

Summerset Group

No Sunset at Summerset

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OUTPERFORM

We have lowered our near-term earnings and our target price for SUM based on an operating scenario that assumes very little sales activity over the next six months, followed by a slow but steady recovery in operating levels over the next 18–24 months. Although near-term uncertainties remain, including investor sentiment towards the sector given the COVID-19 outbreak and how long it will be until residential sales transact, sector share prices are back substantially and already factor in a highly negative outlook. We remain confident of the long term business model for SUM. OUTPERFORM.

NZX Code	SUM	Financials: Dec/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$5.40	NPAT* (NZ\$m)	106.2	40.2	61.2	133.6	EV/EBITDA	13.4	28.0	21.2	11.6
Target price	NZ\$7.20	EPS* (NZc)	47.1	17.8	27.1	59.2	EV/EBIT	14.2	31.9	23.4	12.3
Risk rating	High	EPS growth* (%)	7.1	-62.1	52.1	n/a	PE	11.5	30.3	19.9	9.1
Issued shares	225.8m	DPS (NZc)	14.1	5.3	8.1	17.8	Price / NTA	1.1	1.1	1.0	1.0
Market cap	NZ\$1,219m	Imputation (%)	0	0	0	0	Cash div yld (%)	2.6	1.0	1.5	3.3
Avg daily turnover	369.6k (NZ\$2,348k)	*Based on normalised profits					Gross div yld (%)	2.6	1.0	1.5	3.3

Sizable de-rating for the sector

As is the case with all the major retirement and aged care operators, SUM is in a strong position in terms of locking down villages, protecting and quarantining residents, while also safely providing essential services to residents and a sense of community during the crisis. This should be helpful for sentiment towards the sector once things normalise. While the aged care and retirement sector share prices are down significantly year to date following the uncertainties around the COVID-19 outbreak, SUM included, they all had very strong share price performance late in CY19 and most are now back trading where they were around nine months ago.

Retain OUTPERFORM rating

The near term is very uncertain in terms of sales activity and hence the crystallising of cash deferred management fees, and from an earnings perspective from the actual level of realised gains on new sales and resales. The market is likely to remain volatile, however, we are confident with regard to the financial strength and business model of SUM once operating conditions normalise. We consider the current share price to have significant negativity priced in.

A risk factor for operators has been a near-term oversupply of retirement village units. This is no longer going to be the case and we expect unlisted operators will take considerably longer to re-launch development activity on the other side of this crisis. We also expect that we will now have an even larger shortage of good quality aged care beds, which were only getting built by the large integrated operators given the low returns on new direct aged care investment. Going into this crisis, good quality facilities were already essentially full and the demographics are not changing with a sharply increasing number of people aged in their mid 80s starting to occur. This plays into the hands of the integrated operators with a strong care brand.

While an FY21 PE of ~20x does not look like a bargain, we expect strong EPS growth in FY21 as the earnings recover. At the moment SUM is trading close to the NTA of NZ\$5.02 at P/NTA of 1.1x and while there is downside risk to the NTA we do not expect a large correction given SUM will still deliver some new stock in 1H20. The discount rates used by valuers are relatively large and interest rates have dropped, but we expect some increased conservatism around house price growth assumptions near term. At current pricing SUM is getting little credit for its development and operational track record since listing and its large pipeline of future projects in NZ and Australia. We retain our OUTPERFORM rating.

Summerset Group Holdings (SUM)

