CLARITY

Fifth Annual Highlights Report

Deltek

Know more.
Do more.®

GovCon Industry Study

2014

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GovCon Industry Study

Know more.
Do more.

Introduction

Know more.
Do more.
Profit more.

At this time last year, government contractors were hunkered down under the looming cloud of sequestration. Last year's Clarity report captured a mood of caution with a renewed focus on back-to-basics fundamentals to weather the uncertainty. What a difference a year makes.

Today, pervasive caution seems replaced by an overtone of optimism and confidence. Companies are looking outward and forward, anticipating strong growth in the years ahead. If there were a single word that could sum up this year's report, it is "growth." Firms cite Organic Top Line Growth as their top financial challenge and #1 focus for financial leaders this year. Managing Merger and Acquisition Activity also climbed the list of challenges as organizations look to expand their capabilities through these growth vehicles. And as a whole, respondents told us they anticipate 14% growth in 2015—an eyebrow-raising prediction in light of the economic challenges of the last few years.

In this fifth annual Clarity GovCon Industry Study, we offer a deeper look into the metrics and trends shaping today's government contracting environment. We had over 400 respondents from companies of all sizes share insights into their operations, finances and concerns. It includes several new questions and an entirely new section—Human Resources—aimed at capturing the most important issues for today's GovCon firms.

We invite you now to step inside today's world of government contracting. The following pages capture the most critical data points, their five-year trends and the forces driving them. Together, they paint a robust and up-to-date picture of this dynamic industry. Take some time to examine this picture. How do your own metrics compare? In what areas is your company leading the field? Where are opportunities for improvement? These pages will help you explore those questions and steer to you a stronger tomorrow.

About the Deltek Clarity GovCon Industry Study

Clarity Survey Results

We collected 427 responses from Executives, Business Development, Project Management, Finance and Accounting, and Human Resources leaders from the Government Contracting Industry.

Company Headcount

1 - 24	14%
25 - 99	32%
100 - 499	30%
500 - 999	9%
1000+	15%

Revenue Breakdown

< $20M	69%
$20 - 99.9 M	17%
> $100M - $1B+	14%

Revenue Breakdown By Sector

Federal	84%
State	5%
Other Public Sector	4%
Private Sector	7%

Company Headquarters Breakdown By Region

District-Maryland-Virginia	61%
South	16%
West	11%
Northeast	9%
Midwest	3%
Pacific	0%

Executive Summary

This fifth annual study of the government contracting industry contains new metrics and new sections to provide the most comprehensive review we have ever had the privilege of sharing with the government contracting industry.

The remaining pages are devoted to diving into the details, but before we do so, a step back reveals several clear themes that emerged from the responses:

1. **Growth**. Quite a number of the metrics point to a growth focus for companies of all sizes. With the overall economy stabilized, firms are looking for ways to expand, both organically and through combining with outside organizations. Anticipating success in these ventures, growth predictions for next year are bold.

    - With government spending back on solid footing, Organic Top Line Growth took the lead over Decreasing and/or Unpredictable Federal Spending Environment as the top issue facing financial leaders over the next 2-3 years.

    - The percentage of large firms >$100M-$1B+ projecting a 10%-19% growth rate for 2014 more than doubled from last year. For next year, firms are highly optimistic with target growth rate increases over 14%, on average, for companies of all sizes.

2. **Divergence by size.** When it comes to project management, bigger does not seem to be better. Across the PM metrics, smaller firms showed advancement while larger firms slipped.

    - 70% of mid-sized companies reported High or Very High Visibility into their project status, up sharply from last year's 38%. Larger companies slid in the opposite direction with all firms in the $1B+ revenue bracket reporting Low visibility. We saw similar divergence for project status confidence and schedule adherence.

    - Smaller companies nearly doubled in the number reporting High project management maturity, from 40% last year to over 75% this year. It was the opposite story for large firms. Compared to last year, twice the number of >$100M firms reported their project management discipline as Very Immature.

3. **Looming talent crisis.** Data we collected in prior years pointed to a morale issue for government contracting employees as their benefits took a hit through composite fringe rate reductions. Our first-ever foray into the Human Resources function confirmed the whispers that have floated in the halls over this period: GovCon is on the front end of a talent crisis. Negative press, executive salary caps, declining benefits and other issues are turning away high-potential hires. We wanted to get closer to this issue this year and what we found confirms many suspicions.

    - The top three challenges companies face in acquiring talent are closely intertwined. In order, they include; the Availability of Good Candidates, Matching those Candidates to an Open Position, and the Ability to Offer Competitive Compensation. Respondents tell us the second of these, Matching Candidates to an Open Position, consumes far more time and expense than any other talent management business process.

    - GovCon's inability to match commercial sector benefits is contributing to the talent drain. And that gap is only widening. This year's overall composite fringe rate came in at 23.1%, a decline for the fifth consecutive year. The shrinkage is most pronounced at small firms. Compared to last year, nearly 20% more firms in the <$20M segment reported a composite fringe rate under 15%.

Section 1:

Business Development Trends

Introduction

With the market moving out of the shadow of sequestration and onto more solid footing, 2013 was a year of recovery for government contractors. Responses to this year's survey suggest that firms knuckled down and zeroed in on their core Business Development practices, streamlining internal processes for better external results, and chasing growth through teaming and better targeting.

Win rates dipped, likely because with fewer opportunities competed, companies found more competition for the opportunities they bid. Firms are increasingly moving toward centralized management of Task Orders for better visibility and control. And they are tackling increased competition head-on through better targeting, partnerships and exploration of new markets. As the restrictive spending environment eases, we should see these kinds of efforts begin to pay off. Here is a closer look at how Business Development is shaping up for government contractors this year.

Key data points from the survey:

1. Win rates dipped on average compared to last year and fewer companies are reporting big spikes in any direction (+ or - 10% from the previous year). The largest companies ($100M-$1B+) experienced the toughest year, with just 14% reporting an increase in win rates—half that of the previous year. Our suspicion is that program delays and cancellations are partly to blame. Agencies also used the sequester year to increase efforts to hire small businesses. For the first time in several years, they achieved the 23% government-wide small business contracting goal. So while spending decreased, the pain was not distributed evenly.
2. 89% of firms working under Task Orders claimed a steady migration toward Centralized or Blended systems of managing them. As the role of Task Order-based contracts increases, companies are getting more sophisticated in their management and oversight of their response process to maximize success.
3. The percentage of total annual revenue from Cost Reimbursable (20%), Fixed Price (45%) and Time and Materials (34%) contracts remained, overall, relatively stable with a slight shift away from Fixed Price to Time and Materials. While the Administration has stated that procurement dollars are moving toward Fixed Price contracts, this move isn't yet showing up in the revenue mix.
4. Microsoft Excel continues its reign as the most widely used tool (30%) for managing business development opportunities. Deltek/CRM narrowed the gap with a 4-point jump over last year.
5. While More Restrictive Spending Environment remains the leading business development challenge, it appears to be waning as firms now grapple with Increased Competition and Limited Business Development Resources, both of which saw increases in the number of respondents selecting them as their top challenge.

> "The only difference in selling this year is we have traded spending turmoil for intense competition for every bid. Selling is still tough."

Please describe how Task Order programs are managed at your firm.

Despite a slight 4% year-over-year drop in the number of firms reporting the use of Task Order-based contract vehicles, the vast majority (83%) of contractors continue to rely on this vehicle. Digging into the data, we were unsurprised to find a continuing trend toward Centralized management of Task Orders (+5% over last year) as this structure provides greater command and control and better insight into performance on the vehicle. Likewise, Decentralized management continued its multi-year decline, dropping 6% from last year.

The challenges companies face in successfully competing for Task Order contracts are largely unchanged. As we've seen in the past, companies are frustrated by lack of access to information. Lack of Information on the Task Order Opportunities held firmly to its top spot with a 6-point bump in the percentage of respondents choosing it as their #1 challenge. Notably, We Are Not Able to Effectively Compete With Other Contract Holders received the second highest number of overall votes, up from fourth highest last year. This shift, along with individual survey comments, underscored the heightened price competitiveness in today's marketplace.

Figure 1: How are Task Order Programs Managed?

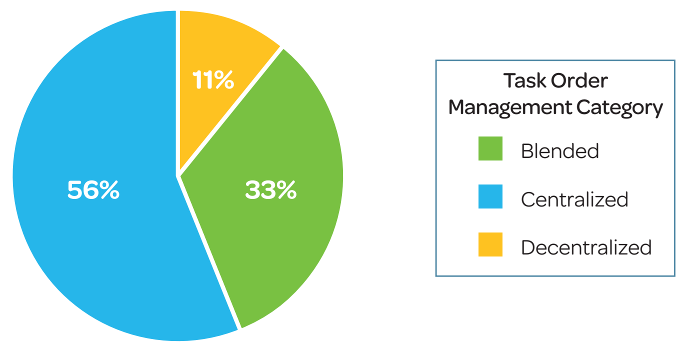
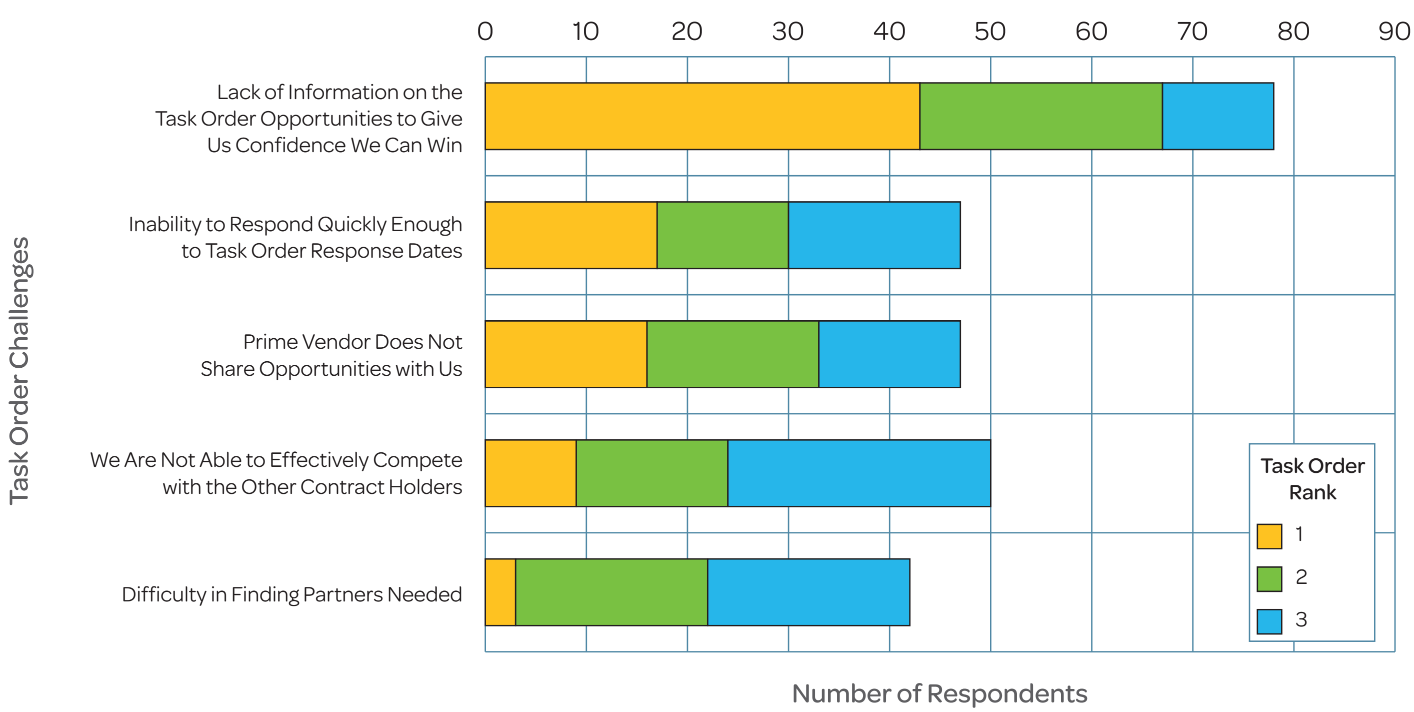


Figure 2: Top Task Order Challenges

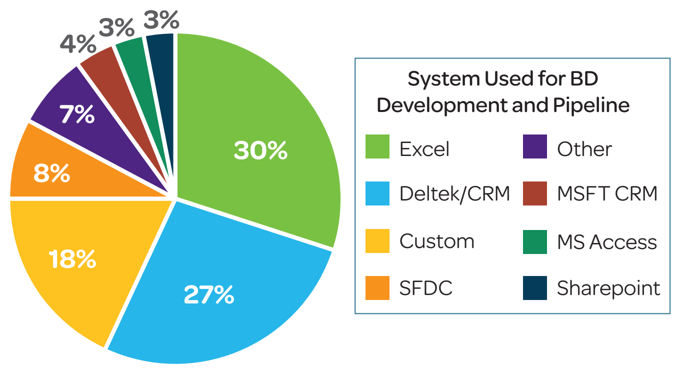


What system does your organization use to manage business development opportunities and pipeline?

