K-Bro Linen Systems (TSX: KBL)

"Sometimes the world's most boring businesses, are the most profitable" – Warren Buffet

LSIF July 2016 Call

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Date: July 9th, 2016

Recommendation: Buy

Target Price: $52.03

Margin of Safety: 24.8%

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LAURIER Student Investment Fund

1.0 Introduction:

K-Bro Linen Systems is the largest owner and operator of laundry and linen processing facilities in Canada. KBL acts as a full-scale linen services provider to hotel and hospitality clients, and operates on a long-term contract basis, with large organizations to assist them with their linen function such that they can focus on their core-competencies and realize cost efficiencies as a result. K-Bro is currently facing an interesting growth opportunity given their recently added capacity through their GTA facility, doubling total capacity in the region and technological efficiencies in their new plants. This has led to the initiation of coverage on K-Bro Linen Systems (KBL: TSX) with a **BUY** recommendation.

1.1 Investment Thesis:

The investment thesis of KBL is that given the companies significant scale and scope advantages present in the Canadian Linen processing market, institutions outsourcing their linen functions will choose KBL as their provider allowing KBL to gain market share going forward. As such, the valuation of KBL will be driven through overall market growth and market share gains in the healthcare and hospitality linen processing industries respectively, in addition to margin expansion. Several components make up this investment thesis, including:

1) K-Bro Linen ("KBL") holds a strong positioning as Canada's only national institutional laundry services provider with leading infrastructure, and increasing penetration in major markets. They operate in a defensible business with high barriers to entry, with a sticky customer base where revenues are derived through long-term, contractual agreements. The implications of this will allow KBL to capture increased market share in the growing Canadian linen processing market over the longer term.

2) Healthcare and hospitality institutions are consistently facing funding pressures and are in need of evaluating the allocation of scarce resources. As a result, they are outsourcing peripheral activities such as linen processing to private companies such as KBL. This has been a strong driver of growth in the size of the linen processing market in Canada.

3) KBL is completing an investment cycle where they have upgraded their facilities to increase efficiencies as well as opened a new state-of-the-art processing facility in Toronto. The facility will likely become the leading institutional laundry in Southern Ontario, Canada's largest institutional laundry market providing a strong tailwind to the business for years to come through enhanced capacity and coverage capabilities. These efficiencies are expected to drive margin improvements in the longer term.

1.2 Roadmap:

This report will present a description of K-Bro's Hospitality and Healthcare linen processing business, discuss industry trends, and highlight DCF modelling assumptions and scenarios. A market share based forecast was used to project the operations of the business. The underlying drivers in the model are growth in KBL market share as well the linen processing market, and will be talked about in depth further in the report. Much of the focus will be placed on the quality of K-Bro's competitive advantage, management, and past performance validating the assumptions made in the DCF. An alternative valuation using a comparable analysis will be presented at the end to provide another perspective on value.

2.0 Company Description:

In this portion of the report, a brief overview of KBL will be presented, followed by a section which outlines KBL's customer and product mix, as well as a section which highlights their organic growth strategy which will ultimately justify continued market share gains going forward, a core part of the current investment thesis. Finally there will be a brief component which speaks about management compensation and alignment with investors.

KBL is currently the largest owner and operator of laundry and linen processing facilities in Canada. The company acts as a "one-stop-shop" for linen services and provides a comprehensive range of general linen and operating room linen processing, management and distribution services to healthcare institutions, hotels and other commercial accounts.

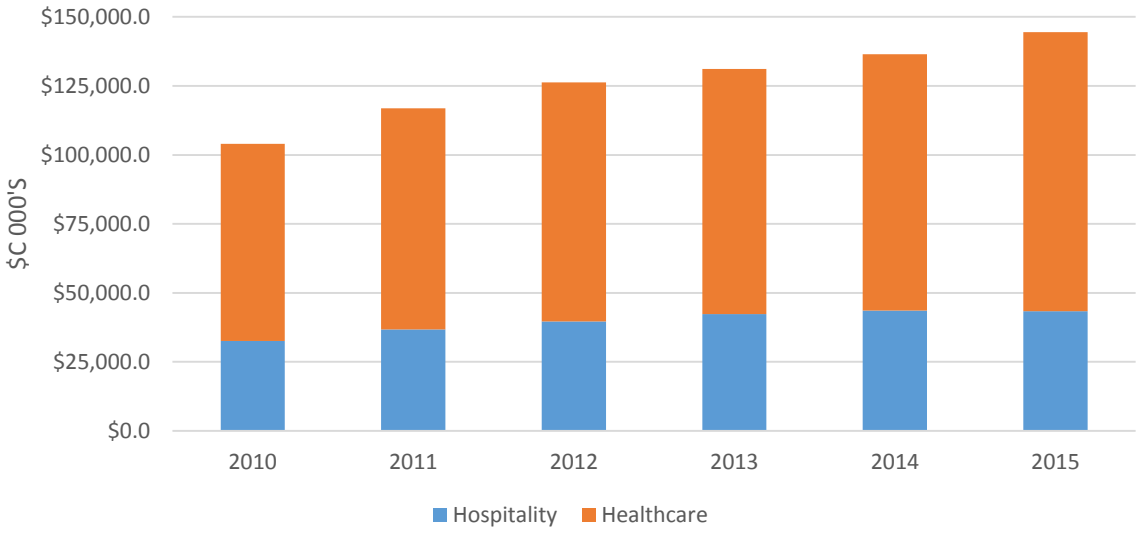
KBL positions itself as the provider of choice for comprehensive linen services to Canada's leading hospital, long-term care and hotel institutions. The company's offering is a complete linen solution, whereby it acquires and owns the linen, and then rents it to clients. K-Bro then provides full management of the linen function – from processing (at its plants) to distribution management within the hospital (in the case of a hospital client). This fee-for-service model essentially relieves the hospital from the day-to day management of this critical function. (Refer to Appendix 8.1 for a detailed description of KBL's business cycle.)

2.1 Customers and Product Mix

KBL's customers include some of the largest healthcare institutions and hospitality providers in Canada. Healthcare customers include acute care hospitals and long-term care facilities. Most of K-Bro's hospitality customers (typically >250 rooms) generate between 500,000 and 3 million pounds of linen per year. Most healthcare customers generate between 500,000 pounds of linen per year for a hospital and up to 30 million pounds of linen per year for a healthcare region. Typical services offered by K-Bro include the processing, management and distribution of general and operating room linens, including sheets, blankets, towels, surgical gowns and drapes and other linen.

Historically approximately 30% of KBL's revenue has been derived through the hospitality segment, while around 70% of revenues have been through the healthcare segment (refer to Figure 1 for a historical breakdown of revenues.) A strong driver of growth going forward will be through the healthcare segment linen market. This will be as a result of the aging in the baby boom demographic and as a result the need for increased hospitals and hospital beds respectively. For the purpose of valuation, this revenue mix has been assumed to be consistent over the five year forecast period.

Figure 1: Historical Revenue Breakdown by Segment:



Source: Company Filings

2.2 Organic Growth Strategy

KBL executes a three-pronged strategy to facilitate organic growth and garner additional market share:

1) **Secure and Maintain Long-Term Contracts with Large Healthcare and Hospitality Customers**

   KBL's core service is providing high quality laundry and linen services at competitive prices to large healthcare and hospitality customers under long-term contracts. KBL's contracts in the healthcare sector typically range from seven to ten years in length. Contracts in the hospitality sector typically range from two to five years.

2) **Extend Core Services to New Markets**

   Management has demonstrated its ability to successfully expand K-Bro's business into new markets from its established bases. Since 2005, K-Bro has entered four new geographic markets across Canada. These new markets have contributed significantly to K-Bro's growth. Management believes that new outsourcing opportunities will continue to arise in the near to medium-term and that K-Bro is well-positioned for continued growth, particularly as healthcare and hospitality institutions continue to increase their focus on core services and confront pressures for capital and cost savings.

3) **Introduce Related Services to Cross-Sell**

   In addition to focusing on its core services, the Corporation also attempts to capitalize on attractive business opportunities by introducing closely-related services that enable it to provide more complete solutions to K-Bro's healthcare and hospitality customers. These related service offerings include K-Bro Operating Room ("KOR") services and on-site services. For three major hospitals in Toronto, K-Bro performs the sterilization of operating room linen packs, which is a core function of hospitals being entirely outsourced to KBL, demonstrating the trust in the capabilities of KBL.

It is believed that by executing KBL's three-pronged organic strategy through maintaining long-term contracts with customers, penetrating new geographic markets, and cross selling services such as KBL's operating room linens, KBL will be able to grow their market share and drive sales in the Canadian linen processing industry in the long term.

2.3 Management Compensation and Alignment

Currently the structure of management compensation keeps them aligned with investors to grow shareholder value. As 65% of their compensation is determined by EBITDA and distributable cash flow[1], these metrics are less prone to accounting manipulations, and doesn't not incentivize value destructive capital allocation decisions. In addition a material portion of the executive's net worth is currently invested in KBL shares, which again provides incentive to continue to grow shareholder value as done in the past. (Refer to Appendix 8.2 for a detailed analysis on the management team and their compensation)

2.4 New GTA Facility:

The new GTA washing facility is state-of-the-art, competing primarily with Booth's older plant, which requires significant capex to reach the same efficiencies as KBL. In addition, the competing booth facility is locked into expensive labor agreements, creating pressures on their cost-competitiveness in the market. KBL's new facility will create a catchment area of 13,000 hospital beds, and 44,360 hotels rooms. In addition to the market reach, this facility doubles KBL's GTA capacity allowing KBL to be offensive when pursuing competitor's business. For more than five years, KBL was forced to be defensive in this particular market, passing down contracts given the capacity constraints inherent in their older GTA plant.

