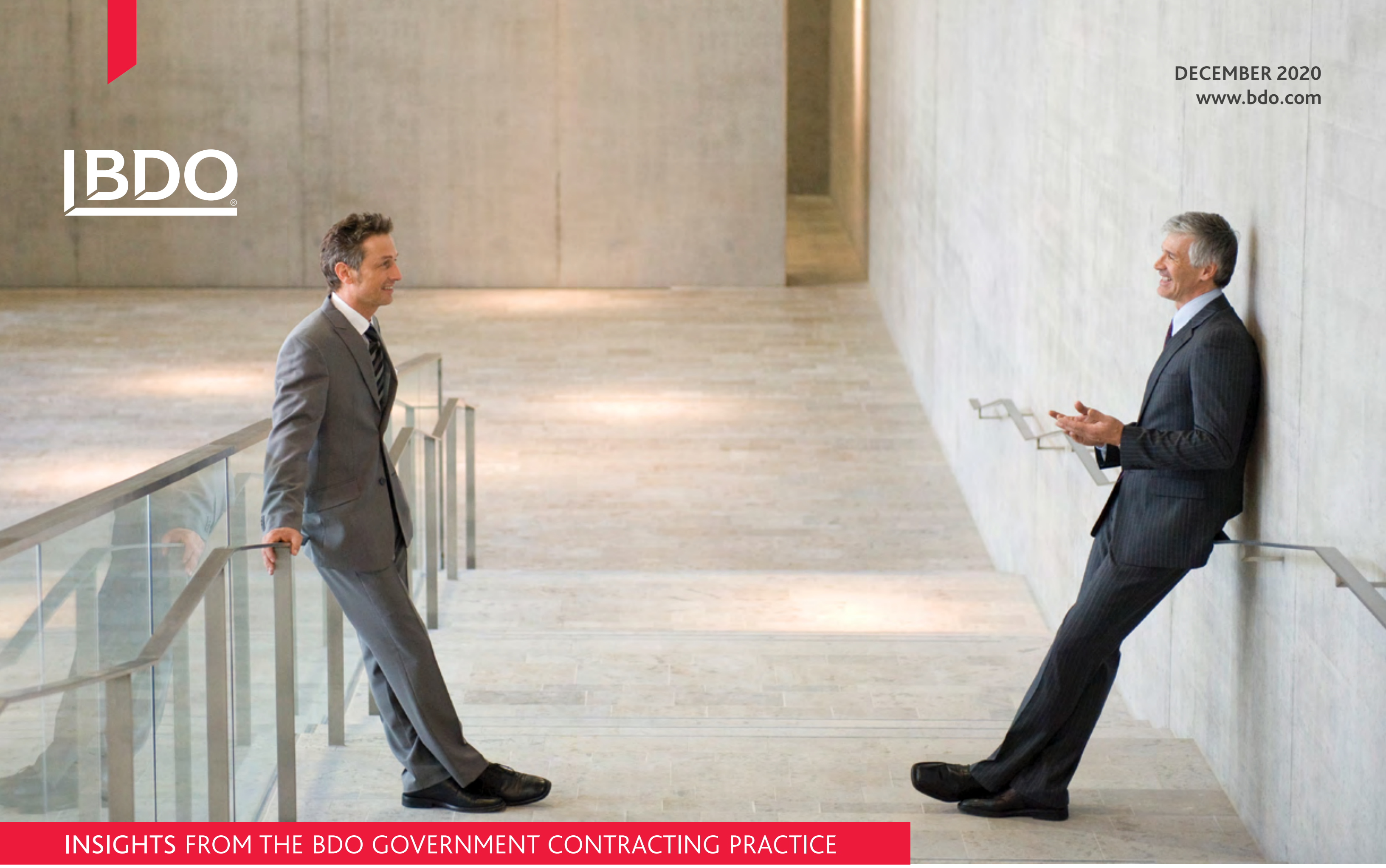
DECEMBER 2020
www.bdo.com



INSIGHTS FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

READY TO SELL? CONSIDERATIONS WHEN EVALUATING A POTENTIAL DIVESTITURE

In the first insight of our three-part Mergers and Acquisitions (M&A) Sell-Side series for government contractors (GCs), we explore key considerations and actions to take before you receive indications of interest (IOI) from potential buyers. Despite the COVID-19 pandemic unleashing levels of uncertainty and instability in much of the economy that few could have foreseen, many GCs have experienced little or no significant disruption to their business. In fact, many GCs have seen an increase in demand for their products and services as the government expedited procurement in response to the pandemic and taken other measures to protect the defense industrial base. There was a flurry of M&A activity and consolidation in the industry preceding the pandemic, and experts believe that activity will ramp up again as the COVID-19 disruption subsides.

As a result, taking a systematic approach to evaluating divestiture opportunities and getting your financial and operational house in order now will put you in the best possible position to ultimately sell your GC business.

Here are three steps to get started:

STEP ONE: WHAT ARE YOU ATTEMPTING TO SELL, AND WHY?

The first step in contemplating a divestiture is to deliberate over a few straightforward questions that can have very complex answers. Firstly, what do you want to sell, and why? There is a broad range of motivations behind the sale of a business, but in general they fall into three categories:

1. Owners who seek to sell 100% of their business are usually looking to exit and monetize the business.
2. Owners sometimes sell a part of their business in order to facilitate a partnership that allows them to expand into adjacencies.
3. Companies sell non-core businesses to reduce losses from that part of the business and generate cash to focus on core businesses.

Explore business units' interdependencies when undergoing a partial divestiture

Once you identify what you want to sell and why, consider the complexity and viability of separating the entity in preparation for sale. How independent is the business unit that's being put up for sale? Does that unit represent a viable ongoing business to a potential buyer? Can you, the seller, generate standalone historical financials for the carve-out business that is for sale? List out all of the dependencies linking the business unit with the greater enterprise and assess the cost impact to both you as the seller and a potential buyer. Considerations include:

