Mednax Research (10/3/19)

Description: Mednax provides newborn, anesthesia, maternal-fetal, radiology and teleradiology, pediatric cardiology, and other pediatric subspecialty physician services in the United States and Puerto Rico. As of September 12, 2019, it had a network of approximately 4,200 physicians. The company was founded in 1979 and is based in Sunrise, Florida.

Ticker: MD
Price: $22.18
Market Cap: $1.8B
Performance: -32.8% YTD

Analysis

Mednax has an interesting business model. At their core, they supply physician services for hospitals and ambulatory care centers (ASC). MD has roughly 4,214 physicians in association or employment covering:

- Neonatal care services, such as clinical care to babies born prematurely or with complications within specific units at hospitals through neonatal physician subspecialists, neonatal nurse practitioners, and other pediatric clinicians
- Anesthesia and anesthesia subspecialty care services
- Acute and chronic pain management services
- Maternal-fetal care services
- Pediatric cardiology care services comprising inpatient and office-based pediatric cardiology care of the fetus, infant, child, and adolescent patient with congenital

heart defects and acquired heart disease, as well as adults with congenital heart defects through affiliated pediatric cardiologist subspecialists and other related clinical professionals

- Pediatric subspecialty care services through pediatric subspecialists, such as pediatric intensivists, pediatric hospitalists, and pediatric surgeons, as well as pediatric ear, nose, and throat physicians; and support services in the areas of hospitals, primarily in the pediatric emergency rooms, labor and delivery areas, and nursery and pediatric departments.

In a sense, MD is a middleman at providing the personnel for the above practices and they are entirely reliant on locking in employment contracts. There are a few flaws in this business model.

1. Contracts expire and those same physicians and doctors will go to whoever pays them the most
2. Hospitals and other areas of care may look to in-house their personnel instead or go to competition making the service somewhat commoditized

MD has received tons of heat over the years. For example, MD ran advertisements about Atrium Health when they decided they won't be hiring MD for personnel by showing a businessman wielding a scalpel, with the caption, "Who will they cut next?" A radio spot also dramatized a mother trying to retrieve her child from a surgery attended by neophyte doctors. Another had hospital personnel calling, "Where is the anesthesiologist? We need the anesthesiologist now!" followed by the sound of a monitor flatlining.

"This has been unlike anything any of us has seen," Atrium Chief Operating Officer Ken Haynes says of the ads. "This is the lowest road you could go, to use such weird, weird antics." Concerned that frightened patients would cancel surgeries, Atrium ran ads to say they had found excellent doctors to replace those of Mednax.

In addition to this, Elliot Management, a popular activist hedge fund, tried shopping the company around for a sale in the past but simply couldn't find a buyer.

At the same time, notorious shorter Jim Chanos targeted MD and Envision Healthcare as prime targets to short. Envision wound up getting bought out by private equity giant KKR for $9.9B but MD has continued to slide. Over the last year, short interest as a percent of outstanding shares has also grown from 1.8% to 7.9% - most likely Chanos.

Why have shares been in a constant downtrend? Many reasons:

1. Margins have been falling

As you can see in the chart below, MD used to maintain margins greater than 10% for a while and has since gone negative. As of recently, a large portion of this related to the write-offs of one of their business they've divested.

As per the most recent 10Q, in accordance with the accounting guidance for discontinued operations, the expected divestiture of the management services service line was deemed to represent a fundamental strategic shift that will have a major effect on the Company's operations, and accordingly, the operating results of the service line were reported as discontinued operations in the consolidated statements of income for the three and six months ended June 30, 2019. This is a non-cash expense but has resulted in significant damage to the company's EPS.