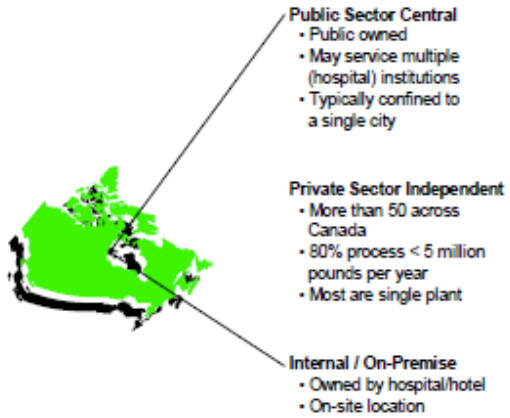
3.0 Industry Description:

K-Bro provides laundry and linen services to Canadian healthcare, hospitality and other commercial customers. Other types of processors in K-Bro's industry in Canada include independent privately owned facilities (i.e. typically small, single facility companies), public sector central laundries and public and private sector on premise laundries (refer to figure 2). Participants in other sectors of the laundry and linen services industry, such as uniform rental companies (which own and launder uniforms worn by their customers' employees) typically do not offer services that significantly overlap with those offered by K-Bro.

The prominent theme in the hospitality and healthcare segment appears to be the outsourcing of peripheral activities to achieve cost efficiencies while those institutions focus more resources towards their core competencies. This industry trend will be a core driver to the growth of the linen processing market in Canada and will be talked about in more detail in the next sections.

[1] Defined as CFO adjusted for changes in non-cash working capital items, share based compensation, and maintenance capex.

Figure 2: Canadian Laundry Service Market-By Provider:



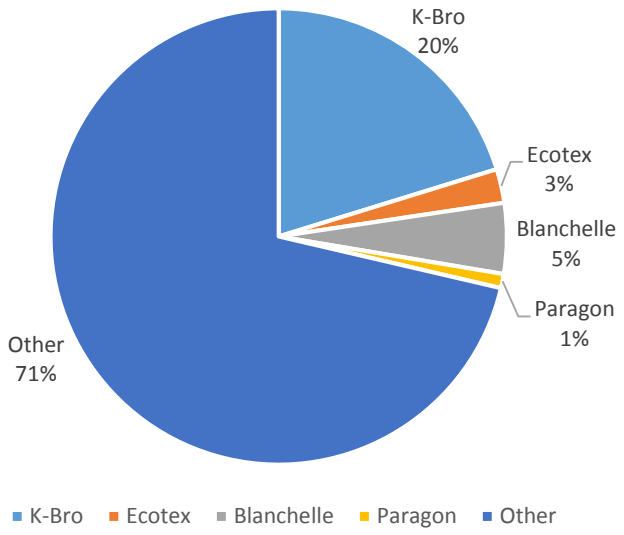
Source: Company Filings

3.1 Market Share Analysis

Market share gains in both the healthcare and hospitality segment are key drivers in the valuation of KBL in addition to the growth of the total sales generated by the linen processing industry. Management has estimated the market for Hospitality linen processing to be worth C$100mm to C$150mm, while estimating the Canadian healthcare linen processing market is worth approximately C$450-550mm[2]. Based on the FY2015 reported figures, KBL currently holds 35% of the total hospitality linen processing segment, and 20% of the healthcare linen processing segment in Canada. Given the fragmented nature of the market, and concentration in the top quartile of linen processing businesses in Canada, this provides a unique consolidation opportunity for KBL to take advantage of. It is expected given KBL's organic growth strategy described earlier in the report, alongside their scale advantages over competitors which is expressed further in the industry section, KBL will continue to steal market share from competitors going forward. (Refer to Figure 3, for a breakdown of competitor market share in the Healthcare Processing Segment)

[2] 2015 Annual Information Form, K-Bro Linen Systems

Figure 3: Healthcare Segment Market Share Analysis



Source: Company Filings, Management Estimates

3.2 Industry Landscape

K-Bro remains to be the best capitalized and best positioned company to benefit from what appears to be a compelling consolidation opportunity in the Canadian linen services market. Small "mom-and-pop" operators have significant disadvantages to grow in an industry where critical mass and economies of scale remain to be a large barrier to entry. The business is primarily driven by price competitiveness, as the reason for outsourcing a linen processing function is to earn the cost efficiencies associated with it. As a result, it is very difficult for smaller, one facility operations to handle the large contracts that often come with conglomerate clients as demonstrated by the 3s Health group, who added 200+ hospitals worth of linen to process given KBL's significant scale advantages over competition. (Refer to Appendix 8.6 for a detailed account and figure 4 for evidence of scale advantages.)

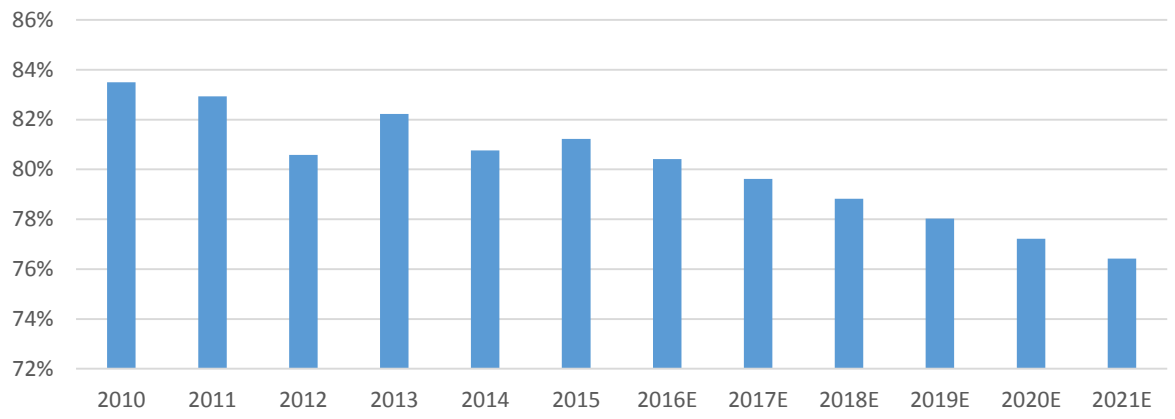
There are three overarching themes in the Linen Processing industry which K-Bro operates in:

1. **Stable Industry with Moderate Cyclicality -** There is apparent stability in the number of approved hospital beds in the healthcare system and hotel rooms in the hospitality industry. Service relationships in the healthcare sector typically range from 7-10 years while contracts in the hospitality sector usually range from 2-5 years.

2. **Outsourcing and Privatization -** Health care institutions are consistently facing funding pressures and consistently is in the need to evaluate the allocation of scarce resources. There are significant advantages in healthcare institutions outsourcing the processing of healthcare linen to private sector laundry companies such as KBL given the economy of scale and significant management expertise that can be provided on a more comprehensive and cost effective basis that customers can achieve in operating their own laundry facilities.

3. **High Fragmentation** - Most Canadian cities have at least one and sometimes several private sector competitors operating in the healthcare and hospitality sectors of the laundry and linen services industry. Management believes that the presence of these operators provides consolidation opportunities for larger industry participants with the financial means to complete acquisitions. 50% of the market is held by private companies with less than C$5mm revenues.[3]

Figure 4: KBL Operating Expenses as a % of Sales



Source: Company Filings & Operating Estimates

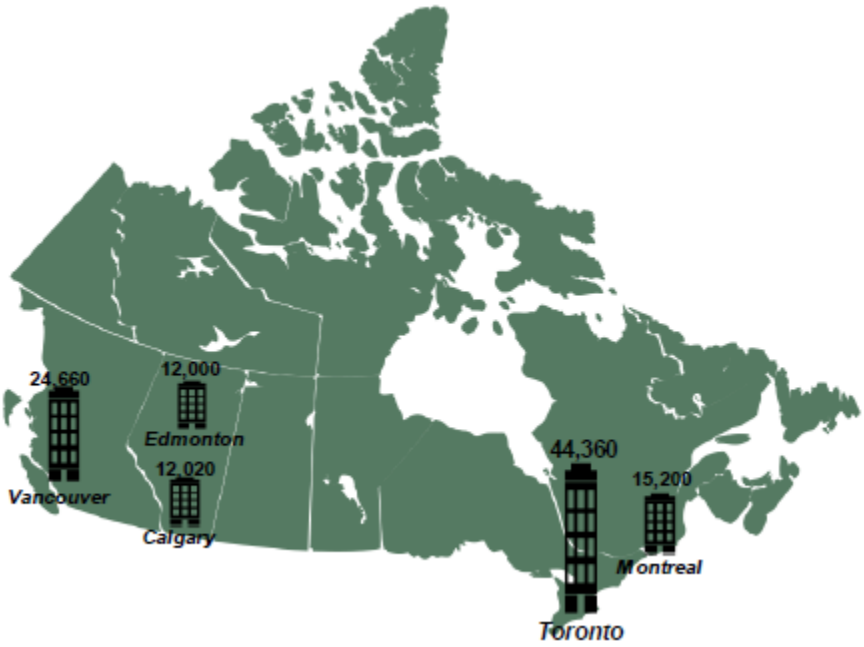
3.2.1 Hospitality Segment

When valuing KBL, a primary driver was the growth of the overall linen processing market for hospitality in Canada. Currently the hospitality segment makes up 30% of KBL's revenues. The lodging industry typically follows the overall growth of the economy which GDP is a dependable proxy. Over the next 5 years, it is expected that the hospitality sector will experience 3% growth year over year[4], which is the rate that is used to drive the size of the hospitality market in the base case discounted cash flow model valuing KBL. With the general improvement in economic condition, there is robust growth forecasted in the hotel industry. Should oil prices recover, this will be an additional catalyst for incremental hotel rooms to come online that would add to KBL's penetrable market.

