Jeff Middleswart
btnresearch.com

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Healthcare Services Group (HCSG)

We were looking at Healthcare Services Group (HCSG) a couple weeks ago because it struck us as odd that a company that operates on contracts of less than a year would be extending credit to customers of more than a year. We noted that for a company that is in a supposed growth industry, its receivable levels as measured by DSOs were at multi-year highs. We questioned the actual quality of these accounts and the level of bad debt reserves. **In the recently filed 10-K, for the first time, HCSG identifies Genesis Healthcare as a significant customer.**

Genesis has a going-concern warning and is threatening bankruptcy unless it gets relief from landlords and creditors as we noted in our Welltower (HCN) report. HCSG has $36.6 million in notes receivable outstanding to customers in financial trouble, up from $19.2 million in 2016 and $17 million in both 2015 and 2014. Compare that $17.4 million increase in one year to pretax earnings of $133 million. If that increase had been written off, earnings would have been lower than 2016.

Let's also look at the history of bad debt reserves and what is written off each year:

	2011	2012	2013	2014	2015	2016	2017
Bad Debt Write off	$2.0	$2.7	$2.0	$2.3	$5.9	$2.3	$1.2
Bad Debt Expense	$2.5	$2.2	$2.0	$4.5	$4.3	$4.6	$6.2
Bad Debt Reserve	$4.5	$4.0	$3.9	$6.1	$4.6	$6.9	$12.0
Total Receivables	$136.7	$146.0	$198.8	$209.4	$222.4	$285.7	$406.2
DSOs	54.3	48.1	61.9	57.4	55.3	65.1	77.1

HCSG can argue that bad debt reserves are at high levels at 3%. However, the age of receivables is rising rapidly, which by the company's own admission means customers are having financial difficulty paying them. Moreover, as receivables are soaring, HCSG only wrote off about $1 million of defaults in 2017 vs. $2-$3 million on much lower levels. A reasonable case can be made that write-offs should have been higher which would have required more bad debt expense in 2017. An additional $3 million in bad debt expense would have cost the company about 3-cents in EPS. Given the trend in credit, this could quickly become a much larger problem and there is history of that in 2015.

A few other things caught our eye comparing the new 10-K to past editions.

First, HCSG is not adding new customers. Here is the total of the number of facilities it states to be working with in each 10-K for the last several years:

HCSG	2011	2012	2013	2014	2015	2016	2017
# of facilities	2,900	3,000	3,000	3,500	3,500	3,500	3,500

It was operating in 47 states in 2011 and 48 states thereafter. The company has been growing by adding meal service at more existing customers in addition to house cleaning which is done at essentially 100% of customers. There is room to grow here, but it has already made a big jump recently after years of essentially stagnation.

HSCG	2011	2012	2013	2014	2015	2016	2017
# Dietary	600	600	800	900	1,000	1,000	1,500
% of customers	21%	20%	27%	26%	29%	29%	43%

We know that the selling point for HCSG is customers can essentially cap their costs for these services by signing a deal with HCSG, and HSCG will let them slow pay. Thus, in an industry where cash flow is under pressure and many other costs (rents, interest, skilled labor) are increasing, this sounds like a win-win deal. The fact that HSCG went many years at basically 26%-29% of its business in dietary despite having a housecleaning contract with the other 71%-74% of customers and suddenly jumped dietary to 43% is to us an indicator that customers are in more financial trouble. To say it another way, if you've been making the same pitch for a decade with few new takers, what changed for the customer to get so many to suddenly say yes?

The growth in revenues and earnings appears to be fully tied to getting this 43% ratio even higher. HCGS is forecasting mid-teens growth rates for this area and basically inflation-driven growth for housecleaning of 1%-2%.

There Are Some Labor Trends that May Be Tough to Maintain

HCSG works to keep labor costs down. It does this by hiring managers who oversee a large group of hourly workers. Many of these hourly workers qualify for WOTC (Work Opportunity Tax Credits). This law gives employers an incentive to hire people who have had a difficult time getting a job such as people on food stamps, ex-felons, disabled veterans, or long-term unemployment recipients. The employer can receive a tax credit of 25%-40% of wages in the first year with caps based on what category the employee fits into and up to 50% of wages in the second year with a cap as well. For rough numbers, $2400-$4000 for year one is possible and about $3000-$5000 in year two. After that, the employer is not eligible for the WOTC on that worker.

