

28 September 2011

KPJ Healthcare Berhad

- Leading private healthcare provider
- Steady rise in demand for healthcare services
- Long-term growth supported by expansion plans
- Relatively defensive industry and earnings

BUY

Price
RM3.85

Market capitalization
RM2,232 million

Board
Main

Sector
Trading/services

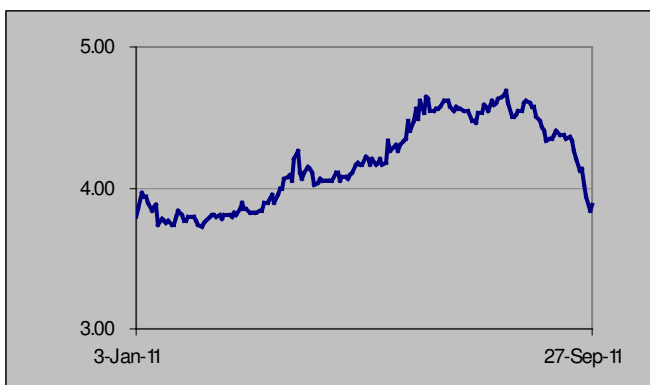
Stock code
5878

By
The Research Team

Key stock statistics	2010	2011E
FD EPS (sen)	21.2	18.4
FD P/E (x)	18.1	20.9
Net DPS (RM)	11.3	10.3
NTA/share (RM)	1.37	1.43
Enlarged share capital (mil)	579.8	
52-week price range (RM)	3.18-4.72	

Major shareholders (%)
Johor Corp 43%

Share Price Chart



Investment Summary

KPJ Healthcare Berhad (KPJ) is Malaysia's leading provider of private healthcare services.

The company opened its first hospital back in 1981 in Johor Bahru and has since grown from strength to strength, through both the acquisition of existing hospitals as well as developing new greenfield projects.

Today, the company manages 20 hospitals – 10 of which are accredited by the Malaysian Society for Quality in Health (MSQH) – in the country, plus another two in Indonesia.

KPJ is estimated to have some 24% share of the country's private healthcare services market – and is sanguine on its prospects going forward.

The industry is relatively recession-proof. Demand for healthcare services – healthcare expenditure is still a relatively low 4.7% of GDP – is expected to trend steadily higher for the foreseeable future.

Some of the main drivers for demand growth include greater affluence and the rise in lifestyle-related diseases, growing awareness of and improved access to quality care, as well as longer life spans and ageing population.

The growth in demand for healthcare services will exert increasing burden on the public healthcare system, which, in turn, is very likely to drive more demand towards the private sector. As it is, the patient-to-doctor ratio for the public sector is now well over two times that for the private sector. Additionally, the number of medical specialists in the country is heavily biased towards the latter.

Aside from rising per capita income, the increasing awareness and adoption of medical insurance amongst the population, including the younger generation, has made private healthcare more affordable. Industry statistics show that the health insurance sector has been growing at a double digit pace annually.

Medical tourism is another potential key driver for longer-term growth. Indeed, our government has identified the sector as one of the national key economic areas.

Asia is experiencing robust demand growth for healthcare services in recent years, driven primarily by attractive pricing compared with that offered in the US, Europe and Australia.

As at end 2010, KPJ had catered to some 12,000 health tourists, who provided almost RM25 million in revenue. The company intends to grow this segment of the market. It is boosting marketing efforts overseas on the one hand and upgrading and investing in new technology, facilities and innovative services as well as gaining accreditations for its network of hospitals on the other.

KPJ has a multi-pronged strategy for sustainable long-term growth. For the near to medium term, it plans to add one to two hospitals to its network every year. This is on top of expansions to the bedding capacity, facilities and range of services offered at existing hospitals – in lockstep with demand growth.

The network expansion will translate into greater economies of scale, for instance in terms of the implementation of common systems and processes as well as centralized purchasing of equipment and medications. Capital expenditure is estimated to total roughly RM150-RM200 million per annum.

The company is also exploring opportunities in providing healthcare business development and hospital management expertise to other providers overseas, in management or consultancy capacities – on the back of its experience and track record.

