Deltek

CLARITY

GOVERNMENT CONTRACTING INDUSTRY STUDY

7th Annual Comprehensive Report

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CLARITY

Government Contracting Industry Study

7TH ANNUAL COMPREHENSIVE REPORT • 2016

INTRODUCTION

The government contracting industry is once again finding firm ground. Results from our annual Clarity Government Contractor Industry Study find signs of strength and improvement throughout contracting operations.

For the first time in the seven years since we started this survey, profit and growth both increased in the same year. Win rates climbed for large and small companies. Government contractors have doubled their investment in project management, where PM maturity and visibility are on the rise. All in all, businesses are experiencing a level of stabilization and growth they haven't seen in years.

But contractors have long memories. Still feeling the sting of the last downturn, companies are in the midst of significant diversification efforts to offset future budget turmoil. Today's push into new agencies, new state & local markets, new commercial markets, new products, and new geographies is happening on a scale we have not seen in the past. As elections approach, there is a renewed urgency around this effort as the outcome promises another period of uncertainty about policy positions and spending. This uncertainty is clearly visible as the survey had yet another first this year—for the first time, companies projected lower growth over the next two years than their average actual growth last year.

Finding the best and brightest talent to lead government contractors into this uncertain future is another major theme of this year's study. Over the past two years, we signaled talent as an area of crisis and companies have responded. On an industry level, organizations are putting enormous effort into re-branding the government contractor image, improving their attractiveness to candidates by communicating the innovation and meaningful work being performed by government contractors today. At the company level, businesses are putting new programs in place to attract and retain talent. From increasing fringe benefit rates to creating retention and succession plans, contractors have recognized the realities of the talent crisis and are putting dollars against it.

Our 7th annual Clarity GovCon Industry Study finds a GovCon world that, while stabilized financially, is changing in new and innovative ways. Based on 582 responses across all sections, this year's study captures the industry on the cusp of its metamorphosis into a financially solid, well diversified, efficient and attractive place to work. We hope the data and insights contained in these pages will help your own company continue this transition into the future.

For the first time in seven years, profit and growth both increased in the same year.

EXECUTIVE SUMMARY

The 7th annual Deltek Clarity Government Contracting Industry Study is a portrait of an industry at the spear tip of some critical changes that will re-define what it means to be a government contractor.

From 582 responses across over 100 questions, several trends emerged for the state of the industry. The following five trends capture where the government contracting industry stands today, as well as give a hint to where it is headed in the future:

Net Profit climbed to 10% while Growth Rate climbed to 11%.

Proft and Growth Increased

Growth Rate and Net Profit, which in the past have had an inverse relationship, both tracked in the same direction this year. Net Profit reversed last year's four-point dip and climbed to 10%, matching its 2014 high. Growth rate improved four points to 11%. While growth still has a long way to go to reach its pre-recession high of 17%, it is moving in the right direction.

External audits and cybersecurity enforcement are going to increase.

Oversight Levels Out but Will Intensify

Survey participants conveyed a mood of relief that the compliance atmosphere was mostly unchanged from last year and seems to have reached a balancing point in the number of audits and amount of oversight. The lull may be deceptive. The survey revealed the first external audits have begun in response to a late 2014 DFAR rule on critical business systems and they are only going to increase. New DFAR security rules on cybersecurity are also looming. Contractors are determining how to comply and what the enforcement actions will be. With DCAA production down due to a hiring freeze, we don't see them picking up the duty for doing cybersecurity audits any time soon but we urge contractors not to wait to take action.

Top challenges center around retention of talent.

Talent is a Focal Point

From acquiring top talent and retaining them to succession planning for the aging workforce, firms are intensively focused on their people and making sure top talent stays with the organization. The top challenges this year center around retention, with Employee Morale & Work / Life Balance jumping to the top from #4 last year. HR leaders are tracking talent retention closely which is evident in the KPIs they are tracking today. Topping the list are Voluntary Turnover, Involuntary Turnover and Employee Retention.

Data security is the # 1 challenge facing contractors.

Cybersecurity & the Cloud Loom Large

Cybersecurity threats have reached such heights that new regulations have been put in place without the standard process for industry comment. Late in 2015, a new DFAR rule made it mandatory for contractors to disclose breach activity to the federal government for any unclassified defense department information. The definitions of this regulation are so broad and vague it's no wonder data security is the #1 IT challenge facing contractors for the second year in a row. While we only saw a modest increase in Cloud usage for functional applications, customers are evaluating every sort of Cloud solution to determine if the quality of service, price, and security can outmatch what they are able to achieve on their own. IT is wise to enlist the power of software as a service (SaaS) offerings to tackle areas not directly in their core competency.

New markets, customers, and product lines are sought for diversification.

Diversify, Diversify, Diversify

When asked about the key financial success factors for their organization over the next 2-3 years, survey participants cited diversification both domestically and abroad. Contractors are looking to move from subcontracting to more prime contract work. They are looking at how they can break into new federal agency customers where they have not been in the past, as well as how to take better advantage of state and local opportunities. While facing a steeper ramp, companies are taking a run at commercial markets, new products and services, as well as new geographies. Many contractors are going through their own build / buy / partner evaluations to achieve the diversification. M&A activity did not show up big in the results even though it can be an easier way to break into a new market. Very few indicated plans to sell, however those who declined to respond were on the rise in small & midsize firms. Whether this is a chilling of the M&A market, or a quiet period before increased activity, time will tell. Regardless, the march to diversify is on in the second year of increased discretionary spending in recent memory.

SECTION ONE

BUSINESS DEVELOPMENT

One of the overarching messages that emerged from this year's Business Development survey was a rise in the influence of small businesses.

43%

win rate

for large firms, and 44% for small firms, both up this year

half

of respondents

manage task order programs in a Centralized manner, up from 40% last year

#1

reason

for not pursuing an opportunity is "Not a Good Fit," suggesting greater caution and less desperation

Companies <$20M are getting a seat at the table and they are winning. In write-in comments, participants pointed to difficulty competing in an environment favorable to small businesses. There are two factors converging here. The government has been more intentional about awarding business to small companies to meet small business goals. And small businesses often are able to operate at lower margins with lower overhead, which translates to more competitive pricing.

The small business advantage showed up in the sales pipeline as well. In a new question this year, we asked firms what they aim for their pipeline to look like compared to their quarterly sales plan. The pipeline multiplier was just 2.7 for small firms <$20M, compared to 3.3 and 3.4 for the two mid-tiers and 11.3 for the largest firms >$1B. These results made a lot of sense in light of everything else firms are telling us. Small companies are winning more and are very selective about what they pursue so they can manage a tighter pipeline. Larger businesses require more opportunities to account for small business set-asides as well as the more sizeable deals and higher-risk competitions they face for business. This competitive frenzy continues to drive firms to explore new markets and seek competitive advantage through more, earlier and better information about opportunities.

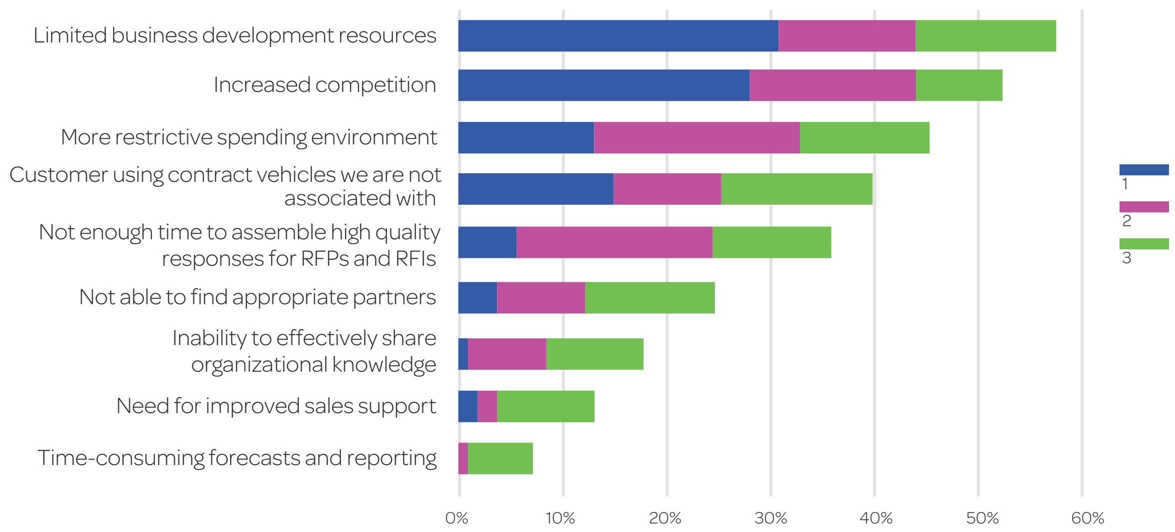
Key Data Points from the Survey

- The amount of revenue allocated to business development ranges from 4.8% at the very largest ($100M->$1B) firms to 8.7% at the smallest firms (<$20M).
- Small firms' Win Rate climbed four points to 44%, large firms' rates climbed a significant seven points to 43%, while mid-sized companies remained flat. At the same time, four in 10 small businesses said their Win Rate increased more than 10% over the past three years while nearly two in 10 said it had increased between 1% and 9%.
- In aggregate, firms reported that nearly 6% of their wins were protested, less than half the rate reported last year.
- Half of the respondents indicated that they manage their task order program in a Centralized manner, which suggests a pendulum swing from the 40% last year.
- Limited BD Resources and Increased Competition remain the top business development challenges today. Write-in comments call out the small business boost as particularly difficult to combat

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

Firms seem to be reaffirming that Limited Business Development Resources and Increased Competition are their biggest challenges. The order of the responses remained very similar to last year, but even more respondents assigned their #1 rating to those two challenges. Specific to the jump in competition responses, this may tie back to the small business boost we are seeing. In remarks, participants cited frustration with small-business set-asides and the difficulty of winning in an environment that favors small business. Larger firms may be finding themselves challenged to fill pipeline as more opportunities shift to small business.

TOP BUSINESS DEVELOPMENT CHALLENGES

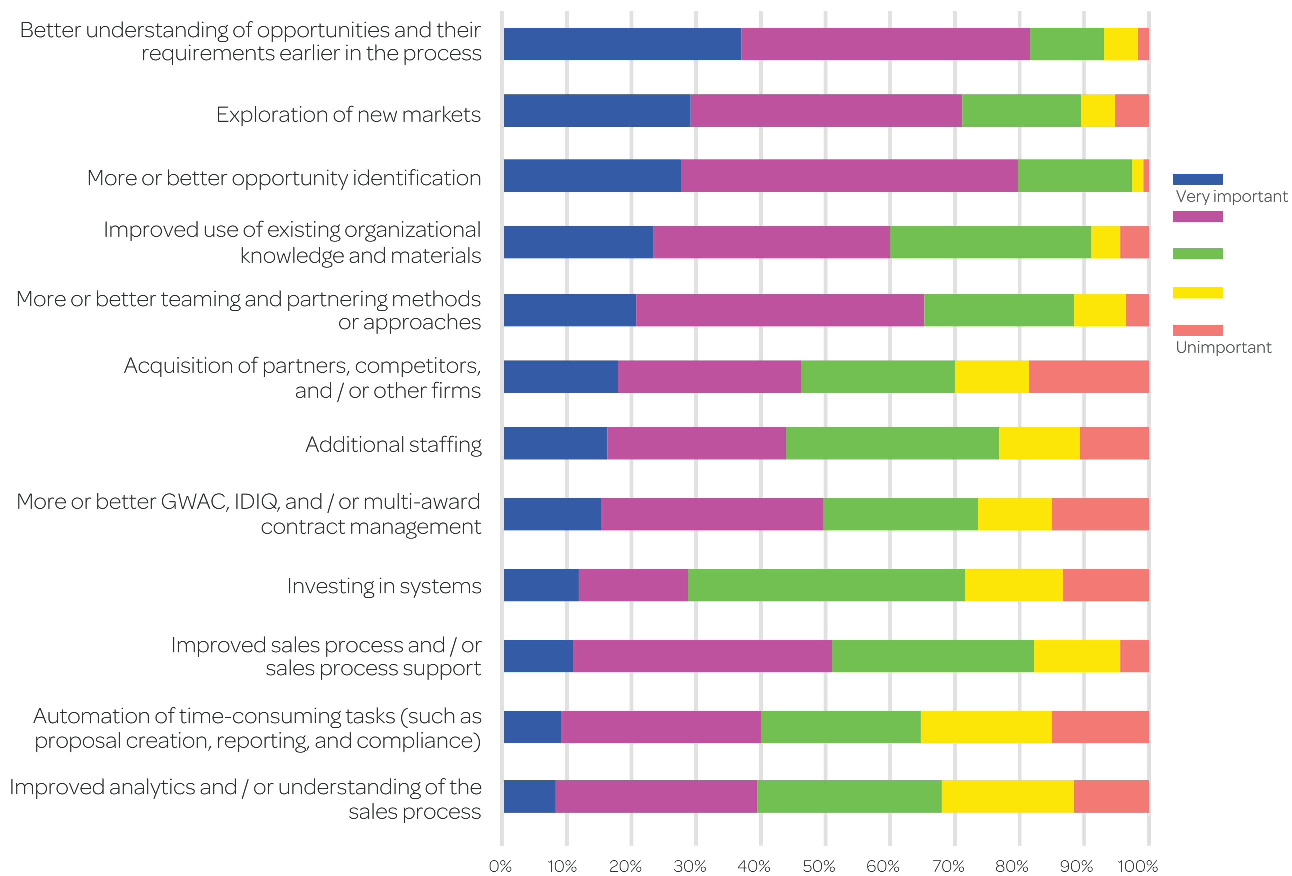


What business development initiatives are you pursuing to address these challenges?

This year saw some real movement in the initiatives GovCon firms are pursuing. The jump in Exploration of New Markets from the #4 spot makes a lot of sense in light of today's increased competition and challenging budget environment. When markets become crowded and growth challenged, firms look for ways to take their products and expertise into new areas. Diversification and differentiation were themes both in the list of initiatives and in write-in comments.

In addition to a significant shuffling of results, we saw a reduction in emphasis on the leading initiatives. Last year, more than 50% of participants ranked the top three initiatives as Very Important. This year, almost a third said their top three were Very Important, suggesting they are more tempered in their emphasis of these initiatives.

