Apollo Hospitals Limited

Q2 FY19 Earnings Conference Call Transcript
November 14, 2018

Moderator: Ladies and gentlemen, good day and welcome to Apollo Hospitals Ltd. Q2FY19 earnings conference call. As a reminder, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during the conference call, please signal an operator by pressing "*" and then "0" on your touch tone phone. Please note that this conference is being recorded. I now hand the conference over to Mayank Vaswani from CDR India. Thank-you and over to you sir.

Mayank Vaswani: Good evening everyone and thank you for joining us on this call to discuss the financial results of Apollo Hospitals for Q2 & H1 FY19 which were announced earlier today. We have with us on the call the senior management team comprising Ms. Suneeta Reddy – Managing Director, Ms. Sangita Reddy – Joint Managing Director, Dr. Hariprasad – President of the Hospitals Division, Mr.A. Krishnan – Group CFO and Mr. Obul Reddy – CEO of Apollo Pharmacy.

Before we begin, I would like to mention that some of the statements made in today's discussions may be forward-looking in nature and may involve risks and uncertainties. For a complete listing of such risks and uncertainties, please refer to the investor presentation.

Ms. Suneeta Reddy will briefly cover the operational progress and financial performance for the quarter and half year following which we shall open the floor for Q&A.

Before I handover, would like to remind everyone that documents relating to our financial performance have been shared earlier, this includes a deck on the Re-organization of the Standalone Pharmacy business. I now invite Ms. Suneeta Reddy to cover the highlights of our performance for the quarter.

Ms. Suneeta Reddy: Good evening everyone and thank you for taking time out to join our call. I trust all of you have been able to refer to our earnings documents.

Our growth momentum continues in this quarter. The Company reported a robust performance both in Hospitals and Standalone pharmacies. Q2 Revenues year-on-year grew 15% to Rs. 2,090 crore; aided by Healthcare services growth of 11% and SAP growth of 20%. Existing hospitals revenues grew 9% and New hospitals reported revenues of Rs. 240 crore representing a 23% year-on-year growth.

Overall Q2FY19 Occupancy across the Group was at 5,020 beds or 70%, compared to 69% in Q2 FY18. The occupancy in Mature hospitals was at 3,884 beds or 72%. New hospitals had occupancy at 1,136 beds or 64%.

Q2 Overall EBITDA was at Rs. 258 crore as compared to Rs. 221 crore in Q2 FY18, a year-on-year growth of 17%.

Healthcare services margins were at 18.4% in Q2 FY19 vs. 18.3% in Q2 FY18 aided by New hospitals which reported a 6.1% EBITDA margin for the quarter as compared to a 4.6% EBITDA margin in the last year. Existing healthcare services margins were at 21.7% vs. 21.1% in H1 FY18.

On SAP, the actual revenues in SAP grew 20% on the back of 82 new stores added. SAP EBITDA grew by 42% to Rs. 51 crore. EBITDA margins were at 5.3%.

PAT grew by 11% to Rs. 79 crore. Interest costs were higher by 12% year-on-year at Rs. 66 crore and Depreciation was higher by 11% year-on-year at Rs. 74 crore on account of additional capex in new facilities added. Effective tax rate for Q2 FY19 was 33%.

Mature Hospitals ROCE has crossed the 20% threshold and has reached 21% in H1FY19. SAP ROCE is at 18%. 11 New hospitals with capital employed of over Rs. 1,900 crore will begin contributing to ROCE from the next fiscal.

Present Debt as of 30th Sep 18 is Rs. 3,222 crore; Cash and cash equivalents of Rs 258 crore. Net Debt of Rs 2,964 crore. Debt equity ratio of 0.84. Net Debt to EBITDA of 3.06 times.

Consolidated performance too grew in line with Standalone financials – reporting a 15% Revenue growth and EBITDA growth of 21%.

AHLL reported Revenues of Rs. 148 crore in Q2FY19 with an EBITDA loss of Rs. 14 crore as compared revenues of Rs. 115 crore and EBITDA loss of Rs. 23 crore in Q2FY18.

We believe the quarter’s performance has demonstrated the resilience of our business model which is well diversified across specialties, geographies and maturities. Of the 7,000+ operating beds across the network (excluding AHLL & our managed beds), 13 hospitals with 1,770+ operating beds are new and the progressive increase in volumes and utilization in the quarters ahead will aid EBITDA growth and sustain margin expansion through the rest of the fiscal and beyond.

Our strategy around both services pricing as well as cost optimization has delivered results in our Existing Units. We have also begun to witness an increased offtake in our ‘Assured Pricing Plans’ across units. While providing certainty to patients on cost, the ‘Assured Pricing Plans’ also recognize the intrinsic value of the delivered service itself, rather than individual inputs.

<u>Looking Ahead,</u>

We have a clear and calibrated strategy for each of our business verticals. From a Healthcare services point of view, our short-term focus areas are clear – we will continue to drive asset utilization. Our ‘Centers of Excellence’ are well-established now, and through higher acuity cases in our mix, we are able to deliver a superior margin profile. We have already stated that we will improve our mature hospital

EBITDA margins to 23% over the next few quarters. Strong focus on these fundamentals will ensure that our mature hospitals will continue growing at 10-12%. Our New hospitals, which are currently growing at 20+%, and contributing close to Rs. 1,000 crore of annualized top-line, will continue growing at high teens. As these new units begin delivering higher EBITDA, we expect overall ROCE to be well in the mid-teens over the next three years.

From a medium to long term perspective, it is important to note that healthcare is changing dramatically, and at Apollo Hospitals, we have to harness that emerging opportunity. We have made investments in what we believe are formats of the future.

