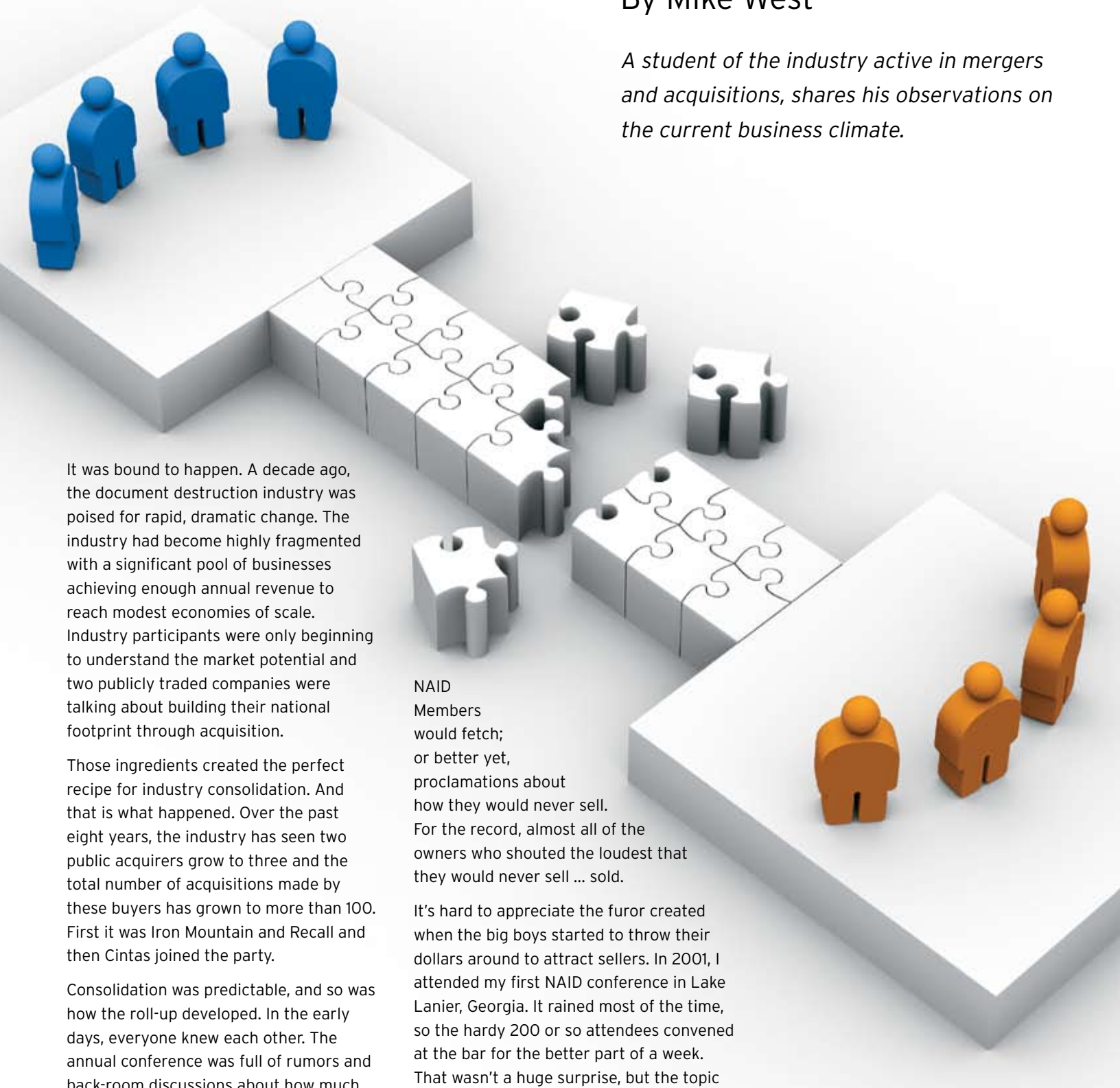


Back to the Basics

By Mike West

A student of the industry active in mergers and acquisitions, shares his observations on the current business climate.