BUSINESS DEVELOPMENT INITIATIVES PURSUED

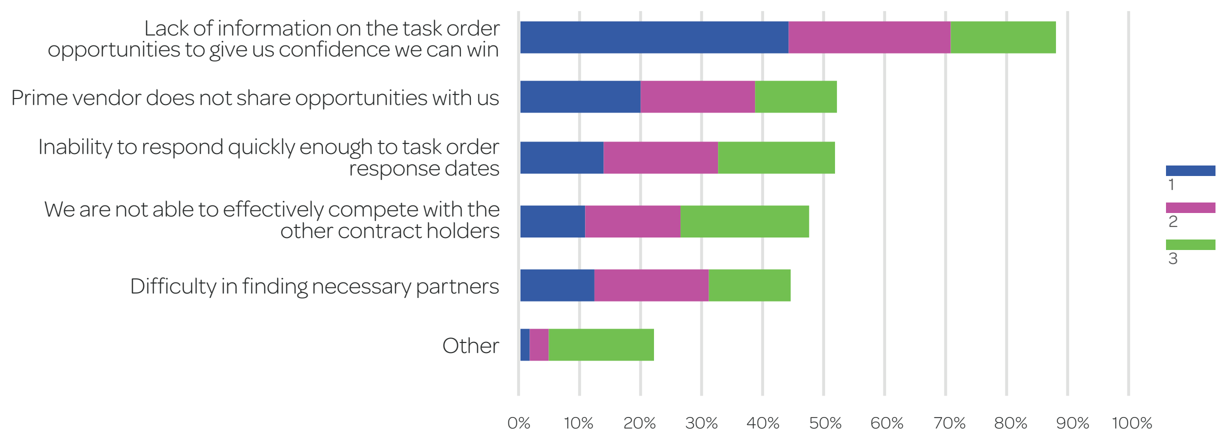


What are the top three challenges you face relative to achieving success with task order vehicles?

These results were essentially unchanged from last year's. The only real shift we saw was near the bottom of the list: Difficulty in Finding Necessary Partners swapped places with Inability to Respond Quickly Enough to Task Order Response Dates.

It is worth pointing out that Lack of Information on the Task Order Opportunities came in at the top for the fourth consecutive year. Almost nine out of 10 firms put it in their top three and 43% cited it as their #1 challenge. This begs the question: What are firms doing to address this problem? It is also interesting to consider this challenge in light of firms' top three sources for new opportunities that are added to the pipeline. If firms continue to rely on PMs, this could contribute to the problem.

TOP CHALLENGES FOR TASK ORDER VEHICLE SUCCESS



BUSINESS DEVELOPMENT

CLARITY OUTLOOK

It's an election year, so GovCon firms are on edge. Depending on the tide, government contractors will either need to tighten their belts again, or will see a more favorable business environment emerge. Regardless, this uncertainty, combined with intensified competition for government contracts, is a warning siren for firms to shore up every aspect of their business development practices.

SECTION TWO

PROJECT MANAGEMENT

Project Management appears to have earned itself a prime seat at the table. Investment in this critical area has doubled. Maturity and visibility continue to increase.

40%

of mid-sized companies

reported a Very Mature PM discipline, up from only 10% last year

59.8%

of all firms

felt the importance of of Project Controls software will increase in the next 2 years

half

of medium and large companies

account for risk and uncertainty in scheduling the majority of projects

The importance of Project Management software is expected to increase over the next 2-3 years, particularly at the largest firms. And Risk/Opportunity Management metrics are trending in the upward direction with firms telling us the importance of this function will increase—in many cases, significantly—in the coming years. The increase in profit and growth we saw this year can certainly be attributed in part to a better grasp on Project Management fundamentals.

Another positive message from the survey: although firms are performing better in most areas of project management, they recognize they still have plenty of work to do. Inexperienced project managers continue to plague project efficiency, but plans to boost internal training, apply best practices and develop KPIs are high on the list of antidotes. In addition, risk management is not yet being applied as widely or frequently as we would like to see, but the growing importance of it should lead to improvements there. We are encouraged to see that where there are gaps, firms are recognizing them and creating plans to address them.

Key Data Points from the Survey

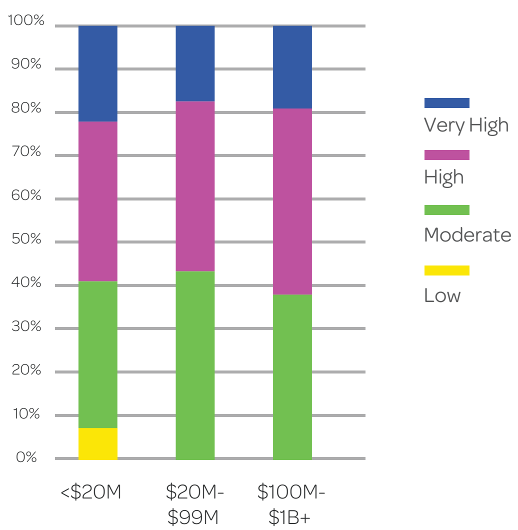
- Overall project visibility improved last year. Only 6% of firms are still reporting Low Visibility—all of which are small companies <$20M. The decline in Low Visibility drove a 5-point increase in Moderate Visibility to 35%. High/Very High Visibility remained essentially flat at 59% of firms.
- The number of projects on/under budget dropped this year and correlated directly to firm size. For small and mid-sized companies, 76% of projects were on/under budget; large companies reported just 63% of their projects on/under budget. This may be due in part to larger companies taking longer to switch from older legacy systems to new tools and technologies that can better manage project timelines and budgets.
- 35% of large firms $100M-$1B+ said the importance of project management software will increase significantly for them over the next 2-3 years. This is a sharp increase from 2015 when just 12% chose this response. Similarly, 22% of mid-sized companies $20M-$99M said PM software would significantly increase in importance going forward, up from 15% last year.
- The percentage of large firms with a Very Mature risk / opportunity management discipline rose from zero last year to 20% of respondents this year.

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

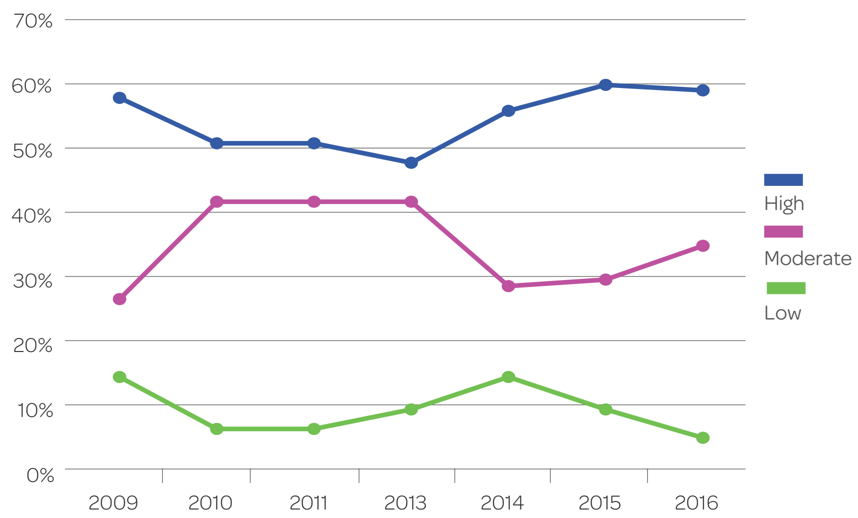
Visibility continued to trend in the positive direction overall, which correlates with the change we saw in PM spending this year. On average, GovCon firms more than doubled their investment in the project management function to 17% of revenues and some of that investment has gone to increasing project visibility. The "Low Visibility" line declined for the second year in a row and is close to bottoming out. Only a few of the smallest companies <$20M acknowledged they still have Low Visibility and this year no companies claimed Very Low Visibility, which is good news for both the federal government clients and for the industry as a whole.

We saw a 5-point increase in those reporting Moderate Visibility, which we'd expect due to the Low Visibility shrinkage. However, some of that bump in Moderate Visibility came at the expense of a slight drop in High Visibility. We will look for that number to turn around next year. As firms continue investing in people, process and tools, Visibility will continue to rise and "Moderate" firms will shift up onto the blue "High" line.

PROJECT VISIBLITY BY SIZE



HISTORICAL PROJECT STATUS VISIBILITY RATING

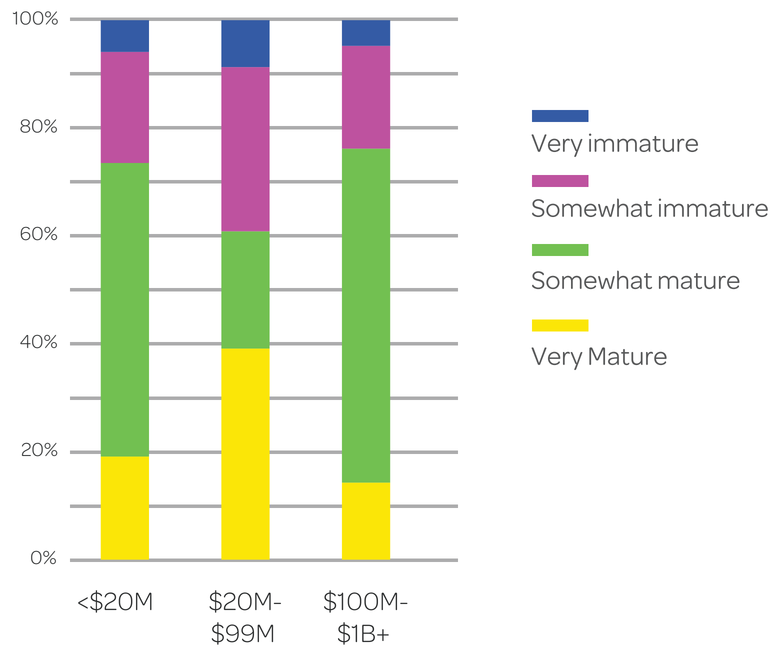


Please rate the maturity of your firm's project management discipline

Firms have been putting a microscope to their project management practices over the past few years and the gains they have made are showing up here as greater PM maturity. Notably this year, mid-sized companies $20M-$99M reported a spike from last year in those reporting Very Mature PM discipline. This is interesting since firms that Deltek assesses are typically in the Somewhat Immature level.

Small firms made significant advancements in this area as well, with 73% of them reporting either a Somewhat Mature or Very Mature PM discipline, up from 58% in 2015. Large companies $100M-$1B+ saw a 10-point dip in the number reporting Very Mature but overall, 75% of large firms claimed either a Very or Somewhat Mature PM discipline—about the same number as last year.

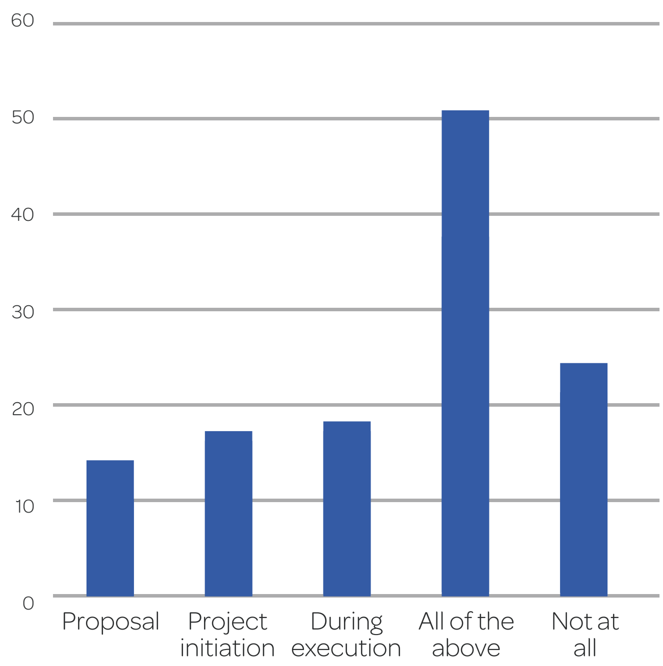
MATURITY OF PROJECT MANAGEMENT DISCIPLINE



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

This year we see a shift away from those doing Schedule Risk Analysis (SRA) in the earlier stages to none at all and it has some surprising results when we look at profitability and visibility of the project. Those who just perform SRA at either the proposal or the execution phases of the project saw 30% higher profit than those who did SRA in all stages. This could be due to the performance of smaller businesses who typically do not have the resources or maturity to perform SRA at all stages. When we look at project visibility however, those that perform SRA at all stages report much higher visibly than those doing it just at the other stages. Our recommendation would always be to perform SRA at all phases because past studies have shown that the higher your visibility, the more likely you are to deliver your projects on time and on budget, which has a direct correlation to increased profit margin.

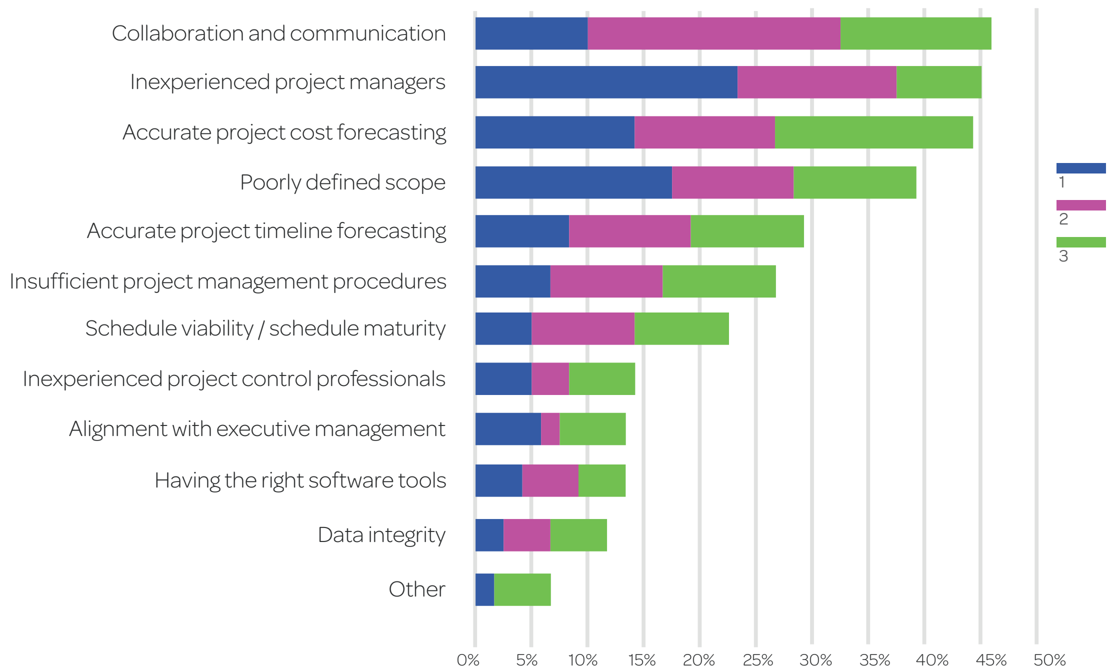
PHASE SRA PERFORMED



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

The top four responses remained the same this year with a few notable shifts. First, this year's numbers 1 (Collaboration and Communication) and 3 (Accurate Project Cost Forecasting) flip-flopped from last year. Inexperienced Project Managers led the way with the most #1 responses. The quality of PMs has been in the forefront for many years now. This could be from the attrition of the more senior PMs and younger, less experienced PMs coming on the scene. The rise in focus on project management may stem from the lack of PMP certifications at small and mid-sized firms. When asked about the percentage of program managers with PMP or other formal training, 6 in 10 mid-sized companies said it was 0-9%, up sharply from 25% last year. It goes without saying that better training will lead to better project management.

