

Capitol Health

Executive summary

- On 20 December 2016, Capitol Health (CAJ) released a statement in response to the MYEFO announcements relating to diagnostic imaging (DI) services. Certain changes previously proposed for reducing bulk-billing incentives for DI services have now been postponed to 1 July 2017, from the originally planned implementation date of 1 January 2017. The deferral is intended to allow time for further consultation on the matter
- CAJ's management reiterated the 1H17 EBITDA guidance range of \$7.7m-\$8.2m, indicating that the higher end of the range is likely to be achieved. CAJ has not provided formal guidance for the full year (FY17). FIIG estimates a base case FY17 EBITDA of \$18.3m. This implies a stronger 2H17, which is consistent with the seasonality in DI volumes reflected in CAJ's historic financials
- CAJ released updates in its November trading statement and AGM relating to various cost-save initiatives (targeted run-rate annual cost-saving of \$2m+) , non-core asset disposals (c.\$1m value associated with the sale of Mach7 Technologies, or M7T) and expected property sales (c.\$3m in proceeds), and have guided that these initiatives remain on track
- On 20 December 2016, FIIG met with CAJ's management James Harkness (CFO) and Andrew Harrison (CEO). The company is currently undertaking a strategic review focussing on ways to fund the desired debt reduction. While an incremental equity capital raise remains an option, at this stage strategic asset sales seem more likely
- CAJ is targeting a medium-term leverage ratio (net debt to EBITDA) of between 2.0x and 3.0x, but sees the potential for a higher leverage ratio of between 3.0x and 4.0x immediately following the potential strategic asset sales. The leverage ratio as at FYE16 was 4.1x, and FIIG forecasts an increase in the leverage ratio to 4.5x by 30 December 2016 (end of 1H17)
- CAJ incurred various asset impairments during FY16, namely the \$0.7m impairment to the M7T investment, and an \$8.1m intangible asset impairment primarily relating to the write-down of NSW assets following the June review in 2016. Management has indicated the potential for further intangible asset impairments on the NSW assets, but have been unable to provide guidance on the magnitude and timing of such impairments as they may depend on the outcome of the strategic review
- The company's intention to reduce debt may be positive for investors in the 8.25% unsecured bonds. However, it is not clear if an asset sale strategy would reduce CAJ's overall financial leverage. In addition, significant asset sales would not only reduce tangible asset recovery expectations, but could also significantly reduce Capitol's potential for future revenue and EBITDA generation



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Company overview

Capitol Health is a leading provider of diagnostic imaging and related services to the Australian healthcare market. Capitol Health was established in 2001 and listed on the ASX in 2006. It is one of Australia's larger medical diagnostic imaging (DI) business and holds a 5-7% share of its addressable market (Victoria and NSW). CAJ is ASX-listed with a market capitalisation of \$73.2m as at 21 December 2016.

See FIIG research report on Capitol Health dated 21 April 2016 for further details.

