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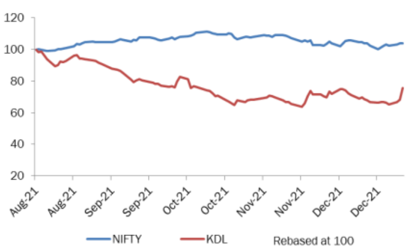
Krsnaa Diagnostics Limited

03 January 2022

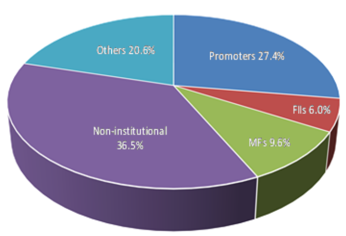
Diagnostics niche play with strong revenue visibility and cost leadership — BUY

Sector	: Healthcare-Diagnostic
Target Price	: ₹1,117
Last Closing Price	: ₹737
Market Cap	: ₹2,317 crore
52-week High/Low	: ₹1100/624
Daily Avg Vol (12M)	: 2,86,334
Face Value	: ₹5
Beta	: 0.39
Pledged Shares	: Nil
Year End	: March
BSE Scrip Code	: 543328
NSE Scrip Code	: KRSNAA
Bloomberg Code	: KRSNAA IN
Reuters Code	: KRSN.NS
NSE Nifty	: 17,354
BSE Sensex	: 58,254
Analyst	: Research Team

Price Performance



Shareholding Pattern



Initiating Coverage

Investment Summary

- Pune-headquartered Krsnaa Diagnostics Limited (KDL) is one of India's fastest growing diagnostics service providers with more than 1,800 diagnostic centres across 14 states.
- KDL has a unique business model, driven by a niche and cost competitiveness. Growing at a brisk pace, KDL's operations expanded at a CAGR of 39% from 682 centres in FY18 to 1,803 by the end of FY21, driving a 54% sales CAGR during this period.
- With over two-thirds of the topline contributed by PPPs, it is the most important component of KDL's business model. The company boasts of a high bid conversion ratio of 75%. Contract periods range from 2 to 10 years with a significant proportion of long-term contracts. PPP is a volume play with robust revenue visibility and minimal risk of bad debt.
- KDL's PPP operations is based on an asset-light model with rent-free space and acquisition of equipment at very competitive prices. The company benefits from lower utility expenses and maintenance contract rates. Consequently, KDL can generate healthy margins while rendering the same services as other private players at a 50%-60% cheaper price.
- KDL's operations are built around the hub-and-spoke model with its Pune-based tele-radiology hub at the centre of its radiology operations. KDL's operations model enables it to maintain a high quality of service while generating high processing utilisation, operational efficiency, cost savings and operating leverage.
- We expect healthy revenue growth in FY22, followed by an acceleration in FY23, aided by new contracts including the Punjab PPP. Modelling a normalisation in the growth rate in FY24, there remains an upside risk to our assumptions from higher-than-expected new business wins. The KDL stock currently trades at an attractive forward P/E level of 16.5x FY24E EPS. Based on a target P/E multiple of 25.0x, we rate KDL a BUY with a price target of Rs 1,117 and an upside potential of 51%.

Key Financial Metrics

₹ Crores	FY19A	FY20A	FY21A*	FY22E	FY23E	FY24E
Total income	211.5	271.4	408.7	506.4	704.1	842.5
Growth		*28.3%*	*50.6%*	*23.9%*	*39.0%*	*19.7%*
EBITDA	62.1	(101.3)	106.0	161.8	227.4	269.6
EBITDA margin	*29.7%*	*-39.2%*	*26.7%*	*32.8%*	*32.9%*	*32.5%*
PAT	12.5	(112.0)	(67.9)	61.3	115.6	140.3
PAT margin	*6.0%*	*-43.3%*	*-17.1%*	*12.4%*	*16.7%*	*16.9%*
Diluted EPS (₹)	12.95	(108.47)	12.25	19.53	36.82	44.67

