HealthEquity Inc

Where the cash flows: Investor Day Preview

Reiterate Rating: BUY | PO: 93.00 USD | Price: 81.63 USD

Cash flow priorities and the organic growth algo

HealthEquity is hosting its first investor day since 2019 next week in Draper, Utah. Heading into the event, we see two key areas of investor interest: 1) How is HealthEquity going to deploy capital over the next few years as cash flow further inflects?; and 2) how should investors think about the core growth algorithm and margin profile from here (revenue growth and EBITDA margins excluding volatility from interest rates). These two questions are inter-related as HealthEquity's decision on where to focus investment will have an impact on its future organic growth rate. The company has indicated it will provide more commentary on its ecosystem partnerships and a deep dive into its transition and acceleration into Enhanced Rate products. We don't think investors are expecting material news from next week's event which is noteworthy if there is a large announcement. We reiterate our Buy rating and increase our PO to $93 (from $85) due to peer multiple expansion ahead of next week's event.

What are the highest ROI/most durable investment opps?

HealthEquity generated $165MM of operating cash flow in the first three quarters of FY24 ($220MM annualized) and this metric should further improve over the next few years as custodial yields continue to rise. HealthEquity could look to continue its recent strategy of buying smaller HSA portfolios, acquire a much larger HSA portfolio, attempt to acquire a horizontal business or build a new service from within. We explore the pros and cons of each opportunity within the note.

Expect commentary on revenue growth/margin targets

We expect HQY will provide commentary around its growth initiatives and how those initiatives can drive revenue, EBITDA margins, and FCF growth. Excluding the benefit of rates, we estimate HQY is a mid-single digit organic top-line growth story. On the margin side, we expect the company to provide commentary on the trajectory of EBITDA margins and we note that 40% margins were a loose guidepost immediately following the WageWorks transaction. We would view any commentary pointing to cyclically adjusted EBITDA margins above 40% over the long-term as an incremental positive. Additionally, any long-term EBITDA guidance (FY27 targets) would help get investors more comfortable with the intermediate term and would likely result in upside earnings revisions. We still view HQY as an earnings revision story. Further context in the note.

Estimates (Jan) (US$)	2022A	2023A	2024E	2025E	2026E
EPS	1.33	1.36	2.13	2.79	3.00
GAAP EPS	(0.53)	(0.31)	0.43	1.02	1.12
EPS Change (YoY)	-20.8%	2.3%	56.6%	31.0%	7.5%
Consensus EPS (Bloomberg)			2.14	2.84	3.53
DPS	0	0	0	0	0
Valuation (Jan)					
P/E	61.4x	60.0x	38.3x	29.3x	27.2x
GAAP P/E	NM	NM	189.8x	80.0x	72.9x
EV / EBITDA*	32.5x	28.2x	21.5x	16.9x	15.8x
Free Cash Flow Yield*	1.9%	2.1%	4.3%	5.0%	5.2%

* For full definitions of *iQmethod*℠ measures, see page 8.

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Refer to important disclosures on page 9 to 11. Analyst Certification on page 7. Price Objective Basis/Risk on page 7. 12660198

Timestamp: 16 February 2024 05:11AM EST

16 February 2024

Equity

Key Changes

(US$)	Previous	Current
Price Obj.	85.00	93.00

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Stock Data

Price	81.63 USD
Price Objective	93.00 USD
Date Established	16-Feb-2024
Investment Opinion	C-1-9
52-Week Range	48.86 USD - 82.00 USD
Mrkt Val (mn) / Shares Out (mn)	7,102 USD / 87.0
Free Float	97.9%
Average Daily Value (mn)	53.51 USD
BofA Ticker / Exchange	HQY / NAS
Bloomberg / Reuters	HQY US / HQY.OQ
ROE (2024E)	9.4%
Net Dbt to Eqty (Jan-2023A)	34.5%
ESGMeter™	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

iQprofile℠ HealthEquity Inc

iQ**method*℠ **– Bus Performance

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	5.2%	5.0%	7.1%	8.9%	9.1%
Return on Equity	6.8%	6.1%	9.4%	11.8%	11.9%
Operating Margin	24.5%	22.9%	28.9%	31.7%	32.2%
Free Cash Flow	132	147	305	358	373

iQ**method*℠ **– Quality of Earnings

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	1.3x	1.3x	1.7x	1.5x	1.4x
Asset Replacement Ratio	0.1x	0x	0.1x	0.1x	0.1x
Tax Rate	22.7%	25.0%	25.0%	23.2%	22.7%
Net Debt-to-Equity Ratio	38.1%	34.5%	19.9%	4.7%	-8.6%
Interest Cover	5.1x	4.1x	5.2x	6.2x	6.7x

