

EUREKA *report*



Healthscope bonds: Take a deep breath

By Elizabeth Moran
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PORTFOLIO POINT: The Healthscope bonds are paying an attractive return, but are only suitable for risk-tolerant investors.

People often ask me what kind of profits they can expect from investing in bonds. I try to provide them with a range depending on the prevailing market conditions. Remarkably, this spectrum is almost perfectly captured by the recent retail bond issues by CBA and Healthscope.

The CBA bond is an easy credit assessment and it has several attractive features, as discussed in my previous article (click [here](#)). With a floating return of +1.05% over the three month BBSW, it's entirely appropriate for my fixed income portfolio.

Healthscope notes, however, are a much lower-quality offering. This investment is paying an attractive fixed return of 11.25% and as a result is only appropriate for investors with a much higher tolerance for risk.

When I established my **portfolio** back in September, it was with the aim of offsetting existing, higher-risk equity investments and being suitable for investors at or near retirement wanting to increase certainty from their portfolio.

Most of the selections were consistent with what I considered to be low-risk, with the aim of providing capital certainty. But as the Healthscope notes demonstrate, it is possible to seek out higher returns in fixed income providing you are comfortable with a higher level of risk.

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Healthscope's notes don't really fit within the charter I established for my portfolio but if I had scope to accept the risk, I would only ever allocate a small percentage of my total funds to boost the overall return.

The return is what many investors might expect from equities, but offer the additional protection as a consequence of being a debt security. They sit higher in the capital structure than equities, have a known distribution (unlike dividends, which can be cut) and have a known maturity date. In that way equity investors who are frustrated by being unable to access the sector on the equity market may find Healthscope notes very attractive (see [The ASX's health problem](#)).

If you've got scope to add risk to your portfolio, Healthscope notes present a known equity-like return and may be a suitable investment depending on your personal circumstances and tolerance for risk.

Any fixed income credit assessment needs to consider the same questions:

- Does the reward (coupon) compensate me for the risk involved?
- Where does the bond sit in the capital structure?
- What buffer is there from investments that are junior in the capital structure?
- If the company has difficulty paying its creditors, what assets does it have to sell to meet payments, yet continue to operate?

Details of the offer

-Healthscope Notes offer details
Issuer

Healthscope Notes Limited

Security Name	Healthscope Notes
Maturity	17-Jun-16
Issue Date	17-Dec-10
First Coupon	25 March 2011 (not franked)
Yield	11.25%
Size	\$170m (may accept over-subscriptions of \$45m)
Minimum Parcel	\$5,000
Structure	Subordinated secured
<i>Source: FIIG Securities Limited, Healthscope Notes Prospectus</i>	

Company background

Healthscope, as the name implies, is an Australian private healthcare services provider. The company operates 44 private hospitals and also has an extensive pathology services network throughout all Australian states and territories. Healthscope is the second-largest private hospital provider in Australia after Ramsay Health Care, and the third biggest pathology operator after Sonic Healthcare and Primary Health Care. The company is also growing its network of medical centres in Australia.

Internationally, the company owns pathology businesses in New Zealand, Malaysia and Singapore.

The hospitals are the largest business of the group. When the private equity firms, TPG and Carlyle purchased the company earlier this year for an enterprise value of approximately \$2.7 billion, the independent experts on the deal ascribed a value of around \$2.0 billion to the hospitals with the remaining \$0.7 billion for pathology.

The business has strong, relatively stable cashflows, and debtors being private health insurers and the government are reliable but can be slow.

Demand for health services is expected to increase as the Australian population lives longer and the percentage of elderly citizens continues to grow.

Below are extracts of the profit and loss and balance sheet as disclosed in the prospectus. A couple of things to note:

- The P&L shows an increase in income and EBITDA before non-recurring items for the past three consecutive years, a positive sign.
- Total assets are \$2.3 billion, which include \$983 million of intangibles, an increase of \$730 million on acquisition of the group by the private equity investors. Net tangible assets would be in the vicinity of \$1.4 billion.
- A portion of receivables have already been sold to Westpac to provide additional working capital, probably limiting this source in future.
- The balance sheet shows the accounts prior to acquisition on October 12 by Carlyle and TPG. Borrowings of \$730 million including a \$215 million bridge on acquisition.
- A complicated ownership structure means that the balance sheet does not show the \$1.2 billion in senior secured facilities owed to the banks. Rather this is shown on a pro forma balance sheet of a special purpose vehicle, an entity established especially to issue debt. Those banking facilities include a \$300 million capital expenditure facility, as yet undrawn, so not shown as a liability.

