30 September 2016 | Sector Update

Healthcare

***Maintain* POSITIVE**

Resilient amidst cost pressures

INVESTMENT HIGHLIGHTS

- **Favourable demographics still the main driver**
- **More public-private sector partnership expected**
- **Higher participation from smaller players**
- **Resilience in earnings expected despite persistent cost pressures**
- **Maintain POSITIVE on the sector**

Favourable demographics still the main driver. We reiterate our view that the demographics shifts and developments in the markets that the operators are in will continue to bode well for the sector in 2016-17. The demographic factors that encourage the adoption of private healthcare services are (i) increase in ageing population, (ii) increase in lifestyle diseases, (iii) increasing awareness on health diseases, (iv) improvement in standard of living, and (v) urbanisation. Furthermore, with Ringgit at its current levels, we also reckon that Malaysia is faring better vis-à-vis neighbouring countries in attracting medical tourism traveller seeking medical treatments. In addition, the increasing adoptions of medical insurance policy and employer tie-up with private hospital operators are also expected to encourage the usage of private medical services. According to Frost & Sullivan, at the current growth rate, Malaysia's healthcare expenditure will reach USD20bn by 2020.

More public-private sector partnership expected. We are expecting to witness an increase in public-private sector partnership happening within the industry in the medium term due to the increasing demand. Currently the average nationwide bed occupancy ratio (BOR) in the government hospitals stands at about 68.2% and the Ministry of Health (MoH) is concentrating on equipping the public hospitals with departments and machineries which focuses more on oncology and various complex cases. This has indirectly led the responsibility of providing primary healthcare services to shift from the public sector to the private sector in order to reduce the pressure on the public sector. This is also so that the public sector can concentrate more on providing services to the lower income patients and those with more complex health issues.

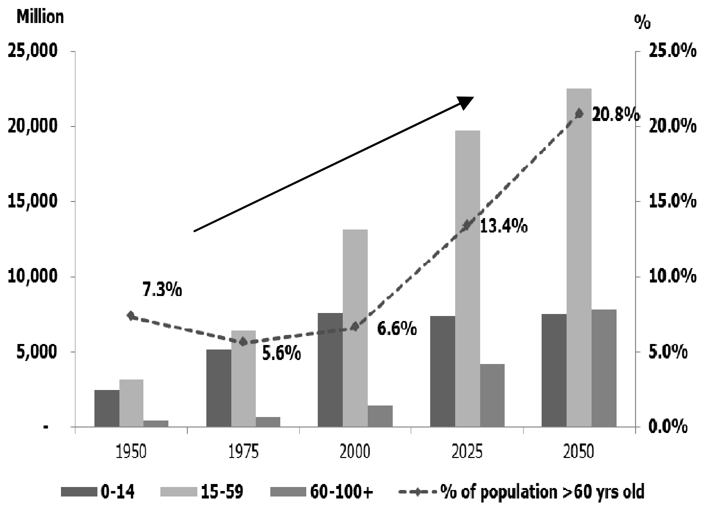
Higher participation from smaller players. The rising demand for private healthcare, its resilient earnings profile and earnings visibility have encouraged some existing smaller players to expand their operations as well as attracting new players into the healthcare business. Some of these players are TDM Bhd and Oriental Holdings Bhd with new pipeline of beds planned for the next 2-3 years.

Resilience in earnings expected despite persistent cost pressures. For FY16, we are expecting both hospital operators to continue recording a low-double digit revenue growth of about 11-12%yoy stemming from both organic growth from existing hospitals as well as newly commissioned hospitals. Despite the increasing cost pressure from the volatile currency market as well as inflationary effect on medical consumables, we believe the hospital players will be able to maintain their PAT margin via: (i) various forms of cost control, and (ii) increasing complex cases mix.

