
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2005
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission File Number 333-110025

Monitronics International, Inc.

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

74-2719343
(I.R.S. Employer
Identification Number)

12801 Stemmons Freeway, Suite 821
Dallas, Texas 75234
(Address of principal executive offices)
(Zip Code)

(972) 243-7443
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

<u>Title of Each Class</u>	<u>Outstanding at April 30, 2005</u>
Class A Common Stock, par value \$.01 per share	31,090,317
Class B Common Stock, par value \$.01 per share	None

Table of Contents

	<u>Page</u>
Part I <u>Financial Information:</u>	
Item 1. <u>Financial Statements</u>	3
<u>Balance Sheets as of March 31, 2005 and June 30, 2004</u>	3
<u>Statements of Operations for the three and nine months ended March 31, 2005 and 2004</u>	4
<u>Statements of Cash Flows for the nine months ended March 31, 2005 and 2004</u>	5
<u>Statement of Shareholders' Net Capital (Deficiency) as of June 30, 2004 and March 31, 2005</u>	6
<u>Notes to Financial Statements</u>	7
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	18
Item 4. <u>Controls and Procedures</u>	19
Part II <u>Other Information</u>	
Item 1. <u>Legal Proceedings</u>	19
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	19
Item 3. <u>Defaults Upon Senior Securities</u>	19
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	19
Item 5. <u>Other Information</u>	19
Item 6. <u>Exhibits</u>	20
<u>Signatures</u>	22

[Table of Contents](#)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

MONITRONICS INTERNATIONAL, INC.
BALANCE SHEETS
(In thousands, except share data)

	March 31, 2005	June 30, 2004
	<u>(Unaudited)</u>	<u>(Unaudited)</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,224	\$ 1,645
Accounts receivable, net	6,240	5,924
Federal income tax receivable	10,243	11,739
Deferred income taxes	1,091	382
Prepaid expenses and other current assets	1,137	1,106
	<u>19,935</u>	<u>20,796</u>
Total current assets	19,935	20,796
Property and equipment, net	5,458	4,111
Deferred income taxes	13,956	12,953
Subscriber accounts, net of accumulated amortization of \$343,215 as of March 31, 2005 and \$286,846 as of June 30, 2004	443,764	434,467
Deferred financing costs, net	13,112	14,718
Goodwill	14,795	14,795
	<u>\$ 511,020</u>	<u>\$ 501,840</u>
Total assets	\$ 511,020	\$ 501,840
Liabilities and Shareholders' Net Capital (Deficiency)		
Current liabilities:		
Accounts payable	\$ 1,228	\$ 1,671
Accrued expenses	1,898	1,943
Purchase holdbacks	7,477	10,386
Deferred revenue	5,671	5,245
Interest payable	3,215	7,234
Taxes payable	201	45
Current portion of long-term debt	1,830	1,750
	<u>21,520</u>	<u>28,274</u>
Total current liabilities	21,520	28,274
Long-term debt, less current portion	404,951	379,207
Redeemable preferred stock, net	13,342	176,146
Commitments and contingencies		
Shareholders' net capital deficiency:		
Class A common stock, \$.01 par value:		
Authorized shares – 80,000,000		
Issued and outstanding shares – 31,090,317 shares as of March 31, 2005 and 3,043,920 shares as of June 30, 2004	311	30
Class B common stock, \$.01 par value:		
Authorized shares – 700,000		
Issued and outstanding shares – none	—	—
Additional paid-in capital	156,677	5
Treasury stock, at cost, 843,194 shares as of March 31, 2005 and 785,465 shares as of June 30, 2004	(8,913)	(8,568)
Accumulated deficit	(76,868)	(73,254)
	<u>71,207</u>	<u>(81,787)</u>
Total shareholders' net capital (deficiency)	71,207	(81,787)
Total liabilities and shareholders' net capital (deficiency)	\$ 511,020	\$ 501,840

See accompanying notes.

MONITRONICS INTERNATIONAL, INC.
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2005	2004	2005	2004
	(In thousands)			
Revenue	\$ 41,463	\$ 37,862	\$ 123,454	\$ 111,248
Cost of services	4,714	4,277	14,176	12,243
Gross profit	36,749	33,585	109,278	99,005
Operating expenses:				
Sales, general, and administrative	7,964	6,260	23,037	19,205
Depreciation	616	514	1,655	1,620
Amortization	19,849	17,584	58,152	51,167
	28,429	24,358	82,844	71,992
Operating income	8,320	9,227	26,434	27,013
Other expense:				
Interest expense	10,235	9,003	30,394	25,626
Other expense	—	—	—	8,828
	10,235	9,003	30,394	34,454
Income (loss) before income taxes	(1,915)	224	(3,960)	(7,441)
Provision(benefit) from income taxes	(596)	79	(1,242)	(2,657)
Net income (loss)	\$ (1,319)	\$ 145	\$ (2,718)	\$ (4,784)
Preferred dividends accrued	—	(5,232)	(878)	(15,426)
Accretion of redeemable convertible preferred stock redemption value	—	(55)	(18)	(163)
Net loss attributed to common stock shareholders	\$ (1,319)	\$ (5,142)	\$ (3,614)	\$ (20,373)

See accompanying notes.

[Table of Contents](#)

MONITRONICS INTERNATIONAL, INC.
STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended March 31,	
	2005	2004
	(In thousands)	
Operating Activities		
Net loss	\$ (2,718)	\$ (4,784)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	59,807	52,786
Amortization of deferred financing costs	2,138	1,706
Write off of deferred financing costs	—	5,934
Deferred income taxes	(1,712)	(5,503)
Provision for bad debt	2,790	2,550
Non-cash interest accretion	343	330
Non-cash expense related to put option	474	—
Non-cash expense related to vacated lease	141	—
Changes in current assets and liabilities:		
Accounts receivable	(3,106)	(2,443)
Prepaid expenses and other current assets	(31)	(291)
Accounts payable	(443)	3,166
Accrued expenses	(341)	(177)
Accrued interest	(4,018)	2,178
Deferred revenue	426	1,947
Income taxes payable and receivable	1,652	1,000
Net cash provided by operating activities	55,402	58,399
Investing Activities		
Purchases of property and equipment	(3,002)	(999)
Purchases of subscriber accounts (net of holdbacks)	(70,358)	(81,882)
Net cash used in investing activities	(73,360)	(82,881)
Financing Activities		
Payment of deferred financing and issuance costs	(1,670)	(16,235)
Payment of subordinated debt	—	(32,491)
Payment of unaccreted redemption cost	—	(24)
Purchase of treasury stock	(345)	(1,000)
Proceeds from credit facility	62,400	248,800
Payments of credit facility	(37,238)	(332,460)
Redemption of preferred stock	(5,610)	—
Proceeds from issuance of senior subordinated debt	—	159,057
Net cash provided by financing activities	17,537	25,647
Increase (decrease) in cash and cash equivalents	(421)	1,165
Cash and cash equivalents at beginning of period	1,645	334
Cash and cash equivalents at end of period	\$ 1,224	\$ 1,499
Significant cash transactions during the period for:		
Interest paid	\$ 31,225	\$ 20,572
Non-cash investing and financing activities:		
Recapitalization (see Note 5 (Recapitalization) to the financial statements):		
Issuance of common stock	\$ 158,090	\$ —
Issuance of New Series A preferred stock	\$ 13,342	\$ —
Retirement of Series A, B, C, C-1 and D-1 preferred stock	\$(171,432)	\$ —
Accrued preferred stock dividends	\$ 878	\$ 15,426

See accompanying notes.

