INSIGHTS FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

A GOVERNMENT CONTRACTORS' GUIDE FOR EVALUATING WHETHER TO PARTNER WITH PRIVATE EQUITY

By Kim Clark Pakstys, Amy Thorn and Scott Hendon

High growth government contractors looking to scale quickly and sustainably often find partnering with a private equity (PE) firm to be an attractive option. In addition to infusing companies with critical capital, PE firms can provide the market access, mentorship, operational expertise and tools needed to drive greater revenues and efficiencies. Furthermore, PE firms can help shoulder the burdens, expenses and risks that come with growing a business—a formidable task executives often underestimate.

While PE interest in government contracting is increasing, success is not guaranteed without significant effort and investment from both sides. *Good* partnerships require proactive management, ongoing communication and a clear alignment of goals between both parties, and *great* partnerships demand an additional level of mutual trust, accountability and respect.

As more PE partners approach government contracting executives to explore the sales of, or investments in, their businesses, one question arises: Is now the optimal time for such a transaction? This guide aims to aid government contractors in answering that question.

PREPARING FOR A DEAL

What are you looking for?

When deciding whether to pursue a PE deal, first look inward. Government contractors who understand their current situation, strengths, weaknesses, opportunities, and near-, medium- and long-term goals are better equipped to identify if, when and how much external capital they may need. Furthermore, it's important to remember that private equity is not the only type of capital contractors can raise. Other options, such as loans and venture capital, may be suitable depending on the scenario, but come with their own set of advantages and disadvantages to consider. When contemplating the potential of a PE deal, contractors should consult their business advisor and discuss the potential opportunities and challenges each investment avenue presents.

While most executives try to calculate and acknowledge the significant risks before entering a deal, "acknowledgment" is often very different from true "comprehension" of the signed and definitive agreement. Government contractors should be aware of the compromises, as well as the ways in which certain amounts of management control are ceded to the PE partners. While sharing power may still be difficult, learning how to articulate and constantly re-define what constitutes "value" throughout the partnership duration—whether it's scaling the business long-term or simply turning a profit—will remain critical for both parties.

Know what a private equity firm can offer

There are many motives driving both PE interest in the government contracting space and why contractors—including many in the cyber, space, health IT and Intel markets—say yes to PE investments. PE firms can help companies access new markets, assist with the organizational and financial sides of a business, provide objective data-driven insights, create efficiencies and increase profitability. However, optimizing collaboration with a PE firm depends on both parties aligning their interests ahead of signing a deal.

Know the Private Equity ecosystem

The PE landscape has changed a lot over the last 10 to 15 years. Today, more and more small government contracting companies are graduating from 8A, trying to move from subcontracting positions into a prime role and looking to add capabilities or expand with a platform strategy, all while seeking interested PE firms to assist. Understanding the focus and nature of each prospective PE firm will help contractors in identifying which will be the best to work with, as all PE firms have different strengths and focus areas—some are generalists, whereas others have specific industry concentrations. Consultants can help government contracting companies in speeding up this process, thanks to their vast business networks and PE contacts.

Know your worth

Before starting negotiations, contractors need to evaluate their worth, as this valuation is necessary for establishing realistic negotiation targets. Many factors can affect a valuation positively and negatively, including technology, IP, solutions, talent base, prime contract positions, customer base, management team, industry trends, growth potential, ability to turn revenue into cash flow, sales and potential future exit opportunities. The valuation is not based solely on a picture of current and past performance, but also on an analysis of what material and immaterial assets (especially IP and contract values) will be worth over time.

Define the relationship

While many government contracting executives have likely interacted with investors before, they might not fully appreciate a longer (typically four to six year) partnership, in which the investors usually have a controlling interest. Similarly, on the PE side, some firms might hesitate to formalize relationships for fear of over-committing or promising more resources than they can realistically provide.

Clarifying roles and responsibilities is crucial to making a partnership work. Assigning titles may not be necessary, but clearly outlining who will be involved, what each side is expected to deliver and contribute, and the appropriate level of transparency for each role is. Defining the relationship between both entities ensures full alignment on critical, strategic matters.

Make it a two-way relationship

Every relationship is a two-way street, and a PE-government contracting partnership is no different. While it's natural for companies to primarily focus on receiving resources, executives need to remember that giving is equally important—and that they, in fact, do have a lot to give.

While government contracting executives may not have the same type of expertise and experience as their PE partners, they are particularly knowledgeable about the operational details of their company and industry. These insights can inform PE partners who may not be as involved in a company's management and may very well translate into advice that's applicable to other portfolio companies. The learnings from one company could perhaps be an idea that benefits a PE firm's entire portfolio.

