Company Focus

7 March 2008 | 9 pages

Fortis Healthcare (FOHE.BO)

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

Downgrade to Sell: Escorts Pain Continues

- **Downgrade to Sell (3M) with a lower target price of Rs75/share** — While we remain positive on Indian healthcare and Fortis' long-term prospects, we believe the pain in Escorts will remain an overhang on profitability & valuations over the next few quarters. The decline on this front has been higher than we anticipated; we consequently cut EBIDTA estimates by 20-36% over FY09-10.
- **Escorts pain** — Escorts Delhi's occupancy fell sharply in FY08 due to the exit of Dr Trehan and the associated negative publicity, thus hurting topline and margins. While this was expected, the decline was higher than we anticipated. Fortis indicated that margins would improve over the next few quarters as costs are reined in, and there are some signs of this in 3QFY08. However, we believe that Escorts will still remain a drag on overall profitability in the near term.
- **High execution risk** — A large part of Fortis' expected growth over the next three years comes from the turnaround in Escorts as well as timely execution of its expansion projects in Shalimar Bagh & Gurgaon – all areas where there are execution challenges. While Fortis has shown the ability to rapidly scale up occupancies at its other hospitals, we believe the street will await signs of progress on these fronts before assigning a higher multiple to the stock.
- **Super speciality focus augurs well for long term** — Fortis' strong brand equity & super specialty focus position it well over long term to gain from the growing healthcare opportunity in India. With recent fiscal incentives for hospitals in tier II cities, we expect Fortis to step up its expansion plans. This should drive growth beyond FY10/11; however, it could be a drag on margins in the interim.

Sell/Medium Risk	**3M**
from Buy/Medium Risk	
Price (05 Mar 08)	Rs77.95
Target price	Rs75.00
from Rs100.00	
Expected share price return	-3.8%
Expected dividend yield	0.0%
Expected total return	**-3.8%**
Market Cap	Rs17,669M
	US$440M

Price Performance (RIC: FOHE.BO, BB: FORH IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	-489	-2.88	na	nm	4.1	-28.6	0.0
2007A	-1,013	-5.92	-105.6	-13.2	3.6	-29.4	0.0
2008E	-870	-3.84	35.1	nm	2.8	-17.4	0.0
2009E	-309	-1.36	64.5	nm	2.9	-5.0	0.0
2010E	43	0.19	114.1	nm	2.9	0.7	0.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	nm	-13.2	nm	nm	nm
EV/EBITDA adjusted (x)	92.0	49.5	53.0	19.9	13.1
P/BV (x)	4.1	3.6	2.8	2.9	2.9
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	-2.88	-5.92	-3.84	-1.36	0.19
EPS reported	-2.88	-5.92	-3.84	-1.36	0.19
BVPS	18.84	21.55	27.96	26.59	26.78
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net sales	2,926	5,124	5,033	8,090	10,506
Operating expenses	-3,144	-5,477	-5,520	-7,994	-9,885
EBIT	**-218**	**-353**	**-487**	**97**	**620**
Net interest expense	-363	-660	-477	-431	-534
Non-operating/exceptionals	44	81	31	73	133
Pre-tax profit	**-538**	**-933**	**-933**	**-261**	**220**
Tax	9	-73	78	-18	-140
Extraord./Min.Int./Pref.div.	39	-7	-15	-30	-36
Reported net income	**-489**	**-1,013**	**-870**	**-309**	**43**
Adjusted earnings	-489	-1,013	-870	-309	43
Adjusted EBITDA	232	485	429	1,089	1,692
Growth Rates (%)					
Sales	296.8	75.1	-1.8	60.7	29.9
EBIT adjusted	-37.4	-61.9	-37.9	119.9	541.1
EBITDA adjusted	422.4	109.3	-11.6	154.1	55.4
EPS adjusted	-470.1	-105.6	35.1	64.5	114.1
Cash Flow (RsM)					
Operating cash flow	**-132**	**-298**	**877**	**1,028**	**1,490**
Depreciation/amortization	450	838	916	992	1,071
Net working capital	-121	-96	886	304	222
Investing cash flow	**-7,167**	**-899**	**-2,281**	**-1,500**	**-1,700**
Capital expenditure	-679	-899	-2,280	-1,500	-1,700
Acquisitions/disposals	-6,276	-1	0	0	0
Financing cash flow	**7,450**	**1,337**	**1,450**	**966**	**1,220**
Borrowings	3,987	-116	-2,070	966	1,220
Dividends paid	0	0	0	0	0
Change in cash	**151**	**139**	**46**	**494**	**1,010**
Balance Sheet (RsM)					
Total assets	**10,596**	**11,438**	**11,983**	**13,603**	**15,639**
Cash & cash equivalent	167	307	353	847	1,857
Accounts receivable	678	882	453	728	946
Net fixed assets	4,541	5,085	6,904	7,867	8,951
Total liabilities	**7,203**	**7,557**	**5,437**	**7,336**	**9,292**
Accounts payable	790	1,053	1,455	2,378	3,104
Total Debt	5,985	5,922	3,852	4,818	6,038
Shareholders' funds	**3,393**	**3,881**	**6,546**	**6,267**	**6,347**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	7.9	9.5	8.5	13.5	16.1
ROE adjusted	-28.6	-29.4	-17.4	-5.0	0.7
ROIC adjusted	-3.9	-4.3	-4.0	0.8	4.6
Net debt to equity	171.4	144.7	53.5	63.4	65.9
Total debt to capital	63.8	60.4	37.0	43.5	48.8

