

Top M&A developments in 2017 for ADG companies

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ADG Insights

We expect 2017 M&A activity in the aerospace, defense, and government services (ADG) industry sector to equal or surpass 2016 M&A activity.

Although 2016 M&A activity was down both by volume and value over 2015 it was stronger than the three years preceding 2015, with fourth quarter 2016 activity being particularly strong. The conclusion of the U.S. elections should remove some of the uncertainty that hindered deal activity in 2016, while ongoing global security threats, instability in the Middle East, the new U.S. presidential administration's focus on strengthening the military, and anticipated increases in defense budgets should help drive growth.

The trend of large defense contractors divesting their federal IT contracting businesses is expected to continue and traditional rationales for acquisitions (growth, technology, synergies, new markets, amongst others) will continue to drive transactions. Despite an optimistic outlook on 2017 M&A activity, participants should be aware of the key developments and trends examined below that may affect deal making in the coming year. Finally, deal making may be hampered in 2017 by uncertainty over the economic impact of implementation of Brexit and rising trade protection and anti-globalization sentiments.

U.S. antitrust authorities expected to increase scrutiny of ADG M&A

An important antitrust development in 2016 for ADG companies was the U.S. Department of Justice (DOJ) and Federal Trade Commission (FTC) (collectively, the Agencies) [joint statement](#) on preserving competition in the industry. The statement reiterated the Agencies' longstanding position that their existing analytical framework for reviewing mergers was "sufficiently flexible to address [Department of Defense (DOD)] concerns that reductions in current or future competitors can adversely affect competition in the defense industry and thus, national security." The statement was widely perceived as a reaction to concerns regarding [future industry consolidation](#) and a suggestion that [new legislation was needed](#) to preserve competition in the industry. Such calls came on the heels of DOJ's clearance of Lockheed Martin's 2015 Sikorsky Aircraft acquisition, which did not raise antitrust issues, but some DOD officials suggested it raised public interest issues with respect to the industrial base. In their joint statement, the Agencies highlighted specific aspects of the industry that make merger review unique, such as high barriers to entry, the importance of R&D investment, the need for surge capacity, a skilled

work force, and strong subcontractor base. Their “substantial experience applying the [DOJ/FTC 2010 Horizontal Merger] Guidelines to defense industry mergers and acquisitions” enables the Agencies to home in quickly on these unique aspects in such review. Under the Trump administration, mergers in the ADG industry might receive increased scrutiny from both an antitrust and national security perspective, particularly considering the administration’s focus on national security and Trump’s populist statements condemning consolidation of economic power in the hands of few. On the other hand, Acting FTC Chairwoman Maureen Ohlhausen, an economic conservative, has recently made statements rejecting the use of antitrust to pursue policy objectives. Given such tensions, much remains unknown as to how the Trump administration will approach antitrust issues.

Expansion of CFIUS reviews likely in 2017

Although much is uncertain about the Trump administration’s policies, due to President Trump’s critique of certain foreign investments in the U.S. and his “America First” platform, we might see an increase in the scope and level of scrutiny of national security reviews conducted by the Committee on Foreign Investment in the United States (CFIUS) in 2017. Trump administration officials have raised concerns about unequal treatment received by U.S. businesses seeking to invest in China and CFIUS’s potential role in protecting American jobs. In a similar vein, members of Congress have questioned whether the scope of CFIUS reviews should be expanded, having called in September 2016 for the Government Accountability Office (GAO) to examine whether CFIUS’s regulatory and statutory powers “have effectively kept pace with the growing scope of foreign acquisitions in strategically important sectors.” More recently, Congress is actively considering legislation that would expand the scope of CFIUS reviews to examine food security and more closely scrutinize acquisitions of advanced U.S. technologies by buyers based in certain countries, such as China and Russia. Ultimately, the precise shifts in the Trump administration’s handling of CFIUS reviews in 2017 may take some time to detect because (1) each case raises distinct national security issues, and (2) CFIUS is obligated by statute to maintain the confidentiality of all cases.

