Who's Buying Whom? Key Trends in the Small- and Mid-Tiers

It's no secret that the merger & acquisition firms in the federal arena have been active lately. The breakup of AMS and the sell-off of a $2B chunk of EDS announced in March are not likely the last big-firm sales we'll see this year.

Churn. But in the middle- and small-size categories, the activity is more intense, if sometimes over-zealous. Case in point: David Roehm, Sr. Vice President and CFO of Management Systems Designers, Inc., a 600-person IT firm, says on some days he and/or his CEO get three calls from various intermediaries, "usually on a fishing expedition rather than something specific. This is in addition to numerous mailings from individuals or new investment banks stating that they represent a client who wants to buy firms exactly like MSD." Roehm's not impressed with some of them—for either their scant knowledge of the industry or the presumption that MSD wants to sell itself in the near term. In fact, he says MSD is interested in expanding by both strategic acquisitions and its consistent organic growth so as to stay independent.

Trend Data. Paul Serotkin of Minuteman Ventures, an M&A firm that specializes in small- and mid-tier acquisitions, has focused for several years on firms that provide information and other technology services to the Department of Defense and the governmentwide IT community. The data in the charts on this page reflects a snapshot of activity in the 17 months from October 2002 through February 2004.

Of particular note: nearly half of the more than 70 transactions recorded were for sellers with less than $20M in revenue. And, almost half of the buyers were themselves in the small- and mid-tier range, <$250M in revenue.

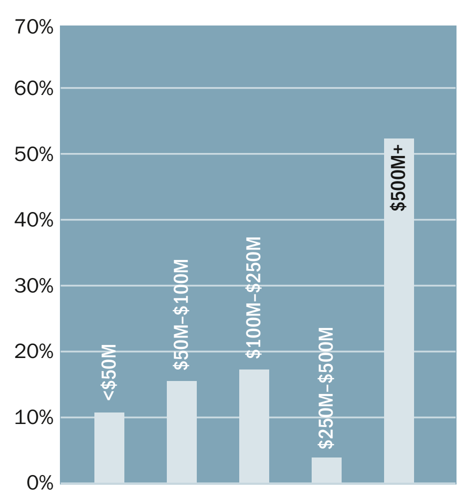
Favorable M&A Environment. Serotkin attributes it to recent double-digit growth in IT budgets; strong revenue growth of technology firms (~20% has been common for some recently); a rise in civil service retirements; the Administration's desire for more IT outsourcing (half of government IT outsourcing is performed by firms under $100M); the ongoing modernization of legacy systems; and supportive capital markets ($2B raised in new issues in the last 18 months).

Serotkin told the *Insider* that he projects a comparable level of activity (and valuations similar to recent record highs) in the balance of this year, but with cautions. The factors that could constrain M&A activity include the small growth in the DoD IT budget, uncertainties about DoD spending due to the war, and the disappearance (by being acquired) of some potential buyers.

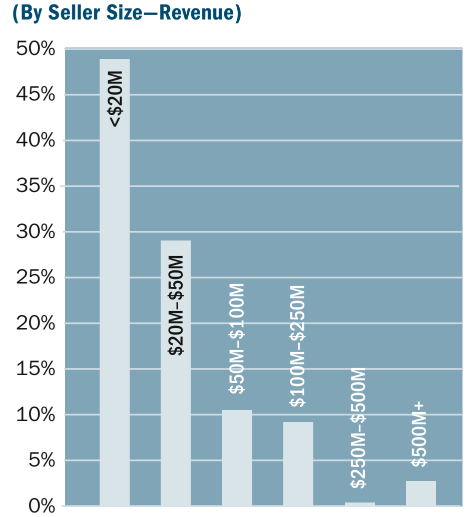
Why Small- and Mid-tier Firms Are Selling. There are many reasons, according to Serotkin. Valuations are high (tracking with public-company values). The number of buyers is probably declining, e.g., a Veridian or Titan. Firms with a differentiated product in demand are well positioned to earn a premium. Also, the integrators are on the prowl for technology, relationships with desirable clients, and cleared staff.

