



The 2017 GAUGE Report:
*An Industry Roadmap of Benchmarks and
Trends for Government Contractors*

Use the GAUGE as a Tool for Annual Budgeting
and Advancing Your Government Contracting Business Strategy

November 2017, First Edition

CONTENTS

- Executive Summary 1
- Using the GAUGE Report..... 2
- Data Source 3
- GAUGE Findings..... 4
- G**overnment Contract Compliance 5
- A**ccounting 8
- U**tilization..... 10
- G**rowth 11
- E**fficiencies 12
- Industry Insights 17
 - KippsDeSanto & Co..... 17
 - Crowell & Moring..... 19
- How to Contribute to the 2018 GAUGE Report..... 20



Executive Summary

2017 was a watershed year. As we entered the uncharted territory of the Trump Administration, the country also faced a host of natural disasters, including hurricanes and wildfires. But, on the positive side, along with the prospect of tax reform, there is speculation that the economy will continue to grow in 2018 and, with that, so will the funding for government contractors with certain agencies. Economic growth often leads to increases in overall spending, more M&A activity, and greater investment in employees/resources.

Many unknowns remain around healthcare reform, budget constraints, debt ceiling limit exposure, and impending tax reform. Interest rates could be a wild card with the overwhelming debt load the U.S. is carrying, but it is truly a double-edged sword, as companies would appreciate more investment earnings on their excess cash.

We still have limited line of sight as to what will ultimately happen on these fronts. Each will likely have a significant impact on strategic decisions as companies look forward and create strategies for the next 3-5 years.

In helping government contractors plan and strategize, CohnReznick and Unanet partnered to conduct this government contracting industry benchmarking survey. Known as the GAUGE Report, we gathered information from many types of contractors to help us define the current state of our industry, including issues important to them. The survey and related commentary covers five major categories:

GAUGE *Tip*

As you begin your annual forecasting and budgeting, use the metrics in the GAUGE to benchmark where you are— Better or Worse?

- G**overnment Contract Compliance
- A**ccounting
- U**tilization
- G**rowth
- E**fficiencies

Respondent Types

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

- Less than \$25M
- \$26M - \$50M
- \$51M - \$100M
- \$101M - \$250M

“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, CohnReznick**



USING THE GAUGE REPORT

Why the GAUGE and Why Read it NOW? It is BUDGET TIME!

The GAUGE is a tool for government contractors to compare themselves to others in their industry. The information in the report is organized by company size, so it is easy for you to make a comparison to your direct competitors. As we embark on a new year, some of the most challenging activities performed by a company are budgeting and forecasting.

10 Tips for Creating and Meeting a Budget

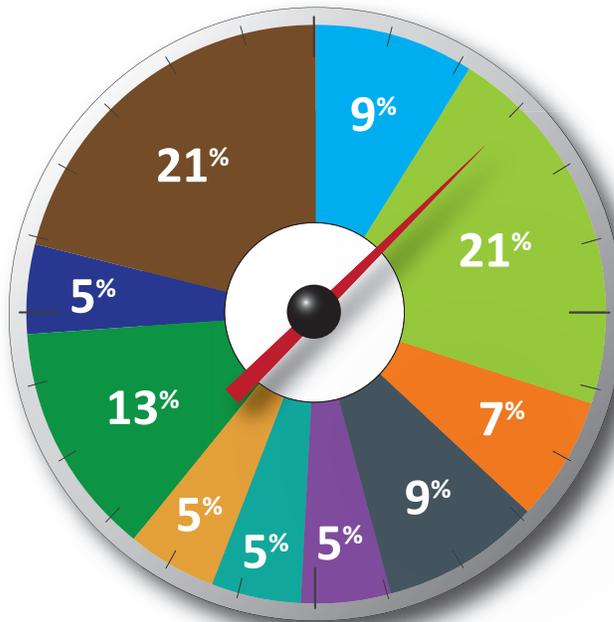
1. Kick-off the budgeting cycle by providing a timeline, parameters, and overall goals. Make sure that all stakeholders are included in this session.
2. Establish guidelines for budgets that are very clear to the overall team. Below are just a few examples:
 - What is the timeline/horizon for the forecast?
 - How to handle proposals in the forecast?
 - What is the growth rate expected?
 - When are the due dates?
 - How are options to be forecasted?
3. Make sure your organization uses a tool that provides all stakeholders with the visibility and control they need over the budget.
4. The budget should be time-phased, and the tool must provide the ability to group information by month, quarter, and year.
5. Budgets should align to the timing of the work. Understand the full scope of your projects to properly align your budget to them.
6. Scenario modeling is critical to understand best case, most likely, and worst case scenarios. A tool that allows the formation of “what-ifs” or modeling is necessary.
7. Account for rate differences, whether they be OH (Overhead), G&A (General & Administrative), MSH (Material/ Subcontract Handling), or GSA labor rates. Make sure your tool is flexible enough to account for project specific rates, ceilings, budget, and forecasting rates.
8. Hold monthly reviews throughout the year to review the budget and make course corrections versus forecast (recasting of the budget).
9. Understand that the budget is a living, breathing document, not a static metric to be filed away. Update the budget to incorporate any significant changes in your business environment.
10. Use GAUGE metrics to benchmark your budgets to others in the industry. For example: see where you are tracking in terms of Revenue per FTEs (Full Time Equivalent), % of Health Care Cost to Revenue, and G&A.

“Every year, large investments are made to create annual budgets. The investment is made by many within the organization, including the cost analyst, finance manager, functional manager, project manager, and others. If you are going to invest weeks of labor preparing the budget, you don’t want it put away to never be used again throughout the year.” — **Donna Kilbourn, Unanet**



Respondents' NAICS Codes

NAICS codes are how we bid, determine size, team, and how we are defined by the IRS for all industries. NAICS codes were also used to gather information for this report. Knowledge of NAICS code(s) will help you interpret the charts presented in the GAUGE.



NAICS Codes

- **541712 & 541715:** Research and Development in the Physical, Engineering, and Life Sciences
- **541330:** Engineering Services
- **541511:** Custom Computer Programming Services
- **541519:** Other Computer Related Services
- **541512:** Computer Systems Design Services
- **541620:** Environmental Consulting Services
- **541690:** Other Scientific and Technical Consulting Services
- **541611:** Administrative Management and General Management Consulting Services
- **541210:** Facilities Support Services
- **Other** 33120, 424210, 541618, 541810, 541990, 551112, 551114, 5415212, 5417152, 541711, and 621399



GAUGE FINDINGS

Overall

- Government contractors are generally optimistic about the country's future considering the economic conditions.
- Overwhelmingly, survey respondents expect government spending to increase in 2018 and beyond.