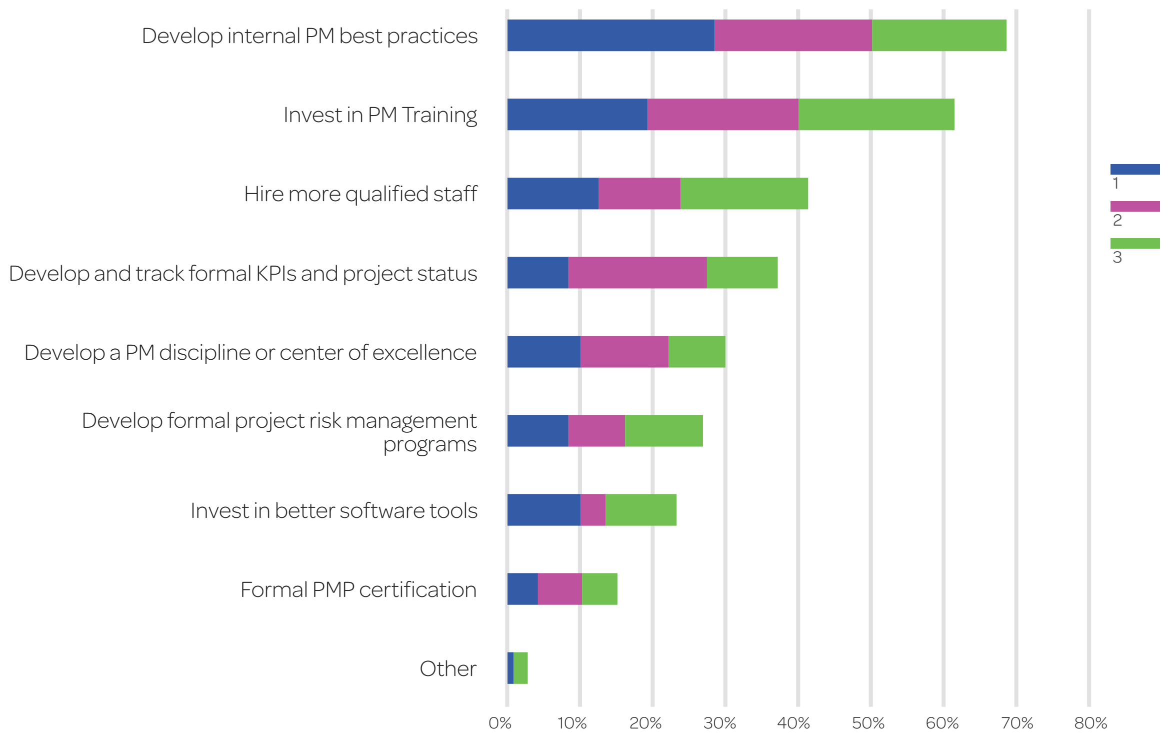
PROJECT MANAGEMENT CHALLENGES



How do you plan to address the top PM challenges in the next 2 to 3 years?

The top four responses to this new question this year all spoke directly to the challenge of Inexperienced Project Managers. Interestingly, although Invest in PM Training was the second most popular initiative, Formal PMP Certification ranked at the bottom. As we saw here and in our question about the number of PMP-certified program managers employed, this certification appears to be waning in importance for firms, particularly those in the small- and mid-sized categories. Part of the reason is cost—PMP certification is expensive. Part of it may be that firms want training more tailored to the unique demands of their own organizations. We know of several companies that are constructing their own PM programs and implementing role-based training based on their specific practices. That training is captured in the top two plans to address today's challenges. The other issue is that the PMP does not replace field experience

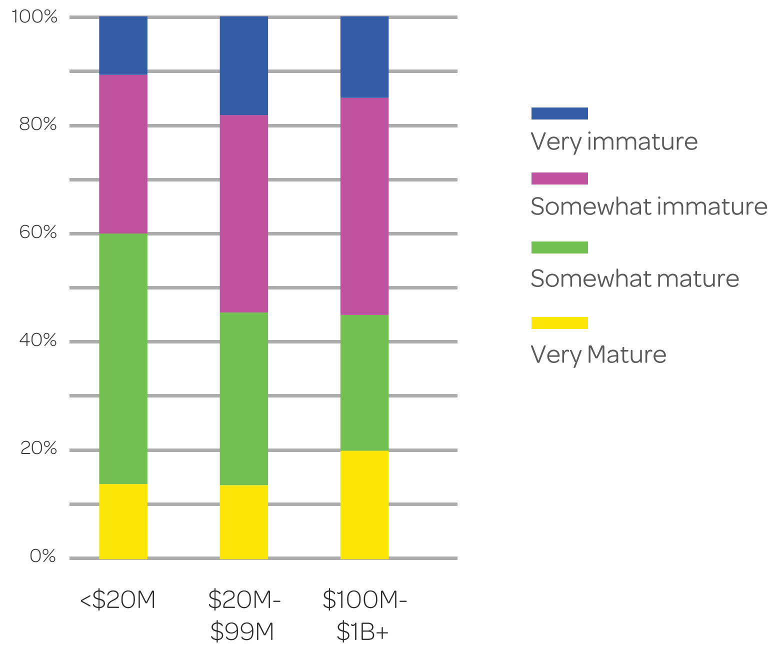
PLANS TO ADDRESS CHALLENGES



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

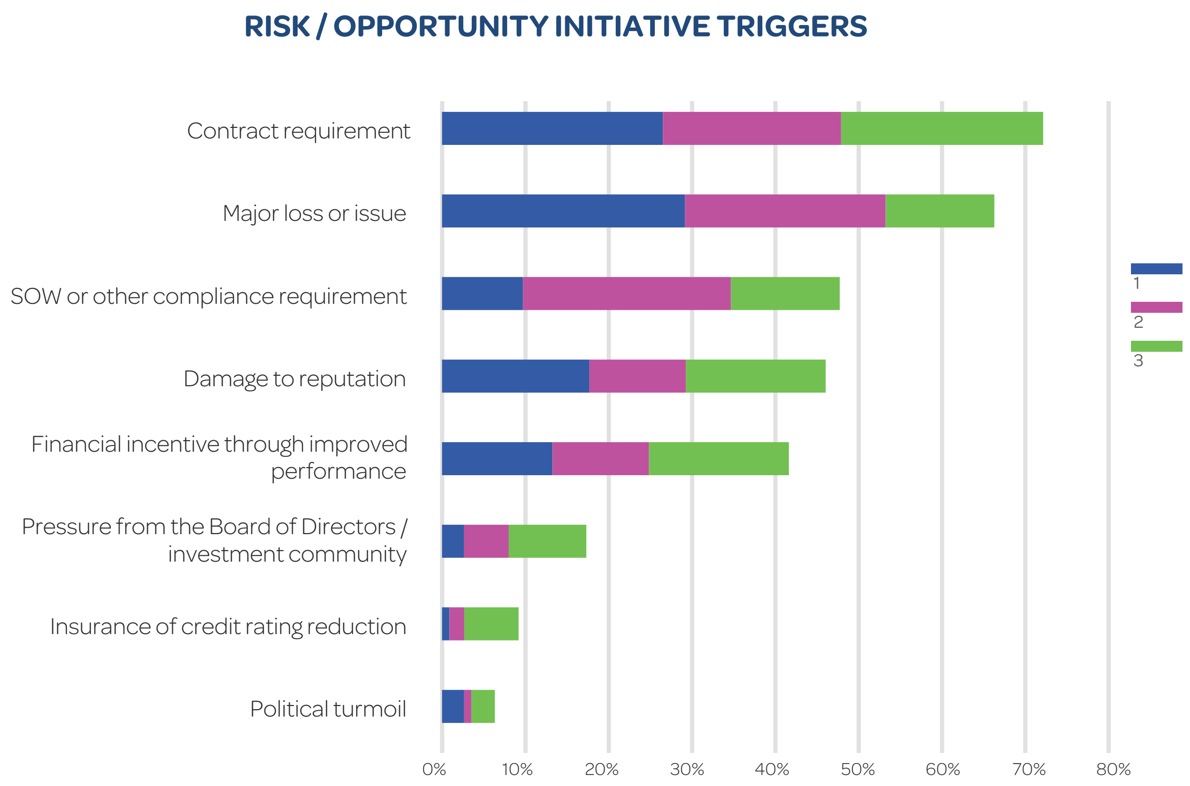
Like PM maturity, we saw an overall rise in Risk / Opportunity management maturity this year. Small and Medium firms lead the way with 20% and 15% bumps respectively in Somewhat Mature or Very Mature. To the contrary, Large firms posted a fairly sizeable decrease. Last year over 60% of firms felt good about their Risk / Opportunity management maturity. This year that number was down to 45%. Many companies are paying attention to risk management and making gains. However, it is clear that Large firms are still working through how to take the best advantage of a well-run risk team.

RISK / OPPORTUNITY MANAGEMENT MATURITY



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

Firms have maintained their reactive posture toward risk. The reactive triggers dominate the top spots in the same order as in years past, with Contract Requirement remaining the top risk trigger, followed by Major Loss or Issue. Even a year of many political unknowns is not enough for firms to kick off a risk initiative for Political Turmoil, which posted at the bottom of the list again.



How often do you account for risk and uncertainty in your scheduling?

We added a new question this year to find out how often GovCon firms account for risk and uncertainty in their scheduling. Almost half of mid-sized and large firms told us they account for risk for the majority or all of their projects. This makes a lot of sense in light of what we are seeing elsewhere in the survey.

In a separate but related question, we asked firms how frequently they look at risk and uncertainty in their schedules. It was good to see that 60%+ of medium and large firms are doing it monthly as part of their reporting cycles. Those companies who are doing it only before a major milestone (about 30% of small and mid-sized firms, 15% of large-sized firms) run a greater risk of missing those milestones. To increase the predictability of the project schedule, risk should be a regular and inherent part of projects. Large and mid-sized firms are getting there but small companies have some catching up to do in this area.

FREQUENCY OF ACCOUNTING FOR RISK AND UNCERTAINTY

PROJECT MANAGEMENT

CLARITY OUTLOOK

While both PM and Risk/Opportunity Management maturity have climbed considerably this year, firms are still actively seeking to improve. Many firms are seeking to address gaps and make continued improvements by increasing the effectiveness of their project managers over the next few years. They are planning higher investments in training, development of best practices and development and tracking of formal KPIs.

Companies of all sizes—and particularly the largest firms—predict increasing importance of project management software, so we will see more legacy systems replaced by modern technologies that can equip firms for success in today's GovCon environment. Risk / opportunity management importance is also increasing quite a bit as firms continue to focus on this critical area.

This is all good news for project management. The industry is making improvements but no one is resting on their laurels as they continually seek better ways to manage projects.

SECTION THREE

FINANCE

GovCon leaders are addressing the uncertainties of the federal spending environment in the same way one might address market cyclicality in their personal investment portfolios—through diversification.

10%

overall net profit

matches the 2014 high, a climb that matches a climb in Growth Rate

5 of 6

approaches

to address challenges centered on diversification and better program management

3.5%

unallowable costs

up from 2% last year, probably due to compensation caps

Contractors are seeking new markets & agencies in which to operate, new products and services to offer, and new geographies to enter in their ongoing quest to bolster their financial positions. Early indicators are that the strategy is paying off: growth and profit were both up for the first time in recent memory.

In a positive sign, Overall Composite Fringe rate, which measures total compensation including bonus, health insurance and benefits, has returned to 2009 levels. Many firms have been looking closely at how they stack up against commercial companies in total compensation. In an effort to become more competitive in attracting top talent we have seen the composite fringe rate increase for the second year in a row. While this alone will not help contractors win the war for talent it certainly is a step in the right direction.

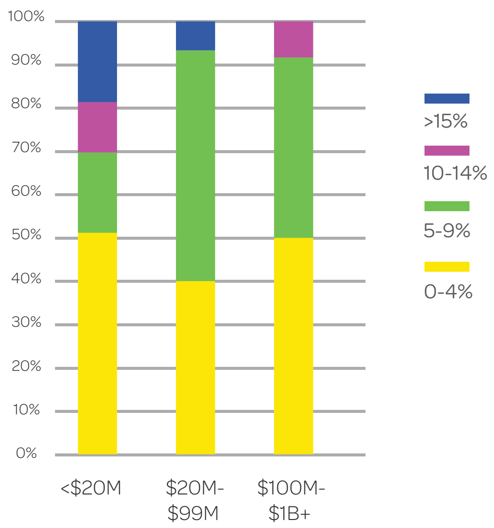
Key Data Points from the Survey

- The amount of revenue firms allocate to their finance budget was essentially unchanged, ranging from 6% at small firms <$20M to 4% at the largest firms $100M-$1B+.
- Unallowable Costs surged to 3.5%, up from 2% last year. The increase is most likely due to executive and contractor compensation caps hitting full swing. Any compensation beyond these cap goes into the Unallowable Cost bucket unless properly justified.
- Overall Composite Fringe rate continued a two-year climb, hitting 34%, up from a low of 23% in 2014.
- Average Monthly Invoice Cycle and Days Sales Outstanding were flat year-over-year at 15 days (Invoice Cycle) and 50 days (DSO).
- The top three challenges facing financial leaders over the next 2-3 years are Increasing Profitability, Decreasing and/or Unpredictable Federal Spending Environment and Cash Flow.
- The environment for M&A remains unchanged in terms of declared buyers, however almost no firms indicated they were selling. Interestingly, the number of midsize companies that declined to respond doubled YoY hinting at the potential for activity in the mid-market.

