Overview

Viemed Healthcare (Toronto: VMD) is a US home healthcare company focused on the respiratory market. The vast majority of their revenue derives from providing NIV (Non-Invasive Ventilation) to COPD (Chronic Obstructive Pulmonary Disease) patients suffering from chronic respiratory failure. NIV is a rapidly-growing niche in a fast-growing patient demographic, as the baby boomer generation turns 65+, and Viemed's revenues and profits are growing quickly.

Although they are headquartered in Lafayette, Louisiana and all their revenue is derived solely from the U.S., Viemed nevertheless trades on the Toronto Stock Exchange, as it was spun out from a Canadian company in December 2017. So although its revenue and income are denominated in U.S. dollars, the stock trades in Canadian dollars. (As of July 9th, the exchange rate is approximately $0.76 USD per CAD.)

Viemed has been growing at a rapid clip, having grown their revenues at an annual rate of 46% over the past 4 years, and Viemed is set to continue to grow at a rapid pace. Nevertheless, the stock trades at a P/E of just 16.3, based on the July 9th close of $4.54 CAD.

We believe that Viemed is a rare example of a high-growth company available at a deep-value valuation, and we see it as an ideal investment for the Fund, with a highly favorable risk/reward profile. Indeed, we have not seen such a superbly attractive opportunity for some years, and we look forward to Viemed contributing positively to the Fund's future performance.

Industry Background

The DME (Durable Medical Equipment) or HME (Home Medical Equipment) industry in the U.S. is a $50 billion industry that provides medical equipment for home therapy, including wheelchairs, hospital beds, commodes, CPAPs, oxygen equipment, and assorted equipment and supplies. The industry is very fragmented, with thousands of mom-and-pop shops across the U.S., a few regional providers, and two major national chains, Lincare and Apria Healthcare. Over the past ten years, with Medicare introducing capped oxygen rentals, the roll-out of competitive bidding, and audits ramping up sharply, the DME industry has been under tremendous pressure, with many providers being forced out of business.

Against this backdrop, Viemed occupies a specialized, fast-growing niche, providing ventilators (mostly non-invasive ventilators, i.e., ventilators using a mask to provide air, instead of inserting a tube directly into the windpipe via an endotracheal or tracheostomy tube) to patients suffering from chronic respiratory failure due to COPD or neuromuscular diseases. COPD (Chronic Obstructive Pulmonary Disease) is a catch-all term including various progressive diseases, including chronic bronchitis and emphysema. COPD has no cure and must instead be managed. As these diseases progress, lung function decreases dramatically until the patient needs help breathing via a ventilator, typically near the end of their life.

There are approximately 16 million patients diagnosed with COPD in the U.S. Of those, about 2.5 million are at Stage 4 COPD (lung function <30% of normal, as measured by FEV1), of which half, or 1.25 million, are eligible for Viemed's NIV therapy. At present, only about 5% of this target market uses home NIV therapy. This is primarily due to its relatively recent introduction to the market in 2012. As hospitals and pulmonologists grow more comfortable with home NIV, the use of NIV within the target market continues to grow.

In addition to the growing use of NIV within the target market, the target market itself is expanding. With the baby boomer generation reaching retirement, there are 10,000 people turning 65 every day for the next 15 years. Due to this, the Medicare population is projected to grow from 59 million now to about 80 million by the year 2030. With this aging population, the prevalence of COPD is increasing yearly, and is projected to continue to increase for years to come.

Indeed, the rising prevalence of COPD and other chronic diseases is a significant factor contributing to the steady rise in overall healthcare expenses. COPD is also a rising cause of death in the U.S and is presently the third most common cause of death (after heart disease and cancer). The increased incidence and mortality of COPD is focusing a spotlight on cost-effective treatments. Treating the disease in the home avoids acute flare-ups and expensive hospital stays and improves mortality rates as well. In fact, Viemed has commissioned a third-party study by KPMG, whose results show that Viemed's NIV therapy saves the healthcare system a net of $25,000 annually per patient.

Competitive Advantage

As mentioned, the DME industry is fragmented, with many small and regional players and two major national players, Lincare and Apria Healthcare. Viemed is the 3rd largest provider of NIV therapy in the U.S., after the two national players, and the three companies combined provide for more than half the market. As smaller DME providers continue to struggle in recent years, Viemed benefits from decreased competition.

Viemed runs a unique business model, differentiated from run-of-the-mill DME providers. Most DME providers, especially the national chains, strive to be one-stop shops for all their referrer's DME needs. That includes wheelchairs, hospital beds, walkers, commodes, CPAPs, oxygen equipment, etc., as well as ventilators. The mentality and business model of these one-stop shops is delivery and drop-off of supplies, and they utilize technicians (read: little more than glorified deliverymen) to deliver the different items prescribed, including ventilators.

