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Cover Story

February, 2008

Investors Find Safety In Security Stocks

Jeffrey Kessler



While most U.S. stock indexes finished 2007 with gains for the year, there was particular cause to be positive about continued investment opportunities in the shares of security industry leaders.

Ongoing weakness in the housing market, concerns about subprime mortgages and crude oil prices that approached \$100 per barrel all undermined overall investor confidence in the fourth quarter of 2007. This year, similar sentiments could likely affect the overall market, including some sectors of the security industry. That said, security services and equipment stocks again outperformed the market — a trend that has continued each year except one during the past six years.

Positive gains similar to last year's can again, in part, be attributed to investors' conviction that homeland security and the war against terrorism will sustain industry growth. Investor expectations also project continued growth and acceptance of commercial technology and services around the corporate network.

Other signs of industry optimism include strong acquisition activity in security technology, and the traditional alarm security area has perked up with spin-off activity by Securitas and Tyco Int'l.

The financial and investment health of the electronic security industry is detailed here in Security Sales & Integration's annual stocks report, a valuable resource to everyone with a vested interest in the overall market environment.

Video Surveillance, Private Prison Operators Lead Market Growth

Lehman Brothers, the New York-based global finance leader, maintains an index of security industry stocks that has appreciated 143 percent since Aug. 31, 2001, compared to a 109-percent rise in the S&P 500 during the same period. During the course of 2007, Lehman's Security Index rose 13 percent, compared with 3.5 percent for the S&P 500.

An overview of the stock index can be seen on page 32. Note that Lehman Brothers attempts to limit the index to companies with significant percentage exposure to security (about 25-percent minimum, so Stanley Works wasn't included in 2007 but will be in 2008 with its acquisition of HSM Electronic Protection Services).

Among several sectors whose performance led security stocks in 2007:

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Video surveillance, +39 percent — In 2007 this sector proved to be the hottest group in security. The U.S. government and corporations are discovering the use of networked video, infrared video and video analytics for everything from perimeter security to securing maritime night vision, to limiting check fraud.

Among the leaders in this space: FLIR (+97 percent), based in Goleta, Calif., a provider of infrared video imaging and thermography (heat analysis); China Security & Surveillance Technology Inc. (+80 percent), the leading surveillance company in China; and Axis Communications AB (+73 percent), a provider of network video cameras with U.S. headquarters in Chelmsford, Mass.

Private prisons, +34 percent — Dramatic increases in demand from homeland security rules are forcing states and federal government agencies to outsource increasing business to companies like Nashville, Tenn.-based Corrections Corp. of America (+29 percent) and The Geo Group (+49 percent) of Boca Raton, Fla. There is a striking demand-supply imbalance for prison beds in public prisons in the U.S. at both the state and federal level.

Two other standout segments in Lehman's 2007 index were sensor companies (+31 percent) and armoring and lethal/nonlethal force protections (+30 percent), which were helped by the acquisition of Armor Holdings by British defense contractor BAE Systems.

Economic Woes Weigh Heavily; Brink's Stock Experiences Volatility

Two sectors in particular proved to be true laggards in 2007. While the struggling U.S. economy had a ball and chain effect on some companies, others were adversely influenced by market machinations.

Background screening and data analytics, -21 percent — Companies in this sector are sensitive to the amount of employees being screened and to factors in other vertical markets, such as the number of mortgage applicants being vetted. As concerns mounted over the U.S. economy in 2007, companies like Alpharetta, Ga.-based ChoicePoint (-12 percent), St. Petersburg, Fla.-based First Advantage Corp. (-30 percent) and Minneapolis-based Fair Isaac Corp. (-21 percent) performed below expectations.

Physical security (guarding, armored transport, et al.), -4 percent — With the exception of Britain's Group 4 Securicor (+24 percent), which appeared quite aggressive in going after business in 2007, other companies in this sector did not fair as well, including Stockholm-based Securitas (-15 percent), which spun off its installation and monitoring businesses, and Spanish security firm Prosegur (-1 percent), which had already risen in 2006 on takeover speculation.

Montreal-based Garda World Security Corp. (-30 percent), the second largest physical security company in North America after The Brink's Co., enjoyed spectacular growth through acquisition in 2006 only to drop precipitously in 2007. The company was hit by concerns related to the torrid pace of its acquisition program and inevitable financial rumoring typical in the wake of such growth. Brink's Home Security (a division of The Brink's Co.), which Lehman Brothers arbitrarily includes in physical security since it could just as easily be placed in monitoring, fell 7 percent in 2007. The performance hurt the group, but special circumstances at the beginning of 2007 justify explanation.

