CRH Medical Corporation

Third Quarter 2019 Results

Conference Call Transcript

Date: November 8, 2019

Time: 6:00 AM PT

Speakers:

Dr. Tushar Ramani
Chief Executive Officer

Richard Bear
Chief Financial Officer

Jay Kreger
President

Operator:
Thank you for standing by. This is the conference Operator. Welcome to the CRH Medical Third 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, one on your telephone keypad. Should you need assistance during the conference call, you may signal an Operator by pressing star, zero.

I would now like to turn the conference over to Richard Bear, Chief Financial Officer. Please go ahead, sir.

Richard Bear:
Thank you, Operator, and good morning, everyone. I am joined today by our CEO, Dr. Tushar Ramani, and the President of CRH Anesthesia, Jay Kreger.

Before we start, I'd like to remind everyone that certain statements you will hear today constitute forward-looking statements within the meaning of the applicable security 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 10-Q for the three and nine months ending September 30, 2019.

During this call, we will discuss non-GAAP financial measures as indications of our performance. You can refer to our Management's Discussion & Analysis for the three and nine months ended September 30, 2019 for reconciliation of non-GAAP measures to reported GAAP measures. These documents are available on SEDAR, EDGAR, and 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 the U.S. dollar, and that all dollar figures referenced today are in U.S. dollars.

With that, I will now hand the call over to Dr. Tushar Ramani.

Dr. Tushar Ramani:

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Thank you, Richard. Thank you also to everyone on the call for joining us as we discuss CRH's third quarter.

We reported last night that we generated yet another quarter of year-over-year double-digit shareholder EBITDA growth and closed on two more acquisitions from our robust pipeline. CRH continues to display strong fundamentals, and while we remain pleased with our continued progress and execution in 2019, we also continue to position the Company for sustainable long-term growth. As I'd outlined last quarter, we are focused on three areas where we can drive future growth: anesthesia services, O'Regan system, and ancillary GI services.

First, our anesthesia services business remains increasingly well-positioned for both organic and inorganic growth. Our expanded scale over the last several years has allowed us to proactively engage with our payer partners and others to optimize our long-term profit potential and improve overall visibility. Our clinical capabilities, our size, and our financial flexibility all combine to support our acquisition strategy. We have an increasing percentage now of deals in our expanded pipeline that are either pending, closing, or in late-stage negotiations. Moreover, we're adding additional resources to help support our business development strategy. We expect deal activity to accelerate in the coming quarters.

Second, with respect to the O'Regan system, we're increasingly confident that the size of the hemorrhoid treatment market greatly exceeds our historical view, thereby warranting additional investment and attention on this segment. Along these lines, among other things, we're seeking to -- for the first time in the Company's history -- hiring a dedicated senior executive who will preside over that segment.

Third, we're working to identify opportunities that will allow us to further support the GI community from an ancillary services standpoint. This effort remains in its early stages.

I will now hand it off first to Jay, and then to Richard to review the third quarter in a little bit more detail.

Jay Kreger:
Thank you, Tushar.

During the third quarter, anesthesia revenue grew 7% to $28 million. As Tushar said, we completed two transactions during the quarter, the first being a majority interest in a new acquisition, Crystal River Anesthesia, while the second, Central Colorado Anesthesia Associates, was the acquisition of the remaining 49% interest in a prior transaction. Through the end of the third quarter, we spent over $18 million on acquisitions, which still does not include our MAC Development Program in North Carolina that we expect to acquire a controlling interest in shortly.

I continue to have the same optimism about our future growth that I expressed last quarter, as our planned transactions remain on our near horizon. In addition to those expectations, the pipeline remains full with deals at all stages, including several under letter of intent that are expected to close late this year, or could go into early next year. Also in the pipeline are many more non-transactional opportunities that we believe will drive EBITDA growth for all of our shareholders. This, in particular, makes me bullish for 2020 and beyond.

Lastly, we are adding two more resources to our deal team, individuals which will ensure execution of these opportunities, which effectively doubles our resources.

I'll now turn it back to Richard for his commentary.

Richard Bear:
During the third quarter of 2019, we recorded total revenue of $30.4 million, a 6% increase compared to third quarter 2018. For the nine months ended September 30, 2019, total revenue has increased 12%.

Total adjusted operating EBITDA attributable to shareholders has increased 10% for the three and nine months ending September 30, 2019 compared to the same periods in 2018.

