

M&A : Why are 2010 and 2011 Being Slated as Strong M&A years?

by Lori Gibson

The public sector is in a curious environment as we enter 2011. According to the Washington Technology, October 2010 edition: “pricing on publicly traded government service companies are taking a beating from investors: federal services are down 19% and defense prime contractors are down 5%; valuation multiples are at their lowest levels in the past decade at an average of 6.5X Trailing 12-month EBITDA “. However, the media is hailing 2010 as one of the strongest years ever for industry consolidation. Why?

Three Factors Converge to Produce “The Perfect Storm”

Budgetary and Regulatory Realities

Defense Secretary Robert Gates has expressed plans to retire in 2011 to allow sufficient transition time for his successor. The members of Congress failed to receive a budget for 2011 causing the US military to operate on an extension of the \$693 billion 2010 defense budget through March 2011. The National Commission on Fiscal Responsibility and Reform released preliminary draft report proposing cuts of \$100 billion of the base defense budget by 2015. This tumultuous environment lends to uncertainty and a general caution concerning the growth prospects for government service entities. Therefore, the industry’s publically traded strategic players are looking to M&A to backfill overall growth expectations that they will not be able to meet organically. In addition, with multiples down and pricing at a low, large prime contractors and financial buyers are likely to be interested due to inexpensive pricing.

Capital Market Environment

Capital markets have continued to show improvement though late 2010. CACI International Inc. announced a closing of a new \$750 million credit facility to replace its existing facility and Veritas Capital obtained strong financing to support its acquisition of Lockheed Martin’s Enterprise Integration Group. In addition, a number of companies recently completed or filed for IPO’s. With capital available to prospective acquirers, more deal volume and more creative deals are possible.

Acquiring More Depth Not Just Size

With the realities of budget cuts and expected organic growth of 4-6% in 2011, (compared to historical growth of 8-10%), government service companies that are looking for substantial growth will be forced to gain market share through mergers and acquisitions. However, the increasing risk of organizational conflict of interest and the scarcity of large, independent targets with high strategic value, are forcing buyers to reposition themselves for budgetary priority by acquiring new capabilities, contract vehicles and customer relationships.

What does this mean to you?

If you are in a position to consider selling or buying, now may be a great time to explore options. If 2008 and 2009 have taught us anything, it's that markets are fickle. They come and go, and what's hot today may not be hot tomorrow or a year from tomorrow. For now, government contractors and the market surrounding them are very active and generating a substantial amount of interest from both strategic buyers and large private equity firms.