WHITE PAPER ON THE U.S. SECURITY GUARD INDUSTRY

MARKET ◆ MARGINS ◆ MULTIPLES

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"White Paper" on the US Security Guard Industry

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Highlights of developments since the last report (July 2009):

1. *Only one major transaction in the US security guard sector: Tri-S Security sold its sole operating subsidiary, Paragon Systems, Inc. to Pinkerton Government Services, Inc.; a wholly owned subsidiary of Securitas AB.*

2. *Margins for large and small security guard companies continue to slide.*

3. *Industry and financial buyers continue to be aggressive and seek quality acquisitions. The multiples paid and being offered continue to hold.*

4. *Several concerns on the horizon for owners of security guard companies:*
   - *Unions are given more freedom to organize the security personnel.*
   - *New healthcare bill signed into law continues to confuse, but definitely means more cost to employers.*
   - *Operating costs on the rise, especially healthcare and unemployment taxes.*
   - *Federal income taxes are expected to increase starting in 2011, which will make owning (and selling) a company a lot more expensive.*

5. *Reports and surveys indicate that the security guard market will continue to grow in the low single digits for the next 3 years.*

6. *More security guard companies are looking to companion markets as a way to offset their shrinking margins on traditional standing security guard services.*

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Size of the US Security Guard Industry

The matrix making up the number of companies in the market continues to indicate a very fragmented market, with a few large companies controlling the bulk of the gross revenues for the industry.

Revenue

The latest Freedonia Group study #2362 (in October of 2008) indicates that the US Contract Security Guard market was $22.150 Billion in 2007 and was expected to grow to $28.9 Billion by 2012 – a 5.5% annual growth rate. This same report puts the worldwide security guard market in 2008 as $38 Billion, which means the US market alone is over half the size of the world market. However, a previous report by Freedonia showed the same US market as $17 Billion in 2007 – the difference being a new definition of what is included in the SIC code for security guard companies to include an expanded population of private investigators and other related security groups.

Most industry experts still talk about the size of the "real" security guard market as $17B - $18B; therefore, we'll use $18 Billion for this "white paper" report.

Number of Companies

Many sources indicate that there are around 10,000 individual security guard companies in the United States alone, with one report indicating 14,000 companies. Our firm has been building a database of US guarding companies for the past 25 years, and has identified around 6,000 individual companies. We feel that our database is reasonably accurate to include just the individual companies. We believe this lack of consistent data results from: 1. In many states, security guard and investigative companies require the same SIC code; and there are thousands of one-to-two man investigative companies in the US.; 2. There is some duplicate counting – each branch office of a multi office national security guard company is counted as a single company.

In spite of the fact that the market is very large, it's also very fragmented and there's very little public information on the financial performance and the operating practices for the privately-held companies. We have, over the past 25 years, come to learn that this lack of public information is due primarily to the nature of the business and the owners' mindset. It is, after all, the security business, which by definition operates through a code of secrecy. There are no associations of private security guard companies that accumulate these operating statistics.

Number of Employees

Also, an interesting fact is that there are approximately 1.5 million security officers in the U.S., about 2.5 times the number of public law enforcement personnel. If, in fact, the contract security guard market is getting more undesirable publicity than the public force – it could be primarily because the contract security guard market is so much larger than the public force; thereby a much larger "public opinion" target.

The Security Guard Market and the Recent Economic Downturn

While traditionally the security guard market has been viewed as recession proof, most security guard companies will feel at least a mild set-back through a prolonged recession. Typically, during a prolonged recession, the security guard industry is among the last industries to go into the recession and the last to come out. Just how much a guard company is affected by the recession depends on how well financed the company was going into the recession and the vertical markets the company serves.

Banking Relationships

Since our last report in July 2009, we have heard from several security guard company owners regarding their present banking relationships. The situations described by these owners do not present a clear picture of what's happening to the banking relationships across the board. Some of the companies have had to change banks because their present bank called their credit line. Other companies had increased borrowing costs, but remained with their present bank. Overall, it seems that the requirements to lend money may have eased up some, but the banks are still performing a deep due diligence on new loans and are more closely scrutinizing the security backing up the loan.

Customer Retention

The guard companies that have customers that are adversely affected by the economy are losing volume, hence profits, as the customers look for ways to cut back and view security as a viable area of savings.

