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# BTN Thursday Thoughts

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"I get up every morning and read the obituary column. If my name's not there, I eat breakfast."
-George Burns

## Miscellaneous News from Senior Living

We have been focusing on Senior Living and Skilled Nursing Facilities as areas many investors continue to see as a great growth area with a demographic tailwind. Nearly every company we see in this area touts that they will receive rising rents each year as passive investors. In reality, the industry appears overbuilt, over-leveraged, and under pressure from people coming in later, staying less time, reimbursements under pressure, and wages rising. We continue to see several problems here such as continual restructuring of leases – so much for the rent increases.

**Welltower has noted in the past that residents do not see much of a rent increase because they simply don't stay long enough.** Instead, raising prices is more a function of what new people will pay when they enter. **Getting people to pay more is a function of occupancy rates. Those are not growing:**

## Welltower Occupancy Rates

| | 4Q13 | 4Q14 | 4Q15 | 4Q16 | 4Q17 | 1Q18 |
|---|---|---|---|---|---|---|
| Senior Housing Triple-net | 88.50% | 89.30% | 89.00% | 89.20% | 87.60% | 87.70% |
| LT Post Acute | 87.70% | 86.30% | 85.70% | 81.50% | 82.40% | 82.60% |
| Senior Housing Operating | 90.20% | 91.30% | 91.60% | 90.70% | 88.40% | 87.60% |
| Outpatient Med | - | - | 95.10% | 95.00% | 93.80% | 94.00% |

| | 4Q13 | 4Q14 | 4Q15 | 4Q16 | 4Q17 | 1Q18 |
|---|---|---|---|---|---|---|
| Brookdale Sr Housing | 88.00% | 88.30% | 86.80% | 86.00% | 85.20% | 84.40% |
| Ventas Sr Housing | 91.40% | 92.10% | 91.40% | 90.20% | 88.50% | 87.40% |

The industry talks openly that these are high fixed cost operations and that filling space with incentives are used. This is not a one-quarter issue. The negative trend in occupancy has been building for years and the industry continues to build more capacity. We are going to reprint the quotes from Starwood Property Trust about this industry from 2Q17 because they describe the market so clearly.

*Barry Sternlicht – CEO: "We have been looking at the assisted living space. We think the train wreck that we anticipated is not going to abate for a while. Senior housing is overbuilt and rents are falling. That is a very tough segment to lend into. So we knew that. We could see the construction. I can't believe the numbers. We just talked about it in the investment committee and 8% increase in supply and rents are falling in many markets. So that is an area of assisted independent living we are kind of staying away from. We are staying away from it. We don't have a single loan that's exposed to that business."*

*Jeff DiModica – President, "Sorry, on the assisted living side, I think I read recently the average age of occupants is 82. But Baby Boomers are still in their mid-60s. So all the supply came in early. And you are going to have a decent amount of time before you can sop it all up in addition to Barry's point."*

Is it any wonder that the landlords like Welltower, HCP, and Ventas are cutting rents for customers? This runs counter to the bullish case that automatic rent increases are built in for these properties. However, the tenants are getting squeezed with falling occupancies:

Ventas is seeing trouble with a SNF (Senior Nursing Facility) tenant that operates in an unconsolidated entity it invests in. Much like Welltower and Genesis, Ventas is hoping to sell these assets, but it did take an impairment in 1Q18:

> *"During the three months ended March 31, 2018, we recognized an impairment of $35.7 million relating to the carrying costs of one of our equity investments in an unconsolidated real estate joint venture consisting principally of SNFs. During the three months ended March 31, 2018, our joint venture partner initiated a transaction with us and as a result, we intend to sell our interest in the joint venture. This sale is expected to occur in the second half of 2018. However, there can be no assurance whether, when or on what terms the sale will be completed."*

It is important to note that Ventas saw losses in all parts of its unconsolidated entities – SNF, Senior Housing, Offices, and other in 1Q18. Ventas also cut rents for Brookdale as noted in the 10-Q:

> *"Annual base rent for the Brookdale Senior Living leased properties of approximately $180 million with an annual rent escalator equal to the lesser of four times CPI and 2.25%, commencing January 1, 2019, ratably reduced by an annual cash rent credit of $8 million in 2018 (prorated for the remainder of 2018), $8 million in 2019, $7 million in 2020 and $5 million in 2021 and thereafter through the remainder of the term of the Master Lease;"*

An $8 million cut in rent on $180 million base is a 4.4% decrease, but Ventas is still touting that rent will grow again by 2.25% in 2019 – that's only a $4 million increase. They are conceding more rent than that level of increase in the coming years. Are rents really growing?

