WHITE PAPER

On The

U.S. CONTRACT SECURITY INDUSTRY

Also known as: Security Guard Industry

MARKET ◆ MARGINS ◆ MERGERS ◆ MULTIPLES

Prepared by:

ROBERT H. PERRY
& Associates, Incorporated

JULY 2012

www.roberthperry.com

Table of Contents

(CONTINUED)

MARKET

Defining the "Contract Security" Market

Important Note: Throughout this report, we will use terms such as "security guards", "security officers", "security professionals" and various other names in describing the industry as it redefines itself to more closely align with the services it offers, as explained below.

"Guard" vs. "Officer" – The Discussions Continue

The contract security officer industry remains in a state of evolution in how it describes itself to the general public. Up until a few years ago, most people used the term "security guard company" in describing this industry. Then, many in the industry started dropping the term "guards" in their brochures, websites and other areas where they described their services and started using words such as "security officers", "security professionals", etc.

Recently there have been intense discussions going back and forth amongst the security professionals about this. Some are adamant that there's a distinct difference between a "guard" and an "officer". In researching this subject, we went to the ongoing blog on the website of *Security Director News* and found some very interesting discussions taking place:

Jeffrey Hawkins, American Military University's manager of strategic initiatives for the private security sector, commented as follows:

> "I think there are some people in the industry that do not like the term 'guard', feeling that is an outdated title, one that demeans the position by creating the image of the old-time security guard that slept in a factory in between doing rounds, mostly to make sure there were no fires in the building. If you look at the actual Webster's definition, the term 'guard' is actually more applicable to what security personnel do 'to protect', 'officer' is defined as one with police authority". He went on to say that …… "my feeling is that there are still 'security guards' and there is nothing wrong with that; I think of these folks who are generally at a fixed location and oversees the protection of an object, or area, or certain point of access. I feel 'officer' is probably more applicable to uniformed security personnel who patrol and perform more 'police-like' functions."

In a June 07, 2012 blog, Siomary Mendez said that in **India**, Security Guards and Security Officers are actually looked upon as separate and each has its own license. He went on to describe the official difference between the two. Below is an explanation of the differences:

Difference in Titles

- **Security Guards** typically have little responsibility other than basic fire safety and building integrity tasks.
- **Security Officers** may have very elaborate protocols that involve a wider range of tasking and responsibilities. He will be the person controlling entire physical security operations at the posted assignment and provide appropriate instruction to the deployed guarding force.

Difference in Training

- **Security Guards** often have minimal training, since they are seen as more of a human alarm system that when tripped, reports incidents which comes to their notice on static or roving post.
- **Security Officers** are typically trained to a standard more to take decision on the spot in coordination with management and also to approaching law enforcement if required. This is because they are often mandated to respond to incidents.

Difference in Wages

- **Security Guards** are entry-level personnel in the protective services field and, as such are paid on average at or just above the state-mandated minimum wage.
- **Security Officers**, due to their higher level of training, experience and job responsibilities, are paid more inline with local law enforcement and corrections personnel in their community.

The Expanding Menu of Services Offered

Although there's no clear cut distinction here in the U.S. on what constitutes calling one who protects and/or reports a "guard" or an "officer", many companies today have dropped the "guard" term in describing the services it provides simply because it implies a limited service offering menu, whereas the security company today tends to be a "one stop" source for a variety of security needs, such as:

- Special Event Security
- Risk Analysis
- Security Consulting
- Loss Prevention
- Investigators
- Background Screening
- Facility Design
- Roving Vehicle Patrol Services
- Concierge Services
- Alarm services and security systems integration (although many contract security companies do not actually perform this service in-house; they refer this type of work to a "partner" that specializes in providing the product or service).

How Contract Security Companies Define Themselves

In researching the subject, we viewed the websites of some of the largest contract security companies. We noted that there are many ways the companies describe what they do in providing the traditional manned and electronics security functions. Here are a few examples of what we found:

- "We are a security solutions company that offer a full range of protection services to companies needing to protect its precious assets"
- "We are a private security services company offering armed and unarmed security officers"
- "We are a contract uniformed officer company"
- "We are an international solutions group. We offer outsourced business processes where security and safety risks are considered a strategic threat"
- "We provide our customers with a range of specialized sources or a complete security solution"
- One company's site we visited showed under the heading of "Specialized Guarding" – "A trained security officer performs services tailored to the needs of medium-sized and large businesses"

Those companies that have dropped the word "guard" in describing their services are having some serious marketing challenges. Regardless of what the security professionals are saying about the true definition of "guards", the general public and potential customers still use this term as they "Google" to find a security vendor, or look in the yellow pages for the list of potentials, which will still be listed under the heading of "Security Guards". Therefore, owners of many companies today that primarily call themselves security officer companies feel they can't get away from using the term "guard" at least somewhere in promoting their company for concern of not being found.

The Public Opinion of the Contract Security Market

The contract security industry has been striving for many years to elevate how it's perceived in the public opinion marketplace and it has made great progress in this endeavor, in spite of Hollywood making movies like "Paul Blart: Mall Cop" and "Night at the Museum" that painted unflattering, demeaning pictures of security officers.

