Australian
National
University

ANU Student Managed Fund

Sonic Healthcare Limited

Investment recommendation

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All dollar amounts in this report are Australian dollars.

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Glossary

AA – Asset allocation

AAE – Active Australian equities

AE – Australian equities

AFI – Australian fixed income

ANU – The Australian National University

CBE – ANU College of Business and Economics

CIO – Chief Investment Officer

CRO – Chief Risk Officer

DCF – Discounted Cash Flow

EBIT – Earnings before interest and taxes

ESG – Environmental, social and governance

FC – Franking credits

FY – Financial year

GW – Goodwill

IAC – Investment Advisory Committee

IE – International equities

IPS – Investment Policy Statement

IOZ – iShares Core S&P/ASX 200 ETF

M&A – Mergers and acquisitions

MoS – Margin of safety

PCR – Polymerase chain reaction

R&C – Risk and Compliance

ROIC – Return on invested capital

RSFAS – Research School of Finance, Actuarial Studies and Statistics

RT – Relationship Team

SHL – Sonic Healthcare Limited

SMF – ANU Student Managed Fund

SRI – Socially responsible investment

WACC – Weighted average cost of capital

Portfolio recommendation

We recommend that the Student Managed Fund (SMF) **sell** its entire active holding in Sonic Healthcare Limited (SHL) within the Active Australian equities (AAE) portfolio, investing the proceeds into iShares Core S&P/ASX200 ETF (IOZ). Our sell recommendation hinges on the share price remaining above $38.00 at the time of the transaction, which would imply a -4.54% margin of safety (MoS).

AUSTRALIA	
ASX code: SHL	
Price (at 15/10/2021)	A$39.11
Valuation	$36.27
- inc. franking credits	$38.40
Margin of safety (MoS)	-7.25%
- inc. franking Credits	-4.54%
Dividend yield (2022F)	1.54%
- inc. franking credits	1.68%
GICS	Healthcare
52-week range	A$30.21 -A$43.99
Recommendation	Sell
Key assumptions	
Required return on equity	5.68%
WACC	4.25%
Carbon intensity	
SHL	15.5
ASX200	201.0

Investment thesis

The SMF initially invested in SHL on 8 October 2019 based on an investment thesis underpinned by the following favourable attributes of the company's business model:

- Revenue growth from market expansion and mergers and acquisitions (M&A)
- Medical leadership strategy
- Defensive characteristics of the healthcare industry

While these attributes remained largely *unchanged*, our valuation analysis indicates that the stock is now too expensive to maintain the position. Our updated valuation is informed by the following considerations:

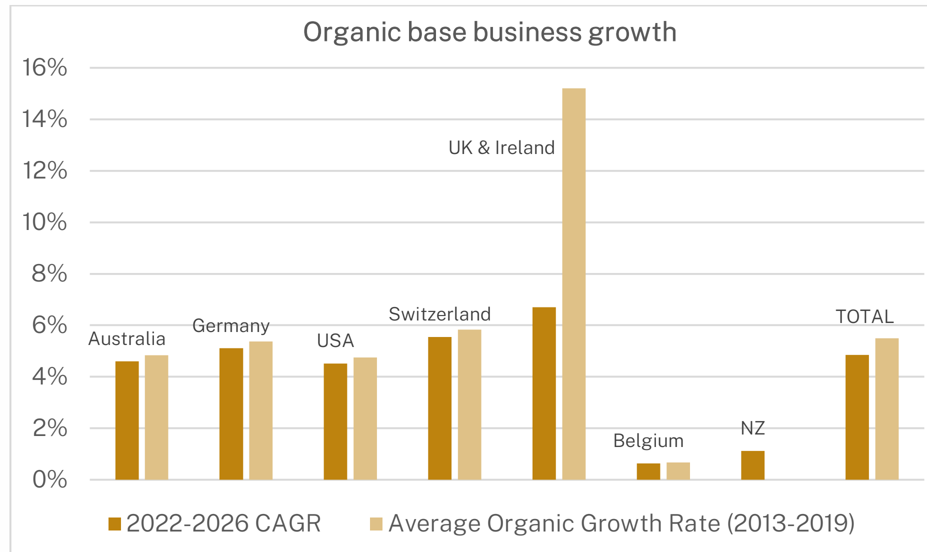
1. The evolving COVID-19 situation, and its ongoing impact on revenue.
2. An associated outlook for margins to deteriorate going forward.
3. Decreased potential for value-adding M&A, with acquisition multiples likely to rise.

Model and investment case update

Revenue

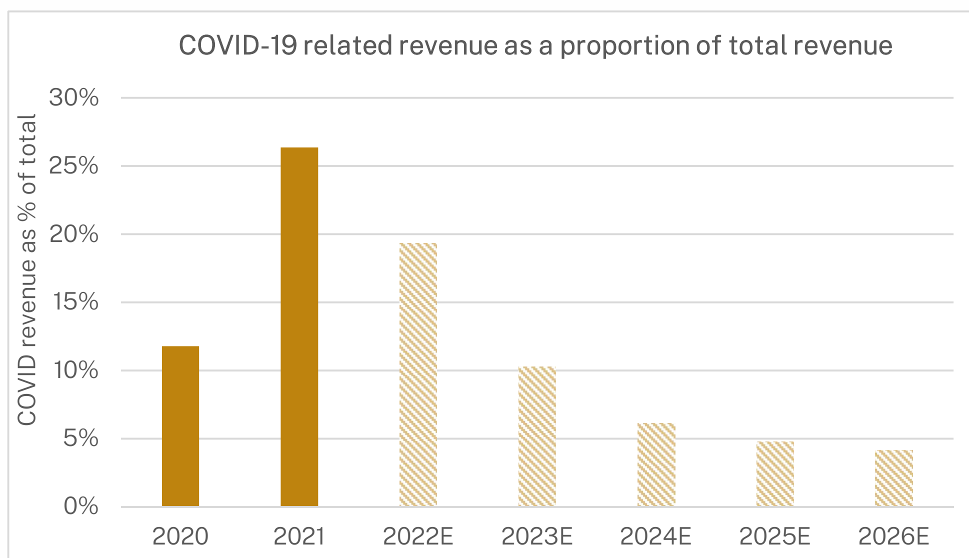
The revenue model is a core area that has been updated within our model of the underlying business. Revenue for the explicit forecast period has now been separated into organic base business growth and COVID-19 related growth, with inorganic growth related to M&A activity being analysed separately.

