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New Rec: ADT Corp. (ADT: $48.00) April 1, 2013

Position: Sell **Target: $34**

$MM	F2Q13e	F3Q13e	F4Q13e	F1Q14e	F2013e	F2014e
Revs	806	804	809	808	3,228	3,220
EPS $	0.42	0.38	0.36	0.36	1.60	1.27
Y/Y Gr	-9%	-13%	-17%	-18%	-8%	-20%
PE	na	na	na	na	30	38
PSR	na	na	na	na	3.4	3.5
Consens	0.43	0.44	0.46	0.50	1.78	2.04

Shares Out: 230M **Market Cap: $11.3B** **FYE: September**

Concept:

1. Customer attrition is increasing. Increasing competition from cable/telecom companies and DIY products are giving customers more options.

2. A change in the business model in FY12 to more company owned systems versus customer owned due to increased competition has temporarily improved EBITDA, and is increasing subscriber acquisition costs.
3. Bulls expect sales of the company's new Pulse home monitoring product to grow rapidly, increasing ARPU and lowering attrition, but industry contacts see little consumer interest in these expensive higher-end home monitoring packages from ADT and peers.
4. Management wants investors to value the company on a mythical "steady-state free cash flow" metric that nearly eliminates the generation of new customers purchased from the dealer channel (now 45% of new contracts), while optimistically assuming flat attrition rates in the existing base. However, under this scenario, dealers would fail or would sell competitive products, damaging ADT's market position, and increasing attrition rates.
5. The "street's" FCF generation models assume high growth with significant reductions in working capital to achieve high estimates. We think neither of these assumptions will be realized.

Summary: ADT is the leading supplier of home monitoring security services in the US. The company, based in Boca Raton, FL, was acquired by Tyco in 1997. In 2010, Tyco acquired ADT's largest competitor, Broadview, (formerly part of Brinks Security), giving ADT 25% share of the residential/small business security monitoring market. ADT was spun out of Tyco in October 2012.

In F2012, 90% of revenue came from recurring monthly monitoring fees, with the remaining 10% from equipment sales and maintenance fees. About 94% of revenue is from residential monitoring, and 6% from small business. Ninety-three percent of sales are in the US, and 7% from Canada.

The company sells its monitoring services through a direct sales force (55% of new contracts) and 400 authorized dealers (45% of new contracts). New contracts include an installation fee and a three-year monitoring services agreement. In all dealer generated contract sales and most direct contract sales, ADT retains ownership of installed equipment (manufactured by Honeywell, GE, and others), allowing it to depreciate the cost of the equipment over a 15 year accelerated depreciation schedule. ADT takes an initial loss on each customer installation, and says it breaks even in about three years as it collects monthly monitoring fees. In F2012, the unit attrition rate was 17%, suggesting the average customer stays with ADT about 5.9 years.

The "street" is excited about ADT because it is launching a new interactive home monitoring product (Pulse) that allows customers to remotely arm/disarm the system, turn lights on/off, adjust the thermostat, use video surveillance to watch who is coming in and out of the home, and remotely lock/unlock doors. Analysts think this offering will increase ARPU and reduce customer attrition. At the same time, they discount the potential impact of sizable new entrants into the home security market like Comcast, TimeWarner, AT&T and Verizon. "Street" equity analysts are also excited about ADT's recent share repurchases and dividend

payments, accomplished by selling an additional $700M in debt a few months after the spin out from Tyco. Bond analysts are less excited, however, as they worry about the increased leverage and its impact on the company's debt rating (already BBB- at S&P).

ADT is currently valued at 23x F2014 consensus earnings of $2.04. The "street" wants investors to look at ADT's valuation on EV/EBITDA basis in order to give it credit for its low tax rate, which the company argues can remain in the single digits through 2019. On this basis, ADT trades at 7.3x 2014 EBITDA, which the "street" justifies as being in line with the much smaller Monitronics (ASCMA). Management argues that the company should be valued on a speculative "steady state free cash flow" metric, which, if accepted, would suggest a FCF yield of 10% on 2012 FCF, making shares look much cheaper than the 4% FCF yield suggested by the traditional calculation of FCF based on actual results.

As we discuss below, we think ADT's revenue growth and margins will fall short of "street" expectations due to increasing customer attrition and share losses caused by increased competition from cable/telecom, as well as by the failure of its new Pulse product to generate the ARPU improvements expected by the "street." Moreover, we think the "street" is underestimating the capex that will be required for each new Pulse subscriber, and the increased spending that will be required to buy accounts to keep up with increasing attrition rates. This higher spend will negatively impact FCF, the strength of which is central to the bull thesis and of great concern to ADT debt holders.

The "street" is looking for $3.31B in revenue, EPS of $1.78, and FCF of $465M in F2013, and $3.47B in revenue, $2.04 in EPS, and FCF of $571M in F2014. We expect revenue of $3.23B, EPS of $1.60, and FCF of $370M in F2013, and revenue of $3.22B, EPS of $1.27, and FCF of $214M in F2014.

Bulls value ADT on a number of different metrics, including EPS, EV/EBITDA, and the company's mythical "steady state free cash flow. Given the high capital requirements of the business model, we think traditional FCF is the most appropriate measure. The company's current valuation is 4% on F2012 FCF and 5% on the "street's" F2014 traditional FCF estimate. Applying a 4% FCF yield on our F2014 FCF estimate of $214M yields a share price target of $25. For the time being, we are setting our price target at $34, which may prove to be too generous.

Borrow information: ADT

Supply Quantity	Quantity On Loan	Available to Borrow	Date
63.3mm	8.8mm	59.9mm	3.27.13

Source: Markit/Data Explorers

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Background:

ADT provides security monitoring services to residential and small business customers in the US and Canada. The company was founded in 1874. Management estimates that ADT has a 25% share of the $13B home/small business market, which it estimates is growing at about 1%-2% per year. ADT expects market growth to accelerate to 2%-3% for 2012-2016 due to increased penetration, housing market improvement, and increased ARPU from interactive services.

The company has 16,000 employees. Of these, 3,900 are in sales, 3,900 are in installation/service, and 3,800 employees work in the company's six monitoring facilities. About 55% of new accounts in 2012 were generated by the company's direct sales force, while the remaining 45% came from its network of 400 authorized dealers.

Other players in the market include established monitoring companies such as Protection One (acquired by GTCR in 2010, 4% share), Monitronics (NASDAQ: ASCMA, 3% share), Vivint (acquired by Blackstone in 2012, 2% share), and many small local/regional vendors. New entrants to the monitored security market include Comcast (Xfinity Home), TimeWarner (Intelligent Home), and AT&T (Digital Life). Verizon is offering a self-monitored system with its own equipment, and also in partnership with Lowes (Iris).

Monitored security market penetration is about 19% of US households, a rate that is virtually the same as in 2008, when Brinks Home Security put penetration at 17%-22%. Looking back even further, data from ADT's 1996 10-K puts penetration at 16%. This penetration rate is understated, however, since security monitoring companies generally will not install systems in rental units. Penetration of the available 77M owner-occupied households in the US is about 30%.

