ALARM CAPITAL ALLIANCE

THE **ACQUISITION** HANDBOOK

Executive Summary

Whether you are looking to grow your business by acquiring another company or you're ready to sell your business, you want to know what's in store for you. If you're considering selling, your goals could range from selling all of your accounts and making a complete exit, obtaining capital to achieve your company's growth objectives, or even finding ways to pay down your debt by selling a portion of your assets. Regardless of the type of sale you're considering, you'll ultimately need a qualified buyer and should be prepared for what the transaction is going to look and feel like.

The flip side holds true if you're the purchaser. You will need to be the trusted and experienced buyer; therefore, the following information applies no matter what side of the transaction you may be on. Understanding the business plan, attrition, operations, location and financials are just a few of the key facets of determining whether or not an acquisition makes sense. Many attempted acquisitions have ended in disappointment due to a lack of adequate planning or inattention to a key element. We'll cover some of the most important aspects of a thoughtful acquisition in this whitepaper.

THE BUSINESS PLAN

The business plan is a formal statement of business goals and a detailing of the specific plans for reaching them. It often includes background information about the team involved in your business (how long they have been in the alarm industry, their prior successes, etc.) and should provide an overall snapshot of your business.

Your business plan should address target changes in customer needs or trends and should identify unique ways that the company has differentiated itself through branding. Your business plan should include detailed descriptions on how you've grown and prospered, and should give investors and other interested parties a sense of your vision, knowledge and experience.

Be sure you've identified and clearly articulated your **vision and core values**. By doing so, you'll have shown that you've continuously had a compass for decision-making at all levels and a method for keeping a consistent "voice" throughout your organization.

Beyond your goals and your values, you'll want to show a crystal-clear picture of **your customers**. Who are they? Why are they expressing the "need" that you will be addressing in your sales approach? How long will they need you and what are the reasons why they might decide to leave? Everything you know about your customer demographic and needs should be outlined in your business plan.

Make sure your plan includes an overview of the **exact products and services** you've been offering those customers, including changes you've made over time. It will be important to touch on the features, benefits and pricing margins for each of your products and services—and how those compare with competitors. Be sure to "call out" any areas in which you have a particular uniqueness or advantage such as the type of technology you offer or how you offer it. Suppliers and inventory, along with any additional research and development, should also be addressed in this section of the business plan.

Potential investors will also want to hear—in detail - about how you've used marketing to promote your business. Include your marketing efforts and highlight any marketing tactics or campaigns that have worked particularly well in attracting or retaining your customers.

Finally, your **financials**. Cash flow is the key metric to focus on because businesses run on cash. Show your Recurring Monthly Revenue ("RMR") forecast for the next 12 months as well as annual projections for the next three years of operation. In addition, make sure you include your assets and liabilities as part of the financial section.

Before you (the seller) offer to let anyone look at your business information ask them to sign a Non-Disclosure Agreement ("NDA") in order to protect your privacy.

If possible, you may also want to show profit and loss (segmenting different areas of your business), cost of sales, operating expenses and net profits. Most importantly, your plan should be updated indicating your present situation. Readers of your business plan will expect to see thorough, in-depth descriptions for each section. Having a thoughtful business plan will prepare you for the numerous questions potential investors may have about your company.

ATTRITION

As a key value driver, attrition will be a primary focus of potential buyers and will directly influence the price they are willing to pay for your accounts or entire company. Your rate of attrition directly impacts the health, profitability, and ultimate value of your security alarm company. Your company's gross attrition rate – the percentage of accounts you lose over a set period of time – directly impacts your revenue.

Gross attrition

Gross attrition is what an investor will be interested in most. If the total number of subscriber accounts (or amount of RMR) your company loses over a period of time (typically measured in losses over the trailing year) divided by the total number of accounts your company owned over the same time period is high (12%+), an investor is less likely to see your company as a valuable investment.

It is important to know your attrition before putting your business on the market!

Make sure you calculate your losses over a period of time and know that, by industry standards, any account more than 90 days past due is considered canceled (regardless of whether notice has been given) and must be factored into your attrition calculation.

