Realizing Value in the U.S. International Development Market

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Synopsis: *Led by the Defense segment, the market of companies that primarily provide services to the federal government is consolidating. This article addresses how to value a company that operates in the International Development/USAID market segment, the state of that market segment, and how to consider realizing value for owners and shareholders through creative transactions*.

Government Services Industry

The entire government services industry, from Defense to Civilian agencies, is for many reasons unique in the spectrum of the U.S. economy. The U.S. government never defaults on an invoice, so customer risk is rarely a concern. The U.S government is the largest buyer of technology in the world as well as the largest outsourcer of services, which can range from janitorial services to complex aircraft maintenance or software development. The U.S. government awarded almost $440 billion of contracts last fiscal year and over $540 billion at its peak in 2008. $440 billion is more than the GDP of all but 25 countries, the 25th being Belgium.

The dominant characteristics of the U.S. government services market are modest and constrained profitability *as well as* revenue growth that fluctuates with government spending. There can be pockets of above-average growth and profitability for services such as cyber security or health care information technology, but even these are constrained by the needs of the overall budget. Overlaying all of this activity are the arcane rules of government contracting, essentially requiring firms to speak two languages—"business" and "government." There are few successful examples of companies that sell equally well into the federal and commercial marketplaces, although the list of those which have tried is long. The federal market is a market unto itself, which makes it both inviting and frustrating for stakeholders and investors.

USAID

A sub-segment of the government services market includes hundreds of for-profit and non-profit companies and organizations whose **primary customer is the United States Agency for International Development (USAID),** and to a lesser extent, the U.S. Department of State and other departments and agencies that have international programs. Broadly defined, these entities are pro-active, idea-generating, human capital companies and organizations as opposed to facilities maintenance, logistics or pure technical services providers. They create solutions and run projects. The projects might include helping to stand up a new government agency in Afghanistan, developing municipal health care systems in South America, installing an anti-corruption campaign in Africa, or teaching new agriculture techniques in Cambodia while helping to develop a market infrastructure to transport products. *Companies and organizations in the International Development space offer highly sophisticated and complex services, often organized to address a discrete need or problem in a foreign country.*

In theory, USAID is an independent agency with dotted line authority to the State Department. In practice, Presidents since Bill Clinton have been under pressure to align USAID more with foreign policy objectives so that today the dotted line looks more like a solid one. The two budgets, contract awards and missions of USAID and the State Department are often cited in some kind of combination.

Although USAID is the primary "implementing agency" for U.S. foreign aid, it is not so simple to say that USAID administers all of the international development and aid programs. The State Department responsibilities can include massive food programs, narcotics control, military aid to Israel and Egypt, support for governments in Afghanistan and Iraq, the Ebola response, grants to U.N. agencies, Syrian refugees, counter-terrorism and more. Other agencies and departments such as Agriculture and Health and Human Services also have international aid programs. Health care aid is one of the largest components of International Development, and health care can cut across numerous departments and agencies.

U.S. DISCRETIONARY BUDGET AUTHORITY BY AGENCY ($ millions)

Department or other unit	FY 2015	% Total
Department of Defense–Military Programs	$560,442	50.2%
Department of Health and Human Services	83,414	7.5%
Department of Education	66,947	6.0%
Department of Veterans Affairs	65,100	5.8%
Department of Homeland Security	46,535	4.2%
Department of Housing and Urban Development	30,384	2.7%
Department of State	**28,305**	2.5%
Department of Energy	27,388	2.5%
Department of Justice	26,294	2.4%
Department of Agriculture	25,029	2.2%
International Assistance Programs (USAID & other int'l agencies)	**23,927**	2.1%
Total discretionary budget authority	**$1,116,661**	
Dep't of State + International Assistance	**$52,232**	

Source: Office of Management and Budget website 7/31/16

The Foreign Aid Market

Although there are hundreds of contractors to USAID, the industry itself is only a cabin on the federal ship of state. The yearly discretionary budget of the federal government was $1.1 trillion for fiscal year ending September 30, 2015. Of that amount, the Defense Department budget overshadowed all other agencies and departments at $560 billion or almost exactly 50% of the total discretionary budget. The U.S. Congress funds a separate line item called *International Assistance Programs* which primarily houses USAID administered funds. That amount in 2015 was $23.9 billion or about 2% of the total discretionary budget over which Presidents and Congress fret.

The table "All US Foreign Aid" shows the total of all disbursements classified as "foreign aid" for 2014, the most recent year of available complete statistics. These are "disbursements" or real money spent. Even if you subtract $10 billion of Defense Department aid, $31 billion of non-defense foreign disbursements is a massive number. USAID controls the lion's share of foreign aid, but its $17.5 billion is a large and misleading number when it comes to what the actual contract market is for firms that consider USAID to be their primary customer. Two-thirds or more of the $17.5

All US Foreign Aid (Disbursements)

	2014	% Total
USAID	$17,539,437,549	43%
Department of Defense	10,140,843,868	25%
Department of State	5,750,526,385	14%
Department of the Treasury	2,832,609,815	7%
Dep't of Health and Human Services	2,345,754,904	6%
Millennium Challenge Grant	1,078,811,645	3%
Department of Energy	432,463,625	1%
Peace Corps	397,105,218	1%
Department of Agriculture	258,604,868	1%
Department of the Interior	235,263,648	1%
Other	164,861,425	0%
Total	$41,176,282,950	

Source: USAID.gov Foreign Aid Dashboard

billion is disbursed in mandated programs, emergency grants, direct transfers, loans, and other funding vehicles that have little or no bearing on companies and organizations seeking to contract with USAID.

Where around the globe does US foreign aid go? The following table offers another cut on that over $17 billion amount. The wars in the Middle East have clearly influenced and increased US foreign aid disbursements. Yet, after Afghanistan, there is a somewhat even level of disbursements to countries known to be in crisis or in need. The huge "Rest of World" and "Others" categories suggest that USAID programs are highly distributed worldwide.

