2018 Outlook

Five Trends That Will Shape Federal Contracting in 2018

Bloomberg Government

The Modernizing Government Technology Act of 2017 Will Shape Information Technology Procurement

Enactment of the law as part of the 2018 National Defense Authorization Act (Public Law 115-91) will change the way government will buy information technology products and services in 2018.

The law established working capital funds for IT modernization at individual agencies, and the General Services Administration will manage a separate technology modernization fund that is authorized to receive $500 million over two years and can be transferred to agencies for IT enhancements.

Spending priorities will be IT products and services that improve efficiency, cut costs, eliminate duplicative programs, and reduce risks.

Cybersecurity, shared services, agile development, commercial off-the-shelf software, cloud migration, and data-center consolidation are likely to be emphasized, so contractors with those offerings could see more obligations in 2018.

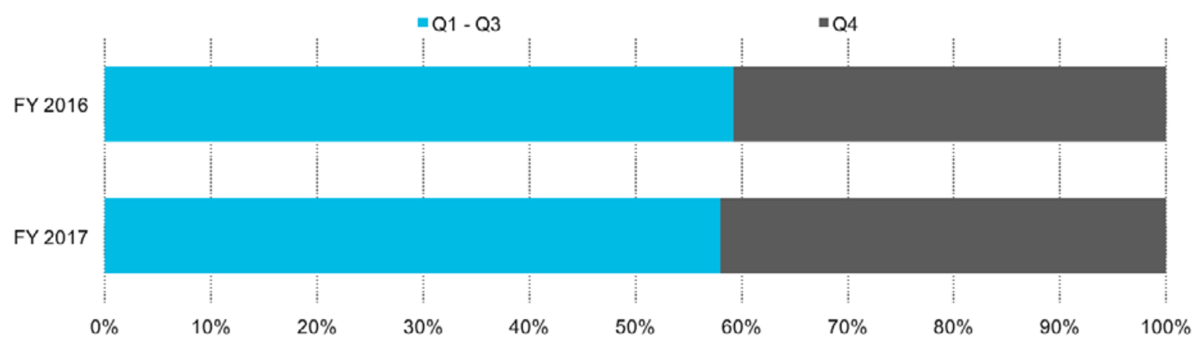
Investments that upgrade legacy systems and supplement innovative but underfunded programs are probably the ideal candidates for modernization money.

Both the individual agency and GSA IT funds offer federal agencies more flexibility by providing additional funds for long-term investments and three years to put the money on contracts.

Rather than being forced to spend funds before the end of the fiscal year, agencies can save that money to put toward the product or service that works best for the agency. That may lead to larger, longer contracts and more emphasis on the best value. It may also motivate agencies to seek out modernization investments with expected future cost savings, since those savings can be reinvested into the working capital funds.

