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M&A in the US government contractor sector

Structuring deals in the US government contractor sector





M&A IN THE US GOVERNMENT CONTRACTOR SECTOR

FW moderates an online discussion examining M&A in the US government contractor sector between Craig King at Arent Fox LLP, Jeremy C. Silverman at McKenna Long & Aldridge LLP and Scott Thompson at PwC.



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FW: Could you outline recent deal trends in the US government contractor sector? What level of activity have you seen over the last 12 months?

King: M&A activity in the US government contractor sector remains relatively robust with transactions requiring increased sophistication on both the seller and buyer side. While trends in some industry sectors merit attention, in particular, defence and aerospace, perhaps the more important trends involve key forces that are affecting deals differently today in the US government sector. First, many US contractors have seen substantial business growth in recent years due to sales related to the conflicts in Iraq and Afghanistan and owners now are seeking to sell these companies at values that reflect that strong performance. However, military draw-downs in Iraq and Afghanistan and, more generally, reductions in defence budgets, give rise to significant uncertainties and contingencies and call into question the valuation of these companies. Second, significant opportunities for strategic acquisitions are arising as a result of certain changes in government focus and spending. While some traditional business lines are in decline, changes in approaches and priorities of the Department of Defense are giving rise to potentially lucrative investments in companies involved in current priority areas such as special operations, unmanned vehicles, cyber defence and satellites. Changes in health care priorities also are giving rise to new opportunities in federal procurement. Similarly, recent government requirements that companies divest business units that involve potential organisational conflicts of interest (OCIs) are creating some wonderful opportunities to buy companies with established, key relationships supporting government agencies. Third, margins for many types of government work are being reduced significantly – due to funding cuts, increased competition and changes in government procurement approaches. Finally, the emergence of private equity funds as more significant players in the US government sector is changing the landscape for mergers and acquisitions.

Thompson: 2011 was a record year for Aerospace & Defence (A&D) M&A, with about \$43bn in deals. A \$16bn acquisition was the industry's largest deal in history, helping to drive the record, but deal volume was also a record. The past two years, there were also a lot of spin-offs and divestitures. These sales and spin-offs have been in response to new conflict of interest rules, as well as the desire to re-balance portfolios based on defence spending trends. In 2012, we expect deal volume to continue at high levels, while deal value returns to more typical levels, probably in the \$15bn-\$20bn range for the year. We also expect to see some consolidation in defence in response to the declining market.

Silverman: Our firm's M&A practice is very middle-

market focused and we have continued to see steady middle market deal flow over the last 12 months. In terms of trends, M&A seems to be serving an R&D function for many acquirers, with targets providing buyers with new technology or service capabilities, as opposed to just adding more contract backlog or personnel bench strength. With respect to specific technology, cybersecurity and other technology geared toward the federal intelligence community continue to be very hot and we expect that to continue based on government budget priorities and newly-imposed regulatory requirements.

FW: Have there been any recent regulatory and legislative proposals that would influence M&A in this space? What impact might an Administration change have in this regard?

Thompson: A few years ago, the government issued new organisational conflict of interest (OCI) rules that prevent companies from providing advice that results in a sister company providing services. Those rules resulted in several divestitures.

Silverman: There has been significant recent legislative and regulatory interest in small business-related issues, including rules related to preferences and set-aside contracts. Many companies have acquired small businesses in the past because of the perceived advantages. Congress appears to view this area as the next big fraud hot spot, which may mean that acquirers' ability to take advantage of small business preferences will become more limited. Because of how far along legislative and regulatory developments are in this area, change at the White House is unlikely to have much impact. A more recent area of executive and legislative branch attention is in the area of sustainable acquisition, including the imposition of environmental-related requirements on federal agencies. On the one hand, for example, servicing the government's needs around improved energy efficiency of federal buildings could drive interesting M&A opportunities, as traditional government contractors look to add environmental capabilities. On the other hand, given that the Republicans are less likely to view climate change as policy priority and, because the relevant regulatory effort is still in its infancy stages, a new administration could shut this down.

FW: To what extent might the recent federal budget crisis influence dealmaking? What is the outlook for federal contract spending against the backdrop of recent defence budget cuts?

