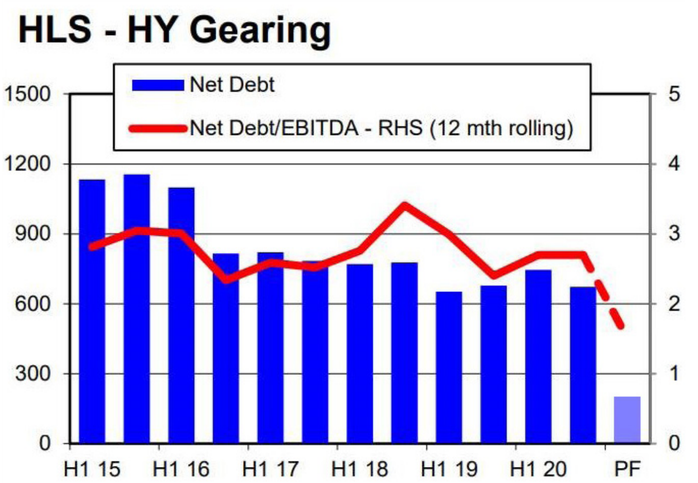
Airlie
Funds Management

Stock Story: Healius

A healthcare company that's shrinking to greatness.

We are always fans of investing in asset rationalisation plays, where businesses are 'shrinking to greatness'. Healius is one such stock in the portfolio. The business formerly known as Primary Health Care, until recently owned medical centres (where GPs are found). This division was a real problem child - soaking up capex and delivering consistently poor returns. In 2020 Healius management bit the bullet and sold the medical centre business to private equity for circa A$500 million. As non-shareholders in Healius at this time, this move automatically garnered our attention. We felt that previously Healius' net debt to EBITDA of more than 4-times was too high for the capital intensity of the business. As the chart below shows, Healius went from over-geared to a company that now has capital management 'options'.



Source: Diogenes Research.

REJIGGING THE BUSINESS TOWARDS PATHOLOGY

Now that Healius has sold its poorly performing medical centre business, it is left with three businesses:

(1) Pathology (about 75% of group EBIT);

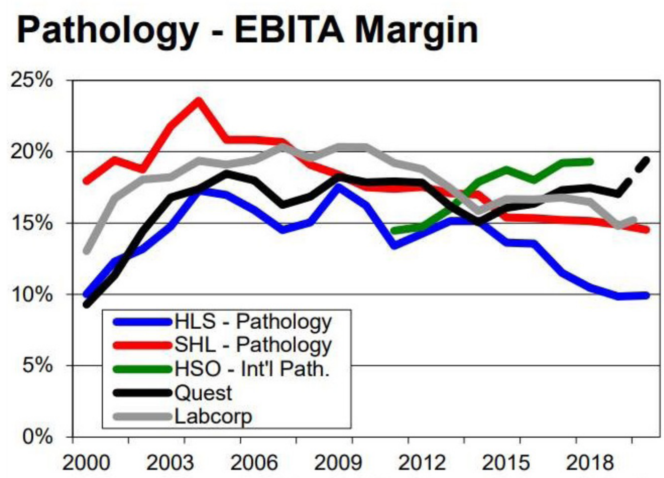
(2) Imaging (about 25% group EBIT); and

(3) Day Hospitals (currently loss-making).

The core driver of future earnings is the pathology division. The Healius pathology business has had basically flat earnings for five years. This is despite very steady 3% to 5% p.a. revenue growth.

PATHOLOGY HAS HAD A MARGIN ISSUE

This has been an industry-wide phenomenon, but the worst for Healius. (Note: Sonic's pathology margin is misleading as it includes international businesses that account for 75% of earnings.)

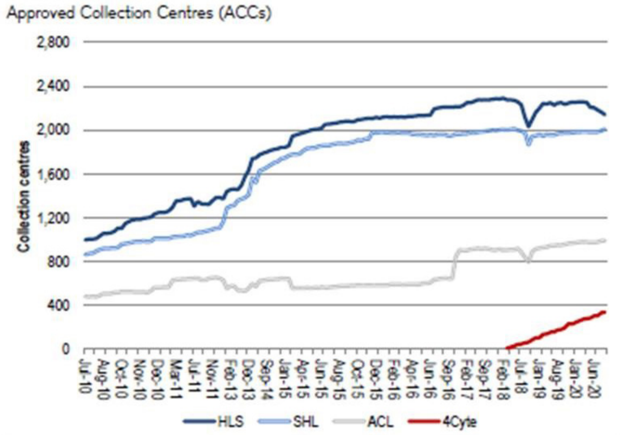


Source: Diogenes Research

The driver of margin pressure has been an arms race to open new collection centres. Healius and Sonic have spent the past five years rolling out collection centres very aggressively to lock in referral volumes, often paying GPs huge rents to have a pathology collection centre opened in their offices.

This dynamic is now changing. Healius has a new, more rational, management team. The company is closing centres. So far, about 170 centres have closed and management has identified another 200 in total that could close. This would bring Healius's centre numbers back in line with peer Sonic (which generates A$1.5 billion in revenue versus Healius's $1.1 billion, hence it makes no sense for Healius to have a higher centre footprint).

Figure 3: HLS reducing collection centres...



Source: Medicare, Company data, Credit Suisse estimates

At its mid-December investor day, management outlined cost initiatives to drive around 300 basis points of EBIT margin improvement in this division. While execution risks remain, we think the risk versus the reward looks attractive.

We believe Healius can grow pathology earnings at 7% p.a. from here, and this isn't a heroic assumption given that industry revenue has historically grown at 5.8% p.a. plus margin improvements. If this occurs, lower corporate and interest costs following the medical centre sale would see group EBIT nearly double over the next four years.

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