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ALARMFORCE INDUSTRIES INC. (TORONTO: AF)

BY ZAIN GRIFFITH
ZAIN@MANUALOFIDEAS.COM

- ► **Canadian microcap engaged in burglar alarm systems industry**
- ► **High ROIC, recurring revenue model with growth characteristics**
- ► **Attractively valued at less than 10x maintenance free cash flow**

Investment Thesis

AlarmForce Industries (Toronto Stock Exchange: AF) operates in the security alarm industry. The shares represent an interesting opportunity to invest in an underfollowed, somewhat illiquid and undervalued Canadian micro-capitalization company (market value of ~C$50 million). While AlarmForce conducts most operations in Canada (~90% of subscriber base), it commenced a U.S. expansion effort in late 2004.

The thesis is to buy into a terrific business that generates maintenance free cash flow (MFCF) of more than C$6 million and returns on invested capital of 30-40%, with regional competitive advantages that appear to be replicable and defensible in various markets across Canada and the U.S.

The company has grown subscribers at a 19% compounded annual rate over the past decade and has a business model that lends itself to similar results in the future.

The AlarmForce model differs from the models of larger competitors such as ADT Security Services, a subsidiary of Tyco International (NYSE: TYC), and Brink's Home Security (NYSE: CFL). AlarmForce acquires customers solely through TV, print and other forms of direct-to-consumer marketing. As a result, the entire investment in new subscribers is expensed in the current period instead of being capitalized and amortized over the estimated customer life. This conservative approach understates the true economic profitability of the AlarmForce business model, as current-period expenses boost revenue in future periods. Growth has been almost entirely financed through retained earnings, with minimal use of debt.

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(Toronto Stock Exchange: AF)

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CAPITALIZATION

Recent stock price: C$4.21
Diluted shares outstanding: 12 million
Market value: C$49 million
Add: Debt: C$1 million
Subtract: Estimated excess cash: C$4 million
Enterprise value: C$48 million

BUSINESS DESCRIPTION

AlarmForce Industries is a Canadian company that develops, manufactures, installs, and monitors burglar alarm systems that incorporate two-way voice technology for residential consumers and small businesses.

The company is vertically integrated, allowing it to maintain high levels of customer care and cost efficiencies in operations. The cost savings are passed on to customers in the form of lower prices relative to competitors. Meanwhile, the customer care efficiencies result in superior customer service and satisfaction (about 10% of new subscribers are referrals).

AlarmForce offers two main products/services to the end customer: Alarmvoice and AlarmPlus. The major difference between the two is that Alarmvoice operates over the telephone line (referred to as “line technology”) and AlarmPlus is completely wireless (“no-line technology”). The company introduced a new product called AlarmCare in the second quarter of 2008.

PRODUCT DESCRIPTION

- **Alarmvoice (line).** This is the company’s two-way voice alarm technology. The product allows AlarmForce to not only monitor/protect against burglary, but also contact the proper authorities in other emergencies, such as medical, fire, flooding, and carbon monoxide leaks. The major benefit of this system is that it allows the end customer to be in direct contact with a live AlarmForce representative in the case of an emergency and describe the situation so that proper authorities can be contacted. There are no installation fees, only a $25-per-month fee with a three-year contact that renews annually (industry standard). The total cost to the customer of this system with no additional equipment is $900 (before tax). This is the company’s most popular system.
- **AlarmPlus (no-line).** Some burglars have smartened up and now cut the telephone line before entering a building, preventing the emergency signal from being sent to the Central Monitoring Station (CMS). AlarmPlus addresses this problem. If the line is cut, a wireless signal is sent to the CMS. This system costs $199 for installation and $29.95 per month for monitoring. This system can be combined with Alarmvoice for no additional fee. AlarmPlus is also used in households with no physical telephone line. The downside of not having a telephone line is that you do not get the benefits of the two-way voice alarm technology.
- **AlarmCare.** This is the new 24-hour personal emergency response system (PERS) launched in the second quarter of 2008. The product is geared toward aging baby boomers and those with medical needs. It is essentially a pendant that is worn around the neck, and if activated, the user is immediately connected via the two-way voice system to the CMS (they keep customers’ medical records on file so they can address potential medical or other issues in a timely manner). The price is $28 per month with no contract or additional fees. At the end of the first quarter of FY09, AlarmForce had 1,000 AlarmCare subscribers.

