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Apollo Hospitals Enterprise Ltd

Detailed Report

Enhancing investment decisions

Explanation of CRISIL Fundamental and Valuation (CFV) matrix

The CFV Matrix (CRISIL Fundamental and Valuation Matrix) addresses the two important analysis of an investment making process – Analysis of Fundamentals (addressed through Fundamental Grade) and Analysis of Returns (Valuation Grade) The fundamental grade is assigned on a five-point scale from grade 5 (indicating Excellent fundamentals) to grade 1 (Poor fundamentals) The valuation grade is assigned on a five-point scale from grade 5 (indicating strong upside from the current market price (CMP)) to grade 1 (strong downside from the CMP).

CRISIL Fundamental Grade	Assessment	CRISIL Valuation Grade	Assessment
5/5	Excellent fundamentals	5/5	Strong upside (>25% from CMP)
4/5	Superior fundamentals	4/5	Upside (10-25% from CMP)
3/5	Good fundamentals	3/5	Align (+-10% from CMP)
2/5	Moderate fundamentals	2/5	Downside (negative 10-25% from CMP)
1/5	Poor fundamentals	1/5	Strong downside (<-25% from CMP)

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

About CRISIL Research

CRISIL Research is India's largest independent and integrated research house. We provide insights, opinions, and analysis on the Indian economy, industries, capital markets and companies. We are India's most credible provider of economy and industry research. Our industry research covers 70 sectors and is known for its rich insights and perspectives. Our analysis is supported by inputs from our network of more than 4,500 primary sources, including industry experts, industry associations, and trade channels. We play a key role in India's fixed income markets. We are India's largest provider of valuations of fixed income securities, serving the mutual fund, insurance, and banking industries. We are the sole provider of debt and hybrid indices to India's mutual fund and life insurance industries. We pioneered independent equity research in India, and are today India's largest independent equity research house. Our defining trait is the ability to convert information and data into expert judgments and forecasts with complete objectivity. We leverage our deep understanding of the macro economy and our extensive sector coverage to provide unique insights on micro-macro and cross-sectoral linkages. We deliver our research through an innovative web-based research platform. Our talent pool comprises economists, sector experts, company analysts, and information management specialists.

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Last updated: March 07, 2013

Analyst Disclosure

Each member of the team involved in the preparation of the grading report, hereby affirms that there exists no conflict of interest that can bias the grading recommendation of the company.

Disclaimer:

Apollo Hospitals Enterprise Ltd

In the pink of health

Fundamental Grade	5/5 (Excellent fundamentals)
Valuation Grade	4/5 (CMP has upside)
Industry	Healthcare Providers & Services

May 02, 2013

Fair Value	**₹982**
CMP	**₹826**

Apollo Hospitals Enterprise Ltd (Apollo) continues to be a dominant healthcare player. Both its businesses - hospitals and pharmacy - are healthy and have registered strong growth in revenues and margins in the past three years. We expect the hospitals business to drive growth impelled by robust performance in the existing hospitals and expected addition of 2,000 beds in the next two years. The pharmacy business has been progressing well too and is expected to contribute materially to return ratios in the next two-three years. We maintain our fundamental grade of **5/5**, indicating that its fundamentals are 'excellent' relative to other listed securities in India.

Both businesses on solid ground

Apollo's businesses - hospitals and pharmacy – have recorded robust growth in revenues as well as profitability over the past three years. The hospitals business' revenues grew 18% with more than 200 bps improvement in EBITDA margin. The pharmacy business' revenues grew 34%, driven by addition of new stores and ramp up in existing stores, with more than 300 bps improvement in EBITDA margin in the past three years.

New beds + better occupancy of existing beds to drive growth

Driven by strong performance in the existing hospitals and expected addition of 2,000 beds in the next two years, the hospitals business is expected to log a robust three-year CAGR of 22.3% to ₹41.8 bn in FY15. The expected capacity addition is broadly on track barring delays of nine-twelve months in a few projects. EBITDA margin is expected to remain stable at 21% in FY15 as improvement of 300 bps in the existing hospitals will be offset by projected initial losses in the new hospitals.

Pharmacy business on track; to record robust growth with improvement in margins

The pharmacy business has been ramping up well in the past three years with revenues up at a CAGR of 34% driven by addition of new stores as well as growth in same store sales (SSS). Revenues per store increased to ₹2 mn in Q3FY13 from ₹1.56 mn in Q1FY12 while EBITDA margin improved by 150 bps to 2.7%. Going forward, we expect Apollo to add about 100 new stores every year. This coupled with 15-16% growth in the mature stores is expected to drive revenues. EBITDA margin is expected to improve to 4% in FY15.

Revenues to grow at a three-year CAGR of 22% by FY15; return ratios to improve

Revenues are expected to grow at a three-year CAGR of 22% to ₹57 bn in FY15 driven by growth in the pharmacy and hospitals businesses. PAT is expected to register higher growth of 30% to ₹4.8 bn due to stable margin and lower tax expenses. RoCE is estimated to improve to 15.8% in FY15 from 12.6% in FY12 and RoE to 13.7% in FY15 from 10% in FY12.

Valuations – the current market price has upside

We continue to use the discounted cash flow (DCF) method to value Apollo and retain our fair value of ₹982 per share. At this value, the implied EV/EBITDA multiples are 19.0x FY14E and 15.4x FY15E EBITDA.

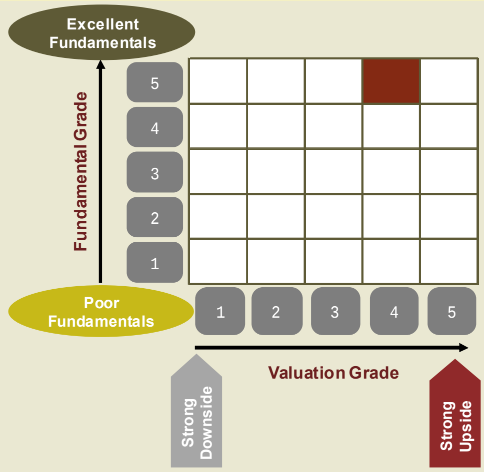
KEY FORECAST

(₹ mn)	FY11	FY12	FY13E	FY14E	FY15E
Operating income	26,054	31,475	37,740	46,311	56,665
EBITDA	4,216	5,168	6,258	7,628	9,377
Adj Net income	1,795	2,169	3,182	3,865	4,802
Adj EPS-₹	14.4	16.1	22.9	27.8	34.6
EPS growth (%)	35.8	12.0	42.1	21.5	24.2
Dividend Yield (%)	0.5	0.5	0.3	0.3	0.4
RoCE (%)	12.0	12.6	13.4	14.2	15.8
RoE (%)	10.2	10.0	11.7	12.3	13.7
PE (x)	57.3	51.2	36.0	29.7	23.9
P/BV (x)	5.5	4.5	3.9	3.5	3.1
EV/EBITDA (x)	26.3	22.5	19.1	16.0	12.9

NM: Not meaningful; CMP: Current market price

Source: Company, CRISIL Research estimates

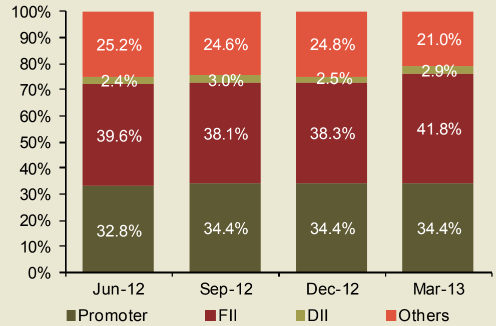
CFV MATRIX



KEY STOCK STATISTICS

NIFTY/SENSEX	5999/19736
NSE/BSE ticker	APOLLOHOSP
Face value (₹ per share)	5
Shares outstanding (mn)	139.1
Market cap (₹ mn)/(US$ mn)	114,609/2,129
Enterprise value (₹ mn)/(US$ mn)	120,862/2,245
52-week range (₹)/(H/L)	902/598
Beta	0.5
Free float (%)	65.7%
Avg daily volumes (30-days)	182,111
Avg daily value (30-days) (₹ mn)	150.3

SHAREHOLDING PATTERN



PERFORMANCE VIS-À-VIS MARKET

	Returns			
	1-m	3-m	6-m	12-m
Apollo	-1%	4%	7%	32%
NIFTY	4.4%	-2%	6%	13%

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Table 1: Apollo - Business environment

Parameter	Hospitals	Standalone pharmacy
Product / service offering	▪ Healthcare services with focus on specialties such as cardiology, neurosciences, orthopaedics and oncology. These specialties contribute 65% to the hospitals business' revenues ▪ Hospital-based pharmacy (prescription drugs, consumables and surgical instruments), consultancy and diagnostics services	▪ Prescription drugs, consumables and surgical instruments; constitute 75% of total pharmacy sales ▪ Also sells over-the-counter (OTC) products and private label goods under Doctors Choice, B Positive and Apollo brands. Over-the-counter products constitute 20% of pharmacy sales and private labels the remaining 5%
Geographic presence	▪ Dominant presence in southern India (40% of 6,000 owned beds are in Chennai and Hyderabad). The Chennai cluster accounts for 45% of the hospitals business' revenues and the Hyderabad cluster 20% ▪ 25% of the owned beds are in tier II/III cities such as Bhubaneswar, Madurai, Bilaspur (20% of revenues) ▪ 35% of the owned beds are under joint ventures (JVs) in cities such as Ahmedabad, Bengaluru, Delhi and Kolkata (15% of revenues) ▪ The company is looking to increase its presence in western India. Of the total envisaged expansion of 3,000 beds, 1,000 beds are expected in western India	▪ Pan-India (more than 60% of the stores are in the southern region)
Market position	▪ One of the largest organised healthcare service providers in India with a network of 6,000 owned beds (2,600 beds are under JVs) and more than 2,000 beds in the managed category	▪ One of the leading players in the organised pharmacy retail market with more than 1,400 stores. Optival Health Solutions (operating under Medplus brand) is the second largest organised pharmacy chain; currently has 1,050 stores
Industry growth expectations and growth drivers	▪ CRISIL Research expects the healthcare services industry to grow at a five-year CAGR of 12% to ₹4,500 bn by FY17 from ₹2,600 bn in FY12 **Growth drivers** ▪ Low government spending, especially in tertiary and quaternary care hospitals, has resulted in inadequate healthcare infrastructure. This has resulted in opportunity for private players. Also states' focus on healthcare under the PPP model will result in opportunities for private players ▪ Rising lifestyle diseases and growing awareness for healthy lifestyle with preventive care will drive demand for healthcare services	▪ The pharmacy retail market is estimated at ₹2,000 bn and has grown at 15% in the past five years – similar to the growth of the domestic pharmaceuticals market. CRISIL Research expects the domestic pharmaceuticals market to grow at a five-year CAGR of 15% in FY17; we expect similar growth for the pharmacy retail market ▪ While the pharmacy retail market is predominantly unorganised (95%), penetration of organised pharmacy retail has been increasing in the past few years. Organised players recorded higher-than-industry growth of 25%+ in the past three years compared to the overall industry growth of 15%. We expect a similar growth trend in the future. **Growth drivers** ▪ Changing lifestyles, high stress levels and unhealthy eating habits will continue to lead to higher incidence of lifestyle-related ailments such as diabetes, cardiovascular diseases and obesity. This is expected to drive demand for lifestyle-related ailment drugs ▪ Growing organised pharmacy retail penetration