Organic base revenue business growth. Base business (see chart over for country breakdown) is forecast to grow at a compounded annual growth rate just below the historical average. This is the case in all countries with the exception of UK and Ireland where extraordinary circumstances are inflating the historical average.



COVID-19 related revenue growth. COVID-related impacts on SHL revenues and margins significantly boosted FY 2021 earnings, contributing approximately $2.3 billion or 26% of revenues versus 12% in FY 2020 (see chart over). Our model update assumes that a substantial portion of these gains will not be sustained, and that margins will eventually settle at levels that do not support the current share price. While the SMF is not focused on short-term earnings trends, we suspect that the market is to a degree, and that the COVID-related earnings boost is contributing to the valuation becoming stretched. The winding back of the boost from COVID could hence act as a catalyst for re-adjustment in the share price in the future.

Since the outbreak of COVID-19, SHL has performed over 18 million COVID PCR tests across all regions of operation. A large proportion of these tests are attributable to the outbreak of the Delta variant and a second wave of infections, which resulted in a significant rise in revenue above what was previously forecast. In Australia specifically, SHL is well positioned to continue to reap the benefits of COVID-19 due to being the contracted provider for testing for aged care facilities, the generous Medicare rebate structure and the largest private vaccination provider. More broadly, however, we are bearish on the ability for SHL to sustain current levels of COVID-19 related revenue. SHL's COVID-19 testing in the U.S. has already dropped significantly from its peak of approximately 55 million in December 2020, to just over 20 million in July 2021 as the vaccine was rolled out. With around 60% of people in developed economies now vaccinated, the need for COVID-19 testing is likely to continue to diminish. Alongside vaccines, the shift towards rapid-antigen testing is also likely to hurt SHL revenue going forward. In Australia, rapid-antigen at home self-tests have been approved for supply from 1 November 2021, and are likely to curb demand for the PCR tests provided by SHL. In consideration of all these factors, we have forecast COVID-19 revenue to fall quite sharply until 2023 to reflect the step-change in global recovery. Thereafter we assume a more gradual decline to around 5% of total revenue, which accounts for any lingering need for testing in the medium term.



Regardless, there is still uncertainty over the outlook for COVID-19. There remains a material possibility that a new strain develops, or the vaccine underperforms due to limited efficacy or anti-vaccination sentiment. Both of these scenarios stand to benefit SHL. This uncertainty raises risk to our valuation. However, we believe the asymmetry of the scenarios to be more weighted towards the downside, in favour of our sell recommendation. Whilst recent share price declines could be interpreted as already correcting for this, it is hard to be sure. On balance, we see it as more likely that ongoing recovery from COVID-19 continues to weigh on the SHL price.

Inorganic M&A revenue. Future inorganic M&A has been stripped out from the base valuation, to be modelled separately (discussed further in "M&A Outlook") and then accounted for within the valuation. We note that the discrete acquisitions already announced for FY2022 are included at $0.38 per share, with an additional amount of $1.07 per share included for future acquisitions.

Margins

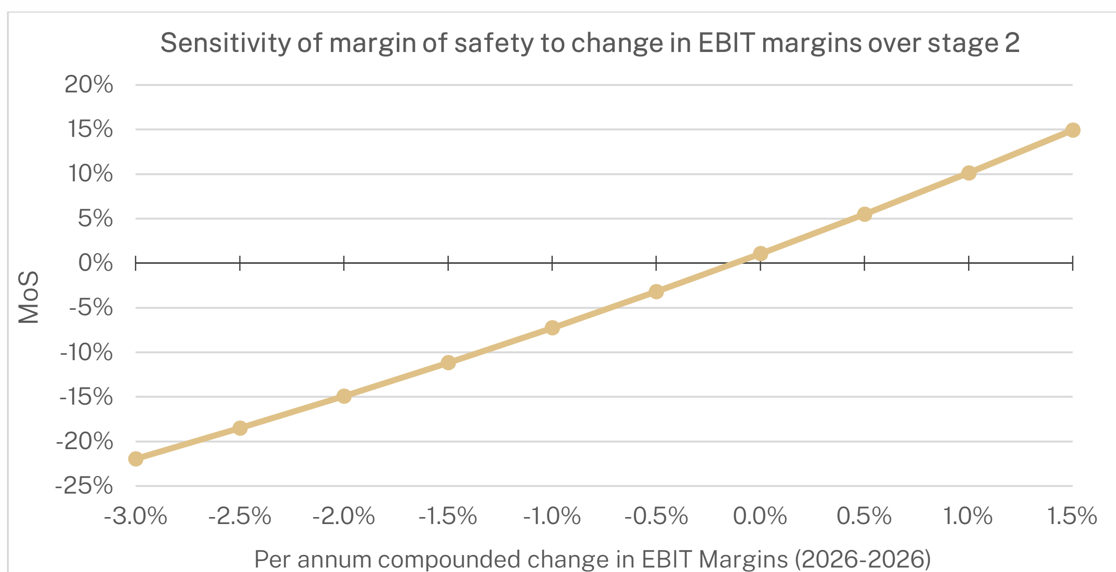
COVID-19 testing is highly cost-efficient and is largely responsible for significantly improved group margins, which rose from a pre-COVID average of around 12% to 21.9% in FY2021. Margins were also assisted by continued market share gains in the Australian imaging business, which has seen strong margin improvements over the last 3 years. This is largely due to a string of acquisitions where SHL has been able to realise synergies in achieving greater economies of scale. However, the impact on overall margins is modest, with the imaging business contributing only 7% to SHL's total revenue in 2021. In the medium-term, we therefore forecast changes in margins to be mainly driven by a decline in COVID-19 related revenue, gradually falling back to pre-COVID levels by 2027 (see page 15 for chart).