[Table of Contents](#)

MONITRONICS INTERNATIONAL, INC.
STATEMENT OF SHAREHOLDERS' NET CAPITAL (DEFICIENCY)
(In thousands, except share data)

	Class A Common Stock		Class B Common Stock		Additional Paid-in Capital	Treasury Stock, at Cost		Accumulated Deficit	Total Shareholders' Net Capital (Deficiency)
	Shares	Amount	Shares	Amount		Shares	Amount		
Balance at June 30, 2004	3,043,920	\$ 30	—	\$ —	\$ 5	785,465	\$ (8,568)	\$ (73,254)	\$ (81,787)
Accretion of preferred stock redemption value	—	—	—	—	—	—	—	(18)	(18)
Accrual of preferred stock dividends	—	—	—	—	—	—	—	(878)	(878)
Issuance of Class A common stock	28,429,907	284	—	—	156,677	—	—	—	156,961
Issuance of Class A common stock upon conversion of Class B common stock	366,626	4	—	—	—	—	—	—	4
Cancellation of Class A common stock	(750,136)	(7)	—	—	7	—	—	—	—
Issuance of Class B common stock upon conversion of warrants	—	—	366,626	4	—	—	—	—	4
Cancellation of Class B common stock	—	—	(366,626)	(4)	—	—	—	—	(4)
Cancellation of warrants	—	—	—	—	(12)	—	—	—	(12)
Purchase of treasury stock at cost	—	—	—	—	—	180	—	—	—
Purchase of treasury stock (Hull Family Limited Partnership, Put Option)	—	—	—	—	—	57,549	(345)	—	(345)
Net Loss	—	—	—	—	—	—	—	(2,718)	(2,718)
Balance at March 31, 2005	31,090,317	\$ 311	—	\$ —	\$ 156,677	843,194	\$ (8,913)	\$ (76,868)	\$ 71,207

See accompanying notes.

Monitronics International, Inc.
Notes to Financial Statements
(Unaudited)

1. Description of Business and Summary of Significant Accounting Policies*Description of Business*

Monitronics International, Inc. (the "Company") provides security alarm monitoring and related services to residential and business subscribers throughout the United States. The Company monitors signals arising from burglaries, fires, and other events through security systems installed by its independent dealers at subscribers' premises.

The accompanying interim unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles. In the opinion of management, the accompanying interim unaudited financial statements contain all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the results of operations for the interim periods.

Stock Compensation

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations, and complies with the disclosure provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under APB 25, compensation cost is recognized over the vesting period based on the difference, if any, on the date of grant between the fair market value of the Company's common stock and the exercise price of the stock option granted. The Company grants options with an exercise price at least equal to or above the fair market value of the Company's common stock on the date of the grant and, as a result, generally does not record compensation cost.

The following table illustrates the effect of net loss if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in thousands):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2005	2004	2005	2004
Net income (loss) as reported	\$ (1,319)	\$ 145	\$(2,718)	\$(4,784)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net value of related tax effects	(80)	(3)	(120)	(10)
Pro forma net income (loss)	\$ (1,399)	\$ 142	\$(2,838)	\$(4,794)

Monitronics International, Inc.
Notes to Financial Statements (continued)
(Unaudited)

Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)", which is a revision of SFAS 123. SFAS 123(R) supercedes APB 25, and amends FASB Statement No. 95, "Statement of Cash flows." Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure will no longer be an alternative. SFAS 123(R) is effective no later than the beginning of the first fiscal year beginning after December 15, 2005. The Company expects to adopt SFAS 123(R) on July 1, 2006. The adoption of SFAS 123(R)'s fair value method will have a significant impact on the Company's result of operations, although it may have no impact on the Company's overall financial position. The Company is currently assessing implementation of the "modified prospective" method as defined by SFAS 123(R).

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, "Accounting For Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). This statement established standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first fiscal period beginning after December 15, 2003 and must be applied prospectively by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the statement and still existing at the beginning of the interim period of adoption which was July 1, 2004. The initial adoption of SFAS 150 had no material impact on the financial statements. However, a subsequent amendment related to an investor put option resulted in the Company recording a \$0.5 million liability and related expense to adjust the put option to fair value as described in Note 3 (Related Party Transactions) to these financial statements.

2. Long-Term Debt

Long-term debt consists of the following (in thousands):

	March 31, 2005	June 30, 2004
Revolving credit line and term loan payable	\$ 226,050	\$ 200,887
Senior subordinated notes payable	160,000	160,000
Subordinated notes payable	21,203	20,936
Investor put option	319	—
	407,572	381,823
Less: discount	791	866
Less: current portion	1,830	1,750
	\$ 404,951	\$ 379,207

At March 31, 2005, the Company had a \$320.0 million credit facility with various financial institutions, consisting of a \$145 million revolving credit line and a \$175 million term loan. As of March 31, 2005, the Company had \$53.7 million in borrowings outstanding under the \$145 million revolving credit line and had \$172.4 million in borrowings outstanding under the term loan. Further, the Company had \$91.3 million in availability under the revolving credit line of which \$28.5 million was immediately available as calculated under the covenants in the Company's credit facility, and is charged a commitment fee of 0.5% on the average daily unused portion. The revolving credit line bears interest at a rate of either prime plus 2.25% or LIBOR plus 3.25%. The term loan bears interest at a rate of either prime plus 2.75% or LIBOR plus 3.75%. For the nine months ended March 31, 2005, borrowings under the credit facility had a weighted average interest rate of 6.6%. Interest incurred on borrowings is payable monthly in arrears.

On March 28, 2005, the Company amended certain provisions of its credit facility, dated August 25, 2003, that included elimination of mandatory reductions to the revolving credit facility, a 75 basis point reduction in the variable interest rate for the Company's revolving credit line and the term loan, and a 25 basis point reduction in commitment fees at the Company's current borrowing level.

