The key growth areas in the intelligence sector have evolved, reflecting the Government’s changing national security requirements, priorities and budget allocations. The current tight fiscal environment and ongoing Department of Defense budget cuts, together with the drawdown of troops from Iraq and Afghanistan, have created increasing uncertainty in the sector, with considerable implications for intelligence M&A activity. The key areas of anticipated M&A activity in the intelligence sector in the next 12 months are likely to broadly reflect the priorities of the intelligence and national security communities.

Background

The market for services supporting the activities and capabilities of the intelligence community (“IC”) and various Department of Defense (“DoD”) customers has been a strategic priority for a broad range of government contractors, other strategic acquirers and financial investors. Over the last several years, the sector has been characterized by a high level of mergers and acquisitions activity, as a significant number of investors have pursued acquisition opportunities providing analytical, operational support, training and IT services to the national-level intelligence agencies, special operations forces, and others parts of the military. Given the attractive characteristics and relatively high barriers to entry in the intelligence sector, acquisition targets that have provided buyers with meaningful access have commanded premium valuations.

Within the sector, key areas of activity have evolved, reflecting the Government’s changing national security requirements and priorities, and parallel changes in budget allocations. Furthermore, the current tight fiscal environment and broader, ongoing DoD budget cuts, together with the drawdown of troops from Iraq and anticipated troop withdrawals from Afghanistan have created increasing uncertainty in the sector with considerable implications for intelligence M&A activity. This note discusses these developments and the implications on demand and supply conditions, valuation drivers and changes in the strategies of the key acquirers.

Recent Market Developments

High Level of M&A Activity but Increased Uncertainty

The level of M&A activity in the intelligence support services market continues to be high with various strategic and financial investors pursuing acquisition strategies to enter the market or to expand their existing platforms.

However, a combination of factors has created more uncertainty in the sector in the last 12 months. The current government fiscal constraints are likely to suppress overall sector growth. Pressure on the military to reduce its reliance on contractors and, specifically, to reduce the redundancies and duplication of analytical capabilities among different combatant commands and other parts of DoD has added further to uncertainties, even when threatened cuts have not materialized, as has often been the case. As if that were not enough, this year’s extended Continuing Resolution resulted in delays in contract awards and ramp-up schedules.

Looking forward, the drawdown of forces in Afghanistan and Iraq is expected to have a significant impact on demand for certain services supporting the military.
As a result, companies providing more peripheral or less differentiated services to the IC and DoD customers, or ones whose revenue streams rely on deploying personnel to support military operations overseas have become vulnerable and, consequently, less interesting as acquisition targets.

**The Evolving Demand for Intelligence Companies**

**Emergence of New Acquirers** – A key development in the intelligence market has been the emergence of new, medium-sized companies, which are often private equity funded, as the most active acquirers and key drivers of consolidation. We have seen the emergence of a group of private equity investors that evaluate acquisition opportunities as strategically as any trade buyers and are as well-versed in the intricacies of contracts, special-access programs and intelligence customer demands as the traditional key acquirers in the sector.

**Strategic Approach to Acquisitions** – Acquirers have become far more discriminating in their acquisition activity. There are few opportunistic buyers in the market and strategic fit is the key demand driver.

While some buyers are still considering the intelligence sector broadly, looking for security cleared people to address their internal growth constraints, most buyers are targeting particular acquisition opportunities that help them address certain strategic issues, including adding a key skill-set or a capability to enhance their offerings, accessing a particular new customer group, or acquiring relevant past performance or contract vehicles.

Often, acquirers are targeting particular subsectors, including cyber security/intelligence; human terrain/sociocultural/geospatial/imagery intel analysis; human intelligence training and operational support; forensic exploitation (document, computer, cellular and sensitive site) and biometric solutions. The clearer the target’s business model and the more focused its offering, the better positioned it is to achieve a successful sale.

