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AdCare Health Systems
AMEX:ADK
Last: $3.65

Summary:

- Rapidly growing skilled nursing facilities operator
- 3-year revenue CAGR of 89%
- Aggressive growth strategy has obscured the company's underlying financial performance
- Co. should turn the corner to profitability in the current quarter
- Excellent management team with large-company experience and a history of value creation
- Significant recent insider purchases
- Insiders own 17% of company
- Peer metrics suggest ADK's intrinsic value is $8 to $13 per share, or 2.0-3.5x the current price

Adcare (AMEX:ADK) is a skilled nursing facility ("SNF") operator growing so quickly that its financials are largely useless and it can't give guidance. As a result, the market is clueless about what the company is worth. I think it is worth at least $10 a share and probably more.

AdCare was founded in 1989 but became a new company in 2009, when Christopher Brogdon bought 10% of the company in the open market and subsequently joined ADK as Director and Chief Acquisition Officer. Mr. Brogdon has previously founded and/or operated a number of businesses, including Retirement Care Associates, an SNF operator he sold to Sun Healthcare for $320M, and Contour Medical, which increased its revenue 7x and its share price 12x under his chairmanship. (AdCare actually has a staggering amount of management talent for such a small company. The new CEO, Boyd Gentry, was previously the CFO and later President of a large skilled nursing facility operator that generated $2 billion in revenue, and the new COO was previously the operator of a 60-facility SNF operator. Insiders as a whole own 17% of the company.)

Skilled nursing facilities treat elderly patients, typically after they have spent time in a hospital, and offer the highest level of care available outside a hospital. Services provided include daily

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living assistance as well as treatment of, and rehabilitation for, injuries and illnesses. The SNF industry benefits from favorable demographic trends: the 65 and older portion of the population is growing much faster than the rest of the population, yet SNF supply has been decreasing due in part to government restrictions regarding opening facilities. Another attractive element of the industry is that SNF companies can usually use long-term fixed-rate mortgages to finance SNF facilities, but receive revenue streams that are indexed to inflation.

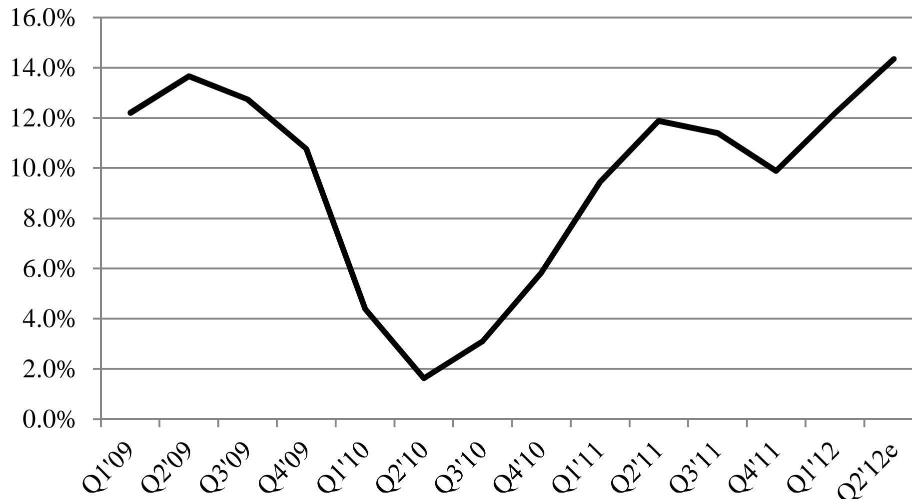
Prior to 2009, AdCare was growing in the low-single-digits and the company was minimally profitable. Mr. Brogdon brought with him a dramatically altered corporate strategy: to aggressively buy underperforming, largely family-owned SNFs, and then improve occupancy, patient mix, and billing practices. AdCare has a competitive advantage in this particular arena of value creation because Brogdon has relationships with private SNF owners throughout the country. His industry relationships have enabled ADK to purchase facilities that its competitors don't even know are for sale. ADK estimates that half of its acquisitions have been of just this sort—deals that were privately negotiated and which never entered any formal sales process.

