CLARITY

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GovCon Industry Study

6TH ANNUAL HIGHLIGHTS REPORT • 2015

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Introduction

After years of declining spending and hyper-vigilant management of costs, we see signs of renewed investment and vibrancy from this year's responses to the Clarity Government Contractor Industry Study. Focus seems to be shifting towards the future business direction and away from the survival posture of the past few years. While this is encouraging, there are still many challenges to overcome. Growth and profits remain elusive for many firms. New, skilled talent is a scarce commodity. And competition remains fierce for contract dollars. We now have a generation of government contractors that has 'grown up' facing serious challenges to their industry.

Another theme emerged this year, too—when the going gets tough, the tough get going. Firms made it clear that they are not standing still waiting for the business environment to improve. Companies are expanding their operations outside of federal contracting in search of higher growth markets. More of them than ever tell us they are pursuing M&A activity. And financial indicators suggest that contractors are investing back into their businesses, presumably to operate more efficiently and to prepare for growth. Firms are proving their ability to be nimble, resilient and persistent in the face of business challenges. These traits will continue to be important as the front lines of the battle extend to attracting and retaining talent and managing costs structure.

In this sixth annual Clarity GovCon Industry Study, we bring you inside the world of government contracting to reveal these and other key trends and metrics shaping the industry today. For this year's study, 311 firms of all sizes shared their performance metrics, challenges, plans for the future and insights in seven key areas including finance, operations and business development. We included some important new questions as well as a new section—Information Technology—to keep you up to date with the issues and initiatives that are top of mind for GovCon firms.

We invite you now to turn the page and get a closer look at this year's important data points and issues. Pay special attention to the powerful links we discovered this year between profit and project visibility as well as the ability to keep projects within budget. They reveal a significant opportunity for GovCon firms. We hope these and the many other insights contained within these pages will help you along your way toward operational excellence.

About the Deltek Clarity GovCon Industry Study

CLARITY SURVEY RESULTS

We collected over 300 responses from Executives, Business Development, Project Management, Finance and Accounting, and Human Resources leaders from the Government Contracting Industry.

Company Headcount

1 -24	12%
25 - 99	22%
100 - 499	34%
500 - 999	16%
1000+	16%

Revenue Breakdown

< $20M	49%
$20 - $99.9M	31%
> $100M - $1B	20%

Revenue Breakdown By Sector

Federal	62%
State	10%
Other Public Sector	12%
Private Sector	16%

Company Headquarters Breakdown By Region

District - Maryland - Virginia	48%
South	13%
West & Pacific	16%
Northeast	14%
Midwest	9%

Executive Summary

This sixth annual Clarity GovCon Industry Study continues to expand in data collected, sections delivered, and in our understanding of long-term trends. This year, we added an IT section since technology drives efficiency and is a critical component to accomplishing so many of the goals toward which GovCon firms are striving. We also deepened our analysis of several key data points and uncovered potentially business-altering correlations.

Over 300 companies responded to this year's Clarity survey, which posed 124 data- and perspective-gathering questions. Across these responses, several metrics rose to the surface as being key to understanding the state of today's GovCon market. The following five data points capture the state of the industry today as well as show where opportunities lie:

Profits plunged four points to 6%.

Overall growth was flat while profits plunged four points to 6%. In an effort to bolster growth, many firms are steering investment toward diversification initiatives, aiming to balance out the sometimes unpredictable nature of government contracting with more work in the commercial sector.

Project management discipline is directly linked to net profit.

Those companies with 90%+ of projects on/under budget reported nearly double the net profit of others. The same is true for visibility: those firms with Very High visibility also had significantly higher profits than other firms. This is a call to action for the entire market, but in particular for mid-sized firms $20M-$99M. Just 44% of them said 90-100% of their projects were on/under budget, half the number of last year.

Retaining employees became the #2 challenge companies face, after health care costs.

The talent crisis is worsening as companies continue to struggle to find quality people, offer them a competitive compensation package, and match resources to open positions. Fueled by these challenges, Retaining Employees moved up to become the #2 challenge companies face in managing human resources, second only to controlling healthcare costs.

Today's top IT challenge is data security.

Technology plays a crucial role in the quest for efficiency and cost savings. In a new IT section this year, we found that Human Resources / Talent Management, Social Media, and Finance are leading the transition to the cloud as firms seek reduced IT-related costs. However, many companies still have security concerns. Today's top IT challenge is data security, followed by budget pressures and the need to manage multiple systems.

58% of respondents said they had undergone a Pre-Award audit in the past two years.

The audit environment is becoming more oppressive as federal agencies continue to rev up the audit engine. A bump in Pre-Award and ICS audits shows DCAA is focused on scrutinizing both ends of projects. 58% of respondents said they had undergone a Pre-Award audit in the past two years—roughly double the number of last year—while 6 in 10 firms experienced an ICS audit.

SECTION ONE

Business Development

Introduction

Over the past year, uncertainty has given way to stability for Government Contractors. After years of BD belt-tightening, increased predictability in Federal spending seems to have eased some of the pressure on this corner of the organization. With more solid footing beneath them, this year's responses suggest firms are turning their attention to core Business Development practices, recognizing that improvements here may be the key to their future growth.

Despite the increased stability, however, the way forward is not easy. Respondents bemoan the lack of information on opportunities, an inability to get access to and forge relationships with potential customers and, in a major theme this year, a dearth of competitive intelligence. This last issue showed up again and again as a top concern. Realizing they are in a tight race for every contract, firms seek improved competitive insights to better position themselves for a win. Here is a detailed look at how Business Development is evolving for Government Contractors today.

> "When the market is tight and contracts are over bid, our only real leverage is knowing our customers and our competition as best as we possibly can."

Key data points from the survey

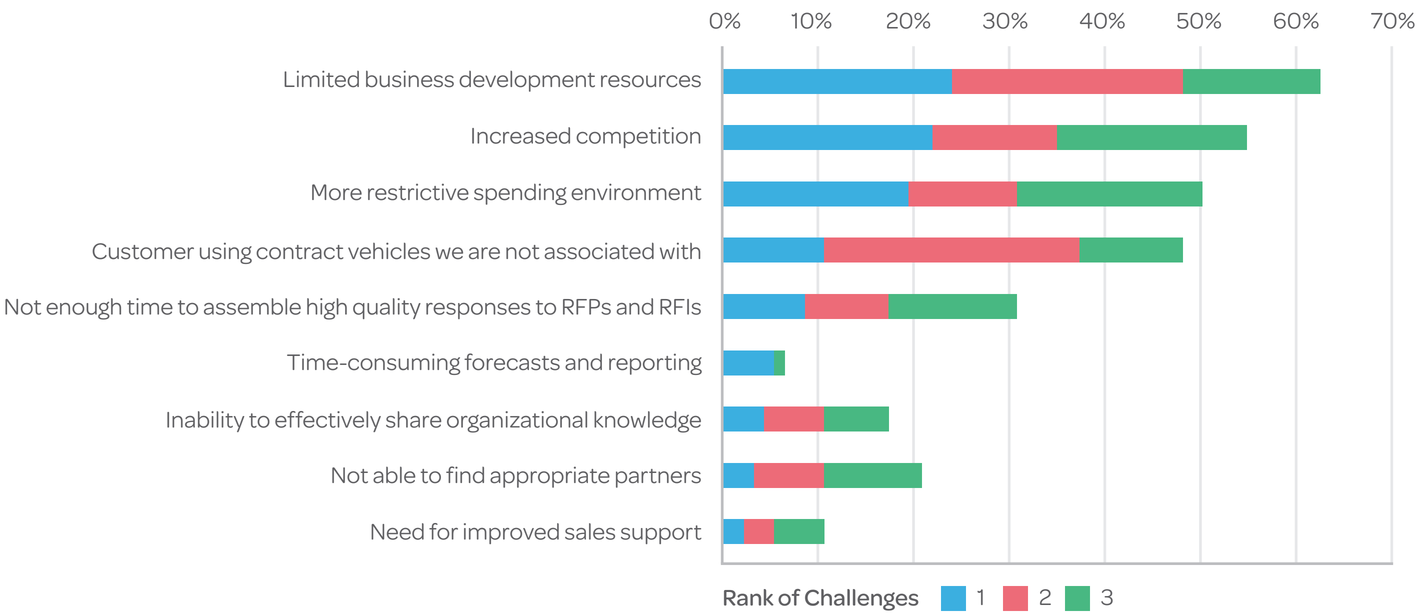
- Asked for the first time this year, companies reported protesting between 12% and 16% of wins and losses. At this rate, firms may consider taking protests into account when risk adjusting opportunity pipelines.
- Last year's Win Rate remained steady and strong at 39% across all businesses, suggesting that companies are going after core competency business where they are strongest and most likely to win.
- This year saw a significant shift in the way Task Order programs are managed. In 2014, 46% of programs were a Blend of Centralized and Decentralized management (up from 33% and 32% in the previous two years). Centralized management dropped to 41% from 56% and 51% in the previous two years. As companies figure out how to maximize their task order business, they appear to be moving to blended models to empower teams across the organization to make quick decisions.
- When asked why they opted not to pursue a relevant opportunity, 9 in 10 firms said a key reason was lack of a good fit for what their do, underscoring a growing focus on bidding opportunities aligned to core capabilities.
- Limited Business Development Resources took over as the top Business Development challenge this year after being in third place last year. It was followed by Increased Competition, and a More Restrictive Spending Environment, which dropped from first last year, which is a positive indication of growth as companies in the survey look to grow.

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

A More Restrictive Spending Environment, in the top spot the last two years, dropped to third place as the Federal budget stabilized and sequester threats retreated. Taking its place as today's top challenge is Limited Business Development Resources. On the heels of several years of limited growth, many firms cut spending in Business Development. Now companies are feeling the pinch and are struggling to execute their BD strategies with a shortage of resources. It will be interesting to see whether investment priorities shift later this year as a potential sequester comes back on the table and the 2016 election comes into sharper focus.

Competition continues to be a theme in this year's Clarity report with Increased Competition retaining its #2 position as a top Business Development Challenge. Also, echoing the write-in Task Order challenges, several respondents pointed to lack of relationships with potential customers as a point of Business Development frustration. As government agencies have constrained travel and event participation by their people, business developers struggle with finding venues to meet with prospective buyers.

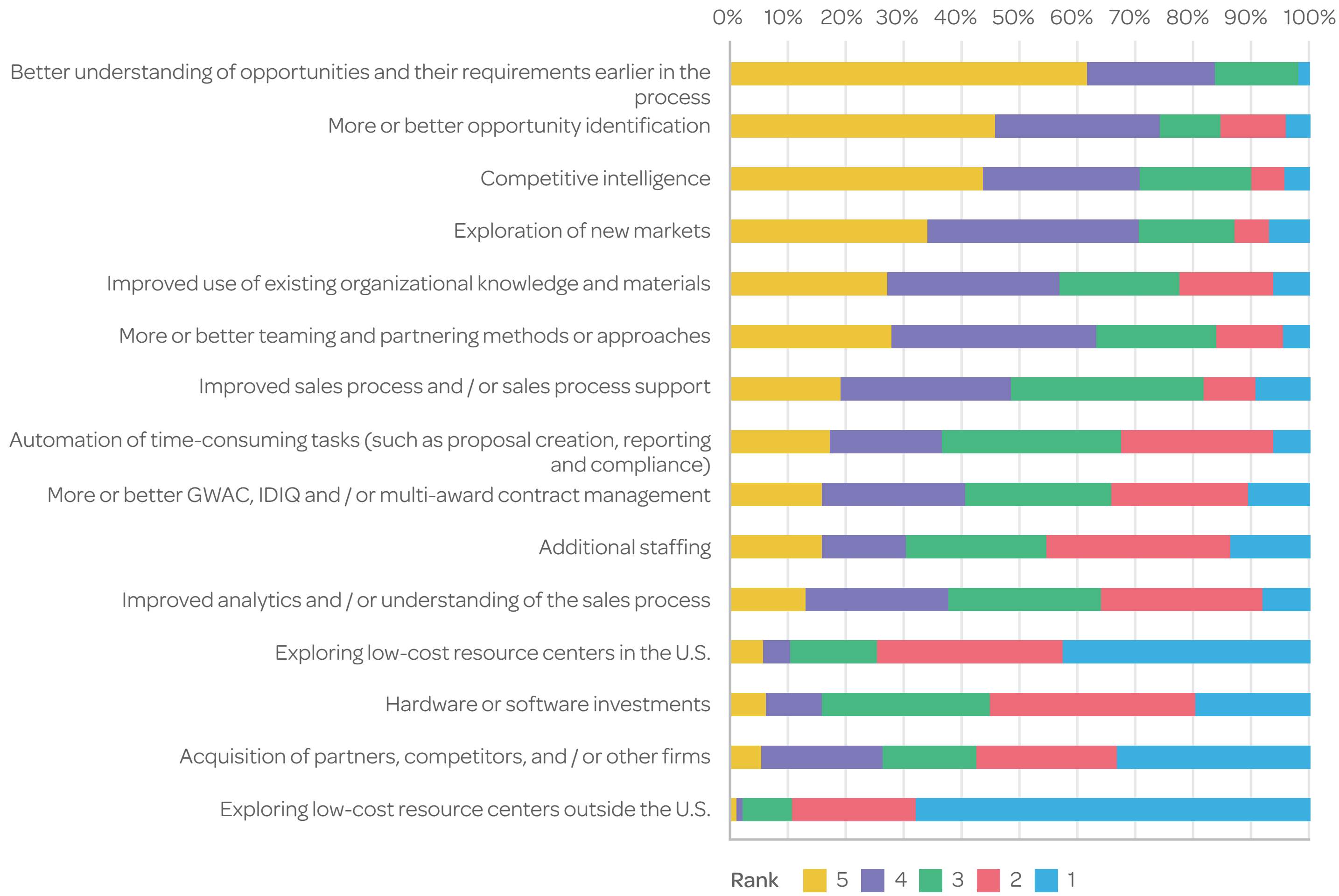
Top Three Business Development Challenges



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.

