Pathology Providers Are Down but Not Out
Market underestimates margin recovery.

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Contents

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Executive Summary

Elevated higher-margin coronavirus testing was never going to last forever, but it appears pathology providers have fallen out of Favor with the market, with margins now below prepandemic levels. While the market doubts a return to prepandemic profitability, we see several reasons to expect a stronger recovery than market consensus.

Top industry players are significantly undervalued. Shares in Sonic Healthcare, Healius, and Australian Clinical Labs have fallen roughly 60% on average since the beginning of 2022, but long-term volume growth drivers are intact. In the near term, we expect elevated volume growth as patients return to routine diagnostic testing and general practitioner attendances recover on new bulk-billing incentives.

Increasing volumes are key to margin recovery as pathology has high fixed costs. We expect margin expansion on operating leverage and improved productivity through the digitization of samples and newer artificial intelligence tools expediting diagnoses. With inflation easing, the main cost pressures in labor and rent are stabilizing. Finally, we see average fee increases through increased pricing and favorable mix benefiting margins. The three main pathology providers, with over 80% combined market share, are well-positioned to benefit from industry trends.

Key Takeaways

- Within the healthcare sector, pathology stocks screen attractively. The subsector trades at an average price/fair value estimate of 0.65 versus the healthcare sector average of 1.11.
- We expect all three major providers to exceed prepandemic group EBIT margins by at least 2 percentage points by fiscal 2028 through increased pricing, stabilizing costs, and scale benefits. We forecast a five-year revenue compound annual growth rate of 5% for the pathology industry, with roughly two-thirds coming from expected volume growth and the rest from pricing. Demand is driven by population growth, aging demographics, higher disease incidence, wider adoption, and more testing.

Companies Mentioned

Name/Ticker	Economic Moat	Currency	Fair Value Estimate	Current Price	Price/ FVE	Uncertainty Rating	Morningstar Rating	Market Cap (Bil)
Healius Ltd/HLS	None	AUD	3.00	1.28	0.43	Medium	★★★★★	0.9
Sonic Healthcare Ltd/SHL	Narrow	AUD	32.00	26.56	0.83	Medium	★★★★	12.8
Australian Clinical Labs Ltd/ACL	None	AUD	3.50	2.47	0.71	Medium	★★★★	0.5

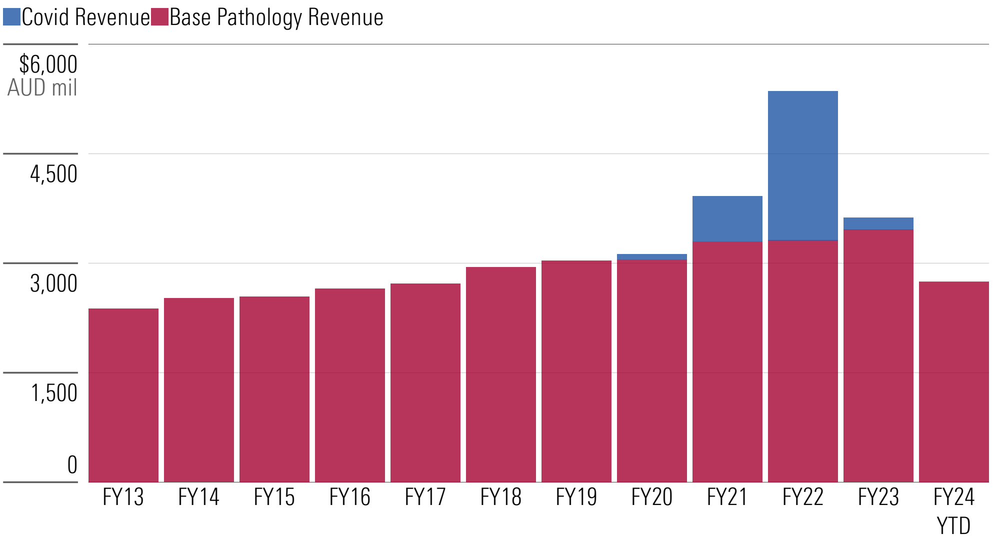
Market Selloff on Industry Margin Contraction

Versus market consensus, we are more optimistic about the pathology industry's margin recovery, which is the main earnings driver for all three companies. While margins are currently under pressure, we forecast margin expansion from fiscal 2025 through increased pricing, stabilizing costs, and scale benefits. Our fiscal 2028 operating margin forecasts for Sonic, Healius, and Australian Clinical Labs are 14%, 12%, and 11%, respectively, versus operating margins of 12%, 8%, and 4% in fiscal 2020, prior to material coronavirus earnings.

