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Healthcare Services Group (HCSG) – 10K Released

We maintain our SELL recommendation on HCSG after seeing the 10-K. The SEC issues appear to have legs and that investigation is ongoing even though HCSG completed its own internal review. The credit quality of receivables is falling rapidly with 26% of the gross receivables outstanding to clients in bankruptcy or other litigation or financial distress. Despite management's continued claims that it is speeding up collections – receivables are up as sales growth turned negative. Some may view the EPS as impaired given a huge surge in bad debt expense in 2018. Even adding a good portion of that back, the P/E here would still be about 23 with no signs of growth and other potential headwinds. We urge readers to refer back to our February 7, 2019 initial review of the 4Q18 where we list several one-time items that helped EPS, which likely came in about 28-cents rather than the reported 42-cents.

- **The focus of the SEC is looking at HCSG's rounding of EPS in its reported results. Looking at six years of quarterly reporting, HCSG routinely rounded up 0.4-0.5 cents per quarter.** This resulted in a situation where annual EPS was often 2-cents lower than the sum of the four quarters EPS. This investigation is still ongoing.

- **Credit quality is still declining. HCSG recorded a $51 million charge to bad debt in 2018, which dwarfs prior years of $2-4 million.** It also saw a surge of receivables moved to long-term notes receivable and the first time HCSG booked a bad debt allowance there. **Yet, the receivables outstanding to troubled customers is still more than twice the total allowance. Troubled receivables rose almost 400% last year.**

- **The receivable balance is growing! We needed the 10-K to get data HCSG does not provide in its earnings release. We found that despite claiming that during 2018, the company moved one-third of its customers to a payment schedule of multiple times per month, receivables are still higher now than 2017 and sales have now turned down. DSO's are at an all-time high at 81 days.** We estimate that if the

payment speed has picked up, A/R should have fallen by about $100 million not risen by $36 million.

- **There is still no growth here for despite a growth valuation of the stock after the drop to $33. The customer totals remain flat, sale growth has turned negative and should fall for dietary going forward. Tax cuts fueled EPS growth in 2018 and should be an 8-cent headwind in 2019.**

- **HCSG has also reported that it lacked the manager numbers to grow and has been correcting that in 2018. Manager totals are down slightly from 2017** and employees are flat. They don't offer many perks and without adding new accounts would have a tough time offering advancement. We believe the tight labor market and the structure of HCSG's business of hiring people that come with a WOTC tax shield for earnings ensure some heavy churn.

The SEC Investigation Continues

The company delayed filing its 10-K report as it conducted its own internal investigation on its EPS calculations. The SEC's investigation is still ongoing. This is a company that has had several rounding issues in reporting higher EPS growth. The rounding up streak suddenly ended when the SEC started asking questions in late 2017:

4Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.42	$0.27	$0.28	$0.13	$0.22	$0.08
Non-Rounded EPS	$0.423	**$0.270**	$0.276	$0.125	$0.216	$0.077

3Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.35	$0.31	$0.27	$0.24	-$0.31	$0.20
Non-Rounded EPS	$0.350	**$0.315**	$0.268	$0.235	-$0.314	$0.196

2Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.35	$0.30	$0.26	$0.23	$0.20	$0.19
Non-Rounded EPS	$0.347	$0.304	$0.256	$0.225	$0.196	$0.186

1Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.00	$0.30	$0.26	$0.22	$0.21	$0.22
Non-Rounded EPS	$0.001	$0.298	$0.255	$0.215	$0.206	$0.218

This is a company that was accustomed to beating by a penny and having a high P/E ratio. Look at how often they rounded up 0.4-0.5 cents in a given quarter to report higher EPS.

Suddenly in 3Q 2017, they rounded 31.5 cents DOWN to 31-cents as the SEC asked questions.

We think there's another issue too. If you add up the four reported quarterly EPS totals for each year – it has routinely been 2-full cents higher than the reported 12-month EPS. For example, in 2016 – Quarterly EPS was reported as 26 cents, 26 cents, 27 cents and 28 cents. Adding that up, annual EPS should be $1.07. However, because HCSG rounded up every quarter, dividing the full year's income by shares one time resulted in reported 2016 annual EPS of only $1.05.