Silverman: There is a general consensus that the pressure to reduce the federal deficit and get spending under control will lead to continued reductions in US defence spending. My partners who closely track the defence

budget believe the areas that are likely to do relatively well – meaning they will be funded at relatively higher rates despite tight funding – include cybersecurity, IT generally, unmanned aerial vehicles, and intelligence. We are already seeing those anticipated budget priorities driving M&A activity – every government contractor deal I have done in the last two years falls in one of those areas. Our policy specialists believe that the areas within the defence sector that are not likely to do as well involve military construction, heavy armoured ground combat vehicles, and personnel and benefits.

King: Historically, draw-downs in US government budgets have spawned an increase in mergers and acquisitions as contractors seek new business arrangements that enable them to maintain at least some portion of shrinking government programs and funds. Sometimes, government customers affirmatively encourage such business combinations – with government program managers seeking to engineer ways to maintain specific capabilities of competing contractors where there no longer is sufficient funding to maintain multiple sources. In this latter situation, government antitrust authorities and other regulators may be readily persuaded by the procuring agencies that proceeding with the transaction is in the public interest. Limits on cash or credit for acquisitions, however, are a significant complicating factor in today's environment. Potential buyers in the US and abroad are analysing a significant number of potential acquisitions but holding back, and not pulling the trigger, pending stabilisation of the cash/credit situation and broader economic uncertainties.

Thompson: The expectation of declining defence spending will cause consolidation that will be in proportion to the drop in defence spending. The ultimate drop in defence spending is still uncertain. While the president's budget calls for \$500bn in defence cuts over the next decade – about 10 percent – the full year 2013 budget is essentially flat. In addition there is the prospect of sequestration hanging over the industry. If sequestration is not averted, it could result in about \$1 trillion in defence in the next decade, or about 20 percent.

FW: Has there been an increase in appetite from private equity and trade buyers, given that this industry is stable with proven long-term returns? Are struggling small and medium-sized contractors typical targets?

King: Private equity firms were slow to come to the US government markets – due in large part to their lack of understanding of, and resulting discomfort with, the many rules, specialised practices, and risks that are unique to these markets. However, a number of private equity funds now have tested the waters with initial, and seemingly successful, purchases of US government

contractors and these funds are becoming comfortable with the unique aspects of doing business with the US government, and the uncertainties and contingencies associated with this business. Private equity funds that are in the US government markets now are looking to do additional deals that build upon and enhance their investment. Other private equity firms are considering entry. Again, right now there is a lot of shopping going on – with a potential for significant transactions in 2012.

Thompson: Private equity has been very active in defence for a long time. Several of the divestitures previously mentioned were acquired by private equity. Small and medium-size contractors are attractive targets for private equity, which focuses on cost cutting or roll-ups to improve absorption of fixed costs.

Silverman: There has been an increase in appetite from buyers. In particular, a much broader group of private equity buyers are looking at federal sector deals today as opposed to five or even three years ago. Although reduced federal spending may temper enthusiasm somewhat, there are and will continue to be attractive sub-niches within the federal sector, as discussed above. And although there was a time when many private equity funds were not interested in dealing with the regulatory hurdles of government contracting, that barrier to entry is viewed as less intimidating than it once was. It has not been my experience that struggling small and medium-sized contractors are typical targets. With few exceptions, the targets we see are successful companies and not struggling. In our experience, the more common target profile is a company that has grown quickly based on size or other status preferences, but for whom the future may be uncertain as it must compete for full and open contracts.

FW: What specific due diligence issues need to be taken into account when executing a transaction in the government contractor sector? What additional considerations need to be made on both the buy and sell-side?

Thompson: There are many issues that need to be considered, including standard issues around understanding the quality of earnings and the business forecast. Specifically for defence contractors, the nature of contracts poses special considerations relating to long term contracting estimates and changing defence priorities and funding. One of the most important things to focus on is due diligence of an A&D company that relates to the estimates to complete contracts, as the contracts may involve advanced technologies and/or execution over many years, both of which make it challenging to evaluate estimates of future performance.