KBL's new GTA facility will provide significant opportunity for the Toronto linen processing market for hospitality clients. Toronto currently has the largest opportunity for KBL in the linen processing market (See figure 5) Given the lack of available land in the downtown core and GTA, this creates a significant barrier to entry, and as such real estate is being purchased at premiums by operators.[5] This creates an impending need to cut costs and outsource non-core activities such as linen-processing where there are significant cost efficiencies achieved, and quality is reliable. This is one of the core investment thesis points on KBL, as it is believed that given their scale, and experience, they will be able to capitalize on this trend to grow their market share in the hospitality segment.

[3] 2015 Annual Information Form, K-Bro Linen Systems
[4] HVS – Canadian Lodging Outlook, 2015
[5] 2015 Annual Information Form, K-Bro Linen Systems

Figure 5: Hotel Rooms by City in Canada:



Source: Provincial Hotel Associations

3.2.2 Healthcare Segment

When valuing KBL, a primary driver was the growth of the overall linen processing market for healthcare in Canada. Currently, the healthcare segment makes up 70% of KBL's revenues. With Canada facing a $10.9bn deficit, a primary pillar of the investment thesis focuses on the point that public healthcare institutions are facing funding pressures. There is continual stress on healthcare costs due to the rapidly rising costs of drugs and new technology, Canada's aging population, the high increasing cost of healthcare human resources, and growing public expectations.[6] Given approximately 11% of Canada's GDP goes towards healthcare spending, there are material benefits in outsourcing their non-core operations such as a linen processing to a private player such as KBL who will offer their clients significant cost efficiencies given the inherent scale in their operations over their competitors. KBL also competes against suppliers of single-use disposable linens, particularly in its K-Bro Operating Room ("KOR") business of providing reusable surgical packs. Management estimates that suppliers of disposable packs currently control 80% of the overall operating room linen market in Canada.

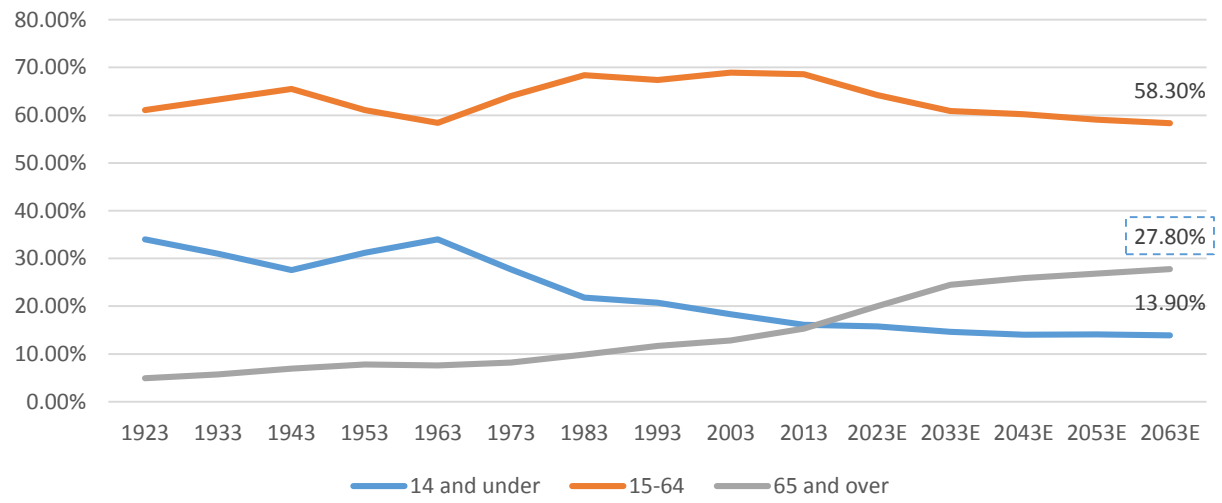
The Canadian Institute for Health Information expects the number of hospital beds in the Canadian healthcare system to grow by approximately 4% year over year, for the next 10 years.[7] This is rate which is used to drive the growth of the size of the healthcare segment in the discounted cash flow model for KBL. This is primarily a function of the number of hospitals in Canada increasing, or being re-outfitted to increase the patient capacity given the trend in Canadian demographics, with the steady growth of the population which encompasses individuals 65 years or older (refer to figure 6). Seniors are typically frequent users of health care segment of the population, with the system spending more on them than any other segment

[6] Parliament of Canada - "The Health of Canadians – The Federal Role", 2015.
[7] Canadian Institute for Health Information, 2015.

in the system[8]. These secular trends in the Canadian healthcare industry are a core component of the investment thesis of KBL, and is poised to be a driver in the growth of KBL's operations.

In addition, KBL's new facility in Toronto will give them capacity to better serve their GTA clients, as they have been unable to serve them in the past given capacity constraints. The GTA is Canada's largest linen processing opportunity which management believe is a $150mm opportunity. Currently KBL holds about 17% of this market[9], however given their scale and new facility location, this gives them very great opportunity to penetrate the healthcare segment in Toronto. In addition, of this market, 26% remains to be "in-house" which is an additional Segway for KBL's market share to grow, primarily driven by continued growth in the GTA market through their new facility. (See Figure 7)

Figure 6: Canadian Population Demographic Trends



Source: Statistics Canada

Figure 7: Hospital Bed Count in the GTA

Source: Company Filings

[8] Ibid.
[9] FY 2016 Q1 Earnings Call Transcript, K-Bro Linen Systems

3.3 Competitive Landscape

The current competitive dynamic for linen processing in Canada is very favourable to KBL. The highly fragmented nature of the industry with several private competitors provides KBL with several consolidation and market penetration opportunities. Several of the private companies operate in different niches of linen processing. For example, Canadian Linen is a private player who specializes in the processing of uniforms for various industry. Although the service of processing healthcare linens is available, it is peripheral relative to the rest of their business and as such minimal businesses that are able to adequately compete with KBL for contracts.

There are two primary competitors in the GTA linen processing market being Booth Centennial Healthcare Linen ("Booth") services and Ecotex Healthcare Linen Services. As of March 1st, 2016 Ecotex and Fengate Capital partnered to acquire Booth. Ecotex is a Canadian based provider of healthcare laundry and linen services to hospitals, sub-acute and medical facilities in Western Canada and the U.S. Ecotex has approximately 1/3 the number of employees as KBL at just over 500. Booth is the largest provider of healthcare linen, laundry, and surgical sterilization services to hospitals and long-term care in Ontario. They solely focus on healthcare and service over 100 customer locations within a 400km radius of its Mississauga, Ontario facility, which is very geographically very close to where KBL's new GTA facility will be placed. (Refer to figure 8 for a summary of pure play comparables in the Canadian linen processing space)

Figure 8: Competitor Analysis and Capabilities

Competitor	Est. Revenues FY2015 ($mm)	Geographic Coverage	Plants	Industries
Ecotex*	$12	BC	2	Healthcare
Blanchelle	$25	QC	2	Healthcare
Paragon	<$5	GTA	1	Hospitality
K-Bro Linen	**145**	**AB, BC, ON, QC, SK**	**9**	**Healthcare, Hospitality**

*Note: Does not include Revenue from Booth Acquisition

In addition, the competing Ecotex / Booth facility is ageing, and locked in to expensive labor agreements. It is believed that KBL's new GTA facility will have significantly higher marketability to customers given the efficiency and cost effectiveness that is in their operations. (Refer to Figure 9 which summarizes developments in key markets, led by Nova Scotia, where there is potential for an RFP to be issued within 12–18 months.) Again, it is believed that these developments are instrumental to the thesis that KBL will be able to continue to gain market share in the linen processing market.

Figure 9: Additional opportunities for KBL to Win Business:

Region	Business Opportunity	Estimated Value ($mm)	Potential Catalysts
GTA/ Southern Ontario	Market share expansion in GTA, Kingston, Hamilton, London, Barrie	10	New Toronto facility to provide capacity to compete
Nova Scotia	Major healthcare reform to replace central laundry, and theme to outsource given capital requirements	$10-15	Decision made in 12-18 months
New Brunswick	Potential outsourcing	n.a.	
Vancouver	Market share expansion	2	Key competitior unsuited for Hospitality segment
Manitoba	Potential outsourcing given capital requirements	n.a.	

