

# Raffles Medical Group – ADD

06 May 2011

Initiating coverage



**IIFL**  
Institutional Equities

## Enough 'room' for growth

Raffles Medical, an integrated healthcare-services provider, operates 80 medical clinics and a 380-bed tertiary hospital in Singapore. This is a non-cyclical, steady-growth business, and we estimate earnings will grow at 19% annually during FY10-13ii. Over the longer term, the group plans to build a new extension to its hospital and set up a large specialist medical clinic on Orchard Road, the full impact of which will be felt in FY14. We expect profit growth of by 24% YoY in FY14ii and free cash flow to more than double to S\$117m in FY14ii, from S\$44m in FY13ii. Raffles Medical's FY12ii P/E of 20x is in-line with its peers, but we believe the stock deserves a premium due to its strong positioning in specialist healthcare services (as reflected in higher net margin of 19% against 7.5-14% for peers), scalable business model and significant growth potential. Based on 23x FY12ii EPS, we arrive at our fair value target price of S\$2.65. We initiate coverage with ADD.

**Existing operations to experience margin expansion:** Against 14% revenue CAGR, we estimate profit to grow at 19% annually during FY10-13ii, driven by 140bps expansion in operating margin over three years. Margin expansion will come from lower growth in operating costs, as the group adds more hospital beds, increases revenue per bed and hikes specialist service fees with less than equivalent rise in overall staff costs (48.4% of revenue in FY10).

**The 'steroids' kick in from 2014:** During FY11ii-13ii, the group plans to use S\$200m of internal funds to add a 20-floor extension to its existing 13-floor hospital and set up a large specialist medical centre on Orchard Road. Both expansions will be used to grow the specialist out-patient services. Although the benefits will be visible from mid-2012, a significant increase in revenue intensity and margins will be felt in FY14. We estimate profit will grow by 24% YoY in FY14ii (19% CAGR over FY10-13ii), driven by 17% YoY growth in revenue (14% CAGR during FY10-13ii) and 130bps increase in operating margins in a single year (140bps expansion between FY10-13ii).

**Initiate with ADD; TP: S\$2.65; DCF: S\$3.37:** The current valuation of 22x 1-year forward EPS is still at a discount to recent Parkway and Thomson Medical acquisitions. On a going-concern basis, 1-year forward P/E also fails to capture the group's long-term growth potential. We value the stock at 23x FY12ii EPS. Our DCF estimate of S\$3.37 offers 47% upside.

## Company update

<b>CMP</b>	<b>S\$2.29</b>
<b>12-mth TP (S\$)</b>	<b>2.65 (16%)</b>
<b>Market cap (US\$ m)</b>	<b>978.2</b>
<b>Bloomberg</b>	<b>RFMD SP</b>
<b>Sector</b>	<b>Healthcare</b>

### Shareholding pattern (%)

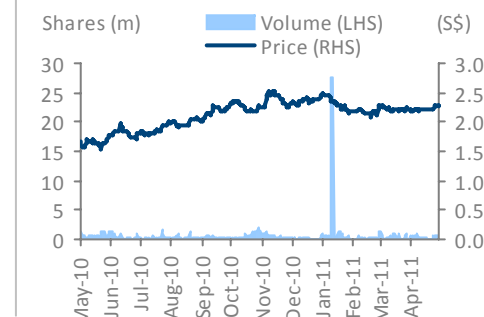
Raffles Medical Hldg	39.2
Choon Yong Loo	10.2
S&D Holdings Pte	3.3
Others	47.3

52Wk High/Low (S\$)	2.52/1.50
Shares o/s (m)	527.5
Daily volume (US\$ m)	.7
Dividend yield FY11ii (%)	1.5
Free float (%)	46.7

### Price performance (%)

	1M	3M	1Y
Raffles Medical	4.6	4.6	38.0
<b>Rel. to ST Index</b>	<b>5.7</b>	<b>7.7</b>	<b>29.2</b>
KPJ Healthcare	-0.2	8.5	44.2
Bangkok D. Med.	2.0	5.6	101.9

### Stock performance



### Financial summary (S\$ m)

Y/e 31 Dec	FY09A	FY10A	FY11ii	FY12ii	FY13ii
<b>Revenue (m)</b>	<b>219</b>	<b>239</b>	<b>277</b>	<b>316</b>	<b>357</b>
EBITDA margin (%)	23.9	25.1	25.2	26.3	27.5
<b>Net profit (m)</b>	<b>37</b>	<b>42</b>	<b>52</b>	<b>60</b>	<b>72</b>
<b>EPS (cents)</b>	<b>7.2</b>	<b>8.1</b>	<b>9.9</b>	<b>11.5</b>	<b>13.6</b>
Growth (%)	18.6	12.4	22.4	15.8	18.3
IIFL vs consensus (%)			3.0	8.0	5.0
PER (x)	31.8	28.3	23.2	20.0	16.9
ROE (%)	15.8	15.8	17.1	17.7	18.5
Net debt / equity (%)	-19.9	-29.6	-6.6	-5.9	-7.5
EV / EBITDA (x)	22.0	18.9	17.7	14.9	12.5
Price / book (x)	4.8	4.2	3.8	3.3	2.9
Dividend yield (%)	1.3	1.5	1.5	1.9	2.2

Source: Company, IIFL Research. Priced as on 05 May 2011

## Company snapshot

Founded in 1976 with just two clinics operated by Dr Loo Choon Yong and Dr Alfred Loh, Raffles Medical Group (Raffles Medical) has grown into a leading regional fully-integrated healthcare organisation providing primary care (through more than 70 fully-owned clinics and medical centres), specialist care (across more than 30 medical disciplines) and tertiary care (through its Joint Commission International accredited Raffles Hospital). Raffles Medical was listed on the Singapore Stock Exchange in 1997.

### Raffles Medical Clinic / Centre

Raffles Medical operates 75 medical clinics in Singapore, 3 in Hong Kong and 1 in Shanghai (China). To complement its primary and specialist healthcare services offered at its medical clinics, in 2003, Raffles Medical set up Raffles Japanese Clinic to exclusively serve Japanese clientele. In 2010, the group opened a Japanese Medical clinic at its Shanghai medical centre. In 2006, Raffles Medical started offering Traditional Chinese Medicine (TCM) like herbal medicine, acupressure and acupuncture through Raffles Chinese Medicine. Raffles Medical Clinic caters to more than 5,500 corporate customers in Singapore and Hong Kong, which account for two-third of the group's total customers in Singapore.

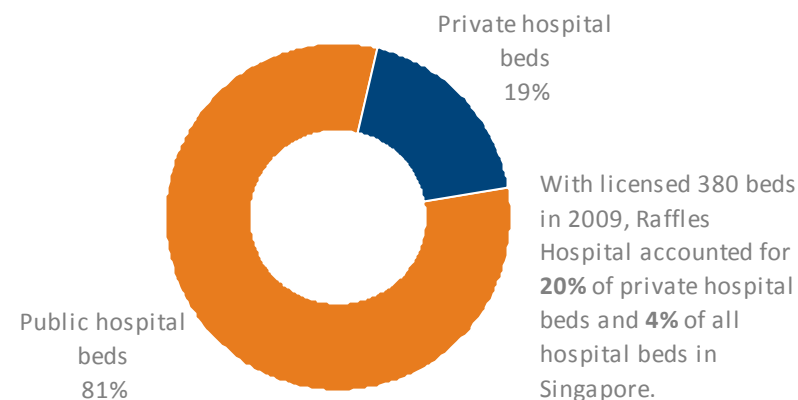
To setup a comprehensive specialist medical centre in the Orchard area of Singapore, Raffles Medical completed the purchase of the 42,668 sq ft 7-storey commercial block of Thong Sia Building in 1QFY11. The specialist medical centre is expected to commence operations in 2012.

### Raffles Hospital

In 1997, the group started to build Raffles Hospital by forming a 50:50 joint venture with Pidemco Land (now part of CapitaLand). Raffles Hospital started operating in 2001. The hospital is licensed to operate 380 beds, of which the hospital currently operates 200 beds. About one-third of the patients at Raffles Hospital are from more than 100 countries.

