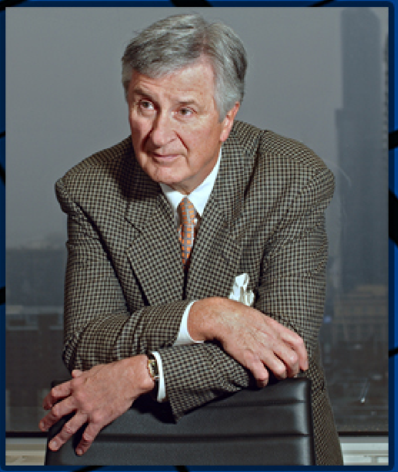
HARDING SECURITY SERVICES INC.

Presents …

10 Rules to Keep in Mind when doing Security Deals



C.M. Victor Harding CA

UNLOCKING OPPORTUNITIES IN THE SECURITY INDUSTRY

10 – 70 Shaftesbury Ave | TORONTO | M4T 1A3 | p: 416.925.7474 | f: 416.915.6259 | victor@hardingsecurity.ca

OVERVIEW

- This webinar is designed for both buyers and sellers in the security industry.
- We will focus here mainly on deals with **alarm, integration, fire and guard companies**.
- In fact these 10 rules could apply to deals in any industry.
- Although my company is an intermediary that focuses on the security industry, I make no attempt here to push the use of intermediaries here or Harding Security in particular.
- The facts are acquisitions are an important part of the security industry because:
  - The industry continues to show growth in most of the different sectors, has proven fairly recession proof and for the most part does not have large barriers to entry. These factors attract buyers
  - Acquisitions in general allow a company to “scale”. There is no way that Telus, Securtek or API Alarms could have grown to what they are today.
- Because it is much harder to grow your account base *organically* in the alarm industry today, acquisitions these days have become the main channel of growth.
- Deals can be done in the industry by 3 kinds of buyers-a) strategic buyers (industry players), b) financial buyers (private equity) or c) individuals.

ACQUISITIONS ARE ALL ABOUT "FREE CASH FLOW"

- In its essence, an acquisition deal is a buyer putting a hunk of cash up front betting that their return will be *the Free Cash Flow from the target company over several years after.*
- If you are thinking of selling, think about what the Free Cash Flow is from your company.
- Free Cash Flow means the Cash from Operations after considering any necessary Capital Expenditures and eliminating any unusual, one time revenue or expenses.
- Although monitored accounts are mostly valued as a multiple of their RMR, it is really their underlying Free Cash Flow that is so valuable.
- It is easy when throwing around multiples to forget that it is Free Cash Flow that is critical.
- This Free Cash Flow could be calculated as the monitoring revenue less any cost of monitoring. The margin here is sometimes as high as 75%
- The great thing about accounts is they keep giving up cash flow year after year.
- Free cash flow is why higher priced accounts with lower attrition attract higher multiples. Each of these variables increases the free cash flow from the accounts.
- Buyers want to see 3 -5 years of financials of integration, fire and guard companies because they want to be able to calculate the average free cash flow
- Warren Buffett says he looks at the free cash flow from a company before investing in it.

ACQUISITIONS ARE ALSO ALL ABOUT “RISK”

- It does not always show itself and buyers don’t always talk about it but RISK is always there in the back ground on any deal.
- A buyer is often putting up 3-5 X or more a company’s earnings to buy a company. The multiple often is decided by a buyers feeling about RISK.
- There is risk whether you are a buyer or a seller
- Here are some things that increase risk for a Buyer:
  - Small companies in general are risker bets than larger companies
  - A company that is not growing its revenue or profitability is riskier
  - A company whose revenue is too concentrated in a few customer hands is riskier
  - A company that is too dependent on the owner is riskier
  - A company whose revenue & profit fluctuates a lot.
  - A company with nothing unique about its business- no moat as Buffet would say
- Risk is also there on the Sellers’s side:
  - Employees and customers hear that a company is selling and leave.
  - The buyer cannot get the necessary financing to complete the deal.
  - Holdbacks or earn outs on a deal are not paid by the buyer.
- In regards to alarm accounts when we talk about a Seller having a high % of signed contracts, or low attrition or a good management team in place, these are all about reducing risk for a buyer

