

“The Impact of Small Business Recertification”

By

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Under previous SBA regulations, a company's size status was determined at the time of the contract award. If a company was considered small at the time of award, it would retain that designation for the life of the contract. This can be a tremendous advantage to a growing contractor as certain contract periods of performance can be up to 20 years in length. Also, under previous regulations, if a large contractor were to acquire a small-business

set-aside contract from a small business, or if it were to acquire the small business as a whole, the large contractor was able to continue contract performance through the remaining life of the contract. This has always been an important factor in the acquisition decision for a large company's acquisition of a small business.

These old regulations also applied to 8(a) contracts. If a company was a qualified 8(a) contractor at the time of contract award, it was able to continue contract performance through the life of the contract, even if the company graduates from the 8(a) program during the period of performance. This is one of the reasons that most 8(a) companies attempt to win as many contract awards as possible prior to graduation. One difference between 8(a) contracts and small business set-aside contracts is that 8(a) contracts contain a provision that if the contract or the company were to be acquired by a non-8(a) qualified company, the Government could immediately terminate the 8(a) contract. This provision resulted in much lower valuations for 8(a) contractors versus other contractors. However, it has been my experience that this provision to immediately terminate is rarely, if ever, invoked by the government.

The new regulations should help achieve the SBA's objective of ensuring that small business contracts and task orders are going to actual small businesses. In a study performed by Eagle Eye Publishing, they found that contractors such as Boeing, Lockheed Martin, Northrop Grumman, SAIC, General Dynamics, among others, were performing work under small business set aside

contracts. These contracts were of course obtained through the acquisition of small businesses by these large contractors. In addition, the Government was taking credit for these as small business contracts in reporting their small business goals even though they were performed by the nation's largest contractors.

Another area that is going to feel the effects of these new regulations are long-term (in excess of 5 years) GWAC contracts. An example of this is the Department of Commerce's COMMITS NexGen contract vehicle. Set-aside only for small businesses and having a period of performance of 5 years with options that could extend it another 5 years, this contract vehicle provides small businesses with a terrific opportunity for growth. However, under the new regulations, the awardees will have to recertify after 5 years or after acquisition. There are many companies that were small at the time of award of this contract, but have grown substantially since. Examples include: ¹

- RS Information Systems - \$347M annual rev.
- SI International - \$276M
- STG - \$154M
- QSS Group - \$151M
- NCI - \$123M
- MSD - \$75M
- Indus - \$75M

If the old regulations had remained in place, these companies would have been able to continue receiving task orders under this vehicle for many years to come. Now, under recertification, they will be unable to receive such orders.

¹ 2006 Washington Technology Top 100 Contractors

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Impact on Valuation

There are, in essence, two types of buyers in the marketplace – financial and strategic. Financial buyers are looking to make a return on their initial investment above and beyond what they could earn elsewhere (publicly-traded stocks, bonds, real estate, etc.). Owning a privately-held business involves significantly more risk than these other types of investments, thus the returns they seek are much greater. There is an inverse relationship that exists between risk and valuation – the higher the risk, the lower the valuation. Thus, financial buyers typically will value a company at lower levels in order to obtain higher returns. Strategic buyers are acquiring companies for reasons other than just financial (i.e. product/service offering, Agency relationships, intellectual property, contract backlog, etc.) though financial performance is a considerable factor. Because of the other factors being considered in their acquisition decision, strategic buyers are generally willing to pay more for a company than a financial buyer.

The new regulations will affect both types of buyers. They will be impacted by the fact that, upon sale of the company, the acquirer will have to recertify as small, or if it is not, will lose those contracts that were small business set-aside. When establishing an acquisition price, both types of buyers project the anticipated revenues and earnings of the seller. A significant factor in this analysis is the company’s contract backlog. The new regulation can have a material impact on the contract backlog of the seller and will result in a lower valuation.

Strategic buyers can be further affected due to the other losses that can occur with the loss of these contracts. These include:

- Loss of project management and a skilled workforce performing under these contracts
- Loss of customer/Agency relationships
- Loss of ability to cross sell other product/service offerings to customers
- Loss of possible ability to perform follow-on contracts.

The end result will be a lower valuation for these contractors.

Impact on Marketability

In addition to the impact on valuation, the marketability of the company will also be affected. Marketability is the ability to convert an asset (i.e. the value of the company) into cash. Different types of assets are more readily converted to cash. An example is owning stock of a publicly-traded company. There is a ready market available for selling these shares and converting it to cash in a relatively short time period. Selling the stock of a closely-held company is a much more difficult and arduous task. Even the most attractive closely-held companies generally take 6 to 9 months to complete a sale.

The marketability of a closely-held contractor with these long-term contracts has now been impacted by these recertification rules. This is due to the fact that the pool of potential buyers has been significantly reduced. While a large contractor may still be interested in purchasing the company for the other contracts and capabilities that the company may have, the loss of the ability to continue performance under these contracts will significantly reduce this interest. In addition, small contractors who would be able to recertify as small, for the most part do not have the financial resources to execute such an acquisition.

It should be further noted that the cost and effort of acquiring a small contractor is generally the same as that of acquiring mid-sized and larger contractors for the prospective buyer. Because of this, these buyers tend to shy away from smaller deals unless there is a compelling reason to pursue it. By eliminating the ability to continue performance under these contracts will further dampen the interest of these prospective buyers in smaller deals.

Conclusion

The goals of the recertification rules by SBA are to increase the opportunities available for small businesses and to improve the reporting of small business awards. The new rules should go a long way towards achieving these goals. However, a consequence of these new rules is a significant reduction of the value and marketability of small contractors.