In 2007, Raffles Medical acquired the remaining 50% stake in hospital property from CapitaLand for S\$67.5m by issuing 25m new shares to Temasek Holdings and Qatar Investment Authority each at S\$1.30. Raffles Hospital received its Joint Commission International Accreditation in January 2009.

**Figure 1: 2009 hospital bed share in Singapore**



Source: Company, IIFL Research

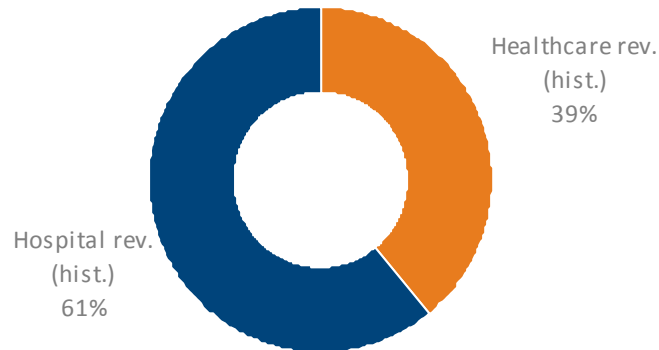
In 2010, Singapore's Urban Redevelopment Authority granted Raffles Medical permission to build an additional 102,408 sq ft of floor space (33% of the existing gross floor area) on its existing site. With the additional floor space, Raffles Medical plans to expand its existing clinical services as well as add new facilities and specialist services.

### Raffles Health & health insurance

In 2003, the group also launched Raffles Health to develop and distribute quality healthcare products. In addition to Singapore, the group currently sells healthcare products in Indonesia as well. In addition to operating medical clinics and the tertiary hospital, Raffles Medical also operates a healthcare insurance company, International Medical Insurers (IMI). IMI commenced operations in January 2005

and currently partners with BUPA International to offer international health plans.

**Figure 2: FY10 revenue contribution**



Source: Company, IIFL Research

The hospital services segment accounted for 61% of the total revenue and 73% of PBT in FY10, while the rest was contributed by the healthcare services segment (39% of revenue and 27% of PBT). Revenue contribution from hospital services has increased from 46% in FY04 to 61% in FY10.

The hospital service revenue includes: 1) in-patient revenue; 2) out-patient revenue (specialist medical services); and 3) laboratory & diagnostic services. *The revenue and profits from independent specialist medical clinics operating all over Singapore is also accounted under hospital services.*

The healthcare service revenue includes revenue from: 1) general medicine (GP) services; 2) insurance business; 3) sale of healthcare supplements; and 4) Japanese clinic and provision of traditional Chinese medicine. We estimate revenue from GP services accounts for more than 90% of the healthcare segment, with each of the other services accounting for less than 3% of the segment.

## Distinct business model

### Fully-integrated model

Raffles Medical operates a fully-integrated business model, which starts with the group’s leadership position in primary healthcare (with one of the largest network of general medicine clinics in Singapore) and extends to specialist clinics and a 380-bed tertiary hospital. If required, this allows doctors at the GP clinics to refer patients to the specialist doctors at Raffles Medical’s specialist clinics and Raffles Hospital, in our view. The specialist clinics could in turn refer patients for admission to the Raffles Hospital when necessary. We believe this fully-integrated model has the potential to create strong volume of patients and allows for a more robust business model.

### Group practice model

Raffles Medical is unique, as it employs the doctors, physicians and surgeons. In contrast, other private hospitals in Singapore such as Parkway and Thomson only provide hospital services, and the doctors operate independently. Raffles Medical’s unique business model is known as the Group Practice Model (GPM) and is adopted in medical institutions like the Mayo Clinic, the Cleveland Clinic and the Memorial Sloan Kettering Cancer Centre in the United States.

We believe Raffles Medical’s GPM allows it to capture higher margins from provision of specialist services. Combined with the group’s fully-integrated medical services model, we believe GPM allows Raffles Medical to have strong control on the quality and quantity of staff, resulting in better control on cost and quality of service offered.

**Figure 3: Quick overview – advantages and disadvantages of Group Practice Model**

Advantages for	Disadvantages for
<b>Doctors</b>	
Ease in starting a new practice	No ownership of own practice
Focus on practice with service provider taking care of business needs	Limited control over practice growth
Assistance from other specialists in handling complex cases	Remuneration is limited by the growth and profitability of service provider
Enables doctors to take breaks for holiday/further studies without impacting practice or loss of income	
<b>Medical service provider</b>	
Fully-integrated model helps create strong customer base	Difficult for a new service provider to build GPM
Greater control on quality of services and costs	Difficulty in recruiting and retaining specialists who are in good demand
Economies of scale	
No loss of patient in case of doctor's absence	
Quality of healthcare, audit of every inpatient case	

Source: Company, IIFL Research

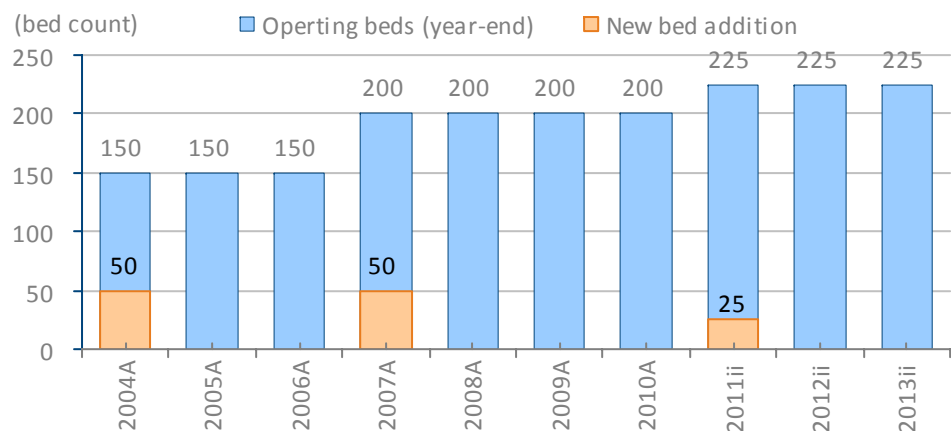
## Specialist medical service business continues to grow

### Hospital services

Raffles Hospital provides in-patient, out-patient (medical specialist) and laboratory & diagnostic services. We believe that rise in patient load translating into new bed addition and higher bed utilisation, along with hike in specialist fees and in-patient bed charges will be the key growth drivers for the hospital services business.

### New bed addition along with improved utilisation

Licensed with 380 beds, Raffles Medical is currently operating only 200 beds, with utilisation rates varying between 40-60% within the year. Management has indicated that to ensure ambient service quality and fast turnaround time, it aims at restricting the utilisation at 65%. Management plans to add more beds only if rising demand for in-patient services pushes the utilisation rates above 65%. To cope with rising demand, the group can re-allocate space for new beds without incurring significant capex - in the past bed count was increased from 100 to 150 in FY04 and from 150 to 200 in FY07. Management indicated that recently they have relocated backroom services out of the hospital premises to create more space for additional medical services. We believe Raffles Hospital can easily add 50 to 100 beds at its existing hospital location by relocating the remaining backroom services and management offices to other areas in the hospital or outside the hospital premises.

**Figure 4: New bed additions at Raffles Hospital**


Source: Company, IIFL Research

In the 1QFY11 results briefing, management had indicated that the recent growth has been driven by rise in patient load factor. Thus to handle the rising patient load factor, we expect management to improve the utilisation rate of the existing 200 operational beds as well as add 25 new beds in FY11ii.

