Notebook of Ideas for
DIVESTITURES
of Security Guard Companies

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Multiples Are Going Up, But Valuations Are Slipping For Some Companies. . . How Can This Happen?

We initiate and manage transactions for sellers of security companies.

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Many security guard companies are actually experiencing growth in revenue in this bad economy. This would ordinarily mean that the owners of these companies could expect a higher price in a sale transaction, but this is not necessarily true today. The valuations (i.e.; selling prices) for some companies are coming down even though the revenues are up; and it's not because the market has turned in the buyers' favor, as many doomsayers predicted. There are still several buyers in the market who remain generous in prices and terms. ***In fact, many of these buyers are stretching their normal multiples farther than they used to in an effort to bridge the gap between sellers' expectations and the realistic, although diminished, value of the company.***

The valuations of these companies are dropping because the bad economy has finally started to show its effect on the financials. Margins are shrinking; a result of increased pressures on billing rates from customers, as well as competitors; and operating costs are increasing - both resulting in less profits to the selling company. Since buyers compute their offering prices on what they can expect to make off the acquisitions, the profit deterioration has a direct negative impact on what these sellers can reasonably expect to get for the company in a sale transaction.

Although this drop in valuations relates, to a large extent, to the decrease in sellers' profits, it also has to do with the buyers' increased costs. Normally, as a buyer is computing the price it's going to offer the seller, it takes into consideration its cost structure in running the business and actually gives the seller credit, in the purchase price computation, for the savings the buyer may bring to the acquisition. But many of the buyers today are also experiencing increased costs of doing business through increased unemployment taxes, health insurance, etc.; which means less cost savings to pass on to the seller in the form of increased purchase price.

Every buyer has its unique way of calculating its pro forma profits from the acquisition as a way of computing the offering price to the seller. However, two of the most important factors in all buyers' profit calculation methods are the site and branch level profits. The buyers make further adjustments from these two profit levels for the amount of additional costs the buyers will have to

incur in order to run the accounts and keep the customers its buying satisfied with the service.

To better understand how valuations may be dropping for some sellers, take the case of the seller of a $20 million security guard company who started to sell his company in 2008 and went so far as to receive offers. A buyer prospect, after going through an analysis of the characteristics of the company and recasting the financials, made an offer of $7.2 million (to include just the accounts and operating assets - seller keeps the rest of the balance sheet, in other words, not on an enterprise value basis).

The seller got "cold feet" and decided not to sell in 2008; then put the company back up for sale in 2010 - expecting at least the same offer, if not better. But to the seller's surprise, the value of the company as seen by the buyer prospects had diminished.

Company's financial situation for 2008 & 2010:

The company's financial situation in 2010 showed no revenue growth for the past 2 years, and the site level and branch profit slipped 2% [a trend consistent with the results we reported in the white paper we published in July 2010].

	2008	2010
Revenue	$20,000,000	$20,000,000
Site Level Profit	3,600,000 (18%)	3,200,000 (16%)
Branch Level Profit	2,400,000 (12%)	2,000,000 (10%)
Net Earnings After Corporate Expenses	*	*

* *The amount for "net earnings after corporate expenses" is not presented since most "industry buyers" (the large companies already in the security guard space) make significant adjustments to this figure in computing their pro forma profit from the acquisition, which significantly lessens the importance this amount plays in the valuation process.*

Since buyers ultimately value their target company based on some multiple of profits, if we use the site level and branch level profits as benchmarks for the multiple, we find that the $7.2 million offer in 2008 was 2 times the site level profit and 3 times the branch level profit.

Therefore, if the buyers in 2010 use the same multiple of either site level or branch profits as the 2008 buyer used, the new valuation based on the $20 million of revenue is between $6 million and $6.4 million, as explained below:

	2008	2010
Value of the Company based on multiples of site level profit:		
$3.6M x 2	$7,2000,000	
$3.2M x 2		$6,400,000
Value of the Company based on multiples of branch level profit:		
$2.4M x 3	$7,2000,000	
$2.0M x 3		$6,000,000

And for the owners who still look at the value of their company in terms of gross units irrespective of the actual profits of the company (i.e.; multiples of gross monthly billing, percent of annual revenue, etc.); in the above example, the value of the company dropped from 4.3 times gross monthly revenue to around 3.7 times gross monthly revenue; and the buyer actually offered the same multiples on profits in 2010 as it offered in 2008.

Therefore, in the above example, the seller of the company that was worth $7.2 million in 2008 would have to sell for somewhere between $6.0 and $6.4 million in 2010 in order to give a buyer the same return on its investment. Conversely, the buyer would have to increase its normal multiples 13% - 20% just to give the seller the same price in 2010 as it was offering in 2008; and some buyers are doing this today in order to get the deal done

In a market of shrinking margins and increased costs, both buyers and sellers become victims. In order to get a deal done, quite often the sellers have to settle for a little less purchase price than they were expecting and/or buyers have to settle for a lesser return on the investment in the acquisition.

What Lies In The Future For Multiples And What Can Owners Expect When They Sell Their Business?

Owners who are able to grow their business and keep, or improve on, margin levels should continue to enjoy an increase in the value (and expected selling price) of their company, since there will continue to be a need for the generous buyers to increase volume through strategic acquisitions. The multiples on profits the buyers are willing to pay should continue at the current level or improve somewhat for certain strategic acquisition candidates.

On the other hand, owners who are experiencing margin pressures and increased costs at the site and branch level should expect lower valuations when the time comes to sell the business. Even though the total dollars received in a sale in today's market may be less than what it would have been a couple of years ago, it still may make sense to sell. The questions owners thinking about selling should ask themselves are:

1. Is the enjoyment factor in owning and running the company diminishing?
2. Are there further margin pressures and operating costs on the horizon which will result in further deterioration of the total value of the business?
3. Can we sell the company for what the market will pay now and invest the proceeds in another business or investment vehicle that will give the same or better return?

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