HollAnd Advisors

Holland Views: Ryman Health – Price: $12.50; Mcap: NZ$6.1bn (US$4.4bn)

Why?

Those wanting to read a piece that explains a new idea to them in full technicolour maybe disappointed by what comes next. Looking at Ryman Healthcare there are many obvious points (such as its great history of growth and highly respected brand and reputation). There are also questions that arise. We looked at the company briefly a few years back. However, it was only in recent months that we spent more time on it, importantly on its business model and its accounts. Having done so we feel we have now answered the questions that arose as we did so. As a result, we are excited about what we have found/concluded. Explaining those questions and answers to someone who has not looked at the company closely however is hard. Attached to this note you will find an excel spreadsheet. In it we have laid out the story of Ryman as we see it in tables and charts. What follows below is a series of questions to try and get readers thinking on the right lines about it. After that, some observations and a short conclusion. We know that a US$4bn company based in New Zealand will not get on many of our readers radars. That is a shame as we think the compounding abilities of this business in the next twenty years are likely as impressive as they were in the last twenty.

Asking the right questions

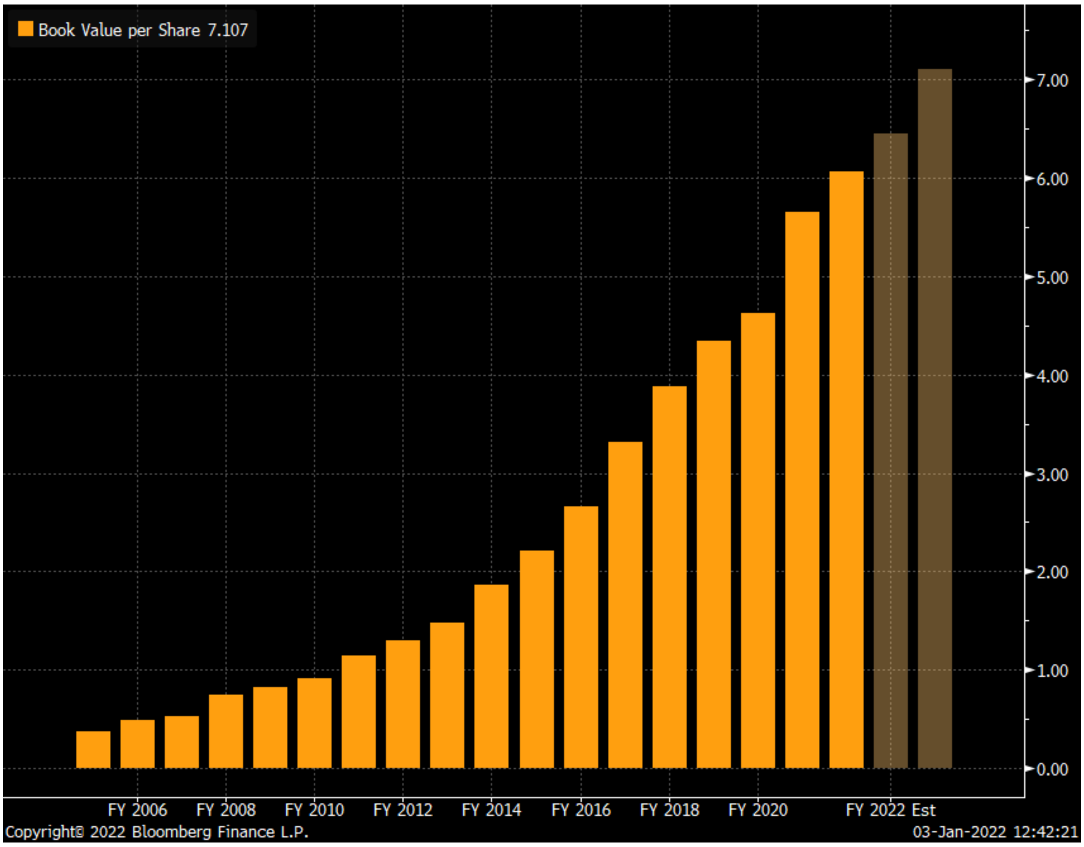
Ryman Healthcare has a wonderful brand having an almost perfect reputation for providing the very best retirement villages in New Zealand and Australia. Indeed, anyone looking at the wider global offering of retirement homes may quickly conclude that they are the best in the world in this area. Furthermore, global populations are aging and the need for elderly care is paramount. It is rarely provided with the love and commitment that Ryman brings. **So, *why* are such a company's shares available to purchase at 12x earnings?**

