Virtus revisited

by Roger Montgomery

Key points

- *Virtus was one IPO in 2013 that focused on the creation of life and was well-positioned to capture a growing trend in Australia of women delaying the birth of children.*
- *But it was difficult to justify the projected high future earnings growth forecast by the company without an associated increase in referring doctors.*
- *At this stage, no more fertility specialist acquisitions are likely in the foreseeable future.*

Experience over the years has led us to form a range of evidenced-based opinions on a number of investing topics. One of these opinions relates to new business coming to market as an Initial Public Offering (IPO), and in particular, when private equity passes around the hat in an attempt to raise large amounts of capital simply to fund the buyout of current shareholders.

There's a simple reason for this. Even if you have the time and ability to intensely research the business' past and future prospects, the seller will always be in a more knowledgeable position than you. This is because private equity will have already been hands on in its management and growth of the business for a number of years.

And buying an asset from someone who's more informed than you means that you've got your work cut out. This is why we endeavour to ensure that we are not left holding the baby so to speak, a fitting pun for today's column.

Don't be fooled

We have found that it pays to be prudent when it comes to the forward earnings projections that many of these IPO's can be anchored (sold) upon.

Time and time again, despite confident management heading into an IPO, we see numerous new floats fall short of their projected earnings in just the first 12 months as a public entity, blaming all forms of external factors from the economic climate to even then weather!

When we assess any IPO with strong growth forecasts, of paramount importance to us is that we can perform our own intensive research and financial modelling to ensure a more "independent" view of the company's prospects.

One float that we thought captured this perfectly is Virtus Health Limited, which we will revisit today (ASX: VRT) following their recent downgrade to growth guidance and subsequent negative share price reaction.

The Virtus view

There are many companies that focus on extending the life of their patients, but Virtus was one IPO in 2013 that focused on the creation of life and was well positioned to capture a growing trend in Australia of women delaying the birth of children.

The average age of women giving birth is now 30 years, but this advancing age leads to a material reduction in fertility and if this trend continues, then demand will continue to grow for Assisted Reproductive Services (ART) which is what Virtus Health specialises in through a network of clinicians, scientists and researchers.

At the time of our initial review, the company was exposed to longer-run earnings potential due to favourable demographics and a well-regarded specialist network. We did, however, note an important issue, which caused us to adopt some conservatism.

A red flag is raised whenever strong, abnormal growth is ‘likely’ to be generated in the years preceding a float and is justified based on the fact that similar growth rates have been achieved in the recent past.

In the year before its IPO, Virtus materially bolstered its network with 14 fertility specialists. These specialists, unsurprisingly, brought in their own patients, which contributed largely to earnings growing by 27%.

To the casual observer, this would appear to be a high-growth business and could be worthy of a higher price. We noted that Virtus’ core growth drivers were simply the recruitment of specialists and their ability to source and perform IVF cycles. We questioned the sustainability of the earnings growth given it would ultimately be highly correlated with the number of new specialists.

Digging a little deeper, in the preceding year, we discovered that only two net specialists were acquired which translated into earnings growing just 1.6% over the following period. On this basis, it was difficult to justify high future earnings growth without an associated increase in referring doctors. After all, a doctor’s ability to refer patients is limited by the amount of hours in a working day.

What was then noteworthy was that the company had only planned to add three doctors in the foreseeable future (its IPO forecast period) and yet earnings growth rates in excess of 20% per annum were being applied by analysts marketing the IPO.

This was clearly questionable, given that unless Virtus could rapidly increase scale in surgeries or add new services, it would become quickly obvious that more specialists would need to be acquired to justify such a bullish outlook. As such, we chose to be conservative in our forecasts, adopting growth rates much lower than those that were kindly pre-prepared for us.

Still a good price

Even after conducting this, the offer price provided a sufficient margin of safety to warrant investment and we participated in the float. What did surprise us, however, was when the company floated on the ASX on 11 June 2013, the market exuberantly considered that the higher growth projections were more appropriate. This was something we subsequently took advantage of by disposing of our shareholding.

Perhaps unsurprisingly today is the company has recently downgraded its growth guidance, rebasing its forecasts from mid-teen growth to mid-single growth. Whilst a number of reasons have been given for this, what we do know from our discussions with management is that at this stage, no more fertility specialist acquisitions are likely in the foreseeable future.

It has taken a number of years, but it seems that our reservations were justified which brings us to another point. With the share price having materially corrected – is now the time investors should again be revisiting this one?

Virtus

Source: *Yahoo!7 Finance, 18 June 2015*

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