Parameter	Hospitals	Standalone pharmacy
Sales growth (FY09-FY12 – 3-yr CAGR)	18%	34% (growth in the past three years was driven by addition of more than 200 stores per year on an average
Average EBITDA margins (FY09-12)	20.2%	-1.2% (margins were negative during FY09-12, the start-up phase. Currently, the pharmacy business has 2.7% margin)
Earnings growth (FY09-FY12 – 3-yr CAGR)	33.4% (the pharmacy business is operated under standalone and business-wise earnings are unavailable)	
Sales forecast (FY12-FY15 – 3-yr CAGR)	22.3% (driven by growth in the existing hospitals and addition of 2,000 new beds in the next two years)	20% (we have assumed addition of 100 stores per year in next two-three years compared to addition of 200 stores on an average in the past two-three years. Accordingly, growth in the next three years is expected to moderate from historical levels)
Average EBITDA margins (FY12-15)	21.6% (improvement of 280 bps in the existing hospitals is expected to be offset by initial start-up losses)	3.3% (due to increase in proportion of mature stores in the total network, we expect margin to improve. We expect mature stores to earn margin of 6.5%)
Earnings growth (FY12-FY15 – 3-yr CAGR)	30.3% (driven by revenue growth, stable margin and lower tax expenses)	
Key competitors	▪ Northern India – Fortis (3,000 owned beds), Metro Hospitals (1,500 beds), Max Healthcare (1,160 operational beds, total capacity of 1,900 beds) ▪ Southern India – Manipal Group (1,600 owned beds and 3,200 managed beds), Columbia Asia (781 beds) ▪ Western India – Sterling Hospitals (1,100 beds)	▪ The two large competitors in organised pharmacy are Optival Health Solutions and Guardian Life Care. Optival Health Solutions operating under Medplus brand has 1,050 pharmacy stores across Andhra Pradesh, Karnataka, Maharashtra, Tamil Nadu and West Bengal. Guardian Life Care has 230 stores in Maharashtra, Uttar Pradesh and the National Capital Region (NCR) ▪ Other organised players are Medicine Shoppe, Religare Wellness, Wellness Forever, Thulasi Pharmacies, but they are small with about 50-100 stores
Key risks	▪ Delays in addition of new beds ▪ Rising land prices ▪ Inability to attract and retain medical professionals ▪ Delays in ramp-up of new hospitals	▪ Delays in break-even of the new stores ▪ Lower-than-expected improvement in margins ▪ Increase in real estate costs

Source: Company, CRISIL Research

Grading Rationale

Businesses in the pink of health

Apollo's both businesses - hospitals and pharmacy – have recorded robust growth in revenues as well as profitability in the past three years. The hospitals business' revenues grew 18% with more than 200 bps improvement in EBITDA margin; hospitals in the Chennai and Hyderabad clusters reported steady growth and those in tier II/III cities also recorded encouraging performance. The pharmacy business' revenues grew 34% owing to healthy performance of the mature stores and strong growth in the new stores; EBITDA margin expanded by more than 300 bps.

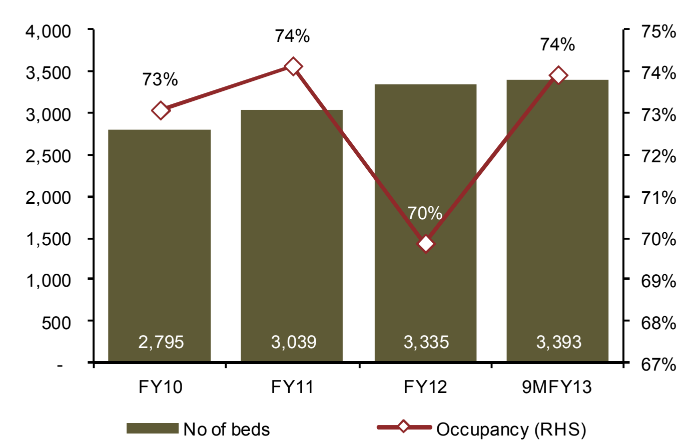
The hospitals and the pharmacy businesses recorded robust growth in revenues and profitability

Hospitals business: Hale and hearty

The hospitals business has consistently improved across all operating parameters. Despite the addition of 350 beds in past two years, average occupancy across owned hospitals was stable at 74% in 9MFY13 compared to FY11. Further, a better mix of services with focus on cardiology, neurosciences and oncology, and reduction in average length of stay (ALOS) resulted in healthy growth in average revenue per occupied bed (ARPOB) of 11% y-o-y to ₹20,162 during FY10-9MFY13. Share of cardiology, neuroscience, orthopaedics and oncology in total revenues increased to 65% in FY12 from 60% in FY10.

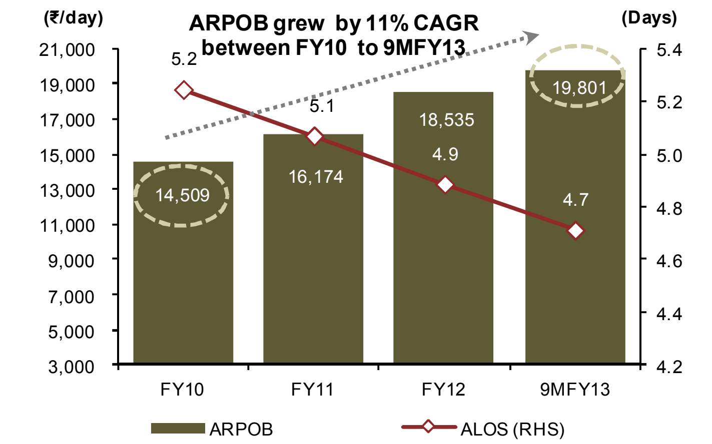
The hospitals business recorded consistent improvement in operating parameters

Figure 1: Stable occupancy despite addition of beds



Source: Company, CRISIL Research

Figure 2: Steady growth in ARPOB, decline in ALOS



Source: Company, CRISIL Research

Chennai cluster = wholesome performance

The Chennai cluster continued to record healthy performance. Revenues grew 17% in the past three years driven by 13% growth in ARPOB and 4% growth in inpatient volumes. Occupancy was stable at 78% as of December 2012 while ALOS declined to 4.41 days from 4.8 days in FY10. This cluster contributed ~45% to standalone revenues of the hospitals business in FY12.

Table 2: Chennai cluster reported healthy growth

	FY10	FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	FY12	Q1FY13	Q2FY13	Q3FY13	9MFY13
Operating beds	1,118	1,103	1,162	1,157	1,194	1,159	1159	1,130	1,136	1,136	1,136
ALOS	4.67	4.67	4.65	4.56	4.46	4.5	4.5	4.6	4.6	4.4	4.4
Occupancy	75%	82%	80.0%	77.0%	73.0%	75.0%	75.0%	80.0%	80.0%	78.0%	78.0%
ARPOB	21,552	23,907	25,301	26,262	27,331	27,853	27,853	29,852	29,519	30,634	30,634
Growth in ARPOB (y-o-y)		10.9%	7.3%	11.6%	15.8%	16.5%	16.5%	18.0%	12.4%	12.1%	
Inpatient volumes	65,220	70,766	17,425	18,229	17,965	16,901	70,520	17,691	18,614	18,878	55,183
Outpatient volumes	198,977	226,373	50,496	106,246	87,216	83,710	327,668	83,489	92,028	95,017	270,534
Inpatient revenues	5,129	6,176	1,599	1,646	1,721	1,737	6,703	1,879	1,842	1,940	5,661
Outpatient revenues	1,441	1,730	449	591	537	564	2,141	568	639	580	1,787
Total revenues (₹ mn)	6,570	7,906	2,048	2,237	2,258	2,301	8,844	2,447	2,481	2,520	7,448
y-o-y growth		20.3%	6.2%	11.7%	13.4%	16.0%	11.9%	19.5%	10.9%	11.6%	13.8%
q-o-q growth			3.2%	9.2%	0.9%	1.9%		6.3%	1.4%	1.6%	

Source: Company, CRISIL Research

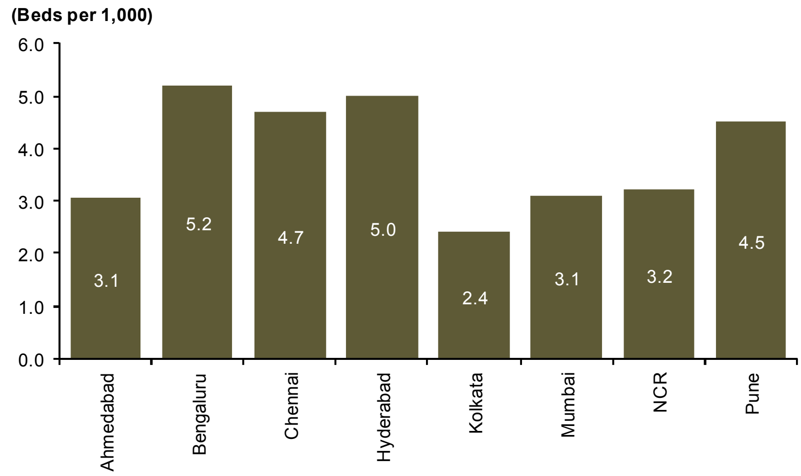
Healthy growth in ARPOB at Chennai cluster driven by better case-mix and decline in ALOS

Hyderabad cluster = slow but steady

Amongst the major cities in India, Hyderabad has one of the highest number of beds at five per population of 1,000. Due to competition, the Hyderabad cluster witnessed slow ramp-up in occupancy. Current occupancy in the Hyderabad cluster is 66% which, in our opinion, is below the desired levels. Despite lower occupancy, revenues grew 23% in the past three years driven by addition of beds, increase in ARPOB and higher inpatient volume. ARPOB registered a growth of 12% in the past three years due to better case mix while inpatient volume grew by 11% during the same period.

Slow ramp-up in occupancy at the Hyderabad cluster

Figure 3: Hyderabad has highest no. of beds per population of 1,000



Source: Company, CRISIL Research

Table 3: Occupancy at the Hyderabad cluster has been flat in the past two years

	FY10	FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	FY12	Q1FY13	Q2FY13	Q3FY13	9MFY13
Operating beds	670	809	930	930	930	930	930	930	930	930	930
ALOS	4.74	4.82	4.78	4.76	4.62	4.64	4.64	4.44	4.54	4.59	4.59
Occupancy	70%	65%	60.0%	64.0%	62.0%	62.0%	62.0%	62.0%	66.0%	66.0%	66.0%
ARPOB	13,229	15,114	16,796	16,672	17,050	17,307	17,307	18,637	18,237	18,213	18,213
Growth in ARPOB (y-o-y)		14.2%	13.8%	11.8%	14.2%	14.5%	14.5%	11.0%	9.4%	6.8%	
Inpatient volumes	36,029	39,776	10,642	12,084	11,654	11,195	45,575	11,804	12,910	12,335	37,049
Outpatient volumes	84,799	113,413	31,278	40,584	35,800	33,542	141,204	34,291	36,775	36,079	107,145
Inpatient revenues	1,925	2,471	687	826	737	777	3,027	809	890	872	2,571
Outpatient revenues	334	430	166	123	167	173	629	168	178	180	526
Total revenues (₹ mn)	2,259	2,901	853	949	904	950	3,656	977	1,068	1,052	3,097
y-o-y growth		28.4%	30.8%	23.2%	26.1%	24.7%	26.0%	14.5%	12.5%	16.4%	14.4%
q-o-q growth			11.9%	11.3%	-4.7%	5.1%		2.8%	9.3%	-1.5%	

Source: Company, CRISIL Research

Hospitals in tier II/III cities = strong show

Hospitals in tier II/III cities strong revenue CAGR of 29% during 9MFY09-9MFY13 (two-year CAGR of 31% in FY12) driven by 14% growth in ARPOB and 16% growth in inpatient volumes. Apollo's Bhubaneswar facility (250 beds) achieved break-even in the first year of operations in FY12 and currently has occupancy of 76% with EBITDA margin of 22%. Hospitals in Madurai, Karimnagar and Vizag also reported steady improvement in occupancy and margins.