Some Security Guard Companies are Growing

Some of the guard companies are actually experiencing growth in this bad economy as customers increase security to combat the increase in the crime rate that goes along with a financially challenging economy. Also, many of the security guard companies (especially the larger ones) are introducing new, and more profitable, services as a way to win new accounts or keep existing ones. Many of the larger companies are getting into the remote video monitoring business as a way to supplement or enhance the existing traditional standing guard service. Some are also pursuing the background screening business, "Alert Line" companies, executive protection, etc. – all as a way to diversify and get more competitive and in a lot of instances set themselves apart from their strongest competitor in the traditional standing security guard market.

Factors Causing Growth and Contraction of Revenue in the Security Guard Industry

- ***Growth Factors – many reports still indicate that the security guard market in the U.S. will continue to grow in the low to mid single digit range for the next three years:***

  1. Companies looking to cut costs are eliminating their in-house security program and using contract guard companies. Typically, in-house security employees will have a higher pay scale due to long term tenure with the company and expensive retirement benefits. By contracting out the security function, companies are getting better trained security personnel in many cases, for less total outlay.

  2. During a "down economy" the crime rate increases, thus companies looking to safeguard against the increase in crime are increasing their security coverage. This is particularly evident in the city and state municipal government sector; where there's a lot of pressure from the public to provide more protection.

  3. As smaller companies have a difficult time operating due to cut-back in security from their customers and the line of credit becomes more expensive (or banks actually terminate the credit lines), these companies will go out of business or sell to their larger competitors. Although this does not cause growth in the overall market, it does cause a shift of the business from the small, thinly capitalized companies to the larger more financially robust regional, national or international security guard companies.

- ***Factors Causing Contraction***

1. Certain industries adversely affected by the downturn in the economy are closing locations, thereby eliminating the need for security once needed in those areas.

2. Some companies are eliminating contract security and using their own personnel to handle the security functions as a way to justify keeping the valuable employees.

3. Companies adversely affected by the economy are reducing the amount spent on security and taking on the risks of leaving the plant or premises vulnerable to incidents.

4. Some companies are trading security officers for electronic security. However, in most instances companies are not actually cutting back on manned security, but are supplementing the security function by installing cameras, alarms, etc. as a way to enhance the existing security. As a result, and as mentioned above, many security guard companies are starting a separate electronics division or partnering with an existing electronics company.

Training, Background Checks and Drug Screening

The security guard industry has received much undeserved bad publicity about its quality of service and lack of hiring standards.

What most of the general public does not know is that many of the smaller companies and all of the larger ones administer drug tests as a condition to employment and have background verification more stringent than the state laws require. Also, many of the companies perform psychological profile testing – a verification of the applicant's ability to handle the stress of security work and places the security officer in positions compatible with his/her personality traits.

Margins and EBITDA Matrix

Typically, the well-run closely-held small to medium sized security guard company will have better margins than its larger competitors. The reasons are:

1. The smaller guard company is selling personalized service from the owner and many users of security guards are willing to pay extra for this personalized attention.

2. The smaller guard company operates in a limited geographic area or region; thereby cannot service or attract the larger customers with multi national or international sites. These "national accounts" are mostly handled by the larger national or international guard companies; but the competition to win these type customers is very intense. Therefore the large guard companies will bid these accounts at much lower margins (than the smaller companies are getting for their "local" accounts) in exchange for a larger volume of revenue, the prestige of providing security for some well known conglomerate, or the possibility of obtaining additional sites or other types of security for this conglomerate at much higher margins once the guard company gets its foot in the door.

Below are the typical margins for the small, regional and national/international U.S. Security Guard Companies – with an insignificant portion of the revenue coming from the governmental sector (typically very low margin business):

	(1) Small Company	(2) Regional Company	National/International Company
Revenue	100%	100%	100%
Profit at site Level	18%	15 – 16%	12 – 14%
Profit at Branch Level		10 %	9%
EBITDA	7%	7%	5-6%

1. Revenues less than $10 million; owner manages the business and has customer relationships; operates from one office. Usually inefficient in back-office operation and pays more on a per unit cost for insurance, uniforms, etc. Margins are slipping due to the competition from the larger security guard companies having more interest in the smaller, higher margin accounts; and margin pressures from existing customers.

(2) Revenues $10 - $100 million; owner less involved in customer relationships, operates multi-offices – usually volume $5 - $10 million per office. Margins are slipping due to the competition from the larger companies and client pressure to maintain or decrease billing rates; while direct costs are increasing.