DON'T SELL " IN THE DARK". GET A VALUATION DONE FIRST

- Almost every article I have read over the last many years about what to do when selling your company has the advice of *getting a valuation done before you sell.*
- This seems obvious to most of us many owners don't do it.
- I never attempt to sell a company without giving the owners a ball park estimate of value.
- Remember that in its essence a valuation is an attempt to get at the Fair Market Value of your company - but remember that this concept in itself is theoretical.
- Fair Market Value can vary from your final selling price for many reasons:
  - Various Buyers can value a target differently depending on their circumstances
  - Strategic buyers will often value a target higher than a financial buyer because they can wring synergies from the deal.
  - Fair Market Value will only be attained if a deal is widely shown
- There are some things to be aware of when getting valuations done:
  - Full valuations done by some Chartered Business Valuators don't always reflect the market in the industry the company is in.
  - CBVs often undervalue Recurring Monthly Revenue (RMR). RMR is worth more than ordinary installation and service revenue
- In the end Value is directly connected to Free Cash Flow and Risk.
- In order to sell, you don't need a full blown valuation done. A ball park estimate of value done by someone that knows your industry can be just as helpful.

SECURITY COMPANIES CAN BE VALUED 2 WAYS

- Depending on the security company, one of 2 methods can be used:
  1. A Multiple of Adjusted or Normalized Earnings or EBITDA (Earnings before Interest, Taxes and Depreciation
  2. A Multiple of the Recurring Monthly Revenue (RMR) .
- Integration, guard and fire companies generally have less RMR and more one- time revenue are generally valued as a Multiple of Adjusted Earnings.
- Alarm companies which have a significant amount of RMR and less installation and service revenue are valued as a multiple of the company's RMR.

1. The Multiple of Adjusted Earnings has the following issues attached to it:
   - What adjustments to earnings are acceptable to the buyer in "normalizing" earnings.
   - Adjusting "Owners Take" to a normalized number usually has to be done.
   - Once you have average normalized earnings, what multiple should be used to arrive at final value.
   - The multiple used will depend on many factors:
     - How fast the company is growing.
     - What concentration of revenue is there
     - Does the company have a unique value proposition?
     - Does the company have an independent management team
   - Multiples for smaller companies generally vary from 3-5 X earnings. Larger companies 5-7 X
2. The Multiple of RMR will depend on all of the following and more
   - Number of accounts, amount of RMR, average price on the accounts
   - Annual attrition rate, % of signed contracts, and % on a call forward line

THE BEST PRICE IS HAD WHEN YOU HAVE A BROAD SEARCH

- My eyes were opened when I saw the list of potential buyers for Alarmforce when it first attempted a sale years before it was actually sold. The list had 100 names on it.
- It is a mistake to narrow your search for a Buyer too soon. The best deals are obtained from a broad search.
- Even for a small alarm company you should contact at least 4-5 different buyers including local or regional players. You never know where the best offer will come from.
- To state the obvious it is risky to start down the path of a sale with just one buyer in mind.
- Remember as a Seller you have the most leverage in your deal **before** you sign a Letter Of Intent. Once a LOI is signed the leverage goes to the buyer.
- One of the reasons why Owners use investment bankers or a broker is to manage the task of contacting many potential buyers.
- It is possible to contact many potential buyers and still keep the deal confidential.
- In terms of potential buyers the easiest buyers to find are other industry players. My bet is than more than 75% of all deals in the security are bought by industry players.
- The next most popular buyers are private equity.
- The hardest buyers to find are individual buyers

GETTING PAID FOR ONE TIME REVENUE IS DIFFICULT

- A large % of the deals done in the security industry over the last 10-15 years are for what could be called *alarm companies.*
- I define alarm companies as those companies with a significant amount of RMR and less installation and service revenue.
- A typical alarm company might do $750,000 of revenue and has 500-750 alarm accounts.
- With companies like this, the value will be contained mostly in the monitored accounts.
- Owners of companies like this often ask me what will they get for the rest of their business. i.e. the installation and service revenue.
- The answer is that if the installation revenue does not make money on its own, then that part of the business will not likely attract much value at all.
- One way to determine whether you should get extra value for your installation revenue is to remove the monitoring revenue and associated costs from your income statement and see whether you still make money. Most smaller alarm companies do not.
- In some cases if you have a great deal of profitable service revenue you can get extra value for that. I have seen this happen.
- With integration companies where the installation revenue is paramount, then obviously one time revenue is valuable.

