CRH Medical Corporation

Fourth Quarter and Year End 2018 Results

Conference Call Transcript

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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

Operator:
Thank you for standing by. This is the Conference Operator. Welcome to the CRH Medical Fourth Quarter and Full Year 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 Miss Kettina Cordero, Director, Investor Relations. Please go ahead, Miss Cordero.

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 reports for the quarter and year ended December 31, 2018, and the risk factors section in our most recent annual information form.

During this call, we will discuss non-GAAP measures of indicators of our performance. You can refer to our management disclosure analysis for the quarter and year ended December 31, 2018, for reconciliations of non-GAAP measures to reported GAAP measures. These documents are available on SEDAR, EDGAR, 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 that 2018 was a record year for revenues and, most importantly, adjusted operating shareholder EBIDTA. Our anaesthesia revenue grew 22%. We are extremely pleased with these results, considering the headwind we faced with the reduction in anaesthesia reimbursement rates that went into effect on January 1, 2018. This growth was partly due to the five acquisitions we completed throughout the year.

The growth of our anaesthesia business continues to be driven by our reputation within the GI community, stemming from our loyal and stable O'Regan customer base. Although our O'Regan revenue decreased 5% in 2018 compared to 2017, our revenue for the fourth quarter exceeded $3 million and was our best quarter ever. Our O'Regan relationships continue to be a conduit to our anaesthesia business, and integral in driving our acquisition pipeline.

Our pipeline remains robust, providing more opportunities for future expansion. An example of this, we announced our first acquisition of 2019 earlier this quarter. Anaesthesia Care Associates marks our 21st acquisition, across 11 states. With this acquisition, we have now invested more than $175 million, accelerating us towards the position of the preeminent provider of GI anaesthesia.

At December 31, 2018, we had approximately $30 million available on our credit facility. This combined with our free cash flow, provides ample funds to continue executing on our growth strategy.

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

Richard Bear:
Thank you, Edward.

I'd like to start by reminding everyone that, since the Company no longer meets the definition of a foreign private issuer, we are required to prepare consolidated financial statements in accordance with U.S. GAAP. Additionally, we are required to report to the SEC on domestic forms, comply with the SEC rules and regulations that are applicable to domestic issuers. Ove all, the conversion from IFRS to U.S.

GAAP had no impact on revenue or adjusted operating EBITDA but did impact historically reported net income.

We also report consolidated financial statements, which means that our financial statements include those of the subsidiaries in which we hold a controlling interest. This practice is in keeping with current accounting standards.

For the year ended December 31, 2018, we reported total revenue of $112.8 million, a 19% increase compared to 2017.

Anaesthesia revenue grew 22% in 2018 to $101.8 million.

For the year ending December 31, 2018, we serviced 276,766 patient cases, which is 37% more than in 2017.

Total adjusted operating EBITDA for the year was $54.7 million, an 11% increase compared to 2017.

Adjusted operating EBITDA margin for the year was 49%. Adjusted operating EBITDA attributable to shareholders was $35.8 million.

For the year ending December 31, 2018, cash flow from operations was $41 million and free cash flow, defined as cash flow from operations less distributions to non-controlling interest, was $21.7 million.

As of December 31, 2018, we had $9.9 million in cash and $20.1 million in working capital.

Our acquisitions continue to be financed through internally generated cash flows, along with our $100 million credit facility, which has an interest rate of LIBOR plus 250 basis points. At year-end we had $30.1 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're very pleased with how the anaesthesia business finished up the year overall. We recognized record revenues and EBITDA, and invested over $27 million on five new acquisitions. We grew the facilities that we serve from 35 at the end of 2017 to 46 at the end of 2018. Of course, these totals do not include our newest MAC development program in North Carolina, that was announced during the third quarter of last year.

