2018 GAUGE REPORT

Second Annual Industry Roadmap of Benchmarks and Trends for Government Contractors

Use the GAUGE as a tool for growing your business regardless of size. This edition is especially useful as you move from small-to-large; sub-to-prime; or sole source to full-and-open.

CohnReznick
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Projects, People & Financials

October 2018, Second Edition

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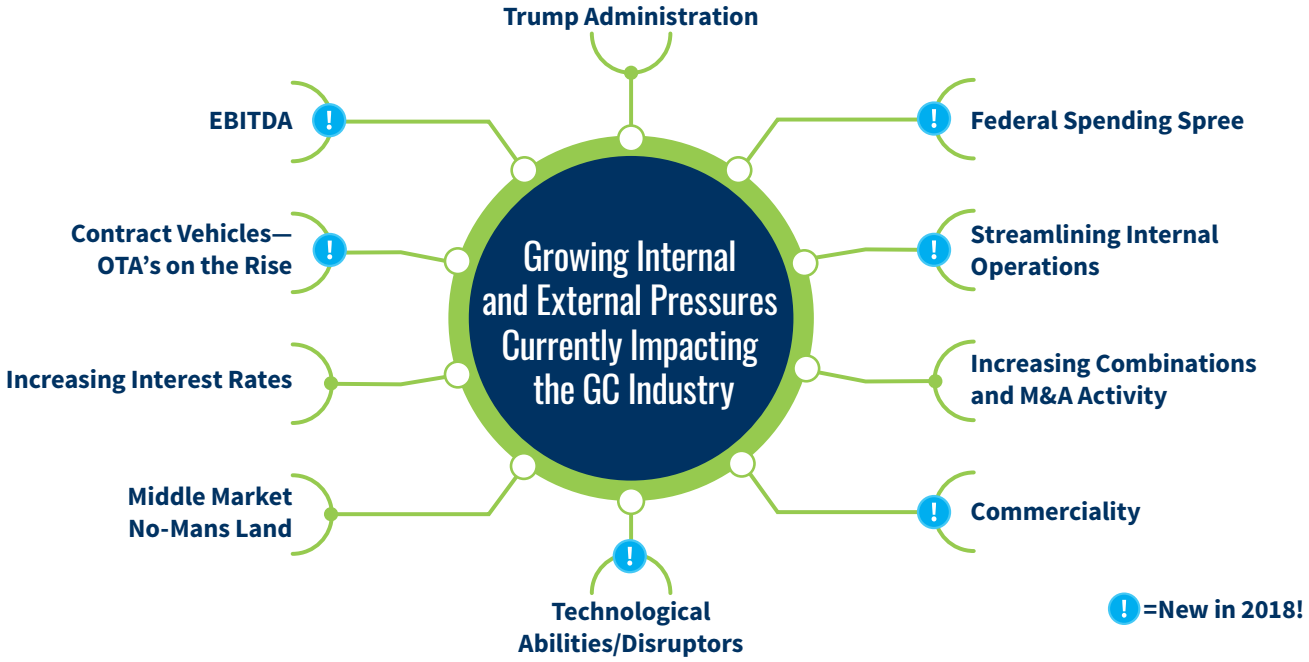
October 2018, Second Edition

Thank you to our respondents and contributors for participating in our second annual survey and providing valuable insights for the GAUGE report. Several new questions were added this year in areas of project management, financial challenges, and relationships with the federal government.

EXECUTIVE SUMMARY

The more things change; the more things stay the same as the old adage goes. The environment for government contractors can be characterized as both vibrant, yet stagnant, and complex, yet simplistic. From one year to the next, our survey findings reveal that companies want to streamline their internal operations with shared-services models and bring consulting work in-house to save money. Mergers and acquisitions began to pick up in mid-2017, and have been climbing in 2018. Interest rate and tax reform discussions are no longer what-ifs but facts of life, and new contract vehicles like Other Transaction Authority agreements are no longer old wives' tales. **Our respondents in 2018 gave us great findings and some surprises.** As the Trump administration weaves through tariff alterations and attempts to shake up the world economy, government contractors remain steadfast and positively focused on how to help the federal government be faster, better and more efficient. Fixed price contracts rose in our respondents by 6% and commerciality determinations are rising too as DCMA Commerciality Centers around the country mature to effectively identify products as commercial. Technology and aritificial intelligence is creating a new world of disruptors, and our respondents are on the forefront of making that happen.

We note in the below environment chart some of the major pressure items listed in the 2017 edition and identified the new items for 2018. Which one of these is affecting you the most? Which ones have you not thought of, but need to be thinking about?



65%

OF THE RESPONDENTS WERE OPTIMISTIC ABOUT THE CURRENT ENVIRONMENT OF GOVERNMENT CONTRACTING

16% WERE NEUTRAL

19% WERE PESSIMISTIC

How will federal contractors ensure their success in the upcoming fiscal year and beyond? CohnReznick and Unanet are honored to partner again for the second annual GAUGE Report by using the survey data we compiled this year to bring you fact-based information on current federal contractor compliance, accounting, utilization, growth, and efficiencies, and then projecting and observing how these areas will be impacted in the coming years.

"We enhanced the survey data with our advice on best practices, a combined 50+ years of industry knowledge, current economic indicators, and forward-thinking advice from fellow advisors. Our goal was to provide a report that would serve as a state-of-the-industry measurement tool for the government contracting ecosystem. We also used this information to provide practical advice for both strategic and budget planning purposes."

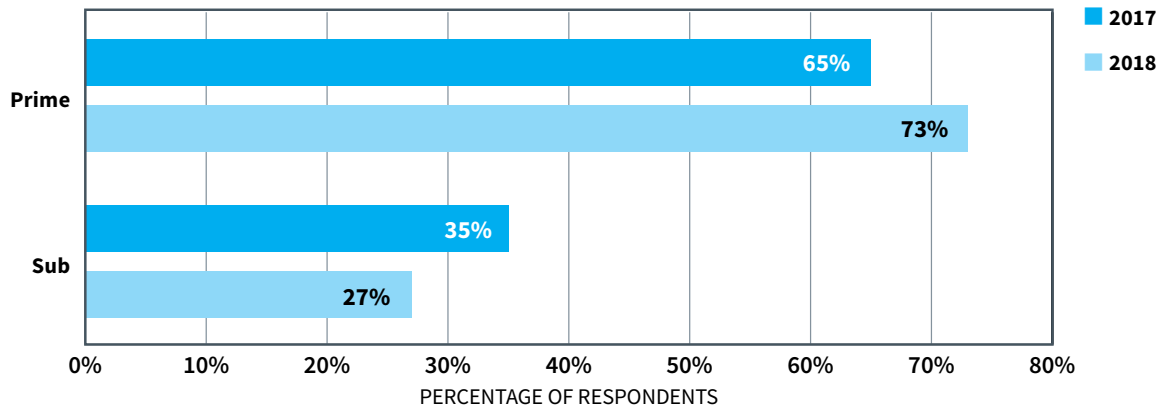
—Christine Williamson, CPA, PMP, Partner, CohnReznick Government Contracting Industry Practice

USING THE GAUGE REPORT

WHY THE GAUGE REPORT AND WHY READ IT NOW AND KEEP IT FOR LATER?

The GAUGE Report is a tool for government contractors to compare themselves to others in the industry. The information in the report is organized by company size, making it is easy for comparisons from one competitor to another. With a tremendous amount of optimism, organizations are thinking about growth and profitability, and how to make them both a reality. One way to grow and be more profitable would be to consider moving from a sub-contractor to a prime, small-to-large size, or sole source to full-and-open contracts. Our respondents say the trend year over year is moving towards prime contracting.

Prime vs. Subcontracting Year Over Year Difference (2017 vs. 2018)



If you are considering making the move to prime, you will need to understand the regulations, responsibilities, and the increasingly competitive contracting marketplace before making the leap. While there are numerous opportunities if you do become a prime contractor, there are costly mistakes that may be damaging to any uninformed new prime contractor.

The 2018 GAUGE Report is intended to provide valuable information for all size contractors, but this edition is especially for subcontractors and smaller companies alike pursuing prime contractor status. We aim to address several questions such as how to determine if your company is ready for prime contractor status, which steps to take to become a prime contractor, and what are the industry best practices for structuring your company and making strategic decisions necessary to ensure success. All contractors face these questions, and major contractors want to know their subcontractors understand the ins and outs of what it means to work with and around the federal government.

The responsibilities associated with supporting the government contracting/procurement lifecycle increase significantly as a company progresses from subcontractor to novice prime contractor, to experienced prime contractor, as illustrated in this table:

EVENT/PROCESS/TASK	SUB	NOVICE PRIME	EXPERIENCED PRIME
Work inside customer	◆	◆	◆
Identify hot buttons/needs			◆
Work with customer on requirements definition			◆
Review draft/shape RFP		◆	◆
Initiate draft proposal		◆	◆
Respond to formal RFP	◆		
Respond to prime data call (rates and resumes)			◆
Formal Make-or-Buy analysis			◆
Develop RFP to subs with SOW			◆
Technical writing		◆	◆
Bubble chart (capabilities matrix)			◆
Compliance matrix			◆
Proposal outline – responsibility matrix			◆
Color reviews			◆

Two terms used in this table may not be familiar to you, so here are the definitions.

A **novice prime contractor** is a small-to medium-sized company that sells its services to the government (no subcontracting; minimal purchases of goods and materials), but is primarily responsible for preparing proposals in response to government solicitations.

An **experienced prime contractor** is a larger business that: 1) pursues larger government opportunities, 2) provides technical solutions to relatively complex requirements, and 3) works with “teaming partners” (potential subcontractors) that typically require teaming agreements, non-disclosure agreements, formal subcontractor solicitations, and related documents.

While there is no hard-and-fast business plan format for moving from sub-to-prime, small-to-large, or full-and-open, the format should address certain key aspects of your company and strategy, including:

- Vision and Mission: What will your business look like in three years? Five years? What is your company's mission? Its purpose?
- Success: How do you define success? How will you measure it?
- Strategy: What are you selling and to whom are you selling? What is your unique value proposition?
- Finances: How much capital will you need to grow? How will your expenses change in three years? Five years? How will you meet those expenses (income)?
- Plan of Action: Who will you hire and when? Who will you market to and when?

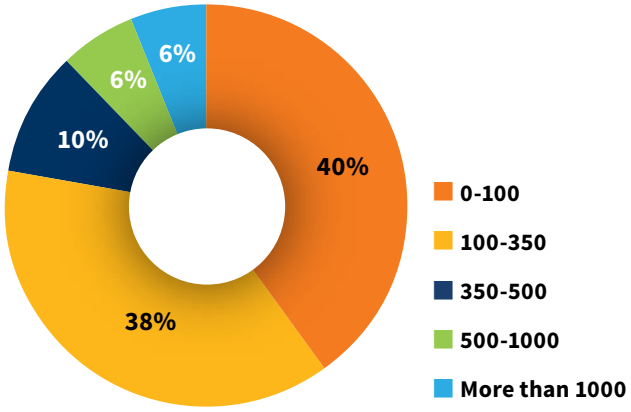
"Are you employing the optimal number of business development, IT, or finance staff? Are your indirect rates above, within, or below the average? Using the GAUGE report as a benchmarking reference will validate or change your government contractor organizational decisions, provide ideas for improvement, and, ultimately drive your company to better results!"

—Fran Craig, Founder and CEO Unanet

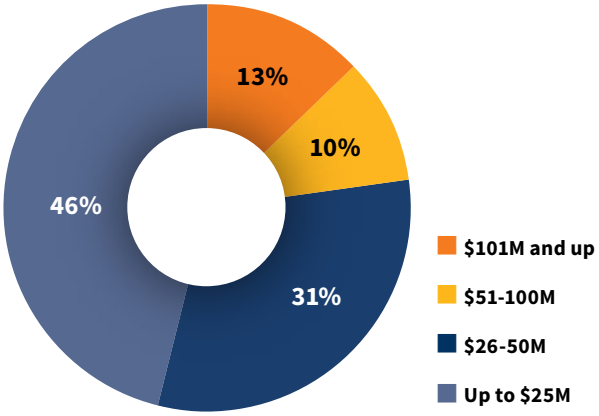
GAUGE SURVEY RESPONDENTS

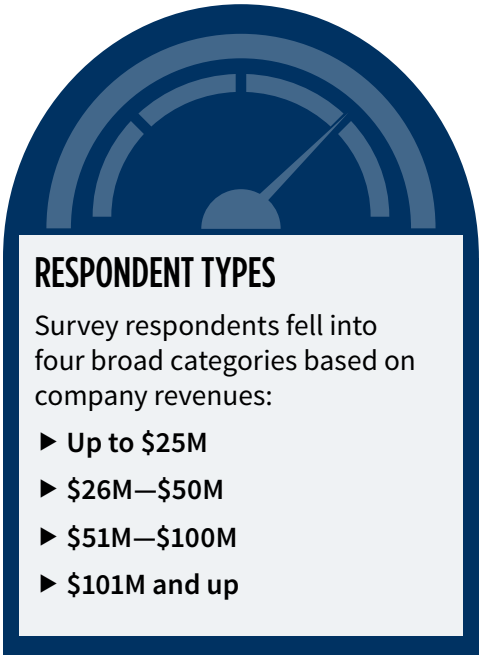
The 2018 GAUGE Survey, conducted from February to May 2018, had over 1,500 contributors representing a wide array of government contractors from all sizes and shapes within various industries and agencies across the United States. Revenue and employee size of the survey respondents is reflective of government contractors, C and S corporations including public and private entities, private equity backed companies, and even some not-for-profits.

