# Extendicare[TSX:EXT]

EXTENDICARE®
... helping people live better

| Stock Rating | Buy |
|---|---|
| 12 – 18 Month Price Target | $9.55 |
| TSX EXE.TO Today | $7.41 |
| 52-Week Range | $9.80 - $7.12 CAD |
| Shares Outstanding | 87.968M |
| Volume | 122,660 |
| Average Daily Trade | 1,172 |
| Market Cap | $741.84M |
| Dividend/Div Yield | $0.48/5.60% |
| Common Equity | $16.7B |
| LT Debt | $11.9B |
| EPS | 0.35 |
| Beta | 0.48 |

## Executive Summary

My recommendation is a **BUY.** Extendicare 2nd quarter results indicate steady stable performance alongside a DRIP (dividend reinvestment plan) that continues to deliver shareholder value. Extendicare has the capabilities to expand their brand and REIT position in a Canadian pure-play strategy for the medium and long term. Most investors appear to rest their analysis on simple demographic expectations. Aside from a few bumpy experiences which are felt across the industry as a whole, Extendicare is poised for future growth in the next 12 to 18 months.

### Extendicare Background

Extendicare [EXE-T] TSX is a Canadian long-term care center as well as government-funded home care[1] operator across a network of 53 owned, and 49 managed long-term care facilities and an "in-community" staff of 11,000 employees delivering care into people's homes. Extendicare has over 26,000 employees in total. The Extendicare company was converted into a REIT (from 2007 to 2012) and then become a publicly traded company in 2012. Within two years of their IPO, Extendicare divested its US operations which were at the time over 60% of its revenue-generating profits. At one point, in 2006, the stock traded as high as $28.04 compared with the present $7.41. The implications of this divesting event are vast and considerably more complicated such that projections are hindered by a lack of like for like comparison: controlling for before and after divestiture. Looking at Extendicare's position today, as part of a niche industry that rarely receives positive media scrutiny, Extendicare is part of, in our estimation, a near oligopoly on accommodations for the last 5 to 10 years of the lives of senior Canadians today.

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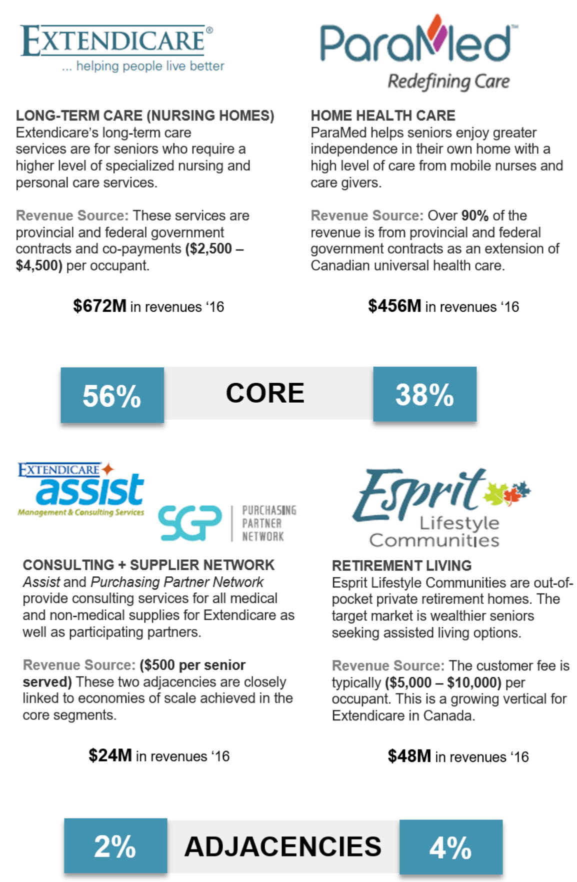
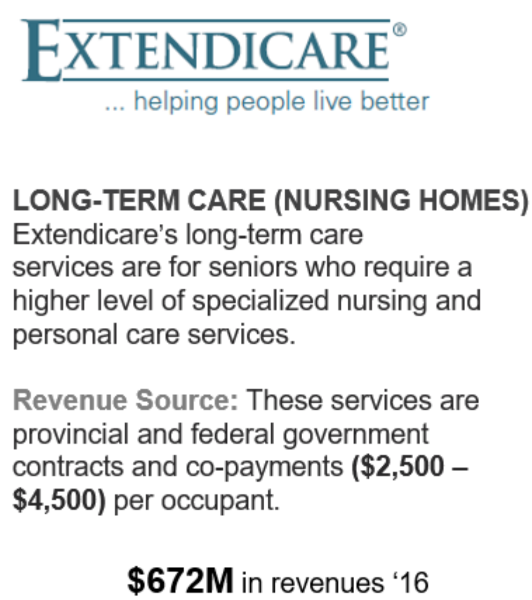
[1] Home care is where nurses or personal support staff visit the client in the patient's home.

## Company Structure



ParaMed
Redefining Care

**HOME HEALTH CARE**
ParaMed helps seniors enjoy greater independence in their own home with a high level of care from mobile nurses and care givers.

Revenue Source: Over **90%** of the revenue is from provincial and federal government contracts as an extension of Canadian universal health care.

**$456M** in revenues '16

### Home Care and Retirement REITs

A critical metric for understanding EXT-TO is Corporate Strategy. As an Equity Research analyst with direct experience in home care, I have a strong sense of opportunities that Extendicare has to change the way PSWs, Nurses and patients engage in the co-production of care.