NEGOTIATING WITH A PE FIRM

Know what PE firms are looking for (and at)

Traditionally, PE firms have a set goal for an investment: to deliver a substantial return in three to five years. During negotiations, PE firms will primarily be focused on the contractor's products, services, contract type, contract value, technology, intellectual property, R&D, management team and future potential. Prior to negotiations, contractors should carry out an analysis and prepare data driven arguments to better position themselves for a deal.

Know your PE firm's situation

Another important factor in negotiations is knowing what the situation is like on the other side of the table, which makes it easier for contractors to discern their position and identify the tactics that will be most effective. ***BDO's Tenth Annual Private Equity Perspective Survey*** provides good insight into PE firms' current outlook, which can help government contracting CFOs, GCs and CEOs during negotiations. According to the survey's findings, PE companies are currently experiencing healthy competition, and with access to a lot of capital, many are looking to make new investments in the government contracting market.

Know PE firms' concerns

Government contracting companies are attractive targets for PE firms. In fact, PE firms are increasingly adding contractors into their portfolios. However, when acquiring target companies, PE firms may find it challenging to identify growth opportunities and retain management teams. To mitigate this issue, PE firms are looking for government contractors who know the business, have strong prime contracts, backlog and relationships with agencies with growth potential.

Have all your documentation in order

The level of detail in the questions PE firms ask during the deal-making process often comes as a surprise. Questions can cover areas such as financial, legal and tax issues, as well as existing business processes, future earning perspectives, risks and more. Contractors may also face very detailed inquiries regarding value created through non-financial activities, such as sustainability, partnerships or mentor programs. This ongoing vetting process requires transparency and communication between both parties. Government contractors should assess every aspect of their business and point out inefficiencies and areas for improvement.

The documentation of strengths and weaknesses in the areas PE investors will likely focus on during a deal negotiation is a process that should be started very early on. And while it's tempting to share only the good news with prospective PE partners, contractors should flag every major development or risk that could potentially affect the business. PE partners, with their industry knowledge and management experience, can help executives calmly and logically navigate crises and arm up against future risks.

COLLABORATING POST-DEAL

Plan for the post-acquisition

Before sitting down at the negotiation table, it is crucial that contractors envision how collaboration with a PE firm will take shape post-deal. The creation of an effective partnership starts with both parties explicitly stating what they expect to get out of the relationship, as well as how it should work in practice. Such plans and statements of intent should include everything from day-to-day collaboration to the outlining of how both parties can work together toward a potential exit.

A critical part of onboarding is developing a new board of directors, as well as defining the roles within the team and in relation to the company. Having strong board governance is critical, as the board is the platform on which most of the partnership—discussions, exchanges of ideas and decision-making—will take place.

For companies with no board or a less mature board model, learning how to bridge the gap between their current board governance practices and the level at which their PE partners expect them to operate can be challenging.

Smaller contractors may be unfamiliar with the routine board practices executed by their more mature counterparts (i.e. performance and financial reporting, strategic planning, etc.), while others may still operate with executive-centric boards that primarily cater to the CEO. Nevertheless, partnering with a PE firm is a great opportunity for companies to get many of these necessary practices in place, while also receiving guidance along the way. While it may be difficult to initially cease total control or formalize the structure, doing so will help both parties deliver maximum value to each other.

Set clear targets

Communication and collaboration issues often arise from misalignment of expectations and goals. Unrealistic plans for sales growth, cost cuts and/or a lack of foresight regarding future challenges can be a red flag for PE firms during a negotiation process, and can create doubts about a management team's business acumen. Collaboration must start during the negotiation process and should be a continuous effort. While the exact structure, form and regularity of communication between the government contracting company and its PE firm will vary, communication should be proactive instead of reactive and follow established guidelines.

Government contracting-PE partnerships are common in this age, and are becoming more prominent in the market. The most successful relationships are those that have both ambitious goals and high-performance expectations, as well as clearly defined strategies, tactics and the resources to get there. Regardless of how formal or long-lasting a partnership is, mutual respect, transparency and accountability will always be essential to creating long-term business value.

To learn more about how your government contracting business can best partner with PE professionals, contact Kim Clark Pakstys, Managing Director at BDO, at kclarkpakstys@bdo.com, or Amy Thorn, Assurance Partner at BDO, at athorn@bdo.com.

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CONTACT

KIM CLARK PAKSTYS
Managing Director, M&A and Transformation Services
703-770-9049 / kclarkpakstys@bdo.com

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

SCOTT HENDON
National Private Equity Industry Group Leader, International Private Equity Co-Leader, Global Practice Leader, International Liaison Partner
214-665-0750 / shendon@bdo.com

ED AMOROSSO
National Co-Leader, Government Contracting Industry Practice
757-640-7295 / eamorosso@bdo.com

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

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