Medical Facilities Corporation

2017 Second Quarter Results Conference Call

Event Date/Time: August 10, 2017 — 8:30 a.m. E.T.

Length: 32 minutes
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Good morning, everyone. Welcome to the Medical Facilities Corporation 2017 Second Quarter Results Conference Call.

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I would now like to turn the meeting over to Mr. Jeffrey Lozon, Interim CEO of Medical Facilities. Please go ahead, Mr. Lozon.

Jeffrey Lozon — Interim Chief Executive Officer, Medical Facilities Corporation

Thank you, Operator, and good morning, everyone. Joining me today is our management team, Tyler Murphy, our Chief Financial Officer; Jim Rolfe, our Chief Development Officer; and Rob Horrar, our Chief Operating Officer.

Prior to market opening today, we released our 2017 second quarter financial results. Our news release, financial statements, and MD&A may be accessed through our corporate website at www.medicalfacilitiescorporation.ca and are also filed on SEDAR today.

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

We are very pleased with the results of our second quarter of 2017, first because we had growth across all financial metrics, but also because it clearly demonstrates that we have an effective strategy in place to grow the Company.

As we have seen in previous quarters, we had strong growth in case volume. Compared to the second quarter of 2016, we had a 14.9 percent growth in total surgical cases. This is our 12th consecutive quarter of growth in surgical cases and the highest quarterly growth we’ve had yet. This growth reflects the same-store volume growth of 5.6 percent combined with contributions from our
new facilities. This volume growth demonstrates the market-leading position of our facilities. They are among the best surgical hospitals in the country and attract leading physicians with extensive referral networks.

In the quarter, we also had general improvement in case quality, resulting in higher revenue per case, and we saw a shift with more complex procedures being delivered on an outpatient basis.

Now let’s look at the success of our strategy in the quarter. Last fall, Prairie States Surgical Center was acquired by Sioux Falls Surgical Hospital and made a department of that hospital. At the time, we stated that we expected this combination would bring synergies for both facilities, particularly as the physicians from Prairie States joined the Sioux Falls team. This proved to be the case in Q2, with 2 million of revenue added to Sioux Falls results by Prairie States, an increase of 8.5 percent over Q2 in 2016. As well, the new positions on the Sioux Falls team helped to increase the overall case volume at the hospital, lifting the year-over-year revenue by 15.5 percent.

The Unity Hospital in Indiana also delivered strong results this quarter and added 11.9 million of revenue. While last quarter there was a decline because of an injury to a key surgeon, he has since returned to work at full capacity. In addition, two other surgeons have joined the team at Unity and contributed to revenue growth.

What this shows is that all three prongs of our growth strategy are effective and contributed to quarterly growth. First, a tuck-in acquisition to enhance an existing facility; second, adding a new
hospital in a new market; and third, bringing new positions on board to increase capacity and utilization.

Now before I hand the call over to Tyler, I would like to make a comment on our stock as it relates to our outlook. While MFC has seen a change in leadership recently, I will reiterate it has not changed our expectations for growth nor our strategy. MFC continues to be focused on growth and is well-positioned to execute on that strategy. As you are hearing today, that strategy is generating success. The Board and management are committed to the success of the Company and to seeing that our investor benefits from that success as reflected in their shareholdings.

We have a normal course issuer bid in place and have been exercising it. As of the end of Q2 2017, we have purchased 60,000 shares and will continue as we feel the current share price does not reflect the underlying value. Also, we are actively engaging the markets by meeting with the investment community to ensure they understand the MFC story and our outlook.

We are also very confident that our growth trend, supported by our solid balance sheet, ensure the stability and reliability of our dividends. In July, MFC shareholders received their 160th consecutive dividend since inception. That’s a track record we are proud of and that we are dedicated to maintaining.

Now Tyler will provide more details and insight into our financial performance for the second quarter of 2017. Tyler?

**Tyler Murphy** — Chief Financial Officer, Medical Facilities Corporation
Thanks, Jeff. 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.

In Q2 2017, MFC had revenue of 96.1 million, a 25.2 percent increase over 76.7 million in Q2 of 2016. As Jeff mentioned, contributions from new facilities and case growth at our existing facilities were key factors in this growth. Also contributing to the increase were the new urgent care and EMT clinics at Black Hills, additional revenue from improved case mix, along with annual price increases. This is now the eighth consecutive year-over-year increase in quarterly revenue.