Income Statement Data (Jan)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	757	862	991	1,158	1,231
% Change	3.1%	13.9%	15.0%	16.9%	6.3%
Gross Profit	435	506	628	763	829
% Change	2.7%	16.4%	24.2%	21.5%	8.6%
EBITDA	236	272	358	456	486
% Change	-2.0%	15.4%	31.3%	27.5%	6.5%
Net Interest & Other Income	(43)	(45)	(41)	(45)	(45)
Net Income (Adjusted)	**110**	**115**	**185**	**247**	**272**
% Change	**-12.7%**	**3.9%**	**61.1%**	**34.1%**	**9.9%**

Free Cash Flow Data (Jan)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	(44)	(26)	37	91	102
Depreciation & Amortization	137	161	158	182	182
Change in Working Capital	(13)	(36)	32	5	2
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	61	52	92	98	106
Capital Expenditure	(9)	(3)	(15)	(17)	(18)
Free Cash Flow	**132**	**147**	**305**	**358**	**373**
% Change	**-21.6%**	**11.5%**	**107.1%**	**17.4%**	**4.1%**
Share / Issue Repurchase	457	7	0	0	0
Cost of Dividends Paid	0	0	0	0	0
Change in Debt	(53)	(9)	(35)	0	0

Balance Sheet Data (Jan)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	225	254	472	770	1,078
Trade Receivables	87	97	92	108	115
Other Current Assets	38	32	37	43	46
Property, Plant & Equipment	23	13	12	11	11
Other Non-Current Assets	2,732	2,693	2,613	2,530	2,440
Total Assets	**3,107**	**3,089**	**3,226**	**3,462**	**3,689**
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	144	131	164	190	201
Long-Term Debt	931	908	873	873	873
Other Non-Current Liabilities	179	154	178	208	222
Total Liabilities	**1,255**	**1,193**	**1,215**	**1,271**	**1,296**
Total Equity	**1,853**	**1,896**	**2,012**	**2,190**	**2,394**
Total Equity & Liabilities	**3,107**	**3,089**	**3,226**	**3,462**	**3,689**

* For full definitions of *iQmethod*℠ measures, see page 8.

Company Sector

Healthcare Technology & Distribution

Company Description

HealthEquity provides a platform for health savings accounts (HSAs) that allows consumers to save for healthcare expenses in a tax efficient manner, compare treatment options, pay bills, and access benefits information. As of October 2023, the company had approximately 8.29MM health savings account (HSA) members and $22Bn in custodial assets. The company also purchased WageWorks in 2019 which added Commuter, COBRA, and flexible spending accounts.

Investment Rationale

Our Buy rating is driven by our positive view of operating leverage over the next few years. This is likely to be driven by improving custodial yields, accretion from recent M&A, as well as some improvement in the Commuter business. The HSA business should also continue to grow faster than the market over time.

Stock Data

Average Daily Volume	655,508

Quarterly Earnings Estimates

	2023	2024
Q1	0.27A	0.50A
Q2	0.33A	0.53A
Q3	0.38A	0.60A
Q4	0.37A	0.50E

What are the highest ROI/most durable investment opps?

HealthEquity should generate $750MM-$1Bn of FCF over the next three to four years as the benefit from higher interest rates flow through the model. We expect next week's investor day to focus on how the company expects to deploy this capital. HealthEquity has a few different paths: 1) continuing portfolio tuck-ins; 2) pursue larger portfolio acquisitions; 3) pursue a horizontal acquisition; 4) build additional capabilities internally; and 5) return capital to shareholders. HealthEquity has driven industry consolidation over the past 4 years, but there is still opportunity to drive more. We admit there are fewer targets. Overall, we think investors are looking for clarity on the growth algorithm of the business and the path forward.

