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Defense Mergers & Acquisitions

An M&A Review for the Defense and Aerospace Industries

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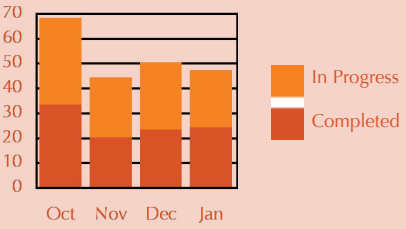

NCI Information Systems: Michael Solley's Third Act

Last October's decision by NCI Information Systems to hire Michael Solley as its president and chief operating officer offers insights into how the movers behind the industry's consolidation can outlast the companies whose growth they helped advance.

Solley, 45, could be viewed as a man too young for his resume. He was part of the executive management team that drove the frenetic growth of Nichols Research Corp. during the 1990s. The company's top-line expansion was largely organic but was augmented by the acquisition of several small, mostly IT, firms, including Welkin Associates and Mnemonic Systems. Revenues quadrupled, from $91 million in 1991 to $427 million in 1998. And then Nichols sold out to CSC for $377 million—a pricey 16 times EBIT—in 1999.

From there Solley took the helm of Modern Technologies, Inc., a small and somewhat sleepy professional services firm drawing most of its sustenance from Wright-Patterson Air Force Base. In three-and-a-half years, Solley transformed the company into a legitimate mid-tier business with $166 million in annual revenues. Most prominently, Solley led a successful IPO in June 2002 that helped fuel three acquisitions during his last twelve months with the company: Torrance, Calif.-based AMCOMP Corp., acquired for $7.2 million; Dayton-based International Consultants, Inc.

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Souping Up SAIC

By Paul Serotkin
Contributions from Bill Burton

The SAIC we all know is changing, as reports of a replacement at the top and a company-wide reorganization became public recently.

SAIC founder Dr. J. Robert Beyster gave up his CEO position on Nov. 3 to Ken Dahlberg, formerly of General Dynamics. Beyster is currently negotiating with the company's board to relinquish his chairmanship prior to July, when his term ends.

The major thrust of SAIC's realignment, which is effective February 1, 2004, is the consolidation of SAIC's federal/DoD business into groups and business units that are aligned to better serve its customers and markets. The new structure departs from SAIC's famously decentralized and fluid configuration, which fragments the company into numerous sectors comprised of largely autonomous groups, divisions, and operations that are realigned annually. For more than 30 years, the decentralized arrangement created an entrepreneurial spirit that facilitated organic growth, but some industry observers believe SAIC outgrew it long ago.

From our perspective the question would be, "how will these changes affect M&A strategy for SAIC, now the most active acquirer in the government tech services market"? The outcome may affect potential selling companies in the small and mid-tier defense and federal tech sector.

SAIC is now a $6 billion company; a company spokesman is quoted as say-

..... *Continued on page 3*

U.S. M&A Highlights for January

Alliant Techsystems (ATK)/Mission Research•••••••

ATK (Alliant Techsystems) (NYSE: ATK) agreed to acquire privately held Mission Research Corp. (MRC) in a strategic transaction that ATK said "will enable an advanced aerospace and defense technology pipeline spanning concept development to full-scale production."

ATK expects to pay between $210 million and $235 million for Mission Research, an amount they say that will be less than ten times the company's current-year EBITDA. MRC has anticipated annual sales of between $170 million and $180 million in the current year.

Since its inception in 1990 Alliant Techsystems (ATK) has always been a prolific buyer (we count 18 acquisitions), with a disciplined program which has traditionally served to bolster its core businesses in propulsion, composite structures, precision systems, and munitions.

Aware of its place in the industry's pecking order, ATK has not attempted to go head to head with the industry's leaders, but like many another mid-sized firm has sought out market niches in which it could compete effectively.

Recently the company's strategy has been to move up the technology chain in the areas where it has expertise. The company has always been a leader in composites technology, for instance, but added to that leadership with the acquisition last January of San Diego, Calif.-based Composite Optics, Inc., whose products include telescope structures, optical benches, mirrors, instrument housings, satellite structures, and antenna reflectors. Likewise the company has always been a contender in the area of rocket and missile propulsion, but added to its technology base with the buys last November of two hypersonic flight businesses—GASL and Micro Craft, Inc. And in October of 2002 the company's acquisition of Woodland Hills, Calif.-based Science and Applied Technology, Inc. (SAT, Inc.) built on its precision-guided military weapon systems business.

