OUTCOME CAPITAL

MARKET INSIGHTS

A Historical Perspective on the Fundamental Drivers of Government Services M&A

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Scope

Most of the commentary about the M&A market for Government Services firms tends to be about recent transactions or recent trends. The purpose of this article is to provide longer term context in this cyclical market.

It goes without saying, but is still important to recognize, that the most basic fundamental driver of the M&A market for Government Services firms is the market demand for their services. Another significant factor is how the Government changes its procurement of those services. These two forces impact both the growth strategies and the valuations of those firms, and each has an enormous impact on the Government Services M&A market.

Since a large majority of the funding for the Government Services market has historically come from the Operations and Maintenance (O&M) spending by the Department of Defense (DoD), it is worthwhile to first take a look at O&M spending over time. One should note that two very important things happened as these O&M expenditures grew. First, the average contract size for services contracts greatly increased, which led to a greater interest in this market by prime contractors and also helped drive the initial wave of industry consolidation. Second, as the shorter term sole source contracts were replaced with five-year contracts, private equity investors discovered that the increased revenue visibility of the services firms could support a level of cash flow-based debt financing that helped make them attractive targets to knowledgeable financial buyers.

The consistent growth in O&M outlays stopped in 2013 when sequestration was put in place. Since the two year budget deal was signed in late 2015, these expenditures returned to growth mode and are expected to continue growing in the near term despite a drop in Q1 2017.

9/11 and the subsequent military operations in Iraq and Afghanistan caused Congress to create a new funding mechanism for "wartime operations" that was exempt from the Budget Control Act restrictions. Rather than just increasing the base DoD budget elements, Congress created the Overseas Contingency Operations (OCO) for the Global War on Terrorism (GWOT) funding mechanism. Below is a chart of these expenditures from FY 2001 through FY 2016.

Clearly this wartime spending had a large impact on those

Figure 1

Department of Defense Outlays

Source: Office of Management and Budget

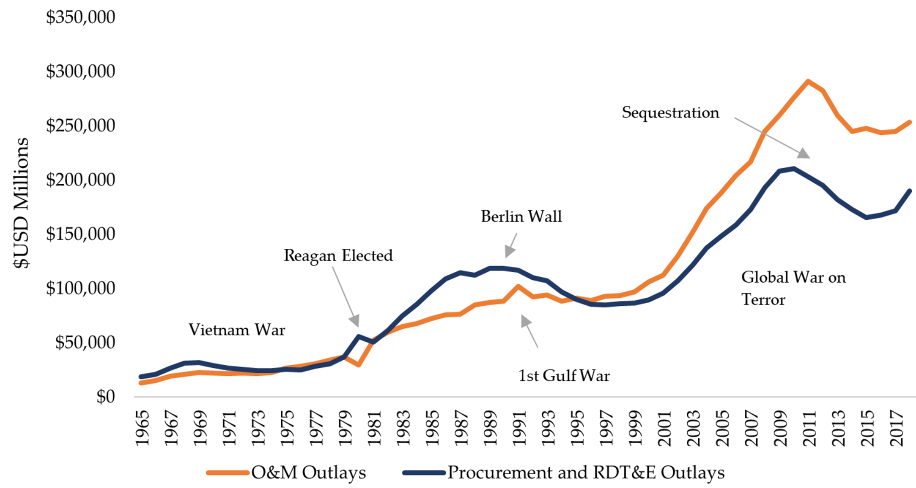
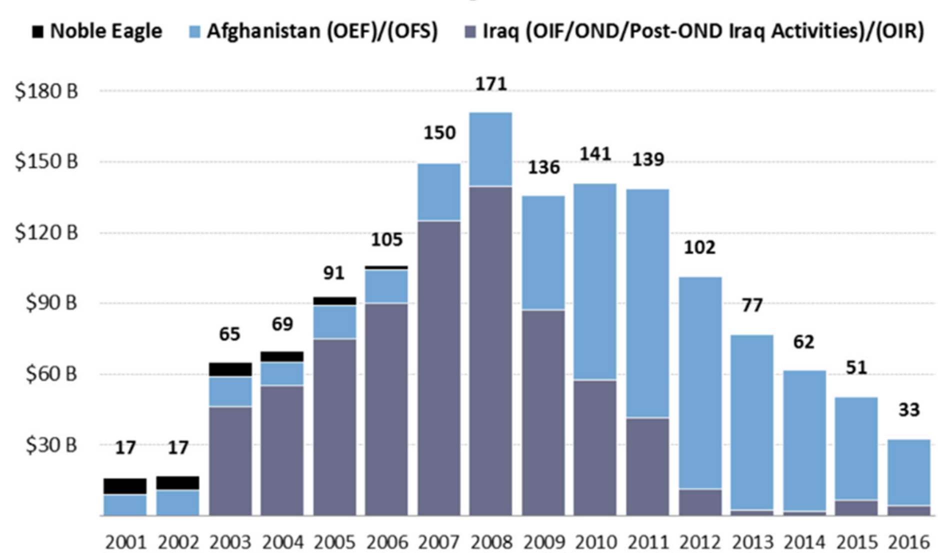