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Downgrade to Sell, Escorts Pain Continues

We downgrade Fortis to Sell (3M) from Buy (1M) with a lower target price of Rs75/share. While we remain positive on Indian healthcare and Fortis' long-term prospects, we believe that the pain in Escorts will remain an overhang on profitability and valuations over the next few quarters. The decline on this front has been higher than we anticipated, and we consequently cut EBIDTA estimates by 20-36% over FY09-10. While there are some positive signs of a turnaround in Escorts in 3QFY08, we believe investors will await signs of a more sustained recovery before assigning a higher multiple to the stock.

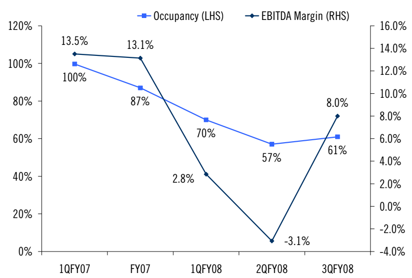
What has changed?

- **Escorts pain**: Fortis has been facing significant challenges in the integration of the acquired Escorts group of hospitals, largely in the flagship Escorts Delhi hospital. Escorts Delhi faced lower occupancy in FY08, due to the exit of Dr Naresh Trehan and associated negative publicity, thus hurting topline and margins. While this was expected, the extent of decline was higher than we anticipated. Fortis indicated that margins would improve over the next few quarters as costs are brought under control, and there are some signs of this happening in 3QFY08 (occupancy up from 57% to 61% QoQ; EBIDTA margins up from -3.1% to 8% QoQ). However, we believe that Escorts will still remain a drag on overall profitability in the near term.

  We have built in significant improvement in Escorts Delhi's margins from FY09, as the company's effort to control costs reflect in financials in the form of lower personnel cost and overheads as well as higher revenues driving operating leverage. Overall, we expect the Delhi facility to move from an EBITDA loss situation in FY08 to 6% in FY09E and 16% in FY10E.

- **Reducing estimates**: In line with the delayed recovery in Escorts Delhi, we have reduced our estimates considerably for FY08-10E. Given that the flagship hospital is one of the largest contributors to Fortis' topline and EBIDTA, the sharp fall in occupancy has taken a heavy toll on the aggregate numbers. We reduce revenue estimates by 19.5%, 6.4% and 3.2% over FY08-10E and EBIDTA estimates by 55%, 36% and 20% over FY08-10E. The sharp reduction in EBIDTA reflects the high operating leverage in a hospital which should work in Fortis' favour once the occupancies begin to pick up again over the next few quarters.

Figure 1. Escorts, Delhi (Occupancy & Margins)



Source: Company Reports, Citi Investment Research

Figure 2. Earnings Revision (Rs M, %)

YE March	2008E	2009E	2010E
Revenues			
New	5,033	8,090	10,506
Old	6,255	8,641	10,858
% Change	(19.5)	(6.4)	(3.2)
EBITDA			
New	429	1,089	1,692
Old	962	1,703	2,116
% Change	(55.4)	(36.1)	(20.1)

Source: Citi Investment Research

Lowering target price to Rs75/share

We lower our target price to Rs75/share from Rs100/share on the back of our lower EBIDTA estimates. We continue to value Fortis at 15x FY09E EBIDTA. However, since the recovery in Escorts should only be a matter of time (some signs are visible in 3QFY08), we believe that the suppressed profitability for Escorts in FY09 does not reflect the true value of the franchise. As such, we base our valuation of the Escorts part of Fortis' business on FY10E EBIDTA, which is a much more normalised number. We use a lower EV/EBIDTA multiple of 12x to value Escorts, given that we are basing it off 24-month forward EBIDTA. We continue to value the rest of Fortis' business at 15x FY09E EBIDTA. Cumulatively, our revised target price comes to Rs75/share.

