November 30, 2018

Surgery Partners: (SGRY)

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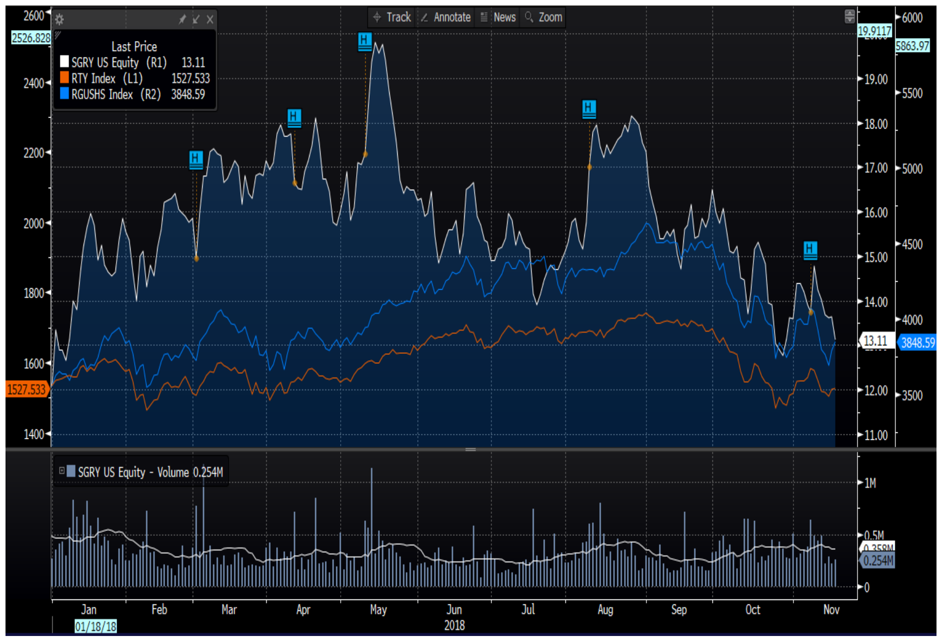
Sector: Health Care
Industry: Health Care Facilities
Current Price: $14.03
Target Price: $20.21

Company Description: Surgery Partners operates more than 180 surgical and ancillary services facilities. They see over 600,000 annual patients for services specializing in spinal, total joint and cardiac surgery.

BUY

Current Price:	$14.03
Target Price:	$20.21
Market Cap:	641M
ROIC	1.43%
ROIC (w/out Goodwill)	10.8%
Debt/EBITDA	9.58
LTD/Capital	55.24
Current Ratio	1.86
Same-Facility Growth	11.4%



Thesis: Surgery Partners (SGRY) operates Surgical and Ancillary services facilities across the United States. Over the past years, SGRY has focused on acquisitions to increase revenue. Looking forward, SGRY is looking at taking steps to improve efficacy and to realize the economies of scales afforded to them by their large network of facilities.

Catalysts: Forward looking projections that call for positive/negative outlook that will strengthen your thesis. Example:

- Full integration of NHS to take effect in upcoming quarters
- Consolidation of data will improve efficiency
- Surgery mix focusing on higher margin and quicker turnaround procedures
- Reviewing and cutting underperforming facilities improves margins and allows SGRY to focus on core businesses

Earnings Performance:

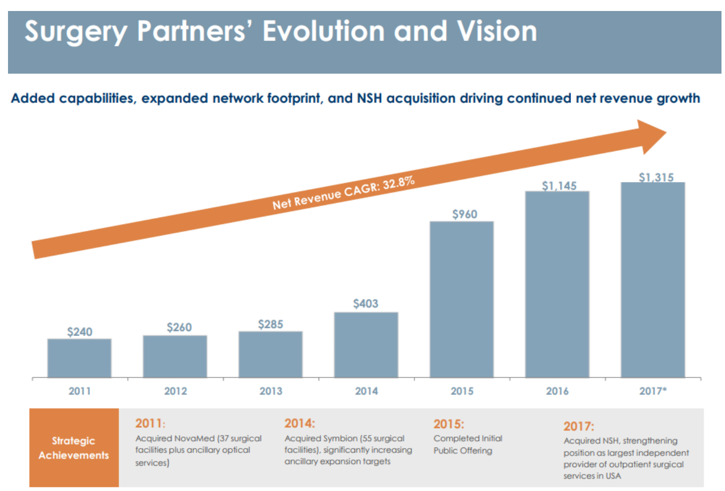
Surgery Partners (SGRY) saw revenues increase 44.9% from the previous year, coming to $443.9 million for Q3FY18. This beat projections by $14.45 million. Much of this growth comes from NSH acquisition, which will be discussed in subsequent sections. Same facility revenue grew 11.4% from Q2FY18. The increasing revenue growth has caused SGRY to raise revenue projections from $1.75 billion to $1.8 billion.

