

GTS Sector Sizzles in Lower, Middle Tiers

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The M&A market for government technology services (GTS) firms remain robust, with the appetite for under \$50 million firms gaining extraordinary interest.

Over 75% of the year-to-date 2003 transactions in the sector were for firms with annual revenue under \$50 million (see chart). Companies of all sizes participated as buyers in this GTS size segment.

Seller and buyer interests are highly aligned.

As smaller, founder-led firms mature, their owners realize how each rung up the growth ladder in any market (and perhaps particularly the federal market) becomes that much more of a struggle.

Additionally, they are also mindful of emerging federal rules to have to recertify each year as a 'small business.' The possible outcome – an inability to bid on their own or new set-aside contracts, or worse, the loss of existing work upon exercise of the next contract option year. CEOs also read the popular press; they know M&A is very active in this sector now at robust valuations.

Even without the onerous recertification rules, companies often lose their ability to bid on small business contracts when they reach the low \$20 millions in revenue, another reason for them to consider transferring the risk of ownership to larger firms.

From the perspective of larger strategic buyers, sub-\$50 million GTS firms can present true value added. Even ones in the \$10-\$15 million range can offer immediate access to new customers

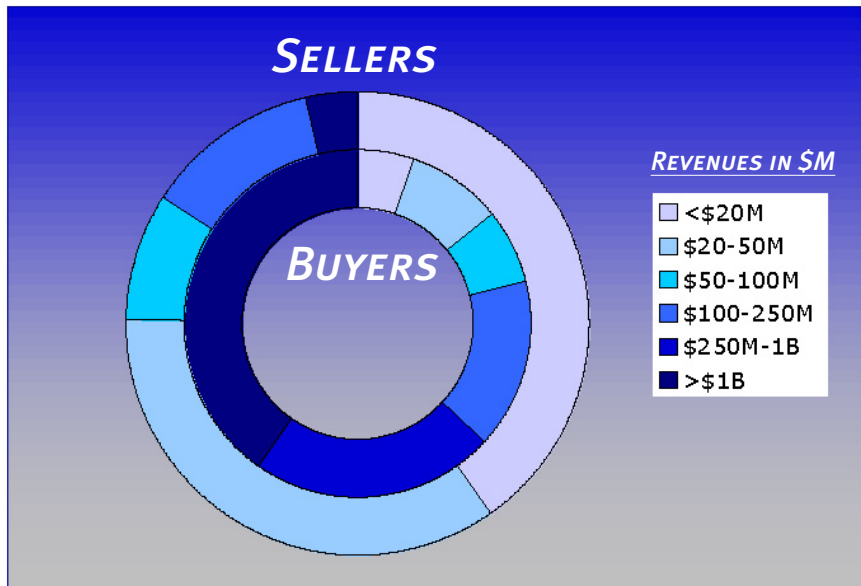
and add 100+ employees as the launch pad to deeper agency penetration. One Minuteman Ventures LLC client - at \$17 million - primed one of 10 Millennia Lite GWACs, a vehicle not held by the buyer and that induced the large integrator to ante up.

Larger companies know that smaller, nimble IT firms become great resources to federal agency customers, desired for more than fulfilling requirements to

The outcome, even after the M&A deal: repeat and expandable business for the acquirer.

The rationale for these mid-tier deals goes on; these firms can bring:

- Employees that have needed SCIF, top secret and secret clearances to perform federal work.
- Prime contract positions that can command project control.



meet small business and 8a set aside quotas.

They specialize in mission-critical technology solutions, customize applications of enterprise software for the government market, manage IT facilities and agency help desks, model business and defense simulations, support program managers in acquisition management, and help the government plan for enterprise rollouts, e-gov transaction management and battlefield scenario planning.

Critically, these firms hold the *sine qua non* of federal contracting – valuable, long-term customer connections that follow the individual relationship.

- Hard-won contract 'vehicles' and single award contracts that limit competition in approaching new government business.
- Contract backlog that approaches two, three and even four times their current annual revenue.

Activity in the GTS M&A markets sparks other observations:

- **Mid-Tier Buyers.** Buyers in the under \$250 million revenue class, most of them privately held, continue to use M&A as a viable growth strategy. Just under 50% of the 2003 transactions

Continued on page 7

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GTS Sector Sizzles

Continued from page 6

were executed by firms in that size. This group, now faced with building the contract/bid pipeline to grow on top of an ever larger revenue base, relies on new revenue sources that smaller firms can bring. These buyers possibly fancy themselves IPO candidates, or simply are playing the arbitrage of government M&A pricing – buy at lower multiples and selling the company at a later date for higher ones.

- **Big Buys Small.** This sector is constantly marked by the acquisition by large companies of small ones, for many of the reasons cited above. Better than one in two firms bought this year by \$1 billion-plus acquirers had under \$50 million in revenue.

- **The Dwindling M&A Middle Class.** The GTS IPO class of 2002 (including Veridian, SRA, SI International, Mantech, MTC, PEC Solutions) will come under pressure for continued strong

performance. Some, such as Veridian and Titan (a long time GTS public firm) have already sold. As this group gets chipped away via acquisition, the concentration of strong middle market public acquirers will lessen. This means tougher sledding for small/mid-tier would be sellers, unless the IPO pipeline gets re-stocked. If it doesn't, the shrinking of the IPO buyer group could mean better looks at good GTS properties by under \$250 million private companies.