Dr Lal PathLab

IPO Note – Valuation not compelling

Dr Lal PathLabs is one of the largest companies in the Indian diagnostic industry, having a market share of 12.0% amongst diagnostic chains. It's one of the fastest growing companies in the space with strong profitability.

Dominant player in the industry: The company, according to our estimates, is the second largest player with an estimated ~12% market share in the organised diagnostic chains. It has grown at a CAGR of 20.7% over FY2013-15, primarily driven by volumes which grew 16.7% during the period, while the rest was on back of pricing power. Thus, given the company's dominance in its industry and its cash flows (~₹148cr cash on the books of the company as of FY2015), we believe that the company can easily leverage growth in the diagnostic healthcare services industry in India, which will grow by a CAGR of 16-17% till FY2018.

Strong financials: The company has strong business fundamentals, which are reflected in its financials. It has exhibited a strong 20.7% CAGR on the sales front over FY2013-15, predominately led by volumes and partially on the back of pricing power. On the profitability front, the company has maintained healthy and steady margins in the range of 22-25%. The same has been driven by improvement in operating efficiency, including prudent management of costs and expenses and lower capital expenditure due to use of a "reagent rental" model.

Outlook and Valuation: The company is valued at a P/E multiple of 43.5x-44.3x its FY2016E EPS at the lower and upper end of the price band respectively, assuming industry led growth. On P/BV basis, the company trades at 10.3x-10.5x FY2016E, which factors in a higher-than-industry growth and continuance of the current profitability of the business, which the company has been maintaining over the past few years. However, though we believe that the company can sustain the profitability trend and is fundamentally strong, we believe that the valuations demanded through the IPO factor in the company's business fundamentals as well as the scarcity premium with it being the only listed company in the space. Hence, **we recommend an "Avoid" on the issue.** Investors could consider waiting for a possible correction in the stock price post the listing of the IPO.

Key Financials

Y/E March (₹ cr)	FY2013	FY2014	FY2015	FY2016E
Net Sales	**452**	**558**	**660**	**792**
% chg	*32.0*	*23.5*	*18.2*	*20.0*
Net Profit	**55**	**80**	**94**	**103**
% chg	*23.5*	*45.3*	*17.4*	*8.9*
EPS (₹)	**6.7**	**9.7**	**11.4**	**12.4**
EBITDA Margin (%)	21.6	24.8	23.6	21.7
P/E (x)	**82.3**	**56.6**	**48.2**	**44.3**
RoE (%)	39.9	40.8	32.9	26.5
RoCE (%)	51.2	52.1	40.2	34.9
P/BV (x)	27.6	19.3	13.1	10.5
EV/Sales (x)	9.9	7.9	6.5	5.4
EV/EBITDA (x)	45.9	31.7	27.4	24.7

Source: Company, Angel Research; Note :Valuations at upper price band and Equity post IPO

AVOID

Issue Open: December 8, 2015
Issue Close: December 10, 2015

Face Value: ₹10

Present Eq. Paid up Capital: ₹82.6cr

Offer Sale:1.16cr Shares

Post Eq. Paid up Capital: ₹82.6cr

Market Lot: 20 Shares

Issue (amount): ₹624-638cr

Price Band: ₹540-555

Post-issue implied mkt. cap ₹4460cr*- 4543cr**

*Note:*at Lower price band and **Upper price band*

Book Building	
QIBs	50%
Non-Institutional	15%
Retail	35%

Post Issue Shareholding Pattern(%)	
Promoters Group	58.7
MF/Banks/Indian FIs/FIIs/Public & Others	41.3

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Company background

Dr Lal PathLabs is a provider of diagnostic and related healthcare tests and services, primarily in India. It includes (a) routine clinical laboratory tests, (b) specialized tests, and (c) preventive tests. The business is based on the 'Hub and Spoke' model, whereby, specimens are collected across multiple locations within regions for delivery to predesignated clinical labs. The company has one national reference laboratory in New Delhi, 172 other clinical laboratories, 1,554 patient service centers and 7,000 pick-up points. Out of 172 clinical laboratories, 166 are owned and 6 are not owned, but operated under the brand of Dr Lal Path. Dr Lal PathLabs' 1,475 patient service centers are under the franchise model.

