InCred PMS

Healthcare BULLETIN

Diagnostics – Primed for Disruption or just a Narrative

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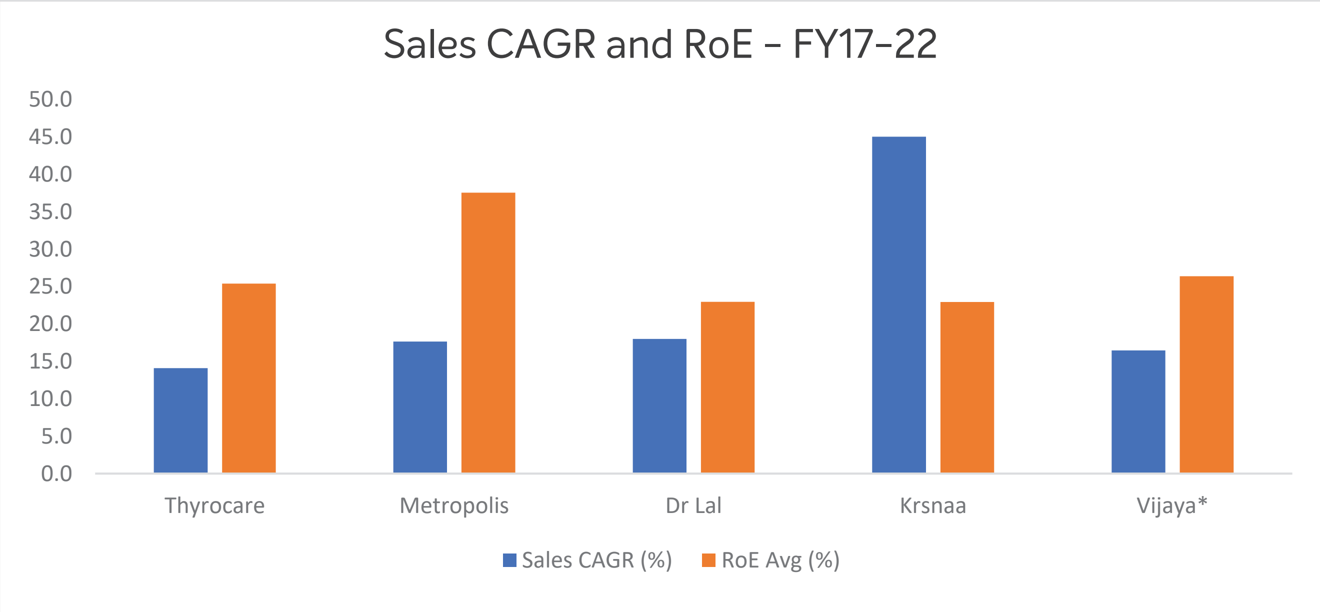
Diagnostics: an interesting sub segment of healthcare

Diagnostics as a sub sector of healthcare has been touted by experts as a secular growth, high margin, asset light and cash generating industry. The listed diagnostic stocks' financials are a testimony to the narrative.

