Dr. Sulaiman Al Habib Medical Services Group

Investment Update

Record high results supported by patient volumes and recent expansions. Expansion campaign to define next chapters in HMG's performance

HMG recorded record high quarterly results with a bottom line of SAR 555.0mn (up 14.0% Y/Y and 0.7% Q/Q) and top line of SAR 2,573.6mn (up 13.3% Y/Y, and 2.1% Q/Q). GP margins remained flat Y/Y at 34.1% while decreasing 70bps Q/Q, though we expect a more pronounced negative effect on GP margins from expansions going forward as HMG schedules a 78% expansion in built up bed capacities for FY24 over FY23 beds. Its expansion campaign, stretching to FY27, looks to expand its capacity by c. 90% of FY23 capacities, and it is this campaign which we see will define HMG's coming periods. We estimate an FY23-28E revenue CAGR of 13.8% and a bottom line CAGR of 13.9% for the same period. We value the stock at an upward revised TP of SAR 266.0 per share, while retaining our "Neutral" recommendation. Potential downside risks to our valuation stem mainly from project delays and higher than expected contraction on gross margins, while key favorable specifications at HMG over it peers warrant a premium over the sector.

Q2-24 results reached record highs as patient volumes and recent expansions supported the period: HMG in Q2-24 reached a bottom line of SAR 555.0mn (up 14.0% Y/Y and 0.7% Q/Q) to record its highest ever quarterly net income to date. HMG also recorded its highest quarterly top line, in line with our forecast, at SAR 2,573.6mn (up 13.3% Y/Y, and 2.1% Q/Q), despite the seasonally down-quarter, due to higher patient volumes at HMG- likely as a result of expansions in the past two quarters. All segments experienced growth with the Hospitals segment and the Pharmacies segment growing 13.0% Y/Y and 12.0% Y/Y, respectively, as patient volumes increase. The Solutions segment also grew 32.8% Y/Y. Despite two major expansions coming in during H1-24 (Sahafa and South West Jeddah), HMG recorded a GP Margin of 34.1% (flat Y/Y, and down 70bps Q/Q). The Sahafa expansion, however, only partially took place during this quarter, opening in early June, and will likely have a more pronounced effect on margins in the next quarter. Operating income of SAR 551.7mn displayed a growth of 10.6% Y/Y, (down 0.8% Q/Q) as OPEX to revenue rose 60bps Y/Y. Net non-operating income (exl non-controlling interests) reached SAR 22.6mn (up 68.5x Y/Y, and 41% Q/Q) to support the bottom line of SAR 555.0mn during the quarter.

636 beds capacity expansions scheduled for the year to define the next chapters of HMG's upcoming future performance: HMG looks to expand its built-up beds capacity to reach an estimated 3,414 beds by FY24's end, a 78% increase over its estimated beds capacity of 1,913 during FY23's end. In the pipeline- North Jeddah (350 beds), Takhasusi (145 beds), and AlKharj are scheduled by EOY, while management indicates that the AlKharj and Takhasusi expansions are ahead of schedule. These expansions come in atop the Sahafa (500 beds) and South West Jeddah (330 beds) expansions seen during H1-24, and a minor Qassim expansion. Operational beds, however, are expected to roll out gradually, as per patient volumes, as HMG tends to initially begin operating at 30% of a facility's capacity during kick off. The expansions scheduled during this year, and ahead (90 beds in Hamra, 2025, and 140 beds in Tabuk, 2027) are the major drivers for our expected FY23-28E CAGR of 13.8%, while we see the effects of adverse quarterly seasonality on the top line to be mitigated by ramp ups in the medium term. We estimate a bottom line growth of an FY23-28E CAGR of 13.9% driven by a 90% beds expansion over FY23 capacities, and favorable demographics and regulatory initiatives.

Margins expected to scale back as a result of expansion campaign: Gross margins are expected to be pressurized during FY24-25, as we expect GPMs to wind down by 100bps by FY25 while recent expansions ramp up. Our reason for modest GPM declines are twofold 1) Recent ramp up in Jeddah has been successful with its first seven weeks of operations surpassing Khobar's ramp up by nearly double. We take that as a sign of good demand for expansions in Jeddah and other areas with a lack of presence of premium private healthcare providers. 2) HMG at its scale and size would be able to mitigate the effects of major expansions more than smaller providers. We expect a similar trajectory for its operating margins, reaching 20.9% in FY25E, from 22.0% in FY23, before improving from FY26 onwards.

