

PErspective in GOVERNMENT CONTRACTING

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

2015 saw robust dealmaking in the government contracting sector, and this dynamic is likely to continue through 2016, according to *Bloomberg Government*.



An improved budgetary environment, including relief from sequestration spending limits, and continued focus on national security

risks have led to improved revenue forecasts and valuations for defense contractors and other government services providers.

As providers evaluate their portfolios, many companies are refocusing on core capabilities, leading to strategic acquisitions and divestitures. CACI International recently completed a \$550 million acquisition of L-3 Communications' National Security Solutions business, expanding the firm's IT, security and intelligence capabilities, and positioning the combined firm to pursue large contract opportunities in federal IT contracting.

Others—such as Lockheed Martin, BAE and L-3—are divesting non-core assets as fierce competition and a strong downward pressure on contract prices from government agencies squeezes profit margins. The U.S. government's use of lowest-price technically acceptable (LPTA) procurement practices is proving especially challenging for middle-market contracting firms. Many are seeking buyers as they find themselves excluded from contracts set aside for small businesses and unable to compete with larger firms' aggressive pricing.

Private equity has been active in government contracting M&A over the past year, taking advantage of higher valuations to exit earlier investments and putting dry powder to work in strategic investments. These tended to be focused around emerging and innovative sectors like Big Data and cybersecurity, providing highly specialized support services in arenas such as healthcare and human resources.

Cybersecurity and cloud computing are growth areas and have been driving significant M&A activity. President Obama recently made federal IT modernization and cybersecurity urgent priorities, proposing significant IT spending increases across all areas of government in his budget for fiscal year 2017, which awaits approval from Congress. The Department of Defense alone is seeking \$37 billion for IT spending for the next fiscal year, with cybersecurity, cloud computing, infrastructure and unified capabilities at the top of the agenda, according to Washington Technology.

Venture capital investment in cybersecurity startups reached an all-time high of around \$3.5 billion last year, having grown roughly 40 percent year-on-year for the last five years, TechCrunch reports. Despite highly efficient capital consumption and good survival rates compared with other verticals, exit valuations tend to be low, and time-to-exit can be long. This can make it hard for cybersecurity startups to compete for funding against more sensational valuations in the broader technology sector, and may mean the cybersecurity market is underfunded, according to TechCrunch.

Such low valuations make them attractive targets for private equity, however, especially when it comes to bundling acquisitions with larger deals. Seeking add-on deals to make frothy valuations more palatable has been a clear trend in the PE world over the last few years. Add-ons represented 62 percent of PE buy-out activity in 2015—a record high—up almost 20 percent since 2006, according to PitchBook data. With industry consolidation set to continue this year, add-on deals may be a good way for PE investors to build scalable, competitive government contracting platforms, while bringing down the net multiples they pay for them.

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

Sources: Bloomberg Government, Gov Con Wire, Washington Technology, NextGov, TechCrunch, PitchBook



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