Occupancy at the overall level in hospitals in tier II/III has improved despite the addition of new beds, signifying good ramp-up

Table 4: Robust performance of hospitals in tier II/III cities

	FY10	FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	FY12	Q1FY13	Q2FY13	Q3FY13	9MFY13
Operating beds	1,007	1,127	1,164	1,215	1,206	1,246	1,246	1,299	1,299	1,327	1,327
ALOS	6.22	5.64	5.66	5.51	5.44	5.43	5.43	4.44	5.14	5.06	5.06
Occupancy	73%	73%	71.0%	70.0%	71.0%	71.0%	71.0%	62.0%	75.0%	76.0%	76.0%
ARPOB	7,540	9,367	10,083	10,422	10,657	10,784	10,784	11,447	11,678	11,639	11,639
Growth in ARPOB (y-o-y)		24.2%	16.0%	16.9%	16.4%	15.1%	15.1%	13.5%	12.1%	9.2%	
Inpatient volumes	42,969	53,451	13,224	15,033	15,152	15,905	59,314	16,476	18,376	19,903	54,755
Outpatient volumes	102,694	151,011	37,061	41,196	41,236	39,444	158,937	44,250	50,898	50,947	146,095
Inpatient revenues	1,711	2,402	627	742	755	818	2,942	843	943	970	2,756
Outpatient revenues	305	416	132	122	138	136	528	143	162	164	469
Total revenues (₹ mn)	2,016	2,818	759	864	893	954	3,470	986	1,105	1,134	3,225
y-o-y growth		39.8%	23.8%	23.6%	20.8%	24.4%	23.1%	29.9%	27.9%	27.0%	28.2%
q-o-q growth			-1.0%	13.8%	3.4%	6.8%		3.4%	12.1%	2.6%	

Source: Company, CRISIL Research

Pharmacy business: In fine fettle and ramping up well

Apollo's pharmacy business has been ramping up well in the past two years. Revenues recorded three-year CAGR of 34% driven by addition of new stores as well as SSS growth. Revenues per store increased to ₹2.0 mn in Q3FY13 from ₹1.56 mn in Q1FY12 driven by healthy growth in the mature stores and fast ramp-up in the non-mature stores. Mature stores (operational since 2008) recorded healthy revenue growth of 18% in FY13; the non-mature stores are also scaling up fast and recorded revenue growth of 33% during the same period. EBITDA margin improved to 2.7% in Q3FY13 from 1.2% in Q1FY12 driven by increase in revenue per store, closure of loss-making stores and increase in contribution from high-margin

Pharmacy business' EBITDA margin improved to 2.7% in Q3FY13 from 1.2% in Q1FY12

private label goods. Mature stores (up to 2010 batch), currently have margins of 3-4%, while non-mature stores have margins of -1%.

Table 5: Strong growth in the pharmacy business with margin improvement

	FY11	Q1FY12	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Q2FY13	Q3FY13
Total stores	**1,199**	**1,220**	**1,257**	**1,290**	**1,364**	**1,357**	**1,399**	**1,445**
Mature stores (up to 2008 batch)	NA	NA	486	484	NA	NA	463	461
(% of total stores)			*39%*	*38%*			*33%*	*32%*
Mature stores (2009 batch)	NA	NA	217	214	NA	NA	206	205
(% of total stores)			*17%*	*17%*			*15%*	*14%*
Mature stores (2010 batch)	NA	NA	200	199	NA	NA	193	193
(% of total stores)			*16%*	*15%*			*14%*	*13%*
Non-mature stores	NA	NA	354	393	NA	NA	537	586
(% of total stores)			*28%*	*30%*			*38%*	*41%*
Total revenues	**6,615**	**1,898**	**2,085**	**2,246**	**2,377**	**2,477**	**2,776**	**2,905**
y-o-y growth		***35.8%***	***25.4%***	***29.5%***	***30.5%***	***30.5%***	***33.2%***	***29.3%***
Mature stores (up to 2008 batch)	NA	1,012	1,059	1,099	NA	1,120	1,204	1,222
y-o-y growth						*10.6%*	*13.6%*	*11.2%*
Mature stores (2009 batch)	NA	363	388	402	NA	416	451	459
y-o-y growth						*14.7%*	*16.1%*	*14.1%*
Mature stores (2010 batch)	NA	295	310	326	NA	345	378	392
y-o-y growth						*17.1%*	*22.0%*	*20.0%*
Non-mature stores	NA	228	327	419	NA	595	743	833
y-o-y growth						*161.3%*	*127.4%*	*98.8%*
Overall EBITDA margin	**0.4%**	**1.2%**	**1.8%**	**2.0%**	**2.5%**	**2.5%**	**2.9%**	**2.7%**
Mature stores (up to 2008 batch)	NA	3.8%	4.6%	4.8%	NA	4.9%	5.4%	5.3%
Mature stores (2009 batch)	NA	-1.2%	0.6%	1.6%	NA	2.0%	2.7%	2.2%
Mature stores (2010 batch)	NA	-0.7%	1.9%	1.2%	NA	2.8%	3.1%	3.0%
Non-mature stores		-4.3%	-5.7%	-4.4%	NA	-1.9%	-1.0%	-1.0%

Source: Company, CRISIL Research

The margins of the pharmacy business

Mature stores (more than four years of operations) are delivering EBITDA margins of 5%+. We expect this to improve to 6% in the next two years

New beds, better occupancy of old beds to give booster dose

Apollo's future outlook looks promising with estimated revenue growth of 22.3% from the hospitals business in the next three years. Growth will be mainly propelled by i) addition of new beds in the Chennai cluster through organic and inorganic routes, ii) improvement in occupancy at the Hyderabad cluster and iii) addition of beds in tier II/III cities as well as improvement in occupancy in the recently commissioned hospitals in these cities.

The hospitals business estimated to contribute 74% to the top line in FY15

We expect the existing hospitals' revenues to grow at a three-year CAGR of 14% to ₹28.8 bn by FY15, while new hospitals are estimated to register revenues of ₹5 bn by FY15 and contribute 12% to consolidated hospitals revenues. The Chennai cluster will continue to account for a dominant share contributing 37% to hospitals business' revenues followed by the Hyderabad cluster and hospitals in tier II/III cities with 16% share each.

Chennai cluster to continue to drive future growth

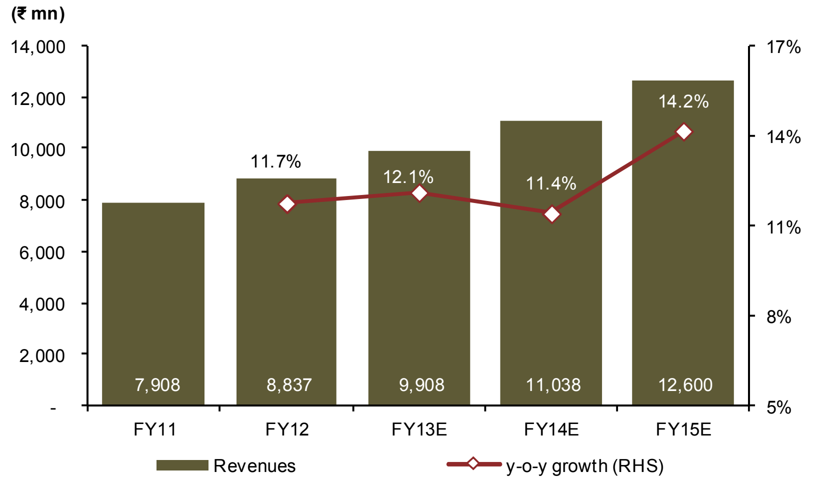
Chennai cluster is currently operating at peak occupancy of 78-80% leaving limited scope to enhance volumes. However, since the company enjoys strong brand equity in Chennai and has a first-mover advantage, it plans to maintain its stronghold and is looking to add more beds in the city. In our opinion, this is a good strategy and will help push future growth. The management is taking the following steps to increase Apollo's presence in Chennai:

Shifting the OPD to a separate building to create space for another 100 beds in the main hospital in Chennai

- Shift the outpatient department (OPD) of Chennai's main hospital (centre of excellence) to a separate building, which is likely to commence operations in the next six-nine months. This is expected to create a space for another 100 beds in the main hospital, which will augment occupancy and drive inpatient revenues.
- Apollo has taken over Lifeline Multispeciality Hospital (180-bed tertiary care) in Perungudi, Chennai on a long-term lease of 29 years. Lifeline was making losses and operations have been closed for the past two months. Apollo will spend ₹500-600 mn to refurbish the facility and bring in its own equipment. The new facility will have specialities such as cardiology, neurology, orthopaedic, critical and trauma care and is expected to start operations in the next six months. The acquisition of Lifeline is expected to strengthen Apollo's presence in Chennai.
- A 200-bed facility in Ayanambakkam (20 km from Chennai's main hospital) has recently commenced operations. The management plans to shift some of the low case-mix patients (high ALOS and low ARPOB) of Chennai's main hospital to the Ayanambakkam facility. This will help boost ARPOB of Chennai's main facility aided by high case-mix such as cardiology, neurology, etc. and also improve occupancy in the Ayanambakkam facility.

  Going forward, we expect the Chennai cluster to register revenue growth of 12.6% during FY12-15.

Figure 4: Chennai cluster's revenues on an uptrend



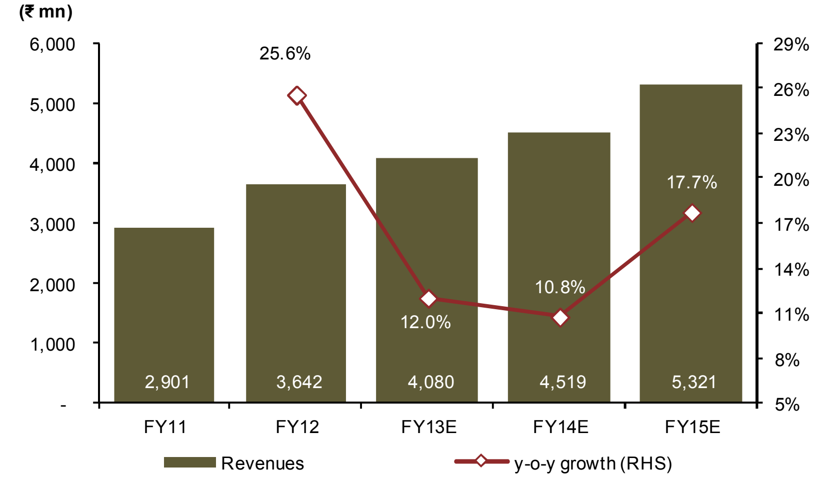
Source: Company, CRISIL Research

Hyderabad clusters' occupancy to improve gradually

Occupancy at the Hyderabad cluster to improve gradually

Owing to the large supply of beds in the past one year, occupancy in the Hyderabad cluster remained flat at 64-66%. The management is cognizant of this and is taking measures such as conversion of the multi-speciality hospital (with low occupancy) to a super-speciality hospital and recruiting more doctors. We believe these measures will gradually improve the occupancy. We expect the Hyderabad cluster to register three-year revenue CAGR of 14% to ₹5.3 bn in FY15.

