الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

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**Significant provisions were the highlight of healthcare Q4-2016 earnings, setting the scene for a disappointing set of results for FY2016. Sizable expansions are expected to rollout on FY2017. Tighter margins are estimated to take effect in early low utilization post expansion phase. Receivables remain as a central concern going forward. We reiterate our positive outlook on the sector. However, we are "Neutral" on sector companies under coverage based on limited upside potential at current multiples.**

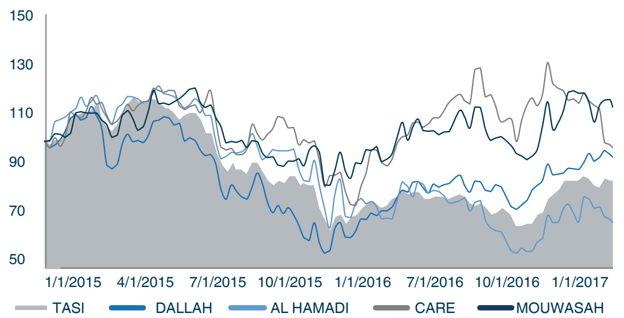
**Disappointing set of Q4-2016 results:** Unprecedented provisions and impairments were the highlight of Q4-2016 results. Al Hammadi, Care, and Dallah took higher than expected provisions for the quarter. Care and Al Hammadi, however, were hit the hardest this quarter. Care ended the quarter with a SAR 71mn loss against consensus of a profitable quarter at SAR 36mn. Al Hammadi on the other hand, recorded a 70% decline YoY this quarter, net income stood at SAR 10.7mn compared to the consensus of SAR 30.1mn registering a 66.7% deviation. Dallah reported lower than expected net income, in line with this quarter's theme, net income for the quarter stood at SAR 52mn, a 4.7% decline YoY, and 18.9% below consensus. Mouwasat was the outlier this quarter, reporting a relatively impressive set of quarterly results. The company recorded 34% growth YoY for Q4-2016 with net income standing at SAR 72.2mn, significantly above consensus of around SAR 58.4mn. With the exception of Care, sector quarterly top line recorded healthy growth levels, largely in line with estimates. On an annual basis, reported sector revenues witnessed solid growth levels, up 11.4% YoY, while total net income for the full period declined 6.7% YoY.

## Key Sector Data

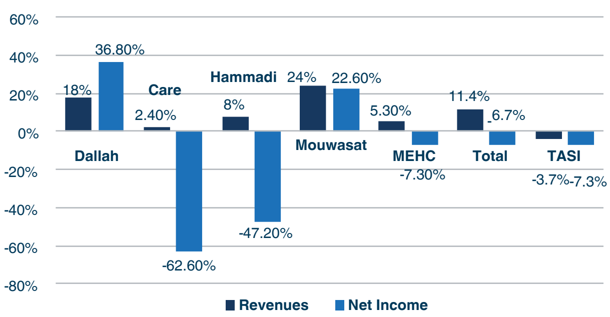
| | |
|---|---|
| No. of companies | 5 |
| M.Cap (SAR) bn | 10.28 |
| YTD % | -7.61% |
| Div. Yld % | 1.82% |
| PE | 27.4x |
| PB | 3.82x |
| ROE | 14.36 |
| EV/EBITDA | 19.9x |
| Net debt | 0.30x |

As on 13th Feb 2017

### Price Performance (Indexed)




### Revenue and Net Income Growth % YoY FY2016




**Tighter FY2016 margins on weak Q4-2016 set of results:** Sector gross margins have shown minor growth by the end of FY2016, an increase of 29bps, from 42.83% in FY2015 to 43.12%. Operating margins declined significantly, down to 19.12% from 21.65% last year; down 253bps. Most of the recorded declines in operating margins were during Q4 (with the exception of Dallah, sector companies recorded a decline in margins), attributed mostly to provisions and relatively prudent revenue recognition during the quarter compared to FY2015 and previous quarters. Tighter margins are estimated to take effect in FY2018 onwards on the back of expensing capitalized interest, higher depreciation charges post expansion, as well as the risk of relatively higher wages (around 50% of healthcare sector COGS).

