2 Reasons I Would Stay Far Away From CRH Medical Corp.

Description

A number of bull cases have been made for **CRH Medical Corp.** (TSX:CRH) lately. Many of these "strong buy" recommendations use an ultra-simplified investment thesis composed of two lines of thought: (1) because the company has done well in the past, it will do well in the future; and (2) because the company's stock price has dropped, its value has subsequently increased.

I'm going to look past these assumptions and dive into two key reasons I believe CRH investors have simply adjusted the company's risk profile and its corresponding equity valuation based on the business's acquisition model and recent earnings release.

Acquisition model reflected in earnings release

As I have written previously, CRH has a unique acquisition model in that the company tends to purchase portions of businesses (typically 51%, sometimes more), recording 100% of the acquired business's revenues and earnings on its consolidated financial statements with adjustments made for specific amounts "attributable to shareholders" and "attributable to non-controlling interests."

This acquisition practice, while compliant with GAAP and sound from an accounting standpoint, requires that investors pay more attention to the details within the company's financials to get a complete picture of what is going on.

The company's most recent financial statements show a quarterly net and comprehensive income increase of 9% year over year from $3.03 million in Q1 2016 to $3.3 million in Q1 2017. The breakdown of these earnings is where investors need to pay attention.

In Q1 2016, CRH reported that net income attributable to shareholders was $2.96 million (or 97.7% of total earnings).

In Q1 2017, CRH reported that net income attributable to shareholders was $1.54 million (or only 46.7% of total earnings).

Because of the company's acquisition model, stock-based compensation, and increases in financerelated costs, CRH is now paying out more than half of its earnings to non-controlling interests. This is a trend which has been ongoing for the past year with the shareholders' portion of earnings consistently declining over time.

Looking at earnings per share (EPS), we can see that earnings have significantly underperformed expectations ($0.02 EPS attributable to shareholders compared to $0.07 EPS expected.

Consider this note from the most recent financial statements: "The company has also stated its intention to acquire or develop additional GI anesthesia businesses. In the future, it may be necessary for the Company to raise additional funds for the continuing development of its business plan, including additional acquisitions."

Insiders selling large amounts of stock of late

CRH directors David Johnson and Edward Wright sold a combined $5.71 million of stock at average prices between $7.45 and $11.05 in March, which amounts to nearly 1% of CRH's total float.

As I have reported previously, insider selling is generally not an issue in large and very liquid equities with compensation structures reliant on stock options. In growth-related businesses, large stock option redemptions can be commonplace and may largely be ignored by the financial markets for those reasons.

That said, any time nearly 1% of a company's stock is sold by insiders, questions undoubtedly come to mind.

Bottom line

I am skeptical about CRH's growth strategy from the standpoint of a shareholder. It appears to me that the substantial dilution effect resulting from this growth strategy is one which will not benefit shareholders in the long run. My skepticism also extends to the recent large liquidation of stock by two company directors, making me more uneasy about this company's long-term prospects.

Stay Foolish, my friends.

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chrismacdonald