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Gov't Contracting Slump Could Spark PE Feeding Frenzy

By Dietrich Knauth

Law360, New York (February 05, 2013, 10:03 PM ET) -- With federal contracting budgets on the wane, private equity firms are looking to snatch up bargains as contractors streamline their businesses and sell off divisions that could see reduced profits or contribute to organizational conflicts of interest.

This should be a busy year for mergers and acquisitions in the government contractor market, experts said, attributing part of the change to declining budgets and the uncertainty around sequestration, a series of automatic budget cuts set to slash about $52 billion from 2013 federal spending unless Congress agrees on an alternative deficit reduction package by March 1.

Private equity firms will look to profit from contractors' belt-tightening, while also seeking to purchase smaller companies in hot areas that will continue to see government investments, such as cybersecurity.

“Government contractors are looking to shed some of their businesses and divisions that are not going to give them the returns they had captured in previous years,” said Scott M. Heimberg, a partner with Akin Gump Strauss Hauer & Feld LLP. “I think that gives some opportunities to private equity companies who are looking for bargains out there.”

While private equity interest in government contractors also spiked during the lean years following the 2009 recession, investors now are looking at contractors for a different reason.

Then, private equity and venture capital firms saw federal contractors as more stable than their strictly private-sector counterparts because of the relatively steady flow of government dollars. Now, the firms are looking for a bargain on companies that were costly just a few years ago, according to Aaron Ghais, a shareholder in the business and financial services department at Shulman Rogers Gandal Pordy & Ecker PA.

"They're opportunists," Ghais said. "It's all about timing and return."

Government services divisions may be one area for bargain shopping, as the U.S. government looks to reduce spending on services and move on after a decade of war, Heimberg said.

“With the war in Iraq ended and Afghanistan winding down, there's less money in the budget for the kind of services that had been making big returns in recent years,” Heimberg said. “That's probably where some of the bargains are going to lie.”

Contractors might try to spin off consulting and services divisions in an effort to refocus on core technology and rid themselves of business units that could create conflicts of interests, disqualifying them from competing on future contracts.

“Organizational conflict of interest is something you've got to keep an eye on when thinking about how those decisions are being made,” Ghais said. “[Contractors are] under so much pressure from Wall Street to show good numbers. So if there's a drag on their business and a way to get get a quick bump by selling, they're only too happy to do that — and waiting with open arms are the private equity firms.”

Private equity firms also will fight to snap up smaller companies whose cutting-edge technologies will continue to benefit from government investment, particularly in areas such as cybersecurity, cyberwarfare, intelligence, complex data sets, cloud computing and health care information technology.

D.C. Capital Partners LLC's Jan. 30 acquisition of Computer Security Solutions Inc., which provides IT services for U.S. intelligence agencies, is one recent example.

Cybersecurity is a hot issue, especially after news that the Department of Defense plans to dramatically expand its Cyber Command staff, from 900 to 4,900. Bryan Brewer, a partner in Crowell & Moring LLP's corporate, securities and international trade groups, called this a strong indication that the government would keep investing in the area despite an overall decline in spending.

"Intelligence is going to be another hot area. ... There will be activity in that space even if there are less resources, whether due to sequestration or otherwise," Brewer said.

Private equity firms likely will try to buy several companies in targeted areas, pooling resources and talent to create a stronger company before reselling down the road, Ghais said.

“They like to go out and pick up a platform company and use that almost like a vacuum company to pick up other companies,” Ghais said.

The availability of cheap debt will fan the M&A flames in the contractor market. In addition, several investment funds started during the private equity boom in 2008-09 are nearing the end of their life spans, and may have cash to burn after the recession temporarily robbed them of attractive targets, Ghais said.

Investors could be boosted by a recent regulatory change that makes it easier for private equity-backed businesses to qualify for technology research funding, according to Thomas Mason, a partner in the government contracts practice group at Cooley LLP.

Under Small Business Administration rules that took effect Jan. 28, businesses partially owned by venture capital companies, hedge funds and private equity groups will be eligible for funds under the Small Business Innovation Research Awards and Small Business Technology Transfer programs.

The rule will benefit small businesses seeking investment and private equity companies looking to make gains in the government contractor market, Mason said.

“That's going to be a welcome change,” he said. “We think that's going to open up some opportunities for some of the private funds and lead to transactions, beginning at the start of this year.”

--Editing by Kat Laskowski and Chris Yates.