| | Recommendation | PT (SAR/share) | Upside/ (Downside) | YTD % | EPS FY2017 | Forward PE |
|---|---|---|---|---|---|---|
| Dallah | Neutral | 103.5 | 6.4% | 2.4% | 4.00 | 24.3x |
| Care | Neutral | 51.2 | -3.7% | -19.2% | 3.13 | 17.0x |
| Hammadi | Neutral | 34.5 | -5.5% | -14.3% | 1.17 | 30.4x |
| Mouwasat | Neutral | 131.1 | -5.8% | -5.8% | 5.96 | 23.3x |

*prices as of 13th Feb 2017

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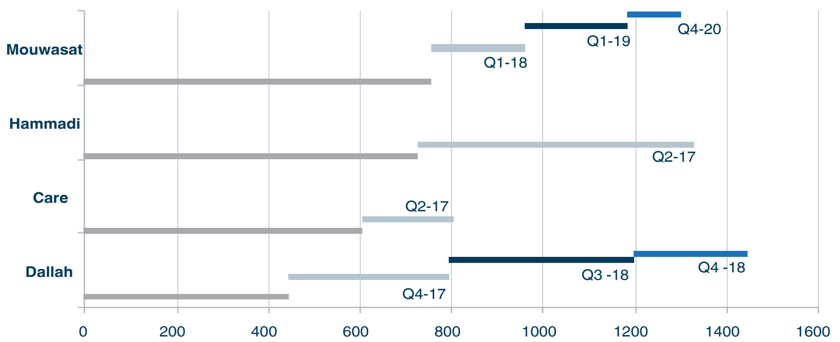
**Healthcare upcoming expansion plans includes 1,768 bedding capacity and more than 600 clinics with total capital expenditure of above SAR3.0bn by 2020. The size of sector expansions unfolds a level of execution risk in the form of potential delays and initial losses:** In its recent budget announcement, the government declared that it is decreasing its allocation for healthcare. However, the private healthcare sector remains unfazed. Dallah Healthcare is expected to add 958 beds in three major projects costs SAR2,200mn to reach a total bedding capacity of 1,406 by 3Q2018. Mouwasat recently announced the acquisition of land parcel in KEC for the planned hospital in Madinah, the hospital is expected to raise operating capacity in Madinah by 51% (currently stands at 120 beds) by the end of FY2020 to reach a total bedding capacity of 1,260 by the end of FY2020. Care and Al Hammadi are expected to add 200 and 600 beds respectively within FY2017. The size of sector expansions retains a level of execution risk in the form of potential delays. A look at Rev/Bed multiples show noticeable growth YoY (even after controlling for in-patient and out-patient revenue). All else equal, taking Rev/Bed multiples and ROC as basis for estimating value added from planned expansions, Dallah and Middle East Healthcare are in a favorable position compared to sector companies.

**Healthcare Expansion Timeline**

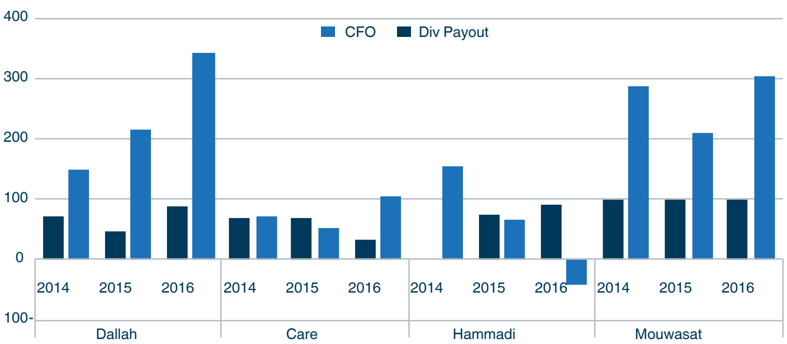



Source: Company reports, AJCR

*Large addition are expected to take effect in FY2017, an estimated 1,100 beds and 250 clinics, most of which will be contributed by Al-Hammadi's upcoming addition of Al Nuzha Hospital.*