We started off strong in 2019 with the announcement of our first acquisition in early January. As Edward stated, it is our first acquisition in Indiana, marking our 11th state. This also marks our 47th ASC served, with our providers now serving over 320,000 patients annually. We look forward to the continuing expansion of our anaesthesia footprint this year and beyond.

Our pipeline is as strong as ever, with our business development team actively speaking to GI groups all over the country. We continue to work in unison with our O'Regan account team to maximize opportunities and to help the GI community realize the value of their anaesthesia businesses. Our operations team is ensuring that we're able to integrate these new practices seamlessly, and that all of our providers are providing care at a quality and experience level which is second to none.

Aside from an ongoing recruitment effort geared towards providing ultimate coverage and making sure we operate most efficiently, we've also continued to emphasize the focus on patient satisfaction and safety. Meanwhile our ability to drive financial performance at an industry-leading level continues to be our competitive advantage, and therefore sets us apart from other ancillary partners.

As I mentioned, we're pleased with how we finished up last year, but we're more excited about how this year is starting off. We expect acquisition growth to be greater than last year, and we have a plan in place to spend $35 million or more this year. Our O'Regan customers will continue to serve as a catalyst for this growth, but we will also rely on our existing physician partners as positive references.

In short, our position as the GI anaesthesia partner of choice continues to thrive.

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

Edward Wright:

Thanks, Jay. 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 speaker phone, 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 Noel Atkinson with Clarus Securities. Please go ahead.

Noel Atkinson:

Hey, good morning. Thanks for taking my call. Nice quarter. I was wondering if you could talk at all about any sort of efforts to improve profitability within the anaesthesia practice unit.

Richard Bear:

Hey, Noel. This is Richard. It's an interesting question. Our anaesthesia—overall our margins are 49%. If you peeled out the corporate costs from that, the margins would be even higher than that. We're constantly looking at maximizing revenue, maximizing the staff in order to deliver services in the most efficient way. I would say that we believe that our profitability at those centres are at optimized level today.

Noel Atkinson:

Okay. Then the average rate shift that happened in Q4, like rate per reimbursement, that's from primarily the shift to in network contracts that was completed?

Richard Bear:

That's correct. As we've stated last year, we talked about a 5% reduction in addition to the CMS changes, so, if you look at the Q4 numbers of 354.23 it was impacted by about 5% compared to fourth quarter 2017 after adjusting for the CMS changes.

Noel Atkinson:

Was that concentrated in any geographic region that you can talk about?

Richard Bear:
No. It was over the entire base of customers that we have. As we look forward, if you take that 354 for the fourth quarter and seasonally adjust that, you get a number closer to about 341, and we believe that's a good number as we look at 2019.

Noel Atkinson:
Okay. Just one more question just on that, sort of, in network stuff. Is there any geographic region in which CRH still has sort of an outsize proportion of procedures that are out of network that would be looking to come in network?

Richard Bear:
No.

Noel Atkinson:
Okay. It sounds like the pipeline for acquisitions is pretty robust, you guys have a meaningful amount of capital. You did a little bit less last year—in 2018 than the couple prior years. Are you seeing any constraints on your acquisition activities? Are you trying to be more focused on the nature or the scale of the acquisitions you're attempting to achieve?

Jay Kreger:
Hey, Noel. It's Jay. I think last year was, in some cases, as much about timing. I think there were some people that were waiting on to see what the full impact of the CMS changes would have on their business. But that's also fuelled more conversations that we'll have this year, and have had to date, which is why we have actually put a number out and felt comfortable doing so. I think we'll do more deals. They may be smaller in nature, but we will get to that total.

One of the other dynamics that we've seen is, now that we have been out in the market for going on five years, is that there's a lot of groups that we've spoken to in the past that have come back to us that will fuel some future growth.

Noel Atkinson:
Okay. If we are looking at the operating EBITDA that's attributable to the CRH shareholders, it seems like the 100% owned centres or the varying majority owned centres seem to be performing well in Q4,

and it sounded like they had performed well in Q3. What do you see driving this? Can you give us any explanation?