Recommendation	**Neutral**
Target Price (SAR)	**266.0**
Upside / (Downside)*	**-5.9%**

Source: Tadawul *prices as of 28th of July 2024

Key Financials

SARmn (unless specified)	FY22	FY23	FY24E	FY25E
Revenues	8,311	9,508	11,139	13,393
Growth %	14.6%	14.4%	17.1%	20.2%
Net Income	1,651	2,046	2,196	2,572
Growth %	19.9%	23.9%	7.3%	17.1%
EPS	4.72	5.85	6.28	7.35
DPS	3.48	4.32	4.70	5.50

Source: Company reports, Aljazira Capital

Key Ratios

	FY22	FY23	FY24E	FY25E
Gross Margin	33.1%	34.4%	33.9%	33.4%
OP Margin	20.5%	22.0%	21.2%	20.9%
Net Margin	19.9%	21.5%	19.7%	19.2%
EBITDA Margin	24.2%	25.3%	27.8%	27.1%
RoE	29.4%	33.1%	32.5%	34.9%
P/E (x)	60.2	48.3	45.0	38.5
P/B (x)	16.9	15.3	14.1	12.9
EV/EBITDA (x)	49.8	42.0	33.0	28.2
Dividend Yield	1.2%	1.5%	1.7%	1.9%

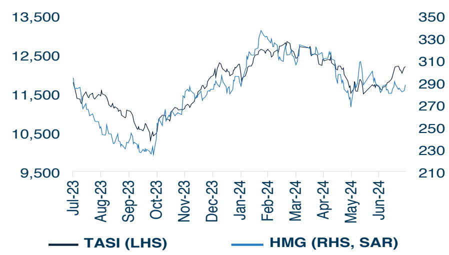
Source: Company reports, Aljazira Capital

Key Market Data

Market Cap (SAR bn)	99.5
YTD%	-0.5%
52 weeks (High)/(Low)	346.8/223.2
Share Outstanding (bn)	350.0

Source: Company reports, Aljazira Capital

Price Performance



Source: Tadawul, Aljazira Capital

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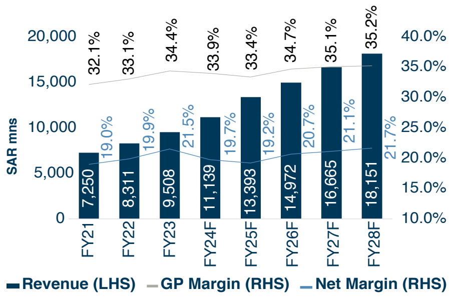
Estimated CAPEX of c. SAR 7bn (FY24-28E) is expected to reshape capital profile towards more debt: D/E for the firm increased over 20 percentage points from 63.0% to 83.7% Y/Y by Q1-24 as scheduled expansion pile on and long term debt increases 51% Y/Y from SAR 3.65bn to SAR 5.52bn in Q1-24. Going forward, we expect HMG's D/E to reach 0.9x by FY24 before winding down amid repayments from operating cash flows. In turn, we expect the charges on the relevant debts to be shown at the P&L level once facilities are online. Finance charges from the latest commercialized facilities are expected to begin appearing this year. In effect we estimate that HMG's net other income-less-finance charges, which was shrinking in the past two years, to turn negative amid more expansions coming online, as out of HMG's cash holding of 2.52bn, 2.02bn are in estimated income earning deposits at near 6%; lower than its finance charges at SAIBOR+ a premium. We forecast finance charges to peak by FY24E's at SAR 204.6mn end before showing improvement in charges by FY26E. We do not see this as a risk, however, to HMG's expected future dividend payouts of above 70%.

Competitive advantages at HMG to deem it a sector leader among peers: HMG possesses leading specifications among its peers, starting with its brand equity among the Saudi Arabian market. Furthermore, its corporate social responsibility (CSR) initiatives, education & research initiatives as well as its efficient pricing strategy is likely to fare well for its DRG multiples once the DRG (diagnosis-related group pricing) system is in effect. Multiples, and DRG bases are however still not announced, though we expect HMG's efficiency and social initiatives to mitigate any negative effects on pricing multiples in urban areas, and should benefit its pricing multiples for facilities in rural areas. Furthermore, HMG's size as the largest publically listed private healthcare provider, and more so after its 90% capacity expansions, should unlock more potentials for efficiency and value in the long run as it also becomes a household name across other regions it is tapping into. We see the stock as one with a fundamental moat around its business for the long term with a solid basis for a premium among its peers.