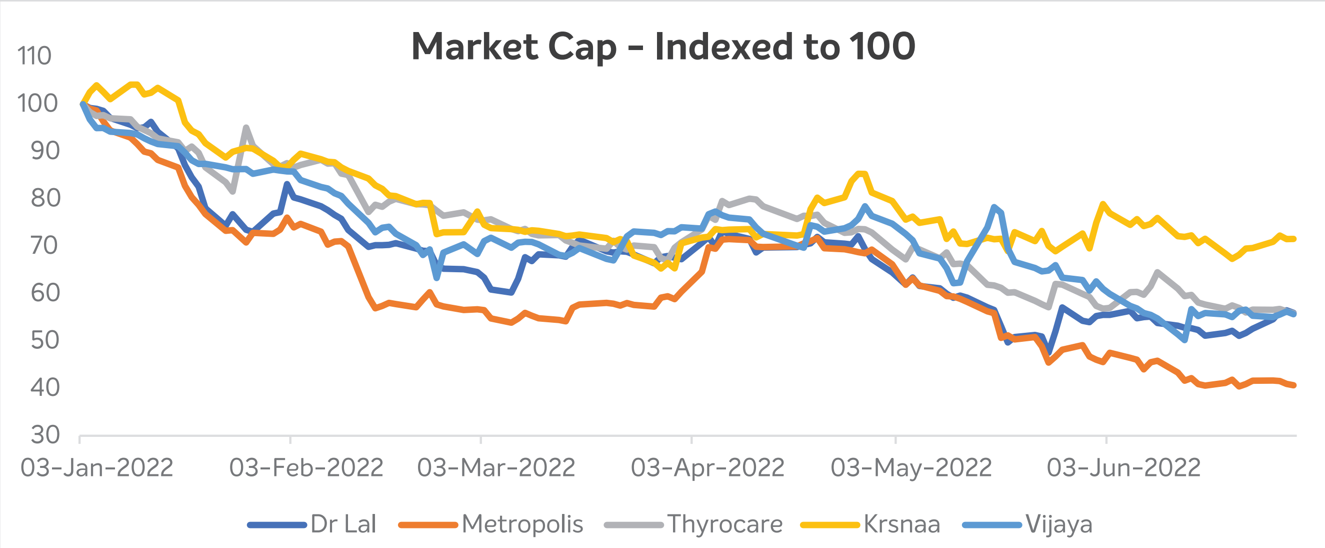


**Three year average (From FY19-22) for Vijaya as earlier numbers are not available. CAGR - Compound annual growth rate, RoE – Return on Equity*

Source – Company, compilation, Internal

Multiple doubts emerge over last 6 months

However, over the last 6 months, diagnostics stocks have seen a substantial decline. We assess that there are 3 reasons for the decline witnessed recently in diagnostics: a) potential disruption from low priced digital players like Tata 1 mg or Healthians; b) increased conventional competition from new brick and mortar entrants like Mankind Pharma (Pathkind Labs) and Lupin (Lupin Diagnostics) and c) poor consolidated growth over last 2 quarters as Covid revenues and margins have subsided.



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Source – BSE Website, Company, Internal

Multiple and earnings estimates both have contracted since COVID volumes came off

Companies (In last one year)	Price correction (%)	Earnings correction (%)	Multiple correction (%)
Thyrocare	-55.1	-41.1	-14.1
Metropolis	-59.4	-20.3	-39.1
Dr Lal	-47.2	-21.9	-25.3

Source – Bloomberg

**Data for August 21-July 2022, *Multiple Correction - Is a Valuation Multiple correction/contraction in price calculated by deducting Earnings Correction from Total Price correction*
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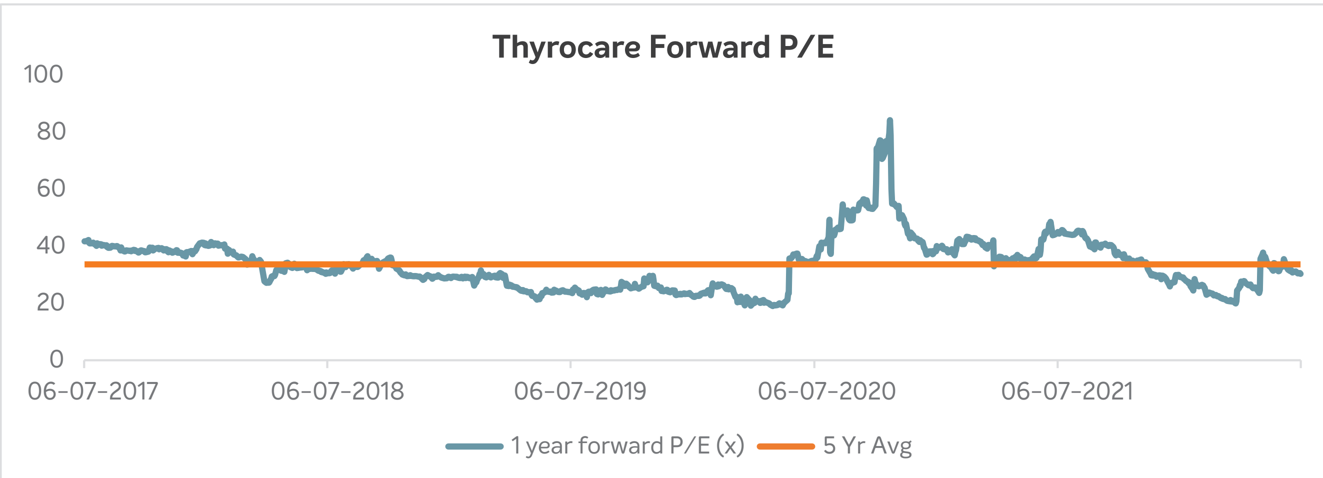
Thyrocare