Contracts

- DCAA/DCMA and similar contract auditors are a fact of life for government contractors.
- Incurred Cost Submissions continue to be the most prevalent contract audits, with pre-award, accounting system, forward pricing, and billing audits comprising the remainder of the top five audit types.

Business Issues

- Cybersecurity is on everyone's mind, especially considering looming regulations.
 - Companies must comply with at least a self-certification of their system by December 2017.
- Professional services companies are looking hard at the amount of revenue one FTE creates.
 - Labor continues to be the lifeblood of these companies—both direct and indirect.

Looking Forward

As you prepare your budget, consider benchmarking your organization to the findings in this report complemented with other sources.

GAUGE Tip

KNOW YOUR KEY PERFORMANCE INDICATORS *(found in this report)*

- **Contract Types** – Know what you are bidding on and why; make sure your sales team agrees as to what type of contracts you have and will go after.
- **Agencies** – Know your mix of customers, visit your customers often, and understand their pain points and their needs.
- **Audit Types** – What type of contract specific audits has your company been through? How many would you like to succeed in, and do you know what is currently required in proposals your company may be bidding on?
- **EBITDA** – Calculate it, understand it, and create a goal for it!
- **Vertical Income Statement Analysis** – What is your DL as a percentage of revenue? Do you monitor that weekly, and do you also know your percent of revenue of other specific items?
- **Subcontractors** – What percentage are they of your total costs? Do you rely on subcontractors too much? How much make or buy analysis do you perform?
- **Full Time Equivalents (FTE)** – Compare your company to others of similar size in either total FTEs to revenue or how many FTEs exist in various back office roles.



GOVERNMENT CONTRACT COMPLIANCE

Larger budgets for contracts may lead to greater competition in an industry that is already very competitive. More contract funding will mean that additional companies may join the contracting ranks and heighten competition with a DCMA push for commercial buying practices.

Government contractors must be ready for regulatory changes while watching the major economic indicators of the commercial world. This can be a balancing act.

Which new compliance mandates may be on the horizon? Here are some you need to think about now:

- DCAA will continue to prioritize the more significant pay-back type audits, such as forward pricing and cost incurred audits. Going forward, contractors should expect to see an uptick of business system audits—accounting system, estimating system, and Contractor Purchasing System Reviews (CPSRs).
- Contractors have until December 2017 to attain full compliance (or self-certify there is a plan) with the cybersecurity requirements in NIST SP 800-171.
- The DCAA timeline for audits is under heightened scrutiny. Contractors are now accountable for making the agreed upon dates for audits and shouldn't expect delays.
- If you are a small business, DCAA has reduced the time it takes to do a pre-award accounting systems audit. They have also provided valuable documentation and seminars to help get the "acceptable rating" in a short time frame. More companies than ever report having at least one pre-award audit. If you haven't been through such an audit, you should expect one and prepare for it.

GAUGE *tip*

CONTRACT COMPLIANCE AUDITS

- Prepare a strategic plan for compliance
- Prepare yourself with policies, procedures, and tools
- Understand the purpose of the audit
- Look up the audit program type on the DCAA website, review, and get outside assistance as necessary
- Choose a point of contact to be a liaison with your auditor
- Understand the record keeping requirements in FAR 4.7
- Insist DCAA hold entrance and exit conferences
- Keep DCAA within the scope of the audit
- Business system reviews are generally good for three years

DCAA Audits



- Incurred Cost
- Accounting System
- Forward Pricing
- Pre Award
- Provisional Rates
- Pricing Voucher
- Purchasing System
- Billing Review
- Floor Checks

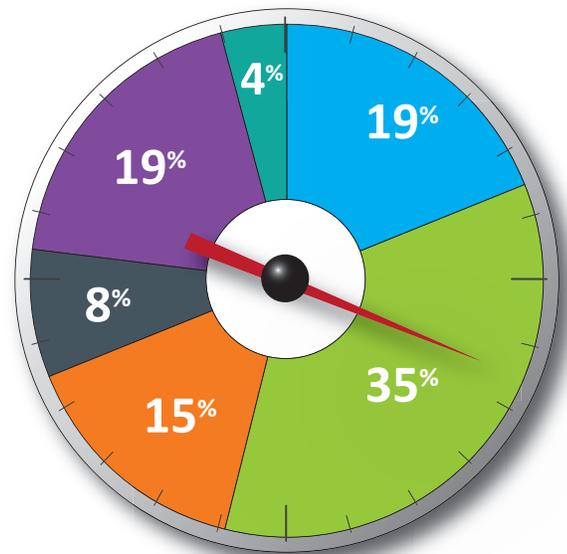
Incurred cost audits are the most prevalent DCAA audits among contractors.

Companies continue to face delays with their incurred cost submission audits. The House and Senate Armed Services Committees have been and continue to work on ways to get the audits complete. Many agencies have supplemented DCAA audits with audits by private accounting firms. One reason is the astounding number of years that are outstanding. From our survey only 35% had been audited through 2012 and only 4% in 2016. Contract closeouts have been severely harmed by the audit delays, and companies financials are in jeopardy with indirect rate implications of possibilities of previous year reversals of revenue. We suggest inquiring with your contracting and administrating officer in the coming year on the status of your audits. Many have seen desk and low-risk audits taking place to close up their open audit years.

GAUGE tip

DCAA audits are a fact of life for government contractors. What audits are you currently experiencing and what do you see on the horizon? The graphic shows the most popular. Which types of audits are you subjected to? Be prepared for the most prominent audits.

Year Rates Audited by DCAA



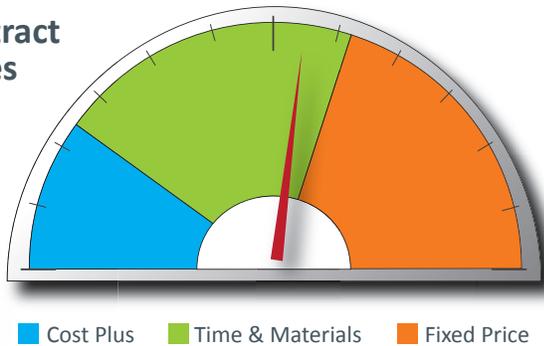
- 2011
- 2012
- 2013
- 2014
- 2015
- 2016

Contract Types and Agencies

The types of contracts and agencies you work with can dictate the level of compliance and scrutiny the government requires of the contractor. Know the mix of contract types and agencies you deal with. Don't be surprised or caught off guard that a certain type of audit may be required for an upcoming RFP. We suggest you include budget dollars to prepare for, coordinate, and reply to contract audits in 2018.

