CRH Medical Corporation

Third Quarter 2018 Results Conference Call

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Speakers:

Edward Wright
Chief Executive Officer

Richard Bear
Chief Financial Officer

Jay Kreger
President, CRH Anaesthesia

Kettina Cordero
Director, Investor Relations

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Operator:

Welcome to the CRH Medical Third Quarter 2018 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, Ms. Cordero.

Kettina Cordero:

Thank you, Operator, and good morning, everyone. I am 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 nine months ended September 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 nine months ended September 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. Yesterday we announced solid results for the third quarter of 2018. This outcome is due to the successful execution of our operational objectives and the integration of recently acquired anesthesia practices, including the two acquisitions we completed in the third quarter, Lake Washington Anaesthesia, which we announced in July, and Lake Erie Sedation, which we announced in September.

Yesterday we also announced our second agreement to develop a monitored anaesthesia care program in North Carolina. By virtue of this new agreement, we will develop an in-house GI anaesthesia practice for our new partner, Digestive Health Specialists, and retain an option to acquire a majority interest of the new practice at a future date. Digestive Health Specialists is an existing O'Regan customer. As our teams work together to expand our anaesthesia acquisition pipeline, we continue to benefit from the strong relationships with GIs who have adopted the CRH O'Regan system and the increased awareness among non-CRH O'Regan customers for our anaesthesia offering.

At September 30, 2018, we had approximately $31 million available on our credit facility. This, combined with our free cash flow, provides us ample funds to continue executing on our growth strategy. Our results clearly demonstrate how strong our business is, despite the CMS changes that were introduced in January 2018.

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

Richard Bear:

Thank you, Edward, and good morning to all. 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 we own, or in which we own 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 on this.

During the third quarter of 2018, we reported total revenue of $28.7 million. Anaesthesia revenue grew 35% year-over-year to $26.1 million. Average revenue per case for the third quarter was $367. During the third quarter of 2018, we serviced 71,044 patient cases, which is a 45% increase over the same period in 2017. Sales of the O'Regan system during the third quarter were $2.7 million compared to $2.9 million for the same period of 2017.

Total adjusted operating EBITDA for the third quarter was $13.5 million, a 24% increase compared to the same period in 2017. Operating EBITDA margin for the third quarter was 47%. Adjusted operating EBITDA attributable to our shareholders was $8.5 million.

As of September 30, 2018, we had $6.8 million in cash and $13.4 million in working capital.

Our acquisitions continue to be financed through these internally generated cash flows along with our $100 million credit facility, which has an interest rate of LIBOR plus 250 basis points. At quarter end, we had $31 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.

During the third quarter, we spent $9.2 million on two acquisitions, as previously stated.

We acquired a majority interest in Lake Washington Anaesthesia, which was our first acquisition in Washington state, and represents the completion of our first business developed under our Monitored

Anaesthesia Care, or MAC program. In addition, we expanded on our existing footprint in the state of Ohio with the acquisition of Lake Erie Sedation Associates.

We're very encouraged by the announcement of our second signed MAC agreement with Digestive Health Specialists in North Carolina, which was announced yesterday. It is similar to the MAC program developed for Lake Washington. DHS owns multiple ASCs in the Winston-Salem area with a total of six procedure rooms.

Our pipeline remains robust, and we'll be adding additional business development resources as part of our commitment and are confident in our ability to continue to grow. We'll continue to leverage our relationships borne out of the O'Regan business, as well as utilize our now referenceable cache of high-quality practices and physicians that we have already partnered with.

On the operations front, we continue to find ways to improve our processes. Our platform is evolving as we continue to position ourselves as the GI anaesthesia partner of choice.

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

Edward Wright:
Thanks, Jay. I think with that we'll just open it up for questions. Thank you.

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

Our first question comes from Richard Close with Canaccord Genuity. Please go ahead.

Richard Close:

Yes, thanks. Congratulations on the third quarter. A question, Richard, with respect to the case rate, or pricing per case. You know, continues to come in significantly above, I guess, what we were modeling. How should we think about case rate in terms of the level of the impact of the reimbursement cut that went into effect at the beginning of the year, and just your thoughts about the case rate trend, since we think about the fourth quarter as well as into 2019.

