Medical Facilities Corporation

Third Quarter 2019 Results

Event Date/Time: November 7, 2019 — 8:30 a.m. E.T.

Length: 30 minutes

CORPORATE PARTICIPANTS

Robert Horrar
Medical Facilities Corporation — President and Chief Executive Officer

David Watson
Medical Facilities Corporation — Chief Financial Officer

CONFERENCE CALL PARTICIPANTS

Doug Miehm
RBC Capital Markets — Analyst

Doug Loe
Echelon Wealth Partners Inc. — Analyst

Endri Leno
National Bank Financial — Analyst

Neil Linsdell
Industrial Alliance — Analyst

PRESENTATION

Operator

Good morning, everyone. Welcome to the Medical Facilities Corporation 2019 Third 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 security 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 to 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 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. Rob 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 on the call today is David Watson, our Chief Financial Officer, and Jim Rolfe, our Chief Development Officer.

Earlier this morning, we released our third quarter results. Our news release, financial statements and MD&A may be accessed through our corporate website at www.medicalfacilitiescorp.ca and have also been filed with SEDAR today.

Although many of our facilities saw an increase in volumes in the month of September, the challenges that we faced in the first half of the year, specifically with Unity, continued in the third quarter. Overall, case volume for the quarter was up slightly. However, our revenue decreased 2 percent, primarily due to changes in payer and case mix. Unity continued to perform lower than expected and was the facility contributing most to the shortfall in revenue and operating income compared to Q3 2018.

In fact, if we exclude Unity from our third quarter results, our revenue would have been up 3.1 percent and operating income would have been up over 6 percent, excluding the impact of IFRS 16.

Addressing the issues at Unity is our first priority. We have been and continue to evaluate all strategic alternatives for Unity. These alternatives could include recruiting additional physicians, partnering with local physician groups or selling all or part of our interest in the facility. The ongoing challenges at Unity, and to a lesser extent, one of our larger MFC Nueterra ambulatory surgery centres have been the most significant impact to our Q3 and year-to-date results.

We are obviously disappointed with our results over the past few quarters, resulting in a payout ratio in excess of 100 percent, which is not sustainable. Therefore, we have taken a difficult step to cut the dividend. We believe that this is in the long-term best interest of the MFC shareholders as it will result in sustainable distribution by allowing us to strengthen the balance sheet. As well, we are moving to a quarterly payment schedule in line with our market peers.

The new dividend payout will be CAD$0.28 per year, which will increase the Company's retained cash flow by approximately $20 million per year. This change provides increased financial flexibility to pursue the best available long-term value-maximizing opportunities.

Cash preserved as a result of this change will strengthen our balance sheet and better position us for growth while still providing a dividend in line with the average yield on the TSX Composite Index. On a pro forma basis, utilizing the new dividend rate, the year-to-date payout ratio would have been approximately 42 percent, which we believe is sustainable, given the Company's operations and cash available for distributions.

I will point out that this change does not affect the monthly dividend we previously declared on October 22 and which is payable on the 15th of this month. The first dividend payment under the new payout schedule will be for the partial period from November 1 to December 31 of this year and will be paid on January 15, 2020. The first full quarterly dividend will be paid on April 15, 2020.

Again, this change has been made with our future in mind, which we believe to be quite strong, rooted in our highly rated facilities, industry-leading quality of care and prevailing demographic trends.

I would like to now turn the call over to David to discuss our financial results for the quarter.

David Watson —Chief Financial Officer, Medical Facilities Corporation

Thank you, Rob.

Before I get started, I would like to remind everyone that our 2019 financial results include the impact of IFRS 16, a substantial change to lease accounting standards. MFC adopted it, IFRS 16, using the modified retrospective approach, and our financial results prior to 2019 were not restated. As a result, when comparing our 2019 EBITDA in 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.

As Rob previously mentioned, our revenue for the third quarter decreased 2 percent year-over-year to $102.1 million, versus $104.2 million in 2018, as facilities experienced lower average revenue per case due to both case and payer mix. This was partly offset by higher case volumes. Excluding the impact of an impairment charge incurred in the quarter, Adjusted EBITDA for the quarter was $21.4 million, a 5.4 percent decrease from 2018. As a percentage of revenue, Adjusted EBITDA for the third quarter was 21 percent.

Consolidated salaries and benefits increased by $0.6 million, or 2.1 percent, primarily due to benefit costs driven by higher utilization, but partly offset by lower stock-based compensation. As a percentage of revenue, consolidated salaries and benefits increased to 30.1 percent from 28.8 percent in 2018.

Consolidated drugs and supplies increased by $0.8 million, or 2.3 percent, primarily due to higher case volumes in some facilities, increased pricing for implants and supplies and case mix. As a percentage of revenue, the consolidated cost of drugs and supplies increased to 32.7 percent from 31.3 percent a year earlier.

