

Network Healthcare Holdings Limited

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Netcare Analyst Day

Web cast - Transcript:



Richard Friedland – Netcare: Chief Executive Officer

We've had some incredible presentations in fact all of them today and I'm going to ask Peter Nelson, our Group Financial Officer to tie that all together in terms of what does this mean in terms of the financial impact certainly for this year and going forward. Thanks very much Peter. If I can just say this here without going forward and back, we'll probably be finishing around two o'clock and there's lunch still to be served and for those of you who've booked one-on-ones with various presenters, we'll probably start that at about 2:30, give you a chance to have some lunch, and we'll just contract those one-on-ones from their hour slot down a bit. Thank you.

Peter Nelson - Netcare: Group Financial Officer

Good afternoon ladies and gentlemen. It's been a long morning. I know many of you are thinking of lunch. I am myself. But you're going to see today we're going to release some information for the first time and we're going into a lot more detail so in a sense we've got quite a lot to talk about and I think the finance team including Belinda have anticipated many of your questions and I think we've tried to address them in this light. That broad outline of what I'm going to talk about, just to remind you that we go back to March. In March the revenue was R9.2 billion. I think you'd been expecting some R18 billion plus for the full year and you won't be disappointed. The EBITDAR was R2.0 billion. If you'd been expecting some R4 billion plus again you won't be disappointed and the operating profit was some 1.5 and you'll see it I guess when we end the year we'll be at R3 billion plus. We showed these figures at March. We showed that the EBITDAR revenue was 51.8, say 52% earned in the UK and some 48% earned in South Africa. Of course this is heavily influenced by exchange rates but the UK is a big contributor and in the second half you're going to see similar percentages although the second half favours South Africa. It's our better part of our financial year but I think you'll see some 49% revenue from South Africa and a slightly bigger increase or contribution to [inaudible] from South Africa. Say some 41 or 42%. If we look at the growth for the six month periods looking, starting at March 05 reported period going through to March 07 you can see the big kick in growth that came in September 06 and March 07. At the core of this we always have good solid growth in the hospitals, in the pharmacies and the [inaudible].

Let's make that quite clear. Good solid growth. The kicker comes prevalent to a large extent by the acquisition of Primecure and Primecure was acquired in February 2006 so you see the first big kicker in the six month is September 2006 and again in the six months to March 2007. In the second six months we will be reporting against figures which were inclusive of the full consolidation of Primecure

but clearly we don't expect to see that type of growth, that 23,9% which was largely driven by Primecure to repeat in the second half period but we are still going to show you later that we really expect our turnover still to reach the turnover growth for the full period to be about 13%. This is upping our guidance and I'll talk about it later and at the core of this is strong performance, continuous strong performance from the hospitals and the pharmacies and the trauma. If we look at some of the impacts on our margins in the six months to March the margin actually declined to 18.7% and we spoke about the losses incurred in the two new hospitals. We opened Alberlito, we opened Tableview, we had start-up costs, the hospitals were not at capacities in the early part and so clearly you expect to have some drag on your margins. In the half-year period there was some R10 million of losses across those two hospitals which were included in our report of numbers.

And of course we're beginning to pick up the higher employment costs and the higher training costs which Richard and Ryan have spoken about. Now what will happen in the second half is that the margin will be a bit better because of normal seasonability factors. We would expect to see that margin going somewhere north of 19%. Not quite at the 20% which was the guidance we gave you last time but then these costs are dragging our margins down a little but the good news is that Tableview and Alberlito are making EBITDAR profits on a fairly regular basis now so the loss for the first six months which was just under R10 million will come down to a loss for the full year of about R6/7 million Rand. For the first time we are now saying this is the effect of Ampath and these are the numbers for the first six months. If we'd adjusted our numbers to take Ampath out of our revenue, out of our EBITDAR those would have been the adjusted numbers and our EBITDAR margin instead of being 18.7% would have been 18.4% because these are the numbers we consolidated for that period from Ampath and you can see that Ampath's numbers give rise to a margin of some 23% and clearly we're taking out higher margin business when we dispose of Ampath.