For the three months ended September 30, net cash flow from operating activities was $10.7 million, and free cash flow, defined as net cash flow from operations less distributions in non-controlling interest, was $7.1 million. Free cash flow for the nine months ended was $21.9 million. For the nine months ended September 30, free cash flow represented 75% of adjusted operating EBITDA attributable to shareholders. As of September 30, 2019, we had $5.2 million in cash and $68.4 million in total borrowings.

On October 23, we announced a new revolving credit facility led by JP Morgan, which provides for up to $200 million in borrowing capacity, doubling the size of our previous facility. The new facility also provides us with greater flexibility and lower effective interest rates than our prior facility. We currently have $131.6 million in unused borrowing capacity. We expect the new facility, which carries a current interest rate of LIBOR plus 125 to 175 basis points, to reduce our annual expense at current borrowing levels by approximately $550,000.

I will now turn it back to Tushar for his closing comments and questions.

Dr. Tushar Ramani:
Thanks, Richard.

I'd like to provide some colour on expectations for the anesthesia business across the balance of 2019 and 2020.

First, we expect 2019 anesthesia revenue per case to be approximately $333. That's down slightly from our prior expectation of $340.

Second note, our preliminary expectation is that our 2020 revenue per case will be consistent now with 2019 levels; maybe a slight lift. We note that our revenue per case projections do not contemplate additional M&A transactions.

Then third, based on how the year has gone so far, we expect that our organic case volumes will be at the high end of the typical one to three range in our fourth quarter, and in 2020 also, as demand for colonoscopies continues to grow. Just as a note, the deals that we've completed to date now represent 350,000 annual cases going forward.

Then fourth, we continue to view our historical capital deployment as an appropriate guide going forward. However, as Jay alluded to, we do expect to augment that investment with non-acquisition opportunities that will further drive shareholder EBITDA growth.

With that, we will go ahead and open up the call for questions.

Operator:

Thank you. We will now begin the question-and-answer session. To join the question queue, you may press star, 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, two. Once again, to ask a question, please press star, one at this time. 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:

Great. Thanks. Congratulations on the quarter. A couple of questions. First, maybe Tushar or Jay, can you just talk a little bit about the two people you added to the Deal Team there? What's their background? Exactly what will they be focused on? We'll start there.

Jay Kreger:

Thanks, Richard, for the question. This is Jay. Effectively, we had two people working on deals before. As you know, we have traditionally and historically been more of an acquisition story. As we evolve into the different models that we've talked about that may or may not be non-transactional, we tried to diversify the team. The two people that we're bringing in, one has more of a specific background in anesthesia and management thereof, while the other has more of an investment banking background and deal-specific, not necessarily GI, but certainly adaptable. The idea here is, again, to diversify the team, and be able to serve our markets, and I believe that they will do that. They're just coming on; in fact, one this week and one next month, so we believe in 2020 we'll be able to take advantage of all the opportunities that we've got in the pipeline.

Richard Close:

Okay, great, and then you mentioned several transactions under LOI to close maybe here in the next couple of months or early 2020. Can you guys size that at all in terms of what those opportunities are maybe from a number of cases per year, or any thoughts in and around that to give us some perspective?

Jay Kreger:

I can throw out a range for you. I think that probably represents, on a go-forward basis, 75,000 to 100,000 cases annually that we can be adding by virtue of the different models. I think that's a reasonable range. We obviously want to do as much business as we can. With our new borrowing line and the scale of people that we've now created, we can handle the growth as easily as any time in our past.

Richard Close:
All right, so that's 75,000 to 100,000 total for all the deals that are under LOI?

Jay Kreger:
Well, I was speaking more of on an annual level, but I think those that are under LOI is probably in the 50,000 to 75,000 range.

Richard Close:
Okay, and then, Tushar, you said something about, on the anesthesia services side, growth opportunities outside of M&A or transactions. What specifically are you referring to there?

Dr. Tushar Ramani:
Yes, Richard. Our goal is to increase the number of associations we have with gastroenterologists and providing ancillary services at their centres, right, and so we can do that in a couple of ways. Primarily, we've done that through M&A transactions, acquiring equity in their existing anesthesia services, but we've identified a fairly significant white space where GIs are interested in creating those anesthesia services, sort of what we call de novo or MAC program, and that has gained significant traction. It's actually one of the areas that we want to resource better, so I do expect that we'll do more of those type of transactions going forward.

Richard Close:
Okay, so we should expect the—I guess you've done two MACs over the last three years or so. Is that something we should think of maybe two in 2020, or more than that, or how should we think about that?