Portfolio tuck-ins can continue, though industry consolidation has accelerated

The most likely scenario for HealthEquity is a continuation of its current strategy: acquiring smaller competitors and integrating the accounts directly into HQY's platform. Since the beginning of 2021, HealthEquity has acquired four of the top 20 HSA vendors by accounts. As of 2019, BenefitWallet was the 9th largest vendor by accounts, Further was the 11th largest, Fifth Third was the 13th largest, and Health Savings Administrators was the 19th largest (Exhibit 1).

Exhibit 1: List of HealthEquity's recent acquisitions, 2021-2023
Since the beginning of 2021, HealthEquity has purchased four top 20 HSA vendors representing ~1.5MM accounts

Date	Target	HSA Accounts	HSA Market Share Ranking (2019)	Inorganic Account Growth	HSA Assets ($MM)	CDBs	Purchase Price ($MM)
March 2021	Luum	0.0	n.a.	0.0%	$0.0	n.a.	$56.5
April 2021	**Fifth Third**	**157,000**	**13**	2.6%	490.0	0	60.8
November 2021	**Further**	**580,000**	**11**	9.7%	1,900.0	270,000	455.0
December 2021	**Health Savings Administrators**	**87,000**	**19**	1.5%	1,300.0	0	60.0
September 2023	**Benefit Wallet**	**665,000**	**8**	8.1%	2,700.0	0	425.0

Source: Company filings, BofA Global Research

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HealthEquity's ~1.5MM of announced portfolio acquisitions since the beginning of 2021 is now larger than the combined accounts of the top 11-20 vendors in the HSA space. Interestingly, the total number of accounts held by the top 11-20 vendors has declined by more than 40% since 2019, due in large part to the consolidation of large players by HealthEquity. Wex's acquisition of Discovery Benefits in 2019 represents another major deal during this time period. Today, very small regional banks and credit unions round out the list of top 20 vendors.

Exhibit 2: Growth of top 20 HSA vendors 2019-2022
Due in large part to HQY's acquisitions, the top five vendors took more share. The top 11-20 vendors are now 40% smaller than 2019

Market Share Ranks	Accounts 2019	Accounts 2022	% Change	Comments
1-5	15,771,000	22,457,000	42.4%	HealthEquity, Optum, Fidelity, Webster
6-10	4,478,000	5,161,000	15.3%	
11-20	1,589,000	938,000	(41.0%)	Consolidation around top 5 players accelerated

Exhibit 2: Growth of top 20 HSA vendors 2019-2022

Due in large part to HQY's acquisitions, the top five vendors took more share. The top 11-20 vendors are now 40% smaller than 2019

Source: Company filings, Devenir

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Despite this, there are still many opportunities for additional M&A, particularly among the largest 5-15 vendors. We believe HealthEquity has further opportunity to consolidate this space over the next few years if it desires that path. The pros of this strategy is that it is straightforward, portfolios are easy to integrate, and accretion is easily definable. The cons of this strategy is that it does not help to accelerate organic revenue growth.

Larger portfolio M&A is another option

HealthEquity seemed to indicate on its most recent earnings call that it may not be interested in acquiring a large peer, if such a company was looking to sell itself. For reference, HSA Bank (owned by Webster) has 3.18MM HSA accounts, making it slightly more than three times larger than Benefit Wallet, HQY's largest portfolio acquisition to date. We note that Benefit Wallet had 930,000 accounts at the end of 2022, but HQY only acquired active accounts, resulting in a net account figure of 665,000. There is nothing mechanically different between acquiring 1MM accounts and 3MM accounts and we believe HealthEquity is significantly better positioned to purchase HSA portfolio assets than both direct and indirect peers. A large portfolio acquisition would require more capital and would define HealthEquity's near-to-intermediate term capital priorities. We estimate HealthEquity's deal for Benefit Wallet could be 8-14% accretive to run-rate FY25 EPS and would expect any other deal for accounts to flow through the model is the same way (link to our Benefit Wallet note here). The pros of making a large portfolio acquisition is that the deal would be substantially accretive. The major con would be that it also does not reaccelerate organic growth.

Acquire an existing business in an adjacent market

HealthEquity could also acquire an adjacent business, similar to its decision to acquire WageWorks several years ago. The hurdle to acquire a horizontal business within the employer benefits space should be high and we would view any non-HSA portfolio deal with a healthy level of caution. Non-core healthcare services deals are notoriously difficult to integrate.