Total Number of Employees



Respondents by Revenue





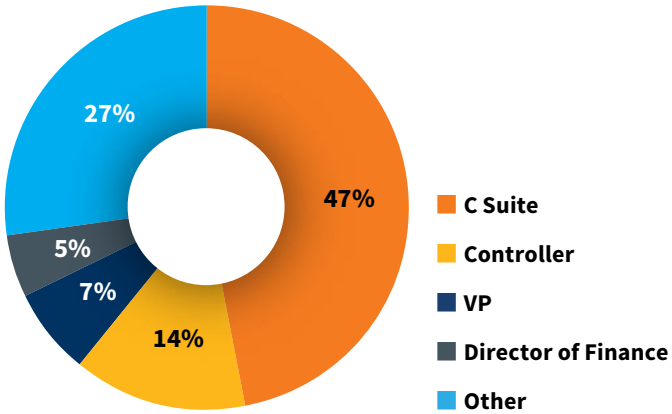
RESPONDENT TYPES

Survey respondents fell into four broad categories based on company revenues:

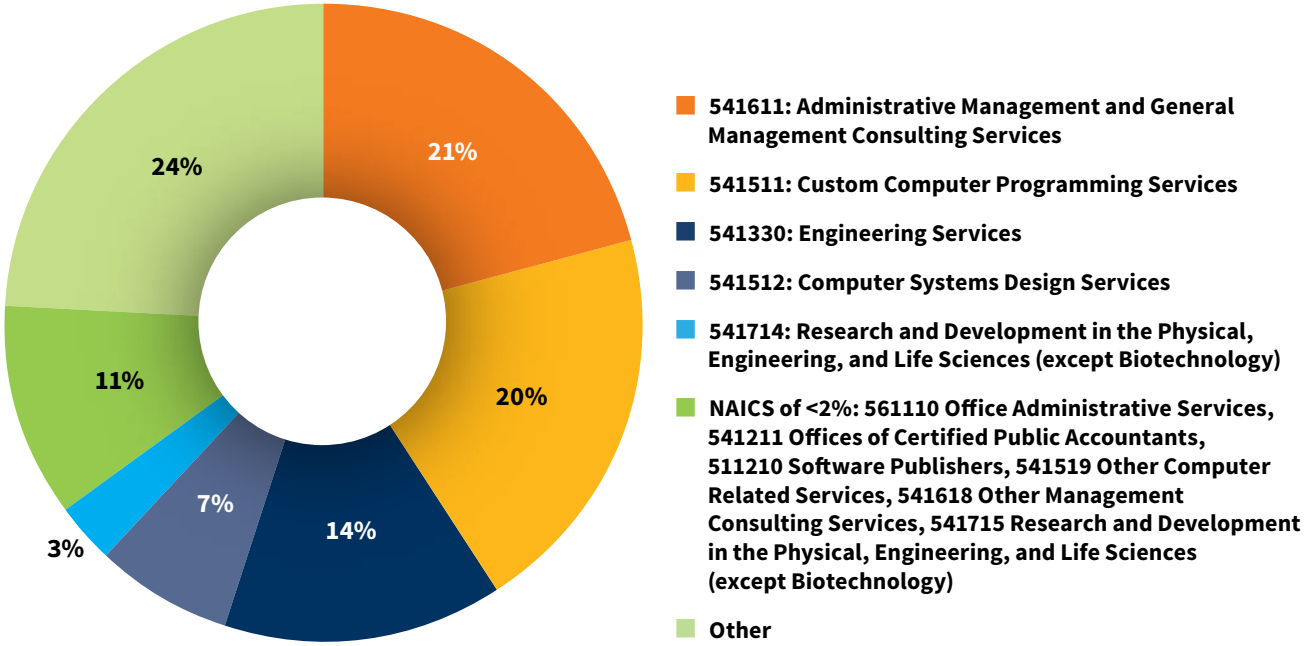
- Up to $25M
- $26M—$50M
- $51M—$100M
- $101M and up

The respondents' job responsibilities are a cross-section of C-suite, VP/Director level and individual contributors making for a balanced set of information.

Titles of Respondents

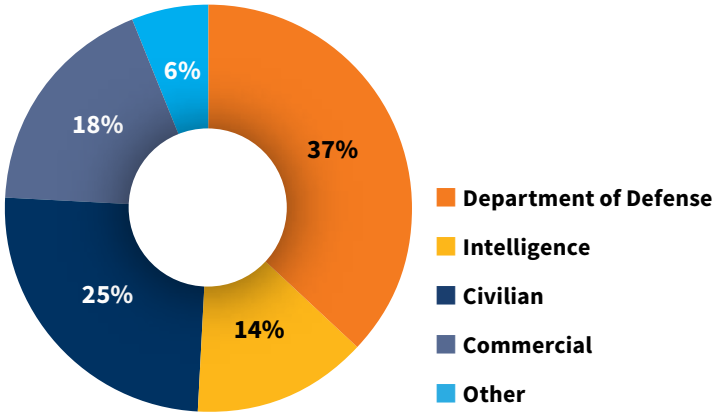


Primary NAICS Codes



NAICS codes are how the government contracting industry bids, determines size, team, type of work, and how contractors are defined by the IRS for all industries. NAICS codes were also used to gather information for this report. Knowledge of NAICS codes will help you interpret the charts presented in the GAUGE.

Agencies



Many of our respondents work with several agencies or just a few. Not surprising, the Department of Defense leads the pack in contracts awarded to respondents, followed by civilian agencies. The government contracting industry in general is branching out into commercial work as the percentage is up to 18% in this year's GAUGE which is a dramatic increase from 2017.

GOVERNMENT CONTRACT COMPLIANCE

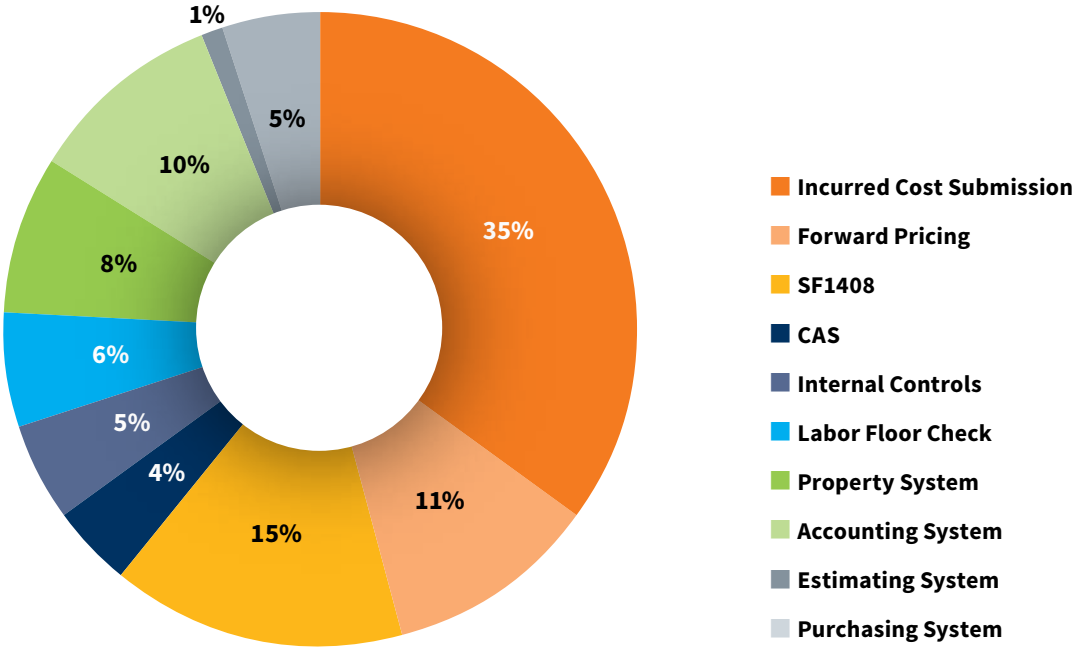
SUMMARY

- 73% of the respondents say that government oversight was the same as last year, and 22% said it increased, while only 5% said they experienced a decrease; making compliance a priority for 2019
- DCAA plans to free up auditors that were dedicated to the incurred cost backlog reduction and anticipates them to focus on proposals and business system audits
- Incurred Cost Submissions were the most popular audit with SF1408 (pre/post award surveys) coming in second, followed by forward pricing

CONSIDERATIONS FOR THE UPCOMING YEAR

- 809 panel recommendations on the type of auditor and when to audit; additional Independent Public Accounting (IPA) firms getting into the mix of auditing for Civilian Agencies, and possibly DOD in the next few years
- Business System audits becoming outdated per the DCMA maintained Contractor Business Analysis Repository System (CBARS) and the likelihood these business systems may be a requirement in any size proposal
- Use the checklist in the appendix to understand how you'd be subjected to one of the business systems
- Training staff new to government contracting compliance due to the influx of new contractors
- Contract Closeout procedures needing to be refreshed and preparing contract closeouts will be on the rise now that indirect rates are finally approved from previous years

DCAA Audits



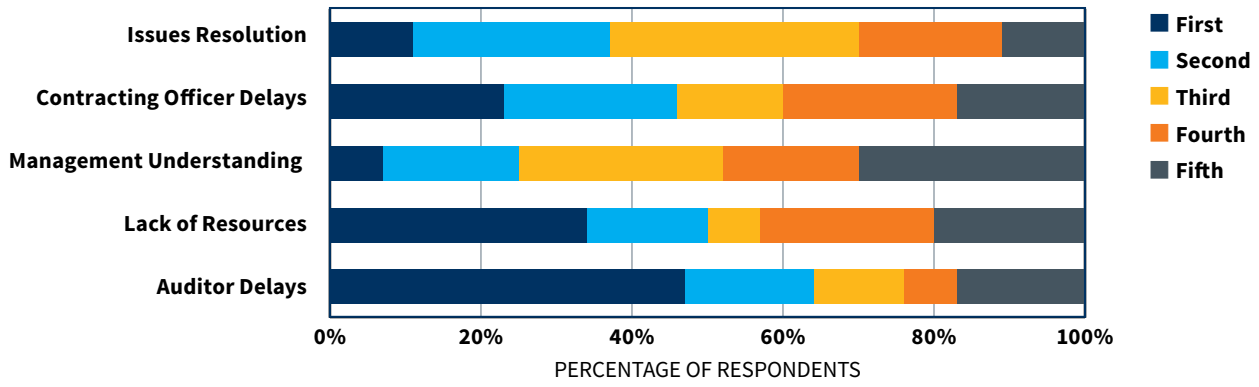
The progression from subcontractor to experienced prime contractor also requires the implementation of certain government-required business systems. As shown in the table below, the Defense Federal Acquisition Regulation Supplement (DFARS) identifies six specific business systems the government requires of most prime contractors and, more recently, subcontractors:

SYSTEM	IMPLEMENTING DFARS CLAUSE	SUB	NOVICE PRIME	EXPERIENCED PRIME
Accounting	252.242-7006	◆	◆	◆
Earned Value Management (EVM)	252.234-7002			◆
Estimating	252.215-7002		◆	◆
Material Management and Accounting System (MMAS)	252.242-7004			◆
Property Management	252.245-7003		◆	◆
Purchasing	252.244-7001		◆	◆

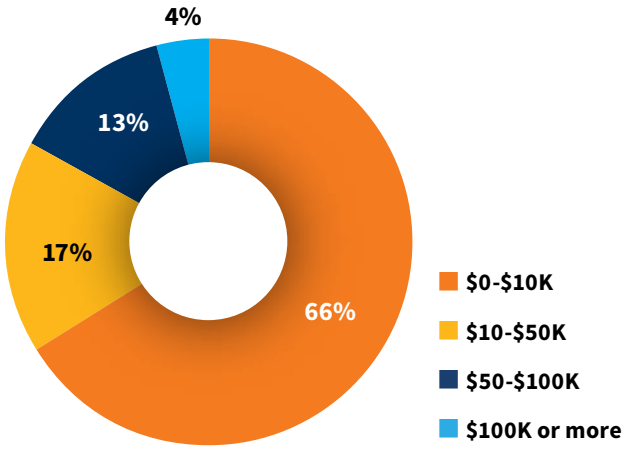
Several years ago, the federal government implemented rules defining certain contractor business system requirements. These rules help to ensure that contractors have the infrastructure, process, and procedures needed to adequately conduct and manage government prime contracts. The table above shows the differences in system requirements between novice and experienced prime contractors. These differences occur primarily because experienced prime contractors will have a higher level of project management responsibilities that will include implementing a larger number of DFARS business systems based on solicitation requirements and the type and complexity of the associated contract.

