



M&A in Government Contracting: Hot Topics Throughout the Deal Lifecycle

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Presenter Biography

David S. Black



- Co-Chair, National Government Contracts Team
- Government contracts counseling and dispute resolution
- Represent contractors in protests and claims and responding to government investigations, audits, False Claims Act investigations and litigations
- Represent subcontractors in negotiating teaming agreements and subcontracts, and in disputes with prime contractors

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Practice

- Government Contracts
- Litigation and Dispute Resolution
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Education

- Georgetown University Law Center, JD
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Bar Admission

- District of Columbia
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Presenter Biography

Aaron Raddock



- Co-Leader, National Government Contracts Team
- Provides government contractor advisory services
- Supports contractors in a variety of accounting, cost, pricing, audit and other regulatory issues
- Provides due diligence support around government contract risks, post-merger integration services, and litigation support services in the event of a dispute

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Practice

- Government Contractor Advisory

Education

- University of Virginia

Bar Admission

- Certifications - CPA, CFE, CFCM

Agenda

- **Overview of the GovCon M&A Market**
- **Growth Cycle of a Federal Contractor**
- **Lifecycle of the GovCon M&A Deal**
- **Deal Structure Approaches**
- **Key Diligence Issues**
- **Post-Merger Integration**



Overview of the GovCon M&A Market

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2018 Highlights & Trends

- » M&A volume declined 19% from 2017 levels:
 - Demand remained high, but supply was down
 - Valuations were up
 - More larger deals than in recent years (18 announced over \$100M) Consolidation Continued
 - GD acquisition of CSRA; SAIC purchase of Engility but, “traditional” buyers were a minor player in deal activity

2018 Highlights & Trends

- » Increase of “non-traditional” buyers
 - Parsons (2), Huntington Ingalls (2) and VECTRUS
 - New entrants – OnAssignment (ECS Federal) and System One (TPSG and GAP Solutions)
 - Mid-tier buyers – Xator, SOSI and PSI; PE funds drove more than 50% of M&A volume
 - Currently, 65 PE-backed government contractors vs. 32 in 2008

What to Expect in 2019

- » Analysts expect increase in deal volume over 2018, with stable valuations
 - Driven by continued PE involvement, particularly more portfolio exits
- » Top Government Services areas =
 - Cybersecurity
 - IT Modernization (Cloud, Big Data)
 - System Engineering
 - Amazon's HQ2 impact?

The Growth Cycle of a Federal Contractor



Growth Cycle

» Stage of a Company and Capital Sources

- **Seed/Start Up Stage**

Typically \$200,000 to \$1 million

Capital provided by friends and family, nonprofit venture groups, and grants

Alpha and Beta stage products – early testing phase

Services or products supplied under a limited set of short-term contracts to a single agency

May have only subcontracts



Growth Cycle

» Stage of a Company and Capital Sources

- **Early Stage**

\$1-5 million

Capital provided by angel investors, regional venture capital firms, high net worth individuals

May have a revolving line of credit with a regional or community bank with borrowing base determined as a percentage of the company's working capital assets (e.g., accounts receivable)

Beta stage product or early adoption period

Services and/or products supplied under a more robust set of contracts to multiple agencies

May have prime subcontracts and prime contracts



Growth Cycle



» Stage of a Company and Capital Sources

- **Emerging Growth and Growth Stages**

Emerging \$5+ million; Growth \$25 to \$50+ million

Capital provided by a variety of sources, including venture capital firms, strategic investors, debt capital providers, and hybrids

May have secured term bank loans (i.e., “Senior Bank Debt”)

Scaling products and services up to full capacity

May grow by acquisition

May lead multi-subcontractor teams and hold GWACs and GSA FSS contracts

May obtain a sufficient amount of CAS-covered cost plus contracts to have significant DCAA and oversight agency activity

Growth Cycle



» Stage of a Company and Capital Sources

- **Liquidity**

Some investors may start thinking about **how to exit and pull out appreciated capital**