*Source – Bloomberg *P/E – Price to Earning*

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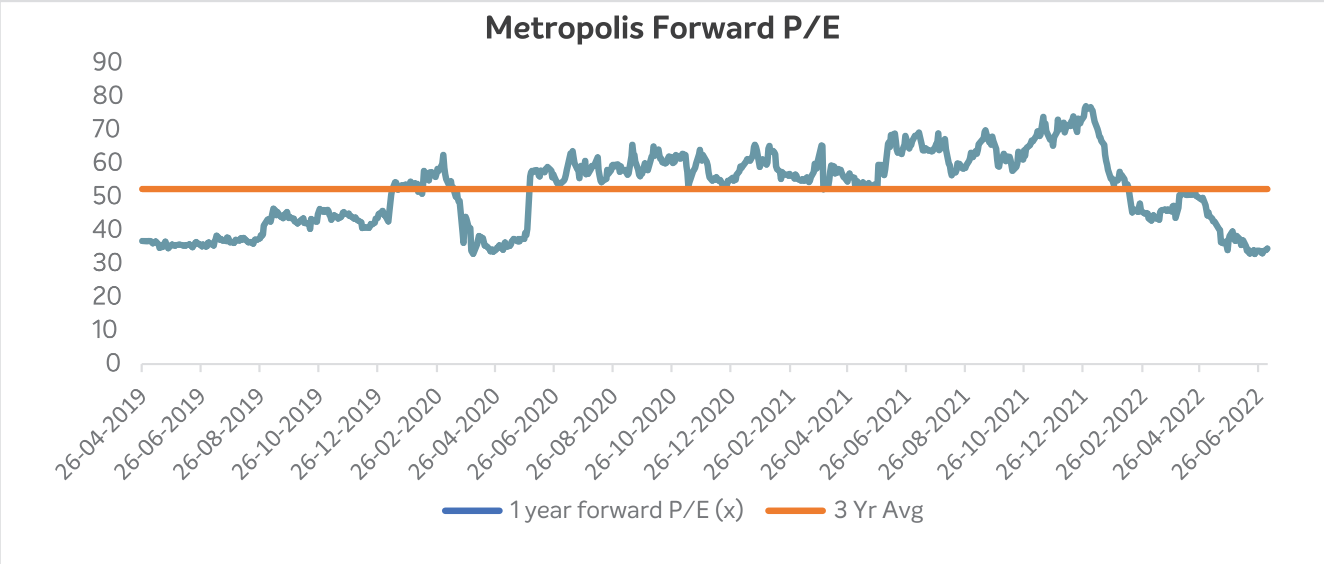
Metropolis