Over the long run, we see a variety of different factors influencing SHL's margins. Whilst in Australia, SHL should be able to maintain its margins due to its almost 50% market share in pathology services, in the global area SHL faces significantly more competition from other laboratory giants and private equity owned operations – especially in the US and Germany. This competition is only set to increase going forward, given the inflow of investment into the industry (see M&A outlook), raising two distinct risks. First, it poses a threat to SHL's existing patents, with any significant innovation from competitors eroding the company's pricing power. Second, it may lead to increased research and development (R&D) expenditure across the sector, including for SHL, as more markets become dominated by international firms. Our margin forecast captures the possibility of this downside risk.

SHL's margins are also vulnerable to increases in inflation, which is of elevated concern given the asymmetry of the current inflation regime. The healthcare industry is exposed to inflation in terms of both medical goods and wages. First, given medical goods are highly specialised, hospitals only have moderate bargaining power with suppliers. In the event of cost increases, we see it as highly likely SHL is unable to substantially pass costs onto consumers in the form of higher prices, given price ceilings in government regulation. Second, the most significant operating expense for SHL is wages, representing 48% of total expenses in 2021. Any sustained increase in inflation would include wage growth as a core component, and this may be compounded by the existing dynamics in the healthcare industry. Whilst wages have grown anaemically in the US for several decades, the last decade has seen an 8.5% rise in wages as a proportion of hospital costs. This trend is largely attributed to the perennial shortage of medical professionals, which is forecast to only become more severe going forward.

Considering all these factors, we conclude that a 1% compounded decline margins over stage 2 forecast period (2026-2036) is the most accurate representation on the outlook, and accounts for industry risks not reflected anywhere else in the model. This sees margins reduce from 12.29% 2026 to 11.11% in 2036.

Nevertheless, it must be acknowledged that our valuation is extremely sensitive to EBIT margin forecasts. The figure below demonstrates how slight changes in EBIT margins during stage 2 result in significant changes to the MoS. Applying a constant margin is enough to generate a positive MoS versus -7.25% under the base case. Further still, a 1% compound annual increase in the stage 2 forecast period (total margin change of +1.3%) raises the MoS to +10.13%. The size of the effect of these changes on EBIT margins raises significant modelling risks that cannot be ignored. Our sell recommendation therefore implicitly rests on the assumption that SHL is unable to sustain margins above pre-COVID levels in the long run.

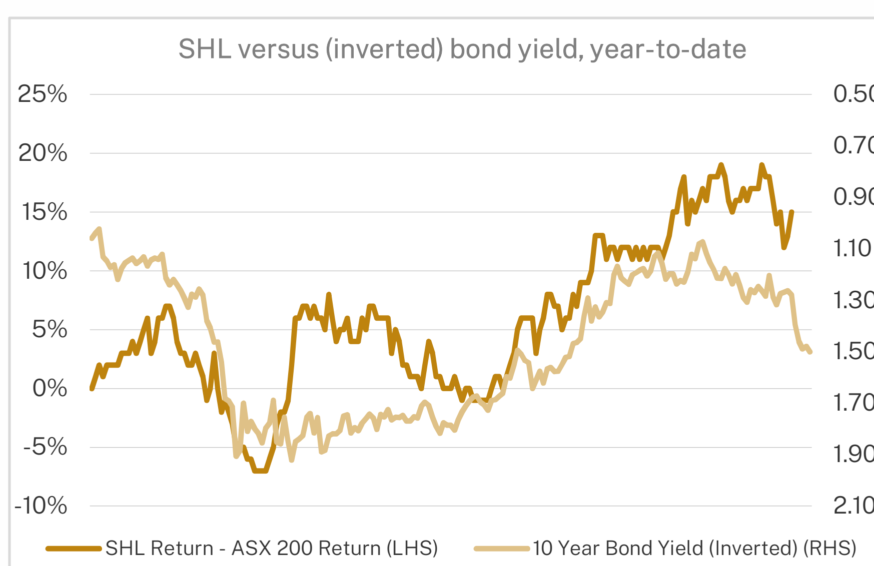


WACC

The WACC calculation has been updated in our model. We have removed the risk premium that was previously being applied for uncertainty over M&A activity by SHL, noting we are now valuing the underlying business and modelling inorganic growth separately. As a result, the WACC has been reduced for the underlying business from 4.66% to 4.25%, reflecting the low risk and reliable returns of an industry that is mainly driven by non-cyclical demographic drivers. Meanwhile, we have applied a higher WACC of 4.75% in estimating the value arising from inorganic growth from M&A.