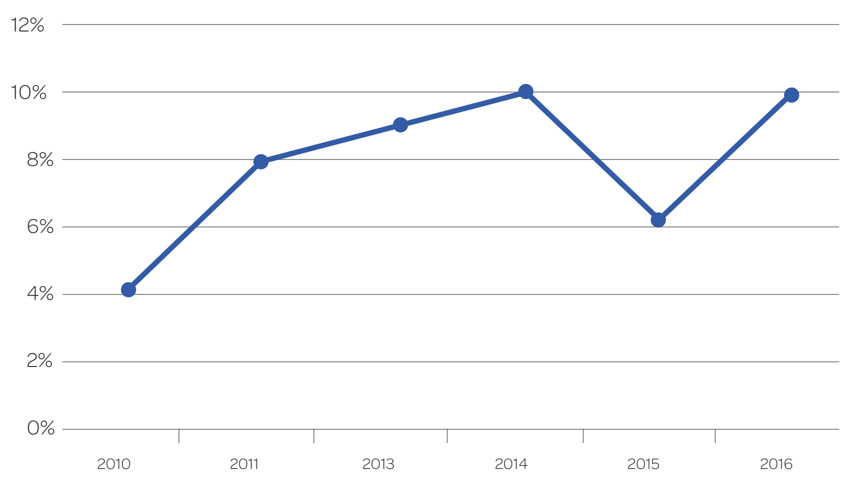
Net profit

Following last year's four-point dip, Net Profit took a turn back upward to match its 2014 high of 10%. This was a result we anticipated. As we noted in last year's report, firms are placing a strong emphasis on diversification as way to offset the ups and downs of government spending. The start-up costs to diversify into other markets consumed cash, which impacted profits. With those initial investments now behind them and revenue beginning to come in from diversified sources, profit figures are on the rise.

NET PROFIT BY SIZE



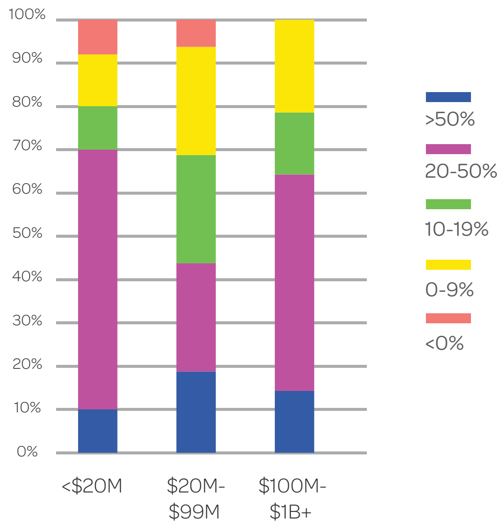
6-YEAR NET PROFIT TREND



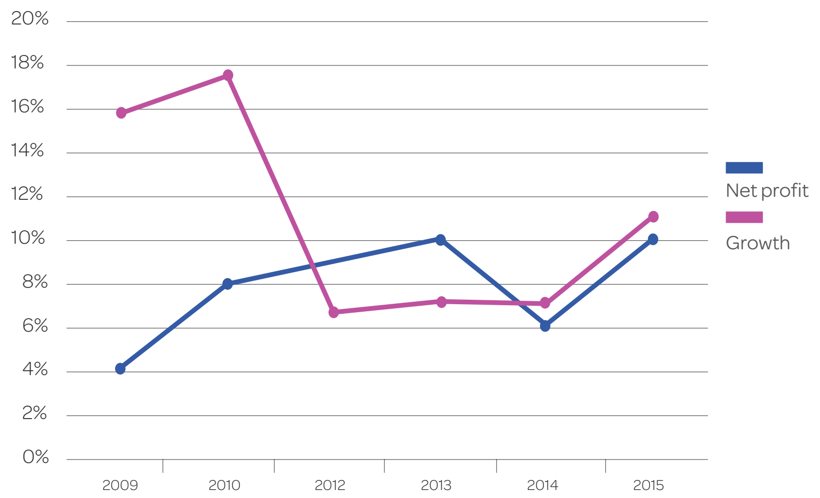
Actual Growth Rate

Growth Rate rose to 11%—the first time we have seen Growth Rate and Net Profit track in the same direction. Usually they have been inverse to each other. These results are consistent with what we are hearing in the marketplace—spending is up and things are moving in a positive direction. Despite the turnaround, firms are looking ahead with some caution as projections for 2016 growth are flat. This tempered prediction is unusual; in past years, firms have tended toward optimism when looking forward. We suspect the unknown election outcome has many firms in wait-and-see mode.

LAST YEAR GROWTH RATE BY SIZE



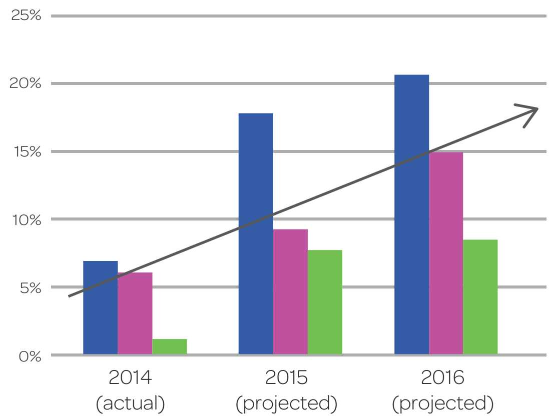
6-YEAR GROWTH VS. NET PROFIT



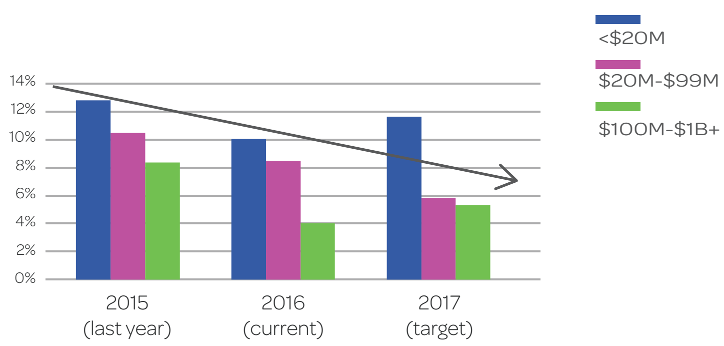
Growth Rate Projections

When we asked contractors about their outlook on the next few years we see a trend we have not seen in the survey, even from the years when the spending environment was in decline. Contractors are projecting less growth in the next two years then actual growth in the current year. Political uncertainty may be contributing to the to uneasiness about the future, making this election as pivotal as ever for those in the business.

2015 DELTEK CLARITY GROWTH RATE PROJECTIONS

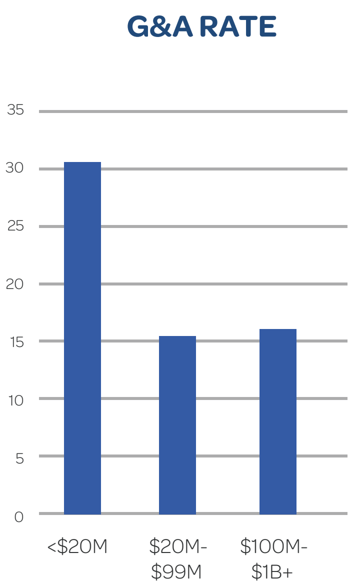


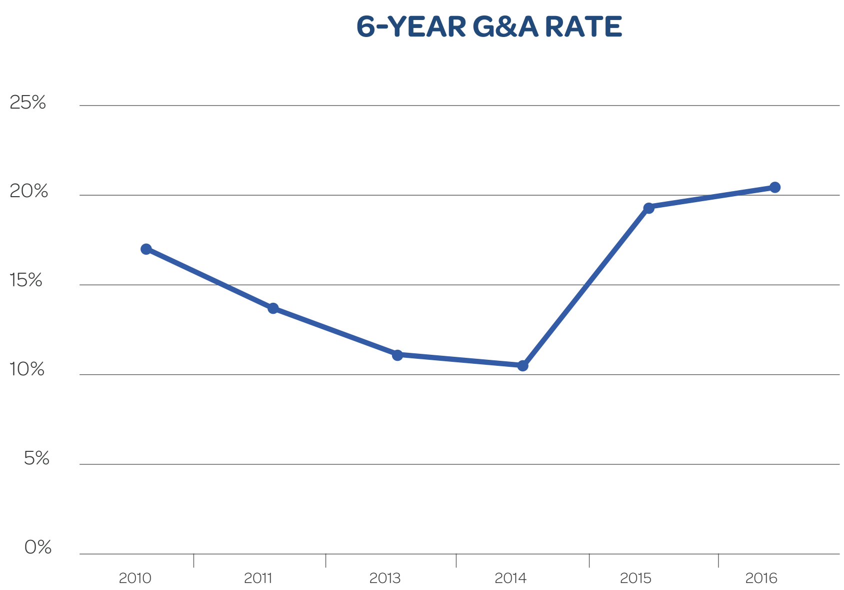
2016 DELTEK CLARITY GROWTH RATE PROJECTIONS



G&A Rate

Historically, we have not published this chart in our Clarity reports but the results warranted inclusion this year. G&A rate has spiked over the last two years from 10% in 2014 to 20% today. We believe this increase is correlated to cloud adoption. Because cloud technology is subscription-based and therefore an operating expense, firms cannot claim a capital expenditure they can amortize over a number of years as they can with a software or hardware purchase. As more and more technology moves into the cloud, this is increasingly impacting G&A. It's an industry-wide phenomenon—and one businesses will need to find a way to manage from an accounting perspective.



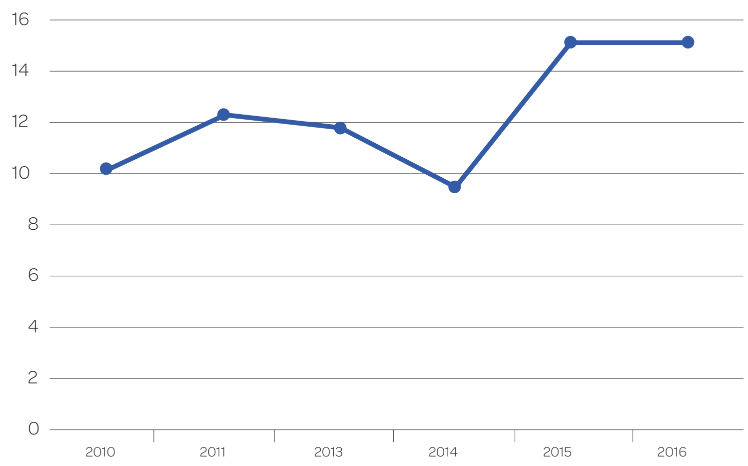


Average Monthly Invoice Cycle

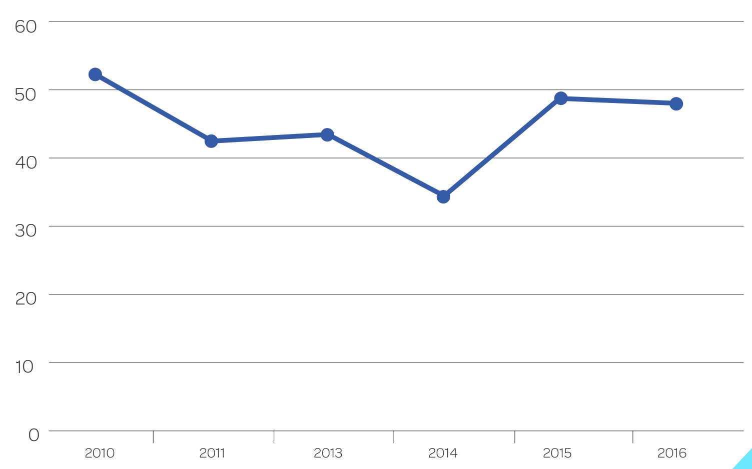
Following big jumps last year, Average Monthly Invoice Cycle and Days Sales Outstanding (DSO) were flat year-over-year. This was not unexpected. In the case of DSO, last year's spike simply brought the metric into the range of historical performance and we anticipated it would level off from there. Today, DSO is at 47 days for small firms and 48 days for mid-sized and large companies.

Average Monthly Invoice Cycle came in at 15 days, exactly where it stood last year. While it is good news that this figure did not continue to climb, we know the industry would like to see it return to the 10-12 day range of the 2010-2014 years. Increased scrutiny of invoices is contributing in part to the higher invoicing times and will make it challenging to return to lower levels, but firms can make some progress in that direction by eliminating internal bottlenecks and other inefficiencies.

