

Curanum AG

A Turnaround Candidate in a Growth Industry

August 2012

## Executive Summary

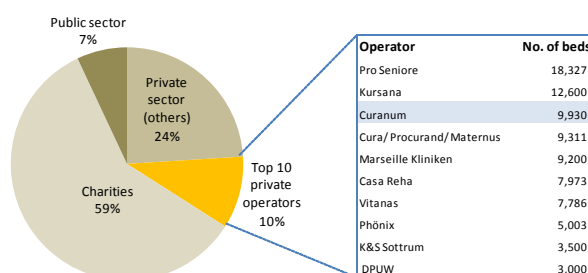
Curanum AG is part of the inpatient care industry for senior citizens in Germany. At first glance the industry looks very attractive. Due to demographics the number of care-dependent people will constantly increase over the next decades. However, the industry is also facing some significant obstacles like overcapacity, cost pressure and limited pricing power. Curanum is one of the larger market players in a highly fragmented industry. After relatively strong growth over the last decade the expansion path seems to have lost momentum as margins are under pressure and financial flexibility is limited.

The following table provides an overview of Curanum's key figures:

Market Cap in EUR mn	61.3	P/E Trailing	n/a	P/B	1.3x
P/S	0.2x	EV/EBITDA	8.2x	Debt/Assets	0.8x
ROE	n/a	ROC	4.1%	ROA	3.4%

## Forces in the Inpatient care industry

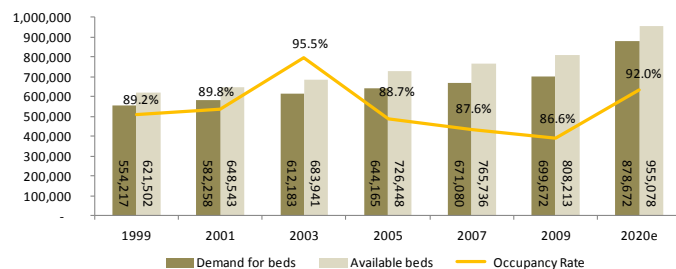
Curanum is a provider of 77 nursery homes with 7,870 care beds and 2,060 serviced apartments for senior citizens in Germany. The sector is split up between charities (59 % of the market), the public sector (7%) and the private sector (34%). Whereas the public companies and charities mostly provide basic services to their patients, most of the private sector companies are currently trying to create a brand and to differentiate their products by providing additional services. The private sector rapidly consolidated over the past decade. Nevertheless, the market remains highly fragmented with the top ten private competitors controlling below 10% of the whole industry and about 29% of the private market segment (In France the largest ten competitors control 66% of the private market segment).



Due to demographics demand for inpatient care in Germany is constantly increasing. Demand for beds is expected to rise by 3% p.a. until 2020. Thereafter, the so called "baby boomer" generation will approach their 80's and this will actually accelerate industry growth beyond 3% p.a. There are other factors which are positively affecting demand for inpatient care. First, the number of people who suffer from dementia is on the rise. Outpatient care which makes up the main competitor for the industry is not an appropriate substitute in this case. To the contrary, dementia and comparable diseases require an intense treatment which can only be provided by inpatient care. Second, the share of women in the German workforce increased steadily over the last decades. In addition, many people do not stay in their hometown and mobility on the job is still increasing. As a consequence there are not enough women (and men) as it used to be the case to care for their parents when they are suddenly dependent on care. Hence, I expect the share of outpatient care to continuously decline in the upcoming years. The inpatient care sector will be the main beneficiary from this trend. However, this development might be decelerated by regulation focusing on the outpatients before inpatients concept due to the financially strained situation of care insurance providers.

As the demand situation is a positive, supply is a major cause for insufficient levels of profitability in the industry. There was substantial overinvestment in new facilities until the outbreak of the financial crisis. This led to a dramatic decline in industry wide occupancy rates from a peak of 96% in 2003 to a

low in 2009 of 86%. While such occupancy rates may look great at first glance one has to keep in mind that due to high levels of operating leverage and regulated care rates, occupancy rates below 90% are not sustainable over the long term in this industry. However, the current oversupply is expected to be reduced in the upcoming years due to the following reasons. First, 30% of nursery homes are older than 25 years and do not comply with regulatory requirements any more. As a consequence, about 2% of the existing stock needs to be replaced each year until 2020. Many of the old facilities will be shut down as investments in these facilities will not earn their cost of capital. Second, a large number of competitors are struggling due to small size, inefficient management and high debt/equity ratios. Hence, current default rates stand at 1.5% or 175 care facilities p.a. Third, the public sector is expected to leave the market. Most of their facilities might be shut down due to low profitability. The chart below provides an overview of the demand/supply situation and the expected development until 2020.



