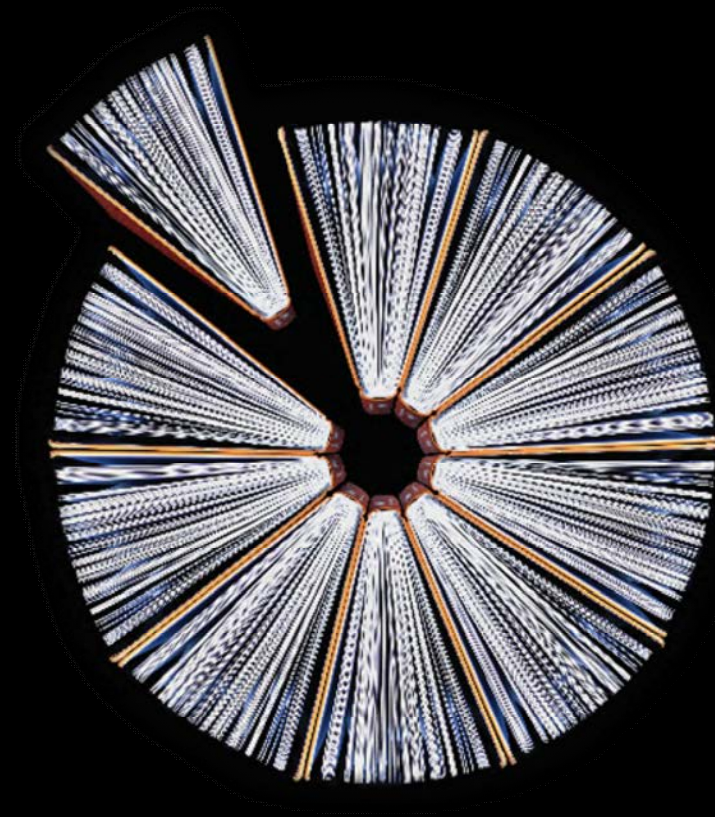


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M&A What You Don't Know

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Host: Mark Burroughs, Managing Director, Deloitte & Touche LLP

Guest Speakers: Paul Debolt, Partner, and Jessica Braun, Associate, Venable LLP; and Gary McDonald, Government Contracts Specialist Leader, Deloitte & Touche LLP

Preface

Welcome to Deloitte's Trending Now, a webcast series on government contracting hot topics.

Mark your calendars: We will hold webinars the second Tuesday of each month at noon.

Feedback: If you have comments, questions, or ideas for hot topics, please feel free to send to Mark Burroughs at mburroughs@deloitte.com.

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Speaking with you today



Paul Debolt
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Paul assists companies and individuals on issues that arise from conducting business with the federal government. He is experienced in the competitive source selection process, defending or prosecuting bid protests, issuing advice concerning compliance with government regulations and laws during the performance of a contract, and helping to resolve disputes and claims during contract performance or as a result of contract termination. He counsels clients on the Service Contract Act, the civil False Claims Act, joint ventures and teaming agreements, prime-subcontractor disputes, internal investigations, mandatory disclosures and data rights issues.



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Jessica is an associate in Venable's Corporate Group. She represents public and private clients in significant transactional matters such as mergers and acquisitions and financing transactions, with a special focus on clients in the government services, defense, technology, and health sciences industries.

She also advises clients on corporate formation and structuring, private placements, and other routine corporate matters.

Speaking with you today



Gary McDonald
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Gary is a specialist leader with Deloitte & Touche LLP and provides advisory services to government contractors in managing their business and contract compliance risks in the Aerospace and Defense (A&D) and other industries. Gary assists entities in complying with federal acquisition regulations and establishing or enhancing government contracting capabilities. Gary specializes in conducting acquisition due diligence analysis of the financial and other risks associated with government contracting entities and providing strategic advice in merger and acquisition (M&A) purchase agreements and has participated in many significant transactions over the last several years. Gary also conducts forensic evaluations to establish fact patterns and quantification of cost or pricing impacts in support of contract request for equitable adjustment, claims, and disputes.