The market appears skeptical about any meaningful profitability improvement, with the past year particularly challenging. Margins have deteriorated with elevated cost inflation, operating deleverage as higher-margin coronavirus testing stops, limited pricing power to offset rising costs for Medicare items, and a slow recovery in general practitioner referrals.

However, we think the market is short-sighted, and investors have an opportunity. Shares in narrow-moat Sonic Healthcare, no-moat Healius, and no-moat Australian Clinical Labs all trade at meaningful discounts to our fair value estimates of AUD 32.00, AUD 3.00, and AUD 3.50, respectively.

Exhibit 1 Pathology Industry Subdued as Higher-Margin Covid-19 Testing Ceases



Source: Medicare. Data as of March 31, 2024.

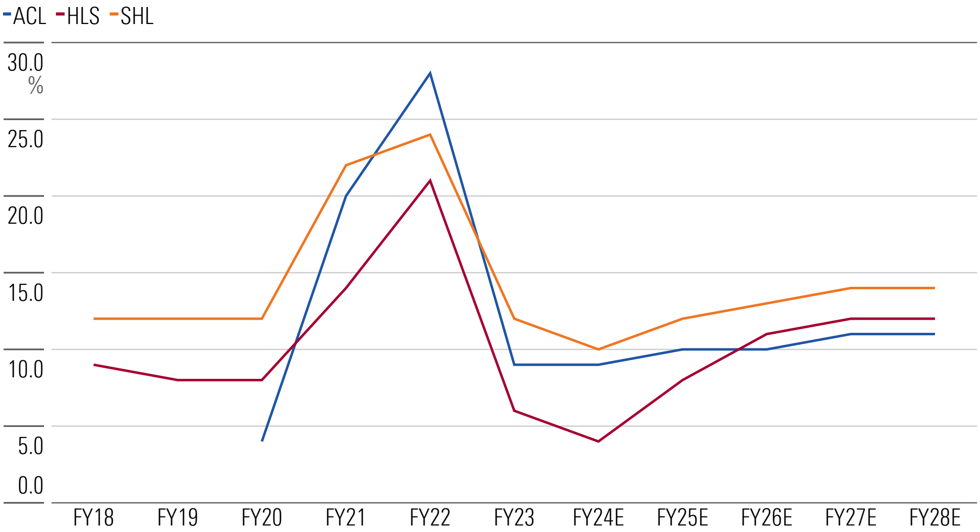
Operating Margins Set to Expand

We see industry margins recovering through increased pricing, stabilizing costs, and scale benefits. Most revenue in pathology is bulk-billed and earned via direct reimbursement from the public health Medicare system at fixed fee-per-service rates. At almost 90%, pathology has the highest rate of bulk-billing in any health sector, and as such, pricing power to offset inflationary pressures is constrained.

Nonetheless, pathology providers are increasing fees for services not bulk-billed, which we estimate at over 10% of revenue. Also, an industry mix-shift to higher-priced testing, such as more complex gene-based and veterinary testing, is driving average fee increases. This trend is largely from a growing specialist referral base and the improved mix supports margin expansion.

In addition, the industry is lobbying for indexation to resume for all pathology items funded by Medicare, which we ascribe a 50% likelihood in our valuations. If indexation is applied at the inflation rate over our 10-year forecast period, on average, we estimate roughly 1% upside to operating margins and 10% upside to our fair value estimates. If fees stay frozen, we estimate a commensurate downside to both metrics. The sector is grappling with an immense cost burden. Despite rapid cost inflation for pathology testing, Medicare rebate indexation has been frozen for 24 years. Between July 2008 and November 2014, the level of Medicare funding for pathology services was also cut four times by 12.5% in total. The industry has historically relied on volume growth, efficiency gains, and low-cost inflation to remain profitable, but this is currently challenging, particularly at a collection center level, given depressed GP referrals, fewer remaining options for productivity improvements, and recent high-cost inflation.

Exhibit 2 Sharp Contraction in Group EBIT Margins but Poised for Recovery



Source: Company filings, Morningstar.