On August 25, 2003, the Company issued \$160.0 million of senior subordinated notes (the "Senior Subordinated Notes") at 11.75% at a discount of \$0.94 million with a maturity date of September 1, 2010. Interest payments are to be made semi-annually in cash in arrears on March 1 and September 1 of each year beginning on March 1, 2004. On December 16, 2004, the Company completed an exchange offer in which it exchanged new notes that were registered under the Securities Act of 1933 for the Senior Subordinated Notes. In accordance with the registration rights agreement associated with these notes, the Company incurred special interest on the Senior Subordinated Notes in the amount of \$470,000 in connection with the exchange offer. On August 25, 2003, the Company also entered into its existing credit facility agreement comprised of a \$175.0 million term loan that

Monitronics International, Inc.
Notes to Financial Statements (continued)
(Unaudited)

matures in fiscal year 2010 and a \$145.0 million revolving credit facility that matures in fiscal year 2009. Payments under the term loan are payable in quarterly installments from December 31, 2003 through June 30, 2009. The quarterly payment is calculated based upon the amount of the original facility multiplied by 0.25% for the quarters ended December 31, 2003 through September 30, 2006, 1.25% for the quarters ended December 31, 2006 through September 30, 2007 and 3.00% for the quarters ended December 31, 2007 through June 30, 2009 with the remaining balance due at maturity. Proceeds from the issuance of the Senior Subordinated Notes and borrowings under the credit facility were used primarily to repay the Company's prior credit facility and its \$12 million senior subordinated notes payable, to repurchase \$20.5 million principal amount of its subordinated notes at a repurchase price of approximately \$23.2 million and to pay debt issuance costs. As a result of the above transactions, the Company incurred a loss on redemption of its debt of \$2.9 million and expensed \$5.9 million of its previously capitalized deferred financing costs. These amounts are included in the caption "Other Expense" on the statement of operations. The terms of the then remaining \$20.5 million principal amount of the subordinated notes were amended, and the maturity date was extended to March 1, 2010. Interest on the subordinated notes originally accrued at 13.5% per annum with interest payable semi-annually at a rate of 12% per annum with the remaining 1.5% interest per annum added to the outstanding principal amount of the subordinated notes. The 1.5% interest rate increased to 2.5% per annum on December 15, 2003 when the subordinated notes were not repurchased by that date, and the increased rate was applied retroactively to August 25, 2003.

The credit facility and subordinated notes have certain financial tests which must be met on a quarterly basis, including maximum total senior debt and total debt to quarterly annualized net operating income, minimum interest coverage ratio, minimum fixed charge coverage ratio and an annual capital expenditure limit. Indebtedness under the credit facility is secured by all of the assets of the Company. As of March 31, 2005, the Company was in compliance with all required financial tests.

On August 18, 2003, the Company entered into an agreement with the Hull Family Limited Partnership (the "Partnership") and Mr. James R. Hull, the Company's president and chief executive officer, as amended on September 23, 2004, that allowed for the put of \$500,000 in value of Class A common stock to the Company in each fiscal year beginning in fiscal 2005 and ending June 30, 2009. On November 22, 2004, the first of five option exercises was completed when the Partnership sold the Company \$500,000 worth of Class A common stock. The fair value of the remaining investor put option was \$0.3 million at March 31, 2005. See Note 3 (Related Party Transactions) to these financial statements.

Scheduled maturities (as defined) of long-term debt at March 31, 2005, utilizing the required payment schedule of the Senior Subordinated Notes, subordinated notes, credit facility and the fair value of the put option are as follows for fiscal years below (in thousands):

2005	438
2006	1,830
2007	7,080
2008	18,017
2009	74,755
Thereafter	305,452
	<u>\$407,572</u>

3. Related Party Transactions

Concurrent with the Senior Subordinated Notes offering, the Company entered into an agreement with James R. Hull, the Company's president and chief executive officer, pursuant to which the Company paid Mr. Hull a \$2 million transaction fee in cash at the closing of the refinancing on August 25, 2003. This fee was capitalized as deferred financing costs. On November 7, 2003, the Hull Family Limited Partnership (the "Partnership") exercised its right to require the Company to purchase 400,000 shares of Class A common stock at a purchase price of \$1 million in cash. Based on the fair value of the Company's stock, no expense was recorded related to the repurchase of the Partnership's shares. The agreement also gives the Partnership and Mr. Hull a written investor put option to sell up to a combined total of \$500,000 in value of its Class A common stock to the Company in each of the subsequent five fiscal years at purchase prices per share that are based on a multiple of the Company's consolidated

Monitronics International, Inc.
Notes to Financial Statements (continued)
(Unaudited)

cash flow. Based on the fair value of the Company's stock at the time of the agreement, the Company recorded no liability in connection with this agreement. The written investor put option was amended on September 23, 2004, resulting in the Company recording a liability and related sales, general and administrative ("SG&A") expense of \$0.5 million based on the fair value of the written put option at September 30, 2004. On November 22, 2004, the first of five option exercises was completed when the Partnership sold the Company 57,549 shares of Class A common stock for \$500,000. As of March 31, 2005, the outstanding liability for the put option was \$0.3 million. The Company will prospectively adjust its liability and related SG&A expense as the fair value of the put option changes.

The Company paid an advisory fee of \$2.7 million to ABRY Partners, LLC, an affiliate of ABRY Capital Partners, L.P., in connection with the August 2003 refinancing. This fee was capitalized as deferred financing costs. An affiliate of ABRY Capital Partners, L.P. purchased a portion of the Senior Subordinated Notes offered in the refinancing transaction.

4. Stock Warrants, Restricted Stock and Stock Options

During the nine months ended March 31, 2005, the Company repurchased 180 unvested restricted shares. On November 24, 2004, the Company granted 161,640 stock options to employees, of which 87,128 vested on the date of grant, 68,512 will vest ratably over four years from the date of grant, and 6,000 will vest ratably over three years from the date of grant. On March 28, 2005, the Company adopted the 2005 Stock Option Plan (the "Plan") and reserved 1,350,000 shares of Class A common stock for issuance under the Plan. On March 30, 2005, the Company granted 564,663 stock options to employees and officers, of which 231,358 vested on the date of grant, 281,171 will vest ratably over four years from the date of grant, and 52,134 will vest ratably over two years from the date of grant.

5. Recapitalization

The Company has historically financed a portion of its operations through issuances of preferred stock. As a result of these equity issuances, the Company's capital structure included outstanding shares of Series A, Series B, Series C, Series C-1 and Series D-1 preferred stock and warrants to purchase the Company's Class A common stock held by four investor groups. Beginning in May 2003, the Company's preferred shareholders began discussions amongst themselves to implement a restructuring of the Company's equity that would reallocate their share ownership and voting interests based on the accrued liquidation preference of their investments. Each of Austin Ventures III-A, L.P., Austin Ventures III-B, L.P., Austin Ventures V, L.P. and Austin Ventures V Affiliates Fund, L.P. (collectively, the "Austin Ventures entities"), who were the Company's initial equity investors, also sought to exchange their voting control position and the right to designate a majority of the members of the Company's board of directors for priority liquidation rights structured to provide them with an opportunity for the return of their investment beginning June 30, 2008. In addition, each of Windward Capital Partners II, L.P. and Windward Capital LP II, LLC (collectively, the "Windward entities") desired to liquidate their investment through the sale of their shares of Series C and Series C-1 preferred stock to a third party or a redemption of these shares, both of which alternatives required the consent of the Company's other preferred shareholders under the terms of existing shareholder agreements.

