CEO on Update

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing®, Sam discusses:

- Continuing growth in North American business, major contracts to contribute in FY2017
- Sustainable growth in free cash flow generation
- Return to franked dividends as Australian earnings increase

Record of interview:

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Pro Medicus Limited (ASX: PME) today reported net profit after tax of $4.80 million for the half year ended 31 December 2016, up 63.1% year on year. Profit again grew faster than revenue, which was up 6.4% to $15.20 million, highlighting increased margins. What were the key drivers of the increase in profit and margins and is there potential for further margin growth?

CEO Sam Hupert

There were a few factors. Firstly, our revenue increased even after factoring in a large capital sale in the previous corresponding period which was not repeated in this half. The key driver of this was our transaction revenue which continues to grow strongly. Another factor was our cost base that decreased as a percentage of revenue. Finally, there were currency gains although some of these have been reversed with the recent strengthening of the Australian dollar. However, even after stripping out the effect of currency our profit was much stronger than the previous half.

As for margins, we believe these will continue to grow. The way we look at it is that revenue from our Australian operations covers our global R&D spend, which is our biggest cost. Revenue coming from the US is higher margin revenue (partly due to relatively fixed costs), and as North America continues to grow as a percentage of our total revenue, it will increase overall group margins.

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North America was the largest contributor to revenue at $9.59 million, up 18.7% year on year. Although this growth was slower than prior years it still helped the North American business deliver a 43.9% increase in earnings and you have previously said growth will be skewed to the second half of FY17. Should we still expect a stronger second half and what were the key drivers of this half's result?

CEO Sam Hupert
Yes, we still anticipate that our second half will be stronger than the first. As mentioned above a key driver of our result this half was our growing base of transaction revenue in the US which was as a result of sites that we implemented in the previous half as well as those implemented early enough in the half to make a material impact. This builds the base going forward.

The latter part of the first half and the early part of this second half have most probably been the busiest periods in terms of implementations in our company's history and it doesn't look like letting up anytime soon so this base will continue to build.

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You announced the $18.0 million Mayo Clinic contract win during the period. When should we expect to see the initial revenue and margin impact from this and when will be the first full six months of revenue and earnings? What is the status of the other contracts you implemented over the last 18 months including those were previously on hold due to a third party?

CEO Sam Hupert
The Mayo contract was always scheduled to start in the June/July timeframe, so the first material revenue will be towards the end of 2H FY17/beginning of the first half of 2018. The project is an 18-month project with revenue flowing largely in line with when their facilities go live. So realistically it will be 18 months from this July when we will see full revenue from Mayo, in line with what we said when we announced the contract.

In terms of the other implementations, they are progressing really well. All of them are on track and in some cases, like the Mercy, are ahead of schedule which I think underpins our reputation of being able to successfully implement these very large scale projects in a timely manner.

Those implementations that were previously on hold due to third party delays are now also in full flight and will be largely behind us by the time we start with Franciscan Missionaries and Mayo. So we think we're well positioned to cater for these implementations and clearly anything else that we can land in terms of contracts going forward.

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Looking at other major contract wins over the last several years, what is the mix in terms of those that are paying minimum contracted volumes versus those that are now paying for additional usage? How will further growth in volumes above contract minimums impact margins and cash flow?

CEO Sam Hupert
Those clients that are fully implemented are not only all above their minimums, they are above the 100% volume they told us they did when we contracted with them, which is great. Their businesses are growing using our technology and our revenues are growing as a result. Clearly, the sooner we implement the systems the sooner this occurs, which is why it is pleasing that we have been able to maintain our aggressive implementation schedule.

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Australia posted its best growth for some time with total revenue growth of 22.1% to $10.45 million and external sales growth of software of 26.2% to $4.37 million. This helped lift segment earnings to $6.04 million, up 85.4% year on year. Is the slowdown in customer decisions that were driven by M&A and uncertainty in things such as Medicare rebates largely over?

CEO Sam Hupert
Firstly, when you look at the Australian figures you need to factor in that they include royalties so you need to look through that to understand how the Australian market is working for us. Having said that, the Australian business did perform well and we were pleased with it.

There definitely has been indecision because of increased M&A activity and the uncertainty surrounding the government's Medicare policies. We are starting to see movement in the market again though. We do think Australia will remain a good market for us. There are opportunities there for us going forward, some smaller opportunities but also some larger ones that may come about. In terms of growth drivers of the overall business though we continue to see the USA as key simply because of its size.

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Europe, as you've noted, did not see the repeat of a capital sale that occurred in 1H FY16 and revenue of software of $0.82 million was down 62.1% year on year with segment earnings of $0.61 million down 40.8%. What's the growth outlook for the European business and will sales mix continue to include significant capital sales?

CEO Sam Hupert
Europe as a market, will take longer to develop for a number of reasons. Firstly, it is not one market, it is multiple discrete markets. Secondly, the mind-set in health IT expenditure in Europe is not as advanced as it is in the US where the government has mandated the use of electronic medical records. Having said that we are starting to see the early signs of change in the mind-set in Europe away from the "monolithic" PACS vendor's of the past which we think will benefit us long term.