One consequence of a lower WACC is that SHL faces heightened exposure to rises in the cost of capital, which would further decrease the valuation relative to other stocks due to higher duration. The main threat to a rise in SHL's cost of capital is an increase in general interest rates. The sensitivity of SHL's valuation to interest rate changes is highlighted in Appendix B, where just a 1% increase in the interest rate more than doubles the negative MoS to -19.03%, while a 2% increase decreases the MoS to -27.01%.

Interest rate exposure is especially relevant when considering the Asset Allocation (AA) team's macroeconomic scenario modelling. The AA team see a significant risk of higher inflation scenarios under which interest rates would rise, including a 41% probability on the 'high Inflation', 41% on the 'medium inflation' and 3.5% on the 'stagflation' scenarios. This leaves only an 14.5% probability to declining inflation, i.e. the 'low inflation' and 'crisis' scenarios (see Appendix B for further details). Rising interest rates could create a sizeable headwind for SHL, whose performance has recently been tracking closely to the inverted bond yield (see below graph).



M&A analysis

Our previous SHL valuations included an element of inorganic revenue growth within the model, recognising that ongoing M&A is a core part of the SHL business model. The company's strong track record of executing value accretive acquisitions was also part of the SMF's original investment thesis. Our updated base business model and valuation have been based on organic growth alone, with value creation (or destruction) from M&A now being analysed separately as described in this section. The decision to exclude implicit value creation from M&A within the model was informed by our view that the cost of acquisitions is likely to rise, although to an unknown extent. Merging inorganic growth with the base business through applying overall averages could add a level of inaccuracy to our modelling, given that the relative value of inorganic and organic growth might diverge as acquisitions premiums rise.

Estimation of the potential value created through M&A involves modelling the acquisition of a representative company based on assumptions regarding the multiples paid, the financial attributes of the business and the synergies generated. This is aggregated to an overall impact on the valuation under assumptions about the quantity and timing of acquisitions. The model is used to answer the question of how much value needs to be created through M&A to change our sell recommendation. The outlook for value creation through M&A is also of particular importance as we have doubts over SHL's commitment to capital management.

Execution risk

SHL has been pursuing a roll-up strategy, which involves consolidating highly fragmented markets where the current competitors are too small to achieve scale economies. (While roll-up strategies are pursued in some industries to diminish levels of price competition, this is not the case in healthcare where prices are highly regulated.) SHL has historically demonstrated continued ability to create value from such acquisitions through consolidating cost bases and thus improving the margins of the acquired company. Reasons exist to expect that attractive acquisitions will be harder to find going forward. In addition to rising acquisition prices (discussed below), it is also possible that the best investments in existing markets have already been made and synergies in such markets may be less realisable in future. While our view remains that execution risk remains relatively low given SHL's experience, the potential to add value from M&A activity has diminished.

M&A price risk

The value created by SHL through completing M&A is highly sensitive to the price paid. Roll-up strategies are hard to disguise and tend to invite competition. In this way, SHL may be a victim of its historical success. The SMF sees the risk of SHL overpaying for acquisitions as very high going forward, given the improved balance sheets of healthcare companies from COVID-19 and increasing focus on the sector following the rise in demand for non-core infrastructure assets. Demand has been enhanced by low interest rates, which have increased acquisition multiples across the market more broadly with the trend being particularly acute in defensive sectors. Alongside this, pathology and radiology clinics have attractive characteristics of inelastic, growing demand along with regulated pricing structures. These characteristics, that initially attracted the SMF to SHL, have increased demand for these assets from various infrastructure and institutional funds that have been squeezed out of traditional core-infrastructure assets.

