

The Reckoning:

Implications of Aerospace, Defense, and Government Consolidation Led by Ongoing Services Segment Reorganization



Timothy Garnett · Timothy Wickham

Budget woes and LPTA are driving defense industry restructuring across the primes, however questions of scale and government unease regarding less competition may affect the evolution of this sector.

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As the end of 2015 looms for the defense and government contracting market, Avascent sees the forces shaping the market that we discussed in our May services sector assessment, *Breaking Bad or Good: Dawn of A New Era*, growing in their potential to fundamentally reshape the industry sooner than most observers expect. Given the more than \$20 billion in defense deals during the first six months of this year, the pressing strategic question to consider is what exactly will the government contracting sector look like when this high-stakes phase is over?

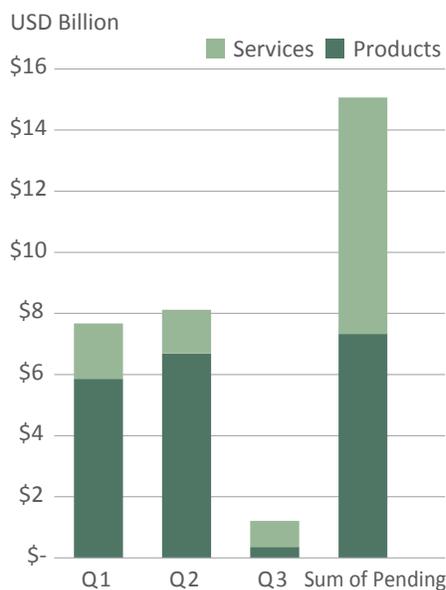
Management Redefines Core Businesses

U.S. defense budget weakness and the rise of lowest-price technically acceptable (LPTA) contracting requires both services companies and

product/hardware companies to focus on their respective core businesses.

Avascent maintains the view that the overall federal budget contraction, increasing use of LPTA contracting, and minimal industry restructuring prior to 2015 will drive significant restructuring. Current conditions will force consolidation among services contractors seeking to grow in scale, while wringing out excess capacity in the market. For large diversified contractors, these firms will likely shed their services lines of business as these operations neither add to their bottom-line nor generate meaningful revenue growth. This services-sector restructuring is likely to kick off a broader realignment of the defense industrial base as

Major M&A in the Government Contracting Market for 2015



Notable M&A Deals from 2015 (by closing date)

Q1	Q2	Q3
<ul style="list-style-type: none"> • ATK (Orbital) • TASC (Engility) • CGRT (Bridge Growth Partners) • USIS (PAE) • Survitec (Onex) 	<ul style="list-style-type: none"> • Exelis (Harris) • Websense (RTN) • Scitor (SAIC) • A-T Solutions (PAE) • Acentia (Maximus) • Universal Robotics (Teradyne) 	<ul style="list-style-type: none"> • CGRT (Salient merger) • Alion (Veritas) • Kratos D&SS (Ultra)

Pending Wave of Deals

<ul style="list-style-type: none"> • Sikorsky (LMT) • LMT IS&GS Potential Divestiture • BAE Systems Intelligence & Security Potential Divestiture • SRA International (CSGov) • PAE (Sale or IPO by Lindsay Goldberg) 	<ul style="list-style-type: none"> • L-3 NSS Potential Divestiture • Vormetric (Thales) • Novetta (Carlyle Group) • STG (Global Defense & National Security Systems Inc)
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companies build out their core businesses with new capital from sales and spin-outs. One can imagine a future defense base made of a class of larger and almost pure-play services contractors on one side of the market, and product and systems integrators with leaner and mission-focused services operations on the other side.

Since Avascent released its May 2015 services sector assessment, there have been significant movements that support these dynamics, which will define 2016 as well. Below is a quick review of the major corporate M&A activities shaping the market this year.

The crucial question for the executives of leading services corporations is: What is the appropriate scale?

Government Constraints Drive Different Strategies Toward Scale

For services companies, their current investment thesis appears to be driven by management's desire to get bigger. The crucial question for the executives of leading services corporations is: What is the appropriate scale? At the top end of the market, Leidos has more than \$5 billion in annual revenue. Meanwhile, CSC's spin out of its Public Sector business into a new corporation to be named Computer Sciences Government Services Inc. (CSGov), along with its potential acquisition of SRA, is expected to create an entity with over \$5.5 billion in annual revenue. Based on Leidos' public statements, it appears the company will seek even greater scale than it currently enjoys.

But at what point does scale potentially begin to work against services companies? Within specific contracting communities or focused market segments (e.g. the U.S. Navy's Naval Air Systems Command or the U.S. Army's Communications Electronics Command), many government customers still want real choice among contractors: Government customers can become leery of having too many outsourced contracts under a single company's control. Whether that number is 20% share or 50% share depends on the specific customer and its needs. At some point a large services contractor faces increasingly smaller market growth opportunities as they reach these invisible ceilings within the various contracting communities they support. As their current strategy succeeds, publically traded services contractors could start to trade at a discount due to their more limited growth prospects due to this market constraint. One benchmark at which growth will become harder for scaled services enterprises could be the \$10B in annual revenue that SAIC reached prior to splitting into Leidos and SAIC. Above this revenue level, business areas may have difficulty generating sufficient new business to continue to propel growth and avoid cannibalizing business.

