WHITE PAPER

On The

U.S. CONTRACT SECURITY INDUSTRY

Also known as: **"Security Guard Industry"**
"Manned Guarding Industry"

MARKET ◆ MARGINS ◆ MERGERS ◆ MULTIPLES

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MARKET

Defining the "Contract Security" Market

TREND: The 2014/15 period saw a continuing increase in the number of companies moving away from being branded as a guard company or even a contract security company. Rather the companies are using broader terms to describe what they do and the services they offer as a result of an expanding menu of services.

The large professionally run security company today will use terms such as "Security Solutions", "Security Technology", "Integrated Guarding" and other terms to indicate the move to offering more services under the same company umbrella.

This white paper, unless otherwise noted, will report on companies that derive at least 75% of its revenue from traditional standing security officer or vehicle patrol services and will variously refer to these type services as "Contract Security Companies", "Outsourced Security Companies", or "Manned Guarding Companies". The expanded menu of services offered by many of these companies are as follows:

- Standing Security Officer and Vehicle Patrol Services (at least 75% of the total revenues)
- 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).
- **Integrated Guarding – a new term coined by the large national and international companies to describe video monitoring and vehicle patrol in combination with on-site manned guarding; or to take the place of on-site guarding.**

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), ASIS International (www.asisonline.org), and NCISS (www.nciss.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 (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.

In previous white papers, we told how the contract security industry has evolved from calling itself "security guard companies" to terms that better identify the multiple menus of services it now offers. For more on how the industry and general public is responding to the evolution from "security guard" to "contract security", click below to view a previous year's White Paper:

July, 2011 July, 2012 July, 2013 July 2014

The Four Leaders
Shaping the Direction of the Industry

There are now 4 companies in the U.S. contract security marketplace; each having gross annual revenues in excess of $2 Billion. Universal Protection, with its acquisition of legendary Guardsmark on July 28, 2015, is now at $2.1 Billion, making it the latest entry into the $2 Billion club. Three of the companies (with the AlliedBarton/Wendel Group transaction to close in September) are foreign owned; the revenues from these three foreign owned companies represent 38 % of the market.

These 4 companies control half the $22 Billion U.S. Contract Security market; thus are the ones shaping the future of the industry. They have the financial resources to do so; and are investing heavily in technology and other tools necessary to meet the increasing demands of today's security conscious customers. Below is an overview of these industry leaders and what they are doing to shape the industry:

- ## Securitas
  - Swedish Public Company – Nasdaq Stockholm
  - Global Revenue – ↑ 7%
  - North American Organic Growth - 3%
  - Earnings Per Share – ↑ 12%

Securitas had $3.6 Billion revenues for 2014 in the North American market. Securitas got its start in the U.S. 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. At $3.6 Billion revenues in North America, Securitas has approximately 16% of the total market; while it has about 12% market share in the United Kingdom.

Direction:

Alf Goransson, Securitas' President and CEO, reiterates his 2013 message in his 2014 report to shareholders – Securitas has deemphasized acquisitions in traditional manned guarding companies in mature markets and has invested heavily in technology; evidenced by its 24% investment in I-Verify, a state of the art remote video monitoring center headquartered in Charlotte, North Carolina (U.S.A.).

Mr. Goransson went on to talk about Securitas' paradigm shift towards combining manned guarding with technology; which underscores the direction many of the security market leaders today are taking their companies. The best way to describe this paradigm shift is to use **a direct quote from Mr. Goransson's message to the shareholders**:

"There is a clear trend in the security industry: labor is becoming more expensive and complex, with new rules and regulations every year. Technology is developing fast and becoming less expensive, and in combination with a new generation of high-capacity telecom networks, the transmission of images and videos is becoming more viable and secure.

This is enabling us to change our service content and offer better security at a lower or equal cost, which is a critical shift in those countries where salary costs are relatively high. In addition, video analytics and intelligent cameras are enabling us to determine suspicious or dangerous behavior at an early stage, thereby minimizing the risk of business interruption.

In short, we can detect potential crime before it happens, and do it more cost-efficiently than before. A pretty good value proposition!

This combination creates a paradigm shift and a brilliant opportunity for security companies that are able to make investments in technology, monitoring and response capacity, and have the financial strength to invest in the required equipment. Security companies that do nothing will not survive over the long term – and this will simply be a matter of time, since creating customer value by only selling guarding hours will become increasingly difficult."

- ## **G4S**
  - Name of Public Exchange – London and Copenhagen Stock Exchanges
  - Global Revenue – ↑ 5%
  - North American Organic Growth – 7%
  - Underlying Earnings Per Share – ↑ 5.4%

G4S had $2.6 Billion revenues for 2014 in the North American market. G4S 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 had very attractive organic growth and, starting in 2013, has divested some of the traditional standing security officer business (with aggregate revenues of approximately $1 Billion). G4S has limited its acquisition activity in the U.S. security market to mostly electronics and high-end investigative type companies. G4S has concentrated most of its recent acquisition activity in the emerging markets, soon to represent 50% of its total revenue. At $2.6 Billion in North America, G4S has approximately 12% market share; while it has about 25% market share in the United Kingdom.

Direction:

In 2013, G4S took a bold move to divest several of its high volume, low margin business units in an effort to clean up its balance sheet, improve earnings per share and create cash to invest more heavily in technology for its own operations as well as service offerings to its customers. During 2014, G4S reviewed 56 business units. Of these 56 units, G4S has sold 8, including US Government Solutions (having a volume of approximately $500 million), which was managed through a proxy structure over which G4S had limited control. Since 2013, G4S has raised around $400 million from divesting businesses which generated a below group average operating margin of 2.8% (approximately $300 million of this was raised in 2014).

In 2014, G4S initiated a strategic review of capabilities in technology – for back office, operations and offerings to its customers. In 2014, 8% of G4S's revenue came from security systems, a market G4S expects will grow in double digits for the next few years.

- **AlliedBarton**
  - Privately Held – Presently owned in the majority by the Blackstone Group. Blackstone has agreed to sell its interest to the Wendel Group (to close late Q3)
  - North American Revenues - $2.2 Billion
  - Organic growth rate – 7%

AlliedBarton has a $2.2 Billion annualized run rate ($2.0 Billion annual revenue in 2013). The current company was formed through the purchase of Allied Security by Spectaguard in 2000. Since that time, Allied has purchased large companies such as Barton Protective with approximately $350 Million in revenue (and renamed AlliedBarton) and Initial Security with approximately $225 Million in revenue. In total, AlliedBarton has made approximately 10 acquisitions with combined revenues of approximately $1 Billion. **In June of 2015, Blackstone, AlliedBarton's financial sponsor, announced that it had agreed to sell its interest to the Wendel Group for $1.67 Billion (11.67 times adjusted EBITDA).** The Wendel Group is headquartered in France and holds majority ownership in several public companies. After this acquisition, AlliedBarton will join the ranks of two other major companies operating in the U.S. and owned by a foreign entity. At $2.2 Billion in gross revenues, AlliedBarton has 10% market share.

