Sulaiman Al Habib

Healthcare

SULAIMAN AB: Saudi Arabia

20 March 2022

الراجحي المالية

Al Rajhi Capital

US$16.79bn	24%	US$8.48mn
Market cap	Free float	Avg. daily volume

Target price	205.00	14% over current
Current price	180.00	as at 17/3/2022

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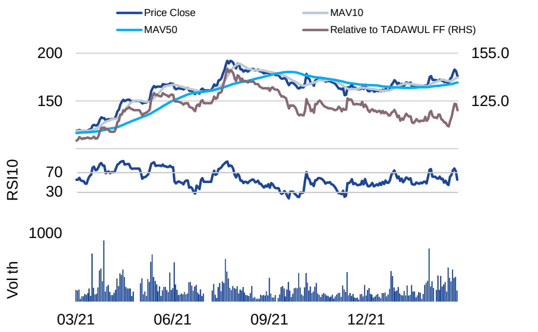
Existing rating

Underweight	Neutral	**Overweight**

Performance



Earnings

(SARmn)	FY2021A	FY2022E	FY2023E
Revenue	7,250	7,028	7,939
Revenue growth	23.7%	-3.1%	13.0%
Gross profit	2,330	2,286	2,530
Gross margin	32.1%	32.5%	31.9%
EBITDA	1,781	1,869	2,071
EBITDA margin	24.6%	26.6%	26.1%
Net profit	1,377	1,365	1,426
Net margin	19.0%	19.4%	18.0%
EPS	3.9	3.9	4.1
DPS	2.7	2.7	2.8
Payout ratio	68.6%	69.0%	69.0%
RoE	26.9%	24.6%	23.8%

Source: Company data, Al Rajhi Capital

Valuation

Multiples	FY2021	FY2022E	FY2023E
P/E	38.7x	46.1x	44.2x
EV/EBITDA	30.3x	34.4x	31.3x
P/B	10.0x	10.9x	10.2x

Source: Company data, Al Rajhi Capital

Sulaiman Al Habib

Initiating coverage with a TP of SAR205/sh

We initiate coverage on Al Habib (HMG) with an Overweight rating and a target price (TP) of SAR205/share. Given that the group is in an expansion phase and structural demand drivers would support growth beyond our explicit forecast period, we have applied a two staged DCF methodology to arrive at the target price. The street has little doubts on the quality and growth potential of Al Habib, the moot point has been at what valuations should the company trade at. Further, the debate has also has been what should be the premium a growth and quality stock command over the market. Our analysis shows that the P/E multiple premium for growth and quality stocks over the rest of the market has increased in the recent years. In the last 3 years (2019-2021), MSCI World Quality and MSCI World growth's average premium over the MSCI World increased to 17% and 43% versus 10% and 17% during 2013-2018, respectively. Further, a study of a set of hospital operators from the emerging markets, that have grown their revenues and cash flows by over 10% in the last decade, confirms that a combination of growth and quality can command significant premium over the market. On an aggregate, these companies have traded at an average forward P/E of 41x since 2015 and have touched a peak of 61x. Currently, the Saudi healthcare sector is trading at a forward P/E of around 35x and Al Habib trades at around 40x (consensus). We believe Al Habib offers an opportunity to gain exposure to a business that offers a unique combination of both quality and growth. Thus, the current valuations would not only sustain, but expand if the company executes its capacity expansion plan successfully and continues to improve utilization levels.

Strong brand image and presence in prime areas: Al Habib scores over its peers through its offering of complex subspecialty and therapeutic services, and having most of its facilities located in the prime centres of the city. Further, its technological expertise is also a major competitive advantage.

Near perfect timing of the expansion, Jeddah to open up a new market: The company has undertaken a significant capex program, that would boost its bed capacity by over 75% (highest growth among the peers) to almost 3,400 beds. This comes at a time when the prospects for private sector hospitals are very strong. AL Habib is also entering a new, but high growth potential market, Jeddah, that currently lacks presence of a major player.

Next phase of growth to come from volumes: Al Habib's move to diversify away from the government clients to insurance over the last 5-7 years is expected to bear fruits going forward, as the near to medium term growth is expected to be driven by insurance segment.

Multiple levers for margin improvement: Margins are poised to improve going forward led by better utilisation, relatively higher growth of pharmacy and HMG solutions, that command higher margins, and efficiency gains.

Valuation and risks: Our target price is SAR 205/share (rounded up), derived through DCF methodology, that offers upside potential of 14% and combined with a dividend yield of 1.5%, the total return potential is over 15%. Our target price implied 2023e P/E is 50x and 2028e P/E is 21x. Key risks include: 1) Weaker than expected growth in 2022 as 2021 was an exceptional year, 2) Weaker capacity utilisation 3) Lack of experience in Jeddah 4) Further outflow of expats that could hurt growth from insurance

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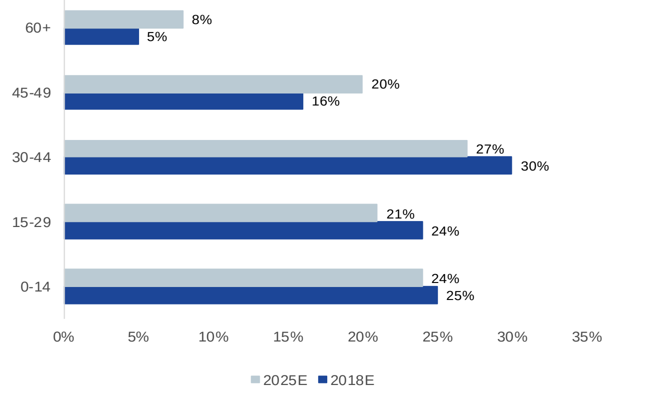
Macro and healthcare sector

Overview in Charts

Figure 1 KSA population by age group



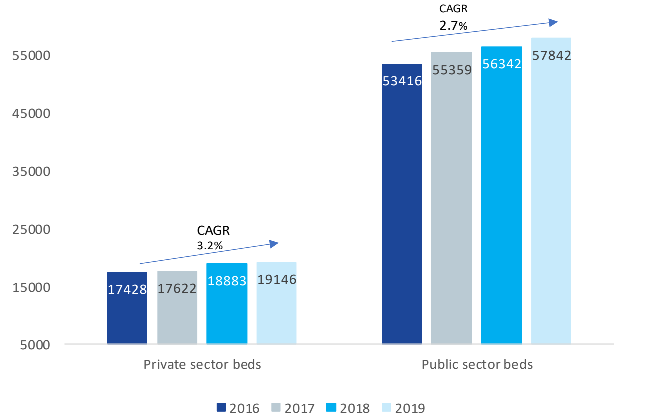
Source: HMG 2020 annual report, Strategy & Market report (data as of 2016) Al Rajhi capital

Figure 2 Diabetes and Obesity Rates by Country

Country	Median Age	Diabetes in Adults as on FY17	Obesity in Adults as on FY16
KSA	28	19%	35%
Bahrain	32	16%	30%
UAE	30	16%	32%
UK	41	7%	28%
Germany	47	12%	22%
OECD	37	7%	20%

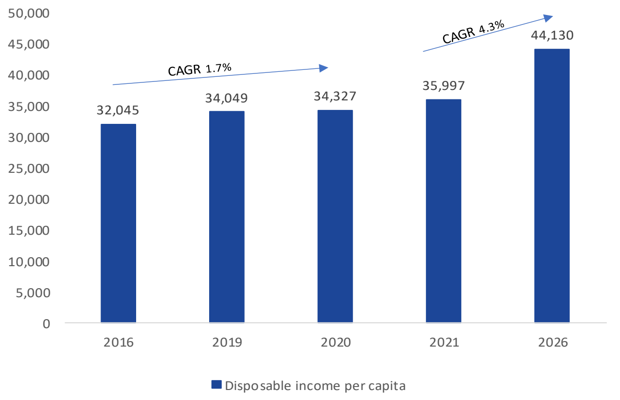
Source: HMG Prospectus World Development Indicators, World Health Organisation, CIA factbook, OECD, Strategy & analysis, Al Rajhi Capital. Note: OCED data is as of 2015

Figure 3 Number of beds trend



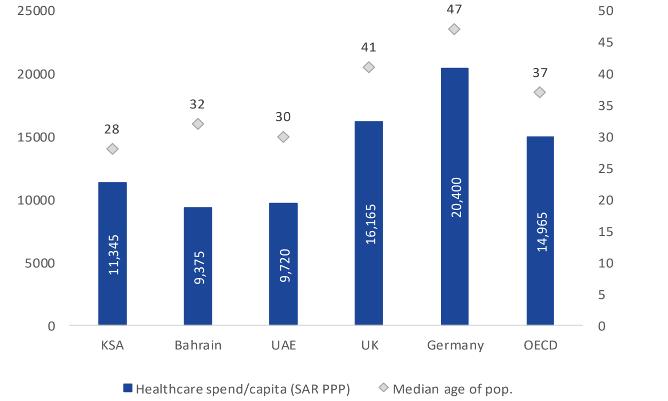
Source: Al Dawaa Prospectus, Saudi Arabia Ministry of Health Statistics, Market Consultant, Al Rajhi Capita

Figure 4 KSA disposable income per capita



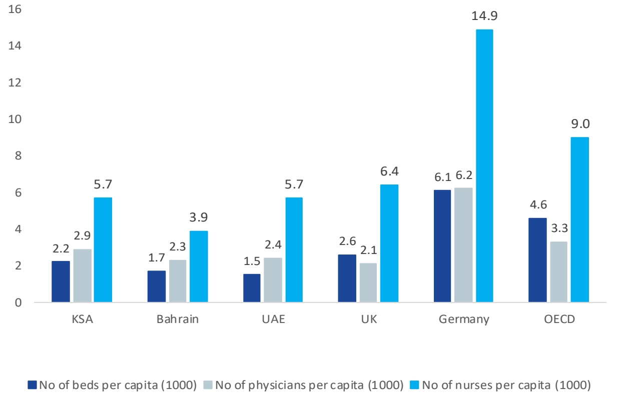
Source: Al Nahdi Prospectus, Euromonitor International estimates from United Nations, World Bank, International Monetary Fund (IMF), General Authority for Statistics (GASTAT), SAMA, MOH Factbook, Stats.Gov.Sa, Colliers International, Statista.com and OPEC. Al Rajhi Capital

