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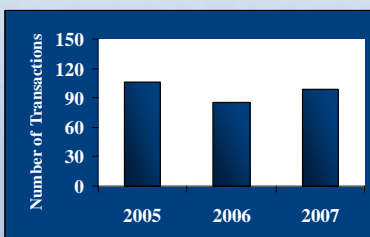
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### Deals Closed Government Services



Source: CapitalIQ & NCC Research

## M&A TRENDS IN GOVERNMENT SERVICES

### Another Strong Year of M&A

#### *M&A Activity returns after slight decrease in 2006*

With almost 100 transactions completed, 2007 was another year of strong M&A activity in the government services marketplace. While there were no \$2+ billion “blockbuster deals” to rival the 2006 General Dynamics acquisition of Anteon or the 2005 L-3 acquisition of Titan, five transactions with consideration greater than \$500 million were completed during the year.

Top 2007 Transactions			
Buyer	Target	Value (\$mm)	Date
ITT Corporation	EDO Corporation	1,571.5	12/20/07
Providence Equity Partners	U.S. Investigative Services, Inc.	1,500.0	08/31/07
Textron, Inc	United Industrial Corporation	991.8	12/18/07
Veritas Capital	Pearson Government Solutions	600.0	02/15/07
Northrop Grumman Corp	Essex Corporation	555.4	01/25/07

As in previous years, 2007 transactions continued to exhibit strong demand for mid-sized government services companies (revenues \$100-\$500 million). A number of well known names in the middle market, including Multimax, Dimensions International, SRS, QSS, Analex, ATS, Pearson, Athena, and Constella, were acquired. Ongoing industry wide consolidation continues to drive buyer demand for critical mass, resulting in premium pricing for mid-sized firms.

Buyer	Target	Value (\$mm)	Date
Veritas Capital	Pearson Government Solutions, Inc.	585.0	02/15/07
Harris Corp.	Multimax, Inc.	400.0	06/15/07
Honeywell International Inc.	Dimensions International, Inc.	230.0	07/03/07
Perot Systems Corp.	QSS Group, Inc.	212.5	01/30/07
CACI International Inc.	Athena Innovative Solutions, Inc.	200.0	10/31/07
ManTech International Corp.	SRS Technologies Inc.	195.0	05/07/07
QinetiQ Group plc	Analex Corp.	186.2	03/13/07
SRA International Inc.	Constella Group, LLC	157.3	08/09/07
Federal Services Acquisition Corp.	Advanced Technology Systems, Inc.	124.4	01/16/07

A new trend seen in 2007 was increased buyer interest in civilian agency contractors such as Constella and Z-Tech. With more attention being focused on environmental and healthcare issues, as well as the upcoming elections, Tier I & II contractors are increasingly looking at opportunities to diversify their customer base and stake out positions in areas with potential for new budget initiatives.

While 2007 was another year of robust M&A activity, turmoil in the financial markets and structural changes impacting government services companies highlight a growing differential in buyer interest for specific market sectors. The following is a discussion of some of the issues which could have a major impact on M&A activity in 2008.

## Government Services By Tier

### Tier I

Company	Ticker
Boeing Co.	NYSE:BA
General Dynamics Corp.	NYSE:GD
L-3 Communications Holdings Inc.	NYSE:LLL
Lockheed Martin Corporation	NYSE:LMT
Northrop Grumman Corp.	NYSE:NOC
Raytheon Co.	NYSE:RTN

### Tier II

Company	Ticker
Alliant Techsystems Inc.	NYSE: ATK
CACI International Inc.	NYSE: CAI
Cubic Corp.	AMEX: CUB
DRS Technologies Inc.	NYSE: DRS
ManTech International Corp.	NasdaqNM: MANT
MAXIMUS Inc.	NYSE: MMS
Perot Systems Corp.	NYSE: PER
SAIC, Inc.	NYSE: SAI
SRA International Inc.	NYSE: SRX
Stanley, Inc.	NYSE: SXE

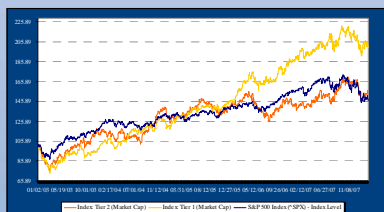
### Middle Market

Company	Ticker
ICF International Inc.	NasdaqNM: ICFI
MTC Technologies, Inc.	NasdaqNM: MTCT
NCI Inc	NasdaqNM: NCIT
SI International, Inc.	NasdaqNM: SINT
United Industries Co. KSC	KWSE:UIC
VSE Corp.	NasdaqNM: VSEC