Brookdale's financial statements talk about having several properties under triple-net lease with HCP being pulled out of the Master Lease over essentially a one-year period, HCP will be able to pull those properties away from Brookdale's management and hire someone else or sell the property. There are some properties getting rent relief – but it is not as widespread as with Ventas.

Brookdale also sold its 10% ownership stakes in two RIDEA structures with HCP. Very quickly – a RIDEA structure allows a landlord to both own the property and participate in the operating profits rather than receiving a fixed lease payment from an operator. It essentially takes the operator off the hook of having to pay fixed rent regardless of occupancy and allows the landlord to participate in the upside if occupancy grows. Common sense would essentially say that a RIDEA structure would only appeal to a lease payer if the occupancy and revenues for a property are low. If occupancy is very high, the triple-net lease payer makes big profits by paying a lower fixed rent. So, the goal is to lower the rent costs and hope both parties can improve profits by turning the operation around. With the aging

of America tailwind, this should be a no-brainer deal and HCP and Welltower are both pursuing these deals for laggard properties in their triple-net portfolio. Well now, HCP is looking to some of these RIDEA properties.

We noted two weeks ago (May 3) that Genesis Healthcare is selling some of its Texas properties and Sabra Healthcare is trying to sell 46 of 54 facilities run by Genesis.

In the April 27 issue, we noted many issues with Welltower's latest acquisition of QCP that was essentially dumped at a loss by HCP in 2016 and has continued to erode in value. Moreover, Welltower cut rents again on its tenant Genesis:

> *"On February 21, 2018, we entered into a definitive agreement with Welltower to amend the Welltower Master Lease (the Welltower Master Lease Amendment). The Welltower Master Lease Amendment reduces our annual base rent payment by $35 million effective retroactively as of January 1, 2018, reduces the annual rent escalator from approximately 2.9% to 2.5% on April 1, 2018 and further reduces the annual rentescalatorto2.0%beginningJanuary1, 2019. In addition, the Welltower Master Lease Amendment extends the initial term of the master lease by five years to January 31, 2037 and extends the renewal term of the master lease by five years to December 31, 2048. The Welltower Master Lease Amendment also provides a potential upward rent reset, conditioned upon achievement of certain upside operating metrics, effective January 1, 2023. If triggered, the incremental rent from the rent reset is capped at $35 million."*

What does it say about the bullish case that so many people are trying to sell properties and others have to cut rents with all this rising demand? The falling occupancy rates should be a big red flag.

We have also been watching Healthcare Services Group (HCSG) as well as it is a support company to this industry. It allows Senior Housing groups to outsource and thus cap its expenses for housekeeping and dining. It routinely touts that this is a huge growth area with the graying of America as the tailwind that will drive its business. We believe HCSG's growth pitch is essentially letting customers slow pay them and thus consume HCSG's cash in the form of receivables. For a customer base seeing declining results and competitive pressure, free cash is an attractive offer. We have pointed out that HCSG's DSOs for receivables have been at decade highs.

The day of reckoning came a few weeks ago as HCSG recorded a $37.1 million hit to bad debt expense in the 1Q18. The problem went deeper than that as that covered two

companies that are restructuring with one in bankruptcy. On top of that, HCSG moved $25 million from receivables to Long-term Notes Receivable to deal with Genesis Healthcare. In total, that's 16% of the receivables HCSG had coming into 2018. It effectively cut EPS to zero for the 1Q18 and we don't think this is done yet.

