

The Government Services Industry: By the Numbers

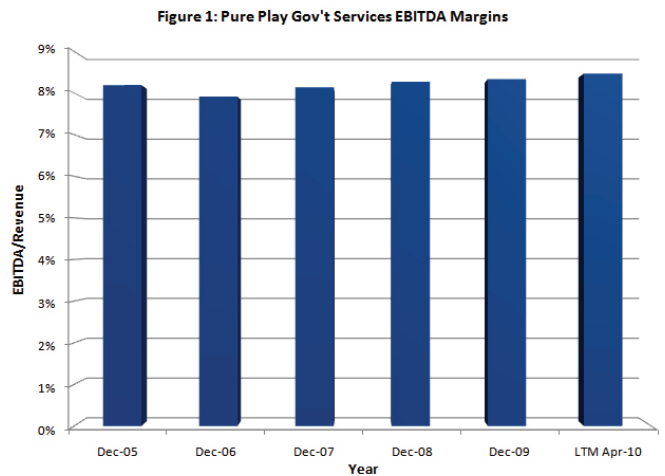
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Profitability

When asked about the future of government contracting in January 2010, former Under Secretary of Defense for Acquisition Jacques Gansler replied the government will “have to figure out ways to get more for less.” By the same token, he implies that federal contractors will have to provide more for less.

Gansler is of course referring to the Obama administration’s advocacy of increased competitive sourcing and consequent pricing pressure on contractors’ margins. These measures have since given nightmares to contractors fearing deteriorating profit margins. However, data suggests that firms have not only prepared for this shift but have made adjustments accordingly to protect against the increasing pressure.

As Figure 2 shows, for the 2005 – 2009 period, Earnings Before Interest, Taxes, Depreciation, and Amortization (“EBITDA”) margins as a percentage of revenue for the Mid-tier government services industry have remained essentially constant, increasing 15 BPS. LTM March 2010 statistics even show rays of optimism – there has been an additional 13 BPS increase over FY’09, ending up at 8.47%. Through a renewed focus on Six Sigma initiatives, increased internal efficiencies, and better management of indirect costs, the Mid-tier government services companies have thus far survived the margin pressure being imposed by the new administration.



While sector performance has been a positive sign thus far in 2010, the model of outperformance based on cost savings rather than core operations can only be sustained for so long. We anticipate that as the Obama administration slowly but surely tightens purse strings across the federal contracting sector, pricing pressure will eventually impact industry profit margins.

Borrowing capacity/debt

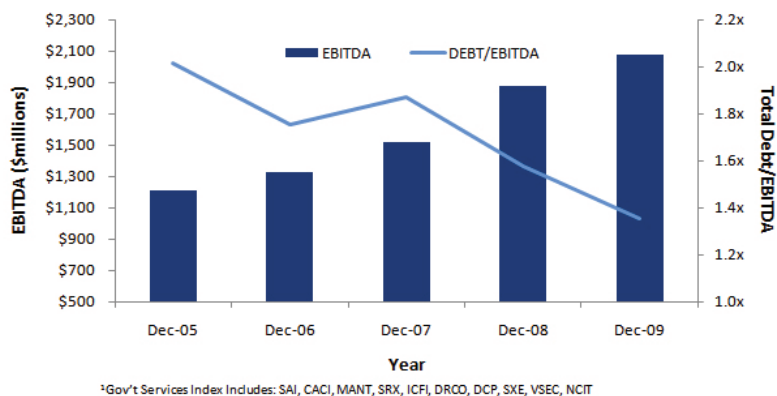
Mid-tier government services firms remain well capitalized with an abundance of financing capacity and are actively seeking M&A opportunities to better position their firms in the current environment. Mid-tier firms along with strategic buyers focused on the Mid-tier segment of the government services market have completed a multi-year deleveraging process

since the period of large-scale consolidation in the 1990s, and their cash positions have increased commensurate with government spending growth and lower debt levels and interest payments over the last several years.

