

Medicare's Easter gift for DI

Industry Update | 06 April 2023 (23:26 AEST)

The Australian Government has announced its latest changes to the Medicare Benefits Schedule. The most notable change is the latest indexation announcement of 3.6%, effective 1 July 2023. Our channel checks describe the increase as 'fair' and 'responsible' and it is clearly a better reflection of inflationary pressures in the system than the 1.6% indexation rate in the prior year. However, the rate does not include any catch-up for the lower indexation rate versus inflation last year. The FY24 indexation applies to most GP service items as well as diagnostic imaging (DI) codes (with the exception of nuclear imaging services). The indexation rate appears to be less generous for pathology, as it applies to only six specific codes that were denied indexation in the previous year. We adjust our earnings forecasts across our DI coverage, augmenting our expectations of an improving revenue profile as DI volumes continue to improve based on the surgical backlog, less COVID disruption and now better indexation for FY24 than we originally forecast (~2.5%). We note there is no change to Medicare pricing in 2H23. However, various DI providers have indicated attempts to pass some inflationary pressures onto the consumer via co-payments. The extent and magnitude of co-payments is a case-by-case proposition depending on geography, competitive positioning and complexity of the scan. For clarity, the following pricing changes reflect only Medicare indexation and we have not attempted to reflect DI providers' ability to increase co-payments. As a result, we make the following changes to our forecasts across the listed Australian DI providers, namely CAJ, IDX, HLS and SHL.

- DI revenue increase +0.9% from 1 July 2023: Medicare indexation of 3.6% covers 95% of revenues (we assume nuclear imaging for all operators represents around ~5% of Medicare revenues), resulting in a weighted-average uplift of ~3.4%. Our forecasts already factored in a 2.5% indexation uplift for FY24; as such, we have processed a 0.9% revenue upgrade to Australian imaging revenues across our coverage to reflect the higher-than-expected indexation.
- Revenue sharing arrangements with radiologists dilutes (~20%) some of the price benefit: This pricing benefit intuitively represents pure margin as it moves through the P&L. However, most operators have an undisclosed mix of radiologists on fixed salary and/or a sliding scale of revenue sharing agreements. For the purpose of our model, we have conservatively assumed 80% of the benefit falls through to earnings to recognise the revenue sharing arrangements that exist. We have applied this consistently to all operators but recognise some operators may not have implemented revenue sharing arrangements to the same extent.
- Earnings impact greatest for CAJ > IDX > HLS > SHL.
 - **CAJ** (AU imaging = 100% of group revenues): We adjust our FY24 and FY25 EPS forecasts by +7.7% and +7.0%, respectively, which highlights CAJ is proportionately the biggest beneficiary across the DI players given the extent to which its operations are bulk billed.
 - **IDX** (AU imaging = 87% of group revenues): We adjust our FY24 and FY25 EPS forecasts by +6.7% and +5.9%, respectively, which looks more muted versus CAJ due to its lower representation of bulk billing revenues.
 - **HLS** (AU imaging = 25% of group revenues): We adjust our FY24 and FY25 forecasts by +3.7% and +2.5%, respectively. We have not processed any indexation for pathology.
 - **SHL** (AU imaging = 10% of group revenues): We adjust our FY24 and FY25 forecasts by +0.6% and +0.5%, respectively. We have not processed any indexation for pathology.

Note: We list valuation and key risks by stock below our earnings revisions tables for each company.

Key financial metrics	Rating	Price (A\$)	12m target price (A\$)	Projected return	Price to earnings (x)	Dividend yield
Sonic Healthcare Limited	Neutral	36.27	31.54	-10.5%	23.6	2.5%
Healius Limited	Underweight	3.23	2.71	-14.9%	51.2	1.1%
Integral Diagnostics Limited	Overweight	3.02	3.13	5.2%	40.5	1.4%
Capitol Health Limited	Neutral	0.27	0.30	17.0%	25.2	3.8%
Source: Jarden Research						