Senior care is an umbrella industry which comprises both long-term care and home care. Extendicare is in both industries at a percentage revenue of 56% retirement home and 38% home care in 2016. Profitability is low margin due to two major factors. The first major factor is the high operations costs which place downward pressure on net operating income (NOI) a key metric of financial analysis from Extendicare's perspective. Fixed costs are considerable in the industry even with the steady monthly payments from government-subsidized customers. The second major factor affecting profitability is that the government imposes regulatory caps on the amount that senior care providers can charge customers. Extendicare in Canada is significantly reliant on government co-paying for customer services in both core areas where Extendicare operates (long-term care and home healthcare services). The profitability is also hindered by the "tyranny of distance" and "climate" which impacts Canada generally but particularly for home care delivery. Private out-of-pocket retirement homes are only 4% of the Extendicare's revenue.

Technology is not significantly advancing the profitability of the senior care space hence both individuals in the industry as well as equity analysts characterize home care as the sleepy cousin of hospital-centered healthcare.

### The Silver Surge

Investors should be able to deduce that the retirement home market is expected to grow as baby-boomers age and live longer. While the margins are challenging in home care, supporting patients in their home relieves hospitals and will likely grow as a universal healthcare costs continue to be managed by provincial and federal governments. The boom is slow, incremental and subject to new technology. However, predicting an increased need for spaces is not a difficult prediction to uphold. It is also a consistent point made in quarterly calls.

## Corporate Strategy

## Five Forces

### Rivalry

This industry has low to medium rivalry. Extendicare, Chartwell, Sienna are consolidating an industry that has historically been fragmented with small owner retirement homes operations. These three players might be appropriately compared to the Big Five banks and the Big Three telecoms in Canada. These three companies are the Big Three of senior care. All other players are smaller operations.

a) ***Industry Growth Rate:*** industry growth is driven by demographics as mentioned above. This is industry caters to the elderly which is growing incrementally as "The Greatest

Generation" exceeds lifetime expectations and the largest proportion of baby-boomers enter their 70s. The increasing health and wellness awareness and the increase in the number of adults 65 and older (3.6% yearly growth)[2] have translated in a higher than ever demand for both home care and retirement home services. The industry is an alternative to reactionary hospital-based healthcare which is less personal and more expensive from a government funder standpoint.

b) ***The Concentration and Balance of Competitors:*** Extendicare, as well as its rivals, have been growing both organically as well as inorganically through acquisitions. Each of the Big Three has been acquiring retirement homes consistently on a yearly basis. Build and buy strategies have been used in many industries and are of particular interest in this REIT model.

c) ***Degree of Differentiation:*** The Big Three in senior care are moderately differentiated with high switching costs as seniors a) tend to have low mobility and b) are thus low desire to relocate for price.

d) ***Scale/Learning economics and Ratio of Fixed to Variable Costs:*** There are high fixed costs such that Extendicare has a REIT (Real Estate Investment Trust) to raise capital for new acquisitions. These economies of scale allow for better leverage against suppliers for example.

e) ***Excess Capacity and Exit Barriers:*** Extendicare and other providers do have capacity issues usually with roughly a 92% occupancy rate of retirement home rooms. Exit barriers make it such that Extendicare would sooner be acquired than exit the industry. With divest Canadian assets as the opposite of their current vision of acquiring and integrating retirement homes into their portfolio.

## The Threat of New Entrance

This industry has a low threat of new entrants. Without belaboring the details, the Big Three (Chartwells, Sienna, Extendicare) have economies of scale in the building of the retirement home. There are small new entrants, however REITs are capital and time intensive to form. While there are fewer players in the constructions space, new entrants such are condominium developers are staved off through acquisitions *with* the Big Three. Real estate developers prefer to take on the capabilities and regulatory burdens required.

### Threats of Substitution

This industry has a low threat of substitutes in most cases, adult children are often the decision-maker when a senior relocates to a long-term care facility. There are two types of entrants, the physically impaired (less mobile) that needs more regular support and the mentally impaired (dementia conditions) who are a risk to themselves if they were to remain at home. Based on the needs of the elderly, there few alternatives to retirement homes, instead, it is a competition for which retirement home the hospital recommends, for example.

### Supplier Power

This industry has low supplier power with Extendicare moving into catering services for retirement home meals themselves. Backward integration by acquisition is a considerable factor in preventing suppliers from engaging in any rent seeking of their own.

### Buyer Power

This industry has low customer power. Price is not as important as peace of mind for the adult children who can no longer accommodate their loved one(s). Extendicare, Chartwell, and Sienna ensure that the prices and packages of

[2] http://www12.statcan.gc.ca/census-recensement/2016/as-sa/98-200-x/2016004/98-200-x2016004-eng.cfm

sufficiently opaque to ensure customers make an emotional decision with the available information.[3] Adult children often have to make a calculation based on financials, proximity of the home and features.