The contract security officer of today tends to be better educated, better trained, and in several areas, more qualified to handle the security functions demanded by the company's customers. This didn't happen overnight – it's the result of efforts on the part of the owners that want their company to be a truly professional security organization; and national security organizations such as NASCO (www.nasco.org), and ASIS International (www.asisonline.org); as well as the many state agencies and organizations working together to create legislation and best practices procedures for the industry. The general public also demanded this change, but there are still serious improvements that need to be, and are being, made in the industry.

Just like any other highly fragmented industry (as reported in the next section, there are an estimated 8,000 individual contract security companies in the U.S.), the contract security industry has its rouge companies that occasionally get bad publicity, but in spite of this occasional happening, the perception about the contract security market in the minds of the general public has definitely been elevated over the past few years.

Size of the U.S. Contract Security 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 majority of the gross revenues for the industry.

Number of Companies

Trend: No significant change from July 2011 white paper report

Many sources indicate that there are around 10,000 individual contract security companies in the United States alone, with 1 (one) report indicating 14,000 companies. We believe these figures are somewhat inflated for the following reasons: 1. the figures were compiled from reports using SIC (Standard Industrial Classification) codes and in some instances, investigative and other small companies not offering traditional contract security services are included in the 7381 classification 2. Duplication in counting – some reporting agencies are counting branch offices of a multi-office national contract security company, as separate companies.

Our firm has been building a database of U.S. guarding companies for more than 25 years, and has identified approximately 6,000 individual companies that employ more than 100 personnel and provide mostly contract security officer services. We feel that our database is reasonably accurate and when the companies employing less than 100 personnel are added, the total number of companies offering contract security officer services is in the 8,000 range. There's no indication that a significant number of new companies have started up since last year, therefore we will continue to use 8,000 as the estimated number for the total U.S. contract security companies throughout this report.

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 under a code of secrecy. There are no associations of contract security companies that accumulate and publish financial statistics on the industry.

Revenue

The Freedonia Group study #2362 (in October of 2008) indicates that the U.S. 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 U.S. market as $17 Billion in 2007 – the difference being a new definition of what is included in the SIC code for contract security companies to include an expanded population of private investigators and other related security groups.

Most industry experts are saying that today's contract security market, to include only traditional standing security officer services, is in the $20 Billion range and is growing around 5% per year. However, much of this growth is coming from increase in billing rates rather than companies adding security coverage. Also, many experts are saying that if the present "in-house" security market were to be expressed in terms of what contract security firms would charge for the service, the size of this segment would be in the $16 Billion range. We will use $20 Billion to describe the size of the present contract security market throughout this report.

Composition – by Company Size

		No. of Companies	Annual Revenue (in million $)
(1) (2)	Over $1 billion	4	9,200
(2)	$300M - $1B	4	1,911
(2) (3)	$100M - $300M	9	1,396
(2) (3)	$50M - $100M	11	650
(2) (3)	$20M - $50M	12	462
(3)	$5M - $20M	200	2,000
(4)	$0 - $5M	7,760	4,381
		(6) 8,000	(5) 20,000

(1) 2 companies, representing $6.1 B in revenue, are foreign owned
(2) From July 2012 issue of *Security Letter*
(3) Estimated based on information in files of Robert H. Perry & Associates, Inc.
(4) Arithmetical function to come to the 8,000 companies and $20B revenue
(5) See information on the "Size of the U.S. Contract Security Officer Industry" – on page 5 of this report.
(6) Some sources indicate the number of companies as 10,000 – 14,000

It's interesting to note that the four companies making up the "over $1 Billion" category didn't get large by adding one customer at a time:

1. Securitas (now $3.5 Billion in the U.S.) started with the initial purchase of Pinkerton's in 1999. Pinkerton's had over $1 Billion in revenues at the time of purchase. Securitas followed with the purchase of Burns, a $1.5 Billion company, in 2000; then went on to make about a dozen other acquisitions with combined revenues at the time of purchase of approximately $500 Million. As indicated later in this report, Securitas has concentrated most of its recent acquisition activity in the emerging markets.

2. G4S (now $2.6 Billion in the U.S.) made its initial entry into the U.S. with the purchase of Wackenhut in 2002. At the time of purchase, Wackenhut was billing approximately $2.8 Billion. Since that time, G4S has divested some of the traditional standing security officer business, and has limited its acquisition activity in the U.S. security market to mostly electronics and high-end investigative type companies. As indicated later in this report, G4S has concentrated most of its recent acquisition activity in the emerging markets, soon to represent 50% of its total revenue.

3. AlliedBarton (now $1.8 Billion) was formed through the initial purchase of Spectaguard in 1998. Spectaguard had revenues of approximately $60 Million at the time of purchase. Since that time, AlledBarton has purchased large companies such as Barton Protective (approximately $400 Million) and Initial Security (approximately $240 Million). In total, AlliedBarton has made approximately 10 acquisitions with combined revenues of approximately $1 Billion.

4. U.S. Security Associates (now approximately $1.3 Billion) got its start with the initial purchase of Advance Security from Figgie International in 1993. At the time of purchase, Advance had revenues of approximately $70 Million. Since that time, U.S. Security has made approximately 15 acquisitions of mid to large sized companies plus a number of smaller acquisitions with combined revenues of over $1 Billion (including $350 Million in revenue from Andrews International, its most recent transaction).