The company has completed a large number of acquisitions since 2009. Here is ADK's annual revenue:

2009: $27 million
2010: $51 million
2011: $151 million
2012e: $250 million

Moving a facility from family or non-profit ownership to corporate ownership can have a dramatic financial effect. More aggressive pursuit of referred patients improves occupancy, often from about 75% pre-acquisition to 85% post-acquisition. More structured billing practices improve the average Medicare billing rate by 17% on average, and the patient mix improves to higher percentage of Medicare patients. The cost of goods declines due to purchasing efficiencies. And so on. All in all, a facility's revenue often improves at least 20% and EBITDA often improves 50-100% 12 to 15 months after purchase.

However, this strategy has an unfortunate but temporary side effect: a deleterious effect on consolidated financial performance. Each time ADK acquires a facility it is consolidating an under-performing business into its financials. As a result, those financials look worse after an acquisition than they did before. The facilities ADK is buying generate less revenue per bed than peers, and earn lower EBITDAR margins on what revenue those beds do generate. To boot, ADK's leverage increases because the debt it is taking on is being compared to depressed EBITDA. The overall effect of ADK's aggressive acquisition plan on EBITDAR margins has been significant, to say the least:



But now the boomerang is swinging back. Facilities that were acquired a year ago are shaping up, driving improvement in the company's consolidated margins. The company expects to be profitable in Q2, and likely thereafter. But the market hasn't caught on yet. This is partly due to the fact that while EBITDAR margins are beginning to approach peer levels, revenue per bed still lags far behind, which is depressing total EBITDAR. Improvement in revenue per bed will come from better occupancy rates and patient mix and is only a matter of time.

	Revenue per Bed
SKH	$ 83,626
ENSG	$ 69,103
SUNH	$ 80,226
KND	NA
ADK	$ 59,025

In the SNF industry, which is highly fragmented, there are four significant public players apart from ADK. They are Ensign Group (ENSG), Skilled Healthcare (SKH), Kindred Healthcare (KND), and Sun Healthcare (SUNH). ENSG and SKH both own more than 70% of their facilities, while KND and SUNH each own less than 20%. As a result, KND and SUNH receive vastly lower EBITDAR multiples than ENSG and SKH—ENSG and SKH are in the 5-6x range, while KND and SUNH are closer to 2x. This disparity is so large because SNF operators that own a high percentage of their facilities get the benefit of using long-term fixed-rate mortgage financing on an inflation-indexed revenue stream, while SNFs that primarily lease can't do that, and have less control of their costs overall.

The table below gives a quick overview of how the SNF companies stack up. It focuses on most-recent quarter figures because new reimbursement cuts went into effect in the first quarter, making SNFs' 2011 financials less indicative of run-rate financial performance. I've also adjusted the enterprise values to reflect self-insurance liabilities.

	MRQ Revenue	MRQ EBITDAR	MRQ EBITDAR Margin	Enterprise Value	EV/ Annlzd. MRQ EBITDAR	Facility Ownership %
SKH	219	30	14%	695	5.8x	68%
ENSG	202	34	17%	804	6.0x	75%
SUNH	458	52	11%	370	1.8x	2%
KND	1580	215	14%	2085	2.4x	13%
ADK	50	6	13%	167	6.5x	65%

ADK is in the high-ownership category, so it should trade at a similar multiple. And it does, on the surface. The problem is, the market has no idea what ADK's true EBITDAR is because of all the change occurring right now. What investors need to focus on is what the revenue and EBITDAR margin *will* be once ADK's recently-purchased facilities are optimized. The table on the previous page provides a clue as to what revenue per bed should be: $70,000-80,000 per bed.

The additional tables below show what ADK should be worth assuming all its facilities are fully optimized. Now seems like a good time to point out that because SNFs use a lot of debt, their values are typically very sensitive to small changes in EBITDAR multiples.

