STANDARD & POOR'S

KPJ Healthcare

Recommendation: **STRONG BUY**

Stock Code: 5878 | Bloomberg: KPJ MK | Price: MYR3.08 | 12-Month Target Price: MYR4.40 | Date: January 21, 2008

Board: Main

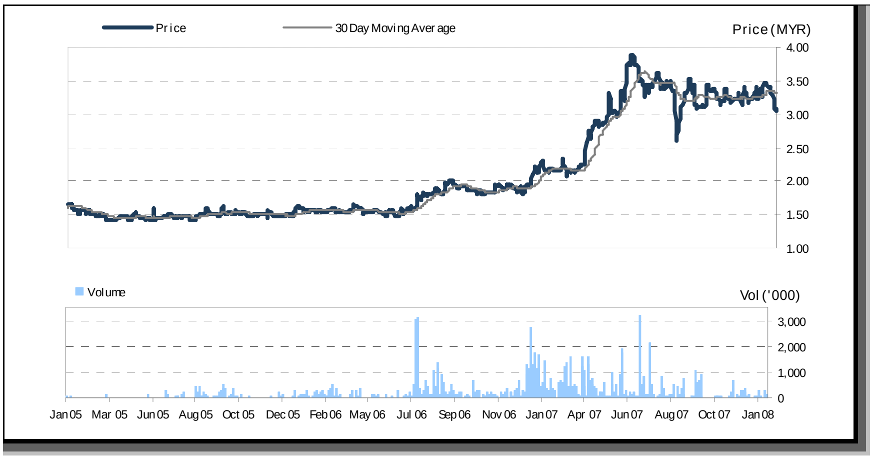
Sector: Trading / Services

GICS: Healthcare / Healthcare Facilities

Market Value - Total: MYR637.9 mln

Summary: KPJ Healthcare (KPJ) is involved in the provision and management of healthcare services. The Group currently owns and manages a network of 17 private specialist hospitals in Malaysia on top of managing another six private hospitals overseas.

Analyst: Siti Rudziah Salikin



Highlights

- KPJ will ride on increasing health awareness in the country, rising affluence and the growing medical insurance industry. The group is also among the frontrunners in catering to the fast growing medical tourism market and expect to increase the sector's contribution to the group's revenue to 10% in the next five years from 2%-3%, presently.

- KPJ is injecting another five hospital buildings into its Islamic REIT and intends to inject more mature hospitals to expand the trust fund. This also allows KPJ to unlock the value of the properties and grow its businesses without straining the balance sheet.

- We lower our 2007 net profit by 6.7% and raise 2008 figure by 8.2% as we defer the recognition of gain from sale of the five hospital buildings to 1Q08 and factor in the acquisition of Taiping Medical Centre into our 2008 forecast. We project a healthy net profit growth of 57% for 2007 and 27.2% for 2008 on the back of its hospital expansion, improved performance from its newer hospitals and contribution from new hospital management contracts.

Investment Risks

- Risks to our recommendation and target price include lower-than-expected patient admissions, which could be due to, among others, a downturn in the economy. In addition, operations could be adversely affected by the failure to attract and retain qualified medical personnel while rising wages may put margins under pressure, in our opinion.

Recommendation

- We maintain our Strong Buy call on KPJ, which offers exposure to the country's growing private healthcare industry. With the delisting of Pantai Holdings in Jan. 2007, KPJ becomes the only listed integrated healthcare group in the country with a track record of nursing ailing private hospitals to health.

- Valuations are among the lowest in the region. The stock currently trades at a PER of 8.8x against a double-digit earnings growth and at a large discount to its regional peer's multiples. Singapore-listed Pacific Healthcare Holdings (PACH SP, SG$0.35, Buy) currently trades at a 2008 PER of 13.5x with a projected net profit growth of 17.7%. The valuation gap could be attributable to the peers' larger exposure to the more lucrative medical tourism sector, in our opinion.

- Our PER-based 12-month target price remains unchanged at MYR4.40. We accord the stock's one-year average multiple of 12x and add our projected dividend for 2007 of 14.5 sen per share to arrive at the target price.

- Primary catalysts for the group would be its new hospitals, which would make KPJ's coverage nearly nationwide, and higher contribution from foreign patients, who generally seek highly specialized medical services that provide better margins.