Net attrition

Net attrition incorporates the accounts you've gained which replace ones that have canceled (moves and transfers). This rate will also be of interest to a buyer as they realize growth opportunities. A buyer will be interested in knowing the reasons and number of accounts you've lost to ordinary (or natural) attrition versus extraordinary attrition, those that have been lost to a competitor, poor service, or other company performance related reasons. *(Please refer to the Additional Resources section for more information about attrition management.)*

Remember, for potential buyers, *gross attrition* is the more critical metric, as it represents the actual number of accounts your company has lost over the course of a year, expressed as a percentage of your overall account base. This metric reflects the stability of your account base and provides a predictable measure of the potential loss in value,

SIMPLE EXAMPLES OF BOTH GROSS AND NET ATTRITION.

A – *Accounts lost over the past year*

B – *Accounts over 90 days past due*

C – *Accounts gained, replacing canceled accounts**

D – *Total number of accounts owned over the last 12 months*

GROSS ATTRITION:

$$\frac{A + B}{D}$$

$$\frac{A=10 + B=2}{D=100}$$

Gross attrition is 12%

NET ATTRITION:

$$\frac{A + B - C}{D}$$

$$\frac{A=10 + B=2 - C=10}{D=100}$$

Net attrition is 2%

*For example, a new customer that moves into the home of a canceled customer, directly offsetting the cancellation.

over time, of the assets they are buying – the RMR from your accounts at the time of purchase. In simple terms, buyers use gross attrition to predict the loss of RMR they are likely to incur each year after purchasing your accounts and to estimate the cost of maintaining the same rate of RMR through replacement of those lost accounts. A good practice to best determine your attrition rate is to request an online/offline report (may be referred to as an add/delete report), covering a designated period of time, from your central station(s) and reconcile the deleted accounts with your own billing system.

Companies with attrition rates below industry standards (10-12%) may receive higher value for their accounts. Having a healthy attrition rate can also reduce the holdback amount in an acquisition. (We'll discuss holdbacks in greater detail later in this whitepaper.) In some circumstances, a buyer will walk away from a potential transaction if the attrition is too high.

> Tracking long-term attrition over a three-to-five year period can also help identify trends and issues that may not be evident in short-term attrition numbers.

To minimize attrition and maximize revenue and value, companies should monitor both short- and long-term attrition regularly. Calculating your annualized attrition monthly or quarterly can help you identify current issues before they get out of hand.

New Sales Impacts Your Company's Value

A solid sales program that puts the needs of the customer first is going to entice a prospective buyer. This includes delivering an outstanding customer experience and an emphasis on quality assurance during the sales cycle. Constant communication between your sales team and the customer throughout the entire sales cycle and installation process ensures the customer knows what they're purchasing and increases the likelihood that they will use the system and any additional services. When a buyer sees that your program includes:

- ***A Focus on Qualified Leads:*** Which includes identifying and pursuing potential customers who have expressed an interest in your services by making an inquiry by phone or e-mail, visiting your website or blog, or signing up for your newsletter or social media posts, is an excellent and cost-effective way of acquiring the right kind of new customers.
- ***Referrals:*** If your sales team has been trained to seek referrals before the end of a successful sales call, (or incentivizing your existing customers to refer family and friends) a buyer will see you have a consistent, effective means for continuing to generate new sales. Unsolicited referral business is an excellent barometer of how well you have taken care of your customers and will be of great importance to a buyer.

OPERATIONS

In an acquisition, it is important to understand the attention that will be drawn to your business' operations. The term "operations" describes the processes and resources that you use to distribute the highest quality products or services as efficiently as possible. Do you have a clear set of operational procedures? Are they efficient? If you are implementing sound standard operating procedures (SOPs), your company will have a competitive advantage. Any SOPs related to collecting, recording, and maintaining customer account data should be readily available and easily explained to a potential buyer.

Key areas of focus include:

- Installation
- Service
- Customers
- Billing
- Employees
- Property and Tangible assets
- Geographic location

Ensure you can easily describe each aspect of your operation:

1. **Installation:** Show that your installers have the experience and training necessary to provide *quality workmanship* and demonstrate they are installing quality equipment. Staying up to date and offering new technology and new equipment from manufacturers is important in order to stay competitive.

2. **Service:** Be able to describe your entire customer service regimen to a potential buyer. Be prepared to provide documentation on any training your technicians have received and whether installers perform any type of sales role.

3. **Customers:** Remember, not all customers are created equally. Being able to rattle off your top twenty customers and their respective RMR shows a buyer that you are aware of and knowledgeable about your VIPs. Being able to define the general demographics of your customer base, in addition to providing reports which identify unique accounts, will ensure that a buyer understands the overall customer base early in the transaction.