He also sees some activity as driven by uncertainty. For example, Defense may be less in vogue at some point in the next few years, and therefore "sector rotation" to diversify might be wise. Further, the ability to do

Buyer Transaction Profile—Defense/Federal IT (By Acquirer Size—Revenue)



Seller Transaction Profile—Defense/Federal IT (By Seller Size—Revenue)



n=70+ transactions

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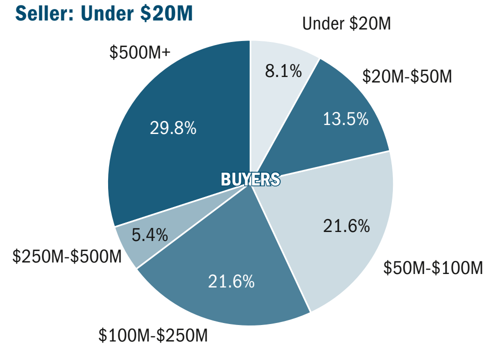
well might be constrained by a change in administration, oncoming acquisition regulatory changes concerning small business contracting, or even BRAC 05. As a result, some sellers might want to advance their timeframe to exit by being acquired, according to Serotkin.

The New Breed. Who are the newly active mid-tier buyers in the $50–250M revenue class? Serotkin describes them as working mainly, if not entirely, for government clientele. They are interested in the fastest route to becoming $500M firms, and "buy vs. make" is a strong case for them. They already have some prior acquisitions, but their core growth is organic. They can readily find willing lenders, and some have private equity backers. For these firms, an eventual IPO is still within reason, according to Serotkin.

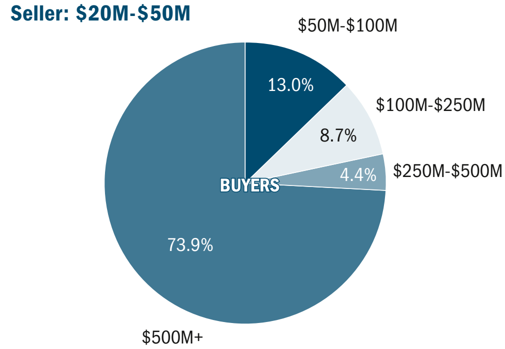
More Asset Sales. Another point, made by Mark Capaldini of Focus Enterprises, an investment banking and corporate development consulting firm, was occasioned by the AMS and EDS deals announced in March. He told the *Insider* that he expects to see more sales of assets (a business line, a location, or a discrete parcel of capability, for example) in the future. The impetus is firms sharpening their competitiveness by streamlining, filling gaps, and refining capabilities to serve specific clients and to prepare for specific large programs. ■

Source: Data compiled and used with permission of Minuteman Ventures. www.minutemanventures.com

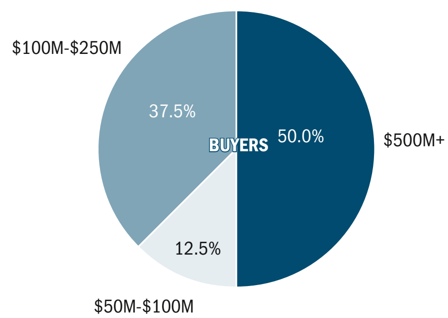
Seller: Under $20M



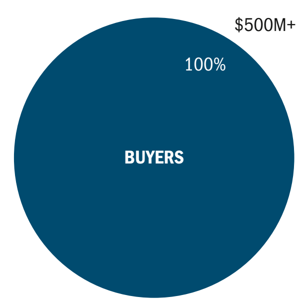
Seller: $20M-$50M



Seller: $50M-$100M



Seller: $100M-$250M



Seller: $500M+