These cash-rich buyers are now in a position to make major cash deployments in the near term.

Additionally, as these buyers employ conservative leverage ratios compared to historical standards, a significant amount of dry powder exists to finance acquisitions.

Figure 2: Pure Play Gov't Services Annual EBITDA and Leverage Ratio



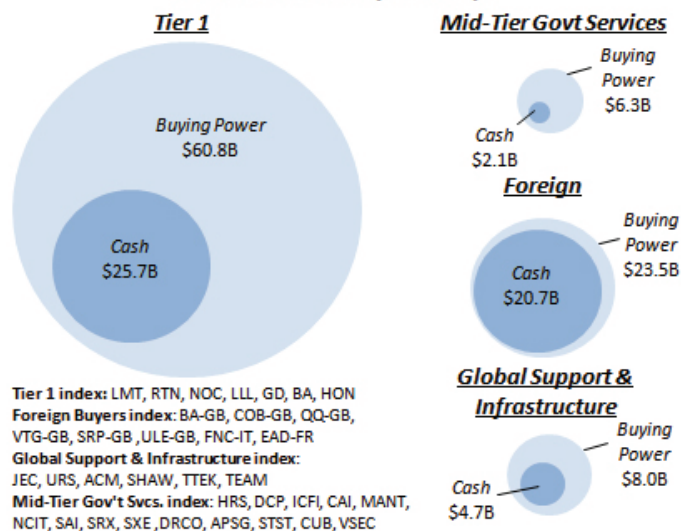
¹ Gov't Services Index Includes: SAI, CACI, MANT, SRX, ICFI, DRCO, DCP, SXE, VSEC, NCIT

For example, as Figures 2 and 3 demonstrate, the Mid-tier government services index is conservatively levered at 1.35x debt to EBITDA with an aggregate of \$2.1 billion in cash and short-term investments.

Assuming a conservative leverage ratio of 2.5x debt-to-EBITDA, these firms could easily take on \$4.2 billion of incremental debt. This abundance of untapped borrowing capacity and cash on hand translates into \$6.3 billion in buying power for Mid-tier firms.

Active strategic buyers from interested buyer groups that have been canvassing the government services market for M&A opportunities are likewise operating from strong balance sheets with low levels of debt compared to other industry sectors. Many of these firms benefit from excess cash balances, available credit under existing facilities, or untapped borrowing capacity. For example, Tier 1, Foreign, and Global Support & Infrastructure buyers have an aggregate \$92.8 billion in total buying power which they can deploy in the attractive government services market through M&A.

Figure 3: Buying Power of Mid-Tier Gov't Services Sector and Interested Buyer Groups



Tier 1 index: LMT, RTN, NOC, LLL, GD, BA, HON
Foreign Buyers index: BA-GB, COB-GB, QQ-GB, VTG-GB, SRP-GB, ULE-GB, FNC-IT, EAD-FR
Global Support & Infrastructure index: JEC, URS, ACM, SHAW, TTEK, TEAM
Mid-Tier Gov't Svcs. index: HRS, DCP, ICFI, CAI, MANT, NCIT, SAI, SRX, SXE, DRCO, APSG, STST, CUB, VSEC

¹ "Buying Power" equals Total Cash & Short Term Investments + Additional Debt Financing up to Total Debt = 2.5x EBITDA.

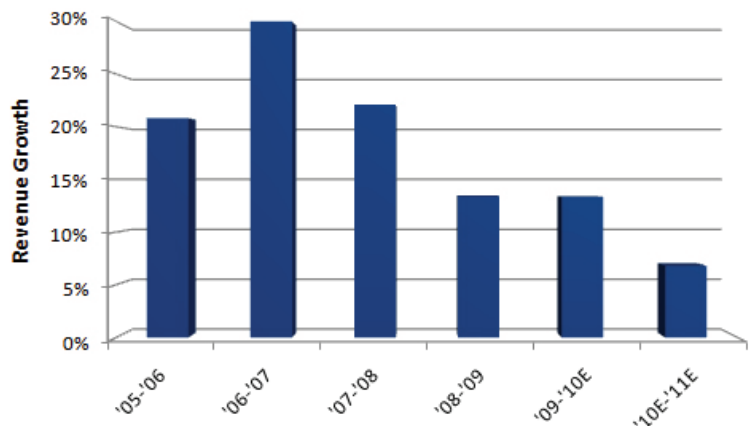
Revenue Growth

The combination of the challenging economic environment, the uncertainty of a new administration, and a rampant federal deficit has had a detrimental effect on both past and future consensus revenue growth rates.

