INSIGHTS FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

PRE-TRANSACTION CONSIDERATIONS WHEN EVALUATING ACQUISITION TARGETS

In the first Insight in our three-part Mergers and Acquisitions (M&A) Buy-Side series for government contractors (GCs), we delve into the critical "pre-transaction" phase to provide key considerations for the industry to identify and vet potential acquisition targets. While M&A activity for the sector has been humming along over the last few years, in 2020, we anticipate that GCs will be much more cautious about the acquisitions they are prepared to undertake. Presidential elections have implications on expected federal spending and acquisitive GCs often take a "wait and see" approach while awaiting clarity. Economic indicators signaling a potential future recession may also cause some indecision and delays, but GCs tend to fair better through recessionary times than sectors without government spending.

For GCs looking to grow through acquisitions, here are six key considerations to focus on during the pre-transaction phase:

1. IDENTIFY POTENTIAL TARGETS

Due to the nature of our industry, there are numerous channels to explore to identify acquisition targets that align with your organization's growth objectives. For example:

Customer penetration through expanding agency focus

What opportunities are there to expand your offerings to agencies not previously serviced? For example, a GC serving the U.S. Air Force may find opportunities to access significant U.S. Navy contracts by making a strategic acquisition when your services or products complement existing contract provisions. Another example is a defense contractor that may seek to diversify their revenue sources by acquiring a company with non-defense contracts, e.g., looking for acquisition targets through the Federal Aviation Administration or Health & Human Services.

Market penetration through expanding geographical focus

Potential buyers should also consider acquisition targets that can expand, or establish their presence in, a new market. This is particularly true for buyers and targets that provide similar services or products. For example, with the U.S. Navy fleet stationed on both the East and West coasts, a company in San Diego, California, that overhauls and/or repairs diesel engines for Navy ships, could be a prime target for a similar company headquartered in Norfolk, Virginia.

Acquiring a division, instead of the entire company

Another buyer consideration is whether the acquisition target will sell the entire company, or a separate division thereof. For example, target companies may have a division providing services to the government, but also operate a division that sells to commercial customers. The acquirer may have to decide whether to buy aspects of the business that might hold less interest to capture the strategic assets, and then potentially divest non-core assets after consummating the transaction.

2. SOURCE THE DEAL

If market conditions make it the right time to pursue acquisitions through one of the channels described above, it's never too early to assemble a team that is knowledgeable and experienced in M&As, including legal counsel, CPAs and bankers to spearhead the deal in the "indication of interest," or "IOI" phase. For example: Chances are you can identify a few companies that fit the bill as ideal acquisition targets for you. While you could reach out to the CEOs of target firms on a case-by-case basis, GCs can add a higher level of rigor to their acquisition strategy by sourcing deals through investment bankers—who are able to "run the numbers" on potential acquisitions, identify red flags and determine how the deal will contribute to the company's growth goals based on the information provided.

3. VET TARGET COMPANIES WITH SET-ASIDE CONTRACTS

Target companies may have small business set-aside contracts, which may not be converted to full and open at recompete. For set-aside contracts that cannot be converted, the buyer can end up as the subcontractor, which could reduce future revenues. Buyers should therefore consider if the set-aside contracts require a separate valuation.

Additional diligence is often needed when targeting small businesses as size-standard issues can arise during or even before the transaction closes. It may not always be the acquisition itself that causes the company to no longer qualify under the size standard. If these contracts are a key component to target selection, getting a full understanding of how you will be able to benefit from them post-acquisition is something to tackle early on.

4. ASSESS TAX STRUCTURE AND ACCOUNTING CONSIDERATIONS

Before beginning negotiations, consider the desired ownership structure from a tax perspective. What type of deal would be most advantageous in terms of future deductions? What role will debt play in light of new 163(j) interest limitations?

Furthermore, different contract types bring complexities in accounting. Revenue on firm fixed price (FFP) contracts are generally recognized using the percentage-of-completion method, and contract losses are recorded when the loss is first determined. For Cost Plus Incentive or Award Fee contracts, revenue is recognized based on cost plus an estimate of the fee. Certain contracts can contain limits on reimbursed cost. For example, the general and administrative (G&A) rate has a limit of 5 percent; which could potentially lead to contract losses. These complexities can cause additional administrative burden or cost for a company, particularly private equity companies that are new to the government contracting industry.

5. PLAN FOR SUCCESSION

While the hard work of succession planning is typically undertaken in future phases of M&As, it behooves acquirers to take time during pre-transaction to evaluate the target's management structure and owners' roles and responsibilities post-merger.

For example, companies need to identify leadership talent that can spearhead the new organization at the next size level, while also helping to integrate the combining cultures. This is the time to think about "upskilling" leaders to meet the needs of the combined company and the plan for current leaders at the target company. Will they continue on with the new company or should there be a transition plan to a new leadership team that can deliver on the deal objectives?

6. KNOW HOW CFIUS MAY IMPACT INBOUND TRANSACTIONS

Inbound transactions may be subject to an additional layer of scrutiny by the Committee on Foreign Investment in the United States (CFIUS). CFIUS focuses on 16 critical infrastructure industries including telecom, financial services, and aerospace & defense. Based on regulators' review of M&As in these sectors, certain actions may need to be taken as directed by the Committee that could impact integration.

In conclusion, M&As can be a strategic way for GCs to grow in uncertain economic times. In particular, we've found synergies occur when the buyer and seller offer similar or complementary offerings and there is potential to expand into new markets geographically or by government agency. For government executives in charge of the procurement role, the benefits are clear: Enhanced product or service offerings from the merged GC results in improved performance on contracts, a key performance indicator for government institutions that are accountable to taxpayers. However, GCs should proceed with caution. As described above, there are myriad accounting, regulatory and organizational issues that need to be identified and addressed in the pre-transaction phase to find an optimal acquisition target. In our future Insights in the M&A Buy-Side series, we'll focus on the remaining transaction phases, Letter of Intent Through Closing, and Post-Transaction.

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

CONTACTS:

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

JOVEN ABRILLO
Director, Transaction Advisory Services
703-770-0583 / jabrillo@bdo.com

LARRY ALLEN
Managing Director
703-336-1409 / llallen@bdo.com

MICHAEL BARBA
National Security/CFIUS Lead, Managing Director
212-885-8120 / mbarba@bdo.com

KIM CLARK PAKSTYS
Managing Director
703-770-9049 / kclarkpakstys@bdo.com

ERIC FAHR
Partner, Atlantic Region TAS Financial Leader
703-770-6328 / efahr@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
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 JD
703-770-1063 / atorres@bdo.com

GIACOMO APADULA
Managing Director
609-617-4191 / gapadula@bdo.com

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