Quarterly stock commentary January 2019

Lifestyle Communities

"Grow old with me. The best is yet to be." ~ Robert Browning

Frank Rickwood was the Cessnock born director of BP's worldwide oil exploration program who was the inspiration for the 1982 BP "quiet achiever" global ad campaign. As a relatively unknown oil industry player it was his team that in 1959 discovered, and then developed, the Alaskan Prudhoe Bay oil field. Since first production in 1977, Prudhoe has generated over 13 billion barrels of oil and today still contributes 8% of BP's worldwide daily production volume. Prudhoe and Rickwood are good reminders that the creation of value for shareholders takes opportunity, dedication, stringent capital allocation and time to execute. An ability to manage these competing corporate interests can create long dated cash flow streams that deliver significant corporate and community value.

Financial markets are busy places. Like a classroom full of competing students, the noisiest often get the most attention. One of the things we try hard to do at Celeste is to look at the quieter companies that appear to be working hard to deliver against their stated strategy and growing wealth for their stakeholders over time.

Lifestyle Communities (LIC) is a Melbourne based developer and manager of affordable independent living communities. Lifestyle was started in 2003 by the current CEO James

Kelly and 2 business partners Dael Perlov and Bruce Carter. The founders sought to create a ‘business for purpose’ – developing affordable living options for people to own and live in, especially those residents on the ‘Age Pension’. The LIC customer base is working, semi-retired or retired people over 50 years. Some 50% of Australians aged over 50 have less than $520,000 in total assets that they need to use to both fund their accommodation and retirement.

So how does Lifestyle Communities fit into the Celeste process?

Small founder created businesses often have board and management teams dominated by founders and sycophants. Good businesses however realise that they must evolve and develop appropriate governance and oversight roles. LIC has been on a journey over the last few years to improve the skills of its board and management team. We rate the current CEO James Kelly highly for his focus and strategic discipline. Building a better team around him over the last few years now enables the company to leverage development opportunities and accelerate growth. CEO Kelly remains a key shareholder, owning around 12% of the company, significantly aligned with shareholders to the future success of LIC.

LIC has built a business around delivering affordable high quality communities that charge reasonable site rental fees. The business model is based around a land lease offer where the customer buys the home and has a lease over the land for 90 years. As such, the new home buy in cost for the resident is cheaper as it does not include the value of the land. This allows the resident to (1) free up more of the equity investment they have in their current home to support and enhance lifestyle in retirement and (2) potentially receive the Federal Government rental assistance rebate. Site fees increase annually by CPI or 3.5%, whichever is the greater, and LIC seek to ensure that the total rent costs is c22% of the total pension paid post the assistance package. Indexed rents are supportive of asset values, increasing earnings and dividends.

LIC also charge a deferred management fee (DMF) based around 4% per annum for the first 5 years, capped at 20% on sale. This fee will over time enhance the predictability of the cash flow streams that the portfolio of homes are able to deliver. It will also support the ability of LIC to invest in growing the number of communities that they manage and residents they support.

A focus on accounting is a good discipline for an investor as it helps one understand the nature of any company. A detailed financial assessment can aid the understanding of the business model - how does it earn revenue?....pay stakeholders?....generate cash?.....reinvest in growth?.....and ultimately create value for shareholders?

Post selling all the homes in a community LIC retain the land on balance sheet. The residents own their own home and their share of the community facilities which often include a club house, bowling green, tennis court and pool. From an accounting perspective, each period LIC must assess the carrying value of the land at each new community to reflect the difference between what they paid for it versus the value of the discounted cash flows the land is expected to deliver over the 90 years of the lease.

Some investors are concerned that LIC books a ‘revaluation profit’ though the income statement that is not backed by cash generated from a more traditional sale. In FY18 LIC reported 50.6cps in eps and 12.1cps in ‘cash backed eps’. These investors look at the cash reconciliation to highlight that the earnings are higher than the cash flow and as such should be backed out resulting in the price to earnings multiple increasing from 12x to 49x.

At Celeste we love to look at the reconciliation of cash flow to earnings. It tells us how much of the earnings were delivered as cash in the accounting period, and how reliable the earnings are as a proxy for cash. Because in the end, only cash matters.

So why would Celeste therefore own a company where there reconciliation suggests that there is a big cash mismatch?