**Reasonable levels of operating cash flows among sector companies, high capex from expansion plans pressure ST FCF:** Sector CFO for FY2016 was moderately pressured by receivables. Among sector companies, Dallah has the highest CFO/NI conversion ratio, followed by Mouwasat. Companies with the largest expansions exhibit the lowest CFO/Capex ratios, adding dividends to the equation point out sector companies' inability to sustain current capex and dividends levels without leverage and a higher level of receivables recovery. Assuming capex would eventually wind down from current levels, healthcare companies are likely to stand in a favourable position in terms of FCF and dividends; higher DPS are estimated to take place in the medium to long term, justifying valuations at the current range from a LT dividend yield perspective. Assuming current cash flow conversion and return ratios, LT FCF broadly justifies sector premiums.

**Dividend Pay-out* and Operating Cash Flow**

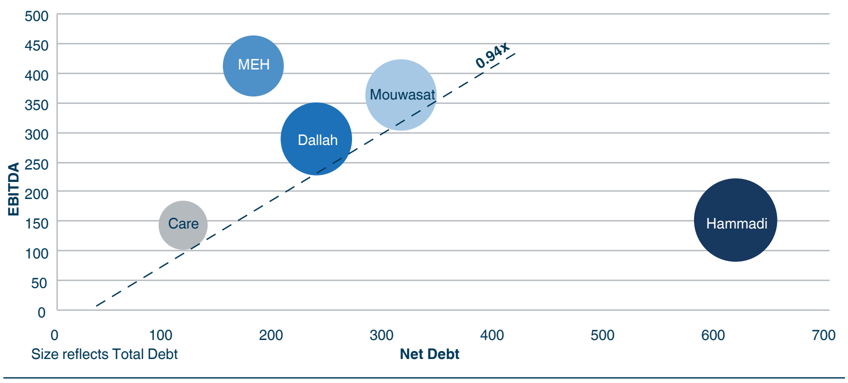



Actual cash outflow during the year.
Source: Company reports, AJCR

*Mouwasat and Dallah stand in a positive position in terms of maintaining and increasing DPS going forward. Mouwasat have recently announced a dividend increase of 25% for FY2016 to be distributed in FY2017. Al-Hammadi on the other hand is estimated to pull back on DPS for FY2017.*

**Steady growth in sector debt levels, further debt additions estimated to take place on FY2017:** Healthcare companies continued to accumulate debt throughout FY2016. Total debt net additions during the year stood at SAR 506mn (a 46% increase YoY) leaving total sector Debt/Equity levels to stand at 0.31x. Debt servicing costs are estimated to increase for the sector post current project capitalization. Net debt to EBITDA levels vary among sector companies, Al-Hammadi remains as the only company with concerning Net Debt\EBITDA levels (currently at 4.05x compared to 0.94x for the sector) which is partially due to depressed EBITDA throughout FY2016 and a disappointing set of Q4-2016 results.