Investment bankers (e.g., Houlihan Lokey, The McLean Group, Aronson, etc.) may become involved and put some or all of the business on the market

Potential buyers could be **strategic** (e.g., Accenture, Leidos, ManTech, CSRA, etc.), **private equity** (e.g., The Carlyle Group, Veritas, Arlington Capital Partners, CM Equity, etc.), or the deal may involve a **“merger of equals”**

Company could **IPO**

Growth Cycle

» Stage of a Company and Capital Sources

- **Liquidity**

Potential buyers will perform extensive due diligence across all areas of the company

The avenue is littered with *broken deals and valuation reductions* resulting from compliance and/or untenable contract per





Lifecycle of the GovCon M&A Deal

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Who's Buying?

» Broad Array of Buyers in the Marketplace

- Private or Public **strategic**
- **Private equity**
- **Former sellers** re-entering the marketplace
- **Foreign**
- **Primarily commercial**

» Buyers Seeking

- New customers
- New capabilities
- **Geographic diversification**
- **New product or service markets**
- **New Revenue and EBITDA Growth** (by acquisition rather than organic)

Who's Buying?

» What attracts buyers?

- Strong backlog, technology, depth with important customers
- Ability to offer customers better solutions at lower costs
- Adequate, sustainable margins
- Reasonable valuations
- High quality of earnings
- Robust pipeline of opportunities

» What attracts buyers?

- Limited or no compliance risk
- Limited set-aside contracts
- Retention of key personnel
- Important contract vehicles with well-funded customers
- History of growth

Who's Selling?

» Broad Array of Sellers in the Marketplace

- **“Emerging” Strategic** (in the “liquidity” stage of growth)
- **“Restructuring” Strategic** (spin off)
- **Private equity** (after holding for growth)
- **Foreign** (divesting)
- **Primarily commercial** (spin off)

» Sellers Seeking

- Highest valuation
- Assurance of closing
- Type of consideration (cash vs. earn outs)
- Minimize post-closing risks

Valuations – Several Tiers

- » **Highest Tier** – Intelligence, Cyber, Health, C4, Innovative technology
- » **Mid-Tier**– Strong margins that are sustainable, prime contract vehicles, strong backlog and pipeline, growth visibility, ability to offer superior solutions to customers at lower cost
- » **Lower-Tier** – Lower margin “commodity” IT services, limited customer penetration, non-specialized services, growth challenges

Timing Considerations

» Influenced by role:

- Are we buying or selling? What are we trying to accomplish?
- Vertical or horizontal expansion
- Key customer, location or technology
- Looking to exit?

