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Contract to wed: What's driving government contracting deals?

Seem like there's a new government contracting merger by the day? No, you're not crazy. It's marriage mania and here's why.

"People are almost salivating at the opportunity to do a deal," says Stu Shea, CEO of Peraton.
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Early on the morning of Sept. 18 came word of a blockbuster M&A deal: Defense giant Northrop Grumman unveiled plans to buy Fairfax County neighbor Orbital ATK for $7.8 billion, bringing two of Greater Washington's largest public companies with some of the largest government contracts under one umbrella.

Later that same day, a mid-market union between publicly held ManTech International Corp. and privately held InfoZen was announced, giving ManTech entry to highly sought-after IT modernization work with the Department of Homeland Security. Herndon-based ManTech paid $180 million cash for the privilege.

Six days later, another deal: Struggling Springfield contractor Versar Inc. sold itself to private equity, albeit in a $1.5 million fire sale. Another eight days later, Compusearch bought FedBid Inc. in a union of companies that help the feds save procurement dollars. That same week, two local private equity firms bought up two more small, local contractors, both for undisclosed terms.

Six government contracting deals over the course of three weeks in Greater Washington – and the year's not over yet.

Deal flow, analysts say, has been driven by an abundance of capital. Buyers – both strategic investors and private equity players – are hungry for opportunities once again, finally spotting signs of potential growth in the federal sector. And gov-cons need to add capabilities, or contract vehicles. That's especially true in the middle market, where competition is fierce.

Already through mid-November in deals where financials were disclosed, the $6.8 billion in closed government contracting deals has topped last year's total of $6.2 billion – so long as you take out the blockbuster $4.6 billion merger of Leidos Holdings Inc. with Lockheed Martin Corp.'s Information Systems and Global Solutions business that closed last year. With that deal, last year's total was $10.8 billion, according to SC&H Capital, an investment banking firm with an office in Tysons.

Part of the price increase this year is an emerging scarcity of good targets on the market, so valuations are trending up – anywhere from 10 to as much as 15 times earnings before interest, taxes, depreciation and amortization, according to several investment bankers, buyers and sellers interviewed in the last several weeks. Companies with specialized cyber technology, for example, or sophisticated analytics

WASHINGTON BUSINESS JOURNAL

tools can command valuations at the higher end of that range.

"That's pretty sporty. That recovers big from what was 8x just a few years ago. And the trend is going up," said Stu Shea, CEO of Peraton, the Herndon-based government IT services division that spun off from Harris Corp. and was acquired by New York-based private equity group Veritas Capital in a $690 million cash deal in April. "Those big deals mean people are moving around big numbers because they have faith in the market."

One source of that faith is the Trump multiple, we'll call it. President Donald Trump has long lobbied for a surge in defense spending, and his administration is pushing IT modernization efforts, though perhaps not as quickly as anticipated, that would pump billions to vendors to help agencies adopt the latest in tech tools and cyber defenses.

The federal government is still operating on a continuing budget resolution, but there appears to be movement toward an omnibus agreement, with Budget Control Act caps raised. And gov-con executives and analysts say the contracting emphasis has shifted from lowest price to best value, meaning contractors need to up their game to better compete. Among public companies, total backlog – expected revenue from awarded contracts – and the funded backlog as a percentage of total backlog have been rising in recent quarters. Both are good indicators of future earnings and signal that contract awards aren't slowing.

It all just might ease the sequestration hangover, still causing heads to pound six years later – analysts see a commitment to spending on defense, space, IT modernization and cyber.

And look for the momentum to continue into 2018, said Jean Stack, managing director at global investment bank Houlihan Lokey in Tysons.

"Even though we haven't seen it manifested in companies' performance yet, we do see it in higher book-to-bill rates, we do see it in pipelines that are out there. There's a lot of enthusiasm in the industry overall,"

Northrop has become Northrop's way in for bigger space bids.

KEY DEALS ANNOUNCED IN 2017

Highlighted numbers show the price of the deal

$7.8 billion *(plus $1.4 billion in debt)*
- **Buyer:** Northrop Grumman (Falls Church)
- **Seller:** Orbital ATK (Dulles)
- **Status:** Expected to close in the first quarter of 2018
- **Why we care:** A blockbuster deal born of global security fears and the ways missiles and missile defense systems can boost the protective capabilities of the U.S. and its allies.

