



**The Walter V. Shipley  
Business Leadership Case Competition**

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## Executive Summary

A CEO's interests are often torn between maximizing the long-term value for all of the company's stakeholders and short-term equity value maximization. Veridian Corp. management's strong commitment to maximizing the long-term value of the company made it a strong candidate for potential acquisition. In the following pages we evaluate the company based on the following criteria:

- Industry Analysis
- Company Strengths and Weaknesses
- Financial Analysis
- Management evaluation
- Acquisition Decision Analysis

Based on our analysis of the company and the existing business environment, we strongly recommend to further explore potential offers that will not only provide value to its stakeholders but will also espouse the same values and ethics promoted by the company and its employees.

## Veridian's Goals

Always seeking to sustain the firm, a CEO can tackle the tradeoff by evaluating the conflict between short and long-term goals, taking the interests of its employees, customers, shareholders and creditors into account, as outlined in the table below. These constituents influence not only the decision to sell the company, but also impact the future value of the company.

	Employees	Customers	Creditors and Shareholders
<b>Short-Term Goals</b>	<ul style="list-style-type: none"><li>• Streamline individual processes</li><li>• Ensure satisfaction and loyalty</li></ul>	<ul style="list-style-type: none"><li>• Ensure satisfaction and loyalty</li><li>• Guarantee quality</li><li>• Maintain affordability</li></ul>	<ul style="list-style-type: none"><li>• Capitalize on current industry trends</li></ul>
<b>Long-Term Goals</b>	<ul style="list-style-type: none"><li>• Set values-based management standard</li><li>• Grow R&amp;D leading to more jobs, innovation, and reduced turnover</li></ul>	<ul style="list-style-type: none"><li>• Expand presence - homeland security</li><li>• Offer extensive technology/defense solutions</li></ul>	<ul style="list-style-type: none"><li>• Ensure organic and inorganic growth and accompanying returns</li></ul>

## Industry Analysis

The following Porter's Five Forces analysis defines the attractiveness of the industry.

1. *Threat of New Entrants* - The threat of entry to the military defense industry is quite low. Infrastructure and R&D require extremely high investments in addition to great risks and non-immediate positive returns on investments. The defense industry's economies of scale, where increasing sales are required to recover the investments, deter entry.

2. *Threat of Substitute Products* - The largest defense companies face almost no threats of substitute products because of the uniqueness of products. The threat of substitute products exists at the part/component level in other industries.
3. *Bargaining Power of Buyers* - There is forced competition between the manufacturing suppliers of the defense industry. Buyers are in an advantageous position and can demand price reductions. The switching costs are very low, which also increases the buyers' power, especially after the changes in the defense industry during the 1990's to today. There is also an increasing demand by the DoD for shorter production runs and better product integration among its various large-scale weapons platforms and warfighters.
4. *Competitor Rivalry* - Competition is fierce in this industry because of the buyer power associated with defense companies. The industry has gone through a period of consolidation leading to a few major players with multiple product lines. This coupled with the strong demand for cutting edge technology forces defense companies to quickly respond and adapt to changes in the sector.
5. *Bargaining Power of Suppliers* - The bargaining power of suppliers is not that strong, but there are exceptions. For example, a supplier may possess key technologies that it can leverage for transaction power. In general, the prime competitors in the defense industry can choose from several suppliers.

### Company Analysis

The following SWOT analysis illustrates the issues that Veridian must overcome, as well as the characteristics that the company should capitalize on.

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Management and long-term commitment to values-based leadership</li> <li>• Adaptability</li> <li>• Dedication to creativity and innovation</li> <li>• Board</li> </ul>	<ul style="list-style-type: none"> <li>• Size</li> <li>• Low emphasis on IPO's benefits or stock performance</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>• Viable sale to another company in an industry with a growing focus on RMA technology and economies of scale</li> </ul>	<ul style="list-style-type: none"> <li>• Industry's continually changing dynamics</li> <li>• Prime defense companies gaining more clout</li> </ul>

Based on the above analysis, examining the short and long-term goals of the company, and assessing industry-based as well as internal opportunities, Veridian is in a prime position to be sold.