### Revenue intensity to rise with increasing patient load

Based on data from the Ministry of Health, it is evident that in terms of average in-patient bill size, which we believe reflects the complexity of the medical cases (utilisation of specialist services) and (to a lesser extent) pricing and length of stay, Raffles Hospital has shown significant growth of 60% from 2007 to 1H2010 for medical specialties. However, from January 2010 to June 2010, Raffles Hospital's average bill size per day was still at a 9% discount to Gleneagles Hospital and a 23% discount to Mount Elizabeth Hospital, which implies that there is room for Raffles Hospital to enhance its specialist service offerings, in our view.

**Figure 5: Medical specialties in-patient bill - mean for January 2010 to June 2010**

Hospitals	Avg. per day (S\$)
Parkway East Hospital	1,334
Gleneagles Hospital	2,518
Mount Alvernia Hospital	1,346
Mount Elizabeth Hospital	2,992
<b>Raffles Hospital</b>	<b>2,302</b>
Thomson Medical Centre	1,129

Source: Company, IIFL Research

We believe Raffles Medical will continue to add high-value speciality and sub-speciality services at the hospital to enhance the revenue intensity of its services. In our recent meeting with the group's officials, management hinted that the current growth is being driven more by volume than by prices. Thus, we believe medical fees could be raised progressively this year across the board. In addition, higher provision of specialist services should boost revenue intensity going forward. Hence, we expect revenue per patient day to increase by 7.5-10% during FY11ii-13ii.

**Figure 6: Hospital service segment**

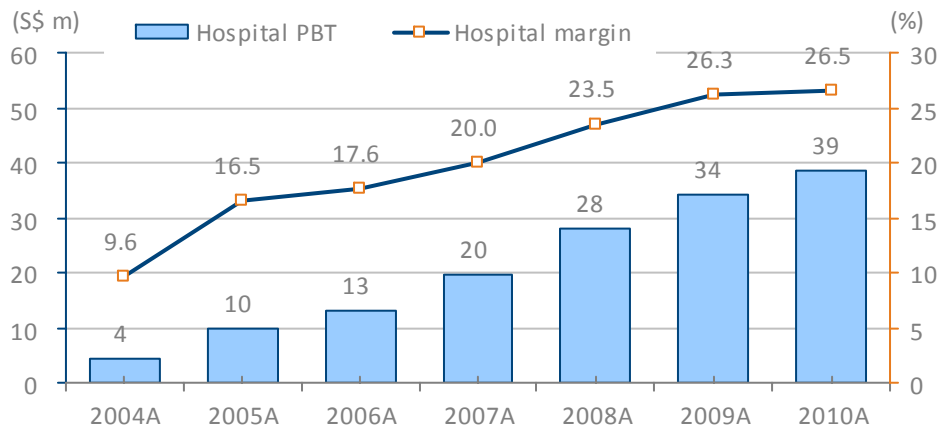
Hospital services	2008A	2009A	2010A	2011ii	2012ii	2013ii
Hospital revenue (S\$ m)	119.9	129.8	145.5	170.4	191.0	212.9
Growth YoY (%)	21.2	8.2	12.1	17.1	12.1	11.5
Operational beds	200	200	200	225	225	225
Utilisation rate (%)	61.0	61.5	63.0	61.0	62.0	63.0
Occupied beds	122	123	126	137	140	142
Rev. per patient day (S\$)	2,686	2,890	3,163	3,401	3,741	4,115
Growth YoY (%)	18.8	7.6	9.4	7.5	10.0	10.0

Source: Company, IIFL Research

### Margins still have significant room to match peers

Operating margin for hospital services have been rising consistently and has improved from 9.6% in FY04 to 26.5% in FY10. In our view, although Raffles Medical is leveraged to margin expansion (as its unique group practice model allows it to capture the high-margin business of specialist medical services), the under-utilisation of the hospital's in-patient beds is hiding the high margin of the group's outpatient specialist service.

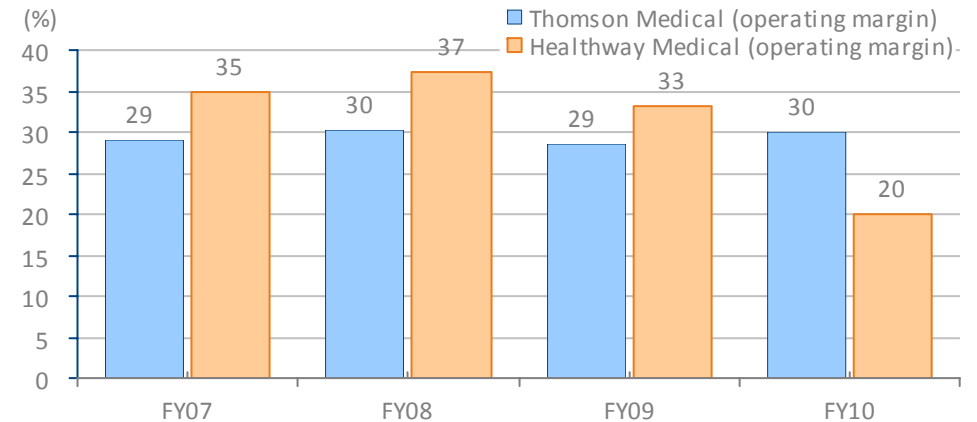
**Figure 7: Hospital segment profits and margins have been on a rise since FY04**



Source: Company, IIFL Research

The published information before Thomson Medical was acquired and taken private indicates that its hospital operation had an operating profit margin of 30% in 2010. Specialist service provider, Healthway Medical's operating margins have consistently remained above 30% over FY07-09 (FY10 margins were impacted by exit of specialist doctors). In FY09, Raffles Hospital's blended operating margin was 26.3%. As Raffles Hospital's occupancy continues to trend up over time, and more specialist services are offered by the hospital, we believe that blended operating margin for the hospital segment could move higher.

**Figure 8: Operating margins for the peers**



Source: Company, IIFL Research. **Note: Healthway Medical's FY10 margins were impacted by exit of specialist doctors**

### Healthcare services

The healthcare service revenue includes revenue from: 1) general medicine (GP) services; 2) insurance business; 3) sale of healthcare supplement; and 4) Japanese clinic and provision of traditional Chinese medicine. We estimate revenue from GP services accounts for more than 90% of the healthcare segment, with each of the other services accounting for less than 3% of the segment. We believe that increase in the number of GP clinics, along with a rise in GP service fees resulting in higher revenue per clinic will be the key growth drivers for the healthcare services business.

#### Continue to add new medical clinics

With a network of 75 general medicine and specialist clinics island-wide, Raffles Medical has attained a strong foothold in the provision of primary healthcare services in Singapore. With a strong corporate customer base, we believe Raffles Medical should witness respectable growth in this segment as corporate spending gets stronger. Management aims to add 3-4 clinics annually in Singapore

over the next 2-3 years. Three new Raffles Medical clinics—Asia Square, I12 Katong (former Katong Mall) and Changi City Point—are scheduled to open in the second half of 2011 in Singapore.

Over the next few years, we believe the focus will be on adding more specialist clinics, as they have the potential to provide strong revenue growth and higher margins. However, the growth in revenue and profit from specialist clinics will not be reflected in the healthcare business segment, and instead will be visible in higher profitability of the hospital services segment. We assume Raffles Medical will set-up four new clinics in Singapore each year between FY11ii-13ii. In FY11ii, the group will add one clinic in Hong Kong.

As the recent acquisition of the 42,668 sq ft, 7-storey freehold podium/commercial block of Thong Sia Building is gradually converted into a specialist medical centre, we expect two new clinics (over and above the four clinics mentioned earlier) to be added in FY12 in the Orchard area of Singapore.

We believe that the expansion of its medical clinic network will result in higher patient referrals to its specialist doctors at its specialist clinics and the hospital, which will drive higher revenue growth and profitability for the hospital segment.