Richard Bear:
I think, as you know, you when you're talking about 100% owned centres, the largest one being GAA, and GAA continues to perform well, and then fourth quarter is always positively impacted by payer mix where our commercial payer mix percentage of commercial cases as a percentage of total is always higher in Q4 than in previous quarters, so that and continued organic growth in those markets continue to help.

Noel Atkinson:
Okay, great. Thanks very much.

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

Richard Close:
Great, thanks. Congratulations on finishing the year off. A lot of those questions were similar to mine.

With respect to the fourth quarter revenue on anaesthesia, in the MD&A you talk about approximately 5% decrease existing contracts with non-contracted payers. Is that just all of the pricing or the rate that you just talked about moving into in network, or if you could give us some sort of characterization of maybe the same store patient case growth in the quarter?

Richard Bear:
To answer your first question, it would all be the result of going from non-contracted to contracted. In terms of the same store sales, our organic, it varies depending on what quarter we're in and by entity, but over all, organic growth rate is about 1% to 3%.

Richard Close:
Okay. I think, in looking at your credit facility, you had mentioned the LIBOR plus, and I think you said 250 basis points. How are you thinking about the credit facility, and is there any thoughts in and around,

you know, there's been discussions of moving away from LIBOR, and have you guys looked at how that potentially would impact any changes for you guys?

Richard Bear:
It's a good question, Richard. It's something now that we're through the filing of our first 10-K, which took a lot of time. Beginning probably more closer to Q2, we'll start looking at our credit facility because we don't want to take it to term which would be June 2020. So, we've had some initial discussions, but nothing to the point where I could provide specific comment about what the nature and structure of a new credit facility might look like.

Richard Close:
Okay. I see you have contingent consideration, I think the $2.9 million there, and that's to be paid here in 2019, correct?

Richard Bear:
Yes, that's the earn-out obligation on the GAA acquisition, that we would expect based on the agreements that are in place, I would expect to payout in June or July of 2019.

Richard Close:
Okay, that's helpful, thanks. My final question, I guess, is related to looking at the impairment of intangibles, part of the MD&A, and you talk about two professional services agreements there? Is there any more colour that you can give us on those two that you're still evaluating?

Richard Bear:
Yes. So, impairment testing under U.S. GAAP, which we now comply with as a U.S. filer, is a two-step program. The first is, we look and see if there's impairment triggers, which is has anything changed dramatically from when we acquired it and the assumptions that we used. Then we perform undiscounted cash flow models, with certain limitations on assumptions, and if we see that there are impairment issues related to the undiscounted cash flow models we go to a different set of assumptions and then a discounted cash flow model. We had to perform that with two of our entities. We haven't named those entities, but they were smaller entities and small dollars. But the analysis didn't result in any impairment, so there's no impairment charges in the financials themselves. What you're reading is honestly required disclosure.

Richard Close:
Okay, great. Just wanted to double check on that. My final question maybe is for Jay, and then just a little bit more clarity or details on the acquisition and the pipeline opportunity. You mentioned that some of these are, I guess, rebounds, potential deals that are coming back. Is there any specific reason maybe that deals weren't consummated in the first place? Was it just way too early? Any specific reason that you're noticing why they're coming back into the fold?

Jay Kreger:
It's an interesting question, Richard. The answer is it's been different with every group. I think two of our deals that we did last year were deals that were pitched originally two years prior, where some could argue that we were just getting started in this business. I think more and more now we're becoming known as an anaesthesia Company, and that credibility goes a long way. Also, just sometimes the timing isn't right because the physicians may be focusing on another part of their practice, other ancillary pieces, or possibly just growing endoscopy and maybe divesting or taking some chips off the table as to some of their ancillaries like anaesthesia. It's just been different with each group.

Richard Close:
Okay. Thank you. Congratulations.

Jay Kreger:
Thank you.

Operator:
The next question comes from Doug Cooper with Beacon Securities.

