Al Rajhi Capital

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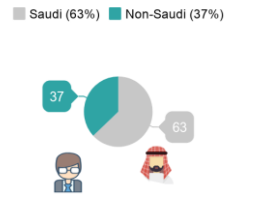
Saudi Healthcare Industry
Update on sector trends

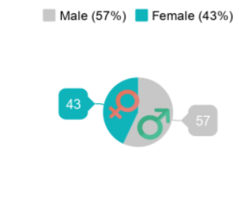
Key takeaways

- Ehala Program will continue to boost Ministry of Health (MoH) referrals at private hospitals.
- The private sector added four new hospitals in 2018 so far, with total capacity of 1020 beds and 185 clinics. The initial plan during project conception stage was to cater to expats but now has changed to Saudi nationals.
- Average number of patients have dropped by ~8% in 2018
- CCHI has increased the deductibles from insurance patients, which could be slightly negative for hospitals.
- The insurance sector continued to remain the major source of revenue for private hospitals in 2018, despite the negative impact of the exodus of expats due to dependent fees, aims rising the government share in total revenue.
- The contribution of the private sector to total healthcare spending is 25% currently and is expected to reach 35% by 2020, as per Government's NTP 2020.
- Specialised centres and geographical expansions are likely to remain the key growth drivers for private hospitals in the near-term.
- Declining patient volume on account of expats departure coupled with rising operating expenses due to Saudization are the primary concerns for the sector.

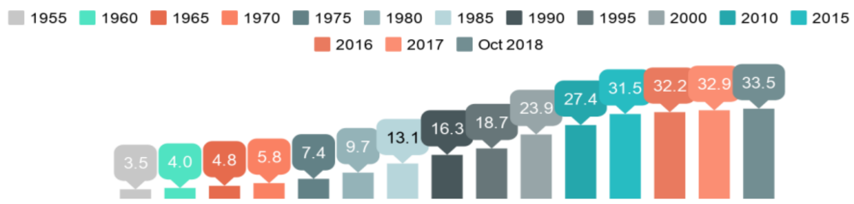
The structure of healthcare industry in Saudi Arabia is somewhat different from that of the sector globally. This report touches these reasons including Saudis lifestyle, differences between demand and supply for public and private hospitals, breakdown of revenue for hospitals, opportunities and threats for private healthcare providers in near term.



Citizens breakdown
Source: GASTAT



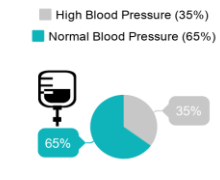
Gender breakdown
Source: GASTAT



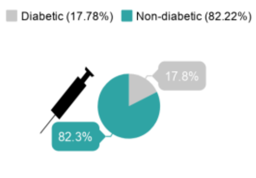
Saudi Arabia population from 1955 to Oct2018 (in Million)
Source: GASTAT

Demography and Lifestyle

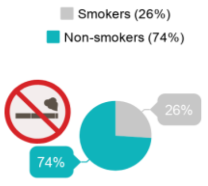
Saudi Arabia's average population growth rate is 2.5%, significantly higher than the world's average of 1.1%. As of October 2018, total population in Saudi Arabia reached 33.5mn with 63% Saudi and 37% expats. We note that the lifestyle of Saudi people generally has been linked with less physical activities, resulting in high number of obesity cases (35% of adults over the age of 18, according to WHO), high blood pressure and diabetes cases (2017: 17.78% diabetes prevalence rate for the age group of 20-79 years, +3.8mn cases). Further, high level of obesity has been leading to the growth in the highly profitable cosmetic surgery market in the Gulf countries, which have witnessed the highest number of obesity treatments including gastric immobilization, gastric bypass surgery and gastric bypass.



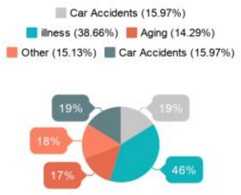
HBP numbers
Source: Moh



Diabetes numbers
Source: Moh



Smoking numbers
Source: Moh

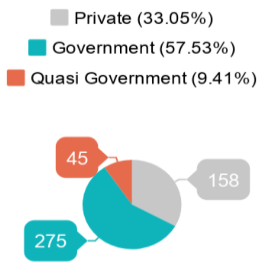


Death causes
Source: CDC

Additionally, the recklessness attitude and unawareness among the youth in Saudi Arabia have resulted into high number of car accident injuries (traffic accidents cause an average of 20 deaths daily in the Kingdom, according to Ministry of Transport) and higher smokers (26% of adults, who are aged 15+, smokes, according to WHO).