Since the Business Development challenges remain similar to previous years, it is no surprise to observe that the BD initiatives follow suit. One area of note is that Competitive Intelligence, newly added this year, made its debut in the #3 spot, highlighting the intensely competitive nature of today's marketplace. Companies are looking to find competitive advantage wherever they can – through better intelligence, better processes, a better understanding of opportunities and other means. Interestingly, despite the search for advantage, technology does not seem to be a priority area of investment yet within the Business Development function.

Business Development Initiatives Pursued

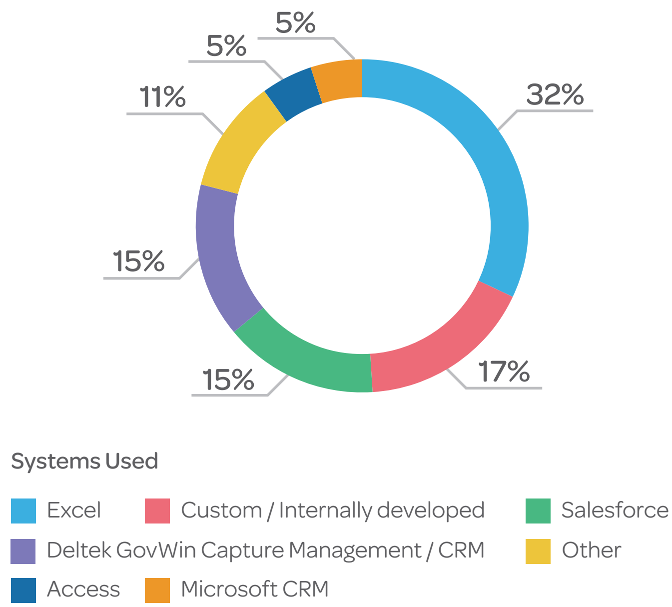


What system does your organization use to manage business development opportunities and pipeline?

As the Business Development arena has become more complex and more data intensive over the years, we have long predicted a drop in the reliance upon Microsoft Excel to manage the pipeline. Our predictions appear to continue to be ahead of their time, as 1 in every 3 companies reported still using Excel to manage Business Development opportunities and pipeline, a tick up from last year. In an area where headcount is expensive and competition is tight, we stay firm in our projection that companies will accelerate investments in sophisticated BD technology to give them an edge. For firms seeking to break out of a growth slump, this may be an area to evaluate.

It is worth noting that this year's responses saw a continued decline in the number of organizations using Custom/ Internally Developed solutions. As the Business Development technology market continues to mature, fewer firms seeking a sophisticated solution to Business Development are choosing to create something on their own.

System Used for BD and Pipeline

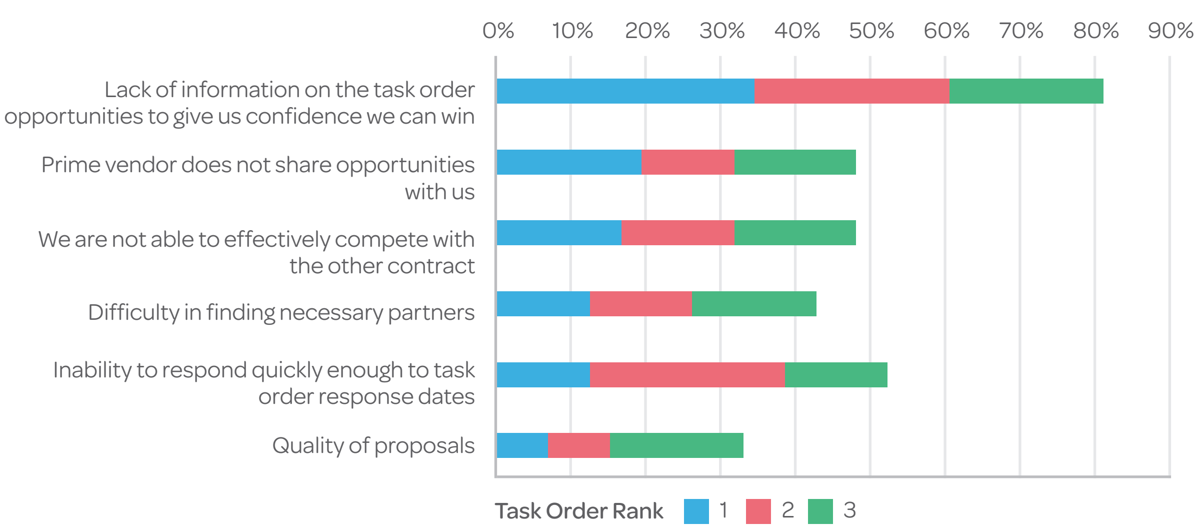


What are the top three challenges you face relative to achieving success with task order vehicles?

Task orders are a way of life today, and firms are finding their footing with regards to how best to manage them. The predominant challenge companies point to again this year is Lack of Information. While a small percentage selected it as their top choice, the second most selected challenge was Inability to Respond Quickly Enough. When we dug deeper, we found that well over half of the companies that complained about response time are relying on Excel or an internally-developed tool to manage their pipeline, perhaps explaining the cause of the trouble.

Write-in comments revealed a few interesting challenges to task order success too, including below-market pricing, lack of competitive intelligence, and an inability to build customer relationships.

Top Challenges for Task Order Vehicle Success



Clarity Outlook: Business Development

Since we have not yet returned to the high-growth market of years past, companies appear timid about making big investments in Business Development and other areas. While this practice may help to conserve cash, it may also negatively impact a firms' ability to identify opportunities, glean intelligence, and respond quickly when potential business pops onto the radar screen.

Whether this is a smart move may be revealed later this year into next year as the sequester and forthcoming election come into play. These two events will be sure to shape the GovCon landscape as well as the tone and attitude of the market as they directly impact the Federal budget and spending priorities. Those who have bolstered their Business Development capabilities in recent years will be best positioned to navigate the changes.

SECTION TWO

Project Management

Introduction

Last year, we combined our sections for Project Management and Risk in acknowledgement of the tight connection between these two disciplines. This year underscored that connection, with results showing just how firmly these areas are linked.

Overall, things are trending in a positive direction. Visibility is up. Project management maturity is improving. And more firms are performing schedule risk analysis at all phases of a project lifecycle. However, challenges remain. Across the board, fewer companies said they had 90%+ projects on or under budget. There was a sharp reduction in the number of PMPs or other certified project leaders, which is impacting many areas of project management and increasing risk to companies. Individual comments revealed a general theme of change—in funding cycles, federal budgeting dynamics, cost/schedule shifts, project scope and more—all directly impacting project leaders.

Still, this year's report revealed just how important it is to get control of the moving parts. Those companies with 90%+ of projects on / under budget reported nearly double the net profit of everyone else. The same is true for visibility: those firms with Very High visibility had significantly higher profits than firms reporting less than crystal-clear insight. The message could not be clearer: companies that have invested in the technology and training to gain visibility and ensure management of projects to budget are reaping the benefits to the bottom line of their business.

Key data points from the survey

- Fewer companies reported Low Visibility into the status of their current projects, reversing a 3-year climb. Low / Very Low Visibility entirely disappeared for the largest companies.
- Mid-sized firms $20M-$99M reported a steep drop in the number of projects on / under budget. Last year, 88% of respondents in this category said 90-100% of their projects were on / under budget. This year, just 44% of mid-sized firms made that claim. On the upside, 81% of the largest firms $100M-$1B+ said at least three-quarters of their projects were on/under budget, up from 64% last year.
- The percentage of current projects reported as on or ahead of schedule dropped 10 points year over year to 69%. Comments from respondents suggest that the Federal Government pushing funding into and out of cycles has made it difficult to keep projects on track. Perhaps as fallout from this, the level of confidence in the status being reported on current projects eroded. Overall confidence dropped and High Confidence is at its lowest point since we began tracking this question.
- 8 in 10 of the largest firms $100M-$1B+ say their PM discipline is Somewhat or Very Mature, 14 points higher than last year.
- Survey takers reported a dramatic reduction in the percent of program managers with PMP certifications or other formal training. Those reporting >50% certification fell from 44% last year to 29% today while those reporting in the 0-9% category increased 11 points to 39%. However, 66% of all respondents said formal project management training will be either Very Important or Critical to Our Success over the next 2-3 years.
- 47% of organizations say they perform schedule risk analysis (SRA) at all phases of a project's lifecycle, up from 42% last year.
- Project management software is becoming more important as organizations recognize the critical role it plays in driving highly visible, on-time and on-budget projects. 66% of firms say its importance will Increase Slightly or Significantly over the next 2-3 years.

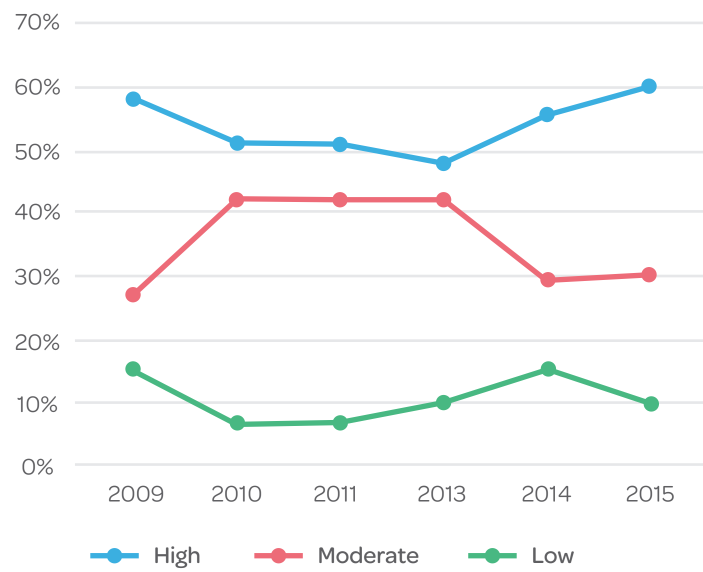
How would you rate the visibility into the status of your organization's current projects?

If project visibility were a weather forecast, we'd label this year's responses partly sunny with clearing skies. We noted an overall increase in visibility across the board at firms of all sizes as companies buckle down and focus on this critical area. Fewer companies reported Low Visibility into the status of their current projects, reversing a 3-year trend. Notably, Low / Very Low Visibility entirely disappeared for the largest companies.

Despite these improvements, write-in comments make it clear that visibility still is not where companies want it to be. Several respondents acknowledged that they need to eliminate spreadsheets in order to make improvements in this area. Others highlighted the reality that visibility depends on project size so that smaller projects may not be getting the attention to visibility they deserve. Finally, a number of respondents hinted that their visibility comes from their role, or close proximity to the project. While this view is powerful and valuable, the risk here is that it does not provide a company-wide view, potentially giving a false sense of security about an organization's total project visibility.

Companies are right to be laser focused on this area and seeking improvement. When we overlaid visibility with net profit data, we saw a clear and strong correlation. For firms reporting Very Low through High Visibility, net profit ranged from 5% to 11%; however, firms reporting Very High Visibility averaged over 18% net profit. This correlation sends a clear message that firms seeking profit growth should focus on project visibility as a key driver of profit improvements.

