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FINAL TRANSCRIPT

Medical Facilities Corporation

2017 Fourth Quarter and Year-End Results Conference Call

Event Date/Time: March 22, 2018 — 8:30 a.m. E.T.

Length: 27 minutes

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PRESENTATION

Operator

Good morning, everyone. Welcome to the Medical Facilities Corporation 2017 Fourth Quarter and Year-End Results Conference Call.

Before turning the call over to management, listeners are cautioned that today's presentation and the responses to questions may contain forward-looking statements within the meaning of the safe harbor provisions of Canadian provincial securities laws. Forward-looking statements involve risks and uncertainties, and undue reliance should not be placed on such statements.

Certain material factors or assumptions are applied in making forward-looking statements, and actual results may differ materially from those expressed or implied in such statements. For additional information about factors that may cause actual results to differ materially from expectations and about material factors or assumptions applied in making forward-looking statements, please consult the MD&A for this quarter, the Risk Factor section of the Annual Information Form, and Medical Facilities' other filings with Canadian securities regulators.

Medical Facilities does not undertake to update any forward-looking statements. Such statements speak only as of the date made.

Listeners are also reminded that today's call is being recorded for the benefit of individual shareholders, the media, and other interested parties who may want to review the call at a later time.

I would now like to turn the meeting over to Mr. Robert Horrar, President and CEO of Medical Facilities.

Please go ahead, Mr. Horrar.

Robert Horrar — President and Chief Executive Officer, Medical Facilities Corporation

Thank you, Operator, and good morning, everyone. Joining me today is Tyler Murphy, our Chief Financial Officer; Jim Rolfe, our Chief Development Officer; and Jimmy Porter, Vice President of Operations.

Prior to market opening today, we released our 2017 fourth quarter and full year financial results. Our news release, financial statements, and MD&A may be accessed through our corporate website at www.medicalfacilities.corp.ca (sic) [www.medicalfacilitiescorp.ca], and are also filed on SEDAR today.

For today's call, I will start by discussing the results of the past year, Tyler will then review the financial performance, and then I will wrap up with some comments on our outlook, after which we will open the call to questions.

In 2017, and has been the case since our inception 14 years ago, our facilities continued to demonstrate their quality and leading market position through increased surgical volume and revenue.

We completed about 36,000 surgical cases in 2017. That's 8 percent more than previous year.

As in previous years, the fourth quarter remains our busiest with about 10,000 in Q4. This was a 3 percent increase over Q4 2016 and with growing (sic) coming primarily from outpatient procedures.

We achieved $385.3 million of revenue in 2017, a 13.5 percent increase over the $339.5 million achieved in 2016. Of this growth, about 30 million was from Unity Hospital and Prairie States Surgical Centre, both acquired in 2016. We achieved 4.5 percent growth, or $15 million from facilities owned in 2016.

Throughout 2017, our focus was on organic and acquisition growth strategies. In terms of organic growth, we focused on expanding our services at our facilities, recruiting positions, and adding access points.

In 2017, we developed urgent care centres in our Little Rock, Arkansas, and Sioux Falls markets. The centre in Sioux Falls opened in Q4 and in Little Rock, Arkansas this past January, 2018. We expect both will increase our outreach in the surrounding communities.

We continue to recruit physicians at our facilities to expand our services. By the end of 2017, we added 17 net new physicians, which included seven orthopaedic surgeons.

Acquisitions were also a priority for us, and we looked at several opportunities and valuated them against our current portfolio to ensure they were aligned in terms of high quality, accretive earnings, and growth potential. We actually walked away from several before we found one that was aligned with our criteria.

Early this year, we announced the acquisition of seven ambulatory surgery centres from Meridian Surgical Partners for $46.5 million. The ASCs are located throughout the US, increasing our geographic diversity, reinforcing our focus on orthopaedic surgery, neurosurgery, and pain management, and most importantly, increasing our investment in the outpatient services space.

As with our other facilities, we have a controlling interest in these ASCs, and all are partnered with local physicians.

An important feature of this acquisition is our partnership with NueHealth, a leading operator of over 50 health care facilities with over 20 years' experience. NueHealth will provide day-to-day management and operations support to the centres, including accounting, recruitment, materials management, payor contracting, and benefits administration.