**Figure 9: Medical specialties inpatient bill - mean for January 2010 to June 2010**

Healthcare services	2008A	2009A	2010A	2011ii	2012ii	2013ii
Healthcare services rev. (\$m)	80.7	88.7	93.5	107.0	124.7	144.4
Growth YoY (%)	15.9	9.8	5.4	14.4	16.6	15.8
Rev. from medical clinics (\$m)	77.5	84.3	86.7	97.9	112.8	128.9
% of healthcare services rev.	96.0	95.0	92.8	91.5	90.5	89.3
Number of medical clinics	74	77	79	84	90	94
Revenue per clinic (\$)	1,084	1,116	1,112	1,201	1,297	1,401
Growth YoY (%)	7.3	2.9	(0.4)	8.0	8.0	8.0

Source: Company, IIFL Research

### Higher revenue per clinic from hike in GP service fee

We expect the healthcare business segment to deliver double-digit growth for the next three years driven by new clinic addition and higher revenue intensity at each of its clinics. We assume 8% growth in average revenue per clinic going forward, in-line with the potential hike in GP service fees.

## The ‘steroids’ kick-in from 2014

### Raffles Hospital expansion to increase specialist services; expected to be completed by end-2013

Raffles Medical has been planning to expand its hospital space for the past three years. In 2008, it had tendered a bid for a hospital site at Novena, Singapore, which it lost to Parkway Holdings.

After three years, in July 2010, Raffles Medical announced that it had received URA approval to build an additional 102,408 sq ft (+33% of existing) of floor space at its flagship Raffles Hospital. The total cost is estimated at S\$80m-100m (S\$80m for construction of the building and S\$20m for equipment), which will be fully funded internally.

Raffles Hospital currently has a gross floor area of 307,875 sq ft, which is spread over 13 floors. With the extended building expected to be 20 floors, it would add 7 additional floors to the existing building.

**Figure 10: Current usage of Raffles Hospital’s 13 floors**

Floor level	Used for
13th floor	Specialist clinics
12th floor	1/2 wards (currently used for admin staff), 1/2 specialist clinics
11th floor	1/2 wards (currently used for admin staff), 1/2 specialist clinics
10th floor	Research laboratory
9th floor	Wards
8th floor	Wards
7th floor	Operating theatres
6th floor	Car park
5th floor	Car park
4th floor	Car park
3rd floor	Car park
2nd floor	Specialist clinics

Source: Company, IIFL Research

Management recently said that the design scheme for the extension is being finalised, and formal application for expansion is expected to be submitted to the URA by 3Q2011. Management has indicated that construction should start in 4QFY11 and the extension will be completed by end-2013.

Management’s priority is to add more specialities and sub-specialties to offer a wider range of outpatient services (e.g. radiation, oncology) in the extension building, rather than to boost in-patient beds (licenced for 380 beds and currently operating 200 beds at 40-60% occupancy).

**Figure 11: Artist’s impression of Raffles Hospital’s proposed extension**



Source: Company, IIFL Research

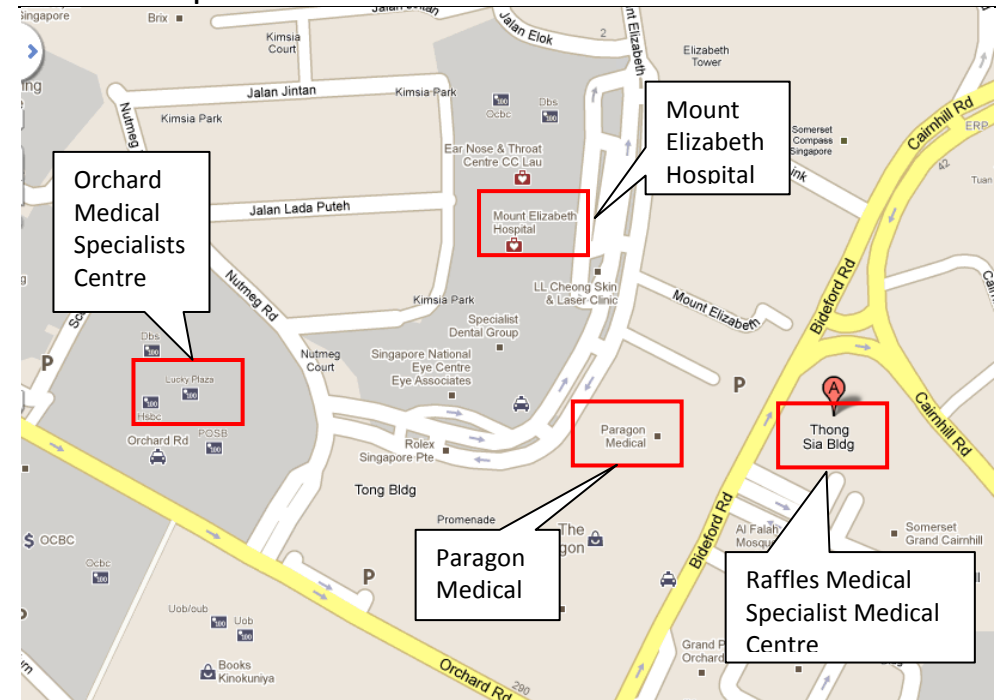
### Acquisition of property in Orchard: more specialist services; starts contributing from mid-2012

Raffles Medical recently announced the acquisition of 42,668 sq ft 7-storey freehold podium/commercial block of Thong Sia Building for S\$92.08m, which will be used to set-up a specialist medical centre. The acquisition cost was paid in 1QFY11, with management intending to spend an additional S\$5m-10m on renovation over the next 2-3 years. We estimate S\$10m of renovation costs to be expensed between FY12ii and FY14ii.

The specialist centre is expected to commence operations in 2012, as the leases for the existing tenants expire gradually between mid-2012 and end-2013. The medical centre is expected to attain full operations by end-2013.

To begin with most of the specialist doctors at the Raffles Hospital will provide specialist services at the medical centre as well. Hence, the specialist medical centre will logically be an extension of the Raffles Hospital (without in-patient facilities), as most of the speciality and sub-speciality services offered at the hospital will be offered at the medical centre as well.

**Figure 12: Thong Sia building is located in close proximity to other specialist medical centres and hospitals**



Source: Company, IIFL Research, Google Maps

**Figure 13: Potential specialist services to be offered at Thong Sia building**

List of specialist services	List of specialist services
Dental centre	Paediatrics
Health screening centre	Cardiology
Radiology and imaging centre	General surgery
Medical laboratory	Orthopaedic surgery
Fertility centre	Ophthalmology
Cancer centre	ENT surgery
24-hour Emergency Care Centre	Dermatology
Obstetrics and gynaecology	Medical Aesthetics

Source: Company, IIFL Research

## FY14ii: profit to grow at 24% YoY; FCF to double

We believe that the addition of more outpatient clinics at the hospital extension and the specialist clinic centre in Orchard will boost hospital segment's profits and margins - the net impact on the group's earnings and cashflow will be visible post 2013.

We currently estimate FY14ii hospital revenue to grow by 20% YoY as against 12% and 11.5% YoY growth in FY12ii and FY13ii, respectively. With greater contribution from high-margin specialists services, we expect FY14ii profit to grow at 24% YoY compared to 16% YoY growth in FY12ii and 18.5% YoY growth in FY13ii.

