CRH Medical Corporation

Second Quarter 2018 Results Conference Call

Date: **August 2, 2018**

Time: **11:00 AM ET**

Speakers: **Edward Wright**

Chief Executive Officer

Richard Bear

Chief Financial Officer

Kettina Cordero

Director, Investor Relations

Operator:
Welcome to the CRH Medical Second Quarter 2018 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. I'm joined today 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 about forward-looking information and the risks inherent to our business, please refer to the Cautionary Notes in our financial report for the quarter and six months ended June 30, 2018, and the Risk 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's Disclosure and Analysis for the quarter and six months ended June 30, 2018 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 gastroenterology.

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.

Edward Wright:
Thank you Kettina. I'd like to start by discussing our latest anaesthesia acquisition. Last week, we acquired a majority interest in Lake Washington Anaesthesia, the first GI anaesthesia practice CRH developed as part of our Monitored Anaesthesia Program agreement, or MAC program, which we announced in March of 2017 with Puget Sound Gastroenterology. This achievement marks the successful proof of concept for the program. Lake Washington marks the 18th transaction for CRH since our initial GI anaesthesia acquisition in December of 2014. We now have exclusive professional anaesthesia service agreements in 10 states, servicing 43 ambulatory surgical centres, and providing anaesthesia for approximately 290,000 patient cases annually.

Yesterday, we announced strong revenue and earnings for the second quarter of 2018, a result of our successful execution on operational objectives and the integration of our recently acquired anaesthesia practices. As our teams work together to enhance our anaesthesia acquisition pipeline, we continue to benefit from the strong relationships that have been cultivated with GIs who have adopted the CRH O'Regan system. To date, the majority of our anaesthesia acquisitions have been a result of existing O'Regan customers.

Year-to-date, we have invested approximately $21 million in acquisitions and are on track to achieve our previously stated growth goals. Our acquisitions continue to be financed through our internally generated cash flows and our $100 million credit facility which has an interest rate of LIBOR plus 250 basis points. At June 30, 2018, we had approximately $35.5 million available on our credit facility. This, combined with our free cash flow, provides us ample funds to continue executing on our growth strategy.

Finally, it is worth mentioning that as we expected, the 2019 proposed Physician Fee Schedule released by CMS last week does not contain any mention of further changes to GI Anaesthesia reimbursements.

With that, 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 current accounting standards.

In addition, please note that effective January 1, 2018, the Company adopted IFRS 15. As a result, we restated prior year revenue and operating expenses. The restatement had no impact on net income or any other forms of income. Please refer to Note 3 of our unaudited interim financial statements for more information.

During the second quarter of 2018, we reported total revenue of $27.3 million. Anaesthesia revenue grew 36% year-over-year to $24.7 million. Average revenue per case for the second quarter was $371, approximately 6% lower than in the second quarter of 2017. The decrease is primarily due to the impact of the CMS final fee schedule that went into effect January, 1, 2018, the execution of contracts with commercial payors, offset by the impact of newly acquired anaesthesia entities. During the second quarter of 2018, we serviced 66,537 patient cases, which is 44% more than in the same period of 2017. Sales of the O'Regan system during the second quarter were $2.7 million, compared to $2.8 million for the same period of 2017. The decrease in product sales is the result of decreased sales of previously trained practices due to changes in practice emphasis, and to a lesser extent, introduction of competitive products.

Total adjusted operating EBITDA for the second quarter was $12.9 million, representing 47% of total revenue. Adjusted operating EBITDA attributable to our shareholders was $8.4 million.

As of June 30 2018, we had $4.5 million in cash, and $12.7 million in working capital. In addition, we had $35.5 million available on our credit facility to fund future growth.

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

Jay Kreger:

Thank you, Richard. We continue to be busy on the acquisition front. We spent $6.4 million in early May to acquire a majority interest in Western Ohio Anaesthesia, which was our first practice in the state of Ohio. In addition, as Edward mentioned, we spent $5 million last week to complete our first acquisition under our MAC program and become majority owners of Lake Washington Anaesthesia, in Washington state.

We established the Lake Washington Anaesthesia practice in March 2017 to progressively adopt deep sedation as a standard of care at all four ambulatory surgery centres where our partners at Puget Sound Gastro operate. By applying our knowledge and implementing best practices in patient care, practice management and all facets of revenue cycle management, we've been able to establish a high quality and efficient practice from Day one.

The $11.4 million that we spent in these two acquisitions brings our total investment for the year to $20.7 million and we're excited to continue growing our anaesthesia business over the remainder of the year.

Our anaesthesia growth into what now covers 10 states marks what's quickly become a national footprint. We expect further growth across the country as we take advantage of new opportunities.