Direction:

Joining the ranks of the other 3 Market Leaders, AlliedBarton continues to expand its technology offerings to its existing customers and as a sales tool to win new customers. It also has invested heavily in other technology platforms that enable it to stay closer to the customer and its needs; and improve its service delivery, especially to the smaller remote-managed accounts.

- **Universal Protection Service**
  - Privately held – majority owners Warburg-Pincus
  - North American Revenues - $2.1 Billion (present annualized run rate with the recent purchase of Guardsmark)
  - Organic growth rate – 10% +

Universal Protection has run rate revenues of $2.1 Billion. Universal has been on the fast track for making acquisitions for the last 7 years (45 acquisitions of Contract Security and Systems Integration companies). Universal was established in 1965 and had revenues of about $15 million 15 years ago. Universal grew organically and reached a volume of around $350 million in 2008, when it made its first acquisition in northern California; which started its path to becoming a mega security company. In addition to growing through acquisitions (totaling about $1.2 billion in revenue), Universal has accomplished double digit organic growth each year since then. At $2.1 Billion, Universal is now the largest U.S. owned contract security company and has 10% market share.

Direction:

Over the past few years, Universal has invested heavily in technology both for making the internal operations more efficient and to increase its service offerings to its customers. In 2013, Universal bought THRIVE Intelligence headquartered in Dallas, Texas, a state of the art video monitoring station and command center and has purchased several other “tuck-in” acquisitions in this security segment. Today, approximately 5% of Universal’s $2.1 Billion annual run rate revenue comes from electronic security systems and other integrated guarding services offered to its customer.

Size of the U.S. Contract Security Industry

TREND: The matrix making up the number of companies in the Contract Security Industry 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 the July 2014 white paper report

Many sources report 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. contract security companies for more than 30 years, and has identified approximately 6,000 single 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 30 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 this industry – although there are several associations and consultants that publish this information for electronic security companies.

Revenue, Size and Growth Prospects for the U.S. Contract Security Market

Trend: The two well-recognized industry reporting agencies are mostly in agreement on the size of the market (currently about $22 Billion) and the prospects for the future: there will be real growth in the overall market figures, coming primarily from companies converting from "in-house" to contract security.

The latest Freedonia Group study indicates that the U.S. Contracted Security Services market, restrained by the economic downturn beginning in 2007, grew only 1.1% from 2006 – 2011. This report also indicates that the contract security services market in the U.S. was $19 Billion in 2011 and was expected to grow at an impressive rate of 5.5 percent per year until 2016, at which time the market should reach $24.5 Billion. Freedonia says the growth is coming from "contract security being supported by the regulatory burden of fielding an in-house security force. Additionally, security is not a revenue-producing activity for most companies and is outside their core competencies, providing opportunities for contractors." The Affordable Care Act has prompted many companies with in-house security to now consider contracting out this function as a way to reduce the labor force, thereby reducing the costs associated with the Act.

The latest IBISWorld industry report (2013) put the U.S. Contract Security market at a little over $21 Billion. This report goes on to say that…." the labor intensive activities of the U.S. Contract Security market are being substituted by monitoring technology and equipment, such as closed-circuit television (CCTV) systems. Coupled with the decline in demand during the recession, rising competition has caused profit margins to fall. In response, larger industry players are offering more value-added services to mitigate profit declines. Although the industry has a lot of non-employer firms (e.g. private investigators and bodyguards, for example), some that offer their services on a part-time basis to supplement other sources of income, the industry also has a lot of medium – and large- size firms, which typically offer integrated security, value-added services and cash handling".

In several places in this white paper, we report on the efforts of the mega companies to ramp up their "integrated guarding" and "offsite video monitoring" offerings as a way to reduce the cost of security provided the customer and, at the same time, enhance the margins of the security provider.

We also, in compiling this year's white paper report, considered the probable impact the inflation rates had on the increase in the total market figures. Based on our research, the U.S. Contract Security market was at about $12 Billion 10 years ago. The Consumer Price Index increase over the past 10 years applied against the $12 Billion comes to about $16 Billion. This coupled with the fact that a few years ago, the reporting agencies expanded their scope of what's included in the definition of contract security to include investigators (often operating as one-man operations) and other non-traditional “manned security” functions, indicates that there’s been very little growth in the overall market in terms of companies converting from “in-house” to contract security or existing customers increasing their contract security needs.

Some of the large security companies don’t seem to agree with the reporting agencies on the projected growth of the security industry. There was a mention of this in the 2014 Full Year Report for Securitas (repeat of 2013 message): the report says ...“due to current market dynamics and a gradual increase of the use of technology in security solutions, the security market in mature markets [such as the U.S.] is no longer expected to grow 1 to 2 percent faster than GDP as it has historically, but rather the same pace as GDP. In the future, this trend could be improved through increased outsourcing of currently insourced traditional guarding activities and by allowing the private security industry to take over services performed by public authorities and governments”. NOTE: The U.S. GDP growth rate for 2014 and the first quarter of 2015 was running around 3.75%.

However, and worth repeating, the good news is that both Freedonia and IBISWorld have predicted a large part of the increase in the U.S. Contract Security market over the next five years will come from companies converting from “in-house” to contract security and not necessarily a function of the expected inflation rates; which underscores what the Securitas Full Report says; and what others are saying about the move from “in house” to “contract security”.

While approximately 51% of the total manned guarding market is outsourced ($22 Billion), several sources put the in-house contract security market at $21 Billion; meaning that there’s still plenty of room for professional contract security companies to grow through selling these companies, presently using in-house security, on the advantages of outsourcing their security needs.

Composition – by Company Size

TREND: The U.S. Contract Security market continues to be very fragmented with 5 companies now controlling over 50% of the market.

Matrix of Market by Number of Companies and Revenue

		No. of Companies		Annual Revenue (in Billion $)
(1) (2)	Over $1 billion	5		11.8
(2)	$300M - $1B	3		1.3
(2) (3)	$100M - $300M	16		2.5
(2) (3)	$50M - $100M	13		.9
(2) (3)	$20M - $50M	50		1.5
(3)	$5M - $20M	200		2.0
(4)	$0 - $5M	7,713		2.0
		8,000	(5)	22.0

(1) 3 companies, representing $8.4 B in revenue, are foreign owned

(2) From July 2015 issue of *Security Letter* (Revenue figures mostly year-end 2014; except current run rate revenues used for AlliedBarton and Universal Protection).

