IT Services – Government Industry

Information Technology

Investment Thesis

We recommend an overweight rating for the IT Services – Government industry over the next year. Companies within this industry mainly provide information technology services and solutions for the government. Currently, the IT Services – Government industry has a $79.3 billion total revenue. The industry development is closely tied to the government IT and defense spending. These two items have a 4.5% and 2.63% 5-year CAGR, respectively. We expect the IT spending and the defense outlay to be $483 billion and $733 billion in 2021. The IT Services – Government industry is expected to grow by 9.1% this year.1,2

Drivers of Thesis

- This is the sixth year that the market has experienced growth, on average, there was a $3.3 billion increase in government IT spending each year. Governments need companies to help them transform into advanced and modernized systems to better handle comprehensive issues.3

- By conducting frequent M&A activities and increasing R&D costs, companies are expanding cloud-based businesses, which can significantly improve efficiency as well as cybersecurity but at lower costs.

Risks to Thesis

- The industry relies heavily on the government. With a decreasing government budget deficit, we anticipate the government to cut spending and the price pressure may get bigger.

- Being a government supplier requires firms to comply with complex procurement rules and subject to audit by the government. The contracts can be terminated at any time.

- To win contracts, firms need to attend the bidding process, which requires a large amount of time and money. The potential protests can make contracts delayed or even canceled.

Top 6 Industry Players

<table>
<thead>
<tr>
<th>Market Cap (in $Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Dynamics</td>
</tr>
<tr>
<td>Leidos</td>
</tr>
<tr>
<td>CDW</td>
</tr>
<tr>
<td>Booz Allen Hamilton</td>
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<tr>
<td>Science Applications</td>
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<tr>
<td>CACI International</td>
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</tbody>
</table>

P/E (FY1)

- General Dynamics | 16.79 |
- Leidos  | 15.90 |
- CDW  | 25.46 |
- Booz Allen Hamilton  | 21.89 |
- Science Applications  | 13.86 |
- CACI International  | 16.67 |

P/S (FY1)

- General Dynamics | 1.36 |
- Leidos  | 1.04 |
- CDW  | 1.31 |
- Booz Allen Hamilton  | 1.47 |
- Science Applications  | 0.70 |
- CACI International  | 1.05 |

Industry Revenue

- Asia 5%
- Europe 11%
- United States 84%

Source: Yahoo! Finance

Industry Description

The industry is committed to providing integrated information technology solutions and services to government agencies and departments. Because the U.S. market accounts for 84% of the global industry revenues and the lack of reliable information of foreign contractors, we mainly focus on the U.S. market in this report.4 The in-depth cooperation between these companies and government agencies like the U.S. Department of Defense developed in various fields, including surveillance and reconnaissance, transformation as well as cybersecurity.

Source: Yahoo! Finance

Important disclosures appear on the last page of this report.
EXECUTIVE SUMMARY

The government’s Information Technology initiatives are the key drivers of the industry’s development, which include improving cybersecurity, optimizing and modernizing data centers as well as IT infrastructure, improving the digital experience, providing easier digital government information access, and managing security clearance & credentialing process. Such transformations have started before the pandemic, but they were accelerated during this period.  

The performance of the Information Technology Services – Government industry is closely tied to the defense and government IT budget. As we mentioned earlier, these two budgets had a 5-year compound annual growth rate of 2.63% and 4.5% (as comparing to the 5-year average inflation rate of 1.30%), accordingly. Overall, we hold a positive attitude on the IT Services – Government industry in the next 12 months. 

INDUSTRY DESCRIPTION

As shown below, we believe the marker leaders General Dynamics (GD) and Leidos Holdings (LDOS). In fiscal 2020, both of these two companies generated over $10 billion in revenue from this industry. Followed by CDW (CDW), Booz Allen Hamilton (BAH), and Science Applications International (SAIC). These top five companies took 73% of the market share. Companies within this industry providing the government with their IT products, either as a primary contractor or a sub-contractor, and they win contracts through bidding processes. The industry revenue as a percentage of the total revenues can range from 33% (GD) to 100% (MANT, PAE). Typically, the revenue from the federal can attribute to 97 – 98% of these revenues. State and local revenues will be no more than 3%.  

On average, the contracts have a base period of 5 years, but it may be followed by an option to extend for 2 or 3 more years. There are three major types of government contracts that companies may win: Cost Reimbursement (CR), Firm-fixed-price (FFP), and Time & Materials (T&M). 

