

We recently worked on a company operating hospitals and healthcare centers in India. While low penetration of healthcare services, rising disposable income and affordability etc. offer high growth potential for the sector, our in-depth analysis of the company revealed perils of growth and raised concerns over the Quality of Earnings.

Our key concerns include:

Complex restructuring arrangement resulting in frequent changes in scope of consolidation and loss-making entity staying off the company's books.

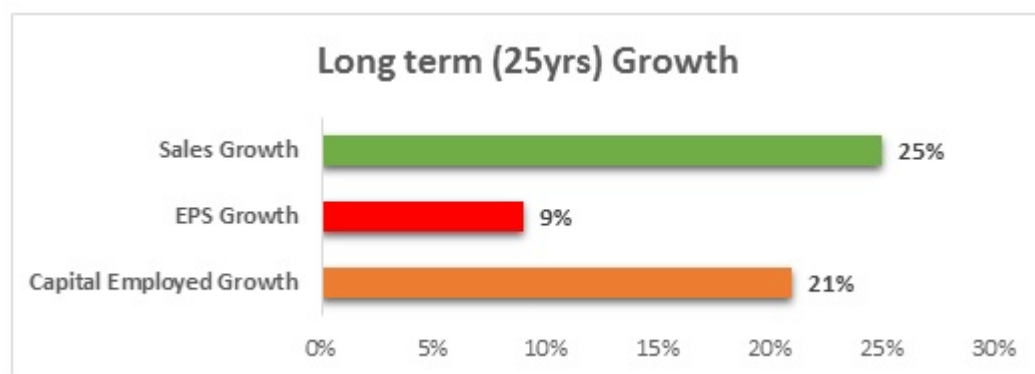
High related party transactions at favorable credit terms.

Heavy reliance on capital markets to fund the expansion.

High level of pledged shares.

Fundamental Analysis:

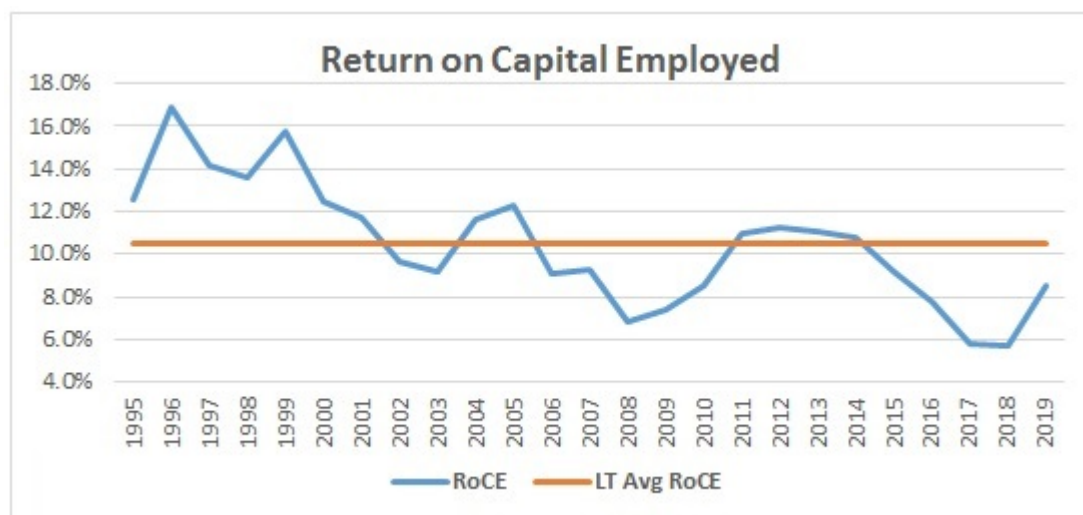
The company has been operating in the healthcare industry for more than 25 years and flaunts an astonishing sales growth of 25% p.a. over the last 25 years. The growth has slowed down in recent years, but it is still growing at more than 15% p.a.



*Source: Company's Annual Reports and Multi-Act research.*

However, such eye catching sales growth hasn't resulted in commensurate growth in shareholders' value. During last 25 years EPS has grown at only 9% p.a., whereas in last five years EPS growth has been negative. To generate this growth, the company has had to continuously pour in additional capital. In last 25 years growth in Capital Employed was 21%

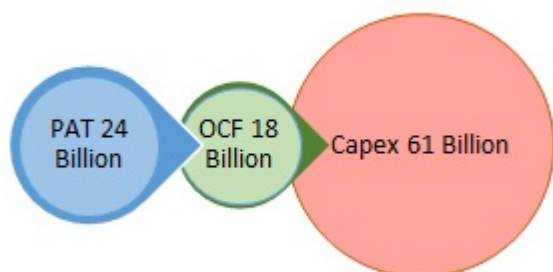
p.a.



Source: Company's Annual Reports and Multi-Act research.

