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Federal IT contracting fuels growth, M&A in down economy

Industry Insight

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The thing about brain surgeons is that they specialize. It's what drives their value above those of other medical disciplines. Federal information technology contractors have been able to access capital and achieve high acquisition valuations despite the down economy partly because of a growing recognition of their specialty, namely, selling to Uncle Sam. In a manner after brain surgeons, federal contractors have devoted substantial resources to mastering what to many is an impenetrable tangle of challenges associated with selling to the federal government. This subject matter mastery has allowed federal contractors access to low-cost capital, attracted private equity investors and driven company values north despite the otherwise unfavorable economic climate.

Access to capital

Government contractors are uniquely able to access low-cost capital to keep pace with their growth imperatives. Government contractors often meet their cash needs with conventional bank financing because of the unique creditworthiness of their customer. Ted Lauer of Access National Bank acknowledges the role this distinction plays when he says, "We are often able to arrange financing and lines of credit for early-stage government contractors that would otherwise have no access to such low-cost funds." Nonbank sources of financing, such as finance companies and other asset-based lenders, are also very vibrant in the government-contracting community, which is not always the case in many commercial sectors.

The problem for many commercial early-stage companies has been qualifying for these loans. Government contractors, on the other hand, are able to leverage their consistent, long-term contract payments from the federal government. The reliability of these contract payments and the security provided by their revenue streams eases the credit concerns of the lenders and makes lower-cost financing possible. In terms of the cost of capital, working capital and acquisition financing from a bank averages less than 10 percent in today's market. By comparison, private equity financing can run as much as 35 percent of the amount raised.

Despite the scarcity of angel groups and venture capitalists in some sectors, more and more private equity groups are interested in acquiring government contractors to provide added diversification to their portfolios. These investors may be looking for the elusive "platform company" from which they will build their enterprise and expand it in a new market. If the company is too small to fit that role, then its value is driven by the complementary products and services it offers that allow an existing platform company to broaden its reach.

Management teams with proven government-contracting experience are important to financial buyers. Merger and acquisition experience can be a big plus because the investors often plan to do more transactions on the journey to "critical mass" — the point where they can liquidate their investments and maximize returns.

Unique M&A value drivers

The unique characteristics of their business not only define government contractors but also drive company valuations in merger and acquisition transactions. Acquiring companies will pay a premium for a government contractor based on the target company's score in certain identifiable factors, some unique to the federal contracting sector. Unique value drivers in the government contracts sector include:

Core competencies: Government-contracting businesses cover the full spectrum of business services. The type and quality of services/products greatly affect valuation. If, in a particular area, a contractor can demonstrate deep technical expertise unmatched by other contractors, it can expect a positive impact on its valuation. For example, contractors that manufacture technically advanced items or that provide a specialized service in a niche market will obtain higher valuations than companies whose service offerings are a mile wide and an inch deep. Currently in very high demand are contractors providing cryptography, security information systems, or other unique, high-end information technology solutions to the defense or intelligence communities.

Contract: If all of a contractor's contracts are with one agency, the contractor may be vulnerable to a change in contracting opportunities at that agency. Contractors with a presence at multiple

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agencies generally achieve higher valuations.

Special designation contracts: Reliance on special program designation contracts such as HUB Zone, 8(a), or small business programs may diminish the value of the business because the underlying contracts are either difficult to transfer or the contractor cannot compete effectively after the acquisition.

Contract platform: There are several different types of government contracts. A mix of different contract platforms and the ability to maximize net profit through economies of scale may push valuations higher.

Prime vs. sub: Prime contractor contracts are generally perceived as adding more value to a contractor. In an M&A context, an acquirer is likely to pay more for a company that "owns" the relationship with the government agency as opposed to a sub-contractor that relies on a third party for that relationship.

In addition to these unique value drivers, acquirers will of course examine the profitability and growth prospects of the target company. In the government contracts sector, margins on earnings between 5 and 9 percent are considered average. But remember, private sector companies are acquiring specialized government contractors because they add a highly predictable revenue stream.

For government contractors, the focus on serving the unique needs of the federal government while foregoing commercial opportunities has proven to be a wise strategy in this economic slowdown.

Government contracting offers the excitement of both high-tech solutions and predictable cash flows.

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