ICRA Lanka revises the ratings of Nawaloka Hospitals PLC to [SL] BBB(Negative) from [SL] BBB+(Stable)

September 5, 2019

Instrument*	Current Rated Amount (LKR Mn)	Rating Action
Issuer Rating	N/A	Revised to [SL]BBB with Negative Outlook from [SL]BBB+ with Stable Outlook
Senior Unsecured Redeemable Debenture(*issued on 30th Aug 2015)*	457.2	Revised to [SL]BBB with Negative Outlook from [SL]BBB+ with Stable Outlook
Senior Unsecured Redeemable Debenture(*issued on 30th Aug 2015)*	1,042.8	Rating withdrawn

Rating action

ICRA Lanka Limited, Subsidiary of ICRA Limited, Group Company of Moody's Investors Service has revised the Issuer rating, assigned to Nawaloka Hospitals PLC's ("NHL"/"the Company") to [SL]BBB (pronounced S L triple B) with Negative outlook from [SL]BBB+ (pronounced SL triple B plus) with Stable outlook. ICRA Lanka has also revised the issue rating to [SL]BBB (pronounced S L triple B) with Negative outlook from [SL]BBB+ (pronounced SL triple B plus) with Stable outlook for the Company's LKR 457.2 Mn Senior Unsecured Redeemable Debenture Programme, which is currently listed on the Colombo Stock Exchange. At the request of the Company, ICRA Lanka has withdrawn the rating outstanding for Senior Unsecured Listed Redeemable Debenture programme, amounting to LKR 1,042.8 Mn as this has been redeemed.

Rationale

The revision of the ratings and outlook take into account the deterioration in the Company's liquidity position amidst the weak financial performance of the Company during FY2019. The revision also takes into consideration the deterioration of the Company's capital structure and coverage indicators on account of higher than expected debt funded capital expenditure, which has resulted in increase in the gearing from 2.71(x) as on Mar 2017 to 3.42(x) as on Mar 2019. During FY2019, the Company has fully completed the new Multistory Carpark & Specialist Center and this facility was fully operationalized during this period. The total cost of this facility has exceeded ~LKR 6.8 Bn. Apart from this project, the Company had also incurred capex for other equipment and machineries during FY2019, which was also partly funded by internal accruals. While the capex of this nature is expected to further help the Company in debottlenecking its operations and addressing infrastructure issues, which had previously resulted in low occupancy levels for the flagship hospital; the ability of the Company to stabilize and translate the benefits of this multistory facility into an improvement in revenue and profit margins, would be key to generate sufficient cash flows for servicing the debt and therefore, this remains as a sensitivity factor.

The ratings also factor in the strong brand name and operational track record of the Company, witnessed by the healthy market share enjoyed by NHL in Sri Lanka's private sector healthcare industry. Over the years, the Company has been able to leverage its locational advantage to attract leading healthcare consultants, which has aided in consistent expansion of service offerings, leading to healthy revenue growth ~17.00% YOY during FY2018 vis– a–vis YOY 9.5% revenue growth in FY2019.

ICRA Lanka also factors positively the favorable long term-demand outlook for the healthcare industry, which is expected to witness a sharp increase in demand, driven by increasing medical insurance penetration and lifestyle related disorders. Given the physical limitations of the public healthcare system, incumbent private players (especially those who are expanding the operations) are expected to benefit from the same.

NHL is also one of the few private sector groups to recently expand its services into the lab diagnostics business. The revenue contribution from the new laboratory operation has witnessed an improvement during FY2018/19. The new laboratory operation is currently carried out as a wholly owned subsidiary under the technical collaboration with a foreign player-Green Cross Group, South Korea. The ability of the Company to attract and retain quality manpower, while realizing the targeted revenue growth from the higher margin-service segments as envisaged, would be critical to augment overall cash flows and therefore, this remains to be reviewed going forward.

These positives are partially offset by the rising competition and regulations in the industry, which is likely to exert some pressure on the profitability margins of incumbents and NHL's reliance on government sector consultants to drive operations (an issue faced by the private sector in general). Inability to match pricing actions in line with rising wages for employee and consultants could also exert pressure on the margins. The weaker macro-economic conditions that prevailed during FY2019, have also affected the overall private healthcare industry in Sri Lanka. Therefore, most industry players (including NHL) have experienced a weaker financial performance during this period. Further, with NHL's higher debt repayment obligations amidst the increased debt levels, compared to the current cash accruals during FY2019, the Company has faced some liquidity pressure. However, some comfort is drawn from the recent debt-restructuring exercise, which is being currently carried out to refinance the higher capital payment commitments over the next two years, with longer tenure debt facilities.

Key rating drivers

Credit strengths

Experience of the promoters and the strength of the Group: The ratings consider favorably the experience of the promoters, the management team and NHL's strong operational track record, which have enabled the Company to record healthy growths in revenues and profits over the past several years. Although, until CY2014, the Company had operated only in Colombo, the Company opened a standalone hospital under Nawaloka Medicare (Pvt) Ltd in Negombo with 75 beds. Moreover, during FY2018, Nawaloka Medicare had expanded its operation into Gampaha. Besides, the Hospital business, the promoters also have interests in educational/nursing center, aviation, construction and an engine oil marketing.

Strong brand name and dominant market share in the private healthcare sector; Commencing operations in 1985, as the first private sector hospital in Sri Lanka, the Nawaloka group has over the years established a strong brand name in the Sri Lankan healthcare industry, where the name 'Nawaloka' is synonymous with private healthcare system in Sri Lanka. Currently, NHL is the second largest hospital chain in Sri Lanka with a total capacity of 470 beds and a total market share of about 25% in the premium segment. Further, the strong brand, modern facilities (including the newly constructed Multistory Carpark & Specialist Center) and the central location has enabled the hospital to attract reputed consultants/ specialists from state hospitals, especially from Colombo general hospital.

