SN VALUATION
SN CAPITAL SN CONSULTING SN ENGLISH

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ADT: Long vs. Short

Courtesy: Corvex and Cablebeach

ADT is the largest residential security alarm company in N. America. 6.45MM users with ARPU of $39. 90% of revenue is recurring. We couldn't run the model with our SNValuation model, since the previous years financials, were not broken down. The co. was previously a subsidiary of Tyco Co.

Bull Case – Corvex

http://www.sec.gov/Archives/edgar/data/1535472/000119312512433991/d429924dex996.htm

1) Introduction, 2) ADT Overview, **3) Investment thesis** – Unique franchise; predictable business model; strong financial profile, stable cash flow, secular growth tailwind, massive balance sheet opportunity; 4) why is ADT mispriced?, 5)Unique franchise, 6) Defensive predictable model, 7)Recurring revenue, 8)Strong financial profile, 9) Right asset for today, **10) Returns summary, 11)Valuation Summary, 12) Steady-state free cash flow info.,** 13) multiple ways to create value, 14)Pulse and home automation, 15) Pulse driving ARPU, 16)Secular penetration opp, 17) continued margin expansion, 18) Cost structure opp, 19) Financial outperformance, 20) Ability to change balance sheet, 21) optimize capital structure and capital allocation, 22) cost of capital arbitrage, 23-26) leverage comparison with comp/peers, 27-30) equity shrink, levered repurchase 31-41) comp tables 42) Bear arguments-Limited FCF after growth capex, cash tax shield taken away after 2 years, cable entry/threat; 43) limited FCF, 44-46) Single tax, 47-49) cable entry threat

1) Adjust co. capital structure by issuing low cost debt and repurchasing equity
   A. The book value is 60% of assets, but minus the goodwill, the book value is 40% of assets, without adjusting the leverage profile.
   B. We are wary of any suggestions to take on more debt for equity repurchase, since that does not add value to the business. It's a clever way to pay out investors, like an LBO, but the entity will be burdened with more debt, and the funds is not stored, or reinvested, but paid out to equity investors in the form of a share –linked dividend. The co. will eventually have to repay the borrowed amount from operating cash flow
   C. Increase Net Debt/EBITDA from current 1.5x to 3.0x, a still conservative figure, but can result in a repurchase of 30% of float, or $2.7BB. The co. generates about $1.8B, so 1.5x $1.8B is $2.7BB.
2) Increased EBITDA assumes 6% recurring revenue growth and 2% margin expansion
   A. Pulse&Home automation will allow co. to offer more services and expand addressable market
      i. Home security, energy management, entertainment and health monitoring
      ii. $39 to $50 ARPU
      iii. Co. should be able to rein in costs, as it has been 4 years since the spin off and management should have a better sense for cost control as a standalone entity

Bear Case – Cablebeach

On the bear side, this particular writer has a difficult time believing the company's FCF is a reliable figure, since the cost of acquiring customers is capitalized, and not reflected in the FCF figure. The growth capex is not really for growth, but to sustain their current revenue. Co. trades at 47x recurring monthly revenue, when peers are at 30-35x, and that would still put the TEV/FCF at ~18x.

Product costs $1100 to install and $39/month for service, but Pulse is a $65/month offering. Not sure whether they can break the 20% market penetration for more costly services, especially with the current state of the economy. Possibly a growth area maybe installation with the new house builds, but that is up in the air.

Conclusion: Bulls are focusing on the capital structure and strong cash flow, relative to the TEV, while Bears are questioning the FCF figures in light of the mandatory capex investments to retain customer levels, which limits the available FCF for interest payment use, should the co. leverage an additional $3BB, to increase the Net Debt/EBITDA from 1.5x to 3.0x, with proceeds used to repurchase equity.

We think the co. is fairly priced right now. We doubt a short is likely, given their low cash flow to TEV, but also question the company's ability to leverage up, if the capex is mandatory investments.