For the long-term, there are plans to diversify into new market segments such as retirement villages and aged care services. With Malaysia forecasted to reach the stage of ageing population by 2015, demand for affordable retirement homes that include quality medical and nursing care is expected to be on the rise. Retirement healthcare for the elderly is already a huge income generator in many developed nations today.

In this respect, KPJ is in the midst of acquiring a 51% stake in Jeta Gardens, which owns and operates a 64-acre retirement village in Queensland, Australia. Whilst earnings contribution is expected to be minimal, the company intends to gain valuable insights and experience from this venture, a business model it hopes to emulate locally.

At the same time, the company is rolling out plans to develop its education arm, KPJ International University College of Nursing and Health Sciences into a leading centre for nursing and medical-related studies in the country.

Aside from being an additional source of revenue, the college will provide a steady stream of qualified and capable nursing and support staff to its growing network of hospitals – and retirement homes venture, if all goes to plan.

The company intends to spend some RM120 million to expand its main campus in Nilai, Negeri Sembilan over the next four-five years. It aims to achieve full University status by 2016, complete with its own medical school and student capacity reaching 10,000. Currently the university college has a capacity of about 2,500 students.

To fund the expansion plans we expect KPJ will continue to inject assets into 49%-owned associate, Al-'Aqar KPJ REIT. This will keep its balance sheet asset-light and allow the company to focus on its key strength, which is hospital management. Gearing stood at a modest 30% at end-June 2011.

Based on the expected industry growth and KPJ's own expansion plans, revenue growth is forecast to remain in the double-digit range over the next few years. The company's revenue expanded at an average compounded annual growth rate of 18.8% between 2006 and 2010.

The stock is currently trading at roughly 20.9 and 19 times our estimated earnings for 2011-2012, respectively, based on its enlarged share capital of 659.5 million shares. Whilst higher than the broader market's average valuations, we believe KPJ will offer positive returns over the long run based on its growth prospects. We recommend a **BUY** on the stock.

The company does not have a fixed dividend policy. Net dividends totaled 11.25 sen per share in 2010, equivalent to 52% of net profit. Assuming a 50% earnings payout going forward, dividends will total 10.3 and 11.3 sen per share for 2011-2012, respectively. That translates into net yield of about 2.7-2.9% at the prevailing share price.

Background

KPJ opened its first hospital on 10 May 1981, in Johor Bahru. Since then, the company has been on an expansion trail, acquiring existing hospitals – and turning around those that were loss-making – and, eventually, developing its own greenfield projects.

In the initial years, the company acquired expertise from external consultants from the US and Europe. Three decades on, KPJ has amassed a solid track record in developing, commissioning and managing the largest network of private specialist hospitals in Malaysia. It has also ventured abroad, having managed hospitals in Bangladesh and the Middle East and at present, runs two hospitals in Indonesia.

KPJ is the leading private healthcare provider in the country with 20 hospitals and over 2,600 licensed beds under its management currently. With almost 800 medical consultants and more than 8,000 staff members, it is the largest employer of private healthcare professionals in Malaysia, second only to the Ministry of Health. It catered to some 226,000 inpatients and more than 2.2 million outpatients last year.

KPJ is the healthcare arm for Johor Corp and was listed on the Main Board of Bursa Malaysia on 29 November 1994. The latter retains a 43% stake in the company. KPJ is the only healthcare group in the country that is listed on the local bourse with the exception of TMC Life Sciences and StemLife, both of which are focused on stem cell storage and related businesses.

In 1991, the company diversified upstream, by starting its own nursing college. The Puteri Nursing College was the first in the country to offer the Diploma in Nursing Programme, jointly offered through its collaboration with the University of South Australia. This was later expanded to include Diploma in Health Sciences programmes (Pharmacy, Medical Imaging and Physiotherapy).

The plan was to provide KPJ with a steady stream of professional nurses for its rapidly growing network of hospitals.

To cater to its growing presence, a branch campus was opened in Johor Bahru in 2008 and this year, a second branch campus opened its doors in Bukit Mertajam.

The nursing college was upgraded to University College status in July 2011, and renamed KPJ International University College of Nursing and Health Sciences (KPJIC). It can now offer 'homegrown' degree programmes ranging from Medicine to Nursing, Pharmacy and others.

