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

June 25, 2020

Instrument*	Rated Amount (LKR Mn)	Outstanding Amount (LKR Mn)	Rating Action
Issuer Rating	N/A	N/A	Revised to [SL]BBB- with Negative Outlook from [SL]BBB with Negative Outlook
Senior Unsecured Redeemable Debenture(*issued on 30th Aug 2015*)	1,500	186.6	Revised to [SL]BBB- with Negative Outlook from [SL]BBB with Negative Outlook
Senior Unsecured Redeemable Debenture(*issued on 30th Aug 2015*)	1,500	270.6	Rating withdrawn

Rating action

ICRA Lanka Limited has revised the Issuer rating, assigned to Nawaloka Hospitals PLC ("NHL"/"the Company") to [SL]BBB- (pronounced S L triple B minus) with Negative outlook from [SL]BBB (pronounced SL triple B) with Negative outlook. ICRA Lanka has also revised the issue rating to [SL]BBB- (pronounced S L triple B minus) with Negative outlook from [SL] BBB (pronounced SL triple B) with Negative outlook for the Company's outstanding LKR 186.6 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 At the request of the Company, ICRA Lanka has withdrawn the rating for the matured amount of LKR 270.6 Mn of the Senior Unsecured Listed Redeemable Debenture programme.

Rationale

The revision of the ratings take into account the deterioration in the Company's liquidity position amidst the weak financial performance of the Company during 9MFY2020. 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 2.35(x) in FY2018 to 3.86(x) and 3.91(x) in FY2019 and 9MFY2020 respectively. During FY2020, the Company has faced operational challenges, amidst the exceptional events such as Easter Sunday Bomb Attacks and Covid-19 Pandemic that took place during this period. However, this impact was largely mitigated by the price-increases of most healthcare services of the Company, despite the slowdown in the outpatient healthcare segment owing to the increasing competition of the private healthcare sector and the significant cost saving measures that were carried out during this period,. During FY2019/20, the Company has fully completed the final phase of the new Multistory Carpark & Specialist Center, while this facility was operationalized during the past two years. The total cost of this facility has exceeded ~LKR 6.8 Bn (without interest capitalizations). Apart from this project, the Company had also incurred capex for other equipment and machineries during FY2020, 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 sustain the current operating profit margins, would be key to generate sufficient cash flows for servicing the debt and therefore, remains 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. ICRA Lanka also factors positively the favorable long term-demand outlook for the healthcare industry. 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.

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). The weaker macro-economic conditions that prevailed during past few years, have also affected the overall private healthcare industry in Sri Lanka. Therefore, with NHL's higher debt repayment obligations amidst the increased debt levels, compared to the current cash accruals during 9MFY2020, the Company has faced some liquidity pressure. This was further exacerbated by the business disruptions in the aftermath of COVID-19 Pandemic and the Company has opted for the Central Bank's debt moratorium during Q1FY2021. This has helped the Company to ease the liquidity pressure to a larger extent. Further, 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

Outlook: Negative

The Negative outlook reflects ICRA Lanka's expectations that NHL would experience some liquidity pressure amidst its higher debt levels, taken up for the construction of Multistory Car Park & Specialist Center.

Key rating drivers

Credit strengths

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. The strong brand, modern facilities (including the newly constructed Multistory Carpark & Specialist Center) and the central location have not only helped the hospital to retain reputed consultants/ specialists from state hospitals, especially from Colombo General Hospital but also to attract new premium customer base. In CY 2014, the Company opened a standalone hospital under Nawaloka Medicare (Pvt) Ltd in Negombo with 75 beds. During FY2018, Nawaloka Medicare had also expanded its operation into Gampaha. During FY2020, Nawaloka Hospital has received the gold accreditation from Joint Commission International (JCI).

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, 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. This facility has not only helped the Company to eliminate its previous capacity constraints, but also to access a new premium market in the local healthcare industry. ICRA Lanka also notes positively the reduction in corporate tax rate on the health sector from 28% in FY2019 to 12% in FY2020. NHL is also one of the few private sector groups to recently expand its services into the clinical/medical diagnostics business. The revenue contribution from the new clinical laboratory operation has witnessed an improvement during FY2019/20. 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.

