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Think Childcare Limited

Childcare

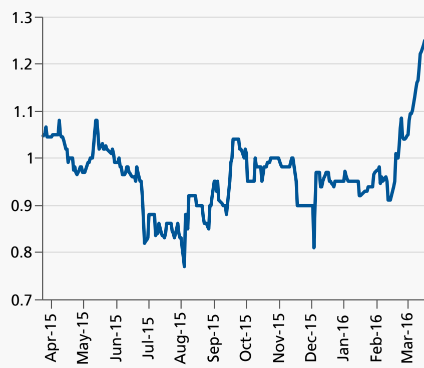
Australian Equity Research
21 March 2016

BUY

PRICE TARGET	A$1.56
Price (18-Mar)	A$1.25
Ticker	TNK-ASX

52-Week Range (A$):	0.77 - 1.27
Avg Daily Vol (M) :	0.02
Dividend /Shr (AUc):	7.2
Dividend Yield (%) :	5.8
Enterprise Value (A$M):	49.9

FYE Dec	2015A	2016E	2017E	2018E
Sales (A$M)	46.5	57.0	66.7	76.9
EBITDA (A$M)	7.7	9.4	11.3	13.3
Net Income (A$M)	4.8	5.2	6.3	7.9
EPS Adj&Dil (AUc)	12.74	14.33	17.07	19.43
EPS Growth (%)	192.2	12.5	19.1	13.8
EV/EBITDA (x)	6.8	6.2	5.6	4.9
DPS (AUc)	7.20	7.80	9.40	11.70
Div. Yield (%)	5.8	6.3	7.6	9.4
P/E (x)	9.8	8.7	7.3	6.4



Source: FactSet

Think Childcare operates a portfolio of 32 childcare and early education centres in Australia with licensed places for almost 2,500 children. TNK also manages 12 childcare centres on behalf of third party owners, essentially establishing a pipeline of potential future acquisitions.

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Initiation of Coverage

Delivering as promised

Think Childcare Limited (ASX:TNK) is a provider of childcare services in Australia. TNK has an impressive EPS growth profile and has developed a strong track record of boosting occupancy rates and hitting financial targets. We are forecasting a four-year EPS CAGR of 13.6% yet the company trades on a CY16 PE of 8.7x and EV/EBITDA of 6.2x and we note the very strong recent share price performance. We initiate coverage of TNK with a BUY rating and $1.56 target.

Background

TNK has a portfolio of 32 long day care centres with the majority located in Victoria. The company also generates revenue by operating 12 externally-owned centres. TNK is differentiated from the other major listed childcare companies in three main areas:

1. TNK are childcare operators, not consolidators.
2. TNK targets underperforming centres with the intention of improving occupancy. To date, the strategy has been successful and TNK management have developed an impressive track record of driving substantial increases in occupancy.
3. TNK has established an incubator program that can potentially act as a feeder and as due diligence of future acquisitions.

Investment thesis

Our positive stance on the stock is based on several key attributes including:

1. Strong EPS growth profile driven by occupancy growth and acquisitions.
2. Strong track record of driving occupancy higher and hitting targets including exceeding prospectus forecasts.
3. Supportive industry drivers including government funding that continues to grow given the economic returns and the social drivers. Demand for centres continues to grow in line or slightly ahead of supply growth.
4. Attractive takeover target given recent activity in the sector and the fragmented nature of the industry.
5. Managed centres effectively act as an incubator program and provides well known acquisition targets.
6. CY16 dividend yield of 6.3%.
7. Catalysts including acquisitions, additional managed centres, dividend announcements and possible takeover bids.

Valuation and recommendation

We initiate coverage of TNK with a BUY rating and $1.56 target, based on a DCF valuation that incorporates a WACC of 11.2% and TGR of 3%.

We note that on 6.0x FY17 EV/EBIT, TNK trades at an attractive 23% discount to its childcare peers and compared to other ASX listed companies driven by acquisition policies, TNK trades on 56% discount on a FY17 PE basis given its 7.3x multiple.

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For important information, please see the Important Disclosures beginning on page 20 of this document.

FINANCIAL SUMMARY

Think Childcare	TNK:ASX		
Analyst:	Aaron Muller and Cameron Bell	Rating:	**BUY**
Date:	18/03/2016	Target Price:	**$1.56**
Year end:	31 December		

Profit & Loss ($m)	2014A	2015A	2016F	2017F
Sales Revenue	**7.2**	**46.5**	**57.0**	**66.7**
EBITDA	**0.9**	**7.7**	**9.4**	**11.3**
Depreciation	-0.1	-0.3	-0.6	-0.8
EBITA	**0.8**	**7.4**	**8.9**	**10.5**
Amortisation	0.0	0.0	0.0	0.0
EBIT	**0.8**	**7.4**	**8.9**	**10.5**
Net Interest Expense	-0.1	-0.4	-0.9	-0.9
NPBT	**0.7**	**7.0**	**8.0**	**9.7**
Tax expense	0.3	-1.9	-2.3	-2.8
NPAT (Normalised)	**1.0**	**5.0**	**5.7**	**6.9**
Significant items	-7.0	-0.2	-0.5	-0.5
NPAT (Reported)	**-6.0**	**4.8**	**5.2**	**6.3**

Valuation ratios	2014A	2015A	2016F	2017F
EPS (cps)	4.4	12.7	14.3	17.1
P/E (x)	28.6	9.8	8.7	7.3
PER Rel - All Ind.	63%	-41%	-42%	-46%
PER Rel - Small Ind.	72%	-39%	-38%	-43%
Enterprise Value ($m)	49.9	52.4	58.1	63.3
EV / EBITDA (x)	57.0	6.8	6.2	5.6
EV / EBIT (x)	61.3	7.1	6.5	6.0
DPS (cps)	0.0	7.2	7.8	9.4
Dividend Yield (%)	0.0%	5.8%	6.3%	7.6%
Franking (%)	na	33%	100%	100%
CFPS (cps)	0.7	17.5	19.2	20.1
P / CFPS (x)	172.0	7.1	6.5	6.2

