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PSC 2010 Annual Conference

In early October 2010, KippsDeSanto & Co. joined top industry leaders at the PSC Annual Conference held at the Nemacolin Woodlands Resort in Farmington, PA. This 3 day feature event was offered exclusively to PSC members and more than 400 senior executives and government officials participated in discussions targeted at current trends and topics dealing with today's unsteady government services market and how policy changes will continue to impact the professional services industry.

As part of the Conference, Kevin DeSanto, a director and co-founder at KippsDeSanto & Co., was privileged to take part in this year's Capital Markets Roundtable along with 13 other industry experts. The Q&A style session took a look at the capital markets from the perspective of investment and commercial bankers. Below is Mr. DeSanto's assessment of the current 'state of play' for M&A activity in the federal services sector.

The Capital Markets Roundtable – From the Perspective of Kevin DeSanto:

1. *What are the current, primary drivers that are either energizing or limiting M&A activity in the federal services markets?*

   M&A activity is steadily increasing, evidenced by 57 announced federal services deals year-to-date (YTD) through August (80 – 90 deal pace for the year) compared to 40 during the same period in 2009. This pickup of activity has been energized by a number of factors.

   First, buyers are looking to reposition their capability and customer portfolios in those areas believed non-discretionary, and that represent the highest growth opportunities over the next five years. Federal budget pressures driven by the deficit, entitlement programs, response to the struggling economy, and continued OCO activities no longer afford universal spending growth government wide. Those areas in highest demand include defense and national intelligence, cybersecurity, healthcare information technology, and C4ISR. Secondary areas include modeling and simulation, training, logistics, and modernization, amongst a few others.

   Second, pent up demand and supply is fueling activity. There was minimal buyer interest or seller motivation from late 2008 through most of 2009 given broader domestic and international economic uncertainty. Unstable capital markets encouraged conservatism and cash preservation by buyers, and hesitation to explore a sale amongst sellers. Fast forwarding to today, the markets are moderately more stable, buyers have considerable capital they're looking to deploy, and liquidity pursuit (i.e., sale) remains part of the typical small and mid-size contractor's lifecycle. Anticipated capital gains and ordinary income tax increases expected in 2011 has only further motivated sellers to test the markets now.

   Third, the federal services market continues to receive interest from a range of buyer types, including traditional defense primes and mid-tier systems providers, pure government services firms, diversified IT companies with meaningful commercial and public sector verticals, engineering and construction firms, and private equity. Irrespective of headwinds challenging the industry, the federal services market remains an attractive growth market and quality customer credit (i.e., federal government) as the focus of or as part of these buyer groups' portfolios.

2. ***Do you expect to see more or less M&A activity in the next 12 months? Do you expect it to be more active within any specific segment(s) of the services sector (i.e., large, mid-tier, or small businesses) or in any specific market niche(s) (i.e., cyber, health IT, logistics, engineering, international development, etc.)?***

   M&A remains the go-to tool for firms to reposition in priority areas. As such, we anticipate M&A activity over the next 12 months consistent with late 2009 and YTD 2010. These priority areas are characterized by growth potential, bi-partisan support, and non-discretionary mission importance. We refer to the highest priority intelligence, cybersecurity, healthcare IT, and C4ISR / Unmanned Systems areas as the "hot lanes". These hot lanes are generally dominated by smaller, niche firms, many of which flew under the radar of most acquirers during the exuberant consolidation from 9/11 through 2007. As a result, the M&A market for smaller, focused firms is more attractive than ever, with the best positioned firms receiving rich valuations and optimal deal terms. The concentration of smaller firms in these hot lanes has also motivated the largest buyers to broaden their aperture when chasing acquisition opportunities, often relying on an investment thesis of how they can leverage the smaller targets' customer access or capabilities to achieve long term impact, rather than immediate financial results. Notably, the second half of 2010 is likely to experience above-average deal volume given the number of sellers looking to close their deals before the end of the year due to anticipated tax increases in 2011 and beyond.

3. ***To what extent do you view policy trends, specifically relating to Organizational Conflicts of Interest and insourcing, as impacting either company valuations or the pace and scope of M&A activity?***

   Policy trends, both rhetoric and those put in practice, have a direct impact on federal services M&A. Hopefully, the most significant sweeping insourcing efforts (at least for DoD contractors) are behind us, having peaked in the late 2009, and early 2010 timeframe. Recent comments by Secretary Gates acknowledging that anticipated cost savings from insourcing may have been optimistic may help further stem this trend. That said, a track record of having positions insourced and / or the expectation of a reduction in contractor jobs has introduced another angle of business performance uncertainty. From an M&A standpoint, uncertainty translates to risk, and risk pulls down valuations. As a result, insourcing is receiving greater diligence attention from buyers.

   Stiffer OCI rules are also influencing M&A activity. While insignificant as a driver of total deal volume, OCI motivated divestitures has significance as a barometer for an important change in the market regarding corporate personality. Government scrutiny concerning OCI, formerly acceptable to be mitigated at the program or customer level, is morphing into corporations embracing a personality of integrator / performer or SETA / trusted advisor, but not both. This change has motivated a handful of transactions to date (e.g., TASC, Mission Solutions Engineering, CAS), with more expected to come. This dynamic will also help to shape the next evolution of the federal services industry, one characterized by such focus, creating more distinct competitive dynamics amongst each business model and bifurcated buyer groups for smaller and mid-size firms pursing a sale in the future. Notably, the inability of the more deep-pocketed defense prime or mid-tier company has translated into more modest valuations of the SETA / trusted advisor business, allowing mid-size and private equity firms to be more active buyers.

4. ***In general terms, do you believe the federal services sector is financially performing as expected, better than expected, or worse than expected?***

Overall, the federal services market has performed remarkably well on a relative basis, especially given the considerable policy changes / challenges over the past few years and domestic and international economic uncertainty. Federal services public company stock performance, as an index tracked by KippsDeSanto, has outperformed both its defense prime peers and the broader market during a difficult economic climate since early 2008. The index has declined approximately 14% compared to declines of nearly 25% and 31% for the defense index tracked by KippsDeSanto and S&P 500, respectively. The government services business model is characterized by nimbleness, adaptability, low capital requirements, and high free cash flow generation. These attributes have served the sector well financially. Wall St. analyst estimates indicate median next fiscal year revenue growth of approximately 10% for the federal services public companies compared to 4% for defense firms. The median EBITDA margin for the federal services sector public companies has remained strong at 9%. While the sector may have a less rosy outlook this decade than last, growth opportunities persist, and the government still relies on contractors to achieve their missions.