

Q3 /Q4 2018 Physical Security Industry Update



Market Update: Another blow out quarter with big changes

For 16 quarters now I have been making this update, and at time struggle to find new ways to describe the overall health of our markets. This quarter is no different. Most of the manufacturers focused on this industry reported strong results for Q3. Assa Abloy and Allegion reported 10% organic growth in the Americas... on top of previous year over year strong performance. SDM Integrator survey results said 94% see business excellent to very strong. The near term market continues to look very strong, but headwinds of tariff uncertainty, product & labor inflation, rising interest rates, and stock market confidence are building up quickly.

The 3rd & 4th qtr ytd has had some significant transactions that have accelerated industry consolidation. I continue to believe the consolidation in the channel will be the most significant change in our industry during the next ten years. I had the opportunity to attend the DHI Summit and SIA's Securing New Ground conference in October, and want to elaborate on a few common themes at these events.

The top 5 Mega Trends presented at SNG are listed below. The DHI Summit shared #2, #4 and #5.

1. Cybersecurity and its impact on physical security
2. Workforce challenges - attracting and retaining talent. #1 issue per SDM survey
3. Artificial intelligence which was argued as Machine Learning being a more accurate terminology
4. Channel Changes: How will they change for the future.
5. Margin Compression from Inflation driven costs - Products & Labor

Regarding channel consolidation, let's first look at a significant channel disruption occurring right now in the residential alarm marketplace. The traditional industry is being turned upside down by the rapid growth of DIY smart home security systems and the success of new co's like Simplisafe. These new entrants offer low cost products, zero to low monthly monitoring and no long term contracts. This completely blows up the traditional models of \$40 / monitoring with three year agreements. DIY systems are generating 90% false alarms and have led to many police / fire agencies refusing to respond to non-verified alarms.

Impact on the major players: Monitronics rebranded in 2017 as Moni, and then Brinks earlier this year. Their stock (PE firm Ascent Capital) has dropped from \$87 to currently under \$1. ADT's IPO was targeted at \$17 per share, came out at \$14 and is now \$7.30. The financial community sees major disruption to this channel and is pricing shares appropriately. Going forward many smaller alarm dealers and monitoring centers will be in trouble, others will move to more commercial business, but won't have the juice to make big moves like ADT's roll up of commercial integrators punctuated by the acquisition of Red Hawk. Watch for development of alarm verification solutions to augment base business decline.

Margin compression is the second major theme. Last Qtr I highlighted large price increases from the major manufacturers which are not over. 37% of the all public companies reporting Q3 results at time of writing reported cost impacts driven by the tariffs and tight labor markets. The public companies have moved and will continue to move quickly to offset costs increases by passing along price increases. When I addressed the DHI Summit distributors I expressed my concern over their financial health if they are not being equally aggressive in passing price increases along to their customers. The manufacturers move much faster than the integrators / distributors who typically take smaller increases in stride. Current

increases are not small, and most company's P&Ls can't deal with double digit product price increases. To the integrators / distributors out there, don't get caught in a big squeeze!

Q3 2018 Highlights from the Manufacturers

Allegion: Another solid quarter. Raised total full year revenue target. Electronics growth at 30%.

- Revenue of \$712 million, +16.8% v PY. +8.5% organic, 2.2% price, 6.3% volume. 9% acquisitive
- Adjusted Operating Margin declined from 22.3% to 20.9%. Excluding acquisitions OM was flat. EPS was up 20.6%, benefiting from favorable tax rates while managing inflationary pressure.
- Americas sales were \$530 million, +16.5%, 10% organic vs PY. Low double digit growth in Non-Residential, high-single digit growth in Residential. 30% growth in electronics! Acquisitions added 6.6% to total growth.
- Americas Operating Income was \$154 million, OM 29.1%. 2018 acquisitions dilutive 120 bps.
- EMEIA revenue was \$134 million, +7.4%, 3.4% organic. OM 7.6% vs 8.1% PY.
- Asia revenue was up 62%, 5.9% organically. Margin was 6.8% vs 7.6% PY.
- Full year revenue growth outlook was raised to 13.0 - 13.5%.

ASSA ABLOY: The company keeps putting up impressive results, 15% overall growth!! 25% Electromechanical product growth.