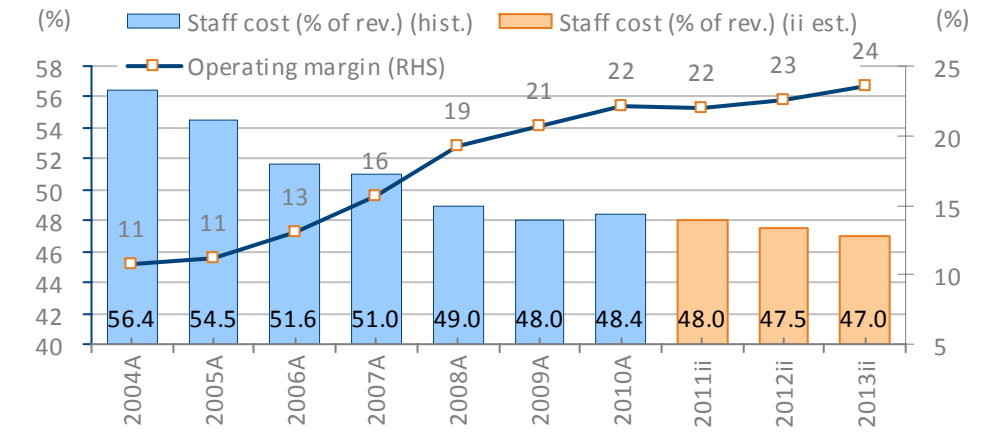
As the group completes its S\$200m expansion plan FY13ii, we estimate the free cash flow to more than double to S\$117m in FY14ii as compared to S\$44m in FY13ii (S\$51m in FY10ii)

## Margins have the potential to expand over long term

Given that Raffles Medical employs all of its medical practitioners under its group practice model, staff costs invariably is the largest cost for the group. In FY10, staff cost represented about 48.4% of the revenue. Over the last few years, with prudent control on staff costs, the group has been able to grow its revenue faster than the growth in staff costs resulting in higher operating margins. Operating margins for Raffles Medical has been on an upward trend and reached 22% in FY10 from 11% in FY04.

We expect staff costs to continue to account for 47-48% of the revenue over FY11ii-13ii. However, we believe that Raffles Medical might be able to attain lower growth in staff costs through greater economies of scale, as the group expands its existing hospital space and sets up a specialist medical centre at Orchard road, Singapore.

**Figure 14: Staff cost as % of revenue versus operating margin**



Source: Company, IIFL Research

We assess the impact of, lower growth in staff cost in comparison with growth in revenue on FY11ii EBITDA margins and FY11ii recurring net profit. Everything else being equal, for every 1% decline in staff cost as a percentage to the total revenue, the net profit increases by 4.5%.

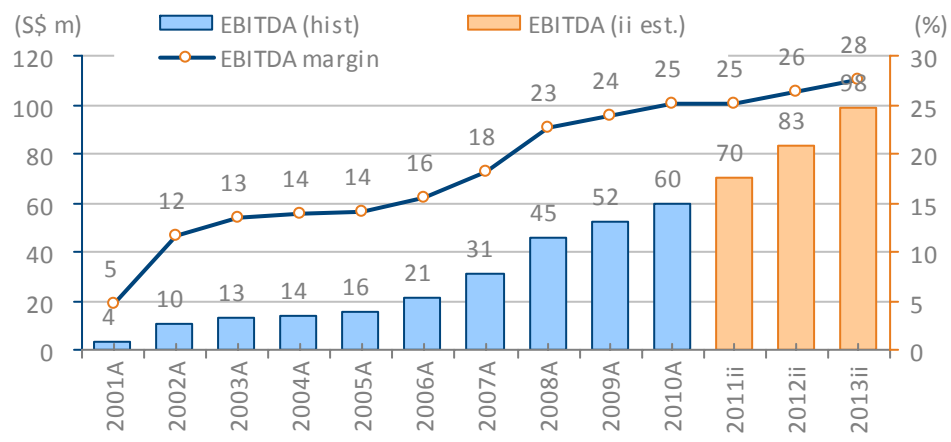
**Figure 15: Earnings sensitivity to changes in staff cost and EBITDA margin**

Staff cost (% of rev.)	Implied EBITDA margin (%)	Net profit (S\$ m)	% change from current est.
<b>FY10 (reported)</b>			
48.41	25.1	42.3	
<b>FY11ii (estimate)</b>			
48.00 (current estimate)	25.2	52.1	
47.50	25.7	53.3	2.3
47.00	26.2	54.4	4.5
46.50	26.7	55.6	6.8

Source: Company, IIFL Research

In addition to the economies of scale resulting into lower growth in staff costs as compared to the revenue, we believe that expansion of the specialist medical services will help Raffles Medical capture higher margins. As discussed earlier, it is evident that the operating margins for specialist medical service provider, Healthway Medical have consistently remained above 30% over FY05-09, in comparison to Raffles Medical's operating margin of just 22% in FY10. As Raffles Medical continues to add more speciality and sub-speciality services to its offerings, we believe that operating margin for the group has the potential to move higher.

**Figure 16: EBITDA and EBITDA margin**



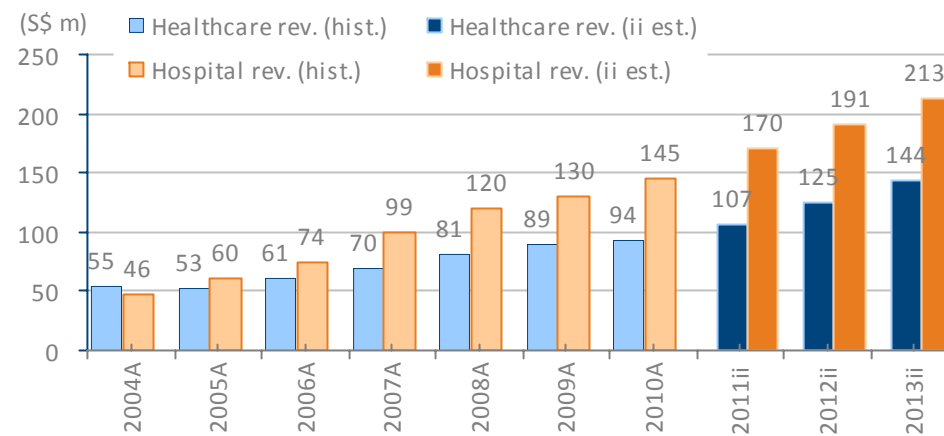
Source: Company, IIFL Research

## Strong financials

### Earnings outlook

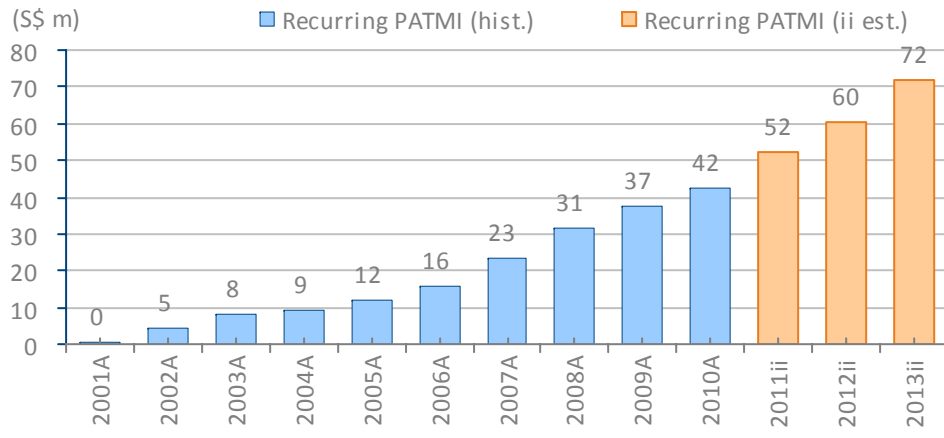
After reporting 90% YoY decline in FY01 recurring profits, Raffles Medical reported 39% recurring net profit CAGR over FY02-07. However, after completing the acquisition of the remaining 50% stake in Raffles Hospital from CapitaLand in FY07, the earnings have reported 22% CAGR over FY07-10. In comparison, we expect Raffles Medical to report 19.2% recurring net profit CAGR and lower 18.8% recurring earnings per share CAGR (accounting for dilution from exercise of outstanding in-the-money options) over FY10-13ii.

