Healthcare Capital Management

BUSINESS ACUMEN WITH INTEGRITY

"The Lazy Balance Sheet"

Manoj Miranda - CEO

Healthcare Capital Management

BUSINESS ACUMEN WITH INTEGRITY

- We are a broking and a consulting firm that specialises in the healthcare industry
- We pride ourselves on adding value to our customers
- We always test for the "best interest of clients"
- Our Relationship with banks is very important- we even advise them on policy matters
- Our circle of influence includes accountants, valuers, sale brokers across the healthcare industry
- We have in excess of 18 years healthcare experience in the healthcare industry

What is a Lazy Balance Sheet?

- Businesses with lazy balance sheets are often those that carry too much cash and with little use of financial leveraging
- The risk of business failure is a bit lower in business with lazy balance sheets.
- However, the profitability on these business is dragged down by the excess cash balance that is not being put to better use.

Debt vs Equity

- The proportion of Debt to Equity that you use to fund your business depends on a wide range of factors such as:
    - the industry in which the business operates;
    - the type of business;
    - the stage of maturity; and
    - the business owner(s) appetite for risk

- It is important to **strike the right balance between the proportion of Debt to Equity** for your business' circumstances.
- **Too much equity** and you potentially have a 'lazy balance sheet' IE: your money isn't working *as hard* as it should be for you.
- **Too much debt** and your business may not have enough cushion to absorb even minor downturns.
- It is also important to have the right type of debt for your business.
    - Inappropriate debt structures can strangle cash flow and ultimately your business.

Debt

- Debt can be a very powerful tool for wealth creation.
  - It lets you use other people's money to grow your business without having to share the increase in the value of your business.
  - It also amplifies the power of a given amount of equity.
- However, debt is like fire – good servant, bad master.
  - If you can control debt, it can really stoke your business.
  - But, let it take control of your business, you can get badly burnt.
- Debt adds financial risk to a business' total risk profile.
  - If a business already has high levels of risk in its operations, then it would not be prudent to add a high level of financial risk as it would take the overall risk profile to dangerous levels.
- Businesses that are in start-up or early commercialization stages do not have stable earnings and cash flow.
  - Their business risk is still high and it is not appropriate to fund these types of businesses with debt.
- Getting the right type of debt to suit your business is important. Structuring the debt adequately to meet the cash flows of the business is as important as the type of debt.

Equity

- Equity is the money provided by owner(s) of the business.
  - Owners are rewarded by dividends (paid from earnings) and increase in value of the business (realised at the time of sale of shares in the business).
- **Equity is also the financial foundation of a business.**
  - The foundation has to be strong enough to hold the business up through tough times.
  - An ‘under-capitalised’ business means there is insufficient equity to cushion the business through bad times or through rapid growth.
- Losses can erode this foundation.
  - If this erosion is not quickly stopped with new injection of equity, the business will get to a point of no-return.
- Also, if a business grows too fast and is not properly funded to deal with this growth, it can be the end of that business.
- Equity ranks last in liquidation.
  - If a business gets into trouble, everyone else (trade creditors, debt providers etc.) all get their money from the proceeds of the sale of the assets of the business before owners/members.
- Owners/members thus have the highest amount of risk and therefore expect commensurately high returns on the funds they invest as capital in business.
- That’s why equity is the most expensive form of financing!!!

‘Good’ or ‘Bad’ debt?

- Ideally, when an organisation borrows money, the debt should be used to generate future revenues that will repay the interest on the debt and also repay the principal due at maturity

- ‘Good debt’ is debt that is used to buy an asset or activity that generates enough income or capital growth to more than cover the principal and interest on the debt

- ‘Bad debt’ is debt that does not achieve the above

The Mergers and Acquisitions Trap

- Given the constraints on growing organically, many owners have turned to a Mergers and Acquisitions ("M&A") strategy to find alternative sources of growth.
  - Many owners believe that acquisitions are a good way to increase Total Member Return ("TMR") because if the acquisition provides an ROI greater than the return on marketable securities (currently around 3 percent), it is a more productive use of cash or debt capacity.
  - Addressing the "lazy balance sheet" by acquisition requires the organisation to have access to a reasonable set of skills in strategic planning either from within the boardroom or from advisers.
- An organisation can avoid the M&A **cash trap** by comprehensively assessing the TMR impact of potential acquisition.
  - What is the impact on earnings or profitability?
  - Will the valuation multiple rise or fall as a result of this deal?
  - Is the organisation's cash or debt capacity better used for this deal or for paying out cash to members?
- The way to answers these questions is to develop a financial forecast of the future TMR that a organisation's current plans will deliver.
  - Do this before any deals are considered and assuming that any excess cash is paid out to members.
- Once this forecast is fleshed out, the next step is to quantify the TMR impact of using cash, debt, or shares to fund a particular acquisition.
- If the resulting TMR is above that of the forecast, then the deal makes economic sense.

ROE

- Return on Equity ("RoE") is possibly the single most important ratio for members of an organisation.
    - It directly influences the profitability of the organisation, which directly influences the valuations of the shares of that organisation.
    - Obviously, members, the higher the valuation of their shares the better.
- Basic RoE is made up of two components:
    - Profit After Tax (PAT) which is divided by;
    - Equity (often, average equity is used).
- Successful organisation that are not reinvesting heavily into operations or acquisitive or organic expansions and who are generating good profits, can utilise their free cash flows to pay off debt.

- Once this debt is reduced, the organisations can actually start to build up excess cash balances.

- Basically, this means that the organisations start to sit with large net cash balances that are doing nothing but earning interest for them.

Key Ratios

Various Societies	A	B	C	D	E	F	G	H	I
Cash Holding (% of Liability)	7%	109%	66%	58%	4%	698%	736%	4%	30%
Debt Equity Ratio (Debt/Equity)	16%	0%	0%	0%	0%	0%	0%	16%	275%
Return on Equity (NPBT/Equity)	11%	6%	4%	2%	-2%	6%	9%	-2%	12%

Various Societies	J	K	L	M	N	O	P	Q
Cash Holding (% of Liability)	200%	16%	66%	343%	292%	501%	8%	25%
Debt Equity Ratio (Debt/Equity)	10%	51%	0%	0%	0%	0%	49%	29%
Return on Equity (NPBT/Equity)	-18%	10%	0%	3%	6%	-19%	0%	3%

Key Ratios – Analysis

- High Level of cash is highly correlated with low ROE
- Low Level of Debt is highly correlated to low ROE

Lazy Balance Sheet

- There is no hard and fast rule to define
- Depends on a number of factors including maturity of your business, the type of business and the industry that the business operates in, the business owmers/members appetite for risk, etc.
- ‘When an organisation borrows money, the debt ideally should be used to generate future revenues that will repay the interest on the debt and also repay the principal due at maturity.
- Leverage that a balance sheet can carry changes with time especially as the risk profile changes.
- Getting the balance sheet right may lead to an organization that is financially sustainable with the ability to generate and regenerate capital for its members.

Important things you should know

Any advice given is of a general nature only and it not based on any consideration of your objectives, financial situation and needs. To decided if a product is right for you, please carefully ready the Product Disclosure Statement ("PDS") for the product. A PDS can be obtained from your credit provider(s).

Healthcare Capital Management

BUSINESS ACUMEN WITH INTEGRITY