A potential star is born

Roger Montgomery sees a bright prospect – and some risk – in healthcare

HEALTHCARE IS A FAVOURED investment theme at Montgomery Investment Management. People are living longer and as a result there will be a constant demand for products and services that arrest the natural deterioration of our bodies. Importantly, the sector's growth transcends the short-term economic cycle.

Many companies focus on extending life, but this month I want to discuss one that focuses on the creation of life. There is, for example, a growing trend of women delaying the birth of children. The average age of giving birth is 30, but this advancing age leads to a material reduction in fertility. If the trend continues, demand will grow for assisted reproductive technology (ART) services. In Australia, 3.1% of babies now born are a result of ART.

ART includes achieving pregnancy by artificial or assisted means, but IVF is not its only use. With increasing frequency, ART is used by fertile couples for genetic reasons. It is used by couples discordant for communicable diseases such as AIDS. And with time ART's use to screen for genetic defects and select embryos without the defect will increase meaningfully. As one experienced obstetrician remarked to us during our inquiries, "the movie *Gattaca* is not science fiction".

Virtus Health provides assisted reproductive technology services, such as IVF, through a network of clinicians, scientists and researchers. Virtus floated on the ASX on June 11 and Montgomery participated in the float as we believe it offers sufficient long-term value. The company's offering was oversubscribed and at its debut the stock closed 9% higher than its issue price.

We really stick our neck on the block writing about a company we are investing in, and telling you about it before its success (or otherwise) is known. So far we have been reasonable happy with our hit rate, but it's still a risk.

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Operating in a market with favourable demographics is a critical criterion of our investment process, but it does not in itself guarantee a company will be profitable.

We are attracted to Virtus's long-run earnings potential because of its specialist network. Typically – with the exception of Primary Health Care – healthcare providers will "acquire" the services of doctors for predetermined periods. In other words, they pay cash to "buy" the doctor. The costs are capitalised (turned into an asset on the balance sheet) and then amortised (expensed annually) over the life of the service and the expense is treated like a salary. The difference, of course, is the cash was paid upfront and the effect is that profits are artificially boosted by the accounting treatment. By contrast, Virtus contracts fertility specialists as independent practitioners who build their own consulting businesses with the help of Virtus's marketing. The specialists are not employees of Virtus, nor are they purchased with equity from the company.

Virtus secures specialists by granting options against five-year contracted terms. The options are based on practice profitability, which is also tied to volume-increase milestones. While the annual cost to revenue is higher in the early years under this model, the ratio smooths out over time, resulting in high returns on investment if specialists stay for more than eight years.

It's important to note that Virtus's earnings growth for 2012 is unlikely to be repeated soon. It materially increased its specialist numbers by 14 in 2012. The 21% jump in referring doctors increased earnings by 27%.

Virtus will focus on nurturing the network to ensure profitability before making acquisitions of a similar scale (a primary reason for the float is to inject much-needed capital). It will take time to realise the expanded network's benefits but the long-term horizon nicely suits our investment style.

The primary risk is retaining doctors when their contracts expire after five years. The assisted reproductive market is fairly concentrated and competitors may entice specialists with more lucrative offers. Virtus has attributed prior attrition to specialists retiring rather than leaving to compete. Needless to say, we will be watching the specialist mix closely.

Some recently floated companies have lost ground as a result of overly optimistic forecasts by analysts. Myer and Collins Foods are examples. Facebook also had a disappointing float. We have applied a further discount to our conservative forecasts to account for this positive bias (although a week after its float, Virtus has risen higher). But there have also been some screaming success stories and we think Virtus may, in time, fall into this latter camp.

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