- **Review of vendor agreements for impact on cost.** The parent may be having enterprise wide agreements that benefit all of the business units, the post-sale parent may not have enough volume to earn the price discounts, and, similarly, the carved-out business may not get the similar pricing after close. This could impact both the seller and buyer.
- **Agreements with other businesses within the enterprise.** The business being sold may be having business arrangements with other businesses within the large enterprise without any formal agreement. These need to be documented.
- **IT systems.** What is going with the sale? Is the seller going to clone the system and be able to provide the business with a stand-alone IT system from day 1?
- **Employees.** Are there any shared employees between the business units and can you delineate their responsibilities to determine if they should be retained within your remaining business?

STEP 2: WHEN ARE YOU HOPING TO EXECUTE THE SALE?

As we mentioned in the introduction, GCs are uniquely susceptible to the priorities of the government, which change over time to address emergent issues like geopolitical strife, voter sentiment and the like. For that reason, GCs should always be aware of the likely impact of changes in government focus and funding on their portfolio. In order to identify the best timing for a sale, you'll first need to determine the exposure of the business unit to specific trends in government priorities and spending. What is the current landscape with regard to government budgeting for that unit's operating niche, and what is the landscape likely to be in the period you're targeting for the sale?

For owners attempting to sell 100% of their business, the best possible value would be when the programs are in growth mode.

While government spending patterns will dictate the value and possible sales timeline, it's important for owners to know that their responsibilities to the business are not necessarily over when a deal is signed. Before making concrete plans for your next chapter, be prepared to continue on in your role in the divested business or carve-out, at least temporarily, to smooth the transition and assimilation to the new owner.

STEP 3: HOW WILL YOU PREPARE FOR THE SALE?

Once a value expectation and timing are determined by the owners of the business, the next step would be to form a project team to prepare for the sale. Start with finance, tax, HR, legal, IT and business strategy leaders who will work together to establish a project plan, timeline and deliverables. In addition to attorneys, consider engaging outside accountants to help with independent quality of earnings analysis and tax consultants to determine the structure and diligence of the tax history.