### Small-Cap

Company	Ticker
Allied Defense Group Inc.	AMEX: ADG
GTSI Corp.	NasdaqNM: GTSI
Halifax Corporation of Virginia	AMEX: HX
TVI Corp.	NasdaqSC: TVIN

## Tier I & II 5-Year Contractor Stock Prices



## BUYERS IN GOVERNMENT SERVICES MARKET

### Large Buyer Pool

*There continues to be a large pool of buyers in today's M&A marketplace*

At all levels, buyer demand remains strong with a wide array of acquirers actively seeking transactions. Tier I & II companies continue to aggressively execute acquisition programs to supplement organic growth. Examples include CACI, Lockheed Martin, ManTech, and L-3, all completing multiple transactions in 2007. Other historically active acquirers including General Dynamics, Northrop Grumman, Perot, and SRA, also completed transactions during the year.

While Tier I & II companies primarily focus on larger mid-market targets, smaller strategic acquirers continue to create an active M&A market for small-cap companies (revenues below \$50 million). Demand for small-cap targets possessing unique skill sets, high-level clearances, and current contracts/experience in the intelligence, homeland security, and/or DOD sectors remains high. Non Tier I & II strategic acquirers continue to seek transactions which will expand customer relationships and diversify capabilities to build critical mass and improve their ability to compete for and win large, unrestricted contracting opportunities.

An increasingly diverse group of investors seeking to enter into and/or expand their commitment to the government services arena, including Private Equity (PE), Special Purpose Acquisition Corporations (SPACs), and foreign buyers, were also active acquirers of government services companies in 2007.

Long time PE investor Carlyle Group completed a significant transaction (ARINC) in 2007, while newer entrants including DC Capital Partners, Laguna Ventures, Lake Capital, Leonard Green & Partners, Roark Capital, and White Oak Group also completed transactions. U.S. based Private Equity firms raised over \$300 billion in new capital during 2007 and with additional capital to invest in this market segment, PE will continue to play an important role in the M&A marketplace in 2008.

While foreign interest has historically been concentrated around a handful of large buyers, 2007 saw M&A activity expand to include new acquirers such as Detica and Global Strategies Group. With the weakness of the U.S. capital markets, foreign buyers have significant financial advantages over their U.S. counterparts and are likely to remain active investors in the government services M&A market.

The acquisition of ATS by Federal Services Acquisition Corp. in January 2007 marked one of the larger transactions completed to date by a SPAC in this market. SPACs, or "blank check" funds, have raised significant levels of funding through public offerings in the last two years to invest in the government services sector. With a relatively short fuse (18-24 months) for deployment of funds, SPACs are expected to continue aggressively pursuing quality government services acquisition targets.

As seen in 2007, the pool of buyers is increasingly diverse and demand for quality government services targets remains strong. It is expected that the presence of non-traditional buyers in this market will continue to expand while traditional buyer activity may slightly decrease due to a lack of attractive targets.

### Election Impact

*Will current level of DOD funding be sustained?*

Since 9/11, demand for government services companies with significant customer relationships in the intelligence, homeland security, and DOD communities has been very strong. This was true again in 2007 with numerous transactions involving companies in these sectors, many with revenues in the \$15-\$50 million range.

The purchase of McDonald-Bradley by ManTech is a good example of the premium that mid-sized targets in the DOD/Intel world can command. On the smaller end of the scale, Paradigm Holdings' acquisition of Caldwell Technology Solutions, which had revenues in the \$5 million range, demonstrates that there is strong demand for smaller targets in this segment.

The upcoming election raises the specter of new budget priorities and, in particular, whether the current level of DOD funding will be sustained. After the last mid-term elections, the general wisdom was that the change in control of the Congress would translate into a significant reallocation of budget priorities. Generally speaking, this has not happened as commitments to the Iraq campaign, and the War on Terror in particular, remain important national priorities. The general sentiment seems to be that, in the near term, there will not be any significant shifts in emphasis on programs of vital national importance.

Although investors have concerns with budgets, growth, and profitability issues, the overall industry fundamentals remain sound and interest in government services remains strong. While investor interest is increasing for civilian-agency focused contractors, targets operating in the DOD, Intel, and Homeland Security segments are expected to remain in high demand and continue to command premium valuations.

### Government Services Stock

Defense contractors have experienced consistent stock appreciation over the last five years. Meanwhile, services contractors experienced volatility between 2003 and mid-2006 consistent with the rapid growth and expansion of outsourced professional services in the government during that time. Since mid-2006, government services/IT firms have returned to normal levels, more closely following the S&P 500, while defense contractors continue to experience steady growth and command a substantial premium over government services/IT contractors.