We expect to see comprehensive synergies from the arrangement, including NueHealth's group purchasing program, which will allow facilities to benefit from immediate supply cost savings through the economies of scale of NueHealth's 50-plus managed facilities.

In addition, this acquisition has a solid platform for further growth. Through the partnership, we have the opportunity to acquire or develop new ASCs in current and new markets. We are excited about the opportunity this presents for MFC.

Now Tyler will provide more details and insight into our financial performance for 2017.

Tyler Murphy — Chief Financial Officer, Medical Facilities Corporation

Thanks, Rob, and good morning, everyone. As on our previous calls, I would like to note that all of the dollar amounts expressed in today's call are in US dollars, unless otherwise stated.

As Rob mentioned, MFC had revenue of $385.3 million last year, a 13.5 percent increase over 339.5 million in 2016. On a quarterly basis, revenue was up $111.3 million, up 3 percent from Q4 2016.

The increase was driven by surgical case growth, offset somewhat by an unfavourable payor mix. Of note was a 15.8 percent increase in revenue at Sioux Falls, reflecting an increase in total knee and spine cases.

Also impacting the quarterly revenue results were revenue adjustments at Unity Hospital based on a change in assessment of collectibility from earlier periods of 2017, which amounted to $1.7 million.

As we mentioned last year, we have put a new finance team in place at Unity, and are taking measures to realign and improve its financial structure.

In line with this, we conducted our annual impairment assessment. We identified an impairment of $7 million at Unity and an impairment of 1.4 million at IMD, our hospital admin services business. It's important to note, however, that these are noncash charges that do not affect our cash balances, liquidity, or operating cash flows.

Adjusted EBITDA, which excludes the goodwill impairment charge, was $32.1 million in Q4 2017, flat compared to $32.3 million in Q4 2016. Adjusted EBITDA for the full year, excluding the goodwill impairment charge, was $94.6 million, a 4.3 percent increase compared to $90.7 million in 2016.

Increased revenue from our facilities, particularly Sioux Falls and Arkansas, contributed to the growth, offset by the CEO transition charge we incurred during the year.

Adjusted EBITDA margin for the past quarter and year was 28.8 percent and 24.6 percent, respectively. This compares to 29.9 and 26.7 percent, respectively, for the same periods the previous year.

Cash available for distribution in 2017 was C$51.7 million compared to $50.7 million in 2016. On a quarterly basis, cash available for distribution was 16.7 million in Q4 2017, a 6.5 percent decline from 17.8 million in Q4 2016.

Impacting cash for distribution was increased interest payments on the corporate credit facility and higher corporate expenses.

On a per share basis, our cash available for distribution was C$1.67 in 2017 compared to C$1.63 in 2016. For the fourth quarter, this was $0.54 compared to $0.57 in Q4 of 2016. The resulting payout ratio was 67.5 percent for the year and 52.3 percent for the quarter compared to 69 and 49 percent, respectively, for the previous year.

At the end of 2017, we had cash and cash equivalents of $65 million and about 32.2 million available on our corporate credit facility. We believe we have sufficient resources to execute on our near-term growth strategies.

For additional detail on specific results for each centre, please refer to our MD&A.

Now Rob will provide some comments on outlook, and then we will take your questions.

Rob?

Robert Horrar

Thanks, Tyler. Overall, we are pleased with 2017 and what we achieved in building a stable platform for growth. As we plan for the future, we will be guided by four key strategies for growth and operational success.

First, industry-leading quality and service. Our facility partners are committed to maintaining high quality and patient satisfaction scores that have placed them among the best in the United States. Our extraordinary physicians, caregivers, and team members consistently maintain high standards of patient care and service excellence, and our facilities are specifically designed for physicians to operate at high efficiency while providing attractive patient amenities and environments, a quality that is also a key factor in physician recruitment and retention.

Second, a strong physician-centric management model. Our success is rooted in partnerships with physicians. Empowered physicians drive higher quality of care and higher patient satisfaction. We bring value to our partnerships with efficient business practices, access to data, resources, and strategic planning. Together with our physician partners, our facilities are able to deliver exceptional patient care in their communities.

Third, growth, both organic and through acquisitions. We will continue to focus on enhancing and adding services at our existing facilities, including the recruitment of new physicians and the addition of ancillary services, such as urgent care clinics. Also, every acquisition opportunity will be assessed with a thorough due diligence process to ensure any new facility we acquire matches the high-quality and strong performance in the existing portfolio.

