

National Defense Industrial Association (NDIA) Small Business Breakfast

Current M&A Environment and Trends in Defense M&A Deal Terms

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About Holland & Knight

- Global law firm with nearly 1,000 attorneys in 17 U.S. offices and Abu Dhabi, Beijing and Mexico City
- Represented parties in approximately 100 M&A transactions involving Government Contractors over the last 5 years
- Corporate, M&A and Securities Group: 20 attorneys in the Mid-Atlantic Region and 120 nationally focusing on serving the middle market companies in M&A transactions, securities, finance and corporate governance
- Experienced attorneys in tax, employee benefits, government contracts, intellectual property, environmental, real estate, employment and antitrust to perform M&A transactions
- Securities: focuses on advising middle-market companies regarding SEC reporting and compliance, public offerings of securities, high yield debt offerings, and private placements

Trends In Defense M&A Terms

- Currently Broad Array of Buyers in the Marketplace:
 - Defense primes and Tier 2
 - Private or small cap public strategic
 - Private equity sponsors and portfolio companies
 - Former sellers re-entering the marketplace
 - Foreign
 - Primarily commercial/diversified

Trends In Defense M&A Terms

- Buyers Are Seeking To Acquire Firms That Will Provide:
 - Additional customer relationships and contract vehicles
 - New capabilities and experience base
 - New product or service offerings
 - Revenue and EBITDA Growth
 - Technologies that provide competitive advantages
 - Platform with management talent
 - Geographic diversification

Trends In Defense M&A Terms

What Factors Are Causing firms to Consider a Sale?

- Changes in forecasts for Defense budget
- Impending increases in capital gains tax
- Competitive challenges: pricing, business development
- Program uncertainty
- Favorable valuation levels
- Robust demand from potential purchasers

Trends In Defense M&A Terms

What Factors Are Causing Firms to Consider Purchasing?

- Government is a safe haven with some predictability in spending
- Strategic Buyers have available cash earning low returns
- Private Equity Sponsors have unused commitments and favorable financing
- Strategic Buyers have pressure to maintain growth
- Private Equity Sponsors have witnessed recent history of favorable returns
- Strategic Buyers' need for technology and intellectual property and increased product offerings

Trends In Defense M&A Terms

Macro Trends:

- Robust Activity – many firms are either Purchasers or Sellers or making divestitures
- Purchasers are VERY PARTICULAR – seeking the right deal at the right price
- Increased due diligence challenges for deals to be completed
- 2-Tiers of selling companies for valuation purposes
- Purchasers seeking stronger risk protection terms
- Ordinary technology services are under price pressure and focus of Purchasers are shifting to products with strong margins
- 10 principal trends in transaction terms

Trends in Defense M&A Terms

Trend 1: More Extensive Negotiation of a More-Detailed Letter of Intent or Term Sheet

- Frequently follows some due diligence by Purchaser
- Items addressed:
 - Structure, purchase price and consideration and assumptions behind purchase price
 - Escrow or holdback
 - Working capital requirements
 - Principal closing conditions

Trends in Defense M&A Terms

Trend 1, Letter of Intent/Term Sheet, continued...

- Indemnity caps, baskets and survival periods
- Non-competes and key employee retention
- Due diligence process
- Exclusive negotiation period
- Exclusivity Period may be staged based on completion of diligence, financing commitment and distribution of draft documents
- Parties' mutual interests to avoid future surprises on major terms

Trends in Defense M&A Terms

Trend 2: Increased Sophistication Purchaser Due Diligence and Concentration on Critical Areas:

- Revenue waterfall
- Backlog, including program assessment
- Contract terms, including set-aside restrictions, OCI analysis
- Margin sustainability and adequacy of business infrastructure
- Customer relationships and insourcing risk
- Key employee skills and employment continuity

Trends in Defense M&A Terms

Trend 2, Purchaser Due Diligence, continued...

- Taxes: income, foreign, sales and use
- Focus on compliance:
 - Government contracts
 - Employment
 - Employee benefits
 - Export controls
 - FCPA
- Capitalization
- Intellectual Property
- IT system adequacy and security

Trends in Defense M&A Terms

Trend 3: Increased Escrow and Other Protections for Purchaser from Post-Closing Losses

- Escrows/Holdbacks –previously 5% to 10% but now frequently 10% to 20% of purchase price; generally held for 15 months or more to secure indemnity claims and working capital deficiency
- Set-off Rights if subordinated notes are used as consideration

Trends in Defense M&A Terms

Trend 4: Increased Emphasis on Employee Retention

- Many Purchasers require as a closing condition that key employees of Target execute retention agreements and a percentage of other direct employees sign standard employee agreements
- Retention or bonus agreements generally contain stay-bonus provisions plus non-solicitation covenants with respect to customers and employees
- Highest level key employees may be required to sign employment agreements as a closing condition, particularly if Purchaser is private equity firm or smaller cap strategic

Trends in Defense M&A Terms

Trend 4, Employee Retention, continued...

