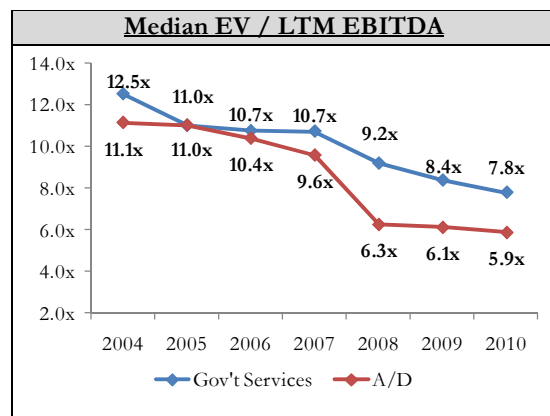
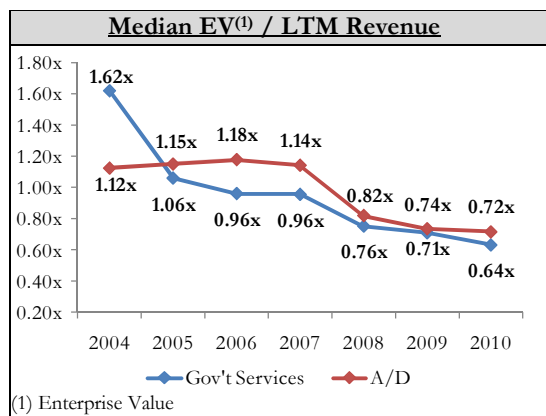


New Era of Government Contracting, Same Expectations for Robust M&A Activity

By Marc Marlin

M&A activity continues to thrive, despite a new era of government contracting characterized by uncertainty. The broken procurement structure and anticipated pullback in federal spending continues to pressure the organic growth outlook for Government Services and Aerospace / Defense (“A/D”) contractors. However, the cash reserves stockpiled during the past few years, the minimal required capital investment native to the labor-based services and solutions business model, and re-energized capital markets presents services companies a high return on investment (“ROI”) strategic alternative in which to deploy cash and drive growth via M&A.

The combination of federal budget uncertainty and the aforementioned acquisition impediment has placed a governor on organic growth for many industry companies. These challenges are reflected in the current public valuations across the sector, encouraging senior leadership to confront the question of where and how to invest capital in a generally slow-to-no growth macro environment. Both public Government Services¹ and A/D² valuations are at or near multi-year lows, on the back-end of strong expansion over the past decade. Since the third quarter 2007 (“3Q2007”), aggregate latest twelve month (“LTM”) revenue for Government Services has increased from approximately \$16 billion to nearly \$21 billion, a compounded annual growth rate (“CAGR”) of 9.3%. The A/D segment has similarly increased, however at a slower pace, from \$229 billion to \$264 billion, a CAGR of 4.8%.



¹ Companies for this analysis include: BAH, CACI, DRCO, GTEC, ICFI, KEWY, KTOS, MANT, NCIT, SAI, SRX

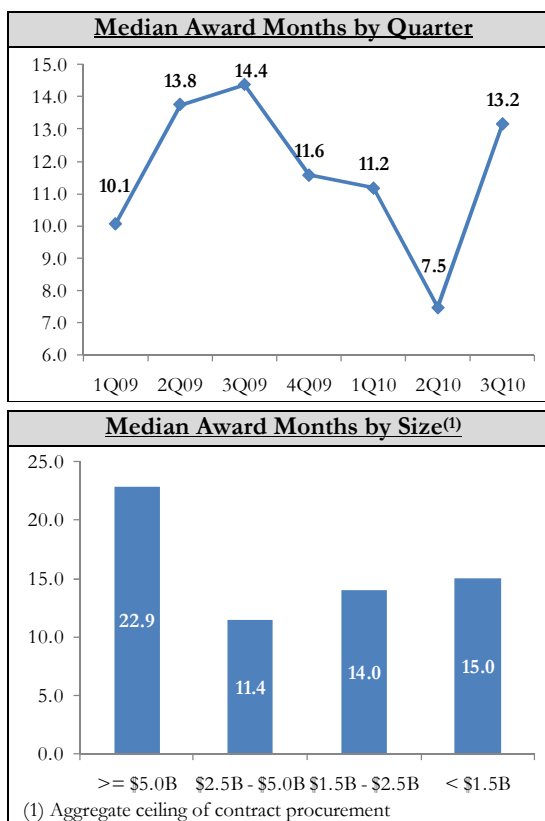
² Companies for this analysis include: BA, GD, IIT, LLL, LMT, LSE:BA, NOC, RTN