Number of Employees

Trend: No significant change from July 2011 white paper report

An interesting fact about the contract security industry is that there are approximately 1.5 million security officers (to include full and part time personnel) in the U.S.; about 2.5 times the number of public law enforcement personnel. If, in fact, the contract security market is getting more undesirable publicity than the public force – it could be primarily because the contract security officer market is so much larger than the public force; thereby a much larger "public opinion" target.

The Contract Security Market and the Recent Economic Downturn

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

Banking Relationships

Trend: Banking Relationships Still Uncertain

When the economic downturn started about three years ago, the relationship owners of contract security companies had with their banks, for the most part, began to deteriorate. Since then, we have heard many disturbing stories about companies having to change banks because their present bank called their credit line, or otherwise informed them that come renewal time the line amount will be reduced or not be renewed. Other companies had increased borrowing costs, but remained with their present bank.

Some Contract Security Companies are Growing

Trend: Fewer Security Companies Have Experienced Growth in the Past 12 Months Than in the Previous 12 Months

A few of the contract security companies are actually experiencing growth, but at a lesser pace than last year, 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 contract security companies (especially the larger ones) are introducing new and more profitable services as a way to win new accounts or keep existing ones; such as the bundling of security services. In fact, many of the larger companies are getting into the remote video monitoring business as a way to supplement or enhance the existing traditional standing security officer service. Some are also pursuing the background screening business, “Alert Line” services, 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 contract security market.

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

- ***Growth Factors – Many reports still indicate that the contract security 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 security 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.

   As mentioned earlier in this white paper, it's believed that this in-house market is presently in the $16 Billion range. As more of the companies presently utilizing in-house security are faced with rising employment taxes and the challenges of the Affordable Care Act, it's expected that the move from in-house to contract security may dramatically increase.

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 at a reduced cost.

3. As smaller companies have a difficult time operating due to a cut-back in security from their customers and increased line of credit costs (or banks actually terminate the credit lines), more of these companies will go out of business or sell to their larger competitors. As a case in point; a recent mass mailing our firm made to our database of contract security companies, resulted in a record number of the letters being returned with an indication that the company was "out of business". 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 contract security 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...however, the converse of this is true in many instances as mentioned in #1 under “Growth Factors” above.

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. More on this topic under “Contract Security Personnel (Guards) vs. Electronics” below.

Contract Security Personnel (Guards) vs. Electronics

For several years, the owners of contract security companies have been discussing whether electronics could replace guard hours or eliminate the need for a human security officer altogether. But until lately, they have not seen this as a real threat to their business.

However, while the contract security industry has been growing in the low single digit range for the past few years, the electronics security industry has been gaining ground and has been performing much better. While there are no statistics pointing to exactly how much, if any, revenue the electronics industry has taken from the contract security industry, there is concern amongst the owners of contract security officer companies that this may start happening as the contract security firm's customers look at ways to trim their security budgets.

The telecommunications giant, Time Warner Cable, recently entered the **home electronics** security market and there has been recent news articles indicating that phone companies such as AT&T and Verizon are considering entering this market as well – a natural progression for these conglomerates to expand their service offerings for their millions of customers. Experts in the industry are saying that this could indicate a game changing event for the electronics business. One scenario is that they would have to team up with the existing electronics companies to handle the installations, service and response, which could actually be good for some of the existing electronics companies; while others are saying that these companies have a very large band width that takes competing in the electronics sector to a whole new level and that would be concerning.

The question in the minds of owners of contact security companies is: will these companies expand their services to the corporate and small business market as well, thereby taking revenues from the contract security companies?

MITIGATING THE CONCERN

However, the above concerns are being mitigated to a large extent by the evidence that, so far, electronics has not taken away from the need for human security officers, but has been used as a way to enhance the overall needs for the security customers.

More and more contract security companies are getting into the video monitoring business as a way to keep the customer that's looking for this service. Those that can't afford the very large investment to get into the video monitoring business are teaming with installation and monitoring companies as a way to offer the service.

Take the case of Securitas: Securitas sold off its electronics system integration business, Niscayah, about 5 years ago, then after finding out that it did in fact enhance the contract security business, tried to buy it back. In the buy back process it lost its chance to acquire the company when Stanley Works outbid Securitas and bought the company for $1.2 Billion. Securitas has subsequently teamed with Convergent Technologies, a giant in the systems integration field whereby Convergent will be the electronics arm for Securitas.

There are many in the industry that say the electronics industry will never adversely affect the contract security officer revenues, but that the contract security officer function will form more of a "partnership" with the electronics security function – both are needed as a way to enhance effective security.

John Briggs, the Operations Director of First Security in London addresses the concern best in his exclusive blog at infologue.com; although this quote comes from a person not in the U.S. market, we feel it accurately describes the situation of humans vs. electronics in the U.S. The quote from Mr. Briggs follows:

> "So how can industry make the best use of this security mix, using both electronic and manned approaches in parallel so that they compliment each other and contribute to a safer environment? With so many different options available it is often difficult for customers to choose the best approach."
>
> "Companies are naturally striving to achieve the best security mix through analysing the various options available to them. CCTV, for example, has the benefit of acting as a deterrent as well as keeping a log of recorded surveillance. Yet at the same time companies still need a human, visible deterrent that is able to intervene and prevent disorder on the ground."
>
> "In our experience at First Security we have found that by adopting a combined approach, an effective, tailored solution can be achieved. There are countless examples of where this is being used to good effect."

