

OPINION

Pivate equity companies have left an indelible mark on the defence and government technology services (GTS) markets. The investments made by private equity funds in the industry have created many of the premier public companies. Once dominated by the activity of a few giants, the number of private equity firms that are active acquirers today has increased dramatically.

Private equity funds now account for a significant share of the mergers and acquisitions (M&A) transactions. A wide array of private equity players have emerged as buyers, including Veritas Capital. While the company has been actively acquiring defence hardware companies since the early 1990s, it then turned its attention to the large and rapidly growing technical and professional services markets with its acquisitions of DynCorp International (the sale of which to Cerberus was announced in April 2010), McNeil Technologies, The Wornick Company and the assets of MZM Inc, which it renamed Athena Innovative Solutions.

Several factors have attracted private equity firms to the defence industry. Despite years of industry consolidation, the defence and GTS markets remain highly fragmented and there are several thousand government contractors with revenues of less than USD100 million.

Many of these are quality companies with strong management teams and unique technological capabilities but lack the scale and access to capital to reach 'the next level'. In addition, the US government's ageing workforce and increasing reliance on outsourcing IT and administrative support functions has increased the demand for these companies' services. Private equity firms have seized on this opportunity by providing a critical role in the development of the companies they acquire.

Private equity companies can create value by providing advice to portfolio companies on strategic direction and growth initiatives. The best fund managers will also provide guidance on operational enhancements to increase shareholder value. However, the key services private equity funds provide to their portfolio companies are to identify acquisition targets, perform related due diligence on these companies and source debt and equity capital at terms that could not be replicated by the portfolio companies themselves.

These funds also play an integral role in managing the final liquidity event, whether it is realised through an initial public offering (IPO) or sale to a strategic buyer.

An illustration of the role private equity can play in industry consolidation and valuation creation can be seen in Caxton-Iseman's 1996 buyout of Ogden's professional services unit, which formed Anteon Corporation. Upon its

Defence and private equity: perfect partners



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Private equity firms are playing a critical role in the development of the middle-market defence and government technology services companies they acquire, writes Philip McMann

acquisition of Anteon, the New-York based private equity firm appointed Joseph Kampf as chief executive officer of the company. During his 10-year stewardship Anteon was transformed into a premier IT solutions provider to national defence, intelligence and homeland security communities. Through a series of nine targeted acquisitions following Caxton's initial USD32 million equity investment, Anteon's revenues grew from USD100 million to more than USD1.5 billion from 1996 to 2005. In December 2002 the USD2.2 billion acquisition of Anteon by General Dynamics was announced. Caxton-Iseman was rewarded by gaining a 23-fold gain on its investment.

With the heightened activity by private equity firms, the distinction between financial buyers and strategic buyers has become increasingly more difficult to discern. The most active private equity sponsors in the industry have assembled investment staffs and senior advisory boards that are dedicated to the defence and GTS markets.

The largest private equity funds have developed deep industry-focused portfolios comprised of platform companies that often provide complementary services.

The advantage of this approach can be brought to bear on large procurement opportunities requiring a broader set of capabilities and critical mass than can be provided by the individual firms. This strategy has encouraged private equity to make acquisitions at premium valuations for well positioned companies.

A control sale to a private equity firm continues to be an attractive option for owners of middle market private defence and GTS companies who remain optimistic about the future prospects of their business but want to achieve substantial liquidity under favourable market conditions.

Typically in platform transactions, the target company is acquired by the private equity firm and the owners of the selling corporation reinvest a portion of the sale proceeds in the recapitalised entity. The owners usually remain actively involved in the day-to-day operations of the company after the change of control occurs. The selling shareholders' equity stake in the business is enhanced through subsequent follow-on acquisitions that are funded through debt that is usually provided by institutional sources and additional equity infused by the private equity sponsor.

As shown in the Anteon illustration, the leveraged return to investors in private equity buyouts can be dramatic. In addition to getting a "second bite at the apple" that is not typically available in a sale to a strategic buyer, owners of middle market defence and GTS companies can share with their senior management and other key employees in the company's appreciation in value through stock options or other equity incentives.

Private equity control transactions can be very attractive to owners of government contractors but are not for everyone. In contemplating this form of transaction careful consideration should be given to the attributes of the company. Private equity investors are attracted to companies as target platform acquisitions that have the sufficient size, management talent and infrastructure to support the critical mass necessary to achieve arbitrage available through increased scale. Finally, the rate of growth, profitability and customer base and how they are perceived by investors are important factors to consider.

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