Raffles Medical RAFG.SI RFMD SP

EQUITY: HEALTH CARE & PHARMACEUTICALS

15th straight year of operational growth

Costs rose faster than revenues in 2016 but we expect this balance to be restored in 2017

Cost pressure to balance revenue growth in 2017

Raffles Medical saw strong revenue growth in FY16, with revenues rising 15.4% y-y driven by its acquisition of MCH clinics in Oct-15, the ramp-up of Shaw Centre and Holland Village medical centres and the Osaka clinic in Japan. However, costs rose faster led by staff costs which grew 1.4pp y-y to 51% of revenues, as the company hired new staff and specialists for the expansion of its existing business operations and the increased staff costs from the MCH acquisition. In 2017, we expect this balance to be restored as the new staff is deployed productively, Shaw Centre and Holland Village break even and the company benefits from rental income from Holland Village. Overall, we see EBITDA margins stabilizing at 20~21%.

Catalysts: Redevelopment of Raffles Hospital; Expansion into China

We see catalysts on three time horizons: 1) Near term (FY17F): continued ramp up at Shaw Centre and the Holland Village redevelopment; 2) Medium term (FY18~20F): Raffles Hospital expansion; 3) Long term (beyond FY21F): expansion into China via its 70% stake in the 400-bed Shanghai Hospital. We see any further investments in China as a long-term positive for the company.

Valuation: Target price of SGD1.70 implies upside of 16.4%

RMG is the only large-cap company listed in Singapore which has shown annual operational performance growth for the last 15 years. With the Raffles Hospital extension unlikely to make any significant contribution until FY18F, in our view, we reduce our net profit estimates for FY17F by 12% and FY17F by 15%. We use sum-of-the-parts to value RMG: 1) Core business we value at an FY17F EV/EBITDA of 20x, in line with regional peers; 2) Shanghai Hospital we value using DCF. Our TP of SGD1.70 implies 16.4% upside, for a target FY17F P/E of 39.0x (EPS of SGD0.04), which is at a relative discount to regional peers in Malaysia, Thailand and India.

Year-end 31 Dec	FY16	FY17F		FY18F		FY19F	
Currency (SGD)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	474	567	523	658	605		733
Reported net profit (mn)	70	87	76	101	86		105
Normalised net profit (mn)	70	87	76	101	86		105
FD normalised EPS	4.02c	4.96c	4.36c	5.76c	4.88c		5.96c
FD norm. EPS growth (%)	0.0	18.7	8.4	16.1	12.0		22.2
FD normalised P/E (x)	36.4	N/A	33.5	N/A	29.9	N/A	24.5
EV/EBITDA (x)	25.8	N/A	23.6	N/A	20.3	N/A	16.2
Price/book (x)	3.8	N/A	3.5	N/A	3.1	N/A	2.9
Dividend yield (%)	1.4	N/A	1.4	N/A	1.7	N/A	2.1
ROE (%)	10.8	12.6	10.7	13.4	10.9		12.2
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash		net cash

Source: Company data, Nomura estimates

Key company data: See next page for company data and detailed price/index chart.

Global Markets Research

21 February 2017

Rating Remains	**Buy**
Target Price Reduced from 1.74	SGD 1.70
Closing price 20 February 2017	SGD 1.46
Potential upside	+16.4%

Anchor themes

The healthcare sector presents secular growth prospects driven by rising incomes, disease awareness, government spending, insurance coverage and medical tourism.

Nomura vs consensus

Our FY17 revenue estimates are largely in line with consensus

Research analysts

Healthcare/Pharmaceutical

Raghavendra Divekar, CFA - NSC
raghavendra.divekar@nomura.com
+81 3 6703 1229

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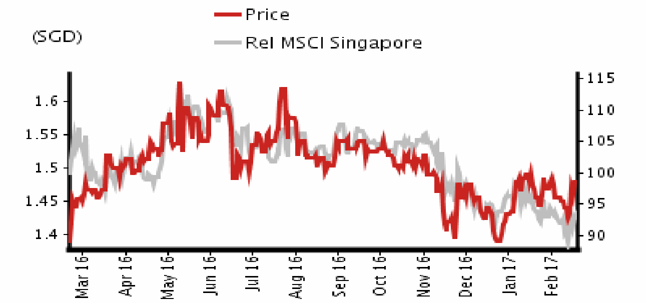
See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Key data on Raffles Medical

Relative performance chart



Source: Thomson Reuters, Nomura research

Notes:

Performance

(%)	1M	3M	12M		
Absolute (SGD)	0.3	2.8	5.0	M cap (USDmn)	1,800.4
Absolute (USD)	1.1	3.3	4.0	Free float (%)	48.0
Rel to MSCI Singapore	-2.3	-6.3	-9.5	3-mth ADT (USDmn)	1.4

Income statement (SGDmn)

Year-end 31 Dec	FY15	FY16	FY17F	FY18F	FY19F
Revenue	411	474	523	605	733
Cost of goods sold	-330	-392	-431	-501	-605
Gross profit	81	82	91	104	128
SG&A					
Employee share expense					
Operating profit	81	82	91	104	128
EBITDA	93	97	107	125	150
Depreciation	-13	-15	-16	-20	-22
Amortisation					
EBIT	81	82	91	104	128
Net interest expense	1	1	1	1	1
Associates & JCEs					
Other income					
Earnings before tax	82	83	92	105	129
Income tax	-13	-15	-17	-19	-23
Net profit after tax	69	68	76	86	106
Minority interests	0	2	1	0	-1
Other items					
Preferred dividends					
Normalised NPAT	69	70	76	86	105
Extraordinary items					
Reported NPAT	69	70	76	86	105
Dividends	-21	-35	-35	-53	-55
Transfer to reserves	49	35	41	33	50
Valuations and ratios					
Reported P/E (x)	36.3	36.4	33.5	29.9	24.5
Normalised P/E (x)	36.3	36.4	33.5	29.9	24.5
FD normalised P/E (x)	36.3	36.4	33.5	29.9	24.5
Dividend yield (%)	1.4	1.4	1.4	1.7	2.1
Price/cashflow (x)	34.6	32.4	25.0	22.5	18.6
Price/book (x)	4.2	3.8	3.5	3.1	2.9
EV/EBITDA (x)	27.0	25.8	23.6	20.3	16.2
EV/EBIT (x)	31.3	30.5	27.6	24.3	19.0
Gross margin (%)	19.6	17.3	17.5	17.3	17.5
EBITDA margin (%)	22.8	20.4	20.5	20.6	20.5
EBIT margin (%)	19.6	17.3	17.5	17.3	17.5
Net margin (%)	16.9	14.8	14.6	14.2	14.4
Effective tax rate (%)	15.4	18.1	18.1	18.1	18.1
Dividend payout (%)	29.9	49.8	46.0	61.6	52.1
ROE (%)	11.9	10.8	10.7	10.9	12.2
ROA (pretax %)	13.1	10.8	10.9	11.0	12.5
Growth (%)					
Revenue	9.6	15.4	10.4	15.7	21.2
EBITDA	8.9	3.4	10.6	16.6	20.4
Normalised EPS	7.2	0.0	8.4	12.0	22.2
Normalised FDEPS	7.2	0.0	8.4	12.0	22.2

Source: Company data, Nomura estimates

Cashflow statement (SGDmn)

Year-end 31 Dec	FY15	FY16	FY17F	FY18F	FY19F
EBITDA	93	97	107	125	150
Change in working capital	5	-1	12	8	45
Other operating cashflow	-25	-17	-16	-18	-57
Cashflow from operations	73	79	103	114	138
Capital expenditure	-35	-14	-150	-150	-50
Free cashflow	38	64	-47	-36	88
Reduction in investments	-116	-28	25	25	25
Net acquisitions					
Dec in other LT assets	-33	0	0	0	0
Inc in other LT liabilities	-2	1	0	0	0
Adjustments	7	-4	1	0	0
CF after investing acts	-105	34	-21	-11	113
Cash dividends	-12	-14	-12	-10	-25
Equity issue	26	7	8	9	9
Debt issue	26	-2	0	0	0
Convertible debt issue					
Others	1	1	0	0	0
CF from financial acts	41	-8	-4	-1	-15
Net cashflow	-64	26	-25	-12	98
Beginning cash	150	86	112	87	75
Ending cash	86	112	87	75	173
Ending net debt	-47	-73	-48	-36	-134

Balance sheet (SGDmn)