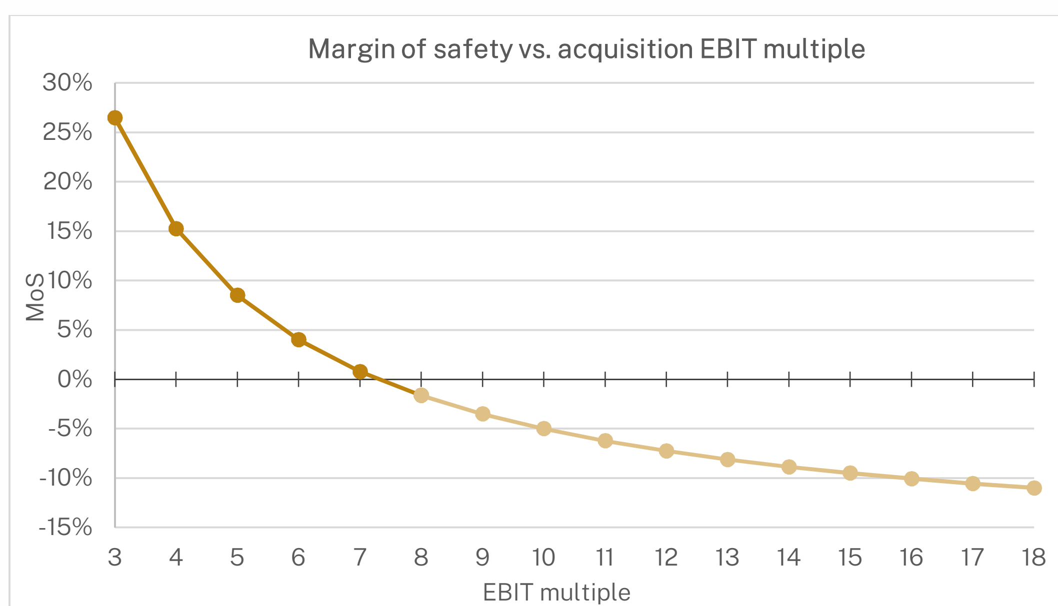
Acquisition model

Our model assumes that SHL continues to execute acquisitions successfully but will pay more for acquisitions than in the past. The inputs for an 'average' acquisition appear in the table beside. We model an average acquisition costing A$400 million in enterprise value terms (~5% of SHL's own value), that commences with a lower EBIT margin and invested capital turnover (excluding goodwill) versus SHL while having slightly faster organic revenue growth of 4%. About 75% of the Return on Invested Capital (ROIC) gap to SHL is subsequently closed due to synergies. The WACC in the acquisition model is also set higher than SHL's WACC to account for added risk of growth via M&A. Acquisitions are estimated to occur at an EBIT multiple of 12-times.

Assumptions for the average company acquired by SHL	
Acquisition size (A$ m)	400
Acquisition EBIT multiple	12
EBIT margin	12%
Invested capital turnover vs. SHL	20%
% of ROIC discount closed via synergies (margins, IC turnover)	75%
Revenue growth	4%
Acquisition WACC	4.75%

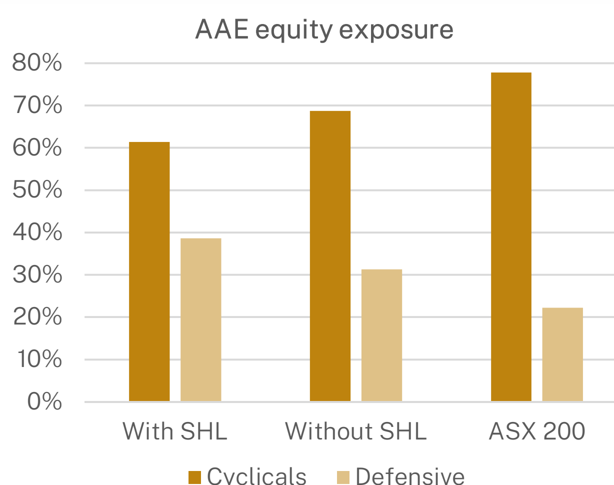
One way of using the model is to estimate how many such acquisitions SHL would need to complete to create the value required to close the gap between our valuation and the share price. Under the above assumptions, SHL would need to complete one such acquisition every year until 2035 (i.e. 14 acquisitions) for the SMF's MoS to improve to -2.73%. This amount of M&A activity seems highly optimistic, and would require the company to potentially expand into new markets or begin completing substantially larger acquisitions.

We conduct further analysis assuming a more realistic M&A timeline going forward, with SHL completing eight similarly sized acquisitions over a 14-year period. We then estimate the value created for shareholders at different acquisition multiples. We find that SHL creates some value if it can acquire businesses for an EBIT multiple of ~15.5x or less. However, SHL would have to pay at a maximum an average EBIT multiple of ~7.2x to generate a positive MoS. This is significantly lower than recent acquisitions. SHL paid 11.87x for Aurora Diagnostics in 2019 and an estimated 14.37x for Canberra Imaging Group, while the healthcare industry average was 14.7x in 2020 (*Grant Thorten, Dealtracker 2020)*. Given our view that acquisition prices will be elevated going forward, continuing to hold SHL entails a bet that either SHL management can generate more significant synergies than we assume, or execute large acquisitions at attractive prices. The low likelihood that SHL would be able to undertake M&A at the prices required to create significant value supports our sell recommendation. Further, there is downside risk to the $1.07 per share included in our valuation for future acquisitions, noting that it is based on an acquisition EBIT multiple of 12x that is below those currently being observed.



Role of SHL in the SMF portfolio

Our sell recommendation occurs notwithstanding the diversification benefits from holding SHL in the portfolio. The Australian market, and therefore the IOZ, is heavily weighted towards cyclical industries such as mining and banking. Including SHL in the portfolio enhances defensive exposure (see chart), while its large proportion of overseas revenues helps to mitigate home bias. The SMF would be more diversified by continuing to hold SHL, despite it being a significant active position.



To date, SHL has played a valuable role in the portfolio as a hedge against COVID-19 and deteriorating economic conditions, outperforming the market in periods of falling interest rates. However, there are encouraging signs of COVID-19 recovery in Australia and across the world, making this hedge of less importance going forward.

Valuation summary

Our valuation of SHL is $36.27 (excluding FC), equating to a MoS of -7.25%. This valuation comprises of valuation of the base business of $34.83, plus an additional $0.38 for acquisitions already to be completed in FY2022 and $1.07 for future acquisitions. Including FC raises our valuation to $38.40, with a MoS of -7.25%.

Our outlook that SHL is overvalued is further evidenced by the elevated P/E ratio of 23.5, compared to the SHL's Australian peers of 15.8, international peers of 20.9, and the ASX200 of 16.94. Heightened market interest appears to have led to the stock becoming priced beyond its forecast growth prospects, making it overvalued based on our analysis. We according recommend selling, subject to the condition that the price remains above $38.00.

