How to know whether the price is right

Considerations in valuing a privately held government contractor

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Introduction

With government outlays representing 35.1% of U.S. gross domestic product in 2018 [1] (out of which federal expenditures came to 20%,[2] and the state and local government the rest), government contracting is big business. This has led to robust mergers-and-acquisitions activity in the sector,[3] particularly of privately held, middle market firms. However, doing business with the government—and arriving at correct valuations for privately held acquisition targets—requires deep knowledge and understanding of the risks and opportunities facing government contractors. To understand government contractors' unique characteristics and how these nuances affect their market value, we'll take an overview of the sector, analyze how contract waterfall features affect future cash flow streams, the role of the federal government in establishing competition, and current market dynamics and the role of private equity in driving acquisitions and valuations.

Overview

Government contracting is one of the largest and broadest sectors in the United States economy, encompassing businesses of all sizes, within an array of industries, including technology, industrial products, business and professional services, and health care. The services rendered range from janitorial services for a local municipality to highly classified cybersecurity support of the U.S. Department of Defense.[4] In fiscal year 2018, government contracting outlays grew to $559 billion, a 9% increase over 2017 and the highest spending levels since 2010, when agencies spent $562 billion.[5] In the past fiscal year, spending was concentrated on information technology, professional services and durable goods.

The government-contractor middle market is home to many small, highly technical service providers and other high-growth niche players—companies that are attractive to the bigger players in the hunt for growth, added capabilities and access to specific contract vehicles. The result is a robust and dynamic market for acquisitions. However, doing business with the government adds a layer of complexity to growth and risk considerations. So understanding the key growth drivers and risk factors affecting the operations of the enterprise is critical to placing valuation multiples on potential M&A targets.

Contract waterfall features

An important factor in valuation is the target's contract waterfall. The contract waterfall is a road map to future revenue streams and business growth while providing visibility into projected cash flows and profitability. It offers investors and business operators an outlook into the future and transparency into a company's operating prospects, minimizing risk and subjectivity associated with forecasting organic growth.

1 Source: Federal Reserve Bank of St. Louis.
2 Source: Federal Reserve Bank of St. Louis.
3 Raymond James: Defense & Government Services Market Intel Report.
4 RSM podcast with Dan Whelan, Dara Castle. January 2019.
5 BGOV200 Federal Industry Leaders 2019, Bloomberg.

Key factors within the contract waterfall are critical to valuation implications. Some of these factors include: win probability, customer concentration, contract duration, prime versus subcontractor status and contract cost structure. Failure to understand these factors may result in applying a lower market multiple (market/relative valuation) or higher discount rate (income/intrinsic valuation) or vice versa.

Win probability

Contracts included within the waterfall can be broken down by win probability in assessing the overall achievability of projected cash flows. The table below summarizes the key distinctions:

Backlog	Contracts already awarded to the company with a defined payment schedule Risk: low risk, given booked nature of revenue.[6]
Recompete	Opportunities to win extensions or follow-on options as the incumbent on a contract vehicle Risk: relatively higher risk than backlog, but less than new business, given past performance, familiarity with agency, contract vehicle and/or mission.
New business	Acquisition of new business from new customers and/or new contract vehicles Risk: highest degree of risk within the waterfall detail. Source, timing and win probability associated with projected cash flows are subjective and less defined.

The classifications of indefinite delivery/indefinite quantity (IDIQ or task order) contracts are unique in that a contractor is initially awarded the opportunity to bid on individual task orders associated with an umbrella contract. While the contractor deserves credit for achieving approved vendor status, the probability of winning individual task orders depends on the task order and competition from other approved vendors.

Valuation implications: The more speculative the projected cash flow stream, the riskier the entity. The greater the percentage of new business in a company's forecast, the higher the risk and lower the value. Alternatively, a greater percentage of backlog relative to total revenue would suggest lower risk and a relatively higher valuation, all else being equal.