Currently, KPJIC has total capacity of about 2,500 students and offers some 15 programmes ranging from Master to Certificate programmes either in collaboration with international partners like Hertfordshire University and Liverpool John Moores University or a 'homegrown' programme.

Cognitive of its ambitious expansion plans and the need to maintain reasonable gearing, KPJ came up with an innovative exercise to lighten its balance sheet. It set up the Al-'Aqar KPJ REIT in 2006 and under a sale and leaseback arrangement, injected six of its hospitals into the real estate investment trust (REIT).

The assets are leased back from the trust for a 15-year period with the option of another 15 years. Rental rates are reviewed every three years, after taking into account the prevailing market value of the properties and benchmark rate of returns.

Al-'Aqar was listed on the local bourse in August 2006, as the world's first Islamic healthcare REIT.

The move served to unlock value in the company's assets, free up cashflow for further expansion while retaining stable dividend income from its now 49% stake in the trust.

Two more rounds of assets injections were completed in March 2008 and July 2010. A total of 20 investment properties, including the nursing college, valued at some RM943 million have been injected into the REIT.

KPJ is currently in the midst of finalizing the sale of three more hospital buildings to Al-'Aqar valued at a combined RM139 million. The exercise is slated for completion by end-2011, once construction of the new Bandar Baru Klang Specialist Hospital is completed.

Business and Outlook

KPJ is an integrated healthcare provider. The bulk of the company's revenue consists of income from operating its network of specialist hospitals. Other sources of revenue include the provision of support services such as management, pathology and laboratory services, marketing and distribution of pharmaceutical, medical and surgical products as well as income from the nursing college.

The company is the leading provider of private healthcare services in Malaysia, with an estimated 24% share of the market. Private healthcare, in turn, is estimated to account for roughly one-quarter of the total expenditure for healthcare in the country.

Plans to add one to two hospitals per year

KPJ's network of specialist hospitals covers the entire nation, with the exception of the states of Perlis, Melaka and Trengganu. Going forward, KPJ intends to add another one to two hospitals to its network every year.

It successfully acquired the Sibu Specialist Medical Centre in Sarawak in April 2011. Construction of the 200-bed Bandar Baru Klang Specialist Hospital is underway and the first phase is slated for completion by end-2011. Once operational, this hospital will be sold to Al-'Aqar, along with the Kluang Utama Specialist Hospital and Rumah Sakit Bumi Serpong Damai in Indonesia for a collective RM139 million.

Two other smaller hospitals – of about 120 beds each – are planned for commissioning in 2012, in Muar and Pasir Gudang. Additionally, construction for a new hospital building in Kota Kinabalu is currently underway. Upon completion, by 2012, the Sabah Medical Centre will be relocated from its existing facility to the new building. The new 250-bed hospital is expected to cost about RM180-RM200 million. Recall that KPJ acquired a 51% stake in Sabah Medical Centre, back in June 2010 for RM51 million.

Looking slightly further ahead, KPJ has plans for two other hospitals on the drawing board, the first of which is a 70:30 joint venture with Pasdec Corp. Located in Tanjung Lumpur, Kuantan, this 180-bed capacity hospital is slated for commissioning in 2013.

The second is a 60:40 joint venture with the Yayasan Islam Perlis in the state of Perlis, expected to commission sometime in 2014. The company is also in preliminary discussions to set up a bigger 400-bed hospital project in Bandar Datuk Onn, Johor.

The new hospitals and organic expansion will underpin growth over the next few years. Typically a new hospital will open in phases, with the addition of more beds, facilities and range of services over time in lockstep with demand growth.

Given its experience, KPJ is also exploring opportunities to provide consultancy to other providers, both locally and abroad, in areas such as healthcare business development and hospital management.

Steady growth envisioned for healthcare industry

Demand for healthcare services in the country is expected to trend steadily higher for the foreseeable future.

Some of the main drivers for demand growth include greater affluence and the rise in lifestyle-related diseases, growing awareness of and improved access to quality care as well as longer life spans and ageing population.

