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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Contents

Healthcare Services Group 2Q18 Update (HCSG)

HCSG missed on both revenues and earnings in second quarter. Despite a larger operation y/y, operating income was essentially flat and only the new lower tax rate boosted earnings:

	2Q18	2Q17
Revenues	503.7	$470.90
Op Income	32	31.6
Income taxes	$7.50	$10.50
Net Income	$25.80	$22.60

So, a $3.2 million gain in income with $3.0 million from lower taxes on a $32.8 million boost in revenues. Going forward, HCSG has now lapped that big increase in revenues from new dietary business taken on in 2Q17.

Receivables Continue to be a Concern

We have been pointing out that receivables keep rising and were at record levels of well over 70 days sales. HCSG is touting some big changes and claiming they are down to 62 days. Specifically, they are touting how they are pushing clients to faster payment terms. This was on both the 1Q18 and 2Q18 calls repeatedly:

Ted Wahl, the CEO, in April said they have been focusing on faster payment terms for a year:

> *"But you know, one of the things when you go through something like this, clearly accelerated payments, lining up payments were in line with customers you know, governmental reimbursement and/or our payroll needs are - when I talk about innovations they're not new in the sense that we've never done them before. But in a more kind of standard business practice type of way, that gives us more visibility into a client's behavior, right if we're getting paid weekly and they miss a check then we can react then instead of waiting to the end of the month.* ***So, there are adjustments and adaptations we're making as we speak and have been making over the past 30 to 60 days really over the past year. And that's why you know, specifically related to the two matters in Q1, that's what happened. That is not indicative of what's happening."***
>
> *"We're not waiting till the end of the quarter and that's when I reference - the best way Chad, aside from financial analysis and credit checks all of which we're doing and we have done. The best indicator of - you know, the best indicators, whether they're paying us in a timely manner from our perspective and again, knowing that when we hear those issues with a specific customer, we're obviously proactively dealing with them in a variety of different ways.* ***But on a proactive basis, accelerating customer payments, so to your point, we're not waiting again not to the end of the quarter, but to the end of the month. We're getting indications early in the month, interim months as to whether or not you know, there are challenges that need to be addressed."***

In July, Ted Wahl again pointed to these changes driving down DSOs:

> "*Yes, I would say the single most significant impact around increasing our visibility, which we view as the key in any relationship has been around advancing or accelerating payment terms.* ***So moving a customer that was historically on a monthly payment to a biweekly payment and then opportunistically advancing those on biweekly payments to weekly payments****. Because when we have a higher frequency of payments, it allows us to engage in conversation when there's a shortfall or there's a mess, rather than waiting until the end of a month. So that that I would say, has been more impactful over the last 12 months than any other single thing we've done."*

So, the company has been actively pushing customers to pay faster is what we are being told. And yet, receivables continue to increase faster than sales. What the company has done is take larger reserves against receivables and classify more as long-term notes receivable to reduce the net receivables figure in calculating the DSOs:

	12/17	3/18	6/18
Sales	$499.40	$501.80	$503.70
Net receivables	$378.70	$335.00	$343.70
Reserves	$12.00	$48.90	n/a
LT Notes rec.	$15.50	$38.80	$37.40
Total Gross Rec.	$406.20	$422.70	n/a

We will not have the reserve figure for the June quarter until the 10-Q is filed. The reserves are likely similar to the March quarter. But clearly, the gross receivables continue to increase while sales growth is essentially gone. In 1Q, gross receivables rose by $16.5 million against sales increasing by only $2.4 million. In 2Q, the net receivables rose by $8.7 million while sales only increased $1.9 million. Remember, this after a big push to cut payment times in half for over a year! Receivables are not falling, they are just being reclassified and removed from the definition of DSOs of essentially comparing net receivables to sales.

What is interesting is the company's guidance on receivables is they hope over the next 12-18 months to reach a period where receivables aren't a drag on cash flow and they will essentially collect what they bill every quarter. Moreover, when asked about DSOs falling from these levels, Mr. Wahl basically said these levels are what they expect to maintain.

In our view, we think HCSG is seeing more customers getting into trouble. So, while it may be accelerating collections on some, others are paying more slowly. That should mean that more write-downs could happen in the near future. In 1Q18, the company noted that two large clients, Golden Living and Kindred, were paying very quickly and they have been selling facilities to dozens of smaller operators. HCSG said, "As they sold facilities, you know, highly unlikely that we'd be able to negotiate such favorable payment terms with the new operators." In 2Q, HCSG also blamed budget issues in Massachusetts delaying payments.

We have looked enough at this industry to see that there is margin squeeze everywhere, low occupancies, higher wage costs, higher regulation costs, and slower government funding increases. Long-time landlords like Welltower, HCP, Brookdale, etc. are selling properties. This is happening across the country. This is a major problem for HCSG's customer base. HCSG has several references to this basic problem and makes it sound like the issues are nearly over, pointing out that all its customers need to do is cut their rents and right-size their payroll and then they could really use HCSG services.

