THE HOMETEAM DEAL: A CLOSER LOOK AT THE NUMBERS

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I am writing this article in a café not more than 100 yards from Independence Hall, where the Declaration of Independence and the US Constitution were signed and currently the epicenter of the PA Democratic Primary, which is taking place as I write (the polls close in about an hour). Last week I promised to get into the financials of the HomeTeam acquisition, which I will. First, however, I want to discuss what's going on today in Pennsylvania: people voting for higher taxes.

What does this have to do with the Rollins / HomeTeam deal? Well, not much, at first glance. It wasn't until I interviewed some of the key players in the deal that I discovered something very interesting. A Centex source, who did not want to be mentioned by name said, "Rollins approached us, and we thought the time was right. With our low basis in the business we weren't about to take a gamble on the next administration and potentially pay an additional $15 to $20 million in capital gains taxes…. What was the point of waiting?"

I wasn't particularly surprised by that comment, considering that we have a handful of sell-side clients right now who are saying pretty much the same thing. "I'm getting ready to retire, I don't know where the credit markets are going and even if the new administration doesn't raise capital gains taxes, Bush's 2003 changes to the tax laws will be expiring soon anyway… let's do it."

Like many of my fellow Pennsylvanians, I am looking forward to a final reprieve from the endless Clinton and Obama commercials telling us how they are going to increase jobs and give us all healthcare, in other words, increase our taxes and spend more of our money. One thing that they've failed to mention in their ads is what they are going to do with capital gains taxes. As it currently stands, the long-term capital gains tax rate is currently 15% and under a Clinton or Obama regime it could potentially double. Below is an excerpt from a recent article from the *Wall Street Journal* on Obama's capital gains tax policies:

"But Mr. Obama has also said he's open to raising – indeed, nearly doubling to 28% – the current top capital gains tax rate of 15%, which would in fact be a tax hike on some 100 million Americans who own stock, including millions of people who fit Mr. Obama's definition of middle class……. Either the young Illinois Senator is ignorant of this revenue data, or he doesn't really care because he's a true income redistributionist who prefers high tax rates as a matter of ideological dogma regardless of the revenue consequences." (See Appendix for more)

This article is not intended to be a political piece and I am certainly not campaigning for the Republicans today, as John McCain apparently hasn't spent a whole lot of time studying economics either, in fact, in January he said, "economics is not something I've understood"… don't worry though, he went on to say, "I've got Greenspan's book."

An increase in capital gains taxes affects our business and it will ultimately affect yours when it comes time to sell. While I certainly hope it will not go back up to 28%, if it does, that would mean the sale of a $5M pest control company with a $500K tax basis, pays $1.26M in capital gains taxes versus $675K as it stands today.

Let's get back to the HomeTeam deal. HomeTeam will close out its fiscal year (3/31/08) doing just shy of $137M in sales and $8.3M in EBITDA. Rollins paid just about 100% of sales for this business and 16.5x trailing EBITDA. The table below illustrates the acquisitions multiples; the Price / Earnings multiple is a non-meaningful figure because HomeTeam's earnings are negative.

(Dollars in Thousands)

Company	Purchase Price	LTM EBITDA Margin	Purchase Price / Sales	Purchase Price / EBITDA	Purchase Price / Earnings
HomeTeam	$137,000	*6.21%*	1.0x	16.5x	NMF

Note: Acquisition multiples based on year ended 12/31/07

By analyzing this transaction, we are going to learn very quickly why an acquisition by a pubic acquirer is quite different than an acquisition by a private acquirer. In our soon-to-be-released report on M&A in the pest control industry we are going to discuss, in-depth, both public and private valuation models for pest control acquisitions. Right now, I am going to give you a crash course on the public side.

One of the techniques that a public company uses when it makes a material acquisition is called the accretion / dilution analysis. This answers the question: will the acquisition increase earnings per share or EPS (accretive), or decrease earnings per share (dilutive)? Generally, if the acquisition makes sense from a strategic perspective and it is accretive (increases EPS), the acquirer will likely move forward with the acquisition. However, if the acquisition is dilutive (decreases EPS) there are additional hurdles that the public acquirer will want to overcome before making the acquisition. When an acquisition is initially dilutive to EPS, the acquirer will take a hard look at the expected synergies to be realized over time.

