



EXECUTIVE SUMMARY

There are a number of fundamental aspects of the government contracting business that need to be addressed in an integrated fashion in order to develop and deploy an effective corporate strategy – one that

This report provides a comprehensive overview of these important aspects through the lens of the experts in the corporate real estate, financial and legal industries. The industry-specific considerations contained in this report provide experienced, actionable guidance for the development of sound business practices for the government contracting industry.



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CORPORATE REAL ESTATE

Facility Acquisition

The process of identifying and securing a facility to lease or purchase in support of a government contract needs to be flexible, fast and thorough. It requires flexibility in lease term, an expeditious ramp-up upon contract award, and a thorough due diligence of facility infrastructure. Proximity and accessibility to the client is also integral to the success of location strategy.

Contract Award Process: Awards are frequently delayed or protested so lease commencement obligations must anticipate potential delays. It is important that the tenant maintain control of the property until the commencement conditions have been met so that the landlord cannot renegotiate terms after award, thereby exposing the tenant to unanticipated increased costs. Typically lease commencement dates coincide with the completion of tenant improvements in the leased premises, whether such work is performed by the landlord or the tenant. In order to obtain an extension of such commencement date in the event of a delay in the award of a government contract, the tenant will likely have to agree to one or both of the following concessions: (i) a day-for-day extension of the lease expiration date so that the landlord continues to have the benefit of the full, anticipated lease term; and/or (ii) a monetary “penalty” for the delay in rent commencement, which will likely be a pro rata rent payment but could be a lesser amount, especially if combined with an extended term.

Ownership Background: The international diversity of real estate investors has resulted in many properties being owned by non-US entities.

Some of these entities could be objectionable to a government customer, although such objections are less likely if the government agency is not in the defense or national security sectors.

Similarly, the ownership structure of the government contractor itself should be carefully considered, since such ownership could be objectionable both to the government agency/customer and to a prospective landlord. Foreign ownership of the contractor/tenant can be mitigated by entering into the contract (and any related lease) in the name of a U.S. subsidiary, preferably with separate U.S.-based management.

Improvements: Depending on the structure of the contract, improvement costs may be an allowable expense if included in rent. If so, then costs above the market tenant improvement allowance should be requested from the landlord in the form of an additional allowance that is amortized over the base term of the lease. The renewal terms should be structured to ensure that this expense is no longer included in rent once the cost has been amortized. However, one potential obstacle to such an approach is the reluctance of many landlords, and their mortgage lenders, to accept any negotiated reduction in the face amount of the rent during the lease term. If this is the case, the tenant might agree to maintain the nominal rent amount at the same level, while obtaining a series of rent abatements to bring the net rent payments to the appropriate, post-amortization level.

If an extraordinary investment has been made in a leased property, the tenant can protect that investment by incorporating set cost renewal options in the lease. Doing so will ensure that the landlord does not take advantage of the tenant by overcharging for the improvements in the renewal periods. Alternatively, since most renewal rents are set by calculating the fair market rental value of the premises at the time of the renewal, the tenant can seek to exclude the value of any tenant-paid improvements from such fair market value calculation.





Facility Disposition

There tends to be a great deal of uncertainty around government contracts beyond the relatively short term that is established in the initial contract (often one or two years at most). Even if there is a high probability of contract renewal, business decisions need to be made to allow for supreme flexibility. Structuring termination options and subleasing options that are aligned with the contract and overall business strategy need to happen at the onset of the negotiation process.

Lease Term: Ideally, the lease term should match the contract period of performance, through either a simple expiration date or a termination option with a set termination cost. It is important that the individual negotiating the lease have direct, complete and timely information about the proposed contract to ensure that the lease conforms to the timing and key dates of the contract. If the lease is flexible enough to respond to all contract contingencies then the need for subleasing can be avoided. Subleasing typically results in a book and cash loss for the tenant, so this must be considered from an accounting and cash flow perspective when analyzing disposition options.

If subleasing cannot be avoided, or to offer an alternative to a material termination penalty, the lease should allow assignment or subleasing to a broad category of occupants and should provide that the landlord's consent shall not be unreasonably withheld, conditioned or delayed. Although a 50 percent sharing of any sublease "profits" (*i.e., sublease rent in excess of the rent paid by tenant, plus costs of the sublease*) is typical, this percentage is negotiable and will often be

waived entirely for a desirable tenant.

Government contractors requiring shorter lease terms and/or flexibility in lease termination are also increasingly taking advantage of such techniques as hoteling and shared office/co-working spaces, which offer short-term, renewable licenses for office space in multiple markets in almost every major metropolitan area.