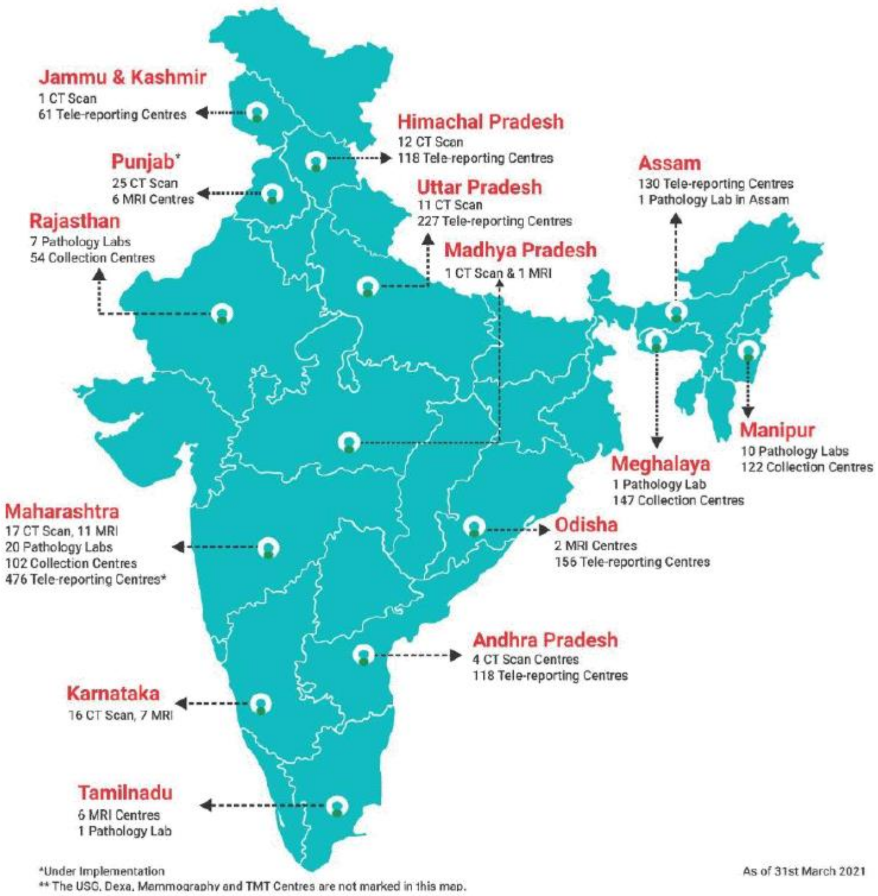
*Source: Company data; Khambatta Research. *For FY21, all numbers are adjusted for gain on fair value movement of CCPS except EPS, which is as-reported*

KDL is one of India's fastest growing diagnostics service providers, operating 1,800+ centres across 14 states

Company Profile

Pune-headquartered Krsnaa Diagnostics Limited (KDL) is one of India's fastest growing diagnostics service providers. The company operates more than 1,800 diagnostic centres across 14 states, having served over 2.3 crore patients since commencing operations in 2013. KDL operates one of India's largest tele-radiology hubs in Pune where radiologists diagnose, process and deliver reports remotely for all field imaging centres with real-time 24X7 connectivity. KDL is especially strong in the public-private partnership (PPP) space where state governments collaborate with private players to provide free or affordable diagnostic services to patients in public healthcare institutions. Expanding its centre count at a brisk pace, KDL has delivered robust revenue growth over the past few years. The PPP piece, which generates two-thirds of the company's sales, is the company's main area of focus with parnerships with private hospitals contributing a significant 33% of total revenues. KDL acquires state-of-the-art diagnostic equipment from leading OEMs as it looks to use its strong bargaining power as a large buyer to procure devices at discounted rates.