Consolidated general and administrative expenses decreased by $2.3 million, or 12.1 percent. The decrease in G&A was mainly attributable to the IFRS 16 impact from lower rent expenses totaling $2.6 million, partly offset by higher professional fees of $0.4 million. As a percent of revenue, consolidated G&A decreased to 16.2 percent from 18.1 percent in 2018.

We recorded a noncash goodwill impairment charge of $22 million in the third quarter attributable to the MFC Nueterra ASCs. The ongoing underperformance at one of our larger ASCs primarily resulted in this charge. We remain optimistic about the long-term growth potential of our ASC platform. While this noncash impairment charge significantly impacted earnings for the quarter, it did not affect our cash balances, liquidity or operating cash flows.

Our cash available for distribution in the quarter was CAD$5.3 million, a decrease of CAD$4.1 million compared to the same period last year. The payout ratio for the quarter was 165.3 percent as compared to 92.4 percent in the same period last year. For the first nine months of the year, our payout ratio was 170.2 percent, up from 86 percent in the same period a year ago. As Rob mentioned, on a pro forma basis, utilizing new dividend rate, the year-to-date payout ratio would have been approximately 42 percent.

Turning to the balance sheet. We had cash and cash equivalents of just over $38 million, $11 million of short-term investments and approximately $81 million available on our credit facility at the end of the quarter.

Finally, our convertible debentures, which had CAD$41.7 million in aggregate principal amount outstanding at September 30, mature on December 31, 2019. We plan to use cash on hand and drawings on our credit facility to repay these convertible debentures in full.

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

I would now like to return the call to Rob to provide a few comments on our outlook before we open the call for discussion. Rob?

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

Thanks, David.

As I mentioned earlier, while the third quarter overall did not meet our expectations, we are encouraged by positive signs we saw in the month of September. I would like to mention a few highlights specific to some of our facilities.

Both Sioux Falls and Arkansas Surgical Hospital recently completed renovation projects and are well positioned for Q4. Black Hills Surgical Hospital, we brought on five new doctors in 2019, two of which started in Q3. As mentioned on previous calls, our expectation for a strong fourth quarter are based on historical trends where patients having met their deductibles seek to maximize their insurance benefits prior to the end of the year.

Looking to the fourth quarter and into 2020, we believe that the Company offers a good value proposition. While strengthening our balance sheet will be a leading priority, we also remain focused on operational improvement and growing our business with our partners. Specifically, our physician partners are committed to ensuring that our facilities continue to rank among the highest in the industry in patient satisfaction and quality scores. We will also continue to leverage our partnerships with new health and physician investors. Further, we look to expand the market share of our existing facilities, including recruitment of new physicians.

Outside of the surgical centres, the performance of the urgent care centres opened in the past few years continues to improve, including the newest one in Gillette, Wyoming. And, while we do not segment out our urgent care centre results in our financial disclosures, we thought it worth mentioning that the total urgent care visits were up 25 percent in Q3 versus the same period last year. We continue to look for opportunities to increase our market share and further enhance the performance of our urgent care centres.

As David mentioned, despite the noncash impairment charge incurred in the quarter, we still see great strategic value in the ASC platform. Moving forward, we will continue to pursue opportunities to develop or acquire additional ambulatory surgery centres.

On that topic, construction will begin in this month for our St. Luke's ASC partnership, which remains on target to begin operating in the second quarter of next year.

In closing, I want to thank our investors for their support and commitment to MFC as we continue to focus on the long-term strength of the Company. While we have experienced a period of substantial challenges, I believe that our approach will result in a strong and sustainable long-term future for MFC. I look forward to providing updates in the near future.

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

Q & A

Operator

Yes. Can you hear me, sir?

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

Yes, we’d like to open the call up for questions.

Operator

Thank you. At this time, if you would like to ask a question, press star, then the number one on your telephone keypad. Again, that is star, one on your telephone keypad. We’ll pause for just a moment to compile the Q&A roster.

Your first question comes from Endri Leno with National Bank.

Endri Leno — Analyst, National Bank Financial

Yes, good morning. Thanks for taking my question. A few for me. I'll start with Unity. I mean, first, you said that you're considering a number of alternatives, potentially even selling your share. Who could the buyer be? Would it be a local strategic one or would it be a larger hospital group? If you can elaborate on that?

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

Yes. Endri, I think what we've said is that, really, for us, all options that would result in a positive outcome for the Company are on the table for us.

Endri Leno — Analyst, National Bank Financial

Okay. Thank you. In terms of kind of the operations there, why did patient (inaudible) this decline at Unity? I mean, was there any physicians that were absent? Or was it more competition?