Silverman: Although many aspects of due diligence for acquiring a commercial business apply when acquiring a government contractor, there are a host of special issues to consider for federal sector deals. A broad set of regulations apply to all government contracting businesses and should be examined in connection with every target. In evaluating contract performance and compliance, acquirers need to go beyond the four corners of the target's contracts and examine contract performance assessment reports (CPARs) and other correspondence between a target and applicable contract officers. One relatively recent area of regulatory attention is business systems, specifically the adequacy of a government contractor's systems for accounting and billing, purchasing, estimating, material management and accounting, government property, and earned value. Since this is an area of enhanced government scrutiny, it should likewise be an area of due diligence focus in an M&A context. Beyond compliance, the strategic analysis of a target needs to take into account unique government contracting considerations. For example, if a target will lose its small size status or other disadvantaged business status by virtue of an acquisition, a buyer must evaluate to what extent the post-deal value of the acquired business may be different than the target's pre-deal value.

King: Newcomers to US government markets are often surprised at the number and nature of unique issues that need to be addressed in acquisitions of companies that contract with the US government. Once a buyer is familiar with these issues, however, and learns how to take into account and address the risks and contingencies associated with government work, those buyers seem to develop a healthy appetite for additional acquisitions in the US government sector. As an example of the government-unique issues: under government contracts, the contractor has an obligation to perform any changes requested by the government, so long as the change is generally related to scope of the contract, and must continue performance even throughout resolution of any dispute as to the compensation due from the government. As another example, the government has the discretion to terminate any contract at any time for the government's own convenience – a feature of government contracting that often needs to be explained carefully to lending institutions not familiar with US government work.

FW: Specifically, are there unique cybersecurity issues affecting government contractors that should be considered as part of M&A due diligence?

Silverman: New and evolving cybersecurity requirements affect all contractors who possess, use or have access to federal information of information systems on behalf of an agency. Failure to comply with these requirements exposes contractors to contractual, civil and even criminal

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liability. Accordingly, acquirers need to understand and take into account legislative and regulatory requirements that will affect their own business and the business of M&A targets and consider these requirements in their due diligence efforts. This is particularly challenging given the changing landscape, with the Cybersecurity Act of 2012 and other legislation currently pending in Congress and new rules potentially on the horizon.

King: Today, cybersecurity is receiving priority attention throughout the US government. Underlying this attention are actual or perceived cyber-attacks on US computer systems that are attributed to hackers, terrorist groups or other foreign entities. Legislation is currently pending that will strengthen laws providing for computer security – and will criminalise a wide range of acts that damage computers, breach data security, or constitute computer fraud. The government's increased focus on cybersecurity is likely to have effects on mergers and acquisitions in US government markets. First, companies offering cybersecurity technologies or services are among the most sought after acquisition targets. Even in these austere times, government money is flowing liberally into cybersecurity – and contracts for cybersecurity technologies and services remain higher value-added, higher margin businesses. Second, the government is viewing a wider range of computers and computer systems as "critical technologies" that merit special protection from foreign control and influence. Congress and the president have charged the Committee on Foreign Investment in the United States (CFIUS) with

interceding to limit acquisitions by foreign buyers that might imperil national security.

Thompson: Cybersecurity should be part of M&A due diligence. Government contractors are subject to some unique regulations pertaining to information on national security. Export regulations – international traffic in arms, or ITAR – is an area of complex, but mature regulation. Regulations surrounding the unintentional breach of national security, as a result of cyber attacks, are less mature. Nonetheless, companies must always consider the regulatory and reputational risks they may inherit as part of an acquisition, including the risk of cybersecurity breaches. Of course, cybersecurity services are a growing area of opportunity as well. Companies with specialised cybersecurity services are very attractive acquisition targets.

FW: Given the rise in interest from potential foreign owners for US government contractors, what obstacles arise from regulatory clearances such as CFIUS and antitrust reviews?

King: At the outset, it is important to note that it is the policy of the US government to allow, even encourage, foreign investment in the US – consistent with national security interests. The government has long acknowledged that foreign investment can play an important role in maintaining the vitality of the US industrial base. That being said, CFIUS review is designed to ensure that foreign investment is consistent with national security interests. Foreign owners should not fear CFIUS review. Notwithstanding a few highly-publicised cases where transactions ran afoul of CFIUS, the CFIUS process generally involves an orderly, disciplined government review of relevant potential effects on national security – and the process most commonly results in CFIUS not taking a position adverse to the transaction. The CFIUS staff may express a desire for changes in the transaction to minimise risks to national security. In those instances, the parties sometimes feel aggrieved. However, most of the time parties look back on the CFIUS review as not having any practical effect on the transaction except for the effort and possible delay of the review itself.

