NOTEBOOK OF IDEAS FOR

DIVESTITURES
OF SECURITY GUARD COMPANIES

1996 **Vol. 2, No. 1**

A periodic informational letter published by Robert H. Perry & Associates, Incorporated - Dedicated to Buyers and Sellers of Security Guard Companies.

VALUE

It's determined by the characteristics of a company

(Written by Robert H. Perry)

CONTENTS

What the caller on the other end of the telephone line said was typical of the many inquiries we receive on a regular basis . . .

"I've received your correspondence over the years and kept it in a file, waiting for the day when I might want to sell. I am now thinking about it, but I want to make it clear that I do not have to sell. I heard you represented a competitor of mine and the selling price for the guard accounts was based on a multiple of gross billings, which happened to be 3.5 times monthly. If I can get that, I will sell. Can you get that for mine?"

The comments we made in the conversation that followed were somewhat surprising to the caller. We agreed that there are some multiples of gross monthly billing circulating through the industry that purport to express the values for security guard accounts, but the multiple is not the starting point for determining the price.

Rather, the buyer determines the value of the company first by examining a number of characteristics of the seller that measure return on invested dollars and the risk in servicing the accounts.

Then, the selling price for the accounts is determined. And it is important to note that value and selling price are rarely the same. Value is a measure of a company's true worth based on its characteristics, while selling price is determined through negotiations between the buyer and seller. It has value as its starting point, but it is increased or decreased according to the skills of the negotiator.

When the selling price is agreed upon, it's then usually expressed in terms of a multiple of monthly revenue in order to have a convenient way of paying the seller for future business.

To further illustrate that the price (and ultimately the multiple) is driven by the individual characteristics of each seller, and also the presence or absence of an aggressive buyer for accounts in the seller's area (a factor we have not yet mentioned), take the case of these two sellers:

One had desirable characteristics, operated in a metropolitan area and was willing to sell when a foreign company wanted to get into the U.S. market. The buyer went through their expected return on investment computation and factored in the risk in running the accounts.

The resulting total price when converted to a multiple of gross monthly revenue was in excess of six.

Quite the opposite was true for the second company. The characteristics were undesirable and there was not a buyer willing to step up to a high multiple. Because the accounts were unstable, not very profitable and were of a high risk type, the buyer had to have a high rate of return on invested dollars in order to assume this risk – which resulted in a much lower selling price – about one times monthly billing. Again, the prices for both companies were determined by the characteristics of each seller and the buyer's need to buy.

We then told the caller that the process gets even more complicated. The importance each buyer places on the various characteristics is different.

For instance, some buyers prefer retail accounts, while others prefer industrial or government accounts. There are different perceptions of risk, different expectations regarding return on investment, and even if their expectations are the same on these two points, their method of computing the return is not. This means that if there are three aggressive buyers for a company, more than likely, there will be three offering prices and the prices could be significantly different.

We know who the aggressive buyers are for the caller's business. We know the value each buyer places on the individual characteristics.

Our next step with the caller is to set up a meeting. In the meeting we will examine and discuss the many characteristics of the caller's company. Once we know the components of the characteristics, we will choose the best buyer or buyers, and advise the "would-be" seller on a realistic selling price, which may actually be the 3.5 times monthly billings the caller is looking for, or it may be 2.7, 3.8, 4.5 or 3.2, etc.

The following are some of the characteristics we will examine and discuss in that meeting in order to determine the selling price and select the appropriate buyer candidates. The extent to which we will examine each characteristic and which characteristics we will examine depends on what we find during our visit.

Value and selling price are rarely the same. Value is a measure of a company's true worth based on its characteristics, while selling price is determined through negotiations between the buyer and seller. It has <u>value</u> as its starting point, but it is increased or decreased according to the skills of the negotiator.

Account Margins

The account margin, as defined in the industry, is the amount billed the customer less the buyer's direct cost associated with the billing; in other words, the amount the buyer can make from servicing the account.

It goes without saying that high margin accounts are usually more desirable than low margin accounts. However, there could be exceptions.

For instance, if the average hourly bill rate for the competitors operating in the same area is $8.00, but the seller has an account or accounts for which they are billing $12.00, then those $12.00 accounts may be considered vulnerable.

All accounts are subject to being lost to a competitor, but these higher than market bill rate accounts are more likely to be lost, so they may be less desirable.

Types of Accounts

Buyers prefer low risk accounts, meaning those with a low probability of accidents or incidents, either of which could result in lawsuits or high worker's compensation rates. However, whether an account falls into the category of low risk or high risk lies in the perception of each individual buyer and often determined by the buyer's experience in servicing certain types of accounts.