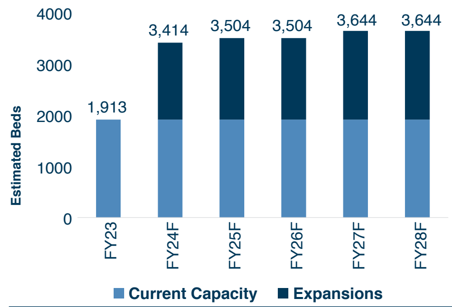
AJC view and valuation: HMG ended Q2-24 with record high results for its bottom line of SAR 550.0mn (up 14.0% Y/Y and 0.7% Q/Q) and top line of SAR 2,573.6mn (up 13.3% Y/Y, and 2.1% Q/Q) while gross margins contract Q/Q but remain flat Y/Y at 34.1%. The period saw a brief operation of the newly opened Sahafa facility, as well as a quarter of the newly opened South West Jeddah facility, which likely supported patient volumes and pressurized margins slightly. Going forward, we expect the additional expansions to define the next chapters of HMG's performance, as HMG braces for planned expansions that can host 90% more beds than its FY23 capacity. In effect we expect an FY23-28E revenue CAGR of 13.8%, as gross profit margin pressurize over FY24-25 to reach 33.4% before improving thereafter. We expect minimal contractionary effects on GP margins from the FY27 Tabuk expansion, at HMG's scale. We expect operating margins at a similar trajectory as gross profit margins, to reach 20.9% in FY25 and improve thereafter. Our forecasts punctuate at a bottom line FY23-28E CAGR of 13.95%. We see that HMG's next periods come with several risks to our valuation: 1) Development risks and delays could reshape the expected timeline of HMG's growth, 2) Staffing challenges could delay expansion licensing from MoH, 3) Slower ramp ups, particularly at the Riyadh facility, and 4) Changes in revenue structure from DRG pricing after the shadow billing period. However, we see that HMG possess many key advantages to the stock granting it a premium over its peers from its brand equity, partnership with government initiatives (NEOM, sporting events, medical centers in tourist areas), scale and size, and efficiency & CSR and their potential effects on DRG multiples. We value the stock using a blended, 50% DCF valuation (WACC = 7.8% and terminal growth rate = 3.0%) and 50% on PE valuations (36.0x on FY25E estimates) to arrive at a revised TP of **SAR 266.0 per share**, while retaining our "**Neutral**" recommendation on the stock, as it trades at a FY25E forward P/E of 38.5x.

Fig 1. Performance to be supported by expansions underway and future expansions from FY24-27



Sources: AlJazira Capital, Company Financials

Fig 2. Significant expansion campaign to set HMG as the largest listed private healthcare provider



Sources: AlJazira Capital, Company Disclosures *Representing facility capacities. Operational capacities are rolled out gradually for new facilities. **Labels representing total capacities