- Sales were 21.2 MESK (\$2.3billion) up 15% vPY. 3% volume, 2% price, 2% acquisitive, 8% currency. EBIT was up 11%, EPS + 11%.
- Strong growth in Global Tech, Entrance Systems and Americas, and smart residential products.
- Americas stated strong growth all aspects of their business. Revenue was \$559 million +10% organic. Operating margin declined another 170 bps after a 200 bps decline in Q2 citing raw material increases and increased residential mix. *Hence my earlier squeeze warning.*
- Yale locks operating on August Home's cloud software was highlighted.
- Global Technology (HID & Ving) group, was up 12% organically. Operating margin jumped to 21.4% from 17.8%. Strong growth identity management was mentioned.
- Entrance Systems, reported 4% organic growth. Realized growth in all product lines except high performance doors. .
- Completed 14 acquisitions in 2018, expected to contribute \$300 million in revenue. The most significant was Crossmatch, a leader in biometric identity management with 270 employees, and revenues of \$125 million.

dormakaba: Full year reporting July 2017 - June 2018

Dormakaba report sales twice per year. Fiscal year ended 6/30/18.

- Full year sales were \$2.92 billion, +12.7% vs PY, +2.6% organic, 8.2% acq, 1.9% currency.
- Gross Margin declined due to mix, raw material increases were offset by pricing.
- EBITDA margin improved from 15.2% vs 15.4%. +11.3% in \$.

- Americas had sales of \$853 million, 19.7% EBITDA. Organically flat. Decline in the ATM & 3rd party service businesses offset organic growth in the core hardware business. Hospitality growth had unfavorable mix impact on margins.
- EMEA had sales of \$805 million, 7.3% EBITDA margin and 2.5% organic growth.
- Key systems & Moveable walls had sales of \$399 million, 14.6% EBITDA and 4.9% organic growth.
- Dk three priorities: Business Performance, Post Merger Integration, and Digitization.
- “Expect to compensate for raw mat'l increases by significant price increases FY 18/19”

Stanley: Security continues to drag down overall results. Seems to be a rudderless division.

- Net sales were \$3.5 billion; up 4% vPY, all organic.
- Tools & Storage +6%, Industrial was flat and Security declined 1%.
- Security (CSS) reported sales of \$485 million, (1%), Op margin declined 100 bps citing investment in business transformation. Americas organic revenue declined 2%.
- Security sales were positive in automatic doors and healthcare, but declined in commercial security. Operating margin was 11%, running a full 5.5% lower than Tools & Industrial segments.

M&A Activity - Another active quarter with some big deals

Convergint continued aggressive acquisitions adding Access Control Technologies (ACT) in New Jersey who brings industry icon Joe Liguori to the team, Quebec based Altel that works across many end markets, Commercial Systems Group (CSG) an Orlando based security and fire life safety integrator and because 3 is not enough, Integrated Security Systems (ISS) a WI based integrator focused on the banking industry.

ADT acquired Red Hawk, A big move to balance commercial security with the declining residential business. Big move, big price tag. ADT paid \$317.5 million, Red Hawk has 2018 sales of \$300 million. ADT has now added more than \$400 million of commercial integration revenue in 2018.

Cook & Boardman the largest commercial door & hardware distribution business' owner Ridgemont Equity Partners sold to Connecticut based **Littlejohn & Co.** C&B has a publicly stated goal to be the first \$1 billion door & hardware systems distributors. Ridgemont bought C&B in 2014 from Blue Point Equity.

VT Industries acquired Eggers Industries, VT is the largest architectural wood door manufacturer in N America, and the strategic addition of Eggers add manufacturing capacity & technologies. VT + Eggers and Masonite's acquisition of Graham & Maiman from Assa Abloy in Q2 consolidates the N American architectural wood door market to two players.

UTC's Lenel acquires S2, S2 brings access control software systems tailored for small business applications, is linux based and does not use the Mercury platform so it brings a strategic adjacency to Lenel.

3SE Corp's Dave Sylvester has teamed with Davis Mergers & Acquisitions Group as a partner to increase our collective presence and involvement in the Physical Security Industry. We focus 100% of our energies on representing sellers of alarm dealers, systems integrators, door & hardware system integrators, and security product companies.

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