KDL's footprint across states



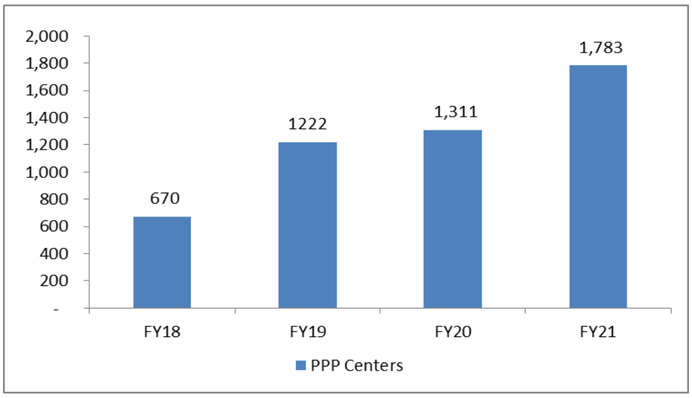
Source: KDL presentation

Investment Thesis

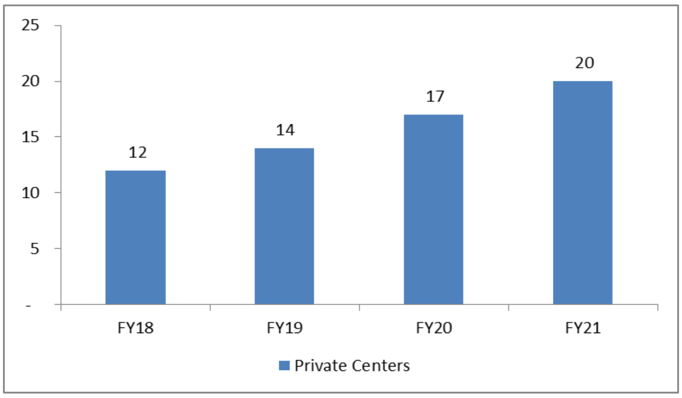
KDL's operations expanded at a CAGR of 39% from 682 centers in FY18 to 1,803 by the end of FY21

KDL has a unique business model, driven by a niche and cost competitiveness. Growing at a brisk pace, KDL's operations expanded at a CAGR of 39% from 682 centres in FY18 to 1,803 by the end of FY21. During this period, the company increased its sales by an average of 54% each year. In 1H FY22, the company won 5 new contracts (3 PPP and 2 private). KDL operates a unique business model, offering diagnostic tests to patients in partnership with hospitals and clinics. This model provides the company a captive market, originating in both the OPD and IPD segments. 67% of KDL's revenues is generated from its PPP business comprising 1,797 centres across 14 states, while a third comes from its partnership with private hospitals that includes 26 centres. KDL's team comprises 186 radiologists, 33 pathologists, 7 microbiologists and over 2,700 qualified professionals including clinicians, technicians and operators. Enabled by the robust scale of its operations, KDL enjoys strong bargaining power with its suppliers as it enjoys other cost advantages.

Expansion in PPP centres



Expansion in private centres



Source: KDL presentation; Khambatta Research

KDL boasts of a high bid conversion ratio of 75%

The PPP model provides strong revenue visibility. With over two-thirds of the topline contributed by PPPs, it is the most important component of KDL's business model. The company boasts of a high conversion ratio for tenders with it having won over 75% of submitted bids. The contract period ranges from 2 years to 10 years with a significant proportion of contracts at the longer-term end of the range. Further, with a well-established infrastructure set up by KDL at the host facilities, there is a high probability of the company securing contract renewals. Annual price escalations between 2% and 5%, on average, are built into the contracts. There are two broad customer segments – paying and non-paying. The non-paying customers comprise two further categories, BPL, and defence and other public service employees. The bills for services provided to non-paying patients are reimbursed by the government with an average payment period of 60-90 days. KDL's 3 recently-

