Successful Federal Practitioner Perspectives

State of the Art in Federal M&A

While the knee-jerk reaction to market uncertainty is more structure, cash is still king and Sellers have the luxury of time.

If the bid/ask spread is too wide, ask yourself if the structuring “squeeze” is worth the potential returns “juice”

Employ earn-outs only where they bridge gaps and contribute to risk sharing and consider the knock-on effects metrics have on operations.

Dynamically shift between various forms of consideration to shift more proceeds to Sellers at Closing within tolerable risk envelopes.

Due diligence is limited by those performing it; seek current, objective expertise where the budget rubber meets the revenue road.

Identify early joint opportunities for success to cement integration – winning masks a multitude of other deal-related sins.

Certainty Equivalent

M&A volumes are down in the federal sector, especially considering that Q1 includes spillover from last year’s feared tax changes. This is the case despite record levels of private equity involvement, high levels of lender appetite, and a need on the part of historic acquirers to reshuffle their portfolios and augment lagging organic growth. The cause is uncertainty. Lack of certainty causes wider bid/ask spreads, increased use of structure, more due diligence, and broken deals.

Belts or Suspenders

A byproduct of overly structured transactions is that very little cash finds its way into Sellers’ pockets at Closing. After holdbacks, taxes, and deferred payments, Sellers often walk away with less than half of total consideration. To combat this breakage, savvy Buyers are finding ways to move proceeds around. For example, reducing escrows in the presence of other deferred payments is a way to avoid double dipping and deliver more to Sellers at Closing by “self-insuring.”

Structure Stricture

Buyer willingness to pay has compressed slightly while Seller expectations have remained the same. Many are trying to bridge this valuation gap with structure in the form of earn-outs, Seller notes, longer escrow periods, and other contingent or deferred payment forms. However, cash is still king and, with the exception of those that have to sell, using too much structure will suffocate deals.

Risk Sharing v. Risk Shifting

In theory, earn-outs provide a flexible risk-sharing tool in an uncertain federal market. For Buyers, earn-outs can align interests, motivate Sellers post-Closing, and ensure that Buyers only pay for the performance achieved. For Sellers, earn-outs offer a higher possible total valuation and a chance to bet on their performance while avoiding lengthy up-front valuation negotiations. In practice, earn-outs can be significantly more sinister. Some risks should be shared by both parties (principally those that arise out of the transaction) and others should be borne by Sellers (those that only the Seller can fully estimate). Buyers who abuse earn-outs to reduce upfront capital and to shift all risks to Sellers often come away empty-handed.

(Dis)Integration

Integration begins at the first meeting. Those who wait until the eve of Closing to address the thorny integration issues risk squandering opportunity. After a protracted due diligence period and tough negotiations, a shared strategic vision and a strong organizational fit are required to smooth over the rougher edges. Additionally, the transaction structure itself may be at odds with integration. Poorly crafted earn-outs, hasty branding, and anything short of meritocratic leadership appointments erode enterprise value from the outset. Buyers who are more interested in protecting against downside risk too-often miss the upside potential. Most transactions fail at the integration phase and there is no comfort in doing a bad deal, even at a good price.

Due Diligence Dalliance

Buyers are increasing the scope and intensity of due diligence, with third party contracts reviews and Quality of Earnings reports now de rigueur. However, many of these reviewers lack current federal market fidelity. When faced with program level, CAS, FAR, or competitive issues, they cover gaps in their knowledge by proposing indemnifications that are self-inflicted wounds.

Key to Successful Federal M&A Execution

1. Share risks; trying to shift all risks to Sellers will often bust the deal.
2. Use earn-outs as a last resort to bridge valuation gaps and align incentives.
3. Avoid overly complex earn-out metrics and their consequences.
4. Understand the tax implications to both sides from the outset.
5. Working Capital is too complex to leave to the end – address it early and often.
6. Craft an escrow to fit the risks of each deal, not just to conform to “market” terms.
7. Never lose sight of how much after-tax proceeds go to the Seller at Closing (it is sacrosanct to them).
8. Quality of Earnings absent current federal competitive awareness is just a math exercise.
9. Do not structure first and ask questions later; indemnification is no substitute for expert due diligence.
10. Focus at least as much on maximizing the upside as on mitigating the downside.

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