Richard Bear:
Good question. The case rate has been declining from Q1 to Q2 to Q3 of this year as compared to previous year. The primary decrease, which is about 10.5%, relates to CMS change. Other changes relate from moving from non-contracted to contracted. We ended Q3 at about $367 per case for the quarter. With what we have in line in terms of contract, I would expect that to decrease slightly as we end up in the fourth quarter, then begin to stabilize into 2019.

Richard Close:
Okay, so like a $360, $370 number for 2019 seems plausible?

Richard Bear:
Yes, I think in that range seems plausible, yes.

Richard Close:
Okay, great. A question maybe for Jay here. You talk about the pipeline remaining robust, and then you said something with respect to adding resources. Wonder if you could dive into that a little bit deeper, and then what you're seeing on the operations front. Your comment was seeking ways to improve processes. Anything specific that you can call out there?

Jay Kreger:
Sure. Thanks, Richard, for the question. As far as resources go, I think our commitment is to make sure that we're casting a wide net and be able to answer every inquiry and every potential customer that's out there. We've added some resources in the back end of our Business Development team this year, and we plan to add more, just so we can reach out not only for acquisitions, but more MAC development programs like what we just announced last week.

Richard Close:

Anything specific on process improvement that you mentioned in your comments?

Jay Kreger:

Process improvement on the operations side?

Richard Close:

Yes.

Jay Kreger:

We put a lot of new things in place, and this just comes from scale; you know, having 10 states that we're now in. We've got some more regional operations folks that allow us to have best-in-class providers, a best-in-class Operations team, and that proximity of geography helps.

Richard Close:

Okay, great. I'll jump back into the queue. Thanks.

Operator:

The next question comes from Noel Atkinson with Clarus Securities.

Noel Atkinson:

Hi, good morning. Thanks for taking my questions. In terms of the new MAC practice that you're developing in North Carolina, can you give us a sense of the potential size of revenue or procedures relative to the first one that you developed in Seattle?

Jay Kreger:

Noel, it's Jay. I think we disclosed that they have six rooms. Generally speaking, the size of these practices is really more based on rooms rather than the number of centres. The practice is existing, and you're probably talking an additional 15,000 patient cases, so you could look at it that way. We look at it ramping up pretty quickly, probably by the end of the first quarter.

Richard Bear:

But we won't exercise our option and consolidate for at least 12 months.

Jay Kreger:

Right.

Noel Atkinson:

Okay, great. Then secondly, maybe this is a question for Edward. Where do you see the Company today in terms of annual free cash flow potential of the existing business after we subtract the scheduled debt repayments and distributions to minority interests?

Richard Bear:

I'll take that. Year-to-date I think it's close to $18 million in free cash flow, which we define as cash flow from operations, less interest payments, less NCIB, which I think is what you just described. That will ebb and flow a little bit just as it relates to working capital changes and other things, but we would expect that obviously to be north of $20 million for the year, and then growing as we do more deals into next year.

Noel Atkinson:

Okay, because I think in the past there's been some discussion that the business was at sort of $6.5 million a quarter of available cash flow for acquisitions or other activities, and I just wondered if now that there is more scale to the business, the business seems to be performing relatively well after the impact at the start of the year, just whether that's ticked up meaningfully from sort of that old number.

Jay Kreger:

Yes. That old number, Noel, if you recall, was based on pre-CMS cuts. We're pretty much at that similar pace right now, and I think we'll end the year at that pace and continue to grow from there into 2019.

Noel Atkinson:

Okay, and then finally, are there any geographic segments that did particularly well or particularly weak for the anaesthesia business in Q3?

Jay Kreger:

No, I think geography doesn't play that big a part in it, so there's really no material difference from a geography standpoint.

Richard Bear:

Maybe you're referring to some of the weather patterns, and none of the hurricanes or other storms impacted us during the quarter.

Noel Atkinson:

Okay, great. Thank you.

Operator:

The next question comes from David Martin with Bloom Burton.

Antonia:

Good morning, this is Antonia Borovina on the line for Dave. My question is, as you look to your business, which is no longer in the start-up phase, do you see any new levers you can pull or issues you can leverage to further enhance your performance? So, for example, with your current scale and the CMS cuts behind you, do you feel you can buy significantly larger target businesses, maybe expand into other areas or cut costs because of synergies in your network?

Edward Wright:

Antonia, this is Edward. I think that one of the major advantages that we have today is really in terms of the number of customers that we have. Having now completed 19 acquisitions, we have quite a large rolodex of people that we can utilize or reference to anyone that we're speaking to. Because the GI community is a relatively small community and people know one another well, that the two single greatest references we have today, obviously, are the O'Regan customers that have been longstanding within the CRH community. Then secondly, the more deals we do, the more doctors that they know that

we're asking them to reach out to, and then Jay and his team are visiting many of those practices and educating them about our offering.