### Financial Analysis

#### Discounted Cash Flow

Exhibit 6 in the case provides us with the data required to calculate the intrinsic value of the Company using the Discounted Cash Flow Methodology.

- Key assumptions
  - 10% growth in the first 5 years
  - 8% growth in the next 5 years
  - Terminal growth of 3%

- The Weighted Average Cost of Capital calculated based on
  - Cost of equity using an industry beta of 1.12
  - Cost of debt based on the cost for similar companies
- The intrinsic value of Veridian Corp: \$798.5 million
- Estimated Equity Value: \$506 million
- **Per share value of \$14.83**

### **Public comparable Analysis**

Exhibit 7 in the case provides us with an insight into the market valuation of comparable companies operating in the Aerospace and Defense technology services sector. A public comparable analysis provides us with the following:

- Anteon International Corp and Titan Corp are very similar to Veridian Corp based on EBITDA and Debt.
- Average EBITDA multiple of 14.15 for Veridian Corp based on the above two companies.
- Estimated Enterprise Value: \$1,014 million
- Estimate Market Value: \$722 million
- **Estimated Stock Price: \$21.16**

Given that Veridian Corp's stock was approximately trading in the same price range, we believe that the market had efficiently priced Veridian stock in comparison with its peers. A further comparison of the public comparable and DCF analysis reveals a *\$216 million premium* paid by the market – for management efficiency and company values. We believe this reflects the valuation of the management and a testimony to the commitment to strong ethics and values of the management and focus on increasing the long-term value for all the company's stakeholders.

### **Acquisition Comparable Analysis**

Having calculated the DCF and performed a public comparable analysis, we referred to Bloomberg for the data to conduct our acquisition comparable analysis. Bloomberg identified Veridian as an Aerospace-Defense company and NAICS identified it as a Computer Aided Design company. We searched for precedent transactions in both industries on Bloomberg and selected the deals in Exhibit III. We made certain judgments in our selection and analysis, which are stated below:

1. *Trade-off between reasonable sample size and the relevance of the deals*
  - Excluded deals that were below \$250 million as we felt they were too small and/or did not have publicly available information.
  - Included some deals that were terminated but had publicly available information because we felt their deal sizes were more relevant to Veridian.
2. *Certain deals were more applicable than others within our sample –*
  - Some deal sizes were too large and another had too high of an EBIT multiple – assigned weighting of 17.50% for deals that were more relevant and 10% to those that were less.
3. *EBIT vs. EBITDA multiple –*

- EBIT multiples more readily available for all of our deals.
- We believe D & A is not as big of a factor for this type of industry as opposed to capital-intensive industries like manufacturing.

We came to the following conclusion.

- Average weighted EBIT Multiple of 19.50
- Estimated Enterprise Value in 2002 (in millions): \$944 million
- Estimated Enterprise Value in 2002 (in millions): \$1,065 million
- Arithmetic average gives final Enterprise Value of approximately \$1,298 million
- Estimate Market Value: \$1,006 million
- **Estimated Stock Price: \$29.50**

### **Real Options: Putting a Value on Values<sup>i, ii</sup>**

As a complement to the above valuation analysis, it is also necessary to attempt and quantify management’s flexibility and ability to respond to developments over time. In other words, valuing real options that give a business the right to make a potentially value-accretive or positive NPV investment by fully utilizing the firm’s real non-financial assets. Real options thinking captures three areas better than a DCF – flexibility – adaptability to a changing business environment, contingency – future investment or growth opportunities that are dependent on today’s investments, and volatility – increased uncertainty makes real options more valuable.

Therefore, a real options assessment is most applicable to businesses that have three important characteristics:

1. Smart and reputable managers who have access to capital. They must also understand options thinking, be able to clearly identify/create and appropriately exercise options.
2. Market-leading businesses will have the best information and best available options.
3. Real options are applicable in uncertain markets where change is evident.