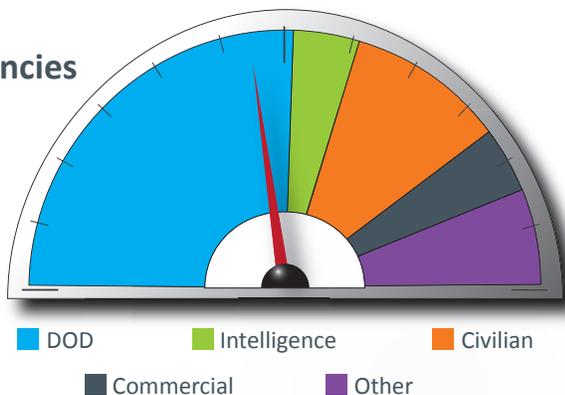
Many companies have suggested that it is unfair to require them to comply with these types of audits at certain size limits. You need to be well-prepared in understanding your contracting officer's needs. If they want to give you the business, they must be able to check off the box on which type of contract your system can handle.

Contract Types



Most contractors surveyed had either Fixed Price and Time & Materials; only about a quarter reported Cost Plus contracts.

Agencies



Half of all contractors reported in the survey were working for the Department of Defense.

The trend of Fixed Price and Time & Materials as the majority types of contracts has been the case for the past several years. However, many believe Cost Plus may be on the rise in 2018 and beyond.

It wasn't surprising that more than half of the respondents had contracts with DOD. With the 2018 budget increase for DOD of 9%, we expect this number will continue to climb or stay steady.

GAUGE tip

What is the mix of contracts in your organization? There are challenges in managing different types of contracts. If you are experiencing challenges with multiple types of contracts and managing rates because of the variety of contracts and customers, you are not alone.

GAUGE tip

Many contractors are facing issues of setting up multiple Fringe and Overhead rates and whether to use Total Cost Input or Value Added G&A Base. Cost of Money (COM) may come into play now as interest rates rise!

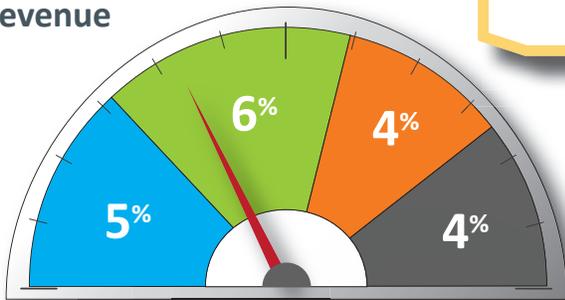


ACCOUNTING

ACCOUNTING

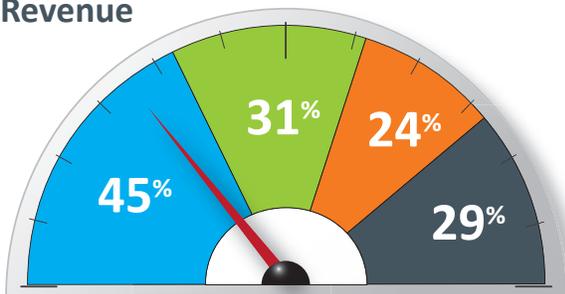
As government contractors loosen their belts after years of constrained federal government budgets, they are now doing some long overdue strategic investing. That investing has been made in business development, infrastructure, training employees, improving project management practices, and recruiting key personnel. What are you investing in currently, and what are your plans for 2018?

EBITDA as a % of Revenue



■ Up to \$25M ■ \$26M-\$50M ■ \$51M-\$100M ■ \$101M-\$250M

Gross Margin as a % Revenue



■ Up to \$25M ■ \$26M-\$50M ■ \$51M-\$100M ■ \$101M-\$250M

GAUGE tip

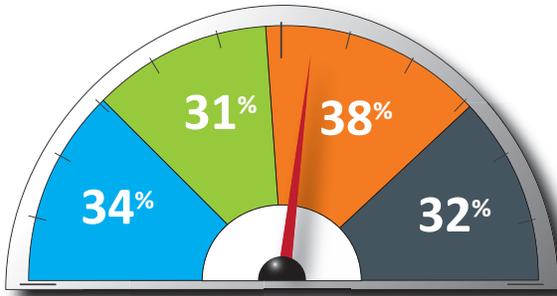
PREPPING YOUR REVENUE PLAN

- Look closely at your pipeline for new opportunities.
- Understand how your EBITDA is trending.
- Use the data in this report as a benchmark for expenditure percent of revenue.
- Know what are you spending on labor vs. subcontractor labor.
- Examine your backlog and break it out between funded and unfunded.
- Classify your backlog by years, not just by contract.

GAUGE tip

As a percentage of your revenue, how does your EBITDA compare with the survey respondents? Are you able to invest and maintain EBITDA in this range?

Direct Labor as a % of Revenue

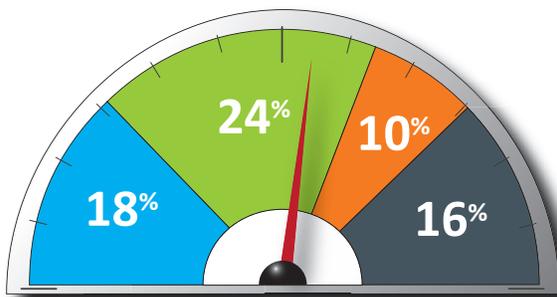


■ Up to \$25M ■ \$26M-\$50M ■ \$51M-\$100M ■ \$101M-\$250M

GAUGE *tip*

The largest spend is on labor, and it is the path to revenue and cash generation. Look at your percentage of direct and subcontractor labor to revenue. Are you in the ballpark of our respondents?

Subcontractor as a % of Revenue

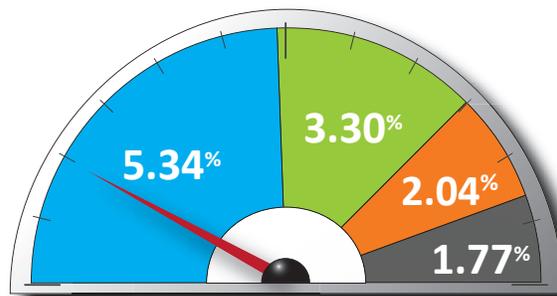


■ Up to \$25M ■ \$26M-\$50M ■ \$51M-\$100M ■ \$101M-\$250M

GAUGE *tip*

Look at your percentage of revenue for other types of cost. One major expense is healthcare. How do your healthcare costs compare to the respondents?

Average Cost of ODCs, Health Insurance, Rent, and Business Development as a % of Revenue

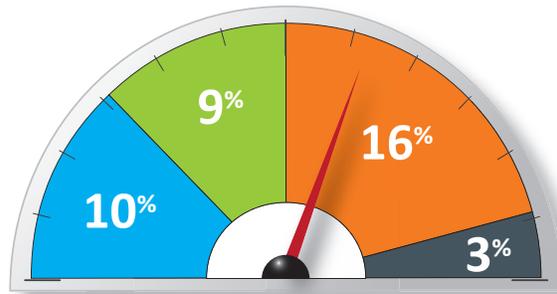


■ ODCs ■ Health Insurance ■ Rent ■ Business Development

GAUGE *tip*

Business Development fuels the pipeline. Do you have more or less BD spending than the respondents? Do you have enough BD personnel to keep the top of the funnel full of new opportunities?