Figure 5 Healthcare spend per capita (2017 data)



Source: HMG Prospectus, Fitch Solutions, OECD, World Bank, CIA Factbook, Al Rajhi Capital
Note: Dubai is based on 2018 figures

Figure 6 Healthcare infrastructure country wise (2017 data)



Source: HMG Prospectus, KSA annual statistic book, Bahrain information and e-government authority, UAE Federal competitiveness and Statistics Authority, Fitch Solutions, OECD, World Bank, Al Rajhi Capital

Socioeconomic and healthcare system in KSA

The Kingdom of Saudi Arabia (KSA) is the fourth most populous country in the Arab World and the most populous country in the GCC. Further, it has a notably higher proportion of nationals (around 65%) compared to the other GCC countries. At the same time, most of the population resides in the urban areas (84%) and the most populous regions are Makkah, Riyadh and the Eastern region, which together accounts for more than 65% of the population in Saudi Arabia. In terms of demographics, the country is still young with 49% of the population (as of 2018) below the age group of 29. However, it is rapidly ageing and by 2025 it is expected that over 56% of the population will be over the age of 29 and 28% of the population will be over the age of 44. Further, the prevalence of obesity and lifestyle diseases are higher in the KSA compared to GCC as well as other developed countries. One of the other important macro developments happening in the KSA is the rising disposable income supported by government's measures to reduce unemployment among the locals through Saudization, boosting female participation in the labour workforce, etc. The disposable income per capita has increased by almost 2% during 2016-2020, and is expected to rise by over 4.0% during 2020-2026.

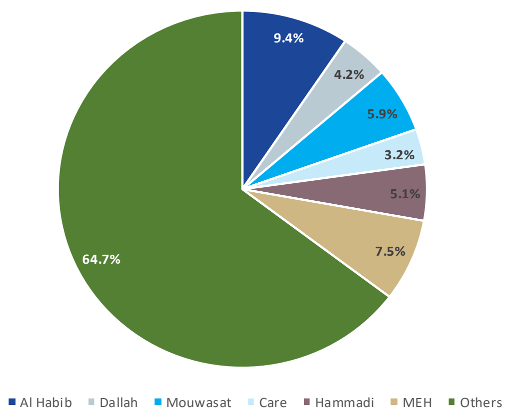
The country's healthcare system continues to be driven by the government, with public expenditure on healthcare (as of 2020e, source: Al Dawaa prospectus) accounting for over 62% of the total healthcare expenditure and public sector beds making the lion's share of 75%. The public healthcare is mainly managed by the Ministry of Health (MoH) as well as other government departments and agencies, that provide healthcare facilities to their employees and their families. However, the country's private healthcare sector is rapidly growing after the government, as part of Vision 2030, announced several measures to boost the share of private sector participation in healthcare from 25% in 2016 to 35% by 2020. These measures include flexible licensing scheme (minimum 30 beds), interest free financing scheme from MoH, privatisation of 290 hospitals and 2300 health care centres by 2030, digitization of medical records, mandatory health insurance for all the private sector employees (including Saudi nationals) etc. Private sector hospitals have grown by almost 2.6% between 2016-2019 compared to 1.6% CAGR for public (source: Al Dawaa prospectus), at the same time private sector beds have increased at a CAGR of 3.2% between 2016 and 2019 versus 2.7% CAGR for public sector beds.

Despite being a wealthy nation, the country's healthcare expenditure per capita (adjusted for purchasing power) is lower (KSA: SAR 11k vs. OECD: SAR 15K) compared to some of the European and OCED countries. Further, in terms of penetration of healthcare services, such as beds/capita (2.2 beds per thousand vs. OECD: 4.6 beds), physicians/capita (2.9 per 1000 vs. 3.3 for OECD), KSA lags the developed countries by a notable margin. This could partly be due to the country's young population (median age below 30 years), however, with ageing population the healthcare requirements are expected to increase in the near future. If KSA has to achieve similar levels of penetration for beds (assumed 4.0/1000, population growth of 1.3% as per World bank), then by 2030 it will have to more than double the total number of beds to 157k from about 77k (2019). In our view, the overall healthcare sector in the KSA is on the verge of entering a phase of strong growth period supported by structural factors such as ageing population that would further exacerbate the prevalence of lifestyle diseases, rising disposable income among the locals and the privatisation push from the government, both would limit the outflow of nationals travelling abroad for medical services. Given that the sentiment towards public institutions is not favourable mainly due to high waiting period for appointments at the public hospitals and the lack of focus on seamless experience/delivery of services, the private sector, primarily the ones with strong brand image are better placed to benefit from the expected growth in the sector.

Peer analysis

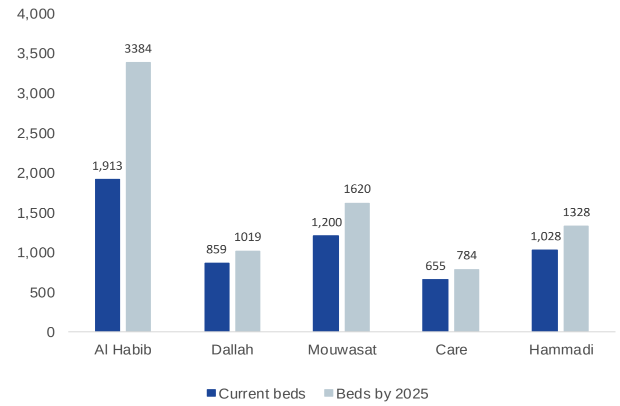
Overview in charts

Figure 7 Market share by beds



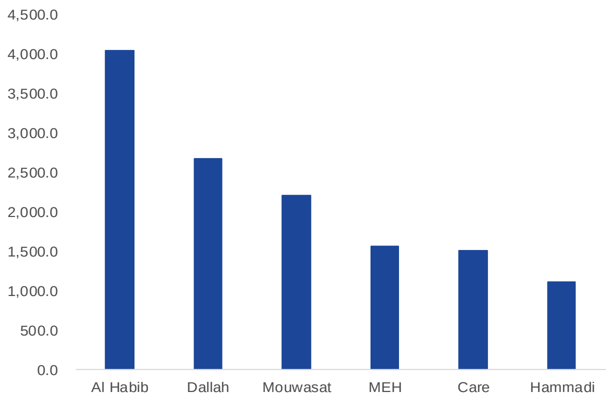
Source: Company filings, Al Dawaa Prospectus, Al Rajhi Capital estimates
Note: For 2021 total private beds, assumed 3% growth over 2019 numbers disclosed in AL Dawaa prospectus

Figure 8 Current (latest data) and future capacity



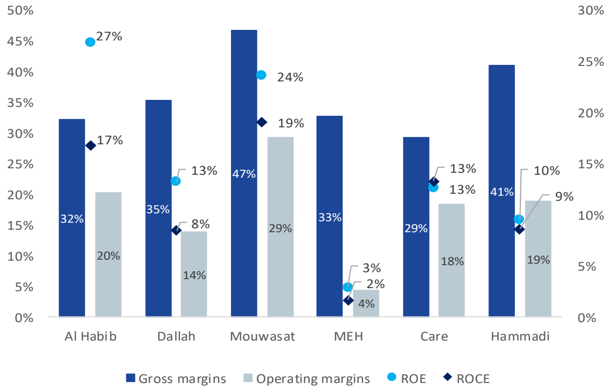
Source: Company filings, Al Rajhi Capital estimates
Note: MEH future capacity not provided.

Figure 9 Hospital revenues per bed (SAR '000s, 2021)



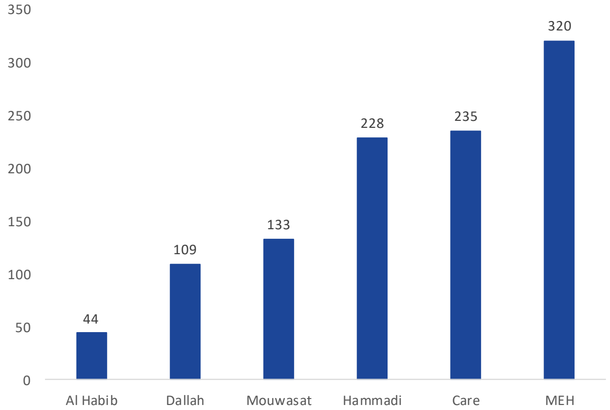
Source: Company filings, Al Rajhi Capital estimates

Figure 10 Margin and return Metrics (data as of 2021)



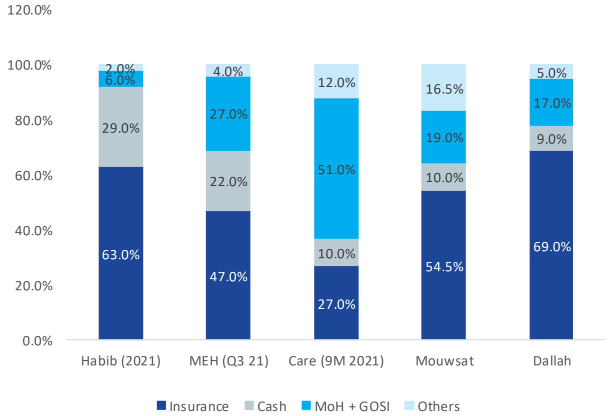
Source: Company filings, Al Rajhi Capital estimates
Note: For companies not reported and under our coverage, considered our 2021 estimates

Figure 11 Receivable days (2021 numbers)



Source: Company filings, Al Rajhi Capital estimates
Note: Al Rajhi 2021 estimates for companies under coverage but not reported

Figure 12 Client Mix (latest data)



Source: Company filings, Al Rajhi Capital estimates
Note: For Mouwasat and Dallah data from earnings calls. Hammadi data not available.

