[BY FRASER DUFF]

ECONOMIC CONSIDERATIONS FOR THE AUSTRALIAN SECURITY INDUSTRY

ECONOMIC AND STATISTICAL DATA on the security industry is usually hard to come by and when it is made available it is questionable as to whether the industry is being accurately measured using the same range of data over time. In 2003 it was estimated that the Australian Security Industry generated revenues of approximately $4.2 billion[1]. In 1997/1998 annual revenues were estimated at $1.2 billion and accounted for 0.13% of GDP[2]. A more recent assessment puts that figure at approximately 0.53% of GDP. My assessment of these figures is that the scope of the security industry today has expanded somewhat from 97/98 in terms of what is being measured. That level of growth over 6 years significantly outstrips prior economic forecasts as the real rate of growth[3] is estimated at 3.9%.

A significant proportion of the security industry competes in the provision of manpower and alarm monitoring services. Alarm monitoring revenues are estimated to be around $300 million per annum, through an estimated 800,000 monitored lines nationally[4]. When you take into consideration, installation, access control, alarms and CCTV this figure grows to just under $2 billion. The manpower sector (including guards, loss prevention, retail security, concierge, investigators, cash collection, armed escorts, event security etc) accounts for an estimated $2.2 billion turnover.

These services are provided in a highly competitive industry. The industry itself is characterised by numerous competitors delivering for the main part services that are easily replicated, and only differentiated by price. In today's environment all markets can be described as competitive to one degree or another. Although, some industries resemble higher levels of competition than others, it's probably fair to say that the competitive nature of the security industry aligns closer to what economists would regard as "perfect competition."

The notion of perfect competition is an academic one and in reality is not likely to be met in its entirety. There are some parallels between the dynamics within the security industry and some elements of "perfect competition". Whilst only a few participants have a dominant market share, the rest of the security industry typically provides a small percentage of the industry output. There is relative freedom of entry, creating a situation that is commonly referred to as low barriers of entry, with numerous suppliers and high levels of rivalry. For the most part the provision of manpower (guarding) and alarm monitoring services are homogeneous in nature. Given that there is very little in terms of product differentiation for guards and monitoring services, the primary output of the security industry is not that dissimilar to a commodity type market except that you're not buying and on selling a commodity.

At present the industry is going through a period of rapid change, driven by a number of external factors, not the least of which has been the impact of the heightened terrorist threat and significant regulatory changes. This has, to some extent increased demand for security services, which has seen the industry scramble in an effort to respond. The net effect being that there seems to be very little upward impact on prices if any at all. The question that arises out of all this, is the security industry responding like a normal market whereby price is affected by changes in both demand and supply?

For a market that demonstrates characteristics of perfect competition, an increase in demand is usually accompanied by an increase in price. In the longer term the initial price reaction attracts additional resources or capacity into the market. In the medium to long run the additional capacity creates downward pressure on prices, so that pricing returns to previous equilibrium levels.

The question remains as to why the security industry does not appear to respond to the simple changes in demand and supply. More to the point why does pricing not respond to increases in demand? The answer to this question probably rests with the fact that there is excess capacity within the industry and having said that we need to consider some of the industry dynamics.

The manpower (guarding) and alarm monitoring segment of the industry operates and competes on relatively low margins, in some cases as low as 1% in manpower and for the most part it is not restricted to the small players. In terms of monitoring

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services, some firms find it difficult to even derive their real cost of service on a per customer basis so they are not sure what their real margin is. Given the favourable climate and conditions that has led to an increase in demand, some companies are reporting higher revenue levels, however this is not flowing through to any margin expansion and prices still remain flat. Accordingly, while revenues are increasing, margins remain under pressure.

Furthermore some of the larger players are willing to be loss leaders with services that are cross-subsidised in order to win market share. From an economic perspective you have to ask yourself, is this an attractive segment of the industry and why would you bother to compete if your margins are somewhere between 1-3% in this highly competitive and mature industry? The answer rests with the fact that firms are attracted to the security industry because of factors such as low barriers to entry, homogeneous products that are easily replicated, and relatively low capital requirements.

During the course of a year a significant number of new entrants enter and leave the security industry. In some cases these new entrants run out of capital, develop cash flow problems and are even acquired by larger competitors who specifically look to purchase distressed assets. Other firms enter the market and keep their costs low through non-compliance. For example, not being registered, not paying award wages, not being a member of an approved association or not being compliant with the prevailing industry regulations and standards etc. Unfortunately, these practices all add capacity to the industry and are detrimental to pricing over the long run. Essentially, it is a situation in which there are too many organisations competing on price alone.