Dr. Tushar Ramani:
Yes. We'll look to do more than that. Our pilots have been extremely successful, well-received. It's very capital-efficient for us, so absolutely.

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Richard Close:

Okay. Thank you. I'll jump back in the queue.

Operator:

Our next question is from Doug Cooper with Beacon Securities. Please go ahead.

Doug Cooper:

Hi. Good morning. I just want to follow on from the prior question about the pipeline. Just to clarify, so the LOIs is 50—represents 50,000 to 75,000 cases, but the total pipeline might be in advance of that, I guess, and is there any reason to think that the M&A program can't, I guess, materially accelerate given you're doubling the infrastructure and you've got double the money?

Jay Kreger:

Doug, this is Jay. We do believe it will accelerate. What's in the pipeline now, and I actually just totaled it up, it was 60,000 cases, coming back to Richard's question. If those all close, we will be well above the $35 million target that we stated before that are all under LOI currently. Next year, we believe we'll accelerate significantly, but how those break down between capital spend versus non-transactional EBITDA, and the growth that comes from our MAC Development Program, will be across the board.

Doug Cooper:

Right, and I guess I just wanted to clarify there's—I mean, these are sort of plug and play. There's no real integration issues. Is there anything stopping you if you find the right companies, or right companies that would look to sell their practices, or any—there's no integration issues, per se, that could slow down the pace of acquisitions?

Jay Kreger:

No. I think that's where we put a lot of our investment over the last 18 months is that infrastructure so that we can bring these groups on regardless of what type of transaction or deal that we put together.

Doug Cooper:

Right, and I guess in the past you've done a number of minority—or buying 51%. Presumably. that's because maybe the GIs weren't 100% comfortable with offloading their entire business to a third party.

Is the industry becoming more accepting of the practice of essentially outsourcing their anesthesia, which could also help to accelerate the pace of acquisitions?

Jay Kreger:
Well, let me clarify your first point, and that is that the acquisitions that we made of those minority portions I think is more of a validation that we believe in this business, and that it was in our best interest and our shareholders' best interest to buy those up, and so—and those other opportunities similar we may have in the future as well. I think the acceptance of the GI space is as high as it's always been, and we expect it to continue going in the same direction. Yes.

Doug Cooper:
Okay, and Richard, just one point. Maybe you can help just on a modeling perspective. The shareholder EBITDA in the first quarter represented 67% of total EBITDA. This quarter was 72%, presumably because you've ended in the remaining 49% on a couple of those prior acquisitions. What do you anticipate—in absence of doing any further acquisitions in 2020, what—from a modeling perspective, what percentage of EBITDA in 2020 would be shareholder versus minority interest?

Richard Bear:
What was the date of the Central Colorado acquisition, Jay?

Doug Cooper:
August 31, I think it was.

Richard Bear:
Yes, so it will increase slightly as we go into fourth quarter because Q3 only represents one month of Central Colorado at 100%, so you could expect it to be a little bit higher in the fourth quarter than the third quarter, and assuming—and for the base business, that will remain, and then on the deals we do, that will change in 2020.

Doug Cooper:
All right, so I think 75%? Is that a half-decent number for 2020, assuming no other acquisitions?

Richard Bear:

Yes, or a couple of ticks higher. Yes.

Doug Cooper:

Okay, great. Thanks very much, gentlemen.

Operator:

Once again, if you have a question, please press star, one.

Our next question comes from Stephen Kwai with National Bank Financial. Please go ahead.

Stephen Kwai:

Hey, guys. Thanks for taking my question. I'm just calling in for Endri Leno. Just a couple from me, so I was just wondering if you could provide a bit more details on your ancillary services initiatives?

Dr. Tushar Ramani:

Yes. This is Tushar. Thanks for that question. That's something that we identified last time as an initiative that we believe that we should extend into giving the extremely favourable relationship and trust that we enjoy in the GI market. We are also often asked by our GI partners about other ways we can help support them, so it continues to be an open area of, call it, investigation for us. We want to make sure that we come to market with something that's sustainable and high value for all sides. I don't have anything more specific than that, but just some of the colour around it.

Stephen Kwai:

Okay, great. Thanks, and I guess a similar question regarding the products, I mean, because I believe a couple of quarters ago you mentioned you see a lot of potential growth there, the market size and everything like that. Could you give a bit more details, maybe like a timeline on when you're expecting to put through your initiatives?

