

TOP 3 PREDICTIONS FOR FEDERAL IT SERVICES IN 2023

The bull market in federal IT will continue in 2023

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▼ FEDERAL IT SPEND IS POISED TO SURGE TO NEW HIGHS ON THE BACK OF DIGITAL MODERNIZATION AND CYBERSECURITY INVESTMENT

The Biden administration's federal fiscal year 2023 (FFY2023, ending Sept. 30) budget looks to be a windfall for federal IT contractors, with a double-digit year-to-year increase in civilian IT spending, significant expansion in cybersecurity outlays across defense and nondefense sectors, and generous funding boosts for public health IT infrastructure and veteran care. Other technology priority areas include 5G and broadband connectivity, AI, enhancement of space capabilities and IT systems modernization.




IT spending growth will be most robust in the civilian segment, where the White House has requested nearly \$66 billion for technology investment, up 12% over FFY2022 levels. Digital transformation and cybersecurity enhancement initiatives will receive prioritization, the latter driven largely by the 2021 Executive Order (14028) mandating that federal agencies fortify cyber defenses. Zero-trust security will feature heavily in civil agency IT cyber strategies to secure supply chains, improve incident response and reporting, and minimize workforce-related security risks.

During the first year of the Biden administration, federal IT contractors with significant footprints in the Department of Defense (DOD) were concerned that the emphasis on the president's domestic agenda would result in significant slowdowns, or even cuts, in defense spending. This scenario did not play out, as proposed DOD outlays in the president's FFY2023 defense budget rose by tens of billions of dollars over FFY2022 levels, including a 2.3% increase for IT and cyberspace activities funding that will push total DOD IT spending to nearly \$58 billion in FFY2023, up from the \$56.6 billion enacted in FFY2022. Like their counterparts in the civilian sector, DOD agencies are looking to adopt zero-trust approaches to shore up the security of enterprise IT and communications networks, and other critical military infrastructure. Enhancing IT-related space capabilities (e.g., missile warning and navigation systems, and advanced satellite communications) will also receive funding increases, and the DOD will also increasingly utilize AI, analytics, big data and next-generation mapping technologies to study the national security implications of climate change.

Against the backdrop of record levels of technology investment spanning civilian and defense agencies alike, federal IT contractors are confident the federal IT market will remain growth friendly through 2023.

▼ PREDICTIONS




FEDERAL AGENCIES ACCELERATE DEMAND FOR COMMERCIALLY DEVELOPED DIGITAL TECHNOLOGIES, PARTICULARLY CLOUD COMPUTING

-  **Trend:** Cloud computing will be increasingly foundational in civilian and defense agency IT modernization initiatives.
-  **Driver:** The federal IT budget for FFY2023 continues to promote migration to cost-effective, commercial cloud solutions and shared services.
-  **Result:** Federal IT vendors can expect demand for cloud-based solutions to remain strong and on an upward trajectory throughout 2023 and the next several years.

Federal spending on cloud was \$11 billion in FFY2021, an increase of more than 40% from the \$7.6 billion spent in FFY2019. Total cloud outlays could expand by double-digit rates again in FFY2022 (the final tally from FFY2022, ended Sept. 30, was not available as of this report) and FFY2023, implying a potential addressable cloud computing market in federal IT worth more than \$13 billion in the current federal fiscal year. The overall volume of baseline modernization of federal IT and communications systems will continue increasing in 2023 to accommodate broad-based and agencywide adoption of cloud infrastructures, as well as zero-trust security, software-defined solutions and next-generation communications technologies like 5G. Many federal departments remain locked into monolithic legacy IT systems that cannot facilitate digital modernization. Agencies seeking to overhaul their IT infrastructures and migrate more data and applications to the cloud will also use application programming interfaces (APIs) with increasing frequency, and will need guidance on developing API strategies from their federal IT partners. Agencies have become more amenable to the notion that commercial cloud services have security advantages over on-premises federal systems, but security will remain a paramount, pre-migration concern for agency IT decision makers in 2023, particularly as large swaths of the federal labor force work in hybrid or remote environments and as the number of mobile devices connecting to federal IT networks proliferates.

Federal IT vendors will also be called upon by their agency clients in 2023 to assist in training federal IT workers on how to use new cloud and digital technologies while also complying with regulatory requirements during cloud migrations.

