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Ten New Federal Market Realities:

1. *Historic win rates have little bearing on current p(win)*
2. *Wrap rates over 1.75x are rarely victorious in competitive procurements*
3. *Awards are slipping 2-3 quarters to the right of estimates*
4. *Recompetes can no longer be taken for granted and, for the first time ever, incumbency is a double-edged sword*
5. *Recompete win rates are plummeting; converging with win rates on new awards*
6. *IDIQ funding is falling well short of published ceilings*
7. *Expect existing work to be awarded at 20-30% less than current run rates (in the best of cases)*
8. *Cost cutting will yield no margin expansion, as savings are reinvested in price competitiveness*
9. *Higher turnover can be a good thing as salaries and benefits reset to current market realities*
10. *A widening range of M&A multiples with organic growth the primary value driver*

Implications for Investors

- 🐾 The headlines are intimidating and the headwinds are real
- 🐾 Subsector themes matter (no longer a rising tide), but ability to compete matters more
- 🐾 Uncertainty creates historic valuation disparity and value investing opportunities
- 🐾 Need for program level due diligence and growth profiling conducted by objective practitioners
- 🐾 Still an attractive \$200B contractor addressable market: highly-fragmented; revenue visibility; low CapEx requirements; and barriers to entry

Warning Signs and Sounding the Alarm

Wolf Den began advising its clients early in 2011 to prepare for a “new normal” of intensifying competition and ruthless pricing pressures. We saw first-hand that federal procurement officials were increasingly serious about low price technically acceptable (LPTA) procurements, we witnessed the tempo of new program starts slowing, we felt the shift in importance of small businesses, and we experienced the increasingly great lengths to which companies were going to retain their existing work. While others maintained that the past was still prologue – that after a brief hiccup, growth would continue a steady march “up and to the right” – we saw a fundamental shift and advised people to brace for impact and to expect a longer-term market shift.

Different Points of View

In order to really understand the tectonic shift taking place in the federal market, you had to have gotten your hands dirty where the budget rubber meets the procurement road. The writing was on the wall – in proposal tanks and procurement offices – well before it ever appeared in headlines, executive suites, and budget briefs, but if you weren’t walking those halls, you would have missed it.

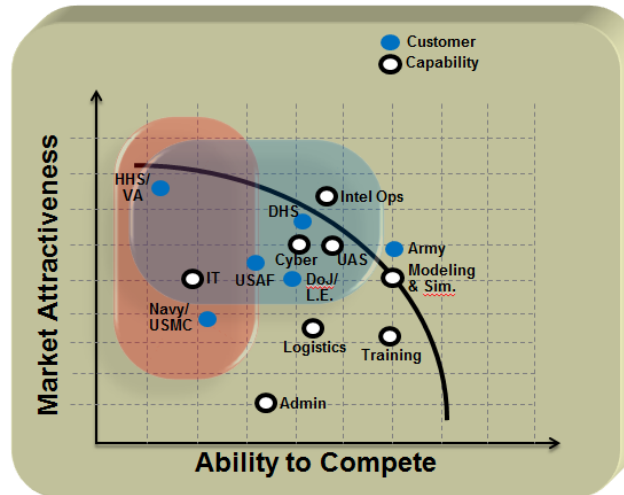
“Look and Know” Versus “Test and Learn”

As practitioners, we know that boiling the ocean over the macro budget picture is an exercise in precision without accuracy. Similarly, predictions on total market growth, assessments of sub-sector attractiveness, and analysis of market share can be helpful exercises but are weak predictors of individual company performance. In order to better evaluate

investment opportunities and credit qualities, we advise capital providers and management teams to lean more than ever on a bottom-up approach and leverage our pattern recognition in the federal sector. We focus on companies’ ability to compete, informed by our team of operators with first-hand experience as current and former partners and competitors in the federal market.

Situational Awareness

As depicted in the chart below, we evaluate investment opportunities by charting them on two distinct axes. The “Y” axis portrays market attractiveness – a function of size and growth rate of addressable market,



vulnerability to budget cuts, and “contractor friendliness” (margin potential, contracting environment, small business preference, etc.). The “X” axis portrays ability to compete – a function of reputation, cost structure, contract vehicle access, differentiated capabilities, credentials, and performance.

The Times They Are a-Changin’

In the decade that followed September 11, 2001, the Y axis dominated the X axis. At the risk of mixing metaphors, the rising tide lifted all boats, the fish were jumping in the boat, and it didn’t matter whether or not you knew how to fish. Those days are over, and we have entered a period of X axis domination. Only those companies with sharply differentiated stories and a competitive advantage are likely to grow. This is not the market to be a “me too” player, and only those who can move to the right along the X axis in this environment will find growth – at the expense of others – even in less attractive parts of the Y axis. 🐾