Long Ryman Healthcare (NZE:RYM)

How to build a rapidly growing capital-intensive business using OPM (other people's money)

Sohn Idea Contest
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Ryman's virtuous circle

Business overview

Ryman Healthcare is the largest retirement village operator in New Zealand. Appalled by the conditions in retirement homes across New Zealand, founders Kevin Hickman and John Ryder started their own retirement village business in 1984. They centered it around genuine care. Customer journey starts by offering clear and fixed financial terms. Elderly are not prey at Ryman. Its unique culture made it loved by the customers. New Zealand regulation on occupational rights agreements (ORA) made it a major success for investors (detailed description on pages 3 and 4).

Ryman plans, designs, constructs, markets and operates retirement villages. Having all segments of the retirement village business in-house ensures consistently high quality of execution and predictable costs. Villages offer a continuum of care: independent service units, serviced units and care center (including rest homes, hospitals and dementia care). Ryman's offering enables spouses and friends to stay together as long as possible. Majority of Ryman competitors are reluctant to spend on care facilities, which they (rightfully) see as a lower margin business.
Ryman currently operates 30 villages in New Zealand (5,717 independent/service units, 3,199 care beds) and one village in Victoria, Australia.

I think Ryman is undervalued. The market is missing the power of Ryman's flywheel. Ryman delivers superb return on equity and a growing value to its shareholders by building profitable villages using other people's money. Ryman's float is interest-free, asks for no collateral and has no repayment risk. Ryman's liabilities to customers are like a perpetual zero coupon bond. What is the real liability to Ryman? Certainly not book value. I think close to zero. Given Ryman is still in the early innings of a long growth runway, I think its stock can compound at 15+% p.a. over the next decade.

Growth runway

New Zealand: Over the next 30 years, the number of 75+ year olds in New Zealand will triple. Ryman has a 19% market share. It expects to have 14,000 units/beds by 2020. Ryman villages are 97% occupied. Ryman is taking share from smaller players that are unprofitable due to increasing regulatory cost. While Ryman won't capture all of the coming growth, thirty years of experience in-house and scale are competitive advantages that add up. Once inferior peers appear, they might even improve Ryman's positioning and allow it to tap its pricing power.

Australia: Victoria region alone is 125% size of New Zealand in terms of 75+ year olds. Australia is getting gray at the same astonishing pace as New Zealand. Ryman has eyed Melbourne area land lots for years and has recently successfully completed its first village. The demand was through the roof. Units sold closer to the launch were at 40% higher prices than the initial units sold. There are long waiting lists for its second village. Ryman has five villages in Australia currently in construction. They expect to have 1,500 beds/units by 2020.

Ryman aims to double the number of units every five years. So far it has delivered on this promise. Australian villages will account for 50% of the growth starting in 2020. Ryman expects to run-rate building at least 1,400 units/beds per year by 2020.

Float, growth and risks

Unit economics and the key to Ryman's virtuous circle (detailed chart on page 4)

Ryman builds a retirement village over a period of 3-5 years. Due to village popularity, Ryman typically collects a substantial part of the cash flows for the units 6-12 months before the completion. The remainder is financed by its own resources or bank financing. Ryman makes a 20-30% development margin on construction. Attractive prices are offered to early entrants. A lively village attracts more demand and leads to better pricing later (more on that below). Ryman villages are typically larger than peers, allowing for high-end amenities whose cost is spread out.

Cash flows it receives from tenants are in the form of occupational rights agreements ("ORA"). In an ORA, tenant pays the price of the retirement unit, but doesn't become its owner. Tenant receives a right to live in Ryman village unit until desires so (typically five years), but never owns the unit. This is key to Ryman's virtuous circle of growth and high returns on equity. Customer occupancy advances are interest-free, near-permanent float. Price of an independent unit ORA is 2/3 of price of an average house (smaller % in Australia), an affordable transition for most of the elderly.

When the tenant leaves, 80% of the ORA is refunded to the successors within three years (usually faster). The remaining 20% is kept by Ryman as a management fee. Ryman signs an ORA with a new tenant on the same unit. New ORA is signed at a market price, which adjusted for housing inflation and promotional pricing that was present in the first ORA. Higher ORA means Ryman will receive higher management fees on the unit going forward. Ryman then uses cash flows from the new ORA to repay the expired ORA and fund the construction of new villages. Ryman keeps the house appreciation upside (and downside) on all of its villages.