Annual	2018	2017	2016	2015	2014	2013
Add EPS for Q's 1-4	$1.12	$1.18	$1.07	$0.82	$0.32	$0.69
HCSG reported EPS	$1.12	$1.19	$1.05	$0.80	$0.31	$0.67
HCSG Non Rounded	$1.119	$1.187	$1.053	$0.800	$0.306	$0.673

We shall see how this turns out or if there are more issues being looked at by the SEC. In the 10-K, HCSG is showing the reported annual EPS figures in Item 6 – the 5-year summary of results. The math is correct on that figure, it just does not match up with the rounded quarterly EPS totals reported throughout several years.

Credit Quality of Receivables Is Growing More Suspect

HCSG does not fully report the various data points needed to review receivables in its press releases and we need to wait for SEC documents. The picture is getting uglier. First, the clients in financial trouble are rising:

$ in mm	2018	2017	2016
A/R from clients in BK/Lit	$115.7	$30.0	$15.9
Bad Debt Exp.	$51.4	$6.3	$4.6
Write-offs	$6.2	$1.2	$2.3
Bad Debt Allowance	$57.2	$12.0	$6.9

HCSG has always said that clients in trouble are a small percentage – yet saw a surge in receivables in bankruptcy, litigation, or otherwise in financial difficulty to over $115 million. It claims that when a client falls behind, HCSG converts their Accounts Receivable to a Long Term Notes Receivable and then charges interest income that is booked when cash is received. The amount of troubled receivables is much larger than the number reclassified as Notes Receivable:

$ in mm	4Q18	3Q18	2Q18	1Q18	4Q17
Notes Receivable	$53.0	$55.9	$37.4	$38.8	$15.5
Allowance	$10.0	$10.0	$0.0	$0.0	$0.0
Net Notes Rec.	$43.0	$45.9	$37.4	$38.8	$15.5

Only 46% of the receivables in trouble have become Notes Receivable. We believe that a customer who falls behind in payments is unlikely to see business improve enough to pay new receivables and older notes. In our opinion, the Notes should have had a substantial allowance from the start, but only in the last two quarters has HCSG recognized a loss allowance against these Notes. The key point is we do not believe the bad debt expense is going to decline going forward. With troubled receivables rising almost 400% in 2018, the allowance for bad debt reserves could still increase in 2019.

Receivables Are Not Falling

The company has been touting its faster collections process. They claim to have moved over one-third of clients to a shorter payment cycle that is less than 30 days. It claims many are paying in 7 and 14 days. If that is the case, receivables should be falling noticeably, and they are not:

$ in mm	4Q18	3Q18	2Q18	1Q18	4Q17
Gross A/R	$389.0	$392.1	$393.4	$383.9	$390.7
Allowance	$47.2	$38.6	$49.7	$48.9	$12.0
Net A/R	$341.8	$353.5	$343.7	$335.0	$378.7
Notes Rec.	$53.0	$55.9	$37.4	$38.8	$15.5
Allowance	$10.0	$10.0	$0.0	$0.0	$0.0
Net Notes	$43.0	$45.9	$37.4	$38.8	$15.5
Total Gross A/R	**$442.0**	**$448.0**	**$430.8**	**$422.7**	**$406.2**
Total Net	$384.8	$399.4	$381.1	$373.8	$394.2

Total gross receivables are up $36 million in 2018 after a year speeding up collections. At the same time, sales are down – coming in at $496.4 million in 4Q18 vs. $499.4 million in 4Q17.

Naturally, the DSOs are still increasing too and sit at a record level of over 80 days.

	4Q18	3Q18	2Q18	1Q18	4Q17
Gross A/R	$442.0	$448.0	$430.0	$422.7	$406.2
DSO	81.0	80.4	77.7	76.7	74.0

We pointed out in our original report that since 2000, the DSOs have been 50-60 days for most years other than when they topped 75 days in 2000, 68 in 2002, 65 in 2016 and 77 in 2017. 81 is the highest we have seen. But, remember, HCSG is accelerating collections according to management.