These non-compliant or 'backyard' operators create advantage through having a very low cost base and can therefore offer below market prices, which becomes their competitive advantage. So what is fuelling the problems with pricing in the industry? Unfortunately businesses still continue to buy unregulated services knowingly or unknowingly, because it meets a need, which in some cases is to spend as little as possible on the provision of security and protection of assets.

Corporate Australia as a general cultural proposition has up until only recently been very laissez faire about their security and protection of assets. Usually adopting the, "we'll wait and see", approach even in the face of good risk analysis of impending threats manifesting. After 14 years of advising corporates and government I feel I can confidently attest that this has been the rule rather than the exception, even though good security is integral to our way of life, more so than ever before. It wasn't that long ago that corporate Australia scrutinised its security services from the perspective of cost savings to the bottom line or just plainly did without. Now the ongoing threat of terrorism creates a need for the protection of vital assets and infrastructure across a number of fronts.

As previously identified even the larger market players are not immune from the market forces that impact price, no matter how good or not so good their brand. They might have a large contract one year, where they try to establish good customer relationships and do the right thing, (if they are not 1st or 2nd tier subcontracting) only to loose the contract in the following year. Business is usually won and lost as a result of competitors shaving their margins to the bone allowing no room to value add to the customer. In addition, some competitors take the risk of signing a contract service agreement in the hope that nothing goes wrong. And if it does then that's something they will hopefully be able to negotiate leniency on at the time.

Having said that, there is also a smaller, micro segment of the industry, which operates in the development of knowledge capital and intellectual property-based products and services. It is estimated, that less than 4% of security firms operate in this segment. These companies invest in and principally focus on research and development of new technologies such as the security biotech products or the advanced integrated security systems and IT security systems etc. These companies operate in a less competitive market, one where they leverage technology and intellectual property, making if far more attractive, creating higher barriers to entry as they compete in more of a duopoly or oligopoly market situation. These companies are usually involved in exporting, have patents in place and are considered to be price makers as opposed to their poorer cousins in the industry who are for the most part price takers.

In considering where to start with the issue of competition, market forces and its effect on pricing, remember security is at its core all about the management and treatment of risks. If there were no threats to business assets then there would be little need for the security industry and the over managed and under resourced Police Force would cope just fine with its limited resources. However, if you consider the external environment since 9/11, security threats are perceived to be abundant. Fuelled by the media and the greater public fear and our obsession with terrorism, let alone the problematic domestic crime and anti social behavioural offences. Politicians also leverage this fear, particularly those in opposition so it becomes self fuelling and perpetuating, creating more demand for protection services, which should be making this a more attractive industry to invest in with greater returns available to investors, but it's not.

This increased level of fear has resulted in an increased demand for security services. This increase in demand however has not necessarily resulted in any significant increases in prices within the security industry, which is to the detriment of the industry. In highly competitive

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industries, the industry won't attract margin expansion, unless they achieve "dynamic efficiency", which is what economists refer to as the development of new technologies, which increases productivity over time. This in itself is a process, which leads to greater product differentiation.

Furthermore, there are supply side issues as well, which don't just relate to the number of providers in the market, but relate to the problem of finding adequate supply of human resources to deliver the services. This is particularly evident in the manpower sector. Companies are experiencing great difficulty in recruitment as they compete for human resources with other low wage industries such as fast food, cleaning and retail etc and given we have the lowest unemployment rate (5.1%)[5] in 30 years. Accordingly, the lack of supply of manpower resources is fast becoming a major problem for many security firms.

In reflecting on these issues and after having observed the industry for some years, the biggest problem I feel is that we have an oversupply of security providers. This situation creates the need for a significant rationalisation of the industry, a shake out, that results in far fewer players to see any real improvement in terms of pricing and return on investment. Alternatively the incumbents need to achieve "dynamic efficiency". That is a point of product differentiation, created via technological development or some other increase in quality of the product / service over time.

The industry requires higher barriers to entry for new entrants, reduced levels of rivalry, less competition and more innovation etc. Whilst this would improve market conditions in terms of pricing for the security industry it goes against current government policy, which is to increase competition and keep downward pressure on prices. But when you're in an industry that in some segments is operating on margins between 1% and 3% there really is no where else to go, but out the door. The issue as to whether non-compliant operators are forcing down margins to unprofitable levels remains, and whether or not the absence of these operators alone would restore pricing to viable levels is yet to be determined.

