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Understanding M&A Value of an Intel National Security Market Focus

The hyper-intensive focus on Intel and homeland security has led to an attractive market opportunity for contractors, and continues to drive premium M&A values. The tragedies of September 11, 2001 awakened the current threat environment in which we live – an environment comprised of disparate, questionably organized, politically and often religiously fueled enemies having a motivation and energy previously unforeseen. The post-9/11 enemy profile is in stark contrast to those of prior conflict environments in which enemies were nations, with relatively transparent organizations and strategies. The emergence of this threat environment exposed various national security vulnerabilities; the recognition of which motivated immediate political and financial resource reemphasis on and enhancement of U.S. intelligence capabilities, such as human intelligence (HUMINT) collection and advanced multi-modal biometric technologies for tracking and identifying persons of interest. Seven years later, this threat environment remains the primary influencer on U.S. defense, homeland security and civil affairs initiatives.

This current threat environment and the ongoing, well-funded programs introduced in response have similarly affected both the strategic positioning of companies, and mergers and acquisition (M&A) activity within the government contracting community. Contractors having a foothold in the difficult-to-penetrate Intelligence Community (IC) and national security markets remain at the forefront of acquisition interest and continue to achieve premium transaction pricing. Premium M&A transaction multiples of Intel/national security firms can be more than 10% higher than those for more diversified government services plays. An understanding of the market characteristics encouraging these multiples, and how to accelerate growth once a player is detailed below.

Both public and private companies alike are focusing branding and business development efforts toward Intel and national security. For example, the opening banner on the CACI website reads “*A National Asset for National Security,*” with its core markets identified as “National Security, Intelligence, Homeland Security and Government Transactformation”. The ManTech International website similarly reads “*Leading the Convergence of National Security and Technology*”. The federal government’s prioritization of Intel and national security programs and resultant wealth of high dollar opportunities has also attracted new and return entrants into the market, such as DC Capital Partners and CoVant. DC Capital Partners is a Washington D.C. based financial sponsor having completed eight recent acquisitions in the space, and CoVant, a partnership of between former Anteon Corporation senior management and financial sponsor CI Capital Partners (formerly Caxton-Iseman Capital). As the universe of players expands, so does competition for assets in the space. With increased competition comes elevated pricing.

Greater competition for a limited universe of assets and correlation to premium M&A pricing is relatively straight forward. However, a more detailed understanding of Intel and national security specific market characteristics provides additional insight as to how/why premium multiples continue to be achieved despite turbulence across the broader financial markets. From an acquisition standpoint, a strong footprint within difficult to penetrate and well-funded market segments is highly coveted. As the U.S. continues to lead the GWOT, robust intelligence capabilities remain critical to both conflict and low intensity military operation and homeland security efforts. The allure of national security directly relates to the attributes of this market yielding “perpetuity” value due to high-confidence long term growth potential. M&A value drivers and undercurrents of this perpetuity value investment thesis include the following:

Bipartisan Support and Emphasis on National Security

Bipartisan consensus has emerged and solidified in support of reconstituting the IC. This consensus is evidenced by unprecedented budgetary and manpower increases for both operations and the IT modernization required to mitigate the risk of a diverse range of national security threats. Politically, both Presidential candidates have touted their commitment to national security despite differing approaches.

Continued Strong Funding Supports Above-average Organic Growth

The annual intelligence budget is estimated at \$48 billion while estimates for overall national security efforts are multiples of this - the largest amount in history. Notably, post-9/11 supplemental may have accounted for nearly double these figures. Diversity within the IC elements and amongst their objectives results in a robust yet complex addressable market for contractors. To many, the mission critical ongoing nature of IC and national security efforts represents above average growth potential compared to other federal government market segments.

Barriers to Entry

Security clearances remain the key barrier to entry into the IC outsourcing market and especially “three letter agencies”. Contractors into this community often require the highest of clearances and are comprised almost exclusively of U.S. citizens who carry a high premium in the market. Given the tight labor supply for such individuals, the ability to identify, recruit and retain talent discourages entry and protects existing players’ positions. Anecdotally, the IC is amongst the most loyal of government customers, greatly enhancing the incumbency value of contractors.

Allure/Lack of Transparency

The closed community characteristics and mission criticality of IC operations have an aura of secrecy and opaqueness. There remains an allure of gaining access to these highly coveted programs and customers. In some instances these characteristics can motivate a herding effect where companies flock to the community in fear of being perceived by investors to have missed out. Given the aforementioned barriers into this market, the quickest entry is often acquisition.

The market attractiveness as set forth above and M&A premiums being realized beg the question - *Strategically, what can smaller and medium sized companies do to accelerate growth within these communities in order to build value?* Ms. Jodi Johnson and Mr. David Young, Co-founders of Oberon Associates, Inc., an intelligence and national security company acquired by Stanley, Inc. in July 2008, recommend:

“When looking to accelerate growth within the community, it is critical to invest in the infrastructure that enables self-sustaining participation, specifically recruitment, human resources and a security team well versed in the clearance process. These investments help smaller companies provide significant value to their teaming partners in the early years and over time achieve independence as the organization grows. Secondly, the Intel space more than any other (except maybe special operations) relies on companies staffed with people that come from that community. Company personnel must “speak the language” and have “easy access” (clearances) to be successful.”

Given the continued mission criticality of intelligence and national security initiatives within the context of the current threat environment, continued emphasis on this market is expected. However, those firms best able to exploit their understanding of the unique characteristics of these communities to position themselves as long-term partners within these sought after customers are best positioned to harvest long-term value through organic growth, as an acquirer or from a liquidity event.