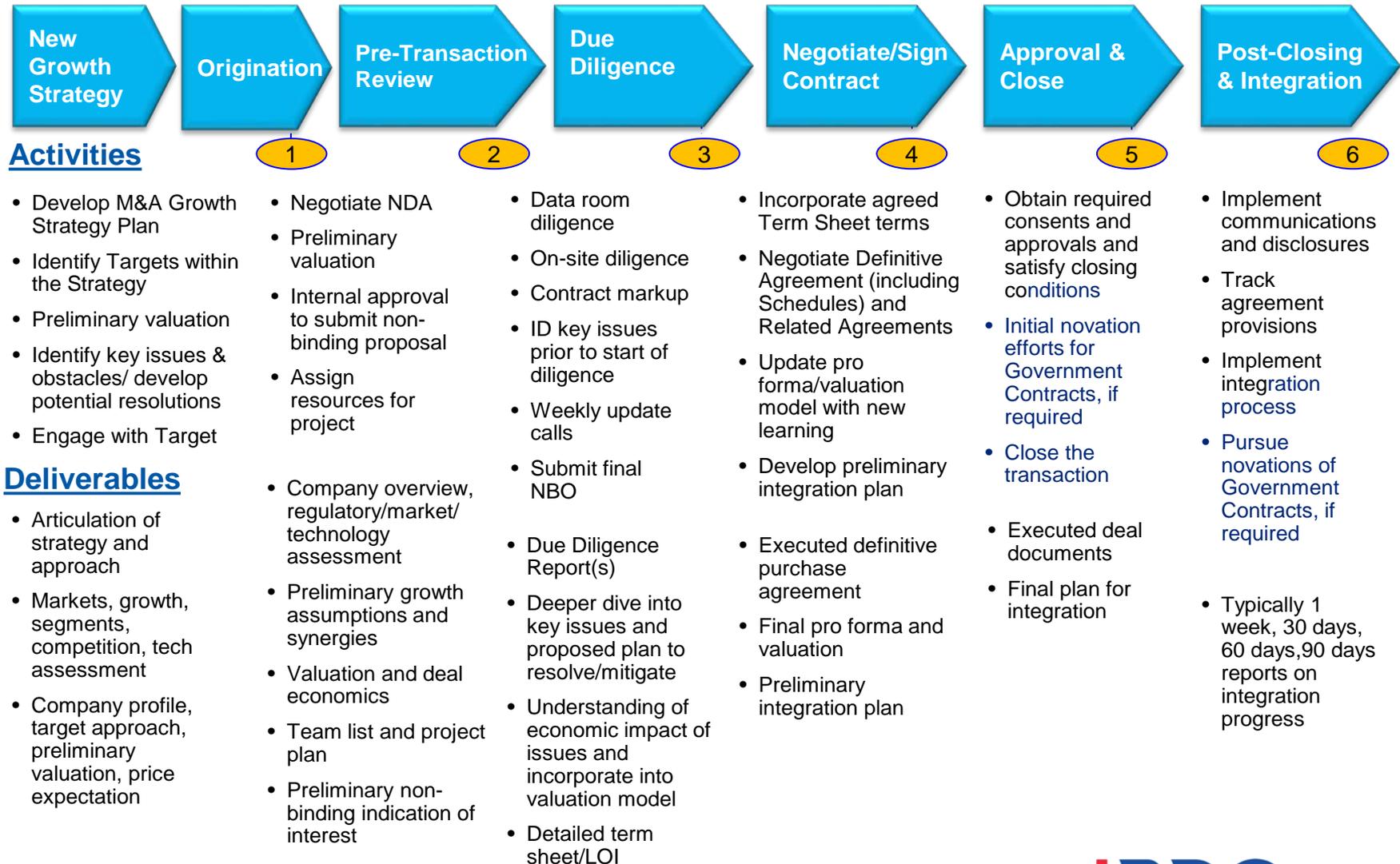
How Do I Find a Good Buyer/Target?

- » Word of mouth
- » Investment bankers (pitch books)
- » Teaming partners
- » Market research – contract wins, \$ awarded, etc.
- » Heavy small business? Consider ANCs or Tribal Natives

Lifecycle of a GovCon M&A Deal

- 1. New Growth Strategy**
- 2. Origination**
- 3. Pre-Transaction Review**
- 4. Due Diligence**
- 5. Negotiation/Sign Contract**
- 6. Approval & Close**
- 7. Post-Closing & Integration**

Overview of M&A Process



Letters of Intent

- » **Frequently follows some due diligence** by Purchaser and management briefing by Target
- » **Many Buyers and most Sellers desire detailed terms, to limit potential future roadblocks**
- » **Buyers reserve right to modify** terms based on due diligence
- » **Items customarily addressed:**
 - Tax and deal structure, enterprise value and purchase price assumptions
 - Purchase price and type of consideration
 - Escrow or holdback
 - Principal closing conditions

Letters of Intent

» Items customarily addressed (cont.):

- Earn-out structure
- Non-competes and key employee retention
- Due diligence process
- Customer visits and employee meetings
- Exclusive negotiation period
- Indemnity caps, baskets, minimum claims, and survival periods

» **Exclusivity Period** often staged based on completion of diligence, financing commitment and distribution of draft documents