USAID by Country

($ millions)

	2014	% Total
Afghanistan	$1,400	8%
Pakistan	629	4%
Jordon	618	4%
South Sudan	574	3%
Kenya	552	3%
Ethiopia	543	3%
Syria	472	3%
Nigeria	366	2%
South Africa	350	2%
Rest of World	4,800	27%
Non-country specific	7,300	41%
Total	$17,604	

Source: USAID.gov Foreign Aid Dashboard

USAID is part of a panoply of entities and countries worldwide that provide development assistance. One measurement suggests that all US assistance (over $30 billion) represented almost one quarter of the total amount expended worldwide in 2013. What makes USAID unique for firms and organizations that serve the International Development market (both for-profit and non-profit) is that USAID is the largest bilateral international aid agency in the world. If you are looking for International Development grants and contracts, the U.S. market, as is true in many industries, is the largest source, and USAID is the principal conduit. Many companies that provide International Development services are multi-national. The United Kingdom, Germany, Japan, Canada, Australia, Sweden and others have their own government funded agencies that promote projects in emerging economies. Consequently, many foreign companies and multilateral organizations bid on USAID projects just as many U.S. companies and organizations bid on foreign sponsored projects—often through subsidiaries purchased or established in the granting country. In other words, when focusing on companies, some foreign companies work through U.S. owned and branded subsidiaries and vice versa.

On the funding side, a new addition to this government constellation is the massive buying power of the Bill & Melinda Gates Foundation and other foundations that have replicated the Gates Foundation example. They offer significant grants, sometimes rivaling USAID projects in size and scope and sometimes combining with USAID to fund individual contract vehicles.

The "Real" USAID Market?

This is a difficult question because it depends upon your relationship with USAID. USAID has hundreds of programs in scores of countries. It awards billions of dollars to a wide range of entities that includes countries, government agencies in foreign countries, companies in foreign countries, public international organizations such as UNICEF and the United Nations World Food Program, for-profit and non-profit companies, universities, and a host of donor-sponsored organizations such as Catholic Charities or Save the Children. USAID awards funds through a variety of different vehicles including grants, contracts, and cooperative agreements, which in turn have many of their own variations. It should surprise no one that as far back as 2003 in a GAO report to Congress, the GAO stated that "USAID does not collect comprehensive or reliable data…"

There are continual reports over the years that the agency is chronically understaffed. Each new administration and director of the agency tends to initiate a reform agenda, including and especially contracting reform. It is not of interest to us to say whether USAID does or does not carry out its mission properly. We are only saying that when looking at the forest, it is nearly impossible to count the trees by species.

The USAID website says that somewhere within the above total of $17 billion, approximately $11 billion represents "core" USAID programs. The chart below shows in 2015 overall USAID disbursements grouped into three categories—Contracts, Cooperative Agreements and Other, which includes a wide assortment of loans and direct payments. Not included below would be agency overhead, which is approximately $1.5 billion per year.

Contract Awards	$4,855,694,013	31%
Cooperative Agreements	$5,102,074,487	32%
Other Grants, Direct Payments & Loans	$5,802,583,736	37%
USAID Total Funds Awarded	$15,760,352,236	
Source: USASpending.gov, an official website of the U.S. Government		

Our objective is to find where within this huge budget is the market for companies and organizations that provide high value International Development services to USAID. What funds are available for companies and organizations that put staff out in the field and run and monitor programs worldwide?

Cooperative Agreements vs. Contract Awards[1]

The largest controversy surrounding USAID funding for International Development companies and organizations involves USAID's use of Cooperative Agreements versus the awarding of Contracts. The crucial distinction between the two is that Grants and Cooperative Agreements do not award any profit to the recipient while Contracts can contain profit. Cooperative Agreements have another key feature. They cannot be protested. This is a feature that winners and the awarding agency appreciate in common. Functionally, Grants and Cooperative Agreements transfer money to another entity, like the many mentioned above, to carry out the public purpose of the award. In contrast, Contracts are made between USAID and an entity (like a company), bringing benefit to USAID as the awardee carries out the purpose on behalf of and under the supervision of USAID. Both for-profit and nonprofit entities can apply for either type of award, but as one can imagine, nonprofits thrive more in the Grants and Cooperative Agreements arena.

Grants and Cooperative Agreements require less supervision by USAID and are administratively easier to award. <u>In FY2015, USAID awarded $5.1 billion in Cooperative Agreements and $4.86 billion in Contracts, according to USASpending.gov.</u> Government-wide U.S. policy has traditionally discouraged the use of

[1] Note: The author has a lifelong academic and professional interest in the interplay between public and private management issues. (By way of example, he is currently the volunteer chairperson of a $200 million revenue nonprofit organization in a social services field.) You will find in the federal marketplace an old and contentious debate when for-profit companies compete for contracts against universities or non-profit research organizations. The for-profit companies complain that the nonprofit organizations have an unfair advantage. Cooperative Agreements force a reformulation of this debate. In this author's opinion, the overuse of Cooperative Agreements is a misdirected use of government funds both for corporations and for non-profit providers. All organizations, in order to thrive, need the use of surplus funds to invest in new programs, capabilities, infrastructure and more. Cooperative Agreements, which allow no profit or surplus, force organizations to find investment funds away from their primary awards. Both for-profit companies and nonprofit organizations are effectively underpricing their services. While they do this, government benefits by shifting the burden of improvements, innovation, and investment to investors or to third party donors, effectively subsidizing the government.

Cooperative Agreements, precisely because of the reduced level of control over and accountability of the recipients. Uniquely in government, USAID is a major utilizer of Cooperative Agreements, seeing a significant percentage of its mission needing the exceptions that allow Cooperative Agreements. No other department or agency in government awards more dollars in Cooperative Agreements than it does in Contracts or even comes close to such a positive ratio. Only the Department of Housing and Human Services awards more Cooperative Agreement dollars than USAID, and that amount was $11.4 billion in FY2015, 1% of its total assistance funds awarded and only half of the dollar amount of Contracts that it awarded. After USAID, the next largest user of Cooperative Agreements is the Department of Defense at $3.3 billion.

Many explanations abound as to why USAID is so reliant on the use of Cooperative Agreements. Some cite the understaffing of the agency. Some claim that non-profit donor agencies and organizations that benefit most from Cooperative Agreements have undue influence on Congress and USAID. Some cite agency priorities to fund local, in-country entities. Some believe that the agency has an inherent bias against for-profit companies which rely on Contracts. USAID itself says that it calls balls and strikes as it sees them and has no preference for one form of award over another.