Many are breathing a sigh of relief that incurred cost submissions audits are becoming caught up but it's not without a little pain along the way. The primary challenge in finalizing incurred cost audits was auditor delay and the second challenge is resolution of issues found during the audit. The DCAA hiring freeze was lifted in April 2018 so expect to see continued improvement in timeliness which may also increase due to pre-approved contractor multi-year audit techniques. With the addition of IPAs in the mix of auditors, we are interested to see the results of this question in the 2019 GAUGE to see if delays continue to be a problem.

Challenges in Finalizing Your Incurred Cost Audit

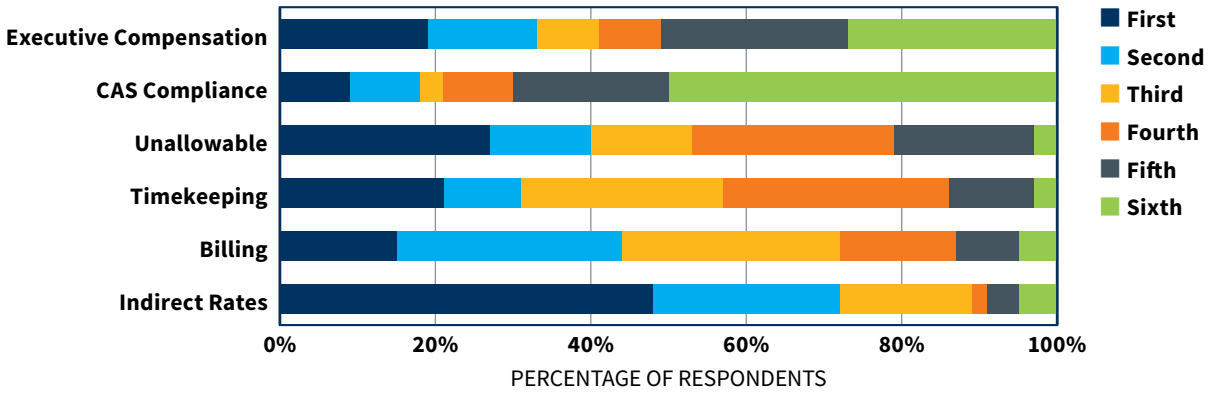


Amount of Questioned Costs on Incurred Cost Submission



The reduced level of questioned costs indicates contractors are getting savvy in their accounting discipline to include processes and tools which emphasize compliance. The industry should be pleased by the results of this question, as audits are not done solely to find questioned costs, but to also prove the contractor has followed the FAR and understands compliance. There are contractors who welcome audits, as they fully understand their responsibilities under the federal government audit process and realize these audits can and improve their image and experience as a contractor.

Biggest Audit Challenges



The most significant incurred cost audit challenge is indirect rates, with billing not far behind. That is no surprise because the calculation of indirect rates and cost pools can be a challenging concept for organizations new to government contracting. Mature contractors in growth mode also struggle as their pools become more complex. There is a need to strategize on the best methodology to accurately reflect cost and bid new work. Billing continues to be difficult as the nature of the beast is timing, accuracy, specificity and completeness. Many customers have specific instructions that cause the need for job cost accounting systems, very detailed billing analysis, and contract knowledge.

ACCOUNTING

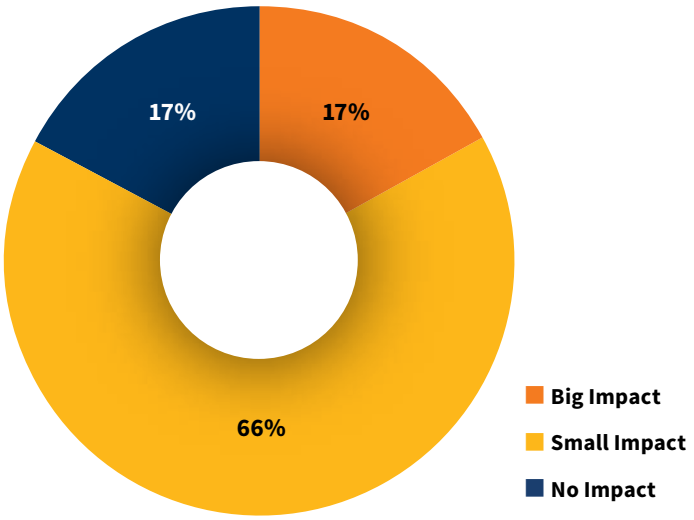
SUMMARY

- Tax reform changes are permanent vs. sunsetting in a year
- Indirect rates continue to challenge organizations
- Cash is king and contractors continue to see a decrease in Days Sales Outstanding (DSO)
- Time to prepare invoices remains extensive and additional automation could help to fix this trend
- The Tax Cuts and Jobs Act of 2017 lowers the maximum corporate tax rate from 35% to 21%, establishes a new deduction for pass-through businesses, and created certain disallowances of meals, entertainment, and transportation
- All revenue categories in our survey are taking advantage of contracts awarded by various Schedules and the organizations in revenue ranges of $26-$100M are reporting over 30% of their total revenue is coming from a Schedule

CONSIDERATIONS FOR THE UPCOMING YEAR

- Many companies should consider tax planning and gain an understanding of the potential impact of the Reform before the end of the year
- 66% of our respondents said there will be a small impact and 17% believe the impact will be significant to their businesses from the tax reform
- Revenue adjustments may occur because of new standards (beginning in January 2019 for non-public companies) on revenue recognition ASC 606, which is especially a concern for contractors with firm fixed priced contracts
- Leases will be accounted for differently (beginning in January 2020 for non-public companies) with the new accounting standard ASC 842 that could have an affect on your debt covenants

Impact of Tax Reform



General Service Administration (GSA)—Schedule contracts are designed to help purchase products and services. They contain pre-negotiated prices, delivery terms, warranties, and other terms and conditions which streamline the buying process. Requirements to obtain a GSA Schedule Contract are:

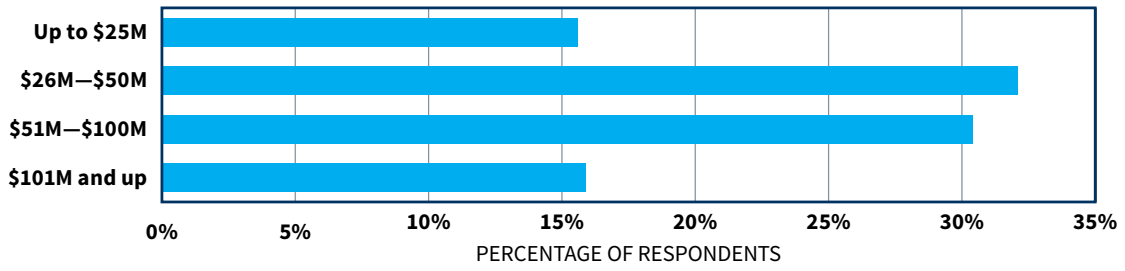
- Financial Stability
- At Least two Years in Business
- Past Performance
- Products Commercially Available
- Products Compliant with the Trade Agreements Act

Make use of all of your options to help grow your business.

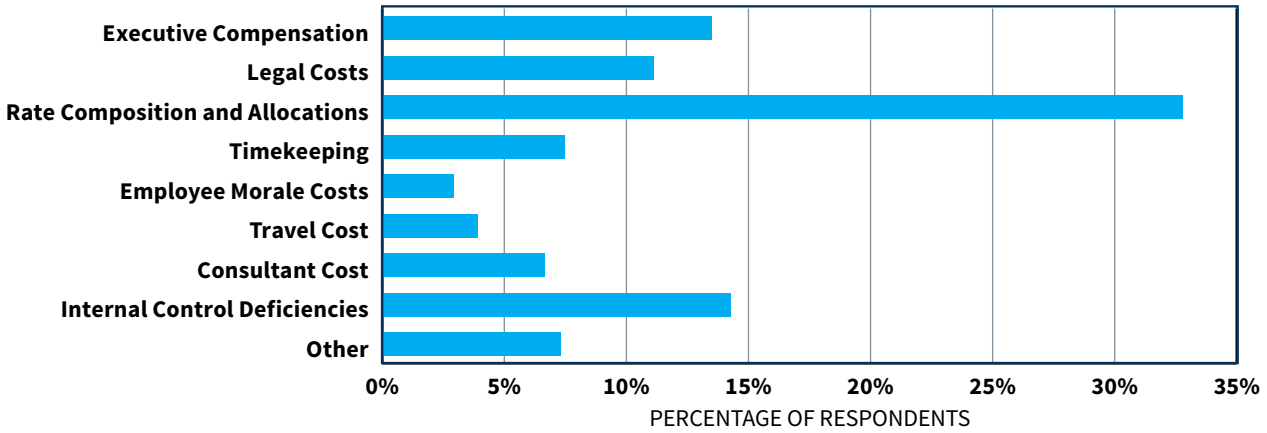
GSA Professional Services Schedule (PSS) Contract contains a subset of services for consulting and training that are classified as Mission Oriented Business Integrated Services (MOBIS).

Companies should consider MOBIS as a way to grow without the burden of the RFP process, and they may be more lucrative in an acquisition due to less compliance concerns.

Revenue from a Schedule (MOBIS, Alliant, GSA, or Other by Revenue Scale)



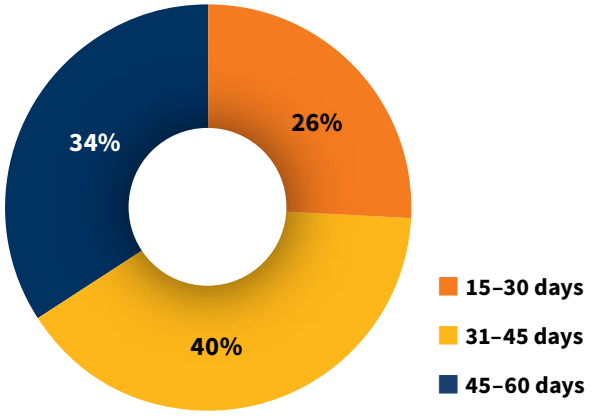
Biggest Indirect Cost Issues



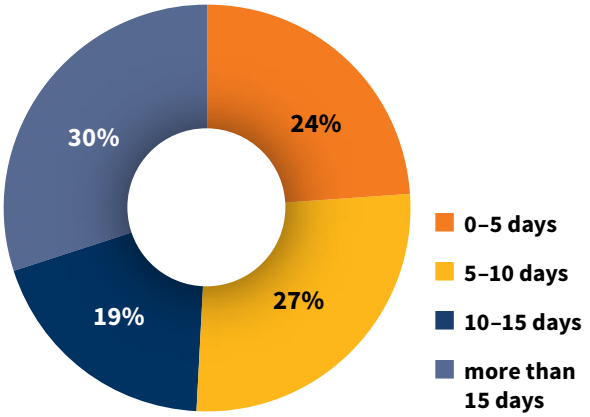
Accounting for indirect costs continues to be a challenge from the reporting and management of the expenses. Respondents note the lack of knowledge of how to compose indirect rates and allocations as their biggest indirect cost issue as this issue was the #1 audit item as well in the compliance section of the GAUGE. Executive compensation and internal control deficiencies round up in a dead heat for second place and respondents also told us the "other" category includes problematic indirect expenses for government contractors such as healthcare, bonuses, pension, ESOP and facility cost.

