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BTN Thursday Thoughts

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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

Macquarie Infrastructure (MIC) Update

Macquarie Infrastructure (MIC) stunned the market (and admittedly, us) by reporting last night that it would be cutting its dividend forecast for 2018 to $1 per quarter. The implied $4.00 annual amount would represent a 28% decline from 2017's $5.56. At the heart of the cut in the dividend was the loss of several storage contracts for heavy oil at the company's IMTT bulk liquids storage terminal business. Demand for heavy oil in the US has been in decline, but management claimed to be surprised by the extent and sudden nature of the contract cancellations. This was not simply a matter of cancelling over rates, as some of the customers apparently shut down heavy oil operations altogether and are exiting the segment. There were several major changes to direction that will impact the MIC growth story over the next several years:

- The dividend payout ratio of adjusted free cash flow will be dropped to 60-65% from its current level of approximately 80%. This is to free up more cash to fund growth capital spending internally.

- In addition to the increased percentage of free cash flow available for investment, the company is looking to sell assets in order to fund all capital spending internally and bring down its debt/EBITDA to 4.0-4.5x from its current level of 4.9x. It mentioned selling all or part of its Bayonne Energy Complex (BEC) and/or its OMI spill response business. MIC should be able to get a good price for BEC in the current market and has already hinted that the project was not something it would be married to over the long-term. MIC has always been an astute recycler of capital, so this should not be viewed as an unprecedented, desperate move.

- Tank capacity utilization averaged about 94% in 2017, but due to the contract cancellations, utilization fell to 89.6% on the last day of the year and is expected to fall to around 85% during 2018. Rather than attempt to fill that capacity with more heavy oil contracts, MIC plans to shut these tanks down and spend $75 million per year over the next three years (roughly 20% of its total projected capital spend of $350 million per year) on repurposing the tanks for use in higher growth areas. It mentioned other petroleum distillates or agricultural products such as ethanol as possible substitutes. However, management is not expecting IMTT to return to growth for three years.

- The decline in expected cash flow from IMTT will be offset somewhat by a full-year contribution from investments made last year in two aviation flight base operations

(FBOs) and the BEC 2 project coming online. However, adjusted free cash flow per share is still expected to fall by 8% in 2018. When the IMTT tank repurposing is complete, management believes it can return to 3-5% organic growth with growth capital spending adding another 2-3% per year. It is implied the dividend would again grow in-line with cash flow.

Our thoughts and observations:

- Oil, particularly heavy oil, has very little if any growth potential. However, we know refined product and chemicals are growing at least 3-4%. When viewed in isolation over the long-term, IMTT's shift to a faster growing area is a positive for the potential cash flow growth rate.

- We do find it strange that the repurposing of a few storage tanks will take three years and $225 million, and plan to follow up with management for more color on what is involved.

- We believe reducing leverage is a positive move. However, management did note that due to reduced cash flow in 2018 and the timing of commitments to spend cash on projects in motion that its debt/EBITDA ratio could creep higher than its current level of 4.9x during the year before going back down. While management said it will dialog with the credit rating agencies and emphasize the ultimate direction of the debt, we can't rule out the possibility that the company doesn't get the response it wants from the ratings agencies.

- The other three components of the company are still delivering. Atlantic is growing, the BEC 2 project will come online and begin adding to growth and Hawaii Gas is still expecting a boost from a rate increase during the year. We do note that with IMTT not growing, Atlantic Aviation will become a bigger part of the company's profits and leave it more exposed the economy until investments in other areas can be made.

- The new tax law should be a huge long-term benefit to the company as the depreciation shield on its $350 million annual investment spending should put off any material deferral tax burden past 2022. This more than outweighs the 60 bps increase in interest expense on the $510 million IMTT tax free debt that requires higher make-whole payments related to lower federal tax rates.

- While the dividend cut and the price drop are certainly an unexpected disappointment, the stock now yields over 10% on the projected $4.00 dividend which will very likely return to a mid-single digit growth rate over the next 2-3 years.

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