The increasing global interconnectivity also translates into faster and wider spread of infectious diseases, resulting into more frequent epidemics and potential pandemics.

With the expected rise in demand for healthcare services, it is envisioned that the additional burden on the public healthcare system will gradually drive more demand towards the private sector. As it is, the patient-to-doctor ratio for the public sector is now well over two times that for the private sector. Additionally, the number of medical specialists in the country is heavily biased towards the latter.

Increasing awareness and adoption of medical insurance amongst the population, including the younger generation, will help aid the switch. Industry statistics show that the health insurance sector has been growing at a double digit pace annually. Coupled with the expected increase in per capita income, private healthcare will become more affordable.

Medical tourism is another growth driver

Medical tourism is another potential key driver for long-term growth. Indeed, our government has identified the sector as one of the national key economic area.

The majority of Malaysia's medical tourists come from Indonesia, due to our higher quality of healthcare services. Patients from richer countries such as Singapore, Japan and the Middle East are also attracted to the lower prices for treatments compared with that offered in the US, Europe and Australia.

As at end 2010, KPJ had catered to 12,000 health tourists, who provided almost RM25 million in revenue. The company intends to grow this segment of the market by boosting its marketing efforts overseas on the one hand and upgrading and investing in new technology and innovative services as well as gaining accreditations for its network of hospitals on the other.

Continuous investments in IT and technological advancement

Its network of hospitals is continuously upgraded with state of the art facilities and the newest diagnostic and treatment processes. The company has also kept up with investments in administrative technology and human resources.

For instance, its hospitals are increasingly able to run as paper-less hospitals. E-ordering by consultants for radiology investigations will be captured and transmitted to the radiology equipment. X-ray images and results will then be transmitted back online.

Similarly, introduction of the e-pharmacy module has enhanced communication between consultants and pharmacy. The hospitals also operate a centralized dispensing, billing and collection system.

Its staff are encouraged to undertake further training and development courses at the Bachelor, Masters and even PhD levels. A target has been set for each staff member to receive a minimum of 30 hours of training every year.

Expanding education arm

As mentioned-above, KPJ first ventured into the education industry in 1991 with the setting up of its own nursing college. Initially, the primary aim was to guarantee a steady pool of capable and qualified nursing staff to its expanding network of hospitals. The college was awarded University College status in July 2011, which allows it to offer its own degree programmes.

In view of its relative success, the company is now intent on developing KPJIC into a leading center for nursing and medical-related studies in the country – to produce qualified healthcare personnel for both the public and private sectors.

KPJ has an edge over similar education groups in the market in that the company can leverage on its existing infrastructure. For instance, its medical consultants and senior nurses can give lectures and guidance to students undergoing clinical practice in its network of hospitals.

Also, branch campuses can be fashioned out of relocated hospital buildings, already outfitted with various facilities and equipment. For example, the new Bukit Mertajam branch campus used to be a hospital before operations were relocated to the new Penang Specialist Hospital that opened in 2009.

Currently, KPJIC has total capacity for 2,500 students at its main campus in Nilai and two branch campuses in Johor Bahru and Bukit Mertajam.

Some RM120 million has been budgeted to expand the campus in Nilai in two phases. The company expects capacity to increase to 5,000 students by 2013. Revenue contribution from the education arm is forecasted to increase to RM100 million by then, up from RM30 million last year.

By 2016, KPJIC hopes to achieve full University status, with its own medical school and total student intake capacity of some 10,000, including both local and foreign students.

Longer-term venture in retirement village and aged care facilities

Over the longer-term, KPJ is looking to expand its services to include retirement homes and aged care facilities.

According to the latest Census 2010, there is a gradual shift in Malaysia's demographics with the proportion of those below the age of 15 falling to 27.6% from 33.3% in 2000 while that aged 65 and above rose to 5.1% from 3.9% over the same period. At this pace, we will hit the definition of ageing population by 2015. The average life expectancy is also on the rise.

Although sending elderly parents to nursing home is still somewhat taboo in Asian culture, this perception is likely to change with smaller nucleus family structure and rising affluence. Indeed, the elderly with financial independence may well 'choose' to stay in well developed retirement homes that encompass quality medical and nursing care.

