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ASX Announcement :

CEO on Update

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing®, Sam discusses:

- Financial results for the year ended 30 June 2019
- Strong cash flows and increased dividend payout
- Record pace of implementation for Partners Health
- Strong pipeline and capacity for implementation of new contracts
- Technology lead versus the market

Record of interview:

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Pro Medicus announced a record after-tax profit of $19.1M up 91.9% year on year for the FY19 year and revenues were up 47.9% for the year to $50.1M. What drove your revenue and profit growth?

CEO Sam Hupert
All three of our divisions performed well this year which drove revenues, margins and therefore profits higher.

In North America, which is our biggest market, the key driver was the significant lift in transaction revenue, which grew 43.5% year on year. Europe benefited from the capital sale in the first half and in Australia we started to see the benefits flowing from our I-MED and Healius (previously Primary Healthcare) rollouts.

Expenses were in line with, if not slightly less than, expectations which also helped.

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In the director's report, you've mentioned that costs are relatively fixed. Margins have risen with revenues growing much faster than costs, but the company's accounts do show some increase in operating costs. What drove this?

CEO Sam Hupert
The increase in operating cost was expected for two reasons.

Firstly, as we said we would, we have incrementally increased headcount in both R&D and in the US as we continue to grow our revenue base there.

The second thing is that R&D for our Visage 7 suite of products is done in Berlin so a large part of our R&D expense is incurred in Euros. The Australian Dollar falling against the Euro, means higher cost in Australian dollars.

That said, our costs were less than we had originally budgeted for and as a percentage of revenue continued to drop reinforcing our view that our business has strong operating leverage.

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If we look forward, how much more capacity is there for margins to continue growing? Or looked at another way, have revenues been growing at a similar pace to transaction volumes and how many more transactions can the business handle with the current business infrastructure?

CEO Sam Hupert
With margins, we said at the half-year that our near-term goal was the 50% mark and we've done better than that with full-year margins at 51.6%. So that is very pleasing. We still see room for further growth, but obviously as you get past 50% there is less headroom.

Revenue was largely, but not solely, driven by the strong increase in transactional revenue, which was up 43.5% but total revenue grew by 47.9% with the delta due to solid performances in Australian and Europe.

Scalability is a key component of our offering so yes; we believe we can handle significantly more transactions with the same business infrastructure, and I think this year (FY19) was a good case in point.

We see these additional transactions coming from three areas. The first is by increasing our footprint by winning new clients. The second is by our existing clients growing their business and with our transaction-based model the more they grow, the more we grow. And finally, we are offering new add-on products such as Visage Open Archive which has already started to contribute to our overall transaction revenue.

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At the half-year you indicated that you expected a strong cash result in the second half. Cash from operations for the year of $24.7M was ahead of net profit of $19.1M. This is despite an increase in trade and receivables of $17.9M, that's up 2.4 times year on year, and total deferred revenue at 30th of June 2019 was $22.9M, plus 37.6% year on year. What should we read into these numbers?

CEO Sam Hupert
Cash reserves increased 28.0% to $32.3M for the year which is another key metric that has moved in the right direction. We did say at the half that we had collected a receivable just after the first half balance date of 31 December 2018 and on top of that we were expecting to build on our cash reserves in the second half which we were able to do.

In terms of the receivables, there were two factors that make up that figure. Firstly, as we have greater revenues, you'd expect greater receivables. Secondly, we had a number of invoices that were sent out in June. We didn't expect that they would be collected before the end of the financial year, but we do anticipate that they will be collected in the first quarter of FY20.

The movement in deferred revenue is largely due to new accounting standards. This has no impact on our cash position, but it does impact on how we report revenues and associated expenses for professional services and the capital sales we make.

In the past, these were brought to revenue as they occurred however the new accounting rules require us to spread the revenue from these across the life of the relevant contract. So deferred revenue is something that you will see going forward in all of our accounting as part of this new standard.

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The company's cash balance was $32.3M at the 30 June 2019 and that's after covering a 91.1% increase in cash dividends paid versus the 91.9% increase in NPAT. What is your dividend policy, and could you pay out a higher percentage of profit?