**Net Debt / EBITDA & Total Debt Size**

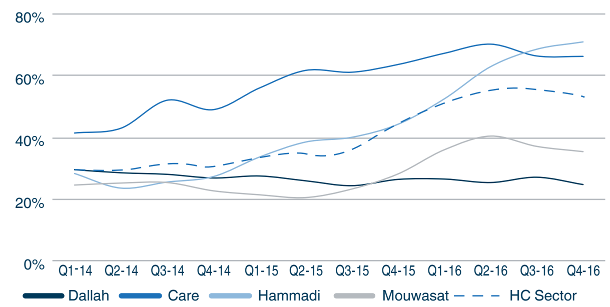



Source: Bloomberg, AJC

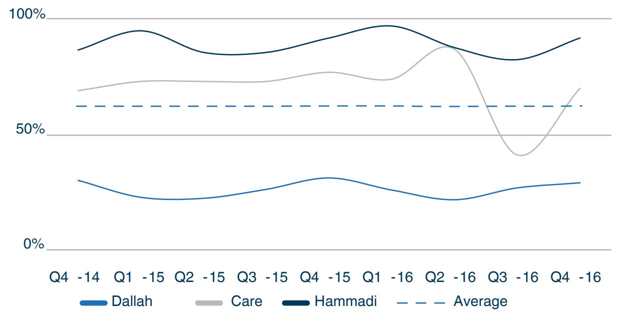
*Sector Net debt / EBITDA stand at 0.94x. Debt servicing costs are estimated to increase for the sector post current project capitalization. Al-Hammadi holds the highest risk from that end given a significantly higher ratio of 4.05x, forward EBITDA presents a better indicator for a company in that position. MEH stands at a relative favourable position of 0.43x.*

**Receivables remain a concern, sector companies recorded large provisions for doubtful accounts on Q4-2016; during FY2017, more prudent inclined approach on receivables, evident in higher provisions, will likely take place:** Unprecedented provisions for doubtful debt were recorded by Care and Al-Hammadi on Q4-2016 results. Receivables peaked on Q3-2016. Healthcare companies had relatively large receivables. Exposure to government entities; however, differ largely from one company to the other. Al-Hammadi and Care had the largest exposure to government receivables, Care managed to lower its exposure on Q3-2016 to stand at around 41% of receivables compared to Al Hammadi's 83% exposure. Dallah is well positioned in terms of receivables concentration (29% Gov exposure as of Q4-2016) compared to sector companies. Receivables recoverability remains a concern going forward. In terms of Q4-2016 provisions, given Al- Hammadi' receivables breakdown, the company stands in a relatively favourable position compared to Care. We estimate Al Hammadi is likely to recover a portion of provisions and write-offs taken on Q4-2016. The uncertainty remains in whether the receivables cycle, provisions, and settlements that took place in FY2016 will repeat itself in FY2017. Prolonged receivables concentration and slower cash conversion would cost the sector in increased ST financing cost.  Provisions as a % of receivables have shown significant increase by the end of FY2016. Our FY2017 estimates assume a relatively conservative approach on receivables going forward. In due course, a clearer relationship is likely to show between health care receivables and insurance outstanding claims data.

**Accounts Receivables as a % of Sales**




**Government and large insurance Receivables as a % of Acc Rec**




Source: Company reports, AJCR
* Al-Hammadi includes top 4 insurance companies
** Mouwasat does not provide quarterly data on receivables concentration

**Valuations price-in sector expansion upside and receivable concerns, we are "Neutral" on sector companies under coverage:** Recent gains in Healthcare companies reflect and fully price-in positive LT outlook. Current sector multiples reflect a premium compared to TASI. Sector PE and PB stand at 27.4x and 3.9x respectively compared to a 3-year historical annual average PE of 32.6x (weekly average stands at 29.6x). The decline in sector multiples took place post a disappointing Q4-2016 set of results. Sector ROE exhibited a similar pattern for the same period.

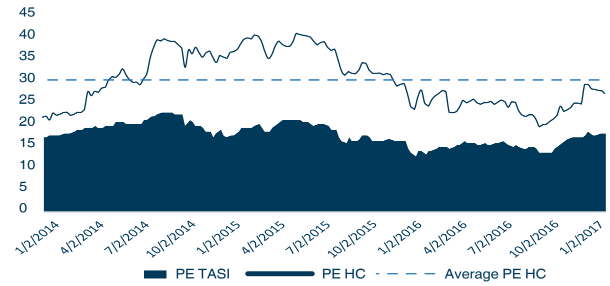
Al-Hammadi is currently trading at a T12-month PE of 58x and an estimated FY2017 forward PE of 30.4x, above TASI and in line with sector multiples, effectively pricing in the expansion estimated to take place in H2-2017(Al- Nuzha Hospital - 95% complete). Concerns remain on the debt and receivables end for the company; a level of receivable recoverability is estimated to take effect during FY2017. Upside and downside risks to valuation hinge on the level of receivables concentration going forward along with utilization of Al-Nuzha hospital. We remain "Neutral" on the company with a PT of SAR 34.5/ share.

