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The Closing Process – *Balancing the needs of the seller and buyer*

(Written by Robert H. Perry)

The buyer and seller who think the handshake guarantees a successful closing should think again. There are still several stages to go through before the deal is finalized. At each stage there lies a threat to a successful closing – not the least of which is a process that seems to take too long.

Imagine this scenario:

The seller is the sole owner of a medium sized security guard company and the buyer represents a large public company. They finish their important meeting where they agree to the price and terms of their deal. They shake hands to seal their intentions. The buyer says they will have their lawyers immediately prepare a letter of intent to memorialize what they agreed to and they will do whatever it takes to close the deal quickly.

The seller walks away feeling good about what just happened. He assumes that a quick closing means he will have his money in 30 days, 45 at the most.

However, the buyer has quite a different timetable in mind. They will move as quickly as possible, but they have to assemble their due diligence

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team, who may already be working on another assignment. After the due diligence, he has to write a report that tells why the acquisition will be good for their company. Then, the report has to be approved by the executive committee before it is submitted to the board of directors.

The executive committee meets bi-monthly and the board of directors meet monthly. As often happens, the report might not be finished until right after an executive committee meeting, so they may have to wait

a month or longer before they can get the deal approved by the board. Somewhere during this process, their attorney also has to prepare the buy/sell contract. The buyer figures the closing process will take 60 days, maybe 90 (or longer).

It is obvious that the parties left that meeting with quite a difference of opinion about what was meant when they agreed to close the deal quickly.

As the deal progresses and the seller finds out about the buyer's elaborate approval procedure, this difference becomes apparent. To the seller, the process is taking too long. He thinks the buyers are dragging their feet.

He starts to feel that he is not as important to the buyer as originally thought. This seller, like most closely held company owners, is an entrepreneur who needs to see things happen and they must happen quickly. He's getting impatient holding his company together waiting for the closing.

And rightly so - not only is he having to run the company longer than he expected, he's also putting major business decisions on hold - the company needs a new computer system and a re-work of the employee benefits program and both will cost a lot of money. These need immediate attention if the company is not sold, but if the deal goes through, the buyer won't need them. They have their own computer system and benefit program.

Also, the seller is starting to feel vulnerable, which is adding to his frustrations. When he shook hands with the buyer at the meeting, their handshake was followed by a letter of intent; which probably gave the buyer exclusive negotiating privileges. This means the seller cannot take the opportunity to another buyer prospect until the exclusivity period

expires; and even if he could, starting new negotiations would only result in a later closing date.

Further adding to the seller's frustrations are the numerous telephone calls these mysterious people (the buyers) are making to the seller's office. The employees, who will be told about the sale at closing, not before, are becoming suspicious.

This deal will eventually close, but not without some scars on the relationships. Much of this could have been avoided if the buyer and seller had done a better

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job of communicating at that meeting when they struck their deal. The buyer should have explained their process to the seller. Both should have established a "game plan" for the due diligence to be done without alarming the employees. Key employees should have been brought into the loop, so they could help in the process and feel comfortable with what was happening.

It took a few months to close this transaction - albeit a normal timetable for the buyer, but seemingly too long for the seller.

The buyer was probably doing everything possible to keep the momentum going on their side of the deal. However, it was how the seller viewed the progress that was important. Oftentimes the delay is a perception, rather than a reality. In other words, if the seller is anxious to close, the process seems to take longer than it's actually taking.

This article is not about whether the proper timeframe for this transaction was 45 days or 90 days, or some other timeframe.

It's about the buyer and seller moving expediently and being aware of each other's needs. However, no buyer should move quickly solely to accommodate the seller's timeframe. The buyer should take the time necessary for a proper due diligence. To do otherwise may undermine the chances of a successful transaction for the buyer and (probably) the seller.

One would think that the time it takes to close a transaction is in direct proportion to the size of the seller's company in terms of gross

billings and number of accounts. Unfortunately, there is no standard by which the size of a company is used to measure whether a deal closes in a proper timeframe. Each transaction is unique. Each

process usually depends on the size of the transaction and/or the size of the buyer's organization. The general rule is – the large buyers require a more elaborate approval process. However, there are exceptions to this. Many large companies have given their representatives – the ones who are handling the negotiations – broad decision making authority and in many cases, complete

It is usually the buyer who controls the timetable for the closing. Some buyers know the importance of closing quickly – and they do it. They know the deal is an emotional event for the seller and if the closing is delayed, THE SELLER MAY CHANGE HIS MIND ABOUT SELLING ALTOGETHER.

requires different due diligence processes, approval procedures, buy/sell contract language – and so forth.