Figure 5: Hyderabad cluster's revenues posted steady growth



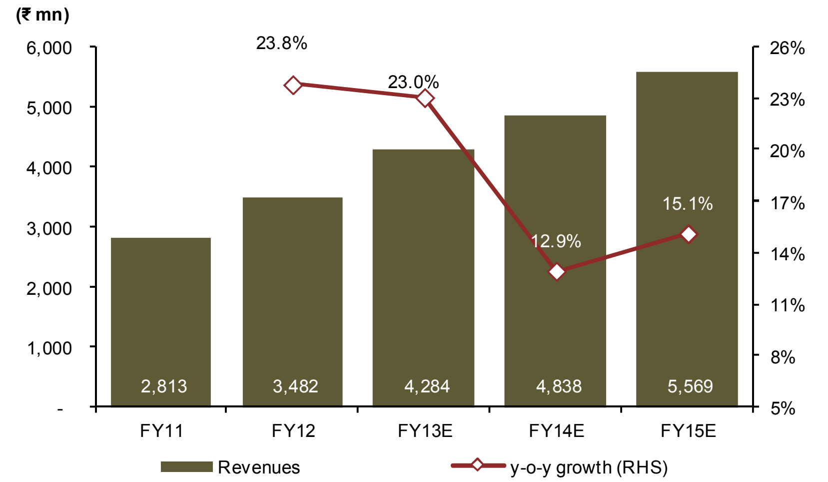
Source: Company, CRISIL Research

Hospitals in tier II/III cities to provide impetus to growth

Healthy growth expected from hospitals in tier II/III cities

Performance of hospitals in tier II/III cities has been robust in the past two years. We expect the momentum to continue and anticipate occupancy and ARPOB to record strong growth. Revenues from existing hospitals are expected to grow at a three-year CAGR of 17% to ₹5.6 bn in FY15.

Figure 6: Existing hospitals in tier II/III cities to record robust growth



Source: Company, CRISIL Research

We expect ~2,000 beds to be added in the next two years, of which 50% are in tier II/III cities such as Trichy, Nashik, Nellore, Vizag, etc. Revenues from these hospitals are estimated to be ₹0.9 bn in FY14 and ₹1.8 bn in FY15.

Investment in new technology gives Apollo an edge

Apollo has been continuously investing to stay abreast of latest technology. Recently, it announced plans to set up a proton therapy centre in Chennai for cancer patients. Proton therapy is an advanced technology which has few side effects compared to standard radiation technology. The dose is targeted to the affected area thereby sparing healthy tissues. The proton therapy centre will be the first-of-its-kind across South East Asia, Africa and Australia. Apollo will invest ₹4,500 mn over the next three years which includes equipment cost of ₹3,000 mn; the equipment will be supplied by Ion Beam Applications SA, a Belgium-based company.

Proton therapy centre requires two patients/day to break-even at PBT; RoCE of 16% with three patients/day

We have analysed the business potential of a proton therapy centre in India. Considering an average treatment costs ₹2 mn per patient (compared to US$60,000-70,000 in the US) and EBITDA margin of 40-45%, our analysis suggests that the proton therapy centre would break-even at PBT at two patients per day (~700 patients in a year). Our analysis also suggests that with three patients per day, the investments in this centre will generate RoCE of 16%+. We have also looked at the performance of some of the key centres in the US using proton technology such as MGH Boston, MD Anderson Houston, Rinecker and UNI Florida Jacksonville. On an average, these centres treat ~300 patients every year. As of 2011, there were 1.5 mn cancer patients and 11 proton therapy centres in the US. In India, over 1 mn of people are estimated to be suffering from cancer and this number is increasing every year by 2%. Given that Apollo's proton centre will be the first across Asia, Africa and Australia, we believe the market potential is large.

Proton therapy is a type of particle therapy which uses a beam of protons to irradiate diseased tissue

Table 6: Two patients per day for PBT to break even

Details	
No. of patients per day	2
Patients per year	694
Revenues (₹ mn)	1,532
Operating costs	992
EBITDA margin	35.2%
Depreciation	225
Interest	277
PBT	37
Tax	12
PAT	25
RoCE	5.6%

Source: Company, CRISIL Research

Table 7: RoCE of 16.5% at three patients per day

Details	
No. of patients per day	3
Patients per year	1,132
Revenues (₹ mn)	2,691
Operating costs	1,509
EBITDA margin	43.9%
Depreciation	225
Interest	185
PBT	772
Tax	255
PAT	517
RoCE	16.5%

Source: Company, CRISIL Research

Capacity additions largely on track despite few delays

As highlighted in our Q3FY13 update, Apollo plans to add 3,000 beds in the next three years. Of these 3,000 beds, 325 beds – spread across the Ayanambakkam and Bengaluru hospitals – have recently commenced operations. While progress on majority of the (2,700) beds is on track, some of the projects are stuck or have been delayed. Projects in Nashik (125 beds) and Navi Mumbai (350 beds) are likely to be delayed by nine-twelve months due to regulatory hurdles. There has been no progress on the 250-bed facility in Thane (under JV with Yash Birla Group) due to certain issues in land purchase. Also, a 300-bed facility in Byculla has not yet received the land allocation letter, resulting in delay in commencement of constructions. If the projects in Thane and Byculla remain stuck, Apollo may eventually not go ahead with these projects and look to add more beds in some other location. The expansion plan has total capital outlay of ₹21.7 bn (including ₹4.5 bn for setting up the proton therapy centre). Apollo had already spent ₹5.1 bn till Q3FY13 and the balance is expected to be funded through a mix of debt, internal accruals and proceeds of ₹2.1 bn from stake sale of 39.4% in associate BPO company - Apollo Health Street.

Progress on addition of 2,700 beds largely on track

Table 8: Status of upcoming hospitals

	Projects	No. of beds	Total cost (₹ mn)	Apollo's share (₹ mn)	Capex/bed (₹ mn)	Earlier expected completion	Expected completion	Current status
Expansion in existing projects (A)		**30**	**180**	**180**				
1	Chennai - Main	30	100	100	3.3	FY13	FY14	To commence operations in Q4FY14
2	Bilaspur - Oncology		80	80		FY13	FY13	To commence operations in May 2013
Reach hospitals (B)		**725**	**2,832**	**2,832**				
3	Ayanambakkam	200	700	700	3.5	FY13	FY13	Commenced operations in March 2013
4	Trichy	200	945	945	4.7	FY14	FY14	Total capex increased by ₹290 mn as it will be a tertiary care hospital instead of secondary care as planned earlier. Likely to commence operations in FY14
5	Nashik	125	520	520	4.2	FY13	FY14	Delayed by a year due to approval hurdles
6	Nellore	200	667	667	3.3	FY14	FY14	Construction on track. To commence operations in Q3FY14
Super speciality hospitals (C)		**1,985**	**18,056**	**18,056**				
7	Bangalore Ortho & Spine	125	558	558	4.5	FY13	FY13	Commenced operations in March 2013
8	Vizag	300	1,150	1,150	3.8	FY14	FY14	Construction work on track. To commence operations in Q4FY14
9	Navi Mumbai	350	3,500	3,500	10.0	FY14	FY15	Delayed by a year due to hurdles in handover of land
10	Women and Child (Chennai)	60	740	740	12.3	NA	FY14	Construction on track. To commence operations in Q3FY14
11	North Bangalore	180	770	770	4.3	NA	FY14	Construction on track. To commence operations in Q3FY14
12	Chennai (OMR)	45	310	310	6.9	NA	FY15	Construction on track. To commence operations in FY15
13	Byculla, Mumbai	300	1,400	1,400	4.7	FY14	FY15	Yet to receive the necessary approval. May not go ahead with the project if the hurdles in getting the approval persist

	Projects	No. of beds	Total cost (₹ mn)	Apollo's share (₹ mn)	Capex/bed (₹ mn)	Earlier expected completion	Expected completion	Current status
14	South Chennai	200	2,000	2,000	10.0	NA	FY15	Recently announced. Construction to commence in three-six months
15	Patna phase I	240	2,760	2,760	11.5	NA	FY15	Recently announced. Construction to commence in three-six months
16	Indore	185	668	668	3.6	NA	FY15	Recently announced. Yet to receive land to begin construction. May not go ahead with its plans
17	Proton		4,200	4,200		NA	FY17	Recently signed an agreement with Ion Beam, a Belgium-based manufacturer of proton equipment. To commence operations in FY17
Total (A+B+C)		**2,740**	**21,068**	**21,068**				
JVs and Associates (D)		**250**	**2,537**	**633**				
18	MLCP		337	83		FY13	FY14	To commence operations in FY14
19	Thane (super speciality)	250	2,200	550	8.8	FY14	FY15	Yet to receive land. May not go ahead with the project in case there are issues in getting the land
Total (A+B+C+D)		**2,990**	**23,605**	**21,701**				

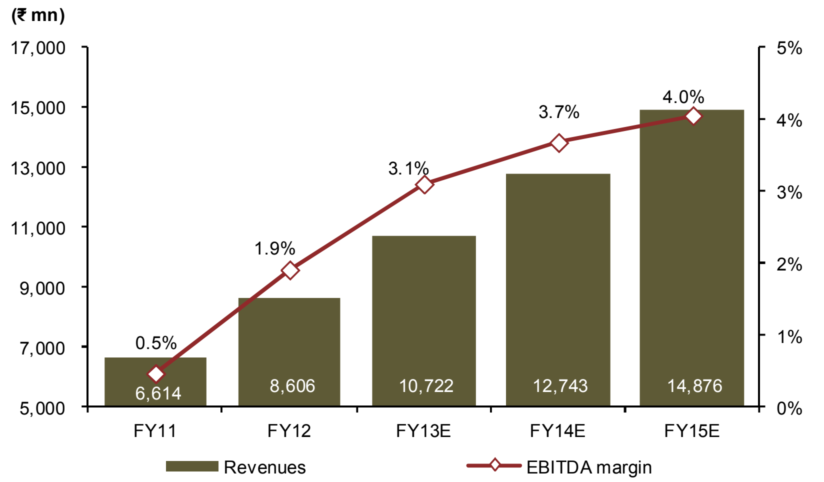
Source: Company, CRISIL Research

Pharmacy business to record robust growth; margins to improve

Apollo is going slow on store additions and is focusing on improving the profitability of existing stores. Going forward, we expect Apollo to add 100 new stores every year. This coupled with the 15-16% growth in the existing mature stores will drive revenue growth; we expect revenues to grow at a three-year CAGR of 20% to ₹14.9 bn in FY15. EBITDA margin is expected to improve to 4.0% in FY15 from 2.7% currently.

Expect 100 new stores to be added every year

Figure 7: Pharmacy business' margin to improve 80 bps in next two years



Source: Company, CRISIL Research

Decoding the business model of pharmacy retail

We have analysed the business model of the pharmacy retail chains to understand the potential margins and return ratios that the business can generate. We have done this analysis at the store level. Based on our sourcing and discussions, we understand the following:

Sales mix - Typically in a pharmacy store, prescription drugs account for 70-75% of the total sales, followed by 20-25% sale from OTC products and 5-7% from private label goods.

Margin – Gross margin on prescription drugs is 20-22%, 8-10% on the OTC products and 35-40% on private label goods.

Fixed costs – A store with 250-300 sq ft of area has fixed cost of ₹1 mn per year, including rentals, electricity expenses, staff costs and other incidental expenses.

Investments and working capital – Initial investment per store is ₹2 mn which includes security deposits to the lessor, interiors and pre-operative expenses. Working capital requirements would be negligible as inventory requirements of 30-35 days are offset by credit period of 30-35 for the goods purchased. Also, debtor days are minimal.