ADK Implied Share Price @ 5.5x EBITDAR

		EBITDAR Margin			
		14%	15%	16%	17%
Revenue per Bed	$68,000	$5.33	$6.21	$7.09	$ 7.97
	$71,000	$5.87	$6.79	$7.71	$ 8.63
	$74,000	$6.42	$7.38	$8.33	$ 9.29
	$77,000	$6.96	$7.96	$8.95	$ 9.95
	$80,000	$7.50	$8.54	$9.58	$10.61

ADK Implied Share Price @ 6.0x EBITDAR

		EBITDAR Margin			
		14%	15%	16%	17%
Revenue per Bed	$68,000	$ 7.57	$ 8.61	$ 9.65	$10.69
	$71,000	$ 8.21	$ 9.30	$10.38	$11.47
	$74,000	$ 8.86	$ 9.99	$11.12	$12.25
	$77,000	$ 9.50	$10.68	$11.85	$13.03
	$80,000	$10.14	$11.36	$12.59	$13.81

While a 16% or 17% EBITDAR margin will be hard for ADK to achieve without the scale that ENSG and SKH have, 14-15% shouldn't be too hard once the company slows the pace of acquisitions and has time to optimize its recently acquired locations.

As a sanity check against the values proposed in the table above, we can use an EV/BED model.

	EV/BED	Facility Ownership %
SKH	$ 66,237	68%
ENSG	$ 68,692	75%
SUNH	$ 16,179	2%
KND	$ 59,558	13%
ADK	$ 48,984	65%

ADK Beds	3,421
Assumed EV/Bed	$ 65,000
Value ($M)	$ 222
Net Debt	$ 101
Equity Value	$ 121
FD Shares	14
ADK Share Price	$ 8.40

Assuming the ~$65k per bed value that the market awards to both SKH and ENSG is appropriate, ADK is worth $8+. My personal price target is even higher, because ADK typically pays less than $50k per bed for acquisitions, so every time it buys an underperforming facility

and improves the operations, it is creating value for ADK shareholders. The company is currently in talks or under contract to buy facilities that will bring its bed count to 4,800, up from 3,900 at 3/31/12. This would be an increase of 20%. Should this equate to a 20% increase in ADK's per share value? Over time, I think the answer is yes (one could even argue the value creation relationship is greater than one-to-one because additional revenue dollars improve absorption of corporate overhead). So one can argue the shares should be worth closer to $10, which is about 120% of $8.40.

Obviously there are a lot of moving parts here and there is no single point estimate that can define this company's value, but I believe the per-share value to be over $10—and well over $10 if the management successfully executes on its strategy. Ultimately the value of the company can increase even further because there is no shortage of SNF facilities to be bought. The industry is extremely fragmented. There are roughly 15,900 SNF facilities in the U.S., but the top 10 SNF companies in aggregate operate just 2,000 facilities.

I think ADK's ultimate goal is to sell itself in a few years, after its acquisition program is complete and its facilities are optimized. There are a number of purchasers who would make sense. Two of the largest SNF operators in the country, Golden Living and HCR Manorcare, are PE-owned. Golden Living was taken private in 2005 and HCR Manorcare was taken private in 2007, so both companies' sponsors are probably thinking about exits by now. ADK would be a great pick-up for either one of them as a way to improve geographic footprint and leverage the IPO process. REITS would also be sensible buyers. The gap in EBITDA multiples between REITs and assisted living facilities is a mile wide, so assisted living facility acquisitions can be hugely accretive to REITs. Last year Health Care REIT acquired Genesis Healthcare's real estate for $2.2 billion, and Ventas acquired Nationwide Health Properties for $7.7 billion, or 18x EBITDA. Before that, HCP acquired HCR Manorcare's real estate for $6.1 billion.

The main risk to the story is CMS, which feels that SNFs make too much money. Every few years CMS cuts Medicare reimbursement rates. This is certainly a risk going forward, but it is not a near-term risk given that the most recent cut just went into effect in the first quarter of 2012. More importantly, I think this risk is fairly well-captured by the depressed multiples at which all the SNF companies trade.