The only way to get it lower is to ignore the total moved to Notes Receivable and focus only on Net Current A/R after subtracting the growing allowance – even then it would remain far above the average:

	4Q18	3Q18	2Q18	1Q18	4Q17
Net A/R and Notes	$384.8	$399.4	$381.1	$373.8	$394.2
DSO	70.5	71.7	68.9	67.8	71.8
Net current A/R	$341.8	$332.9	$321.7	$312.9	$357.6
Notes Rec.	62.7	59.8	58.1	56.7	65.2

Even after boosting allowances from 12.0 million in 4Q17 to $57.2 million in 4Q18 to reduce the net receivables, the DSOs on net A/R and Notes would still be near a record high at over 70 days. Only when taking out all allowances and moving another $37.5 million out of current to Notes Receivable does the DSO fall much at all by 2.5 days. It has also been rising every quarter throughout 2018 and would remain above the historical range for gross receivable DSOs. So, we see no evidence that the company has successfully sped up collections.

But, let's try one last method. We'll take the gross receivables and notes from 4Q17 $406.2 million and subtract $30.0 million of clients in bankruptcy/litigation for $376.2 million. That would be a DSO of 69.6 on the rest of the non-troubled receivables.

Now, by 4Q18, the company says that one-third of customers are paying multiple times per month. Of the 376.2 million, one-third is $125.4 million. Let's cut the DSOs for that one-third to 12 days. That would mean that $125.4 million should decline to $21.6 million. We should be seeing evidence that receivables are down by at least $100 million between 4Q17 and 4Q18. It's not here. Receivables are up!

Let's subtract the full surge of bankrupt/litigation accounts of $115.7 from the $448.0 in gross receivables for $332.3 million in current accounts. It declined $43.9 million from

$376.2 in current accounts at 4Q17. That's still less than half what we should be seeing and likely the huge increase in problem accounts still skewed that favorably like when HCSG touts falling DSOs because they wrote-off receivables. The last way to look at this would be to say that the faster-paying accounts are still one-third of receivables after subtracting the problem accounts. That would show a decline from $125.4 million to $110.7 million – basically $15 million. Again, far short of the $100 million that should be closer to reality if one-third of accounts are being collected multiple times a month in 2018 vs 2017.

We also know that A/R was helped in 2018 by pushing the costs of food on the Genesis contract back to the customer. Genesis will now buy the food directly and HCSG will provide the labor. It is expected to reduce sales by $20 million per quarter, which should be about $3 million every two weeks in lower A/R and should be reflected by the end of 4Q18.

The still sizeable and rising receivable total continues to be a drag on cash flow. Three years ago, as DSOs really took off and broke out of the 50-60 day range – cash from operations began to lag net income:

	2018	2017	2016	2015	2014
Net Income	$83.5	$88.2	$77.4	$58.0	$21.9
CFO	$80.0	$7.6	$41.4	$63.6	$57.7
A/R drag	-$44.4	-$121.6	-$65.6	-$18.9	-$13.5

Depreciation is essentially a $7-9 million benefit for cash flow from operations. In 2018, the company even had a non-cash charge of $51.4 million for bad debt expense that gets added back to cash flow and HCSG still couldn't get CFO above Net Income.

The Is Still No Growth Here

HCSG is considered a growth business because of the aging of America. We have noted that many of the senior housing operators are reporting weak occupancy and the general view is that supply exceeds demand and that should be the case for many more years. The stock has dropped from $55 to $33 and yet the P/E ratio is still 30 based on the $1.12 in EPS in 2018. Last year, EPS was hurt by the $51 million bad debt expense. Every $10 million that does not recur would add about 10-cents back to EPS. If investors want to argue that $30 million of bad debt expense won't recur – then EPS is $1.42, and the P/E is still 23. We still think 2019 could see a large bad debt expense because the receivables to troubled customers

rose 400% in 2018 and the reserve on Notes Receivable, which represent customers who already announced they can't pay is only 19%.