We continue to focus on providing best-in-class operations along with the ability to effectively and efficiently integrate these acquired businesses. Our platform continues to evolve as the GI anaesthesia partner of choice.

Our Business Development Team is continuing to work closely with our O'Regan Team each day in order to further grow our acquisition pipeline and uncover new opportunities for the rest of 2018 and beyond. Our financial and operational resources are in place to support these continuing acquisitions and so I look forward to the remainder of the year to come.

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

Edward Wright:
With that, I'm going to ask the Operator to open it up for questions, and we're happy to take your questions.

Operator:
Thank you. We will now begin the question-and-answer session. To join the question queue, you may press star, then one on your telephone keypad. You will hear a tone acknowledging your request. If you're using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question, please press star, then two.

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

Lennox Gibbs:
Good morning, thank you. Considering the make-up of your acquisition pipeline in addition to the businesses building out into the market, what trends might we expect in terms of your deal mix going forward? I'm thinking about metrics like deal size, locations of some of the transactions you might engage in, therapeutic area — I know there had been some talk previously about ophthalmology — valuation. That's the first question.

Jay Kreger:
Sure. Lennox, this is Jay. Thank you for the question. I think you can expect, certainly in the short term, more of the same. The size of deals we've encountered are representative of what we're seeing in the pipeline for the rest of this year and into next year.

Lennox Gibbs:
Any comment specifically on MAC development? Transactions that would include MAC development?

Jay Kreger:
First of all, we're very excited to have completed the process of not only developing the program but then transacting on the Lake Washington Anaesthesia program. As you know, from that program, it

included an option that could conclude after a year of the development of the program, and so those transactions would not take place any time within the next 12 months, but we continue to talk to groups that would be a prime candidate for those.

Lennox Gibbs:

Okay. Secondly, can you explain the sequential decline in the operating margins? Presumably reflect a similar decline in anaesthesia margins, but I'm wondering exactly what caused the drag and if you can give us a sense as to whether that's the typical quarter-to-quarter fluctuation, or perhaps more than that?

Richard Bear:

What's driving the trend in operating margins is primarily going to come from the changes in CMS and changes as entities that were acquired prior to this year go from non-contracted to contracted. The margins, we believe — again, going back to the press release that we put out last year — that we still will have a strong margin profile and I think what you're seeing here is, again, that reflection of the CMS change as well as moving from non-contracted to contracted.

Lennox Gibbs:

Right, but I'm referring to the sequential trend Q2 over Q1 '18, so I don't think that's reimbursement.

Richard Bear:

Well, some of it is going to be related to — again, we're constantly moving from a non-contracted to a contracted phase, offset by new acquisitions. I wouldn't expect that number to change dramatically as we continue through 2018.

Lennox Gibbs:

Thanks very much, Richard.

Richard Bear:

Mm-hmm.

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

Richard Close:
Great. Thanks for the questions. On the MAC program, is there any other metric you can provide us in terms of rather than just high level continuing to talk to groups? Anything like the number of potential programs that you could have on an annual basis? In terms of just trying to gauge how active the MAC program could be.

Jay Kreger:
Richard, I think that the MAC program opportunities are a function of a couple of things. We talked about the adoption of anaesthesia or deep sedation as a standard of care, and I think that's a moving target as certain geographic regions in the United States open up to deep sedation. We're watching those markets closely, and as they adopt it, then we're a prime candidate to go in with those programs, but that can be a wait and see.

The other side is groups that may be looking to make a change from a third party, or groups that do decide to change right now, but it's region by region and group by group. A lot of times it's a smaller group that would be looking to make that change because the larger groups have already adopted deep sedation if they're in a market where it is the standard of care already.

Does that help?

Richard Close:
Yes. Yes, it does. Then in your comments, Jay, with respect to acquisitions, obviously you had Ohio and that was a new state, but it sounded as though there could be additional new states there. Maybe talk a little bit about geography, maybe where you're seeing more discussions bubble up on potential M&A. Is there anything you can point to on that front?

Jay Kreger:

Well, as we've said, we've always been opportunistic with our acquisition opportunities, and given that our O'Regan customers are in all lower 48 states, we have the pipeline, if you will, to talk to anyone anywhere, so I would say that we're in at least preliminary discussions almost everywhere, and that's why I feel that we will continue to expand beyond the 10 states that we're in.

Richard Close:
Okay.

Jay Kreger:
There's not a specific state or region though that we focus on.

Richard Close:
Okay. I understand your comments with respect to the size, typical size of deals. Are there any significantly or outsized deals out there in the marketplace that you're currently having conversations with, either preliminary or far along? Just trying to gauge whether there could be anything of significance at some point here over the next year.

Jay Kreger:
Nothing imminent at this time.

Richard Close:
Okay. All right, thank you.

Operator:
The next question is from David Martin of Bloom Burton and Company. Your line is open, sir.

