Smart Company Analysis

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The Company: Mediclinic International plc

A sector in search of cure for regulatory pain

Our call

Hold

Intellidex estimate of fair value:	*R70.58*
Spot price:	*R61.59*
Potential move:	*14.6%*

Share price graph and Intellidex's previous calls

Background

Mediclinic International provides acute care, specialist-orientated and multi-disciplinary hospital and related services in three regions: Southern Africa, Switzerland and the United Arab Emirates (UAE). Its primary listing is in London, with secondary listings in SA and Namibia.

In Southern Africa it has more than 8,000 inpatient beds through 51 hospitals and three day-care clinics. Hirslanden (Switzerland) has more than 1,800 inpatient beds and operates 17 private acute care facilities and four clinics; and Mediclinic Middle East operates seven hospitals and 22 clinics with more than 930 inpatient beds in the UAE. Mediclinic also has an associate stake in the UK-listed Spire Healthcare.

Sensitivity analysis: discounted cash-flow valuation

	Terminal growth	2.0%	4.0%	6.0%
Wacc	7.0%	11820	20381	63187
	9.0%	6510	9644	16959
	10.0%	4921	**7058**	11350
	12.0%	2637	3726	5540
	13.0%	1838	2654	3936

This reflects the sensitivity of our forecasts to assumptions of the terminal growth rate and the weighted average cost of capital (WACC). The highlighted cell shows our target price in cents.

Investment thesis

To understand the story of Mediclinic we begin by shedding light on how much each of its three segments contribute to group operations. Its biggest source of revenue is Switzerland, which contributed 45% of revenue and 42% of operating profit (down from 48%) before depreciation and amortisation (Ebitda) in 1H19 to end-September. This is followed by southern Africa which accounts for 32% of revenue and 44% (up from 40%) of Ebitda. Finally, UAE makes up 22% of group revenue and 14% (up from 12%) of Ebitda.

Since 2016 Mediclinic has battled with negative regulatory developments in all its operating geographies. At the moment most of the regulatory pain is emanating from Hirshlanden in Switzerland.

Patient outmigration in Hirslanden is gathering pace, which saw the inpatient revenue per admission declining by 2.8% after dropping by 0.8% in the comparative period. (Outmigration occurs when ailments which used to be treated as inpatient conditions are reclassified as outpatient. Outpatient conditions draw lower tariffs, thus lower margins. This development has seen Hirshladen's Ebitda margin compressing to 14.3% from 17.4%. Given that it is the major revenue contributor, this has overshadowed margin gains in the UAE. Group Ebitda has fallen 8.2% to £214m.

The market was not amused and the counter has been hammered. Between FY16 and 1H19 the Ebitda margin has fallen from 18.1% to 15.4%. The scary part is that more outmigration regulation is expected in 2019 and it is difficult to ascertain how much more damage it will inflict.

However, management is doing something about it. During 1H19 it identified and implemented some cost-saving initiatives, which will become more entrenched in 2H19. Furthermore, the customary Swiss seasonal benefits in the second half of the year typically generate higher patient volumes and an improved patient mix. As such Hirslanden is expecting to deliver an Ebitda margin of around 16% for FY19 from 14.3% in 1H19 (FY18: 18.3%).

For the medium term, Hirslanden is adapting to the changing inpatient environment, making fundamental changes to its service model and cost structure, including areas such as supply costs, service differentiation, operational efficiency, doctor recruitment and hospital reconfiguration. It is also improving its outpatient delivery model – borrowing from its SA and UAE experiences – including the opening of outpatient surgery units, medical centres and doctors consulting rooms. It is reconfiguring theatres and recovery areas in existing hospitals to treat the growing volume of outpatient cases cost-effectively. Additionally, management is reducing Hirslanden's capital allocation.

The group is taking advantage of the low interest environment by raising most of its funding in Switzerland, yet ringfencing it with its Swiss assets. This has reduced the cost of capital in our Mediclinic valuation model. Most top line growth is expected to come from the UAE – albeit off a low base – through the new Parkview hospital in Dubai that opened in September. Margins in the UAE are also expected to continue improving as capacity utilisation increases.

Southern Africa is expected to continue delivering modest growth in line with inflation.

We expect Mediclinic to experience average annual revenue and earnings growth of 4.1% and 10.5% respectively in the short to medium term. We see earnings gradually falling to a sustainable growth rate of 4.0% in the terminal year of our model. We assume that its adjusted pre-tax operating margin will stabilise at around 13.7%.