Zone-wise, about 73-74% of sales are from North India and 12.6% are from East India. West India and South India contribute lower proportions of ~8.5% and 5.6% of total sales, respectively.

Issue details

Through the IPO, Dr Lal PathLabs proposes to offer 1.16cr equity shares for sale by Promoter and Investors. The Promoter is offering upto 0.41cr shares and Investors are offering upto 0.75cr shares through an offer for sale. Since it is an offer for sale, the company will not receive any proceeds from sale of shares.

Exhibit 1: Shareholding pattern

Particulars	Pre-Issue		Post-Issue	
	No. of shares	(%)	No. of shares	(%)
Promoter group	52,616,200	63.7	48,486,200	58.7
Others	29,983,800	36.3	34,113,800	41.3
Total	82,600,000	100.0	82,600,000	100.0

Source: Company, Angel Research

Industry

The domestic diagnostic market is highly fragmented and has a current size of US$ ~US$5.7bn. The industry is expected to grow at a CAGR of 16-17% to ~US$9.2bn by FY2018 as per CRISIL estimates.

Diagnostic centres in India can be classified as hospital-based, diagnostic chains, and standalone centres. Standalone centres form a majority share of 48%, followed by hospital based at 37%. Thus, diagnostic chains control ~15% of the market. The absence of stringent regulations and low entry barriers has led to evolution of standalone centres, while hospitals tend to have their own pathology labs. Within diagnostic chains, large pan-India chains form 35-40% and regional chains forms 60-65%.

Specialized tests require expensive infrastructure and economy of scale and this has led to formation of diagnostic chains in India through the "Hub and Spoke" model. The fragmented nature of industry indicates low pricing power of service providers in the near term.

The key drivers for the industry are - increase in evidence-based treatments, huge demand-supply gap, increase in health insurance coverage, need for greater health coverage as population and life expectancy increase, rising income levels making quality healthcare services more affordable, and growing demand for lifestyle diseases-related healthcare services.

Key investment rational

Dominant player in the industry

The company has built a national network comprising a national reference laboratory in New Delhi, 172 clinical laboratories, 1,554 patient service centres and over 7,059 pick-up points (data as of 1HFY2016-end). The company's network has wide coverage across India, including in metropolitan areas of New Delhi, Mumbai, Bengaluru, Chennai, Hyderabad, and Kolkata.

The company, according to our estimates, is the second largest player with an estimated ~12% market share in the organised diagnostic centres space. It has grown at a CAGR of 20.7% over FY2013-15, primarily driven by volumes which grew 16.7% during the period, while the rest was on back of pricing power. Thus, given the company's dominance in its industry and its cash flows (~₹148cr cash on the books of the company as of FY2015), we believe that the company can easily leverage growth in the diagnostic healthcare services industry in India.

Currently, the company has presence in North India (which accounts for 72% of revenue) and intends to grow through enhancing presence in Eastern and Central India by setting up another reference laboratory and opening additional clinical laboratories associated with the reference laboratory. The company also plans to grow inorganically through acquisitions and strategic partnerships with key franchises and hospitals.

Strong financials

The company has strong business fundamentals, which are reflected in the financials of the company. It has exhibited a strong 20.7% CAGR on the sales front, predominately led by volumes and with some pricing power. On the profitability front, the company has maintained healthy and steady margins in the range of 22-25%. This has been driven by improvements in operating efficiency, including prudent management of costs and expenses and lower capital expenditure due to use of the "reagent rental" model. Thus, healthy operating margins along with high asset turnover has led the company to post significantly higher ROIC (in the range of 45-63%) in the past, leading to high operating ROE of 47-63%. Given the opportunity and low capital intensive nature of the business (through the franchise model), the company is a good free cash flow generating one in the healthcare space.