Apollo Health and Lifestyle Limited, our retail format with Clinics, Day Care Centers, Cradles, Sugar, Dental and Diagnostics is one such investment, catering to the community and primary care space, and leveraging patient preference for short stay and premium birthing experiences. Here, Revenues are growing at a healthy pace, we expect that the entity will achieve EBITDA break-even by mid FY2020, and thereafter deliver healthy returns.

Healthcare delivery is also becoming ubiquitous. In an effort to take care into our patients' homes, we have strengthened our Home Health vertical, which we believe will gain critical mass over time.

The democratization of healthcare is another important trend. Our Digital strategy recognizes the consumer's interest in taking charge of his or her own health, and will seek to engage with each consumer, across the care lifecycle, and across all formats – hospitals, clinics, pharmacies, home health. This opens up a rich source of data and opportunities to maximize wallet share.

More importantly, we believe our Digital and AI work will enrich our focus on Preventive Health and Wellness.

And that brings us to Pharmacy. Our Board today approved the reorganization of the Standalone Pharmacy business. AHEL's SAP business stands at an inflection point requiring greater focus and attention, independent of the hospital business, to fully leverage its potential and growth opportunity, and enable a foray into Digital Commerce and execute an Omni-Channel strategy. Most importantly, we believe this reorganization will help us maximize Shareholder Value and set the platform for "Value Discovery" of the pharmacy business at a later stage, through a regulatory compliant structure.

Overall, the SAP business will be grown to achieve a revenue of Rs. 10,000 crore and 5,000 stores over 5 years. Contribution from private labels will double from 6% currently to 12%. We will deliver a combined ROCE of 30%.

Under the reorganization, we will segregate the front-end SAP business into a separate Company – Apollo Pharmacies Limited ('APL') which would carry out the front-end operations of direct sales to retail customers. This would be supported by back-end supply chain which will continue to be housed within AHEL. AHEL will be the exclusive supplier for APL, under a long-term supplier agreement. AHEL will enter into a Brand Licensing Agreement with APL for use of the "Apollo Pharmacy" brand.

As far as the impact on AHEL is concerned, we will still be able to retain 85% of the business economics in the books of AHEL, and will continue to strengthen our back-end capability to fulfil orders of front-end business.

15% of the SAP revenue or approximately 5-6% of overall AHEL revenue will be shifted to the front-end. This amounts to Rs. 600 crore of top-line at current levels. However, given that the SAP business has grown at 20% consistently, we are confident that there will be no significant impact on AHEL topline going forward. Similarly, while 1-1.3% EBITDA will reside in APL, we do believe that overall margins will expand significantly.

We have circulated a separate Press Release and Presentation on the reorganization.

I now open the floor for questions. Dr. Hariprasad, Krishnan, Sangita Reddy and Obul Reddy are here with me to take your questions.

Moderator: We will now begin the question-and-answer session. We have the first question from the line of Kashyap Pujara from Axis Capital.

Kashyap Pujara: My question was mainly related to the recent transaction that has been announced in terms of segregation of the front-end - . I basically seek a clarification on that. You mentioned about regulatory requirement, so has this segregation been mainly driven because of the need of the restriction on FDI and retail that we have? So would that be the key reason for the segregation?

Suneeta Reddy: I think you should not look at it only from a regulatory point of view, because there is also a value discovery opportunity, and we were waiting for SAP to get to these mature margins. So one, we do want omni-channel presence. We do believe that value discovery is important. And we need to do it in a regulatory framework. So compliance and regulatory is also one of the factors.

Kashyap Pujara: Sure. So when you say 15% economics would go to APL, so Rs. 600 crore of topline and typically 5% margins thereof. So essentially, it will be around Rs. 30 crore or Rs. 40 crore sort of EBITDA kind of an impact as far as SAP is concerned. So essentially, the EBITDA margin impact because of this and we continuing to retain 85% would be 1% at the standalone pharmacy level. Would that be a fair understanding?

Krishnan A: That is correct, at the EBITDA level, you are right, approximately Rs. 40 crore in current-term should be shifted to the front-end. But it is also important for you to understand that the cash flows would be even lesser in the front-end, because the front-end pharmacy will also take care of the expansions of the stores at that level through the cash flows generated in the front-end pharmacy. So if you look at the cash flows which is going to be captured in AHEL, it will be even higher than the 85%.

Kashyap Pujara: Okay. So my question was if you look at the operational performance of SAP, it has been pretty encouraging. We have reached 20% ROCE in this quarter. Now we are doing this at this point when we are already at our threshold ROCE's is here. Now how do I basically judge the impact on return on capital employed for the residual 85%, which remains with Apollo Hospitals in terms of economic interest? So could you elaborate in terms of what is the capital-employed which will go there? What will be the cost reduction that we can see? If you can just give us a glimpse of the ROCE for the 85% which remains with us versus the 20% which was there with us before this transaction is segregated, essentially?

Obul Reddy: Yes. As explained, the ROCE is expected to improve further because out of Rs. 800 crore of capital employed currently in the business about Rs. 500 crore capital-employed will move into the new Company. You will see that the capital employed in the back-end will be about Rs. 300 crore with 80% of the economic benefit attributed to that ROCE should improve further. Also given our growth in the past few years, we are growing at 20%, that will further compensate for what we are transferring in terms of the business to the Apollo Pharmacy Limited, the new entity.

Kashyap Pujara: Okay. So just to get this right, when you say 85% is retained with us, would that also include the brand licensing revenues that we are looking at or that would be add-on to that?

Obul Reddy: Including that. Okay, so it would not be brand license to the front-end entity, the front-end entity gets an EBITDA of 1%. So today, at current terms, if you look at 1% out of 5% will move away and the 4% remains, given that we have been growing this business at 20% plus at the revenue level and almost 30% plus at the EBITDA level in the last few quarters. So it should further improve from the current absolute levels. And given that capital employed is sensibly coming down, ROCE should improve.