**Figure 17: Hospital revenue has outgrown healthcare revenue post acquisition of remaining 50% stake in the Raffles Hospital from CapitaLand in 2007**



Source: Company, IIFL Research

**Figure 18: Earnings to grow 19% annually between FY10 and FY13ii**



Source: Company, IIFL Research

### Strong cash flow business

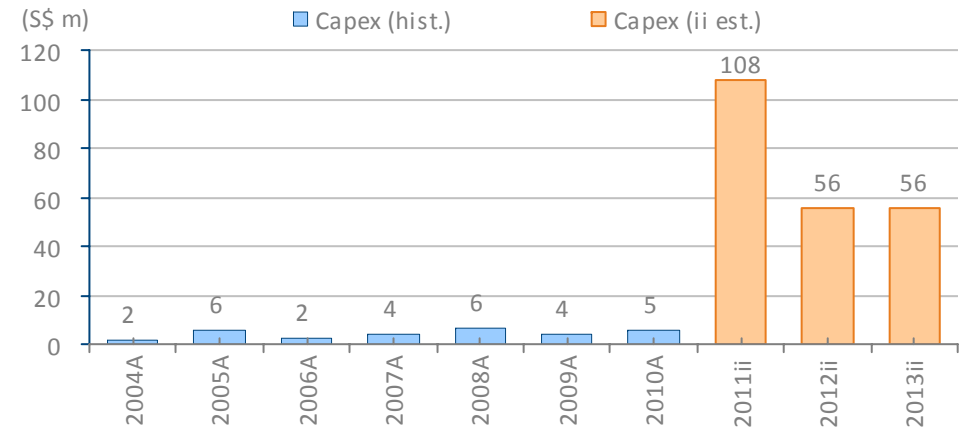
Raffles Medical has historically generated strong free cash flows, as the existing hospital building has been paid for and maintenance capex requirements have been relatively low (\$4m-5m per year).

Raffles Medical spent S\$92m in 1QFY11 to acquire the 42,668 sq ft 7-storey freehold podium/commercial block of Thong Sia Building in Orchard road, which is going to be converted into a specialist medical centre. The conversion of the exiting set-up into a speciality clinic will cost S\$5m-10m, which will be expensed between FY12ii and FY14ii.

In addition, the group plans to spend S\$100m (S\$80m on building and S\$20m on equipment) to expand its current Raffles Hospital. The expansion is expected to be completed by end-FY13ii.

In addition, to the capex related to expansion of the hospital and renovation of the Thong Sia building, we are building-in S\$6m of maintenance capex each year over FY11ii-13ii and beyond (guidance of S\$4m-6m every year).

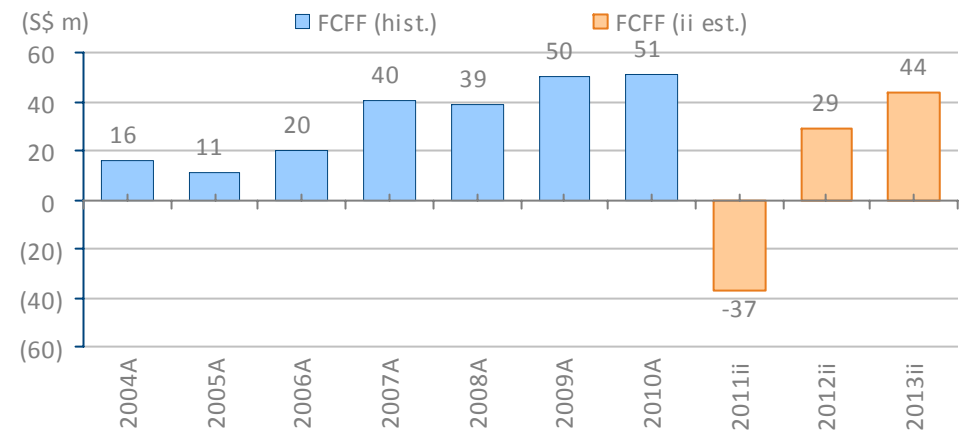
**Figure 19: Most of the planned capex will be expensed by end-FY13ii**



Source: Company, IIFL Research

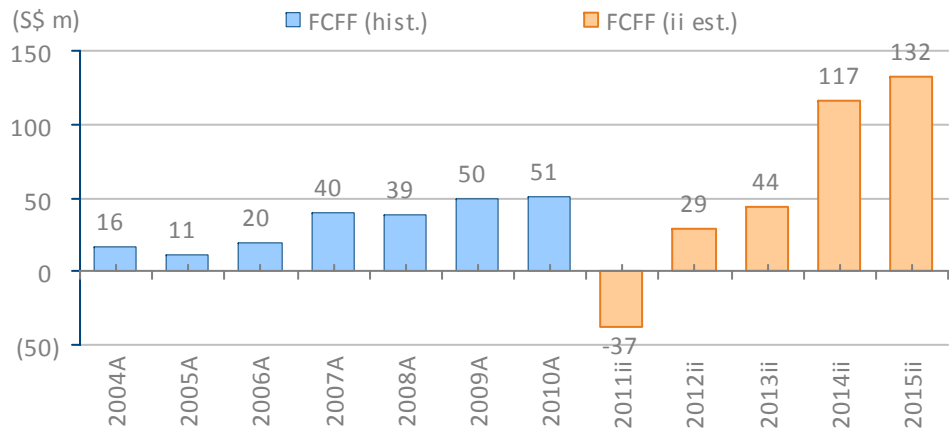
Despite S\$56m of capex spending in FY12ii and FY13ii each, we expect Raffles Medical to generate S\$29m-44m of free cash flow over FY12ii-13ii. We assume the group to take S\$10m of debt in FY11ii and FY12ii each to maintain a stable cash balance.

**Figure 20: FCFF could turn negative in FY11ii, as the group spends on acquisition of the Thong Sia building and construction of the hospital extension**



Source: Company, IIFL Research

**Figure 21: FCFF is expected to double in FY14ii after the group completes the expansion of the hospital and specialist medical centre**



Source: Company, IIFL Research

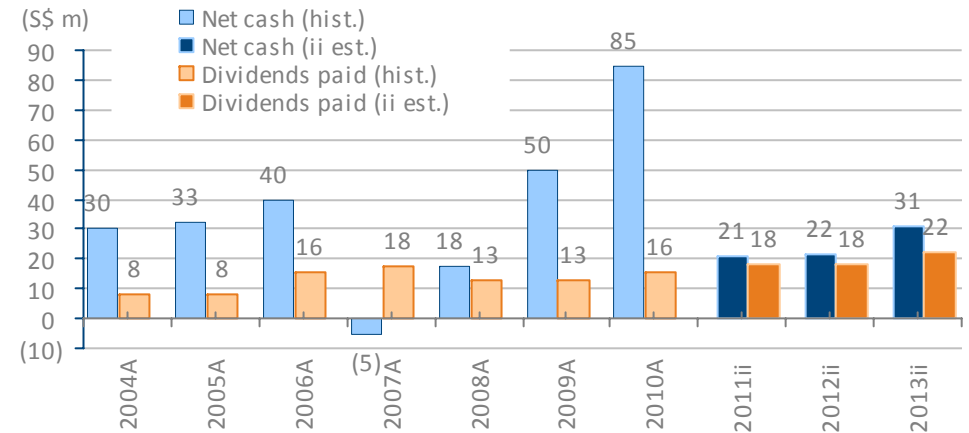
## Dividend payout of 35%

Raffles Medical stopped paying special dividends and cut its dividend from S\$0.040 in FY06 to S\$0.025 in FY07, as the net cash position had turned negative post acquisition of the remaining 50% stake in Raffles Hospital from CapitaLand in FY07. However, since FY07, management has raised the dividend from S\$0.025 annually in FY07-08 to S\$0.035 in FY10, in-line with the rising cash position. Although the group has no clear dividend policy, management aims to retain the current dividend payments (not payout ratio) going forward.

