BLUEBIRD PORTFOLIO SERVICES

# Company Research

| Company: | Sonic Healthcare |
|---|---|
| ASX code: | SHL.AX |
| Share price: | 28.88 |
| Market cap ($bn): | 13.6 |
| Market weight: | 0.6% |
| GICS sector: | Health Care |
| GICS industry: | Health Care Equipment & Services |
| Report Issued: | 28 August 2019 |

Sonic Healthcare (SHL) is one of the world's leading providers of medical diagnostic services. SHL provides specialised pathology/clinical laboratory and diagnostic imaging services to clinicians (GPs and specialists), hospitals, community health services, and their patients. Sonic is the world's third largest provider of pathology/clinical laboratory services. Employing approximately 35,000 people, Sonic enjoys strong positions in the laboratory markets of eight countries, being the largest private operator in Australia, Germany, Switzerland and the UK, the second largest in Belgium and New Zealand and within the top three in the USA. In addition, Sonic is the largest operator of medical centres and the largest occupational health provider in Australia, and the second largest participant in the Australian diagnostic imaging market.

## Quality, Value and Momentum (QVM) Factor Analysis

In Bluebird's experience, to be a successful investor you need to invest in quality companies that offer value. We add one more factor, momentum, because we like to 'get on at the station' rather than 'standing in front of the train and hoping it will stop in front of us'. What we don't want are quality companies that are expensive or poor-quality companies that are cheap. This is EXACTLY where most investors go wrong. All our focus is on assessing each company for Quality, Value and Momentum. Those that get a tick (✓) in each box are the 'little gems' of the market and become candidates for the Bluebird portfolios.

| Quality ✓ | |
|---|---|
| **Score** | **75.1%** |
| Sector rank | 6/16 |
| ASX 200 rank | 44/200 |
| Quartile rank | 1st quartile |

Bluebird assesses each company across 9 quality factors with a total score of 70% or above required to meet our definition of quality.

SHL's total quality score is 75.1%, which means it is a quality company. It ranks 6th within its sector and 44th in the ASX 200. See page 2 for details.

| Value ✓ | |
|---|---|
| Required Return (p.a.) | 8.5% |
| Current price | 28.88 |
| Forecast IRR (p.a.) | 9.1% |
| **Fair value** | **30.00** |

To determine value, a stock must deliver an expected return that exceeds its minimum required return. The expected return is the sum of a future dividends and capital growth, over a 10-year holding period, divided over the entry price and expressed as an Internal Rate of Return (IRR).

At the current share price, the stock offers an IRR of 9.1%, which is above its required return of 8.5%. The stock offers value up to $30.00, where IRR = Required Return. See page 4 for details.

| Momentum ✓ | |
|---|---|
| 2-year price trend | Up-trend |
| 5-year price trend | Up-trend |
| 10-year price trend | Up-trend |
| 2-year relative perf. | Outperforming |
| 5-year relative perf. | Outperforming |
| 10-year relative perf. | Outperforming |

Bluebird also looks for positive momentum before investing. We assess short-term and long-term price trends, as well as relative performance vs the ASX 200, to assess market sentiment towards the stock.

SHL has recovered after a large capital raise in FY19. It remains in medium to long-term uptrend and continues to outperform the market over the short and long-term. See Volatility in the Quality analysis and page 5 for further details.

## Quality Analysis

Bluebird assesses each company across 9 quality factors with a total score of 70%, or above, required to meet our definition of quality.