Mark Burroughs
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Mark Burroughs is a managing director with Deloitte & Touche LLP in the McLean, Virginia office. Mark has over 20 years of experience in providing auditing and consulting services to government contractors and has helped companies understand and develop practical solutions when dealing with matters associated with Defense Contract Audit Agency (DCAA) audits, the Federal Acquisition Regulation (FAR) and the Cost Accounting Standards (CAS). Prior to joining Deloitte, Mark was a Senior Auditor at the DCAA and holds a MBA from Loyola College.

Mark is a CPA in the states of Maryland and Virginia and a member of the American Institute of Certified Public Accountants. Mark is also active in the Professional Services Council (PSC) and the National Defense Industry Association (NDIA).

Agenda

- The marketplace
- Deal structure
- Due diligence
- Integration

Observations regarding the current M&A market

- According to Deloitte's 2016 M&A year-end Trends report, October 2016 was the busiest month ever for domestic M&A. In 2017, M&A activity is poised to accelerate
- 2017 forecast:
 - Industry convergence is a theme—many acquirers are looking to consolidate with technology companies
 - The acquisition of technology assets will continue to grow in importance
 - Anticipate more deals involving targets operating principally in foreign markets
 - Divestitures are to be expected to be a major focus
 - Effective integration planning is an essential component of ensuring that deals work

Polling question #1

What is your prediction/observation of M&A activity in the upcoming year or two:

- A. Agree with study - Increasing
- B. Decreasing
- C. Still waiting for things to settle down
- D. No change

Structural considerations: Deal structure

- Deal structure:
 - Asset purchases (FAR § 42.1204(a)) constitute a “transfer” that requires novation
 - Stock purchases do not require novation (FAR § 42.1204(b))
 - Mergers are a gray area
- Traditional drivers
- Anti-Assignment Act

Structural considerations: Payment of purchase price

- Earnouts and contingent payments are common ways to capture pipeline value and account for key contingencies
- In addition to earnouts based on achievement of revenue and/or profit targets, contingent payments based on one or more of the following are common:
 - Significant awards, including recompetes of existing work
 - Option exercises under key contracts
 - Novation, if applicable

Foreign buyer concerns

Classified information:

- Contractors can lose clearance and ability to perform under contracts if acquisition is by a non-US company or a company with foreign ownership, control, or interest (FOCI)
- Contractors should implement a mitigation strategy and corporate control measures:
 - Export control licenses
- Regulations:
 - Export Administration Regulations (EAR) (15 C.F.R. §§ 730-774)
 - International Traffic in Arms Regulations (ITAR) (22 C.F.R. §§ 120-130)
- Prohibit the transfer of technical data to a foreign person within the US (*i.e.*, not a lawful permanent resident or LPR). *See* 22 C.F.R. § 120.16
- Foreign owners: must seek a license from the Agency to permit access for foreign persons to export-controlled data, or implement firewalls and other screens to prevent access

Foreign buyer concerns, continued

National security

- The Committee on Foreign Investment in the United States (CFIUS) reviews transactions that can result in the control of a US business by a foreign person to determine the effect of the transaction on national security (Executive Order 11858, as amended; 31 C.F.R. Part 800)
- CFIUS review is a voluntary process, but is effectively mandated for acquisitions involving:
 - Security clearances (31 C.F.R. § 800.402(c)(3)(iii));
 - Certain EAR/ITAR-controlled exports (31 C.F.R. § 800.402(c)(4)); and
 - Significant defense, national security, or homeland security contracts (31 C.F.R. § 800.402(c)(3)(iv))

Due diligence: FOCI

- Administered by the Department of Defense Security Service (DSS):
 - Facility security clearances are handled by DSS
 - Notify DSS of discussions that may lead to foreign ownership
- Financing/debts must be disclosed
- Private equity firms: usually have some foreign limited partner investors; must proactively disclose that information, pre-closing
- Actions to mitigate (e.g., board resolutions regarding exclusion) are often necessary and should be put into effect on the closing date

Due diligence: Organizational Conflict of Interest (OCI) (FAR Subpart 9.5)

- Three types:
 - “Biased ground rules” OCI: The contractor is unable to render impartial assistance or advice to the government (FAR § 9.505-2);
 - “Impaired objectivity” OCI: The contractor’s objectivity in performing evaluative work is impaired (FAR § 9.505-3); and
 - “Unequal access to information” OCI: The contractor obtains unfair competitive advantage from non-public information (FAR § 9.505-4)
- A contractor and its affiliates are treated as a single entity for purposes of analyzing biased ground rules and impaired objectivity OCIs
 - Acquiring a government contractor can, therefore, create an OCI even if the target will remain a separate legal entity
- Private equity firms may have conflicts between portfolio companies

OCI, continued

- Identification:
 - A deep dive of the target's contractual relationships and statements of work should be done by individuals with a solid grasp of the buyer's government contracts, if any
- Mitigation (?)

