The Pulse of GovCon

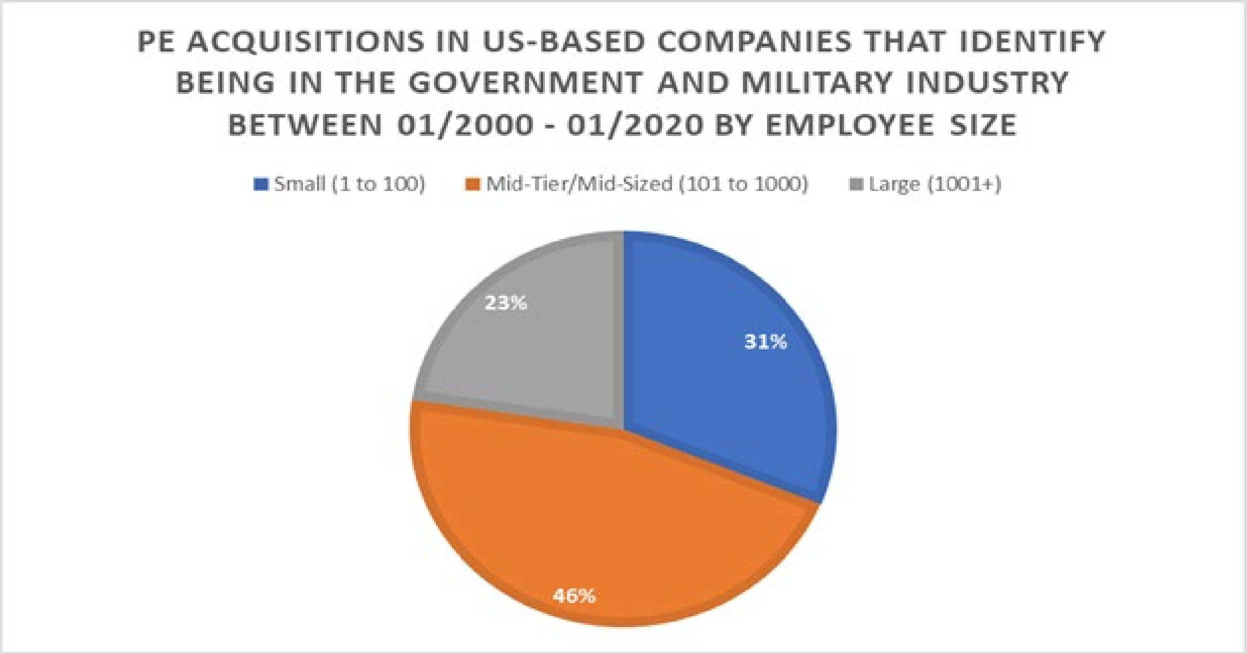
Stuck in the Middle of GovCon

An Analysis of PE in Government Contracting

October 2021

I. Introduction.

It's no secret that size matters in the federal government contracting industry. It's a common trope that small businesses who support the federal government work to build larger, only to become paralyzed, or worse, parish, in the valley of death once their organization reaches the dreaded undefined and undesirable mid-size/-mid-tier standard[1]. Without the socio-economic set-aside benefits of a small business, or the established internal resources of a large organization, these mid-sized companies get lost at sea - small catamarans against the giant yachts of industry. Yet, in the last 20 years, there has been a massive uptick in private equity interest in mid-size federal contracting firms.



[1] https://docs.house.gov/Committee/Calendar/ByEvent.aspx?EventID=108230

Private Equity Acquisitions in US-based Firms that Identify as a Primarily Government and Military Firm (2000 - 2020)

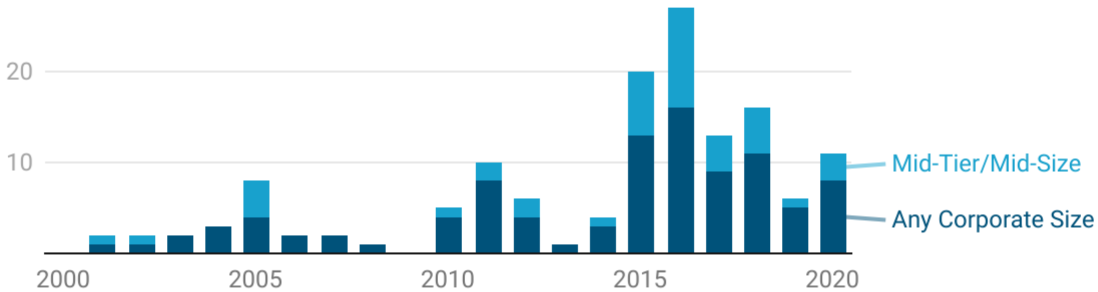


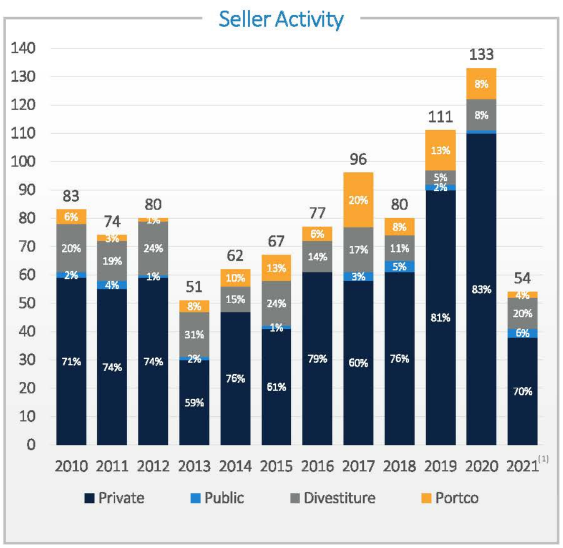
Chart: The Pule of GovCon • Source: crunchbase • Created with Datawrapper