GAO decisions complicate evaluation of proposals pending while a corporate deal or reorganization is also pending

While mergers and acquisitions and other corporate restructuring have continued apace in the ADG industry, a wave of recent GAO decisions has created yet another potential complication for companies that are contemplating and executing deals and reorganizations that involve government contracts. These cases address situations where an agency is evaluating a proposal while the company that submitted that proposal or its assets are subject to a pending corporate deal or restructuring. The GAO has taken a firm stance that when agencies are in that situation, they cannot simply ignore the potential implications of a planned corporate transaction that is imminent and essentially certain on the pending proposals. The GAO’s decisions essentially require that agencies try to evaluate the impact that the transaction will have on the technical

approach and anticipated cost to the government, among other things. The GAO, unfortunately, has not provided any sort of a roadmap of the steps that it would expect a company to take to avoid the Draconian result of having an otherwise competitive or even successful proposal discarded. Absent such guidance, it is important for companies to be cognizant of the risks in this area and to take steps to mitigate those risks where possible. The following are just a few of the best practices that companies might consider:

- Companies should foster communication between the teams handling the planned deal or reorganization and the teams handling pending proposal efforts. If the proposal teams are not aware of the planned corporate activity, they cannot address that activity in their proposals; however, companies need to be cognizant of antitrust limitations, SEC disclosure rules, and potential organizational conflicts of interest that prevent such disclosure. During this limbo period, companies should strive to be positioned to alert the customer about a planned deal or reorganization as soon as it is feasible to have those conversations.
- Although agencies generally can recognize a “successor-in-interest” to a proposal where a company acquires all of the assets that are committed in a proposal, agencies tend to apply this test strictly. When a corporate deal or reorganization is anticipated or reasonably foreseeable, companies should aim to limit reliance on, and even reference to, entities and assets that may not be transferred with the proposal.
- A government contractor that will be affected by a planned deal or reorganization should assess the potential impact on pending proposals. For each competition where an agency conducts discussions, the company should use the opportunity to disclose the nature of a planned deal or reorganization and revise their proposal as necessary to try to put the agency in a position to evaluate the possible impact. For each competition where an agency does not conduct discussions, the company should still consider approaching the agency to discuss the impact on pending proposals. There is risk, however, that the agency could refuse to entertain the information and use the uncertainty against the company. Yet, there is often greater risk in not approaching the agency and allowing it to jump to its own conclusions about the potential impact.
- When contemplating buying a company with pending government proposals, the prospective buyer should assess the target’s approach to mitigating the risk associated with pending proposals, especially those on critical programs or vehicles. Where possible, the prospective buyer and seller should coordinate on an approach to protecting pending proposals, but there can be challenges to doing that, including antitrust and other limitations on sharing information related to proposals.

Large, traditional defense contractors moving away from federal IT market and consolidation of largest providers of IT services to U.S. Government

During recent years, perhaps the most significant trend in transactional activity in the ADG space has been government contractors divesting large portions of their federal IT portfolios. Last year, BAE publicly explored the possibility of selling its most IT-centered Intelligence & Security division, and Northrop Grumman is thought to be considering a similar move based on a recent internal reorganization. And in late January 2017, Harris Corporation announced that it intends

to sell its federal IT services business to Veritas Capital. The biggest deal of this type to date was Lockheed Martin's 2016 sale of its Information Systems & Global Solutions business to Leidos. The Lockheed Martin-Leidos deal, which closed in August 2016, moved most of Lockheed Martin's federal IT business, including approximately US\$6bn in annual revenue and 15,000 employees, to Leidos. What is driving this trend? The budget cuts of recent years have forced federal buyers to search for ways to cut costs, with IT spending often among the items to be squeezed. Agencies are resorting more frequently to lowest-price, technically-acceptable (LPTA) procurements, where price is the only discriminator between firms that meet minimum technical specifications. Additionally, the government has sought to leverage its buying power by consolidating contract vehicles, while at the same time setting aside certain contracts for small business concerns to comply with government-wide goals. Due to these and other factors, competition for federal IT contracts can be fierce, with large, commercially-focused IT providers competing with the more traditional government contractors. Of course, not all companies are moving away from the government IT market. Far from it. Leidos is doubling down on this market, and other firms remain highly interested in the space. Last year, in addition to Leidos's acquisition of Lockheed Martin's IS&GS business, CACI acquired L-3's National Security Solution unit, and SRA merged with CSC's government services unit. At the moment, Leidos holds a portfolio of roughly US\$10bn in IT solutions and technical services, making it considerably larger than competitors like CACI International, CSRA, and Booz Allen Hamilton. Others—who view greater upside in this space—may consolidate to try to improve economies of scale, lower costs, and secure critical contract vehicles in order to keep pace.

Conclusion

Despite a generally optimistic outlook for 2017 M&A activity, ADG companies should prepare for the possibility that the Trump administration will subject deals to increased antitrust scrutiny and expanded CFIUS reviews. In addition, companies with proposals awaiting agency action that are also engaged in merger or acquisition talks should be prepared to provide information to the government addressing the impact of any imminent and essentially certain M&A deal on the pending proposal. Finally, continued fierce competition for federal IT contracts may drive additional consolidation in this area.

Contacts



John B.
Beckman

Partner



Brian P.
Curran

Partner



Allen Hicks

Partner

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