| Quality factors | Score | Comments |
|---|---|---|
| **Industry/10**<br>Macro drivers, Market size Growth rate, Life-cycle, Industry profitability, Industry structure, Barriers to entry, Competition intensity, Government regulation and taxes | **8.0** | Sonic operates in stable developed countries where healthcare is reliable and well-funded. Within these markets there is increasing demand for diagnostic services arising from growing and ageing populations, preventative testing and new types of tests. These markets are generally fragmented allowing for Sonic to also grow by acquisition. Changes to healthcare funding by government and insurers is the key risk to revenue in the short-term but growth remains steady over the long term. Competition intensity is moderate and barriers to entry are reasonably high in terms of licensing, scale and practioner relationships. |
| **Competitive advantages /10**<br>Product, Price, Distribution, Location, Marketing, Brands, Service, Reputation, Patents, Licenses, Market share, Assets, Productivity, Technology, Management, Corporate culture, Scale, Capital strength | **8.0** | Sonic holds leading market positions in pathology in Australia, Germany, Switzerland and the UK. It is building its position in the US market and ranks in the top 3. Sonic also holds leading imaging and medical centre positioning in the Australian market. Other competitive advantages include its 'Medical Leadership' culture, its strong management team, economies of scale, capital strength and geographical diversification. The use of technology and innovation are also key strengths. |
| **Profitability /10**<br>Profit margins, ROE, ROA, ROCE | **7.0** | Sonic has moderate profitability with EBIT margins around 13% and ROE around 10%. The company carries a lot of goodwill from acquisitions which keeps a lid on ROE. |
| **Earnings quality /10**<br>Track record, Volatility of revenue & earnings, EBITDA cash conversion, Sustainability of revenue, Key customer risk, Contract risk | **8.0** | Sonic has a strong track record of EPS and DPS growth. Cash conversion is high with operating cashflow/EBITDA conversion of 102%. That said, EBITDA can be impacted by currency movements and regulatory changes in key markets. Sonic also makes regular acquisitions and raises capital, so investors need to watch diluted EPS growth, more so than EBITDA growth. |
| **Growth prospects /10**<br>Past growth, guided growth, consensus growth, theoretical growth rate (ROE x retention rate), industry/peer growth | **7.0** | Sonic's 5-year CAGR of EPS is 6%, while EPS grew by 9% in the last year. Sonic generates low organic growth with most of its growth coming from acquisitions. We model a similar growth rate to its past 5 years, with a 10-year CAGR of 6.1%. |
| **Gearing /10**<br>Net Debt/EBITDA, Net Debt/ND+E, Interest cover | **7.0** | Sonic runs moderate gearing, mainly to fund acquisitions. Its net debt/EBITDA ratio is 2.2x and net/debt/capital is 30%. We expect Sonic to maintain these gearing metrics over the medium term. |
| **ESG /5**<br>Thomson Reuters Environmental, Social, Governance Score out of 5 | **3.9** | Sonics ESG score is fairly high as the company has an ESG policy and has been seeking to improve its ratings across the various metrics in the survey. |
| **Volatility /5**<br>Lower vol = higher score<br>Short term volatility and long-term beta scores combined | **4.2** | Volatility has increased with its recent capital raise and the market correction but its long-term beta is quite low (0.6) which helps improve its volatility score. |
| **Company risk /10**<br>Lower risk = higher score<br>Macro risks, Industry risks, Regulatory risks, Company-specific risks | **7.0** | Key risks include: changes to healthcare fee schedules by government or insurers, changes to healthcare regulations, currency movements, maintenance of high standards and medical licenses, acquisition risks, competition risks, maintenance of relationships with medical practioners and maintenance of technology systems. |
| **Total score /80** | **60.1** | Score out of 80 |
| **Quality score /100%** | **75.1%** | Percentage score, >=70% required to meet Quality threshold |
| **Risk factor (0.9, 1.0 or 1.1)** | **1.0** | Similar to a beta score but determined by the Volatility and Company Risk Score above. Used to determine the Required Return for the stock. See page 4. |