Customer concentration

As in any business, customer composition and concentration are distinguishing characteristics of the firm's risk profile. Customers consist of government agencies such as the Department of Defense, Department of Homeland Security, Treasury, Army, Navy and Air Force. A contract waterfall helps to identify the company's number of customers, the distribution of revenue amongst contracts and reliance on key contracts.

Valuation implications: The greater the diversity and number of customers and contracts, the lesser the risk and the higher the value. Alternatively, a company that is reliant on the renewal of a single contract or small collection of contracts is riskier and would be valued lower, all else being equal.

Contract duration

The duration of contracts is another critical feature. High-volume/short-duration contracts are less certain and provide less long-term visibility, but they provide smoother growth trends. On the other hand, low-volume/long-duration contracts provide more certainty into the future until the contract expires or is once again up for recompete.

Valuation implications: Contract duration affects the forecast period of a discounted cash flow model and affects how management views a business cycle. Additionally, the level of certainty or uncertainty inherent in the forecast drives risk. A large contract coming due in the near-term can make or break a company's long-term growth and profitability forecast.

Prime vs. subcontractor status

A prime contractor engages directly with a federal agency to deliver requested goods and services. Subcontractors are selected by and dependent on the prime contractor.

Valuation implications: A company operating with a backlog consisting of primarily prime contracts is of greater value than one that is reliant on subcontracts. Prime contractors often maintain control over the engagement and are better able to maintain a relationship with the end customer. This often leads to greater insight and control over recompete opportunities.

Contract cost structure

Government contracts are explicit as to the costs that are the responsibility of the contractor to manage versus those that can be passed on to the government. As a result, the cost structure of a company's contracts directly affects the business' earning capacity. The three most common structures are:

Time and material (T&M)	Contractor directly bills federal agency for their time and cost of materials to fulfill the project. Risk: low risk to contractor, high risk to government
Cost reimbursable (Cost-plus)	Dictated level of profitability over costs incurred (i.e., allowable costs + X% profit). Risk: shared risk
Fixed price	Prenegotiated price of the engagement where the contractor must work within the bounds of the budget. Risk: high risk to the contractor, low risk to government

Valuation implications: The contract mix dictates the level of control a government contractor has over the operating margins it can achieve. In recent years, the prevalence of cost-plus contracts has largely caused profit margins among

6 Some risk exists for backlog depending on whether the government contract is funded or unfunded. Unfunded backlog implies there is risk that the government does not allocate funds for the products/services as expected.

large, diversified government contractors to fall within a narrow range. Understanding contract mix and their implications on earning capacity are critical to identifying the business' underlying profitability. This is why government contractors are typically valued and purchased based on multiples of EBITDA as opposed to revenue.

Competition

Unlike a full and open competitive environment, the federal government controls the level of competition in the marketplace by requiring certain criteria be met by a contractor in order to be awarded the contract. Government programs seek to limit competition for contractors meeting certain criteria in order to support disadvantaged people groups or small businesses. The table below summarizes a few common competitive environments.

Full and open (F&O)	▪ No limitations on parties who can bid ▪ **Result**: competing with large, established companies who can bid lower rates due to economies of scale, extensive technical resources and other advantages ▪ **Challenge**: competing with large, public conglomerates
Small Business Program (SBSA)	▪ Intended to support U.S. small businesses by providing opportunities to bid on sole-source contracts or contracts with a limited pool of competitors ▪ **Challenge**: transitioning to a full and open competitive environment once the business outgrows the SBSA program
8(a) Small Disadvantaged Business Program (8(a))	▪ Intended to support disadvantaged groups by providing opportunities to bid on sole-source contracts or contracts with a limited pool of competitors ▪ Contracts set aside for small businesses that qualify based on their owner being economically or socially disadvantaged ▪ **Challenge**: maintaining access to limited competitive environment upon a change of ownership

On the buy-side, purchasers must view the competitive environment closely, as certain regulations may prohibit the ability to transfer and continue to fulfill such contracts (such as contract novation) or rebid on them in the future.

Valuation implications: Transitioning from one competitive environment to another can pose significant risk to a company's future growth if not managed properly. Therefore, consideration of the company's ability to compete in a F&O environment, presence of a transition plan related to SBSA graduation, key person risk for individual(s) associated with 8(a) designated businesses, and contract novation upon a sale are key considerations.