(3) Estimated based on information in files of Robert H. Perry & Associates, Inc.

(4) Arithmetical function to come to the 8,000 companies and $22B revenue

(5) Estimated from recent Freedonia and IBISWorld reports

Number of Employees, Compensation and Armed Personnel

Trend: No significant change from July 2014 white paper report

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Number of Employees:

A 2013 ASIS/IOFM survey indicated that there are between 1.75 and 1.93 million full-time workers in service of operational security in the U.S. This is an estimate of the number of security personnel fully dedicated to operational security and employed in the private sector. It does not include local, state, or federal law enforcement and refers to the number of individuals hired by organizations to provide security (either contract workers or proprietary). The figure is a calculation of full-time workers (e.g., two half-time workers are counted as one security employee). Approximately 70% of these workers are security officers; with the remainder in administrative functions or providing other non-operational type services.

Based on the above, with outsourced manned security representing a little over 50% of the market, and based on the fact that there's more part-time workers in the outsourced security sector, it's estimated that there are around 800,000 security officers working in the Contract Security Industry.

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. Further; the *SECURITY LETTER* reports in its July 2014 issue that 8% of the U.S. guard force are members of a labor union.

Compensation:

A recent report – "Occupational Employment Statistics" - indicated that the median wages for contract security officers were $13.48 per hours worked; or $24,410 for full time gross annual pay. These figures vary significantly depending on the area of the country, as well as whether or not the employees are members of unions and whether or not the employees are working at a Federal government facility (where the wage and benefits are mandated by the Federal government contract) vs. a commercial site.

Armed Personnel:

It is estimated that, contrary to public opinion, less than 10% of security officers working for Contract Security Companies carry weapons; and the ones that do today are more thoroughly vetted upon employment and go through extra training to qualify to carry the weapon. Further, many Contract Security Companies hire off duty policemen to fill the posts requiring an armed security officer.

However, as more and more incidences occur that could have been prevented by a weapon carrying security officer, the security customers are demanding that their contract security company find ways to meet this need; while at the same time not creating the undue risk associated with lethal weapons (i.e.; handguns).

Many contract security companies today have responded to this need by equipping certain of their security officer personnel with "Intermediate Services" – a term used to describe "Non-Lethal Weapons". There has been great strides in developing and improving on the non-lethal weapons in use today. Unlike the stun guns of the past, with limited range, these new non-lethal weapons can produce a pepper spray chemical from as far away as 10 feet, with pin point accuracy. Further, these new devices are outfitted with cameras that record every event, to be used as evidence and support of the officer's need to use this type of force to disable the intruder.

The Factors Causing Growth and Contraction in the Industry

Trend: No significant changes from July 2014 report – the two large industry reporting agencies predict 5% annual growth in the industry for the next five years, although at least one of the international Industry Leaders predicts modest growth at a pace no greater than GDP – about 3.75%

Also, as mentioned earlier in this White Paper, the 4 Industry Leaders have enjoyed an aggregate of 7% organic growth for 2014; which means, at 3.75% industry growth, the larger companies are winning customers away from their smaller competitors.

- ***Factors that bring about growth for contract security companies***
    - Contract Security Companies will see growth coming from four sources:
        - COMPETITORS - $22 Billion market
        - IN-HOUSE CONVERSIONS - $21 Billion market
        - PRESENT CUSTOMERS INCREASING SECURITY
        - COMPANIES PRESENTLY WITHOUT SECURITY

      The move to increase or add security; or make a change in the security provider will be brought about by the following factors:

        - **Cost Considerations**

          Companies, **and more recently, municipalities,** 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 and municipalities are getting better trained security personnel, in many cases, for less total outlay.

- **Increasing Crime and Terrorism**

  Immediately after 9/11 there was a large spike in contracted security, which eventually settled back down; albeit a much higher level than before the attacks. There's been increasing terrorists threats to our country over the past several months, which is reminding many people of what happened on September 11, 2001; and they're concerned that it could happen again.

  Also, there's been a growing number of mass murders in our schools, theatres and shopping malls; and growing concerns over airports, nuclear sites, subways, and sporting events – all having a chilling effect on our nation. All this points to a compelling reason to initiate or ramp up security at these type locations or other locations where large number of people are gathered. The public police forces are not equipped to handle the special security expertise required to secure some of these critical infrastructures; therefore the owners are looking to outsource these functions to companies with the experience and technology to handle this type security.

- **The Need to Upgrade the Security Function**

  Many companies today are finding that their in-house force isn't prepared to handle a major crisis. Therefore, they're looking to outsource this function, not only for the cost savings described above, but also to make sure they have the right security in place when it's needed. The contract security company will, in most instances, have better trained personnel and more state of the art technology to handle the security challenges of today. After all, it's the contract security company's goal to have the best and most effective security at competitive prices (the competition makes sure this happens); that's what they do and they have to do it best.

- **Enhancing Manned Guarding with Electronics**

  A recent survey by our firm indicated that many contract security companies today that are actually growing, are doing so by offering systems integration, integrated guarding or some other type of electronic security enhancing services. So far, there hasn't been signs of a large number of customers replacing security personnel with electronics or reducing the guard force significantly.

- ***Factors Causing Contraction***

  - **Companies Closing**

    Certain industries adversely affected by the downturn in the economy are closing locations, thereby eliminating the need for security once needed in those areas.

  - **Converting to In-House**

    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 under “Growth Factors” on page 14.

  - **Eliminating Security**

    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.

  - **Replacing Manned Guarding with Electronics**

    Some companies are eliminating security officers entirely and replacing with electronic security; and some companies are just reducing the security force and supplementing with “integrated guarding” or other electronic security options. More on this topic under “Manned Guarding vs. Electronics” on the following page.

Manned Guarding vs. Electronics

Trend: Contract Security Companies are starting electronic security divisions or teaming with companies that specialize in electronic security. While some customers are replacing security officers with electronic security, most of the customers are keeping their manned guard force and enhancing their security effectiveness by using security officers AND electronic security devices – hence the larger growth percentages of the Industry Leaders that have been preparing for this paradigm shift.

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 companies that this may start happening as the contract security firm's customers look at ways to trim their security budgets and/or enhance its existing security.

Many of the telecom/cablecom and internet giants such as AT&T, Verizon, Time Warner and now Google have entered the home electronics security market and there have been recent news articles indicating that others are considering this move 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 security business. One scenario is that they would have to partner with the existing electronics companies to handle the installations, service and response [which we see already happening], 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.