Figure 2

Overseas Contingency Operations/Global War on Terrorism Funding

Source: Department of Defense Cost of War Report, July 2016; Congressional Research Service



firms with significant logistics and security services businesses. Currently about 50% of the outlays from these funds are being used for activities that were previously funded in the base DoD budget. While the cycle of OCO/GWOT outlays is extremely significant as a percentage of O&M outlays, a fairly small portion of those operational expenses went to the publicly traded, pure play Defense Services firms other than Man-Tech. This can be seen in the chart below which compares the Defense Services' pure play organic growth to the O&M outlays growth since the outset of 2010. These rates are highly correlated.

After Reagan was elected, DoD outlays for the acquisition of weapons overtook the DoD outlays on O&M until a few years after the fall of the Berlin Wall. Since 1995, O&M outlays have exceeded outlays on weapons. Despite this, since the beginning of 2010, the total organic growth rates of the prime contractors have exceeded the organic growth rates of their services businesses.

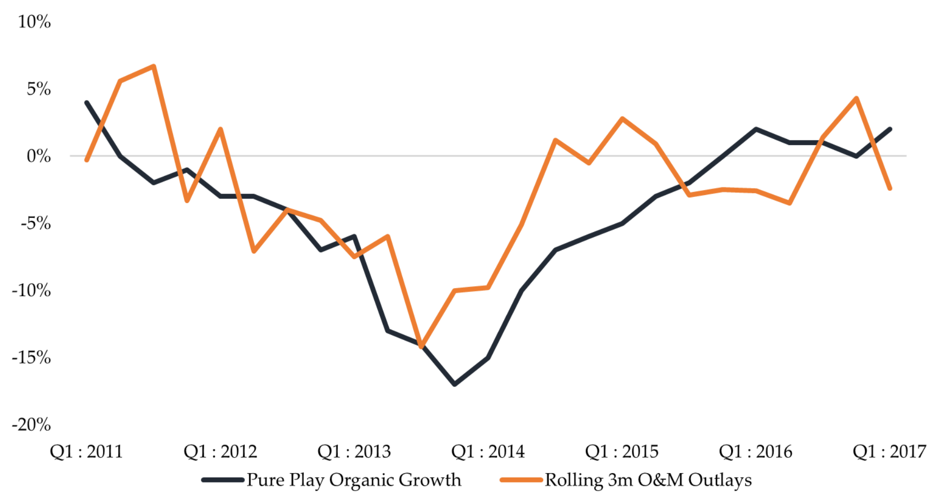
Primes have experienced underperformance in their services businesses relative to their systems businesses, along with increased attention of Government procure-ment officials on the potential for

OCI issues in their services businesses, the proliferation of LPTA procurements, and other risk management issues. Thus, many prime contractors have chosen to refocus on their core systems businesses, and either sell or spin off large portions of their services businesses. Examples of this include L-3's spinoff of Engility and sale of its National Security Solutions business, Lockheed Martin's sale of PAE and the combination of its IT and Technical Services businesses with Leidos, CSC's spinoff and subsequent combination of its Government Services business with SRA, and Excelis' spinoff of Vectrus.