Source: Company Filings

3.4 Industry Structure – Porter's Forces Analysis:

The Canadian linen processing industry has apparent barriers to entry. Given KBL's established positioning within this market, this provides a very attractive industry dynamic which KBL can capitalize on. The strength of KBL in its industry provides defensible reasoning to the market share assumptions used in its operating model. The low rivalry inherent in this industry allows for KBL to benefit from greater share of industry economics for the foreseeable future.

Threat of Industry Substitutes:

The primary threat in the Canadian linen processing market is the in-sourced linen facilities. This threat however is diminishing as there are an increasing number of institutions who are seeing substantial cost savings by outsourcing this function to a private firm such as KBL where expertise and scale will expedite the achieved synergies.

Bargaining Power of Buyers:

The primary objective of outsourcing the linen processing function is to achieve cost benefits on the part of customers. Given the nature of customers, primarily being large public institutions, or hotel chains, there is high bargaining power on the end of the customer. This being said, as KBL has significantly larger operations and capabilities that its competitors in Canada, it is believed that KBL will remain to be the provider that offers the most economically viable prices to its customers. This further defends the assumption of KBL being able continue to grow sales at a higher rate than the industry has been projected to grow on a base case forecast.

Threat of New Entrants:

The Canadian linen processing market is extremely difficult to penetrate for a new player given the level of capital intensity that is involved initially to open a processing facility. In addition, service providers such as KBL have long term relationships with their clients, and have locked down long-term contracts with many of them, with several of the clients renewing their contracts given the "stickiness" associated with the business model. The minimal entrance of new entrants protect KBL's forecasted margins, and will continue

to allow KBL to earn high incremental returns on their invested capital allowing them to generate positive economic value.

Given KBL's established position in the Canadian linen processing industry, and the attractiveness of the industry they operate in it is believed that they will be able to earn higher returns on their invested capital relative to their competitors driving shareholder value going forward.

4.0 Base Case Forecasts:

4.1 Sales Forecasts

For the purpose of valuing a KBL, a market-share based approach was used to forecast sales. As mentioned in the introduction, KBL's primary drivers of sales was the growth of the Canadian hospitality and healthcare linen processing industry, coupled with market share growth in the hospitality and healthcare segments respectively. This section will detail how sales were modelled to value KBL. In the base case model, it is assumed that KBL's revenue mix stay consistent at a mix of 70% from Healthcare, and 30% from hospitality.

4.1.1 Hospitality Linen Industry Sales

The estimated size of the Hospitality segment is C$100-150mm. As of FY 2015, KBL had 35% share of the hospitality sector. The base case model applies a growth rate to the current size of the hospitality linen processing market. The hospitality sector is projected to grow at around 3.5%-4.5% in the next five years as mentioned in the industry section of the report. In addition, KBL also passes the cost of inflation through their contracts to their customers, which is added to the forecasted industry growth rate to arrive at an ultimate growth rate over the five year forecast period. As a base case, the mean was taken between estimated market sizes and the industry growth rates presented by the industry bodies. (Refer to Figure 10, for the forecasted period sales breakdown)

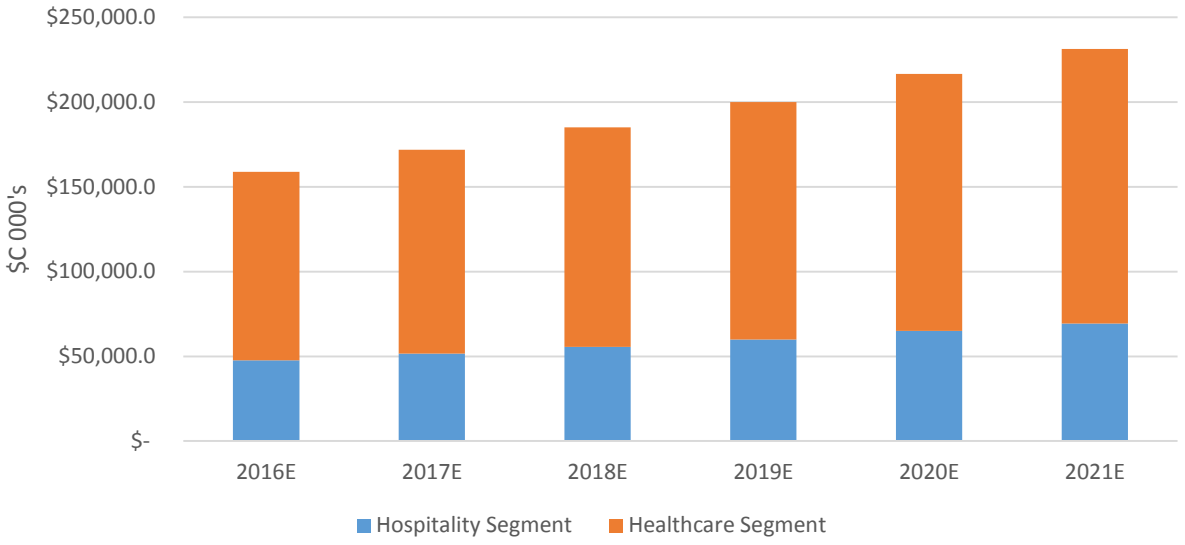
4.1.2 Healthcare Linen Industry Sales

The estimated size of the healthcare linen processing market is within the range of C$450mm-550mm. As of FY2015, KBL had 20% of the total Canadian Healthcare Linen processing sector. According to the Canadian Institute for Health Information, the number of beds in the Canadian health care system is projected to grow by 4.5-5.5% over the next five years. In addition, as mentioned in the hospitality sales forecast section, KBL passes the cost of inflation through their contracts to their customers, which is added to the forecasted industry growth rate to arrive at an ultimate growth rate over the five year forecast period.

4.1.3 Market Share Expansion

In the base case operating model, it is assumed that market share increases by 1% YoY to factor in incremental revenue that will coming through gains in the GTA market, KBL's probability of winning additional contracts through upcoming RFP's, and ability to leverage their service offerings to cross sell their services such as K-Bro operating room linens to existing clients.

Figure 10: Base Case Sales Forecast:



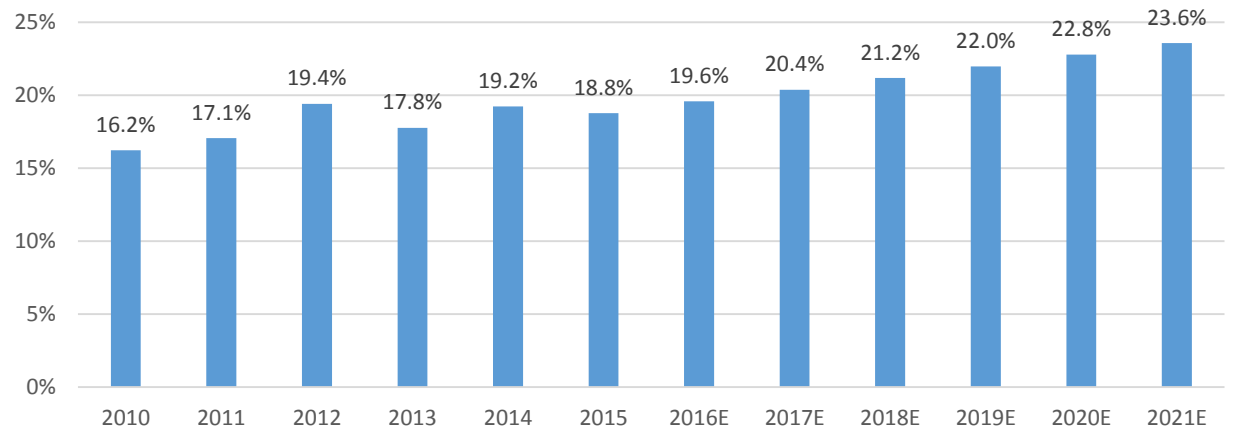
4.2. Margin Forecasts

Given the lack of pure-play public comparable in the industry, it was difficult to derive a margin benchmark to compare KBL to. That being said, the primary margin expansion are expected to come via cost containment through efficiency gains through the newer facilities as they come online and outfitting the older facilities with new technology over the upcoming years. Specifically, it is believed gains will be driven through lower usage of utilities given the technological advantage, as a result of the increased efficiencies, I believe that would translate to lower wage and benefit expenses in the washing facilities given the scalability of operations, and a lower headcount per washing facility given the automation of processes. In addition, the repair and maintenance costs are expected to decline given the new technology, and recent investment cycle that has just been completed resulting in less overall maintenance costs.

In the base case operating model it is assumed that utilities as a percentage of sales decline by 25bps YoY, Wages and Benefits as a percentage of sales decline by 50bps YoY, and Repairs and Maintenance costs decline by 5bps YoY[10]. This equates to approximately 80bps of EBITDA margin expansion YoY during the course of the forecast period in the base case (refer to figure 11).