However, the firm decreased EBITDA outlook from over $240 million to between $230 and $235 million. This is due in large part to pruning efforts being made by SGRY to ensure long-term growth. The current adjusted EBITDA LTM is $321.4 million, an 18.2% margin. This is better than 2017's EBITDA margin of 17.9%, but bellow 2014, 2015, and 2016's adjusted EBITDA margins, which were all over 20%. When compared to Q3FY17, adjusted EBITDA is up for the quarter by 153.8%.

Same Facility revenue for Q3 was up 11.4% from Q3FY17. Compared to Q3FY17, this increase was caused by a 0.9% increase in same facility cases and a 10.5% increase in revenue per case.

NSH Acquisition:

In 2017, SGRY acquired National Surgical Healthcare, a holding company owning 21 surgical facilities. NSH's facilities specialize in orthopedic, spine and back, pain management, and neurosurgery. These highly specialized procedures offer strong returns for hospitals. We will discuss this later.

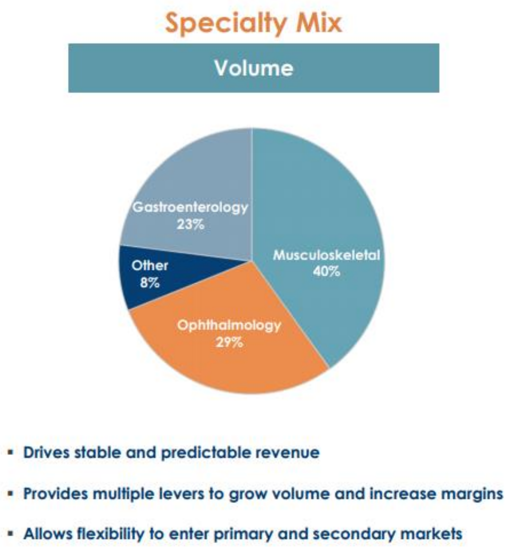


The NSH acquisition only affected 4 months of FY17. FY18 will be the first full year NSH has been incorporated with SGRY. Further to that point, NSH has completed most of its integration in Q3FY18. We have yet to see the full impact and benefit of the synergies created from this acquisition. As this integration has been completed in the past several quarters, SGRY has maintained duplicate staff positions between the two firms and has only just executed closing the NSH headquarters in Chicago. As the duplicate positions are cut over the next quarter, this will lead to cost savings for SGRY which will not be fully realized until 2019. Per the Q3FY18 earnings call, SGRY believed it would be able to achieve double digit and sustainable EBITDA growth in 2019 and onward.

Consolidation of Data:

SGRY is currently working toward migrating facility data to one destination platform by the end of the year. Currently 75% of facilities are migrated. SGRY is also working on moving data to a single data warehouse. Currently 90% of surgical facilities have been migrated or about 70% of revenue. With over 180 locations, a centralized data location allows for enhanced data analytics. This will support the firm's decision-making ability and help SGRY find trends and patterns which may be more difficult to spot when the data is not in one location. While there is no direct way to correlate this to financial impact as we have yet to see what the firm finds until they complete the transition, the move should help the firm find areas where revenues can be grown or costs can be cut, overall increasing margins.

SGRY is also working toward moving all facilities to a standardized clearinghouse for claim submissions. This is also expected to be completed by the end of the year. 2 out of 3 facilities have already been migrated into the standardized clearinghouse. This move will improve revenue cycle management, potentially leading to lower costs. SGRY also believes this move will help with revenue leakage, which would increase revenues. All stated, all of these initiatives are expected to be completed by the end of the year, leading to the full benefit being recognized in FY19.



