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New Year's Resolutions That Build Value

By Marc Marlin and Robert Dowling

2009 was indeed the year of change - change of Administration, change of priorities, and change of market environment for government contractors. Having experienced robust federal spending, rich contracting dollar opportunities, and feverish M&A activity from 2004 - 2008, the exuberance tapered amidst continued economic uncertainty and the longer-term financial stresses of new (e.g., bank and automotive bailouts) and pre-existing (e.g., social security, healthcare) government actions and programs, overseas contingency operations, and pressing cybersecurity protection and response capability needs. As a result, discretionary spending for professional / consulting services and technology solutions, the financial lifeline for many contractors, was selectively crowded out. Heightened oversight and scrutiny of federal agencies and consequently their contractors became synonymous with White House activity to improve efficiency, effectiveness, and transparency of government. This focus translated into lower tolerance for cost overruns or struggling programs and postponement of select new projects. Contractors also faced more stringent focus on OCIs, calls for insourcing, and a renewed government emphasis on FISMA and more broadly cybersecurity compliance (across defense, healthcare, and other civilian agencies alike). That said, with challenge comes opportunity, so consider the following 2010 New Year's resolutions to help build value given the new world order for government contracting.

Resolution 1 – Define Your Corporate Identity

Increased government emphasis on OCIs has encouraged contractors to more definitively choose an identity as either a "Trusted Advisor" or "Integrator / Performer," at minimum by program, and more broadly by customer organization or corporate-wide. Looking forward, heightened government energy around OCI management could lead to a more bifurcated marketplace, with equally vibrant and competitive Advisor and Integrator / Performer segments.

M&A opportunities as both a buyer and seller have been influenced by the enhanced concern over OCI. From a buyer perspective, the self selection of the deep-pocketed defense primes toward high dollar integration / platform work leaves a fertile advisory M&A market for small and mid-size services firms and private equity players. Albeit not small, a recent example of such M&A activity was Northrop Grumman's divestiture of TASC to private equity groups KKR and General Atlantic.

From a seller's perspective, it's also important to consider how identity as a Trusted Advisor or Integrator / Performer impacts one's own M&A value. While midsize firms often effectively mitigate OCI through "Chinese" walls on a program or customer basis, this strategy gets infinitely more complicated with potential larger buyers' numerous conflicting positions. The more consistent the corporate identity across the portfolio, the less difficult / risky an integration plan for the acquirer, thereby increasing a potential target / deal's attractiveness. Further, valuations for "Trusted Advisors" are likely to be relatively less than the similarly situated "Performer" as a result of the more limited buyer pool (which excludes the large, cash-rich defense primes).

Resolution 2 – Build Customer Dependence and Employee Loyalty

Concern surrounding President Obama's plans to grow the government workforce and its potential impact on contractors materialized as an unwelcome 2009 New Year's gift. In March 2009, the Administration issued its Contracting Reform Memorandum, ordering the OMB to review contractor procurements and in particular, outsourcing of work historically performed by federal employees. Later that month, the President signed the Omnibus Appropriations Act, which further discourages the government's ability to hold public / private competitions and requires agencies to give primary consideration to insourcing new and existing functions. In December, the House reaffirmed these initiatives by approving more than $600 billion in Defense Department spending, which included initiatives to reduce outsourcing. The insourcing shadow adds an additional complexity to the contractor / customer partnership, especially as government hiring becomes more aggressive. Furthering customer dependence and driving employee loyalty are potential first steps in managing this insourcing risk. Mission critical, higher-end services are perceived to be more shielded from at least near-term insourcing, making this work more valuable from an operational stability and M&A attractiveness standpoint. Examples of this work include cybersecurity, healthcare IT, and more complex systems engineering. Firms should also refocus on employees' satisfaction as culture, compensation, and professional development opportunities may help sway key personnel away from the stability of government work, or at a minimum encourage favorable consideration if these folks transition into customers.

Resolution 3 – Invest in New Markets and Infrastructure

Government agencies have been tasked to do more with less – stretching each contracting dollar and shifting increased accountability and responsibility to the contractor. While on the face this trend is another example of tougher operating conditions, it also presents opportunities for leading firms to differentiate from the pack. Money is still flowing into higher-end mission critical programs and IT initiatives such as the Defense Information System Network (DoD), Warfighter Information Network (Army), Next Generation Enterprise Network (Navy), NPPD National Cybersecurity & Protection System (DHS), Consolidated IT Infrastructure (HHS), Consolidated Enterprise Infrastructure (DoJ), and Medical Program IT Support (VA). Positions supporting these programs may not only drive organic growth, but also have a higher likelihood of attracting potential suitors. Infrastructure investment can also build value. A long-term approach of investment in processes, technology, and procedures can better enable responsiveness to the challenges of an increasingly fixed price contract environment, accommodate DCAA audits, improve accuracy of reviewable information, and manage the business more efficiently overall; all of which are within the spirit of the government's do more with less mentality.

With the arrival of 2010, there is anticipation of continued oversight and scrutiny on both federal agencies and contractors as the Administration looks to fulfill promises of improved efficiency, effectiveness, and transparency of government spending. However, those willing to embrace the changes and seize opportunities can drive longer-term value for their businesses, operationally and through M&A as a buyer or seller.