### Earnings Management Tests

Looking at Extendicare's books, there is minimal evidence of income statements. From 1997 to 1998, revenues increased sharply from $1,647.9 MM to $2,094.0 MM. This naturally increased COGS, interest expenses, and tax expenses. Due to this increase, the earnings before taxes excluding unusual items dropped from $92.4 MM to $46.9 MM. However, Extendicare decided to realize an unusual gain from a sale of assets for $150.9 MM. This increased the net income to $65.3 MM to stay within last year's range of $73.4 MM. After this instance, the net income dropped to -$159.9 MM and there were no efforts to smooth the decline. Beyond that example, there was a steep drop in revenues from 2012 to 2013. However, there were also no attempts to smooth the income by way of unusual items. There was a large influx of income from discontinued operations in 2015 for $208.4 MM which subsequently raised the net income from a loss of $18.8 MM in 2014 to $232.1 MM in 2015. It is clear to see that this is not a smooth increase in income and the earnings from discontinued operations did not persist in future years. Furthermore, this increase in income stemmed from the sale of the US operations, which is clearly outlined in the annual reports. sudden increase/decrease in revenues or other line items to boost or dampen income. The only exception to this is the sale of operations in November of 2014. This lowered revenues by less than half and as a result, the income statements of 2013 and 2014 had to be restated. The CEO's statement implied a renewed focus on the Canadian market as it is considered less volatile considering the public policy debates in US healthcare which, arguably, made operating in the US unsustainable.[4]

### Legal Challenges

Extendicare only recently shifted from being a pure-play in Canada long-term care operator. Prior to the sale of all of the 165 US facilities, Extendicare was a majority American operation with a Markham, Ontario head office posting over $2.1 billion in top-line revenue in 2011. There are several reasons why Extendicare divested their US operations, but primary among them would likely be the US Department of Justice had forced Extendicare to pay $38 million in 2014 for false claim allegations for misbilling as well as providing unnecessary treatments under Medicare.[5] Recognizing a need for a strategic shift well before the legal decision, Extendicare's CEO Tim Lukenda began efforts to divest of the US properties as well as the human capital that would have been responsible for the DOJ filing.


Just this week, late July 2018, Tim Lukenda resigned pending a new CEO to replace him by the end of 2018. While the stock price has declined since the announcement of the $150M lawsuit on May 2nd, 2018 over issues of patient neglect at an Extendicare as well as a Sienna Senior Living at two retirement homes. Extendicare continues to have strong fundamentals.[6] Extendicare's lawyers do not believe the cases have merit. The centrality of

[3] Retirement home, telephone companies think of mobile phone package pricing as a Confusopoly (https://en.wikipedia.org/wiki/Confusopoly)

[4] http://www.mcknights.com/news/extendicare-mulls-sell-off-of-us-operations-amid-decline/article/301394/

[5] https://www.justice.gov/opa/pr/extendicare-health-services-inc-agrees-pay-38-million-settle-false-claims-act-allegations

[6] https://www.ctvnews.ca/health/families-sue-ontario-long-term-care-providers-over-disgusting-neglect-1.3912770

patient care is paramount, in order for a lawsuit to emerge, there has to be have been some communication errors between the victim's families and Extendicare's legal team. This is a highly complex and sensitive topic in an industry that deals with senior's passing away on a regular basis. Further comment might better be service in a blog post.

### Forecasting Background

This forecast uses financial information to project forward over the next five years, based on some key assumptions. In addition to the forecasting component, the company will also be valued based on three valuation methods leading with discounted cash flow as my primary method. The benefits of financial valuation modeling include the fact that I can back my notions with numbers! The results are as follows:

### Summary of DCF & Multiples

Scenarios

| Valuation | Pessimistic | Base | Optimistic |
|---|---|---|---|
| **DCF** | $7.50 | $9.75 | $14.37 |
| | **Low** | **Average** | **High** |
| **P/E Multiple** | $6.78 | $8.55 | $12.50 |
| **P/B Multiple** | $7.00 | $9.00 | $14.50 |
| **Average** | $6.89 | $8.78 | $13.50 |

DCF (see Appendix)

| Year | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| Book Value | 174.759 | 174.14 | 173.47 | 172.77 | 172.06 | 171.32 | 170.57 |
| Net Income | | 32.54 | 35.62 | 36.84 | 37.94 | 38.90 | 39.72 |
| Normal Earnings | | 8.10 | 8.07 | 8.04 | 8.00 | 7.97 | 7.94 |
| Abnormal Earnings | | 24.45 | 27.56 | 28.81 | 29.94 | 30.93 | 31.78 |
| Terminal Value | | | | | | | 1231.27 |
| AE+TV | | 24.45 | 27.56 | 28.81 | 29.94 | 30.93 | 1263.05 |
| ROE | | 19% | 20% | 21% | 22% | 23% | 23% |
| Value | | 1260.60 | | | | | |
| Per Share | | 14.23 | | | | | |
| Projected Market Price | | **9.29** | | | | | |

### Forecasting Indicator Assumption

#### i. Return on assets

The ROA of Extendicare over the past five years has been very volatile due to the frequent addition of earnings and losses from discontinued operations, on top of the decrease in other assets. This has caused the ROA to have a low of -1.00% in 2014 and a high of 15.78% in 2015. Its 2016 ROA was 3.52%, which was higher than its peers Sienna and Chartwell with 2.31% and 1.88%, respectively.

#### ii. Return on equity

The ROE of Extendicare was also greatly affected by the unusual earnings. Extendicare had a low of -107.54% in 2014 and a high of 273.64% in 2015. It is also important to note that Extendicare's equity levels were low throughout the years, and was negative in 2014. It's 2016 ROE was 20.44%, which was significantly higher than its peers Sienna and Chartwell with 1.23% and -0.09%, respectively.

#### iii. Return on capital

Similar to the ROA and ROE, the ROIC of Extendicare was at varying levels. With the addition of its liabilities, which made up most of its capital, the ROIC was brought down to lower levels. In 2016, Extendicare had an ROIC of 5.79%, which was still higher than its peers Sienna and Chartwell with 2.65% and 1.99%, respectively.