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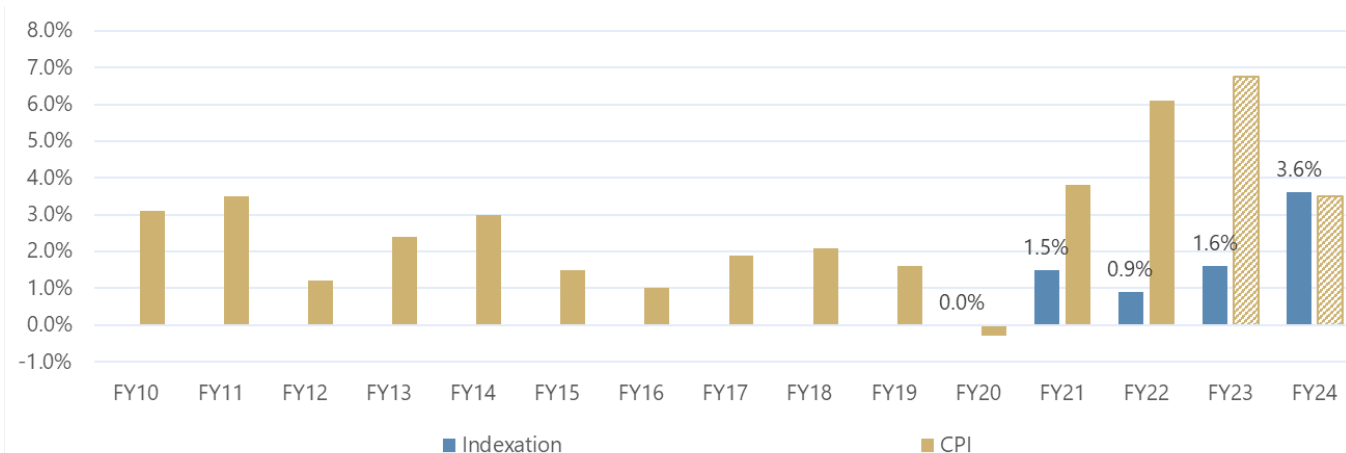
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Indexation vs CPI

Our channel checks indicate that indexation of 3.6% will be well received by industry operators, who have not previously had indexation match inflation, including 20 years to FY20 when no indexation was granted to the industry. Focusing on the commentary specific to Diagnostic Imaging over the past four years, we can see indexation has been typically applied to more than 90% of Diagnostic Imaging items.

- **FY21:** Indexation of 1.5% was applied to 90% of MBS items, equating to 80% of benefits.
- **FY22:** Indexation of 0.9% was applied to 90% of MBS items, equating to 80% of benefits.
- **FY23:** Indexation of 1.6% was applied to 97% of DI Services, including MRI items.
- **FY24:** Indexation of 3.6%, which we assume applies to 95% of MBS DI benefits.

Figure 1: Indexation vs CPI FY10-FY24



Source: RBA, Medicare. Note: Shaded bars represent RBA forecasts for inflation.

Earnings changes

Indexation of 3.6% was a 0.9% positive surprise to our previous expectation, which we have now pushed through our FY24 Australian imaging revenue forecasts across our coverage. We assume 80% of this benefit falls through to earnings, with most costs being fixed and only a portion of radiologists' costs being variable based on revenues. Whilst we understand the proportion of radiologists on these contracts varies by operator, we have initially kept this assumption the same across each operator.

Our FY24 EPS revisions are greatest for those with the greatest exposure to AU imaging: CAJ +7.6% (100% AU imaging), IDX +6.7% (87% AU imaging), HLS +3.7% (25% AU imaging) and SHL +0.6% (10% AU imaging).

CAJ

Figure 2: Jarden CAJ earnings forecast revisions

CAJ \$m	FY23e			FY24e			FY25e		
	Prior	Current	%pcp	Prior	Current	%pcp	Prior	Current	%pcp
Revenue	213.4	213.4	0.0%	233.6	235.9	0.9%	245.3	247.6	0.9%
EBITDA	44.6	44.6	0.0%	52.2	53.9	3.4%	56.1	57.9	3.2%
	20.9%	20.9%		22.3%	22.9%		22.9%	23.4%	
D&A (incl AASB 16)	(23.7)	(23.7)	0.0%	(23.8)	(23.8)	0.0%	(24.4)	(24.4)	0.0%
Total EBIT (incl. FX impact)	20.9	20.9	0.0%	28.4	30.1	6.1%	31.7	33.5	5.7%
EBIT margin	9.8%	9.8%		12.2%	12.8%		12.9%	13.5%	
Net Interest expense (income)	(4.6)	(4.6)	0.0%	(5.2)	(5.2)	0.2%	(4.8)	(4.7)	1.0%
PBT	16.3	16.3	0.0%	23.2	24.9	7.5%	26.9	28.8	6.9%
Income tax expense	(4.9)	(4.9)		(7.0)	(7.5)		(8.1)	(8.6)	
Tax rate	30.0%	30.0%		30.0%	30.0%		30.0%	30.0%	
Underlying NPAT	11.2	11.2	0.0%	16.1	17.3	7.6%	18.6	19.9	7.0%
Diluted EPS	1.05	1.05	0.0%	1.49	1.60	7.6%	1.73	1.85	7.0%

Source: Jarden estimates

CAJ valuation and risks: Our three-stage DCF-based 12-month target price for CAJ increases to \$0.30 (from \$0.29) and we maintain our Neutral rating. Key investment risks are COVID disruption, increased/reduced GP/staffing shortages, M&A risk, persistent inflationary pressures, a recovery of in-clinic GP attendances and an improving profile of DI volumes in CAJ-weighted states.

