

End of Year Factors Impacting Government IT M&A

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The government IT industry is not immune from the macro economy or political winds but it is more isolated than many industry sectors. What is the M&A environment for the sector for the balance of 2008?

Generally, the government contracting industry is once again “weathering” an economic downturn better than most other industry sectors. Like in 2000-2001 and the early 90’s, the industry is viewed as a “safe haven” due to: (1) the government is the customer and will not go bankrupt; (2) long-term contracts that result in backlog visibility; (3) generally more being outsourced to private companies due to the retiring government workforce and technology change; and (4) margin improvement due to procurement reform (T&M and fixed price contracts).

There is uncertainty in the air, however, due to the upcoming national election and the impact on spending priorities, budgetary constraints, contract award delays and general economic conditions that is resulting in buyers being more discerning and careful in evaluating acquisition opportunities. Buyers are focused on highly strategic targets that have barriers to entry and are synergistic. Adding revenue or increasing critical mass is not as significant a driver as it has been in the past.

Furthermore, this uncertainty is resulting in deals taking longer to close due to more comprehensive and difficult due diligence and contract negotiations. Both buyers and lenders have become much more sensitive to potential liabilities and risk.

The general tightness of credit has still not had as much of an impact on this industry as other sectors of the economy. Lenders are still lending 4-4.5 times EBITDA for the right deals and the right buyers but they are doing a “deeper dive on due diligence.” Larger transactions, especially for private equity buyers, are not getting the same leverage they were a year or two ago. Some lenders to the industry that have been seriously impacted by the credit crisis have retreated to the sidelines but they have been replaced by other lenders who want to increase market share with the government IT industry. However, despite the macro headwinds that are blowing, the balance of 2008 should result in more high profile deals being announced.

Two more international transactions have just been announced at very high multiples. BAE Systems is acquiring Detica which does business with both the US and UK governments at 17 x EBITDA and 2.6 times revenues. QinetiQ North America, a wholly owned subsidiary of UK-based QinetiQ Group, is acquiring Dominion Technology Resources, Inc. (DTRI) a provider of high end services and products to the US intelligence community for \$123 million in total consideration at closing which is in excess of 20 x EBITDA.

The invasion of European (mainly UK) buyers driven in part by exchange rate differentials continues to be the big news story of 2008 for government/defense M&A.

Another driver will be buyers seeking to make strategic acquisitions to better position themselves for changing political and budgeting priorities. SRA's recent acquisition of ERA Corp. illustrates this trend. SRA announced in 2007 its intent to add leading-edge product capabilities that differentiate its services in new and rapidly growing markets. ERA is the leading supplier internationally of next generation surveillance and flight training solutions.

The increased spending by DHS and the prospect of future Congressional increases in the DHS budget, increased spending on cyber security solutions and more spending on energy, environmental programs and healthcare initiatives should also stimulate M&A activity for the balance of this year.

Finally, the specter of a Federal capital gains tax increase to 25% or more (from 15%) in 2009 is stimulating owners to consider taking their companies to market earlier than many were planning to.

In summary, deals are taking longer to cross the finish line and with more issues and obstacles to achieve closure but M&A in the US government/defense contracting industry remains active with a good mix of buyers and sellers.