

GUEST ARTICLE

Federal Technology M&A Activity Ran High in 2006

New players and old stalwarts combined to keep activity at historic highs, *writes Minuteman Ventures' Paul Serotkin.*

M&A in the defense/federal services market kept roaring along in 2006. Private equity and other financial buyers remained strong in the sector while the UK invasion, so powerful in past years, slowed in 2006.

2006 compared favorably to 2005 in terms of M&A transactions in the sector, with 82 recorded this year and 81 in 2005. Again, reflecting the demographics of the sector, most of the transactions were for smaller firms. Nearly 67% of deals were for purchase prices under \$50 million, while 16% went to companies who were bought for values between \$50 and \$100 million.

Market conditions for sector M&A 2007 still look favorable. Industry fragmentation remains a major factor, which should lead to further consolidation, as should appetite by all sized companies to beef up their revenue from intelligence and homeland defense components. Certain inhibitors could offset some of the forward charge, or at least the height of valuation multiples. Macro issues include budget concerns, the drain of the Iraq commitment on domestic IT programs and new SBA rules governing small business recertification.

With the exception of the major UK companies, the buying groups in the sector remained similar to those

in 2005, composed of the following:

Private equity funds, large system integrators, weapons platform makers, public federal IT pure-plays and private, mid-tier government services companies.

Whither the Middle Class?

A continuing concern for the industry is the vanishing middle class—those companies in the \$100-\$300 million range that are both viable buyers of smaller companies yet are of a size to interest much larger buyers.

Three well known mid-tier firms were acquired this year - Management Systems Designers, Inc. (by Lockheed Martin), QSS (by Perot Systems) and Datatrac Information Services (by CSC).

Yet several companies continued to grow from their middle tier perch, either building toward an IPO and or fattening up for sale.

Alion Science and Technology emerged most powerfully among the mid-tier acquirers, buying BMH Associates, Micro Analysis, Washington Consulting, and, the coup de grace, the pick-up of 900 employees

divested by Anteon after the General Dynamics acquisition.

Three other mid-tier notables completed deals last year as well—McDonald Bradley, Netco/Multimax and Schafer Corporation.

Still a Healthy Public Market

Like other sectors, the defense services M&A market is driven by the amount of capital flow in the market, starting with the public market appetite.

2006 saw four sector companies go public. The long awaited SAIC offering went effective later in the year, as did Stanley Associates, a venerable industry name that built up successfully with acquisition and internal growth, and ICF International, having doubled in size since becoming a CM Equity portfolio company in 1999. Dyncorp International, having been earlier purchased by Veritas Capital from CSC, also completed its IPO in 2006.

Private Equities Play On

Private equity firms continued active in the sector, both coming and going.

The aforementioned Veritas Capital, after selling a piece of its DynCorp subsidiary to the public (while keeping controlling interest), also acquired Pearson Government Solutions from Pearson plc for \$600 million.

CM Equity sold portfolio company ICF International in a public offering this fall, raising \$56 million. The



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New York equity firm also acquired LandAir for another portfolio firm, 3001 International.

Kelso Partners, after shepherding an extraordinary ramp up of portfolio company Overwatch Systems, sold the company to Textron.

Hellman Friedman and Texas Pacific Group teamed to acquire Integraph Corporation for \$1.3 billion.

Intelligence Deals Dominate

The pursuit of firms with revenue from the intelligence agencies (NSA, CIA, FBI, et al) continues as a priority for many buyers.

Note the following deals executed by federal and defense public companies:

- SRA International acquired Raba Technologies
- EDO bought Impact Science and Technology
- SI International completed the Zen Technology deal
- Compudyne took over Signami

No doubt the largest intelligence-centric transaction in 2006 was the \$580 million buy of publicly traded Essex Corporation by Northrop Grumman. Reprising the trend among major primes like Lockheed Martin to diversify further in high-end IT and specialized information services, Northrop acquired Essex in November, its only announced transaction in the sector in 2006. Essex provides advanced optoelectronic imaging for U.S. government intelligence and defense customers.

It provides optoelectronic 3D imaging and signal processing services to classified U.S. Government customers. The price – a gaudy \$580 million on 2005 revenue of \$159.8 million.

Associates), and the aforementioned Intergraph deal with the two equity houses.

SPACs Show Some Muscle

New to the defense market, the so-called Special Purpose Acquisition Corporations raise capital in an IPO without having any operational company. They then must apply the raised funds to acquire operational firms within 18 months.

Several defense SPACs sent public in 2005. With 2006 as their key year to acquire, deals were announced.

Federal Services Acquisition Corporation, which raised more in the IPO than the other sector SPACs, announced its intent to buy Advanced Technology Systems (ATS).

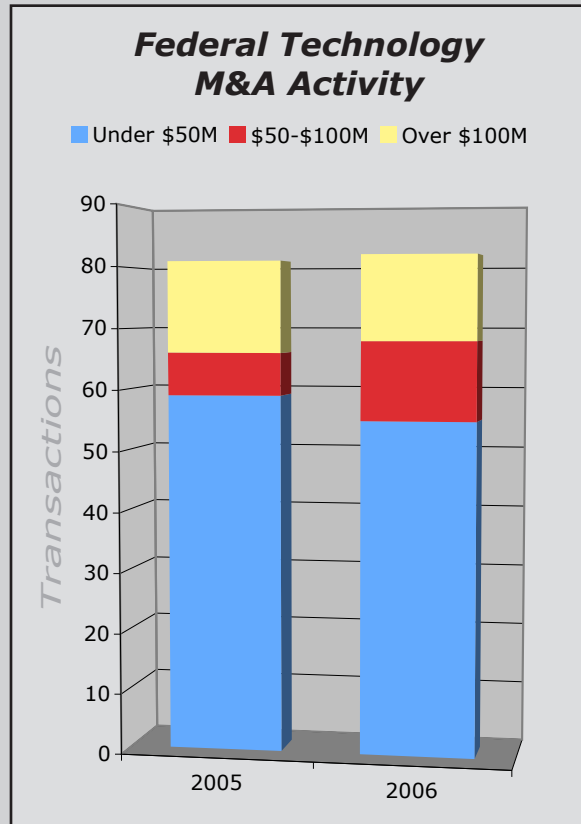
Another SPAC, Fortress America Acquisition Corporation, announced it had completed negotiations to acquire VTC LLC (comprised of TotalSite and Vortech).

A third deal was announced but fell apart within the past month, that being the transaction by TAC Acquisition

Corp. to acquire Aviel Systems. Not enough TAC shareholders approved the deal. Whether this portends the end of SPAC interest in the sector remains at issue.

Legends Live On

No analysis of M&A in this sector is complete without a mention of SAIC. The newly public company won the race for most announced deals this year with five, all apparently smaller, tactically enhancing companies. ♦



The Huntsville Phenomenon

While it may not qualify as a M&A trend, it's worth noting the acquisition frenzy for companies based in Huntsville, Alabama.

The beneficiary of favorable BRAC decisions, Huntsville companies became trendy targets in 2006. No fewer than five such deals were announced – CAS (by EDO Corporation), Madison Research (by WFI), 3D Research (by Schafer Corporation), Morgan Research (by Stanley