It will be a discontinued operation. It will be reported as a discontinued operation so you'll see it in the income statement at year end as a single line item adjustment for the business. This is based on the assumption that between now and the end of the year nothing changes and this is the basis of accounting that we choose or elect to take. If I talk about the capex, last year we spent R805 million on capex. At half year we'd spent R386 million on capex in South Africa and we gave guidance and I'll talk about that a bit later with some R850 million but we're now expecting the capex to be down at about R800 million. We've got a lot of timing issues and carry over and we're really disciplined about our capex particularly having regard for the high cost of financing now and the gearing on the balance sheet. Just to cover a couple of things, there's 190 million plus or minus of capex included in our numbers for the remaining spend this year, cash spend on Alberlito and Tableview. There's going to be some R50 million of cash expenditure on SAP and I'm not quite at the budgeted level of 100 there

and we've also spent quite a lot of money upgrading certain of our hospitals. Now importantly for us that when we close this out our capex in South Africa will be plus or minus R800 million.

Our depreciation in South Africa plus or minus R300 million so we are reinvesting at a rate of about 2.7, 2.8 times depreciation back into the business. Partly in expansion capex and partly in replacement capex. If we look at SAP, just to touch sides on SAP. SAP has been rolled out through all of our hospitals. It's been rolled out at operation centres. It's been rolled out to Medicross and it's been rolled out to Netcare 911, procurement creditors and I'm talking about SAP financials and SAP logistics. It's been an incredible effort by the IT team and the business to take it on board and bed it down. SAP on the billing side, on the hospital information side has been much more complicated than anybody ever envisaged but we're in quite a good space now and we expect and plan to roll that out from 1 October at the pilot site. We could have potentially have rolled it out earlier but there's a lot of advantages in doing it with the financial year in terms of the statistics that you gather and how you manage your business. Importantly it does provide us with a 15 to 20 year platform for shared service which is our next big project and clinical costs analysis. Richard has spoken earlier about the coding that we had to tackle and we need to do this in a much more organised fashion much quicker and I think SAP provides a better tool for doing all of that. Importantly we're also looking to outsource and partner our IT infrastructure, the technical side, the networking, hardware operation, all of that with a world-class partner.

We're well down the road on that negotiation and I think in the next month we're going to wrap that up. And then we do need to focus also as the next big initiative on clinical systems. How they connect onto our platform and to take SAP, because we will only be using SAP at some 65% functional when we take it on board and we need to use it 80/90% and these continued business improvements make us more productive, make us into quicker, rapid close at month end, things like that. If we touch sides on the UK, this time is the first time we've shown this slide and we wanted to show the effects going back on the G sub-contracts. The NHS G sub-contracts which we processed in 2005 and also in September 2005 and 2006 drove up the revenue in those two years. You saw revenue growth for GHG 5.8%, 13% in those periods. Those G sub-contracts came to an end and our growth declined to 2.4% but importantly it looks pedestrian but it's based off of, it's measured off of base which includes the G sub-contracts and the G sub-contracts were a big portion of that business. When you strip out that G sub actually the growth is pretty much in line with our expectations. What's important also is that similarly to South Africa, when we don't quite achieve the volumes which we're expecting we often make it up with higher revenues per case or per patient day and that has happened in the GHG as well. If we look at the profitability, we spoke at half year quite extensively about the improved margin, the BMI, the 26.5%.