Cash Flow ($m)	2014A	2015A	2016F	2017F
Operating EBITDA	**0.9**	**7.7**	**9.4**	**11.3**
- Interest & Tax Paid	0.2	-2.3	-3.2	-3.7
+/- change in Work. Cap.	2.8	-0.7	0.5	0.4
- other	-3.7	2.3	0.9	0.0
Operating Cashflow	**0.2**	**6.9**	**7.6**	**8.1**
- Capex	-0.1	-1.1	-1.4	-1.6
- Aquisitions/divestments	-19.1	-4.6	-7.5	-7.5
- other	-0.9	-1.1	-1.1	-1.1
Free Cashflow	**-19.9**	**0.1**	**-2.4**	**-2.2**
- Ord Dividends	0.0	0.0	-3.8	-3.3
- Equity /other	19.2	-2.4	0.3	0.3
Net Cashflow	**-0.6**	**-2.3**	**-5.9**	**-5.2**
Cash at beginning of period	0.0	4.4	2.4	2.5
+/- borrowings / other	5.0	0.3	6.0	5.0
Cash at end of period	**4.4**	**2.4**	**2.5**	**2.3**

Profitability ratios	2014A	2015A	2016F	2017F
EBITDA Margin (%)	12.1	16.6	16.6	16.9
EBIT Margin (%)	11.3	15.9	15.6	15.8
ROE (%)	8.2	29.0	29.8	32.2
ROA (%)	3.4	26.5	24.5	23.7
ROIC (%)	9.2	26.1	22.6	21.2

Balance Sheet ratios	2014A	2015A	2016F	2017F
Net Debt (cash)	0.6	3.0	8.8	14.0
Net Gearing (%)	5.1%	17.5%	46.0%	65.6%
Interest Cover (x)	6.7	18.0	10.2	12.1
NTA per share ($)	nm	-0.07	-0.21	-0.33
Price / NTA (x)	nm	-16.9	-6.0	-3.8
EFPOWA (m)	23.8	39.6	39.7	40.1

Growth ratios	2014A	2015A	2016F	2017F
Sales revenue ($m)	nm	544.0%	22.6%	17.0%
EBITDA ($m)	nm	781.1%	22.4%	19.5%
EBIT ($m)	nm	806.7%	20.3%	18.4%
NPAT ($m)	nm	386.9%	12.9%	20.4%
EPS (cps)	nm	192.2%	12.5%	19.1%
DPS (cps)	na	nm	8%	21%

Balance Sheet	2014A	2015A	2016F	2017F
Cash	4.4	2.4	2.5	2.3
Inventories	0.0	0.0	0.0	0.0
Debtors	2.9	1.2	1.7	2.0
PPE	1.0	1.9	2.7	3.4
Intangibles	17.1	20.3	27.4	34.5
Other assets	3.2	4.5	4.5	4.5
Total Assets	**28.5**	**30.2**	**38.8**	**46.7**
Borrowings	5.0	5.4	11.3	16.3
Trade Creditors	5.7	3.3	4.3	5.0
Other Liabilities	5.3	4.1	4.1	4.1
Total Liabilities	**16.0**	**12.8**	**19.7**	**25.4**
NET ASSETS	**12.6**	**17.4**	**19.1**	**21.3**

Interim Analysis	1H15A	2H15F	1H16F	2H16F
Revenues	18.6	27.9	23.2	32.9
EBIT	1.8	5.5	2.5	6.4
EBIT margin (%)	9.9%	19.9%	10.6%	19.6%
EPS	3.0	9.8	3.6	10.7
DPS	0.0	7.2	2.3	5.5

Board of Directors / Substantial Shareholders

Board of Directors	Shareholding	%
Mark Kerr - Non-Executive Chairman	1.3	3.4%
Mathew Edwards - Managing Director	13.5	34.2%
Paul Gwilym - Executive Director & CFO	0.7	1.7%
Andrew Hanson - Non-Executive Director	0.1	0.1%

Substantial Shareholders	Shareholding	%
Mathew Edwards	13.5	34.2%
Perpetual	3.5	8.9%
Colonial First State	2.9	7.3%
Riversdale Road Trust	2.5	6.3%
Top 20 Shareholders	**120.5**	304.2%

Valuation	2016F
Normalised EBITDA multiple (x)	
EBITDA ($m)	9.4
Target EBITDA multiple (x)	7.0
Net Debt (cash) ($m)	8.8
Implied Valuation	57.3
Per Share	**$1.45**
Target PE Multiple	
EPS (c)	14.3
PE Target (x)	10.0
Per Share	**$1.43**

Discounted Cash Flow

Cost of equity	13.0%	WACC	11.2%
Cost of debt	5.5%	Terminal Growth Rate	3.0%
Net Debt/ Net debt + equity	20.0%	Per Share	**$1.56**

Description

Think Childcare operates a portfolio of 32 childcare and early education centres in Australia with licensed places for almost 2,500 children. TNK also manages 12 childcare centres on behalf of third party owners, essentially establishing a pipeline of potential future acquisitions. The company focusses on low occuapcny centres that are cheaper to acquire, and relies on its track record of increasing occuapcny levels such that returns are greater.

Source: Canaccord Genuity estimates, Company reports

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INVESTMENT CASE

Company overview

Think Childcare Limited (ASX:TNK) is a provider of childcare services in Australia. The company has a focus on long day care (LDC) centres that provide care and education for children from six weeks to school age. The company was formally incorporated on IPO in late 2014 but has effectively been in operation since 2009. TNK's IPO involved the acquisition of 15 centres previously owned by Learning and Education Australia (LEA) which was owned by the current CEO of TNK, Matthew Edwards as well as the acquisition of 15 additional centres that are collectively referred to as the Baker Street Centres and were purchased from various owners. The company has since acquired an additional two centres and now owns 32 centres and manages a further 12 centres owned by third parties.

Investment thesis

We initiate coverage of TNK with a BUY rating and $1.56 target. Our positive stance on the stock is based on several key attributes including:

Strong EPS growth profile

Based on our forecasts, we have a four year compounding annual EPS growth rate out to CY19 of 13.6%.

We believe TNK has attractive growth prospects to be driven by both organic and acquisitive strategies. TNK has established effective strategies of improving attractiveness and demand for centres within the portfolio which in turn has driven occupancy higher. Targeted capital works, hands on management and staff, efficient systems and local marketing campaigns have capacity to drive occupancy and day rates higher to drive positive organic growth.