5-Year Trend - Project Status Visibility

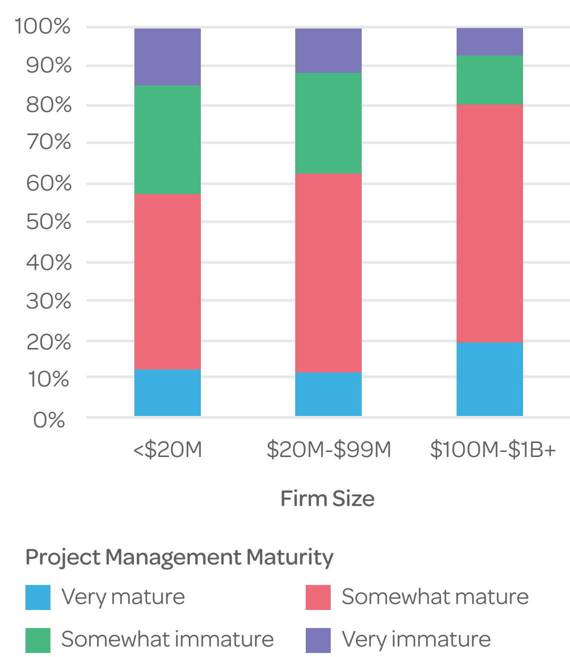


Please rate the maturity of your firm's project management discipline.

Viewed by company size, last year's trends in project management maturity reversed direction. In our 2014 report, we observed that the largest firms were slipping toward immaturity with double the number of companies year over year reporting a Very Immature PM discipline. This year, they have not only put the brakes on that slide but taken big strides in the right direction. 8 in 10 of the largest firms $100M-$1B+ now say their PM discipline is Somewhat or Very Mature, 15 points higher than last year.

On the flip side, smaller firms, which were making significant gains, lost some of their footing. Last year, 75% of firms <$20M reported Somewhat or Very Mature PM discipline; this year, that figure dropped to 58%.

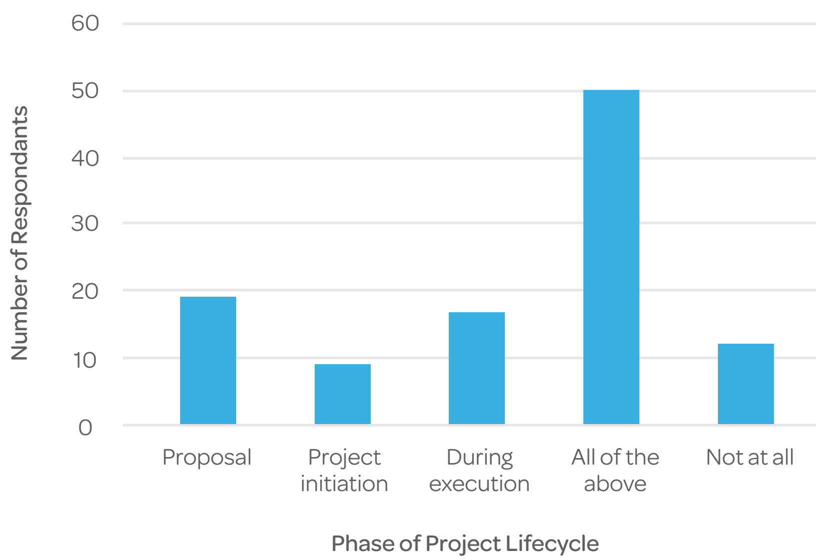
Project Management Maturity by Firm Revenue



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

A growing number of GovCon organizations are recognizing the importance of schedule risk analysis (SRA). Half of all firms now perform it at every phase of a project's lifecycle, up from 42% last year. At the same time, the number who chose Not At All contracted slightly. These results parallel the overall modest improvements in project management maturity we reported. Last year, we noted a direct correlation between SRA frequency and both PM maturity and project status confidence. If SRA frequency continues to climb, we predict those other metrics will follow.

Phase of Project Lifecycle Where SRA is Performed



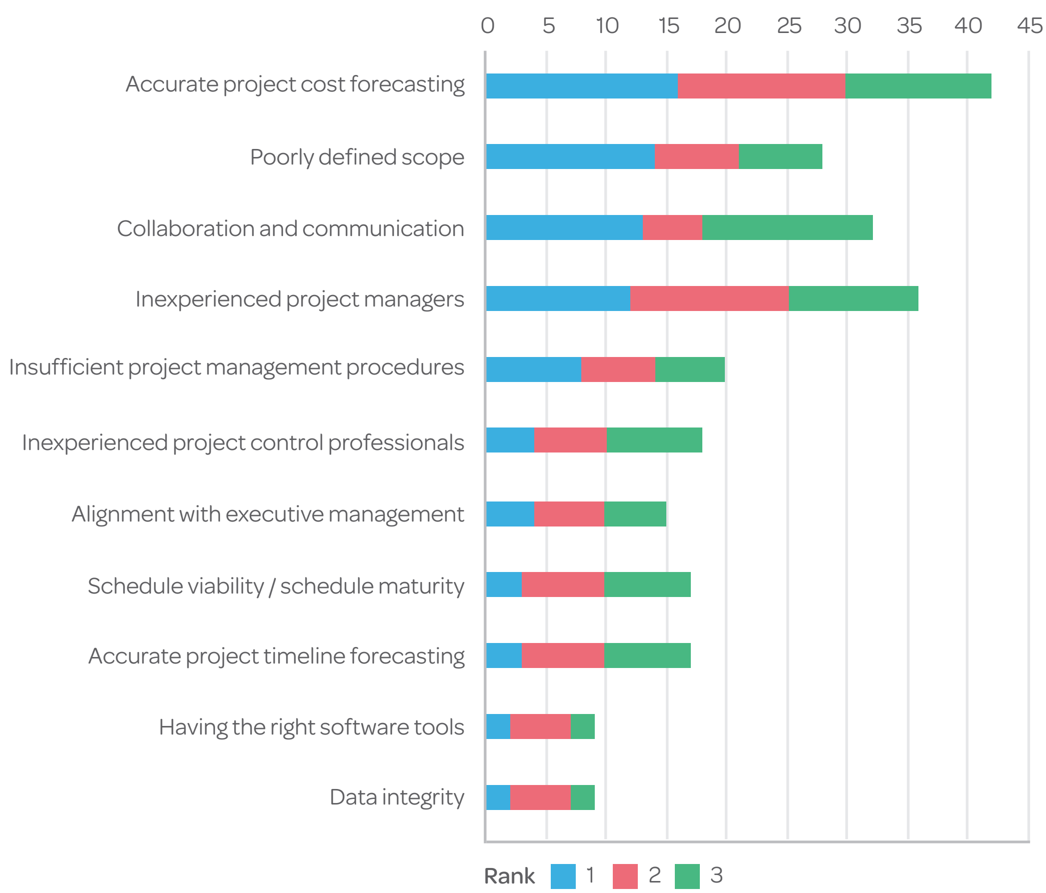
> "Our company-wide mandate for the past few years has been to make all projects successful. This has meant deeper inspection at all phases, and an increased level of risk analysis to alert us earlier to potential problems."

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

After three years of hovering in second and third place, Accurate Project Cost Forecasting took a seat as the top challenge facing the PM function over the next 2-3 years. Budget pressures and missed forecasts have put the heat on this area and companies are sensitive to the need to get it right. Part of the problem may stem from lack of experience. While fourth place in #1 responses, Inexperienced Project Managers posted the second highest number of responses overall. Write-in feedback reinforces this is an area of widespread concern, as respondents expressed frustration that project managers' inexperience has impacted efficiency, communication and scope definition.

The reported inexperience and drop in PMP certifications cause us to wonder why so many firms are putting inexperience at the helm of their projects. Is it a decline in training dollars? Is it an eroding appreciation for formal PM training? We intend to keep an eye on this dynamic. The encouraging news is that firms recognize the problem. Nearly 7 in 10 companies said formal project management training will be either Very Important or Critical to Our Success over the next 2-3 years. This investment in people, alongside an investment in the tools that provide the insight and analysis necessary for good decision-making, will be key to effective project execution.

Top Project Management Challenges



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

The first step to recovery is admitting there is a problem. This year's survey takers recognize they have a problem in their risk / opportunity management discipline. Compared to last year, significantly more small- and mid-sized companies admitted the discipline is Somewhat or Very Immature in their firm. And while large firms saw an overall upswing in maturity, last year's Very Mature slice of 2 in 10 large firms backslid into the Somewhat Mature bracket. Risk / opportunity management continues to be the next frontier of competitive advantage for GovCon firms. New technology solutions enabling this capability are the key to boosting maturity in this area.

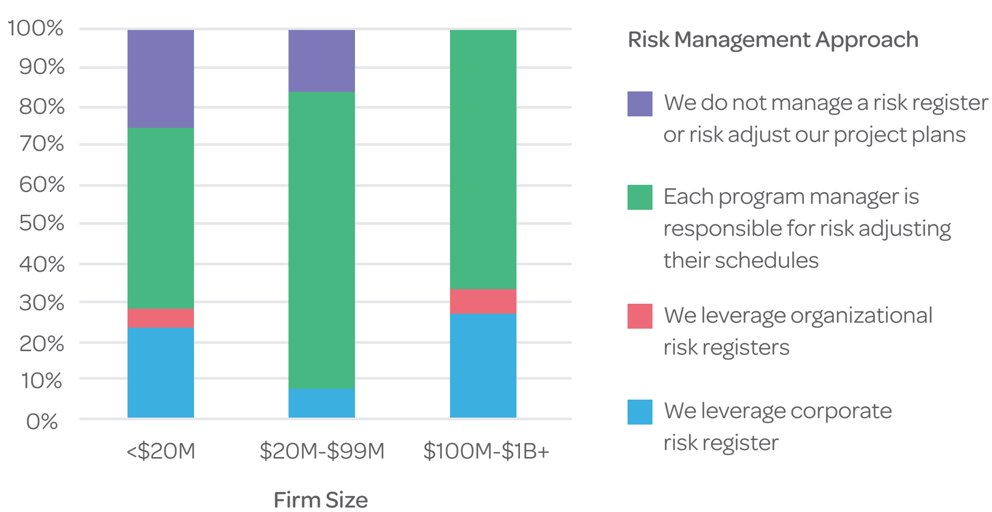
RIO Maturity

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

We were encouraged to see that all of the largest firms are now managing risks applied to project plans. This is a vast improvement from a year ago when 1 in 4 large companies admitted they did not manage a risk register or risk-adjust their project plans—an alarmingly high percentage. The other positive trend here is an across-the-board increase in the momentum toward corporate risk registers. Shifting risk management to the corporate level increases visibility and leverages collective corporate knowledge to manage and mitigate risk.

Although these data points are moving in the right direction, firms of all sizes continue to place a heavy and increasing reliance on individual program managers to risk-adjust project work. This presents a risk in itself, especially in light of the previously reported challenges with respect to PM experience.

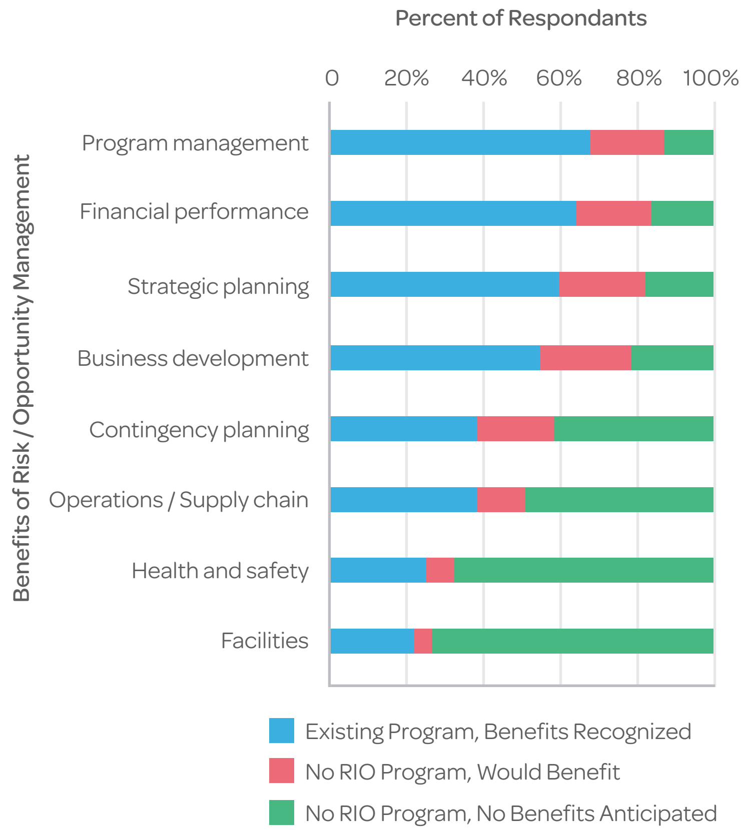
Risk Management Approach by Size



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

The order of results remained essentially unchanged from last year. Amongst responses for Existing risk management programs with benefits, both Strategic Planning jumped by 10% over last year, perhaps as a nod to the need to improve risk management within key aspects of the business. The other notable development is an across-the-board contraction of firms reporting No RIO Program, No Benefits Anticipated.. We expect to continue seeing these bars stretch to the right as risk/opportunity management continues to pay off.