As at 31 Dec	FY15	FY16	FY17F	FY18F	FY19F
Cash & equivalents	86	112	87	75	173
Marketable securities					
Accounts receivable	75	101	93	108	131
Inventories	10	10	11	12	15
Other current assets					
Total current assets	171	223	190	195	318
LT investments	344	371	346	321	296
Fixed assets	264	270	402	532	560
Goodwill					
Other intangible assets	32	31	31	31	31
Other LT assets	4	5	5	5	5
Total assets	815	901	975	1,084	1,211
Short-term debt	11	13	13	13	13
Accounts payable	118	145	149	173	209
Other current liabilities	27	26	29	31	35
Total current liabilities	157	184	191	218	257
Long-term debt	28	25	25	25	25
Convertible debt					
Other LT liabilities	8	9	9	9	9
Total liabilities	193	219	226	252	292
Minority interest	19	15	15	15	15
Preferred stock					
Common stock	286	314	345	378	415
Retained earnings					
Proposed dividends					
Other equity and reserves	317	352	390	439	489
Total shareholders' equity	603	666	735	817	904
Total equity & liabilities	815	901	975	1,084	1,211
Liquidity (x)					
Current ratio	1.09	1.21	1.00	0.89	1.24
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Per share					
Reported EPS (SGD)	4.02c	4.02c	4.36c	4.88c	5.96c
Norm EPS (SGD)	4.02c	4.02c	4.36c	4.88c	5.96c
FD norm EPS (SGD)	4.02c	4.02c	4.36c	4.88c	5.96c
BVPS (SGD)	0.35	0.38	0.42	0.46	0.51
DPS (SGD)	0.02	0.02	0.02	0.03	0.03
Activity (days)					
Days receivable	49.9	68.2	67.9	60.6	59.3
Days inventory	10.0	9.1	8.8	8.5	8.3
Days payable	107.0	123.0	124.3	117.4	115.3
Cash cycle	-47.1	-45.7	-47.6	-48.4	-47.6

Source: Company data, Nomura estimates

Revenues grew strongly in 2016 ….

Raffles saw strong operational growth in FY16, with revenues rising 15.4% y-y to SGD473.6mn as shown in Figure 1. This was largely due to the strong growth of the Healthcare Services segment, consisting of the company's clinic network, which grew 30.8% y-y due to the ramp-up of the Shaw Centre and Holland Village Medical centres, the new clinic in Osaka and the acquisition of International SOS and its subsidiaries (MCH) in October 2015. On the other hand, the Hospital Services segment grew 6.3% y-y as it prepares for the Raffles Hospital extension which is on track to be completed in 2H17. Excluding the revenue contribution of the newly acquired MCH, the company's revenues would have grown 7.5% y-y.

Fig. 1: Raffles Medical – FY16 results summary

	2015	2016		
		Actual	Nomura	difference (%)
Revenues (SGDmn)	410.5	473.6	486.1	(2.6)
Staff costs (SGDmn)	203.5	241.7	248.9	(2.9)
— as a % of revenue	49.6	51.0	51.2	(0.2)
Operating profit (SGDmn)	80.6	81.9	85.7	(4.4)
EBITDA (SGDmn)	93.4	96.6	100.8	(4.2)
Net profit (SGDmn)	69.3	70.2	73.0	(3.9)
Margins (%)				
Operating margin	19.6	17.3	17.6	(0.3)
EBITDA margin	22.8	20.4	20.7	(0.3)
Net margin	16.9	14.8	15.0	(0.2)

Source: Company data, Nomura estimates

… but costs grew faster led by staff costs

However, this strong revenue growth was impacted by an even faster rise in costs. This cost increase was led by staff costs, which rose sharply by 1.4pp y-y to 51.0% of revenues due to the recruitment of more doctors, specialists, nurses and ancillary staff for the expansion of the existing business operations. Staff costs at the MCH were higher than the rest of the company at ~60% of revenues at the time of acquisition, and while the company has worked to reduce these costs, they remained at ~56% of revenues at the end of 2016. The company also saw higher inventories and consumables used due to increased sales of medical supplies and services. These higher costs resulted in EBITDA rising only 3.4% y-y and coming in 3.9% below our estimates.

Local patients grew faster than foreign patients in 2016

While Raffles continues to benefit from medical tourism, we understand that local patients grew faster than foreign patients in 2016. While local patients generally tend to have lower revenue intensity compared with foreign patients, their growth tends to be 'sticky', as these patients are more likely to use the company's services for future treatments, which should be beneficial to the company in the long run. Raffles noted that in 4Q16, medical tourists were impacted by: (1) strengthening of the SGD versus regional currencies; (2) lower growth among Indonesian patients due to political uncertainty in the country. While a large share of the company's medical tourists came from Indonesia and Malaysia, Raffles continued to benefit from its diversified patient base, and the company noted that it treated patients from 120 countries in 2016, with 45% of its medical tourism business coming from patients outside the top 10 countries ranked by number of Raffles foreign patients.

