Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

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Top 10 Ways to Win the Federal M&A Pennant

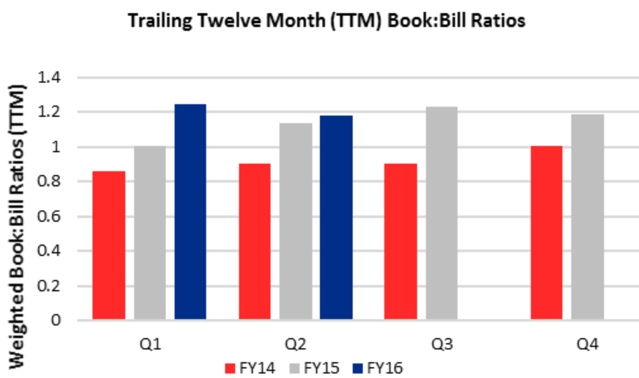
1. ***Rigorously define and clarify strategic M&A priorities***
2. ***Develop thoughtfully tiered target candidate list "draft boards"***
3. ***Act swiftly and certainly when a top draft board candidate presents itself***
4. ***Take your base; be willing to walk away early if not a "must have" deal***
5. ***Focus on real time positioning at the individual contract level, not QOE, as the harbinger of future growth***
6. ***Embrace the "third pipeline" revenue upside potential***
7. ***Develop a clear view of cost synergies rooted in relative rate structures, not mechanical headcount reductions***
8. ***Consider pricing in the very real opportunity cost of <u>not</u> doing a particular deal***
9. ***Maintain clean deals and use structure sparingly, as a last resort, not as a financing mechanism***
10. ***Augment internal teams with trusted third parties that are credible with lenders***

Aggressive M&A Moves Heading into the Fall Postseason

- Increasingly, in competitive federal M&A processes, bidders are tightly clustered together, with a single outlier "spike bid" prevailing
- These "spike bids" signify the willingness of some buyers to knowingly overpay given the worse alternative of organic shrinkage
- Traditional QOE and top-down due diligence are insufficient in projecting future growth given recent market and procurement trends
- Winners use a combination of revenue synergy, pro forma rate modeling, and pricing in opportunity cost to prevail
- Buyers who are not prepared to lean that far forward – or who need structure to play – are better off exiting competitive processes early
- "Spike bid" expectations are leading to an increase in busted deals as sellers test the market and experience mean reversion firsthand

The "Spike Bid" Phenomenon

Intense competition in the federal sector continues to put pressure on organic growth rates. Additionally, the federal M&A landscape is increasingly wide open, with more participants in the game and increasing parity amongst bidders for any given target. To prevail against these "market" bidders, winners have had to distance themselves materially from the pack. Similar to the Cubs front office topping the market to get flame thrower Aroldis Chapman in pursuit of their first World Series since 1908, this "spike bid" phenomenon is becoming the norm in federal M&A auction processes. The emergence and persistence of these spike bids has major resource allocation, due diligence, and game theory implications for anyone looking to win in federal M&A.



The old adage that a book:bill ratio greater that 1.0x presaged organic growth no longer holds in an era of recompete compression. While ratios have topped 1.0x in 2016, they are still insufficient to offset increased erosion, which is driving M&A.
Source: Wolf Den Analysis

Playing Moneyball

The vast majority of M&A players are clear-eyed about target customer positioning, near and medium term growth potential, management team and cultural strength, and the desire to "buy it right." Not surprisingly, these bidders arrive at a similar view of near-term expected cash flows and cluster around a tight dispersion of valuation and structural alternatives. In contrast to this conventional wisdom, winning bidders are getting in touch with their inner Billy Bean and finding innovative ways to compete. While some of these spike bidders may be motivated by a need to plug organic growth holes (as mentioned in the graphic above), the common characteristic among them is a bias towards forward-leaning, not backward-looking due diligence. They focus on revenue synergies, customer access, in-demand capabilities, contract vehicles, and talent, while pricing in the cost of not doing the deal given the scarcity of high-quality targets in their strike zone.

Pick Your Spots

In this spike bid environment, it is more critical than ever for buyers to understand how plays are being executed on the field and anticipate the next move. Some of this preparation comes in the form of disciplined strategic planning and internal consensus gathering. Together these enable buyers to proactively identify M&A candidates and "have to have" attributes. When successful buyers see their highest-and-best candidate become actionable and available, they move aggressively and with certainty to "swing away" when they find themselves ahead in the count. This preparation will also arm savvy Bidders with a keen eye at the plate and the foresight to quickly "take their base" and walk away if they do not have a compelling need to acquire that target.

Manufacturing Runs

Once a target is within reach, buyers need to act swiftly and surely to secure victory. Expert due diligence focused on real-time situational awareness at the program level has become a necessary condition. Opportunity-specific distillation of backlog and pipeline can identify upside potential that backward-looking and top-down approaches might miss. Similarly, examining pro forma combined rates – and the related impact to legacy company profitability – and illustrating the upside potential from the "third pipeline" (opportunities they could bid together that neither could bid on their own) can lead to better financing terms and higher valuations. Lastly, winning bidders are avoiding unnecessary structure. Some recompetes and set-asides beg for structure, but too often we see bidders strike out when they use structure as a financing tool, not a risk-sharing method. Armed with these insights, buyers put themselves in the best possible position to play deep into the postseason.

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