As the group undertakes large amount of capex spending on purchase and renovation of the Thong Sia commercial block and construction of Raffles Hospital extension over the next 2-3 years, we expect the group's net cash position to remain stretched. In-line with Raffles Medical's stretched net cash position over the next two years, we expect management to retain dividend payment of S\$0.035 in FY11ii, before raising it to S\$0.05 by FY13ii. Raffles

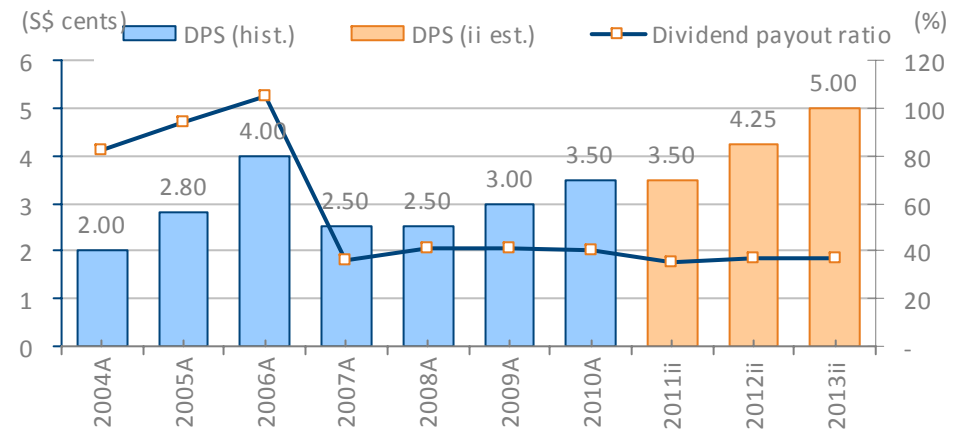
Medical currently offers 1.5% dividend yield for FY11ii and 1.9% dividend yield for FY12ii.

**Figure 22: Stretched net cash position could restrict dividend growth**



Source: Company, IIFL Research

**Figure 23: We expect Raffles Medical's dividend payout ratio to fall below 40%**



Source: Company, IIFL Research

## FY10 - continued to deliver strong results

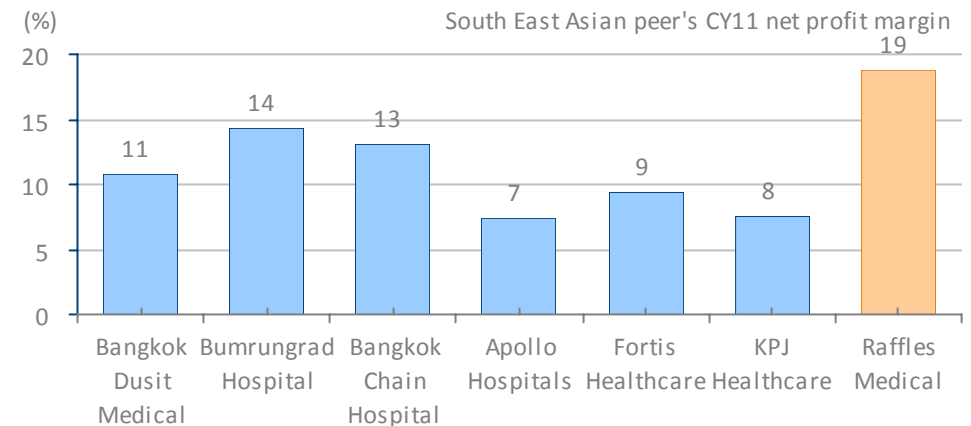
For full-year FY10, Raffles Medical reported recurring net profit of S\$45.3m (+19.5% YoY), while revenue was at S\$239.1m (+9.4% YoY). The growth in revenue was driven by both hospital (+12.1% YoY) and healthcare operations (+6.1% YoY), while the boost to net profit came from 144bps expansion in operation margins; operating margins expanded from 20.7% in FY09 to 22.2% in FY10. In addition to the interim dividend of S\$0.01 announced, Raffles Medical paid a final dividend of S\$0.025, bringing the FY10 dividend to S\$0.035 or 40% payout ratio and 1.6% yield. The balance-sheet continued to remain robust, as the cash balance expanded from S\$74.2m in FY09 to S\$107m in FY10 (FY10 - S\$84.7m net cash).

## Current valuation fails to capture long-term value

### We initiate coverage with ADD; target price of S\$2.65

We initiate coverage on Raffles Medical Group (Raffles Medical) with ADD and target price of S\$2.65. The group's South East Asian peers (excluding KPJ Healthcare) are trading between 17.5x-23.5x CY12 earnings (refer to **Figure 30: Peer comparison**). Although, Raffles Medical's P/E of 20x FY12ii is in-line with the peers, we believe the valuations fail to capture the value in the group's strong and scalable business model, higher net margins (19% for the group against 7.5%-14% for peers) and significant growth potential beyond FY13ii.

**Figure 24: Raffles Medical has higher profitability compared to its peers**



Source: Company, IIFL Research

At 22x 1-year forward earnings, the stock is trading close to +1 standard deviation above its historical average. Although the market could be pricing-in the scarcity factor for healthcare plays in Singapore, the valuation is at a significant discount to recent acquisition valuations in Singapore's healthcare space. In August 2010, Khazanah offered to acquire 76% stake in Parkway at 38.3x

trailing 12-month earnings, and in October 2010, Peter Lim offered to acquire 100% stake in Thomson Medical at 40.0x trailing 12-month earnings.

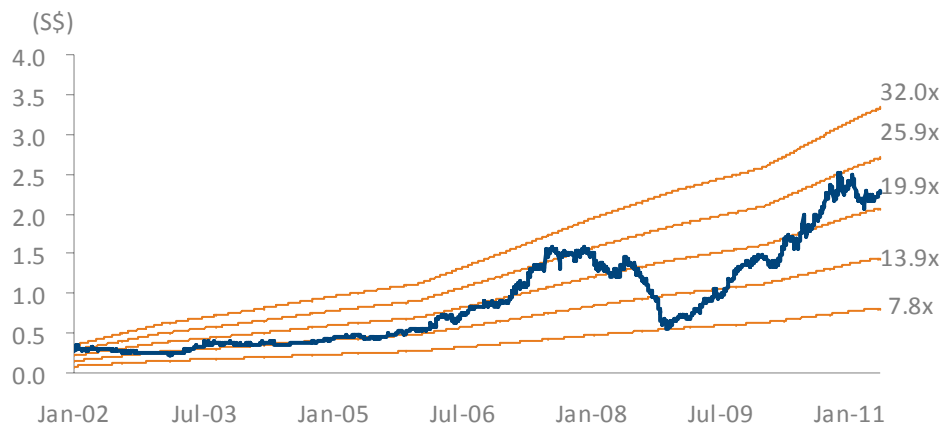
We value Raffles Medical based on 23x FY12ii earnings. Our target price implies FY11ii earnings multiple of 26.8x, against a 3-year earnings CAGR of 19% between FY10 and FY13ii. The stock offers a 1.5% and 1.9% dividend yield for FY11ii and FY12ii, respectively.

**Figure 25: We value Raffles Medical based on FY12ii earning multiple**

Valuation	
FY12ii earnings per share (S\$ cents)	11.4
1-year PE for comparable peers (x)	22.8
Target FY12 earnings multiple (x)	23.0
Implied FY12 price target (S\$)	2.63
<b>Raffles Medical price target (S\$)</b>	<b>2.65</b>

Source: Company, IIFL Research

**Figure 26: PE bands based on 1-year forward earnings**



Source: Company, IIFL Research

**Figure 27: Historical acquisition valuations**

Acquirer	Price on Announcement date (S\$)	Price paid (S\$)	Premium (%)	Trailing valuations		
				P/E	P/B	EV/EBITDA
<b>Parkway</b>						
TPG	1.38	1.69	22.5	19.0	3.4	14.0
Khazanah	3.09	4.11	33.0	43.4	3.6	22.0
Fortis	3.12	3.56	14.1	34.5	2.8	23.0
Khazanah	3.02	3.78	25.2	36.7	2.9	25.0
Fortis	3.57	3.80	6.4	36.9	2.9	25.0
Khazanah	3.88	3.95	1.8	38.3	3.1	26.0
<b>Thomson Med.</b>						
Peter Lim	1.08	1.75	62.0	40.0	3.8	20.2
<b>Raffles Med.</b>						
Temasek	1.30	1.30	-	37.2	3.9	26.1
Qatar Invest.	1.30	1.30	-	37.2	3.9	26.1

Source: Company, IIFL Research

## DCF valuation of S\$3.37 (47% upside)

We assess the DCF value for Raffles Medical's FY11ii–20ii FCFF with a terminal growth rate of 2% at S\$3.37, which implies 47% upside. (see **Figure 29: DCF valuation**).