Al Habib leads in capacity growth, Mouwasat in margins

On the back of strong growth prospects for the sector, all the private players are aggressively expanding their capacity in the near future, with Al Habib at the forefront. Despite being heavily concentrated in the Riyadh region, Al Habib is the largest player across the country in terms of beds, with a market share of 9.4% (2021 estimated), followed by Middle East Healthcare (7.5%) and Mouwasat (5.9%). In the city of Riyadh, Al Hammadi has the largest market share of 25% with total number of beds of over 1300, followed by Al Habib's 21% market share (based on 2017 numbers) with total number of beds of over 1100. However, Al Hammadi's Olaya facility of 300 beds is closed for refurbishment, that makes Al Habib currently the leader in the Riyadh city. Post completion of the expansion, Al Habib's total bed capacity would increase by over 75% to almost 3,400 beds compared to average 26% growth in beds for the other players, further cementing Al Habib's leadership position.

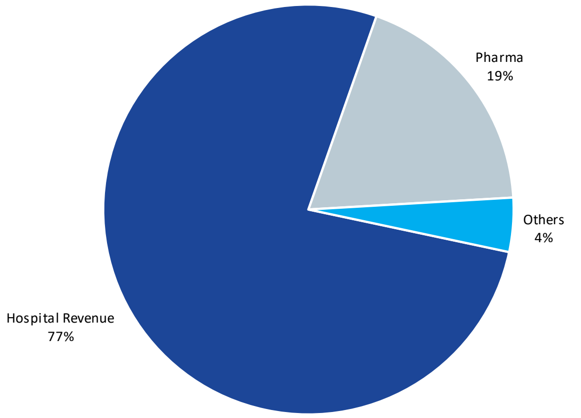
Al Habib also leads its peers in terms of hospital revenues/bed, that is around SAR 4.0m compared to SAR 1.0m-2.5m per bed for the peers. The significant divergence is mainly due to Al Habib's higher exposure to Class A patients and expertise in complex surgeries. However, in terms of margins, Mouwasat is the winner with gross margins of over 45% and operating margins of 29% compared to the sector average of 36% and 18%, and also better than Al Habib's margins of 32% and 20%, respectively. Further, Mouwasat also scores better on return ratios, ROCE of 19% and ROE of almost 24% versus sector average of 11% and 15%, respectively. The better margins and return ratios are explained by Mouwasat strong exposure to Eastern region, where the company has long term corporate contracts such as with Aramco that have better margins than insurance clients. Further, the management of Mouwasat, similar to Al Habib, is also known for a strong track record of efficiency and maintaining profitability.

In terms of client mix, the insurance segment accounts for the major chunk, except in the case of Care (insurance just 27%) which is largely exposed to government entities (over 50%). Dallah has the highest exposure to the insurance clients (69% share), followed by Al Habib (63%) and Mouwasat (55%). In terms of cash exposure, Al Habib has the largest exposure, 29% compared to peers 10% to 22% range. The high exposure to cash and insurance is reflected in the working capital, with Al Habib having the lowest receivables days of 44 days followed by Dallah's 109 days, versus MEH's 320 days and Care's 235 days, both have high exposure to the government entities. Moreover, the exposure to insurance clients also secures future volume growth as the insurance segment is expected to lead the growth in the sector in the near future.

Al Habib

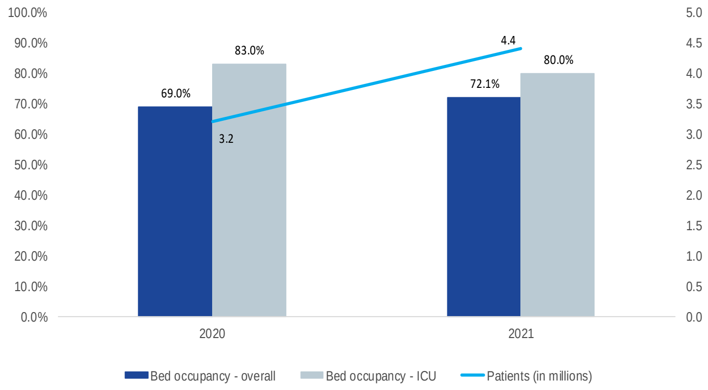
Group in charts

Figure 13 Al Habib Revenue breakup



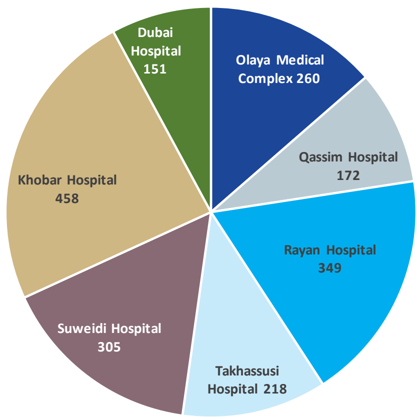
Source: Company data, Al Rajhi Capital

Figure 14 Bed utilization level



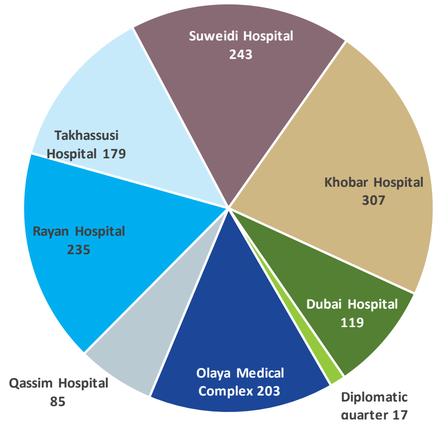
Source: Company data, Al Rajhi Capital

Figure 15 Current bed capacity mix



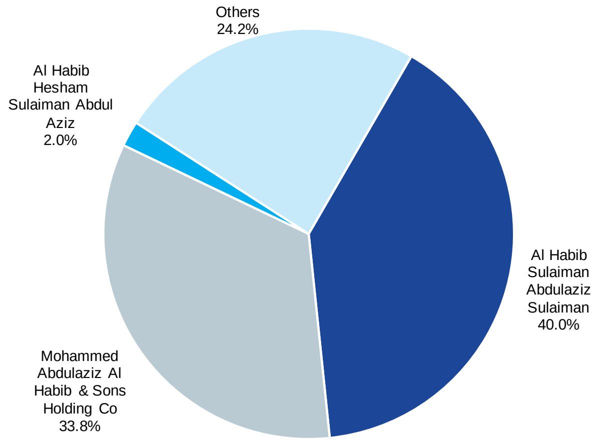
Source: Company data, Al Rajhi Capital

Figure 16 Current clinics capacity mix



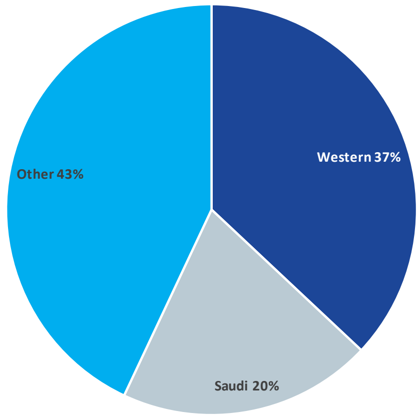
Source: Company data, Al Rajhi Capital

Figure 17 Shareholder's mix



Source: Company data, Al Rajhi Capital

Figure 18 Physician's qualifications



Source: Company data, Al Rajhi Capital

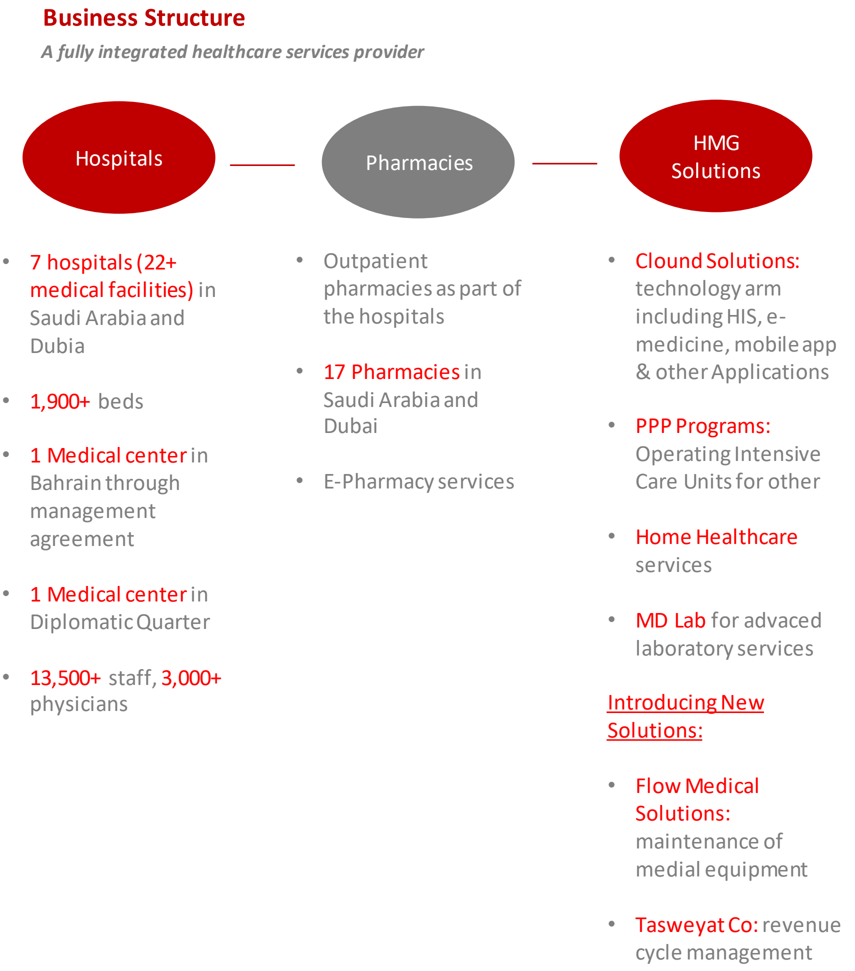
Background and business model of the group

Dr. Sulaiman Al-Habib Medical Services Group ("The group" or "Al-Habib" or "HMG") is a leading healthcare facility operator in the Kingdom of Saudi Arabia (KSA) with a track record of over 25 years. The group is a holding company and manages the business through various subsidiaries. It was incorporated as a sole proprietorship under the name of "Dr. Sulaiman Abdulaziz Al-Habib Medical Services Clinics Complex, but later converted into a joint stock company. The group continues to be controlled by the Sulaiman family, which together has a stake of 75% in the company. The group listed its shares on the Saudi Stock Exchange (Tadawul) in March 2020 and has a free float of slightly over 24%. Dr. Sulaiman Al Habib, the founder, is the Chairman of the Board of Directors, and the group has an experienced management team headed by Mr. Naseer Al Huqbani, the CEO since 2000 and Faisal Al Nassar, the CFO since 2011.

