CEO on Update

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing®, Sam discusses:

- Financial results for the six months ended December 2017
- Ongoing increase in the company's recurring revenue base and the positive impact on margins
- Record pipeline both in terms of quality and quantity
- USA market share and scope for further growth
- Increased dividend pay-out and full franking
- Pro Medicus' capacity to implement greater volumes of work

Record of interview:

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Pro Medicus announced an after-tax profit of $5.07m, up 5.7% year on year for the first half of FY18 and underlying profit, which excludes currency movements, of $5.42m, +33.0% year on year. This again reflects an increase in margins, as revenues were up by 9.0%. Can you tell us what drove the margin and revenue growth and also explain how FX movements impacted the headline result?

CEO Sam Hupert

Margins went up period on period as we had forecast and this was largely as a result of the increased revenue we derive from North America. This was underpinned by the strong growth in our transaction revenues which are high margin and recurring. We also have our biggest single expense in the first half which is the RSNA trade show so we expect the margins in the second half to be greater and are therefore well positioned for overall margins to continue to improve for the full year.

Transaction revenue was also a major contributor to overall Group revenue which continued to grow year on year despite the lower level of one-off professional services in this half compared to the first half of FY17 which, as we said at the time, was the busiest period for installs in our company history.

In terms of FX it was truly a tale of two different halves. In the half-year ending December 2016 we made an unrealised FX gain of $1.0m, compared to an unrealised FX loss of $0.50m, for the half ending December 2017. This was despite putting in measures to mitigate the effect of currency which were only partially successful due to the extreme volatility at the end of the period. The delta was $1.5m which even though it is unrealised, reduced our growth in net profit to 5.7% despite underlying profit increasing by 33.0%.

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Given the high volumes of contracts you've won in the prior 12 months, should we have expected an even stronger level of growth in this half and how is the pipeline positioned for the next 12 to 18 months?

CEO Sam Hupert

As mentioned above, the six months to December 2016 was our busiest period when it comes to implementations, so even though we had a solid level of professional services in the half ending December 2017, it was lower year on year, but this delta was more than made up by the growth in transaction revenues. Having said that, we know that we will have another step up in professional services in the second half due to Yale New Haven Health and Mayo Clinic.

In terms of contract wins, we won an unprecedented number of contracts in the 12 months to July 2016 and we went to lengths to tell the market that this was not the norm. Clients come to the market in their own time and the sales cycle can be anywhere from six months to 3+ years, so it is always going to be difficult to predict the timing of when opportunities turn into contracts.

We won Yale New Haven Health, a key contract in the first half, so our win rate is greater than 75% of the major contracts that we've bid on. Of the few where we weren't successful, each one went to a different competitor. So whilst I'm sure there are contract renewals in the industry that do not go to RFP, there is not a single competitor or group of competitors getting a material share of the contracts we compete on.

As to the pipeline, we've had some of our best lead generation both before and after RSNA, so even accounting for Yale New Haven Health, which has now moved from an opportunity to a contracted client, we think our pipeline is most probably the best we have had both in terms of quantity and quality of prospects and it is continuing to grow.

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Can you explain how contract implementations impact earnings early in their implementation and over their whole life cycle?

CEO Sam Hupert

Our US revenue comprises a mix of professional services and transaction revenue.

In the early stages of a contract, most of the revenues come from professional services which include project planning and implementation etc. This revenue is recognised as the services are provided and is largely one off. Post implementation the vast majority of revenues are transaction based. These are recurring and represent roughly 85% to 90% of the total contract value and are spread over the contract period which typically is for 5 to 7 years.

The split between these two forms of revenue can vary from half to half particularly if we have a heavy implementation schedule in a half but longer term we anticipate that transaction revenue will continue to grow as a percentage of the total as more and more clients come on board.

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Dividend for the first half of FY18 was 2.5 cents, +66.7% year on year, and was fully franked. This compares to 1.5 cents unfranked for the first half of FY17. What does this signal for the full year and ongoing level of dividends and franking?

CEO Sam Hupert
Our franking account has been replenished which as we've said previously occurred approximately 6 months earlier than we had foreshadowed to the market.

We've also reached a level of cash holdings where our board is comfortable in terms of our ongoing requirements for R&D and other investments in our business. So in terms of returns to shareholders, we felt this was an appropriate dividend level taking these factors into account.

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You've been growing your North American revenues strongly for a number of years now, with this half +17.2% to A$11.24m. Where does this position you in the USA market in terms of critical mass and further room for expansion?