Customer totals remain flat:

Clients	2018	2017	2016	2015	2014
House Keeping	3500	3500	3500	3500	3500
Dietary	1500	1500	1000	1000	900

The company has not added any new customers in years and we believe its surge in dietary in 2017 was owed to HCSG giving customers extended payment terms and essentially a 2-month loan. That growth has vanished too. We know HCSG wants to be valued as a growth stock and when we see the flat customer totals – we understand more why the company does not fire customers and keeps trying to extend them credit despite a rising problem in payments. If there is a day of reckoning where clients leave as they liquidate or are acquired by another group that does not outsource housekeeping and meal service – what is HCSG going to do? They already have 95% of the outsourced market. Perhaps the outsourced market may be shrinking if larger firms take over more of these retirement homes.

The company has now lapped the increase in customers who added dietary food preparation to their contract and revenue growth has vanished:

	4Q18	4Q17	3Q18	3Q17
Total Revenues	$496.4	$499.4	$506.9	$491.4
Housekeeping	$239.7	$245.0	$242.2	$247.4
Dietary	$256.8	$253.5	$264.7	$244.0

Housekeeping revenue has been lower y/y the last two quarters. Dietary was essentially flat in 4Q18 and had only a $7 million hit from switching food costs back to Genesis. Going forward, that will be a $20 million negative to quarterly Dietary revenue. We see negative revenue growth going forward at this point.

The tax cuts helped drive EPS in recent years too. The company's tax rate had been 34%-36% in prior years, dropped to 16.4% in 2018 and is expected to be 21%-23% in 2019 going forward. So that change has run its course in our view as a source of earnings growth. Simply bouncing to a 22% rate this year is an 8-cent headwind on EPS.

Other Earnings Headwinds

HCSG has said repeatedly that it has a labor problem. It wants to grow its customer base but lacks enough trained managers and employees to do this. They assured investors that it has been changing this situation in 2018 and has been adding more staff. The 10-K shows little evidence of a change here:

	2018	2017	2016	2015	2014
Hourly Employees	48,400	48,300	43,100	37,300	37,100
Managers	6,600	6,700	5,800	8,600	8,600

Both employees and manager levels are flat. Manager levels remain far below levels seen in 2014 and 2015 when the company had one-third fewer food-prep clients. They aren't growing the number of clients so the only way a manager can advance is through having other managers quit. HCSG does not match 401(k) plan contributions. Employees can receive some stock-based incentive pay if they hit goals and remain, but the stock has gone from $55 to $33 and we've seen that drive many people out of tech companies as they can't rely on the stock rising to $100 vs. their option strikes at $40. HCSG wants a 14% margin at both units and blames weakness at dietary on the surge of 500 new contracts in 2017 – but it wasn't close to that goal in 2016 either or 2018:

	2018	2017	2016
Dietary Margin	8.4%	7.3%	8.2%

So, are managers getting bonus pay here? On top of that, the labor market is tight, so the managers have other options available.

The hourly employees are likely to churn rapidly also. They have a tight labor market helping them. More importantly, HCSG likes to hire people who come with a tax credit (WOTC – Work Opportunity Tax Credit). This incentive for employers to hire people recently out of prison, chronically unemployed, past military personnel only lasts for two years. HCSG has an incentive to let them leave and find the next person who will have some of their pay offset by the tax credit. High churn among employees also does not attract managers as easily in our view.

By the company's own admission for over a year – it needs to hire and train more managers. If they do that, it would seem they would be unproductive and duplicate wages for a period of time as they learn and study under an experienced manager. If that happens, that's a headwind on wages. If they don't do that, the lack of managers is a headwind on growth.

HCSG self-insures for workman's comp expense for accidents on the job. It has been cutting this cost noticeably in recent years which it attributes to better training, better emphasis on prevention, and being more proactive in dealing with claims. Since 2014, this has added 360bp to margin:

	2018	2017	2016	2015	2014
Self-Insurance % Sales	1.9%	2.4%	3.0%	3.4%	5.5%

This looks like another catch-22 situation. Even HCSG believes that its primary source of growth will be converting more clients to add food preparation to the contact. Knives, stoves, hot coffee, walking among many people with hands full – this sounds like an area likely to see more claims, not fewer. Also, add in more new managers and high churn of hourly employees. So, if they grow at all, this cost could become a headwind. If they don't grow, employee and manager churn may rise further and still hurt this metric. 1% of sales in this area is 21-cents in EPS.

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