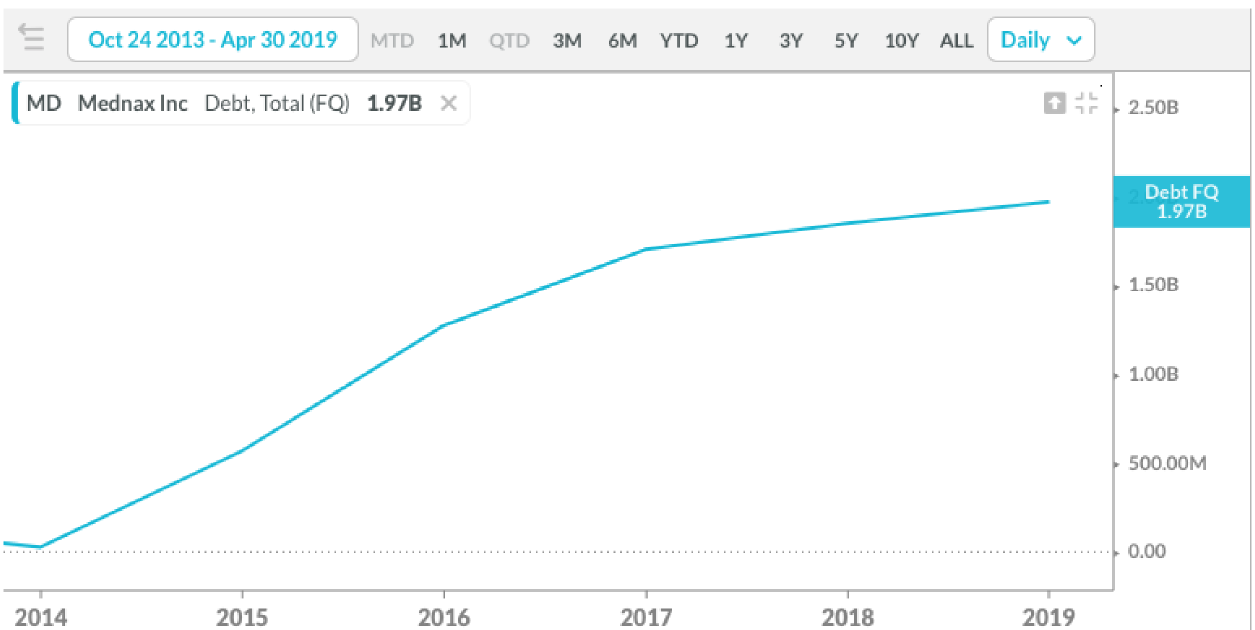
	Three Months Ended June 30, 2019	Three Months Ended June 30, 2018	Six Months Ended June 30, 2019	Six Months Ended June 30, 2018
Net revenue	$868,309	$864,987	$1,719,492	$1,717,615
Operating expenses:				
Practice salaries and benefits	608,962	593,047	1,230,501	1,197,004
Practice supplies and other operating expenses	28,016	28,329	53,807	55,730
General and administrative expenses	103,540	100,938	205,361	202,631
Depreciation and amortization	19,809	20,280	39,842	40,195
Transformational and restructuring related expenses	27,482	—	31,026	—
Total operating expenses	787,809	742,594	1,560,537	1,495,560
Income from operations	80,500	122,393	158,955	222,055
Investment and other income	1,222	1,225	2,869	2,699
Interest expense	(31,080)	(21,618)	(61,803)	(41,553)
Equity in earnings of unconsolidated affiliates	1,990	1,257	3,226	2,782
Total non-operating expenses	(27,868)	(19,136)	(55,708)	(36,072)
Income from continuing operations before income taxes	52,632	103,257	103,247	185,983
Income tax provision	(17,116)	(28,482)	(26,078)	(51,202)
Income from continuing operations	35,516	74,775	77,169	134,781
(Loss) income from discontinued operations, net of tax	(43,761)	4,637	(328,286)	8,059
Net (loss) income	$ (8,245)	$ 79,412	$ (251,117)	$ 142,840
Per common and common equivalent share data:				
Income from continuing operations:				
Basic	$ 0.43	$ 0.80	$ 0.91	$ 1.45
Diluted	$ 0.42	$ 0.80	$ 0.91	$ 1.44
(Loss) income from discontinued operations:				
Basic	$ (0.53)	$ 0.05	$ (3.88)	$ 0.09
Diluted	$ (0.52)	$ 0.05	$ (3.86)	$ 0.09
Net (loss) income:				
Basic	$ (0.10)	$ 0.85	$ (2.97)	$ 1.54
Diluted	$ (0.10)	$ 0.85	$ (2.95)	$ 1.53
Weighted average common shares:				
Basic	83,234	92,987	84,623	92,922
Diluted	83,689	93,529	85,087	93,516

Including discontinued operations has pushed EPS to –($2.97) for the year but if we remove it and just look at income from continued operations it stands at $0.91 which is still down from $1.44 in the 6 months ending in 2018.

2. Debt

Debt has been another pretty big issue for shareholders. If we look back to 2013 when MD started taking on debt it has skyrocketed to $2B as per the most recent quarter. This is an issue because as we saw in the last quarter it amounted to $31M in interest payments.

