Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

December 2018 (Vol. 7; Issue 12)

10 Reasons to Buy at Current Valuations

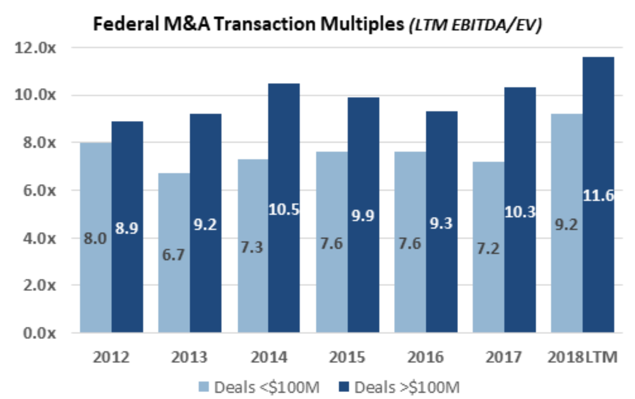
1. ***Large, increasing federal budgets after several lean years***
2. ***Global instability is driving increased demand for contractor support***
3. ***Increasing shift to outsourcing in the wake of government hiring freezes and pending retirements***
4. ***Ability to access and service debt at generally lower spreads than other sectors***
5. ***Very high free cash flow yields (low capital expenditure requirements and no bad debt)***
6. ***Adaptability to changing spending realities (limited fixed costs and lead time to production)***
7. ***Limited exposure to wage inflation by re-setting prices each bid***
8. ***Expanding margins as customers are increasingly willing to pay for value***
9. ***While historically high for the sector, federal valuations are still low relative to other market segments***
10. ***Opportunity cost as the best properties are coming to market now, pulling forward future year deal flow***

Federal M&A Solstice

- The federal M&A market has reached a fever pitch over the past 12 months, with valuations at record highs and deal volume up
- While unsuccessful bidders scoff at winning multiples, it is important to turn the map around to see the new owners' perspectives
- Federal contractors command a premium because they are non-correlated to wage inflation, bad debt, and other late-cycle risks
- Valuations are propped up by the highest federal spending in a decade and receding LPTA emphasis that relieve some pricing pressures
- Trailing metrics do not factor in margin improvements after years of leaning out costs, or increasing revenue synergy visibility
- FOMO also contributes to high valuations, as buyers are pricing in the opportunity cost of missing out on quality deals in this market

Role Reversals

The Romans celebrated the Saturnalia near the winter solstice by mimicking the reversal of the length of days with societal role reversals. We are amid a similar role reversal in valuations as concerns over broader market valuations drive buyers to the counter-cyclicality of federal properties. Federal outlays have typically grown through economic recessions, with consistent, predictable spending providing a macro-economic hedge. In addition to stable cash flows, federal businesses are largely immune to an increasingly unstable geopolitical climate that may harm technology and industrial sectors. Similarly, federal business evades fallout from rocky trade relations and is protected from wage inflation by cost-plus contracting and pricing resets. Put together, buyers are increasingly rotating into the federal market.



Valuations have risen for both large and small transactions in the federal market, with a corresponding increase in deal volume that is expected to continue well into 2019.
Source: R. W. Baird & Co. Valuation Data – December 2018

Sunrise at Newgrange

The ancient Irish painstakingly built religious sites like Newgrange to align with the first rays of sunlight on the winter solstice. Similarly, years of cost-cutting from sequestration and LPTA pressures have prepared most federal businesses for the current awakening. As pricing pressures abate and cost structures remain lean, buyers can expect profit expansion. Acquirers are also looking to the horizon with respect to embracing revenue synergies in addition to standard cost synergies to fully realize ROI and justify higher entry valuations. Even financial sponsors are now loosening the valuation purse strings and paying up to acquire good platforms. They can price future synergies into the first deal and dollar cost average with future tuck-ins, especially if there is a market pullback during their hold period.

Days Getting Longer

After several years of waning daylight in the federal market, brighter days are here. Free spending on both sides of the aisle is lifting boats and, after a decade, this CR-fatigued community began the government fiscal year with significant budget approval. This spending comes at the same time as a cyclical rotation toward more lucrative T&M/FFP contracts and the gradual return to best value contracting over LPTA procurements. Amid these tailwinds, contract consolidation around Category Management and Best-In-Class contracts raises the value of large, complex past performance that positions buyers for must-have contract vehicles and enables selling contract-holders to command a premium. Budget and procurement indicators point to sustained higher federal M&A multiples independent of the near-term chatter around a potential shutdown.

Famine Months

The midwinter feast in agrarian societies was historically celebrated by slaughtering cattle so that they would not have to be fed during the winter. It was one of the few times when fresh meat was plentiful, but starvation was common in the following months. The current frothy federal M&A market may similarly be pulling forward the feast and presaging a possible lean period in 2020. Non-traditional acquirers (insurance providers, staffing firms, A&E firms), new and established private equity platforms, foreign buyers, and strategic buyers are all active. Valuation expectations are coaxing properties out to market before the window closes and there is scarcity value to nabbing top performers before the next cycle. Pricing in this opportunity cost – or fear of missing out (FOMO) – is the difference between winning and losing in this competitive deal environment.

1751 Pinnacle Drive
McLean, VA 22102
wolfdenassociates.com

Meghan Gifford
(517) 648-6223
meghan@wolfdenassociates.com

Weston Helms
(731) 614-5982
weston@wolfdenassociates.com

Robert Stackhouse
(817) 899-7885
robert.stackhouse@wolfdenassociates.com