The core business is constructing, operating and maintaining the medical facilities owned by itself as well as operating and maintaining the facilities for third parties for management fees. The group distinguishes itself as an integrated medical service provider that offers primary to tertiary services such as subspecialty services, therapeutic services including IVF, obesity, obstetrics, gynaecology, microsurgeries in cardiac, spinal cord. etc. The group's first healthcare facility was opened in 1995, Olaya Medical Complex, in Riyadh. Since then, the group has increased the number of hospitals to 7 in total and plans to add another 5 new hospitals. Al Habib enjoys a strong brand image in the country and has competitive advantages in the form of strategic location of its hospitals, a well-qualified strength of physicians (over 3000 with 15+ years of average experience) and a pioneer in healthcare technology. Among the private players, Al Habib has the largest market share of almost 9.5% in KSA (based on 2021 estimated numbers) and over 20% market share in Riyadh.

The Group conducts its business activities through three segments, hospitals, pharmacy and others. The hospital segment is the primary business, accounting for over 75% of the revenues (2021 numbers), through which it manages and operates healthcare facilities. Currently, the seven hospitals in operation have a total capacity of over 1900 and almost 1400, beds and clinics, respectively. Most of the hospitals are concentrated in the Riyadh region, while it also has presence in other key regions such as Al Qassim and Al Khobar, and has plans to enter into Jeddah. Moreover, the group also has presence overseas through one hospital in Dubai and a medical center in Bahrain. The group's pharmacy segment, contributes about 18% to the total revenues and generates stable margins of around 33%. Al Habib's pharmacies are all part of the hospital premises, 17 in total, and cater to the needs of both inpatients as well as outpatients. The third segment is categorised as 'other', also known as HMG solutions, and it includes various services such as technological solutions, managing medical centres for 3rd parties, operating intensive care units (ICUs) for Ministry of Health (MoH), home healthcare services, laboratory services, etc. The company operates intensive care departments in six healthcare facilities of MoH in five cities of KSA, that includes Jeddah, Medina, Buraidah, Al Kharj and Qatif.

Figure 19 Overview of the business



Source: Company presentation, Al Rajhi Capital

Key investment rationale and catalysts

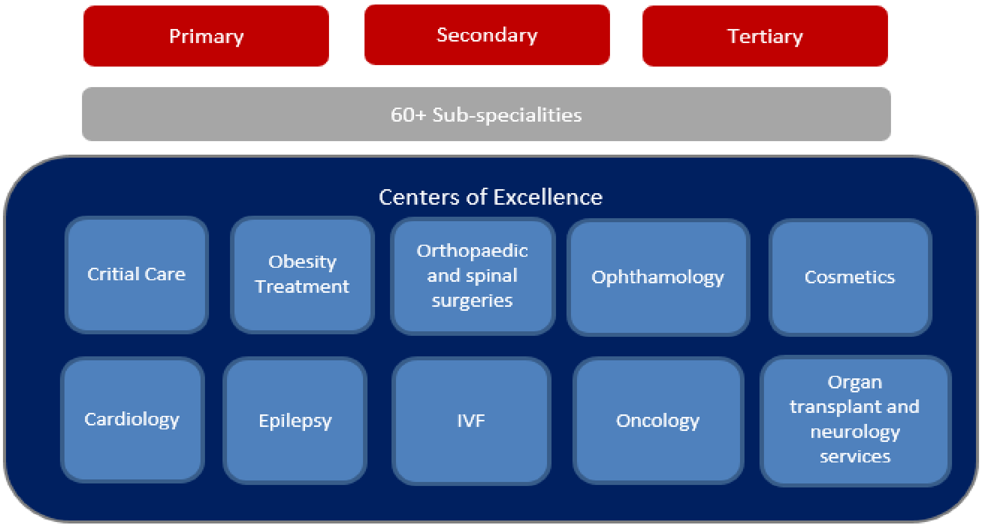
Brand image built on specialised services and strategic locations

Among many factors, a few of the most important ones that differentiate a healthcare operator are the range of specialised services it offers, the location of its facilities and the experience provided to the patients. Al Habib provides integrated healthcare services under one roof, that has hospitals, medical centres, clinics, pharmacies, etc. The hospitals provide primary and secondary medical services in addition to 60 plus subspecialty services. It also provides therapeutic services that includes obesity, IVF, orthopaedics, etc. The hospital offers a range of services for neuromuscular disorders that is unique in the region. Further, its Spinal hospital, that is part of the Olaya Medical complex, is the first and largest medical facility that specialises in joint and spinal cord osteopathy and surgery in the KSA.

In terms of locations, most of its hospitals are located in densely populated areas and in the prime location of the city, where the demand for high quality medical services is present. It has earned a strong reputation in the Riyadh city, where it is present in all the corners, its Olaya Medical complex lies on a major commercial centre between King Fahd Road and the Olaya street, that caters to the central part of the city, while its Takhassusi hospital, Suweidi hospital, and Rayan hospital caters to the northern, southern and eastern part of the city, respectively. Further, the group would strengthen its presence in the growing Northern part of the Riyadh, through its upcoming North Riyadh Hospital. Similarly, its Qassim hospital, which is the largest private medical service provider in the Qassim region, is located in the heart of Buraidah in the Qassim region, that helps it attract numerous patients from the cities and towns surrounding Buraidah.

Al Habib has earned a reputation among the patients of having a team of high qualified medical practitioners (60% of physicians from western and Arab boards), which is also supported by the numerous accreditations it has earned from renowned global and local bodies. The group is known for the rigorous system it has put in place to manage the quality of medical services, that includes monitoring patient waiting times, adherence to physicians' appointments, etc. The group invested in cloud solutions as early as 2013 to provide technical services and support to all its hospitals as well as the third parties. Its technological solutions match global standards and the group holds a Guinness world record of proving tele-ICU services for 796 beds. Its E-medicine solutions also provide tele-radiology (medical imaging, image storage and archiving), tele-medicine (second opinion through robotics), tele health (home health care), etc. Further, its patient health information system (VIDA) that manages electronic health records of patients and results of lab. tests, etc, provides seamless experience to both patients as well as helps efficiency of physicians.

Figure 20 Overview of the business



Source: Company presentation, Al Rajhi Capital

Near perfect timing of the expansion

In the backdrop of strong prospects for private medical services, Al Habib is undergoing the biggest expansion since its inception. Currently, the group operates six healthcare facilities in KSA and one in Dubai with a total capacity of 1,913 beds and 1371 clinics. The group has a plan of investing over SAR 6.0 bn, that would increase its total bed capacity bv over 75% to 3384, and number of clinics would rise to almost 2400, an increase of over 70%. The bulk of the new capacity would come in two critical locations, about 44% of the incremental capacity would be in the Riyadh city (+650 beds to almost 1800 beds), that would further cement its market position and go past ahead of Al Hammadi's bed capacity of over 1300 beds in Riyadh. Al Habib would be opening up its largest hospital in terms of bed capacity (500 beds) in North Riyadh, which is an upcoming strategic location in Riyadh. Another key expansion, that could be a major driver for volume growth, is the expansion in Jeddah, the group is constructing two hospitals, one each in North and South Jeddah (50% stake), with total capacity of 680 beds, that would help the company to diversify its presence from a more Riyadh focus player to the southern part of the kingdom.

The group has already secured the financing for all the projects and all the hospitals are currently at the advance stages of execution (3 hospitals at the construction stage and 2 at excavation) implying minimal execution risks. Out of the five hospitals, two hospitals, North Riyadh and South Jeddah, are targeted to be completed by 2023 and the remaining three by 2024. Given that the company has a track record of achieving breakeven within 10 to 24 months, the impact of the expansion would start reflecting in the financial numbers from 2026e onwards. On the back of this significant expansion plan, we believe Al Habib's revenues would grow at a CAGR of over 10% in the next decade, more than doubling its revenues from SAR 7.3bn to almost SAR 18bn.