The way in which firms manage their business development opportunities has a significant bearing on their ability to compete and win. Deltek/CRM (27%) came in close on the heels of Microsoft Excel (30%) as the most prevalent system used by respondents to manage opportunities. Custom solutions (18%) and Salesforce.com (SFDC) (8%) comprised the other significant pieces of the pie.

More interesting than the results, however, are the trends behind them. While Microsoft Excel comprises the largest share, its usage was up just 1% over last year while Deltek/CRM rose 4%, closing the gap. Slicing the data by firm size revealed that Excel is concentrated heavily in smaller firms while the largest organizations almost wholly use Deltek/CRM or Custom software. Both Custom solutions and SFDC appear to be on the downswing, however. There was a 2% retraction in the number of firms using Custom software while SFDC usage was sliced in half from last year's 16%.

Figure 3: System Used for BD Development and Pipeline

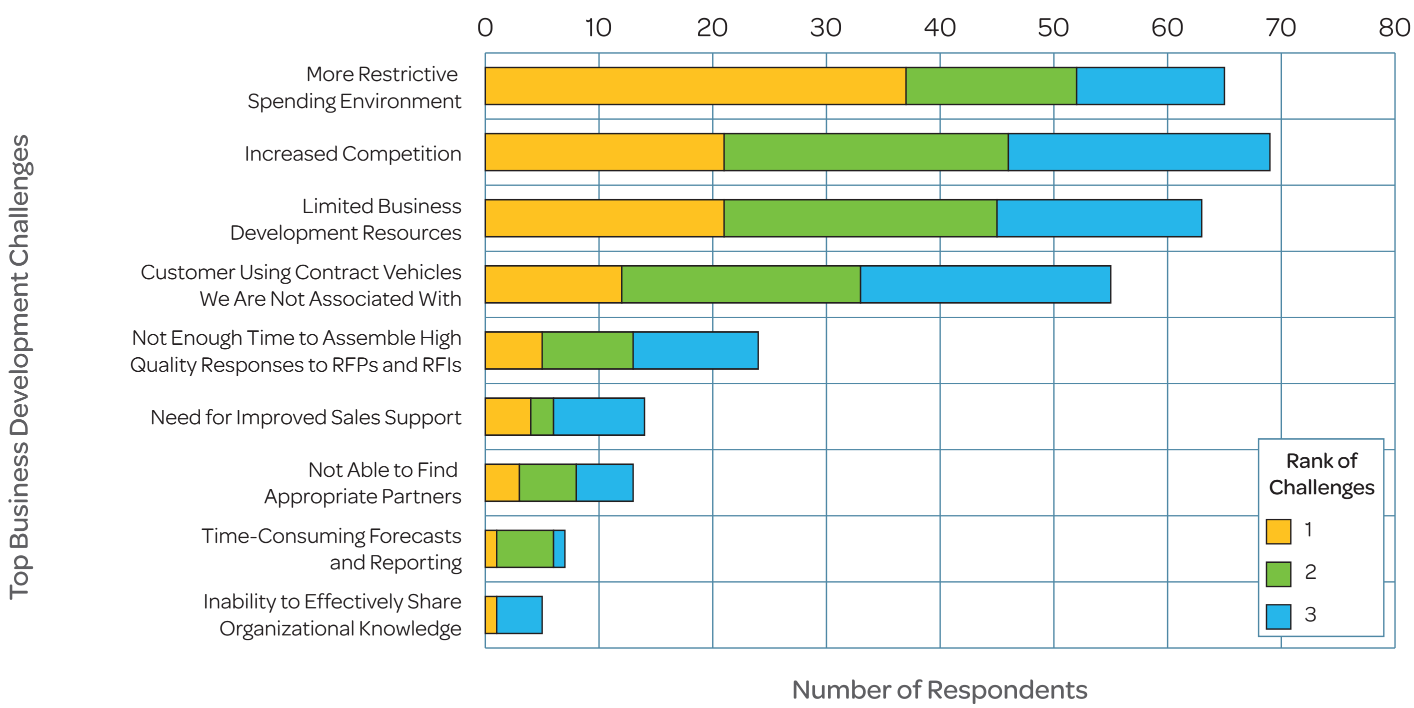


What do you see as your top three business development challenges?

Business development challenges saw a shift this year, perhaps thanks to relief from the political uncertainty that cast such a long shadow through much of 2013. While More Restrictive Spending Environment maintained pole position, the number of respondents choosing it as their #1 challenge shrank nearly 10 points and it fell behind Increased Competition in total number of responses. This contraction tells us firms have finally broken out of their post-sequestration caution mode amidst an environment of more concrete government spending and certainty from appropriations.

It is interesting to note that firms reporting Inability to Effectively Share Organizational Knowledge dropped dramatically over the past year, travelling from the middle of the pack to the bottom. This is possibly due to a renewed focus on internal system streamlining through new software and other means as companies embrace their reliance upon information sharing to more effectively compete and win.

Figure 4: Top Three Business Development Challenges

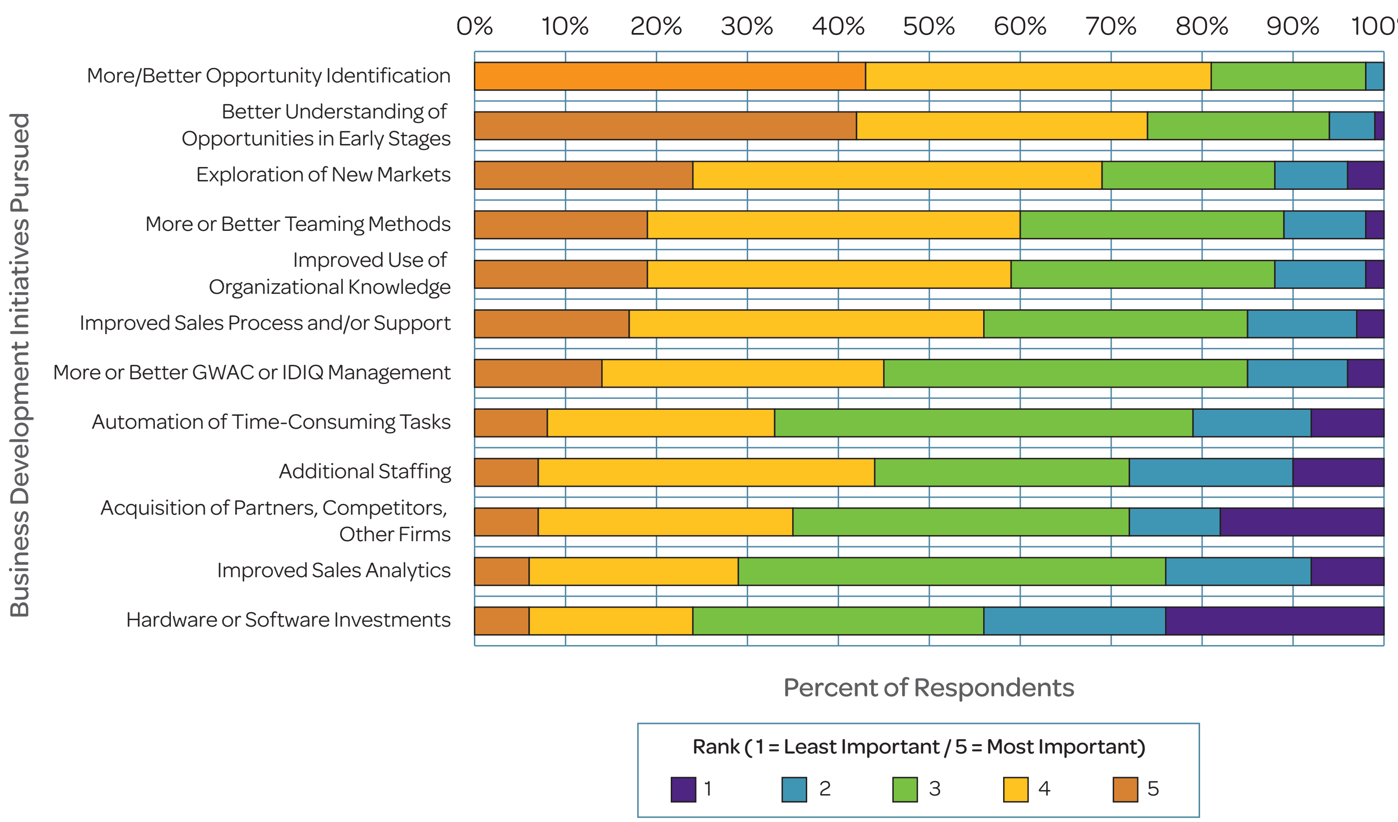


What business development initiatives are you pursuing to address these challenges? Assign the numbers 1 through 5 to the initiatives below, with 5 being the most important.

With firms listing top challenges as Increased Competition and Limited Business Development Resources, it was no surprise to see that the top initiatives centered on beefing up the pipeline and strengthening resources through teaming. Better identification and knowledge about leads earlier in the buying process, along with exploring how firms' capabilities might be applied in new markets, are by far the top initiatives companies are pursuing to address today's Business Development challenges. The ability to zero in on leads early—and recognize which are worth pursing—conserves limited resources, boosts win rates and leads to a healthier bottom line.

We saw a bump in the number of respondents choosing More or Better Teaming Methods as their #1 initiative. This is consistent with what we have heard in conversations with firms in the marketplace. Many of them are expressing the desire to add to their own capabilities in this highly competitive environment. Most other responses remained largely similar to last year with the exception of Improved Use of Organizational Knowledge, which fell from third position last year to fifth this year. This is no doubt a response to fewer firms reporting Inability to Effectively Share Organizational Knowledge as a Business Development challenge.

Figure 5: Business Development Initiatives Pursued



Clarity Outlook

For such a slow moving market, the GovCon sector has sure seen some wild swings over the last few years. The specter of sequestration just a few months ago has been replaced by much more budget certainty and predictability—and even a glimmer of hope for modest growth. Responses this year suggest the market has begun to reflect that stabilization. Feeling more solid ground beneath their feet, GovCon firms are beginning a slow re-hiring in Business Development to offset the deep cuts made pre-sequestration. They are also investing again in tools and software for more efficient Business Development practices and processes. We can expect to see this continue in a gradual, calculated manner.

With this more stable business environment, companies are looking for expansion opportunities but finding it difficult to differentiate in what is still an extremely competitive market. We anticipate continued stability and predictability in funding going forward, with firms seeking growth both inside and outside the government contracting sphere

Section 2:

Project Management and Risk Management Trends

Introduction

In previous years, Project Management has stood alone in its own section. This year we decided to combine it with Risk Management to underscore the tight connection between these two disciplines. As many have learned the hard way, when firms fail to consider risk sufficiently, they find themselves in choppy waters burning resources to keep projects afloat. That correlation was very apparent when we laid the data from these two areas side by side.

Companies would do well to keep this correlation in mind as they think about risk and its role in the organization. In the past, an overwhelming majority of firms predicted risk importance would increase in their organizations over the next 2-3 years. This year, we saw a big drop in that number. With so many tools and evolving best practices emerging in the area of risk, this does not seem the right time to ease up here. Companies that are embracing these developments are seeing positive changes in their project management stats.

Key Data Points from the Survey:

1. 7 in 10 mid-sized firms reported High or Very High visibility into their project status, a huge leap from last year's 38%. Larger companies slid in the opposite direction with almost 60% of firms in the $100M-$1B+ revenue bracket reporting Low to Very Low visibility. The divergence is similar for project status confidence, likely due to visibility—or lack thereof.

2. Smaller companies significantly increased the number reporting project management maturity, from 50% last year to over 75% this year. At the same time, compared to last year, twice the number of >$100M-$1B+ firms reported their project management discipline as Very Immature.

3. Companies are reinvesting in project managers. Larger firms of >$100M-$1B+ report that 50% of their PMs have formal certification, double last year's figure. Small companies <$20M also showed a spike with a 14% increase in the >50% PMP certified category.