Continued Procurement Problems

While spending pressures capture most of the headlines and accepting this as a relatively universal growth obstacle, upon closer examination procurement difficulties may also be considered a key contributor.

Anecdotally, acquisition personnel are stretched from a resource and capability perspective. In practice, this can translate into delayed / drawn-out procurements, and a more likely disconnect between requirements definition at the request for proposal (“RFP”) and the requirement needs upon eventual contract execution. In this disconnect lies the potential for execution and financial inefficiencies. Add into the mix a heightened protest environment, and timelines further drag. Having analyzed publicly available data for a sample of high profile procurements since 2009, the median time in months from solicitation to award (“Median Award Months”) is nearly 12. This figure can be further examined as an average of approximately 15 months for Department of Defense (“DoD”) let contracts and nearly 14 months for non-DoD opportunities; these averages are influenced by select procurements that experienced significant delays.

A drawn out procurement cycle poses various challenges to contract suitors over and above the additional compliance and disclosure burdens recently levied on contractors. First, a longer time from bid preparation to realization of contract revenue, if and upon award, can lower the ROI on business and proposal (“B&P”) dollars, time, and effort. Second, the uncertain procurement process complicates how to allocate (or budget) B&P resources today, when returns are more than a year away. Bid, no-bid decisions appear tougher than ever. Third, requirements sometimes seem in a constant state of flux, especially over a 12 - 24 month period. These procurement characteristics can complicate financial management, business operations, and thereby inhibit organic growth.

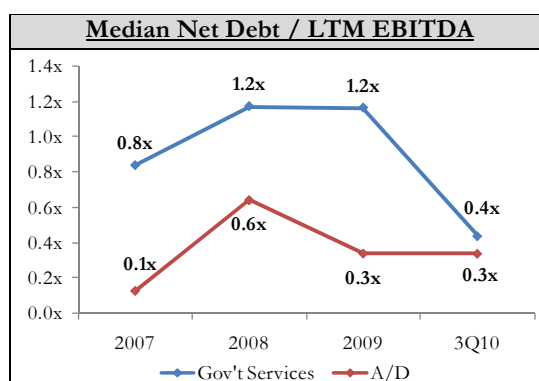


Strong Balance Sheets

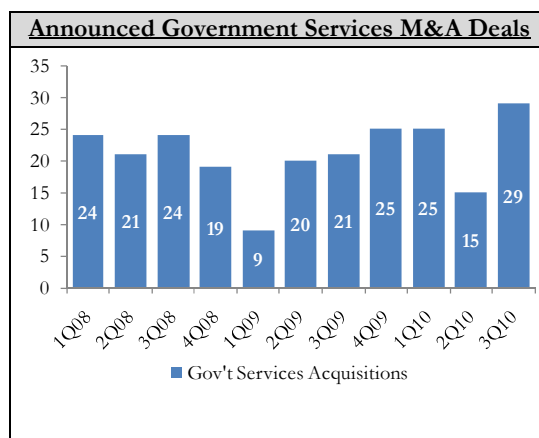
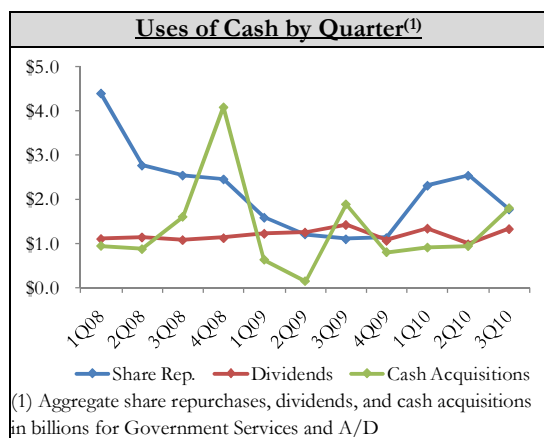
Interestingly, while the market environment may have pulled-back from a spending and overall contracting perspective, Government Services and A/D contractors find themselves with very strong balance sheets. The combination of organic growth pressures and high levels of cash have and are expected to continue to wet acquisition appetites.