As a result of higher case load, operating expenses increased to 79.9 million in Q2 2017 from 62.9 million in Q2 2016, but as a percentage of revenue, we were essentially flat quarter over quarter at 83.1 and 82.1 percent respectively. Impacting operating expenses in Q2 2017 was a 1.9 million transition charter related to our former CEO.

Payer mix continued to have an impact on revenue as we performed a higher proportion of cases paid for by Medicare. This was particularly the case at our Black Hills and Sioux Falls hospitals in South Dakota. However, this was offset by case mix and volume improvements across all centres resulting in a 17.6 percent increase in income from operations to 16.2 million from 13.8 million in Q2 2016.

To provide investors with a consistent way to track our progress, this quarter we will begin to report EBITDA. EBITDA in Q2 2017 was 23.1 million, a 22.2 percent increase from 18.9 million in Q2
2016. Higher revenue and income drove the increase. EBITDA margin for the past quarter was 24.1 percent compared to 24.7 percent a year earlier.

Cash available for distribution in the quarter was 12.1 million Canadian, a 14.5 percent increase from 10.5 million Canadian a year earlier. On a per share basis, our cash available for distribution was $0.39 in Q2 2017 compared to $0.34 per share in Q2 2016.

The resulting payout ratio was 72.4 percent for the quarter compared to 82.8 percent in Q2 2016. With cash and cash equivalents of 67.3 million and about US$32 million available on our credit facility at June 30th, we believe we are well resourced to execute on our growth strategy. 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?

Rob Horrar — Chief Operating Officer, Medical Facilities Corporation

Thanks, Tyler. After a strong second quarter, we anticipate continued solid results for the rest of 2017. And I believe we are well-positioned to achieve this from the strength of our management team, our focused growth strategy, and the high quality of our current hospital base.

MFC’s management team has proven skills in financial leadership, operations, acquisitions, and managing growth. I’ve recently come on board with the responsibility of amplifying MFC’s organic growth initiatives, improving operational efficiencies, and supporting our acquisitions and development activity led by our Chief Development Officer, Jim Rolfe.
As Jeff mentioned, organic growth remains a priority for MFC. We continue to realize the benefits from these initiatives such as the addition of Prairie States Surgical Center, opening new urgent care centres, adding and enhancing service lines, and recruiting new physicians and bringing renewed focus to our supply cost management initiatives.

In terms of acquisitions, the funding and reimbursement pressures that have been driving the consolidation trends in the healthcare sector still remain, and many physician groups are looking for a partner to help them manage these challenges. With MFC’s reputation and track record with physician-run hospitals, we are a partner of choice. As we have discussed in the past, our acquisition pipeline remains robust, and we are currently in advanced stages with a few of these opportunities. It is our belief that these discussions could result in an announcement by the end of the year.

Finally, it’s important to emphasize that our strategy is built on a solid platform of high-quality medical facilities. Our surgical hospitals are all top rated by national local market surveys for quality and patient satisfaction. They have been a reliable source of stable distributions for our shareholders, and we expect that will continue into the future.

With that, we would now like to open the line for questions. Operator?
At this time, if you would like to ask a question, you can press *, and the number 1 on your telephone keypad. And we’ll pause for just a moment to compile the Q&A roster.

And your first question comes from the line of Lennox Gibbs with TD Securities. Your line is open.

Lennox Gibbs — TD Securities

Good morning. Thank you. With respect to UMASH, can you provide more detail on the recent hires; some information around their specialties, et cetera?

Secondly, where does the total surgeon complement stand at UMASH? And where are you aiming to take that complement to in terms of numbers and in what time frame?

Jeffrey Lozon

Thanks, Lennox. It’s Jeff. I’m going to ask Rob to comment on your question.

Rob Horrar

Sure. We’ve added several neurosurgeons to that market, Lennox. And as we’ve said before, UMASH has the chassis to grow, and we see tremendous opportunity to continue to add surgeons, both orthopaedic and neurosurgical specialists to this particular hospital as well as opportunistic other sub-specialties here. It’s got a good chassis we can build on, and we expect that development activity to continue.

Jeffrey Lozon
To add to that, Lennox, the first places that we’ll look are our bread and butter, neurosurgery, which we’ve added to; orthopaedics, which we’re contemplating as the next area of growth. And the facility itself has capacity for capital redevelopment that would increase our operating rooms. And as we get there, we’ll make those capital investments to allow those people to do their work in an excellent market.

Lennox Gibbs

And how should we think about—can you tell us what are your targets like, in terms of returns on a neurosurgical hire, perhaps in terms of revenue per surgeon? How should we look at that? How do you think about that?