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

No. In fact, if you look at our volumes at Unity, they've actually increased. But part of the issue is that we have seen a decline in a higher case of orthopedic spine procedures there. So, while we brought on new physicians, we've seen a deterioration in a higher case mix at that facility. So, our plans are to reverse that and recruit additional partnerships.

Endri Leno — Analyst, National Bank Financial

Okay. Great, thank you. On the ASCs on the MFC Nueterra, I mean, what are the concerns to reverse? Is there any way you can mitigate them? Or, what are the options to mitigate them for the future quarters?

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

Yes. It's a good question. Thanks for the question. There is—right now, there's an internal fundamental disagreement with the practice that we're partnered with, and that has impacted the volumes in the surgery centres, the surgery centre at Two Rivers and actually resulted in a departure of a physician. So, while we're still very bullish on the opportunity that the platform brings us, this was one of the largest contributors, and we continued much like Unity to evaluate all the options going forward for Two Rivers to strengthen that.

Endri Leno — Analyst, National Bank Financial

Okay. Is a possibility of adding a new physician there as well? I guess that will be on the table, too?

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

Yes. All those options are on the table.

Endri Leno — Analyst, National Bank Financial

Okay, thank you. The last one for me, if you can talk a little bit about the higher bad debt expenses at Sioux Falls? How do you expect them evolving in the next few quarters?

David Watson —Chief Financial Officer, Medical Facilities Corporation

Yes. The part of the issue there, Endri, was just a comparison year-over-year. Obviously, bad debt expense is going to fluctuate period to period. Some quarters, we have positive movements in the bad debt expense; some periods, negative. Third quarter of last year had a positive movement or a pickup. So, on a comparative basis year-over-year, third quarter 2019 looks relatively higher. There really are no issues there; it's for the quarter on a comparative basis, and just within the quarter, they had a few more write-offs than in prior quarters. But we don't see a trend there.

Endri Leno — Analyst, National Bank Financial

Okay, great. I'll get back on the queue. Thank you.

Operator

Your next question comes from Doug Miehm with RBC Capital Markets.

Doug Miehm — Analyst, RBC Capital Markets

Good morning. A couple of questions. First one is you do talk about value-maximizing opportunities. I think based on what you just said that you're still looking at potential acquisitions and hoping to build the business. But maybe you can help us out, why should investors trust your ability to do that given the last couple of acquisitions that you've completed?

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

Yes. We've seen the opportunity that the ASC platform brought to us, which is why we did the deal. We see, in the U.S., a shift more in a lot of cases. More and more cases are being done on an outpatient basis. We think that's a good platform. Right now, it's a relatively small platform. It's one that will benefit from scale. It also brought to us a de novo opportunity that we called out at St. Luke's, which is slated to open in the second quarter, and those are the opportunities. That's why we did the platform itself.

The issues around Unity are complex. It was a centre that benefit from more partnerships, and that's what we're focused on in getting that resolved. But for right now, we believe that the future opportunity in the ASC world and universe is significant.

Doug Miehm — Analyst, RBC Capital Markets

Okay. If I look at the nine months ended September 30 in terms of cash provided by operating activities this year and last year, they're roughly the same. This year, it's a couple of million dollars lower, and yet, cash available for distribution has dropped by $15 million. And, even if we consider the payment of the lease liabilities under IFRS 16, what accounts for the remainder of the difference, the $4 million to $5 million, in your view?

David Watson —Chief Financial Officer, Medical Facilities Corporation

Yes. It relates to the ownership percentages. So, to the extent we had a higher ownership percentage in Unity, for example, which is underperforming, that has a disproportionate impact on cash available for distribution because the Company rather than the non-controlling interests are bearing that loss.

Doug Miehm — Analyst, RBC Capital Markets

Perfect. Finally, just to wrap up, you set the dividend at $0.28, which you indicated was in line with the average TSX dividend paying company at around 3.6 percent, I guess, it is. Do you consider yourselves an average Canadian operating company that pays a dividend?

David Watson —Chief Financial Officer, Medical Facilities Corporation

I'm not sure what else we'd be.

Doug Miehm — Analyst, RBC Capital Markets

No. I meant from operationally and capability and size and all those sorts of things.

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

No. I think what we—the comment really is the fact that the yield is in line with the—on the dividend, and we feel it's sustainable. We feel that it's an important component of shareholder values to maintaining that, and that's the comment.

Doug Miehm — Analyst, RBC Capital Markets

Yes, okay. Thanks.

Operator

Your next question comes from Neil Linsdell with Industrial Alliance.

Neil Linsdell — Analyst, Industrial Alliance

Hey, good morning guys. Just to go into the debt. So, you're going to take the converts, you're going to—before maturity, you're going to repay them with your credit facility. You're within your debt covenants right now. Pro forma, how do you stand on the covenants? Or, are there any changes that are going to have to be made?