CYBERSECURITY INVESTMENT ACCELERATES TO DEFEND AN EVER-EXPANDING THREAT LANDSCAPE AND COMBAT RISING CYBER DISRUPTION IN FEDERAL IT

-  **Trend:** Federal outlays for cyberspace activities (such as implementing zero-trust security, securing cloud and edge computing, and fortifying the Defense Industrial Base [DIB]) are steadily increasing.
-  **Driver:** The Biden administration's 2021 Executive Order (14028) seeks to prevent security intrusions into federal IT networks, which are accelerating in frequency and increasing in sophistication.
-  **Result:** Federal IT contractors with leading cybersecurity capabilities will be called on to offer their security expertise across a broader range of civil and DOD missions.

In FFY2022, civilian agencies requested nearly \$11 billion for cybersecurity (up 26% over FFY2021) while the DOD asked for over \$11 billion (up an estimated 14.3% over FFY2021, as in FFY2022 the DOD stopped publicly reporting details about its cybersecurity budget) in cyber-related funding. Cyber-related budget allocations will likely continue to grow at a similar pace in FFY2023. For example, the Cybersecurity and Infrastructure Security Agency (CISA), a division of the Department of Homeland Security (DHS), has requested \$2.93 billion for FFY2023, an increase of \$334 million over FFY2022 levels. As in FFY2022, in FFY2023 civil departments will prioritize supply chain risk management, incident response and reporting, and minimization of employee risk with their cyber outlays. DOD agencies will enhance the security of critical military infrastructures and the DIB, and increase support for Cyber Mission Force Teams. New and expanded investment in zero-trust architectures will continue across both sectors.

The competition for cybersecurity talent will intensify in 2023, especially for individuals with security clearances. Federal technology providers are looking to hire more experienced cyber leaders from the DOD, the intelligence community, and the Department of Justice (DOJ).

Federal IT vendors will also ramp up efforts to forge partnerships with peers, large and small, that bring unique and innovative security capabilities to the table. Vendors like Booz Allen Hamilton and Raytheon Technologies stood up venture capital investment arms in 2022, and we expect more top-tier federal technology contractors to follow suit in 2023 as one way to build and expand their networks of partners with transformational cybersecurity and digital technologies. Booz Allen Hamilton and Raytheon Technologies also appear poised to parlay their long-standing cyber expertise into security-related opportunities in the commercial sector in 2023.

ACQUISITIONS CONTINUE AT A SLOW PACE IN THE FEDERAL IT M&A MARKET DURING 2023



Trend: After a lively, multiyear period of M&A in federal IT through 2021, overall activity declined sharply in 2022.



Driver: Recent rises in interest rates have made debt more expensive to carry and use to finance new M&A.



Result: Capital allocation strategies at leading federal IT vendors will continue deprioritizing M&A.

From 2018 through 2021, federal IT contractors were highly active, acquiring smaller peers while strategic mergers (e.g., Raytheon Technologies buying United Technologies) were not uncommon. Vendors entered 2022 with continued strong M&A ambitions, thanks to the abundant availability of cheap debt financing and generally strong liquidity levels (at least among the top-tier players). Inflationary pressures increased, along with supply chain disruptions (particularly in the global supply of computer chips), but the outlook for the macroeconomic environment remained generally positive. 2022 ushered in sharp increases in inflation and in interest rates as an inflationary countermeasure. High stock market volatility, the threat of new waves of COVID-19, and Russia's invasion of Ukraine have also increasingly discouraged M&A activity.

Federal technology contractors, undoubtedly anticipating negative balance sheet impacts of high debt leverage, began shifting capital deployment away from M&A (though their internal M&A scouting functions remained on the hunt for new acquisition candidates) toward using free cash to tidy up their balance sheets (mostly by reducing debt leverage), rewarding shareholders in the form of stock buybacks and investing internally to generate future margin benefits. Some federal IT executives also expressed a lack of enthusiasm about the availability of attractive M&A candidates while others indicated M&A may also take a back seat to venture investments in smaller peers or startups with innovative solutions in AI, analytics, advanced communications, cloud or next-generation security capabilities such as cognitive cyber. Potential buyers might also be waiting for record valuations to ebb. The DOJ lawsuit blocking Booz Allen Hamilton's acquisition of EverWatch may also have a chilling effect on strategic M&A in 2023. While the overall pace of M&A activity in federal IT may change little in 2023 from 2022, vendors will remain opportunistic regarding acquisitions, seeking strategically accelerating purchases that broaden and deepen relationships with federal agencies and provide capabilities in advanced technologies.

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