



iInvest Securities

Stockbroking & Wealth Management

INDEPTH RESEARCH NOTE

G8 Education Ltd – Buy

Price: A\$3.40 | Price Target: A\$4.00 | ASX: GEM | 5 December 2017

GEM provided a trading update in which the Company noted that it expected underlying group EBIT of approximately \$160m (now expected to be +5% higher on previous year after adjusting for the movements in Long Day Care Professional Development Program Funding). The drivers of the downgrade include weaker occupancy levels and increased costs due to regulatory changes and additional investment in employee development. The new guidance is 8.5% below previous Company guidance of mid \$170m. We upgrade our recommendation to Buy. In our view, the share price reaction to the downgrade was a little over done – a 8.5% downgrade equates to 23.1% drop in the share price? Whilst we are not blind to the challenges the Company faces over the next six to nine months (as noted by the Company itself), we believe the current valuation more than accounts for this (trading on a FY18 PE multiple of 13x and dividend yield of 5.9%). Further, we believe the share price reaction also likely highlights that investors are giving management no benefit of the doubt for achieving their 40cps EPS by 2019 (which we couldn't disagree with). Hence given the reset in market expectations we see reduced probability of management disappointing expectations from here. We expect challenging conditions over the next 12 months, but we also see positive green shoots such as development & acquisitions pipeline (performing to expectations), much of the \$3m additional costs called out are temporary (in our view) and the new childcare packages are expected to benefit a significant portion of GEM's existing family base.

- **Drivers of the downgrade. (1)** GEM has seen occupancy growth slow, with average like-for-like occupancy in 2017 expected to be around 77% versus 79.7% in 2016. The Company called out supply issues in Western Sydney, Gold Coast, East Brisbane and Inner Melbourne plus sluggish wage growth and employment conditions in regions such as North Queensland for the weakness in occupancy levels. As we have previously noted improving occupancy is critical given the leverage to group earnings – on our estimates +/- 1% occupancy leads to +/- \$10m in EBIT (all else being equal). **(2)** Regulatory changes in relation to staffing ratios during breaks in NSW, SA and Victoria (which took effect from 1 Oct) came in before management expectations – they assumed these states could follow the lead of QLD and implement these structures end of 2019. This will temporarily lead to the use of agency labour to meet immediate requirements resulting in costs of approximately \$3m. **(3)** Investment in the professional development of employees has resulted in a further increase of approximately \$1m.
- **Acquisition and development pipeline as expected.** In the trading update the Company also noted that the acquisition and development pipeline was performing to expectations, with the EBIT contribution relating to 2016 and 2017 acquisitions of \$13m and \$3m, respectively.
- **40cps EPS by FY19 now looks unlikely (however market expectation has been reset).** Management has previously articulated their target for a 3-year EPS growth – to achieve \$1.0bn in revenue by FY19, 40.0 cents per share EPS, 65% customer and team engagement. Management's 40.0 cps by financial year end 2019 implies compound annual growth rate (CAGR) of +17.5%. In order to achieve this, management was required to grow EBIT from A\$160m in FY16 to ~\$290m in FY19, which is an increase of \$130m in absolute terms. Part of this target included growing occupancy by 2% by FY19 (which would have taken GEM back to its FY15 level). We believe this target is now unlikely to be achieved given the challenging conditions but importantly in our view the market is no longer estimating this either (median consensus estimates for FY19 - EBIT \$218m and EPS 32.1cps).
- **Valuation.** We have updated our estimates to reflect the recent trading update and now sit in line with management's guidance. Further, we have updated our market multiples for our PE-relative and EV/EBITDA valuations. We use a peer group average – including Arena REIT and Folkstone Education Trust – for both multiples we apply a 20% discount to reflect the risk associated with the movement in GEM's occupancy levels and development risk. Our price target of \$4.00 is the average of these two valuations and rounded to the nearest ten cents.

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Investment Thesis

We rate GEM as a Buy for the following reasons:

- Post recent share price drop we see value re-emerge in GEM's valuation.
- Long-term outlook for childcare demand remains positive – growing population (organic and net immigration).
- New management team (CEO and CFO), with a greater focus on organic growth as well as acquired growth.
- Increasing exposure to offshore markets (Asia).
- Strategic investor in China First Capital Group (12.45% stake in GEM) could see a partnered expansion into the Chinese market.
- National footprint allows the Company to scale better than competitors and mum and dad operators.
- Potential takeover target by a global operator.