Financial analysis and commentary

Capitol Health	Actual			Forecasts			Actual			Forecasts			
A\$m - FYE 30 Jun	1H16	1H17*	LTM 1H17*	FY12	FY13	FY14	FY15	FY16	2H17E*	FY17E*	FY18E*	FY19E*	FY20E*
Service Revenue	77.0	77.6	158.5	51.5	61.6	89.8	110.2	157.9	81.5	159.1	164.8	172.5	182.7
Other Income	0.2	0.2	0.1	0.5	0.8	0.4	0.4	0.1	-	0.2	-	-	-
Adjusted Revenue	77.2	77.7	158.6	52.0	62.4	90.2	110.6	158.1	81.5	159.3	164.8	172.5	182.7
Interest Income	0.2	0.2	0.3	0.0	0.1	0.1	0.6	0.3	-	0.2	-	-	-
Total Revenue	77.4	77.9	158.9	52.0	62.5	90.3	111.2	158.3	81.5	159.4	164.8	172.5	182.7
Chg (YoY, %)		0.7%	0.3%	-	20.0%	44.6%	23.1%	42.3%	0.8%	0.7%	3.4%	4.6%	5.9%
Employee Expense	(47.4)	(48.4)	(97.5)	(30.3)	(36.4)	(51.1)	(61.5)	(96.5)	(48.6)	(97.0)	(97.5)	(99.7)	(102.4)
Equipment Expense	(3.6)	(4.3)	(8.4)	(5.3)	(5.4)	(6.7)	(6.7)	(7.7)	(4.6)	(8.9)	(9.1)	(9.5)	(10.2)
Management Fees	(0.4)	(0.4)	(0.8)	(0.8)	(0.7)	(1.3)	(1.7)	(0.8)	(0.5)	(0.8)	(0.9)	(1.6)	(2.7)
Consumables	(3.0)	(3.9)	(6.9)	(2.4)	(2.7)	(3.5)	(4.1)	(6.0)	(4.1)	(8.0)	(8.2)	(8.6)	(9.3)
Other Operating Expense	(6.4)	(7.0)	(14.2)	(4.3)	(5.0)	(6.9)	(7.5)	(13.6)	(7.2)	(14.2)	(14.4)	(15.4)	(16.4)
Total Operating Expense	(60.8)	(63.9)	(127.8)	(43.1)	(50.2)	(69.5)	(81.4)	(124.6)	(64.9)	(128.9)	(130.1)	(134.7)	(141.2)
Chg (YoY, %)		5.2%	2.6%	-	16.4%	38.5%	17.2%	53.0%	1.7%	3.4%	1.0%	3.5%	4.8%
EBITDAR	16.6	14.0	31.1	8.9	12.3	20.9	29.8	33.7	16.6	30.6	34.7	37.8	41.5
Rent	(5.9)	(5.9)	(12.2)	(3.5)	(4.2)	(6.3)	(7.8)	(12.1)	(6.3)	(12.2)	(12.5)	(12.8)	(13.2)
EBITDA	10.8	8.0	18.9	5.5	8.1	14.6	22.0	21.6	10.3	18.3	22.3	25.0	28.3
D&A	(3.4)	(3.5)	(7.1)	(2.1)	(2.2)	(3.5)	(4.9)	(7.0)	(3.6)	(7.1)	(7.4)	(7.8)	(8.2)
EBIT	7.4	4.5	11.8	3.3	6.0	11.0	17.1	14.6	6.6	11.2	14.8	17.2	20.1
Interest Expense	(2.3)	(3.6)	(8.6)	(0.6)	(0.5)	(0.8)	(1.5)	(7.4)	(3.6)	(7.1)	(7.1)	(7.1)	(7.1)
Underlying Profit/(Loss)	5.2	1.1	3.5	2.8	5.6	10.3	16.1	7.5	3.1	4.2	7.7	10.1	13.0
Impairment	-	-	(8.9)	(0.1)	(0.2)	(0.0)	(0.0)	(8.9)	-	-	-	-	-
Other one-offs	(1.5)	0.3	0.3	0.3	0.0	-	(7.9)	(1.5)	1.5	1.8	0.7	-	-
PBT	3.7	1.4	(5.1)	3.0	5.4	10.3	8.2	(2.9)	4.6	6.0	8.4	10.1	13.0
EBITDA	10.8	8.0	18.9	5.5	8.1	14.6	22.0	21.6	10.3	18.3	22.3	25.0	28.3
Cash Interest	(2.5)	(3.6)	(5.9)	(0.6)	(0.5)	(0.8)	(1.5)	(4.8)	(3.6)	(7.1)	(7.1)	(7.1)	(7.1)
Cash Tax	(3.3)	(0.9)	(2.2)	(0.1)	(1.5)	(2.5)	(3.3)	(4.6)	(1.5)	(2.4)	(2.6)	(3.0)	(3.9)
Chg W/C	-	-	(0.0)	(0.8)	(1.3)	(1.6)	2.9	(0.0)	-	-	-	-	-
Capex	(4.4)	(2.3)	(6.0)	(1.5)	(1.8)	(3.1)	(7.0)	(8.2)	(2.3)	(4.5)	(8.2)	(9.0)	(10.0)
Disposals/(Acquisitions)	(31.9)	1.7	(3.3)	0.4	(7.9)	-	(86.0)	(36.9)	2.0	3.7	1.0	-	-