Priced as at 01 Apr 2020 (NZ\$)						5.40									
12-month target price (NZ\$)*						7.20	Spot valuations (NZ\$)								
Expected share price return						33.3%	1. DCF					6.70			
Net dividend yield						1.2%	2. n/a					n/a			
Estimated 12-month return						34.5%	3. n/a					n/a			
Key WACC assumptions						DCF valuation summary (NZ\$m)									
Risk free rate						2.00%	Total firm value					2,110			
Equity beta						0.88	(Net debt)/cash					(576)			
WACC						7.7%	Less: Capitalised operating leases					0			
Terminal growth						1.5%	Value of equity					1,534			
Profit and Loss Account (NZ\$m)						Valuation Ratios									
Sales revenue	2018A	2019A	2020E	2021E	2022E	2018A	2019A	2020E	2021E	2022E					
Normalised EBITDA	229.5	251.9	210.7	252.3	344.4	EV/EBITDA (x)	13.8	13.4	28.0	21.2	11.6				
Depreciation and amortisation	117.0	129.5	65.3	88.0	160.4	EV/EBIT (x)	14.6	14.2	31.9	23.4	12.3				
Normalised EBIT	(6.7)	(7.8)	(7.9)	(8.3)	(9.1)	PE (x)	12.3	11.5	30.3	19.9	9.1				
Net interest	110.4	121.7	57.4	79.7	151.4	Price/NTA (x)	1.3	1.1	1.1	1.0	1.0				
Associate income	(11.6)	(15.4)	(17.2)	(18.5)	(17.8)	Free cash flow yield (%)	-7.1	-8.5	-4.7	3.4	8.2				
Tax	0	0	0	0	0	Net dividend yield (%)	2.4	2.6	1.0	1.5	3.3				
Minority interests	(1.7)	1.6	0	0	0	Gross dividend yield (%)	2.4	2.6	1.0	1.5	3.3				
Normalised NPAT	0	0	0	0	0	Capital Structure									
Reported NPAT	98.8	106.2	40.2	61.2	133.6	Interest cover EBIT (x)	2018A	2019A	2020E	2021E	2022E				
Normalised EPS (cps)	116.0	69.0	0	0	0	Interest cover EBITDA (x)	9.3	7.3	2.9	4.1	8.3				
DPS (cps)	214.8	175.2	40.2	61.2	133.6	Net debt/ND+E (%)	10.1	8.4	3.8	4.8	9.0				
	43.9	47.1	17.8	27.1	59.2	Net debt/EBITDA (x)	31.3	33.7	36.2	34.7	30.6				
	13.2	14.1	5.3	8.1	17.8		3.8	4.4	9.9	7.1	3.5				
Growth Rates						Key Ratios									
Revenue (%)	2018A	2019A	2020A	2021A	2022A	2018A	2019A	2020E	2021E	2022E					
EBITDA (%)	23.2	9.8	-16.4	19.7	36.5	Return on assets (%)	3.9	3.3	1.5	2.0	3.6				
EBIT (%)	19.7	10.7	-49.6	34.8	82.2	Return on equity (%)	10.1	9.4	3.5	5.2	10.5				
Normalised NPAT (%)	18.5	10.3	-52.8	38.8	89.9	Return on funds employed (%)	8.4	7.5	3.0	4.2	8.1				
Normalised EPS (%)	21.0	7.6	-62.1	52.1	>100	EBITDA margin (%)	51.0	51.4	31.0	34.9	46.6				
Ordinary DPS (%)	19.7	7.1	-62.1	52.1	>100	EBIT margin (%)	48.1	48.3	27.3	31.6	43.9				
	20.0	6.8	-62.1	52.1	>100	Capex to sales (%)	126.5	130.0	54.7	61.1	86.8				
						Capex to depreciation (%)	4,344	4,198	1,461	1,853	3,293				
Cash Flow (NZ\$m)						Operating Performance									
EBITDA	2018A	2019A	2020E	2021E	2022E						2018A	2019A	2020A	2021A	2022E
Working capital change	117.0	129.5	65.3	88.0	160.4	Revenue (NZ\$m)									
Interest & tax paid	100.5	108.2	9.8	125.6	256.5	Care fees		91.2	101.3	109.8	123.3	136.2			
Other	(13.1)	(13.3)	(17.2)	(18.5)	(17.8)	Management fees		45.6	52.5	57.2	62.3	71.5			
Operating cash flow	0	0	0	0	0	Other		0.2	0.2	0	0	0			
Capital expenditure	204.4	224.4	57.9	195.1	399.2	Fair value m'tment in Investment Property (NZ\$m)									
(Acquisitions)/divestments	(290.4)	(327.4)	(115.3)	(154.2)	(298.8)	Realised		92.5	97.9	43.7	66.7	136.7			
Other	0	0	0	0	0	Unrealised		0	0	0	0	0			
Funding available/(required)	(87.2)	(103.0)	(57.4)	40.9	100.4	Total revenue		229.5	251.9	210.7	252.3	344.4			
Dividends paid	(19.7)	(19.5)	(12.1)	(18.4)	(40.1)	Key Drivers									
Equity raised/(returned)	1.9	2.2	0	0	0	Sales - new units		339	329	169	225	425			
(Increase)/decrease in net debt	(105.0)	(120.4)	(69.5)	22.5	60.3	Ave unit price - new sales (NZ\$000s)		566	665	685	705	726			
						Sales - resold units		301	323	180	299	470			
Balance Sheet (NZ\$m)						Ave unit price - resales (NZ\$000s)		406	445	423	444	462			
Working capital	2018A	2019A	2020E	2021E	2022E	Gross development margin (%)		33.2	27.9	22.0	22.0	26.0			
Fixed assets	(57.4)	(98.0)	(41.0)	(49.1)	(67.0)	Gross resales margin (%)		23.5	25.7	24.0	24.0	26.0			
Intangibles	2,717.8	3,261.0	3,412.1	3,624.7	4,051.1	New apartments/units		454	354	225	300	500			
Right of use asset	6.6	6.1	6.1	6.1	6.1	New beds		52	0	80	80	80			
Other assets	0	0	0	0	0	Portfolio									
Total funds employed	4.6	12.6	12.6	12.6	12.6	Apartments/units		3,732	4,086	4,311	4,611	5,111			
Net debt/(cash)	2,671.6	3,181.7	3,389.9	3,594.4	4,002.9	Beds		845	845	925	1,005	1,085			
Lease liability	445.3	575.6	645.1	622.6	562.3										
Other liabilities	0	0	0	0	0										
Shareholder's funds	1,247.6	1,474.2	1,608.0	1,798.5	2,163.6										
Minority interests	978.8	1,131.9	1,136.7	1,173.3	1,277.0										
Total funding sources	0	0	0	0	0										
	2,671.6	3,181.7	3,389.9	3,594.4	4,002.9										

