



Q1 2011

MAINSTREAM MANAGEMENT'S

Sector Brief: Government Contracting

Inside this Issue

Welcome to the first quarter issue of our Sector Brief newsletter. In this issue, we feature an overview of the government contracting industry sector. As a major provider of management consulting services to the government contracting space, MainStream Management welcomes the opportunity to provide

an overview of the industry as well as our view of the major trends impacting providers of services to the industry.

Key topics covered in this issue include:

- The Top 10 Industry Trends in Government Contracting (p. 1-3)

- Recent MainStream engagements in the government contracting sector (p. 4)

We hope you find this issue informative, and we welcome your comments and suggestions for future publications.

Government Contracting: Top 10 Industry Trends

With the United States economy remaining in the doldrums and the prospect of sustained economic growth low over the near-term, the federal government continues to accelerate growth in spending. For the fiscal year ended September 2009, U.S. government spending was approximately \$540 billion on contracts to buy goods and services. This level of activity represented growth of 12% over 2008 activity according to Grant Thornton. In the late stages of 2009 and the first nine months of 2010, government contracting activity has also increased significantly.

According to the official budget of the United States Government, total cash outlays are expected to increase 15.0% from 2010 to 2011 and an additional 6.0% from 2011 to 2012. This represents an overall slowing of the growth rate in federal spending. Over the longer

term, government purchases of goods and services (excluding employee compensation), a major indicator for government contractors, are forecast to grow at an annual compounded rate of 3 percent between 2010 and 2015 according to First Research. These increases do not take into account possible additions to federal expenditures resulting from incremental stimulus currently under consideration by the Federal Reserve and Obama administration.

Approximately \$370 billion of the \$540 billion of 2009 spending, or 68.5% was for defense-related items, from about 260,000 companies, according to First Research Corporation. The industry is heavily concentrated with the 100 largest federal contractors accounting for more than 70% of contract spending. While a myriad of contracting types exist, nearly half of all federal contract

spending is on fixed-price contracts and a quarter of the money is spent on cost-reimbursement contracts. Generally, production contracts are fixed-price, while development contracts are cost-reimbursement. Research and defense-related spending are the biggest contracting sectors; services are the largest federal spending category.

Industry Trends

Uncertainty of Government Spending

The federal government as an entity does not guarantee its overall spending level. As such, the rate of growth and the application of spending is highly uncertain during recessionary times. This issue generates significant concern from government contractors relative to the uncertainty of future growth, rendering long and short-term planning extremely difficult. As an example of this uncertainty, The Washington Post

reported that defense contractors are wary of a federal plan to cut spending at the Pentagon, which includes a lower reliance on private contracts. Defense Secretary Robert Gates has been quoted as saying that he would slash thousands of jobs and reduce spending on contracts by 10 percent over three years. Concerns related to reduced tax revenues from the ongoing recessionary climate; the potential of cutbacks in defense spending relating to the Iraq and Afghanistan wars; and the ongoing debate over the national deficit, all combine to create uncertainty for government contractors.

A Time of Economic Uncertainty

Government spending is tied to tax receipts, which boomed in the mid- and late-1990s, and in the mid-2000s, as the economy expanded rapidly, but fell during the challenging economic environment of the late 2000s recession. Federal individual income tax receipts rose 47 percent from 2003 to 2007, but quickly fell back 21 percent between 2007 and 2009 as the recession deepened. Corporate income taxes, another major revenue source, dropped over 50 percent between 2008 and 2009. These statistics are provided by First Research.

Compliance, Compliance and More Compliance

Industry experts are unanimous in their view that there has been a significant increase in the complexity and depth of compliance for government contractors. Grant Thornton contends that the government has expanded requirements for compliance systems which are applicable to most government contractors. The federal Costs Accounting Standards (CAS), overseen by the Cost Accounting Standards Board (CASB), now requires contractors to operate a more detailed set of accounting books. Defense

contractors are audited by the Defense Contract Audit Agency (DCAA) while nondefense contractors are audited by other agencies. Compliance with these increased regulations is, of course, mandatory, with the increased costs placing pressure on the bottom line of already cost conscious contractors.

Sagging Profitability

While there has been much hyperbole in the popular press over profitability levels in corporate America, a survey by Grant Thornton suggested that 45% of the leading government contractors, up 8% over prior year, had either no profit or profit rates between 1-5%. Even more alarming, 85% of the companies surveyed had either no profit or profit rates ranging from 1% - 10%. That compares to 76% in the prior year. The number of surveyed companies with profit rates above 10% shrank from 24% last year to 15% this year. As evident from the above, profit rates are not only low, but they are shrinking. This is particularly true when considering the performance and financial risks inherent in government contracting along with the potential risk to corporate reputations from being unfairly targeted for public criticism.

