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THE "DOWN" ECONOMY— INSIGHT FOR OWNERS OF SECURITY COMPANIES

The Wall Street Journal reporters did not mince words in summing up the dismal state of the economy in the October 16, 2008 issue. The front page heading read "Economic Fears Reignite Market Slump." The article went on to say that "The latest data suggest that the U.S. economy is poised to fall into its deepest recession since the early 1980s. That news, coupled with renewed signs of trouble in the all-important markets for credit, reignited the sell-off in stock markets, all but wiping out the huge gains that shares had made in Monday's [October 13th] rally.

The Dow dropped 733.08 points, or 7.9%, to 8577.91 as recession fears and continuing doubts about the world financial system's prospects shook investors. Wednesday's decline marked the Dow's largest percentage drop since October 1987 and the second-biggest point drop ever [the largest point drop was about 2 weeks ago]. The index is down 21% this month and almost 40% from its record close a year ago."

In this same daily issue of The Wall Street Journal, another article told about how companies were "...draining billions of dollars from 'rainy day' revolving loans arranged previously with banks. ...some of the drawdowns are out of a sense of caution and prudence, hoping to ally jitters about their access to funding. Others simply appear desperate for cash."

This serious erosion of the markets, now estimated in the trillions of dollars, is not only a US problem, it's a world-wide concern. Almost every individual and business—large and small—in this country, and around the world, is somehow affected by this downturn in the economy. And the markets and general economic conditions will not recover quickly. Many experts predict that it will take several years of disciplined spending and government oversight to gain confidence back into the economy.

But how does this news affect the owners of security guard companies?

HOW THIS GLOBAL ECONOMIC BAD NEWS AFFECTS THE SECURITY GUARD INDUSTRY

Owners will be faced with new challenges in growing and running the company on a day-to-day basis.

Some reports indicate that the guard industry will not be as adversely affected by what's going on with the economy as the general population of industries. The reports state the belief that security is a recession-proof business; citing the notion that even when the customers' buildings are empty, someone has to look after the premises.

The events leading up to this disappointing financial correction seemed to support this theory. Although, the economy has been slowing down over the past several months, indicating signs of tight credit, two major deals were announced in the security industry:

- In September, the Blackstone Group bought AlliedBarton (a $1.5 Billion company) for a reported $750 million.

- In October, Andrews International announced that it had changed its financial sponsor. The new sponsor, the Audax Group, is a much larger financial group.

In announcing the sales, both companies indicated that the alignment with the much larger investment groups allows them access to a larger amount of financial resources already in place; enabling them to enter new markets and grow organically, as well as through strategic acquisitions. Also, there have been a large number of unannounced transactions this year and our firm in particular has had a banner year due to this robust activity.

However, some security companies have fallen victim of the downturn. One large publicly held security guard company has seen its market cap fall 90% in recent weeks due to the high cost of borrowing money, which made it miss its reported earnings estimates, causing its stock prices to take a nosedive.

Many company owners, who haven't felt the pain just yet, will probably get unpleasantly surprised when they pay their next visit to their friendly banker. In the past, our economic system received its fuel for growth mostly from the commercial banks. The events of the past few weeks have caused the banks to change the lending policies. In the months ahead, as security guard companies need to increase the credit line or even to renew the present line, the owners will discover that the banks have become a lot more cautious in its dealings; thereby making loans much more difficult to obtain. If the banks do give the loans, it will require a much higher interest rate and most certainly will require a larger amount of collateral.

This increase in the cost of money and the downturn in the economy in general, will make running and growing the security guard company particularly challenging:

- Growing will become much more difficult since growth requires working capital, which usually comes from the banks.

- Running the company, irrespective of growth, will become more challenging. As the economy slows down, the customers of the guard company will have a more difficult time in paying their bills - thus the guard company's days receivables outstanding ratio will start to increase—this has a dramatic negative impact on the cash balance, the most important asset necessary to making the payroll to the guard force.

- The competition to get new accounts and maintain existing accounts will increase, thus driving the margins at the account level even lower.

Other reports indicate that there will be challenging times for owners trying to sell their security guard companies in this dismal market.

The Environment for Selling Companies is Changing

Many of the buyers that were active in acquisitions over the years have stepped to the sidelines in today's market. These were companies that relied on a combination of cash-on-hand and bank loans to fund the acquisitions. Many still have a large balance on their credit lines with the banks, but are preserving it to fund the increased working capital requirements for running the company on a day-to-day basis caused by this bad economy.

On the good news side, several buyers still remain in the market and have ample cash reserves in place to make acquisitions—and are targeting mostly the small to mid market size companies, since these buyers would not have to depend on the capital markets to fund the transactions.

Also, large investment groups that already have their funds committed, or have ample cash, are now looking at the security guard space as possible investments. They turned away from buying security guard companies in the past because other industries offered them a better return on investment. The security guard industry was looked upon as a low margin, high liability and low barrier to entry industry. With the entry into the industry by two investment group leaders, the Blackstone Group and the Audax Group, many other investment groups are seriously considering major investments in the security industry. This move was also prompted by the published information that the security guard industry will continue to grow faster than the general economy; and is somewhat recession proof.

Getting through transactions with these groups will be more challenging. For an initial purchase, most of the investment groups are only interested in companies with revenues in the $100 million and over range; although there are some that say they will consider companies with revenues as small as around $50 million. They are financial buyers, therefore place a lot of emphasis on the historical bottom line earnings of the target companies. Since they are not already in the security guard business, they don't bring synergistic savings to the transaction. They usually pay a high multiple for the first company they buy in order to entice the owners of the company to sell; then pay lesser multiples for future acquisitions as a way of justifying premiums for the first company.