Thompson: The principal challenge relates to restrictions on access of foreign nationals to information of national security. As a result, foreign investors often have to establish proxy boards and are restricted from access to national security information.

FW: Broadly speaking, what advice would you give to players in this market on how to conduct successful deals during 2012?

Thompson: Perform thorough market analysis and due

diligence covering finance, operations and compliance. The industry poses special challenges in all areas. The nature of contracts can be complex, involving leading edge technologies and/or long periods, presenting special operational and financial challenges. For example, one of the operational challenges we see pertains to the supply chain. Combined commercial and military aircraft production is forecast to grow at 10 percent CAGR over the next five years. A PwC study suggests that 20 percent of the supply chain may be at high risk of not being able to respond to the demands. In addition, the unique regulations in the industry require special skills and attention.

King: History teaches that the realignments that occur in the US government market during periods of government austerity can give rise to new business combinations that are potent and profitable into the future. In this environment, potential buyers should focus on identifying value-added technologies and services that will be valued by the government as part of its future direction; key businesses supporting government programs where OCIs are leading to divestiture; and businesses selling services to the government where the margins may no longer fit in the higher-return portfolio of the owner. Buyers should feel confident that if the deal makes sense from a business perspective, the transaction generally can be accomplished. Government reviews generally will not impede a sound business deal – unless it involves foreign investment in an area deemed to be critical to national security. Foreign buyers also should be assured that the accommodations necessary to mitigate FOCI generally have proved to be workable and the return on such businesses almost always has proved to be well worth the limitations on foreign control and influence that are a part of such transactions.

Silverman: Those who are not experienced dealmakers in the federal sector need to make sure they know what they are buying. For example, will any of the target's contractors – or options or task orders – be affected or potentially lost as a result of a change of control? This could occur as a result of change in size or other preferential status or just customer sensitivity to a change. If these acquirers don't have in-house capabilities to analyse and evaluate special government contracts issues, then they should engage appropriate legal and other resources to assist them. Experienced federal sectors M&A players don't need to be reminded or educated on the items noted above. However, anyone looking to expand their presence in the government contracting sector should be paying close attention to Congressional and executive branch priorities, both from a budgetary standpoint so they can try to best position themselves for the available dollars, and from a compliance standpoint to ensure they get to keep the dollars that flow from their federal business. ■



STRUCTURING DEALS IN THE US GOVERNMENT CONTRACTOR SECTOR

by Matt Atkins

Due to their sensitive nature M&A transactions in the US government contractor sector raise a number of risks and regulatory hurdles, which new entrants to the sector may find particularly daunting. Acquirers need to manage risk by carefully assessing the target's finances, operations and compliance processes, bearing in mind specific regulatory issues which also require attention during the due diligence process. While navigating the pitfalls can be a challenge, the sector presents attractive opportunities for buyers and investors alike.

Unique risks

In the past 10 years M&A activity in the contractor sector has grown markedly, with deals increasing in sophistication and complexity. While, in essence, acquisitions in the commercial arena and those of government businesses share a great deal in common, contractor acquisitions require acquirers to address a number of key differences, which could unravel the deal, or undermine its value, if overlooked. "Structurally, government contractor acquisitions are almost always acquisitions of stock or other equity interests, which minimises the need to obtain formal government consent to the novation – assignment – of contracts from the seller to the buyer," says Jeremy Silverman, a partner at McKenna, Long & Aldridge LLP. "The equity acquisition structure means that buyers are at greater risk from liabilities relating to the pre-transaction operation of the target business. Beyond structural considerations, another key distinguishing feature in government contractor acquisitions is that the customer has a level of power and control that is different in kind from that of the typical commercial customer," he adds. Indeed, the ability of the government to terminate a contract at any

time is unique, and factors such as changing budgetary priorities, heightened security threats, or the ending of war can result in money being reallocated from certain projects to others.

