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IPO opportunity in Japara Healthcare

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In recent weeks, we have analysed no less than 10 individual prospectuses for IPOs and out of those, two have passed our filters for quality, and possess what we believe to be identifiable competitive advantages and bright future prospects. Importantly, and despite a hot market generally, they also passed our 'value' test.

It is estimated that the number of people over the age of 75 will double in Australia over the next 20 years. This 'Grey Market' (or the 'Generational Avalanche' as we have been referring to it at Montgomery for a number of years) is going to fundamentally and dramatically reshape Australia's economic landscape and a number of opportunities will emerge to excite investors.

There are a number of quality Australian healthcare companies that are perfectly positioned for this growing market. Several are listed and many more are not.

On the listed side, we have Cochlear Limited; at the forefront of hearing aid devices, Ramsay Health Care Limited; the leading private hospital operator, CSL; on the cutting-edge of biological advances, and Sirtex Limited with their potentially game-changing SIR-Spheres for inoperable liver cancer.

Japara Healthcare

To this select group, we would also like to add Japara Healthcare Limited, which should be listed shortly. We currently believe Japara is a high quality business that's being offered at a price we consider not overly expensive when compared to its peers. It's also a business with excellent tailwinds.

According to the japara.com.au website, the company operates 35 aged care facilities and five retirement complexes throughout Vic, SA, NSW and Tas. In total, it manages 3,075 patient beds and is the fourth-largest provider in Australia, caring for elderly Australians, specifically those who can no longer live independently. Somewhat sadly, as those in such situations have an average longevity of 2.5 years, Japara provides a service to a growing need.

Although Japara does not provide private hospital services, the majority of revenue is generated from providing services not dissimilar to the private hospital system. We believe the businesses' assets and revenues are quality.

Fees are charged based on a variety of living arrangements, amenities, services, meal plans, social activities and care options, for example for those requiring respite, dementia and Alzheimer- related care.

Potential risks

The government currently provides the majority of funding to the industry. Around 70% of Japara's fees are predominantly sourced through a prescribed fee schedule termed ACFI, which bases reimbursement on the acuity (acuity represents the resident's dependency and the level of care required to match it) of residents.

The balance of Japara's fees generally comes from wealthy residents, who may opt for higher standards of care. With higher standards of service levels comes higher associated costs, and therefore, higher fees.

These fees are regulated by the government and are indexed to CPI. There's no pricing power but government funding providing some certainty of recurring revenue (not earnings).

The economics of age care benefit from 'bonding'. Bonding essentially provides the business with capital at zero cost and these funds can be used for a multitude of investment purposes but not the payment of dividends.

In addition to a lack of pricing power, however, the industry employs unionized labour and approximately 80% of Japara's expenses are wages. Limits to fee growth, amid scheduled wages increases, can impact profit margins and a heavy reliance on fixed costs means any drop in occupancy can lead to quick margin compression.

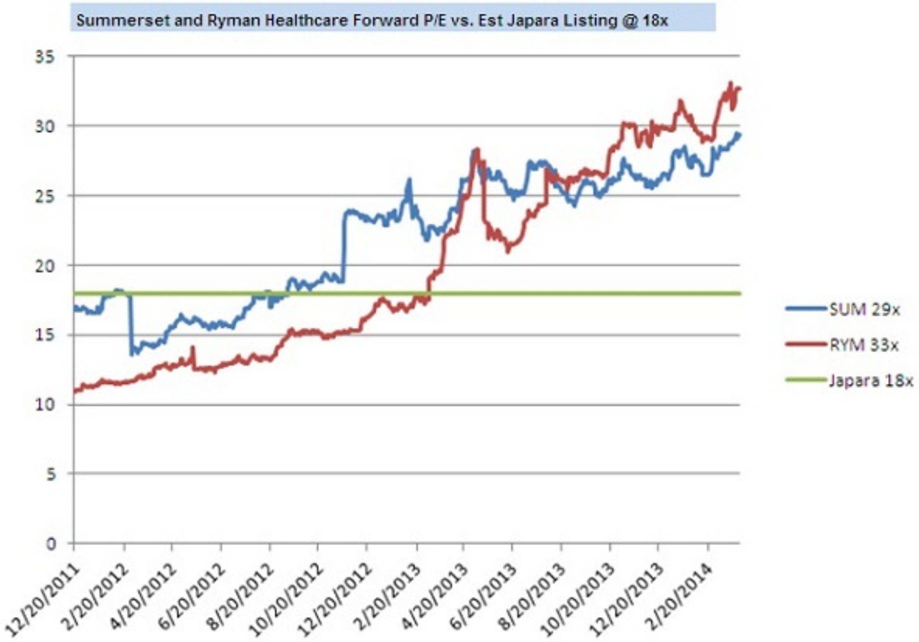
Offsetting all this is the compounded 9.2% annual growth in government funding – well in excess of wage cost growth. In the last two years, the government has reigned in funding, inflation and fee growth has declined slightly to 7.2% – still in excess of wage growth in a normal year. Importantly, training an increasing number of nurses could cap salary growth but it could also embolden unions representing a larger cohort of constituents.

Another potential negative stems from government regulated growth in the total number of beds – currently about 1.9% per annum.

The potential upside

But these negatives have to be measured against the quality of the business's assets, the certainty of its revenue and the rising demand for their services. There is also plenty of room for acquisitions in a highly fragmented industry with 186,000 beds, and the occasional brownfield development provides potential upside.

The company's shares are being offered at 18 times forecast earnings, well below the multiples commanded by other recognised listed quality operators in similar spaces.



Japara Healthcare currently appears to us to be a quality company with bright prospects, providing a quality level of care, bolstered by the tailwinds of an ageing population. We cannot say at this early stage whether we will be allocated any shares but over time we expect to do well investing in high quality and rationally priced IPOs.

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