December 12, 2024

Company Report | Sector: Healthcare

Metropolis Healthcare

Core Diagnostics buy – Pros and cons

Metropolis recently purchased Core Diagnostics at 2.2x revenue funded by Rs1.4bn cash and Rs1.1bn in shares. Key positives that have been already highlighted include specialists connect in growing therapy and cross sell specialized tests of Metropolis to customers of Core. However, in this update we touch upon few factors that might make the acquisition not such a uniformly positive one. Firstly, deal would be ROE and ROCE accretive only from FY28. Secondly, high-end cancer testing market by definition would have low volumes so investment made would have fewer patients to contend with. Thirdly acquisition does not solve the volume growth issue that remains a lingering concern. Lastly opinion is divided on whether cancer testing is best done under an independent chain or should be left to oncology focused/multi-specialty hospitals. We incorporate Core financials into our estimates and cut gross margin estimate by 2% and EPS by 4.4% in FY26. Albeit margin impact would recede in FY27 as Core turns profitable likely next fiscal. Our ex-Core Diagnostic estimates remain largely unchanged, and we stick to 35x FY27E EPS with revised TP Rs2,000 (earlier Rs1,600) and Reduce rating.

Impact of Core Diagnostics buy may not be a uniformly positive one

While we are cognizant of the deal positives, in this update we highlight few pointers that might not make it a uniformly so. Being oncology focused, it has low volume and high value tests. OPD nature of testing and lack of insurance cover entails keeping tests affordable; this leads to lower gross margin compared to routine pathology business. Hence the break-even timeline is longer, and Core Diagnostic could be operating at a EBIDTA loss (or possibly a low single digit margin). We reckon bulk of the margin difference between the two businesses is traced to gross margin difference which stands at 55-60% for Core Diagnostics.

About 2% gross margin dilution and slight EPS pullback in FY26

A presumed 55% gross margin for Core leads to ~200bps gross margin dilution in FY26 as we factor in Rs1.2bn revenues added to Metropolis. Higher operating costs would lead to ~150-170bps margin dilution upon consolidation next year flowing into slight EPS pullback due to the merger. Margin would remain impacted due to the B2B nature of business and near-term efforts to rationalize lab presence and process synchronization. We assume ~15% revenue growth in FY27 largely on back of (high end) oncology test market growth and contribution from cross selling of Metropolis specialized tests to hospitals connected to Core network.

'Expectation of Core turning profitable in FY26'

In its post-acquisition call, management highlighted a) EBIDTA pay back of 6-8 years and 9-10 years on PAT basis b) Do not offer super specialized tests within Metropolis and it would have taken 5+ years hence acquisition accelerates oncology capabilities c) Over the life cycle of a cancer patient, about 3-4x number of tests are required of which about 1/3rd would be oncology linked and rest would be routine especially done after remission which is currently not done in Core but can be taken care of by Metropolis d) Only 30% overlap in oncology tests with Metropolis and rest is exclusive to Core e) Core gets lots of testing from medical oncology and nearly 85% of revenues come from such OPD type of demand

Surprise on volume growth key for a constructive stance

We retain high single digit growth in patient footfalls in FY25/26 along with 4-5% mix change driving 11-12% ex-Core revenue growth. While there have been modest downgrades in last 12 months, we believe a more constructive stance is dependent on volume surprise beyond 7% reported in H1 FY25. Retain Reduce based on an unchanged 35x FY27E EPS and await evolving volume growth trajectory.

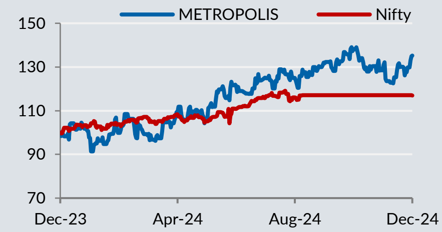
YES SECURITIES
INSTITUTIONAL EQUITIES

Reco	:	**REDUCE**
CMP	:	Rs 2,227
Target Price	:	Rs 2,000
Potential Return	:	-10.1%

Stock data (as on Dec 12, 2024)