Kashyap Pujara: Okay. So basically, what you are saying is that if I take the 85% of the economic profits which accrue to us, all in including brand licensing and back-end selling that is involved, the Rs. 500 crore which comes in, so basically, we are looking at a capital employed of Rs. 500 crore and to that extent we are looking at Rs. 160 crore. Is that how you are doing the math?

Obul Reddy: That is right. At the current terms, it is.

Moderator: The next question is from the line of Anubhav Aggarwal from Credit Suisse.

Anubhav Aggarwal: Just continuing on the previous question on the pharmacy business. In the new kind of structure, would it mean that the margins for AHEL will now largely become capped? Basically, all the operating leverage benefits will go to the front-end?

Obul Reddy: No. As explained that the operating expenses will also move there. So to the extent any margin expansion will stay with us, given that the EBITDA maintained at front-end Company is maintained.

Krishnan A: So it is clearly through the combination of supply agreement that we have and also the brand license agreement. Remember that it is some way like a franchisor/franchisee, right. If you look at it, there is the front end is exists only because of the brand of Apollo Pharmacy. So clearly, through the combination of supply and the brand licensing agreement, as we said, almost around it will be an 85% of the overall EBITDA margins will always be with us. And we do not expect over 1% to 1.2% of the EBITDA margins to be in the front-end pharmacy. So the operating leverage will continue to be captured at AHEL.

Suneeta Reddy: And we truly believe that the EBITDA, the absolute EBITDA will increase and the margins over a period of time because the plan for the private label business is to actually double it. And when that happens, you will see an increase in both absolute EBITDA and in margin.

Anubhav Aggarwal: And ma'am, you talked about value discovery here. So the numbers suggest you sold this business or effectively transferred this business at 18x trailing EV/ EBITDA. Is the calculation correct?

Obul Reddy: That is right.

Anubhav Aggarwal: So is that the fair multiple, effectively, you are looking now? Is that the value discovery that you were talking about?

Krishnan A: So that has to get discovered over time. What we have said, obviously yes, obviously, potentially, if you look at the current value at which transactions can be done, that would be the right value. But eventually, this will become even more valuable.

Suneeta Reddy: And during the part of this process, we had Deloitte, KPMG, Luthra & Luthra, all of them together watching on it. So in terms of valuation of 18x, I think that you have to recognize that it was done in a fair manner.

Obul Reddy: Given that it is more a franchisee construct.

Anubhav Aggarwal: Sure. I have one question on the hospital business also. In the Karnataka cluster, we have seen a very sharp decline in utilization in this quarter; so any particular reasons over there?

Dr. Hariprasad In that cluster, we have added a new hospital in Sheshadripuram. So the volumes have been distributed in the Karnataka cluster. Secondly we have been strategically focusing on the payer and the specialty mix with emphasis on the margins. So we have consciously actually stopped some of the low-paying corporates and low-paying patients coming into the hospital. So wherein you would see a lower volume in terms of the Karnataka region, but the revenues have grown and the EBITDA margins have increased significantly.

Anubhav Aggarwal: Okay. I need clarity on one more aspect; this Proton timelines have shifted, is it? Because we earlier mentioned about Fiscal 19 end and we are yet to spend Rs. 300 crore balance amounts. So have the timelines shifted for the same? If yes, then could you state the reasons for the delay?

Krishnan A: So there is some vendor financing which is for the Proton equipment itself. The Proton project itself will actually be phased out over the next one year. It is not going to be operational all of a sudden in a quarter. Because obviously, there are three gantries in that, and each gantry has to be calibrated, and that goes live, I think, 6 months after the first gantry. So we are expecting the go-live date around between the Jan. to March quarter. That is what we are expecting the go-live for the Proton itself and followed by the hospital thereafter. That is the broad plan as it stands. So there will be some of the monies which will definitely move into FY20.

Moderator: The next question is from the line of Saion Mukherjee from Nomura Securities.

Saion Mukherjee: My question is a follow-up from the last question on the pharmacy business. You mentioned Rs. 40 crore, right, of EBITDA that will go into the new Company, and your EBITDA run rate is currently Rs. 200 crore. So it is 20%, right? You were mentioning it is 15%. I just wanted to clarify that first.

Obul Reddy: It also when that really happens in the next financial year, we have to factor the growth that will happen. So we can say we are growing at 20%. So effectively, it goes to 15%.

Saion Mukherjee: Okay. Also your EBITDA margin is slightly less than 5%. I understand that over time it was supposed to expand. Now that entire expansion, where will it happen? Will this expansion happen in the front-end or at the back-end?

Obul Reddy: The expansion will happen in the front end.

Suneeta Reddy: But the growth will be reflected in the back end.

Saion Mukherjee: Okay. I have just one very basic question. When you say front-end and back-end, what exactly is the activity at the back-end? What value does Apollo bring to the table besides the ‘brand’ thing which you mentioned?

Obul Reddy: Apart from the ‘brand’, Apollo has over a period of last few decades of expansion has established a robust supply chain which enables us to enjoy special pricing and better terms. So these things would get us an advantage to the overall system. And then we retain those margins in the manner we structured upon the transaction.

Suneeta Reddy: Also, it is the ability to leverage the strong distribution and supply chain and increase operational leverage.

Obul Reddy: If you look, we have operations in over 20 states. So creating the largest fleets, the delivery mechanics, all that advantage today lies with the Apollo. So apart from the ‘brand’, the entire logistics support will move to the front-end Company as a Company and whatever the private label they will develop, that is under the ownership of existing listed AHEL.