Netcare UK came in at 3.8% because of the write-offs from the mobilisation costs of the half year and those all still play a role in the full year numbers and if we adjust it for Netcare UK then they would have about 15% margins which is more or less what we would expect on the NHS contracts so what we have is an adjusted margin of some 26.1 that's absorbing all the costs at half year. We were at 25.7 and we do have some rationalisation costs. We've put teams together, we've moved offices, we've consolidated offices and the like so I'm not expecting very much more than 25% for the full year for GHG although if we strip out all the one-off costs we are looking at margins of 26, 27% at BMI on an ongoing monthly basis. A lot of you asked questions after our half year presentation, how do we calculate our earnings per share and how can our diluted earnings per share be more than our normal earnings per share? Because normally that's not the case. And we decided we'd actually show the figures so what I wanted to just show is the 1.7 or 1.8 billion shares that we issued at the 30th September. We issued a further 7 million shares and share options and we issued shares to unwind the [inaudible] 47 million shares. So the shares in issue at March were 1.833 billion shares of which 596 million are treasury shares and therefore after that or net of that we had 1.237 billion shares and issue.

The weighted average number of shares which is a little less because we take timing factors into account and we've got to assume of course that the convertible bond is going to convert in full so there's 111 million shares assumed for that and we issued another 56 million options late last year so the fully weighted or fully diluted weighted shares and issue for your models and for your calculations, 1.386 billion shares. Now here's where the, where a lot of guessing and estimating took place. Headline earnings were 289 million. We add back R1 million assuming that the share options are exercised, people pay the exercised price and the company earns the interest on that. Here's the big one. We have to make an assumption regarding if the convertible bond converts and all of the shares are issued then what is basically the interest that we save on that convertible bond? Now typically what happens is that we use current market rates to determine that. It's a judgmental issue to a large extent and the figures we used at March were 65 million and you can double that to 130 million for the full year so that gave us fully diluted headline earnings of 355 million and it gave rise to that number. Now I think if you look at this the only issue of judgmental is around that and I think you know we take it on board the messages, interest rates have gone up, we'll recalculate that at the end of the year and I'm not sure it'll give rise to the exactly same degree or percentage or upliftment in that number but we will be looking at it. There's a lot of good news that floating around in Netcare and I'd like to start getting into some of that.

Just to look at the debt. The group lead debt at March, because that's what it was, we were 83% UK, 17% SA and the UK debt of course was mostly underpinned by the property portfolio. We've been through all of that. But have a look at this. Everybody phones us up and says to us Netcare's highly

geared, got all this debt on the balance sheet, sub-prime crisis is taking place, interest rates are going up, liquidity is becoming a problem and Netcare must be worse off. Netcare was 95% fixed in its interest rates and only 5% floating so I put it to you that basically we are extremely well positioned through this crisis. Let's have a look at the UK cost of debt. A lot of people have got this calculation wrong so now we're basically like just giving you the end number for your models and it will save a lot of problems here. We've got the propco debt which is 1.648 billion at the moment and we're talking Pounds. The opco debt, £214 million, some small other debt, gross debt £1.865 billion. Included in those debt numbers are costs or financing costs which we amortise. If we take that off it's 42 million, the net debt £1.8 billion. We've shown you exactly what the interest rates are on that debt. You can see they average out at 6.4. The interest costs on those is about £120 million. We've also got to provide for the amortisation of the financing transaction costs which goes to amortisation not finance costs which is 6.2 and we had some commitment and arrangement fees which we expensed at the half year so in total we're looking at £130 million for interest for your modelling for GHG.

The good news is that we've made quite a lot of money on our swats but this is up and down and it changes every day and every month. But as I stand here today there's £7 million of profit that we go through the income statement a big chunk of profit that goes to the balance sheet and I'll talk about that later but if we were finalising our year end today we'd be finalising in at about £123, 124 million of interest costs in GHG. Okay, now everybody says, well what are the repayment terms? Is there a problem just looming on the horizon? Now look at this. Within the first six years we've got fairly small compulsory payments or repayments on the UK debt. 14 million in the first year, 18 million, 23 million so we don't have to refinance Netcare UK in this crisis circumstance where it's difficult to get good terms and to raise liquidity. There's a big bullet payment, 1.5 billion that has to be paid 2013 so we've said to you we've got our time between now and 2013 to organise ourselves, we're not painted into a corner here. If we just ask, a lot of you ask about the covenants, we've tried to record the most important covenant which is the interest cover to rent or rental income to interest in Propco. We're on autopilot. All these arrangements are in place. We're renting from ourselves. It's a synthetic structure and those ratios are pretty much easy to meet and in our financial models.

