CRH Medical Corporation

Fourth Quarter and Year End 2017 Results

Conference Call Transcript

Date: **March 6, 2018**

Time: **8:00 AM PT**

Speakers: **Edward Wright**

Chief Executive Officer

Richard Bear

Chief Financial Officer

Jay Kreger

President, CRH Anaesthesia

Kettina Cordero

Director, Investor Relations

Operator:
Welcome to the CRH Medical Fourth Quarter and Full Year 2017 Results Conference Call. As a reminder, all participants are in listen-only mode and the conference is being recorded. After the presentation, there will be an opportunity to ask questions. To join the question queue, you may press star, then one on your telephone keypad. Should you need assistance during the conference call, you may signal an operator by pressing star and zero.

I would now like to turn the conference over to Ms Kettina Cordero, Director, Investor Relations. Please go ahead.

Kettina Cordero:
Thank you Operator, and good morning everyone. Today I am joined by our CEO, Edward Wright, our CFO, Richard Bear, and the President of CRH Anaesthesia, Jay Kreger. Before we start, I would like to remind everyone that certain statements you will hear today constitute forward-looking statements within the meaning of applicable securities laws. For important assumptions, definitions, and cautionary statements relating to forward-looking information and the risks inherent to our business, please refer to the Cautionary Notes in our financial report for the quarter ended December 31, 2017, and the Risks Factors section in our most recent Annual Information Form.

During this call, we will discuss non-IFRS measures as indicators of our performance. You can refer to our Management Disclosure & Analysis for the quarter and year ended December 31, 2017 for reconciliations of non-IFRS measures to reported IFRS measures. These documents are available on SEDAR and on the Investors section of our website.

In addition, please note that we use the abbreviation GI to refer to gastroenterologists.

Finally, please be advised that our reporting and functional currency is the U.S. dollar, and that all dollar figures referenced today are in U.S. dollars.

Now, I leave you with Edward Wright.

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Edward Wright:

Thank you, Kettina. Yesterday we announced strong results for the fourth quarter and the year ended 2017. Both our anaesthesia business and our product business grew significantly. In 2017, our anaesthesia revenue grew by 31%. This is due in part to the six acquisitions we completed throughout the year and organic growth in patient cases. Our O'Regan business grew by 9% in 2017. The relationships with gastroenterologists who have adopted the O'Regan System continues to be a strong conduit for our anaesthesia acquisition pipeline. Given our customer relationships throughout the lower 48 states, we believe that this provides fertile ground for further anaesthesia expansion. Last year, we completed six anaesthesia acquisitions and invested over $33 million. We expect to continue investing in anaesthesia acquisitions in 2018 at a similar rate to that of 2016 and 2017.

We will continue to finance our growth through our free cash flow and our credit facility. Last year we expanded our credit facility from $55 million to $100 million. At December 31, 2017, we had in excess of $38 million available on our credit facility. This, combined with our free cash flow, will provide ample funds to execute on our growth strategy.

I will now turn it over to Richard for his commentary.

Richard Bear:

Thank you, Edward. I'd like to start by reminding everyone that in accordance with International Financial Reporting Standards, also known as IFRS, we report consolidated financial statements, which means that our financial statements include those of the subsidiaries in which we hold a controlling interest, such as the anaesthesia practices that we own, or in which we hold a majority interest. This practice is in keeping with our current accounting standards.

During the fourth quarter of 2017, we reported total revenue of $32.3 million, and for the year ending December 31, 2017, we reported revenue of $100.2 million. During the fourth quarter of 2017, our Anaesthesia revenue grew 27% to $29.2 million. For the year ended December 31, 2017, Anaesthesia revenue grew 31% to $88.7 million.

During the fourth quarter of 2017, the percentage of commercial patient cases increased to 66% of total cases. For the year ending December 31, 2017, commercial patient cases represented 63% of the total anaesthesia cases. Average revenue per case for the fourth quarter was $452, 11.5% lower than in the

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fourth quarter of 2016. Average revenue per case for the year ended December 31, 2017 was $440, 8.5% lower than when compared to 2016. These decreases are due to the changes in commercial payor mix at GAA and changes to rates within our commercial payors at practices acquired prior to 2017.

During the fourth quarter of 2017, we serviced 64,684 patient cases, 44% more than in the same period of 2016. For the year ending December 31, 2017, we serviced a total of 201,578 patient cases, 43% more than in 2016.

Sales of our O'Regan System during the fourth quarter were $3.1 million, 9% higher than the same period of 2016. For the year ending December 31, 2017, our O'Regan System sales were $11.5 million, also 9% higher than last year.