Reporting of executive compensation is mandatory in the incurred cost submission. It is no longer defined as executives but has been changed to the top five highly paid. The compensation cap for contractors for 2017 was $512k and for 2018 is $525k, but keep in mind compensation must be reasonable for the company size. If you are a small government contractor, DCAA would consider it unreasonable for the top-5 highly paid to earn up to the ceiling. Auditors will use salary surveys and their own analysis to develop a position on what would be reasonable for a firm of your size. There is no rule of thumb for when DCAA will take notice to your compensation. However in almost every audit there is a requirement to review compensation in some capacity. Major contractors will certainly have the most scrutiny on their executives because of bonuses, stock options and other benefits that are not available to the masses. We recommend a compensation analysis be done by most contractors to determine what the excess is and voluntarily delete the excess from the company's indirect rates, because you will encounter a deficiency and face questioned costs in your audit findings.

Days Sales Outstanding (DSO)



Invoice Cycle



Companies are paying close attention to DSO, because cash is king and the government is paying many contractors in less than 45 days. Companies in the 45-60-day range should continue to look at their processes and tools to make sure they are maximizing their key performance indicators (KPI). Invoice cycles are evenly spread in our survey but 30% of respondents are still taking more than 15 days to get invoices out the door which is concerning. Many companies, as they grow, will find efficiencies in this area and invoicing automation can help get invoices done timely and correctly.

UTILIZATION

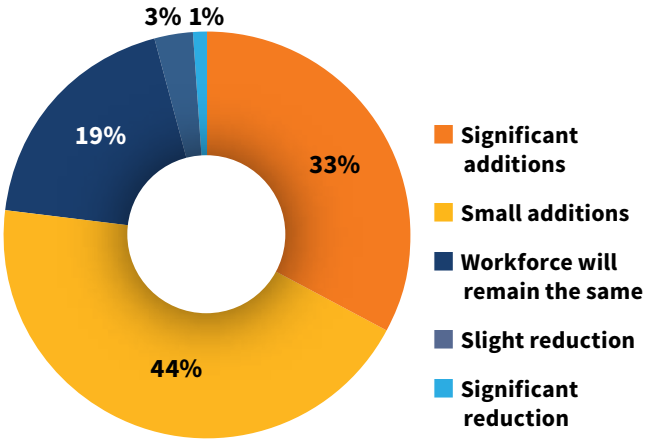
SUMMARY

- Optimism continues and companies are hiring
- Challenges exist in finding qualified talent, and talent with existing security clearances
- 56% of the respondents said that over 76% of their projects were performing to budget, which means there is room for improvement in the area
- 77% responded that projects were on time
- Indirect labor categories continue to be a KPI of keeping cost constrained and a new indirect labor category type was created in this year's survey called "Compliance"

CONSIDERATIONS FOR THE UPCOMING YEAR

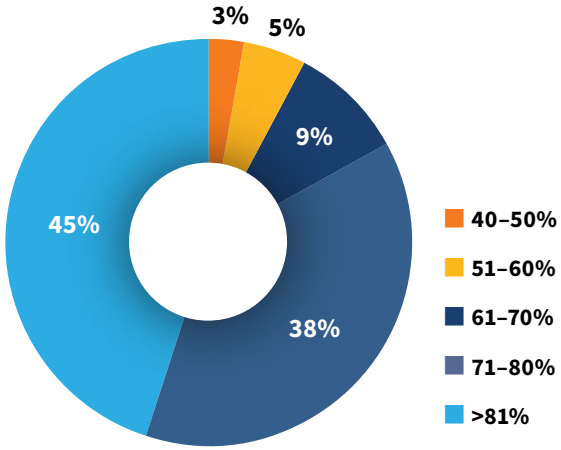
- Make sure you are maturing your resource management discipline
- 45% of the respondents said that their resource management discipline was immature
- Update your plan and understand the skill sets needed for new and existing projects
- Review the headcount by functional groups and compare to your company
- While preparing your budget, compare the number of indirect folks to the GAUGE, because this data has been used and consistently applied by many contractors

Workforce Expectations



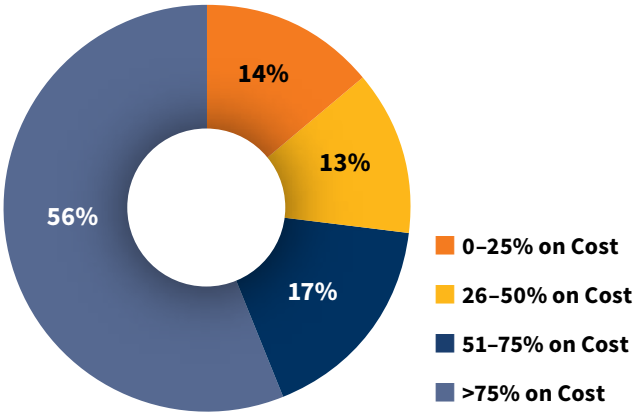
Hiring will be an important activity for 2018 and beyond. Accurate forecasting will be critical to make sure you have the right skills at the right time.

Overall Billable Labor Utilization

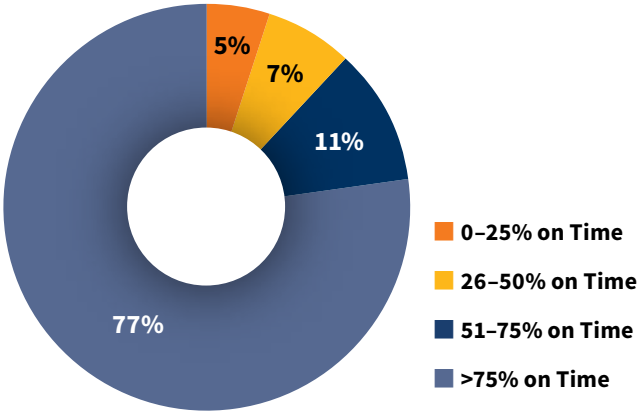


The survey shows high billable utilization, but there is still room for improvement as the government is slow to give acceptance of personnel and clearances can be untimely.

Percentage of on Cost Projects Enterprise Wide



Percentage of on Time Projects Enterprise Wide



Delivering to the customer on time is critical. This positive trend needs to continue to win follow-on work with your customer due to increased competition.

FTEs PER FUNCTION 2017

Revenue Size	Accounting	HR	Recruiting	IT	Contracts	Business Dev	Project Control
Up to $25M	2.5	1.1	0.6	1.2	1.4	1.9	1.2
$26M—$50M	4.4	2.4	1.6	2.3	2.0	3.9	1.6
$51M—$100M	7.3	3.8	0.8	3.5	3.5	7.3	2.5
$101M—$250M	15.8	8.3	5.8	11.3	5.3	8.5	5.8

FTEs PER FUNCTION 2018

NEW!

Revenue Size	Accounting	HR	Recruiting	IT	Contracts	Business Dev	Project Control	Compliance
Up to $25M	2.4	1.3	1.5	2.6	1.3	2.2	1.4	.9
$26M—$50M	4.1	2.5	2.2	2.6	1.9	4.7	3.0	1.3
$51M—$100M	6.0	3.1	3.2	3.0	2.4	7.9	4.6	1.4
$101M—$250M	9.1	3.9	4.9	5.7	4.8	9.4	4.4	1.4

Utilization of your indirect workforce is just as important as your direct workforce. The survey data compares the functional areas by revenue and company size, and provides year over year information. The data in these charts of the GAUGE are the most sought after data other than the indirect rate bands found in the efficiencies section of the GAUGE.

GROWTH

SUMMARY

- Growth is top of mind generally for contractors and the two-year federal budget could indicate stability; therefore, many believe it is time to seize new contract opportunities
- Increasing competition is keeping executives up at night
- 26% reporting win rates greater than 51% and 33% say their win rates increased from the prior year
- Best value is becoming in vogue, and LPTA is losing popularity
- Optimism is slightly tarnished by the years of political drama, as our respondents are worried about shutdowns, congressional delays, and funding constraints
- The number one finance challenge is organic growth
- Finding Business Development (BD) resources continue to be a challenge for organizations

CONSIDERATIONS FOR THE UPCOMING YEAR

- Make sure you have allocated business development (BD) resources to fuel your pipeline
- Watch performance on existing projects as increased competition is top of mind for executives

With so much opportunity, defining growth strategies is critical in this current environment. Good quality data can be put to work to help unlock growth strategies with the eight steps below.

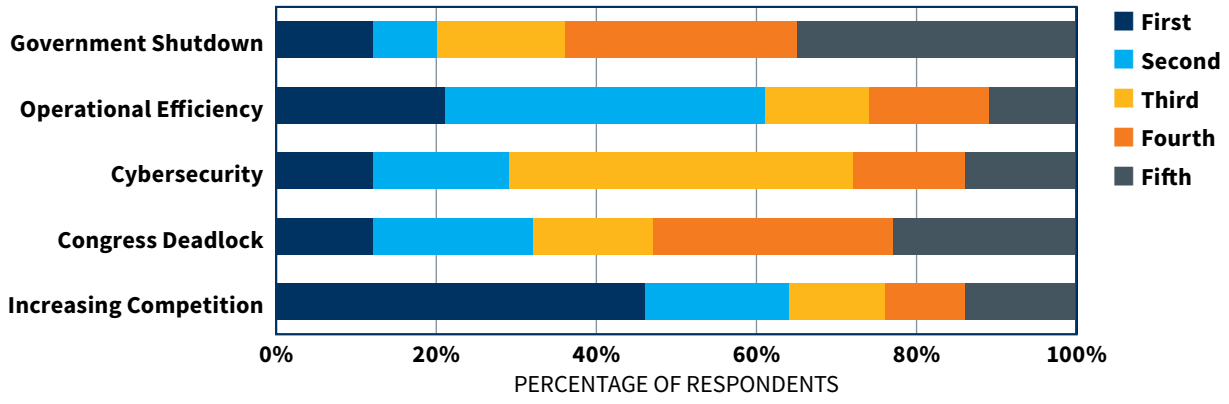
- Define your KPI's that help drive your strategy
- Use internal and external benchmarks
- Look for trends in the data
- Account for anomalies
- Take the time to probe deeper
- Utilize an Integrated Tool Set
- Create a revenue plan
- Develop marketing strategies

Budgeting revenue is crucial as it drives many other metrics (profit, growth rates, etc). The revenue plans are the barometer of your company health. The revenue plan will contain awarded contracts and opportunities that are still in the pipeline so make sure both are included.

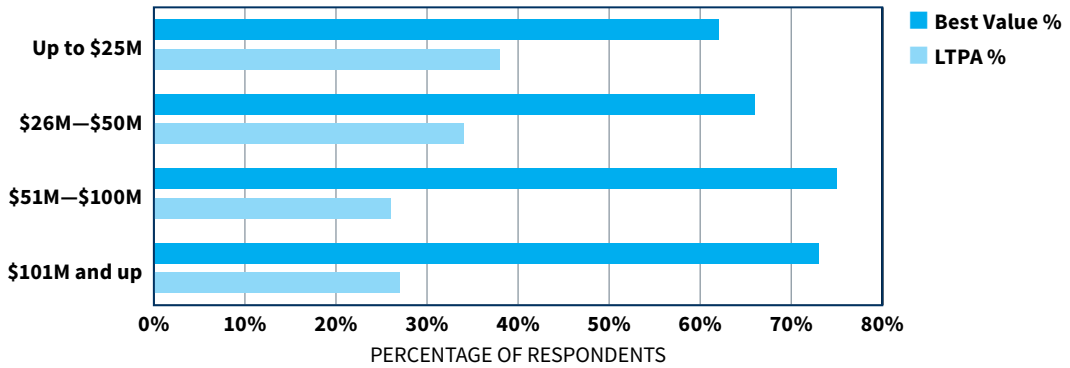
Tips for revenue budgeting are below:

- Look closely at your pipeline for new opportunities
- Understand how your profit is trending
- Labor vs Subcontractor—examine closely
- Examine backlog, breaking it out between opportunities and awarded work
- Benchmark your expenditures with prior year

What Issues Are Keeping You Up at Night



LTPA% vs. Best Value% by Revenue Scale



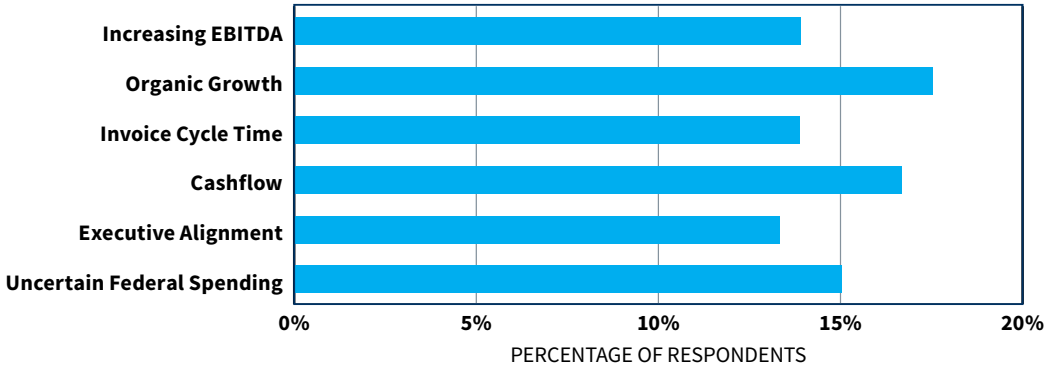
Developing a Successful Marketing Strategy

Which marketing strategy should you use? An inch deep and a mile wide? Or an inch wide and a mile deep? The answer is both!

