Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

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Top 10 Valuation Drivers at any Size

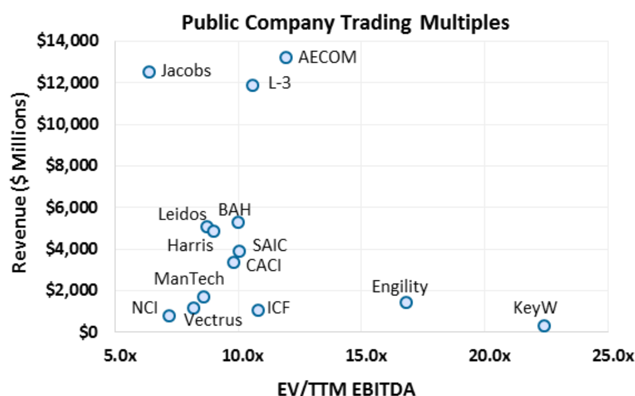
1. ***Organic revenue growth rate: both realized and future prospects***
2. ***Profit margins: demonstrated history and sustainability going forward***
3. ***Backlog size and duration: stability and visibility (all PoPs are not created equal)***
4. ***Recompete timing: discounts for near-term recompete risk***
5. ***Full and open prime awards: proven ability to prevail in the face of considerable set-aside pressures***
6. ***Contract vehicles: premier vehicle ownership speaks to customer intimacy and limited competition***
7. ***Contract concentration: customer concentration is good, contract concentration is bad***
8. ***Attractive customer presence: already operating where others seek to be***
9. ***In-demand capabilities: it takes too long to build what customers are buying today***
10. ***Direct labor mix: owning more of end item delivery decreases risk and increases value***

Size Does Not Matter

- Proponents of the federal market consolidation theory wrongly assume "bigger is better" and that valuation and size are correlated
- Tax advantages and structure can often cause transaction multiples to appear larger than the effective prices paid by buyers
- Extraordinary events like scandals and liquidity crunches can also cause large companies to sell at discounted valuations
- A marquee contract vehicle win – and the implied growth prospects – can attract premium valuations regardless of company size
- Portfolio composition matters – larger set-aside portfolios will be valued lower than smaller full and open portfolios
- High-growth, high-margin, well-positioned companies with attractive prime contracts command a premium regardless of size

Philistines

Over the past several quarters, consensus has emerged that the federal market is heading into a sector-wide consolidation. This groupthink is rooted in observations that M&A volume is up in 2015 and that the increase will spill over into 2016. Pro-consolidation theorists further argue that because "bigger is better," these assets will congeal into a few very large publicly traded companies that command premium valuations. However, in a labor services industry, there are limited economies of scale. Smaller competitors are routinely able to bid, win, and execute at lower price points than their larger counterparts. A review of trading and transaction multiples reveals that growth is nearly three times more strongly correlated to valuation than to size. Positioning trumps scale, profitable organic growth is the holy grail, and the current M&A tempo reflects a wave of portfolio reshaping, not consolidation.



While publicly traded federal service providers cluster in the 8-10x EV/TTM EBITDA range, closer examination shows bigger may not be better, with no positive correlation between company size and trading multiple.

Israelites

Given that the journey to the valuation promised land is about more than just size, the underlying rationale for recent transactions is illuminating. Contrary to some prevailing OCI and commercial pricing myths, corporate parents shedding businesses with subpar growth prospects can explain many recent divestitures. These newly independent businesses have moved quickly to counteract unfavorable spending trends, pricing pressure, and evolving government priorities by buying into new capabilities and customer presences. Companies need to grow in order to increase valuation. Growth in the current market environment requires portfolio shaping to increase differentiation and to align more closely with current government spending priorities. Many recent deals, such as Vencore's purchase of QinetiQ and PAE's string of recent acquisitions, have enabled buyers to significantly expand their capabilities and addressable market to improve their positioning.

The Case Against Goliath

Any correlation between size and valuation is endogenous: attributes that enable companies to grow are the same that accrue to premium valuations. These include strong management teams and the proven ability to win full and open prime contracts at price points that deliver respectable margins. This is why a $75M company often commands a premium over a $10M company with similar capabilities and customers. At the larger end of the market, organic revenue growth and profitability reign. Booz Allen commands the highest multiple because it has the highest organic growth and EBITDA margins, not because it is the largest. Similarly, Scitor was three times larger than Six3 when each sold, yet Six3's multiple was thirty percent larger. Knowing this, some prospective sellers, in an effort to show growth, are bidding and winning at ultra-low rates and masking margin impact with pro forma cost reductions.

The Case for David

Among publicly traded federal companies, KeyW makes the strongest case for the lack of correlation between size and valuation. Despite being one of the smallest publicly traded companies in the sector, it trades at the highest multiple in the peer group. This valuation premium is due to its expectations of superior growth and profitability, independent of size. At the other end of the spectrum, the public markets seem to be signaling that Jacobs' portfolio has the least attractive growth prospects in the peer group. In addition to trading multiples, many of the most eye-popping transactions in the federal sector have come from smaller, privately held businesses. These companies can command thirty to sixty percent premiums to the valuations of comparable public companies. From TexelTek, Potomac Fusion, and 42Six, to Six3, Ventura, and Scitor, these businesses have the differentiated capabilities, contracts, and customer positioning that buyers and investors covet – and pay premiums for – at any size.

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