Those doing business with government agencies must expect unique risks to arise, especially given the complex regulations associated with these transactions and the procedural and political backdrop against which such deals take place. Buyers must bear these areas in mind, ensuring that their target is compliant with relevant regulations and in a position to secure ongoing contract awards. Indeed, the twin risks of customer and contract concentration are under particular scrutiny in today's market. "Contract funding, of course, is going to be of particular concern," points out Erik Choy, vice president of Investment Banking at D.A. Davidson & Co. "Given the sequestration threat, all government contracts are being scrutinised, delayed or are under threat of cancellation. In order to mitigate these types of risks, the general consensus has been to invest in the more stable parts of the budget – health IT, cyber security, intelligence or energy. Additionally, buyers will have a preference for targets that have a more diversified customer base." Assessing a contractor's active contracts and potential future contracts is of great importance. Acquirers should ask if the target's area of expertise is likely to be required by the government in the future, whether demand is on the increase or decrease, and whether the target is in a position to re-secure its current contracts when they expire.

Regarding regulatory compliance, due diligence for companies that contract with the US government should involve an assessment of the contractor's compliance with

Federal Acquisition Regulations (FAR), Cost Accounting Standards (CAS), and Defense Contract Audit Agency (DCAA) requirements. Other regulatory matters may arise dependent on the type of work that the contractor carries out.

No matter how complex such regulation appears to be, it is fundamental to government contracting and must be followed to the letter. If not, a company may jeopardise its ability to do business in the sector. Firms should remain particularly wary when acquiring smaller targets. Given the complexity of regulations, the burden of compliance, and the frequency with which rules change, smaller business can often fall short of full compliance. Larger contractors acquiring these companies must therefore remain vigilant for such infractions, or else leave themselves open to government penalties which can include significant fines, personal criminal liability or a total prohibition from further contracting work.

Acquirers approaching deals in the sector cannot afford to underestimate the complexity of structuring deals in the contractor sector, and in general need a healthy knowledge. Those with little or no experience in the sector can be naïve to the risks. "Some may not fully understand the risks, the ways to manage those risks, or the role of the various interested government agencies in approving aspects of the deal," explains Craig S. King, a partner at Arent Fox LLP. "However, acquirers learn quickly. The vast bulk of our work is with acquirers who now have done at least one deal in the government contracts sector – and desire to do more. Today, buyers and sellers in the government contractor arena are much more sophisticated than they were just a few years ago."

Fortunately, those who have only recently entered the market will find an army of advisers, emergent in recent years and willing to offer their in-depth experience for a price. "As the government contracting M&A market has evolved, a community of specialty advisers – accountants, lawyers, and other consultants – with deep knowledge of the regulatory complexities and risks has grown," says Stephen M. Saunders, managing director at Fennebresque & Co. "Most experienced acquirers are cognisant of the unique risks in the sector and are quick to bring together a team of experienced advisers to help them thoroughly assess any acquisition target they actively pursue. In my experience, most are cautious, thorough and well prepared when it comes to structuring acquisitions and managing their risks."

Target analysis

The cost of regulatory non-compliance can be enormous, both from a financial and legal standpoint. Buyers must

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therefore perform in-depth analyses of their target's finances, operations, employees and existing contracts. Drilling down on key areas can be all the more important in government contractor deals. "Buyers should carefully diligence the quality of the target's relationships with its government customers, ideally via direct discussions with the customer," Mr Silverman says. "Customer calls are certainly not unique to government deals, but their importance is generally as great as or greater than in commercial deals given the power of the customer. With regard to legal compliance, again, the buyer should try to get behind the curtains as much as possible. Buyers should carefully focus on a target's compliance functions and culture – and consideration of possible post-acquisition improvements and related costs – as they evaluate the potential transaction."

