

# Security Finance Newsletter

December, 2003

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Volume I, Issue 1

## Newsletter Debut

This is the first of a series of quarterly financial newsletters that **Peter A. Sokoloff & Co.** will produce for Security company owners, CEOs, CFOs and corporate development executives. We will endeavor to provide you with insights

***This newsletter will track various financial trends, especially those that suggest corporate valuations.***

and experiences gleaned from the activities of the private and public companies in the sector. Our goals are to illuminate and educate, thus contributing to the growth of our readers' companies. **Peter A. Sokoloff & Co.** advises on mergers and acquisitions in the Security industry. We welcome all inquiries.

## Sokoloff's "Back Page"

Sokoloff & Co. compiles and tracks a group of publicly-held Security companies. Beginning with the third quarter of 2002, we have published various financial and valuation metrics for these companies. Each quarter's information is consolidated into a chart on the back page. We use this information to point out trends and provide facts and analysis. Where other attribution is not given, facts cited in this newsletter are extrapolated from current and past Back Pages.

## The Financial State of the Security Industry in 2003

- After three quarters of 2003, the

Security industry has an annualized revenue growth rate of about **11.3%**.

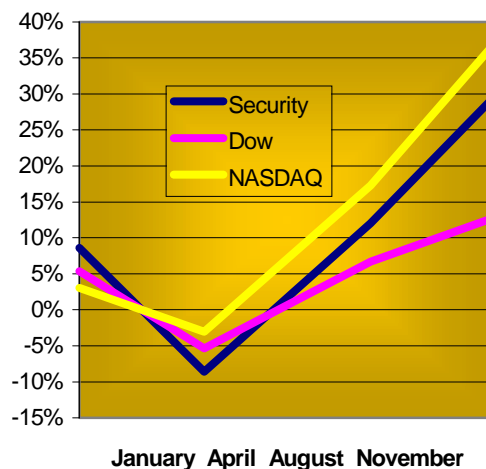
### As of November 12th, 2003:

- Security company public market valuations have risen by **29.7%**.

After a near 10% drop in value from January through early Spring, the **Sokoloff Security Index** rebounded, mirroring the rise in the **NASDAQ** and beating the **Dow Jones Industrial Index**.

*A note about stock indexes: In a similar fashion to the NASDAQ and the Dow, the Sokoloff Index is determined by totaling the trading prices of the stocks tracked on the Back Page. This is done as of the*

**2003 Sokoloff Security Index Compared to Dow and NASDAQ**



*closing of the market on periodic days, thus creating a means for statistical comparison.*

- The median *P/S* of the public companies tracked rose 21%, to **1.15**.

*Analysts sometimes look at a multiple of revenue, called "Price to Sales" (P/S) when comparing corporate value. P/S is derived by taking the market*

*capitalization of a company and dividing it by trailing twelve months' revenue.*

- The median *P/E* rose 31.4%, to **27.16**.

*"Price to Earnings" (P/E) is another analytical tool, created by dividing the market capitalization by trailing twelve months' earnings.*

- The median *Enterprise Value Multiple (EVM)* rose by 22.6%, to **13.08**.

*Please see the top of the Back Page for an explanation of Enterprise Value Multiples.*

## Honeywell Acquires Silent Witness

On October 10, **Honeywell (HON)** and **Silent Witness (SILW)** announced **HON's** all-cash takeover bid for 100% of the shares of **SILW**.

**SILW** is based in British Columbia and the offer of C\$11.27 per share was made in Canadian dollars. **SILW** trades on the NASDAQ and daily quotes are expressed in US dollars. That equates to about US\$8.65 per share. This represents a 60.5% premium over **SILW's** trading price just prior to the announcement.

