

Mossberg's Investor Digest

Best Idea Profile

America Service Group, Inc. (Nasdaq: ASGR)

DESCRIPTION:

In 1978, shortly after the landmark Supreme Court case that ruled that inmates have rights to medical care, America Service Group became the first private company to provide health care services to prisons and jails. Since its founding, the company has grown to be the largest (by market share) in a fragmented market. The company now has about 16% of the \$3.9 billion market for outsourced medical services to correctional facilities. Services include dental, mental health, recruitment and staffing, pharmacy management, and utilization management. The company's staff includes 5,000 medical, professional and admin personnel, some of which are contracted. At the end of the 3Q09, the company had 63 contracts to provide healthcare services to approximately 178,000 inmates at over 160 sites in 21 states.

KEY INVESTMENT CONSIDERATIONS:

\$½ billion in contracts up for bid in 2010 – The Company is currently bidding on \$90 million of new contracts and there are \$500 million in contracts up for bid during 2010. In addition, California may consider contracting for medical services, which could provide significant upside for the outsourced industry. According to one research firm, California represents a \$1 billion opportunity for the industry.

Attractive business model capable of producing 25%+ return on equity – ASGR's business model requires little in the way of fixed assets...just \$8 million in PP&E. In addition, the company collects on its receivables in 30 days and has negligible inventory. In this asset light model, the company is able to generate \$575 million in revenue with \$142 million of assets, or 4x assets turnover, which is a great way to generate returns. In addition, the company is capable of producing negative working capital because accounts payable and other current payables often exceed accounts receivable. Essentially, ASGR finances its working capital requirements by using credit from vendors...this is a great business model. The third driver for ROE is profitability. While ASGR has not consistently produced targeted profitability over the last few years, profitability trends are improving. With 1% net margin last year, the company produced 13% ROE. Current guidance reflects 30 basis points improvement in net margin which should drive ROE above 17% this year. Longer term the company should be able to produce 2% net margin and ROE in excess of 25%.

Outsourcing medical service to private providers has solid value proposition for tax payers - In addition to lowering costs by approximately 15%, outsourcing medical care to focused providers, produces better health outcomes and lowers litigation rates.

Risk profile of contracts has changed significantly - Gone are the days where the providers bare all of the risk for cost overruns. Of ASGR's current contracts 21% are on a cost plus, 71% are shared risk and only 8% are full risk contracts. Six years ago, full risk contracts were approximately 1/3 of revenue.

RISK:

While ASGR's recent track record for re-bidding existing contracts has been successful (8 for 8), the potential for losing re-bids, or renegotiating at less favorable terms, creates risk for revenue and earnings growth.

VALUATION:

Trading at 6x EV/ EBITDA, shares appear attractive at current levels. ASGR had several one-time events (audit committee investigation, unusual medical claims, etc.) over the past year. Adjusting for these charges TTM EBITDA is \$20 MM to \$25 MM, which implies an even lower multiple of 4x to 5x. Multiple levels should expand as results begin to reflect true earnings power and the company secures new contracts and margin levels and returns improve. This past year the company initiated a dividend, which provides a nice yield of 1.3% and should reduce share price volatility.

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Investment Data (as of 2/26/10)

Recent Price	\$14.96
52-Week Range	19.00 - 10.61
Fiscal Year End	December
Dividend	.020
Yield	1.3%
Shares Outstanding	9.3 MM
Average Trading Volume (3 mos)	40,000
Market Capitalization	139 MM
Cash	35 MM
Long Term Debt	N/A
Enterprise Value (EV)	103 MM
LT Debt/ Equity	N/A
Tangible BV/ Share	\$0.45
TTM Revenue	\$576 MM
P/ Revenue	0.2x
2010 EPS (estimate)	0.99
P/ EPS	15x
TTM EBITDA	16.9 MM
EV/ EBITDA	6.1x

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