



3 Reasons Why Alaris Royalty Corp. Continues to Fall

Description

I got it wrong—sort of.

It's never fun to admit when you get an investment call wrong, but that's exactly what's happened to me with **Alaris Royalty Corp.** (TSX:AD), the Calgary-based quasi-private equity company that lends money to middle-market businesses in need of growth capital that are unwilling to give up equity control.

In March, I ended my [article](#) "Which Is the Best Private Equity Stock in Canada?" by proclaiming that despite seriously underperforming, Alaris stock would return to the mid-30s by the end of 2016 or the middle of 2017 at the latest.

Since the article was published the stock has declined 32%. The latest significant correction (almost 5%) came November 4 when Alaris announced it has demanded that its partner, Agility Health, repurchase the preferred units held by Alaris as part of its original loan agreement with the company.

This is just the latest piece of the Alaris puzzle. While its business model is a good one, like life itself, sometimes you're going to get burned. As with any lender you invest in, you must be aware of the risks associated with making loans to growing companies. Steve King and the rest of his team at Alaris might know what they're doing, but it doesn't mean they'll never be left holding the wrong end of the stick. It happens.

So, what's a long-time shareholder to do? They should understand the reasons why Alaris's stock continues to fall and decide if they should stay or go.

Alaris will have announced its third-quarter earnings November 8 after the markets closed. Things will be made clearer during its conference call to be held this morning. I recommend that you listen to the analyst questions or obtain the transcript.

Here's what to look for.

Agility Health

Alaris has lent Agility US\$20.1 million.

Agility provides physical and occupational therapy services to over 100 healthcare facilities across the U.S., which has been outstanding since 2012. Agility is currently losing money and has US\$37 million in liabilities (54% owed to Alaris) and just US\$25 million in assets to cover those liabilities. It's nearly insolvent.

Alaris feels that Agility has broken the terms of their agreement and, as such, has demanded the full redemption of its preferred units within 90 days of November 2. Agility disagrees that it broke the conditions of its agreement. It's working with investment bankers to find a solution, including its possible sale.

Alaris stock is down on this news because it's entirely possible that it won't get back some of the US\$20.1 million outstanding. Conservatively, investors probably should consider this a future impairment.

Fortunately, Agility represents less than 4% of Alaris's total revenue.

KMH

Another healthcare company, KMH, operates 12 diagnostic clinics in Ontario and eight in the U.S. Alaris first lent money to KMH in 2010 and received \$54.8 million preferred partnership units for its capital contribution.

The company stopped receiving regular monthly distributions from KMH in November 2014—\$7.5 million annually—so we're into year three without any payment on its contribution.

As of June, Alaris was working with KMH to figure out a way for it to recapitalize its business so Alaris could get some of the \$54.8 million in preferred shares redeemed. In Q2 2016, Alaris decreased the fair value of the preferred units from \$35 million to \$28 million. Expect the final number to be less than \$28 million.

Any good news

In early October Alaris announced that its investment in Solowave, a company that designs ready-to-assemble children's backyard play and other products for outdoor use, was being redeemed due to the sale of its children's play division, which represents most of Solowave's annual revenues.

As a result, Alaris will make a total return of \$33.5 million, or 79% on its investment—an internal rate of return of 17%. Those funds will be redeployed into future investments, including the US\$18 million contribution it announced October 11 into Matissia LLC, a Seattle management consulting business that's one of the fastest-growing firms of its kind in the U.S.

I'd be looking for other positives beyond this nice fourth-quarter update.

Bottom line

Alaris currently makes money and will continue to do so regardless of what happens with both Agility and KMH. Bad loans are bad loans, and even though two failures out of 16 isn't great, they're likely outliers from an otherwise great management team.

But make no mistake. There's real risk investing in Alaris stock. As they say, "If you can't stand the heat, get out of the kitchen."

CATEGORY

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