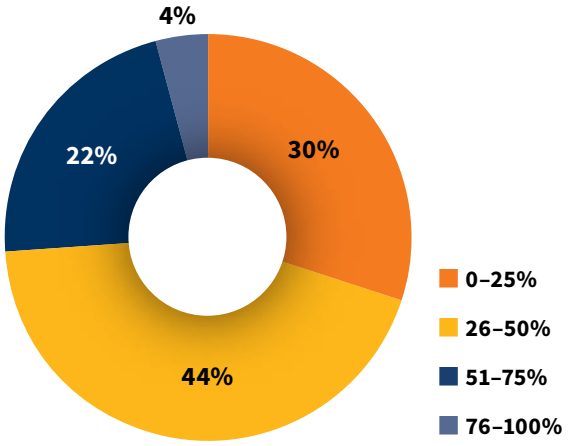
Your marketing activities should initially target 'low-hanging fruit'—non-stretch opportunities that provide you with a realistic chance of getting work. These opportunities, over time, will give you the experience, exposure, and funding you'll need to pursue the more technically-challenging (inch wide and mile deep) work that will really make an impact on your target customer base. The inch wide and mile deep work will begin to emerge after you forge a closer relationship with the customer, become more well-known, and develop a better understanding of the customer's wants, needs, style, and philosophy.

Part of your marketing strategy will be based on what you want to become and where you want to go. At least initially, niche-market opportunities that focus on your core capabilities should provide you with the best chances of success. Highly developed and crowded markets typically provide challenges that a smaller subcontractor will find difficult when pursuing prime contracts.

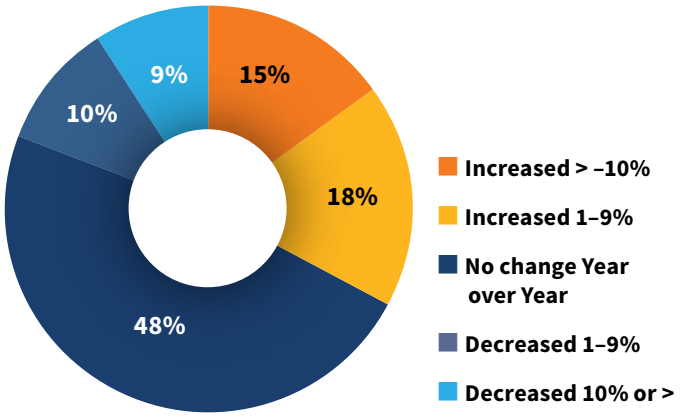
Biggest Financial Challenges



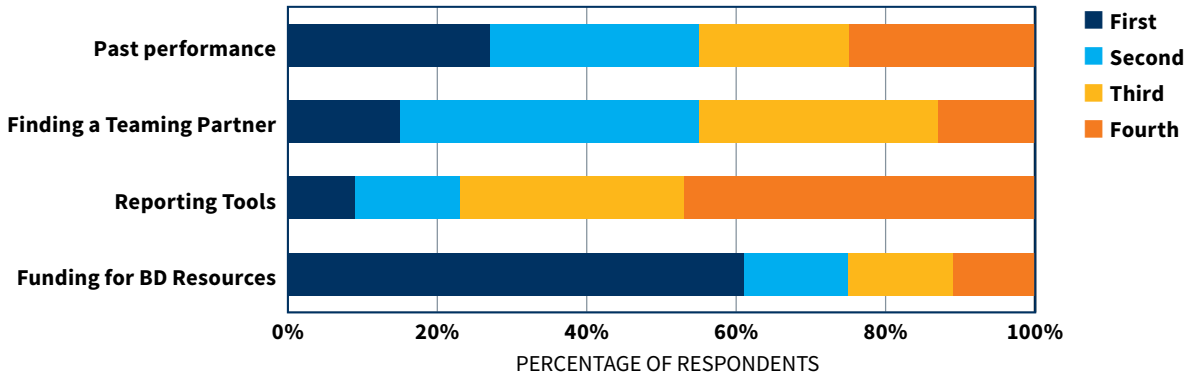
Current Win Rate



Changes in Win Rate Compared to Prior Year



Significant BD Challenges



7 TIPS FOR WINNING A GOVERNMENT CONTRACT

TIP 1

Carefully watch pipeline
Establish a pipeline review cadence and keep the opportunities up to date. Those successful at pipeline management have a contract selection methodology and process that they follow.

TIP 2

Fully assess the Probability of Win (Pwin)
If that probability is low, do not waste your valuable B&P dollars. Ask yourself this question, "Have you ever met or talked with the customer?" If the answer is 'no,' then don't include the opportunity in your pipeline.

TIP 3

Know your customer
What problem or pain is the customer looking to resolve? Take the time to truly comprehend how the customer operates. Several visits and research of the customer's operation is almost a necessity before they'll do business with you.

TIP 4

Listen to your customer
Stop talking about how great your company is and truly listen to customer needs. Ask them questions and listen attentively.

TIP 5

Identify what makes your company unique
What do you have that others don't? Technology? Inventions? Patents? Methodologies? Find a differentiator and highlight it.

TIP 6

Consider a teaming partner
A trend in today's govcon marketplace is to find a teaming partner. This is great for the customer and the contractor because it spreads the risk and makes for a stronger contractor, team. Get your agreement in place before you bid.

TIP 7

Have a documented capture process
Document the entire capture process and follow it. Keep continuity in the teams from capture, proposal, and, at a minimum, into the initial planning phase of execution.

EFFICIENCIES

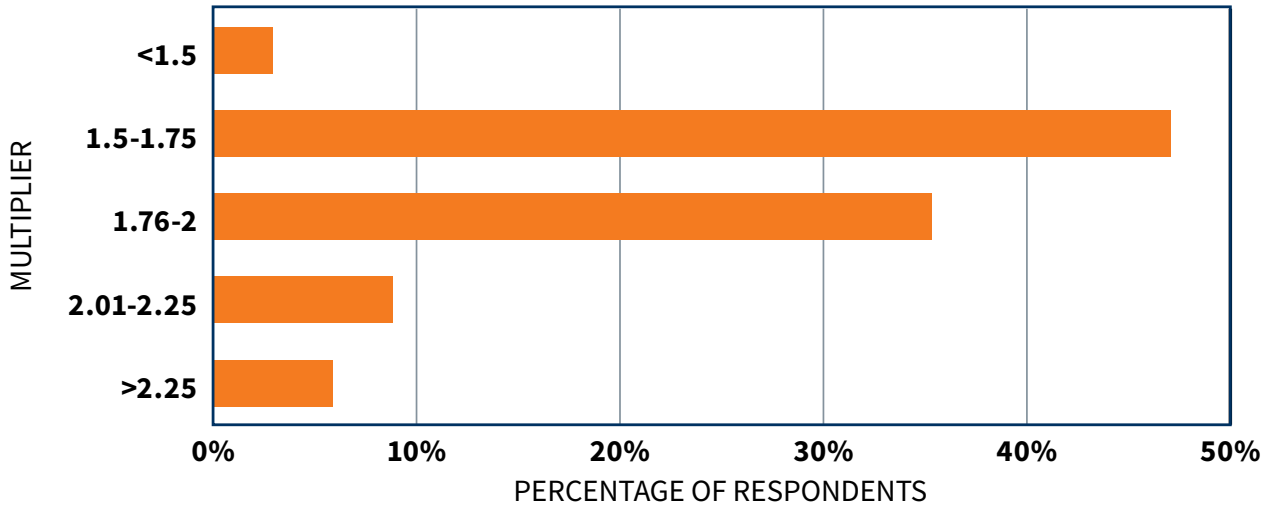
SUMMARY

- Indirect rate data is the most popular section of the GAUGE and provides a window into your competitor's rates
- Operational effectiveness is top of mind, so new questions were added to the survey in 2018 surrounding project management
- Survey indicates the #1 project management challenge is the inexperienced project manager

CONSIDERATIONS FOR THE UPCOMING YEAR

- Have a disciplined process for budgeting indirect costs and get buy-in from all parties
- If you do not have a Project Management Office (PMO) consider forming one and if you have an ineffective PMO revive it
- Consider investing in a project management training program and treat project management as a discipline in and of itself
- Compare your rates in 2018 to these rates in the GAUGE and use it again when you create your 2019 budget

Wrap Rates



Successful government contractors manage and monitor their indirect rates constantly regardless of contract type. Since the rates are going to be scrutinized by your customer a contractor must be aware of how their rates compare to others. Indirect rates are part of the dialogue and genetics of the business.

Observations and trends in rates from 2017 to 2018 are as follows:

$101M AND ABOVE COMPANY SIZE:

- Fringe was split among contractors in this year's survey as half of the respondents had a fringe rate of less than 30% in 2018 and the other half were somewhere in-between 36-40%, but none were higher than that. There was a split in 2017, but more respondents were in the 36-40% range.
- Overhead rate for contractor site remained the same at 31% or more for the majority of the respondents as well as the government site majority rate was 21% or more in both years.
- Materials/Subcontract Handling (M&H) has flipped in 2018 for our respondents and an overwhelming number (67%) are using a rate of 6% or more. In 2017, all of the respondents were lower than 6%.
- G&A rates overall have decreased for contractors at this revenue size and is hovering in the 11-15% range for 40% of the respondents compared to 33% of the respondents in 2017. G&A is definitely lowest in this revenue category as larger companies are generally able to make changes to infrastructure because of better management of rates in real time. With LPTA no longer an acceptable bid philosophy, many contractors still have to watch G&A costs and keep them reasonable for survival and winning.

$51-100M COMPANY SIZE:

- Fringe in this revenue size changed dramatically from our 2017 survey to this 2018 survey. We now have a significant number of respondents in all ranges of fringe rates, helping you to compare this year better than ever. 43% of the respondents have a fringe rate of less than 30% and 28% are operating with a fringe rate of 31-35%, which seems more realistic. As health care continues to be the biggest fringe cost, it will be interesting to see how companies continue to balance their fringe rates while keeping employees happy with more telework and flexible arrangements that are hard to value but, are a real benefit.
- Information on overhead for both contractor site and government site is also more useful in the 2018 survey than it was in the 2017 survey. The predominant rate is <20% for contractor site and <15% for government site overhead. Both of these are less, compared to what was reported in 2017.
- M&H surprisingly has decreased by resounding number of respondents using a 1%+ or lower rate in this revenue category. Contractors at this size are sometimes required by the government to use subcontractors and SMEs, subs and therefore, the cost of subcontractors is high and only takes a few internal resources of the company to manage the subcontractors which keeps the M&H rate low.
- G&A was predominantly a rate of 11-15% in the 2017 survey and now has crept up to the predominant range of 16-20%. The rise in G&A is apparent in all categories of revenue size except the $101M and above in this year's survey as some companies are spending more on compliance that weren't required to in the past.

