Healthscope healthy over the long term

by Roger Montgomery

Australia's population is ageing, yet the public and private hospital systems are growing at very different speeds. Public hospital beds grew by 1% each year between 2010 and 2014, compared to 3% annual growth in the private system. Increasing demand for hospital care will flow to operators that are expanding capacity, which means that major private hospital companies like Healthscope (ASX: HSO) and Ramsay Health Care (ASX: RHC) are well placed to grow earnings over the long term.

Ramsay Health Care is the larger and more profitable operator of the two companies, but Healthscope is a quality operator in its own right. The market may not fully appreciate this though because of the company's chequered history.

Healthscope previously tried to position itself as a healthcare conglomerate. The group had interests in hospitals, pathology and medical centres, and also tried to enter the aged care market but the attempt was blocked by shareholders.

Healthscope was then acquired by private equity in 2010 and re-floated in 2014. While all floats should be considered with a healthy dose of scepticism, investors may be warier of companies coming out of private equity hands after a number of floats performed particularly poorly in recent years. Yet Healthscope's hospital division was well run prior to acquisition, and margins have gradually expanded since 2010 to modestly trail Ramsay's today.

Healthscope has since exited its domestic pathology business, and its remaining medical centres and international pathology assets only comprise 17% of operating profits. Healthscope should predominantly be viewed as a domestic hospital operator, and a good one at that, particularly since it won the tender to build and operate the Northern Beaches hospital in Sydney.

The Northern Beaches hospital will have 450 overnight beds, with 40% allocated to private patients and 60% allocated to public patients. Healthscope can coordinate the shared facilities between the two systems, and transfers of public patients from neighbouring hospitals will provide strong utilisation when the hospital opens. The Government will also pay the public share of the capital expenditure to Healthscope as soon as the lights come on, so Healthscope is incentivised to finish the build as soon as possible. If Healthscope executes this contract successfully, it will position the company very well for future tenders based on this public/private model.

For those concerned that rising health insurance premiums may adversely impact Healthscope's long-term earnings prospects, we consider that Australia's healthcare funding system actually favours the major hospitals. This is because the reimbursements for treatments are based on market-wide averages. Large, metropolitan hospitals are better equipped to perform complex operations than smaller, regional hospitals, as higher patient concentrations provide wider access for specialists.

Private hospitals also have greater discretion for case selection than public hospitals. This means that Healthscope, with its significant metropolitan presence, can coordinate its facilities to favour the highest margin operations but remain more cost-effective on a national level.

Taken together, Healthscope operates local monopolies in a sector with very high barriers to entry. This should support returns over the longer term, particularly if demand for healthcare continues to outpace supply. We feel that the market is yet to appreciate Healthscope's quality and growth prospects, which we consider provides material upside for an investment. As such, the domestic Montgomery funds have taken a meaningful position in the company.

Source: Yahoo!7. Data as at 27 June, 2016

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.*