If you listen to any conference call or management interaction with analysts, everyone is very concerned about what regulation means for the inpatient care industry. During the last couple of years very strict regulatory requirements have been implemented which can hardly be handled not only by small market participants, but also by the larger players like Curanum. One of the major issues here is the requirement of a minimum single room rate of 80% in North-Rhine Westphalia and even 100% in Baden-Wuerttemberg until 2018. It is important to note that there is no federal regulation authority which further complicates matters. Most of the other German states are still in the process of finalizing their laws in this regard. However, Curanum's CEO has already indicated that these minimum single room rates will not be achieved by most of the industry members.

In addition, the industry faces limited pricing power due to the fact that providers of nursing facilities have to negotiate daily tariffs directly with the care insurers and the federal states. To enforce price increases providers need to present their cost structure to the authorities and need to justify that their cost structure is appropriate from an economic perspective. Nevertheless, care insurers have been reluctant to increase their payments to the daily tariffs due to their tight financial situation. Hence, daily tariffs have been mostly flat over the last couple of years and there is no indication that this will change in the near future.

As revenue suffers from low occupancy rates and stable tariffs the industry is currently facing tremendous cost pressure. The implementation of minimum wages and a lack of examined nurses put pressure on margins. Surging energy and food prices cannot easily be passed to the customers. In addition, many competitors have to bear high capital expenditures as old nursing facilities do not comply with regulatory requirements any more.

Overall, the high fragmentation in the industry sharpens the competition between the market participants. Over the medium term margins might be supported by reduced supply and constantly increasing demand leading to acceptable occupancy rates. Over the long term while increasing demand will further relax the supply/demand situation, industry profitability will stay suppressed by high regulation and limited pricing power while the cost level is expected to increase further.

### Curanum's profitability during the last decade

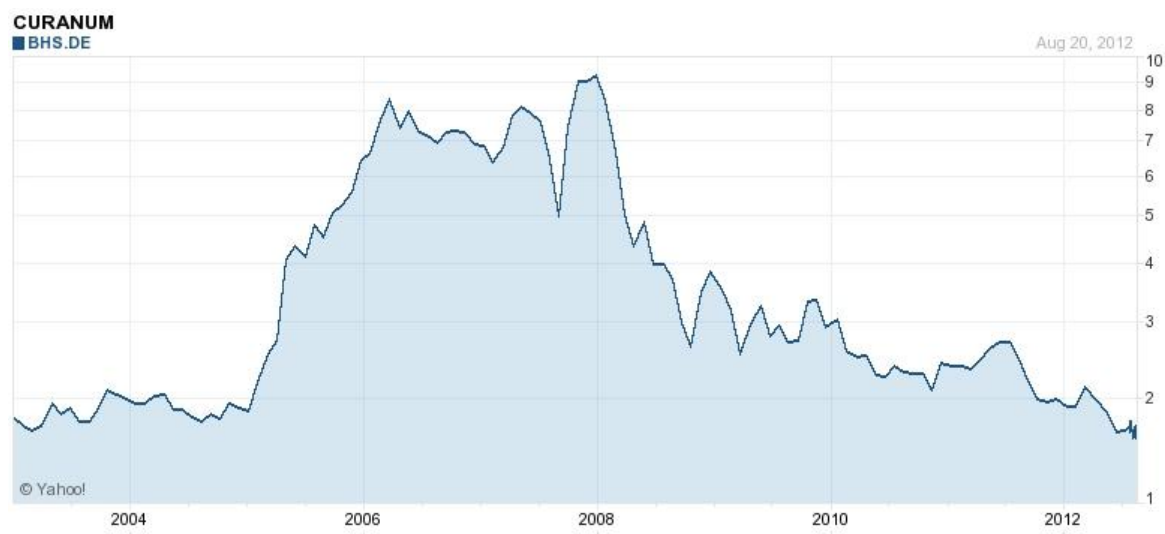
Curanum is the third largest private operator of nursing facilities in Germany. During the last decade the management has focused on revenue growth and on increasing its market share. Curanum was one of the driving forces of the consolidation process in the private sector of the inpatient care

industry. The company used acquisitions of smaller competitors to strengthen their existing clusters of nursery homes. In addition, together with financiers they developed new facilities. This form of expansion requires low levels of capital as real estate is held and financed by third parties. From the table below you can see how profitability has developed since 2002:

Year	Revenue	EBITDA	EBITDA Margin	EBIT	EBIT Margin	Net Income	Net Margin	ROE	ROC
2002	164.0	10.6	6.5%	8.4	5.1%	3.4	2.1%	13.4%	15.2%
2003	170.2	12.2	7.1%	9.4	5.5%	3.6	2.1%	14.7%	16.3%
2004	183.7	23.3	12.7%	16.7	9.1%	5.0	2.7%	17.6%	13.0%
2005	188.5	24.5	13.0%	19.2	10.2%	6.6	3.5%	20.3%	9.3%
2006	215.7	29.5	13.7%	22.8	10.6%	9.3	4.3%	26.8%	9.0%
2007	230.1	29.8	13.0%	21.3	9.2%	4.2	1.8%	8.0%	6.7%
2008	257.1	28.6	11.1%	19.7	7.7%	7.0	2.7%	10.9%	5.9%
2009	253.1	27.3	10.8%	18.3	7.2%	5.9	2.3%	9.8%	5.5%
2010	256.8	23.8	9.3%	14.3	5.6%	(17.4)	n/a	n/a	4.3%
2011	265.9	24.5	9.2%	14.2	5.3%	(12.9)	n/a	n/a	4.1%

The cumulative average growth rate of revenue has been 3% p.a. since 2002. The same applies for operating expenses increasing by 3% p.a. since 2002. As a consequence, operating margins declined from their peak at 10.6% in 2006 to only 5.3% in 2011. Hence, more volume does not create more scale in expenses and margins do not expand.

Curanum's operative performance is clearly reflected in its share price:



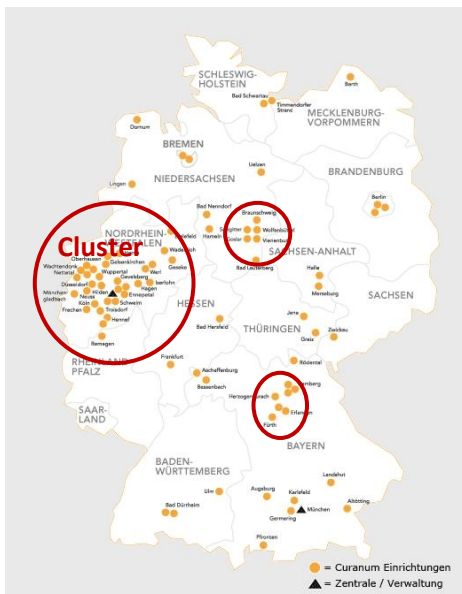
### Reasons for declining profitability

As most of its competitors Curanum is suffering from weak occupancy rates currently standing at 87%. Apart from that, ramp up costs for new developments and costs for the integration of acquisitions depress margins. In addition, the expansion into the business field of serviced apartments for elder people which now makes up about 12% of revenue has not delivered a positive contribution yet as free cash flow in this segment remains negative.

Another major reason leading to lower margins is cost pressure coming from increasing personnel expenses. There is a substantial lack of examined nurses and Curanum needs to employ relative expensive extra-temporary help to cover the shortfalls. Curanum has already tried to cover the

shortfalls with nurses from Eastern Europe, but based on the CEO's comments acceptance by many patients is low and the language barrier prevents an efficient working environment between colleagues. However, there would be an obvious solution: Almost one third of the personnel working in Curanum's nursing facilities have no or an unrelated degree. Hence, there is huge potential for advanced training. However, wage differences between high qualified personnel like examined nurses and lower qualified personnel are small. As a consequence, low qualified personnel are currently not incentivized to receive advanced training. Given a minimum wage for low qualified personnel, Curanum can only increase the income level of examined nurses to incentivize the low qualified personnel to make use of advanced training. Although this could solve the structural problem Curanum is facing, it would have again a negative effect on margins at least in the short term.