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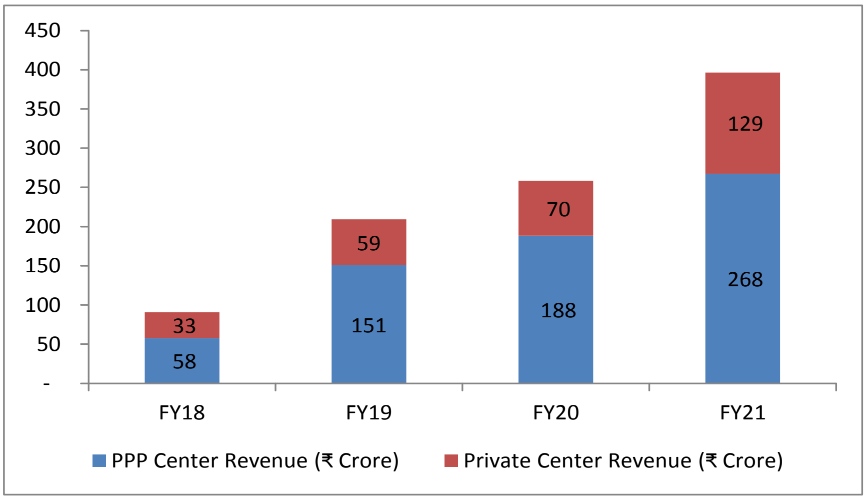
won PPP engagements include a sizeable contract to establish radiology centres at 24 public hospitals in Punjab with a mandate to deploy 23 CT and 6 MRI scanners. The company also bid for establishing pathology centres in Punjab. The PPP business is a volume play with robust revenue visibility and minimal risk of bad debt.

PPP-private revenue mix



Source: KDL presentation; Khambatta Research

KDL delivers the same services as other players at a 50%-60% cheaper rate

A combination of low capex and opex enables KDL's cost leadership. KDL's PPP operations are based on an asset-light model. As the PPP centres are located in public healthcare institutions such as government hospitals, primary health centres (PHCs) and community health centres (CHCs), KDL gets rent-free space within the institutions' premises to set up its centres. The company's utility expenses are also subsidised as the electricity charges are taken care of the host institution in several locations. Further, KDL benefits extensively from its relationships with OEMs by procuring equipment at very competitive prices, which is enabled by the big orders it places with the equipment suppliers, thanks to the large scale of its PPP operations. The company owned 62 CT scanners and 26 MRI scanners as of March 2021. Further, due to the large number of equipment it owns, the company is able to successfully negotiate lower comprehensive maintenance contract (CMC) charges compared to its peers. With significant cost advantages on both the capex and opex fronts, KDL can generate healthy margins while rendering the same services as other private players at a 50%-60% cheaper price.

KDL's price leadership vis-à-vis peers

Segment	Test	Player 1	Player 2	Player 3	Krsnaa	% from min price
RDL	CT Brain	4,500	4,500	3,500	2,000	(43%)
RDL	MRI Brain	8,000	8,250	7,000	3,500	(50%)
PTH	CBC	250	250	200	146	(27%)
PTH	Blood Sugar	85	80	70	26	(63%)
PTH	Thyroid	500	550	550	216	(57%)
PTH	Vitamin D	1,500	1,250	1,450	595	(52%)
PTH	Vitamin B12	1,000	1,100	1,300	243	(76%)
PTH	HbA1C	550	440	400	141	(65%)

Source: KDL presentation

KDL's pathology operations comprise multiple hub-and-spoke setups with a processing lab for every 10 collection centers

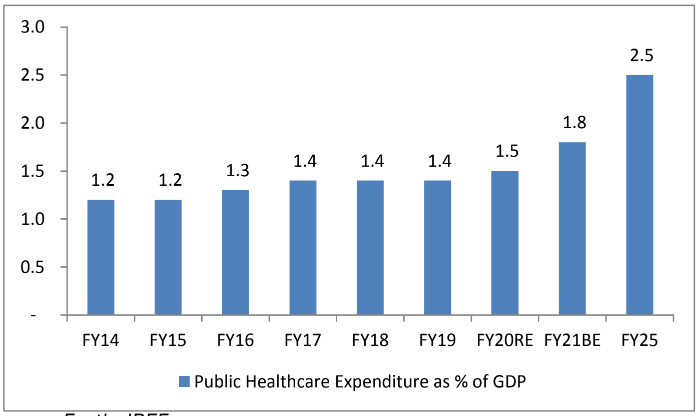
Hub-and-spoke model generates efficiency and operating leverage. KDL's operations are built around the hub-and-spoke model. The company's tele-radiology hub in Pune, which is one of the largest in India, is a captive centralised processing and diagnosis nerve-centre for all radiology/imaging tests conducted by KDL's field centres across the country. This model enables the company to process and interpret large numbers of imaging studies conducted at various centres including those located in lower tier towns at a state-of-the-art hub by a team of radiologists and reporting specialists. With 24X7 uninterrupted connectivity with the imaging centres on the field, the radiology hub has the capability to generate reports with a quick turnaround time regardless of the location of the test centre. The pathology testing and reporting organisation is based on a comparatively decentralised model comprising multiple hub-and-spoke setups with one processing lab serving approximately 10 collection centres on average. KDL's operations model enables it to maintain a high quality of service while generating high processing utilisation, operational efficiency, cost savings and operating leverage.

