# Spotlight: Sri Lanka Listed Hospitals

Strong Growth Trajectory to Continue Despite Resource Constraints

**Hospitals' Balance Sheets to Improve:** Fitch Ratings expects the balance sheets of Sri Lanka's listed hospitals to improve in the medium term as their capex moderates and operating performances improve. Most private operators expanded capacity in the last few years to meet growing demand. As a result, the combined net debt-to-EBITDA of the four largest listed hospitals rose to 2.6x at end-December 2017 from 1.7x at end-March 2013. However, we believe most hospitals will now focus on stabilising operations and strengthening balance sheets before funding further expansion.

**Improvements in EBITDA Margin**: We expect the EBITDA margin of the listed hospitals to improve modestly in the medium term as patient volume increases. Higher occupancy at hospitals and larger revenue contributions from high-margin value-added businesses, such as diagnostics and laboratory services, should help to more than cover the high fixed costs of the sector and widen margins. We also believe hospitals should be able to pass on cost increases from staff-related costs or currency depreciation to end-customers amid strong demand for private healthcare.

However, regulatory pressure from increased taxes on healthcare and recently introduced price controls on certain procedures may limit sector profitability in the near term. The listed hospitals' EBITDA margin averaged around 23% in the last five years. Asiri Hospitals Holdings PLC, the largest listed operator in the country in terms of revenue and number of beds, was able to maintain better margins than peers due to its strong laboratory revenues.

**Geriatric, NCD Care Drive Demand:** We believe the increasing demand for private healthcare is driven by Sri Lanka's aging population and rising incidence of non-communicable diseases (NCDs), which state hospitals are not well-equipped to handle. Geriatric care tends to be long-term, while treatment of NCDs requires long hospital stays, long-term medication and, in some cases, palliative care. We expect geriatric care to become a strong growth area as per capita incomes increase, while the incidence of NCDs are rising in Sri Lanka, particularly in urban areas.

**Rise in Medical Insurance Penetration:** Demand for private healthcare in Sri Lanka is likely to improve in the medium to long term with wider acceptance of medical insurance, helped by government-led insurance schemes and increasing personal income.

**Shortage of Trained Professionals**: We expect further expansion of private hospitals to be hobbled by the shortage in qualified physicians and nursing staff. We do not expect the shortage to resolve in the medium term.



#### Most Hospitals' EBITDA Margins Improved Recently

Spotlight: Sri Lanka Listed Hospitals 24 May 2018

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# Peer Financial Summary

Company	Date	Bed count	Gross Revenue (LKRm)	Operating EBITDA (LKRm)	Operating EBITDA Margin (%)	FCF (LKRm)	l Net debt/ EBITDA (x)	EBITDA/gross interest coverage (x)
Asiri Holdings PLC	FYE17	584	10,396	2,911	28.0	-626	2.8	3.5
	FYE16		9,952	2,842	28.6	637	2.5	4.0
	FYE15		8,593	2,466	28.7	1,668	2.9	4.0
	FYE14		7,913	2,664	33.7	1,276	3.1	4.0
Nawaloka Hospitals PLC	FYE17	475	6,300	1,253	19.9	-1,947	6.5	2.8
	FYE16		5,860	1,117	19.1	-2,165	5.4	3.0
	FYE15		4,602	750	16.3	-1,865	5.1	2.6
	FYE14		3,993	782	19.6	-279	3.1	3.9
Ceylon Hospitals PLC (Durdans)	FYE17	260	5,289	936	17.7	180	1.2	9.5
	FYE16		4,728	937	19.8	348	1.0	10.8
	FYE15		4,083	657	16.1	272	1.7	5.3
	FYE14		3,961	697	17.6	233	1.9	3.7
The Lanka Hospitals Corporation PLC	2017	350	6,382	1,112	17.4	377	net cash	nm
	2016		5,886	1,207	20.5	738	0.1	nm
	2015		5,514	1,094	19.8	1,073	net cash	nm
	2014		4,754	702	14.8	-70	net cash	nm

#### Credit Profiles of Listed Hospitals to Improve as Capex Reduces

We expect the credit profiles of the established listed hospitals (excluding new entrant Singhe Hospitals PLC, which has yet to break even) to improve in the medium term due to better profitability and lower capex following the completion of major projects. The hospitals' average net leverage (defined as net adjusted debt to EBITDA) rose to 2.6x by end-2017 from 1.7x at end-2013, with a peak of 2.8x at the height of the capex cycle in 2016.