More Than 40 Percent of IT Obligations are Awarded in the Fourth Quarter

Share of information technology contract obligations by quarter

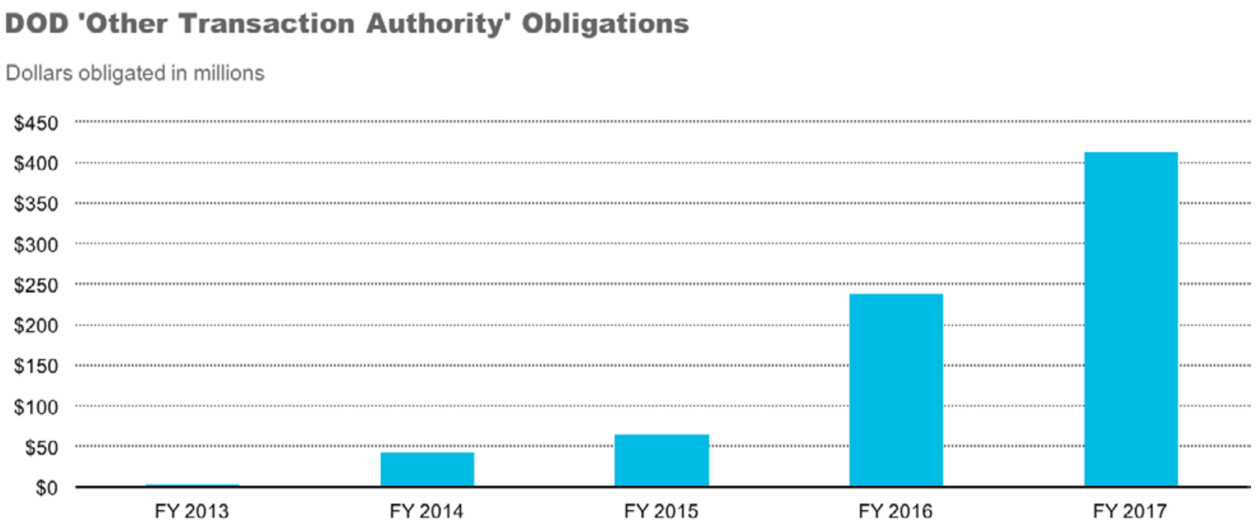


Source: Bloomberg Government proprietary data

Something to watch, three-year money could lead to a spending surge for IT after three years rather than an annual fourth-quarter spending spree.

DOD's Increasing Use of 'Other Transaction Authority' Will Continue

In fiscal 2017, the Defense Department set a record high of $412 million in spending obligations through the use of Other Transaction Authority contracting, according to Bloomberg Government data. That's a significant surge compared with the Pentagon's reported OTA obligations of $3.5 million in fiscal 2013.



Notes: OTA spending based on government definition of "other transaction IDV"
Source: Bloomberg Government data

The military often uses OTA to work with a variety of consortia set up to encourage nontraditional defense contractors to develop innovative technologies, though more traditional defense contractors also participate. Bloomberg Government has identified 18 consortia, including the Consortium for Command, Control, and Communications in Cyberspace (C5) and the American Metalcasting Consortium.

The National Defense Authorization Act for fiscal 2018 included several provisions encouraging the DOD to use OTA more extensively, raising the threshold for use in prototype projects from $250 million to $500 million.

There is some risk with using OTA, since the process bypasses many of the contracting safeguards built into regulations and laws. But barring the emergence of a major setback, the use of OTA is likely to increase in fiscal 2018 and beyond.

Opportunities for Audit Services Will Bloom

The U.S. government is required to prepare consolidated financial statements. That means each agency must prepare a set of books. The biggest problem: the Defense Department hasn't been able to do so.

It's not that the Pentagon can't get a clean audit — it's that, according to the Government Accountability Office, its financial management problems have resulted in statements that can't be audited.

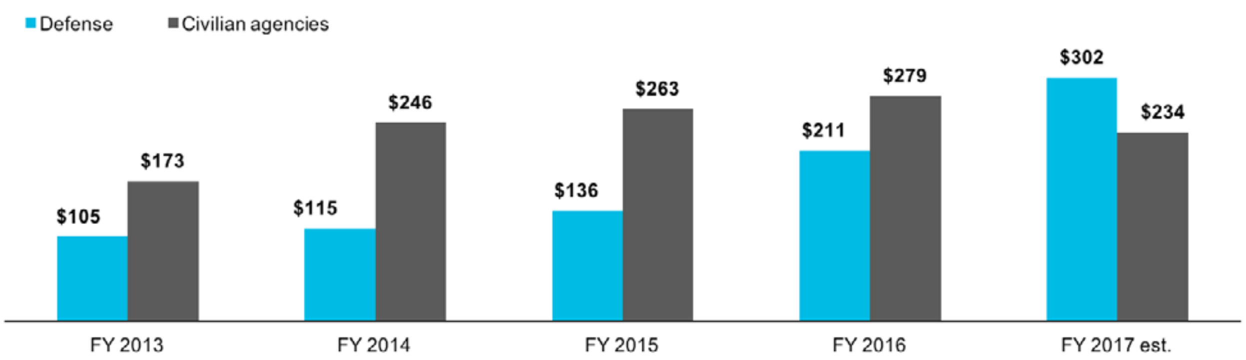
DOD began preparing its first-ever agencywide financial audit last fall, which has translated into more work for companies with auditing expertise — with the potential for follow-on work in the coming years.

