CRH Medical Corporation

First Quarter 2019 Results

Conference Call Transcript

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Speakers: **Tushar Ramani**
Chief Executive Officer

Richard Bear
Chief Financial Officer

Jay Kreger
President, CRH Anaesthesia

CRH Medical CORPORATION

Operator:
Thank you for standing by. This is the conference Operator. Welcome to the CRH Medical First Quarter 2019 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 Richard Bear, CFO. Please go ahead, sir.

Richard Bear:
Thank you, Operator, and good morning, everyone. I'm joined today by our new CEO, Dr. Tushar Ramani, 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 10-Q for the quarter ended March 31, 2019.

During this call, we will discuss non-GAAP measures as indicators of our performance. You can refer to our management's Discussion and Analysis for the three months ended March 31, 2019, for reconciliations of non-GAAP measures to reported GAAP measures. These documents are available on SEDAR, EDGAR, and on the Investor section of our website.

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

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

With that, I'd like to welcome and introduce our new CEO, Dr. Tushar Ramani.

Tushar Ramani:

Thank you, Richard. Good morning, all. I'm pleased to have this opportunity to introduce myself and address everyone, now that I've been appointed as CEO of CRH Medical Corporation. With my background you'll find that I bring to this role a genuine empathy for clinical professionals, a strong focus on business development, customer service and accountability, allowing me to fully represent the various stakeholders in our Company.

More specifically, I'm a former anaesthesiologist and a co-founder and leader of Anesthetix, a national provider of comprehensive anaesthesiology solutions for hospitals and surgery centres. As well, I've led and developed several other healthcare companies, some in anaesthesia, some without, including a full-service healthcare staffing firm and an anaesthesia revenue cycle management company.

Now, I'm on to CRH where I'm humbled to lead what I've seen to be a highly skilled and motivated team of professionals and administrators, and thanks to their dedication we enjoy a well-earned reputation in our industry for high quality customer care and reliability, and we are eager now to leverage that reputation for the enormous market opportunity ahead of us, and to deliver maximum value to our customers and shareholders alike.

I share the Board and management's commitment to continuous improvement in all aspects of our business. We will continue to invest in our people, knowing that personal accountability and integrity are the anchors of our culture, and we'll continue to manage our capital and finances in the best interest of our shareholders.

Best of all, as a supplier of critical and valuable services to gastroenterologists and their patients, at CRH we have earned a cherished and unique relationship with our GI community, and CRH will strive to be even more so the trustworthy and sought after partner that our customers and patients have always relied on.

I believe that CRH is well-positioned to rapidly grow its footprint in its core services, even as we look to expand its offerings and be more useful and more valuable to this specialized market.

Now, regarding our 2019 Q1 results, we're very pleased with the steady double-digit revenue growth, coupled with adjusted shareholder EBITDA of $8.8 million. This shows that our model continues to

deliver on its potential and validate our acquisition and operational strategies. CRH is well-positioned now to grow its current model, expand its offerings, and continue to deliver strong financial results.

I will hand it off now, first to Jay, and then to Richard to review the first quarter in details.

Jay Kreger:
Thank you, Tushar. The first quarter of 2019 ended with substantial year-over-year gains for total revenues and adjusted operating shareholder EBITDA. Our Anaesthesia revenue grew nearly 21% over the same period from 2018. This growth was mainly due to 2018 acquisitions that we completed throughout the year, along with our first acquisition of 2019 that was announced earlier in the quarter. We are now serving 47 ASCs and 320,000 patients annually, which does not include our MAC development program, currently in North Carolina, that was initiated last year. We remain confident and look forward to the continued expansion of our anaesthesia footprint this year and beyond.

The pipeline is strong with our business development team and myself having active discussions with GI groups all over the country. We'll continue to capitalize on these opportunities, utilizing all of our resources including our O'Regan account team and help the GI community realize the optimized value that CRH provides to their anaesthesia businesses.

To reiterate, the O'Regan relationship and our reputation within the GI community will continue to help drive our anaesthesia business, and more specifically, our acquisition and development pipeline.

Our Operations team continues to streamline our integration process and ensure that our anaesthesia providers are second to none. CRH has now gained a national reputation across the provider network, which assists our ongoing recruitment efforts, and puts a premium focus on safety and patient satisfaction.

Meanwhile, our industry-leading financial performance continues to be our competitive advantage and sets up apart from other ancillary partners.