The positive reaction to the sale of BAX Global, the repurchase of 10 million shares, and the subsequent shareholder activism to split up the company, in part, caused Brink's stock to fluctuate 15 percent up or down during the year, simply depending on the timing of corporate and shareholder-related announcements. Fundamentally, the company operated at or ahead of analyst estimates for most of the year.

Looking Toward Trends in 2008, There Is Good Cause to Be Bullish

With 2007 in the rearview mirror, what does Lehman Brothers see as the specific investment trends and related venture areas for the security industry in 2008?

Video — Video will remain a core driver of security systems in 2008. The case for video on the network or in a hybrid design will continue to attract private and public investment.

FLIR is looked to as a favorite, long-term investment, with only high valuation keeping Lehman Brothers from projecting the stock could outperform the unweighted expected total return of the sector.

Axis Communications AB, publicly traded on the Stockholm Exchange as the leading network video camera producer, also carries a very high valuation and additionally deserves serious consideration by investors for the long term.

IT — The IT IQ of the security industry is on the rise, which is creating issues in market, storage and employee hiring/education strategies. The increasing demands by the first generation of corporate chief security officers is causing a major headache in the go-to-market channel. The old legacy go-to-market strategy of selling product through thousands of small security dealers is giving way to more sophisticated systems integrators that have both physical and IT knowledge.

Now we are seeing companies like Stanley Works' Convergent Security Solutions (the combination of HSM Electronic Protection Services and legacy systems integrators) and Securitas Systems (a second spin-off from Securitas) become more IT savvy by hiring and educating their employee bases and generating what should be more than 30 percent recurring

monthly revenue (RMR) in 2008. And there are other smaller, private security integrators that have built businesses competitive with other IT integrators.

Stanley Works' acquisition of HSM should eventually increase the base of investors in the company who may now regard it more than simply a general industrial play. Schneider Electric's acquisition of Clovis, Calif.-based Pelco, a leading manufacturer of video security systems, also moves that company's security installation and integration business up to 20 percent of revenues.

Ultimately, the pure play investors must take a look at is Securitas Systems. Although the company continues working to boost its IT acumen, it has made tremendous strides and created a very profitable RMR model in Europe. Securitas Systems' challenge is to execute that same model and success in the United Kingdom and the U.S.

Interoperability — There are many large, slow-to-develop government identification projects in the Americas, Europe, Middle East and Asia that are creating the need for interoperability and open architecture standards in order to be successful.

This has not gone unnoticed by the major players in the security industry. We can all wonder when TWIC, US-VISIT, Real ID, HSPD-12, SBI, Registered Traveler, and a host of other large identification and security programs are going to reach stages of implementation that finally satisfy Congress, pundits, and those public companies and their investors waiting to sell to the leading systems integrators. The initial phases of TWIC and the "PassCard" portion of the Western hemisphere travel initiatives actually have been awarded. What cannot be disputed is the development of ID programs around the world, some in countries where privacy is not the main debate.

Lehman Brothers continues to recommend Stamford, Conn.-based L-1 Identity Solutions as the leading ID and biometrics company. There are so many small and mid-sized ID contracts being awarded and/or bid around the world that L-1 does not need the high-profile U.S. mega-contracts to continue growing its organic revenues. Furthermore, L-1 has increased its footprint in access control markets such as transportation and health care with the recent acquisition of Bioscrypt Inc. of Ontario, Canada.

Monitoring — Financial report users and analysts following the alarm monitoring industry are finally learning to focus value on the steady state cash flow (the current value of a company using future cash flows adjusted for time value) of the RMR base and on attrition (*see sidebar*).

Raw growth, RMR (which can be unprofitable), EBITDA (earnings before interest, taxes, depreciation and amortization), and regular earnings per share, have always been key drivers for the public market — but not for those inside the industry who do the consulting and make the deals.

At least in the U.S. we are seeing some real sophistication around the values being created by quality RMR based on attractive companies like Brink's and Securitas Direct in the residential monitoring business.

