Robert H. Perry & Associates, Incorporated

Notebook of Ideas for
Divestitures
of Security Guard Companies

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VALUATION METHODOLOGY:

For Small/Medium Size Security Guard Companies

Most of the buyers for the small/medium size security guard companies in the US – less than $50 million in gross annual revenue - are the larger security guard companies operating in the same or contiguous markets as the sellers. And as explained later in this article, these buyers are paying the sellers very attractive multiples on the sellers' profits because of the redundant costs that are eliminated in the transaction.

One of the most important factors to having a successful sale depends on the seller's understanding of the value and probable selling price of the company before it's offered for sale. Unrealistic, inflated price expectations usually arise when the owners use the "street formulas" (based on gross units irrespective of the profits of the company) that have been floating around the industry for many years, without an understanding of how the street formulas are a bi-product of a more detailed financial analysis. The mis-valuation also occurs when the owners attribute attractive characteristics to the company, not necessarily perceived by the buyer prospects.

This article will explain the valuation methodology from the buyer's perspective, thus offering owners who are seriously thinking about selling, a realistic view of what to expect in a sale.

1 *The buyer's first step is to decide whether it's interested in the seller, irrespective of the financial considerations.*

Most astute buyers have an acquisition criteria established that gives them a guideline to follow when deciding whether or not to pursue a certain target that may be for sale. This guideline sets forth the map the buyer will follow in carrying out its growth plans and has mostly to do with the **type of accounts** it will accept (a buyer will not buy an account it wouldn't ordinarily bid on), the **geographic areas it has targeted for growth**, as well as certain other characteristics we've mentioned many times in previous issues of "Divestitures", such as:

- Number of armed guards – less is better

- Account retention history
- Customer contract language
- Concentration of accounts – do a small number of accounts control a major portion of the overall revenue?
- The mandatory structure of the transaction - stock sale vs. sale of assets
- Quality of management going with the sale

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Once the buyer has decided that the seller's company meets its criteria as to the characteristics, then the buyer prepares a financial model to calculate how much it will make from the acquisition.

It's very important to mention at the outset of this presentation on the buyers' valuation methodology that astute buyers do not use multiples of gross units – such as gross monthly revenue or percentage of annual gross revenue – as a way to determine the offer to the seller. However, usually multiples of gross units are a convenient way to make adjustments after the closing of the transaction and some buyers may use the gross units test as a "reasonableness check" for the offering price.

In determining the offering price, the buyer will prepare a financial model that tells the buyer what it can expect to make from the seller's company. Ideally, a starting point for the model is the seller's historical financial statements, but these often prove to be of little value to the buyer because the statements for these small companies usually do not give a true picture of the financial standing or operating results. Many of the smaller companies do not have an adequate financial system in place that allows for a matching accounting cut-off of billing and direct expenses, which can greatly distort the profit results. Also, many of the smaller companies prepare the financials on the cash basis (usually for companies with revenues of less than $5 million), again, a reporting method that distorts profits.

In these cases, the buyer has to build more of the financial model from ancillary records – in effect having to work outside the historical financials. In doing this, the buyer will rely on its experience in operating a similar size office somewhere within the buyer's organization.

Obviously, account margins are one of the most important factors in the buyer's model. In building the model, the buyer will determine the bill and pay rates on the accounts by proving the information the seller provides - such as a computer or manually generated account profitability report. The buyer will use this figure without many adjustments, if any, because the buyer cannot improve much on the margins after the purchase. The accounts have already approved the billing rate and will be expecting no change going forward. The buyer may be able to improve on non-billable over time some, assuming the buyer can be more efficient in the dispatching process (or maybe not).

The buyer will also be putting several other factors in the profit model when determining the margins it will be assuming, such as whether or not some of the expenses are billed additionally to the account or are in the overall billing rate, such as – guard vacation expense, vehicles or other equipment provided at the account site, account mandated medical insurance for the guards, etc.

After the buyer determines the profit at the account level, the buyer will start building the overhead expense section of the profit model. In building this section, the buyer will use the buyer's known cost for running an operation the size of the seller's. The following are some of the most common adjustments the buyer will make to the seller's figures in building the buyer's model:

- the buyer will use its workers compensation rate against the labor, rather than the seller's rate
- the buyer will use its uniform cost, which is usually much cheaper than the seller's cost, since the buyer is buying the uniforms in larger quantities
- the buyer will use its vacation policy, rather than the seller's, in determining the going forward vacation expense; although the buyer usually "grandfathers" the sellers employees for vacation tenure purposes
- the buyer will factor in the efficiencies of using the seller's supervisors to manage some of the buyers existing accounts in the area
- the buyer may also increase the profits in the model for factors unrelated to the seller's existing company – such as the buyer using the seller's organization to service account locations for some national accounts of the buyer.

It's important to note that a mere 2% negative difference in the buyer's target margin versus the seller's actual margin can be a dramatic difference in the offering price. For instance, if the buyer's target guard labor to billing ratio for a particular area is 65% and the seller's labor to billing ratio is 67%, the offering price difference on a $12 million company is about $1.2 million, assuming the buyer is only paying 5 times the profit shown in the model. Here is how this is calculated: Again, assume the seller is billing $12 million per year, the 67% ratio gives a direct labor

cost of $8,040,000. The 65% ratio gives a direct labor cost of $7,800,000. This is an annual profit difference of $240,000; which means that if the buyer is only paying 5 times the annual profit model, the diminution in price is $1.2 million and would be much larger if the buyer is paying a higher multiple – and for the would be sellers who still look at gross units to value security guard companies, this 2% variance in the direct labor ratio would amount to a valuation difference of over one times the gross monthly revenue.