Jeffrey Lozon

Jim? I’ll ask Jim Rolfe to talk to that, Lennox.

Jim Rolfe — Chief Development Officer, Medical Facilities Corporation

Hi, Lennox. Back at my—in my previous job at a consulting firm, typically an ortho will bring in, on an industry average, around 2 million to 2.5 million in revenue. And like Rob said, our chassis is already built. And so again that contribution margin on that 2 million to 2.5 million is probably going to run 35 percent to 40 percent margin because we already had the staff in place to handle that volume.

Lennox Gibbs
Excellent. And then one last question. There appears to have been broad-based strengths on the quarter. Are there any broader market dynamics or internal initiatives that you would want to point to or emphasize that might help explain the strength? And then also speak to sustainability as well. I’ll leave it there.

Jeffrey Lozon

I think I’ll make a few comments on it. I think what we’re seeing is we’re seeing a very good sort of set of facilities who have thought through their local strategies quite well and who are being enabled by some expertise based in Nashville. So we don’t see really any big clouds on the horizon, Lennox. We see mostly good opportunities to grow in market. We have a series of initiatives that are underway in virtually every one of our centres, and in addition to that, as I think Rob mentioned, we’ve got a pretty robust pipeline that we’re closing in, a de novo thing. So if there were some negatives on the horizon, I would be talking about them. But we just don’t see any at the present point in time.

Lennox Gibbs

Thanks very much.

Operator

Your next question comes from the line of Neil Linsdell with Industrial Alliance Securities.

Your line is open.

Neil Linsdell — Industrial Alliance Securities

Jeffrey Lozon

Thanks, Neil.

Tyler Murphy

Thank you.

Neil Linsdell

Just on the spine surgeon at Unity, was there any kind of catch-up in the quarter from his absence? Or was it all just normal course?

Rob Horrar

Well, Neil, this is Rob, and I’ll answer that.

I think we did see some catch-up. Again, the procedures here are elective in nature, not emergent. So there’ll be continued catch-up. I think we’ll see that play out through the next couple of quarters, but there’s some catch-up to that. And hopefully, we didn’t lose a whole lot of that from the first part of the year.

Neil Linsdell

Okay.

Rob Horrar

Goods will be spread out.

Neil Linsdell
Okay. And then just on a broader view of what’s going on in the industry, are you seeing any changes or attitudes or policies at the insurers right now, which are changing anything as far as the deductibles and copays and altering the demand for the types of procedures that may be working in your favour or against you?

Rob Horrar

Yeah. Clearly, the trend has just continued and that is more employers that are adding high deductible health plans and increasing. Nothing unusual that we haven’t seen on a national basis. And again, we’ve got a preponderance of commercial payers in our payer mix, so there’s really not been any aberration there. It’s just continuation of the same trend.

Jeffrey Lozon

Neil, I wonder if I could interject because I think there’s something that Lennox asked about in terms of the future that I think maybe I should comment on; I forgot when I was answering it the first time.

I think the continuing uncertainty in the US healthcare system is something that’s hard for Canadian investors to understand, and that’s just a dynamic that we live with on a day-in and day-out basis. It has, as you can see from our case volumes and from the demand for our facilities, not really affected our business. And so we look at the underlying business as very strong and as very positive and going at a very good momentum. The challenge, of course, in a Canadian investor to understand
all of the rhetoric that’s going around healthcare reform and to see how that plays itself out in the US healthcare market.

And I think that’s not really a storm cloud, but it’s a factor that we have to deal with and we have to explain. And so we’re looking forward to the opportunity to say that, notwithstanding all of that white noise, I mean there is very good value and very good productivity at this corporation in the healthcare system of the United States.

**Neil Linsdell**

Yeah. No. Agreed. On the specializations that you have in your different hospitals, it looks like you’re adding some diversity with additional capabilities, looking at maybe cardiology and such. How much of what you are looking at doing driving the business forward comes from diversifying the mix of cases? And how much of that can you do say organically, adding surgeons to existing facilities? And would you look at say buying hospitals in overlapping geographies where you already operate but with different specializations?