Total adjusted operating EBITDA for the fourth quarter of 2017 was $17 million, representing 53% of total revenue. Adjusted operating EBITDA attributable to our shareholders was $11.5 million. Total adjusted operating EBITDA for the year ending December 31, 2017 was $49 million, representing 49% of total revenue, and for the year ending December 31, 2017, adjusted operating EBITDA attributable to our shareholders was $34.3 million.

In 2017, we generated $22.6 million in free cash flow. We define free cash flow as cash provided by operations, less payments made for interest and other finance expenses, less distributions for non-controlling interest.

At December 31, 2017, we had $12.5 million in cash, and $20.1 million in working capital. In addition, we had $38.4 million available on our credit facility to fund future growth.

Looking forward to 2018, the Company expects revenue from anaesthesia services for the acquisitions completed through December 31, 2017 to be negatively impacted by the November 2nd, 2017 CMS final rule and changes in the per unit reimbursements received from our commercial payors as we enter into contracts for our acquired entities. The CMS Final Rule will impact our revenue per case by an estimated 12% and the contracting with commercial payors is expected to impact our revenue per case by an additional 5%. We expect these negative impacts to anaesthesia revenue to be offset through organic growth in patient cases and the successful implementation of our growth strategy.

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With that, I will leave you with Jay for his update.

Jay Kreger:
Thank you, Richard. As Edward stated earlier, we were very active on the acquisition front last year. CRH Anaesthesia is now present in seven states, providing anaesthesia at 35 facilities on behalf of 15 GI anaesthesia practices, with approximately 235,000 patient visits annually. These totals do not include those facilities which are De Novo opportunities. This would include our Monitored Anaesthesia Care program with Puget Sound Gastroenterology, in Washington State. This MAC program is on track and we still expect to exercise our option in mid-2018.

We focused much of our attention in the fourth quarter of 2017 on integration of the four acquisitions we announced in August and September. I'm proud to say that they are all firmly operating on the CRH platform. This platform, which includes our experienced management team, is scalable in order to support best practices in revenue cycle, quality and efficiency, and is solidifying our place as the GI anaesthesia partner of choice.

Our business development team continues to work closely with our O'Regan team in order to further grow our acquisition pipeline and uncover more opportunities in 2018 and beyond. Again, as Edward stated, we're very optimistic that we will continue our spending pace this year as in the past. I'm pleased that our financial and operational resources are adequate to support this pace, and so I will look forward to updating you on our progress in the coming months.

I will now leave you back with Edward for his closing remarks.

Edward Wright:
Thanks, Jay. We're very pleased with our 2017 operating and financial results, and we will look forward to reporting our 2018 first quarter results in approximately 90 days.

With that, I'll turn the call back to the operator and open the call for questions. Thank you.

Operator:
Thank you. We'll now begin the question-and-answer session. To join the question queue, you may press star, then one on your telephone keypad. You'll hear a tone acknowledging your request. If you're

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using a speaker phone, please pick up your handset before pressing any keys. To withdraw your question, please press star, then two. We'll pause for a moment as callers join the queue.

The first question is from Lennox Gibbs with TD Securities. Please go ahead.

Lennox Gibbs:
Good morning. Thank you. Given the incremental 5% cut discussed in the updated guidance, I just would like to circle back on the migration that's taking place in your book towards in-network; hoping to better understand that risk going forward.

So, what is the pricing differential between in-network and out-of-network? That's the first question. The second one is what percentage of your book is currently out of contract and where would you expect that percentage to drop to by year end? Assuming no further acquisitions.

Richard Bear:
Yes. I think it's best to use the term contracted and not contracted because even if we're not contracted we're utilizing RAP provisions, so patients are treated as if they're in network, not out of network.

As we acquire entities, we structure those as Newcos so we can take over the billing, we have limited legal liability on an old entity and that we can effect our revenue cycle management strategy.

At the beginning of each acquisition and for several months, possibly quarters, we are kind of migrating from that of an uncontracted to a contracted state and it's really a continual process. You could say that in 2017 probably a lot of the 2015s are wrapped up; in 2018, a lot of the 2016s will be wrapped up. In 2019, a lot of the 2017s will be wrapped up, but it's dynamic and it depends a lot on the market, our GI partners and it's hard to put a consistent timeframe on that.

Lennox Gibbs:
Okay, but still wondering with respect to the price differential and also a sense as to where the book currently stands with respect to what percentage would you say continues to be out of contract at this point and where would you expect to exit the year?

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Richard Bear:
We don't provide the breakout between what's uncontracted and contracted at any given point. I think the guidance that we provided with the 12% cut in CMS and additional 5% as an impact of the commercial contracting will put us in a pretty strong position by the end of 2017 for all the acquisitions completed basically up through 2016, leaving 2018 to finalize some of the 2017 contract changes.