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Earnings and valuation review

Summerset's market comments since the COVID-19 lockdown

- SUM has scaled up its pandemic preparation and processes since January, and like the major operators, it already had established infectious disease prevention and control systems.
- SUM stated that it has a strong balance sheet and can withstand a prolonged COVID 19 situation, and SUM has indicated this is around 12–18 months. A mitigating factor for SUM is that it only has one large main building at an advanced stage, while other developments under way are of a broad acre style involving villas and townhouses, making it relatively easy to stage development spend as required depending on how demand unfolds and how tight its gearing levels are.
- SUM has commented that it is not able to provide FY20 earnings guidance at this point.
- SUM has lowered its FY20 build rate guidance from 400 to 300–350 units and this assumes a three month development shutdown.
- Recent sales activity up to and including the week of 16 March 2020 was strong. SUM will provide 1Q20 sales numbers on 9 April.
- The company has been advertising for caregiver and registered nurses and has received strong interest.

Forecast changes to key drivers – we have assumed a very slow next six months with no new build activity

We have adopted a scenario where new sales and resales are very modest, if not non-existent, over the next six months and we have assumed development activity remains stalled over this period as well.

- We assume new build completions in FY20 are 225 units compared to our previous assumption of 450 units and SUM's updated guidance of 300–350 units (which assumes a three month pause). We assume the build rate then slowly recovers to reach its medium term target of 600 units in FY23, versus FY22 previously.
- With the slower build rate and uncertain near-term market conditions and the difficulty for future residents to transact, we have assumed a significant drop in forecast new sales volumes over the next three years.
- In terms of resales, we again assume very little over the next six months, so forecast resales volumes have been halved for FY20, a partial recovery in FY21, and then back to expected normal levels in FY22.
- We have also shaved average pricing and margins materially in the near term as detailed in Figure 1.

Figure 1. Changes to key drivers

Year ending 31 December	Old	New	% Chg
Gross devel margin % FY20	24.0	22.0	-8.3%
Gross devel margin % FY21	23.0	22.0	-4.3%
Gross devel margin % FY22	22.0	26.0	18.2%
Sales - new units FY20	360	169	-53.1%
Sales - new units FY21	440	225	-48.9%
Sales - new units FY22	510	425	-16.7%
Ave price - new sales FY20 (NZ\$m)	0.685	0.685	0.0%
Ave price - new sales FY21 (NZ\$m)	0.705	0.705	0.0%
Ave price - new sales FY22 (NZ\$m)	0.726	0.726	0.0%
Sales - resold units FY20	370	180	-51.3%
Sales - resold units FY21	422	299	-29.2%
Sales - resold units FY22	470	470	0.0%
Ave price - resold sales FY20 (NZ\$m)	476	423	-11.2%
Ave price - resold sales FY21 (NZ\$m)	509	444	-12.9%
Ave price - resold sales FY22(NZ\$m)	525	462	-12.0%
Gross resales margin % FY20	27.0	24.0	-11.1%
Gross resales margin % FY21	25.0	24.0	-4.0%
Gross resales margin % FY22	24.0	26.0	8.3%

Source: Forsyth Barr analysis

In addition to halting development activity, the other near-term lever for the retirement and aged care operators will be to cut the dividend. Although sector dividend pay-out rates are low (typically 20–50%) and in SUM's case it already has a DRP. At this stage we remain with a forecast dividend pay-out of 30%, at the low end of SUM's target range.