4. Risk/Opportunity management slightly leans toward maturity, with just over 50% of all firms reporting they are Somewhat or Very Mature in this discipline.

5. 28% of firms across the board admit not managing a risk register or risk-adjusting their project plans. Those who do tend to rely on individual program managers to do so.

6. A sweeping majority of firms report that Risk/Opportunity initiatives are most likely triggered by forcing functions rather than a preemptive strategic decision.

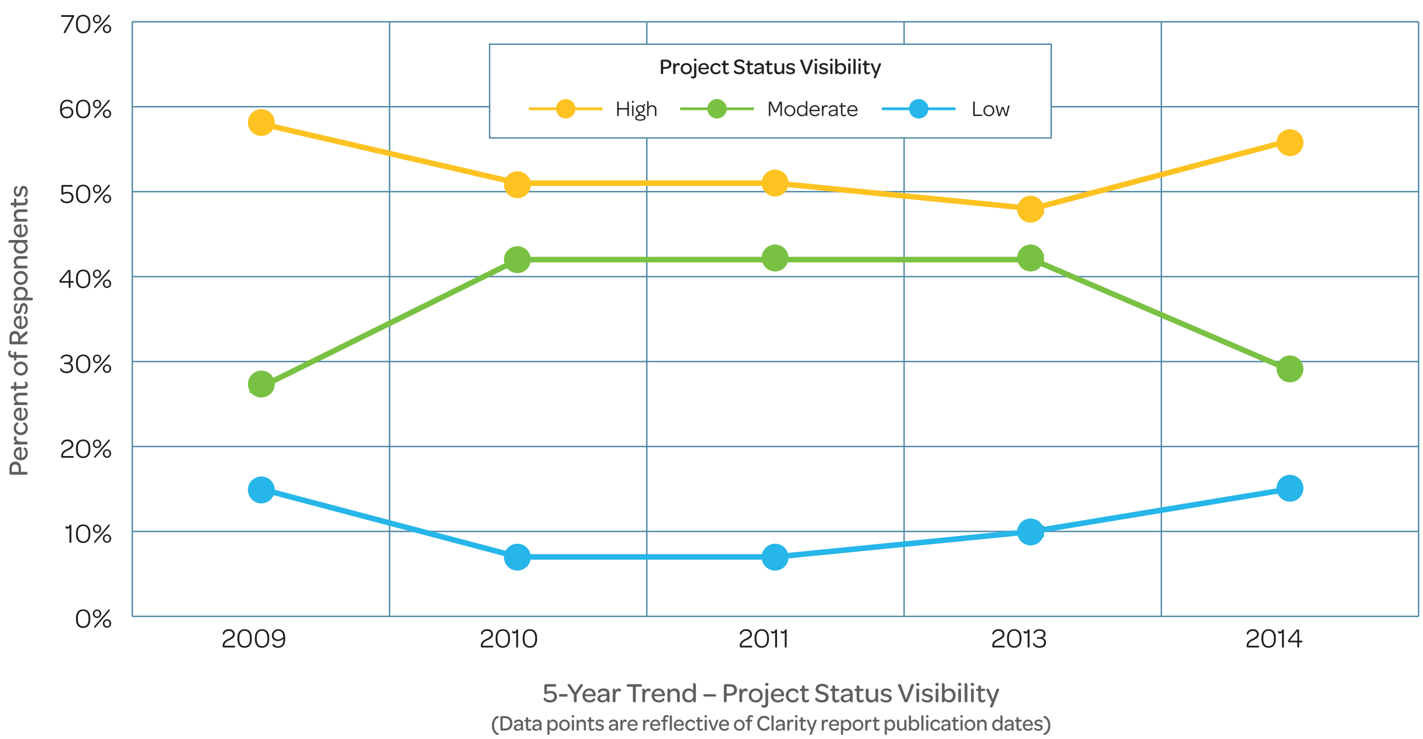
"Program management has become even more important for us in light of fewer projects and more occurrences of teaming."

How would you rate the visibility into the status of your organization's current projects?

We continue to see a divergence in visibility based on firm size. For the fifth year running, large firms (>$100M) reported a decrease in visibility. Last year, nearly 50% of them said they had High or Very High visibility into projects; this year, it was less than 40%. Breaking down the data further, we found the very largest firms ($1B+) universally acknowledged having Low visibility.

Mid-sized firms saw a striking shift in the other direction. While just 38% of them reported High or Very High visibility in our 2013 report, this year that figure ballooned to 70%. The smallest firms held relatively steady compared to last year. Mid- and small-sized companies show a willingness to engage with new technologies to help streamline their processes, leading to these visibility gains. If larger companies don't reverse their slide, they will risk being outperformed and outsold by smaller competitors.

Figure 6: Project Status Visibility (5-Year Trend)



"We are much better than in the past at having a real-time view of our project status and being able to report on and communicate it."

Please rate the maturity of your firm's project management discipline?

With each passing year, we'd expect to see firms of all sizes increasing in PM maturity, but that is not the case. Instead, the largest firms are trending toward increased immaturity. This year, 1 in 10 >$100M firms rated their PM discipline as Very Immature, double the number from last year. We will be keeping an eye on this metric; its continued expansion would spell trouble for big firms.

Still, there are some bright spots within the project management discipline. The smallest companies seem to have grabbed the project management bull by its horns and are driving it in the right direction. 75% of firms under $20M reported a Somewhat Mature or Very Mature project management discipline this year, nearly twice the 40% reporting in these brackets last year. This is a big leap forward for these smaller companies, which again appear to be preparing themselves for a competitive marketplace where every dollar of profit is precious.

"Project Management used to be something we left to specific professionals. Now it seems like our systems, procedures and training all surround getting a better feel for our projects."

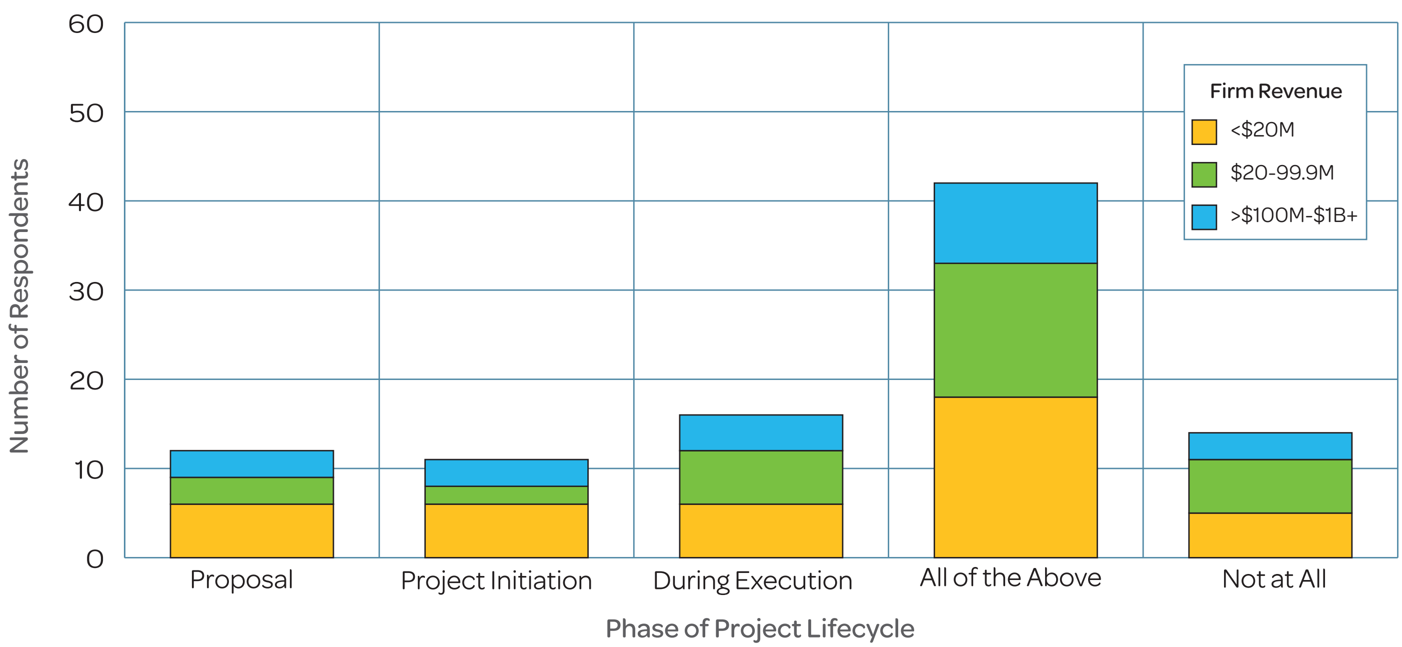
Figure 7: Project Management Maturity by Firm Revenue

At what phase of the project lifecycle do you perform schedule risk analysis (SRA)?

In a new question this year, we asked survey takers to tell us when during a project's lifecycle they perform schedule risk analysis (SRA). The density of responses in All of the Above suggests companies have embraced SRA and feel it is important to ensure that what they win is executable. In the future, we may even see companies doing not just SRA but also schedule optimization to maximize profits.

There are interesting stories that lie beneath these numbers, too, as we correlate this SRA data with project management maturity. None of the largest firms performing SRA in all project phases have a Very Immature PM discipline. Similarly, large firms with a Very Mature PM discipline are represented in the "All of the Above" segment for SRA at nearly twice the number of their less mature counterparts. The same phenomenon appeared when we cross-referenced SRA data with project status confidence—higher confidence correlated directly with more frequent SRA. This direct and clear connection puts an exclamation point on the importance of performing SRA in all phases of business.

Figure 8: Phase of Project Lifecycle Where SRA is Performed



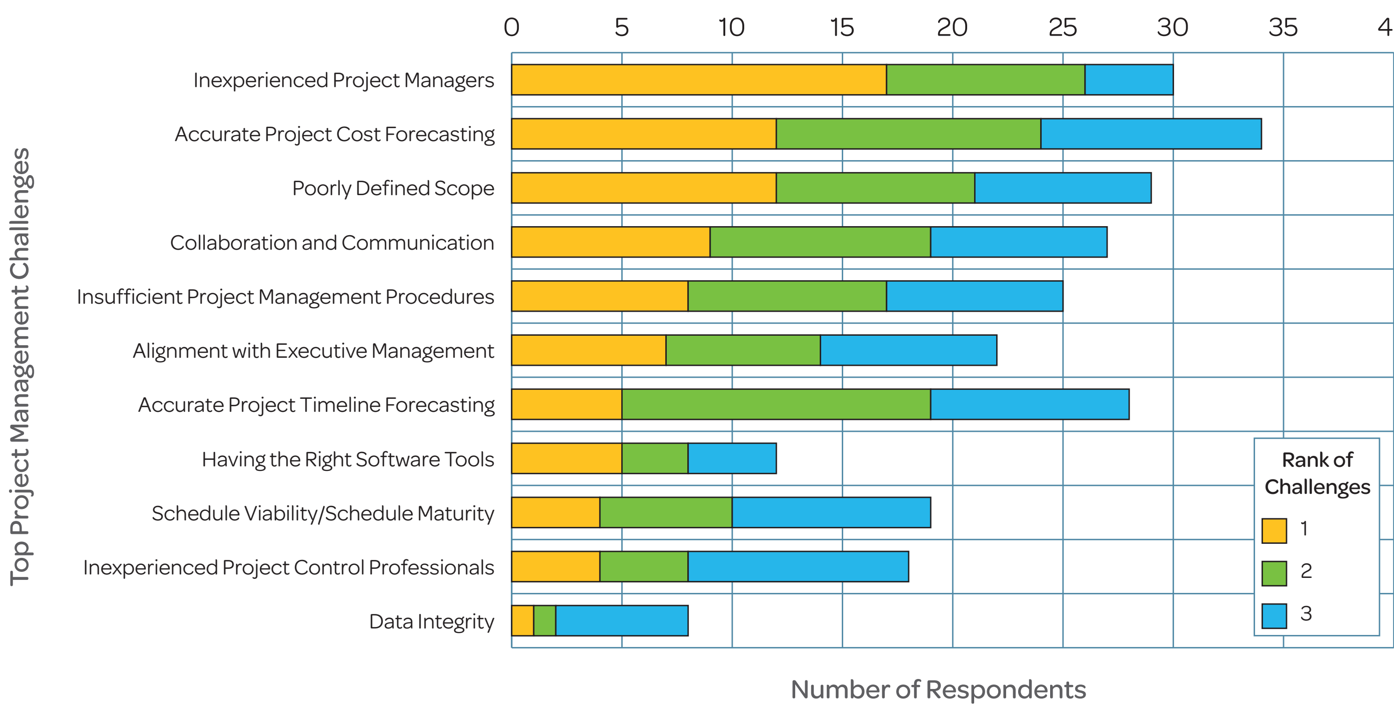
"We started performing (SRA's) for every significant bid two years ago. It has absolutely enabled us to bid more confidently, and I feel like those projects get launched more smoothly."