Net assets/shareholders equity of \$1194 million					
\$ MILLION	FY08	FY09	FY10	LTM TO 30-SEP-10	CHANGE FY08 – LTM SEPT 10 (%)
Revenue¹	1,487	1,654	1,843	1,906	28
EBITDA	180	208	253	235	31
Non-recurring Items	18	20	11	43	
EBITDA before Non-recurring Items	198	228	264	278	40
Pro forma adjustments				15 ²	
Adjusted EBITDA				293	

1. Includes prosthetics revenue of \$170m for FY08, \$197m for FY09, \$198m for FY10 and \$204m for LTM to Sep 10.
2. Further details regarding the pro forma adjustments are included at Section 7.7.

\$ MILLION	BALANCE SHEET AS AT 30 SEPTEMBER 2010	NET ADJUSTMENTS ¹	PRO FORMA BALANCE SHEET AS AT 30 SEPTEMBER 2010
Current assets			
Cash	2	–	2
Trade and other receivables	110 ²	–	110
Prepayments	15	–	15
Inventories	46	–	46
Total current assets	173	–	173
Non-current assets			
Trade and other receivables	8	–	8
Property, plant and equipment	1,122	–	1,122
Deferred tax assets	54	–	54
Intangible assets	983	730	1,713
Other	13	–	13
Total non-current assets	2,180	730	2,910
Total assets	2,353	730	3,083
Current liabilities			
Payables	164	–	164
Provisions and other liabilities	104	–	104
Borrowings	7	–	7
Deferred purchase considerations	13	–	13
Current tax liabilities	7	–	7
Total current liabilities	295	–	295
Non-current liabilities			
Provisions	15	–	15
External Borrowings (including notes of \$215 million)	780	649	1,429 ³
Shareholder Loans	–	449	449
Deferred purchase considerations	20	–	20
Capitalised finance costs	(1)	(82)	(83)
Deferred revenue	4	–	4
Deferred tax liabilities	46	–	46
Total non-current liabilities	864	1,016	1,880
Total liabilities	1,159	1,016	2,175
Net assets	1,194	(286)	908
Shareholders' funds			
Contributed equity	1,075	(95)	980
Reserves	(18)	18	0
Retained earnings	137	(209)	(72)
Total shareholders' funds	1,194	(286)	908

1. Net Adjustments reflect the investment in Healthscope Limited by funds advised and managed by Carlyle and TPG and the new structure following the acquisition of Healthscope Limited. As the acquisition price exceeded the net asset value of Healthscope Limited and its controlled entities, intangibles have increased by \$730 million.
2. Trade receivables are disclosed net of receivables sold to Westpac under the Receivables Purchase Agreement. The receivables sold at 30 September 2010 were \$108.9 million and the proceeds from the sale were used to retire non-current borrowings and reduce the overall cost of debt servicing. Refer to Section 11.5 for further details regarding the Receivables Purchase Agreement.
3. Refer to Section 8 for further details in relation to these borrowings.

Capital structure

Healthscope notes are subordinate to the secured banking facilities totalling \$1.55 billion (\$1.214 billion drawn to date) and should the company go into liquidation then the banks would be repaid from sale of the assets first, then any additional proceeds would be applied to the note holders. The private equity partners have injected more than \$1.5 billion of equity into the group via direct capital or shareholder loans, which are subordinate to the Healthscope notes providing a relatively equal level of debt to equity weighting on the \$2.7 billion deal. The notes rank above ordinary unsecured creditors.

		Healthscope Group's key debt obligations and equity ¹	Pro forma amount drawn as at the Acquisition Date (\$ million) ^{2,3}
Higher ranking	Senior secured debt	Senior Facilities	1,214 ⁴
	Subordinated secured debt	Healthscope Notes	215
	Subordinated unsecured debt	Shareholder loans	1,516
Lower ranking	Ordinary equity	Ordinary shares	

Advantages

- High, fixed return.
- Stable and growing business.
- Debt covenants to protect note holders' investment.
- Private equity investors rank lower in the capital structure and support more senior debt holders including the Healthscope notes.
- Probability of further equity injections from the private equity partnership if needed.
- Diversity of businesses provides Healthscope with more flexibility in the event of the company encountering operational or financial difficulties. The hospital business can be broken down in to two business assets: the hospital buildings and the actual hospital operations. Ownership of the physical buildings allows for a sale and leaseback arrangement.

Risks

- High gearing.
- Possible government policy changes impacting hospital and pathology businesses.
- Relationships with doctors and private equity funds.
- Likely high capex to grow the company quickly so that equity investors can list and recoup their investment.
- High cost of borrowing on senior debt of 9.52%, although this cost will amortise and reduce in time.
- Possible illiquidity if you need to sell the notes prior to maturity.
- Suspension of coupon – If the debt service coverage ratio (DSCR), which currently sits at around 1.31 times, were to drop to 1.10 times (a downgrade in EBITDA of about \$35 million) then interest on the Healthscope Notes would be suspended. Investors should keep in mind that if this condition is invoked that interest on the securities is cumulative and penalty provisions will apply which provide the issuer with an incentive to quickly rectify the situation.
- In the event of liquidation there may be insufficient funds available from sale of the assets to repay note holders.