Composition – by Company Size

	No. of Companies	Annual Revenue (in million $)
(1) (2) Over $1 billion	3	7,175
(2) $300M - $1B	4	1,885
(2) $100M - $300M	10	1,500
(2) (3) $50M - $100M	3	168
(2) (3) $20M - $50M	13	509
(4) $5M - $20M	200	2,000
(4) $0 - $5M	7,767	4,763
	(6) 8,000	(5) 18,000

(1) 2 companies representing $5.6 B in revenue are foreign owned
(2) From July 2010 issue of *Security Letter*
(3) The 2010 *Security Letter* list dropped 4 companies because of incomplete data that appeared on the 2009 list – 2 companies from the $50M - $100M category, and 2 companies from the $20M - $50M category.
(4) Estimated based on information in files of Robert H. Perry & Associates, Inc.
(5) See "Information on the Size of the US Security Guard Industry" – on page 1 of this report.
(6) Some sources put the size of the market as 10,000 – 14,000

Selling Multiples for Large Security Guard Company Transactions

The following summarizes the large **announced** transactions in the security guard industry for the past 10 years. Note that there's no consistency in reporting the assumption of long term debt when the companies made the announcement, thereby producing somewhat misleading conclusions on the total enterprise value price for some of the transactions. Also, in some cases – as in the Cognisa/US Security transaction – part of the purchase price was paid based on account retention post closing; and the amount of the post closing payment was not announced:

Pinkerton

Sold February 1999 to Securitas
Volume $1 billion
EBITDA $33M
Price $407M
Multiple of Sales 40%
EBITDA Multiple 12.3 X

Burns

Sold August 2000 to Securitas
Volume $1.5 billion
EBITDA $65M
Price $576M
Multiple of Sales 38%
EBITDA Multiple 8.9 X

Wackenhut

Sold March 2002 to Group 4/Falck
Volume $2.8 billion
EBITDA $73M
Price $570M
Multiple of Sales 20%
EBITDA Multiple 7.8 X

Vance International

Sold October 2002 to SPX
Volume $95 M
Price $67M
Multiple of Sales 84%
EBITDA Multiple – not announced

Allied Security (now **AlliedBarton**)

Sold February 2003 to MacAndrews and Forbes
Volume $500+ M
Price $250+ M
Multiple of Sales 50%
EBITDA Multiple – not announced

Cognisa Security

Sold August 2005 to US Security Associates
Volume $100 M
Price $40M
Multiple of Sales 40%
EBITDA Multiple – not announced

Vance International

Sold January 2006 to Garda World Security
Volume $155 M
Price $67.25M
Multiple of Sales 43%
EBITDA Multiple – not announced

Initial Security

Sold July 2006 to AlliedBarton
Volume $240 M
Price $73.6 M
Multiple of Sales 31%
EBITDA Multiple – not announced

AlliedBarton

Sold July 2008 to Blackstone Group
Volume $1.5 billion
Price $750M
Multiple of Sales 50%
EBITDA Multiple –not announced

Vance International

Sold June 2009 to Andrews International
Volume $128 M
EBITDA $4.5 M
Price $44.25 M
Multiple of Sales 35%
EBITDA Multiple 9.8 X

Paragon Systems, Inc.; wholly owned subsidiary of **Tri-S Security**

Sold June 2010 to Pinkerton Government Services, Inc.; a subsidiary of Securitas AB
Volume $140 million
Price $34.5 million
Multiple of Sales 25%
EBITDA multiple – not announced

This was the first announced transaction for a major provider of security guard services to the Federal Government. Typically, the margins for Federal government accounts are less than traditional commercial accounts, thus the selling multiple as a percent of revenue is less than the industry average for traditional commercial accounts.

As can be concluded from the previous analysis, most of the large **announced** transactions indicated purchase price values in the 8 – 10 times EBITDA range; or 40% of annual revenues. Many of the transactions have involved a larger security company buying its competitor, or in the case of Securitas buying Pinkerton, APS and First Security, the purchase was a way to get large in the US market quickly. What the announcements don't say is what the buyer's return on the investment was after considering consolidating advantages, elimination of redundant costs, etc.

In the case of investment groups buying a large security guard company as a way to enter the market, the multiples paid were at least as high as what the industry buyers were paying, even though the investment group's return on investment in the short term was not as attractive as the industry buyers were getting. However, they had to be competitive in the bidding process for the initial buy. As they made future acquisitions, their returns became a lot more attractive, especially if the acquired company folded into the flagship company's operations – thereby through averaging the prices paid for the multiple purchases, the return on the initial purchase became a lot more attractive.