On July 14, 2004, the Company completed a series of transactions which it refers to as the "recapitalization." In the recapitalization, the Company redeemed approximately \$5.6 million of the Series C and C-1 preferred stock held by the Windward entities and then issued shares of a new Series A preferred or Class A common stock to its preferred shareholders in exchange for all of their preferred stock, Class A common stock and warrants to purchase Class A common stock. The preferred shareholders determined the number of shares to be received in the exchange based on the liquidation preference of, and accrued but unpaid dividends on, the existing preferred shares as of July 14, 2004 for the shares held by the Windward entities and as of June 30, 2003 for the remaining preferred shares. The Company's preferred shareholders agreed to value the Class A common stock and new Series A preferred stock received in the exchange at \$6.00 per share. The valuation was based on a negotiation amongst the Company's preferred shareholders and the agreement of New York Life Capital Partners II, L.P. and PPM America Private Equity Fund L.P. to subsequently purchase the shares of Class A common stock received by the Windward entities in the exchange for \$6.00 per share. No independent third party valuations or appraisal opinions were obtained by

Monitronics International, Inc.
Notes to Financial Statements (continued)
(Unaudited)

the preferred shareholders or board of directors during the negotiation process. The Company's lenders and preferred shareholders consented to the recapitalization as required under the terms of the Company's applicable agreements.

The Company's preferred shareholders also negotiated the terms of the new Series A preferred stock issued to the Austin Ventures entities. The Company's board of directors and the holders of at least two-thirds of the outstanding shares of Class A common stock, Series A preferred stock, Series B preferred stock, Series C preferred stock, Series C-1 preferred stock and Series D-1 preferred stock, each voting as a separate class as required by the Company's articles of incorporation, approved the amendment and restatement of the Company's articles of incorporation to create the new Series A preferred stock. The new Series A preferred stock initially does not accrue dividends, votes with the Class A common stock as a single class and is convertible into an equal number of shares of Class A common stock at the holder's option. Prior to a dividend election, as described below, the new Series A preferred stock automatically converts into Class A common stock upon an initial public offering, a sale or liquidation of the Company, the expiration of the last date on which the holders may make a dividend election or at the option of the holders. The holders of the new Series A preferred stock may elect for shares to begin accruing dividends only during the 30-day periods following the determination of annualized EBITDA for the Company's quarterly periods ending June 30, 2005, December 31, 2006 and June 30, 2008 or in the event of covenant or leverage defaults.

If the holders of the new Series A preferred stock make a dividend election, dividends will initially accrue on such shares at 8% per annum and will increase at a rate of 2% per annum on each anniversary of the dividend election up to 16% per annum. The dividend rate may increase up to 24% per annum following covenant or leverage defaults. Following a dividend election, the new Series A preferred stock will become non-voting and will no longer be convertible into Class A common stock. However, the new Series A preferred stock will become subject to mandatory redemption following a dividend election. If the Company fails to redeem the shares on the later of June 30, 2008 or 30 days after such date if the dividend election is made for the quarterly period ending June 30, 2008, the maximum dividend rate will increase from 16% to 24%. If the Company fails to redeem the new Series A preferred stock on or prior to June 30, 2009 following a dividend election, the holders of the new Series A preferred stock may initiate the sale or liquidation of the Company. The aggregate liquidation preference of the new Series A preferred stock is the amount that would be paid to holders of Class A common stock (assuming conversion of the new Series A preferred stock) out of liquidation proceeds equal to an initial multiple of 5.5 times annualized EBITDA less outstanding debt and accrued dividends on the new Series A preferred stock. The EBITDA multiple will be adjusted following any covenant or leverage defaults. The Company may also redeem these shares at its option at any time after a dividend election.

The Company financed the total \$6.8 million cost of the recapitalization, including the \$5.6 million redemption payment and approximately \$1.2 million of fees and costs, with borrowings under its credit facility. The preferred stock and accrued but unpaid dividends redeemed by the Company was retired. The new Series A preferred stock was recorded as preferred stock at its issuance cost at the date of the recapitalization. The Company issued 28,429,907 shares of Class A common stock and recorded the Class A common at the liquidation preference of the exchanged preferred stock plus the accrued and unpaid dividends as of July 14, 2004 for the shares held by the Windward entities and as of June 30, 2003 for the remaining preferred shares. Conversely, the Company canceled a total of 750,136 shares of Class A common stock in connection with the recapitalization transaction which included 33,344 shares owned by Austin Ventures III-A, L.P., 28,167 shares owned by Austin Ventures III-B, L.P. and 688,625 shares owned by Capital Resource Lenders II, L.P.

6. Commitments and Contingencies

The Company is subject to various legal proceedings and claims that arise in the ordinary course of its business. In the opinion of management, the amount of ultimate liability with respect to these actions will not have a material impact on the financial position or results of operations of the Company.

[Table of Contents](#)

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

We are a leading national provider of security alarm monitoring services. The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our financial statements, and the related notes to those financial statements, included in Part I - Item 1 of this Quarterly Report on Form 10-Q.

Forward-Looking Statements

Certain statements contained or incorporated by reference in this Quarterly Report on Form 10-Q including, without limitation, statements containing the words "may," "will," "expect," "intend," "estimate," "anticipate," "plan," "foresee," "believe" or "continue" or the negatives of these terms or variations of them or similar terminology, are forward-looking statements within the meaning of the federal securities laws. Such forward-looking statements involve known and unknown risks, uncertainties and other matters which may cause actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Factors, risks and uncertainties that could cause actual outcomes and results to be materially different from those projected include, among others, the following:

- our high degree of leverage;
- our anticipated growth strategies;
- anticipated trends and conditions in our business, including trends in the market;
- our ability to acquire and integrate additional accounts;
- our expected rate of subscriber attrition;
- our ability to continue to control costs and maintain quality;
- our ability to compete;
- the impact of "false alarm" ordinances on our results of operations;
- the expectation that we will realize the benefit of our deferred tax assets; and
- our ability to obtain additional funds to grow our business.

We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They can be affected by inaccurate assumptions we might make or by known or unknown risks, uncertainties and assumptions. Reference is hereby made to the disclosures contained under the heading "Risk Factors" in "Part 1 - Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" of the Company's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on December 17, 2004. In light of these risks, uncertainties and assumptions, the forward-looking statements may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. When you consider these forward-looking statements, you should keep in mind these risk factors and other cautionary statements.

Our forward-looking statements speak only as of the date made. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless the securities laws require us to do so.

Overview

Nearly all of our revenues are derived from monthly recurring revenues under security alarm monitoring contracts purchased from independent dealers in our exclusive nationwide network. Our alarm monitoring contracts generally have a non-cancelable initial term of three years, generally allow for periodic price increases and provide

Table of Contents

for automatic renewals during which the subscriber may cancel the contract upon 30 days' proper written notice. Revenues are recognized as the related monitoring services are provided. Other revenues are derived primarily from the provision of third-party contract monitoring services and from field technical repair services.