$26-50M COMPANY SIZE:

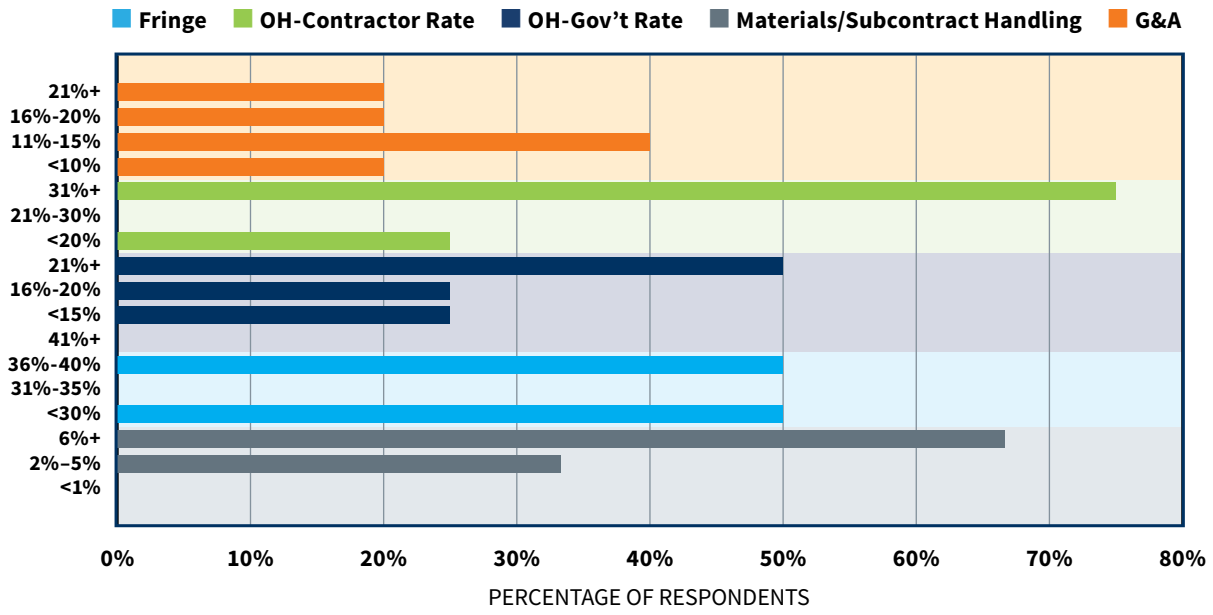
- Fringe rates of 30% or less increased in the percentage of respondents from 16% in 2017 to now 30% in 2018, and there are a decent number of respondents that have fringe rates of >41% or more indicative of companies increasing fringe benefit packages focused to keep talent over competitive proposal rates.
- Overhead rates for government site showed a new rate range where a number of respondents (approximately 12%) appeared to have increased their rate from less than 15% to an overhead government site rate between 16-20%. The majority sill remain at the 15% or less rate even though it appears to be on the decline.

- M&H of 2-5% is the optimal spot to be and that range did increase in respondents from 67% to 73% of the respondents from 2017 to 2018. Respondents also experienced an increase in the 6% or more M&H rate from 11% to 18% of the respondents from 2017 to 2018.
- G&A of 11-15% remains the overall majority rate in this revenue category but we did experience some creep of the +21% rate from 8% to 22% of the respondents in 2017 versus 2018. This was also evident in the up to $25M revenue size company as well.

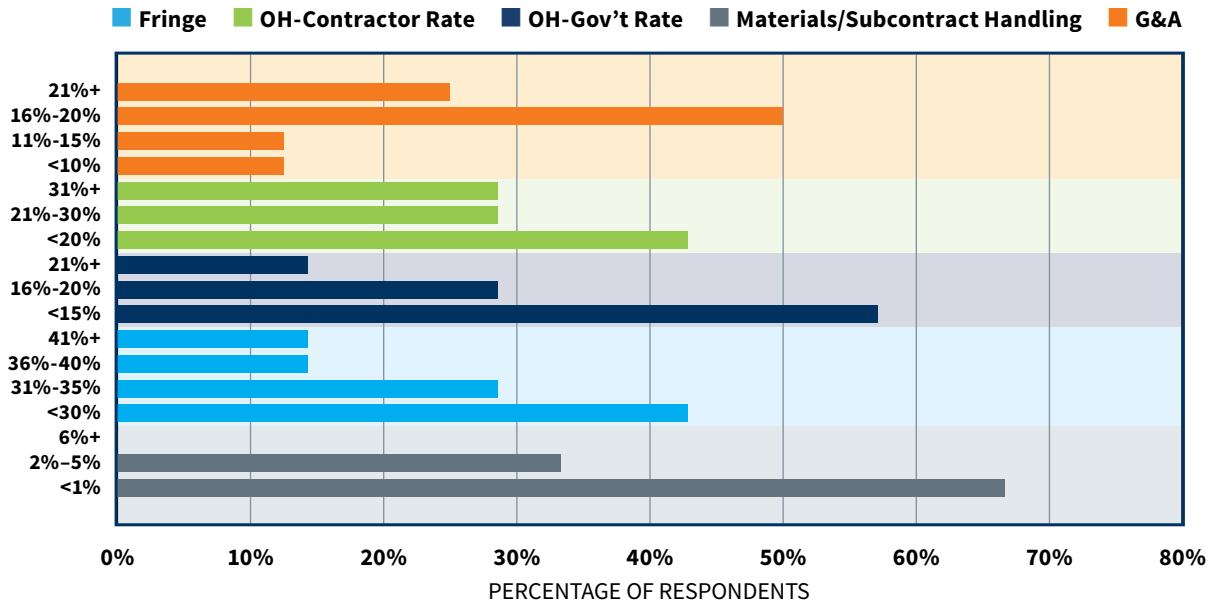
UP TO $25M COMPANY SIZE:

- Fringe is trending downward at this revenue size. The most dramatic is that 41% of the respondents in 2017 had fringe rates of +41%, but in 2018, this percentage of respondents dropped to 18%. The majority (52%) of the respondents in 2018 had a fringe rate between 31-40% which is indicative of improved operations and higher win rates we are hearing about in this revenue size.
- Overhead has seen a drop or remained the same in both contractor and government site overhead rates in 2018, just as we've noted in every size range. It's interesting that the contractor overhead rate dropped to <20% for the majority of respondents compared to a +31% rate in 2017. The more sophisticated the contractors (taking the survey) the more we hear they can effectively manage their overhead rates.
- M&H more or less stayed the same with a slight decrease in the number from 80% of respondents having a rate of 2-5% to 73% of the respondents and almost 10% have a rate of 1% or less.
- G&A remains all over the place in this revenue range. There are some as high as 21%+ and then others as low as <10% which was similar to the 2017 results. We did not see a reduction in the number of respondents of the highest rates at 38% of the respondents in both years remained at a +21% G&A rate which was expected as the smaller the company the more difficult it is to build the base of G&A to bring their rate downward.

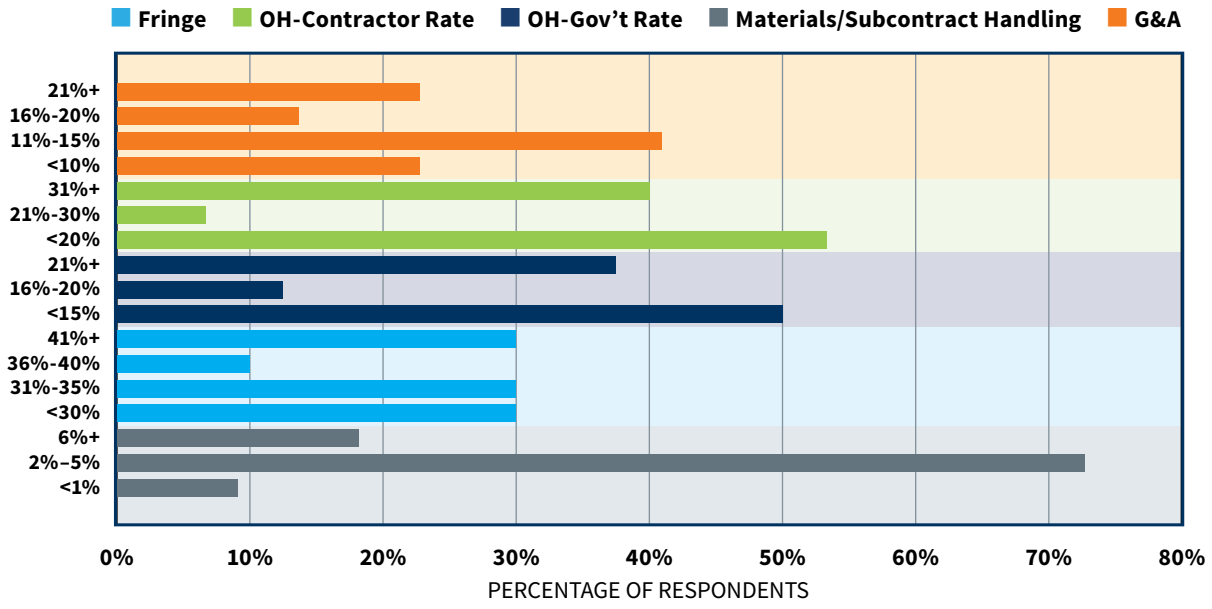
Fringe, OH, M&H, and G&A Rates for Companies with Revenue Above $101M



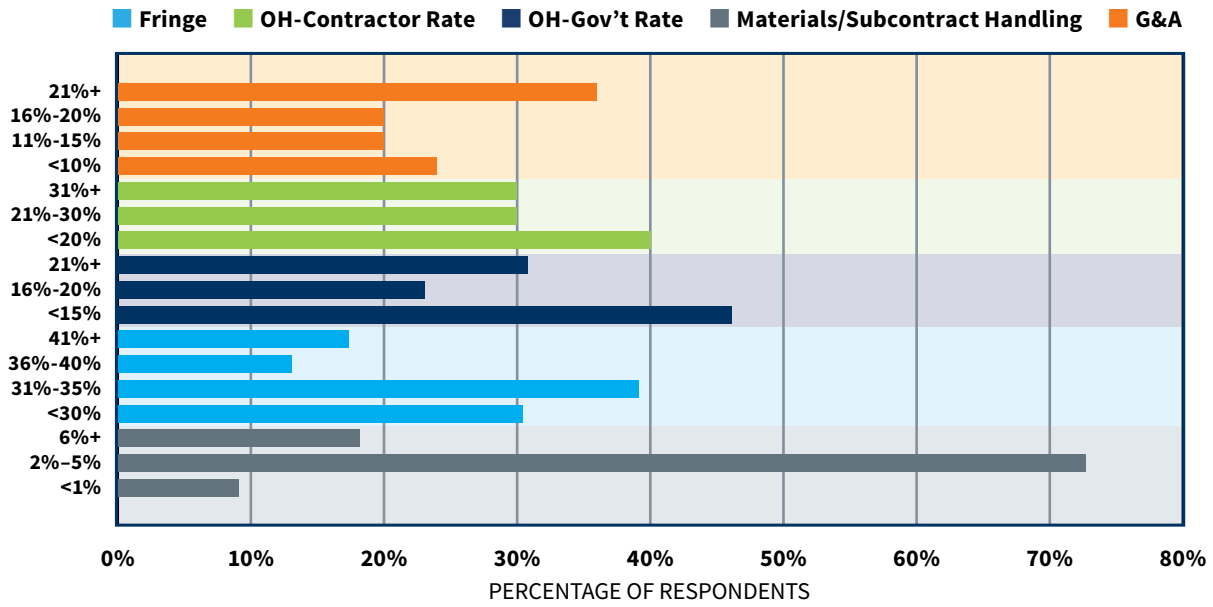
Fringe, OH, M&H, and G&A Rates for Companies with Revenue from $51M—$100M



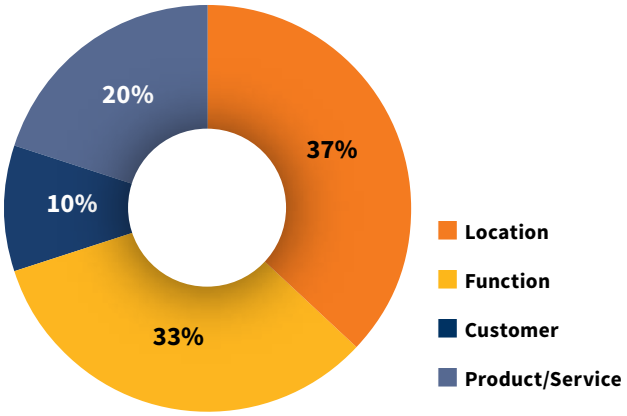
Fringe, OH, M&H, and G&A Rates for Companies with Revenue up to $25M—$50M