What do you think will be the top three challenges facing the Project Management function within your organization over the next 2 - 3 years?

For the fourth consecutive year, Inexperienced Project Managers led as the top challenge facing the PM function. The results were no surprise considering the deep cuts made in 2011-12 when companies were slicing down to bare bones. However, firms appear to be reinvesting here. Organizations in the >$100M-$1B+ bracket reported a doubling in the number of program managers with PMP or other formal certification. We also saw a spike at the smallest companies (<$20M). If investments continue, we should begin to see a contraction in the Inexperienced Project Managers bar.

Challenges #2 and #3 swapped places from last year due to a bump in Accurate Project Cost Forecasting, likely from uncertainties surrounding sequestration. We also saw a couple changes in the middle of the pack. Alignment with Executive Management and Having the Right Software Tools each nudged up one spot from a year ago. Some of the movement no doubt came in the wake of sequestration, which forced firms to take a hard look at their underlying processes and challenges. In good times, it can be easy think your project management function is working well; tough times often reveal a harder truth.

Figure 9: Top Project Management Challenges



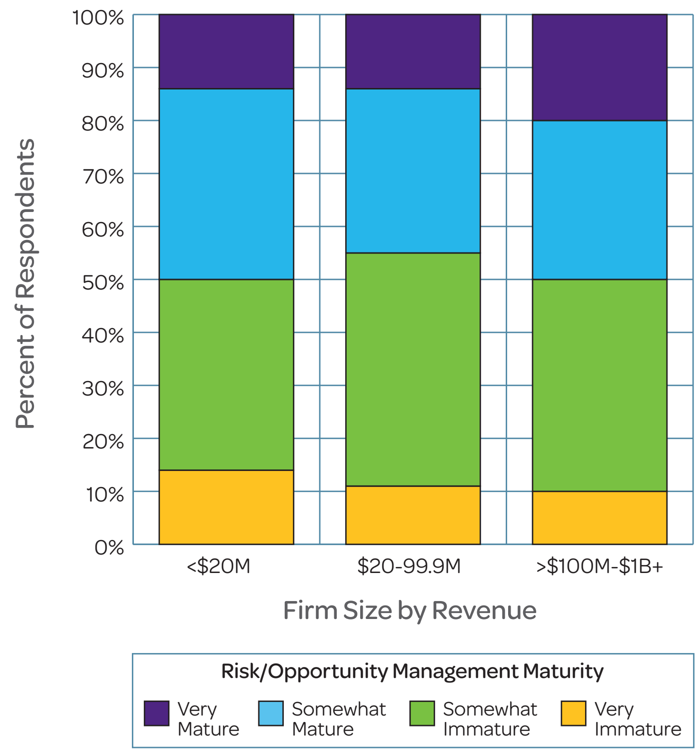
"My biggest fear for our projects is that our PMs are stretched too thin across projects. If we had 20% more PM capacity, things would look a lot different."

Please rate the maturity of your firm's Risk/Opportunity management discipline.

The results here are similar in shape to firms' project management discipline maturity. Like PM, risk processes continue to be immature, partly due to lack of enforcement for this standard discipline. The fact that 1 out of every 2 companies is reporting their Risk/Opportunity management discipline as either Somewhat or Very Immature should be a wake-up call to government contractors. This is an area that demands attention as firms today cannot afford derailed projects and a tarnished reputation in the area of project delivery.

We have been saying for years that we expect firms to begin concentrating on this area. We still see this day coming, but so far a dearth of collaborative risk management tools has hindered progress. Forthcoming solutions will enable companies to gain consensus on their biggest risks and understand how to mitigate those risks. Once firms implement these tools, we should see maturity begin trending up.

Figure 10: Maturity of Firm's Risk/Opportunity Management Discipline by Firm Revenue

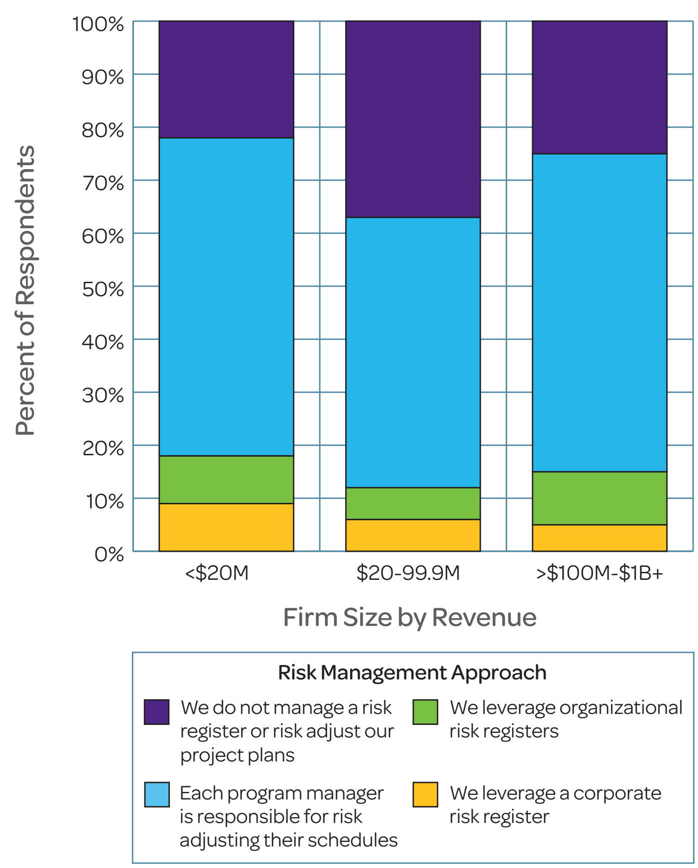


How does your company manage risks that should be applied to project plans?

For the first time, we asked firms to tell us how they manage risks that should be applied to project plans. Overwhelmingly, the preference is to leave individual program managers responsible for risk adjusting their schedules, but this puts PMs out on a limb. Without a corporate risk register, PMs are unable to leverage collective corporate knowledge. These results show a need for better tools to monitor risks at the PM level and, eventually, the need for a shift to risk management at a higher corporate level.

A far more alarming revelation here is that 1 in 5 firms across the board do not manage a risk register or risk-adjust their project plans at all. Those 20% of respondents total over $500B a year in revenue, meaning half a trillion dollars of taxpayer money is invested where risk is unmanaged and unmitigated.

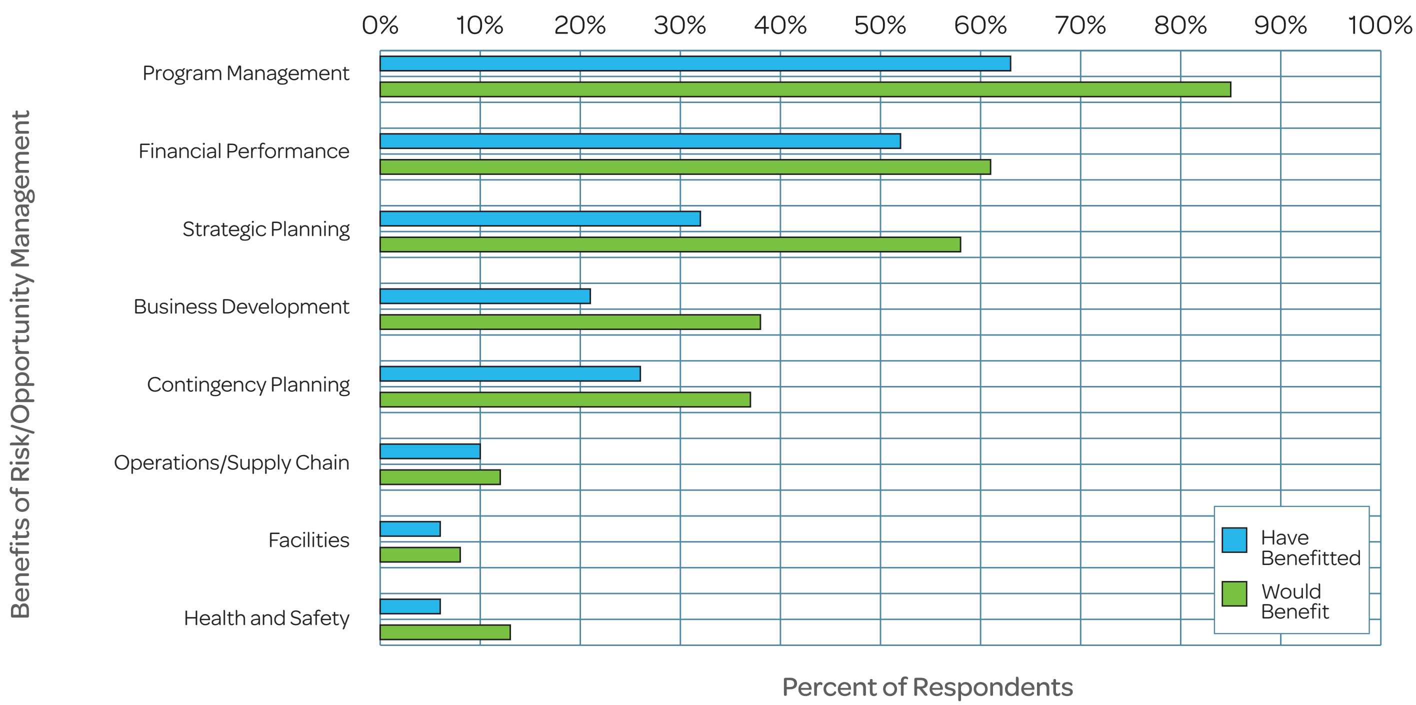
Figure 11: Risk Management Approach by Firm Revenue



Please identify the areas of your organization that have benefited from Risk/Opportunity Management.

In spite of reported softness in Risk management maturity and practices, this year saw a slight push to the right for "Have Benefitted" answers, suggesting firms are aware of the benefits. Program Management, in second place last year, vaulted into the top spot and closed last year's biggest gap between "Have" and "Would." In 2013, just 38% of respondents said this area Has Benefitted; today, more than 6 in 10 make that claim. The leading "Have Benefitted" response in 2013, Financial Performance, pushed past the 50% mark this year but dropped into the #2 position behind Program Management. Going forward, we expect to see leaders incorporating Risk/Opportunity management into every facet of their business as well as driving it down into the rank and file.

Figure 12: Organizational Functions Benefiting from Risk/Opportunity Management



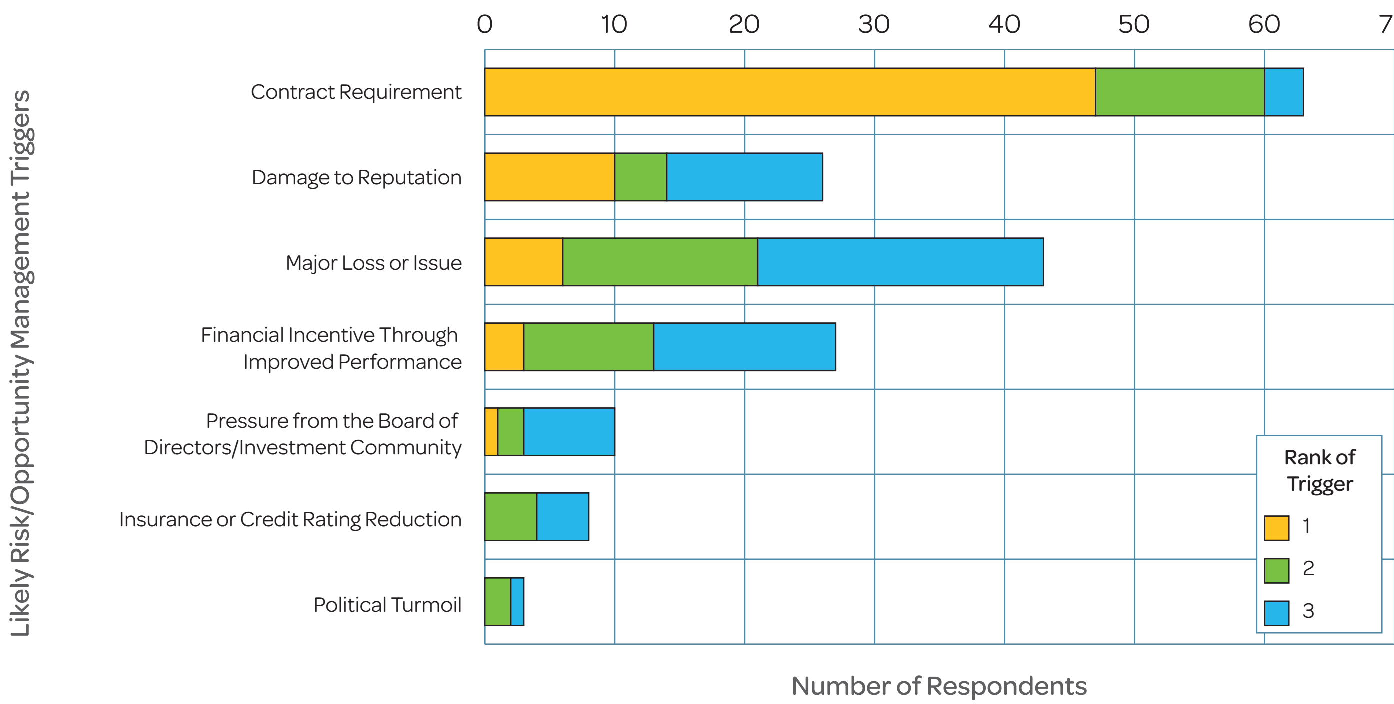
"We are very reactive when it comes to risk, and every time we find ourselves fighting a fire we say 'we should have seen this coming'."

