Estia Health 25/07/2017 **FAT-AUS-832**

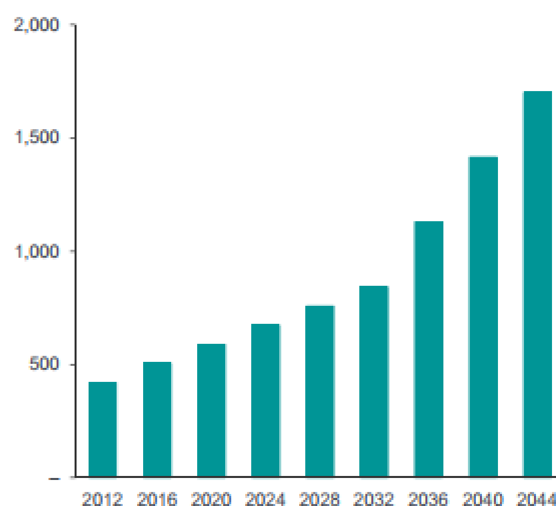
EHE AUD $3.00 Spec. **HIGH** B

Taking care in the recovery

Despite being what would seem something of a defensive 'sure thing', the share prices of several of Australia's large listed aged care operators have not performed well in the past year or so. Concerns over regulatory risks, government funding, as well as media exposes which have sullied the industry's reputation, have meant that investors generally have been lukewarm in committing funds to the sector. The fact that some constituents have over-expanded aggressively has only compounded matters in some instances.

With Australians living longer, and the baby boomers set to retire over the next 15 years, the underlying thematic remains compelling in our view. Particularly as studies show that most will need to cash up equity in their own homes, and move into care to sustain themselves in their twilight years.

Given a powerful top down case, and with valuations that have come back into more modest territory, and with 'some' uncertainty removed following the Federal budget, we have been canvassing the sector for opportunities. One which we have identified as ticking a number of boxes is Estia Health (EHE) which has halved in value since its IPO in December 2014, and we believe that the roadblocks for a recovery in shareholder value are being put in place.



Company presentation

We are always very cautious on IPOs, and those that are spun out of private equity are always in our 'avoid' bucket. This is as private equity firms typically load the companies up with debt and then looking to get out at the top.

Such would appear to be the case with Estia, which was floated by Quadrant Private Equity in 2014. What was remarkable perhaps was that the shares had only just emerged from the starters gates before tanking. The shares lost 17 percent on their opening day, although to be fair recovered and rose back above the IPO price over the following 12 months.

Since early 2016 the market has lost increasing confidence in the stock, due to various industry headwinds noted above, and also issues of the company's own making. As is often the case with newly listed companies with excitable CEOs, Estia was guilty of biting off more than it could chew in terms of its expansion plan. This put a drain on the company's finances, as well as raising question marks over earnings and product quality.

The company though has taken steps to write the wrongs in our view, with the new direction seeing the dismissal of Paul Gregersen last year. A capital raising earlier this year has addressed the company's balance sheet, while acquisitions have been put on hold in the short to medium-term. The company is though focussing on a significant refurbishment program, along with greenfield and brownfield developments. We believe this is a prudent approach, and one that is more likely to drive shareholder value over the longer term.

In terms of valuation, Estia's earnings multiple has come back to around 17 times, which we believe is reasonable for the growth on offer. The prospective yield is under 2 percent this year, but this is forecast to rise to 4percent in FY18.

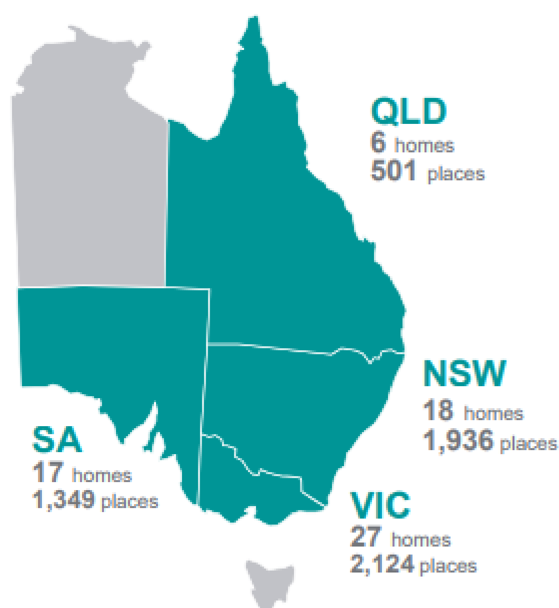
Accordingly, we are initiating on Estia Health as a high risk buy recommendation to Members.

