

Healthcare Services Group (HCSG) Cancel SELL

After HCSG missed again yesterday on revenues and EPS, we are going to cancel our warning with the stock down from \$40 to \$23. The market cap is now under \$2 billion and 30% of the float is short at this point. We were following it as a supplier to the assisted living market, which is an area we still consider overbuilt and in considerable transition among the industry participants. We're not certain how much value we can still add on HCSG by pointing out that the same problems continue to worsen.

However, we are not predicting a turn-around for this company by any means. It still has an SEC investigation ongoing for past EPS calculations. Nor do we think this can be a growth company based on what the company is touting as the plan of not extending credit to customers. Without credit, we think many customers will simply vacuum their own carpets and prepare their own food. Investors should still be concerned that the stock trades above 20x EPS for negative growth as well as the following problems:

- The tight labor market is likely hurting HCSG more than most companies. It hires the chronically unemployed to get WOTC (Worker Opportunity Tax Credits), but that also sets it up for considerable churn as the tax credits drop in year-2 and normally vanish in year-3. So HCSG has an incentive to replace the workers too. But, people may be tougher to find and pressure labor costs. They have had trouble hitting their labor cost targets and wages have been rising overall in the market already.
- The company has been calling out a lack of managers and higher training costs for those managers continually for several quarters now. In 2Q19, it was \$4 million again – which is about 4-cents in EPS. Despite the word “Healthcare” in the company’s name, it is vacuuming carpets, dusting, washing sheets, and running a small dining hall in some cases. The skills needed by the manager to oversee this operation shouldn’t take 18-months to acquire. We would be skeptical of adding back

these training costs as “one-time” items. We think churn within manager ranks is a more likely explanation for why the company wants to hire more.

- HCSG is not growing and has not been in many years in terms of number of customers. It operates in 47 states and has been around for decades. The idea that there are retirement homes that do not know who HCSG is far-fetched in our view. Most are simply opting to use in-house staff to clean. This also calls into question how many managers HCSG really needs to be training with these “one-time” expenses because the business isn’t expanding.
- The company is losing business faster than forecast. When a troubled customer started buying its own food and hired HCSG simply to prepare food, the company pointed out to expect approximately a \$20 million y/y decline in revenues. In 2Q19, the drop was \$40 million.
- Receivables actually went down in 2Q19 by \$6.3 million. That is at least moving in the right direction. However, revenue fell \$14.0 million and outstanding receivables remains a huge problem.
- HCSG touted again that it has moved 55% of the customers to accelerated collections. Yet, net A/R was over 68 days at the end of 2Q19 and net Notes Receivables added another 8 days. On top of that, we know reserves would boost that figure even higher by probably 11-15 days, based on recent quarters. After a year, this company should be seeing solid evidence that A/R is declining due to payments being received – not because they wrote them off and reclassified them as long-term notes.
- This company continues to be slow releasing full financial information with a press release containing only a consolidated income statement not broken out by division and a balance sheet with no reserve accounts listed.
- Having a customer base that was able to slow pay HCSG for years and essentially use its balance sheet for a 0% loan as their businesses were squeezed does not bode well going forward. Customers who cannot use HCSG’s capital may leave and do the house-cleaning themselves. Other properties may simply not be viable longer term as new supply has exceeded demand in this industry for many years. The churn rate for assisted living centers is about 33%, so HCSG’s customers have to add many new residents to post flat results. Many older properties may have a tougher time doing

that in an industry with oversupply and many newer locations. We would expect credit quality to remain an issue for HCSG's receivable for a long time.

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