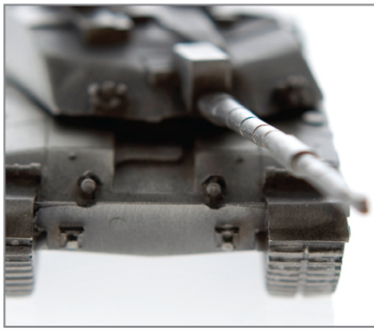

Meet the expert
Aerospace & Defense

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Jeffrey Roncka

Jeffrey Roncka has extensive merger and acquisition (M&A) experience within the aerospace, defense, and government services markets, including positions in both the public and private sectors. He began his work in this area in the early 1990s when he wrote his master's thesis on consolidation in the US defense market and its impact on competition. Mr. Roncka followed this effort by joining the Office of the Secretary of Defense and working in the Industrial Affairs office from 1995 to 2000 where he performed antitrust and foreign direct investment reviews of defense transactions as a senior financial analyst. For the past decade, Mr. Roncka continued to build his knowledge base by working in the private sector, first in an investment banking capacity at Global Technology Partners, LLC and for the past seven years at Charles River Associates.

Jeff has participated in over fifty aerospace and defense transaction processes, representing a diverse range of US and international clients, over the past decade. While at CRA, he has worked on deals ranging in size from less than $5 million in enterprise value to over $4 billion. Mr. Roncka and the CRA team support clients by providing M&A targeting, growth / acquisition planning, market and revenue forecasting, competitive intelligence, valuation, and deal structuring advice, particularly with respect to investments in cleared US companies by non-US entities.

What current or emerging trends do you see with respect to transaction activity in the defense industry?

Over the past twelve to eighteen months, global defense firms have focused on reassessing their views of the evolving business environment, and much of today's M&A activity flows from the strategic decisions generated by this process. For example, major US defense primes have demonstrated a new willingness to reshape their portfolios through the divestiture of sizable operations. The Northrop-TASC, GD-Spectrum Astro and recent Lockheed Martin announcements are examples of this. Meanwhile, activity by private equity and financial sponsors has increased significantly as small- to mid-sized firms are deciding that now is the optimum time to transition to a new ownership structure and growth strategy. Finally, the average deal size appears to be increasing as well, evidenced by the recent purchases of DynCorp, Vought, and TASC.

Lockheed Martin recently announced they plan to divest two major business areas. What larger significance does this move suggest for the defense industry?

Before you can answer that question, you need to understand Lockheed Martin's specific rationale for these decisions. The planned sale of their Enterprise Integration Group suggests that concerns about mitigating organizational conflicts of interest (OCIs) are real, or at least real enough to convince Lockheed Martin that they will get greater value from this operation by selling it to someone who is not facing potential OCI-driven impediments to growth. In this respect, Northrop's decision to sell TASC was not an outlier or exception, but rather the first reaction to new DoD policies regarding OCI. I predict that you will see at least one more OCI-driven divestiture within the next few months. With regard to Lockheed Martin's decision to divest the PAE contingency support business, one should not interpret this as an indication that the addressable market is not attractive. Ultimately, as some wondered at the time of Lockheed Martin's purchase of PAE, the business model required to scale this type of business turned out to be evolving in a different way than Lockheed Martin was comfortable with. Specifically, while other defense services businesses saw customers bundle information technology requirements with facilities management / logistics requirements, customers in the contingency support area are seeking to add more security operations, project management, and construction requirements. Hence, Lockheed Martin felt that its core services business model was incompatible with the long term growth requirements of PAE.

So, to answer the question, what does this mean for industry more broadly? This move—along with General Dynamic's divestiture of Spectrum Astro earlier this year—suggests that firms that bought properties to launch new lines of business should not be afraid to exit them if it subsequently turns out that these purchases don't fit their strategy going forward. I believe these deals suggest that we will see increased "portfolio pruning" over the next year or two.

In the current industry environment, how should M&A fit within defense firms' overall strategies?

Given the overall flattening in US and Western European defense budgets over the near term, companies will have a hard time finding new sources of organic growth, and competition in the most attractive areas (e.g., cybersecurity, unmanned systems, intelligence processing) is increasing. As a result, M&A is one of the leading ways a firm can gain immediate access to the desired markets and customers and establish a credible competitive position. Also, as management and stakeholders shift their focus from top line growth (i.e., revenue) to bottom line growth (i.e., profitability) we will likely see more divestitures of healthy but lower margin or more capital intensive operations.

What are some of the key challenges facing buyers and sellers of defense firms?

Two of the biggest issues remain the valuation gap between buyers and sellers and the ability to demonstrate credible, long-term growth during a sale process. In terms of the valuation gap, many sellers are performing well, and their cash flows will remain healthy for the next couple of years even though their order books may be lightening a bit. Hence, they continue to seek high purchase price multiples at a time when buyers are becoming increasingly uncertain about how to sustain top line growth over the next five to seven years. Recent transaction pricing patterns suggest that this gap is beginning to close a bit, but as several current auctions illustrate, these differences are resulting in longer sales processes and more difficult negotiations between buyers and sellers.

Buyers, on the other hand, must figure out how to value the greater uncertainty in the market created by program restructuring, acquisition reform (e.g., OCIs, government in-sourcing) and the challenge of accessing non-US growth markets. These issues are making it difficult to value opportunities and may force buyers to adjust how risk averse they are, relative to recent history. As businesses become more global and diverse, integrating the operational, political, business, and value aspects of an acquisition target becomes much more difficult.

What advice would you offer to participants about the M&A process?

M&A needs to be thought of as a core component of a company's strategic planning process rather than a part-time mission or a strictly functional area. Management needs to develop and resource the M&A role commensurate with its strategic value to the future of the company. Also, it is critically important to have a dedicated process for building a pipeline of targets and organizing the execution of a transaction. Finally, companies need to be pragmatic. Successful firms are strategically rigid but tactically flexible in their pursuit of transactions. Don't allow yourself to be constrained by the exact shape or form of a deal (e.g., proactively targeting firms vs. joining an auction process); focus on ensuring that it satisfies a consistent set of underlying strategic objectives.

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