ADT and other security monitoring companies hope that adding home monitoring services (e.g., video surveillance, remote control of lighting, temperature, door locks) will increase penetration. Bulls hope to see penetration

rates go to 50%, and point to wired phones (currently 66% of US households) as an example of another widely adopted technology. Of course, these bulls ignore that wired phones were once in 95% of US households. As we discuss below, we think the availability of new self-monitoring solutions managed via the internet, texts and emails may reduce penetration of systems monitored at staffed central monitoring stations.

According to its 2012 10-K, most of ADT's customers connect to its monitoring station via a landline. Basic residential packages sold by ADT using a landline to communicate with the central monitoring station cost about $37 per month plus a $99 installation fee. The package includes three window/door intrusion sensors, one motion detector, a keypad to control the system, a high-decibel alarm, and a keychain remote. Adding more intrusion/motion sensors, smoke, or carbon monoxide detectors adds to the installation fee. Monitoring fees for systems including fire may be higher if local fire/safety regulations require dedicated/redundant connections to the monitoring station. For this package and the ADT packages discussed below, ADT retains ownership of the system. Monitoring contracts have a 36-month term (24 months in California).

For homes without a landline (about 34% of US homes in December 2011 and increasing about 5 percentage points a year, according to a recent CDC survey (www.cdc.gov/nchs/data/nhis/earlyrelease/wireless201206.pdf)), a basic package with the same equipment and installation fee described above using a cell-based connection (Safewatch Cellguard) costs about $45 per month. Interestingly, the shift away from landlines has benefited ADT's ARPU, but has generated little if any extra profit since it must pay the wireless company each month for a cell connection dedicated to each system.

ADT's new Pulse home security system communicates with the central monitoring station using the customer's broadband internet connection, and includes a cell-based backup used if there is a power outage. The system uses a software platform licensed by privately held iControl. The basic (Pulse Select) package lists for $48 per month plus a $399 installation fee ($99 after a $300 rebate offer that expires May 10, 2013). After negotiation, we were able to get the monthly monitoring fee down to $35, lower than ADT's current ARPU of $38.60. The package includes three wireless door/window/motion detectors, a touch screen keypad, a high decibel alarm, and a key chain remote. Customers can set up the system to receive email/text notifications when alarms are activated or doors open (e.g., to determine when a child returns from school).

The high end Pulse Premier system includes home automation equipment and a smart phone app to control the home automation equipment. The system pitched to us included the keypad, two wireless remote lighting controls, one

remote thermostat, two wireless video surveillance cameras, a motion detector, and a key chain remote. The system would use the door/window sensors already in place in our home. Installation was initially quoted at $1,000, with a $57.99 monthly monitoring fee. After negotiation, the representative lowered the amounts to $560 for the installation and $41 for the monthly monitoring fee. This puts the monthly monitoring fee for the highest end Pulse system (broadband with cell backup) at a discount to ADT's basic cell-based monitoring system for homes without a land line ($45).

Discussion:

1. New entrants are challenging ADT in both the basic security and home monitoring markets.

ADT is positioning Pulse as a game changer that can drive ARPU higher and expand the number of homes with monitored security systems. In fact, Pulse is one of a number of undifferentiated home monitoring offerings that are based on the same or very similar software platforms. Pricing is cut-throat, as new cable/telecom entrants are using home monitoring to stem attrition in other services.

Comcast's Xfinity Home, launched in 2012, positions itself squarely against ADT in its advertising on radio/TV/internet, pitching itself as 20% cheaper. The primary connection to the central monitoring station is over broadband (customers must be Comcast subscribers) and the system has a cell backup. There is little difference from the ADT Pulse system, and it uses the same iControl software platform as ADT. For the Xfinity Home Preferred System (compare to Pulse Select), the monthly fee is $40 ($30 since we are already Comcast customers) plus a $99 installation fee. It includes three window/door sensors, one motion detector, and a touch screen keypad. For the Xfinity Home Premier system, the monthly fee is $50 ($40 since we are already Comcast customers), plus a $399 installation fee. It includes the same equipment as Preferred in addition to two wireless lighting controls, a digital thermostat, and two indoor/outdoor surveillance cameras.

Comcast is offering an even better deal to customers who sign up for home monitoring services as part of a triple play deal. Signing a triple play for home monitoring locks customers into 36 months of bundled services, protecting Comcast from attrition for its cable TV/internet/phone services. We were offered cable/internet/home security for $110 per month for the first year, $130 per month the second year, and $180 for the third year. Our current cable/internet bill is $122 (before taxes and equipment charges). Therefore, over the three years, adding Xfinity Home's Premier package would cost $18 per month plus $399 for installation, well below ADT's $41 per month and $560 installation fee for a

comparable package.

TimeWarner is rolling out a system to its subscribers that is similar to Comcast's called IntelligentHome. It is currently available in nine markets, and will be available nationwide at the end of 2013. Like ADT and Comcast, the system uses the iControl platform. Installation starts at $99 ($399 for a system with light/thermostat controls and video), but the company is offering free installation of a basic system to customers who switch from another home security service. The monthly fee is $34 per month, and the contract lasts 18 months.

AT&T has begun rolling out its own home monitoring offering called Digital Life. It is currently available in Dallas, and will be available in Atlanta in April. The company has built two all digital monitoring centers, and is working with dedicated partners licensed to install the systems. Hiring is underway for rollouts in Boston and other cities. The company plans to be in 50 US cities by the end of 2013. Its system is cell-based, and uses an internet connection as backup. It uses software developed by Xanboo, which AT&T bought in 2011. In Dallas, we were offered $250 in free equipment/installation, and a $40 per month monitoring fee, with the first three months free. The free equipment includes a keypad, four door/window sensors, the smart phone app, an indoor siren, and our choice of three other devices (window sensors, carbon monoxide detectors, smoke detectors). Automation packages add $5 per month to the monitoring fee, and an additional equipment cost. For example, energy automation package would push the monitoring fee to $45 per month, and costs $149 for a digital thermostat and two lighting controls.

Verizon's Home Monitoring and Control product is a self-monitored system that uses the 4Home platform The platform was part of Motorola Mobility, but after acquiring MMI, Google sold it to Arris (ARRS) in 2012. Verizon offers its service for $9.99 a month with no contract, but users must have a Verizon broadband connection. Users purchase and install equipment themselves. A DIY starter kit from Verizon costs $90, and includes a door sensor, an indoor camera, and a light control.

Lowe's is marketing its own DIY home monitoring system called Iris. Launched in July 2012, the Iris is a self-monitored system. Lowe's is currently expanding the number of stores that sell Iris from 500 to all of its 1,700 stores. There are no monthly fees with basic service. Upgraded service that allows six people to be notified when an alarm/alert is triggered, streaming and recorded video, door lock/unlock with access PINs, and other services costs $9.99 per month. Customers buy their own Iris enabled devices to use with the system. Lowe's has established partnerships with Whirlpool, Honeywell, Jarden Safety, Orbit Irrigation, Yale, Pella, First Alert, and others to develop devices that can be

controlled remotely with the Iris system. In addition, in March 2013 Verizon Wireless began offering the Iris system in its own stores in 10 Eastern and Southern States.

