The real daycare challenge: making money [1]

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Source: Globe and Mail
Format: Article
Publication Date: 8 Feb 2012

EXCERPTS:

Edleun , the private-sector company storming into Ontario as part of its plan to dominate the Canadian child-care industry, has kicked up a fuss with people who question whether it's an area in which large corporations should profit.

Reasonable people can see both sides; however, that debate is beyond the purview of VOX. Instead, our question is whether investors can profit from owning Edleun shares. In this as well, reasonable people can see both sides - but, in my opinion, a deep amount of skepticism is warranted.

First, a little history. Edleun (for "Education Learning Universe") is practically a startup, as it acquired its first 11 day-care centres in Alberta in May, 2010. It simultaneously went public by merging with a dormant company on the Venture Exchange. Today, it has 38 centres, with six more coming via acquisition or new construction.

The company's management, including CEO Ty Durekas and vice-chairman Leslie Wulf, have backgrounds in for-profit child care in the United States. Financial backing for the company comes, in part, from Jeffrey Olin and Gary Goodman of Toronto firm Vision Capital, two men with time spent working for Paul Reichmann at Olympia & York Developments Ltd.

Edleun sees a huge opportunity in a deeply fragmented industry where, it says, the other five biggest operators have just 1 per cent of Canada's child-care centres. Growth can come, Edleun says, from both acquisitions and building new centres.

Citing Statistics Canada, Edleun says fewer than 20 per cent of Canada's children under the age of six with mothers in the work force have access to a licensed child care space. This creates a "child care gap" of 2.2 million spaces, Edleun argues; even taking smaller government estimates that 165,000 new spaces are needed suggests 1,000 to 1,500 new centres are required.

Filling this need sounds like a fabulous plan, which leads one to wonder: If all this is so obvious, why hasn't anyone done it before?

A look at a hypothetical acquisition suggests the case for Edleun rests on the company creating quite a bit of value, quickly, with very little investment.

The scenario, created a year ago by Desjardins Securities analyst Jeffrey Roberts, looks at what Edleun can do after paying $1.16-million for an existing child-care centre with real estate worth $800,000 and a business valued at $360,000.

The hypothetical business, a 6,500-square-foot centre with capacity for 100 children, has revenue of $662,000 and EBITDA - earnings before interest, taxes, depreciation and amortization - of $200,000. It has just 80 per cent of its spaces filled.

After the purchase, Edleun invests $200,000, primarily by improving the property. It introduces its nutritious menus and standardized learning program.

Occupancy rises from 80 per cent to 95 per cent despite a 5 per cent fee increase. Revenue goes from $662,000 to $825,000, and EBITDA climbs from $200,000 to $265,000.

The improved business leads to a higher implied rent, so the building's value goes from $1-million ($800,000 plus the $200,000 in improvements) to $1.3-million.

And the business, which Edleun bought for three times its EBITDA (minus $80,000-a-year implied rent) is now worth 9.5 times EBITDA minus a new, implied rent of roughly $100,000 a year, or $1.53-million.

So, through one $200,000 investment and the implementation of the Edleun way, the value of the building and business more than doubles, from $1.16-million to $2.83-million.

Mr. Olin, an Edleun board member, does not dispute this scenario (and, in fact, subsequently hired Mr. Roberts to work for him at Vision Capital).

Edleun says it has already driven its same-centre occupancy from 79 per cent to 89 per cent since taking over, increasing same-centre revenue and operating profit by 28 per cent and 43 per cent, respectively.

However, we have heard variations on this theme before in the world of the "roll-up," where companies buy up pieces of a fragmented industry at one, low EBITDA multiple, put those pieces together, and get a public valuation with a much higher EBITDA multiple. The problem is that the acquiring has always been the easy part; it's the integration and operation where many, many roll-ups have stumbled.

It seems strange that in a country that supposedly has such a shortage of day-care options that there would be so many underperforming centres for Edleun to acquire and spruce up, or that it has a clear path to, in their words, "'Cherry Pick' prime sites with [the]best demographics and location enabling premium price." (Edleun's answer to this, Mr. Olin says, is that a modern centre takes more capital than today's mom-and-pop operators can muster.)

Edleun stock trades for around 83 cents a share, but since it has net losses and doesn't even have positive EBITDA, trailing multiples are elusive. Assuming it can post about $8-million in EBITDA in the next year, as Standard & Poor's Capital IQ does, Edleun's enterprise value - market capitalization plus debt - is about 10 times EBITDA.

It is, in other words, already priced at the kind of multiple Edleun should command if everything goes right. Which would give investors an expensive education if Edleun can't execute its profitable scenario.

-reprinted from the Globe and Mail

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