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#### Federal M&A Outlook 2010: Deal Opportunities and Risks – Insights from CEOs and Dealmakers

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Morrison & Foerster hosted its Annual Federal M&A Outlook for 2010 on Wednesday, October 14, in McLean, Virginia. Co-sponsored by the *Washington Business Journal*, the event was attended by close to 400 federal contracting executives and industry experts who gathered to hear leading dealmakers discuss the prospects for growth, investment, and M&A activity in the sector.

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#### Quick Outlook Takeaways

- Federal M&A market not fully recovered, but should see a re-acceleration in 2010
- Continued high valuations in the fields of cyber-security, health IT, intelligence, asymmetrical warfare, and national security
- Organizational conflicts of interest and insourcing pose significant risks to buyers
- Companies must differentiate from competitors with technology, customers, geographies
- Private equity and large strategic buyers will be the most active
- Improvement in the credit markets could facilitate growth and M&A activity

#### **Keynote Presented by Michael Lewis, Senior Equity Research Analyst, Technology Group for BB&T Capital Markets**

Mr. Lewis kicked off the event with a cautiously optimistic keynote presentation discussing past, present, and expected future trends for the government services industry, with a focus on the mergers and acquisitions environment for 2010. Overall, Mr. Lewis continues to see a number of significant opportunities in the government services sector despite a decline from the peak activity following 9/11 and a secondary peak in August 2005. In the past 18 months, the government services industry has entered a more mature phase that appears to trend in line with the overall market.

Mr. Lewis identified a number of current trends in the market, including the strengthened buying power of the federal government, a more heated protest environment for contracts, budget uncertainty, increased insourcing and reduced use of support service contractors, more fixed price contracts and less sole sourced awards, as well as ongoing issues with organizational conflicts of interest particularly among large primes. Mr. Lewis also noted the government's increased ability to compete with the private sector for talent and innovation.

In the short-term, Mr. Lewis sees government spending increasing by a modest 3% - 4%. Mr. Lewis stated that organic growth rates for public companies in the sector have declined from their peak in early 2008 into a more sustainable range of 7% - 12% for the foreseeable future. As there appear to be few new areas for expansion within the sector, Mr. Lewis believes the competitive environment will intensify, with companies striving to achieve an indispensable relationship with the government. Mr. Lewis, however, warned that contractor oversight and organizational conflicts of interest could continue to pose significant risks for some companies. Despite this uncertainty, Mr. Lewis identified opportunities in the fields of cyber-security, health IT, cloud computing, green initiatives, asymmetrical warfare, defense training and operations support, non-military assistance to critical countries, and reset of military

Mr. Lewis also previewed the mergers and acquisitions market for the government sector. Currently, while overall deal flow is down, valuations remain at elevated levels particularly for companies in niche markets or that have highly specialized capability or technology. Mr. Lewis expressed his belief that the sector will see a re-acceleration of mergers and acquisitions in 2010 with a continued focus on acquiring specialized companies with a high probability of growth in one of the insulated areas of the federal budget: intelligence, cyber-security, biometrics and healthcare IT. Mr. Lewis stated that strategic buyers will remain the dominant players in the field for the near term, with financial buyers becoming more active. Mr. Lewis also believes that organizational conflicts of interest will continue to pose risks for buyers that could jeopardize potential deals.

Following Mr. Lewis's presentation, Lawrence Yanowitch, partner and co-chair of the Global Mergers & Acquisitions Group at Morrison & Foerster, and Paul Feeko, partner with the Transaction Advisory Services Group at Ernst & Young LLP, moderated two panel discussions covering a wide range of topics affecting government contractors.

### ***What Investment Bankers Are Saying***

The first panel consisted of five managing directors at investment banking firms that have been active participants in the federal mergers and acquisitions markets.

**2010 M&A Market.** Most in attendance were eager to hear the panel's thoughts on the current and near-term future of the mergers and acquisitions market. Overall, the panel believed that activity would increase particularly in the "hot" areas identified in the keynote address. Buyers will be looking to replace revenue lost due to cuts in defense and weapons spending. Companies that are strategically located in high growth sectors or that offer a unique technological acquisition for a buyer, will find themselves in high demand. Several panelists stated that for companies not in the high demand segments, there is no expectation that valuations will increase significantly and some companies may simply be unsellable in the short term.