As I mentioned on our last call, when we discussed our year-end results, we expect to spend $35 million on acquisitions this year. We will rely on both our O'Regan customers and our existing

anaesthesia physician partners as catalysts for this growth. We believe that our position as the GI anaesthesia partner of choice will only continue to flourish.

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

Richard Bear:

Thank you, Jay. I'd like to start by reminding everyone that beginning December 31, 2018, and on a retrospective basis, our financial reports are being prepared in accordance with U.S. GAAP. We also 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 hold majority interest. This practice is in keeping with current accounting standards.

During the first quarter of 2019 we reported total revenue of $29.1 million, an 18% increase compared with the first quarter of 2018. Anaesthesia revenue grew 20.7% to $26.7 million. During the first quarter of 2019, we provided services to 77,501 patients, which represents a 34% increase compared to the same period in 2018.

Sales of the O'Regan system during first quarter were $2.4 million compared to $2.5 million for the same period in 2018.

Total Adjusted Operating EBITDA for the first quarter was $13.1 million. The operating EBITDA margin for the quarter was 45%. Operating EBITDA margin was 48% for the Anaesthesia segment, and 57% for the Product segment. Adjusted Operating EBITDA attributable to our shareholders was $8.8 million.

For the three months ended March 31, 2019, net cash flow from operating activities was $12.4 million, and free cash flow, defined as net cash flow from operating activities less distributions to noncontrolling interests was $8.3 million.

As of March 31, 2019, we had $5.6 million in cash and $12.3 million in working capital. Our acquisitions continue to be financed through internally generated cash flows along with our $100 million credit facility which currently has an interest rate of LIBOR plus 250 basis points. At quarter end, we had $36 million available on our credit facility to fund future growth.

Now, I'll give you back to Tushar.

Tushar Ramani:
Thank you, Richard. Again, I would just like to say how excited I am to be here, and how optimistic I am about the future of CRH.

I think with that, we'll just open it up for 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 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.

The first question comes from Lennox Gibbs of TD Securities. Please go ahead.

Lennox Gibbs:
Good morning. Thank you. My first question is for Dr. Ramani. Can you speak more specifically about areas of CRH's business in which you see yourself being most hands-on, and in which you think you're likely to bring the greatest value?

Tushar Ramani:
Sure, Lennox. Thanks for the question. I think the greatest thing that I bring to CRH is my physician sensibility, and so developing relationships with our key customer market, gastroenterologists, as well as our anaesthesiology providers, should allow us to strengthen those bonds as well as, as we seek to extend them, allow us hopefully a better entrée and a peer-to-peer level of relationship.

Lennox Gibbs:
Okay. Perhaps the same question in a different way. What are your top three priorities? If we look through the balance of 2019, what are your top three priorities for that period?

Tushar Ramani:

I think our priorities will be first to set and understand exactly the level of opportunity we have in our core business, and next will be to identify accelerators that we can use to, again, leverage the relationships that we have spent all this time developing.

Lennox Gibbs:
Okay. Then just secondly, with respect to growth, can you speak to the organic headwinds you're experiencing in the established practices? I think there was mention in the MD&A of CRNA costs. Also, give us a sense as to how much you expect contract migration to cost you in 2019.

Richard Bear:
Hey, Lennox, Richard. I will attack a couple of those. Organic growth continues to be in that 1% to 3% range. Revenue attributable to organic growth in Q1 compared to Q1 2018 was close to a million dollars, so our organic growth continues. We continue to reduce our overall cost per case. I think the cost per case is down a couple of dollars when compared to the same period, in 2019, and in terms of revenue per case, the revenue per case reported for Q1 is $344. That's been impacted positively by some accrual true-ups, but we are still expecting revenue per case in that $340 range for 2019.

Lennox Gibbs:
Then specifically CRNA costs, in which regions are you experiencing sort of labour inflation there, and again, the contract migration? I know for 2018 you said you expected a 5% hit. What do you expect for '19?

Jay Kreger:
Lennox, this is Jay. I'll address the CRNA costs. You mentioned that it's regional in nature, but I think we have taken that into account, and as we increase utilization through organic growth, we offset that cost increase, and so it's not material at this point. …

Richard Bear:
Yes, from a contract standpoint, if you look at some of our previous acquisitions completed in 2015, 2016 and a large part of the 2017s, those have gone through from non contracted to contracted probably to the extent that they're going to, so the contract changes we'll see will be primarily related to 2018 acquisition activity, but that will be offset by new acquisitions that come in noncontracted in 2019. We believe that levels that we've reported for 2019, the $340 per case, which is really the seasonally

adjusted Q4 numbers, Q4 2018 numbers adjusted for the commercial payer mix, and so that will remain steady through 2019.

