Contractor Survival Tactics: SAIC Splits Company In Two; Investing In Health IT Via Acquisitions

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In today's evolving federal marketplace, contractors of all sizes are evaluating their current strategies to achieve success going forward, while bracing for potential budget cuts that could significantly impact the way they do business over the next several years.

Over the past few months, one company which has been making noticeable moves is federal contracting giant SAIC, which recently announced plans to split into two separate companies, while also boosting its presence in the health IT sector with the acquisition of maxIT Healthcare. In addition to the split, SAIC also recently said it would divest its operational test and evaluation unit, which generates roughly $75 million in annual revenue.

FIA Perspective:

SAIC seeks to unlock long-term value/growth potential via business spin-off. Last week, SAIC said it plans to spin-off its government services business, separating it from the unit that provides IT for the national security, health and engineering markets. Under the proposed plan, the government services unit is expected to generate about $4 billion in revenue for fiscal 2013, while the national security business will book around $7 billion in revenue.

SAIC said the move is intended to reduce potential operational conflicts of interest (OCI), especially for the government services unit, while allowing the two companies to be "more differentiated and more competitive in their own space." It will also provide SAIC more business opportunities – the company noted that it has already identified over 150 new opportunities within the Department of Defense alone worth around $25 billion. SAIC said it expects the spin-off to occur in the latter half of next fiscal year.

Over the past few years, a number of larger contractors in the defense and government services market have looked at spin-offs as a way to maximize value, while allowing the separate businesses to more narrowly focus on the markets they service. Recent examples include L-3 Communication's spinoff of Engility, which encompassed the majority of L-3's government services business, and ITT Corp.'s spin-off of its ITT Exelis and Xylem Inc. businesses.

Northrop Grumman has also been divesting units over the past several years. In 2009, the company sold its TASC advisory services unit to an investor group led by General Atlantic LLC and Kohlberg Kravis Roberts & Co. for $1.65 billion. In 2011, Northrop also spun-off its Huntington Ingalls shipbuilding business to shareholders after failing to find a suitable buyer.

SAIC expanding in Health IT sector via acquisitions. In July, SAIC agreed to acquire healthcare IT consulting firm maxIT Healthcare for $473 million. The acquisition expands SAIC's capabilities in providing EHR implementation and integration services to its large base of federal healthcare customers, as they move toward the use of commercial-off-the-shelf (COTS) EHR applications.

maxIT, which is the largest private independent healthcare IT consulting firm in North America, provides a wide range of health IT services and solutions primarily to commercial hospital groups and other medical delivery organizations. These include IT strategy and planning, electronic health record (EHR) implementation and optimization, and management consulting across a broad range of activities such as accountable care transformation.

Last year, SAIC also acquired Vitalize Consulting Solutions (VCS), a provider of clinical, business and IT services for healthcare enterprises, for an undisclosed sum. Combined, these two acquisitions will allow SAIC to compete for new opportunities in the growing health IT market, an area where the company previously had little experience.

Besides acquisitions, SAIC has also been making divestitures to become more streamlined and efficient, including recent plans to sell its operational test and evaluation business (mentioned above). In April 2011, SAIC also sold certain assets that provided IT services to international oil and gas companies. These assets, which were sold to Wipro Ltd. for an undisclosed sum, included SAIC's U.S. oil and gas IT services business along with units SAIC Ltd., of the U.K.; Science Applications International, Europe S.A.R.L., of France; SAIC India Private Ltd., of India; and its Middle East operation, SAIC Gulf LLC.

At the time, SAIC said the sale of the oil and gas assets would enable the company to better focus on its strategic growth areas, including market segments in the energy sector, such as smart grid, renewable energy implementation, and energy efficiency, where it has successfully built its business through organic growth and acquisitions.

Previous spinoffs could set the stage for further divestitures within the government sector. Looking to the future, the SAIC, L-3 and ITT spin-offs could serve as a model for other large and mid-sized conglomerates looking to reorganize themselves by breaking-off units to survive in today's challenging federal marketplace.

It's also worth noting that investors prefer to invest in publicly-traded companies that are "pure plays," or single-industry enterprises, which could further drive the trend towards spinning-off or divesting various units going forward. Companies which could potentially spin-off units in the future include mid-tier defense contractors like Textron and Kratos Defense & Security Solutions, and tech giants such as Hewlett-Packard or VMWare.

Our Take:

Overall, we believe that SAIC will continue to be aggressive in making moves to remain competitive while streamlining operations, especially in the wake of proposed defense budget cuts and a challenging federal marketplace which is constantly evolving. We believe SAIC sees the writing on the wall with regard to the slowdown in the federal IT sector, and will be making investments in areas that are slated for growth over the next several years.

Moving forward, companies which will succeed in this challenging landscape will need to be flexible and make strategic adjustments where needed, and we believe SAIC is taking the right steps to remain competitive in these uncertain times.