Monetization of Assets: The monetization of owned assets is also an important disposition strategy that can allow for the reduction of expenses and the redeployment of capital into the core business. This should be analyzed on a regular basis and evaluated against the overall corporate strategy and financial objectives. One such monetization technique is the sale-leaseback. In this transaction, the government contractor sells its facility to a third-party investor and immediately leases the facility back upon terms which closely resemble a permanent mortgage loan. The seller/tenant retains full control over the facility for the duration of the lease, and often reserves an attractive purchase option at the end of the lease term.

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FAR AND DCAA

Compliance with FAR and DCAA

Compliance with the multitude of regulations by a variety of agencies and federal policies is complex and critical. To ensure such compliance, Federal Acquisition Regulation (FAR) 52.215-2 authorizes the Defense Contract Audit Agency (DCAA) to examine and audit a government contractor's records, books, documents, accounting procedures and practices and other data. When entering into purchase contracts or leases for real property, contractors must maintain proper records of such transactions and costs related to the use of such facilities. A contractor should implement a record keeping system to ensure that all records relating to the facility can be found promptly and that all records are maintained for the required length of time.

While FAR 52.215.2 states that records must be maintained until three years after a final termination settlement, this period may be changed by the contract language or by other statutes. Thus, each contract should be reviewed to guarantee compliance of records maintenance.

During an audit, the DCAA may request use of the facility. While FAR 52.215-2 requires a contractor to make available "its office at all reasonable times," this does not allow the DCAA to have a permanent space at the facility. The contractor should have a designated space for the auditors so that proper privilege is maintained and workflow and collaboration are not affected.

The DCAA can only review contractors' documents that are prepared in the ordinary course of business and cannot require contractors to prepare records that the contractor does not already have. A contractor should be cautious in turning over requested material so that privileged information is not disclosed. It is important, however, to reach a balance regarding such overzealous requests. In terms of real property-related documents, it can be prudent for a contractor to keep records of

documents that may support the reasonableness of facility-related decisions that may not normally be saved and provide same to the auditor upon request.

For example, according to FAR 31.205-36, when there is common control between the lessor and the contractor, allowable rental costs are limited to the "normal costs of ownership" of the property. Common control is not defined, and contractors have been surprised when the DCAA has found that the leasing parties are under common control. While the DCAA has indicators of common control, including higher rental rates than at other facilities, relaxed termination provisions, and other uncommon favorable lease terms, determining when there is "common control" can be somewhat subjective. By having additional documentation that may not be available in the ordinary course of business that helps show that the agreement was more "at arms' length," the contractor may be able to support that there is not common ownership and thus, can have allowable rental costs.

Utilization of Facilities

Contractors should also designate a property manager to periodically evaluate the facilities to ensure that they are being properly utilized and to maintain records of same. Facility-related costs, such as maintenance, repair, housing, rent, and other related costs, including property taxes, insurance and depreciation, are allowable so long as the facility is reasonably necessary and being adequately used. If not, the DCAA may disallow such costs by finding that the facility is an "idle facility" meaning that it is a "completely unused





facility(ies) that [is/are] excess to the contractor's current needs."

Pursuant to FAR 31.205-17, costs arising from idle facilities are unallowable unless the facilities: (i) are necessary to meet workload fluctuations; or (ii) were necessary when acquired and are now idle due to changes that could not have been reasonably foreseen. Thus, it is essential for a contractor to identify potentially idle facilities and promptly make efforts to decrease those costs through sale, sublease or a new use. Having a system set up to periodically review such utilization can prevent having an idle facility.

Costs of idle facilities are only allowable for a reasonable period of time, typically not to exceed one year. The ASBCA, however, determined in *Aerojet General Corporation* that a period of time of more than one year was reasonable when the decrease in use of the facility was unforeseeable and the contractor made diligent efforts to reduce costs. On the other hand, the ASBCA has also found that costs were not allowable for an idle facility when the facility was unnecessary at the time it was obtained. Thus, not only must a contractor be aware of facilities that may become idle, it must also evaluate whether the acquisition of a facility is necessary at the outset.

While costs associated with idle capacity are typically allowable, contractors should still be aware of any idle capacity as excessive idle capacity can become idle facilities. Idle capacity is the unused capacity of partially used facilities, and is the result of normal business fluctuations.

Costs associated with idle capacity are typically allowable so long as the capacity is reasonable, necessary and not subject to reduction or elimination by subletting, renting, or sale in accordance with sound business practices.