Despite a large amount of M&A activity within the childcare industry in recent years, the industry remains highly fragmented and the acquisition opportunities are still attractive. Our analysis suggests that there are ~5,300 centres that are operated outside of the major groups being Goodstart (9.4% of the LDC market), G8 Education (ASX:GEM with 6.9%, Affinity (2.4%), KU Children's Services (2.2%) and Guardian (1.0%).

TNK has acquired two centres since listing and we expect the company to take a more active approach given the IPO portfolio is now running more efficiently and integration is effectively complete. We expect TNK to continue to pay acquisition prices of 4x-5x EBIT.

Established track record

We believe that compared to other listed and previously listed childcare operators, TNK has so far taken a more cautious approach in its expansion and in doing so has managed to integrate its prospectus portfolio efficiently, has increased occupancy at its underperforming centres and has reported results ahead of its prospectus forecasts. Additionally, prior to listing, senior management had extensive experience in successfully operating a portfolio of centres.

A disciplined process led TNK to making sure its IPO portfolio was operating according to plan prior to expanding and the company has only acquired two additional centres since listing. We expect this part of TNK's growth prospects to accelerate over the coming 12 months.

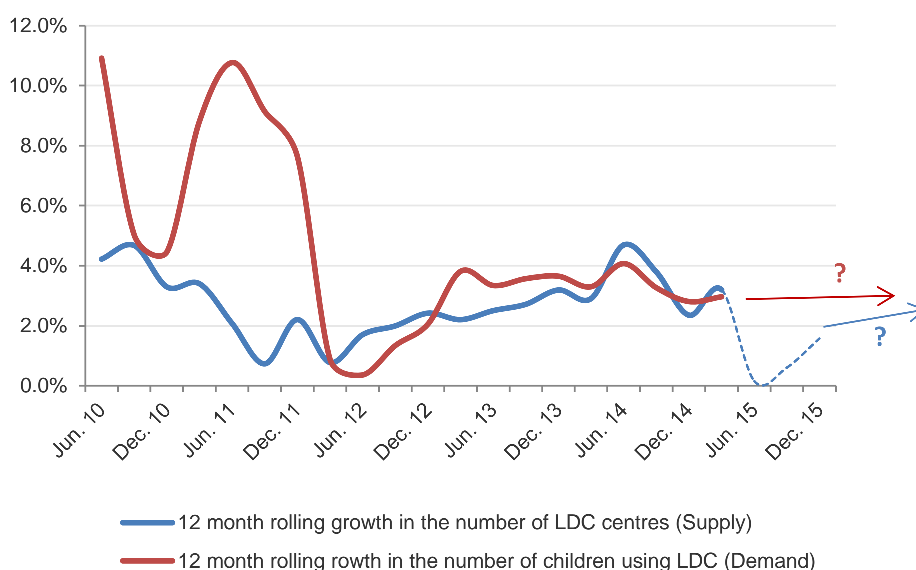
Hands on approach

We believe management's focus on individual centres and placing an emphasis on working alongside the centre staff has driven a more "local family" feel that the parents and children have so far responded well to.

Supportive industry drivers

We believe the long day care side of the childcare industry remains a highly attractive sector with support from the government and favorable demand and supply drivers. Despite increasing supply of centres largely from greenfield developments, we view the industry fundamentals positively and expect demand to have continued to increase either in line or ahead of supply growth.

Figure 1: LDC supply vs demand – note dotted blue line is not directly comparable data

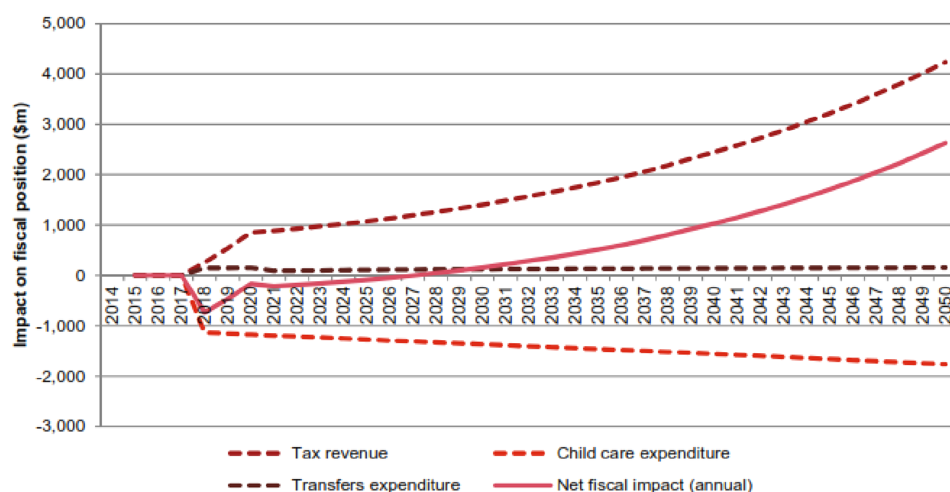


Source: mychild.gov.au, Australian Government Department of Education & Education, Canaccord

The government is expected to increase funding to the sector by $3.2b over four years, reflecting the ongoing support to the industry and an ~11% increase on the estimated $7b per annum currently. Both sides of politics are supportive of legislation that encourages female workforce participation and provides assistance to families, however we note that the voting and implementation appears to have been delayed a year and we now expect this to occur in 2018.

As recently shown by PwC, the legislation that is currently in front of the Senate should increase real GDP by $7.6b by 2050 which reflects a net fiscal saving to the Australian Government of $4.3b in NPV terms.

Figure 2: Fiscal result of increased childcare funding and workforce participation



Source: PwC, Economic impacts of the proposed Child Care Subsidy, February 2016

The industry also maintains a strong position within society and in our view its public good status means that it's in the government's interest to support it for economic and social reasons.

Strong takeover target

We believe that TNK will at some stage become a likely takeover target either by a larger industry participant or private equity. We point to recent activity within the sector with Affinity Education acquired by Anchorage Capital following a takeover bid from G8 Education (ASX:GEM) and Guardian Childcare being acquired by private equity firm, Partners Group. Affinity underwent a challenging period and was marked down by the market but still managed to be sold for 7.1x forward EBITDA, well ahead of TNK current CY16 EV/EBITDA multiple of 6.2x.

Incubator provides well known acquisition targets

TNK's "managed centres" revenue stream can act as an incubator program that we expect can provide a form of due diligence of future acquisitions. There are currently 12 centres owned by third parties that TNK manages for a fee and we believe there is potential for that to expand dramatically. This would indicate that 20-30 centres could be converted into managed centres over the coming 2 years, after which we believe TNK could be the likely acquirer.