Most hospitals expanded to cater to the growing demand for private healthcare, which drove the ratio of capex to revenue to around 20% in 2015-2017 from less than 10% before that. Asiri and Nawaloka Hospitals PLC led the expansion with the setting up of regional hospitals and expansion of at their existing facilities, while capex was more moderate at Ceylon Hospitals PLC (which operates under the "Durdans" brand) and The Lanka Hospitals Corporation PLC.

We expect most of the operators will slow their expansion in the coming years to strengthen their stretched balance sheets. The recent expansions by Asiri and Nawaloka were mostly debt funded as internally generated funds were not sufficient to cover the large projects. Lanka Hospitals' management says it will continue to invest to expand capacity locally and internationally and expand its laboratory network, but we do not expect the capex to be as large as that of Asiri or Nawaloka. Consequently we expect the sector's capex intensity to reduce to 12%-15% of revenue in the next couple of years, which should bode well for the sector leverage. However, in the long term, private hospital operators' capex are likely to pick up as they step in to fill the growing supply gap in government hospitals.

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#### Leverage Rose on Debt-Funded Investments

Source: Company, Fitch Ratings





Source: Company, Fitch Ratings

#### EBITDA Margins to Improve, But Capped by Regulatory Controls and Staff Shortage

We expect sector leverage also to benefit from modest improvements in profitability over the medium term helped by strong top-line growth. In 2017, most hospitals' EBITDA margins widened due to improved occupancy levels resulting from a dengue epidemic. Higher occupancy also helped to reduce the ratio of sales, general and administrative (SG&A) expenses to around 34% of revenue, the lowest level in the past six years. However, government price controls on certain drugs and laboratory tests carried out by the hospitals cut the profitability of their pharmacy and laboratory operations, offsetting some of the overall margin improvement.

Over the past five years the combined EBITDA margin of listed hospitals has averaged around 23%, with each operator's margin ranging from high teens to low 30s.

The hospital operators will continue to face pressures from the depreciation of the Sri Lankan rupee, which increases their cost of sales, and the shortage of trained staff, which compels hospitals to pay a premium to recruit them. The operators are able to pass on most of these costs to customers and protect margins in the medium term because of the specialised service they provide and the undersupply of providers. However, the pass through of costs has been curtailed by government price controls on certain services, such as physician consultations, surgical procedures and lab tests.

We do not expect the listed hospitals to face liquidity pressure in the medium term because they have more long-term debt in their capital structures, spread-out maturity profiles, and stable FCF generation as capex declines. Historically, only around 25% of the sector's debt structure consisted of short-term debt, with half of it in revolving credit facilities used for working capital requirements. We believe the lenders will easily roll over these facilities given the strong operating performance and stable cash flow generation of the hospital operators.



#### Listed Hospitals' FCF Recovering as Capex **Declines**



#### Long-Term Demand Drivers Intact for Private Hospital Operators

We believe the strong demand in 2015, when we first published our report on Sri Lanka's private-sector hospitals, continues. We expect the following factors to drive the demand for private-sector hospitals in the medium to long term.

#### Aging Population Drives Demand for Geriatric Care

By 2030, one in seven Sri Lankans will be above the age of 65, making Sri Lanka one of the fastest aging populations in the world. The country has one of the lowest fertility rates in Asia, as well as a high life expectancy rate, which contributes to the rapid aging of the population. Currently the public sector does not provide long-term inpatient geriatric care due to resource constraints and such patients have to turn to private hospitals or nursing facilities for such services. However geriatric care is still at the infancy stage, even at private hospitals, given the lack of trained professionals. Thus we believe there is a strong incentive for private hospitals to expand capabilities in geriatric care in the medium to long term.