6-YEAR MONTHLY INVOICE CYCLES



6-YEAR MONTHLY DSO

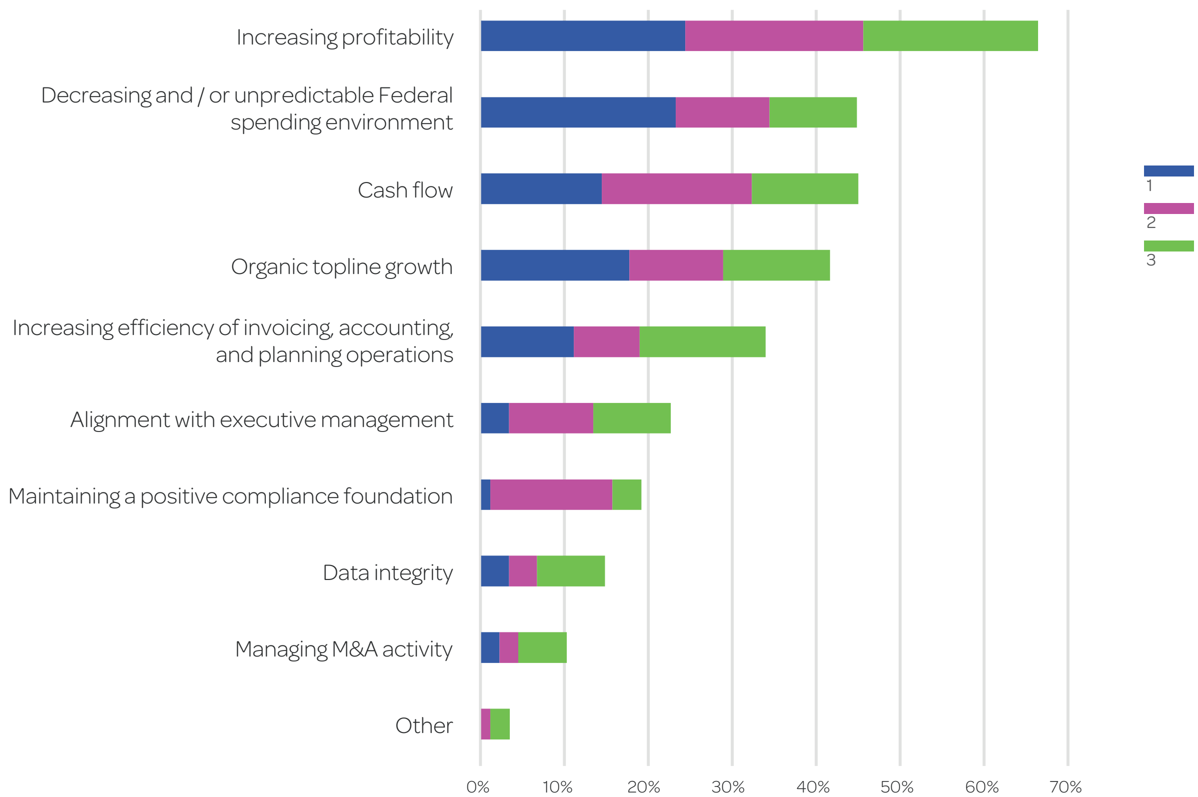


What do you think will be the top three challenges facing the financial leaders of your organization over the next 2-3 years?

Foundational financial concerns—increasing profitability, preserving cash and growing revenues—came in as three of the top four challenges facing GovCon financial leaders over the next 2-3 years. Echoing last year's results, profitability remains the top concern for firms and it is on the mind of many more survey participants this year. Last year, 40% of respondents put Increasing Profitability in their top three; this year, 65% cited it in their top three. Cash Flow and Decreasing and/or Unpredictable Federal Spending Environment swapped spots.

In a new request this year, we asked participants to explain the rationale behind their challenges. Responses included some key themes: inadequate PM training, poor forecasting, soft localized federal spending, and delays in fund appropriations. In particular several companies raised on-time payment of invoices being a challenge impacting cash-flow. This blamed in part by seemingly random invoice audits, as well as requirements to simultaneously submit invoices and progress reports, causing companies to spend more time on creating the package, resulting in payment delays.

FINANCE CHALLENGES

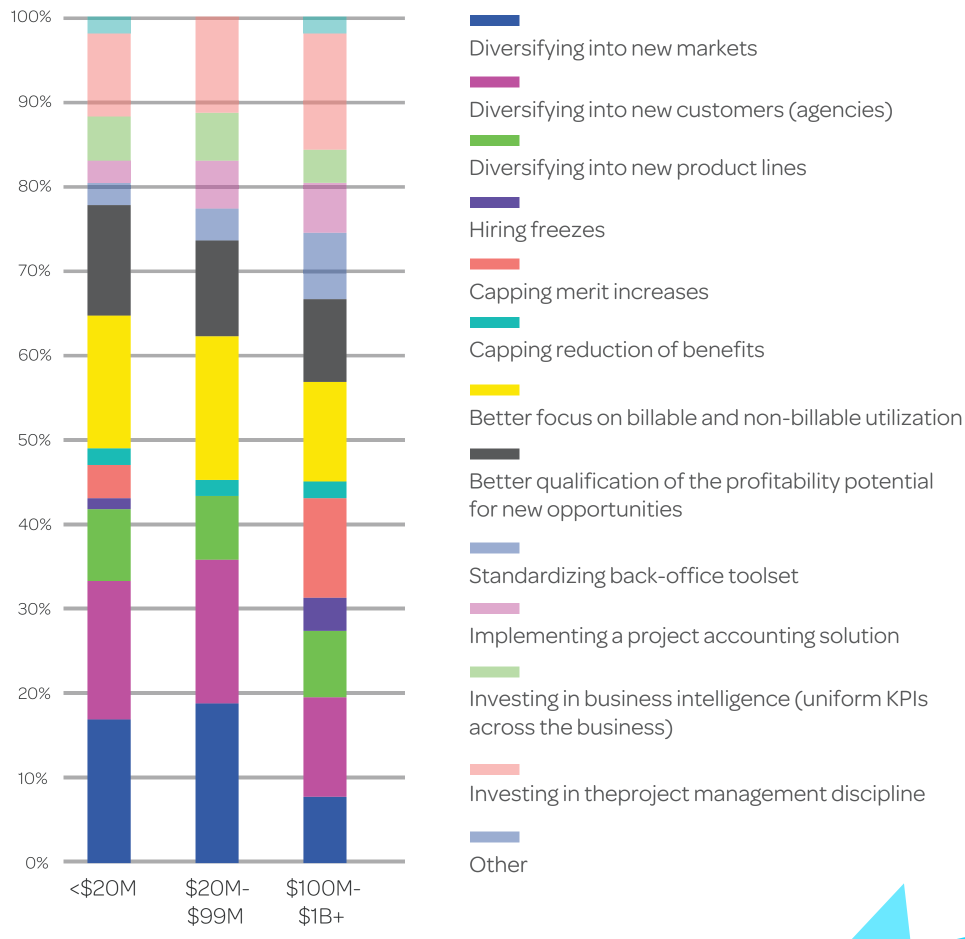


What do you think will be the key financial success factors for your organization over the next 2-3 years?

We added a new question this year asking what actions respondents will be taking to address their top financial challenges. Diversification of customers, products, and markets represents around 35% of the responses and is a key underpinning of the sentiment this year. Another 15% focuses on better control of billable time, which is a direct tie to having antiquate and trained PM's.

It's interesting that the PM section shows that PM maturity and investment are on the rise and finance would agree this needs to be an area of focus to maximize bill-ability. The third largest action relates to better qualification of profitable new projects, which correlates well with a jump in firms not bidding on opportunities due to their projected profit margins. Finance is making it clear that they need more skilled PM's and better qualified profitable work to achieve their objectives, but broadening the portfolio is still top of mind.

ACTIONS TO ADDRESS CHALLENGES



FINANCE

CLARITY OUTLOOK

It is the rare GovCon firm that is putting all its eggs into one basket today. Instead, companies seem to be aggressively pursuing diversification as a way to counterbalance the unpredictable nature of the federal spending environment and improve revenues / profits going forward. From expansion to new agencies, or around the world, or by expansion to new product offerings, companies' long-term strategy for continued growth includes work outside government contracting. We foresee this trend only continuing to accelerate as it is already paying dividends in higher growth rates and higher profits.

SECTION FOUR

COMPLIANCE

Government oversight, which saw a boost last year as the federal government dug into its audit backlog, seems to have leveled off. Firms characterized compliance levels as mostly flat or unchanged from last year.

56%

of firms

have been through an Internal Controls audit in the past two years

69%

of companies

cited labor and time keeping a top challenge

The number of Internal Controls audits—the #1 most common audit in the past two years—jumped but the increase was offset by a decline in Pre-Award and Incurred Cost Submission (ICS) audits. All the data pointed to compliance reaching a balancing point.

This may be a temporary position. We see a potential eye of the hurricane—a short lull before oversight intensifies. Firms are reporting the first external audits in response to a late 2014 rule. This is the tip of the external auditing iceberg; we a likely to see many more in the coming years. New DFAR security rules are going to boost oversight in the area of cybersecurity, a brand new audit landscape that firms and the government will have to navigate. This will further complicate the issue of inexperience amongst auditors, which was noted as being a challenge on both the government and project management side.

On the government side, firms bemoaned the problem of having to teach "green" auditors how to perform their jobs while being audited. If DCAA expands to accommodate new cybersecurity audits and adds more personnel, this problem will only intensify. On the contractor side, respondents said PM turnover was an issue that left inexperienced PMs answering auditor questions about old projects that were before their time. Within here is a call for better technology: companies that have a good system in place to track and report on all project data have audit trails that don't fade with years or with PM turnover.

Another sign that we are in the eye of the hurricane is Executive Compensation. This is a rising problem that moved into the #4 position on the list of top challenges, right behind the related Unallowable Costs. Both auditors and contractors are struggling to understand all the nuances of compensation caps which have increased firms' compliance and accounting burdens.

This year's expanded Compliance section reflects our prediction that compliance/oversight is going to expand for GovCon in the near future. Firms would do well to buckle up and prepare for the impending storm by meticulously documenting and tracking everything within their control.

Key Data Points from the Survey

- Internal Controls audits took an 18-point jump to become the leading audit companies of all sizes have undergone in the past two years. 56% of firms said they had been through an Internal Controls audit in the past two years. Ranked in terms of their cost, the top three most costly audits for firms were Internal Controls, Pre-award, and ICS.
- When asked how many hours per year they spend preparing for and participating in government audits, large firms said they spend an average 387 hours, mid-sized companies spend 110 hours and small firms devote just 45 hours to the task.
- Medium firms have .7 FTEs currently focused on external audits, while large firms have 1.2 and small companies have 0.4 FTEs. We anticipate this number will start to increase soon. As GovCon firms have to undergo more audits with third parties, they will need more internal resources to support those audits.
- Indirect Rates and Labor & Timekeeping remained the top two audit challenges firms are facing, with both challenges being cited as problems by roughly double the number of firms as last year. Unallowable Costs and Executive Compensation were increasingly problematic for firms, rounding out the top four audit challenges companies faced last year.
- To address their top audit challenges, firms said they would be Conducting Internal Audits (50%), Investing in Automation (40%) and Hiring Better Qualified/Experience People (30%).

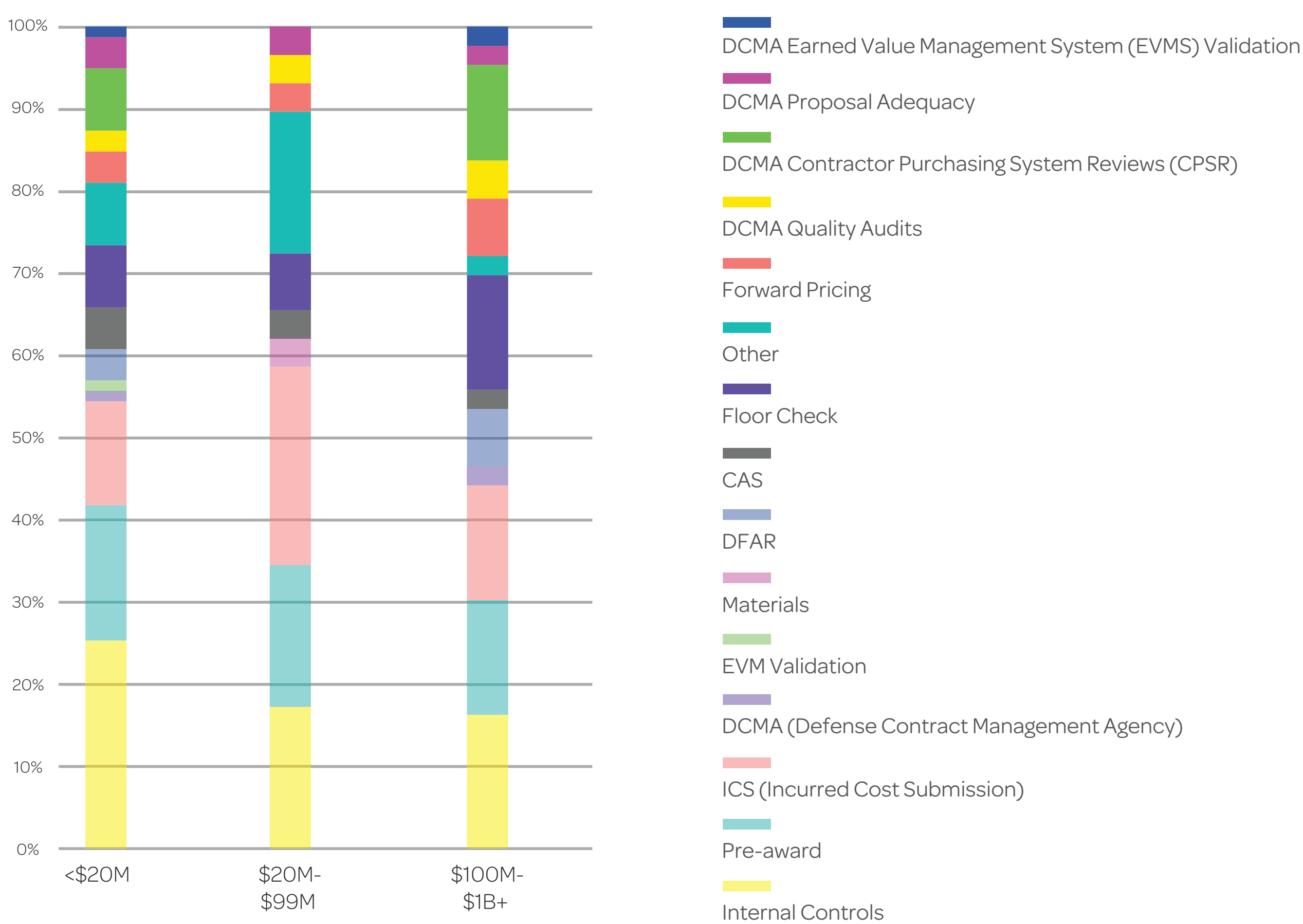
Which audits has your firm undergone within the last two years?

The past year saw some significant shifts in the types of audits GovCon firms are undergoing. The most notable change was in Internal Controls audits, which saw a nearly 20-point jump and was by far the leading audit for companies of all sizes. Incurred Cost Submission (ICS) and Pre-Award audits, which dominated our charts last year, both shrank considerably. In the case of ICS, the number of firms reporting that they have experienced this audit in the past two years contracted by more than half.