Top DOD audit support contractors include PricewaterhouseCoopers LLP, KPMG Europe LLP, Ernst & Young Europe LLP, and Kearney & Co. DOD audit support spending in fiscal 2017 will top $300 million, based on preliminary year-end data, a significant increase from 2016.

If the first DOD audit reveals big problems, as expected, spending on audits and related financial management support to help address those deficiencies is likely to be significant in fiscal 2018, though it's too early to tell how that will compare with 2017.

Federal Contracting for Auditing Support

Prime contract obligations in millions of current dollars



Notes: Defined by Product Service Code R704 - Support Management: Auditing
Source: Bloomberg Government data

Civilian agency spending on audit support contracts peaked in 2016 and declined in 2017.

Although the most lucrative work will be at the Pentagon, civilian agencies will have their share. In October, GSA issued an Audit Services Ordering Guide that lays out procedures for issuing task orders for audit services on the Professional Services Schedule and is designed to foster best practices.

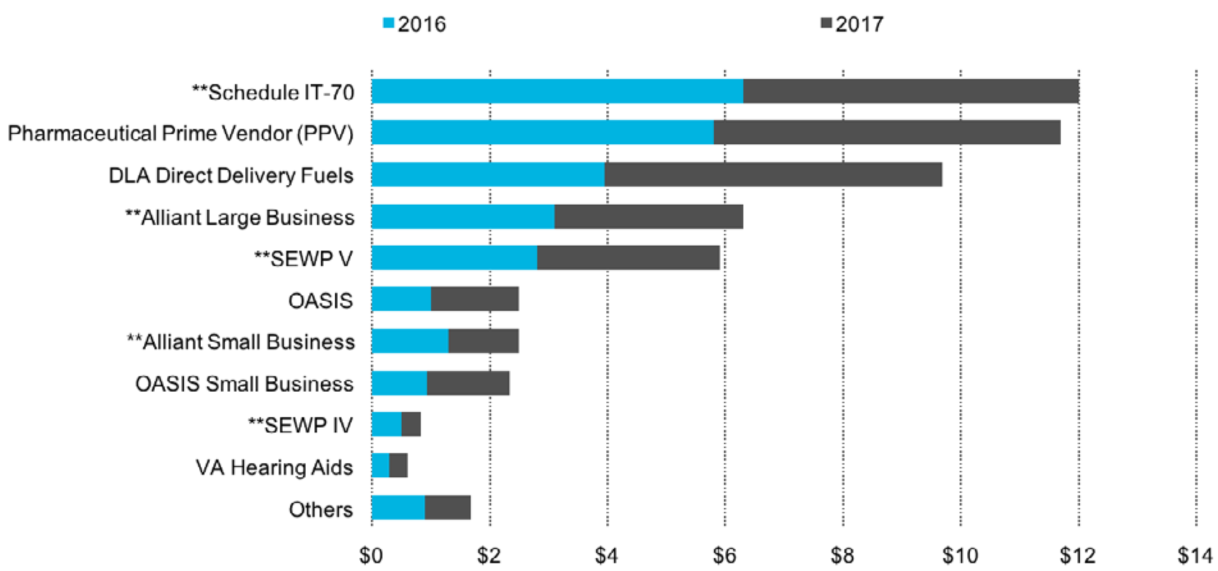
Best-in-Class Contracts Will Reshape Category Management

BIC contracts will gain momentum in 2018, and agencies face mounting pressure to squeeze efficiencies out of constrained budgets.

In November, the federal government introduced its first comprehensive list of “Best-in-Class” (BIC) contracts, selected based on competitive pricing and access to market-proven solutions. This approach enables agencies to take advantage of volume discounts, benchmark labor rates, standardize requirements for common products and services, and gain a better sense of governmentwide demand.