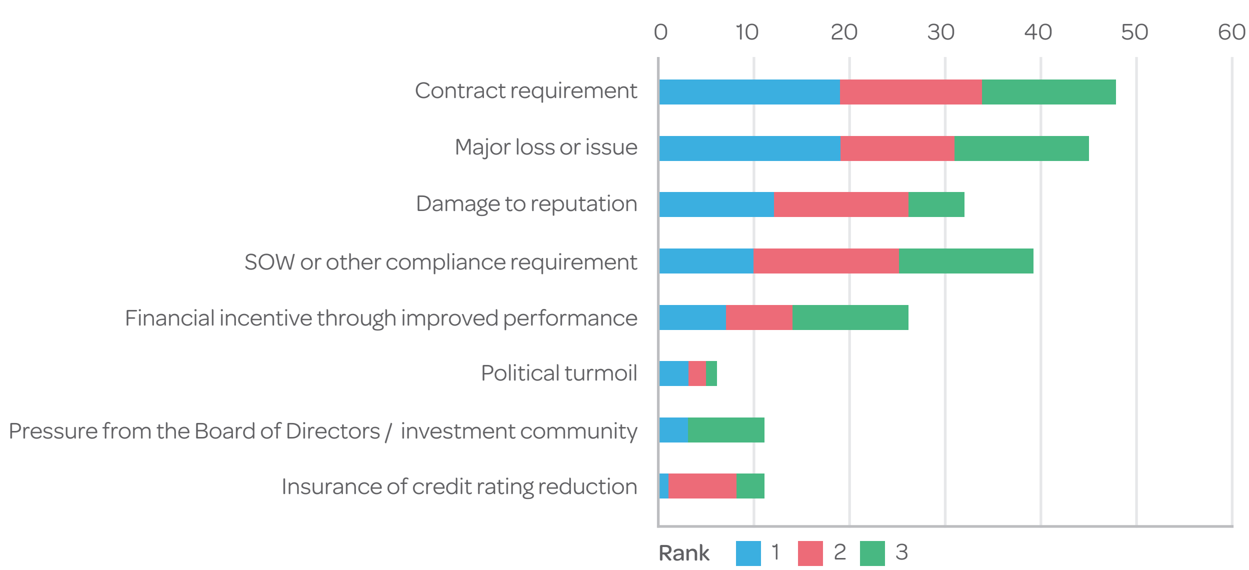
RIO Management



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

As it has every year since we first asked this question, a Contract Requirement is the primary trigger of a risk/opportunity initiative for GovCon firms. A nearly equal number of respondents chose Major Loss or Issue, representing the first time for such a close top finish. We continue to note that these top two choices are reactive, forced by an outside issue, while the others are more proactive. We suspect it is likely to be some years before more proactive triggers appear at the top of this list.

RIO Initiative Triggers



Clarity Outlook: Project Management

Schedule risk analysis will continue its upward trend as the recognition of its value for improved project maturity and successful project completion increases. Companies will look for ways to begin implementing SRA as part of their project management process or expand its use throughout the entire project lifecycle.

Surprisingly, given the availability of software to rectify this, accurate cost forecasting continues to climb the list of top challenges facing project teams today. This is partly due to the fact that more than ever, project-focused businesses are recognizing the role that Estimate at Completion (EAC) plays in driving key business metrics like revenue, cash, EBIT, and new orders. As the importance of getting the EAC right climbs, so does the recognition of the difficulty in doing so. Fortunately, we see these same companies also highly ranking the importance of software for improving EAC accuracy and expect that they will continue to look for solutions to improve their forecasting efforts. Tied closely to this trend is the increasing use of lessons learned from past performance to help improve the accuracy of estimates during the bidding process. Pre-Award audits are more prevalent, making past cost performance more and more important.

More and more companies are recognizing the importance of visibility into their projects. We expect this trend to continue as companies continue to recognize that the ability to manage by exception leads to higher profit. The largest companies surveyed are leading this trend and reaping the benefits, reporting fewer projects as late and / or over budget. Small and mid-sized firms will now follow suit.

SECTION THREE

Finance

Introduction

The macro-economic factors point to a market stabilization for Government Contractors. Federal budgeting has been more reliable in the past few years, spending is steady, and contracting processes seem to be operating smoothly. With this backdrop, we expected to see growth inch up and profits to level off this year. Instead, growth remained relatively flat and profit declined dramatically. This is likely due to several factors. First, internal cost rate structures have gone up and fringe rates have increased for the first time in four years. While this is due in part to rising healthcare costs, conversations with clients suggest companies are also investing in richer benefits programs to attract and retain employees. Second, GovCon leaders tell us they are attempting to diversify their revenue streams in pursuit of growth. Many are expanding into the commercial markets, either organically or through M&A activity, as a way to offset uncertainties and challenges in winning, executing and adhering to regulations within federal contracts. If this is true, investments in these diversification objectives are sure to be affecting bottom line numbers. Here is a closer look at these and other key financial metrics.

Key data points from the survey

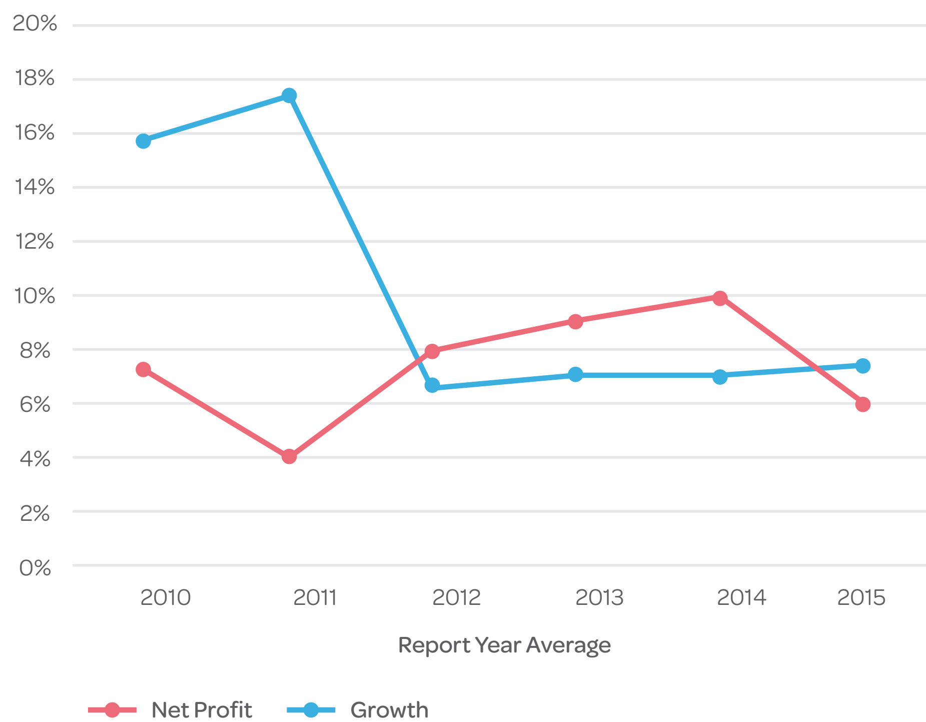
- On average, firms devote 6% of their annual revenues to financial operations within their companies. At smaller firms, the number was slightly higher, 7.5%, likely due to startup costs, the Finance department wearing many hats and a lack of cost accounting sophistication.
- Growth remained flat for the third year in a row while profits plunged four points, from 10% in in the 2014 report to 6% last year.
- Unallowable Costs took a slight dip to just under 2%. We expect to see it rise this year as the total contractor compensation caps came into effect on new contracts expanding the effect of the regulations beyond the executive teams.
- Overall Composite Overhead Rate continued to climb, hitting 40% last year, up from 27% in 2014. However, there was wide variation by company size. Small firms <$20M reported an average rate of 50%; mid-sized firms averaged 35% while large firms $100M-$1B+ averaged 28%. Rising healthcare costs are most likely the biggest driver of this rate jump.
- Invoice cycles climbed 61% to 14.3 days, the longest time reported in five years, indicating payment challenges now lie in the hands of GovCon firms. The good news is that this provides an opportunity for businesses to improve their invoicing and accounting processes and reap the rewards of quicker payments.
- For the first time in years, the top challenges facing financial leaders has shifted. In overall responses, the top three issues today are Increasing Profitability, Cash Flow, and Decreasing and / or Unpredictable Federal Spending Environment. Another notable response is Increasing Efficiency of Invoicing / Accounting. These results are consistent with reports of a drop in profitability and an increase in invoice cycle times.
- 27% of firms say they have Definite M&A plans, an increase over last year. We suspect we will see a continued rise in M&A activity as valuations climb and companies look for acquisitions as a way to grow revenue.

Please report on the following metrics – Net profit and Growth Rate. Data should reflect firm performance for the most recent completed fiscal year.

As the market leveled out, we anticipated companies would begin reinvesting profits in areas that were trimmed during the leaner years. What we didn't anticipate was a full four-point drop in overall profit. There is one theme that occurs throughout the respondents' comments and responses that provides encouragement that the drop may be temporary. Firms have been talking a lot about diversifying their revenue streams into commercial and even international markets. These efforts require start-up investments, and would certainly impact profit reports. If firms are successful in offsetting the ebb and flow of federal budgeting constraints with more diverse work streams, we will see profit numbers recover.

Overall, companies reported flat growth, which is to be expected in a marketplace that experienced a mere 1% federal budget increase. As the pendulum swings back toward companies investing in the businesses after 4-5 years of living in survival mode, we anticipate those investments will yield a steady increase in growth in the coming years.

5-Year Growth vs. Net Profit

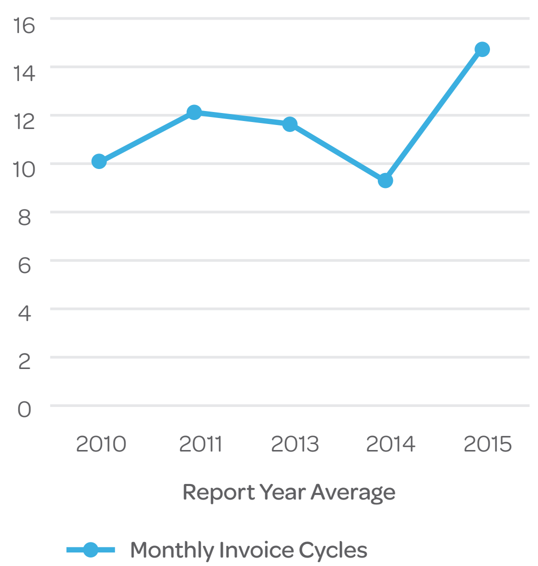


Please report on the following metrics – Average Monthly Invoice Cycle and Average Days Sales Outstanding. Data should reflect firm performance for the most recent completed fiscal year.

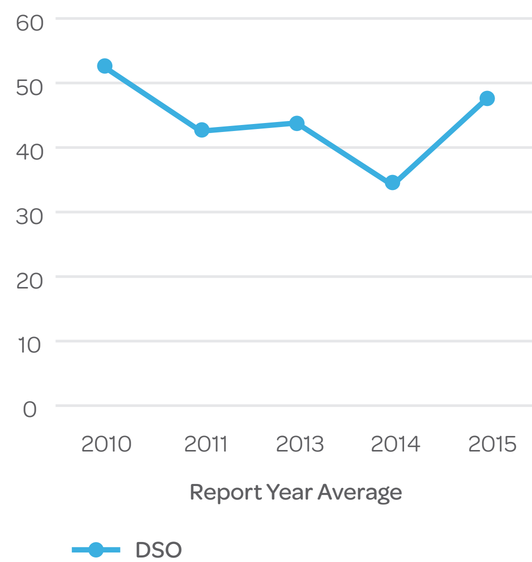
Last year saw a five-day spike YOY in invoice cycle times, the time it takes companies to get invoices out of the door after the invoice period. At 14.8 days, invoice cycles are now at their highest point in five years. One possible explanation is increased compliance scrutiny. Big firms felt the brunt of this spike more than smaller firms. Companies $100M-$1B+ in revenues reported a 17.5-day average, sharply higher than the 13.7 and 14.9-day averages of the mid-sized and small firms, respectively. Still, all firms saw an invoice cycle increase of 3-5 days coupled with an increase in DSO, indicating that the challenges are occurring on both the company side and government side. Armed with this information, we might expect GovCon firms to pay greater attention to their internal processes as a way to trim their invoice-to-cash cycle.