Fig.1: Ryman Healthcare price/book value

Source: Bloomberg

Ryman has grown its book value per share at 18% pa over the last 25 years. Additionally paying a c.2-3% dividend yield on top of that growth each year. It has done so by making past ROE's that are c.20%. **If such a level of return is likely to be replicated in the future *why* do the shares today trade on 2x book?**

Fig.2: Ryman Healthcare book value per share



Source: Bloomberg

Answers and getting lost to find them

Whilst we think the answers to the above questions are partly in the spreadsheet we have enclosed and what follows, we think there is a danger in readers looking for them too quickly. The reason being that just more questions will arise (we have done this advisory job for a long time now!). Crucially we think an understanding of a company like Ryman rests upon an investor already having great foundations in their own approach to a number of factors. These being:

- What is the right accounting measure of return to focus on when trying to understand a company's equity compounding potential? Our answer is unequivocally Return on Equity (ROE)
- How mid-range ROE companies (15-25%) can compound capital powerfully if they have sufficient redeployment opportunities to so do
- Having an eye always toward deferred gratification and how today's investment return can be ignored if you think tomorrow's is compelling enough
- Being genuinely open minded as to where your future investing compound returns may come from in terms of sectors, business models and geography.

It is quite likely that on reading the above list many professional investors whom we advise will be offended. "*Of course, I understand those factors*" being their response. All we will say in riposte is that we thought we did too, until only a few years back when we started to see the compounding wood for the trees...

So, whilst the job of the researcher and analyst is to find new ideas, we think in this case just representing the conclusion will likely illicit the wrong response. Whilst of course we provide our conclusions below we think investors would be best to lose themselves in reading the accounts and conference calls of Ryman as we have, listing the questions that arise as they go. If this piece acts as a prompt to do just that we are happy.

Property revaluation

The role that property profits and revaluations play in this company's business model is crucial to its valuation and understanding. Simply put, part of the company's revenue and profit is derived from the management fee it charges the resident. **However, a large component is also the future value participation share they have with residents (Ryman get to keep up to 20% of the value of the property at its future sale). Important also the company renews this arrangement with every new owner of the property post a resident leaving or dying.**

Whilst this is a simple to understand offer to the buyer that Ryman residents seemingly welcome and enjoy it does not make for easy accounting. In practice the company has a modestly profitable business day to day (c.10-12% ROE pre-revaluations). That is supplemented when a future sale of properties is made. The way the model is accounted for however means that the investment properties that the group possess are revalued every six months. The result is that part of the profits that are reported under GAAP and used by us in our EPS and ROE calculations in the attached excel sheet are non-cash. In a world of sometimes inflated profits and where cash is the truth-teller many readers might be forgiven for getting a little twitchy at this point. However, we observe a few important points:

1. There has almost never been a downward valuation/reversal of the group investment property in any period in 25 years
2. Whilst part of property profits are made from revaluations, a good proportion are made from actual cash sales (both of new units and second-hand ones when an occupant dies/leaves)
    a. These cash sales create regular and sizable profits. These profits are importantly a function of the carrying value of the property. Aka if past revaluations were erroneous, losses on sale would result, not profits
3. The participation in the future value of each property and the village it is situated in is a core part of this company's businesses model
    a. As such if no revaluations occurred and instead larger profits on sale were reported profits would more closely match cashflow
    b. But the outcome would be lumpy – the revaluation method effectively smooths the value created
4. Property revaluations are done assuming c.3% rises in value. More importantly however is the 11-16% discount rate used to bring those values back to today's prices. This is an important point we think. By using such a high rate, the company is still ensuring that a high proportion of value accretion is deferred, not booked to profits today
5. Finally, the revaluation contribution to profits needs to be looked at in context. If it related to constant revaluation of say Oxford Street then of course there is only so many times that can occur. Also, it could not be considered recurring. But that is different to say the revaluation that might regularly happen of a housebuilders land once it has been built upon. Every year's new land is bought and developed. Whether all the resulting profits are booked at sale or before sale will only affect their timing not their quantum.
    a. In a business such as Ryman which talks to 20-25% development margins
    b. And who keeps c.20% of the upside of the property sold

c. Regular and repeatable lifts in value are highly likely as more and more sites are developed and retained

The answer to the "why" question earlier is that the 12x PE multiple we are using at the start of this note uses GAAP earnings. Part of those earnings come from the regular biannual revaluation of its investment properties.