This is a handsome price for **SILW**. Despite a strong, well established CCTV product line, revenues have been on the decrease. **HON's** distribution clout should improve revenues. Meanwhile, **SILW** had made reductions and succeeded in increasing earnings significantly. The

Enterprise Value Multiple (EVM) that **HON** is paying for **SILW** is about 7.6x; the *P/E* is about 27.7x. If we adjust **Honeywell's** trailing twelve months financials to exclude a one-time mammoth write-down the company took in Q4 2002,

*(Continued on page 2)*

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HON's current EVM is about 11x and its P/E would be about 20.67. *The difference in EVM suggests that the transaction will be accretive to HON's shareholders.*

Typical for these types of offers, HON is requiring that 90% of the outstanding shares be voluntarily tendered. This is the magic number that allows a "cram-down" whereby any straggling shares under 10% are forced to take the cash. HON will then own 100% of SILW. SILW shareholders have until Dec 3rd to accept the offer.

*From the desk of Pete Sokoloff:*

### **How Much is a Security Systems Integrator Worth?**

Deciding how much a company is worth is a complex process of developing a forecast of a business's performance, and then determining the value of cash after taxes that may reasonably be expected in future years. *Buyers and sellers use a common shorthand method for achieving a ballpark valuation by multiplying EBITDA times a multiple.*

EBITDA is Earnings Before Interest, Taxes, Depreciation and Amortization. Multiples historically paid in the Security industry generally range from 4x - 6x. Thus a systems integrator with revenue of \$10 million and EBITDA of \$1.5 million would sell in a range of \$6 million to \$9 million. Some factors that would drive the multiple up or down are historical and anticipated revenue growth, quality of the customer base, proprietary skill sets or technology, management controls, the way that the transaction is structured and market conditions. These are a few of the many factors a skilled appraiser considers.

Generally, the degree of revenue growth expected in the future is the single greatest factor affecting which multiple is used. A company that has historically grown at 30% per annum and has excellent prospects of continuing that rate of growth in the future, might fetch a 6x multiple. The same company, with 5% growth in revenues might only bring 4x.

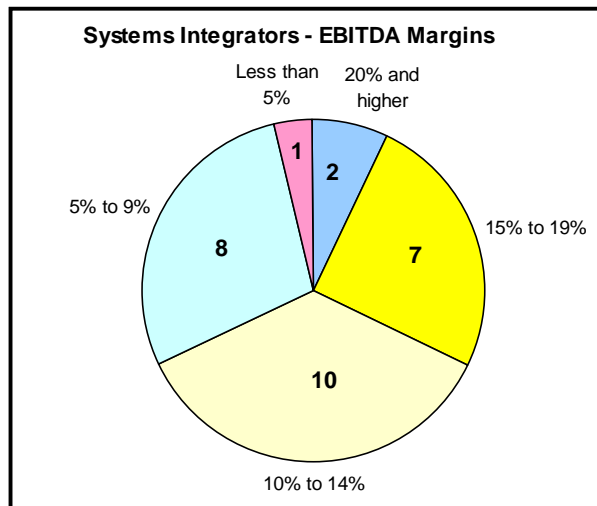
#### **EBITDA vs. Revenue Growth**

In the day-to-day challenge of running a company, managers may make decisions

that sacrifice some profitability in favor of more revenue. This can be a slippery slope that produces revenue growth, but less value. Consider a fictitious company with annual revenues of \$10 million. The company's value is the result of multiplying its EBITDA times a multiple. The multiple used tends to drop as revenue growth is slowed.

*Which is a better scenario? Growing revenue faster and reducing EBITDA margins? Or increasing EBITDA margins while slowing revenue?*

A slow, or no-growth company, which might sell for a 4x multiple and has 15% EBITDA, is potentially worth the same as a rapid revenue growth company that trades at 6x and has a 10% EBITDA margin. Look at the chart below and compare what happens to value at the 5%, 10% and 15% EBITDA levels shown. It is easy to conclude that EBITDA, which



run SIs regularly produce 15% and better EBITDA margins. *What's the secret to converting a single digit margin company into a stellar EBITDA performer?* In our interviews, we discovered that well run companies have much more than the inside line on negotiated bids. In fact, some of the high margin performers derive most of their business from competitive bids.

Tips we have seen in play at strong EBITDA margin producing systems integrators:

**Lean and mean management.** A Project Manager does not just drive around and check on jobs. He carries tools and gets hands on so that he is a senior tech with Project Manager responsibilities.