Critics of current USAID contracting policy believe that the use of Cooperative Agreements is growing, but this is not an easy trend to track given the complexity of the data. What can be observed is that Grants and Cooperative Agreements have been a major component of USAID awards for well over a decade. Understanding the dynamic of how Cooperative Agreements and Contracts work not only helps define the market for companies and organizations serving the USAID space, it also defines their profitability.

A First Cut

Like all departments and agencies in the federal government, USAID reports its statistics to multiple data repositories for a variety expenditure categories—including Contracts and Cooperative Agreements. The first set of numbers below are found in USASpending.gov, a website repository mandated by an act of Congress. These are gross expenditure numbers in which we isolate Contracts and Cooperative Agreements for USAID. The statistics lump together all disbursements from large scheduled payments on major contracts to small change orders and payments for services and supplies worldwide. For Contracts alone, USAID counts an average of 10,000 discrete transactions each year. At first glance, the totals might suggest a potential market size of $10 billion. But if you are a company or organization seeking sizeable contracts and work through USAID, these gross disbursements do not represent the market of biddable opportunities. Your addressable market has to be some subset of this $10 billion.

These gross statistics on disbursements can be informative. The high water mark for USAID Contract and Cooperative Agreement disbursements was $12.1 billion in 2009. The combined 2015 amount was approximately $10.0 billion or a drop of almost 23% from the peak. This “USAID Funds Awarded” table, if read optimistically, suggests that USAID disbursements have stabilized at the current level of funding. For the next six years, the Office of Management and Budget projections for both the State Department and International Assistance Programs are essentially flat. *Past and future point to a USAID market that contains no growth.*

Year	USAID Funds Awarded			
	Contract Funds Awarded	Cooperative Agreements Awarded	Total Contracts & Cooperative Agreements	Contracts as % of Total
2008	$4,371,348,771	$5,053,713,691	$9,425,062,462	46%
2009	$5,698,044,810	$6,425,589,371	$12,123,634,181	47%
2010	$5,640,095,350	$5,434,584,125	$11,074,679,475	51%
2011	$4,583,710,793	$6,515,387,806	$11,099,098,599	41%
2012	$5,001,004,660	$4,743,150,954	$9,744,155,614	51%
2013	$4,458,440,351	$4,080,738,684	$8,539,179,035	52%
2014	$3,852,537,371	$4,731,957,434	$8,584,494,805	45%
2015	$4,855,694,013	$5,102,074,487	$9,957,768,500	49%
Median	$4,719,702,403	$5,077,894,089		

Source: USASpending.gov, an official website of the U.S. Government

A Better Cut and a $5 Billion Market

Chessiecap has uniquely analyzed two separate government data bases to arrive at a unified view of the total market for International Development companies and organizations seeking awards from USAID. The first is a distinct data base of **Grants** awarded across all of government. It is maintained by Health and Human Services. In this data base, Grants from USAID primarily consist of Cooperative Agreements along with other no-fee/no-profit awards. Grants are posted for competition and then "closed" and "archived" when the competitive period is ended.

The second data base FedBizOpps.gov is maintained by the U.S. General Services Administration (GSA) and lists **Contract Awards** throughout the government. FedBizOpps.gov is less robust and user-friendly in accessing its data, but we were able to isolate Contracts awarded by USAID and then to assign them to "sectors" of International Development such as Governance or Education. These Contracts are competitively bid, for-profit awards. Both sets of data are not a perfect record of awards, because many things can change with a program after the competition is ended. We are relying upon accurate reporting and populating of the data bases by USAID. *In this combined data of Grants and Contracts is the bread and butter of awards that fuel the International Development segment of the federal market.*

Chessiecap analyzed over 1,000 Grants offered from 2008 until the present as well as over 150 Contract Awards from 2004 to the present. In the Grants.gov data base, we found that USAID divided the Grants into twelve sectors, which we considered too many and sometimes too small to be useful in analysis. We also found that many of the USAID reported awards were, in our opinion, inaccurately assigned to certain sectors. Chessiecap re-imagined and re-engineered the data by looking at the largest companies in the industry and pattern-matching how these companies segment their International Development businesses. The result is that we have reassigned the Grants, one-by-one, into eight sectors. In the Contract data base, which had no sector information, we assigned sectors for the first time based on project descriptions. In addition, we culled the data bases of innumerable notices, withdrawn solicitations, and tiny awards that, for instance, called for the submission of discussion papers or upgrading of facilities.

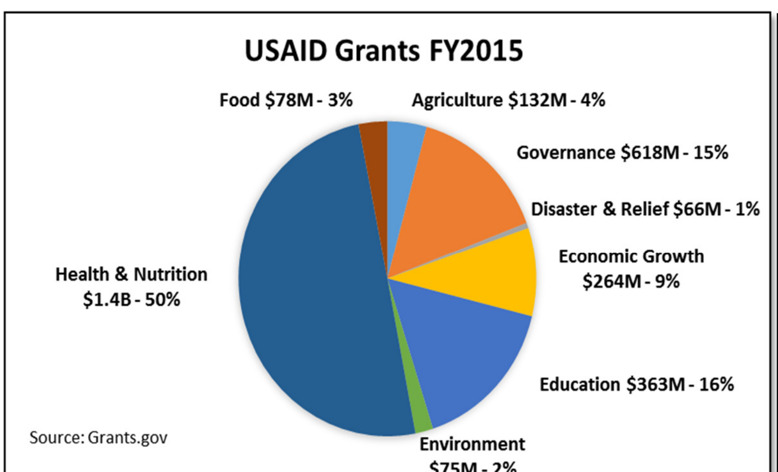
Size of Market

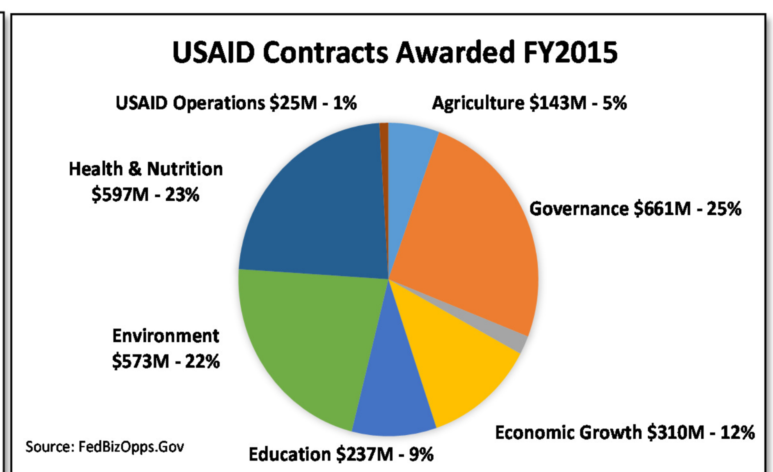
After scrubbing both sets of data and eliminating awards less than $10 million in value, *Chessiecap believes that the contracting market for International Development through USAID is approximately $5 billion per year, which includes both Grants/Cooperative Agreements and Contracts. But, the addressable market for for-profit contracts is only half of that number or approximately $2.5 billion per year.* This is consistent with data found in previous years and consistent with year-to-date figures for FY2016. The ratio between Grants and Contracts is also consistent with the gross disbursement data found in the "USAID Funds Awarded" table above.