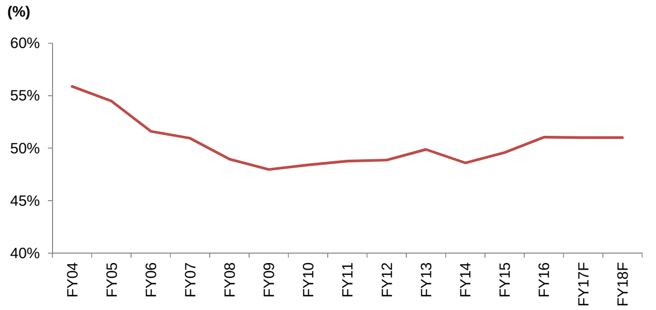
Cost pressure to balance revenue growth in 2017F

While costs rose faster than revenues in 2016, we expect this balance to be largely restored in 2017F, as: (1) The newly hired specialists, nurses and ancillary staff are used productively as Holland Village and the Shaw Centre Medical Centre ramp up. We see these medical centres breaking even in 2017; (2) We expect staff costs at MCH Holdings to continue to trend downwards from current levels of 54% of revenues and come closer to the company's average of 51% of revenues; (3) We see the company benefiting from rental revenues from Holland Village. We see growth in FY17 continuing to be led by the Healthcare Services segment, which consists of the company's clinics and medical centre business, and expect it to grow 14% y-y compared with 8% growth for the Hospital Services business. Overall, we see revenues growing 10% y-y in FY17F, while operating profit and EBITDA grow 11% y-y.

Staff costs to stabilize at ~51% of revenue in the near term

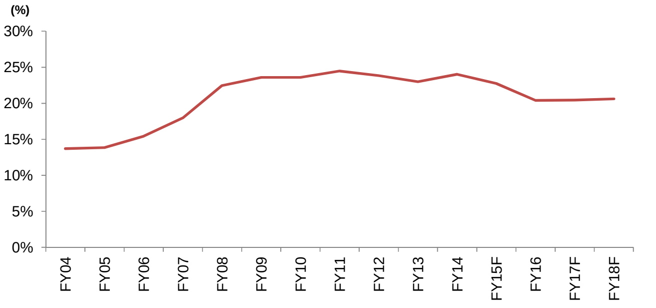
As Raffles expands its clinic network and redevelops its hospital, the company has been recruiting additional staff and specialists to help meet these needs. Generally there is a lead time for training purposes between when additional personnel are hired and when they can be deployed. This has led to an increase in staff costs as a percentage of revenue from 49% in FY14 to 51.0% in 2016. As Shaw Centre and Holland Village ramp up, we expect these additional staff to be deployed productively. However, as Raffles continues to hire new specialists for its Raffles Hospital expansion in FY17F, we expect staff costs to remain at 51% of revenue in the near term, as shown in Figure 2.

Fig. 2: Staff costs to stabilize at 51% of revenues



Source: Company data, Nomura estimates

Fig. 3: EBITDA margins to stabilize at 20~21%



Source: Company data, Nomura estimates

EBITDA margins to stabilize at 20~21% in FY18F

Raffles EBITDA margins grew sharply, from ~14% in FY04 to ~24% in FY11, as the company benefited from the ramp-up of Raffles Hospital and the reduction in staff costs as a percentage of revenues. While an increase in operating costs caused a temporary dip in margins in FY12, Raffles continued to grow revenues faster than costs, resulting in margins returning to ~23% by FY15. However, in FY16, Raffles EBITDA margins declined 2.4pp y-y to 20.4% due to a rise in costs as the company continued its expansion in Singapore and the region. With the Shaw Centre and Holland Village medical centres ramping up and with revenue growth and costs expected to be largely balanced in the near term, we expect Raffles EBITDA margins to remain stable at 20~21% in FY18F, as shown in Figure 3.

Maintain Buy; Reduce TP to SGD1.70

With the Raffles Hospital extension likely to be completed by end-2017, we update our estimates for FY17 and 18F. In the near term, and we see the company continuing to benefit from: 1) the MCH acquisition; 2) ramp-up of Shaw Centre and the Holland Village project; 3) the three new clinics opened in 2016. However, we also expect costs to continue to rise, with staff costs remaining at 51% of revenues as the company ramps up the newly opened clinics, hires new specialists and staff for its hospital expansion and gears up for the opening of its Shanghai Hospital in China. We also raise our tax rate for the company to 18% from 16%, given its international operations. Overall, we see the Raffles Hospital extension contributing significantly to revenues only from FY18F and reduce our net profit estimates by 12% for FY17F and 15% for FY18F, as shown in Figure 4.