Indirect Labor as a % of Revenue



■ Up to \$25M ■ \$26M-\$50M ■ \$51M-\$100M ■ \$101M-\$250M



UTILIZATION

UTILIZATION

People are, by far, the largest investment for government contractors. However, they are the revenue generators for service-based companies. In our survey of predominantly service-based government contractors, it's not surprising that people are the largest investment and the largest revenue generators. That said, many companies still struggle to effectively manage human resources from a cost and utilization perspective. Human resources need to be managed during the entire project lifecycle, beginning with the proposal and through project initiation, execution, and closeout. Having Key Performance Indicators (KPIs) are critical.

Revenue Per FTE
(minus sub-contractor revenue)



■ Up to \$25M ■ \$26M-\$50M ■ \$51M-\$100M ■ \$101M-\$250M

Contractors with revenue between \$51 and \$100 million generate the most revenue per full-time employee.

Indirect labor needs to be well-managed as Accounting, HR (Human Resources), and BD (Business Development) make up a large percentage of these costs. Managing indirect labor cost is critical to making rates competitive in the bid cycle and market place.

FTEs Per Function

	Accounting	HR	Recruiting	IT	Contracts	Business Development	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

GAUGE tip

People generate REVENUE. They must be managed. What is your revenue per FTE? Are you measuring utilization?

GAUGE tip

AT A MINIMUM, YOU SHOULD BE ABLE TO ANSWER THE FOLLOWING QUESTIONS:

- What utilization do you need to be profitable?
- What utilization should you aim for to avoid burnout?
- Do you understand billable and non-billable utilization?
- Are you accurately forecasting human resource needs and costs to understand both billable revenue and utilization?
- How many back-office personnel does it take to run your business?

GAUGE tip

How many of these indirect types do you have in your organization? Are you in line with the respondents?



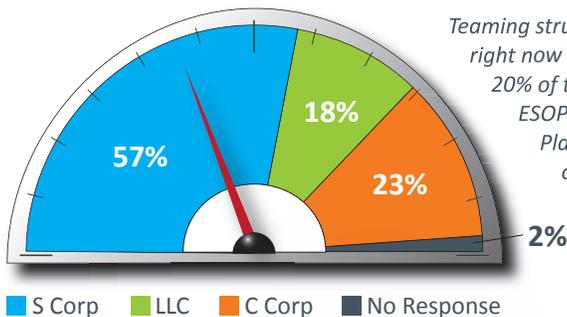
GROWTH

Contractors will continue to divest, merge, and restructure to stay competitive. One major trend over the last several years is a greater focus on profit. It is very important to manage projects effectively to achieve the desired profit margin and to win new or follow-on business.

While organic growth is possible, the fastest path to growth and profitability may be through an M&A or restructuring. M&A enables growth, especially if integration costs are well-managed. Internal restructuring is also an effective technique to reduce overhead.

Entity Structuring

Almost 60% of the respondents polled were structured S Corps. This has been a popular structure due to positive tax treatment. 23% were C Corps, followed by LLCs. This is very consistent with the industry mix. There is heightened focus on the use of joint ventures because they allow companies to share technology and investment.



Teaming structures are very popular right now and will help minimize the risk. 20% of the C Corp respondents were ESOPs (Employee Stock Ownership Plan Companies) and 15% were owned by private equity.

GAUGE Tip

TO GROW YOUR BUSINESS, ARE YOU ASKING YOURSELF:

- Organic growth vs. M&A or similar strategy?
- Am I managing the pipeline?
- Have I been examining portfolios to see which have the best return?
- Have I considered teaming arrangements to enter new areas and share risk?

GAUGE Tip

Companies are bidding and winning less than 50% of the time for contracts >\$25M. This number begs the question: Are you bidding on the right projects? Have you looked at your win/loss ratio recently?

Contract Vehicles

Examining contract vehicles can also help companies grow and win. Smaller companies are using LPTA bid strategies to grow their revenue streams. Large prime contractors reported that they are looking for higher margin work and will forego bidding on lower margin, high risk work.

Company Size	Active	Bid	Won	Loss	Delayed	Protested
Up to \$25M	28	13	7	4	1	0
\$26M - \$50M	36	38	12	3	1	0
\$51M - \$100M	76	79	32	29	18	0
\$101M - \$250M	89	129	30	28	1	3



EFFICIENCIES

EFFICIENCIES

The management of indirect rates can be the difference between winning a bid, losing a bid, making a profit, and enabling growth. With so many competing issues, such as what executive orders will be repealed, pricing pressures, subcontractor compliance, increased competition, and board or management desires, the government contractor has many internal and external pressures as depicted below. Getting your indirect rates, escalations, and teaming partners is monumental to your success.

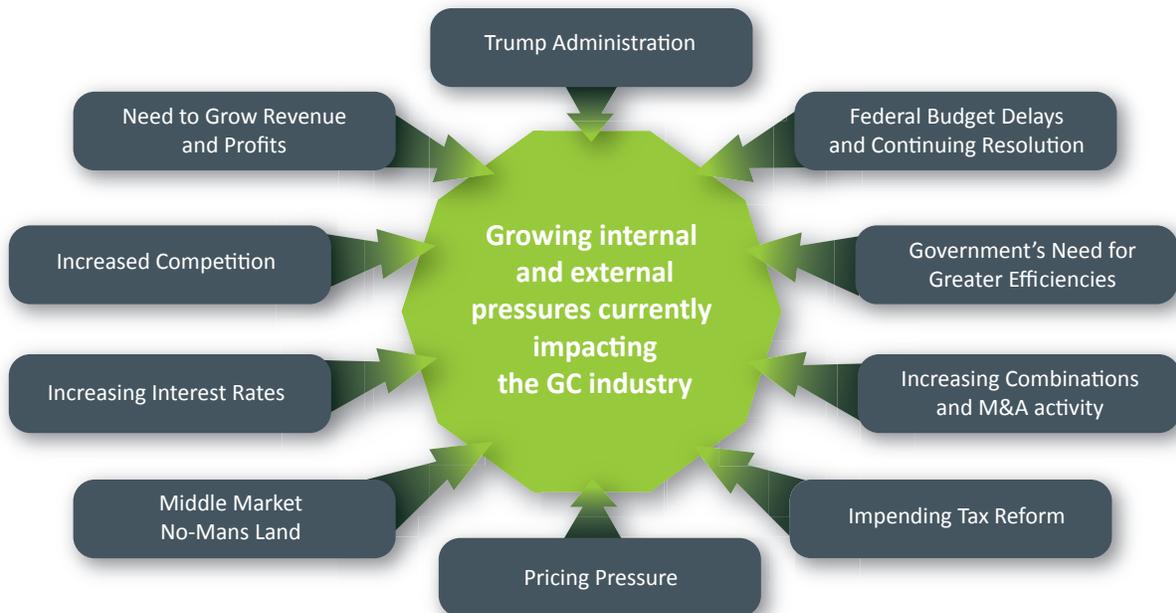
In the next few pages, we will size up indirect rates by our respondent revenue level categories. During your budget process, match your rates up to these, all the while developing what makes sense for your business. Companies at every revenue size spend money on infrastructure and benefits. G&A rates have been rising over the past few years. As you prepare your budget for this year, think about what you need to maintain infrastructure as a cost of doing business while paying for the proper costs for insurance, accounting, and business development. We hear from employees all the time that maintaining infrastructure matters because it means owners value keeping their house in order, which may mean employees stay longer. Companies have found that the bare bones of limiting indirect labor will be an unsustainable approach to growth and the happiness of indirect personnel.