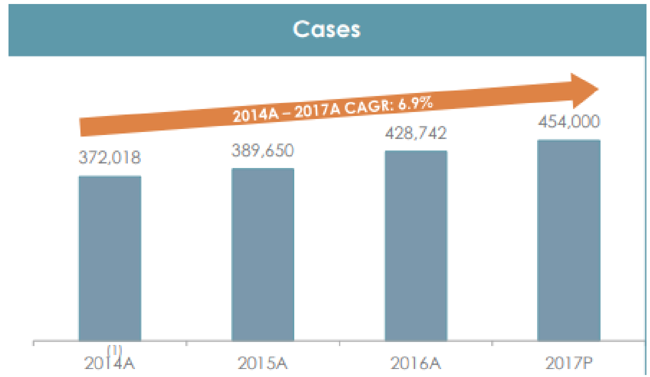
Recruitment and Surgery Mix:

As stated earlier, the acquisition of NSH provided SGRY with specialty facilities for orthopedic, spine and back, pain management, and neurosurgery.

According to Becker's Hospital Review, full-time orthopedic surgeons are each generate approximately $2.7 million a year in revenue. General orthopedics are among the most desirable of specialists for healthcare facilities. Orthopedics can handle a comparatively large case volume in relatively short amounts of time, this quick turnaround time leading to increased revenue from volume. General orthopedics are also difficult to recruit according to Blue Chip Surgical Partners' president of acquisitions and development Chris Bishop. According to Bishop, "Most of the busy orthopedists are already invested in surgery centers, so it's hard to find a group that's not invested or eager to leave…" Acquiring NSH has given SGRY access to a strong mix of surgeons that may be difficult to recruit otherwise.

Pain management is another one of the most desirable specialties. Like Orthopedics, these cases take relatively short amounts of time when compared to other procedures. They are also relatively inexpensive to treat, leading to higher margins. One of the main things that determines SGRY's margin is the mix of procedures performed an d the cost of each component in that mix. With more relatively inexpensive procedures such as those done by pain management specialists, margins improve.

A main driver of revenue is the recruitment of doctors and specialists to drive case volume. As of Q3FY18, SGRY has recruited 20% more physicians than the same in FY17. Recruitment efforts have been focused on high-growth specialties, driving revenue. As compared to physicians recruited the previous year, revenue and case volume have doubled for this year's recruits. Focusing recruiting efforts on highly-specialized surgeons not only drives revenue but gives a higher rate of return for the money spent on recruitment efforts.



Hedging Against Rising Interest:

The following table summarizes our contractual obligations by period as of December 31, 2017 (in thousands):

	Payments Due by Period				
	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Long-term debt obligations, including interest [1]	$ 2,643,403	$ 174,406	$ 1,533,085	$ 484,374	$ 451,538
Capital lease obligations, including interest	33,314	9,100	12,424	5,491	6,299
Operating lease obligations [2]	564,716	67,513	129,871	109,140	258,192
Other financing obligations, including interest [3]	187,476	12,307	25,628	27,043	122,498
Tax receivable agreement	65,141	537	23,613	39,218	1,773
Total contractual obligations	$ 3,494,050	$ 263,863	$ 1,724,621	$ 665,266	$ 840,300

[1] Included in long-term debt obligations are principal and interest owed on our outstanding debt obligations. These amounts exclude our unamortized fair value adjustments related non-cash amortization for the Term Loan and 2021 Unsecured Notes. These obligations are explained further in Note 7 to our consolidated financial statements included elsewhere in this report. We used the applicable annual interest rate as of December 31, 2017 of 4.6%, based on LIBOR plus the applicable margin, for our $1.3 billion outstanding Term Loan to estimate interest payments on this variable rate debt instrument.

[2] This reflects our future minimum operating lease payments. We enter into operating leases in the normal course of business. Substantially all of our operating lease agreements have fixed payment terms based on the passage of time. Some lease agreements provide us with the option to renew the lease. Our future operating lease obligations would change if we exercised these renewal options and if we entered into additional operating lease agreements. These obligations are explained further in Note 8 to our consolidated financial statements included elsewhere in this report. Operating lease obligations do not include common area maintenance, insurance or tax payments for which we are also obligated to pay.