In the past couple of years, the following announcements were made regarding cablecom/telecom and other mega companies moving into the electronic residential security market:

- **Polaroid gets into security surveillance** May 29, 2013

- **Oplink enters home security market with DIY alarm system** October 31, 2013

- **Google bought Nest Labs, a manufacturer of smart thermostats and smoke alarms** – Some feel that this is a signal that Google may use this as a platform to offer a security product for homeowners see the last bullet point below. January 29, 2014

- **AT&T announced that it was planning to pay $48.5 Billion for DIRECTV.** Security Systems News reports AT&T as announcing that this acquisition will expand its broadband network to more than 70 million customer locations. May 19, 2014

- **Samsung may be making a home automation push with a $200 million buy of startup SmartThings.** July 22, 2014

- **U.S. Cellular moves into DIY security by launching OnLook Digital System, a self-installed security and home automation system.** OnLook is now available in U.S. Cellular's retail stores in various places across the U.S. January 26, 2015

- **Research firm Citigroup predicts that self-serve security solutions from tech firms like Google and Apple will make up 62.5 percent of the home security market in 20 years.** July 28, 2015

All these acquisitions are about mega companies moving into the homes to provide bundling of services to include video and high-speed broadband that can be viewed direct or remotely through hand held devices; and some are talking immediately about video burglar and fire monitoring. The question in the minds of owners of contract security companies is: will these companies eventually expand their services to the corporate and small business market as well, thereby taking revenues from the contract security companies? Some feel that these transactions will make the public more aware of the need for security, thus driving more business toward the already established security companies; others feel these offer cheaper and sometimes more effective security thus diverting business to the handheld monitored devices.

Mitigating the Concern

However, the above concerns are being mitigated to a large extent by the evidence that, so far, electronics have not materially taken away from the need for human security officers, but have 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 from going to other security contract companies that offer this integrated packaging of manned guarding and electronics. Those that can't afford the very large investment to get into the video monitoring business; or just wants to "wait and see" where all this is heading, are teaming with installation and monitoring companies as a way to offer the service.

Manned Guarding Companies are Buying/and or Building Video Monitoring Companies

Securitas

Securitas sold off its electronics system integration business, Niscayah, about five 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. **On June 5, 2014 Securitas made an even bolder move when it bought a 24% stake in Iverify (www.iverify.net), a state-of-the-art video monitoring center headquartered in Charlotte, NC.**

G4S

On December 16, 2013, G4S Technology created a new service and maintenance division in Chicago in an effort to leverage the technology resources it already had in-house. This new business served to combine already established G4S call centers and hosted video monitoring centers in other parts of the U.S. In addition to its security business (monitoring and installation), G4S Technology has a telecom division.

Universal Protection Service

On December 04, 2013, Universal (the newest member to the $2 Billion Club) purchased THRIVE Intelligence, a state of the art monitoring center headquartered in Dallas, Texas. Steve Jones, the CEO of Universal, said this about the acquisition: …"the acquisition of THRIVE is part of our overall strategy to provide our clients with a "total security" solutions approach where we deliver more services and value to our clients than any other security provides is capable of. We are excited to be able to roll out this service offering to all of our clients across the U.S. and to lead the way in how security services operate in the future". In Universal's recent purchase of Guardsmark, a $500 million contract security company, Steve Jones repeated this message that the Guardsmark acquisition would give Universal a larger customer base to offer these integrated services.

There are Major Contract Security Companies that have Teamed with Electronic Companies as a way to Mitigate the Concern

- In April, 2013, **U.S. Security Associates (a $1.3 Billion contract security company backed financially by Goldman Sachs) announced that it had structured an arrangement with Stanley Security Systems** whereby the two companies would refer business to each other.

- In November, 2013, **AlliedBarton teamed with ViewPoint, a Massachusetts based video monitoring company with commercial accounts across North America.** Brad Gordon, the CEO of ViewPoint, said this about the partnership, "AlliedBarton demonstrated a firm commitment to supplementing their guard services with video monitoring technology; choosing to embrace technology as the future rather than fight it." He went on to describe the partnership as, "…efficient and cost effective for both companies."

A good article on the subject of Mitigating the Concern has been presented in our past 3 white papers, but it still very much applies to what's happening today; and is worth repeating:

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 the industry make the best use of this security mix, using both electronic and manned approaches in parallel so that they complement 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 judgment, 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 (profit at the site level) have been trending down for the past 5 years, but have now leveled off; albeit at a much undesired lower level. This downtrend in margins has been brought about through competitive pressures and increased direct costs. The EBITDA line shows insignificant change for the regional and national/international companies, but a drastic negative change for the small company.

In today's competitive environment customers are asking for more and better security, but expecting to pay less. Hence the progressive security companies are finding ways to meet these needs at the customer's price point by getting more efficient and coming out with service offerings that differentiate them from their competitors; such as "integrated guarding".

But as more and more security contracts are being awarded on price instead of quality service, the effectiveness of security as the public has grown to appreciate it may diminish. The industry- wide improvements may become much more difficult as the companies have less profit to reinvest in new technology.

David Ward of Ward Security in England writes on this subject in a recent Infologue article – although he's writing about what's happening to the security industry in England, his poignant comments apply just as well to what's also happening in the North American security market:

The Growing Threat [to Security] of Low Margins and Poor Payment Terms

"The security industry can – and should – be extremely proud of what it has achieved in recent decades. It has matured to become an industry that, on closer scrutiny, bears little resemblance to what it was only a few decades ago (even if clients and the general public don't always recognise the full extent of the change). It has evolved according to changing market conditions to ensure it delivers a superior, all-encompassing offer that perfectly matches what clients want and need. It has embraced new technologies and new ways of working to deliver impressive efficiencies and even more impressive effectiveness, and in this respect it has pushed the evolution from old ways of working to new ways of working. And it has cleaned up its act, realising that there was a job to do in tackling reputational issues. In short, the industry has grown up and become far more professional.

The problem with any profession is that the closer you are to the detail, and the more focussed you are on delivery means you can't always see the bigger picture. To see it you need to step back, just as a painter has to step back *from a canvass to see the entire picture they've created. And if you step back far enough and look at the security industry as a whole you can surely come to only one conclusion; that the industry we have moulded today is of a far greater quality and intrinsic value to what it was yesterday.*

So why do we undervalue it? Why do we undersell it? And, most important of all, why have we, as an industry, dropped the ball in making sure we receive adequate recognition and recompense for all the hard work we have done on behalf of our industry and our clients?

There is a clear disparity between the offer we now deliver, and the commercial relationship we have with clients. While the service and offer has vastly improved, the way we do business has not, and when it comes to the transaction we may as well be back in the bad old days.

