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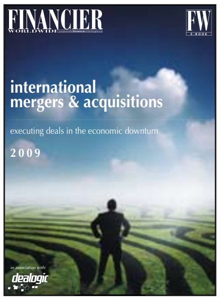

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2009 International Mergers & Acquisitions

executing deals in the economic downturn

FW E-BOOK

Deal trends in the US defence and government services sector

BY GREG GIAMMITTORIO

The US government services and defence sector continues to provide good opportunities for merger and acquisition activity. The sector has not been immune to the current economic downturn, but key drivers for these companies, such as long-term contracts, relatively predictable cash flow, and a large, creditworthy customer base (the federal government) continue to provide a solid foundation that makes growth companies in this sector attractive acquisition targets. In particular, small to middle-market companies that are closely held by the founders are often quality targets for both strategic buyers and private equity investment.

Looking at six large diversified aerospace and defence companies as an example, it is clear valuations in this sector have declined significantly from their peaks. Based on their 31July stock prices, Boeing, General Dynamics, ITT Corporation, Lockheed Martin, Northrop Grumman and Raytheon were at 37.6 percent, 41.3 percent, 29.2 percent, 37.9 percent, 38.2 percent and 26.6 percent below their 52-week high stock prices. Based on trailing 12 months EBITDA as of 30 June, the enterprise value to EBITDA multiples of these six were Boeing (7.4x), ITT Corporation (6.6x), Raytheon (5.9x), Lockheed Martin (5.7x), General Dynamics (5.6x), and Northrop Grumman (4.8x). One could argue that multiples at these levels do not provide the ability for publicly traded strategic buyers to offer valuations to targets that will be sufficiently attractive.

However, certain sub-sectors of the defence and government services industry command higher EBITDA multiples. For example, according to CapitalIQ data, sensor companies were at 7.4x EBITDA, homeland security companies were at 10.3x, and government services companies were at 8.5x. And while it is true that multiples across the board have generally declined from those one or two years ago, it is also true that sellers have become more comfortable with the new valuation realities. Anecdotal evidence suggests that some potential sellers who were attempting to wait things out in hope of a bounce back in valuations have decided there has been enough of a recovery to entice them back into a sales process. After all, while the value of their company may be 20 percent less today than 18 months ago, the value of the vacation home they have been eyeing is at least equally depressed.

Public company EBITDA multiples in the 7.4x to 10.3x range for certain types of federal businesses, together with the downside risk protection off ered by companies that have good relationships with their government agency customers, demonstrate why this sector continues to be fertile territory for dealmakers.

Certainly, with the financial industry meltdown and subsequent rescue plan, the overall condition of the economy, and skyrocketing federal budget deficits, a level of uncertainty is hanging over which initiatives will be top priorities and which may be put on hold or trimmed. Notwithstanding these restraints, there appears to be consensus that areas such as cyber security, intelligence, Department of Defense transformation (highly mobile and network-centric operations), and federal healthcare are poised for growth. Moreover, the need to provide new technologies and enhanced capabilities to the government, particularly to defence and intelligence agencies, is not going away.

One area of dealmaking in the defence and government services sector that is particularly noteworthy is private equity firms continuing to demonstrate a high regard for the sector and their ongoing ability to consummate a significant number of deals in the sector. For example, one of the largest transactions of 2008, when other large private equity deals were essentially dead, was the $2.5bn buyout of Booz Allen Hamilton by the Carlyle Group, which closed in July 2008. Looking at deals announced in June of this year, six out of the 21 announced transactions in the US defence and government services sector involved private equity funds or their existing platform companies.

Although the leveraged lending environment remains constrained, private equity firms focused on doing acquisitions of federal sector companies with enterprise values of $30m to $300m appear to have ample capacity to consummate their deals. Based on the quality of the federal government cash flow behind them, they can still find senior debt financing in the 2.5x to 3.0x EBITDA range. With valuations that are somewhat lower than they were a year or two ago, funds are bridging any remaining gap with structures such as seller-provided subordinated financing, retained non-participating redeemable equity, and earnouts. By adjusting such terms as the preferred stock accrual percentage, pay-in-kind features, participation rights of the preferred, and the features and amount of the rollover equity retained by the sellers, the funds can create an alchemy that results in projected returns that meet their desired targets.

A typical federal government services target for a private equity fund is a privately-held, middle market company with annual revenues in the range of $50m to $300m. Many of these companies were built by a small group of founders, often with no material outside investment, instead grown from initial contract revenues of under $1m in their first year of operations to upwards of $300m in annual revenue 15 or 20 years later, when the founders are ready for an exit and liquidity event.

Another trend is also emerging to supplement this traditional supply of target companies. The number of divestitures by larger companies is likely to increase. Changing federal budget priorities will likely cause many companies to reassess their core operations and divest non-core business units. For example, in June of this year, a subsidiary of risk management firm Marsh & McLennan divested Kroll Government Services in an acquisition by Veritas Capital, a private equity firm focused on the government services sector. The business unit, which was renamed KeyPoint Government Solutions, provides security-clearance background investigations and fraud prevention services. In announcing the acquisition, Veritas pointed to an increasing US government need for investigative and fraud, waste and abuse prevention services; while Marsh & McLennan's press release noted the divestiture was consistent with its intention to focus on its core business offerings.

In addition, in May of this year, President Obama signed the Weapons System Acquisition Reform Act, which included rules tightening the prohibitions on organisational conflicts of interest. This enhanced scrutiny of conflict issues will also drive increased divestiture activity. According to a Reuters report, Northrop Grumman recently engaged investment bankers to sell its TASC business unit, which provides systems engineering, analysis and advisory services, primarily to the Department of Defense and intelligence agencies. Executives in the government services arena expect other diversified prime contractors with weapons systems and products businesses to engage in similar divestitures. Failing to do so may limit, or at least be perceived as a limitation, on winning opportunities to provide such systems and products.

Economic conditions are continuing to result in a drag on merger and acquisition activity, even though some signs of a general increase in activity levels are starting to emerge. The US defence and government services sector, however, has strong business fundamentals that will appeal to both private equity investors and larger strategic buyers looking to expand their offerings in specific areas that are poised for growth.

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Mr. Giammittorio has recently worked on several mergers and acquisitions for semiconductor, government services, telecommunications, energy, software, information technology, medical device, media, and life science companies. He has also worked on numerous acquisition programs for companies whose growth strategy involves a consistent mix of both organic growth and growth through acquisitions.