Cost of services primarily consists of direct labor associated with monitoring and servicing subscriber accounts and expenses related to field technical repair services. Sales, general and administrative expenses primarily include the cost of personnel conducting sales and administrative activities and other costs related to sales, administration and operations. All direct external costs associated with the purchase of subscriber accounts are capitalized and amortized over ten years using a 135% declining balance method. Internal costs, including all personnel and related support costs incurred solely in connection with subscriber account acquisitions and transitions, are expensed as incurred.

Attrition

We purchase subscriber contracts from our exclusive network of independent dealers. These contracts with our subscribers are typically three-year non-cancelable contracts with automatic renewal provisions during which the subscriber may cancel the contract upon 30 days' proper written notice. A portion of our subscriber base can be expected to cancel its service every year. Subscribers may choose not to renew or terminate their contract for a variety of reasons, including relocation, cost, switching to our competitors' service and service issues. A majority of canceled accounts result from subscriber relocation or the inability to contact the subscriber.

Account cancellation, otherwise referred to as subscriber attrition, has a direct impact on the number of subscribers we serve and hence our financial results, including revenues, operating income and cash flow. We define our attrition rate as the number of canceled accounts in a given period divided by the average of the beginning and ending balance of subscribers for that period. We consider an account canceled when a subscriber terminates in accordance with the terms of the contract or if payment from the subscriber is deemed uncollectible. If a subscriber relocates but continues his service, this is not a cancellation. If the subscriber relocates and discontinues his service and a new subscriber takes over the service continuing the revenue stream, this is a cancellation and a new owner takeover. We adjust the number of canceled accounts by excluding those that are contractually guaranteed by our dealers. Our typical dealer contract provides that if a subscriber cancels in the first year of its contract, the dealer must replace the lost monthly revenue attributable to the canceled contract and either replace the canceled account with a new one or refund our purchase price. To help ensure the dealer's obligation to us, we typically hold back approximately 10% of the purchase price for every account we purchase. In some cases, the amount of the purchase holdback may be less than actual attrition experience. In recent years, a substantial portion of the accounts that canceled within this initial 12-month period were replaced by the dealers at no additional cost to us.

The table below presents subscriber data for the twelve months ended March 31, 2005 and 2004:

	Twelve Months Ended March 31,	
	2005	2004
Beginning balance of accounts	425,291	372,715
Accounts purchased	83,911	100,425
Accounts canceled ⁽¹⁾	(58,150)	(45,535)
Accounts guaranteed to be refunded from holdback	(1,924)	(2,314)
Ending balance of accounts	449,128	425,291
Attrition rate	13.3%	11.4%

(1) Net of canceled accounts that are contractually guaranteed by the dealer and new owner takeovers.

Our trailing twelve-month attrition rose to 13.3% for the period ended March 31, 2005 from 11.4% for the period ended March 31, 2004. This increase primarily reflects a slight change in policy we adopted in June 2004 to permit subscribers in their annual renewal period to cancel with proper 30-days written notice. This change resulted in the cancellation of a small number of accounts ahead of schedule. This change in policy was made as a result of our comparing the small amount of revenue lost to the level of customer dissatisfaction created when a one-year renewal is enforced and deciding that customer satisfaction is the much greater influence on the level of our future business. The primary three-year term of the contract remains non-cancelable.

Table of Contents

We also analyze our attrition by classifying our accounts into annual pools based on the year of purchase. We then track the number of accounts that cancel as a percentage of the initial number of accounts purchased for each pool for each year subsequent to its purchase. Based on the average cancellation rate across our pools, we achieve nearly 0% attrition in the first year net of canceled accounts that are contractually guaranteed by the dealers. In the next three years, the number of subscribers that cancel as a percentage of the initial number of subscribers in that pool gradually increases and historically has peaked between the third and fourth years. The peak between the third and fourth years is primarily a result of the buildup of subscribers that moved or no longer had need for the service prior to the third year but did not cancel their service until the end of their three-year contract. After the fourth year, the number of subscribers that cancel as a percentage of the initial number of subscribers in that pool declines. As a result, we believe our attrition rate decreases as the age of our accounts increase. Our pool analysis also indicates that, on average, over 30% of each pool remains by the end of the tenth year.

Results of Operations

Three Months Ended March 31, 2005 Compared to Three Months Ended March 31, 2004

Revenues. Total revenues increased \$3.6 million, or 10%, to \$41.5 million in the three months ended March 31, 2005 from \$37.9 million in the three months ended March 31, 2004. This increase was primarily attributable to an increase in the number of subscriber accounts to 449,128 as of March 31, 2005 from 425,291 as of March 31, 2004 and a small net increase in average revenue per customer.

Cost of services. Cost of services was \$4.7 million for the three months ended March 31, 2005 which was an increase of \$0.4 million from \$4.3 million for the three months ended March 31, 2004. As a percentage of revenues, cost of services was 11% for both the three months ended March 31, 2005 and the three months ended March 31, 2004.

Sales, general and administrative ("SG&A"). SG&A was \$8.0 million for the three months ended March 31, 2005 which was an increase of \$1.7 million from \$6.3 million for the three months ended March 31, 2004. As a percentage of revenues, SG&A was 19% for the three months ended March 31, 2005 and 17% for the three months ended March 31, 2004. The increase in SG&A as a percentage of revenues was principally due to increased professional fees primarily related to ongoing legal matters, increased rent expense resulting from our additional office lease agreement dated May 3, 2004, and the immediate recognition of expense related to vacated leased office space.

Amortization. Amortization of intangibles increased \$2.3 million, or 13%, to \$19.9 million in the three months ended March 31, 2005 from \$17.6 million in the three months ended March 31, 2004. The increase was attributable to growth in our purchased subscriber accounts through our authorized dealer program.

Interest expense. Interest expense increased \$1.2 million, or 14%, to \$10.2 million in the three months ended March 31, 2005 from \$9.0 million in the three months ended March 31, 2004. The increase resulted from higher borrowing under our revolving line of credit throughout the quarter incurred to fund our purchase of subscriber accounts and increases in variable interest rates. Our average interest rate increased to 10.2% in the three months ended March 31, 2005 from 9.5% in the three months ended March 31, 2004 as a result of higher average interest rates on our credit facility. As we continue to acquire subscriber accounts with proceeds from our revolving line of credit, our average interest rate will decline based on current interest rates under that line of credit.

Net income (loss). Net income decreased \$1.4 million to a loss of \$1.3 million in the three months ended March 31, 2005 compared to net income of \$0.1 million in the three months ended March 31, 2004 primarily due to lower operating income and higher interest expense.

Nine Months Ended March 31, 2005 Compared to Nine Months Ended March 31, 2004

Revenues. Total revenues increased \$12.2 million, or 11%, to \$123.4 million in the nine months ended March 31, 2005 from \$111.2 million in the nine months ended March 31, 2004. This increase was primarily attributable to an increase in the number of subscriber accounts to 449,128 as of March 31, 2005 from 425,291 as of March 31, 2004 and a small net increase in average revenue per customer.