The company's long-term average Return on Capital Employed (RoCE) is just above 10% as against its cost of debt of ~9%. It means the returns are barely covering the cost of debt. We would argue that the equity risk premium does not compensate for the additional risk undertaken by equity capital providers.

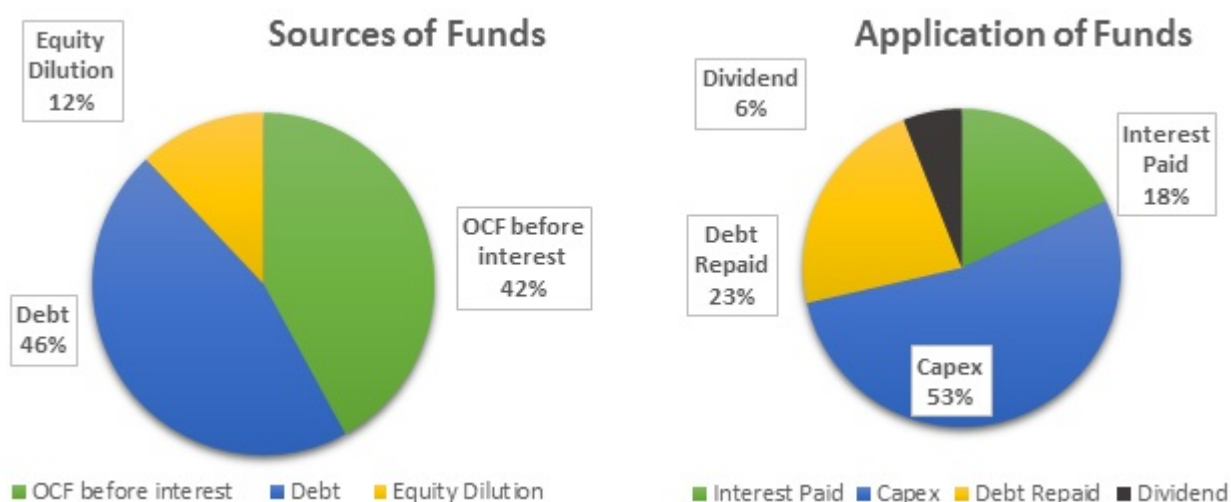
To add to company's woes the 10% RoCE is only in the Book of Accounts and not adding anything significant to the Bank Accounts. The company has not generated any Free Cash Flow over last 25 years. Entire cash generated from operations is required for business expansion.



Source: Company's Annual Reports and Multi-Act research.

Between 2010 and 2019, as against the cumulative Profit after Tax (PAT) of INR 24 billion, the company generated INR 18 billion of Operating Cash Flow (OCF). In that same period the company incurred capital expenditure (Capex) of INR 61 billion and paid dividend of INR 7 billion. The shortfall was funded by raising debt and issuing new equity.

During last ten years, sources and application of funds were as follows:



Source: Company's Annual Reports and Multi-Act research.

Most of the capital expenditure was for setting up new hospitals and clinics. Even though currently the company's RoCE is below cost of capital, our analysis of hospital industry indicated that mature, well managed hospitals could earn decent margins and returns. So, there was a possibility of improvement in fundamentals once company moves from the current growth phase to a mature phase.

In such company's investment gains are possible if

The company survives till it reaches the maturity phase.

It has a good Corporate Governance.

Investors have applied a sufficient margin of safety while buying.

1. Company's ability to survive bad patches depends on its financial strength

#### 1A. Leverage

The company's debt exceeds its net worth. Additionally, the company has significant contingent liabilities in the form of Bank and Corporate Guarantees.

Financial Position	Mar-19	Leverage Ratios	Mar-19
Total Debt	36,713		
Other Obligations	8,066		
Cash & Investments	4,432		
Net Debt	40,347	Net Debt/Equity	1.16
Equity	34,689		
Contingent Liabilities	10,232	Contingent Liability / Equity	0.29

Source: Company's Annual Reports and Multi-Act research.

#### 1B. Pledged Shares

A significant part of total promoters' shareholdings is pledged. Some promoters have pledged almost all their shares with the lenders. High level of pledged share poses a risk of sell off by lenders in the events of market price decline or failure to repay borrowings by promoters.

Quarter End	Mar-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
No of shares pledged (million)	32.1	32.8	35.2	35.3	35.8	37.4	34.1
Pledged shares as % of promoters' holding	67.2%	68.5%	73.6%	73.7%	74.8%	78.1%	71.3%
Pledged shares as % of company's total shares	23.1%	23.6%	25.3%	25.4%	25.7%	26.9%	24.5%

Source: BSE Filings – Shareholding Pattern.

### 1C. Debt Servicing Ability

The most crucial indicator of financial strength is company's cash flow generation. Any company needs to generate sufficient cash to fund its day to day operations and repay its lenders on time. If the company is dependent on external funding, it is likely to get affected negatively when liquidity in the capital market dries up.