This was the first year we split out DCMA audits by type rather than grouping them all under the DCMA heading so we can better see the ebb and flow of each of these audits. The numbers here will provide a baseline for us to observe the trends of audits under the DCMA umbrella.

One interesting trend appeared in write-in comments for our "Other" category. Several firms noted they had undergone external audits. This is likely a result of DCAA dealing with its audit backlog in part by mandating that companies requiring to comply with Cost Accounting Standards (CAS) begin conducting critical business systems audits on their own through a qualified 3rd party CPA firm. This was the first year we saw the results of that mandate show up in the survey. The audit burden is increasing: in addition to dealing with DCAA and DCMA reviews, now GovCon firms are having to coordinate with third-party auditors to meet federal requirements, which is ratcheting up the cost of compliance.

AUDITS IN PAST TWO YEARS

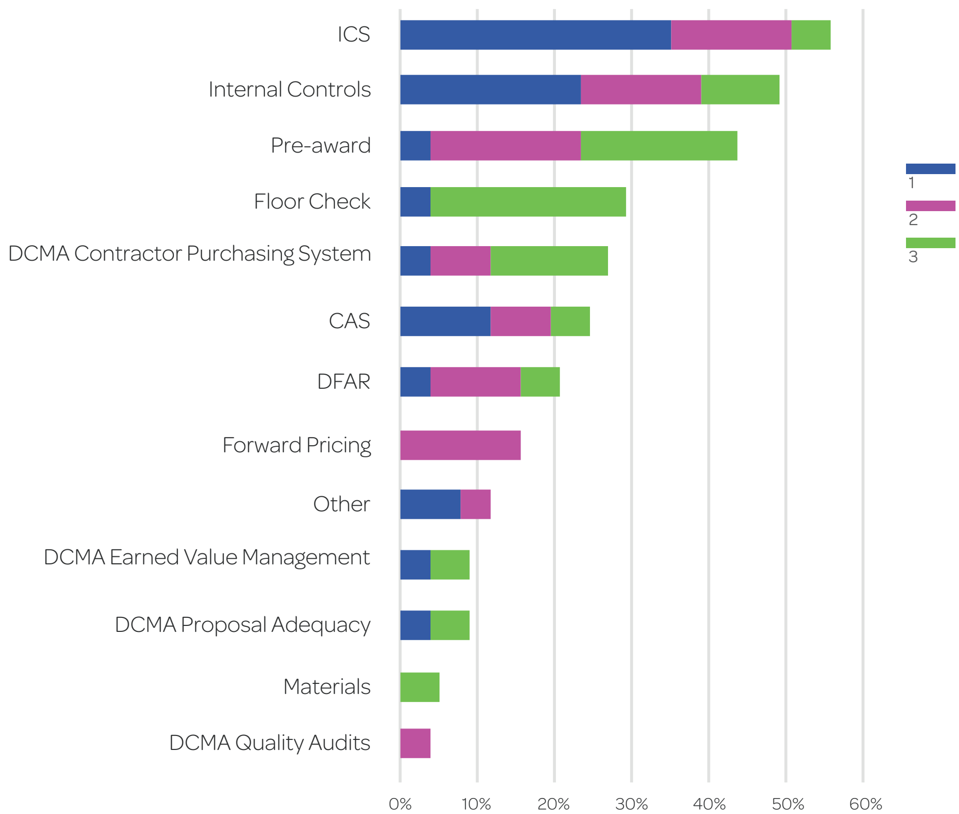


From the audits selected above, in what order would you rank them in terms of cost of compliance?

Incurred Cost Submissions continue in the top spot in terms of the cost of compliance related to different audit types respondents endured. Comments would suggest the costs continue to hold steady for contractors as they have to maintain historical records and systems in tact as they wait for DCAA to work down it's backlog of ICS audits. With DCAA reporting 1,000 fewer audits conducted in FY 2015 due to a hiring freeze and reporting being down 5% of their auditing staff, this trend could continue.

Internal controls takes the #2 spot, up from #3 after we broke up DCMA audits into their individual types in this years survey. Pre award audits come in at number three, likely a result of the increase in small and mid-sized business in this year' s results and those size firms being a target for this type of audit. If they have to rapidly put systems in place it likely costs more due to constrained time-lines and pressure to comply immediately or risk loosing an award.

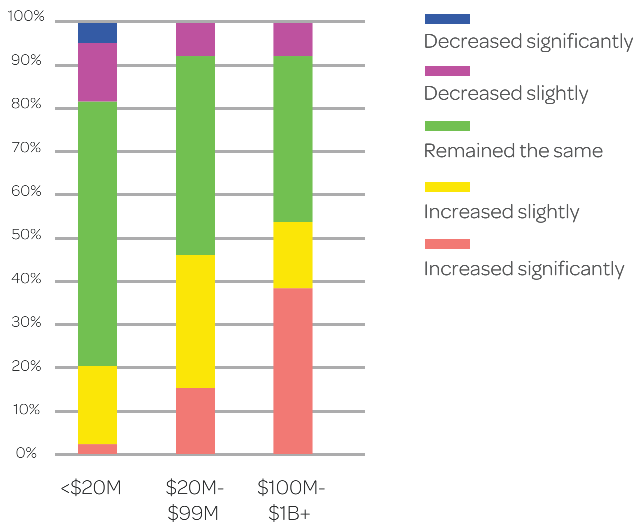
COST OF COMPLIANCE

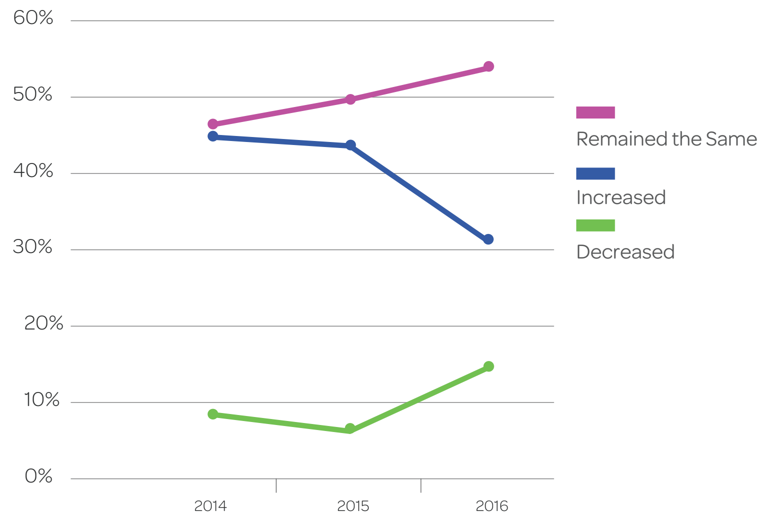


How would you characterize the change in the overall level of government oversight of your organization over the last year?

Firms tell us government oversight of their organization has, for the most part, plateaued. Responses from small and medium-size firms were essentially unchanged from last year; large companies saw a 10-point decrease in the number expecting oversight to increase. However, this may be misleading. If DCAA ramps up its ability to conduct cybersecurity audits in response to new DFAR security rules, the oversight landscape will completely change. This is not just an IT problem. Repercussions from a poor cybersecurity audit can bleed over into Finance since the government can withhold payment to contractors who aren't in compliance. While DCAA doesn't have the manpower to do these audits on a large scale today, firms need to keep a watchful eye on this area in the event that Congress releases funding to ramp up oversight.

CHANGE IN GOVERNMENT OVERSIGHT





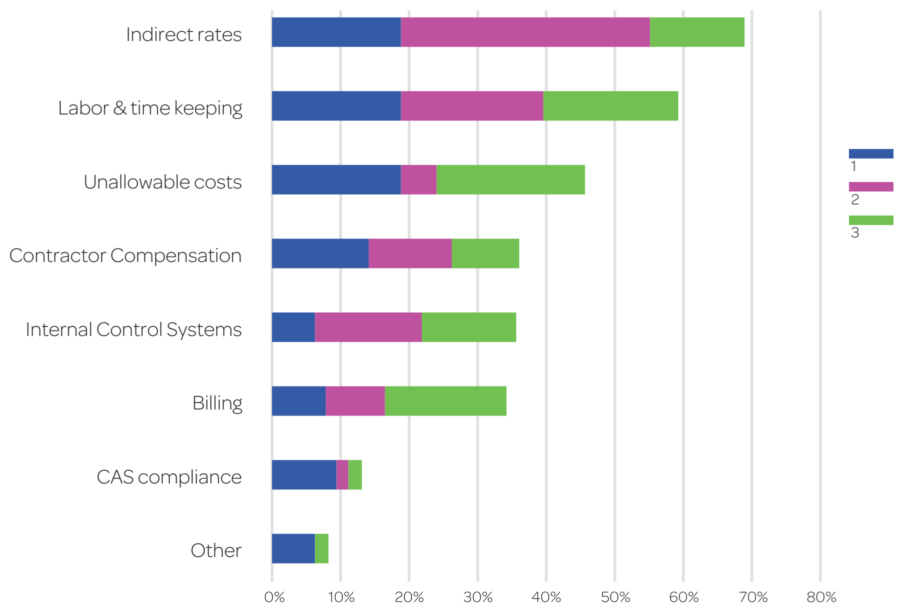
What are your top three audit challenges over the last year?

For the second year in a row, Indirect Rates and Labor & Timekeeping came in as the top two audit challenges firms are facing. While the order was unchanged, the order of magnitude of these challenges increased dramatically. Last year, 38% of firms cited Indirect Rates in their top three; this year, 69% of companies said it was a problem. In 2015, 24% of respondents said Labor & Timekeeping was a top audit challenge; this year, 59% cited it. So these problems are not being resolved. On the contrary, both issues are becoming increasingly challenging for contractors.

Another growing challenge appeared in the area of Total Contractor Compensation. For the past two years, this category ranked fifth with 18% (2014) and 13% (2014) of firms citing it in their top three. This year, Total Contractor Compensation moved into fourth place with 36% of companies saying it was a top audit challenge. This issue is closely tied to Unallowable Costs, ranked third this year. With caps on total contractor compensation at $487K per year, any additional compensation hits the Unallowable Cost bucket.

Although firms are trying to get a handle on managing all this from an accounting perspective, many are still relying on spreadsheets and off-book calculations, which is compounding the problem. To address their top audit challenges, firms said they would be Conducting Internal Audits (50%) and Investing in Automation (40%).

TOP AUDIT CHALLENGES



COMPLIANCE

CLARITY OUTLOOK

Many GovCon leaders we heard from think the current leveling-off of government oversight means things are going to get better. We think there may be more to it. Due to new DFAR security requirements, we think things are about to get worse. Be warned: this is not an IT problem. If you are in Finance, this is your problem as cybersecurity failures could mean a disruption to your contracts, leading to new accounting headaches.

As DCAA ramps up to handle security audits, this won't just increase the level of oversight firms experience, it will compound other problems firms told us were a challenge, including inexperienced auditors, turnover of personnel who could best answer auditors' questions about past projects, and knowing which rules DCAA will and will not enforce.

Another emerging issue that surfaced in a number of write-in comments—one we intend to keep an eye on—is managing ACA compliance. Though we appear to be in a compliance quiet period, there are many unknowns going forward and many issues that are outside contractors' control. The means firms need to be ultra-prepared in the areas over which they do have control.

SECTION FIVE

TALENT MANAGEMENT

It was clear in this year's survey recruiting and retaining talented staff is the key to business success for government contractors. For years, survey respondents have indicated there is a difficulty in finding and attracting top candidates.

7 in 10

respondents

said Talent Acquisition is one of the most expensive HR processes

58%

of organizations

said their HR budgets decreased

#1

challenge

contractors are facing is employee morale & work/life balance

While this is still challenging, the picture that emerged this year was one of companies ratcheting up efforts to improve retention of existing employees. More than ever before contractors are turning a spotlight on employee retention – making sure top talent does not walk out the door for another opportunity. We saw from the survey, the top three KPIs HR leaders are tracking include Voluntary Turnover, Involuntary Turnover and Employee Retention which all point to the reasons employees are leaving an organization. The Top HR management challenges today all relate to keeping employees content: Morale & Work / Life Balance; Succession & Career Development Planning; Employee Retention; and Employee Engagement.

No matter how successful government contractors are in boosting retention, it is clear they face a forthcoming talent drain at the top of their organizations. Government contractors will lose 20-30% of their workforce within the next 10 years as Baby Boomers retire. This will hit large companies, where the older generation makes up nearly one-third of the payroll, especially hard.

The impending departures of seasoned leaders and subject matter experts have implications for succession planning as well as talent development. Half of companies said coaching and mentoring was the #1 tool they use to develop top talent. The challenge many organizations have is that their experts are in the twilight of their careers and they need a plan for who will replace them. Coaching and mentoring the next generation of leaders can bridge the gap and help transition top performers to leadership positions, but there has to be a plan which includes good succession planning and career development. It's no secret Millennials switch jobs often, but if they have opportunities for mentoring and career development statistics show, they will be more likely to stay.

Key Data Points from the Survey

- Headcount in government contracting organizations grew 9.2% overall, of which 21% was negative growth and 51% was positive growth. The contingent workforce is growing at a slower pace than total payroll employees.
- The percentage of annual revenue government contractors allocate to the human resources budget is 5.9% for small organizations, 5.1% for mid-sized, and 2.7% for large. Notably, this contrasts to 5-6% (small and mid) and 8% (large) last year. Some of the drop may be from an actual decrease in budget as 58% of organizations said their HR budget had decreased year over year.
- Firms remain frustrated by the lack of good candidates in the marketplace, their #1 challenge in acquiring new talent. This issue is a top-three challenge for 8 in 10 government contractors. Matching Qualified Candidates to Open Positions (#2) and an Ability to Offer Competitive Compensation to Candidates (#3) came in right behind. Competition is fierce with the commercial sector as each industry tries to attract the best talent, forcing government contractors to improve their attractiveness as employers to stay competitive.
- Employee Morale & Work/Life Balance jumped from #4 to the top of the list of challenges government contractors are facing in managing talent. The top four responses in this category all indicated that firms are challenged by—and focusing on—employee retention.
- Large government contractors on average fill open positions within 60 days, faster than small or mid-sized companies. This likely is due to the fact that larger firms have automated talent management solutions integrated to their ERP and other systems. This allows their time to hire to be much more efficient, shaving weeks or months off the hiring process.
- Baby Boomers account for about 25% of the workforce within government contracting organizations. This means that in the next 5-10 years, companies will need to replace 20-30% of their experienced workforce, bringing the topic of succession to the forefront for many.
- Voluntary Turnover is the #1 HR-related KPI government contractors are tracking. Following closely are: Involuntary Turnover, Employee Retention and Revenue per FTE. It is evident government contractors are realizing it is cheaper and better for their organizations than hiring new talent.