Valuation

The company is valued at a P/E multiple of 43.5x-44.3x its FY2016E EPS at the lower and upper end of the price band respectively, assuming industry led growth. On P/BV basis, the company trades at 10.3x-10.5x FY2016E, which factors in a higher-than-industry growth and continuance of the current profitability of the business, which the company has been maintaining over the past few years. However, though we believe that the company can sustain the profitability trend and is fundamentally strong, we believe that the valuations demanded through the IPO factor in the company's business fundamentals as well as the scarcity premium with it being the only listed company in the space. Hence, **we recommend an "Avoid" on the issue.** Investors could consider waiting for a possible correction in the stock price post the listing of the IPO.

Risks for the company

- Highly fragmented market with intense local competition (standalone centers make for 48% of the industry).
- Training and retention of critical staff such as lab technicians, who are employed at labs and collections centres.

Consolidated Profit & Loss Statement

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E
Gross sales	342	452	558	660	792
Less: Excise duty	-	-	-	-	-
Net sales	342	452	558	660	792
Other operating income	0.8	2.8	2.2	2.9	2.0
Total operating income	**343**	**455**	**560**	**663**	**794**
% chg	*44.2*	*32.5*	*23.3*	*18.3*	*19.8*
Total expenditure	256	354	419	504	620
Net raw materials	76	97	118	139	167
Personnel	54	94	102	134	161
Other	126	163	200	230	292
EBITDA	**87**	**98**	**139**	**156**	**172**
% chg		*12.9*	*41.9*	*12.5*	*10.2*
(% of Net Sales)	*25.3*	*21.6*	*24.8*	*23.6*	*21.7*
Depreciation& amortisation	20	20	27	28	28
Interest & other charges	3	0	0	0	0
Other income	1	1	6	9	9
(% of PBT)	2	1	5	7	6
Share in profit of Associates	-	-	-	-	-
Recurring PBT	**66**	**80**	**117**	**140**	**152**
% chg					
Extraordinary expense/(Inc.)	-	-	-	-	-
PBT (reported)	**66**	**80**	**117**	**140**	**152**
Tax	21	25	38	45	49
(% of PBT)	*32.0*	*30.6*	*32.7*	*32.0*	*32.0*
PAT (reported)	**45**	**56**	**81**	**95**	**104**
Add: Share of earnings of asso.	-	-	-	-	-
Less: Minority interest (MI)	1	1	1	1	1
Prior period items	-	-	-	-	-
PAT after MI (reported)	**45**	**55**	**80**	**94**	**103**
ADJ. PAT	**45**	**55**	**80**	**94**	**103**
% chg	*53.5*	*23.5*	*45.3*	*17.4*	*8.9*
(% of Net Sales)	*13.1*	*12.2*	*14.4*	*14.3*	*13.0*
Basic EPS (₹)	**5.4**	**6.7**	**9.7**	**11.4**	**12.4**
Fully Diluted EPS (₹)	**5.4**	**6.7**	**9.7**	**11.4**	**12.4**
% chg	*53.5*	*23.5*	*45.3*	*17.4*	*8.9*

*Note: *EPS calculation is based on Post IPO outstanding shares*

Consolidated Balance Sheet

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E
SOURCES OF FUNDS					
Equity share capital	5.1	5.0	80.3	81.3	82.6
Preference Capital	-	-	-	-	-
Reserves & surplus	110	157	151	260	352
Shareholders funds	**115**	**162**	**231**	**341**	**435**
Minority Interest	1.1	1.6	1.8	2.3	**2.3**
Total loans	-	0	1	-	-
Deferred tax liability	(3)	(13)	(20)	(25)	(25)
Total liabilities	**114**	**151**	**214**	**318**	**411**
APPLICATION OF FUNDS					
Net block	**86**	**94**	**98**	**109**	**119**
Capital work-in-progress	23	33	42	42	42
Goodwill	6	1	0	1	1
Investments	**4.8**	**54.8**	**8.6**	**37.9**	**37.9**
Current assets	55	74	183	261	371
Cash	13	22	106	148	182
Loans & advances	16	21	24	41	103
Other	25	32	53	72	86
Current liabilities	60	105	117	132	158
Net current assets	**(5)**	**(31)**	**66**	**129**	**213**
Mis. Exp. not written off	(1.0)	(0.5)	(1.0)	-	-
Total assets	**114**	**151**	**214**	**318**	**411**