GAUGE *tip*

HOW TO GAIN EFFICIENCIES WITH RATES:

- Don't forget to budget indirect costs.
- Examine your labor utilization to better understand the indirect component.
- Question the rate ceilings on potential contract wins.
- Have a system to handle cost pools and allocations.
- Understand your sales forecast and demand for resources.
- How do your rates compare?

Current Environment

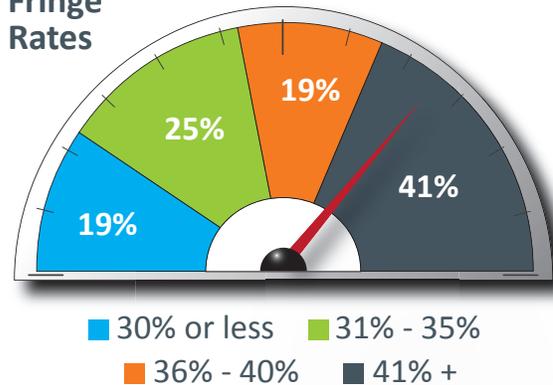


Companies with Revenue of Up to \$25 Million

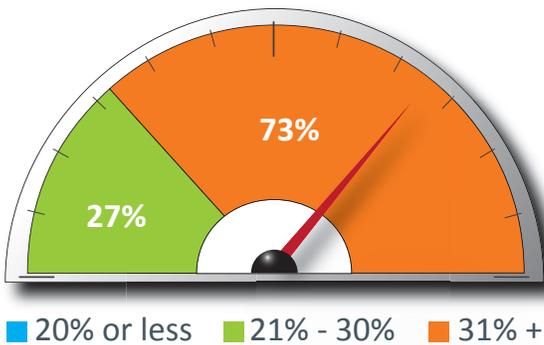
Companies with less than \$25M in revenue may struggle with keeping their fringe rates down. However, many respondents from the survey continue to want to provide great fringe packages to their employees. Therefore, we see greater than 60% of respondents with a fringe rate of 36% or higher. Paying high benefits is one way that small, niche companies retain their employees. And if they can't pay high salaries, small companies tend to incentivize employees with perks and special benefits. Most companies of a certain size need to create a rate they will use for employees that co-habitate with the government (the "government rate"). They also need a rate at their HQ location, called the "contractor rate." These rates need to be very competitive. The charts below show very similar rates regardless of government or contractor site. Contractors need to allocate costs appropriately when creating these two OH rates for their budgets.

Some respondents at this level of revenue are using a single rate and, consequently, their single overhead and G&A rate is above 21%. Not many government contractors start out with a value-added G&A base. However, eventually at the high end of this range, companies realize an MSH (Material/Subcontract Handling) rate may keep the customer agency happy. MSH rates normally range between 2-5%.

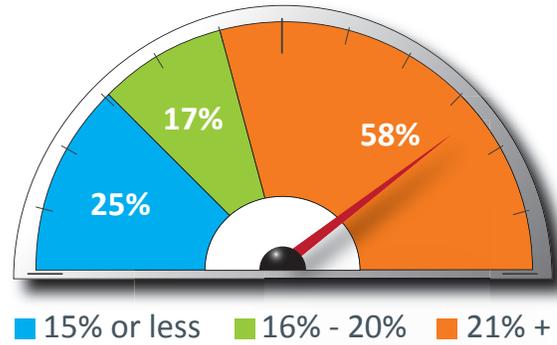
Fringe Rates



Overhead — Contractor Rate



Overhead — Government Rate

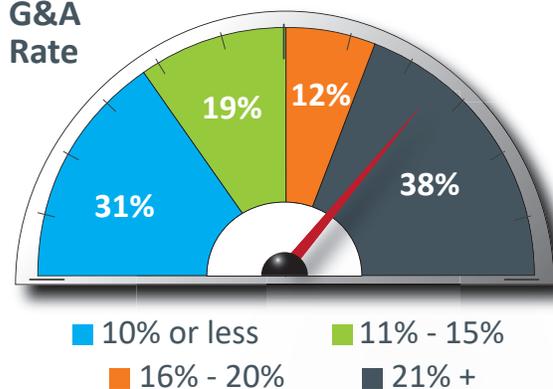


These gauges show the percentage of respondents who fall within the indirect rate percentage that is shown in the key.

MSH Rate



G&A Rate



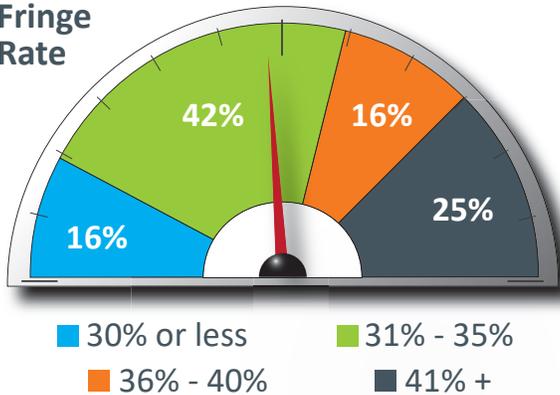
Companies with Revenue of \$26 Million to \$50 Million

Companies at this size are indicating fringe rates of 31-35% which allow them to operate normally. Negotiations relative to insurance and health benefits are more of a reality than a wish. There are still companies providing or paying 80-100% of healthcare insurance, but the ability to stay competitive gets harder with high fringe rates as companies enter the \$26-50M levels. Companies at this size are starting to get

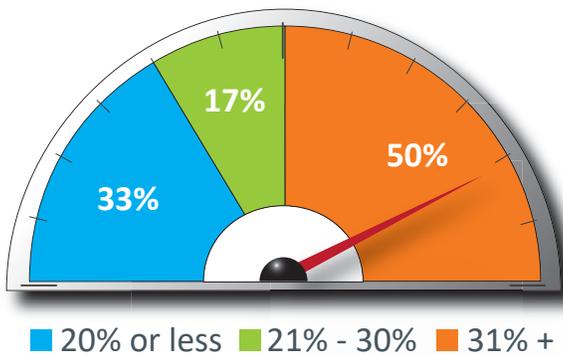
both their contractor (HQ) rate and government (site) rate down slightly from when they were smaller as their base of DL (Direct Labor) builds. The contractor (HQ) rate will begin to climb as more infrastructure for DL personnel is needed and as contracts are won where the government does not house your employees.