[10] Q4 FY2015 Earnings Transcript, K-Bro Linen Systems

Figure 11: Base Case EBITDA Margin Profile:



4.3 CAPEX Requirements

Capital expenditure forecasts and depreciation expense was calculated using the Dr. Smith & McNally approach. In the linen processing industry, a key barrier to entry is the capital intensive nature of the business. A significant initial capital investment is required to purchase a linen processing facility which will wash, dry, & fold linens to industry standards. This being said, when a facility is completed, the cost of processing additional linen volume in non-material and begins to facilitate scope advantages as more processing facilities are added to the current infrastructure. The capex in KBL's business model is intermittent, as there are large capital outlays which are associated with developing a new facility, followed by significantly less maintenance capex related to the upkeep of the facilities. The Dr. Smith & McNally approach was used to provide a smoothed out capex figure over time, such that the capex requirements of the business are not understated going into the terminal value calculation. Given the scalability of the business, and recently completed investment cycle, the growth capex as a % of sales is reduced by 50bps from 2017 to the terminal year of 2021 such that capex requirements are not overstated into the terminal period.

4.4 Other Model Assumptions

Although KBL is always looking for strategic consolidation opportunities in the fragmented linen processing industry, acquisitions have not been incorporated into the model given the extreme difficulty of accurately forecasting size, price paid, and synergies achieved from and M&A transaction. As a result, this model is a represents the business and its growth organically via sales and cost cutting measures, and the M&A component to the business will be a bonus to investors.

4.4.1 Forecast Period WACC

The risk free rate that was used was 1.5% representing the current yield on the 10-Year Canadian government bonds. The market risk premium was left at 7% as per the LSIF standards. Beta was calculated via a regression between to KBL's share price and the S&P/TSX index over the last 10 years to incorporate the volatility faced during the 2008 financial crisis. Note, during the financial crisis KBL's operations were

not impacted in terms of sales or margins given the sticky customer base they have in both healthcare & hospitality industries. A regression was used due to the lack of any pure play comparable in the healthcare/hospitality linen processing space. As of the end of 2015, there was approximately C$2.4mm in prime rate loans outstanding yielding 2.7%. The low forecast period WACC of 4.2% is a material driver in this valuation case, primarily driven by the low beta of the business. The low cost of capital can be conceived given the long-term, inflation-hedged, contractual nature of KBL's business model. At the end of the supply chain, KBL's customers are primarily public government funded hospitals, and large conglomerate hospitality providers. Given the low risk profile in this business, and "economic moat" it has developed in its industry, the WACC is seen as justified.

Forecast Period WACC Derivation	
Risk-Free Rate	1.5%
LSIF Risk Premium	7.0%
Beta	0.39
Cost of Equity	**4.3%**
Cost of Debt	2.7%
Tax Rate	26.5%
After Tax Cost of Debt	**2.0%**
Current Share Price	$41.70
Shares Outstanding	7,986
Equity Capital	333,004
Debt Capital	2,349
Total Capital	335,353
Equity Weight	99.3%
Debt Weight	0.7%
WACC	**4.2%**

4.4.2 Terminal Period WACC

A separate terminal period WACC was derived to normalize the risk-free rate. It is highly unlikely that interest rates will stay at today's levels. As such the risk-free rate was adjusted to 3% as per Dr. McNally's guidance. Keeping all other components of the WACC the same as the forecast period, this equates to a terminal WACC of 5.7%.

Terminal Period WACC Derivation	
Risk-Free Rate	3.0%
LSIF Risk Premium	7.0%
Beta	0.39
Cost of Equity	**5.7%**
Cost of Debt	2.7%
Tax Rate	26.5%
After Tax Cost of Debt	**2.0%**
Current Share Price	$41.70
Shares Outstanding	7,986
Equity Capital	333,004
Debt Capital	2,349
Total Capital	335,353
Equity Weight	99.3%
Debt Weight	0.7%
WACC	**5.7%**

4.4.3 Terminal Growth Rate

KBL, given the contractual nature of its business and relatively low risk-profile is believed to grow at the same rate as the Canadian economy over time. As such, the appropriate terminal growth rate will be pegged to the long term expected Canadian GDP growth rate of 2.1%.[11] It will be very difficult to assign a terminal multiple for this business, given the lack of pure-play comparable companies, which is why the Gordon Growth method is seen as appropriate.

5.0 DCF Valuation:

5.1 Scenario Analysis:

It is important to assess the best, worst, and base case for KBL's operating results. This allows us as investors to ascertain a considerably clearer view of the risk to reward profile which surrounds this business. The following subsections will outline what KBL is estimated to be worth should various assumptions relating to market size, market share, and market growth rates materialize.

5.1.1 Base Case Results

The base case reflects a scenario which has the highest chance of coming to fruition. It assumes modest market share gains primarily driven by the GTA expansion alongside modest margin expansion of 80bps YoY given efficiencies through newer plants, coupled with the refitting of existing plants to drive efficiencies.

[11] Bank of Canada, 2016

Free Cash Flow to the Firm	2016E	2017E	2018E	2019E	2020E	2021T	
EBIT	17,648	20,733	23,964	27,730	32,070	36,247	
Tax Rate	27%	27%	27%	27%	27%	27%	
NOPAT	12,971	15,239	17,614	20,381	23,571	26,641	
Plus: Deprecation & Amortization	13,463	14,291	15,235	16,240	17,272	18,300	
Less: Change in Net Working Capital	3,166	2,084	2,139	2,311	2,465	2,330	
Less: CAPEX	21,285	22,448	23,480	24,425	25,245	25,788	
Mid Year Discount Factor	0.5	1.5	2.5	3.5	4.5	5.5	
Unlevered Free Cash Flow	1,983	4,997	7,230	9,886	13,133	16,823	17,193
PV of Unlevered FCF	1,942	4,696	6,517	8,548	10,894	13,387	
Terminal Value at Year 5						490,704	

Valuation	
Present Value of Cash Flows	45,983
Present Value of Terminal Value	371,850
Enterprise Value	417,833
Less: Debt	2,349
Add: Cash	-
Equity Value	415,484
Implied Share Price	**$52.03**
Current Share Price	$41.70
Margin of Safety	**24.8%**

5.1.2 Bull Case Results

The bull case reflects a scenario should Management's assumptions of doubling their GTA throughput, alongside winning additional RFP's coming online in the next 12-18 months come to fruition. This is materialized in the operating model through increased market share gains YoY during the forecast period. In addition, it assumes accelerated EBITDA margin expansion through quicker transitions to the newer facilities.

Free Cash Flow to the Firm	2016E	2017E	2018E	2019E	2020E	2021T	
EBIT	22,050	25,907	30,007	34,798	40,330	45,731	
Tax Rate	27%	27%	27%	27%	27%	27%	
NOPAT	16,207	19,041	22,055	25,576	29,642	33,612	
Plus: Deprecation & Amortization	13,463	14,448	15,541	16,686	17,849	18,997	
Less: Change in Net Working Capital	4,835	2,135	2,304	2,503	2,683	2,533	
Less: CAPEX	22,440	23,701	24,814	25,830	26,706	27,278	
Mid Year Discount Factor	0.5	1.5	2.5	3.5	4.5	5.5	
Unlevered Free Cash Flow	2,395	7,654	10,478	13,930	18,102	22,798	23,300
PV of Unlevered FCF	2,346	7,191	9,445	12,045	15,016	18,142	
Terminal Value at Year 5						664,988	

Valuation	
Present Value of Cash Flows	64,185
Present Value of Terminal Value	503,920
Enterprise Value	568,104
Less: Debt	2,349
Add: Cash	-
Equity Value	565,755
Implied Share Price	**$70.85**
Current Share Price	$41.70
Margin of Safety	**69.9%**

5.1.3 Bear Case Result

The bear case reflects a worst-case scenario should managements guidance not materialize, and no additional market share is gained. This forecast assumes pure organic growth at the rate of the overall linen processing market in healthcare and hospitality respectively. In this forecast, margin expansion is limited, and only accounts for gains through utility efficiencies, ignoring any potential wage and labor savings inherent through increased automation in the new facilities.

Free Cash Flow to the Firm	2016E	2017E	2018E	2019E	2020E	2021T	
EBIT	13,016	15,049	17,075	19,411	22,080	24,501	
Tax Rate	27%	27%	27%	27%	27%	27%	
NOPAT	9,567	11,061	12,550	14,267	16,228	18,008	
Plus: Deprecation & Amortization	13,463	14,134	14,929	15,794	16,696	17,603	
Less: Change in Net Working Capital	1,461	1,997	1,931	2,067	2,187	2,060	
Less: CAPEX	20,131	21,195	22,146	23,021	23,783	24,298	
Mid Year Discount Factor	0.5	1.5	2.5	3.5	4.5	5.5	
Unlevered Free Cash Flow	**1,437**	**2,002**	**3,402**	**4,974**	**6,954**	**9,254**	**9,457**
PV of Unlevered FCF	**1,408**	**1,881**	**3,067**	**4,301**	**5,769**	**7,364**	
Terminal Value at Year 5						**269,919**	

Valuation	
Present Value of Cash Flows	23,789
Present Value of Terminal Value	204,542
Enterprise Value	228,331
Less: Debt	2,349
Add: Cash	-
Equity Value	225,982
Implied Share Price	**$28.30**
Current Share Price	$41.70
Margin of Safety	**-32.1%**

6.0 Alternative Valuation Models:

6.1 Comparable Peer Analysis

Given the lack of pure-play public comparables operating in the linen processing industry within Healthcare and Hospitality, there would be minimal value in looking at where peers trade on a relative basis in terms of FCF, earnings, or EBITDA. This being said, ABM Industries, Cintas, and G&K Services are all service providers operating primarily in the U.S. who do not focus primarily healthcare and hospitality linen servicing. These were the companies used to get a basic idea of where a business with relatively low risk & cyclicality, with a contractual business model should be trading on a relative basis (Refer to figure 12).