SELLERS WANT TO DO SHARE DEALS. BUYERS WANT TO BUY ASSETS

- In Canada, more so than in the US, an owner should almost always try to sell the shares of his or her company first.
- This is mainly due to the one-time capital gains exemption that every Canadian gets when selling the shares of a Canadian Controlled Private Corporation (CCPC) .
- It is important to note that *a CCPC has to qualify in order to get this tax advantage.* Not every CCPC will qualify. Check with your accountant
- While selling shares has its distinct tax advantages, share deals generally take longer to do, involve more due diligence and can come with a larger holdback.
- Buyers like to buy assets because not only can they pick and chose what they want to buy but *they can write the purchase price off for tax purposes after.*
- With share deals, the Buyer cannot write off the purchase price. Because of this share deals are sometimes done at lower prices than asset deals.
- In the alarm industry, the larger buyers generally buy just the accounts but pay up for them. The smaller local players will buy shares but don’t normally pay as much.
- Integration, fire and guard companies are often sold in share deals. Alarm companies not so much.
- Connected to do share deals is the issue of Working Capital. Buyers often want some working capital left in the company when selling.

THE INTEGRATION PROCESS IS CRITICAL TO A DEAL'S SUCCESS

- Jack Welch, the infamous CEO of GE used to have his team start planning the process of integrating a potential acquisition while GE was doing the due diligence on a deal.
- *Integrating an acquisition is critical to the success of a deal*. Along with making sure you are pursuing the right deal in the first place integration is the next most important step.
- *In my experience more deals fail due to integration than almost any other factor.*
- A good integration process involves looking at all of the following issues at the very least:
  - Do you keep the target **as is** after you buy it or merge it completely into your company
  - What key people in the target do you hope to keep on board and how.
  - Who are the target's key customers and what do we haver to do to hold onto them.
  - What synergies or cost reductions can we wring out of the deal.
  - How does the target manage their monitored accounts now and will that fit with our processes?
- I sold a good fire alarm company to national company 8 years ago. The integration was handled terribly. They lost good employees and customers.
- In addition, some of the national alarm companies think they do a good job on integration. But in my view a better job can be done.
- With alarm accounts the best indicator of success in integration is the attrition rate on the Seller's accounts in each of the 1st two years after purchase.

MISCELLANEOUS OTHER TIPS IN DOING DEALS

- Get your books, financials and accounts in order well before you sell. Buyers respond well to Sellers who are organized.
- Buyers generally have a team helping them buy . As a Seller you should have one too. Get an accountant, a lawyer and a broker onside before you pull the trigger.
- Stats show the companies that do deals the best are the ones that have lots of experience doing deals. All things being equal, *as a seller try to sell to someone who has done deals*
- Selling your company will take longer and involve many more details than you think. The quickest deal will take 3 months to do. Some deals take a year.
- If a Buyer has to go to a bank to borrow to get a deal done, that deal will likely take longer.
- If you are a seller, It is very difficult to get all your money upfront at closing on any deal in the security industry or even outside.
- Being paid out over 2 years on a set purchase price is different than being paid on an “earn-out”. Earn outs are risky for the Seller
- If you decide to use a broker:
  - Try to find one that has had some experience in the industry.
  - Ask for references from clients on other deals the broker has done
  - Get the broker to explain the selling process to you up front.
  - Ask the broker for a “ball park “ value on your company at the very least
  - Ask the broker for a copy of the Selling Package they have create4d to sell the company

ABOUT HARDING SECURITY SERVICES INC.

Harding Security Services Inc (HSSI) was formed by Victor Harding in 2009 to provide certain consulting services mainly to the security industry. The two areas that HSSI specializes in are *mergers & acquisitions* and *valuations of alarm, integration, fire and guard companies.*

Regarding its M & A work, HSSI acts as an intermediary to help owners buy or sell security assets. HSSI builds on Victor Harding's more than 12 years experience buying alarm companies for two of the national companies in Canada and is paid its fees mainly when a transaction is done.

HSSI's also provides valuation services to owners of all kinds of companies particularly those that have significant amounts of recurring monthly revenue.

Victor Harding lives in and works from Toronto, Canada. He is a chartered accountant by training and had many years of both small and large company experience in financial, sales and consulting roles before owing his own security company for several years. HSSI does work mainly across Canada.

Visit us on the web: www.hardingsecurity.ca

Victor Harding