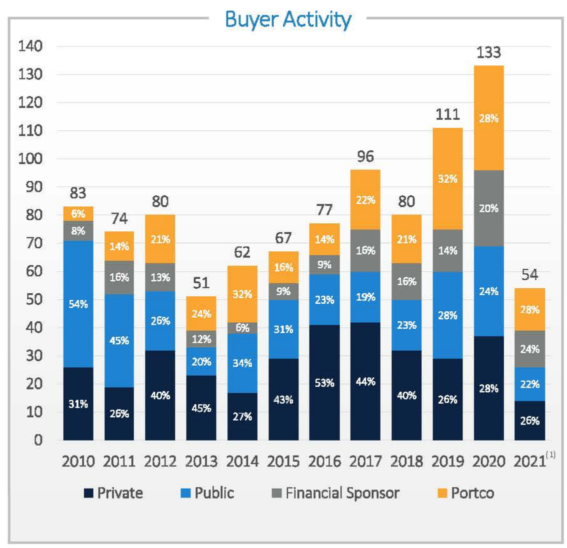
The aforementioned information comes from Crunchbase, an opensource, albeit imperfect, platform for finding information for investments and funding information. M&A companies typically track this information internally. KippsDeSantos for example, tracks PEG platforms and PEG Platform add-on acquisitions by year back to 2010.

THE PULSE OF GOVCON

Government Technology Solutions Buyer and Seller Composition Has Evolved

- Public strategics have become increasingly selective in their M&A strategies; prioritizing impact over volume (i.e., number of deals)
- PEGs have become more active, willing, and able to pay "strategic" valuations
  - Attractive federal budgetary trends and increased sector awareness drove increase in interest
  - Strong capital market dynamics led to a more active fundraising climate
  - Combination of available capital and favorable fundraising markets – availability, leverage, and low interest rates – encourage aggressive M&A activity and competitive valuations alongside strategic buyers





KippsDeSanto INVESTMENT BANKING

(1) As of April 16, 2021

In the current world of federal contracting, there are various barriers to entry to working with the federal government. From Cybersecurity Maturity Model Certification (CMMC) to Defense Contract Audit Agency (DCAA) compliant accounting system, federal government contractors need to meet various criteria to bid on certain contracts[2][3]. Size is another one of these barriers. Companies find themselves either too big to benefit as a small business, but not large enough to compete with the industry titans. So why, if mid-sized firms are the middle child of contracting, are these companies appealing to private equity firms? While many proponents would argue that mid-tier firms are the right size to fit into private equity firm's investment profile, this is not their incentive for doing so. Their reasoning for investing into this particular market is because they know that they do not receive the special benefits that a small business would receive and simply do not have the resources or capital to compete with their larger competitors, which leaves them in a position to be a prime target for equity firms.

GovCon PEG Activity - 2010 - 2020

Deal Volume and Mix	2010-2014	2015-2018	2019-20
PEG Platform	7.8	10.3	21.5
PEG Tuck-in	12.8	15.0	36.5
Total PEG Deals	20.6	25.3	58.0
Total Deals	70	80	122.0
	30.4%	30.9%	47.5%

($ in millions)

PEG Platform Medians	2010-2014	2015-2018	2019-20
Enterprise Value[1]	201.3	197.8	74.6
Revenue	251.1	228.0	71.8
EV / EBITDA	7.3	8.0	7.7

PEG Tuck-in Medians	2010-2014	2015-2018	2019-20
Enterprise Value[1]	63.0	48.3	46.4
Revenue	29.4	46.3	63.6
EV / EBITDA	7.2	7.5	7.9

The Pulse of GovCon aims to explore the impact of these investments and speculate as to whether small businesses will one day need to pursue private equity in order to stay competitive. In this case study, we will consider the impact of increased private equity interest in the federal contracting, government, and military industry, especially in mid-sized/mid-tier organizations.

The Pulse of GovCon engaged 4 subject matter experts (SMEs) to answer the following questions:

1. **What type (i.e. PSC [Service, Product, Research & Development (R&D)]) and size (based on a number of employees) are federal government contracting companies attracting private equity interest?**

[2] https://www.acq.osd.mil/cmmc/

[3] https://www.dcaa.mil/

2. **Do federal government contracting companies become objectively more "successful" (profitable and/or notable) within 5 years of receiving private equity backing?**
3. **Are mid-tier/mid-size companies less likely to close their doors if they have private equity investment?**
4. **Will trends show a "trickle-down effect" of private equity interest in smaller companies?**

The theory of natural selections says, "*It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is most adaptable to change*". In the future of federal government contracting, will that theory change to *"only the ones that can adapt to be funded will survive?"*

II. Literature

Mid-Tier Federal Government Contractors

Definition

Currently, there is no formal or legal definition of a mid-tier/mid-size standard in the federal government contracting industry. Some Private Equity firms will define a mid-tier federal government contractor as a business which possesses an EBITDA between $10-50 million and equates to $75-750 million in revenue for that government contracting firm. However, for the purposes of this research, The Pulse of GovCon relied upon Bloomberg Government and Forbes to define a mid-tier/mid-size standard of a federal government contracting organization. According to Bloomberg Government, a mid-tier/mid-size federal contractor is defined as having an annual spending obligation greater than or equal to $25 million and less than $500 million[4]. And according to Forbes, a mid-tier/mid-size business is defined as one between 100 - 1,000 employees[5].

Market Share

As of Fiscal Year (FY) 2017, mid-size/mid-tier federal government contractors claim 26.8% of the market share while only making up 1% of all active vendors, according to Bloomberg Government[6][7]. Despite only making up 1% of market vendors, mid-tier/mid-size federal