Increased Customer Concentration

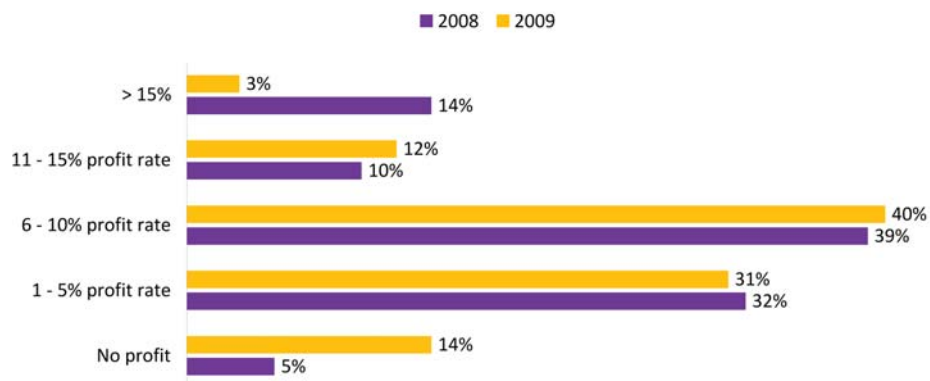
Investor and lender appetite for government contracting firms can be

negatively impacted by the fact that many government contractors rely on the federal government for virtually all of their revenue. This means that the loss of contracts or the inability to get new ones is a major threat in today's economic climate. According to Market Connections, a research firm specializing in government contractors, the success rate in pursuing new government contracts is 40 to 75 percent. Larger, more diversified firms are able to withstand the vagaries of contracts of different lengths, but the issue of customer concentration is one that continues to have a major impact on the profitability and viability of many government contracting companies.

M&A Activity on the Rebound

Studies show that changes in the profile of U.S. troops in Iraq and Afghanistan combined with a cutback in traditional weapons have sparked a wave of deal-making among defense contractors rushing to get deeper into the fast-growing world of cyber warfare. Thomson Reuters reported on October 12, 2010, that deal volumes in the global aerospace and defense industry are up 87% in 2010, from \$3.1 billion in 2009 to \$5.8 billion in 2010. BAE Systems has outwardly stated its interest in utilizing external growth to create shareholder value. Companies like ManTech International is an example of a high-end

Leading government contractors' profit rate before interest and taxes



Source: Grant Thornton: 15th Annual Government Contractor Industry Highlights Book (2010).

technical defense services firm with cyber warfare capabilities that has become more attractive to potential buyers, driven in part by the declining budgets for tanks, planes and other hardware in the United States. Buyers are looking for cyber-security companies as well as those active in command, controls and communications; intelligence, surveillance and reconnaissance.

Need for Advanced Technological Expertise

According to Melissa Hathaway, President of Hathaway Global Strategies, LLC and Senior Advisor at Harvard Kennedy School's Belfer Center, "The need for partnership between industry and government will increase over the next decade especially as our enterprises become further interconnected due to our dependence on information technology. The seams between private networks and government networks will continue to blur and it will be harder to know where one ends and the other begins." Data from First Research indicates that over the past decade, a greater percentage of spending by the Department of Defense and some other departments has been for goods and services that require high levels of technological or scientific expertise. As government programs have also become more technologically demanding, contractors have increasingly joined forces to bid on contracts, or have used a larger number of subcontractors with special expertise.

Changing Nature of Government Contracting

In an effort to increase the number of small businesses that participate in government contract work and also to reduce expenses, the Obama administration recently implemented a series of new initiatives that impact government contracting. New rules

were recently initiated to increase competition for new government contracts, in an obvious effort to allow competitive bidding to reduce costs. A second initiative – something that the government calls "insourcing" – would result in less work for external government contractors. According to First Research, insourcing received a major boost when the Obama administration declared it part of a new suite of priorities for reining in government contractor spending. These initiatives collectively shift the playing field for external government contracting firms. "Industry continues to face a move toward fixed price development contracts, long procurement cycles, and insourcing," according to Linda Mills, Corporate Vice President and President, Northrop Grumman Information Systems.

Growth of Homeland Security

The Obama administration has allocated a majority of the Department of Defense Homeland security budget to security, enforcement and investigations mission area, according to Frost & Sullivan. The overall budget grew in 2010 by 6.2%

from 2009 as the country continues to act on the both the real and perceived threat of terrorism. In addition to core Homeland Security spending, the federal Department of Homeland Security is spending large amounts of money to integrate the many agencies that are now part of the agency. According to First Research, defense industry analysts expect homeland security funds to reach companies beyond the traditional, well-known military defense contractors.

Demand for Highly Skilled Sub-Contractors

The demand for highly skilled sub-contractors with the necessary security clearances has increased dramatically over the past five years. With the increased focus on advanced technological expertise as a requirement for government work, a skill set not always found in the government, outside contractors face increased needs to find highly skilled direct or indirect employees to meet the complex demands of governmental agencies.