Source: Bluebird

## Value Analysis - Financials

| SHL.AX | Price close | Currency | Issued Shares | Fiscal Year |
|---|---|---|---|---|
| | 28.59 | AUD | 474,081,904 | 30/06/2020 |
| **Financials** | **FY-1** | **FY0** | **FY1** | **FY2** |
| Revenue | 5,541,371,000 | 6,133,671,000 | 6,788,752,000 | 7,127,374,700 |
| EBITDA | 962,052,000 | 1,060,828,000 | 1,228,046,300 | 1,295,502,500 |
| EBIT | 706,014,000 | 850,972,000 | 875,960,200 | 931,839,200 |
| NPAT | 466,312,000 | 538,900,000 | 584,402,440 | 630,550,000 |
| EPS | 1.10 | 1.20 | 1.23 | 1.32 |
| DPS | 0.81 | 0.84 | 0.88 | 0.95 |
| Net debt | 2,482,781,000 | 2,298,953,000 | 2,096,938,380 | 1,872,756,130 |
| Net assets | 4,282,925,000 | 5,491,866,000 | 5,673,825,000 | 5,871,225,000 |
| Capital employed | 6,765,706,000 | 7,790,819,000 | 7,770,763,380 | 7,743,981,130 |
| Market cap | 13,554,001,635 | 13,554,001,635 | 13,554,001,635 | 13,554,001,635 |
| EV | 16,036,782,635 | 15,852,954,635 | 15,650,940,015 | 15,426,757,765 |
| **Ratios** | | | | |
| P/E (x) | 26.0 | 23.9 | 23.3 | 21.7 |
| EV/EBITDA (x) | 16.7 | 14.9 | 12.7 | 11.9 |
| Price/Book (x) | 3.2 | 2.5 | 2.4 | 2.3 |
| Dividend yield | 2.8% | 2.9% | 3.1% | 3.3% |
| Payout ratio | 74% | 70% | 72% | 72% |
| **Growth** | | | | |
| EBITDA growth | | 10.3% | 15.8% | 5.5% |
| EBIT growth | | 20.5% | 2.9% | 6.4% |
| NPAT growth | | 15.6% | 8.4% | 7.9% |
| EPS growth | | 8.8% | 2.3% | 7.6% |
| **Profitability** | | | | |
| EBITDA margin | 17.4% | 17.3% | 18.1% | 18.2% |
| EBIT margin | 12.7% | 13.9% | 12.9% | 13.1% |
| ROE | 10.9% | 9.8% | 10.3% | 10.7% |
| ROCE | 10.4% | 10.9% | 11.3% | 12.0% |
| **Gearing** | | | | |
| Net debt/EBITDA (x) | 2.6 | 2.2 | 1.7 | 1.4 |
| Net debt/Capital | 37% | 30% | 27% | 24% |

Steady EPS and DPS growth

Moderate to high P/E and EV/EBITDA

Good yield

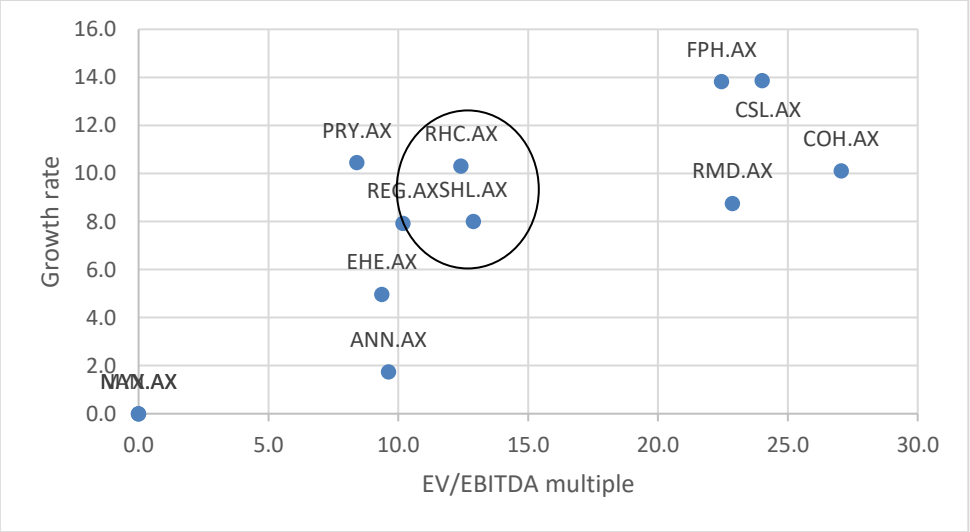
We model a 10-year CAGR of 6.1%

Good margins

Good ROE and ROCE

Gearing is moderate

## Healthcare sector scatterplot – Growth rate vs trading multiple




We compare SHL to its Healthcare peers.