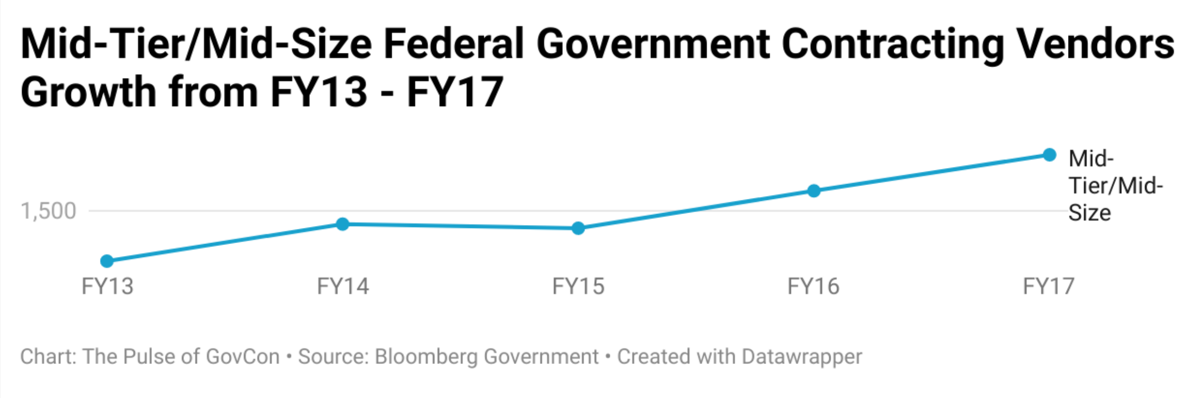
[4] https://data.bloomberglp.com/bna/sites/3/2018/12/Bloomberg-Government_2018Mid-TierMarketReport.pdf

[5] https://chrismercer.net/middle-market-companies/

[6] Vendors that received federal spending obligations in that fiscal year

[7] https://data.bloomberglp.com/bna/sites/3/2018/12/Bloomberg-Government_2018Mid-TierMarketReport.pdf

government contractors are increasing in the ecosystem with an average growth rate of 6%. In FY17, the number of mid-tier/mid-size firms reached its highest level in 5 years with the average spending per mid-tier/mid-size vendor growing in FY17 after 3 straight years of decline.



As outlined in Bloomberg Government's 2018 Mid-Tier Market Report, half of all federal spending obligations on mid-tier/mid-size federal contractors are classified as information technology (IT), professional services, facilities, and construction[8]. In FY17, the number of mid-tier/mid-size spending has increased with the overall market with mid-tier spending growing by 17% since FY13 as the entire market grew by 10%.

It is important to note, that due to no formal or legal definition of a mid-tier/mid-size standard in the federal government contracting industry, hundreds of large commercial enterprises fall into the mid-tier segment; while many are officially designated as "small" federal contracting vendors as they either qualify with a) a special socioeconomic status, or b) a high labor size standards. This is further complicated by the new SBA rules which "extend the runway" for graduation (both in higher dollar thresh holds and longer look-backs), which make it difficult for many of these mid-tier firms because it allows higher-tier firms to continue to compete in their thresh hold rather then pushing them into the other category where they could compete with the larger-tier government contracting firms[9]. This expanded mid-tier classification which lacks a proper formal or legal definition only further encourages an environment in which Private Equity firms can pick and choose which firms to provide resources and capital for and which ones will be left behind to struggling in the ever changing, competitive environment of government contracting.

Private Equity

[8] https://data.bloomberglp.com/bna/sites/3/2018/12/Bloomberg-Government_2018Mid-TierMarketReport.pdf

[9] https://www.jdsupra.com/legalnews/small-business-runway-act-regulation-62437/

Definition

Private equity is an alternative investment class and consists of capital that is not listed on a public exchange. Private equity is composed of funds and investors that directly invest in private companies, or that engage in buyouts of public companies, resulting in the delisting of public equity[10]. For the sake of this research, we are just looking at private equity acquisitions (buyouts[11]), which is just part of the greater merger and acquisition world[12].

Private Equity Firms and Historical Investment in Mid-Tier/Mid-Size Federal Contractors

According to Crunchbase, there are at least 10,010 private equity firms around the world[13]. 237 (2%) of those firms have invested in, acquired, and sold U.S.-based organizations that primarily sell products and services to the U.S. federal government[14]. Based on our Crunchbase query, between 2000 – 2010, there have been significant swings in response to two major events, the first being after 9/11 leading to PE investments into Government and Military firms and the follow up investments after the 2009 market crash. From 2010 - 2021, there have been over 82 private equity acquisitions of organizations matching these criteria, with the peak occurring in 2016[15]. The sudden peak in 2016 is not clearly identified, but is believed to have been caused by the lean budget years under the Obama administration and buoyed by the Trump Administration's excessive spending. Another theory for this sudden rise is that PE piled into this market based on the perceived safety of the counter-cyclical nature of the sectors based on the late innings of a long bull market.

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[10] https://www.investopedia.com/articles/financial-careers/09/private-equity.asp

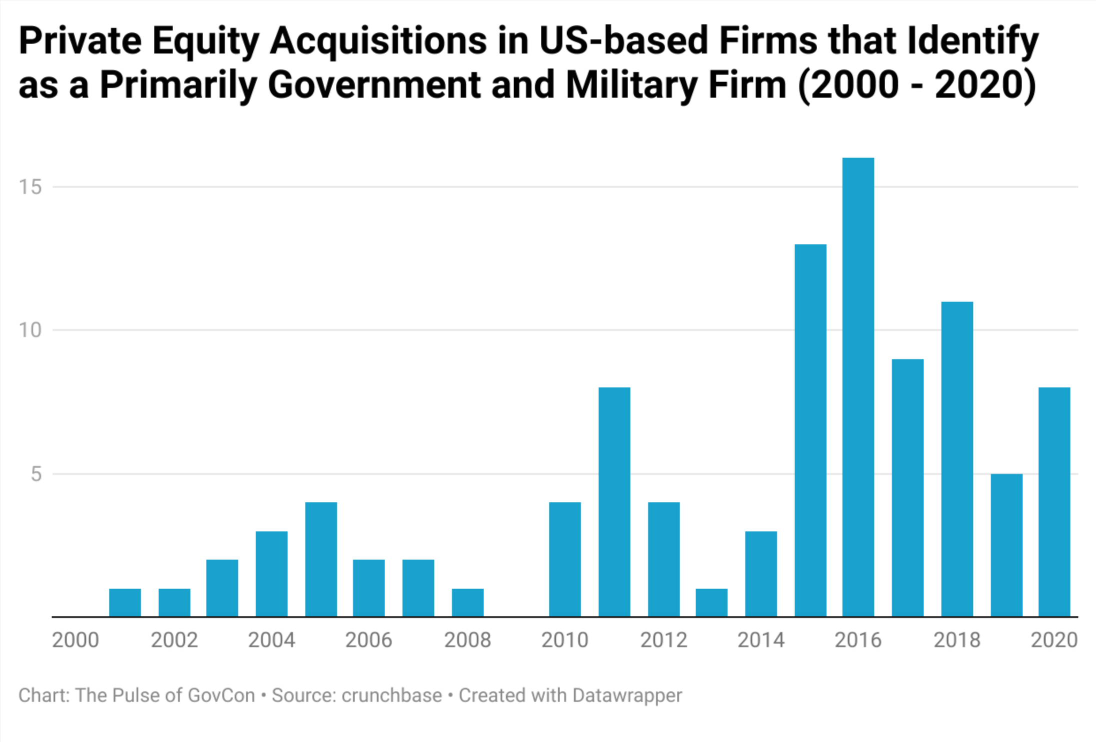
[11] https://blog.darcmatter.com/7-private-equity-strategies-investors-should-know/