Appendix

Appendix A: Valuation summary

	Bear case	Base case	Bull case
Share price (15/10/2021)	$39.11	$39.11	$39.11
Organic valuation, exc. FC	$25.62	$34.83	$37.66
Valuation, inc. acquisitions	**$27.07**	**$36.27**	**$39.11**
Valuation, inc. FC	$28.73	$38.40	$41.37
Margin of safety, exc. FC	**-30.77%**	**-7.25%**	**-0.01%**
Margin of safety, inc. FC	-26.53%	-1.81%	5.77%
Required return on equity	4.93%	4.93%	4.93%
Cost of debt	1.53%	1.53%	1.53%
WACC	4.25%	4.25%	4.25%

Appendix B: Interest rate sensitivity analysis

Sensitivity analysis - Interest Rate					
Change in Interest rate	Cost of equity	WACC	Value per share	Price	MoS
0.00%	4.93%	4.25%	$36.27	$39.11	-7.25%
0.25%	5.18%	4.45%	$34.93	$39.11	-10.69%
0.50%	5.43%	4.65%	$33.72	$39.11	-13.77%
0.75%	5.68%	4.85%	$32.64	$39.11	-16.54%
1.00%	5.93%	5.05%	$31.67	$39.11	-19.03%
1.25%	6.18%	5.25%	$30.78	$39.11	-21.30%
1.50%	6.43%	5.45%	$29.97	$39.11	-23.37%
1.75%	6.68%	5.65%	$29.23	$39.11	-25.27%
2.00%	6.93%	5.85%	$28.55	$39.11	-27.01%
2.25%	7.18%	6.05%	$27.92	$39.11	-28.61%
2.50%	7.43%	6.25%	$27.34	$39.11	-30.09%
2.75%	7.68%	6.45%	$26.80	$39.11	-31.47%
3.00%	7.93%	6.65%	$26.30	$39.11	-32.75%

Appendix B: Asset allocation team - Inflation scenarios

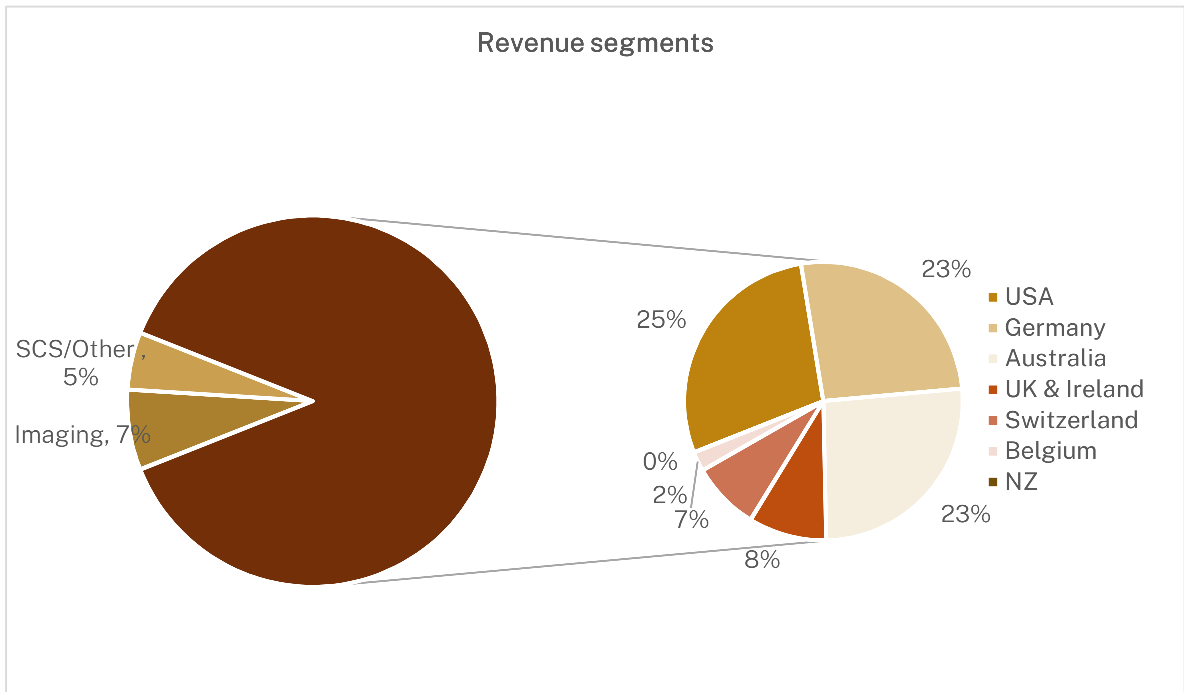
The 'AA Investment Process' entails specifying 10-year scenario projections and probabilities across both economic drivers and asset class inputs. The latter are fed into DCF-based asset models to generate wealth and return paths for each scenario.

