Medical Facilities Corporation

Second Quarter 2019 Results

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CORPORATE PARTICIPANTS

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David Watson
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CONFERENCE CALL PARTICIPANTS

Lennox Gibbs
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Neil Linsdell
Industrial Alliance — Analyst

Doug Miehm
RBC Capital Markets — Analyst

Endri Leno
National Bank Financial — Analyst

PRESENTATION

Operator

Good morning everyone. Welcome to the Medical Facilities Corporation 2019 Second Quarter Results Conference Call. Before turning the call over to management, listeners are reminded that certain statements made in today's call, including 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 Factors 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 dates 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. Bob Horrar, President and CEO of Medical Facilities. Please go ahead, Mr. Horrar.

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

Thank you, Operator, and good morning everyone. Joining me on the call today is David Watson, our Chief Financial Officer, and Jim Rolfe, our Chief Development Officer. Earlier this morning we released our second quarter results. Our news release, financial statements and MD&A may be accessed through our corporate website at www.medicalfacilitiescorp.ca and were also filed on SEDAR today.

As we said in our news release this morning, while we are disappointed with our second quarter results, we continue to work with our physician partners to improve same facility performance including access points and expanding our services. I'll leave it to David this morning to discuss our earnings for the quarter, but I did want to speak briefly about our revenue.

Overall, surgical case levels were down slightly from last year by 1.6 percent. However, weaker contributions from two of our facilities, due to changes in the case mix or payer mix, weighed on the overall quarterly revenue. In fact, the decreases at these two facilities amounted to $5.1 million with Unity's decrease of $3.1 million having the largest impact.

Due to the continued case mix challenges at Unity, we made the decision to recognize a noncash goodwill and intangible asset impairment charge of $29.5 million in the second quarter. This did significantly impact earnings for the period, but did not affect our cash balances, liquidity or operating cash flows. We are focused on partnering with new physicians in this market in evaluating new service lines to improve financial performance.

We continue to believe that the Company will benefit from the demographic changes occurring in the United States resulting in increased demand for care. Growth rate of the 65 and older population is running more than three times greater than the total population growth rate, and according to the Census Bureau projections, this is expected to be the case for the next decade. We do, however, expect to continue to see a shift in payer mix to include more Medicare cases over time.

Despite our challenges in the second quarter, we look towards the remainder of 2019 with optimism as we anticipate a stronger back half of the year. This expectation is driven in part by seasonally favourable fourth quarters as patients historically seek medical procedures at the end of the year, after they have met or are close to meeting their insurance deductibles or out-of-pocket limits for the year.

We remain focused on both organic and inorganic growth initiatives. Our MFC Nueterra partnership remains a platform that affords us additional opportunities. One example is the St. Luke's Surgery Center of Chesterfield, Missouri, a suburb of St. Louis, which is expected to open next spring. This new ambulatory surgery centre will initially offer five specialties including orthopaedics, gynaecology, gastrointestinal, plastic surgery and general surgery. The ASC will feature extended care rooms to accommodate outpatient surgeries such as total joint replacement of the knee and hip. The new ASC will be jointly owned by St. Luke’s Hospital and MFC Nueterra and local physicians.

In addition, our acquisition pipeline remains strong and we are evaluating new opportunities that are accretive to the portfolio. We remain confident that this comprehensive approach to growth will continue to better position the Company to capitalize our demographic trends and increasing need for orthopaedic and other surgical procedures. We look forward to updating you on the developments on these initiatives over the coming months.

Now, before I turn the call over, I would like to take a moment and introduce our new CFO, David Watson. David has extensive senior financial experience with multi-site and multi-state healthcare operations. Prior to joining us back in June, he served as CFO for Florida-based Clearway Pain Solutions Institute. From 2011 to 2015, David served as Senior Vice President and CFO for National Surgical Hospitals, a leading owner and manager of physician-partnered surgical hospitals and ambulatory surgery centres. He's a great fit for our company and we are very pleased to have him on the team.

I'd like now to turn the call over to David for the first time to discuss our financial results for the quarter.