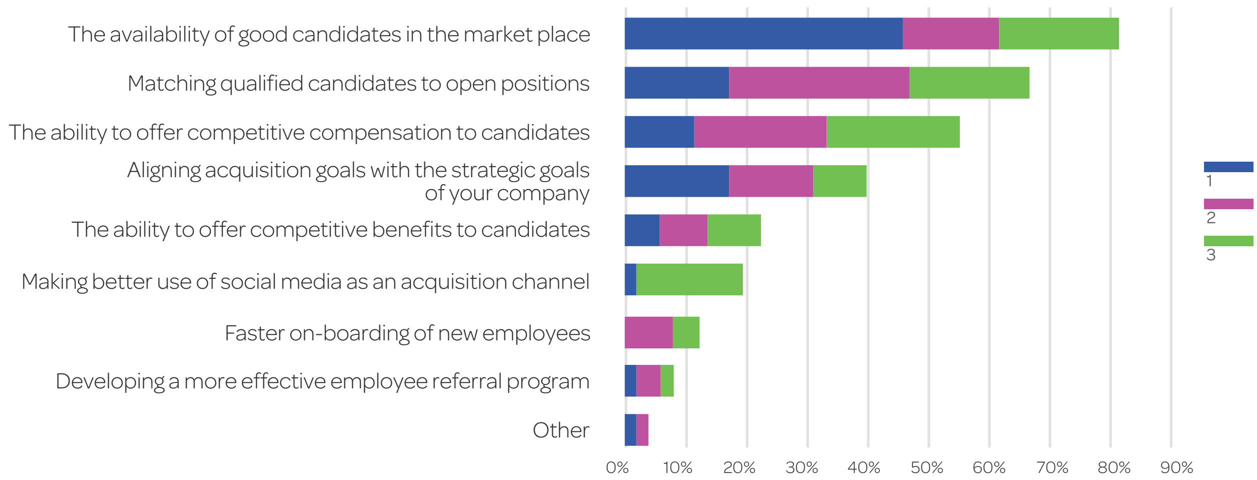
Top Three Challenges in Acquiring Talent

Echoing past results, availability of good candidates in the marketplace came in as the top talent acquisition challenge. It is the #1 issue for almost half of our respondents. 7 out of 10 organizations selected it in their top three challenges. It's not the lack of good candidates; it's that they are looking outside of the government contracting industry for their next position.

Government contractors are challenged when competing with other industries when it comes to compensation and with softer benefits such as work/ life balance, employee engagement and professional development programs. It is clear many government contractors do not have the systems in place to pinpoint good candidates, engage them and match them to open positions. Doing this manually or with outdated processes just isn't working as contractors try to compete for the best talent. By leveraging up-to-date talent management technology, integrated with other systems, government contractors can better manage the recruiting process and hire the top talent they need.

Matching Qualified Candidates to Open Positions bumped up to the #2 spot from #3 last year. Again, technology can help here, but we would also urge organizations who find great candidates with the soft skills and cultural fit they desire to consider finding ways to bring them up to speed on the technical skills needed for available jobs. Hard skills can be learned; a strong personal fit with company culture cannot.

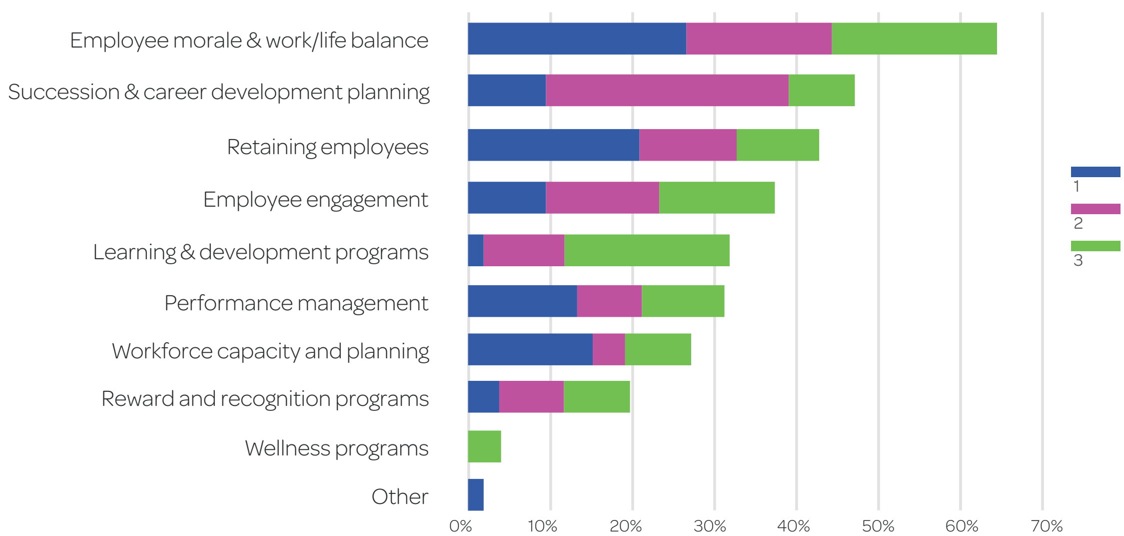
CHALLENGES IN ACQUIRING TALENT



Challenges Managing HR

Employee Retention was a clear top challenge in this year's study. The responses told us government contractors are very concerned about retaining their employees and are focused on employee retention. While employee retention received the third most overall responses, it was a very close second in #1 responses with 20% of respondents selecting it as their top challenge, up from 8% last year. Furthermore, we saw a surge in retention-related challenges. Employee Morale & Work/Life Balance leaped into the top spot from 4th place last year. Succession & Career Development Planning (#2) and Employee Engagement (#4) rounded out the top four responses. Contractors are focusing on how to keep employees from leaving—and on ensuring they are prepared when employees do depart.

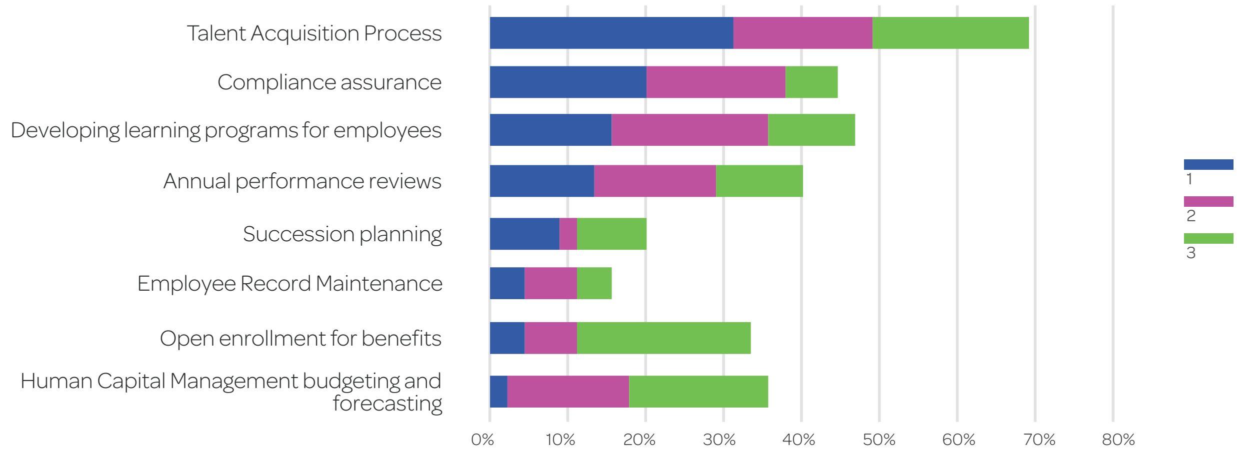
CHALLENGES IN MANAGING HR



Most Expensive HR Business Processes

Talent Acquisition remains the most expensive business process for today's government contractors with almost 7 in 10 respondents putting it in their top three. Developing Learning Programs for employees jumped into the second position from a fifth-place ranking last year. While this was not surprising considering the heightened emphasis organizations are placing on retention , we were heartened to see organizations investing more in this critical area. Better learning programs will positively impact both retention and attraction of new talent.

MOST EXPENSIVE HR PROCESSES (ORDERED BY TIME AND EXPENSE)

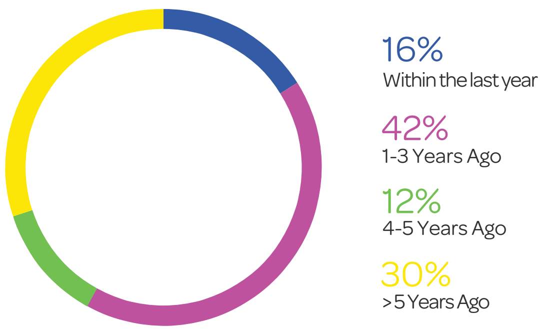


Last HRIS Upgrade

When it comes to keeping HRIS systems up-to-date, government contractors have some opportunity for improvement. Fully 42% of organizations have not upgraded, added to, or replaced their HRIS systems in over four years. Nearly half of small business government contractors say it has been more than five years since their last HRIS improvement.

Understandably, companies were not eager to invest in this area during the downturn when many were forced to lay off employees. Now that they are having to attract, hire and manage more workers, it is time to take another look at this critical system. Outdated systems can impede the HR function and keep organizations from reaping the many benefits of a modern, integrated HRIS.

LAST HRIS UPGRADE



TALENT MANAGEMENT

CLARITY OUTLOOK

In the struggle to boost retention and keep top talent from leaving government contracting organizations, the best defense is a good offense. Now is the time to bolster the areas candidates and employees care about most: compensation, morale, work/life balance, engagement, and career development. By addressing these high-value issues, government contractors can positively impact employee retention as well as make themselves more attractive to good candidates.

Replacing outdated systems can help contractors be more efficient in the overall hire to retire process. Current technology is the engine of a well-functioning HR department. Companies that neglect to tune that engine not only miss out on the powerful benefits of a modern, integrated system, they put themselves at a competitive disadvantage and struggle on both ends, losing good employees and failing to get new ones in the door. In the ever increasing war for talent, what can your organization do to improve your attractiveness as an employer and keep top talent with the organization?

SECTION SIX

INFORMATION TECHNOLOGY

Leveraging Technology has always been a critical and central function of the Government Contracting world. As technology advances, it becomes more interconnected, more complex, and essential to how firms of all sizes gain competitive advantage in the marketplace.

9.4%

annual revenue

allocated on average to IT, up from 8% last year

56%

of large companies

dramatically increased their investment in protecting their firm from cyber threats

30

point jump

in the number of firms citing IT and Data Security as a top concern

Leveraging Technology has always been a critical and central function of the Government Contracting world. As technology advances, it becomes more interconnected, more complex, and essential to how firms of all sizes gain competitive advantage in the marketplace.

The IT department is more strategic to an organization that it has ever been. They must determine how to make their internal customers more effective and efficient every day amidst a tornado of technological advancement and the crushing advance of cyber threats. This message showed up powerfully in this year's survey results.

IT budgets are up, the use of cloud solutions has increased since last year, and investments to safeguard the business against cyberattacks continue to rise.

Investments against cyberthreats may be working as we saw less companies reporting physical and data breaches year over year. However, this positive trend may be effecting how IT views future investment as 40% of large companies and more than 60% of small ones predict a slight decrease in their cyberthreat protection investment going forward. We would urge firms to weigh those decisions heavily and remain vigilant in the face of the cyberthreat environment that continues to increase in sophistication and scale.

The following section offers a snapshot of the state of IT in the industry today.

Key Data Points from the Survey

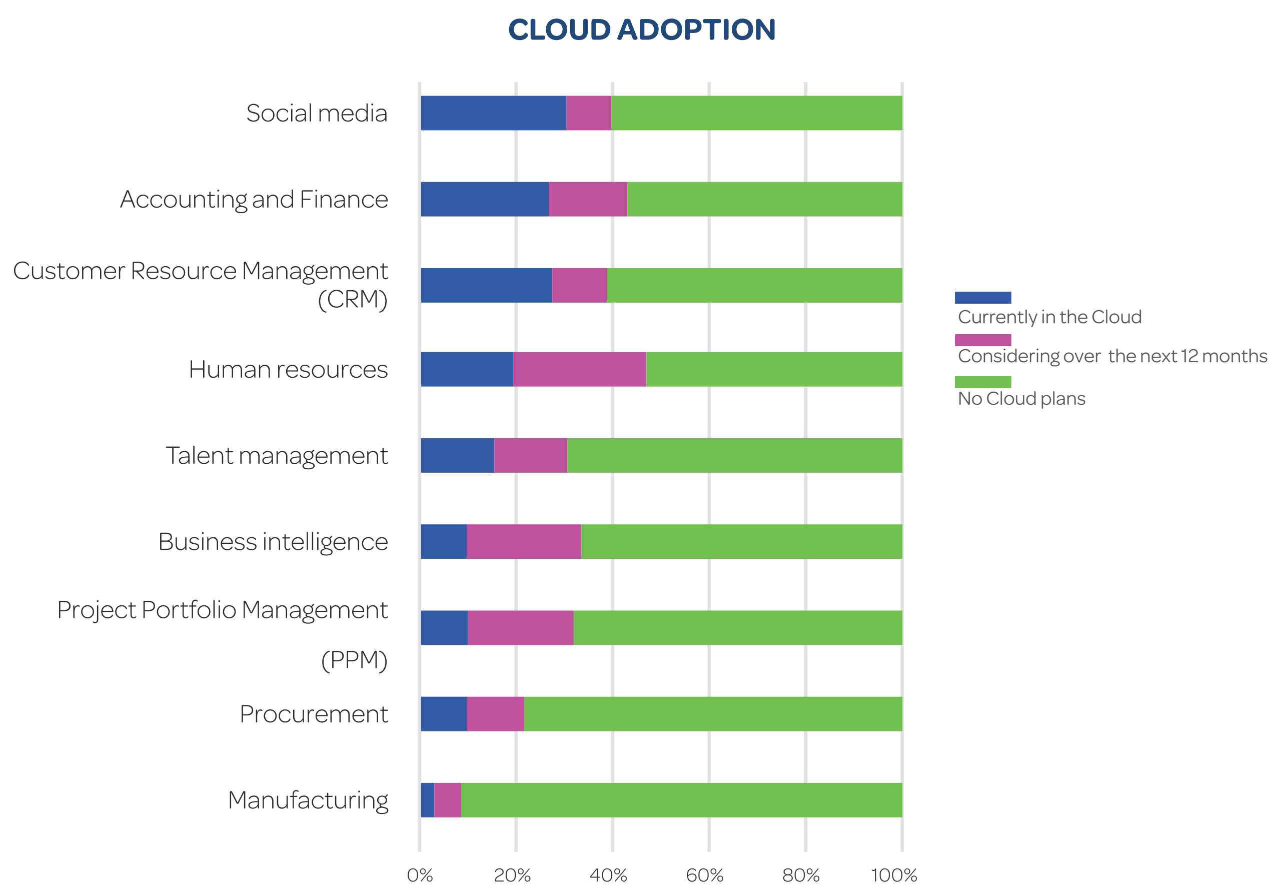
- IT budgets are increasing. Companies now allocate an average 9.4% of their annual revenue to IT, up from 8% last year.
- In the past two years, 60% of large firms reported their IT spend had grown 1-9% while 2 in 10 said it increased 10% or more. Half of small and mid-sized firms also reported an increase in spend. The boost may be temporary as more than half the respondents predicted their IT spend will decrease in the next two years. Still, roughly 35% of small and large firms and 60% of mid-sized predict a continuing increase in spend—in some cases, significantly.
- This past year saw positive movement towards the adoption of cloud-based solutions. Social Media, Accounting & Finance, CRM and HR are still the top cloud suspects for firms.