Nifty	24,549
52 Week h/l (Rs)	2318 / 1450
Market cap (Rs/USD mn)	113942 / 1343
Outstanding Shares (mn)	51
6m Avg t/o (Rs mn):	429
Div yield (%):	-
Bloomberg code:	METROHL IN
NSE code:	METROPOLIS

Stock performance



	1M	3M	1Y
Absolute return	2.4%	2.3%	37.4%

Shareholding pattern (As of Sep'24 end)

Promoter	49.4%
FII+DII	46.6%
Others	4.0%

∆ in stance

(1-Yr)	New	Old
Rating	REDUCE	REDUCE
Target Price	2,000	1,600

∆ in earnings estimates

	FY25e	FY26e	FY27e
EPS (New)	32.7	43.7	55.6
EPS (Old)	34.5	45.7	-
% change	-5.3%	-4.4%	-

Financial Summary

(Rs mn)	FY25E	FY26E	FY27E
Net Revenue	13,472	16,544	18,625
YoY Growth	11.6	22.8	12.6
EBIDTA	3,446	4,276	5,125
YoY Growth	21.9	24.1	19.9
PAT	1,690	2,262	2,879
YoY Growth	32.2	33.8	27.3
ROE	13.8	15.5	17.0
EPS	32.7	43.7	55.6
P/E	68.2	51.0	40.0
BV	261.7	301.4	353.0
EV/EBITDA	33.2	26.1	21.1

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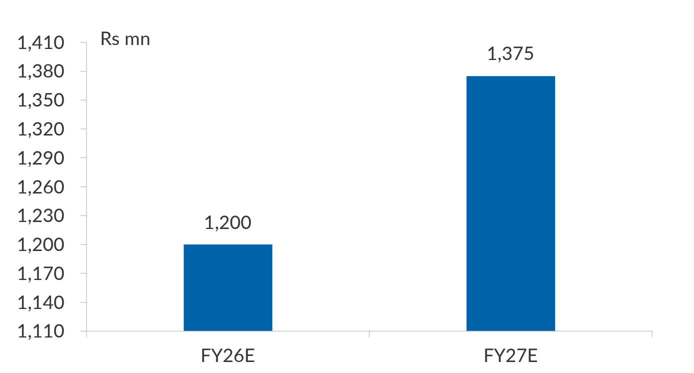
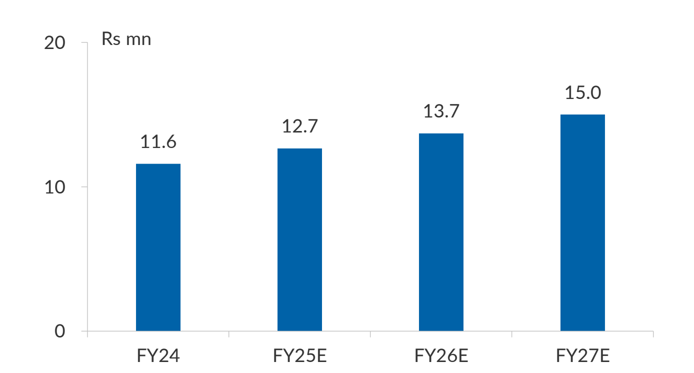
STORY IN CHARTS