China — The so-called rapidly developing "BRIC" countries (Brazil, Russia, India and China) are drawing a lot of investor attention. This is especially true in China where revenue in its security market is already in the billions, compared to hundreds of millions in other BRIC countries.

Security revenue in China is growing in excess of 20 percent annually in advance of the upcoming Olympic summer games in Beijing and the 2010 World's Fair in Shanghai. China's developing "Safe Cities" security program, along with the aforementioned international events, is attracting companies like Honeywell, Siemens, Verint and Pelco, while creating a home-grown leading commercial consolidator in China Security & Surveillance Technology Inc.

Sensors — Mobile, handheld identification and sensor devices were highly sought after in 2007 and could be in even more demand in 2008. While Lehman's could focus on L-1's portable biometric HIIDE™ device and its penetration of the government maritime ID contracts with mobile fingerprint identification IBIS devices, it is really just one example of the entire mobile identity and security business and why it is in demand by civilian and commercial users.

Indeed, all players in biometrics — from South Pasadena, Calif.-based Cogent Systems Inc. to Palm Beach Gardens, Fla.-based Cross Match Technologies Inc. — are introducing mobile, wireless devices. Lehman Brothers believes this is a value-added need for the security industry at good margins and not the making of a commodity.

The development of mobile biological, radiological and infrared sensor devices combined with biometrics may be one of the untold security growth stories during the next several years. In the category of handheld devices used to detect explosives, biological and chemical agents, and nuclear compounds, ICx Technologies of Arlington, Va., has by far the widest range of products. Lehman Brothers believes the company could generate 30-percent growth in the next several years.

Acquisitions — Large publicly-held industrial corporations will continue to try to increase their functional capabilities, as well as their growth rates with the acquisition of security companies.

During the past 15 months, Stanley Works (HSM), Schneider Electric (Pelco), Cisco (Broadware), BAE Systems (Armor Holdings) and United Technologies Corp. (Initial Electronic Security Group) have all made significant acquisitions in the industry. At this point, among the major international conglomerates it would appear only Tyco, ASSA ABLOY, Schneider Electric, Stanley Works and Diebold have large enough percentages of their business in security for

investors to seriously consider this sector's effect on the company's stock prices.

Data — Should a noticeable recovery in the economy begin to develop, Lehman Brothers will be looking closely at the background screening companies it covers, including ChoicePoint and First Advantage Corp. First Advantage Corp. could receive a major boost from a rebound in its normally high-margin mortgage and credit screening businesses, at such time as investors sense a turnaround in the real estate market. These trends, of course, may be some time in coming.

Jeffrey Kessler, a vice president with New York-based Lehman Brothers, has been covering the security industry for more than 20 years. He is the supervising analyst for the company's Security Annual, which is now in its 13th year.

2007 Security Stocks Listing by Sector

Lehman Brothers' Security Index consists of about 50 security company stocks or companies with significant security divisions or subsidiaries. In 2007, the index rose 13 percent.

Below, a partial list of the index excludes the Background Screening, Data Analytics, Private Prisons, and Armoring, Weapons sectors. The table provides the final company, sector and market figures.