The company under our analysis had negative Free Cash Flow, however in adverse conditions it could suspend its capital expenditure, thus we focused on company's Operating Cash Flows to assess its debt servicing capacity.

Coverage Ratios	2015	2016	2017	2018	2019
OCF before Interest / Total Interest	2.68	1.90	1.70	1.42	2.16
OCF / Short Term Debt	1.38	0.73	2.26	0.48	0.78
Net Debt / OCF	5.15	9.54	8.10	15.29	7.23

Source: Company's Annual Reports and Multi-Act research.

Based on 2019's financials, the company has sufficient interest coverage, even if the OCF declines by 50% or interest expense doubles, it can pay interest cost through internal cash generation. However, 2019's Operating Cash Flows were not sufficient to repay all short-term loans. Company will have to either rollover or raise fresh debt to meet its short-term debt obligations. The company would take around 7 years to repay all its debt if it utilizes all of its OCF for repayment.

## 2. Corporate Governance

### 2A. Related Party Transactions

Purchases from related parties have grown exponentially over last few years. The company does not disclose the nature of these transactions. These parties are engaged in distribution of pharmaceutical drugs and surgical supplies so they must be supplying medical consumables and drugs to company's hospitals and pharmacies.

Purchases from enterprises in which KMP has significant influence						
	2014	2015	2016	2017	2018	2019
Purchases from RP	3,699	5,692	12,571	17,914	21,139	25,286
% of total raw material cost	17%	22%	41%	50%	52%	54%

Source: Company's Annual Reports and Multi-Act research.

Till 2014 there was only one related entity supplying material to the company, by 2019 the number of related party suppliers has growth to 14. It could be the case that

- There were no purchases from those entities till 2014. Or
- Company has always been procuring supplies from those entities but till 2014 those entities were not considered Related Parties.

In 2015 amount payable to some of the entities was more than the purchases made during the year. We obtained Income Statements of those entities from ROC. There was no commensurate growth in total sales of those entities when the Company started reporting high amounts of purchases from RP. Thus, we are inclined towards the second assumption.

Some of the related parties derive majority of their revenue from the company.

	Purchases from RPs as per Company's AR					Total Sales of RPs as per their ROC Filings				
	2014	2015	2016	2017	2018	2014	2015	2016	2017	2018
Related Party 2	-	424	3,330	3,950	4,491	5,145	6,093	7,055	8,539	9,439
Related Party 3	-	163	1,111	1,418	1,649	n/a	2,449	2,916	3,355	4,117
Related Party 4	-	28	932	1,036	995	1,291	1,404	1,733	1,995	2,220
Related Party 5			n/a	4,044	4,264	n/a	n/a	1,393	3,921	4,366

	Sales to the Company as % of Total Sales				
Related Party 2	-	7%	47%	46%	48%
Related Party 3	-	7%	38%	42%	40%
Related Party 4	-	2%	54%	52%	45%
Related Party 5	-	0%	n/a	103%	98%

Source: Company's Annual Reports, Probe42 and Multi-Act research.

Payable Days to Related Parties: Company is prompt in paying to related parties. In 2019 company's total payable days were 56 however it paid to its related parties within 15 days and took 104 days to pay to third parties.

Payable Days	2015	2016	2017	2018	2019
Consolidated	59	60	51	53	56
Related Parties	18	12	11	16	15
Third Parties	71	94	90	94	104

Source: Companies Annual Reports and Multi-Act research.

2B. Complex restructuring arrangement resulting in frequent changes in scope of consolidation and loss-making entity staying off the company's books.

#### I. Changes in scope of consolidation of clinics business

In recent years the company has started setting up health clinics in India. The clinics are operated under a separate entity let us call it the Clinic Company (CC). The clinics are at



infancy stage and thus are incurring heavy losses. The segment had negative 19.5% OPM in 2019.

The Company, let us call it the Listed Company (LC) holds stake in the Clinic Company (CC) through a subsidiary, let us call it the Subsidiary Company (SC). Following chart depicts changes in shareholding of these entities during 2015 to 2017.