Source – Bloomberg

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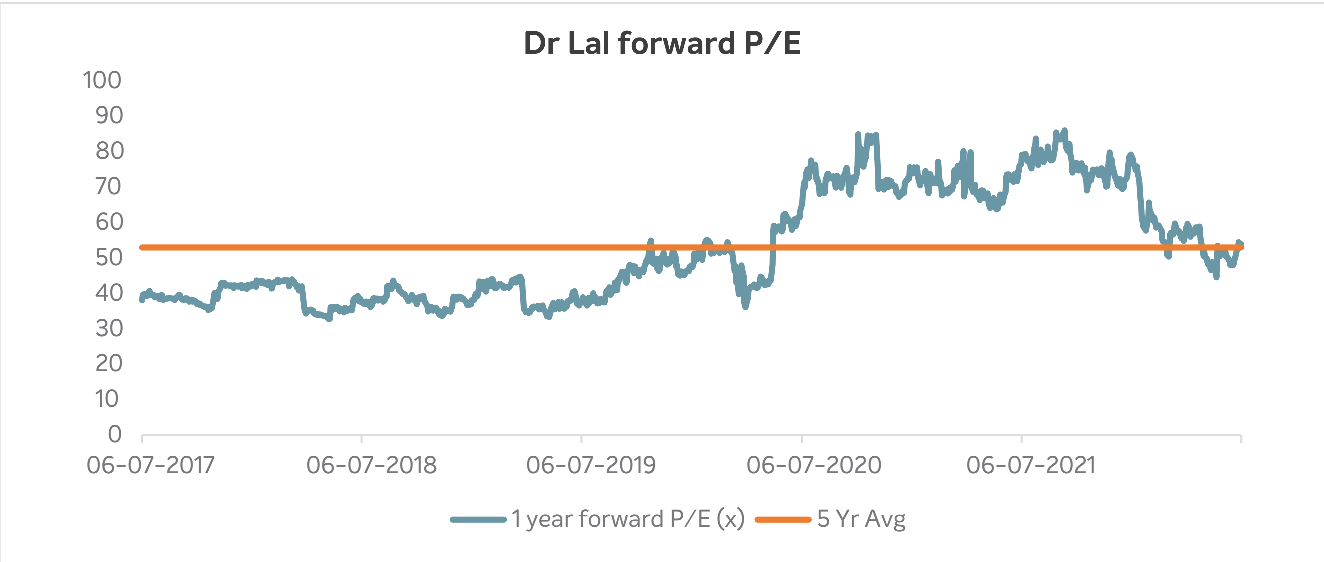
Dr Lal



Source – Bloomberg

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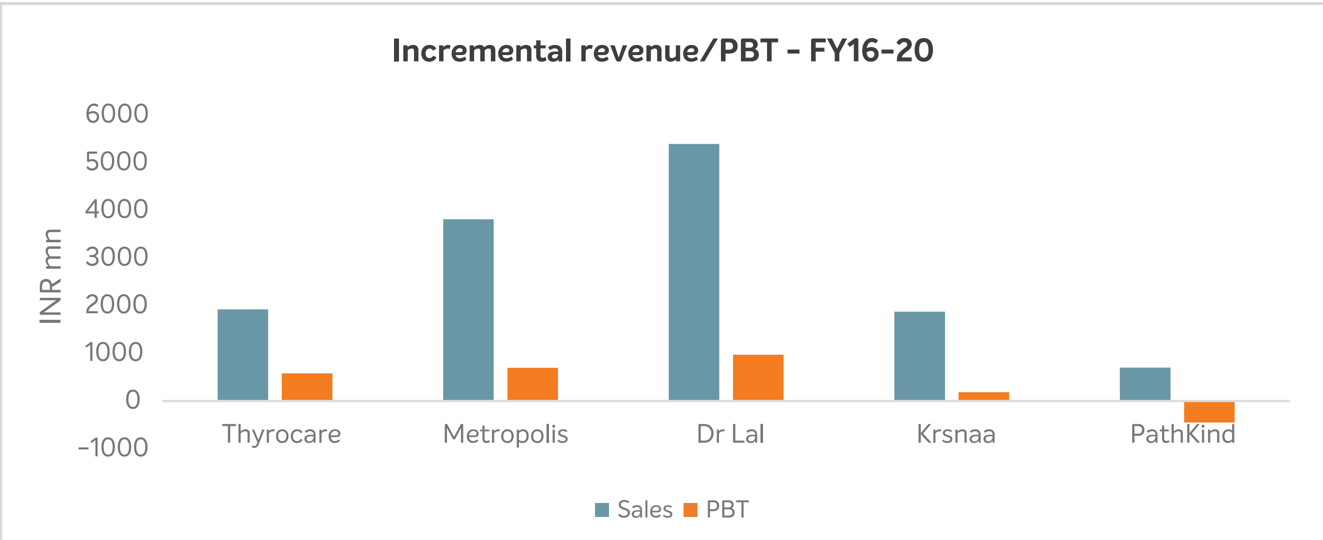
What we observe from the charts above is that as earnings and multiples both went up during Covid, the stocks gave phenomenal returns over the Covid era. However, as Covid related tests are subsiding, we have seen a significant derating and cut in consensus earnings over the last 6 months.

