

10 Signs The Federal Market Has Bottomed

1. Budgets are tight, but sequester-related uncertainty is passing
2. Declining volume and frequency of contract deobligations
3. RFP volume, including new GWACs and IDIQs, has begun to accelerate
4. Contract extensions and add-ons are increasingly common
5. Government hiring has slowed and insourcing risk has substantially abated
6. Awards are still moving to the right, but not as far or as fast as before
7. Industry cost reductions have taken root; companies are more competitive today than ever before
8. Industry has begun to reinvest in growth rather than continue to retrench
9. Increased volume and prevalence of BD/Capture hiring
10. M&A interest is increasing, with portfolio shaping fueled by strong strategic, lender, and financial sponsor appetites

Calling the Bottom

- ☛ First derivative of growth curves will likely remain negative for the next few quarters, but the second derivatives are turning positive
- ☛ Positive leading indicators coming out of proposal shops and procurement offices are not yet visible to most industry observers
- ☛ We are witnessing a market bottom (in terms of growth), but it may take several years to see a return to sector-wide growth
- ☛ The much anticipated GFY 4Q flush will miss expectations, as the government lacks sufficient resources to get everything under contract
- ☛ The “new normal” has ushered in a period of lower spending, increased price sensitivity, aggressive competition, and profit pressure
- ☛ Well-run companies will increasingly take market share from those clinging to a sclerotic and outdated procurement model

Cassandra’s Curse

Three years ago, Wolf Den predicted an abrupt halt to the seemingly endless growth that had characterized the prior decade in the Government services industry. This view was wildly unpopular at the time and, like Cassandra’s predictions of future events, few wanted to believe us. When we made that prediction in the summer of 2010, we saw nearly every leading indicator of growth turn negative and felt obligated to sound the alarm for our clients. Small business preferences, LPTA pressure, anti-incumbent bias, deobligations, bid protests, and contract delays were all on the rise. It has been a rough several years, but we now see many of those trends abating. We still have a long way to go to recover, but the market is beginning to stabilize.

Status Quo Ante Bellum

It is too soon to evoke the hackneyed saying that a “rising tide lifts all boats.” This is not yet a rising tide and we do not see the tide rising for several more years. The Dionysian days of double digit revenue growth by a majority of companies in the sector are unlikely to return anytime soon. However, the indicators of a comeback are affirmative and enduring signs that the Government services industry has bottomed out. The worst days of decline – a rapidly shrinking market – are behind us and a new equilibrium has been established. The federal market has reset itself as sequester-related uncertainty and the annual drumbeat of budget delays have given way to a new era of lower spending levels, greater emphasis on LPTA and low price (even for best value procurements), lower salaries, leaner benefits, aggressive competition, “beauty contest” type competitions, and lower margins.

This Too Shall Pass

We have seen these cycles of federal industry feast and famine before. What was different this time was the confluence of so many different headwinds. To be sure, federal spending on contractors remains under pressure, OCO and COIN related defense spending will continue to decline, large programs continue to be mechanically set aside for companies without regard to their ability to manage or perform them, the protest environment is toxic, fiscal challenges persist, and pricing pressure prevails. The environment is no less challenging, but the prevailing “sky is falling” mentality of recent years is receding. The trends we see across industry today are intuitively defensible, analytically provable, and give us cause to be optimistic.

Potomac Oracle

While calling a market bottom (measured by growth, not stock price), we prefer to think of it as a reset, acceptance of

the new normal, and broad adaptation of best-practices needed to succeed going forward. The leading indicators (see a partial list at left) are not yet visible to most industry participants and observers. These trends are at least as powerful as the current headwinds and augur a return to better days. Companies who are still in denial about the new normal or who cling to past strategies will continue to struggle, but the vast majority of well-run Government services companies will begin to see a resurgence and return to modest but steady growth by taking market share from underperforming companies. While the first derivative of growth curves may still be negative, the inflection point is in sight and the second derivatives are beginning to turn positive.