Dr. Tushar Ramani:

Yes. We remain extremely bullish on that segment in a way, maybe, that the Company has not been here before. A large part of that, of course, is the prevailing tailwinds and awareness about hemorrhoid treatment that's happening currently in the United States. As the market-leading treatment for this condition, we're well-positioned and well-placed to be able to capitalize on that. As we get set for 2020, as I mentioned, we are in the stages of identifying a segment leader that will help bring experience and continuous focus to developing our plans for next year, and I think, as we said, our budgets—we'll began to see what that develops into, but as far as an inflection point on that, I don't have a time for you.

Stephen Kwai:
Okay. That's fine. Okay, great, and just my last one, just on margins, how do you see those developing going forward? If I'm not mistaken, I think EBITDA margins were a bit lower year-over-year.

Richard Bear:
Yes, so for Q3, EBITDA margin was around 43%, and it was about 44% for the year. Based on fourth quarter seasonality, which positively impacts both our product and anesthesia product line, we'd expect to end the year around 45% margins, and I think that's probably a solid number as we look forward into 2020.

Stephen Kwai:
Okay, perfect. That's all my questions. Thanks.

Operator:
Our next question is from Doug Miehm with RBC Capital Markets. Please go ahead.

Doug Miehm:
Good morning. Just one sort of group of questions associated with reimbursement. I know you already really touched on this with respect to the outlook you gave, but could you talk more specifically about what you're seeing in terms of reimbursement with your commercial and government pay, and if you expect any changes to that over the next, call it, 12 to 24 months, and why? I'll leave it there. Thanks.

Dr. Tushar Ramani:
Yes, Doug. This is Tushar. We're not seeing anything—any material trend that we can identify up or down, and all of our focus at the Company, though, as I outlined in my initial comments, are really focused on maintaining our current case rates, and we've got good visibility on that for next year, so I think we sit in a pretty good position.

Doug Miehm:

Right, so the odds of anything changing like we saw a few years ago are very low in your opinion?

Dr. Tushar Ramani:

Yes. As far as we know, there is nothing on the horizon at CMS regarding another re-evaluation of GI services. That feels like a settled issue.

Doug Miehm:

Okay, great. Thank you.

Operator:

Our next question is from David Martin with Bloom Burton. Please go ahead.

David Martin:

Good morning. I kind of wanted to follow on Doug's question there, so you had the reimbursement cuts a couple of years ago, but your revenue per case hasn't stabilized yet, and in fact it dropped the most this quarter sequentially than it had in any quarter since the reimbursement cut. So I know you have the out of network coming into in-network, but as your revenue base grows, that impact should be less, I would think. So did anything happen this quarter that was unusual, and when do you think the revenue per case is going to stabilize?

Richard Bear:

It's not so much what happened. I think it's more of what didn't happen. We didn't have the level of acquisitions that we had anticipated, and if you'll remember, CRH's prior model has been that the new acquisitions would come in, they would be fairly heavier, non-contracted, which would carry a little bit of a higher case rate, and that actually brought up our average blended rate. Since we didn't have that level of acquisition add-on, our prevailing case rate trended more towards our base rates. As far as going forward, no, as I indicated, we'll end up this year somewhere in the $330s, and that's exactly where we end up—where we're projecting 2020 to be. We're fairly confident about that.

David Martin:

Is that $330 for Q4, or $330 on the year?

Jay Kreger:

On the year.

David Martin:

The year.

Jay Kreger:

Remember David, in Q4 we had a strong payer mix, so in Q3 58% of our cases were commercial, 42% federal. Historically, Q4 is 64% commercial, 36% federal, which has a very positive impact on our revenue per case.

David Martin:

Okay. As far as figuring out what your base reimbursement is, if everyone was in network now 100% across your network, where do you figure your revenue per case would be?

Richard Bear:

Yes. I think we projected that. That's what we expect the $330s or so for next year.

David Martin:

That's all 100% in network?

Richard Bear:

Effectively, that's the way we're modeling it. Yes.

David Martin:

Okay. Okay. Thank you.

Operator:

This concludes the time allocated for question-and-answer session. I would like to turn the conference back over to Dr. Tushar Ramani for any closing remarks.

Dr. Tushar Ramani:

Thank you. I just want to finish by saying I have the privilege of speaking for the Company, but the real work here is done by the hard-working team of clinical and administrative staff at CRH, and my thanks go out to them for another great quarter and for the exciting future prospects we have here at the Company. Thank you all for joining us.

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