Figure 21 New projects

New Projects	Stake	Beds	Clinics	Land cost (SAR mn)	Construction cost (SAR mn)	Timeline
North Riyadh	100%	500	300	660	2,200	2023
Takhassusi Maternity and Pediatric	100%	150	100	81	391	2024
South West Jeddah	50%	330	245	133	1,500	2023
North Jeddah	100%	350	270	244	1,500	2024
Sehat Al Kharj	100%	141	92	30	455	2024
Total		**1,471**	**1,007**	**1,147**	**6,046**	

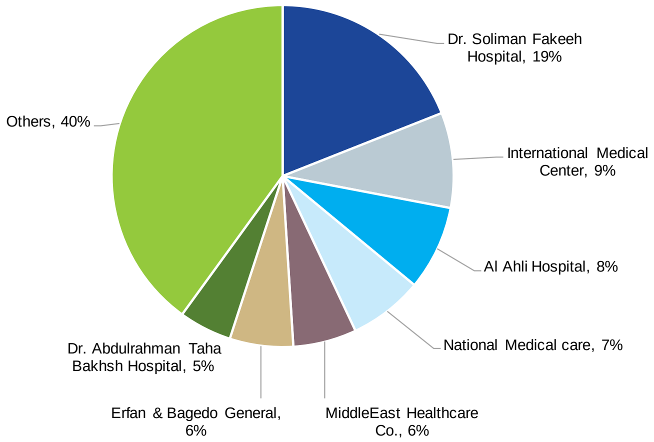
Source: Company presentation, Al Rajhi Capital

Expansion into Jeddah to open a new market

Jeddah is the second largest city in KSA after Riyadh with about 14% of the population. However, in terms of supply of beds, Jeddah has the lowest number of beds, just 1.7 beds per capita (1000) compared to an average of 2.3 in KSA, and 2.2 in Riyadh and 3.2 in the eastern region. Given the high share of expatriates, the city has high share of private operators (70% hospitals private) compared to other areas in KSA (32% hospitals private). Similar is the case with clinics, 83% of the clinics are private. However, the market is fragmented with the top private player, Dr. Soliman Fakeeh Hospital has 19% share of beds (2017), while the next six players have less than 10% share each. Moreover, the city also lacks a high quality integrated medical service provider that can cater to VIP and class A patients.

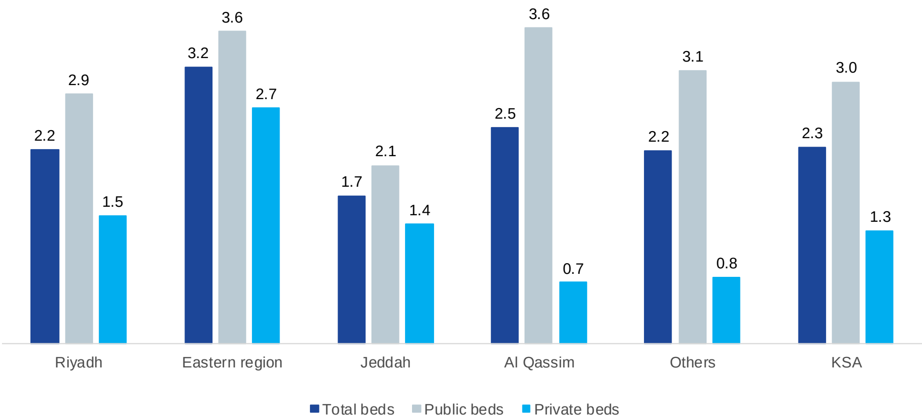
Post completion of the expansion in Jeddah, Al Habib's capacity of 680 beds would make it the largest private operator and it will go past Dr. Soliman's current capacity of 450 beds. The group's healthcare facilities would come up on the two extreme corners of the city, North and South, reducing the risk of cannibalization and capturing maximum of the demand. Given the strategic important of Jeddah as it is main arrival point for the Haj pilgrims and government's focus is on boosting the number of pilgrims and tourism, the expansion in Jeddah would be a key strategic decision in the years ahead. It could open up a new market for the group, which can be further leveraged to expand into the adjacent cities of Makkah and Medina.

Figure 22 Market landscape in Jeddah (as of 2017)



Source: HMG Prospectus, MOH, Annual reports, Company websites, News articles, and Strategy & Analysis, Al Rajhi Capital

Figure 23 No of beds/1000 capita (based on 2018 estimates)

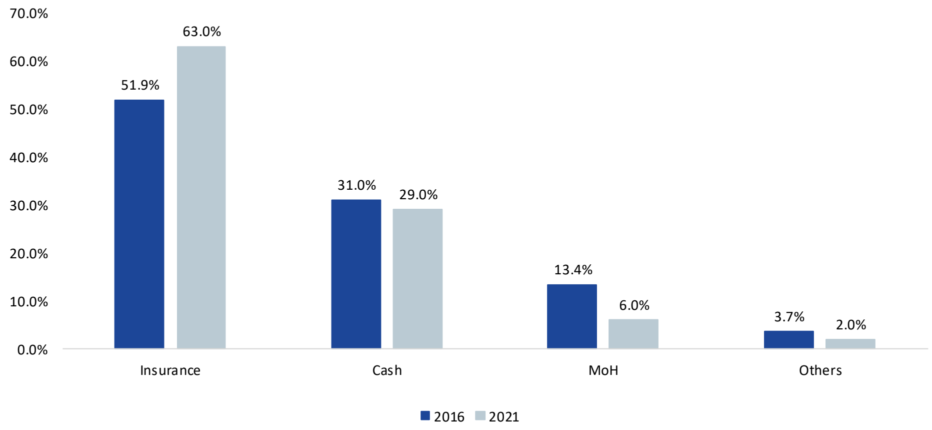


Source: HMG prospectus, MOH, Strategy & analysis, Al Rajhi Capital

Focus on insurance clientele to drive volumes

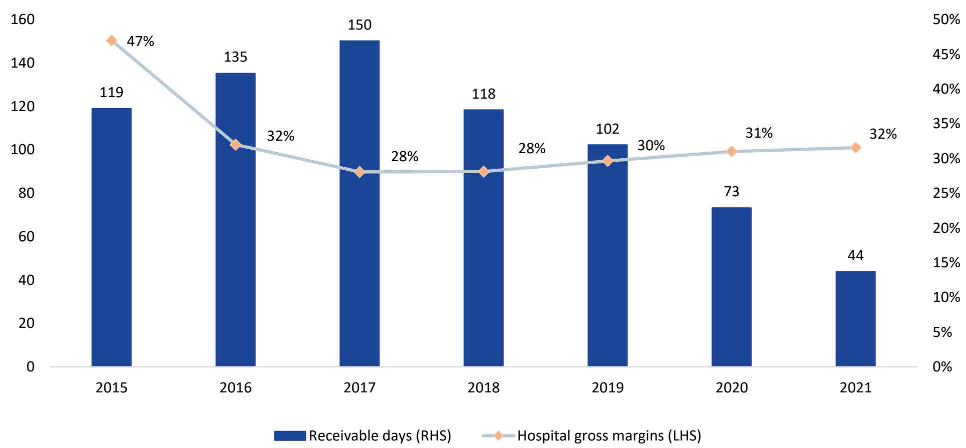
In terms of client mix, Al-Habib has undergone a massive change over the last 5-7 years. The company has focussed on building and strengthening its relationship with the insurance companies. The group has entered into agreements with top three insurance companies, that includes Bupa Arabia and Tawuniya, and together these 3 players command a market share of almost 85% in health insurance market in KSA. The terms of these agreements include tenure ranging from one to four years and are entitled to price increases by giving a notice of 30-60 days. The strategy to reduce the reliance on government and boost its exposure to insurance has pushed the share of insurance from 52% in 2016 to 63% in 2021, and at the same time, the share of revenues from government entities that used to be over 13% in 2016, declined to below 5% in the next two years. This is reflected in the growth of revenues from insurance clients, which grew by a CAGR of over 12% (2021-2016) and more than offset the decline of over 8% in the revenues from government entities. In 2021, the MoH mix was 6.0%, slight increase compared to Pre Covid-levels due to rise in referrals from MoH in the wake of Covid. The strategy has hit the hospital gross margins (fell from 47% in 2015 to 28% in 2018), however, the move has benefitted the working capital needs, the receivable days have improved from over 130 days in 2016 to below 45 days in 2021.

Figure 24 Revenues by clients



Source: Company presentation, Al Rajhi Capital

Figure 25 Better cash conversion

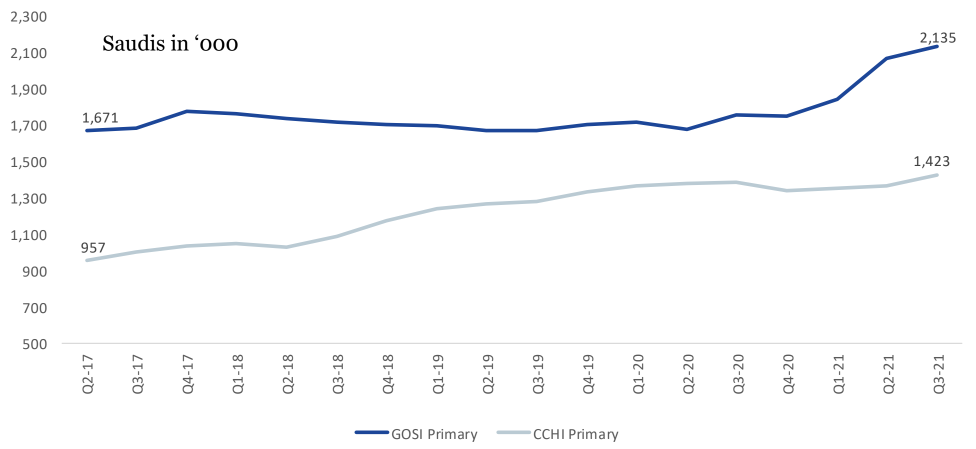


Source: Company data, Al Rajhi Capital

In our view, this diversification move could prove to be a solid strategic decision as the future leg of growth in hospital operators is expected to come from the insured clients. In the near term, there are many catalysts for the growth in health insurance such as mandatory health insurance for all the private sector employees (including Saudi citizens), rising disposable income, government's support for privatisation of medical services, etc.