Consolidated Cash Flow Statement

Y/E March	FY2012	FY2013	FY2014	FY2015	FY2016E
Profit before tax	66	80	117	140	152
Depreciation	20	20	27	28	28
(Inc)/Dec in Working Capital	(0)	(36)	77	104	7
Less: Other income	-	-	-	-	-
Direct taxes paid	21	25	38	45	49
Cash Flow from Operations	**65**	**40**	**183**	**228**	**139**
(Inc.)/Dec.in Fixed Assets	(24)	(21)	(20)	(32)	(32)
(Inc.)/Dec. in Investments	-	-	-	-	-
Other income	-	-	-	-	-
Cash Flow from Investing	**(24)**	**(21)**	**(20)**	**(32)**	**(32)**
Issue of Equity	-	-	-	-	-
Inc./(Dec.) in loans	(18)	0	1	(1)	-
Dividend Paid (Incl. Tax)	(3)	(15)	(10)	(10)	(10)
Others	(30)	3	(71)	(141)	(63)
Cash Flow from Financing	**(50)**	**(12)**	**(80)**	**(152)**	**(73)**
Inc./(Dec.) in Cash	(9)	8	84	43	34
Opening Cash balances	**23**	**13**	**22**	**106**	**148**
Closing Cash balances	**13**	**22**	**106**	**148**	**182**

Key Ratios

Y/E March	FY2012	FY2013	FY2014	FY2015	FY2016E
Valuation Ratio (x)					
P/E (on FDEPS)	101.6	82.3	56.6	48.2	44.3
P/CEPS	70.4	60.1	42.2	37.1	34.7
P/BV	38.8	27.6	19.3	13.1	10.5
Dividend yield (%)	0.2	0.1	0.1	0.3	0.3
EV/Sales	13.1	9.9	7.9	6.5	5.4
EV/EBITDA	52.0	45.9	31.7	27.4	24.7
EV / Total Assets	39.6	29.7	20.6	13.4	10.3
Per Share Data (₹)					
EPS (Basic)	5.4	6.7	9.7	11.4	12.4
EPS (fully diluted)	5.4	6.7	9.7	11.4	12.4
Cash EPS	7.8	9.2	13.0	14.8	15.8
DPS	1.1	0.6	0.7	1.5	1.5
Book Value	14.2	19.9	28.5	42.0	52.6
Dupont Analysis					
EBIT margin	19.5	17.1	19.9	19.4	18.2
Tax retention ratio	68.0	69.4	67.3	68.0	68.0
Asset turnover (x)	3.4	4.0	4.7	4.8	4.0
ROIC (Post-tax)	45.4	47.1	63.4	62.9	49.0
Cost of Debt (Post Tax)	0.0	138.8	20.7	60.4	54.4
Leverage (x)	0.5	0.0	0.0	0.0	0.0
Operating ROE	67.4	47.1	63.4	62.9	49.0
Returns (%)					
ROCE (Pre-tax)	58.7	51.2	52.1	40.2	34.9
Angel ROIC (Pre-tax)	93.9	92.3	137.0	132.2	91.4
ROE	38.8	39.9	40.8	32.9	26.5
Turnover ratios (x)					
Asset Turnover (Net Block)	4.0	5.1	5.8	6.4	7.0
Inventory / Sales (days)	6.0	5.4	6.2	6.8	6.9
Receivables (days)	14.9	13.4	14.1	14.7	13.5
Payables (days)	30.9	25.6	26.1	23.4	10.6
WCcycle (ex-cash) (days)	(19.5)	(28.2)	(29.9)	(16.2)	2.7
Solvency ratios (x)					
Net debt to equity	(0.1)	(0.1)	(0.5)	(0.4)	(0.4)
Net debt to EBITDA	(0.2)	(0.2)	(0.8)	(1.0)	(1.1)
Interest Coverage (EBIT / Interest)	26.7	193.2	556.6	319.4	359.4

*Note:*EPS and other valuation parameters is based on post IPO outstanding shares at upper price band*

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