Exhibit 1: Core Diagnostic revenue estimates



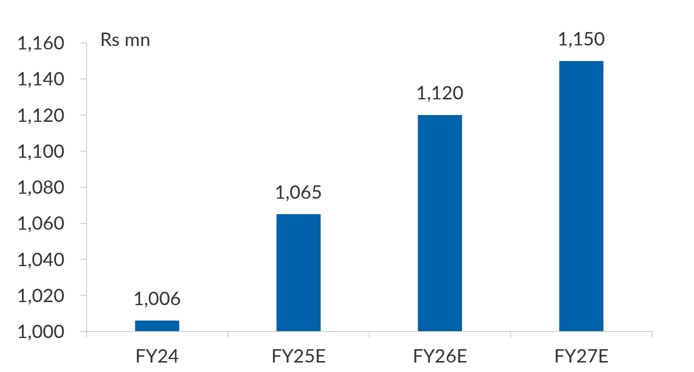
Source: Company, YES Sec

Exhibit 2: Metropolis- volume growth expectation



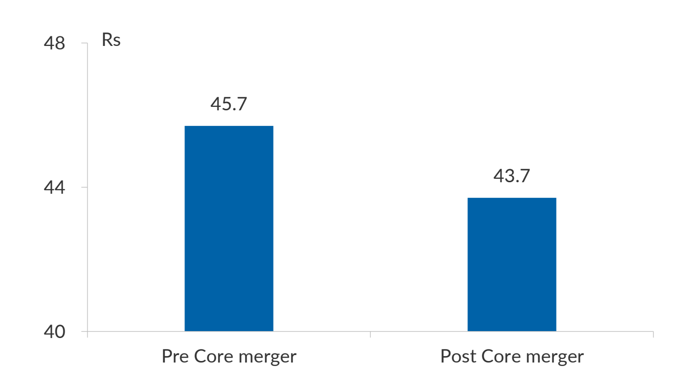
Source: Company, YES Sec

Exhibit 3: Trend in patient realization



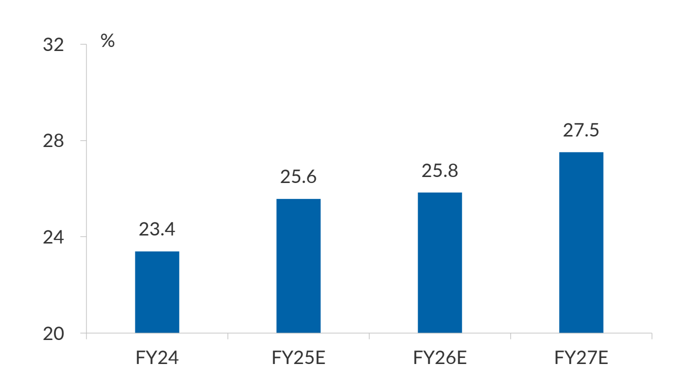
Source: Company, YES Sec

Exhibit 4: FY26E EPS impact upon merger of Core



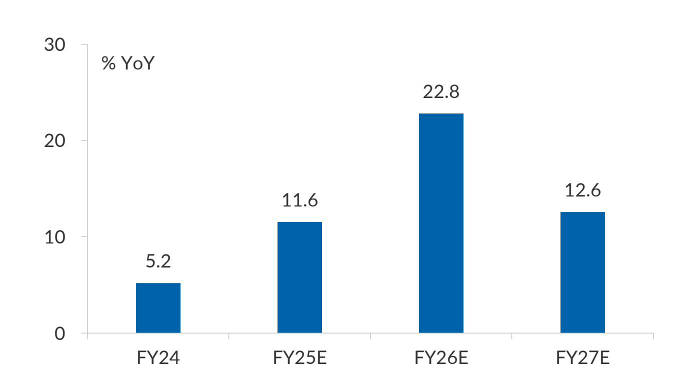
Source: Company, YES Sec

Exhibit 5: OPM impact seen in FY26 from Core merger



Source: Company, YES Sec

Exhibit 6: Metropolis – revenue growth trend



Source: Company, YES Sec

ACQUISITION CALL HIGHLIGHTS

- Revenue break up - 51% from B2C and 15% from pharma companies and rest form B2B hospitals
- Has significant entry barriers requiring R&D capability and pure oncology market size of Rs45bn and not counting routine tests that are also typically prescribed for onco patients
- EBIDTA Pay back of 6-8 years and on PAT basis 9-10 years
- Specialized tests operate at lower gross margin but made up by EBIDTA margin due to increased rev/test
- Reason for lower margin than pathology business - Lower gross margin due to constraints on pricing to keep it affordable (due to OPD nature and not covered by insurance), low scale of business and thirdly need to put up labs in regional markets to build local oncologists connects
- Do not offer super specialized tests within Metropolis and would have taken 5+ years hence acquisition accelerates oncology capabilities
- Over the life cycle of a cancer patient, about 3-4x number of tests are required of which about 1/3rd would be oncology linked and rest would be routine tests especially done after remission to check on routine parameters which is currently not done in Core but can be taken care of by Metropolis
- Transition would take 18 months involving merging overlapping (satellite) labs/collection infra, optimization of test portfolio, standardization of lab process and driving cross selling opportunities; later on, would merge oncology teams of Metropolis and Core in second phase
- About 40% overlap in international markets between the two cos and also lot of opportunity to do cross selling as tests offered by Core not offered by Metropolis and vice versa
- High operating costs in oncology (and also, say, neurology) combined with cost of acquisition of patients leave little scope for profitability
- Starting FY26, expect to see Core turn profitable on back of cost synergies
- Entry and mid-level tests comprise blood based (PSA) and tissue based followed by high end tests that include genomics to facilitate targeted medication; overlap of ~30% in oncology tests but rest is all exclusive to Core Diagnostics