SHL ranks amongst the value quadrant offering an 8% growth but at a moderate EV/EBITDA of 12x

Data source: Thomson Reuters Company actual and consensus estimates

## Value analysis - Internal Rate of Return (IRR) calculation

To calculate if a stock offers value, we calculate the total return (dividends + capital return) we expect to generate from buying the stock at current levels and exiting at the end of a 10-year holding period. We then compare this expected return (IRR) to the minimum required return (R) that we expect to generate from the stock. If the IRR>R then the stock offers value, if the IRR<R then the stock is overvalued. We can go further and find the price where IRR=R and that price becomes our target price for the stock. The minimum required return (R) is determined by multiplying the stock's Risk factor (similar to beta but determined from the Quality analysis) by our expected return for the equity market. Generally, R will range between 8-10% p.a.

| SHL.AX | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| EPS | 1.22 | 1.29 | 1.38 | 1.48 | 1.58 | 1.70 | 1.80 | 1.90 | 2.00 | 2.10 | 2.20 |
| DPS | 0.84 | 0.90 | 0.97 | 1.04 | 1.12 | 1.21 | 1.29 | 1.38 | 1.46 | 1.54 | 1.63 |
| Payout ratio | 69% | 69% | 70% | 70% | 71% | 71% | 72% | 72% | 73% | 73% | 74% |
| EPS growth | | 6.0% | 7.0% | 7.0% | 7.0% | 7.0% | 6.0% | 6.0% | 5.0% | 5.0% | 5.0% |
| Share price | 28.59 | | | | | | | | | | 50.10 |
| P/E | 23.4 | | | | | | | | | | 22.7 |
| Yield | 2.9% | | | | | | | | | | 3.3% |

| IRR at current price | | | Assumptions | | |
|---|---|---|---|---|---|
| Purchase Price | - 28.59 | | EPS 10-year CAGR | 6.1% | |
| Dividends Yr 1-10 | 12.53 | | Payout ratio increase p.a. | 0.5% | |
| Capital Price Yr10 | 50.10 | | Year 10 growth rate | 5.0% | |
| IRR (p.a.) | 9.1% | | Year 10 P/E ratio | 22.7 | |
| Required Return (p.a.) | 8.5% | | Year 10 Yield | 3.3% | |
| | | | | | |
| **Fair Value (IRR=R)** | | | **Required return calculation** | | |
| Purchase Price | - 30.00 | | 10-year bond yield | 2.5% | |
| Dividends Yr 1-10 | 12.53 | | Equity Risk Premium | 6.0% | |
| Capital Price Yr10 | 50.10 | | Equity market expected return | 8.5% | |
| IRR (p.a.) | 8.5% | | Stock risk factor (from Quality analysis) (x) | 1.0 | see table on page 2 |
| Required Return (p.a.) | 8.5% | | Required return | 8.5% | |

Source: Bluebird

**IRR at current price**

At the current share price, we forecast a total return (dividends + capital return) of 9.1% p.a. over a 10-year holding period. The expected return of 9.1% p.a. is above its required return of 8.5% p.a., thus the stock offers value at current levels.

Sonic's 5-year CAGR of EPS is 6%, while EPS grew by 9% in the last year. Sonic generates low organic growth with most of its growth coming from acquisitions. We model a similar growth rate to its past 5 years, with a 10-year CAGR of 6.1%.

**Fair value**

We calculate a fair value of $30.00/share, which is the level where the Expected Return (IRR) = the Required Return (R). SHL is a BUY below its fair value and a HOLD when trading between 0-20% above fair value. A stock trading >20% above fair value is considered a SELL, although Bluebird will review its IRR model before removing the stock from the portfolio.

Note: the IRR and R calculations are based on the assumptions in the above table, which we believe are reasonable. The growth forecasts and risk factor are key inputs that are derived from the Quality analysis. The P/E at year 10 is calculated by reference to the growth rate (G) at year 10, the yield curve and the minimum required return (R).

## Momentum analysis

Bluebird also looks for positive momentum before investing. We assess short-term, medium-term and long-term price trends, as well as relative performance vs the ASX 200, to assess the stock's momentum. We only show medium-term trends below in the interests of space. Ideally, we like to see a combination of short-term and long-term momentum.

## 5-year price trend

The SHL share price has recovered after weakness caused by an equity capital raise in FY19. SHL remains in medium and long-term uptrend.


## 5-year relative performance vs ASX 200

SHL continues to outperform the market over short and long time-frames.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Source : Thomson Reuters Eikon

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