More traditional ADT competitors are offering security and home monitoring packages that are priced similarly to ADT. For example, Protection One offers a basic home security system for a $99 installation fee and $35 per month. Their package comparable to ADT's Pulse Select is priced at $99 for installation and $45 per month for monitoring. Its Premier package is priced at $99 for installation, $700 for the equipment, and has a $60 per month monitoring fee. After negotiation, we were only able to get the price down to $499 for the equipment and $53.99 per month for monitoring, significantly higher than Xfinity/ADT/AT&T.

Independent regional players are also offering home monitoring products. For example, Supreme Security in Union, NJ offers home monitoring services using equipment and software from Honeywell (Total Connect Remote Services). These companies try not to compete on price, instead emphasizing service, better quality equipment, and more customized installations.

Finally, we note that ADT may soon face competition from Brinks (from whom it bought Broadview in 2010) and from its former parent, Tyco. When Brinks spun out its home security business, it agreed to not compete in the space until October 31, 2013. When ADT was spun out of Tyco, Tyco agreed not to compete with ADT in the home/small business security market until October 2014.

2. Attrition is increasing along with increased competition.

ADT has seen an increase it its attrition rates over the past five quarters. As shown in the table below, the unit attrition rate was 17.1% in F1Q1, up from 15.8% a year ago.

Table 1: ADT Trends in Customer Attrition, Average Life of Customer

	F2010	F2011	F2012	1Q12 Dec-11	2Q12 Mar-12	3Q12 Jun-12	4Q12 Sep-12	1Q13 Dec-12
Customers BOP (000)	4,753	6,285	6,351	6,351	6,394	6,432	6,447	6,422
Adds	2,425	1,088	1,167	295	291	291	290	257
Losses	893	1,022	1,096	252	253	276	315	251
Net	1,532	66	71	43	38	15	(25)	6
Customers EOP	6,285*	6,351	6,422	6,394	6,432	6,447	6,422	6,428
Y-Y chng	32.2%	1.1%	1.1%	2.0%	1.8%	1.4%	1.1%	0.5%
Unit Attrition Rate	16.2%	16.2%	17.1%	15.8%	16.4%	16.9%	17.1%	17.1%
Avg Cust Life (yrs)	6.2	6.2	5.8	6.3	6.1	5.9	5.8	5.8

*includes 1.358M customers from Broadview acquisition. Organic growth 3.7%.

The company blames the higher attrition on two factors. First, it says a price increase taken across the base in 2Q12 and 3Q12 has increased attrition. However, we note that ARPU increased 5.8% in F2011, with no corresponding increase in attrition, while APRU increased 3.9% in 2012 with nearly one percentage point increase in attrition. It would appear there is more going on here than just customer price sensitivity.

Table 2: Trends in ARPU, F2010-F1Q13

	F2010	F2011	F2012	1Q12 Dec-11	2Q12 Mar-12	3Q12 Jun-12	4Q12 Sep-12	1Q13 Dec-12
ARPU (calc)	34.46	36.47	37.88	37.03	37.42	37.94	38.44	38.60
Y-Y chng	0.2%	5.8%	3.9%	2.3%	3.6%	3.7%	4.0%	4.2%

Source: Calculation based on recurring revenue and average customers in period. Differs slightly from ADT's reported ARPU

Secondly, the company blames increased attrition on the recovery of the housing market, which it says increases disconnects when customers move to a new home. According to the company, in 4Q12 and 1Q13 35%-40% of disconnects were due to customer relocations, while 20%-30% were from "voluntary" attrition, 20%-30% were from non-pay attrition, and 10% were due to competition. We think it would be difficult for the company to parse "voluntary" attrition from that due to competition, suggesting much more than 10% of disconnects could be due to competition. While the company suggests the housing recovery will eventually create new opportunities for ADT to win accounts, we note that home buyers now have many more choices for home security suggesting that ADT is likely to win back fewer relocation accounts than it has in years past, further increasing attrition. Also, we have spoken to large national developers who tell us they are no longer including security systems for homes in new developments, since wireless options make pre-wiring unnecessary.

The company prefers to focus investor attention on its reported recurring monthly revenue (RMR) attrition rate, which is about 3.3 percentage points lower than unit attrition. The company explains this difference is due to the fact that it is losing lower dollar accounts that it is replacing with higher dollar accounts. We think unit attrition is a more valuable metric, since it gives a better view into the average life of a customer—a key metric since ADT has shifted to owning most of the equipment it installs. Higher attrition rates translate into lower average customer lives, which will mean more capex spending to replace lost accounts, which will eventually impact the company's depreciation schedule. We discuss this in more detail below.

3. The "street" is underestimating potential share gains for cable by failing to recognize that 50% of ADT customers are currently not under contract and are therefore an available market.

The “street” models potential share wins for cable companies Comcast and TimeWarner by assuming that the available market is limited to customers from an estimated 14% churn of current 25M home security monitoring customers (3.5M customers per year), 2.6M of which are in the Comcast/TimeWarner footprint. It assumes cable can win 20% of this churn, resulting in a slow build of cable home security monitoring of about 520,000 customers a year. By the “street’s” line of reasoning, with 25% share, ADT would lose about 130,000 customers a year.

However, the available market for new competitors is actually those home security monitoring customers who are not currently covered by a three year contract. In ADT’s case, this is 50% of its customer base, since the company signs up about 1M new customers a year and has a total customer base of about 6M. Applying this across the entire home security market, the available market is actually 12.5M customers, making this a very attractive market for cable/telcos to aggressively pursue.

If we assume just 10% of home security customers currently not under contract switch to a new cable/telco provider, the potential annual win for these new entrants is 1.25M customers. With 25% share, ADT could lose 312,500 customers per year, or 5% of its customer base. If we add the 130,000 customers the “street” thinks ADT could lose to Comcast/TimeWarner just to churn (not even factoring losses to AT&T Digital Life and Verizon), ADT could lose 442,500 a year, or 7% of its customer base, in just the first year.

To illustrate the potential impact, at a monthly fee of $40, this would be $212M in annual lost recurring revenue. Assuming the same attrition rates through 2014, the lost annual recurring revenue would grow to $425M. Absent a big increase in subscriber acquisition spending to replace these customers, ADT’s top line would fall 7%-8% per year versus the 2% y-y growth expected in 2013 and 5% y-y growth expected in 2014 and 2015.

Current monitoring customers would seem to be the richest target for new market entrants. They do not need to be sold on the benefit of security monitoring, and may be swayed to switch companies by the extra bells and whistles offered by home monitoring, especially if upfront switching costs are low. A recent “street” report suggests that current monitoring customers are quite price sensitive. In the survey, 31% said they would switch companies and 14% said they would disconnect if faced with a 5%-10% price increase. As we discussed in the background section, Xfinity and TimeWarner are actually offering a discount on monthly monitoring versus current standard home security packages (e.g., $399 installation and $18 per month for Xfinity customers signing up for a Triple Play cable/internet/home security) while also offering many new features. ADT seems

to be aware of this risk, and is offering its existing customers a Pulse Premiere Lite package (thermostat, two light controls, 2 video cameras, one motion detector) for a $99 installation fee (after a $400 rebate). Despite the low upfront costs, the deal still does not beat Xfinity, since it comes with a hefty $57.99 monthly monitoring fee.