Obviously, the cyclical character of overall defense spending in the US is directly tied to changes in appropriations that are driven by changing political priorities. Historically there has been a greater volatility of Weapons outlays than O&M outlays. This lower volatility of O&M outlays has historically made the services business attractive to both strategic and financial investors. Despite the historically low level of volatility in the Defense Services industry, the reduction in spending on the Global War on Terror together with the 2013 – 2015 sequestration period have shown how resilient these Defense Services firms are and how investors look at valuing them in both

Figure 3

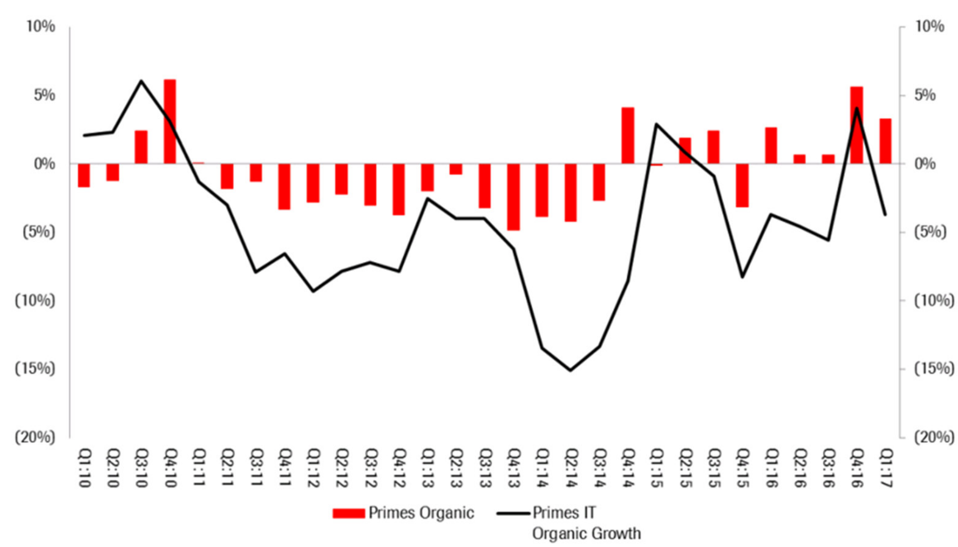
O&M Outlays vs. Pure Play Organic Growth: Government Services



Source: Cowen and Company

Figure 4

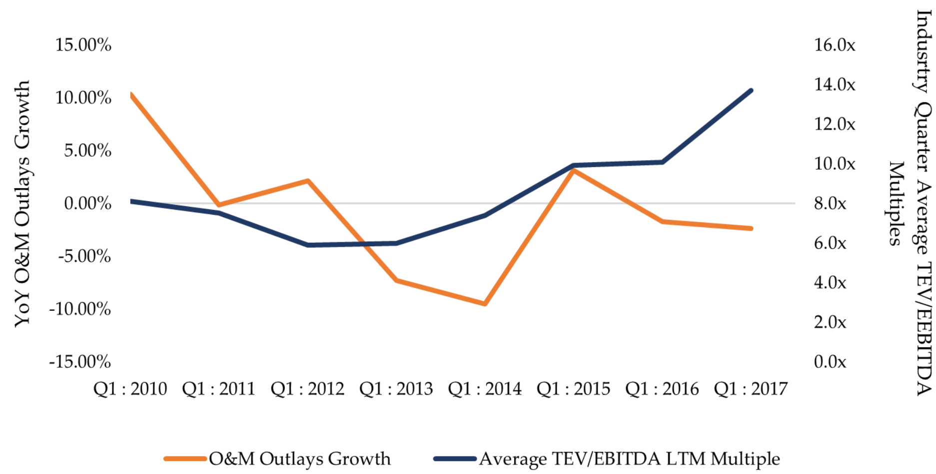
Growth Rates of Primes' Overall Revenue vs. Services Revenue



