CEO on Update

Open Briefing interview with CEO Sam Hupert

Pro Medicus Limited
450 Swan Street
Richmond VIC 3121

In this Open Briefing®, Sam discusses:

- Financial results for the six months ended 31 December 2018
- Partners Health, initial roll out, contract minimums and significant scope for expansion
- Enhanced market position in USA, with 2 of the top 4 US hospitals now customers
- Strong pipeline, with continued growth from level reported in August 2018
- Implementations all running on or ahead of schedule

Record of interview:

openbriefing.com

Pro Medicus announced an after-tax profit of $9.1m, up 184.3% year on year, for the first half of FY19 and this was off revenues which were up 59.4%. What drove the ongoing margin and revenue growth? Also how did FX movements and a capital sale in impact the result?

CEO Sam Hupert

It was very pleasing that all of our divisions, Australia, Europe and the US, delivered increased operating results and as a result pre-tax profit of $13.2m was up significantly from $5.6m last year.

Currency, although we have an active hedging policy, contributed a small gain of $0.4m versus a loss of $0.5m last year. So, excluding currency, the pre-tax profit was $12.8m for the six months ended 31 December 2018, up from $6.1m in the prior year.

As we announced towards the end of the half, we had a substantial capital sale, from an extension of a contract with the German government. The margin from this, which is the revenue minus the cost of the hardware we supplied, which is included in our pre-tax profit was A$3.0m.

Even if you exclude the capital sale and currency, we had a very strong performance driven by increased transaction volumes in the US which is what we forecast at the announcement of the full year result back in August 2018.

Operationally what drove this was a full six months from Mayo Rochester which we implemented in May, five months of Yale which we implemented in July and

our other clients that kept building their transaction volumes all of which underpinned our performance in the US.

In Australia our major rollouts for Primary and I-Med are continuing apace which is good, and as we said the capital sale in Europe was clearly significant.

openbriefing.com
The underlying result, excluding currency, shows continued growth in earnings, revenues and margins. Is there still capacity for further margin growth in the business and what is driving this?

CEO Sam Hupert
Our margins in the first half are normally lower because we expense the full cost of the RSNA conference which is by far our biggest advertising spend in the period. This year our RSNA cost were actually higher because we had a bigger booth and more staff, but we also had the German capital sale which more than offset this. Having said that, even if we strip out the German capital sale our underlying EBIT margins still grew half on half despite increased RSNA costs so we were very pleased about that.

Importantly, we see that there is still some capacity for margin growth. Exactly how much is harder to predict but and as we've said our business has high operating leverage. So, as we grow transaction volumes and revenues in the US, and Australia, both of which are high margin business with good leverage, we expect margins to continue to grow incrementally, at least in the foreseeable future.

openbriefing.com
Capital sales are a part of how most European health care systems operate. Can you explain how this differs from the USA, where you have up front implementation revenues and then ongoing transaction related revenues? How does the sale in Germany impact your market position and what sort of ongoing revenues can we expect to follow from this contract?

CEO Sam Hupert
We always plan to have some incremental capital sales in Germany and we do every year, we just don't announce all of them because of the size of the individual deals. This one at A$3.0m is clearly material so we announced it.

The sales model and contract structures are different in Europe, particularly when you're dealing with government, like this contract is. They work with defined budgets and therefore they need to spend that budget within the allocated year, and hence the reason capital sales are preferred. Having said that there will be ongoing revenue from these contracts as they enter into service contracts that sit outside the capital sale we have announced.

So, there are two different models. Overall the sales mix in Europe is more skewed to up front capital sales with smaller ongoing revenues, whereas in the

USA it is more focused on ongoing volume related revenues. We offer the model that best suits the market, and as I said in Europe that seems to be the capital model at this point but this could well change as Europe tends to follow trends from the US particularly in this market.

Europe and Germany in particular are tough markets to crack so in terms of impact, it certainly helps as do our wins in the US like Mayo and Partners.

openbriefing.com
Cash flows from operations grew slightly to $6.4m up from $6.2m, in part reflecting an increase in short term debtors from $5.0m as at 30 June 2018 to $13.6m as at 31 December 2018. What drove this increase and what ongoing level can we expect for the debtor's balance?

CEO Sam Hupert
In terms of the debtor balance there were two things.

Firstly, of the $8.6m increase in debtors, $4.1m relates to a payment we expected before the end of the half which arrived in the first week of January.

Secondly our revenues are increasing, so clearly our short term debtors' balance will increase which is part of a normal billing cycle. The bulk of the debtors are current and a number of those have been paid since the half as you expected under normal trading terms.