IDX

Figure 3: IDX Jarden earnings revisions

	FY23e			FY24e			FY25e		
	Prior	Current	Chg (%)	Prior	Current	Chg (%)	Prior	Current	Chg (%)
Existing Australia	308.6	308.6	0.0%	331.9	335.0	0.9%	351.9	355.1	0.9%
Imaging Queensland	72.0	72.0	0.0%	77.6	78.3	0.9%	82.2	83.0	0.9%
Existing New Zealand	39.0	39.0	0.0%	44.3	44.3	0.0%	46.6	46.6	0.0%
Ascot (NZ)	18.2	18.2	0.0%	19.2	19.2	0.0%	20.3	20.3	0.0%
Total revenue	437.8	437.8	0.0%	473.0	476.8	0.8%	500.9	505.0	0.8%
EBITDA	82.5	82.5	0.0%	102.7	105.7	3.0%	112.9	116.1	2.9%
EBITDA margin	18.8%	18.8%		21.7%	22.2%	0.5%	22.5%	23.0%	
Depreciation	(40.4)	(40.4)	0.0%	(40.5)	(40.6)	0.0%	(41.3)	(41.4)	-0.1%
EBITA	42.0	42.0	0.0%	62.1	65.2	4.9%	71.6	74.7	4.4%
EBIT margin	9.6%	9.6%		13.1%	13.7%		14.3%	14.8%	
NIE	(16.9)	(16.9)		(17.0)	(17.0)		(17.1)	(17.0)	
PBT	25.1	25.1	0.0%	45.1	48.1	6.7%	54.5	57.7	5.9%
Tax	(7.3)	(7.3)		(13.1)	(14.0)		(15.8)	(16.7)	
Tax rate	29.0%	29.0%		29.0%	29.0%		29.0%	29.0%	
Underlying NPAT (post AASB 16)	17.8	17.8	0.0%	32.0	34.2	6.7%	38.7	41.0	5.9%
Underlying EPS (Diluted)	7.7	7.7	0.0%	13.8	14.8	6.7%	16.7	17.7	5.9%

Source: Jarden estimates

IDX valuation and risks: Our three-stage DCF-based 12-month target price for IDX increases to \$3.13 (was \$3.04) and we maintain our Overweight rating. Key investment risks include further COVID infections, MRI competition and reimbursement risk.

HLS

Figure 4: HLS Jarden earnings revisions

HLS \$Am	FY23e			FY24e			FY25e		
	Prior	Current	% diff chg	Prior	Current	% diff chg	Prior	Current	% diff chg
Pathology BAU (ex-COVID)	1,232.7	1,232.7	0.0%	1,297.2	1,297.2	0.0%	1,362.1	1,362.1	0.0%
Agelix	31.0	31.0	0.0%	36.0	36.0	0.0%	41.7	41.7	0.0%
Pathology BAU (incl. Agelix)	1,263.7	1,263.7	0.0%	1,333.2	1,333.2	0.0%	1,403.8	1,403.8	0.0%
COVID	90.8	90.8	0.0%	30.0	30.0	0.0%	30.0	30.0	0.0%
Imaging	432.4	432.4	0.0%	458.3	462.6	0.9%	485.8	490.4	0.9%
Day hospital / IVF	-	-		-	-		-	-	
Other / Corporate	5.1	5.1	0.0%	5.1	5.1	0.0%	5.1	5.1	0.0%
Intersegment	-	-		-	-		-	-	
Total revenue (continuing operations)	1,792.0	1,792.0	0.0%	1,826.6	1,830.9	0.2%	1,924.7	1,929.3	0.2%
Discontinued operations	37.9	37.9	0.0%	-	-		-	-	
Pathology (incl. Agelix)	297.1	297.1	0.0%	334.6	334.6	0.0%	381.9	381.9	0.0%
Imaging	98.5	98.5	0.0%	115.7	119.1	2.9%	126.3	130.0	2.9%
Other	(17.2)	(17.2)	0.0%	(17.6)	(17.6)	0.0%	(18.0)	(18.0)	0.0%
EBITDA	378.4	378.4	0.0%	432.8	436.2	0.8%	490.2	493.9	0.7%
...margin	21.1%	21.1%		23.7%	23.8%		25.5%	25.6%	
Discontinued operations	8.0	8.0		0.0	0.0		0.0	0.0	
D&A	(267.2)	(267.2)	0.0%	(279.6)	(279.6)	0.0%	(282.0)	(282.0)	0.0%
EBIT	111.2	111.2	0.0%	153.2	156.6	2.2%	208.2	211.8	1.8%
...margin	6.2%	6.2%		8.4%	8.6%		10.8%	11.0%	
Net Interest expense (income)	(59.4)	(59.4)	0.0%	(61.9)	(61.9)	0.0%	(62.1)	(62.0)	-0.1%
Profit before tax and significant items	51.8	51.8	0.0%	91.2	94.6	3.7%	146.1	149.8	2.5%
Income tax expense	(15.5)	(15.5)	0.0%	(27.4)	(28.4)	3.7%	(43.8)	(44.9)	2.5%
Underlying NPAT	36.3	36.3	0.0%	63.9	66.3	3.7%	102.3	104.9	2.5%
Diluted EPS - Underlying (cpts)	6.3	6.3	0.0%	11.1	11.5	3.7%	17.7	18.1	2.5%