It is important to note that DSO, when compared only with 2013, appears to be a big story as the result jumped over five days year over year. However, when we look back over a five-year period, it is apparent that DSO has simply settled into a stable range and we expect it to remain within sight of the 45-day mark going forward.

5-Year Monthly Invoice Cycles



5-Year DSO



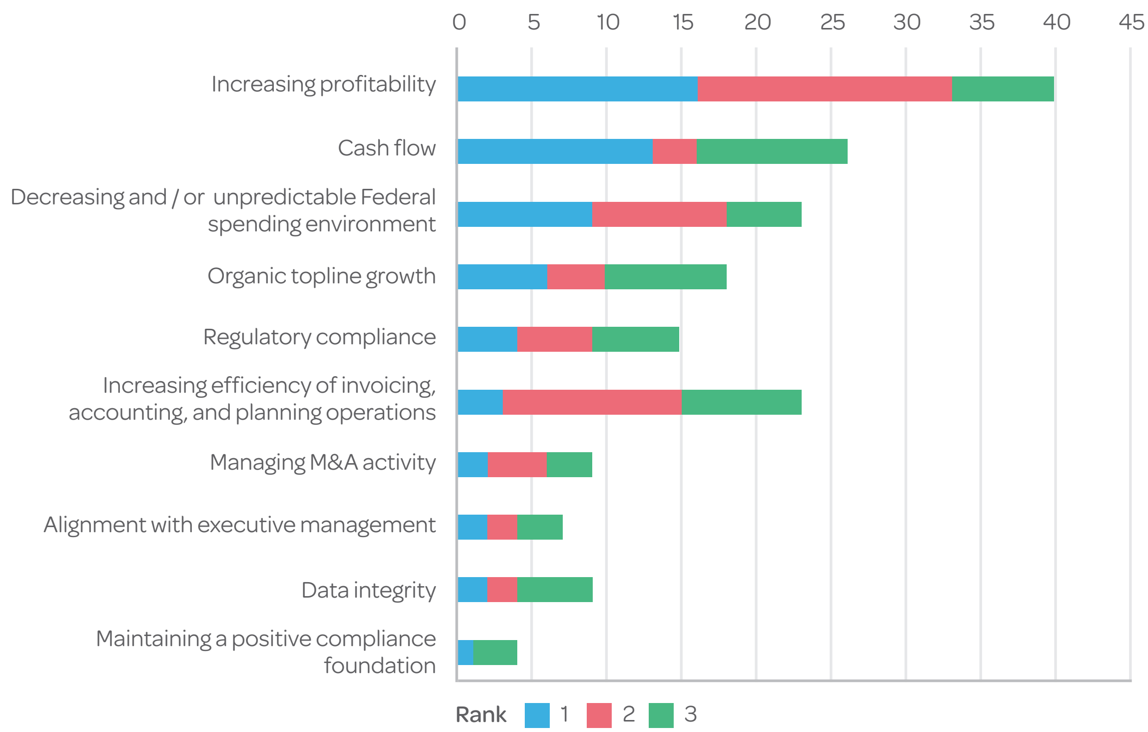
> "As CFO, people ask me what keeps me awake at night. My quick answer is cash flow. Anything that delays my ability to get an invoice out, or get paid in a timely manner, becomes a blinking light on my screen."

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.

After several years of little change in the order of the top challenges facing financial leaders, this year saw some significant shifting of concerns. Dips in the metrics for profitability and invoice cycle showed up here as important issues for financial leaders to address. Increasing Profitability and Cash Flow top this year's list of concerns. Invoicing efficiency, though sixth in #1 responses, came in third in overall responses. Considering the 64% increase in year-over-year invoice cycle times, this high level of concern makes sense. Firms should strive to improve their invoicing and related accounting processes to control their end of the invoice-to-cash cycle, thereby improving cash flow.

In last year's survey Organic Topline Growth was the number one challenge. It would appear that investments made in 2014 to retire that challenge may have contributed to eroding profits. Financial professionals are now turning their eyes towards the anticipated benefits of those investments in a big way. Under a stable but flat budget we anticipate that additional investment will be required to sustain growth for contractors, making a return to higher profits take longer than respondents might hope.

Finance Challenges



Clarity Outlook: Finance

As GovCon firms struggle to squeeze growth out of the existing Federal market, many are intensifying their search for growth outside the government contracting sphere, outside the domestic market, and through M&A activity. We expect to continue to see these trends strengthen as federal budgeting uncertainties come back into the picture later this year. Although profits and cash flow are down in the short term as they are diverted to growth opportunities outside GovCon, we expect these investments will pay off in the forms of growth and profit improvements in the coming years.

SECTION FOUR

Compliance

Introduction

The audit swell is growing as we predicted. Last year, we noted early signs of the government beginning to dig into its backlog of audits. This year, they are going at it full force. As DCAA focuses on that backlog, contractors are having to keep their books open longer and substantiate projects that occurred years ago. Many are holding funds in reserve in case of an audit finding, impacting profitability. To add to the picture, project leaders are also undergoing substantial audits up front, long before a project ever begins.

A tighter audit environment translates to more resources required for companies. As profits increasingly get eaten up meeting audit demands, fewer funds are available to pursue expansion. If this increased scrutiny is here to stay for the time being, figuring out how to efficiently manage the audit process will be critical for GovCon firms going forward.

"For the first time in years we are having to look at growing our audit team."

Key data points from the survey

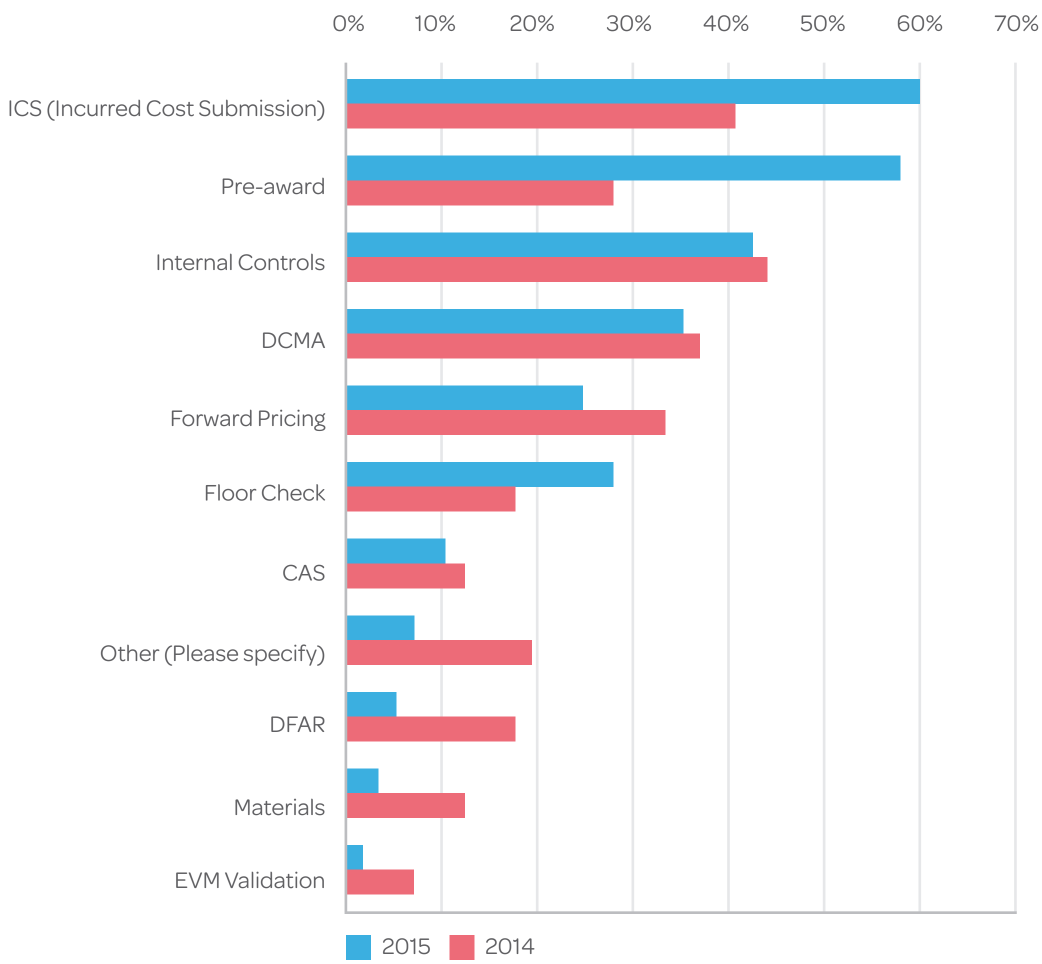
- A jump in the number of Pre-Award and ICS audits shows DCAA is focused on scrutinizing all phases of projects. 58% of respondents said they had undergone a Pre-Award audit in the past two years—roughly double the percent of last year—while 6 in 10 firms experienced an ICS audit.
- Indirect Rates, Labor & Time Keeping and Internal Control Systems remain the top three audit issues for firms, although the total number of respondents selecting each of them decreased year over year.
- We asked GovCon firms to characterize the change in the overall level of government oversight of their organization over the last year. While the Decreased Significantly slice disappeared, overall the levels were unmoved compared to 2014.
- Firms ranked ICS and DCMA audits highest in terms of cost of compliance. The rise in DCMA audits suggests auditors are taking a closer look at the scope and quality of work being performed.

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

Contractors take note: DCAA is putting both ends of your projects under the microscope. On the front end, the agency is increasingly using Pre-Award audits to ensure costs, structures and systems meet requirements. Nearly 6 in 10 firms say they have undergone a Pre-Award audit within the last 24 months, about double the number that made this claim last year. On the back end of the project, Incurred Cost Submission (ICS) audits are becoming increasingly common as the government leverages its final opportunity to claim every penny it can. ICS audits are only likely to increase as DCAA focuses on working through its backlog in this area. Fortunately for contracting firms, the government released some of the restrictions on these audits, making them easier to conduct.

Going forward, we expect DCAA to continue focusing on the front and back ends of projects and put less emphasis on helping contractors remove risk from their business. This steady shift away from a helping role will lead to continued erosion in the contractor-auditor relationship.

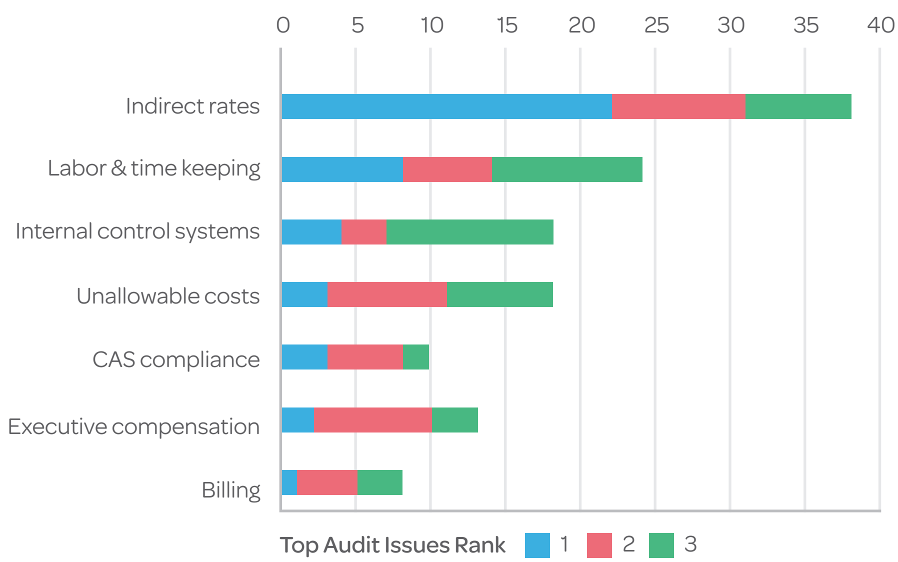
Audits in Past Two Years



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

While the number of respondents citing Indirect Rates and Labor & Time Keeping as top audit issues dropped this year, comments reveal both issues remain top of mind for many organizations. “Defending indirect rates has been increasingly challenging over the past few years,” observed one firm. Another noted: “Indirect rate support now requires the last four years of rate history.” These types of burdens are creating an environment where contractors are running their operation in a perpetual state of financial risk. Auditing agencies are behind schedule and contractors are paying the price for it, incurring additional costs to hold their records open.

Top Audit Issues



> “Prior to last year, we had never seen a Pre-Award audit. Over the last two years almost every single one of our contract wins has gone through one.”