Fig. 4: Raffles Medical: Changes in estimates

	2017F forecast			2018F forecast		
	Previous	Current	change (%)	Previous	Current	change (%)
Revenue (SGDmn)	567.2	522.7	-7.9%	658.1	604.9	-8.1%
Staff costs (SGDmn)	289.3	266.6	-7.9%	335.6	308.5	-8.1%
— as a % of revenue (%)	51.0	51.0	0.0pp	51.0	51.0	0.0pp
EBIT (SGDmn)	101.4	91.3	-9.9%	120.1	104.3	-13.2%
EBITDA (SGDmn)	117.4	106.9	-8.9%	138.1	124.6	-9.8%
Net profit (SGDmn)	87.0	76.4	-12.2%	101.4	85.9	-15.3%
Margins (%)						
EBIT margin	17.9	17.5	(0.4)	18.3	17.3	(1.0)
EBITDA margin	20.7	20.5	(0.2)	21.0	20.6	(0.4)
Net profit margin	15.3	14.6	(0.7)	15.4	14.2	(1.2)

Source: Nomura estimates

We continue to like the company for its strong core business, consisting of flagship Raffles Hospital in Bugis and over 90 clinics and medical centres in Singapore and in the region, and we see its recent expansion plans for China as a long-term growth driver. We maintain our Buy rating but reduce our target price slightly to SGD1.70 (previously: SGD1.74).

TP of SGD1.70 is based on sum-of-the-parts valuation

We use sum-of-the-parts to arrive at a valuation for RMG, as shown in Figure 5. Given the company's expansion plans in Singapore and China, we divide the business into two parts:

- **Core business**, consisting of its flagship Raffles Hospital in Bugis, over 90 clinics — mostly in Singapore — and its Holland Village project. We value the core business at an FY17F EBITDA multiple of 20x, which is largely in line with its regional peers. We believe this is justified given the concentration of the company's operations in Singapore and major urban areas such as Shanghai and Hong Kong. Based on our FY17F EBITDA estimate of SGD107mn, we value the company's core business at SGD2.1bn
- **Shanghai Hospital project**, in which Raffles has a 70% stake, is expected to become operational in FY18F. Given this, we value the hospital using a DCF approach, since it is likely to be two years before it breaks even. We expect the hospital to achieve an EBITDA margin of 27% in FY25F. We use a WACC of 7% and a terminal growth rate of 2% post FY30F to value the hospital. Given these variables, we arrive at a valuation of ~SGD785mn for RMG's stake in the hospital.

Fig. 5: Sum-of-the-parts valuation for Raffles

Region	Valuation methodology	Raffles stake	Important terms	EV (SGDmn)
Singapore	FY17F EV / EBITDA multiple	100%	EBITDA multiple = 20x	2,138
China - Shanghai	DCF of EBITDA	70%	WACC = 7% Terminal growth rate = 2%	785
Total Enterprise value (SGDmn)				2,923
Net cash (SGDmn)				48
Total Equity value (SGDmn)				2,971
Value per share (SGD)				1.70
Premium				16.4%

Source: Nomura estimates

As shown in Figure 5, we arrive at an equity valuation of SGD2.9bn for Raffles using sum of the parts, for a target price of SGD1.70 (previously: SGD1.74). This implies an FY17F EV/EBITDA of 27.3x and a FY17F P/E of 39.0x. As a comparison, the global EBITDA multiples for healthcare services companies range between 15x and 25x, with emerging market hospitals trading between 18x and 22x on average and Australian franchises trading below 15x. The higher valuation for Raffles reflects the upside potential from its new hospital project in China, in our view.

