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CEO on FY2014 Results

Open Briefing interview with CEO Sam Hupert

Pro Medicus Limited
450 Swan Street
Richmond VIC 3121

In this Open Briefing®, Sam discusses:

- US contracts starting to contribute to earnings, cash flow
- Major new US contract to have positive impact going forward
- Strong cash position, outlook for cash flow growth

Record of interview:

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Pro Medicus Limited (ASX: PME) today reported net profit after tax of $1.51 million for its continuing operations for the year ended 30 June 2014, compared with a loss of $3.48 million in the previous year. The previous year's result included an after tax impairment expense of $3.22 million relating to capitalised development costs. FY2014 EBIT was $2.27 million, up from a loss of $0.52 million, with the second half bringing EBIT of $2.15 million compared with $0.12 million in the first half. What were the key drivers of the strong second half and is the earnings growth sustainable?

CEO Sam Hupert
The key driver was revenue from new contracts in the US, particularly vRad and VISN23. As we foreshadowed when we announced our first half results, those contracts have had a material impact in the second half. The vRad contract contributed only a little revenue in the first half, but more in the second half. We also got our first tranche of revenue from the VISN23 contract in the second half.

We believe the growth is sustainable, given growing revenue from our existing US contracts, and the start of revenue from the new contract with the large US health system we announced in April. The contract is structured on an operational model, based on transaction numbers, so revenue will grow as our product is installed across more of the customer's network. This means we should see revenue building toward the second half of this year as we implement this contract.

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Your North American business reported EBIT of $0.36 million, compared with a loss of $0.12 million in the previous year. Revenue was $5.31 million, up 85 percent. Revenue rose to $3.68 million in the second half, up from $1.63 million in the first half, reflecting the contributions from the vRad and VISN23 contracts. To what extent is the second half revenue representative of the expected contributions from these contracts once your products are fully implemented?

CEO Sam Hupert
The interesting thing is that the two contracts are structured under different models. The vRad contract is an operational model, whereas VISN23, being a government organisation, chose a capital model, where much of the revenue is paid up-front with the sale of the licenses and implementation of the products. This is traditionally how we structured our contracts before we introduced the operational model.

Some revenue from the VISN23 license sale and product implementation fell in the second half of FY2014, and some will fall in the first half of FY2015. There is then trailing revenue from support and maintenance that continues over the contract life. In contrast, under the operational model, revenue is more evenly spread over the life of the contract, with the potential for growth in the later years if transaction volumes increase.

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The level of earnings in the US seems disappointing in light of the strong revenue growth. Can you comment on how US earnings might be impacted as revenue grows over the medium to long term?

CEO Sam Hupert
First, our fixed costs in the US business were higher given we expanded our team there to cater for these new contracts and position us to address new opportunities. Second, the intellectual property (IP) for all our products is owned by our Australian entity, so our cost of doing business in the US includes royalties paid back to Australia. Going forward, we expect earnings in the US business to increase as revenues grow and the operating cost base decreases as a proportion of revenue. And we know revenue is going to grow given the contracts we already have. Hopefully that effect will accelerate if we win new contracts.

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The new contract you announced with a major US health network is expected to generate revenue of over $20 million over its six year life. What is the progress in implementing the contract and how will it impact your revenues in the current year and beyond?

CEO Sam Hupert
The project is on track, which is very pleasing as it's a large contract with a very big organisation that has a large number of radiologists, hospitals and imaging centre facilities. It may take 12 to 14 months to roll out Visage 7 across the organisation just because of its size and geographical distribution.

Revenue from the contract will start in the current half and will build as we roll out the product to more and more sites. Given the contract is transaction based, we won't see the full impact of revenue from transactions until the roll-out is complete, which is scheduled for the first half of FY2016.

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What further opportunities are you seeing in the US market? What are the drivers of demand in the market and do you have adequate resources to meet the expected demand?

CEO Sam Hupert
The US is our most buoyant market in terms of the number and size of opportunities we're actively engaged with. And the US is not just one market, its multiple markets, from large enterprise health players and health systems, to the private imaging centre market and the corporate remote reading or tele-radiology groups like vRad. We're pleased to see there are opportunities for us in all of those markets because our product is well suited to their various needs. We really can address the whole spectrum of radiology businesses and not just a part of it, as is the case with our competitors.

There is no doubt that major contracts we have just won have had a positive impact on the number of opportunities we're being invited to tender for which is great. As you'd expect, our pipeline includes opportunities at various stages of maturity – from those where discussions are just beginning to some that are getting close to final decision. The fact that our pipeline is growing is a healthy sign.

Regarding resources, we've increased our staff numbers in the US and we plan a further increase. We believe that will be a very good investment for us given we have such unique technology and that we now are starting to get the attention of the market. We want to ensure we can fully address every opportunity that comes our way.

One driver of demand for our product is the near exponential increase in the size of the data sets generated by modern radiology equipment, for example breast tomosynthesis, which is like 3D mammography and generates massive files as big as 6 to 8 gigabit per examination. Our technology is well suited to handling those huge data sets whereas traditional technology struggles with them.

Another driver of demand is that customers are increasingly seeking out best of breed product for the components of their enterprise systems or what we call “deconstructed PACS”, whereas in the past they were forced to buy a single vendor solution. Our products are the ones the radiologists and clinicians use: the diagnostic layer and the technology that distributes to the referring clinicians. It sits on top of a VNA or Vendor Neutral Archive which is an image storage bank supplied by another third party, and this new approach is creating a whole new market opportunity for us. The large health system we recently won took this approach: it was looking for best of breed solutions and in radiology, Visage really stood out.

