Kotak Institutional Equities

Apollo Hospitals (APHS)

Pharmaceuticals

ADD

NOVEMBER 25, 2011

UPDATE

Coverage view: Neutral

Price (Rs): 602

Target price (Rs): 650

BSE-30: 15,858

Key beneficiary of allowing FDI in multi-brand retail. Apollo's stated intentions of divesting its retail pharmacies business (either fully or partially) were dependent on this key policy change. We believe any value unlocking is important as it will (1) release capital for its mammoth hospital expansion plan and reduce need to pick up substantial debt and (2) lead to improvement in overall profitability and capital efficiency ratios as retail pharmacies dilute profitability of the core hospitals business. However, we think Apollo is well-funded for its Rs16 bn capex program over FY2012-15E and will divest this business over the medium term upon achieving (1) right valuations and (2) improvement in its profitability. ADD, TP at Rs650.

Company data and valuation summary

Apollo Hospitals

Stock data			
52-week range (Rs) (high,low)			612-432
Market Cap. (Rs bn)			83.7
Shareholding pattern (%)			
Promoters			33.2
FIIs			32.2
MFs			0.4
Price performance (%)	**1M**	**3M**	**12M**
Absolute	17.5	11.0	26.5
Rel. to BSE-30	25.5	13.9	55.2

Forecasts/Valuations	2011	2012E	2013E
EPS (Rs)	13.2	17.1	21.2
EPS growth (%)	21.0	29.3	24.0
P/E (X)	45.5	35.2	28.4
Sales (Rs bn)	26.1	31.2	37.4
Net profits (Rs bn)	1.8	2.4	2.9
EBITDA (Rs bn)	4.2	5.2	6.4
EV/EBITDA (X)	20.6	15.4	13.2
ROE (%)	9.8	10.3	10.5
Div. Yield (%)	0.0	0.0	0.0

QUICK NUMBERS

- Apollo is the largest player in organized pharmacy business
- Apollo's stated intentions of divesting its retail pharmacies business (either fully or partially) were dependent on this key policy change
- Value unlocking will improve overall fundamentals and release capital for expansion

Apollo is the largest player is organized pharmacy business—to benefit from policy change

Apollo was up ~15% this week in anticipation of the much-awaited approval of FDI in multi-brand retail. We believe the policy change yields an opportunity for established retail players to unlock value given their established front-end system and presence in prominent real-estate locations. Apollo is the largest player in the organized pharmacy business, and value-added services differentiate Apollo pharmacies from mom & pop chemists. Apollo has 1,257 pharmacies as of September 2011 with revenues of Rs6.6/3.9 bn in FY2011/1HFY12 (25% of consolidated sales). Apollo has invested Rs2.2 bn in this business till date. However, this business currently enjoys poor EBITDA margin although profitability has improved substantially over 1HFY12 with EBITDA margin increasing to 1.8% in 2QFY12 from nil in FY2011.

Value unlocking will improve overall fundamentals and release capital for expansion

We believe any value unlocking through the sell of this business (partial or full) is important as: (1) It will release capital for Apollo's expansion plans (Apollo plans to add 2,800 beds over FY2012-15E) and reduce Apollo's need to take on substantial debt which is important in hospitals as they take 3-4 years to break even at the EBITDA level. We believe Apollo is well-funded for its Rs16 bn capex program as out of this total capex, Apollo has spent Rs1.6 bn YTD. Out of the balance—(a) Rs5.3 bn will be the equity portion (Rs3.3 bn through recent QIP and Rs2 bn from the two tranches of outstanding warrants), (b) Rs4 bn from internal accruals and (c) balance through debt. (2) Pharmacies are currently not profitable (on a full-year basis) hence dilute the overall profitability of its core hospitals business which enjoys EBITDA margin of 22-23% and ROCE of 19-20%. Divestment will result in improvement of return ratios of the overall consolidated business.

Divestment of pharmacies not likely in near term

We believe Apollo is in no hurry and will divest this business only upon achieving (1) right valuations and (2) improvement in profitability.