Maintain POSITIVE. We are maintaining our POSITIVE view on the sector with IHH Healthcare as our Top Pick due to: (i) strong earnings growth forecasted for FY16-17, (ii) strong management team, (iii) robust balance sheet, and (iv) well-diversified revenue base. At present, we believe that there is potential for further upside to the earnings of both IHH and KPJ should operational environment improve in 2HFY16. Backed by strong demand for private healthcare services especially in the urban areas, we opine that private healthcare operators will continue to be the preferred choice for the urban dwellers with higher disposable income and insurance coverage.

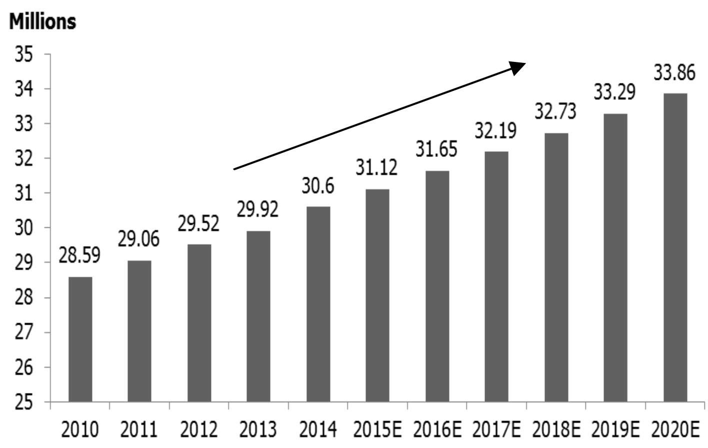
Favourable demographics still the main driver. We reiterate our view that going forward the private healthcare players will continue to benefit from favourable demographic shifts in the market. In particular, we think the increase in aging population in Malaysia will drive the demand for private healthcare services. This is due to the aging population segment growing faster than other age segments as a result of both longer life expectancy and declining fertility rates. According to the World Health Organisation's (WHO) definition, a country will be classified as an ageing nation when 10% of its population are of 60 years old and above. Malaysia is expected to become an ageing nation by 2025 as its population aged 60 and above reaches about 13.4% of the total population. Meanwhile, the fertility rate growth per woman will decline from 2.9% in years 2000-2005 to about 2.1% in years 2025-2030.

Chart 1: Malaysia's aging population forecast



Source: Population division United Nations, MIDFR

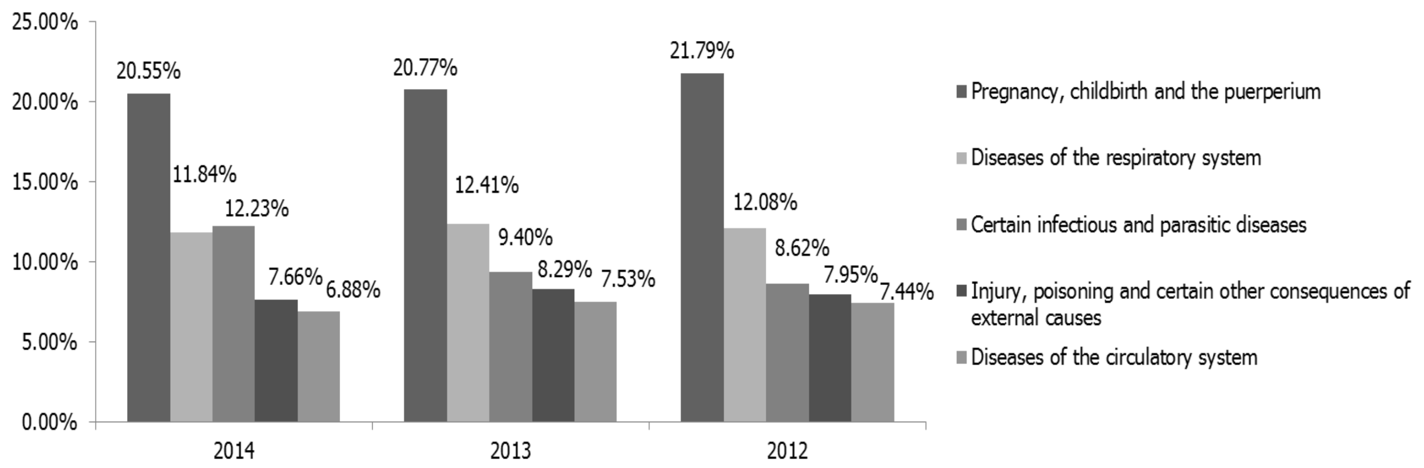
Chart 2: Malaysia's total population forecast



