Contact:

Marc Marlin
KippsDeSanto & Co.
703.442.1403
mmarlin@kippsdesanto.com

www.KippsDeSanto.com

Government Contracting Industry and Market Trends in 1st 100 Days

By Marc Marlin and Martin O'Brien

Federal spending to curtail the global financial crisis highlighted the first 100 days of the Obama Administration. Beyond the headlines, campaign promises of more efficient, effective and transparent government and an emphasis on social programs without compromising national security were positioned front and center. Life as a government services contractor is increasingly challenging as firms confront anticipated spending reductions (and / or potential in-sourcing), increased oversight, greater responsibility for and repercussions from performance, and heightened importance of being positioned in priority areas.

Impact of Budget Priorities and Stimulus

During the first 30 days in office, the Obama Administration guided $3.6 trillion plus in Federal spending via the draft 2010 government fiscal year budget ("GFY10") submission and the American Recovery and Reinvestment Act of 2009 ("Stimulus") alone. While the base GFY10 budget sustains Department of Defense ("DoD") funding for Overseas Contingency Operations (f.k.a. GWOT), these events and accompanying rhetoric blueprint considerable support for and prioritization of Civilian programs such as healthcare, alternative energy, education and infrastructure as well as national security, especially in cybersecurity and "soft power" foreign policy.

Federal Civilian is back in vogue after having played back-up to the DoD for the past decade. The Administration intends to substantially increase GFY09 and GFY10 funding by supplementing the base budget in select areas with non-tax break Stimulus monies. For example, the GFY10 budget suggests 1% and 3% funding increases for the Department of Education and the Department of Transportation, respectively, compared to 2007 and 2008. However, including Stimulus, total funding growth for these Departments approaches 96% and 39%, respectively. The Department of Energy and Health and Human Services GFY10 base budgets slightly declined, yet inclusive of Stimulus they increase approximately 90% and 27%, respectively. While the Intelligence budget is predominantly classified, there is general consensus of similar increases given the allocation and priority of funds within the DoD and IC, especially in the areas of cybersecurity and Intelligence collection and analysis. Consequently, contractors are motivated and mobilizing to reposition towards these "hot areas".

Competitiveness and a sense of urgency amongst contractors appears to be reaching new heights, especially given the limited window to capture these surge Stimulus dollars and stay ahead of any upcoming contraction in overall Federal spending. The Stimulus funds have a two year intended investment horizon; however, there are inconsistent perspectives on whether the money is flowing yet and if the government will continue such investment thereafter. A recent email received summed-up the current environment best, the spirit of which was: "…on a plane chasing Stimulus".

Greater Scrutiny of Contractors

The financial implications of the Administration's spending spree are significant. The base budget request, Stimulus, and supplemental needs given continued support for Overseas Contingency Operations are key contributors to estimated GFY09 and GFY10 deficits of $1.8 trillion and $1.2 trillion, respectively. With national debt estimated in excess of $11.0 trillion as of April 2009 and growing, the Administration will soon face little choice but to increase taxes and decrease spending in order to reduce this mounting deficit to more manageable levels. The government may undergo a similar deleveraging as currently evident in the broader economy.

The eventual spending pull-back, the timing of which is a point of much debate, alongside an expanding Administration agenda, is expected to task government agencies and their contractors alike to "do more with less". This dynamic could intensify performance pressures on a growing pool of contractors competing for more limited contracting dollars. The threat of more limited contracting dollars was also expressed in recent White House remarks promoting in-sourcing. In a March 4th proposed expansion of government contracting policy, President Obama remarked, "We will stop outsourcing services that should be performed by government". One month later in an April 7th press conference, Defense Secretary Gates echoed this theme in his suggested DoD reformation plan that included the conversion of 11,000 contractors to full-time government employees and the hiring of 9,000 additional acquisition professionals by 2015. The White House also continues to emphasize oversight and accountability, which will be tied to each dollar of government spending, making good on goals of efficiency and transparency. Along these lines, a growing preference towards performance based contracting and fixed price contract types would further shift performance risk onto contractors.

Economic Impact

Government Services M&A volume dropped dramatically in the first quarter of calendar year 2009, a lagging effect of the continued broader economic collapse experienced during the fall of 2008. First quarter 2009 had nine closed M&A transactions, a 56% decline from 20 in the fourth quarter of 2008. While this drop-off lagged the public equity and credit markets chaos throughout the second half of 2008, it is important to recognize that many of the fourth quarter deal closings were near the end zone prior to the credit meltdown following the collapse of Lehman Brothers and AIG in September 2008. Simply put, the lack of credit and buyer conservatism in the fourth quarter squashed M&A momentum entering these first 100 days in early 2009 despite increased spending.

Deal volume has shown a slight pickup, with five announced deals in April, a positive development for the full year outlook. Notably, the deals that have occurred amidst the broader market turbulence and within the context of the first 100 days mirror the priority areas promoted by the Obama Administration leading up to the election and those implemented thereafter. Of the 26 Government Services transactions announced since Election Day, nearly 70% included sellers who promoted a connection to the aforementioned hot areas. For example, Parson Corporation's Infrastructure and Technology Group recently acquired McMunn Associates, Inc., a provider of analytical, technical, training, and management services and solutions to the Intelligence Community, while Harris Corporation acquired Crucial Security, Inc. in order to broaden capabilities and customer footprint in offensive and defensive cybersecurity. Many were also smaller, more niche companies. We expect this trend to continue, as companies reposition and prepare for the contracting environment to come.

There is an argument that the combination of tighter spending, increased competition and acceptance of greater performance risk may translate into slowed top-line growth and compressed profit margins for contractors, two primary drivers of valuation from an M&A perspective. This challenging market outlook magnifies the importance of being positioned in the aforementioned priority areas and on programs that are less likely targets for in-sourcing. A formidable presence in priority areas, anchored by truly differentiated capabilities or relationships, enhances value as a bridge for acquirers to reposition to capture a greater share of contracting dollars. More than ever, we anticipate market leaders to separate themselves from the pack, increase market share through M&A, and thrive in the second 100 days of the Obama Administration and beyond.

Outlook

The first 100 days of the Obama Administration reshaped the landscape of government contractor strategy within the context of monumental fiscal spending and policy changes brought to Washington alongside President Obama's arrival. The next 100 days will include new challenges and political milestones. The government contracting and M&A community alike await clarity around policy initiatives regarding oversight, outsourcing and organizational conflicts of interest. As a community, we await specific fiscal spending decisions such as automotive bailout vs. bankruptcy and broader economic recovery which may have trickle down effects to available contracting dollars for discretionary programs such as information technology modernization. As a nation we accept the continued challenges and threats presented by the Overseas Contingency Operations and recognize the increased stakes of asymmetric warfare over the internet with cybersecurity and cyber offensives the weapons of choice. Because of these challenges, leading government contractors who assist their customers to achieve their missions more efficiently, effectively and economically will continue to flourish and enhance their intrinsic value.