We have of course normal Opco covenants based on cash cover, interest, leverage and capex. I'm not going to go into those. Now let's go to the South African debt because the UK debt story seems to be a very good story. On the South African debt we meet exactly the same situation. This was our at March we had R5.2 billion of debt. 1.4 is on the DKW bridging loans to acquire GHG. 1.4 million is the convertible bond at a fixed rate of 6%. 1.5 is our medium term note programme which is very successful. One of the reasons why we went into the corporate bond market, not the convertible bond, the corporate bond was to create a track record with investors, was to raise money wholesale and we're doing that very regularly now and the same participants are rolling over from one term to the

next on these notes. So for us we're very happy with the medium term note programme, the preference shares are there. The convertible bond, when we look back we couldn't have chosen a better time. We're now paying 6% on those convertible bonds and for us it's been an integral part of getting the right mix there. Our weighted average maturity, 2.85 years. We don't have to go out next week or next month and re-negotiate any financing. In the South African market we're 70% fixed in the interest rates and 30% floating. It's a position which we're very happy with as well and some work that Dawn and I did with one of the banks a little while ago, they looked at our balance sheet, they wanted to make comments on gearing and they said to us it's the first time that they've ever seen a South African company which they think is in the perfect leverage zone, the perfect gearing zone. Now it was nice to hear that comment from them. I'm going to touch sides on more good news, the derivative instruments. At September 2006 we had liabilities on our balance sheet of R1.3 billion in relation to our derivatives.

There was a zero cost collar linked to the net partner, 288 million. On interest rate swaps we had a 1.5 billion liability and on cross-currency swaps which was mainly our forex cover of our GHG investment we had a profit of 422. That liability has moved R2.5 billion into the money. R2.5 billion is now on our balance sheets in net asset value per share. A small portion came through the income statements. Some R85 million and the bulk or the rest going through the balance sheets. If we look at this, I'll come back to this, this is primarily driven by the GHG funding and the swaps we put in place both the GHG acquisition and we can see the cross-currency swap basically it's down because we have repaid some of those loans, the DKW and we've unwound some of those positions. So let's just touch sides with the UK swap liability. At 30th of June we've got an asset which is worth £73 million. It did go a little bit against us in July. It went down in value to £54 million. We're taking £7.2 million of the total gain through income statements because that's the ineffective portion of the hedge and interestingly when we watch these numbers, when I come up to the next few slides you'll see there's no direct correlation between short term interest rates and long term interest rates but if we look at the ten year UK swap when we made the GHG acquisition the rate of 5.09% as an interest rate and it's now 5.78% and bearing in mind that we had swaps with 25 years on debt and that's basically what's driving the conversion of this liability into asset value for us. So just to summarise basically since September 2006 we've started with a minus 100 million liability on the swaps in the UK.

You can see as the interest rate in the UK went up so this liability came down and it now sits in this area here and it went down a bit in July into asset value. More good news. It never stops today. We decided we'd talk a bit about our property portfolio in South Africa. We get a lot more questions. We've had a path walked to our door with people that want to do something with our property and let's just go through these. We've had a valuation done of our properties at the end of June. Our hospitals and ancillary buildings we're carrying them in our books at R3.1 billion. The latest valuation coming in

at R9.2 billion for the hospital properties. Medicross buildings we're carrying them at R124 million. Latest valuation coming in at R342 million. So I say to you that basically we're sitting with a property portfolio which is worth some R9.5 billion at the moment. So that's about R7.84 a share if you ignore CGT and deferred tax on those properties. Let's have a look at it. It's valuing the beds at about R1.4 million a bed. It's not that far off from the numbers that we showed you just now if you want to build a bed. The building and the land is probably some 8 or 900 000 but when you want to equip it you basically get to the type of figures which are in line with what we're talking about. We've seen that the hospital cap rate now they range 8-10%. Two years ago people were taking 13% so yields on properties are compressing and by holding onto our properties in this time we've done exactly the right thing for our shareholders.