HealthEquity recently highlighted two areas where it could make sense to focus investments: 1) healthcare cost transparency; and 2) credit. The company could look to acquire assets in these spaces. We aren't sure exactly how an investment into healthcare cost transparency would integrate into HQY's current asset base and would have questions around how a cross-sale/integration would work. Acting as an intermediary for customers to access credit for healthcare expenses is an adjacency, though it is not clear exactly how large this opportunity could be. HealthEquity would likely act as an intermediary only and not take credit risk, an important consideration if the company decided to enter that market.

Accelerate share repurchases

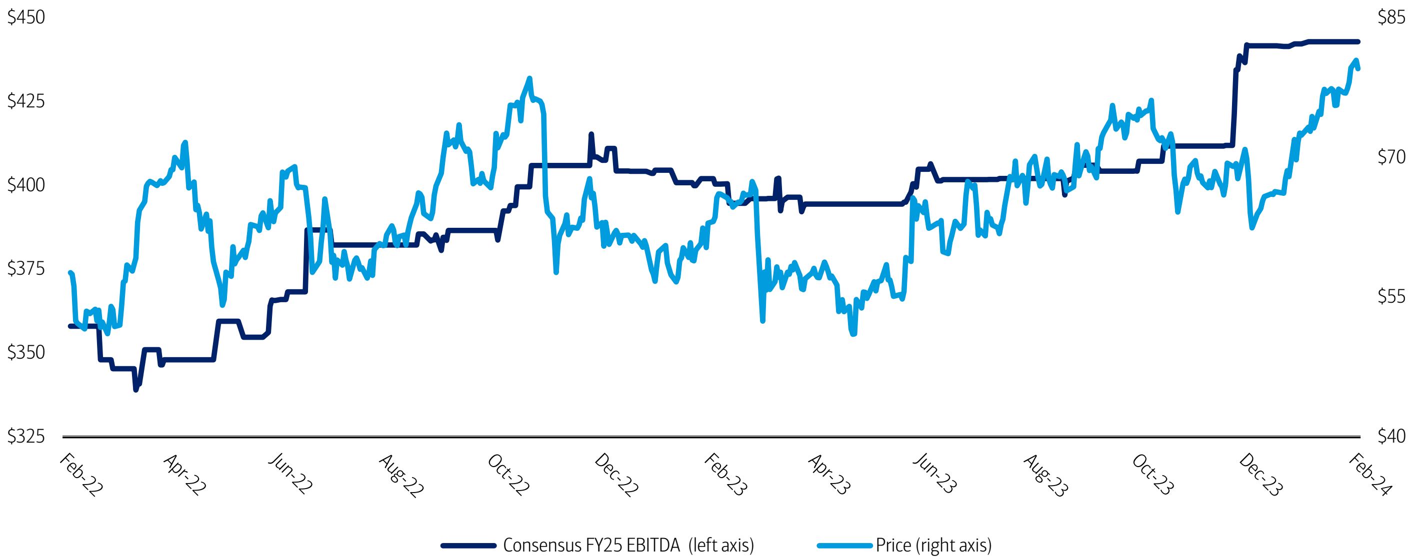
HealthEquity could also decide to accelerate share repurchases. For every $100MM of share repurchases at $80, HQY could increase EPS by ~1.5%. $750MM-$1Bn of share repurchases would increase EPS by 10-13%, all else equal. The pros of share repurchases is higher earnings. The cons of share repurchases is it does not reaccelerate revenue growth.

Earnings revisions moving in HQY's favor; should continue

In August 2022, we wrote a note comparing HQY to ADP/PAYX (link to the note here). In the note, we highlighted HealthEquity's significant share price underperformance relative to these peers and noted HQY's lack of positive earnings revisions was likely a key contributor to its underperformance from 2020-2022. Fast forward to today, HQY shares have outperformed and earnings revisions have been significant. Looking forward, we anticipate HQY will have more positive earnings revisions over the course of FY25. Furthermore, HealthEquity's disclosure at a competitor conference in January gives us greater confidence its custodial yield can increase through at least FY27, which creates a longer tail for upside earnings revisions (link to our initial takeaway and model update notes).