We believe that Veridian satisfies all of these characteristics through its values-based leadership, innovative culture, focus on “cutting edge” business, and being in a market that is rapidly changing.

Real options can be generally categorized as invest/grow options (scale, switch or scope up), defer/learn (timing – option to wait) and disinvest/shrink options (scale, switch or scope down). Therefore, it will be very complex to value each separately or as a whole for a firm like Veridian, which has many options.

This real option can be estimated using a proxy – the difference between the current equity value and the DCF equity value. We have determined this to be *approximately \$200 million*.

### ***Approximate Valuation Pyramid.***

Real Options Value: (Management Ethics and Values Option): \$1.5 Billion
Acquisition Comparable Analysis Value: \$1.3 Billion
Public Comparable Analysis Value: \$1 Billion
Discounted Cash Flow Value: \$800 million

## Acquisition risks

Since Veridian is a service company, it is heavily dependent on its most important resources, its people. The fact that 80% of Veridian Corp’s employees had security clearance gave the company a clear edge over its competitors. The most critical acquisition risk is the disillusion of its key employees. In addition to above-mentioned risk, the following are some issues and precautions that an acquiring company will need to consider:

Risks	Mitigants
<ul style="list-style-type: none"> <li>Technical obsolescence of Veridian employees</li> </ul>	<ul style="list-style-type: none"> <li>Focused knowledge transfer initiatives</li> <li>Maintaining the morale of the employees by focusing on creativity and high-end quality work.</li> </ul>
<ul style="list-style-type: none"> <li>Differing cultures and values</li> </ul>	<ul style="list-style-type: none"> <li>Focused knowledge transfer initiatives</li> <li>Strong program management and integration from both sides</li> </ul>
<ul style="list-style-type: none"> <li>Inefficient allocation of resources and overarching bureaucracy</li> </ul>	<ul style="list-style-type: none"> <li>Effectively merge the culture and values of the companies by allowing the free transfer of ideas</li> </ul>
<ul style="list-style-type: none"> <li>Integration risk such as redistribution of assets</li> </ul>	<ul style="list-style-type: none"> <li>Due Diligence</li> </ul>
<ul style="list-style-type: none"> <li>Unsustainable goals and expectations</li> </ul>	<ul style="list-style-type: none"> <li>Checks and balances of goals and expectations</li> </ul>

Based on the above risks and mitigants, the following decision model is derived:

	Sell	Stand alone
<i>Employee Short-Term Goals</i>		
➤ Streamlined processes rewarding creativity	<ul style="list-style-type: none"> <li>Possible dilution</li> </ul>	<ul style="list-style-type: none"> <li>Strong existing values</li> </ul>
➤ Opportunity to work on high end quality project	<ul style="list-style-type: none"> <li>Better with an bigger contractor</li> </ul>	<ul style="list-style-type: none"> <li>Limited by size</li> </ul>
➤ Higher stability	<ul style="list-style-type: none"> <li>Could lead to short term concerns</li> </ul>	<ul style="list-style-type: none"> <li>Limited by size and cyclical nature of business</li> </ul>
➤ Ethics and Value based management	<ul style="list-style-type: none"> <li>Possible dilution in a larger environment</li> </ul>	<ul style="list-style-type: none"> <li>Strong proven value based management</li> </ul>
<i>Employee Long-Term Goals</i>		
➤ Financially rewarding career	<ul style="list-style-type: none"> <li>Better with a bigger contractor</li> </ul>	<ul style="list-style-type: none"> <li>Possible risks in an uncertain business environment</li> </ul>
➤ Professional Legacy	<ul style="list-style-type: none"> <li>Can get lost in the “masses” – less likely to make a significant impact in a larger firm</li> </ul>	<ul style="list-style-type: none"> <li>Strong innovative and small “feel” culture creating a conducive environment to make a lasting imprint</li> </ul>
➤ Ethics and Value based management	<ul style="list-style-type: none"> <li>Possible dilution in a larger environment</li> </ul>	<ul style="list-style-type: none"> <li>Strong proven value based management</li> </ul>
<i>Customer Short-Term Goals</i>		
➤ Creative solutions for a changing world	<ul style="list-style-type: none"> <li>Dependent on the acquirer</li> </ul>	<ul style="list-style-type: none"> <li>Proven technical creativity and innovation</li> </ul>
➤ Reliable delivery	<ul style="list-style-type: none"> <li>Possible delays in delivery</li> </ul>	<ul style="list-style-type: none"> <li>Proven delivery process</li> </ul>
<i>Customer Long-Term Goals</i>		
➤ Reliable procurement from a few vendors	<ul style="list-style-type: none"> <li>Better served with acquisition</li> </ul>	<ul style="list-style-type: none"> <li>In the current RMA environment, sourced from large number of vendors</li> </ul>
➤ Strong financial strengths of vendors	<ul style="list-style-type: none"> <li>Better served with acquisition</li> </ul>	<ul style="list-style-type: none"> <li>Uncertain</li> </ul>