David Watson —Chief Financial Officer, Medical Facilities Corporation

Thanks Rob. Before I get started, I would like to remind everyone that our 2019 financial results include the impact of IFRS, a substantial change to lease accounting standards. MFC adopted IFRS 16 using the modified retrospective approach and our financial results prior to 2019 were not re-stated. As a result, when comparing our 2019 EBITDA to periods prior to January 1, 2019, the impact of IFRS 16 should be considered. Also, all the dollar amounts expressed in today's call are in U.S. dollars unless otherwise stated.

Rob has already discussed the revenue for the quarter, so I will start with EBITDA adjusted for the noncash impairment charge. Adjusted EBITDA for the quarter was $19.1 million, which was down from

$23.9 million in the second quarter of last year. This was due to lower operating income at several facilities as a result of decreased revenue, in addition to increases in certain expenses and a $1.1 million in contractual separation costs charge.

As a percentage of revenue, Adjusted EBITDA in Q2 2019 was 18.9 percent of revenue compared to 22.5 percent in Q2 2018. Consolidated salaries and benefits for the quarter were up $1.9 million or 6.6 percent, primarily due to the contractual costs related to the outgoing CFO, increased pain clinic staff at Oklahoma Spine Hospital, the opening of the Gillette Urgent Care Centre and annual wage increases. Excluding the $1.1 million contractual costs, salaries and benefits increased 2.9 percent compared to the second quarter of last year. As a percentage of revenue, consolidated salaries and benefits increased to 31.3 percent from 27.8 percent a year earlier.

Consolidated drugs and supplies were up $1 million or 3.3 percent, mainly due to case mix resulting in more implants and neurology supplies being required. As a percentage of revenue, consolidated drugs and supplies increased to 32.4 percent from 29.8 percent in the second quarter of last year. We continue to explore opportunities for cost savings in this area through our group purchasing initiatives.

In Canadian dollars, we had cash available for distribution $4.9 million, which was down from $11.7 million in the same quarter last year. Despite the decrease in cash available for distribution, thanks to our strong cash position and low leverage, distributions for the quarter remained constant at CA$0.28 per share. Our resulting payout ratio for the quarter was 179 percent compared to 74.3 percent for the same period a year ago.

When evaluating our ongoing ability to pay our dividend it is best to view our payout ratio over the course of the year rather than in any particular quarter. As Rob mentioned earlier, the fourth quarter is generally the strongest quarter for us as we typically see patients maximizing the use of insurance benefits prior to year-end. With this in mind, our trailing 12-month payout ratio was 91.9 percent.

Our balance sheet remains strong as of quarter end with cash and cash equivalents of $39 million, short-term investments of $10.8 million and approximately $81.2 million available on our credit facility. For additional detail on our financial results, including specific results for each facility, please refer to our MD&A.

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

Q & A

Operator

Thank you. At this time, I would like to remind everyone in order to ask a question, press star, then the number one on your telephone keypad. We'll pause for just a moment to compile the Q&A roster.

Our first question comes from the line of Lennox Gibbs from TD Securities. Your line is open.

Lennox Gibbs — Analyst, TD Securities

Good morning. Thank you. Start with UMASH. Can you share the strategic options that might be available to you with respect to that facility at this point?

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

Yes. Yes, Lennox, I will talk about that a little bit. For Unity, we've seen actually volumes were up. The issue that we have, lower inpatient, and with the volume that's coming into the facility, physicians we've recruited and added lately are bringing outpatient cases. So, our growth strategy is to partner with physicians in this market and bring in not only more volume, but more higher case mix volume. We called out that this was a case mix issue and that's very much it. Lower inpatient replaced and increased actually by outpatient business.

Lennox Gibbs — Analyst, TD Securities

What is the current complement of surgeons and where do you think you need to get that number to in order to get to sustained profitability, within UMASH again?

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

Really, that number, Lennox, would just depend on the specialty of the physician. We have about eight owners right now. We have probably 20-plus physicians doing surgery at the facility. We've actually just added two more urologists at this location, which is good growth. But this is a chassis we've talked about that benefits from a lot of volume and we do have opportunities in this market we're actively pursuing and this is our focus. This is our number one focus.