- As shown in the chart, generally, more than half of the total contracts are Cost Reimbursement contracts. The proportion ranges from 15% to 68%. This type of contract covers both direct and indirect costs in addition to the contract profit. It is suitable when involving uncertainties that are hard to be priced at fixed costs. It carries the lowest risks for the company.
And it requires the company to accomplish as much as possible within the time scope.¹

- The weight of Firm-fixed Price contracts ranges from 19 – 46%. These contracts have prices that are predetermined by the firm. If companies achieved the goal with lower costs, the profit would be higher. However, it also takes the risk of having higher than expected costs.¹
- Usually, the smallest segment is Time & Materials (9 – 50%). This type of contract offers a fixed hourly rate and direct cost coverage. It is common when the time scope or work scale is uncertain.¹

Source: FactSet¹ (CDW is not included as the company did not provide relevant information)

The major downside risk to this industry comes from the volatilities in the government spending budget. As indicated below, the government budget surplus reached the highest point in 2000 ($0.24 trillion), while the budget deficit reached the lowest point in 2009 (-$1.41 trillion). Overall, we found that there exists a rebound tendency as the budget deficit tends to get smaller. In other words, the government may cut spending, which will lead to higher price pressure.

Source: Statista⁴

INDUSTRY TRENDS

The Threat of New Entry

The barriers to entry into the industry are relatively high, which means that the threat of new entries is relatively lower than in other industries.

- New suppliers know little about the contracting processes, they even do not know how to get the initial contract.
- Research & Development expenses are critical within this industry. Even though the R&D expenses only account for about 1% of the total revenue, it is still a considerable millions dollar amount. Small or emerging suppliers rarely have the ability to handle that.
- It is difficult to build relationships with government departments and agencies, especially when these major players have built the relationship for decades.
- Companies need to comply with complex bidding processes and regulations. They are subject to the government’s audit. However, the contracts may be terminated by the government at any time.
- The contracting cycle is not certain. In 2020, many contracts were adversely affected by the COVID-19 as the government has to change the priority so that the contracts were delayed.¹⁰

M&A Activities

Companies within this industry conduct M&A activities frequently in recent years. For example, GD finished nine acquisitions in the past three years.³ By doing so, companies are expected to enhance their competitiveness, broaden product lines, and attract new clients. The low-interest-rate environment also contributed a lot. However, we are expecting a rebound in the interest rate in the foreseeable future, which means it would be more costly to acquire businesses.

Steady Increase in Budgets

The industry’s development relies heavily on government IT spending (see Executive Summary) and defense budgets. There was a sharp budget reduction followed the record high Department of Defense budget of $691 billion in 2010. Until the Bipartisan Budget Act of 2018 became
effective, the modified spending caps improved the DoD budget. The budget level rose by 4.5%, 10.7%, and 2% in 2017, 2018, and 2019, accordingly. The 2019 budget level has increased to $685 billion, and it is projected to grow by 3% in 2020 to $705 billion thereafter. The defense budgets carry a relatively stable growth rate in the next few years. Thus, we hold a positive view of this industry.

**MARKETS AND COMPETITION**

As we introduced before, this industry is made up of 13 major players. Sorted by the industry revenue, the top six companies, GD, LDOS, CDW, BAH, SAIC, and CACI account for 82% of the US market share. Therefore, we decided to mainly focus on the competitions between these six companies in this part.

**General Dynamics (GD)**

General Dynamics is one of the top 5 defense contractors in the United States, which primarily engages in providing tanks, missiles, submarines, etc. to the military. It develops business through Technologies, Marine Systems, Aerospace, and Combat Systems four segments. Before 2018, the Technologies segment is known as Information Systems & Technology. In 2018, the company formed the Information Technology segment and later integrated with CSRA, which they acquired in April 2018. In 2020, this segment is renamed Technology. General Dynamics aims to build a leading segment that can provide IT and cloud services and solutions to the government. Currently, this segment is working with the Department of Defense on a cloud program which is known as milCloud 2.0.

**Leidos Holdings (LDOS)**

Leidos engages in providing science, engineering, and information technology services and solutions through the Defense Solutions (60%), Civil (24%), and Health (16%) segments for both government and commercial consumers. The primary clients include the Department of Defense (DoD), Department of Homeland Security (DHS), and other government agencies. In 2020, about 85% of total revenues were generated from the U.S. government and less than 10% of revenues are from foreign businesses.