FAR provides additional guidelines regarding allowable costs if a contract is terminated for convenience. FAR 49.206-1 provides that a contractor must submit a final settlement proposal to the Termination Contracting Officer (TCO) within one year from the effective date of the termination. It is typically in the best interest of a contractor to settle such claim as soon as possible, as the contractor cannot add to the amount recovered by prolonging the settlement period. Some costs are allowable after settlement, but only if the contractor has taken steps to minimize same.

If the contractor has leased property in connection with the contract and cannot terminate the lease when the contract is terminated, those costs can be allowable as part of the settlement proposal.

Sufficient records, however, are important here as the contractor has the burden of proving that the lease was necessary, that it was reasonable as to its terms and that the contractor took reasonable efforts to terminate or shorten the terms of the lease upon notice of termination of the contract. The contractor can also claim the costs of alterations and reasonable restorations required upon the termination of the lease when the alterations were necessary in the performance of the contract.

Thorough evaluation of each contract is essential to ensure compliance with FAR. Contractors need to be prepared for DCAA audits by maintaining adequate records so that they can provide support for such compliance and prevent negative findings by the DCAA relating to the disallowance of property-related expenses.





M&A AND CORPORATE REORGANIZATIONS

M&A activity is robust within the government contracting sector. An often overlooked component of the due diligence process is corporate real estate.

In order to get a clear understanding of opportunities and risks, it is necessary to fully understand the expense obligations, current valuation of owned facilities, and potential savings opportunities.

Existing Portfolio Analysis: All lease obligations of an acquisition target should be reviewed for reasonableness and any excess costs, especially those that benefit related parties to the transaction, should be disallowed or deducted from the purchase price. This information is obtained through comprehensive lease abstracting, market rent benchmarking, portfolio assessments, and facility occupancy analysis. Additionally, a professional environmental review should be included in any acquisition process that includes owned real estate, or leased real estate that is controlled exclusively by the tenant.

Proactive Negotiation: At the beginning of the lease negotiation process, government contractors should be diligent about including language that allows for an unfettered right for tenant to assign the lease to an affiliate or other successor in a corporate reorganization, merger or sale, without the need for prior landlord consent (but with reasonable notice and assumption of lease liabilities), so that no landlord consent can affect the implementation of a business sale or acquisition.



Corporate Financing Mergers & Acquisitions

Following the 2008-2010 recession, the banking industry as a whole has seen a few continuous trends. First, credit quality has generally improved

as companies have taken conservative steps to strengthen balance sheets, reduce expenses and uncover operating efficiencies. Second, with improvement in credit quality, pricing for debt to those healthy borrowers has decreased. Government contractors, however, have needed to weather the storms of the government shutdown, sequestration, and continued uncertainty with regard to budgets, which has required an even greater focus on efficiency within the industry.

In many ways, efficiency can be gained through scale, which has been a strong driver of M&A activity for government contractors. Access to contract vehicles and technological capabilities, or the entry into adjacent markets, can bring additional levels of revenue along with higher profit margins when managed properly. A company's access to capital to enable these transactions has continued to play an important role.

When analyzing a company on a pro-forma basis after an acquisition takes place, lending institutions focus on a number of areas that can be indicators of risk, and time is taken to understand how a company plans to mitigate those factors.

Being able to produce a detailed contract waterfall report is very helpful during the analysis process and can save time during due diligence.

Revenue Visibility: Visibility into the combined company's revenue stream provides the clearest level of understanding as to how acquisition-related debt can be repaid.

Cash Flow Analysis: Analyzing a company's cash flow is critical in determining the capacity for repayment. Will the cash flow generated by the combined company cover all required fixed charges? Will earn-out payments lessen free cash flow availability? Are any large, one-time items being added back for the purposes of cash flow analysis, and can these be defended? Answers to these questions can help to determine the payoff structure and may require lower amortization up front with a larger balloon payment at maturity. Although a back-loaded amortization schedule is often viewed as riskier by lending institutions,



visibility into future revenue streams can strengthen the argument to utilize this structure.

Working with your banking partners is crucial when determining the type of structure that meets the goals of debt reduction and also enables growth. Approaching an acquisition with the understanding of financing options in concert with an understanding of the borrower's strategic priorities will enable an efficient borrowing process.

Working Capital

One of the most basic forms of financing is an establishment of a line of credit to smooth a company's cash needs during its normal sales cycles. For government contractors, this type of financing is often completed by advancing funds at a certain rate based on the collateral that is available. This working capital collateral is most often in the form of accounts receivable and inventory. Different advance rates are applied to the different types of collateral, which equates to the line of credit availability.

The following scenario provides an example of a working capital financing need. This illustration is common in the government contracting industry and often leads to the need for a line of credit.