As such, the industry is lobbying for fee indexation similar to imaging, which was 4.1% in first-half fiscal 2024. Indexation for diagnostic imaging was similarly frozen from 1998 before resuming in July 2020. This sets a strong precedent and we could see a positive outcome in the May 2024 federal budget. However, this is not guaranteed or may apply only to certain items rather than the whole Medicare Benefits Schedule.

Increased government funding is essential as pathology is a critical preventative tool. It is used to proactively manage patient health and reduce national healthcare costs downstream. It helps detect disease early and inform appropriate treatment options, benefitting both patients and taxpayers. Diagnostic information provided by pathology tests informs roughly 70% of all medical treatment decisions. Anatomical pathology is the study of organs and tissues to determine the cause and effect of disease and is necessary for 100% of all cancer diagnoses. Around one million Australians access pathology services every week through blood tests, tissue biopsies, swabs, and a range of other tests. Despite a perception of wasted costs in unnecessary testing, increased spending for proactive screening and monitoring through pathology testing is warranted as it lowers health system costs overall and, more importantly, enhances patient outcomes. Many conditions could be mitigated if treated earlier, lowering hospitalization, morbidity, and mortality rates.

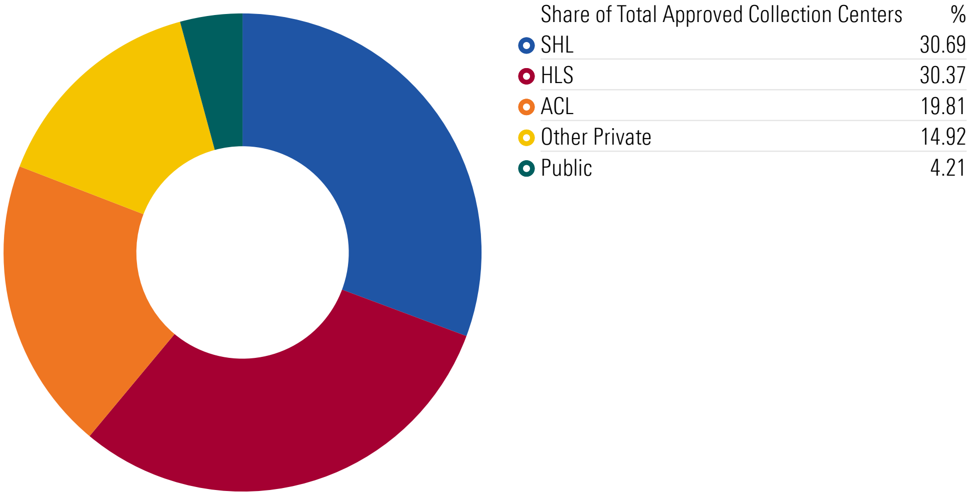
Cost pressure on Australia's pathology sector threatens the viability of collection centers, particularly in regional and remote areas. Roughly a third of pathology collection centers are in regional, remote, and Indigenous communities. As of April 2024, many are unprofitable and at risk of closure without additional government funding, per the Pragmatic Policy Group. Pathology has high fixed costs, which are hard to reduce when profitability falls.

Remote, rural, regional, and Indigenous communities are the highest-cost areas for pathology services, given high labor costs, expensive long-term sample storage, complex logistics, and high sample transport costs to pathology laboratories for diagnostics. These collection centers bring in less revenue, given the lower population density of service areas. It is in the government's best interests to retain critical services to patients in these areas. Between June 30, 2023, and April 22, 2024, Sonic, Healius, and Australian Clinical Labs closed 69, 32, and 27 centers, respectively, rationalizing collection center footprints by more than 2% on average. We think this indicates a willingness of providers to close less profitable centers.

Pathology service provider profitability is also suffering from increasing rates of coned work. Coning is a government payment rule to only reimburse pathology providers for the three most expensive tests requested by a GP for each patient visit. By restricting the number of pathology tests claimed by pathology providers, they effectively provide additional tests for free. This Medicare reimbursement system was introduced in 1992 and the number of tests offered for free continues to increase. Tests ordered by GPs during an average patient visit have risen from less than three tests in 1999 to around eight tests per person today. We see the essential nature of pathology in prevention and reducing healthcare costs overall, risk of site closures, and increased rates of coning as valid reasons for pathology indexation to resume and, hence, pricing and margins to increase. In addition, despite the significant efficiency gains realized over the last few decades, we estimate the industry is currently earning returns on invested capital below the weighted average cost of capital. We estimate Sonic, Healius, and Australian Clinical Labs to earn an ROIC including goodwill of 6.6%, 1.3%, and 8.1%, respectively, on average over the three years to fiscal 2025, all below their respective WACCs of 7.2%, 8.0%, and 8.6%.