We say that because HCSG is going to continue providing service to these same customers, so they are ramping up new receivables with them. They are in bankruptcy because their cash flow isn't covering their bills. HCSG has reserved for loans here, but not written them off yet. HCSG would not be a secured creditor in this picture and governments, new legal fees, employee wages, new lenders, prior secured debt are all going to be paid before HCSG's pre-bankruptcy receivables. We would anticipate a sizeable haircut to those receivables and payment to be made far in the future. In the case of Genesis, this is a situation of extending two months of credit and they couldn't pay. Now they're extending those past due bills to beyond a year, while giving them new receivables credit. We find Genesis restructuring and companies trying to get out of those situations in almost every company we've looked at. They are getting reduced rents, they are having loans forgiven, they are paying people with $1 stock and their squeeze continues to worsen as people stay less time and pay less as wages increase. We believe HCSG will start to write off some of these notes too.

HCSG believes it will grow because only 18% of its potential market outsources housekeeping and dining. It already works with 95% of the current outsourced market. On one hand, after 40 years of working at this, it would seem like the outsourced market should be larger for HCSG and it already has the bulk of a small pond. On the other hand, outsourcing is attractive to cash-strapped operators, as HCSG will extend them credit – so as this industry struggles – HCSG may be able to grow even faster. The question is will they get paid?

## Sysco (SYY)

We believe food and dining stocks will be an interesting area to watch over the next few quarters as there are several conflicting factors impacting the industry including a rising economy offset by rising food cost inflation and higher gas prices. As the world's largest distributor of food and related products to the restaurant and food service industry, Sysco (SYY) will be a key company to watch. Through a series of acquisitions and internal expansion, the company has grown to serve over 500,000 locations. Restaurants account for about 60% of the customer base with healthcare, education and travel customers making up the balance. An initial review of SYY's 3/18 quarter turned up some items of concern listed below.

- Case volume growth has not been impressive. Despite an improving economy, consumers have yet to flock to dine out as they have in past recoveries. This is further born out by recent franchise bankruptcies, a blowup at kitchen supply company Middleby, and SYY's mention of lower traffic as having an impact on recent results.

- Food price inflation has picked up significantly in the last few quarters. While this may help top-line growth as the company passes these costs along to customers, it eats into margins and threatens to stunt the end demand for SYY's products.

- Beef prices are at near-record levels and are expected to remain elevated at least for the medium-term. There are signs that higher beef prices are leading to substitution by diners to lower-priced chicken. This has pressured sales and margins in the whole industry during previous cycles.

- SYY has benefitted from a shift in sales to higher-margin local customers, but this trend shows signs of topping.

- Rising trucking and fuel costs are pressuring margins. SYY is only partially hedged on diesel costs and only for the short-term. Even more concerning is the likelihood of higher gas prices cutting into diners' budgets in upcoming quarters.

- Recent adjusted results have benefitted from the year-ago periods including accelerated depreciation for the company's ERP system which was fully depreciated as of 6/17. We estimate this is adding an approximate $0.02 per share boost to adjusted EPS which will be gone after the 6/18 quarter.

- SYY has grown its cash flow in the last few years, allowing it to rapidly increase its dividend without hurting the free cash flow payout. However, its aggressive share buyback has more than consumed the remaining cash which is adding to its debt load. It has already begun to throttle back the cash spent on repurchases, but the boost to EPS growth through lower share count will be diminished.

## Case Volume Growth Is Not Stellar

The US Foodservice segment accounts for about 67% of company sales and 95% of operating income before corporate expenses. The below table shows a breakdown of the components of growth at US Foodservice for the last seven quarters:

US Foodservice Growth

| | 3/18 | 12/17 | 9/17 | 6/17 | 3/17 | 12/16 | 9/16 |
|---|---|---|---|---|---|---|---|
| Case Volume | 1.5% | 3.0% | 0.4% | 0.2% | 1.8% | 0.0% | 1.8% |
| Inflation | 2.6% | 3.3% | 3.8% | | -0.2% | -2.0% | 0.4% |
| Acquisitions | 0.8% | 0.6% | | | 0.4% | 0.4% | |
| Other | 0.2% | -0.3% | -0.3% | | 0.2% | 1.1% | 1.6% |
| Total | 5.1% | 6.6% | 3.9% | 0.2% | 2.2% | -0.5% | 0.6% |
| | | | | | | | |
| Local case volume | 2.6% | 4.8% | 2.8% | | 3.5% | 1.6% | 1.9% |
| Multi-unit case volume | 2.2% | 1.9% | "declines" | | "declines" | -2.0% | NA |
| | | | | | | | |
| Sysco Brand Sales as % of Cases | | | | | | | |
| US Broadline | 37.4% | 37.5% | 38.3% | 37.8% | 37.0% | 37.2% | 37.6% |

There are several things to take away from these results:

- Case volume growth has been erratic and far from strong. While we believe the economy is improving, it is not showing up in a mad rush for consumers to eat out as freely as they have in past recoveries. Recent problems in the restaurant industry include the bankruptcy of one of the largest holders of Appleby's franchises. In addition, Middleby (MIDD), a maker of kitchen appliances for the foodservice industry imploded last week after reporting lower sales which it largely blamed on lower demand from high-end operators. With that in mind, consider the quote from SYY's outlook section of its 10-Q:

> "The macroeconomic environment continued to be generally favorable in the U.S., leading to increased spend for retail and food services sectors and improved conditions for foodservice operators, as sales at restaurants continue to rise, **offsetting somewhat lower traffic counts."**

- The company may be selling more cases if the number of restaurants is increasing or if people who are eating out are ordering more. However, if the traffic growth is flat to down, neither of these drivers will be able to offset that for long.

- Food price inflation has reared its head dramatically in the last few quarters. This may benefit headline sales growth and the company may be able to pass much of this increased cost along to its customers. However, it does not result in a proportional increase in gross margin dollars.

- Rising food costs may prompt diners to trade down. Management stated that the food price inflation is the most intense in meat, dairy and produce. We have seen several cycles in the past where restaurants and distributors have benefited from customers moving to higher-priced beef from chicken which boosts both reported sales and margins. When beef prices rise, the process reverses itself. Over the last ten years, beef prices skyrocketed to an all-time high of $10.48 and have been trading in a range of $9.50 to $10.50 since. Strong overseas demand coupled with a slowing supply growth from a decline in the number of heifers retained and drought in the southern plains threaten to keep the prices high. Interestingly though, stocks of beef in freezers were actually down 7% as of January 31st while stocks of chicken were at an all-time high. This may be an indicator that higher beef prices are already causing a shift to chicken. The beef outlook is discussed in this Foodbusiness News article.

- SYY realizes stronger margins from its "local" customers which essentially refers to its non-national chain customers. It discloses the growth in case volume to local customers as well as its 'multi-unit" chains which we show in the table above. We note that through the end of calendar 2017, local customer case growth was materially outstripping multi-unit growth. However, this seems to have normalized in the 3/18 quarter. A quarter does not make a trend, but this is worth keeping a close eye on as SYY has repeatedly referenced the shift to local customers as a significant contributor to recent and future gross margin improvement. Likewise, SYY's margins benefit from shift to its Sysco branded products. Penetration of its own brand actually

peaked in the 9/17 quarter. Again, there is not yet evidence of a definite end to the shift, but it is worth watching.

## Gross Margin Improvement Has Turned

We discussed the impact of rising food costs on gross margins above. The below table shows how gross margin has begun to show a slight year-over-year deterioration after a long string of improvements:

| | 3/18 | 12/17 | 9/17 | 6/17 |
|---|---|---|---|---|
| Sales | $14,350 | $14,411 | $14,650 | $14,421 |
| Gross Profit | $2,676 | $2,699 | $2,794 | $2,760 |
| Gross Margin | 18.6% | 18.7% | 19.1% | 19.1% |
| | | | | |
| Adjusted operating income | $536 | $580 | $662 | $667 |
| Adjusted operating margin | 3.7% | 4.0% | 4.5% | 4.6% |

| | 3/17 | 12/16 | 9/16 | 6/16 |
|---|---|---|---|---|
| Sales | $13,524 | $13,457 | $13,969 | $13,648 |
| Gross Profit | $2,534 | $2,572 | $2,692 | $2,503 |
| Gross Margin | 18.7% | 19.1% | 19.3% | 18.3% |
| | | | | |
| Adjusted operating income | $500 | $558 | $627 | $628 |
| Adjusted operating margin | 3.7% | 4.1% | 4.5% | 4.6% |

