

Company Flash

26 June 2007 | 7 pages

Apollo Hospitals (APLH.BO)

Buy: In-Line Results; Strong Underlying Trends

- **Maintain Buy (1M)** — as FY07 results were in-line with expectations, and growth is expected to sustain. In our view, Apollo's superiority in a growing sector with high entry barriers calls for premium valuations. Project specific tie-ups with financial partners as well as a focus on building an optimum mix of specialty hospitals and less capital intensive primary/secondary care facilities augur well for capital efficiency in the medium term.
- **Robust growth in FY07** — with consolidated revenues up 25% on the back of price hikes across key hospitals and improved occupancies across all the facilities (80% overall for FY07). EBIDTA margins improved 22 bps to 16% (as against our expectation of a decline), despite the sharp increase in staff cost (up 26%) and general expenses (up 25%).
- **Are margins a concern?** — We do not think so. We highlight that despite the sharp increase in staff cost and general expenses in FY07 (both a consequence of the sharp ramp-up in retail pharmacies – 180 added in FY07), EBIDTA margins have improved by 22bps YoY on the back of price hikes in the hospitals business. With a large part (84/180) of the expansion in pharmacies coming through in 4Q, we expect operating leverage to play out as revenues ramp up.
- **Potential catalysts** — include moves to unlock value in the medical BPO subsidiary and the retail pharmacy business.

Buy/Medium Risk	1M
Price (26 Jun 07)	Rs525.35
Target price	Rs610.00
Expected share price return	16.1%
Expected dividend yield	1.6%
Expected total return	17.7%
Market Cap	Rs27,128M
	US\$665M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	320	7.68	7.4	68.4	7.3	12.0	0.8
2006A	427	8.44	9.9	62.2	4.3	9.3	0.9
2007E	968	18.74	122.1	28.0	3.6	14.1	1.1
2008E	847	16.40	-12.5	32.0	3.1	10.4	1.6
2009E	1,023	19.81	20.8	26.5	2.6	10.6	1.9

Source: Powered by dataCentral

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

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Buy: In-Line Results; Strong Underlying Trends

We maintain our Buy (1M) rating on Apollo Hospitals, as FY07 results were in-line with expectations and growth is expected to sustain. In our view, Apollo's superiority in a growing sector with high entry barriers calls for premium valuations. Project specific tie-ups with financial partners as well as a focus on building an optimum mix of specialty hospitals and less capital intensive primary/secondary care facilities augur well for capital efficiency in the medium term.

FY07 results in-line with expectations – slightly better than expected at the sales and EBITDA levels

Revenues up 25% as Apollo took price increases in most of its established facilities and with average occupancy moving up to 80% in 4QFY07

Margins improved by 22bp YoY despite the sharp increase in staff cost and general expenses as well as the sharp ramp-up in lower margin pharmacies

Increase in staff costs and general expenses primarily driven by sharp increase in number of pharmacies set up in FY07 (180, of which 84 were set up in 4Q)

Hospital EBIT margins for FY07 came in at a healthy 14.9%; we estimate EBITDA margins at c18.9%

Figure 1. FY07 Consolidated Earnings Summary (Rupees In Million, Percent)

Year Ended March	FY06	FY07	% Ch YoY
Net Sales	7,596	9,495	25.0
Material	3,729	4,709	26.3
Staff	1,127	1,422	26.2
Other exp	393	416	5.9
General	1,048	1,313	25.3
Selling & Distribution	99	114	15.2
Total Expenditure	6,396	7,974	24.7
EBITDA	1,200	1,521	26.8
<i>EBITDA margins</i>	<i>15.8</i>	<i>16.0</i>	<i>22 bps</i>
Interest	244	270	10.7
Depreciation	378	407	7.7
Other Income	95	71	(25.3)
PBT	673	915	36.0
Tax	238	326	37.0
<i>Effective tax rate</i>	<i>35.4</i>	<i>35.6</i>	<i>-26 bps</i>
Profit after Tax	435	589	35.4
Minority Interest	(46)	-	nm
Share in associates	39	55	41.0
Net Income	520	644	23.8
Extraordinary Items	0	310	
Reported Net Income	520	954	83.5

Source: Citigroup Investment Research

Figure 2. Q4 FY07 Standalone Earnings Summary (Rupees In million, Percent)