During the '01 – '08 period, year-over-year revenue growth exceeded 15% in every year. For the three periods between 2003 and 2005, growth actually exceeded 25% in each year. Even after a dip in '05 – '06, revenue growth continued rising again, topping back at 24.9% from '07 – '08. However, growth beyond that point has been less than encouraging.

We expect the 2010 federal budget—the largest federal budget to date – has been enough to hold revenue growth in the Mid-tier government services sector constant from the '08-'09 to the '09 – '10E period (13.34% - 13.63%, respectively). However, future revenue estimates have been tempered because of greater uncertainty in macro trends: the consensus estimate year-to-year growth rate for 2010E-2011E is only 8.34% for our government services index, which is the lowest year-to-year growth rate for the industry since the end of the dot-com bubble.

Figure 4: Year-Over-Year Annual Revenue Growth: Gov't Services



Among the macro trends putting a ceiling on 2011E

and beyond revenue growth is the Obama administration's initiative to trim at least 5% from agency budgets, on top of his already-proposed spending freeze to take place over the next three years. To put the severity of this "trimming" in perspective: in the recent past, budget analysts have always justified program spending, but this is the first time in recent memory that projects will actually be volunteered for elimination.

While the specific areas targeted for cutting are yet to be announced, projections are down across the board in the government contracting industry as the Obama administration remains committed to his goal of freezing all discretionary spending by 2012 – except in national security.

Insourcing has also played a role in tempering future revenue growth estimates. A flurry of pilot programs across federal agencies seeking to "achieve the best mix of public and private labor resources" have been in effect after being announced just over a year ago, with progress reports due on May 1 of this year. These programs are attempting to hire "20,000 acquisition professionals by 2010"; an estimated "11,000 of these jobs would be converted from contractor held-positions."² While the results of these reports are yet unknown, we anticipate they could lead to additional insourcing, specifically within the contract management sector. The real fear, however, is that such an insourcing policy (specifically the lack of a clearly defined definition as to what is "inherently governmental") will become common practice across all federal agencies.

While insourcing certainly exacerbates specific areas affecting revenue growth, the biggest challenge to growth undoubtedly remains the federal deficit and the over-arching need to cut spending. Under the current economic and political environments, government spending will continue to be repressed, and growth projections will remain in the single-digit range for years to come.

² Source: US Office of Management and Budget's "Acquisition and Contracting Improvement Plans and Pilots"; Dec. 2009

Capital Raised

Favorable industry dynamics have created a robust contracting base over the past ten years that has attracted substantial capital to the government services sector. Over this time period, aggregate capital raised by pure play government services companies has grown from less than \$1.5 billion to in excess of \$4.5 billion, reflecting Wall Street's recognition of strength in the sector (illustrated in Figure 5).

A favorable current financing environment catalyzed by thawing credit markets and the re-emergence of the initial public offering (IPO) market, as evidenced by:

- (1) Global Defense Technology & Systems' (GTEC) IPO in November 2009;
- (2) ManTech's \$200 million Senior Note Offering in April 2010;
- (3) Kratos' \$225 Senior Note Offering in May;

