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Healthcare Services Group (HCSG)- 9/18 10-Q Review

HCSG released its 10-Q and the results now look even worse in our opinion. Moreover, we are not seeing evidence that DSOs are falling at all despite management's claims that it is cutting payment terms in half for many customers.

- Management claims it is pushing customers to pay faster and started that process 2-year ago and now more than one-third pay in less than 30 days.
- Receivables continue to rise faster than sales and L-T Notes are rising faster too.
- HCSG moved some bad debt allowance to L-T Notes receivable for the first time.
- DSOs continue to increase to historically high levels despite claims that collection frequency is increasing.
- Bad debt expense and write-offs last quarter were higher than entire recent years.

Here are the statements from HCSG officers on the 3Q18 call:

> Ted Wahl CEO:
> *__"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 COO:
> *"This process for us, you could go back to __the formative stages of the company when the original billing was done on a weekly or bi-weekly basis. Over the years, there was a migration to a monthly billing system and process rather than a weekly or bi-__*

weekly. 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."*

HCSG's summary is - the company was built on weekly and bi-weekly payment terms, which migrated to monthly. For two years, HCSG has been pushing payment terms back to weekly and bi-weekly. More than one-third of customer now pay in less than a month.

We see no evidence of this looking at the company's receivables:

	3Q18	2Q18	1Q18	4Q17	3Q17
Gross A/R	$392.1	$393.4	$383.9	$390.7	$376.8
allowance	$38.6	$49.7	$48.9	$12.0	$9.8
Net A/R	$353.5	$343.7	$335.0	$378.7	$367.0
LT Notes Rec.	$55.9	$37.4	$38.8	$15.5	$11.5
Allowance	$10.0	$0.0	$0.0	$0.0	$0.0
Net LT Notes Rec.	$45.9	$37.4	$38.8	$15.5	$11.5
Total Gross	$448.0	$430.8	$422.7	$406.2	$388.3
Total Net	$399.4	$381.1	$373.8	$394.2	$378.5

Several things jump out at us. First, for the first time, the company recorded a bad debt allowance for Long-Term Notes receivable. We already find it odd that a company that wants to have credit terms of 7-14 days is extending credit for over 1-year. Second, the short-term receivables are not declining at all. This runs counter to the statements that

they have been accelerating collections for two years now. Third, the company continues to move more receivables to long-term notes.

Any way we calculate DSOs for receivables in any manner that shows they are rising. This is largely because there is very poor sales growth and the company is guiding to a $10 million revenue headwind from cutting payment terms.

	3Q18	2Q18	1Q18	4Q17	3Q17
Sales	$506.9	$503.7	$501.8	$499.4	$491.3
Seq. Sales Growth	$3.2	$1.9	$2.4	$8.1	$20.4

We are looking at growth rates in total gross receivables, total net receivables, and total net receivables less net promissory notes. All are growing faster than sales sequentially:

	3Q18	2Q18	1Q18	4Q17	3Q17
Total Gross A/R	$448.0	$430.0	$422.7	$406.2	$388.3
Seq. Gross Change	$18.0	$7.3	$16.5	$17.9	$34.5
Total Net A/R	$399.4	$381.1	$373.8	$394.2	$378.5
Seq. Net Change	$18.3	$7.3	-$20.4	$15.7	$32.6
Net Prom. Notes	$66.5	$59.4	$60.9	$36.6	$31.9
Seq. Change	$7.1	-$1.5	$24.3	$4.7	$10.7
Net current A/R	$332.9	$321.7	$312.9	$357.6	$346.6
Seq. Change	$11.2	$8.8	-$44.7	$11.0	$14.0

- Total Gross A/R is A/R + N/R + allowances
- Total Net A/R is Gross A/R less allowances
- Promissory Notes are net of allowances and are listed in short-term and long-term receivables
- Net current A/R is short-term receivables less short-term promissory notes less allowances for short-term receivables.