Medicross cap rate, 9.25% to 11.5%. A lot of these depend on location, profitability, etcetera, etcetera and just to remind you that in our current renovation programme which covers about six or seven hospitals we've been able to spend about R185 million on our portfolio. The UK property portfolio is going to this. We currently own thirty five freehold hospitals with 2122 beds which could be sold. Many of you know that we've agreed a phasing with our partners of selling five, five, ten, ten and ten. We're in the second year so in theory those two fives could be sold. Ten properties. But we've agreed with our partners that we're prepared to sell all of the properties on the right terms and conditions and people might say that the top of the property market has been lost but there's still a market and we will be exploring the sale and lease back of all of our properties in one hit and I'm not going to draw into what deals I expect etcetera because I think it's sensitive now. In September we intend formally going into the market and testing the market in a structured way and if we're successful on that then basically we will sell all of those properties. We have the option to increase our shareholdings from 50.1% to 65%. This option existed when we entered into this contract with consortium partners on the whole company. In other words the Opco and the Propco and we've agreed with our partners a mechanism to adjust that so if Propco is sold then we have a mechanism whereby we can increase our stake to 65% in Opco at a price. Now there are very complex accounting implications and bear with me while we go through some of these because we're going to have to get used to thinking about our business in a different way and our communications are going to have to be very different. And don't jump to conclusions, let's look at the whole picture and then go away and reflect on that. But here's a typical example of what our business could look like if we've sold all of the businesses, all of the properties of GHG and we just have an [inaudible]. Our cash rent would be about £120 million, some R1.7 billion.

We of course would save interest because we would have repaid our property loans. We'll save interest of 1.5 billion. We'd have some surplus cash. Opco would reduce its interest and we would have some cash to pay back DKW and etcetera so that interest would go down. So we could see that

of the cash flow items there could be basically a net outflow of some £23 million on the cash and income statement diagrams. But then we have to straight-line our leases. The classic thing, we go backwards, an operating lease that's over 25 or 35 years its got escalation built in and we've got to straight-line that lease and that would have to be expense. Some 798 million. So then we would save depreciation because at the moment we're depreciating these profits. We would save 376 million and we would save, we would have bulleted the amortisation costs on the debt raising fees in one go so what you find is that basically the bottom line would be a net pre-tax loss of 359 million. You'd have a tax shield which would shield 109 million so you'd have an after-tax loss of 250 million. The minorities would pick up the biggest chunk of that. All of the bulk of the losses are in GHG so they would pick up 185 million of that loss and we would have to pick up 65 million so what we're really saying is when we've done all of this if we do it, if the terms are right, that it could actually impact our earnings per share by five cents negatively.

So why would we do it if it impacted the share price negatively? Well we think that we'll relieve the de-gearing of the balance sheet, the uplift in value of Opco, the price and the terms that you get for the property. All of these things make it worthwhile. Look what would happen. Our property price and equipment on our balance sheet would go down from twenty six to five. Our goodwill would go down from 16 billion to say 4 billion and if we pick up our long term bank debt here it would go down from 30 billion to 5.2 billion and I think importantly to remember on this bank debt, every five or six years you're going to have to re-negotiate that financing. You're going to have X million Pounds of transaction costs which have to be written off and you're going to have to do hedging around all of that. If we go down this path basically you get a long term financing solution, you rent your properties, built-in escalation, the type of number we have in mind is like 3% escalation which is typically what inflation is at the moment. So, sorry and I should have mentioned the deferred tax of course also goes down quite a lot in the process. So it's a very complicated procedure but the end gain is worth doing what we think but you can only take that view when we see what terms we can get for the business or for the properties when we sell them. Now the final, another bit of good news which I haven't touched on, I meant to do it in the UK profitability, we spoke about it at half year, the UK government reduced the tax rate from 30% to 28%. They did that before the end of March but it wasn't properly legislated and we couldn't account for that at March but we can now so in our numbers for UK not only will we have plus or minus £7 or 10 million or swap profits which we have spoken to you about, we will also have £28 million of a tax credit for the income statement which you can multiply by say 14, 15 and take it through. Remember the minorities. Because what has happened is they've raised the deferred tax provision on our balance sheet at 30% on the revaluation of the properties and now the UK government has reduced the tax rate to 28, our provision comes down and that gets released through the income statement.

