Notebook of Ideas for
Divestitures
of Private Security Companies

Robert H. Perry & Associates, Incorporated

Vol. 19 No. 1

What the Owners of Privately Held Contract Security Companies are Saying about Today's Market

We initiate and manage transactions for sellers of private security companies.

Click *here* to visit our website. View our recently updated - *Publications* section, and read about industry acquisitions in our *News and Press* section.

Contact Information

Physical Address
301 N. Elm St. Suite 710
Greensboro, NC (USA) 27401

Mailing Address
PO Box 67
Greensboro, NC (USA) 27402

Telephone
(336) 272-2266

Facsimile
(336) 272-1142

Email
rhpa@roberthperry.com

As part of the research for my presentation at the annual NASCO Private Security Industry Leaders' Roundtable in Ft. Lauderdale, Florida in early February, I called several owners of privately held contract security companies around the country to ask what has been happening with their company and their plans for heading off the challenges 2013 is surely going to bring.

Admittedly, the poll was not scientific and targeted just a small number of owners with revenues between $10 - $150 million. However, we feel the responses mirrored the voice of the majority of the owners of the professionally managed and well run contract security companies in the U.S. today. Below are the questions we asked and an overview of the owners' responses:

1. Looking back over the past three years, are your company's revenues increasing, decreasing or staying even?

> Surprisingly, the overwhelming response we received from the owners in the NASCO poll indicated that their companies were growing at a modest rate, with some quoting impressive internal growth rates in the 10 - 15% range. Only a few of the owners said their revenues have been flat or declined over the past 3 years.

2. If your company is growing, where are most of the new

customers coming from - competitors or first-time security users?

There were many different reasons for the growth in revenue, most of which had nothing to do with the smaller companies taking customers away from the larger security providers. Some of the owners have been successful in selling personalized services - in other words, marketing their ability to provide a closer relationship with the customer to respond and resolve issues as they arise.

Other owners said they were successful in creating specialized vertical markets, which made them the contract security company of choice for customers that had unique security requirements in their particular industry.

A few owners cited the increasing concern over recent terrorism and mass murders in our country, as well as around the world, as a reason for their increase in revenues.

3. Have your company's margins at the site level decreased, increased, or stayed even?

All the owners we talked with responded that the margins at the site level have decreased over the past 3 or 4 years, with some citing the decrease being as much as 5%.

4. What has been the most significant cause of the shrinking margins?

The answers to this question did not surprise us since it mirrored the responses we've heard from many sellers recently as the reason for selling their company.

Below is what many of the owners told us:

- Increasing state unemployment taxes.

  Some companies have seen their rates double or quadruple over the past 3 to 4 years and they expect the situation to get worse as more and more people are staying in the unemployment ranks longer. The problem with this is that even though the company may be managing the unemployment claims, the company gets hurt by the other companies that are experiencing high claims.

- Pressures from customers to decrease billing rates or not increase rates even though the pay rates and other expenses are increasing.

- Increase in workers compensation rates (more on this when we get to question #6)

- Increase in non-billable overtime premium pay.

5. Have you done any research to determine how much "Obamacare" will affect your profits?

Without exception, all of the owners we talked with said they were very worried about what Obamacare will do to the contract security industry. All of the owners had talked with experts and done as much research as possible on their own to try to determine exactly how it will affect their company. Unfortunately, even the experts don't have all the answers yet, which leaves the owners in a quandary as to what may really happen to their company and their future as it relates to Obamacare. As for now, the owners are going on a lot of suppositions that hopefully will be resolved in the coming months.

Here are some of the owners' responses:

- A few of the owners said they were prepared (or almost prepared) for Obamacare to become effective. They have been preparing for this day for a long time and have been inserting clauses into their customer service contract that provides for the cost increases to be passed on to the customer.

- Some of the owners said their company employed a lot of union personnel that would not be adversely affected by Obamacare.

- Some of the owners said that if they offer an affordable, qualified plan and the employee doesn't accept it and the employee goes into the state exchange, then the company is relieved of any penalties. The owners are hoping that a large number of employees will opt out of the plan (because it's too expensive), which would mean that the company might have to pay the insurance for only a limited number of employees. However, at this point, it's anyone's guess as to whether or not this position will ultimately be supported by the lawmakers; if it is in fact a correct interpretation of the current provision, and if so, just how many employees will opt out.

- Some have made computations to determine whether it's better to offer and pay for the health insurance or pay the $2,000 or $3,000 (in some cases) per employee penalty. In many instances, owners are thinking they will just pay the penalty. However, it seems that many of these owners are still not sure whether or not the penalty will be tax deductible, which leaves a large gap between what the owners think the insurance will cost them versus what it may really cost if the penalty proves to be a non-deductible expense (which is the position of most tax experts).