Is the competition and slowdown in earnings correlated?

We analyze the impact of brick and mortar and low-priced online entrants on the incumbents in the diagnostics space.

Large unorganized pie - To begin with, as per industry reports, Indian diagnostic market is USD12bn in size. However, almost 85%-90% of the market is still unorganized and large organized chains account for a miniscule 10%-15% of the market. Thus, intuition suggests that new entrants might not take the incumbents head on and may rather aim for the low hanging fruit which is the unorganized sector.

Data of brick and mortar entrants is not indicating disruption – Pathkind Labs was launched in 2016. Yet, as of FY20, it had a turnover of INR 70 crores and a loss before tax of INR 45 crores. Lupin diagnostics have also mentioned in analyst call that their operations are loss making as they are in a build up stage as of now. However, if we compare Dr. Lal, Metropolis and Thyrocare revenues to what Pathkind has been able to achieve over 4 years of operations till FY20, it is fairly conclusive that competition isn't really hurting incumbents.



*Source – Company, *PBT- Profit before Tax*

**Figures are arrived at by subtracting FY20 sales and PBT from FY16 numbers*

Data of low-priced online entrants is also not indicating disruption – While the launch of low-priced diagnostic tests by online platforms isn't anything new, the street has been largely worried about Tata 1 mg given the formidable house it comes from. However, data on Healthians, (an online platform that provides lower prices than Tata 1 mg) which was incorporated in 2013, shows that Healthians post 8 years in operations, has been able to achieve a turnover of INR 69 crores and loss before tax of INR 45 crores. In our opinion, Healthians is also backed by multiple power brands including former cricketer Yuvraj Singh^. We would like to highlight here that prices of multiple tests are lower for Healthians even when compared to recently launched menu of Tata 1mg. Hence, given that Healthians has not been able to make any significant in roads over the last few years, we cannot substantiate a hypothesis that lower prices might attract high market share or volumes.

^https://economictimes.indiatimes.com/tech/startups/yuvraj-singh-backed-healthians-draws-up-expansion-plans/articleshow/83989186.cms

Pricing of diagnostic tests comparison

Test Prices	Dr Lal	Metropolis	PharmEasy	Tata 1mg	Apollo 24/7	Lupin	Healthians
Complete blood count (CBC)	250	310	349	319	350	280	150
Glucose (fasting)	85	90	199	99	80	70	150
Lipid profile	800	800	449	100	750	340	150
Thyroid profile	550	550	249	100	600	550	150
Liver function	800	1,475	499	100	750	750	150
Kidney function	850	1,900	449	449	800	400	150
Urine routine	150	165	299	149	180	100	120
Electrolytes panel	480	525	399	399	500	400	150
Vitamin B12	1,100	1,150	499	549	1,100	1,050	210
Vitamin D	1,500	1,650	499	549	1,700	1,500	210
Iron studies	550	775	299	449	750	700	150

Source: IIFL research

Interestingly, Pathkind Labs (non discount brick and mortar model) has been able to achieve in 4 years what Healthians (high discount online platform) has taken 8 years to achieve. This also drives us to believe that unlike many segments which could be disrupted by lower prices and digital platforms, diagnostics is more of a referral and branding play.