Antonia Borovina:
Hi, hello. This is Antonia on the line for Dave. I just have one question and it's related to the CMS related cuts that were supposed to have a full impact in January. Have all of those cuts been baked into the 2Q numbers, or are there still some private payors who haven't yet adjusted down and we can expect those in third and fourth quarter?

Richard Bear:
Based on everything that we've seen to date, we believe that the cuts announced by CMS have been fully incorporated into all the private payor systems as well as the federal system, so what we've seen is what we'll continue to see.

Antonia Borovina:
Okay. Thank you.

Richard Bear:
You're welcome.

Operator:
The next question is from Ammar Shah with National Bank Financial. Your line is open.

Ammar Shah:
Hey guys, thanks for taking my questions and congrats on the quarter.

Edward Wright:
Thank you.

Ammar Shah:
I was just hoping if you could touch again on the margin front, but particularly with the product segment. I know you mentioned higher product support costs. I was just wondering, is that something that should be viewed as one-time, or something that would be ongoing the next few quarters?

Richard Bear:
I would look at the product business this way; we are just launching initiatives to increase the usage from previous trained practices, so we're going to make investments in re-education, retraining, lighting the fire because these are practices that have done a lot of hemorrhoid banding in the past and we believe are candidates to continue to increase their growth. The margins that you see in Q2 of 2018 of

approximately 52% would be the margins that I would expect, plus or minus a point or two, for Q3 and Q4.

Ammar Shah:
Okay. That's it from me. Thanks.

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

Richard Close:
Great, thanks. I was wondering if you could give us some perspective as we look into the back half of the year in terms of just thoughts on procedure trends. Anything related to volume? Maybe thoughts on same-store sales or same-facility volumes and in around that?

Richard Bear:
Yes. Good question, Richard. For the three months ending, we did 66,000 cases. If you look at what made up that, that was 100% of all of the deals that we did up through Q1 and two months of Western Ohio, so we're going to get three months of Western Ohio when we have the third quarter, plus we're going to lay in Lake Washington Anaesthesia, so case counts will go up.

From a seasonality perspective, I think we've stated before that Q2 seasonality is less than 25%, so just on a normalized basis, we would expect case counts to go up in Q3 and Q4.

Talking about organic growth, I mean low single digits, as we've said, organic growth of the base, which remains consistent. And then through the great work of Jay and his team we continue to do acquisitions and add patient cases.

Richard Close:
Okay. Then with respect to the metrics, I think, on commercial and federal in the documents you provided, have you guys reclassified anything or is …?

Richard Bear:

There's a note at the bottom of that page. There's a small reclassification related to one of the properties, Community Anaesthesia. Community Anaesthesia was just an entity that the billing was done by that entity up until January 1, 2018, then it came over to our side. When it came over to our side, we had a little bit better view of making sure that the classification between federal and commercial was more consistent with all the other properties, which had a minor change in some historical numbers which we noted.

Richard Close:

Okay. I guess my final question is on the new CMS payment rules that came out. I think there's some stuff in there with respect to hospital outpatient and changes there in terms of reimbursement, and as that compares to, I guess, ambulatory standalone clinics. Jay, I was wondering maybe if you could just provide your thoughts on how that impacts potentially the business going forward in terms of the setting of care, where people receive procedures, whether it's a positive or negative for you guys maybe?

Jay Kreger:

I think if the reimbursement in the hospitals was impacted, I don't think that changes where a patient goes because the patient goes where their doctors tell them to go. Just as these physicians are invested in anaesthesia, they're invested in their outpatient setting, their ambulatory surgery centre, so I don't think it has an impact on volumes at all.

Richard Close:

Okay. Now, could it be something where maybe GIs aligned themselves with hospitals previously, maybe because they could get paid more in terms of salaries or something like that and drive volumes, and now that maybe there's lower reimbursement on that side that they decide, 'Hey, maybe it's better to go into private practice,' and begin to shift, maybe, out of hospitals and potentially set up new businesses, GI practices, and thus, ultimately, anaesthesia services as well.

Jay Kreger:

I think you're talking about …

Richard Close:
Am I reaching? Am I reaching there?

Jay Kreger:
I think you're kind of talking about a monumental shift of care. That is many, many years away, if it were to ever happen.

Richard Close:
Okay.

Jay Kreger:
Yes. GIs, historically have not been purchased by hospitals, and when they have, they've gone back to being independent because it didn't work. Certainly history is no proof of the future, but I think what you're suggesting is nothing that we need to be concerned about any time soon.

Richard Close:
Okay. Great, thanks.

Operator:
This concludes the question-and-answer session. Thank you for participating in CRH Medical's conference call. You may disconnect your lines. Thank you for participating, and have a pleasant day.