Market landscape

Over the past decade, the government contracting sector has been evolving rapidly. Recent trends include industry fragmentation and consolidation and heightened private equity influence. In addition, the sector has been directly affected by federal government spending and policy decisions.

Fragmentation and consolidation

The sector is fragmented between large conglomerates that deliver a breadth of services and small, privately held businesses that provide specialized, niche offerings. The conglomerates leverage economies of scale and can compete aggressively throughout the bidding process, making competition with small firms fierce. A survey conducted by Deltek found that 56% of industry participants cite increasing competition as their biggest challenge. The implication of this competition has been declining win rates among small and midsize businesses. Specifically, the median win rate for small business contracts was 33%, 40% for midsize businesses and 55% for large firms. The report cited the median win rates for small and midsize businesses declined year over year, whereas large business win rates rose.[7]

Increased competition often places challenges on understanding the future scalability and opportunities of small and midsize business. This, in turn, enables the bigger and more sophisticated conglomerates to pounce and acquire smaller rivals, allowing them to grow inorganically. The wave of consolidation within the sector over the past two decades has led to a less competitive bid process, leaving a greater share of proposals to the conglomerates. This consolidation has led to a rise of single-bid processes and in cost-plus fixed fee contracts, areas where conglomerates are most competitive.[8]

Strategic vs. financial buyers and private equity influence

A key, yet not readily identifiable factor is the premium investors are prepared to pay for a synergistic and strategic business, compared to a financial target. Such synergy is "the additional value that is generated by combining two firms, creating opportunities that would not have been available to these firms operating independently," according to NYU Stern School of Business Professor Aswath Damodaran, a valuation expert. [9]

Nearly three-quarters of all defense industry transactions are considered strategic acquisitions, the balance being financially motivated.[10] Of those strategic transactions, 60% are initiated by the large conglomerates. Such statistics make insight into private company transaction multiples difficult, given the embedded synergistic premiums.

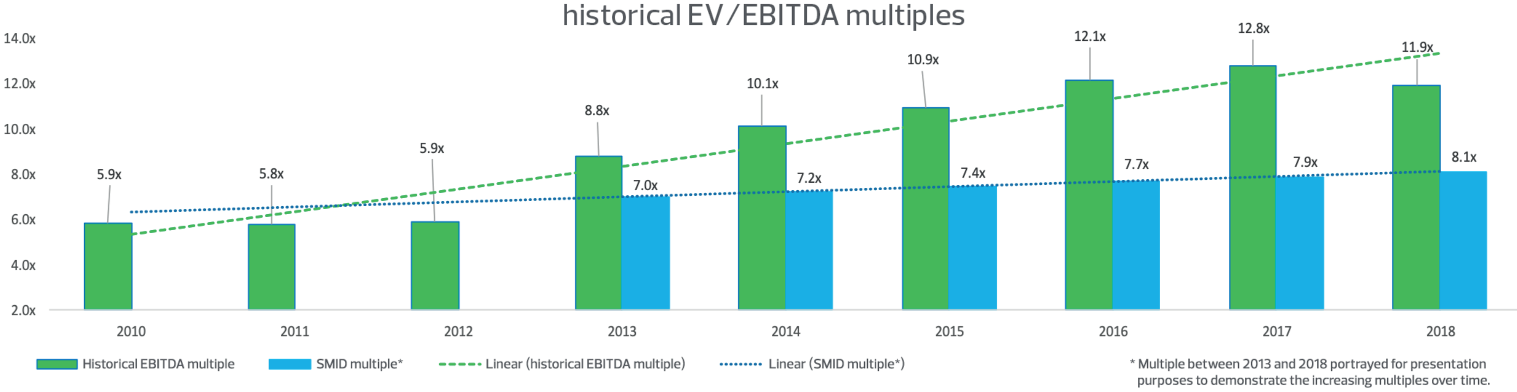
7 "Government Contracting Industry Study", DelTek, Inc. Industry Report. June 25, 2019.