Source: Cowen and Company

Figure 5

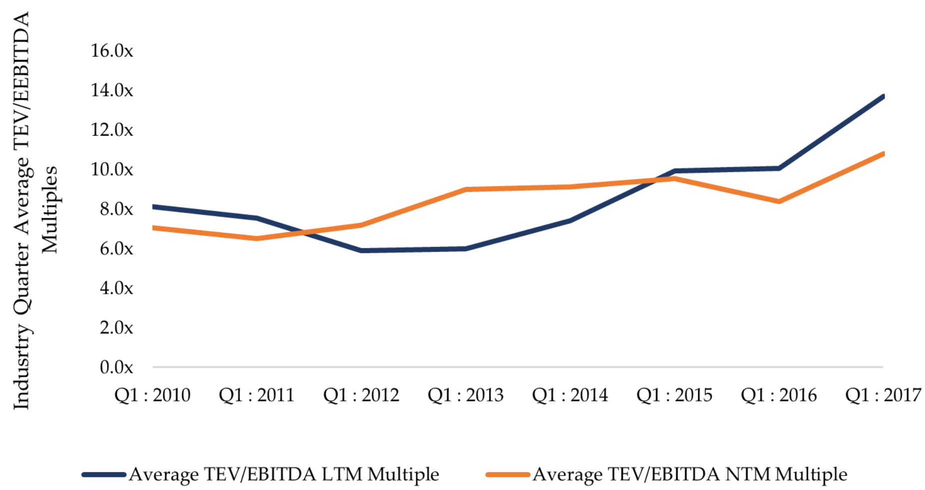
LTM Trading Multiples vs O&M Outlays Growth: Government Services



Source: US Treasury Dept., S&P Capital IQ

Figure 6

Trading Multiples LTM vs. NTM: Government Services



Source: S&P Capital IQ

good times and bad. Below is a chart showing the weighted average EBITDA multiples over time of the public pure play Defense Services firms since the beginning of 2010 together with the changes in O&M spending.

With the pure play Defense Services firms experiencing negative organic growth rates from Q2 2011 through Q4 2015, these firms became even more focused on acquiring businesses in growth subsectors to help them improve their overall organic growth prospects. This included targeting healthcare IT, cyber security, and other growth niches.

Figure 5 shows the weighted average LTM EBITDA trading multiple as ranging from 5.6x (Q4 2010 and Q3 2012) to 13.7x (Q4 2016 and Q1 2017) from 2010 to date for the public pure play Defense Services firms (excludes high and low multiples). Given the longer term stability of this market, one might think that these public stocks are subject to being oversold on bad news and overbought on good news. The forward multiples compared to the LTM multiples show a tighter range since the lower multiples were in periods of expected shrinking revenue while the higher multiples were in periods of expected organic growth.

Not surprisingly, the ranges are similar to the range of EBITDA multiples paid in M&A transactions. In theory, there should be some discount to the public comps for the EBITDA multiples paid in Government Services M&A transactions. As a general rule over the years, M&A pricing as measured by LTM EBITDA multiples generally moved in line with public multiples, but M&A multiples tended to be slightly less volatile compared to valuation swings in the public market. There has always been a willingness on the part of both financial and strategic buyers to pay a size premium for larger companies. In addition, there has also been a willingness on the part of purchasers, especially strategic buyers, to pay more for faster growth businesses in attractive market niches. As anyone who has been involved in the M&A community in the Defense Services market knows, every situation is unique. Every buyer will have its own acquisition criteria, its own view of pricing and its own way of evaluating the business of a potential target. Every seller will have its own unique characteristics as well. Understanding where these interests overlap is best based on combining a current understanding of the market dynamics with an appreciation of the longer term backdrop of this cyclical market.

With the election of Trump, his expressed desire to increase defense spending by about 10%, and the recently passed House Defense Appropriation Bill adding nearly $30 billion to the President's request, there is significant optimism in the financial markets for growth in the Defense Services market. Not only have the pure play public Defense Services companies seen their stock prices increase by about 20% since the election, but so too have private equity investors greatly stepped up their M&A activity in the space to a level nearly equal to that of strategic buyers (as measured by number of deals). It remains to be seen what level of growth will ultimately be funded and in what areas.

In summary, both buyers and sellers in the Defense Services market need to understand the major drivers in this market, both long term and short term, and how they impact their particular circumstances.

About the Author

Mike Cromwell is a co-founder and Managing Director at Outcome Capital. He provides investment banking services for companies in Government Services, and has been the lead on more than 40 middle market M&A transactions ranging in transaction size from $20 million to $250 million.

About Outcome Capital

Outcome Capital is a specialized investment bank with a global reach, providing middle-market growth companies in the technology and life sciences markets with a value-added client-centric approach to mergers & acquisitions, corporate finance and advisory services. The firm uses its proven 'strategy-led execution' approach to value enhancement by assisting boards and management teams in navigating both the financial and strategic markets and in implementing the best path for success. Outcome Capital's strength stems from its unique ability to draw on its wide range of operational, strategic and investment experience, its expertise across the value chain, and its broad industry relationships.

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