**CDW Corp. (CDW)**

CDW Corporation is an integrated IT services and solutions provider for all sizes of businesses, government, and education & healthcare institutions. They offer both hardware and software products to consumers. Hardware products include tablets, computers, and other mobile devices. Software products include applications, systems,
and management tools. CDW corporation also offers hybrid cloud services to both public and private sector customers. CDW operates through the Public (44%), Corporate (37%), Other (11%), and Small Business (8%) four segments.¹

Supporting by a strategy, growth and innovation organization, SAIC operates through three customer-facing segments, which focuses on customer relationships, development, management, and delivery & execution. We do not provide a revenue decomposition pie chart here as these three operating segments are aggregated into one reportable segment for financial reporting purposes.¹

The major clients consist of the U.S. Army (17%), the U.S. Navy (11%), the DoD (19%), and other federal government departments or agencies (51%).

**CACI International (CACI)**

CACI International mainly focuses on providing IT services and solutions to its clients through domestic and international segments. The domestic business is made up of Business Systems & Business Process Services, C4ISR & Cyber (ensure information superiority), Engineering Services, Enterprise IT, and Mission Support.¹

Typically, it generates more than 95% of the total profit from the government business area¹. In specific, it helps the government to transform business processes that aim to enhance efficiency and equip the government with the most advanced technologies like the 5G wireless network.

**Peer Comparisons**

**Capital Structure**

As shown in the chart, to compare the capital structure across these 6 companies, we chose two metrics: Debt-to-Equity ratio and S&P debt rating.

- D/E ratio reflects the company’s ability to cover all outstanding debts with stockholders’ equity. The
higher the ratio, the riskier the company is. CACI has the lowest D/E of 64%, while CDW has the highest ratio of 358%. In other words, CACI has $0.64 of debt for every $1 of equity. CDW has $3.58 of debt for every $1 of equity. The IT Services industry has an 85.8% D/E ratio, comparing to that, CACI does a better job than its peers.

- Debt rating is the quantified assessment of the creditworthiness of companies. Moreover, it implies the potential interest rate at which the loan will be repaid. The higher the rating, the more likely the company can pay back without issues. The S&P debt rating ranges from AAA (the best) to D (the worst). A rating below BB is considered to be a junk bond, which means it is more likely to be delinquent on loans. As shown below, the best rating is A. The worst but the most common rating is BB+. As compared to peers, GD does a better job.

<table>
<thead>
<tr>
<th>D/E</th>
<th>Debt Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>GD</td>
<td>94%</td>
</tr>
<tr>
<td>LDOS</td>
<td>141%</td>
</tr>
<tr>
<td>CDW</td>
<td>358%</td>
</tr>
<tr>
<td>BAH</td>
<td>251%</td>
</tr>
<tr>
<td>SAIC</td>
<td>180%</td>
</tr>
<tr>
<td>CACI</td>
<td>64%</td>
</tr>
</tbody>
</table>

*Source: FactSet¹*

**Geography Sales**

We are not surprised to find these companies within the US IT Services – Government industry earn most revenues domestically. Comparing to others, GD does a good job at diversifying as it earned 18% revenue from foreign countries. On the contrary, SAIC only focuses on the US market, which may be a potential concern in the future.

**Margins**

We chose to use gross margin as well as operating margin to evaluate companies’ performance. Both margins represent how efficiently a company is generating profit, and they are expressed on a per-sale basis.

As shown in the chart, CACI has the highest gross margin which is 33%. The company was doing well in managing resources that directly contribute to the production of goods and services. GD has the highest operating margin of 11%, which implies that GD was in a better position if they want to take on additional financing.

**Valuation**

We decided to use forward P/E, forward P/S, and EV/EBITDA ratio in the valuation part.

- As indicated below, SAIC stands out when it comes to the forward P/E ratio. It has the smallest P/E ratio of 13.89, which is about half of CDW’s. It implies that SAIC is probably undervalued, and CDW is overvalued.
- Similarly, SAIC also performs better when we use the P/S ratio to evaluate. Comparing to its competitors, SAIC is undervalued by investors, while BAH is overvalued by investors.
- To combine the valuation of firms’ total value and their overall financial performance, we applied the EV/EBITDA ratio in the valuation process. We found that CACI has the highest enterprise multiples. In other words, we think it is undervalued in the current market. On the contrary, CDW is more likely to be overvalued.
<table>
<thead>
<tr>
<th></th>
<th>Forward P/E</th>
<th>Forward P/S</th>
<th>EV/EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>GD</td>
<td>16.79</td>
<td>1.36</td>
<td>12.83</td>
</tr>
<tr>
<td>LDOS</td>
<td>15.90</td>
<td>1.04</td>
<td>14.55</td>
</tr>
<tr>
<td>CDW</td>
<td>25.46</td>
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<td>17.84</td>
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<td>14.84</td>
</tr>
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<td>SAIC</td>
<td>13.86</td>
<td>0.70</td>
<td>12.36</td>
</tr>
<tr>
<td>CACI</td>
<td>16.67</td>
<td>1.05</td>
<td>11.43</td>
</tr>
</tbody>
</table>