Cash vs Profits and value creation

Like us many readers will have numerous Cash vs Profit experiences at other companies they have analysed. Thus, 'follow the cash' is an often-repeated phase to make sure an investor is not deceived in his analysis. In the case of Ryman, we think investors should look closely at cashflow, but also at the very long-term increases in the book and tangible book value of the company.

Anyone that has read the above disclosure we have given, that part of annual profits are derived from property revaluations, will know that this company's reported profits and cashflows will differ. This is indeed the case. However not in the way a reader might imagine. Whilst current year free cashflow omits to have the boost from non-cash property valuations shown in the P/L it has another positive driver not evident in profits. This being the proceeds the group has received from new and second-hand sales.

Fig.3: How Ryman spent its 3/2022 cash inflow of NZ$839m

Source: Ryman Healthcare 2021-year end results presentation

As such the group's cashflow is actually better not worse than its P/L profits. What does its use the cash received on residential sales for…? Significant investment in new centres and funding the building of the care homes within them. As a result, the group regularly talks of planning to grow profits by 15% pa over the medium term, achieving this via new village growth and their slow but steady maturity. It's cashflows show this growth can be fully afforded.

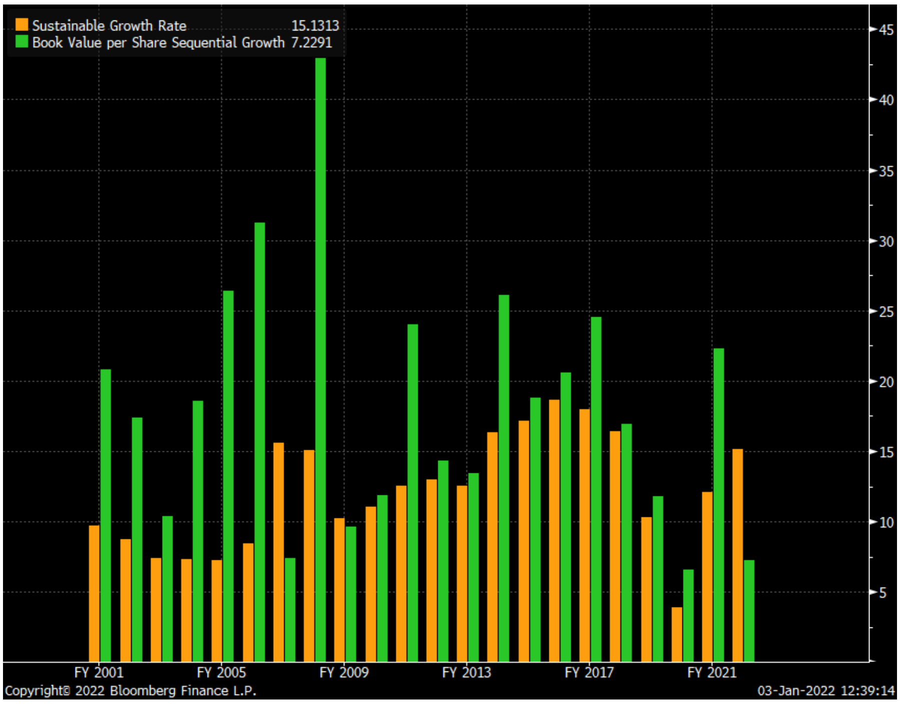
This we think is interesting as cashflows should be observed as not 'better' or 'worse' than profits, but in Ryman's case 'different'. This is due to advance receipt of payments for units sold and delayed profits on sale that are being estimated in revaluations but not yet received in cash.

Another way to get an insight into the company's cashflow is to look at its total assets vs net assets and how the difference is funded. As at March 2021 total assets were NZ$9.17bn and net assets were NZ$2.82bn. The gap between the two suggest leverage (aka risk). However a glance at the company's balance sheet shows only NZ$2.2bn of debt. The remainder of gross assets are funded by 'occupancy advances – noninterest bearing – NZ$3.7bn'. This is the accumulation of all the property purchases the group has received less what it has paid out. At its most simple level this is float (other people's money) and most readers know how powerful a driver of future returns that can be.

Value creation

In recent years we have become more interested in 'put up to make more' businesses, especially in what has driven their value creation over time. Mostly for the reason that they can often be misunderstood by markets. One thing we noticed when looking at Ryman was that its book value growth was actually greater than that what would have been achieved just from the compounding of its ROE alone. As this is seemingly impossible in the wonderful world of accounting, we set about looking a little closer assuming we had made a mistake. What we found we think is interesting. Whilst the company regularly re-values its investment property and this contributes to annual reported profits, its PPE (land bank) is also revalued. However, this PPE valuation uplift is taken straight to reserves (i.e. it does not flow through the profit and loss account at all). This can be seen in two charts. The first below shows how actual rises in book value have been greater than that calculated just looking at the ROE less the Pay-Out ratio.