Deal Structure Approaches

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Type & Structure of Deal

» Equity/Stock Purchase

- Most common structure
- **Pro:** Eliminates “novation” risk
- **Con:** Buyer retains all government contract liabilities, including penalties (*think False Claims Act*)
- Results in long-term capital gains for Seller

» Asset Purchase

- Less common **but** this is the required structure when **spinning off a “division”**
- **Pro:** Buyer can limit assumption of some liabilities
- **Con:** Requires Government’s consent (novation – FAR 42.12)

Type & Structure of Deal

» Reverse Triangular Merger

- Often used if (a) Target is publicly held; (b) significant number of shareholders; and (c) less than all stockholders are willing to sell
- **Pro:** Generally avoids the novation requirement
- **Con:** Buyer retains all government contract liabilities, including penalties (*think False Claims Act*)

Type & Structure of Consideration

» Cash

- Still the most prevalent consideration

» Subordinated Notes

- Used by smaller private Buyers or private equity Buyers

» Contingent Payments

- Earn-outs based upon future economic performance
- Earn-outs based upon future events related to contracts
- Future payments based on sale of Buyer

Type & Structure of Consideration

» Assumption of Obligations

- Debt assumption is unusual except for capital leases

» Stock

- Public: Not frequently used except in public to public deals, due to availability of cash
- Private: Used principally by private equity firms or their platform companies as rollover equity

Type & Structure of Consideration

» Earn-Outs – Contingent Deferred Payments

- Single Event based

- Contract award
- Contract Renewal
- Exercise of one or more options (especially small business contracts with recertification as “other than small”)
- Successful claim, litigation, or collection of contested receivable

Type & Structure of Consideration

» Earn-Outs – Contingent Deferred Payments

- Performance based

- Overall **financial performance** of the Target
- Performance for **specific customer**
- Performance under **specific contract**
- **Mitigation of set-aside work** to full and open

Type & Structure of Consideration

» Earn-Outs – Contingent Deferred Payments

- **Issues relating to Earn-Outs (Contested Negotiations!)**
 - Maintain Target's separate identity for measurement
 - Limit on overhead or parent charges
 - Adequate financial reporting
 - No diversion of the Target's resources and personnel
 - Limits on operational controls over Target
 - Acceleration upon transfer of Target or its assets during earn-out periods

Type & Structure of Consideration

» Escrows and Holdbacks

- Sources of funds to secure

- Indemnity claims
- Deficiencies in closing balance sheet
- Payments related to specific claims and litigation

- Amount and Term is Negotiated as Percentage of Purchase Price

- Based on Buyer's perceived risks; stockholder composition, and availability of other assets to satisfy potential claims
- Usually 1-2 year holdback period, except for specifically identified claims

What Affects M&A Transaction Legal Terms?

- » **Competitive demand** for Target, e.g., auction process vs. single purchaser
- » **Risk tolerance and historical practices** of particular Purchaser
- » **Composition of Target owners**
- » **Nature and magnitude of perceived future business and legal risks**
- » **Overall Target preparation and compliance posture**
- » **Negotiation process**
- » **Practices of advisors to parties**



Key Diligence Issues

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Due Diligence Generally

» **Due Diligence is a critical aspect of the M&A process**

» **Why Due Diligence:**

- **Understand the business or assets** to be acquired
- **Identify liabilities** and areas of **potential risk** exposures
- Determine whether there are **any contractual or other restrictions on current or future operations** (e.g., OCIs)
- Determine which **transaction structure** is most optimal
- **Confirm business model and valuation** and identify positive and negative synergies
- Inform review of **disclosure schedules** and transaction agreements

Principal Focus Areas of Due Diligence

- » **Key Focus: Review Quality of Revenues and Earnings**
 - Dependence on **set-aside contracts**?
 - Pending proposals
 - **Current Program & Contract Assessment**
 - Remaining term, remaining options, “follow on” prospects
 - **Customer Relationships**
- » **Sustainability of Contracts, Customers and Margins**
- » **Other “competitiveness” factors:** OCIs, Key Personnel & Data Rights, trends in industry, technology, and Federal budget
- » **Compliance and Other Potential Risks (next slides)**