Finally, maximized operating efficiencies. With a strong and growing portfolio of facilities, our scale enables us to leverage operational efficiencies. We will focus time and attention on assisting facility partners to improve efficiencies in value-added services like group purchasing and the sharing of best practices.

Now is an exciting time for Medical Facilities Corporation. Our reputation for performance and excellence is only possible with the sincere commitment of our physician partners, facility leaders, and teams who provide high-quality patient-centred care every day.

On behalf of Medical Facilities Corporation's management team and the Board of Directors, thank you for your ongoing support.

With that, we would now like to open the line for questions.

Operator?

Q&A

Operator

If you'd like to ask a question at this time, press *, then the number 1 on your telephone keypad. If you would like to withdraw your question, press the # sign. We'll pause for just a moment to compile the Q&A roster.

And your first question comes from Neil Maruoka from Canaccord Genuity. Your line is open.

Neil Maruoka — Canaccord Genuity

Good morning.

Robert Horrar

Good morning.

Neil Maruoka

A question on Unity. You generated $11.5 million in revenue. Even if we adjust for the $1.7 million, your margins are still a relatively weak 18.2 percent. Can you give an update on the integration there? Is that an issue? And what can be done to drive revenue or cost reductions at that facility in particular? I know that there was a heavy reliance on one physician there that had impacted the results in previous quarters, but what is your strategy to turn that around?

Robert Horrar

Good. Sure. I appreciate the question. I'll take them in reverse, Neil. Number one, it's growth. That's what we can do to add to this centre. We bought it with … the acquisition was made with the understanding and belief there were plenty of opportunities, and we still believe that. Those growth plans are in process and active, and there are opportunities to grow both in volume and with new physicians. So that's the number one thing we can do at this centre.

As Tyler mentioned in his remarks, to answer your first question, we brought on a new CFO, a new finance team at this hospital to match expenses to their performance, and they're very focused on getting that in line right now.

Neil Maruoka

And is there any issues with integration? Or is that substantially complete?

Robert Horrar

There's not any issues with integration. We continue to, again, execute on the growth plans and rightsize the expenses. But there's no issues on integration.

Neil Maruoka

Okay. Thank you very much.

Robert Horrar

Sure. Thank you.

Operator

Your next question comes from Prakash Gowd from CIBC. Your line is open.

Prakash Gowd — CIBC

Thanks. Good morning, everybody. Just one follow-up on the Unity Medical. Can you elaborate a little bit more with regards to the decrease in revenue? You mentioned that it was due a change in assessment of collectibility from earlier periods. Is that related to an out-of-network issue and harder to collect? Or is it other billing issues? Or something else entirely?

Tyler Murphy

No, it's more that, as you know, having things on books you have to do retrospective look-backs to see what you actually collected. And so as we brought in a new finance team, part of what we tasked her with was take the balance sheet, go through every category, and let's make sure we have everything cleaned up, taken care of in 2017.

So as we looked back retrospectively at the collectibility of certain all up and down, commercial, Medicare, private pay, that's where the adjustment came from. So we feel like everything is clean going forward, and we're where we need to be.

Robert Horrar

And just to add some more colour to your question, this is not a network centre—

Tyler Murphy

Yeah.

Robert Horrar

—so that's not the issue. It was more the bad debt collectibility issue that we needed to clean up going forward.

Prakash Gowd

Okay. That's fine. And then specifically for your South Dakota facilities, could you talk a little bit about physician and nursing turnover? And where were you at the end of 2017 in terms of your optimal personnel numbers?

Tyler Murphy

Well, I can tell you that we don't have any unusual turnover in the South Dakota market versus any of our other facilities at this point. We're appropriately staffed in all markets. So we have no issue on that right now.

Robert Horrar

Yeah. And as we've said before, our centres because of their nature, because of the scheduling of the surgeries, we actually have a lot of good recruitment tools for nurses and other staff because they want to come to a place where they're not having to work the emergency room; they're not covering the ICU. So we have some benefits.

But yes, there hasn't been any change in that turnover.

Prakash Gowd

Okay. And just lastly, more of a high-level question. With regards to the trend we're seeing in the industry around value-based care and bundled payments, can you comment specifically about your business? Are you seeing this creep into your business at all specifically for the orthopaedic procedures? And how you think it might impact you going forward?