Fig.4: Book value grows faster than sustainable growth rate!



Source: Bloomberg

The second chart which shows that no recognition of this uplift was recognised in profits can be seen in the Appendix. It shows the Ryman changes to equity statement from its March 2021 annual report. In terms of the simplicity of what we are looking for in companies, this statement is a great example. It shows Ryman has shareholder equity of NZ$2.829bn. Of this we can clearly see that NZ$2.385bn has come from multiple year retained earnings. However, what we can also see is that a further NZ$453m has been contributed from 'asset revaluation reserve'. Very, very, few companies have accounts that look like this.

Roughly right or accurately wrong

Hopefully what is laid out above and, in our spreadsheet, gives a glimpse as to the financial model of Ryman Healthcare. This note has not spoken to the company's business model, brand or reputation, but we concluded in our work that all three were exceptional.

Accepting that we cannot know exactly what the true profitability for this company might be in a given year we think is a helpful and liberating process. For only by doing so can we start to think less about accuracy and more about what exactly this business model is and what its future prospects are most likely to be. In turn we can then consider what price we might pay for it.

Simply put this company has a remarkable reputation in a global industry that is otherwise consistently poor. Its brands, business model and market growth potential when combined offer a long runway of growth. Its offering to customers is fair and its business model self-funding. The deferral of some of its charges (i.e. a max 20% take on sale) is a clever deferred gratification offering that resonates with customers. All this means an ability to reinvest c.70% of its earnings for many years (decades?) to come. As such Rymans target to achieve 15% profits growth may well be achieved and we think at similar ROE's to its past (i.e. c.20%). Adding to that 15% growth is a 2% pa dividend yield (1/3 profits on PE of 15x). The result is we are looking at potential increases in shareholder value of 17% pa.

On a trip to Omaha a few years ago a wise old man advised us to look for businesses that are a 'win win for all' (stakeholders). Ryman we suggest is one such company.

Our best guess is that we are paying 2x book for such future compounding and likely a 12x PE today. Maybe the PE is 14x or 15x….. does it really matter?! Such prices for c.17% prospective growth and 20% ROE is such a growing sector look exceptional to us.

Enjoy your study of Ryman Healthcare, we did.

"Good enough for Mum" **Ryman Healthcare motto**

With kind regards

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Appendix

Consolidated statement of changes in equity

FOR THE YEAR ENDED 31 MARCH 2021

	Notes	Issued capital	Asset revaluation reserve	Cash-flow hedge reserve	Cost of hedging reserve	Foreign-currency translation reserve	Treasury stock	Retained earnings	Total equity
		$000	$000	$000	$000	$000	$000	$000	$000
Balance at 1 April 2019		**33,290**	**257,775**	**(9,643)**	**-**	**(5,876)**	**(27,465)**	**1,922,049**	**2,170,130**
Profit for the year	16	-	-	-	-	-	-	264,710	264,710
Other comprehensive income for the year	16	-	-	(7,500)	-	(4,469)	-	-	(11,969)
Total comprehensive income for the year	16	-	-	(7,500)	-	(4,469)	-	264,710	252,741
Treasury stock movement	16	-	-	-	-	-	(4,894)	-	(4,894)
Dividends paid to shareholders	17	-	-	-	-	-	-	(117,000)	(117,000)
Balance at 31 March 2020		**33,290**	**257,775**	**(17,143)**	**-**	**(10,345)**	**(32,359)**	**2,069,759**	**2,300,977**
Balance at 1 April 2020		**33,290**	**257,775**	**(17,143)**	**-**	**(10,345)**	**(32,359)**	**2,069,759**	**2,300,977**
Profit for the year	16	-	-	-	-	-	-	423,061	423,061
Other comprehensive income for the year	16	-	195,793	5,081	2,702	12,132	-	-	215,708
Total comprehensive income for the year	16	-	195,793	5,081	2,702	12,132	-	423,061	638,769
Treasury stock movement	16	-	-	-	-	-	(3,030)	-	(3,030)
Dividends paid to shareholders	17	-	-	-	-	-	-	(107,500)	(107,500)
Balance at 31 March 2021		**33,290**	**453,568**	**(12,062)**	**2,702**	**1,787**	**(35,389)**	**2,385,320**	**2,829,216**

Source: Ryman Healthcare, 2021 Report & Accounts

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