*Source: FactSet*

### Economic Outlook

#### Real Gross Domestic Product

Real GDP is a non-biased inflation-adjusted measure of the value of economic outputs. As the following chart shows, it decreased by 3.5% from 2019-2020. Although the growth rate in 2020 Q4 is substantial, it is the outcome of ongoing restrictions brought by the pandemic that offsets the continuing economic recovery. As the vaccination rates going up (~40%), the Henry Fund team expects to see a 5.17% growth in the next 6 months, and gradually return to the pre-pandemic level. During the pandemic, many of the government contracts have been or are probably going to be delayed by the government as the priority changes. With a relatively stable real GDP recovery rate, we believe there will be fewer volatilities for ongoing and future contracts.

*Source: Bureau of Economic Analysis*

#### Unemployment Rate

From 2007 to 2021, the United States unemployment rate hit the lowest point 3.5% in March 2020 and reached the peak of 14.7% in May 2020. The volatile unemployment rate hurt the company as government needs to spend more to support unemployed people. As indicates in the following chart, although the unemployment rate has dropped to 6%, which means that the economy is continuing to recover, there is still a long way to go back to the pre-pandemic level. The Henry Fund team estimates it to decrease to 5.59% in the short run and 4.79% in the long run. We are also concerned about the potential increase in the mean wage as the unemployment rate is projected to decrease in the future.

*Source: US Bureau of Labor Statistics*

#### Treasury Yields

As we can see in the chart below, the market has experienced a low-interest-rate environment in the past 2 years. The lowest point was in March 2020, which was the outbreak of the pandemic. This environment did help companies to accomplish M&A activities with lower costs by entering different debt facilities for repaying debts and conducting acquisition activities. However, both Henry Fund’s assumption and the yield curve showed that the rebound tendency. We expect it to adversely affect future M&A activities and the cost of capital.
COVID-19

With the vaccination rate approaching 40%, we can see a downward trend in the number of COVID-19 cases reported to CDC which is shown in the following chart. We believe this is a positive signal to the industry.\(^8\)

The pandemic has brought us volatilities on revenues and expenses. For instance, the pandemic decreased our travel and accommodation expenses. However, the cost to create a safer working environment may offset part of it. In the last year, many firms experienced or still experiencing the delay and disruption. we believe that the vaccine will further accelerate the recovery rate and decrease the adverse impact that COVID-19 has brought.

Data Source: CDC\(^5\)

INVESTMENT POSITIVES

- Growing needs for the integrated IT services and solutions from the government. The government is increasing the IT spending year by year.
- The industry is less susceptible to be influenced by the pandemic as compared to other industries.
- Vaccination and travel restrictions are effective in controlling the spread of the pandemic, the market began to recover, there are fewer uncertainties so that businesses are expected to gradually back on the normal track.

INVESTMENT NEGATIVES

- Industry’s performance is subject to the contracts awarded by the government. Although there is continuous growth, we know it is volatile. Any changes in government budgets or regulation rules may negatively affect this industry.
- The competition is increasing, which means that price advantage must be taken into consideration in the bidding process. Nonetheless, providing price advantages means firms have to reduce profit margin. We are questioning that whether the remaining profit could cover the bidding expenses. Moreover, potential bidding protests can make things worse.
- The Debt-to-Equity ratio and S&P credit ratings may lead to concerns about the ability to pay back the principal on time.

KEYS TO MONITOR

- The decreasing employment rate leads to the concern of higher wage expenses, which may hurt the operating margin.
- The decreasing government deficit can be perceived as a signal of decreasing government spending. We need to keep track of volatilities.
- The increasing-interest-rate environment will slow down and increase the cost of potential M&A activities, which will hurt companies’ development in the long run.
- Cybersecurity is always one of the most important things to watch for. Companies need to pay more attention to it, which may lead to additional costs as well.

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