The customer has been allowed to call the shots when it comes to the pricing of the service they receive because we have not been strong enough in explaining the difference between the service they got yesterday and the service they get today. But the reality is; that today's much improved offer is essentially more expensive to deliver. Who could honestly think any different? Security staff are more skilled and therefore rightfully expect better salaries. Training and accreditation, as well much improved management systems and structures all require more resource to manage. The back office needed to support the improved service is now an expensive function for any company that takes the job seriously.

To sustain the industry's improved offer and support further industry-wide improvements we need to ensure we protect and improve margin, and insist on better payment terms. Unfortunately, as an industry we are failing to do this. The cost of failure is dramatic and in the worst cases we are seeing businesses go to the wall. It is increasingly hard to pay staff on time or to resource the back office.

The security industry has reached a crossroads and needs to make a decision. Do we address this extremely important issue, or do we allow the problem to continue and wait to see the effect it has? It's an issue that threatens the continued existence of the security industry we have built today, because we are now in an unsustainable situation. The likely outcome of a failure to address the issue will be increasing unprofitability, more company failures, no further evolution of our service, and even a possible sliding backwards towards the old days. Nobody wants that; not the customer, and certainly not the security industry.

It will take an industry-wide effort to tackle this problem, and we need to be united on focussing on the future and our own sustainability. This is not a time for opportunism, because opportunism has got us to where we are today – working hard for not enough reward."

The Margins for the small and medium sized companies are usually better than the margins for the large national and international companies

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

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

- 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 the following page 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 decrease in site level profits over the past few years of approximately 4%. We see a larger decrease in areas that have recently been unionized as unions force the company to pay union dues and mandate expensive employee benefits. The overwhelming majority of the owners of the small companies feel the margins will only get worse due primarily to competition from the larger companies.

All the companies are presently experiencing or anticipating increases in direct costs due to the following factors:

- **Wage creep –** without a corresponding pass through of the cost to the customer. Although this may be a rising cost factor, most companies see this as a viable alternative to the much more expensive high turnover of the security officer force.
- **Affordable Care Act –** although many companies have made a temporary "fix" in their concerns over the ACA, most companies are concerned about the rising cost in future years, not only in premiums but the cost of administering the plans and meeting all the complicated reporting requirements.
- **Increasing Unionization**
- **Increase in minimum wage**
- **Mandated benefits –** some states already have a 3 day sick pay requirement and it's anticipated that this policy will spread throughout the country.
- **Investment in technology** necessary to offer more services to the demanding customers – i.e.; integrated guarding.

It's interesting to note that although the margins at the site level have slipped approximately 4%, EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) has remained relatively steady over the past couple of years for the regional and national/international companies. 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. However, the small companies are usually operating at optimum levels of overhead personnel already and do not have much room for decreasing operating costs; hence the reason we are seeing the EBITDA decreasing significantly for these smaller companies.

Revenue, Profit and EBITDA Matrix

	(4) Small Companies	(5) Regional Companies	(6) National/International Companies
Revenue	100%	100%	100%
Profit at site Level (1)	15 – 16%	12 – 14%	10 – 12%
Profit at Branch Level (2)		8 -9 % (6)	8%
EBITDA (3)	Breakeven/loss	6-7%	5-6%

1. **Profit at site level -** 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. **Profit at branch level -** the profit at site level 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 -** 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. Adding to the gross margin erosion for the small company has been the pricing pressures from the customers and competition. **Many of the smaller companies (revenues to $50 million) are now losing customers to the larger companies on national bids, where the smaller companies can’t compete.**

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. **Although the margins are decreasing, the EBITDA has remained relatively constant due to a lot of “belt tightening” at the administrative cost level. Some owners are saying they have cut overhead as much as they possibly can without affecting the quality of service to the customers.**

6. **National/International Companies** – as indicated in several places in this white paper report, many of the national/international companies are now investing heavily in electronics and technology as a way to compete in the market place. While the gross revenue line is remaining relatively flat (most reporting 3% or less growth – although the four industry leaders are reporting 7% organic growth), the gross margins are not decreasing as much as in the past due to the move to have more volume in the higher margin security offerings (i.e.; systems integration, video monitoring, “integrated guarding”, etc.).

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. 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

2014 was a "moderate activity" year for merger and acquisitions in the traditional guarding and electronics security industry; not only here in the United States, but around the world as well.

In fact, both 2013 **and** 2014 were "moderate activity" years, when compared to the robust acquisition activity for 2012; which boasted an increase of worldwide transactions of 52% over the 2011 year and 74% over 2010.

However, the activity in the **non-traditional** security space - the cablecoms and telecoms - continued at a heightened pace in 2014 as these huge companies leveraged their subscriber base by bundling security systems with their other cable/internet offerings. Michael Barnes (President of Barnes Associates, a well-known and respected M&A firm specializing in the electronic security industry) indicated in his popular Industry Overview report, at the Barnes-Buchanan conference in Palm Beach in February 2015, that the cablecoms/telecoms now comprise about 4% of the $16 billion of U.S. Recurring Revenues (out of a total $25 billion in electronic security market including Installation Revenue); and the market share is growing.

THE TOP STORIES IN THE MERGER AND ACQUISITION ACTIVITY AROUND THE WORLD IN 2014 [and 7 months ended July 31, 2015], AND PARTICULARLY IN THE U.S.

Below are the transactions we feel are of significance to the traditional guarding and electronic security industry - mostly because of the size of the transaction, but some because of its unique significance to the buyer or the vertical market it serves:

G4S Divestitures (**2014**):
Jan. 17 - ***Canadian Cash Solutions Business*** - C$110M Price 13.5 x PBITDA
July 17 - ***G4S Sweden to Sector Alarm*** - $50M Price
Dec. 02 - ***U.S. Federal Government Business to Alvarez & Marsal*** - $135M Price

March 3, 2014 - ***Carlyle Group Buys Tyco's Korean Security Business*** - $1.93B Price

March 18, 2014 - ***SecurAmerica Acquired American Security Programs***

March 27, 2014 - ***U.S. Security Associates Acquired StaffPro*** (event staffing company)

April 22, 2014 - ***Sequoia Capital Acquired Simplisafe Alarm Company***

May 2, 2014 - ***ADT Acquired Reliance Protectron, Inc.***

June 4, 2014 - ***Securitas Acquired 24% Stake in I-Verify***

September 29, 2014 – ***Brink's Sells Minority Interest in CIT Business in Peru***

February 04, 2015 – ***Universal Protection Service acquired two SMS Holdings Corp. security services companies — Valor Security Services and Brantley Security Services.***

March 03, 2015 – ***Third-party monitoring giant Monitronics has acquired LiveWatch Security for $67 million***.