What would most likely trigger a Risk/Opportunity initiative for your company?

For years, we have watched this question to see whether firms are recognizing the strategic value of risk. We are not yet there. This year's answers show risk practices still hover outside the strategic aspects of a business.

With an even wider lead than last year, the most likely trigger for a Risk/Opportunity initiative remains a Contract Requirement. This answer and the two that follow it are forcing functions, meaning a risk initiative will only be undertaken if compelled. It is not until we get down to answers 4-7 that strategic decision making shows up. Companies that recognize risk management as a strategic advantage will see higher profits and improved results across a range of critical metrics. As leaders begin to recognize this reality, we should see Pressure from the Board of Directors start inching up the list of triggers.

Figure 13: Likely Risk/Opportunity Management Triggers



Clarity Outlook

It may take a real event to shake risk management to the top of government contractors' strategic priorities. Consumed with the day-to-day challenges of keeping projects on track and costs in check, companies are pushing off risk management adoption at the strategic level. There could be repercussions to this postponement—and possibly not too far in the future. With project visibility and maturity languishing on the low end, particularly for large firms, conditions are ripe for an unexpected event.

The day is coming when risk will be more widely embraced and a solid risk strategy will permeate every corner of the business. When that happens, we will begin to see a turnaround in key metrics such as visibility, on-time/on-budget and other critical project measures. Firms that continue to turn a blind eye to this area put themselves at the mercy of the times, subject to the rapid ebb and flow of policy, administration changes, or geo-political disturbances.

Section 3:

Financial Metrics and Operational Trends

Introduction

The clouds of sequestration seem to be dissipating, and firms are once more reflecting a Spring-like optimism for their businesses. They are bullish on growth for this year, with a large contingency of firms projecting in the 10% - 19% growth rate range, signaling a clear shift in the mood of the industry.

Today's optimism seems rooted in solid business operations. Monthly invoice cycle times are down. Days Sales Outstanding (DSO) plummeted. The composite fringe rate continued its four-year decline. These results suggest the intensive cost-cutting and improvement of business processes during the lean years are paying off in today's more stabilized economy. Here is a closer look at these financial trends.

Key Data Points from the Survey:

1. Overall profits were essentially flat year over year at 10.8%. This marks a leveling-off after two years of big gains. Contributing to this figure was a drop in profits at large companies offset by a boost in profits at smaller firms.

2. Average Monthly Invoice Cycle time is just 9.4 days, down significantly from last year's 11.7 days. The drop was driven largely by small companies (<$20M), 20% more of whom reported invoice cycles of 0-4 days. DSO plunged from 43.7 days last year to just 34.6 today, which came as a surprise. Having heard firms bemoan delayed payments by federal agencies due to the three-week government shutdown, we expected DSO to rise.

3. The percentage of large firms >$100M-$1B+ reporting a 10%-19% Growth Rate for the current year more than doubled over 2013. However, unlike last year, no one in this category reported an expected growth rate of >20%. For next year, firms are highly optimistic with target growth rate increases over 10% at firms of all sizes.

4. The top two challenges facing financial leaders over the next 2-3 years flip-flopped from last year, with Organic Top Line Growth taking the lead over Decreasing and/or Unpredictable Federal Spending Environment. Cash Flow came in third but significantly narrowed the gap since last year with the #2 choice.

5. This year saw a slight growth in Unallowable Costs for small firms. Last year, just under 30% of firms <$20M reported 3%+ growth, while this year 40% reported in that range. For the biggest firms, there was a slight increase at both ends—those reporting >3% and those reporting <1%. We may see this number start to rise as more and more compensation rolls into the unallowable category.

6. The Overall Composite Fringe Rate is 23.1%, continuing a 4-year downward trend. The shrinkage is most pronounced at small firms—almost 20% more firms in the <$20M segment reported a Composite Fringe Rate under 15%.

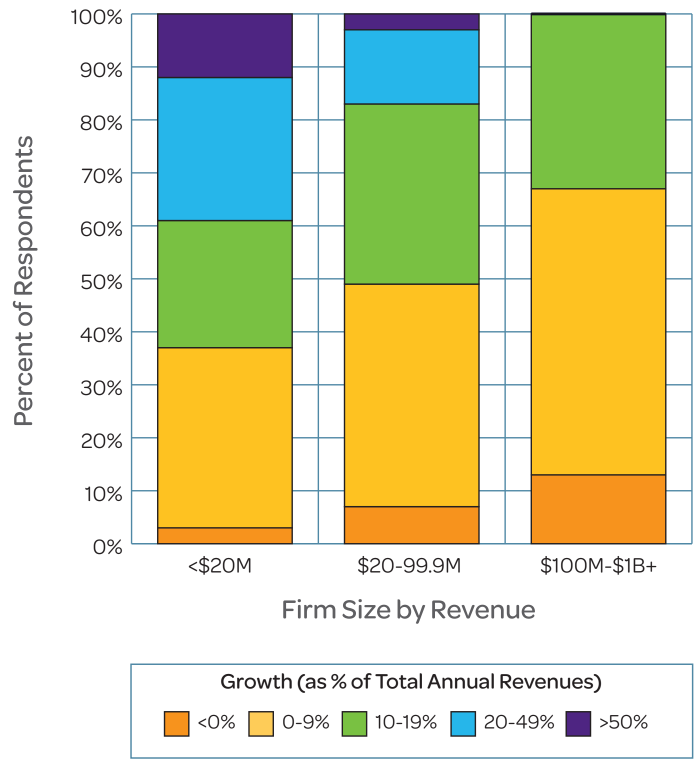
> "It seems like we are fighting both the top line and the bottom line to earn the same profit for the past few years."

Please outline historical and planned growth rates (as a percent of Total Annual Revenues)—Current year growth rate (projected).

Today's more stable environment has firms predicting higher growth rates for the current fiscal year. Mean growth for 2013 was 7.6%, slightly less than firms had anticipated in the early part of the year. Expectations for 2014 are much higher. The number of large firms >$100M-$1B+ forecasting a 10%-19% growth rate for the current year ballooned to 33% from just 5% in 2013. However, no one in this category anticipates 20%+ growth; last year, roughly 7% of large firms predicted it. Small companies averaged a 13.8% growth prediction, up nearly 4 points over last year. Positive metrics from small firms, including DSO and net profits, adds some credence to their optimism.

We also asked firms to predict their growth rates for next year. Expectations were overwhelmingly positive with no negative growth predictions from any of the respondents. Moreover, we saw significant (10%+) target growth rate predictions across the board for 2015: +12%, 30%, and +38% for small, medium and large size firms, respectively. While growth indicators look promising to us also, we feel these numbers may be a bit aggressive.

Figure 14: Current Year Growth Rate (projected) by Firm Revenue

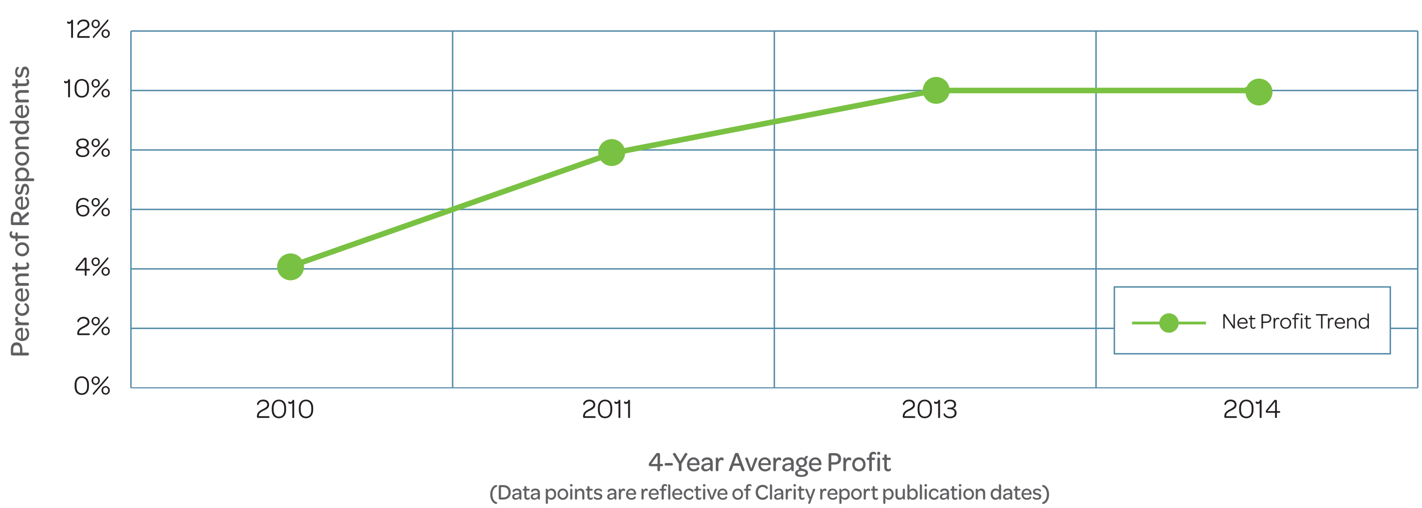


Please report on Net Profit for the most recently completed fiscal year.

Overall profits held relatively steady at 10.8%, marking a leveling off after two years of big gains. Yet the number hides the real story as each segment experienced a sharp swing in the profit needle. Larger companies saw profits tumble, reversing the gains reported in 2013. Compared to last year, double the number of firms in the >$100M-$1B+ bracket reported profits of 0- 4%. At the same time, large firms reporting 15%+ profits fell by half to 7%.

The story was reversed in the small- and mid-sized segments. There, profits climbed, offsetting the drop at the larger firms. We anticipate profits for all categories to improve this year. Organizations are right-sized from a cost perspective. And while choppiness in the economy impacted business last year, that appears to be leveling out, paving the way for a more profitable 2015.

Figure 15: Net Profit (4-Year Trend)



Please report on the following metrics—Average Days Sales Outstanding. Data should reflect firm performance for the most recent completed fiscal year.

The downward trend in invoice cycle times continues, likely driven by more widespread adoption of technology to automate and streamline the invoice process. The overall average is now 9.4 days, down significantly from last year's 11.7 days. The drop was led by small companies (<$20M), where 20% more than last year reported an increase in invoice cycles of 0-4 days. Firms <$20M are now reporting invoices cycles between 0-4 days at almost twice the frequency of firms $20M+.

Overall Days Sales Outstanding (DSO) is also down from years past. Now at 34.6 days, the figure shed nine days from last year's mark. Most notably, firms of all sizes reduced their percentages in the >60 days category. In last year's report, we projected an expansion in DSO based on an anticipated slowdown in payments from the government. Our projection was overshadowed by Uncle Sam's insistence that firms utilize electronic billing on some contracts. This is a win-win for contractors and the government alike. Contractors can bill faster, get paid more quickly, and lower their costs. The government spends less time moving paper and auditing invoices. Everything is in one central system rather than on many pieces of paper, driving faster, more efficient billing and payments.

