



HOULIHAN LOKEY

# AT A CROSSROADS

GOVERNMENT SERVICES 2018 YEAR IN REVIEW





# 2018 Year in Review

What a difference a year makes? Last year a confluence of tailwinds provided the impetus to name our Year in Review piece *The Perfect Storm*. Numerous factors, including budget stability, strengthening broader market trends, increased debt availability at historically low costs, bullish public company growth forecasts, and a Republican-led Congress positioned to fund the current Administration's defense priorities, supported this bold prognostication. The question we now face is whether the government technology and services market has peaked, given a more mixed set of market indicators as we enter 2019.

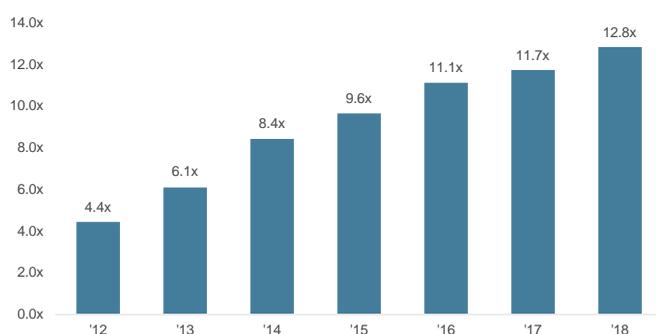
## Have Public Company Valuations Plateaued?

*The Perfect Storm* manifested itself most visibly in the public market arena. Median EV/EBITDA multiples for publicly traded government services companies surged to 14 by early September 2018, approaching all-time highs. Revenue forecasts for the next fiscal year ballooned to more than 7%, relative to flat to nominal growth registered during the calendar year 2017. Industry book-to-bill ratios, which reached 1.4x during the last round of Wall Street earnings releases, have supported a very optimistic picture of the future.

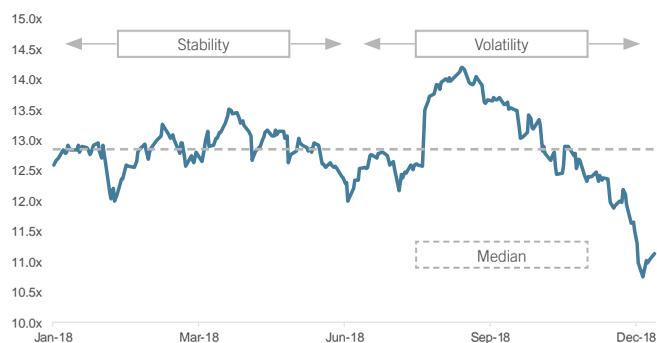
Notwithstanding these positive signs, during the sixth consecutive year of consistent EV/EBITDA multiple expansion (from 2012 through 2018), public company valuations in the government technology and services sector saw significantly increased volatility during the latter part of 2018. Following a peak of 14.0x EBITDA in September, median valuation multiples declined to 10.9x at year-end. During our *Market Meets Market*, we discussed the significant correlation between broader market indices and the government services index over the past 20 years. Except for the two major recession periods (from 2000 to 2003 and from 2008 to 2009) in which investors pursued a “flight to safety” in government spending, there has been a high correlation between the government services sector and the S&P 500. So should we be surprised that the market value of federal services companies recently declined with the overall market? Based on history, probably not, however it is extremely noteworthy that declines in the market values of federal services companies were more extreme than declines in the broader market (25% decline in the federal services index from Labor Day through year-end, versus 13% decline in the S&P 500 index over the same time period). This suggests that sector investors are beginning to consider some of the industry risks threatening *The Perfect Storm*, such as the prospect of Budget Control Act spending caps returning in fiscal 2020, the government shutdown, a split Congress, and general political uncertainty.

Perhaps we should be calling 2019 *The Crossroads*?

**Government Services Industry Median Valuation Multiples (2012-2018)**



**Last 12 Months Government Services Index TEV/EBITDA Volatility**



Source: S&P Capital IQ and public filings

# Rated No. 1 M&A Advisor for All U.S. Transactions in 2018

by Thomson Reuters

**No. 1** M&A Advisor for All U.S. Industrials Transactions

**Top 10** Most Active Global M&A Advisor

Source: Thomson Reuters

## 2018 M&A Advisory Rankings All U.S. Transactions

Advisor	Deals
<b>Houlihan Lokey</b>	<b>207</b>
Goldman Sachs & Co	197
JP Morgan	154
Morgan Stanley	135
Jefferies LLC	117



### HOULIHAN LOKEY

Our Aerospace•Defense•Government (ADG) practice is among the leading M&A advisory services to aerospace, defense, government services, and national security companies. Since 2016, Houlihan Lokey closed 55 transactions and with a staff of approximately 30 investment bankers in Washington, D.C. and Los Angeles. The ADG practice is one of the largest dedicated industry banking groups worldwide.