Why eliminate awards under $10 million to arrive at an estimated size of market? Our goal was to estimate the size of the industry for firms and organizations that solicit and compete for awards from USAID. For most of the industry, one or more large contracts create a stable foundation. These contracts are often four or five years in length, providing long-term revenue stability for the firm. A multitude of small companies may participate in awards under $10 million, but these small awards cloud the true bidding landscape. By eliminating small awards, we arrive at a much more accurate picture of available bidding opportunities and average bid sizes, with only a small reduction in overall dollars awarded. For example, in FY2015, if we include all Grants, the total number of Grants double from 57 to 118 while the volume of Grants only increases from $2.45 billion to $2.71 billion. (See the "USAID Grants & Contracts Awarded FY2015" table below.)

Sectors

In a side by side analysis of Grants versus Awards for fiscal year 2015, the Contracts Awarded show a relatively even distribution of awards among Governance, Environment, Health & Nutrition, Education and Economic Growth. But for Grants, the Health & Nutrition sector dominates the other sectors by capturing 50% of the total grants awarded. Over a seven year period, Health & Nutrition has represented 58% of the dollar volume of all Grants. This is not surprising given the large dollar programs



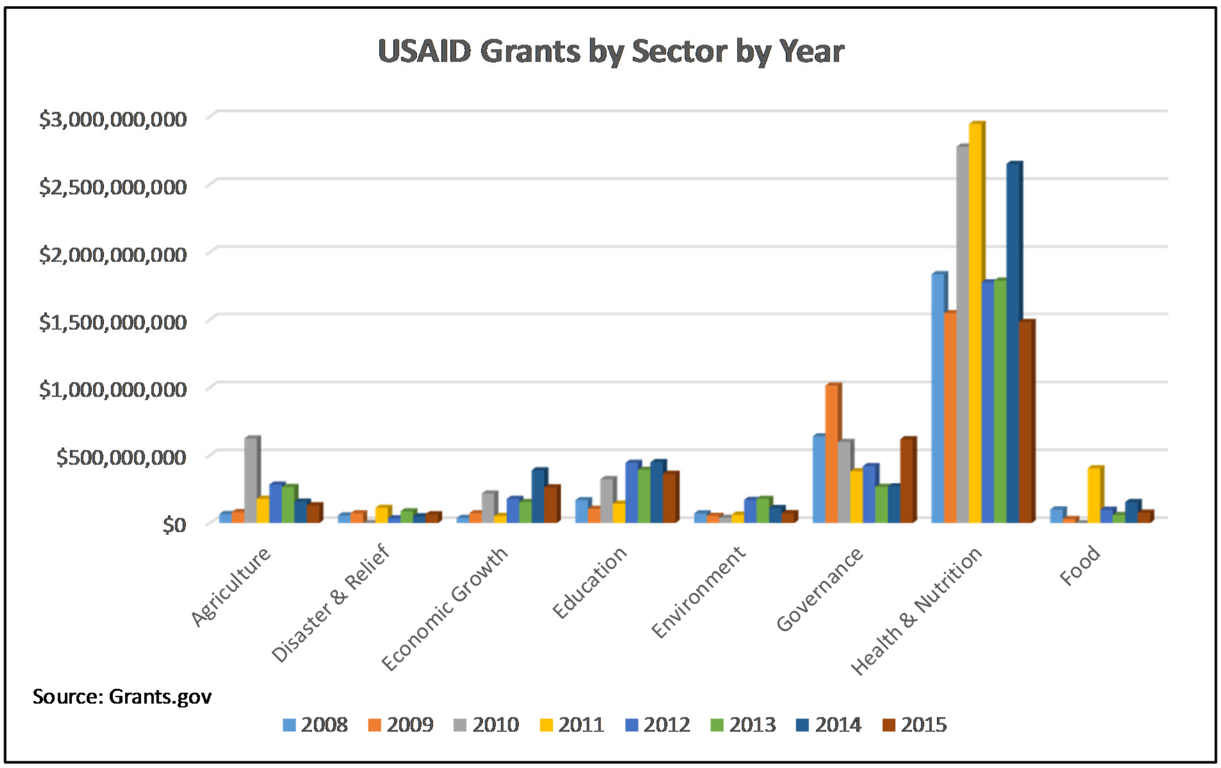


in the past sixteen years that have addressed malaria, HIVAIDS, tuberculosis and Ebola. Even when these large crisis programs are stripped away, the underlying grants in Health & Nutrition are significant and are ones that all societies value, such as improving health care delivery, organizing national systems, reducing hunger in impoverished countries, and improving mother and child health and nutrition.

Many Health & Nutrition programs, whether crisis-oriented or not, are viewed as non-profit humanitarian programs which explains their dominance in Grants. If we remove Health & Nutrition from Grants, there remains an even distribution among the remaining sectors similar to what is observed in Contracts Awarded. The major exception is the lack of Environment/Natural Resources/Engineering awards in Grants. This is a sector seemingly more oriented toward for-profit Contracts.

<u>Volatility of Awards</u>

As industry participants know well, the yearly fluctuation of awards in a sector has a great deal of volatility as well as unpredictability. The bar chart below is a multi-year view of volatility in Grants only. (The Grants multi-year data by sector is more readily available and downloadable). There is no reason to believe that Contract Awards behave with any less volatility. The chart shows that there is no stability or trend from year to year in the awarding of Grants, exacerbated by the fact that the total volume of Grants is not growing.