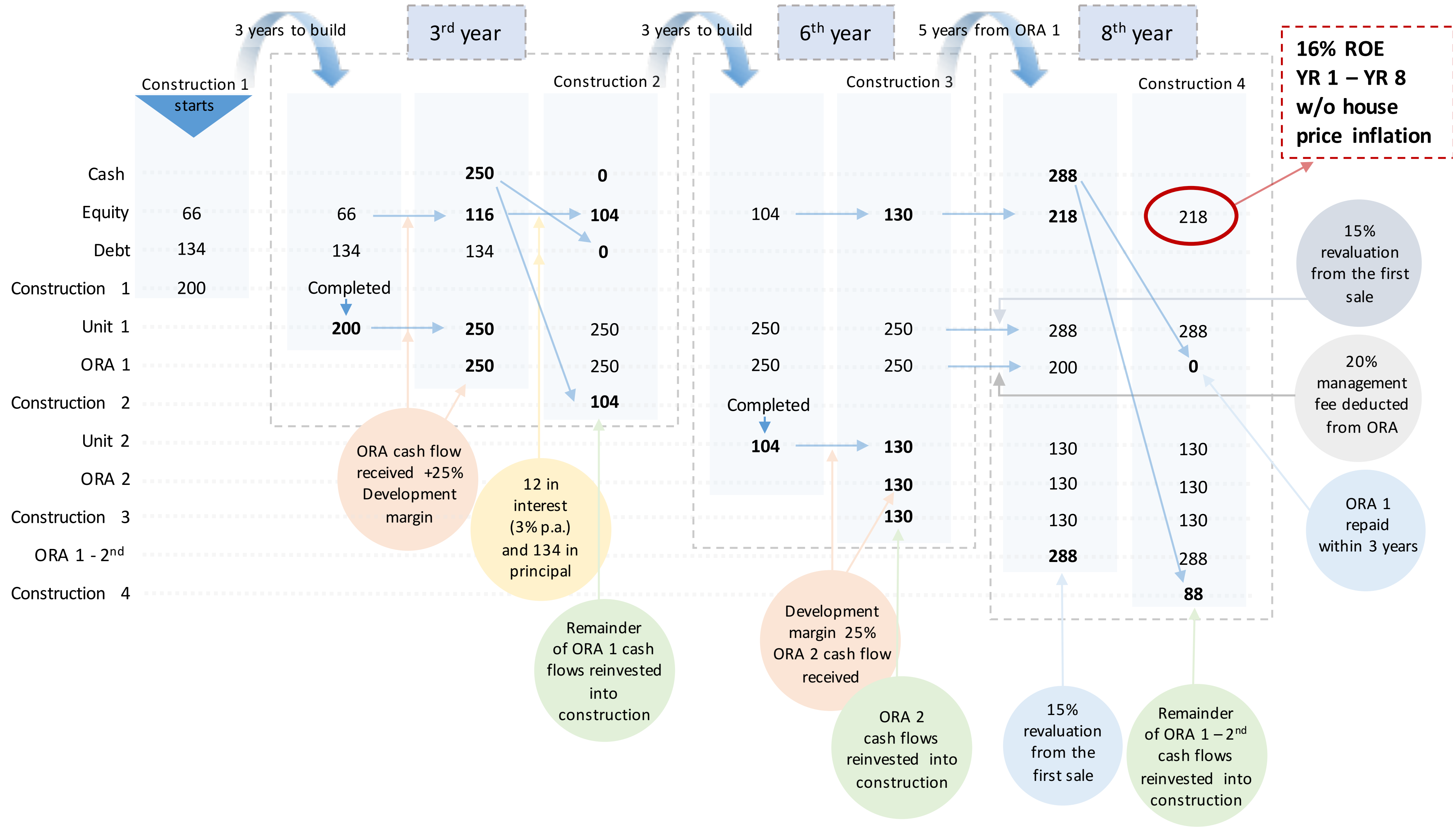
Risks

Execution: Ryman's goal is doubling in size every five years. This will be more challenging as significant part of the growth will come from Australia and less affluent parts of New Zealand, where Ryman is currently not a dominant player. In July 2017 A+ CEO Simon Challies has retired from running the company full-time due to illness. Gordon Macleod, his right hand man for 10 years, has taken over. Kevin Hickman, co-founder, is still actively involved, sits on the board and owns 7.2% of the company.