$690 million
- **Buyer:** Veritas Capital (New York City)
- **Seller:** Harris Corp. (Melbourne, Florida)
- **Status:** Closed in April
- **Why we care:** The sale of the Herndon-based government IT division is the latest example in a wave of major defense and government services companies shedding noncore business units.

$283 million
- **Buyer:** H.I.G. Capital (Miami)
- **Seller:** NCI Inc. (Reston)
- **Status:** Closed in August
- **Why we care:** Another private equity deal taking a mid-market gov-con private so it can reposition amid contract delays and revenue declines.

$250 million
- **Buyer:** Booz Allen Hamilton (McLean)
- **Seller:** Aqulient (Laurel)
- **Status:** Closed in January
- **Why we care:** The consulting giant opens another hub in its growing digital solutions business by buying the digital services and federal cloud company.

$235 million
- **Buyer:** CSRA Inc. (Falls Church)
- **Seller:** Praxis Engineering (Hanover, Maryland)
- **Status:** Expected to close by the end of the year
- **Why we care:** The deal is a bid by CSRA to extend its reach into the intelligence community and is the second acquisition since its spinout in 2015.

$54million
- **Buyer:** Forcepoint LLC (Austin)
- **Seller:** RedOwl Analytics (Baltimore)
- **Status:** Closed in August
- **Why we care:** The acquisition by a unit of defense giant Raytheon illustrates the hunger for cutting-edge capabilities to add to a portfolio, in this case cyber and data analytics.

she said. "There's also a lot of enthusiasm in public company stock prices, which are right around 10-year highs."

Here, we explore why we're seeing the boost – and the higher prices – in M&A activity across the sector.

Reason No. 1: The 'extra muscle'

Stu Shea's been running Peraton – a government IT services company that expects about $1.1 billion in revenue this year – as CEO since June with a mandate to add capabilities and fuel growth. He's steering the company to high-growth markets in what Shea calls "emergent warfighter domains," primarily cyber, intelligence and space.

M&A is one avenue to achieve that, and Shea has looked at 20 deals in four months. But he's being selective – valuations feel a bit frothy to him, thanks in part to a shortage of good acquisition targets.

"People are almost salivating at the opportunity to do a deal. So I wish the deal volume was up but I wish the valuations we're down. But I'm also a pragmatist and I have to be opportunistic," Shea said. "You know, I don't want to buy a $100 million company because it has $10 million worth of cool stuff and have to deal with the other $90 million. I don't want to create a dog's breakfast of business. I'm going to try and be more strategically focused and tactically relevant."

An October deal by Reston-based Serco Inc. to buy Massachusetts radar and satellite communications company BTP Systems is just the first of what CEO David Dacquino expects will be a couple more acquisitions across the next year as the Reston company moves to broaden its capabilities and nab new customers.

Serco, the North American arm of the British Serco Group PLC, works on ships and submarines doing modifications for communication combat systems, running cables under decks and installing new communication racks. BTP's radar technology sits on top of those systems. Now Serco has an enhanced engineering offering for both under deck and top side.

Serco also does maintenance for the Navy's close-in weapon system, or CIWS ("sea-whiz"), but couldn't bid on engineering-based task orders on that contract – until now.

"My peers, and I've talked to a few them even since this acquisition, have said, 'Well, that was a small acquisition.' And I said, 'Yeah, exactly right,' " said Dacquino, who started as CEO in June, of the deal that adds $20 million to his company's top line. "It's strategic and small and we're going to grow together. I'm not interested in the big bang because once the flash is over, then you're looking for the next big one. And feeding the beast gets very expensive, and it's not good for my shareholders."

HighPoint Global, headquartered in Indianapolis but with offices in Reston and Baltimore, provides customer service training and IT infrastructure support for federal agencies – the so-called "citizen experience" products and services that are surging in demand among an increasingly mobile consumer base. It's now banking on a deal to buy Herndon-based Primescape Solutions to better compete on work supporting government websites, apps, video, social media and call centers – that too, as a prime contractor for more than 90 percent of that work.

"Because we're in the full-and-open arena, we're a large business. We're going up against the Leidos, CSRAs and multiple billion-dollar firms," said Cal Shintani, HighPoint Global's chief growth officer. "So, we don't mind fighting above our weight class. But it's nice to have a little extra muscle."

Reason No. 2: Bigger is better

You'd be hard pressed to find a more ambitious grab for scale than DXC Technology's plan to spin out its U.S. public sector business, which will then combine with Chantilly-based Vencore Inc. and Colorado's KeyPoint Government Solutions Inc.