Table of Contents

Cost of services. Cost of services was \$14.2 million for the nine months ended March 31, 2005 which was an increase of \$2.0 million from \$12.2 million in the nine months ended March 31, 2004. As a percentage of revenues, cost of services was 11% for both the nine months ended March 31, 2005 and the nine months ended March 31, 2004.

Sales, general and administrative. SG&A was \$23.0 million for the nine months ended March 31, 2005 which was an increase of \$3.8 million from \$19.2 million for the nine months ended March 31, 2004. As a percentage of revenues, SG&A was 19% for the nine months ended March 31, 2005 and 17% for the nine months ended March 31, 2004. During the nine months ended March 31, 2005, \$0.5 million of expenses was recorded to reflect the fair value of the Hull Family Limited Partnership's written investor put option described in Note 3 (Related Party Transactions) to the financial statements included in Part I - Item 1 of this Form 10-Q. Other increases in SG&A during the nine months ended March 31, 2005 were principally due to increased professional fees primarily related to ongoing legal matters, increased rent expense resulting from our additional office lease agreement dated May 3, 2004, and the immediate recognition of expense related to vacating other leased office space.

Amortization. Amortization of intangibles increased \$7.0 million, or 14%, to \$58.2 million in the nine months ended March 31, 2005 from \$51.2 million in the nine months ended March 31, 2004. The increase was attributable to growth in our purchased subscriber accounts through our authorized dealer program.

Interest expense. Interest expense increased \$4.8 million, or 19%, to \$30.4 million in the nine months ended March 31, 2005 from \$25.6 million in the nine months ended March 31, 2004. The increase resulted from higher overall average interest rates resulting from the issuance of \$160.0 million of our 11.75% senior subordinated notes on August 25, 2003, the restructuring of our credit facility on August 25, 2003, and an increase in variable interest rates during the nine months ended March 31, 2005. Our average interest rate increased to 10.1% in the nine months ended March 31, 2005 from 9.2% in the nine months ended March 31, 2004. Interest expense also increased as a result of the increase in our average long-term debt outstanding throughout the nine months incurred to fund our purchase of subscriber accounts. As we continue to acquire subscriber accounts with proceeds from our revolving line of credit, our average overall interest rate is expected to decline based on current interest rates under our line of credit.

Loss on debt refinancing. For the nine months ended March 31, 2004, we incurred a loss on debt refinancing of \$8.8 million related to our refinancing completed August 25, 2003. This loss included a \$5.9 million write-off of deferred financing costs related to our prior credit facility and \$2.9 million of prepayment penalties associated with the retirement of a portion of our 14.5% subordinated notes due March 1, 2010.

Net income (loss). Net loss decreased \$2.1 million to a loss of \$2.7 million in the nine months ended March 31, 2005 from a loss of \$4.8 million in the nine months ended March 31, 2004. The smaller loss was primarily due to last year's results which included \$8.8 million in expenses incurred in connection with our August 2003 refinancing. In connection with our refinancing, we wrote off \$5.9 million of deferred financing costs and incurred prepayment penalties of \$2.9 million (see "Loss on debt refinancing" above).

Liquidity and Capital Resources

General. Our operating strategy requires the availability of significant funds to finance growth through subscriber account purchases. Additional cash requirements include debt service and capital expenditures. We have financed our growth from a combination of long-term borrowings, issuance of preferred stock and cash flows provided by operations.

Major components of our working capital include accounts receivable, deferred revenue, purchase holdbacks and accrued interest payable. We expect to experience negative working capital in the future primarily due to accrued interest payable and purchase holdbacks. Purchase holdbacks are dependent on the number of subscriber accounts we purchase and the percentage of the purchase price we withhold to ensure a dealer's obligation during the guarantee period. Accrued interest payable is dependent on the level of our debt and the timing of interest payments.

Table of Contents

As of March 31, 2005 and June 30, 2004, we had working capital deficits of \$1.6 million and \$7.5 million, respectively. The \$5.9 million improvement in our working capital was primarily due to a \$4.0 million reduction in interest payable and a \$2.9 million decrease in purchase holdback. Interest payable decreased to \$3.2 million as of March 31, 2005 compared to \$7.2 million as of June 30, 2004. The decrease in interest payable was primarily due to the semi-annual payment, on March 1, 2005, of accrued interest related to the issuance of \$160 million of senior subordinated notes on August 25, 2003. Purchase holdbacks decreased to \$7.5 million as of March 31, 2005 from \$10.4 million as of June 30, 2004 primarily due to lower volume in our accounts purchased and some return of holdback ahead of schedule.

Net cash provided by operating activities for the nine months ended March 31, 2005 was \$55.4 million, as compared to \$58.4 million for the nine months ended March 31, 2004. The decrease in cash provided by operating activities for the nine months ended March 31, 2005 was primarily due to changes in the timing of interest payments resulting from the issuance of our \$160 million of senior subordinated notes on August 25, 2003.

Net cash used in investing activities for the nine months ended March 31, 2005 was \$73.4 million, compared to \$82.9 million for the nine months ended March 31, 2004 primarily because of purchasing fewer accounts during the period. For the nine months ended March 31, 2005, capital expenditures were \$3.0 million versus \$1.0 million for the nine months ended March 31, 2004. Capital expenditures were primarily for our central monitoring station equipment, telephone systems, computer systems and leasehold improvements for our offices. Capital expenditures are expected to vary based on the growth of our subscriber account base and improvements to our technology, operating and financial systems. Purchases of subscriber accounts consist of all direct external payments associated with the purchase of subscriber accounts. The portion of the purchase holdback paid to dealers at the end of the guarantee period is included in this amount when paid.

Our net cash provided by financing activities for the nine months ended March 31, 2005 was \$17.5 million, as compared to \$25.6 million for the nine months ended March 31, 2004.

As of March 31, 2005, we had \$226.1 million outstanding under our credit facility, bearing interest at a weighted average rate for the nine months ended March 31, 2005 of approximately 6.6% per annum, and we had approximately \$91.3 million in borrowing availability under our revolving credit line, of which \$28.5 million was immediately available as calculated under the covenants in our credit facility. In addition, we had \$181.2 million in principal amount outstanding of senior subordinated and subordinated notes as of March 31, 2005.

On March 28, 2005, we amended certain provisions of our credit facility dated August 25, 2003 that included elimination of mandatory reductions to the revolving credit facility, a 75 basis point reduction in the variable interest rate for our revolving credit line and term loan, and a 25 basis point reduction in commitment fees at our current borrowing level.

On July 14, 2004, we completed a recapitalization in which we redeemed approximately \$5.6 million of the Series C and Series C-1 preferred stock held by the Windward entities and then issued shares of a new Series A preferred stock or Class A common stock to our preferred shareholders in exchange for all their shares of preferred stock, Class A common stock and warrants to purchase Class A common stock. The Windward entities subsequently sold the shares of Class A common stock they received in the exchange to two new investors at \$6.00 per share. We financed the total \$6.8 million cost of the recapitalization, including the \$5.6 million redemption payment and approximately \$1.2 million of fees and expenses, with borrowings under our senior credit facility.