Exhibit 3: HQY Historical Consensus FY25 EBITDA estimates (in $MM)

HQY's consensus estimates have steadily increased since 2022 and so has the share price



Source: BofA Global Research, Bloomberg

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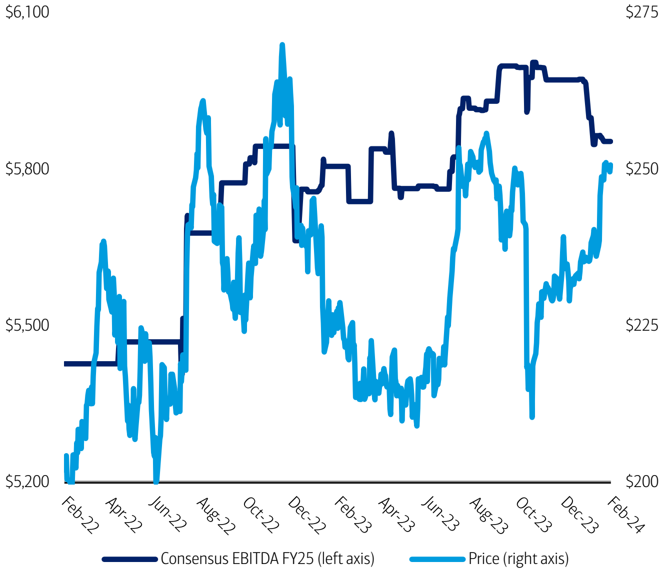
Exhibit 4: ADP Historical Consensus FY25 EBITDA estimates (in $MM)
EBITDA revisions have been modest over the past year



Source: BofA Global Research, Bloomberg

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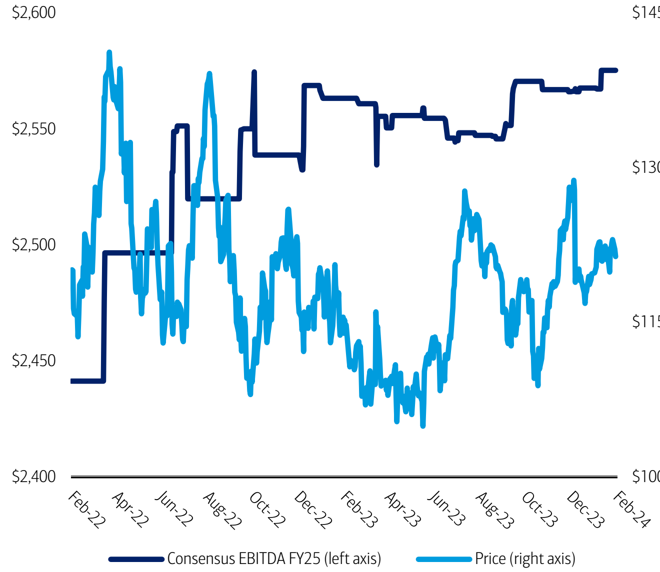
Exhibit 5: PAYX Historical Consensus FY25 EBITDA estimates (in $MM)
EBITDA revisions have been modest over the past year



Source: BofA Global Research, Bloomberg

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PO Change

Ahead of next week's event we revise our price objective to $93 (from $85) due to peer multiple expansion. We now use c.18x our CY24E EBITDA estimate (was 17x previously). This represents a 1-2 turn premium to peers, which we believe is justified by HQY's depressed EBITDA base, faster top-line growth, and rates optionality.

Price objective basis & risk

HealthEquity Inc (HQY)

Our $93 price objective is based on c.18x our CY24E EBITDA estimate. This represents a 1-2 turn premium to peers. We believe HQY should trade at a premium to peers given HQY's depressed EBITDA base, faster top-line growth, and rates optionality.

Downside risks to our PO are any long-term changes in demand for Commuter benefits from a broader shift in preference to work from home could permanently impair that part of the business. Additional downside risks to our PO are inability to drive expected revenue/operational synergies from recent M&A, and slower-than-expected growth from the HSA market and changes in interest rates. Less significant risks are new entrants to the market gaining share and fewer opportunities to acquire peer portfolios from companies exiting the HSA market.