Bankruptcies and restructurings come in two varieties – a company that has a strong operating model that simply ran out of cash due to some short-term issue like a big hedging loss hit in 2008 during the chaos, or a big project was supposed to be completed in 2 years is now taking 4-years and has cost overruns. That company generally has growth and good profitability and if it can delay debt payments and get past this one-time hiccup it will probably be fine. The other type is the operating model doesn't work and just coming in every day is a cash drain. That type of company has to rework the whole operation, shed weak assets, lay people off, bring in new management, and slash debt. Those turnarounds take a long time and almost everyone involved is going to get a haircut on what they are owed. HCSG's customers are in this second group. Medicare and Medicaid are not going to suddenly double in size and bail them out, nor are their residents going to magically start needing less care and allow them to cut labor.

In our view, a big reason customers sign up with HCSG is because they are cash-strapped and can use HCSG's cash for two-months. HCSG works with people who cannot pay them by extending their debts to over a year and reclassifying them as notes receivable. We still question how many operators in that situation will catch up.

One of our favorite quotes about receivables at HCSG was on the 1Q18 conference call discussing the big bad debt charge they took:

> *"About half of the charge relates to a multi-state operator that filed for Chapter 11 in March. Although this is a relatively new matter, over the past few weeks we actively pursued all sources of potential recovery, as a critical vendor, member of the creditors committee, as well as outside of the re-org with other stakeholders. Last week after CMS filed papers with the court indicating they had claims in the case, our assessment changed as this introduced the likelihood of an unknown claim that could dilute the pool of available funds for creditors, which is why we decided to reserve but not write off the amount served. We realize that Friday's withdraw of the CMS objection has gotten some attention, but the reality is that withdrawal is only the withdrawal of the objection not a withdrawal of the claims that are now believed to exist, with still no visibility into the potential size of the claims, who they*

may be against and how or when they may be resolved. Obviously, we're disappointed with the situation and we will continue to pursue all avenues of recovery."

We think this demonstrates that it will be very difficult to get paid in some of these cases. If receivables are bifurcating into one pool of 15-30 day payments and another of 90+ days and that's why DSOs are actually still rising on a gross basis, then we think there is a risk here of more write-downs.

HCSG Is Forecasting Margin Gains

One of the issues for this company is it still has a high valuation at about 25x earnings. It has to grow and looking at the revenue figures above, that's not happening. It certainly does not appear to be happening unless HCSG extends more credit – which gets back to the receivable problem.

On gross margins, HCSG has a goal of 14%. They are currently running about 80-90bp below that, which they blame on some new dietary customers coming online last year and they have been unable to get them fully into the HCSG system. They highlighted a lack of management talent at lower levels and they hope to train more and get them in place.

We pointed this out in our March 8 report as a margin headwind that could impact HCSG going forward. We are reprinting that table here:

	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%

The company looks to be about short by many managers. The company claims that the strong economy pushing up wages has not impacted them too much as many trainee managers buy into the story that HCSG is growing and can offer them advancement opportunities. We know there is churn in the hourly employees because HCSG focuses on employees that will come with at Work Opportunity Tax Credits, and that only lasts for two years. That certainly puts more pressure to have good managers to deal with staff turnover. We're not sure how easy it will be to add more managers to deal with existing accounts and have margins increase. Flat revenue from an existing client and higher wages generally crimps margins unless productivity is boosted and fewer employees overall are needed. The labor trends do not show that has happened. And keep in mind, this isn't a restaurant that suddenly started making the best fajitas in town and gets more customers to push up revenue. It's the dining hall in a retirement home. People off the street with no relatives living there aren't stopping by to eat. So, revenues are unlikely to increase.

We think HCSG could continue to see some disappoint in this margin area and could also see headwinds if more hourly employees join the union as well.

HCSG Is also Forecasting More Growth

The company says revenue growth has been restrained by a lack of managers so that issue may be more important than adding 80bp of margin. It continues to see cross-selling existing clients that get housekeeping services to add food preparation as the easiest way to grow. We would agree with that concept and the customers could use HCSG's balance sheet via long receivables to help their cash situation more.

We have noted before that HCSG has been in business for over 40 years. It already has 95% of the customers that outsource housekeeping. That is why they have not added any housekeeping customers in four years. The number has been 3,500 the whole time. However, as the customer base has been squeezed by their problems, the dietary side that had been fairly flat too, suddenly jumped last year:

	2014	2015	2016	2017
# of facilities	3,500	3,500	3,500	3,500
# with dietary	900	1,000	1,000	1,500

HCSG has been making this pitch for years and suddenly in 2017 many more signed up. Now, HCSG wants to reduce payment terms to bi-monthly or even weekly. Is that going to push more people to sign up? We would think that would slow conversion and historically, cross-selling was already a long process.