Using a discount rate of 10.0%, we obtain a target price of R70.58/ share, which translates to upside potential of 14.6%. However, a price:earnings-to-growth (PEG) ratio of 1.5, based on our expectations of Mediclinic's short- to medium-term earnings growth rate, is bearish. (A PEG ratio of less than one indicates that growth is expected to be strong relative to the current price:earnings ratio). Since the PEG ratio is well above one, it reflects heightened downside risk in our price target. As such this is a hold even though the upside potential suggests a buy.

Analysis of results

Although revenue was up in all three operating currencies (rand, Swiss franc and dirham), the average exchange rate of the reporting currency (pound sterling) was stronger than all the operating currencies during 1H19. This saw the reported pound revenue edging lower. The Ebitda margin shrank to 15.4% from 16.5%, primarily as a result of regulatory headwinds in Switzerland.

During 1H19 the pound strengthened 4% against the rand and Swiss franc and 3% against the dirham. A 10% change in the average exchange rate during 1H19 would increase/decrease: Swiss profit by £3m (1H18: £5m); southern Africa profit by £4m (1H18: £5m); and UAE profit by £1m (1H18: £2m).

Hirslanden (Swiss) revenue edged up 1% to CHF826m. Margins came under pressure due to draconian regulatory changes that have adversely affected the pricing of services. Ebitda fell to 14.3% (17.4%). Southern Africa revenue grew 5% to R7.96bn. The Ebitda margin widened to 21.2% from 21%.

UAE revenue grew 5% to AED1.5bn. Its Ebitda margin rose to 9.4% from 8.8%, benefiting from increased capacity utilisation.

The group realised significant impairment charges which saw its operating profit tank by more than 70%, but headline earnings grew 23% a share since it excludes these non-frequent charges.

Macroeconomic analysis

Over the past few years hospitals have enjoyed premium valuations but recently these have come down sharply as earnings have consistently disappointed. We don't believe the high valuations were due to growth potential but rather to their defensive, non-cyclical properties: basic need status, ageing populations and a growing disease burden.

The two primary sources of organic growth for hospitals are patient volumes and price increases – with the latter under regulatory pressure, which is chipping away the sector's pricing power. A third dimension relates to expansion of services, but it is still tied to volume. Volume is directly related to population growth – which by nature is quite pedestrian. However, areas of potential volume growth include expansion of services/products and the growing demand for high-margin procedures as the middle class expands and the population's average age increases.

In SA, private healthcare providers have low market penetration of less than a fifth of the population. This presents huge growth potential but in the face of low economic growth, high unemployment and the possibility of national health insurance, the outlook is far from certain.

Bull Factors

- Reversal of draconian medical insurance in UAE
- New capacity added in UAE
- Pivoting towards higher-margin services and premium insurance patients in UAE
- Recent acquisition in Geneva should help stem revenue and margin decay
- Cost-containment initiatives
- Ageing population in Europe, Africa and Middle East is expanding and expenditure on health care is expected to catch global levels
- Geographical diversification reduces business risk
- LSE listing improves access to cheaper capital and share liquidity

Bear Factors

- Tight regulatory environment in Switzerland and SA to curb medical cost inflation
- Affordability might constrain growth, especially in Africa
- Currency impact difficult to predict

Key statistics

Share details – JSE Code: **MEI**
Sector: **Healthcare providers**

Market cap: **R45.4bn**	12-month high: **R120.23**
Net debt:equity ratio**: 54.5%**	12-month low: **R60.10**
Price:earnings ratio: **12.0**	Ave monthly volume: **24.3-million**
Forward PE ratio (FY19): **11.9**	Financial year-end: **31 March 2019**
Dividend yield: **2.2%**	Latest event**: Interim results**
Forward dividend yield**: 2.23%**	Date announced: **15 November 2018**
Risk: **High**	

RESULTS IN BRIEF	1H19	Change	1H18	FY18
Revenue (£'m)	1 387.0	-1.3%	1 405.0	2 870.0
Operating profit (£'m)	39.0	-70.7%	133.0	-288.0
Operating margin (%)	2.8%	-70.3%	9.5%	-10.0%
Attributable earnings (£'m)	-168.0	236.0%	-50.0	-492.0
HEPS (pence)	10.7	23.0%	8.7	27.6