Source: IMF, MIDFR

We also note the increasing case of lifestyle diseases recorded and increase in health awareness are other significant contributors to the adoption of private healthcare services. From the data provided by MOH, we can see within the past 3 years, four out of five main causes of hospitalization in both MOH and private hospitals are due to lifestyle diseases. We think this will continue to be the trend in the coming years partly due to the increasing aging population.

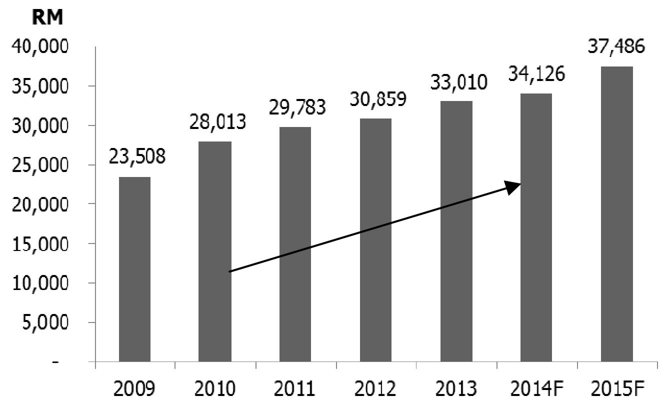
Chart 3: Top 5 causes of hospitalisation in MOH and private hospitals



Source: Ministry of Health, MIDFR

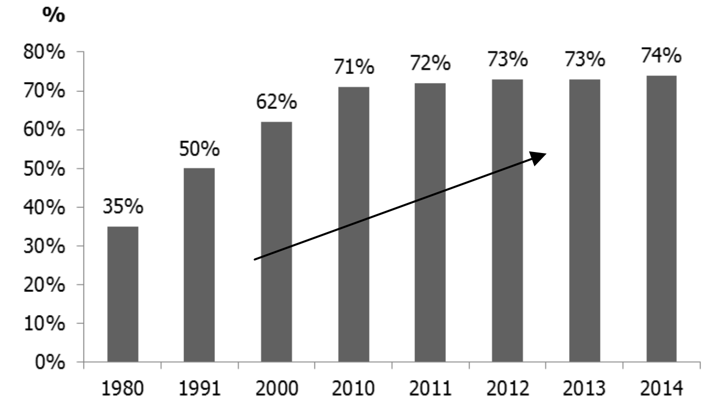
Additionally, we also view that the improving standard of living as well as the high rate of urban dwellers against rural dwellers are contributing to the increasing demand for private healthcare services. According to the Ministry of Finance Economic Report 2014/2015, annual per capita income for Malaysia is forecasted to be about RM37,486 in 2015 from RM23,508 in 2009, up by 59%. This, we think commensurate with the higher year-on-year admissions to private hospitals. Furthermore, the increasing number of population moving to the city to seek better job opportunities and better standard of living is also driving the number of patients using private healthcare services. This is due to most of the private healthcare providers are based in the urban areas.

Chart 4: Malaysia's per capita income



Source: Ministry of Health, MIDFR

Chart 5: Malaysia's urbanisation rate (%)