It was bound to happen. A decade ago, the document destruction industry was poised for rapid, dramatic change. The industry had become highly fragmented with a significant pool of businesses achieving enough annual revenue to reach modest economies of scale. Industry participants were only beginning to understand the market potential and two publicly traded companies were talking about building their national footprint through acquisition.

Those ingredients created the perfect recipe for industry consolidation. And that is what happened. Over the past eight years, the industry has seen two public acquirers grow to three and the total number of acquisitions made by these buyers has grown to more than 100. First it was Iron Mountain and Recall and then Cintas joined the party.

Consolidation was predictable, and so was how the roll-up developed. In the early days, everyone knew each other. The annual conference was full of rumors and back-room discussions about how much

NAID Members would fetch; or better yet, proclamations about how they would never sell. For the record, almost all of the owners who shouted the loudest that they would never sell ... sold.

It's hard to appreciate the furor created when the big boys started to throw their dollars around to attract sellers. In 2001, I attended my first NAID conference in Lake Lanier, Georgia. It rained most of the time, so the hardy 200 or so attendees convened at the bar for the better part of a week. That wasn't a huge surprise, but the topic

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on everyone's mind was whether or not to sell, how much so-and-so got for his business, etc. It was out of control. I left that conference and had 11 companies call me the following Monday and ask me to help them sell their businesses.

Two years later, the industry was even hotter. The number of new businesses had grown substantially. Some, if not most, of the new entrants came because of the promise of a growing industry that is "easy" to enter and the certainty of a huge payday delivered by the big-money buyers.

At the 2003 conference I presented the topic, "What Happens When Industries Consolidate?" My presentation was centered on the belief that the industry was in Phase I of consolidation. Phase I is a time when revenue growth is exponential, pricing of services is at a premium, competitors aren't viewed as competitors and profit margins are high. Life is good. At the time, I was accused by some encouraging people to sell. Maybe that criticism was fair. I did believe those who wanted to obtain an optimal return needed to act.

Today, the rapid consolidation and the corresponding above-market valuations experienced for a decade are over. The national players have secured their domestic footprint. Yes, they still acquire companies in the space. They just are not motivated to pay high multiples and act quickly to close a deal. So where does that leave owners? It leaves you owning a business in a great industry with huge potential.

At the most recent NAID conference this past April, I participated in a roundtable discussion about maximizing business

valuations. At the time, I stated that now is not the time to sell your business. I stand by that statement.

Sure, someone will always be trying to buy your business, but the feeding frenzy has passed. It's time to focus your attention on enhancing return by building an excellent business, a business that can withstand and prosper through the long industry life cycle.

Given that, if I were in your shoes, I would do the following.

Maintain Pricing Discipline

One of the notable characteristics of a consolidating industry moving into Phase II is the pressure the market places on pricing. Said differently, as more companies enter the industry, more

I have witnessed a recent trend: Numerous companies seem to be losing site of the economics of the shredding business. Paper prices are at an all-time high, giving owners a sense of invincibility. Paper is a by-product of being a shredder: It is a commodity, and thus susceptible to commodity pricing. Study your numbers and make sure the bottom line you see isn't attributable to unsustainable paper prices. If your profit is driven in large part from your paper revenue, you are destined for trouble.

Given outside pressures on pricing, and recognizing the price you collect from your customer impacts your overall profitability, you must carefully review your pricing strategy. It isn't a good idea to lose a little bit on every transaction thinking you will make it up in volume.

Profitability

The bottom line is important. Granted, that sounds silly to say, but it is an important concept to remember. I stress this point because for the past several years, many shredding companies have focused only on the top-line sales number. This occurred because the rumor mill was full of examples of

the buyers paying multiples of revenue regardless of the net income of the business.

As stated above, those days are gone. Profits matter. They matter to you as the owner, to outside investors, to the bank and to your employees. Everything you do should be to enhance the profit margin of your business.