**Key areas of M&A Activity**

The key areas of anticipated M&A activity in the intelligence sector in the next 12 months are likely to broadly reflect the priorities of the IC and DoD customers. We expect a significant amount of activity in areas that are closely aligned with and supportive of the continuing intelligence transformation process, the fusion of intelligence and military operations, improved understanding of operational environments and further development of the intelligence capabilities of the special operations community. Finally, we expect continued activity in the cyber space as the government assesses its inherent capabilities in the cyber defense realm and develops its cyber strategy.

**Analytic and Operational Support Services**

Companies providing personnel to augment the less differentiated analytic capabilities of the combatant commands and other DoD customers are likely to be vulnerable and face negative growth, resulting from budgetary pressures toward consolidation and elimination of redundancy.

However, we would expect continued, strong demand for high-end analytic services related to technical and geopolitical threats, as well as in areas of specialized expertise, such as geospatial analysis, imagery (including full-motion video) analysis, human terrain mapping, biometrics, forensics and other niche capabilities. We expect these to be some of the key areas of M&A activity in the next 12 months.

We also expect the major providers of analytical and operational support services to pursue a defensive acquisition strategy, adding more value-added services as well as increasing their access to a broader set of customers.

**Cyber Security**

Cyber security has been and is likely to continue to be one of the most active areas in the intel M&A market. There have been a number of cyber transactions in the last 24 months and a broad universe of acquirers continue to pursue cyber acquisition strategies. As a result, transaction valuations have been high.

The government’s cyber priorities include: (1) Training the government workforce to ensure enterprise-wide knowledge of cyber issues; (2) Recruiting and training cyber security experts; (3) Developing technologies to employ active cyber defenses and other new defense approaches; and (4) Developing comprehensive policy approaches to cyber issues.

Acquirers’ priority services continue to evolve in line with the government’s need to increase both its defensive, tracking and “hunting” capabilities (information assurance, C&A, network monitoring, vulnerability assessment, cyber forensics) and its offensive capabilities (cyber identity tracking and counter-operations).

In the past, acquirers’ strategies have not always been clear and many have pursued cyber acquisitions in what appears to have been an indiscriminate manner. We believe this is changing, as many acquirers are defining their cyber strategies more clearly and becoming more discriminating. Increasingly, buyers are focusing on targets with certain unique capabilities, relevant past performance, contract vehicles, access to specific customers (including USCYBERCOM, NSA, CIA and DHS), and access to high-level decision makers.

**Training, Modeling and Exercise Development Services**

Although outsourced training and related services – in particular basic, tactical and other less specialized training – will come under budgetary pressure, these trends will run headlong into the need to retrain and refit returning forces to deal with anticipated threats, particularly in counter-insurgency, and to develop the new skills required by irregular and asymmetric warfare. Given the importance of intelligence in irregular and asymmetric warfare, we expect the growth in demand for specialized intelligence collection-, analysis- and exploitation-related training to continue.

In addition, virtual training will continue to be a key DoD priority in an increasing number of areas, including cultural and language training in addition to the more mature virtual training and simulation services available in weapons and equipment use.

The trend toward continuing, and in some cases enhanced demand in specialized and esoteric areas of training and exercise development will continue, even in the face of a declining overall market for such services.

**The Special Operations Community**

We single out the special operations community, as the role of the U.S. Special Operations Command (“SOCOM”) continues to grow as the regular troop drawdown from Afghanistan and Iraq progresses. Even in the current fiscal environment, DoD plans also call for SOCOM funding to continue to increase sharply over the next several years.

The special operations forces are the focal point for the fusion of intelligence and military operations, and SOCOM is devoting considerable resources to develop its organic intelligence collection, analysis and
The barriers to entry for provision of services to this customer base are high, and acquisition targets that offer a buyer differentiated capabilities, high-level access and significant past performance are likely to be of great interest to a broad universe of acquirers.