David Watson —Chief Financial Officer, Medical Facilities Corporation

We anticipate that we will remain within our covenants, taking down the debt—or taking down the converts through draws on the credit facility and the use of cash. I guess I'd add to that, we've got a very supportive lender group. And to the extent we decide to make a change to our credit agreement in the future, I don't foresee any issues with that.

Neil Linsdell — Analyst, Industrial Alliance

Okay. So then given the pressure on your stock and within your credit facility, would you be looking at share buybacks with the share price being under pressure the way it has been?

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

Well, we just cut our dividend to strengthen the balance sheet and support our growth. At this point, I'm not sure that deploying capital in a normal course issuer bid makes sense now. But depending on the future share price, we always look at the best use of our capital.

Neil Linsdell — Analyst, Industrial Alliance

Okay. And you talked—you gave a few examples of physicians that had joined or left. Can you talk about in the last quarter and anything anticipated really through the end of the year of physicians and the specializations in each one of the facilities as far as who's joined and who's left?

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

Well, we brought on a number of surgeons. We called out Black Hills in terms of bringing on five this year, which was really good. We did have a departure in the same market. But really, I think their volumes remain strong and actually increased. We continue to focus on opportunities going forward for recruiting, particularly orthopedics and neurosurgery, those are the specialties that we're most recruiting in the Company. It's sourcing the right candidates; the right fit has always been the challenge. And so far with the opportunities to practice at our facilities, with the quality and the patient satisfaction has been a good story so far. But what I'd tell you is that we continue to fill the needs, and it's primarily in orthopedics and neurosurgery are our top recruit.

Neil Linsdell — Analyst, Industrial Alliance

Right. So, that was a neurosurgeon you lost in Black Hills. Are they—out of the five that joined, were there any neurosurgeons there? Is there a significant difference in the profitability or the volumes or the revenue that can be handled by the different types?

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

No. Actually, they had recruited an orthopedic spine physician and still have—as again, I think we saw volumes were actually slightly above prior quarter there. So right now, no impact.

Neil Linsdell — Analyst, Industrial Alliance

Okay. And then each quarter, when we look at the volatility or disappointments or what have you, it's typically based on, obviously, a mix of procedures and payer mix. So, on the payer mix, is there anything that's fundamentally going on with your client base with the doctors that you're recruiting that is impacting that still? Or any kind of a...

David Watson —Chief Financial Officer, Medical Facilities Corporation

Neither. There's really nothing tied to specific physicians or physician mix. In the third quarter, it continued to increase in government payers as a percentage of our gross revenue. So, there was a bit of a payer mix shift in the quarter, but it's not tied to procedures or physicians.

Neil Linsdell — Analyst, Industrial Alliance

Is it a more demographic thing? You're getting more older patients that are getting more of their funding from the Medicare side?

David Watson —Chief Financial Officer, Medical Facilities Corporation

Yes. We are seeing—at least in the quarter, we saw an increase in Medicare, which given the demographics is not unanticipated. But, as we move into the fourth quarter, you typically see an increase in commercial as patients are—met the deductibles and are trying to get their cases in prior to the end of the year.

Neil Linsdell — Analyst, Industrial Alliance

Okay. As you mentioned having a positive September, now we're into November, so are you seeing the same type of pickup and the same improvement in mix as we normally see in Q4, normally being your best quarter?

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

We're starting to see that. I mean, we only have right now indications and clearly, we haven't announced anything. But in October, our volumes are continuing to look strong.

Operator

As a reminder, if you would like to ask a question, please press star, one on your telephone. Again, that is star, one on your telephone keypad.

Your next question comes from Doug Loe, Echelon Wealth.

Doug Loe — Analyst, Echelon Wealth Partners Inc.

Yes, thanks Operator. Good morning Rob. Maybe just kind of following on on the revisions in your dividend policy here. I mean, the cut from $1.13 to $0.28 is clearly substantial. I'm just wondering if you can just walk me through the thinking on why you retained the dividend at all because, clearly, you could have brought it down to zero to preserve even more cash for future acquisitions that wouldn't require any revisions to your capital structure. So, just walk me through the thinking on why you just didn't take it down to zero.

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

Sure, Doug. We believe that at this level, it is sustainable and we looked at it. And the yield is still, we believe, in line with peers. And finally, we also believe it is an important component of shareholder value and to keep that in the mix. So that was the calculus.

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

Okay. Fair enough. Thanks Rob.

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

Yes sir.

Operator

Again, if you would like to ask a question, please press star, one on your telephone keypad now.

Sir, there are no further questions at this time.

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

Well, 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.

Operator

Thank you for joining on today's call. At this time, you may disconnect.