

Healthcare Services Group (HCSG) 3Q18 Update

For the fourth quarter in a row, HSCG missed on both EPS and revenues. Keep in mind, people own this company because it is supposed to be a growth story based on more people moving into senior living facilities. It trades for over 28x EPS. If we back the income tax cut out, there is no growth here at all:

	<u>3Q18</u>	<u>2Q18</u>
YY Op. Inc Growth	-1.7%	1.4%
YY pretax Inc. Growth	0.0%	0.7%
YY Net Income Growth	11.1%	14.5%

They will anniversary the tax cut soon so there better be some improvement in growth coming. Otherwise, a 2% yield and 28 P/E ratio are both obvious reasons that the stock is overpriced. Our July 19, 2018, May 17, 2018, and February 22, 2018 issues have more discussion on HCSG.

- There is no customer growth and HCSG is working against the reasons that customers sign up in the first place.
- HCSG is trying to push labor costs back onto customers to boost its own margins even though margins have been rising.
- Receivables continue to grow faster than sales many months after HCSG claimed to be cutting payment terms in half.
- HCSG blames lack of staff for the reason there is no growth in 2018, but that doesn't explain the last five years of missing growth and now a tight labor market should make additional employees more expensive.

What Growth?

This is not a new thing. We have talked for some time about how HCSG is already dealing with 95% of the senior housing industry that outsources its housekeeping operations. It had a surge of dietary customers (largely from existing housekeeping customers) in 2017. Other than that, HCSG does not grow.

	2Q18	2017	2016	2015	2014
Housekeeping Customers	3,500	3,500	3,500	3,500	3,500
Dietary Customers	1,500	1,500	1,000	1,000	900

Let's remember what HCSG offers to customers and why they should sign up:

1. The customers face rising costs from wages, insurance, and other operating costs. HCSG can cap costs related to housekeeping, laundry, and cafeteria operations.
2. HCSG offers a 2-month interest-free source of cash by converting those operations into an outsourced aspect of the business and slow paying HCSG.
3. They offer experienced management for these duties.

Focusing on the conference call, management talks often about trying to pick up 20bp of margin by tweaking customer contracts and other methods. The company makes 35-cents in EPS per quarter. Much of the margin gains they are aiming for add up to 1-cent in EPS or about 3% growth. That doesn't solve the problem and maintain the 28 P/E multiple. We think the much bigger growth problems are more obvious – no one is signing up, the customer base has its own margin squeeze, and the labor market is tighter.

HCSG wants to push labor costs back on customers as a way to grow its earnings

HCSG is working against every one of these selling points. It is adjusting relationships to push labor costs back onto the customers. This will result in lower revenues and HCSG gave guidance for negative \$10 million in revenue in this area. When asked on the 3Q18 call if this is a moving more of the labor costs back on the customers for margins or credit issues, Matthew McKee responded:

“I’d say it’s a bit of the former in the sense in line with those company priorities [to boost margins] that Ted outlined in his company remarks, we are prioritizing, putting the company in the best position possible as we close out the year and look to ’19. And part of that included taking a hard look at the housekeeping and laundry business.”

“But ultimately, in these scenarios (where a customer falls into the bottom 10% profitability), it typically took the form that you described in the sense that the first step is to give the payroll back to the customer.”

The funny part about this debate is HCSG’s housekeeping margin is actually rising:

	2Q18	2Q17	1Q18	1Q17	2017
HK Labor % Rev	78.2%	80.5%	78.4%	80.1%	80.1%
HK Supplies % Rev.	7.9%	8.1%	7.9%	8.0%	8.0%

As is normal for HCSG, they do not report full numbers in the 2-page press release and we will need to wait for the 3Q 10-Q to see 3Q results. But, this has been an area of rising margin for them and they are asking for price hikes or they will punt customers. As HCSG claims they will try to muscle clients – they ate a \$3 million tax settlement in the quarter for a dispute over an account. That has little to do with this full situation, but the fact that they have not seen growth in the Housekeeping area for years when they are handing out free credit is a good picture that HCSG does not have much power in these deals.

Receivables still exceed revenue growth and HCSG claims it is cutting payment terms – another reason to doubt it will see customer growth

We have pointed out the problems with extending credit to customers for several quarters and HCSG reserved \$37.1 million or 9% of receivables in 1Q18. Remember in 1Q, they did not write these receivables off. They took a reserve and pushed many of them into Long-Term Notes receivable. After boosting these reserves, HCSG touted that their DSOs magically improved, and their receivables aren’t excessive. Again, they do not report the size of the reserve in the 2-page press release, but does anyone think the gross receivables are going down here?