There are, however, factors that determine the logical timeframe for a closing. It's obvious that some of these factors are outside the control of the buyer or seller:

- **Form of transaction** – the structure of the transaction will affect the timeframe for closing. An asset purchase is the simplest form and allows for a more expedient closing process. A stock purchase is more risky for the buyer since it subjects the buyer to possible liabilities that were not known to the buyer or seller at closing. For these reasons, the buyer will perform a more extensive due diligence and prepare a buy/sell contract that properly indemnifies the buyer from these possible liabilities – both of which add more time to the closing process.
- **Outside approvals** – certain transactions in the security guard industry must be approved by the Federal Trade Commission. This approval usually takes 30 – 45 days to handle the paperwork and get the FTC approval. There may also be other approvals necessary before closing, as in the case of account contracts that require written permission to assign – if the parties agree that the assignments will be gotten before closing, not after as is often the case.
- **Tax consequences** – sometimes, the seller wants the process delayed. The seller may want to close after a certain date because of tax advantages.
- **The buyer's approval process** – the number of steps and the time it takes in an approval

authority. Which means the deal does not have to wait for approval by the board of directors.

On the other hand, small companies who may have a simple approval process for acquisitions – approval by the sole owner – may be borrowing the acquisition funds from a bank, in which case the bank becomes the authority board that may delay the process.

- **The buyer's interest in the seller and experience in the closing process** – in order for a deal to close expediently, the buyer has to stay focused. The buyer cannot stay focused unless there is a strong interest in the seller's company. The buyer also has to be knowledgeable in the closing process.

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In fact, some of these buyers use a promise of a quick closing as a way to compete with other buyer prospects that may be offering a larger price, but will take longer to conclude the transaction.

Other buyers, ones who are not experienced in the process, would like to close quickly, but they don't know how to go about it.

The things they examine during the due diligence are not consistent with what they should be trying to accomplish. They spend too much time examining insignificant documents.

The personnel doing the due diligence often do not know how to adjust the due diligence procedure to an asset purchase if the agenda is prepared for a stock purchase (there is a large difference in the procedures between these two types of transactions).

Some buyers let insignificant happenings within their company keep them from being focused on the acquisition. The acquisition team is putting out fires in other areas.

What most of these buyers don't realize is that their lack of experience or distractions cost them a lot of money when they delay the closing.

One large monetary penalty is that the seller might decide not to sell or take the opportunity to another buyer.

Another penalty is a loss of income from the seller's operations - since the earnings during the closing process goes to the seller, not the buyer.

The economic effect of this loss of income is more formally called "opportunity costs."

Opportunity Costs - a way to measure the penalty a buyer pays for delaying the closing

The economic books define opportunity costs as the difference between what a company is earning on their committed resources compared to what they would be earning from an alternative investment.

Here is how opportunity costs applies to buyers of security guard companies:

Take as an example a buyer who determines they will receive a 25% return on a security guard company costing \$10 million. The buyer presently has the \$10 million invested in some bank instrument earning 10%. The opportunity cost or penalty the buyer suffers if the deal does not happen is \$1.5 million - per year (15% difference between the earnings from the bank instrument and the earnings from the target company times \$10 million).

If we assume the above deal closes, but the closing process takes 2 months, then the buyer suffers a \$250,000 penalty in terms of opportunity costs (15% difference between earnings from the bank instrument and the earnings from the target company times \$10 million times 2 months).

Opportunity costs also apply to buyers who may be borrowing all or part of the purchase price. Using the above example, assume the buyer is borrowing the \$10 million from a bank and paying 12% interest. Under this scenario, the penalty to the buyer during the 2 months it takes to close the deal is \$216,667 (13% difference between the

amount of interest paid to the bank and the earnings from the target company times \$10 million times 2 months).

There's an opportunity cost for every type of transaction: there is one for public companies that use equity funds to make the acquisition, as well as deals financed by sellers.

The bottom line: all buyers pay penalties in terms of opportunity costs during the time it takes to close the deal. Once a buyer determines that the purchase will give them an economic benefit, they suffer opportunity cost for every day they do not own the company.

As mentioned before, most buyers don't realize just how costly the delays are. If they did, they would not be concerned about paying attorneys a premium for meeting due dates, or the travel costs to have face to face meetings instead of trying to handle negotiations over the telephone.

A delay can be caused by a complicated approval process, as in the case of the public company buyer in our scenario, or a buyer who just doesn't know how to close expediently. Regardless of the cause, there are several procedures that can improve on the time it takes to close a transaction and maintain the good relationships while still allowing the buyer enough time to do a proper due diligence. These procedures make the closing process more efficient - they have to do with **COMMUNICATING** and getting **ORGANIZED**:

- **Set timelines** - at the meeting when the buyer and seller shake hands on price and terms, they should set timelines for having certain things finished. Deadlines need to be established for: signing the letter of intent, seller getting records ready for the due diligence, buyer concluding the due diligence, first draft of the buy/sell contract, final draft of the buy/sell contract and the closing of the transaction. If any of these dates are missed, new realistic timelines must be established.

As is often the case, the attorneys who are responsible for the legal part of the transaction have their own timetable for getting the deal done. This may require several revisions to the original timetable which take us to the next point.