MoH has undertaken various initiatives to increase awareness among people, which should help in curbing the growth in the number of smokers as well as diabetes patients going forward. In addition, there is a shift in the spending patterns of Saudis due to rise in the living costs (higher fuel & utility expenses) post various governmental' structural reforms. Even healthcare spending was not immune to this trend as sickness has been seen as a cost. Further, we also observed that few patients have shifted to public hospitals, due to low disposable income, despite longer waiting time. On the other hand, the rise of female participation in the labour force is likely to increase spending towards private hospitals, specially through specialized centres such as cosmetic and obesity.

Supply & demand

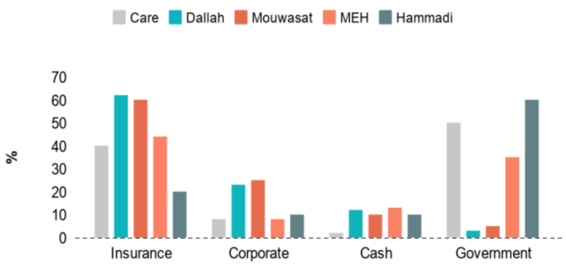


Number of Hospitals
Source: Moh

In terms of supply, both private & public hospitals provide almost the same services, however what differs is the capacity, quality, waiting time and most importantly, efficiency. Private hospitals provide a range of quality services to their patients including backup analytics, with a full medical experience but at a high cost. This supply dynamics may change in the long run as the government is encouraging the private sector participation in the healthcare sector as the public sector's role is gradually transitioned to becoming more of a regulator rather than as a provider of healthcare facilities, as highlighted in the National Transformation Plan (NTP) and the privatization plan. The contribution of the private sector to total healthcare spending is 25% currently, which is expected to reach 35% by 2020, as per the government's NTP 2020.

For Saudi citizens, the demand for healthcare services through private hospitals focuses more on treating medical cases such as seasonal illnesses, minor fractures, delivery surgeries and cosmetic treatments, largely on the back of the pool of experienced doctors, coupled with lesser waiting time. On the other hand, the importance of government hospitals is mostly for the treatment of severe medical conditions, for an example, Cancer, Internal Medicine and Ophthalmology. Nonetheless, those, who can afford the treatment, either through cash or insurance coverage, prefer to go to private hospitals.

Business Model



Revenue sources breakdown
Source: Company data, Al Rajhi Capital

The insurance sector continued to remain the major source of revenue for private hospitals in 2018, despite the negative impact of the exodus of expats due to dependent fees, amid rising the government share in total revenue. Meanwhile, the Ministry of Health (MoH)'s collaboration with private hospitals through Ehala Program may put pressure on receivables. We observed that Hammadi hospital has increased business with the government more than others after winning a deal to provide vaccines to the government health authorities, which enables the company maintain the revenue growth in future, despite a reduction in the number of patients and prices.

Going forward, as the number of expats are likely to continue decline, we expect the revenue contribution from the insurance sector will remain under pressure. Further, we believe that the hospitals should improve their business model by dealings with the government and opening more specialized centres to cater wealthy clients.

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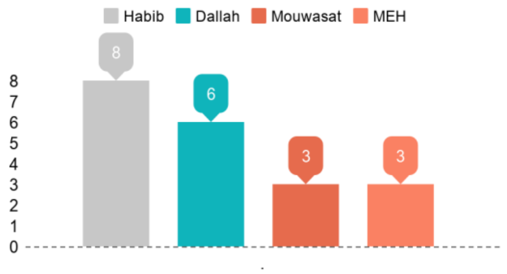
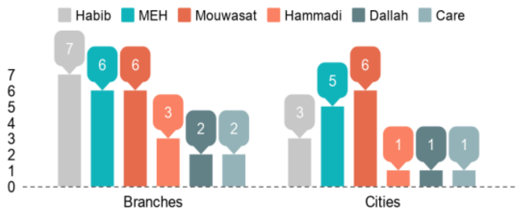
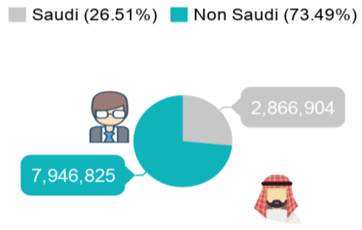