- Hospitals vs diagnostics on oncology testing – hospitals are investing in top 1000 tests and not the full menu of 4k tests as offered by Metropolis and this is observed globally; even if top 2 or 3 hospitals go deep in to onco testing, there would always be requirement of a specialist diagnostic lab
- Core gets lots of testing from medical oncology testing and nearly 85% of revenues come from such OPD type of demand
- Founder of Core has very little equity – 2-3% and 34% is owned by Eight Roads and rest by smaller shareholders

FINANCIALS

Exhibit 7: Balance sheet

Y/e 31 Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
Equity capital	102	102	103	103	103
Reserves	9,780	10,859	13,436	15,491	18,162
Net worth	**9,882**	**10,962**	**13,540**	**15,594**	**18,266**
Debt	1,677	1,349	1,349	1,349	1,349
MI	25	31	31	31	31
Def tax lia	782	751	751	751	751
Total liabilities	**12,366**	**13,092**	**15,670**	**17,724**	**20,396**
Goodwill	4,547	4,547	5,815	5,815	5,815
Fixed Asset	6,855	7,224	7,514	6,567	5,605
Investments	518	545	545	545	545
Net Working Capital	**378**	**700**	**1,719**	**4,720**	**8,354**
Inventories	446	387	432	530	597
Sundry debtors	1,219	1,263	1,403	1,722	1,939
Cash	1,063	1,243	2,134	5,051	8,629
Other current assets	300	266	337	414	466
Sundry creditors	(941)	(994)	(1,109)	(1,362)	(1,534)
Other CL	(1,709)	(1,464)	(1,476)	(1,635)	(1,742)
Def tax assets	69	76	76	76	76
Total Assets	**12,366**	**13,092**	**15,670**	**17,724**	**20,396**

Exhibit 8: Income statement

Y/e 31 Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
Revenue	11,482	12,077	13,472	16,544	18,625
Operating profit	**2,883**	**2,826**	**3,446**	**4,276**	**5,125**
Depreciation	(892)	(945)	(1,060)	(1,097)	(1,112)
Interest expense	(268)	(225)	(202)	(224)	(224)
Other income	152	91	100	100	100
Profit before tax	**1,875**	**1,747**	**2,284**	**3,056**	**3,890**
Taxes	(441)	(462)	(594)	(795)	(1,011)
Adj. profit	**1,434**	**1,285**	**1,690**	**2,262**	**2,879**
Exceptional	-	-	-	-	-
Reported profit	**1,434**	**1,285**	**1,690**	**2,262**	**2,879**

Exhibit 9: Cash flow statement

Y/e 31 Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
Profit before tax	1,875	1,747	2,284	3,056	3,890
Depreciation	892	945	1,060	1,097	1,112
Def tax assets (net)	(55)	(39)	-	-	-
Tax paid	(441)	(462)	(594)	(795)	(1,011)
Working capital Δ	(206)	(142)	(129)	(83)	(56)
Other operating items	-	-	-	-	-
Operating cashflow	2,065	2,048	2,621	3,275	3,934
Capital expenditure	(1,647)	(1,314)	(2,618)	(150)	(150)
Free cash flow	**418**	**735**	**3**	**3,125**	**3,784**
Equity raised	(4)	(0)	1,095	(0)	0
MI	5	6	-	-	-
Investments	109	(27)	-	-	-
Debt financing/disposal	(862)	(328)	-	-	-
Dividends paid	(410)	(205)	(207)	(207)	(207)
Net Δ in cash	**(744)**	**180**	**891**	**2,918**	**3,577**