In terms of financing preferences, the market in Europe is largely government hospital based and governments typically opt or insist on capital sales simply because of their budgeting mechanisms. So, I think we see Europe as a growing market for us, it will just take longer, and the mix of capital sales will most likely be higher in that market simply due to the profile of the potential clients.

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What is the status of the sales pipeline in terms of both quality and quantity? Has M&A activity in the USA and the presidential election caused any slowdown in client's decision making? If so, are we now through that period?

CEO Sam Hupert
Our pipeline continues to grow in both quantity and quality. We had our most successful RSNA to date in November/December last year. As expected, a number of the larger institutions are now looking to come to market to replace their old, legacy systems, which clearly is positive for us, however these large opportunities can often take 18 months or more to finalise. There is also a good mix between large hospital/enterprise scale opportunities as well as those in the private imaging and tele-radiology space. So there is a healthy spread both in terms of timing of opportunities as well as the size and segment of the radiology market they work in.

As for the presidential election, it's hard to tell for certain what impact it has had. We think that it may have delayed some people's decision making process but now the election is over, people are getting on with it. In terms of M&A, the US market is going through a period of consolidation so there is currently a lot of M&A activity. Certainly, if a practice is in the process of being acquired, then they will usually defer any major IT decision but on the flipside the bigger a group gets the more important its IT platform becomes, so M&A activity is usually positive for us, particularly if the acquiring group already uses our technology.

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Capitalised development costs for the six months to December 2016 were $2.75 million, marginally up from $2.67m for the six months to December 2015. As the business continues to grow is this level of R&D enough to sustain your business and your technology lead? How far ahead of the competition do you think Visage RIS and PACS are?

CEO Sam Hupert
The development spend was pretty much as we've heralded before and very much in line with our budgets. Importantly, we do think that amount is enough to keep our current product set ahead of the market. As we continue to grow, we do expect some incremental increase in this spend but as a percentage of revenue our core R&D spend will continue to drop as our revenue goes up.

We believe our technology is still 18 months ahead of the market and in some areas, possibly more. We are seeing some of the opposition claiming they are coming out with new technology or in some cases trying to repackage their existing offerings which is pretty much what we have

expected. But we don't know of anyone yet that can provide a system with our speed, functionality, and scale and prove that in the market.

In terms of the RIS our new technology stack has proven that it is very scalable, particularly for large enterprises here in Australia and we don't believe that any of our competitors have the same modern technology base to allow them to continue to scale like we do. Whilst it has taken us a while to get to this point we believe this product is also well ahead of the curve, particularly in terms of the competition.

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Cash from operations before tax for the period was $8.34 million, up 52.2% on the $5.48 million from prior corresponding period. This growth is faster than the 44.7% increase in the result from underlying operations (pre-currency movements) which grew to $4.08m. Should we expect to see cash generation continue to outpace underlying earnings?

CEO Sam Hupert
We were very happy with the cash flow. We did have some largish collections come in towards the end of the half which helped so, whilst we may not accrue cash at this rate in the second half, we will continue to be cash flow positive going forward even after paying out dividends and paying tax.

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Pro Medicus carries no debt and had cash reserves of $20.28 million at 31 December, up $3.17 million for the 6 month period. With the company generating strong cash flows and this level of cash holdings is there room to increase the dividend, which was maintained at 1.5 cents unfranked for the period, and/or consider other capital management options?

CEO Sam Hupert

We view cash and how we use that cash in three areas: Firstly, and most importantly, investment in the business. This could range from incremental investments in additional staff through to new areas of product development. Secondly, return to shareholders which we are very cognizant of. The question of dividends is something we, as a board, review on a constant basis. As our chairman said at our last AGM our preference is to build up our franking credits in order to pay fully franked dividends which we anticipate will occur in FY 2018. Third, is keeping some cash for M&A or other investment opportunities.

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You have previously mentioned M&A as one of the possible growth options for the company. Can you tell us what you would look for in an M&A opportunity and also tell us what the other key growth options are for the company?

CEO Sam Hupert

In terms of M&A we feel that opportunities would most likely come out of the US but there is also a lot of innovation coming out of parts of Europe and countries like Israel so we are keeping an open mind and assessing opportunities as, and when, they arise. The main area we would look at for M&A would be for add-on products that we think we could enhance because of our technology and user base.

Importantly, we also have a number of organic growth options available to us. Expanding our footprint in North America via our pipeline of opportunities is the obvious one. But there are also add-on technologies that we are looking at which we believe would be of value to existing clients. Given the size and quality of the client base we've built over the last 3 years these could become significant growth opportunities. An example of this is Enterprise Imaging where we are able to display all the images throughout the enterprise including the photos and videos within the one, Visage viewer. As we've indicated previously, we're expecting this to be commercially available in the first half of FY 2018. There are others in the pipeline.

We’re also looking at longer term investments in the technology and in particular what are some of the emerging trends in radiology and how would they fit into our technology stack. This is more like a 2 to 3 year development horizon but we see this as an important investment in our future.

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Thank you Sam.

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