The problem is also that MD is only sitting on $107M in cash and short-term equivalents. It is worth noting that MD has $750M maturing in 2023 and $1B maturing in 2027 so I don't believe liquidity and solvency is an issue anytime soon.



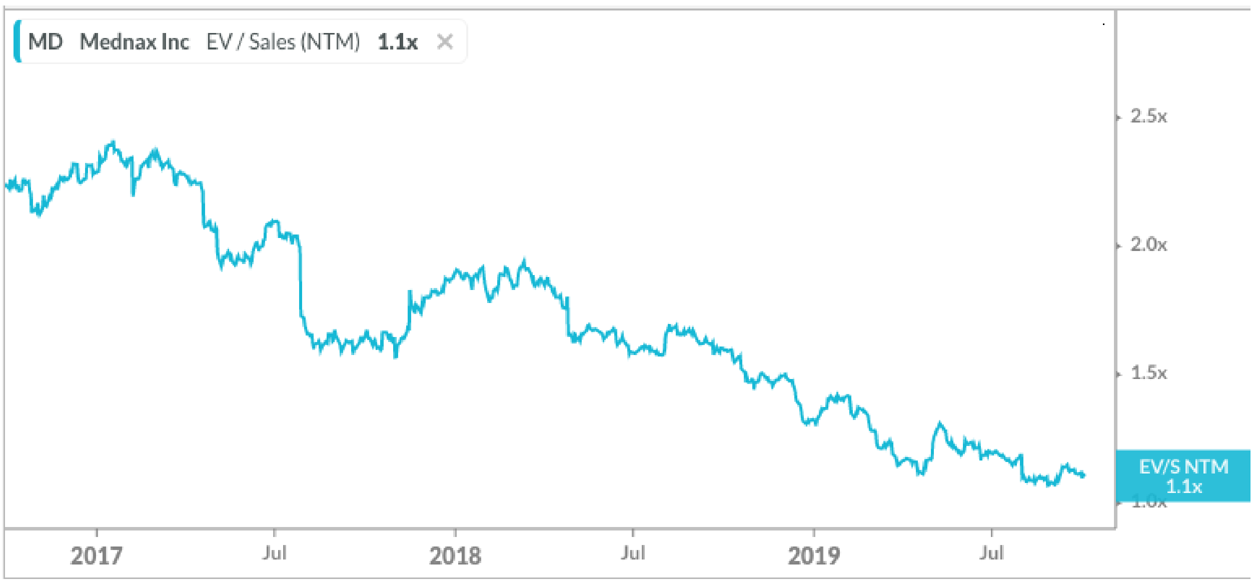
3. Lack of growth in revenues

Over the years, MD has grown their revenues quite well from $2.4B in 2014 to $3.6B in 2018. The issue here is that since 2017 the growth has really stalled off as 2019 is looking like another flat year, if not negative Y/Y. A lot of this could be attributed to not being able to acquire additional companies as the debt balance has already ballooned.

	FY 2018 Dec 31 '18	FY 2017 Dec 31 '17	FY 2016 Dec 31 '16	FY 2015 Dec 31 '15	FY 2014 Dec 31 '14
REVENUE					
Revenues	3,647.1	3,458.3	3,183.2	2,780.0	2,438.9
Other Revenues	-	-	-	-	-
Total Revenues	3,647.1	3,458.3	3,183.2	2,780.0	2,438.9

While we're on the topic of revenues, from a valuation standpoint MD is pretty cheap in this regard. The stock now trades at an extremely low 1.1x forward Enterprise Value to Sales.

Remember that we are using EV instead of market cap to account for MD's net debt. If we went purely with a P/S ratio it would be closer to 0.33x but that wouldn't tell the whole story.



If we look at EBITDA, the same applies. MD trades at an attractive 7.9x EV/EBITDA. For reference, though, KKR bought out Envision for 10x EV/EBITDA so there might be some more interested buyers now that MD is down in this area as opposed to spending most of 2018 over 10x.

What MD needs to do though is ensure EBITDA remains healthy otherwise this ratio could start making its way north.

Something that is also alarming is that MD has been buying back their shares and the stock continues to fall despite doing so.

