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CEO on H1 Results

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing® Sam discusses:

- Progress on Implementations
- Recurring income streams from contracts in the US
- Impact of one-off costs on earnings
- Sustainability of free cash flow and increased dividend

Record of interview:

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Pro Medicus Limited (ASX: PME) today reported net profit after tax of $2.94 million for the first half ended 31 December 2015, up 83 percent from $1.61 million in the previous corresponding period (pcp). Revenue rose 66 percent to $14.26 million, and underlying profit before tax excluding currency gains and one-offs increased by 197 percent to $5.06 million driven by the North American business, where sales more than doubled versus the pcp to $8.31 million. You've stated that three of the large operational contracts you've won in the US in recent years have been implemented. To what extent does the first half result reflect a full, recurring income contribution from these contracts?

CEO Sam Hupert
We've flagged our expectation that North America would become an increasing part of our revenue stream and this result confirms that trend.

We were extremely pleased with the performance of our US business during the half. In addition to winning a significant contract, the team has done a great job in implementing a number of the key contracts we've previously won. These are large and complex implementations so being able to successfully complete three of them in a six-month period is a real testament to the quality of the software and the efficiency of the team.

In terms of revenue contribution, one of the implementations was completed early in the period so pretty much made a full contribution, whereas the other two were completed part way through the period, so while they contributed, it was not for the full six months.

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Do you expect these existing contracts to continue to generate revenue growth, or will future growth be reliant on winning new contracts?

CEO Sam Hupert
Realistically, we believe it will come from both.

Our forward contracted revenue over the next five years now totals more than $60 million based on contract minimums so there is inherent room for growth in all of these contracts. It is our expectation that once a system is fully live, we'll pick up the delta between a client's committed minimums and their normal examination volumes. We'll also pick up any growth in their business over the contract period which could be organic, via acquisition or both.

In addition, we think we're well placed in terms of future contracts, so if we win them, we'll further add to our future revenue streams.

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What are your prospects in regard to winning further large contracts in the US? Are there still opportunities for your products in the enterprise imaging/major hospital or private imaging centre markets? What is the current pricing and competitive environment in the North American market?

CEO Sam Hupert
As we said at our AGM, our North American pipeline has grown substantially over the past 12 to 18 months. Many of the opportunities that were in the pipeline then have progressed and new opportunities have been added, so we believe our prospects of future contract wins are positive. The other good thing is that our pipeline is diverse – we're in negotiations under some large enterprise requests for proposals (RFPs), as well as with a number of major imaging groups and other entities so the opportunities are spread across multiple market segments.

North America is, and always will be, a highly competitive market so as you would expect we're seeing competition from everything from the big multinationals all the way through to some smaller players who claim they can do part or all of what we do. Despite this we've been able to grow our margins which I think is proof that our technology is different. The fact that we are known in the market as a result of recent contract wins, coupled with the implementations we've successfully completed, no doubt helps. We now have a growing pool of reference sites so prospective clients can see our technology in a live environment and speak to our clients. This definitely gives them a better understanding of the value we deliver.

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Cash expenses increased 42 percent versus the pcp. There was a significant increase in salary and employee benefits expense, but also in advertising and public relations, legal, and travel and accommodation costs. To what extent did these cost increases relate to the North American business? Will further significant cost increases be required to continue growing the business?

CEO Sam Hupert
Roughly $750,000 of the total cost increase was due to one-off expenses. These related mainly to staff costs. For example, we made some planned redundancies of people working on legacy products overseas. This reflects our view that our future is very much with the Visage 7 product set rather than our legacy products.

If you strip out the one-off costs, our ongoing cost base increased by $1.4 million or 27 percent. This was largely related to growth in the US, where we increased our headcount in order to align our capabilities with the growth in contracts we've won. We also increased our advertising spend to have a bigger presence at the Radiological Society of North America (RSNA) annual meeting and spending on legal fees to compete for large contracts, particularly at the enterprise level. We believe these investments are prudent in order to build up our capability in the US market, and we're confident revenue growth will continue to far outstrip cost growth going forward.

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The Australian business booked EBIT of $3.26 million, up from $1.32 million in the pcp. Revenue was $3.24 million, down 3 percent, suggesting Australian EBIT growth was driven by royalty income from North America rather than product sales to local clients in Australia. What is the outlook for sales in the local market?

CEO Sam Hupert
Yes, Australian EBIT growth was largely driven by royalty income which was expected.