For product and pricing info versus competitors, visit www.alarmforce.com/competitiveedge_new.php#comp1

INDUSTRY OVERVIEW

The security alarm industry is highly fragmented. There are 14,000 local and regional security alarm monitoring companies in North America. The major players include ADT, Brink’s, Protection One, Monitronics, and Stanley Works. ADT controls the largest share of recurring monthly revenue (RMR) at 29%, followed by Brink’s at 5%. ADT’s market share has declined from a high of 32% of industry RMR in 2005. Most of the major players operate in many states and other countries.

Industry attractiveness:

- **Low market penetration.** Market penetration rates for electronic security systems are less than 20% in Canada and about 20% in the U.S. A market research study by SDM Magazine and

Interlogix indicated that 56% of non-alarm owning homeowners would consider purchasing a security alarm system.

- **Large market size.** The estimated size of the market for electronic security systems was $32 billion in 2007.
- **Stable cash flows and high operating margins.** Credit risk is dispersed across many individuals and geographic regions.
- **Strong profitability.** Alarm monitoring is the most profitable segment of the security alarm industry.
- **Historically strong demand.** Over the past decade, the industry has grown at a compound annual rate of 8.6%.
- **Recession resistance.** Higher crime and concerns about terrorism lead to greater demand for security products.

COMPETITIVE MOAT

AlarmForce has several competitive advantages that appear to be defensible and reproducible in select markets in which the company *chooses* to enter. The company currently conducts operations in all major Canadian markets, where the AlarmForce brand name is well known. At the end of 2004, AlarmForce began an expansion program in the U.S. by entering North Carolina and subsequently Ohio and Georgia. The company offers services to the following regional areas: Charlotte, Raleigh, Winston-Salem, Columbus, Cincinnati, Cleveland, and Atlanta.

AlarmForce Links:
Website
FY08 annual report
FQ1 earnings release
SEDAR filings

The company's strategy is to be the low-cost provider of alarm monitoring systems and offer the end customer better service relative to the competition. As stated earlier, AlarmForce is vertically integrated. The company develops, manufactures, installs, and monitors all of their security systems from the headquarters in Toronto. The benefits of this strategy include the following: 1) increased product and service quality; 2) in-house R&D allows the company to develop new products and services by listening directly to customer needs; and 3) the company lowers customer acquisition costs by cutting out middlemen, including dealers and regional sales teams, which larger competitors ADT and Brinks still rely upon.

AlarmForce has a business model that allows the company to acquire customers more efficiently than competitors. Many larger players operate in many states across the U.S. and in other countries. They either 1) purchase customer accounts from dealers or 2) employ regional sales forces that visit potential customers in order to close a sale. AlarmForce operates more efficiently, as it acquires customers through TV, radio and print marketing and closes the sale over the phone. Middlemen such as dealers and overhead associated with establishing and maintaining regional sales offices thus do not existent at AlarmForce. The combination of vertical integration and lower-cost customer acquisition provides to the following advantages:

- **Supply,** both in the form of cost advantages inherent in the business model as well as proprietary technology.
- **Demand.** High switching costs in the form of three-year contracts with automatic annual renewals. In our conversations with management, we have confirmed that the average customer life is 7-8 years. Regarding attrition, management has stated that it is currently running a bit higher than normal at about 11%. This number has historically been in the 7-11% range, which is below the industry average of 10-14%.
- **Regional economies of scale.** When management locates an attractive new market, the company invests in establishing the brand through concentrated marketing efforts until a critical mass of subscribers has been reached.

VALUATION

Our analysis suggests that AlarmForce currently trades at a valuation that does not appropriately reflect the company's earning power.

The shares currently provide an opportunity to purchase the existing subscriber base at a slight discount while receiving any future growth for "free." AlarmForce has grown the top line at 15-20% annually over the past decade and recently reported Q109 results that reflected a 17% increase in revenue over the prior-year period.

We use three methods to arrive at a range of fair values for AlarmForce: 1) MFCF, i.e., the amount of cash the business earns and could distribute to shareholders if it chose to do so; 2) we capitalize a portion of direct marketing expenses and run the changes through the income statement; and 3) private-market valuation multiples based on recurring monthly revenue (widely used metric in the security alarm monitoring industry, particularly in M&A situations).