Lennox Gibbs:
Okay. Fair enough. Now, with respect to the fourth quarter numbers, any sense as to the contribution from patients who were originally booked in the third quarter and would have been deferred as a result of Hurricane Irma, I believe it was.

Richard Bear:
Yes, it would be marginal. With the size that we're at now, when we look at things like the weather on the east coast today or a strong flu season, those might have an impact week-to-week, month-to-month; but I think we learned with the hurricane that people are going to come in. It's not that we're losing cases, it's just the cases are being moved from one period to the next, but when we're doing in excess of 240,000 cases a year, these regional differences really won't have an effect on our quarterly results.

Lennox Gibbs:
Good. Thanks very much.

Richard Bear:
You're welcome.

Operator:
The next question is from Richard Close with Canaccord Genuity. Please go ahead.

Richard Close:
Yes, great. Congratulations on a strong end to the year. Just maybe a follow-on onto that last question there. With respect to the strength in the quarter, obviously the number of cases was well above what we were forecasting. Can you give any granularity in terms of where you guys saw the strength, how it

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compared to your internal projections? Anything that stands out with respect to the strong demand in the quarter?

Richard Bear:

I think we can attribute the strong demand, Richard, to that on the commercial side. I mean, we had weakness in commercial as a percentage of total in Q2 and Q3 that we discussed a lot on those calls, and we hoped that commercial would increase in Q4. But I think if you look at our transcripts, we weren't saying it's going to all come back. But based on our commercial mix for Q4 and how it impacted the year-to-date, it appears that a lot of the growth that we had in patient cases all came from commercial and that must be due to the construct of the insurance plans, and I think that propelled not only the number of patient cases but also added significant impact on the revenue per case total revenue and EBITDA for the quarter as well.

Richard Close:

Then, I know you guys don't give guidance really, but just thoughts on last year, you just mentioned the second and third quarter. There was that dynamic I think really across the entire U.S. healthcare services sector in terms of people scratching their heads on the low volumes. We're two months into 2018. Did you see a big drop-off in January/February? Is this going to be just a total back end loaded type of situation again this year?

Richard Bear:

I think if we look back historically on our seasonality, we've always seen more patient cases in Q4 than in Q1. I think if you look at Page 13 of our MD&A, we're seeing around 24%, 23.8% of the cases will be in Q1; 24.4% in Q2; 24.9% in Q3; and 26.9% in Q4. It's going to be weighted more heavily in Q4 but I don't think that those percentages show that one quarter is going to be way high and one quarter is going to be way low.

Richard Close:

Okay. Going back to the 5% cut that you're stating on the commercial side, you also had some, I guess, writedown of intangibles. I guess that's associated with GAA. On the 5% cut first, is that across the entire book, or is that maybe more focused in on GAA? Then if you could talk about the write-down that you had and the financing recovery of the $10 million?

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Richard Bear:
The 5% cut would be driven more on more recent acquisitions than older acquisitions that would have a higher percentage of payers contracted. But the 5% we gave is just an overall impact to the business just to keep it simple for the readers of the financials.

In terms of the write-down, when we did the acquisition of GAA in December 2014, as you'll recall, it was a $73.2 million acquisition, $58 million paid up front, $14.6 million deferred, and that $14.6 million deferred is something that we revalue each period based on our forecast. The measurement date for that $14.6 million ends May 31, 2019, so as of now we have significant clarity with payer mix changes, with rate changes and with the CMS cut to determine what that expected payout is going to be, and now we have it set in our books at about $1.875 million, so that results in about $11 million recovery recorded as finance income per IFRS on our financial statements.

With that change, we also looked if there's any impairment of the GA asset. We have to compare the carrying value of the GAA intangible to the discounted future cash flows, and that resulted in a $6.6 million impairment charge, which you'd expect if you're not going to pay out a large chunk of that $14.6 million. That negatively impacts operating income and net income on the face of the financials, but it's offset, more than offset, by the $10 million recovery to finance income that just impacts net income.

Richard Close:
Finally, on this point, would you have to look at any other acquisitions in terms of similar changes or revaluations? Obviously GAA was the platform to get into anaesthesia services and most of the other ones have been smaller, but just any sense there.

Richard Bear:
We looked at all of them and really because that one we acquired and just took over versus all the other ones where we have basically taken over their billing and put them on our new platform and get the enhancement of our revenue cycle management, we don't have any impairment issues with any of the other entities based on the analysis that we performed at December 31.