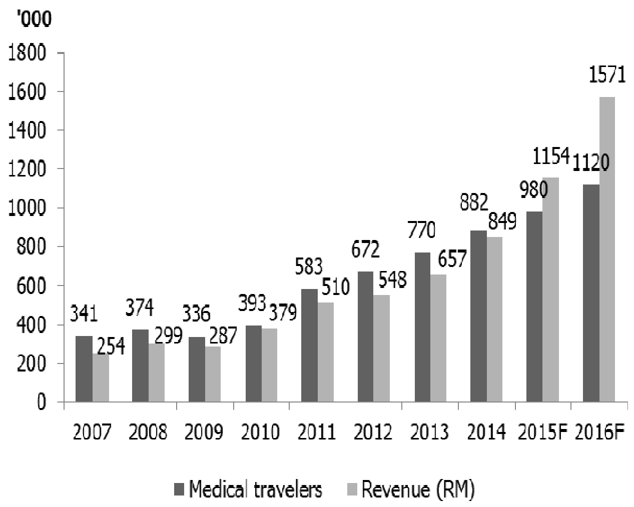


Source: World Bank, MIDFR

On top of that, we are also seeing an encouraging trend on the medical tourism front where the number of medical travellers and revenue contributed by medical tourism showed an increasing trend since 2007. Number of medical travellers and revenue from medical tourism are expected to grow at a CAGR of 14% and 22% respectively by end-2016. Private hospital operators are already ramping up their capacity targeting areas which are more susceptible to accepting medical tourist such as: Penang, Malacca and Johor Bharu to capitalize on the growing arrival of medical tourists to Malaysia.

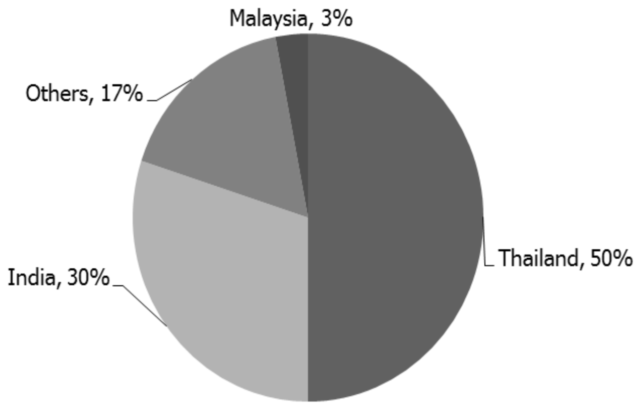
Aside from leveraging on high quality core medical services such as: oncology, orthopaedics, cardiology and infertility, the Malaysian Health Travel Council (MHTC) acknowledges the growing demand in wellness coming from countries with high spending capacity. These travellers seek more on prevention methods such as: detoxification and traditional complimentary medicines which the MHTC feels that Malaysia can further tap into. Another area that is worth developing and currently growing is cosmetic surgery. The government is expecting to generate RM1.3bn of revenue from medical tourism this year and meanwhile, we are expecting both IHH and KPJ to increase revenue coming from medical tourism to about 10% of total revenue (from ~5% currently) in the medium term.

Chart 6: Medical travellers to Malaysia



Source: Malaysian Healthcare Travel Council (MHTC), MIDFR

Chart 7: Asia Pacific medical tourism market share



Source: Frost & Sullivan, MIDFR

More participation from smaller players. Due to the prolonged soft economic activities, we are seeing increasing interests from companies with non-core private healthcare business ramping up on their respective healthcare divisions. This, we opine are in order to: (i) cushion the impact of the slow economic activities on the companies' topline and bottomline, as well as (ii) capitalise on the growing demand for private healthcare services. Companies such as: TDM Berhad (TDM MK, NR) and Oriental Holdings Berhad (ORIENT MK, NR) are some of the companies that have recently announced expansions and ventures into the healthcare business.

From the disclosure made by the companies, we understand that TDM is on track to open a new hospital called Kuala Terengganu Specialist Hospital which will be a 130-bedded hospital and it will also be adding another 61 beds in its existing hospitals. TDM is expecting to increase its number of beds to 427 from 297 currently by end-2016. Meanwhile, Oriental will be opening a 300-bedded Oriental Melaka Straits Medical Center (OMSMC) in Malacca.

Despite the potential increase in competition, we do not think that this will affect IHH and KPJ as we believe that demand is still greater than available supply currently. Additionally, the target market for TDM and Oriental will be different as compared to IHH and KPJ whereby TDM expects to operate an affordable private healthcare model while Oriental, we believe will be targeting medical tourists due to its location. Nonetheless, we believe that the emergence of new players and expansion of existing ones are in line with our view that demand for private healthcare is still in an uptrend and has a big potential to bring in good revenue.