### Dedicated Industry Expertise

- Business Services
- Consumer, Food & Retail
- Data & Analytics
- Energy
- Financial Institutions
- Healthcare
- Industrials
- Real Estate, Lodging & Leisure
- Technology, Media & Telecom



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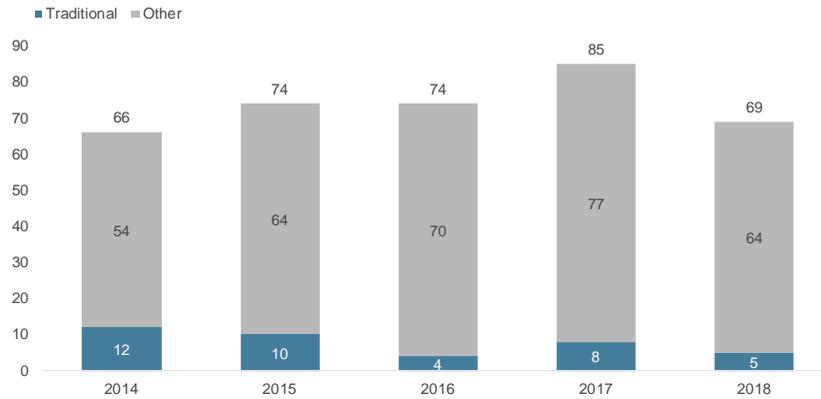
## M&A Volume is Modestly Down in 2018 – The Shifting Buyer Landscape Is the Real Headline

Despite the strong alignment between U.S. government technology and services industry fundamentals and the interest levels of companies in engaging in M&A activity as we entered 2018, M&A volume for the full year was down 19% from 2017 levels. Lower than expected M&A volume was primarily attributable to a general imbalance between the (low) supply of well-positioned targets (particularly those with scale) and (high) demand for acquisition targets. Additionally, many companies considering a near-term exit decided to hold at second base while awaiting the government’s adjudication of significant pipeline pursuits that would drive meaningful growth in 2019. Naturally, one might jump to the conclusion that a decline in volume suggests a softening of valuations, but in many cases, we saw historically high M&A valuations that were well into the double-digit zip code. This juxtaposition of low volume and high valuations underscores the notion that supply is down or buyers were preoccupied, or both. In summary, we expect deal volume to rebound in 2019 as would-be sellers generally have a more firm view of their 2019 forecasts and consider more seriously the potential risks looming on the horizon that could adversely impact the M&A market.

## Is the “Traditional” Buyer Becoming an Endangered Species?

One of the most notable trends in the government services M&A market over the last few years has been the disappearance of the “traditional” buyer as a dominant force in sector M&A—the large, multibillion dollar publicly traded government services company or defense prime contractor which drove a disproportionate share of M&A volume during the last upcycle. In 2018, “traditional” buyers completed only five of 69 (7%) of announced transactions in the sector. Two of these transactions were scale transactions (GD’s purchase of CSRA and SAIC’s purchase of Engility), and the other three represented strategic middle-market transactions and/or acquisitions consummated for the purpose of contract vehicle access. As indicated in the following chart, this trend, which has persisted for the last three years, represents a significant decline from 10 to 12 completed transactions per year in 2014 and 2015. Notwithstanding this decline in M&A activity, many of these so-called “traditional” buyers have publicly stated that M&A is their preferred capital allocation method, supporting the notion that there just are not that many targets of scale available for purchase.

## M&A Transaction Volume Driven by “Traditional” Buyers (Last 5 Years)



Source: S&P Capital IQ and public filings

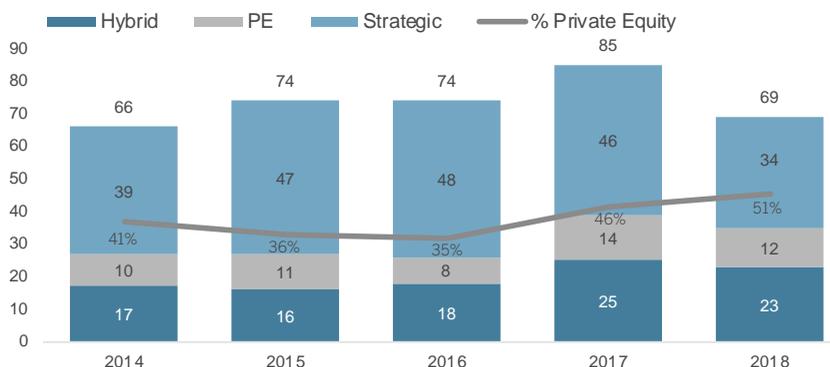
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So, who are the buyers in today’s M&A market? First, there is a broad range of “non-traditional” strategic buyers focused on business transformation that are aggressively pursuing government services acquisitions. Parsons (acquisitions of Polaris Alpha and OGSystems), Huntington Ingalls (acquisition of G2 and pending acquisition of Fulcrum), and Vectrus (acquisition of SENTEL Corporation) are examples of large strategic buyers with a meaningful presence in the government services market (\$1+ billion in revenue) that are focused on integrating higher end technology solutions into their portfolios. At the same time, we have seen other “non-traditional” strategic buyers such as staffing companies, including OnAssignment (acquisition of ECS Federal) and System One (acquisitions of TPSG and GAP Solutions) stand up new government services divisions to capitalize upon favorable sector growth dynamics.

