

SIZING UP THE M&A MARKET FOR GOVERNMENT CONTRACTORS IN 2012

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PAPER**

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Merger and acquisition activity among government contractors continued to rise in 2011, as it has for most of the last decade. The uptick in 2011 is especially notable in light of still-stagnant economic conditions. But will this activity continue at the same pace in 2012? Federal budget concerns, procurement patterns, and potential regulatory changes in 2012 surely will impact the merger and acquisition market. Businesses aware of these trends in the next year will be best able to position themselves for possible acquisitions or sales.

While uncertainty exists regarding the 2012 federal budget, one issue is clear: federal contract spending will decrease in 2012. Forecasters suggest that federal contract spending in 2012 will be 10 percent lower than 2010 levels, with possible deeper cuts driven by the Congressional debt supercommittee and the changing landscape in an election year. Decreases in spending will spur uncertainty in the status of government programs on which contractors depend. Agency anxiety about funding will delay programs. New or expanded programs will be shelved. Procuring agencies will consolidate more contracts, or extend existing contracts, rather than incur costs to rebid the work. When agencies do request proposals, they will use lowest price, technically acceptable criteria and “price shootouts” in awarding their contracts.

The silver lining in the cloudy budget conditions for government contractors is that experienced contractors with proven abilities to perform efficiently and economically will rise among competitors. These contractors have spent years cultivating relationships with the government, know how to service their government-client, and fully understand where they stand in their niche.

Plus, the government will continue spending procurement dollars on innovation – sectors in which the government is desperately committed to expenditure – like cybersecurity, healthcare, and information technology.

Forecasters suggest the market for IT systems and services will continue to grow in the next year despite tight federal budget conditions.

Moreover, small- and medium-sized contractors will get a boost from proposed regulatory changes. The concept of “small business” will likely expand in 2012. First, the Small Business Administration’s proposed changes in size standards for North American Industry Classification System Sector 54, covering professional, scientific, and technical services, should be finalized in early 2012. The expected size standard increases for many industries in Sector 54 have the potential to

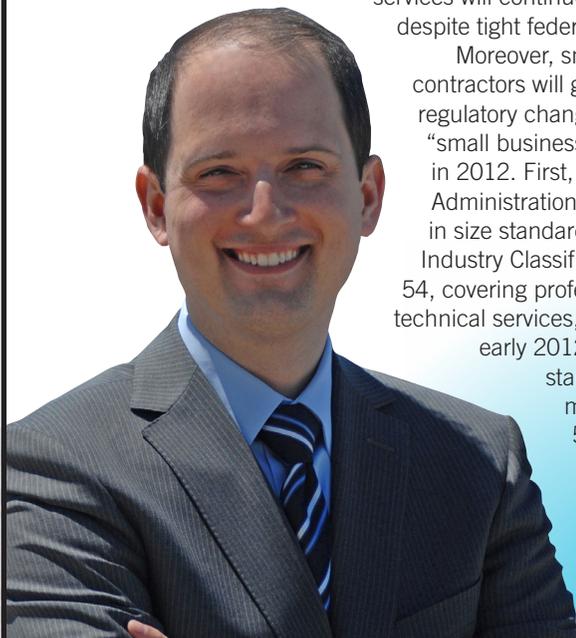
create over 9,000 new companies eligible for small business programs. Second, Congress may consider implementing a procurement preference for medium-sized businesses in 2012. Such a preference could be based on participation in the General Services Administration’s mentor-protégé program or the business’ size (akin to the preference for small businesses currently in place).

These legislative and regulatory proposals could potentially change the game in terms of acquisitions for government contractors. Companies face big questions once they outgrow their small business status. Without the option for set-aside government contracts, a medium-sized business might consider selling to another company or even buying another small business to increase capabilities. Expanding the definition of a small business helps smaller contractors stay small longer. By remaining a small business longer, contractors have more time to position themselves for merger or acquisition. Businesses that outgrow their small business status may continue cultivating their relationship with the government on a medium-sized preference basis.

Extra development time for small- and medium-sized businesses will increase the pool of attractive acquisition targets. Existing contracts and relationships with the government are a valuable asset for any business. In the last decade, large prime contractors focused on acquiring smaller government contractors in order to round out capabilities. Such acquisitions allow the large prime to buy in to government contracts and relationships nurtured by the smaller contractor. Acquiring these relationships, rather than developing them organically, saves the large contractor time and money.

What do these trends mean for your business? As the calendar turns to the new year, now is the time to size up your business. If you are a potential seller – maybe a small business looking to shorten your horizon – then begin assessing your market value. Do you hold free and open government contracts through 2012 and beyond? Are you in cybersecurity, healthcare, IT, or another growing sector? If not, are you otherwise an experienced company with proven capabilities in a niche market? The next year is an opportunity to assess where you stand in the market and start planning for a liquidity event or sale, which could include corporate restructuring or reorganization. Spend 2012 positioning yourself so that whether sale is a short- or long-term goal, you will be able to name your asking price.

For potential buyers, consider where your acquisition efforts are best spent in 2012. What are your best, realistic targets for acquisition? Maybe an experienced niche small business about to outgrow its small business status? Does the small business have a mixed portfolio of contracts or are they all set-asides? If the latter, there are certain government-imposed obstacles to consider, like recertification, but nothing insurmountable. 2012 is your chance to scout potential acquisitions – companies with the right experience and relationships – and grow your capabilities.



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