The Indian government targets increasing its healthcare expenditure from 1.8% of GDP in FY21 to 2.5% by FY25

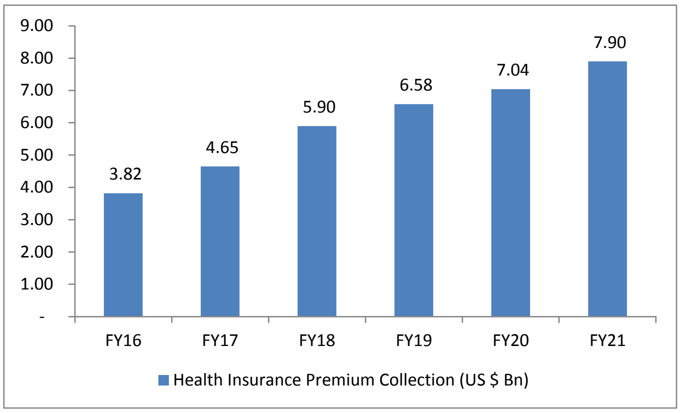
Low penetration of healthcare and diagnostics services in India presents solid growth potential. India has a very low hospital bed density of 15 beds per 10,000 people, significantly lower than the global median of 29 and the density in China (42), Brazil (21) and other countries. Between FY11 and FY20, India's public health expenditure remained in the range of 1.2%-1.5% of GDP. This increased to 1.8% according to FY21 budget estimates as the Indian government targets increasing it further to 2.5% by FY25. Policy initiatives such as 100% FDI in the hospital sector and the adoption of the PPP model bode well for India's healthcare sector. Growing disposable income, more people going for health insurance, increasing awareness about health, and higher life expectancy as well as an ageing population will drive growth for healthcare services going forward. While India's decadal population growth progressively declined over the last 3 decades (from

23.9% in 1981-1991 to 12.4% in 2011-2021), it is projected to further fall to 8.4% between 2021 and 2031. The decadal growth in elderly population, on the other hand, is set to go up to 40.5% (vs 35.8% in 2011-2021 and 29.7% in 1981-19191). *(Source: MOSPI).* These demographic changes will drive the uptake of overall healthcare services and diagnostics in tandem. Greater awareness about wellness, lifestyle-related health issues and preventive healthcare will contribute to the growth of diagnostics. With the price of diagnostic services in India amongst the lowest in the world, the market is seen to expand as penetration increases, offering strong growth opportunities, especially in lower tier cities/towns. Diagnostics service is one of the fastest growing spaces within the healthcare sector as well as the overall services segment. The Indian diagnostics industry, currently pegged at USD 9.5bn, is expected to expand at a CAGR of ~11% over the next 5 years *(source: Investing.com)*.

