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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

USING "MARKET COMPARISONS" TO VALUE A SECURITY GUARD COMPANY

One of the important steps in valuing companies in general is to compute the expected return the buyer-prospect will have from the acquisition. In order to compute the return, the appraiser has to know what return percentage the buyers are looking for and what cost savings the buyers will gain from the combined companies. This step becomes very difficult and mostly unreliable when valuing security guard companies since the expected rate of return on investment and specific cost savings vary greatly from one buyer-prospect to another in this industry.

This variability makes the "market comparison" step in valuing security guard companies very important. In this step, the company being valued is compared to a "similar," recently sold company. Using this third-party verification actually values the company based on proven market conditions, greatly minimizing the emotional effect on the valuation process whereby owners arrive at an expected selling price based on what they think their company should sell for, regardless of its real value.

The credibility of the "market comparison" approach hinges on the "comparability" of the companies involved. Making sure the companies are comparable enough can be very difficult when valuing security guard companies. If not done correctly, the result can be a very unrealistic selling price expectation, meaning the seller may sell the company for less than it's really worth or may put the company on the market at unrealistically high expectations that results in the company not being sold and actually losing value for a future sale.

Expertise in the industry becomes very important when using the "market comparison" approach in valuing security guard companies. And even more important is the appraiser's familiarity with the buyer's specific criteria as to the company being purchased and the structure of the transaction.

A Recent Example

A case in point is a sale transaction we recently managed. Before the owners contacted us, they had hired a well-known business appraisal firm to advise on an expected selling price. The appraisers prepared the usual detailed report to support their conclusion. In their report, they showed what the company would be worth based on the "discounted cash flow," "alternative investments," "liquidation value," and "replacement value" methods. They also compared the sellers' company with companies that had recently been sold in the security guard industry.

The report was seemingly credible. It appeared that they had followed all the steps set down by the governing board for business appraisers for valuing companies in general. But they did not take into consideration the uniqueness of the security guard industry. They did not consider that this industry does not have a "one size fits all" formula for valuing these companies. Most importantly, they did not understand the details of the completed transactions they had used as the "market comparisons."

The owners did not like the low valuation the appraisal firm put on their company, so they called us. We prepared our own valuation using primarily "market comparisons" of transactions with which we were familiar. As a result, we actually sold the company for more than double the valuation calculated by the appraisal firm.

The 4 Factors to Consider in Determining Comparability

1 *Was the "Market Comparison" a Recent Transaction?*

For a valuation based on market comparisons to be credible, the comparison transaction has to be recent. As we've mentioned in many of our prior issues of this informational letter, the market conditions for the sale of security guard companies are constantly changing. A company may have been worth a lot of money 12 months ago but have very little value today (from the standpoint of a sale to a third party).

2 *Was the "Market Comparison" Transaction a Unique Event?*

Many security companies are purchased as part of the buyer's strategic plan, so once the plan is complete, the buyer stops making acquisitions or reduces the price it's willing to pay for future acquisitions. The appraiser needs to know why the target

company was of particular importance to the buyer and whether, once the acquisition was completed, the buyer will be looking for similar companies. If the appraiser finds that the completed transaction was a unique event, or completed the buyer's strategic plan, then the transaction should not be used as a "market comparison" in the valuation process. Following are some examples of unique situations:

- The buyer for a recently purchased company may need to get into a **certain geographic area** quickly, perhaps to have an established office for a recently awarded national account. In certain cases, it's more prudent to buy an existing company in the area with an organization in place than it is to establish a new office with only the one account site.

- The buyer may have **plans for an initial public offering**, in which case it is making acquisitions to reach a certain volume level. Once it reaches the desired volume, it will probably curtail its acquisition activities for a while.

- The company being purchased may become **the buyer's flagship company**. This company with the organization in place can take the buyer to the next level, which may or may not include future acquisitions. The buyer is willing to pay a premium for this first, flagship company then rely on normal market multiples for additional acquisitions.

3 Are the Companies' Characteristics Really Comparable?

As we pointed out in a previous issue of "Divestitures" (Volume 2, Number 1), the value of security guard companies is determined by the company's characteristics. While each guard company is unique, some similarities between certain companies make "market comparisons" a useful tool in the valuation process. However, one must compare the characteristics very carefully by asking questions like these:

- **Do the companies operate in the same geographic market?** Aggressive buyers often are interested only in certain markets, which means anything outside those markets would be of little or no interest to the buyer. And the boundaries for the desired markets may be very narrowly defined. For instance, the buyer may pay a premium for a company in San Francisco, but not be interested in buying anything in Los Angeles (or vice versa). In this case, assuming the appraiser knows this level of detail about the buyer's criteria, he should not use a Los Angeles transaction as a comparable when valuing a security guard company operating in San Francisco.

- **Are the annual revenues relatively the same**? Under certain market conditions, larger companies command better multiples, while the reverse could be true for other market conditions.

- Following are **some other characteristics that affect the selling price**, which appraisers must consider in comparing the company being valued against a completed transaction (or transactions):

    - Types of accounts
    - Gross margins
    - Average site size

- Account retention history
- Number of armed guards
- Number of Department of Defense (DOD) or set-aside contracts (if any)
- Distribution or concentration of revenue sources—Do a few large customers control a major portion of the business?