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Pharmacies have turned profitable at EBITDA level

Apollo intends to improve profitability in its retail pharmacies business through

- **Shutting down unprofitable stores.** Apollo has a strategy of closing down stores that do not achieve breakeven at the EBITDA level in 12 months. In keeping with this strategy, it shut 78 stores in FY2010 and 55 in 2QFY12.

- **Increasing contribution from private label business.** Apollo plans to increase private label products, which currently comprise 2-4% of revenues, to 20-30% of revenues over the next 3-4 years. According to the company, this should increase its steady-state margin in older stores to 8-10% from 6% currently. Apollo has around 120 products sold under its private label (under brand name B+).

- **Efficiencies from purchasing.**

Value-added services differentiate Apollo pharmacies from mom & pop chemists

- It provides free health insurance of Rs20,000 on purchases exceeding Rs6,000 in a year at any Apollo pharmacy.

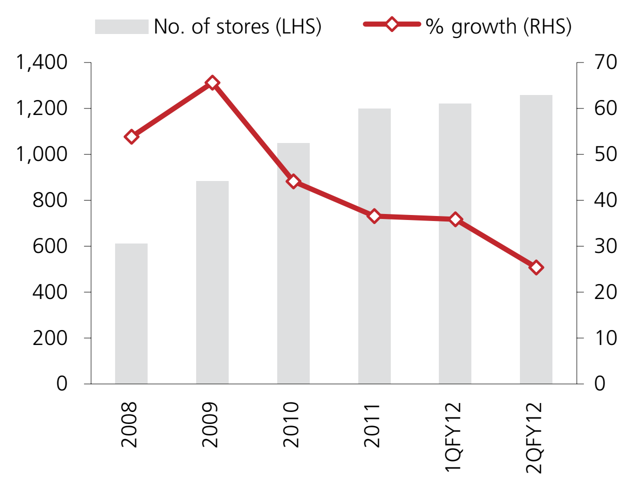
- It provides IT-enabled services such as maintenance of database of customers and personalized pharmacy-refilling services.

- Apollo pharmacies have better storage facilities with controlled temperature which helps maintain the cold chain for thermo labile medicines.

- Its outlets are manned by qualified and trained pharmacists, which is mandated by law but seldom followed.

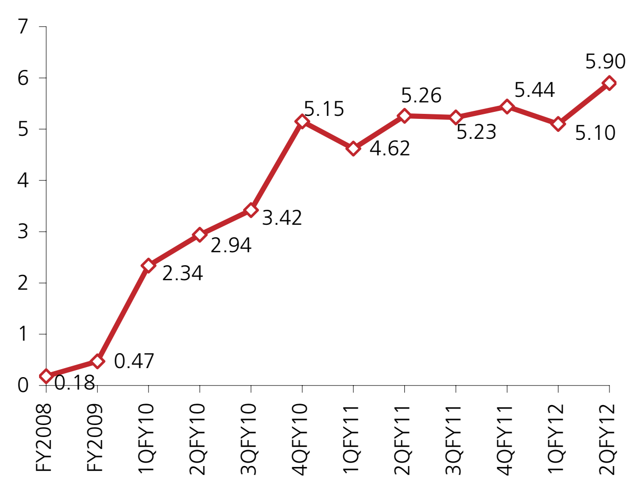
- Most of Apollo pharmacies have nursing stations attached. The nursing stations provide basic medical services like measuring blood pressure, dressings etc.

Standalone pharmacies—revenue profile



Source: Kotak Institutional Equities estimates, Company

Standalone pharmacies (up to 2007 batch)—EBITDA margin



Source: Kotak Institutional Equities estimates, Company

Apollo pharmacies revenues

	2008	2009	2010	2011E	2012E	2013E
Mature stores (upto 2007)						
Revenue (Rs mn)	1,756	2,069	2,290	2,638	3,066	3,565
Yoy growth (%)		18	11	15	16	16
# of pharmacies	352	330	318	314	312	310
Revenue per store (Rs mn/unit)	5	6	7	8	10	11
Yoy growth (%)		26	15	17	17	17
New stores (post 2007)						
Revenue (Rs mn)	264	1,276	2,531	3,945	5,387	7,248
Yoy growth (%)		384	98	56	37	35
# of pharmacies	260	553	731	885	1,007	1,129
Revenue per store (Rs mn/unit)	1	2	3	4	5	6
Yoy growth (%)		128	50	29	20	20
Total pharmacy revenues	**2,020**	**3,345**	**4,821**	**6,583**	**8,453**	**10,812**
Yoy growth (%)	54	66	44	37	31	26
# of pharmacies	**612**	**883**	**1,049**	**1,199**	**1,319**	**1,439**
% of total revenues	17	21	24	25	28	29