[3] Other financing obligations includes amounts due under our facility lease obligations at four of our surgical facilities as discussed further in Note 2 to our consolidated financial statements included elsewhere in this report.

SGRY has a substantial amount of debt. Long-term debt makes up 63.6% of SGRY's capital structure with another 1.6% made up of short-term debt as of Q3FY18. In 2017, 68.5% of the capital structure was long-term debt. Paying down the debt will increase the firm's ability to make future acquisitions, growing revenue and creating the opportunities for synergies that can improve efficacy, patient care, and margins. Revenue growth will be able to cover future debt payments.

The rising interest rate environment with this level of debt is concerning. Rising interest rates lead to higher interest payments and lower margins. In Q3 and Q4, SGRY entered into several interest rate swaps to lock in a LIBOR rate of 3.12%. These swaps will hedge the interest on $900 million worth of debt, which currently accounts for approximately 75% of debt. The swaps reduce a majority of the interest rate risk for the firm, which will benefit they it this rising interest rate environment.

Trimming Underperformers:

As mentioned with the NSH acquisition, there is still consolidation that needs to be made. While a majority was completed in Q3 for the NSH acquisition, there is still consolidation that needs to be done for both NSH and other areas of the company. SGRY is currently analyzing their assets to find those that are underperforming. Year to date, SGRY has closed or sold 19 physician practices and 5 ASCs. The firm also closed the sale of its Family Care Vison practice and optical laboratory. Options are being explored as to the best way to deal with SGRY's remaining optical services.

Another point mentioned earlier was the recruitment focus on core high-growth specialties. SGRY is also considering what to do with current facilities with do not cater to these specialties. These firms could potentially be creating negative synergy within SGRY, which would make it beneficial for SGRY to sell o, close, or convert these facilities to focus on those core specialties. Even without negative synergy, these facilities could be producing lower margins than the targeted specialties and EBITDA margins would rise if these facilities were no longer in the equation. Value would be created if SGRY were to prune these facilities. SGRY could use the funds from the sale of these facilities to purchase new facilities in higher margin specialties or use the funds to unlever the firm.

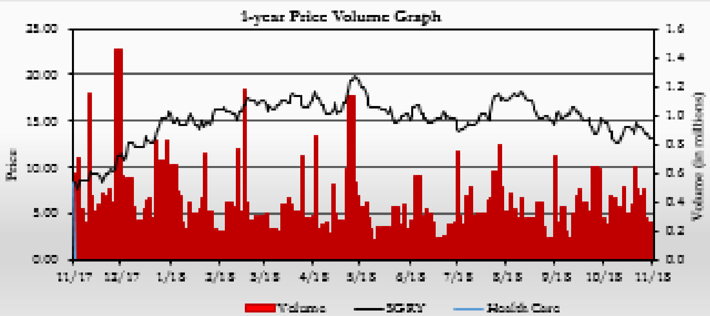
Conclusion:

Over the next few quarters, SGRY will have the opportunity to make the most of economies of scale by realizing synergies, decreasing nonperforming assets and consolidating data and processes. There strong revenue growth over the past several years will now be paired with improving margins. Overall, if SGRY can take advantage of possible efficiencies in their system, the potential for value creation is strong.

Surgery Partners, Inc. (SGRY) — CENTER FOR GLOBAL FINANCIAL STUDIES — BULLISH

Analysis by Sam St.Germain	Current Price:	$13.11	Intrinsic Value	$12.24
11/18/2018	Divident Yield:	0.0%	Target Price	$20.21

Target 1 year Return: 54.13%
Probability of Price Increase: 55



Description

Surgery Partners, Inc., through its subsidiaries, operates surgical facilities in the United States.