FY 2015	FY 2016	FY 2017												
<p><u>Listed Co.</u></p> <p>↓ Held 100% in</p> <p><u>Subsidiary Co.</u></p> <p>↓ Acquired 100% in</p> <p><u>Clinic Co.</u></p>	<p><u>Listed Co.</u></p> <p>↓ Held 99% in</p> <p><u>Subsidiary Co.</u></p> <p>↓ Diluted 52% Held 48% in</p> <p><u>Clinic Co.</u></p>	<p><u>Listed Co.</u></p> <p>↓ Diluted 29% Held 69% in</p> <p><u>Subsidiary Co.</u></p> <p>↓ Bought Back 52% Held 99.9% in</p> <p><u>Clinic Co.</u></p>												
<p><u>CC's Financials (INR M)*</u></p> <table><tr><td>Revenue</td><td>397</td></tr><tr><td>PAT</td><td>74</td></tr></table> <p>*Consolidated</p>	Revenue	397	PAT	74	<p><u>CC's Financial (INR M) *</u></p> <table><tr><td>Revenue</td><td>1,395</td></tr><tr><td>PAT</td><td>-1,211</td></tr></table> <p>*Not Consolidated</p>	Revenue	1,395	PAT	-1,211	<p><u>CC's Financial (INR M) *</u></p> <table><tr><td>Revenue</td><td>2,115</td></tr><tr><td>PAT</td><td>-1,177</td></tr></table> <p>*Consolidated</p>	Revenue	2,115	PAT	-1,177
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Source: Companies Annual Reports and Multi-Act research.

## Stake Changes

The company ventured in to short-stay surgery segment by acquiring a specialty hospitals company in January 2015 through the Subsidiary Co. (SC). After the acquisition the group changed the name of the acquired company in June 2015 (FY 2016).

In FY 2016, as a part of the restructuring of the retail operations of the group, SC transferred some clinics to the Clinic Co. (CC). Post this, SC diluted 52% stake in CC to a Private Equity



Firm (35%) and the LC's promoter company (17%) for INR 709 million. The group had right to acquire Private Equity Firms' shares at later date.

In FY 2017 SC diluted 29% equity by issuing fresh shares to an international investor for INR 5.6 billion. Post this equity infusion, in Dec 2016 SC bought back the 52% stake in CC for INR 900 million, at 1.3x the price at which it was sold in earlier year.

Changes in scope of consolidation.

1. In FY 2015, both CC and SC were fully consolidated in the books of LC.
2. In FY 2016, SC reported CC under the list of Associates however the loss incurred by CC was not reflected in LC's consolidated accounts. There was also a discrepancy in % shareholding reported by LC in its Annual Reports of two different years.

Annual Report of LC	Name of CC reported in AR	March 2015	March 2016	March 2017
FY 2016 AR	Old Name	***	Nil	
FY 2017 AR	New Name	100.00%	48.60%	99.92%

\*\*\*- Nil% subsidiary of SC (2014-15: 100%).

3. From Q1 2017 (June 2016) due to adoption of Ind AS the company had to consolidate CC even when it held 48.6% stake, since the group exercised control over CC's decisions. Subsequently in December 2016 SC bought back 52% stake and made CC a wholly owned subsidiary.

4. In FY 2017's AR, 2016's financials were restated to consolidate CC's operations in SC and LC's books.

The essence of the series of transactions could be interpreted as avoiding the consolidation of a loss-making subsidiary. By selling 52% stake in CC, the company managed to avoid consolidating the loss of INR 1.2 billion and reported 37% higher profits for FY 2016.

## II. Proposed Restructuring of Pharmacy Business

The company derives ~40% of its revenues and 25% of profits from Pharmacy business. In FY 2019 it announced the sale of front-end pharmacy business (not the entire Pharmacy business) for INR 5.2 billion. Company plans to use the proceeds to repay debt. This

transaction is awaiting approval from the stock exchange.

The business will be transferred to a new entity, let us call it a Front-End Pharmacy Company (FEPC). The LC will retain 25% stake in FEPC. The remaining 75% stake will be held by three different investors. LC will have a call option to buy the stake in FEPC from other 3 investors. LC will continue to be the long-term supplier to FEPC.

Currently FEPC has 4 directors on the Board, 3 of which are related to the LC. Thus, even after divesting 75% stake, the LC could be deemed to have control over FEPC. The transaction appears to avoid an actual divestiture.

### III. Restructuring of Proton Therapy:

The Company was setting up an advanced therapy center. It has recently announced plans of selling a part stake in this prestigious and awaited center via SPV for financing needs. This will be the 3<sup>rd</sup> business undergoing change of hands in last four years.

Our detailed analysis of company's fundamentals and accounting policies revealed possible weakness in the company's financial position. In such cases the margin of safety available to protect investors from an adverse outcome may be limited to nonexistent. In our opinion investors may want to conduct their own due diligence to ascertain the suitability for their portfolios.

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Statutory Details: Multi-Act Equity Consultancy Private Limited  
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### Risk factors

#### General risk factors

Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.

Past performance of MAECL does not indicate its future performance.

As with any investment in securities, the value of investments can go up or down depending on the factors and forces affecting the capital market. MAECL is not responsible / liable for any losses resulting from such factors.

Securities investments are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.

MAECL has renewed its SEBI PMS registration effective October 14, 2014 and has commenced its portfolio management activities with effect from January 2011. However MAECL has more than 10 years of experience in managing its own funds invested in the domestic market.