ICRA

Indian Hospital Sector:

Despite the regulatory headwinds, outlook on the sector remains stable

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Executive Summary

HIGHLIGHTS

- The National Pharmaceutical Pricing Authority (NPPA) has imposed 30% cap on trade margin earned on sale of 390 oncology drugs. The regulatory action is likely to adversely impact the margins of the hospital chains, particularly those who have high dependence on the oncology segment. In the last two years, the NPPA has imposed price caps on cardiac stents, knee implants and the current order by the NPPA adds on to the list of products already placed under price restrictions.
- Ayushman Bharat - Pradhan Mantri Jan Aarogya Yojna (AB-PMJAY) continues to face challenges in implementation; nonetheless, despite the initial teething problems, the scheme holds promise in providing much-needed healthcare to the marginalised section of the society.
- After two years of subdued performance, the aggregate performance of sample companies has likely bottomed out and has shown some improvement in performance in Q3 FY2019.
- Despite headwinds of regulatory restrictions, outlook on the sector remains stable, as demand is expected to continue to rise steadily, given the underlying fundamentals including a growing population, increasing life expectancy, rising incidence of non-communicable lifestyle diseases, growing per capita spend, increasing penetration of health insurance and double-digit rise in medical tourism.

OVERVIEW

Regulatory Restrictions Placed by National Pharmaceutical Pricing Authority (NPPA)

The National Pharmaceutical Pricing Authority (NPPA) has, through the order dated March 8, 2019, put a cap of 30% on the trade margin earned on 390 drugs, that are used for treatment of cancer. The action by the NPPA will lead to reduction of up to ~87% (range of reduction being 1-87%) in the prices of the anti-cancer drugs. In the last two years, the NPPA has imposed price caps on cardiac stents, knee implants and other drugs and the current order by NPPA adds on to the list of products already under price restrictions. Most of the cancer-related drugs are high-value medicines and are sold directly through the hospital chains.

Further, Oncology is one of the highest value-added-specialty for the hospitals and is one of the fastest growing ones due to increasing cancer-related ailments. Hence, the order is likely to impact the profitability of the sector. Nevertheless, the impact on profitability may be moderate as hospitals may look for alternative brands/substitute. Additionally, ICRA expects the hospitals to increase the margins on services/tariffs, at least partially offsetting the margin pressure on drugs on account of this order.

Aayushman Bharat - Pradhan Mantri Jan Aarogya Yojna (AB-PMJAY)

The scheme was announced in February 2018 and was formally launched in September 2018. After six months of the launch, challenges remain in effective implementation of AB-PMJAY- the scheme has issued 2.4 crore e-cards, out of the target population of ~50 crore; thus, the coverage is right now low, at 5% and there is a long way to go to improve the same. Further, many of the large private sector hospitals have not empaneled under the scheme, primarily on account of the low package rates. Additionally, while states like Odisha and Delhi have not participated in the PMJAY till date, some like West Bengal and Chhattisgarh have already pulled out of it.

In the budget for FY2020, Rs ~6600 crore has been earmarked for the AB-PMJAY in FY2020, up by ~1.5 times, from Rs. 2700 crore in FY2019. Though the budgetary allocation has gone up, much more is needed, especially as the number of beneficiaries is expected to increase substantially. As coverage improves, the funding requirement will rise multifold and may prove to be a strain on the Governments' finances. Nonetheless, with abysmally low insurance penetration and high out-of-pocket expenditure on healthcare in India, the scheme continues to hold promise to provide much-needed healthcare coverage to marginalised sections of society.

ICRA continues to believe that the introduction of NHPM is likely to improve the occupancies at implementing hospitals albeit with lower profit margins. The scheme is expected to be a major positive for hospitals in Tier II and III cities and smaller towns, particularly for healthcare facilities which have low occupancies and/or those that are positioned for affordable care. With an increase in patient volumes and occupancies, the viability of such private hospitals is expected to improve.

Performance of Hospital Companies in ICRA's Sample Set

The regulatory action from the NPPA comes when the performance of the companies in ICRA's sample set[1] has likely bottomed out and has shown an improvement in Q3 FY2019 after posting subdued performance for two years: starting from CY2017 (due to cap on pricing of cardiac stent) and continuing in H1 FY2019 and FY2018. The companies in ICRA's sample set reported a healthy YoY ~10% increase in revenues and 7% rise in earnings before interest, tax, depreciation and amortisation (EBITDA) in Q3 FY2019. This comes against the backdrop of a modest YoY 3% rise in revenues and a 11% fall in EBITDA in H1 FY2019 (the EBITDA had declined both in Q1 as well as Q2 FY2019). Additionally, in FY2018, the sample set had reported the first fall in aggregate EBITDA in over six years and also saw operating profitability hitting a multi-year low, dropping to 11.4% in FY2018 from the peak profitability of 15.7% during this six-year period.

In Q3 FY2019, the aggregate number of operational beds increased by ~4% and the aggregate occupancy level improved to 64.1% from 62.9%. Average occupancy for FY2018 and H1 FY2019 was much lower, at 62.3% and 62.6%, respectively. Prior to Q3 FY2019, on a YoY basis, the occupancy had dropped in five out of the six preceding quarters, partly on account of new capacity becoming operational and partly due to promoter-related challenges and stretched liquidity position being faced by one of the entities in the sample.

Though the performance has now likely bottomed out, the hospital sector's financial profile had been witnessing a deterioration since the beginning of CY2017 due to several factors that have adversely affected its profitability. These include GST, regulatory restrictions, start-up costs of new hospitals and promoter related challenges of one of the entities. Owing to these factors, the Average Revenue Per Operating Bed (ARPOB) grew at a modest 2% in H1FY2019 on a YoY basis, much below the five-year compounded annual growth rate (CAGR) of ~7%. Nonetheless, the ARPOB growth has improved marginally to 4% in Q3FY2019.

Net debt of the companies in the sample set increased to Rs. 6783 crore as on September 30, 2018 as compared to Rs. 3502 crore as on March 31, 2015. As the revenues and margins have been under pressure and the companies have undertaken debt-funded expansion, the debt protection indicators have deteriorated – the interest coverage ratio dropped to 2.03 times in 9MFY2019 from 3.21 times in FY2015 and net debt/EBITDA deteriorated to 3.84 in H1FY2019 from 3.09 in FY2015. As the companies are now at the end of the current capex cycle, the maturity profile of hospitals is improving, impact of regulatory restrictions on pricing of medical devices is waning and management related challenges are settled in the concerned entity, the debt coverage indicators are likely to improve hereafter, sans any new regulatory measure.

Stable Outlook on the Sector

Though the recent NPPA order may have some impact on the profitability, ICRA expects that after two years of muted growth and pressure of margins, the worst is behind for the sector. The hospitals are expected to gradually offset the impact of recent headwinds over the medium-to-long term. Further, the significant capex in the last four years has started contributing to the profitability and start-up costs of new hospitals will be much lower, which will also aid profitability and debt protection indicators. Thus, despite the current headwinds in the sector, ICRA's long-term outlook on it remains Stable as demand is expected to continue to rise steadily, given the underlying fundamentals, including a growing population, increasing life expectancy, rising incidence of non-communicable lifestyle diseases, growing per capita spend, increasing penetration of health insurance and double-digit rise in medical tourism. On the supply side, India currently faces significant shortage of beds and Government investments towards hospital bed addition are limited. This provides private sector players with the opportunity to step in to fill the gap.

ABOUT ICRA

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