In each case the strategy has been to make an existing ATK business a more formidable competitor, often by beefing up capabilities on the research end of the spectrum. And that strategy has been bearing fruit. In the area of precision systems, the company has during the past year won two programs—the XM395 Precision Guided Mortar Munition (PGMM) and the Advanced Anti-Radiation Guided Missile (AARGM)—which have added more than $700 million to its backlog. The buy of AARGM in particular appears to have been directly due to the SAT acquisition in 2002.

Buying backlog is one thing—companies like L-3 (and Loral before it) have shown that money can be made by acquiring companies with a mature product line and a large installed base. But buying research capability that turns into backlog—that's buying a future, not a past. It's a chancier business, of course, requiring success in integrating the acquired company, in merging technology roadmaps and business development efforts—and in melding two teams into one mind where "the vision thing" is concerned. Upon winning the PGMM competition, ATK CEO Murphy said that the company's strategy is "to offer highly effective, low-cost solutions fully compatible with existing platforms and combat doctrine. This affordable, innovative, and successful formula provides enhanced combat capability to operating forces while enhancing prior taxpayer investment in existing military platforms. Our philosophy discriminates ATK solutions from others in the industry, enabling us to gain a foothold in a tough competitive precision weapons environment."

The acquisition of Mission Research Corp. could be considered the perfection of the R&D-based strategy. For its size (560 employees, revenues of about $115 million) the company is involved in an unusually broad range of development-focused activities, ranging from directed energy to electro-optical and infrared sensors to aircraft sensor integration to high-performance antennas and radomes to advanced signal processing to specialized composites. Some of these represent obvious fits with ATK's existing businesses, while others represent intriguing possibilities for future growth. Having demonstrated that it can build an integrated capability backward (beginning with production, adding front-end development assets through acquisitions), we see no reason why ATK couldn't work in the opposite direction (beginning with R&D, and adding production through M&A activity).

And, as long as ATK remains true to its focus on niches in which it can be a leading player, we don't see any reason why the company can't be true to its vision of building, in its own words, "an advanced aerospace and defense technology pipeline spanning concept development to full-scale production." At a time when some of its competitors are moving to focus their efforts on the portions of the value chain which they deem to be the most desirable, ATK's strategy represents a fascinating move in the opposite direction.

Arlington Capital (ITS Services)/SEA ••••••••••••

ITS Services, Inc. (ITS Services) of Springfield, VA, a

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Souping Up SAIC

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ing that Dahlberg wants to grow the firm to $12-$15 billion in three-five years. This is neither surprising nor unrealistic: Dahlberg's career has been characterized by such growth. While serving as executive vice president of General Dynamics Corp., Information Systems & Technology Group (IS&T), Dahlberg oversaw the acquisition and integration of five companies with more than $1.8 billion in revenues, including Motorola's $830M/year Integrated Information Systems Group (IISG) in September 2001 and $834M/year Veridian Corp. in August 2003.

SAIC's new regime has major implications for the company's M&A program.

For starters, to meet Dahlberg's goal of doubling the firm's size in five years, revenue must grow at least 15% on an annual compounded basis—a tall order on top of a $6 billion base. (Although, in fairness, the company appears to be growing by at least 10% per year this year, based on annualized Q3 results from October 31, 2003.)

Coming up with that extra five percent will probably require acquisitions. SAIC has always been an active acquirer: in 2003 the company (including its majority held JV, AMSEC) acquired eight companies, adding some $300-$350 million in revenue. The company historically has undertaken smaller deals, snapping up very specific add-ons from founder-led firms. This strategy does not seem to be fully aligned with the growth bogey. Does this mean SAIC will be looking for larger M&A fish? Certainly their well-

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The New SAIC: Consolidate and Conquer

By Bill Burton

In place of its former sprawl, at its highest level the new SAIC will have but three operating segments:

- **Federal Business** (McLean, VA), which will be comprised of five groups.
- **Commercial Business** (San Diego, CA), which will be split into two groups.
- **Telcordia Technologies, Inc.** (Morristown, NJ), the company's telecommunications software and services subsidiary, which will have six groups.

