CEO on Update

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing®, Sam discusses:

- Record profit
- Ongoing margin growth driven by North America transaction revenues.
- Growth from the Australian operations.
- The return of franked dividends and the expectation for this to continue.
- Growth outlook for FY18 and potential uses for the company's growing cash balance.

Record of interview:

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Pro Medicus Limited (ASX: PME) today reported a record net profit after tax of $9.32 million for the year ended 30 June 2017, up 46.4% year on year. If we exclude the impact of FX fluctuations, underlying profit was $9.87m, up 53.4% year on year. Margins also continue to grow, with profit growing faster than revenue, which was up 14.7% to $31.62 million. What were the key drivers of the increase in profit and margins and is there potential for further margin growth?

CEO Sam Hupert

There were many factors that contributed to our record result but I suppose the key ones were the strong performances of our North American and Australian operations particularly the growth in transaction numbers in North America coupled with our ability to control our cost base, which actually decreased in real terms not to mention as a percentage of revenue.

As for margins, they increased in line with expectations. Historically our Australian operations and our global R&D costs largely net off against each other. As a result, the margins we get out of North America are relatively high and with North America approaching 70% of our revenues; it clearly helps grow our overall group margins.

Australia also contributed by delivering growth and higher margins. We are starting to see increased traction particularly with Visage RIS, our practice management product. We announced the Primary Health contract during the year, but there has only been a small amount of revenue from that during FY17. We expect a much larger contribution in FY18 and beyond as transaction numbers build which will also help increase our margins.

I think all of this confirms our belief that our business model is highly scalable. It's a software only model - there's no capex so as the number of transactions grow the top line grows, margins grow and that flows to the bottom line.

In terms of future growth, we already know at a minimum what we're going to have in FY18. Not only from the contracts we've implemented, all of which will contribute a full year's worth of transaction revenue, there are also those contracts still to be implemented such as Mayo Clinic and Primary which will add to that. So we know there will be more transaction revenue out of North America supplemented by growing transaction revenue in Australia and that doesn't include any new contracts that we may win throughout the year. So there is still room for margin growth in the coming year - we don't believe we have peaked.

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Currency fluctuations had a much bigger impact this year than last year. Why was this so and how do you manage currency risk given that you work in three jurisdictions - Australia, Europe and North America?

CEO Sam Hupert

We've been dealing with the complexity of working in three key currencies since acquiring Visage back in 2009. Essentially, we earn the bulk of our revenue in USD but our biggest expense which is R&D is funded in Euros and to some extent AUD. Two things changed this year. Firstly, the amount of US dollar denominated revenue has grown significantly. The second is the currency spread of the AUD against the USD and the Euro. Usually the Australian dollar moves in the same direction, up or down, against both currencies so the impact on us is less as they tend to net each other out to a degree. In the last month or two of FY17 the Australian dollar strengthened against the US but weakened against the Euro. So even though we manage currency fluctuations via various mechanisms, this year the size and nature of the movements impacted us negatively, at least in terms of an unrealised position.

Despite this we still had by far our best year on record and if you look at our underlying profit which we feel is the best indicator of business performance, it grew by over 50% so it clearly shows that the business is in the strongest position its every been in.

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Transaction revenues are clearly growing strongly and have higher margins. Can you explain how your revenue model works and the importance of transaction revenues?

CEO Sam Hupert

Transaction revenues have now become the cornerstone of our business providing an increasing base upon which new contracts are layered.

The way the model works is that when clients contract with us they commit to a percentage of their examination volumes (transactions) - usually between 70% to 90% of what they would expect to perform in any one year. We call those the minimums, so whether they actually achieve those volumes or not they pay us for those minimum number of transactions. Once they go past these minimums, they pay us for each additional transaction so in effect the minimums provide a floor to the revenue we realise from each client. There is no ceiling.

What we've seen is once a client has been fully implemented they invariably not only go above their minimums, they go above the full volumes that they told us they were doing prior to implementing Visage. Whilst some of this may be due to industry growth, we are seeing an increasing number of clients who have grown by more than this through organic expansion or acquisition and in some cases both.

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North America drove your growth again, with revenue +27.6% to $21.52m, representing 68.10% of your total external sales. This compares to Australia which had external revenues of $8.34m, +28.6% year on year but also had intersegment revenues of $14.38m. Can you explain what is driving the strong external North American sales growth and how the intersegment revenues work?

CEO Sam Hupert
The factors we have previously sited such as exponentially growing data sets and the industry wide adoption of enterprise medical records are driving adoption of technologies such as ours and we see this trend continuing.

The strong North American external sales growth is a result of the implementation of contracts and the increase in transaction volumes these contracts have generated as mentioned above. Given that our contracts are 5 years and in some cases 7 years, we expect this trend to continue. The software is owned by a Pro Medicus company here in Australia so royalties flow from North America back to Australia and tax is paid on those profits in Australia, hence the franking of dividends. Two things that contribute to that flow back is increased sales and the royalties back on those increased sales.

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Australia's external revenue growth of 28.6% for the full year was the strongest by percentage of your 3 geographical segments and ahead of the 26.2% rate of growth it delivered in 1H FY17. What sales mix underpins the Australian revenues and what is driving the growth rate?

CEO Sam Hupert
We are getting more traction particularly with our Practice Management or RIS product. That's the product we redeveloped a number of years ago and it is now starting to show a positive return on investment. We've started to see the first blush of revenue from contracts like the Primary contract but we will see more from it in 2018 as we transition from the planning to implementation phase come the end of the calendar year and the first half of next year. So we'll see the flow on effects of that contract towards the second half of this financial year and hit full speed FY19.