### D. Margin Analysis

#### i. Gross margin

Extendicare's gross margin remained in the range of 12% to 13% throughout the last five years, with its 2016 gross margin of 12.27% being the lowest. Despite Extendicare's high reported revenue compared to its peers, its gross margin was significantly lower than its peers Sienna and Chartwell with 19.57% and 35.09%, respectively.

#### ii. EBITDA margin

Extendicare's EBITDA margin also remained at a constant level, which was in the high 8% and low 9% range with the majority of its operating expenses being SG&A. Similar to its gross margin, its EBITDA margin was also lowest in 2016 and significantly lower than its peers Sienna and Chartwell with 15.83% and 29.87%, respectively.

### iii. EBIT margin

Extendicare's EBIT margin also remained at a constant range from high 4% to high 5%. Relative to its peers, Extendicare's 2016 EBIT margin of 5.44% was still lower than its peers, but the gap was slowly closing. Sienna and Chartwell reported an EBIT margin of 7.99% and 10.64%.

### iv. Profit margin

Extendicare's profit margin over the past five years fluctuated due to several adjustments and occasional earnings from discontinued operations. Although profit margin dropped significantly from 2015 to 2016, its 2016 profit margin of 3.34% was now higher than its peers Sienna and Chartwell with 2.27% and 0.63%.

## E. Long-Term Solvency

### i. Interest Coverage

Extendicare's interest coverage ratio is at its highest level in the past five years. This was caused by the increasing EBIT and decreasing levels of long-term debt, which reflected the decline in interest rates. Compared to its peers, Sienna and Chartwell had interest coverage ratios of 1.42 and 1.2, respectively, both lower than Extendicare.

### ii. Total Debt to Equity

Extendicare's total debt to equity is significantly high due to its high level of debt in comparison to its very low levels of equity. As discussed earlier, its equity was negative in 2014. Although Extendicare's 2016 D/E ratio was significantly high, its peers Sienna and Chartwell also had significant high D/E of 251.52% and 219.86%, respectively.

### iii. Long-Term Debt to Equity

Extendicare's long-term debt to equity was also relatively high throughout the five years, except 2014, since the majority of its debt consisted of long-term debt. Similarly, its peers Sienna and Chartwell also had majority long-term debt, which resulted in 2016 D/E of 220.21% and 202.44%, respectively.

### iv. Total Liabilities to Total Assets

Extendicare total liabilities to total assets decreased to a low of 82.32% over the course of the last five years. After the sale of its US operations, it had high liabilities held for sale, as well as high assets held for sale. Starting 2015, Extendicare began acquiring, which increased its total assets. Its liabilities on the other hand saw a decrease in payables, provisions, and other long-term liabilities. Relative to its peers, Extendicare's total liabilities to total assets remained higher than its peers Sienna and Chartwell with 75.07% and 70.50%, respectively.

## F. Summary of Financial Analysis vs. Peers

Looking at the 2016 financial ratios of Extendicare, Sienna Senior Living, and Chartwell Retirement Residences, we see that Extendicare has the highest ratios on almost criteria except for the gross margin, EBITDA margin, and EBIT margin.

## H. Cash Flow Analysis

### i. Net Cash from Operating Activities

Extendicare's net cash from operating activities begins with its net income, which has been fluctuating due to earnings and losses from discontinued operations. The company has experienced several changes throughout the years in its depreciation and amortization due to a huge drop from the sale of its US operations, as well as other gains and losses from impairments and disposals. However, in 2016, Extendicare's depreciation and amortization began increasing again due to acquisitions. The accruals for self-insured liabilities in provisions were decreasing since 2013 and eventually stopped in 2016. Also, in 2016, there was a new line item of share-based compensation.

### ii. Net Cash from Investing Activities

Throughout the five years, Extendicare has been actively purchasing property, equipment, and software. Extendicare also began to actively invest in nursing centers in 2014, which reflects its transition from US operations to mainly Canadian operations. Regarding its sale of US operations, in 2015, Extendicare was able to finalize the sale, which resulted in its recorded proceeds. However, in 2016, there was an additional line item that reported a loss from the sale of its US operations. In addition to sales of assets, Extendicare has been reporting net proceeds from dispositions yearly. Lastly, starting in 2013, Extendicare has been having fluctuations with its investments held for self-insured liabilities and other assets.

### iii. Net Cash from Financing Activities

Extendicare has been having consistent issuance and payment of long-term debt throughout the past five years. Its other source of capital, the issue on the line of credit, stopped after the year 2012, with the final repayment being in 2014. Additionally, the increase in investments for self-insured liabilities also stopped after the year 2012. The restricted cash, which has been connected with the debt policies, show that there has been some flexibility in terms of how much cash should actually be kept out of use. We also see that dividends paid by Extendicare decreased from 2012 to 2014 and remained constant until 2016. An unusual item on the investing activities account would be its one-time purchase of securities for cancellation, which reflects that in 2015 Extendicare had an unusually high amount of outstanding securities.

| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| Sienna FFO | $26,725.00 | $ 37,965.00 | $ 26,233.00 | $24,447.00 | $48,223.00 | $46,879.00 |
| | | 42% | -31% | -7% | 97% | -3% |
| Sienna FFI | -$81,662.00 | -$ 87,367.00 | -$ 162,158.00 | $ 4,023.00 | -$16,102.00 | -$92,546.00 |
| | | -7% | -86% | 102% | -500% | -475% |
| Sienna FFF | $62,240.00 | $ 36,979.00 | $ 142,305.00 | $15,060.00 | -$34,819.00 | $46,522.00 |
| | | -41% | 285% | -89% | -331% | -234% |
| | | | | | | |
| Year | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
| Chartwell FFO | $ 111.00 | $ 97.10 | $ 131.90 | $ 123.40 | $ 115.80 | $ 158.40 |
| | | -12.52% | 35.84% | -6.44% | -6.16% | 36.79% |
| Chartwell FFI | -$ 80.60 | -$ 278.20 | -$ 69.30 | -$ 8.50 | -$ 72.30 | -$ 231.70 |
| | | -245.16% | 75.09% | 87.73% | -750.59% | -220.47% |
| Chartwell FFF | -$ 34.70 | $ 172.30 | -$ 54.50 | -$ 113.40 | -$ 51.90 | $ 100.30 |
| | | 597% | -132% | -108% | 54% | 293% |

## A. Abnormal Earnings Based Valuation

| Year | 2016A | 2017E | 2018E | 2019E | 2020E | 2021E | 2022E |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Book Value | 174.76 | 187.67 | 202.07 | 217.27 | 233.22 | 249.90 | 267.26 |
| Net Income | | 32.54 | 36.32 | 38.32 | 40.23 | 42.06 | 43.77 |
| Normal Earnings | | 8.10 | 8.69 | 9.36 | 10.07 | 10.81 | 11.58 |
| Abnormal Earnings | | 24.45 | 27.63 | 28.96 | 30.17 | 31.25 | 32.19 |
| Terminal Value | | | | | | | 1,247.07 |
| AE+TV | | 24.45 | 27.63 | 28.96 | 30.17 | 31.25 | 1,279.26 |
| ROE | | 18.62% | 19.35% | 18.96% | 18.52% | 18.03% | 17.51% |
| | | | | | | | |
| Value | | 1,273.60 | | | | | |
| | | | | | | | |
| Per Share | | 14.37 | | | | | |

## B. Discussion of Abnormal Earnings valuation

In calculating the abnormal earnings, we first got the unlevered beta for the REIT industry, which was 0.41[7]. We also assumed a risk-free rate of 2.30%[8], which is the yield of a 30-year Canadian bond. The market risk premium of 5.69%[9] was obtained by using the market risk premium of Canada. Using these inputs for the CAPM model, we were able to calculate a cost of equity of 4.63%. For the terminal growth, we assumed it to 2%. Applying all of these factors to the abnormal earnings valuation, we were able to calculate a per share price of $14.23, which is higher than its current share price of $9.44. This implies that the current share price is undervalued.

## AE Valuation Sensitivity Analysis

| | | Growth | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 14.37 | 1.40% | 1.60% | 1.80% | 2.00% | 2.20% | 2.40% | 2.60% |
| | 4.03% | 15.31 | 16.28 | 17.43 | 18.81 | 20.48 | 22.57 | 25.23 |
| | 4.23% | 14.18 | 14.99 | 15.94 | 17.06 | 18.41 | 20.04 | 22.07 |
| | 4.43% | 13.19 | 13.88 | 14.68 | 15.61 | 16.70 | 18.01 | 19.61 |
| rE | 4.63% | 12.33 | 12.92 | 13.60 | 14.37 | 15.28 | 16.35 | 17.62 |
| | 4.83% | 11.57 | 12.08 | 12.66 | 13.32 | 14.07 | 14.96 | 16.00 |
| | 5.03% | 10.90 | 11.34 | 11.83 | 12.40 | 13.04 | 13.78 | 14.64 |
| | 5.23% | 10.29 | 10.68 | 11.11 | 11.59 | 12.14 | 12.76 | 13.48 |

We decided to take a look at the sensitivity levels of Extendicare's cost of equity and growth assumptions. As seen in the sensitivity analysis above, Extendicare's share price is relatively more sensitive to a 0.2% change in the

7 http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html

8 https://ca.investing.com/rates-bonds/canada-30-year-bond-yield

9 http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

cost of equity. Adjusting its growth and cost of equity assumptions by 0.4% will result to Extendicare's price to be in the range of $11.34 and $20.04.

## D. Abnormal Earnings with ROE Mean Reversion

| Year | 2016A | 2017E | 2018E | 2019E | 2020E | 2021E | 2022E |
|---|---|---|---|---|---|---|---|
| Book Value | 174.76 | 187.67 | 202.07 | 217.27 | 233.22 | 249.90 | 254.90 |
| Net Income | | 32.54 | 36.32 | 38.32 | 40.23 | 42.06 | 43.77 |
| Normal Earnings | | 8.10 | 8.69 | 9.36 | 10.07 | 10.81 | 11.58 |
| Abnormal Earnings | | 24.45 | 27.63 | 28.96 | 30.17 | 31.25 | 32.19 |
| Terminal Value | | | | | | | |
| AE+TV | | 24.45 | 27.63 | 28.96 | 30.17 | 31.25 | 32.19 |
| ROE | | 18.62% | 19.35% | 18.96% | 18.52% | 18.03% | 17.51% |
| Value | | 452.25 | | | | | |
| Per Share | | 5.10 | | | | | |

| | ROE Mean Reversion | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Year | 2023E | 2024E | 2025E | 2026E | 2027E | 2028E | 2029E | 2030E | 2031E | 2032E |
| Book Value | 255.73 | 256.50 | 257.21 | 257.86 | 258.44 | 258.97 | 259.43 | 259.83 | 260.16 | |
| Net Income | 41.51 | 38.49 | 35.45 | 32.38 | 29.29 | 26.18 | 23.04 | 19.89 | 16.72 | 13.54 |
| Normal Earnings | 11.81 | 11.85 | 11.88 | 11.92 | 11.95 | 11.97 | 12.00 | 12.02 | 12.04 | 12.05 |
| Abnormal Earnings | 29.70 | 26.65 | 23.57 | 20.47 | 17.35 | 14.20 | 11.04 | 7.87 | 4.68 | 1.49 |
| Terminal Value | | | | | | | | | | 57.66 |
| AE+TV | 29.70 | 26.65 | 23.57 | 20.47 | 17.35 | 14.20 | 11.04 | 7.87 | 4.68 | 59.15 |
| ROE | 16.28% | 15.05% | 13.82% | 12.59% | 11.36% | 10.13% | 8.90% | 7.67% | 6.44% | 5.21% |