Saion Mukherjee: The exclusive supply agreement is there for a certain period or will it continue for a long time? What is the timeline to that?

Obul Reddy: The brand and supply arrangements are fundamental to the structure, and they will continue very well.

Moderator: The next question is from the line of Sudarshan Padmanabhan from Sundaram Mutual Fund.

S Padmanabhan: My question is around the valuation. I think you mentioned Rs. 40 crore of EBITDA is moving out and I think you are getting Rs. 527 crore or Rs. 528 crore. Would that basically mean it is on an EV / EBITDA of about 13.2x? I mean, if that is the case, it is really not value accretive, right?

Krishnan A: So two things I think that is why it is very important for you to understand that EV/ EBITDA is not the only metric which has to be seen. The discounted cash flows is the basis of the Rs. 527 crore. As I said, we are incurring almost around Rs. 30 crore to Rs. 40 crore of capex every year on the front-end growth. All of this growth will also be spent, growth Capex will also be incurred from the front-end Company. So if you look at the cash flow discounting, obviously, EV/EBITDA is one metric that we use as from our perspective. But if you look at what goes at what is being valued at Rs. 527 crore, as I said, is probably 10% of the cash flows of the pharmacy business and not 15% of the EBITDA. So that is why it is getting reflected as Rs. 527 crore. So this is the yardstick which you should use to look at the overall combined pharmacy business.

Point two, as Obul already articulated, the ROCE of this business will be significantly uplifted in the back-end itself from next year because out of the Rs. 850 crore capital employed that is there, almost around Rs. 500 crore of capital employed is moving to the front-end. And at the back-end level, you will have significant uplift in the ROCE. So the back-end is significantly more valuable than as is visible in the sum of the parts based on EV/EBITDA, because the front is based on the DCF valuation.

S Padmanabhan: Yes, sure. With respect to the other private equity holders and others coming into this entity, is there a hurdle rate which you have promised? Or is there any performance related metric that has been given to the people who are coming in? Secondly, you also mentioned that you have the rights to buy the stakes back from the holder. So what would be the contours of it? I mean, would we be buying the same at a certain IRR? What could be the range of that?

Krishnan A: See, the valuation is always going to be based on fair market value, the current fair market value estimated was Rs. 527 crore. But if you ask us based on the EBITDA that is being estimated by us, between 1% and 1.2% in the front end, we think the range of IRR that they may get would be between 14% to 16%. It is not committed IRR.

Suneeta Reddy: But we do have a call option.

Krishnan A: And it is also important that you realize that out of the Rs. 527 crore, the equity portion which is being brought in by the outside investors is Rs. 106 crore, because there is also a debt which is coming there which will be a Bank borrowing, which will get liquidated through the front-end profits.

S Padmanabhan: I did not understand that. I mean, can you repeat that?

Krishnan A: So the Rs. 527 crore is not all equity rates which is happening there. Out of the Rs. 527 crore…

Obul Reddy: Rs. 143 crore is funded through the equity, and the domestic investors will be putting about Rs. 106 crore. So that will have an exit after some period, at the fair market value.

Krishnan A: The balance is coming through Bank borrowings and debt which will be raised at the front-end Company, which will get liquidated through its own profits.

Moderator: The next question is from the line of Neha Manpuria from JP Morgan.

Neha Manpuria: I am still not able to understand as to how AHEL will be able to expand EBITDA margins, because we already have an entity which supplies to the pharmacy business. So AHEL will just continue to provide those supplies to APL?

Krishnan A: So AHEL currently purchases from a set of manufacturers directly or through distributers, as you are aware. That function continues to be in AHEL. AHEL will continue to do its purchases from distributors, as applicable, and it will in turn supply to the front-end Company. And through that activity, 85% of the top line of the combined pharmacy business still continues to be in AHEL. And almost around 85% of the EBITDA also continues to be in AHEL. The incremental, the brand licensing is made in such a way, it is a percentage of the topline because of which, obviously, some of the operating leverages, which would otherwise be available as a combined entity, will move into AHEL, which is the reason that the EBITDA margins of AHEL will continue on the back-end pharmacy will continue to expand as the overall pharmacy business continues to grow.

Neha Manpuria: So you are trying to say that the brand licensing that is based on the percentage of topline of APL?

Krishnan A: Of total, that is correct, of APL.

Neha Manpuria: Okay, understood. My second question is on the New hospital performance. Navi Mumbai has been turning around well. But if I look at the New hospital EBITDA excluding Navi Mumbai, that has been sort of tepid over the last 2 or 3 quarters after peaking in December last year. Any specific reasons? How should we see the recovery of the new hospitals, ex Navi Mumbai?

Dr. Hariprasad: See, if you actually look at all the New hospitals, there were at least five or six hospitals which were losing on the EBITDA level in the last year at the same time. This year, we have none of our New hospitals losing at all at the EBITDA level. And Navi Mumbai has definitely added on to the EBITDA margins and the EBITDA of the current year. And it has been a high-focus area for us, because investments are large and the hospital has got a lot of operating expenditure on it. So the Navi Mumbai has definitely contributed significantly to the EBITDA of the New hospitals.

Neha Manpuria: But excluding Navi Mumbai, you are saying that all hospitals are performing better than they did last year?

Dr. Hariprasad: Yes.

Suneeta Reddy: I think the way to look at it is this way; last year they were EBITDA negative and for the past two quarters they have been EBITDA positive. Our Navi Mumbai is a quarternary care hospital so you can expect to see quite a dramatic turnaround. With these hospitals, we are focusing on occupancy. So I think the occupancy, has moved from a 52% to 60%. So clearly, there is 8% uplift in this and an overall 23% growth in New hospitals.

Moderator: The next question is from the line of Eshit Sheth from Anvil Wealth Management.