But, there is some light on the horizon with government policy, even though they stipulate increased competition, their current focus in most states of increasing the levels of regulation and making significant imposts on the industry, is going some way towards increasing these barriers to entry and reducing the impact of non compliant firms. Whilst most see this as painful, and there is definitely short-term pain, there will inevitably be long-term gain for those who can adapt and survive the change. The fundamental issue out of all this is that we cannot really change the market conditions and improve pricing and margins with the current level of suppliers in the

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market and the low barriers to entry.

So for the incumbent providers, the big question is, how do you compete, grow market share, obtain better margins and create higher exit / switching costs for customers whom you need to lock in for longer terms, with such high levels of competition and rivalry, whilst making such small margins?

Well, if you haven't planned to develop any intellectual property or knowledge capital around your business processes or business systems or you cannot provide additional utility to your clients through the management of their security risks then you're pretty much at risk. Simply put, you won't be able to establish any form of competitive edge and your services will be easily replicated by competitors, whilst you add little value to your clients. It is no longer an option regardless of whether you are a large or small company to be "just doing business as usual" – those days are over. And it's not just about saying you're different or a boutique provider it's more about thinking and preparing to do business differently, by being able to add real value in the management of your client's risks.

Change is underway, just look at the buy side of the market and what it is doing. The level at which some major corporates and government organisations are now recruiting people into security risk management roles is a far cry from 5 to 7 years ago, as are their salaries. There is a much greater emphasis and requirement for specific tertiary qualifications and experience. These individuals are expected to function at higher levels, manage risks appropriately and proportionally, not do the security role per se and report in some cases directly to the board or at the very least senior management.

So where does this leave the supply side of the market? The focus needs to be on how you can effectively provide greater utility to your clients. In other words value add so that they don't see you in the same light as they see other suppliers. One approach might be to understand what their particular risks are and to identify a means by which you can assist them to minimise those risks. It might require you to have strategic relationships with other direct or indirectly related providers so you can bring additional capability to the table.

Alternatively you may need to consider developing systems that provide additional utility to clients. That is, once they start using those systems particularly if they provide value then you start to lock clients in and make the opportunity cost of switching services to the next low cost provider in the market much higher. In effect you are providing your own business insurance, because the opportunity costs associated with finding a new client are far greater than servicing the ones you already have. Think about their security risks and how you can effectively help them manage those beyond just putting another guard in place or offering to monitor their lines, because that's what the next bloke does.

Imagine the problems you would face if another large insurance company entered the market and advised customers that they will reduce their insurance premiums by 20% if they switched their monitoring and other security services over to them. What enormous value they would be able to provide their customers at the same time taking away your market share. And if you don't think this is possible just look at how diverse some insurance companies are becoming in their race to capture and lock in clients. Through this strategy, not only do insurance companies grab market share, but they also potentially reduce their claims costs.

If you really want to be profitable or even around in 5 or so years, ask yourself these 6 key questions and they will give you some guide as to whether you are thinking on the right track or whether you need to make some changes to your concept of business:-

1. What additional utility (benefit) do my clients get from using my services as opposed to that of my competitors and is this unique?
2. Furthermore, will the benefits I provide to my clients over and above my competitors be sustainable over the long run?
3. How do I add value to my clients, can that be measured and will it stop them from going to the next cheapest supplier?
4. What intellectual property or knowledge capital do I have around my business processes and business systems? Are these unique to the industry and do they actually add any value to the client and are they protected?
5. Do I have any strategic partnership options available that I can secure and which will be unique to the market and create value to clients?
6. Am I ready to accept change and will I be able to adapt my business quickly?

About the author: Fraser Duff has been in the industry for some 14 years, principally as the Managing Director of Passmore Duff Pty Ltd, a leading security consulting advisory firm and training company, which now specialises in web based workplace violence e-learning training products as seen on the www.carmtraining.com website. Fraser has been a Director of ASIAL for the past 5 years and has an MBA from the Australian Graduate School of Management (UNSW) and is a strong advocate for the industry.

1. ASIAL industry estimate 2003
2. IBIS Industry Outlook – L7864 Security and Investigative Services (Except Police) (Dec 98)
3. IBIS and the Aust Bureau of Statistics forecast up to 2002 - 2003.
4. ASIAL estimates based upon member data 2004 - 2005
5. Unemployment figures for last quarter 2005