[12] https://www.visualcapitalist.com/25-largest-private-equity-firms-chart/

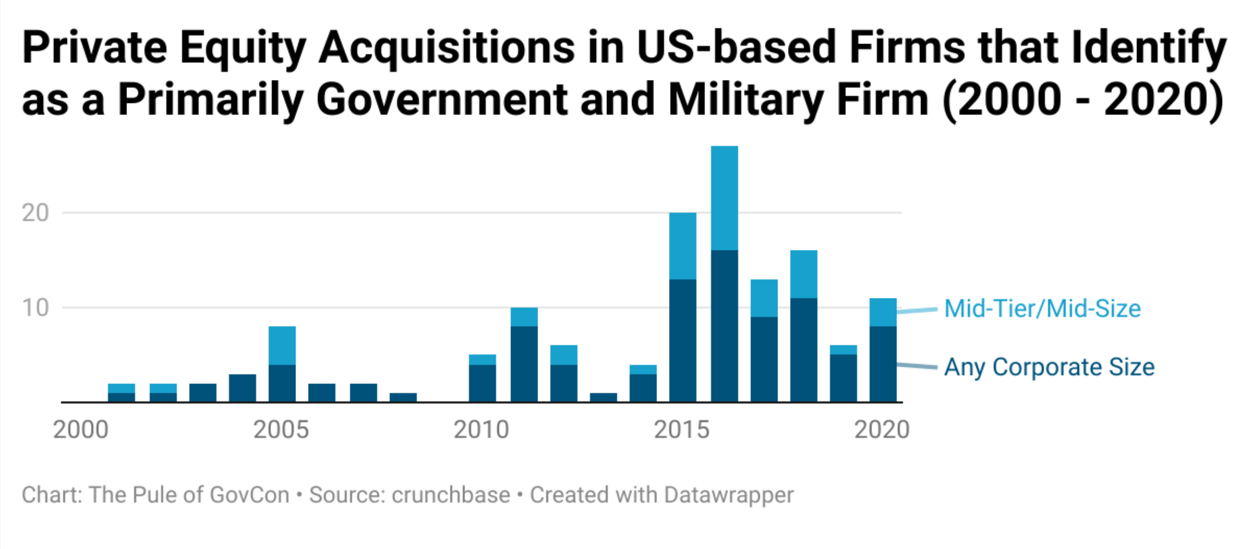
[13] https://www.crunchbase.com/home

[14] https://www.crunchbase.com/home

[15] https://www.crunchbase.com/home



To explore how many of these transactions included a mid-tier/mid-sized federal contracting organization, we looked at how many of these acquired organizations fit our mid-tier or mid-sized definition outlined above. Out of the 82 private equity transactions, 37 (45%) of those are acquisitions of a mid-tier or mid-sized federal contractor.



Contract Novation

Typically, government contracts cannot be moved from one contractor to another, however, when a merger or acquisition (M&A)[16] takes place, a contract novation may occur[17]. This is different from a stock sale which requires no novation because it is a change of control. A novation is an agreement between two contracting parties that allows the substitution of a new party in place of an existing old party. The original party that is replaced by the new party is exempted because of the novation. This means the original party has given up any rights (benefits and burdens) it initially had through the agreement. Both original parties must agree for a novation to occur[18]. The federal government's rules for novations can be found in FAR 42.1204[19].

A novation agreement applies when: (1) a transfer of ALL the contractor's assets occurs; (2) transfer of the entire portion of assets involved for the performance of the contract occurs[20]. This is needed when (1) a party needs to recognize a third party as a successor in interest of the government contract; (2) transferred assets need to be recognized[21]. A novation is not needed when (1) there is no change in ownership; (2) there is no legal change in a contracting party; (3) the contracting party remains in charge of assets and performance[22]. In cases when assets are not being transferred, an equity transfer of ownership occurs and is viewed as an easier process than relying on the transfer of assets and can vary depending on the contracting office.

During the merger and acquisition process, M&A agreements should account for the performance of any government contracts to continue with the original entity until all novations are approved. In the meantime, the incoming party may position itself as a subcontractor[23]. Novation is best done

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[16] For the sake of this research, we are just looking at private equity acquisitions (buyouts), which is just part of the greater merger and acquisition world

[17] https://www.wardberry.com/assignments-and-novations/

[18] https://www.law.cornell.edu/wex/novation#:~:text=A%20novation%20is%20an%20agreement,party%20for%20an%20existing%20one.&text=Both%20original%20contracting%20parties%20must%20agree%20to%20the%20novation.

[19] https://www.acquisition.gov/far/42.1204

[20] https://www.gsa.gov/cdnstatic/Guidelines-Novation_Agreement.pdf

[21] https://www.gsa.gov/cdnstatic/Guidelines-Novation_Agreement.pdf

[22] https://www.gsa.gov/cdnstatic/Guidelines-Novation_Agreement.pdf

[23] https://www.wardberry.com/assignments-and-novations/

with preparation and time, as there is no official timeline or schedule for novation approval[24]. Ultimately novation takes flexibility and a willingness to roll with the punches from the administrative contracting officer[25].