	3Q18	2Q18	1Q18	4Q17
Sales	\$506.9	\$503.7	\$501.8	\$499.4
Net A/R	\$353.5	\$343.7	\$335.0	\$378.7
Reserves	n/a	\$49.7	\$48.9	\$12.0
LT Notes Rec.	\$45.9	\$37.4	\$38.8	\$15.5
Total Gross A/R	n/a	\$430.8	\$422.7	\$406.2

The company noted that \$10 million of the increase was due to the quarter ending on a weekend and it was paid the next week. However, net receivables rose \$7.3 million in the second quarter on a sales bump of only \$1.9 million. Plus, the bad debt reserves rose again in the second quarter. Now, in 3Q, net receivables rose \$18.3 million on a sales gain of \$3.2 million. The excuse that receivables rose due to the weekend doesn't hold much weight as the sales would have accrued on the weekend too. We also note that the long-term receivables increased by \$8.5 million too and remember those are due over a period greater than 1-year. They convert standard receivables into long-term notes when customers run into cash problems and cannot pay their bills so those are lower quality credits to begin with and they are rising.

Let's match the receivables growth exceeding sales growth several quarters with the discussion on the conference call. That sounds exactly like 2Q18 when HCSG was cracking down on extended payment terms:

Ted Wahl from 3Q18:

“Strengthening customer payment terms and conditions, which includes increasing customer payment frequency from monthly to semi-monthly or semi-monthly to weekly payments, with the goal of collecting what we bill and having operating cash flows approximate net income and replenishing the management pipeline with the goal of being prepared for the next wave of growth in 2019 and beyond.”

Matthew McKee from 3Q18:

“Over the years, there was a migration to a monthly billing system and process rather than a weekly or biweekly. A couple years ago, we started the migration back for a couple reasons. One, and most importantly for us, it gives great visibility into the customer. Having four look-sees or two look-sees a month versus one at the end of the month provides us with a whole different level of visibility as well as a more constructive conversation if and when there's a shortfall.

From a customer perspective, it lines up better with either their own payroll cycle they had as well as their revenue stream, whether it be from the Medicare and

Medicaid or insurance programs they may be part of. So, it's win-win. That's the way we think about it. That's the way we've approached it. It's been positively received. Here we are two years into this focus, this strategy, which is a migration.

*It's a process, not an event, but **more than a third of our customers are now paying us on something other than an end of month payment.** We'll continue to have those conversations with our customers and where it makes sense for both of us, we'll have that change take place. But again, very well received and something we look forward to continuing into the future.”*

So, receivables are growing faster than sales for several quarters. At the same time, HCSG is cutting payment terms. The turn is 60-75 days depending on how you account for the huge bump in bad debt reserves. We should be seeing evidence of the 14-day terms if they cut the bulk of customers payment terms in half and that is not happening. **HCSG also noted that its customers continue to see declining occupancy rates. Running a senior living facility is a high fixed cost operation so lower occupancy hurts profitability.** HCSG continues to extend nearly a full quarter's sales in credit to these customers. If one-third of the customers are paying in under a month now, the rest must be stretching terms because the numbers clearly show receivables are growing faster than sales.

HCSG is blaming lack of staff to support growth

We would also argue that if you cut payment terms in half, customers will leave – or not sign up. Obviously, extending credit did not make more customers sign up. Either way, this should be a sizeable headwind. Yet, a company that has not increased customer totals in years, claims they have a huge backlog:

Ted Wahl:

***“The pipeline of customers is as great as it's ever been.** That is, of all of the priorities -- and growth is one of them, but it's as an offshoot or an output of management development, but the actual opportunity as reflected within our pipeline and even outside of the pipeline, the targets that we would have that we've engaged in some sort of dialogue or even beyond that with is as robust and enough to keep us busy for the next five years without meeting another customer.*

The pipeline and the demand for the services are very strong. It's just a matter of having the management depth and then growing in a smart and strategic type of way, which has always been the focus of the company, but now as much as ever before -- selective expansion."

We are not believing this at all. Not only has the company not grown its customer base in years, but it also has cut back on managers that seem to be the magic key to future growth:

	2017	2016	2015	2014
Managers	6,700	5,800	8,600	8,600

HCSG has been losing managers for years. We have pointed this out as an impediment to growth for some time now. They took a charge for \$1.6 million in 3Q to retain more staff. Managers in the past have sued the company for unpaid overtime. Let's keep in mind, they have been cutting unionized workers too. HCSG has a history of hiring people who qualify for tax credits like paroled prisoners and chronically unemployed. Those tax credits are big in year one, decline in year two and then disappear. HCSG hires more of the same types of people to restart the tax credits. Essentially, employees leave and get better jobs. This is where HCSG is actually a counter-cyclical company. They hire people who have few options and potential employers can be choosy. They are a company that offers the customer a way to control wages. It was announced last week the country had 7 million more job openings than people to fill them. Wages are rising and nearly every issue of the *WSJ* notes that retailers cannot find people to work at Christmas, there are not enough truck drivers, e-commerce warehouses cannot get enough workers. HCSG should be seeing wage pressure and a lack of people to hire. We would also expect unionization to increase at the company.

	2017	2016	2015	2014
Hourly Employees	48,300	43,100	37,300	37,100
Unionized Employees	5,500	5,400	8,600	7,800

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5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
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