“For instance, an automatic number plate recognition system (ANPR) placed at the entrance of a car park is able to recognise vehicles that have been registered with the police as stolen. When this happens, notification is flagged automatically to a security guard who determines where the vehicle is parked and reports this to the police for action. Awareness that a number plate recognition system is in use often acts as a deterrent.”

“Equally, turnstile technology acts as a physical barrier only allowing access to those with swipe cards or tags, which are read by computer-operated detectors. However, this does not stop individuals trying to beat the system by tailgating or jumping the electronic obstacle. This is where a security guard has an important role to play; firstly by acting as a warning and also, when incidents do occur, making a judgement, confronting the individual and dealing with the situation appropriately.”

“The right security solution does not have to comprise of technology alone or rely solely on manned guards. In fact, the best approach is to use both together to support and complement each other in an intelligent manner. Ultimately, an effective solution lies in creating the right balance to deliver an effective, safe and secure solution.”

MARGINS

Margins and EBITDA

Trend: The Gross Margins are trending down due to competitive pressures as well as operating costs. EBITDA shows no change.

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

1. The smaller contract security company is selling personalized service from the owner and many customers are willing to pay extra for this personalized attention.

2. The smaller contract security 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 security companies; but the competition to win these types of customers is very intense. Therefore, the large security 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 security company gets its foot in the door.

On page 16 is a chart showing the typical margins for the small, regional and national/international U.S. Contract Security Companies – with an insignificant portion of the revenue coming from the governmental sector (typically very low margin business). There is no margin or EBITDA information published for the industry. The information was prepared based on a limited number of financial reports we examined, along with interviews with owners of contract security companies across the U.S.

The chart indicates a drop in site and branch level profits over the past couple of years of approximately 2%. The overwhelming majority of the owners feel the margins will only get worse due primarily to more increases in the unemployment tax rates, anticipated increase in workers compensation rates, and having to absorb some of the cost of the Affordable Care Act that will come into full effect in 2014.

It’s interesting to note that although the margins at the site and branch level have slipped approximately 2%, EBITDA has remained relatively steady over the past couple of years. This is due primarily to a lot of “belt tightening” at the home office level accomplished by being more efficient in utilizing the non-billable personnel, or eliminating altogether some non-billable personnel through investing in technology.

Revenue, Profit and EBITDA Matrix:

	(4) Small Companies	(5) Regional Companies	National/International Companies
Revenue	100%	100%	100%
Profit at site Level (1)	18%	14 – 16%	11 – 13%
Profit at Branch Level (2)		9 % (6)	8%
EBITDA (3)	6-7%	6-7%	5-6%

1. ***Site level profit*** is the billing to the customer less all costs assigned to the site, such as: compensation for the billable officer, wages for the dedicated non billable supervisor (if any), uniforms, employer payroll taxes, workers compensation insurance, general liability insurance, employer portion of health benefits, cost of equipment dedicated to the site, union cost, cost for non billable roving supervisors if there are a lot of "cold start" sites, etc.

2. ***Branch Level profit*** is the site level profit less all the cost to operate the branch office (for companies with multiple branch offices) such as: all non billable personnel in the branch, office lease cost, telephone, supplies, etc.

3. ***EBITDA*** is Earnings Before Interest Taxes Depreciation and Amortization.

4. ***Small Companies - 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. In addition to the previously mentioned cost increases, gross margins are slipping due to the larger companies' recent interest in the smaller accounts, which typically have higher margins.

5. ***Regional Companies - Revenues $10 - $100 million***; owner less involved in customer relationships, operates multi-offices – usually volume is $5 - $10 million per office. These medium sized companies are also experiencing margin slippage due to the previously mentioned costs

6. The Branch Level profit can be much lower for regional companies with many small offices in areas with an insufficient volume to justify the branch office overhead necessary to service the volume. This is often found in companies that are expanding through entering new markets, or having to maintain a support office to service a large account with multiple locations.

MERGERS

Merger and Acquisition Activity

Trend: There was no increase in the merger and acquisition activity in the U.S. security sector during the 12 month period ending in July, 2012 over the same period ending in July, 2011.

Below is a summary of some of the *significant announced* transactions – pertaining mostly to the contract security and electronics sector of the security industry. The list includes foreign as well as domestic transactions for international companies with a significant U.S. presence. Although security company giants Securitas and G4S were very active in making acquisitions; their concentration was primarily in the emerging markets rather than the U.S. In fact, G4S indicates that 29% of its group revenues are already coming from the emerging markets and expects 50% of its revenue from these markets in 2018. Also, the list would not be complete without mentioning the deal that "almost happened" – G4S' proposed bid to buy ISS.

- ***April 2012 –*** **Comvest Investment Partners acquired the security and fire branch operations of UTC Climate, Controls & Security,** which will be called Red Hawk Fire & Security U.S. The business includes 50 branch offices and 1,350 employees and does about $250 million in sales and installation revenue annually.

- ***February 2012 –*** **Andrews International** "joins forces" with **U.S. Security Associates.** In its July 2011 issue, the "Security Letter" puts Andrews' volume at $350 million. After the transaction, the combined US Security/Andrews entity boasts revenues of over $1.3 Billion. The terms of the transaction were not publically disclosed.