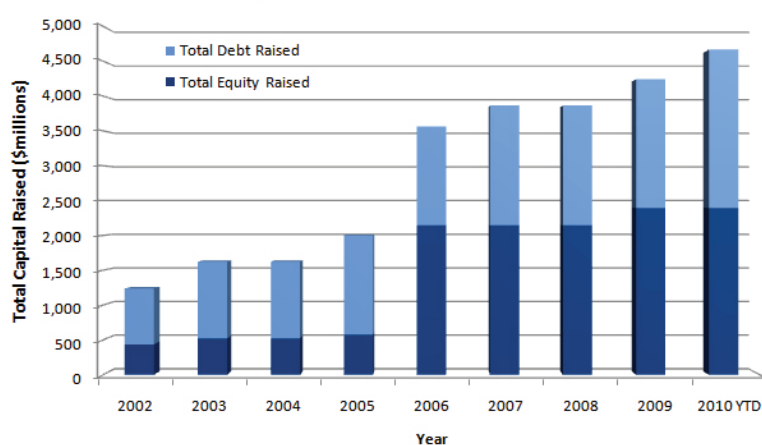
are positive signs that underscore the attractiveness of the government services sector and investors' appetite for new issues.

The public market has witnessed its fair share of pure-play government services success stories over the last decade as firms have gone public and completed their exits by selling to larger strategic buyers (e.g., Veridian, Anteon, SI International, MTC Technologies, DigitalNet). Many of the principals and executives of these successful companies have reengaged in the government services market and are actively building new companies as they seek to replicate their past successes.

On the heels of several pure-play services companies getting snatched up over the past several years, the Mid-tier segment of the government services market is beginning to fill in as credit markets thaw and emerging platforms scale to reach the size to consider an IPO. With former public company management teams in place, and often backed by strong Private Equity partners, we expect the Mid-tier government services segment will develop further as new platforms emerge and existing players acquire niche companies in specialized areas entwined with customers' missions.

Examples of emerging Mid-tier consolidators include TASC (backed by KKR), Camber (backed by New Mountain Capital), KeyW Corp., Six3 Systems (backed by GTCR), A-T Solutions (backed by CoVant/CI Capital) and Salient Solutions, to name a few.

Figure 5: Cumulative Capital Raised by Mid-Tier Public Gov't Services



Valuations

In the years following the post-9/11 defense contracting boom, double-digit Enterprise Value/EBITDA valuation multiples were the norm in the government services market. While recent economic conditions have not been overly harsh on the Mid-tier government services sector, we have seen the average recede back to a more historically typical range.

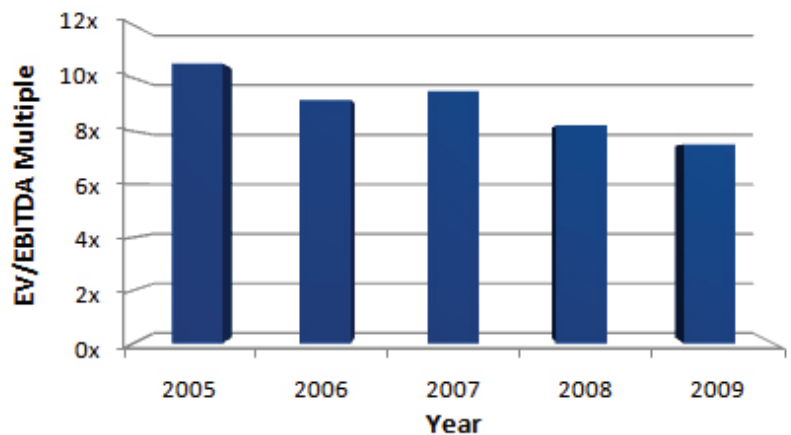
In the Mid-tier government services industry, each year from 2000 to 2005 saw an average multiple exceeding 10x, with the peak occurring in 2004 at 12.6x. Today, however, these firms are valued in the 6x to 8x EBITDA range, with the average being 7.5x.