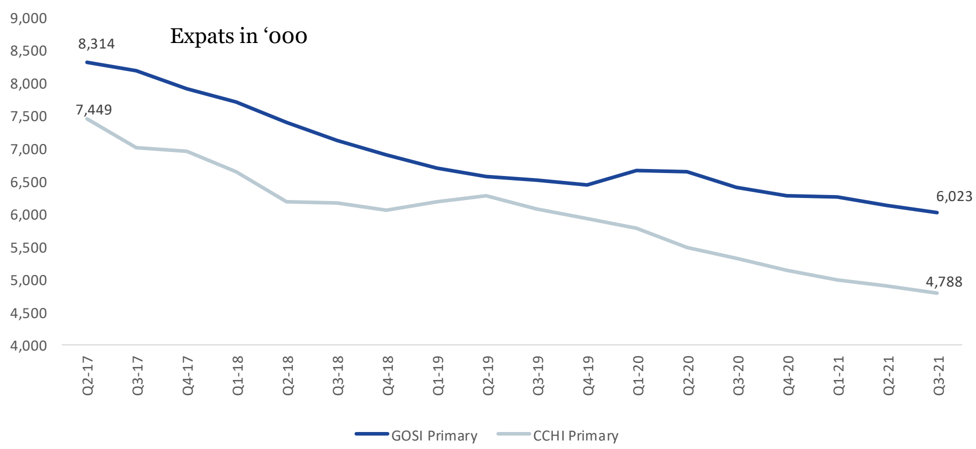
The near-term catalyst for the insurance sector is the need to be compliant with the rule of mandatory insurance of all the private sector employees. In September 2016, the government announced the policy of compulsory health insurance program for all the private-sector employees to be fully implemented by the end of June 2017. However, the progress on complying with this policy has been gradual and hit by two major factors, one is the exodus of expats and second by the weaker compliance from small and medium size enterprises. As per Bupa, currently the expats that need to be covered by insurance is around 1.2m, while the potential for nationals to be included under insurance coverage is over 700k, together this results in about 2.0m incremental insurance clients, that implies a growth potential of almost 20% (currently about 9.8m population is insured, 28% of the population, as per CCHI). Further, there are other long-term drivers such as government's push to curb its healthcare expenditure and privatise the sector that would continue to support the growth in health insurance. As per CCHI, the health insurance market is expected to grow at a CAGR of almost 12% between 2030 and 2021, and double its share in the GDP to 2% by 2030.

Figure 26 700+k Saudi nationals in the private sector need to be covered by insurance



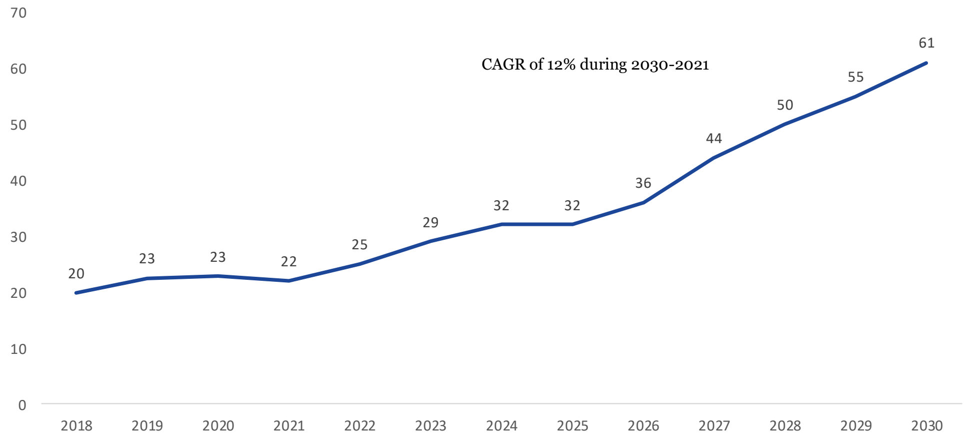
Source: Bupa presentation, Al Rajhi Capital

Figure 27 1.2m expats in the private sector need to be covered by insurance



Source: Bupa presentation, Al Rajhi Capital

Figure 28 Health insurance market (SAR bn) base case scenario by CCHI

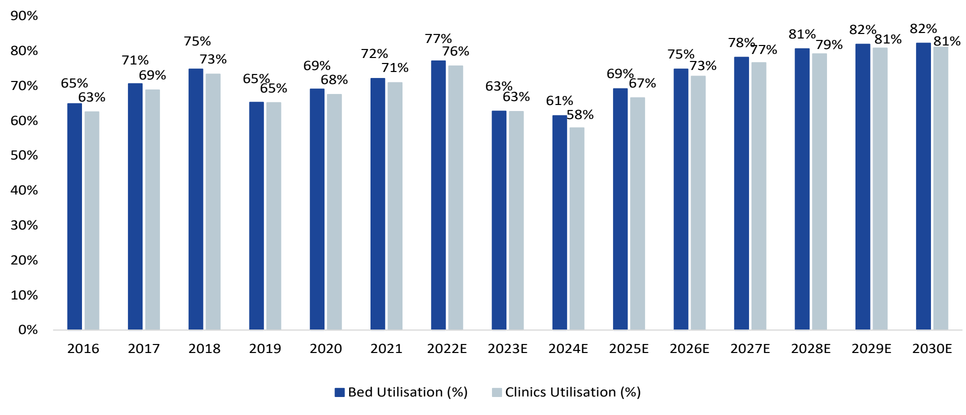


Source: CCHI report 2020, Al Rajhi Capital

Multiple levers for margin improvement

As mentioned above, the group's margins have come under pressure in the recent years due to the change in mix from government to insurance clients. However, the margins have stabilised in the last couple of years ranging between 30-32%. In our view, there are three levers of margin improvement in the near to medium term. First is the volume growth that is expected to come from the ramp up of Khobar hospital in the near term, which has a capacity of over 450 beds, currently its largest hospital in terms of beds. Other hospitals are already running close to peak capacity with limited scope for improvement, however, outpatient clinics have scope for better utilisation. Given that the phase of expansion coincides with a period where insurance market is also expected to see revival in growth, the volume growth in the medium term is expected to be strong. The insurance market has suffered from the exodus of expats in the recent years, which is now showing of stabilization. Going forward, the health insurance market (premiums written) is expected to grow by 12% over the next decade. In our view, the group would not struggle with the utilisation of the capacity that it is bringing into the market, we believe the utilisation levels will continue to improve post the completion of capex cycle and will hit a peak of over 82% in 2030.

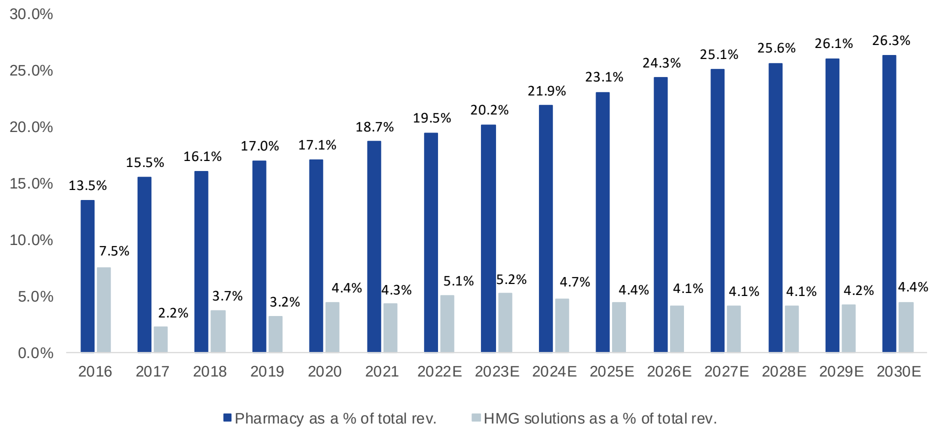
Figure 29 Utilisation levels to improve from here on



Source: Company data, Al Rajhi Capital

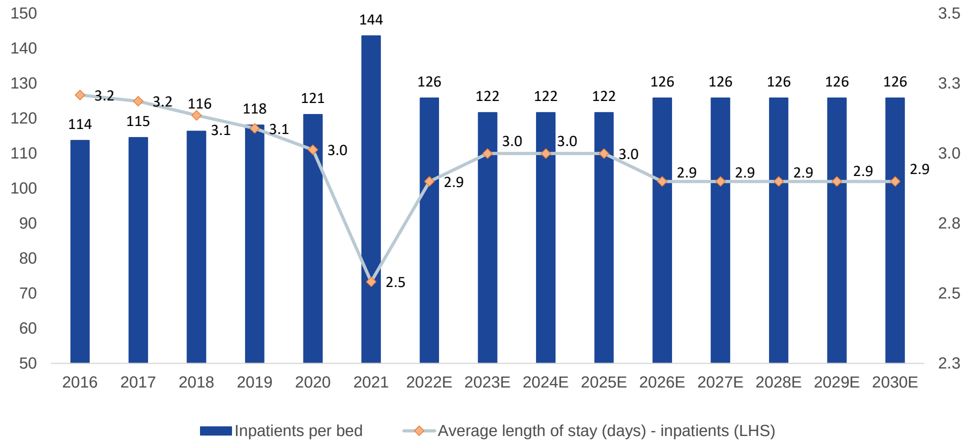
Second is the growing share of pharmacy business and HMG solutions, that currently enjoys a margin of 33% and 40%, respectively, higher than hospital business' margins of between 30-32%. We believe, the pharmacy and HMG solutions, together currently accounts for 23% of the total revenues (2021) will increase to almost 30% of total revenues by 2030. Third is the improvement in efficiency, particularly in managing inpatients. The recent data shows that the group has managed to boost the number of inpatients per bed (adjusted for utilisation), which has improved from 114 patients per bed in 2016 to 118 in 2019 (pre Covid) and 144 in 2021 (partly due to Covid). This has notably improved the average length of stay for inpatients from 3.2 nights in 2016 to 3.1 nights in 2019 and 2.5 nights in 2021. The management says that the growth in 2021 revenues and the improvement in efficiency is not entirely due to Covid, however, we prefer to be cautious and will wait for H1 2022 numbers for confirmation. Nevertheless, we have assumed the efficiency to continue and assumed 2.9 nights per inpatients (Q1 2022 had some impact of Covid) and expect it to be 3.0 nights from 2023e and 2.9 from 2026e (post completion of capex), better than Pre-Covid levels.