Every government services industry company agonizes over its major proposals and lives a tortured existence preparing and submitting grant proposals and then awaiting the government's decision. In the International Development space, this process is particularly harrowing, aided by the lengthy USAID award process. The volatility shown in this chart illustrates the 'boom or bust' mentality that exists in the International Development market. With such fluctuations in awards, there is no contracting environment in which a firm can win a constant share of a constant stream of opportunities and thus maintain a steady backlog. It is a basic tenant of finance that “predictability facilitates investment.” For an individual International Development company or organization, when the future is uncertain, it is difficult to plan staffing levels, bid & proposal budgets, real estate decisions and more.

<u>Industry Concentration and Constrained Bidding Opportunities</u>

The “USAID Grants & Contracts Awarded FY2015” table below details why Chessiecap believes that the real market for organizations pursuing substantial award opportunities with USAID was approximately $5 billion in FY2015, with half of that amount ($2.5 billion) available as for-profit contract opportunities. There are a large number of participants in the industry, including for-profit and non-profit companies as well as universities, NGOs and multilateral institutions. Yet, the number of awards per sector available for these bidders and awardees is clearly limited. Taking Agriculture as an example—the number of Grants each year that are greater than $10 million is only 12, with 4 of these being non-profit Grants/Cooperative Agreements. In the robust Governance sector, for-profit Contract awards outnumbered Grants by more than 2 to 1. But in the even larger Health & Nutrition sector, the number and volume of Grants far out-weighted the Contract Awards, with companies in this sector chasing only four major Contract Awards in FY2015.

USAID Grants & Contracts Awarded FY2015[1]

USAID Sectors[2]	$ Grants	# Grants	$ Contracts[3]	# Contracts	Total $ Grants & Contracts	Tot # Grants & Contracts	Mean Grant Size	Mean Contract Size
Agriculture/Food Production	$115,437,501	9	$142,750,409	8	$258,187,910	17	$12,826,389	$17,843,801
Agriculture > $10M Award	97,737,501	4	142,750,409	8	240,487,910	12	24,434,375	17,843,801
Disaster & Relief	15,000,000	3	50,000,000	3	65,000,000	6	5,000,000	16,666,667
Disaster & Relief > $10M Award	10,000,000	1	50,000,000	3	60,000,000	4	10,000,000	16,666,667
Economic Growth	246,050,000	12	309,669,071	11	555,719,071	23	20,504,167	28,151,734
Economic Growth > $10M Award	219,000,000	3	305,569,071	10	524,569,071	13	73,000,000	30,556,907
Education & Training	438,750,000	18	237,416,683	9	676,166,683	27	24,375,000	26,379,631
Education & Training > $10M	412,200,000	12	215,538,319	5	627,738,319	17	34,350,000	43,107,664
Environment/Nat. Resources/Eng.	52,200,251	8	573,100,822	16	625,301,073	24	6,525,031	35,818,801
Environment > $10M	23,000,251	1	527,784,559	5	550,784,810	6	23,000,251	105,556,912
Governance/Civil Society/Monitoring	405,406,697	24	660,509,710	21	1,065,916,407	45	16,891,946	31,452,843
Governance > $10M	328,600,000	8	643,890,421	18	972,490,421	26	41,075,000	35,771,690
Health & Nutrition	1,351,958,954	41	597,239,223	4	1,949,198,177	45	32,974,609	149,309,806
Health & Nutrition > $10M	1,280,228,954	27	597,239,223	4	1,877,468,177	31	47,415,887	149,309,806
Food Aid	84,399,999	3	0	0	84,399,999	3	28,133,333	N/A
Food Aid > $10M	74,999,999	1	0	0	74,999,999	1	74,999,999	N/A
USAID Operations	0	0	24,969,123	2	24,969,123	2	N/A	12,484,562
USAID Operations > $10M	0	0	23,760,523	1	23,760,523	1	N/A	23,760,523
TOTALS	$2,709,203,402	118	$2,595,655,041	74	$5,304,858,443	192		
TOTALS only > $10M Grants & Contracts	$2,445,766,705	57	$2,506,532,525	54	$4,952,299,230	111		

Footnotes:

(1) Sources: Grants.gov and FedBizOpps.Gov

(2) Grants and contracts are assigned by Chessiecap to sectors redesigned by Chessiecap based on USAID and industry categorizations.

(3) 2015 Health & Nutrition sector does not include the $1.1 billion Global Health Supply Chain IDIQ award which is uniquely a sole-awardee and unusually large, while being awarded only once in every five-to-eight years. It distorts the 2015 totals for comparison purposes.

Once a company or organization is bidding on opportunities greater than $10 million, the average award size can be $20 million or much more, requiring significant resources to convince the U.S. government of an organization's capacity to manage the award. Not coincidentally in 2015, there were 102 companies that received at least $5 million of awards from USAID, *with the top ten firms garnering 56% of the awards. The top 20 recipients secured two-thirds of the awards.*

Add to this mix of competitors: USAID's emphasis in recent years on awards to more small and disadvantaged businesses; USAID's reliance on the use of non-profit Cooperative Agreements; and USAID's objective of driving more awards down to the local/country level. In addition, there is the reduction in spending in all of government, which increases the number of bidders and competition for a smaller pool of available awards. In summary, the U.S. government-dependent International Development industry is highly competitive with unique additional pressures coming from the scarcity of yearly awards and the desirability of securing the largest, multi-year grants. As one industry executive recently stated, *"In my opinion, USAID has long since passed the point of "optimal competition" and now suffers deeply from too many similar competitors chasing too few awards."*

Extraordinary Growth and Now Stagnation

The following sections will focus primarily on for-profit companies.

There is an old saying on Wall Street that goes something like this, "Everyone is a genius in a bull market."

The influence of macroeconomics on the history and growth of the International Development market is unmistakable. We said that the federal market is a market unto itself. For a period of thirteen years from the 1996 to 2009, the federal discretionary budget grew by an astounding compound annual growth rate (CAGR) of 8.8%. If we use the International Assistance Program budgets as a proxy for growth in U.S. International Development, then the U.S. International Development market grew at approximately 6.5% per year for thirteen years, somewhat below the total discretionary budget rate.