The large bad debt expense recorded in 1Q18 skews the net figures and allows net receivables to appear to fall in that quarter only. Notice that total Net receivables is already higher than 4Q17 again despite having loss allowances of $48.6 million vs. $12.0 million. Sales are only up $7.5 million from 4Q17 with net A/R up $5.2 million even after the giant charge. Gross receivables are essentially rising at 2-6x the rate of sales.

The company will argue that people should ignore the big increases in promissory notes because that those arose before they started to clamp down on slow paying customers. So, we even pulled all promissory notes out of the equation and just focused on short-term receivables net of all promissory notes and allowances. Those are the best of the best. Those are also growing faster than sales!

	3Q18	2Q18	1Q18	4Q17	3Q17
Total Gross A/R	$448.0	$430.0	$422.7	$406.2	$388.3
DSO	80.4	77.7	76.7	74.0	71.9
Total Net Rec.	$399.4	$381.1	$373.8	$394.2	$378.5
DSO	71.7	68.9	67.8	71.8	70.1
Net current A/R	$332.9	$321.7	$312.9	$357.6	$346.6
DSO	59.8	58.1	56.7	65.2	64.2

The DSOs are not declining under even the best definition – leaving out all long-term and short-term promissory notes and pushing down the receivables figure with the huge bump in allowances. It does not appear to us that this is a company that is now collecting more than one-third of customer receivables in under a month.

The company noted that its receivables were up because the quarter fell on a weekend. We didn't give that much credence because the HCSG was still cooking meals and doing laundry on the weekend too and thus generated sales too. Even if we adjust for that and take $10 million off the Net current A/R total and take 2 days of sales off too: we end up with a DSO of more than 56 days. On a gross A/R basis it would be 79 days and remain the highest yet seen.

Moreover, from an annual basis – we have never seen Total Net Receivables DSOs even close to 30 days. We have shown this table before:

	2017	2016	2015	2014	2013	2012	2011	2010	2009
DSO	77.1	65.1	55.3	57.4	61.9	48.1	54.3	53.5	57.4

	2008	2007	2006	2005	2004	2003	2002	2001	2000
DSO	60.4	56.2	61.3	49.9	50.5	63.5	68.3	69.5	75.6

Historically, DSOs move up in recessions and down in better times. DSOs are never under 30 days. Remember, 2018 is running higher than 2017, which was the all-time high. Where is the recession in the US? There isn't one, however, HCSG customers are being squeezed by rising wages, lower occupancy, and flat to down rents. Their cash bind is showing up on the HCSG balance sheet.

As far as customers paying them after being converted to long-term, write-offs are also accelerating:

	3Q18	2Q18	1Q18	2017	2016	2015
Bad Debt Exp.	$3.0	$2.3	$37.1	$6.2	$4.6	$4.3
Write-offs	$4.1	$1.4	$0.2	$1.1	$2.3	$5.9

From 2011-2014, annual write-offs were about $2-$3 million per year. In 3Q18 alone, the write-off of bad debt was $4.1 million. Bad debt expense used to run $2-$3 million per year also. It rose to over $4 million in 2014-2015. Now it's running $2-3 million per quarter.

with the balance accounted for under FIFO (first-in, first-out). This means that for the bulk of inventories, the newer, higher cost inventories remain on the balance sheet longer before being recognized in cost of sales with the delay approximating around 60 days. ITW has been increasing prices for several quarters and noted in the 9/18 quarter commentary that price increases are now offsetting raw materials cost increases on a dollar-for-dollar basis. Still, the rising inventory balances are evidence that there are higher-cost inventories still waiting to be recognized. Note that ITW does not hedge its raw materials purchases.

Additionally, given that raw materials costs have been increasing for some time, the sudden acceleration in the DSI increase coupled with the admitted lower-than-expected performance in certain segments of the business leaves open the possibility that there was an unplanned buildup in inventory in the period, increasing the risk of future discounting to move those products. Again, we will be looking for more color on the inventory increase when the 10-Q is released.

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