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The Australian business booked EBIT of $1.18 million, a turnaround from its EBIT loss of $0.74 million in 2013. Revenue was $6.15 million, up 12 percent. The Australian business also performed more strongly in the second half, when EBIT rose to $0.92 million from $0.26 million in the first half, on revenue of $3.26 million versus $2.89 million. To what extent are you seeing take-up of the integrated Visage-Visage RIS (radiology information system) product by new clients in Australia and what are the growth opportunities in this market?

CEO Sam Hupert
Some of the turnaround in Australia was due to the receipt of royalties on our increased US sales. However, the performance of the underlying Australian business also improved, which was pleasing.

We saw an increased number of groups who bought both our new RIS and the Visage PACS products which together make a compelling solution. The whole is really greater than the sum of the parts. Over next 12 months we will be transitioning all of our Australian clients who have our traditional RIS/practice management product to the new RIS platform. We think this will create a good opportunity for us as many clients are coming to the point where they will need to update their existing PACS systems and Visage PACS is a perfect fit.

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The European business booked EBIT of $0.73 million for the year, up from $0.34 million, on revenue of $2.81 million, unchanged from the previous year. However, operating cash flow for Europe was negative $2.87 million, a deterioration from negative $1.57 million in the previous year. What is your strategy for Europe, given sales have been stagnant, cash flow negative and the market structure is very different from your key Australian and US markets?

CEO Sam Hupert
The European office has some sales and costs related to those sales but the more important part of the business is that it’s the home of the Visage products and also the R&D base for Visage. So the cash flow of the European business reflects R&D spending on Visage for the whole of Pro Medicus.

That is not to say that we’re ignoring Europe, but at the moment we’re focusing our sales efforts in the US simply because we’re seeing many opportunities opening up there for us. Having said that, success in the US should help us with sales in Europe, particularly to the larger institutions such as major hospitals as they often look to the US in terms of technology trends. Being able to show them large reference sites using this new “deconstructed PACS” model will be a big plus. But Europe is not a homogenous market and will likely take longer to get a foothold in, so realistically we think that the possibility of material sales in this region will be 12 to18 months away.

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In FY2014, sales of RIS products totalled $5.94 million, up 2 percent, while sales of PACS products totalled $8.31 million, up 58 percent. Are sales of the new RIS product meeting your expectations? How do you expect sales of the two product sets to trend over the short to medium term?

CEO Sam Hupert
Growth in sales of PACS products reflects our growing sales momentum in the US. For our new RIS product, its early days but we now have a base and we're building on that. As I mentioned earlier, with clients moving to the new RIS product over the next 12 to 18 months, we think there's a great opportunity for us in the medium term as their existing PACS comes up for renewal.

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Pro Medicus booked net cash flow from operations of $4.23 million in FY2014, up from $3.81 million in the previous year, with increased working capital partly offsetting operating earnings growth. To what extent do your new contracts in the US require a relatively larger call on working capital than in the past? What is the outlook for operating cash flow as the large new contracts ramp up?

CEO Sam Hupert
We don't expect too much call for working capital. Even though under the operational model it may take longer for revenue to build up, during the initial stages we're able to charge and are paid for our professional services such as training, project planning and implementing the solution. Then as we implement systems under the operational model, they will generate recurring revenue year after year, and that will have a positive impact on our cash flow. The large contract we've just won will start to have a positive impact on cash flow this financial year during the phase-in period, with the full impact in FY2016 and onwards.

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Pro Medicus's reported capitalised development costs of $5.16, million, up from $3.24 million. What have been the key targets of this investment? Has R&D spending peaked?

CEO Sam Hupert
This increase is due to a number factors. Firstly, we've flagged for some time that we'd continue investing in R&D. That increase in investment last year was roughly split between R&D on our practice management/RIS product in Australia, and R&D on Visage in Berlin to ensure the product maintains its leading edge position.

Secondly, there was a foreign currency impact as a significant portion of our R&D is done in Berlin and even though the net figure in Euro did not change significantly it did in Australian dollars due to the strengthening of the Euro during the period.

Finally, there was an increase in our amortisation which was expected, but also in our capitalised costs due a slightly different accounting treatment, recommended by our auditors, where we've now capitalised some product development costs that had previously not been capitalised.

Going forward, we're comfortable with this level of spend, which may decrease with the maturity of the products, so we don't expect any material increase in R&D spend going forward.

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As at 30 June 2014, Pro Medicus had cash in hand of $15.26 million, down from $18.02 million, reflecting negative free cash flow and the payment of $2.01 million in dividends. With

more than a year having passed since you received the cash from the sale of Amira, and no acquisitions in sight, what are your current plans for utilising this cash?

CEO Sam Hupert
We expect free cash flow to increase now the US contracts we've won are coming on stream. We're hopeful this will allow us to cover our operating and working capital needs.

In terms of investment, we expect our investment in R&D to stay roughly at its current level or maybe slightly less, and while we'll look to build up our team in the US, we believe that should be largely self-funding. The question is whether we should make an even greater investment in our US team to make sure we stay ahead of the demand and not miss any opportunities.

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Pro Medicus has declared a fully franked final dividend of 1.0 cent per share. This brings the full-year payment to 2.0 cents, the same as last year. How will you seek to balance continuing returns to shareholders with the funding demands of growing the business?

CEO Sam Hupert
Like everything, it's always a delicate balance but we feel at this stage we're in a good position. Our cash balance is strong and we have no debt. We also have an increasing number of transaction based contracts that are either on stream or coming on stream so as I said earlier, our cash position should build from here and give us flexibility going forward. How much you reinvest in growing the business versus how much you return to shareholders is something we as a Board constantly review but clearly the US business is the prime focus for us and is where we look to make the majority of our investments in the near future.

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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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