On an EBITDA multiple basis, KBL trades relatively in line with its corresponding linen peers in the U.S currently sitting at 10.3x 2016E EBITDA. This being said, the thesis is that the scale advantages and "customer stickiness" associated with this business should warrant a premium multiple to peers closer to KBL's historical trading range of 10.0-13.5x EBITDA. Note over the past 3 years, KBL has averaged an EV/EBITDA multiple of approximately 11.6x.

Figure 12: Service Provider Peers Analysis

(All Figures in $Cmm except per share data unless stated)					*EBITDA*				*EV/EBITDA*				*EBITDA Margins*			*Net Income Margins*		
Linen Service Providers	Ticker	Price	Market Cap.	EV	2014A	2015A	2016E	2017E	2014A	2015A	2016E	2017E	2014A	2015A	2016E	2014A	2015A	2016E
ABM Industries	ABM	34.24	1,921	2,151	193.0	196.8	204.0	233.3	11.1x	10.9x	10.5x	9.2x	4.2%	4.0%	4.0%	1.7%	2.0%	2.2%
Cintas	CTAS	87.74	9,487	10,115	802	876	932	1007.8	12.6x	11.5x	10.9x	10.0x	17.9%	19.1%	19.3%	7.4%	9.1%	9.1%
G&K Services	GK	69.23	1,377	1,606	131	142	157	170.4	12.3x	11.3x	10.2x	9.4x	14.1%	14.1%	15.4%	6.2%	6.7%	6.9%
Peer Average									**12.0x**	**11.3x**	**10.5x**	**9.6x**	**12%**	**12%**	**13%**	**5%**	**6%**	**6%**
K-Bro Linen	**KBL**	**41.70**	**335**	**337**	**26**	**27**	**36**	**40**	**12.8x**	**12.4x**	**9.5x**	**8.4x**	**19%**	**19%**	**20%**	**9%**	**8%**	**9%**

7.0 Conclusion:

KBL seems to be the wide-moat business which aligns well with LSIF's mandate. Given its significant scale advantages, the inherent need for linen processing in Canada with minimal capacity, and recent completion of an investment cycle which increases KBL's capacity to process further contracts. There is also consolidation opportunities which exist within the industry facilitating potential geographic expansion which KBL has been very successful with in the past.

With the valuation coming down approximately 25% over the last year high due to emotional, short-term horizon investing there is an apparent opportunity for LSIF to potentially exploit in KBL. I see this business as stable, defensible, and predictable. The idea here would be to take a position with an adequate margin of safety relative to KBL's risk profile and allow management to prudently allocate capital and execute operationally continuing to reward shareholders as they have done in the past. Given where KBL trades today at $42.00, I reinstate the recommendation to **BUY** with a base-case target price of $52.46.

7.1 Business Risks:

1. **Completion Risk** - Ability to complete capital projects on time and within budget.
2. **Quality Assurance** - Ability to complete general & client imposed quality standards can be a material risk to the business through lost contracts & potential closure of facilities
3. **Public Sector Cost Inefficiencies** - The government culture promotes the de-prioritization of cost efficiencies in the public sector, one of the key value propositions derived through KBL's core business model.
4. **Concentration Risk** - Termination of major contracts would be an impediment to KBL's financial performance. As of 2015, 43% of KBL's revenue was derived via three customers. (See Figure 13)
5. **Utility Expenses** - The use of electricity, natural gas, & water is a significant component (6%) of KBL's operating expenses. The majority of this consumption is linked to operating the eight wash facilities.
6. **Cost of Linens** - The increase in the price of cotton could result in higher costs of Linen, which can affect the cost competitiveness in K-Bro's business model.
7. **Ability to Win/Retain Business** - The primary source of growth in this business is through the acquisition of new contracts. Although poised to continue benefiting from their scale advantage, KBL needs to be able prove its value proposition to potential new clients.

Figure 13: Major KBL Customer Contracts w/ Expiry Dates:

Customer	Expiry	Number of Institutions
Health Shared Services Saskatchewan (Regina)	2025	200+
Alberta Health Services (Edmonton)	2023	7
Provincial Health Services Authority (Vancouver)	2020	6
Providence Health Care Society (Vancouver)	2020	4
Mount Sinai Hospital (Toronto)	2020	1
Alberta Health Services (Calgary)	2018	7
St. Michael's Hospital (Toronto)	2016	1
Hospital for Sick Children (Toronto)	2016	1
Vancouver Coastal Health Authority (Vancouver)	2020/2027	10/23
Fraser Health Authority (Vancouver)	2020	3

Source: Company Filings

7.2 Potential Acquisition and M&A Opportunities:

KBL operates in an industry where there are inherent opportunities for consolidation. Recently, there was the joint acquisition of Booth Centennial by Ecotex and Fengate Capital. Booth's operations were in Ontario with its plant being located in Mississauga. An interesting acquisition opportunity for KBL will be Ecotex, a private competitor who has linen processing operations in the United States, Vancouver, and Toronto after the acquisition of Booth. This will be an excellent way for KBL to enter the U.S. market and will allow for significant growth opportunities and cost synergies in the Toronto and Vancouver operations that they currently have.

In addition, I view KBL as the ideal candidate for a takeover target by a private equity firm. The business fits the description of an ideal candidate with its stable contractual cash flows, sustainable competitive advantage, and excellent management team. In addition, the debt profile of this business is currently 0.1x net debt/EBITDA, allowing for significant leverage capacity on the company's books should a financial sponsor be looking to drive levered returns. The purchase of Booth Centennial by Fengate Capital with Ecotex is a prime example of financial buyers entering the linen processing industry given the characteristics of its business model. Given the runway KBL currently has, it is believed that a sizeable premium will be offered to take the company private.

7.3 Additional Service Offerings

KBL has recently introduced its "K-Bro Operating Room" services which primarily serve any linen processing needs particularly in the operating rooms of hospitals. This requires extreme caution and quality assurance as given the exposure of patients in the operating room, diseases or bacterial infections are most likely to spread. Given the inherent need for quality and consistency, KBL will be well positioned to grow its share in the market as their service offering begins to gain traction in the coming years. In addition, there is significant cross selling opportunities to KBL's existing healthcare customer base. The tailwinds from this new product have not been explicitly incorporated into the current model, however will be a reaffirming thesis point relating to KBL's market share gains in the healthcare segment over the longer term.

8.0 Appendices:

8.1 Description of Business Cycle:

KBL has four core components in their operating cycle, which are Linen Collection and Transportation, Soil Sort and Wash floor, Dryers, Ironing and Dry fold.

Linen Collection and Transportation

K-Bro's employees or its customers collect the soiled linen in designated soiled linen collection containers, known as "tubs". Tubs of soiled linen are transported using K-Bro's delivery fleet that includes mid-size trucks and tractor trailers. In Vancouver and Saskatchewan, K-Bro outsources portions of its deliveries by utilizing third party delivery companies. Once collected, the soiled linen is delivered to K-Bro's facilities to be unloaded and staged on the wash floor for processing. Following laundering and processing, fully loaded exchange carts are placed onto delivery vehicles for return to the healthcare facility. The full exchange carts are delivered to the end-user department and the return linen cart is sent back to the K-Bro plant for refilling. Tubs and carts used in this process are owned by K-Bro at each of its facilities, other than in Edmonton.

Soil Sort and Wash floor

Healthcare linen is sorted prior to washing into different categories (e.g. by product, colour and soil content).The sorting is accomplished by various automated conveyance systems. Once sorted, linen is automatically transported by way of monorail or conveyance systems to washers for laundering.

The majority of K-Bro's laundry is processed in tunnel washers. Tunnel washers are very large (up to 70 feet long) long-life stainless steel cylinders with up to 19 different washing chambers. The chambers are designed to operate independently and can operate at different temperatures, chemistry and water levels to allow for a number of different products to be laundered simultaneously. Depending on the size of the tunnel washer, up to 7,000 pounds of laundry can be processed hourly. Tunnel washers are generally more efficient than smaller industrial washers, which reduces K-Bro's natural gas, electricity and water consumption and labour costs. Tunnel washers use compression extraction to remove water from the linen following the washing stage. Wet linen from the tunnel washer is automatically discharged into a perforated basket where the linen is compressed under significant pressure by a hydraulic press in order to extract the water for reuse. Once this process is completed, the linen is automatically conveyed to the dryers.