A very important aspect of changes on the horizon for sellers of security guard companies has to do with the upcoming presidential election. The two presidential candidates have significant differences of opinion on what it takes to get the economy back on track. Senator Obama is proposing to double the present capital gains rates. Senator McCain is proposing to cut the present capital gains rate in half. These are two very different approaches to fixing the sick economy—with dramatic impact on sellers. As an example: under the present tax structure (assuming a state tax rate of 5%), owners selling their company for $10 million will walk away with approximately $8 million after taxes. Under Senator Obama's plan, the same sale would net the owners about $6.5 million and Senator McCain's plan would net the owners around $8.75 million.

Suggestions for Running the Company in this "Down" Economy:

- **Keep an Eye on the Accounts Receivable Balances—** The old adage that "cash is king" rings especially true in a down economy. However, just preserving the cash balance at its normal level becomes difficult as the security company's customers experience hard times. The company's accounts receivable clerk should keep a very close eye on each customer's account balance and pay particular attention to patterns of slow payment. Slow payers should be contacted immediately by a senior officer of the company—if necessary. The company should also consider expediting the sending of invoices after the end of a billing period.

- **Make Sure the Credit Line is Safe—**The company should check with the bank well in advance of the time the line comes up for renewal to find out whether or not the line is going to be renewed—the amount and interest rate. The credit line is the lifeblood of the company and is just as important as the customers; without it, most companies can't survive; which becomes especially true in a down economy. However, as stated above, banks have become a lot more cautious. The rules of lending change in a down economy—not to the borrower's favor, unfortunately. The amount of funds the banks have available to lend has been limited. What the security company owner needs to know is that the person he usually deals with is not necessarily the person that approves the loan. The loan is approved by a committee, who often only see the information regarding the sufficiency of the collateral, the history of how the company has complied with covenants of past loans and the company's current ability to repay the loan on a timely basis. The company should also monitor the compliance with the loan covenants more frequently than normal and make sure it stays within the safe limits at all times. This is not a time to be asking the bank to excuse loan covenant violations. If the company feels that it may have a difficult time in renewing the line of credit when the times comes to renew, then the company should immediately start looking for alternative banks. In fact, it would be a good idea to have this back up plan in place at any case.

- **Reduce Administrative Costs—**For the past couple of years, as the competition in the market place has become more intense, the margin at the account level has dropped. And in this dismal economy, the healthy companies will become more competitive, thus putting even more pressures on the margins. Since the competitive environment controls the billing rate to the customer and to a large extent, the pay rates, a company can't improve much on the margins at the site level. The cost savings will have to be made below the gross margin line and it's here that the competition will become intense in months to follow. Most companies we've visited have had a lot more overhead in place than the level of revenue justified and do not have the IT systems in place that enable them to control non billable costs, etc. Companies looking to survive in this economy will be looking for ways to reduce these "back office" costs, while not sacrificing the level of service to the customers.

Suggestions for Selling the Company in this "Down" Economy:

Chances are, unless a company is well under way with negotiations, a transaction will not be completed in this 2008 year. Based in the promises of the presidential candidates —the winner to be decided upon in about a week—sale transactions completed in 2009 or thereafter, will certainly produce dramatic results for the sellers.

- **Get the Company Tax Ready—**The amount of taxes a seller pays on a sale transaction has always been one of the major decisions in whether or not to sell. It becomes even more important if either of the presidential candidates gets their way in changing the capitals gains rates. If the taxes increase (under Obama's plan) structuring the transaction in such a way as to minimize the portion that gets taxed becomes very important. This may involve the change of the corporate form (from "C" corporation to "S" corporation, but be aware of the restrictions). Obviously, the transaction under McCain's tax proposal plan would be a lot more attractive to an owner, but nonetheless would require some planning. An owner thinking about selling should start talking with the tax advisors now about any changes that need to be made in the corporate form, the timing of the transaction, etc.

- **Become an Attractive Target for Buyers—**Since buyers will be watching their own cash needs and borrowing capacity when they make acquisitions under this down economy, they will be cautious in their buying criteria. Not all companies will be salable in today's environment, or are not salable at a price the owners deserve for their many years of hard work. The buyers will be looking for companies that equal or upgrade their present account base, or get them into certain vertical markets. The owner looking to sell should be aware of what the buyers are looking for in a purchase candidate and build on this requirement.

- **Retain a Transaction Manager with Industry Experience [Note: Transaction Manager, also known as Investment Banker, Broker or Intermediary.]—**As previously indicated, there are many investment groups looking to make investments in the security guard sector, given the notion that it's a recession proof business. And there are still a number of larger security guard companies making select acquisitions—at unprecedented premiums. The problem comes in knowing which investment groups already have their fund in place, which industry buyers are making acquisitions and doing this without advertising that the company is for sale. The owner looking to sell should seek the advice of an experienced transaction manager with the resources and the credibility in the industry to find the investment groups and the industry buyers without having to do a massive search (which would certainly lead to the marketplace and the company's competitors finding out that the company is for sale). A transaction manager that has been in business for awhile will have a following of buyers (including the generous investment groups) that are already qualified to handle the transaction. The transaction manager will also be able to work with the tax and accounting advisors on the best structure of the transaction in order for the seller to maximize the after tax proceeds of the sale—again, a very important aspect of selling in this economy.

Written by Robert Perry

This periodic informational letter is published by:

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

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