

The WISTLR Chronicle

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Insights on Investing & Government Contracting

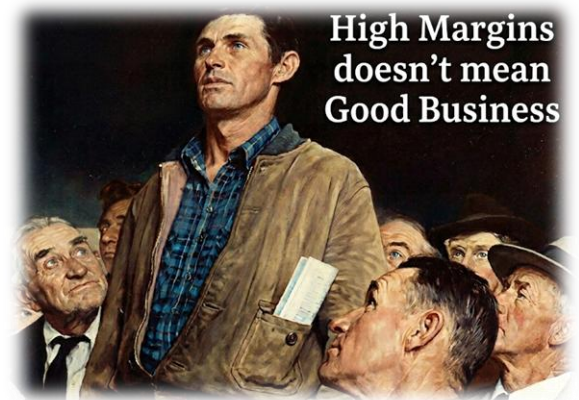
Investment Insights | Article 1

Margins. Measuring What Doesn't Matter.

Because of our advisory business, we deal with *a lot* of private investors each year, and this vantage point gives us an opportunity to see how many within the private markets conduct the investment decision-making process. Over the past year, on two occasions we've taken businesses to market to sell or raise capital, that were extremely sound businesses but had profit margins between 3%-5%. Neither received a warm reception from the private investment community, with one of the key reasons being "low margins".

On the short list of most private investors' "investment checklist" is the EBITDA margin profile of a business. Said another way, a business must have >[x]% EBITDA margin in order for it to warrant an investment from the group. Indeed, EBITDA margin might be the #1 checklist item many private buyers use to filter investments between *investable* and *uninvestable*. In isolation, however, profit margins have nothing to do with business quality. **Zero.**

Sure, some of the great businesses in the world operate with extremely high margins (Visa as a classic example, 65%+ EBIT margins), but there are also as many examples of low margin businesses being just as competitively advantaged (Costco the classic counter example, <4% EBIT margins). If you pressed us to choose between which business we would rather own (Visa or Costco), which company had a higher EBIT margin would factor not at all into our decision-making process. However, the standard private buyer, using their standard filters, if given a blind teaser on Costco and Visa would surely pass on Costco and be wild on Visa.



So, if margins in isolation don't matter in investing, then what does? In truth, there are only six variables that drive investment results:

1. Returns on capital invested by the business,
2. Revenue growth,
3. Profit margin *trajectory*,
4. Shares/equity outstanding,
5. Capital returned to shareholders via dividends,
6. and finally, the multiple paid by buyers for the earnings.

That's it. Those are the variables that matter. To be sure, a lot of *qualitative* analysis is required to determine how each of those variables will play out over time for a specific business (and we'd note is where the money is made), but there are no other *quantitative* variables that matter for investment returns that don't feed into the six variables listed above. No extra investment bonus points if the company you buy has high margins to start.

As for how such an intelligent class of investors could be so woefully wrong on their filters, the reason for this is a tale as old as time: human miscognition. Daniel Kahneman teaches us in *Thinking Fast and Slow* that System 1 drives most

human decision-making processes. Said another way, humans desire *simple* mechanisms to make decisions, and EBITDA margin is a simple variable private investors use to make investment decisions. 30% EBITDA Margin = **good** and 3% EBITDA Margin = **bad**. No further analysis required for many in the market. It isn't a relevant variable though. Yes, one is bigger than the other, but it still... *doesn't matter*.

If we're being generous, what investors are optimizing for in the six quantitative factors that matter listed above is #6 *the multiple paid by buyers for the earnings*, as the investors believe that other buyers themselves will pay more for higher margin businesses (the greater fool theory if you will). We

suppose that might be true, but it really does no good unless you feel particularly well-suited to winning the greater fool game. In reality, it's the one variable over which investors have the least control. The other five are more suited to being exploited by the skilled practitioner.

So, the **punchline**: when making an investment ourselves, we find it prudent to limit the weight we put on analyzing profit margin. Instead, we attempt to focus on the qualitative factors of the business, and how those qualitative factors will influence the six quantitative variables that drive investment performance. If we get that right, we should do well over time.