Fringe, OH, M&H, and G&A Rates for Companies with Revenue up to $25M

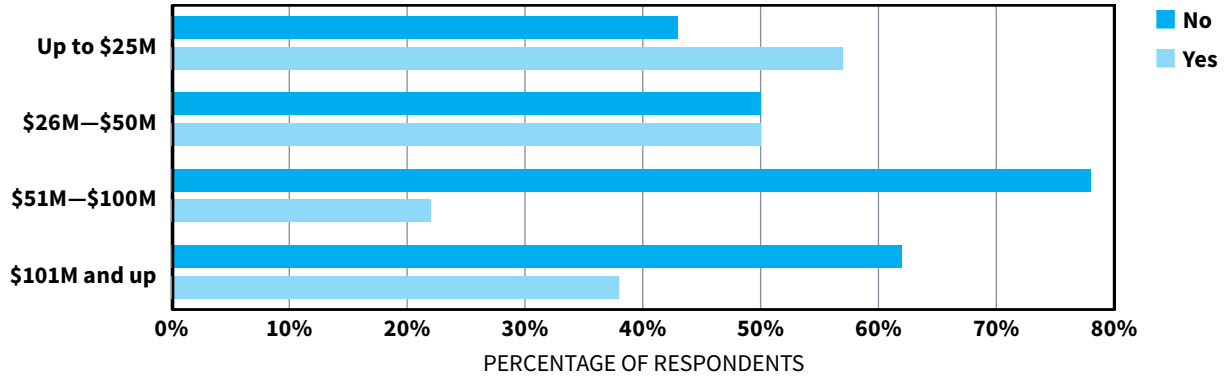


Overhead Rate Base

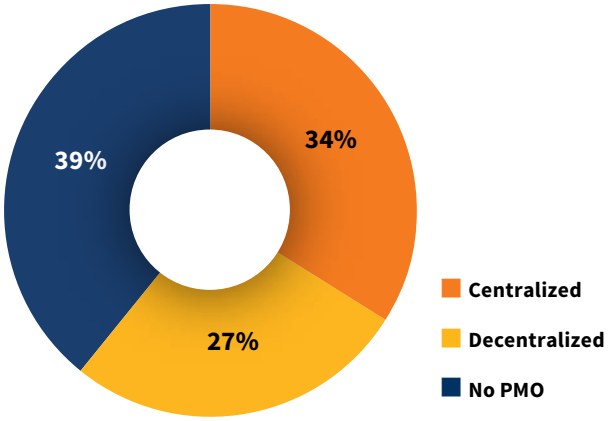


It is interesting that contractors use a mix of bases to calculate their overhead, such as location, function, customer and product/services, and not surprising, that there is a varying degree that use service centers. The larger your company size and number of employees, usually the more complex your rates become for competitiveness. The more customers you have the more strategic you might need to be in contemplating a new rate structure. We advise clients to review their rates every 3-5 years to make sure they are accurately factoring your company's operations and business development. As BD folks bid on new types of work the need for sophisticated rates grows. Always remember Bid=Book=Bill. Do not get caught with winning work that you're not prepared to calculate or prove the calculation of rates is appropriate for your business.

Use of Service Center Allocations

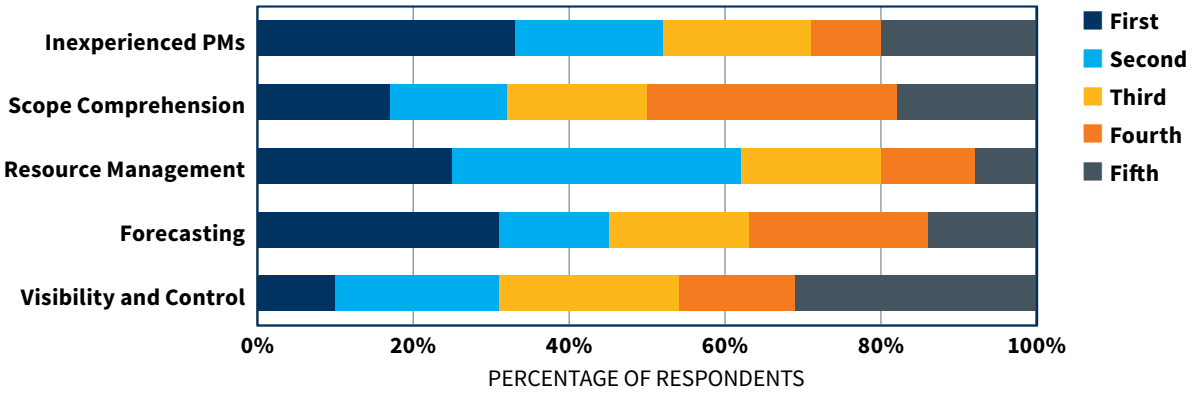


PMO Activity



Overall Project Management Offices (PMOs) are on the rise. The PMO's role is to define best practices and incorporate those into policies and procedures for the entire lifecycle of the project. A PMO is the primary enabler for project execution components that managed in a disciplined way.

Hurdles in the Project Management Discipline



WHAT IS THE DIFFERENCE BETWEEN CENTRALIZED AND DECENTRALIZED?

A centralized PMO supports the entire enterprise. They are defined and evolve the project management path for all the projects in the enterprise. Decentralized PMOs are centered around a program or a project and they serve those specifically. Since inexperienced project managers is the No. 1 challenge, it makes sense that PMOs are being established to help bridge that gap. Companies need to invest in the PM discipline to keep their projects on time and on budget.

INDUSTRY INSIGHTS

To provide more comprehensive information, regardless of whether your company is more dominant as either a subcontractor, and/or a novice or experience prime, we have enlisted the advice of our colleagues in the investment banking and financing industries. Please see below for additional insights from KippsDeSanto & Co. and Republic Capital Access.

STRATEGIC SHIFT TOWARD FULL-AND-OPEN

BY KIPPSDESANTO & CO.

One of the most pervasive challenges for buyers in the government services industry is valuing and successfully acquiring businesses with set-aside contracts, which are difficult to transition to full-and-open ("F&O"), unrestricted competition following an acquisition. Thus, generally speaking, buyers tend to avoid set-aside businesses when pursuing mergers and acquisitions ("M&A") or discount them from a valuation perspective. To position for an eventual sale or liquidity event, small business owners often pursue transition strategies aimed at growing F&O revenue. That said, transitioning to a F&O business that competes with the largest companies in the industry is extremely difficult. Before making the strategic shift towards F&O competition, small business owners should strategically assess the available options.

CREATING VALUE AS A SMALL BUSINESS OWNER

1 What are the company's revenue and cash flow expectations, and can it be a set-aside cash cow?

If a company is generating stable and sufficient revenue and cash flow, and still qualifies for restricted competitions under certain NAICS codes, then it may be able to operate as a lucrative set-aside business for years to come and create significant wealth. For example, NAICS codes based on the total number of employees can allow for a company to grow to up to 1,500 employees and still qualify for certain set-aside contracts. Similarly, Alaskan-native and other minority-operated businesses can qualify for 8(a) contracts for a defined or undefined period of time, enabling businesses to grow well beyond various revenue and/or employee-based NAICS codes. If, however, a set-aside company is on the verge of graduating from a set-aside program or size-based NAICS code, then it may be time to consider a transition strategy, depending on owner objectives.

2 How long do the owners plan to operate/remain affiliated with the business?

Owners can choose to operate within defined NAICS code thresholds as described above, but if the owners wish to exit in the next three to five years via a sale process, then it becomes more critical to properly position for a successful sale. This typically requires various investments as well as making certain operating decisions that will decrease the revenue concentration from set-aside contracts and increase F&O revenue contribution. Selected investments that can help drive a successful transition strategy are further discussed below.

3 From a financial planning perspective, are the owners looking to materially increase their wealth or does the business currently generate significant annual cash flow to satisfy the owners' current and future financial goals?

Because F&O businesses garner higher valuations in the M&A marketplace, it can pay off for shareholders to pursue a transition strategy if they are both interested in maximizing value/proceeds at an exit event and have the time to execute a transition strategy. However, and as highlighted above, if a business provides ample cash, then it may make sense to remain in a set-aside program, if possible. A lower risk strategy is staying in set-aside programs as long as possible and withdrawing cash from the business. A riskier strategy, albeit with a higher potential reward, is to invest heavily in the business and forgo cash withdrawals while transitioning the business to materially increase valuation potential at time of sale.

A small percentage of small businesses can attract buyers and consummate a sale despite generating most of its revenue from small business contracts.

4 Does the business have unique and in-demand capabilities, customer access, IP, or growth potential?

A small percentage of small businesses can attract buyers and consummate a sale despite generating most of its revenue from small business contracts. These unique businesses generally have: highly sought-after capabilities (i.e., NextGen IT, cyber, data analytics, artificial intelligence, etc.); long-term, prime contracts and positioning with desirable customers, such as those within the Intelligence Community (IC); and/or solution-based offerings that are hard to replicate and provide strong differentiation. In addition, these companies typically provide buyers with growth opportunities that only exist to the combined entity (i.e., a "third pipeline"). As a result, buyers often believe that the rewards outweigh the risks and hope to maintain the set-aside contract(s) upon recompete by moving them to F&O competition and realize valuable revenue synergies.

5 Is the Company positioned to attract a perpetual set-aside buyer?

Over the last several years, there has been an increase in buyer interest from companies that are able to perpetually operate as a set-aside business. These include businesses that are owned by Native Americans, Hawaiians, and Alaskans. Because they can qualify for 8(a) and small business status perpetually, and regardless of revenue and number of employees, they are able to acquire set-aside businesses and recertify as a set-aside. These perpetual set-aside buyers typically seek to acquire companies with positions on attractive contract vehicles, differentiated capabilities, and long-term and predictable cash flow.

6 Does the business have adequate cash flow to support necessary investments for several years?

Transitioning from set-aside to F&O can be, and often is, expensive and requires patience. Therefore, it is critical to plan accordingly and determine if the business can support multi-year investments. This is especially true because revenue, profitability, and cash flow may decline as legacy set-aside contracts are flipped to subcontracts or exited entirely and new F&O work is still ramping up.

MAKING THE SHIFT FROM SET-ASIDE TO F&O

Funding spent on federal contracts ebbs and flows year-to-year but over time tends to grow in the low single digits. From GFY07 to GFY17, it grew from $470B to $510B, which represented a compound annual growth rate of less than 1%. With largely predictable and stable budgetary dynamics, large and small businesses looking to grow in the F&O marketplace are forced to compete for a relatively flat amount of contract funding. As a result, set-aside businesses looking to transition into F&O contracts typically must displace F&O incumbents and compete in a very mature and competitive marketplace with hundreds of established large and mid-sized players. To make this difficult transition, set-aside business owners may want to consider the following investments and strategic pursuits, which may help to drive increases in F&O revenue.

- Senior-level business development talent: Investing in the right people, who have the right relationships within your targeted agencies, is critical. In addition, BD personnel with track records of winning F&O business can be instrumental, even though they often command higher salaries and more lucrative incentive packages. Similarly, it is important to tie the financial objectives of key BD resources to F&O award activity to align interests.
- Bid and capture activity: Capture and proposal resources help to ensure active and hopefully successful bidding and can be the difference

According to outside sources, there are currently more than 200,000 companies that can qualify as set-aside when doing business with the federal government and just 1% classify as mid-tier or large (defined as greater than $25M of annual revenue).

between winning and losing opportunities. In addition, effective pricing is as important today as ever given the current highly competitive environment.

- Pursuing key vehicles: Getting F&O seats on sought-after and well-funded GWAC and IDIQ vehicles can add instant value as large businesses often "buy" their way on to such vehicles. Examples of in-demand vehicles include Alliant 2, CIO-SP3, Eagle II, RS3, Encore III, and Oasis.
- Teaming / subcontractor / Joint Venture ("JV") pursuits: As businesses shed legacy set-aside contracts and transition to F&O work, it is important to team with the right partners, both as a subcontractor and as a prime. While prime, F&O revenue is the holy grail in an M&A context, a manageable amount of subcontract work (i.e., less than ~30% of total revenue) is generally considered acceptable to buyers. As such, sub work, whether subbing to small or large businesses, or even to set-aside JVs, can help fund transition costs as well as provide transitioning businesses with important past performance qualifications and customer access.
- Selective acquisitions: While acquisitions can be costly and often require third-party financing, they can provide valuable customers, capabilities, vehicles, and/or past performance and therefore expedite a transition strategy.

According to outside sources, there are currently more than 200,000 companies that can qualify as set-aside when doing business with the federal government and just 1% classify as mid-tier or large (defined as greater than $25M of annual revenue). Only a small fraction of these companies will likely make the difficult transition to become purely F&O. In the 2015 study by Bloomberg, approximately 700 small businesses (defined as less than $25M of annual revenue), or less than 1% of the total small business population, transitioned to mid-tier during the five-year period from 2011 to 2015. While the rewards associated with transitioning to F&O can be lucrative and help to drive a successful M&A exit event, there are significant associated costs and time commitments. Therefore, it is critical that small business owners thoroughly assess their business' unique strengths, weaknesses, and financial profile along with their own personal goals and objectives before determining if it is the right time to make the pivotal shift to F&O competition. If not, and as noted above, there exist various other wealth creation strategies for small business owners.