Real estate bubble: New Zealand prices have rose 5x over the past 25 years, c. 6% annually. Housing was the topic #1 in New Zealand elections. The party that formed the government built its appeal on banning foreign purchases of NZ real estate. Ryman is a need-based decision, especially given its offering of care beds vs. peers. Demand for retirement homes won't drop when/if house prices drop. A housing downturn will certainly test Ryman's pricing power. I think there is space to hold prices and narrow the price gap of ORA vs. median house, by a decrease in the house prices.

Run on Ryman: ORAs are non-interest bearing, long-term liabilities with minimum refinancing risk. Contracts allow Ryman to pay the successors within three years of tenant exit or when a new tenant comes in, whichever happens first.

Occupational right agreement (ORA) flywheel explained (illustration)



Source: Ryman Healthcare annual reports, estimates

Valuation

Asset side is driving wonderful returns… but take a better look at those liabilities

*"So how does this attractive float affect intrinsic value calculations? Our float is deducted in full as a liability in calculating Berkshire's book value, just as if we had to pay it out tomorrow and were unable to replenish it. But that's an incorrect way to view float, which should instead be viewed as a revolving fund. If float is both **costless** and **long-enduring**, the true value of this liability is **far lower** than the accounting liability."*

Warren Buffett, Letter to the shareholders of Berkshire Hathaway (2012)

Ryman's occupancy advances (ORA proceeds) are costless and long-enduring. The "revolving fund" is near-permanent, because of advantageous redemption terms allowing Ryman plenty of time to fill units with new tenants. Occupancy advances as a % of liabilities and revenue are stable/growing. Occupancy advances are like a perpetual, zero coupon bond. Their real liability to Ryman is close to zero.

Profit drivers and historic multiples (NZDm)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Care Fees	52	63	77	90	106	127	148	165	182	209	227
Management Fees	9	11	14	19	23	27	32	37	43	51	61
Realised FV adjustments (New) (New+Existing 2007-2012)	29	42	41	43	50	56	41	50	62	62	63
Realised FV adjustments (Existing)	included in Realised FV adjustments (New)						28	39	50	61	77
P/Underlying profit (Care fees + Management fees – Expenses + Realized FV)	25.4	14.7	11.6	16.6	15.9	19.1	32.4	36.8	28.4	28.1	26.7
P/Reported earnings (Underlying profit + Unrealised FV adjustments)	16.2	9.9	8.7	11.6	11.0	11.8	20.5	20.8	16.0	14.1	12.9
P/BV	3.7	1.9	1.4	2.0	2.0	2.2	3.8	4.4	3.5	3.3	2.8
P/(BV + Occupancy advances)	1.6	0.9	0.6	0.8	0.8	0.9	1.5	1.8	1.4	1.4	1.2

In order to fully appreciate Ryman's growth runway and the nature of its business model, look for fair value in 10 years time.

Fair value 2027 = [2017 BV $1.6bn] + [2017 ORA $2.1bn] + [2018 – 2027 Mgmt fees $2.7bn] + [2018 – 2027 incremental ORA $10bn] + [2028 – terminal value $5bn] = $21.4bn

Growth pathway and its cashflows (NZDm)	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Number of units built	1,000	1,150	1,311	1,481	1,659	1,842	2,026	2,208	2,385	2,552
ORA 1 inflow	545	627	721	829	953	1,096	1,206	1,315	1,420	1,519
Construction cost	409	470	541	622	715	822	904	986	1,065	1,139
ORA 1 redemption						436	501	577	663	763
ORA 2 inflow						600	690	793	912	1,049
Net cash flow (reinvested)	136	157	180	207	238	438	490	545	604	666
Management fee	83	116	152	193	235	277	324	375	430	489
Cumulative occupancy advances 2018-2027	545	1,172	1,887	2,694	3,598	4,657	5,824	7,099	8,479	9,961

Terminal value calculation

2017 management fee: $61m
Resales bank[1] 2017: $760m
Incremental 2017 management fee:
$760m * 20% / 5 = $30m; 2017 run-rate: $91m
2027 incremental ORA management fee:
$9.96bn * 20% / 5 = $398m
2027 management fee = $91 + $398 = $489m
WACC = 10%, Growth rate = 2%

Source: Ryman Healthcare annual reports; estimates; ORA inflow inputs: unit growth starting at 15% and decreasing 100bps p.a.; Flat house prices/cost of building 25% development margin, 5 years average tenant stay, 20% management fee, 10% ORA 2 – ORA 1 repricing

[1] - represents real estate appreciation which has not fed into management fees as ORAs are yet to be renewed