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Foreign Buyers One of Multiple Alternatives for Government Services M&A
By Marc Marlin

The British defense technology company QinetiQ Group PLC acquired US defense firms Westar Corporation and Foster Miller in 2004, forming the foundation for QinetiQ North America. At that same time and into 2005, the Chairman of another defense firm, BAE Systems, outlined a growth strategy focused on North America. The strategies of these two prominent UK based defense firms set in motion a trend of targeted M&A focused on the US defense market. The government contracting community witnessed the subsequent acquisition of 49 government services businesses by foreign buyers from 2006 through 1Q2011. Today, defense and technology firms spanning the globe continue to seek a piece of the high-spending US government contracting industry, and more specifically, the largest defense budget in the world. While acquisition interest in professional services capabilities has mostly been by British and Canadian firms, defense systems and hardware M&A activity and interest has extended from the UK through Italy and further east into Israel and beyond. The US defense industrial base has truly gone global.

2010 MILITARY BUDGETS

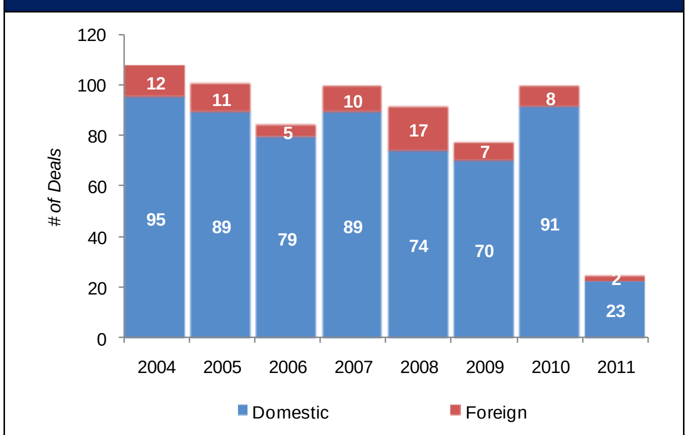
($ in billions)

1.	United States	$687.1
2.	France	61.3
3.	United Kingdom	57.4
4.	Germany	46.8
5.	Italy	38.2
…		…
25.	Latvia	0.3

Source: NATO

Acquisition activity by foreign buyers of government services firms (broadly defined as labor-based businesses) peaked at 17 announced deals in 2008, representing 19% of total government services deal volume[1]. The romanticism of becoming a platform for a foreign buyer continues to be characterized by the perception of premium valuations given the purchasing power of foreign currency against the dollar, the allure of access to the US market, and the expectation of relative autonomy post deal. It's understandable how this alternative seems like the best of both worlds – the value proposition of a deeper pocketed strategic buyer coupled with the continued stand-alone post deal operating freedom of an often lower purchase price private equity platform strategy. Moreover, the likelihood of the acquired company being broken up at the outset and deeply integrated

M&A ACTIVITY BY BUYER TYPE



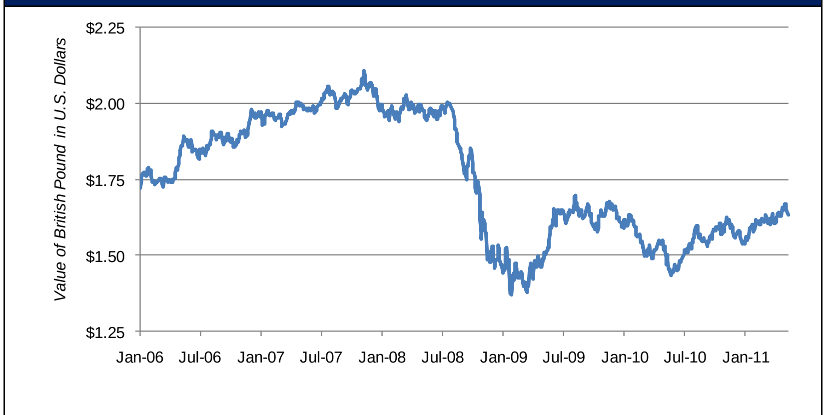
Source: Washington Technology and KippsDeSanto

[1] Washington Technology and KippsDeSanto

can be meaningfully reduced with a foreign buyer across the negotiating table, conveying a comfort to both employees and customers that little will change. Over the past few years, a number of firms capitalized on this market opportunity including SI International's sale to Serco Group, Project Performance Corporation's sale to AEA Technology Group plc, and Stanley, Inc.'s sale to Canadian based CGI Group, amongst others.

The value equation of a successful M&A deal generally includes price, terms and conditions, certainty of close, and cultural fit. Despite the attractiveness of the international platform deal are complications unique to the foreign buyer, especially International Traffic in Arms Regulations (ITAR), Committee on Foreign Investment in the United States (CFIUS), and proxy board requirements. These added complexities can extend diligence and overall time to close. Time is the enemy of all deals, as the sale process can distract senior management's attention while the rank and file operate under a cloud of heightened concern (perception or otherwise) regarding their role in the surviving entity. These dynamics unabated can work to erode the salient attributes (e.g., growth, culture) that motivate buyer interest and comprise the fabric of a company's overall value proposition.