Our analysis suggests that a standalone store need to clock yearly turnover of ₹5 mn (~₹14,000 per day) to break-even at EBITDA level. Expected revenues for a store to break-even at PBT level is ₹8 mn (₹22,000 per day). Our analysis also suggests that a store with yearly turnover of ₹10 mn (₹28,000 per day) will be able to generate a RoCE of 16%.

Table 9: Revenues of ₹8 mn will lead to PBT break-even

Details	
Revenue per day (₹)	22,000
Revenue per annum (₹ mn)	7.9
Gross margin	22.2%
Fixed costs (₹ mn)	1.4
EBITDA (₹ mn)	0.4
EBITDA margin	4.5%
Depreciation (₹ mn)	0.1
Interest (₹ mn)	0.2
PBT (₹ mn)	0.1
Tax (₹ mn)	0.0
PAT (₹ mn)	0.0
RoCE	9.7%

Source: Company, CRISIL Research

Note: Assuming a capital structure with 50% debt

Table 10: RoCE of 16% at revenues of ₹10 mn

Details	
Revenue per day (₹)	28,000
Revenue per annum (₹ mn)	10.1
Gross margin	22.4%
Fixed costs (₹ mn)	1.7
EBITDA (₹ mn)	0.5
EBITDA margin	5.1%
Depreciation (₹ mn)	0.1
Interest (₹ mn)	0.1
PBT (₹ mn)	0.3
Tax (₹ mn)	0.1
PAT (₹ mn)	0.0
RoCE	16.3%

Source: Company, CRISIL Research

Where does Apollo's pharmacy business currently stand?

As of December 2012, Apollo has 1,445 pharmacy stores. At an aggregate level, current revenue per store is ₹8 mn (₹22,000 per day) with EBITDA margin of 2.7%. Mature stores (up to 2008 batch), comprising 32% of the current network, have revenue per store of ₹10.6 mn (₹29,500 per day) with EBITDA margin of 5.3%. Given that the yearly revenue for Apollo's mature stores is ₹10.6 mn, these stores already have RoCE of more than 15% and have the potential to earn higher returns in the subsequent years. Going forward, once the pharmacy business achieves a particular scale and the existing stores achieve maturity, we expect RoCE to improve to 12.9% in FY15 from the current 7.5%.

What kind of RoEs can a mature, successful pharmacy store generate in 6-7 years of operations? Our analysis: can be as high as 30%

We have also tried to analyse the return potential of a mature pharmacy store which has been operational for six-seven years. Based on our analysis, we understand the following;

i) Once mature (six-seven years of operations), SSS growth will be in the range of 11-12%.This will be driven by 3-4% price growth and 8-9% volume growth.

ii) Once mature, the asset turnover of a pharmacy store will be close to 6-7x and EBITDA margin will be 6.5-7%.

Accordingly, we understand that an established store with operations of more than six-seven years has a potential to earn RoCE of ~30%. With some proportion of the capital being funded through debt, RoE can be more than 30%. While this is possible for a mature store at an aggregate level, due to corporate overheads and some stores which may not be performing well, RoE could be in the range of 28-30% once all the stores mature and no new stores are added.

International pharmacy chains earn margin of 6-6.5%, RoCE of 12-13%

We have looked at the performance of the international pharmacy chain companies such as Walgreens and CVS Caremark who own more than 7,500 stores. Majority of the owned stores are mature and earn EBITDA margin of 6-6.5%. However, due to low asset turnover of 2-2.5x, RoCE is in the range of 12-13%. While EBITDA margin of the mature stores in India is comparable to international companies, revenue growth potential for organised players in India is huge since organised pharmacy retail penetration is 5% vs. 75-80% in the US. Compared to asset turnover of 2-3x for the international companies, we believe mature stores in India have the potential to have asset-turnover of 6-7x.

Table 11: Details of international players and comparison

Particulars	Number of stores			Revenue/ store (US$ mn)			EBITDA margin			Asset turnover (x)			RoCE (%)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
International Companies															
Walgreens	8,046	8,210	8,385	8.4	8.8	8.5	6.7%	7.6%	6.5%	2.6	2.6	2.1	13.2	14.5	10.4
CVS Caremark	7,248	7,388	7,508	13.2	14.5	16.4	7.9%	7.4%	7.3%	1.5	1.7	1.9	9.9	9.8	11.7
Rite Aid	4,780	4,714	4,,667	5.4	5.3	5.6	2.1%	2.1%	2.3%	3.2	3.3	3.5	2.5	2.6	4.1
Shoppers Drug Mart	1,182	1,257	1,295	8.4	8.4	8.3	11.5%	11.5%	11.1%	1.4	1.5	1.4	12.8	13.5	12.5

	Number of stores			Revenue/ store (₹ mn)			EBITDA margin			Asset turnover (x)			RoCE (%)		
Particulars	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Domestic Companies															
Apollo (pharmacy division)	1,049	1,199	1,364	4.6	5.5	6.3	-2.1%	0.5%	1.9%	2.7	3.0	3.2	-8.7	-1.9	2.9
Optival Health Solutions	741	800	1,052	4.7	5.5	5.9	1.9%	1.1%	0.1%	NA	NA	NA	-18.2	9.8	-2.8

Source: Company, CRISIL Research

Private labels' contribution grew; further increase in share a challenge

Apollo is focusing on increasing the sale of private label goods given the relatively high gross margin of 35-40% compared to 20-22% in medicines. It sells private label products under three brands: a) Doctors Choice, b) B Positive and 3) Apollo. The company was successful in increasing the contribution of private labels to the top line to ~5% in Q3FY13 from 2% in Q1FY12. However, we believe that further increase will be a challenge given the limited brand recall due to minimal spends on marketing. Also, there is intense competition from established FMCG players. Our analysis of the revenue profile of international pharmacy retail chain players highlights that their share of private label goods is 5-7%.

Stake sale in pharmacy business will help unlock value; FDI in multi-brand retail paves way for strategic partner

In September 2012, the Government of India approved foreign direct investments (FDI) in multi-brand retail. To unlock value in the pharmacy business, Apollo is looking to bring in a strategic partner once it achieves reasonable scale and profitability. Given the largest organised pharmacy retail chain network, we believe large international companies would be interested in acquiring a stake in Apollo. However, this may take time as there are risks and challenges:

Implementation of FDI in multi-brand retail in India to take time

- Since FDI in retail is a state subject, every state has to give clearance for setting up a store. Till date, only nine states and two union territories have approved the policy. With the general elections in May 2014 and some state elections in FY14, political uncertainty exists.
- Retailers can set up stores in cities with a population of 1 mn - this restricts the foray into upcoming tier II/III cities.

Transactions in Indian pharmacy space have happened at EV/store of ₹15 mn, EV/sales of 2x

Mount Kellet Capital, TVS Capital and Ajay Piramal Group's healthcare fund have valued Optival Health Solutions (operating under the Medplus brand) at ₹11.7 bn (acquired 35% stake for ₹4.1 bn). Considering 800 stores at the time of acquisition (currently 1,050 stores), EV/store multiple is ₹15 mn. Similarly, a private equity arm of Japanese firm Mitsui Corp. invested ₹800 mn for 26.7% stake in Guardian Life Care. It has 230 stores and the assigned EV/store multiple is ₹13 mn. Given that Apollo has the largest network of 1,445 stores with profitability more than these pharmacy chains, it should command premium multiples compared to the previously inked deals.

Table 12: Deals in the Indian pharmacy industry

Particulars		
Acquired stake in	**Optival Health Solutions**	**Guardian Life Care**
Acquired by	Mount Kellet Capital, TVS Capital and Ajay Piramal group	Mitsui Corporation
Year	Apr-11	Dec-12
Stake acquired	35%	26.7%
Amount (₹ mn)	4,100	800
Equity value assigned (₹ mn)	11,714	2,995
EV (₹ mn)	12,162	2,995
No. of stores (at the time of acquisition)	800	230
FY12 Sales (₹ mn)	6,188	1,100
FY12 EBITDA (₹ mn)	8	NA
EV/store (₹ mn)	15.2	13.0
EV/sales (x)	2.0	2.7
EV/EBITDA (x)	1,483	NA

Source: Industry, CRISIL Research

Table 13: Valuation multiples of international pharmacy chains

		EV/sales (x)			EV/EBITDA (x)			EV/store (US$ mn)	
Company	**EV (US$ mn)**	**CY13E**	**CY14E**	**CY15E**	**CY13E**	**CY14E**	**CY15E**	**CY11**	**CY12**
Walgreens	50,296	0.69	0.66	0.64	8.9	8.2	7.7	6.1	6.0
CVS Caremark	80,441	0.64	0.62	0.60	8.2	7.7	7.3	10.9	10.7
Rite Aid	8,428	0.33	0.33	0.33	7.4	6.9	6.9	1.8	1.8
Shoppers Drug Mart	10,320	0.93	0.89	0.86	8.5	8.3	8.0	8.2	8.0
Raia Drogasil	3,572	1.09	0.91	0.79	15.5	12.0	10.9	4.8	4.1

Source: Industry, CRISIL Research

The assigned EV/sales multiple of 2-2.5x for Indian pharmacy chains is at a significant premium compared to 0.6-0.7x for international pharmacy chains. We believe the premium for Indian players is due to the strong growth potential of the industry and rising organised pharmacy retail penetration in India.

Return ratios to improve; pharmacy business' RoCE to expand

RoCE to improve to 15.8% in FY15 from 12.6% in FY12

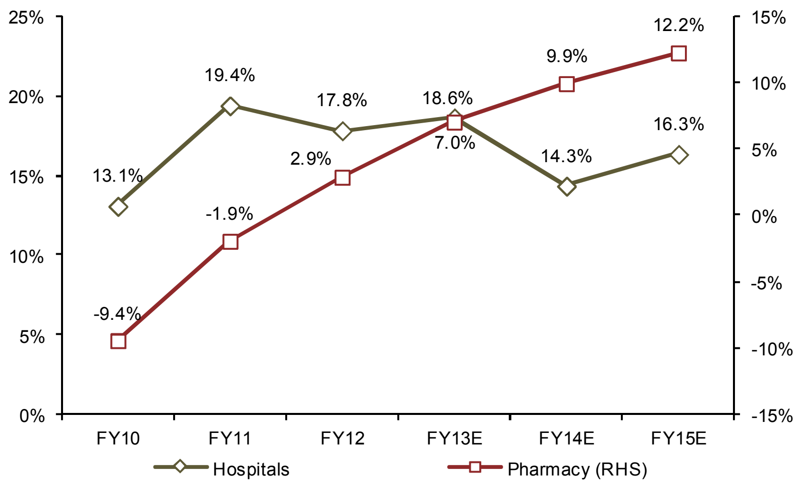
Apollo's RoCE improved to 12.6% in FY12 from 8.2% in FY09 driven by growth in the hospitals business and fewer losses in the pharmacy business. While the hospitals business' RoCE (excluding funds deployed in capital work-in-progress) improved to 17.8% in FY12 from 15.8% in FY09, the pharmacy business recorded significant improvement to 2.9% in FY12 from negative 16.2% in FY09. Of the total balance sheet (₹34.9 bn) in FY12, 13.5% was in the form of investments mainly in associate companies, which were not yielding any returns. However, with the divestment of stake in Apollo Health Street (invested ₹1.8 bn), Apollo will get ₹2.1 bn, which is expected to be deployed in the hospitals business (higher profitability).