4. Cable companies are using aggressively priced home security promotions to reduce attrition for other services and maximize revenue per customer

Cable companies are faced with increasing attrition of TV subscribers, who are taking advantage of low priced introductory offers from IPTV (Verizon/AT&T) and satellite TV (Dish, DirecTV). In 2011, Comcast saw a 1.5% y-y decline in its cable TV subscriber count. In contrast, data and VoIP subscriber counts are growing. Comcast's high speed data subscribers increased 6.7% y-y in 2012, and VoIP increased 6.5%.

Bundling services together provides a way for cable companies to keep subscribers and maximize revenue per subscriber. This approach has been successful with high speed data and VoIP. In 2012, 88% of Comcast cable TV subscribers also subscribed to its data plan, and 45% subscribed to VoIP. Cable companies are expanding bundling options by adding wireless phone services (e.g., Comcast with Verizon Wireless), and, now, home monitoring services. Signing an existing customer into a new bundled deal locks that customer in for 36 months, reducing attrition at a time when even more non-cable video options are becoming available (e.g., Apple TV, Intel set-top boxes, video functionality for the Microsoft Xbox 360).

When pricing a triple/quadruple/quintuple play package, cable companies are looking to not only maximize revenue from the whole package, but also to keep the customer and so reduce customer acquisition costs. Therefore, Comcast is offering very aggressive pricing on home monitoring to existing customers who bundle the service with video and data. As we discussed in the background section, we were offered a Comcast triple play of video/data/home monitoring that gave us home monitoring for $18 per month for three years. As we learned when we discussed this pricing with an ADT sales rep trying to win our business, this is a price that ADT simply cannot afford to match.

Industry contacts in the Boston home security market also tell us that Comcast has been very aggressive in hiring high volume ADT sales reps to increase the face-to-face selling it is doing for home security systems. This strategy seems to be having an impact, based on the deep discounting we were offered at the end of February by ADT on both the installation and monthly fee.

Our industry contacts also note that ADT's service wait times have increased significantly in recent months, and are now 2-4 weeks for existing customers in some markets. These contacts speculate that ADT lacks the personnel to quickly service these accounts, perhaps because its service technicians are being hired away by Comcast and other new entrants. Waiting weeks with a nonfunctioning system can be an eternity for customers who are concerned about security. If the customer is no longer under contract with ADT, a local company will come in and service the equipment (often for free) and take over the monthly monitoring at the same fee or even less than ADT was charging.

Cable companies have EBITDA margins in the mid-30%s compared with ADT's 50% EBITDA margins. Cable companies can therefore easily undercut ADT's pricing without damaging their margins. We think ADT will have to respond to this lower priced competition, resulting in EBITDA pressure going forward.

5. Telecom companies are using home security to expand into new mobile services, and to increase revenue per customer.

AT&T and Verizon have also begun to aggressively enter the home monitoring market. AT&T's home monitoring service does not require the customer to subscriber to its broadband services (U-verse, available in 22 states, with 6.5M high speed internet customers in 2012 compared to 19M for Comcast). Instead, its system uses a cell number as its primary connection to the central monitoring station, with any providers' broadband as backup. Home monitoring is an initial foray into new mobile services for AT&T, which plans to expand to its offerings to the connected car, mobile healthcare, and mobile payments products.

Verizon's approach to home monitoring is different from the cable companies and AT&T, who provide staffed monitoring services. It has decided to promote a self-monitored system that Verizon broadband customers can add on for $9.99 with no annual contract. As discussed above, the customer buys compatible home monitoring devices from Verizon, Lowe's, and others. This DIY approach seems to be doing well, as both Verizon and Lowe's are currently expanding distribution of equipment across their stores.

6. Average customer life is declining, and is increasingly shorter than the company's stated average depreciation period.

Rising attrition and rapid technological change should impact ADT's depreciation policies. In 1996, ADT depreciated residential security systems over 10 years. In 2012, it was using an accelerated depreciation schedule, with 58% of the depreciation taken in the first five years, 25% taken in the second five years,

and 17% in the final five years. On a weighted basis, the depreciation period is eight years.

At the current 17% attrition rate, the company's average customer life is now 5.8 years, more than two years shorter than that implied by its depreciation schedule. This suggests the ADT is not recognizing enough depreciation expense, which would inflate earnings per share. Even if the life of the average customer were not declining, we think the equipment ADT is installing today is likely to be outdated much more quickly than has historically been the case. In the past, ADT connected to homes with equipment that used plain old telephone service (POTS) lines that had not changed in decades. Today, cell phone systems are changing from 2G to 4G/LTE, broadband connections are changing, and customers are demanding more applications from all of their electronic devices. Cell phone customers replace their phones every two years. Tablets are replaced every 3-4 years. Customers will switch to the home monitoring provider that is offering the hottest new technology. It is unlikely, in our view, that ADT's Pulse installations will last an average of eight years in such a rapidly changing environment.

This under-depreciation shows up when looking at the difference between ADT's depreciation expense and capex spending. As shown below, ADT consistently spends more on capex than it depreciates, which increases reported earnings, but could result in write-downs in the future.

Table 3: ADT Depreciation/Amortization and Capex Spending, F2009-F2012

($M)	F2009	F2010	F2011	F2012
Deprec/Amort Exp	560	674	813	862
Capex	736	801	902	1,087
Deprec/Amort- Capex	(176)	(127)	(89)	(225)

7. ADT is retaining ownership of more equipment installations, boosting EBITDA margins, as depreciation is higher, but this strategy also increases the risk of customer attrition.

Prior to June 2012, new ADT customers who signed up through the company's direct sales force paid an upfront installation and equipment fee and had ownership of the system. After June, however, ADT began retaining ownership of the equipment installed from these direct sales, just as it has historically done for accounts purchased from dealers. The shift to more company-owned installations appears to be an industry phenomenon, perhaps driven by the low cost equipment deals being offered by Comcast and others. According to a study conducted by *Security Systems News* and Barnes Associates, although there was an 8% y-y increase in recurring monthly revenue for the security monitoring industry in 2012, overall revenue was flat y-y in 2012 as a decline in installation revenue offset the recurring revenue increase (http://www.securitysystemsnews.com/blog/martha-

talks-mike-barnes-rmr-growth-rate-other-metrics-revealed). According to the survey, about half the recurring monthly revenue increase came from higher ARPU, and half from net new systems.

The downside to this strategy, as one of our contacts put it, is that companies who give away equipment are caught on a "treadmill to replace the ferocious attrition" that comes at the end of a low upfront fee contract when customers see much lower monthly fees available from competitors. Other companies will gladly monitor the installed ADT system for a lower fee since they need not worry about covering the upfront costs. ADT says new customer installations typically breakeven in about three years. If new accounts are lost at the end of a three year contract, they never earn money for ADT, and ADT must spend to acquire a new account to replace the monthly revenue.