Lennox Gibbs:
Thanks very much.

Richard Bear:
Thank you, Lennox.

Operator:
The next question comes from Noel Atkinson of Clarus Securities. Please go ahead.

Noel Atkinson:
Hi, good morning. Thanks very much for taking my questions. First off, the procedure volume, we actually thought it was pretty strong in Q1. Are you seeing any sort of positive benefits from the move to more in-network agreements last year sort of smoothing out some of the historical seasonality in Q1?

Jay Kreger:
Noel, it's Jay. The network/in-network has no impact on case volume or patient volume.

Noel Atkinson:
Okay. Could you tell us a little bit more about the Arapahoe minority interest acquisition in terms of EBITDA multiple, what the motivation was there for the sale, that sort of thing?

Jay Kreger:
Absolutely. Last year we proactively made a decision to solicit certain partners that we had who might wish to sale additional interests, up to and including 100% ownership by CRH as, obviously, we're very bullish on the business. The valuation of the transaction for the 49% was done consistent with how we valued the original transaction yet adjusted for CMS code changes.

Noel Atkinson:
Okay. Do you folks have any change to your acquisition outlook for 2019? Are you still looking at sort of a similar rate of acquisition activity as in the last few years?

Jay Kreger:
On the year-end call, we actually gave guidance of $35 million, and that remains the number for this year for acquisitions. We've also mentioned that we have—our development pipeline is growing, which will lead to future transactions in 2020 and beyond.

Noel Atkinson:
Do you see that minority interest purchase as a part of that $35 million?

Jay Kreger:
Yes.

Noel Atkinson:
Okay. Okay, great. That's it. Thanks very much.

Operator:
The next question comes from Tania Gonsalves, who's with Cormark Securities. Please go ahead.

Tania Gonsalves:
Good morning, gentlemen. Firstly, just on the collections, you noted significant collections in April. Does this all relate to payers having now properly updated their systems with the new codes, or is this just the backlog from high volumes in Q4? We've been waiting for those DSOs for normalize for a year now, and while I know Q1 is seasonally higher, can we expect these levels to start trending downward beginning in Q2?

Richard Bear:
Yes. Thank you, Tania, for the question. April was a very strong collections month, and if we reported monthly, you'd see days outstanding less in April than they currently are, and we expect that to continue. There is a backlog of some outstanding claims, primarily because of the code changes, the interpretation of when somebody comes in for a screening that turns into a diagnostic, and then the rebilling of those. Our goal is to maximize our collections, so we're not going to close out claims just to decrease our days outstanding. We want to work those claims as long as possible to ensure maximum collectability, but that being said, we expect to see the days outstanding decrease through 2019, at least compared to 2018.

Tania Gonsalves:
Excellent. Following the acquisition of ACA earlier this year, I noted that the annual procedures you referenced were 316,000, I believe. When you reported Q1 results, though, those jumped to 320,000 even though there was no M&A between that period. I'm wondering if that 4,000 of extra procedural volumes relates to GAA maybe, considering we saw that big—that revaluation at the earnout. Has it just been performance of GAA, or was this something else blended possibly?

Richard Bear:
It was overall. When that ACA press release went out on January 2, we had not closed out December yet, so did not have final year-end numbers. With final year-end numbers, we're able to true up what the annual case volume is, and that's why it went from the 316,000 to 320,000.

Tania Gonsalves:
Got you, okay. Then lastly, for Dr. Ramani, I have a couple of questions for him, just because we haven't spoken yet. I'm wondering if there's any—because he did spend some time at Team Health, which runs quite a similar business, are there any specific strategies or tactics that you used there to grow their revenue that are transferable to CRH, do you think?

Tushar Ramani:
Well, Tania, I think—first, I appreciate the question and thank you. I think the Team Health business is actually distinct from this one. This one is primarily outpatient focused, primarily single specialty, sort of rapid turnover anaesthesia services in a nonacute care setting.The strategy is different as well. Here, we're developing partnerships and joint ventures, and in some cases outright acquisitions from established services that our GI partners have developed, as well as a medical product strategy that helps drive those relationships in sales as well. Again, just two different businesses.

The commonalities, I guess, are the types of professionals that we work with, and then to the degree that there was a greater organic strategy, displacement sales at Team Health, we don't have that here as much; it's more of an acquisition plan.

