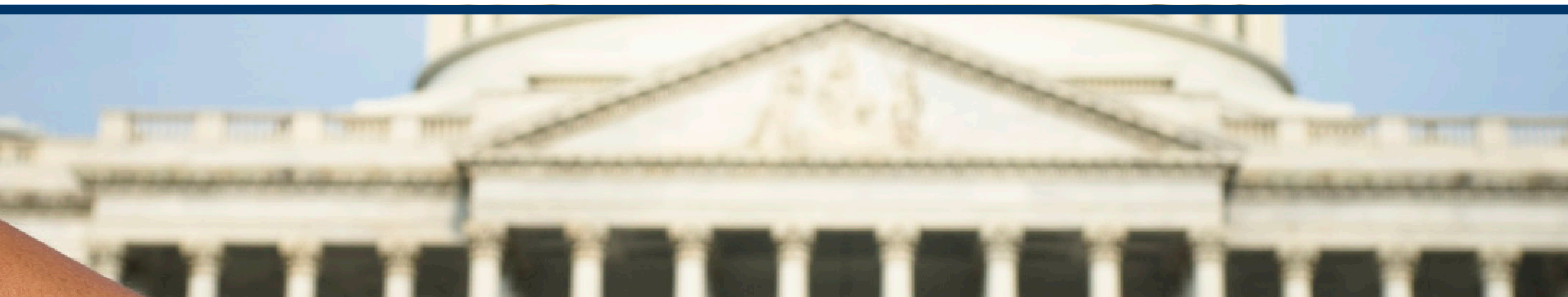
A BVR Special Report

Excerpt from

Key Trends in the Valuation of Government Contracting Firms



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What It's Worth

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3. Enhanced Market Understanding Needed to Value Government Contractors

By Bob Kipps

Federal budget battles, unclear tax positions, and domestic and international economic trends are creating a challenging environment for government contracting firms and the business appraisers that value them. BVR interviewed Bob Kipps, managing director of KippsDeSanto & Co., a defense and technology focused mergers and acquisitions banker, for insight into the current state of the government contracting market.

BVR: How is the government contracting market changing?

Bob Kipps: For the first decade of this century, government spending on wartime and homeland security efforts escalated significantly, and government agencies leaned heavily on contractors to provide consulting services, support, and solutions. However, over the last few years, government budgets have been mostly flat or declining.

Government contractors are now operating in an extremely competitive environment with fewer new business opportunities outside of a handful of areas, such as cybersecurity, data analytics, cloud computing, health information technology (IT), and C4ISR (national security-oriented solutions for command, control, communications, computers, intelligence, surveillance, and reconnaissance). Efforts and programs related to the above areas are perceived to be less prone to potential budget pressure; in fact, on a relative basis, these areas are booming in terms of business growth and mergers and acquisitions. However, the companies that provide products and services in these areas represent less than 20% of the marketplace, and many of the remaining contractors are struggling.

Given the broader budget trends, valuations for most other government contracting firms—including even the large public companies—have been flat to down over the last couple of years. As such, executives are rethinking strategies and becoming more aggressive in order to grow. Many large firms' cash balances are at historic levels, and these firms are poised to make strategic acquisitions for building capability sets, expanding into new markets, and ultimately stimulating growth.

M&A volume has picked up somewhat compared to 2011; 51 aerospace, defense, and government services transactions were announced in the third quarter of 2012 and 187 deals year-to-date (versus 180 year-to-date in 2011). Notably, M&A activity in the aerospace sector has surged in 2012 to volumes not seen since before the recession. Seventy-four aerospace deals were announced in the first three quarters of 2012, *up significantly* from the 54 announced through the equivalent period in 2011. The number of transactions in the defense and government services sectors, meanwhile, has declined slightly in 2012 relative to 2011. As we approach year-end, the threat of sequestration is becoming increasingly eminent. On the tax front, the previously extended breaks set forth by the Bush administration are due to expire, with uncertain probability of being extended into 2013. With a lack of clarity around the next fiscal year mounting, sellers are becoming more aggressive about reaching deal terms before closing the books on 2012. This portends a potential rise in activity during the fourth quarter of 2012.

BVR: What drives government contractors' value?

BK: This question requires an understanding of the basics of the business. To work as a prime contractor with a governmental agency, a business must have: (1) desired products or services; (2) established customer relationships; and (3) a contract in place with those customers. As an aside, when looking at acquisitions, most buyers are focused on buying at least two, if not all three, of the above components. When it comes to placing value on such firms, the target's growth, risk, and leveragability also heavily influence the analysis.

Growth. Especially in a tightening market like today's, the ability for a business to deliver sustainable medium-to-long-term growth is a crucial valuation input. That growth potential typically is a function of the company's customers (do they have growing needs and budgets?) and whether the solution offerings are experiencing increased need or demand (e.g., cloud computing or cybersecurity).

Business risk. Like the valuation of any asset, inherent risk or uncertainty is a major valuation consideration. For government contractors, business risk includes the common factors such as management quality, strength of internal processes and procedures, and business diversification, as well as several unique considerations. In particular, the nature of their contracts can heavily influence the risk profile of government contractors—specifically, the amount of their backlog (or awarded work less work performed to date), whether the business works as a prime contractor or subcontractors, and whether their contracts were awarded based on any government "preference" programs (perhaps based on the business's size or minority ownership). Buyers are generally larger firms that do not qualify for these types of contracts and, as such, often are careful about placing much emphasis or value on them.

Leveragability. Another value driver is what I call leveragability, or situations where the proverbial 1 plus 1 may equal more than 2. For example, a small business may have a new technology, but it can't do anything with it because the company doesn't have the reach, capital, or scale. Another example is when a company that has a large, attractive customer relationship—or in the government world, a large prime contract vehicle. A large contract vehicle often can be much more valuable to a large business than to a smaller company that may not be able to harvest business opportunity from it on its own.

BVR: What advice can you give to business appraisers valuing small government contracting firms?

BK: Valuations of government contractors are more difficult than in the past. First, there's the lack of publicly available data on smaller transactions. If you're not doing deals as an M&A advisor or if you're not otherwise heavily involved in the marketplace, you have almost no visibility into 90% of the transaction's terms or more.

Second, there's a larger dispersion of valuations in today's market than in the past. So valuing a government contracting company requires an enhanced level of market understanding in order not to dramatically overvalue some companies. Appraisers who value just one or two businesses a year might incorrectly assume that all government contracting companies are similar to the larger public firms or are at risk because federal spending is declining. There are very few pure-play public government contractors, so it's very hard to find comparability. As mentioned earlier, business performance and prospects are very different for different sectors. Valuing a company that manufactures parts for unmanned air vehicles is very different from valuing a company that provides security guards in Afghanistan. It can be a mistake to use the public comparable financial data and deduce that a government contracting firm trades at a 12 P/E multiple or a 7 EBITDA multiple or 50% of revenue, whatever the case might be. The large bellwethers, such as Lockheed Martin and SAIC, are trading at very low market multiples because they have exposure to both the attractive and less attractive market areas.

Appraisers who are not familiar with the particular niches should follow the announcements of transactions, read the analyst reports, and listen to analyst calls. But because a lot of information isn't publicly disclosed, appraisers need to do some investigative work because there is a dramatic difference in the valuation of a cloud computing or cybersecurity business and the valuation of Lockheed Martin or SAIC.

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