Half of the Largest BIC Contracts Are in IT

Dollars obligated, in billions; fiscal years 2016 through 2017



Note: Starred vehicles (**) are primarily IT product and service contracts.
Source: Bloomberg Government data

One area where BIC contracting could reshape category management is information technology procurement. Of the 29 BIC contracts, nine are used primarily for IT products and/or services. In fiscal 2017, 25 cents of every dollar the U.S. government spent on IT was on a BIC contract. GSA estimates that standardizing acquisitions through BICs could save agencies 10 to 20 percent compared with one-off IT contracts.

In fiscal 2018, the federal government will expand the role of BICs in its category management strategy. Contractors should expect growth in the market share of existing BIC contracts.

Number of Midtier Companies Will Continue to Grow

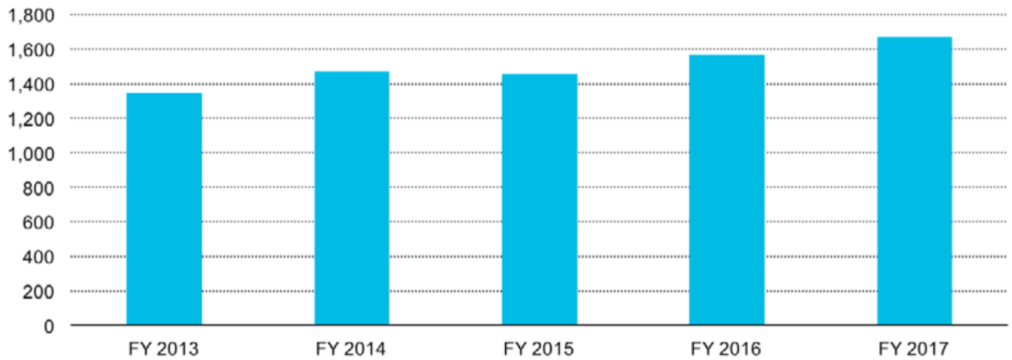
Midtier companies, or those defined by annual revenue between $25 million and $500 million, will continue to make progress with policy issues on Capitol Hill as their numbers and influence expand.

The main issues those companies will seek to address will almost certainly be structural procurement barriers such as size standard calculations and teaming restrictions. If these efforts succeed, the positions held by midtiers in growth markets and on key contract vehicles will probably lead to continued gains in 2018.

Overall, fiscal 2017 was a positive one for midtier federal vendors, which posted 9.1 percent year-over-year revenue growth along with an increase in the number of vendors, market share, and average company size.

Fiscal 2017 year-end figures show spending with the midtier sector at $138 billion, the highest total since at least fiscal 2012. The number of midtier companies reached 1,672 while market share inched back to 27 percent.

Number of Midtier Companies Is on the Rise



Notes: Mid-tiers are defined as companies with $25 million to $500 million in annual revenue.
Source: Bloomberg Government data

Perhaps most significantly, average midtier company size in fiscal 2017 reversed several years of decline, climbing back to $82.6 billion in annual revenue, just below the fiscal 2015 level but still less than the peak $87.5 million levels of fiscal years 2012 and 2013.

The vast majority of spending obligations that went to midtier companies was through professional and technology services multiple-award contracts. Vehicles including NASA's Solutions for Enterprise-Wide Procurement V (SEWP-V) and the General Services Administration's IT Schedule 70 are most likely to propel midtier performance in 2018, just as they did in 2017.

The challenges faced by midtiers are perhaps illustrated by the fact that officially designated small vendors holding positions on multiple-award contracts, such as OASIS Small Business and Alliant Small Business, won a combined $2.5 billion in fiscal 2017, while midtiers forced to compete with large companies on the unrestricted versions of these two vehicles won a combined $488 million. In other words, official small business size status and preferences enable certain small businesses to grow very large on important contracts in key government markets as their midtier counterparts struggle to compete with large, deep-pocketed competitors in the same markets.

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