Tania Gonsalves:

Okay. All right. Then lastly, as well, you might not have a proper idea about this yet, but you did spend some time at a private equity firm. I'm wondering what your thoughts are on maybe if the stock market is not giving CRH what it wants, are you open to perhaps taking this platform private?

Tushar Ramani:
Tania, I'm quite comfortable managing this Company, both in a public venue as well as a private venue. I think we have to do what's best for the shareholders, depending on whatever the circumstances might be.

Tania Gonsalves:
Okay, perfect. That's all for me. Thank you.

Operator:
The next question comes from Richard Close, who's with Canaccord Genuity. Please go ahead, sir.

Richard Close:
Great, thanks for the questions. Welcome, Dr. Ramani. Obviously, very impressed and interested in your background, and you just received a question in and around that a little bit, but I'm curious how maybe your past history, various positions, portends for the future growth strategies for the companies, or for CRH. You mentioned expansion of the breadth of services but didn't really provide much detail there. Can you go into maybe your thoughts in terms of expanding the breadth of services at the Company?

Tushar Ramani:
Richard, thank you. I appreciate the inquiry there. I would say that in time I will be able to answer your question. I think that right now I'm getting my arms around things, and we're assessing what the landscape looks like, but for now let me just say that our plans are to continue to maximize the opportunities that present themselves.

Richard Close:
Okay, so we'll wait to hear some more there. Maybe a higher level question. I'm just curious what was your thought process in terms of what attracted you to CRH. Did you know them before? How did you

come to discovering the Company and what you believed was most attractive in terms of the opportunity going forward?

Tushar Ramani:
Sure. First, I will say that, yes, I've been aware of CRH for a number of years, just because of its adjacency to my original business, and profession. I've always admired the business plan because it's a particular segment of our space that has sort of built in accelerators with colonoscopies being an increasingly important and increasingly valued screening tool, as well as ultimately a therapeutic tool. Then, the margins that are available in this type of business are attractive that allow you to develop the business in so many ways, and so that was attractive to me as well.

When I specifically looked at it most recently, the fact that it has two service lines already which are each probably a billion to $2 billion market spaces, where we essentially still just have a drop in the bucket, that just represents such a significant opportunity for some good business development, that was pretty attractive for me.

Richard Close:
Okay. I guess my next question might be for Jay here. Jay, you've thrown out the $35 million in acquisition spend. For 2019, you just did the 49% remaining on Arapahoe, and the other transaction earlier in the year. Do you think you need to—I mean, we're already here in May. Do you need to ratchet up here in order to hit that target? How should we think about the timing of transactions as we look at the rest of the year?

Jay Kreger:
Thanks, Richard. Fair question. If you look back historically at our transactions, the majority of them have taken place in the second and third quarters. While I realize the second quarter is one-third over, I think you'll find that to be the case again this year, with the third quarter especially being the strongest, which I think it has been if you were to go back and count up all the dollars spent.

I'm not sure what you mean by ratchet up, but I can assure you we're all hands on deck to maximize the opportunities that are out there, to make sure they get closed this year.

Richard Close:

Your confidence level in terms of being able to spend that $35 million hasn't changed at all since the last call?

Jay Kreger:
I am quite confident it has not changed.

Richard Close:
Okay, great. My final question, I guess this was hit on a little bit earlier, but, Richard, can you go over the change in the earnout valuation there? Just what's the background on that?

Richard Bear:
Yes. At the end of each period, we look at the historical and expected performance of GAA up through May 31 of 2019, which is the end of the measurement period, and adjust the earnout relative to that analysis. GAA is beating our estimates for Q1, which increased our estimates for April and May, that resulted in the earnout being revalued to $4.34 million, which is a $1.4 million increase from where it was at, at 12/31, and that $1.4 million increase was reflected through finance changes in our financial statements.

Like I said, the measurement period, May 31 we'll provide the seller a reconciliation and expect 45 to 60 days after that, so early Q3, to finalize that payout.

Richard Close:
Okay. I guess I do have one final one. There was the recommendation to get colonoscopies, I think it was 45 years old or whatnot. That was a change to recommend getting it at an early age. Have you guys seen any impact with respect to that in your practices, in terms of higher demand?

Jay Kreger:
Hey, Richard. That was brought out by the American Cancer Society as opposed to the College of Gastroenterologists. At this point, I think other than driving some awareness, we have not seen any material change or uptick from that recommendation. Don't expect (inaudible 27:27).

Richard Close:
Okay. Thank you.

Richard Bear:
Thanks, Richard.

Richard Close:
Thank you. Congratulations, again.

Operator:
The next question comes from David Martin who's with Bloom Burton. Please go ahead, sir.

