

Healthcare Services Group – 10-Q Update

Maintain SELL

After seeing the latest 10-Q we maintain our SELL recommendation on HCSG. We won't belabor the issues we discussed a few weeks ago after earnings. We will point out that **the SEC investigation into reported earnings continues.** We still believe the selling point for customers to hire HCSG is to slow pay the bills and essentially use HCSG's capital. Despite claims of accelerating collections, the A/R and DSO trends continue to show growth even against falling revenues.

- We believe the SEC issues center on years of the company rounding up fractions of a cent and noted that the sum of the quarterly EPS reported by HCSG was often higher than the annual EPS reported by the company. We discussed this in prior reports.
- The cash flow statement shows receivables continue to consume cash despite falling revenues and the company's repeated statements that is speeding collections in a material way.
- Even with massive reserves for bad debt, writing off reserves, and reclassifying some receivables to long-term notes receivables – the gross DSOs are 89.5 days now! The highest we have seen. Net DSOs are being lowered by 13.1 days due to rising bad debt reserves and 7.5 days by classifying receivables out of current status.
- Troubled receivables have risen from 7% of total A/R to 29% in the last year. If we subtract the troubled figure from gross receivables – the concentrated pool of clean receivables should be isolated. It should show the impact of the company's statement that it has moved 55% of customers to a faster collection cycle often of only 7-14 days. Instead, DSOs of just that pool remains above 60 and is not declining.

Now that we can see the cash flow statement and the actual bad debt reserves, the receivables continue to grow. This runs completely counter to what investors should expect from a company that is not only losing business but also claiming it is accelerating collections. Last quarter, HCSG noted that it has increased collection speed with 55% of customers in the last year. How can receivables be a drain on cash flow if that is true?

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Sales	\$476.1	\$496.4	\$506.9	\$503.7	\$500.6	\$499.4
Seq/Sales Chg	-\$20.3	-\$10.5	\$3.2	\$3.1	\$1.2	\$8.1
Seq A/R growth	\$26.0	-\$5.5	\$23.7	\$9.4	\$16.8	\$17.9

The company should be seeing receivables growth match sales growth if collection speed is flat – they aren’t even close to doing that. 1Q19 showed a \$26 million rise in receivables as sales fell sequentially by over \$20 million!

HCSG wants investors to focus on simply net Accounts Receivable.

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Revenues	\$476.1	\$496.4	\$506.8	\$503.7	\$501.8	\$499.4
Net Receivables	\$392.4	\$384.8	\$399.4	\$381.1	\$373.8	\$394.2
Net DSOs	75.0	70.5	71.7	68.9	67.8	71.8

Even under this measure, the receivables are increasing. The talk is that many customers are now paying in 7-14 days. DSOs net of reserves are 75! What makes this picture still worse is HCSG is writing off receivables, taking huge reserves for bad debt, and reclassifying receivables into long-term assets. In fact, we have never seen the gross receivable balance this high.

	1Q19
Net A/R	\$353.1
Net N/R	\$39.3
Reserves	\$68.6
written off in 1Q	\$7.0
Total Gross A/R	\$468.0

By this measure – DSOs are 89.5 days. They are classifying 13.1 days of DSOs in bad debt reserves and 7.5 days in long-term notes receivable. Trying to take the most optimistic view, HCSG discloses the size of their problem receivables that the reserves are held against. This figure continues to rise rapidly. Subtracting the troubled receivables from the total gross receivables should be the receivables that customers are current on and it should be obvious that HCSG has accelerated collections. It does not show that at all:

	1Q19	4Q18	3Q18	2Q18	1Q18
Gross A/R	\$461.0	\$442.0	\$448.0	\$430.0	\$422.7
Troubled A/R	<u>\$133.8</u>	<u>\$115.7</u>	<u>\$102.6</u>	<u>\$98.2</u>	<u>\$30.0</u>
Current A/R	\$327.2	\$326.3	\$345.4	\$331.8	\$392.7
DSOs of Current	62.5	59.8	62.0	59.9	71.4

Troubled receivables have risen from 7% of the total to 29% in the last year giving the pool of clean receivables to really shine. DSOs have still held at 60 days or higher of just the current receivables. All the talk of having 55% of customers now paying more quickly with many on 7-14 day terms should be evident by isolating the “quality” receivables. These are not going down at all. This is confirmed again by the receivables balance continually rising quarter after quarter. Forget 7-14 days, if current receivables were being paid in 30 days – those DSOs should be about \$150-\$160 million. They are holding flat at more than twice that level.

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