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Healthcare

***Maintain* POSITIVE**

Positive earnings trajectory ahead

INVESTMENT HIGHLIGHTS

- **Sector earnings remain resilient despite high OPEX**
- **Organic growth to continue driving revenue and earnings**
- **Zero-rated GST to encourage inpatient admissions and outpatient visits**
- **Proposed increase in healthcare budget allocation to benefit HSS providers**
- **Business as usual for pharmaceutical players**
- **Maintain POSITIVE on the sector**

Sector earnings remain resilient despite high OPEX. In the recently concluded earnings season, **KPJ Healthcare (KPJ MK, BUY, TP: RM1.16)** and healthcare support services (HSS) provider **UEM Edgenta (UEME MK, BUY, TP: RM3.26)** posted earnings that were in line with our full-year earnings estimates. Due to this, we have maintained our full-year earnings estimates for KPJ and increased our estimates for Edgenta. However, we have revised our FY18-19F earnings estimates for **IHH Healthcare (IHH MK, BUY, TP: RM6.95)** and **Pharmaniaga (NEUTRAL, TP: RM4.20)** as we opine that meaningful recovery in earnings will only be visible in 2H18. During the quarter, IHH experienced high operating costs associated with opening of new hospitals which disrupted earnings growth whilst KPJ had lower inpatient and outpatient admissions in Indonesia. That said, most healthcare operators reported year-over-year improvement in earnings due to the: (i) revision in prices to accommodate inflation effect on OPEX; (ii) increase in number of complex cases undertaken and; (iii) increase in contribution from existing and newly opened hospitals.

Table 1: Healthcare sector's earnings report card

Companies	Upgrade/ Downgrade	Previous Recommendation	New Recommendation	Previous TP	New TP
IHH Healthcare	Maintained	BUY	BUY	RM6.91	RM6.95
KPJ Healthcare	Maintained	BUY	BUY	RM1.12	RM1.16
Pharmaniaga	Maintained	NEUTRAL	NEUTRAL	RM4.66	RM4.20
UEM Edgenta	Maintained	BUY	BUY	RM3.09	RM3.26

Source: MIDFR

Organic growth to continue driving revenue and earnings. We reiterate our view that we expect earnings of the private healthcare operators to display further improvements from 2H18 onwards. As per 1H18, we are expecting revenue and earnings growth to be mainly driven by organic growth from existing hospitals as well as hospitals that were newly opened back in 2015-17. In addition, we are also expecting the opening of new specialization wards in recently opened hospitals will contribute positively to the operators' earnings as well. Furthermore, as the contribution from newly opened hospitals grows, it will offset the high operating expenditures associated with the opening of the new hospitals.

Zero-rated GST to encourage inpatient admissions and outpatient visits. Aside from the organic growth from existing and new hospitals, we are also expecting better revenue in 2H18 as the zero-rated goods and services tax (GST) will encourage inpatient admissions and outpatient visits to private hospitals. Despite the GST being zero-rated for three months pending the re-introduction of sales and services tax (SST), we believe this will nonetheless encourage the patients who have been delaying surgeries or treatments to come in and take advantage of the zero-rated GST period due to the increase in disposable income. Furthermore, with the current stable currency situation patients could also take advantage of lower medical consumable costs compared to last year.

Table 1: IHH's licensed bed pipelines

Target Completion	Country	Hospital	Description	Type	Licensed bed pipeline
2018					
2018	Malaysia	Pantai Hospital KL	Phase 2: ~120 beds capacity	Expansion	120
2018	Turkey	Acibadem Maslak		Expansion	210
Late 2018	China	Gleneagles Chengdu		Greenfield	350
Total					**680**
2019					
2019	China	Gleneagles Shanghai		Greenfield	450
Total					**450**
2020 and beyond					
By 2020	Malaysia	Pantai Hospital Ayer Keroh		Expansion	160
By 2020	Malaysia	Pantai Hospital Klang		Expansion	140
By 2020	China	Gleneagles Nanjing		Greenfield	70
To be evaluated	Turkey	Acibadem Atasehir		Greenfield	128
To be evaluated	Turkey	Acibadem Kartal		Greenfield	120
Total					**618**

Source: Company, MIDFR

Table 2: KPJ Healthcare's capacity expansion plan (Greenfield)