Figure 30 Pharma and HMG solutions to grow larger



Source: Company data, Al Rajhi Capital

Figure 31 Improving efficiency



Source: Company data, Al Rajhi Capital

Financial health of the company and our assumptions

During 2015-2018, Al Habib's revenues sharply declined from SAR5.1 bn to SAR4.6 bn, a fall of 10%, mainly on account of the group's decision to reduce its exposure to government clients. The revenues improved in 2019, grew by 10% post the opening of the Khobar hospital, while 2020 and 2021 revenues jumped by almost 17% and 24%, respectively, primarily on account of ramp up at Khobar hospital, positive effects from Covid and travel restrictions that led to better utilisation of hospitals in KSA from the expats as well as Saudi citizens that used to travel abroad, mainly to Asian countries for treatment. Given that the share of government clients has stabilised around 5-6% and the insurance is now around 63%, the next phase of growth appears to be largely secured and will be led by increase in bed and clinics capacity. Total reported beds would grow from just over 1900 to almost 3400 by 2024. However, given the phased manner of improvement in utilisation, the full impact of capacity utilisation will reflect only in 2028e, when we assume over 80% utilisation at the group level.

Given the expected improvement in efficient utilisation of beds (lesser average length of stay) and the addition of capacity, we believe total inpatient volumes would double from around 0.15m in 2019 (pre Covid) to 0.34m in 2028, a CAGR of almost 10% and grow by 8% CAGR over 2021. We have assumed the growth to be mainly volume driven as the company focusses on attracting class B patients and the growth in pricing (inpatient) to be just 2.5% CAGR by 2028e from the 2019 base and 2.4% CAGR over 2021. We have assumed similar trend for outpatient clinics, efficient utilisation of clinics and growth to be volume driven rather than price. Overall, we assume hospital revenues to grow at a CAGR of 11% during 2028-2021 and over 9% during 2030-2021, which is our explicit forecast period.

We believe pharma revenues to grow at a much higher rate than the hospital revenues, which has been the trend historically. Pharma revenues will grow at a CAGR of 18% during 2028-2021 and almost 15% during 2030-2021. HMG solutions that has been growing rapidly is expected to maintain its strong growth trend, we assume 12% CAGR growth during 2028-2021 and 11% during 2030-2021.

On the back of better utilisation, growth in pharmacy and HMG solutions, we believe margins would improve in the years going forward. Except the years of capacity expansion, during 2023-2024, when the margins would dip, gross margins are expected to witness improvement. It is expected to touch 34% by the end of 2030, a gain of 200 bp from 32% in 2021, and given the high operating leverage, the operating margins are expected to improve by almost 400bp to 24.0% by 2030 from 20.2% in 2021.

Al Habib has a solid financial and liquidity situation with a net debt to EBITDA (including lease) of just 0.23x. Despite the capex growth, we believe the peak leverage would hit 0.68x in 2024e mainly on the back of improved cash conversion and thereafter the company would become net cash. We are assuming 45 days receivable cycle as the payment terms with insurance players are 30-45 days, this is a marked improvement from 145 days in 2016, when the exposure to government was high. In light of improving margins and leverage, the return on equity, which is highest among its peers, would further improve from the current 27% to 32%by 2030e. This should be supportive to the current high valuations at which the shares trade at.

During our explicit forecast period (2030e-2021), we believe the cash flows would grow by a CAGR of 28% driven by multiple factors such as higher revenues, better margins and cash conversion, etc. In our view, the phase of high growth for Al Habib will continue beyond 2030 as structural demand drivers in place and we believe the group will achieve a CAGR of 8% for the next five years beyond 2030 and the growth would be funded by internal cash flows.

Figure 32 Income Statement

(SAR mn)	2020	2021	2022E	2023E	2024E
Sales	5,862	7,250	7,028	7,939	10,079
y-o-y growth	*16.5%*	*23.7%*	*-3.1%*	*13.0%*	*27.0%*
Cost of Sales	-3,997	-4,920	-4,742	-5,409	-6,898
y-o-y growth	*14.4%*	*23.1%*	*-3.6%*	*14.1%*	*27.5%*
Gross Income	**1,864**	**2,330**	**2,286**	**2,530**	**3,181**
y-o-y growth	*21.2%*	*25.0%*	*-1.9%*	*10.6%*	*25.7%*
margins	*31.8%*	*32.1%*	*32.5%*	*31.9%*	*31.6%*
Employee costs	-349	-402	-380	-437	-564
Selling and distribution expenses	-163	-183	-169	-198	-262
Administrative expenses	-237	-278	-260	-302	-393
Other					
Operating Income	**1,115**	**1,466**	**1,478**	**1,593**	**1,961**
y-o-y growth	*28.5%*	*31.5%*	*0.8%*	*7.8%*	*23.1%*
margins	*19.0%*	*20.2%*	*21.0%*	*20.1%*	*19.5%*
Investments and other	60	66	66	66	66
Others	0	0	0	0	0
Financing Expense	-48	-38	-53	-74	-161
Income from Affiliate	2	7	8	9	9
Net income before tax	**1,128**	**1,501**	**1,499**	**1,593**	**1,875**
Zakat & Tax	-93	-114	-123	-131	-154
tax rate	*8.2%*	*8.2%*	*8.2%*	*8.2%*	*8.2%*
Net Profit Before Minority Interest	**1,035**	**1,387**	**1,376**	**1,462**	**1,721**
Minority Interest (loss)/profit	-20	11	11	36	26
Reported net income	**1,055**	**1,377**	**1,365**	**1,426**	**1,694**
Extraordinary income/expense					
Adjusted net income	**1,055**	**1,377**	**1,365**	**1,426**	**1,694**
y-o-y growth	*21.3%*	*30.4%*	*-0.8%*	*4.5%*	*18.8%*
margins	*18.0%*	*19.0%*	*19.4%*	*18.0%*	*16.8%*
EPS	3.0	3.9	3.9	4.1	4.8
DPS	2.1	2.7	2.7	2.8	3.3

Source: Company data, Al Rajhi Capital

Figure 33 Balance Sheet

(SAR mn)	2020	2021	2022E	2023E	2024E
Assets					
Cash & Cash Equivalents	2,339	2,644	3,214	3,622	3,949
Receivables, Net	844	899	866	979	1,243
Advances to suppliers/contractors	8	16	16	16	16
Prepaid expenses and other assets	222	168	168	168	168
Inventory	380	407	404	390	445
Total Current Assets	**3,793**	**4,133**	**4,669**	**5,174**	**5,820**
Property and equipment	5,648	6,653	7,564	8,389	9,132
Investment from associates	40	41	42	42	42
Total Non-current Assets	**5,688**	**6,694**	**7,607**	**8,432**	**9,174**
Total Assets	**9,481**	**10,827**	**12,275**	**13,605**	**14,994**
Liabilities and Equity					
Short-term Debt	330	318	448	605	739
Trade payable	628	805	809	779	889
Advance from customers	37	33	33	33	33
Accrued expenses and other liab.	555	716	716	716	716
Zakat payable	101	131	131	131	131
Current portion of govt. grants	4	5	5	5	5
Other					
Total Current Liabilities	**1,694**	**2,048**	**2,197**	**2,329**	**2,577**
Long-Term Debt	2,030	2,445	3,299	3,997	4,561
Govt. grant	74	66	66	66	66
Long-term lease liabilities	233	253	263	285	309
Other					
Total Non-current Liabilities	**2,699**	**3,253**	**4,117**	**4,837**	**5,426**
Total Liabilites	**4,393**	**5,300**	**6,314**	**7,166**	**8,003**
Equity					
Capital	3,500	3,500	3,500	3,500	3,500
Statutory reserve	573	711	711	711	711
Change in Fair Value					
Total Equity	**4,912**	**5,339**	**5,762**	**6,204**	**6,730**
Minority Interest	177	188	199	234	261
Total Owners Equity	**5,089**	**5,527**	**5,961**	**6,439**	**6,991**
Total liabilites and equity	**9,481**	**10,827**	**12,275**	**13,605**	**14,994**

Source: Company data, Al Rajhi Capital

Figure 34 Cash flow Statement

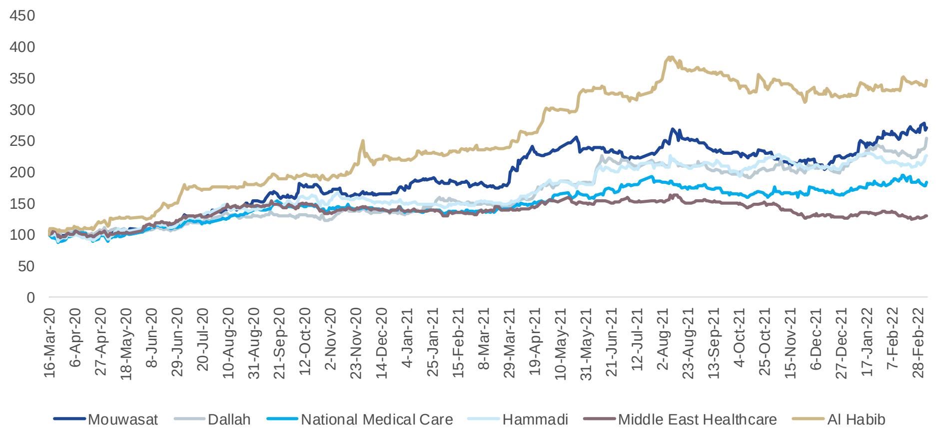
(SAR mn)	2020	2021	2022E	2023E	2024E
Net cash flows from Operating Activities	2,234	2,183	1,851	1,878	2,224
Cash Flows from Investing Activities	-812	-1,248	-1,295	-1,294	-1,294
Cash Flows from Financing Activities	-280	-631	15	-177	-603
Net change cash & cash equivalents	**1,143**	**305**	**570**	**408**	**327**

Source: Company data, Al Rajhi Capital

What is the price for a business that offers both quality and growth?