So whilst we anticipate a rise in debtors as we increase our revenue we think that as a percentage of revenue they will stay stable or decrease.

openbriefing.com
The company's cash balance was $24.7m as at 31 December 2018, with no debt and you received a further $4.1m after balance date in January. Cash tax paid for the half was $4.1m, up from $2.4m. Do you have any specific plans for this cash and the franking credits generated by the tax paid?

CEO Sam Hupert
We believe that we'll have an increased cash balance, subject to dividend payments, by 30 June 2019. We have more than enough cash for our day to day requirements and have substantial franking credits so we decided to pay a fully franked special dividend as an advance to the final dividend.

Other than that, we plan to use some of the cash to make incremental changes to both staff numbers and R&D spend as we have done over the past few years.

openbriefing.com
The notes to the 31 December 2018 accounts refer to the impact of new accounting rules, namely AASB 15. Can you explain how this impacts revenue recognition for Pro Medicus and what it means in practical terms for both the balance sheet and cash flows?

CEO Sam Hupert

The biggest change for us will be in how we recognise revenue for professional services, particularly from our contracts in the US. With the previous accounting standards, we would recognise professional services revenue based on when the services were performed or on achieving milestones that were detailed in a statement of work or implementation plan. Under the new accounting standards the value of those professional services will be spread across the life of the contract. So, it doesn't impact us in the total dollar value of the contract or the timing of receipt, it's just the timing of how those implementation dollars get brought to revenue. Other areas of our business, in particular the transaction-based part of our business, which is the biggest and fastest growing part, won't be affected by the new accounting standards.

openbriefing.com

You recently announced a $27.0m, 7-year deal which you have signed with Partners HealthCare. Their announcement says that this is an enterprise wide project, suggesting there is significant upside to the contract value you've announced. Aside, from the financial benefits can you tell us how this contract is important to your market position and business outlook in the USA?

CEO Sam Hupert

It's really important to us from a number of perspectives.

Partners Health is one of the largest and most prestigious health systems in North America. It includes Massachusetts General Hospital and Brigham and Women's Hospital, voted number four and number twenty best hospitals in the US respectively. These hospitals are renowned for both their research and academic side being the main teaching hospitals for Harvard Medical School.

So, purely from the perspective of who the client is, the size of the client and the geographic spread on the East Coast, that's clearly of major importance to us.

That fact that it has come on the heels of our success at Mayo has resonated throughout the industry. People are saying "you've got Mayo and now Partners, so there must be something highly differentiated with your offering" which certainly helps consolidate our position as a leader in this market.

This contract is also significant because it is part of much larger initiative by Partners called Partners 2.0, which is a reengineering of the Partners Health system aimed at providing higher levels of care across their enterprise. It is a transaction based deal with minimums and those minimums are calculated based on exam numbers for Brigham and Women's and Mass General however their goal is to roll out the platform to all of Partners not just Brigham and Mass General so there is even more upside in this particular deal for us than is usually the case.

openbriefing.com
The Mayo contract, which you've now fully implemented, and the Partners Healthcare contract show you have strong credentials with the major operators? Looking at the smaller operators are you still winning contracts and market share there too?

CEO Sam Hupert
Yes. We have been very successful in that large hospital/ academic space with the likes of Partners, Yale, Mayo, Mercy, Allegheny, and Sutter Health but that doesn't mean we're not active in other parts of the market. We have recently completed an implementation at Carle Foundation in Illinois, a highly regarded mid-sized hospital system. We've also recently re-signed another 5-year contract with VISN23 a division of the Veterans Affairs that we originally won in 2013. So, whilst each contract is under our million dollars per annum threshold, between the two of them they will provide A$9+million of revenue over the next 7 years.

So yes, we are addressing the medium to smaller end of the market and these are two good examples of how we have been successful there. Clearly, it's not as consolidated and the ability to address it requires some different sales and marketing initiatives, but we've been pleased that we have some penetration and the software works well in that space.

openbriefing.com
Looking at your pipeline, in August when you announced the FY18 financial results you said the contract pipeline was probably the best it has been. Noting that the Partners Health contract will have moved out of the pipeline now it is an actual contract, what does the current pipeline look like in terms of quantity and quality?

CEO Sam Hupert
Partners clearly was a material part of our pipeline and as you mentioned it's now come to contract but a number of new opportunities have come in. When we announced our full year results last year, we said that more RFP's came in during August. That has continued through to the RSNA trade show in November and into December. So, we've had the largest number of new RFP's hit our desk in the most recent half.

