Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

April 2016 *(Vol. 5; Issue 4)*

Top 10 Tips for M&A Set-Aside Gardening

1. ***Get dirty. Set-aside risk is a fact of life for targets <$500M.***
2. ***Check the almanac. Understand agency-level budget and procurement trends.***
3. ***Choose soil type. Customer > contract concentration.***
4. ***Fertilize. Invest in target's sustainable organic growth.***
5. ***Establish drainage. Chart subcontract path for non-transitioning revenue.***
6. ***Plant hardy stock. Perform over many seasons and varied weather conditions.***
7. ***Stake and tie. Use structure and contingent consideration sparingly.***
8. ***Prevent weeds. Execution hiccups will choke out growth.***
9. ***Combat pests. Erect barriers to entry and switching costs.***
10. ***Water liberally. Additional post-closing investment is always required for a successful transition.***

Harvesting and Pruning Set-Aside Revenue

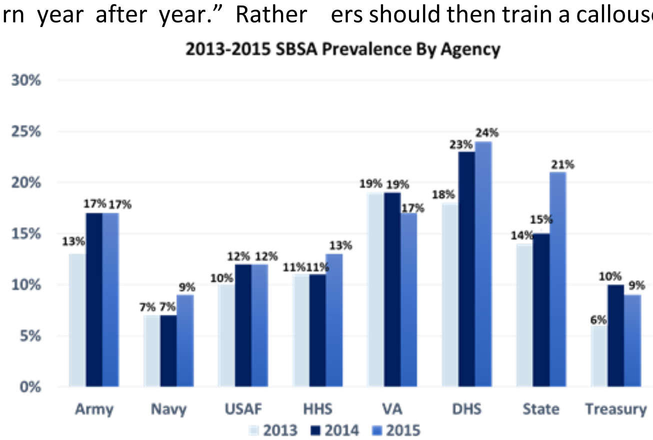
- Incumbents trying to convince government to transition set-aside work to unrestricted are watering fallow fields
- Certain types of work are unlikely to ever re-emerge from set-aside status regardless of performance or customer intimacy
- Customer environment and procurement preferences weigh heavily in determining post-merger survivability of set-aside work
- Not all set-asides are created equal, with size-based and WOSB contracts often easier to transition than 8(a) or SDVOSB
- Each set-aside award must be analyzed separately for contractual, technical, and competitive factors in order to handicap durability
- Set-aside contracts can provide customer intimacy and technical ability that are more valuable than their cash flow visibility

Plant the Best Varietals

An unintended consequence of small business set-aside policy and the 2007 recertification rule change is a lot of M&A headache. Nearly every sub-$500M revenue federal business has some set-aside legacy, leaving no alternative universe of targets free of set-aside risk. Sellers and buy-side M&A champions, like gardeners, are optimistic that what has been planted will flourish. However, most buyers adhere to the old adage that "[set-aside] annuals can live fast and die young but [unrestricted] perennials return year after year." Rather than rote adherence to rules, focus on the underlying degree of differentiation – the technical prowess and customer intimacy that will survive set-aside transition – and back teams with a record of thriving in unrestricted environments.

Choose the Right Soil

As the graphic to the right suggests, set-aside permeation varies greatly by agency. Prior to planting anything, conduct a detailed soil analysis of customer procurement trends, set-aside preferences, and performance against SBA quotas to handicap probability of success. Some agencies, like VA, State, and NSA, are attractive sub-segments with enduring missions, but that have a very clear bias towards set-asides. Buyers who want exposure to those customer missions and budget streams have no choice but to plant there. Mission-centricity and barriers to entry also play large roles in the set-aside landscape, with those capabilities farthest from the mission and with the lowest barriers to entry generally the most at-risk for set-aside dominance. For example, A&AS, program management, IV&V, and other support functions are far more susceptible to set-asides than performing work on mission systems.



While total set-aside obligations have only increased slightly from 11% in 2013 to 13% in 2014 and 2015, an agency-level view reveals valuable trend and comparative data.
Source: Wolf Den Associates, fpds.gov

Let the Sun Shine In

Buyers must determine if growth is the result of a unique crop that has been expertly farmed, or if any seed landing in that combination of rich soil and favorable weather would have flourished. Start by examining the root stock of the original award to determine the influence of effective capture, technical innovation, and predatory pricing in winning the business. Assuming this scrutiny reveals that awards were not made solely on the basis of set-aside status, the next test is contract performance. Buyers should then train a calloused eye on any CPARs, SLAs, award fees, initial contract startup and transition, and overall performance against budgeted ceilings. Additional review of target direct labor mix and key personnel roles can also help determine the level of transition risk.

Manage Crop Yield

Despite rose-scented CIMs and optimistic management views on growth prospects, the reality is that much set-aside work will not transition to full and open. That which can be harvested always requires more investment than originally planned to transition successfully. This is not an argument against buying targets with set-aside revenue or for blindly applying discounts and deal structuring. Rather, buyers should carefully diligence set-asides to identify the opportunities to maximize the yield from investments. Analyzing current program lifecycles and revenue runways can help establish a performance floor. From there, socializing follow-on pathways and crafting credible transition plans can dramatically improve the odds of success. Like advances in fertilization and irrigation, sophisticated buyers with means can bring additional scale, credibility, and contract vehicles to help set-aside work blossom into full and open contracts.

1751 Pinnacle Drive
McLean, VA 22102
wolfdenassociates.com

Dave West
(917) 657-4525
Dave@wolfdenassociates.com

Jim Sherwood
(571) 253-5706
Jim@wolfdenassociates.com

John Descalzi
(908) 591-7853
John@wolfdenassociates.com