Vol. 9, No. 1

NOTEBOOK OF IDEAS FOR

DIVESTITURES *of* SECURITY GUARD COMPANIES

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

MYTH vs. REALITY in reaching the sale decision

MYTH

Owners assume there is and always will be an attractive market for the sale of their security guard company. Consequently, they wait until they have to sell before starting the sale process, then expect to get top dollar.

REALITY

The buyers determine the ideal market conditions for selling a security guard company, not the sellers. Sellers who wait until they have to sell or until some predetermined event occurs will most likely be very disappointed with the results.

There are times when an otherwise attractive company is just not saleable. As explained below, the market is driven by many factors – most of which the seller cannot control.

As we write this letter in early 2003, we are recovering from a "soft" cycle in the U.S. market for selling security guard companies, which began about fourteen months ago. During this period, we had to tell many owners anxious to sell that their companies were not saleable, or if so, at a much reduced price expectation because the generous buyers of the past were not buying. This particular down market was brought about by three major factors. First, there were the terrorist attacks. In spite of the heightened interest in security following the attacks of September 11, aggressive buyers were not acquiring companies, at least not enough to make an attractive "sell" market. They were just not in the buying mood and many were preoccupied with handling their own increase in business (albeit temporary).

The second factor was the consolidating activities of the large security guard companies. Over the past 25 years, we have seen a definite pattern in selling and acquiring security guard companies. The pattern indicates that the aggressive buyers go through cycles in their acquisition activities. They go through a period of buying security guard companies at a rapid pace. Then almost overnight they quit buying as they integrate their acquired companies into their operations. This happened in late 2001. A case in point is the consolidating activity of Securitas in the U.S. It started with the acquisition of Pinkerton, then it acquired several smaller national, regional, and local companies – around 10 acquisitions – before it bought Burns. Securitas doubled in size overnight from the Burns acquisition. This purchase created a huge integration challenge, one that would take Securitas out of the market of acquiring other security guard companies for awhile. There were other large security guard companies that were in their "on-hold for acquisitions" mode and integration cycle during this same time. The remaining buyer population was too small to create an attractive market for the sale of security guard companies.

A third and equally important factor that drove the market into a downward spiral was the softening of the capital markets. Again, although there was a lot of talking going on amongst the financial groups about how attractive the growth rate for the security industry was going to be, the groups were still not buying companies in this industry. And the ones who already had investments in security guard companies were not putting capital into these portfolio companies for acquisitions. This was partly because many of them relied on bank financing; and the banks, because of the decline in the general economy, were not making loans.

The good news is that we're now back to a very good market for owners that want to sell their security guard companies. The industry buyers and financial groups are aggressively pursuing acquisitions, but are very selective. They are looking for acquisition candidates that have low liability-type accounts, high margins (considering higher wages to guards), and located in geographic areas already identified in their growth plans. Unfortunately, there are many companies that will not fit these buyers' profiles – especially the geographic locations. So many companies are still not saleable.

MYTH *Owners assume that they will have to provide long-term financing or earn-out conditions when they sell their company; therefore many are reluctant to start the sale process.*

REALITY The transactions we've managed for the past several years have been paid out quickly. Typically, the buyer pays around 75% of the purchase price at the date of closing, with the remainder paid in 90 – 120 days. This short deferred balance is not really a financing mechanism for the buyer, but is put in place to cover any liabilities of the seller that may come up after closing related to pre-closing activities, for which a claimant may be holding the buyer responsible. Also, some transactions may be structured to provide a guarantee that

the accounts will stay with the buyer for a short period of time after closing and this deferred amount is to take care of any shortfall in price.

MYTH

Owners delay selling because even though an offer they may have in hand is very attractive, they think they can make as much as the offering price in just a few years by continuing to run the company.

REALITY

First of all, I'll repeat some advice I've given several times in these information letters " . . . if you're making good money, enjoying what you're doing and there's no outside force such as wanting to retire, health or family concerns that indicates it's time to sell the business, then it probably does not make sense to sell."

However, owners who find themselves needing or wanting to sell are often misled by the "I can make more money by keeping the company than I can by selling it" analysis.

We did the calculations. We used as a model a theoretical security guard company with annual sales of $30 million. We further assumed that if the owner kept the company:

1. The company would grow 5% per year
2. The pre-tax profits were 7% in the earlier years but dropped to 6% as the company grew and required a larger infrastructure and entered new markets
3. The business did not pay income taxes at the corporate level (operating as an "S" corporation, a common form for U.S. companies)
4. The owner, while owning the company, would pay taxes on the earnings at a combined rate of 45%, then would earn 5% after tax on the accumulating investment
5. The owner would put 10% of the growth each year back into the company to cover additional working capital requirements as a result of the increased revenue.

We then made calculations showing the results of selling the $30 million company for $14 million (average going rate for accounts and working capital for a $30 million company); then paying capital gains taxes at 25% and earning 5% after tax on the sale price each year.

Surprisingly, it took 12 years for the theoretical seller to have accumulated as much investment outside the company by keeping the business than it would by selling it in spite of the fact that the selling price was $14 million at a time when the company was making $2.1 million pre-tax (selling price less than 7 times pre-tax).

The benchmark for the comparisons is as follows:

	Balance in Investment Account (in 000 U.S. dollars)	
End of Year	Selling The Company	Keeping The Company
2	11,025	2,275
4	12,155	4,661
6	13,400	7,301
8	14,774	10,434
10	16,288	14,132
12	17,958	18,478

The accountant types who are reading this notice the obvious - the difference in the tax rates for selling the company is much less than the rates for the operating earnings by the company, thereby allowing the investment from the proceeds of a sale to accumulate much faster.

And the obvious argument one can make against this presentation is that at the end of the 12 years, the theoretical owner still has the company, which is now much larger and presumably worth more money. This of course is true as long as the market for the sale of security guard companies remains attractive, but as explained in myth #1, this is not always the case. Also, the owner stands the chance that some careless (or intentional) act by an employee will subject the company to a large financial liability (exceeding the insurance coverage), which may adversely impact the worth of the company. RHPA

Written by: Robert Perry

This informational letter does not render legal, accounting or tax advice. Neither Robert H. Perry & Associates, Incorporated nor its employees offer such services, and accordingly assume no liability whatsoever in connection with the use of the information contained herein. If legal, 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

We initiate and manage transactions for sellers of security guard companies. Established in 1977, we have successfully represented over 120 sellers located in the United States, Canada, Western Europe, South America, and the Caribbean.

P.O. Box 67 (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