Resilience in earnings expected despite persistent cost pressures. As demand remains robust for private healthcare services, we are also expecting the resilience in earnings of both players under our coverage. In FY16, both IHH and KPJ are expected to add 135 and 180 number of beds into their existing pool of beds. Although it is relatively a small addition, the pipeline of beds coming on stream from both players from FY17 onwards shows an impressive ramp up in capacity both locally and internationally for the players which reaffirms our believe that the sector will continue to experience resilient demand going forward.

Additionally, despite the increasing cost due to inflationary pressures as well as currency volatility and increasing competition for medical personnel in most countries, we opine that both operators will adjust their pricing accordingly to reflect the increase in the said variables. Having said that, we understand that this could potentially turn patients away from getting treatments at private hospitals, however, we believe that this will not impact the players' earnings significantly as the target market for the players range from premium upper class to middle class with high disposable income and insurance coverage or employer's medical coverage.

Table 1: IHH's licensed bed pipelines

2016	Licensed bed pipeline (units)
Gleneagles Medini	24
Mount Elizabeth Novena	30
Acibadem Sistina Skopje	81
Total	**135**
2017 onwards	
Gleneagles Hong Kong	500
Gleneagles Khubchandani India*	450
ParkwayHealth Chengdu	350
Acibadem Altunizade	325
Acibadem Maslak	200
Pantai Ayer Keroh	160
Continental Hospital India	100
Total	**2,085**

**Tentative*
Source: Company, MIDFR

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

Project	Location	Total Capacity (beds)	First Phase (beds)	Completion	Opening
Perlis	Perlis	90	60	4Q2016	1Q2017
Kuching	Sarawak	150	130	3Q2017	4Q2017
Miri	Sarawak	100	60	2Q2018	3Q2018
Bandar Dato' Onn	Johor	150	90	3Q2017	4Q2017
UTM	Johor	150	60	2Q2018	3Q2018
Melaka	Melaka	90	60	TBA	
Bayuemas, Klang	Selangor	180	110	TBA	

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

Hospitals	Description	Capacity	Completion	Opening
KPJ Selangor	Clinics	54	1Q2016	2Q2016
KPJ Puteri	Beds	220	4Q2016	1Q2017
Taiping	Clinics	18	4Q2016	1Q2017
KPJ Ampang	Beds	150	1Q2017	2Q2017
	Clinics	33		
KPJ Johor	Beds	53	1Q2017	2Q2017
Sri Manjung	Beds	30	1Q2017	2Q2017
KPJ Seremban	Beds	80	2Q2017	3Q2017
KPJ Penang	Beds	156	2Q2017	3Q2017

Source: Company, MIDFR

Recommendation. Pursuant to the recent 2QFY16 earnings announcement, we have maintained our NEUTRAL calls on both IHH and KPJ with TP of RM6.95 and RM4.05 respectively. Domestically, we are seeing the number of inpatient was slightly affected in FY15 by the implementation of goods and services tax (GST) since April 2015 followed by Ringgit depreciation which has spilled over to the first half of this year. These situations have caused the cost-sensitive patients or those under the Out-Of-Pocket (OOP) category to switch to cheaper alternatives which in turn reduced the number of patients admitted to the private hospitals.

Nonetheless, we believe the recovery of consumer sentiment from the dip caused by the implementation of GST as well as a more stable currency environment both locally and abroad will gradually improve in 2H16. We also think the recovery in 2H16 could potentially lead to a better upside in terms of both revenue and earnings for both players than what we have forecasted for the year.

Further to this, we are maintaining our **POSITIVE** stance on the sector given the bright prospect of the sector going forward. Our Top Pick for the sector is IHH Healthcare due to its: (i) strong earnings growth forecasted for FY16-17, (ii) strong management team, (iii) robust balance sheet, and (iv) well-diversified revenue base.

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BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
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.