Selling Multiples for Small Security Guard Company Transactions

It's still a seller's market. The large security guard companies, which are usually the most generous on pricing, need to grow to replace some of the business lost in the downturn of the economy. The very large companies are finding it difficult to maintain their 5% - 8% **net** growth through internal sales alone; they need to make acquisitions of smaller companies in order to make these growth targets and keep the stockholders happy. The generous buyers presently have an abundance of cash on their balance sheet that they need to put to work; and buying smaller companies that they can make more profitable through eliminating redundant costs makes for the most prudent use of their idle capital.

Also, as stated earlier, the smaller companies are a particular good acquisition target for these larger conglomerates because the margins for these smaller companies tend to be 5 – 8 points higher than the average margins for the customers of the larger companies.

The prices being paid for these smaller companies over the past two years, expressed as a percentage of annual revenue, are about the same as the larger transactions; and in some cases, for strategic acquisitions, are much higher. However, the multiples of the **sellers'** reported EBITDA are much higher for the smaller transactions than the larger transactions, since the buyers in the security guard industry give the seller credit for the redundant cost savings that benefit the buyer in the transaction.

For many years, "would be sellers" have used "street formulas" based on multiples of gross units as a way to put an estimated value on their company. However, these street formulas usually result in the company being grossly over-priced or, worse yet, under valued. When we look at the transactions we've managed over the past two years for companies with volumes between $5 million and $150 million, the selling multiples as a percentage of annual revenue were as low as 20% to as high as almost 50% of revenue, for just the accounts (i.e.; if the buyer purchases the balance sheet items, these items are added to the price based on the balance sheet carrying value). The factors that make a company worth 50% vs. 20% (or some point in the middle) are:

1. Geographic location of the accounts
2. Gross margins (must have wages high enough to attract quality personnel)
3. Average site size
4. Kinds of accounts
5. Tenure of accounts
6. Armed situation (less is better)
7. Quality of management going with the sale
8. Revenue history (best time to get the high multiple is when the company is growing, not contracting).
9. Existence of few accounts making up a large proportion of the total business.
10. Workers compensation claims history
11. Accounts receivable turnover rate
12. Number of aggressive buyers in the market. If the buyer really needs to get into, or get larger in, a geographic or vertical market, then the buyer will be willing to pay a higher than average multiple to accomplish this quickly.

Although these multiples of gross units usually put the price being offered at a very high multiple of earnings based on the SELLER'S reported profits, the multiple comes down to something more reasonable when the synergistic cost savings to the buyer are considered.

A case in point is the sale we recently managed for the owners of a $15 million security guard company. The selling price was about 15 times the **seller's** adjusted EBITDA. However, the company sold for about 4 – 5 times the **buyer's** pro-forma EBITDA since the buyer was able to eliminate a lot of redundant cost in consolidating the operations – such as billing clerks, payroll clerks, costs of duplicate offices, etc. Additionally, the buyer, being a multi-billion dollar conglomerate, was able to buy insurance and uniforms (a large expense item for security guard companies) at a much lower per item rate than the seller was paying.

Private Equity Groups Making Investments in the Security Guard Industry

There has definitely been an uptick in the Private Equity Groups' interest in the security guard sector in the recent months. Typically, the life of a single fund for a Private Equity Group is around 10 years. Collectively, the Private Equity Groups raised a record amount of commitments during the years 2005 – 2007 and because of the downturn in the economy they're behind on putting these funds to work for their investors. Some estimate the size of the idle cash to be several hundred billion dollars. The Private Equity Groups are now scrambling around to find viable investments that will give their investors an attractive return and are looking to the security industry as investment possibilities. While most of the Private Equity Groups are interested in the high margin side of the security sector (i.e.; biometrics, electronic security, etc.) some are looking at **large** security guard companies (even though the industry is expected to grow at an "unexciting" rate of around 5% per year) as a platform from which to build for the next 5 years; then sell at the end of the 10 year life of the fund that they raised in the 2005 – 2007 era. There are presently several large security guard companies "ripe" to be acquired by Private Equity Groups; however no large transactions have been ***announced.***

The newest entry by a Private Equity Group into the security guard sector is LaSalle Capital; which bought 3 security guard companies in April of 2010.

Some well known Private Equity Groups with significant investments in the security guard industry are:

1. *The Blackstone Group* (www.blackstone.com) has a significant investment in AlliedBarton (approx. $1.5 Billion in annual revenue)

2. *The Audax Group* (www.audaxgroup.com) has a significant investment in Andrews International (approx. $350 million in annual revenue)

3. *Windpoint Partners* (www.wppartners.com) has a significant investment in US Security Associates (approx. $750 million in annual revenue)

4. *Pegasus Capital Advisors* (www.pcalp.com) has a significant investment in T & M Protection Resources (about $125 million in annual revenue)

5. *Trivest* (www.trivest.com) owns Allegience Security Group (approx. $60 million in annual revenue).