We expect RoCE to improve to 15.8% in FY15 driven by margin expansion in the pharmacy business. Though the pharmacy business was a drag on the return ratios until FY12, we expect it to aid improvement in RoCE in the coming years. The pharmacy business' RoCE is expected to increase to 12.2% in FY15 from 7% in FY13. Due to the addition of ~2,000 beds in the next two years, we expect the hospitals business' RoCE to decline to 16.3% in FY15 from 18.6% in FY13 but it is projected to improve in the subsequent years. We expect RoE to improve to 13.7% in FY15 from 10% in FY13 driven by growth in revenues and profitability.

Table 14: Business-wise RoCE break-down as of FY12

Segment	Capital employed (₹ mn)	EBIT (₹ mn)	RoCE
Hospitals *(capital deployed for 6,000 owned beds)*	20,511	3,655	17.8%
Pharmacy *(capital deployed for 1,350 stores)*	2,716	78	2.9%
Capital WIP *(for the addition of 3,000 beds, which are not yielding returns)*	2,009	NA	NA
Cash and marketable securities *(these investments have yields of 7-8%)*	3,297	NA	7-8%
Investments in JVs *(these include ₹1.8 bn invested in Apollo Health Street)*	4,713	196	4.2%
Others *(deferred tax liabilities)*	1,665		
Total	**34,911**	**3,929**	**11.3%**

Figure 8: Return ratios to improve from the current levels



Source: Company, CRISIL Research

Small presence in standalone clinics, diagnostics; exploring expansion opportunities

Apollo provides consultation and diagnostics services through its primary care clinics. As of December 2012, Apollo Health and Lifestyle (Apollo's wholly-owned subsidiary) has 70 primary care clinics and plans to expand it to 100 clinics in the next two-three years. We believe the expansion of primary clinics will have the following advantages:

- Drive inpatient volumes in the centre of excellence (quaternary care hospital with the latest equipment and technology). Patients diagnosed with critical illness are likely to be admitted to the nearby Apollo Hospital.
- Ease the pressure on the OPD of the nearby hospital.

Expansion of standalone clinics to drive inpatient volumes in the centre of excellence

Key Risks

Delay in addition of new beds

Over the next two-three years, Apollo is likely to add 3,000 beds at different locations such as Bengaluru, Chennai, Mumbai, Nashik, Nellore, Patna, Trichy and Vizag. Some of the projects in Byculla (Mumbai), Nashik (Maharashtra) and Thane (Maharashtra) are behind schedule due to delays in approvals and hurdles in site acquisitions, which we have adequately factored in our projections. More-than-expected delays or cost overruns may impact financials and, consequently, the valuations.

Unavailability of skilled professionals might impact prospects

Given the plan to add 3,000 beds, Apollo will need doctors, nurses and paramedical staff commensurate with its expansion. Its growth strategy and performance are highly dependent on its ability to attract and retain healthcare professionals. Unavailability of skilled professionals or the inability to retain key doctors could impact future prospects.

Rising real estate prices

Land and buildings together account for 40-45% of the total capital costs in setting up a hospital. Rising real estate prices, especially in metros and tier I cities, are making it difficult to put up commercially viable hospitals.

Contingent liability of ₹1 bn, low risk of it getting materialised

As of FY12, Apollo has contingent liability of ₹1 bn on account of export promotion capital goods (EPCG). As per the EPCG scheme, import of capital goods is at a concessional 3% customs duty but is subject to an export obligation ranging from 6 to 8 times of the duty saved. Apollo gets a concessional rate of 3% customs duty on import of medical equipment. Foreign currency income (export obligation) from medical tourists is 5% of total revenues and is more than 6 to 8 times of the duty saved. Therefore, we do not foresee the aforesaid contingent liability materialising.

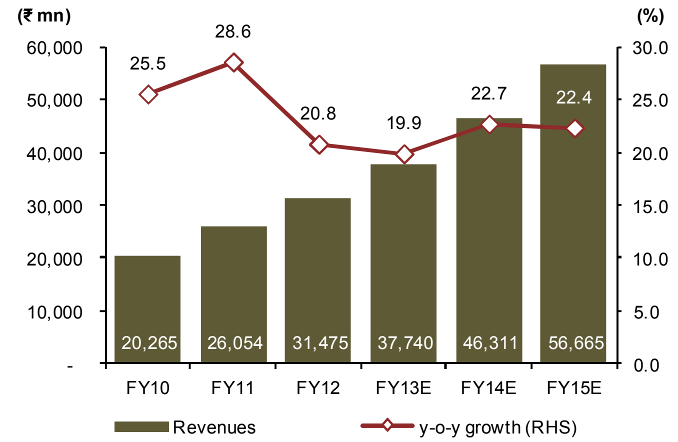
Financial Outlook

Revenues to grow at a three-year CAGR of 22% by FY15

Apollo's consolidated revenues are expected to grow at a three-year CAGR of 22% to ₹56.7 bn in FY15. The hospitals business' revenues are expected to record a growth of 22.3% to ₹41.8 bn in FY15 driven by growth in the existing hospitals and contribution from the new hospitals. The pharmacy business is expected to register a three-year CAGR of 20% to ₹14.9 bn in FY15.

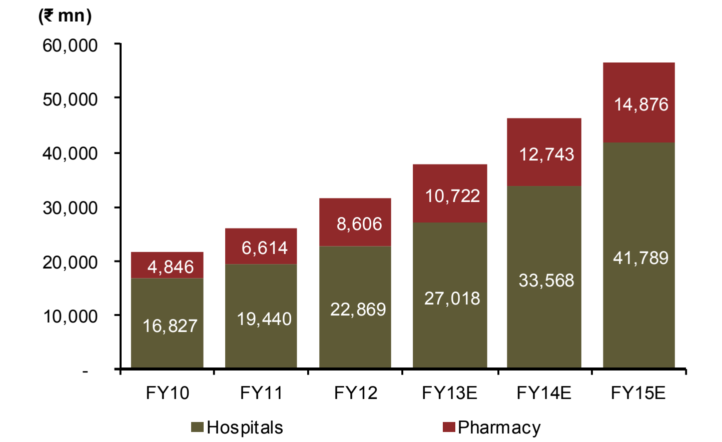
Revenues driven by growth in the hospitals and pharmacy businesses

Figure 9: Revenues to grow 22% in next three years



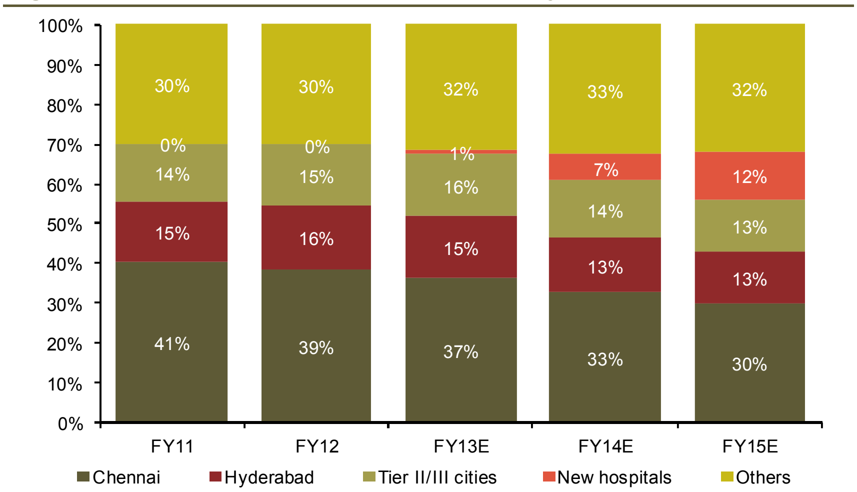
Source: Company, CRISIL Research estimates

Figure 10: Hospitals business to contribute 74% to revenues



Source: Company, CRISIL Research estimates

Figure 11: Chennai cluster to continue to be major contributor



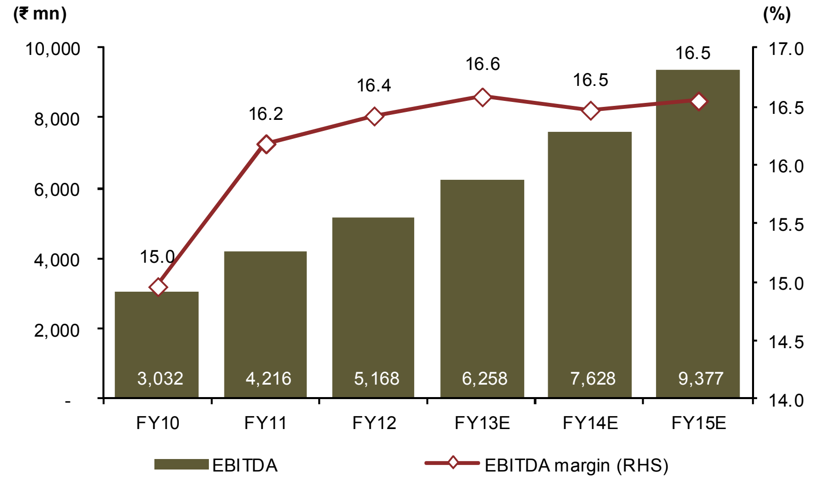
Source: Company, CRISIL Research estimates

EBITDA margin to remain stable

We expect EBITDA margin to remain stable at 16.5% in FY15. Improvement in the pharmacy business' margin by 210 bps in the next three years is expected to be offset by lower margins from new hospitals. We expect about 2,000 beds to be operational by FY15, which are projected to report operating losses in the initial years.

EBITDA margin to remain stable at 16.5% in FY15

Figure 12: EBITDA margin to remain stable



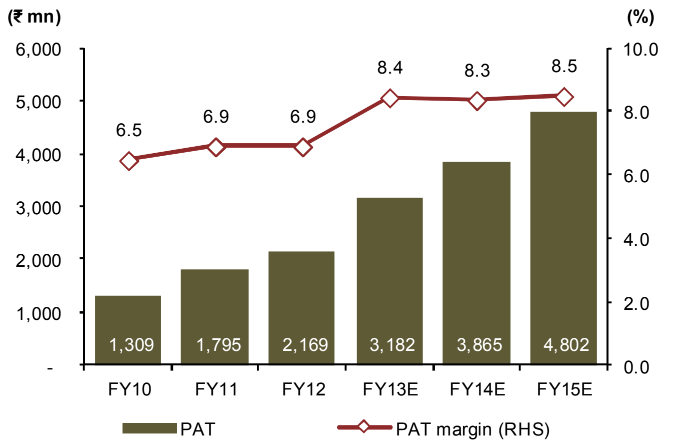
Source: Company, CRISIL Research estimates

PAT to register 30% growth in next three years

Consolidated PAT is expected to grow at a three-year CAGR of 30.3% to ₹4.8 bn driven by revenue growth and lower tax expenses. Post revision in benefits under Section 35AD in the last budget, the company can claim deduction of 150% of the total capex (excluding land). Owing to these benefits, we have considered tax liability at 26% as a percentage of PBT. Adjusted EPS is expected to increase to ₹34.6 in FY15 from ₹16.1 in FY12.