High dividend yield

We are forecasting a CY16 dividend of 7.8c which equates to a yield of 6.3%. We also note the company paid a 7.2c final dividend in March 2016 which combined with our CY16 forecast would equate to a 13 month yield of 12.0%. The 7.2c dividend will be franked to 33.3% and we are forecasting future dividends to be 100% franked. The stock went ex-dividend on Friday March 18th and the company has a DRP in place.

Catalysts

We see multiple possible short term catalysts for TNK, including likely centre acquisitions, adding further third party owned centres to its managed portfolio, dividend announcements and possible takeover bids.

The company has a dividend policy in place to pay up to 65% of earnings as dividends. TNK announce a dividend at its full year result of 7.2c, in line with prospectus guidance.

Valuation and recommendation

We initiate coverage of TNK with a BUY rating and $1.56 target, based on a DCF valuation that incorporates a WACC of 11.2% and TGR of 3%.

We note that on 6.0x FY17 EV/EBIT, TNK trades at an attractive 23% discount to its childcare peers and compared to other ASX listed companies driven by acquisition policies, TNK trades on 56% discount on a FY17 PE basis given its 7.3x multiple. Given our forecast four year EPS CAGR of 13.6%, we view the current CY17 PE of 7.3x as undemanding.

COMPANY OVERVIEW

Background

Think Childcare Limited (ASX:TNK) was listed on the ASX late in 2014 as part of the merging of 30 childcare centres. TNK provides long day care (LDC) services to children aged between six weeks and six years old.

As part of the company's formation, TNK acquired 15 centres from Learning and Educations Australia (LEA). LEA was formed at the start of 2009 and was indirectly owned by the current CEO of TNK, Matthew Edwards. The remaining 15 original centres came from various sources and were labelled the "Baker Street centres". Baker Street is the name of the company that was established in 2014 in order to acquire the various centres which were expected to settle within two months of the company listed. 28 of the initial portfolio are based in Victoria and the remaining two are in New South Wales.

TNK has also established an incubator program via its managed centres. TNK entered into management agreements with 17 externally owned centres prior to IPO and declared its intention to enter into further agreements with third party owners. TNK is engaged to manage each centre for a minimum fee of $60,000 per annum for an initial term of 12 months.

Earnings model and drivers

TNK provides long day care (LDC) services to parents with young children. LDC centres generate revenue by charging a daily rate per child for care and education and are generally open for around 10 hours per day on weekdays. The daily rate is paid by parents however payments are partially subsidised by the government under a number of different forms.

The total daily revenue of an individual centre can be calculated by the simple formula of: centre revenue = "licensed places" x "occupancy percentage" x "day rate".

Number of licensed places – Each centre is licensed for a maximum number of places, which is related to the useable play space. Licensed places are allocated based on there being at least 3.25m2 per child of usable indoor play area, however TNK has been in the process of utilising its space better as part of its program of capital works and in the lead up to changing staff to child ratios that were introduced at the beginning on 2016.

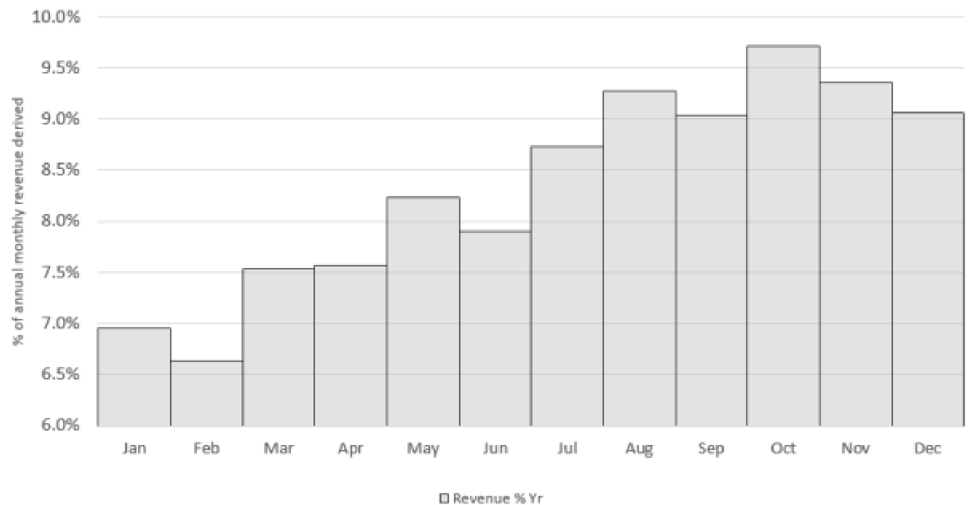
TNK had 2,244 licensed places at IPO but has since acquired two centres and the total number has increased to 2,401. As part of its program of maximising the possible licensed places, the company has managed to increase its places to 2,476 and we expect there to be a small upside to number still.

Occupancy – Occupancy refers to the percentage of licensed places that are being utilised. A common rule of thumb within the industry is that a centre will break even at ~70% occupancy so maximising occupancy beyond this level is key to the underlying financial performance of each centre.

TNK provided the following commentary in early December 2015 regarding occupancy: "TNK commenced the year at 67% occupancy across its foundation 30 centre portfolio. In October occupancy peaked at 87% and has subsequently held an average in excess of 86%; with an occupancy of 86.28% for the week ended 27th November 2015."

Seasonality plays a substantial role in childcare and TNK readjusted their prospectus forecast 1H:2H split given the greater 2H contribution. Occupancy is at its lowest early in the calendar year during school holidays and as children leave childcare to begin school. Occupancy gradually ramping up over most of the year.

