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Financial Service

Shoring Up Foundations: A Look at Trends in Financial Services

With possible shifts in the industry over the past year or so, slowing sales and acquisitions aren't necessarily cause for alarm, but they should be cause for wise planning and awareness.

By Tim A. Scally

Rising interest rates continue to have a moderating effect on financial activity in the industry. //
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In times of general prosperity, financial success does not always mean long-term success and viability — the dot-com bubble of the late ’90s and the housing crisis of the late 2010s demonstrated that. Perceptive and discerning people and companies, however, can thrive even when things swing toward the bearish.

The late ’90s and early 2000s also marked a time of increased activity in the security industry, during which many of the larger companies had been merging or had been acquired or were acquiring other companies, describes Ron Davis, founder, president and CEO, Davis Group Mergers & Acquisitions, Long Grove, Ill. “Alarm dealers were being brought into what seemed like a very frenzied cycle,” Davis says.

And that trend continued well into the new millennium. “Up until and even during the pandemic, companies were being sold at a fairly rapid pace. We would get a listing for a medium-sized company and we would have it sold in 60 days. The sheer number of deals attracted a lot of people to become brokers, thinking that this would go on forever.” But Davis says at the end of last year he started to notice that the number of sellers was drying up and the number of integrators available for sale had taken a severe dip.

The Banks Pump the Brakes

About a year ago, rising interest rates began having a noticeable impact on the security industry, as SDM writer Laura Stepanek called attention to last December. That trend has certainly continued to have a moderating effect on financial activity in the industry. David Stang, founder, Stang Capital Advisory, Chicago, says, “Bank debt is priced in the high single digits (off a SOFR base rate of greater than 5 percent) and senior debt from alternative lenders is north of 10 percent.” The impact of this higher cost of capital, he says, is slowing growth, making cash flow generation imperative for companies.

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> — Jim Wooster, Alarm Financial Services

Additionally, the amount of resources required to keep up with the ever-increasing demands for the commercial market, including video, access control, network security, cybersecurity, etc., affects the market, along with the shortage of employees, specifically, technicians, points out Jim Wooster, president, Alarm Financial Services, San Francisco. “The electronic security industry has known for years that we have not kept pace bringing young technically oriented people into our field,” he says, “and we’re now seeing the consequences.”

Compounding and related to these concerns is the increased conservatism by lenders. “Banks are withholding precious capital for their current customers,” Stang says.

A result of these high rates is depressed valuations and more strain on operating businesses, says Henry Edmonds, president of The Edmonds Group, St. Louis. “This in turn causes lenders to be more cautious and tighten lending terms. The result is that transaction activity is down significantly except for a few hot sectors where buyers have a stockpile of cash to deploy.”

Hot sectors notwithstanding, the large companies continue to bring buyers to the table. “The bigger companies that have private equity backers — they are buying,” says Rory Russell, owner, Acquisition & Funding Services, Kattskill Bay, N.Y. “It is very frothy right now.” Russell describes a booming business in which baby boomers are looking for an exit strategy; these boomers have built big and prosperous businesses, especially in the security, fire and integration spaces. “Those companies are going for good money. There are a lot of well-qualified buyers for the decent-size companies.” Russell says interest rates are not affecting the bigger deals. “Any revenue above $2 or $3 million dollars, I can get traction with the private equity if it is a tuck-in for a larger company.” Russell says you want to get to at least $2 million in revenue, preferably $3 million. The higher the revenue, the more people are going to come to the table and want to talk to you.

In fact, Russell sees a shift in the industry toward the basics. The door-to-door tactics of no-cost/low-cost systems are over. These methods, people are learning, are not effective for a couple reasons. First, they have high attrition rates, and second, people see no-cost/low-cost systems as having little value because they are not financially invested in them. “The industry is going more toward the traditional methods,” he says. “It’s going back to more good product and good selling and good installation. We’re going back to good foundations. Do it right and sell it to the right people.”

> ### Au Revoir, RMR?
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> For years the drumbeat in the security industry has been a focus on RMR. Companies have offered various promotions and have had many methods of increasing RMR at all costs, including installing free or nearly free products to create that recurring revenue stream.
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Russell believes the shift took place in the past three years. Davis agrees, adding you don’t see anywhere near the number of medium-size companies that there were five years ago, calling it a “paradigm shift” in which smaller companies are consolidating among themselves. So what are companies to do in the face of a changing landscape? Improve efficiency and focus on the bottom line.