Second, we expect stabilizing direct costs to enable margin expansion. Sonic, Healius, and Australian Clinical Labs all recorded significantly weaker first-half fiscal 2024 margins than prepandemic levels. This is largely from inflationary pressures, with pathology providers susceptible to inflation as staffing and rental expenses make up most costs. However, the rate of inflation declined to 3.6% in the March 2024 quarter from 7.8% in the December 2022 quarter. In addition, all three companies are still resizing labor and infrastructure costs with coronavirus testing ceasing. We estimate all three are bearing additional costs for site closures and severance payments. But margins stand to benefit as networks are optimized and as less profitable centers close.

Exhibit 3 Major Three Largest Providers Dominate Industry Given Consolidation



Source: Medicare, Morningstar. Data as of April 22, 2024.

Finally, we see scale benefits from improved operating leverage and digital initiatives supporting margin expansion. Pathology has a high fixed cost of operation, and margins are thus sensitive to volume growth which drive lower cost-per-test outcomes. By maximizing throughput across a network of laboratories and collection centers, scale efficiencies are realized. As underlying testing volumes increase, we anticipate operating leverage to boost margins in the long term.

With volumes the main earnings driver, productivity improvements are key to throughput and operational performance. Pathology is a technologically driven service, and all players are balancing the competing aims of managing costs and investing in digitisation. We expect digital initiatives to drive further productivity, efficiency improvements, and cost reductions by optimizing staff, increasing automation, and reducing administrative paperwork and manual, repetitive processes. All three major pathology providers are investing in their laboratory information management system, ensuring integration with electronic referrals and My Health Record, and supporting consumer-driven care through new patient booking systems. Given limited pricing power, providers have largely used productivity improvements to offset cost inflation and drive profitability, and we do not anticipate the government to prise this away given the essential role they play in reducing healthcare costs overall.

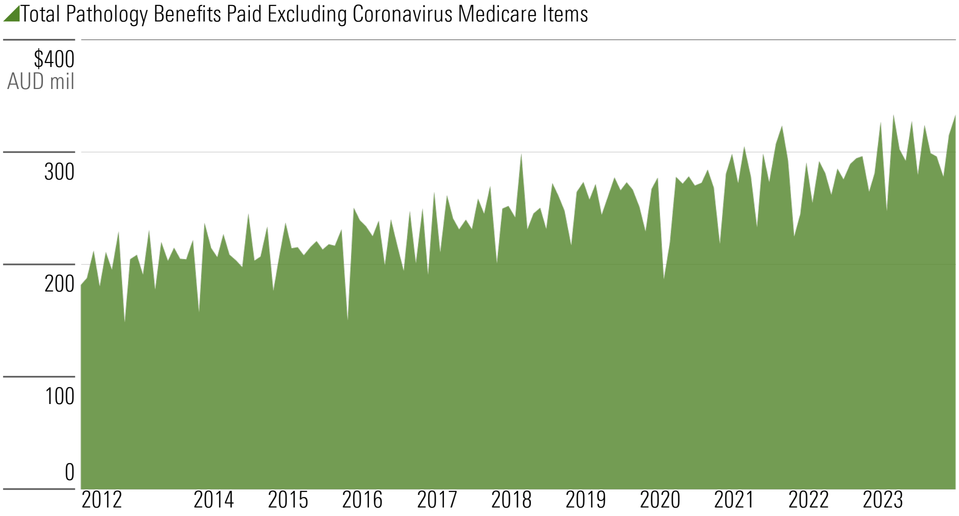
Sonic, in particular, is making acquisitions in digital pathology and artificial intelligence. It acquired Pathology Watch in November 2023 to support the transition to digital pathology, beginning with skin pathology. Digital pathology, namely, allows pathologists to view digital slides or scans of samples on a virtual microscope rather than being tied to a physical microscope. Sonic's joint venture with Harrison.ai, Franklin.ai, has also created an AI product to help predict and diagnose prostate cancer. The tool is designed to assist specialist anatomical pathologists by enhancing workflows such as examination and report writing, ultimately saving labor and improving turnaround times. The product is being deployed across Sonic's sites, and we expect meaningful upside from efficiency gains through faster diagnoses. Algorithms for analyzing slides are objective and have the potential to be significantly faster and more accurate than traditional microscopy. Digital slides and electronic medical records and reports also enable remote and fast access for pathologists, further increasing productivity. Costs of making copies of samples and transporting them to multiple pathologists can also be reduced, given digital remote access.

