ADT deals with publicity fallout

BY JOHN T. FAKLIER

Tyco International (NYSE: TYC) has more than the feds to worry about. An increase in customer, vendor and dealer attrition rates at Tyco's ADT Security Services unit in Boca Raton could hurt revenues at the conglomerate, according to an SEC filing. Although the company's stock is at a 52-week high, observers also wonder about Tyco's convertible debt and the possibility of more charges to write down goodwill.

Customer attrition rates at Tyco's biggest unit, the global security services business that includes ADT, increased to 14.4 percent for the quarter ended March 31 and 14.9 percent in the quarter ended June 30, according to filings by Tyco. In the previous three years, the range was

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Tyco takes steps to retain customers at ADT unit

ADT launches MobileSafety GPS product

Earlier this month, ADT launched MobileSafety, a portable Global Positioning Satellite system locator and safety device for vehicles. The device guides drivers and passengers inside the vehicle with access to 24-hour emergency services, including the ability for ADT to locate the vehicle and call for help in an emergency. It also helps families to log on to their own private ADT Trak Web site and locate the vehicle in seconds, anytime they choose, the company said.

MobileSafety is the first product in ADT’s new Mobile Security Network, a family of protective services to help people stay safe when outside the home.

The ADT MobileSafety unit costs $99.95, plus $29.95 for activation, shipping and handling. There is also a monthly monitoring fee of $19.95.

Last month, ADT announced it would now make an additional phone call to verify burglary alarms prior to notifying police in the city of Los Angeles.

The new procedure, which has been endorsed by the International Association of Chiefs of Police (IACP), aims to reduce false alarms and promote police response to legitimate alarms. ADT previously made one phone call to the premises to verify a burglary alarm before notifying police. The IACP has endorsed enhanced, or second call, verification by security firms as an effective way to reduce false burglary alarms. The association acted after studies by ADT and other security firms showed that enhanced alarm verification procedures reduced false alarm dispatches by as much as 50 percent.

ADT said the action could minimize the perceived need to enact a police policy requiring visual verification of alarms.

ADT will continue to improve protecting its customers, said company President Mike Snyder, adding it has a long history of working along side law enforcement agencies and fire departments.

“We take the issue of false alarms very seriously,” Snyder said in a release, noting they can impact the safety of citizens and resources of the community.

ADT has to introduce the “enhanced call” verification process to its 6 million customers nationwide over the next year.

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12.3 percent to 13.2 percent attrition.

If the attrition rate continues to rise, AT&T’s recurring revenues and results of operations “will be adversely affected,” the filing said.

Tyco’s filing said that, as a result of actions taken by its former senior corporate management and press reports of improper accounting treatment of several prior acquisitions, it had “experienced reluctance on the part of certain customers and suppliers to continue working with us on customary terms.”

A number of suppliers have requested letters of credit to support purchase orders, the company said.

On Aug. 13, the SEC announced that Tyco’s former lead outside auditor, Richard Scalo of Waterhouse/Coopers, had agreed to be permanently barred as an auditor of a public company. He was accused of being reckless in ignoring wrongdoing at the company.

Formed CEO and Chairman Dennis Kozlowski, former CFO Mark Swartz and former counsel Mark Belnick are facing financial fraud charges from the Manhattan District Attorney, a civil fraud suit from the SEC and a suit from Tyco itself for alleged misuse of company funds. The company said the trio, who have pleaded innocent, were the main beneficiaries of $600 million in unauthorized bonuses and loans.

The senior executives frequently operated out of Boca Raton, although the company is ostensibly based in Bermuda and had a U.S. office in New Hampshire.

The company had $7.3 billion in charges in the last fiscal year and Standard & Poor’s has expressed concern about the possible need for write-downs on some of the $26.1 billion in goodwill still on the books as of March 31.

While a $3.5 billion chunk of the $7.3 billion charge had to do with underwater cables, ADT’s accounting is being in the news as well.

In March, Tyco announced it would take a $265 million charge because of accounting issues at ADT.

Jerry Boggs, president of Tyco’s security division, earned $85.5 million in 2001, but was dismissed by Tyco’s new management.

The move was a major embarrassment for Tyco’s new team because a specially commissioned report a few months earlier on Tyco’s accounting had not found the problems.