Robert Horrar

We've seen very little of it actually. And our approach to this has almost been proactively where can we find those opportunities to engage in bundles and bring in more volume into our centres? So we see this just in terms of a positive and approaching it where it could bring us additional volumes, but we don't have a great deal of that in place right now.

Prakash Gowd

Okay. Thanks very much.

Robert Horrar

Welcome.

Operator

Your next question comes from Neil Linsdell from Industrial Alliance. Your line is open.

Neil Linsdell — Industrial Alliance

Good morning, guys.

Robert Horrar

Good morning.

Tyler Murphy

Good morning.

Neil Linsdell

Congratulations on a good finish to the year.

Robert Horrar

Thank you.

Neil Linsdell

I just want to ask you about the NueHealth JV completed in February. Can you give us any additional details that will help us incorporating this into the models?

Robert Horrar

I can. Let me just give you a high-level, and then I'm going to have Jim Rolfe tell you about the structure. So it's important to note that the NueHealth team gives us a very broad infrastructure to manage these facilities and to add additional facilities at no additional cost. We did not add cost to the centres for moving this to a partnership with NueHealth.

So with that, I'll let Jim give you a bit more colour.

Jim Rolfe — Chief Development Officer, Medical Facilities Corporation

Yeah. Neil, we did extensive due diligence on NueHealth when we were looking at this Meridian transaction. And we were very impressed with their operations. And for me and for us, we're excited about this complement.

They've been in the business, in the ASC business for 20 years, which is a long time. And they managed from one ASC to a large hospital, and so they're very robust in that. But also I'm excited on the development side because, again, they've been in business for 20 years, they've seen a lot of deals, and their old—well, not their old, but their existing model is they take a minority stake in these ASCs, these surgical hospitals, and they manage them.

As so I think that we compliment them as far as being able to buy a controlling interest in new entities like ASCs and surg hospitals and having their expertise in managing.

So I'm real excited about the pipeline. And our pipeline is really full just in the two or three months that we've been associated with them. So like Rob said, this gives us a platform to grow organically around our existing markets, as well as it gives us a vehicle to actually go after onesies and twosies on the ASC side.

Robert Horrar

Final remark. It's not exactly a hands-off relationship, either. Our MFC management retains board positions in each ASC. So we are also active in the operations as well, so.

Jim Rolfe

Yeah. And, Neil, one last thing to note, I'm sorry, is that this is we are not exclusive with each other. If they find a deal that we don't want to do, they can do it. If we find a deal that they don't want to do, we can do it. So this is not an exclusive arrangement, but it is a good one.

Neil Linsdell

Okay. Can you provide any more details on the financial impact, though?

Robert Horrar

At this point, this is too early. We just bought it in February, but I will tell you that we look at the acquisition in terms of the opportunities going forward. And we know and have identified a lot of good opportunities on the growth side, as well as on the expense management side.

So this acquisition affords us some good opportunities on both.

Neil Linsdell

Okay. So on the growth side, anything you would do would go into this JV?

Robert Horrar

Not necessarily. As Jim said, this is not exclusive.

Neil Linsdell

An open relationship, right.

Robert Horrar

We'd prefer it. Yeah. If it comes through the pipeline and we want to do it together and it makes sense, we absolutely would like to do that. If not, it's not an exclusive arrangement.

Neil Linsdell

Okay. And you were talking about the administrative kind of benefits and everything they bring to the table. Is there any kind of plan or opportunity to extend what they do to your other existing facilities?

Robert Horrar

Not at this point. It really is a little bit of an apples and oranges. They're focused on the ACS space, and the surgical hospitals are a different world for us. So we don't have any plans like that at this time.

Neil Linsdell

Okay. And then just lastly, I think for every of your facilities that I've visited they're always undergoing construction to improve. Are there any kind of major construction plans to increase services or switch over rooms or expand the facilities that are worth noting?

Robert Horrar

Nothing that I will call out on the call today, but I will tell you that this year, the beginning of—the end of 2017, we went through an extensive strategic planning process, and we identified opportunities to grow. And we do have those on our future plans, but nothing specific that we can call out today.

Neil Linsdell

All right. Fair enough. Okay. Thanks, guys.

Robert Horrar

Thank you.

