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ACCOUNTING FOR CUSTOMER ACQUISITION AT ADT CORPORATION

We initiate coverage of ADT at Outperform with a \$45 target price. ADT's separation from TYC dramatically lowered its cost of capital and has created an attractive long-term value opportunity for investors in our view. Positive cadence forming between key value drivers: (i) ARPU growth should see continued momentum given record spreads between gross account adds and disconnects made possible by Pulse; only 2.6% of ADT's 6.5mn subscribers represent Pulse customers, offering substantial penetration upside for highly ARPU accretive services across ADT's subscriber base; (ii) increased customer loyalty leveraged through Pulse may help limit subscriber disconnects due to unsatisfactory service (10% of attrition) and help ADT recapture accounts that move or relocate (44% of attrition); (iii) wireless systems are shortening installation times and enabling remote troubleshooting, driving down costs....Net of incremental interest expense, 2.5 turns of leverage would give ADT \$1.6bn in cash to invest in new subscriber growth, pursue M&A, and/or buy back stock; all three would be extremely value accretive for shareholders in our view.¹

Anna Amphlett, a financial analyst with Southern Cross Capital LLC, spent the first days in her new job gathering information about ADT Corporation, a company whose shares Southern Cross was considering acquiring for its Business Services portfolio. Amphlett graduated with an MBA in accounting and finance, and had spent a summer as an intern with Southern Cross specializing in the service sector before joining the company. On September 28, 2012, ADT became an independent publicly traded company listed on the New York Stock Exchange, after Tyco (TYC) split itself into three independent companies.² ADT generated revenues by charging customers monthly subscription fees for security services. Southern Cross's portfolio manager had asked Amphlett to pay close attention to the company's accounting methods, and particularly to its policy of capitalizing and amortizing subscriber acquisition costs, instead of expensing them immediately. Southern Cross had become wary of companies such as Pre-Paid Legal Services, PolyMedica, and Excel Communications, which experienced significant stock price declines after popular press articles discussed their accounting policies. Such companies also experienced significant stock price declines when it was subsequently disclosed that they were under investigation by the U.S. Securities & Exchange Commission (SEC).

Amphlett's research revealed that the company's stock price performance since becoming a publicly listed company had substantially outpaced the Nasdaq stock market index (see Exhibit 1). ADT had grown rapidly, with revenues increasing from \$2.2 billion in 2008 to \$3.2 billion in 2012, while net income increased from \$222 million to \$394 million over the same period (see Exhibit 2). Amphlett's research also revealed that ADT accounted for some of its customer acquisition costs by capitalizing them to the company's balance sheet and amortizing them over time.

Company Background

The ADT Corporation was a leading provider of electronic security, interactive home and business automation, and related monitoring services in the United States and Canada (see Exhibit 3). The company began in 1874 as the American District Telegraph Company, a consortium of 57 telegraph operators. During the early part of

¹ ADT Corporation, *Credit Suisse*, October 17, 2012.

² "Tyco Plans Three-Way Split-Up," *The Wall Street Journal*, September 20, 2011.

the 20th century, ADT began offering fire and burglar alarm solutions. Over the years, it engaged in a variety of communications-related activities, and by 1987 had become one of the leading electronic security services providers. In 1997, ADT was acquired by Tyco International Ltd. In 2010, ADT acquired its largest competitor, Broadview Security.³ By 2012, ADT was one of the most trusted and well-known brands in the security industry, serving more than six million residential and small business customers, and making it the largest electronic security company in the United States and Canada. The company's operations were conducted under the trade names ADT, ADT Pulse, and Companion Service, which were leading brands in the electronic security industry, due to the company's record of providing quality, reliable electronic security services.⁴ Electronic security and home/business automation offerings involved the installation and monitoring of residential and small business security and premises automation systems designed to detect intrusion, control access and react to movement, smoke, carbon monoxide, flooding, temperature and other environmental conditions and hazards, as well as to address personal emergencies, such as injuries, medical emergencies, or incapacitation. The company's electronic security systems connected, upon the occurrence of a triggering event, to one of its monitoring centers. Monitoring center personnel responded to alarms by relaying appropriate information to local fire or police departments and notifying the customer or others on the customer's emergency contact list.

Through the introduction of ADT Pulse, the company pioneered interactive technologies that allowed their customers to remotely monitor and manage their homes and small business environments through their electronic security systems. Customers could remotely access information regarding the security of their home or business, arm and disarm their security system, adjust lighting or thermostat levels, or view real-time video from cameras covering different areas of their premises, all via secure access from Web-enabled devices (such as smartphones, laptops, and tablet computers) and a customized Web portal. ADT Pulse also allowed customers to create customized schedules and automation for managing lights, thermostats, and appliances, and could be programmed to perform certain functions, such as recording and viewing live video and sending text messages, based on triggering events. Many customers were driven to purchase monitored security as a result of a perceived or actual increase in crime or other life safety concerns in their neighborhood, such as a break-in or fire nearby, or as a result of a move to new home and/or neighborhood. These life events tended to heighten interest in solutions, which might enhance safety and security and provide customers with greater peace of mind. Many customers purchased security systems and monitoring services as a result of encouragement by their insurance carriers, who often offered lower insurance premium rates if a security system was installed or sometimes required that a system be installed as a condition of coverage. The majority of ADT's customers used standard land-line telephone service as the primary communication method for alarm signals from their sites. However, as the use of land-line telephone service decreased, the ability to provide alternative communication methods from a customer's control panel to ADT's central monitoring stations became increasingly important. Accordingly, ADT offered a variety of alternate and back-up alarm transmission methods including cellular, digital radio, and broadband Internet.

Under the Companion Services brand, ADT provided monitoring center supported personal emergency response system products and services which used the company's safety monitoring infrastructure to provide customers with solutions that helped sustain independent living, encouraged better self-care activities, and improved communication of critical health information. The core offering consisted of a console unit and a wireless transmitter generally worn as a necklace or wristband by the client. In the event of an emergency, the transmitter allowed the client to summon assistance via a two-way voice system that connected the client's home telephone with ADT's emergency response center, where dedicated monitoring specialists relayed information to the appropriate local emergency responder, including police and fire departments.

Customers were served from approximately 200 sales and service offices located throughout the United States and Canada. From these locations, staff of approximately 3,900 installation and service technicians provided security and home/business automation system installations and field service and repair. All monitoring facilities operated 24 hours a day on a year-round basis. Incoming alarm signals were routed via an internal communications network to the next available operator, which allowed for real-time load sharing across these facilities.

³ "Tyco to Buy Brink's Home Security Arm in \$2bn Deal," *Financial Times*, January 19, 2010.

⁴ ADT Corporation's Annual 2012 10-K filing.