**Overall Diligence Theme:
Sustainability of Existing
Business**

Key Issues in Due Diligence of Government Contractors

» Past/Current Compliance:

- Analysis of contract backlog
- Past performance history
- Claims, disputes, government investigations
- Internal investigations
- Audit liability (DCAA) and CAS
- SCA/DBA and related labor laws
- GSA/VA Schedule compliance

Key Issues in Due Diligence of Government Contractors

» Past/Current Compliance:

- Required business systems for government contractors
- Organization Conflicts of Interest (OCI)
- Socio-economic compliance (e.g., OFCCP, human trafficking) and other compliance programs
- Supply chain integrity
- Cybersecurity compliance

Key Issues in Due Diligence of Government Contractors

» Forward-Looking Due Diligence:

- Regulatory consents, security clearances, filing, registrations (e.g., novation, CFIUS, DSS, DDTC, FCC)
- Significant amount of work if foreign assets and/or foreign company
- Business size issues
- Cost Accounting Standards
- Indirect rate changes and cost impacts
- Allowability of organizational changes

Key Issues in Due Diligence of Government Contractors

» Forward-Looking Due Diligence:

- Outstanding proposals
- Protest risk associated with the transaction
- OCI risk
- Teaming agreements
- Joint ventures
- IP rights and restrictions
- Key personnel

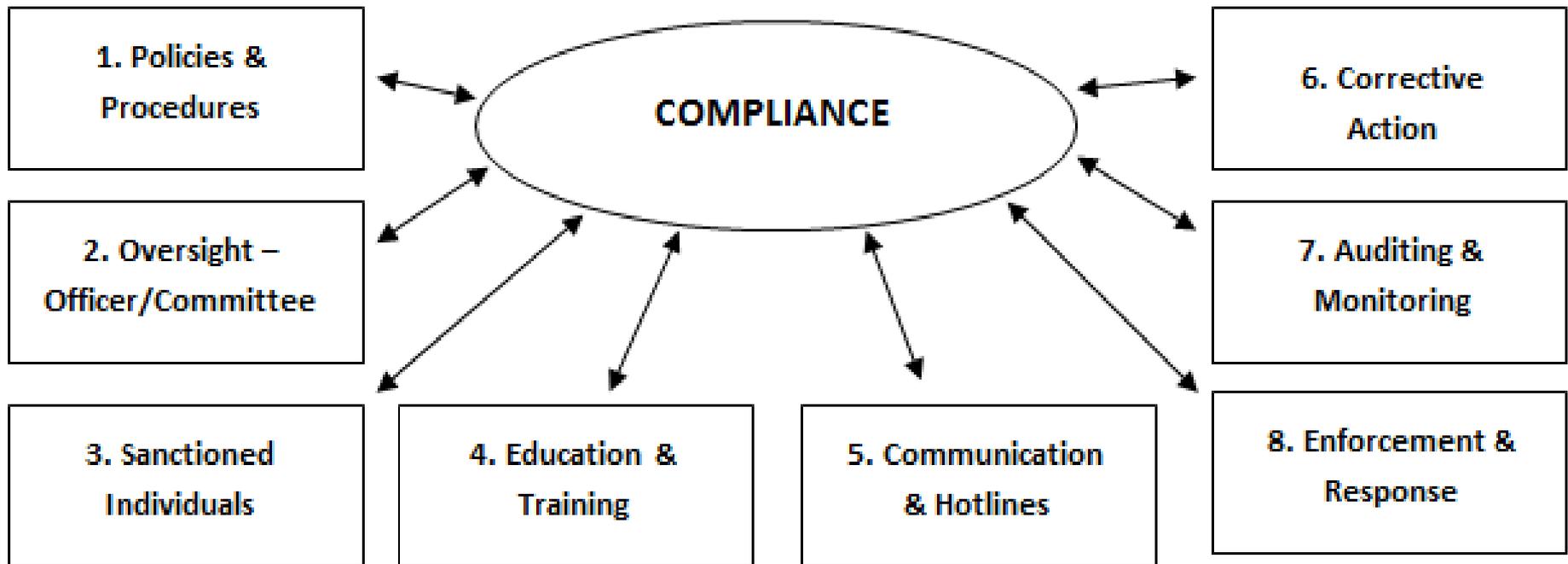
Common “Reps and Warranties” in GovCon M&A