Company Background

Estia Health is the owner and operator of aged care facilities in Australia, and had 5,910 operational places as at 31 December 2016. The company was formed through the merger of Cook Care, Lasting Changes and Padman Health. Estia has a wide geographical spread across the Eastern states as shown below. The company has no presence in WA and no plans to expand there at present.

Estia has a significant and geographically diverse portfolio of facilities

Key portfolio statistics	31 Dec 16
Total number of homes[1]	68
Metro	*53*
Regional	*15*
Freehold sites	61
Total operational places	5,910
Single rooms (% of total rooms)	90%
Employees	~7,400
Average occupancy[2]	93.0%



1. There were 69 homes as at 30 June 2016. Subsequent to that date, the licences of two homes have been merged resulting in Estia now operating 68 homes.
2. Average occupancy for the six month period to 31 December 2016.

Company Presentation

Estia has a deliberate strategy of targeting higher income social economic metro areas. The company is therefore targeting its product at customers who are after a ‘higher’ level of service.

Stock market listing and fall from grace

As we have seen from many ‘roll-up’ listings there was certainly an air of expectation baked into Estia’s IPO and ultimately it failed to deliver. At the centre of proceedings was an overly ambitious acquisition strategy, to the tune of more than $400 million in FY16, including the purchase of Kennedy Health Care. Not only were the multiples paid far from modest, the deals put undue pressure on the company’s balance sheet at an early stage in its listed life.

Lower than expected occupancy growth rates combined with higher than expected operating expenses saw profit warnings emerge last year. A dramatic share price collapse rang the bell on the then CEO’s tenure, and also ushered in a turnaround plan under new broom Norah Barlow.

Turnaround initiative

Change always starts at the top and there should have been no surprise that a major management shakeup was needed. Already a director, Norah Barlow was elevated to CEO late last year. We believe her to be a very strong CEO, having also headed up NZ focussed Summerset Group, one of the most respected retirement village operators in Australasia.

Estia also elevated Dr Gary Weiss to the role of Chairman in February. As one of the highest profile agitators in Australia, the well-known fact that Dr Weiss does not suffer fools, should actually provide comfort to shareholders.

The company’s comprehensive strategic review has come up with a relatively straightforward plan of halting acquisitions, showing up the balance sheet, reducing costs, and making selective divestments. And while not home yet by any account, there has been some heartening progress on a number of fronts in our opinion.

Balance sheet strength has been addressed following a $137 million cap raising at the start of this year. This along with select (smaller but not immaterial) divestments of underperforming sites, will have significantly increased the amount of financial headroom which Estia has. We estimate net debt/underling earnings will be around 1.6 times at FY17, with net cash of more than $80 million.

This will also bolster the ability to plough ahead with a refurbishment program which in our view will be the key to boosting occupancy rates, and margins. Six projects have been completed, and a refurbishment at a further five homes is underway (at an estimated capex of $9m with an estimated $2m earnings payoff). Further out, another 16 homes are in the plans, at a capex of $20/25m but with an estimated $5m earnings payoff.

While acquisitions are off the table, developments are being progressed as well. This will add 230 places by the end of FY18, and will come at a capex spend of around $80m. We therefore believe that organically, Estia has more than enough on its plate to driver further earnings growth.

Recent Financials

Full year results from Estia are due next month on 24th August, but we believe there was enough in the half year numbers to provide much comfort.

Management reported the integration of Kennedy Health Care was progressing well, and this helped to boost NPAT (net profit after tax) by some 86 percent to $19.8 million. Revenues rose 5 percent to $263 million, while EBITA (earnings before interest tax and depreciation) jumped 26 percent to $43 million. Most encouragingly, management confirmed full-year earnings guidance of $86 million to $90 million. The company also laid out a future policy of paying 70 percent of NPAT out as dividends.