EPS is a very important metric for valuing public companies as it is the denominator in the rather notorious P/E multiple (Price / Earnings multiple). As of the HomeTeam acquisition, Rollins's P/E was 27.2. That means that the market values each share of Rollins's stock at 27.2x its EPS. The calculation looks like this:

Rollins's EPS: $0.64

Rollins's P/E: 27.2x

Share Price: $0.64 x 27.2 = $17.40

What this all means is, if Rollins pays less than 27.2x a target's earnings in an acquisition, the acquisition is accretive, and provided that the market views the acquisitions as a smart move, Rollins has increased its market value. Likewise, if Rollins pays more than 27.2x a target's earnings, then the acquisition is dilutive, and the merger has decreased Rollins's market value.

(Dollars in Thousands)

Company	Enterprise Value	Equity Market Value [1]	LTM EBITDA Margin	EV / EBITDA LTM	Price / Earnings LTM
Rollins, Inc	$1,759,389	$1,759,446	14.5%	13.6x	27.2x

While this doesn't explain exactly how Rollins, Sunair or Rentokil, does or should value a target, it does explain how you, the CEO of a private pest control company can get blown out of the water by a public acquirer in a competitive bid scenario for the same acquisition target – and the public company still coming out the winner in the end. For example, you do your analysis of an acquisition target and determine that the most you can pay and still realize your target return on investment is 4.5x EBITDA. You make your initial bid and survive the first round. The investment banker representing the seller comes back at you hard and tells you to sharpen your pencil. You get caught up in trying to win the deal so you issue a final LOI at 5.0x, only to lose out to Rollins, later finding out that they paid 7.2x EBITDA for the business. You know that you would do a much better job than Rollins in retaining the business, but still they outbid you. How can Rollins make that work?

Even if Rollins loses 20% of the business in the first year, as long as the implied purchase price multiple is less than what the market is valuing Rollins at, which is currently 13.6x EBITDA, the deal will still have a positive impact on EPS (even is it's only the smallest fraction of a penny). If your company will ultimately end up selling for 5.0x EBITDA, let's say, and you're making acquisitions at 7.0x, because you are focused on sales and not profitability, you are destroying value right out of the gate.

Below is the actual pro forma calculation for the merger on a GAAP (Generally Accepted Accounting Principles) basis for the year ended December 31, 2007. On the very bottom of the columns are the EPS numbers, and you'll see how they have decreased from $0.64 per share before the acquisition to $0.61 per share post acquisition. The HomeTeam deal is initially dilutive to Rollin's EPS.

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(In thousands, except per share data)	Rollins, Inc		HomeTeam		Pro Forma Adjustments for the Acquisition	Pro Forma for the Acquisition
Revenue						
Customer Services	$894,920		$133,858		-	$1,028,778
Cost of Goods Sold	468,665		59,550		-	528,215
Gross Profit	**426,255**		**74,308**			**500,563**
Gross Profit Margin %	***47.6%***		***55.5%***			***48.7%***
Operating Expenses						
Sales, General & Administrativce	296,615	*33%*	65,994	*49%*	-	362,610
Depreciation & Amortization	27,068	*3%*	3,544	*3%*	5,093	35,705
Gain on Sale of Assets	(52)		(252)		0	(304)
Interest Expense (Income) - Related Party	-		13,996		(13,996)	-
Interest Expense (Income)	(2,289)		915		3951	2,577
Total Operating Expenses	**321,342**		**84,197**		**(4,952)**	**400,588**
Pre-Tax Net Income	**104,913**	*12%*	**(9,889)**	*-7%*		**99,975**
Provision for Income Taxes	40,182	38%	(2,086)		195	38,291
Net Income	**64,731**		**(7,803)**			**61,684**
Net Income Margin	**7.2%**		**-5.8%**			**6.0%**
Income Per Share (EPS) - Diluted	0.64					0.61

So why did Rollins pay $137M for an acquisition that's dilutive to EPS? The answer, according to Rollins, is in the synergies that Rollins expects to realize from the deal. For example:

1. Almost immediately, Rollins's high-volume chemical procurement will shave over $1 million from HomeTeam's cost of goods sold.

2. Approximately 1,000 vehicles will be added to Rollins's current fleet of 6,000, and guess what, and as fate would have it, it's just about time to negotiate new leases.

3. Additional general and administrative cost savings include office consolidations (HomeTeam has 50 offices with some significant Rollins overlap), payroll processing (HomeTeam I believe, utilizes ADP now, but will likely be transferred to Rollins's system at some point), etc.

4. The Rollins Call Center – this is a big one. Rollins has the best call center infrastructure in the industry. Currently HomeTeam doesn't do a whole lot of calling on current customers to remind them that they have tubes in the walls that need to be serviced. I have to imagine that HomeTeam's 418,000 customer accounts will be getting a lot more annoying phone calls in future months from the Rollins Man.