Additionally, mid-tier strategic buyers focused on building scale, expanding customer access, and adding specialized capabilities, remained active in the M&A market in 2018. Xator, SOSi, and American Systems are excellent examples of companies that have utilized acquisitions as a means to supplement organic growth and to become the new class of well-positioned mid-tier companies of scale. The robust capital environment, which has only recently shown signs of peaking at historically high levels, supports the ability of mid-tier buyers to continue their aggressive M&A pursuits.

Finally, and perhaps most notably, for the first time during the past 5 years, private equity sponsors (via new platform investments or add-on acquisitions for existing platforms) drove more than 50% of M&A activity in the sector. Trends in private equity investing in the government services sector are notable enough that they warrant closer examination.

## M&A Transaction Volume by Buyer Type (Last 5 Years)



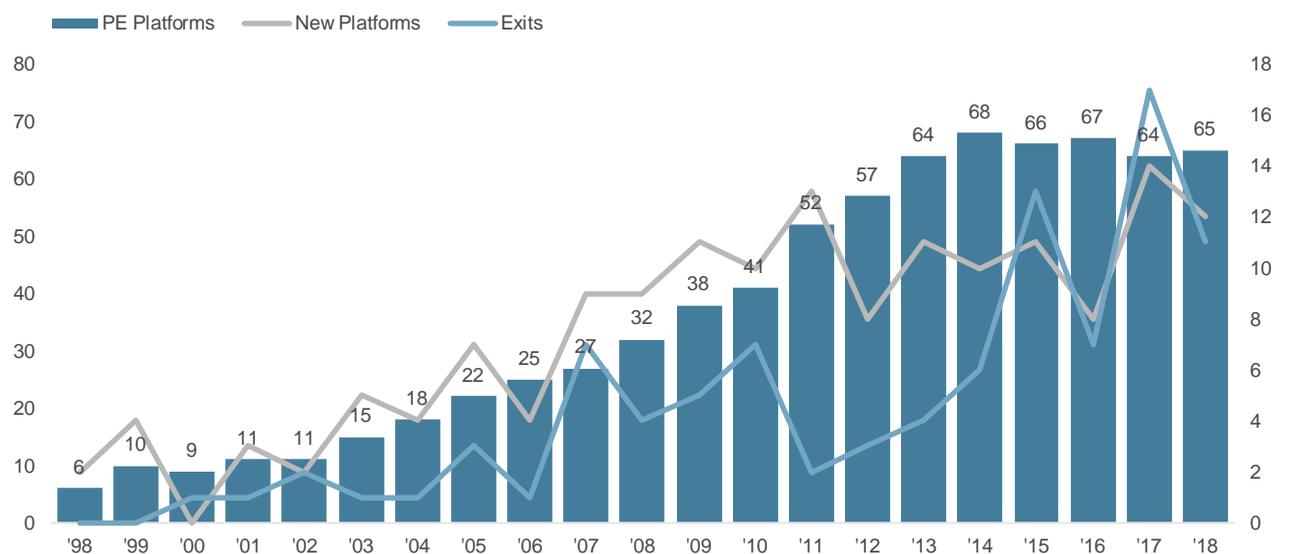
Source: S&P Capital IQ and public filings

## Private Equity Will Again Headline 2019 M&A Activity

Private equity investment activity in the government technology and services sector has grown steadily over the past two decades, as new entrant funds have supplemented the activity of established, sector-focused funds such as Veritas Capital, The Carlyle Group, and Arlington Capital Partners. Currently, there are 65 private equity-backed government technology and services companies, up from 32 in 2008. Notwithstanding the frothy valuation environment (and in defiance of conventional logic suggesting that investors should buy low and sell high), private equity sponsors were as active on the buy-side as on the sell-side in 2018, with 12 new platform investments and 11 platform exits. The number of new platforms in 2018 represents a near peak (within the last 20 years, we only saw more new private equity platforms—14—in 2011 and 2017). Private equity groups and their platform companies have been bullish on their abilities to pay high multiples for businesses and still see a path to value arbitrage on their future exits.