Protection Mechanisms

- Notes are secured, albeit after the banks have been repaid.
- Debt covenants (see the table below).
- Early redemption premium offered.
- Saleable assets or businesses.
- Dividend stopper on equities.
- Leverage is limited to five times, but if Healthscope sell assets, leverage using those funds is reduced to 4.25 times.

\$ MILLION, UNLESS OTHERWISE NOTED	LTM TO 30-SEP-10	HEALTHSCOPE NOTES		
		SENIOR COVENANTS ¹	RESTRICTION ON FINANCE DEBT ²	SUSPENSION OF INTEREST CONDITION ³
Adjusted EBITDA	293			
Pro forma Net Interest Expense				
Senior Debt and other ⁴	137			
Healthscope Notes ⁵	24			
	161			
Senior Leverage Ratio (times) ⁶	4.17x	5.15x		
Total Leverage Ratio (times) ⁷	4.91x		5.00x	
Total Interest Cover Ratio (times) ⁸	1.82x	1.45x		
Debt Service Cover Ratio (times) ⁹	1.31x	1.05x		1.10x

1. Covenants under Senior Facilities as at the first calculation date being 31 December 2010 for DSCR (only for the purposes of paying Interest on Healthscope Notes) and 30 June 2011 for all other covenants. Refer to Section 8 for further information.
2. The Total Leverage Ratio is required to be below 5.00x (prior to a Material Disposal) or 4.25x (on or after a Material Disposal) before additional debt facilities can be incurred by the Issuer or other member (or other member of the Security Group). Investors should note, however, that further debt can be drawn under the Senior Facilities and other Permitted Finance Debt may be incurred without needing to satisfy the Total Leverage Ratio. Refer to Section 8 and the Terms of Issue in Appendix A.
3. Interest payments under the Healthscope Notes will be suspended on the occurrence of any of the Suspension Conditions set out in the Terms of Issue, including the Interest Suspension Financial Covenant which requires a Debt Service Cover Ratio of greater than 1.10:1 at all times. The Interest Suspension Financial Covenant will be tested at each Ratio Testing Date being the end of the previous calendar quarter before the relevant Interest Payment Date.
4. Interest expense is calculated on drawn facilities at an effective interest rate of 9.52%, plus commitment fees on undrawn facilities at 2.7%.
5. Interest expense is calculated at an effective interest rate of 11.25% on \$215 million of Healthscope Notes.
6. Senior Leverage Ratio is the ratio of the aggregate amount outstanding under the Senior Facilities, the transactional banking facilities and the leasing and additional capital expenditure facilities permitted under the Senior Facility Agreement (excluding any contingent indebtedness and exposure under hedging agreements), less cash and cash equivalents, to the Adjusted EBITDA and is required to be below 5.15x on the first calculation date (being 30 June 2011). Refer further to Section 8.5.
7. Total Leverage Ratio is the ratio of the aggregate amount outstanding under all Finance Debt on a consolidated basis (excluding any contingent indebtedness and exposure under hedging agreements, shareholder debt and intra-group liabilities or indebtedness), less cash and cash equivalent, to Adjusted EBITDA.
8. The Total Interest Cover Ratio is the ratio of Adjusted EBITDA to Net Interest Expense (excluding capitalised or suspended interest) is required to be at or above 1.45x on the first calculation date (being 30 June 2011). Refer further to Section 8.5.
9. Debt Service Cover Ratio is the ratio of the Adjusted EBITDA (less relevant capital expenditure paid in cash, less certain net taxes paid in cash and less any increase (or plus any decrease) in working capital) for the 12 month period ending on the relevant Ratio Testing Date to the aggregate of Net Interest Expense, scheduled repayments under the Senior Debt Facilities and certain payments on finance leases and hire purchase agreements for that same period.

Conclusion

This article only provides a very brief overview of the Healthscope notes issue, which I've covered to give investors some insight into the range of risk/reward securities available to fixed income investors. Although the Healthscope notes are bonds, they are unusual in that in certain circumstances the coupon may not be paid but this will not be considered a default event. However, the coupons are cumulative, which means they must be made up and the company will incur an additional step-up in margin making the funding even more expensive. The notes are available in retail parcels of \$5000, which will be listed on the ASX. I think the 11.25% fixed coupon is sufficient for the risk involved, but as with any investment, contact a fixed income broker or your financial adviser and seek further, more detailed research.



Elizabeth Moran is director of fixed income research at **FIIG Securities**. Note: FIIG is a co-manager of both the CBA retail bond offer and the Healthscope notes.