III. Method.

The Pulse of GovCon performed research to add context and data to back our theories. To answer our four questions above, The Pulse has identified a selection of SMEs in the field:

1. **Bob Kipps | KippsDeSanto & Co.:** Bob Kipps founded KippsDeSanto & Co. in 2007 and has grown the M&A firm to be the largest investment bank exclusively focused on the Aerospace / Defense and Government Services sector. KippsDeSanto advises on ~ 20 industry M&A transactions per year. Over the years, Bob has worked with some of the most successful industry firms both advising them on their strategy as they grew and assisting them with their eventual sale.

2. **Kristjan Kornmayer | The Chertoff Group:** Kristjan Kornmayer is a Senior Director at the Chertoff Group and leads the Merchant Bank's Buy-side Practice, which provides services such as M&A strategy development, target screening and full buy-side diligence analysis to financial and strategic buyers. He also supports Chertoff's investment banking and private equity activities, conducted through its wholly-owned subsidiary Chertoff Capital.

3. **Richard Philips | Crossroads Capital:** Richard Phillips is the Senior Partner of Crossroads Capital, LLC. He founded this boutique M&A advisory to better serve companies in the middle-market with actionable, data-driven intelligence to make better strategic decisions. He is a seasoned dealmaker and accomplished financial analyst with over 20 years of corporate finance, consulting, and investment banking experience. For the past several years, Government Contracting, Defense, IT Services, and Life Sciences have been sectors of focus.

4. **Kevin Robbins | Blue Delta:** Kevin is a co-founder of Blue Delta Capital Partners, a growth capital firm which is focused on the U.S. Federal Government Services marketplace, particularly on technology-enabled solutions and services companies. Mr. Robbins has been actively involved in all of Blue Delta's investments, including Metis

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[24]https://governmentcontracts.foxrothschild.com/2016/08/articles/ethics-and-compliance/government-contract-novations-practical-practices-under-far-42-1204/

[25]https://governmentcontracts.foxrothschild.com/2016/08/articles/ethics-and-compliance/government-contract-novations-practical-practices-under-far-42-1204/

Solutions (acquired by PAE), IST Research (acquired by The Carlyle Group), The Tauri Group (acquired by LMI), and KTSi (acquired by Scitor).

5. **Austin Libowitz | Independent Investor:** Austin Libowitz is an independent investor and advisor in the defense, government, and technology sector. Previously, at Veritas Capital, Austin invested in businesses and partnered with management teams to drive strategic and operational initiatives in the government and technology markets. Additionally, Austin has supported/advised Enlightenment Capital and leading companies in the industry.

IV. Discussion.

Bob Kipps

1. What type (i.e. PSC [Service, Product, Research & Development (R&D)]) and size (based on a number of employees) are federal government contracting companies attracting private equity interest?

Each private equity group (PEG) has a particular comfort zone for the size and profile of companies they're interested in, and each investment has its own thesis/focus. With the broad array of PEGs focused on the GovCon sector (some with multiple "platforms" or portfolio companies with the U.S. government as their end customer), there is interest in most market sectors. That includes Intelligence (Peraton/Veritas), Space (Linquest/Covant & Madison Dearborn), Digital Services (Octo/Arlington Capital) and Base Operations (Amentum/Lindsay Goldberg). Like strategic buyers, PEGs generally prefer to own "mission-oriented" companies that support government's citizen-focused activity rather than firms that support back office needs.

Historically, PEGs liked to start with a platform that was at least $100MM in revenue and/or $10MM in EBITDA; however, smaller PEGs are open to starting at a lower level. While PEGs are often willing to buy businesses with more set-aside contracts than larger strategic buyers, they do like to see a strong management team and either success in transitioning some of the target company's set-aside work to Full & Open or success in the pursuit/win ratio of unrestricted work.

2. Do federal government contracting companies become objectively more "successful" (profitable and/or notable) within 5 years of receiving private equity backing?

If successful means having a high likelihood of remaining in business and/or growing, then yes, I believe they will be more successful. However, one caveat is that most PEGs have a preferred holding period of 3-6 years. One of the biggest risks/obstacles for GovCon firms is the transition from set-aside dependency to the unrestricted world. PEG backing enables companies to take the necessary actions to successfully navigate that by helping them 1) finance acquisitions to garner adequate scale to be competitive, 2) attract management talent accustomed to hunting and winning unrestricted prime opportunities and 3) adopt mature internal processes and procedures.

In addition, over the past 5 years, more PEGs are focused on owning minority stakes in GovCon firms. Some of these firms, like Blue Delta Capital in particular, have a stable of very experienced industry veterans. Enlightenment Capital is another 'smart money' firm that is more hands-on, which could dramatically increase the success rate of the portfolio companies.

3. Are mid-tier/mid-size companies less likely to close their doors if they have private equity investment?

See above

4. Will trends show a "trickle-down effect" of private equity interest in smaller companies?

Given the difficult path for smaller firms to successfully transition to the larger unrestricted and the aforementioned benefits, PEG involvement in smaller companies may very well become much more common.

Kristjan Kornmayer

1. What type (i.e. PSC [Service, Product, Research & Development (R&D)]) and size (based on a number of employees) are federal government contracting companies attracting private equity interest?

I would start by breaking down the PE buyer landscape into two types: Specialists vs. Generalists. Each category approaches the A&D / GovCon market differently and will be searching for different types of companies.

Specialists: A&D / GovCon-focused PE firms with deep experience and expertise investing in this market. They are looking for specialized companies who differentiate by their capabilities (services, solutions, products), their customer relationships, and/or the mission. If a firm possesses some of these differentiating characteristics, specialist PE buyers will (and do) consider smaller firms but they have to be past growth stage with stable/growing revenue + EBITDA growth and attractive margins (a reflection of their differentiation). Buyers will have a preference for prime contracts and a limited tolerance for a lot of restricted and sub work. OTAs have become of greater interest to these types of buyers, especially in the R&D + prototyping world. In terms of size, some buyers will go as small as 10 employees and $10M revenue, but those would be for highly specialized companies (e.g., NSA cyber); typically it's more like 25+ employees / $25M+.