Figure 16: Average Invoice Cycle

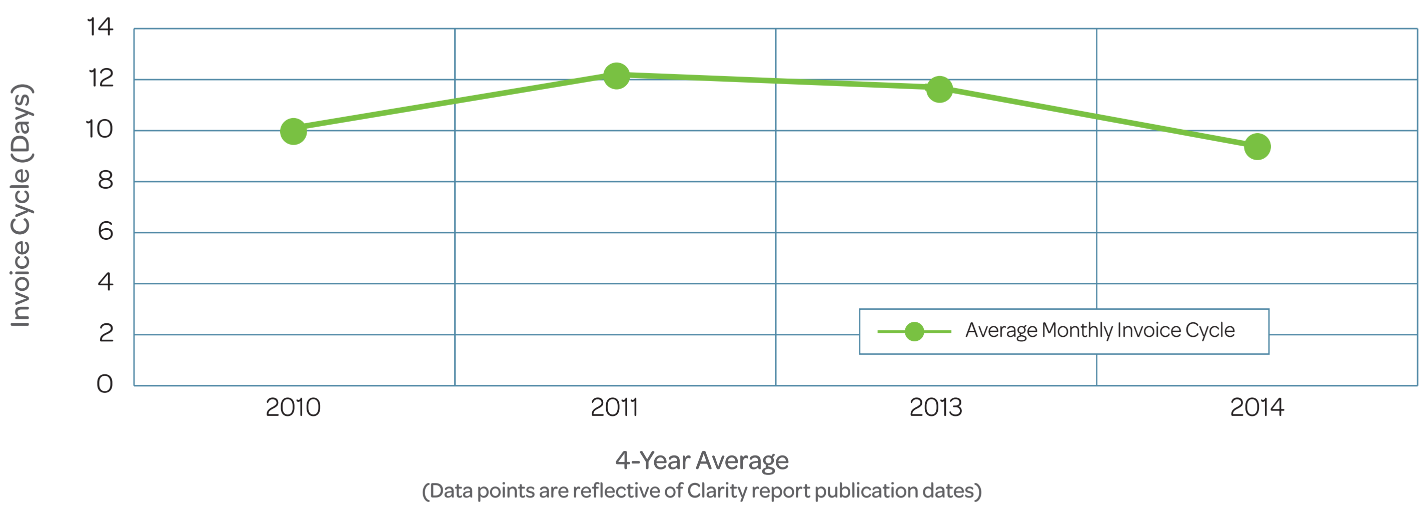
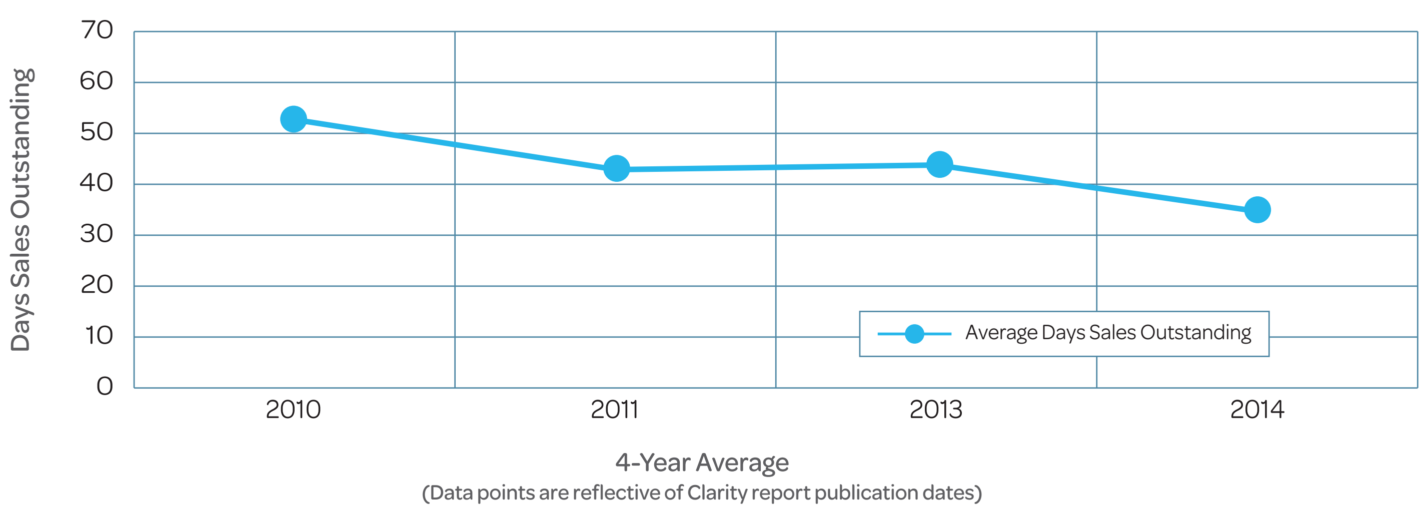


Figure 17: Average Days Sales Outstanding

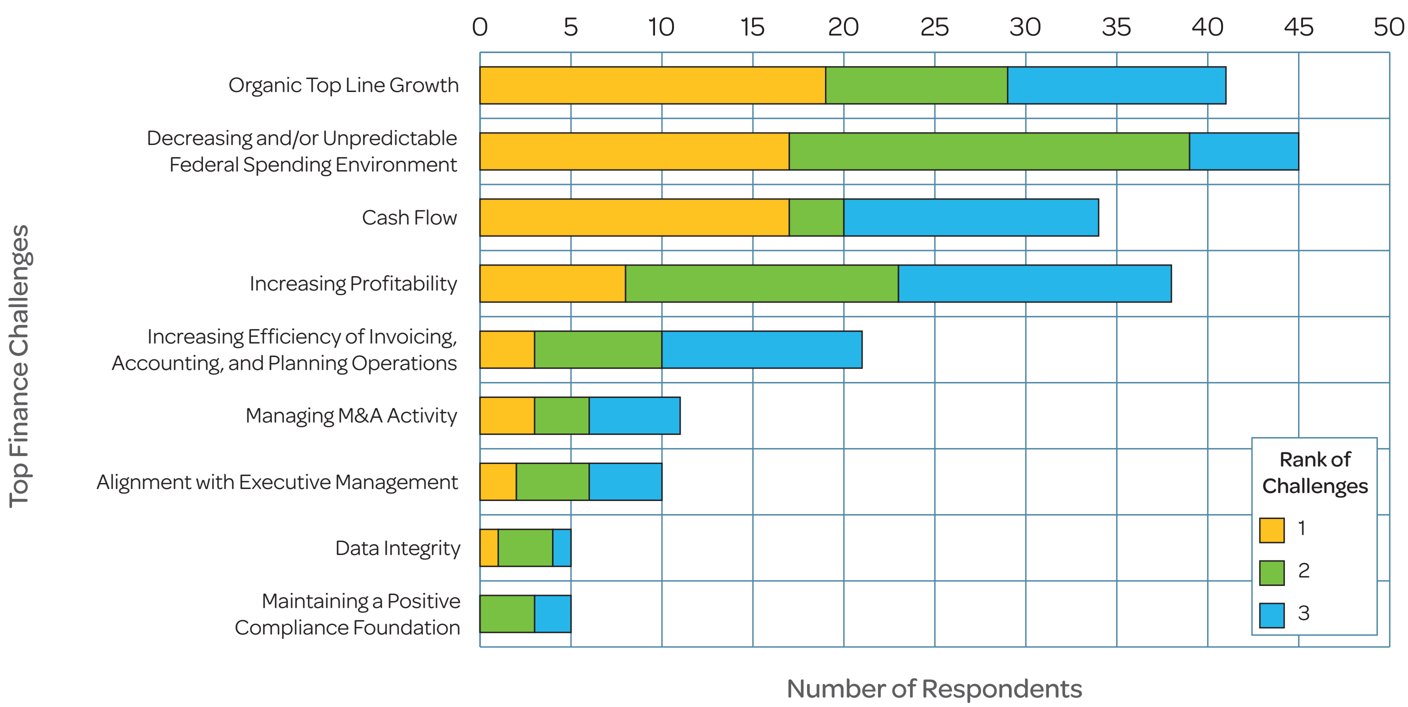


What do you think will be the top three challenges facing the financial leaders of your organization over the next 2-3 years? Please rank your top three choices.

Last year, Decreasing and/or Unpredictable Federal Spending Environment made its debut in the top spot. This year, with the sequester threat eliminated, it slid into the #2 position behind Organic Top Line Growth. This makes sense considering the pervasive optimism about a return to growth after several years of clamping down on internal costs to control profits. The spending environment, still on the map in second place, tied for #1 votes with Cash Flow, which pulled in nearly twice the number of #1 responses as last year. Cash flow has become more critical than ever to small- and mid-sized companies. The economic storms of the past few years strained the coffers of these smaller entities and they are looking to re-build them in today's more stable environment. Assuming DSO continues to decline, cash flow should improve throughout 2014.

As profits climb, firms often look to expand capabilities through mergers and acquisitions. This may explain why Managing M&A Activity, a low priority when firms were hunkered down last year, moved from last place to the middle of the pack this year. This correlates with the answers to a survey question we posed about firms' long-term strategies for continued growth. One key theme that emerged involved diversification of the customer base and revenue streams. Despite stabilization in spending, firms clearly understand they cannot be a one-trick pony and expect to grow.

Figure 18: Top Finance Challenges



Clarity Outlook

We agree with the pervasive sentiment that growth is on the horizon for GovCon firms—just maybe not at the rates firms tell us they anticipate. Growth predictions for 2015 from all respondents averaged 14%; we think it more likely to be in the 7-9% range.

Firms should realize that growth of any size will demand increased precision in the way businesses are run. With cash flow a chief and growing concern for small and medium firms, it is imperative that companies have the right systems in place to run the business. This includes systems for doing business with the government electronically—soon to be a mandate in many areas. While electronic billing will aid DSO and other invoice/payment metrics, it will also force businesses to automate processes which, for some, are still manual. While growing pains are inevitable, the end result will be beneficial to all.

Section 4:

Compliance Trends

Introduction

Look out, contractors—here comes the DCAA and the DCMA. This year's results revealed significantly greater scrutiny of large firms as well as a deeper examination of costs across firms of all sizes. This is unlikely to let up any time soon, too, as the federal government seeks savings in every corner of the industry.

In particular, the Defense Contract Audit Agency (DCAA) has begun touting year-over-year increases in documented savings to the government. Demonstrating a growing ROI gives DCAA the ammunition it needs to expand, but it comes on the backs of government contractors. Every dollar DCAA can declare unallowable in its audits makes the agency appear more successful. Unfortunately for GovCon firms, this audit-rich environment in which every dollar is intensely scrutinized appears to be the new normal.

Key Data Points from the Survey:

1. Half of all audits at the smallest firms (under $20M) were Pre-Award (30%) and DCMA (20%), a sharp increase in both types.
2. Incurred Cost Submission (ICS) continues to lead as the most costly type of audit with which to comply. Nearly three-fourths of firms chose it as their #1 response.
3. Indirect Rates jumped from the #3 top audit issue in 2013 to #1 this year, leaping over Internal Controls and Labor and Time Keeping.
4. 50% of firms in the $100M-$1B+ revenue range saw a significant increase in oversight. The vast majority of smaller firms said it stayed about the same.

"We used to pull Compliance resources in as needed. Now we have two full-time staff responsible for pulling information required to respond to audits."

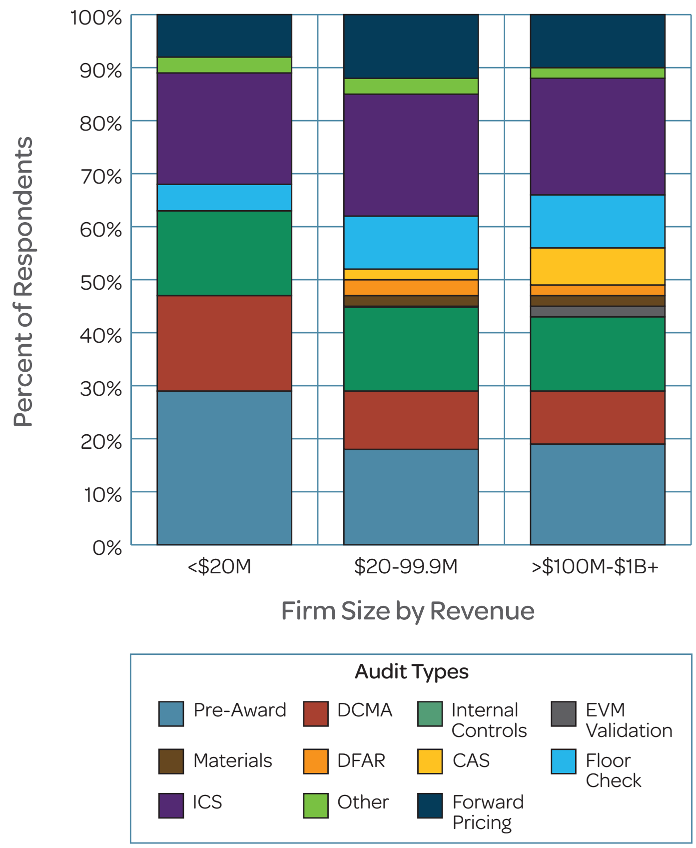
Which audits has your firm undergone within the last two years? (Select all that apply.)