Lennox Gibbs — Analyst, TD Securities

Maybe you can share some goals, some targets there? Where do you think you need to get that physician complement to in order to get some more consistency here in terms of the profitability?

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

As I said, I don't think we've got a number in mind. It depends on the surgery type, the case, the specialty type. Orthopaedics, neurosurgery, of course, that's the bread and butter of this facility and the focus of our strategy.

Lennox Gibbs — Analyst, TD Securities

Okay. Then sort of a second question. Can you help us understand the increase in drugs and supplies expenditures? I think it was 3 percent year-on-year. Help us understand that in the context of the declines in case volume as well as the implementation of your procurement initiatives.

David Watson —Chief Financial Officer, Medical Facilities Corporation

Yes. Hi Lennox, it's David. The drugs and supplies were largely driven by case mix during the period.

Lennox Gibbs — Analyst, TD Securities

Okay. Are you satisfied with how the procurement initiatives are working?

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

We are. We continue to see benefits year-over-year from the procurement from the Vanderbilt consolidation. We also have from time-to-time in one of our hospitals called it out this quarter a bulk buy situation where hospitals will take advantage of pricing to buy and over—but again, as David said, in some of our facilities you'll see a little bit of a case mix issue that'll drive up drugs and supplies. But overall, our procurement continues to pay dividends for us.

Lennox Gibbs — Analyst, TD Securities

Thanks. I'll get back into the queue. Thank you.

Operator

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

Neil Linsdell — Analyst, Industrial Alliance

Hey, good morning, guys.

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

Good morning.

Neil Linsdell — Analyst, Industrial Alliance

Just to stick on the Unity. If you are looking at—talking about the strategy about things you want to try and improve to get that better case mix, are you making any specific changes as far as the type of doctors, the surgeons that you're trying to bring into that facility, like, dramatically different than what do you have now?

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

No, no. We're not—we've got a chassis that could benefit from a lot of additional volume. As I've said earlier, we've called this out, orthopaedics and musculoskeletal has been the historical bread and butter here, but we also are one of the top ophthalmology centres in the area. That's great, we love to have those volumes, but that doesn't replace orthopaedic, spine and neurosurgery. Our focus is to grow the facility and increase the complex cases, in particular inpatient cases.

Neil Linsdell — Analyst, Industrial Alliance

Okay. Are there any regional or geographic—I'm thinking about the population around hospitals obviously or how you're feeding it in—that's impacting Unity in ways that it is not impacting some of your other facilities?

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

No. The demographic trends are fairly consistent. We see the same growth opportunities. Our service area is quite large and our draw, so this is very much a growth story for us.

Neil Linsdell — Analyst, Industrial Alliance

Okay. Again, you don't really have any kind of timeframe that you can picture when we're going to start seeing some of these improvements or some of these changes impacting the results?

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

It is our goal to make that timeframe as short as possible.

Neil Linsdell — Analyst, Industrial Alliance

Okay. Then on the drug and supply question about the costs, those increased costs, are they not more or less pass-throughs as well with a markup when you're doing the billing?

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

Well in some cases—in most cases, no. Our reimbursement is typically fixed on a DRG or case rate, so your reimbursement, particularly from Medicare and from commercial payers, are not sensitive to that pass-through. That's part of the case cost.

Neil Linsdell — Analyst, Industrial Alliance

Okay, so it's more about just how you're managing the cost than working with your supplier base?

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

That's right. That's right. There's a lot that goes underneath that in terms of what drives the increase costs. You might have a particularly sick patients or just higher utilization of a certain case that requires a higher level of drug or antibiotic, so there are a lot of moving parts to that. But once again, we see our procurement arrangement with the Vanderbilt bending that cost curve.

Neil Linsdell — Analyst, Industrial Alliance

Okay. Then on the payout ratio, obviously we've seen some—it's been elevated recently and you want to focus on the last 12 months. We previously talked about targeting a 70 percent payout ratio. Do you think that's still reasonable for this year?