Source: Jarden estimates

HLS valuation and risks: Our three-stage DCF-based 12-month target price increases to \$2.71 (from \$2.66) and we maintain our Underweight rating. Risks to our view are additional M&A interest, a rebound in pathology and imaging volumes and revised/improved merger terms from ACL (Not Covered).

SHL

Figure 5: SHL Jaren earnings revisions

SHL \$Am	FY23e			FY24e			FY25e		
	Prior	Current	% difference	Prior	Current	% difference	Prior	Current	% difference
Revenues									
Pathology	6,795.7	6,795.7	0.0%	6,985.0	6,985.0	0.0%	7,273.9	7,273.9	0.0%
Imaging	769.4	769.4	0.0%	807.9	814.8	0.9%	848.3	855.5	0.9%
Other	395.2	395.2	0.0%	411.0	411.0	0.0%	427.4	427.4	0.0%
Total sales to external customers	7,960.3	7,960.3	0.0%	8,203.8	8,210.8	0.1%	8,549.6	8,556.9	0.1%
Unallocated revenue / income	-	-		-	-		-	-	
Total revenue	7,960.3	7,960.3	0.0%	8,203.8	8,210.8	0.1%	8,549.6	8,556.9	0.1%
Pathology	1,565.1	1,565.1	0.0%	1,613.2	1,613.2	0.0%	1,710.3	1,710.3	0.0%
Imaging	187.5	187.5	0.0%	197.9	203.7	2.9%	207.8	213.9	2.9%
Other	26.6	26.6	0.0%	32.9	32.9	0.0%	38.5	38.5	0.0%
EBITDA	1,779.2	1,779.2	0.0%	1,844.0	1,849.8	0.3%	1,956.6	1,962.6	0.3%
...margin	22.4%	22.4%		22.5%	22.5%		22.9%	22.9%	
Depreciation	(621.1)	(621.1)	0.0%	(646.6)	(646.6)	0.0%	(651.3)	(651.4)	0.0%
Amortisation	(72.9)	(72.9)	0.0%	(83.0)	(83.0)	0.0%	(85.5)	(85.6)	0.0%
NIE	(70.7)	(70.7)	0.0%	(81.6)	(81.6)	0.0%	(74.9)	(74.9)	0.0%
PBT	1,014.5	1,014.5	0.0%	1,032.8	1,038.6	0.6%	1,144.8	1,150.8	0.5%
Tax	(268.8)	(268.8)	0.0%	(268.3)	(269.8)	0.6%	(296.7)	(298.2)	0.5%
Tax rate	26.5%	26.5%		26.0%	26.0%		25.9%	25.9%	
MIE	(21.0)	(21.0)	0.0%	(25.0)	(25.0)	0.0%	(26.3)	(26.3)	0.0%
NPAT (post minorities)	724.8	724.8	0.0%	739.5	743.7	0.6%	821.9	826.4	0.5%
EPS	152.8	152.8	0.0%	156.8	157.7	0.6%	174.3	175.2	0.5%

Source: Jarden estimates

SHL valuation and risks: Our three-stage DCF-based 12-month target price increases to A\$31.54 (from A\$31.43) and we maintain our Neutral rating. Key risks are the sustainability of global COVID testing, reimbursement risk, increased/reduced GP referrals and competitive pressures.