5. The Residential Construction Cycle – as we all know, this is a very tough time for the residential housing market. In fact, if it weren't, I probably wouldn't be writing this article. The *Wall Street Journal* noted this morning that it probably won't be improving much until 2009, which is a good thing for Rollins. HomeTeam's margins are so low because about half of its business is related to installing tubes in slabs and walls. As we all know, this is very, very low margin work and due to the current residential building market, this work has just about come to a halt. If Rollins can effectively get the workforce

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focused on service as opposed to installations right now, margins should increase at a pretty quick clip.

There are certainly many more synergies that Rollins is hoping to realize than what I've described for you above. For those of you who are out in the field making acquisitions, the last thing that you should do is value an acquisition target taking synergies into consideration like this (and we'll show you what we mean by this in the next few weeks).

Based upon Rollins's cost structure and potential synergies that can (and it's a big can) be achieved through this acquisition, we've put together another set of pro forma numbers. The Rollins team was most likely looking at numbers very similar to those in the table below when valuing HomeTeam.

(In thousands, except per share data)

	HomeTeam	HomeTeam Synergies Realized
Revenue		
Customer Services	$133,858	$133,858
Cost of Goods Sold	59,550	57,559
Gross Profit	**74,308**	**76,299**
Gross Profit Margin %	***55.5%***	***57.0%***
Operating Expenses		
Sales, General & Administrativce	65,994	55,551
Depreciation & Amortization	3,544	7,698
Gain on Sale of Assets	(252)	
Interest Expense (Income) - Related Party	13,996	
Interest Expense (Income)	915	4,500
Total Operating Expenses	**84,197**	**67,749**
Pre-Tax Net Income	**(9,889)**	**8,550**
Provision for Income Taxes	(2,086)	3,249
Net Income	**(7,803)**	**5,301**
Net Income Margin	**-5.8%**	**4.0%**
EBITDA	**8,314**	**20,748**
EBITDA Margin	***6.2%***	***15.5%***
Income Per Share (EPS) - Diluted		

After (or rather, IF) the cost savings and synergies are realized, Rollins has effectively paid 25.8x earnings (less then Rollins's current P/E of 27.2x, and therefore, accretive), and 6.6x Adjusted EBITDA (a more reasonable EBITDA multiple, much closer to the normal 3.5x to 5.0x EBITDA range). Was this a good move for Rollins? I think so, but only time will tell. I leave you with a final thought from Warren Buffet's letter to shareholders in Berkshire Hathaway's 1982 annual report:

"The market, like the Lord, helps those who help themselves. But, unlike the Lord, the market does not forgive those who know not what they do…A too high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments."

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APPENDIX: WHAT WE'RE IN FOR

This was printed in today's *Wall Street Journal*, it is the transcript from last week's Democratic debates. If this guy has his way, I am not so sure it will make sense to go to work anymore.

CHARLES GIBSON: You have however said you would favor an increase in the capital gains tax. As a matter of fact, you said on CNBC, and I quote, "I certainly would not go above what existed under Bill Clinton, which was 28%."

It's now 15%. That's almost a doubling if you went to 28%. But actually Bill Clinton in 1997 signed legislation that dropped the capital gains tax to 20%.

BARACK OBAMA: Right.

MR. GIBSON: And George Bush has taken it down to 15%.

SEN. OBAMA: Right.

MR. GIBSON: And in each instance, when the rate dropped, revenues from the tax increased. The government took in more money. And in the 1980s, when the tax was increased to 28%, the revenues went down. So why raise it at all, especially given the fact that 100 million people in this country own stock and would be affected?

SENATOR OBAMA: Well, Charlie, what I've said is that I would look at raising the capital gains tax for purposes of fairness. We saw an article today which showed that the top 50 hedge fund managers made $29 billion last year – $29 billion for 50 individuals. And part of what has happened is that those who are able to work the stock market and amass huge fortunes on capital gains are paying a lower tax rate than their secretaries. That's not fair.

And what I want is not oppressive taxation. I want businesses to thrive and I want people to be rewarded for their success. But what I also want to make sure is that our tax system is fair and that we are able to finance health care for Americans who currently don't have it and that we're able to invest in our infrastructure and invest in our schools. . . .

MR. GIBSON: But history shows that when you drop the capital gains tax, the revenues go up.

SEN. OBAMA: Well, that might happen or it might not. It depends on what's happening on Wall Street and how business is going. I think the biggest problem that we've got on Wall Street right now is the fact that we've got a housing crisis that this president has not been attentive to and that it took John McCain three tries before he got it right.

And if we can stabilize that market and we can get credit flowing again, then I think we'll see stocks do well, and once again I think we can generate the revenue that we need to run this government and hopefully to pay down some of this debt.