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BTN Earnings Quality Review

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Healthcare Services Group (HCSG)

Healthcare Services Group (HCSG) provides cleaning, laundry, and cafeteria services for senior housing, nursing homes, and hospital facilities across the country. The essential value-add for clients is HCSG will cap these costs via a contract with customers. The customers are in the medical industry and face many rising costs and may not want to deal with wage inflation and extra liability when they can essentially outsource those duties.

HCSG operates in an area we have been studying. Facilities that deal with the elderly have been under revenue pressure due to Medicare/Medicaid funding becoming a rising source of revenue and all third-party payers pressuring for shorter stays in facilities. At the same time, regulations are requiring more service and more skilled labor, so wages are rising faster than revenues. On top of that, senior housing has been overbuilt, so occupancies are flat to down and incentives are being offered to help people move in at lower fees.

HCSG risk factors report:

1. State budget deficits can hurt reimbursements to clients
2. Medicare/Medicaid rates are under pressure and can hurt clients
3. Federal healthcare reform can squeeze clients
4. Several clients are over 5% of revenue – losing any of them could have a material negative impact on HCSG

People who have followed our work know we think there are huge problems in some of these areas dealing with the elderly, and the skilled nursing care areas and senior housing areas of the market are under intense pressure. That is where HCSG operates and HCSG has the same issue:

> "The Company has substantial investment in the creditworthiness and financial condition of our customers. The largest current asset on our balance sheet is our accounts and notes receivable balance from our customers. We

> grant credit to substantially all of our customers. Deterioration in the financial condition of a significant component of our customer base could hinder our ability to collect amounts from our customers. The potential causes of such decline include national or local economic downturns, customers' dependence on continued Medicare and Medicaid funding and the impact of additional regulatory actions. We have sometimes been required to extend the period of payment for certain clients beyond contractual terms. Such clients include those who have terminated service agreements and slow payers experiencing financial difficulties. In making our credit evaluations, in addition to analyzing and anticipating where possible the specific cases described above, we consider the general collection risk associated with trends in the long-term care industry. We also establish credit limits, perform ongoing credit evaluations and monitor accounts to minimize the risk of loss. Despite our efforts to minimize credit risk exposure, our clients could be adversely affected if future industry trends change in such a manner as to negatively impact their cash flows. If our clients experience a negative impact in their cash flows, it could have a material adverse effect on our consolidated results of operations, financial condition and cash flows.

At the same time, we found evidence that that HCSG wants customers to pay very quickly. It is part of its service.

> "We primarily provide our services pursuant to agreements which have a one-year term, cancelable by either party upon 30 to 90 days' notice after an initial 60 to 120-day service agreement period. We do not enter into long-term contractual agreements with our clients for the rendering of our services. Consequently, our clients can unilaterally decrease the amount of services we provide or terminate all services pursuant to the terms of our service agreements. Any loss of a significant number of clients during the first year of providing services, for which we have incurred significant start-up costs or have invested in an equipment installation, could in the aggregate materially adversely affect our consolidated results of operations and financial position."

HCSG gives clients plenty of time to pay, even more than 1 year, despite only offering short-term contracts. The company has an account for Long Term Notes Receivable. In our view, once a client who signed a deal with HCSG to cap expenses gets into trouble, they are unlikely to catch-up on bills. The company views revenue growth on a 5% margin more important than we do.

But, we have seen the receivables play a big role in cash flow and for a company that deals with short-term contracts, DSOs are very long. We looked at DSOs as defined as Accounts Receivable plus Long Term Notes Receivable net of loss reserves divided by 365 days of revenue. They are normally longer than the company seems to operate with and they also change for the worse when the industry runs into financial problems such as a recession. DSOs are currently at the highest level we have seen:

	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

Are we in a recession? Or just for Senior Housing?

The rising receivables also chokes off HCSG's cash flow:

	2012	2013	2014	2015	2016	9 mos 9/17
Net Income	$44.20	$47.10	$21.90	$58.00	$77.40	$68.00
Cash Ops	$60.40	$32.20	$57.70	$63.60	$41.40	$3.10

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