- ***November 2011 –*** G4S Abandons Pursuit of ISS. Had this, approximately 7.5 BUSD, deal consummated, the G4S/ISS combination would have been the world's largest integrated security and facilities management company.

- ***October 24, 2011 -*** **Universal Protection Service, a division of Universal Services of America, announced that they have acquired Security Forces, Inc. (SFI) and their electronic security systems company, SFI Electronics, Inc. (SFIE).** After buying the $85 million SFI, Universal Protection Service is now the 5th largest security company in the U.S. and the 3rd largest U.S. owned security organization. In addition to the SFI acquisition, Universal bought several smaller companies during the reporting period.

- ***September 9, 2011*** - **Stanley Black & Decker Inc. (SWK), the largest U.S. toolmaker, completed its 7.6 billion kronor ($1.2 billion) acquisition of Niscayah AB, bolstering its presence in video surveillance and fire-alarm systems.**

- ***August 4, 2011*** - **Stanley CSS announced that they'd finalized the acquisition of First National AlarmCap, which operated under the name of Microtec Security Systems - as was, according to Stanley, Canada's fourth largest alarm company.**

- ***August 2, 2011*** - **Securitas has agreed to acquire the Belgian security services company Cobelguard. Enterprise value is estimated to MSEK 347 (MEUR 39).** Securitas is one of the leading security service providers in 45 countries in North America, Europe, Latin America, Middle East, Asia and Africa with over 280,000 employees.

Overview of Worldwide Completed Transactions

There were 74 ***announced worldwide*** completed transactions in the year 2011, compared to 65 in 2010 and 56 in 2009.

Also of interest is the number of guard company transactions: On a ***worldwide*** basis, the number of guard company transactions represented about 33% of the total transactions for 2011, but was 50% of the total transactions in 2010. This underscores the fact that the electronic security market is growing faster than the security officer market on a ***worldwide*** basis, as well as here in the U.S., as mentioned on page 11 of this White Paper report.

	2011				
	Q1	Q2	Q3	Q4	TOTAL
Guarding	8	7	5	5	25
Alarm Monitoring	9	8	7	7	31
Systems Integration	3	3	3	4	13
Other - Investigative, Armored Car, etc.	0	4	0	1	5
Total Announced Transactions	20	22	15	17	74

	2010				
	Q1	Q2	Q3	Q4	TOTAL
Guarding	5	10	6	10	31
Alarm Monitoring	2	4	4	5	15
Systems Integration	3	2	5	4	14
Other - Investigative, Armored Car, etc.	1		2	2	5
Total Announced Transactions	11	16	17	21	65

2011 Country	Guard	Alarm Monitoring	Systems Integration	Other	TOTAL
Argentina	1		2		3
Australia		1			1
Belgium	1				1
Bosnia	1				1
Canada	1	1		1	3
Chile	1				1
Costa Rica	1				1
Croatia	1				1
Denmark	1				1
Ecuador	1				1
France	1				1
India			1	1	2
Ireland		1			1
Jordan	1				1
Netherlands	1				1
Serbia	1				1
Singapore	2				2
South Africa			1		1
Sweden		1			1
Tanzania	1				1
Turkey			1		1
United Kingdom	1		1	2	4
United States	8	27	7	1	43
TOTALS	25	31	13	5	74

2010 Country	Guard	Alarm Monitoring	Systems Integration	Other	TOTAL
Bangkok			1		1
Bosnia		1			1
Canada				1	1
Denmark		1			1
Mexico				1	1
Montenegro	1				1
Poland	1				1
Romania	1				1
Singapore	1				1
South Africa	2		1		3
Sri Lanka	1				1
Thailand	1				1
United Kingdom	9		1	1	11
United States	14	13	11	2	40
TOTALS	31	15	14	5	65

Private Equity Groups Making Investments in the Contract Security Industry

The Private Equity Groups continue to be interested in making acquisitions in the contract security market, although there as been no indication of a significant acquisition of a contract security company as an initial buy by a private equity group in the past twelve months.

However, as the writing of this White Paper, there are a few large private equity groups seriously considering making a significant investment in the industry and hopefully we will be seeing announcements on completed transactions in the near future.

So why are private equity groups still considering making acquisitions in the contract security market? 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. However, in spite of this pent up demand to put the cash to work, most private equity groups are not interested in investing in contract security companies for reasons set forth later in this report.

However, there are a number of Private Equity Groups interested in the high margin side of the security sector (i.e.; biometrics, electronic security, etc.) and some are looking at **large** contract security companies (even though the industry is expected to grow at an "unexciting" rate of around 5% per year – mostly from increased billing rates and not increased security coverage) 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. There are presently several large privately held contract security companies "ripe" to be acquired by Private Equity Groups; the latest large transaction was the acquisition of Wind Point Partners interest in U.S. Security (now a $1.3 Billion company) by Goldman Sachs in July of 2010.

Also, some of the Private Equity Groups with investments in the contract security industry are reaching their time to exit. This may create "buy" opportunities for the large international security companies or other Private Equity Groups trying to get into the industry. Some well known Private Equity Groups presently with significant investments in the contract security industry are:

- *The Blackstone Group* (www.blackstone.com) has a significant investment in AlliedBarton (approx. $1.8 Billion in annual revenue).