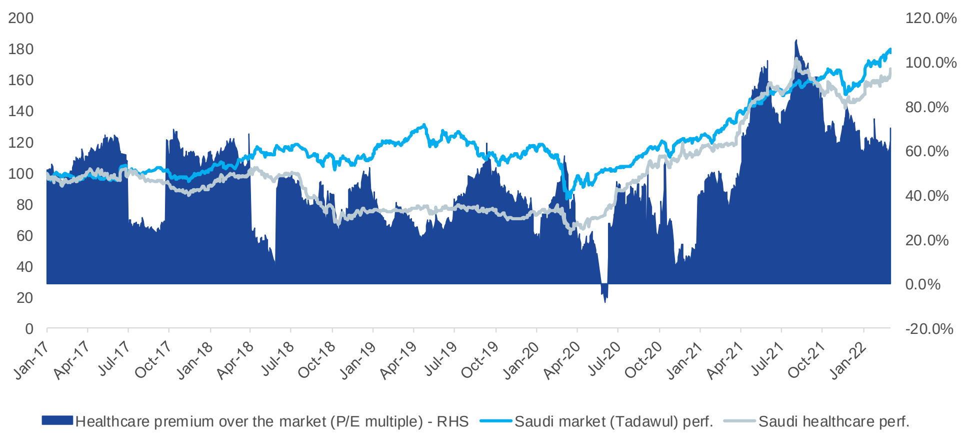
Al Habib made its debut on the market during the onset of Covid in March 2020. Since its listing, the company's share price has been the best performing among its peers with returns almost 250% versus average gains of over 110% for its peers. The stock currently trades at a consensus P/E of 41x, 24% premium to its closest peers' average of 33x. In our view, Al Habib provides a unique combination of both quality and growth. Although, most of the hospital operators are expanding capacity in the near future, Al Habib is leading the all by growing its capacity by over 75%. Moreover, in terms of competitive advantages over its peers it has an edge, such as strong brand image, solid position in the lucrative Riyadh market, high return ratios (ROE, low debt and strong cash conversion), etc. Further, the stock also has benefited from the rerating of the healthcare sector in general. The 1 year forward PE multiple for the healthcare index has expanded from 21x (as per Bloomberg for the index) at the start of 2017 to 35x currently, while the P/E for the market (Tadawul index) expanded from 14x to 21x. Currently, the healthcare index trades at a premium of over 70% compared to the market, much higher than the 50% premium it commanded at the start of 2017.

Figure 35 Peers price performance



Source: Bloomberg, Al Rajhi Capital. Last data point is 8th march 2022

Figure 36 Healthcare premium

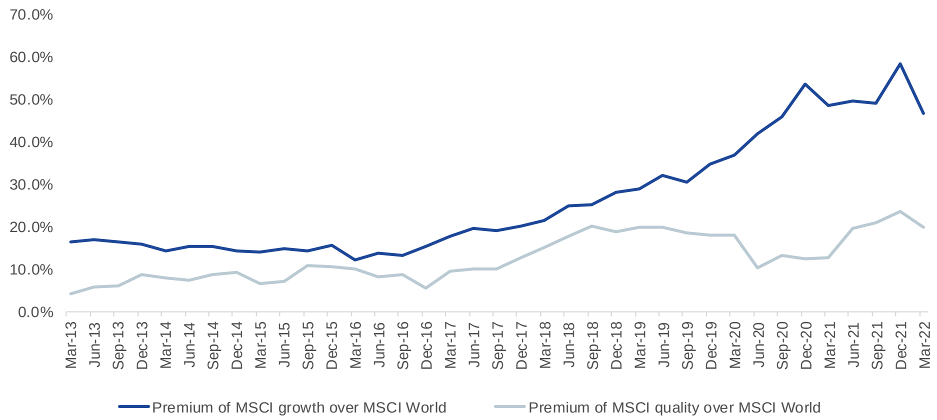


Source: Bloomberg, Al Rajhi Capital. Last data point is 10th march 2022

The street has little doubts on the quality and growth potential of Al Habib, the moot point has been at what valuations should the company trade at. Further, the debate has also has been what should be the premium a growth and quality stock command. The historical evidence indicates the range of premium that growth and quality companies command over the market has expanded in the recent years. On an average since 2013, MSCI World Quality Index has traded at a valuation premium (P/E multiple) of over 12% compared to MSCI World and MSCI World Growth Index has traded at a 25% premium. However, in the recent years, since 2018, the MSCI World Quality index's premium over MSCI World has averaged 17%, while the MSCI Growth's premium has averaged almost 40%. This indicates that the investors' risk appetite for quality and growth companies have increased and the companies that have attributes of either quality or growth command premium in the range of 17-40% over the rest.

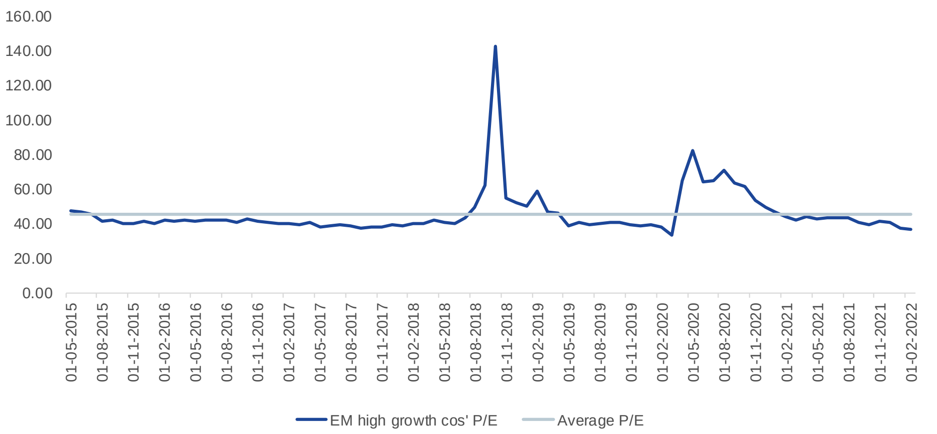
We believe a sector with defensive attributes and is in the growth phase should command significant premium over the market. We looked at the set of hospital operators from emerging markets that have grown their revenues and cash flows over 10% in the last decade. On an average, these companies have traded at a P/E of 41x since 2015 and the aggregate P/E has touched highs of 61x. Thus, we believe the current high multiple of hospital operators in Saudi Arabia reflects the growth expected in the sector (almost all the hospital operators expanding capacity) and the structural demand drivers.

Figure 37 Quality and growth premium (1 year forward P/E multiple)



Source: Bloomberg, Al Rajhi Capital

Figure 38 EM high growth healthcare companies' average forward P/E multiple



Source: Bloomberg, Al Rajhi Capital, Last data point is 28th Feb. 2022

Note: Companies: IHH Healthcare, Mitra Keluarga, Bangkok Chain, Bangkok Dusit Med., Fortis, Apollo Hospitals, Raffles Medical

Valuations

Given that Al Habib is in the expansion phase and most of the capacity would start contributing after 2024, we have applied discounted cash flow (DCF) methodology to arrive at the target price for Al Habib. Moreover, the sector has structural demand drivers such as rising population, rising disposable income, scope for improvement in beds per population, which implies the high growth phase for the sector would continue beyond 2030. We have used a two-stage growth model, that assumes 26% growth in the cash flows during the explicit growth phase (till 2030e) followed by a transition phase of high single digit growth (8% CAGR) in cash flows till 2035e.

Beyond 2035e, we have used terminal growth rate of 2.5%, which is largely in line with the medical inflation. The cost of equity and the WACC used throughout the forecast period are 9.4% and 7.5%, respectively. The intrinsic value per share derived through DCF methodology is SAR 201, we round that up to SAR 205, which is our target price for the stock. Our TP provides an upside of 14% and along with the dividend yield of 1.5%, the total returns are over 15%. The 2023e implied P/E multiple at our target price is 50x, however, the multiple drops to 21x on 2028e EPS, which is when the group is expected to reap full benefits of the expansion and achieve close to peak utilisation levels.

Figure 39 DCF Valuation (figures in SAR mn, except for per share number)

	High growth period									Transition phase				
	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E	2031E	2032E	2033E	2034E	2035E
Operating profit	**1,478**	**1,593**	**1,961**	**2,399**	**3,011**	**3,449**	**3,819**	**4,125**	**4,294**					
Net capex	-1,303	-1,303	-1,303	-237	-279	-308	-330	-348	-362					
FCFF	**484**	**510**	**848**	**2,378**	**2,835**	**3,323**	**3,655**	**3,933**	**4,113**	**4,442**	**4,798**	**5,181**	**5,596**	**6,044**
Discounted FCF	457	448	694	1,810	2,008	2,190	2,242	2,245	2,184	2,195	2,206	2,217	2,228	2,239
Terminal value (TV)														**124,604**
Implied EV/EBITDA multiple of TV														*17.6x*
Enterprise value		**71,516**												
Add: Cash and investments		2,644												
Add: Associate		41												
Add: Value of other income (assumed 15x multiple)		984												
Less Debt and grants (incl. lease liab.)		-3,126												
Less: Accrued liab. and exp.		-716												
Less: Long term employee benefits liab.		-489												
Less Minority interest		-351												
Equity value		**70,503**												
number of shares		350												
value per share		***201***												

Source: Company data, Al Rajhi Capital

Key Risks:

1. One of the immediate risks for the company is maintaining revenue growth in 2022 given that 2021 was a very strong year in terms of patient volumes, efficiency and revenues per bed. 2021 benefitted from the travel ban as well as Covid related medical usage.
2. The company is expanding its capacity by over 75%, thus attracting patients and maintaining healthy utilization levels would be key to the profitability.
3. Al Habib has been a major player in Riyadh, but lacks experience of operating in Jeddah. The company plans to expand aggressively in Jeddah, which is a fragmented market, thus could see competition form the established players.
4. Among physicians, it has high exposure to western and others, while Saudi nationals represent only 20%. Thus, Saudization in the hospital sector could be a risk.
5. The company relies on the insurance segment for future growth, which in turn is driven by expats to the large extent. Any further expats' exodus is a major risk.

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"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

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Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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