Michael Hoffman, a stock analyst at Friedman Billings Ramsey, told MSNBC at the time that customer churn is a major factor in profitability for ADT and other security companies.

It costs monitoring companies $1,200 to $1,500 to install alarm systems in a typical home, an investment that typically isn’t earned back for more than two years. Moreover, ADT focused on building volume almost regardless of customer credit quality, he said.

Those factors contributed to the accounting issues, he said.

During a July 29 conference call with stock analysts, Tyco Chairman and CEO Ed Breen said Tyco has implemented an improvement plan for ADT.

He characterized cash flow and profit margins at ADT as “solid,” but said margins could be improved.

Starting last quarter, a program of no zero-down transactions was instituted for dealers.

ADT Security Services, the largest company in its industry, operates out of an office building in Boca Raton.

ADT dwarf rivals

ADT is a key component in Tyco, which had $35.64 billion in revenue during the past year. Some have likened it to being the company’s crown jewel.

Standard & Poor’s estimates that fire and security services account for 30 percent of Tyco’s overall revenue and 25 percent of operating profits. ADT is seven times the size of its next biggest rival, according to Security Distributing & Marketing, a trade publication.

In its amended filing, Tyco said it has substantial cash needs and will need to obtain additional funding to satisfy those needs.

As of March 31, Tyco had about $4.4 billion of debt, and “substantial” capital requirements, including about $700 million of cash to acquire ADT accounts from dealers, of which $360 million has already been spent.

Alan Axelrod, head of the corporate and securities department at Bilzin Sumberg Baena Price & Axelrod in Miami, said highly leveraged companies often see stymied growth.

Tyco’s $4.5 billion debt offering in January was convertible, which Axelrod characterized as a more expensive form of financing and potentially dilutive to existing shareholders.

Tyco said in its most recent quarterly report on Aug. 14 that it believes its cash flow from operations — together with proceeds from the convertible debt offering and a new $1.5 billion credit line — is adequate to fund the company and service its debt through June 30.

The available cash may be used to fund pension and benefit liabilities during the fourth quarter, the company said. On Aug. 14, it was disclosed the U.S. Department of Labor had subpoenaed Tyco about losses in its retirement funds.

Tyco has warned that events beyond its control, such as litigation and a decrease in products and services demand, could still impact operations in a negative way.

One of Standard & Poor’s concerns is shareholder lawsuits against the company.

Signs of progress

Still, Tyco has made an effort to pay off its debt obligations, Axelrod said.

“They have accomplished that,” he said, “and subject to the revenue being there, they are signaling they have it under control.”

“They are on the road to try and patch things up,” agreed Dana Forgione, a CPA and chairman of the Accounting at Florida International University in Miami.

But issuing convertible debt a second time to cover losses could have a downside, said shareholder advocate Gunther Karger with the Discovery Group in Miami.

“People seem to be a trend by troubled companies with declining revenues to use a convertible,” he said.

Karger noted the practice is dilutive and depresses the stock price.

Often, he said, a period of “no good news” and “deathstar” disclosures in SEC filings — “to make sure all the risks are paraded right up front” — are followed by Chapter 11 bankruptcy.

According to Karger, that is because some companies believe they are better off restructuring the massive number of shares outstanding than trying to deal with further dilution resulting from the convertibles.

“Who would pay for a convertible feature if their Tyco customers are defecting?” asked Forgione, adding that the cost of customer attrition at ADT must be paid for somehow.

“A lost customer is very tough to get back,” he said. “A dollar of revenue takes a lot off the bottom line. You have to make 10 other sales to replace it.”

Another caveat, Forgione said, is that the cost of replacing suppliers is at a “premium.”

Tyco’s exposure relating to its pension fund liability is also a concern, he said.

Tyco lost $1.35 a share in the most recent quarter, compared with a $1.37 loss in the previous quarter, according to its 10-Q filed Aug. 14.

Stock on the upswing

Despite the earnings hit, Tyco’s stock has been on the upswing.

Shares traded at $60.50 on Aug. 20, slightly above its 52-week high of $20.20, but a third of the $60 a share it once fetched in 2001.

Of the 12 brokers covering Tyco polled by First Call/Thomson Financial, 10 rate the stock either a “strong buy” or “buy.” None recommend selling.

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