Downside risks to our TP

Key downside risks include:

- **Drop in medical tourists:** Medical tourists make up over 30% of Raffles Hospital's patient load. Given the current economic environment, there is a risk that the number of medical tourists will decline as they put off treatment. However, we believe that RMG's target clientele is generally defensive as its patient base seeks care for acute diseases which they cannot delay (e.g., cancer), unlike elective procedures (e.g., plastic surgery). Furthermore, we understand that its customer base consists of relatively less price-conscious patients who are unlikely to stop seeking quality care. In addition, RMG has developed another layer of defence by building up a diversified foreign patient base, with patients from over 100 countries.
- **Execution of China project:** While RMG management has a strong execution record in Singapore, we note that it does not have significant experience operating overseas. The execution risks involved include recruitment of medical professionals and attracting a sufficient patient base to avoid prolonged initial losses. We believe regulatory risks for the Shanghai hospital are mitigated, given that the company's partner – Shanghai LuJiaZui – is owned by the Pudong government.
- **Attracting and retaining top medical professionals:** The success of RMG's group practice model is highly dependent on its ability to attract and retain top medical professionals. Given the limited supply of doctors in Singapore, the group may face challenges in attracting competent specialists, who may prefer to set up their own practices.
- **Ability to contain staff costs:** Operating leverage is a double-edged sword: in the event of negative revenue growth, a high fixed cost base would hurt margins. While we understand that RMG has considerable flexibility in managing staff costs through bonuses, the group would have to maintain a delicate balance to avoid losing its top specialists..

Appendix A-1

Analyst Certification

I, Raghavendra Divekar, hereby certify (1) that the views expressed in this Research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of my compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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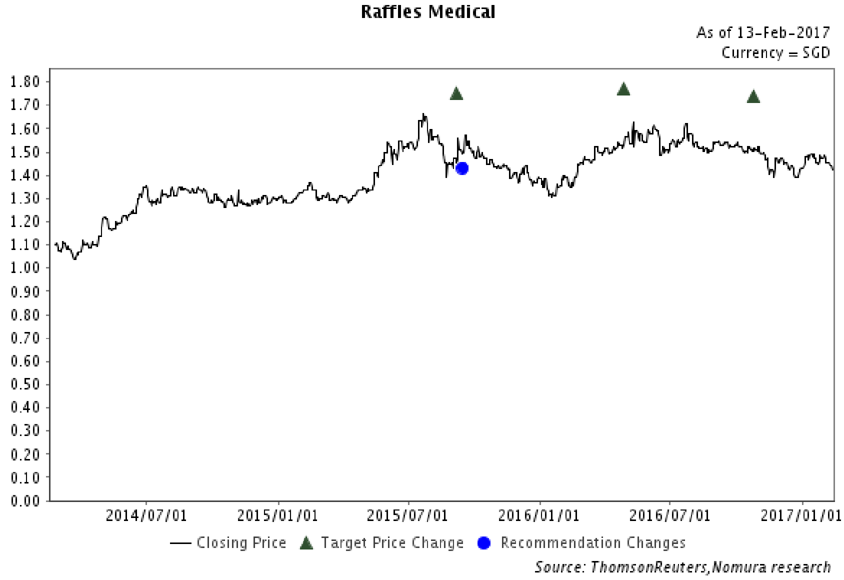
Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Raffles Medical	RFMD SP	SGD 1.48	17-Feb-2017	Buy	N/A	

Raffles Medical (RFMD SP) **SGD 1.48 (17-Feb-2017)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
25-Oct-16		1.74	1.515
27-Apr-16		1.77	1.527
07-Sep-15	Buy		1.457
07-Sep-15		1.75	1.457

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We use SOTP valuation for RMG. 1) We value the company's core business, which consists of Raffles Hospital and its clinics in Singapore, Shanghai and Hong Kong, at FY17F EV/EBITDA of 20x, in line with regional peers. 2) We value its Shanghai Hospital project using a DCF approach, with a WACC of 7% and a terminal growth rate of 2%. Adding these two parts, we get a target price of SGD1.70. The benchmark index for this stock is the MSCI Singapore.

Risks that may impede the achievement of the target price Key downside risks: 1) a drop in medical tourists; 2) execution risks for its China project; 3) inability to attract and retain top medical staff; and 4) staff cost overruns.

Important Disclosures

Online availability of research and conflict-of-interest disclosures

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42% have been assigned a Neutral rating which, for purposes of mandatory disclosures, is classified as a Hold rating; 52% of companies with this rating are investment banking clients of the Nomura Group*. 0% of companies (which are admitted to trading on a regulated market in the EEA) with this rating were supplied material services by the Nomura Group

8% have been assigned a Reduce rating which, for purposes of mandatory disclosures, are classified as a Sell rating; 7% of companies with this rating are investment banking clients of the Nomura Group*. 0% of companies (which are admitted to trading on a regulated market in the EEA) with this rating were supplied material services by the Nomura Group.

As at 31 December 2016.
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