The complex deal will create a company – dubbed NewCo for now until a permanent name is crafted – with $4.3 billion in revenue, placing it among the government IT and professional services behemoths: Leidos at $10 billion in revenue; Booz Allen Hamilton at $5.8 billion; CSRA at $5 billion; Science Applications International Corp. at $4.45 billion; and CACI International at $4.35 billion.

The need for that kind of scale nowadays is simple: so players can aggressively go after new and larger contracting opportunities. The opportunities are there as agencies grapple with legacy IT systems. An estimated $3 billion worth of federal IT equipment will reach the end of its shelf life in three years. An estimated $80 billion is spent each year on IT systems, 80 percent on maintaining outdated legacy systems.

As the players grow larger, so must their competition. That has long been true for mid-sized companies that often operate in a no man's land. Smaller gov-cons, typically below about $25 million in revenue, can rely on the government's small business set-aside programs. Larger companies, generating more than $2 billion a year in revenue, can comfortably bid on most government services jobs. But lately, even the biggest of contractors are embracing the need for scale.

"The bigger you are, the more synergies you have," said Charlie Katz, managing partner of the Northern Virginia office of Morrison & Foerster, an international law firm. "There's only so much overhead you need. At a certain size, you can then start being able to compete more effectively on bigger deals. But you're also getting to see more deals. You have great performance history, so there's opportunity to be more successful in the market-

WASHINGTON
BUSINESS JOURNAL

place. You have more expertise in more areas, so as things come up you can bid more effectively."

That Northrop-Orbital ATK deal also underscores a go-big ethos. In broad strokes, it's portrayed as a landscape-shifting union in the aerospace and defense market. But drill down a bit and focus solely on the guided missile market, where intercontinental ballistic missile systems are being replaced and precision weapons are maturing as geopolitical tensions roil.

Modernizing the nuclear triad – ICBMs, strategic bombers and submarine-launched ballistic missiles – will cost $350 billion across the next decade, as Arlington business intelligence firm Govini pointed out in a research note on the deal. Lockheed Martin Corp. and Raytheon Co. have dominated the guided missile market but a nuclear modernization push gives Boeing and Northrop a way in – and Orbital provides interceptor boosters and propulsion and control systems for tactical missiles that will now position Northrop as a prime integrator.

Reason No. 3: Dry powder

Private equity continues to have a voracious appetite for gov-con deals and, according to reports that came out during the summer, there is nearly $1 trillion in dry powder waiting to be invested.

That's because the money firms are raising is outpacing the money they are investing. Capital is flowing into private equity but values are considered high so fund managers are being particular about investments.

Government contractors were seen as a bargain buy for private equity firms during sequestration, a series of scheduled federal budget cuts that ate into profits and caused contractors to shrink or consolidate. Despite those headwinds, PE firms lit up at the financial models around contractors, courtesy their revenue visibility inherent in long-term contracts and a paying customer in Uncle Sam.

In Northern Virginia alone, PAE, Vencore Inc., Engility Holdings Inc. and DynCorp International Inc., among others, are all fully or majority-owned by private equity firms. D.C. private equity owner The Carlyle Group LP made four times its investment in Booz Allen, while Harris Corp. sold its IT services business to PE player Veritas Capital for $690 million in cash to create Peraton.

In recent months, Miami-based H.I.G. Capital has taken Reston-based NCI Inc. private in a $283 million deal and acquired Whitney, Bradley & Brown Inc., also headquartered in Reston, for an undisclosed amount.

Arlington Capital and Veritas Capital – which owns both Chantilly-based Vencore and KeyPoint, key components of the DXC spinout – have been players in the gov-con market for years. We're also starting to see more nontraditional private equity players emerge and compete for deals.

Take Sagewind Capital, a New York-based middle-market leveraged buyout firm. In May, it quietly completed a deal for an undisclosed price to buy Arlington-based By Light Professional Services, which provides IT services, custom software and hardware, cloud technology and cyber tools to the Department of Veterans Affairs, the Defense Information Systems Agency, the Department of Defense and other agencies.

Sagewind deploys committed capital but also has the flexibility to tap investor funding deal by deal. That means it will hold investments for longer than other firms, with a target of seven to 10 years. The firm is now working with By Light – its management team has retained significant equity ownership – to build the company into a large-scale, government IT services platform through both organic growth and still more acquisitions.

Private equity has already snapped up a good number of the region's federal contracting contenders, including Engility.