For the largest product and integration companies, their strategic goals may also be constrained by their customers — at the policy level. U.S. defense officials voice growing unease with possible consolidation among prime contractors because of its potential negative impact on competition. "If the trend to smaller and smaller numbers of weapon system prime contractors continues, one can foresee a future in which the department has at most two or three very large suppliers for all the major weapon systems that we acquire,"

said Frank Kendall, Under Secretary of Defense for Acquisition, Technology and Logistics, during a September briefing with reporters. “The Department would not consider this to be a positive development and the American public should not either.”

Services business spinoffs will play a key role in how prime contractor CEOs and boards of directors evaluate their strategic choices and whether they want to test this administration’s position on further prime contractor consolidation. While attention is on the expected closing of the Lockheed Martin acquisition of Sikorsky, the outcome of the ongoing “strategic review” of significant portions of Lockheed’s Information Systems & Global Solutions (ISGS) business should not be overlooked for its far-reaching implications. Speculation of a potential tax-free transfer, known as a Reverse Morris Trust, of over \$4 billion in IS&GS assets to one of the leading services contractors would certainly establish a clear leader in the race to achieve scale in that market.¹ If successfully accomplished, it could spur other diversified prime contractors to consider similar moves in the attempt to focus on the business lines they believe represent the best long-term bet. Northrop Grumman’s recent reduction of major business units from four to three can be seen as a step in this very direction. Other pending activities in the market include: The potential sale of BAE Systems Inc.’s Intelligence & Security business, CSC’s spin out of

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 1 A Reverse Morris Trust or RMT is a tax-avoidance strategy, in which a corporation wanting to shed assets can do so while avoiding taxes on any gains from those assets, through the selling company creating a subsidiary that then merges with the external buyer. This subsidiary then issues shares to the shareholders of the selling company and transfers the assets. (Source: Investopedia)

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CSGov, and the potential merger of CSGov with SRA International upon the spin out of CSGSI.

Other Issues Key to the Industry’s Future Structure

In the near- to mid-term, however, executive management should make time to consider four areas key to an organization’s long-term strategy:

1. **Resolution of Pending M&A and Spin-outs:** A number of either pending deals or announced “strategic reviews” could unleash another round of catch-up moves by competitors or potentially put the proverbial cork back in the bottle. How Wall Street perceives second-movers will be crucial to setting the tempo for how rapidly companies act to restructure.
2. **Budget Drama:** Budget uncertainty continues to be one of the major forces shaping corporate leader’s decision making. Depending on how the current political wrangling over funding the government this fall and winter proceeds, companies may reevaluate their exposure to certain customer segments that are not well supported during an ongoing continuing-resolution funding scenario.
3. **Large New-Build Contract Awards and Pending Competitions:** Large New-Build

Contract Awards and Pending Competitions: A select number of major Defense Department contract awards for clean-sheet aircraft and ground vehicle platforms will influence how industry leaders shape their portfolios. The recent award to Northrop Grumman to develop the Air Force's Long Range Strike — Bomber forces the winner, and the loser, to make strategic decisions about existing business lines as it takes on this high-stakes program. As well, the recent award of the Joint Light Tactical Vehicle program to Oshkosh, for example, will certainly force the losing bidders to reevaluate their commitment to their tactical vehicle operations. Likewise, with Boeing on the losing team of the LRS-B program and facing the sunset of the F-18 line, the aerospace giant faces some tough corporate decisions about its military aircraft business. At the very least, it raises the pressure to win the upcoming Air Force T-X training-jet program.

4. *Market Multiples for Public Companies:*

Lastly, it is important to consider how the trends discussed here will impact historically high price-to-earnings multiples for most companies across the defense and government contracting market. If interest rates rise or we see reduced holdings of defense stocks by institutional investors (or some other shift that lowers share prices significantly), board room conversations on strategy will certainly change.

By no means do we answer all the key questions facing executive management in this piece — and there are many more worth exploring: As there may finally be a glimmer of growth looming within the core of the government and defense contracting market, could this also accelerate

focus on core markets? Will government and defense contractors finally stop pretending to diversify into commercial markets? As growth prospects in the U.S. reach a sort of parity with those in international markets, will that intensify attention and inorganic investments on U.S. customers, especially given the complexity and difficulty of international markets? In addition to seeking scale, will the services market also see a further segmentation across high-end engineering services and low-end technical services?

Each firm will arrive at its own answers to these questions. There is no one right answer or a single correct conclusion. Yet for management to chart a sensible course requires understanding the long-term implications of the services segment's strategic choices in the coming year — and the role such decisions will have in shaping the future structure of the U.S. defense industry.

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About Avascent

Avascent is the leading strategy and management consulting firm serving clients operating in government-driven markets. Working with corporate leaders and financial investors, Avascent delivers sophisticated, fact-based solutions in the areas of strategic growth, value capture, and mergers and acquisition support. With deep sector expertise, analytically rigorous consulting methodologies, and a uniquely flexible service model, Avascent provides clients with the insights and advice they need to succeed in dynamic customer environments.

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