To put this in perspective, for approximately the same period of time, the S&P 500 grew at a CAGR of only 3.2%–half of the International Assistance rate. Is it any wonder why the sleepy federal marketplace of the 1980s and early 1990s grew into such a vibrant, highly sought-after transaction market? It is estimated that at its height, over 100 private equity firms were invested in the federal market—a market that had only a handful of institutional investors in the 1990s. In the middle of this extraordinary run of growth, the Dot-Com Bubble burst (2000-2001) and the general market experienced a stock market retreat and a short recession. But not the federal government. In large measure due to 9/11, homeland security, and the subsequent wars in Afghanistan and Iraq, federal expenditures kept advancing, benefiting greatly those International Development companies which could respond to economic and civil society RFPs in the Middle East.

Owners of companies in the federal marketplace across all segments found liquidity in the robust merger and acquisition (M&A) market from the mid-1990s to 2009. In the same time period, the group of federal market publicly-traded companies continually replenished its ranks as some public companies also became acquisition targets. As government spending grew year after year, the wealth creation of government services companies attracted the attention of private equity funds. Led by innovators at the Carlyle Group, CM Equity Partners and individuals like Joe Kampf (Anteon International Corp.), these private equity funds would buy a platform company and keep adding acquisitions, eventually looking to the public markets or to an aerospace or large IT services company buyer for an exit.

But the music finally stopped in 2009 with the Great Recession, soon followed by various legislative maneuvers resulting in Sequestration. From 2009 to 2015, the Discretionary Budget for the first time in over a decade actually began yearly decreases, resulting in a compound annual growth rate for that period of negative 4.7%. The International Assistance Program budget treaded water during this period with a slightly negative 0.23% CAGR.

Sequestration was not a cause but a symptom. It was the growth of the federal budget that fueled and defined wealth creation in the market of federal services companies. That revenue growth was unparalleled in the U.S. economy for any sector for that length of time. It produced thousands of M&A transactions and funding events among federal market companies. It raised expectations among owners that their services companies could actually yield a liquidity event–like selling a house at a profit.

We are now in a new paradigm where federal discretionary spending is static with no belief that it will accelerate at any point in the foreseeable future. M&A transactions are still occurring in three segments of the federal marketplace, and their occurrence is instructive. Cyber Security and Health Care IT stand apart as two segments where market need and dynamics allow revenue growth. And then there continue to be significant transactions occurring among Defense and Aerospace companies, driven by the concept of **consolidation**–a concept that the International Development segment, in the absence of alternatives, should be considering.

Value Creation

In basic corporate finance theory, there are three components of value creation. One is **revenue growth**, which we have shown has been the primary driver of wealth creation in the entire federal services marketplace. There is no substitute for a rising tide, and for many years such a tide was coming in for the U.S. International Development market. In a rising market, many companies experienced exceptional growth. Some went from being small companies to formidable players. Many new companies entered the market. But since 2009, most small and medium-sized companies in International Development would be delighted to experience the same no-growth yearly statistics found in the overall USAID budget. Instead, many have experienced significant negative growth, which threatens their very existence.

Why negative growth? First of all, as the release of RFPs and the awarding of new contracts slowed, industry participants started bidding on contracts out of their traditional expertise, searching for replacement revenues from any source. Secondly, in a cruel twist experienced throughout the federal marketplace, when revenue growth slowed for the major Defense and IT contractors, those behemoths began foraging elsewhere in the federal market looking for revenues. In a typical current scenario, an incumbent on an International Development contract might see five to ten bidders whereas in previous times there might be only several or none. And now, one or more of those bidders might be a large Defense contractor or a publicly-traded services company or a major accounting or consulting firm. Finally, just as the growth in federal expenditures came to a halt, USAID instituted an ongoing objective "to increase competition and expand the use of small business concerns as prime contractors…" Of course, this a noble and important goal for every federal agency and department. Nonetheless, coming at a time when budgets began treading water, this initiative only exacerbated the bid and proposal frenzy among small and large competitors alike.

The second component of value is **profitability.** If companies are the same size and growing revenues at the same rate, the company with higher margins or profitability is obviously more valuable. In regard to profitability, the International Development segment of the federal market is something of an outlier, if not an anomaly. A typical major government services company can achieve EBITDA (earnings before interest, depreciation and amortization) profitability between 7% and 10%. In the International Development segment, a typical company will be pleased to achieve EBITDA margins in the 5% to 7% range, with many falling well below that threshold. There is no definitive argument as to why this disparity exists. It is not just a comparison between International Development and Defense contractors. A similar disparity exists between International Development companies and other civilian agency companies.

One concrete reason why some companies have margins below 5% is because some companies are driven to compete for and acquire no-profit Cooperative Agreements when formerly these companies eschewed such grants. With more competition for awards and fewer wins, we have seen companies chase Cooperative Agreements because those Cooperative Agreements are squarely in a company's primary market. In order to maintain market position and demonstrate ongoing expertise in a sector, the company is compelled to bid on Cooperative Agreements. The profit dilution is immediate.

Our anecdotal observation is that the International Development segment has lower margins in part due to the philanthropic underpinnings of the industry. As shown above, a significant portion of Food and Health & Nutrition aid is directly granted to recipients and is not appropriate for for-profit awards. This philanthropic ethic may infuse and distort the awarding of Contracts as well as Grants. USAID has always been known as an agency that does not award high margin contracts and may have a built-in prejudice against awarding profit to companies pursuing a humanitarian mission.

This is not just about USAID. Some who work for non-profit NGOs and multilateral organizations may look askance at for-profit companies in the field. Likewise, we have met owners in the industry who have only a moderate interest in maximizing profits or in pricing their services commensurate with their technical value-add. USAID-dependent companies were often founded by men and women whose companies were vehicles to make the world better. Many, if not most, of the early founders in this industry segment never dreamed of selling to a big company for personal profit. To this day, some flinch at the thought. We at Chessiecap respect this attitude, but at the same time, we believe that every person and firm should be paid fair value for their services. The level of expertise and consulting in International Development is no less sophisticated than in other government markets and is, in many cases, more sophisticated. Experienced consultants with international credentials require time and investment to create, so there is no oversupply to drive down pricing.

The third component of value creation is **risk**, a factor that is difficult to measure but is ever-present—like gravity. How risk is managed or reduced adds value to a company versus a competitor. Risk can be parsed into many elements, but the two most important ones are systemic risk and idiosyncratic risk. Since all companies in International Development are in the same general industry (the federal government market) and the same segment of that industry (International Development), then systemic risk is a wash. As we have seen, if federal expenditures create a good growth environment for companies that serve the government, then all companies are favored. The same is true if USAID suffers in funding–all participants suffer. It is difficult to mitigate systemic risk without adding to or changing your industry and mission.