Clarity Outlook: Compliance

All signs indicate the audit environment will continue to worsen as DCAA plows through its audit backlog. The new DFAR rule which allows for third-party auditors to step in and perform audits on the larger Primes will only intensify this dynamic when it becomes the new reality. Firms should anticipate thorough, rigorous audits up front and expect to keep their books open for longer after a project is completed. Investing in these areas is problematic as it only detracts from profitability and offers no financial upside.

One silver lining is that we are starting to see some DCAA initiatives around applying automation to audits, which will likely take the subjectivity out of them as well as speed the process. We are optimistic that over the next five years, automated solutions will come to bear, taking the pressure off auditors and making the interaction between auditor and contractor more seamless.

SECTION FIVE

Human Resources

Introduction

In our 2014 report, we pinpointed a talent crisis. This crisis appears to be worsening as companies continue to compete against the private sector for today's top workers. Several themes cropped up repeatedly in this year's responses. For starters, companies struggle to source and attract quality candidates. Following that, firms are stretched to offer a total compensation package that is competitive with those from outside government contracting. And once inside the company, GovCon firms report having trouble matching employees to open positions, further aggravating the attraction and retention challenges.

All of this means organizations must embolden their strategies for finding, retaining and developing talent. This means leveraging digital and social media and other technology solutions to better find, engage, and maintain an active candidate pool. It also means putting a spotlight on issues such as work / life balance, corporate culture, employee morale, and learning and development programs. A best practice that would serve firms well is to keep a close watch on the metrics that drive workforce health such as monitoring natural attrition of top performers and tracking the cost and duration of requisition-to-hire life cycles. These initiatives tend to be neglected in lean years, but they are as important—if not more so—to attracting and retaining today's skilled workers. Improvements in the battle for talent can be expected only when GovCon companies begin to embrace today's best practices for recruiting, hiring, and employee retention.

Key data points from the survey

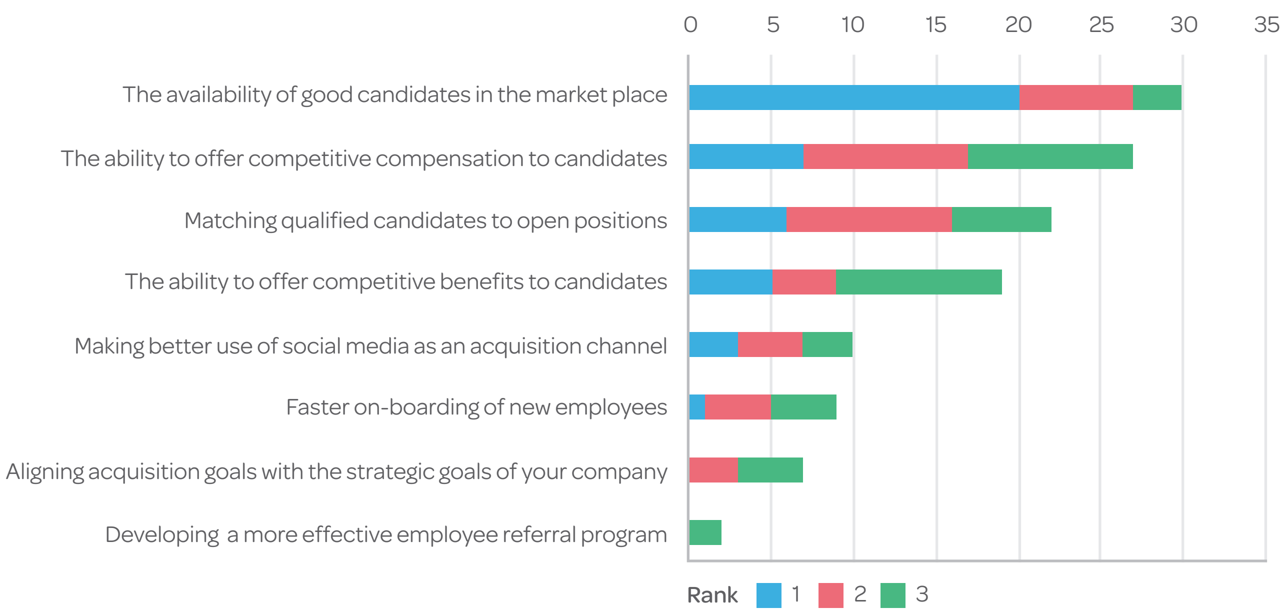
- The largest firms $100M-$1B+ devote 8% of their revenues to HR operations, quite a bit higher than the 5-6% at small- and mid-sized firms. We feel 8% is high but it could be attributed to growth or to HR leaders attributing HRIS systems to HR instead of IT.
- The top challenges in acquiring new talent remain largely unchanged from last year and underscore the problems of attracting top candidates to GovCon: the availability of good candidates, the ability to offer those candidates attractive compensation and benefits, and the ability to match good candidates to an open position.
- Controlling Healthcare Costs will again be the biggest challenge companies face in managing human resources over the next 12 months. This is not surprising considering healthcare is often the biggest cost companies carry. Retaining Employees moved up to second place as companies strive to keep good employees from leaving at a time when new talent is tough to find and attract.
- HRIS applications are increasingly moving into the cloud: 75% of mid-sized firms and 28% of large firms say their HRIS applications are now cloud-based, up from 50% and 9% a year ago.
- When asked to rank business processes in order of time and expense, Matching a Candidate to an Open Position and Annual Performance Reviews came in neck-and-neck as most time-consuming and costly.

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

Consistent with previous years, firms overwhelmingly pointed to the Availability of Good Candidates as their top challenge in acquiring new talent. However, in light of the HR issues reported by GovCon firms, we suspect the core problem isn't the availability of good candidates in the marketplace as a whole. The bigger problem is that the government sector is losing the beauty contest with the private and commercial sectors. Pay is one problem. The Ability to Offer Competitive Compensation moved into the #2 position this year, underscoring contractors' difficulties with compensating employees on par with the private sector. Offering Competitive Benefits, which bumped up a spot to #4 this year, is another challenge, as contractors feel the need to reduce internal costs as much as possible to remain competitive within contracts. With total contractor compensation caps coming down, contractors will have to balance their ability to attract and retain top talent with corporate profits.

The battlefield for talent continues to evolve and companies are making investments in total candidate engagement. Contractors will need to make similar investments to keep up with their private sector counterparts. Just as much of a key to candidate engagement will be re-inventing the culture and image of government contracting. New candidates select employers for culture just as much as compensation. Innovative companies are investing in candidate engagement solutions to cultivate talent hives of professionals interested in particular technologies, or business sectors, using social media and other channels prior to them becoming candidates or positions becoming available to draw them into the company. Tomorrow's GovCon leaders will do well to look to these best practices and technologies to overcome the current talent crisis.

Top Challenges in Acquiring New Talent



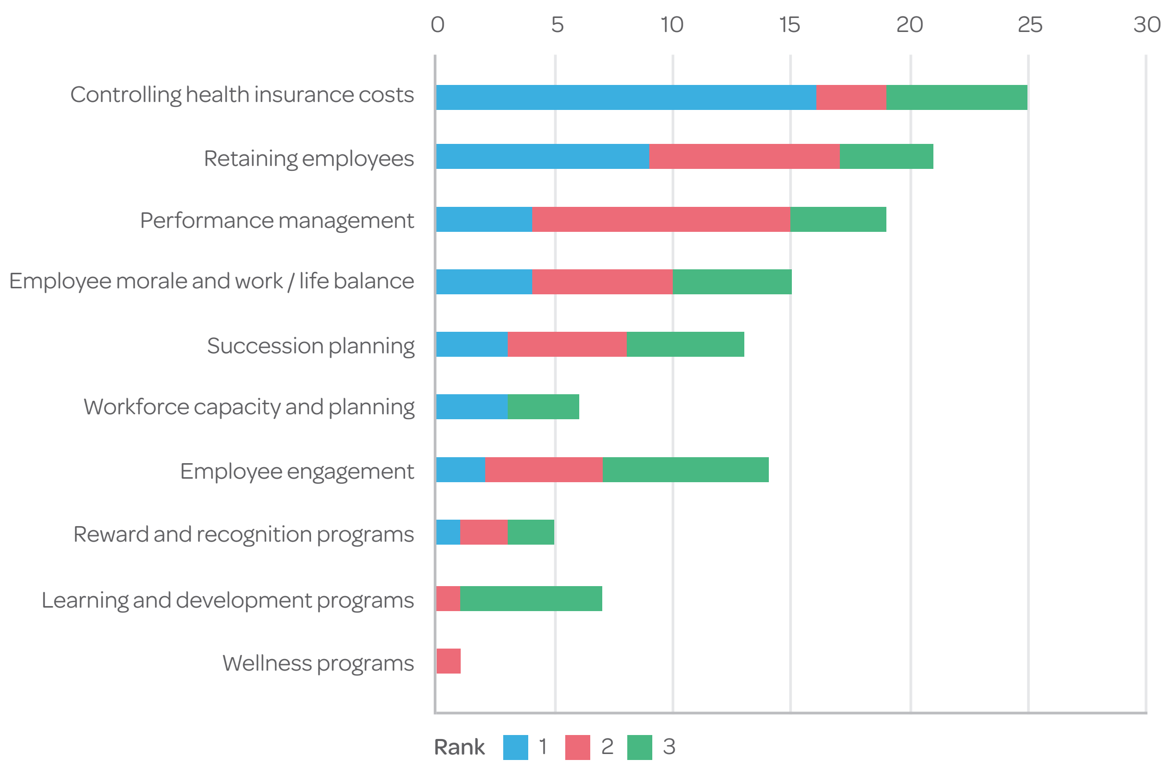
Over the next 12 months, what are the biggest challenges you have in managing human resources?

Healthcare is a heavy burden, and controlling these costs remains the biggest focal point for companies. Retaining Employees moved up a spot to the #2 position this year, which makes sense at a time when acquiring talent is such a challenge. Companies recognize that it is more important than ever to retain the good employees they have as filling an empty slot is getting harder and harder.

With this in mind, we found it counter-intuitive that Learning & Development Programs fell from #4 last year to #9 this year. There is a close correlation between L&D and retention. When employees are getting the training they need to grow and develop their skills, they are more inclined to stay with their employer and continue to move up. Companies that place a priority on developing existing talent will find it addresses both retention and acquisition issues.

One other result worth noting here is that Employee Morale & Work / Life Balance leaped into the #4 spot from second-to-last in last year's report, re-enforcing the need for the Government Contracting community to spend time on its image and culture. Companies have been running lean for the last 4-5 years and they are worried about burning out their employees, particularly those in the 25-40 age range for whom Work / Life balance is paramount. Firms are wise to pay attention to this issue. If they don't, the grass will start to look a lot greener in the commercial sector where many organizations are placing a renewed emphasis on work / life balance and corporate culture.