Under this scenario gearing remains steady around the current ~35% level versus the bank covenant of 50%. We remain confident from a banking perspective given the support and understanding of the sector by the major banks, the ability for SUM to halt development spend if required and the level of unrealised embedded gains within the portfolio.

Downgraded earnings and price target

Figure 2 summarises our forecast changes. The changes detailed above have pulled back near term underlying profit forecasts considerably.

Our forecast for care revenue is largely unchanged at this point. Deferred management fee revenue drops from the lower level of resales and the lower pricing. However, the key driver of the change is the lower realised gains from new sales and resales which are around half of the previous forecast for FY20 and FY21. This has resulted in a similar fall in forecast underlying profit and dividends.

SUM's earnings are expected to be more volatile than some of its sector peers under this scenario given new sales gains are a larger component of underlying profit as it is building at a higher rate relative to its size, and resales are less significant as it has a lower turnover rate than RYM and ARV and less mature villages. SUM's care facilities are also less of a profit source than they are for RYM and ARV, which have more scale and care earnings cover a larger amount of head office costs. Overall SUM has a lower needs-based ratio than RYM and ARV, but its villages built over the last seven years have a stronger needs-based focus with larger care facilities and more serviced apartments.

Under the above scenario, our DCF valuation has dropped from NZ\$8.00 to NZ\$6.70, down-17%, and our target price has dropped from NZ\$8.70 to NZ\$7.20, down -17%.

Should sales transactions remain problematic for over six months the operators will need to consider how they handles resales that have not been sold for over a six month period. Under the Retirement Village Act, operators do not need to repay the occupation right agreement (less the deferred management fee) unless the unit has been resold, however. in NZ a number of operators try not to keep families waiting any longer than six months.

Figure 2. Summary of forecast changes (NZ\$m)

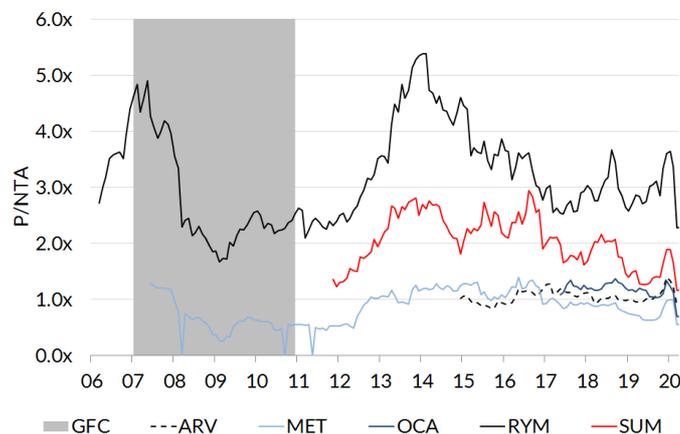
Year ending 31 December	Old	New	% Chg
Revenue FY20	277.0	210.7	-23.9%
Revenue FY21	320.5	252.3	-21.3%
Revenue FY22	362.7	344.4	-5.0%
EBITDA FY20	131.7	65.3	-50.4%
EBITDA FY21	156.3	88.0	-43.7%
EBITDA FY22	178.7	160.4	-10.2%
Realised new sales gains FY20	59.2	25.4	-57.0%
Realised new sales gains FY21	71.4	34.9	-51.1%
Realised new sales gains FY22	81.5	80.3	-1.5%
Realised resales gains FY20	47.6	18.3	-61.6%
Realised resales gains FY21	53.7	31.8	-40.8%
Realised resales gains FY22	59.2	56.4	-4.7%
Underlying profit FY20	106.6	40.2	-62.3%
Underlying profit FY21	129.2	61.2	-52.6%
Underlying profit FY22	151.3	133.6	-11.7%
Dividend FY20 (cps)	14.2	5.3	-62.3%
Dividend FY21 (cps)	17.2	8.1	-52.6%
Dividend FY22 (cps)	20.1	17.8	-11.7%
Price Target	8.70	7.20	-17.2%