Fig 4. Key Financials

Amount in SAR mn, unless otherwise specified	FY21	FY22	FY23	FY24E	FY25E	FY26E	FY27E	FY28E
Income statement								
Revenues	7,250	8,311	9,508	11,139	13,393	14,972	16,665	18,151
Y/Y	**23.7%**	**14.6%**	**14.4%**	**17.1%**	**20.2%**	**11.8%**	**11.3%**	**8.9%**
Gross profit	**2,330**	**2,748**	**3,270**	**3,781**	**4,470**	**5,194**	**5,844**	**6,392**
OPEX	(379.4)	(398.1)	(369.0)	(419.6)	(550.5)	(615.3)	(684.6)	(745.4)
Operating profit	**1,466**	**1,700**	**2,096**	**2,367**	**2,798**	**3,325**	**3,763**	**4,198**
Y/Y	**31.5%**	**16.0%**	**23.2%**	**12.9%**	**18.2%**	**18.8%**	**13.2%**	**11.6%**
Financial charges	(37.9)	(49.4)	(70.1)	(204.6)	(198.4)	(162.8)	(137.6)	(124.3)
Other income/income from associates	73.1	145.5	144.4	195.4	185.6	184.0	178.6	166.7
Profit before zakat & minority interest	**1,501**	**1,797**	**2,170**	**2,357**	**2,785**	**3,346**	**3,804**	**4,240**
Zakat and minority interest	(114.1)	(107.7)	(68.5)	(89.3)	(139.3)	(167.3)	(190.2)	(212.0)
Net income	**1,377**	**1,651**	**2,046**	**2,196**	**2,572**	**3,096**	**3,523**	**3,931**
Y/Y	**30.4%**	**19.9%**	**23.9%**	**7.3%**	**17.1%**	**20.4%**	**13.8%**	**11.6%**
EPS	**3.93**	**4.72**	**5.85**	**6.28**	**7.35**	**8.85**	**10.07**	**11.23**
DPS	**2.8**	**3.48**	**4.32**	**4.70**	**5.50**	**6.55**	**7.55**	**8.42**
Balance sheet								
Assets								
Cash & bank balance	2,644	2,747	2,620	3,005	2,223	2,313	3,596	5,084
Other current assets	1,490	1,413	1,517	1,621	1,902	2,043	2,198	2,367
Property & Equipment	6,653	7,937	11,163	12,884	14,393	15,064	14,754	14,316
Other non-current assets	41	487	498	498	498	498	498	498
Total assets	**10,827**	**12,584**	**15,798**	**18,008**	**19,015**	**19,918**	**21,046**	**22,264**
Liabilities & owners' equity								
Total current liabilities	2,048	2,590	3,299	4,448	5,137	5,526	5,968	6,346
Long-term loans	2,445	3,033	4,810	5,214	4,660	4,188	3,785	3,441
Total other non-current liabilities	808	856	922	957	1,110	1,210	1,328	1,433
Non-controlling interest	188	227	281	352	425	507	596	692
Total owners' equity	5,339	5,879	6,485	7,037	7,682	8,487	9,368	10,351
Total equity & liabilities	**10,827**	**12,584**	**15,798**	**18,008**	**19,015**	**19,918**	**21,046**	**22,264**
Cashflow statement								
Operating activities	2,183	2,844	3,244	3,408	4,104	4,476	4,983	5,318
Investing activities	(1,248)	(1,939)	(3,487)	(2,451)	(2,344)	(1,576)	(624)	(519)
Financing activities	(631)	(801)	116	(573)	(2,543)	(2,809)	(3,076)	(3,312)
Change in cash	305	103	(127)	385	(783)	91	1,283	1,488
Ending cash balance	**2,644**	**2,747**	**2,620**	**3,005**	**2,223**	**2,313**	**3,596**	**5,084**
Key fundamental ratios								
Liquidity ratios								
Current ratio (x)	2.0	1.6	1.3	1.0	0.8	0.8	1.0	1.2
Quick ratio (x)	1.8	1.4	1.1	0.9	0.7	0.6	0.8	1.0
Profitability ratios								
Gross profit margin	32.1%	33.1%	34.4%	33.9%	33.4%	34.7%	35.1%	35.2%
Operating margin	20.2%	20.5%	22.0%	21.2%	20.9%	22.2%	22.6%	23.1%
EBITDA margin	24.6%	24.2%	25.3%	27.8%	27.1%	28.3%	28.2%	28.4%
Net profit margin	19.0%	19.9%	21.5%	19.7%	19.2%	20.7%	21.1%	21.7%
Return on assets	13.6%	14.1%	14.4%	13.0%	13.9%	15.9%	17.2%	18.2%
Return on equity	26.9%	29.4%	33.1%	32.5%	34.9%	38.3%	39.5%	39.9%
Leverage ratio								
Debt / equity (x)	0.6	0.6	0.8	0.9	0.7	0.6	0.5	0.4
Market/valuation ratios								
EV/sales (x)	7.8	12.1	10.6	9.2	7.6	6.8	6.0	5.4
EV/EBITDA (x)	31.9	49.8	42.0	33.0	28.2	24.0	21.3	19.0
EPS (SAR)	3.93	4.72	5.85	6.28	7.35	8.85	10.07	11.23
Market price (SAR)*	161.40	284.00	284.00	282.60	282.60	282.60	282.60	282.60
Market-Cap (SAR mn)	56,490	99,400	98,910	98,910	98,910	98,910	98,910	98,910
Dividend yield	1.7%	1.2%	1.5%	1.7%	1.9%	2.3%	2.7%	3.0%
P/E ratio (x)	41.0	60.2	48.3	45.0	38.5	31.9	28.1	25.2
P/B ratio (x)	10.6	16.9	15.3	14.1	12.9	11.7	10.6	9.6

Sources: AlJazira Capital, Company Financials

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RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

Disclaimer