Almost all of the company's facilities are owned by third party investors. Therefore, Curanum can focus on its core business without having any direct exposure to real estate. However, about 26% of revenue is spent for ordinary leases and capital/operating leases. As it is difficult to compare that number to other competitor's lease expenses, it seems to be rather high. Using a rough calculation I can estimate the implied value of the nursing facilities operated by Curanum. Given that the companies total lease expenses (including interest expenses and depreciation for capital leases) are about EUR 70 m and using an operating expense ratio of 10%, net operating income (NOI) generated by the whole portfolio is about EUR 63 m per annum. To value the portfolio I am using a conservative capitalization rate of 8% leading to a market value of EUR 788 m ( $\text{EUR } 63 \text{ m} / 8\%$ ). This implies an average valuation of EUR 80,000 per bed which I think is ambitious. Why is the rental level so high? Demand for comparable assets seems to be relatively low at the moment, so Curanum has to offer higher rents to find interested buyers for their facilities. However, most of the leases were signed before the financial crisis. As already outlined at that time the industry received substantial amounts of capital from investors which consequently should have led to lower rent levels and high bargaining power for Curanum. While I cannot figure out why Curanum has to pay such high rents, it is definitely a negative aspect in the assessment of the company.



As increasing costs levels cannot be associated with rising prices given the strict regulation mentioned above, the management tries desperately to control expenses. The implementation of a so called cluster strategy plays a major role in this regard. The map on the left hand-side provides an overview of the location of Curanum's facilities and its clusters. Curanum's largest cluster of nursing facilities is in North-Rhine Westphalia. Within these clusters secondary services like laundry, food supply, medical care, purchasing, marketing and branding can be centralized and synergies can be created. In addition, staff can be allocated more easily to facilities with high occupancy rates. Generally, nursery homes with 100-200 beds show best profitability. As only 50% of Curanum's facilities have more than 100 beds, clusters mitigate the negative effect on profitability of small size nursery homes.

## Curanum's financial position

After analyzing Curanum's profit generation capability I have a brief look at Curanum's balance sheet and its financial position. Tangible book value is actually negative at EUR -15.7 m due to high goodwill of EUR 57.4 m and other intangibles of EUR 5.2 m compared to total book value of EUR 46.9 m. In addition, the company is highly leveraged with net debt of EUR 165.3 m leading to an enterprise value of EUR 226.6 m (excl. operating leases). The development of short term liquidity and long term

solvency ratios from 2007 to 2011 which are presented in the following table makes clear that Curanum's financial flexibility has deteriorated over that period and that it is not in good shape<sup>1</sup>:

Year	2007	2008	2009	2010	2011
Current Ratio	1.5x	0.8x	0.6x	0.4x	0.5x
Quick Ratio	1.1x	0.6x	0.4x	0.3x	0.4x
Total Liabilities excl. Operating Leases/Total Assets	73.2%	73.0%	72.0%	79.2%	83.1%
EBIT / Interest Exp.	2.7x	2.2x	2.0x	1.5x	1.3x
EBITDA / Interest Exp.	3.8x	3.2x	3.0x	2.4x	2.2x
(EBITDA-CAPEX) / Interest Exp.	2.8x	2.8x	2.6x	1.8x	1.5x
Total Debt excl. Operating Leases/EBITDA	4.9x	5.1x	5.3x	6.5x	7.6x
Total Debt excl. Operating Leases/(EBITDA-CAPEX)	6.7x	5.9x	6.2x	9.0x	11.1x

## Valuation

There are several ways to approach valuation. There is one "pure play" German competitor, Marseille Kliniken AG. As Marseille and Curanum are using a lot of off-balance sheet financing it makes sense to include operating lease liabilities in the enterprise value computation to ensure comparability.

Concerning Curanum when I add the present value of the operating leases which are not included in the balance sheet but are part of the company's liabilities, net debt increases from EUR 165.3 m to EUR 597.0 m leading to an adjusted enterprise value of EUR 658.3 m. From this perspective, I treat the expenses for operating leases of EUR 54.0 m in 2011 as interest payments. Hence, operating lease payments have to be added back to EBITDA. Adjusted EBITDA for 2011 is now EUR 78.5 m (24.5+54.0) leading to an adjusted EV/EBITDA of 8.4. I am using the same approach for Marseille. Their comps look as follows:

Company	P/S	P/B	Adj. EV / Adj. EBITDA	Adj. EV / Bed
Curanum AG	0.2x	1.3x	8.4x	EUR 0.07 m
Marseille Kliniken AG	0.2x	0.9x	8.2x	EUR 0.05 m

Marseille is in a comparable situation like Curanum suffering from declining margins and high leverage. From the numbers above there is no significant over- or undervaluation observable.