Approaches to valuing AlarmForce:

- **Valuation based on estimated maintenance free cash flow (MFCF).** We define free cash flow (FCF) as cash from operations (CFO) minus capital expenditures. In order to estimate MFCF, we add back growth investments in marketing and capitalized expenditures. Meanwhile, we view a portion of marketing expenses as required to maintain the existing subscriber base and brand. Based on historical results, AlarmForce spends approximately one-third of its selling expenses on maintaining the current subscriber base.

  With regard to capex, most of the change over the years has been attributable to additions to rental equipment (security monitoring equipment). The spike in capex in 2006 was due to increased spending on a central monitoring station to handle the growing subscriber base. In our financial model of the company, we assume that one-third of capex is for maintenance (the actual numbers are a bit lower, but we use a higher number to add conservatism to our analysis).

  Our model assumes that the company grows net subscribers by 12%, including an attrition rate of 13%. Both of these assumptions are conservative, as the company has historically grown subscribers by 19%, with a 7-11% annual attrition rate. In our fairly conservative growth scenario, maintenance FCF is roughly C$6 million. This implies maintenance FCF per share of C$0.50 (versus reported EPS of C$0.22 in 2008) and a recent trading multiple of less than 8x maintenance FCF.

  A company with stable recurring revenue, sound management and strong growth prospects may deserve a 15-20x multiple of maintenance FCF. Applying this range to AlarmForce would yield a stock price of C$7.50-10.00 per share, reflecting meaningful upside potential over the current stock price.

- **Marketing expense add-back.** We carry out this exercise as a "sanity check" on the just-discussed conclusion regarding maintenance FCF. In order to do so, we analyze the years 2007 and 2008. Instead of using total selling expense, we conservatively add back only direct marketing expense, which is broken out in the company's financial statements. We assume that the average customer life is seven years and the corporate tax rate is 40%. Under these assumptions, the company would have earned C$0.51 per share in 2007 and C$0.63 per share in 2008. The resulting stock price upside confirms the findings we discussed in the previous paragraph.

- **Private market value.** Approximately 88% of AlarmForce's revenue can be considered recurring. Based on trailing revenue of C$31 million, we estimate that AlarmForce recently traded at roughly 20x recurring *monthly* revenue (RMR). Obviously, our discussions with industry experts confirm that deals are not being completed at historical multiples at this time in the security alarm industry. Historically, acquisition transactions have occurred at multiples of 35-40x RMR, or about 3x annual recurring revenue. One recently announced private transaction exhibited the following characteristics: The target company had slightly higher RMR than AlarmForce, sourced RMR from a less geographically diversified customer base, and the company was in some financial distress. The purchase price was not disclosed.

  In a more normalized environment, AlarmForce may be expected to be sold for 50-60x RMR, or 4-5x annual recurring revenue, reflecting the company's strong growth profile and unique business model. This would imply that the company recently traded at a steep discount to its estimated private market value.

OTHER CONSIDERATIONS

- **Share repurchase.** The company instituted a buyback program in December 2008, authorizing it to purchase up to 350,000 shares. As of the end of the first quarter of fiscal 2009, the company had repurchased 37,130 shares for C$144,540.
- **Insider ownership.** Management is economically aligned with shareholders, as CEO Joel Matlin owns 12% of the company and has served as CEO since the founding in 1988.
- **Subscriber growth by geography.** The company recently began breaking out subscriber growth in Canada versus the U.S. In the recent quarter, in which "economic activity fell off a cliff" according to Warren Buffet, AlarmForce

grew net subscribers by 7% in Canada and 63% in the U.S.
- **No net debt.** Management appears to be averse to taking on debt, and the company has not had a major need for debt financing. The company took on a relatively small amount of debt in 2006 in order to purchase a new central monitoring station and some intangible assets.

KEY RISKS

- Global economic weakness could cause the attrition rate to increase and net subscriber additions to decrease.
- The company may fail in expand profitably inside the U.S.
- The company may be unable to maintain the cost-effectiveness of its marketing programs.

CATALYSTS

- The company may attract more investor attention as it continues to expand within the U.S.
- A larger competitor may decide to bid for AlarmForce in an attempt to grow the customer base and expand its footprint in Canada.
- Continued share repurchases would expand the gap between market value and fair value, increasing the likelihood of stock price outperformance.
- A return to a more normal economic environment would likely motivate investors to pay a higher multiple for AlarmForce's high-quality free cash flow stream.

Disclosure: The author of this report, Zain Griffith, owns shares in AlarmForce.