Eshit Sheth: I have a couple of questions on the pharmacy business. In the press release, you have mentioned that you have a plan to take the revenues to almost Rs. 10,000 crore versus the current run rate of close to Rs. 4,500 crore that we have in the pharmacy business. In that, you all have mentioned that the addition of stores would be closer to something like 5,000 pharmacy stores versus 3,200 pharmacy stores that we already have. So what are we looking at? Are we looking at significant same-store sales growth also happening in our existing chain because of which the revenue growth…

Obul Reddy: It is a combination of both expansion and same-store sales growth. Currently we have about 3,200 pharmacy stores and to reach 5,000 pharmacy stores we need about 1,800 stores to be added, which at the current run rate we should be able to add in the next five years. On revenues, if you look at its current growth rate, even if you factor about 2%-3% volume-related lesser growth, we should be able to reach that number.

Suneeta Reddy: And it is also going to be an omni-channel, which is, we are activating the digital presence of the pharmacy network.

Eshit Sheth: The target of 30% ROCE that we talk about; so right now we are closer to almost 20%. So when we grow to almost Rs. 10,000 crore kind of a number, we are talking about margins being at least 2%-3% higher from the current levels?

Krishnan A: So 30% ROCE is what we said, the combined ROCE of the business including the Apollo Pharmacy Limited asset. Overall, combined ROCE would be 30% is what we have said. Clearly, if you look at even the ROCE now for the quarter at 5% EBITDA margins that we have provided, it is already at 20% ROCE on an annualized basis. And getting to a 30% ROCE is also considering a few costs which could be incurred even on the expansion. So that is not something that we have a worry about. And you are right, if you look at the most mature stores now, we have crossed 7% EBITDA margin, it is at 7.4% for the quarter. And clearly, we are seeing that even private label growth is something that will further foster the EBITDA margins to go to over 7%. So our overall target for the pharmacy is 7% over time.

Eshit Sheth: And another way to look at this valuation that we have done, is basically, this Rs. 527 crore that we have received in terms of the slump sale that we did, and we still have 25.5% stake in that. Does that value the entire pharmacy business at close to Rs. 5,000 crore? Is that correct?

Obul Reddy: Yes.

Eshit Sheth: My next question is on the Hospital business. In the last couple of years we have seen a lot of one-off issues that we had with some celebrity patients, then the capping of stent pricing and all of that. Now with all that behind us now, how do you see the overall trajectory for our Hospital business in terms of actually growing on topline as well as EBITDA being much better than top line growth in the next 2-3 years?

Suneeta Reddy: I think we will be able to deliver in excess of 15% topline. We have already proved by two quarters of 15% growth. On a standalone basis, we actually grew by 17%. Our EBITDA have grown by 20%. So clearly, as now that we have built up the capacity, we believe by higher asset utilization, cost optimization, we should also be able to increase EBITDA, improve margins, and therefore, deliver on our ROCE. Also our New hospitals' occupancy is ramping up. We have been able to cover all the fixed costs. So I think, looking forward, you can see that mature hospitals at 23% margin and the New hospitals should move to 20%.

Eshit Sheth: And just one last question I had on AHLL. If I look at AHLL, like, we have done better over the last year in terms of the operational metrics. When do you expect this business to breakeven for us?

Sangita Reddy: So as committed, because of the various improvements, strengthening of team, enhancing of the entire formats and close monitoring as well as some aggressive cost rationalization, we are committed to mid-20, and that target will definitely be met. We also are looking to make sure that this continued growth happens while we keep our focus on cost.

Eshit Sheth: Okay. So this mid-20 is for EBITDA breakeven. Is that correct?

Sangita Reddy: That is correct.

Moderator: The next question is from the line of Nitin Agarwal from IDFC Securities.

Nitin Agarwal: On pharmacy restructuring I need two clarifications. First one being, the question has been asked a few times. So assuming hypothetically, we get like a 3% margin improvement from current levels over the next 5 years, so is the understanding right that 85% of the 3% will be retained in the AHEL, and only 15% of the 3%, which is, say, about 50 bps would be retained by the front end? Is that the right understanding?

Obul Reddy: That is the plan. That is the right understanding.

Nitin Agarwal: Okay. So only so basically, even of incremental EBITDA margin gains, 85% of it will be retained by AHEL, and the balance will stay in APL?

Krishnan A: That is correct. So 1% to 1.2% EBITDA margins will go to the front-end Apollo Pharmacies Limited. The balance will be here. So as we start, assuming that we did this quarter at 5%, and we exit, hopefully at the higher number, 5% minus 1%, 4% will remain in AHEL. 1% will go to Apollo Pharmacies Limited as we start next year. Over a period of time, that 1% will increase to 1.2% to Apollo Pharmacies Limited, and the balance will be in AHEL.

Nitin Agarwal: So 1.2% is a cap for the front-end on the margin?

Krishnan A: Kind of. For the cap, it is the expected range because the licensing agreement will significantly help us extract value into AHEL.

Nitin Agarwal: Sure. And secondly, you mentioned that the equity that the investors are bringing in is only about Rs. 140-odd crore, right?

Obul Reddy: That is right. The total equity, including Apollo.

Nitin Agarwal: Okay. So in terms of, when we are looking to buyout, these investors we will have to give returns only this component of it?

Obul Reddy: Only on the component of the Rs. 106 crore.

Krishnan A: Rs. 106 crore because the balance is from AHEL's investment for the 25%.

Nitin Agarwal: Right. And the balance as you mentioned, the bulk of the other amount which is being raised is through debt, which obviously you can liquidate by the cash flows of business?

Krishnan A: Correct. That is right.