- *Goldman Sachs* (www.goldmansachs.com) has a significant investment in U.S. Security Associates (approx. $1.3 Billion in annual revenue). Goldman Sachs purchased WindPoint Partners' ownership on July 29, 2011.

- *Pegasus Capital Advisors* (www.pcalp.com) has a significant investment in T & M Protection Resources (about $150 million in annual revenue).

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

- *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; and has since grown to be a significant player in the contract security industry through several "tuck in" acquisitions.

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 contract security industry for Private Equity Groups:

1. There are still many consolidating opportunities left for Private Equity 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 make "tuck-in" acquisitions for EBITDA multiples (from the buyer's pro-forma profit calculation) in the 5-6 range (and sometimes much lower).

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 contract security industry, in terms of future growth prospects, is much better than the general population of investment opportunities.

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

1. **Target for lawsuits:** Since the contract security companies are labor intensive, they are prime targets for 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.

4. **"Perceived" Bad Reputation:** The contract security industry in the U.S., unlike its counterparts in other parts of the world, has a reputation of getting its work force from the ranks of personnel that do not qualify for other industries. It's perceived as a low pay/high labor turnover, poorly managed industry, resulting in a "not so favorable" industry in which to invest. However, as mentioned earlier in this white paper, one of the reasons contract security companies get bad publicity is because they are larger targets than the public security providers – having about twice as many personnel as the public police forces.

MULTIPLES

Selling Prices for Large Contract Security Company Transactions

The following summarizes the large **announced** transactions for the past 13 years for U.S. sellers offering primarily contract security officer (guarding) services. 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. In some cases – as in the Cognisa/U.S. 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.

	Company Sold	Buyer	Revenue	EBITDA	Price	Price as Multiple Revenue	Price as Multiple EBITDA
1999							
	Pinkertons	Securitas	$1B	$33M	$407M	40%	12.3x
2000							
	Burns	Securitas	$1.5B	$65M	$576M	38%	8.9x
2002							
	Wackenhut	Group4/Falck	$2.8B	$73M	$570M	20%	7.8x
	Vance International	SPX	$95M	N/A	$67M	84%	N/A
2003							
	Allied Security	MacAndrews & Forbes	$500M+	N/A	$250M+	50%	N/A
2005							
	Cognisa	U.S. Security Associates	$100M	N/A	$40M	40%	N/A
2006							
	Vance International	Garda World	$155M	N/A	$67.2 M	43%	N/A
	Initial Security	AlliedBarton	$240M	N/A	$73.6M	31%	N/A
2008							
	AlliedBarton	Blackstone Group	$1.5B	N/A	$750M	50%	N/A
	Andrews International	Audax Gorup	$225M	N/A	$161M	72%	N/A
2009							
	Vance International	Andrews International	$128M	$4.5M	$44.25M	35%	9.8x
2010							
*	Paragon Systems, Inc.	Pinkertons Government Svcs	$140M	N/A	$34.5M	25%	N/A
2011							
*	Security Consultants Group	Paragon Systems, Inc.	$106M	N/A	$22M	21%	N/A
**	U.S. Security Associates, Inc.	Goldman Sachs	$765M	N/A	N/A	N/A	N/A
2012							
***	Andrews International	U.S. Security Associates, Inc.	$350M	N/A	N/A	N/A	N/A

N/A = not provided in the announcement

* These are the only announced transactions for a major provider of security 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.

** WindPoint Partners sold its equity portion to Goldman Sachs. The revenue amount shown is from the July 2011 issue of *The Security Letter.*

*** This transaction was announced as a merger.

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 U.S. market quickly. The announcements do not indicate 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 contract security 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 enjoying. However, the investment groups had to be competitive in the bidding process for the initial buy. As the investment groups made future acquisitions through the flagship company, 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 Prices for Small Contract Security Company Transactions

Selling Multiples

The prices being paid for the 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, and unfortunately even today, many owners thinking about selling are still using the traditional "street formulas" as a way to estimate the eventual selling price of the company. These "street formulas" use multiples of gross units (percentages of gross annual revenue or multiples of gross monthly billing) as a way to put an estimated value on the 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 few 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).

In fact, the "street formulas" were never used by most of the experienced buyers. These buyers use the profit at the account site level (which determines the buyers' economic return on the acquisition), along with the attractiveness of the accounts, quality of management going with the sale, geographic location of the accounts – along with several other characteristics important to buyer prospects.

The Affordable Care Act and the Anticipated Valuation of Selling Companies

The question on the minds of owners thinking about selling today is: what is the Affordable Care Act going to do the selling price of the company? If the seller has been preparing the customers for an increase in billing rates to take care of the additional healthcare costs, then the selling value of the company should not be negatively impacted. However, if there is an increase in the number of quality companies going on the market, the market may change to be more buyer favorable; in which case, the values of even the quality companies may diminish. Since there will be more companies on the market, the buyers can better "pick and choose" who they want to buy and have more influence in dictating the price. As of the writing of this white paper, the effect of the Affordable Care Act on the sale of contract security companies is still very uncertain, so we cannot predict how this Act will affect the sale of companies, if at all.