Project	Location	Total Capacity (beds)	First Phase (beds)	Completion	Opening
Bandar Dato' Onn	Johor	150	90	2Q2018	3Q2018
Kuching	Sarawak	150	114	1Q2019	2Q2019
Miri	Sarawak	96	61	1Q2019	2Q2019
UTM	Johor	150	90	TBA	
Nilai	Negeri Sembilan	96	61	TBA	
Bayuemas, Klang	Selangor	90	90	TBA	

Table 3: KPJ Healthcare's capacity expansion plan (Brownfield)

Hospitals	Description	Capacity	Completion	Opening
Taiping	Clinics	16	2Q2018	3Q2018
KPJ Ampang	Beds	149	3Q2018	4Q2018
	Clinics	24		
Sri Manjung	Beds	30	4Q2019	1Q2019
	Clinics	14		
KPJ Puteri	Beds	101	2Q2019	3Q2019
KPJ Penang	Beds	138	1Q2021	2Q2021

Source: Company, MIDFR

Proposed increase in healthcare budget allocation to benefit HSS providers. The appointment of a new Minister of Health came with an announcement that the ministry would look into increasing the allocation for healthcare-related spending. Currently, Malaysia is spending about 4.5% of its total gross domestic products (GDP) annually on healthcare and the new minister is looking into increasing it to 6-7% of GDP going forward. This is in-line with the spending of developed countries worldwide. Due to this, we opine that Edgenta in its role as the HSS provider for the ministry of Health (MoH) would benefit from the increase in healthcare budget allocation as this would open new opportunities for maintenance of various MoH facilities going forward. We also opine that the current HSS contract with MoH is unlikely to be terminated by the new government as there is a scarcity in terms of companies that could provide HSS to MoH in Malaysia. Edgenta is currently maintaining 33 hospitals in the northern region of Malaysia until year 2025.

Business as usual for pharmaceutical players. Despite the change in Federal Government and the pending re-introduction of SST, according to local pharmaceutical players business is as usual. To recall, under the GST system 2,900 drug brands listed in National Essential Medicine List (NEML) were exempted from GST. This only make up about 25% out of 12,000 drugs brands registered in Malaysia where the balance 75% is still subjected to GST. With the re-introduction of SST, prices of drugs are expected to increase depending on the quantum of the SST. That said, the generic drug manufacturers in Malaysia expect minimal impact on earnings. For the two largest generic drug manufacturer in Malaysia, Pharmaniaga and CCM Duopharma Biotech (CCMD MK, NR), the largest buyer of generic drugs (70% of the country's total medicine) is Malaysia's MoH. Currently, the sales to MoH make up 90% and up to 60% of Pharmaniaga and CCMD's revenue respectively. Therefore, we opine that the revenue coming from the government will potentially remain intact with a potential increase due to the re-introduction of SST.

With regards to the concession agreement Pharmaniaga has with MoH, we do not expect any major changes to the current agreement but we do not discount the potential revision of prices for drugs supplied by the company in light of the recent government financial position. That said, we take comfort in the fact that the government has announced that it will relook into increasing the annual budget allocation to the MoH as this would potentially mean more business for the local pharmaceutical players. However, how much of the expected +2.5% increase in annual budget (from 4.5% currently) will flow to the pharmaceutical business remains uncertain. For 2018, spending on drugs and medical consumables are allocated at RM4.1b or 15% of the total RM26.5b healthcare budget.

Maintain POSITIVE. All in, we are reiterating our **POSITIVE** stance on the sector as we expect demand for healthcare services to remain robust for the remainder of 2018 and that the announcement by MoH on the potential increase in healthcare budget allocation would spur demand for healthcare and healthcare-related services even further going forward. We opine that the sector's earnings growth will remain resilient which is evident by the increase in inpatient admissions despite the ongoing battle against high cost of living. Our **POSITIVE** stance is premised on: (i) strong demand for quality healthcare and, (ii) lack of public healthcare amenities to cater for patients both in the urban as well as suburban areas. We also opine that private healthcare operators will continue to be the preferred choice for the urban dwellers with higher disposable income and insurance coverage. **IHH Healthcare (BUY; TP: RM6.95)** is our Top Pick for the sector. We like IHH for its: (i) geographically-diversified revenue base; (ii) robust balance sheet and; (iii) strategic expansion plans.

Noor Athila Mohd Razali
noor.athila@midf.com.my
03-2772 1679

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STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive news flow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative news flow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.