Company	Symbol	Exchange	% change 2007
INTEGRATORS			
DIEBOLD	DBD	NEW YORK	-35%
HENRY BROS. ELECTRIC	HBE	AMERICAN	17%
SECURITAS SYSTEMS	YSI	STOCKHOLM	-20%
TOTAL			-13%
MONITORING			
ALARM FORCE	AF	NEW YORK	-1%
DEVCON	DEVC	NASDAQ	-56%
LO-JACK	LOJN	NASDAQ	-5%
PROTECTION ONE	PONE	NASDAQ	-2%
SECURITAS DIRECT	SDIR.B	STOCKHOLM	19%
TYCO (spin-off adjusted)	TYC	NEW YORK	28%
ZICOM	631327	MUMBAI	22%
TOTAL			1%
VIDEO/AUDIO SURVEILLANCE			
AXIS COMMUNICATIONS	AXISB	STOCKHOLM	73%
CHINA SECURITY & SURVEILLANCE	CSR	NEW YORK	80%
FLIR SYSTEMS	FLIR	NASDAQ	97%
ICOP DIGITAL	ICOP	NASDAQ	-28%
MARCH NETWORKS	MN	TORONTO	-52%
NICE SYSTEMS	NICE	NASDAQ	11%
VICON INDUSTRIES	VII	AMERICAN	171%
VERINT SYSTEMS	VRNT.PK	OTC	-44%
TOTAL			39%
SENSORS, SYSTEMS			
CEPHEID	CPHD	NASDAQ	210%
L-3 COMMUNICATIONS	LLL	NEW YORK	30%
MAGAL SECURITY SYSTEMS	MAGS	NASDAQ	-32%
OSI SYSTEMS	OSIS	NASDAQ	26%
RAE SYSTEMS	RAE	AMERICAN	-18%
ARGON ST	STST	NASDAQ	-13%
TOTAL			34%
ID, TRACKING, ACCESS CONTROL			
ASSA ABLOY	ASSA.B	STOCKHOLM	-15%
CHECKPOINT SYSTEMS	CKP	NEW YORK	24%
COGENT	COGT	NASDAQ	1%
L-1 IDENTITY SOLUTIONS	ID	NEW YORK	19%
ID SYSTEMS	IDSY	NASDAQ	-35%
LASERCARD	LCRD	NASDAQ	-7%
TOTAL			-2%
PHYSICAL SECURITY SERVICES			
BRINK'S COS.	BCO	NEW YORK	-7%
GROUP 4 SECURICOR	GFSL	LONDON	24%
GARDAWORLD	GWTO	TORONTO	-30%
SECURITY CORP.			
PROSEGUR	PSG	MADRID	-1%
NAPCO SECURITY SYSTEMS	NSSC	NASDAQ	2%
SECURITAS	SECU.B	STOCKHOLM	-15%
SECOM	9735	TOKYO	-1%
TOTAL			-4%
ENTIRE SECURITY MARKET			
			13%

Note: The index, which is unweighted by market capitalizations (i.e. giving equal weight to small and large companies' performance), was skewed by dramatic changes in two of the smallest companies on the list — a 56-percent decline in the price of Hollywood, Fla.-based alarm monitoring leader Devcon Security Corp., and a 210-percent increase in the price of biological detection company Cepheid of Sunnyvale, Calif. Taking these two peripheral companies out of the mix, the index in total would have increased another 1 percent.

Study: RMR Attrition Rates Across the U.S. Continue to Improve

By John Brady

Since 2000 TRG Associates has accumulated annual customer attrition rates from a growing number of small, community based operations to large national security companies. The ongoing study measures the level of customer recurring monthly revenue (RMR) losses (gross attrition) and the offsets to those losses such as other increases in RMR related to the same base of customers (net attrition).

As the security industry continues to attract outside debt and equity based on its solid operating margins, predictable cash flows and market value liquidity, attrition is often looked to as a key depleting operating dynamic.

The study's latest results from the 2006 national sampling, which includes more than \$60 million of RMR, show for the second year running gross attrition figures continued to decline compared to the previous year. The average residential/commercial gross attrition figure dipped to 11.56 percent from 11.67, while the average net attrition figure fell to 8.06 percent from 8.58.

The amount of RMR in dollars is broken down by geographic region, size of company, initial customer source and service type. The results since 2004 have also been broken down by respective branch in some cases as to geography, size, etc. This breakdown has helped isolate the impact on attrition within those regions of the U.S. that have suffered damaging effects from natural disasters since 2005.

Many 2006 study participants that measure their "resigns" and "like customer" movements demonstrated a continued improvement in their results vs. 2005. On average for those companies that tracked "resigns," the retention percentages approached 37 percent for "like customer" and 44 percent for "like location" resigns.

The leading reason for cancellation continues to be "moves within and outside" of the marketplace, which in 2006 amounted to a combined 46 percent for the residential and commercial sectors. There was a significant percentage increase in the "lost to competition" category, while "no longer using system" remained relatively steady vs. 11.3 percent in 2005.

The study brought to light the impact on the net attrition reductions due to price increase, and also the decrease in "price increase rescinded" as a reason for cancellation (1.3 percent). In a number of instances, participants monitored the RMR price increase rollbacks within this category rather than including the original RMR lost from a customer due solely to a price increase. Thus, the category is also more indicative of the net price increases realized.

On a percentage basis, because most of the study participants segregated the price increase and the rollback/losses, it appears the price increases continued to be effective based upon the "net acceptance" by the respective customer bases.

TRG Associates is currently accumulating the 2007 results from the study participants. While it is early yet, the results appear to indicate the overall net attrition rate is stable to trending downward again.

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