Usually buyers prefer unarmed commercial or industrial accounts. Retail establishments, banks, trucking terminals and malls are normally less attractive, but there are buyers who specialize in these. In areas where there are buyers looking for these type of accounts, we can get our sellers a premium.

Armed accounts are considered high risk accounts, but the degree of risk is determined by several factors, such as the amount of training required, the kind of account, the control over the weapons, and whether the weapon is owned by the guard or the security guard company.

Sometimes an account that is normally classified as low risk may still be undesirable to certain buyers. For instance, we know one buyer who does not like upscale condo accounts. To most buyers, this kind of account would be very attractive, but to this particular buyer, it was a negative because of a series of problems they had with this type of business. Although they never had any liability problems, they still had to deal with a lot of tenant complaints and late payment of invoices.

Government accounts are usually not as desirable as those in the private sector. They often require periodic bidding and the contract negotiations are time consuming and expensive. The offset to this negative is the fact that the margins are usually higher, so more profit can be made in a short period of time.

Again there are companies who specialize in these accounts; if one of these buyers is available in the seller's area, the seller can get a good price for the government accounts.

Government set-aside accounts (small business, minority or resident) are even less attractive because they usually cannot be retained by the buyer past the renewal dates. This is true because most buyers who have the financial resources to purchase the seller's business do not meet the set-aside requirements since they are either too large or they do not qualify as a minority.

And one of the most important considerations in examining types of accounts is the expected duration of service. Accounts with no discernible ending date (permanent accounts) are worth more than temporary accounts. In fact, very few buyers will put a value on temporary business.

Site Size

The size of the individual sites determines how much non-billable overhead is necessary for servicing the account base.

The most desirable account site, from a size standpoint, is one that requires one or several guards at a single site for 24 hours per day, 7 days a week. This type of site requires less dispatch time and roving supervision.

While the larger sites are more attractive, the smaller site can still be desirable, depending on the daily coverage requirements. A site that calls for 32 hours of coverage per week – 16 hours on Saturday and 16 hours on Sunday, is more desirable than a 36-hour site calling for 6 hours per day Monday through Saturday. This is true because the site has to be dispatched and supervised for two days rather than six.

Site Density

The site density is the term used to describe the distance from one site to another and how far each site is from the operating office.

For a desirable density, the sites should be located close enough together, so the supervision cost is reduced as well as the need for multi-office overhead.

Just how desirable this characteristic is depends on the operations of the buyer. Sites widely dispersed from a geographic standpoint could be desirable to a buyer prospect with accounts in the same area, but may be undesirable to a buyer who is from or has accounts outside the area.

Account Retention History

A look at a company's history of keeping accounts is a way of measuring how well the company is managed and whether the account base consists of "fickle" customers who habitually change guard companies, or ones that are stable and loyal.

Despite most sellers' fears that accounts leave after their company is sold, this rarely happens except in the case of the "fickle" account who really doesn't leave because the company is sold, rather because it is simply time "to move on."

From the seller's standpoint the "fickle" account is a concern because if it leaves within a certain period after the sale, it could mean that the seller would not receive all of the purchase price. However, the seller can lessen or eliminate this possibility by negotiating provisions to get paid for replacement accounts.

The hard part comes in measuring the account retention characteristics for a guard company experiencing rapid growth. Although one can determine how long the older accounts have been around, it is difficult to know if any newer accounts are going to be "fickle." By most measures, the rapidly growing company is very attractive overall, but this retention history problem may be one point for the negative side of the valuation scale.

Depth of Management

One reason for making acquisitions is to get stronger in a certain area or enter a new market. In either case, the quality of the selling company's managers who will continue to work for the new owner is very important to the buyer.

The buyer sees these new managers as the ones who will straighten out their problems in the area, and this usually happens. It is also these managers who have the account relationships, which makes their staying after the sale very important.

An interesting observation about this transfer of managers to the buyer is that during the negotiations, one of the seller's largest concerns is that the managers will find out about the impending sale. While it is true the employees get concerned when they hear about their company being sold, they also get very enthusiastic when they find out they will be working for a much larger company. Their benefit program is usually much better, as is their opportunity for promotion.

Contract With Customers

Most security guard companies have some type of written contract with their accounts. But if a company has some or all oral contracts, it is not all that bad, as pointed out later in this section.