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Europe delivered revenues of $1.74m for the year down, 58.2% year on year. This was a lower decline than 1H FY17 which saw revenues from Europe decline 62.1%, reflecting the fact that there was a large capital sale in 1H FY16. What's the growth outlook and time frame for your European operations?

CEO Sam Hupert
We've always said that we think there are going to be opportunities for us in Europe but that they will take longer than North America and Australia. That doesn't mean we are going to neglect Europe, quite the opposite. We do see opportunities particularly in Germany where we have a business base and have already sold some product. There will also be opportunities in some of the other European countries, but clearly Europe is made up of multiple countries and each one has to be handled differently.

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At the end of 1H FY17 you said you were experiencing your busiest period ever for implementations and that all were on, or ahead of, time. How have these implementations gone? Has this level of implementations continued and what are the implications for both revenues and margins looking into FY18 and beyond? How large an impact will the Mayo Clinic contract have in FY18?

CEO Sam Hupert
It was our busiest time and I'm pleased to say all the implementations went exceptionally well. The largest one in Mercy was ahead of schedule, which was great, good for them and good for us. All of the other implementations that were planned have been successfully completed. Clearly that will help our transaction revenue going forward in FY18 as all of those sites will contribute 12 months of transaction revenue. The Mayo contract that we signed last year, has come on stream at the beginning of the FY18 financial year as planned. It is an 18 month roll out because it is dovetailed into a larger IT project of which we are just one piece. So yes it's all going on schedule.

As we continue rolling out Mayo things will get busy which is to be expected. The good thing is that because we were able to implement some of our other larger contracts ahead of time, we have the capacity to cater for any new opportunities that might come our way, especially those that may want to implement in a tight time frame.

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Looking further out, can you tell us about the pipeline, including some of the larger opportunities in North America that you mentioned in 1H FY17?

CEO Sam Hupert
The pipeline continues to build. There's been a steady stream of RFP's, that are at various stages in the cycle as you would expect including some RFP's that we have just submitted responses to. We're encouraged not only by the volume but also by the spread which includes some larger institutions, some smaller hospital groups and some private groups. So there's a mix across the market which I think is a positive sign.

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Development costs of $6.07 million were capitalised, +8.3% year on year, which is consistent with your first half comment that R&D Spending will decline as a share of revenue. What should we expect for FY18 and onwards? Are you happy with your competitive edge?

CEO Sam Hupert
The R&D spend was well within our budget. Some of the increase was purely due to the Euro to Australian dollar translation, so in Euro currency terms there was a slight increase but as a percentage of revenue our R&D spend went down and we were pleased with that. We still feel we are 18 months to 2 years ahead of the competition and we think that the spend we have is keeping us ahead. We have told the market that if we think that we might lose our competitive edge or there was an area of technology or product where we felt that not having it would cause us to lose sales, we will invest in that.

We've also in the last half year been able to bring out a new product, which is the Visage Open Archive. From a cost perspective, it was a product we had in that we had spent the R&D on it in the past and so could commercialise without significant additional expenditure. All in all we think we're in a good position in terms of our technology edge and level of R&D spend. With growing revenues for FY18, R&D will continue to decline as a % of revenue.

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You introduced a new remuneration structure during the year. Can you explain how it works and how it aligns management and shareholder interests?

CEO Sam Hupert
We first introduced an LTI program 5 years ago. That program has come to the end of its cycle and it has been very successful. The idea is to extend it to senior management in Australia, North America and in Europe and build on that plan for the next 5 years and going forward. So the new plan really is built on the first one-It's a super set. It has very much been designed to align senior management of the company with the shareholders.

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Cash from operations of $14.83 million for the year was up 31.8%, which is slower than the growth in NPAT. What were the key reasons for this?

CEO Sam Hupert
The key reason was that we paid about $4.5m in tax during the year. If you added that on top of the $14.83 million I think the growth in profit and the growth in cash would be pretty much equal. So we think it was a pretty balanced result and are pleased that total cash grew significantly as well. This gives us a bit more flexibility in terms of what we can do with that cash moving forward.

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The final dividend increased to 2.5 cents per share and is fully franked, which contrasts to the first half dividend of 1.5c that was not franked. What level of dividends should we expect going forward

and can you continue to fully frank them given your strong cash generation and rising stockpile of cash, which was $22.78m at year end, up from $17.11m at the end of FY16?

CEO Sam Hupert
At our last AGM we told our shareholders that we were looking to get back to a fully franked position in FY18 and we have managed to get there six months earlier. Having paid the tax that we talked about above our franking account has built up substantially so we are anticipating paying fully franked dividends from now on.

In terms of retained cash, again it gives us flexibility and there are three areas we will look at. One is return to shareholders, which we have increased this year. The second is reinvestment in the business and we have indicated that over the next six to twelve months there may be some more special, longer term projects. If there is a need for capital for those it would come out of retained earnings. The last thing is M&A. If there are any opportunities that make sense, then having cash gives us some flexibility. So again we will balance between those three requirements.

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What are your growth options in terms of new technology and M&A?

CEO Sam Hupert
There are a few things. Firstly, we are always developing our technology and we've talked about Enterprise imaging and Visage Open Archive as extensions of our current technology that we would look to offer to our large enterprise clients. We see these as more near to mid-term opportunities.

We are also looking at some longer term "over the horizon" investments which would commercialize in 2 to 3 years. This would be in areas where we think radiology and visualisation of medical images are going. Finally with cash reserves and no debt, if we think anything makes sense from an M&A perspective, especially where we could add value to that offering through our technology platform and or our client base, then we would seriously look at it. So we do see a broadening horizon both through new technology development and possible M&A.

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Thank you Sam.

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