Prior to the recapitalization, we were obligated to accrue cumulative dividends on each series of our previously outstanding preferred stock at varying rates, but we were prohibited from paying these dividends under the terms of our credit facility and the indenture governing the senior subordinated notes if an event of default existed or would result from such payment. The recapitalization allowed us to restructure our accrued dividends by converting the accrued dividends into common and preferred stock. Our new Series A preferred stock issued in the recapitalization is not currently accruing dividends, and payment of any dividends after a dividend election will continue to be prohibited under the terms of our credit facility and the indenture if an event of default exists or would result from such payment. Accordingly, we do not expect to pay any dividends over the next one to three years.

On August 25, 2003, we issued \$160.0 million of senior subordinated notes at 11.75% with a maturity date of September 1, 2010. Interest payments are to be made semi-annually in cash in arrears on March 1 and September 1 of each year beginning on March 1, 2004. On December 16, 2004, we completed an exchange offer in which we

Table of Contents

exchanged new notes that were registered under the Securities Act of 1933 for the senior subordinated notes. In accordance with the registration rights agreement associated with these notes, we incurred special interest on the senior subordinated notes in the amount of \$470,000 in connection with the exchange offer.

Further on August 25, 2003, we entered into a new credit facility agreement with Fleet National Bank (“Fleet”) as administrative agent, Bank of America, N.A. as syndication agent, and a syndicate of lenders, including Fleet and Bank of America, N.A., as amended on July 14, 2004. Our credit facility is comprised of a \$175.0 million term loan that matures in fiscal 2010 and a \$145.0 million revolving credit facility that matures in fiscal 2009. Payments under the term loan are payable in quarterly installments from December 31, 2003 through June 30, 2009. The quarterly payment is calculated based upon the amount of the original facility multiplied by 0.25% for the quarters ended December 31, 2003 through September 30, 2006, 1.25% for the quarters ended December 31, 2006 through September 30, 2007 and 3.00% for the quarters ended December 31, 2007 through June 30, 2009 with the remaining balance due at maturity. We used the borrowings under this credit facility together with the proceeds of the senior subordinated notes offering primarily to repay our prior credit facility, to repay all of our \$12 million 12% senior subordinated notes due June 30, 2007, and to repurchase \$20.5 million principal amount of our 14.5% subordinated notes due March 1, 2010 at a repurchase price of approximately \$23.2 million. As a result of the repayments, we expensed our previously capitalized deferred financing costs totaling \$5.9 million and recognized a pre-tax loss of \$2.9 million in the repurchase of the subordinated notes. In connection with our August 2003 refinancing, we amended the terms of our subordinated notes to extend the maturity date of the then remaining \$20.5 million principal amount from January 18, 2009 to March 1, 2010. Prior to the amendment, interest accrued on the subordinated notes at 13.5% per annum with interest payable semi-annually in cash at a rate of 12% per annum with the remaining 1.5% interest per annum added to the outstanding principal amount of the subordinated notes. The 1.5% per annum interest rate increased to 2.5% per annum on December 15, 2003 and the increased rate applies retroactively to August 25, 2003.

We will require substantial cash flow to fully implement our business strategy and meet our principal and interest obligations with respect to the senior subordinated notes and our other indebtedness. We anticipate that cash flow generated from operations and borrowings under our current credit facility will provide sufficient liquidity to fund these requirements for the foreseeable future. Following the August 2003 refinancing, we continue to have significant borrowing capacity under our current credit facility. This increased capacity coupled with anticipated cash flow from operations is expected to meet and satisfy our short-term obligations.

We further preserve our borrowing capacity by following a cash management practice of maintaining as low as possible ongoing cash balance. However, our ability to meet our debt service and other obligations depends on our future performance, which in turn is subject to general economic conditions and other factors, certain of which are beyond our control. If we are unable to generate sufficient cash flow from operations or otherwise to comply with the terms of the indenture governing the senior subordinated notes or our other debt instruments, we may be required to refinance all or a portion of our existing debt or obtain additional financing. Further, the agreements or indentures governing our new credit facility, our senior subordinated notes and subordinated notes contain financial tests relating to capital expenditure limits, maximum total debt to annualized quarterly EBITDA, maximum total senior debt to annualized quarterly EBITDA, interest coverage and fixed charge coverage that may impact our ability to refinance all or a portion of our existing debt or obtain additional financing. As of March 31, 2005, we were in compliance with all required financial tests.

Critical Accounting Policies

Our discussion and analysis of results of operations and financial condition are based upon our financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The preparation of financial statements in accordance with GAAP requires management to use judgment in making estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and disclosure of contingent assets and liabilities. We base our estimates and assumptions on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. These estimates and assumptions are evaluated on an ongoing basis. Due to the nature of certain assets and liabilities, there are uncertainties associated with some of the judgments, assumptions and estimates which are required to be made. Reported results could have been materially different under a different set of assumptions and estimates for certain accounting principle applications.

Table of Contents

Income Taxes and Deferred Tax Assets. As part of preparing our financial statements, significant management judgment is required in determining our provision for income taxes and our deferred tax assets and liabilities. This process involves us estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, especially the amortization of subscriber accounts, which are amortized using a 10-year 135% declining balance method for financial reporting purposes and are amortized using a 10-year straight-line method for tax purposes. These differences have resulted in deferred tax assets totaling \$15.0 million at March 31, 2005.

Since there is no absolute assurance that these assets will be ultimately realized, management periodically reviews our deferred tax position to determine if it is more likely than not that such assets will be realized. Such periodic reviews include, among other things, the expected timing when certain assets will be realized and our expected future earnings. If, after conducting such a review, management determines that the realization of the tax asset does not meet the “more-likely-than-not” criteria, an offsetting valuation allowance is recorded, thereby reducing net earnings and the deferred tax asset in that period. No valuation allowance has been established because of the expectation that it is more likely than not that these deferred tax assets will be realized.

Goodwill. As of March 31, 2005 we had goodwill of \$14.8 million, which represents 2.9% of our total assets. We test goodwill annually for impairment and record an impairment charge if the carrying amount exceeds the fair value. We use a discounted cash flow approach as well as other methods to determine the fair value used in our test for impairment of goodwill. The results of this methodology depend upon a number of estimates and assumptions relating to cash flows, discount rates and other matters. Accordingly, such testing is subject to certain uncertainties, which could cause the fair value of goodwill to fluctuate from period to period.

Recent Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), “Share-Based Payment” (“SFAS 123(R)”), which is a revision of SFAS 123. SFAS 123(R) supercedes APB 25, and amends FASB Statement No. 95, “Statement of Cash flows.” Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure will no longer be an alternative. SFAS 123(R) is effective no later than the beginning of the first fiscal year beginning after December 15, 2005. We expect to adopt SFAS 123(R) on July 1, 2006. The adoption of SFAS 123(R)’s fair value method may have a significant impact on our result of operations, although it will have no impact on our overall financial position. We are currently assessing implementation of the “modified prospective” method as defined by SFAS 123(R).