Operator

Once again, if you would like to ask a question, press *, then the number 1 on your telephone keypad.

Your next question comes from Endri Leno from National Bank. Your line is open.

Endri Leno — National Bank

Good morning.

Tyler Murphy

Good morning.

Endri Leno

Thanks for taking my questions.

Tyler Murphy

Sure.

Endri Leno

Just a couple for me. I'll start off a little bit with Unity. I have a question on there's a provision for physician professional service and billing services of $4 million for 2017. So I was wondering if you can expand on that a little bit? And also whether you see any changes to this going forward, given the impairment charge and the non-collectibility for revenues at that hospital? Thanks.

Tyler Murphy

Yeah. Again, I'll kind of go reverse again on that one like Rob did. The non-collectibility, again, we were just cleaning up all the old balance sheet accounts. So we don't believe that the revenue that's coming in the door today is not going to be collectible any different than any other centre your normal bad debt percentages, that type of thing. Again, most of our stuff is scheduled. It's Medicare. It's commercial. It's private pay. So our collectibility's actually really high. It's not—so that was kind of a onetime cleanup item. It's not a long-term thing.

The impairment, as far as that goes, is just again we have to do annual impairment testing for all of our facilities, and obviously, I mean, this is no secret, Unity hasn't lived up to our expectations of the original deal model when it was bought. So it was determined based on the performance and the near-term model that we needed to write that down.

The growth prospects, though, have not changed. They might have tracked slower than we originally thought, but we still really like the market. There's a lot of independent groups, orthopaedic groups, other groups in that market that are not affiliated with hospitals at the current time. So we do feel good about the prospects.

It's just, again, this is kind of a onetime cleanup of all of this stuff.

Endri Leno

And would you expect any sort of renegotiation on that provision for services and billing charges at all going forward? Or it's just going to remain around that $4 million level?

Robert Horrar

Well, I'll tell you that we as a part of our strategic plan we're reviewing every contract and arrangement we have at the centre, and will do that at all times.

Endri Leno

Okay. Thank you. My next question is just a quick one actually on how you're seeing the urgent care centre, particularly in Little Rock. I mean are you seeing any good traction since January? I mean, it's been a pretty tough flu season. I mean, has that impacted traffic at all? And any commentary around that?

Robert Horrar

Yes. Actually, we are very pleased that that urgent care centre is on budget, on track for our pro forma adjusting for the flu, actually, so even normalizing the growth and the patients per day, which we did benefit from at that urgent care centre, to your point.

We are very much on track with our pro forma, so very pleased with the progress there.

Endri Leno

Great. Thank you. And last one for me is just a general what you're seeing for further acquisitions, I mean, in terms of a multiple out there? Would you still expect to realize something around the 10 times EBITDA that you paid for the ambulatory surgical centres, the last one? Or has it decreased a little bit or gone higher?

Robert Horrar

Well, remember the Meridian acquisition—NueHealth partnership, the Meridian, I mean, this is a platform deal, so. And again, you're looking at a trailing 12 on that multiple. As I've said, we look at this in terms of opportunities going forward, synergies, and we've identified that. So we think that that's actually a better deal for us than that.

But you want to, Jim—I'll turn this over to Jim Rolfe and comment on—

Jim Rolfe

No, that's right. As Rob said, we look at deals we make sure that it hits our core attributes with good quality doctor alignment, good earnings, but more importantly, growth potential. And when we price a deal we look at things that are in place already that really weren't factored in to trailing 12. They could have brought on some new doctors, new service lines, what have you. So again, we're going to stay disciplined. But as Rob said, that acquisition was a platform acquisition with seven ASCs, and it's a pretty limited market when you start talking about platform ASCs, several onesies and twosies, but having a platform ASC company with pretty limited space.

And so we definitely paid a premium for that—or paid out a little bit for that.

Endri Leno

Great. Thank you. That's all the questions I have.

Robert Horrar

Good. Thank you.

Operator

Once again, if you would like to ask a question, press *, then the number 1 on your telephone keypad.

We do not have any questions over the phone line at this time. I will turn the call over to the presenters.

Robert Horrar

Thank you for participating on today's call, and for your continued interest in MFC. We look forward to reporting on our progress next quarter.

Thank you.

Operator

This concludes today's conference call. You may now disconnect.

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