Doug Cooper:
Hi. Good morning, guys. A great quarter with the headwinds you were faced, especially early in the year. Just on the getting back to the acquisitions, you've made a number, as you've indicated over the past five years or so. Can you give us any indication of what you think your market share is and I guess how many—I guess just trying to figure out or trying to put in context how many more acquisitions you can make. Is it sort of you talked about accelerating the program a little bit this year to get market share upwards of say 10%, 20%, 30%, is this a multi-year continuation of the strategy?

Jay Kreger:

Sure, Doug. I think the runway, over all, is still—we consider it to be long. Right now, we're in 47 ASC's meanwhile we have a list of approximately 800 GI-specific ASCs. There is a percentage of those that are providing anaesthesia, and a sub-percentage of those that are owning that anaesthesia, that open themselves up for acquisitions. But there's also a number of those where they're either using third party anaesthesia, where we could become a partner for them in the future, or those that are still using conscious sedation, which we believe will eventually convert to deep sedation from conscious. That number is probably around 400 or 500 centres in total, based on ample volumes that would make it worthwhile. So, if you're looking at it from that standpoint, we've got approximately 10% of that market, and we'll go a long way in future years.

Doug Cooper:

Okay. I guess the question, is the program sort of running on its own with you Jay, or—and how much time would the senior guys, like Edward and Richard for example, spend on that acquisition program, or how much time of the senior guys is spent looking for the next leg of growth in terms of transformational acquisition into an ancillary product?

Jay Kreger:

I'll let Edward answer in a second. One thing I would add is that every GI physician that we speak to is a potential customer. Whether it's Edward or Richard or anyone on the senior team as well as the anaesthesia-specific team, if we're speaking to doctors, I think we're always selling our services and the level of quality and credibility that we bring. So, I think they're involved all the time. But I will let Edward answer that.

Edward Wright:

No, absolutely. Jay, if you go back to a year or maybe a little bit longer, Doug, I would say a significant portion of Jay's time was focused on integrating operations. Actually, about a year ago we hired a wonderful gentleman by the name of Beemal Shah who's become the Senior Vice President of Operations and has done terrific work with the entire operations team, freeing Jay basically to spend the vast—almost always time but certainly the vast majority of his time on the BD side. I think that, in the latter half of 2018, was significant when we saw the effect of the pipeline and what we have in front of us now. I mean his team, Jay's team on the BD side, is growing, and that team's on the road every

week. Richard obviously is very actively involved in all of the financial aspects of any and every opportunity.

So, yes, everybody is very focused. Even here, as Jay alluded to earlier, the O'Regan team, which has a very strong interfacing with all of their customers across the country and our doctors that are traveling throughout the weeks, there's all initiatives which cross back and forward between the two business segments. So, it's very much a focus of everybody in the Company towards the anaesthesia opportunities.

Doug Cooper:
Do you think the acquisitions are going to get easier and maybe accelerate as CRH itself gets bigger, because the other guys would feel more comfortable selling their business to a larger operation especially on a JV status, you know what I mean?

Edward Wright:
Possibly. I think that will happen, but it's also a result of awareness. I think it's important to note that when we moved into this business four and a half years ago, it really was not something that people were doing. So, although it seems like a long time for us, and we've done 21 acquisitions, a lot of the people that we spoke to early on, whether it was year one, year two, or year three, as Jay mentioned, a lot of them were coming back around. I mean those early discussions were very much "well that's interesting," and we would try to encourage them to speak to the one or two or four or five customers that we had done acquisitions with. Well as time goes on, there's just more and more awareness of who we are and what we're doing in this area of business. The beauty is, now that we've got a customer list of 21 practices that we've been successful with, we can hand that out and really encourage these people to speak to their counterparts around the country. So, I think it's more awareness than anything else.