4 What Was the Structure of the Transaction for the "Market Comparison" Company?

The selling price for most completed transactions usually becomes a matter of public knowledge, whether in the form of an official press release announcement as in the case of public companies or a more informal and private venue whereby the seller reveals the details to some of his "closest and most trusted friends" who then tell their "trusted friends." In either case, the announcement usually gives a selling price and gross annual revenue, but very little if any other details having to do with the structure of the transaction or, even more importantly, the stipulations under which the seller gets paid. As indicated below, there are many ways to structure a sale transaction, each of which affects how much a buyer is willing to pay, the net proceeds to the seller after taxes and expenses, and the amount of risk each assumes in the transaction. Many appraisers use the ratio of the published selling price to the annual volume as a benchmark for valuing their "similar" company, which will result in a very unrealistic valuation if the appraiser does not understand the structure of the "market comparison" transaction. Answers to the following questions will help determine comparability:

- **Who received the proceeds from the sale?** One would assume that the owners of a company always receive the proceeds from an announced sale transaction. This is not always true and, if not, could produce deceptive conclusions when using this type transaction as a "market comparison."

  For example, we were recently advising on an expected selling price for a foreign company. In accumulating our "market comparison" we came across a published announcement for a major transaction in the country our client operated in. The announcement indicated that the buyer paid approximately 50% of annual revenues for one-half ownership. If we had stopped our investigation at this point, we would have concluded that this company was valued at 100% of annual gross revenue (seemingly unrealistically high). However, I called one of the parties to the transaction and found out that the present owners received very little of the published purchase price. The buyers bought newly issued stock and most of the monies went into the existing corporation to pay down debt and provide working capital for future growth. The net effect to the original shareholders is that they owned half of a debt-free company having excess cash, but the company was certainly not valued at 100% of annual revenue.

- **Was the transaction structured as an asset sale or a sale of the company's shares?** Whether a transaction is structured as an asset or stock sale is often determined by the resulting tax ramifications of the seller and/or buyer. But there may be other situations that make either structure more or less desirable. And the structure of the transaction can (and usually does) have an impact on the selling price. As an example, if it's advantageous for sellers to sell stock instead of assets, oftentimes they'll accept a lower price in order to entice a buyer to agree to a stock sale purchase structure. Even

though the selling price appears low, sellers may actually wind up with more money to put in their pockets through the tax savings resulting from the stock sale purchase.

If appraisers were to use stock sale transactions as “market comparisons” for anticipated asset sale transactions, then the appraisers would likely wind up undervaluing the selling company.

- **What were the conditions under which the seller receives the deferred payment?** In selling security guard companies, rarely do sellers receive 100% of the purchase price at the close of the transaction. A portion is usually deferred for a short (or long) period of time to cover unknown events at closing, which may become liabilities the buyer has to settle after it buys the company. In certain circumstances, the selling price may actually increase.

  The selling price of the company is usually announced at the first closing of the transaction and may actually wind up being much less (or sometimes more) based on the structure and events that may take place after the initial closing. Appraisers face a problem in trying to determine what the “market comparison” company finally sold for, after the post-closing adjustments, because the adjustments (up or down) are rarely announced. For the appraiser to use a transaction effectively, he would have to have a close working relationship with the parties to the transaction in finding out the details of the final settlement.

- **What assets are included in the price?** A few years ago, we managed the sale of a small security guard company for an owner who was very conservative from a financial standpoint. He had no debt on the balance sheet and always kept about $2 million in excess cash in the company. We sold the company for $5 million (on an asset sale basis), and the seller distributed the $2 million cash to himself at the time of closing. He told his friends in the industry that he got $7 million for his company— which was true. However, the operating assets needed to run the company sold for $5 million. If there had been an official announcement on this transaction by virtue of the requirements of the public company buyer, the announcement would have indicated a price of $5 million, not the $7 million the seller was informally announcing.

- **Were there other unique provisions of the structure of the transaction?** We’ve managed the sale of over 130 security guard companies. Something about each transaction made it unique — some provision that would make it a misleading “market comparison” to some appraiser not familiar with the details. Here are some of the variations in the structure of the transactions:

  - Some of the transactions were structured as stock purchases, while others were asset purchases.
  - In some of the transactions, the accounts receivable were part of the purchase price; while in other transactions, the seller collected and kept the accounts receivable.
  - In some of the transactions, a significant portion of the compensation going to the seller was in the form of a covenant not to compete or consulting contract; which made the amount allocated to

the operating assets of the business appear to be much lower than standard market multiples.

- In some of the transactions, the purchaser bought the working capital along with the equipment necessary to run the operation; and the seller paid off the bank debt from the amount he received from the buyer.
- In some transactions, the purchaser bought the working capital, along with the operating equipment and also assumed the bank debt.

These are just a few of the many scenarios of how transactions may be structured and how an announcement on such a sale may be very misleading since the announcements usually do not provide sufficient detail to really determine what the seller(s) ultimately received for the business.

In working through the "Market Comparison," the person performing the appraisal should make sure that the company chosen was a recent transaction, did not represent a unique event, and had characteristics similar to the company being appraised. Also, the appraiser should make sure he understands the details and structure of the completed transaction and terms of the sale. Only then is the seller likely to have a realistic valuation on which to base the asking price.

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We initiate and manage transactions for sellers of security guard companies. Established in 1977, we have successfully represented over 140 sellers located in the United States, Canada, Western Europe, South America, the Caribbean, and the Middle East.

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