This downward slip is a culmination of all of the trends discussed in this article, summarized below:

- (1) **Slower organic growth:** due to difficult macroeconomic trends and credit availability.
- (2) **Federal budget deficits:** constantly highlighting the need to reduce government spending.
- (3) **Risk of insourcing prospects:** proven by recent multi-agency pilot projects and still no definition as to what is “inherently governmental.”
- (4) **Declining margins:** resulting from pricing pressure caused by the Obama administration’s proposed procurement policies.
- (5) **Restriction on growth due to OCIs:** which are limiting contract possibilities for firms, even where no internal conflict could arise.

These trends also coincide with a slight deceleration of strategic consolidation in the industry. In recent years, buyers have paid a premium to acquire firms that fill long-term strategic needs. However, after years of firms consolidating prime strategic plays, today’s market is one where transformational acquisitions are fewer and farther between. While the M&A market is still very active, recent transactions have functioned more to fill specific niche capabilities gaps or provide customer access, rather than fulfill broad long-term goals. In other words, current transactions are now less frequently carrying the strategic premium of the mid-2000’s.

Figure 6: Pure Play Gov't Services Valuation Multiples



¹Gov't Services Index Includes: SAI, CACI, MANT, SRX, ICFI, DRCO, DCP, SXE, VSEC, NCIT

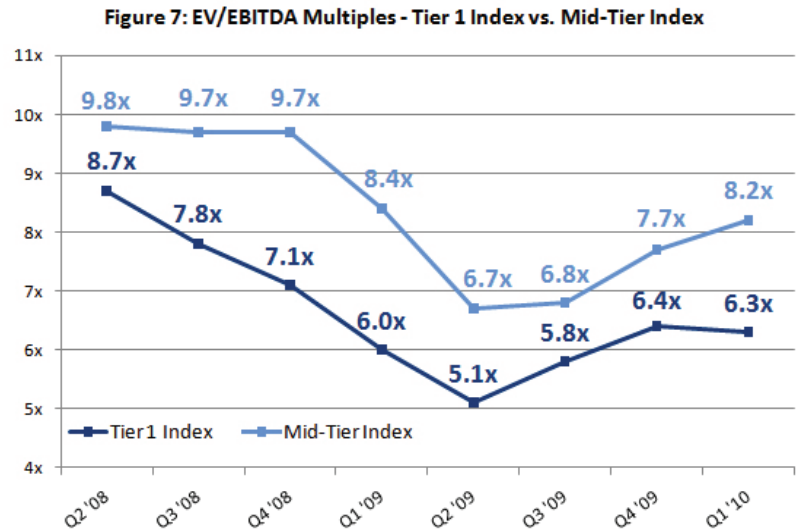
Although there are challenges within the sector, there still is reason to be optimistic. While multiples have been on the decline, it is by no means an indicator of poor performance.

Valuations *continued*

On the contrary, as Figure 7 shows, the Mid-tier segment has actually significantly outperformed the Tier 1s since April 2008, culminating in the Mid-tiers posting a 7% multiple increase while the Tier 1s posted a 2% decrease over the last six month period.

In addition, specific subsegments within the government services market are outperforming as well Those companies aligned with. priority Department of Defense initiatives, specifically intel and national security missions, are still reporting a steady demand for their services, and remain industry leaders in terms of public valuation multiples.

In conclusion, the Mid-tier government contracting sector certainly faces some significant challenges ahead. However their speed and ability to adapt to changes in federal spending policies and needs has proven they have what it takes to weather the economic storm and retain its status as a premier investment platform.



Federal Sector M&A

Mergers and acquisition activity in the federal sector has been strong thus far in 2010. Several market trends witnessed in the first quarter suggest that M&A deals will continue at a brisk pace for the foreseeable future, supported by current industry dynamics. We have observed several key market themes that we expect to catalyze M&A activity over the next 12 to 24 months:

- **Capabilities and Customer Reprioritization:** While cyber security and Intelligence Community activities remain top priorities, strategic buyers have taken note of the FY2011 Budget Request's increased support of federal civilian agencies focused on energy, healthcare, homeland security, and international assistance, and are reprioritizing their M&A programs accordingly.
- **Abundant Buyer Universe with Ample Dry Powder:** As discussed earlier, the government services sector is attracting a variety of traditional and non-traditional buyers armed with robust cash reserves and under-utilized leverage positions and are set to deploy their capital in this outperforming market.
- **Organizational Conflict of Interest ("OCI") Sensitivity:** Shifting government policies regarding OCI are creating a bifurcated contracting market for buyers and sellers. SETA averse primes are divesting conflicted divisions, and private equity and Mid-tier services firms are snatching up these spurned properties.
- **Portfolio Shaping – Increased Divestitures and Portfolio Realignment:** A renewed focus on the role of portfolio and business strategy in defining current and future positioning has fueled a significant increase in asset divestitures of non-core units in 2009; a trend that has kept up thus far in 2010, and one we expect to continue into the foreseeable future.
- **Tax Policy Impacting Exit Planning and Market Timing:** The sunset of former President Bush's capital gains tax cuts coming in 2011 and incremental Medicare taxes on investment income of high-income taxpayers contained in the healthcare bill are causing many shareholders to seriously reconsider their exit plans.

The strategic turbulence created by a change in administration, priorities, and policies has altered corporate strategies and the overall competitive framework of the industry. While intimidating to some, this environment has created significant opportunities for seasoned executives and investors. For this reason, we are optimistic about M&A outlook for the remainder of 2010, particularly in the middle-market, as the underlying market fundamentals that have fueled federal contracting M&A activity over the past decade are still very much in effect.

Figure 8: YTD Government Services M&A Deals Closed

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Government Services Companies - M&A Activity 2010						
Acquisition Completed	Buyer	Target	Target Description	Revenue (\$ in millions)	Valuation Multiples	
					EV/ Revenue	EV/ EBITDA
Pending	CGI Group, Inc.	Stanley, Inc.	Provides information technology services and solutions to U.S. defense, intelligence, and federal civilian government agencies.	\$865.30	1.2 x	12.1 x
Pending	Cerebrus Capital Management, L.P.	DynCorp International, Inc.	Government services provider in support of U.S. national security and foreign policy objectives, delivering support solutions for defense, diplomacy, and int'l development.	\$3,334.20	0.5 x	6.1 x
Pending	Babcock International Group plc	VT Group plc	Provides facilities management & base operations, equipment support, education & training, and design, procurement and construction services for int'l gov'ts.	\$1,720.90	1.5 x	13.3 x
Pending	Symantec Corp.	Gideon Technologies, Inc.	Provides standards-based information security solutions that automate and orchestrate IT security and risk management.	N/A	N/A	N/A
Pending	Kratos Defense & Security Solutions	Gichner Systems Group, Inc.	Engineers and integrates tactical & other shelters, products, solutions, modular containers, subsystems, and support equipment for the military.	\$147.10	0.9 x	7.9 x
May-10	Molina Healthcare Inc.	Unisys Corp., Health Information Management Bus.	Provides health information and business process outsourcing solutions for state Medicaid administration.	\$110.00	1.2 x	N/A
Apr-10	Consolidated Safety Services, Inc.	Dynamac International, Inc.	Professional services firm primarily supporting the government sector.	N/A	N/A	N/A
Apr-10	Applied Signal technology, Inc.	Seismic LLC	Specializes in cyber security solutions, software engineering, datamanagement, and systems engineering & integration services of U.S. DoD and IC.	\$15.00	N/A	N/A
Apr-10	L-1 Identity Solutions, Inc.	Retica Systems, Inc.	Develops iris-on-the-move and iris-at-a-distance retinal scanning products.	N/A	N/A	N/A
Mar-10	Versar Inc.	ADVENT Environmental, Inc.	Environmental contractor with significant capabilities in Military Munitions Response Plans (MMRP) and Unexploded Ordinance (UXO) clean-up for the DoD.	\$12.00	0.3 x	N/A
Mar-10	KeyW Corporation	Insight Information Technology	Provides program management, management consulting, and systems engineering/integration services to NSA and commercial customers.	N/A	N/A	N/A
Mar-10	TrustWave Holdings, Inc.	Intellitactics, Inc.	Provides Security Information and Event Management (SIEM) technology to identify and encrypt sensitive data in every form, in every environment.	N/A	N/A	N/A
Mar-10	IBM Corporation	National Interest Security Company, LLC	Provides information technology & management, and management technology consulting services and solutions for the IC, DoD, DHS, and DOE.	N/A	N/A	N/A
Mar-10	IBM Corporation	Initiate Systems, Inc.	Provides master data management and integrity software for healthcare and government customers.	N/A	N/A	N/A
Feb-10	KeyW Corporation	The Analysis Group, LLC	Provides analytical and tech. support services, including ops. analysis, modeling/simulation, info. management, and SETA services to AF intelligence and other DOD customers.	N/A	N/A	N/A
Feb-10	MAXIMUS, Inc.	Deltaware Systems, Inc.	Provides health administration management systems, including the Medigent integrated software suite, to the government healthcare market.	N/A	N/A	N/A