Doug Cooper:
Right. As a final one, just on that, GAA was obviously—I think they're still the biggest one to date; is there any sort of big elephants out there? I know you talked about in the past that they're a bit of the anomaly but are most of them…

Edward Wright:
There certainly is. There's a handful of large ones. Clearly, we know who they are. We're continuing to make them aware of our offering and speak with them. But there's a handful, whereas there are many many others, the number of opportunities in the 3 to 5 up to 15 million are much, much greater, and that's I think when Jay cautioned earlier and said you should expect more deals as opposed to one deal in a given year. I would certainly support that, and that's what our pipeline would indicate.

Doug Cooper:
Okay, gentleman. Thank you very much.

Edward Wright:
Thank you.

Jay Kreger:
Thanks.

Operator:
Our next question comes from David Martin with Bloom Burton. Please go ahead.

David Martin:
Good morning. I've got a couple of questions. The first is, how many service agreements with AFCs expired during 2018, and were you able to reap all of them, and then how many are expiring in 2019?

Richard Bear:
Our PSAs, professional services agreements, associated with the acquisitions we've done to date range anywhere from 1 to 15 years in term. Again, it's the structure of the asset purchase agreements, or in some cases membership purchase agreements, that really drive that relationship and the PSAs just renew as a matter of course. So, during 2018 I think we had one or two that auto-renewed as expected, and would expect the same number in 2019, because it's not—the PSA defines our relationship but it's the membership purchase agreement or the asset purchase agreement that controls our relationship.

David Martin:
Okay. The second question is, when I do my calculations on the price to revenue or price to EBITDA that you are paying for your acquisitions, certainly after the reimbursement cuts were initiated in January 2018, your revenue multiple looks like it's trending lower, which makes sense, you're going to pay less for revenues where there's less profit on them. By my calculations it looks like the price to EBITDA is trending off a bit, and I'm wondering, is that a trend, do you expect you're going to have to pay more for EBITDA than you did previously, or have these just been better quality businesses that you bought since January 1, 2018?

Richard Bear:
Not knowing exactly what you're looking at, David. I would say that our effective multiples are all EBITDA-based, and our range anywhere from four to five times, and are consistent with how we've been pricing deals since 2015. So, maybe what you're seeing is just effect of acquisitions that maybe based on your calculations might be on the higher side, but we have not seen our valuations change. We continue to have discipline of our valuations and believe that we'll continue to be able to acquire to the numbers that Jay mentioned earlier based on those valuations.

David Martin:
Okay. Yes, it was just a small data set post January 1, 2018, but I thought I'd ask. Are you seeing any competition out there that wasn't there before, as far as acquiring assets?

Jay Kreger:
Our competition has been and continues to be just the physicians deciding not to do anything. That's always been, again, which goes back to Edward's statement about awareness. As we've stated on other calls, these businesses are generally not for sale. When we've come to them, it's the first time that they've ever even considered the option. I think that continues to be the biggest competition there is. There is not another anaesthesia company making acquisitions in this space currently.

David Martin:
Given that you're at 10% penetration a few years into this now, that means a lot have either said no or they haven't been approached by you yet. Would you say de novo introductions to these businesses, the majority say no we want to keep it, or is it 50-50 on the first interaction, or—at 10% are most people still saying no, we want to keep it, I guess, is my question.

Jay Kreger:
Like anything, David, they don't always know what they're saying yes or no to. So, if it's a no, it's a short conversation.

David Martin:
Is that the majority of your new interactions, or is that not the majority?

Jay Kreger:
We had conversations with everyone of varying degrees, and so I couldn't put a number on it specifically.

David Martin:
Okay. All right, thanks.

Operator:
The next question comes from Tania Gonsalves with Cormark Securities.

Tania Gonsalves:
Good morning gentlemen. Just a few from me. Firstly, we've seen one of your peers Medmax experience a shift in payer mix toward more federal payers, much like you have also seen. I know this is difficult to predict, but have you put any thought into how long you expect this to continue, based on demographic trends?