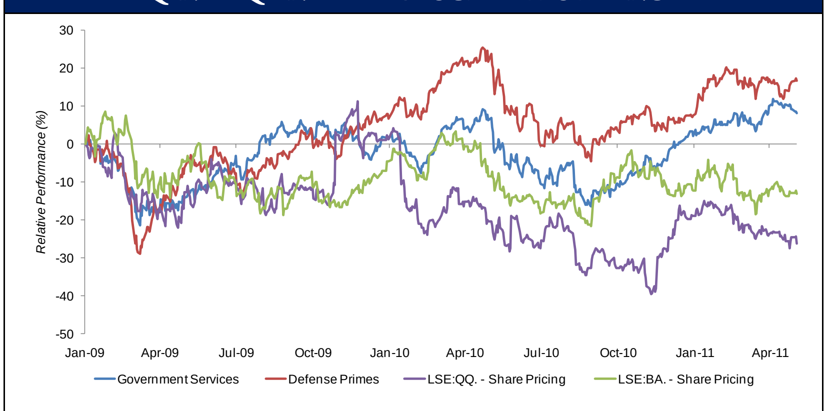
RELATIVE STRENGTHENING OF THE US DOLLAR



Source: CapIQ

While the foreign acquirer remains a legitimate buyer community actively explored with prospects and clients alike, a snapshot of the current M&A environment handicaps the likelihood of that result and more so as a platform investment. Acquisitions by foreign buyers have declined steadily since their peak in 2008. Many of the well-know global firms such as QinetiQ, CGI, Serco, Cobham, AEA, and Babcock International Group (VT Group) have acquired US platforms. Second, despite volatility, the dollar has continued to strengthen against the British pound since late 2007 / early 2008. This trend weakens the purchasing power of the UK buyers, encouraging greater valuation discipline. Finally, growth / operational challenges and share price volatility may have also resulted in less aggressive M&A posturing as of late. QinetiQ North America for example, who was one of most active government services acquirers having consummated nine transactions since 2004, hasn't made an acquisition since its June 2009 acquisition of Cyveillance, and to the contrary actually divested its security

QINETIQ AND BAE STOCK PERFORMANCE



Source: CapIQ

and intelligence business to ManTech in 2010. Similarly, although still acquisitive, BAE has undergone a number of reorganizations both in the UK and North America. Notably, both companies stock performance has lagged an index of the broader government services firms and defense primes. All that said, opportunities for deals with foreign buyers are still achievable. BAE recently acquired the L-1 Intel services business, while global firms such as CapGemini have yet to consummate a transformational transaction in the US market. For the most part, those with an existing US presence continue to seek acquisitive growth opportunities as further evidenced by AEA's 2010 acquisition of Eastern Research Group, Inc.

As the fever around the international platform has cooled, the market has increasingly presented alternative platform opportunities with some similar attributes to the foreign buyer. These alternatives include the likes of technology firms without critical mass in the government vertical or looking to expand a public sector practice, engineering and construction ("E&C") firms, and private equity, amongst others. The first two showcase the vastly expanding defense industrial base for professional services, while the latter has and continues to be a viable player in defense technology M&A.

The profile of the firms providing professional services to the Federal government and potential acquirers of those businesses is considerably more diverse than the stereotypical pure play IT services business of the early 2000's. Non-pure play government services providers were the buyers in approximately 60% of the announced transactions from 2009 through March 2011. The professional services businesses of defense primes and Tier 2 suppliers (e.g., General Dynamics Information Systems and Technology, Northrop Grumman Information Systems) and those without critical mass in or with an emphasis on the public sector as part of a broader portfolio (e.g., Dell Services - formerly Perot Systems, CSC North American Public Sector) in many respects dwarf the pure plays in size and footprint, and are formidable M&A players. For example, Paul Bell, president of Dell's Global Public and Large Enterprise sector recently indicated the intent to continue to aggressively pursue government services acquisitions given the early success of the Perot deal. Xerox continues to explore Federal M&A opportunities for its legacy ACS business. In other deal activity, CA Technologies recently expanded it public sector footprint with the acquisition of Base Technologies.

Similar Federal acquisition interest can be seen across the E&C community. Examples would include URS's recent acquisition of Apptis, Inc. or Jacobs Engineering's 2009 acquisition of Tybrin Corp and 2010 acquisition of the TechTeam Government Solutions unit. When thinking about market hot spots such as healthcare IT, big data analytics, and cyber security, the field is even further crowded to include more pure non-public sector focused technology companies now seeking to exploit cross-over technologies in both the Federal and commercial markets.

More than ever private equity firms are also expressing strong interest in the government services market. While always a player in the government services M&A action, financial sponsors have recently upped their game with large, higher valuation, high profile deals - like GTEC, EIG, SRA, and TASC - fueled by a combination of abundant capital to put to work, a longer-term bullish viewpoint on the Federal marketplace opportunity, and the aggressiveness of credit markets that facilitate more competitive pricing. Acquisitions by private equity or private equity backed companies have comprised approximately 25% of total announced transactions since 2009.

In summary, the foreign buyer remains a viable path to explore; however, opening the aperture to these other groups may also accomplish sale objectives with a very similar look and feel.