- False Claims Act violations
- Fraud claims
- Procurement Integrity Act violations
- Investigations or non-DCAA audits related to GovCon
- Mandatory disclosures
- Cost and pricing compliance with FAR Part 31 and CAS
- Suspension or debarment proceedings
- Requests for Equitable Adjustment
- Contract disputes
- Subcontract disputes
- Other civil litigation
- Security clearance compliance
- Export controls compliance
- Bribes or unlawful gifts
- FCPA compliance
- Anti-Kickback Act

Common “Reps and Warranties” in GovCon M&A

- Small business certification compliance
- Online reps & certs compliance
- Proposals were current, accurate, and complete
- GSA Schedule compliance
- Truth in Negotiations Act compliance
- Service Contract Act and other wage compliance
- Labor & employment compliance
- Indirect cost compliance
- Invoices were current, accurate, and complete
- Internal controls and business systems were compliant
- Terminations for default
- Any setoffs?
- Any OCIs?
- Any recent adverse past performance?
- Intellectual property & data rights compliance

Evaluation of Target's Compliance Program



Key Documents

- 1. Code of Conduct** (Sets the Tone; Helps Employees Issue-Spot Key Risk Areas)
- 2. Program Framework** (Assigns Roles & Responsibilities)
- 3. Policies & Procedures** (More detailed guidance)

Evaluation of Target's Compliance Program

» Elements of Internal Control System (FAR 52.203-13)

1. Code of Business Ethics and Conduct

2. Compliance Program Framework

- a. Assign responsibility at a sufficiently high level
- b. Establish relevant **internal controls, policies, and procedures**
- c. Train relevant employees and communicate with workforce
- d. Monitor and audit
- e. Internal reporting mechanism – anonymous “hotline”
- f. Consistent disciplinary action
- g. Periodic review of the program (at least annually)
- h. Timely mandatory disclosure
- i. Full cooperation with Government audits and investigations

Function-Based Look at Non-GovCon Diligence Issues

Risk Assessment:
Different business functions of a Federal contractor have **unique legal & compliance risks**





Post-Merger Integration Issues

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Post-Merger Integration – Now the Work Starts

- » **Revisit Indirect Cost Structure for New Organizational Structure**
 - Definition of a segment / business unit
 - Impacts to home office allocations and service centers
 - Additional or revised indirect cost rates
 - Organization design and governance considerations
- » **Cost accounting practice changes**
 - Not all organizational changes equate to cost accounting practice changes
 - Assess need for GDM or cost impact
 - Revise disclosure statement as needed
- » **Consolidation of GSA Schedules / SINs / Labor categories**
 - Streamline duplicative offerings
 - Implications of changing labor categories on business model and culture (i.e., customer and employee retention issues)

Post-Merger Integration – What Typically Happens?

» Consolidation / Revision of Business System Descriptions

- Align business systems and compliance processes
- Update policies, procedures, and system descriptions to reflect new organization
- Consider business system changes and the impact on the business model and customer service process

» Notifications / Disclosures

- Novations and Agency-specific requirements (e.g., DOD contractors with restructuring costs > \$2.5M)

» System Integrations / Updates

- To operate as one
- Reflect aforementioned changes to indirect rates
- Facilitate internal controls and management policies/practices

» Change Management / Cultural Effects

- Communication is key

QUESTIONS?

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