Figure 3. Fortis Healthcare: Target Price Calculation

	Target EV/EBITDA(x)	EBITDA (Rs M)	Target EV (Rs M)	CIR Comments
Escorts	12.0x	700	8,397	at 12x FY10 EBITDA
Fortis (Excluding Escorts)	15.0x	800	12,007	at 15x FY09 EBITDA
Target EV (Rs m)			**20,404**	
Debt			3,499	
Target Value of equity			16,905	
No of Shares			227	
Target price/ Share			**75**	

Source: Citi Investment Research

Fortis Healthcare

Company description

Fortis was set up and is owned by the founders of India's largest pharmaceutical company, Ranbaxy Laboratories. Fortis went public in May 07. It is a professionally managed company with a fairly broad management team, headed by Mr. Shivinder Singh (founder shareholder and Managing Director).

Investment strategy

We rate Fortis as Sell/Medium Risk (v/s Buy/Medium Risk earlier) with a target price of Rs75/share (v/s Rs100 earlier). While Fortis looks well placed to gain from the growing market for healthcare delivery services in India over the longer term, we believe its medium-term outlook depends on how soon it is able to turn around the operations at Escorts, Delhi. This hospital has gone through some pain in the recent past due to the exit of Dr Naresh Trehan and the associated negative publicity, leading to lower occupancies and margins. While we believe that the recovery in the Delhi hospital's revenues and profitability is only a matter of time (some signs visible in 3QFY08), we believe it could remain a drag on growth and valuations over the next few quarters.

Valuation

We prefer to use EV/EBIDTA versus EBIDTA CAGR as the primary method to value Fortis. We believe that hospital companies in India will have a predictable and steady revenue stream, given high unmet demand and low but growing penetration of organized healthcare. Fortis has only one directly comparable company listed on the Indian market - Apollo Hospitals. We continue to value Fortis at 15x FY09E EBIDTA, which is in line with the valuation we use for Apollo Hospitals as well. However, since the recovery in Escorts should only be a matter of time (some signs are visible in 3QFY08), we believe that the suppressed profitability for Escorts in FY09 does not reflect the true value of the franchise. As such, we base our valuation of the Escorts part of Fortis' business on FY10E EBIDTA, which is a much more normalised number. We use a lower EV/EBIDTA multiple of 12x to value Escorts, given that we are basing it off a 24-month forward EBIDTA. We value the rest of Fortis' business at 15x FY09E EBIDTA. Cumulatively, our target price comes to Rs75/share.

Risks

We rate Fortis as Medium Risk, as opposed to the default Speculative Risk rating we assign for stocks with a trading history of less than 260 days. We believe a Medium Risk rating is appropriate as Fortis enjoys strong visibility in revenues/earnings and looks well poised to take advantage of the growing market for healthcare delivery in India, which is partly offset by the various litigations against Fortis, especially related to the Escorts group of Hospitals. Key upside risks to our rating include: (1) If occupancy rates in Escorts increase much faster than expected, the company could beat our earnings estimates; (2) Any significant acquisition, if accretive, could change the outlook on the stock; (3) any progress on Fortis' plan to unlock value in its land holding could also trigger off an upmove in the stock.

Appendix A-1

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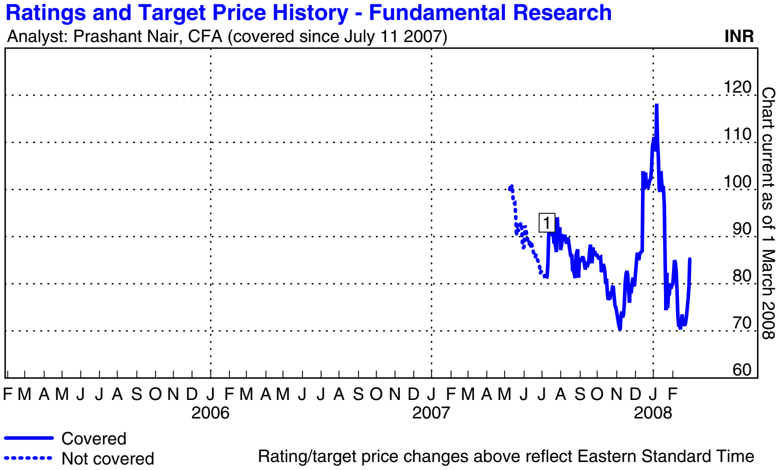
Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since July 11 2007)



Rating/target price changes above reflect Eastern Standard Time

#	Date	Rating	Target Price	Closing Price
1:	10 Jul 07	1M	100.00	81.40

*Indicates change.

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