The industry in which a target operates should also be considered prior to completing an acquisition. For instance, while defence contractors have been big business in the past decade, budget cuts and the winding down of operations has impacted the long-term prospects of a number of firms, as Mr King explains. "Many US contractors have seen substantial business growth in recent years due to sales related to the conflicts in Iraq and Afghanistan – and owners now are seeking to sell these companies at values that reflect that strong performance. However, military draw-downs in Iraq and Afghanistan, and, more generally, reductions in defence budgets, give rise to significant uncertainties and contingencies and call into question the valuation of

these companies. While some very appealing businesses are being offered, there is a 'buyer beware' approach where valuation is tied to revenues from the hostilities in Iraq and Afghanistan," he says. But defence is not the only industry to take a hit. Funding cuts and new procurement strategies have impacted on a wide range of government services and related industries. With companies divesting business units where profitability is low, a wealth of targets are there for the taking – but investigating the long-term outlook of these businesses is a must.

On the other hand, firms will need to ensure that a target company can keep on top of the contracts it does have, and hold up to Defense Contract Audit Agency (DCAA) audits. The number of staff a target employs and its government clearances work well as an additional indicator of the company's ability to execute its contracts, according to Mr Choy, though the nature of the targets contracts must also be analysed. "Contracts and their respective funding sources underpin the company's ability to generate consistent revenues," he states. "In addition to the face value, the nature of the contract is also important. Buyers should and do identify whether or not contracts are full and open or preference – and if so, whether or not they are multiple award contracts. From a profitability perspective, it is important to note if the contracts are fixed-price – potentially more lucrative – or cost-plus."

Regulation and compliance

Buyers, naturally, must also be mindful of applicable legislative and regulatory frameworks, which may differ depending on the type of organisation being acquired and the nature of its business. In addition, acquirers should understand that, depending on the structure of the acquisition, the buyer company, including its non-government businesses, may become subject to other compliance and reporting obligations.

A further consideration is export controls and International Traffic in Arms Regulations (ITAR) which, despite the name, apply much more broadly than to companies selling weapons overseas, and can extend to software and services with no obvious military application. It is critical for a buyer to fully understand the compliance obligations it will bring on itself when buying a government contractor, else it may find itself facing the scrutiny of the US State Department, which enforces the regulations.

Any acquisition will draw the attention of government antitrust agencies, charged with determining whether the transaction will have anticompetitive consequences that harm consumers. Where transactions involve companies

While those on the buy-side face considerable regulatory pressure, sellers must additionally consider steps to make the sales process run smoothly and enhance their valuation.

in the business of selling to the US government, the government procuring agencies are, in effect, the consumers. In these cases, antitrust agencies seek the counsel of the procuring agencies and together they will assess whether the transaction will have adverse effects on competition. Coordination between antitrust agencies and procuring agencies has, in recent years, become particularly refined.

Regarding corporate culture, the US government sets minimum standards for contractor ethics and compliance programs, which are generally stricter than the ethics and compliance programs of companies in commercial markets. Laws pertaining to contracting with the US government also make any contractor error or misrepresentation in obtaining or performing a contract, or in invoicing, potentially a fraud. This can result in the government suspending or debaring a contractor from contracting. Due diligence on the target's compliance with legislation, as well as its ethics and compliance programs, is therefore essential.

Foreign entities

The globalisation of the economy has undeniably led to a significant increase in cross-border M&A, and while the policy of the US government is to allow and encourage foreign investment in the US – consistent with national security interests – the security concerns make government contracting M&A more confined by national borders. This is not to say that cross-border

M&A is impossible, quite the contrary is true. Companies domiciled in US ally countries have historically been successful in gaining approval for acquisitions of US contractors. Several foreign companies have been active acquirers of US assets, for example BAE SYSTEMS, Cobham and Meggitt. Early planning and recognition of the exhaustive requirements are key to success. "Within the US, additional regulatory hurdles must be met in order for a foreign company to acquire a US-based government contractor," stresses Mr Saunders. "Importantly, the acquisition must secure the approval of the Committee on Foreign Investment in the United States (CFIUS), whose role is to ensure that foreign investment in or ownership of US enterprises does not place US national security at risk. In order to secure CFIUS approval, a foreign acquirer must make special arrangements through a proxy board or Special Security Arrangement (SSA) to have the target company overseen and governed by US citizens that meet the approval of CFIUS and other agencies. These arrangements and approvals can be time consuming, so any non-US company considering an acquisition of a US company would be wise to start the process early."