Polling question #2

What do you see as biggest struggle when considering a deal:

- A. Concerns with novation/deal structure
- B. OCI concerns
- C. We're a global company – FOCI
- D. Everything

Due diligence

- Risks with business/ownership of the target or the buyer
- Accounting and financial risks
- Risks associated with applicable legal requirements

Government contracts due diligence

Government contracts compliance due diligence frequently focuses on risk such as:

- Open year audit impact on completed contracts
- Accuracy and legitimacy of past small business status assertions:
 - North American Industry Classification System (NAICS) Code representation
 - Other small business program qualification requirements
- Cost Accounting Standards (CAS)
- Contractor business systems
- Government audit and settlement history
- Open contract change orders, requests for equitable adjustment, and contract disputes

Government contracts due diligence, continued

- Other areas of compliance due diligence inquiry include:
 - Contract-specific performance or financial risk
 - Accuracy of target management assertions
 - Target management and systems compliance capabilities
 - Retention of records and future cross-audit support
 - Transition services and purchase agreement terms
 - Post-transaction integration and external restructuring
 - Other target-specific risks or circumstances
- Due diligence challenges often include:
 - Limitations on access to target records and management
 - Time constraints

Due diligence: Cyber requirements

- Mandatory cyber incident reporting process
- NIST 800-171 compliant systems by December 31, 2017
- Subcontracts flowdown and subcontractor program verification requirements

Due diligence: Fraud, suspension & debarment

- Due diligence can turn up evidence of wrongdoing before the government is aware of it
- Comprehensive due diligence should focus on fraud enforcement mechanisms
- The Civil False Claims Act (31 U.S.C. § 3729-3733):
 - False statements and claims can lead to prison sentences
 - Reputational damage is a key consideration
- Commission of offenses indicating a lack of business integrity can be a basis for debarring the contractor from doing business with the Government:
 - Suspension can last for up to one year and be extended for an additional six months (48 C.F.R. 9.407-4(b)) and may extend suspension to affiliates
 - Debarment typically lasts three years, although the contractor can try to negotiate a shorter duration (48 C.F.R. 9.406-4(a)(1))

Due diligence: Mitigating identified risks

- Buyer should ensure the purchase agreement contains government contract-specific representations and warranties relating to:
 - Specific indemnity for non-compliance with requirements identified during due diligence or otherwise disclosed
 - If issues are identified requiring mandatory disclosure, timing of disclosure is an important consideration

Polling question #3

What risks are you concerned about during due diligence:

- A. Quality of Earnings
- B. Personnel
- C. Reserve Structure
- D. Audit History
- E. All the Above

Post-merger activities: Deal closeout

- Post-closing price adjustments and earnouts
- Novation
- Small business recertification, if required, and updates to the System for Award Management (SAM) website to reflect any changes to the of the previously entered information
- Action on any compliance deficiencies identified during due diligence and not addressed prior to closing

Post-closing activities: Integration

- Employees:
 - Consider retention bonuses to keep key employees on through the bumps of transition
 - Employee compliance training
 - Benefit plan/policy integration
 - Consistency of employment agreements
 - Cultural considerations

Post-closing activities: Structural integration

Financial integration:

- Harmonization of accounting practices
 - Separate accounting for acquired business if there is an earnout tied to economic performance
- Consolidation of accounting systems
- Cost accounting practice changes
 - Potential external restructuring requirements/benefits DFARS 231.205-70
- If transaction was originally structured as an equity purchase to avoid novation and the intention is to operate as a single entity, a post-closing transfer of assets with novation to the buyer is not uncommon
- Buyer retains economic benefit while novation is pending
- System integration; cyber issues

Polling question #4

What is your experience with post deal integration:

- A. Went great! Exactly as planned
- B. Bumps and Bruises but all good
- C. Every rock a new surprise
- D. Never make me do this again



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