SAIC's corporate executive vice president Duane P. Andrews has been named president and chief operating officer (COO) for the Federal Business, which accounts for 80% of the company's total revenue. Andrews will oversee all federal activities for the company, a role not unlike the one he performed previously.

The five groups under Andrews' Federal Business segment are:

- **Research & Intelligence** (McLean, VA) led by Don Foley.
- **Systems & Network Solutions** (McLean, VA) led by Mark Hughes.
- **Test, Training, Transformation & Logistics** (McLean, VA) led by George Singley.
- **Enterprise & Infrastructure Solutions** (Oak Ridge, TN) led by Larry Peck.
- **Naval Engineering & Technical Services** (Virginia Beach, VA) led by Carl Albero.

At the next level of organization, the five Federal groups will have 25 business units between them; a dramatic shift from the old structure, which featured some 13 sectors and as many as 49 groups.

Replacing the smallish sectors with the five larger groups gives federal/DoD business developers the resources to pursue larger programs, while helping to ensure that SAIC's factions no longer compete against one another for contracts (a drain on the company's financial, and emotional, resources). And customers—who under the old regime were often forced to have business dealings with multiple SAIC managers—should be heartened by a structure under which each major customer will be assigned to one manager.

As discussed in the companion article ("Souping Up SAIC"), the reorganization is also expected to retool the company's M&A strategy, laying the groundwork for bigger deals.

New SAIC CEO Kenneth C. Dahlberg has high expectations for the new org chart: "By reorganizing the company into more capable units, we are in a position to better serve our customers and more rapidly capitalize on the innovative ideas and talents of our employee-owners. Under the new structure, it will also be easier for our customers to more rapidly access the diverse resources of our company. I look forward to helping SAIC realize its full potential and bring the company into a new era of growth and success with both our government and commercial customers."

The ATK/Mission Research Deal

Since its inception in 1990 Alliant Techsystems (ATK) has always been a prolific buyer (we count 18 acquisitions), with a disciplined program which has traditionally served to bolster its core businesses in propulsion, composite structures, precision systems, and munitions.

Never losing sight of its place in the industry's pecking order, ATK has not attempted to go head to head with the industry's leaders, but like many another mid-sized firm has sought out market niches in which it could compete effectively.

Recently the company's strategy has been to move up the technology chain in the areas where it has expertise. The company has always been a leader in composites technology, for instance, but added to that leadership with the acquisition last January of San Diego, Calif.-based Composite Optics, Inc., whose products include telescope structures, optical benches, mirrors, instrument housings, satellite structures, and antenna reflectors. Likewise the company has always been a contender in the area of rocket and missile propulsion, but added to its technology base with the buys last November of two hypersonic flight businesses -- GASL and Micro Craft, Inc. And in October of 2002 the company's acquisition of Woodland Hills, Calif.-based Science and Applied Technology, Inc. (SAT, Inc.) built on its precision-guided military weapon systems business.

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(ICI), acquired for $9.9 million; and Eatontown, N.J.-based Vitronics, Inc., acquired for $8.8 million.

This biography provides clues to where Solley could lead NCI (which reported $138 million in revenues in 2002). Under Solley the company has already made a small acquisition: privately held Scientific & Engineering Solutions, Inc., a $20 million/year provider of secure information systems to the intelligence community. This is a deal which in terms of size and program lines would have fit comfortably into the acquisitions programs of either Nichols Research or MTC Technologies.

More such deals are likely in NCI's future. *[Ed: Solley provides some hints as to the types of companies being screened for in the interview appearing below.]* Further out, management may be mulling an IPO—a possibility we'd hang on the words of Charles Narang, Solley's new boss, who spoke of Solley's experience in "running a public company" in the October announcement of Solley's hiring. As to whether the company might eventually be sold—well, Nichols was, and MTC Technologies hasn't been (yet). And when the time comes for making that decision, the only certainty is that the pros and cons for the decision will have changed, making any present-day speculation pointless.

So let's come back to the present day, and speculate about acquisitions. The SES deal provides one clue about future directions for NCI. The intelligence market is hot, barriers for entry are high, and acquisitions remain a preferred method for market entry. NCI isn't the only company whose shopping list is headed by intelligence companies.

INTERVIEW

Michael Solley

President and CEO,
NCI Information Systems

The emergence of the mid-tier buyer in the defense/federal M&A sector continues apace. This month, DM&A interviewed Michael Solley, newly installed President of NCI Information Systems, one of the buyers in that $100-$250 million strata.