Richard Close:
Okay, great. I'll jump back into the queue, let some other people ask questions here.

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Richard Bear:
Thank you, Richard.

Operator:
The next question is from Noel Atkinson with Clarus Securities. Please go ahead.

Noel Atkinson:
Hi, good morning. Thanks for taking my call. Just one more question here on the in contract, out of contract. What is your internal target for the proportion of commercial cases that you serve that have in contract coverage?

Richard Bear:
We deal with a number of major players so the major players would be Cigna, Humana, Blue Cross, United, Aetna. Those are really the five major players. There's a lot of smaller players. They don't account for a whole lot individually but could add up to be 10% or 15% of the total market. Our strategy is to work with our GI partners to establish contracting criteria for the big players, those top five that I mentioned, and then as we look at all others, which could be a basket of 20 or more different providers, those it just never will make sense to contract with. We'll never be fully contracted. The percentage that we're not contracted with will vary market to market just based on their payor mix.

Noel Atkinson:
Okay. Can you give us some sense of what your same store organic sales growth was for the portfolio that was owned for all of 2017?

Richard Bear:
Fair question. We provided guidance outlook of 3% to 5% organic growth for entities acquired prior to 2017, and I would say that we achieved somewhere right in that range, and we would provide similar guidance for 2018.

Noel Atkinson:
Okay, great. Are you undertaking any cost saving initiatives for 2018 within the Anaesthesia group?

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Richard Bear:

Yes, we're looking at all areas. We're carefully examining all areas to maximize the efficiency of our providers. Our number one cost in anaesthesia is going to be our CRNA providers that are working side by side with the GIs doing cases at each of the 35 ASCs that we service. We're looking at how they do their job; we're looking at how well we're staffed, how efficiently we're staffed; where we can assist the GIs in becoming more efficient, because when we see so many different ASCs there's best practices that we can provide. I would expect that we will have some incremental savings in cost, but I wouldn't say it's anything material enough that I would talk about on the call.

Noel Atkinson:

Okay.

Jay Kreger:

This is Jay. I would just remind you that as we talked about last quarter, what we pay and how we pay our providers is very market specific. Geography dictates. We've got many tight markets, so the ability to change pay structures is somewhat limited, but to Richard's point, we are looking at data in an effort to be more efficient with how we staff and how we schedule as opposed to payment methodologies.

Noel Atkinson:

Okay. Then just lastly here before I get back in the queue, are any of the ASCs that your units serve planning any expansions, new centers, significant expansions for 2018?

Jay Kreger:

They are. There's somewhat of a consolidation going on across all ASCs across the country and so there's always that possibility, and I think that any of the groups out there that have ASCs, if they're not growing then they're probably going backwards, and we're very fortunate to be partnered with groups that are growing.

Richard Bear:

As an example, the Knoxville group that we partnered with in 2015, in 2017 they opened up a facility that would probably increase capacity by more than 50%. One of the groups in Texas over the next 12 to 18 months will be opening up an additional center in Atlanta. Additional centers are also being planned. We try to partner with the strong players in each market, and larger players some would think

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don’t need to add centers, but it’s the larger players that actually have the intelligence and wherewithal and desire to grow, so they actually get bigger and bigger.

Noel Atkinson:
Okay, great. All right, thank you very much.

Operator:
The next question is from David Martin with Bloom Burton. Please go ahead.

David Martin:
Good morning. I’ve got a few questions, the first one related just to that last question. The 4% growth, the 3% to 5% growth, does that include the opening of new ASCs by your existing clients, or would that be in addition to the 4%?

Jay Kreger:
No, that would include new ASCs as well.

David Martin:
Okay. Back to the 5% additional revenue per procedure impact coming from the commercial side, is that all because of transitioning from uncontracted to contracted, or is there still some payor mix changes that you’re expecting or even some reimbursement cuts beyond the unit cuts to the codes, even with already contracted payors?

Richard Bear:
No. I’ll address those and try to address those in order. So, in terms of payor mix, not expecting any payor mix changes. As we said last year, the payor mix changes that we experienced in 2017 and 2016 were primarily due to a single payor in GAA and the percentage of cases we get from that payor currently is much lower than it was in 2016 and 2015, so no, we don’t expect any changes in revenue per case associated with payor mix changes. It’s also not related to any changes of relationships that we have with commercial payors that are contracted. We don’t expect any of those to decrease. This would all be really the migration of the entering into contracts from those properties that were recently acquired.

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David Martin:
If you were to make no further acquisitions, once we exited 2018, you'd expect your revenue per case to be stable going forward.

Richard Bear:
Yes, all things being equal.