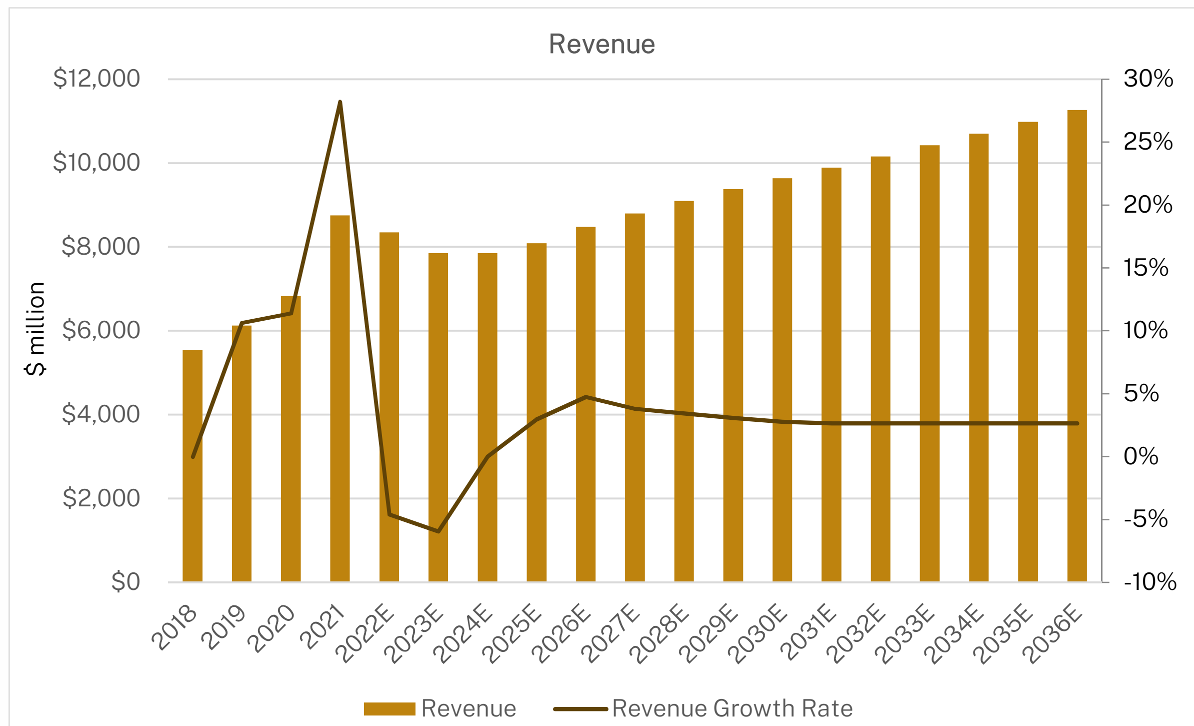
Scenario	Historical level (1992-present)	Historical probability	Forecast level	Forecast probability
High	6.1%	23.0%	4.5%	41%
Medium	30%	53.1%	2.5%	41%
Low	1.6%	23.9%	1.0%	14%
Stagflation			7%	3.5%
Crisis			0%	0.5%