An experienced dealmaker with MTC Technologies and Nichols Research, Solley quickly went to work at NCI by acquiring $20 million Scientific & Engineering Solutions Inc. of Annapolis Junction, MD, expanding its presence in the intelligence community.

Q: NCI had not been an acquirer previously except for one small transaction several years back. What internal structural changes did you make in order to undertake an acquisition program?

A: NCI had personnel strong in the major functional areas. It was simply a matter of organizing them in a manner attuned to executing deal pipeline generation, due diligence and closing.

One key piece to our M&A program was to develop – and live by – criteria that met various needs. With the large number of opportunities we are seeing, it is important for NCI to have that filter.

In the case of SES, we were fortunate to find a company that fit the criteria so tightly.

Q: What are those criteria?

A: We set parameters around client, geography, capability and size.

My rule of thumb is that the acquired firm should not be more than a third the size of the acquirer, meaning a firm with $50 million in revenue represents the higher end of the size curve for NCI. A 10% ratio (of acquiree-to-acquirer size) is probably optimal. On the low end we would prefer not to go below $10 million in revenue.

The customers we are focused on near term include intelligence agencies, the U.S. Army and the U.S. Air Force, Homeland Security and other Federal Agencies and generally in that order.

To the extent that the acquired firm's customers are close to ours and we anticipate a high level of integration requirements, we would prefer a firm in close proximity to one or more of our existing operation centers. When the company's operations involve mostly new clients in new areas, we are more comfortable looking at firms in new geographical locations.

Functionally, we seek high-end companies—those with a solid management team, good past performance, and capabilities in high performance computing, information assurance, system engineering, networking and government policy capabilities.

Q: How have you found the lending environment for transacting M&A deals in the federal technology sector?

A: Very strong. As a private company we prefer to use cash as the resource for acquisition, as we did with SES. Our bankers have been very supportive and helpful in the process.

Second on Solley's list come companies serving the U.S. Army, and here the reasons are tuned more closely to NCI's circumstances. In October (only a week after Solley was hired), NCI and three other companies landed seats at the table for a seven-year, $500 million program that will serve as the Army's primary contracting vehicle for enterprise mission support services. NCI views this vehicle, known as Functional Area 2 (FA-2) of the Army's Information Technology Enterprise Solutions (ITES) program, as its ticket to Mid-Tiersville; NCI's vice president of business development, David Gardner, said he expects to earn more than $100 million on the contract during its seven-year life.

So, look for NCI to go after small Army IT services companies. Solley probably already has a long list of prospective targets, since he was digging through that bargain bin when he found $25 million/year ICI and $16 million/year Vitronics for MTCT last year. More specifically, we wouldn't be surprised if one or two NCI acquisitions were small businesses that do a majority of their work for the U.S. Army Communications - Electronics Command (CECOM), as speculation swirls around whether Fort Monmouth will be on the next Base Alignment and Closure (BRAC) list due out in five months. The value of CECOM contractors will be up in the air, and some will be looking to get out. Michael Solley and NCI could be there to help them out.

Q: Given your career in operational leadership and deal-making for federal IT firms such as Nichols Research and MTC Technologies, how would you characterize the mid-tier M&A environment in the sector?

A: I think the impetus for consolidation in this sector remains strong. There are a lot of smaller firms (under $50 million) that started during the Reagan Administration; many of the founders are near retirement age. That fits with the desire of the mid-tier and large company buyers who want to augment internal growth to enter new strategic areas rather than wait 3-4 years to penetrate that customer.

From a buyer's perspective, I am concerned with the high multiples being paid for some private company transactions. Another issue is the unrealistic expectations of some selling founder(s)/owner(s). The expectation by some is often out of line with reality. Many do not have the context of the many years of much softer valuations in this sector. Nor is there an appreciation for the difference in company quality, customer focus, growth potential, and margin growth prospects that make company substantially different in value from one to another.

Interestingly, while there are more deals getting closed recently, there are also many that have not closed due primarily to unrealistic expectations.

Q: The federal mid-tier is full of solid and growing companies in the $100-$250 million range. Do you foresee a pick-up of IPO activity for these companies and/or an increase in merger of like-sized firms?

