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CEO on Acquisition Strategy and Outlook for 2011

Open Briefing with Greencross Limited CEO and MD, Dr Glen Richards

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In this Open Briefing®, CEO and MD and Dr Glen Richards discusses

- Acquisition strategy and succession plan for the veterinary industry
- Outlook for margins, cash flow and debt
- Strategic focus over FY11

Open Briefing interview:

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Greencross Limited (ASX: GXL) reported underlying net profit of $2.2 million for the first half ended December 2010, up 8.2 percent from the previous corresponding period. Reported EBITDA was $4.4 million, up 7.6 percent, on revenue of $29.9 million, up 12.2 percent. EBITDA margin fell to 14.7 percent from 16.1 percent, reflecting increases in costs, particularly payroll and occupancy costs, apparently due to acquisitions in the period. Given GXL's stated goal of acquiring a practice a month, what is the outlook for margins and how will GXL generate sustainable revenue and EBITDA growth?

CEO Glen Richards
The decline in margins is short term and reflects the infrastructure we have put in place to grow the business significantly from its current size. Currently we have 54 veterinary practices and on our current cost base, we could double in size with very little additional increase in overhead at the group level. Therefore, we expect margins to grow as we increase our practice numbers.

We have stated a target of acquiring at least one practice per month on average. During the first half of FY2011, we acquired nine practices so are well ahead of that run rate. We'll continue aiming to acquire at least one practice a month. At the moment, we have a very good pipeline of opportunities.

We achieve revenue and EBITDA growth by integrating the practices we acquire into our Greencross Network, applying better management, standard processes and implementing our supply chain efficiencies. Once the integration process is complete, which typically takes three months; we expect revenue growth of a minimum of 5 percent year on year at the practice level and a minimum EBITDA margin, excluding corporate office costs, of 20 percent.

We are fortunate that the veterinary services industry is reasonably resilient to swings in the economy with companion animal numbers steady and with pets often seen as part of the family. Therefore the average veterinary business is quite stable. Together with our acquisition strategy, I believe we can achieve sustainable double digit earnings growth.

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To what extent is GXL seeking to replicate the industry consolidation in (human) healthcare in recent years? How does the veterinary services market differ from human healthcare and where are the key opportunities to gain efficiencies in service delivery?

CEO Glen Richards
We're not attempting to replicate the consolidation of any other industry. The veterinary industry has its own opportunities and is quite different from other industry consolidation plays.

One of the most important aspects of our business model is that we offer an attractive succession option for baby boomers, who currently own the majority of the 2,500 vet practices in Australia. After we purchase a practice, the vendors help transition it to a Greencross practice and will typically look to exit over a 2-5 year period. Importantly, our practices have between 2-4 practitioners, so when a vendor leaves we typically see little impact on the business.

Another important point is that Generation Y veterinary graduates, who are the typical succession option, are less likely, either for financial or social reasons, to make the significant commitment required to own a practice. This leaves Greencross as the succession option of choice. Our strong pipeline of opportunities allows us to be selective when buying, ensuring that we acquire well and add value to the business.

To gain efficiencies in service delivery we remove the administration responsibilities from the vendor. Vendors are then free to utilise additional time to focus on clients and patients and increase their number of consultations. Further to that, we assist in maximising returns by lifting the average spend per consultation.

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What is GXL's competitive position in the market and how are you positioned to take advantage of the major trends in Australia's veterinary services industry over the medium term?

CEO Glen Richards
One of the key competitive advantages from a practice level is that we are becoming the preferred employer in the industry and attracting the highest quality staff, which in turn improves service levels. We are focussed on creating exciting, professional work places with good facilities and equipment. We also provide professional development for employees and with locations around Australia, there is flexibility for staff to move intrastate or interstate. Our scale and access to capital also allows us to significantly invest in our facilities and equipment, which leads to improved service for pet owners compared with our competitors.

One of the key trends in the industry is that pet owners are changing the way they treat their pets. In many households, pets have become equal to a family member and trends over the last few years strongly indicate that pets are being moved from the backyard to the living room. "Pet parents" have a strong expectation that the local veterinary practice will provide high-end care similar to human healthcare. They want preventative care right through to full diagnostic workups and treatment plans offering solutions similar to those in human healthcare.