Other Operating Items	(4.3)	(0.4)	(5.7)	0.0	1.5	2.6	(6.3)	(9.5)	(0.5)	(0.9)	-	-	-
Free Cash Flow	(35.7)	2.7	(4.2)	2.9	(3.4)	9.1	(79.2)	(42.5)	4.4	7.1	5.3	5.8	7.3
Net Borrowings	22.6	-	2.0	(2.2)	1.8	(3.4)	56.2	24.6	-	-	-	-	-
Net Share Issuance	(0.0)	-	0.0	0.4	7.6	(0.0)	55.4	(0.0)	-	-	-	-	-
Dividends	(3.1)	-	(0.0)	(0.6)	(1.6)	(2.7)	(4.8)	(3.1)	-	-	(5.0)	(10.0)	(10.0)
Est. Change in Cash	(16.1)	2.7	(2.2)	0.5	4.4	3.0	27.6	(21.0)	4.4	7.1	0.3	(4.2)	(2.7)
Debt													
Cash	20.6	18.4	18.4	1.7	6.1	9.1	36.7	15.7	22.8	22.8	23.1	19.0	16.2
Total Debt	97.6	103.2	103.2	5.6	12.2	11.5	75.0	103.2	103.2	103.2	103.2	103.2	103.2
Net Debt	77.1	84.8	84.8	3.9	6.1	2.4	38.3	87.5	80.4	80.4	80.1	84.2	87.0
Lease-adjusted net debt	150.1	182.0	182.0	31.8	39.4	52.9	100.6	150.1	178.3	178.3	179.8	186.6	192.4
Margin Analysis													
EBITDA margin	13.9%	10.3%	11.9%	10.5%	13.0%	16.1%	19.8%	13.7%	12.6%	11.5%	13.5%	14.5%	15.5%
EBIT margin	9.5%	5.8%	7.4%	6.4%	9.5%	12.2%	15.4%	9.2%	8.1%	7.0%	9.0%	10.0%	11.0%
EBITDAR margin	21.5%	17.9%	19.6%	17.2%	19.7%	23.1%	26.8%	21.3%	20.3%	19.2%	21.1%	21.9%	22.7%
PBT margin	4.7%	1.9%	-3.2%	5.7%	8.7%	11.4%	7.3%	-1.8%	5.6%	3.8%	5.1%	5.8%	7.1%
Staff Expense (% Revenue)	61.3%	62.1%	61.4%	58.3%	58.2%	56.6%	55.3%	61.0%	59.7%	60.8%	59.1%	57.8%	56.1%
Equipment Expense (% Revenue)	4.6%	5.5%	5.3%	10.1%	8.6%	7.4%	6.0%	4.9%	5.6%	5.6%	5.5%	5.5%	5.6%
Management Fees (% Revenue)	0.5%	0.5%	0.5%	1.6%	1.2%	1.4%	1.5%	0.5%	0.6%	0.5%	0.6%	0.9%	1.5%
Rent Expense (% Revenue)	7.6%	7.6%	7.7%	6.7%	6.7%	7.0%	7.0%	7.6%	7.7%	7.7%	7.6%	7.4%	7.2%
Total Operating Expense (% Revenue)	78.5%	82.1%	80.4%	82.8%	80.3%	76.9%	73.2%	78.7%	79.7%	80.8%	78.9%	78.1%	77.3%
D&A (% Revenue)	4.4%	4.5%	4.5%	4.1%	3.5%	3.9%	4.4%	4.4%	4.5%	4.5%	4.5%	4.5%	4.5%
Credit Metrics													
EBITDA/Interest Expense	4.6x	2.3x	2.2x	9.7x	17.9x	17.7x	14.3x	2.9x	2.9x	2.6x	3.1x	3.5x	4.0x
EBITDA - Capex / Interest Expense	2.7x	1.6x	1.5x	7.0x	13.9x	14.0x	9.7x	1.8x	2.2x	1.9x	2.0x	2.2x	2.6x
EBITDAR/Interest and Rent Expense	2.0x	1.5x	1.5x	2.2x	2.7x	2.9x	3.2x	1.7x	1.7x	1.6x	1.8x	1.9x	2.0x
Total Debt/TTM EBITDA	4.2x	5.5x	5.5x	1.0x	1.5x	0.8x	3.4x	4.8x	5.6x	5.6x	4.6x	4.1x	3.6x
Net Debt/TTM EBITDA	3.3x	4.5x	4.5x	0.7x	0.8x	0.2x	1.7x	4.0x	4.4x	4.4x	3.6x	3.4x	3.1x
Total Secured Debt/TTM EBITDA	3.9x	2.8x	2.8x	1.0x	1.5x	0.8x	3.4x	2.5x	2.9x	2.9x	2.4x	2.1x	1.9x
Lease adjusted net debt/TTM EBITDAR	4.5x	5.9x	5.9x	3.6x	3.2x	2.5x	3.4x	4.5x	5.8x	5.8x	5.2x	4.9x	4.6x
Key Debt Incurrence Covenants													
Total Secured Debt/EBITDA		2.50x	2.50x					2.50x		2.50x	2.50x	2.50x	2.50x
Total Net Debt/EBITDA		4.25x	4.25x					4.25x		4.25x	4.25x	4.25x	4.25x