There are also a number of opportunities that were more mid-staged that have progressed in the pipeline over the last 6 months. So, whilst Partners was a huge win it's certainly not the only opportunity that was in the pipeline. More have come in plus those that were already there have been progressing. So, we are positive on the pipeline. We think it's healthy with a good range of clients by size, type and quality.

openbriefing.com
In November you attended the RSNA trade show in the USA, which is the major trade show for your industry. What was feedback at the show both in terms of

how Pro Medicus is viewed by clients and competitors and also your view of the strength of the USA healthcare market?

CEO Sam Hupert

We rank this as our biggest and best RSNA. We had a bigger stand that enabled us to cater for more clients and meetings at once. That was a big plus because there were quite a number of times we were booked solid, which was great in terms of people coming to see us, both new opportunities and existing clients.

I think there's no question that the Partners' announcement, which we made just before heading off to America for the RSNA, resonated throughout the industry so that helped at the RSNA.

From everything we've heard and seen at the RSNA we still believe we are 18 to 24 months ahead of the competition. Also bear in mind we haven't stood still since the last RSNA, quite the opposite. If anything, we've increased our R&D efforts. We showed a number of works in progress including our latest release of Visage 7, integration with 3rd party AI, and our own AI platform. These were well received not only by our existing clients but also with prospective clients that came to see us.

We have also gained a growing reputation for the speed at which we can successfully implement our system, even for the biggest clients. This is as important as the technology itself. I think our technology and our reputation for rapid, successful implementation, are the two pillars with which we feel differentiate ourselves in the market and we saw this at the RSNA.

As for the US healthcare market, we see that it is strong and that there are plenty of opportunities both within radiology and the broader health enterprise. Image is becoming such a large part of the electronic medical record. Some estimate it is 90% by volume of a patient's electronic record and we think with our technology and user base we are well positioned to take advantage of this.

openbriefing.com

Implementations and how smoothly they are done are very important to your clients. What is the status of your current contract implementations and given the Partners' announcement and the record pipeline you have just discussed; do you have the capacity to keep performing strongly on this front?

CEO Sam Hupert

The last half was a big half for implementations. We did 85% of Yale in July, the remaining 15% will be done in the next month or two. We also completed the 4th and final stage of Mayo which included their Jacksonville and Phoenix campuses, 2 large campuses outside of their main base in Minnesota.

There has been a lot of work done on the Mercy archives where we migrated more than 25 million exams in six months so that has also gone well, not to mention all the other implementation activity that goes on in the background. So,

we've really kept up with our implementation in terms of installing and they've been successful.

We have also been actively recruiting. As we have told the market we are adding incremental headcount, and that helps provide additional capacity in these areas should we win further contracts.

openbriefing.com
Looking externally, at your end markets, where are the growth opportunities and risks for the next 12 months and beyond? What major factors drive your end markets?

CEO Sam Hupert
Well we think the factors driving the market have been in play for the last few years. The size of the data sets generated by modern imaging equipment, it doesn't go up by 20 or 40 per cent, it goes up exponentially, and that trend is continuing.

Also, the move towards enterprise medical record is helping us. Organisations are spending hundreds of millions, sometimes billions of dollars, to get a unified medical record across the whole organisation. Everything goes into that record and everything needs to be accessed from that record and image is a key part of that. So, I think these 2 factors that we've talked about in the past have created a need. Just as importantly, we think our system is different and that has been proven in the market. So, we can offer these organisations somewhere to go that is different and is proven to deliver significant clinical and financial benefits which have also increased the number of opportunities we've seen.

In terms of the market itself, health is a little different from other markets, it's the biggest business in the world, and it's one that's more shielded from some of the forces such as interest rate changes etc. It is a largely a non-discretionary spend, so whilst there have been headwinds in some of the areas like retail, particularly in Australia, and regulatory issues in some of the financial areas, we don't feel that in our market. We do expect some ups and downs, but they should be far less in terms of amplitude that we see in the general market. So, as we stand here today, we are seeing an increasing number of opportunities in a market that is to a degree protected from external forces, maybe more so than most others. We have a positive view of the next 18 to 24 months.

openbriefing.com
Thank you, Sam.

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

For previous Open Briefings by Pro Medicus, or to receive future Open Briefings by email, visit openbriefing.com

DISCLAIMER: Ramsgate Advisors Ltd and Orient Capital Pty Ltd have taken all reasonable care in publishing the information contained in this Open Briefing®; furthermore, the entirety of this Open Briefing® has been approved for release to the market by the participating company. It is information given in a summary form and does not purport to be complete. The information contained is not intended to be used as the basis for making any investment decision and you are solely responsible for any use you choose to make of the information. We strongly advise that you seek independent professional advice before making any investment decisions. Ramsgate Advisors Ltd and Orient Capital Pty Ltd are not responsible for any consequences of the use you make of the information, including any loss or damage you or a third party might suffer as a result of that use.