H1 FY2017 FINANCIAL HIGHLIGHTS

Source: Company Presentation

Net refundable accommodation deposits increased to $38.7 million from $33.8 million and occupancy also rose to 93.5 percent versus guidance for 92.8 percent. Management is confident it can lift this further and is targeting a further 10 underperforming homes. The rate rose to 94.4 percent in April.

The company also made progress in taking costs out, with admin expenses 30 percent lower at $9 million versus previous periods. Staff costs ticked up to 64 percent of sales versus 61 percent, but we acknowledge it will be difficult to reduce these (around 7,400 on the payroll) to maintain a high level of care, and in line with the company’s market positioning. We do though see further scope for non-wage costs being taken out elsewhere.

As noted, the company’s balance sheet also improved significantly following the capital raise. Net debt reduced from $223.7 million as at 30 June 2016 to $140.1 million at 31 January 2017.

Management did at the half year highlight one point about the changes to aged care funding, and we also take this opportunity to highlight that regulatory risks need to be considered before investing in Estia. The industry is highly regulated and changes in government funding schemes of ACFI (age care funding instrument) payment policies can have a material impact on earnings.

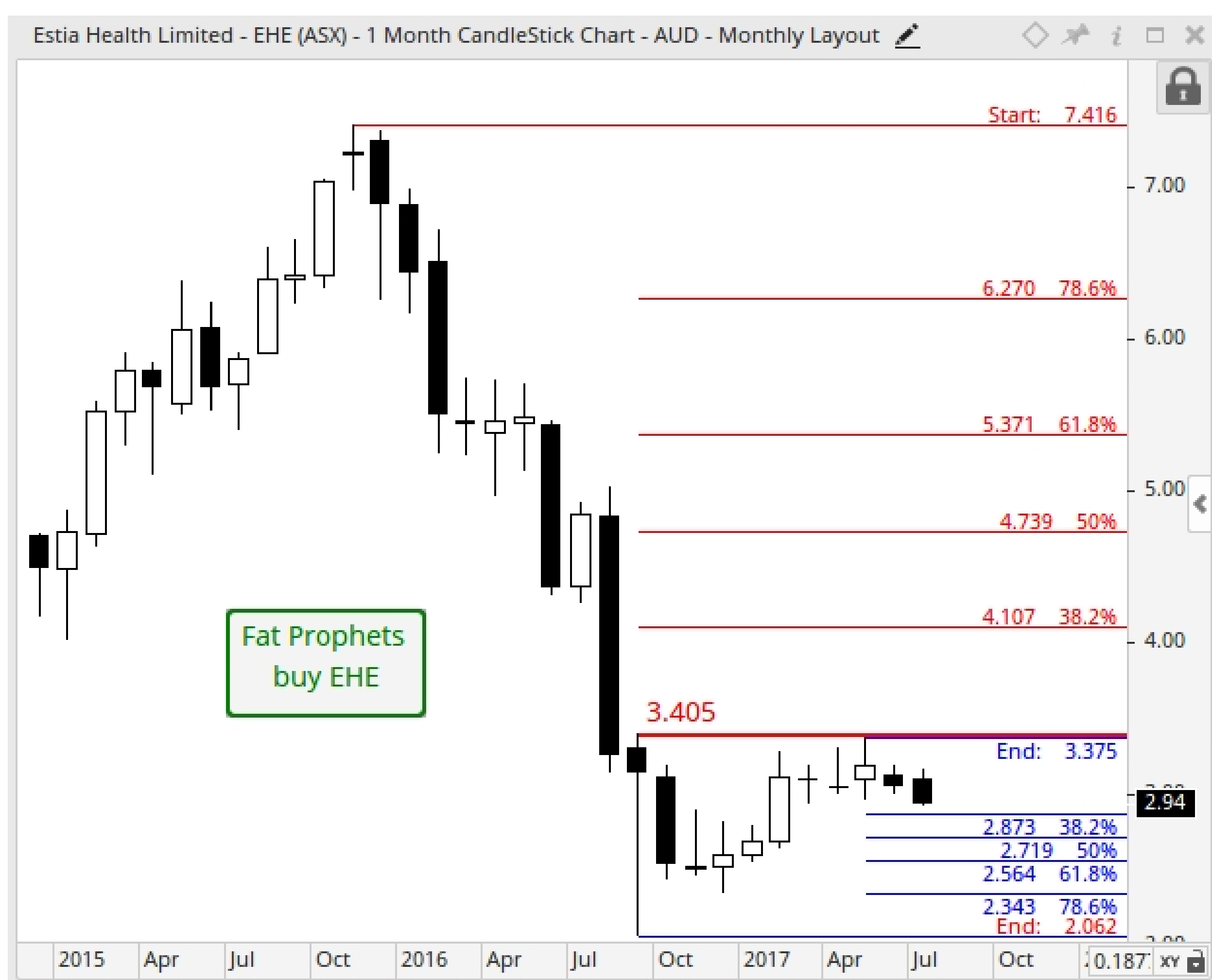
Significant changes though have already been enacted by the Federal government, and this has likely been priced into the shares in our view. Officials have already clamped down on the types of fees that can be charged. Complex care charges will though have minimal impact on FY17 but were in management’s frame for the years beyond. The company is looking at a “range of strategies to mitigate this impact, including increasing occupancy across the portfolio and increased and more targeted charging for additional services."