The risk that matters is idiosyncratic risk or individual business risk. Is your company's portfolio of contracts diversified or are you highly dependent upon a limited number of contracts, the loss of any one of which could jeopardize the company's existence? In an effort to secure revenues, are your contracts too thinly priced and in danger of consuming cash instead of generating cash? Does your company manage receivables to an acceptable low number of days or are bank financing costs destroying your profits? These are all examples of how idiosyncratic risk affects value. It is in the management of risk where companies in International Development have the greatest potential, through creative transactions, to increase value and potentially achieve liquidity.

The Case for Consolidation in International Development

Companies in the International Development segment should consider consolidation transactions as an effective strategic path to increasing value and potentially delivering liquidity. This industry segment has matured, and future industry growth is constrained. As in all industries when these events coincide, consolidation and combinations become important.

The Defense services segment of the government contracting market, the largest segment by far, is already undergoing a major wave of consolidation. The headline transactions are ones like Leidos combining with Lockheed Martin's Information Systems & Global Solutions business (a combined $10 billion in revenue), CACI International's acquisition of L-3's national security services business (a combined $4.4 billion in revenue), and the merger of CSC's government services business with SRA (the new CSRA with $5.5 billion of revenue). There have been waves of consolidation in the federal market in the past, but this one is rooted in basic economics and is predictable. Thousands of government services businesses were created in the extended growth market for government outsourcing. With static or declining government outsourcing, thousands of federal market companies will struggle to tread water, will entertain transactions, or will close their doors.

What drives consolidation? First and foremost, it is <u>the quest for revenues in order to stop the hemorrhaging of current contracts and to try to re-establish growth.</u> In the International Development segment of the federal market, we have established that overall funding is static and, at the same time, that USAID is favoring Cooperative Agreements over for-profit contracting. Incumbency is more threatened than ever. New competitors from both within and without the industry are bidding in sectors where they have never been seen before. Internally generated growth is impossible unless a company has a competitive advantage that separates its business from competitors. (In almost all cases in services industries that have no intellectual property, that seeming advantage is rarely sustainable.) Companies have promised their shareholders and private equity funds have promised their limited partners the same thing–growth. The primary available opportunity is to buy that growth through acquisitions and mergers.

A second driver for many companies is <u>a need for liquidity</u>. This varies from company to company, but as a market contraction wears on, more and more companies find themselves with long-in-the-tooth investors, founders and employees who need an "exit". In a rising market, one's own company seems like the best investment; but, when growth slows, diversification of assets becomes a more pressing personal objective.

One of the most important objectives of consolidation is diversification of the contract base. In no segment of the government market is this more important than in International Development. The evidence is clear that companies limited to one sector of the USAID budget are exposed to extreme yearly swings in new contract awards. For any one company, the data points (yearly contract wins) can be too few. One or more years of a "dry hole" in awards can lead to catastrophe. Again, it is the lack of growth in the market and the lack of hope for new and larger awards that makes this all too obvious. It becomes magical thinking to base a company's existence on the expectation that any one company can outperform and out-hustle all other bidders. Diversification builds stability and provides the opportunity for owners to sleep better at night.

A close cousin to diversification is the opening up of new customers, capabilities or locations. This is particularly important in the International Development market because many companies are single silo entities, working in Economic Growth or Agriculture or Education. These companies have regional specific capabilities which they can better leverage in one country or take those capabilities to a new continent. In the Leidos-Lockheed Martin transaction, the Leidos CEO Roger Krone is quoted in the *Washington Business Journal* saying, "With this move, we are now big enough that we can open a field office in Abu Dhabi." That is the leader of a $3 billion market capitalization company thinking about the importance of a field office.

A final key advantage of consolidation is simply "size" or "mass". In the financial markets, large companies receive an additional valuation premium compared to similar smaller companies. This premium is a recognition by investors that where smaller trees may be swept away in a flood, larger ones will remain rooted. In the International Development segment, as smaller companies see more and larger competitors come after their legacy contracts, it is a clear advantage to have larger revenues, more reference customers, and a larger list of capabilities to support your proposal. It is a clear advantage when bidding for contracts that average $20 million or more to be a company with substantial revenues. In a down market, it is often observed that contracting officers find safety in choosing the largest and most established names in the industry.

Increased size also creates the ability to spread out overhead over a larger base of revenues. This is of great importance to government services companies, whose revenues are often directly related to the health of their *bid and proposal activity*. In the current constrained market for new contracts, many smaller International Development companies are at a disadvantage with poorly funded bid and proposal functions. Not only do these smaller companies need to fund a larger number of new proposals to find replacement revenues for lost contracts, but they also need to fund stronger and more complex proposals for their legacy contracts as new competitors up the stakes.

What Kind of Transactions Make Sense in this Environment?

The challenge becomes what kind of transactions, if any, can stabilize or add value to companies in a no growth environment? For many compelling reasons addressed above, industry consolidation is a normal response to these conditions. But the International Development market segment is not a typical market; it contains a number of unique factors that affect strategic decisions.

Some industry players are financially well-grounded and sufficiently diversified so that maintaining the status quo is a reasonable option. Some will use their industry position to add new capabilities and customers through acquisition and thus become "consolidators." Some companies will believe that they have such a market leading advantage in a sector that they only need to stay the course. Most companies will “do nothing” because inertia is a strong force when facing life-changing decisions such as consolidation. Doing nothing seems like a neutral choice, but in an industry that projects no growth and increasing competition, not acting can be full of risk.

Our advice is for industry participants to be brutally rational in assessing their market position, to think and to analyze, to be open to new ideas and combinations, and to recognize that no market lasts forever or stays the same. Innovate and act, especially when the winds are poor. We at Chessiecap Securities have participated in some innovative and even daring new combinations in the International Development industry, and we can attest to positive outcomes.

Consolidation

In corporate finance, there are many varieties of transactions that facilitate “consolidation.” Let us look at the categories of transactions that are most applicable to the International Development industry segment.

