A (re)visit to the hospital: Healthscope and Ramsay

by Roger Montgomery

Over the course of 2016, we have provided an insight into the competitive dynamics and aggregate prospects of several industry sectors, from financial markets to supermarkets, listed on the Australian stock market.

Any experienced value investor would know, however, that finding value in 2016 has been difficult. Indeed, I cannot readily recall a time in my career when so few investment opportunities were available. As a result of this dearth of high quality investment candidates, we have been building cash and urging others to speak to their advisers about doing the same. The possibility of large share price falls, which increases as prices rise beyond what is justified by earnings growth or when fuelled by debt or enthusiasm, would make the 2% earned on cash look like a relatively attractive option.

We accept that cash creates a drag on performance during rising markets and it can burn a hole sitting in your pocket – tempting you to stray from the patient investing path. We have however not been persuaded to diverge from our investment style, philosophy or process and so the market has not been replete with buying opportunities.

Fortunately, that has been prudent because in the second half of 2016, several very-high quality businesses, and those with strong long-run growth prospects, have announced issues of a temporary nature that have been treated by the market as permanent.

When that happens, shares prices fall precipitously and value emerges. We note also Warren Buffett's Berkshire Hathaway is holding a record $110 billion in cash. When Buffett has lots of cash, it also suggests few investment opportunities and therefore an expensive market.

This month we revisit one sector where value might have emerged. We believe Australia has few sectors with as clearly bright prospects as healthcare.

An ageing population – we note the number of those aged 65-74 will double in the next 15 years, as will the number of those aged more than 85 years – as well as a generation who took up aerobics and jogging for the first time, and nine month waiting lists at public hospitals, will essentially guarantee a conga-line of elective surgery separations. A separation is recorded when an episode of care for an admitted patient ceases.

In 2014–15, there were approximately 10.2 million separations in Australia's public and private hospitals. Between 2010–11 and 2014–15, the number of separations in all hospitals increased by 3.5% on average each year, and by 4.0% for private hospitals. It is also worth appreciating that the ageing population means the number of the separations is growing at a faster rate than the population, which grew by just 1.6% annually over this period.

In 2014–15, about 41% of separations were for people aged 65 and over. Public hospitals accounted for the majority of childbirth separations (75%), medical separations (73%) and emergency admissions (92%). Private hospitals accounted for 60% of surgical separations.

Between 2010–11 and 2014–15, elective admissions involving surgery (of which there were 2.1 million in 2014-15) rose by an average of 2.4% per year, by 1.3% for public hospitals and by 3.0% for private hospitals.

Of course, this growth is well understood and reflected in generally very high earnings multiples across stocks representing the health care sector. When a business then fails to meet the market's expectations, as Healthscope did recently, it tends to be reappraised harshly, with many investors shooting first and asking questions later.

Healthscope stated: *"Various data points across the industry tell us that the average rate of hospital volume growth generally has slowed. We have seen this impact a number of our hospitals resulting in increased variability in volumes and case mix month to month in the first quarter and particularly in September. Management focus continues to be on driving revenue growth and disciplined cost control."*

The company also added that were conditions in the first quarter to continue for another three quarters earnings growth, as measured by EBITDA (earnings before interest, tax, depreciation and amortisation) would be flat year-on-year.

"If the trend for the first quarter was to continue, it is likely that operating EBITDA growth for our hospitals division would be flat year on year."

Given consensus analyst, and therefore market, expectations were for greater than 10% growth, it is understandable that the shares would be de-rated.

We know the trends for elective surgeries – for which private hospitals dominate – coincide with the ageing population. When asked in a subsequent interview with *The Australian* about the share price reaction to the announcement, Healthscope chairman Paula Dwyer and boss Robert Cooke said; *"That's an overreaction. We have taken a really cautious view to our outlook statement and we are talking about a couple of per cent of volume*" adding;

"*The crazy thing about this is that you have waiting lists of nine months in the public sector, you then have the federal government getting billed for radiology, pathology and other things — so it's cost shifting by the states. Then they go and build extra beds for $2m to $3m per bed — we can build them for $1m.*"

As long-term value investors, we aren't concerned with the monthly, quarterly or even one-year changes to admission numbers. The long-term trends are intact and we believe any diversion from these trends represents noise.

Healthscope Limited (ASX:HSO)

Healthscope is the second largest operator of private hospitals in Australia, and is investing heavily to accommodate our growing demand for health care. Healthscope not only provides services more economically than the public system, it is able to construct facilities at lower cost as well, which is compelling for Governments, as pressure mounts from rising private health care premiums and longer waiting lists.

Despite positive underlying trends, Healthscope disappointed the market recently by announcing weaker volumes in the September quarter, which when annualised could translate to flat earnings growth for this financial year. Its share price subsequently fell 30%, yet the weakness seems to be industry wide and not specific to Healthscope.

When it comes to the highest quality prospects, we feel the market is offering value by treating that which appears temporary as permanent. The demand for health care will continue to rise for many decades, and for an experienced and major operator like Healthscope, this should translate to increasing volumes, expanding margins and ultimately strong earnings growth for shareholders over the long term.

The one caveat in the short-term is the impact of any changes to the payments made to suppliers, such as prosthetic manufacturers, and the associated rebates paid back to hospitals. These changes may occur following public hearings on the issues. This could potentially be an issue for all hospital operators.

Ramsay Health Care Limited (ASX: RHC)

Ramsay is one of the top private hospital operators in the world. It has been a stellar performer on the ASX with a track record of providing shareholders with solid returns. In the last 10 years, the shares have provided an average total shareholder return of 24% per annum. Ramsay delivered a Net Profit After Tax of $481.4 million for the year ended 30 June 2016, a 16.8% increase on the previous year.

Ramsay has hospitals in Australia, the United Kingdom and Asia, and has acquired hospitals in France, where medical supplies are cheaper to source than in Australia. The Group's size has allowed management to negotiate meaningful savings with global suppliers for medical supplies, which should support Ramsay's domestic earnings amidst the ongoing health care reviews by the Australian Government. Ramsay is also using its global buying power to pursue economic returns in pharmacies.

Health care volumes were weaker across the industry in the September quarter, yet Ramsay has reiterated its existing earnings guidance for this financial year of 10-12% earnings growth.

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