A: On the IPO front, I believe there are several companies who have the capabilities and requirements to get to the public market. Whether 2004 will see a surge in new IPOs in this market is hard to say.

Regarding the merger-of-equal scenario, I see this much more in product companies. In the defense tech sector it has only happened on a few occasions and is a more difficult task due to the strong cultural issues present in our industry and the strong influence individual founder(s)/owner(s) might have on a business. Often there is a single strong founder/owner who may still be operating the company as the CEO and that individual is frequently very close to the customer set and the employees. The distinct culture that individual has created and the history of complete control necessitates a requirement to document and understand who will be in control going forward. That becomes more difficult when the companies are of equal size.

Q: How much will M&A play a role in NCI's growth plans?

A: Our plans call for 20-30% annual growth rates with approximately half being organic and the other half being from acquisitions on average. [Ed. Note - On top of NCI's $136 million revenue base in 2003, that would infer a target of $350-$500 million in the next five years.] We anticipate being an active acquirer, though more so for strategic penetration than size expansion.

Paul Serotkin is President of Minuteman Ventures LLC, an investment bank focused on sell- and buy-side M&A for defense and federal technology companies.
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Equity stakes

COM DEV International Ltd. (TSX: CDV) confirmed that **Technology Horizons Ltd.** (THL) sold all of its remaining COM DEV shares, bringing to a close the long standing ownership interest by THL in the company.

On Jan. 13, 2004 the remaining holdings by THL in COM DEV, totaling just under 3 million shares were traded at C$2.85 ($2.20) per share in a transaction with institutional investors.

Miscellany

GlobalSecure Holdings, Ltd., a consolidator of homeland security product and service companies, paid $4.2 million to acquire **HazTrain, Inc.**, a Maryland-based training company providing weapons of mass destruction (WMD) and hazardous materials management training.

Behrman Capital, a private equity investment firm based in New York and San Francisco, paid $90 million to acquire **Hunter Defense Technologies, Inc.**, a privately held manufacturer of military and homeland defense products.

Based in Solon, Ohio, Hunter (which also goes by the name of Hunter Manufacturing Co.) designs and manufactures niche defense and homeland security products. Its primary product lines include nuclear, biological and chemical collective protection air filters and air filtration systems for military and homeland security applications, as well as highly-engineered heating equipment for military vehicles, tents and shelters.

Arotech Corp. (NasdaqNM: ARTX) acquired **FAAC Inc.**, a privately-owned corporation with headquarters in Ann Arbor, Michigan. The purchase price was $14.0 million ($12.0 million in cash and $2.0 million in Arotech stock), plus an earn-out based on 2004 net pretax profit, with an additional earn-out on the 2005 net profit from certain specific and limited programs.

Thales Readies for Action

While Snecma's upcoming IPO has garnered most of the attention where the upcoming round of French company privatizations is concerned, Thales S.A. chairman Denis Ranque has sought to ensure that the interests of his company are not neglected.

The differences between Snecma, which is 97% state owned, and Thales, which is 30% state owned, are more of degree than they are of type. Both Snecma and Thales feel their strategic options to be impaired by state ownership—Snecma because its near-total ownership by the French state precludes it from making desirable deals outside of the nation's borders, and Thales because financial marketplaces are nervous about the large overhang of shares which they expect to come onto the marketplace as the French government's privatization inititiative gathers momentum.

Ranque, ever politique, declines to characterize the government as an undesirable shareholder. Rather he expresses the wish that the government's shareholding be gradually reduced from 30 percent to something on the order of 15 percent—a "real" minority shareholding which would still preserve national interests.

French finance minister Francis Mer supports this goal. Mer's wish is that French companies be unencumbered in their pursuit of a larger national interest: spearheading the consolidation of European defense companies.

With Aerospatiale now subsumed into the greater glory of EADS, the lot of advancing French national interests falls to Thales, Alcatel, and Snecma. Of these, Thales has been by far the most active acquirer historically. So any impediment to its M&A program, coming on top of the financial difficulties engendered by the acquisition of Racal in September 2000, are to be taken seriously.

A sale of French government shares in Thales is expected to occur in the second half of the year, after regional elections and a sale of government shares in France Telecom have taken place.

Once the government ownership issue is out of the way, Ranque says that Thales will be ready to revive its acquisitions machinery. One area of interest he identifies is Germany, where his interest is in acquiring small- to medium-sized companies (an interest shared by EADS, we would add).

