COMMENTARY

January 6, 2017

Dear clients and colleagues,

As we begin 2017, the Global Alpha team would like to wish everyone the best of health for the New Year.

2017 promises to be filled with headline-grabbing events that should keep us all busy. Nevertheless, we confidently look ahead as we will continue to navigate the global small cap universe with the same strategy that has proven sound through different cycles of the economy.

Part of our methodology consists of assessing market opportunities under an investment theme for companies we like. Under the demographics theme, the aging population is a significant trend to which Global Alpha often looks to be exposed. The elderly care market certainly acts as viable exposure. Selecting the right investment requires understanding regulatory requirements, government reimbursement rates, all-in operating costs and growth opportunities of specific countries and regions.

Japan leads the way in market maturity with 22% of its population over 65 years of age, followed by European nations at 20%, while the US sits at 15% and Canada at 16%. Although aging rates are peaking, Japan's penetration rate for nursing home is slightly lower than the US and Canada. The penetration rate of nursing homes is 3.5% in Japan, 2.5% in Denmark, 3.7% in the UK and 4.0% in the US. Assisted living has only a 0.9% penetration rate in Japan, a very low level compared with Denmark at 8.1%, the UK at 8.0% and the US at 2.2%.

In coming years, China will experience a strong increase in the percentage of its population that is aged 65 years or over, rising from 15.0% to over 24.1%. This increase will be the largest in the world.

The assisted living and home health markets offer above average growth opportunities compared to the nursing home market as they play into government cost-cutting initiatives and the growing need for specialized care, such as for Alzheimer's disease. Organic volume growth rates are in the low- to mid-single-digit range for nursing homes and in the high single-digits for home health.

A very good indicator of mid-term growth in demand for nursing homes is occupancy rates. When occupancy rates exceed 95%, this would tend to indicate a healthy balance of strong market demand for beds or apartments and good management execution. However, there are variations as occupancy rates will fluctuate according to therapeutic intensity. This means it's not easy to compare countries. As an example, US nursing homes operate at lower occupancy rates than those in Canada as US Medicare and Medicaid allows for a wider breadth of therapeutic procedures to occur within nursing facility. Length of stay is therefore shorter as acute care is more prevalent.

Occupancy rates for nursing homes are highest in Canada, at 98% in some cases, indicating low therapeutic intensity and a fairly robust market. McKnight's reports US occupancy rates in nursing homes are at 87%. Historically, US occupancy rates reach 93% and above in high demand years. US independent living occupancy rates are at 91% for an all-in senior living blend of 89.8%.

US Market Fundamentals 3Q 2016

	3Q16	2Q16	1Q16
Occupancy	89.80%	89.70%	90.0%
Annual Rate Growth	3.80%	3.20%	3.10%
Annual Absorption	2.50%	2.40%	2.50%
Annual Inventory Growth	2.60%	2.40%	2.60%

Source: NIC for Seniors Housing & Care's MAP Data Service

Government reimbursement remains one the most important factors in forming an investment opinion. Most governments run tight policies on nursing home reimbursement rates. High margins caused by technology improvements, both in general operations and medical support, usually do not last. Historically, the industry has served as a poster child for opportunities to cut costs. We have seen hefty reimbursement rate cuts following periods of excessive earnings in the US, Europe and Japan. The lobby periods prior to rate announcements are a cause for highly volatile stock prices, especially in the US. Canada figures as a jurisdiction where pricing is never cut (at worst price hikes are not as high as anticipated), so stock prices here tend to be less volatile.

Although gross margins are highest in the US, its operators are required to navigate a complex reimbursement system through Medicaid (49% of revenues) and Medicare (16% of revenues). In addition, onerous practice insurance and high legal expenses add to overall costs and hence an additional level of risk.

Comparative Table

	Net Margins	Reimbursement Risks	Legal Risks	Nursing Occupancy	Annual Retiree Pool Growth
Canada	4.5%	-	-	95+	3.5%
USA	2.5%	++	++	87	3.5%
Europe	5.4%	+	+	95	2.8%
Japan	3.1%	+	+	95+	1.3%
Australia	5.4%	+	-	94	3.3%

Source; Global Alpha Capital Management, OCDE, Bloomberg

Global Alpha presently owns Extendicare (TSE:EXE), a leader in the Canadian senior health care services market. The company operates in three distinctive divisions: nursing, home health and assisted living. Extendicare operates 12,784 long-term beds, with a strong focus in Ontario; 2,474 retirement suites, mostly in Ontario and Western Canada; and 47 home health care locations across Canada.

The investment thesis for Extendicare is based on strong Canadian demand for elderly care as well as a stable reimbursement and legal environment. Extendicare's strategy is to expand into the higher-margin assisted living industry and into the immature home health industry where it is already the largest Canadian player.

The company recently went through a bold reorientation of its strategy. After selling all of its international nursing home activities in 2014, Extendicare acquired additional Canadian home health assets to ensure a pan-Canadian coverage and accelerated its assisted living new build projects. With three balanced divisions, Extendicare expects synergies to emerge between them as part of its next phase of growth.

Have a great weekend.

The Global Alpha team