3 *After the buyer determines the profit model, it calculates the total investment in the transaction.*

Most transactions for the small/medium size companies are structured as an asset sale, which means the buyer may or may not be buying the working capital necessary to run the business. However, the working capital needed to run the business is an important part of computing the total investment in the company – thus the offering price. Below are some of the areas the buyer takes into consideration when computing the amount of investment necessary to run the seller's company:

- **The average accounts receivable balance of the seller.** The valuation is enhanced somewhat for sellers who bill the accounts in advance or on a more frequent than average basis and are successful in actually collecting from the accounts quickly.
- **The cost of borrowing money**. Since this article addresses the valuation technique for the small/medium size company, a lot of the buyer population for these size companies will not have to go to the bank to finance the transaction. In the case of a buyer who may be a large public security guard company, the funds are already in place. The buyer usually puts in the profit model a cost for the funds being committed to the particular acquisition, since the funds are no longer available to use for other profit making purposes. In which case, the valuation of security guard company targets can actually be affected by the fluctuation in the interest rates for the capital markets in general.
- **The investment needed to bring the equipment up to the buyer's standards**. If significant equipment is needed to run the business, which has been depreciated under the ownership of the seller and will need to be replaced, the buyer will factor in the cost of replacing the equipment in arriving at the valuation on the company.

4 *The last step for the buyer in arriving at the offering price is to determine the multiple it will apply to the profit model.*

Many buyers have guidelines dictated by outside investors or board of directors that set the multiples they can pay for the acquisition targets. In cases where the buyer has discretion in setting the multiples, the multiples may be higher for companies that have demonstrated a consistent period of growth – an indication that the organization going with the seller's company has the ability to continue this growth for the buyer after the acquisition. It may also give a higher multiple for target acquisition companies that enhance the buyer's vertical markets or get the buyer into new vertical markets. These are just a few of the many instances where the buyer may improve the multiples paid for attractive companies.

However, even if the seller were to know the multiple the buyer is willing to pay, it would be of little or no value since each buyer is paying the multiple from the buyer's internally prepared profit model. Each model will be different depending on the unique circumstances of each buyer. Which means that one buyer's offer, at say 6 times the buyer's profit model may actually be less in total amount than another buyer's offer at 5 times the profit – again, because the buyer offering the lesser multiple is applying the multiple to a higher profit model figure.

How the seller benefits from knowing the buyer's valuation methodology.

As this article points out, there's not a "one-size-fits-all" valuation method or multiple owners can use when trying to determine a probable offering price for their company. There's not much, if any, public information from which to determine the multiples that should be used. For the very large announced transactions, there has been published information on what buyers pay as a multiple of the seller's reported profits; but even for these announced transactions, there is often no mention of what the buyer expects to make after the consolidated savings on the transaction. And there's no published information in the industry that gives any insight as to what the buyers may be paying as a multiple of the buyer's profit model for the small/medium size acquisitions.

However, this article does tell the owner what's important to buyers in the valuation process; and ***just as important as knowing the buyer's valuation methodology is knowing what not to do when valuing the company.*** We've found that one of the largest mistakes owners make in valuing their company

themselves and not knowing the buyers' valuation methodology, is putting too much importance on factors the owner thinks are important, not necessarily shared by the buyers. These items have more to do with the owner's emotional attachment to the business and do not necessarily add to the buyers' profit models. Some of these factors are:

- **Number of years the company has been in business** – although this may be one of the things that attracted the buyer to the seller, it doesn't necessarily add more profits for the buyer's model. It does add a certain amount of value to the company from the account retention standpoint, but certainly not nearly as much as a lot of owners seem to think.
- **High profile, prestigious accounts** – while it's certainly nice to have accounts that add prestige to the company, it's the margins on the accounts that ultimately determine the value of the seller. A prestigious account that has slim or no profits will result in little or no value when the buyer computes its profit model.
- **Future business or projected revenue and profits** – Buyers are looking at what it can make from the seller's business based on the accounts and amount of business in place at the closing of the transaction. As mentioned above, buyers tend to add some premium for sellers that have demonstrated an attractive revenue growth rate, which indicates an organization in place that may continue this rate for the buyer after closing. But again, most owners tend to place a higher that realistic value on this growth rate. However, it's important to note here that some buyers will give the seller credit for revenue growth that may occur after the closing of the transaction as an inducement to get the transaction consummated.

The best way for owners to find out how a buyer's methodology would value their company, and if they're on track for a premium price when they sell, is to consult with someone who has experience in managing sale transactions for the security guard industry. The expert will be able to tell the owner how the most aggressive buyer will price the owner's company based on its unique characteristics – the multiples to expect and the probable credits the buyers will give the owner in computing the profit model.

If we look at the prices our clients received for many of the transactions we've managed and state the price in terms of multiples of the seller's **reported** earnings, the multiples are off the charts. This is because the sellers, in most instances, did not have reliable financials, or if they did, they reported little or no profits because they need an organization in place to run even a small amount of business. The buyer gave our clients credit for the cost savings the buyer brought to the acquisition, thus producing an attractive price for the marginally profitable company.

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We initiate and manage transactions for sellers of security guard companies. Established in 1977, we have successfully represented over 150 sellers located in the United States, Canada, Western Europe, South America, the Caribbean, and the Middle East.

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