<i>Shareholder Short-Term Goals</i>		
➤ Maintain strong positive cash flows	• Better served with acquisition	• Limited due to uncertain business environment
➤ Maximize shareholder value	• Better served with acquisition	• Uncertain due to business environment
<i>Shareholder Long-Term Goals</i>		
➤ Maintain strong consistent growth	• Better served with acquisition due to the ability to be the lead contractor	• Possible issues in garnering lead contracts
➤ Strong consistently positive earnings	• Larger size provides for smoothening of earnings	• Inconsistent earnings performance.

Based on the decision matrix, it is clear the long-term prospects of all the stakeholders are better served by selling the company to not only a larger bidder but also a responsible partner who share Veridian Corp’s values and culture.

### **Recommendation, Legal Implications and Conclusion**

By employing various techniques, the thorough strategic and valuation analysis conducted in this paper supports a decision for Veridian to be sold at its true value that should be satisfactory for all stakeholders.

- Porter’s industry analysis – industry consolidation encouraged by a powerful buyer – the U.S. government – to serve its needs efficiently forcing many large defense contractors to change.
- SWOT business analysis – matching company strengths and weaknesses to threats and opportunities reveals that by selling, it will be better prepared to maximize value for all stakeholders in an ever-changing environment.
- Financial Analysis – determined the true value of Veridian at approx. \$1.5 billion taking into account the value of non-financial impacts such as management and company values.
- Management evaluation – two comparisons revealed an approx. \$200 million premium which reflects the value of management’s values-based leadership and focus on long-term value maximization for all stakeholders.
- Acquisition Decision Analysis – weighing the short-term and long-term goals of all stakeholders in our decision matrix showed that everyone’s goals are better served by selling the company – “perfect solution” for a “perfect storm”.

Therefore, it is now the fiduciary responsibility of the CEO and board under Revlon duty to report and consider all viable offers (maximize shareholder wealth) made for the company. Additionally, Smith vs. Van Gorkom states that due diligence needs to be done before an offer is accepted. We acknowledge the tension between the fiduciary duty and being an institutional leader focused on effective running of a business. In other words, the constant conflict between short and long-term time frames as well as the differing requirements of the investment market and the market for corporate control. It could be argued that a private company better serves long-term goals but our analysis shows a public company can do that if it is governed correctly and decisions made in the context of long-term value maximization for all stakeholders. It is also very important to have symmetry of information among all stakeholders especially in the vision and focus of the company. This is, in turn, reflected in the premiums commanded by the company.