We've consistently told investors that we expect the Australian business will be status quo for some time. This is a function of a couple of factors. First, the recent increase in radiology group corporatisation and M&A activity has meant major IT infrastructure purchasing decisions are being put on hold whilst the dust settles. Second, the recent campaign by the Government and Medicare to reduce healthcare costs, including diagnostic radiology costs, is having a negative impact on investment decisions and this will also take time to wash through the system. Whilst it is extremely difficult to predict the timing of this we believe it will be more mid-term than short-term.

Regardless of when the market turns, we think there will be opportunities for us when it does.

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The European business booked EBIT of $1.03 million for the first half, up 38 percent, on the back of revenue of $2.72 million, up 75 percent. To what extent did the European result reflect a contribution from the contract with a large German government hospital, which you announced in November last year? What further opportunities are there for your products in the European market?

CEO Sam Hupert
Our European office has primarily been an R&D centre with some sales functions. It's done an exemplary job, but we're looking to expand its sales capabilities. The German contract was the first result of this. It had a positive impact on our European revenue in the half, and will continue to contribute, in terms of its related five-year service contract.

We're hopeful we can use the German site as a model/reference site for future sales in Germany, and also longer term, other European countries.

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Net cash flow from operations was $5.73 million in the first half, up from $2.24 million in the pcp. After R&D investment of $2.67 million, free cash flow was positive $3.06 million, versus negative $0.41 million in the pcp. What level of confidence do you have that you can maintain positive free cash flow?

CEO Sam Hupert
We're pretty confident we can maintain positive free cash flow given we have a high level of predictability regarding the future revenues from our existing contracts in the US, and do not foresee our expenses growing as much as revenue.

We acknowledge there was some contribution to cash flow in the first half from the capital sale in Germany, but we believe our recurring cash flows, excluding any capital sales, will still be positive going forward.

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As at 31 December 2015, Pro Medicus had cash in hand of $16.19 million, up from $12.94 million six months earlier. You've declared an unfranked interim dividend of 1.5 cents per share, up from last year's 1 cent. Given that the business has now returned to positive free cash flow, can you comment on your capital management priorities, particularly the appropriate level of cash on hand required by the business at its current stage?

CEO Sam Hupert
Our position is always fluid and depends on balancing three things: returns to shareholders, retaining funds for potential M&A opportunities, and retaining funds for the cash requirements of our growing business. We had a good first half and think we are well placed with our forward contracted revenue plus there is the prospect of new sales so we felt we were in a good position to increase our dividend.

Certainly we'll review these different needs as we continue to accrue cash. We estimate that our ability to deliver fully franked dividends is approximately 18 months away, so we will most likely also review our dividend policy then.

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A recent entry in the Diagnostic Imaging blog rated Visage Imaging's image streaming technology as market leader, "with a three year head-start". Are there any signs that competitors are narrowing this technological lead? How are you seeking to ensure that your products maintain their competitive edge?

CEO Sam Hupert
It's hard to accurately assess how far ahead a given technology is however we do have a number of good indicators that lead us to believe we're conservatively up to 18 to 24 months ahead of our competitors, so the Diagnostic Imaging estimate is in the ball park. In support of this view is the fact that we've won considerably more contracts then we've lost over the past 18 months despite being in the upper echelon when it comes to pricing. We also didn't see any technology that we felt matched ours at the recent RSNA, the de facto world radiology conference held in November last year. Finally, a few clients trialled other products before finally selecting Visage, which also helps confirm our view.

In terms of ensuring that we stay ahead, our approach is, and always has been to continue to invest in R&D and accelerate our ongoing product development. For example, during the first half we released a number of key product enhancements which have been very well accepted by our user base and which will open up further opportunities for us, particularly in the enterprise/hospital space.

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Given on-going growth in the North American market, what are your strategic priorities for Pro Medicus? Where do you see the most promising growth opportunities?

CEO Sam Hupert
With opportunities in front of us in North America, our immediate strategy is to win as many of the contracts available to us as possible.

As we said at our AGM, we continue looking to expand horizontally, by winning more market share, and vertically, by expanding into non-radiology images included in the electronic medical record such as photos and videos. Visage is ideally suited for all types of images in the large enterprise imaging space.

We also plan to grow geographically, first in Europe and then into other geographies where we think our technology is suitable. Longer term, we may look outside the medical/healthcare space, to other markets where our image streaming and management technology can add value.

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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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