Key Stock Statistics

FY Dec.	2006	2007E
Reported EPS (sen)	20.3	27.5
PER (x)	15.2	11.2
Dividend/Share (sen)	14.0	14.5
NTA/Share (MYR)	1.68	1.80
Book Value/Share (MYR)	2.17	2.28
No. of Outstanding Shares (mln)	207.1	
52-week Share Price Range (MYR)	2.06 - 3.90	
Major Shareholders:	%	
Johor Corporation	51.7	
Kumpulan Wakaf An-Nur Bhd	9.0	

Per Share Data

FY Dec.	2004	2005	2006	2007E
Book Value (MYR)	1.79	2.04	2.17	2.28
Cash Flow (sen)	33.1	31.7	35.6	47.1
Reported Earnings (sen)	15.8	16.2	20.3	27.5
Dividend (sen)	7.0	11.0	14.0	14.5
Payout Ratio (%)	31.8	48.8	56.7	52.7
PER (x)	19.4	19.0	15.2	11.2
P/Cash Flow (x)	9.3	9.7	8.7	6.5
P/Book Value (x)	1.7	1.5	1.4	1.3
Dividend Yield (%)	2.3	3.6	4.5	4.7
ROE (%)	9.0	8.5	8.5	12.5
Net Gearing (%)	82.4	82.8	62.5	59.3

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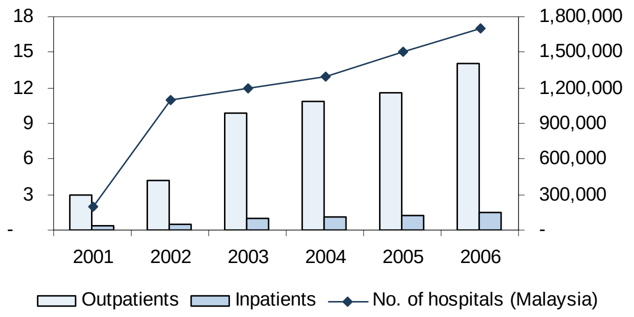
Businesses

KPJ is the largest private hospital group in Malaysia and is still expanding. The group's strength lies in its large network of 17 specialist hospitals with over 2,000 licensed beds that are mostly located in prime areas throughout the country. Its nearest privately-owned competitor is Pantai Hospital, which operates eight hospitals with 1,093 beds. While the group offers diverse and integrated healthcare services, the hospitals also focus on specific niche services in a wide area of specialties including interventional cardiology, cardiothoracic surgery, oncology, pediatrics, neonatology and a full range of surgeries.

The hospitals served a total of 1.4 mln outpatients and 144,976 inpatients in 2006, an increase of 3.4x and 3.3x, respectively since 2002. The growth was propelled by both organic growth and a series of acquisitions, including several ailing private hospitals such as Tawakal, Puteri Specialist (Johor), Kuantan Specialist and Bukit Mertajam Specialist, which were successfully turned around. The latest hospitals to join the group are Sentosa Medical Centre, Kuala Lumpur and KPJ Kajang Specialist Hospital, which were acquired (in Dec. 2006).

A Steady Growth In The Number Of Patients



Source: Company Data, S&P Equity Research

Another hospital will soon be added to its stable. KPJ's wholly-owned subsidiary Kumpulan Perubatan (Johor) Sdn Bhd is acquiring a 100% stake in 39-bedded Taiping Medical Centre in Perak from Dr. Ong Boon Taik @ Ong Boon Teik and family for MYR18 mln cash. The proposed acquisition has been given the approval of the Foreign Investment Committee (it is not subjected to the approval of KPJ's shareholders) and should be completed by end-Jan. 2008. Dr. Ong will continue to practice full time at the hospital for at least three years from the date of the completion.

KPJ is also establishing its presence overseas. Currently, it manages two hospitals in Indonesia (Rumah Sakit Medika Permata Hijau in Jakarta and Rumah Sakit Selasih in Padang) and owns a 75% stake in recently opened Rumah Sakit Medika Bumi Serpong Damai (in Jakarta). In Bangladesh, it manages United Hospital Ltd., the country's second major private hospital which was officially opened in Aug. 2006. KPJ ventured into the Middle East in Mar. 2007 when it clinched a contract to manage two hospitals in Jeddah, Saudi Arabia for five years with an option to renew for another five years. Generally, KPJ collects management fee plus some form of profit sharing. Currently, profit contribution from the overseas operations is still small but is expected to account for 15% of group earnings in 2-3 years, helped by the Middle-East ventures. We expect more acquisitions and new hospital management contracts in the future as KPJ aims to at least acquire one hospital or secure one hospital management contract a year.