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150, “Accounting For Certain Financial Instruments with Characteristics of both Liabilities and Equity” (“SFAS 150”). SFAS 150 established standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first fiscal period beginning after December 15, 2003 and must be applied prospectively by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS 150 and still existing at the beginning of the interim period of adoption which was July 1, 2004. The initial adoption of SFAS 150 had no material impact on the financial statements. However, a subsequent amendment related to an investor put option resulted in us recording a \$0.5 million liability and related expense to adjust the put option to fair value as described in Note 3 (Related Party Transactions) to the financial statements included in Part I – Item 1 of this Form 10-Q.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements, as defined in Regulation S-K Item 303(a)(4)(ii)(A)-(D), that have or are reasonably likely to have a current or future effect on the Company’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We have interest rate risk, in that borrowings under our credit facility are based on variable market interest rates. As of March 31, 2005, we had \$226.1 million of variable rate debt outstanding under our credit facility.

Table of Contents

Presently, the revolving credit line bears interest at a rate of prime plus 2.25% or LIBOR plus 3.25%, with the term loan at a rate of prime plus 2.75% or LIBOR plus 3.75%. To control our exposure to interest rates under our facility, we utilize interest rate caps as required by our credit facility. As of March 31, 2005, these interest rate caps provided that the interest rate on approximately \$70 million of borrowings under our credit facility cannot exceed an interest rate of 10%. A hypothetical 10% increase in our credit facility's weighted average interest rate of 6.6% per annum for the nine months ended March 31, 2005 would correspondingly decrease our earnings and operating cash flows by approximately \$1.1 million.

Our privately issued \$21.2 million subordinated notes due March 1, 2010 have a fixed interest rate of 14.5%, but have exposure to changes in the debt's fair value. In connection with our August 2003 refinancing, we amended the terms of these subordinated notes to extend the maturity date from January 18, 2009 to March 1, 2010 and to increase the interest rate from 13.5% per annum to 14.5% per annum. In addition, we issued \$160.0 million aggregate principal amount of our senior subordinated notes due September 1, 2010 with a fixed interest rate of 11.75%, which has exposure to changes in the debt's fair value.

Item 4. Controls and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. We evaluated the effectiveness of the design and operation of our disclosure controls and procedures as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e) under supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, as of the end of the period covered by this Quarterly Report on Form 10-Q our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 are effective in timely alerting them to material information required to be included in our periodic Securities and Exchange Commission filings. No significant changes were made to our internal controls over financial reporting or in other factors that have materially affected or are reasonably likely to materially affect these controls during our most recent fiscal quarter. The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events.

PART II . OTHER INFORMATION

Item 1. Legal Proceedings

The Company is subject to various legal proceedings and claims that arise in the ordinary course of its business. In the opinion of management, the amount of ultimate liability with respect to these actions will not have a material impact on the financial position or results of operations of the Company.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Table of Contents

Item 6. Exhibits

- 2.1 Recapitalization Agreement, dated July 14, 2004, among Monitronics International, Inc., Austin Ventures III-A, L.P., Austin Ventures III-B, L.P., Austin Ventures V, L.P., Austin Ventures V Affiliates Fund, Capital Resource Lenders II, L.P., ABRY Partners IV, L.P., ABRY Investment Partnership, L.P., Windward Capital Partners II, L.P., Windward Capital LP II, LLC, New York Life Capital Partners II, L.P., PPM America Private Equity Fund LP and The Northwestern Mutual Life Insurance Company. (previously filed as Exhibit 2.1 to Amendment No. 3 to the registrant's Registration Statement on Form S-4 (File No. 333-110025) and incorporated herein by reference)
- 3.1 Restated Articles of Incorporation of Monitronics International, Inc. (previously filed as Exhibit 3.1 to Amendment No. 3 to the registrant's Registration Statement on Form S-4 (File No. 333-110025) and incorporated herein by reference)
- 3.2 Bylaws of Monitronics International, Inc. (previously filed as Exhibit 3.2 to the registrant's Registration Statement on Form S-4 (File No. 333-110025) and incorporated herein by reference)
- 4.1 Form of Global Note for the 11^{3/4}% Senior Subordinated Notes due 2010 of Monitronics International, Inc. (contained as an exhibit to Exhibit 4.2 hereto)
- 4.2 Indenture, dated as of August 25, 2003, by and between Monitronics International, Inc. and The Bank of New York Trust Company of Florida, N.A. with respect to the 11^{3/4}% Senior Subordinated Notes due 2010 (previously filed as Exhibit 4.2 to the registrant's Registration Statement on Form S-4 (File No. 333-110025) and incorporated herein by reference)
- 10.1 Second Amendment to Agreement, dated September 23, 2004, by and between James R. Hull and Monitronics International, Inc. (previously filed as Exhibit 10.1 to the registrant's Form 10-Q dated February 8, 2005 (File No. 333-110025) and incorporated herein by reference)
- 10.2 First Amendment of Lease, dated January 14, 2005, by and between Monitronics International, Inc. and AGF Valley View II, Ltd. (previously filed as Exhibit 10.2 to the registrant's Form 10-Q dated February 8, 2005 (File No. 333-110025) and incorporated herein by reference)
- 10.3 2005 Stock Option Plan of Monitronics International, Inc. (previously filed as Exhibit 10.1 to the registrant's Form 8-K dated April 1, 2005 (File No. 333-110025) and incorporated herein by reference)
- 10.4 Form of Officer and Employee Award with Change of Control Provision (previously filed as Exhibit 10.2 to the registrant's Form 8-K dated April 1, 2005 (File No. 333-110025) and incorporated herein by reference)
- 10.5 Form of Officer and Employee Award with No Change of Control Provision (previously filed as Exhibit 10.3 to the registrant's Form 8-K dated April 1, 2005 (File No. 333-110025) and incorporated herein by reference)
- 10.6 Second Amendment to Credit Agreement, dated as of March 28, 2005, by and among Monitronics International, Inc., the lenders (named therein), Fleet National Bank, as administrative agent for each of the other credit parties thereto, and Bank of America, N.A., as syndication agent for each of the other credit parties thereto (previously filed as Exhibit 10.4 to the registrants Form 8-K dated April 1, 2005 (File No. 333-110025) and incorporated herein by reference)
- 31.1* Certification of the Chief Executive Officer of Monitronics International, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Table of Contents

- 31.2* Certification of the Chief Financial Officer of Monitronics International, Inc. pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1** Certification of the Chief Executive Officer of Monitronics International, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2** Certification of the Chief Financial Officer of Monitronics International, Inc. pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith.

** Furnished herewith.

CERTIFICATIONS

I, James R. Hull, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Monitronics International, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 12, 2005

/s/ James R. Hull

James R. Hull
Chief Executive Officer and President

CERTIFICATIONS

I, Michael R. Meyers, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Monitronics International, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 12, 2005

/s/ Michael R. Meyers

Michael R. Meyers
Chief Financial Officer and Vice President