David Watson —Chief Financial Officer, Medical Facilities Corporation

I think when you look at historically, it’s certainly (inaudible) than it is today. Given where we are at this point in the year, driving back to that rate is probably not the right answer.

Neil Linsdell — Analyst, Industrial Alliance

Okay. Would that still be your target maybe for next year to get back to that range?

David Watson —Chief Financial Officer, Medical Facilities Corporation

We certainly want to see it get back to that range.

Neil Linsdell — Analyst, Industrial Alliance

Okay. All right. That’s it for me. Thanks.

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

All right. Thank you.

Operator

Again, if you'd like to ask a question, that's star, one on your telephone keypad.

Our next question comes from the line of Doug Miehm from RBC Capital Markets. Your line is open.

Doug Miehm — Analyst, RBC Capital Markets

Thank you. I just want to talk a little bit about the acquisition pipeline and maybe you could refresh my memory. Was the largest acquisition you've made in the last 18 months or so the Nueterra one, to begin with?

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

Yes. That's the only one.

Doug Miehm — Analyst, RBC Capital Markets

Yes, and I have two questions related to that. Number one, what's holding you back from maybe completing some other acquisitions to infill around that? You'd think that within that 18-month timeframe you probably would have found something. Is it multiples, or what is it that seems to be the problem?

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

Well, number one, it's a very competitive sector right now. There's a lot of consolidation going on. It has driven up multiples and we need to be a smart acquirer of these centres. It has to have a growth profile going forward and a low-risk profile.

We did add to the portfolio a partnership with St. Luke’s. We called out on the script a moment ago a de novo project that will open in May. We like those projects. The de novo opportunities, while they take a while to germinate, are very attractive for us.

The market of existing ASCs, we've seen a lot of consolidation, a lot of increase in multiples there. Because of that, it’s a little bit more challenging. Probably a lot more of those are aligned than they were, so we're going to be wise about the existing facilities. We certainly are focused on looking for additional de novo projects in this platform.

The pipeline is strong. We have got a lot of opportunities that we've looked a. It’s just, is it right for us and for our and for the partnership?

Doug Miehm — Analyst, RBC Capital Markets

Okay. I think if I recall you paid a fairly hefty multiple for the Nueterra. How has that company done in terms of operations relative to your initial thinking, especially given what it did this latest quarter?

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

Yes. The operations in terms of the day-to-day operations, it has been a very, very good partnership. They've been doing great job in terms of managing day-to-day, managing the staff, managed care negotiations, accreditations. It's all been first rate and we're very pleased with the partnership.

The issues are really below ground for us around a one centre that there are just some practice dynamics that are not management platform related; they're just individual physician practices that have challenges within their own situation that bleed over to the ASC for us.

Doug Miehm — Analyst, RBC Capital Markets

Okay. That's fair. I know you can't give specific numbers but over the next six months, let's say, between now and the end of the year, do you think you're going to do better on an absolute basis, let's say on the revenue and EBITDA performance versus last year, or do you think you're going to be weaker like we've seen for last two quarters?

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

Our anticipation is we'll be stronger. As we've called out, the back half of the year is typically stronger for us.

Doug Miehm — Analyst, RBC Capital Markets

No, no. I mean, stronger than last year.

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

Yes. Difficult to project that.

Doug Miehm — Analyst, RBC Capital Markets

Okay. Just to wrap up, what level of payout ratio would cause the Company to cut the distribution?

David Watson —Chief Financial Officer, Medical Facilities Corporation

I don't think, that's—I don't think there's a set level that we'd target for that. I think if you look at the balance sheet, as I mentioned the balance sheet continues to be very strong. We've got a very good cash position. We've got availability under our credit facility, but there's not a specific number that we would target at this time.

Operator

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

Endri Leno — Analyst, National Bank Financial

Hi. Good morning, guys. Thanks for taking my question. A few for me. I'll start quickly with Unity. Over the last few quarters, you guys increased the ownership in that hospital. In light of the current development in this quarter, I was wondering what the rationale was back then? Do you still expect to increase any more ownership there?