## Exhibit II. Public Comparable Analysis

Date	Company	Stock Price	Shares Outstanding	Preferred Stock	Stockholder Equity	MV	Total Debt	EV	EBITDA	EBIT	Sales Growth	EV/EBITDA	EV/EBIT	Debt/Equity	Debt/EBITDA	EPS	P/E
Jun-03	CACI Intl Inc	\$34.30	28.7	0.0	421.5	985.2	4.6	989.8	\$83.0	\$70.4		11.93	14.06	0.01	0.06	\$1.56	21.99
Dec-02	Anteon International Corp	\$24.00	34.4	0.0	128.8	823.6	105.7	929.3	\$68.7	\$64.4	14%	13.53	14.43	0.82	1.54	\$0.90	26.67
Jun-03	SRA International Inc	\$16.00	50.1	0.0	283.0	514.3	0.4	514.7	\$51.0	\$42.0	20%	10.09	12.25	0.00	0.01	\$0.69	23.19
Dec-02	Titan Corp	\$10.40	78.1	0.7	312.3	811.4	602	1413.4	\$95.7	\$74.0		14.77	19.10	1.93	6.29	-\$0.11	N/A
Dec-02	Mantech Intl Corp	\$19.07	31.3	0.0	246.0	293.5	26	319.5	\$41.1	\$38.5		7.77	8.30	0.11	0.63	\$0.89	21.43
Dec-02	MTC Technologies Inc	\$25.30	12.9	0.0	49.8	325.5	0	325.5	\$14.2	\$13.7		22.92	23.76	0.00	0.00	\$0.67	37.76
Dec-02	Veridian Corp	\$21.34	34.1	0.0	309.6	704.2	292.7	996.9	\$71.7	\$60.6	19%	13.90	16.45	0.95	4.08	-\$1.52	N/A
Based on the above, Veridian is closest to Anteon Corp and Tital Corp																	
<b>Potential valuation for Veridian</b>																	
Average EV/EBITDA of Anteon and Titan		14.15															
Estimated EV		1,014															
Estimated MV		722															
Estimated Stock Price		\$21.16															

## Exhibit III. Acquisition Comparable Analysis

Deal Type*	Announce Date*	Target Name*	Acquirer Name*	Announced Total Value (USD mil.)*	Deal Status*	EBIT Multiple*	Weights	Weighted EBIT Multiples	Comments
ACQ	9/15/03	TITAN CORP	LOCKHEED MARTIN CORP	\$2,295.51	Terminated	13.92	17.50%	2.44	
ACQ	12/21/00	LITTON INDUSTRIES INC	NORTHROP GRUMMAN CORP	\$5,102.20	Complete	10.98	17.50%	1.92	
ACQ	11/9/00	PRIMEX TECHNOLOGIES INC	GENERAL DYNAMICS CORP	\$486.74	Complete	9.95	17.50%	1.74	
ACQ	11/12/99	HOWMET INTERNATIONAL INC	CORDANT TECHNOLOGIES INC	\$261.88	Terminated	28.39	17.50%	4.97	
ACQ	5/17/99	GULFSTREAM AEROSPACE CORP	GENERAL DYNAMICS CORP	\$5,674.53	Complete	58.33	10.00%	5.83	High EBIT multiple
ACQ	7/3/97	NORTHROP GRUMMAN CORP	LOCKHEED MARTIN CORP	\$11,600.00	Terminated	15.18	10.00%	1.52	Very large deal size
ACQ	12/16/96	MCDONNELL DOUGLAS CORP	BOEING CO	\$15,519.04	Complete	10.79	10.00%	1.08	Very large deal size
							100.00%	19.50	<b>Average</b>
<b>Veridian EBIT</b>		Quarter (millions)		Annual (millions)		<b>Transaction Value (millions)</b>			
Exhibit 4	2002	12.112		48.448		<b>944.590656</b>			
Exhibit 6	2003	21.166		84.664		<b>1650.694008</b>			
				<b>Average</b>		<b>1297.642332</b>			
*Information retrieved from Bloomberg									

## Appendix

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<sup>i</sup> Mauboussin, Michael J., “Get Real: Using Real Options in Security Analysis,” Credit Suisse, June 23, 1999

<sup>ii</sup> Edleson, Michael E., “Real Options: Valuing Managerial Flexibility,” Harvard Business School, June 4, 1999