So, just to wrap up on the updated guidance, it's a lot of good news and some of those underlying numbers. On the SA side we're saying turnover up. We previously said 11-12%. We're now saying 13% odd. Maybe it's a little bit better. The EBITDAR we're saying some 19-20%. It's probably closer to 19% but we're going to have higher revenue because of that extra 1% and on the Rand basis I don't expect to be behind on our guidance insofar as Rand EBITDAR is concerned. Capital expenditure we've said 900 million or 800-900 and now I'm saying 800 million and we'll try and manage that quite closely between now and the end of the year. On the UK side we had said turnover between 650 and 700. I think that was a very wide guidance. We could hardly go wrong on that I guess. We're now narrowing that at 660 to 680 and I guess we'd be closer to the top end of that. That includes about just under 30 million of Netcare UK client revenue. The EBITDAR target we'd said 26% margin. Probably 25% is better type of number for that and on the capex we'd said 40-50. We're not really changing that. Adrian mentioned wherever we need to spend capex to [inaudible] bottleneck something we're doing it but the standing capex probably closer to 25 million. With that, thank you very much. There's a lot of new information to digest and I guess we'll get some questions in time.

QUESTIONS AND ANSWERS

Richard Friedland – Netcare: Chief Executive Officer

Are there any questions? There must be one or two questions?

Audience member

Just a couple of questions on the sale and lease-back. The 1740 cash rent expense, what yield are you assuming there.

Peter Nelson – Netcare: Chief Financial Officer

I don't want to get into yields because we're going to be going into negotiations, okay?

Audience member

Okay then. And secondly, you've got a negative earnings impact here. Just on a, obviously you've got change and depreciation, on a cash basis would this be cash earnings [inaudible] or not?

Peter Nelson – Netcare: Chief Financial Officer

I think its cash revenue [inaudible] as well. Particularly in time with the escalations on the rentals I'd say increase the 3% band going up but you get enormous benefit by settling and having certainty on the financing and by focusing the Opco and the Opco business and when you look at the title value you might expect if you took Opco to an IPL on a type of 12, 13 times multiple that shareholder value uplift will shoot out the way any other negative in the equation.

Audience member

Okay, thanks.

Richard Friedland – Netcare: Chief Executive Officer

Thank you very, very much. Ladies and gentlemen it's been a long five hour session and just three small issues before we break for lunch. One is that Adrian omitted to tell you that he's also a non-executive director for the UK government's Department of Work and Pensions and he sits on three of their boards, government boards for job centres plus the disabilities and [inaudible] and for the Pension Commission. I suppose as an economist he's very well know within government circles. I wanted to thank Peter, thank you very much for an outstanding presentation and giving some updated guidance there. Today's presentations and the entire organisation would not have been possible had it not been for this individual who put a foot into it as you saw and I really want to pay tribute to Belinda Williams for the quality and the standard and the organisation. Thank you Belinda for what you've done today in this [inaudible] today. For those of you who attended our previous days I think you can tell the standards have moved substantially higher and we're warned by Belinda it's got to go even higher and just to thank the panel of presenters. I hope you're left with a feeling of the passion, of the commitment and the absolute engagement that everyone who has presented here today has for improving patient care and ensuring adequate returns for our shareholders. Ladies and gentlemen please join us for some lunch outside and within the next half hour we'll be going into the one-on-ones. Thank you very, very much for your attendance here today.

ENDS



You're in safe hands

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