On ADT's income statement, recurring revenue has been boosted by higher ARPU from company owned systems, and equipment revenue has fallen. The company has acknowledged that the increase in depreciation due to the shift to company ownership of equipment has benefited EBITDA margins in recent quarters. In F1Q13, it reported that EBITDA margins expanded 210 bp y-y, and that 200 bp of that expansion was from the mix shift.

On the balance sheet, the deferred subscriber acquisition cost and deferred subscriber acquisition revenue accounts from installation are growing, and will be amortized on an accelerated basis over the anticipated 15 years of the relationship.

Table 4: Trends in Deferred Subscriber Acquisition Revenue and Costs, F4Q11-F1Q13

	4Q10 Dec-09	4Q11 Dec-10	1Q12 Dec-11	2Q12 Mar-12	3Q12 Jun-12	4Q12 Sep-12	1Q13 Dec-12
Deferred Sub Acquis Cost, net	388	417	405	437	454	464	476
Y-Y chng	n/d	7%	n/d	n/d	n/d	11%	18%
Deferred Sub Acquis Revenue	630	630	633	640	650	675	696
Y-Y chng	n/d	0%	n/d	n/d	n/d	7%	10%
Implied GM on Deferred Rev	38%	34%	36%	32%	30%	31%	32%

Interestingly, the implied margin on deferred revenue is declining. As shown in the table above, the deferred revenue gross margin was 32% in F1Q13, down from 34% in F4Q11 and 38% in F4Q10. We note that ADT is offering higher rebates on customer installation fees, which may be driving down these margins. For example, according to ADT offers detailed on its website, the rebate on installation of a Pulse Enabled system is $200 off of a $349 fee, leaving the customer to pay $149. This rebate deal expires April 23, 2013. Another deal expiring on May 30, 2013 offers a $400 rebate on a $499 installation of "Pulse Premier Lite" to existing customers, leaving the customer to pay just $99 for installation. These rebates are not mentioned by management, who at its

September 2012 investor day suggested "stickiness from high average install fee ($650) for new subscribers."

8. Capital spending is up significantly with the shift to company-owned systems, while dealer contract purchases are down.

On the cash flow statement, capital spending is up primarily due to increased spending on subscriber system assets (equipment related to direct sales). As shown below, total capex spending was up 21% y-y in 2012, with about half the increase coming from higher spending on subscriber system assets. At the same time, as we discuss, below, spending on dealer account purchases has been down y-y for the past two quarters. The company blamed the decline in F1Q13 on financial difficulties faced by one large dealer because it was growing too fast.

Table 5: ADT Capex Spending Trends F2010-F1Q13

	F2010	F2011	F2012	1Q12 Dec-11	2Q12 Mar-12	3Q12 Jun-12	4Q12 Sep-12	1Q13 Dec-12
Dealer Acct Purchases	532	581	648	164	159	171	154	125
Subscriber Syst Assets	247	290	378	81	91	96	110	122
Maintenance capex	22	31	61	5	7	32	17	13
Total	801	902	1,087	250	257	299	281	260

Y-Y change

	F2010	F2011	F2012	1Q12 Dec-11	2Q12 Mar-12	3Q12 Jun-12	4Q12 Sep-12	1Q13 Dec-12
Dealer Acct Purchases	4%	9%	12%	27%	14%	10%	-1%	-24%
Subscriber Syst Assets	31%	17%	30%	19%	30%	32%	39%	51%
Maintenance capex	-39%	41%	97%	400%	-22%	220%	55%	160%
Total	9%	13%	21%	26%	17%	25%	14%	4%

We think ADT's dealers may be facing more intractable problems. First, until very recently, Pulse was not being sold through the dealer network, so any customer responding to ADT's Pulse promotions would necessarily be handled by an ADT direct sales rep. Second, since ADT now owns the equipment installed from its direct contracts, its offering to customers is much more similar to that offered by dealers, who have always sold ADT a contract that included installed equipment and monthly payments. Third, just like ADT, these dealers are now experiencing significant new competition from cable/telecom companies. Faced with these significant changes, one has to wonder if the dealers will choose to remain in the business. With 40%-45% of new business coming from the dealers, an exodus from the business would be a significant problem for ADT.

9. The Pulse "take" rates cited by management seem misleading. Pulse seems likely to disappoint.

ADT has touted increasing uptake of its Pulse product as evidence that it can increase ARPU going forward and expand the security monitoring business with the addition of home monitoring services. As shown below, the company is reporting that take rates have increased from 14% in F1Q12 to 29% in F1Q13.

Table 6: Pulse Take Rates, New and Reactivated

	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13
Pulse direct residential take rate	10%	14%	19%	20%	23%	29%
Pulse small business take rate	2%	7%	8%	11%	15%	19%
Pulse dealer take rate	1%	1%	1%	1%	1%	5%
Pulse take rate (all channels)	5%	7%	10%	10%	13%	19%
Pulse ARPU	n/d	$50	n/d	n/d	n/d	$50
Pulse % total customers	n/d	n/d	n/d	n/d	3%	4%

We think the growth in Pulse take rates, which include both new and reactivated accounts, actually represent significant cannibalization of traditional security packages by lower end Pulse packages with little ARPU upside. With customers disconnecting landlines at increasing rates, for many, traditional packages are simply no longer an option. Customers must choose between a cell and a broadband connection, and ADT's pricing makes broadband the obvious choice. ADT is pricing its basic Pulse system at $48 per month plus $99 for installation versus its basic cell connected package (Safewatch QuickConnect) at $43 per month and $299 for installation. Over a 36 month contract, the SafeWatch package costs $20 more than Pulse Select, and requires $200 more cash upfront.

The company also said on its F1Q13 earnings call that average Pulse ARPU remains unchanged at $50. Our experience in negotiating for a Pulse Premier package suggests that this may not stay the case for long. When we told our ADT representative that Xfinity was offering us a $30 monthly monitoring fee ($18 per month as part of a triple play), he was able to lower his monthly fee to $41. This was on the Pulse Premier package that was initially quoted at $58.

Bulls think there is still significant potential adoption for Pulse in the dealer channel, which only began selling the product at the end of F2012 and has a 5% take rate. We think these take rates will increase, but again due to cannibalization of traditional basic service rather than expansion of the market or adoption of home monitoring. ADT management has suggested that dealers may be slower to push higher end Pulse systems due to the longer installation times associated with the video surveillance systems and educating the customer on how to control the system. This, in addition to price competition from cable/telcos, should keep total ARPU from increasing significantly going forward.

10. ADT's valuation is justified using a mythical "steady state free cash flow" metric.

ADT shares trading at 24x the "street's" F2014 EPS estimate, despite expected EPS growth of just 13%-15%. Bulls ask investors to ignore this high multiple, as it is high relative to expected growth and fails to consider the company's low tax rate, which is expected to remain in single digits until 2019. Some bulls want investors to look at ADT on an EV/EBITDA basis. On this metric, ADT trades at 7.3x 2014 EBITDA, which the "street" justifies as being in line with the much smaller Monitronics (ASCMA), which trades at 7.3x. We think this metric is not appropriate for high capex companies like ADT. What matters, in our view, is FCF. The "street" provides detailed FCF models, but by traditional FCF calculations (cash from operations less capex), ADT shares are very expensive, at a FCF yield of 4%.