Source: Kotak Institutional Equities estimates, Company

Apollo—abridged profit model, balance sheet, December year-ends, 2008-14E (Rs mn)

	2008	2009	2010	2011	2012E	2013E	2014E
Profit model							
Net sales	**12,164**	**16,142**	**20,265**	**26,054**	**31,221**	**37,372**	**46,870**
EBITDA	**1,836**	**2,267**	**3,006**	**4,189**	**5,220**	**6,412**	**8,099**
EBITDA margin (%)	15.1	14.0	14.8	16.1	16.7	17.2	17.3
Other income	253	208	322	187	216	210	110
Depreciation	(517)	(632)	(750)	(948)	(1,264)	(1,600)	(1,948)
Financial charges	(382)	(459)	(602)	(814)	(736)	(750)	(650)
PBT	**1,190**	**1,384**	**1,976**	**2,613**	**3,436**	**4,272**	**5,610**
Tax	(374)	(505)	(676)	(873)	(1,168)	(1,453)	(1,907)
PAT	**816**	**879**	**1,300**	**1,740**	**2,268**	**2,820**	**3,703**
Exceptionals (net) loss/(profit)	—	26	—	—	—	—	—
MI, share in profit of associate	(44)	171	75	99	110	130	155
Reported net profit	**772**	**1,025**	**1,376**	**1,839**	**2,378**	**2,950**	**3,858**
Balance sheet							
Total equity	13,332	14,954	16,776	19,238	25,309	28,794	31,367
Total debt	5,322	6,706	9,132	9,585	6,700	9,216	7,170
Total liabiilities and equity	**18,653**	**21,660**	**25,908**	**28,823**	**32,008**	**38,009**	**38,537**
Net fixed assets incl CWIP	9,778	12,884	16,257	18,905	17,619	24,636	25,688
Investments	6,242	5,914	4,166	5,020	5,020	5,020	5,020
Net current assets	1,818	2,432	2,905	3,962	5,271	6,198	7,674
Cash	1,283	876	3,117	1,781	4,943	3,000	1,000
Net deferred tax asset	(467)	(446)	(536)	(845)	(845)	(845)	(845)
Total assets	**18,653**	**21,660**	**25,908**	**28,822**	**32,008**	**38,009**	**38,537**
Ratios							
Diluted EPS (excl excep.) (Rs)	6.6	8.5	10.9	13.2	17.1	21.2	27.8
ROE (%)	7.9	6.4	8.3	9.8	10.3	10.5	12.4
Debt/equity (%)	39.9	44.8	54.4	49.8	26.5	32.0	22.9

Source: Kotak Institutional Equities estimates, Company

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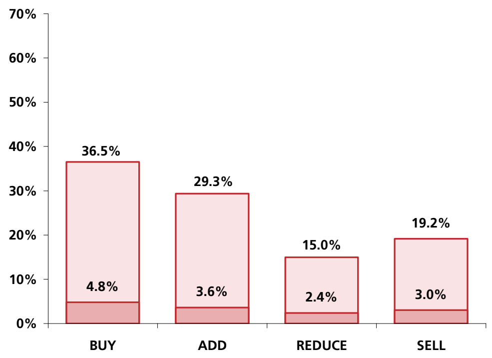

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Source: Kotak Institutional Equities

As of September 30, 2011

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ADD. We expect this stock to deliver 7.5-17.5% returns over the next 12 months.

REDUCE. We expect this stock to deliver 0-7.5% returns over the next 12 months.

SELL. We expect this stock to deliver less than 0% returns over the next 12 months.

Our target prices are also on a 12-month horizon basis.

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