Like many of the consumer products companies we have looked at, SYY is also struggling with rising trucking costs. SYY has fuel risk that is much greater than can be quantified or hedged. The company obviously uses a large amount of fuel operating a fleet of trucks to deliver orders to all its customers. SYY had fuel swaps representing 13 million gallons of diesel through June 2018 and another 29 million gallons into early 2019. With rising fuel prices, gains on the swaps offset some of that increase with $4.4 million of income in the March quarter and $5.7 million over the last three quarters.

The company is very open about its hedging and we do not have a problem with what they are doing at all. However, investors should understand that SYY's hedges essentially remove some of the volatility of fuel prices. They are not designed to insulate the company from a long upward move in fuel costs. We say that because they only hedge about half their total fuel needs and the rest is purchased at spot prices. Moreover, most of their hedges

are very short-term as in less than one year. Thus, the program is designed to offset the highs and lows of fuel movements, not offset the full move. So, changes in long movements in fuel costs either needs to be passed on to customers or absorbed in SYY's margins.

We actually see SYY's exposure to fuel in a much bigger picture beyond filling up its own trucks. First, the company sells to restaurants who rely on disposable income from American consumers to drive their sales. If fuel prices are increasing, that can cause restaurant customers to eat out less or trade down (no appetizers, no beer, no dessert) as some of their entertainment money is now going toward gasoline. At the same time, SYY will be trying to pass along the higher operating costs of rising diesel fuel to the restaurants who need to pass it on to customers. Thus, as customer dollars fall, the price of eating out goes up. If consumers cannot pay the increase, the restaurants and SYY have to absorb it as lower sales and margins. So, sales growth itself is impacted at SYY by rising fuel prices and that may have a greater impact on results than the change in its own operating costs.

Second, SYY doesn't make its own food. It is reselling what comes from food companies and farmers to the restaurants. All that is delivered to SYY by truck too. Therefore, the suppliers to SYY also face rising fuel costs and they want to pass that along to SYY. Thus, cost of goods sold can increase to reflect higher fuel prices. This can pressure the company's earnings on the cost side at the same time they are getting top-line pressure.

Again, there is not a problem with SYY's hedging and it can protect the company from some of the highs and lows in the movements of diesel fuel. The issue is the whole business model is exposed to benefits and problems related to changes in fuel prices. We see this like companies that hedge foreign currency exposure. They may have instruments in place to ensure that once a sale is made, they can avoid a currency loss. However, if the dollar moves up 10%, its foreign competitors can sell at a 10% discount and thus the other company either loses the sale entirely or has to cut prices and margin to compete. That cannot be hedged out of the model.

## Depreciation Expense Down

SYY has an ongoing cost reduction program in place in addition to continuing to integrate its 2016 Brakes acquisition. This has been offset by the company making investments in new sales associates which it hopes will help drive the top line in 2-3 quarters from now. In addition, the company pointed out in the conference call that bad debt expense increased versus an easy comparison last year, which is shown in the table below:

| | 3/18 | 12/17 | 9/17 | 6/17 |
|---|---|---|---|---|
| Provision for losses | $12.2 | $11.2 | $9.0 | $1.4 |
| Allowance as % of Receivables | 1.53% | 1.31% | 0.94% | 0.77% |

| | 3/17 | 12/16 | 9/16 | 6/16 |
|---|---|---|---|---|
| Provision for losses | $11.3 | $4.4 | $3.5 | $4.8 |
| Allowance as % of Receivables | 1.30% | 1.21% | 0.97% | 1.11% |