LIC is a relatively new company with its first community developed in 2003 and the company only floated on the ASX in 2007. The LIC business model is to create communities where people want to live, in order to build a long term cash flow rental stream from the land on which these homes sit. Last year LIC settled a record 327 homes. The total number of homes under management on which LIC collect rent and fees is 1,947 (30 June 2018). At the rate of 325 additions per year LIC will add between 10-15% to the embedded housing stock each year for the next 4-5 years. This portfolio of home rental sites contributes to wealth through an annual cash rental stream and a cash DMF flow when the resident sells their home. As such, rent and DMF differ in terms of both size and timing. One is smaller and more regular (rent) and the other is bigger and less predictable (DMF). In fact there may be no DMF for a period of years in a newly built community. But like death and taxes, communities will reach a turnover rate reflecting the fact that residents do wish to sell up, move out and start new phases in their lives. As such the sales turnover rate and linked DMF will reach a normalised rate and this will deliver more predictable cash flows over time. The requirement of the accounting standard to reflect this value before it has been delivered is what drives the cash mismatch.

Celeste views the nature of the LIC business model, the contractual relationships between LIC and their resident owners and the aging demographic profile of the baby boomers as key components in driving both initial sales and ongoing home turnover. We believe these characteristics will see the cash flow generated from this fast growing home management portfolio increase dramatically as the portfolio matures. As such, we think it's a timing thing, and we are comfortable to own LIC today at a headline price to earnings ratio that looks expensive to some (we will chat valuation a little later).

Often shareholders see little in the way of dividends as high growth companies seek to reinvest in order to continue growing. High growth companies generally also seek capital to fund their growth. The risk being a shareholder in high growth companies is that by issuing new equity to grow, investors are constantly being diluted. So the growth is good, but an investor's share of the growth continues to be less at each raising because other shareholders are funding it and participating in it.

LIC was floated on the ASX in 2007 and raised $6.5m. In 2012 the company had a rights issue to allow investors to participate equally and raised a further $37m. LIC stated in this raising that it intended to raise no further capital and it would use the proceeds of the rights issue, cash and self-generated earnings to fund all future growth. The rights issue was effectively done at $0.70/share versus today's price of $5.20/share. While it would have been easy to raise more equity in the last few years' to supercharge the development portfolio, management and the board have exhibited no strategy drift, remained true to their statements and worked hard to increase the speed of turnover in their developments, to drive growth in communities developed. Shareholders remain the winners when capital discipline wins over dilution.

So LIC rates well on the assessment of board and management, business model and accounting quality. So how does the valuation look?

You can look at LIC in a number of ways. If you assume that LIC build 325 houses every year and you, the investor, just receive a dividend each year based on the historic payout ratio, then from 2025 as an investor you are happy to receive a 6% yield. With growth in the cash flow stream post 2025 the initial yield increases over time leading to an LIC valuation of $6.50/share. If you assume however that LIC stops developing any further communities in 2025 and as such has no need to reinvest earnings and cash flow back into the company to grow (they just maintain the current home portfolio at 2025 of 4,200), the valuation increases to around $8.50/share.

Clearly the longer that an investor assumes increased portfolio size the higher the potential valuation. There does not appear to be any intention from the current management team to have a terminal build point. The valuation rises to $11/share if you assume building remains at 325 per year until 2030 when LIC would have around 5,800 homes under management. If you assume that they stop at that point and give back the bulk of the rent and DMF as dividends then it's worth more again.

It's easy to build forecasts into a spreadsheet and produce a valuation in isolation. A valuation is only one representation of reality as it might play out. As active investors we remain focused on trying to assess what the current reality is and how it might be changing by reviewing all the factors that formed the basis of our initial assessment. This means we continue to meet with the company, discuss strategy and try to meet many employees across the business to gauge culture, alignment, motivation, and skills. To help us gauge capital efficiency we look at new land purchases, the build rate at each of the communities and the sell through rate of these new homes. We also assess the median house prices around the Lifestyle Community developments, resale prices and average price growth since acquisition for residents. It is all these factors that we attempt to assess that form the basis of assumptions we make in building a financial model that is trying to forecast the future.

Management of the majority of these issues form part of the remit of the management team and so we need to continue to remain comfortable that LIC attract and retain people with key skills. The skills to manage the things that work, change the things that don't and continue to build a company that is strategically focused, a patient capital allocator, and remains true to its purpose. Like the Prudhoe Bay oil fields developed by Frank Rickwood, the growth of the home sites under management will see significant increases in cash flow generated by rent and DMF. These in turn drive further growth. As it sits today, we think we are just at the start of the cash flow generation process for LIC and think that the property portfolio is gaining momentum, a little like a fly wheel. We expect this flywheel growth effect will deliver long dated cash flow streams that create significant shareholder and community value for decades to come.

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