Areas where we see a lot of activity in this realm include cybersecurity, C4ISR, R&D / S&T, modeling & simulation, intelligence solutions / services, space, AI/ML. Example PSC codes could include R&D codes (AC11 – 13, AC 31 – 33), and Category H (Quality Control, Testing, & Inspection)

Generalists: These are PE firms who typically don't dabble in A&D / GovCon, but who might be looking at targets in adjacent markets (e.g., cybersecurity) or as "safe harbor" in an otherwise volatile economy. These types of buyers will typically look for larger services + products businesses with stable, predictable businesses and accompanying cash flows; they will also generally look for companies with some scale. Thus, they will stick to mid-sized companies (50+ employees, $100M rev) and will also want leadership to stick around and continue to grow the business.

Example areas of activity: IT services, subsystem / components manufacturing, logistics, AEC, system MRO; commercial aero is seeing a lot of M&A recently. PSC category codes would include Categories C1, D3, H1/2, J0, K, and M1.

2. Do federal government contracting companies become objectively more "successful" (profitable and/or notable) within 5 years of receiving private equity backing?

Generally, I would say that most DoD GovCon companies do become more successful within 5 years of PE backing, defining "successful" as continued revenue growth and profitability. Compared to other industries, we see a lot more growth investing in our space. Companies for sale are seeking new resources and backing to continue growing in their respective GovCon market segments, and PE backers usually provide those additional resources (BD / B&P, sales & marketing, recruiting, infrastructure, etc.) to facilitate continued growth and scale.

When this does not happen, it's usually due to a change in the customer environment - budget constraints, shifting priorities, shuffling / cancellation of contracts - that results in an adverse impact to the company.

3. Are mid-tier/mid-size companies less likely to close their doors if they have private equity investment?

Yes, for the reasons highlighted above. PE investors are inherently incentivized to grow their assets so they can sell for a higher multiple. Another approach to generating value is through cost-take out (downsizing and optimization) which isn't nearly as prevalent in GovCon as in other industries.

4. Will trends show a "trickle-down effect" of private equity interest in smaller companies?

To an extent, but there's a threshold below which companies are simply too small with too much risk (e.g., too much small business / restricted work, too much sub work, etc.) with too much risk for PE to acquire There are other options available to smaller companies (minority recap, VC, etc.)

Richard Phillips

1. What type (i.e. PSC [Service, Product, Research & Development (R&D)]) and size (based on a number of employees) are federal government contracting companies attracting private equity interest?

Companies want to see past performance heavily sought on the most attractive, best-in-class contract vehicles that key agencies are deploying in their spending. Typically, institutional buyers and PEGs want to see Full & Open work of 70% or greater. Sub-work is heavily discounted. Contract diversity is more important than agency diversity. That said, differentiated capabilities drive buyer interest more than customer access. The proven ability and track record of winning competitive work and making the transition beyond reliance on SB set-asides is a key determinant in showing the business can scale.

2. Do federal government contracting companies become objectively more "successful" (profitable and/or notable) within 5 years of receiving private equity backing?

In a word, yes. It helps a company evolve from small to large with more resources, more robust corporate infrastructure and better governance having gone through the diligence rhythm and the change management a PE buyer will demand.

3. Are mid-tier/mid-size companies less likely to close their doors if they have private equity investment?

Generally yes, it provides credibility, financial resources, talent, and increased capability to expand and build beyond current revenue plateaus. A private equity overseer will be demanding but they will do what is required to navigate a company through trouble waters. A PEG answers to its even more demanding LPs, so they are on the hook too.

4. Will trends show a "trickle-down effect" of private equity interest in smaller companies?

Yes, I think so – there are currently 70+ PE platform companies in the sector and counting. These PEGs will look for "bolt-on" acquisitions that will by definition will be smaller but more targeted in terms of unique capability and complementary services. We have seen this in deal activity over the past three years and it should continue.

Kevin Robbins

1. What type (i.e. PSC [Service, Product, Research & Development (R&D)]) and size (based on a number of employees) are federal government contracting companies attracting private equity interest?

It is an interesting question, because most PE firms do not think in terms of PSCs or employee counts. They are seeking capabilities and specific customer concentrations and measure size by EBITDA or Revenue. That said, I see the most interest for services and to a far lesser extent, some select specialized hardware or software. Very few people are actively seeking R&D right now. With respect to size, most PE firms require leverage, so typically they are looking for a bare minimum of $5M of EBITDA, but prefer to be in the $10-30M range, which means there is a little appetite for companies once they get over $50M of revenue and far more once they are in the $100-300M revenue range. For services companies at $200K/employee, that means there is little interest below 250 employees and the most interest in the 500-1,500 employee range

2. Do federal government contracting companies become objectively more "successful" (profitable and/or notable) within 5 years of receiving private equity backing?

There really isn't a lot of empirical data here, just a lot of rumor and innuendo. Generally speaking, PE firms are best at extracting operational efficiencies (cutting costs to expand profitability) and aiding in inorganic growth (making acquisitions). I know of very few companies that have failed to grow post-investment, but most of the topline (revenue) growth has been the result of making acquisitions and most of the bottom line (profit) expansion has been from cutting costs or leveraging existing costs over a broader revenue base.

3. Are mid-tier/mid-size companies less likely to close their doors if they have private equity investment?

Yes. The mid-tier is a lonely place to be. You no longer have the set-aside protections from the SBA and have to fend off the ankle-biting small businesses, yet you lack the scale, credibility and process maturity to go toe-to-toe with the big companies. The only way to succeed is to concentrate your fire and make fewer, bigger bets. That is a risky strategy that few management teams have the intestinal fortitude to execute, so bringing in a PE sponsor to add resources OR to let the founder de-risk the path forward by taking chips off the table makes a lot of sense.

