This Turnaround Story Has Massive Upside Potential in 2020

Description

It hasn't been a good 2019 for **Medical Facilities** (TSX:DR).

The company's shares tanked twice this year on bad earnings — most recently when the company released its second-quarter results on August 8. Issues with the company's latest quarterly numbers included a 5.2% decrease in revenue versus the same quarter last year, a US$29.5 million non-cash impairment charge related to one of its hospitals, and earnings fell off a cliff. The company had a payout ratio of 74.3% in the second quarter of 2018. The payout ratio surged to 179% in its most recent quarter.

The stock, which was already struggling because of weak first-quarter numbers, tanked again. It fell all the way from the $12.50 range to settle in the $6-$7-per-share range. The good news is, shares have rallied recently and recently surpassed $8 each on strong volume.

I personally believe the company is a great turnaround story, and shares could march higher in 2020. But investors shouldn't crowd into the name quite yet for a very important reason.

The bull case

In theory, Medical Facilities should have a pretty steady business. The company owns five specialty surgical hospitals as well as eight ambulatory service centres, all located in the United States. These centres deal with specific procedures that the doctors who work at the facilities specialize in, which offers plenty of predictable revenue. At least they should, anyway. So, what happened in the most recent quarter?

Perhaps the biggest issue has been the company's investment in Unity Medical and Surgical Hospital in Mishawaka, Indiana. It posted revenues of US$3.1 million less than the same quarter last year due to changes in the case mix or payer mix. Management is confident a focus on partnering with new physicians in this market will improve operating results.

Medical Facilities also made a one-time payment of US$1.1 million to sever a contract in its most recent quarter.

Once we exclude all these one-time items, the quarter wasn't so bad. The company also sees results picking up over the last half of the year, since many people will want to use their medical insurance benefits before they lose them. And investors should be reminded that there's still a new ambulatory service centre on track to open in 2020, which should boost the bottom line.

How safe is the dividend?

If I were on the board of directors, I'd push for Medical Facilities to cut its generous dividend. The yield, which checks in at a whopping 14% today, is simply too high. The company should cut it in half and use the proceeds to ramp up its acquisition program.

The good news for income investors who already own the stock is, there's no guarantee of a dividend cut. The company's payout ratio over the last year is under 100% and should remain there if results start to improve. The company also has a strong cash position that can be used to pay distributions in the case of continued weak results, although that can't be maintained indefinitely.

Wait to buy

Overall, I think Medical Facilities has decent turnaround potential. After a couple of decent quarters, shares could easily be 25-50% higher. Yet I think investors should wait to buy. Why?

The company is a prime candidate for tax-loss-selling season, which will really pick up momentum in November and December. Shares will be under pressure, as disappointed dividend investors look at their statements and see a stock that's down 50% for the year.

It's better to buy in January, when we won't have tax-loss selling pushing down shares. The stock has massive upside potential — I don't see any reason why it can't trade at $15 again — but I don't think that'll happen until 2020.

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nelsonpsmith