Figure 3: Typical revenue seasonality

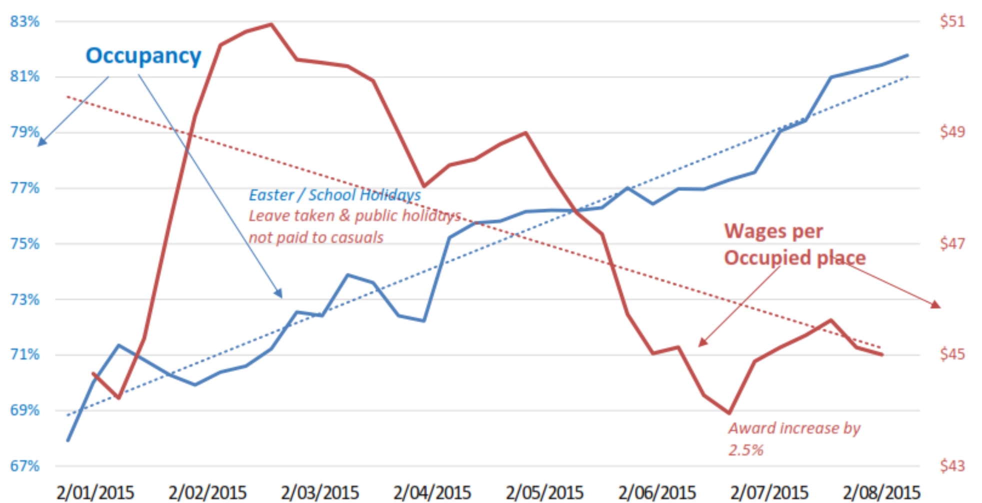


Source: Think Childcare

We estimate the accumulated percentage of revenue in 1H accounts for around 44.7% and 2H revenue of 55.3%.

Occupancy is largely seen as the key operational measure in the industry and TNK derives a substantial portion of its strong operating reputation from its ability to increase occupancy at historically underperforming sites via capital works, hands on management and staff and local marketing campaigns. As occupancy increases, the cost per child declines and the increased scale drives higher returns.

Figure 4: Wages per child driven down by increasing occupancy

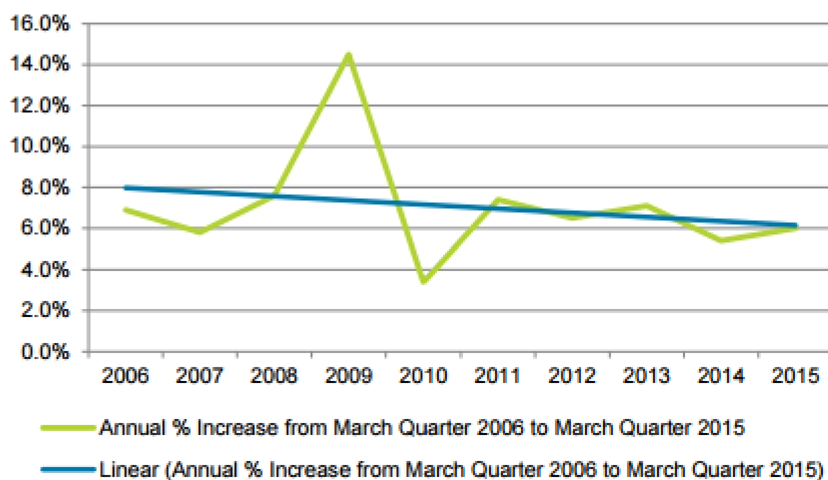


Source: Think Childcare

Average daily fees – Fees can vary greatly depending on several factors including the location and services provided. Varying levels of demand and costs have led to a broad range of $50-$200 across the industry.

Rates have been increasing at above CPI levels for several years and we understand that the industry has largely increased 4%-5% in January 2016. Most centres increase rates twice a year and the average annual increase over the last ~10 years has been 7%.

Figure 5: Changes to LDC fees



Source: Department of Education and Training, Folkestone Education Trust

Managed centres - TNK has the management rights to 12 externally owned centres. At IPO, this number was 17. The company was engaged to manage the centres and received an annual fee of $60,000 each from 16 centres and $100,000 from the remaining centre, all paid on a monthly basis. The contracts in place were for an initial 12 month period. TNK provided prospectus forecasts for revenue from the managed centres with an expectation of $1.1m revenue for CY15.

The additional revenue provides a form of scale that takes advantage of the operating structures and corporate profile of the business. The company hopes to enter into additional management agreements with existing third party owners.

We see the portfolio of managed accounts as providing acquisition opportunities without taking on the early operating risk of the assets.

Acquisition history and strategy

Similar to current and previously listed childcare operators, a large part of the company's strategy involves acquisitive growth. TNK was established in order to participate in the ongoing consolidation in the highly fragmented childcare industry.

We expect TNK to generally pay between 4-5x EBIT, in line with their historical acquisitions. We also do not expect the same level of competitiveness that has driven prices for premium centres upwards. TNK occasionally compete directly with the likes of GEM and AFJ for centres; however, TNK often targets centres with lower occupancy that will require some form of turnaround. In saying that, we note that outside of the prospectus portfolio the only centres acquired since listing have had a high level of occupancy.

TNK has only acquired two centres since listing and we note that the disclosures around the transactions included far more detail than we have been used to. TNK paid $3.05m in cash (initially announced as $1.3m cash and $1.75m equity) and a forward EBIT multiple of 3.71x. With the inclusion of payroll tax, the final multiple was 4.08x, still cheap in our view. One of the centres has an earn out that could result in

$300k payable in CY17. Importantly, we note the large amount of detail that was provided around the transactions including funding, costs, multiples, etc.

We also note that the two centres were both acquired out of TNK's portfolio of managed centres that we believe will continue to act as an incubator.

Our model currently has 5 centre acquisitions in both CY16 and CY17 however we note that given the market opportunity this could be noticeably higher. The bulk of the funding will come from debt and we note that TNK has $19m debt available for future acquisitions of which $9m is available immediately provided certain measures are met. As mentioned, TNK acquired 2 centres in CY15 and the company has guided to a more active period in CY16.

We also have a terminal rate of 3 additional centres which increases the capex charge in our terminal year free cash flow, thereby reducing our valuation. Removal of the terminal year capex increases our valuation substantially. We have chosen 3 as we expect the company to remain acquisitive but also to take a "slow and steady" approach to its expansion.

We have incorporated a 5x EBIT multiple in our forecasts to be conservative and we note that the actual multiple could be lower and therefore more accretive. Our CY16 and CY17 acquisitions include assumptions of $1.5m price per centre, 80 licensed places at each centre, 80% occupancy and day rates of $90 when acquired.

Acquisition costs are expensed, not capitalized and we have incorporated costs of 10% in our forecasts.

WHAT'S THE DIFFERENTIATOR?