While CFIUS review can be of great concern to foreign acquirers, there is little to fear. The process generally involves an orderly government review of relevant potential effects on national security – and most commonly results in CFIUS not taking a position adverse to the transaction; however CFIUS staff may demand alterations to the transaction to minimise national security risks. The most common cause for deal failure comes when a transaction comes under Congressional scrutiny, suggests Mr King. "Many of the most highly-publicised cases involving potential foreign direct investment that have run afoul of the US government involving, and not involving, government contractors – generally have done so due to Congressional interest that arose independent of the CFIUS review process. A buyer is well advised to include a Congressional outreach strategy when a transaction has the potential to raise political concerns, for example, due to the nationality of the buyer or the nature of work of the seller," he says.

While the US encourages international buyers to enter the contractor sector, it is not surprising that many are put off by the regulatory hurdles. However, with the use of specialised counsel, these requirements can be navigated relatively painlessly, notes Mr Choy. "We always recommend that buyers use internal teams or advisers – financial, legal and accounting – who have strong cross-border capabilities with government contractor experience. Unless you are a foreign buyer with significant existing North American operations, you will need to learn to navigate through the 'voluntary' CFIUS process as well as establish a proxy board or

SSA. Buyers will also need to be familiar with the laws that govern business practices, such as the Truth in Negotiations Act (TINA). Furthermore, understanding the target's relationship with the customer is essential to investigate since it will be a factor when the target's contracts come up for renewal."

Sell-side considerations

While those on the buy-side face considerable regulatory pressure, sellers must additionally consider steps to make the sales process run smoothly and enhance their valuation.

Sellers should consider hiring a lawyer who specialises in government contracting to perform an assessment of their company's compliance and put right any shortcomings that are identified. In order to ensure that their finances are solid, they must also hire a reputable accounting firm to audit the company's financial statements. Large strategic buyers and private equity funds will often engage outside accounting firms to conduct a quality of earnings review of the target. If that review identifies problems, the seller may see its purchase price reduced. It is therefore preferable to engage in a pre-sale review to clean up any issues before starting the sale process. It is also wise to install an independent board of directors to oversee corporate decision-making and assist with corporate strategy well in advance of a sale, as well as to develop a clear plan for management succession and evaluate any managerial weaknesses that should be addressed.

Sellers can further waterproof the sale process by addressing potential legal and regulatory issues through self-diligence. "We frequently advise our clients to undertake a pre-transaction 'self-diligence' exercise," says Mr Silverman. "We then review the company's contracts, compliance functions and other areas of due diligence attention, taking a buyer's perspective. To the extent we identify issues or problems, we can typically address them before the sale process starts, thereby avoiding later surprises and loss of momentum during the transaction process. Regardless of whether problems are identified, the self-diligence process has the benefit of helping prepare and organise the seller and its management team for the buyer diligence exercise, as well for the negotiation of representations and warranties and preparation of disclosure schedules as the deal progresses." Many sellers make the mistake of preparing too late. Planning is best taken years in advance of the sale process, for its true value to be realised.

Market outlook

Government contracting is in something of a period

of flux, with austerity measures and global changes re-ordering priorities. The winding down of operations and the withdrawal of troops from Iraq and Afghanistan, for example, have impacted M&A activity in the defence industry sector. Planned reductions in federal budgets have also affected transaction volume. Despite these developments, M&A activity in the US government contractor sector remains relatively robust. "Changes in government spending priorities have caused many large contractors to re-evaluate their businesses and strategic direction," says Mr Saunders. "The result has been divestiture activity in some cases, with larger companies selling businesses they expect to grow more slowly, and acquisitions of perceived higher growth businesses in other cases. I expect this activity to continue for several

years and to likely increase in certain areas once the election cycle passes and brings increased clarity to budgetary decisions."

Shifting federal budget priorities have also resulted in a transfer of M&A activity. Where M&A may be in decline in one industry, it is on the ascent in others. Traditional defence spending is on the slide but investment is rising in other areas. Cyber security is an area of growing investment, and changes in health care priorities also opening up new opportunities in federal procurement. In the coming months and years, acquirers and investors must follow political events closely, to keep ahead of the spending curve and the direction of the government contracting sector. ■

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