General Information

Sector	Health Care
Industry	Health Care Providers and Services
Last Guidance	May 8, 2018
Next earnings date	February 28, 2019

Market Assumptions

Estimated Equity Risk Premium	6.00%
Effective Tax rate	21%

Market Data

Market Capitalization	$640.97
Daily volume (mil)	0.25
Shares outstanding (mil)	48.89
Diluted shares outstanding (mil)	48.10
% shares held by institutions	45%
% shares held by investments Managers	39%
% shares held by hedge funds	4%
% shares held by insiders	8.61%
Short interest	6.80%
Days to cover short interest	10.21
52 week high	$19.95
52-week low	$7.55
Volatility	0.00%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
9/30/2017	-3.57%	-62.94%
12/31/2017	3.03%	86.64%
3/31/2018	0.81%	60.63%
6/30/2018	1.38%	109.44%
9/30/2018	-1.73%	73.94%
Mean	-0.02%	53.54%
Standard error	1.0%	48.2%

Market and Credit Scores

Recommendation (STARS) Value--0
Recommendation (STARS) Description--0
Quality Ranking Value--NR
Quality Ranking Description--Not Ranked
Short Score--2
Market Signal Probability of Default % (Non-Ratings)--5.02%
CreditModel Score (Non-Ratings)--b+

Industry and Segment Information

LTM Revenues by Geographic Segme	LTM Revenues by Business Segments
United States--100%	Surgical Facility Services--93%
--	Ancillary Services--6%
--	Optical Services--1%
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Peers

HCA Healthcare, Inc.	Quorum Health Corporation
Tenet Healthcare Corporation	LifePoint Health, Inc.
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Universal Health Services, Inc.	Community Health Systems, Inc.
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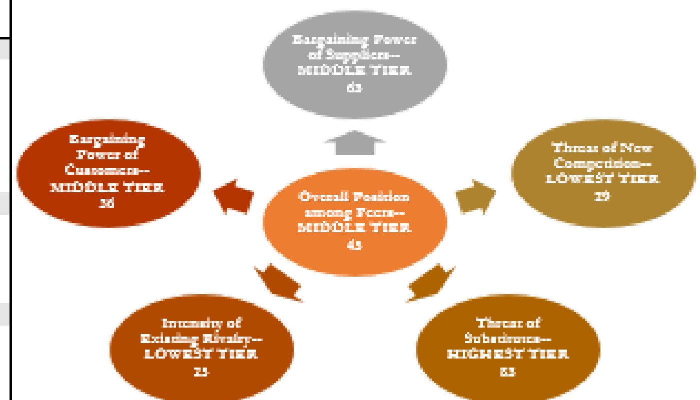
Management	Position	Total Compensation Growth	Stock Price Growth During Tenure
Baldock, Jennifer	Executive VP & Chief Legal Officer	26.5% per annum over 2y	-23.15% per annum over 2y
Doen, Dennis	Executive Officer	55.34% per annum over 1y	-23.66% per annum over 1y
Adlers, Clifford	Consultant & Director		0% per annum over 0y
DeVeydt, Wayne	CEO & Director		
Cauhey, Thomas	Executive VP, CFO & Principal Accounting Offi		
Zolhof, Ronald	Senior Vice President of Operations		

Profitability	SGRY (LTM)	SGRY Historical	Peers' Median (LTM)
Return on Capital (GAAP)	2.8%	3.11%	4.76%
Operating Margin	8%	16.03%	10.30%
Revenue/Capital (GAAP)	0.35	0.19	0.46
ROE (GAAP)		1.0%	2.3%
Net margin		0.7%	7.2%
Revenue/Book Value (GAAP)		1.44	0.33
Invested Funds	**SGRY (LTM)**	**SGRY Historical**	**Peers' Median (LTM)**
Cash/Capital	0.8%	2.3%	1.7%
NWC/Capital	4.9%	2.1%	6.7%
Operating Assets/Capital	-3.9%	46.5%	58.9%
Goodwill/Capital	98.2%	49.1%	32.6%
Capital Structure	**SGRY (LTM)**	**SGRY Historical**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.75	0.52	0.97
Cost of Debt	6.2%	6.7%	5.1%
CGFS Rating (F-score, Z-score, and default Probabilit	CC		
WACC	5.1%	8.5%	7.7%

Porter's 5 forces (Scores are percentiles)



Valuation

Forecast Assumptions	Explicit Period (14 years)	Continuing Period
Revenue Growth CAGR	10%	3.0%
Average Operating Margin	12%	12%
Average Net Margin	6%	8%
Growth in Capital CAGR	5%	3%
Growth in Claims CAGR	0%	3%
Average Return on Capital	6%	7%
Average Return on Equity	16%	11%
Average Cost of Capital	6%	7%
Average Cost of Equity	11%	11%