April 01, 2015 – ***Imperial Capital Group of Toronto acquired Ackerman Security of Atlanta.***

May 20, 2015 – ***Protection 1, ASG Security to Merge***; after being acquired by Apollo.

June 30, 2015 – ***The Wendel Group, to acquire AlliedBarton Security Services***

July 14, 2015 – ***GardaWorld entered into a binding agreement for the acquisition of Aegis Group***

July 20, 2015 – ***Universal Services of America Gets Major Investment from Private Equity Firm***

July 28, 2015 – ***Universal Protection Service acquired Guardsmark***

WHY HAS 2013 AND 2014 CONTINUED TO BE JUST "NORMAL" YEARS FOR MERGER AND ACQUISITION ACTIVITY IN THE GUARDING AND ELECTRONIC SECURITY SPACE?

For guarding and electronic security company owners, 2012 was the ideal year to sell in order to take advantage of the lower capital gains tax rates. The Federal long-term capital gains tax rate was 15% for 2012, but increased to 20% in 2013, with an additional 3.8% investment income tax some tax advisers are saying might apply to the sale of a business. This made the owners that were thinking about selling in the near future (maybe 2013 or 2014?) decide to accelerate their plans and sell in 2012. This mindset to sell sooner rather than later was enhanced by the proposed legislation and ongoing discussions in Washington to increase taxes in order to deal with the huge national debt.

Also, the year 2012 was when many owners started to become more aware of the perils of the Affordable Care Act ("Obamacare") and how it negatively affected the security industry - especially the labor intensive contract guarding sector. The attempt to repeal the ACA did not go through, which made many concerned owners accelerate the sale of their companies.

In 2013, continuing through 2015, the mega international companies- Securitas, G4S and Prosegur are still dramatically curtailing their acquisition activity in order to implement organic growth strategies.

THE M&A OUTLOOK

As for the large public international security companies, we don't see much activity in buying plain vanilla guarding companies from these mega conglomerates in 2015 anywhere in the world. They will continue to curtail their buying activities; unless opportunities arise in the non-traditional security sectors, such as large high-end systems integration companies or opportunities to leverage their integrated guarding efforts.

We see continued growth pressures from the guarding companies partnered with Private Equity Groups (PEG's), evidenced by the fact that they are getting more aggressive in targeting select acquisition candidates and are pursuing the relationships aggressively.
The security companies owned in the majority by the PEG's are getting pressured to grow so they can put their huge stash of idle cash to work; and some are reaching the time to return the invested capital back to the PEG partners - in which case, the PEG's want the companies to be as large and as valuable as possible for the exits. Even though the PEG's are hungry for acquisitions, they are not letting their need to grow get ahead of their good judgment on the multiples they are willing to pay.

Although the multiples have increased over the past couple of years, the gap between what owners are expecting in a sale and what buyers are willing to pay is still keeping many owners from putting their company on the market. They don't have to sell and the return on what they would get from the sale proceeds is still at an all-time low.

But then there are the owners that are worried about the new round of proposed capital gains tax increases that will, if they are approved by Congress, greatly lessen the "take home pay" in a sale. And there are owners that are still concerned about how the ACA will play out in the future financial health of their company, as well as unionization possibilities, and continuing margin pressures from customers and competitors - all taking away from the retirement nest egg when the time comes to sell

Private Equity Groups Making Investments in the Contract Security Industry

Trend: Increasing acquisition activity

Private Equity Groups are basically firms made up of executives and MBA's with an attractive track record in finding, buying and managing (either passive or active) struggling or fledging companies needing the financial resources to take the company to the next logical level. The investors in these firms are primarily very large pension funds, insurance companies, high net worth individuals, family partnerships, municipalities, the members of the Private Equity Group and usually the owner of the company they are buying.

According to the Private Equity Growth Capital Council, there are more than 3,300 private equity firms in the United States that own more than 11,000 businesses, which employ roughly 7.5 million people.

Collectively, the Private Equity Groups raised a record amount of commitments during the years 2005 – 2007; and because of the downturn in the economy back then, 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. Also, the interest rates for acquisition loans are low, making an even more compelling reason for the PEG's to seek acquisitions at a rapid pace.

Traditionally, the PEG's interest in the security sector was mostly centered around the biometrics and electronic security businesses because these companies carried larger margins, with less liability, than the traditional manned guarding companies. Though fewer in numbers, some PEG's are **NOW** looking at large contract security companies (even though the industry is expected to grow at an "unexciting" rate of around 4% per year) 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 – although many funds today have a much longer life span.

This renewed interest has been primarily sparked by the recent auction Credit Suisse ran for the sale of AlliedBarton. Several groups with multi-billion dollar funds were invited to the auction and in the end, the Wendel Group came up with the best offer at roughly 12 times adjusted EBITDA – a very respectful price for a service company in today's market. We think this attractive multiple has piqued the interest of many of the groups who are now eyeing the contract security industry more favorably than in the past. There's still many opportunities for well financed PEG's to continue growing through attractive tuck-in acquisitions (at multiples in the 5 – 6 times EBITDA range) and the growth in the industry is at least as good as the GDP; even though much better for the larger Contract Security Companies.

The Private Equity Groups with investments in the contract security industry are presented below – all the groups have been and remain very active in buying smaller, tuck-in companies; a trend that will continue and probably accelerate in the next twelve months. It's important to note that the annual revenue from the contract security companies owned by these Private Equity Groups amounts to approximately $6 Billion and represents approximately 30% of the total U.S. contract security market.

- *The Blackstone Group* (www.blackstone.com) has a significant investment in AlliedBarton (www.alliedbarton.com) - approx. $2.2 Billion in annual revenue. In a June 30, 2015 press release, BlackStone announced that it was selling its interest to the Wendel Group for $1.67 Billion. The transaction is expected to close in the latter part of Q3.

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

- *LaSalle Capital* (www.lasallecapitalgroup.com) started United American Security LLC (www.unitedamericansecurity.com) 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.

- *ZS Fund L.P.* (www.zsfundlp.com) entered the contract security industry in December 2012 with a major investment in SOS Security (www.sossecurity.com). Since then, SOS has make over a dozen tuck- in acquisitions as well as enjoyed attractive organic growth.

- Warburg Pincus bought controlling interest in Universal Protection from Partners Group on July 14, 2015. With the recent purchase of Guardsmark, Universal now has annualized revenues of approximately $2.1 Billion.

MULTIPLES

Selling Prices for Large Contract Security Company Transactions

The following summarizes the large ***announced*** transactions for the past 15 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, part of the purchase price was paid based on account retention post-closing and the amount of the post-closing payment was not announced.