Nitin Agarwal: And secondly on the money that we are raising, to what end are we looking to use this money? Is this money being utilized for the pharmacy growth or for the growth of the overall group, per se?

Suneeta Reddy: So the money will come from APL, it will go into AHEL to reduce debt.

Nitin Agarwal: So at the Group entry level? At the group level?

Suneeta Reddy: Yes.

Moderator: The next question is from the line of Sameer Baisiwala from Morgan Stanley.

Sameer Baisiwala: I have one question on APL. Your DCF-based valuation which has generated, I think, the value of roughly Rs. 4,500 crore for the SAP business. That is a value discovery. AHEL's enterprise value right now is about Rs. 20,000 crore. So roughly, what percentage, you think, has been the value discovery in this?

Krishnan A: So as you said, it should be around Rs. 5,000 crore is the pharmacy value discovery itself basis this number that has happened. The front-end cash flows are roughly 10% and 90% still is in the back-end. So Rs. 527 crore of enterprise value of the front-end represents approximately 10% of the combined cash flows of the pharmacy business. So given that if you use that, we will obviously, there is no valuation done on the back-end or the combined pharmacy. It is only the front-end which was done. So if you use that as a proxy, the over Rs. 5,000 crore valuation is the right number that you should look at for the enterprise value which is embedded in AHEL, which does not have any debt.

Sameer Baisiwala: No, fair point Krishnan. But I am saying that, was the market more or less valuing SAP business at the same level?

Krishnan A: I do not know. I guess, I would not really know that answer exactly because it is people like you who decide the value which is embedded in the overall price. I would think it is still not fully captured.

Sameer Baisiwala: Okay. What is the end game for APL?

Krishnan A: So we have said that at a future date, we have said that we will unlock value in the overall business. So one is, over time, we can figure out how to unlock that value and how the value discovery can happen for the combined business because now this can at a potential future date, the AHEL business along with the front-end, which is APL which is in a regulatory-compliant structure can now be monetized in whatever fashion you think it can be monetized. So it can be monetized, it can be demerged. Those are all things that we will have to over a period of time come to an answer. But this first step helps us for a potential value discovery over time.

Sameer Baisiwala: Why are you moving 15% or 10% of economic value to the front-end but a much larger, I would say a 60%-65% of the capital employed in that entity? Are you not artificially boosting ROCE for AHEL?

Krishnan A: No, that is how the capital employed of that front-end is actually. If you look at it, the assets which is 3,167 stores which is there and the inventory which is being carried in those, apart from the back-end inventory, will still rest with Apollo Hospitals, which is the inventory which is there at the back-end. But the significant portion of the front end, the lease, the deposits and everything else will have to move to the front-end. So it is not artificially done number. It is a very scientifically done number.

Suneeta Reddy: I think it is good to remember that with this team, we are creating optionality for Apollo. So there is an opportunity to create a multichannel, omni-channel play. There is the opportunity to actually grow the private label and not be constrained by any other regulatory framework.

Sameer Baisiwala: SAP is currently buying the back-end supply chain from certain distributors and manufacturers. These distributors are related parties, promoter entities? And will this arrangement continue?

Krishnan A: So if you look at the overall, around 60%-65% of the revenues of the supplies happen from the related parties, you are right. But the point is, even if you look at that Company supplies to Apollo Hospitals, it is only 45%. Because those Companies which is 'KeiMed' and the other related parties which supply, they have an independent business of their own outside of Apollo Hospitals on the distribution side, which is growing significantly.

B, as you know even 'Mitsui' is a 30% holder in that distribution business. And that business is independently growing, which is quite independent of Apollo Hospital's business. And we still continue to get a significant value accretion on the economic front from getting the supplies from them because we get a preferred pricing over most of the other supplies that they make to other Non-Apollo entities because we have a preferred supply agreement with them which allows us to procure at over 1% to 1.5% lower than Others.

Suneeta Reddy: And 'KeiMed' has distributorships in 20 states. So it allows us to purchase at a significant discount to other distributors in those states.

Obul Reddy: And uniform pricing across the states, and they will deliver to our network directly. So we will have significant logistics cost savings in account of that.

Krishnan A: And since you are asking, Sameer, it is also important that because it is for the larger set of investors, I would also like to let you know that one of the big 4s, even last year, Deloitte had done an arm's length transaction for the purchases from all the related parties. As we speak, one of the other big 4s, because Deloitte is now conflicted because they are our auditors as well, one of the other big 4s is working on ensuring and establishing to the audit committee and the Board that it is at an arm's length.

Sameer Baisiwala: That is fair enough. Just shifting the focus to the Hospitals side of the business, I have a couple of strategic questions. How are you thinking of expanding the bed capacities going forward, next 2-3 years?

Suneeta Reddy: So first, we have operationalized 7,250 beds, whereas, we have another 2,500 beds that we can operationalize with hardly any costs with no fixed costs over the next few years, just some variable costs. So we are looking at growing at least by 17% and that is what we have factored into our plans. And I think that we should be able to deliver on that while growing EBITDA significantly because the fixed costs have all been met.

Sangita Reddy: I think it is also important to look at our change in case mix and reducing ALOS. Because of our high degree of robotics surgery and quicker turnaround times with our new anesthesia techniques, we are able to get better utilization out of the beds that we have as well.

Sameer Baisiwala: Sure. So first, you would want to use this 2,000 bed excess capacity, which you have not operationalized before you move on to expand capacity?

Suneeta Reddy: Yes.

Sameer Baisiwala: Okay. One final question is on your update on two things Suneeta. On the outpatient-to-inpatient strategy, I see that the inpatient volumes this time has been probably one of the highest. So how far do you think this has worked well? And second is on the digital strategy.