Source: Forsyth Barr analysis

Retain OUTPERFORM rating

The near term is very uncertain in terms of sales activity and hence the crystallising of cash deferred management fees, and from an earnings perspective from the actual level of realised gains on new sales and resales. The market is likely to remain volatile, however, we are confident with regard to SUM's financial strength and business model going forward, once operating conditions normalise and consider the current share price to have significant negativity priced in. SUM is getting little credit for its development and operational track record since listing and its large pipeline of future projects in NZ and Australia. We retain out OUTPERFORM rating.

Figure 3 below highlights the scale of the re-rating of the listed retirement and aged care sector in CY19 and the recent de-rating.

Figure 3. Long run sector P/NTA


Source: Forsyth Barr analysis, Company reports

Investment Summary

With a strengthening development and sales track record, and a land bank of circa seven years, Summerset Group (SUM) has been confident of achieving its medium term build target of 600 units per annum. However, development time frames are less certain near-term due to the economic uncertainties at present. There remains significant growth potential from demographic trends, and expansion into Australia with the acquisition of further sites in Victoria.

Business quality

- **Positive demographic trends:** SUM has the expertise to leverage the ageing population and growing popularity of retirement village living.
- **Growing development track record:** SUM built 450 units in FY18 and 354 in FY19, and has achieved attractive development margins. Execution is becoming critical as SUM starts building larger high rise developments and increasing project debt.
- **Investing in quality of care:** SUM is investing heavily in its care operation which is increasing the needs based nature of its portfolio and it has started adding dementia services to new developments.

Earnings and cashflow outlook

- **Underlying EPS growth track record:** Since listing on the NZX in 2011, SUM has generated strong EPS growth on a consistent basis. After a flatter year in FY20, SUM was expected to achieve strong EPS growth in FY21, however, this has been dialled back with the COVID-19 outbreak. This is expected to dampen earnings in FY20 and FY21 before recovering strongly in FY22.
- **Recycling capital:** The occupational right agreement (ORA) structure provides the ability to self-fund development, subsidise the cost of a care facility, recycle capital into new development, and capture capital gains when units are resold.

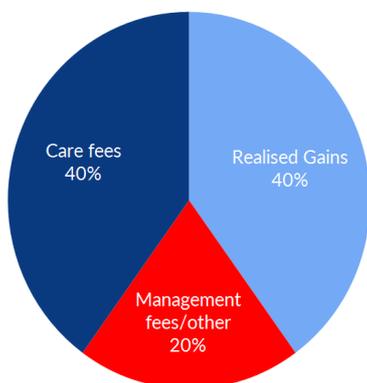
Financial structure

- **Balance sheet:** Gearing has increased as SUM has rapidly lifted its build rate and invested in higher priced metropolitan land, but debt remains largely project related.
- **Dividends:** SUM has a 30%–50% target pay-out rate and has a dividend reinvestment plan in place.

Risk factors

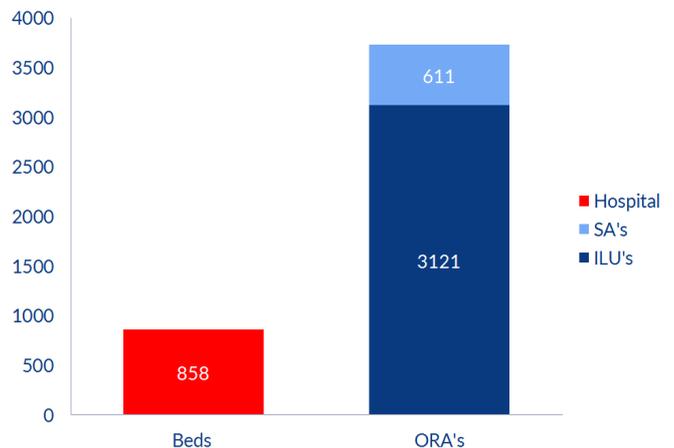
- **Oversupply:** The significant industry pipeline poses the threat of short-term oversupply, offset by a likely shortage of quality beds longer term. With a stalling in the economy with COVID-19, we expect private operators will find it tougher to resurrect development programmes than the well funded listed operators.
- **Economic and housing market concerns:** A protracted downturn in the housing conditions and difficulty in new residents transacting is a threat to SUM's resales volumes, cash flows, and gearing.