As such, KPJ believes that retirement homes and aged care facilities will be a growth segment in the future. This market is already a big business in most developed countries.

To gain a first mover advantage, KPJ is in the midst of acquiring a 51% stake in Jeta Gardens for RM19 million. Jeta owns and operates a 64-acre retirement village in Queensland, Australia. The project is still only partially developed and currently consists of 23 retirement villas, 32 apartments and a 108-bed aged care facility. The longer-term plan is to develop it into a one-stop center that includes aged care nursing college and medical center.

Whilst earnings contribution is expected to be minimal, the company intends to gain valuable insights and experience from this venture, a business model it hopes to emulate locally.

Earnings Outlook

Taking into account the organic growth in healthcare demand as well as KPJ's expansion plans, we expect revenue will expand in the double digit range for the next few years. Between 2006-2010, the company's revenue grew from RM831.5 million to RM1,654.6 million, equivalent to a compounded annual rate of 18.8%.

In view of the larger revenue base, the pace is expected to taper off slightly, but we forecast revenue growth will remain within the range of between 12-16% per annum over the next three years.

Net profit is estimated at roughly RM119.5 million in 2011, up from RM110.7 million in 2010 (after excluding one-off gains totaling some RM8.2 million). Earnings are forecast to expand further to RM131.2 million in 2012.

Balance Sheet

KPJ plans to spend about RM150-200 million per annum on capital expenditure.

The company maintains an asset-light balance sheet by selling – and leasing back – most of its assets to 49%-associate, Al-'Aqar. Gearing stood at 30% at end-June 2011 with net debt totaling RM244.6 million.

KPJ is in the midst of finalizing the fourth tranche of assets injection into the REIT, valued at RM139 million. The sale will be finalised once the Bandar Baru Klang Specialist Hospital is completed, expected by end-2011.

We expect the sale and leaseback arrangement will continue for the company's future developments.

Investment Risks

Cyclical and business risks

Every industry is affected by economic cycles, some more so than others. Healthcare is generally viewed as one of the most defensive sectors – the sick need medical care regardless of whether it is boom or bust time.

Indeed, KPJ's revenue and earnings track record for the past five years showed a steady uptrend, including through the last recession in 2008-2009. We expect this to remain the case going forward.

Competition

Strong growth expectations and the industry's relative resilience have, in turn, attracted increasing investments in the private healthcare segment. Competition is growing.

KPJ is currently the leading private healthcare provider in the country with the largest network of specialist hospitals. However, its competitors are also on the expansionary path.

Some of its biggest competitors are Pantai Holdings and Columbia Asia. The former's network of 11 hospitals includes the flagship Pantai Hospital KL as well as Gleneagles KL. Columbia Asia, which recently opened its 9th hospital in Cheras, has presence in both East and West Malaysia, as well as in neighboring Vietnam, Indonesia and India.

The Sime Darby Healthcare Group, which operates the Sime Darby Medical Centre Subang Jaya, is in the midst of completing two new hospitals in Ara Damansara and Desa ParkCity. Another major player in the Klang Valley is Sunway with its Sunway Medical Centre in Bandar Sunway. There are also many smaller privately owned hospital operators in the country.

Whilst there are zoning regulation that limits the number of hospitals based on population count, it is possible that there could be short-term oversupply of beds in select locations. Nevertheless, the longer-term uptrend in demand for healthcare is intact and any excess capacity should gradually work itself out. KPJ aims to maintain its track record and quality of service to remain competitive. The company has a low turnover in terms of its medical consultants and support staff.

Cost escalation

Cost escalation for technology, processes and equipment is another concern, resulting in rising overall cost for healthcare. At the same time, insurance companies are negotiating for bigger discounts as they gain more bargaining power. In this respect, KPJ hopes to minimize the impact with economies of scale gained through its expanding network.

Valuation and Recommendation

Based on our earnings forecast, the stock is currently trading at roughly 20.9 and 19 times fully diluted P/E multiples for 2011-2012, respectively. This is higher than the average valuations for the broader market. We suspect this is due to the company's relatively defensive business as well as its positive longer-term growth prospects.

