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Key Building Blocks to Creating Value

By Kevin DeSanto and Robert Dowling

With the New Year upon us, what better time to take a look at the industry and market trends impacting government services companies, as well as the fundamental aspects of value creation in the current M&A environment and how they can be applied to businesses.

These are tumultuous times for contractors, defined by the necessity for companies to adapt to tightening federal budgets, continued contract and procurement delays, escalating oversight and OCI concerns, and insourcing initiatives – all within a backdrop of clear priority areas for federal funding and M&A transactions (e.g., intelligence, cybersecurity, healthcare, C4ISR, energy).

These dynamics have created shifts in both public company pricing and M&A activity:

- ***Industry Trends Impacting Public Pricing*** – The mid-term elections, uncertainty around the 2012 budget, and a challenged government procurement process drove government services median pricing multiples in mid-September to 6.5x and 0.59x trailing EBITDA and revenue, respectively, the lowest levels over 2009 and 2010; however, pricing has since rebounded to levels closer to recent historical norms (currently 7.3x and 0.64x, respectively).
- ***Robust M&A Environment*** – There was significant government services M&A activity during 2010. 95 transactions were announced throughout the year, a level not reached since 2005 and 2007, when 100 and 99 transactions were announced, respectively. It's anticipated that uncompleted 2010 transactions and continued repositioning of larger government services companies into priority funding areas will drive significant activity into 2011 as well.

Attempts by government services companies to supplement modest financial performance through acquisition has placed heightened focus on growth and profitability as the fundamental drivers of value for potential targets; however, these metrics are merely the quantitative result of a tightly run organization with the proper infrastructure, processes, focus, and management team in place.

Select key building blocks of M&A value:

- ***Strategic Planning / Setting Objectives*** – It's important to run a business within an established framework of the short- and long-term objectives of key stakeholders. In addition to narrowing the strategic focus of the company's operations on well-defined capabilities, customers, and milestones, these initiatives will establish a clear understanding as to the required current and future investments to reach the desired goals of owners and senior leadership. Some key areas to communicate include (i) professional and personal aspirations, (ii) compensation structure to attract key management personnel, (iii) establishment / use of employee ownership plans, (iv) future liquidity desires and timing, and (v) valuation requirements should a liquidity event be pursued.

- Focus / Depth / Identity** – The government services acquisition market has shifted away from the size and breadth of services providers, and toward the focus and depth of a company’s capabilities and customers. This is primarily driven by clear priorities areas within the federal budget and the need for larger players to reposition in “hot areas” to garner these opportunities. In addition, heightened oversight of contractors, especially with regard to OCI, has also placed increased scrutiny on an acquisition target’s clear identity as either a performer or SETA / trusted advisor.
- F&O / Prime Contracts** – Since the change in recertification requirements for set-aside contracts in June 2007, M&A dynamics have shifted such that a smaller revenue provider with F&O contracts can be worth more than a larger contractor with significant set-aside exposure. This is a function of the ability to continue performance on set-aside work and the capability to win F&O opportunities post transaction. Companies should also place increased emphasis on garnering prime positions on contracts given it is the default assumption of buyers that this is where the customer relationship is held.
- Infrastructure, Processes, and Talent** – As indicated in Michael Tinsley’s [Plan Now for Acquisition Opportunities](#) article, ensuring the proper infrastructure processes and procedures are in place is essential to improving performance. Firms with strong infrastructure are also better positioned to detail strong forecast visibility and sustainability of margins, which drives incremental value by mitigating perceived risk of future financial performance. With regard to business development, it is essential to have strong personnel and processes to target and win increasingly competitive strategic contracts. In conjunction with this, the ability to retain and attract key personnel is fundamental to generating strong growth as well as distinguishing your company as a coveted asset with significant upside potential.

Sample Business Snapshot

Reflects coveted attributes of a government services company pursuing a liquidity event.

Growth

>10% annual growth (organic)

Margins

>8% adjusted EBITDA margins

Prime / Sub Mix

>70% prime revenue

Set-aside Exposure

<20% of revenue

Duration of Existing Contracts

Average remaining period of performance greater than 2.5 years

These are important topics and sound principles for enhancing value in today’s environment, in which even the most dedicated of entrepreneurs can lose focus during the daily myriad of pricing and proposals, hiring and firing, implementing new systems and fixing old ones, and the countless other tasks management is faced with when running a government services company.

Although daunting in aggregate, focusing business units on strengthening select value drivers will improve day-to-day operations, enhance overall financial performance, and increase the value of a company during the future stages of its lifecycle, including evaluation of minority sale, recapitalization, or M&A transaction alternatives.