In terms of marketplaces, Ranque says that Thales has an interest in the land systems sector. This alone should be sufficient to pique the interest of Mer, who is in an excellent position to understand the burden that GIAT Industries represents on the French government's treasury. Having Thales enter the land systems consolidation fray would insert France into a game that has until now been dominated by the United States and, to a lesser extent, the United Kingdom.

Ranque believes that political commitments in the U.K. and France will support this marketplace in coming years. And the opportunities available to a determined consolidator are great. This is a neglected marketplace, and one which is in urgent need of attention. Germany's land systems sector is fragmented, and its players are hobbled by divided, apathetic owners. In France the fragmentation is also notable, and the nation's largest player (GIAT) is kept alive solely by government handouts. It is a marketplace which is walled off from the U.S. and U.K. buyers who have been picking away at Europe's periphery. Against this backdrop, Thales' plans to create a land systems and joint operations business unit comes as welcome news indeed for the land systems sector of "Old Europe".

FAAC provides simulators, systems engineering and software products to the U.S. military, government and private industry. This acquisition significantly expands Arotech's simulation business into the military arena.

Springfield, Va.-based **McNeil Technologies, Inc.** acquired **Research and Evaluation Associates Inc.**, a Chapel Hill, N.C.-based company that provides services to state and federal agencies.

Research and Evaluation Associates is a $7.5 million/year company which has expertise in policy research and program evaluation, training and technical assistance, information dissemination and conference coordination, and program development.

With 700 employees worldwide and $33 million in 2002 revenues, McNeil Technologies provides professional and security services to business and government customers, including the Air Force, Energy Department and the Defense Intelligence Agency (DIA).

Engineous Software, Inc. acquired **Synaps, Inc.**, an Atlanta-based design optimization software and services company. The acquisition will allow Engineous to expand its business, especially in the aerospace market, an area where Synaps has made strong inroads.

On the Continent

French computing services company **Atos Origin S.A.** completed its acquisition of information technology services business **SchlumbergerSema** from Paris- and New York-based **Schlumberger Ltd**.

Atos is paying only 1.29 billion euros ($1.47 billion) in stock and cash for the business, which Schlumberger acquired in September 2001 for $5.3 billion. Selected assets of Sema are being retained to boost the Schlumberger Information Solutions operating unit, which is focused on providing IT solutions to the

Fencing Out Foreign Buyers

As this newsletter was going to press Germany's parliament was beginning to debate the proposal to give the government power to reject the sale of defense companies to foreign buyers.

The legislation would give the government the power to block the acquisition of more than 25 percent of a German defense company's shares by a foreign firm. Passage of the legislation is expected.

The debate comes in the wake of the acquisitions of two German defense firms by U.S. private equity concerns. In 2002 Chicago-based One Equity Partners acquired submarine maker Howaldtswerke Deutsche-Werft (HDW). Last year engine manufacturer MTU was acquired by New York-based Kohlberg Kravis Roberts (KKR).

*Proponents of the legislation argue that the legislation is needed to safeguard the investment which the government has made in the firms. Hans-Peter Bartels, a security expert for the governing Social Democratic Party, complains that DaimlerChrysler had lobbied to get MTU a role building the engine for the A400M airlifter, but then turned around and sold the company to a U.S. investor.**

The proposed legislation appears to us to be much ado about very little. While the German government may not have overt control over who owns its defense companies, it certainly influences the equation. We'd offer as Exhibit A the most controversial example of foreign ownership in Germany: One Equity Partners' control of HDW.

** Bartels has no complaints, apparently, about the manner in which Pratt & Whitney was shoved aside in order to hand the plum contract to the higher-priced, but all-European, Europrop International consortium.*

Many observers saw OEP as a Trojan horse designed to insert Northrop Grumman into HDW's ownership. There were certainly grounds for suspicion: the U.S. had promised to provide diesel submarines to Taiwan—submarines which no U.S. company could build—but which HDW could. But laws were on the books to prevent the transfer of such technology. The German government's determination to enforce the ban was all that it took to dissuade Northrop Grumman from buying a stake in HDW.

We'll go further: the German government was not only able to turn away Northrop Grumman, it was also able, through word and deed, to drive OEP itself to seek to prematurely cash out its investment in the company.