**Buyers.** The panel agreed that the most active acquirers in the near term will be larger strategic buyers and private equity firms. One panelist noted that some strategic buyers may be sitting on a lot of cash, eager to jump into the market, but still very concerned about risks and uncertainties in the federal sector. For other companies, notwithstanding a slight thaw in the credit markets, the continuing high cost of credit will rule them out as potential buyers for the near term. As a result, the panel agreed that private equity buyers will be the most active in the government sector, particularly in acquisitions of companies in the lower to middle market level. Commercial buyers looking to diversify may also turn their attention to the government services industry.

**Risks.** According to the panel, there are several primary risks that may cause buyers to reconsider a potential deal. Among them is the continuing threat of organizational conflicts of interest. One panelist stated that primes are under increased pressure to evaluate and resolve potential conflicts early in the acquisition process. The panel also discussed how such conflicts have recently forced high profile divestitures of assets or sections of the overall business, and the panel expected additional divestitures as both buyers and sellers attempt to mitigate the impact of potential conflicts. Several panelists also noted that an analysis of organizational conflicts of interest is complicated by the fact that each governmental agency deals with conflicts in a different manner, and companies that have relationships with several agencies could face additional risks. As a result, conflicts analysis may need to be conducted on a contract by contract basis, with divestitures of individual contracts becoming common. Another risk factor that the panelists are closely monitoring is insourcing, which they predicted will particularly affect the IT sector and could be a dampener to M&A activity and a risk to valuations.

**Strategies for Sellers.** The panel uniformly stated that for companies in the hot areas of high growth, now may be a good time to take advantage of what are expected to be continued high valuations. For other companies, the panelists recommended reviewing the company's contract base, technology portfolio and customers to determine if the company is differentiated enough to stand out to buyers in the current environment. Absent a unique presence, potential sellers could find that valuations will not have fully recovered in 2010. Panelists also noted that companies should evaluate and attempt to limit the risks posed by organizational conflicts of interest and small business and insourcing issues before putting themselves on the market. One panelist also discussed that, as the IPO market regains traction, "dual-tracking," or simultaneously positioning a company for an M&A event and an IPO, has once again become popular. The group also suggested that sellers be up front with potential buyers about cultural issues and other qualitative factors that may jeopardize an otherwise successful deal.

The second panel consisted of CEOs of companies that have been active participants in mergers and acquisitions in government contracting in recent years. Panelists included George Pedersen, ManTech International Corporation; John Belcher, ARINC Incorporated; Edward Casey, Jr., Serco, Inc.; and Ramzi Musallam, Veritas Capital.

**2010 Market.** With respect to the government services sector, the panel reiterated both the keynote speaker and the investment banker panel in choosing cyber-security, intelligence, health IT and national security as the “hot” areas for growth in 2010. Panelists expressed their opinion that growth will be more difficult for companies not affiliated with these select fields, but that differentiation and specialization can still attract high values. In terms of financing acquisitions, several executives believe that, while pricing and restrictive covenants are still unfavorable for buyers, the overall debt and capital markets seem to be improving, and recent conversations with financial institutions have provided reason for hope. One panelist felt that the increasing federal deficit will be a drag on a full recovery in the U.S., and he contrasted the U.K.’s seemingly successful approach of increased privatization and outsourcing. The panelists were split in evaluating the level of M&A activity, with one panelist stating he had seen a significant drop in the quality of target companies his team had evaluated. Other executives believed their companies had an adequate amount of deal flow to fulfill their objectives for the next few years.

**Valuations.** The panel generally believed that valuations will be mixed for the near term. The panelists stated that they are willing to pay top dollar for superior or unique technology, or for the opportunity to expand into new business or geographic segments, but that many sellers continued to have lofty expectations not supported by the current market.

**Buyer’s Wish List.** The panelists relayed a varied list of attributes they look for in a potential acquisition. Among them is a strong record of growth that will complement the buyer’s existing business and drive the bottom line goals. However, several executives stated that sales alone will not seal the deal; the selling company must offer some unique attributes to distinguish it from the rest of the market, such as exclusivity of technology or offering the buyer the opportunity to expand to new customers or new geographies. One executive said that his M&A team spends significant time and energy in evaluating a potential target’s technology – examining whether the technology is cutting edge and whether it can be combined with the buyer’s existing products. Another executive explained that the ability to fully integrate the acquired company is a must, and his team assesses the culture of the target at an early stage to avoid potential road blocks later in the process.

**To receive a copy of the Keynote Presentation by Michael Lewis, please email [vaevents@mofocom.com](mailto:vaevents@mofocom.com).**