Specialized Clinics per Hospital





Saudization in Private healthcare provider

Source: CCHI, Moh, Al Rajhi capital

Near future outlook for the private sector

Opportunities

Specialized clinics

For the private sector, the best way to increase and diversify revenue stream is to create more specialized clinics such as cosmetic, obesity, dental and delivery. In addition, these types of clinics offer high margins, along with immediate realization post treatment, which will ease pressure on receivables. We note that Dr. Suliman Al Habib hospitals is the market leader in this business model among the private hospitals and we believe others should follow the same.

Expansions

We noticed that three out of the five listed hospitals are located only in Riyadh, which provides them a room for geographical expansion. This will help them to increase their client base (providing more negotiating power with insurance companies) and target special medical cases (such as Beverly Clinics from MEAHCO). Makkah city , for an example, is considered as one of the attractive locations, given high population amid low number of beds availability. Additionally, Yanbu city, is an another potential market, where there are less number of private hospitals despite most of citizens being labour workers with insurance cover.

Threats

Expat levy

The major threat for the sector is the exodus of expats due to levy imposed on them and their dependents by Saudi government in July 2017. Since the beginning of 2018, around 1.3mn expats have already left the Kingdom. Given that the expats fee is set to increase to SAR400 a month in July 2020, we expect the expats to continue decline in the periods, which is a potential threat for private healthcare providers, as the majority of their patients are expats. Moreover, this factor also hurts the insurance companies, which forced them to bargain for more discounts from the healthcare providers. We noticed that the aggregate income of listed healthcare companies declined ~21% during the 9M 2018.

Saudization

The number of expatriate workers in the private sector has reached 111,100 (89%) compared to 12,900 (11%) Saudis. The total number of doctors in private hospitals and healthcare centres has reached to 33,800 with the Saudization rate of 8%. The staff cost of hospitals in Saudi Arabia is likely to increase due to the government's continuous push towards higher Saudization rate given the fact that Saudi worker gets higher salary than expats.

Here we are providing our notes and views taken from companies Q3 conference calls, direct meetings and news.

Dallah Healthcare

Overall highlights

- Under Hospitals segment, this year the company added Namar hospital (in the southwest of Riyadh area) with beds capacity of 150 beds and 100 clinics (1st stage) which can be further increased to 400 beds and 200 clinics with the minimal costs because infrastructure is already in place now.
- Nakheel hospital has 450 beds and around 200 clinics. West expansion of Nakheel hospital is underway and is likely to complete by of 2H19 with capacity of 150 beds and 30 clinics. Company continue to operate at maximum capacity for Nakheel (may be 2-3% lower than 2017).
- The company is hopeful to add more 250 beds and 100 clinics in the Namar hospital.
- The company plans to complete all their expansions over the next 3 to 4 years may be by FY 2021.
- Under Pharma segment, the company is involved into manufacturing and distribution with manufacturing facility for engineering & generic products in Jeddah. The company is trying to increase the number of products from the segment.
- Under Operations & Management which is related to operating third party hospitals. The company did not have much activity in 2018 so far other than the bidding because number of beds in private and public sector declined this year. There is one contract which is company is likely to start from early 2019.
- The company mentioned that both Nakheel and Namar hospitals are general hospitals but have all the specialties. Dallah hospitals are pioneer in few specialties in the domestic private sector such as IVF baby delivery, use of ratio active materials, heart surgery etc.
- Due to the recent labor laws, fees and family levy, expats population declined considerably this year.
- There had been significant shift in patients from government sector to private sector due to demand for high quality facilities during 2012-16.
- In the Outpatients market, average visit per person in the government hospitals declined by 9% while it increased by 2.6% in the private hospitals during 2012-16. That means market share of government sector declined by 4% while market share of private sector rose by 8%.
- In the inpatients market, number of patients declined by 30% in the Government sector while increased by 25% in the private sector during 2012-16. Market share for the government sector dropped by 25% while it increased by 48% for the private sector.
- GOSI subscribers (Saudi) increased by 3.8% y/y in 1H18 while GOSI subscribers (non-Saudi) declined by 11% y/y. Total impact was drop of 8.6% y/y.
- In Riyadh only, GOSI subscribers (Saudi) increased by 4.7% y/y in 1H18 while GOSI subscribers (non-Saudi) declined by 8.2% y/y. Total impact was drop of 5.8% y/y.

