Vol. 9, No. 2

NOTEBOOK OF IDEAS FOR

DIVESTITURES *of* SECURITY GUARD COMPANIES

A periodic informational letter published by Robert H. Perry & Associates, Incorporated
Dedicated to Buyers and Sellers of Security Guard Companies

WHAT THE SELLER SHOULD KNOW *BEFORE* SIGNING THE LETTER OF INTENT

The usual process for selling any company is to first provide the buyer prospect with very general information; sufficient for the prospect to determine further interest, but not to reveal competitive secrets.

The seller and buyer prospect will then discuss various aspects of the business, followed by a letter of intent that sets forth, usually in broad terms, the basis on which the buyer proposes to purchase the company. The letter of intent, which is prepared by the buyer, requires the seller to take the company off the market as to other purchaser prospects. It also starts the process of the detailed due diligence at which time the buyer will see the competitive information, such as customer names, billing rates, operating procedure manuals; and may talk with key personnel.

Having reached this point in the process, the seller has lost its chance to negotiate a better deal from other purchaser prospects, and has shown the buyer prospect its competitive secrets. It's now critical that there are no misunderstandings or surprises that keep the transaction from closing. This is even more important for security guard company sellers when negotiating with a competitor - usually the most logical buyer.

The likelihood that the transaction will be successful is very high if the process is properly managed. A transaction manager, who should be experienced in handling the sale of security guard companies, will have qualified the buyer prospect's financial resources to consummate the transaction, and track record from previous deals, before the negotiation process begins. Before the letter of intent is signed the manager will guide the owner in understanding the details of the proposed transaction that determine the price, terms, and other conditions that are important to the seller.

An experienced transaction manager will know that there are many pricing computation methods and conditions to the sale that are unique to security guard company transactions. The manager will know that every active buyer in the marketplace today has its own criteria when looking at seller candidates. The different assumptions underlying each of these various models make it highly likely that a seller not being represented by a manager will not understand the letter of intent, or worse yet, will misinterpret it.

For these reasons the seller should not make any assumptions on the important details of the transaction not spelled out in the letter of intent. The seller's manager should ask the probing important questions - how the selling price will be computed; the conditions that affect the seller's ability to receive the agreed upon price; and, if it's important to the seller, how the employees will be treated after the sale. Here are a few of the details a seller should know before signing the letter of intent:

The seller should understand how the price will be computed.

Experienced buyers go through return on investment (ROI) computations in arriving at the price they are offering for the company. This price is based on general financial and account information provided to the buyer prospect. It often takes several weeks after the initial offer for the transaction to close, and this preliminary information on which the buyer made its offer usually changes. For example, the seller may add or lose accounts, or have price increases. This necessitates setting up a price adjustment mechanism in the purchase agreement, which increases or decreases the initial offering price based on those changes.

There's not a standard formula in the industry for making this adjustment. Just as it uses its own pricing and valuation models, each buyer also has its own unique method for the adjustment, which usually uses gross units as its base. As an example, the adjustment may be based on a percentage of annual gross revenue or multiples of gross monthly billings. The adjustment may also be made as a multiple of changes in net profits of the company.

This reconciliation of the initial offering price to a company's actual level of business at closing becomes even more complicated. Not only do buyers differ in the mechanism they use in making the adjustment, they also differ in choosing the time period on which the adjustment will be based. Some use the book of business at the day of closing; others use a two-week period before closing; while others use various other methods such as three-month average before closing or trailing twelve-month (TTM) revenue.

The seller needs to know which of the above methods the buyer will use. The method and the time period determine what the seller will get out of the transaction. The resulting difference between the methods may be significant.

The seller needs to know what assets or liability assumptions are included in the offering price.

This is one area where there's likely to be a misunderstanding between the parties regarding the offer; and the misunderstanding could represent very large discrepancies in price and/or terms. This happens when the buyer simply states that it is buying the business for a certain sum. Whether the transaction is being structured as a stock or asset purchase, the seller should make sure there's an understanding of what is included in this offering price: Does it include equipment? Does it include working capital? If it includes working capital, does it also include cash in the bank?

As a result of several financial buyers recently entering the security guard business, many of the offers – even in asset transactions – now are assumed by the BUYER, but often not the seller, to include "normalized" levels of working capital (cash and accounts receivable less payables and accrued payroll).

