

2005 REVIEW

# Defense Services M&A Market Steams Onward

The great consolidation wave in the federal and defense services sector continued throughout 2005, writes **DM&A** contributing editor Paul Serotkin.

By the end of December 2005, 77 sector transactions had been completed, compared to 79 in 2004.

The year closed in dramatic fashion, with the announcement Dec. 14 by General Dynamics that it would acquire Anteon International for \$2.1 billion in cash. Known for warships, Abrams tanks and Gulfstream business jets, General Dynamics paid 13+ times Anteon's 2006 projected EBITDA.

"This superb company (Anteon)," said Nicholas D. Chabraja, General Dynamics chairman and CEO, "strengthens the ability of our Information Systems and Technology group to provide a broad menu of seamless IT services to Defense, Intelligence and Homeland Security customers."

This trend dominated 2005. Military platform and electronics contractors used M&A to add intelligence, technology and outsourcing services assets to offset pruning of big-ticket weapons programs.

Lockheed Martin's M&A strategy was clearly evident – absorb information services firms. During 2005 the industry giant acquired or announced the acquisition of Aspen Systems, Coherent Technolo-

gies, INSYS Group and The Sytex Group. As further evidence of the trend, L-3 Communications acquired Titan Corporation and DRS Technologies acquired Engineering Support Services.

## Smaller Deals Dominated

Defense/federal services M&A remained a small and mid-tier market, however, despite the headliner deals (see "Federal Services M&A Transactions" on facing page).

Deals were consummated for companies throughout the size spectrum, with 53 of them (out of 77) for firms with purchase values under \$50 million. Both strategic buyers (including foreign companies such as SERCO and Nortel Networks) and financial buyers were attracted to sector dynamics.

Along with continuing growth in the DoD budget, procurement, policy and demographics helped to drive consolidation.

U.S. government policy continues to call for outsourcing of "non-inherently governmental" activity, a boon to contractors. While politics have, at times, slowed this process, other dynamics argue for sustained use of outsourcing (and the resulting

attraction of buyers to the sector).

To wit:

- As the federal workforce ages and more government employees retire, government turns increasingly to industry;
- The demands for advanced technology integrated across platforms, programs and agencies requires support by private sector entities motivated by innovation and profit; and
- With troops deployed overseas in large numbers, the private sector must be optimized to supply logistics and develop more 'intelligent' information systems for use in combat.

Margin performance remains an attractive feature of the services world.

While cost-plus contracts still have a strong foothold in agency pockets, the use of time-and-material and fixed priced contracts has become more prevalent in recent years. Even with some analysts suggesting that margins may have peaked, the likelihood is that contractors will still fetch higher profits than cost-plus contracting allowed.

Defense and civilian agencies count on the services industry to help them adapt across the value chain – whether managing human capital, planning mission logistics, managing base operations, modeling everything from combat plans to ERP implementations, staffing help desks and call centers, and providing cost analysis for project tracking.

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Paul Serotkin is President of [Minuteman Ventures, LLC](#), an investment bank focused on sell- and buy-side M&A for defense federal, intelligence and homeland security markets. For the roster of 2005 sector transactions, reach him at 781 750-8065, paulserotkin@minutemanventures.com, or contact Chuck Chappell, Director, Washington Operations, Minuteman Ventures LLC, 703 842-9536, charleschappell@minutemanventures.com.

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### The Buyer Pool Expands

As the services sector grows in importance, buyers come from companies of all sizes, including some relatively new buying groups.

Tier 1 companies such as General Dynamics and Lockheed Martin, as cited, continue to add services pieces, while Tier 2 services 'pure-plays' - ManTech, SRA, CACI, MTC Technologies, NCI Information Systems and SI International among them - acquire to reinforce their brand, sustain their public market valuations, meet growth expectations, and address the need to bid on larger procurements.

ManTech acquired Gray Hawk Systems at an eye-popping 1.43x 2004 revenue, testimony to the willingness of buyers to pay strong value for the premium segment of the services market - intelligence services, homeland security, and mission-critical DoD programs. Sellers who bring a cadre of Top-Secret cleared employees capable of providing technology services to the NSA, CIA, DIA and other intelligence agencies command robust valuation.

What is striking is the number of small and mid-tier strategic acquirers actively seeking acquisitions.