GovCon Guru | Article 1

Better Serving Those That Served.

We are long-time GovCon participants (indeed it has been the focus of our entire careers). Recently, we supported two Service-Disabled Veterans (“SDVs”) with the acquisition of a Service-Disabled Veteran Owned Small Business (“SDVOSB”). Even for us, long-time GovCon practitioners, and no strangers to GovCon small business peculiarities, the process to get this completed was extraordinarily difficult. The difficulty arose from the complexity of legal structuring, appropriate document wording, and SBA rule navigation that would ensure the new group of SDVs would certainly retain the requisite statuses post-closing (of note, the group we supported comfortably checked every box necessary to retain SDV eligibility).

In the past, we’ve made the case that SDVOSB should be the only eligible super set-aside small business designation. The reason we say that is because it is the only small business designation for which you must have **done something**, not simply *be* something or *located* somewhere to qualify. There is a true price of admission. As a result, we are happy to see the government’s goals move up for the category (the government is changing SDVOSB spending goals from 3% to 5%). With these spending changes and more work flowing into SDVOSBs, now is a good time to think about how to make the M&A process easier for veterans looking to acquire small businesses.

We’d note, there is an abundance of SDVOSBs in the market owned by individuals squarely in retirement age. There is also an abundance of qualified SDVs looking to purchase businesses. There are natural forces at play which should support more SDV transactions. However, the administrative nuances required to ensure

continuity are currently too onerous, and requires deep pockets to afford the many (extremely qualified) third-party advisors needed to complete a transaction. Though credible third-party advisors exist, it is unfair to expect an average SDV to afford the burdensome \$500-1,000 an hour bill rates for these skilled practitioners (especially when transaction completion is never a certain outcome). Most SDV buyers do not have the purse strings to foot six-figure third-party bills likely required to ensure perfect compliance.

Fixing the problem is a noble cause though. Our country should want there to be smooth transitions from one SDV to another. Old to young. The regulations however make it so that the buyer pool is limited to individuals, and with the current setup the expenses required to adequately complete are too high.

So, the **punchline**: we believe the government would benefit by making it easier for smooth transitions from SDV sellers to SDV buyers while meeting the following: 1. not burdening SDV buyers with extraordinary third-party expenses (or risk of non-compliance), 2. allow SDV buyers to obtain the requisite capital to make a fair acquisition (with terms that also work for funding sources, as currently they do not), and 3. ensure that buyers (and funding sources) are not taking advantage of the designation (as we’ve witnessed in certain well-publicized 8(a) instances). It’s a tough needle to thread, but with the right industry participants we believe a better system could be designed that would bring about a **win-win-win-win** (a win for the government, a win for the buyers, a win for the sellers, and a win for those providing the capital).

About WISTLR

WISTLR is an M&A advisor and investment firm focused on military & civilian services related businesses.

We Have Two Goals

1. To be the go-to strategic consultant and sell-side M&A advisor for GovCon owners. *Specifically, we work with businesses between \$2-15mm in EBITDA.*
2. To invest in and be a long-term home for lovingly built small businesses. *Specifically, over time we expect to raise a rationally incentivized investment fund to further support this initiative.*

Clients & Businesses that Trust Us

Advisory Clients

- 2026: ~\$20mm Naval Logistics Services Business
- 2026: ~\$30mm Health IT & Military Training Services Business
- 2025: ~\$5mm Military Cyber & Cloud Services Business
- 2024: ~\$40mm Civilian Program Management Services Business
- 2024: ~\$10mm Nuclear Engineering Services Business
- 2024: ~\$40mm Marketing & Communications Services Business

Investments

- 2026: Health IT Testing Business
- 2025: Military IT & Mission Assurance Services Business
- 2024: Cyber & IT Ops Services Business
- 2021: Military Testing & Logistics Business

A Constant
Pursuit to
Earn the
Trust of
Business
Owners

Contact Information



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"I never gave anybody hell! I just told the truth, and they thought it was hell." - Harry Truman