Applying the ROE mean reversion to the abnormal earnings valuation gave us a per share price of $5.10, which is lower than the current share price of $9.29. Using the same assumption as the abnormal earnings, the main difference would be that the ROE of Extendicare will be decreasing over time to equal the ROE industry average. The ROE industry average was calculated based on the average LTM ROE of its competitors selected for the multiples valuation. Initially, we got an average ROE of 6.89%. However, we decided to use the average of the Canadian companies only since they better reflect the ROE for Extendicare to revert to. Given that, we used an average ROE of 5.21%. Decreasing its current ROE on a straight-line method for ten years had a drastic change in its value per share. The main reason for the initial higher price that was calculated was due to the significantly higher ROE as compared to its competitors.

## Recommendation

According to the AE valuation of $14.37, my forward 2018E P/AFFO multiples valuation of $9.96, the additional forecasts, and analysis of the current state of the company under the Canadian Pure-Play Model, we have valued the stock as undervalued. Therefore, I recommend a BUY with a target price at $9.55. We believe that Extendicare's current price is undervalued due to its current state, which is still recovering from the sale of its US operations and recent legal difficulties. The minimum wage hike is likely to be reverted in 2019 down from $14.00 under Doug Ford. For the longest time, its US operations was the majority of its revenue stream. Now, with Extendicare planning to focus in the Canadian market, we see some growth opportunities via its expertise as seen in its LTC care, and improving performance in its other business units. However, as a team, we were reminded that any financial valuations are impacted by various confounding future variables. For example, the rate of acquisitions may be under or overplayed and depends on Extendicare CEO Tim Lukenda's successors decision-making in the future. If we were to fully embrace the academic argument that markets are efficient and acknowledge the notion that we have limited predictive power in determining future growth rates, we would conclude that the buy is not appropriate. Unless there are pockets of market inefficiency in which Extendicare directly falls under, I nor anyone else can be certain that our recommendation to buy is appropriate.

| Extendicare | |
|---|---|
| beta unlevered | 0.41 |
| beta | 0.99 |
| rF | 2.30% |
| Shares Outstanding | 88.6 |
| Market Premium | 5.69% |
| rE | 4.63% |
| g | 2% |

Thank you for your interest!

Ping me with questions.

# APPENDIX

## KEY ASSUMPTIONS

| Summary of Base Case Assumptions | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|
| Revenue Growth | 4% | 3.60% | 3.20% | 2.80% |
| Operating cost as % of revenue | 91.18% | 91.05% | 91.18% | 91.18% |
| Return on Equity | 18.62% | 20.46% | 21.24% | 21.96% |
| Interest Expense (lagged debt i.e. CY INT / op. Debt) | -7.15% | -7.15% | -7.15% | -7.15% |
| Tax rate | 27.97% | 27.97% | 27.97% | 27.97% |
| CAPEX as % of Sales | 20% | 20% | 20% | 20% |
| Depreciation as % of Sales | 31.50% | 31.50% | 31.50% | 31.50% |
| Payout Ratio | 101.89% | 101.89% | 101.89% | 101.89% |

| Extendicare | |
|---|---|
| beta unlevered | 0.41 |
| beta | 0.99 |
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| g | 2% |