While the government shutdown moderately slowed the total number of audits last year, federal agencies are already ramping their audit machines back up. This year's survey revealed several types of audits on the rise. For firms under $20M, DCMA more than doubled to nearly 1 in 5 of all audits. Pre-Award jumped 10 points to comprise 30% of the audits performed at small companies. The message: small companies must be ready to show they have FAR and CAS compliant project-based accounting systems in place to chase new business because they will get audited.

The largest companies over $1B experienced nearly equal distribution of audit types. All firms saw an expansion in ICS audits as DCAA worked to relieve its backlog.

"We are seeing way more Pre-award audits than ever before."

Figure 19: Top Audit Types by Firm Revenue

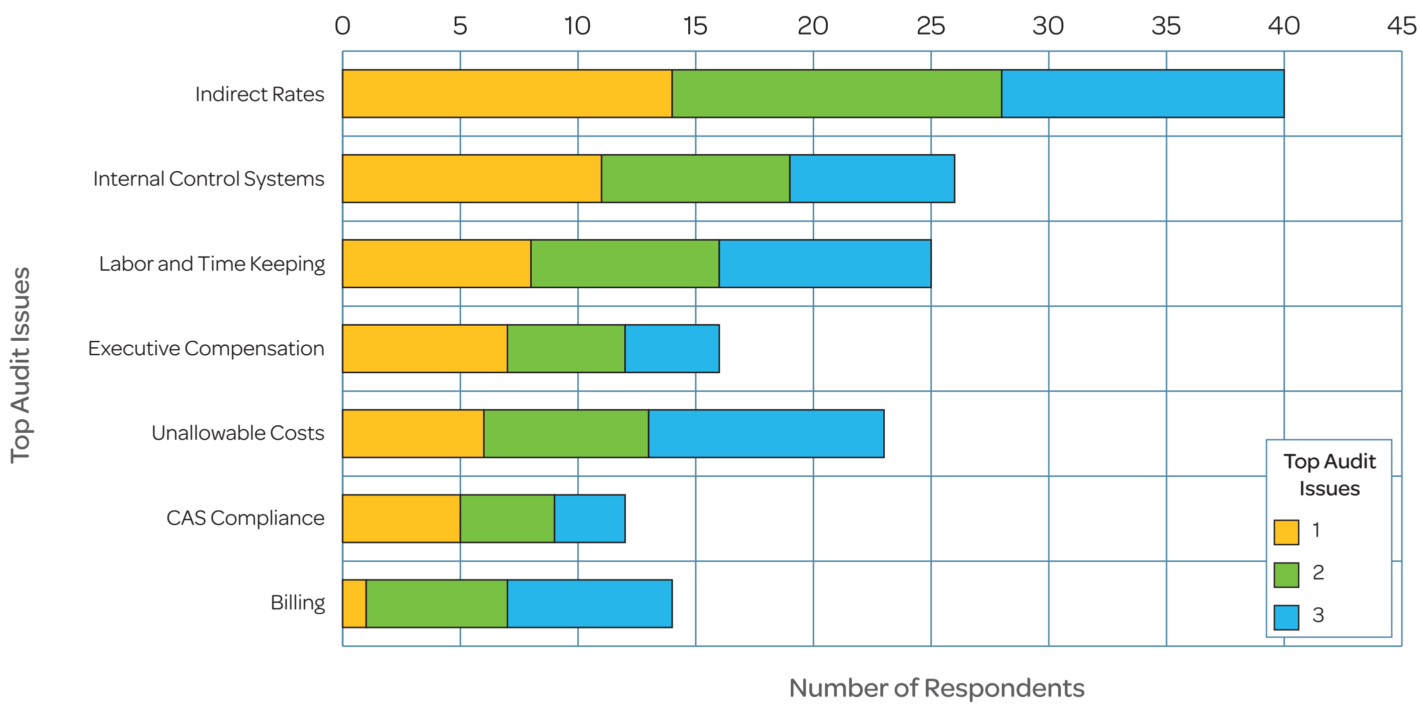


What are your top three audit issues over the last year?

Indirect Rates leap-frogged over Internal Controls and Labor and Time Keeping to take a dominant hold as the top audit issue this year. We saw the front edge of this shift last year as several comments noted the increased scrutiny DCAA was putting on financials. This trend may continue with more incurred cost checks and fewer floor checks going forward.

Part of the reason for this shift is the backlog of Incurred Cost audits at DCAA. Staffing challenges at the agency forced delays in many of these audits through the late 2000s. In late 2012/early 2013, the agency began relieving that backlog by ramping up these rate-focused audits. As a result, Indirect Rates are likely to retain a firm grip on the top position for the next few years.

Figure 20: Top Audit Issues



Clarity Outlook

The cost scrutiny pendulum is on the rise. The growing number of Incurred Cost audits, individual comments about meticulous cost examinations, and proposed regulations around GovCon executive compensation caps all point to an environment in which every penny—not just every dollar—will be put under the microscope. Having systems that can tie every hour billed, and every material used, back to the contract as well as a clear accounting of direct and indirect charges is critical to staying compliant while lowering the cost of compliance.

We do not expect this to ease up any time soon. DCAA has embraced an ROI-positive approach to their work as a way to justify growing its team of auditors. But their ROI comes at the expense of contractor profits. We foresee the direct conflict between these goals persisting into the foreseeable future.

Section 5:

Human Resources Trends

Introduction

People are the engine of any business. No matter how efficient your processes or how advanced your systems, without the right people to make it all come together, a company will suffer. So how are GovCon firms finding great talent? What are their most pressing challenges related to hiring and developing these people? Which HR processes are costing the business the most time and money?

In seeking the answers to these questions, we discovered a looming HR crisis. Today's government contractors are struggling to find good people and attract them to the industry. And when talented employees are signed, companies have trouble matching them to the right positions. These difficulties—coupled with pay and benefits that don't stack up to the commercial market—are creating a talent drain that will impact firms far into the future if not addressed immediately. If this movie continues to play out, it will surely impact government contractors, but the biggest loser could be their customers. The Federal Government and the United States as a whole risk lower quality solutions, services, and products over time as a result of this impending talent crisis. The industry would be wise to take a hard look at how to engage and retain top talen. In addition, the leaders should recognize how factors such as the cost of compliance and the potential for total contractor compensation laws could hinder their own strategic objectives. In this new section this year, we take a closer look at the human element of government contracting and the issues affecting this critical area.

Key Data Points from the Survey:

1. Most HR organizations run lean. With the exception of a single firm, all companies in the small (<$20M) and mid-sized ($20M-$99.9M) segments operate HR teams with 0-10 employees and the lone outlier uses 11. For large firms >$100M-$1B+, HR organizations are fairly evenly split between 0-10 personnel, 11-20 and 21-50 with one large firm reporting more than 51 on staff.

2. Companies can neither find good hires nor place them. These two issues came in tied as the top challenges around talent acquisition for GovCon firms.

3. Controlling Health Insurance Costs by far leads the pack as the top issue firms face in managing Human Resources. In light of current political wrangling over health insurance, this challenge will likely remain prominent for some time.

4. Firms are using many different technology solutions to help manage the HR function. Respondents were split in their use of Deltek Costpoint HR (27%) Custom/Homegrown (16%), Taleo (12%), and Other (14%). Smaller percentages of firms cited usage of nine other solutions. This is a wake-up call to vendors. With so many different tools addressing so many different pieces of HR, vendors are called to provide a more unified, integrated solution to improve efficiency and lower costs.

5. Matching a Candidate to an Open Position by far consumes more time and expense than any other business process. Open Enrollment for Benefits and Annual Performance Reviews came in at #2 and #3, highlighting the need for better automation in these areas.

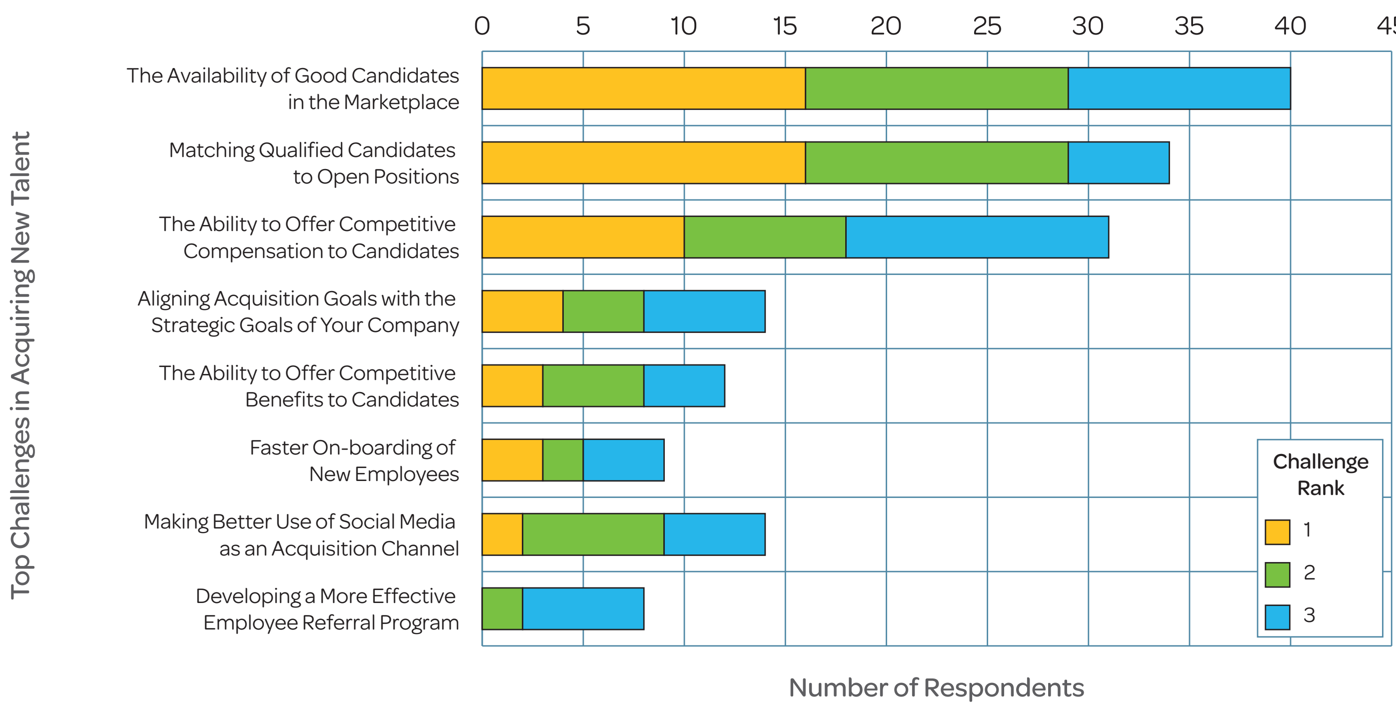
"Ours is a people-centric business, and without the right people in the right place at the right time, the machine does not work."

Over the next 12 months, what are your biggest challenges in acquiring new talent?

Firms are struggling to find good hires—and place them well when they are found. These two issues run side by side as the top talent acquisition challenges facing GovCon firms today. The problems stem in part from pending legislation aimed at reducing the amount the government pays toward contractor salaries. Congress is still hammering out details, but with proposed salary caps as low as $230,700 annually, the proposal is already steering talented executive leaders, upper management, and tenured R&D experts away from government contractors and towards more lucrative commercial positions. If the legislation passes, it will get even tougher to fill key roles. Perhaps more importantly, the absence of top talent could impact the ability of the industry to deliver ever-more sophisticated solutions and capabilities to our military, intelligence community, and our infrastructure over time.