**Figure 28: DCF assumptions**

DCF assumptions	
Target equity (%)	100.0
Tax rate (%)	15.0
Risk-free rate (%)	3.0
Market risk premium (%)	6.0
Equity beta	0.80
Terminal growth rate (%)	2.00
<b>Weighted average cost of capital</b>	<b>7.80</b>

Source: Company, IIFL Research

## Risks to our rating

Key upside and downside risks to our rating are: 1) substantially better-than-estimated operating results, which will lower the forward valuation; 2) any merger and acquisition activity in the healthcare space resulting in an upward re-rating of valuations; 3) delays in ramping up of expansion plans; 4) failure to add and retain specialist doctors; 5) failure to maintain above 60% utilisation of the operational beds at Raffles Hospital; 6) slowdown in growth in the corporate sector could hurt earnings given its large corporate client base; and 7) disproportionate rise in staff costs.

**Figure 29: DCF valuation**

WACC	7.30			7.80			8.30		
	1.50	2.00	2.50	1.50	2.00	2.50	1.50	2.00	2.50
Perp. FCF Growth (%)									
PV FCFF (\$\$ m)	786.6	786.6	786.6	762.1	762.1	762.1	738.5	738.5	738.5
PV of Terminal Value (\$\$ m)	1,125.4	1,237.6	1,373.2	947.0	1,033.7	1,136.8	802.3	870.2	949.9
% of Agg. Value	59%	61%	64%	55%	58%	60%	52%	54%	56%
Aggregate Value (\$\$ m)	1,911.9	2,024.2	2,159.8	1,709.1	1,795.8	1,898.8	1,540.8	1,608.7	1,688.4
Less Net Debt (\$\$ m)	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8
Less Minority Interest (\$\$ m)	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Equity Value (\$\$ m)	1,889.5	2,001.7	2,137.3	1,686.6	1,773.3	1,876.4	1,518.3	1,586.3	1,665.9
Shares Outstanding (m)	527.0	527.0	527.0	527.0	527.0	527.0	527.0	527.0	527.0
Equity Value per Share (\$\$)	3.59	3.80	4.06	3.20	3.37	3.56	2.88	3.01	3.16

Source: Company, IIFL Research

**Figure 30: Peer comparison**

	Price (LCY)	Market cap (US\$)	FV/ EBITDA		Price / earnings			2-year EPS CAGR	N. margin CY11	ROE CY11	Div. Yield CY11
			CY11	CY12	CY10	CY11	CY12				
<b>Thailand</b>											
Bangkok Dusit Medical	52.0	2,560	10.1	8.6	27.7	22.5	18.8	21.4	10.4	15.5	2.1
Bumrungrad Hospital	37.8	914	10.9	10.1	21.8	19.3	18.1	9.8	14.2	23.1	2.7
Bangkok Chain Hospital	7.4	406	8.7	7.6	19.3	20.1	17.5	5.1	13.1	19.9	3.2
<b>India</b>											
Apollo Hospitals	480.4	1,339	14.1	11.7	43.1	27.9	23.0	36.8	7.4	11.1	1.1
Fortis Healthcare	152.5	1,381	34.4	25.3	58.3	33.9	23.5	57.5	9.4	5.3	-
<b>Malaysia</b>											
KPJ Healthcare	4.1	772	10.8	9.8	18.1	16.0	13.5	15.9	7.5	18.1	3.2
<b>Average (ex RFMD)</b>		<b>7,373</b>	<b>15.5</b>	<b>12.6</b>	<b>34.0</b>	<b>24.4</b>	<b>19.7</b>	<b>28.1</b>	<b>10.0</b>	<b>14.3</b>	<b>1.8</b>
Raffles Medical	2.3	979	16.3	13.7	28.4	23.2	20.0	19.1	18.8	17.1	1.5
<b>Average (with RFMD)</b>		<b>8,352</b>	<b>15.6</b>	<b>12.7</b>	<b>33.3</b>	<b>24.3</b>	<b>19.7</b>	<b>27.0</b>	<b>11.0</b>	<b>14.6</b>	<b>1.7</b>

Source: Company, IIFL Research

## Financial summary

### Income statement summary (\$\$ m)

Y/e 31 Dec	FY09A	FY10A	FY11ii	FY12ii	FY13ii
<b>Revenue</b>	<b>219</b>	<b>239</b>	<b>277</b>	<b>316</b>	<b>357</b>
EBITDA	52	60	70	83	98
EBIT	45	53	61	71	84
Net interest (exp) / inc.	0	0	0	0	0
Exceptional items	0	0	0	0	0
Others items	0	0	0	0	0
<b>Profit before tax</b>	<b>45</b>	<b>53</b>	<b>61</b>	<b>71</b>	<b>84</b>
Tax expense	-7	-8	-9	-10	-12
Extraordinary items	-1	-3	0	0	0
<b>Net Profit</b>	<b>37</b>	<b>42</b>	<b>52</b>	<b>60</b>	<b>72</b>

### Cash flow summary (\$\$ m)

Y/e 31 Dec	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	45	53	61	71	84
Depreciation & amortization	7	7	9	12	14
Tax paid	-8	-7	-9	-10	-12
Working capital change	0	-2	1	1	1
Other operating items	0	0	0	0	0
<b>Operating cash-flow</b>	<b>45</b>	<b>51</b>	<b>62</b>	<b>74</b>	<b>87</b>
Capital expenditure	-3	-5	-108	-56	-56
<b>Free cash flow</b>	<b>42</b>	<b>46</b>	<b>-46</b>	<b>19</b>	<b>32</b>
Equity raised	4	10	1	1	1
Investments	0	0	0	0	0
Debt financing / disposal	-2	-2	10	10	0
Dividends paid	-13	-16	-18	-18	-22

Source: Company data, IIFL Research

### Balance sheet summary (\$\$ m)

Y/e 31 Dec	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	74	107	54	64	74
Other current assets	30	31	37	41	47
Fixed assets	146	144	243	287	328
Intangible assets	0	0	0	0	0
Other assets	86	89	89	89	89
<b>Total assets</b>	<b>337</b>	<b>372</b>	<b>423</b>	<b>481</b>	<b>537</b>
Short-term debt	5	5	5	5	5
Other current liabilities	61	61	67	73	79
Long-term debt	20	18	28	38	38
Other long-term liabilities	1	2	2	2	2
Minority	0	1	1	1	1
<b>Net worth</b>	<b>250</b>	<b>286</b>	<b>321</b>	<b>363</b>	<b>413</b>

### Ratio analysis

Y/e 31 Dec	FY09A	FY10A	FY11ii	FY12ii	FY13ii
<b>Growth ratios (%)</b>					
Sales growth	8.9	9.4	16.0	13.8	13.2
EBITDA growth	15.1	14.8	16.6	19.0	18.3
EBIT growth	16.9	17.0	15.0	16.7	18.5
<b>Margins (%)</b>					
EBITDA margin	23.9	25.1	25.2	26.3	27.5
EBIT margin	20.7	22.2	21.9	22.5	23.6
Net profit margin	17.1	17.7	18.8	19.1	20.0
<b>Return ratios (%)</b>					
Return on assets	11.5	11.9	13.1	13.4	14.1
Return on equity	15.8	15.8	17.1	17.7	18.5
<b>Other key ratios (%)</b>					
Dividend payout ratio	41.1	40.5	35.4	37.1	36.9
Tax rate	15.6	14.3	14.2	14.3	14.2
Net debt / equity	-19.9	-29.6	-6.6	-5.9	-7.5

Source: Company data, IIFL Research

## Key to our recommendation structure

**BUY** - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

**SELL** - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the risk-free rate of return + equity risk premium.

**Add** - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

**Reduce** - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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