- A few of the owners who have made some determination of what the insurance might cost them have a three-part plan for passing the cost on or better absorbing the cost internally:

    1. The first part is to try to get the customer to pay for as much of the insurance as possible, although the owner is admittedly prepared to get a lot of push back on this approach even though the customers are fully aware of the real cost increase to the company. They also said any increases in billing rates to the customers may cause the customers to eliminate security personnel and replace them with electronic security, or best case, cut back on the number of required billable hours.

    2. The second part involves decreasing the labor cost. Under this plan, the company will delay (or eliminate) wage increases, and reduce benefits such as vacations, sick leave and personal time off.

    3. The third part involves getting more efficient on the administrative side of the operations by investing in better technology that will help the company operate the billing and payroll functions with less people, realistically this would produce only nominal savings, if any at all.

- None of the owners thought managing the shifts to create more "part-time" employees was an option that would work in the contract security industry even though it was a plan for a lot of the other industries such as restaurants, etc. The additional cost in scheduling personnel to handle the around-the-clock posts, as well as probable increase in customer dissatisfaction brought about by having more personnel at a site, more than outweighed the costs savings in the limited number of personnel that could be reduced to "part-time" status.

- Most owners said that they thought the Healthcare Bill would probably not go into effect on the scheduled dates because of all the still unanswered questions and the many filings and decisions that must take place between now and 2014.

- Many of the owners said they may seriously think about selling their company as they learn more about what the real cost of Obamacare may be to their company and the message that it's sending - just how much more legislation is the government going to pass down making it more difficult and expensive for owners of privately held companies to stay in business?

6. On the next workers compensation renewal date, is your rate going to increase, decrease, or stay about the same?

All of the respondents said their insurance company has already indicated an increase in total workers compensation cost for the next few years. The owners that have been in the contract security business for a long time cited a pattern of dramatic increases for two or three years, followed by decreases. We're going into the rate increase stage now because the insurance company's reserves are getting low - due to the low rates they're getting on the invested premiums and the claims to reserve ratios moving in the wrong direction. Some of the owners indicated that they would try to minimize the impact of the increase by increasing the amount the company would pay on the claims (the deductibles). Other owners are looking into self insured plans - although most expressed that this option may not be available to them.

7. What would have to happen in the marketplace to make you seriously consider selling in 2013? what would the multiple have to be to take you from a "non-seller" to a "seller"?

Some of the owners we talked with had family members in the business; or key, loyal, long-term employees whose jobs they wanted to protect; and they indicated that they would not even think about selling unless they started to seriously "feel the pain" of Obamacare and/or other legislation that harmed the economic stability of the company. If this were to happen, and the impact seriously threatened the family's ability to continue enjoying the generous profits, then they would probably seriously consider selling - they owe it to the other family members and key employees to preserve the net worth they worked so hard to build.

Other owners said they probably will take a serious look at what their company might be worth around the middle of the year. They really don't want to sell, but may not have a viable option if Obamacare makes it harder for the smaller company to compete with the large security providers. They should know more about this in about 3 or 4 months as their advisors learn more about how Obamacare will affect their company.

As to the question about multiples: most said they would sell now if the buyers were offering about 20% more that the traditional multiple. An interesting fact about this is that in our presentation in Volume 18, No. 1 of "Divestitures" (published last year), we indicated that in order for an owner to sell in 2013 under the new capital gains rates, and net the same amount of after tax dollars as a sale in 2012, the company would have to sell for about 10% more. This means that the owners have not significantly raised their expectation on net dollars in a sale - about 10% of the 20% increase in expectation represents the additional amount the owner would have to get in order to take care of the additional capital gains taxes brought about by the change in 2013.

It's going to be interesting to see how the rest of the year plays out. Will the buyers and sellers, through more creative negotiations, bridge this 20% gap between the current "bid" and "ask" price, thereby creating more completed transactions in 2013? Some owners will need or have to sell this year; in a market where the buyers are still needing to buy. This may very well create the "perfect storm" for the buying and selling activity in the contract security market.

Stay tuned!

Written by Robert Perry

ROBERT H. PERRY
& Associates, Incorporated

P.O. Box 67 (zip 27402)
301 N. Elm Street, Suite 710
Greensboro, NC 27401 (U.S.A.)
Tel: 336.272.2266 Fax: 336.272.1142
E-mail: rhpa@roberthperry.com
www.roberthperry.com