Operators, not consolidators - Other listed childcare companies have led highly successful consolidation strategies involving multiple arbitrage combined with scale benefits and operating efficiencies. TNK's focus is on operating the centres to the best of their individual potentials and will consider acquisition opportunities if and when they arise. TNK favour the strategy of turning around centres that were previously underperforming and therefore were acquired cheaper than might be expected.

By way of example, we can compare the approaches and management experience of Affinity Education (formerly ASX:AFJ) and TNK. AFJ floated around ~10 months prior to TNK and rapidly acquired centres over a period of 18 months. Eventually the company flagged that occupancy was well below expectations, that recently acquired centres weren't improving quick enough and that corporate overheads were running at high levels as the company expanded. Conversely, since TNK listed ~18 months ago the focus has not been on expansion but rather on the IPO portfolio and making sure that occupancy was maximised at existing centres and that appropriate processes and infrastructure were in place prior to expanding.

A reflection of TNK's credentials as an operator is also reflected in their approach to the recent changes to staff to child ratios. All centres were re-measured, adjusted by age offering and architectural measurements and reconfigures. The result was an increase of fees with an additional 2.5% on top to counter the measures and compared to a simple calculation of the changed ratios that would reflect an increase in wages of ~35% for the care of over 3 year olds. The total base wage per child for CY15 of $43.75 is forecast to increase to $46.23, or 5.7%.

Targeting underperforming centres – As part of the IPO process, TNK acquired a number of underperforming centres with the intention of using its centre management experience, incorporating its own systems, executing a limited amount of capital works (playground update, fresh coat of paint etc.) and local marketing in order to drive an increase in occupancy. To date, the strategy has been successful and TNK management have developed an impressive track record of driving substantial increases in occupancy.

We note that TNK has only acquired two centres since listing and they were operating at 93% occupancy according to the original acquisition announcement. We do not see this as evidence that TNK is not targeting underperforming centres but rather that its initial focus was securing reasonable performance from the IPO portfolio that had only recently been put together. We again note that a number of the IPO centres were not operating particularly strongly and seemingly have since improved at impressive rates. Additionally, we highlight that the two centres acquired were able to operate at 93% occupancy under TNK's management which emphasises the operating expertise at a centre level.

Other than potential earnings uplift, this strategy also provides benefits on the acquisition front as we believe there is generally a lower level of competition in bidding for underperforming centres. We believe TNK has a strong likelihood of keeping acquisition multiple low at levels around 4x-5x forward EBIT.

Incubator program – TNK has established an incubator program that can potentially act as a feeder and as due diligence of future acquisitions. TNK enters into agreements with third party owned centres where they offer to provide an outsourced

management service. Although fees vary, a base of $60,000 per annum is a reasonable assumption in our view.

Originally, the incubator program had one main partner but it has now expanded to the point that there are 3-4 main partners.

We believe there are over 100 centres in the pipeline for the incubator and believe a conversion rate of 20-25% is very achievable. This would indicate that 20-30 centres could be converted into managed centres over the coming 2 years, after which TNK could be the likely acquirer.

FINANCIAL FORECASTS

Profit and Loss forecasts

Revenue – As we outlined earlier, revenue is largely a function of day rates, the number of licenced places and occupancy. Organic revenue growth is largely based on the gradual increase in rates and TNK's strategy of increasing occupancy. Acquisitive growth drives the number of licenced places and margins improve due to scale benefits.

EBIT margins – The childcare operators tend to generate EBIT margins of between 12%-20% at the operating level. We estimate that TNK's margins are currently around 15%-16% after corporate costs and expect that margins will gradually grow as scale efficiencies are reached. By comparison, given the far larger size, GEM operates on EBIT margins of ~22%.

The key costs with a LDC centre are:

Wages – Staff costs are the largest cost within a LDC centre and wage/sales in the industry can range between 55%-65%. TNK reported wage/sales of 62.2% in CY15 and we expect this to remain reasonably flat in CY16 as the scale and revenue benefits are partially offset by higher staff to child ratios. Over 70% of the operating costs are made up by staff and we are generally of the opinion that success at the centre level within the industry is driven largely by the educators. TNK has ~1000 staff.

Building lease costs – Rent expense is the second largest cost and TNK reported rent/sales of 12.1%, within the industry range that we typically see as 12-14% of sales. TNK lease all their properties and do not intend to own property. Leases are generally long term with 10-15 year terms and additional options. Although terms vary across properties and landlords, rental increases are generally tied to the consumer price index, occasionally with a minimum increase.

Direct expenses of providing services – This include electricity, food, nappies and equipment etc. for the day to day provision of childcare services.

Strong CY15 result

TNK reported an impressive set of results following its first full year as a listed entity. Revenue of $46.5m was 7% above prospectus forecasts of $43.4m; however, the company acquired two centres during the year. On a like-for-like basis (backing out the acquisitions), revenue still came in 5% above the prospectus forecasts, at $45.5m.

As shown in the table below, EBITDA was 13% above prospectus forecasts. The only negative surprises were a slightly higher than anticipated wage to revenue and rent to

revenue ratios. Both variations were small in our view and were more than offset by lower than anticipated costs of providing service and other expenses.

The full year dividend of 7.2c was in line with company forecasts and given there was no interim dividend, the full 7.2c is to be paid as a final dividend. The stock will go ex-dividend on March 18th.

Operating cashflow was an impressive $6.9m, with capex of $1.1m. Average occupancy for the full year was 78.8% with peak occupancy of 87.2% reached in October.