Dryers

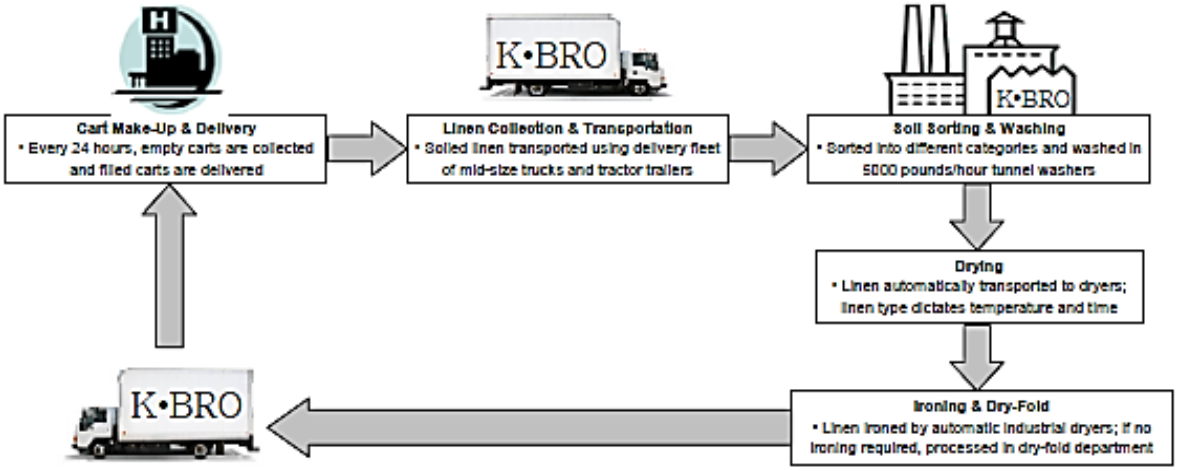
After the washing and water extraction processes are completed, linen is automatically transported into the dryers. Linens are dried for predetermined lengths of time and temperatures based on the linen type. Volume from the conventional washers is loaded into conventional dryers. Once the drying process is completed, linen is discharged and automatically conveyed to the finishing department for ironing and dry fold.

Ironing and Dry fold

Any linen requiring ironing is processed by advanced ironers that employ automated feeders and folders to ensure high quality and productivity. Product that does not require ironing (e.g. terry towels) is processed in the dry fold department through automated folding equipment or "small piece folders". After completing the ironing and dry fold process, finished hospitality linen is counted, placed into sanitized carts and tubs, weighed and loaded onto delivery vehicles for return to the customer. Finished healthcare linen is conveyed automatically to the cart makeup department and generally stored by linen classification.

KBL delivers clean linen to its healthcare customers using a cart exchange system, whereby each hospital unit is assigned two exchange carts — one of which is located at the KBL plant and the other at the hospital unit. Every 24 hours, K-Bro collects empty, or partially empty, carts at the hospital and returns them to its facilities for refilling, while also delivering carts filled with processed linen to the hospital. Daily quotas for each healthcare institution are filled by K-Bro employees taking the appropriate pieces off of the flow rack and filling the empty carts to an established quota. The finished exchange carts awaiting delivery are stored in a holding area at the KBL plant until the next exchange takes place.

Business Cycle Illustration:



Source: Company Filings

8.2 Key Management Profiles

President & CEO - Linda McCurdy

Ms. McCurdy joined K-Bro in May 1998 as Chief Financial Officer and became President & Chief Executive Officer in January 2000. Prior to joining K-Bro, she was Chief Financial Officer of Canadian Inovotech Inc., a biochemical products processor. Ms. McCurdy's prior experience also includes six years at the Overwaitea Food Group where she held a number of financial positions.

SVP & General Manager (Edmonton) - Sean Curtis

Mr. Curtis joined K-Bro in 1984 and has over 30 years of experience in the laundry and linen services industry. As Senior Vice President, Mr. Curtis works directly with K-Bro's President & CEO in the areas of plant expansions, capital equipment installations and business development into new markets.

CFO – Kristie Plaquin

Ms. Plaquin has been with K-Bro since 2001 and was the Chief Financial Officer from January 2004 through May 2005 during which time the company completed its Initial Public Offering and debt financings. After stepping away from K-Bro for a year through 2005 - 2006, Ms. Plaquin has served as Director of Financial Planning during which time she has played a lead role in all of K-Bro's growth and financing initiatives.

General Manager (Calgary) - Jeff Gannon

Mr. Gannon joined K-Bro in 1992 and has over 22 years of experience in the laundry and linen services industry. Prior to being named General Manager (Calgary) in 2003, Mr. Gannon served as the Operations Manager of K-Bro's Edmonton facility. As General Manager (Calgary), Mr. Gannon is responsible for the overall management of the K-Bro's Calgary operation.

General Manager (Vancouver) - Ron Graham

Mr. Graham originally joined K-Bro in 1984 and has over 30 years of experience in the laundry and linen services industry. Prior to returning to K-Bro and being named General Manager (Vancouver) in 2002, Mr. Graham worked as an independent consultant for the laundry and linen services industry in North America and the United Kingdom. As General Manager (Vancouver), Mr. Graham is responsible for the overall management of K-Bro's original Vancouver operation.

General Manager (Toronto) - Jerry Ostrzyzek

Mr. Ostrzyzek joined K-Bro in 1987 and has over 27 years of experience in the laundry and linen services industry. Mr. Ostrzyzek has served as General Manager (Toronto) since 1995. As General Manager (Toronto), Mr. Ostrzyzek is responsible for the overall management of K-Bro's Toronto operation.

8.2.1 Management Compensation Analysis

Officer Compensation Metrics:

1. Achievement of a Target Distributable Income (35%) - Defined by company as cash flows from operations adjusted for changes in non-cash working capital items, share-based compensation, and maintenance capex.
2. Achievement of a specified EBITDA target (35%)
3. Discretionary Bonus (30%)

Note: A "Stretch Bonus" is approved up to 70% of base salary should EBITDA and Distributable Income targets be exceeded by a target amount set by the compensation committee.

The "Stretch Bonus" is calculated as follows:

1. 50% of the stretch bonus is based on the Corporation exceeding a specified DI stretch target which is determined annually by the CNCG Committee. For each percentage by which the Corporation's DI exceeds the approved stretch target, 2.5% of the stretch bonus is earned, to a maximum of 30% of base salary

2. 50% of the stretch bonus is based on the Corporation exceeding a specified EBITDA stretch target which is determined annually by the CNCG Committee. For each percentage by which the Corporation's EBITDA exceeds the approved stretch target, 2.5% of the stretch bonus is earned, to a maximum of 30% of base salary.

   In addition, 50% of the target bonus for distributable income and EBITDA is earned when 90% of the target is achieved, while the remaining 10% is earned when the target is hit.

8.2.2 Historical Officer Compensation Analysis

Compensation Analysis:

Officer:	Year	Base	Cash Bonus	Share-Based Awards	Other Compensation	Total Compensation	Growth in Compensation	Total Shareholder Return	Multiple of Total Gross Compensation in Shares
Linda McCurdy	2015	480,000	624,000	624,000	38,657	1,766,657	14%	13.1%	3.3x
President & CEO	2014	422,000	548,600	548,600	35,386	1,554,586	3%	19.4%	
	2013	410,334	533,000	533,000	32,668	1,509,002			
Kristie L. Plaquin	2015	210,000	63,000	147,000	16,109	436,109	90%	13.1%	n.a.
CFO	2014	134,769	24,382	58,333	11,603	229,087			
Christopher Burrows	2014	137,987	-	-	9,776	147,763	-66%	19.4%	n.a.
Vice-President & CFO	2013	220,000	44,000	150,535	15,084	429,619			
Sean Curtis	2015	300,000	180,000	300,000	27,327	807,327	9%	13.1%	4.6x
SVP & General Manager	2014	275,000	165,000	275,000	25,041	740,041	8%	19.4%	
	2013	255,000	153,000	255,000	23,529	686,529			
Ronald Graham	2015	176,000	82,800	88,000	22,355	369,155	2%	13.1%	2.0x
General Manager	2014	172,000	81,600	86,000	21,055	360,655	5%	19.4%	
	2013	165,000	79,500	82,500	18,098	345,098			
Jeffrey Gannon	2015	141,250	42,375	70,625	11,815	266,065	7%	13.1%	2.1x
General Manager	2014	138,373	45,512	54,657	10,633	249,175	7%	19.4%	
	2013	135,660	40,695	47,566	9,283	233,204			

		Total Compensation	% of CFO	% of EBITDA
Total Compensation Ratios	2015	3,645,313	21%	13%
	2014	3,133,544	13%	12%
	2013	3,203,452	17%	14%

8.3 Ownership Analysis

When analyzing a business, it is important to get a grasp on who exactly wields ownership and the type of investor they may be. It is also beneficial to see how much of the business management owns.

8.3.1 Insider Ownership

When analyzing a business it is important to analyze the level of ownership management has. By doing so, you can see whether their incentives are aligned with you as an investor to drive shareholder value over time. Comparing the market value of ownership to total compensation, on average the key officers of KBL own 3.0x their total compensation in 2015 in KBL shares, a strong indicator of their commitment to the business.

Officer	Percent Owned	Number of Shares	Market Value of Shares
Linda McCurdy	1.73%	138,055	5,863,196
Sean Curtis	1.08%	86,500	3,673,655
Steven Matyas	0.34%	26,980	1,145,841
Ronald Graham	0.21%	17,005	722,202
Jerry Ostrzyzek	0.17%	13,243	562,430
Other	0.39%		
Total Insider Ownership:	**3.92%**		

Source: Bloomberg as at Jun-15-2016

8.3.2 Institutional Ownership

With a 17.3% holder of KBL it is important to understand the type of investor they are. With this position owned through Sentry Investments Equity Income fund, this fund typically looks for strong underlying business models, with high barriers to entry, aligned management teams, and the ability to earn outsized returns relative to those in the industry. This thinking aligns well with that of LSIF's investment philosophy.