Richard Bear:
We have not seen, if we look back historically at acquisitions, we've made in 2014–15–16-ish, we're not seeing demographic changes. We're seeing fairly consistent payer mix at an entity level. Typically, when you see shifts in our payer mix, it's a result of just the acquisitions that we've done. I think it's difficult to compare a facility-based entity like Medmax and others to an outpatient facility company more like ours, where we're servicing physicians in private practice who honestly self-select the patients they want, ensuring they have a strong commercial mix because that is going to be most profitable for every aspect of their business.

Tania Gonsalves:
Okay. So, just assuming we see an aging population, I would have expected there be more volume with Medicare. You're not experiencing this?

Richard Bear:
No. I wouldn't think that—I have not seen any material shifts nor are expecting any material over the current timing horizon.

Tania Gonsalves:
Okay, perfect; and then another one a little also macro-based. Have there been any changes in labour cost pressure on the AFCs, and have you witnessed any increased utilization of CRNAs to combat this?

Richard Bear:
We're constantly looking at utilization metrics across our entire platform by site, by room, by day, ensuring that our staffing algorithms are as efficient as possible. So, we're always looking at initiatives to drive those costs down where we can. Our adjusted—our cost per case in 2018 was $177, compared to our cost per case in 2017 of $187. We are seeing, as you would expect, as everybody sees, there are increases in labour costs. We built in a consumer price index and ensuring that we can retain those people that are doing a great job for us. But we also have appeared, based on the numbers, to offset that with greater efficiency of the kind of the platform that we've created, and maximizing utilization at each market.

Tania Gonsalves:
Perfect. Okay, yes, that was clear. And then on the pricing of the Tennessee Valley acquisition, I noticed on an EBITDA sales basis it was a little bit more expensive than what you typically pay. Do you assume then that the EBITDA margins are better than other acquisitions?

Jay Kreger:
I think in—rather than looking at each acquisition only by the numbers, there is a holistic component to it as well, and what we believe the future growth to be. So, any that might fall generally at the top end of the range that Richard mentioned earlier would be for those types of reasons.

Tania Gonsalves:
And then just one last one from me, do you have an update on how the MAC program is progressing at Digestive Health Specialists?

Jay Kreger:
You're talking about Triad?

Tania Gonsalves:
Yes. Yes.

Jay Kreger:
Yes. Thank you. We generally don't speak of the practice name. It has launched and going very well.

Tania Gonsalves:
Okay. All right, that's it for me. Thank you, gentlemen.

Operator:
We have a follow-up question from Richard Close. Please go ahead.

Richard Close:
Great, thanks. Just a clarification. Looking at the seasonality in the 10-K, Richard, should we just assume similar flow in patient cases during 2019 as occurred in 2018? That would be the first question; and then, with respect to the rate, as it progresses throughout the year, should we see the first quarter being the lowest and then maybe second and third a little bit higher, and then obviously the fourth with more commercial, if that being the highest, as we think about 2019?

Richard Bear:
Two good questions, Richard, and to both questions, I will answer yes and yes.

Richard Close:
Okay, great. Thank you.

Operator:
We have another follow-up question from David Martin.

David Martin:
Thanks. Kind of like corollary to one of Tania's questions, if they lowered the recommended age for colonoscopy screening in the U.S., your number of procedures were higher than we had forecast. I'm wondering, is that part of it, or did any of your AST groups open new clinics during the year, and if you are seeing more younger patients coming in, is it actually pushing your percentage of commercial payers higher because of that?

Jay Kreger:
David, I don't know that I would say that it's due to guidelines getting younger, or that there are more cases from younger patients. I think growth may be, like anything else, based on awareness. I don't see that, at least in the near term, pushing our payer mix more towards commercial.

David Martin:
Okay. Okay, thanks.

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

Edward Wright:
I'd just like to thank everyone for joining us, and we'll look forward to updating on our Q1s in the near future. Thank you and have a great day.

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