ASX Announcement : 20 February 2015

CEO on H1 Results

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing®, Sam discusses:

- Continuing growth in US revenue, earnings
- Transaction based revenue ramping up
- Moving toward cash accretion in shorter term

Record of interview:

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Pro Medicus Limited (ASX: PME) today reported net profit after tax of $1.61 million for the first half ended 31 December 2014, up from $0.20 million for the previous corresponding period. The result for the six months was ahead of your $1.51 million NPAT for the full 2014 year, even though first half revenue of $8.59 million was significantly less than FY2014's revenue of $14.27 million. What were the key reasons for the increase in profitability and is it indicative of expected future earnings?

CEO Sam Hupert
One of the main two factors contributing to the improved profitability was that we're beginning to see revenue growth and margin expansion in the US as we gain traction and scale in that market. We're also seeing improvement in our Australian business so the two together have resulted in a strong operational result. A third factor was forex. We've had a negative impact from forex in the last couple of years, but with the increased strength of the US dollar in the first half, we've started to see that reverse.

We're confident the margin expansion will continue as our installed base of operational, or transaction-based, contracts grows. We obviously can't predict forex movements, but given our growing level of US revenue, a stronger US dollar is positive for us.

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Your North American business reported EBIT of $0.49 million, compared with a loss of $0.44 million in the previous corresponding period. Revenue was $3.69 million, up from $1.63 million. Nevertheless, revenue was flat compared with the second half of FY2014, and EBIT was 43 percent lower than the second half. How do you reconcile this with your current focus on North America as the growth driver of the company?

CEO Sam Hupert
The two halves are not directly comparable. In the second half of 2014, we had significant revenue from our contract with the VISN23 regional healthcare network run by the US Department of Veterans Affairs. That was a "capital" sale, where the client pays up-front for the product license. In contrast, in the first half of 2015, the majority of our revenue from the US was from operational contracts where customers "pay per view". Pleasingly, the growth in operational revenue was strong enough to more than offset the absence of a contribution from a "capital" sale.

Going forward, we expect we'll have varying contributions from capital and operational sales. While the majority of our recent sales have been operational, it really depends on the client and so is very hard to predict. VISN23 is a government organisation, which tend to favour payment under a capital model. Others prefer a transaction-based operational model. Either model is good for us.

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Can you comment on the contributions to the North American result of the major contracts that you have won in the region in recent periods? How do the actual transaction volumes of your operational contracts compare with the guaranteed minimums set out in the contracts?

CEO Sam Hupert
The second half of 2014 marked the phase-in period for some of our recent major contracts, particularly our biggest contract, which we've previously flagged would take 12 to 14 months to fully implement. Once we've completely implemented our technology the minimum volume commitments come into play so we'll have a growing baseline of transactions from these contracts, some of which will be approaching this point in the second half of FY2015 and the beginning of FY2016.

The contract wins we've announced over the past three months, namely Wellspan and Zwanger-Pesiri, will start phasing-in in the second half of FY2015 so we anticipate these will be fully implemented late in the first half of 2016.

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What is your progress on implementing your biggest contract – the $20 million contract you won last year with a major US health network? How has the contract impacted your ability to secure and service new contract opportunities?

CEO Sam Hupert
As I mentioned, the implementation was scheduled to take 12 to 14 months, and the project is proceeding to the expected time line. We'll start to see the full impact of the minimum transaction volumes in the second half of this financial year.

There is no doubt there has been a step change in the market's perception of our product suite as a result of this contract. The group is one of the biggest in the US healthcare market and our experience in implementing our technology across such a huge network is an advantage in winning new contracts.

In terms of servicing this and other contracts, our growing revenue in the US allows us to continue building up our US team which is a key focus for us. We're actively expanding the team so we can sustain our growth.

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Your recently announced contract with Zwanger-Pesiri Radiology, an out-patient imaging centre group based in Long Island, New York, is a five-year, $5 million operational contract. The group will use Visage 7 enterprise viewer as the core component of a "deconstructed" picture archiving and communication system (PACS). What is the potential for Visage 7 in the US imaging centre market? To what extent has the deconstructed PACS model been adopted in the segment?

CEO Sam Hupert
We think the product is ideally suited to the imaging centre market. The scalability, speed and accessibility of our technology are just as crucial in this market as in the larger enterprise market. Also, pricing pressure is more intense in this segment than in the hospital segment, so the efficiencies Visage provides make it a very compelling solution, particularly for the bigger imaging centre groups

The US imaging centre market is starting to consolidate, and we believe this will be a driver of demand for our product. We think the deconstructed PACS model – comprising "best of breed" components – is just as relevant in the imaging centre space as the larger enterprise space.

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Can you provide an update on your current sales pipeline in the US?