India's public healthcare expenditure as % of GDP

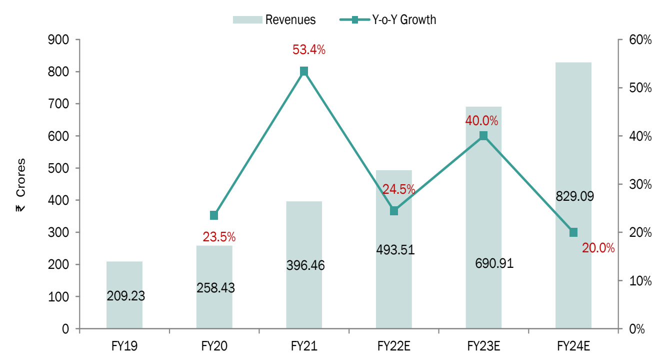


Health insurance premium collection in India

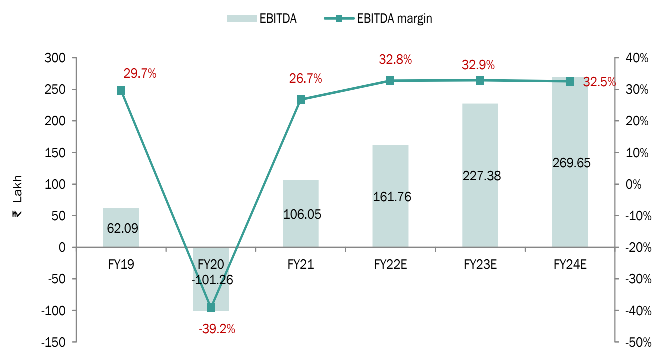


Source: Factly; IBEF

Revenue and y-o-y growth



EBITDA and EBITDA margin



Source: Company data; Khambatta Research

Peer Comparison

There are as many as 19 listed healthcare services companies in India. We compare KDL with its listed diagnostics services peers.

Peer Comparison: Key Financials Metrics, FY21

₹ Crore	KDL	Dr Lal Pathlabs	Metropolis	Thyrocare	Vijaya Diagnostic
Operating revenue	396.5	1,632.6	1,010.0	507.1	378.1
EBITDA	106.0	487.6	298.0	183.7	174.1
EBITDA margin	*26.7%*	*29.9%*	*29.5%*	*36.2%*	*46.0%*
PAT	(67.9)	291.6	183.1	113.2	82.8
PAT margin	*-17.1%*	*17.9%*	*18.1%*	*22.3%*	*21.9%*
EPS (Rs)	12.3	35.2	35.8	21.4	182.8
ROCE	76.4%	29.6%	31.5%	34.0%	25.2%
ROE	-29.3%	23.4%	25.9%	26.5%	23.0%
Current market cap	2,317	31,776	17,579	5,828	5,932

Source: Company data; Bloomberg; Khambatta Research

Valuation

The KDL stock currently trades at an attractive forward P/E of 16.5x FY24E EPS

At 25.0x FY24E EPS, we rate KDL a BUY with a price target of Rs 1,117 and an upside potential of 51%. KDL reported a 53.4% y-o-y growth in operating revenues in FY21, in line with the sales CAGR of 54.2% from FY18 to FY21. The robust growth in FY21 was witnessed in spite of the covid pandemic as the company ramped up covid testing. KDL reported a 19% y-o-y increase in operating revenues in 1H FY22 even as revenues from covid testing dipped sharply by 75% y-o-y while revenues from regular radiology and pathology tests more than doubled on a y-o-y basis, thanks to a slowdown in covid infections following the second wave. 1H FY22 revenue mix by test type included 50% radiology, 39% pathology and 11% covid. We expect revenue growth to remain healthy for the full year, followed by an acceleration in FY23, aided by new contracts including the Punjab PPP and in line with management's guidance. Modelling a normalisation in the growth rate in FY24, we observe that there remains an upside risk to our assumptions on account of higher-than-expected new business wins. We expect EBITDA margins over the forecast period to be maintained around 1H FY22 levels with lower interest expense due to a decline in debt contributing to incremental PAT margins. The KDL stock currently trades at an attractive forward P/E level of 16.5x FY24E EPS. Based on a target P/E multiple of 25.0x, we rate KDL a BUY with a price target of Rs 1,117 and an upside potential of 51%.