CEO Sam Hupert

We have most probably gone further, faster than most people would have thought in the US.

But if you calculate market share by the total number of radiology exams performed across all sectors, we think we are still under 5%. Having said that it is also a matter of quality. If you look at the rollcall our clients such as Mayo Clinic, Yale New Haven Health, University of Florida, Mercy and Sutter Health to name a few, they're not only large but also blue ribbon clients and they give you a more visible footprint in the market.

This being said, we think there is still a huge amount of runway ahead of us not only in terms of new clients but also the potential of selling new products to existing clients. We are more towards the beginning of our journey than at the end.

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All of your deployments were on or ahead of time. As you continue to grow and win larger contracts, do you have the capacity in the USA to maintain the very strong track record that Pro Medicus has of implementing on or ahead of time?

CEO Sam Hupert
We are confident that we have the capacity to maintain our track record. We have proven that we can implement in a third to a quarter the time of our competitors. This rapid implementation methodology means that our people can get the job done and then be re-deployed to other jobs. A six month implementation doesn't mean we are on site for six months. We will be on site for a few weeks during the go live for the first region and then come back a month later for a few weeks to do the next region etc. So we have a lot of flexibility in how we can cater for our implementations. We have also expanded our headcount in this area in anticipation of increased demand. So we are comfortable that we have the resources to not only implement the work we have won, but importantly any new contracts we may win.

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Changes in USA company tax law relating to the repatriation of offshore income back into the USA have generated a lot of headlines. Is there any impact on Pro Medicus?

CEO Sam Hupert
When we first acquired Visage in 2009 we had tax credits in the US but these have been offset over the years by the growth in our US business. Based on our current understanding the new laws dealing with transfer pricing pertain to companies with more than US$500m in revenue in the US so at this stage we don't believe there is any direct impact on Pro Medicus from these recent changes.

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Europe segment revenues of $3.81m were +20.0% year on year, while external revenues were +47.6% and segment EBIT for Europe of $0.69m was +14.2% yoy. What were the key drivers of the revenue growth and why did margins decline?

CEO Sam Hupert
In Europe we made a number of sales which are typically sales to smaller hospitals and institutions, a trend we expect to continue. As we've said previously though, it is a more fragmented market than the USA, so it will take longer to grow our business there. That said, the fact that we are making sales and spreading the word about our technology, particularly in Germany is as a positive.

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Australia segment revenues of $11.24m were +7.6% year on year, while segment EBIT of $5.39m was -10.8%. There are some significant inter-segment sales and R&D included in these numbers, and you have commented you were satisfied with the Australian performance. Can you help us understand what is happening behind the numbers for Australia including the roll out of new contracts such as Primary?

CEO Sam Hupert
The increase in intersegment sales for our Australian business was driven by increased royalties received from our North American and European entities. Capital sales in Australia declined slightly but were within expectations and we are yet to see the impact of the Primary rollout which starts in the next few weeks. It has an estimated time frame of 12 to 14 months so will start contributing to revenue in the second half of FY2018 as planned.

There was also a slight increase in costs as we ramp up for the Primary rollout and the majority of the $1.5m swing in unrealised FX movements which we discussed above is also taken into the Australian result.

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How far ahead of the competition do you think the Pro Medicus/Visage technology stack is currently and how does your AI offering fit into that?

CEO Sam Hupert
We've previously said we feel we're around 18-24 months ahead of our competition and we still think that is the case. We have continued to invest heavily in R&D to ensure our products remain at the forefront and will continue to do so. We believe we have a truly leading edge offering and we think that our track record in terms of contract wins supports this view.

As for AI, it has a number of applications for us. One of them is within the product itself. We believe Visage 7 is one of the most automated products currently available but some functions are still "semi-automatic". With AI, it may be possible to automate things even further to the point that they are fully automatic, things such as volume measurement of tumours or hot spots on a PET scan. This will serve to improve radiologist accuracy and productivity even further.

On top of that we think our platform is inherently better than others in terms of visualising the output of various diagnostic algorithms be they algorithms that we create or those created by a third party. Our platform is completely open, and we think that will enhance the attractiveness of the product set for potential buyers.

So in the medium to longer term, AI will have a significant impact both in terms of the feature function we are able to give in our own product set and the ability to integrate algorithms be they ours or someone else's further differentiating us from the others

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Thank you Sam.

For more information about Pro Medicus, visit www.promedicus.com or call Sam Hupert on (+61 3) 9429 8800.

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