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Restructuring, business growth boost for Fortis' investors

Value unlocking from diagnostic business the biggest near–term trigger for the stock

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Mumbai, 15 August

Improved business performance and expected unlocking from the listing of its 57 per cent diagnostic subsidiary, SRL, helped the Fortis stock gain 20 per cent over the past month. On August 4, the board of directors had given in-principle approval to demerge the diagnostic business.

A restructuring committee, formed to decide on the structure of the demerger process, including valuations and share entitlement, is expected to report by this Friday. SRL is currently valued at around ₹5,000 crore. This could move up, going by the valuation of two listed diagnostic entities, Dr Lal PathLabs and Thyrocare Technologies. This is because Dr Lal Pathlabs commands a valuation of 28 times the FY18 enterprise value to operating profit estimate; SRL is valued at 24 times.

In terms of business, both are of equal size, with Dr Lal slightly ahead in operating margin at 24-26 per cent, compared to 22-24 per cent for SRL. SRL is expected to catch up in margins as well. Given the current market capitakisation of Fortis Healthcare at ₹8,846 crore, the subsidiary accounts for 55-65 per cent of the parent's market cap, though it contributes only 17 per cent of the revenue.

Operationally, too, things are expected to improve. While the diagnostic space (SRL) grew seven per cent to ₹192 crore, operating profit was flat at ₹43 crore in the June 2016 quarter. The rationalisation of imaging centres, including exit from non-profitable ones and reduction in collection centres, impacted growth. Relocation of a lab led to sales loss and one-off costs, dented profitability.

Operating profit margins for the diagnostic business were down 160 basis points (bps) over the year-ago period to 22.4 per cent. Going ahead, the company expects to get double-digit growth from the business and an expansion in margins.

The hospitals business, too, has triggers. The latest being the company's acquisition of 51 per cent stake (to be closed at the end of this month) in Fortis Hospital (FHTL), which owns the FMRI and Shalimar Bagh hospitals. FMRI is the flagship facility of Fortis and generates the highest average revenue per bed in that network, at ₹2.72 crore per day. FHTL is a subsidiary of Religare Health Trust, listed on the Singapore Stock Exchange, of which Fortis is a sponsor and owns 28 per cent. The transaction is positive for Fortis, as it will pay a lower service fee (net business trust fees), helping its margins.

Notably, this business' performance is seeing improvement. It reported better than expected results in the June quarter, with India revenues growing nine per cent year-on-year and operating profit before business trust costs at ₹139 crore. Higher occupancies, which improved to 74 per cent (up 400 bps, year on year), as well as increased average revenue per bed, up five per cent, aided revenue growth.

While revenue growth is higher after subdued performance in the previous two quarters, its operating profit before business trust costs, too, is the highest ever quarterly number achieved by the company. Operating profit and margins, including business trust costs, though came in below estimates. The management expects to deliver double-digit revenue growth for this business in FY17.

With the performance improving, its valuation discount to peers should get narrower. The discount in the hospitals segment is due to higher operating profit margins for Narayana and Apollo Hospitals at 12-20 per cent; for Fortis, it is in lower single digits. This is expected to change as business trust costs come down and hospitals mature.

The downside risk would be inability to make a timely closure of the acquisition or scale up the hospitals and diagnostic business margins. Also, if the diagnostic space sees increased competition, it could hurt revenue growth and delay SRL's margin improvement.

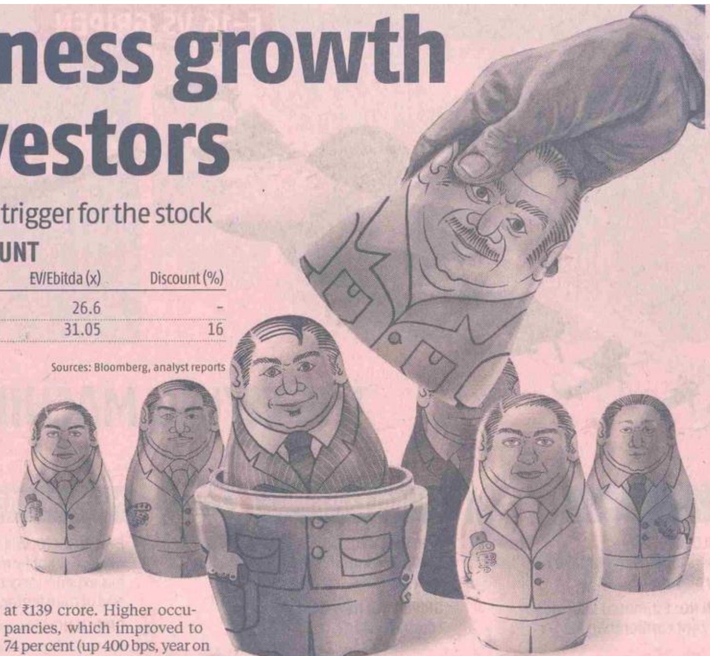
VALUATIONS AT A DISCOUNT

Company	Ebitda (%)	EV/Ebitda (x)	Discount (%)
SRL	24-25	26.6	-
Dr Lal PathLabs	25.6	31.05	16

All numbers are FY17 estimates
Compiled by BS Research Bureau
Sources: Bloomberg, analyst reports

FORTIS: STRONG GROWTH AHEAD

E: Estimates, Source: Bloomberg



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LIVE MARKET

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