CEO Sam Hupert

This was an unusual year, with us paying a special dividend in May, which at the time we said was an advance on the final dividend. At financial year end, we reviewed where the business is at and decided that in addition to the advanced dividend, we would pay a final dividend, thus lifting the total dividend payout for the full year.

As a board, we review our dividend payout every half taking into consideration a number of factors. We are comfortable that with this final dividend and increased payout we have more than enough retained earnings to fund further growth and also to look for other opportunities.

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In calculating the underlying profit of $22.7M, that's up 83.1% year on year, you've had to adjust for the impact of some changes in the accounting rules and currency gains. Can you talk us through the impact of these accounting changes on reported earnings?

CEO Sam Hupert

Yes, as discussed above, the main change is how we bring to account our revenue for professional services and also capital sales. In the past we would invoice professional services based on milestones with revenue booked as these milestones were achieved. Now we still invoice and get paid based on those milestones, but the revenue is recognised across the life of the contract. That's the largest change. There are also changes on how we account for capital sales, which are a smaller part of our revenue. License revenue, will in most cases now be recognised across the life of the contract rather than being taken up as revenue when the software is installed. The net effect of these two changes is purely the timing of revenue recognition.

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Can you remind us of the details of the Duke Health and Partners Health contracts and who these groups are? What is the status of these implementations and what revenues were included in the FY19 results from these contracts?

CEO Sam Hupert

Partners, which we signed in November 2018, is our largest deal to date and is one of the largest health systems in the country employing 75,000 people. It comprises three components, Massachusetts General, which is rated number 2 hospital in the US, Brigham Women's, which is rated number 13 and a number of other community and other hospitals within the Partners group. The contract is for $27M over 7 years, but that is just for Phase 1 which is Massachusetts General and Brigham Women's. I'm pleased to say that implementation has gone "at record speed" and we have already completed over 95% of that implementation with only one department left to go where we are waiting on a third party to complete some work before we finish.

Duke Health is the largest healthcare provider in the state of North Carolina. It is a part of Duke University, and is a tier one academic, as is Partners. The Duke deal was signed in April 2019 and will be implemented early in the second half of FY20.

Importantly, neither of these deals contributed any revenue to FY19, it is all ahead of us. Even though we've done the bulk of the implementation for Phase 1 of the Partners deal, under the new accounting standards, the professional services revenue will only start in FY20 and will be spread over the next 7 years. Transaction revenues from Partners started in July of this year and will be a significant contributor for about eleven months of FY20. We expect revenue from Duke to start early in the third quarter FY20 and build transaction revenues on top of what we get from Partners.

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With these very large implementations now complete, what spare capacity do you have to implement further new contracts? What's the status of the pipeline and does that include further work from other members of Partners Health or other major hospital operators?

CEO Sam Hupert
We've pretty much completed Partners, at least phase one which was the biggest phase so whilst we still have Duke and other smaller work that always goes on in the background, we have the capacity to take on new clients and implement them as soon as they are ready which is where we want to be.

As for the pipeline, it remains strong. We had a large intake of RFP's in the last part of calendar 2018 and the first half of 2019. It was one of the strongest we've had. As Duke and Partners transitioned from the pipeline to contract we have been able to backfill the pipeline with other opportunities. As is to be expected, the opportunities are at different stages of the cycle but we are happy with both the quality and quantity of what we have.

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Where does Pro Medicus' technology stack stand versus your competitors? Previously you've estimated you had an 18 to 24 months lead on the competition.

CEO Sam Hupert
We believe we are still well ahead. We are not aware of anybody who has been able to successfully bring out a streaming platform that works in large scale production like ours. Quite the opposite. We hear that some competitors who have purported to emulate us have found it far more difficult than they initially thought.
This is a dynamic market and things could change quickly but we are not standing still either.
We continue to invest heavily in R&D and are constantly adding new feature/functionality to the platform to make sure that we maintain our lead. We also believe we are very well positioned in the emerging field of artificial intelligence (AI) and think we have a number of unique assets in this area, both technological and in terms of our user base. So yes, I think the 18 to 24 months lead is still a very realistic estimate.

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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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