Practitioner Perspectives

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Top 10 Reasons This Downturn is Different Than Prior Down-Cycles

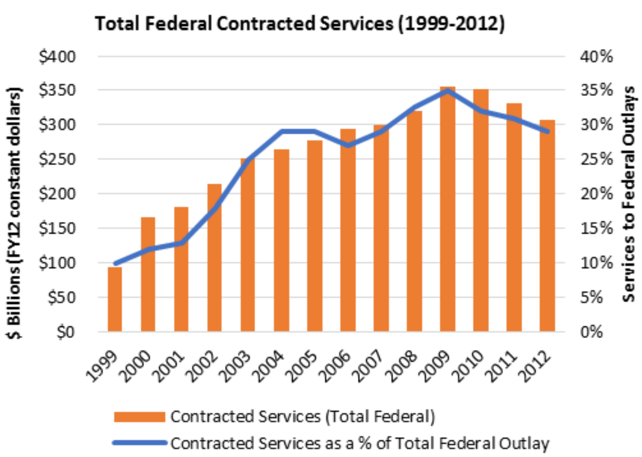
1. ***Contracted federal services have grown three-fold since 1999 in absolute and relative terms versus all other spending***
2. ***Incumbency has become a liability as parvenus are increasingly taking share***
3. ***Bigger is not necessarily cheaper in an era where low cost is the high hand***
4. ***Several years of cost-cutting have wrung out most excess cost***
5. ***While recently diminished, the "uncertainty quotient" still clouds visibility***
6. ***Many PE-backed platforms and rollups are struggling, deterring new entrants***
7. ***Few bargains to be had – P/E and M&A multiples remain stubbornly robust***
8. ***Borrowing cost is increasing as willingness to lend ebbs***
9. ***Contracts, past performance, and relationships can be had more cheaply than through acquisitions***
10. ***Portfolios are better reshaped by buying into growth areas than by merging more of the same***

Federal Market M&A – Whither Consolidation?

- The higher ratio of services spending in current federal budgets is fundamentally distinct from previous cycles and will alter M&A incentives
- Large scale peer consolidations are unlikely to occur because the previously prevailing scale and incumbency rationales no longer hold
- Expect more divestitures as companies realize that efficiency and innovation trump scale in the current market environment
- Debt service and earnings dilution will limit divestitures to stock spin-offs except in the cases of distressed properties or very high valuations
- While a large deal may mask a lack of near-term growth, longer-term growth is better achieved through a "string of pearls" M&A strategy
- As larger primes reshape their portfolios and eschew IR&D to cut costs, look for them to adopt the Big Pharma serial M&A playbook

Past as Prologue?

During every previous post-War down-cycle in defense spending, overcapacity coupled with budgetary pressures and depressed asset prices created strong structural incentives for firms to combine their operations. Similarly, countercyclical leveraged acquisitions and sector rollups were also attractive given the large and predictable cash flows of government hardware contractors. These twin dynamics led to some 50+ major defense primes evolving into the current "Big 5" top-tier defense primes of today, as well as considerable transactional churn in the sector. A familiar narrative is spreading in Beltway and Wall Street corridors today, with many suggesting current budgetary austerity is likely to usher in a new wave of consolidation. Moreover, with some degree of predictability returning to Washington and the Damoclean sword of sequestration temporarily removed, many predict that the "uncertainty quotient," which has delayed and busted so many federal M&A deals in recent years, may be waning. Their hope is that we are entering the next phase of industry consolidation.



Total Outlay - all USG spending, including salaries, services, hardware, and grants.
Source: FPPS-NG, CSIS, Wolf Den Analysis

The Rise of Services

As outsourced services comprise an increasing share (up 200 percent since 1999) of agency budgets, M&A incentives have shifted. Services differ from products in a number of important ways: barriers to entry are lower, incumbency is less of a factor (you can rebadge personnel but not assembly lines), and cost is increasingly king. As evidenced by recent divestitures, there are also potential diseconomies of scale in services businesses that undercut traditional rationales for consolidation.

Capital Market Muzzle

Unfavorable capital markets conditions have compounded the dampening effect that services business models have had on consolidation activity. Defense and government services equities are trading at high P/E ratios and many private equity platforms purchased at the top of the market are underperforming. At the same time, leverage ratios and borrowing costs have crept up, as many lenders have begun to pull back in response to the uncertainty quotient mentioned earlier. These factors obviate any capital markets catalyst to spark a consolidation.

Beltway Beckett: *Waiting for AcquiCo*

Some bankers, advisors, and institutional investors have girded themselves for the presumed "wave of consolidation" by standing up in-house advisory groups of retired industry, military, and governmental luminaries to position and differentiate their firms. Now several years into the downturn, the consolidation thesis appears invalid. Apart from the failed BAE-EADS merger, neither companies nor funds undertook any marquee transactions. Instead, transactions largely involve niche capability, contract vehicle, and customer acquisitions in attractive federal subsectors, as well as a growing list of lower middle-market divestitures.

The Parable of Big Pharma

Growth will come from increasing share in a flat market and repositioning portfolios to match current federal priorities. As has been the case with the pharmaceutical industry, established players will turn to tuck-in acquisitions to keep pace with evolving trends. The M&A landscape will be shaped by concentrated customer, capability, and contract pickups. The most attractive targets will be those with innovative solutions, differentiated capabilities, and entrenched customer relationships in critical spending areas. Expect plenty of *sub rosa* M&A activity with smaller players banding together, but nothing like past multi-billion dollar consolidations.

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