Challenges in Managing Human Resources



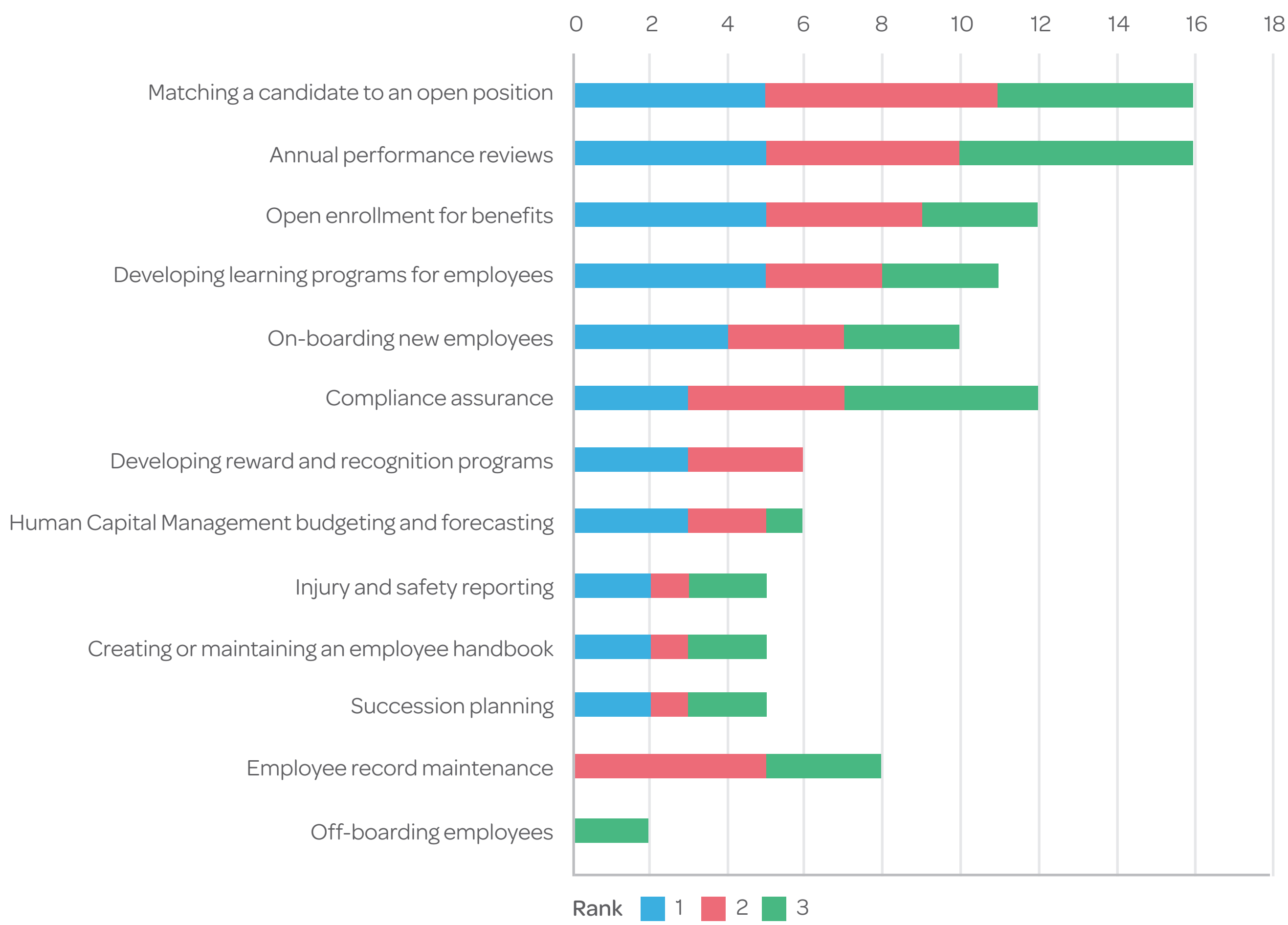
Please rank these business processes in order of time consumption & expense (1 = Most time consuming and most expensive; 13 = Least).

When asked to rank Human Resources processes by the time and expense required to support them, firms identified Matching a Candidate to an Open Position and Annual Performance Reviews as their most time-consuming and costly processes. Generating an equal number of top responses were Open Enrollment for Benefits and Developing Learning Programs for Employees. The top three answers were unchanged from last year while Learning Programs slid up one spot, which could be a positive sign that companies are investing more in this area.

Contractors will be keenly focused on how they can balance the rising health care and benefits costs with the cost of delivering on core HR processes to their employees. Manual processes or custom solutions are de rigueur for many of the processes below (and yes, Sharepoint is a custom solution).

In other cases, companies have a heterogeneous set of solutions that is either not connected or loosely connected via internal IT with custom integrations. All of these factors add cost to HR's ability to offer solutions to their company and employees in a cost-effective manner. We have started to see signs of investment in both point automation and throwing out the spider web of solutions for a more unified solution approach. We agree that a single solution that spans core HR information and talent management will help to lower costs while allowing HR professionals to deliver superior services to their primary customers. This approach will enable executives to measure the health of their workforce and make strategic decisions around their most important asset...their people.

Business Processes by Time Consumption and Expense



Do you prefer your HRIS applications to be cloud-based or on premise?

Last year saw a seismic shift to cloud-based solutions for HRIS at mid-sized and large companies. This year, 75% of mid-sized firms and 28% of large firms say their HRIS applications are cloud-based, up from 50% and 9% last year. These results validate trends we are seeing in other areas—in particular IT where HR came in as the top system either already in the cloud or being considered for it in the next 12 months. Write-in comments suggest some firms still have lingering concerns about security. The fact that cloud adoption continues to grow so strongly confirms companies are finding it easier, cheaper, and faster to base their HR & Talent solutions in the cloud. We are encouraged by this trend and we believe that cloud will be one of the key strategies for companies to drive down costs, allowing them to invest more in their people.

HRIS Hosting Preference by Firm Revenue

> “We have been asked to transform our HR organization into a more strategic, more efficient operation, all on a highly controlled budget. Our success has been due in large part to our aggressive pursuit of cloud-based applications such as employee microfeedback and applicant tracking. These enable us to centralize and streamline what used to be big and complex operations.“

Clarity Outlook: Human Resources

GovCon is deep into the War on Talent. To win, firms cannot simply do more of what they have done in the past. A more modern, balanced approach is called for. This means focusing on things like culture and work / life balance which is critically important to today's young professionals. It means bringing benefits up to par with competing industries. And it means finding new ways to engage and attract candidates that leverage their corporate digital space and recruiting best practices. It means finding more cost effective means of delivering on HR and talent solutions through more automation, unified solutions, and cloud adoption. If GovCon companies hope to staff projects efficiently and effectively, and deliver on their contractual obligations with excellence, they will have to pay more attention today to the entire spectrum of the employee experience.

SECTION SIX

Information Technology

Introduction

Technology lives at the intersection of efficiency and productivity—two priorities that are critical to the success of government contractors. Because of its importance, we added a section this year to dive deeper into IT trends in government contractors. What technology initiatives are firms pursing? What challenges are they encountering? What systems are firms moving into the cloud? What types of mobile devices are companies supporting and on what platforms? These and other questions will be part of our ongoing study of how leading firms are harnessing technology to boost their business and comply with complex government requirements.

Responses showed that firms are often caught in a Catch-22 when it comes to IT investments. On the one hand, it is clear that technology solutions can sharply reduce costs and improve efficiency. On the other hand, uncertainty in government budgets can make firms gun shy with respect to pulling the trigger on IT investments. Firms are pursuing cloud solutions in some areas, but security concerns are keeping them from a wholesale migration to the cloud. Everywhere, firms are striving toward the triple crown of "better, faster, cheaper." Here, in this new section, is a closer look at how they are getting there.

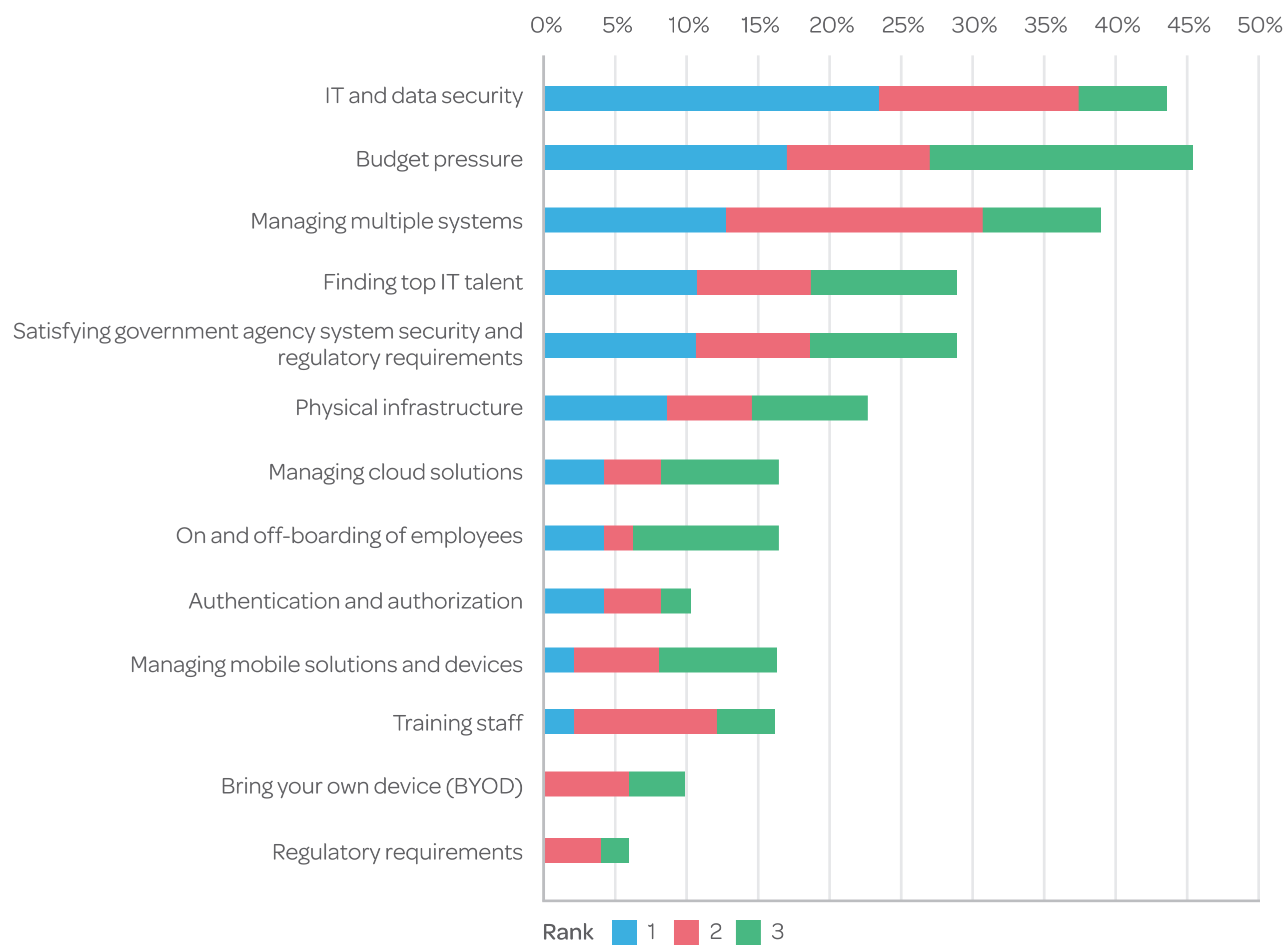
Key data points from the survey

- Companies allocate on average 8% of their annual revenue to IT. The highest IT-related costs are labor (40% of firms' IT spend), hardware (17% of spend) and software (13% of spend).
- 60% of large firms ($100M-$1B+) saw a decrease in their IT budgets last year while 66% of small firms <$20M saw an increase. This divergence is likely to equalize over the next two years, as large companies say they expect a slight increase in IT spend through 2016 while smaller companies anticipate decreased spending in that timeframe.
- Penetration of smartphones and other mobile devices is near 100%. While iOS and Android remain the platforms of choice, Windows has been coming on strongly over the past two years, capturing nearly a quarter of the market where a few year back they had virtually no presence. .
- Human Resources / Talent Management and Social Media are leading the transition to the cloud, which is no surprise as these are seen as low-risk functions. However, Finance came in third, suggesting more firms are open to moving sensitive data into the cloud in an effort to reduce costs and improve functionality.
- Today's top IT challenges for firms of all sizes are: (1) IT & Data Security, (2) Budget Pressures and (3) Managing Multiple Systems.
- When asked which solutions they are using to manage user authentication, most firms said Windows Active Directory (On Premise) and Windows Federated Active Directory (On Premise). At small and mid-sized firms, a small number of companies are starting to leverage the cloud with Windows Azure Active Directory (Azure Cloud). We expect to see gains in cloud share with large companies beginning to leverage it in conjunction with a move to Office 365.
- Firms overall reported an increase in spending over the past 24 months for protecting the firm from cyber threats, further reinforcing the top IT challenge. Spending by smaller firms was higher, perhaps due to the need to make early stage investments in protection.
- GovCon companies ranked Upgrade / Implement ERP Systems as the most expensive line item on their IT budgets over the next 24 months. Following closely behind were both Upgrade / Implement New IT Security Policies & Procedures and Upgrade / Implement Datacenter Hardware.

Please drag and rank your top three IT challenges.

This year's top IT challenges—security and budget—remain the specters that follow IT everywhere. Faced with continuing profitability struggles and headlines fraught with security breaches and data compromises, we don't expect the top slots will change in the near future. The third challenge, Managing Multiple Systems, underscores the tension that exists between IT and business. When a business decision to adopt a "best-in-breed" solution trumps an IT mandate for uniform platform adoption, IT finds itself managing multiple systems. This can further exacerbate the budget and security concerns.