Given the aforementioned historical growth and flat to declining NWC and CAPEX requirements, industry firms are in an enviable position from a cash perspective. There was approximately \$28 billion of available cash and cash equivalents amongst the public Government Services and A/D contractors at June 30, 2010. Strong cash flow, combined with generally multi-year contracts contribute to the attractiveness of government contracting to the capital markets.

As shown in the graph to the right, net debt³ to earnings before interest, taxes, depreciation, and amortization (“EBITDA”) multiples for Government Services and A/D have declined substantially since 2008 following increases in the 2007 / 2008 time frame. Net debt for Government Services firms has decreased as a percentage of total revenues from greater than 10.3% in 2007 to 4.2% in 2010.



So where did the cash go? A significant value went to M&A and stock-buybacks. Since 2Q2007, there have been nearly 315 acquisitions of government services businesses, broadly defined as labor based businesses selling time or solutions to which a meaningful portion of overall business for the benefit of the federal government as the end customer, by the Government Services and A/D firms. There has also been nearly \$29 billion in aggregate stock buybacks by these companies over this period. In summary, the Government Services and Defense firms have invested the cash to either improve their strategic positioning via M&A or enhance earnings per share and share price through buybacks.



³ Generally defined as total interest bearing debt less cash and cash equivalents

Looking Forward

The new era of contracting may be marred with uncertainty driven by spending pressures, procurement delays, and macro organic growth headwinds, but healthy balance sheets, access to capital, and need to supplement slower organic growth are expected to continue to fuel M&A. A few key takeaways serve to support this thesis:

- 1) As budgets tighten and the breadth of growth opportunities narrow, M&A will likely remain the tool of choice to affect change and reposition in response to organic growth pressures. Companies need to show a renewed ability to deliver attractive financial performance to remain competitive and justify valuations approaching more historical levels. Outside of specific sub-segments such as Intel, Cyber, C4ISR, and healthcare, the macro federal market is unlikely to support such growth government wide;
- 2) Ample access to capital. As mentioned, the labor-based government services business model is inherently a low investment, high cash flow business which is conducive to debt financing;
- 3) The buy vs. build proposition for a customer, contract, or capabilities in a low cost of capital environment (i.e., cash interest or cost of debt) increases the ROI of potential transactions. Potential buyers are motivated to deploy capital through dividends, stock repurchases, or M&A given the current low interest rate environment. M&A, amongst the three alternatives mentioned, directly facilitates revenue growth and improved strategic positioning. The low interest rate environment and attractive federal government end customer also presents attractively priced debt financing capital. For example, SAIC recently settled the sale of \$450 million of 4.45% Notes due 2020 and \$300 million of 5.950% Notes due 2040, and expects to use approximately \$300 million of the net proceeds to repurchase additional shares of common stock. The low cost of debt capital encourages using the balance sheet to pursue M&A. Notably, increasing leverage across the Government Services and A/D firms to 3x LTM EBITDA would equate to total incremental acquisition capital of approximately \$77 billion;
- 4) Wealth of buyers and sellers in a mature, consolidating market. The market challenges faced by the larger public firms are only exacerbated as smaller and mid-size contractors lack the infrastructure and in some cases financial wherewithal to weather the new era challenges. To the positive, these smaller and mid-sized firms often have innovated solutions more leverageable on the platform of larger players who are flush with capital. This combination drives M&A interest amongst both parties.

Where there are challenges remains opportunity, and this reigns true within the backdrop of the new era in government contracting. With strong momentum entering 2011, the Government Services and A/D market is well capitalized, and motivated to continue to participate in M&A transactions aimed to supplement organic growth and drive shareholder value.