To justify ADT's lofty valuation, management tries to focus investors on what it calls its "steady state free cash flow." This metric assumes reduced spending on dealer generated customer accounts to just the amount needed to hold recurring revenue constant. By the company's math, in F2012, this would have reduced capex spending by $389M, more than doubling FCF to $908M. By this reasoning, ADT's yield on F2012 FCF is a very attractive 8%. "Street" analysts' estimates of future steady state FCF assume attrition rates stay the current 17%-17.5%, and model steady state FCF of $950M in 2013, $1B in 2014, and $1.1B in 2015.

Such a steady state FCF analysis might be seriously considered if it could actually work in reality. However, ADT's theoretical plan conveniently ignores the obvious business ramifications of this approach if it were actually implemented. ADT bought 45% of its new contracts from dealers, and spent $648M on these contracts in F2012. Reducing this spending by $389M would have decimated the dealers' businesses, and the dealer network. These businesses need to cover significant expenses related to equipment inventory and sales/installation personnel before they get paid by ADT. With the dealer network in effect decimated, where would ADT have gotten the $259M in contracts it needed for steady state revenue in 2012, to say nothing of needed revenue in subsequent years? No doubt, many of these dealers would go independent, or begin working for competitors, driving up attrition rates and, ironically, increasing ADT's reliance for contracts on the remaining dealers, whom ADT was putting out of business.

11. Recent results and guidance:

F1Q13 revenue of $809M was in line with consensus, and EPS of $0.43 was a penny higher. Management reiterated its F2013 guidance of 4.9%-5.2% recurring revenue growth, EBITDA margins of 49.5%-50.5%, and FCF of $375M-

$425M. Current consensus is for recurring revenue growth of 5% and a 15% decline in equipment/other revenue, resulting in 2% top line growth. The "street" expects EBITDA margins of 50.8% and FCF of $465M, above guidance.

12. The "street's" FCF generation models assume high revenue growth and strong margins with significant reductions in working capital to achieve its high FCF estimates. We doubt these assumptions will be realized.

Much of the bulls' excitement about ADT results from its supposed ability to generate consistent FCF from its subscription based model. The table below outlines the assumptions made by the "street" to get to its projection, and compares them to our model for F2013-F2015.

Table 7: "Street" vs. OWS Assumptions, F2013-F2015

	F2012a	"Street" F2013e	"Street" F2014e	"Street" F2015e	OWS F2013e	OWS F2014e	OWS F2015e
Revenue ($M)	3,228	3,307	3,470	3,628	3,228	3,220	3,196
EBITDA ($M)	1,609	1,680	1,780	1,850	1,635	1,551	1,549
EBITDA Margin	49.8%	50.8%	51.3%	51.0%	50.7%	48.2%	48.5%
EPS	$1.74	$1.78	$2.04	$2.30	$1.60	$1.27	$1.10
Total Capex	1,087	1,243	1,348	1,404	1,120	1,173	1,179
FCF ($M)	406	465	571	526	395	239	237
Average subs (M)	6.4	6.5	6.7	6.8	6.4	6.2	6.0
ARPU	$37.88	$38.71	$40.23	$41.64	$38.96	$39.73	$40.52
Unit Attrition	17.1%	16.9%	17.0%	16.7%	18.4%	20.3%	22.1%

Y-Y change

	F2012a	"Street" F2013e	"Street" F2014e	"Street" F2015e	OWS F2013e	OWS F2014e	OWS F2015e
Revenue	4%	2%	5%	5%	0%	0%	-1%
EBITDA	5%	4%	6%	4%	2%	-5%	0%
EPS	5%	2%	15%	13%	-8%	-20%	-14%
FCF	-24%	15%	23%	-8%	-3%	-40%	-1%
Total Capex	21%	14%	8%	4%	3%	5%	1%
FCF ($M)	-24%	15%	23%	-8%	-3%	-40%	-1%
Average subs (M)	1.1%	1.7%	2.3%	1.7%	-0.3%	-2.5%	-3.7%
ARPU	3.9%	2.2%	3.9%	3.5%	2.9%	2.0%	2.0%
Unit Attrition (bp)	92	(18)	7	(27.7)	131	190	177

Bulls expect revenue of $3.31B in 2013, $3.47B in 2014 and $3.63B in 2015 versus our $3.23B, $3.22B, and $3.20B. The difference between our models is driven primarily by lower average subscribers, and also by our lower ARPU growth assumptions in F2014-F2015. The "street" thinks unit attrition remains at the current 17%, and that the company can grow its subscriber base by about 2%

per year. We think attrition rates will climb 130-190 bp per year due to increasing competition, and that ADT's subscriber base will fall (0.3%) in F2013, (2.5%) in F2014, and (3.7%) in F2015.

The "street" also expects EBITDA margins to hold at about 51%, while we think spending due to stronger competition should drive EBITDA margins down to 50.7% in F2013, 48.2% in F2014 and 48.5% in 2015. Note that adjusted EBITDA did range from 42%-48% from 2007-2011, so our lower assumptions are not unprecedented.

We expect FCF of $395M in F2013, $239M in F2014, and $237M in F2015 versus the "street's" $465M, $571M, and $526M. As shown in the table below, a good part of the difference between our FCF expectation and the "street's" is driven by changes in working capital, which "street" models show declining by $181M in F2013, $268M in F2014, and $259M in F2015.

Table 8: "Street" vs. OWS FCF Assumptions, F2013-F2015

	F2012a	"Street" F2013e	"Street" F2014e	"Street" F2015e	OWS F2013e	OWS F2014e	OWS F2015e
Net income	394	411	452	474	353	250	220
D&A	982	1021	1073	1127	1061	1,148	1,217
Amort deferred sub acq rev	(120)	(133)	(149)	(158)	(132)	(144)	(160)
Non cash comp	7	7	7	7	10	8	8
Deferred tax	206	203	226	237	176	125	110
Changes working cap	-72	181	268	259	-64	0	0
Other	96	18	42	-16	0	0	0
Cash From Operations	1,493	1,708	1,919	1,930	1,404	1,387	1,395
Subscriber System Assets	(648)	(670)	(745)	(783)	(549)	(582)	(584)
ADT Dealer Accts	(378)	(514)	(527)	(548)	(513)	(530)	(535)
Maintenance Capex	(61)	(59)	(76)	(73)	(58)	(60)	(60)
Total Capex	(1,087)	(1,243)	(1,348)	(1,404)	(1,120)	(1,173)	(1,179)
FCF	406	465	571	526	284	214	216

It is unclear from where such large reductions in working capital can come, given that the company's F1Q13 DSO is consistently just 9 days, and inventories are consistently 22-24 days, and payables are consistently 39-46 days. The "street" makes little change to these accounts in its balance sheet projections, as shown in the table below. We are left to conclude that the change in working capital in "street" models is just a "plug" to generate the FCF necessary to justify the company's valuation, despite the expected increase in capex spending. A close look at one of the "street" models reveals that the increase in cash on the balance sheet for F2013 is actually driven by the company's additional $700M in long term debt closed in January 2013. The "street" model adds this debt, and then claims that the increase is "free cash flow." It has to be driven by added borrowing, since

net income is not enough to drive the increase, and there are not enough non-cash current assets from which to get cash. This cash flow claimed by the "street" is not what the "street" claims it is. Where the additional reduction in working capital comes from in the F2014 and F2015 "street" projections remains a mystery, just as it was mysterious for F2013, however, but in 2014 and in 2015 no further increase in debt appears in the model.