Let's have a look at the company's cash flow generation. Due to the complex capital structure and the mixed use of operating leases and finance leases it makes sense to compute free cash flow to equity as this numbers includes all cash flows which are part of operating leasing costs (i.e. depreciation, interest expenses, lease expenses). The numbers are quite interesting:

(in EUR millions)						
Year	2006	2007	2008	2009	2010	2011
EBIT*(1-t) <sup>1</sup>	14.23	13.28	12.34	11.46	8.95	8.86
Interest Expense*(1-t) <sup>1</sup>	-4.19	-4.86	-5.61	-5.61	-6.12	-7.05
Depreciation	6.77	8.56	9.55	9.63	10.16	11.08
Capex	-17.14	-8.06	-3.96	-4.03	-6.53	-7.76
Change in NWC	<u>-1.53</u>	<u>-13.28</u>	<u>5.81</u>	<u>-1.18</u>	<u>8.41</u>	<u>9.93</u>
<b>FCFE</b>	<b>-1.86</b>	<b>-4.36</b>	<b>18.14</b>	<b>10.27</b>	<b>14.87</b>	<b>15.06</b>

1) Assumed tax rate of 37.5%.

<sup>1</sup> Curanum has to refinance EUR 27.3 m of senior debt until December 2012. Though the management is optimistic to achieve that, the uncertainty weighs on the current stock price.

Over a six year period **the average FCFE is EUR 8.7 m**. Until 2007 Capex was higher or in line with depreciation. Afterwards, the management reduced investment activity, which had a positive effect on FCFE. However, over the long run this will not be sustainable. Alternatively, I can assume that capex and depreciation compensate for each other. Hence, excluding capex and depreciation provides me with the following free cash flow numbers:

(in EUR millions)						
Year	2006	2007	2008	2009	2010	2011
EBIT*(1-t) <sup>1</sup>	14.23	13.28	12.34	11.46	8.95	8.86
Interest Expense*(1-t) <sup>1</sup>	-4.19	-4.86	-5.61	-5.61	-6.12	-7.05
Change in NWC	<u>-1.53</u>	<u>-13.28</u>	<u>5.81</u>	<u>-1.18</u>	<u>8.41</u>	<u>9.93</u>
<b>FCFE</b>	<b>8.51</b>	<b>-4.86</b>	<b>12.55</b>	<b>4.67</b>	<b>11.24</b>	<b>11.74</b>

1) Assumed tax rate of 37.5%.

Over a six year period the **adjusted average FCFE is EUR 7.3 m**. Due to the highly competitive environment in the industry and limited economies of scale I assume a growth rate of zero. As Curanum is highly leveraged I assume a discount rate between 12%-15% which shall reflect the company's relatively high risk of default. This leads to the following valuation matrix from an equity's holder perspective:

(in EUR millions)		
	Average FCFE	Adj average FCFE
12% Discount	72.5	60.8
15% Discount	58.0	48.7

Based on this valuation the intrinsic equity value is somewhere between EUR 49 m and EUR 73 m or between EUR 1.3 and EUR 1.9 per share. Given a current market cap of EUR 61 m and a current share price of EUR 1.6 the stock seems to be fairly valued from a FCFE perspective. Nevertheless, investing in the stock does not provide any margin of safety.

## Conclusion

As overcapacity is expected to be reduced in the upcoming years I expect occupancy rates to recover from their current lows. As this will give Curanum some time to breathe, the management will have to make additional investments in their facilities to be able to comply with regulatory requirements. From my perspective there is not much room for additional acquisitions for the following reasons. First, the company is highly leveraged. Second, the company just increased its number of outstanding shares by almost 20%. Hence, demand from equity holders should be satisfied at the moment and banks are currently reluctant to even refinance existing debt. Given the high cost pressure and limited pricing power a further decline in margins within the next years is highly likely from my perspective. The company is currently generating healthy cash flows, though capex seems to be too low, which will negatively affect cash flow generation in the future. Most of this is reflected in the current share price, so I do not think that Curanum is a prime short candidate. To the contrary, given the current downside trend in the stock price, the stock seems to be ready for a rebound. A short term catalyst could be a successful refinancing of the maturing debt facility. However, from a long term investor perspective I do not think that the company does offer an attractive risk/return profile.