ADT and the Ham Sandwich Test

The ham sandwich test, credit for which goes to Warren Buffett, asks whether a company you're invested in has such a great business with such high barriers to entry that it could be run by a ham sandwich. I'm increasingly beginning to think that ADT will be subject to this test, and we'll see how good a business it is in spite of their management.

ADT has a great competitive position. They are by far the biggest home security business with 25% residential market share. Their target market is higher income households who have more to protect and the means to pay for it. They ought to be able to steadily acquire far smaller firms, increasing market share and finding operating synergies.

Instead, they are seeing rising customer attrition, barely growing revenues and declining profits. The big cable companies are looking at home security as an attractive service that they can bundle with cable and internet, making switching costs higher for consumers. And yet, their enthusiasm for home security cannot be driven by the execution of ADT's business plan.

Last year Keith Meister of Corvex completely outfoxed (or "outbullied", might be more appropriate) ADT's CEO Gursahaney by selling stock back to the company as part of a stock buy back program Meister had himself advocated. His access to the company's books and records had given Meister a far more negative view of ADT than Gursahaney, and as subsequent events have shown these two do not belong at remotely the same poker table.

After ADT announced it had bought back Corvex's stake at $44.01, the stock collapsed and is currently around $30. Leon Cooperman of Omega asked the best question on today's earnings call when he noted that ADT's buybacks represented a far bigger investment than their acquisitions or capex, and asked what type of analysis management had done to assess that $44 a share represented a good return on invested capital.

One would think that such a question demands a quantitative response, something that describes the expected return on invested capital with a number. But since the answer to Cooperman’s question consisted of vague optimistic statements about the business the answer was clearly, “No, we have not done that analysis”.

Of course it’s possible that Gursahaney is smarter than I give him credit for, and that the return on capital decision for buying back Corvex’s stake was less important than getting rid of an investor likely to be vocal in his criticism of the company, even at the cost of poorly allocating shareholder capital. In which case some other adjective is more appropriate, but even so this explanation is no more shareholder friendly.

Which sounds like a company entering the ham sandwich test. For our part, we are modestly invested in ADT, in no small part because we believe there’s some chance another company (Comcast? Google?) will find ADT’s current market cap of $5.5 billion a bite-sized way to obtain a leading position in home security at a time when more and more devices are linked – the “internet of things”. Somebody needs to put current management out of its misery.