At this stage, many companies are examining their allocations of depreciation, IT costs, training, recruiting, etc. As you develop your budget and become more complex, you need to pay attention to your service centers and bases of allocations. These are key elements for documentation in your budgeting phase so that all the stakeholders understand what those are and the accounting staff can properly set up the accounting system. You will also have to explain the pools and bases and allocation methodologies to DCAA in your forward pricing rate submission. At this revenue level, the MSH rate has matured and leveled out. The base is getting bigger, but many of the resources needed to manage the MSH will stay the same. Thus, the rate begins to come down. Companies need to compare themselves to others in the G&A arena now that LPTA has come into play.

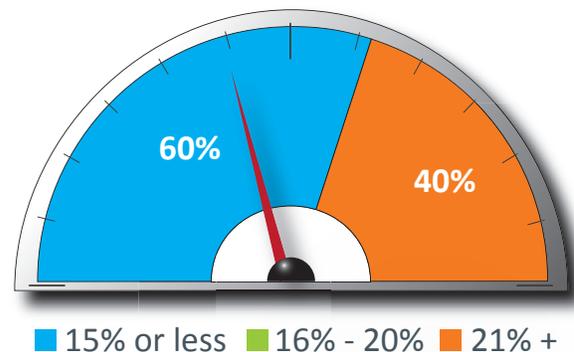
Fringe Rate



Overhead — Contractor Rate

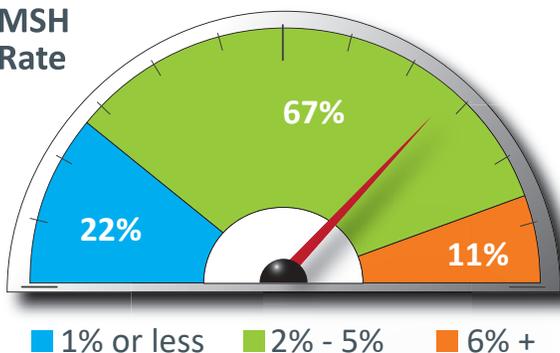


Overhead — Government Rate

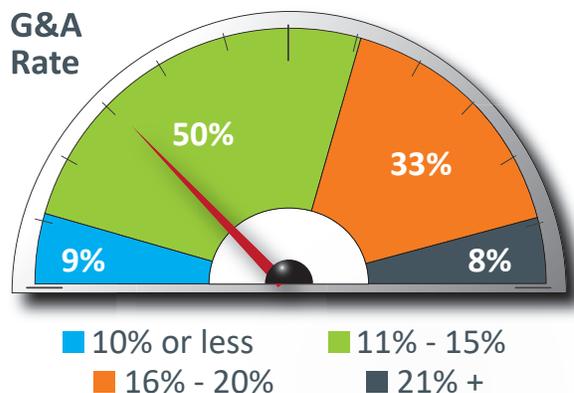


These gauges show the percentage of respondents who fall within the indirect rate percentage that is shown in the key.

MSH Rate



G&A Rate

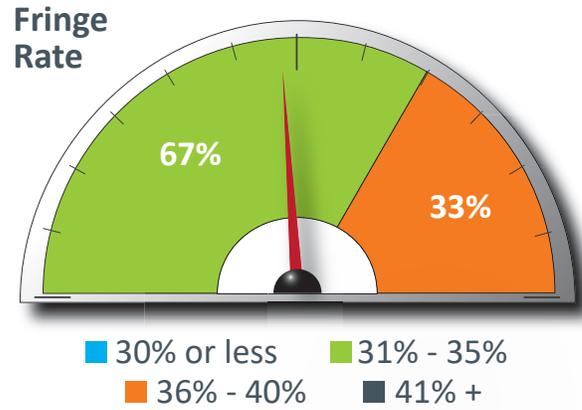


Companies with Revenue of \$51 Million to \$100 Million

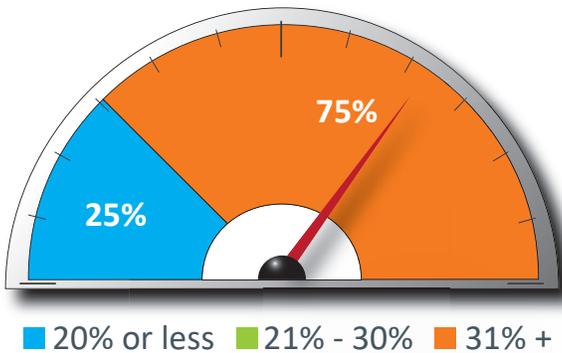
In our survey, the fringe was shown to be in the 30% range for companies of this size. We did not expect to see any below 31% or any above 40%. Competitiveness is the name of the game with LPTA highly anticipated for some agencies and contracting officers.

Similar levels of indirect rates begin to occur regardless of the NAICS of the companies versus the various results we saw at below \$50M revenue size. At greater than \$50M, operations and efficiencies set in and management becomes a fixed amount at the C Levels. This data can be very helpful when management asks for ranges of indirect rates at the various size levels. At this level, companies need to be concerned with executive compensation in the rates and performing a self-study to make sure their voluntary deletions are being made properly. Accounting system reviews are common at this revenue level, and this is when compliant G&A functions and systems become ever more important. Policies and procedures should be

developed to ensure your staff across all functions are receiving the proper documentation and sign-offs to pass a pre-award survey or other reviews. The cost of compliance should be budgeted in G&A for this sized company, and this may be the reason G&A rates in our survey are above 21%. The high G&A rate begs the question: are these companies truly bidding at the 21% or something lower to win the work in this era of LPTA?