Another issue contributing to this problem is worker qualification. Until recently, there was a shortage of graduates with STEM-related degrees—and top students in these fields were not choosing GovCon, partly due to widespread negative press surrounding the industry. Today, while STEM degrees are up, these students often choose jobs in fields with more pay or status (i.e., math majors going into finance), according to a recent *Scientific American* article. Additionally, many STEM graduates go on to pursue MBAs, aiming to take higher-salaried management positions to pay off student debts. Finally, the long decline in GovCon fringe benefits has scared off many good candidates. Taken together, these factors are converging into a human resource crisis for government contractors and may have a dramatic long-term impact on the strategic initiatives being carried out by industry on the behalf of the Federal Government.

Figure 21: Top Challenges in Acquiring New Talent

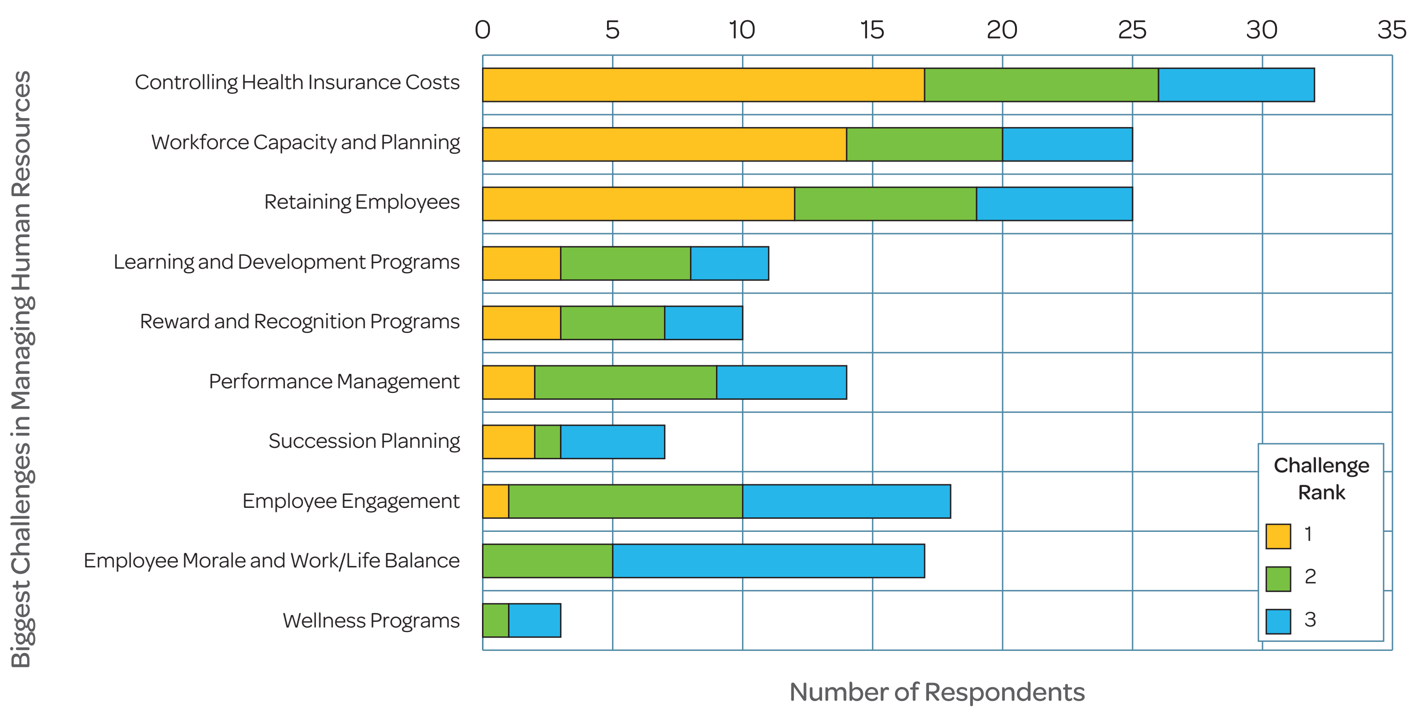


Over the next 12 months, what are the biggest challenges you have in managing human resources?

With all the headlines surrounding healthcare over the past year, it was no surprise to see Controlling Health Insurance Costs emerge as the clear leader among firms' HR challenges. The issue is twofold, encompassing uncertainty around the Affordable Care Act and a rise in premium costs. Ongoing political wrangling over health insurance means this issue will remain a prominent one in the years ahead.

Workforce Capacity and Planning, the second most prevalent response, is closely linked with the previous question in which firms cited concerns about their ability to match people to qualified positions. Without visibility into the resource pool, it is difficult to see when people are under- or over- utilized. An inability to staff work appropriately not only leads to retention problems—a close third place behind capacity—it also drives higher risk around Incurred Cost Audits as well as contractors' ability to maximize revenue. Finally, while Employee Engagement and Employee Morale and Work/Life Balance came in near the bottom of the list, overall they received the fourth and fifth highest number of mentions. These issues are closely tied to talent acquisition/retention and with how to do them well.

Figure 22: Biggest Challenges in Managing Human Resources

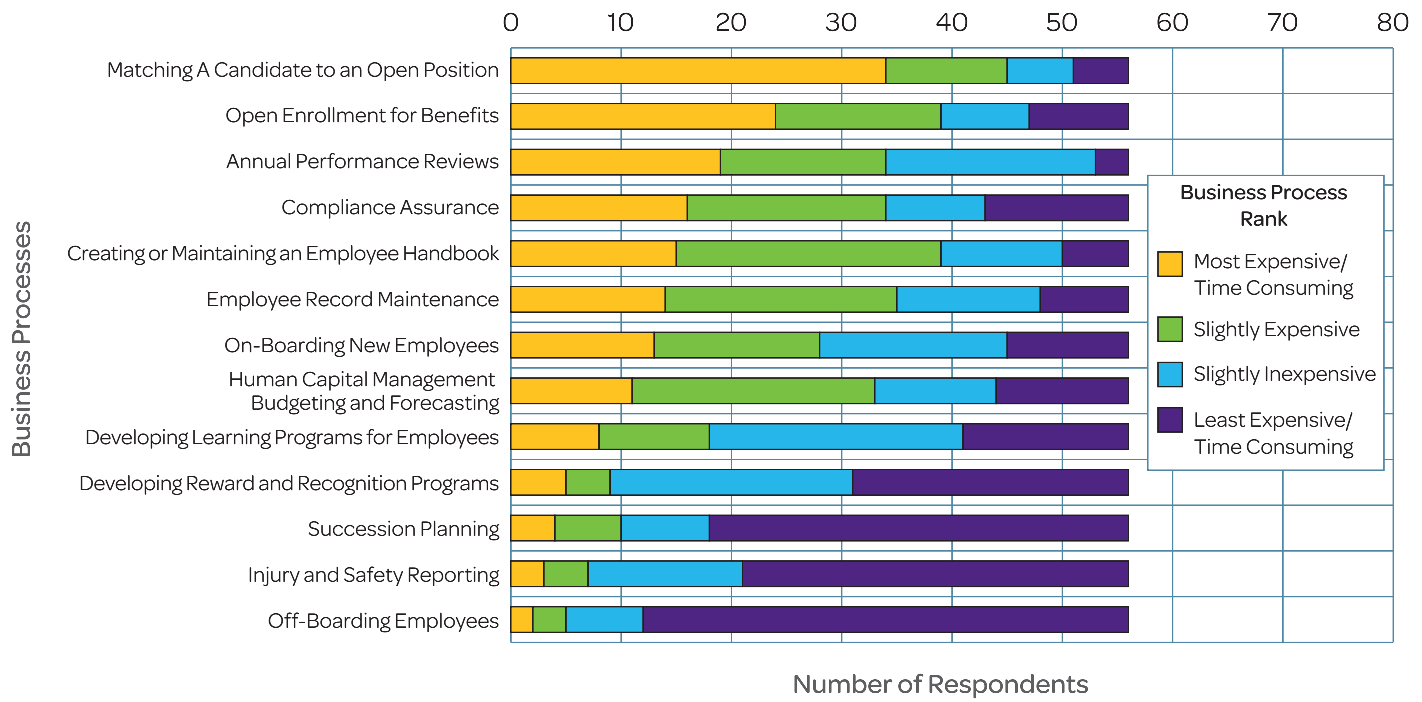


Please rank these business processes in order of time consumption and expense (1 = Most time consuming and most expensive; 13 = Least).

Underscoring the problems around talent management, firms told us that Matching a Candidate to an Open Position consumes more time and expense than any other business process. While we grouped responses into four categories, we asked firms to rate each of these 1 – 13. Matching a Candidate to an Open Position received more #1 rankings than all the other processes combined. Open Enrollment for Benefits and Annual Performance Reviews came in with the second highest number of #1 responses, particularly among smaller companies. This is likely because smaller organizations may be doing these processes manually.

To eliminate the pain around any of the processes on this list, businesses must automate them. Government contracting perpetually lags in technology adoption and it comes at a price. Lacking systems for managing important HR business processes, those processes will be difficult and expensive—doubly so in HR where core functions tend to be some of the most expensive areas for small businesses. This pain won't go away on its own; only an investment in the right systems can ease it. The good news is there are many new SaaS-based HRIS solutions available for small business that promise relief.

Figure 23: Business Processes by Time Consumption and Cost



Clarity Outlook

The crystal ball is crystal clear when it comes to the human resource crisis in government contracting. The decline in fringe rate and benefits has already taken its toll on the talent pool. Forthcoming legislation capping executive salaries and negative press around the GovCon industry are weakening it further. As a result, today's talented STEM graduates do not place GovCon high on their list of desired workplaces. And for the few that do, firms are struggling to place and utilize them well.

We are at the front-end of this problem. Contractors may still be in cost-cutting mode, meaning benefits may further erode. A looming wave of retirements will drain longtime experience from the industry at a time when companies will be challenged to replace it. All this adds up to a critical problem that the Government Contracting community must make a priority. There is a glimmer of possibility that the industry will have the resources to focus on this challenge with 2014 and beyond showing the first increases in the base contractor spending (less the decline in the overseas contingency funding) and a more stable budget presenting itself. At the same time, the Federal Government has a responsibility to carefully weigh the cost on industry for the increased scrutiny and pressure that is being applied. Total contractor compensation could put a damper on the caliber of talent that is attracted to work for a government contractor, which will invariably diminish the quality and innovation coming out of this industry.

Data Profile

Revenue Range	Small < $20M	Mid-Sized $20M - $99M	Large > $100M - $1B+
Business Development			
Win Rate (ave.)	66%	61%	57%
Project Management			
Project Status Visibility	High 26% Moderate 14% Low 5%	High 24% Moderate 8% Low 2%	High 8% Moderate 7% Low 6%
Project Status Confidence	High 33% Moderate 8% Low 2%	High 27% Moderate 7% Low 1%	High 13% Moderate 8% Low 1%
Project Management Maturity	Very Mature 13% Somewhat Mature 22% Somewhat Immature 6% Very Immature 5%	Very Mature 7% Somewhat Mature 16% Somewhat Immature 9% Very Immature 2%	Very Mature 3% Somewhat Mature 10% Somewhat Immature 5% Very Immature 2%
Risk, Issue and Opportunity (RIO) Management Maturity	Very Mature 6% Somewhat Mature 16% Somewhat Immature 16% Very Immature 6%	Very Mature 4% Somewhat Mature 16% Somewhat Immature 11% Very Immature 5%	Very Mature 2% Somewhat Mature 8% Somewhat Immature 6% Very Immature 4%
Risk, Issue and Opportunity (RIO) Management Scope	Organization-wide initiatives 17% Divisional initiatives 8% Isolated initiatives 12% No initiatives 7%	Organization-wide initiatives 18% Divisional initiatives 5% Isolated initiatives 12% No initiatives 1%	Organization-wide initiatives 5% Divisional initiatives 5% Isolated initiatives 9% No initiatives 1%
Financial Metrics and Operations			
Growth Rate (ave.)	23%	10%	2%
Days Sales Outstanding (ave. days)	32	37	36
Invoice Cycle (ave. days)	9	8	12
Net Profit (ave. %)	14%	8%	5%
Top Finance Challenges	1. Organic Top Line Growth 2. Decreasing and/or Unpredictable Federal Spending Environment 3. Cash Flow		
Compliance and Risk Management			
Top Audit Issues	1. Indirect Rates 2. Internal Control Systems 3. Labor and Time Keeping		

Deltek Profile

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- Improve contract win rate and retention rates
- Complete projects on time and under budget
- Ensure project, IT and corporate governance
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