When we see how many facilities in senior housing and skilled nursing centers are changing hands these days and going from large players to smaller private groups that has to play a role here too. It does not look like HCSG is losing many customers yet, but it could start to see more churn as more of its customers are sold and restructured. Then it would need to sign up more business to stay flat. The change in ownership and restructurings could also delay deals with HCSG until those transactions are complete.

We question if top line growth is going to be very significant beyond some inflation being added in to offset higher food costs. That leaves this company at 25x EPS supported by single digit revenue growth and flat or even lower margins. Furthermore, it has several issues with receivables and could report more problems there or see growth slow further if it tries to reign in receivable growth.

Ocean Yield 2Q18 Earnings (OCY NO, OYIEF)

The biggest news continues to surround the FPSO – *Dhiruabhai-1* completing a 10-year contract with Reliance Industries in India. As of now, the contract expires on September 21. Talks with Reliance on extension, new contract, or purchase option are expected in the coming weeks.

On the current field, another well was closed recently due to lower production volume, leaving two. Production could continue beyond September 21 and Reliance would need the FPSO for that. Ocean Yield puts a low probability on the idea that Reliance would exercise an extension option in the current contract. The belief is they would need it for more than 130 days and the charter rate is based on rates of 10-years ago and the market is lower now. Moreover, the current field has seen production decline over time due to the normal decay of older wells. Reliance has filed plans to decommission the rest of the field – giving one-year notice to the Indian government. **Thus, continued work at the current field is not a long-term solution and an extension of the charter would likely be done at a lower price.**

Reliance and British Petroleum are still moving forward to develop new nearby fields and expect to start drilling in 2Q19. This field has 3 trillion cubic feet of gas. The current field is producing about 4.3 million standard cubic meters per day. The new field is expected to produce 30-35 million cubic meters per day. They intend to use an FPSO solution and the *Dhiruabhai-1* has been determined to be a candidate for this situation.

Listening to the conference call, Ocean Yield seemed to indicate that it believes one outcome could be that Reliance would purchase the FPSO, in our opinion. During the 1Q18 call, Ocean Yield noted that Reliance was looking at making some new investment in the *Dhirubhai-1* and would purchase it. However, Ocean Yield also noted that they are looking at another opportunity outside of India. Both options are subject to upcoming discussions with Reliance. They cannot commit the FPSO to another party when it is under a contract that contains a purchase option. The outcome should be known in a few more weeks. Creating a long-term solution for the FPSO is a top priority Ocean Yield.

On the positive side of this, Ocean Yield is confirming that net cash flow from the FPSO will rise because they have been aggressively paying down the debt on that vessel and it is now debt free. Thus, the FPSO has not been contributing much cash toward the dividend. We showed this table in the last update and some of this data is only presented in annual reports:

	2017	2016
Total EBITDA	$340.70	$291.30
FPSO EBITDA	$115.90	$114.50
FPSO Interest	$1.90	$4.90
FPSO other Fin. Exp.	$2.20	$2.40
FPSO Debt payment	$67.60	$79.90
Net Cash from FPSO	$31.90	$39.60

For the quarters, we can see EBITDA, net income and debt paydown to approximate the cash impact of the FPSO:

	2Q18	1Q18
Net Income FPSO	$10.50	$7.20
Depreciation FPSO	$14.20	$14.20
Cash flow	$24.70	$21.40
Debt Paydown	$20.00	$0.00
Net cash from FPSO	$4.70	$21.40

So, while the FPSO has been a huge part of EBITDA, it actually has not been producing much cash flow toward the dividend. With no debt to pay in 3Q18, it should help Ocean Yield accumulate even more cash. Cash was $266 million at the end of the quarter with another $41 million undrawn on the bank line and the FPSO should boost cash by another $22-$23 million in 3Q. That gets Ocean Yield to $330 million in cash and availability.

The next twelve months of the dividend will be $121 million, there is $175 million of scheduled debt maturities, and the company will invest a net cash of $27 million in the remaining ship acquisition agreements. Thus, Ocean Yield has cash obligations of $323 million in the next twelve months. So essentially, cash on hand covers the next twelve months of cash needs and the FPSO situation will be resolved before the end of that time. Either it will have a new contract and be producing cash flow, or it will be sold and thus have generated cash to the company.

Cash from operations over the next twelve months would be approximately $260 million (defined as net profit + depreciation +/- non-cash adjustments in interest income/expense) less the FPSO that is doing about $96 million in net profit + depreciation per year. So, cash generated would be $164 million over the next twelve months plus the additions from the four new container vessels that came online in very late June/early July and three Suez tankers arriving in 3Q and 4Q18.