4. **Billing:** Clear and appropriate billing practices are another critical component of the account buying and selling process. Having well defined billing practices and procedures in place for key business functions, including billing cycles and types, expenses related to billing, and past-due collections, allows you to quickly provide this information.

   In addition to providing documented billing processes and procedures, providing the payment history for your subscribers can positively affect the acquisition and will often be required in due diligence. Providing a report detailing customer payments (monthly, quarterly, etc.) gives the buyer more confidence in your accounts and may value them at a higher multiple. To ensure you can provide customer payment histories, work with a PCI-compliant vendor who processes credit card or ACH payments (make sure they can transfer payment information in the event of an acquisition).

5. **Employees:** Hiring and retaining the right employees is a crucial component of a thriving alarm company. When purchasing or selling a business, understanding the culture and attitude of the employees is key to a successful acquisition or divestiture. Attitude, experience and work ethic are just a few of the traits a buyer will evaluate. Each essential employee—from technician to back-office administrator - should have an employee agreement on file. Non-solicitation and non-compete agreements for employees are critical, and help put your company in a stronger position to negotiate future employment if you are selling your entire business. Be prepared to show employment history, salary, bonus schedule, and benefits for each employee to a potential buyer.

6. **Property and Tangible Assets:** Although not as vital as employees, other assets of your business also require good documentation. Fleet of vehicles, inventory, computers, desks, and other tangible assets will come into play. You should know the approximate value of each of these and should have them listed out in the event that you're selling your entire company.

7. **Geographic Location:** Logistics also play a substantial role in determining whether or not an acquisition is favorable.

Remember to consider the proximity to customers and competitors as a key strength or weakness of your business!

The time it takes to provide service to a customer may play a key role in overall attrition. Factoring travel time of a technician will also impact the revenue earned from a new installation or the expense of a service call. Although this information should be included in the business plan, one of the initial pieces of due diligence that a buyer will want to see is the geographic location of the accounts. This could potentially weaken the pool of buyers if the account radius is too far reaching and does not indicate good focus.

FINANCIAL REPORTING

Most often, the major goal of a buyer is to obtain financial synergies, gain market share or improve their sales or leadership team. Analyzing a seller's financial statements ensures that a transaction actually makes financial sense. Therefore, the buyer will want to ensure that it knows what it is buying and what obligations it is assuming. Knowing the nature and extent of the target company's contingent liabilities, contracts, litigation risks and intellectual property issues, all become fair game. This is particularly true in private company acquisitions, where the buyer has little (if any) ability to obtain the information it requires from public sources.

Income Statement

Income statements illustrate the financial profitability of a company. The revenue line of the income statement shows the company's top-line momentum, while the expenses show whether or not the company is using its resources properly. Both parties will be paying special attention to the tax and income expense lines.

An income statement can show you financial synergies that can include a variety of things, such as increased revenue from improved market share, decreased overhead costs and increased expenses such as those related to service. If you only have certain items from the income statement, such as sales and expenses, evaluate those line items only. Once you proceed into negotiations with the target company, you can obtain full financial records.

Balance Sheet

The balance sheet shows a company's major assets, such as land and equipment, and its financial leverage, more commonly known as debt. Most investors will focus on your ratio of total debt to total equity when determining your value. A debt to equity ratio that is too high could jeopardize your company's ability to attract an investor.

Cash Flow Statement

To analyze the cash flow statement, your first concern is to be sure to evaluate whether or not the company has enough cash to cover its payables. A buyer is going to focus on whether or not a company is operating in the red to determine if the acquisition makes good financial sense.

Non-Monitoring Related Contracts

One of the most time-consuming (but critical) components of a due diligence inquiry is the review of all material contracts and commitments of the selling company both in terms of monitoring and otherwise.