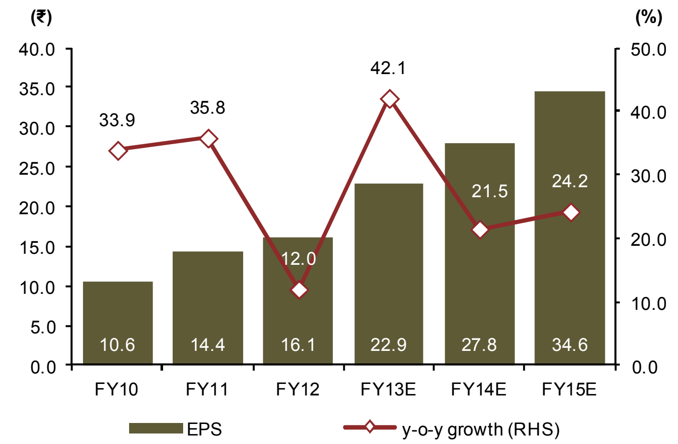
PAT to register higher growth than revenues due to lower tax expenses

Figure 13: PAT to register strong growth



Source: Company, CRISIL Research estimates

Figure 14: EPS and EPS growth



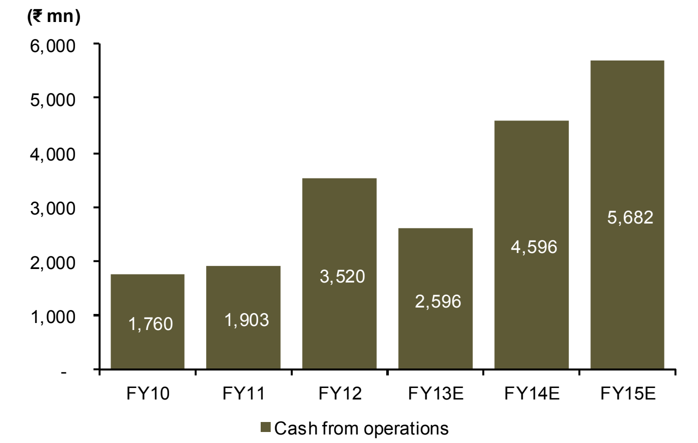
Source: Company, CRISIL Research estimates

Strong cash from operations and a robust balance sheet

Cash flows from operations are expected to increase to ₹5.7 bn in FY15 from ₹3.5 bn in FY12. We estimate debt to increase to ₹11.5 bn in FY15 from the current ₹8.5 bn. Gearing (gross debt to equity) is expected to remain stable at 0.3x and interest coverage ratio is expected to increase to 7.4x in FY15 from 4.4x in FY12 driven by growth in revenues and stable EBITDA margin.

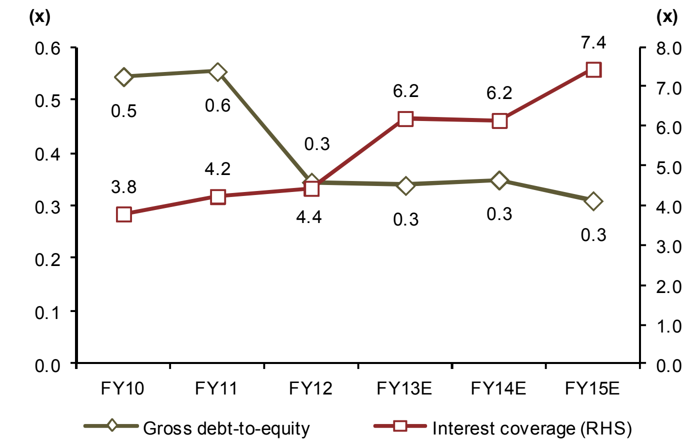
Interest coverage ratio to improve to 7.4x in FY15 from 4.4x in FY12

Figure 15: Strong cash flows from operations



Source: Company, CRISIL Research estimates

Figure 16: Gearing under check, room for further expansion



Source: Company, CRISIL Research estimates

Management Overview

CRISIL's fundamental grading methodology includes a broad assessment of management quality, apart from other key factors such as industry and business prospects, and financial performance.

Experienced and professional management

Experienced management with more than three decades of experience

Apollo has a professional management with more than three decades of experience in the healthcare services industry. The management team is headed by Dr Prathap Reddy, founder and executive chairman. He holds a medical degree from Stanley Medical College, Chennai and has received Fellowship from the Massachusetts General Hospital, Boston, US. He was felicitated with Padma Vibhushan in FY10 by the Government of India for his exceptional service in the healthcare industry. Mr Reddy is supported by his four daughters:

Ms Preetha Reddy (managing director) holds a a Masters in Public Administration from Madras University. She oversees operations, planning, designing and funding of new projects.

Ms Suneeta Reddy (joint managing director) completed the President Management Program at Harvard Business School. She oversees finance.

Ms Sangita Reddy (executive director – operations) has done Masters in Hospital Administration from Rutgers University, US. She heads the HR and IT functions.

Ms Shobana Kamineni (executive director – special initiatives) has done BA in Economics from Stella Maris College, Chennai. She heads the pharmacy business.

Strong second line of management

Apollo has a strong second line of management represented by Mr K. Padmanabhan (group president), Mr S.K. Venkataraman (chief strategy officer) and Mr Krishnan Akhileswaran (CFO). Our interactions with the second line indicate that they have been given sufficient powers to take independent decisions.

Succession plan in place

Ms Preetha Reddy will take over after Mr Prathap Reddy retires

We believe Apollo has a succession plan in place. Ms Preetha Reddy will take over the position/role of Mr Prathap Reddy post his retiremnent and all the daughters of Mr Prathap Reddy have well-defined roles and responsibilities. Also, recently, Apollo has formed a team to draft a will to detail the distribution of wealth amongst the family members. The team includes Mr Reddy, his four daughters and two professional advisers. The promoter holding of 34.4%, currently held by different family members, is being consolidated under one entity - PCR Investments. Given proper mechanisms with pre-defined roles and responsibilities and distribution of wealth to family members through a will, we do not foresee any succession issues.

Corporate Governance

CRISIL's fundamental grading methodology includes a broad assessment of corporate governance and management quality, apart from other key factors such as industry and business prospects, and financial performance. In this context, CRISIL Research analyses the shareholding structure, board composition, typical board processes, disclosure standards and related-party transactions. Any qualifications by regulators or auditors also serve as useful inputs while assessing a company's corporate governance.

Corporate governance at Apollo reflects good practices supported by a fairly independent board with relevant experience. Board processes and structures confirm to minimum standards.

Board composition

Apollo's board consists of 15 members, of whom eight are independent directors, exceeding the requirements under Clause 49 of SEBI's listing guidelines. The directors are well qualified and have strong industry experience. The independent directors have a good understanding of the company's businesses and processes.

Of the 15 members on the board, eight are independent

Board processes

The company has various committees – audit, remuneration, investors' grievance, investment – in place to support corporate governance practices. CRISIL Research assesses from its interactions with independent directors that the quality of agenda papers and the level of discussions at the board meetings are good. We understand that the independent directors are well aware of the company's businesses and are fairly engaged in all the major decisions. The audit committee is chaired by an independent director, Mr Deepak Vaidya, who has more than 20 years of experience in finance. The audit committee meets at timely and regular intervals. The board also includes known names such as Mr N Vaghul, who is on the board of major organisations such as Piramal Healthcare and Wipro, and Mr T Balaji, who is on the board of Titan Industries, Sundaraman Clayton.

Good disclosure levels

The company has good disclosure levels judged by the level of information and details furnished in the annual report, presentations, websites and other publicly available data. For instance, the company provides cluster-wise hospitals and other businesses' performance in its quarterly presentations. The disclosure level is sufficient to analyse varied business aspects, however additional information on cluster-wise margins would be helpful in analysing the margin trends.

Related party transactions with group companies

Apollo purchases medicines from Keimed Ltd, an entity owned by the promoters. Apollo gives 2-3% margin to Keimed, which we believe is on an arm's length basis. It purchased medicines worth ₹3.2 bn in FY12 and ₹2.6 bn in FY11. The management highlighted that Keimed will be eventually merged with Apollo pharmacy; this remains a monitorable.

Apollo purchases medicines from its group company

Valuation Grade: 4/5

Retained fair value of ₹982 per share

We continue to value Apollo by the discounted cash flow (DCF) method and retain our fair value of ₹982 per share. At this value, the implied EV/EBITDA multiples are 19.0x FY14E and 15.4x FY15E EBITDA. At the current market price of ₹826, it translates into a valuation grade of **4/5**.

Key assumptions

We have considered the discounted value of the firm's estimated free cash flow from FY15 and have assumed a terminal growth rate of 5%.

WACC assumptions

	Explicit period	Terminal value
Cost of equity	13.5%	13.5%
Cost of debt (post tax)	7.7%	7.7%
WACC	11.2%	10.6%
Terminal growth rate		5.0%

We have also done a sensitivity of the valuation to terminal growth, changes in ARPOB and occupancy.

Sensitivity of fair value to WACC and terminal growth

WACC \ Terminal growth	3.0%	4.0%	5.0%	6.0%	7.0%
8.6%	1,062	1,273	1,602	2,184	3,491
9.6%	880	1,021	1,223	1,537	2,093
10.6%	749	848	**982**	1,175	1,475
11.6%	649	722	817	946	1,130
12.6%	572	628	697	788	911

Sensitivity to WACC and change in ARPOB

WACC \ Changes in ARPOB	2.0%	5.0%	8.0%	11.0%	14.0%
8.6%	1,593	1,598	1,602	1,607	1,611
9.6%	1,216	1,220	1,223	1,226	1,230
10.6%	977	980	**982**	985	988
11.6%	813	815	817	819	821
12.6%	693	695	697	699	701

Source: Company, CRISIL Research

Sensitivity to WACC and occupancy

WACC \ Occupancy	70%	75%	80%	85%	90%
8.6%	1,582	1,592	1,602	1,612	1,623
9.6%	1,208	1,215	1,223	1,231	1,238
10.6%	970	976	**982**	988	994
11.6%	807	812	817	822	827
12.6%	689	693	697	701	705

Source: Company, CRISIL Research

CRISIL RESEARCH

Valuation multiples of Indian and international players

		ROE			P/E			P/BV			EV/EBITDA		
Indian Players (₹ mn)	**Mkt Cap**	**CY12**	**CY13E**	**CY14E**	**CY12**	**CY13E**	**CY14E**	**CY12**	**CY13E**	**CY14E**	**CY12**	**CY13E**	**CY14E**
Apollo Hospitals Enterprise*	114,609	10.0	11.7	12.3	51.2	36.0	29.7	4.5	3.9	3.5	22.5	19.1	16.0
Fortis Healthcare Ltd*	41,676	2.2	(2.7)	0.7	57.7	(43.6)	47.5	1.3	1.0	1.0	15.8	16.6	22.0
Median		**6.1**	**4.5**	**6.5**	**54.5**	**(3.7)**	**38.6**	**2.9**	**2.5**	**2.3**	**19.2**	**17.9**	**19.0**
US Players (US$ mn)													
Universal Health Services-B	6,397	17.7	14.5	14.7	14.3	14.5	12.8	2.3	2.0	1.8	18.7	8.3	7.6
Community Health Systems Inc	4,215	10.4	11.7	12.8	15.0	12.2	10.0	1.5	1.3	1.2	7.1	6.9	6.4
Median		**14.0**	**13.1**	**13.8**	**14.6**	**13.4**	**11.4**	**1.9**	**1.7**	**1.5**	**12.9**	**7.6**	**7.0**
Other Global players (US$ mn)													
Ramsay Health Care Ltd*	6,497	20.4	19.1	19.6	28.5	23.5	20.7	5.5	4.4	4.0	14.8	12.1	11.0
Raffles Medical	1,876	15.7	15.4	16.5	32.6	30.1	25.0	4.8	4.4	3.9	25.4	21.6	18.5
Bangkok Dusit	258,092	22.9	17.9	19.2	32.5	35.8	29.9	6.9	6.2	5.4	27.0	22.8	19.8
Bangkok Chain Hospital Pcl	24,339	26.6	23.7	25.1	26.5	27.2	23.9	6.7	5.9	5.3	17.0	15.0	13.4
Median		**21.6**	**18.5**	**19.4**	**30.5**	**28.6**	**24.5**	**6.1**	**5.1**	**4.6**	**21.2**	**18.3**	**15.9**
Overall median		**16.7**	**15.0**	**15.6**	**30.5**	**25.4**	**24.5**	**4.7**	**4.2**	**3.7**	**17.9**	**15.8**	**14.7**