					Price as Multiple	
Company Sold	Buyer	Revenue	EBITDA	Price	Revenue	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						
(1) Paragon Systems, Inc.	Pinkertons Government Svcs	$140M	N/A	$34.5M	25%	N/A
2011						
(1) Security Consultants Group	Paragon Systems, Inc.	$106M	N/A	$22M	21%	N/A
(2) U.S. Security Associates, Inc.	Goldman Sachs	$765M	N/A	N/A	N/A	N/A
2012						
(3) Andrews International	U.S. Security Associates, Inc.	$350M	N/A	N/A	N/A	N/A
2013						
(4) IPC International	Universal Protection Services	$130M	N/A	$24M	N/A	N/A
2015						
Valor/Brantley	Universal Protection Services	$130M	N/A	N/A	N/A	N/A
(5) AlliedBarton	Wendel Group	$2.1B	$150M	$1.67B	80%	11.67x
Guardsmark	Universal Protection Services	$500M	N/A	N/A	N/A	N/A

N/A = not provided in the announcement

(1) 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.

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

(3) This transaction was announced as a merger.

(4) IPC was sold out of Chapter 7 Bankruptcy. Universal purchased the accounts and goodwill; and assumed certain contingent liabilities.

(5) Scheduled to close the end of Q3

As can be concluded from the chart, most of the large announced transactions indicated average purchase price values in the 8 – 10 times EBITDA range; or 40% of annual revenues (except in the case of Universal's purchase of IPC, which was bought out of Chapter 7 bankruptcy and was not an "enterprise value" purchase). **However, the recent announcement by the Wendel Group of its intention to buy AlliedBarton greatly exceeded these averages coming in at almost 12 times EBITDA and 80% of annual revenue; which underscores the greatly improved multiples being paid for large and small contract security companies today.** Many of the transactions have involved a larger security company buying its competitor, or in the case of Securitas buying Pinkerton, APS, Burns 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 Private Equity 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 PEG'S return on investment in the short term was not as attractive as the industry buyers were enjoying. However, the PEG's had to be competitive in the bidding process for the initial buy. As the PEG's 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 Companies

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; except for the proposed AlliedBarton/Wendel transaction, which came in at 80% of annual revenue – greatly exceeding the averages. The multiples of the **sellers'** reported EBITDA are still higher for the smaller transactions than the larger transactions, since the buyers in the contract security industry (unlike many other industries) 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 using the traditional "street formulas" as a way to estimate the eventual selling price of the company. These "street formulas" are based on multiples of gross units (percentages of gross annual revenue or multiples of gross monthly billing), irrespective of the actual earning potential of the company, and are often used 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 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) – thereby proving the fallacy of valuing the company on gross units.

In fact, the "street formulas" were never used by the experienced buyers. **These experienced buyers today are buying profit, not gross revenue and they're paying more for it**; they're buying the accounts based on a multiple of the profit at the site level (which determines the buyers' economic return on the acquisition) and that multiple is adjusted depending on: the attractiveness of the accounts, quality of management going with the sale, geographic location of the accounts – and several other characteristics important to buyer prospects.

The multiples the buyers are paying for the small contract security companies have increased 50% over the past 5 years

The multiples being paid for the small companies today are the highest we've seen in over 25 years, but this doesn't necessarily mean the total selling prices have increased for all these sellers. As the revenue and/or gross margin of many of the small companies have dropped, the selling price has remained steady or decreased since the higher multiple is applied to a lesser profit**. As previously stated, the buyers are buying profit, not gross revenue**. There are several things that are contributing to this increase in buying multiples:

- **Buyers are paying less to borrow money** and are passing this savings on to the seller in order to entice the "fence straddlers" to come to the closing table.

- **The Private Equity Groups, that already have investments in the security space, are sitting on a lot of idle cash** and they need to put these investments to work quickly. They're stepping up to high multiples early in the negotiation process so as not to risk the owner losing interest in selling.

- **The increase in the Federal capital gains rates** from 15% to 24.8% caused many owners of very attractive companies to put their sale plans on hold; the buyers, in an effort to get the seller's back to the negotiating table, offered more money to offset much of this increase.

The Affordable Care Act and the Anticipated Valuation of Selling Companies

TREND: Unchanged since the July 2014 report. Owners are still concerned over the long term effects of the ACA – the cost of the premiums as well as the additional administrative cost to implement and comply with the reporting requirements.

During the year 2014, owners got a chance to discover some of the perils of the ACA. Most owners say that it hasn't been as expensive as originally thought, at least for the year 2014; but are concerned about what happens in future years as more and more employees decide to leave the expensive exchanges (because of the tax penalties) and go with a company plan. Most of the small companies have experienced 10% or less participation; and almost all the companies have said that around 30% of their customers have agreed to a bill rate increase to offset most, if not all, of the cost increase brought about by the ACA.

It's still unclear as to what effect, if any, the ACA will have on the selling prices of the small companies. While there have been many owners to put their company up for sale in the past couple of years because of the concern over the ACA, there still has not been a mad rush to the closing table. We think most of the owners that are concerned are still in a "wait and see" mode – hoping for sweeping changes that will eliminate the expense of implementing the plans or an outright repeal of the Act, which most politicians say can't happen.

It's Still a Seller's Market

Trend: Seller's multiples reached an unprecedented high for the July 2015 reporting year as buyers increased their offers in order to get the attention of owners of quality contract security companies.

The aggressive buyers today are the large contract security companies owned in the majority by Private Equity Groups and these PEG's are under pressure to grow. They're sitting on a lot of cash that needs to be put to work; and some of the PEG's are nearing the time to exit. Organic growth alone cannot increase the value of the exit enough to satisfy the investors – they need acquisitions; and, in order to get the attention of owners of attractive smaller target companies, they're having to be generous in their offers.

Most of these smaller company targets have gross margins that tend to be 4% - 6% higher than these large buyer's – so acquiring the smaller competitor is the most prudent use of this cash or untapped credit line. However, while these generous buyers are still very active in making acquisitions, they are doing so with caution. Unlike the acquisitions of the past, these buyers are not just buying revenue. They're buying quality earnings and are performing a more thorough due diligence on the companies they're buying.

Factors Driving Owners to Sell in Today's Market

Trend: Higher Operating Costs, Shrinking Margins, Increased Competition and Unprecedented Selling Multiples are putting owners in the selling mode.