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

We don't anticipate doing that. In fact, it's our goal to hopefully have additional partnerships, the partners to buy ownership, but the reason for that was contractual at the time of the acquisition. There were certain put-rights that were negotiated and those were executed. That's the reason for the ramp-up in the ownership.

Endri Leno — Analyst, National Bank Financial

Okay. Are there any more put-rights outstanding at this point?

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

No, no. There are a none.

Endri Leno — Analyst, National Bank Financial

Okay, great. Next question I had on BHSH. There's a bit of a lower case volume and I was wondering if you can elaborate a little bit how that came to be? Was it from competition or was it the surgeon that was absent last quarter? A combination of both? How do you see that case volume developing over the course of the year?

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

You're talking about Black Hills Surgical Hospital?

Endri Leno — Analyst, National Bank Financial

Yes.

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

Yes. Well, actually, Black Hills did have a little bit lower volume and it was physician availability, basically, in this market. We're very pleased that we called out in the, I believe, fourth quarter call that this facility has recruited four physicians this year as they begin to ramp up and phase in throughout the year, but also, they opened a Gillette Urgent Care and the orthopaedic partnership opened a clinic there as well. So, the issues are not related to any competition in this market; it's just more of an internal dynamic.

Endri Leno — Analyst, National Bank Financial

Okay. At Sioux Falls, the lower case volume, what caused that?

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

Yes. That's the same thing, lower surgical volume there. The greatest variance that we saw, again, was inpatient cases and that was largely, again, due to physician availability.

Endri Leno — Analyst, National Bank Financial

Okay, great. One last question on the South Dakota hospitals. At Sioux Falls, there was an article published in a local newspaper, I believe a couple of months ago, that Avera is potentially thinking of closing the employee health program or not reimbursing for procedures not done at their facilities. I was wondering what's your take on that? Would you expect any impact on the facilities there? Do you have any mitigations planned if there is an impact? Just any color.

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

We would expect a de minimis impact. The hospital has never been in-network with the competitive employee health plan itself, so we think this is a de minimis issue.

Operator

Our next question comes from the line of Lennox Gibbs from TD Securities. Your line is open.

Lennox Gibbs — Analyst, TD Securities

Thanks again. Just the St. Luke's Hospital ASC partnership, an you share what are the key strategic underpinnings for that deal? Why that specific geography? Why St. Luke's? Then, secondly, if you could provide some estimate as to the capital outlay and the likely timeline for that facility to reach breakeven?

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

Sure. I'll sort of take that in order. St. Luke's is a tremendous high-quality acute care hospital system in the St. Louis area and we're very pleased about partnering with them, not only at this location, which is on their campus, but hopefully future locations as well and with our existing City Place ASC. A really good partnership for us.

As we called out, de novo or newly developed surgery centres, your capital is essentially the cost of equipment, renovations and opening the centre, so you really have a—you're not paying the acquisition premium or multiple that you would if you were buying one in existence. De novos are historically very good investments and have a strong ROI and RRR.

The partnership with St. Luke's includes their employed physicians and surgeons but brings us a whole other level and layer of physicians to partner with. As I said, we'll open this in May.

Typically, and I will just say in general, you see a year ramp-up for an ambulatory surgery centre to hit its stride, but when you're starting with a pretty large complement, it could be shorter.

Lennox Gibbs — Analyst, TD Securities

And the capital outlay?

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

Well, we don't really have it. We’re not calling out a number yet on that. But, again, it's essentially the partnership pays their fair share for equipment, any type of tenant improvements on the building or building costs, and just start-up capital. It’s, like I said, generally a lot less than an acquisition of a like SaaS facility would be.

Lennox Gibbs — Analyst, TD Securities

Thanks very much.

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

You're welcome.

Operator

We have no further questions in queue. I'll turn back to the presenters for closing remarks.

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

Thank you for joining us today and for your continued interest in Medical Facilities Corporation. We look forward to updating you on our progress next quarter.

Operator

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