Institutional Holders:

Firm	Percent Owned	Mandate
Sentry Investments	17.34%	Value
1832 Asset Management	15.63%	Value
Fidelity Investments	2.21%	Value
Empire Life Insurance	2.16%	Growth
CIBC Global Asset Management	1.79%	Value
Other	8.84%	
Total Institutional Holders:	**47.97%**	

Source: Bloomberg as at Jun-15-2016

8.4 Acquisition Criteria

With KBL operating in a fragmented market with several smaller players serving very niche markets there is plenty of opportunity where growth can be achieved through strategic acquisitions. When evaluating how effective a company is at pursuing acquisitions, it is important to assess the types of criteria that is used to evaluation potential acquisition candidates. KBL management has set in place a criteria that is ensured to create long-term shareholder value should they be met, and are very strict on any potential candidates that may not fit within the outlined criteria below.

1) Does the acquisition open up a new or strategically placed geographic market or market niche for KBL?
2) Is there growth potential for the market it currently serves?
3) Will KBL be able to strategically build on relationships that the company already has in place?
4) Can KBL build on an already existent base of business?
5) Does it enhance overall resources and capacity?
6) Will management and labor force of new company stay aligned with growing the operations?

8.5 Value Analysis:

A company's intrinsic value is ultimately driven through its ability source reinvestment opportunities while being able to deploy capital at high incremental rates of return. KBL has plenty of reinvestment opportunities for reinvestment given its continuous need to build capacity. When a linen processing facility is online, the scalability of the facility is what drives ROIC's in the long term ultimately compounding shareholder value. KBL will continue to be able to source reinvestment opportunities in capacity or other product development opportunities to tie into their "moat-driven" business model. Working through their capital deployment profile, and assuming K-Bro continues to deploy capital the way they have done historically for the last 10 years, they will reinvest 80% of their generated capital into the business, delivering incremental returns of 11% on that capital. This derives a 12% compounding effect on the intrinsic value of this business. Equities as an asset class have typically compounded between 8-10% historically, and this is proven piece of KBL's operational effectiveness that they have been able to deliver 20% higher intrinsic value growth than the upper bound of equities.

K-Bro ROIC Profile:

	2005	2015	Change
Net Income	3,500	12,068	8,568
Total Equity Investment	37,600	108,079	
Debt Obligations	5,400	2,349	
Add: Goodwill	12,400	20,456	
Total Capital Invested	55,400	130,884	75,484
Cumulative 10 Year Earnings	94,300		
Incremental Capital Invested	75,484		
Cumulative 10 Year Dividends	80,078		
Reinvestment Rate	80%		
Return on Incremental Capital Investments	11%		
Shareholder Yield	3%		
Value Compounding Rate of the Company	12%		

8.6 Primary Account from 3SHealth about KBL Services:

In order to get a sense of how KBL's relationship is with their customers, a primary account from 3sHealth, a major customer of KBL was used to understand the true value proposition of KBL's business model. Note, 3SHealth outsourced their entire linen processing function in Saskatchewan when they realized the efficiency benefits from privatizing the function to a private provider such as KBL. As of now, KBL has opened a facility in Regina, Saskatchewan, to process this new volume.

Question 1: How do linen services impact the patient and resident experience?

Answer: High quality linen products, comfort and cleanliness, infection prevention and control and availability are all factors that clients notice and appreciate. Improved linen services will support the province's "patient first" mandate.

Question 2: Why do we need a provincial linen service?

Answer: Processing linen centrally makes the most sense. New laundry technology is designed to work most efficiently and effectively on a large scale. A provincial linen solution will also create uniform standards for linen, infection prevention and control, and linen processing.

Question 3: What will the new Provincial Linen Service look like?

Answer: There will be one central laundry located in Regina and two distribution depots located in Saskatoon and Prince Albert. The central laundry in Regina will process all of the soiled linen currently processed by the five existing central laundries. The creation of depots will allow for timely delivery and collection of linen throughout the province.

Question 4: How long will it take to implement the new linen service?

Answer: It is expected to take approximately two years from the signing of the contract with K-Bro to implement the new linen system.

Some key target dates are:

- December, 2013 - Sign contract with K-Bro Linen Systems
- April 1, 2014 - Saskatoon Depot is operational
- June, 2015 – New Regina plant is operational
- December 31, 2015 – All health regions have transitioned to new services

These target dates can be impacted by construction delays for the new plant. The current central laundries are expected to remain operational unless transition activities dictate earlier closures.

Question 5: Who will deliver the Provincial Linen Service?

Answer: The service will be delivered by K-Bro Linen Systems Inc. (K-Bro). K-Bro is the largest linen service provider in Canada. It has operations in Ontario, Alberta, Quebec and British Columbia. Its core business is healthcare linen services. K-Bro is a publicly traded company with over 60 years in the linen service industry.

Question 6: Who will administer the contract with K-Bro?

Answer: Health Shared Services Saskatchewan (3sHealth), our province's shared services organization, will administer the contract. Highlights of the contract include:

• Detailed financial reporting that allows 3sHealth to compare actual costs to industry best practices

• The new plant design, work processes, and 3rd party testing will ensure that the laundering process meets or exceeds current and future infection prevention and control standards.

• Quality audits, agreed upon service levels and penalties for non-compliance that do not exist in the current system

• A menu of services and cost levels will be available to health regions and facilities to meet current and future service requirements. 3sHealth currently manages a number of shared services that support our province's health care system including payroll, employee benefits and group purchasing of health care supplies and equipment. In the past 3 years, shared services initiatives have saved over $33 million for Saskatchewan's health care system.

Question 7: Who is going to pay for this contract?

Answer: The regional health authorities and Cancer Agency will pay K-Bro for the services they receive. The cost of the contract will be significantly lower than the cost of providing that service today. The estimated savings over a ten year period are $97.7 million.

Question 8: How did you select K-Bro?

Answer: K-Bro was selected as the preferred vendor after concluding a competitive tendering process.

Question 9: Who made this decision?

Answer: This decision was made by the 3sHealth Board, Regional Health Authority and Cancer Agency leadership and the provincial government.

Question 10: Why are we not just upgrading the central laundries that we have?

Answer: The central laundries require over $30 million in capital reinvestment. Even with the investment, upgrading would not result in the most efficient or effective option.

Question 11: What are the advantages of contracting out linen services to a third party provider?

Answer: There are several advantages in partnering with K-Bro:

• K-Bro has extensive experience in healthcare linen services. This is K-Bro's core business. Allowing third parties to focus on their core business allows the health system to focus on its core business of providing care to patients and residents

• Reduced capital investment on the part of the province;

• Reduced operating costs

• Contingency services are available out of K-Bro's Calgary and Edmonton plants in the event of a major event like a flood or fire.

Question 12: Isn't this just a first step in privatizing healthcare?

Answer: Contracting out linen services is part of the health system's commitment to improve quality for patients while maintaining a sustainable, publicly funded health care system.

Question 13: Doesn't the private sector pay lower wages to its employees?

Answer: Wage rates will be determined by K-Bro. However, we believe that K-Bro will need to pay competitive market rates to attract and retain a qualified workforce.

Question 14: What criteria were used to locate the plant in Regina?

Answer: K-Bro proposed to locate the plant in Regina because the majority of linen processed in the province is used in the areas closest to Regina.

Question 15: Isn't this decision going to have a negative impact on some rural communities?

Answer: This decision is about ensuring quality, cost effective service is available to Saskatchewan patients, families and residents in both rural and urban Saskatchewan. Rural communities can expect to receive the same standard of quality linen service as is expected in urban Saskatchewan.

Question 16: Does it make sense to decommission North Saskatchewan Laundry in Prince Albert? Didn't it recently add a new tunnel washer and other equipment?

Answer: The North Saskatchewan Laundry did undergo an upgrade with the purchase of new equipment. Utilizing that laundry, and/or expanding it to take on more linen volumes were considered as part of 3sHealth's review. However, the K-Bro option was deemed more effective and efficient. The new equipment can be sold and the space where the laundry is currently located can be used by the Victoria Hospital for other purposes without the need for extensive capital costs.

Question 17: With the price of fuel as high as it is, does it really make financial sense to ship all of this linen across the Province?

Answer: Yes. Having more linen processed at one plant reduces the costs to wash the linen, and significantly reduces the capital costs required for more plants and equipment. These efficiencies more than make up for the increased transportation costs.

8.7 Booth Centennial Acquisition Commentary

A primary catalyst for KBL's shares to fall approximately 25% over the last 4 months, was the loss of a potential contract opportunity in Quebec, as well as the acquisition of Booth Centennial by KBL's competitor on financial sponsor, Ecotex and Fengate Capital. It is to be noted however, that KBL's seems to be positioning itself aggressively, with their new "state-of-the-art" facility located in Mississauga, where Booth's single facility is located.

Prior to being acquired by Ecotex and Fengate, they were a non-for-profit linen laundry service owned by 22 member hospitals and healthcare institutions. As a part of the definitive agreement, Fengate and Ecotex will enter into long-term service agreements with the members of booth. This will be the primary competitor to KBL's new Toronto facility which is expected to come online in the second half of 2016 when it comes to bidding for contracts. However, given that these facilities were formerly non-for-profit, efficiency driving practices will not be present at the Booth facilities, and here is where KBL can couple its quality assurance, with its scale advantages to steal significant share in the GTA linen processing market.