About KippsDeSanto & Co.

KippsDeSanto is an investment bank focused on delivering exceptional results for leading, growth-oriented aerospace/defense and government technology companies. We leverage our creativity and industry experience to provide M&A, private financing, and strategic consulting. Our senior team has advised on over 150 transactions totaling more than $10 billion in deal value. Capitalizing on real-time industry trends and in-depth technical and strategic analysis, our solutions-driven approach is highly structured and uniquely tailored to each client. We are recognized for our market insight and broad industry relationships. We help market leaders realize their full strategic value. KippsDeSanto & Co is not affiliated with any other company mentioned herein.

TRENDS IN GOVERNMENT CONTRACT FINANCING—"MEASURE TWICE, CUT ONCE"

BY REPUBLIC CAPITAL ACCESS

A small government contractor has annual revenue of $14 million as a subcontractor to a Tier 1 systems integrator. The contract is flipped to small business set aside. They win. The small business' annual revenue increases from $14 million to $28 million overnight.

This scenario happened earlier this year for a Virginia-based contractor, and has been repeated with increasing frequency over the last several years. The challenges posed by rapid, massive revenue increases are numerous. This article will review the financial stress that this trend imposes.

WHY THE TREND

The preference of government customers to utilize large IDIQ, BPA and GWAC contract vehicles has led to many out-sized contract awards to small businesses. It's not uncommon for us to see a contractor win work that is at least 3 to 4 times the size of their existing portfolio of contracts. In many cases, this may be the result of desired efficiency, where a Contracting Officer chooses to merge multiple legacy contracts into a single vehicle. More frequently, contracts are "flipped" from full-and-open to a small business preference (such as HUBzone, SDVOSB, etc.) to achieve set-aside goals, introducing the potential awardee to what was previously a large business task, most likely at the high end of their NAICS ceiling.

For value-added resellers, the trend of awarding outsized contracts to small businesses is even more prevalent. Compounding the financial challenges this poses is the fact that product sales are lumpy in nature, often surging significantly at the federal fiscal year. For many small businesses holding vehicles such as NASA SEWP V and CIO-CS, a combination of receivable and vendor financing is critical to executing large product orders. While vendor credit programs can be affordable sources of financing, not all small business balance sheets can support tens of millions in product orders on vendor credit alone. Resellers need to firm-up financing before pursuing task orders that exceed their credit facilities. Resellers also need to make certain that their financial institution is prepared for significant fluctuations in demand for financing during the busy season.

For value-added resellers, the trend of awarding outsized contracts to small businesses is even more prevalent.

Joint ventures are proliferating and feed this trend. Joint ventures that can be classified as "small" can demonstrate strong past performance but the structure itself often struggles to qualify for stand-alone financing without significant capital contributions or guarantees from its participating partners. Even when the joint venture partners maintain their own financing independent from the joint venture, financial institutions are often unwilling to extend credit to the joint venture. Make sure your financial partner is fully on board with financing the joint venture without requiring capital contributions from either party.

WINNING THE BID

When the RFP drops, the first order of business is to be in the competitive range. We have seen increasing scrutiny on the part of Contracting Officers to make sure small businesses can demonstrate evidence of "financial capability" to execute the contract in compliance with the FAR. Many solicitations now require a commitment letter from a financing institution that is RFP-specific and equal to at least three months of expected billing. Make sure you submit such a letter from your financing institution - which should be at no cost. We have seen proposals rejected due to the absence of financial capability.

YOU WON—THE DOG HAS CAUGHT THE BUS

Once a contract is awarded, expenses can start accumulating immediately, whereas generation of the first invoice is at least 30 days in the future, and actual payment another 60 days out. This working capital challenge can actually sink a small business. Capital providers may be able to fund receivables but many, especially those unfamiliar with government contracting, will not fund unbilled receivables. Small business owners need to have frank conversations with their capital providers to make sure that working capital needs are covered. It is tough enough to perform on a new, large contract without having to worry about cash flow, delay vendor payments, etc.

SUMMARY

In short, the old adage of "measure twice, cut once" applies perfectly. The trend of small companies winning large contracts will not abate soon. Don't avoid the hard discussions, and decisions, related to having adequate capital to perform. Just like that semi-annual trip to the dentist—if you put it off, the time and cost to fix the problem multiplies.

Small business owners need to have frank conversations with their capital providers to make sure that working capital needs are covered.

About Republic Capital Access

Republic Capital Access opened its doors in 2009 and is now the largest, and fastest growing, commercial finance company exclusively for government contractors, both large and small. In 2011, Republic became a subsidiary of Stephens Investment Holdings, LLC, a multi-billion dollar investment firm headquartered in Arkansas.

THE OUTLOOK

In 2018, optimism and growth are fueling today's federal contractors' maturation in an ever-changing environment. Managing and adapting to change was the overwhelming theme from our survey for success in federal contracting. Compliance remains key; although compliance may feel like a moving target with new and changing regulations issued on an almost monthly basis. Along with this ever-changing environment are the highs and lows of the current federal budget process where increasing budgets are being set for two years instead of one; and shutdown showdowns are the norm instead of the exception. Federal contractors are constantly on edge, but ever optimistic, about the increased federal dollars while trying to juggle their internal budgets in tandem with the ebbs and flows of the external federal budget.

Federal contractors and agencies are also dealing with a multitude of Executive Orders; some that repealed previous administration orders and some that created new regulations. New organizations, such as the 809 Panel are ramping up efforts to review and recommend changes to the federal acquisition process and talks of a separate CAS Board continues to keep us on high alert to stay active and informed. The 809 Panel released the bulk of their recommendations in FY 2018. The expectation is that many of the recommendations will be implemented in FY 2019. How changes will impact federal contractors is uncertain; but contractors are hopeful that the changes will ease their compliance burdens and provide greater efficiencies and growth. There's an increase in the use of Other Transaction Authority (OTA) by many agencies. The use of OTA's could be a disruptor in greatly reducing compliance burdens by removing many if not all the federal clauses from contracts. These contract vehicles and commerciality determinations may greatly improve the efficiency of agencies to achieve starting a contract in weeks/months instead of the current months/years.

Even with less complex contract vehicles, the compliance focus will change as regulatory agencies, such as DCAA and DCMA try to catch up on aging Business Systems. Contract closeouts for all agencies are finally coming under scrutiny due to recent Government Accounting Office (GAO) findings. Contractors are starting to feel the pressure to ensure their contract files are in good order to ensure a smooth closeout process.

CohnReznick and Unanet hope this survey and commentary assist you and your company to look forward to 2019. We are excited for the advancements government contractors create for the well being of our country and grateful for your responses to our survey.

HOW TO CONTRIBUTE TO THE GAUGE

If you have any questions or feedback regarding the 2018 GAUGE Report, and how to participate in the 2019 survey, please contact:

CohnReznick
Christine Williamson, CPA, PMP
Partner, CohnReznick
Government Contracting Industry Practice
Christine.Williamson@cohnreznick.com
703-847-4412

Unanet
Donna Kilbourn
Customer & Partner Success
EVP Revenue Acquisition
dkilbourn@unanet.com
703-689-9752

About CohnReznick

CohnReznick LLP is one of the top accounting, tax, and advisory firms in the United States, combining the deep resources of a national firm with the hands-on, agile approach that today's dynamic business environment demands. With diverse industry expertise, the Firm provides companies with the insight and experience to help them break through and seize growth opportunities. The Firm, with origins dating back to 1919, is headquartered in New York, NY with 2,700 employees in offices nationwide. CohnReznick is a member of Nexia International, a global network of independent accountancy, tax, and business advisors. For more information, visit www.cohnreznick.com.

About Unanet

Unanet is a leading provider of Cloud and On-Premise soft ware for project-based professional services organizations. Unanet delivers a purpose built Project ERP solution with skills management, resource planning, budgeting & forecasting, time & expense reporting, billing & revenue recognition, project management analytics and dashboards, and integrated financials with AR, AP, GL and cost pool calculations. Over 1,000 organizations trust Unanet to maximize staff utilization, reduce overhead and administrative, improve speed and accuracy of invoicing, and support forward decision-making for improved operations. Unanet has several videos available if you would like to learn more about our firm and capabilities: www.unanet.com/videos.

APPENDIX

BUSINESS SYSTEM APPLICABILITY RULES						CRITERION APPLICABLE? INDICATE "YES" OR "NO"
SYSTEM		FAR, DFARS, PROVISIONS, and CLAUSES	CRITERIA			
ACCOUNTING (AS)	NON-DOD	FAR 16.301-3 Cost-Reimbursement Contracts - Limitations	1. Does your company have a Government cost-reimbursement contract? - AND -			
			2. Did the ACO determine a need for accounting system audit based on significant cost-reimbursement contracts, change in cost accounting practices, billing or invoicing issues, audit recommendation, or other rationale?			
	DOD	DFARS 242.7502(a) DFARS Clause 252.242-7006	1. Is your Company a DoD prime contractor or subcontractor?			
			2. Does any prime contract or subcontract contain a similar DFARS clause or language requiring an adequate accounting system?			
			3. Was the Company awarded or executed any of the following contract types:			
			(a) Cost-reimbursement contract (FAR 16)			
			(b) Incentive contract based on cost information			
			(c) T&M (Both Commercial FAR 12 and non-commercial FAR 15)			
			(d) Labor hour contracts			
			(e) Contracts with progress payments made on the basis of costs incurred or on % completion			
			DETERMINE OVERALL SYSTEM APPLICABILITY			
ESTIMATING (ES)	NON-DOD	FAR 15.407-5 Estimating Systems	1. Did the Company's CO under a prime contract determine a need for an estimating system review?			
	DOD	DFARS 215.407-5 Estimating Systems DFARS Clause 252.215-7002 Estimating Business System	1. Is your Company (DoD contractor or subcontractor) considered other than small as defined in the Small Business Administration? - AND -			
			2. Did your Company receive in its ***preceding fiscal year*** a DoD prime contract(s) or subcontract(s) totaling $50 million or more for which ***certified cost or pricing data were required*** ? or			
			3. Did your Company in its preceding fiscal year receive a DoD prime contract(s) or subcontract(s) totaling $10 million or more (but less than $50 million) for which ***certified cost or pricing data were required*** and the contracting officer, with concurrence or at the request of the ACO, determined it to be in the best interest of the Government?			
			DETERMINE OVERALL SYSTEM APPLICABILITY			
PURCHASING (CPSR)	DOD/NON-DOD	FAR Subpart 44.302 Requirements FAR Clause 52.244-2 Subcontracts	1. Did the Company's ACO determine the need for a CPSR based on, but not limited to, your past performance, and the volume, complexity, and dollar value of subcontracts? -AND-			
			2. In the next 12 months, your sales to the Government are expected to exceed $25 million excluding:			
			(1) Competitively-awarded firm-fixed-price			
			(2) Competitively-awarded fixed-price with economic price adjustment			
			(3) Commercial items (pursuant to FAR Part 12)			
			As a preliminary CPSR eligibility evaluation:	TOTAL VALUE		
			3. Indicate estimated total value of sales to the Government as defined above and not including identified exclusions:			
			4. Indicate number of following contract/subcontract types received in past 12 months:	COUNT	TOTAL VALUE	
			(a) Cost-reimbursement			
			(b) Time and Materials/Labor Hour			
			(c) Fixed-price competitively-awarded			
			(d) Fixed-price with economic price adjustment competitively awarded			
			(e) Contracts/subcontracts for sales of commercial items pursuant to FAR Part 12			
			(f) Fixed-price other than those in (c) and (d) above			
	DOD ONLY	DFARS 242.7000 Contractor Business Systems DFARS Clause 252.242-7005 Purchasing System	1. Is your Company DoD prime contractor or subcontractor? - AND -			
			2. Does any prime contract or subcontract contain a similar DFARS clause or language requiring your company to maintain an adequate or approved purchasing system? - AND -			
			3. Will your Company be making purchases (services or supplies) under your prime contract or subcontract?			

For a complete PDF of the **Business System Applicability Rules**, please contact:

Christine Williamson, CPA, PMP
Partner, CohnReznick
Government Contracting Industry Practice
Christine.Williamson@cohnreznick.com