

Contact:

Bob Kipps
KippsDesanto & Co.
703-847-3695
bkipps@kippsdesanto.com



www.KippsDeSanto.com

2008 Defense/Government Services M&A Market Dynamics

Could the market have been any worse over the past 12 months? First the SBA recertification ruling went effective 6/30/07 followed by financial market turmoil, home value deterioration and foreclosures, economic weakness, Continuing Resolutions and the ongoing debate over the war supplemental. And that's only 2007. Let's now mix in the typical election year political rhetoric and uncertainty.

What does all this mean for demand and valuations for defense and government services firms? Surprisingly, outside of the SBA ruling, most of the other factors have not had a material impact on industry M&A activity. While the credit market tightening has complicated the lives of private equity firms, it by no means has curtailed their activity or interest in the sector—seasoned financial sponsors (i.e., CM Equity, DC Capital, Veritas, Arlington Capital) have both remained active and some been some of the most aggressive suitors on several recent deals (deals both above and below \$100M in transaction value). Similarly, stocks of the most active strategic buyers (SAIC, Lockheed Martin, CACI, Stanley, ManTech, etc.) have remained relatively strong and their interest in supplementing their technology/capability repertoire and customer base to be competitive in areas of perceived higher growth have kept their acquisition appetite for the larger and most attractive companies at elevated levels. Moreover, the buyer universe remains very eclectic including numerous foreign and out of market buyers (Engineering and Telecom, in particular). Given the shortage of “clean” growing companies, their valuations, in many cases, have actually gone up over the past year (reflecting the supply/demand imbalance).

No question that last year's SBA recertification ruling has adversely impacted M&A involving smaller companies. Initially, the impact of the ruling was a near halt of buyer interest (vs just lower valuations and more complex deal structures). While buyer concern about retention of Small Business contracts has not generally eased--and there has yet to be a successful test case--we are beginning to see more interest from buyers in well-positioned/growing companies with unique, non-commodity skillsets and strong customer relationships even if they have above an immaterial level of Small Business contract exposure (that's a change from 6-12 months ago). Naturally, buyers are very inquisitive about the set-aside risks from the get go, asking lots of

questions and to a large extent relying on the credibility of the investment banker or company advisors as to whether the situation is workable and/or a wise use of their time.

Furthermore, several “boomerangs” have re-entered the market providing an interesting new type of buyer for selling companies. These buyer groups are typically led by a previous owner/CEO (e.g., Mark Green/Tim Fleischer, Bob LaRose, Clarence Jones) who sold their business a few years ago and no longer have non-compete constraints. The boomerangs typically bring market understanding, ample private capital, no SBA affiliation issues (unlike the typical private equity or corporate/strategic buyer) and a strong interest in re-applying their wisdom in today’s market. In addition some Alaskan Native Corporations (Artic Slope, in particular) have ongoing acquisition campaigns. However, the ANCs (however long that loophole lasts) are by no means a solution to the oversupply of firms with material “set-aside” contract risk.

For those stranded firms, traditional management and/or ESOP buyouts remain an option-like bellbottom jeans, even ESOPs could be coming back into vogue. Having not been the exit of choice over the past few years (given the vibrant M&A market), the SBA recertification risk combined with the very real threat of increased capital gain tax rates in the near future could create déjà vu all over again rationale for ESOPs.

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