**Jeffrey Lozon**

I’ll let Rob talk about that, but I would just maybe put a point of clarification on kind of what I would consider to be the adjacencies to our core markets, which are neurosurgical and orthopaedic. So the correct adjacencies there or the best adjacencies there are things like general surgery and other procedure-based activities. Cardiology is like a little bit of a step removed, but Rob, maybe you want to comment.
Rob Horrar

Yeah. So clearly, our bread and butter and the preponderance of our cases are neurosurgical and orthopaedic. So we’ll continue to look for growth opportunities there. And as Jeff said, complementing that to a lesser degree, but also providing us opportunity, are things like GI, general surgery, pain ...

Jeffrey Lozon

ENT.

Rob Horrar

ENT is correct; services. So we see those as a good, organic strategies, where they’re complementary or we’ve got capacity. And to your point, if there’s acquisition opportunities that are complementary, you’ve seen that we’ve added an ASC in a market where we’re certainly ready to do that where it makes sense. That’s a part of our growth strategy.

Jeffrey Lozon

Jim?

Jim Rolfe

Yeah. And, Neil, also, in all of our markets, we are also trying to expand our access points, and we’re also trying to expand our affiliations with primary care. And to have that affiliation, you need to offer other services than ortho and neuro. Right? So in a lot of our hospitals, we are looking
at trying to add some additional and expand some service lines to help out with our affiliations with primary care.

Neil Linsdell

Okay. Great. And I think maybe you touched on it in your initial comments. I think it might have been Jim. Are you seeing any attitudes shifting with the acquisition targets for the surgeons that you’re looking to try to bring in to your current facilities as far as uncertainty in the market? It’s becoming easier conversations?

Jim Rolfe

Easier conversations on bringing in surgeons? Or acquisitions?

Neil Linsdell

Both.

Jim Rolfe

Okay. No, not really. Again, we have a model that you can’t replicate. We have that physician alignment model that you can actually do your inpatient cases. So no. Nothing’s changed on that. And as Rob mentioned, our pipeline is still very, very robust, and actually the recruitment of physicians is also robust, too. So there’s been no change. Actually, to the positive it’s changed a little bit. But no. No change at all in that.

Neil Linsdell

Okay. Great. I’ll leave it there. Thanks.
Prakash Gowd — CIBC

Thanks very much. Good morning, gentlemen. I have a few questions. First, you’ve touched on this a little bit. I’m just wondering if we can maybe go into a little bit more detail. You’ve reported a strong quarter in what appears to be a very challenging environment where a lot of your larger peers have been experiencing a lot of difficulty maintaining, let alone growing, surgical volumes. And they are attributing much of this to higher deductible plans and higher proportion of government-paid cases. Can you give us your perspective on those specific issues and how you’re, I guess, preemptively managing the risks where others have not fared so well? And you think you’re really insulated from those issues despite the higher quality of your facilities?

Jeffrey Lozon

Thanks, Prakash. I’ll let Rob speak to that.

Rob Horrar

So, again, I think this is just a good reminder about our model. Our model is mostly elective cases. So we don’t have emergency rooms, and we don’t have the same types of payer mix that you see in the acute care side, some of the exposures that they have on their exchange products and Medicaid movement back and forth. So keep in mind most of our cases are elective in nature.
And I wouldn’t say that we’re insulated. We’ve made a comment that we’ve seen some more Medicare, but I think that’s more of a demographic trend than anything that’s programmatically occurring. So we’re going to see, again, some degree of exposure there, but again, our model, our centres and success is rooted in the high-quality physician groups that we’re aligned with and their communities for a very long period of time.

These are well-established physician groups that have maintained very high quality on outcomes of patient satisfaction and reputations. And that’s easily replicated. So that’s ...

Jeffrey Lozon

I would just add, Prakash, that no one is immune to big trends. So you’re not going swimming upstream on those things. But I think, really, the strength of the facilities, the quality of the referral relationships, the quality of the outcomes, the quality of the facilities themselves allow us to continue to prosper and to grow in a tough market. But it means that we have to continue to be sharp. We have to continue to look at organic growth opportunities.

So it’s not a status quo in any way, shape, or form.

Prakash Gowd

Okay. Then there’s just a couple of questions related to CMS. I understand, in terms of proposals for 2018, they’ve provided a 1.9 percent rate adjustment for ASCs, and I’m wondering if you can explain how that works. And is that just simply an inflation adjustment? And is there any potential read through to specialty surgical hospitals?
Jeffrey Lozon

Tyler, do you want to address the CMS initiatives?

Tyler Murphy

Yeah. So the outpatient pay rates is the increase you’re talking about. So obviously, we do a number of outpatient cases in our facilities. So that is attributable to us and that will help offset some of the other costs and everything.