The precise amount of working capital usually

cannot be agreed upon without some financial due diligence by the buyer. This is why the amount of "normalized" working capital in the letter of intent may be left open for the parties' agreement later in the process. At a minimum the seller should have a general idea or estimate of the amount of working capital the buyer is expecting.

The seller should also understand whether the offer includes payment for a level of temporary or seasonal work and separate divisions that may be involved in the operations – such as mobile patrol, investigations or alarms.

The seller should know if the offering price is conditioned on the accounts continuing for a period after closing.

If the seller finds out that the buyer requires a guarantee of accounts, it should understand the terms and conditions of the guarantee:

- What is the time period?
- What is the multiple used to compute a shortfall?
- Will the seller get credit for accounts brought in during the guarantee period?
- How is the credit computed?
- Can the credit exceed any shortfall amounts (resulting in a purchase price increase)?

The seller should also find out how the company will be run during the guarantee period: Is the seller involved in maintaining the accounts? Are the key personnel going to be hired? Will the seller be protected from a shortfall should an account leave because of poor service by the buyer or billing rate increases?

The seller should understand the structure of the transaction.

Is the purchaser buying the owner's stock or is the purchaser buying the assets from the corporation? There's a significant tax difference in these two structures determined by whether the seller's company is organized for federal (U.S.) tax purposes as a "C" or "S" corporation, limited liability corporation (LLC), limited liability partnership (LLP), or a sole proprietorship.

Also, relating to the structure of the transaction and the tax status of the selling entity, the seller needs to know how the non-compete agreement will be handled in the purchase contract. Will part of the purchase price be allocated to the covenant? If so, how much? Some sellers will want a low allocation, while others may want it as high as possible - both circumstances depending on the seller's tax status. However, the allocation amount has to be agreed upon by the parties, and the buyer's policies and tax status often counter the needs of the seller. An unfavorable allocation can be very economically disadvantageous to the seller. It's for this reason that the seller should know those details before signing the letter of intent.

The seller should understand the conditions that will be put in the non-compete agreement.

While many owners sell their company in order to retire and are not concerned about the conditions put on a non-compete, there are other sale transactions that may concern an owner in what can or can't be done after the sale.

For instance, the owner may be selling the guard business, but wants to stay in the investigative or alarm business. Or the owner may be selling and moving, because of family or health reasons, to another part of the country and will start another security company. In these instances, or other circumstances, the owner, before signing the letter of intent, should make sure the non-compete agreement will not contain prohibitions from pursuing the activities for which the company was sold.

The seller needs to understand how credible the offer really is.

Before the seller signs the letter of intent, which again requires the seller to take the company off

the market and start the detailed due diligence process, the seller should assess the probability of the buyer consummating the transaction. Some of the questions the seller needs answered are:

- Has the buyer made a thorough examination of the selling memorandum (the presentation usually prepared by the transaction manager representing the seller)?
- Are there any issues resulting from the memorandum that need to be resolved before going any further?
- Is the buyer relying on bank financing in order to complete the transaction? If so, the seller needs to make sure the bank is on board with the deal.
- What is the buyer's approval process?
- Does the transaction have to be formally approved by the board of directors – if so, when do they meet to make the approval? Also, what is the board's track record of approving or turning down similar transactions?

The seller should also inquire through the deal manager about the buyer's performance in prior transactions. Were the sellers satisfied? Were there issues that came up after closing for which the buyer took an unreasonable position? Has the buyer completed the due diligence stage in negotiations with other sellers, then did not complete the deal? If so, why?

This presentation is not intended to be an all-inclusive list of the points the seller needs to know early in the sale process and before signing the letter of intent. Some of the above would not be necessary for large transactions . There are many other items not listed that are equally important - such as other terms of the purchase contract, and time period for completing the transaction. RHPA

Written by: Robert Perry

This periodic informational letter is published by:

ROBERT H. PERRY
& Associates, Incorporated

We initiate and manage transactions for sellers of security guard companies. Established in 1977, we have successfully represented over 130 sellers located in the United States, Canada, Western Europe, South America, and the Caribbean.

P.O. Box 67 (27402)
301 N. Elm Street, Suite 710
Greensboro, NC 27401 (U.S.A.)

Tel: 336.272.2266 ◆ Fax: 336.272.1142
E-mail: rhpa@roberthperry.com ◆ www.roberthperry.com