Greencross's quality facilities and equipment as well as our ability to attract high quality staff positions us to take advantage of these trends.

Strategically, the other key competitive advantages for Greencross are the scale advantages gained from controlling the largest portfolio of veterinary practices nationally. Our size and scale gives us access to capital and also positions us to provide a succession solution for the industry as baby boomers look to move into retirement.

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GXL booked operating cash flow of $2.9 million in the first half, up from $2.1 million, but free cash outflow was $3.9 million versus positive free cash flow of $1.1 million in the previous corresponding period. This reflected capex of $6.8 million, up from $1.0 million, including $5.4 million for acquisitions. What is the expected level of sustenance and growth capex going forward? What is the expected trend in free cash flow over FY11?

CEO Glen Richards
We have a disciplined approach to managing capital expenditure. Buying and replacing equipment for our practices costs the equivalent of 1 to 2 percent of revenue. If we need to buy big ticket items like ultra-sound, CT scan or stem-cell therapy equipment, we allocate part of a practice's budget into a central pool for one of the bigger clinics in the region. This way, our larger practices get leverage and access to higher-end technologies and we get more efficient utilisation of capital expenditure.

We are in active acquisition mode and we are going to buy 10 to 15 practices a year. Including those acquisitions, we'd expect to spend $7 million to $10 million a year, which will be funded by a combination of bank debt, vendor deferred settlements and free cash flow.

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GXL secured a $23.9 million debt funding facility with the Commonwealth Bank of Australia in September 2010, which you've indicated will increase your capacity to execute your acquisition strategy. What level of funds had been drawn from the facility as at the end of December? How sustainable is the debt-funding of acquisitions?

CEO Glen Richards
We've used $21.4 million of the bank facility, with about $2.5 million still available for further acquisitions. We have the ability to obtain additional funding under the current arrangements, with the CBA supportive of our acquisition strategy and five year plan. We believe debt funding of acquisitions is sustainable given acquisitions will also be supported by free cash flow and vendor deferred settlements.

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Net debt at December 2010 was $16.3 million, up from $14.2 million at June 2010. Gearing (net debt/shareholders' equity) was 55.9 percent, down from 56.3 percent. What level of debt can the business sustain and what is your gearing target for the business?

CEO Glen Richards
Veterinary businesses generate strong cash flow. There is very little in the way of working capital with minimal inventory and virtually no debtors. Therefore, our business can comfortably service higher levels of debt than other businesses, particularly given the predictability of earnings.

Although our gearing may seem high relative to other ASX listed companies and industries, our interest cover is 5.8 times, which is well above our minimum target of 4 times. Based on our strong cash flow generation, we're very comfortable with these ratios and Greencross's ability to service its debts and creditors now and into the future.

Our focus is to grow and expand our footprint in Australia. While we're mindful of not over-extending our gearing, we believe gearing might rise temporarily above 60 percent as we execute our acquisition plan. We're comfortable we can retain strong debt service ratios and we believe this strategy delivers the greatest return to shareholders.

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You have declared a fully franked interim dividend $0.03 per share. Do you have a dividend policy? Given your expectation of an improved performance, what's the outlook for dividends in 2011?

CEO Glen Richards
Greencross has formally adopted a dividend payout ratio of 50 percent of earnings and announced this in the recent results release. We also provided detailed guidance for 2011, which included EPS of between 12-13 cents. On this basis, we expect to pay at least a further 3 cents as a final dividend, taking our full year dividend to 6 cents, fully franked.

We have put in place a dividend reinvestment plan (DRP) to allow shareholders to reinvest in the company. We are most likely to have this partially underwritten in order, to balance our need for cash to take advantage of the growth opportunities we see.

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What will be the strategic focus for GXL over FY11 and what milestones do you expect to achieve?

CEO Glen Richards
The strategic focus for Greencross over the next six months will be to continue to improve operational performance across the group and extract efficiencies following the 9 acquisitions we made during the first half. We are focussed on improving our margins and confident we can get margins, including corporate office costs, back up over 16 percent for the group.

The other main focus will be on growing via acquisition and taking advantage of our pipeline. We will continue to target one acquisition per month but given that enquiry levels have been high, we may exceed this run rate.

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Thank you Glen.

For more information about Greencross, please visit www.greencrossvets.com.au or call Glen Richards on (+61 7) 3435 3535

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