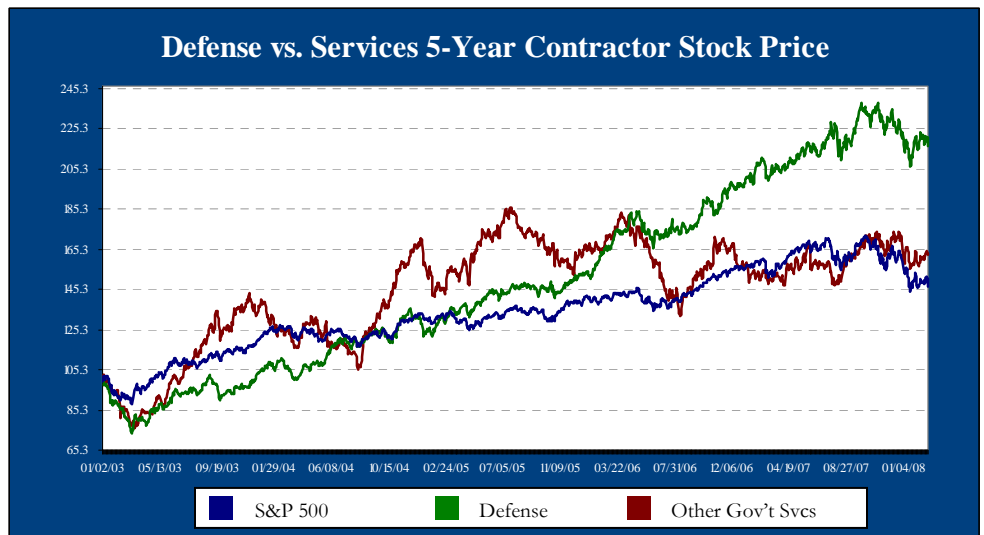
### Turmoil in the Financial Markets

*What does this mean for M&A?*

While the capital markets are experiencing significant turmoil and distress, government contractors continue to have reasonably good access to funding for operational requirements and, to a lesser degree, for M&A transactions. With strong overall industry fundamentals and historically outstanding credit experience, regional and local banks continue to provide a large portion of the operational funding requirements for government services companies. These same fundamentals are also attracting a larger group of mezzanine and equity financing sources for M&A.

M&A financing is still readily available though loan pricing is firming and loan terms are becoming more demanding, raising the cost of capital for acquisitions. The structure of M&A transaction funding has undergone noticeable changes with senior lenders returning to more traditional asset-based lending, with a much reduced appetite in extending unsecured or "air ball" financing. Increasingly, mezzanine lenders are becoming the primary source of cash flow financing for M&A. At all levels, the lenders "risk premium" on these transactions is resulting in higher financing costs, although recent declines in the prime interest rate may slightly offset these higher costs.

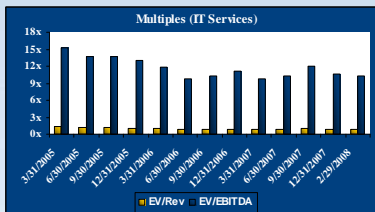
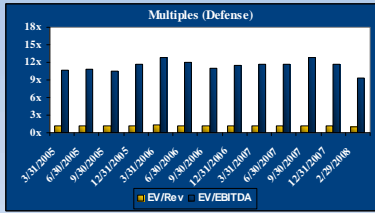
In addition to pricing issues, lenders are also demanding more stringent terms for loans although not yet at a level seen as overly restrictive. Shorter repayment terms for unsecured borrowings, reductions in senior debt levels before allowing any repayment of seller financing, and overall structure and lender liquidation preference are a few issues where lenders are taking a more conservative approach. Nevertheless, financing for the acquisition of government services companies remains available and should not be a deterrent to completing transactions.



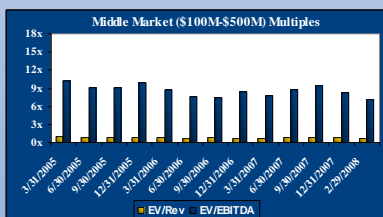
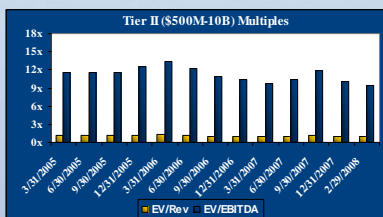
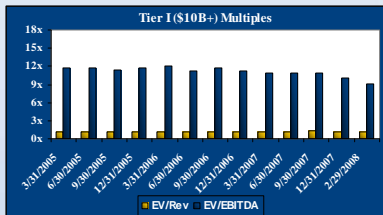
**Valuations Take a Hit**

*The aftermath of the 2007 market correction*

**BY SECTOR**



**BY TIER**



Over the last three years, valuation multiples for public defense contractors have remained relatively stable. Until early 2008, average multiples have consistently ranged between 10-13x EBITDA. Overall, stock prices have declined since late 2007 driving down the average multiple for defense contractors to approximately 9.3x EBITDA as of the end of February. However, even after factoring in the recent correction in prices, defense contractor valuations remain at historically attractive levels and are expected to continue outperforming valuations for other government contracting sectors.

