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1 Year After the SBA Recertification Ruling—Glimmers of Hope for M&A

The capital markets just experienced one of the worst quarters ever. With banks failing, Freddie Mac and Fannie Mae in financial distress, oil prices continuing to skyrocket and seemingly no hard bottom to the credit/subprime mortgage crisis, it seemed like there was very little good news in the 2nd quarter. In June alone, the S&P and NASDAQ were down 8% and 7%, respectively. The market declines were not only in the US. In June, market indices in China and India (two of the darlings of the recent past) were down 16% and 23%, respectively. Overall, pretty nasty across the board!

As they have done over the past few quarters, Defense and Government Services Contractors fared much better than the general market. During the quarter, Government Services firms were actually up 2.6% while Defense Electronics/Hardware firms were down about 5%. In addition, M&A activity within these sectors remained brisk with valuations for top firms holding up quite well as evidenced by the Stanley/Oberon Associates and AEA Technology/Project Performance transactions that were announced in June (KippsDeSanto & Company advised on both of those transactions).

As most know, uncertainty over the SBA and Government customer behavior following the SBA's Small Business Ruling has materially impacted the M&A market over the last year for smaller Government Services firms in particular---deals involving firms with Small Business Set Aside contracts have been fewer in number and (if completed at all) contained less attractive terms since the Ruling went into effect June 30, 2007. While some noteworthy deals, like the RS Information Systems transaction (terms not disclosed), have been completed, the terms were significantly impacted by the post-Ruling uncertainty. Complicating the situation is the various shades of gray with respect to Small Business credit and contract risk. While these situations and risks vary dramatically, for most of the past year, buyers and investors have generally been treating the risks similarly---either shifting the risks to the sellers through deal structure (e.g. earn-outs) or avoiding the risks entirely by staying on the transaction sidelines.

Fortunately for owners of small and mid-size companies (and their advisors), the broad brush approach may be ending. Helping the cause were two distinct but similar announcements from major government agencies on treatment of small business contracts – first from the Air Force on April 22nd in connection with its long-term multiple award contracts and then the Department of Homeland Security (DHS) on May 7th in connection with DHS EAGLE. Both announcements were specifically focused on what happens to those contracts awarded to Small Businesses following a merger or acquisition transaction of such businesses in which following the consummation of the transaction the sellers (contract holders) can no longer certify themselves as “small”. The DHS Memorandum was very specific in the handling of its EAGLE contract stating that if following a merger or acquisition transaction, an EAGLE contractor can no longer represent that it is “small”, that “...the contractor is no longer eligible to

compete under a “set-aside” requirement...” but--most importantly—the previously “small” contractor “...will continue to be eligible to compete on future “unrestricted” requirements until the expiration of the five year base period.”

The Air Force Memorandum while not quite as specific contained substantially the same message, “...businesses that become large during the term of a small business set-aside indefinite delivery contract should be allowed to continue competing for individual task and delivery orders under fair opportunity procedures.” While only related to multiple award vehicles of these agencies, these two Memoranda provided clear direction where only anecdotal evidence previously existed (and had, for the most part, not been deemed reliable enough in the current market).

The positive effect of these announcements has already begun. On April 19th, VSE Corporation announced the acquisition of G&B Solutions, an active EAGLE SB awardee. On July 2nd 2008 Bart & Associates acquired Digital Solutions, another active EAGLE SB awardee.

With the late April award of DISA’s ENCORE II contract—containing an attractive \$12.2 billion ceiling--to 12 Small Businesses (in addition to 14 Large Businesses), plus many other large IDIQ vehicles coming down the pike, the DHS and Air Force’s clarifying memoranda could be a harbinger for other agencies to provide similar guidance. These precedents might be exactly the much needed feedback the market has been waiting for...