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IF THE ECONOMY IS SO BAD...

WHY AREN'T THERE MORE SECURITY GUARD COMPANIES FOR SALE?

In spite of all the dismal global economic news and predictions causing many owners of companies in general to put their company up for sale, there isn't any "panic" selling by owners of security guard companies. This is sending the message that the security industry is relatively "safe"— at least for now.

Owners who might normally be sellers are instead taking a "wait and see" approach. Why are they waiting? What factors are at work in the current economic climate that might impact the security guard industry and thereby the value of the companies? Unfortunately the economic conditions are changing so fast, there's more lingering questions about what to do than there are answers.

What owners might not know is that while sales continue (though less frequently), and the outlook for the industry is better than for the economy in general, the "rules" for buying and selling security guard companies have changed because buyers have changed their buying criteria from when the economy was more robust. These buyers are not necessarily buying just to add volume. What's more, the ailing economy and tightened credit can negatively impact some companies, especially smaller ones, in ways the owners might not anticipate, making it more difficult for them to run the company on a day-to-day basis.

Why Owners Are Waiting

1 ***Owners Consider The Industry Recession Proof.*** Security guard 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. Their company is still doing all right, so why hurry? In addition to what owners are seeing, they're also hearing some gurus who predict the future for the security industry saying that there will be little if any growth, but by the same token, if there is any shrinkage, it will be less significant than the large downturn expected for the general economy. **And some security experts are saying there may actually be a large increase in security as the worsening economy increases the vulnerability to terrorists attacks and a rise in local crime.** This is sending owners the message that the industry is relatively recession-proof.

What a lot of owners do not realize is that security guard companies are among the last segments of the economy to be adversely affected by a **prolonged** recession. Even though the predictions are that the security industry will not be impacted as badly as the rest of the economy, the bad part may not have arrived yet if the downturn we're in continues. Conversely, when the economy turns back around, security guard companies may be the last to recover. It's also interesting to note that security guard companies do not usually feel bad effects of a short recession, which has been the case for the most recent economic down turns. It's the **prolonged** recession periods that could adversely affect the industry; unless of course the experts who are predicting an increase in security turn out to be correct.

2 ***Alternative Investment Opportunities Are Not As Attractive.*** Before the recent economic downturn raised its ugly head, many sellers of security guard companies made more money from the funds they invested from the sale of the company than they made while owning and operating the company. They could invest the proceeds from the sale in real estate, stocks, money market funds or another thriving business that was less stressful than the guard business and do quite well financially. 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 to say the least.

3 ***Owners Have Not "Tested" Their Credit Lines.*** We have seen very few security guard companies that are able to operate without outside financing. In fact, the companies that have had attractive growth curves have done so through line-of-credit financing arrangements. For the recent period leading up to 2007, bank loan terms and rates were more liberal than at any other time in the past 20 or so years. Things in the credit market have changed dramatically.

Many of the luckier security guard companies established or renewed their loans back when the banks were eager to please and were anxious to lend money, and their 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.

As we began sliding (more like crashing!) into the recession, the banks began to dramatically tighten credit and increase the cost of loans. Loan credit terms that previously permitted debt-to-cash flow ratios of 4-5 times have now been dramatically reduced to the 2.5 times range, cutting the company's borrowing capabilities in half. It's important to note that the measure for the credit terms is not profits, it's cash flow, and the two can be dramatically different. Cash flow can be negatively affected as customers start falling from the "current" to the "past due" column, but the company's reported profits are not affected by the slowdown in collections until the amount owed becomes a bad debt write-off.

Some of the owners who are waiting haven't visited their friendly banker to talk about getting their credit line renewed since the downturn in the economy. They do not yet know that their banker may be less friendly these days because the banks themselves are struggling to keep their cash-to-loan ratios in line with the requirements. In fact, we're already starting to see some security guard companies divest certain geographical areas that are not doing so well financially, or vertical account markets that may be a minor part of their overall account concentration as a way to raise cash to combat the line-of-credit dilemma.

In many instances, the banks are actually looking for reasons to not renew the loans because the banks themselves are under pressure to bring their outstanding loan balances back in line with their cash reserves to improve their increasingly important risk ratios. Many economists feel that this trend will continue for some

time despite the government's efforts to force the banks to ease up on the loan requirements.

We are already starting to hear war stories about credit lines being reduced for medium-size guarding companies. In some instances credit lines are terminated even before the credit line reaches renewal dates by banks they've long done business with. Banks put language into the loan credit terms that give the banks a lot of leeway in deciding when a company may be a bad credit risk even though the loyal banking customer may in fact be financially healthy with a record of prompt payments.