Figure 6: TNK Profit and Loss

	CY15 Prospectus	CY15A	Variance	CY16F	CY17F
Number of centres opening	30	30		32	37
Centres acquired	0	2		5	5
Number of centres closing	30	32		37	37
Revenue	**43.4**	**46.5**	**7%**	**57.0**	**66.7**
Employee expenses	26.7	28.9	8%	35.5	41.5
Building occupancy expenses	4.8	5.6	17%	6.9	8.0
Direct expenses of providing services	2.0	1.8	-9%	2.3	2.6
Other expenses	3.0	2.4	-20%	3.0	3.3
Total expenses	36.6	38.8	6%	47.6	55.5
EBITDA	**6.8**	**7.7**	13%	9.4	11.3
D & A	0.2	0.3	39%	0.6	0.8
EBIT	**6.6**	**7.4**	13%	8.9	10.5
Net finance expense	0.4	0.4	8%	0.9	0.9
Net profit before tax	6.2	7.0	13%	8.0	9.7
Income tax expense	1.9	1.9	4%	-2.3	-2.8
Underlying NPAT	**4.4**	**5.0**	**15%**	**5.7**	**6.9**
Significant Items	0.1	0.2	137%	-0.5	-0.5
Statutory (loss)/profit	**4.3**	**4.8**	**11%**	**5.2**	**6.3**
Underlying EPS	10.9	12.7	17%	14.3	17.1
DPS	7.1	7.2	1%	7.8	9.4
Ratios					
Employee costs/revenue	61.6%	62.2%		62.2%	62.1%
Building occupancy costs/revenue	11.1%	12.1%		12.1%	12.0%
Direct costs/revenue	4.6%	4.0%		4.0%	4.0%
EBITDA Margin	15.7%	16.6%		16.6%	16.9%
EBIT margin	15.1%	15.9%		15.6%	15.8%
PER		8.6		8.7	7.3
Dividend payout ratio	65%	57%		54%	55%
Dividend yield		5.8%		6.3%	7.6%

Source: TNK Prospectus, Canaccord Genuity estimates

Balance sheet

TNK's balance sheet is in a strong position and we expect the company to draw drown additional debt over the coming 12-24 months. TNK had gross debt of $5.4m which equates to 17.5% net debt to equity and 18x interest cover.

TNK has a $25m bank loan with ANZ as well as a $4m inter-changeable facility. The unused portion of the bank loan was $21.5m at the CY15 results of which $19m is only available for future acquisitions and we note that TNK needs to meet certain criteria prior to draw-down. The facility is renewable in December 2017.

In regards to the company's capacity for acquisitions, $9m debt is available immediately provided certain measures are met and an additional $10m is an uncommitted advance.

Figure 7: TNK's Balance Sheet

	CY15A	CY16F	CY17F
Total Current Assets	4.4	5.0	5.2
Property, Plant & Equip	1.9	2.7	3.4
Intangibles	20.3	27.4	34.5
TOTAL Assets	**30.2**	**38.8**	**46.7**
Total Current Liabilities	6.9	7.9	8.6
Borrowings	5.4	11.2	16.2
Non-Current IBLs	6.0	11.8	16.8
TOTAL Liabilities	12.8	19.7	25.4
NET ASSETS	**17.4**	**19.1**	**21.3**
Net Debt	3.0	8.8	14.0
ND/E	**17.5%**	**46.0%**	**65.6%**
ND/EBITDA	0.4	0.9	1.2
EBIT/Interest	**18.0**	10.2	12.1

Source: TNK, Canaccord Genuity estimates

VALUATION

We derive a DCF valuation of $1.56 per share, based on a cost of debt of 5.5%, risk free rate of 5%, market risk premium of 5%, equity beta of 1.6, WACC of 11.2% and terminal growth rate of 3%.

Figure 8: DCF valuation

		2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
EBIT	$m	8.9	10.5	12.3	13.6	14.9	16.2	17.5	18.9	20.4	21.9
Dep & Amort	$m	0.6	0.8	0.9	1.1	1.3	1.4	1.6	1.7	1.9	2.0
Δ in WC	$m	0.5	0.4	0.5	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Capex	$m	(10.0)	(10.2)	(7.4)	(7.6)	(7.9)	(8.2)	(8.4)	(8.7)	(9.0)	(9.3)
less Tax	$m	(2.3)	(2.8)	(3.2)	(3.5)	(3.9)	(4.2)	(4.5)	(4.9)	(5.3)	(5.8)
Total FCF	$m	(2.4)	(1.3)	3.1	3.9	4.7	5.6	6.5	7.5	8.3	9.3

PV FCF (10 years)	$m	21.0
PV Franking Credits	$m	0.0
PV Terminal Value	$m	43.8
Net Debt	$m	(3.0)
Net Company Value	$m	61.8
Per Share	**$**	**1.56**
Current Share Price	$	1.245
Upside to Valuation	%	25.3

WACC Assumptions		
Cost of Equity	%	13.0
Risk Free Rate	%	5.0
Beta		1.6
Market Risk Premium	%	5.0
Cost of Debt	%	5.5

Implied Multiples	
PER	10.9
EBITDA	6.9

Source: Canaccord Genuity estimates

We also cross check our valuation on a multiples basis. Our target CY16 EBITDA multiple of 7x generates a valuation of $1.45 and a target CY16 PE multiple of 10x values the stock at $1.43.

Comparative analysis

TNK appears to be very good value when compared to other childcare listed companies as well as other ASX listed roll-ups. Compared to other childcare companies (including Affinity Education at its acquisition price), TNK trades at an attractive 23% discount on a FY17 EV/EBIT basis.

Figure 9: Listed childcare comps

	Mkt Cap (A$m)	FY16F EV/EBITDA	FY17F EV/EBITDA	FY16F EV/EBIT	FY17F EV/EBIT	FY16F P/E	FY17F P/E
G8 Education	1,394	9.4	8.4	10.1	8.9	13.6	12.1
Evolve Education	161	7.4	7.3	8.0	7.9	10.2	9.7
Affinity (at acquisition price)	214	7.1	6.3	7.6	6.3	9.8	8.7
Average	590	8.0	7.4	8.5	7.7	11.2	10.2
Median	**214**	**7.4**	**7.3**	**8.0**	**7.9**	**10.2**	**9.7**
Think Childcare	49	6.2	5.6	6.5	6.0	8.7	7.3
Discount to median		**-17%**	**-23%**	**-18%**	**-23%**	**-15%**	**-25%**

Source: Capital IQ, Factset, Canaccord Genuity estimates

Figure 10 below shows how TNK compares to the other listed consolidation plays. We note the 56% discount on a FY17 PE basis.