Speaking of private equity exits, the most compelling factors likely to alter the current supply and demand imbalance in the marketplace are the sheer volume of private equity-backed platforms (65) and percentage of them (29%) which are long in their investment periods (five years or more). As private equity sponsors continue to examine the tradeoffs between exiting (taking advantage of the current market window while it lasts) and holding (continuing to build), we expect that sponsors will favor exiting sooner to avoid having to hold, as many were forced to do during the last downturn. This could be the single most important driver of increased M&A volume in 2019.

**Private Equity Investment Activity. Government Technology and Services Sector, 1998-2018**



Source: S&P Capital IQ and public filings

# Select Defense & Government Services Transactions

<p><b>C5ISR</b></p> <p>Transaction Pending</p>  <p>a portfolio company of</p>  <p>has agreed to be acquired by</p>  <p><b>Sellside Advisor</b></p>	<p><b>Engineering</b></p> <p><b>GENERAL DYNAMICS</b> Information Technology</p> <p>has divested its Systems Engineering and Acquisition Support Services Business Unit to</p>  <p><b>Sellside Advisor</b></p>	<p><b>IT/Managed Services</b></p> <p><b>IRON BOW™</b> TECHNOLOGIES</p> <p>has been acquired by</p>  <p><b>Sellside Advisor*</b></p>	<p><b>Cyber/SIGINT</b></p> <p><b>PARSONS</b></p> <p>has acquired</p>  <p><b>Fairness Opinion</b></p>
<p><b>Data Analytics</b></p>  <p>has been acquired by</p>  <p><b>Sellside Advisor*</b></p>	<p><b>IT/Data Analytics</b></p>  <p>has completed a recapitalization with</p>  <p><b>Sellside Advisor*</b></p>	<p><b>IT/Cloud</b></p> <p><b>ECS</b></p> <p>along with minority investor</p> <p><b>LINDSAY GOLDBERG</b></p> <p>has been acquired by</p>  <p><b>Sellside Advisor</b></p>	<p><b>Cyber</b></p>  <p>has been acquired by</p>  <p>a portfolio company of</p>  <p><b>Sellside Advisor*</b></p>
<p><b>Mission Support</b></p>  <p>has been acquired by</p>  <p><b>Sellside Advisor*</b></p>	<p><b>Aviation Training</b></p> <p><b>E.I.S. AIRCRAFT</b> (Aviation Operations)</p> <p>a portfolio company of</p>  <p>has been acquired by</p>  <p><b>Sellside Advisor</b></p>	<p><b>Unmanned</b></p> <p><b>ASV</b> unmanned marine systems</p> <p>has been acquired by</p>  <p><b>Sellside Advisor</b></p>	<p><b>Unmanned</b></p> <p><b>LATITUDE</b></p> <p>has been acquired by</p>  <p><b>Sellside Advisor</b></p>
<p><b>Health</b></p>  <p>has completed a recapitalization with</p>  <p><b>Sellside Advisor</b></p>	<p><b>Health</b></p>  <p>has been acquired by</p>  <p><b>Sellside Advisor</b></p>	<p><b>Staffing</b></p> <p><b>TP★GS</b></p> <p>has been acquired by</p> <p><b>system one</b></p> <p>a portfolio company of</p>  <p><b>Sellside Advisor</b></p>	<p><b>Space</b></p> <p><b>Anaren®</b></p> <p>a portfolio company of</p>  <p>has been acquired by</p>  <p><b>Sellside Advisor</b></p>

Selected transactions were executed by Houlihan Lokey professionals while at other firms acquired by Houlihan Lokey, or by professionals from a Houlihan Lokey joint venture company.



## 2019 – The Crossroads

In summary, we expect 2019 to be a *crossroads* year. While there are a number of favorable factors supporting continued strength in both valuations and M&A activity in the government technology and services sector (favorable budget trends, strong company operating performance, solid capital environment), the current political climate has thrown proverbial cold water on the industry’s otherwise positive outlook. Will public company valuations return to the levels seen last summer? Sector book-to-bill ratios suggest that the underlying industry fundamentals remain strong, however, most industry observers were scratching their heads at median valuation multiples of 14.0x EBITDA, so we should not be surprised if the peak is behind us.

For sure, “traditional” buyers are at a crossroads—while they have more recently focused on transactions of scale, which are not extinct but certainly scarce, will they return to middle-market M&A in 2019? Their appetites and strong balance sheets suggest they will, and the private equity community can provide the supply, so chances are high. We are kicking off 2019 with cautious optimism. There is a buzz in the air, but one would need rose-colored sunglasses to predict another year of smooth sailing down an open road. The house odds would suggest a fork in the road is approaching.

As the great Yogi Berra once said, “When you come to a fork in the road, take it.”

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## HOULIHAN LOKEY

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