CEO Sam Hupert
Winning a number of high profile contracts has certainly helped us in terms of new opportunities, and our pipeline continues to show healthy growth. We're actively pursuing a number of opportunities but lead times can vary depending on the institution – some of the contracts we've won have been negotiated in a matter of months, others have taken significantly longer.

We believe there is a lot of pent-up demand in the US radiology market for a technology "refresh", and we have a compelling proposition. The big contracts we've won have demonstrated to the market that the deconstructed model is being embraced by some of the healthcare technology leaders. We think the model will continue to gain traction.

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The Australian business booked EBIT of $1.32 million, up from $0.26 million in the previous corresponding period. Revenue was $3.34 million, up 16 percent. EBIT was well ahead of the recent second half's $0.92 million, even though revenue was just 2 percent up from the second half. To what extent did the Australian result reflect royalty income from North America, and to what extent actual product sales to local clients in Australia?

CEO Sam Hupert
The Australian result reflected a mix of both royalty income from our US sales and local sales. Our Australian business is improving, with our new generation radiology information system (RIS), Visage RIS, gaining traction and continuing sales of the full Visage package (Visage PACS and Visage RIS). We're seeing sales of the RIS to new clients as well as "refresh" sales to existing clients as part of a software update.

A number of our sales of the Visage PACS-RIS package have been to new radiology practices. Some of these clients prefer the capital model but more and more are opting for operational.

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The European business booked EBIT of $0.75 million for the first half, up from $0.30 million. Revenue was $1.56 million, up 10 percent. Both EBIT and revenue were also ahead of the recent second half. What were the key contributors to the growth in European revenue and earnings and is the growth sustainable?

CEO Sam Hupert
In Europe we saw some improvement in our OEM business. These sales tend to be a bit lumpy. We also had some sales of Visage 7, mainly under the capital model. We'd expect our European results to broadly continue their current trend. While the US is the current focus of our growth strategy, we intend to relook at possible opportunities in Europe in the next 12 to 18 months.

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Net cash flow from operations was $2.24 million in the first half, down from $2.72 million in the previous corresponding period. This partly reflected slower growth in receipts from customers (at 12 percent), compared with a 24 percent increase in working capital to $2.66 million. Given growth in revenue of 45 percent, to what extent does the slower growth in receipts reflect relatively longer payment terms under your new operational contracts in the US? What is the outlook for operating cash flow as the large transaction-based contracts ramp up?

CEO Sam Hupert
Our first half cash flow reflected temporary timing issues. We bill our operational clients at the end of the quarter, and the cash receipt of those funds falls into a later period. Given many of our operational contracts are new and in the process of ramping up, the impact on cash flow was amplified in the first half. We expect the effect to level out as we go forward and build up a stable base of quarterly transaction revenue flows.

This will result in more solid and predictable cash flows over the longer term.

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First half capitalised development costs totalled $2.64 million, up slightly from $2.59 million. How is your product development spending changing with growing use of your products in North America? How are you seeking to ensure the Visage product suite maintains its competitive edge?

CEO Sam Hupert
As we've flagged to the market, we expect R&D costs to remain largely around current levels. It's very important to us that we retain our product edge and ensure that Visage, including the new RIS, remains ahead of competing products. For the present, we're comfortable our current spend will allow us to do that.

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As at 31 December 2014, Pro Medicus had cash in hand of $14.65 million, down from $15.26 million six months earlier, reflecting negative free cash flow, including the payment of $1.00 million in dividends. Given cash in hand remains equivalent to nearly one year's revenue (based on FY2014), are you still considering potential acquisitions? What are your acquisition criteria?

CEO Sam Hupert
We've always kept a healthy cash buffer. We believe it's in the interest of the company and our shareholders to have funds available for three purposes: reinvestment in the business in the form of R&D and increasing our presence in the US; making returns to shareholders; and retaining funds for acquisitions that might arise.

Having successfully integrated Visage, our last transaction, we're certainly in a position where we might consider a transaction should the opportunity come up. Any opportunity would have to bring a product set that was complementary to our existing products and be at a price point that makes economic sense.

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Pro Medicus has declared an unfranked interim dividend of 1.0 cent per share. In light of the investment required to continue growing the business, is the dividend sustainable at this level if free cash flow remains negative?

CEO Sam Hupert
It's up to our board to reassess our dividend payment at the end of every six-month period.

The current second half should be cash flow positive and we're confident we'll be able to cover the dividend out of free cash flow in the future. As we move back into cash accretion mode, we'll continue to ensure that part of that cash goes to our shareholders. As I said earlier, our policy is to also ensure that an appropriate share of our cash goes back into the business, with some retained for potential acquisitions.

Certainly having a greater proportion of revenue coming from the transaction model gives us much better ability to predict future revenue and cash flow for the purpose of capital management.

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Thank you Sam.

For more information about Pro Medicus, visit www.promedicus.com or call Sam Hupert on (+61 3) 9429 8800.

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