## Financial Analysis

| Extendicare Inc. (TSX:EXE) | | | | | | | |
|---|---|---|---|---|---|---|---|
| Financial Ratios | | | | | | | |
| | | | | | | Sienna TSX:SIA | Chartwell TSX:CSH.UN |
| | **2012A** | **2013A** | **2014A** | **2015A** | **2016A** | **2016A** | **2016A** |
| **Liquidity Ratios** | | | | | | | |
| Current Ratio | 0.95 | 0.92 | 1.04 | 0.97 | 0.88 | 0.29 | 0.25 |
| Quick Ratio | 0.79 | 0.73 | 0.06 | 0.72 | 0.75 | 0.28 | 0.2 |
| Days Inventory | NA | NA | NA | NA | NA | NA | NA |
| Days Accounts Receivable | 38.82 | 97.86 | 55.36 | 17.31 | 18.05 | 5.69 | 6.35 |
| Days Payable | 7.99 | 123.98 | 56.14 | 61.97 | 47.78 | 59.29 | 65.69 |
| | | | | | | | |
| **Asset Turnover** | | | | | | | |
| Fixed Asset Turnover | 1.72 | 0.67 | 1.10 | 2.49 | 2.38 | 0.74 | 0.31 |
| Total Asset Turnover | 1.13 | 0.43 | 0.43 | 0.64 | 1.05 | 0.46 | 0.28 |
| Accounts Receivable Turnover | 9.43 | 3.73 | 6.59 | 21.09 | 20.22 | 64.28 | 57.59 |
| Inventory Turnover | NA | NA | NA | NA | NA | NA | NA |
| | | | | | | | |
| **Profitability** | | | | | | | |
| Return on Assets | 3.66% | 0.29% | -1.00% | 15.78% | 3.52% | 2.31% | 1.88% |
| Return on Equity | 53.65% | 11.48% | -107.54% | 273.64% | 20.44% | 1.23% | -0.09% |
| Return on Capital | 0.52% | 0.49% | -2.49% | 44.14% | 5.79% | 2.65% | 1.99% |
| | | | | | | | |
| **Margin Analysis** | | | | | | | |
| Gross Margin | 12.63% | 13.54% | 13.24% | 12.70% | 12.27% | 19.57% | 35.09% |
| EBITDA Margin | 8.99% | 8.87% | 9.15% | 8.87% | 8.76% | 15.83% | 29.87% |
| EBIT Margin | 4.84% | 5.86% | 5.83% | 5.65% | 5.44% | 7.99% | 10.64% |
| Profit Margin | 3.08% | 0.67% | -2.30% | 24.60% | 3.34% | 2.27% | 0.63% |
| | | | | | | | |
| **Long Term Solvency** | | | | | | | |
| Interest Coverage | 1.51 | 1.33 | 1.45 | 1.72 | 2.14 | 1.42 | 1.2 |
| Total Debt/Equity | 2071.41% | 3116.28% | -18850.96% | 263.80% | 288.15% | 251.52% | 219.86% |
| LT Debt/Equity | 1900.45% | 2720.20% | -18099.04% | 249.05% | 256.78% | 220.21% | 202.44% |
| Total Liabilities/Total Assets | 96.98% | 97.98% | 100.13% | 83.24% | 82.32% | 75.07% | 70.50% |
| | | | | | | | |
| | | | | | | | |
| **Altman Z-Score** | | | | | | | |
| EBIT/Total Assets | 0.05 | 0.02 | 0.02 | 0.05 | 0.06 | 0.03 | 0.03 |
| Retained Earnings/Total Assets | (0.22) | (0.24) | (0.26) | (0.31) | (0.33) | (0.18) | 0 |
| Working Capital/Total Assets | (0.01) | (0.02) | 0.02 | (0.01) | (0.02) | (0.10) | -0.05 |
| MV of Equity/BV of Liabilities | 0.38 | 0.33 | 0.30 | 0.99 | 1.08 | 1.10 | 1.50 |
| Sales/Total Assets | 1.13 | 0.42 | 0.43 | 0.92 | 1.07 | 0.41 | 0.27 |
| Z | 1.21 | 0.35 | 0.35 | 1.25 | 1.42 | 0.80 | 1.21 |
| Bankruptcy Prediction | Bankrupt Likely | Bankrupt Likely | Bankrupt Likely | Bankrupt Likely | Bankrupt Likely | Bankrupt Likely | Bankrupt Likely |
| | | | | | | | |
| Market Capitalization | 660.20 | 600.84 | 582.24 | 847.27 | 875.37 | | |
| Share Price | 7.65 | 6.82 | 6.52 | 9.65 | 9.88 | | |
| | | | | | | | |
| | | | | | | | |
| Earnings | $ 62.66 | $ 5.28 | -$ 18.75 | $ 232.08 | $ 35.45 | | |
| Shares Outstanding | 86.30 | 88.10 | 89.30 | 87.80 | 88.60 | | |
| EPS | $ 0.73 | $ 0.06 | -$ 4.76 | $ 0.38 | $ 2.50 | | |

## Extendicare's Net Earnings v Operating Cash Flows

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 Q1 | 2017 Q2 | 2017 Q3 |
|---|---|---|---|---|---|---|---|---|---|
| Net Earnings | -30,396 | 62,656 | 5,283 | -18,753 | 232,078 | 35,452 | 4,947 | -22,994 | 6,545 |
| Operating Cash Flows | 106,779 | 108,787 | 97,916 | 85,607 | 52,798 | -281 | 11,314 | 7,488 | 16,767 |
| **Difference** | **-137,175** | **-46,131** | **-92,633** | **-104,360** | **179,280** | **35,733** | **-6,367** | **-30,482** | **-10,222** |

The difference between net earnings and operating cash flows exhibits a growing trend from 2011 to 2016. This may be a sign of deteriorating accruals.

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017* |
|---|---|---|---|---|---|---|---|
| **Revenue** | 2094.1 | 2037.4 | 783.8 | 816.1 | 943.3 | 1060.8 | 1092.8 |
| | | -2.71% | -61.53% | 4.12% | 15.59% | 12.46% | 3.02% |
| **Depreciation** | 76.6 | 76.8 | 21.6 | 23.8 | 23.7 | 31.2 | 31.7 |
| | | 0.26% | -71.88% | 10.19% | -0.42% | 31.65% | 1.60% |
| **Net Income** | -30.4 | 62.7 | 5.3 | -18.8 | 232.1 | 35.5 | 13.1 |
| | | -306.25% | -91.55% | -454.72% | -1334.57% | -84.70% | -63.10% |

***LTM from Sept 2016**

From the above exhibit, we can see that the depreciation is proportional to the revenue. Furthermore, if we examine the negative net income in 2014, we can see that Extendicare did not alter the depreciation value to boost the net income.