To quote a recent Associated Press article, **"The Federal Reserve in its quarterly survey of bank lending practices released Monday (Feb. 2, 2009) found large numbers of banks reporting tighter credit standards across a broad range of loan products."**

Nearly 60 percent of banks responding to the survey said they had tightened lending standards on credit card and *other* consumer loans, about the same share as in the previous survey released in early November. And about 80 percent of domestic banks said they tightened lending standards on commercial real-estate loans, slightly less than the roughly 85 percent that reported doing so in the previous survey.

All told, though, the proportion of banks that **"reported having tightened their lending policies on all major loan categories over the previous three months stayed very elevated, the Fed concluded..."**

4 ***Some Companies May Have Already Lost Value.*** Some of the security guard companies have, in fact, already felt the effects of this bad economy and have lost value. 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. These companies may have had a heavy concentration of accounts in sectors that have been hard hit by the sagging economy such as retail chains that have filed or are close to filing for bankruptcy. The value has been lost not because the accounts left; the accounts are still there, but can't afford to pay for services, which strains the guard company's working capital. Remember, when it comes to credit terms, banks look at cash flow. Ironically, some of the tardy accounts could very well be victims of the tightened credit market themselves, creating a snowball effect that security guard company owners cannot control.

There Are Still Attractive Opportunities For Sellers In Today's Market

In spite of all the bad news about the economy, some sellers in today's market are receiving very attractive multiples. They're selling now and taking advantage of some of the aggressive buyers' need to buy.

Large Security Companies. Some large security companies secured bank loans well before the credit crunch, which are good for several more years. They are sitting on a lot of cash. For them, select, strategic acquisitions prove a better use of the idle funds than a low-return financial instrument. However, they know they will probably not be able to get more acquisition funds in today's tight credit environment, which makes them very careful in selecting the companies they buy.

For these buyers, current acquisitions are strategic to long-range plans to enter vertical markets or get stronger in certain geographical markets. In looking at acquisition candidates, they are very selective—focusing on geographic areas of interest and the type of accounts they are willing to accept. They are looking for companies that have accounts that will not be adversely affected by the recession.

Most importantly, the acquisition candidate in today's market has to be squeaky clean. The seller has to be able to produce credible information in the due diligence. For the most part, the aggressive buyers are staying away from buying the shares of the selling company. Instead, they are insisting on asset purchases only. The difference between the two alternatives could be very costly from a tax standpoint, depending on the seller's corporate structure.

Investment Groups. Investment groups are now looking at security guard companies as investments of choice. In the past, security guard companies were not as attractive as most of the other opportunities available to the investment groups, but now that the high tech, manufacturing and retail sectors have fallen out of favor with them, they are looking for "safer" places to put their investments. In spite of the downturn in the general economy, security is still seen as somewhat of a recession-proof industry.

These groups are aggressively contacting the medium to large security guard company owners, either directly or through aggressive brokers they compensate for finding owners interested in selling. Some of the investment groups are generous, have already done their homework about the industry and have the money

in the bank. However, many of the investment groups in the marketplace today ultimately have to go to a bank to complete the deal, and because the banks are not lending money, the deal cannot be finalized. By that time, the company owners have already spent a considerable amount of money on attorneys and accountants, not to mention countless hours in negotiations leading up to the aborted transaction.

Unfortunately, the groups that are not already financially qualified are not easy to spot. Owners who get into serious negotiations with these groups must conduct a thorough financial due diligence on the group before spending a lot of time and expense in negotiations and document preparation.

Choosing the Right Time to Sell – Still A Question Mark

Is it wise to wait to sell? Is it better to adjust retirement expectations? The question is impossible to answer without a magic crystal ball. There is no way of predicting when the economy will turn around. While waiting for the economy to recover, tightened credit could instead reduce the smaller company's value for a sale to a third party. It could also negatively impact the company's overall financial strength making it more difficult for the owner to run the company on a day-to-day basis, much less grow the company.

As an owner, if you are considering selling, but planning to wait until your company's value reaches expectations, be sure to keep very close tabs on your company's finances and accounts. Do not assume your longstanding relationship with your bank will protect you from the credit crunch. Talk to your bankers well before your loan comes up for renewal to see what to expect and to allow you to plan ahead.

If you do decide to sell, be aware of the new criteria that buyers are using and critically assess if your company fits. If you are thinking of entering into an agreement with an investment group, take precautions to ensure they have the funds in place before investing time and money negotiating details.

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This periodic informational letter is published by:

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