Suneeta Reddy: So I think both, in a way are connected. The one thing that we can say is that with OP to IP conversion, we are looking at our data analytics to see how we can improve that. In Hyderabad, we have actually done a live case.

Sangita Reddy: So I will move first to the digital strategy and come back to the impact on our numbers. So we are going through an overall digital transformation. Right now, in some of our mature hospitals, where we aggressively implement it, we have almost 85% data capture. So when in an outpatient environment, we are able to do a high degree of data capture, this translates into a higher realization per patient in diagnostic revenue, pharmacy revenue and the conversion rate. And all these metrics are being measured. We actually saw a 12% enhancement in conversion rate in Hyderabad where the pilot project was done, and this is something that we are focusing on even further. We are also looking at moving into Day-care surgery.

And those numbers have increased as well. Also, I think it is a fairly significant thing, based on the CRM system that we have put into place. We are working on re-enrollment or re-utilization rates. So our loyalty plan across referral, across from clinics to hospital and reference from pharmacy and the CRM are now making us realize further loyalty in our mature customers. So these are all evolving strategies where we are doing specific pilots. Once we have perfected this system, we are scaling them across the enterprise.

Moderator: The next question is from the line of Manish Poddar from Reliance AIF.

Manish Poddar: I just wanted to dwell on the margins aspect which you mentioned. So if I understand, there are two areas where you are making money, or this business would make money for AHEL. One is the branding part, which you said, is linked to sales. And the second is the supplier agreement. Are these the only two areas which profits will be booked for AHEL?

Krishnan A: Yes. The supplier agreement has a set of activities. Both these the agreements are two, as you rightly said. But the agreements capture both these agreement sets captures the list of activities that AHEL will perform on behalf of the overall combined pharmacy business.

Manish Poddar: What I am trying to understand then is, let us say, you said the incremental margin of 85% flows through you. So let us say, when the sales grow higher, and you are just going to be a supplier to the entire mechanics for the pharmacy business, only the COGS part gets taken care of. The COGS part will be, as a percentage of sales, would be taken care of. But the all the additional margins, which are on the basis of operating leverage, would not that flow to the original entity or the acquirer?

Krishnan A: No, it comes here because of the brand licensing agreement, as we said. The brand licensing agreement over a period of time keeps increasing in the overall percentage of revenues. Assuming it starts at 0.5 and over time it goes higher as the overall revenues increases for the business. And that is something which even AHEL as an activity does perform actively on the customer data leveraging loyalty. It administers the loyalty program for the overall customers. So all those are activities that under the brand licensing agreement is done and performed by AHEL, which is the reason that there is a lot of growth which comes there. And which is in the overall front end and that gets captured in the back-end because of AHEL performing this brand licensing, which is why the brand licensing is an important agreement through which that additional EBITDA margin comes back to the back end. So that is the reason that the front end would be in the range of 1% to 1.2%.

Manish Poddar: Got it. So it is something that is a loyalty agreement, wherein would you evaluate it annually that this percentage would step up by X percentage every year?

Obul Reddy: Yes.

Manish Poddar: And this evaluation, so are there set terms of contract initially, or this will be evaluated every year?

Krishnan A: It will be evaluated every year.

Obul Reddy: On an annual basis.

Manish Poddar: And just wanted to understand something with regards to this pharmacy business When we go on the online channel, let us say, initially if there is some sort of investment which is required, would AHEL also participate in that round to the proportion of 26%?

Obul Reddy: It will be in the front-end Company. We expect that to be funded by the front end Company out of its cash flow. But if necessary, we will do the funding at that time.

Manish Poddar: And the management of the business of the front-end part completely goes to the acquiring entity? That is how it is? So the management bandwidth for this part of the business would be relatively lesser for the AHEL. Is it the right understanding?

Obul Reddy: That is right. It will have its own independent Board and ANP and senior team will manage that activity.

Moderator: The next question is from the line of Nitin Gosar from Invesco Mutual Fund.

Nitin Gosar: I am just trying to understand the way now this pharmacy business is positioned. So typically, there are multiple layers, the Company gets followed by C&F agent then get followed by distributor, then the sub-distributors or super stockiest and then the retailer. I fail to figure out, where this Company newly formed, will reside in? I mean, the AHEL, where it will stay?

Krishnan A: So as we articulated, this is being done to be in a regulatory compliant manner as well. This is a significant first step that is being taken for value discovery over time. We are not in a position to currently, you know in the current form that and structure the pharmacy business is, we cannot discover value in this business independent of this structure, which is the reason that there is a significant this is one of the important reasons why we had to go ahead with this structure, which is regulatory compliant blessed by Luthra & Luthra, blessed by Deloitte, blessed by the legal consultants. So clearly, from that perspective, you should remember, so you should look at this as a combined business. You should just because at some at all points in time, we should remember that there is a call option that we have to be able to call the buyback, the investors' interest in that front-end Company, which when the regulatory framework allows us to do, we have the ability to do so. So AHEL still continues to be an overall you should look at it as a potential standalone pharmacy operator over a period of time.

Nitin Gosar: Okay. And you mentioned about the back-end part. So back-end, around 65% of our back end is still coming in from distributor/related party?

Krishnan A: Yes.

Suneeta Reddy: I mean at this time. But you can factor always, as revenues increase, I mean as the mix changes that could change as well.

Nitin Gosar: Mix regarding purchased directly from the Companies versus purchased from the distributor?

Suneeta Reddy: Purchase I mean, no…

Obul Reddy: We have significant plans to improve private label. We may get other preferred network partners to buy directly. So that might change over period of time based on the economics.

Nitin Gosar: And does the current region allow us to source more directly from the Company? Why do we need to go from via distributors?

Obul Reddy: We are not allowed to do that.