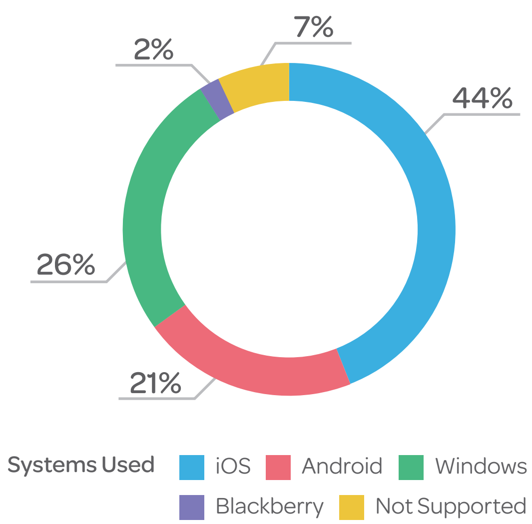
IT Challenges



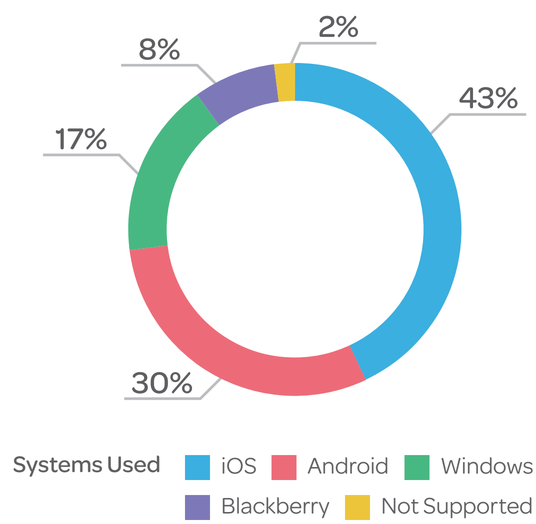
What type of mobile devices and platforms are supported by your IT organization? (Select all that apply)

Penetration of smartphones and other mobile devices is nearing 100%, proving the adage that mobile phones are on the hip of every GovCon employee. The breakdown of supported platforms revealed some interesting results. First, Blackberry represents a tiny sliver and shrinking, a trend we expect will play itself out over the next year or two. Across the other three—Windows, Android and iOS—the big story is the large market share commanded by Windows. Had we asked this question just two or three years ago, Windows would likely have been just a sliver itself. However, Microsoft has been aggressive in its efforts to penetrate the mobile enterprise space and those efforts are paying off. Some of this may be due to IT departments pushing for Windows smartphones and tablets for a more uniform support model. The mobile landscape has undergone massive transformational shifts in the past decade, from Blackberry domination in the mid 2000s giving way to the iOS takeover followed by Android lighting the market on fire. Windows has quietly captured market share from the dominant players and we will watch with interest how Apple and Google respond in the coming years.

Mobile Devices Supported - Tablets



Mobile Devices Supported -Smartphones



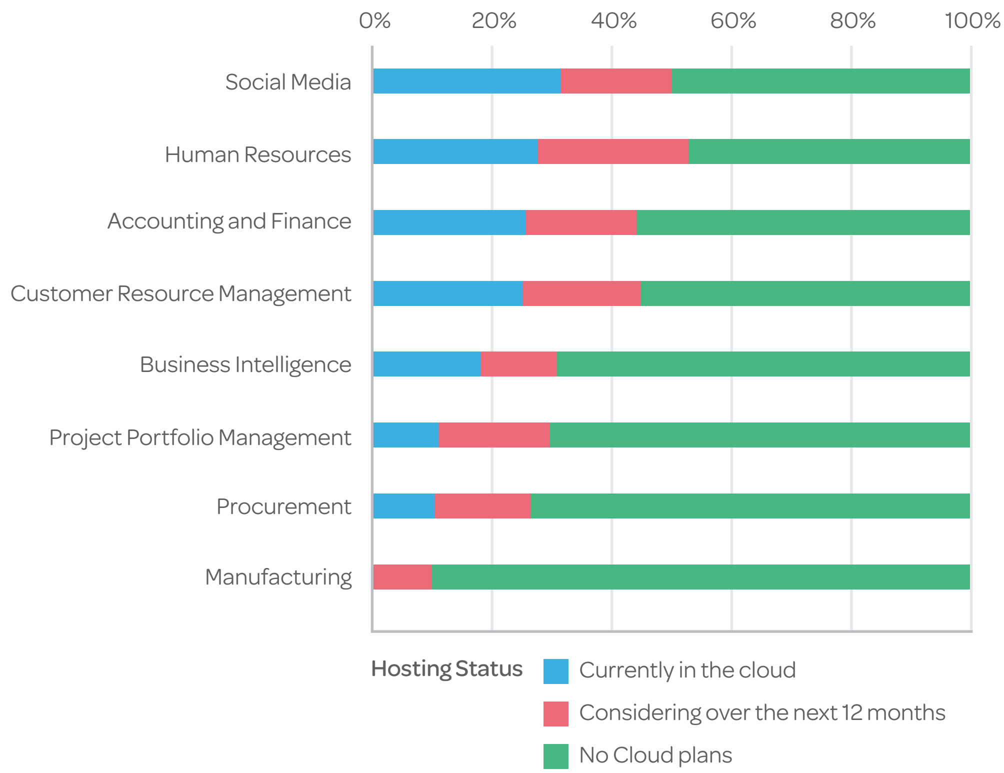
"We used to be consumed by tech evaluations, implementations and upgrades. Now we are focused on keeping all of our systems and data safe and secure when it is scattered across multiple clouds and networks, and assets are all going home with people each night."

Which of your current systems are hosted in a third-party / cloud?

Social Media and Human Resources / Talent Management lead the charge into the cloud, mirroring many other industries. These functions are seen as containing less sensitive data than others, which makes this move easier. That said, we were surprised to see Accounting and Finance show up in the #3 position. In conversations, GovCon leaders express reluctance to put financial data in the cloud. However, these responses suggest Finance could be more ready than we thought to embrace solutions delivered in the cloud. We anticipate a steady push of Customer Relationship Management solutions towards the cloud, which has been happening for years. It will be interesting to watch Business Intelligence solutions move to the cloud. Conventional thinking would say BI will follow the resource systems into the cloud as there are too many challenges for aggregating on-premise data into a cloud-based BI environment tailored to a company's specific needs.

One of the biggest stories here is that for nearly all categories, over 50% of firms reported having no cloud plan. Since data security is such a high concern among firms, we suspect that this is one of the biggest obstacles. Write-in comments indicated many are still uncomfortable with the idea of sensitive data being hosted outside their firm's own data centers. It may also be due to some confusion around definitions of the cloud, third party hosting, and SaaS.

Cloud Adoption

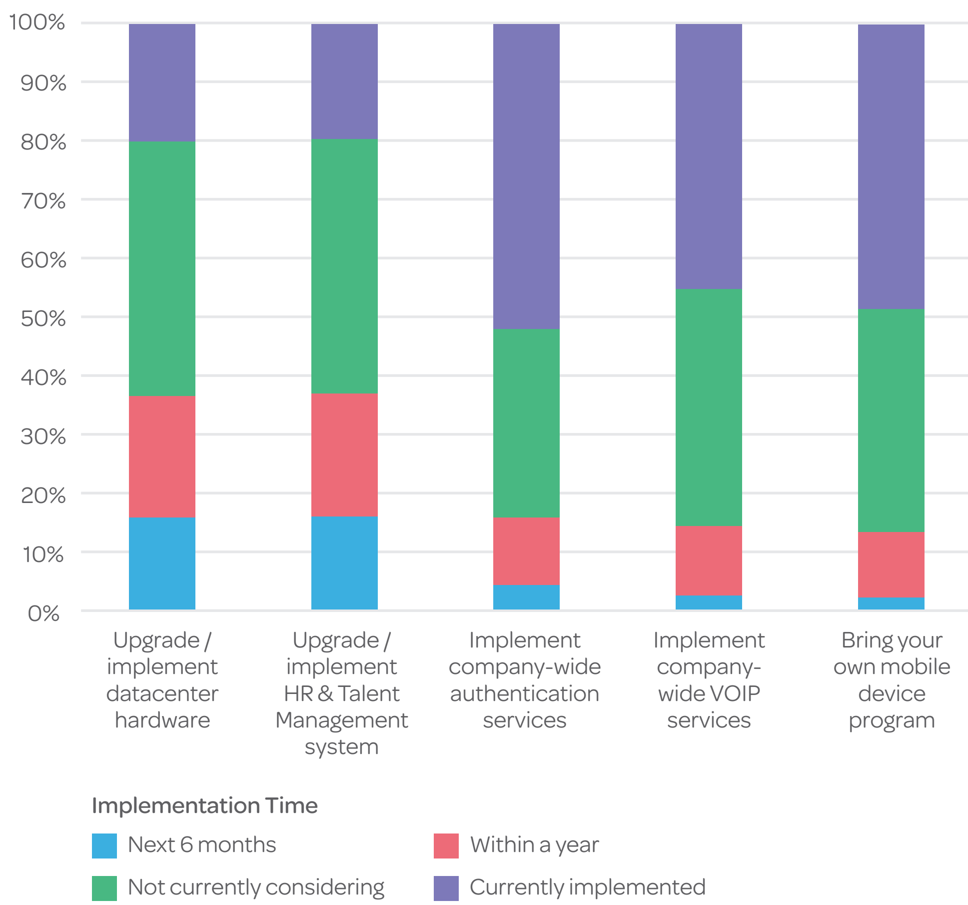


Indicate when your organization might be implementing the following IT initiatives.

The initiatives leading the way in the near term (Next 6 Months, and Within a Year) are clearly Data Center Hardware and HR & Talent Management Systems. The first of these presents an interesting tension within IT. When we asked firms to rank their most costly IT initiatives, Data Center Hardware came in near the top at #3. If refreshing hardware is so expensive and yet many firms have near-term plans to do it, cloud adoption may start to look increasingly attractive.

On the other side of the spectrum, while Bring Your Own Mobile Device Program shows up as one of the most highly implemented initiatives, just over 50% of firms reported a program in place, and nearly 40% reported Not Currently Considering. This is interesting in light of previous responses which indicated nearly 100% of firms are supporting mobile devices and platforms. There seems to be a gap between the high adoption of smartphones and the implementation of BYOD programs and policies. This could be based on companies continuing to provide mobile devices for employees, although in our observation this is a benefit in decline. More likely, as increased functionality and bandwidth push the boundaries on what smart devices can do, BYOD programs and policies will be forced to catch up.

IT Initiatives



Clarity Outlook: Information Technology

IT will continue to sit at the crossroads of cost reduction and efficiency conversations. This is even more true in the government contracting world with the emergence of ITAR and 'govcloud' alternatives. As firms grow, this equation becomes more complex because broader policies and platform standardization must be accounted for. We expect to see an increased push to the cloud especially in non-sensitive areas. Firms that are best able to navigate this intersection going forward will be the ones that can best maintain internal cost structures as well as harness new and emerging technology to help their businesses compete and win.

Data Profile

Revenue Range	**Small** **< $20M**	**Mid-Sized** **$20M - $99M**	**Large** **$100M - $1B+**
Business Development			
Win Rate (ave.)	39.9%	$38.6%	36.0%
Project Management			
Project Status Visibility	High 35% Moderate 14% Low 3%	High 20% Moderate 7% Low 4%	High 7% Moderate 10% Low 0%
Project Status Confidence	High 34% Moderate 13% Low 5%	High 18% Moderate 11% Low 2%	High 11% Moderate 6% Low 1%
Project Management Maturity	Very Mature 9% Somewhat Mature 22% Somewhat Immature 13% Very Immature 7%	Very Mature 3% Somewhat Mature 16% Somewhat Immature 8% Very Immature 3%	Very Mature 3% Somewhat Mature 10% Somewhat Immature 2% Very Immature 1%
Risk, Issue and Opportunity (RIO) Management Maturity	Very Mature 9% Somewhat Mature 37% Somewhat Immature 44% Very Immature 9%	Very Mature 0% Somewhat Mature 35% Somewhat Immature 46% Very Immature 19%	Very Mature 0% Somewhat Mature 64% Somewhat Immature 29% Very Immature 7%
Risk, Issue and Opportunity (RIO) Management Scope	Organization-wide Initiatives 42% Divisional Initiatives 14% Isolated Initiatives 26% No Initiatives 19%	Organization-wide Initiatives 19% Divisional Initiatives 15% Isolated Initiatives 54% No Initiatives 12%	Organization-wide Initiatives 47% Divisional Initiatives 27% Isolated Initiatives 20% No Initiatives 7%
Financial Metrics and Operations			
Growth Rate (ave.)	17.7%	9.2%	7.6%
Days Sales Outstanding (ave. days)	49.4	48.4	48.7
Invoice Cycle (ave. days)	15.4	13.7	17.5
Net Profit (ave. %)	7%	5%	6%
Top Finance Challenges	1. Increasing profitability 2. Cash Flow 3. Decreasing and/or unpredictable Federal spending environment		
Compliance and Risk Management			
Top Audit Issues	1. Indirect Rates 2. Labor & Time Keeping 3. Internal Control Systems		

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- Improve contract win rate and retention rates
- Complete projects on time and under budget
- Ensure project, IT and corporate governance
- Streamline the financial management of their organizations

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