Analyst Certification

I, Allen Lutz, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Healthcare Technology & Distribution Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Accolade	ACCD	ACCD US	Allen Lutz, CFA
	American Well Corp	AMWL	AMWL US	Allen Lutz, CFA
	Cencora Inc	COR	COR US	Allen Lutz, CFA
	CVS Health	CVS	CVS US	Allen Lutz, CFA
	Definitive Healthcare Corp	DH	DH US	Allen Lutz, CFA
	dentalcorp	YDNTL	DNTL CN	Allen Lutz, CFA
	Envista	NVST	NVST US	Allen Lutz, CFA
	HealthEquity Inc	HQY	HQY US	Allen Lutz, CFA
	Hims & Hers	HIMS	HIMS US	Allen Lutz, CFA
	McKesson	MCK	MCK US	Allen Lutz, CFA
	Omnicell Inc.	OMCL	OMCL US	Allen Lutz, CFA
	Patterson Companies	PDCO	PDCO US	Allen Lutz, CFA
	Progyny	PGNY	PGNY US	Allen Lutz, CFA
	R1 RCM	RCM	RCM US	Allen Lutz, CFA
NEUTRAL				
	Cardinal Health	CAH	CAH US	Allen Lutz, CFA
	Dentsply Sirona, Inc.	XRAY	XRAY US	Allen Lutz, CFA
	Doximity Inc	DOCS	DOCS US	Allen Lutz, CFA
	Teladoc Health	TDOC	TDOC US	Allen Lutz, CFA
UNDERPERFORM				
	GoodRx	GDRX	GDRX US	Allen Lutz, CFA
	Henry Schein	HSIC	HSIC US	Allen Lutz, CFA
	Owens & Minor	OMI	OMI US	Allen Lutz, CFA
	Premier, Inc.	PINC	PINC US	Allen Lutz, CFA
	Walgreens Boots Alliance	WBA	WBA US	Allen Lutz, CFA

*iQ*method[SM] Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5 Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A

Quality of Earnings	Numerator	Denominator
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt – Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense

Valuation Toolkit	Numerator	Denominator
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap = Current Share Price × Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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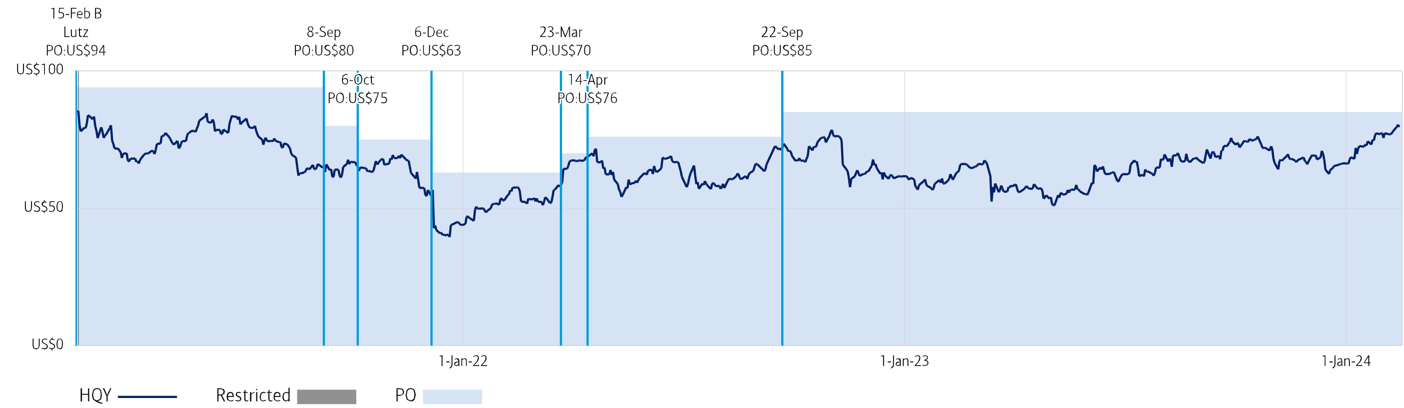
Disclosures

Important Disclosures

HealthEquity (HQY) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Health Care Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	234	60.94%	Buy	115	49.15%
Hold	80	20.83%	Hold	36	45.00%
Sell	70	18.23%	Sell	29	41.43%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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