Nitin Gosar: The current system is not sure?

Suneeta Reddy: No, I mean, APL will buy from AHEL.

Nitin Gosar: No. I got it. I am saying, AHEL, which is currently buying from the related party?

Obul Reddy: Current distribution system does not allow direct procurement.

Nitin Gosar: No, but 34% is still getting distributed?

Obul Reddy: We have to go through the distribution channel. And when we have a preferred network partner who brings the economy, we prefer that because it is more important to have the logistics and uniform pricing across 20 states where we are present.

Nitin Gosar: So correct me on this. So AHEL is not allowed to buy any distributor license?

Suneeta Reddy: No. It is not allowed.

Nitin Gosar: And on the Capex part, so around 1,500 stores are yet to come up as per the plan to reach 5,000 stores. Per store, I think capital employed is roughly around Rs. 30 lakhs as of now. So Rs. 450 crore is the additional investment which will happen over period of time in this new entity?

Obul Reddy: This 1,500 stores we have to add over a period of 5 years, and then the 300 stores which we are currently doing. The real capex will be only about Rs. 10 lakhs to Rs. 12 lakhs, what we are talking about including the stocking is about Rs. 20 lakhs average. So I would say, yearly, about Rs. 50 crore to Rs. 60 crore of capex, which we are confident that the new Company will generate out from the business operation.

Nitin Gosar: Okay. So overall, this transaction is more structured to make it more compliant rather than cash flow generation because cash flow that you are going to generate out of this transaction is Rs. 400 crore - Rs. 500 crore is not going to materially move the needle.

Krishnan A: So as we said, this is more of a regulatory-compliant structure. That is exactly the point we said. And it helps us to keep the option to buy that back once the regulator is, once there is easing up of the regulation and if it allows it because obviously we have foreign investors in AHEL, which does not allow us to keep the pharmacy business in the current structure.

Nitin Gosar: And one final bit on this. So when the optionality is available, have you defined at what valuation we can or what IRR we can settle out this transaction?

Krishnan A: As we said, it is the business the buyback, the buying will be at an SMB at the appropriate time. And we do not think, based on the current estimates of the front-end Company, we think that the IRR would be between the 14% to 16% range.

Nitin Gosar: Okay. So that is the IRR which the existing investors or the new investors will end up getting?

Krishnan A: Yes.

Moderator: The next question is from the line of Shyam Srinivasan from Goldman Sachs.

Shyam Srinivasan: Just on the Hospital business. I was just looking at some of the inpatient volume numbers and I think sequentially we have seen a slowdown in say Tamil Nadu or in Karnataka. So can you just walk us through what is happening? I just want to know what is happening to the volumes.

Dr. Hariprasad: Yes. You need to look at the like-for-like in the numbers, as I said earlier, in Karnataka we have a new hospital which is functional. And in Tamil Nadu, we have mean the Cradle which is functional. So all the women care has moved from the main hospital into the mother's hospital. So that way there has been some volume distribution. And second thing is as we have just explained; a lot of procedures which needed IP admission are now being done as day care procedures. And the third and last thing is; we have taken a conscious decision to shut out some of the low-paying corporates and low-margin corporates where we were not earning much. So all this put together; you will see a decrease in the volumes in the Tamil Nadu and Karnataka regions in terms of inpatients. But the revenues have gone up significantly in double digits in both the areas.

Suneeta Reddy: And I think we should also recognize that the ARPOB has gone up because of this strategy, by 8%.

Shyam Srinivasan: No. I was going to come to that. But before that, if you can help us understand, what is the like-for-like kind of growth if I were to kind of normalize for this because we are not able to see it. Could you just help us understand what could be a like-for-like volume growth in some of these regions, if we were to do this historically as well?

Krishnan A: I think you should take this off-line and Krishnakumar can help you with that. But one perspective that you should also remember is, for example, even if you look at Chennai, we have been focusing on the CoEs. And clearly, the focus on CoEs has helped us grow our volumes in cardiac, oncology and places like that, which is accretive to the overall revenues. And also, simultaneously, some of the Daycare work has also moved into places like Apollo Health & Lifestyle. Because there is this Day-surgery center in MRC Nagar in Chennai for example, where there is some movement of volumes of Day-care which has happened from Apollo into Apollo Health & Lifestyle. So these are certain calibrations which are happening at a volume level because we follow a cluster approach for our strategy. Hence, that is why if you look at the overall revenue, the revenue growth is healthy 6% on inpatient and outpatient there is a 13% growth. And clearly, there is a lot of outpatient growth that we are seeing in most of these specialties. And some of them are also being referred to Day-care centers.

Shyam Srinivasan: I am just saying, we did an exercise looking at procedure pricing and trying to improve transparency on some of our procedures. How much of this has translated into the kind of ARPOB growth that we have seen?

Krishnan A: So almost around, there has been an upliftment which we have got because of that also. And broadly around I would think almost around 30%-40% of this would have been a combination of service pricing and CoE and case mix at a broad level.

Shyam Srinivasan: Got it. And you think this is sustainable on a go-forward basis? I think that is the key question.

Krishnan A: Yes.

Moderator: We will take that as the last question. I would now like to hand the conference back to the management team for closing comments.

Suneeta Reddy: Thank you for joining us on this earnings call. As always we believe with the fundamental demand and supply gap we will continue to increase the demand for quality healthcare. At Apollo especially we believe that creating the entire ecosystem of smart healthcare delivery will not only result in revenues and profits but better outcome for patients. As an institution we remain committed to patient care and value creation for all our shareholders and stakeholders. Once again thank you and good evening.

Moderator: On behalf of Apollo Hospitals Limited, that concludes this conference. Thank you for joining us. Ladies and gentlemen, you may now disconnect your lines.