- Bonus payments sometimes are based on percent of entire management group that remains employed after period of time as well as other performance metrics
- Private equity Purchasers may require or encourage purchase of equity by key managers
- Strategic Purchasers often grant stock options or restricted stock to key employees

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Trend 5: Selective Use of Earn-Outs

- Earn-outs – used by selected Purchasers if extraordinary growth projected, set-aside contracts or to bridge valuation gap
 - More widespread use by private equity and small and mid-tier strategic buyers willing to pay upside if financial projections are achieved or key contracts are maintained or migrated
 - Earn-out covenants in general becoming less restrictive to Purchaser; however covenants more extensive if EBITDA-based earn-out
 - Can be event-based or performance-based; usually no longer than 2 years from closing
 - Performance-based earn-outs based on revenues, gross profits, contribution margin or EBITDA
 - Earn-outs used less frequently by strategic buyers that prefer near-term integration of Target

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Trend 6: Purchaser's Concerns with Set-Aside Contracts Continues

- Set-aside contracts and task orders generally afforded significantly-reduced value compared to full and open contracts
- Some Purchasers will not acquire Target with a material percentage of set-aside revenues
- Earn-outs payable on continuation of contracts, exercise of options and/or migration to full and open
- Concern over full and open contracts where customer takes small business credit
- More extensive customer due diligence conducted to examine
- Certain small businesses, owners without other affiliates or Native American firms may have ability to afford higher value for certain set-aside contracts

Trends in Defense M&A Terms

Trend 7: Use of Creative Tax Structures to Achieve Step Up in Basis and Deferral of Rollover Equity

- Many Purchasers attribute value to availability of step-up in basis of Target's assets from IRS Section 338(h)(10) or 754 election
- In transaction with rollover equity, creative tax structures have evolved to enable tax deferred treatment of rollover equity, in some cases even where there is a Section 338(h)(10) or 754 election
- Careful tax examination by Sellers of effects of Section 338(h)(10) election and installment sales treatment required
- Plus-up by Purchaser for portion of adverse tax effects occurs in many transactions

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Trend 8: Continued Importance of Target's Net Working Capital or Tangible Net Assets At Closing

- Usually determined based on cash-free, debt-free net working capital of business over an agreed period before closing
- Most Purchasers seek to exclude or limit deferred tax assets
- Some Purchasers require an adjustment if Accounts Receivable not collected within an agreed time
- Reserves to be in accordance with GAAP
- Separate escrow or holdback to serve as payment source if a deficiency

Trends in Defense M&A Terms

Trend 8, Net Working Capital/Net Assets, continued...

- Tax benefits from option termination payments and transaction bonus payments usually allocated to Sellers
- Built-in-gains tax or cash-to-accrual tax adjustment arising as a result of transaction usually included as liability
- Usual forms of adjustments:
 - (i) Both upward and downward;
 - (ii) Downward only; or
 - (iii) No adjustment if within range

Trends in Defense M&A Terms

Trend 9: Trend Toward Increased Protection to Purchasers for Indemnity Claims

- Indemnification
 - Sellers – typically joint and several, sometimes several (if limited number of Sellers); Widely-held or ESOP-owned – indemnification usually limited to escrow or holdback
 - Cap – typically 10% to 30% of purchase price for general representations based on circumstances
 - Potential exclusions from cap and/or basket: capitalization, authority, title, breach of covenants, fraud, willful misconduct, tax, ERISA, environmental, ongoing litigation/investigation/claims, special indemnities; Government Contracts may be treated in different ways based on circumstances

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Trend 9, Purchaser Protections, continued...

- “Materiality” scrape – elimination of “materiality” qualifiers for determining breach or loss becoming more frequent
- Basket – negotiated amount (generally 0.25% to 1.00% of purchase price) – deductible or first dollar (tipping basket)

Trends in Defense M&A Terms

Trend 10: Private Equity Transaction Structures Continues to Use Leverage and Investment by Sellers and Key Employees

- Increased availability of senior and mezzanine debt in 2009, *e.g.*, 2.5 to 4.0 x TTM EBITDA
- Consideration frequently consists of:
 - Cash
 - Subordinated notes
 - Rollover equity
 - Equity investment by key executives
 - Earn-outs

Trends in Defense M&A Terms

Trend 10, Private Equity Transaction Structures, continued...

- Opportunity for “2 Bites at the Apple” by Sellers and equity appreciation by key executives
- Subordinated Notes – payment terms and subordination provisions may be among most heavily negotiated items
- Rollover Equity – usually *pari passu* to or one level behind sponsor and subject to shareholders agreement
- Management fees and transaction fees paid to sponsor

Trends in Defense M&A Terms

Conclusions:

- Prevailing trends can be helpful to provide guidance in formulating party's negotiating strategy
- Resulting terms reflect the particular circumstances, bargaining power and practices of the parties involved
- Experienced financial, legal and accounting advisors can assist in developing creative compromises