1. Sale Transaction. The most obvious and least creative consolidation strategy is to effect a Sale Transaction, where the seller gives up all of its equity in exchange for cash and/or stock from the buyer. For companies in the International Development segment and other civilian agencies, it is not clear that a Sale Transaction option will obtain an acceptable result—or any result. Why? Because of the scarcity of buyers. Supply and demand. There is no abundance of well-financed, large, and acquisitive buyers in the industry. As we have discussed, with no top line growth and constrained profit margins, the industry is not currently an inviting one to outside players or new capital.

   Are Sale Transactions impossible to achieve? No. For selling companies that have a unique market position in a USAID sector or unusually strong revenue/profitability dynamics, Chessiecap Securities believes that some Sale Transactions are possible. But even for these exceptional firms, cash prices are likely to be modest multiples of earnings. In a market where the few well-financed buyers are not compelled to purchase, then pricing suffers.

2. Merger. Mergers are a traditional transaction form in a consolidating industry and will be a likely choice in future years for International Development companies. Two or more companies come together in an exchange of stock. Sometimes, their combined size allows for a limited amount of cash to be paid to exiting shareholders or executives. Future payouts are possible, based on the continued performance of the combined companies. Mergers help companies achieve scale, diversification and limited liquidity for some stakeholders.

   The biggest hurdle for mergers is the issue of control. Rarely do we observe a “merger of equals.” In almost every merger, one set of owners or executives will be dominant, so that trust and a belief in the ultimate outcome must override personal ambitions. Curiously enough, we have observed over the years where executives of the smaller entity may become leaders of the larger one. The concerns over control are not limited to the smaller firm in the merger.

3. Recapitalization. A recapitalization can use the borrowing power of the company to provide liquidity to one or more shareholders. One form of recapitalization which Chessiecap Securities has assisted with is the tax-advantaged ESOP (Employee Stock Ownership Plan) or a related stock purchase plan.

These can provide immediate and/or future liquidity for major shareholders and employees. Today, the International Development market has a unique opportunity to provide liquidity options to shareholders through recapitalizations because commercial banks have excess capital and are currently in a lending mode for good credits. Historically, when companies are consolidating or recapitalizing, it is because the overall economy is poor and is applying pressure to every company's revenues and earnings. When the overall economy is doing poorly, banks and other sources of capital are also suffering from bad loans—and are not in an aggressive lending mode. But in today's environment, the overall economy is in a modest period of growth. Banks have capital; their portfolios are performing well; and, they are lending. The government sector, in need of bank-financed transactions, benefits from the entire economy's performance.

4. Creative Transactions. Chessiecap Securities believes that the future of the International Development industry will be one of creative transactions, where mergers will be matched with financing transactions tailored to the needs of the combining companies. What entity becomes the surviving company? What executives are retiring or leaving? How can employees benefit and gain liquidity for their interests? Larger companies may be consolidators. Private equity may facilitate combinations. Small and medium-sized industry participants can choose to merge.

Larger revenues and diversity of contracts lead to more options. Capital is the grease that smooths all transactions, and capital is attracted to predictability. Banks will only want to lend into ESOPs and companies with diversified contract portfolios and steady, predictable future cash flows. Banks do not need growth; banks need predictability for repayment of their loans. This is the premise of creative transactions such as consolidations, recapitalizations and ESOPs. You can create value and even liquidity in a no-growth cycle of the industry by controlling variability and risk. Should the industry return to growth or improve profitability, then those combinations will even accelerate in value.

The Role of Investment Banking

Principals at Chessiecap Securities have worked in the government services industry for over two decades. In recent years, we have been a key advisor to companies in the International Development industry segment. We know the players in the industry and their individual strategic directions. We understand, appreciate and support the unique humanitarian mission of companies in this industry segment. Our services include:

1. Effecting combinations. "Fit" is the complex definer of successful transactions. Both parties have to believe in the combination. Both parties have to believe that they can harness the elusory concept of "synergies." In many instances, when two experienced leaders and sets of owners exchange industry insights, this becomes the easiest of the three elements to put in place. One Chessiecap Securities expertise is our senior transaction experience and ability to bring leaders together to find shared capabilities and goals.
2. Relative valuation. In a sale of a company, the absolute valuation of the target company is by far the most critical element. One founder may be handing over the keys to her company. How much value do you place on a life's work? Value in a sale transaction gets very personal and it should be. In a consolidation transaction or a merger, value becomes relative and often complex. Relative valuation means using the same criteria to measure the value of each party, so that no one party feels taken advantage of in the combination. It is not always as simple as the big fish swallowing the smaller fish. If the larger party has several or more partners or

investors, then the smaller party can become the largest (but not majority) shareholder of the combined entity. Relative valuation is important to everyone. Again, Chessiecap Securities understands the dynamics of the industry, plus we are known for our valuation expertise. Our work is based on evidence and is designed to be transparent in order to create a bridge between two or more parties.

3. <u>Control and leadership.</u> This is often the most difficult and emotional of the three elements for success. There are transaction techniques for leaders to share responsibilities and titles, but the ultimate success for leadership comes down to maturity, humility, vision and trust. There is no quantitative answer. Trust is by far the most important ingredient. Trust begins with a conversation or a presentation, and then it builds with increased contact between companies—like creating concentric circles from the inside working outward. Two parties do not follow through with a transaction involving millions of dollars unless there is complete transparency and trust leading to a shared vision of leadership. At Chessiecap Securities, we understand this dynamic and facilitate it.

In Summary

Consolidation in an industry is a natural consequence of slowing or static growth. In the government services industry, consolidation is in full force in the Defense/Aerospace segments. Companies that supply services to civilian agencies are not immune to the factors that advocate for consolidation. The International Development industry segment experiences unique pressures involving availability, size, and profitability of contract awards. Many companies in the industry need to achieve a critical mix of size, diversity and predictability in order to stay financially viable, win contracts, and provide for liquidity. This mix can be established through creative transactions and a willingness to explore new ideas and combinations.

Mr. Schmidt has been a pioneer financier in the government services market, leading investment banking practices at the former Ferris, Baker Watts and the former Legg Mason Wood Walker (now Stifel Nicolaus). In 2003, he founded Chessiecap Securities which serves growth and technology companies throughout the Mid-Atlantic and nationwide. Mr. Schmidt has been the investment banker for scores of government services companies for over two decades. In recent years, he has had assignments for a number of International Development companies, including the sale of Management Systems International to Coffey International, the establishment of an ESOP for CARANA Corporation, and the sale of CARANA Corporation to Palladium.