Long-term demand prospects in the healthcare segment: ICRA Lanka factors positively the favorable long term-demand outlook for the healthcare industry, which is expected to witness a sharp increase in demand, driven by increasing medical insurance penetration and lifestyle related disorders. Given the physical limitations of the public healthcare system, the Company is in a better position (compared with the industry competitors) to benefit from long term industry prospects, given the expansion of their capacity levels with the new Multistory Carpark & Specialist Center.

Credit challenges

Rising competitive as well as regulatory pressures could adversely affect the Company's profit margins: The competition has been intense in the sector, despite ample growth opportunities. While the public sector caters to bulk of the market, in the private sector space, the five key players -Asiri Hospital PLC, Lanka Hospitals PLC, Hemas Hospital PLC Durdans Hospital PLC and the Company- compete aggressively. The same has led to poaching of talent, leading to pressure on wages. Although, GOSL had introduced some regulations into the essential pharmaceutical products during FY2018, the impact from the same on the private healthcare operators were very minimal. During FY2019, although, some regulations into surgical & diagnostic segments were proposed by GOSL, these were not strictly implemented during this period.

The Company's exposure to policy directives and other macroeconomic volatilities: the healthcare sector in Sri Lanka is largely dependent on imports for the supply of drugs and medical devices. Therefore, the depreciation of Sri Lankan rupee is likely to affect the profitability margins of this sector to an extent, although the private healthcare operators could pass on most cost increases through a regulated price formula. Given that the private healthcare system in Sri Lanka is largely dependent on the price-sensitive middle income category of the country, the health of the economy also determines the level of demand for private healthcare vis-à-vis public healthcare services. Also, the corporate tax rate on the health sector has been increased from 12% to 28% in FY2019. Therefore, these factors have exerted some pressure on the profitability margins during this period.

Increased financial leverage on the back of debt funded capital expenditure programs: The Company has recorded a healthy revenue growth in the past years, supported by its strong brand name, capacity expansion and growing consultant base. During FY2018, the Company had recorded a turnover of LKR 7,955.3 Mn, a YOY 26.3% growth from FY2017. This was largely due to the growth in the in-patient segment and the consolidation of financial performance of new laboratory operation, Nawaloka Green Cross Laboratories (Pvt) Ltd. Moreover, during FY2019, the Company has recorded a revenue of LKR 8,727.8, a YOY 9.7 % from FY2018. This was largely contributed by the growth in the outpatient segment of the Company. The operating profit margins during FY2019, have moderated to 16.5% from 17.8% and 20.3% in FY2017 and FY2018 respectively. This is largely attributable to the higher revenue contribution from the service portfolios, favoring lower mix of profitable revenue streams, amidst the weaker macro-economic conditions that prevailed during this period and downward pressure on the price of most basic healthcare services during this period under review. The Company's PAT has also declined to a net loss of LKR 280 Mn in FY2019 from a net profit of LKR 180 Mn in FY2018 and LKR 240 Mn in FY2017. The moderations in net profits in FY2018 and FY2019 are largely on account of increase in interest costs amidst the large debt-funded capex for Multistory Carpark and Specialist Center.

As a result of the recently debt funded Multistory Carpark & Specialist Center, the Company's capital structure deteriorated with a gearing level of 3.42(x) in FY2019 from 3.35(x) and 2.64(x) in FY2018 and FY2017 respectively. Correspondingly, the debt service indicators (interest cover and TD/OPBDITA) have also deteriorated. Although, the Company enjoys good banking relationships and has access to capital markets (being a listed entity), which has also enabled the Company to refinance its higher annul repayment dues during Q1FY2020, with longer tenure-debt facilities, the Company still has large annual repayment commitments (~LKR 1.00 Bn annually) over the next 4-5 years. Therefore, the ability of the Company to successfully implement the new business plans as envisaged and thereby further improve the profitability metrics remains critical to support repayment of the restructured debt obligations going forward. Therefore, this remains as a key rating sensitivity going forward.

Lack of trained manpower availability; rising wage costs on foreign hires: Generally, the private healthcare sector has faced an acute shortage of trained medical practitioners. The inability of private hospitals to attract the services of specialist consultants could significantly reduce the demand for private hospitals. Specialized consultants opt for the public sector because of better exposure, opportunity for further training, and for benefits such as tax free income. The competition among private players to attract skilled staff has resulted in significant cost escalations in the private healthcare sector in the last few years. The shortage of human resources is not only limited to doctors, but also to availability of other medical staff, such as trained nurses. However, ICRA Lanka notes that the Company continues to train new nurses through the Nawaloka College of Health (separately owned by the promoters of the group) and this has helped the Company to infuse new talent while rationalizing staff costs.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below**.**

Links to applicable criteria: *www.icralanka.com/images/pdf/Corporate%20Rating%20Methology.pdf*

About the Company:

Incorporated in the year 1982 by the late Mr. Deshamanya H K Dharmadasa, Nawaloka Hospitals PLC ("Nawaloka"/"the Company") is a leading private sector hospital chain in Sri Lanka. The business commenced operations in September 1985 and currently has 470 operational beds (including Negambo regional Hospital), being operated under four separate entities. Nawaloka is listed on the Colombo stock Exchange with the next generation of the promoter, holding a majority share (~65%). All of the hospitals are operated as wholly owned subsidiaries of the Company. During FY2018, Nawaloka has also started a standalone fully functional referral based laboratory through a technical partnership with Green Cross Group-South Korea.

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