6. *LaSalle Capital* (www.lasallecapitalgroup.com) started United American Security LLC in April 2010, through the simultaneous purchase of 3 existing companies – Industrial Security, Inc., Leonard Security Services, Inc. and Eagle Security, Inc.

As mentioned earlier, Private Equity Groups typically see a lower return on their initial investment in the industry since they do not have the advantage of synergistic savings when making this initial acquisition. However, as the groups make future acquisitions that are "fold-ins" to their existing flagship portfolio company, the returns are much more attractive. When all the investments are averaged, the return on the initial purchase becomes much higher.

The positive aspects of the security guard industry for Private Equity Groups:

1. There are still many consolidating opportunities left for investment groups wanting to get large in the industry through a series of acquisitions. [See previous chart of "Composition – by Company Size"] Typically, the investment group will have to pay around 8 - 10 times (or even higher) the sellers' adjusted EBITDA to get into the business, then can make the "tuck-in" acquisitions for EBITDA multiples (off the buyer's pro-forma profit calculation) in the 5-6 range.

2. The multiples for the resale of the companies when the investment groups make their exit have been and still are very attractive.

3. The security guard industry, in terms of future growth prospects, is much better that the general population of investment opportunities for Private Equity Groups.

The negative aspects of the security guard industry for Private Equity Groups:

1. The security guard industry is a large target for lawsuits – workers compensation, employee harassment, equal opportunity workers violations and general third party claims (theft, harassment, destruction of premises, accidents, etc.).

2. Labor intensive – frequent target for unions, unemployment law changes, low paid employees, constant changing training and hiring requirements etc.

3. Low barrier to entry. Presently the states mandate the laws required to enter the security guard business and in some states all that is required is a $40 business license.

Future Challenges for Owners of Security Guard Companies

In the past 12 months, there have been many developments that have been announced that will, or may, take place in the coming years that will have a dramatic effect on owners of security guard companies:

New Healthcare Bill

Everyone in the industry is aware of this provision, but hardly anyone knows now its real impact on their particular company. The general consensus is that it will certainly increase operating costs. Many owners say they will be able to pass all or part of this cost increase onto their customers; but they are saying this with reservation. They admit that some customers cannot, or will not, accept the price increase; which will result in lost customers, decrease in billing hours; or decrease in the guard company's earnings, in the case where the guard company has to absorb the additional cost.

Further Unionization of the Security Guard Industry

In early 2010, President Obama, in a recess appointment, appointed a SEIU lawyer to head up the National Labor Relations Board. This, coupled with several news articles surrounding the SEIU's connection to the White House (the frequent visits by SEIU executives and the large financial support to President Obama's election campaign), gave security guard company owners great concern over the gaining strength and influence of the unions and their continuing heavy handed approach to unionization. Recent reports indicate the unions' attempt to establish union work forces through a "card check" procedure (making it much easier for the unions to get certified), as well as allow part time employees to join the union and the use of corporate e-mails for organization efforts.

Increase in Federal Income, Capital Gains and Inheritance Taxes

Because of the heavy Federal deficit, the Federal Government is looking for ways to bring more money back into its coffers. Unfortunately, the business owners and the high earners will be paying its "unfair" share of helping restore the treasury. There are several tax increases that are being considered and some will automatically be put into law by Congress if certain tax cuts implemented by President Bush are not extended past the sunset date of December 31, 2010. If the tax increases are put into effect (or some of the present cuts are not extended) high income earners will pay more Federal income taxes, businesses will pay higher taxes on payroll and heirs of decedents will be facing a much larger inheritance tax.

Also, business owners selling their company after 2010 will pay a lot more taxes on the sale. In a recent article our firm published on this subject, it was pointed out that if the capital gains taxes go back to just 20% (from the present 15%), the company will have to be about 7% larger just for the owner to net the same dollars as it would have netted had it sold the company in 2010. However, this probably gets worse: there's mention of a 3.8% tax on investment income exceeding $250,000; which if enacted will make the effective capital gains rate in the 25% range; which means the company would have to be about 13% larger in order for the seller to net the same as it would if the owner had sold the company in 2010.

ABOUT ROBERT H. PERRY & ASSOCIATES, INCORPORATED:

Established in 1977, Robert H. Perry & Associates, Incorporated is a specialized acquisition and merger firm focusing on the security industry. Our firm has initiated and managed transactions for over 150 sellers located throughout North and South America, Western Europe, the Caribbean, and the Middle East.

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