Source: CAJ, FIIG Securities. *FIIG Forecasts

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Key points:

- CAJ enjoyed a period of strong growth from FY12 to FY16 inclusive, as a result of strong industry growth and recent acquisitions. However, in April 2015, the Government established a Medicare Benefits Schedule (MBS) review, which among other things, included proposed changes to bulk-billing incentive programs for the DI sector. These changes along with continued uncertainty relating to the ongoing MBS review led to a sharp fall in DI volumes. Recently acquired assets in NSW have also been underperforming versus management expectations, which led to an intangible asset impairment of \$8.1m in FY16, recorded as an individually significant item (ISI)
- According to previous CAJ market guidance, the negative impact on revenue that was expected with the implementation of the proposed changes to bulk-billing incentives was estimated at around 5% of total revenues. The deferral of the implementation of these changes is now expected to postpone the anticipated negative impact to after FY17 year end, which is positive. However CAJ released further market guidance indicating that the impact of these changes was not yet clear due to lingering uncertainty as to the exact timing and nature of the incentive cuts
- CAJ released EBITDA guidance for 1H17 in the range of \$7.7-8.2m, with most recent management indications erring towards the higher end of the range. CAJ has not released FY17 EBITDA guidance. FIIG estimates a base case FY17 EBITDA of \$18.3m, with 2H17 expected to contribute a greater than proportional share to earnings driven by the seasonality typically seen in the DI sector. Management reports that DI volumes for 1H17 are likely to have grown around 0.6% year-on-year (YoY), but are around 4% below CAJ budget. Whilst 1Q17 Medicare billing data revealed a recovery in DI volume growth rates (although still below the 15 year volume and revenue compound annual growth rates (CAGRs) for the DI sector of 5% and 7% respectively, as reported by CAJ), the impact is expected to flow through to CAJ with a lag. CAJ management report some volume recoveries in the second half of 1H17, with November being the strongest month in the period and current volumes improving to around 3.8% lower than CAJ's original budget
- Various cost-saving initiatives have also been announced, including \$2m+ targeted annual run-rate cost savings to come from lower management salary expenses, lower sponsorship expenses from CAJ's decision to explore a withdrawal from their sponsorship agreement with the Cronulla Sharks (still in negotiation), and other marketing-related savings. Management indicated that approximately \$1.2m-\$1.3m of the targeted \$2m savings have been achieved to date, with the timing of the remainder dependent on the outcome of the strategic review and sponsorship negotiations, but likely to occur within the next six to eighteen months. Cash costs associated with these cost-save initiatives are guided to be minimal by CAJ management, and may include redundancies and break-fee type costs associated with the exiting of some sponsorship agreements
- CAJ has also announced its intention to sell its M7T stake (non-core asset disposal), estimating a value of approximately \$1m, with the timing dependent on the outcome of the strategic review
- Certain properties have been identified for sale, with maximum proceeds estimated to be around \$5m. Management has indicated that around \$3m of this is likely to be confirmed in the near future, but again the exact timing is somewhat dependent on the outcome of the strategic review
- Capital expenditure (capex) guidance for FY17 is half of the FY16 figure, and is currently estimated at around \$4.5m
- Dividends will be unlikely for FY17, and with management signalling a preference for debt reduction, FIIG forecasts do not factor in any dividends until 2H18
- Management have indicated that further intangible asset impairments are likely on the NSW assets, although they have been unable to provide any guidance on the magnitude or timing of such impairments as they depend on the outcome of the strategic review. Such impairments will be non-cash write-downs to goodwill

