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PErspective in GOVERNMENT CONTRACTING

A FEATURE EXAMINING THE ROLE OF PRIVATE EQUITY IN THE GOVERNMENT CONTRACTING SPACE.

The U.S. government's pursuit of contracts on a LPTA basis has pushed margins down significantly in the post-financial crisis environment, driving divestitures of non-core businesses and consolidation between rivals in the government contracting space.

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With defense spending also down 20 percent from its 2010 peak, many government services firms have found they can no longer afford to position themselves as a one-stop shop.

Prime contractors have come under increased pressure to spin off their non-core IT services divisions over the last few years. These businesses may be large and even profitable, but their margins are relatively slim. As such, they are especially vulnerable to government pricing pressures. Separating public sector and technology verticals into independent entities enables both businesses to compete better in the tight budgetary environment without having to tussle over internal resources.

In late 2014, defense contractor Exelis spun off its services unit into a new publicly traded company called Vectrus. Similarly, L-3 Communications spun off its software support, consulting and management services to create Engility in 2012, while Northrop Grumman sold its services unit TASC to private equity groups General Atlantic and Kohlberg Kravis Roberts for $1.7 billion in 2009.

Given this year's stock market volatility and prolonged IPO drought, selling assets to financial or strategic buyers is currently more appealing than taking them public. The only cyber technology IPO this year to date was Dell's SecureWorks division, which was spun off largely to help fill a $10 billion funding gap in Dell's $67 billion acquisition of EMC. The firm's lackluster debut did not help instill confidence in further tech services IPOs, *Reuters* reports.

In fact, several government services firms have explored IPOs over the last year, but ended up selling off in a private equity transaction instead, according to the *Washington Business Journal*. Alion Science & Technology and PAE both ditched IPO plans to be acquired by Veritas Capital (July 2015) and Platinum Equity (January 2016), respectively.

Low profit margins have also driven pure-play services players to seek scale and synergies through M&A, providing private equity firms with both investment and exit opportunities. Engility acquired TASC from its private equity owners for $1.1 billion in late 2014. Computer Sciences Corp (CSC) divested its government services division at the end of 2015, merging it with SRA International, to form a new public sector IT services provider, CSRA Inc. SRA's private equity backer Providence Equity retains a minority share in the new firm, which became one of the largest

FUTURE PERSPECTIVES: GOVERNMENT CONTRACTING IN 2H 2016

With the government contracting space continuing to experience low revenue growth, the second half of 2016 will see sustained strong M&A activity. Many in the sector are looking to simultaneously create a competitive advantage and enhance value, leading them to more frequently turn to M&A to add scale, and to pursue tuck-in acquisitions to add portfolio-enhancing assets, according to forecasts published by *Washington Technology*. Additionally, government contractors are likely to continue to forego IPOs in favor of private equity deals, reports *Washington Business Journal*. Investors are expected to focus on niche subsectors with robust budgets and strong valuations, including cybersecurity, intelligence analysis, data analytics, special operations and healthcare IT, predict *CNBC.com* and *Washington Technology*. While deals will remain prevalent, the market isn't likely to see any further mergers between big U.S.-based government contractors due to opposition from Pentagon acquisition chief Frank Kendall, who may put forth official legislation to prevent mergers of top defense firms later this year, notes *Defense News*. Furthermore, the presidential race presents the potential for a slowdown in government contracting M&A as we near Election Day, with investors grappling with uncertainty around candidates' policies. However, *Washington Technology* anticipates that any slowdown would be minor and short-lived, as spending in many areas isn't likely to be affected by a new president.

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providers of government IT services with a combined revenue of $5.5 billion, and 19,000 employees, according to the *Washington Business Journal* and *Washington Technology*.

As the divestiture and consolidation trends keep the M&A market active, the government technology services sector will provide interesting takeover targets as well as exit opportunities for private equity firms with an interest in the space.

PErspective in Government Contracting is a feature examining the role of private equity in the government contracting industry.

Sources: CFO.com, CNBC.com, Defense News, Forbes, Reuters, TechCrunch, Wall Street Journal, Washington Business Journal, Washington Post, Washington Technology

People who know Government Contracting, know BDO.

Government Contracting Industry Contacts:

JOE BURKE
Greater Washington, D.C.
703-770-6323 / jburke@bdo.com

CHRISTOPHER CARSON
Greater Washington, D.C.
703-770-6324 / ccarson@bdo.com

STEPHEN RITCHEY
Greater Washington, D.C.
703-770-6346 / sritchey@bdo.com

JEFF SCHRAGG
Greater Washington, D.C.
703-770-6313 / jschragg@bdo.com

ERIC SOBOTA
Greater Washington, D.C.
703-770-6395 / esobota@bdo.com

ANDREA WILSON
Greater Washington, D.C.
703-752-2784 / aewilson@bdo.com

Private Equity Industry Contacts:

KAREN BAUM
Dallas
214-969-7007 / kbaum@bdo.com

FRED CAMPOS
Miami
305-420-8044 / fcampos@bdo.com

LENNY DACANAY
Chicago
312-730-1305 / ldacanay@bdo.com

JERRY DENTINGER
Chicago
312-239-9191 / jdentinger@bdo.com

LEE DURAN
San Diego
858-431-3410 / lduran@bdo.com

ERIC FAHR
Washington, D.C.
703-770-6328 / efahr@bdo.com

JOE GORDIAN
Dallas
214-969-7007 / jgordian@bdo.com

RYAN GUTHRIE
Costa Mesa
714-668-7385 / rguthrie@bdo.com

SCOTT HENDON
Dallas
214-665-0750 / shendon@bdo.com

TUAN HOANG
Los Angeles
310-557-8233 / tmhoang@bdo.com

KEVIN KADEN
New York
212-885-8000 / kkaden@bdo.com

TODD KINNEY
New York
212-885-7485 / tkinney@bdo.com

MATT SEGAL
Chicago
312-616-4630 / msegal@bdo.com

DAN SHEA
Los Angeles
310-557-8205 / dshea@bdocap.com