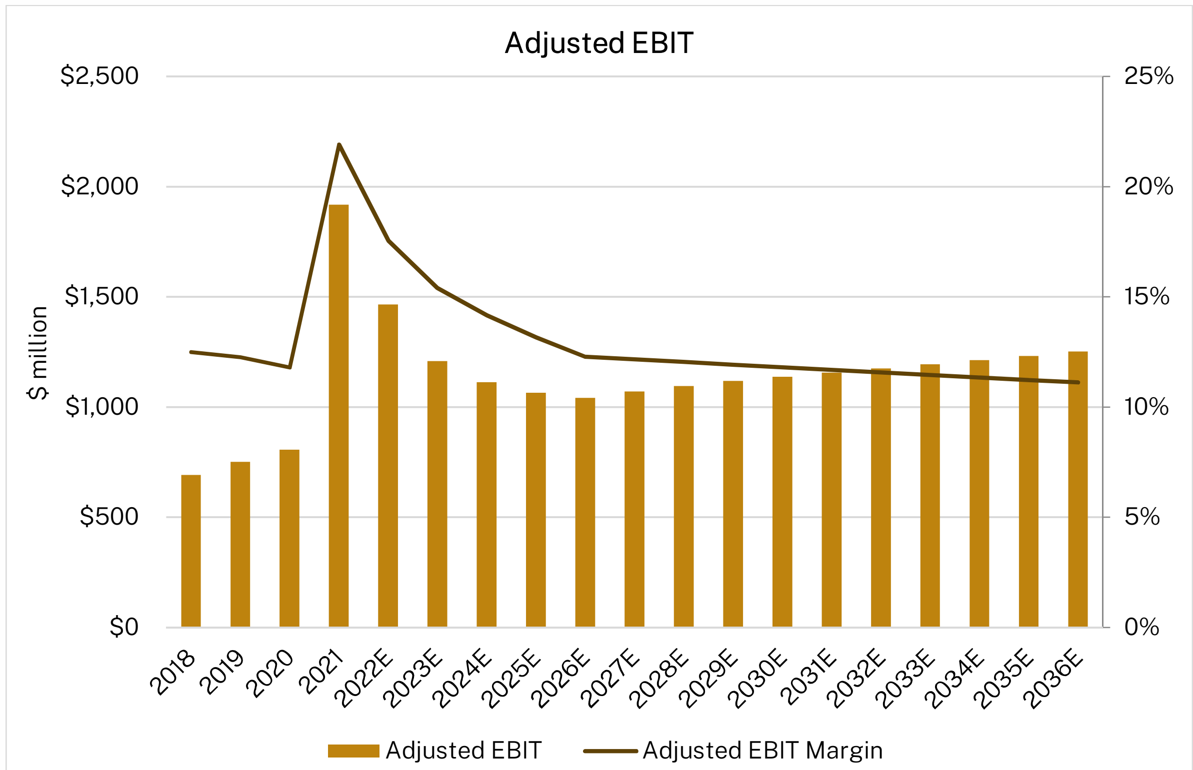
Appendix C: Key financial summary

Financial year ($million	2019(A)	2020(A)	2021(A)	2022(E)	2023(E)	2024(E)	2025(E)
Total revenue	6127	6826	8751	8349	7854	7855	8089
Revenue growth	10.63%	11.41%	28.21%	-4.60%	-5.93%	0.01%	2.98%
EBIT	751	806	1918	1513	1083	1024	965
EBIT margins	12.26%	11.81%	21.92%	18.13%	13.79%	13.03%	11.93%
NOPLAT	608	635	1546	1152	745	772	729
NOPLAT margin	9.92%	9.30%	17.66%	13.80%	9.48%	9.83%	9.01%
Invested capital (ex. goodwill)	2685	2648	2732	2966	2961	2981	3016
Invested capital (inc. goodwill)	9450	9603	9445	9688	9687	9710	9750
ROIC (ex. goodwill)	22.64%	23.98%	56.57%	38.84%	25.16%	25.90%	24.16%
ROIC (inc. goodwill)	6.43%	6.61%	16.37%	11.89%	7.69%	7.95%	7.47%
Free cash flow	-643	482	1704	909	746	749	688
IC turnover (ex. goodwill)	2.28x	2.58x	3.20x	2.82x	2.65x	2.64x	2.68x
Financial year ($ million)	2026(E)	2027(E)	2028(E)	2029(E)	2030(E)	2031(E)	2032(E)
Total revenue	8474	8797	9098	9378	9639	9893	10154
Revenue growth	4.76%	3.81%	3.43%	3.08%	2.77%	2.64%	2.64%
EBIT	994	1011	1025	1035	1043	1049	1055
EBIT margins	11.73%	11.49%	11.26%	11.04%	10.82%	10.60%	10.39%
NOPLAT	767	743	753	761	766	771	775
NOPLAT margin	9.05%	8.45%	8.28%	8.11%	7.95%	7.79%	7.63%
Invested capital (ex. goodwill)	3053	3169	3278	3379	3473	3564	3658
Invested capital (inc. goodwill)	9794	9916	10030	10137	10237	10334	10434
ROIC (ex. goodwill)	25.13%	23.44%	22.97%	22.52%	22.06%	21.62%	21.19%
ROIC (inc. goodwill)	7.83%	7.49%	7.51%	7.50%	7.49%	7.46%	7.43%
Free cash flow	723	621	639	654	667	673	675
IC turnover (ex. goodwill)	2.78x	2.78x	2.78x	2.78x	2.78x	2.78x	2.78x

Appendix D: Key financial drivers






Adjusted EBIT
$2,500
$2,000
$1,500
$1,000
$500
$0
$ million
25%
20%
15%
10%
5%
0%
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2020
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2022E
2023E
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2025E
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2027E
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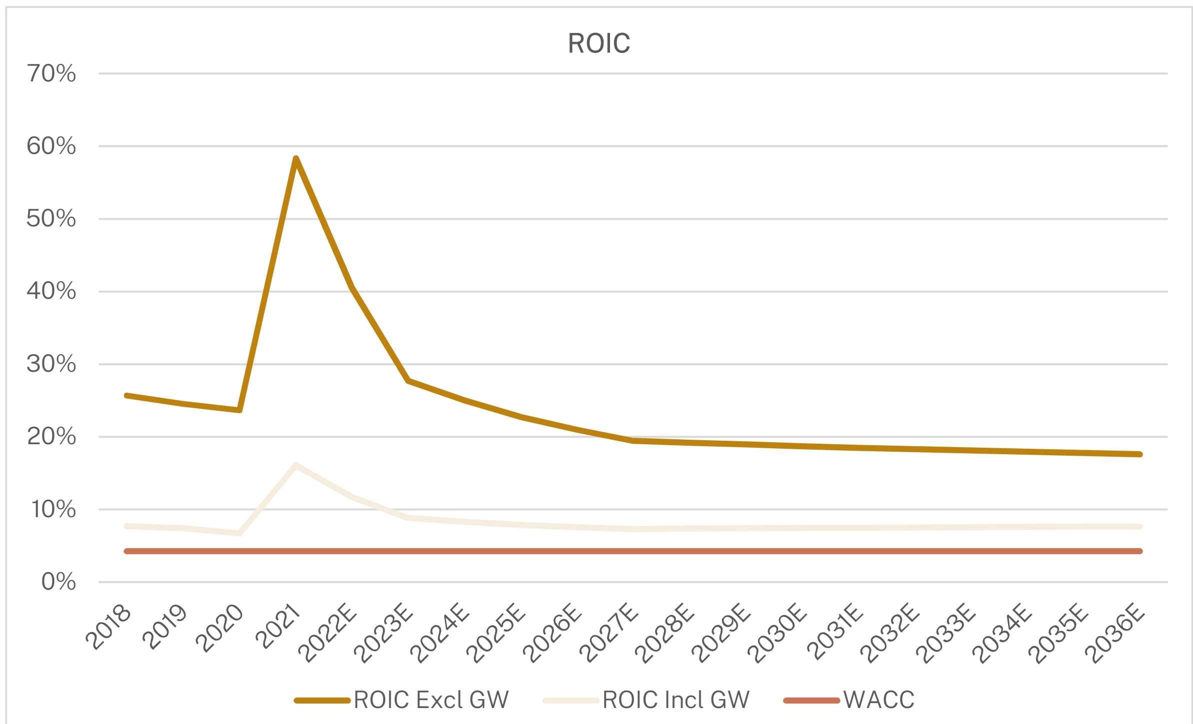
Adjusted EBIT
Adjusted EBIT Margin


ROIC
70%
60%
50%
40%
30%
20%
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0%
2018
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2028E
2029E
2030E
2031E
2032E
2033E
2034E
2035E
2036E
ROIC Excl GW
ROIC Incl GW
WACC

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