It's still a Seller's Market

The large contract security companies, which are usually the most generous on pricing, need to work hard to replace the business lost in the economic downturn – shareholders don't like to see decline in revenues even in a challenging economy. But these large companies are finding it difficult to maintain its 5% - 8% **net** growth through internal sales alone. A $500 million company with a 5% customer attrition rate has to grow 10% - $50 million - just to maintain a 5% overall net growth. Therefore they are looking to acquisitions to make up what they can't accomplish through their internal sales efforts - the larger the company, the more the need to make the smaller, tuck-in acquisitions as a way to keep the shareholders happy. In order to attract the attention of owners of attractive target companies they have to be generous in their offers.

Also, another reason the larger companies are buying and paying generous prices is that they presently have an abundance of cash on their balance sheet that they need to put to work and buying the smaller companies – with gross margins that tend to be 5% - 7% higher than the buyer's – is the most prudent use of this cash. However, while the generous buyers are still very active in making acquisitions, they are doing so with cautious optimism. Many are concerned that they need to preserve more of this idle cash to hedge against the uncertainness in the economy today, such as: the new healthcare bill, rising operating costs and loss of customers.

How long will the market be in the Sellers' favor?

Do the buyers' uncertainness signal a slow down in the acquisition activity? Some say yes, while some say the present economic climate may spur an increase in acquisitions as more and more "quality" companies come on the market. Do we see a "buyers market" on the horizon?

Factors Driving Owners to Sell in Today's Market

1. **The cost of implementing the New Healthcare Bill (Affordable Care Act) -** While it's unknown what the exact impact this bill will have on the contract security market, most owners think it will definitely mean less profits and loss of customers or billable hours. (See discussions on this under the section "Challenges for owners of contract security companies".)

2. **Small to medium sized companies are losing business to the national account providers** - This trend has been going on for several years and, according to the owners of many of these companies, the situation is getting worse. The large, well financed, companies are now going after the smaller customers that tend to have better margins. Previously these customers were too small to be a target for these large security providers. This trend is further underscored by the fact that the largest 3 U.S. Contract Security providers grew by over $1 billion in the past 18 months – a lot of the new business coming from the customers of their smaller competitors. This loss of business is causing the owners of the smaller companies to seriously think about selling before more business is lost to the large national companies.

3. **Possible lower valuations later -** Many owners feel that the challenges of the future will mean more companies will be put on the market, thereby causing a decrease in the valuations for a future sale.

4. **Probable increase in taxes** - (See discussions on this under the section "Challenges for owners of contract security companies".)

5. **Unionization** – (See discussions on this under the section "Challenges for owners of contract security companies".)

6. **Not being able or willing to keep up with the changes needed to stay competitive in today's market.** As we mentioned in the section on margins, the margin at the site level is dropping for all companies – whether small, medium or large and the way most of these companies are compensating is by getting more efficient below the site level line. These companies are reducing clerical labor and non billable overtime percentages by investing in technology that enables them to run the company with less people and at the same time be more efficient. However, the technology costs money and many owners today, especially those getting close to retirement age, just aren't willing to make the investment that doesn't give an immediate return. Also, the training, tax, and licensing laws are getting much more complicated, which in some cases have required an investment in outside consultants – which is another new expense; not to mention the expense that will be associated with complying with the new Affordable Care Act.

Why Owners Are Not Rushing To Put The Company On The Market, In Spite of Shrinking Margins and Revenue

In **Volume 15, No. 1 of our issue of *Notebook of Ideas for Divestitures of Security Guard Companies***, we mention four reasons owners are not putting their company up for sale now:

1. **Owners consider the industry recession proof:** Contract Security Company owners see continuing activity in the market, so they are taking a "wait and see" approach to selling, thinking that buyers will still be there when they get ready to sell.

2. **Decline in alternative investment opportunities:** Before the recent economic downturn raised its ugly head, many sellers of contract security companies made more money from the funds they invested from the sale of the company than they made while owning and operating the company. However, with the dramatic drop in real estate values, and money markets and the stock market declining so dramatically, doing this safely and profitably in the current economic climate would be very difficult.

3. **Owners have not yet "tested" their credit lines:** Many of the more fortunate contract security companies established or renewed its credit lines back when the banks were eager to please and more anxious to lend money, and the credit line will not come up for renewal for several more years. Most are still safe with their loan terms and have not actually talked with their bank about what to expect come renewal time. They feel reasonably, but cautiously, optimistic that their banks will continue to support their financial needs.

4. **Some companies have already lost value:** Some of the contract security companies have, in fact, already felt the effects of this challenging economy and have lost value – not because the selling multiples have gone down, but because the company has lost valuable and profitable revenue. The owners do not want to have to sell for a reduced price because they still have high expectations, so they are waiting for the economy to turn around before they think seriously about selling.

OUTLOOK

Challenges and Opportunities for Owners of Contract Security 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 could have a dramatic effect on owners of private security companies. Many of these developments are prompting the owners to seriously consider selling their company in 2012, before these expensive provisions (taxes and certain ACA provisions) take effect:

CHALLENGES:

New Healthcare Bill (**Affordable Care Act**) *and the Individual Mandate*

On June 28, 2012, owners of contract security companies received the news they were dreading (and most had not expected) about the Affordable Care Act – and it was "bad news" for this labor intensive industry. The U.S. Supreme Court ruled that the "Individual Mandate" provision of the Act was a tax (and not a penalty) therefore, for the most part, the Act was constitutional.