Wooster believes success is determined more by internal ability to execute rather than external economic fluctuations. “What I have seen over the years is that well-run security companies do well in good economies and bad. Our industry has been extremely stable, and company valuations have been relatively consistent for a long period of time.”

Things may evolve and patterns may change, but the need for good security installed and maintained by experts will always be in demand. Companies should have a solid business that is well managed and also ensure that their financial models demonstrate a strong ability to support projected debt service. // SANJERI/E+ VIA GETTY IMAGES

This is a good time to tighten your belt, but keep your eyes open for good opportunities that may surface due to the high interest rates, says Les Gold, partner & chair of MSK’s Security Alarm & Monitoring Technology Practice Group, Mitchell Silberberg & Knupp LLP, Los Angeles, and author of *SDM’s* Security & the Law column. “Make sure you have a good solid contract with privacy protection with your subscriber before providing service; stay abreast of what is happening in technology, particularly with artificial intelligence and don’t oversell.” Gold points out the continuing movement in the industry, such as Secom’s purchase of Eagle Eye Networks and Brivo for $180 million.

Stang offers this advice: “Companies really need to have their financial house in order. They need a strong grasp of unit economics, creation costs and growth costs. They need a solid and believable business plan that is evidenced in improving historical and projected financial results. Lenders are in a ‘risk-off’ mode that can only be overcome by a convincing story, strong management team and demonstrated financial performance.”

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Edmonds says his company is working with a number of clients to focus on improving operating efficiency and improve their operational and financial reporting. “Going into next year in the strongest possible posture will help companies weather a recession if one comes, or maximize their ability to transact if conditions improve and uncertainty abates,” Edmonds advises.

Steve Rubin, partner, Davis Group, offers some practical tips for creating a robust and efficient business with a strong bottom line. He recommends, for one thing, focusing on technology.

“Cybersecurity, robotics, artificial intelligence and more — are you up to speed? Do you have employees who are knowledgeable in these areas? The companies that do embrace all of this will be more apt to satisfy customer needs, and you’ll be passed by,” Rubin says.

These new technologies, however, are creating new opportunities. “With the new technology creating greater appeal to new entrants into the industry, plus new investor interest in our space and the likelihood of continued consolidation, our industry is prime for new opportunities and significant growth,” says Kelly Bond, partner, Davis Group.

Davis agrees. “Companies in the industry are continuing its growth by adapting new technologies, new types of electronics, and new methods of identifying and capturing perpetrators of crimes in the homes and businesses.”

An Industry in Flux

In effort to differentiate themselves, companies are looking for their own proprietary hardware. This drive toward new technology is taking the industry further ahead. For example, there’s a great deal of activity in video and video monitoring, and the quality that manufacturers bring to that segment of the industry has changed significantly.

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All of this speaks to the robustness and resiliency of the security industry. Things may evolve and patterns may change, but the need for good security installed and maintained by experts will always be in demand. Companies should have a solid business that is well managed, yes; but they should also ensure that their financial models demonstrate a strong ability to support projected debt service, Stang says. This focus on the strength of the bottom line will always make a company desirable for buyers. “This is especially important in times of pull-back and conservatism among buyers and private equity investors, who, although they may be looking for deals, are mostly interested in very high-quality businesses with few or no problems and at modest valuations,” Edmonds describes.

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For buyers, acquisition opportunities abound. As mentioned, a demographic wave of alarm company owners who are reaching the age where they’d like to retire are looking for an exit strategy, which may involve a lesser role or possibly walking away altogether. Many of these retirees, Wooster says, are not trying to time the market; in fact, some “need to sell because their spouse is telling them to do so.” And that’s a bidding not easily ignored. This abundance of acquisition opportunities is one reason for reassurance, says Davis, who points out the relatively nominal requirements to enter the industry and adds, “Almost anybody could start a company, and almost anybody can buy a company, and they do. So there’s always going to be movement of companies and technology and people.”

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Former Associate Editor Tim Scally wrote and edited news-focused articles and columns, including Insider and Newswire. Along with attending shows and delivering breaking news, Tim wrote blog posts, feature articles and company profiles; he also deployed the SDM e-newsletter and posts to social media. Before joining SDM from a previous editorial position at BNP Media, Tim spent more than 10 years as a middle- and high-school English teacher. He holds a Bachelor of Science degree in English Education from Maranatha Baptist University.

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