**Above 80% employee productivity.** That is actual on-the-job time, delivering billable services. Technician production time is not eaten up by having them show up at the shop every morning for coffee

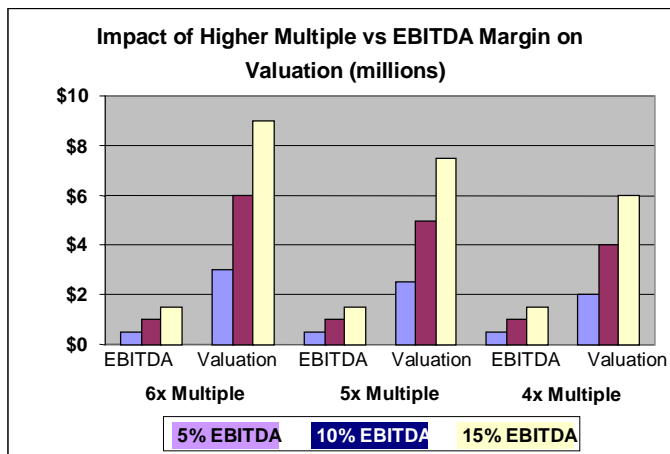
and orders or to pick up a truck. Know how long certain jobs should take and track and schedule accordingly.

***"Which is a better scenario? Growing revenue faster and reducing EBITDA margins? Or increasing EBITDA margins while slowing revenue?"***

**Just-in-time inventory capability.** Very, very little inventory is carried on the balance sheet.

**Keep a lid on hiring while increasing**

*(Continued on page 3)*



translates into profitability, should not be sacrificed for revenue growth.

You say that a 15% EBITDA margin is impossible? On the contrary, in a survey of 28 systems integrators, we found that overall margins varied substantially. The pie chart shows the percentage EBITDA margins generated by a group of 28 security SIs we interviewed. 28% of the companies produce EBITDA margins of 15% or better. 32% have single digit margins. 36% have margins between 10% and 14%.

#### **Improving EBITDA Margins**

We have established that margin is king. We have also shown evidence that well-

(Continued from page 2)

**productivity.** Track revenue per employee every month and keep this number moving upward. The firms we interviewed varied between \$100,000 and \$450,000 of revenue per employee.

**Clean house.** Based on revenue per employee, if the operation is fat, use Jack Welch's (former GE CEO) policy of regularly cleaning out the bottom 10% of employees. Do not replace them unless there is a tactical benefit (tactical means that they pay for themselves with a good margin immediately).

**Strong financial and management reporting.** The reports are used to run the business. Small businesses have difficulty transitioning from "management-by-walking-around" to include managing by the numbers. We have not seen a Security business, with more than \$10 million revenue, making a decent margin - unless they had reporting systems in place and really used them to manage their business. It also helps smaller businesses - One of the SIs we interviewed has \$5 million in revenue and yet achieves a 20% EBITDA margin through very professional management.

**Standard acceptable margins are built into job costing.** Have a sliding scale on Account Manager commissions that drops the commission percent as the gross margin drops.

**EBITDA numbers are known.** Consistently, when we asked the poor performers what their EBITDA margins were, they did not know! Often, we had to review their financial statements with them and extrapolate EBITDA. We found these managers may be aware of gross margin, but are losing the EBITDA battle by not controlling their gross margin, much less general & administrative overhead. Keeping strong profitability going is a constant discipline, requiring company-wide awareness while watching, and driving down costs from every angle.

**Conclusion**

Simply put - *Improve EBITDA and get more for your business!*

*Pete Sokoloff is managing director of the firm. He may be reached at psokoloff@sokoloffco.com.*

**A Look at UTC's Acquisition of Chubb**

Defense and aerospace giant, **United Technologies Corp. (UTX)** closed the acquisition of **Chubb Plc** at the end of July 2003. **Chubb** is a provider of electronic security and fire protection products and



is more than twice the gain made by the **Dow Index** overall. The market appears to be validating **UTX**.