The government has announced an indexation freeze for 2017/8 and a partial freeze in 2018-19. Audits are also going to have to increase though to address the driving allegations that some operators are over-

claiming their grants. The government is also looking to facilitate the opportunity for 'home-based' care, although we believe this in reality will apply to a limited segment.

We are ultimately of the view that Estia is well placed to withstand the remaining industry headwinds, and given a still powerful underlying thematic. We are encouraged by the company's investment and refurbishment plan, which will enable it to further cement its service as being of a higher standard. The company's balance sheet meanwhile is also on a much firmer footing.

Turning to the charts, and on the monthly, the share price of Estia Health touched an all-time low of $2.06 in September 2016. Positively, prices have spent the remainder of 2016 until May 2017 in recovery mode. At present, a short-correction has ensued, and should the bears remain in control, then a zone of support is indicated between $2.56 and $2.87. This consists of the Fibonacci retracement region of 38.2% to 61.8% (as shown by the blue set of retracements). In order for the long-term technical outlook to strengthen, a decisive clearance of resistance evident between $3.38 and $3.41 is required. This is made up of the May high and September 2016 'bullish doji' (horizontal solid-red line) respectively.



On the daily, prices have broken below the 50-day moving average (red line) of $3.07 which on the face of it suggests that momentum has rotated south. Should the bears exert downward pressure over the near-term, then a zone of support is sighted between $2.86 and $2.89. This is made up of the 50% Fibonacci retracement and the 200-day moving average (green line) respectively. In order for the medium-term uptrend to resume its course north, a sustained break above the aforementioned 50-day moving average (red line) of $3.07 is required to take place. We believe that the fundamental building blocks are being put in place to facilitate this scenario,

Summary

With Australians living longer, and the baby boomers set to retire over the next 15 years, the underlying thematic for high quality aged care operators remains compelling in our view. Particularly as studies show that most retirees will need to cash up equity in their own homes, and move into care to sustain themselves in their twilight years.

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Snapshot EHE

Estia Health

Latest Closing Price: $3.00

Estia Health is engaged in operating and developing owned and leased residential aged care facilities throughout Australia. The Company's homes offer a range of care services, from providing semi-independent living, to specific and comprehensive care for those with memory or cognitive support needs. The Company offers services, including personal assistance, meals, therapies and lifestyle activities. It offers residents with general activities, such as gardening, reading, movies, music, parties, cultural celebrations, art sessions or daytrips and lifestyle coordinators, and can also cater for many specialist interests. It offers clinical care that includes regular reviews and includes daily medication; pain management program; medical services, such as physiotherapy, pharmacy, podiatry, optometry and dental; specialist dementia care, and personal care. It operates homes in Victoria, South Australia, New South Wales and Queensland.

Market Capitalisation:$781.81M

	FY1	FY2
Price to Earnings	16.7	17.3
Dividend Yield (%)	1.9%	4.0%
Price to Book	1.0	1.0
Return on Equity (%)	6.0%	5.76%

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