4. Will trends show a "trickle-down effect" of private equity interest in smaller companies?

This is really hard. For starters, control private equity immediately vacates the SB protections for smaller companies by virtue of the SBA Affiliation rules. This alone is typically a deal killer. Second, without more than $5M of EBITDA, banks and institutional lenders have trouble putting much leverage on these businesses, which means PE firms have to put in way more equity than they typically like to do (normally 50/50 equity/debt) OR are restricted to paying lower prices to preserve their ratios, which prices are rarely compelling to Founders selling a stake in their companies. Minority equity (as evangelized by Blue Delta as far back as 2009) is the right solution to this problem: arm the smaller companies with the resources they need to scale into the mid-tier and beyond. We are seeing some new entrants trying their hand at this and have also seen brand new PE firms make controlling interests in small businesses to take advantage of a once-a-firmlifetime opportunity to Affiliate with no other portfolio companies. Some institutional and mezzanine debt funds have also started to get aggressive at the lower end of the market as well, but without $3-5M minimum, sustainable EBITDA, there isn't a lot they can do to help either.

Austin Libowitz

1. What type (i.e. PSC [Service, Product, Research & Development (R&D)]) and size (based on a number of employees) are federal government contracting companies attracting private equity interest?

Size: Private equity firms determine the size of their target acquisitions based on the firm's desired equity check size (amount of equity invested in a transaction). Target equity check size is a range driven by the firm's fund size or capital able to be deployed and the number of desired investments with parameters on the larger and smaller ends based on investment mandate, concentration requirements, and time/economic factors. Then, the leverage quantum (debt amount) available and business multiple/valuation impact the private equity firm's purchasing power. The U.S. private equity market boasts significant dry powder (amount of committed, but unallocated capital a firm has on hand), ~$750bn currently, representing a 2.2x increase over the last decade, creating healthy PE demand. About 90% of that dry powder concentrates in funds with >$500mm of capital, and thus most private equity capital seeks larger platforms (~$100mm of revenue / ~$10mm of EBITDA and larger). It is important to note, however, only a very small portion of that dry powder finds its way into the federal government contracting market.

Equity check size and EBITDA/financial metrics drive the target business size for investment rather than a specific employee count. Nevertheless, employee count in a government services-based business highly correlates to revenue based on appropriate revenue per employee benchmarks.

Set-aside work and retaining small business designation restricts target business size in the lower end of the market given the challenges for most private equity investors and strategies. In addition to the risk inherent in the lower end of the market, which is more prevalent for generalist buyers, as previously noted, investor capital is generally searching for a platform much larger than this.

Type: There is broad investor interest across government business types. An investor's experience, focus, and familiarity drive specific business type interest. Investors without an A&D/government focus are more likely to search for companies with capabilities, customers, and end markets that are adjacent and familiar to their typical areas of focus, whereas a specialized buyer in the market may focus elsewhere, especially where the investor believes they can uniquely add value. In terms of PSC codes, investors focus on business capabilities, customer base, differentiation, competitive advantages, etc. rather than PSC or NAICS codes.

At the end of the day, each investor has their own thesis, focus areas, and size requirements, and private equity is very much a people, culture, and fit business.

2. Do federal government contracting companies become objectively more "successful" (profitable and/or notable) within 5 years of receiving private equity backing?

The All else equal, the answer is yes. I am defining success here from the perspective of revenue and EBITDA growth and/or staying in business. A private investor backed business generally has greater capital and resources to achieve success. Businesses will experience inevitable ups and downs, issues, and challenges (i.e. major recompete loss), especially in the middle market, that a private investor backing can help de-risk. An investor who knows the end-market well and provides support with BD, strategy, product/solution, human capital/recruiting, infrastructure and operations, M&A, customer knowledge, etc. will prove valuable to enable success.

3. Are mid-tier/mid-size companies less likely to close their doors if they have private equity investment?

In short, yes. For mid-size companies, especially at the smaller end of the market, a focused investor could provide financial backing, know-how, and support to increase the likelihood of survival compared to a solely founder owned company. A talented private investor deploying an appropriate capital structure, providing financial reserves, helping with growth initiatives and processes, and assisting in scenario planning and risk mitigation techniques will de-risk the likelihood of failure. To provide a frame of reference, the loss ratio (percentage of capital realized below cost divided by total invested capital) in private equity generally is ~8.5%, and for a firm knowledgeable in the sector, anecdotally that number should be lower than average.

4. Will trends show a "trickle-down effect" of private equity interest in smaller companies?

This ties into the first question about investment size requirements, leverage available, and generalist or sector specific investors, and has implications about the investor landscape and search for alpha (performance of an investment as compared to a relevant benchmark return). Smaller companies can be an attractive market for targeted strategies from a specialist investor, but I would find it generally uncommon for a non-specialist to attempt to trickle down lower into the market. Smaller companies generally have an increased risk profile, and greater market knowledge would be required to successfully invest further down market. This increased risk profile is due to greater small business risk, sub risk, conversion risk, business concentration risk, etc., which could be a difficult endeavor for most, particularly a generalist investor. Also, from a practical perspective, depending on the investor size and firm/fund dynamics, the attractiveness of smaller transactions is limited for many.

V. Summation

Based on our SME interviews, we can conclude the following:

What type (i.e. PSC [Service, Product, Research & Development (R&D)]) and size (based on a number of employees) are federal government contracting companies attracting private equity interest?

- The average revenue to attract private equity is $100M — right in the sweet spot of what would constitute a mid-sized government contracting firm. However, other factors play into consideration when private equity's make the decision to pursue these investments and meeting that revenue stream does not guarantee an investment. Many mid-tier firms that do meet this threshold are put aside by private equity firms because of other reasons and concerns.

Do federal government contracting companies become objectively more "successful" (profitable and/or notable) within 5 years of receiving private equity backing?

- Yes - based more on lore than facts, and with caveats on what it means to be successful.

Are mid-tier/mid-size companies less likely to close their doors if they have private equity investment?

- Yes - not only by helping to alleviate the general risk, but also because PE investors are inherently incentivized to grow their assets so they can sell for a higher multiple.

Will trends show a "trickle-down effect" of private equity interest in smaller companies?