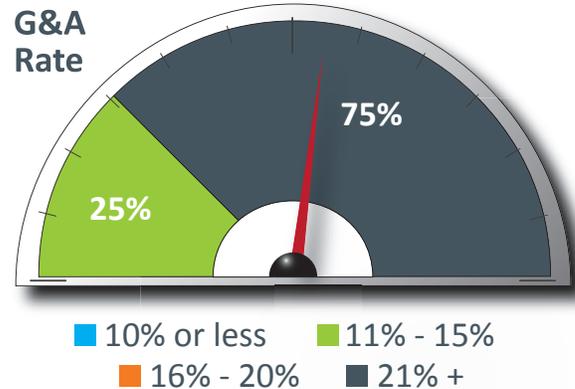
Overhead — Contractor Rate



Overhead — Government Rate



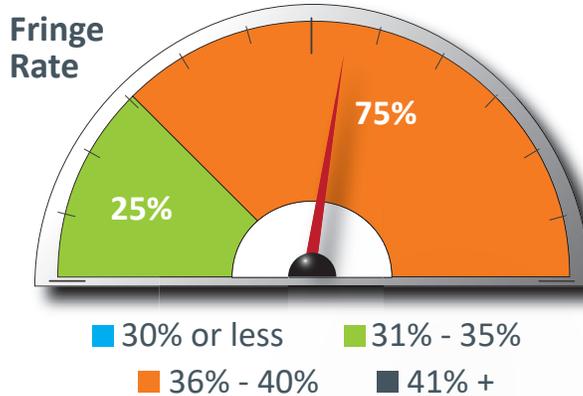
These gauges show the percentage of respondents who fall within the indirect rate percentage that is shown in the key.



Companies with Revenue of \$101 Million to \$250 Million

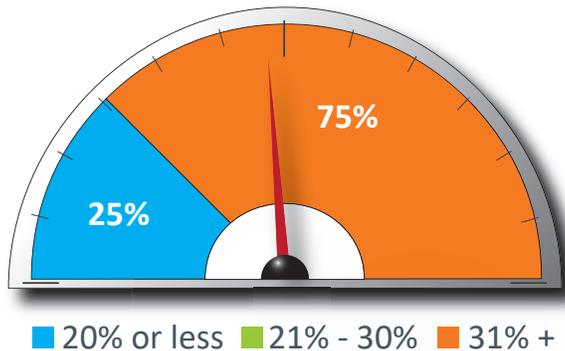
Companies over \$100M have many indirect rate types and service centers—even more than shown here. Home office allocations are also common at this size level. Emphasis on defining what goes into your bases and pools could be magnified with the possibility of becoming CAS (Cost Accounting Standard) covered. Keep in mind that any

changes you make to your rates or allocations may require a cost impact study. Understanding which contracts may be CAS covered at this level is very important and should be monitored by your contracts department. Develop your budget with solid assumptions for auditors, as the entire budget could be subjected to not only a forward pricing audit, but a proposal audit as well.

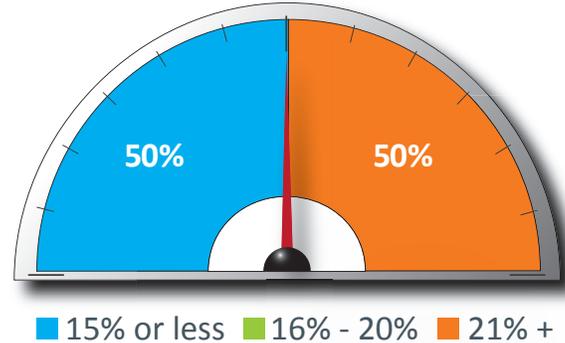


These gauges show the percentage of respondents who fall within the indirect rate percentage that is shown in the key.

Overhead — Contractor Rate



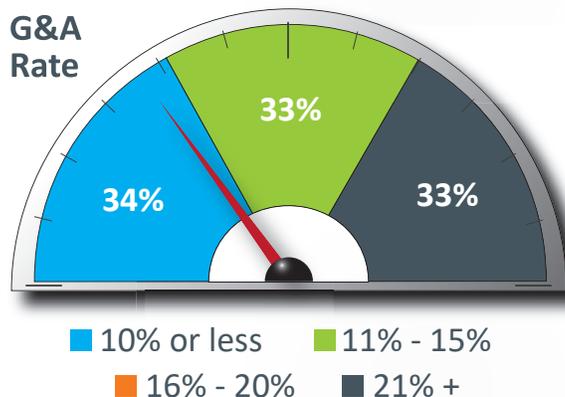
Overhead — Government Rate



MSH Rate



G&A Rate





INDUSTRY INSIGHTS

To provide more comprehensive information on how to prepare for the next budget year, we have enlisted the advice of our colleagues in the legal and investment banking industries. Please see below for additional insights.

Value Drivers for Today’s Government Contractor by KippsDeSanto & Co.

To effectively position a company for a value-maximizing sale process, government contractors should focus on building a sustainable business that provides tangible, long-term growth opportunities for buyers. This can be achieved in several ways—by building strategic relationships with high-profile customers, developing in-demand capabilities, and obtaining sought-after contract vehicles. Understanding what active acquirers are looking for in target companies can help owners and executives implement strategies that can drive meaningful value to their businesses in the context of a sale. While every buyer has a unique set of parameters that drive merger and acquisition (M&A) interest and establish a purchase price for a target company, the following themes highlight several key drivers within today’s government contracting deal environment.

In-Demand Capabilities: Buyers typically pay a premium for niche, in-demand, and well-funded capabilities. Today, these capabilities include, but are not limited to, big data analytics, Agile and DevOps, cybersecurity, mobility, cloud computing, and Internet of Things (IoT). Many buyers use M&A to add or enhance a capability that can be difficult to grow organically. Acquisitions bring alternative past performance qualifications and technical certifications that can be instantly leveraged to pursue new programs and to cross-sell to existing customers. Buyers are also likely to pay more for companies with significant depth across a select few capabilities as opposed to having substantial breadth across numerous service offerings.

High-Profile Customers: Difficult to penetrate customers, such as those within the Intelligence Community (e.g., NSA, CIA, NRO, NGA, FBI, etc.), and well-funded and high-profile agencies, such as CMS, DHA, and SOCOM, typically drive premium valuations. Like capability depth-driving value, the significant presence at a few quality agencies is likely to attract a higher relative value than having numerous small contracts that are diversified across multiple agencies.

Sought-After Contract Vehicles:

Companies that provide buyers with access to key contract vehicles, such as Alliant, T4, OASIS, CIO-SP3, etc., can garner robust valuations as they bring

customer access and growth opportunities to buyers. As is the case with all contracts, full-and-open (F&O) and prime positions on in-demand vehicles are considerably more advantageous than set-aside or subcontracts for acquirers, and therefore command a higher purchase price. In addition, vehicles that offer limited competition provide greater barriers to entry and therefore, typically garner higher values. Lastly, buyers will value a seller’s track record of performance on a vehicle. A proven ability to win task orders and generate revenue on a vehicle is viewed as a strong positive.