David Martin:
Good morning. I guess my first question will be for Dr. Ramani as well. You mentioned you are positioned to provide a better entrée, more peer-to-peer. I'm wondering, do you have a lot of contacts in the GI ASC universe right now that maybe CRH didn't previously?

Tushar Ramani:
I'm sure that there's a significant amount of overlap in our contacts, but there are probably a handful that I can make introductions more readily than what we've achieved before.

David Martin:
Okay. On the M&A front, I'm wondering, the last few M&As have seemed to be more the 100% ownership than some of the ones done in the previous years. Are you leaning more towards that 100% ownership? Is that your choice? Is that the seller's choice? I'm wondering why that seems to be happening, or is it just a blip?

Jay Kreger:
Hey, David. It's Jay. I can say that it has 100% been the physician's choice. We've noted before that physicians all sell for different reasons, and the amounts that they sell are for different reasons. Some of that may be just based on the profile of the practice and maybe because of where their practices are located. I think, as we've noted before, the CMS coding change in 2017 made some doctors look at their anaesthesia business, and so some—it was a risk mitigation strategy to sell, and so they may have wanted to sell more, and that accounted for why I think three of the last six transactions were

100%. I do not believe that that is an ongoing—based on what I know of the pipeline, I don't think it's an ongoing trend. I think it's hit and miss.

David Martin:

Okay. Are you seeing a trend in the space? Prices increasing for assets? Competition increasing? Or is it pretty much the same it's always been?

Jay Kreger:

Same as it's always been, where we continue to have effective multiples of four to five. In fact, when the deals get too rich like that, we'd walk away from them.

David Martin:

Okay. Last question. Amongst your current clients, are any of them planning to build and open new clinics this year?

Jay Kreger:

When we look at organic growth, that comes from many different directions. It comes from new doctors being added to the practice and can come from new centres being opened, but it's really being driven more by the number of doctors, not how many clinics or rooms they have open.

Richard Bear:

David, there would be some coming on, but as we spoke previously, that would already be included in that 1% to 3% organic guidance that we provided.

David Martin:

Got it. Okay, thanks.

Operator:

The next question comes from Endri Leno, who's with National Bank. Please go ahead.

Endri Leno:

Hi. Good morning. Thanks for taking my questions. A couple for me. First, I just wanted to touch a little bit on the debt. You had a relatively large debt payment in the quarter, and I was wondering how do you

see that going forward? Can we expect a little bit of a repayment on the credit facility? What would be your optimal or target debt ratio?

Richard Bear:
In terms of the debt payment, as you'll recall, we have $100 million credit facility, $25 million term, $75 million revolver. We use the revolver just like people use a personal line of credit. When we have excess cash, we put it against the revolver because we can reborrow on it at any time. We're trying to manage our cash balances really just to make sure we have enough for working capital, because it's difficult to get banks these days to pay you 5% on your savings, so we'd rather knock off the interest expense off our books.

In terms of where we're comfortable, in terms of a debt to EBITDA, we're sub-2 today. With the types of acquisitions that we're doing, accretive, strong margin profiles, if we did a chunk of acquisitions in a given quarter, we could expect that to creep up, but it would slowly retrace because then we'd have the benefit of that EBITDA. I'm not concerned about the structure of the current debt facility limiting our ability to grow.

Endri Leno:
Great. Thank you. The next question, perhaps for Dr. Ramani. You alluded a little bit to CRH having two segments that they do but they both have $1 billion to $2 billion potential. We've seen and we can see acquisitions and growth in the Service segment. If you can talk a little bit to the opportunities on the Product segment, I would greatly appreciate it.

Tushar Ramani:
I can, Endri. Specifically, I was referring, when I talked about the market size on the hemorrhoid treatment side, there have been recent estimates that the current state of hemorrhoid treatment represents upwards of $2 billion in expense for treatment, and we obviously have a very, very, very small share of that, yet we have the gold standard for treatment. I think that that represents an enormous opportunity for us to educate the market and continue to gain our share of that market.

Endri Leno:
Great. Thank you. That's it for me. Thanks.

Operator:
This concludes the question-and-answer session. I would now like to turn the conference back over to Tushar Ramani for any closing remarks.

Tushar Ramani:
Thank you. Again, I'll just say, if it's not clear, I am really excited to take advantage of the opportunities that we have in front of us here, and I look forward to having more of these discussions with you in more detail in the future. Thank you again all for attending.

Jay Kreger:
Thank you, everyone.

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.