**UTX** joins other corporate conglomerates like **GE** who are driving synergies and growth to rapidly build dominant positions within the security sector. **Chubb** President **Oliver Robert** has stated that "the acquisition will provide **UTX** with a unique platform for rapid growth in a fragmented industry ...this acquisition will afford the opportunity to expand our services in North America the biggest market in the world, and mainland China, our biggest future market."

**Chubb's** plans were to double their revenue over the next five years, but the company was not growing. **George David**, Chairman of **UTX** believes that **UTX** is just the right tonic to cure **Chubb's** growth problems. "This is a strategically important deal for **UTX**, adding a new platform for internal growth and additional acquisitions in the security and fire protection markets. It further enhances **UTX's** already exceptional presence in buildings around the world. "

October 2003  
This notice appears as a matter of record only.

Has been acquired by

An Employee-Owned Company

The undersigned advised Jullien

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services. It joins a **UTX** stable which includes other well known commercial building resource companies like **Otis** and **Carrier**.

**UTX paid \$1billion or .425 X 2002 revenues.** Based upon published financial data from **Chubb's** 2002 annual report *the purchase price equates to 8.53 X 2002 EBIT* (Earnings Before Interest and Taxes).

When announced in June, **UTX** was trading at about \$70 per share. **UTX** paid cash and expected that the transaction would be accretive (add to) its earnings in 2003. In mid November, **UTX's** shares were trading above \$86. The 23% increase

**Contact Sokoloff & Co.**

Please contact **Bernie Walko**, **Managing Director of New Business Development** for a confidential consultation about your company's merger and acquisition strategies. **Bernie Walko**, (818) 547-4500, [bwalko@sokoloffco.com](mailto:bwalko@sokoloffco.com).

**"Always do right. This will gratify some people and astonish the rest."**  
- Mark Twain (1901)

# SOKOLOFF & CO. VALUATION RANKINGS OF PUBLIC SECURITY COMPANIES

## Third Quarter 2003 Reports and November 12, 2003 Closing Prices

Sokoloff & Company compiles a quarterly review of selected public Security companies (and companies that dedicate a portion of their business to Security) and compares how each is valued by the public marketplace. Comparative values for each company are expressed as: **P/S**, Price/Sales, which is total market capitalization divided by revenues; **P/E**, Price to Earnings (market cap divided by earnings) and; **Enterprise Value Multiple (EVM)**. EVM is obtained by dividing EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) into the sum of the company's market capitalization, plus any debt or preferred stock and minus cash on hand. Companies with negative EBITDA and/or negative Earnings are listed as ---. All multiples are based on trailing twelve months (TTM) numbers through the most recently reported quarter.

Note: The 3rd Q 03 percentage column is the increase (or decrease) from 3rd Q 02. Where fiscal year has differed from calendar year, the most recently reported information is used.