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 NHL- compete aggressively. The same has led to poaching of talent, leading to pressure on wages. During FY2020, the company's outpatient healthcare services have slowed down amidst the increasing competition in the private healthcare system in Sri Lanka. Although, GOSL had introduced some regulations into the essential pharmaceutical products in the past, the impact from the same on the private healthcare operators were very minimal. During FY2019/20, 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 (for pharmaceutical products). 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. Therefore, going forward, these factors are likely to exert some pressure on the profitability margins of the Company.

Increased financial leverage on the back of debt funded capital expenditure programs: Although, the Company had recorded a healthy revenue growth in the past years, supported by its strong brand name, capacity expansion and growing consultant base, during 9MFY2020, the Company's turnover has increased marginally by 1.1%(annualized) to LKR 6,640.6 Mn from FY2019. This was largely attributable to the exceptional events that have took place during this period. The Company's operating profit margins during 9MFY2020, have increased noticeably amidst the price revisions of most healthcare services during this period. The Company's PAT has increased to LKR 42 Mn in 9MFY2020 from a net loss of LKR 565 Mn in FY2019. The improvement in net profits in 9MFY2020 was largely on account of increase in operating profit margins despite the higher finance costs owing to 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 3.91(x) in 9MFY2020 from 3.86(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 FY2020, with longer tenure-debt facilities, the Company still has large annual repayment commitments (~LKR 900 Mn annually) over the next 4-5 years. Therefore, the ability of the Company to successfully implement the new business plan as envisaged and thereby further improve the profitability metrics remains critical to support repayment of the restructured debt obligations going forward. This remains 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. Specialized consultants opt for the public sector because of better exposure, opportunity for further training, and for benefits such as tax free income. These consultants could only practice in the private hospital systems during their off-duty periods. This has not only affected the demand for private hospitals but also affected the ability of the private hospitals to fully utilize its capacity levels. However, this risk is mitigated to an extent by permanent/resident medical practitioners in the private healthcare system. 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 Nursing School , which 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: https://www.icralanka.com/corporate-rating-methodology/

About the Company:

Incorporated in the year 1982 by the late Mr. Deshamanya H K Dharmadasa, Nawaloka Hospitals PLC ("NHL"/ "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 Negombo regional Hospital), being operated under four separate entities. NHL 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, NHL had also started a standalone fully functional referral based clinical laboratory operation through a foreign technical collaboration.

Key Group Financial Indicators (audited)

Revenue and profitability indicators -Figs are in LKR Mn	FY14	FY15	FY16	FY17	FY18	FY19	9MFY20*
Operating Income	3,993.5	4,602.4	5,860.2	6,299.9	7,955.3	8,755.7	6,640.6
OPBDITA	725.0	684.9	1,022.4	1,124.0	1,618.6	1,435.2	1,403.0
PAT	209.0	84.3	206.0	240.9	180.0	-565.1	42.9
ROCE (%)	9.9%	6.0%	9.7%	10.3%	11.2%	5.9%	9.3%
Total Debt	2,552.5	3,867.4	6,179.2	8,290.4	10,626.7	9,746.7	10,043.8
Networth	2,912.1	2,896.8	3,004.0	3,143.1	3,175.0	2,525.2	2,568.1
Gearing (x)	0.88	1.34	2.06	2.64	3.35	3.86	3.91
OPBDITA/Interest & Finance Charges(x)	3.59	2.40	2.75	2.49	2.62	1.21	1.64
Total Debt/OPBDITA (x)	3.52	5.65	6.04	7.38	6.57	6.79	5.37

**Unaudited Financials*

ICRA

Rating history for last three years:

Instrument	Current rating (FY20) Type	Amount Rated (LKR MN)	Chronology of Rating History for the past 3 years Date & Rating in June 2020	Date & Rating in August 2019	Date & Rating in July 2018	Date & Rating in May 2017
Issuer rating	N/A	N/A	**[SL]BBB- (Negative)**	**[SL]BBB (Negative)**	**[SL]BBB+ (Stable)**	**[SL]A- (Negative)**
Issue rating	Unsecured listed debenture	186.6	**[SL]BBB- (Negative)**	**[SL]BBB (Negative)**	**[SL]BBB+ (Stable)**	**[SL]A- (Negative)**

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