Bad debt provision is a key item to watch given the unstable nature of the restaurant industry. The allowance as a percentage of receivables has run about 1.5% of sales the last three years, so the decline in bad debt expense last year and resulting decline in the allowance percentage looks questionable. In addition, while the company specifically blames part of the increase in adjusted operating expenses in the 3/18 quarter on a rise in bad debt expense, the increase in bad debt expense was actually quite muted compared to the previous two quarters. **What was not mentioned in the call was the much greater benefit from a decline in depreciation expense.** While SYY does not disclose depreciation expense separately, we can see the unusual decline in depreciation and amortization expense in the following table:

| | 3/18 | 12/17 | 9/17 | 6/17 | 3/17 | 12/16 | 9/16 |
|---|---|---|---|---|---|---|---|
| Depreciation and amortization | $193 | $191 | $180 | $235 | $218 | $237 | $212 |
| Net PPE | $4,392 | $4,366 | $4,388 | $4,377 | $4,272 | $4,331 | $4,419 |
| Intangibles | $1,056 | $1,056 | $1,053 | $1,038 | $1,086 | $1,095 | $1,204 |
| | | | | | | | |
| Accelerated Dep. from ERP | | | | | $45.9 | $45.9 | $45.6 |
| Accelerated Dep. in "Certain Items" | | | | | $27.7 | $27.7 | $28.2 |
| Impact on Adjusted Operating Income | | | | | $18.2 | $18.2 | $17.4 |
| Impact as % of Sales | 0.13% | 0.13% | 0.12% | | | | |
| EPS Impact | $0.02 | $0.02 | $0.02 | | | | |

Despite an increase in net PPE and flat intangibles, depreciation and amortization expense in the 3/18 fell by $25 million from the 3/17 quarter. **The company discloses in the 10-Q that the 3/17 quarter included $45.9 million in accelerated depreciation expense related to its previously existing ERP system which was fully depreciated by the end of fiscal 2017 (6/17). However, only $27.7 million was included in the "certain items" categories that it adjusts out of operating expenses to arrive at adjusted operating profits. This implies that the 3/17 quarter's adjusted operating expenses included over $18 million in accelerated depreciation on equipment no longer in service. We estimate this has been an approximate 2 cps boost to EPS in the last three quarters which will disappear after the 6/18 quarter.**

## Cash Flow Does Not Cover the Buyback

The following table shows SYY's trailing 12 cash flow data for the last three years:

| | 3/18 | 3/17 | 3/16 |
|---|---|---|---|
| T12 Operating Cash Flow | $2,218 | $1,969 | $1,684 |
| T12 Capex | $645 | $580 | $466 |
| T12 Free Cash Flow | $1,573 | $1,389 | $1,218 |
| T12 Dividends | $712 | $697 | $702 |
| Dividend % of Free Cash Flow | 45% | 50% | 58% |
| | | | |
| T12 Net Stock Repurchases | $1,266 | $1,769 | $1,711 |
| **T12 Cash Flow After Dividend and Buyback** | **-$405** | **-$1,043** | **-$1,196** |
| | | | |
| T12 Proceeds from Stock Option Exercises | $268 | $235 | $261 |

SYY has generated cash flow growth over the last few years as the environment for eating out and benign cost inflation has been favorable for business. The company has used this to grow its dividend without increasing the free cash flow payout ratio. However, it has also undertaken a very aggressive share buyback which has been regularly reducing the share count by 3-5% per year. While this has been a significant supplement to EPS growth in addition to reducing the cash draw of the dividend, the buyback and the dividend together have been consuming more cash than the company is generating. Between this and the acquisition program, the company has had to increase its debt load which has already topped 2.5 times EBITDA. While not daunting yet, this is a situation than cannot go on much longer, and in fact the company has started to pare back the buyback in the last year. We would also point out that with the shares at multi-year highs, they are much less of a bargain.

We would also point out that cash flow has been supplemented by about $250 million a year through stock option exercises which should not be viewed as a sustainable operational benefit.

## Disclosure

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