Underlying Volume Growth Supports Revenue Growth

Underlying Australian pathology volume growth drivers are solid and underpin our long-term revenue growth forecasts. Growing demand for diagnostic testing is largely defensive and underpinned by population growth, aging demographics, higher incidence of diseases, wider adoption, and a higher number of tests available. We forecast a five-year Australian pathology industry revenue CAGR of roughly 5% to fiscal 2028. This is made up of roughly 3.5% volume growth due to population factors and volume growth per capita and 1.5% average fee increases, partly due to a mix shift to more complex tests such as veterinary and gene testing, but mostly assuming a 50% likelihood of indexation resuming at an average rate of 3% over our explicit 10-year forecast period. Industry volume and price CAGRs were 3.7% and 0.8%, respectively, in the seven years to fiscal 2019, resulting in an Australian pathology industry revenue CAGR of roughly 4.5% for this period. The Australian population is aging with increasing life expectancies and declining fertility rates. Those aged 65 and over have grown at a 3.3% CAGR for the past 10 years versus 1.0% for people aged under 65. Meanwhile, in the past 30 years, life expectancy has grown by at least five years, and the age-standardized incidence rate for cancer has steadily grown to 0.5% from 0.4%.

However, since the pandemic, there has been known underdiagnosis for routine healthcare services. While Australian pathology industry revenue grew by a CAGR of roughly 4.5% in the seven years to fiscal 2019, revenue growth excluding coronavirus Medicare items slowed to a 3.4% CAGR in the four years to fiscal 2023. We anticipate the delay in new diagnoses and patient backlog to drive elevated near-term sales growth for pathology providers due to a catchup period to return to the previous underlying trend. We think this is evidenced by the Australian pathology industry revenue growing 6% in the March 2024 quarter on the previous corresponding period. However, we think this healthy revenue growth largely reflects abnormal pent-up demand, and still think there is a decent case for indexation. Within the network, some collection centers are underutilized but essential for the communities they serve. Pathology providers have shown they both can and will close these centers, which weighs on profitability. We think the government can no longer rely on the cross-subsidization of remote and regional centers by the more profitable urban and suburban centers. Given community sensitivities, the government is likely to want to address center closures, and the obvious path, in our view, is to relax the constraint to pathology payments.

Exhibit 4 Industry Revenue Growth Below-Trend Since the Pandemic but Recovering



Source: Medicare. Data as of March 31, 2024.

Another driver supporting elevated near-term sales growth are GP attendances improving since late 2023. Fiscal 2023 saw a sharp 13% decrease in GP attendances per capita, which had a proportionate impact on referrals to pathology services. This was largely due to more GP visits requiring out-of-pocket payments from patients. With only about half of standard GP consultations now bulk-billed direct to Medicare, patients are likely to visit the GP less often because of higher costs. In addition, a greater share of GP attendances is now in the form of GP telehealth consultations, which produce a lower rate of pathology test ordering. Only about 10% of telehealth consultations result in pathology testing, compared with 20% for face-to-face consultations.

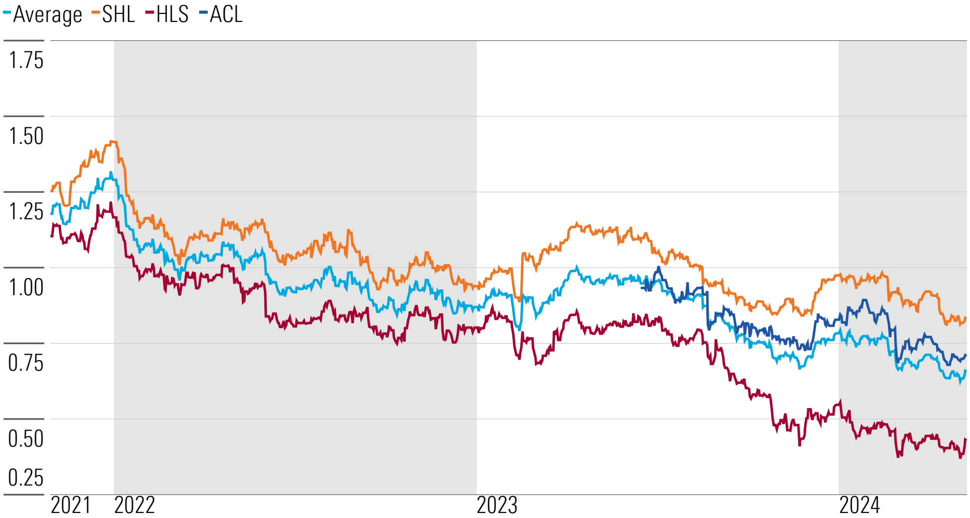
Healius and Australian Clinical Labs have a higher exposure to GP-referred volumes versus Sonic, which has recorded lower growth relative to specialist-referred volumes. However, the Australian government has been rolling out new bulk-billing incentives for GPs since November 2023, supportive of a recovery in attendances. Medicare is covering more GP appointments, particularly for children, pensioners, and people in rural areas. Making doctor appointments more affordable is likely to improve volumes for diagnostic testing.

