CEO on FY2016 Results

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing®, Sam discusses:

- Drivers of FY2016 revenue and profit growth
- North American sales pipeline
- Prospects for future growth

Record of interview:

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Pro Medicus Limited (ASX: PME) today reported net profit after tax of $6.37 million for the year ended 30 June 2016, up 98 percent from the previous year's NPAT of $3.22 million. Profit growth was well ahead of revenue growth of 57 percent. What were the key drivers of the relative growth in profitability and can earnings continue to outpace revenue in the longer term?

CEO Sam Hupert
There were a few drivers of the growth in earnings, but the two biggest were the increase in the North American contracts we've brought on line over the last 12 months particularly transaction-based contracts and the higher margins we derive from this additional revenue. As we've said previously, our biggest cost is R&D and this is relatively fixed and largely covered by recurring revenue from our Australian business. So the more revenue we get from the US as a proportion of our total revenue, the higher our overall margins. This was reflected in this year's results and we expect this trend to continue.

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The net profit result included a small currency loss of $0.09 million, compared with a net currency gain of $1.65 million in the previous year, suggesting that underlying earnings increased by 212 percent. Is this maintainable and how will you seek to deal with currency volatility in the year ahead?

CEO Sam Hupert
We were exceptionally pleased that our underlying profit over doubled throughout the year. And whilst currency had virtually no impact on our reported earnings this year that may not always be the case in the future. To a certain extent we have a "natural" hedge in that we have US dollar costs against our US dollar revenues but clearly we are continuing to accumulate US dollars as a result of the increase in transaction volumes we are doing so, as we do now, we will need to closely monitor the currency and adjust our mitigation strategies where appropriate.

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Top line growth continued to be driven by the North American business, which reported revenue of $16.87 million, up 90 percent from the previous year. North American revenue growth remained strong in the second half, at 65 percent year on year, albeit down from the first half's revenue growth of 125 percent year on year. With much of the growth reflecting contributions from the large operational contracts you have won in recent periods, can these contracts continue to generate growth in the current FY2017?

CEO Sam Hupert
As we've noted in the past, there is significant upside from our existing transaction-based contracts as minimum transaction numbers are met and in a number of cases exceeded not to mention that we are still implementing some of these projects so there is still further upside from them in terms of transaction revenue. Also, when we announced the Mercy Health, Mayo Clinic and Franciscan Missionaries of our Lady Health System contracts we flagged that they would only begin to contribute to revenue in the latter part of FY2017 so these are all to come. As a result, we expect revenue and earnings in the second half of FY2017 to materially outweigh those of the first half.

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How are the implementations of your recent contract wins progressing and what is the progress of those implementations that had previously been held up by third-party delays?

CEO Sam Hupert
Previously we have told the market that one of our big contracts had been held up by third party delays, but the good news is that it is now very much back on track with implementation expected to continue in the current half. A second smaller contract that was also held up by a third party is in the process of finalising dates. As for our other installations, they are progressing very well and are on, or in some cases slightly ahead of, schedule which is good.

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Can you provide an update on your sales pipeline in the North American market, particularly given your recent win of the prestigious Mayo Clinic contract?

CEO Sam Hupert
Our North American sales pipeline continues to be buoyant as we've been able to continue to replenish it after converting three major opportunities in the recent past. We've had a number of new "requests for proposals" or RFPs come in the door that we've responded to and of course there are the existing opportunities, the ones that were in the pipeline prior to our recent announcements. These continue to progress through the various stages of the cycle and to date we have not lost any of them.

In terms of future opportunities we think that our recent wins have reset us in the market and whilst it is still a bit early to fully gauge the impact of it, we are starting to see what we call the "network effect".

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The European business booked EBIT of $1.74 million for the year, up 41 percent. Revenue was $4.17 million, up from $2.35 million, apparently reflecting a capital sale to a German hospital in the first half. Has this sale changed your European pipeline and outlook? How do you expect European revenue and earnings to trend in the nearer term?

CEO Sam Hupert
While we now have a small "wedge" in the European market, we think it's too early for the outlook to change significantly. We've made a good first step, but Europe is a longer term opportunity for us and will take time to build our presence given it's not one single market.

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The Australian business booked EBIT of $7.28 million, up from $3.72 million in the previous year. Australian revenue was $6.49 million, up 4 percent, implying Australian EBIT growth continues to be driven by royalty income from North America rather than product sales to local clients in Australia. With Australian revenue remaining relatively flat, as you've previously flagged, what is your strategy in this market?

CEO Sam Hupert
The Australian market continues to face pressures from uncertainty regarding Medicare rebates and corporate activity but we're certainly holding our own in this tough environment. We do believe we have the best two products in the market in our new generation RIS and Visage 7 and we have unparalleled experience in the local market so we're well placed to respond to any local opportunities as and when they arise.

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Net cash flow from operations was $11.25 million in FY2016, well up from $4.18 million in the previous year, which included a tax payment of $3.36 million relating to the sale of the Amira business in FY2013. Excluding that payment, operating cash flow was still up strongly for the year, driven by strong growth in receipts from customers. Free cash flow, including R&D and other investment spending of $5.77 million, was positive $5.48 million. Can you sustain positive free cash flow going forward?

CEO Sam Hupert
We believe so, given the long-term, transaction-based contracts we've secured, which will continue to generate higher margins and continue to generate free cash flow. Then there is always the prospect of new contracts that will layer on top of our existing transaction volumes.

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Pro Medicus booked capitalised development costs of $5.61 million in FY2016, up slightly from $5.36 million. What is the outlook for this spending, and can your product suite remain competitive with R&D spending of around this level?

CEO Sam Hupert
Our R&D spend is largely fixed with a large portion of the spend in Europe – so the amount can vary from year to year according to exchange rates as we pay in Euro but report in Australian dollars, but Euro for Euro it is largely the same. Our focus is always to stay well ahead of our competitors so we are continually reviewing this. From what we can tell, we are at least 12 months ahead of our competitors and in some instances more so. We believe the amount we're spending is more than adequate to maintain our product lead for the product sets we currently have.

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As at 30 June 2016, Pro Medicus had cash in hand of $17.11 million, up from $12.94 million a year earlier. You've declared an unfranked final dividend of 1.5 cents per share, up from 1 cent in the previous year, bringing the total dividend for the year to 3 cents, unfranked, up from 2 cents for FY2015. Given that dividends remain unfranked, what are your nearer term capital management priorities?

CEO Sam Hupert
Our priority is to maintain enough cash to continue to build the resources we need to grow our business particularly in the North American market, and potentially invest in the development of complementary products that respond to an unfilled market need. We are also very conscious that we need to continue rewarding our shareholders and we fully intend to do so.

As our Chairman stated at our AGM last year, our franking credits are expected to begin rebuilding in the not too distant future, which should allow us to frank our dividend in the short to medium term.

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Given the increasing scale of your North American business, what are your longer term strategic priorities for the broader group?

CEO Sam Hupert
North America remains a strategic priority and we are looking to build on the recent successes we have had there. As we've said previously, we're at the beginning of our journey in this market so there are still plenty of opportunities ahead of us. We also see opportunities for new, complementary products such as Enterprise imaging which we plan to offer, as an add-on to our current product suite, to our growing number of large hospital clients. On top of this there is always the prospect of geographic expansion, particularly in Europe with the possibility of expanding into other geographies, at a later date. Therefore we believe there is still plenty of runway ahead of us.

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Thank you Sam.