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people compete based on price, resulting in lower average prices for services.

Anecdotally, prices for bin tips appear to be about half what they were only four or five years ago. Again, this is driven by new entrants who have concluded being the low-cost provider is the only way to grow their businesses. It is also attributable to the price competition the large players can inflict on a given market. They have deep pockets and can go as low as necessary, if it makes sense to their overall strategy.

With pricing pressures and increased competition, it is difficult to achieve the profit levels of the early days. Frankly, paper prices are masking that fact. This isn't bad news: It's an opportunity. The document destruction business can be very lucrative. If you pay attention in the good times to your margins and your costs, in the bad you will thrive while others struggle and fall away.

Want to test how you stack up? Look at your P&L year to date and cut the paper revenue in half. If you still look viable, you're managing the business well. If you see your profit vanish, it's time to look at the P&L carefully to see what you can do to enhance margins.

Growth Is Good

Along with paying attention to the expense side, you can never lose focus on growing the business. The future offers a unique opportunity. Awareness for the need to shred is at an all-time high. As an owner, you have benefited from the activities of NAID and the industry leaders who have gone before you. I am not sure how much of the industry is vended, but I suspect the percentage is still relatively modest. In the end, this industry still has a lot of growth ahead of it. As an independent, you better make sure you get a piece of that growth curve.

Additionally, because so many new small entrants have entered the game, there is a huge opportunity to grow through acquisitions. You should be thinking about growing organically, but don't miss the chance to buy local competitors who are struggling. Getting them out of the way keeps them from hurting local pricing and helps to add volume to your business.

The current feeling among the financial types who pay attention to this industry is that a secondary, more local, consolidation is in order. It is starting to happen and will only gain momentum. As the large buyers become more selective and the opportunity for an exit is less obvious, you will see more small companies combining forces to create a

stronger offering. This is a good thing and a trend you should embrace. If you aspire to thrive in the future, you should be looking to grow through all available means.

Infrastructure

By now you should have figured out that you may own this business for a while. Given that, I suggest you build the business in a manner that will allow you as the owner to become, over time, more irrelevant to the overall success of the business. Sound crazy? Not really.

You should be building your business, its infrastructure and its management team so it doesn't revolve around you. I am not suggesting a passive approach. To the contrary, I am simply suggesting the strength and viability of your business will only grow if you have a deep team capable of running the business through any circumstance. Building a strong team will lead to a strong organization. In the end, it might be the distinguishing feature between you and your fiercest competitor.

Owning for the Long Haul

Finally, and most importantly, run this business like you plan to keep it. The best advice I can give someone interested in selling their business or enhancing its value is to run it as if you and your name will always be associated with the business.

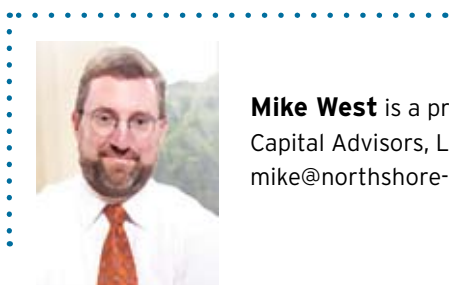
So many times businesspeople get ahead of the game and fail to see what is in front of them. If you are still in the shredding industry, you didn't participate in the first big wave of consolidation. That's okay, nothing wrong with that. However, the reality is you should now focus on the future and not worry about multiples of revenue.

The Future

My guess is most of you have already figured out the environment has shifted and you have started managing your business to reflect the new reality. To you I say congrats.

I would expect the trend toward fewer large shredding transactions will continue and the buyers will continue being very selective about whom and what they buy. I also believe local acquisitions/mergers will gain momentum and pace. That will be fun to watch.

Finally, the document destruction industry is a great place to be. Because of its upside, and the emergence of regional independents with some size, new buyers will find the industry and begin a second wave of consolidation. I suspect we are three to five years away. And if my guess turns out to be true, now is the time to get back to the basics.



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