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Feb-10	Autonomy Corp. plc	MicroLink, LLC	Provides knowledge management, eDecision, collaboration, and governance risk & compliance solutions to DISA, DoS, and other federal agencies.	N/A	N/A	N/A
Feb-10	WidePoint Corp.	Vuance, Ltd., Government Solutions Division	Focuses on security solutions for locating, credentialing, and managing essential personnel.	N/A	N/A	N/A
Feb-10	CACI International	SystemWare, Inc.	Provides state-of-the-art signals acquisition and analysis systems that enable users to monitor and detect cybersecurity and physical vulnerabilities.	\$16.00	N/A	N/A
Feb-10	SAIC, Inc.	Forterra Systems, Interactive Virtual Product	Enables customers to deploy their own persistent and secure 3D Virtual Worlds where users can collaborate over networks.	N/A	N/A	N/A
Feb-10	SRA International, Inc.	Perrin Quarles Associates, Inc.	Environmental consulting firm that specializes in environmental program development and implementation for air quality and climate change.	N/A	N/A	N/A
Jan-10	SAIC, Inc.	Science, Engineering and Technology Associates Corp.	Creates and commercializes information technologies for a diverse base of defense, homeland security, and IC customers.	N/A	N/A	N/A
Jan-10	DynCorp International, LLC	Casals & Associates, Inc.	Helps U.S. foreign policy priorities by assisting the dev. of stable & democratic gov'ts. and aiding the growth of democratic public and civil institutions.	N/A	N/A	N/A
Jan-10	Platinum Equity Holdings	OAO Technology Solutions, Inc.	Provides managed IT services and solutions including applications outsourcing, data center and infrastructure management, and staffing solutions.	N/A	N/A	N/A
Jan-10	World Wide Technology, Inc.	Performance Technology Group, Inc.	Systems engineering and managed services firm involved in cybersecurity initiatives for federal, state, and commercial clients.	N/A	N/A	N/A
Jan-10	ManTech International Corp.	Sensor Technologies, Inc. (STI)	Provides mission-critical systems engineering and C4ISR services and solutions to the DoD.	\$340.00	0.7 x	N/A
Jan-10	FGM, Inc.	Edge Technologies, Inc., Enterprise Services Group	Delivers high-end engineering services relating to cyber security to the IC and law enforcement agencies.	N/A	N/A	N/A
Jan-10	SAIC, Inc.	Spectrum San Diego, CarScan Product Line	High-tech security firm specializing in ultra-low-dose X-ray scanning systems. Customers include U.S. government, law enforcement, and military organizations.	N/A	N/A	N/A
Jan-10	Korn/Ferry International	SENSA Solutions, Inc.	Management consulting firm providing leadership and organizational development solutions utilized by U.S. federal agencies.	N/A	N/A	N/A

Min	\$12.00	0.3 x	6.1 x
Max	\$3,334.20	1.5 x	13.3 x
Median	\$147.10	0.9 x	10.0 x