Supply-Side Developments

The high valuations reflected in recent transactions have not gone unnoticed by entrepreneurs and executives of companies in the intelligence sector and, consequently, we expect a number of companies, particularly in the cyber realm, to come to the market in the next 12 months. However, they are likely to find the market increasingly challenging, as buyers are defining their cyber strategies more carefully than may have been the case in the past and, in some cases, are focusing more on the integration of their previous acquisitions than on making new ones. More discriminating buyers, combined with an increased supply of targets is likely to depress valuations, in particular for companies that don’t have a truly differentiated skill-set, relevant past performance and access to the right customers.

The other expected supply-side development is that smaller companies, providing more commoditized services, are being impacted by the budget cuts and are looking to sell, not from a position of strength but for defensive reasons.

Valuation Drivers

Intel has been a strategic priority to many buyers and a relative safe haven in turbulent markets. The sector’s safe haven status has been driven by ongoing national security needs and significant budget allocations. As a result, transaction valuations of intelligence companies did not suffer a major correction during the financial downturn and recent market volatility. Intel valuation multiples have remained high relative to other industries, including other government services sectors.

However, while transactions valuations may have generally been relatively high, they have varied considerably, depending on the specific characteristics of the target and the dynamics of the transaction. Certain subsectors have tended to attract higher multiples. Broadly speaking, cyber-related companies have been valued at a premium to other intel-related transactions. Other key valuation drivers include visibility of growth as supported by contract backlog and pipeline underpinned by past performance, and level of revenues from prime contracts and set-aside contracts.

The high transaction valuations provide only a partial picture of current market conditions. For every completed transaction there are many more deals that are not completed. Buyers are willing to pay a high price for the right deal, but will not proceed if the target is not a very good strategic fit, or fails to meet its financial forecasts.

The strategic approach to acquisitions has resulted in decreased price elasticity. In other words, acquirers are prepared to pay full valuations for the right targets but even a low valuation is unlikely to attract buyers if the target is not a good fit with the buyer’s strategy. There are few opportunistic buyers or bargain hunters and, as a result, reducing valuation expectations is not going to work as a motivating factor if the deal lacks a strategic rationale.

Finally, earn-outs continue to be an important risk mitigation tool for acquirers, and other terms are subject to negotiation as much as valuation.

Conclusions

The key growth areas in the intelligence sector have evolved, reflecting the Government’s changing national security requirements, priorities and budget allocations. Furthermore, the current tight fiscal environment and ongoing DoD budget cuts, together with the drawdown of troops from Iraq and Afghanistan, have created increasing uncertainty in the sector, with considerable implications for intelligence M&A activity.

The key areas of M&A activity in the intelligence sector in the next 12 months are likely to broadly reflect the priorities of the IC and DoD customers. We expect a significant amount of activity in areas that are closely aligned with these priorities:

- Support to the continuing intelligence transformation process;
- Fusion of intelligence and military operations;
- Improved understanding of operational environments;
- Further development of the intelligence capabilities of the special operations community; and
- Cyber intelligence, as the government assesses its inherent capabilities in the cyber defense realm and develops its cyber strategy.

Acquirers have become far more discriminating in their acquisition activity and are targeting acquisition opportunities that help them address key strategic challenges, including adding a specific skill-set or a capability to enhance their offering, access to a particular new customer group, and acquisition of relevant past performance or contract vehicles. Some of the more active buyers are likely to focus on digesting and integrating their previous acquisitions in the next twelve months.

At the same time, we expect to see more companies to come to the market either trying to take advantage of the recent high market valuations, or for more defensive reasons. This change in the demand/supply equation is likely to weaken the position of sellers that offer services that are less differentiated or peripheral to evolving national security priorities.

However, companies closely aligned with and supporting the critical priority initiatives of the intelligence community and the DoD, with a truly differentiated offering and past performance, continue to be in a very strong position and are likely to be of interest to a broad universe of acquirers looking to address certain strategic issues through acquisitions. These acquirers, moreover, are prepared to pay premium valuations for the right deals.
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