Year Ended March	4QFY06	4QFY07	% Ch YoY	3QFY07	% Ch QoQ
Net Sales	1,920	2,334	21.6	2,328	0.3
Material	996	1,206	21.1	1,188	1.5
Staff	272	334	22.8	349	(4.3)
Other exp	81	91	12.3	85	7.1
General	248	350	41.1	298	17.4
Selling & Distribution	21	34	61.9	28	21.4
Total Expenditure	1,618	2,015	24.5	1,948	3.4
EBITDA	302	319	5.6	380	(16.1)
<i>EBITDA margins</i>	<i>15.7</i>	<i>13.7</i>	<i>-206 bps</i>	<i>16.3</i>	<i>-266 bps</i>
Interest	27	45	66.7	45	-
Depreciation	69	83	20.3	75	10.7
Other Income	31	34	9.7	13	161.5
PBT	237	225	(5.1)	273	(17.6)
Tax	76	78	3.2	94	(17.0)
<i>Effective tax rate</i>	<i>31.9</i>	<i>34.7</i>	<i>-277 bps</i>	<i>34.4</i>	<i>23 bps</i>
Profit after Tax	161	147	(8.9)	179	(17.9)
Extraordinary Items	(37)	-	nm	-	nm
Reported PAT	124	147	18.6	179	(17.9)

Source: Citigroup Investment Research

Apollo Hospitals

Company description

Apollo Hospitals is an integrated healthcare company in the private sector, with the largest hospital network in Asia. The group and its subsidiaries own 16 hospitals, and it operates 24 hospitals. These hospitals are owned either by joint ventures and associated companies or operated under contracts as franchise hospitals or under consultancy contracts across the Afro-Asian region, with more than 5,000 operational beds. It has a network of more than 2,000 doctors (including more than 1,300 "fee-for-service" doctors), around 2,000 nurses and 1,000 paramedical personnel on its payroll. It also operates a network of primary-care clinics, a medical back-office operation, a health-insurance company and a healthcare staffing company that provides nurses to the UK, the US and other countries. Its retail pharmacy business is one of the largest in India, with a network of 482 outlets.

Investment thesis

We rate Apollo Hospitals Buy/Medium Risk (1M) with a target price of Rs610. We are positive on the Indian healthcare delivery market and believe that Apollo is one of the best plays on the burgeoning healthcare opportunity in India. It appears poised to benefit from healthcare opportunities in India, driven by both domestic and international patients, and is ahead of most of its competitors on scale, brand recognition and service offerings. It has an integrated business model that, in addition to hospitals, includes clinics, diagnostic services, pharmacies, telemedicine, and healthcare education and training. The company, which dominates the tertiary-care segment, is pursuing a strategy of expanding presence in secondary- and tertiary-care markets. This should expand its reach to smaller towns, and its primary-care facilities could act as referral points for tertiary hospitals. This strategy should also bode well from a return perspective. We estimate that secondary hospitals can offer 25-30% higher returns than tertiary hospitals. Apollo is also enhancing its presence in the cardiology segment, a key driver of the in-patient market over the next 10 years. We expect Apollo's new hospitals and improvements in asset utilization to drive a 22% revenue CAGR and 20% in recurring net profit over FY06-09E.

Valuation

Apollo lacks listed comparables in the domestic market, but has a reasonable and well-diversified global peer group. Some of these are much bigger than Apollo, but we see healthcare growth opportunities as greater in India than in developed markets given the country's current low expenditure and health care penetration. P/E and EV/EBITDA in relation to earnings growth seem ideal tools to value Apollo, given the high predictability and stable earnings stream for companies operating in the healthcare services industry. We believe that this method may not be optimal - since the high interest and depreciation charges incurred upfront would lead to earnings not fully reflecting its operating performance. We therefore use EV/EBIDTA v/s EBIDTA CAGR as our primary methodology to value Apollo Hospitals. Our target price is based on 15x FY09E EBIDTA, which is within the stock's EV/EBIDTA trading band of 12-20x over the past two years. At 15x FY09E EBIDTA, we value the stock at Rs610/share.

Risks

We rate Apollo Hospitals Medium Risk based on our quantitative risk-rating system. Main downside risks to our target price and estimates are: 1) Apollo Hospital has a fixed-cost-intensive business with high operating leverage. Inability to scale up occupancy and realizations could depress capital efficiency;

2) The business requires large investment in technology-intensive medical equipment that could be rendered obsolete quickly by rapid progress in technology; and 3) Slippage in service quality by Apollo's primary-care franchisees could dilute its brand equity.

Appendix A-1

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Apollo Hospitals (APLH.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since October 11 2005)



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