PHILO CAPITAL ADVISERS



# Changes that boost Healthscope's value

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Fund managers are yet to be convinced **Healthscope** has improved enough to warrant a $1 billion-plus rise in its market value, as the private hospital and pathology operator steams towards a $4 billion float in July.

Private equity funds TPG and The Carlyle Group bought Healthscope in 2010 for $2.6 billion. Analysts from brokers working on the float have put out research suggesting an equity value of up to $4.6 billion, although most estimates point to $4 billion as the midpoint of their range.

Philo Capital fund manager **Hugh Dive** said it was difficult to see an improvement in the business that justified its value when compared with hospital operator **Ramsay Health Care** and pathology and medical centre outfit **Sonic Healthcare**. Mr Dive said he could model a "synthetic Healthscope" made up of 80 per cent Ramsay and 20 per cent Sonic that offered "higher margins for a cheaper price".

"Those businesses are far higher-quality businesses," he said.

Mr Dive said Healthscope was a "strong business exposed to a lot of very favourable dynamics" and had reported solid earnings growth under TPG and The Carlyle Group. However, he said, the pricing by the brokers' analysts, suggesting Healthscope equity value was equivalent to 21 to 27 times forward earnings, was "very challenging". Ramsay is trading at 24 times forward earnings and Sonic is at 16 times.

He also said the private equity owners had left significant capital expenditure to be "paid for by future shareholders". Mr Dive said research showed a decline in capex from 2011 to last year, but it was expected to increase again in fiscal 2014 and 2015 as Healthscope ramped up its brownfield expansions of existing hospitals.

Wilson Asset Management chief investment officer **Chris Stott** said the fund was interested in owning health stocks but would scrutinise how Healthscope had evolved under its private equity owners.

"We will assess the current structure of the business compared to how it looked a couple of years ago when it was listed and make a decision," he said. "We believe that the Australian healthcare space exhibits strong growth prospects for the next 10 years."

Mr Stott has yet to examine the marketing research released on Monday, as first revealed by Street Talk online, but wanted evidence of positive changes.

The analysts have gone to great lengths to illustrate initiatives put in place by TPG and The Carlyle Group.

CIMB analyst **Derek Jellinek** has dedicated a page in his research note to "what's new about Healthscope". CIMB, along with CBA Equities and Evans & Partners, have been brought on as co-managers to sell the float, which will be the biggest since the $4.6 billion privatisation of rail group QR National, now **Aurizon**, in 2010.

Mr Jellinek outlines seven big changes to the Melbourne-based company, which may go some way to explaining how its equity value could increase by about 54 per cent in four years.

Seven changes to Healthscope that could explain an increase in its equity value by about 54 per cent over four years. PHOTO: JIM RICE

### 1. Experienced personnel

TPG and Carlyle brought in 30-year healthcare veteran Robert Cooke as chief executive, as well as slowing churn among staff and initiating succession planning, Mr Jellinek said.

### 2. Clinical and quality outcomes

Healthscope has struck a deal with health insurer Bupa to forgo payments if any of 14 preventable errors occur during care. It also began publishing data on a set of 21 quality care indicators, such as infection rates, patient falls and unplanned readmissions, for each of its 44 hospitals. It aims to enhance its reputation with doctors, patients and insurers, as is explained in point three.

### 3. Better health fund pricing

Private hospitals get the bulk of their revenue from health insurers, a problematic aspect of the business for Healthscope. "We believe health fund payments are below industry peers, as prior management was not focused on obtaining the best outcomes and junior managers were utilised in price negotiations," Mr Jellinek said.

Healthscope derives 81 per cent of earnings from its hospitals division. It has locked in pricing contracts linked to about 96 per cent of its revenue from insurers out to next year and top ups" for some if it meets quality targets.

### 4. Growth initiatives

Under previous management, Mr Jellinek said, Healthscope was about five years behind larger rival **Ramsay** on hospital development. Since it was bought by TPG and The Carlyle Group, it has completed $196 million of brownfield projects, which have added 318 beds and 18 operating theatres. The company has a further nine under way, which will cost $274 million and deliver 199 extra beds and 14 new theatres.

### 5. Operational improvements

Macquarie analysts **Craig Collie** and **Ben Tedder** note the company "only recently" centralised procurement across its 44 hospitals. It has also created a team of 14 workers to obtain better prices for the $541 million of consumables and medical prosthetics it buys. Mr Jellinek said management had improved rostering of nursing staff and increased reliance on agency staff to increase flexibility in labour costs.

### 6. Australian pathology

In some ways, this is a bit of a problem child of Healthscope's portfolio. Goldman Sachs analysts note Healthscope's operations are far smaller than their rivals' and "the economics of pathology rest largely on scale". Healthscope controls about 12 per cent of the market compared with the combined 70 per cent held by **Primary Health Care** and **Sonic Healthcare**. However, Mr Jellinek said management had been restoring profitability by selling and closing underperforming outlets and reversing the previous strategy of rapidly expanding the number of collection centres.

### 7. International pathology

Mr Jellinek said Healthscope was focusing on "cementing its market positions", as well as "benchmarking, laboratory automation and cost saving" across its New Zealand, Singapore and Malaysia operations.