Table 9: "Street" Balance Sheet Projections

	F2012a	F2013e	F2014e	F2015e
Cash and Cash Equivalents	234	413	468	474
Net A/R	78	81	85	89
Tot inventory	42	66	55	58
Prepaid Exp & Current Assets	46	77	77	77
Deferred Income Taxes	40	68	68	68
Total Current Assets	440	705	753	766
Current maturities of LT debt	2	2	2	2
Accounts Payable	144	140	147	154
Accrued & Other Current Liabil	181	219	211	145
Deferred Revenue	245	325	430	532
Total Current Liabilities	572	686	790	833
Long Term Debt	2,525	3,225	3,225	3,225

If we exclude the "street's" changes in working capital, the "street's" FCF is $284M in F2013, $303M in F2014, and $267M in F2015. These estimates are not much higher than our $284M, $214M, and $216M, despite the "street's" higher expected net income. This is because the "street's" expected capex for subscriber system assets (direct account installations) is higher than ours, driven by higher subscriber additions. The "street" assumes the company adds 1.19M subscribers in F2013, 1.23M in F2014, and 1.25M in F2105 versus our estimates of 1.05M, 1.04M, and 1.03M.

13. S&P has lowered ADT's debt rating to BBB- from BBB as a result of increased borrowing

Equity investors like ADT's perceived strong FCF, and have pushed the company to use it to finance more debt. Management has responded, taking on an additional $700M in debt in January 2013, and accelerating stock repurchases. The company's debt/EBITDA multiple has increased from 1.6x at the time of the spin out from Tyco to 2.0x. Equity bulls think this still a low multiple that can go even higher to drive growth, pay dividends, or buy back more stock. ADT debt holders are not so happy, since the new debt caused S&P to cut its rating on ADT's debt from BBB to BBB-.

According to ADT management, the low rating by S&P is due to the

emphasis it puts on (EBITDA-maintenance capex)/cash interest, a ratio it says "is particularly constraining to us." We are not sure what S&P includes as maintenance capex for ADT, but for the sake of this analysis we include total capex to get a sense of the magnitude of change in this metric when ADT raised an additional $700M in debt. In F2012, ADT's ratio, using our metric, was 6.3x. With its higher interest expense and the higher capex expected by the "street" as it rolls out Pulse, the ratio based on "street" EBITDA and capex assumptions will be 3.6x in 2013, 3.2x in 2014, and 3.3x in 2015. We model lower EBITDA and higher capex, so our ratios are 4.3x in 2013, 2.7x in 2014, and 2.6x in 2014. ADT's high spending on "maintenance" capex that merely replaces revenue lost to attrition could limit its ability to access more debt at reasonable interest rates, particularly if attrition rates increase as we expect.

14. Valuation:

Bulls value ADT on a number of different metrics, including EPS, EV/EBITDA, and the company's mythical "steady state free cash flow." Given the high capital requirements of the business model, we think traditional FCF is the most appropriate measure. The company's current valuation is 4% on F2012 FCF and 5% on the "street's" F2014 traditional FCF estimate. Applying a 4% FCF yield on our F2014 FCF estimate of $214M yields a share price target of $25. For the time being, we are setting our price target at $34, a 3% FCF yield, which should prove to be too generous.

15. Risks:

The main risks to our position are lower than expected attrition in ADT's customer base driven by better than expected uptake of ADT's Pulse system, and better than expected ARPU gains.

A change in control might cause ADT to lose its NOLs. This, and its size relative to peers, limits takeout risk, in our view.

16. Financial projections:

Quarterly Projections:

Income Statement ($M)	Dec-12 1Q13a	Mar-13 2Q13e	Jun-13 3Q13e	Sep-13 4Q13e	Dec-13 1Q14e	Mar-14 2Q14e	Jun-14 3Q14e	Sep-14 4Q14e
Recurring Cust Rev	744	744	742	746	744	741	737	738
Deferred Install Rev	32	33	33	34	35	36	36	37
Equipment sales	14	10	10	10	10	10	10	10
Other	19	19	19	19	19	19	19	19
Total Other Revenue	65	62	62	63	64	65	65	66
Total Revenue	809	806	804	809	808	806	802	804
Cost to Serve	336	342	346	355	357	365	369	378
SG&A	281	288	294	301	300	301	301	310
Op Inc (GAAP)	186	176	164	153	151	140	132	117
Op Inc pre special items	192	183	171	160	158	140	132	117
Interest Expense	(24)	(27)	(35)	(35)	(35)	(35)	(35)	(35)
Other Income	6	0	0	0	0	0	0	0
GAAP Pretax Income	168	149	129	118	116	105	97	82
Taxes	63	56	49	44	43	39	36	31
GAAP Net Income	99	93	81	74	72	66	60	51
Adj for special items	4	4	4	4	5	5	5	5
Adj Net income	103	97	85	78	77	71	65	56
GAAP EPS	0.42	0.40	0.36	0.34	0.34	0.31	0.29	0.25
Adj EPS	0.44	0.42	0.38	0.36	0.36	0.33	0.31	0.27
S/O	236	230	222	219	216	213	210	207

Y-Y change	Dec-12 1Q13a	Mar-13 2Q13e	Jun-13 3Q13e	Sep-13 4Q13e	Dec-13 1Q14e	Mar-14 2Q14e	Jun-14 3Q14e	Sep-14 4Q14e
Recurring Cust Rev	5%	3%	1%	1%	0%	0%	-1%	-1%
Deferred Install Rev	10%	10%	10%	10%	9%	9%	9%	9%
Equipment sales	-63%	-73%	-68%	-47%	-29%	0%	0%	0%
Other	-5%	-5%	-5%	-5%	0%	0%	0%	0%
Total Other Revenue	-25%	-29%	-23%	-10%	-2%	5%	5%	5%
Total Revenue	2%	0%	-1%	0%	0%	0%	0%	-1%
Cost to Serve	-3%	-2%	1%	6%	6%	7%	7%	7%
SG&A	3%	6%	6%	0%	7%	4%	3%	3%
Op Inc (GAAP)	6%	-6%	-15%	-8%	-19%	-20%	-20%	-24%
Op Inc pre special items	5%	-4%	-12%	-10%	-18%	-23%	-23%	-27%
Interest Expense	9%	23%	52%	59%	46%	30%	0%	0%
GAAP Pretax Income	9%	-9%	-24%	-18%	-31%	-29%	-25%	-31%
Taxes	3%	-5%	-20%	-13%	-31%	-29%	-25%	-31%
GAAP Net Income	6%	-11%	-21%	-21%	-27%	-29%	-25%	-31%
Adj for special items	0%	0%	100%	-43%	25%	25%	25%	25%
Adj Net income	6%	-11%	-18%	-23%	-25%	-27%	-23%	-28%
GAAP EPS	6%	-9%	-16%	-15%	-20%	-24%	-21%	-27%
Adj EPS	6%	-9%	-13%	-17%	-18%	-21%	-19%	-24%
S/O	0%	-3%	-6%	-7%	-8%	-7%	-5%	-5%