David Martin:
Okay. Next question. You've written down part of GAA and reduced the amount of the future earnout liability. How prescribed is that earnout amount, and could a different interpretation lead to a situation in which you still need to pay the full amount?

Richard Bear:
Yes, at the end of May 2019, there is a reconciliation process. We provide our numbers to the seller and the seller has the ability to audit our numbers. It's revenue less expenses. It's not very sophisticated and we spent a lot of time analyzing it, and our auditors spent a lot of time auditing it, so I wouldn't expect that there'd be a significant difference, if a difference at all, between what we are estimating and putting forward to the seller and what the seller will receive.

David Martin:
Okay. Last question. With the CMS cuts, on the M&A side are you finding there's more interest from GIs who want to sell this part of their business, or has it changed it all?

Jay Kreger:
I think the environment with the CMS cuts has created a position where the physicians may be more willing to listen and see what we're willing to offer in light of those cuts. Back in November, we were not sure how up to date the physicians who are even in this business were with the cuts and what they could expect in 2018. They all seem to be educated on what the cuts will mean going forward, and so they've been willing to listen and meet with us and see what we can provide. Time will tell if it makes a difference. I don't think it makes it any worse for us, but we've got more people at the table, and that's important.

David Martin:

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Okay. Thank you.

Operator:
The next question is from Endri Leno with National Bank. Please go ahead.

Endri Leno:
Good morning. Thanks for taking my questions. The first one is just as a follow-up on discussions and the pipeline and future acquisitions following the CMS cut. Are you seeing, or do you expect any changes in the multiples that you would pay for any new acquisitions?

Jay Kreger:
No, I don't. We've always valued these businesses based on a predetermined multiple or an effective multiple as we move forward. The valuations overall are lower because the earnings are lower, but our methodology remains the same, so we're paying the same relative value for those.

Endri Leno:
Okay. Great, thank you. The next question is if you can expand a little bit on the Puget Sound development and if there are any other opportunities for more of these developments sort of organically developing then. Thanks.

Jay Kreger:
Sure. Puget Sound is a very large great group out in the Seattle area that has four ASCs. For the last year we have been moving them from conscious sedation to deep sedation, or MAC as we call it. We're on line with that where we have an option to acquire 51% of that business once they are completely up and running and we've got a history of the earnings. We've been ramping that up throughout this year, and as I mentioned, we still look for that to transact this summer.

There are a lot of other opportunities out there for that of varying sizes, again, market specific. Whereas in certain areas of the country, anaesthesia has been generally accepted, other areas, out west predominantly, where they haven't. So we are looking at some of those markets as greenfield or our ability to get them into the anaesthesia business. So yes, I think you'll hear more about those types of opportunities later in 2018.

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Operator:
The next question is a follow-up from Richard Close with Canaccord Genuity. Please go ahead.

Richard Close:
Great, thanks. Helpful on Puget Sound there with respect to the timing, possibly in the summer. Can you talk a little bit about the cadence of the M&A? I mean, you talked about expecting to do similar levels. Obviously not any in the fourth quarter. I assume that was because of the tax law change, but just thoughts around the cadence throughout 2018?

Jay Kreger:
Sure, Richard. Interesting, as I think we've mentioned before, it's hard to time these things. Physicians have seasonality in their ability to focus and want to talk about these things. If you go back historically, outside of GAA you'll see that we've done 82% of the acquisitions, or the spend has been in either the second or the third quarter. They're timed when they're timed. I would expect that to continue this year, where most of what we do is in the middle six months of the year. Again, that's not related to the activity level on our side, but just what it takes to kind of get ramped back up after the holidays and then close things out before the holidays get our physician partners paying attention to their businesses.

Richard Close:
I guess my final question will be on the O'Regan offering. I think in the press release you put a sentence in there about competition and I just want to get your thoughts on what seemed new to me. Maybe it wasn't, but are you seeing increased competition on that front?

Edward Wright:
At the moment, Richard, there's a number of different competitors that have been out there for quite some time. I think it's safe to say that if you talk to the gastroenterology community, the training program that we've developed and the different aspects to the turnkey business, there's great loyalty to the product.

I think in time we've created really a paradigm shift into gastroenterology, if you look back in time. We are the device that has really helped create that paradigm shift and there will be from time to time other technologies that are going to be introduced, or adopted now that we've created that marketplace, but still today by and large we are the market leader in that segment.

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Richard Close:

Okay, great. Thanks. Congratulations again on a solid year.

Edward Wright:

Thank you very much.

Jay Kreger

Thank you.

Operator:

This concludes the question-and-answer session and concludes today's conference call. You may disconnect your lines. Thank you for participating and have a pleasant day.

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