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| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017* |
|---|---|---|---|---|---|---|---|
| **Revenue** | 2094.1 | 2037.4 | 783.8 | 816.1 | 943.3 | 1060.8 | 1092.8 |
| | | -2.71% | -61.53% | 4.12% | 15.59% | 12.46% | 3.02% |
| **Account Payables** | 42.2 | 35.5 | 31 | 106.4 | 137 | 118.8 | 126.7 |
| **Days Payables** | **7.36** | **6.36** | **14.44** | **47.59** | **53.01** | **40.88** | **42.32** |

***LTM from Sept 2016**

## Key Ratios

Analyzing the aging of trade receivables, we find that due to the sale of US operations, accounts receivables of $173 MM were reclassified to assets held for sale during 2014. After this reclassification, the mix of account receivables varies, making Current A/R higher than before the transaction.

| **Account Receivables Aging Distribution** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** |
|---|---|---|---|---|---|---|
| Current | 59% | 61% | 57% | 71% | 74% | 78% |
| 30-90 | 32% | 30% | 34% | 20% | 18% | 17% |
| 90-365 | 14% | 16% | 14% | 11% | 12% | 7% |
| Over 365 | 4% | 5% | 6% | 4% | 2% | 2% |
| Less: Provision for receivable impairment | -9% | -11% | -12% | -6% | -6% | -4% |
| **Total** | **100%** | **100%** | **100%** | **100%** | **100%** | **100%** |

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Leverage Ratios** | | | | | | |
| Debt | 1,134.4 | 1,132.2 | 1,164.8 | 472.0 | 454.1 | 503.6 |
| Equity | 48.3 | 54.7 | 37.4 | -2.5 | 172.1 | 174.8 |
| **Debt-to-equity** | **23.5** | **20.7** | **31.2** | **-188.8** | **2.6** | **2.9** |
| **Interest Coverage** | **1.4** | **1.6** | **1.4** | **1.5** | **1.9** | **2.4** |

## Consolidated Balance Sheet

| | 2012A | 2013A | 2014A | 2015A | 2016A |
|---|---|---|---|---|---|
| **Revenue** | 2,037.41 | 783.81 | 816.12 | 943.28 | 1,060.76 |
| COGS | (1,780.02) | (677.71) | (708.10) | (823.49) | (930.62) |
| **Gross Profit** | 257.39 | 106.10 | 108.02 | 119.79 | 130.14 |
| **Other Operating Expenses** | | | | | |
| SG&A | (63.16) | (31.38) | (28.29) | (30.14) | (30.55) |
| Lease | (10.99) | (5.16) | (5.06) | (5.96) | (6.65) |
| **Total Other Operating Expenses** | (74.14) | (36.54) | (33.36) | (36.10) | (37.20) |
| **EBITDA** | 183.25 | 69.55 | 74.67 | 83.69 | 92.94 |
| D&A | (76.81) | (21.64) | (23.84) | (23.67) | (31.18) |
| Loss from asset impairment and other items | (7.93) | (1.96) | (3.25) | (6.71) | (4.01) |
| **EBIT** | 98.52 | 45.95 | 47.57 | 53.32 | 57.74 |
| **Interest Accounts** | | | | | |
| Interest expense | (65.31) | (34.50) | (32.91) | (31.09) | (27.04) |
| Accretion of decommissiong provisions | (1.69) | (0.35) | (0.35) | (0.35) | (0.35) |
| Other accretion | (0.61) | (1.56) | (1.83) | (2.13) | (2.15) |
| Loss on foreign exchange and financial instruments | (1.10) | (0.52) | - | 9.74 | (1.20) |
| **Total Finance Costs** | (68.71) | (36.93) | (35.08) | (23.83) | (30.74) |
| Interest revenue | 3.57 | 4.17 | 3.84 | 8.06 | 10.84 |
| Fair value adjustments | 4.82 | 3.10 | 0.30 | - | 0.99 |
| **Total Finance Income** | 8.39 | 7.27 | 4.13 | 8.06 | 11.82 |
| **EBT** | 38.20 | 16.30 | 16.62 | 37.55 | 38.83 |
| Income tax | (10.57) | (6.13) | (5.55) | (13.84) | (7.41) |
| **Earnings from continuing operations** | 27.62 | 10.17 | 11.07 | 23.71 | 31.42 |
| **Gain (loss) on sale of U.S. operations** | - | - | - | 205.42 | (8.46) |
| **Earnings from discontinued operations** | 35.03 | (4.88) | (29.82) | 2.95 | 12.49 |
| **Net Income** | 62.66 | 5.28 | (18.75) | 232.08 | 35.45 |

## Consolidated Income Statement

| **Condensed Income Statement** | | | | | |
|---|---|---|---|---|---|
| Revenues | 2,037.41 | 783.81 | 816.12 | 943.28 | 1,060.76 |
| Operating Expenses | (1,854.16) | (714.26) | (741.45) | (859.59) | (967.82) |
| Non-Operating Income/(Loss) | (68.42) | (14.37) | (19.71) | (15.61) | (19.36) |
| Restructuring Costs | (7.93) | (1.96) | (3.25) | (6.71) | (4.01) |
| Interest Expense | (68.71) | (36.93) | (35.08) | (23.83) | (30.74) |
| Income pre tax | 38.19 | 16.30 | 16.62 | 37.55 | 38.83 |
| Tax | (10.57) | (6.13) | (5.55) | (13.84) | (7.41) |
| Gain (loss) on sale of U.S. operations | - | - | - | 205.42 | (8.46) |
| Income from Discontinued Operations | 35.03 | (4.88) | (29.82) | 2.95 | 12.49 |
| Net Income | 62.66 | 5.28 | (18.75) | 232.08 | 35.45 |