KPJ's own private nursing college, PNC International College of Nursing and Health Sciences in Nilai, Negri Sembilan with a newly set-up branch in Johor Bahru, would provide a steady stream of trained nurses to meet the needs of the expanding KPJ's activities and help to mitigate the risk of a shortage of qualified nurses in the country. Its other supporting activities such as healthcare technical services, retail pharmacy, bulk purchasing and laboratory services have also grown in tandem with the expansion of the hospital activities.

At the same time, KPJ has unlocked the value of its matured hospitals through its Islamic real estate investment trust, the Al-'Aqar KPJ Real Estate Investment Trust [AAREIT (AQAR MK, MYR0.97, Not Ranked)]. It was listed on Bursa Malaysia in Aug. 2006. AAREIT started with six hospital buildings (Ampang Puteri Specialist, Damansara Specialist, Johor Specialist, Ipoh Specialist, Puteri Specialist and Selangor Medical Centre), which were acquired from KPJ in Aug, 2006 in exchange for AAREIT shares and cash. The properties are leased back to KPJ as specialist hospitals. Presently, the rental payment from KPJ is the only source of revenue for AAREIT.

KPJ is injecting another five hospital buildings (Sentosa Medical Centre, KPJ Kajang Specialist, Kedah Medical Centre, Perdana Specialist and Kuantan Specialist) into AAREIT. The proposal has been approved by the respective companies' shareholders. It also involves the issuance of new AAREIT shares (which will raise KPJ's effective stake in AAREIT to 57.9% from 48.2% and expand AAREIT unit capital to 428.7 mln from 340 mln) and a cash payment (which will be used by KPJ to repay debts and for future investments). We expect KPJ to place out some AAREIT shares in the future to cut its stake to less than 50%. It has started with the distribution of 14.5 mln of AAREIT shares to its shareholders on the basis 7 AAREIT for every 100 KPJ shares (completed in Dec. 2007), which will reduce KPJ's interest in AAREIT to 55.6%. As the other hospitals become more established, KPJ intends to inject more hospitals into AAREIT to expand the trust fund. This also allows KPJ to grow its businesses without straining the balance sheet.

Earnings Outlook

The industry dynamic is favorable for KPJ to maintain its growth momentum. Malaysia's spending on health has been steadily increasing to 3.8% of the country's GDP in 2002 from 3.0% in 1998, according to the latest available statistics by World Health Organization (WHO). However, the spending was still behind WHO's recommendations of 5% and that of other developed countries.

Malaysia's Total Expenditure On Health (as % of GDP) Is Comparatively Low

	1998	1999	2000	2001	2002
Australia	8.7	8.9	9.2	9.3	9.5
Canada	9.2	9.0	8.9	9.4	9.6
China	4.8	5.1	5.6	5.7	5.8
India	5.2	5.7	6.3	6.1	6.1
Japan	7.2	7.4	7.6	7.8	7.9
Malaysia	3.0	3.1	3.3	3.8	3.8
Singapore	4.2	4.1	3.6	3.9	4.3
Thailand	3.9	3.7	3.6	3.5	4.4
USA	13.0	13.0	13.1	13.9	14.6

Source: World Health Organization, S&P Equity Research

The overall health spending will continue to rise, in our opinion, in view of increasing awareness towards preventive health and primary care in the country. While the government health services will remain the popular choice because of the affordability factor, rising affluence and the pick-up in the medical and health insurance sectors are pointing to greater access to private healthcare services. Increasing population of older age groups (which may give rise to old age-related ailments) and rising cases of non-communicable diseases (such as cancer, heart diseases and diabetes) should also boost demand for specialty services, creating greater opportunities for KPJ.

Another healthy source of growth is the medical tourism industry. With its competitively-priced services and high medical standards, Malaysia is becoming one of the preferred medical tourism destinations in Asia. The number of medical tourists in the country grew to 296,687 in 2006, bringing total revenue of MYR203.7 mln from MYR9.5 mln in 1998. The sector's revenue is expected to reach MYR2.0 bln by 2010. KPJ has been among the frontrunners in catering to the tourist market, offering specialized medical services (KPJ has developed specialties in reconstructive and plastic surgery) that are combined with holiday packages. Presently, health tourism only accounts for 2%-3% of KPJ group revenue compared with 50% for some private hospitals in Singapore. KPJ expects to increase the contribution to 10% in five years.