The company has been slowing dividend growth and building cash for this event. It stated several times on the call and the earnings presentation that it plans to maintain the dividend. The FPSO will be resolved soon and it will either be recycled into new cash to fund a larger fleet or it will be debt free and operating on a new contract.

Campbell Soup (CPB)-EQ Review

Our review of CPB's recent results turned up a few minor points of concern. While the company struggles with all the fundamental problems faced by the packaged food group, overall, we consider the company's earnings to be of relatively high quality compared to its peers.

On the surface, CPB's receivables and inventory accounts jumped noticeably in the 4/18 quarter, but this was all due to the 3/26/18 acquisition of Snyder's-Lance. The company gives a detailed breakdown not only of the value of the accounts at the time of the Snyder's deal, but also the amount of sales generated by the acquisition in the quarter. This allows us to make adjustments to facilitate the analysis of working capital accounts. While the company did acquire Pacific Foods on 12/12/17, this did not have a material impact on the 4/29 quarter's working capital ratios.

After adjustment for the Snyder's acquisition, accounts receivable days of sales (DSOs) were roughly in line with the year-ago period

	4/29/2018	1/28/2018	10/29/2017	7/30/2017	4/30/2017
Accounts Receivable DSOs	31.1*	30.9	32.3	33.2	30.4

**Adjusted for Snyder's Lance acquisition.*

The average DSO of the packaged food group (KHC, MDLZ, HSY, CAG, K, CPB, GIS, SJM) was approximately 34 using the most recently reported quarters. As such, CPB appears to have very strong receivables management and thus relatively little room to boost cash flow from collections.

Inventories adjusted for the Snyder's deal declined about 3 days from last year's quarter

	4/29/2018	1/28/2018	10/29/2017	7/30/2017	4/30/2017
Inventory DSIs	56.6*	56.1	66.3	79.8*	60.8

**Adjusted for Snyder's Lance acquisition (assuming 40% gross margins)*

***Adjusted for large pension mark-to-market in COGS*

The group average DSI using the most recently reported quarter is approximately 65, implying CPB has efficient inventory management and therefore little room to boost cash flow from improvement in that area.

Accounts payable days-of-sales (DSPs) rose approximately 4 days over the year-ago quarter after our adjustment for the Snyder's deal

	4/29/2018	1/28/2018	10/29/2017	7/30/2017	4/30/2017
Accounts Payable DSPs	47.8*	45.6	47.2	58.9**	43.6

**Adjusted for Snyder's Lance acquisition (assuming 40% gross margins)*

***Adjusted for large pension mark-to-market in COGS*

This continues a multi-quarter trend of meaningful increases in DSPs which is consistent with all the other companies in the group. Our medium-term concern for the group is the impact to cash flow growth when the trend of rising payables reverses. However, we note that CPB's DSP is well below the industry average of over 75. In addition, its approximate 4 day increase in payables versus the year-ago quarter is roughly half the average increase in DSPs for the group. This implies CPB has not leaned as hard on its suppliers as most of its peers.

The company wrote off the final $540 million in goodwill associated with the Campbell Fresh unit

The write-off was a result of several factors, including certain private label customers informing the company that they would begin in-sourcing production, reduced forecasts at the Garden Fresh Gourmet business, and below-expected performance of the Bolthouse Farms business unit. An additional $143 of intangible assets related to these units was also written off. In light of these write offs, we found the following downbeat commentary in the 4/18 10-Q to be notable:

> *"Through the third quarter of 2018, our performance has been below our expectations. This lower-than-expected performance was driven by increased cost inflation, primarily higher than anticipated increases in transportation and logistics costs, as well as increased costs in Campbell Fresh, under performance with a key customer, and slightly higher promotional spending. We expect these factors to continue*

through the remainder of 2018. We also expect margin performance to decline in 2019 due in part to the anticipated impact of import tariffs and the ongoing increases in transportation and logistics costs."

Acre limited partnership

We note that in February of 2016, CPB made a capital commitment of up to $125 million to form a limited partnership known as Acre. The purpose of the partnership is to make capital investments in "innovative" new food-related companies. However, CPB is the sole limited partner of Acre, it owns a 99.8% interest, and it has been deemed the primary beneficiary - hardly an "arms-length" deal. Acre is considered a variable interest entity (VIE) and is consolidated on CPB's financial statements. So far, CPB has funded $74 million of its $125 million commitment which Acre has used to make investments. It is unclear what the ultimate goal of these investments is but on the surface, this deal reminds us of a common practice used by many pharmaceutical companies of setting up research partnerships with capital contributions which are later bought back when the new technology is fully-developed. This has the effect of keeping research spending off the income statement. We are not sure if something similar is going on with Acre, but we consider the deal to be unusual.

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