The stock did not escape unscathed in the recent global equity sell off, falling off the peak of RM4.72 to the current RM3.85. There could be further downside risks if sentiment for equities deteriorates from hereon. Nevertheless, we believe the stock will yield positive returns in the long run. Hence, we recommend a **BUY** on the company.

KPJ paid out roughly half of annual net profit as dividends in the past four years, on average. Assuming a similar payout ratio going forward, dividends are estimated to total 10.3 and 11.3 sen per share in 2011-2012, respectively. That translates into decent net yields of about 2.7% and 2.9% for shareholders over the two years.

KPJ pays dividends on a quarterly basis. Net dividends totaling 4.8 sen per share have already been paid so far this year.

The company will receive some 56.6 million units in Al-Aqar – worth roughly RM62.3 million at the current unit price of RM1.10 – as part payment for the injection of three hospital buildings into the trust. It could distribute these units to shareholders as dividends in specie or sell them in the open market. KPJ opted for the former option with respect to units received for two of its earlier assets injections, back in 2007 and 2008. This is so that the company can maintain its stake at less than 50% to keep the REIT's assets and borrowings off balance sheet.

The company has some 79.8 million warrants outstanding. The warrants can be converted into ordinary shares at anytime up to January 2015 at an exercise price of RM1.70. At the prevailing price of RM2.18, the warrants are trading at a very slight 1% premium.

Assuming full conversion, KPJ's total share capital will increase to 659.5 million shares, from the current 579.8 million shares.

Profit & Loss Analysis

Yr-end Dec (RM mil)	2009	2010	2011E	2012E
Turnover	1,456.4	1,654.6	1,853.2	2,112.6
EBITDA	179.9	200.3	239.1	268.3
Depreciation	46.4	59.4	72.0	87.7
Interest inc/(exp)	(14.1)	(6.4)	(14.2)	(14.7)
Extraordinary loss/(gain)	(5.6)	(8.2)	-	-
Pre-tax profit	143.9	166.7	177.8	195.5
Tax	29.2	40.5	43.6	48.9
Minorities	3.9	7.3	14.8	15.4
Net profit	110.9	118.9	119.5	131.2
Operating margin (%)	12.4	12.1	12.9	12.7
Pre-tax margin (%)	9.9	10.1	9.6	9.3
Net margin (%)	7.6	7.2	6.4	6.2

Per Share Data

Yr-end Dec	2009 *	2010	2011E	2012E
FD EPS (sen)	21.0	21.2	18.4	20.2
FD P/E (x)	18.3	18.1	20.9	19.0
Net dividend (sen)	8.0	11.3	10.3	11.3
Net yield (%)	2.1	2.9	2.7	2.9
NTA/share (RM)	1.20	1.37	1.43	1.54
Price/NTA (x)	3.2	2.8	2.7	2.5
Cashflow/share (RM)	-	-	0.65	0.73
Price/cashflow (x)	-	-	5.9	5.3
Gearing (%)	35.6	26.3	32.7	24.4
ROE (%)	18.3	17.0	15.0	15.2

* Adjusted for 1-to-2 share split and 1-for-4 bonus exercise implemented in Jan 2010

Balance Sheet

Yr-end Dec (RM mil)	2008	2009	2010
Fixed assets	307.9	446.8	536.8
Associates	227.0	239.5	307.4
Intangibles	110.2	115.6	136.3
Others	14.9	13.9	15.9
Investments	29.5	26.5	28.3
Trade debtors	206.6	252.6	310.8
Stocks	29.7	29.7	41.6
Assets held for sale	246.5	103.8	106.0
Cash and equivalents	(262.3)	(224.9)	(202.3)
Total current assets	220.5	161.1	256.1
Trade creditors	249.7	289.5	344.3
Tax payable	1.8	0.8	3.3
Dividend payable	-	-	14.7
Total current liabilities	251.5	290.3	362.2
Total assets	658.5	713.0	918.4
Share capital	209.5	211.1	280.0
Reserves	371.6	421.0	488.7
Shareholder's fund	581.0	632.0	768.6
MI	47.5	45.4	94.7
Other long term liabilities	29.9	35.6	55.0
Total capital employed	658.5	713.0	918.4



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