Exhibit 10: Du Pont Analysis

Y/e 31 Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
Tax burden (x)	0.76	0.74	0.74	0.74	0.74
Interest burden (x)	0.87	0.89	0.92	0.93	0.95
EBIT margin (x)	0.19	0.16	0.18	0.20	0.22
Asset turnover (x)	1.09	1.13	1.16	1.22	1.14
Financial leverage (x)	1.12	1.02	0.95	0.93	0.96
RoE (%)	**15.3**	**12.3**	**13.8**	**15.5**	**17.0**

Exhibit 11: Ratio analysis

Y/e 31 Mar	FY23	FY24	FY25E	FY26E	FY27E
Growth matrix (%)					
Revenue growth	(6.5)	5.2	11.6	22.8	12.6
Op profit growth	(15.9)	(2.0)	21.9	24.1	19.9
EBIT growth	(27.9)	(8.0)	26.0	31.9	25.4
Net profit growth	(33.2)	(10.4)	31.6	33.8	27.3
Profitability ratios (%)					
OPM	25.1	23.4	25.6	25.8	27.5
EBIT margin	18.7	16.3	18.5	19.8	22.1
Net profit margin	12.5	10.6	12.5	13.7	15.5
RoCE	17.4	15.5	17.3	19.6	21.6
RoNW	15.3	12.3	13.8	15.5	17.0
RoA	13.6	12.0	14.5	16.6	17.7

Metropolis Healthcare

Y/e 31 Mar	FY23	FY24	FY25E	FY26E	FY27E
Per share ratios					
EPS	28.0	25.1	32.7	43.7	55.6
Dividend per share	8.0	4.0	4.0	4.0	4.0
Cash EPS	45.4	43.5	53.1	64.9	77.1
Book value per share	193.0	214.0	261.7	301.4	353.0
Valuation ratios (x)					
P/E	79.8	89.3	68.2	51.0	40.0
P/BV	11.5	10.4	8.5	7.4	6.3
M Cap/Sales	9.9	9.4	8.6	7.0	6.2
EV/EBIDTA	39.8	40.4	33.2	26.1	21.1
Payout (%)					
Tax payout	23.5	26.5	26.0	26.0	26.0
Dividend payout	28.6	16.0	12.2	9.2	7.2
Liquidity ratios					
Debtor days	39	38	38	38	38
Inventory days	14	12	12	12	12
Creditor days	30	30	30	30	30

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Associates of YSIL may have actual/beneficial ownership of 1% or more and/or other material conflict of interest in the securities discussed herein.

RECOMMENDATION PARAMETERS FOR FUNDAMENTAL REPORTS

Analysts assign ratings to the stocks according to the expected upside/downside relative to the current market price and the estimated target price. Depending on the expected returns, the recommendations are categorized as mentioned below. The performance horizon is 12 to 18 months unless specified and the target price is defined as the analysts' valuation for a stock. No benchmark is applicable to the ratings mentioned in this report.

BUY: Upside greater than 20% over 12 months

ADD: Upside between 10% to 20% over 12 months

NEUTRAL: Upside between 0% to 10% over 12 months

REDUCE: Downside between 0% to -10% over 12 months

SELL: Downside greater than -10% over 12 months

NOT RATED / UNDER REVIEW

BHAVESH INDRAVADAN GANDHI

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ABOUT YES SECURITIES (INDIA) LIMITED

YES Securities (India) Limited ('YSIL') is a subsidiary of YES Bank Limited ('YBL'). YSIL is a Securities and Exchange Board of India (SEBI) registered Stock broker holding membership of National Stock Exchange (NSE), Bombay Stock Exchange (BSE), Multi Commodity Exchange (MCX) & National Commodity & Derivatives Exchange (NCDEX). YSIL is also a SEBI-registered Investment Adviser and Research Analyst. YSIL is also a Sponsor and Investment Manager of Alternate Investment Fund - Category III (YSL Alternates) and AMFI registered Mutual Fund Distributor. The Company is also a registered Depository Participant with CDSL and NSDL.