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- CAJ management have communicated the intention for debt reduction, aiming to approximately halve the current debt load of around \$103m, as at FYE16. On 20 December 2016, FIIG met with CAJ's management James Harkness (CFO) and Andrew Harrison (CEO), and discussed the company's thoughts with respect to their stated intentions for significant debt reduction. The company is currently undergoing a strategic review relating to various ways to fund the desired debt reduction, and whilst an incremental equity capital raise remains an option, strategic asset sales seem more likely. The intention is to repay the majority, if not all, of the secured bank debt (c.\$47m outstanding as at year end FY16), and for any excess asset sales proceeds to be applied primarily towards reinvestment in new strategic assets
- CAJ is targeting a medium-term leverage ratio (net debt to EBITDA) of between 2.0x and 3.0x, but sees the potential for a higher leverage ratio of between 3.0x and 4.0x immediately following the potential strategic asset sales, which would gradually fall thereafter through organic and strategic revenue growth, as anticipated by CAJ management. The leverage ratio as at year end FY16 was 4.1x, and FIIG forecasts an increase in the leverage ratio to 4.5x by 30 December 2016 (end of 1H17)
- As the strategic review is currently in progress and the likely range of outcomes can be large and uncertain, FIIG forecasts to CAJ financials above have been based on current trends indicated by management, incorporating the various cost-save and asset-disposal initiatives already announced and quantified by management. FIIG forecasts also build in an expectation that capex will normalise to historic levels once the regulatory uncertainties have passed and the DI sector recovers towards trend industry growth rates. Similarly, FIIG forecast do not factor in any dividends until 2H18
- CAJ has various other potential sources of revenue, stemming from 1) a revenue sharing agreement with Enlitic, 2) a JV agreement with Citic in China which is expected to be signed in the next few weeks, and 3) a MOU agreement with Sunshine Insurance in China to provide training and expertise in DI services for a new 2,000 bed hospital in the province of Shangdong. FIIG views these arrangements as potential sources for future revenue growth, but they are unlikely to provide additional revenue within the next two or three years
- FIIG's forecast for CAJ FY17 EBITDA is \$18.3m. This compares with FIIG's previous FY17 EBITDA forecast of \$23m (as per the FIIG research note dated 21 April 2016), which was based on average Bloomberg broker forecasts as at 15 April 2016. FIIG expects growth rates in DI services to normalise towards long-term industry trends over the next few years, which will drive a recovery in EBITDA margins towards the mid-teens. Current FIIG EBITDA forecasts are \$22.3m in FY18, \$25.0m in FY19, and \$28.3m in FY20

Conclusion

Capitol Health has experienced strong historic growth rates, which have been negatively affected in the last eighteen months by regulatory uncertainty which has impacted end-user behaviour and reduced demand for DI services. This has led to significantly lower than expected volumes, which in turn have negatively impacted the outlook for near-term revenues and earnings relative to prior expectations. The reduction in earnings expectations results in an expected increase in financial leverage, with FIIG forecasts estimating net debt to EBITDA of approximately 4.5x by the end of 1H17, from 4.1x as at FYE16. Whilst recent Medicare billings data show some improvement to DI growth rates, they remain below long-term industry trend growth rates and have been slow to feed through to CAJ's operations.

Management have communicated a strong desire to reduce financial leverage to more sustainable levels through debt reduction, and are currently undergoing a strategic review to explore various ways to facilitate the desired debt reduction, including pursuing various asset sales. CAJ's intention to reduce debt is positive for investors in the 8.25% unsecured bonds. However it is not clear if it would reduce CAJ's overall financial leverage.

Depending on the outcome of the strategic review, there could be significant risks associated with various strategic initiatives. For example, significant asset sales, including sales of physical assets (plant, property and

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equipment, or PP&E), would not only reduce tangible asset recovery expectations, but could also significantly reduce Capitol's potential for future revenue and EBITDA generation. In addition, CAJ may not be able to realise the current book value of the goodwill attached to certain assets in a disposal scenario. For example, \$8.1m of asset impairment was incurred on the NSW assets in FY16, and the company has indicated that further goodwill write-downs may be likely on those assets.

It is not currently possible to quantify the magnitude of the impact of potential strategic initiatives for debt reduction as the CAJ strategic review is still ongoing. As such, FIIG forecasts shown in this research report incorporate industry and operating trends and the impact of the various known initiatives, as has been communicated by CAJ management, and do not assume any significant asset disposals or acquisitions.

For a more detailed discussion of key strengths and risks relating to Capitol Health 8.25% senior unsecured bonds maturing in May 2020, please refer to the FIIG research note released on 21 April 2016.

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