It is a consensus in the industry that the best contract is one that is in writing and protects the security guard company from acts they cannot control and for which they may not be covered by liability insurance. There are numerous versions of what constitutes this well-written contract.

If the security guard company cannot get one of these best written contracts, the alternative is no written contract at all. At least with this type of arrangement, if a lawsuit occurs, the courts will determine the outcome of the case based on some reasonable standard of fault – well, maybe.

The contract that causes the most problems in consummating a sale transaction is the written contract with strong indemnification language in favor of the customer. Whether a new contract has to be executed as a condition to the sale depends on just how bad the contract language is and the requirements of the buyer.

Another important factor in evaluating the written contract is whether it requires written permission to assign. Some buyers will assume the seller's written contract without having to get the customer's approval, if the language is acceptable; while other buyers will require that a new contract be signed, either in a standard form or a special contract acceptable to buyer's counsel, which will state the buyer as the contractor.

Regardless of the buyer's decision to accept all or part of the seller's written contracts, there is no choice for the ones that require permission to assign. The buyer and/or the seller, with each other's help, has to approach the account and get the assignment. If they do not, the seller is in default on the contract.

What do the customer contracts have to do with the evaluation of the accounts? . . If there is a lot of contract re-writing to do, unwanted risk to assume, and cost to otherwise meet with the accounts, then the buyer will have additional costs in consummating the transaction. This cost is passed on to the seller in the form of a lesser purchase price.

Auxiliary Services

In addition to stationary guard services, a company may also perform vehicle patrol checks, provide executive protection, or monitor alarms. Each service is examined to determine the degree of profitability on the overall company and the degree of risk in performing such service.

Type of Corporation

Most security guard companies operate in the corporate form – either as a S corporation, or a conventional C corporation. Since almost all security guard company sale transactions are structured as an asset purchase, the Sub S form usually allows for a less complicated and more tax-favored transaction for both the seller and buyer.

Billing and Payroll Cycle

Rarely does the seller have the same billing and payroll cycles as the buyer. However, when they are the same, the transition can be accomplished with less disruption to the customers and employees. These cycles determine the cash flow, which dictates return on investment.

Accounts Receivable Turnover

How quickly customers pay their bills is a measure of the amount of working capital required to run the business – which is also a measure of return on investment and ultimately used as a calculation in determining the purchase price for the accounts.

New Accounts in Process

This is a measure of what the buyer can expect in the way of future business from the purchased company.

History of Lawsuits

Usually buyers do not have to worry about the seller's lawsuits. However, the litigation history tells the buyer how well the seller manages the liability aspect of the company.

History of Workers' Compensation

Whether the history is good or bad usually does not affect the workers' compensation rate for the buyer. However, in instances where it does, it will be used in computing the return on invested dollars – and ultimately the price.

Size of Largest Accounts

For obvious reasons, there's a large risk if one or several accounts make up a significant portion of the total volume. Because there could be a significant impact on earnings if one of these accounts left, the buyer will probably factor the price downward to hedge this possibility.

History of General Liability Claims

Unless the transaction is structured as a stock purchase (rather than an asset purchase), the buyer probably will not assume any of the seller's liability claims. However, the claims history is an indication of how well the company has been managed.

Unemployment Tax Rates

In most states, the seller's unemployment tax rate can be passed on to the buyer. This can be an attractive savings if the seller's rate is significantly less than the buyer's.

Worker's Compensation Rates

The seller's workers' compensation claims history and rate can affect the buyer's rate in certain states.

Workers' Union Contracts

Usually a unionized guard force is perceived as a negative. However, there are some areas where unions are necessary – i.e., New York and Chicago.

Secret Clearance Requirements

A security guard company owned by certain foreign entities usually cannot service accounts requiring secret clearance. This eliminates foreign buyers for sellers with a significant amount of secret clearance business. Also, the higher the level of clearance required, the harder it is to recruit qualified personnel.

Training Programs

A seller's training program is a measure of how well the guards are prepared to perform their duties.

In summary, after we finish examining the characteristics of the caller's company, we will know how it compares to the large U.S. and worldwide security guard companies. If it's small, the sale will be structured as an "asset sale," which will identify the accounts, goodwill and employees as individual components.

If we find it's a large domestic or foreign company, there would be many more characteristics used in the valuation process. In the instance of these companies, usually entire organizations are purchased by an even larger security guard conglomerate or an investment group who controls the invested funds for insurance companies, pension plans and very wealthy individuals.

Because the deals are larger in foreign countries, the volume of paper to examine and the number of characteristics to consider is greatly increased. All aspects of the due diligence process take longer – after all, the purchase price is much larger and the buyer wants to minimize the possibility of mistakes.