We maintain our "Neutral" recommendation on Care with a PT of SAR 51.2 / share. The company is currently trading at a PE and PB of 49.6x and 2.6x respectively. Forward FY2017 PE is estimated at 17.0x. The company is expected to take a more conservative approach on receivables going forward. A 200 bed – 40 clinic expansion is expected to take effect on H1-2017. From an expansion standpoint, the upcoming addition is estimated to add 22%-27% to top line once fully operational. The recent impairments, provisions, and allowance for doubtful debt have added pressure on company expectations and multiples. We maintain the potential for an upgrade on the back of better than estimated receivables recoverability on Q1-2017 which is marked as the main upside risk to valuation.

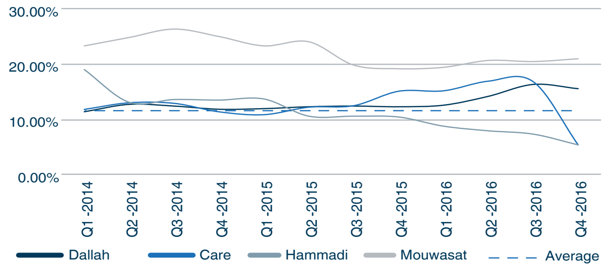
Mouwasat is trading at a T12-month PE of 26.7x, in line with sector multiples. Estimated forward PE stands at 23.3x with an estimated FY2017 EPS of SAR 5.96 per share. FY2016 top line saw a lift from the Riyadh hospital and the Jubail extension. The company's expansion plans are mostly scheduled at later dates compared to sector peers. Comparatively high ROC and ROE (relative to sector peers) reflects favorably on estimated forward multiples post expansion completion. We remain "Neutral" on the company with an updated PT of SAR 131.1/share.

We downgrade our recommendation on Dallah to "Neutral" with an unchanged PT of SAR103.5/ share. T12 PE currently stands at 25.1x while estimated forward PE stands at 24.3x. Dallah maintains a favourable position in terms of receivables concentration compared to sector companies. Large growth plans are estimated to weigh on earnings growth (assuming initial operating loss on expansions). FY2017 EPS is estimated at SAR 4.0 per share growing 4.4% YoY, the deceleration in growth in FY2017 is mostly attributed to a higher base point.

**Healthcare vs TASI multiples**




**Healthcare Sector ROE**




Source: Bloomberg, Company reports, AJCR

**NTP outlined healthcare initiatives, privatization to play a major role, starting with outsourcing MOH facilities operations:** Privatization of healthcare in the kingdom is becoming essential, as the state-funded public healthcare system is below par relative to OECD standards. A portion of healthcare capital expenditure shall be shifted to private entities, creating investment opportunities in the process while the MOH will likely introduce a form of site neutral pay insurance program. The first phase of privatization taking place involves outsourcing MOH hospital operations. Privatization efforts will come hand in hand with the National Transformation Program (NTP) initiatives, in which private sector participation plays a major role.

## National Transformation Program Initiatives

| Key Performance Indicator | Baseline | 2020 Target | International Benchmark |
|---|---|---|---|
| Private Sector contribution in total healthcare spend | 25% | 35% | 60% |
| Saudi citizens who have unified digital medical record | 0% | 70% | 100% |
| Licensed medical facilities (affiliated with MoH and private) | 40% | 100% | 100% |
| Revenue generated from private sector for utilizing government health resources (SARbn) | 0.3 | 4.0 | N/A |
| Primary healthcare visits per capita | 2.0 | 4.0 | 7.0 |
| Hospitals that meet the US median for patient safety culture | 10% | 50% | 50% |
| Healthcare facilities reporting comprehensive performance & quality measures | 10% | 100% | 100% |

Source: National Transformation Program

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RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated “Overweight” will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated “Underweight” would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated “Neutral” is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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