Major Providers in Strong Position

We think the three major publicly listed providers will continue to dominate the Australian pathology market. Together, they have a combined market share of over 80% in both Australian Approved Collection Centres and revenue. As of April 2024, Sonic, Healius, and Australian Clinical held 31%, 30%, and 20%, respectively, of Australian ACCs. In fiscal 2023, Sonic earned Australian pathology revenue of AUD 1.9 billion versus AUD 1.2 billion for Healius and AUD 0.7 for Australian Clinical. This makes Sonic's Australian pathology business over 50% larger than Healius' and almost three times the size of Australian Clinical, translating to superior profitability given greater scale. Sonic's pathology EBIT margins have been higher than its closest two competitors by an average of 5 percentage points over the last four years, and we expect Sonic to continue to lead the industry in profitability and maintain its scale advantage. Sonic has posted an average ROIC of 10% over the last 10 years. We estimate the firm to earn an average ROIC of 9% over our 10-year explicit forecast period, exceeding its WACC of 7%.

Exhibit 5 Sonic Trades at a Relative Premium Given Its Moat but All Listed Providers Are Undervalued

Price/Fair Value Estimate



Source: PitchBook, Morningstar. Data as of May 8, 2024.

Our narrow moat rating for Sonic is based on superior cost advantages derived from economies of scale in its main pathology segment. Scale matters in pathology as they operate a hub and spoke model whereby collection centers, mostly either in hospitals or near doctors' rooms, feed samples through to large, centralized labs for processing. Sonic's higher testing volumes result in a lower cost per test as labor, equipment, rent, and overhead costs are all leveraged. In addition, Sonic's footprint of ACCs is comparable with Healius. This highlights that Sonic's network is not only superior in terms of efficiency but also difficult to replicate, with centers being larger on average and in more populous locations. Sonic's ability to accommodate higher throughput with fewer spokes also achieves efficiency in transportation costs. Finally, we think Sonic's scale benefit over smaller competitors lends greater buying power as procurement of consumables can be centralized at national or even global levels. However, given poor profitability of remote and regional collection centers, the importance of servicing those communities, and Sonic's openness to closing centers not making sufficient money, we think there is a decent case to be made for better testing payment terms from the government. We do not believe this is priced into the shares of the pathology providers.

While Sonic is the only pathology provider with a narrow moat, all three major providers benefit from a relative cost advantage compared with other incumbents and smaller providers. While cost inflation burdens Sonic, Healius, and Australian Clinical, it has a greater effect on smaller competitors with skinnier margins. This relative cost advantage often leads to market share gains and losses with smaller players more likely to consolidate. Since June 2021, the combined ACC footprint of Sonic, Healius, and Australian Clinical has grown 4% to 5,299 ACCs versus the remaining aggregate ACC footprint declining 3% to 1,254 ACCs.

We see limited competitive pressure long-term on the three main providers. While the investment to add or acquire collection centers is fairly incremental and service offerings are largely undifferentiated, significant structural challenges remain for existing smaller competitors or new entrants. First, the location of collection centers is key as patients tend to submit test samples at a convenient pathology lab, and doctors are unable to specify the lab unless there is a medical reason for it. This poses a significant barrier for competitors to gain throughput efficiently in more populous states as more mature competitors are better positioned. In addition, the amount of infrastructure and throughput required on a macro-level to generate sufficient economic profits remains a significant deterrent for other rational players that are considering investing in the industry.

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