Viemed, on the other hand, focuses exclusively on ventilators, striving to run a high-touch, superior service. Each patient is serviced by a qualified, experienced Respiratory Therapist, all of whom are certified COPD Educators. The RT begins the intake process in the hospital, coordinates with case managers and discharge staff, sets up the patient at home, visits them as much as necessary to assure comfort and compliance, and is on call 24x7 with a direct phone line (with backup RTs, if necessary). Although this high-touch service costs Viemed more (the company estimates it costs them an extra $100 per month), which they are not reimbursed for presently, the difference is in the results. Mortality rate improves drastically, and 30-day readmissions for Viemed's NIV patients average 5.7% vs. an industry-wide average of 20%. (Under Medicare rules, hospitals are dinged for 30-day readmissions, so hospitals pay close attention to this number.) The savings to the hospitals and the payers are significant. Indeed, when Viemed looks to enter new territories, they search for areas with the *worst* patients and *highest* readmission rates, where they can bring significant benefits to the hospitals.

In addition to their business model offering hospitals and pulmonologists better results than standard DME providers, Viemed benefits financially as well. With patients living an average of 17 months under the Viemed system vs. 12 months or less under a delivery model, Viemed is reimbursed for longer, more than making up for the increased monthly costs. (Medicare classifies ventilators as Frequent and

Substantial Servicing, which is reimbursed monthly with one bundled rate as long as the patient is serviced, with no cap on length of rental and not subject to competitive bidding.)

Viemed's focused business model enjoys enviable economics as well. They do not dilute their business with low-margin or money-losing lines of business like many DME providers must in their quest to be a one-stop shop. Instead, Viemed concentrates on the high-margin, growing sector of ventilators. A ventilator costs them ~$6,500 (after volume rebates) and has a useful life of about 10 years (according to the manufacturers), during which time they are paid ~$950 a month for patient rentals. This has to cover the cost of the ventilator, maintenance, supplies, the cost of the RT, and overhead. Typically, it takes on average about 18 months for them to break even on each ventilator they purchase, including all expenses. And with its narrow focus, Viemed does not have to carry a large range of inventory. Rather, they typically have about a 10% buffer of extra ventilators, three per RT (to allow immediate deployment to new patients) plus ventilators undergoing maintenance.

Viemed's relatively asset-light model also shows in their organization of territories. They do not rent warehouses or storefronts (except in states that require them); instead they organize their territories around the RT. A new RT is typically hired from a hospital, so as to hire highly experienced personnel. The RT is often a mini-entrepreneur, responsible to bring in referrals to grow the business (partly on commission). After a training period to learn Viemed's protocols and process, the RT is outfitted with a car and an initial batch of ventilators. The focus of the business is meeting doctors and servicing patients and is organized around the RT, not a physical location.

Historical and Projected Growth

Viemed was founded in 2006 in Lafayette, LA as a DME business focused on the respiratory market, offering oxygen equipment and CPAPs (used to treat sleep apnea) and later expanding into home sleep testing (home kits to self-test for sleep apnea). This remains a small part of their business, offering oxygen and CPAPs in Louisiana and home sleep testing nationwide via mail. With the introduction in 2012 of NIV designed for the home, Viemed pivoted to concentrate on ventilators, bringing their revenue from $4.6 million in 2012 to $10.2 million in 2013 and $23.3 million in 2014.

Viemed continued to grow rapidly in 2015, growing revenue 61% to $37.6 million. In mid-2015, Viemed was sold to PHM, a Canadian company which rolled up many home healthcare companies, with Viemed's management being tasked to lead the combined company. Not long after, Medicare combined various reimbursement codes for ventilators, cutting reimbursement for NIV by 35%, beginning January 1, 2016. Between the 35% Medicare cut and integration issues, Viemed's growth reversed, with revenue for 2016 dropping to $31.4 million, a drop of 16.5%. Notably, even during this tough period, Viemed continued to grow their active patients significantly, just slower than before. This helped mitigate somewhat the harsh 35% cut in reimbursement. Indeed, Viemed recovered to their pre-cut run rate in about one year.

About a year after being acquired, Viemed and PHM decided that the two businesses were not a good fit, with different business models and growth strategies, and the decision was made to spin out Viemed as a separate entity with the original founders continuing on with Viemed as before. The deal was fully consummated December 21, 2017, but even before the final split, the two divisions began to operate entirely separately. This freed Viemed management to focus on Viemed and its unique business model and results were quite positive. For 2017, Viemed resumed its rapid growth, growing revenue by 49% to $46.9

million, significantly higher than pre-cut. In the last quarter of 2017 alone, active vent patients rose by 8.4% over the previous quarter, to 4,385.

In sum, over the past 4 years, Viemed has grown its revenue at a compounded annual growth rate of 46%. At the same time, they have been profitable throughout, even in the throes of the 35% Medicare cut, and over the same 4 years, they have grown the bottom line at a compounded annual rate of 31% to $8.2 million for 2017. We estimate that their present annual run rate is approximately $10.0 million for net income, and it is sure to grow as they continue to add active patients every quarter.

In Viemed's case, we believe that past is prologue, and we expect Viemed to grow for many years to come. We expect Viemed's growth to come from seven favorable trends. First, as pulmonologists and hospitals grow more comfortable with home NIV therapy and studies continue to show better outcomes and cost savings, usage will continue to rise within their target market. With only ~5% of eligible COPD patients on home NIV, there is plenty of room for expansion.