Key Risks

We see the following key risks to our investment thesis:

- Execution risk with achieving its FY19 earnings per share (EPS) target.
- Increased competition leading to pricing pressure.
- Increased supply in places leading to reduced occupancy rates.
- Value destructive acquisition(s).
- Offshore expansion execution risk.
- Adverse regulatory changes or funding cuts to childcare.
- Recession in Australia.

Company Description

G8 Education Limited (GEM) owns and operates care and education services in Australia and Singapore through a range of brands. The Company initially listed on the ASX in December 2007 under the name of Early Learning Services, but later merged with Payce Child Care to become G8 Education.

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Figure 1: GEM Financial Summary

Year-end Dec (\$ millions)						
PROFIT & LOSS (P&L)						
	FY14A	FY15A	FY16A	FY17E	FY18E	FY19E
Sales Revenue	479.2	686.7	775.0	800.0	903.1	997.0
Operating Expenses	368.2	517.0	602.6	626.3	701.1	761.6
EBITDA	111.0	169.8	172.4	173.7	202.0	235.4
% Margin	23.2%	24.7%	22.2%	21.7%	22.4%	23.6%
Depreciation & Amortisation	6.7	9.4	11.7	13.7	15.0	17.9
EBIT	104.3	160.4	160.7	160.0	187.0	217.4
% Margin	21.8%	23.4%	20.7%	20.0%	20.7%	21.8%
NPAT	52.7	88.6	80.3	94.7	117.1	138.3
Underlying NPAT	46.4	74.8	80.5	94.7	117.1	138.3
Underlying EPS (cps)	0.14	0.21	0.21	0.21	0.26	0.31
DPS (cps)	0.19	0.24	0.24	0.23	0.20	0.22
Growth Rates:						
Revenue		43.3%	12.8%	3.2%	12.9%	10.4%
EBIT		53.8%	0.2%	-0.4%	16.9%	16.3%
Underlying NPAT		61.2%	7.6%	17.6%	23.7%	18.1%
VALUATION						
	FY14A	FY15A	FY16A	FY17E	FY18E	FY19E
PE multiple (x)	23.9	16.6	16.0	16.1	13.0	11.0
P/B ratio (x)	2.7	2.2	2.2	2.2	2.1	2.0
Dividend Yield (%)	5.6	7.1	7.1	6.8	5.9	6.3
EV/Sales (x)	3.6	2.5	2.2	2.2	1.9	1.7
EV/EBIT (x)	16.6	10.8	10.8	10.8	9.3	8.0
BALANCE SHEET SUMMARY						
	FY11A	FY12A	FY13A	FY14A	FY15A	FY16A
Cash	14.2	21.8	114.0	120.8	193.8	26.5
Current Receivables	3.0	4.4	6.9	11.5	17.0	19.4
Current Inventories	0.0	0.0	0.0	0.0	0.0	0.0
Property, Plant & Equipment	8.0	10.6	18.1	29.6	41.4	54.8
Other	163.3	232.4	343.0	840.9	982.0	1,072.5
Total Assets	188.5	269.2	482.0	1,002.8	1,234.2	1,173.2
Current Payables	2.2	4.5	4.6	7.0	7.6	7.5
Total Debt	36.4	49.3	114.2	352.9	515.2	410.6
Other Liabilities	34.7	33.2	58.3	100.9	108.7	129.2
Total Liabilities	73.3	86.9	177.2	460.8	631.4	547.3
Shareholders Equity	115.2	182.3	304.8	542.0	602.8	625.9
Net Debt / Equity	19.3%	15.1%	0.1%	42.8%	53.3%	61.4%
Net Debt / (ND+E)	16.2%	13.1%	0.1%	30.0%	34.8%	38.0%
CASH FLOW SUMMARY						
	FY11A	FY12A	FY13A	FY14A	FY15A	FY16A
Net Income	17.3	19.2	31.1	52.7	88.6	80.3
Depn & Amortisation	1.9	2.5	3.5	6.7	9.4	11.7
Other Non-cash Adj.	-5.4	-3.1	-2.2	0.5	-7.2	23.7
Changes in Non-cash capital	-2.0	1.4	10.7	14.8	4.3	-7.1
Operating Cash Flow	11.8	20.0	43.0	74.7	95.1	108.6
Capital Expenditure	-2.3	-4.8	-10.5	-16.5	-54.3	-25.0
Free Cash Flow	9.5	15.2	32.5	58.2	40.8	83.6

Source: BTIG, Company, Bloomberg

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