Now, just to remind everyone, what we are doing is, you know, we've sort of come out with something that was new to the marketplace that we introduced in 2014. Then in 2015, we did our first JV, and it's that JV model that resonates with most people.

Antonia:
Okay. Then in a somewhat related question, in an environment of rising interest rates, are you adjusting down the price you're willing to pay for acquisitions, and do you see any softening or hardening of potential target ask valuations?

Richard Bear:
We don't see valuations change. We haven't seen valuations change significantly, to answer your first question. We value these in a number of different ways. One of them is on a discounted cash flow basis, so the hurdle rates adjust with our internal interest rates.

Antonia:
Okay, thank you.

Operator:
Once again, if you have a question, please press star, then one. Our next question comes from Richard Close with Canaccord Genuity.

Richard Close:
Great. I was wondering if you could talk a little bit about volumes. I know you don't give same-store, but MEDNAX, which does some anaesthesia, they reported today and they talked about some volume weakness. Now, they have different business lines, but I'm just curious your thoughts on the volume trends that you're seeing.

Richard Bear:

Yes, I'll start with that one, Richard. We've historically stated organic growth in case volume of around 1% to 3%, again depending on the market and the maturity of the business. We continue to see that. We have some underperforming, we have some over performing. But on average, it's 1% to 3%. Remember, we're servicing GIs in the ASCs. These ASCs are GI-specific. The GIs are in private practice, and they work hard to drive volume into these centres. I haven't seen MEDNAX's results, but ours are consistent with previously stated expectations. Jay, anything to add?

Jay Kreger:
Okay. The only thing I would add to that, Richard is that to Richard's point about the GIs and this is their business, the only time we usually see any kind of movement is when there's succession issues within a practice, and usually it's temporary because they'll be replaced with newer, younger doctors as, for instance, in a retirement situation.

Richard Close:
Okay. I guess my second question, or follow-up here, would be on DSOs. I think you talked a little bit about that picking up, if I'm not mistaken, and cited maybe the CMS reimbursement change. What are your thoughts there? Is that just a couple quarter blip, or … any details?

Richard Bear:
Yes, you know, good question, Richard. We've obviously spent a lot of time on the accrued revenue side of our business because, you know, we haven't collected all the revenue in Q3 and we're still collecting revenue in Q2. I would say Q1 at this point is fully collected. So, we do deep dives at the payor level, at the market level, to make sure that our accruals are correct and then kind of look at what that means in terms of days outstanding by payor, by market. The impact of the new codes started impacting us in Q1 but just kind of slowed the whole process that we're seeing in Q2, Q3 as well. I think what we're going to see is we're going to see a slight tick-up in the days outstanding in Q4 just because of the volumes of revenues that typically comes in in Q4. But by Q1 and going forward, we'll be normalized again.

Richard Close:

Okay. Final question, are you guys seeing any changes in terms of maybe receptiveness of deep sedation? Obviously, there's been a big push or growth over the last 5 to 10 years in terms of this becoming the standard of care, but I've seen some articles, maybe some pushback by commercial payors. Are you seeing or hearing about anything along those lines?

Jay Kreger:
Richard, it's Jay. You know, there's not been a lot of specific data, so it's really anecdotal and it's very regional in nature, just like you said you've heard out there. I think at the same time that areas of the country are accepting deep sedation as the standard more and more, you do have some narrow networks that are considering it, but it's always been pushed back from the other sides. Overall, we're still very optimistic that approximately 60% of the endoscopic procedures are accepting deep sedation.

Richard Bear:
Nationwide.

Jay Kreger:
That's across the nation, excuse me.

Richard Bear:
Yes, at the centres we serve we are not seeing any material pushback.

Richard Close:
Great, thanks.

Operator:
The next question comes from Endri Leno with National Bank Financial.

Endri Leno:
Hi, good morning. Thanks for taking my questions. Just a couple for me. First of all, on the debt side, I mean, it has been ticking up almost every quarter for the last few. I was just wondering, like, what kind of debt level are you comfortable with, and where do you see it stabilizing?