If that isn't power over foreign ownership, what is?

We should state that we have no problem with the proposed legislation itself. Viewed on its own merits, it merely gives the German government a role in controlling its defense industrial base—with powers not disproportionate to those enjoyed by other Western governments. But we are concerned about how that power will be wielded. With German politicians fulminating against buyers as innocuous as KKR, we're concerned that the legislation will become an instrument for walling off German industry from potential technological and financial benefactors. Germany's land and naval sectors are in urgent need of consolidation. But if the nation limits itself to partnerships with the French—whose own companies in these areas are struggling to shake off the effects of decades of subsidized state ownership—then this legislation has the potential to inflict real harm on Germany's defense industrial base.

The High Technology Solutions Deal

Wireless Facilities, Inc. (NasdaqNM: WFII) paid $48.8 million in cash to acquire High Technology Solutions, Inc. (HTS), a San Diego-based privately held provider of communications systems engineering and operational outsourcing services to federal government agencies.

Founded in 1990 as a provider of technical outsourcing services to the U.S. Navy, HTS has significantly diversified its core capabilities and customer base. HTS currently has more than 80 active contracts or task orders, many of which extend for multi-year periods, and a backlog of over $130 million.

HTS was also until recently a company under the wing of the 8(a) program, and like many another 8(a) it chose to celebrate its graduation by surrendering its independence... in another demonstration of the vital role that the 8(a) program plays in providing taxpayer-subsidized sustenance for hungry acquirers.

During its 10 years under the protective wing of the SDBA, HTS has used its privileged competitive position to build an strong stable of contracts focused at the higher end of the communications O&M spectrum. One of the more interesting contracts, won in March, has HTS supporting a variety of C4ISR systems, subsystems, and networks for the Key West, Fla.-based Joint Southern Surveillance and Reconnaissance Operations Center (JSSROC) and the Joint Inter-Agency Task Force - East (JIATF-E)—key players in federal drug interdiction efforts. Whether HTS would have been able to continue to meet the demands of such customers without its artificial competitive advantage is open to question.

Enter WFI, with its strengths in engineering and maintaining wireless networks. Profitability is surging, and the value of its stock has tripled in less than three years. To date WFI has focused exclusively on commercial markets, but its jump into the federal technology sector hardly represents a blind leap of faith. That's because the company's newly minted president and chief operating officer, Eric M. DeMarco, held those self-same titles only 10 months ago at The Titan Corp. (NYSE: TTN).

While at Titan DeMarco played a key role in a string of federal IT and technology buys. He left the firm, interestingly enough, because his strength was deemed to be in building commercial entities, not federal technology firms. But since that time the commercial wireless marketplace has been slow to regain its footing, while the federal marketplace has been purring along in high gear. DeMarco had been in his new position for only a month when he moved to return to his roots, picking up a federal contractor that would have fit squarely in Titan's comfort zone (and hails from Titan's hometown, San Diego).

We don't doubt that the HTS deal will open doors to the federal marketplace for WFI's technologies. This will especially be true in the long term, as the company works its strengths into new contract proposals. In the short term the primary attraction of HTS for WFI is probably strong cash flow and reliable revenue. Its expectations in this area appear to be very high, judging from the limited financial information it has provided about this deal. It's not every O&M firm that fetches 110 percent of revenues (L-3 paid 81% of revenues for Vertex Aerospace; URS paid 59% for EG&G; CSC paid 40% for DynCorp). And WFI expects the deal to be accretive to its earnings in the dawning fiscal year. Considering the price it's paying, that suggests that suggests that HTS has been able to secure contracts with unusually rich margins for a company in the O&M sphere.

The ITT/Kodak Deal

A good acquisition can always be boiled down to a good story—or two. This one works whether told from the perspective of the seller or the buyer.

For seller Eastman Kodak, the satellite systems business was a technological crown jewel which stood out from its other businesses, many of whom are lagging the state of technology in their marketplaces. But a sub-$500 million business, no matter how good, was too small to serve as the fulcrum for lifting up a $13 billion corporation. So it had to go: Eastman Kodak is putting all of its chips onto the square marked "infoimaging"—and that includes the $475 million it will clear after taxes and transaction costs from the sale of RSS.