Following the data and not the rhetoric

Given all the data we have seen above, we conclude that there is no evidence that suggests the incumbents of diagnostics could be disrupted by traditional or modern / digital / low-priced players.

We at InCred Healthcare Portfolio believe that even if there were to be a potential disruption due to online players, it is highly improbable to be significant in next 5 years. We currently infer so from the financial performance data of companies like Healthians and Pathkind Labs.

Further, data suggests that the fabric of the business is akin to that of a branded generic business where the doctor’s trust on the brand is key to business prosperity. Trust can’t be built over short time frames and can only be done through a consistent and quality service at reasonable price, in our view.

Further, in our view, true potential disruption occurs when the proposition is win – win for both the buyer and the seller. So far, it seems that while the end consumer might benefit from the lower prices, the provider in the absence of critical mass, is unlikely to be cash flow positive any time soon.

We believe that the recent stock price actions of diagnostic companies could be driven by normalization of trading multiples post Covid and an optical slowdown in business as Covid revenues subside. Hence, we would expect the stocks to start doing well once the base normalizes (goes ex Covid) and multiples might also revert to mean as the street sees lack of evidence of any potential slowdown in the sector.

Through this Newsletter, we would like to present Case Study on Thyrocare. Here are some highlights of happenings in the company.

Case Study on Thyrocare

- Thyrocare provides diagnostic testing services to patients, laboratories, and hospitals in India. The company is a dominant player in pathology and has a relatively recent foray in radiology.
- Thyrocare was a disruptor in the diagnostics space in 1990s where it cut prices of Thyroid tests and garnered high volume share from competitors. However, we note that the company got critical mass only after 15 years of operating.
- The company was earlier operating out of single reference lab (B2B) in Navi Mumbai but post acquisition by Pharmeasy, is adopting the model of its competitors (B2C) where it is opening regional labs for better service and faster delivery.
- In FY21 and FY22 company saw robust growth on account of COVID testing, contributing 24-26% to sales. The competitive scenario in the diagnostic industry has increased with new players entering in the last few months. There are also concerns with regards to pricing with online players such as 1MG launching basic test at INR 100, which may see some slowdown in non-COVID volumes picking up. However, we believe that the diagnostic sector has significant unorganized contribution (almost 85% of the market), hence, the new organized entrants are likely to cannibalize the unorganized rather than the organized segment. In FY23 we expect decline in revenues for Thyrocare due to high base of COVID related tests which is likely to come down to zero sales from 29% of sales in FY22. However non-COVID biz may see healthy growth of ~18% with increase in volumes.
- The volatile quarterly performance of Thyrocare over FY22 has been a result of the experimentation done by the new management with pricing / positioning and target segments. However, data suggests that the company has stabilized the operating model only in March 2022 and the results of which would be fully reflected in June 2022 quarter.
- Thyrocare has predominantly been a B2B player where margins are lower. With the recent acquisition by Pharmeasy which is a B2C player, Thyrocare might see sharp improvement in its B2C business, aiding in healthy profitability and better quality of revenues (brand equity).
- The stock has corrected >50% from its 52-week high (5th Aug 2021). We estimate a PAT CAGR of 19% over FY22-24E. At CMP the stock trades at 17.4x FY22 EV/EBITDA.

Source – Company, internal analysis, BSE India.com, CMP as on 6th July, 2022

*Notes - *EBITDA- Earnings before interest, taxes, depreciation, and amortization, EV – Enterprise Value, PAT – Profit after Tax, CMP- Current Market Price,*

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