

## New Government Contractor PPA Work Requires Careful Customer-List and Backlog Analysis

By Nathan E. DiNatale, CPA/ABV, CVA

The government contracting sector continues to be a major source of merger and acquisition activity despite the unsettled nature of the economy. General Dynamics and Lockheed Martin, two of the largest companies in the industry, have maintained their acquisition activity and expanded their diversification into the healthcare IT sector with recent deals such as Vangent Holding Corp. and QTC Holdings Inc., respectively. With middle-market companies looking to secure market share and offset some of the bleak government long-term growth prospects, there is likely to be increased activity in this area for them as well. In light of this increase in government contractor M&A, it is useful to revisit the points involved in valuing a contract backlog or customer list in connection with a purchase price allocation for a government contractor.

**Valuing contract backlog.** The contract backlog and customer list are two distinct intangible assets that must be valued by the acquirer. Contract backlog represents future revenue on signed contracts that have yet to be completed. This uncompleted backlog is probably the easiest revenue stream to project since most contracts run for a set period of years and are negotiated at the start of the contract. Obviously there are unique provisions in many contracts, such as cancellation clauses and auto-renewals. Accordingly, the acquirer must have a good grasp of each contract in backlog.

The following factors should be considered in projecting the revenue under existing contracts: expiration of the contract vehicle, level of the funding

ceiling, potential award protests, and termination for convenience. The calculated present value of the contract backlog normally represents a very small portion of the purchase price since it represents only those contracts already “in the door.”

**Valuing the customer list.** The customer list intangible represents the acquirer's best estimate of the continuation and growth of those contracts based on the customer relationship; it is normally a much larger portion of the purchase price. Follow-on contracts should be projected based on the company's historical contract win percentage. For example, if the company historically receives contract renewals approximately 70% of the time, the first contract renewal projection should contain 70% of the original contract value plus some factor for growth of the original contract ( $\$100 \times 1.03 \times 70\% = \$72$ ). The second follow-on of this contract should be at 70% of the first follow-on contract plus some factor for growth ( $\$72 \times 1.03 \times 70\% = \$52$ ). This process is repeated until the point where the contract is no longer relevant to the value calculation. This is just one method to project follow-on revenue. Lastly, management's experience and assumptions used in acquiring the company should also be used to project the follow-on revenue.

**Projecting follow-on revenue.** Here are some factors to consider in projecting the follow-on revenue: customer's obligation to change service providers after a certain number of contracts; loss of contracts due to acquisition of the business; known changes in government spending; volatility of re-compete wins; and classification of re-compete as sub or prime contractor.

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When valuing customer intangibles, the acquirer should be cognizant of the following:

- Both the contract backlog and customer list are typically valued using an income approach under a multi-period excess earnings method. Under the income approach, the cash flows of the acquired company should be adjusted to remove any selling costs previously incurred to obtain the contracts because these are additional costs not required to maintain the current acquired contracts. The removal of these expenses will increase the overall EBIT margin and should have been considered during the due diligence process.
- The discount rate used to value the customer intangibles should be commensurate with the level of risk associated with maintaining the customer. This rate varies from the weighted average cost of capital to a few basis points above WACC to account for additional risk inherent in customer relationships.
- A tax amortization benefit (TAB) should be calculated to recognize the additional value of the asset as a result of the acquirer's ability to deduct the amortization of the asset over its 15-year tax life. This element of the intangible asset is included regardless of how the transaction is structured. Cheryl K. Tjon-Hing, a valuation specialist at the Office of the Chief Accountant, U.S Securities and Exchange Commission, made this comment in 2006:

TABs should be taken into account in determining asset fair values, no matter what the tax attributes of a transaction are. But for those requiring more specific guidance, FAS 109, paragraph A129, implicitly states that TABs should be factored into an asset's fair value. To the extent that a portion of the step-up value is not deductible for tax purposes, that is what deferred tax liabilities are for.

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- Review the reasonableness of the overall WACC used in the calculation. The internal rate of return of the transaction, calculated by using the projected cash flows and the actual purchase price, should approximate the WACC used in the analysis. If the overall WACC and IRR do not match, then there is a good chance that the cash flows do not accurately reflect market participant assumptions. The cash flows, EBIT margins, and projections should reflect the assumptions used to determine the purchase price of the acquired company.

Step back from the calculation once it is complete. Analyze each and every assumption, including the overall WACC, the projected EBIT margins, the term of the contract renewals, the historical renewal rate, and the inclusion of the TAB. In addition, the final values should appear reasonable to a market participant.

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