## Special Report

### Sri Lanka's Aging Population



Source: World Developmental Indicators, Fitch Ratings

#### Private Healthcare Within Reach as Incomes Rise

Mean Per Capita Income (Monthly Basis)

We believe more people will opt for private healthcare as personal incomes rise. Also, consumers seek convenience and better service standards that are not met by the public sector due to under capacity. Consequently, average household spending on healthcare increased 2.6x from 2006 to 2016.







Source: Department of Census and Statistics, Fitch Ratings



Sri Lanka's urban population, which forms 15% of total population, earns income that is 25%-30% higher that of the rest of the country, and most private operators have located hospitals close to them. However, income levels in rural areas have increased at a faster pace than urban areas in recent years, and decline in the use of outpatient and inpatient care at state hospitals by the rural population in recent years also indicates a shift to private healthcare. These create opportunities for private operators to expand outside of the main cities.

#### Rising Incidence of Non-Communicable Diseases

Unhealthy diets and lifestyles due to increased urbanisation and higher incomes have resulted in an increase in NCDs that require extended care and medication. The proportion of Sri Lankan households with someone suffering from a chronic illness rose to 17% at end-2016 from 14.4% in 2006. The incidence is higher in urban areas at 18.6% of households, with the highest concentration in the Western Province, which accounts for 28% of the country's population and 38% of its household income. According to the Demographic and Health Survey Report – 2016, 8.2% of the country's population suffered from high blood pressure 5.7% from diabetes and 5.4% from high blood cholesterol.

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Most types of NCDs require expensive medical procedures followed by long hospital stays, a life time of medication and palliative care. We do not believe the state sector infrastructure is able to handle the increasing incidence of NCDs, which will leave the private sector to fill the gap. Private operators have been setting up specialised cardiac, renal, neuro and oncology units within their hospitals to tap opportunities in NCDs.

# **Rising NCD Incidence, Led by Urban Areas** (% of households with someone with chronic illness)



#### High Blood Pressure is Most Prevalent NCD



Source: Demographic and Health Report - 2016, Fitch Ratings

#### Increased Penetration of Medical Insurance

Source: HIES Final Report 2016, Fitch Ratings

We expect the private hospitals to benefit from the increase in medical insurance schemes over the long term. Historically, around 85% of spending on private healthcare was borne by the patient, with 8% funded by company-sponsored health and medical benefits. Only 5% of such expenditure was covered by medical insurance schemes.

We believe this trend will change in the medium term due as the government implements medical insurance schemes for the state sector and for school children. At end-2017, state-sector employees and their dependants who qualify for the Agrahara insurance scheme accounted for more than 10% of the population. The government has also allowed state employees to make nominal additional contributions to the scheme if they prefer, which could increase their claims coverage to LKR350,000/year from LKR150,000 under the normal cover. Under the enhanced covers, the policy holders may also claim up to LKR1 million for complex procedures, such as heart surgeries and kidney transplants. Gross written premiums under this scheme were around LKR2 billion, latest data show, with very high claim ratios. Most private hospitals, including the listed ones discussed in this report, already partner the government to provide services under the Agrahara insurance scheme.

In 2017, the government introduced a free medical insurance scheme for school children, which provides a maximum hospitalisation cover of LKR200,000/year (which is around USD1,300) and other benefits. The government aims to cover 4.5 million school children aged 5-19 (around 21% of the population) under this programme and plans to allocate around LKR2.4 billion in annual premiums for this purpose.

We also expect the take-up of individual medical insurance policies to increase, driven by rising personal incomes and the trend among insurance companies to offer medical coverage with life insurance policies for nominal additional premiums. As of end -2016 there were 2.9 million life insurance policies in the country.

#### Under-Capacity in the Public Sector to Continue

We do not expect the government to meaningfully increase capacity in the medium term to cater to the growing healthcare needs of the country. The government's capex on the healthcare sector rose sharply in 2015, but has since stagnated with the bed count at government hospitals remaining flat over the same period. In contrast, the private hospitals have increased bed capacity by around 10%. At present, 95% of inpatient care and around 50% of outpatient care is provided by government hospitals, where patients receive free treatment or pay nominal fees.

