Practitioner Perspectives

WOLF DEN ASSOCIATES, LLC

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Top 10 Tricks to Navigate Inflation

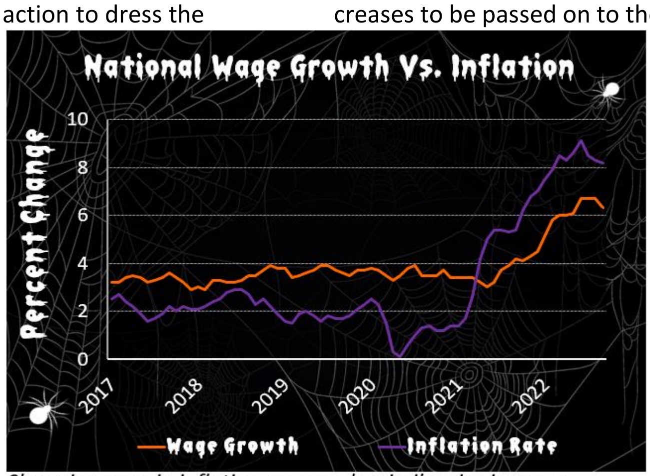
1. ***Migrate billable staff into the highest possible LCATs***
2. ***Take inventory of contracts with excess ceiling as the ones most likely to entertain rate increases***
3. ***Request and justify rate relief – leverage recent government Economic Price Adjustment (EPA) willingness***
4. ***Under-run LOE on fixed price efforts for as long as you can without sacrificing quality of delivery***
5. ***Shape new work to include strict evaluation criteria around cost realism rooted in current market wages and materials costs***
6. ***Make conscious decisions between winning work at a loss using historic rates or losing work bidding current rates***
7. ***Insert EPA clauses into new contract awards wherever possible***
8. ***Cut indirect costs to offset margin compression***
9. ***Triage cash for maximum enterprise value creation (tradeoffs are real)***
10. ***Think twice before coming to market – is the right buyer interested right now?***

Inflation's Impact on GovCon: More Tricks Than Treats

- As the Federal Reserve tries to curb inflation, even aggressive interest rate hikes will be muted by unprecedented money supply
- While inflation is likely to be with us for the next several quarters, contractors are struggling with the corollary wage growth
- Initially unsympathetic to contractors, DoD has softened its stance with a willingness to consider Economic Price Adjustment (EPA)
- Historically insulated from inflation through cost plus and contract duration "ladders", recent wage growth shocks threaten contractors
- Indirect rate cuts, share repurchases, and debt paydown may begin to steal some of the headlines from recent M&A euphoria
- Persistent PE interest in the federal market, dry powder, and a recessionary flight to quality provides an M&A valuation floor

Spooky Season is here

Despite months of signs and building anticipation, the U.S. got quite the jump scare when the realization hit that current inflation is going to haunt everyone for the foreseeable future. It is top-of-fold news now because it has reached the highest levels since 1981. The October CPI report signaled that prices rose 0.4% in September, with year-over-year inflation now at 8.2%. The Federal Reserve is belatedly taking action to dress the economy in a new costume with a rapid succession of interest rate hikes to slow runaway expansion, reduce inflation to a target level of ~2%, and to prevent the house of recession horrors no one wants to walk through again. Despite recent moves, it may take several quarters to let the air out of the balloon. In short, inflation is here, it is real, and it is not going away anytime soon.



Sharp increase in inflation presaged a similar rise in wage growth over the last 12 months
Source: Bureau of Labor Statistics & FRED St. Louis

Trick or Treat for GovCon

Historically, government contractors were not haunted by inflation, hauling in massive bags of candy in all economic conditions. Contract type and the ability to manage a laddered contract portfolio with the opportunity to reset pricing with every bid insulated government contractors from a serious scare in any particular year. Additionally, cost plus contracts allow for labor price increases to be passed on to the government, further limiting any scares. A sudden spike in labor rates and increased reliance on firm fixed-price and T&M contracts leaves industry vulnerable to inflation. Eroding margins and performance declines from open billets are the tooth decay and stomach aches on this Hallows Eve. The real tricks this season will be rate relief, reductions of effort on FFP work, and migration of staff into higher LCATs.

New Bag of Treats

For government contractors, the DoD initially disappointed by slipping toothbrushes and apples into trick-or-treat bags with no willingness to grant sweet relief in the face of a sharp uptick in wage inflation. As the illumination of the labor crisis has risen from waxing crescent to full moon, the government is recognizing the potential loss of services and suppliers due to the rising costs of wages and materials, upping their candy game. They are now openly encouraging the use of Extraordinary Contractual Relief in facilitation of national defense via memos from the Office of the Under Secretary of Defense. The memos, released in May and September of this year, reference the use of an Economic Price Adjustment (EPA) clause, potentially providing modification of the stated contract price and/or rates in the event of certain price fluctuations dependent upon funding.

M&A's House of Horrors?

Beyond haunting your labor pools, rising interest rates increase the cost of borrowing and decrease the amount of leverage buyers can use for transactions. Gross margin compression – if unchecked by offsetting indirect rate cuts – will also decrease earnings and cash flow, further reducing the ability to service increasingly expensive debt. Taken together, many expect downward pressures on M&A multiples. However, like savvy children, sellers know which neighborhoods to target and which houses to avoid. While the zombie at the end of the hall is paying down debt and the witch in the attic is repurchasing shares, the private equity fund in the fun house mirror knows there is nothing "fun" about "fun size" candy and is handing out king-size candy bars from its dry powder stash to increase exposure to the federal market as a hedge against the recession.

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