- The company holds 31% stake in Dr. Mohammed Alfaglh Co. Hospital (capacity of around 300 beds (150 beds initially) and 150 clinics (70-80 clinics initially) which is under construction and is likely to
- complete by the end of 2Q19. This hospital will be managed by Dallah under operations & management division. In terms of product mix, it will be general hospital.
- In outpatients segment, the company had 797,000 patients in 9M17 which declined to 781,000 in 9M18.
- In inpatients segment, number of patients declined by 2,000 from 30,000 in 9M17 to 28,000 in 9M18.
- The company mentioned declining Riyadh population resulted in lower patient volume.
- The company's EBITDA margins declined due to pre-operating expenses related to Namar hospital, however, cost control measures helped lower drop in margins.
- Net income margins dropped to 13% in 9M18 from 26% in 9M17 as a result of drop in sales in Nakheel are and slow ramp up at Namar hospital.
- There was increase in selling expenses due to channel expansion by Dallah Pharma.
- The company changed number of years from 33 years to 55 years for depreciation calculations for building which resulted in savings of SAR 4.5mn this quarter and is expected to save SAR 17mn annually. This was in line with the experts recommendations.
- The company had revenues around 2-3% from Ministry of Health cases in 2017, so there was no impact due to the price changes for the procedures.
- The company is accepting more government/ MOH referrals (already signed with them) for the Namar hospital due to excess capacity.
- For Namar, the company has signed contract with Tawuniya. Discussion with Bupa is in final stage. These contracts are likely to support higher ramp up at Namar hospital (current utilization is very low) in the coming periods. The company has also signed contract with SIECO. The company is in final discussions with Aramco.
- The company continues to offer deep discounts for Namar hospital to increase the business; however, there is no change in pricing for Nakheel area.
- Q3 2018 receivables days increased marginally due to low base of last year as the company collected lots of pending receivables in 3Q17.
- Capacity is increasing in the Riyadh area mainly due to new hospital openings in the private sector. Currently, there are 2.3 beds available per 1,000 people and the government has target of 2.7 beds per 1,000 people. So there is still room of further additional capacity in the area. Jeddah and Makkah areas are also likely to see more capacity.
- The company has best retention rate (13-15 years for Doctors) in the KSA.
- The company continues to focus on insurance companies as it contributes 62% of the business.

- In Nakheel area, 85% patients are Saudi. There is some decline in Saudi patients due to policy downgrade from class A to class B. The company expects more favorable business outlook from 2H19 in the Riyadh area.
- The company is the biggest services provider for Aramco (one analyst mentioned it is around 18% of Nakheel hospital revenues) in Riyadh. There are some price revisions expected with Aramco by the next contract update.
- The company break even period around 18-24 months for a new hospital and the company expects Namar hospital to break even by end of FY19.
- The company remains committed to dividend payout of 40-65% in the coming periods.
- The company looks to complete negotiations with third party soon and start pre development for Jeddah hospital.
- The company's cost of operations generally increases in line with inflation rate trends.