We do not believe the current infrastructure in the government healthcare sector is sufficient to cater to the kind of longterm care required by an aging population and increasing number of patients suffering from NCDs. In addition, the wait for surgeries and diagnostic procedures at government hospitals runs as long as years, forcing patients to shift to the private sector for faster treatment. According to the government's Household Income and Expenditure Survey 2016, 17% of patient admittance at private hospitals was for surgeries versus 12% for government hospitals. We believe more people will be willing shift to private hospitals in the medium term in order to obtain a more convenient and swift service, aided by higher incomes and increasing insurance penetration.

#### Other Growth Opportunities

We believe medical tourism and investments in technology-based health platforms present growth opportunities for private hospitals. Sri Lanka is still in the early stages in developing the medical tourism industry, with only around 12,000 tourists (0.5% of total arrivals) arriving annually for medical reasons, compared with millions for more established markets, such as Thailand and Singapore.

However, we believe Sri Lanka has a strong foundation on which to build its medical tourism industry, with the improving quality of private healthcare, availability of highly skilled English-speaking medical staff, and the low cost of services offered. The global medical tourism market is expected to double in value to around USD50 billion by 2021, says market research firm Orbis Research. Three hospitals in Sri Lanka – Durdans, Asiri Central (part of the Asiri Group) and The Lanka Hospitals – have obtained the Joint Commission International (JCI) accreditation, which is an endorsement of international standards in patient safety and quality.

A flood of tech-based health platforms have come to the market in Sri Lanka, offering online services such as channelling appointments, physician consultations, diagnostic services and prescription-based drug delivery services. Some of the leading listed hospitals have invested in such platforms to build a captive customer base. We believe the demand for such online platforms will significantly increase in the medium term, helped by the rising smart phone penetration, round-the-clock availability of such services and the convenience to the customer.

#### **Regulations and Shortage of Skilled Staff Remain Key Risks**

The hospital sector was previously exempt from certain indirect taxes, such as Value Added Tax (VAT), and subject to a lower corporate tax rate due to the essential nature of the service provided, but this changed in 2016 when the government implemented a 15% VAT on hospital rooms and physician consultations. The government has said several times it has considered removing this VAT, but has yet go ahead with such a decision. In addition to the VAT, the applicable corporate tax rate for hospitals was raised to 28% from 1 April 2017, from 12%, which has squeezed the sector bottom line and cash flow generation.

In 2016 the government also imposed price caps on certain essential drugs, blood tests, channelling services and medical devices such as lenses used in cataract surgeries and stents used on heart patients to reduce costs for patients. The changes reduce the prices of medical devices dramatically, ranging from around 50% for stents and 35% to 75% for lenses, which has reduced the profitability of private hospitals carrying out such procedures. We believe continued intervention by the government via taxes and price controls add volatility to sector profitability, which was previously generally stable.

We expect private hospitals to continue to face a shortage of skilled medical staff. Most of the qualified and established consultants are with the government sector now, and they are concentrated in the Western Province. Private operators have had to establish their hospitals close to these skilled professionals to obtain their services. Latest data from the government show that 55% of state-sector consultants are attached to hospitals in the Western Province and in the Galle and Kandy districts. Any private hospital seeking to expand outside of the Western Province runs the risk of not attracting popular physicians, which may hamper the long-term success of the hospital.

Shortage of experienced nursing staff is also a key constraint for the private sector. Government data show that there are around 35,000 nurses while the requirement is for 65,000. Due to the shortage, the private players are competing to attract skilled employees, which has negatively impacted their profitability. As a solution, some of the private hospitals have started their own nursing schools, though there is leakage of their graduates to jobs overseas and to competitors once their commitment periods end.

### **Special Report**

Health Care / Sri Lanka

### Outlooks

https://www.fitchratings.com/site/outlooks

## **Related Research**

Sri Lanka Private-Sector Hospitals (September 2015)

Sri Lanka (February 2018)

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