Having reached certain mass and developed teams and balance sheets capable of M&A execution, several firms are using M&A to their benefit - with the list growing. Consider this sampling of active mid-tier M&A purveyors:

- **Indus Corp., Inc.**, Vienna, VA, with revenue in the \$100 million range, acquired AB Floyd and the secure networking group Halifax Corporation, with combined reported revenue of \$28 million.

- **McDonald Bradley, Inc.**, Herndon, VA, with revenue estimated in the \$75 million range, bought Infodata Systems for \$7.6 million.
- **ICF Consulting, Inc.**, Fairfax, VA, with revenue reportedly approaching \$200 million, acquired \$40 million Caliber Consulting and \$25 million Synergy, Inc.
- **ITS Corp.**, Oxnard, CA, bought \$32 million Noesis Systems and \$3 million Charis Corporation.

Even smaller public companies got into the act, such as Analex, SYS Technologies and Applied Signal Technology, who aggressively

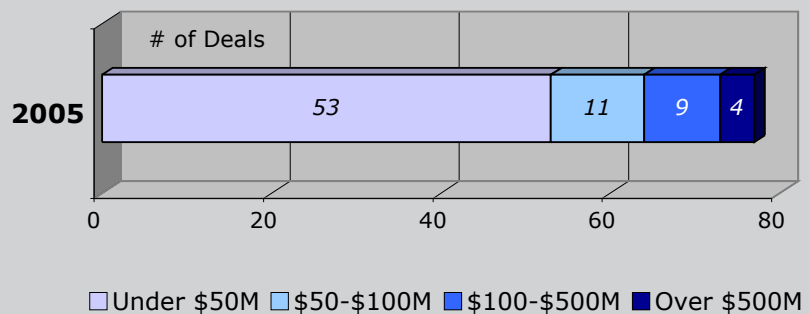
out Veritas Capital weighed in this year, as it registered with the SEC to take public its DynCorp unit.

Taking advantage of this opportunity to arbitrage public market valuation and private company acquisition prices, PE firm Caxton-Iseman Capital stands to reap significant returns when the General Dynamics acquisition of Anteon closes.

A variation on the PE theme this year came from the onset of Special Purpose Acquisition Corporations (SPACs), publicly traded entities that raise public money for acquisition of companies in a specific industry.

In October, Federal Services Acquisition Corporation (FSAC), backed

**Federal Services M&A Transactions**



acquired.

Private equity (PE) firms still like the space. In fact, 13 of the 77 transactions in 2005 were completed by PEs directly or through platform operating companies. In addition to well known sector players such as Carlyle, CM Equity and Frontenac, new firms continue to emerge.

This year saw the coming out of PE-backed Federal IT Systems, which became Overwatch Systems (funded by Kelso and Pegasus) when it acquired IT Spatial. Sector PE stand-

by the managers who run CM Equity, raised \$126 million in an IPO to buy federal services companies, a sign that the smart money on Wall Street feels valuations in this sector will hold.

Overseas firms continued their intense interest in the U.S. defense market -with the buyers largely from the U.K. The three most active U.K. buyers, BAE Systems, QinetiQ and SERCO, while from vastly differ-

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ent backgrounds, have targeted the U.S. market, backing up their strategic goals with sizable deals. Services offerings have been the main object of their attention. In the last two years, these three U.K firms completed six U.S. transactions.

### Sector M&A in 2006

The prognosis for the sector in terms of consolidation is mixed. The federal services M&A market swings in large part on the availability of mid-tier companies, as small as \$50 million and as large as Anteon (at \$1.5 billion) in the public market.

These companies are both active buyers of smaller firms and provide fodder as acquisition candidates for much larger firms. With the pace of deals, however, the mid-tier has been gradually disappearing. Further, the number of public companies in the services sector

### Most Active Dealmakers Federal/Defense Services

Company	'05 Transactions
Lockheed Martin	4
General Dynamics	3
ICF Consulting*	3
MTC Technologies	3
SAIC*	3
SYS Technologies	3

\* Private companies; others are public.

has dwindled, with too few IPOs to replace those public firms that have been acquired.

Given the huge number of smaller companies, the push by platform firms into services, the government's use of outsourcing and generally favorable economic conditions, sector consolidation will doubtless continue apace. We question whether the valuations can continue at these high levels and will be tracking the market for *DM&A* readers throughout the year. ❖