There’s some other proposals on the table right now at CMS, but they’re still in their comment stage. The final proposals have not come out yet. So we will continue to monitor those, and we’ll obviously have additional information when we get to our next quarter call.

Prakash Gowd

Okay. But CMS is also proposing adding three additional procedures to the covered procedures list; total knee, partial hip, and total hip. Can you comment on how that might positively impact your business in 2018 and forward? Are those procedures that are already being done on a regular basis? Or do you see that as upside to your business?

Jeffrey Lozon

Tyler?

Tyler Murphy

Yeah. We are doing those procedures on an inpatient basis now. So we wouldn’t expect to lose those procedures because the physicians that are doing them are obviously the ones practising
in our facilities. We do have some risk there that if they flip to the outpatient rate from the inpatient rate that we will lose some of the top-line revenue. That number has not been—we haven’t forecasted that number yet, but there is some risk there from not losing the cases but just having lower reimbursement for those actual codes.

**Prakash Gowd**

Okay. Thanks. And just lastly, any status update on the CEO search? And any specific time line you could attribute to concluding that search? Thanks very much.

**Jeffrey Lozon**

As I think I mentioned, Prakash, when we did our initial tour of the analyst community, we foresaw this search accelerating faster than previous examples, previous searches we had, and that’s being proven out.

Russell Reynolds Associates are in the market now scanning internal and external candidates. So we’re pleased with the progress of this search, and I think we’re well-positioned to make it a much shorter runway than we’ve had in the past.

**Prakash Gowd**

Does that mean you’ll have somebody in place by year-end?

**Jeffrey Lozon**

That would be yes. That would be my anticipation; we’d have someone in place by year-end.

**Prakash Gowd**
Great. Thank you very much.

Operator

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

Endri Leno — National Bank

Hi. Good morning, and thanks for taking my questions. I have a couple, actually. First one, on your cost-saving initiatives, I was wondering have they already been implemented? And if you can comment on their progress and what you estimate was their impact in the quarter.

Jeffrey Lozon

Thanks, Endri. I’ll let Rob talk about the group purchasing initiative and other related activities.

Rob Horrar

Yes. So primarily organizing around our supply and purchasing initiatives, so we have enhanced those strategies. We have made some progress, and we’ve identified even more so. So I think that we’ll see continued progress with our supply costs, both on the drugs, medical supplies, and implants going forward.

So we do have more to go, and we’ve seen some good progress and collaboration with our centres and their leadership and physician groups.

Endri Leno
Thanks very much. And another quick question is on you have a 1.9 million CEO transition charge. I was wondering, is that it? Or is there going to be a little bit more off in coming quarters?

Tyler Murphy

Yeah. That’s a book number, which we’ve accrued for. It’s not resolved yet, so that number could go up, could go down a little bit. But we went and booked it ahead. And our auditors have given us a sign off on that. So we think it’s a ballpark.

Endri Leno

Okay. Thank you. And last question, it’s more of a general comment. If you can provide your insights on the KKR acquisition of the Covenant Surgical Partners, particularly in terms of multiples, and what does it imply for your acquisition strategy?

Jeffrey Lozon

Endri, it’s Jeff. There’s a lot of kind of nodded from a broad stroke because I don’t think we actually understand the question.

Endri Leno

Right. So I’m saying KKR, they acquired Covenant Surgical Partners. I mean, it’s still directly related to orthopaedics and neurosurgery. I mean, they also do a lot of GI surgery in ASCs. I was wondering if you have any commentary in terms of multiples or if it implies anything on your acquisition strategy at all.

Jeffrey Lozon
Specifically, we don’t. We have a pretty frothy marketplace that we’re operating in. We have a good handle on the multiples. But I can’t really comment on that specific deal, Endri. Sorry.

Endri Leno

Okay. Thank you. That’s all the questions I had. Thanks very much.

Jeffrey Lozon

Okay. Thanks for your questions. Appreciate it.

Operator

There are no further questions.

Jeffrey Lozon

Is that it? Okay.

Operator

I will now turn the call back over to Jeff Lozon for final remarks.

Jeffrey Lozon

Okay. First of all, I’d like to thank our doctors, our centre executives, our nurses, and all of our employees that deliver outstanding care to our patients every day. They’re the people and they’re the engines for Medical Facilities Corporation going forward.

I’d also like to thank all of you for participating on today’s call and for your continued interest in our company. We look forward to reporting on our progress in the next quarter.

Thanks very much, Operator.
Operator

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