Richard Bear:

Currently, I thinkdebt to EBITDA is around 2.2. In our financials I think we clearly state that our max is 2.5. So, under our current debt facility, we are comfortable staying below 2.5.

Endri Leno:

Okay. Okay. Do you see it stabilizing under 2.5, or would you…

Richard Bear:

Yes, I think it will stabilize. Again, depends on the calculation. If you just did a straight-up calculation, it would probably be less than what I just stated. But, the covenant calculation that we use is a rolling four quarter calculation that takes into account a number of different things. But yes, I believe it will stabilize, but it will increase and decrease just by the pace of acquisitions.

Endri Leno:

Great, thank you. Next question is more—I mean, you have alluded—you have in your financial statements that you're switching to GAAP accounting next year, so I was wondering if you have any early guidance on what it could mean for all your disclosures and in terms of how you present financial statements in general.

Richard Bear:

Yes, good question. Because more than 50% of our shares are now owned in the U.S., we've lost our foreign private issuer status and exemptions. So, effective January 1, we become a full SEC filer, so our 12/31/2018 financials, instead of being presented in the format that you've all been used to, they'll be presented in a Form 10-K. As a result, the MD&A, financial statements, Annual Information Form will all be kind of combined into a single document. There will be some enhanced disclosures as a result of that. There'll be some disclosures that are not required as a result of that, as we harmonize IFRS and U.S. GAAP. But we don't expect there'll be any material changes in the presentation of the numbers themselves.

Endri Leno:

Great, thanks. That's all the questions for me.

Operator:

The next question comes from Tania Gonsalves with Cormark Securities.

Tania Gonsalves:

Good morning, gentlemen. Congratulations again on the announcement of your second MAC program deal. My question follows along the line of questioning from Richard, actually. I'm trying to figure out what kind—like, how big the slice of market you can capture out of the roughly 50% of GI ASCs in the U.S. that haven't yet converted to monitored anaesthesia care. Practically speaking, what kind of a piece do you think you could ultimately convert? I imagine there are barriers to entry, such as reimbursement, operation size, etc. It's not just the education and treating aspect.

Jay Kreger:

Thank you for the question. You're right, there are qualifiers that we try to use. We look at the broader market, which is approximately 1,000 GI-centric ASCs, and a certain percentage of those are of a size that we would go after. We believe that size is ample and will be a product for us to transact with for years to come.

Tania Gonsalves:

Okay. Then specifically looking at the earn out, which caused a bit of—you have to revalue the fair value of it. Other than the actual volume performance, is there anything else that ties to that fair value? How does that fluctuate?

Richard Bear:

The earn out is based on cumulative EBITDA from the date of acquisition, which is 12/1/2014, so it's volume rate and expense driven. It's basically everything that affects earnings from that asset. As we see changes in cases, changes in rates positive or negative, changes in cost positive or negative, it causes us to revalue and look at the earn out.

So, in this quarter, we increased the earn out, which means that that asset, the GAA asset is performing better than it was last quarter. That's the positive news, but as we increase that liability—for those who love accounting, that's a credit—the debit has to go somewhere, and that goes to finance expense, which impacts net and comprehensive income.

Tania Gonsalves:

Okay, perfect. Then lastly, I know you mentioned that you haven't really seen any changes to valuations when you're looking for acquisitions. I did notice the last couple ones of Lake Washington and Lake Eerie, they were kind of lower than normal on a revenue basis, so a price revenue basis. Does that have to do with the cuts, or was that basically just circumstantial?

Richard Bear:

When you look at our multiples, we always talk about effective multiples based on income, not revenue, because margin profiles will differ from practice to practice based on payer mix. Lake Washington was really right in that sweet spot of around 4 to 5, which we guide to. We only had one month of operations at Lake Erie. We had no collections data just because of where we're at, so we used a pretty conservative number. I wouldn't look at that one until fourth quarter.

Tania Gonsalves:

Okay, and the EBITDA margins for the Lake Erie Sedation Associates, it's kind of standard for what you have seen in the past?

Richard Bear:

Yes, the EBITDA margins are consistent with what we've seen in the past. Yes.

Tania Gonsalves:

Okay, perfect. That's all for me. Thanks, guys.

Operator:

This concludes time allocated for the question-and-answer session. I would like to turn the conference back over to Mr. Edward Wright for any closing remarks.

Edward Wright:

I'd just like to thank everyone for joining us, and we'll look forward to speaking with you again. Thank you.

Richard Bear:

Thank you.

Operator:

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