*FY12, FY13, FY14

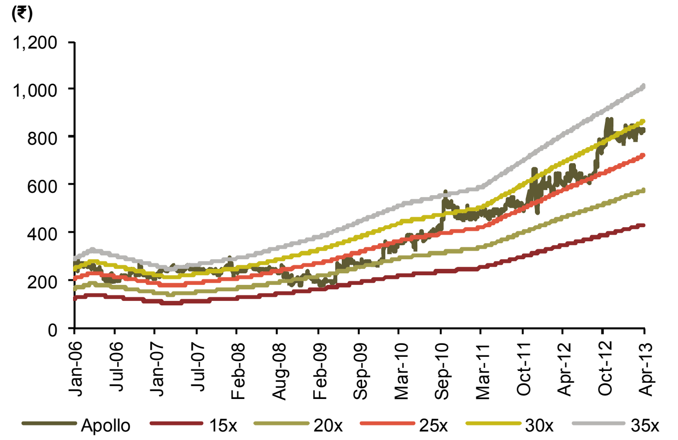
Source: Company, CRISIL Research

Apollo commands premium multiple

Apollo is currently trading at an EV/EBITDA multiple of 16.0x based on our FY14 EBITDA estimate. We have also analysed valuation multiples of other Indian and international healthcare players. Based on our fair value of ₹982 per share, an implied one-year forward EV/EBITDA multiple for Apollo is 19x FY14 EBITDA. This is at a premium compared to overall median of 14.7x for Indian and international companies. We believe that the premium over other companies is justified given Apollo's strong brand equity, healthy growth prospects, improving profitability margins, better return ratios, strong balance sheet and prudent management.

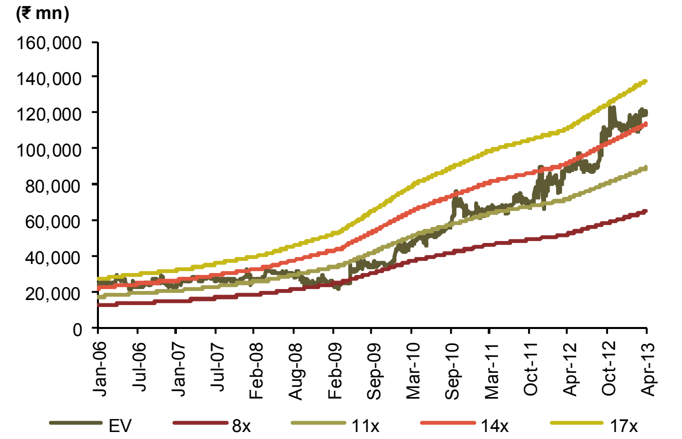
Some of the international players such as Bangkok Dusit (4,285 beds) have historically traded at a one-year forward EV/EBITDA multiple of 19-20x due to healthy revenue growth of 17%, superior EBITDA margin of 23% and RoCE of 20%+ in the past two-three years.

One-year forward P/E band



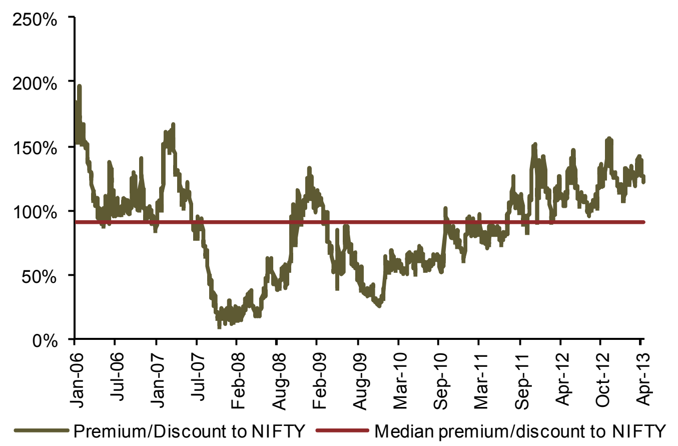
Source: NSE, CRISIL Research

One-year forward EV/EBITDA band



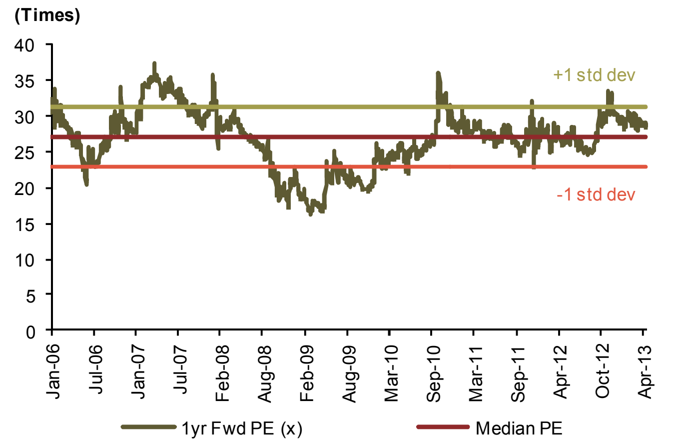
Source: NSE, CRISIL Research

P/E – premium / discount to Nifty



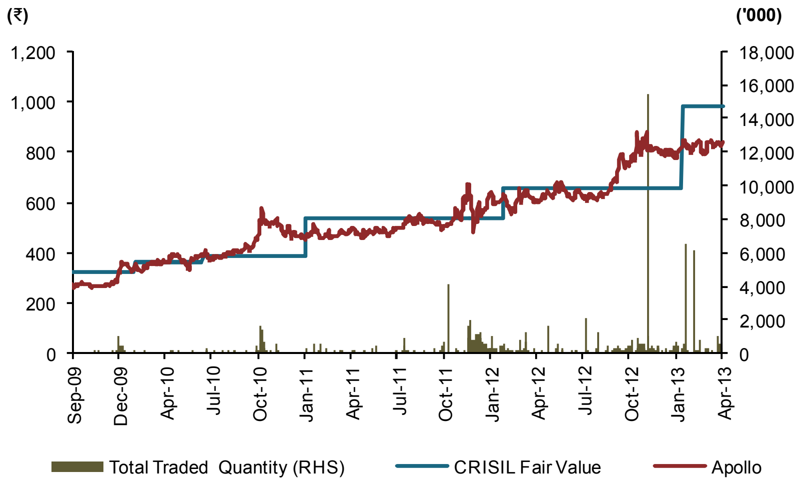
Source: NSE, CRISIL Research

P/E movement



Source: NSE, CRISIL Research

Figure 17: Fair value movement since initiation



Source: BSE, NSE, CRISIL Research

CRISIL RESEARCH

CRISIL IER reports released on Apollo Hospitals Enterprise Ltd

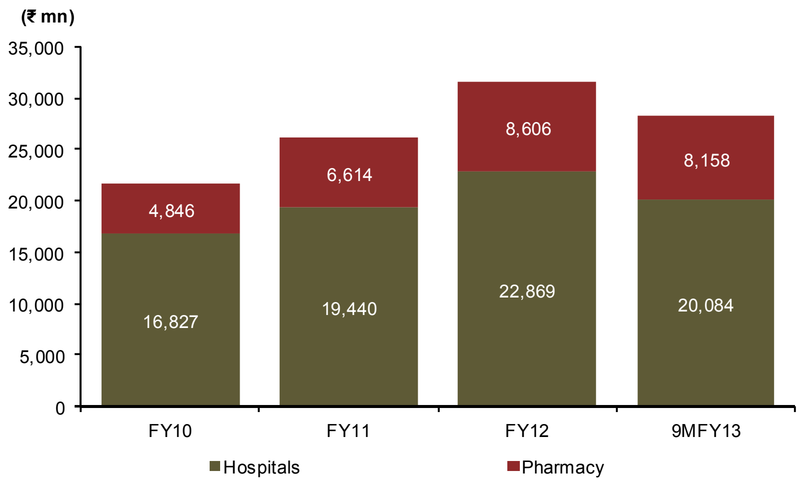
Date	Nature of report	Fundamental grade	Fair value	Valuation grade	CMP (on the date of report)
22-Sep-09	Initiating coverage	4/5	₹321#	4/5	₹270#
30-Nov-09	Q2FY10 result update	4/5	₹321#	4/5	₹264#
01-Feb-10	Q3FY10 result update	4/5	₹362#	3/5	₹356#
18-Jun-10	Q4FY10 result update	4/5	₹387#	3/5	₹390#
27-Aug-10	Q1FY11 result update	4/5	₹387#	3/5	₹402#
07-Jan-11	Detailed Report	5/5	₹533	4/5	₹454
15-Feb-11	Q3FY11 result update	5/5	₹533	4/5	₹463
06-Jun-11	Q4FY11 result update	5/5	₹533	3/5	₹489
15-Aug-11	Q1FY12 result update	5/5	₹533	3/5	₹516
10-Nov-11	Q2FY12 result update	5/5	₹533	3/5	₹549
23-Nov-11	Detailed Report	5/5	₹533	3/5	₹559
16-Feb-12	Q3FY12 result update	5/5	₹655	3/5	₹613
07-Jun-12	Q4FY12 result update	5/5	₹655	3/5	₹680
17-Aug-12	Q1FY13 result update	5/5	₹655	3/5	₹626
16-Nov-12	Q2FY13 result update	5/5	₹655	2/5	₹834
14-Feb-13	Q3FY13 result update	5/5	₹982	4/5	₹840
02-May-13	Detailed report	5/5	₹982	4/5	₹826

adjusted for stock split from ₹10 to ₹5

Company Overview

Incorporated in 1979 and promoted by Dr Prathap Reddy, Apollo commenced its operations in 1983 with a 150-bed hospital in Chennai. Over the years, Apollo has emerged as India's leading healthcare service provider. It has 6,000 owned beds (2,100 beds under joint ventures) and ~2,000 managed beds. Apollo has treated over 27 mn patients until March 2012. The company has a dominant presence in Chennai, Hyderabad and other southern cities such as Karaikudi and Madurai. It is also expanding its hospital network in western India and tier II/III cities through its reach initiative. Apollo is also one of the largest organised players in the pharmacy business. As of December 2012, it has 1,445 pharmacy stores across 20 states in India.

Figure 18: Hospital and pharmacy businesses revenue break-down



Source: Company, CRISIL Research

Milestones

1979	Incorporated by Dr Prathap C Reddy
1983	Started first private hospital in Chennai with 150 beds
1992	Introduced artery stent for the first time in India
1994	Set up state-of-the-art cancer hospital in Chennai
1995	Did first bone marrow and multi-organ transplant in India
2000	Extended operations to Sri Lanka, Dubai, Saudi Arabia and Ghana
2007	Partnered with Munich Health to enter the health insurance business
2008	Chennai and Hyderabad hospitals received healthcare award
2009	Launched the CyberKnife Robotic Radio Surgery System at Chennai hospital
2010	JV with British American investment company – Mitus Ltd – to set up a multi-speciality hospital in Moka, Mauritius
2010	Launched 50th hospital with 150 beds in Secunderabad
2011	Bhubaneshwar, Karaikudi and Hyderguda hospitals commenced operations
2011	Seven hospitals received Joint Commission International (JCI) accreditation. Three hospitals received accreditations from the National Accreditation Board for Hospitals
2012	US-based Sutherland Global Services, a business process outsourcing (BPO) company acquired 100% stake in Apollo Health Street (Apollo's BPO arm)

Source: Company, CRISIL Research