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Summer of Opportunity - M&A Activity Heating Up Following Cooler Market Temperatures

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The weather is warm, the sun is shining, the beverages are cold. Life is good. Suddenly, the sky darkens as clouds roll in. The wind picks up speed and the seemingly therapeutic cadence of the ocean waves begin to crash with a newfound anger. In a blink, raindrops attack the sand, sending vacationers scattering. Amidst the drama, watches the seasoned surfer. Confident this storm too shall pass, he calmly waxes his board, eyeing the waves, and eagerly waiting for what's next.

The government and defense contracting environment circa 2008 – 2009 has similarities to that unexpected rain shower we've all likely experienced. Few see it coming, others don't want to believe, and select folks always seem prepared to adapt their plans and embrace it. A myriad of market changes and new challenges have emerged over the past few years, including but not exclusive to the Obama Administration's anti-contractor sentiment, complex economic and budgetary pressures, capital markets conservatism, and paused M&A markets in the wake of broader domestic and international economic instability. However, the ripples are settling and a new dawn of opportunities has arisen, shaping the next chapter for the government and defense contracting community. These characteristics embody focus, M&A as a preferred tool to reposition and flourish, transparency, and renewed access to capital.

The growing federal deficit and political strategies to curtail spending have caused stronger headwinds for contractors. These headwinds have included program cuts such as NASA Constellation, a freeze on non-security domestic discretionary spending, insourcing rhetoric put into practice, and more recently Defense Secretary Gates' recently proposed $100 billion funding reallocation (e.g., cuts to the Joint Forces Command, select staff, and transition towards a centralized IT environment) over the next five years. These actions present market uncertainty for contractors, a stark contrast to the robust environment post 9/11. That said, when government spending is tight and changes abound, IT programs may benefit as the government looks for trusted advisors and integrators to identify, design, and execute the changes and agencies themselves are tasked to do more with less. In addition to change motivated opportunities, meaningful dollar values of spending cuts are anticipated to morph into reallocations towards intelligence, cybersecurity, and defense modernization programs. While there will be winners and losers, the overall federal information technology market is anticipated to experience 5-6% per year growth through 2015[1], signaling continued market strength and opportunity.

Many current big winners of the stormy contracting environment are ironically the smaller, innovative, niche technology and services contractors that often flew under the radar of their larger peers pre- 2007; a period characterized by universal growth, rapid consolidation, and a premium placed on scale. These smaller firms

[1] Input. Annual Forecast: Federal Information Technology Market, 2010-2015 (Jun 2010)

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have emerged as extremely well positioned in above-average growth intelligence analysis and support, cybersecurity, and healthcare information technology mission areas. For example, technology experts in database technology, information sharing, data centric security, and network / cyber response – each at the forefront of critical national and DoD intelligence needs - have matured into highly sought after teaming partners, employers of choice for top talent, and those possessing the innovation government customers thirst for.

Companies too small to immediately move the needle from a revenue standpoint for larger buyers and thus passed-over as viable M&A targets during the robust consolidation pre- 2008, are now the darlings of M&A. The M&A markets have really opened up for these focused, high technology firms, as acquirers are laser focused on maximizing investment in fast growth areas. Acquisition appetite and resulting premium valuations for these companies has, to some extent, trumped sale processes for larger firms having diverse capabilities and/or customer sets. Recent examples of smaller, high-growth targets include Boeing's acquisition of Narus and Schafer Corp.'s acquisition of Asynchrony Solutions Inc. Narus is a provider of security, intercept, and traffic management software solutions for the protection and management of Internet protocol networks. Boeing highlighted Narus' application to develop smart grid energy projects, as well as help to protect Boeing's in-house computer network. Asynchrony is a provider of systems integration, custom application development, and secure collaboration solutions. Schafer was attracted to Asynchrony's capability focus on cybersecurity and weapons of mass destruction counter proliferation.

Insourcing and OCI concerns have also comprised other dark clouds hovering over the sector, with the most ominous outlook occurring in late 2009, early 2010. On a positive note, government officials are selectively acknowledging that the anticipated cost savings may have been optimistic. While still an ongoing challenge, the most sweeping insourcing efforts for DoD/Intel contractors may be behind us. Government concern and actions surrounding OCI mitigation has also created both headaches and opportunities. OCI motivated divestitures has resulted in sizeable, strong performing acquisition opportunities for strategic and financial buyers alike. Private equity firms General Atlantic and KKR acquired TASC from Northrop Grumman and Court Square owned Wyle acquired CAS, while Lockheed Martin's announced divestiture of most of it divest most of its Enterprise Integration Group ("EIG") business has attracted considerable financial sponsor interest. These larger deals have also expanded the universe of active acquirers, especially for SETA firms. Similarly motivated but smaller in size deals include Arctic Slope Regional Corporation's buy of CSC's Missions Solutions Engineering and MCR's acquisition of select Navy contracts from Alion Science & Technology. These divestitures have also released these business units from growth constraints brought on by unrelated sibling businesses with their prior parents, adding to the robustness of their go-forward opportunities.

Finally, credit and public market receptivity for government services and defense firms are showing positive momentum. Working capital financing (i.e., lines of credit) for smaller contractors has eased, enabling firms to think more strategically as it relates to investment and longer term strategic planning. Lenders are once again aggressively pursuing acquisition financing opportunities, a reversal especially important to financial sponsor buyers. Leverage multiples for sub $10 million EBITDA business have settled in around 2-3x latest-

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twelve-month EBITDA whereas acquisitions of $10 million+ EBITDA companies have exceeded 4x total debt. Public market financing alternatives, IPOs and secondary offerings, have also resumed as viable financing and liquidity alternatives. Booz Allen and KEYW have both filed S-1, with the potential for additional filings from TASC, Wyle, Camber, and Vangent, amongst others, in the not too distant future.

The government and defense contracting environment hasn't returned to the pre-2008 exuberance, however, there is a growing sense of stability that has enabled players to focus forward, rather than triage the present. With change, comes opportunity, and as outlined above, there are reasons for optimism as the community ushers in the next phase of its evolution.

The winds die down, the sky returns to blue, the sunlight peeks out from behind the clouds, and the storm retreats far out to sea. The casual vacationer dwells on relaxation lost, however, for the experienced and patient surfer, the reenergized ocean represents a new set of waves to ride.