Figure 10: Listed childcare comps

	Mkt Cap (A$m)	FY16 EV/EBITDA	FY17 EV/EBITDA	FY16 EV/EBIT	FY17 EV/EBIT	FY16 P/E	FY17 P/E
1300SMILES Limited	159	11.2	10.2	14.0	12.7	21.2	19.1
AMA Group	414	15.9	11.8	18.4	13.6	22.2	17.5
Austbrokers	545	12.8	11.9	10.8	12.1	14.6	13.8
Capitol Health	68	5.7	5.3	8.3	8.2	4.6	5.7
G8 Education	1,394	9.4	8.4	10.1	8.9	13.6	12.1
Greencross	847	10.8	9.5	13.3	11.7	19.6	16.9
Invocare	1,375	14.4	13.5	17.7	16.4	25.7	23.5
Shine Corporate	139	7.1	3.8	8.1	4.1	9.3	5.0
Steadfast	1,367	12.3	10.9	15.1	12.5	17.8	16.5
Average	701	11.1	9.5	12.9	11.1	16.5	14.5
Median	**545**	**11.2**	**10.2**	**13.3**	**12.1**	**17.8**	**16.5**
Think Childcare	49	6.2	5.6	6.5	6.0	8.7	7.3
Discount to median		**-45%**	**-45%**	**-51%**	**-51%**	**-51%**	**-56%**

Source: Capital IQ, Canaccord Genuity estimates

RISK ANALYSIS - SWOT

Strengths

Favourable industry drivers – Demand for childcare services is expected to increase over the long term and generally displays a low level of volatility.

Ongoing government support – The government is expected to eventually increase funding to the sector by $3.2 billion. Both sides of politics are supportive of legislation that encourages female workforce participation.

Strong track record – TNK has quickly developed a strong track record of hitting target and driving increases in occupancy.

Industry position within society – Childcare occupies a public good status in society and it is the government's interest to support it for economic and social reasons.

Bank support – TNK has a $25m facility with ANZ.

Weaknesses

Limited synergies – Although cost savings and operational efficiencies exist, the amount of synergies gained from scale in childcare are limited.

National quality framework (NQF) – Government regulation dictates the level of quality that is required and can be restrictive in regards to margins.

Staffing – Staffing is a challenge and the growing influence of the NQF and nannies could place further pressure on staffing requirements.

Opportunities

Acquisitions – The childcare industry in Australia remains highly fragmented and TNK intends to make acquisitions in the coming years.

Improved efficiency and occupancy – TNK target lower performing centres with the aim of driving occupancy higher. TNK also plans to increase centre capacity through efficiency improvements.

Increasing fees – Fees increased by 7% pa from June 2005 until June 2013. Although we don't expect future increases to be quite as high, CY16 will likely be higher given staff to child ratio changes.

Managed centres – TNK manages 12 externally owned centres. We expect this number to grow and also for the managed centres to prove possible acquisitions.

Threats

Government funding – A change in the government subsidies to parents could have an impact on occupancy in the industry and therefore our forecasts.

Execution and integration risk – TNK's growth strategy is partially acquisition driven which relies on effective execution and .integration.

Competition for assets –Competition for acquiring centres may push up prices.

Government regulation – The childcare industry is highly regulated by the government. Any changes to the regulations could have a material impact on our forecasts.

Wage pressure – Staff costs are the biggest cost to the business and the requirement to have higher qualifications is putting upward pressure on wages.

Greenfields development – Newly developed sites pose a potential threat to centre occupancy.

BOARD & MANAGEMENT

Mr. Mark Kerr (Non-Executive Chairman)

Mark is an experienced company director. He is currently Chairman of Contango Microcap and Hawthorn Resources as well as being a Director of Contango Income Generator and Berkeley Consultants. Additionally, Mark was a Director of Baker Street which formed part of the initial portfolio of centres.

Mr. Mathew Edwards (Managing Director & CEO)

Mathew was previously the Managing Director of Learning and Education Australia (LEA) from 2008, which owned 12 centres and formed part of the original TNK portfolio. The LEA business had a focus on either developing greenfield sites or building up underperforming centres. Prior to childcare, Matthew had management experience in retail and commercial property.

Mr. Paul Gwilym (Executive Director & CFO)

Paul is a Chartered Accountant with over 20 years' experience. He was formerly CFO of LEA from 2013 and prior to that had experience in insolvency and reconstruction. Paul also ran his own consultancy with a focus on strategic planning, restructuring and capital raising.

Mr. Andrew Hanson (Non-Executive Director)

Andrew is a highly experienced accountant having spent over 27 years at PricewaterhouseCoopers including 16 years as a Partner. Since leaving PWC he has held a number directorships and advisory roles includes being an independent adviser to the board of ASX listed Beacon Lighting.

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Target Price / Valuation Methodology:

Think Childcare Limited - TNK

Our $1.56 target is based on a DCF valuation that incorporates a WACC of 11.2% and TGR of 3%.

Risks to achieving Target Price / Valuation:

Think Childcare Limited - TNK

Limited synergies – Although cost savings and operational efficiencies exist, the amount of synergies gained from scale in childcare are limited.

National quality framework (NQF) – Government regulation dictates the level of quality that is required and can be restrictive in regards to margins.

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Wage pressure – Staff costs are the biggest cost to the business and the requirement to have higher qualifications is putting upward pressure on wages.

Greenfields development – Newly developed sites pose a potential threat to centre occupancy.

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Rating	Coverage Universe		IB Clients
	#	%	%
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Hold	272	29.53%	14.71%
Sell	26	2.82%	3.85%
Speculative Buy	63	6.84%	61.90%
	921*	100.0%	

*Total includes stocks that are Under Review

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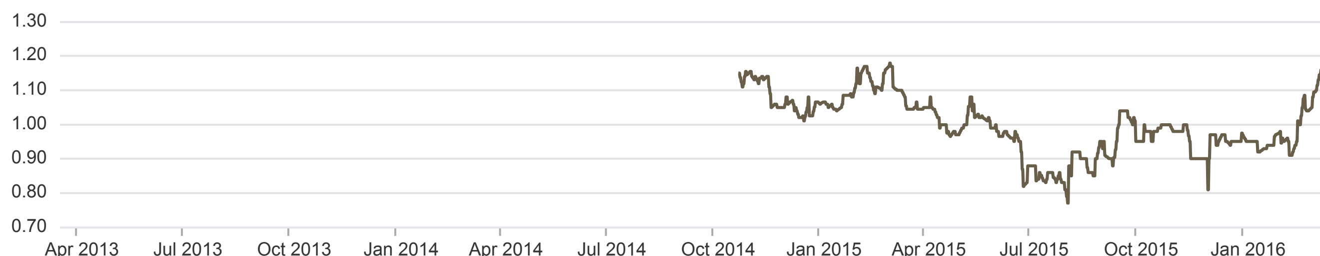

Closing Price | Target Price

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