KPJ's 2007 revenue is expected to pass the MYR1.0 bln mark. We believe our projected 23% growth in the total number of patients for KPJ in 2007 and 10% increase in 2008 is within reach given the rising demand for private healthcare in the country, higher admissions of foreign patients and the expansion of its hospitals. 2007 will also see the full-year impact of Sentosa Medical Centre, Kuala Lumpur and KPJ Kajang Specialist Hospital in the group as well. Margins are expected to improve with better performance of new hospitals. Perdana Specialist in Kelantan and Kuching Specialist are expected to break even in 2007 and become profitable in 2008, while Sentosa Specialist in Kuala Lumpur should turn around in 2009 (it normally takes 3-4 years for a hospital to show profit). Material costs are on the rise but we do not see this is as an issue for the company since the cost increases are normally fully passed on to customers.

The net impact of the proposed sale of five hospital buildings to the group's bottomline (excluding the one-off capital gain of MYR5.7 mln at the group level) will be marginally positive as savings on interests and depreciation charges are offset by rental expenses. Similarly, the acquisition of Taiping Medical Centre, which recorded a net profit of MYR1.7 mln in FY06 (Apr.) will be earnings accretive, albeit marginally due to interest elements.

We have made some adjustments to our earnings forecast due to the slight delay in the completion of the sale of the five hospital buildings to AAREIT from the original target of Dec. 2007. We have also factored in the net impact of the acquisition of Taiping Medical Centre into our 2008 forecast. All in, we lower our projected 2007 net profit by 6.7% and raise our 2008 forecast by 8.2%. Without the gain, we project a healthy net profit growth of 57% for 2007 and 27.2% for 2008.

We expect group net gearing to drop below 50% in 2008 from 55.9% at end-Sep. 2007 due to debt repayments and a higher shareholders' funds base. As its financial position strengthens, we expect KPJ to be able to maintain at least 50% dividend payout going forward.

Valuation

The earnings adjustment has no impact on our 12-month target price of MYR4.40, which is derived from a PER of 12x on recurring earnings for 2008. We also add our projected dividend of 14.5 sen per share for 2007 to arrive at the target price.

As per the historical trend, the assigned valuation is at a discount to its regional peers, such as Pacific Healthcare Holdings, which currently trades at 13.5x 2008 earnings. The valuation gap could be attributable to its peers' larger exposure to the more lucrative medical tourism sector. For instance, about 53% of Pacific Healthcare patients are foreigners.

Profit & Loss

FY Dec. / MYR mln	2005	2006	2007E	2008E
Reported Revenue	659.6	831.5	1,072.4	1,256.6
Reported Operating Profit	58.8	70.3	91.2	111.9
Depreciation & Amortization	-31.1	-35.6	-40.6	-38.4
Net Interest Income / (Expense)	-15.9	-18.6	-17.6	-15.8
Reported Pre-tax Profit	42.3	60.1	85.0	114.0
Effective Tax Rate (%)	32.1	31.5	27.0	27.0
Reported Net Profit	32.7	41.0	57.0	78.2
Reported Operating Margin (%)	8.9	8.5	8.5	8.9
Reported Pre-tax Margin (%)	6.4	7.2	7.9	9.1
Reported Net Margin (%)	5.0	4.9	5.3	6.2

Source: Company data, S&P Equity Research

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Glossary

Strong Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.
Buy: Total return is expected to outperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months, with shares rising in price on an absolute basis.
Hold: Total return is expected to closely approximate the total return of the KLCI or KL Emas Index respectively, over the coming 12 months with shares generally rising in price on an absolute basis.
Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months and share price is not anticipated to show a gain.
Strong Sell: Total return is expected to underperform the total return of the KLCI or KL Emas Index respectively, over the coming 12 months by a wide margin, with shares falling in price on an absolute basis.

S&P 12 Month Target Price – The S&P equity analyst's projection of the market price a given security will command 12 months hence, based on a combination of intrinsic, relative, and private market valuation metrics.

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For residents of Malaysia. All queries in relation to this report should be referred to Alexander Chia, Desmond Ch'ng or Ching Wah Tam.

Recommendation and Target Price History

Date	Recommendation	Target Price
4-Dec-07	Strong Buy	4.40
5-Sep-07	Strong Buy	4.31
11-Jun-07	Buy	4.31
6-Mar-07	Strong Buy	2.94
4-Dec-06	Strong Buy	2.43
11-Oct-06	Strong Buy	2.42
4-Sep-06	Buy	2.42
6-Mar-06	Buy	1.88
17-Nov-05	Buy	1.75