8 "The Impact of Industry Consolidation on Government Procurement: Evidence from DoD Contracting," Mark Duggan and Rodrigo Carril, July 2018.

9 "The Value of Synergy," Aswath Damodaran, October 2005.

10 "The Impact of Industry Consolidation on Government Procurement: Evidence from DoD Contracting," Duggan and Carril, July 2018.

Top 10 government contractors historical EV/EBITDA multiples



Source: Capstone Headwaters Research

Positive industry trends coupled with the current investing landscape (such as plentiful private capital, access to debt markets and global search for real returns) make private equity and government contractors a natural match. In 2018 alone, private equity accounted for 38% of defense industry acquisitions, significantly higher than the average 31% since 2008.[11] Recent industry growth, visibility into future cash flows and insulation from recession make the sector an attractive and ripe target for private equity firms seeking stable cash flow streams to round out their portfolios.

Many private equity firms, particularly those that specialize in the government contracting sector, are implementing investment strategies more akin to strategic than financial buyers. Specifically, private equity groups often invest in a platform company and complete one or more bolt-on acquisitions before selling the larger, combined firm. This blending of financial and strategic investment strategies is unique to the sector and drives private company transaction multiples up.

Valuation implications: Relative value market approaches can be difficult given significant differences in size and risk between large, public conglomerates and small, privately held contractors. Since 2010, the median multiple of the top 10 government contractors increased from 5.9x to 11.9x EBITDA.[12] Given industry size fragmentation, the rise in market multiples does not necessarily translate directly to small, privately held businesses. It is in the middle market where the impact of private equity is most observable, as businesses typically transact at lower multiples in comparison to the rest of the industry, enabling investors to enact multiple arbitrage. Investors are willing to pay relatively lower multiples for smaller businesses in order to integrate and create larger businesses to be resold at higher valuations. For instance, from 2013 to 2018 the median enterprise value to EBITDA multiples for small- to mid-cap companies expanded from 7.0x to 8.1x,[13] the largest increase between any classification over this time and a result of private equity interest in the market.

Government spending trends

Ultimately, the success of these firms depends on the needs and availability of fiscal resources for public investments. For instance, investor sentiment was strong following increases in defense spending in the 2017-19 government budgets. Sequestration in 2013, on the other hand, caused funding delays and increased uncertainty, thus dampening investor sentiment. Similarly, government shutdowns can negatively affect the timing of payments, business operations and services to be performed. In 2018 and 2019, the United States government shut down twice for 38 days, affecting employees of government agencies and businesses. Payments to affected government contractors were delayed, inhibiting their ability to pay their employees and subcontractors.

Valuation implications: Government contractors must secure funded contracts with government agencies that have been allocated portions of federal, state and/or local budgets. During periods of increased allocation of public resources, greater opportunity is afforded to these businesses. However, an uncertain political environment—elections, budget disputes, congressional stalemates, government shutdowns—can translate into increased risk or volatility. Macroeconomic and industrywide challenges are inherently captured within market valuation inputs such as market multiples and beta (that is, industry risk). However, a company's essential or nonessential status, or level of exposure to shut down or sequestration based on the agencies served, could be a meaningful differentiator.

Conclusion

Doing business with the United States government requires specialized knowledge around contracting requirements, competitive environments and the constantly evolving market landscape. A company's ability to navigate these complexities has a direct impact on future cash flow and value. Estimating the value of a privately held government contractor requires careful consideration of these factors in order to arrive at a meaningful conclusion that is supported by the business' cash flow expectations and what potential buyers would be willing to pay in the marketplace.

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11 "Mergers & Acquisitions Update 2019: Aerospace, Defense, Government, Security." Capstone Headwaters Research. Accessed Oct. 2, 2019.

12 Data from S&P Capital IQ for LMT, BA, GD, RTN, NOC, MCK, LDOS, BAE, HII.

13 "Mergers & Acquisitions Update 2019: Aerospace, Defense, Government, Security." Capstone Headwaters Research. Accessed Oct. 2, 2019.

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