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Previous		Stock	(000s)	(000s)	(000s)	3rd Q 03	3rd Q 03							
Rank*	Rank	Company	Symbol	11/12/2003	High	11/12/2003	Revenue	Revenue	Revenue	Incr/decr	P/S	P/E	EVM	Mkt Cap
1	1	Genetex Corporation	GNTX	41.99	42	3,207,952	395,258	446,621	112,879	11.2%	7.18	31.64	16.99	3,207,952,020
2	2	Identix Incorporated	IDNX	5.47	7.25	470,743	84,500	91,325	21,332	-14.9%	5.15	---	---	470,742,730
3	3	Digimarc Corporation	DMRC	15.96	17.48	287,232	86,617	93,064	22,300	-15.8%	3.09	29.41	13.11	287,232,120
4	5	Fargo Electronics, Inc.	FRGO	14.2	17.1	176,179	66,035	66,847	17,059	-4.3%	2.64	19.17	13.05	176,179,400
5	8	Engineered Support Systems Inc.	EASI	46.79	47.93	1,148,039	435,452	508,988	155,669	46.0%	2.26	31.69	16.41	1,148,039,440
6	4	Visage Technology, Inc	VISG	3.95	5.84	80,426	30,500	38,216	11,332	39.7%	2.10	---	---	80,425,950
7	7	Diebold	DBD	55.74	57.43	4,041,652	1,940,163	1,991,062	570,239	7.6%	2.03	25.24	11.07	4,041,651,660
8	10	Armor Holdings, Inc.	AH	21.65	21.7	599,077	305,117	333,572	90,882	12.8%	1.80	27.16	16.36	599,077,150
9	6	Diversified Security Solutions, Inc.	DVS	6	7.7	30,828	18,829	18,663	NA	NA	1.65	---	---	30,828,000
10	9	Magal Security Systems Ltd.	MAGS	9.08	9.97	69,889	42,966	51,160	15,332	61.6%	1.37	36.35	19.45	69,888,760
11	11	ManTech International	MANT	25.38	28.31	812,058	472,900	637,214	181,590	39.2%	1.27	32.54	21.17	812,058,480
12	12	ADT Security Services Inc.	TYC	22.19	22.65	44,322,373	35,700,000	36,801,300	9,472,800	1.0%	1.20	44.12	19.57	44,322,372,570
13	17	Silent Witness Enterprises Ltd	SILW	8.58	9.67	66,152	57,954	56,636	12,954	-14.6%	1.17	36.51	9.91	66,151,800
14	13	Honeywell	HON	30.32	31.12	26,076,868	22,274,000	22,485,000	5,768,000	3.6%	1.16	---	11.049	26,076,867,600
15	18	Invision Technologies	INVN	28.06	32.5	484,512	439,131	426,831	86,118	-26.4%	1.14	5.43	2.01	484,512,020
16	14	Ingersoll Rand	IR	60.39	61.8	10,344,747	8,951,300	9,418,200	2,519,500	14.1%	1.10	21.17	15.75	10,344,746,610
17	16	Titan Corporation	TTN	21.23	21.6	1,705,066	1,472,600	1,640,233	471,854	33.7%	1.04	49.79	70.03	1,705,066,220
18	15	Checkpoint Systems, Inc	CKP	19.5	20	641,336	639,486	668,166	177,229	11.6%	0.96	20.21	8.63	641,335,500
19	20	Siemens Building Technologies	SI	70.82	71.28	63,026,259	82,436,499	87,203,600	20,264,100	-15.1%	0.72	31.59	9.26	63,026,258,999
20	22	FirstService	FSRV	20.3	21.14	289,681	535,766	594,300	166,531	14.7%	0.49	16.1	8.36	289,681,000
21	21	Napco Security Systems, Inc	NSSCE	8.09	10.2	25,872	55,836	57,376	NA	NA	0.45	---	---	25,871,820
22	23	Johnson Controls	JCI	108.01	110.8	9,670,999	20,469,000	22,646,000	5,999,700	15.0%	0.43	15.03	10.14	9,670,999,380
23	26	Richardson Electronics, Ltd.	RELL	11.21	12.57	173,531	459,463	474,216	119,306	9.8%	0.37	---	17.98	173,530,800
24	24	CompuDyne Corporation	CDCY	8.45	10.78	66,958	155,556	188,821	53,136	28.4%	0.35	22.82	10.46	66,957,799
25	19	Wackenhut Corporation	WHC	22.31	22.31	207,461	566,200	598,015	157,848	11.4%	0.35	6.19	6.24	207,460,690
26	27	Brinks Company	BCO	20.5	20.53	1,112,187	3,776,700	3,851,900	1,005,200	6.2%	0.29	37.71	99.51	1,112,186,500
27	25	Protection One, Inc	POI	0.61	2.25	59,845	290,600	282,620	NA	NA	0.21	---	---	59,844,660
<b>Total</b>		<b>Index</b>	<b>706.78</b>			169,197,920	182,158,428	191,669,946	47,472,890					
									<b>Average</b>	<b>11.5%</b>	<b>1.55</b>	<b>26.99</b>	<b>19.39</b>	
									<b>Median</b>	<b>11.4%</b>	<b>1.15</b>	<b>27.16</b>	<b>13.05</b>	

\*Rankings are based upon Price to Sales (P/S).

NA: Information not available at press time.