National Medical Care

Overall highlights

- Reason for increase in revenue per client from MOH; decline in insurance: the company is accepting higher number of cases as compared to previous year from MOH; decline in revenue per client from insurance is due to lower number of patients (reduction in expat population) and general decline in footfalls in the hospitals.
- Update on layoffs, staff reduction: The company reduced its staff as of its strategy to improve productivity and efficiency of the operations. Currently, company has employed 300+ doctors.
- In the beginning of 2018, the company had started initiatives to reach benchmark margins and the company is moving in the right direction and this process is likely to take 24-36 months.
- Expansion plans: National hospital: current capacity of 335 beds, the company is in process of receiving approvals from government authorities; expect to reach capacity of 400 beds by Q1 2019; ultimate target is 495 beds for National hospital; construction is already completed, hence no capex required; for Riyadh hospital current capacity is 330 beds.
- Drop in revenue due to lower number of patients, contract with GOSI at the beginning in year which contributed in growth in terms of value; no changes in pricing.
- The company too SAR7.5mn hit in revenue from insurance settlement (the case pertains to FY2016-17) the final number was higher than the provision, however the company has adequate provision for any such event in the future.
- The company hasn't started any discussion with GOSI for 2019 contract pricing as of now.
- Regarding pricing with MOH, they generally issue their own price list (they do not discuss pricing on individual hospital levels) which is for the whole market.

- Utilization rates: Previous year utilization rate was 70%; for 2018 average utilization rate is 81%.
- Contract with National Guard and Aramco; the contract with national Guard is revenue based and is capped at 200 beds
- The company reiterated that the deal between NMCC and Hassana is between the shareholders of the two companies. There are no other plans of acquisitions.
- Reason for decline in volumes: the decline came largely from GOSI and insurance patients; insurance patients contribute ~16% of total revenue; main revenue drivers are GOSI, MOH, National guard and Aramco; decline in expat population (mostly insurance patients) is not expected to impact the top-line in a major way.
- Revenue split: 55% of revenue is generated from in-patients and 45% from out-patients
- Revenue per patient from Insurance declined by 7.3% YTD which is mainly on account of expats exodus.
- On CCHI's new table of benefits for medical insurance, the company said they expect very limited impact considering the company's business exposure of only 16-17%.
- Ideally the company expects payment from government authorities in six months, but actual remittance is received in 7-10 months; delay from GOSI due to system issues which delayed submission of claims and receipt of money; some cash flows expected from government agencies soon.

Mouwasat

- Revenue breakdown: 10% Cash, Aramco 16%, GOV& Companies 14% , Insurance 60%
- More than 90% of Mouwasat hospitals patients are Saudi nationals.
- Number of patients witnessed an increase this year despite expat levy, backed mainly by increase dealings with Moh.
- This is coincidentally the key reason behind receivables jump.
- The utilization of Al Khobar which opened in Q3 2018 is better than management expectation.
- Mouwasat wasn't forced to give any discounts to insurance companies for Khobar hospital.
- The hospital doesn't pay levy for its Expat employees as they pay themselves.
- The required Saudisation rate is 32% with which Mouwasat is compliant.
- Damam expansion project (+204 beds) is expected to be opened by 2020
- Madina Hospital project (400 beds) is expected to be opened Q1 2021

Al Hammadi Hospitals

54% top line growth was driven by mainly the jump in pharmaceutical revenue after the acquisition of Medical Support Services Company and the increase of Nuzha hospital's utilization rate.

- Going forward, the increase in revenues from pharmaceutical segment will ensure revenue growth sustainability in short term, specially that the hospitals revenue is witnessing a decline as number of patients fell due to overall macro concerns of expat levy and decrease in disposable income. On the other hand, this has resulted into higher levels of receivables, thereby raising debt to meet its working capital requirements.
- The company has signed with major insurance players for Nuzha Hospital during this quarter and utilization rate started to pick up.
- Al Hammadi Company for Development and Investment's fully-owned subsidiary was awarded on Dec. 5, a SAR 20 million deal to supply vaccines to the Ministry of Health. The final contract is expected to be signed on March, 31, 2019. The deal has no related parties, and its financial impact is likely to show on Q1 2019 results. The company succeeded to increase dealing with Moh through pharmaceutical sector, which is a smart way to increase revenue while the hospital sector is facing drop in number of patients, but it will add more pressure to receivables.

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Al Rajhi Capital uses a three-tier rating system based on absolute upside or downside potential for all stocks under its coverage except financial stocks and those few other companies not compliant with Islamic Shariah law:

"Overweight": Our target price is more than 10% above the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company’s profits or operating performance exceed or fall short of our expectations.

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