- **Make sure the attorneys for both sides understand and agree to the timeline** - each party should ask their attorney if they can meet

the designated timeline for getting the deal closed. They should find out if the attorney has a qualified associate who can “stand-in” if the attorney is not available when needed.

Each party needs to let their attorneys know the importance of getting the deal closed in a timely manner. Then each party should keep the attorneys focused on just the legal issues. The attorneys should not get involved with the business aspects of the deal, especially the ones that have already been negotiated.

- **Organize the due diligence** – most buyers have a standard list of things they examine during every due diligence. They need to give the seller a copy early in the process so the items can start being accumulated. There may be special reports that have to be prepared (i.e., interim financial statements) and if the seller knows about these early in the process, they can be prepared on a timely basis and be ready for the buyer come due diligence time.

The seller can also make sure the appropriate personnel are available to answer the buyer’s questions, even if it means delaying someone’s vacation plans.

- **Meet frequently** – the buyer and seller should not only talk on a regular basis, they need to meet. The face to face meetings enhance their relationships, which is important to keeping the deal on track. At these meetings they can discuss the progress of the closing process or plan the transition activities. These meetings are also a good time to discuss key employees. In fact, if the key employees have already been told about the pending deal, it would be good to have them at the meeting.

However, the parties should keep the meetings as informal as possible. Remember – the reason for the meetings is to keep the friendships going through the delayed closing process and formal meetings tend to be somewhat intimidating.

- **Establish working relationships with the attorneys and accountants** – this step is for the intermediary. Presumably the buyer and seller already know their advisors. It’s important for the intermediary to get to know the buyer’s and seller’s advisors even though the intermediary represents only one side. There may have been discussions during the negotiation meetings that

were attended only by the buyer, seller and intermediary that are important to the tax planning or buy/sell documents. If the intermediary has the proper experience, he/she can advise the attorney or accountant of the significance of such discussions so they can be handled in the preparation of the first draft buy/sell agreement.

- **Send memos** – the intermediary usually handles this task. The memos sent on a frequent basis serve as a written reminder to every one of the agreed upon deadlines for certain events in the closing process. If it looks like someone may not have received the message because they appear to be “dragging their feet,” then the intermediary needs to call them.
- **Call everyone on a frequent basis** – the intermediary also usually handles this task. The intermediary calls the buyer, seller and advisors frequently to make sure they’re working according to the timelines established. He/she needs to inquire about any problems and if there are any should take immediate steps to get the proper person involved in resolving them. While it’s better to place these calls to the respective person’s office, the intermediary should not hesitate to call them at home for urgent matters.

All parties should also have each other’s office, fax and home telephone numbers. There will be occasions when the advisors and principals will need to call the other parties direct (without the intermediary involved) and the timetables should not be delayed simply because someone did not know how to reach their party.

Writer’s Note:

Had experienced intermediaries been involved in the negotiations described in our opening scenario, they would have made sure the parties talked about the timeline for closing before they left their meeting.

Organizing the closing process is one of the ways intermediaries add value to a deal or rescues it from failure. There are many adjustments that have to be made during the closing process. Experienced intermediaries know the needs unique to the buyer and seller. They know how to handle these adjustments so the deal stays on course for a successful closing. ■

Merger and Acquisition Prospects for the Global Security Guard/Investigative Services Market

The anticipated growth in the world contract security guard (and investigative) services should attract the attention of the large security companies serving the international market. They will now want to enter or expand their current operations in certain growth areas and they will accomplish this through acquiring market leaders or establishing joint venture relationships.

A recent study made by the Freedonia Group shows that the world market for contract (i.e., third party) guard and investigative services is projected to be over (US)\$33 billion by the year 2000, a 7.1% annual increase. By the year 2005, the market is expected to reach (US)\$46 billion. Two factors contribute to this expected robust growth - one is the on-going conversion from proprietary to third party - provided guard services, a dynamic effecting both developed and developing country markets. The other factor is greater use of higher-paid, better-trained security guards,

whose services can be priced at a premium.

The areas showing the largest percentage growth (and the most likely prospects for increased merger and acquisition activities) are Eastern Europe, Central and South America and Asia/Oceania areas.

(Amounts in Billion U.S. dollars)

	<u>1995</u>	<u>2000</u>	<u>2005</u>
World	23.7	33.5	46.1
United States	11.4	15.4	20.4
Canada & Mexico	.8	1.2	1.7
South & Central America	.6	1.0	1.7
Western Europe	7.6	10.4	14.0
Eastern Europe	.2	.5	.9
Africa/Mideast	.6	.9	1.4
Japan	1.5	2.1	2.9
Other Asia/Oceania	1.1	2.0	3.2

(A comprehensive study can be ordered from the Freedonia Group, Inc. 216/921-6800 or www.freedoniagroup.com)

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Established in 1977, we are the recognized specialists in the sales and valuation methods for security guard companies. We have successfully represented nearly 100 sellers of security guard companies located in the United States, Canada, Western Europe, the Caribbean and South America.

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