Profit & Loss Account (Consolidated)

₹ crore	FY19A	FY20A	FY21A*	FY22E	FY23E	FY24E
Total income	211.5	271.4	408.7	506.4	704.1	842.5
Growth		*28.3%*	*50.6%*	*23.9%*	*39.0%*	*19.7%*
Cost of service & operations	149.5	372.6	302.6	344.7	476.7	572.9
EBITDA	62.1	(101.3)	106.0	161.8	227.4	269.6
EBITDA margin	*29.7%*	*-39.2%*	*26.7%*	*32.8%*	*32.9%*	*32.5%*
Depreciation & amortization	25.6	32.4	37.4	56.1	69.3	78.9
EBIT	36.5	(133.7)	68.6	105.7	158.1	190.8
PBT	20.6	(158.4)	42.6	81.2	153.1	185.8
Tax expense	(8.2)	46.4	(110.5)	(19.9)	(37.5)	(45.5)
PAT	12.5	(112.0)	(67.9)	61.3	115.6	140.3
PAT margin	*6.0%*	*-43.3%*	*-17.1%*	*12.4%*	*16.7%*	*16.9%*
Diluted EPS (₹)	12.95	(108.47)	12.25	19.53	36.82	44.67

*Source: Company data; Khambatta Research. *For FY21, all numbers are adjusted for gain on fair value movement of CCPS except EPS, which is as-reported*

Key Balance Sheet Items (Consolidated)

₹ Crore	FY19A	FY20A	FY21A	FY22E	FY23E	FY24E
Total shareholders' equity	(84.9)	(197.0)	231.9	164.0	225.3	340.9
Total debt	169.2	231.2	231.8	49.1	10.0	10.0
PPE	222.4	273.6	307.3	467.3	577.3	657.3

Source: Company data; Khambatta Research

Ratio Analysis

	FY19A	FY20A	FY21A	FY22E	FY23E	FY24E
ROE	-14.7%	56.9%	-29.3%	37.4%	51.3%	41.1%
Total D/E ratio	N/A	N/A	1.00x	0.30x	0.04x	0.03x

Source: Company data; Khambatta Research

Key Risks

- With the PPP model dependent on government policies, programmes and healthcare budget, any significant changes in policy can potentially affect our outlook and forecast.
- An increase in competition with bigger experienced players from the private diagnostics market entering/expanding in the PPP market poses a risk to KDL's bid conversion ratio, growth and margins.
- Further severe and/or prolonged waves of covid-19 can potentially have a negative impact on KDL's execution capacity and growth in the medium term.

Guide to Khambatta's research approach

Valuation methodologies

We apply the following absolute/relative valuation methodologies to derive the 'fair value' of the stock as a part of our fundamental research:

DCF: The Discounted Cash Flow (DCF) method values an estimated stream of future free cash flows discounted to the present day, using a company's WACC or cost of equity. This method is used to estimate the attractiveness of an investment opportunity and as such provides a good measure of the company's value in absolute terms. There are several approaches to discounted cash flow analysis, including Free Cash Flow to Firm (FCFF), Free Cash Flow to Equity (FCFE) and the Dividend Discount Model (DDM). The selection of a particular approach depends on the particular company being researched and valued.

ERE: The Excess Return to Equity (ERE) method takes into consideration the absolute value of a company's return to equity in excess of its cost of equity discounted to the present day using the cost of equity. This methodology is more appropriate for valuing banking stocks than FCFF or FCFE methodologies.

Relative valuation: In relative valuation, various comparative multiples or ratios including Price/Earnings, Price/Sales, EV/Sales, EV/EBITDA, Price/Book Value are used to assess the relative worth of companies which operate in the same industry/industries and are thereby in the same peer group. Generally our approach involves the use of two multiples to estimate the relative valuation of a stock.

Other methodologies such as DuPont Analysis, CFROI, NAV and Sum-of-the-Parts (SOTP) are applied where appropriate.

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Buy recommendations are expected to improve, based on consideration of the fundamental view and the currency impact (where applicable) by at least 15%.

Hold recommendations are expected to improve, based on consideration of the fundamental view and the currency impact (where applicable) between 5% and 15%.

Sell recommendations are expected to improve up to 5% or deteriorate, based on consideration of the fundamental view and the currency impact (where applicable).

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