The categories of non-monitoring contracts that are important to have in place and available to a buyer include the following:

- Guaranties, loans, credit agreements, liens, and judgments
- Supplier contracts *(manufacturer and central monitoring station)*
- Agreements of partnership or joint venture, limited liability company, or operating agreements
- Past acquisition purchase and sale agreements
- Equipment leases
- Indemnification agreements
- Employment agreements
- Exclusivity agreements
- Real estate leases/purchase agreements that may impact the sale
- Licenses
- Powers of attorney
- Franchise agreements
- Licensing and documentation of compliance
- Proper insurance including errors and omissions
- Non-competition and non-solicitation agreements
- Union contracts and collective bargaining agreements
- Contracts that the termination of which would result in a material adverse effect on the company

Monitoring Contracts

The amount of contractual RMR and types of services a selling company owns is the most valuable part of a transaction. The selling company needs to understand its contracts by knowing the dates and length of its obligations and whether or not a contract contains the following:

1. Assignability *(able to transfer contract ownership)*
2. Third-party indemnification
3. Limits of liability
4. Right to increase rate
5. Contract term, including renewal language *(is Evergreen allowed in your state?)*
6. RMR amount
7. Warranties
8. State regulations

You don't want to wait until you're in the due-diligence phase with a buyer before you make sure your contracts are properly written and saleable. A buyer will scrutinize every detail of your monitoring contracts to make sure they are buying something that will hold its value and provide the proper protection.

Legal

In order to complete an acquisition, there are certain legal documents that will be created by the buyer and their counsel. This time-consuming step typically does not occur until after the due diligence phase has been completed. It is well within the rights of the seller to request the buying company provide what documentation they'll be asked to sign and commit to early in the process. The earlier you (the seller) obtain the legal documents to review, the more time you will have to digest the contents. Prior to signing any documents, have your own legal representation review the paperwork so that you completely understand what you're signing. Allow yourself plenty of time to discuss any items in the documents that you may have questions on and understand that the buyer's documents often cannot be negotiated due to legal requirements, bank covenants, etc.

The Final Negotiation

Ultimately, based on a thorough review of the above factors, a buyer will make an offer to the seller in terms of a multiple of the RMR, often minus a holdback amount.

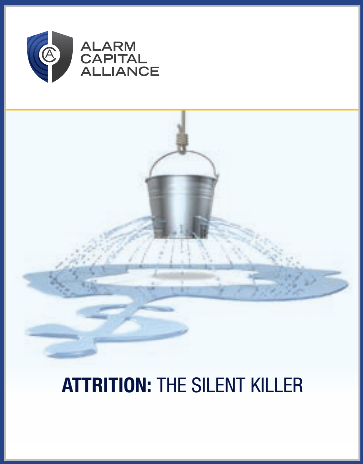
For example, if you are a seller with accounts worth $10,000 of RMR, a buyer may offer you 33x that RMR (or $330,000) to purchase those accounts. The multiple you are offered is dependent on your ability to prove the worth of your accounts. In addition, in almost every scenario, the buyer will require a "holdback" amount as part of their offer. Meaning, a portion of the final selling price (most often 10-15%) will not be remitted when the transaction closes. This is a standard practice in the alarm industry and is done in order to protect the buyer from unnatural attrition that may occur after the transaction closes. This amount is typically withheld during the first year of the transaction (known as the "guarantee period") and is disbursed once the guarantee period concludes. For example, if you have a spike in attrition after selling your accounts, you may lose a portion of your holdback dollars as a result. In order to mitigate a potential loss of your holdback amount, you'll want to actively monitor any attrition throughout the holdback period. Make sure to ask your buyer to provide you with monthly attrition reports so that you can assist them in minimizing attrition and always know the status of your holdback. It is important to note, it is not guaranteed that you'll receive money at the end of the holdback period. It is entirely possible you may owe the acquiring company following the guarantee period if the attrition exceeds the holdback amount. To avoid this scenario, getting regular attrition reports or negotiating for a cap on your potential holdback amount are both options to consider.

Often, both buyers and sellers are unaware of the obstacles they face in an acquisition, which can ultimately turn a good deal into a bad one. Having a keen understanding of your own business plan, attrition rate, operations, location, financials, and legal agreements (along with holdback adjustments) can help ensure the success of the transaction.

During the selling process, the buyer will scrutinize every facet of your business, some more than others, to determine if your company or accounts are a strategic match for their business. The more you know about the process, the more equipped you will be to enjoy a win-win situation. Selling all or part of your business can be an excellent way to raise cash to invest, pay off debt or retire. By taking each of these crucial elements into account, you'll be well-prepared to move forward.

ADDITIONAL RESOURCES

If you are not quite ready to sell your business, but want to ensure you are fully prepared when the time does come, take the time to review our Transforming Your Company into a High-Value Business and Attrition: The Silent Killer whitepapers.



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