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Ramsay passes health check with flying colours

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By now, many readers will be aware of the generational shift that is occurring in Australia. According to the Australian Bureau of Statistics, the population aged 65 years and over is projected to increase from 3.2 million in 2012 to around 5.7 million by 2031.

The shift is being driven by the baby boomers. After a lifetime of hard work, many will be looking to exit the workforce and enjoy their retirement. In order to maintain their health, the generation will require increasingly greater levels of medical care.

This has profound implications for the healthcare sector. While a growing market certainly makes for a favourable investment dynamic, it does not in itself guarantee profitability or sustainable returns. Investors who want exposure to this sector shouldn't be allocating capital in a scattergun approach. Rather, investors should be targeting those companies with the best fundamentals, prospects and value for money.

Quality scorecard

The healthcare sector is classified by a number of segments, including biotechnology, equipment manufacturers, pharmaceuticals and service providers. Many healthcare companies are exposed to the favourable tailwind presented by the ageing population, yet the underlying quality varies considerably. Let's explore the quality of the following companies by comparing Return on Equity (ROE), Gearing (Net Debt to Equity) and Profit Margins (Net Profit After Tax / Sales).

Code	Company Name	Industry Name	ROE (%)	Net Debt to Equity (%)	Profit Margin (%)	Market Cap ($mill)
CSL	CSL LTD	Biotechnology	36	30	25	33,647
SRX	SIRTEX MEDICAL LTD	Biotechnology	25	(59)	19	957
MSB	MESOBLAST LTD	Biotechnology	(12)	(50)	(338)	1,544
COH	COCHLEAR LTD	Health Care Equipment	21	33	19	3,401
RMD	RESMED INC-CDI	Health Care Equipment	19	(36)	20	7,745
ANN	ANSELL LTD	Health Care Equipment	16	30	10	2,799
RHC	RAMSAY HEALTH CARE LTD	Health Care Providers	21	64	6	9,358
VRT	VIRTUS HEALTH LTD	Health Care Providers	8	61	5	623
SHL	SONIC HEALTHCARE LTD	Health Care Providers	13	60	10	7,327
SIP	SIGMA PHARMACEUTICALS LTD	Health Care Providers	9	(12)	2	793
PRY	PRIMARY HEALTH CARE LTD	Health Care Providers	6	39	10	2,412
API	AUSTRALIAN PHARMA INDUS LTD	Health Care Providers	4	20	1	261
MYX	MAYNE PHARMA GROUP LTD	Pharmaceuticals	7	23	6	502
SPL	STARPHARMA HOLDINGS LTD	Pharmaceuticals	(20)	(73)	(623)	189

Source: *Bloomberg, Latest Applicable Financial Year, Market Capitalisation as at 13 May 2014*

The segments with the highest quality according to these metrics are biotechnology companies and equipment manufacturers. You'll note that CSL, Sirtex, Cochlear and Resmed each have a return on equity above 19%, high profit margins and strong balance sheets.

Control over valuable intellectual property helps explain each company's financial position. Resmed specialises in sleep, Cochlear provides hearing to the deaf, CSL produces life-saving vaccines, while Sirtex is showing promising results in the treatment of liver cancer – these are all treatments that customers pay a premium for.

Considerable time and investment is required to generate these profit margins. You will note that Mesoblast, a developer of biological therapies for regenerative medicine, is unprofitable. Yet the company has a market capitalisation of $1.5 billion, which is 2.4 times greater than its book value of equity.

High profit margins generally attract competitors, and this means substantial reinvestment is required to maintain strong positioning and pricing power. Cochlear, in particular, has recently experienced considerable pressure in this regard.

Best providers

Looking at the healthcare providers, the quality operators are Sonic Healthcare, which focuses on pathology, Ramsay Health Care, a builder and operator of hospitals, and Virtus, the owner of fertility clinics.

We regard Ramsay Health Care as one of the highest quality companies on the ASX. You may wonder why, given it has a high return on equity but low profit margins and high gearing. Operating hospitals is a difficult game, evidenced by the lower profit margins. But Ramsay is very good at it.

Because of this reputation, Ramsay is favoured over many of its competitors when tendering for projects or pursuing acquisitions. This dynamic makes for a very strong value proposition, given the sheer scale of domestic and international opportunities. This is demonstrated by the company's recent announcement that it has entered into exclusive discussions to acquire a majority stake in Générale de Santé, one of the France's leading Private Healthcare Service Groups.

When companies do not control intellectual property, it tends to be difficult to generate value. This is the case with Sigma Pharmaceuticals and Mayne Pharma, manufacturers and distributors of generic products through wholesale and pharmaceutical networks. Companies that handle generic products have little pricing power, and this translates to both modest margins and returns on equity.

While this is a broad overview of what to look for when diagnosing the well being of health care companies, it should go some way to demonstrating that a favourable industry tailwind does not automatically translate to favourable returns. Of course, further research is required if you were to consider any of these companies as investment prospects.

The Montgomery Funds own CSL, Ramsay Health Care, Resmed and Sirtex Medical.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

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