- **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 in the long run, most owners think it will definitely mean less profits and loss of customers or billable hours. While owners had to comply with the ACA in 2014, its real impact on the company and industry as a whole is still very much uncertain; which is driving some owners to put their company on the market now [See page 46 under "Challenges and Opportunities for Owners of Contract Security Companies"]

- **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. Note in the "Industry Leaders" section of this White Paper that the organic revenues of the "Leaders" increased around 7%, while the total market grew at an unimpressive 4%. This means that a lot of the increase in revenue for the larger companies is coming from their smaller competitors – with a small percentage coming from increases in security from their existing customers. 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.

- **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.

- **Probable increase in taxes** - [See page 47 under "Challenges and Opportunities for Owners of Contract Security Companies"]

- **Unionization –** [See page 46 under "Challenges and Opportunities for Owners of Contract Security Companies"]

- **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 most companies – whether small, medium or large. The companies that can (i.e.; the large and medium-sized companies) are compensating by getting more efficient below the site level line. They 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.

- **Original owners reaching retirement age.** Many contract security companies today were started 30 – 40 years ago, when the trend to outsource security was getting started in a big way. These owners are now reaching retirement age and are looking to sell their business.

Why Owners Are Not Rushing to Put the Company on the Market, in Spite of Shrinking Margins and Revenue

Trend: Unchanged since our July 2014 report

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:

- **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.

- **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 market returns declining so dramatically, doing this safely and profitably in the current economic climate would be very difficult. The profits they are making from their company cannot be replaced by returns on the after tax monies invested from the sale of the business.

- **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.

- **Many companies have already lost value:** Many of the contract security companies have, in fact, felt the effects of this very competitive market 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 settle for a reduced price because they still have high expectations, so they are hoping their company will get large and more profitable again; at which time they will think seriously about selling.

OUTLOOK

Challenges and Opportunities for Owners of Contract Security Companies

TREND: In the past 24 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.

CHALLENGES:

- **The Affordable Care Act**

  As mentioned in past White Papers, the ACA is and continues to be a great concern to owners of ALL contract security companies – large and small. The cost of the insurance premiums mandated by the ACA is still a moving target and a big question mark in the minds of the owners of contract security companies. The year 2015 will soon be in the past, but there is lingering concerns as to the number of new enrollees in future years as well as the additional burden and cost of administering the plans and the penalties for non-compliance; even if unintentional.

- **Increase in Minimum wage**

  Several states have announced a "proposed" or already "approved" increase in the minimum wage – some gradually increasing up to as much as $15 per hour; others getting there at a much faster pace. The concern to the owners of contract security companies is that the increase in billing rates necessary to offset the wage increase may cause many customers to have to reduce security coverage hours or eliminate security altogether.

- **Deeper Unionization of the Contract Security Industry**

  For some companies the wage rates and benefits mandated by unions are lower than what the company provides its non-union personnel. However, for the vast number of companies, unions increase operating cost, which in turn lower margins.

- **Continuing Proposals to Increase the Federal Income tax rate on Capital Gains**

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. In January of 2013, the capital gains rate was increased from 15% to 20%, which has already adversely affected owners selling their company. But there are rumors that another change may be coming that will make it even more expensive for owners to sell to sell their companies.

In a July 20, 2015 issue of the Wall Street Journal; there was an article on Hillary Clinton, the Democratic Presidential candidate, that stated her position on new taxes: it went on to say that she proposes to re-vamp the capital gains taxes – indicating that under most circumstances the capital gains rages would be higher than the 28% rate proposed by President Barack Obama earlier this year.

In a recent article our firm published on this subject, before the tax increased from 15% to 20%, we gave examples of how much the worth of a company had to increase for an owner to net the same after taxes on a future sale as it would net had the company been sold in 2012.

- **Higher Unemployment and Other Taxes**

Owners of large and small companies are still experiencing very large increases in unemployment taxes even though the unemployment rate has decreased over the past year. As state unemployment funds have been depleted during the high unemployment period, the rates are continuing 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 revenues. 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.

- **Mandatory Paid Leave**

Some states have already mandated paid sick days to all employees and the trend is growing. A June 22, 2015 "New York Times" article indicated that there's …. "New Momentum on Paid Leave, in Business and Politics". The article went on to say that …"Oregon this month became the fourth state to pass a bill requiring that companies give workers paid sick days to care for themselves or family members". The obvious concern to the owners of contract security companies is that this is just one of many new laws being passed that increases the cost of operating a business that probably will not be able to be passed along to the customer.

OPPORTUNITIES:

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

- **The Affordable Care Act**

  Just as there are concerns over the ACA, as mentioned above, there are also companies that see this as an opportunity: Some owners say the ACA 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" on page 46). However, there is still a concern among many owners of small contract security companies that their larger competitors will be buying insurance at cheaper rates because they will be buying in larger volumes or may even be self- insuring.

  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.

- **Municipalities Continue the Trend of Outsourcing its Security Function**

  A look at the public bid list will reveal that more and more municipalities are looking for ways to contain cost as it's faced with having to raise rates to its customers; and the municipalities are doing it through outsourcing its security functions and in some cases, its police force. Not only is it outsourcing to reduce its cost, but also to get more effective security now being provided by the contract security companies that have invested heavily in technology – something the municipalities have been lax on doing over the past few year because of budget restraints.

- **Expansion of Private Airport Screeners**

  The 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.

  A recent report by ABC News indicates that the TSA agents are failing miserably in carrying out their duties of protecting the traveling public. It reported that undercover agents in the Department of Homeland Security (DHS) successfully smuggled fake explosives and weapons through 67 of 70 checkpoints in a secret nationwide exercise. One of the solutions being considered [and probably the most viable] is to expand the Screening Partnership Program (SPP). Created in 2001, the SPP allows private airport screeners to operate under the oversight of the TSA. Private personnel check bags, screen passengers, and manage daily affairs while meeting the same standards of originally enacted by Congress after 9/11.

- **Increasing Crime and Terrorism**

  Immediately after 9/11 there was a large spike in contracted security, which eventually settled back down; albeit a much higher level than before the attacks. There's been increasing terrorists threats to our country over the past several months, which is reminding many people of what happened on September 11, 2001; and they're concerned that it could happen again.

  Also, there's been a growing number of mass murders in our schools, theatres and shopping malls; and growing concerns over airports, nuclear sites, subways, and sporting events – all having a chilling effect on our nation. All this points to a compelling reason to initiate or ramp up security at these type locations or other locations where large number of people are gathered. The public police forces are not equipped to handle the special security expertise required to secure some of these critical infrastructures; therefore the owners are looking to outsource these functions to companies with the experience and technology to handle this type security.

- **The trend of outsourcing the security function is still growing as the Contract Security Companies are offering a wider menu of services, especially in the electronics security and technology areas.**

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