% Total Sales	Dec-12 1Q13a	Mar-13 2Q13e	Jun-13 3Q13e	Sep-13 4Q13e	Dec-13 1Q14e	Mar-14 2Q14e	Jun-14 3Q14e	Sep-14 4Q14e
Recurring Cust Rev	92%	92%	92%	92%	92%	92%	92%	92%
Deferred Install Rev	4%	4%	4%	4%	4%	4%	4%	5%
Equipment sales	2%	1%	1%	1%	1%	1%	1%	1%
Other	2%	2%	2%	2%	2%	2%	2%	2%
Total Other Revenue	8%	8%	8%	8%	8%	8%	8%	8%
Total Revenue	100%	100%	100%	100%	100%	100%	100%	100%
Cost to Serve	42%	42%	43%	44%	44%	45%	46%	47%
SG&A	35%	36%	37%	37%	37%	37%	38%	38%
Op Inc (GAAP)	23%	22%	20%	19%	19%	17%	16%	15%
Op Inc pre special items	24%	23%	21%	20%	20%	17%	16%	15%
Interest Expense	-3%	-3%	-4%	-4%	-4%	-4%	-4%	-4%
Other Income	1%	0%	0%	0%	0%	0%	0%	0%
GAAP Pretax Income	21%	18%	16%	15%	14%	13%	12%	10%
Taxes	8%	7%	6%	5%	5%	5%	5%	4%
GAAP Net Income	12%	12%	10%	9%	9%	8%	8%	6%
Adj for special items	0%	0%	0%	0%	1%	1%	1%	1%
Adj Net income	13%	12%	11%	10%	10%	9%	8%	7%

Annual Projections:

Y-Y change	2009a	2010a	2011a	2012a	2013e	2014e	2015e
Recurring Cust Rev	1,936	2,282	2,765	2,903	2,976	2,960	2,906
Deferred Install Rev	111	111	114	120	132	144	158
Equipment sales	n/d	n/d	152	125	44	40	56
Other	n/d	n/d	79	80	76	76	76
Total Other Revenue	312	309	345	325	252	260	290
Total Revenue	2,248	2,591	3,110	3,228	3,228	3,220	3,196
Cost to Serve	935	1,065	1,341	1,374	1,379	1,469	1,517
SG&A	839	1,022	1,076	1,125	1,164	1,211	1,187
Op Inc (GAAP)	474	504	693	722	679	539	493
Op Inc pre special items	480	557	721	747	706	546	493
Interest Expense	(81)	(106)	(90)	(93)	(121)	(140)	(140)
Other Income	0	0	0	0	6	0	0
GAAP Pretax Income	393	398	603	629	564	399	353
Taxes	150	159	228	236	212	150	132
GAAP Net Income	243	239	375	393	347	250	220
Adj for special items	n/d	n/d	17	17	16	3	0
Adj Net income	n/d	n/d	392	410	363	270	220
GAAP EPS	1.03	1.01	1.59	1.67	1.53	1.18	1.10
Adj EPS	n/d	n/d	1.66	1.74	1.60	1.27	1.10
S/O	236	236	236	236	227	212	201

Y-Y chng	2009a	2010a	2011a	2012a	2013e	2014e	2015e
Recurring Cust Rev	2%	18%	21%	5%	3%	-1%	-2%
Deferred Install Rev	n/d	0%	3%	5%	10%	9%	10%
Equipment sales	n/d	n/d	n/d	-18%	-65%	-9%	40%
Other	n/d	n/d	n/d	1%	-5%	0%	0%
Total Other Revenue	8%	-1%	12%	-6%	-22%	3%	12%
Total Revenue	3%	15%	20%	4%	0%	0%	-1%
Cost to Serve	n/d	14%	26%	2%	0%	7%	3%
SG&A	n/d	22%	5%	5%	3%	4%	-2%
Op Inc (GAAP)	13%	6%	38%	4%	-6%	-21%	-9%
Op Inc pre special items	14%	16%	29%	4%	-5%	-23%	-10%
Interest Expense	n/d	31%	-15%	3%	30%	16%	0%
Other Income	n/d	n/m	n/m	n/m	n/m	n/m	n/m
GAAP Pretax Income	n/d	1%	52%	4%	-10%	-29%	-12%
Taxes	n/d	6%	43%	4%	-10%	-29%	-12%
GAAP Net Income	9%	-2%	57%	5%	-12%	-28%	-12%
Adj for special items	n/d	n/d	n/d	0%	-6%	-81%	-100%
Adj Net income	n/d	n/d	n/d	5%	-12%	-26%	-18%
GAAP EPS	9%	-2%	57%	5%	-8%	-23%	-7%
Adj EPS	n/d	n/d	n/d	5%	-8%	-20%	-14%
S/O	0%	0%	0%	0%	-4%	-7%	-5%

% Total Sales	2009a	2010a	2011a	2012a	2013e	2014e	2015e
Recurring Cust Rev	86%	88%	89%	90%	92%	92%	91%
Deferred Install Rev	5%	4%	4%	4%	4%	4%	5%
Equipment sales	n/d	n/d	5%	4%	1%	1%	2%
Other	n/d	n/d	3%	2%	2%	2%	2%
Total Other Revenue	14%	12%	11%	10%	8%	8%	9%
Total Revenue	100%	100%	100%	100%	100%	100%	100%
Cost to Serve	42%	41%	43%	43%	43%	46%	47%
SG&A	37%	39%	35%	35%	36%	38%	37%
Op Inc (GAAP)	21%	19%	22%	22%	21%	17%	15%
Op Inc pre special items	21%	22%	23%	23%	22%	17%	15%
Interest Expense	-4%	-4%	-3%	-3%	-4%	-4%	-4%
Other Income	0%	0%	0%	0%	0%	0%	0%
GAAP Pretax Income	17%	15%	19%	19%	17%	12%	11%
Taxes	7%	6%	7%	7%	7%	5%	4%
GAAP Net Income	11%	9%	12%	12%	11%	8%	7%
Adj for special items	0%	0%	1%	1%	0%	0%	0%
Adj Net income	0%	0%	12.6%	12.7%	11%	8%	7%

17. Financial Metrics

Debt	3,225
Equity	4,733
Tangible book	(1,699)
Market value	11,040
Cash	571
EV	13,694

Note: Values adjusted for $700M in debt closed January 2013 and estimated share count of 230M based on announced accelerated share repurchase program

	FY12	FY13e	FY14e	FY15e
EBITDA	1,609	1,635	1,551	1,549
Capex	1,087	1,120	1,173	1,179
Free cash flow	406	363	214	216
EV/EBITDA	8.5	8.4	8.8	8.8
FCF Yield	4%	3%	2%	2%