A word of caution – lest we leave the impression that every company with desirable characteristics can be sold at an attractive price; and those with undesirable characteristics are not sellable, or if so, at a low price, we refer back to an article in our first issue titled "Timing is Everything." In that article we pointed out that, ". . . selling at the opportune time is not necessarily about selling when the owner thinks all the characteristics are as desirable as they'll get (. . . a result of the grooming process), rather it's selling when a buyer exists in the marketplace." Unless a buyer exists, no matter how attractive a company's characteristics are, it cannot be sold.

If a generous buyer does exist, even a mediocre company can usually be sold at a good price. AND IT GOES WITHOUT SAYING THAT THE MORE DESIRABLE THE CHARACTERISTICS, THE BETTER THE PRICE. ■

INTERMEDIARIES *Don't go without one, but choose them carefully*

(Written by Robert H. Perry)

Recently I needed to make a trip from my office in Greensboro, NC to Amarillo, TX. When I called our travel agent, she checked all the airlines that leave from Greensboro and the cheapest fare was $1,450 for the round-trip.

Our firm calls this agent on a regular basis. She knows that given a little inconvenience for the sake of saving big bucks, we'll take some discomfort. The agent then said I could save a lot of money if I would drive 70 miles and leave from the Raleigh airport.

There was a new airline that just started in business and their promotional fare round trip to Amarillo was $350. I told her to book the Raleigh flight as soon as possible. We could have called all the airlines that left from Greensboro ourselves and we would have eventually made it to Amarillo. The problem is we would only have known to call the airlines listed in the Yellow Pages or in some other published directory, which means I would not have found the airline that just started in business. I would have paid $1,450 for the round-trip. There is absolutely no way I could have known about this cheaper flight, except through our travel agent.

Our travel agent makes it her business to know these things. In fact, I'll bet when the airline started, they contacted all the travel agents in North Carolina soliciting business. So when I called, she was able to give me the good news. That's how she gets firms like ours to use her service.

Just as we had a choice to make in getting to Amarillo, a business owner has a choice when the time comes to sell his business. But the wrong choice can be very costly. He can try to sell it himself; he can use an attorney or an accountant; or he can go to a generic business broker. Either way, the business probably eventually gets sold. Does it get sold for the highest price

There is a much better alternative – use an intermediary that specializes in the security guard industry.

and the most attractive terms? – probably not.

These intermediaries (or the seller) usually do not know how to find the most aggressive buyer. At best, they contact the companies in the Yellow Pages, who happen to be in the security guard industry. It goes without saying, that contacting competitors can be very risky, and they usually do not pay the highest price, or they run ads in the local newspaper or the *Wall Street Journal* hoping to catch a prospect.

There is a much better alternative – use an intermediary that specializes in the security guard industry. We are such an intermediary firm. Just as our travel agent, who specializes in arranging travel, saved us big dollars on my trip to Amarillo, we specialize in selling security guard companies, which means we get our client/sellers the best deals – the best price and terms.

We have already identified the aggressive buyers who are willing to pay top dollar for a company. They prefer a low profile and are not listed in the Yellow Pages or directories. We have completed transactions with over 30 of them and have in our files over 300 prospects, domestic and foreign, in the security guard industry alone.

Although I do not know how other specialists work, I do know that we are regularly contacted by aggressive companies that want to buy security guard businesses. They find out about us through word of mouth, because of our reputation in the industry. It is within this group that we are able to get our seller/clients the best prices and terms.

I need to go to Timbuck, Idaho, Friday. I think I'll go call my travel agent.

This informational letter does not render legal, accounting or tax advice. Neither Robert H. Perry & Associates, Incorporated nor its employees [illegible]ffer such services, and accordingly assume no liability whatsoever in connection with the use of the information contained herein. I[illegible] accounting or tax advice is required, the services of a competent professional should be obtained.

© All rights reserved. May not be reproduced without permission.

This periodic informational letter is published by:

ROBERT H. PERRY & ASSOCIATES, INCORPORATED

Established in 1977, we are the recognized specialists in managing the sale of security guard companies. We have successfully represented over 70 sellers of security guard companies located in the United States, Canada, Western Europe, and the Caribbean.

P.O. BOX 67 (27402)
400 West Market Street, Suite 301
Greensboro, NC 27401 (U.S.A.)

Phone 336/272-2266 • Fax 336/272-1142
E-mail: rhpa@mindspring.com • www.roberthperry.com