Get your financial and operational house in order

Once the team is in place, one of their first tasks will be to get the house in order by revisiting, in greater detail, some of the considerations noted above. Presumably, you have determined that you can produce standalone financials for the business unit you are preparing to sell. Now, you have to identify and address any deficiencies in the quality of systems, book and record keeping, and ensure that the data required by outside accountants, tax consultants and attorneys can be generated easily. They'll be looking for:

- Tax information, including nexus issues and potential exposures.

> **Sales tax in particular is a common issue for GCs, so confirming positions and gathering resale exemption certificates ahead of time will help during due diligence.**

- Analysis of how current service offerings align with government priorities and funding to validate a valuation.
- A robust business plan that will support the value expectation and ensure the existence of adequate infrastructure and personnel within the business to deliver on that business plan. In particular, does the owner or existing management team have a growth plan to double or nearly double EBITDA in the next three to five years? Can they explain it clearly and concisely? If so, why does the current owner want to exit now?
- A compliance "health check" to get a clear picture of where your organization stands with rate settlements, outstanding proposal audits, Contractor Business System adequacy and other policies and procedures.

- Accuracy of your systems to produce the detail necessary to provide a buyer with information on contract financials to support due diligence activities.
- Financial information that can help them evaluate the costs and benefits of acquiring assets versus stock.

The project team should also prepare a detailed waterfall schedule and consider offering retention bonuses to employees essential to carrying out the project plan. Engaging an estate attorney to chime in on elements of the plan is also a prudent practice for individual owners selling their companies.

All of this groundwork will make preparation of the executive summary and Confidential Information Memorandum (CIM) easier, which we'll explore in the next insight in this series.

External analysis will strengthen your IOI

Concurrent with the internal analysis and data gathering your project team is carrying out, you will also need to begin gathering information about the marketplace for M&A within your industry niche. That entails gathering market intelligence on potential buyers and identifying any Organization Conflict of Interest (OCI) and/or Small Business Set Asides (SBSA) issues. Thorough research will help you understand the potential investment theses of the potential buyers. In addition to focusing on industry peers as divestiture targets, it's also prudent for you and your project team to assess the value of your business or business unit if you were to sell at auction or to private investors.

In conclusion, while the current financial, social and political situation makes the near-term landscape for M&A in the GC sector difficult to predict, there are steps that you as the seller can take now to ascertain whether your business is an attractive acquisition target. The key in determining whether and how to move forward with a sale will be in gaining clarity around the state of your business, the outlook for your industry, and your best guess on how likely outcomes in government priorities and spending may impact both. Investing the time and effort in this research, analysis and preparation now will help you mitigate uncertainty as you enter the IOI phase. Getting your house in order today will also put both you and your business in a stronger negotiating position, as you move through the letter of intent and closing phases, as well as post-transaction, that we'll explore in future M&A Sell-Side Insights.

People who know Government Contracting, know BDO.

www.bdo.com/**government-contracting**

Learn more about how your organization can best navigate the *pre-IOI* phase by reaching out:

CONTACTS:

AARON RADDOCK
Partner, Government Contracting Industry National Co-Leader
703-336-1693 / araddock@bdo.com

ERIC FAHR
Partner, Atlantic Region TAS Financial Leader
703-770-6328 / efahr@bdo.com

CHANDRA CHUDAMANI
Managing Director, Transaction Advisory Services
703-245-0367 / cpakala@bdo.com

JOHN KRUPAR
Managing Director, Operational Value Creation
602-293-2545 / jkrupar@bdo-ba.com

MEREDITH PILARO
Government Contracting Tax Practice Leader
703-770-6357 / mpilaro@bdo.com

DEREK SHAW
Managing Director, Government Contracts
703-336-1501 / dshaw@bdo.com

AMY THORN
Partner, Government Contracting Assurance Practice Leader
703-770-6318 / athorn@bdo.com

ALISON TORRES
Principal, Atlantic Region TAS Tax Leader
703-770-1063 / atorres@bdo.com