Valuation multiples of publicly held non-defense government services companies have been on a downward trend since 2005. This decline is particularly evident for middle market companies with the pace accelerating since the fourth quarter of 2007. While some of the recent decline can be attributed to the broader stock market sell off, concerns surrounding government industry fundamentals including slower revenue growth, pressure on profit margins, budget and funding delays, and the impact of upcoming elections, present investors with a greater degree of uncertainty. Government services companies that have not yet reached the critical mass of many of their defense contractor counterparts are more susceptible to these concerns which is reflected in significant declines for many publicly held non-defense government services companies since 2005.

Given the illiquidity of privately held companies relative to their public counterparts, the discount between private and comparable public multiples has traditionally been in the 20-50% range. Restricted revenues from the 8(a) set aside program have always been highly discounted due to restrictions on a buyer's ability to continue performing under these contracts. More recently, new restrictions on a buyer's ability to assume small business contracts have significantly increased the discount factor applied to these targets. The divergence in valuations between targets with barriers to entry such as: size, high-end clearances, specialty work/services, long term contract vehicles, robust opportunity pipelines, and a sound management team, and targets without such barriers has become more pronounced and volatile.

Whether public or private, size plays an integral role when it comes to valuation. As shown on the left, not only are the valuations of non-Tier I companies more volatile, but they are also discounted anywhere from 15-30% for middle market companies and up to 65% for small cap companies (below \$100M). As a general rule, the larger the company, the greater the ability to compete for contracts and win unrestricted contracting opportunities, reducing investor uncertainty.

Transaction volume for smaller privately held companies slowed in 2007, providing fewer data points to draw conclusions on pricing. While some of this slowdown may be attributable to seller unwillingness to accept lower prices, the changes in small business regulations, which became effective in July 2007, are having a major impact on pricing, structure, and transaction volume at the small-cap level.

It is not clear whether the full impact of the recent correction in the public markets has yet been absorbed into pricing for privately held companies. As we enter 2008, the full extent of the 2007 correction in the public markets will be factored into pricing for privately held companies. Small targets or those with relatively large amounts of revenue generated from small business set aside contracts will likely experience greater price declines than the overall market.

### **What's going on with Small Business?**

#### ***Have the new regulations had any impact on M&A?***

The short answer is YES! (for now anyway). The big story in M&A for smaller government services companies is the additional uncertainty introduced by changes made to the small business regulations in November 2006, effective July 2007. These changes have had a chilling impact on transactions involving smaller targets as the ability for an acquirer to continue performing under a target's small business contract(s) post-acquisition is now less certain.

For some time, large public companies, Tier I & II companies in particular, were active acquirers of smaller, privately held companies. Many of the acquired companies had significant small business contract revenues. With regulations favorable to an acquirer's ability to fulfill the remaining term on existing small business contracts, giving the acquirer sufficient time to develop new business with the customers, large companies were actively acquiring a broad array of smaller targets offering operations, maintenance, and program management services across a wide customer base. Since the new regulations were implemented, however, there has been a dramatic decline in the interest level of large buyers for small companies with substantial revenues tied to small business contracts.

In addition to valuations for smaller targets taking a hit as they continue to absorb the impact of market conditions, transaction structure and process at this level are also undergoing dramatic changes. While buyer demand remains strong, acquirer candidates are increasingly smaller strategic industry participants, newly formed small and mid-sized private equity funds, and management groups looking to re-enter the market. In a recent transaction where National Capital represented a seller with the small business profile, we received offers from multiple qualified buyers, the majority of which were received from buyers with the above mentioned characteristics.

Another significant trend involves transactions largely being structured with less cash at closing and larger amounts of seller financing and earn out provisions. Though sellers can still receive a significant amount of cash at closing, this is a major change from recent market experience where virtually all transactions included a large percentage of the purchase price in cash and little, if any, conditional compensation.