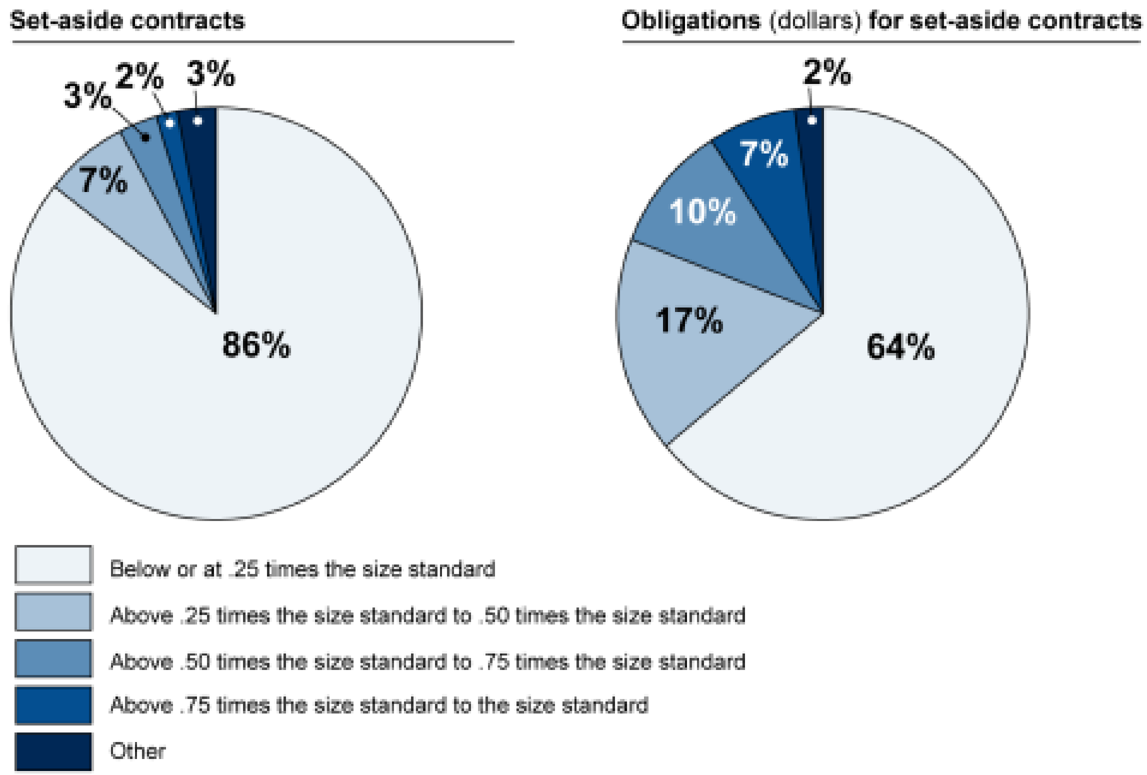
Possibly - but only to a point. There comes a point where a business is too small to be worth the risk, but in general the hearty, stable smalls could be a point of interest.

VI. Conclusion

Through this exploratory case study, The Pulse of GovCon performed further research to measure the answers to these questions. According to a 2018 Government Accountability Office (GAO) report, a very small percentage of small businesses grew to be mid-sized and continued to receive federal contracts during FY08 - FY7 as most small businesses awarded set-aside contracts in FY17 were well below the Small Business Administration (SBA) size standards[26].

[26] https://www.gao.gov/assets/gao-19-523.pdf

Figure 2: Percentage of Set-Aside Contracts and Contract Obligations Awarded to Small Businesses in Fiscal Year 2017, by Quartile of Size Standard



Source: GAO analysis of Federal Procurement Data System-Next Generation data. | GAO-19-523

Note: Other includes contracts awarded to small businesses for which we did not have size information or for which the size information was zero or inconsistently coded. Percentages may not sum to 100 due to rounding.

GAO analyzed the extent to which small businesses that grew to be mid-sized in 2013 continued to receive any type of contract in FY14–FY17[27]. Here is what they found[28]:

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[27] https://www.gao.gov/assets/gao-19-523.pdf

[28] It is important to note that in this GAO publication, researchers only looked at the number of total contract awards, and not the dollar value of those contract awards. In this instance, GAO is valuing quantity over possible quality which is not exactly relevant to growth of a federal government contracting firm.

- Of the 5,339 small businesses awarded only set-aside contracts in FY08 and awarded any sort of federal contract in FY13, 104 (2%) grew to mid-sized by FY13.
    - Of those 104 mid-sized businesses, 23 (22%) remained mid-sized in subsequent years and were awarded 75 contracts.
    - 3 (2%) grew to large and were awarded 6 contracts.
    - 17 (16%) of the 104 mid-sized businesses became small again.
    - 37 (36%) of the 104 mid-sized businesses were awarded 306 contracts and were categorized as small, mid-sized, or large depending on the NAICS code listed in the contract.
    - Of the 24 (24%) mid-sized businesses not awarded any contracts in 2014–2017, 9 (38%) were no longer registered in the System for Award Management (SAM), a central registration system for federal contractors.

In a 2017 Naval Postgraduate School (NPS) research publication[29], researchers looked at 700 small businesses over a 10-year period (FY05 - FY14) to determine whether there is a difference between firms that remain a small business throughout the 10-year period and those that transition to the middle market and become mid-sized firms.

Researchers identified 77 (11%) firms in their larger dataset that moved in and out of the small business market two or more times during the 10-year time period. This means that 11% of these small businesses grew into the middle market, and then re-certified as a small business after at least 1 year. Now there may be many explanations for this behavior, but this type of activity reinforces the belief that firms that are not able to thrive as they emerge into the middle market, and either intentionally constrain to fall meet small business thresholds in later years or fail to win contracts when competing outside of the set aside market[30].

While this is not definitive proof correlating PE involvement to future success, we can ascertain that the middle of the pack size standard is not an ideal place to be and does not provide a strong enough foundation for continued operational success. Smalls to the left of us, larges to the right — we do not want to be *stuck in the middle with you*.

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[29]https://calhoun.nps.edu/bitstream/handle/10945/58954/SYM-AM-17-077-016_Brown.pdf?sequence=1&isAllowed=y

[30]https://calhoun.nps.edu/bitstream/handle/10945/58954/SYM-AM-17-077-016_Brown.pdf?sequence=1&isAllowed=y