Applying the technology lens to ITT's side of the transaction is also instructive. The space systems side of ITT Aerospace/Communications Division is primarily a provider of meteorological sensors (imagers and sounders) and of payloads for GPS satellites (communications systems, navigation systems, and EMP sensors) . ITT owns these niches, but niches they are. And at a time when strategic consolidation is shaking the foundations of the satellite payload world (of which more below), standing pat in specialized niches would be a chancy strategy.

ITT and Kodak know one another well. A strategic relationship has been in place between the companies for a number of years. One of the programs in which this relationship played was the camera for Quickbird, on which Ball was the prime; another was the Advanced Baseline Imager for the GOES weather satellite, on which Kodak acted as a supplier to ITT.

While ITT has the lead on the GOES program, Kodak has the lead on Quickbird—an observation which provides insights into the strengths of both companies. Where ITT is a major player in meteorological satellites, Kodak rules the roost in remote imaging payloads. It is the camera maker of choice for the National Reconnaissance Office (NRO), including the current KH-11 series and its successor, the Future Imagery Architecture (FIA) program. And it has successfully negotiated the leap from the black world to the commercial world, supplying the sensor subsystems both for DigitalGlobe's QuickBird series and Space Imaging's Ikonos.

The commercial remote imaging marketplace has had well-publicized problems, of course, but these have been receding in the post-911 environment. The Pentagon's appetite for imagery appears to be nearly insatiable, and has been fed by program management woes in the classified marketplace. If this is indeed a $6 billion marketplace, then Kodak is the company to attack it with. And being able to blend in ITT's meteorological offerings will only make it more dangerous.

Organizationally, ITT's decision to place its new Space Systems Division under the headship of Kodak RSS makes sense. It is the smaller of the two businesses (probably less than half the size), and it is less well positioned to address the remote imagery marketplace (Kodak owns the critical high-resolution side of the equation). Strategically, the creation of a dedicated Space Systems Division makes all kinds of sense—the current Aerospace/Communications Division, with its juxtaposition of satellite sensors and Army tactical communications systems, has never had a coherent brief.

Strategically, this deal is a well-modulated response to the consolidation moves of competitors within the space payloads marketplace. While it approximately triples ITT's size in this marketplace, it maintains the company's niche oriented profile, meaning that even now the company won't be going up against the marketplace's heavies: Lockheed Martin, Boeing, and Northrop Grumman. Its closest analogue, in fact, is Goodrich, which built up a business providing satellite payload subsystems through a series of acquisitions during the 1997-2000 timeframe. The last of them, interestingly, was a Kodak competitor: the Optical Systems business of Raytheon. Like Kodak, it is a supplier both of commercial remote imaging hardware (the panchromatic imagers for OrbImage's OrbView series) and of space-based telescopes (the Spitzer space telescope).

Souping Up SAIC

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oiled internal M&A machinery would be able to transact such deals.

And the company's new, customer-facing businesses should be able to absorb them. These businesses, larger than their predecessors (see the companion article, "The New SAIC: Combine and Conquer"), should be capable of integrating larger deals, as much as $250 million in revenue. While smaller deals might still get done, they would probably be in support of building a major presence at one customer—NSA, for example—where larger companies for sale generally do not exist.

The 'larger deal' strategy also argues for an IPO of the company stock, where the proceeds and public stock can be used for larger M&A plays. The valuation of the company's SEC-registered - but only internally traded - shares suffers by not having a public float. Trading only once a quarter within the SAIC employee family, the shares now price at $36.72, according to information on SAIC's web site. While up 27.7% year-over-year according to the web site, the shares still figure to be valued at least $10 more per share were an IPO to occur. Some industry analysts suggest even greater appreciation were the limitation on trading to be lifted and the shares traded on a public market. SAIC has been known to offer its stock when making acquisitions in the past; having public shares to offer would level the playing field between it and the companies which it seeks to join in the industry's top tier.

SAIC is a proven strategic buyer in the federal IT sector of smaller and mid-tier firms. It can be counted on to review many situations that other acquirers would not. It has a strong track record in paying market prices and closing deals once having signed a letter of intent (LOI). Given its breadth across DoD and the civilian sector, SAIC makes a logical home for many entrepreneurs. Its highly decentralized system (which, we suspect, will retain some of that feel even after the reorganization) can readily absorb smaller firms. We suspect that even if the company does go upstream in terms of size, it will remain a buyer of choice for founder-led firms in the $10-$100 million range as well.