Figure 4. SUM FY19 revenue mix (NZ\$m)

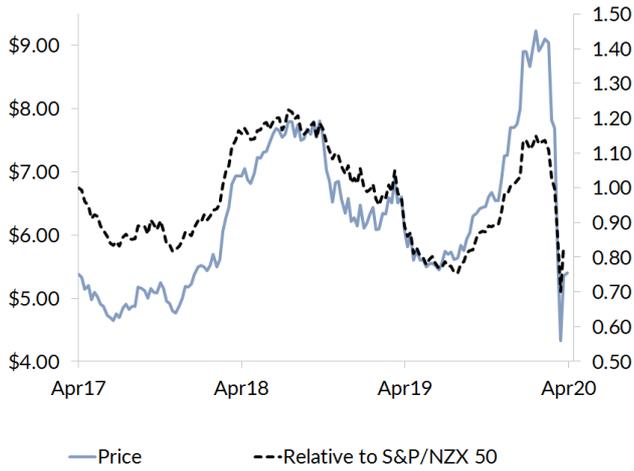


Source: Forsyth Barr analysis, Company Reports

Figure 5. SUM portfolio as at 31 December 2019



Source: Forsyth Barr analysis, Company Reports

Figure 6. Price performance


Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
Harbour Asset Management & Jarden Securities Limited	10.3%
Fisher Funds Management	5.1%

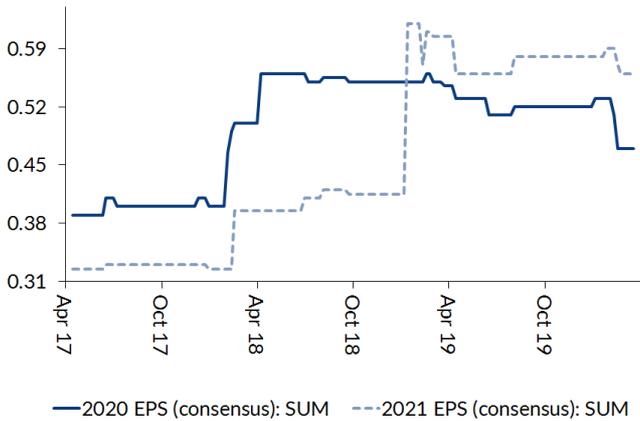
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International valuation comparisons

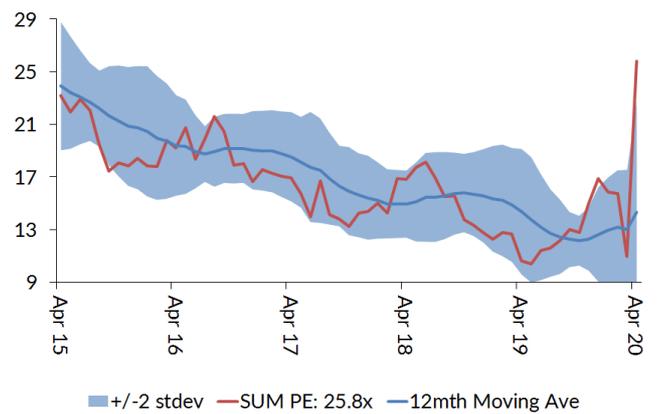
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Summerset Group	SUM NZ	NZ\$5.40	NZ\$1,219	30.3x	19.9x	27.5x	20.4x	31.3x	22.5x	1.5%
Metlifecare *	MET NZ	NZ\$4.15	NZ\$885	9.4x	8.6x	11.3x	10.4x	12.0x	11.1x	2.8%
Ryman Healthcare *	RYM NZ	NZ\$8.22	NZ\$4,110	14.0x	12.0x	15.7x	13.5x	17.1x	14.7x	4.2%
Oceania Healthcare *	OCA NZ	NZ\$0.47	NZ\$289	4.8x	4.4x	7.1x	6.7x	8.3x	7.7x	12.5%
Arvida Group Limited *	ARV NZ	NZ\$1.00	NZ\$542	8.4x	7.4x	9.1x	7.8x	10.0x	8.6x	7.4%
Compco Average:				9.1x	8.1x	10.8x	9.6x	11.9x	10.5x	6.7%
SUM Relative:				231%	145%	154%	112%	163%	114%	-78%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (SUM) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)


Source: Forsyth Barr analysis

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