Mechanism of a Working Capital Line of Credit:

Company A is a management consultancy that bills its government clients on a monthly basis. When a bill is sent to the client, a receivable is created, and the client is required to pay the bill per the terms of the contract. Prior to that bill being paid, however, items such as payroll, rent, utility bills and other costs associated with proposals and other opportunities are required. In many cases, a company's cash on hand may not be sufficient to cover these costs and expenses. The working capital line of credit enables the borrower to draw funds to pay these required expenses prior to receiving payment from its client. When payment is received, the line can then be paid off. Given the short term nature of these transactions, this cycle would be expected to continue throughout the year.

Key Points to Consider:

Reliability: Due diligence will help to determine that the borrower's clients have a history of paying their bills. For government contractors, it is rare that delinquencies cause issues, and routine payment delays that can be explained are often acceptable. Providing a lender with an accounts receivable aging report will help prove a strong history of collection.

Use of the Line of Credit: The lender will also require that the working capital line be used appropriately. Borrowing money on a short term working capital line to buy a piece of equipment or build out new office space is often not what the line is intended for. It is imperative that financing needs are understood up front so that the line of credit can be structured accordingly

In a low-interest-rate environment, it often makes sense to finance longer term assets under a line of credit so that cash can be used to make more value-added purchases, but proper communication about the line's use is important to ensure that it meets all of the borrower's needs.

Unbilled Receivables: In the example above, there may be a portion of the accounts receivable pool that is considered "unbilled." There are certain circumstances where a portion of unbilled receivables can be lent on, which are often tied to timing requirements under service contracts. Understanding the nature of the unbilled receivable may enable a lender to increase availability under a line of credit.

There are many other lending services and products that can enable government contractors to maintain flexibility when managing working capital, completing a transformational acquisition and investing in future growth. Understanding the needs of a lending institution when requesting financing will ensure an efficient process and will often lead to dynamic and creative solutions that are tailored to the needs of the borrower.





SECURED SPACE/SCIF

A great deal of the work performed by government contractors requires at least some elements that are sensitive and/or classified in nature. As a result, secure space of varying levels is required to both complete and to bid/review the work. Bid-in proposal work, program review requirements and special projects are specific areas that might require secured areas in facilities that do not otherwise have a need for such space. In these instances, access to small, short-term secured facilities – or the ability to construct mobile units that can be moved in the future – might be viable options, and should be considered as alternatives.

Controlled Access: Any lease that includes the potential for secure space should provide the tenant with the rights to establish areas within the leased premises that the landlord cannot enter for any reason or can enter only if in compliance with specific advanced notice and escort requirements. The lease should also provide the right to allow the tenant to provide their own janitorial and minor facility maintenance. To the extent that landlord's personnel perform such tasks, the lease should require the landlord to provide evidence of a criminal background check and/or allow the tenant to conduct such background checks itself. Such individuals might also be required to sign confidentiality and/or non-disclosure agreements with respect to any materials they might encounter during their visits.

Existing SCIF: All SCIF space is certified and sponsored by a particular government agency. Any space that was formerly used as SCIF but is vacant is no longer certified or sponsored.

Though the current SCIF standard has provided for some standardization of SCIF improvements, any reuse of SCIF requires a time intensive recertification and sponsorship by the government customer, and proactive measures should be taken to obtain specifics on the infrastructure and former level of accreditation/certifications.

Architectural and Construction: Building relationships with the architectural and construction contacts that have experience with designing and constructing secure/SCIF space will increase the likelihood of an on-time and on-budget project. Engaging these specialists early in the facility acquisition process, in concert with a reputable construction management professional, will mitigate expense and schedule risks, which can add up considerably in the form of lost revenue and penalties.

Building Security: In addition to security within the leased premises, government contractors (particularly those in the defense and national security industries) must often concern themselves with the security of the landlord's building itself, which involves compliance with applicable Anti-Terrorism/Force Protection standards, including setback-requirements, blast resistance, lobby and garage security and similar considerations.



A STRATEGY FOR SUCCESS



A successful strategy begins with developing a sound plan, but that does not happen in a vacuum, nor does it rest solely on the contractor or an individual advisor. It takes a diligent effort through the counsel of a collective team of trusted advisors who are working in concert to align the contractor's evolving needs with its corporate goals and objectives.

It is critical that the contractor assemble the right team and instruct the team to work together from the outset.



The collective wealth of industry knowledge and experience, coming together well in advance of a specific requirement, will yield the operational and financial efficiency necessary for sustained success in the rapidly changing landscape of the government contracting industry.



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