Attractive Contract Portfolio: A critical element of value creation for government contractors is developing a stable and “transitionable” contract portfolio. It is often difficult for large buyers to maintain contracts and programs that have historically been competed among small business, 8(a), service-disabled, or other designated set-aside companies.

A critical element of value creation for government contractors is developing a stable and “transitionable” contract portfolio.

While set-aside contracts may remain in place through a transaction, and even through contract completion, buyers typically cannot re-compete them as prime unless they can transition them into F&O procurements. This is uncommon. Thus, buyers look much more favorably upon contracts that have been competed in an unrestricted, or F&O, environment. Similarly, buyers prefer prime contracts over subcontracts as they have greater customer intimacy and contract control.

Limited Near-Term Re-compete Risk: Given that revenue and earnings visibility drive value across all industries, backlog is a critical component of a government contracting company's inherent value. Having significant backlog provides buyers with sufficient runway to execute programs before having to re-compete them. If you assume that the average length of a government contract is four years, then, on average, most companies will have ~25% of their contracts up for re-compete in any given year. This makes it critical to time a sale process around key re-competes and go to market following major contract awards to ensure plentiful backlog and to maximize enterprise value.

Employee Clearances and Certifications: An employee base that is rich in expertise, technology and industry certifications, and government security clearances provides key differentiators and barriers to entry, and therefore drives value in an M&A context. When you combine hard-to-obtain security clearances with expertise and certifications around cutting-edge technologies and platforms, such as Hadoop, Salesforce, ServiceNow, Ruby on Rails, AWS, etc., a company can attract considerable value as the combination is rare and in high-demand.

Strong Financial Performance: Historical organic revenue growth demonstrates a company's ability to effectively pursue and capture new business and provides support for future growth. Ultimately, buyers leverage M&A to supplement their own organic growth initiatives, so companies with established growth stories provide more confidence in continued growth post-transaction. In addition, most buyers are attracted to high-margin capabilities and contracts that are viewed as "stickier" and therefore, more likely to remain in place upon re-compete.

... highly unique capabilities, sought-after company-owned intellectual property, and other niche characteristics can drive value regardless of contract and company dynamics.

Cost & Revenue Synergies: If a buyer believes that it can eliminate redundant costs and expand margins because of an acquisition, it will be more willing to pay a higher purchase price. Similarly, many smaller and medium-sized companies are using M&A to not only become more cost competitive, but also to pursue larger, and sometimes more diversified, contracts. If a buyer believes that an acquisition will allow it to pursue opportunities that would have otherwise been unavailable (i.e., achieve revenue synergies), it will likely be more willing to pay a greater EBITDA multiple and purchase price.

While all buyers are looking for something different in an ideal target company, the above highlighted characteristics drive value for many active acquirers in the current government contracting marketplace. That said, highly unique capabilities, sought-after company-owned intellectual property, and other niche characteristics can drive value regardless of contract and company dynamics. Addressing even a few of these suggestions can help to drive value and ensure a successful M&A transaction.

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.

De-Regulating Commercial Item Procurements in 2018 and Beyond

by Robert Burton and Elizabeth Buehler of Crowell & Moring

As the Department of Defense's Commercial Item Handbook recognizes, "[s]ince the passage of the Federal Acquisition Streamlining Act of 1994 (FASA), the preference within the Federal Government has shifted from the acquisition of items developed exclusively for the Government to the acquisition of commercial items." Despite such change in preference (which is reflected in Federal Acquisition Regulation ("FAR") Part 12), over the past twenty-plus years, the government has subjected commercial item procurements to an increasing number of regulations and executive orders. In fact, an analysis of FAR 52.212-5 (Contract Terms and Conditions Required to Implement Statutes or Executive Orders – Commercial Items) demonstrates that the number of clauses to implement provisions of law or executive orders that are potentially applicable to prime contracts for commercial items has increased from 17 in 1995 to 51 in 2015, while the number of potential flow down clauses to subcontracts has risen from four in 1995 to 18 in 2015.

While one particular contract may not be subject to these flow downs, the fact remains that commercial item procurements are now more highly regulated than 20 years ago—a situation that is antithetical to the government's clearly stated preference for the procurement of commercial items. Indeed, it appears that commercial item procurements are so highly regulated at this point that many commercial companies simply choose not to conduct business with the government or rely on resellers where possible. Given the statistics cited above, one can hardly blame such companies. However, both the government and contractors (or potential contractors) should be motivated to rectify this situation. Without question, less-regulated access to the government provides contractors additional opportunities to generate revenue and this increased participation rate, in turn, creates greater competition and more competitive prices for the government.

Indeed, the Trump administration appears to be focused on just that and companies should too as they begin to budget and project new wins in 2018. Specifically, early in the Administration, the President issued the so-called 2-for-1 Executive Order, which has prompted the Office of Information and Regulatory Affairs (part of the Office of Management and Budget) to more closely scrutinize the burden (including costs) that various regulations impose on contractors. In this respect, Congress is also involved. For example, while contractors previously included in their budgets compliance costs associated with the Fair Pay and Safe Workplaces Executive Order, Congress, through the Congressional Review Act, subsequently revoked that Order. Consequently, contractors no longer must budget for such costs. Based on these actions, it appears that other reductions are likely, and contractors can be optimistic regarding lower compliance costs (though some requirements, e.g., the Buy American Act, will remain).

Without question, less-regulated access to the government provides contractors additional opportunities to generate revenue, and this increased participation rate, in turn, creates greater competition and more competitive prices for the government.

In sum, the government in 2017 and in the future appears to be focused on streamlining commercial item procurements and reducing the burden of such procurements on industry, which align with one of the Administration's cornerstones—regulatory reform. This may or may not reduce the burden on compliance to the government contractors budget, but it's worth contemplating when building your compliance budget.

Rob Burton is a partner in Crowell & Moring's Government Contracts Group and the former Deputy Administrator of the Office of Federal Procurement Policy. Elizabeth Buehler is an associate in Crowell & Moring's Government Contracts Group.



HOW TO CONTRIBUTE TO THE 2018 GAUGE REPORT

If you have any questions or feedback regarding the 2017 GAUGE Report, please contact:

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

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

If you would like to contribute to the 2018 GAUGE Report, by completing our upcoming Government Contracting Benchmarking Survey, please let us know. Your participation will be greatly appreciated.

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 software for project-based 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 administrative costs by 90%, improve invoicing by 10X, 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.



COHN  REZNICK
ACCOUNTING • TAX • ADVISORY

Unanet
Projects, People & Financials

CohnReznick LLP © 2017

This has been prepared for information purposes and general guidance only and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is made as to the accuracy or completeness of the information contained in this publication, and CohnReznick LLP, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.



CohnReznick is an independent
member of Nexia International