As sellers extend increasing amounts of transaction financing, greater attention is being focused on the buyer's financial capability to meet all terms of the sale as well as operational plans post-acquisition. Increased due diligence demands are

also requiring sellers to involve more levels of their organization at earlier stages of the M&A process, always a concern for privately held companies.

Buyers and sellers are also approaching transactions involving small business revenue in an evermore deliberate and cautious manner. Buyers are conducting more due diligence earlier in the process to insure that customer and contractual relationships will be retained. Thorough business and legal examinations of contracts and customer relationships including on-site visits are also being addressed in the earlier stages of conversations, in some cases even before a letter of intent is signed.

Since becoming effective, the new small business regulations have had a chilling impact on the pricing, structure, time to complete, and volume of transactions at the small business level. Until more experience is gained with the actual implementation of these new regulations, valuations for businesses with a large amount of small business awards will continue to be volatile. In the near term, valuations for these targets will be under significant pricing pressure and, most likely, experience greater price declines than the overall market for public defense and other government services contractors.

On the contrary, the demand for targets of all sizes with large portions of full and open business remains strong and targets with these characteristics continue to command attractive valuations.

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### **Don't Miss Out!**

#### ***Capital Gains rates to end in 2010***

For privately held companies in particular, the tax aspects of a transaction can be significant. For some time sellers have enjoyed historically attractive capital gains rates. With these rates scheduled to end in 2010 and a new administration expected in 2009, the general feeling is that capital gains rates will increase.

For sellers considering an exit over the next few years, the decision of when to go to market can be complicated. Although valuations are down from recent highs, they remain at historically attractive levels. Current market conditions impacting financing and due diligence can result in longer transaction cycles. While it may seem premature, it is not too early for sellers hoping to take advantage of current capital gains rates to begin planning their exit now.



National Capital Companies, LLC provides specialized M&A advisory services to both buy and sell side firms in the government services industry.

Members of our firm have deep domain knowledge and extensive experience advising government services firms with revenues of \$10-100 million.

Together with our advisory board, National Capital has developed an extensive network of relationships with corporate, strategic, and private equity participants in the government sector. For over 20 years, our structured approach and disciplined focus have resulted in superior results for our clients.

We would welcome the opportunity to assist you in assessing current market conditions and the options available to your company. For a consultation please contact a National Capital team member:

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## M&A Exit Less Attractive

### *What other options are available?*

For most government services companies, the robust M&A market over the past 7-8 years has presented an attractive exit strategy. Given current market conditions, however, this may not be the case for smaller targets, particularly those with a large amount of revenues from small business contracts. As a result, there has been increased interest in leveraged recapitalizations (recap) and employee stock ownership plans (ESOP) as a way to achieve partial liquidity and formalize an orderly though longer term exit strategy.

Both a recap and ESOP entail the company taking on a substantial amount of debt to make cash distributions to its shareholders. While the fundamental business aspects of these transactions are very similar, ESOPs must follow a very strict set of legal, tax, and other rules and regulations. In contrast, the terms of a leveraged recap are essentially dictated by the lender and usually involve substantially lower legal and other professional fees.

Both of these alternative strategies require extreme care to ensure that the leverage being assumed can be comfortably serviced and will not negatively impact a company's current or future operational and financial viability. For government contractors operating in a cost reimbursable environment, the impact of substantial interest costs from either of these transactions on the company's cost structure could be dramatic and should be thoroughly examined.

In addition, tax efficient treatment of shareholder distributions can have a substantial impact on the financial aspects of either transaction. ESOPs in particular offer shareholders some extremely attractive tax deferral opportunities. The degree of control and level of personal financial commitment shareholders are willing to assume are other considerations which need to be examined.

Designing mechanisms which create and communicate consistent appreciation and access to liquidity without a complete sale of the company can be challenging for a government contractor considering an ESOP transaction. In addition, while these transactions offer shareholders some attractive near term benefits, they do not address the fundamental challenge for smaller targets of how to build value when confronted with current market conditions.

## A Look Forward

### *What is the 2008 M&A Outlook?*

As we enter 2008, strong industry fundamentals, a large and diverse pool of buyers, the availability of relatively low cost investment capital, and historically attractive valuations should translate into a continued strong M&A market for government services companies.

Targets with critical mass, a high concentration of unrestricted contract vehicles, and a strong customer base in the intelligence, homeland security, and other sectors of vital national importance will continue to command attractive valuations. Targets with civilian agency customers may also be in greater demand than in the past, but are not expected to command the premium prices associated with defense contractors. The M&A outlook for small-cap targets is not as clear, particularly due to changes in small business regulations. 2008 will prove to be a challenging environment for the majority of small-cap companies.