- The growth in the share of Windows devices seems to have subsided this year. On the tablet side, Windows, iOS and Android split a nearly equal share of the market. On the smartphone side, Windows share is slightly less than the other two.
- 56% of large companies $100M-$1B+ dramatically increased their investment in protecting their firm from cyber threats over the past 24 months. Last year, just 20% of large firms noted their investment had Increased Dramatically.
- The number of firms reporting a data or physical breach plummeted. Over the past year, just 8% of small companies and 34% of large firms experienced these security challenges. This is down from 42% (small companies), 30% (mid-sized) and 66% (large) of companies that reported experiencing one or both breaches in last year's report.
- Two initiatives tied for the #1 most expensive item on GovCon IT budgets over the next 24 months: Upgrade/Implement New IT Security Policies and Procedures and Upgrade Server-Side OS & 3rd Party Platform Software.
- IT and Data Security still tops the list of IT leaders' concerns over the next 2-3 years. It surged in importance with a 30-point jump in the number of firms citing it as one of their top three challenges.

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

We continue to watch Cloud adoption closely, and in spite of everything we see and hear in the market cloud adoption was only up modestly across the respondents but never-the-less increased. Social Media still leads the way, and the top four continue to be rounded out by Accounting & Finance, CRM and HR. We added Talent Management this year, which may have stolen a few responses from HR. And for the first time this year there is a very small contingent of Manufacturing solutions reported as operating in the Cloud.

As Cloud caution continues amongst firms, we are observing significant improvements in functionality and performance in cloud-based solutions in the marketplace. We expected to see more of an increase in cloud adoption as nearly every company we talk to, in every industry, is evaluating cloud solutions unless prohibited by the nature of sensitive classified work. We suspect that it is only a matter of time before these efficiencies start to overcome security fears and change reluctance in the industry.



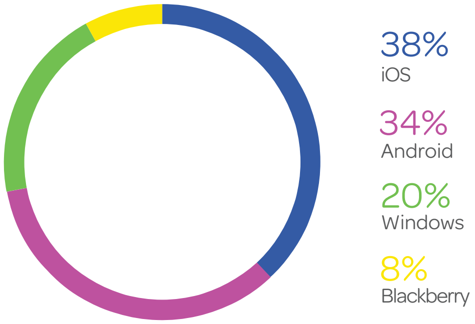
What type of mobile devices and platforms are supported by your IT organization?

Last year we noted the growth of Windows share of the mobile and tablet market in GovCon. This year that appears to be holding steady. Whether Microsoft's efforts to penetrate the enterprise space have eased up, or the barriers to change are too great is unclear.

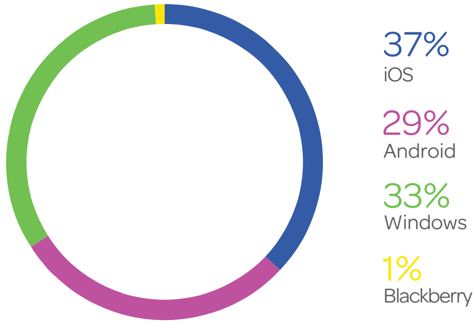
On the tablet side, the three main operation systems are locked in a nearly three-way tie. On the smartphone side, Windows is a bit less represented but iOS and Android are again neck and neck. This is very representative of the adoption breakdown of the overall population. We are starting to wonder if companies are allowing their employees to use whatever device they want realizing they will have to support all three systems.

Notably, Blackberry's share continues to get squeezed out. In addition, we are nearing 100% support of mobile devices and platforms by contractors' IT organizations. Just 2% of companies are not yet supporting smartphones and tablets, but we suspect they will be there within the year.

MOBILE DEVICES SUPPORTED - SMARTPHONES



MOBILE DEVICES SUPPORTED - TABLETS

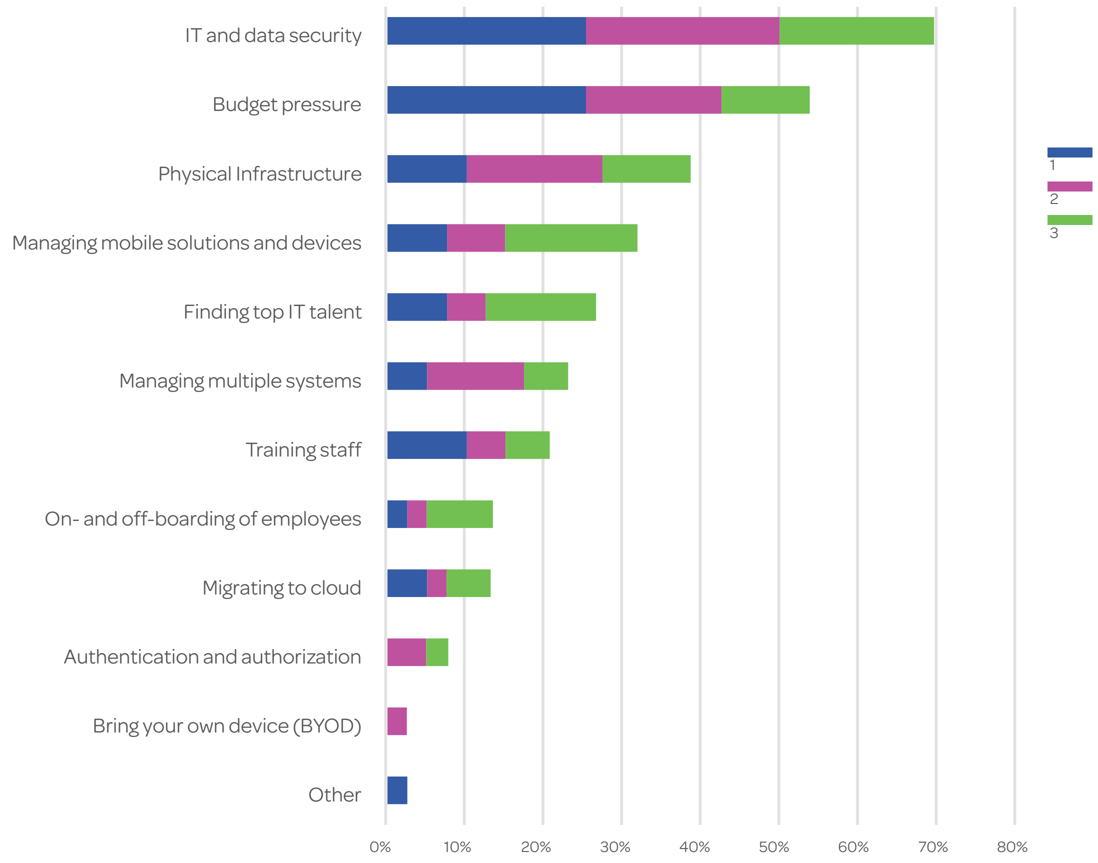


What do you think will be the top three challenges facing the IT leaders of your organization over the next 2-3 years?

IT and Data Security took a commanding lead as the top challenge facing GovCon IT leaders over the next 2-3 years. Last year, it was second in overall votes with 43% of firms putting it in their top three. As cyber threats have increased in both frequency and intensity, the issue is now sitting in the crosshairs of nearly 70% of GovCon firms. This correlates with the increased investment we are seeing organizations make in this area. Budget Pressure did not move in terms of its overall position or in the number of firms selecting it in their top three, but considered beside IT and Data Security, the issue seems to pale somewhat. Physical Infrastructure, sixth last year, leaped into the #3 spot.

Three in 10 organizations said they would be addressing their top challenges through Business Process Reengineering. Other leading initiatives to address these challenges include Build Out New IT Infrastructure (21%) and Outsource IT Administration and Infrastructure (16%).

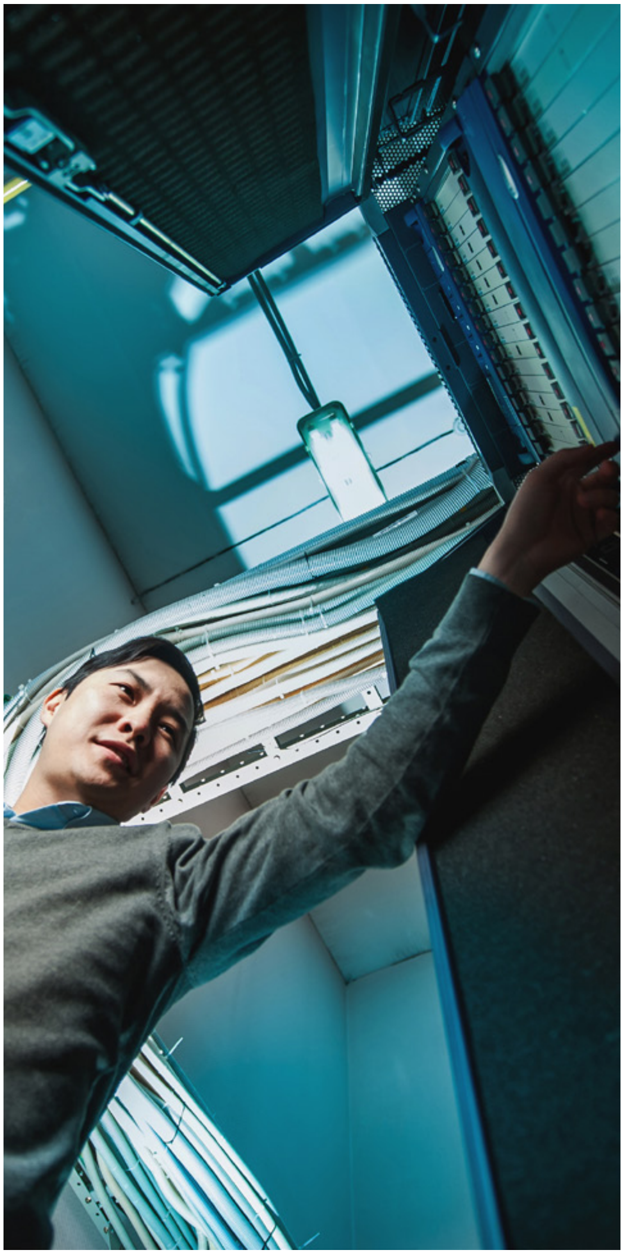
IT CHALLENGES



INFORMATION TECHNOLOGY

CLARITY OUTLOOK

IT is playing an ever-increasing role within GovCon and we expect the importance of, and investments in, this function will only continue to rise. The need to ward off growing cybersecurity threats, upgrade and integrate critical systems and support an expanding number of mobile devices means the IT burden is increasing. This is a tricky balancing act for companies. They need to invest here to stay competitive, efficient and secure, but must weigh IT investments with other needs of the company. Companies can offload some of that cost by shifting into the Cloud, however companies continue to be reluctant to do so. The rapid changes in technology and growing importance of IT makes this an area to watch closely going forward.



STATISTICS AT A GLANCE

	SMALL	MID-SIZED	LARGE
Business Development			
Win Rate	44.2%	38.8%	42.9%
Project Management			
Project Status Visibility	High 36% Moderate 21% Low 4%	High 12% Moderate 9% Low 0%	High12% Moderate 7% Low 0%
Risk Management Maturity	Very Mature 8% Somewhat Mature 28% Somewhat Immature 18% Very Immature 7%	Very Mature 3% Somewhat Mature 7% Somewhat Immature 7% Very Immature 4%	Very Mature 4% Somewhat Mature 5% Somewhat Immature 7% Very Immature 3%
Top Project Challenges	Collaboration and communication Inexperienced project managers Accurate project cost forecasting		
Finance			
Growth Rate	10%	24.4%	4%
Days Sales Outstanding (ave. days)	53.2%	45.4%	48.5%
Invoice Cycle (ave. days)	17.1%	17.1%	16.1%
Net Profit (ave. %)	12.9%	6.7%	5.5%
Top Finance Challenges	Increasing Profitability Decreasing and / or unpredictable Federal Spending Cash Flow		
Compliance			
Top Audit Issues	Indirect rates Labor & Timekeeping Unallowable costs		
Talent Management			
Top Challenges in Acquiring Talent	The availability of good candidates in the market place Matching qualified candidates to open positions The ability to offer competitive compensation to candidates		
Information Technology			
Top IT Challenges	IT and data security Budget pressure Physical infrastructure		