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CEO on Mercy Contract

Open Briefing interview with CEO Sam Hupert

Pro Medicus Limited
450 Swan Street
Richmond VIC 3121

In this Open Briefing®, Sam discusses:

- New A$21 million contract with Mercy Health System in the US
- Implications for revenue
- US pipeline and opportunities

Record of interview:

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Pro Medicus Limited (ASX: PME) today announced a seven-year, A$21 million contract with Mercy Health System, the seventh largest Catholic healthcare system in the US. The contract is under a pay-per-transaction model and you've indicated that full implementation of your technology will take 12 to 16 months, beginning in the first quarter of FY2017. When will revenue begin to flow from the contract, and when do you expect the contract to make a full revenue contribution?

CEO Sam Hupert
Revenue should begin to trickle in from the end of FY2016, as we commence project planning, and build throughout FY2017 as we roll out the system. But the first year will be a phase-in period simply because of Mercy's size and geographic spread. We'd expect to reach full volume, and therefore full revenue contribution, early in the first half of FY2018. Given this is one of our biggest contracts to date, it will be a significant addition to our growing base of recurring revenues from existing contracts.

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What are the expected costs involved in implementing the Mercy contract and will implementation require a further increase in your US resources?

CEO Sam Hupert
We've already worn the bulk of the costs, for example legal costs, which we alluded to in our half-year results, as well as all the costs associated with the pre-sales activity. These have been expensed over what has turned out to be a relatively long contract negotiation period, which to some degree was expected given this deal involved two contracts, the second one being a master purchasing agreement. So, we don't foresee any significant further costs given we get paid for providing the professional services relating to implementation, and like all our other sales, this is a software only model and does not involve any capex on our side.

Also, as we've indicated previously, we've been actively adding to our US team over the past 18 months, and in January we hired a highly experienced industry professional in anticipation of winning this contract and hopefully others in the future, so we think we're well covered from a resource point of view.

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The contract, which will see Pro Medicus' Visage 7 technology used for primary diagnosis and distribution of medical images across Mercy's 46 acute care and specialty hospitals, was signed under a master agreement with ROi, a health care purchasing organisation of which

Mercy is a major shareholder. This is your first deal via such a purchasing organisation; how do its terms, and particularly pricing, differ from your existing direct contracts with US healthcare organisations?

CEO Sam Hupert
The deal with ROi is not a reseller agreement. We deal directly with the customer so the pricing framework is commensurate with other deals we've done with groups of similar size, the key differences being that the terms and pricing we've negotiated with ROi extend to all its members. Importantly the agreement allows ROi members to pool their transaction volumes so, if as a group they reach agreed volume milestones, they all benefit from per-transaction price discounts.

For us, the agreement not only gives us access to other ROi members, it fast tracks the contracting process for those members who elect to go with us. This is very significant for us given that contracting can take anywhere between 6 to 18 months and can be a costly and time-consuming process.

The other benefit of the ROi agreement is that it gives us a template for dealing with other group purchasing organisations in the future.

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To what extent is the agreed A$21 million a minimum amount under the contract with Mercy? What is the potential revenue upside?

CEO Sam Hupert
All our transaction-based contracts are based on an agreed minimum volume which is never 100 percent of the client's current volume. Upside comes from the client exceeding the agreed minimums which would happen if Mercy just maintains its current exam volume, and would be further enhanced if the client grows organically or by acquisition. Also, as is the case with our other large enterprise clients, there is always the possibility of extending our relationship to other products we bring to market at a future date.

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You've indicated that other members of ROi will be able to benefit from this group-wide master purchasing agreement. What are the potential revenues Pro Medicus may be able to access under the agreement?

CEO Sam Hupert
It's hard to predict and clearly will depend on the uptake by other ROI members. Mercy is the largest member of the group, but there are other ROi members whose deals would be material in their own right. And, as I mentioned, there is an incentive for them to purchase Visage through this agreement so we're hopeful that others will follow Mercy's lead.

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Can you provide an update on Pro Medicus's current pipeline in the North American market? What impact do you think the Mercy deal may have on the pipeline?

CEO Sam Hupert
We continue to have a strong and growing pipeline in North America even taking into account that Mercy, which previously was a large pipeline opportunity for us, has now become a client. Our prospects range from entities we've only just begun to engage with, to ones where negotiations are nearing the final stages, and are spread across the many different segments of the market. Importantly, we haven't lost any opportunities since we last updated the market following our half-year results.

Clearly, winning another big organisation gives us even more credibility in the market – particularly an organisation as large and high profile as Mercy. We would expect the win to help with existing prospects in the pipeline, helping to sway the decision making our way.

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In the recent first half, Pro Medicus grew revenue by 66 percent to A$14.28 million. Can you comment on the pace of revenue growth in the current second half?

CEO Sam Hupert
We still expect good revenue growth period on period but as we explained when we announced our first half results, revenue for that six months partly reflected contributions from two large capital sales – one to the University of Florida, which was a hybrid capital/transaction agreement, and one to a government hospital in Germany. Capital sales are hard to predict, given that they depend on client preference, but at this stage we don't anticipate any material capital sales in the second half. We do however know that our transaction based revenue is continuing to grow compared with the first half which will go some way to offset the reduction of capital sales in the second half.

I'd also note that in our budgeting for the year, we expected the Mercy deal to be closed earlier than it was and that it would make a contribution to the current second half. As I said earlier, that revenue will now be pushed back to FY2017. Even so, we expect full year sales growth to be robust.

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The first half also saw a turnaround to positive free cash flow. Do you remain on track to generate positive cash flow for the full year?

CEO Sam Hupert
Yes. While first half cash flow benefitted from the capital sales I just mentioned, cash flow continues to be strong and we're still confident we'll generate positive free cash flow for the full year.

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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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