Up until the ruling, most owners were in a hold pattern on taking any action to adhere to the ACA provisions. Now owners are scrambling around trying to find out just how the ruling affects their business and what they need to do to get it in place. But as of the writing of this white paper, there has not been any clear guidance issued as to how the Act will work – particularly the precise requirements of an "Affordable Qualified Plan" – what companies employing more than 50 people must offer their employees or pay a large per employee penalty. 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 on to their customers; but they are saying this with reservation. While some owners started putting a clause in their customer contracts a couple of years ago that gives them the right to pass this additional cost along in the form of higher billing rates, they readily admit that some customers cannot, or will not, accept the price increase. This will result in lost customers, decrease in billing hours; or decrease in the security company's earnings, in the case where the security company has to absorb the additional cost.

The few optimistic thinkers are saying the ACA will create a level playing field when time comes to bid on a customer contract. In the past, the company that furnished its employees with an expensive health care plan had a difficult time competing with the company that did not provide an expensive plan, or provided no plan at all. With all the bidders having to have an expensive health insurance plan in place, for the most part the bidding companies are now working with the same cost structure.

The big winners will be the security officers and "maybe" the large security companies

Robert McCrie's March 2012 issue of the "Security Letter" says this about the ACA:

> "At first glance it may appear that this Act will have a material benefit for guard service providers employing fewer than 50. That's only partially true. The winners from this law are security officers who need health care coverage. (Some have told us they need to obtain health care as charity patients since their compensation is too low to be able to pay for the premiums.) The big winners will also be the larger service providers. They have the capacity, due to their larger scale, to self-fund health care benefits rather than buy commercial coverage. This will be one of the inducements for smaller guard service providers to seek a merger in the months ahead."

The industry is definitely in a state of uncertainty right now and some owners are anxiously waiting to see if Mitt Romney gets elected President in November before taking action to put an affordable plan in place. Romney has promised, if elected, to repeal the ACA the first days he's in office.

To view an article that ran in the "Security Management" digital edition on June 28, 2012 about this subject, click here.

Further Unionization of the Contract Security 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 contract security 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. The Bush tax cuts that were set to expire at the end of 2010 have been extended to December 31, 2012, but eliminating these concessions and raising several types of taxes are inevitable. If the tax increases are put into effect (or some of the present cuts are not extended, again) 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 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 before the tax increase. However, this gets worse: thanks to the Affordable Care Act, there's a 3.8% tax on investment income exceeding $250,000; which 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 at the present tax rates.

To view the entire article, click here.

Higher Unemployment and Other Taxes

Owners of large and small companies are experiencing very large increases in unemployment taxes as a result of the U.S. high unemployment rates – which presently does not have any significant improvements predicted for the near future. As state unemployment funds continue to diminish, the rates will continue to rise – already approaching double digits in some states.

Also, many municipalities are trying to pass legislation to tax services (not presently subject to sales tax) in an effort to make up for the diminishing tax based revenue resulting from the diminishing economy. This sales tax is usually passed on to the customer contracting for the security, but it definitely impacts the customer's cost of security, which in turn puts pressure on the customer to ask for price concessions from the security service provider.

OPPORTUNITIES:

Some owners see opportunities ahead. They are still experiencing growth and have positioned their company to "deal" with the challenges:

1. New Healthcare Bill creates a level playing field in the bidding process. Up until now, when several companies were bidding on new business; many of the bidders had very expensive healthcare plans and couldn't compete on the cost structure against the companies that were self insured, or did not provide and/or pay for the employees insurance. With the passage of the Bill, many of the companies that have been disadvantaged in the bidding process feel that this passage will help them win more new accounts as the playing field for new business is now more leveled. (See more discussion under "Challenges" above).

2. Many owners feel that the "in-house" security market may now open up as a result of the New Healthcare Bill and overall cost increases in employing workers – especially workers that have been with the company for a long time.

   Below are a couple of examples of municipalities looking for ways to contain cost as it's faced with having to raise rates to its customers

   - A recent article in the "Security Director News" tells about the Tennessee Valley Authority laying off 61 police officers for more technology and contact "guards". This came as a cost saving strategy as the TVA struggled with the inevitable need to raise the rates to its customers.

   - The November 2, 2011 issue of the "Security Director News" describes two municipalities looking at contract security as a way to save taxpayer monies. Admittedly, the larger security companies will benefit more from the "Healthcare" reason to move from "in-house" to contract security because the larger companies can afford the less expensive self-insured plans.

3. Some of the larger regional companies have recently improved their credit lines to open up a source of borrowings for small, tuck-in acquisitions. As companies that have not prepared themselves to handle the "challenges" come on the market, these well-funded regional companies may be in the position to make a few acquisitions at prices more favorable to the buyer.

4. Recent move to privatize security screening at airports could create a large market not available to most contract security companies since the TSA was formed after the events of 9/11.

ABOUT ROBERT H. PERRY & ASSOCIATES, INCORPORATED:

We initiate and manage the sale of privately-held security companies. Since 1977, we have represented over 150 owners located throughout North and South America, Western Europe, the Caribbean, and the Middle East.

ROBERT H. PERRY
& Associates, Incorporated

P.O. Box 67 (zip 27402)
301 N. Elm Street, Suite 710
Greensboro, NC 27401 (U.S.A.)
Tel: 336.272.2266 ⬩ Fax: 336.272.1142
rhpa@roberthperry.com ⬩ www.roberthperry.com