Budget for the Department of Homeland Security

Total Budget Authority, by Organization	FY 2009 Revised Enacted	FY 2010 Revised Enacted	FY 2011 President's Budget
<i>In Millions of Dollars</i>			
Departmental Operations	\$ 659.1	\$ 802.9	\$ 1,270.8
Analysis and Operations	\$ 327.4	\$ 335.0	\$ 347.9
Office of the Inspector General	\$ 114.5	\$ 113.9	\$ 129.8
U.S. Customs & Border Protection	\$ 11,250.7	\$ 11,449.3	\$ 11,180.0
U.S. Immigration & Customs Enforcement	\$ 5,968.0	\$ 5,741.8	\$ 5,835.2
Transportation Security Administration	\$ 6,992.8	\$ 7,656.1	\$ 8,164.8
U.S. Coast Guard	\$ 9,624.2	\$ 10,123.0	\$ 10,078.3
U.S. Secret Service	\$ 1,640.4	\$ 1,702.6	\$ 1,811.6
National Protection and Programs Directorate	\$ 1,188.3	\$ 2,432.8	\$ 2,361.7
Office of Health Affairs	\$ 157.6	\$ 139.3	\$ 212.7
Federal Emergency Management Agency	\$ 5,971.2	\$ 6,194.3	\$ 6,527.4
FEMA Grant Program	\$ 4,220.9	\$ 4,165.2	\$ 4,000.6
U.S. Citizenship & Immigration Services	\$ 2,876.3	\$ 2,860.0	\$ 2,812.4
Federal Law Enforcement Training Center	\$ 333.0	\$ 282.8	\$ 278.4
Science and Technology Directorate	\$ 932.6	\$ 1,006.5	\$ 1,018.3
Domestic Nuclear Detection Office	\$ 514.2	\$ 383.0	\$ 305.8
Total Budget Authority	\$ 52,771.2	\$ 55,388.5	\$ 56,335.7

Source: U.S. Dept of Homeland Security Budget FY 2011 (2010).

Government Contracting is Our Specialty

MainStream's Government Contracting group has completed a number of engagements in the government contracting space. Using our extensive knowledge of the industry's value drives, growth opportunities, and challenges, along with our deep experience of working the agencies and organizations within the public sector, we create value and drive superior results for our clients.



Industry: Aviation
Size: \$16.8 billion

MainStream provided performance improvement and conducted a technical assessment of operations for this private equity owned engine component manufacturer. Results included increasing productivity by 33% and decreasing raw material costs by 25%. Annual savings totaled \$5 million.



Industry: Heavy
Manufacturing
Size: \$1.5 billion

MainStream provided advisory services, working with the company to create a long-term armor vehicle manufacturing strategy, supervising new plant construction, and initiating an overhaul of the supply chain. Client exceeded expectations of aggressive manufacturing time frame to produce over 1,000 MRAP vehicles for the DoD.



Industry: Electronics
& High Tech
Size: \$100 million

MainStream provided performance improvement services to ensure timely delivery of critical components the client was producing on a DoD DPAS contract. Defect rates of 14% were being experienced by client. Results included reducing the defective rate by 12% to a 2% defective rate and increasing productivity by 20%.



Industry: Aerospace
Size: \$40 million

MainStream provided performance improvement services for this aerospace component manufacturer. Results included streamlining the company's supply chain and creating multi-million dollar expense reductions, in part through outsourcing of key production overseas.



Industry: Aviation
Size: \$65 million

MainStream provided advisory services by conducting a technical assessment and financial analysis of this structural airframe component manufacturer. Performance improvement initiatives resulted in reducing changeover time by 50%, increasing through-put of 20%, and multi-million expense reduction.

About MainStream

MainStream Management is a professional services firm that specializes in management consulting for privately held and publicly traded middle market companies. Our team of senior executives, management consultants, and operating technicians offer knowledge, maturity, and judgement that has provided unparalleled results for our clients.

Having worked in multiple industries involving a broad set of strategic, operational, and financial challenges, MainStream has worked for some of the most respected individuals, private equity firms, lenders, and public sector organizations in the world. The majority of our work is with middle market companies, however, our engagements range from consulting start-up companies to advising on the reorganization of the U.S. Navy and Air Force's nuclear weapons programs.

Since founded, MainStream has successfully completed engagements in 18 countries across four continents. We have deep experience in the government contracting, defense, consumer products, manufacturing, and food & beverage industries. For over ten years, MainStream has worked with companies in the government contracting space, including organizations owned by private equity firms and institutional lenders which have provided debt support to government contractors.

Defense Contracting group contacts:

Jim Burritt, Managing Director
877.785.6888 ext: 2117
jim.burritt@mainstreamllc.com

Jim Still, Managing Director
877.785.6888 ext: 2118
jim.still@mainstreamllc.com