Second, continued demographic growth of the target market from an aging population.

Third, Viemed's continued geographic expansion. They have been steadily expanding the territories they service, up to 24 states at present. Continued geographic expansion, both within the states they already operate in and in new states, offers low-hanging fruit for expansion.

Fourth, as they become in-network for more and more insurers, they expand the patient population they can service. In the last quarter of 2017 alone, they added 3 new insurers in the states of Arkansas, Arizona, and New Mexico, for which they had to reject over 250 cases over the course of 2017 for being out-of-network. The savings and improved clinical results which they bring help them greatly in negotiations with payers. And in the first few months of 2018, they have already signed 11 new payer contracts. Viemed is also actively in discussions with major insurers to begin a shared savings pilot program, where they service a few hundred of their patients and share in the savings they demonstrate over the next 6 to 12 months.

Fifth, they are strongly considering expanding into the pediatric ventilator market (for diseases such as cystic fibrosis, interstitial lung diseases, and others). With far fewer providers for the pediatric market and a highly emotional patient population, it is far easier to become in-network for them. Children also have a much longer use span than the typical ventilator population.

Sixth, they have begun an initiative of providing their top salespeople with clinical liaisons to deal with ongoing, routine contact with doctors and hospitals, freeing their salespeople to develop new referral sources. A pilot program for their top five salespeople which they ran in the end of 2017 showed a 75% increase in performance in those salespeople provided with clinical liaisons.

Seventh, economies of scale and operating leverage drive their bottom line to increase at a faster rate than their top line revenues, with revenues growing at a faster rate than expenses.

Risks

Viemed's main risks stem mostly from their being heavily reliant on Medicare, which represents approximately 68% of their revenue. The biggest risk is if Medicare would change NIV's classification from Frequent and Substantial Servicing to Capped Rental, capping reimbursement at a limited number of months and subjecting NIV to competitive bidding. We consider this to be unlikely, based on Medicare's own rules and years of precedent, but Medicare can at times be capricious and arbitrary, so it is impossible to rule out. Such a change would definitely harm the business greatly, as years of competitive bidding for the greater DME industry have demonstrated. Viemed would suffer and would probably have to change their business model if ventilator rentals were capped at 13 months and no reimbursement was offered for respiratory therapists.

Even under the present Medicare regime, Medicare has limited but real ability to adjust the reimbursement rates, arbitrarily at times. We do not think this is a near-term risk, especially in light of the relatively recent sharp cut of 35% in 2016. Viemed and the industry at large are hard at work reaching out to Medicare and Congress, demonstrating that although the DME expense for ventilators is definitely rising, this is more than offset by the savings on the hospital side. And as Viemed's performance in 2016 and 2017 have demonstrated, they are able to grow and thrive even in the face of significant cuts to reimbursement.

Finally, a major headache from dealing with Medicare stems from the proliferation of multiple levels of audits, both pre-pay and post-pay. These audits are conducted by private contractors who are paid contingency fees for successfully denying claims, so they are highly incentivized to deny claims. This flawed structure, together with vague or non-existent rules surrounding ventilators, medical necessity, necessary medical documentation, etc., leads to audits being a fact of life for DME businesses, particularly when dealing with ventilator reimbursements. There are many different types of audits and multiple regions, so that Viemed is undergoing one sort of audit or other at all times.

Viemed, recognizing the risk and damage that audits inflict, is conservative and careful with required paperwork and medical documentation, at times rejecting as many as 40% of applications for missing documentation that Medicare may require in the future. Viemed has demonstrated an excellent track record of handling audits, and historically, they have not lost any significant revenue due to audits, having won substantially all audits at either the audit level or at least the redetermination level (the first of many levels of appeals). This past October, an ongoing audit froze all payments for a number of months, causing accounts receivables to rise significantly. Viemed was again vindicated, when in January, the freeze was lifted, and beginning in April past due payments started to be made as the audit was wound down. Audits will always be a fact of life, but for a well-run company, they are not a major risk.

Conclusion

Viemed is a fast-growing company, with multiple tailwinds propelling years, if not decades, of future growth. Viemed is highly profitable (with gross margin of 75%, net margin of 17%, and ROE of 34%) and has no debt. As with any company, there are some risks, but they appear to be unlikely and surmountable.

With its highly favorable risk/reward profile, Viemed has a surprisingly low P/E of 16.3, even after a recent run-up in price. No doubt their relatively small size ($131 million USD market cap), their trading on a second-tier foreign exchange, and their tortured route to public markets all contribute to investors overlooking this gem. All the more opportunity for investors willing to do the necessary research.

The Fund initiated a position in VMD on March 14, 2018 at $3.25 CAD (at which point it was trading at a P/E of just 11.7!) and continued to purchase over the following weeks at an overall average price of $3.52 CAD. With the stock presently trading at $4.54 CAD, the Fund has already enjoyed a 27% rise in its position.

We conclude with what we began. We at Focus Capital Management have not seen such a superbly attractive opportunity for some years, and we look forward to Viemed contributing positively to the Fund's future performance.