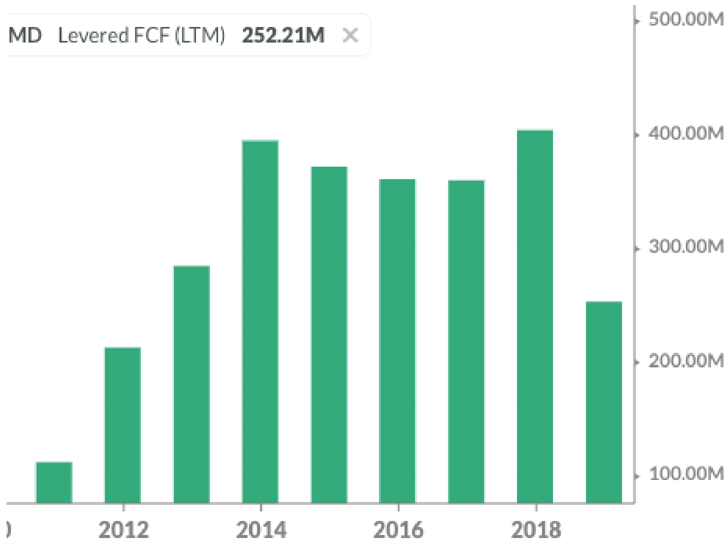
In August 2018, the company announced that its Board of Directors had authorized the repurchase of up to $500.0M of the Company's common stock in addition to its existing share repurchase program, of which $250.0M remained available for repurchase as of December 31, 2018.

Under this program, during the six months ended June 30, 2019, the company repurchased approximately 5.0 million shares of its common stock for $144.5M, inclusive of 63,666 shares withheld to satisfy minimum statutory withholding obligations of $1.7 million in connection with the vesting of restricted stock during the six months ended June 30, 2019.

In other words, MD has bought up nearly $150M worth of stock halfway through the year, approximately 10% of the market cap, and shares are still down over 30% YTD.

How is the company able to buy back shares at this pace? It brings us to the company's brightest spot and that is cash flow.

Despite margins shrinking and revenues flatlining, MD has been able to generate steady cash flow. In 2018, the company brought in $403M in levered free cash flow.



While on the topic, in addition to the share repurchases, management has also begun buying shares.

Transaction Summary

Total insider purchases and sales reported to the SEC

Timeframe	Transactions	Shares
Last 3 months	6 Purchases 2 Sales	500,000 24,675
Last 6 months	7 Purchases 6 Sales	550,690 69,010
Last 12 months	25 Purchases 15 Sales	1,135,570 138,671

Date	Name	Shares	Transaction	Value
09/03/2019	Pascal J. Goldschmidt Director	5,000	Disposition at $20.81 per share.	104,050
09/01/2019	Stephen D. Farber Chief Financial Officer	19,675	Derivative/Non-derivative trans. at $21.08 per share.	414,749
08/12/2019	Michael B. Fernandez Director	61,204	Acquisition at $21.35 per share.	1,306,705
08/12/2019	Michael B. Fernandez Director	61,205	Acquisition at $21.35 per share.	1,306,726
08/09/2019	Michael B. Fernandez Director	124,553	Acquisition at $21.52 per share.	2,680,380

This is a pretty bullish sign from management despite seeing Goldschmidt sell 5000 shares in early September. Overall, management has added 500,000 shares over the last 3 months in comparison to sales of only 24,675 shares.

Overall, there are some things CUBE likes about MD like the free cash flow, the buybacks, management adding shares, and the fairly attractive valuation but I worry that MD can be susceptible to more write-offs if they shut down and divest anymore business segments, getting cut out of the value chain the way Atrium cut them out, the fact that Envision only got bought out for 10x EV/EBITDA when the industry was in a better place, and also don't like the growing short interest.

The company's inability to grow top-line and what I believe was a peak year for the firm with regards to cash flow last year, makes me think the best days of the company are behind them. It may be more wise for the company to transition the buybacks into dividends this way they can attract a different kind of investor and also give them the option to decide what to do with the funds.

On top of this, CUBE is unsure of how the political landscape will look with next year's elections around the corner and how that ultimately may affect the hospitals' decisions to cut costs and navigate around finding their workers. While not directly in the space, CUBE also wonders how the future of robotics can play a role in the overall need for physicians.

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Technical Analysis

Technically speaking, the stock is oversold on W%R but not on RSI or MFI. It is sitting on a super important pivot level of $22.19 and the 50DMA of $22.27. There should be significant support in this area and if it does hold, should see a move back up to 100DMA (not shown) of $23.80 and if it does break that make a move to the next fibbonaci sequence of $24.60.

The stock has been in a really bad downtrend and it has caught a bounce off that S1 level of $20.29. If the stock is unable to hold this level of the pivot and 50DMA it could retest that S1 level.