Because WOTC is a short-term program and these are entry-level jobs, it is likely that HCSG sees a decent level of churn and continually has new employees coming into the system. The tighter labor market may accelerate this churn or require a boost in wages from HCSG.

Two things jumped out at us looking at employee stats. HCSG has been cutting managers at the same time the hourly workers have been rising. Also, the level of unionization has been falling with the jump in dietary services:

	2011	2012	2013	2014	2015	2016	2017
Hourly employees	29,400	33,600	33,000	37,100	37,300	43,100	48,300
Unionized Hourly	5,300	6,700	6,300	7,800	8,600	5,400	5,500
% unionized	18%	20%	19%	21%	23%	11%	10%
Managers	6,850	7,000	7,600	8,600	8,600	5,800	6,700
Hourly % Total	81%	83%	81%	81%	81%	88%	88%

Unionization rates have been 20% for years and suddenly they're only 10% even though HSCG is operating in the same facilities? That is likely due to diluting the employee base with more hourly employees very quickly. However, the unions are still there and probably will make a push to add more of these employees. We would not be surprised to see this ratio move closer to 20% again and boost wages.

It is important to remember, HSCG's selling point is capping costs for customers. However, its contracts allow it to pass along wage increases:

> *"We typically adopt and follow our clients' employee wage structures, including policies of wage rate increases, and pass through to the client any labor cost increases associated with wage rate adjustments." – HCSG 10-K*

Also, WOTC only lasts two years for employees who stay that long, and it currently is set to expire next year. So, there may be two forms of wage inflation coming and that may reduce the incentive for customers to switch their dietary operations at the same speed as 2017 with sticker shock.

Let's say 10% of the hourly workers lose $100 of tax credits – that would cost HCSG 4-cents in EPS for every $100 change.

Let's say all hourly employees get a 25-cent per hour raise and work 1000 hours per year – that would cost 11-cents in EPS.

HCSG will point out that they don't have to pay all that – they'll pass it on to customers. Then recall that in 2015 the age of receivables was 55 days, today it's 77 days. So, are the customers really paying it, or is this just future bad debt?

HCSG has also been cutting its managerial staff in the last two years. The long-term figure was about 81% hourly employees and 19% managers. Now suddenly as hourly employees jump, HCSG cuts the number of managers in absolute terms and the ratio is 88%-12%? We think this is even tougher to justify given these are employees who are more entry-level for many jobs and they likely churn more as they acquire skills and seek better wages. Also, the company notes that there is more specialization required on the food side:

> *"Our labor force is interchangeable with respect to the services within Housekeeping, while the Dietary labor force is specific to Dietary operations. In addition, there are some differences in the expertise of the professional management personnel responsible for the services of the respective segments. We believe that the services of each segment provide opportunities for growth."– HCSG 10-K*

If the company needs to add 1,750 new field staff positions for management (basically 0.5 per facility), that would bump the management side to 8,450 and the ratio would fall to only 85%. Even at $35,000 all in cost for those 1,750 – that's over $60 million in expense (54 cents in EPS). The company only earned $133 million pre-tax last year ($1.20 in EPS).

There seems to be some sizeable cost pressure building here which could quickly be a material hit to EPS. Or, higher costs mean higher contract prices to customers, who may not sign up as readily.

Other Accrued Liabilities Have Been Low

This is not the most significant issue, but in prior years HCSG had much higher legal expenses related to labor. Part of this involved overtime and hiring employees already in place at retirement homes and then reducing as they were now outsourced to HCSG to do the same job in the same building. We would argue that if more clients are unable to pay, legal expenses may increase in the future regardless of labor issues.

Accrued liabilities represent expenses booked on the income statement but not yet paid in cash. They generally should move up and down with growth or lost business.

	2011	2012	2013	2014	2015	2016	2017
Accrued Liabilities	$1.7	$3.5	$8.5	$9.0	$13.6	$4.4	$4.6
Pretax Income	$57.8	$70.3	$66.5	$31.7	$89.8	$120.4	$133.0
Accrued %	2.9%	5.0%	12.8%	28.3%	15.1%	3.7%	3.4%

In 2014 and 2015, there were $5.1 million and $10.5 million of accrued liabilities related to legal issues. It does not appear that accrued liabilities of 4%-5% of income would be out of line. In 2017, the rapid jump in dietary operations seems to have diluted the accruals. A 1% change in accruals as a percentage of pretax income would be $1.3 million or about 1.2 cents in EPS.

We don't consider this a material item unless legal expenses jump significantly again, but are just pointing it out.

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