JSC Evex Hospitals
Georgia, Healthcare Services

STABLE
BB

Corporate profile

JSC Evex Hospitals (Evex) is a subsidiary of privately owned Georgian Healthcare Group (GHG), listed on the premium segment of the London Stock Exchange. Evex operates 18 hospitals located in major regional cities of Georgia. After its successful IPO in November 2015, GHG acquired and renovated new healthcare facilities to enlarge its network and create high-quality and wide-ranging medical services across the hospitals. GHG decided in 2018 to separate its individual businesses going forward.

Key metrics

			Scope estimates	
Scope credit ratios	2017	2018	2019F	2020F
EBITDA/interest cover (x)	4x	4x	4x	5x
Scope-adjusted debt (SaD)/EBITDA	3.6x	3.3x	2.7x	2.1x
Scope-adjusted FFO/SaD	21%	25%	27%	36%
Free operating cash flow (FOCF)/SaD	-12%	-8%	17%	27%

Rating rationale

Scope Ratings assigns an issuer rating of BB to Georgian-based hospital operator Evex Hospitals. The rating Outlook is Stable.

The issuer rating is mainly driven by Evex's credit-supportive business risk profile. This reflects our view of the company's relatively protected underlying market of healthcare services, significant market shares in Georgia as the country's leading operator of referral hospitals, and high level of profitability. Credit metrics in 2018 still reflected the high capex levels from the expansion and modernisation programme which ended that year, but we believe they can improve significantly in 2019. The rating also reflects the evolving macro-economic and industrial environment in which the company operates, with risks and opportunities presented by expected market consolidation. We have not added notches for parent support as we deem both companies to have similar credit qualities. We believe, though, that Evex's corporate governance standards will be aligned to those of its London-listed parent.

The business risk profile is rated BB. Evex's underlying industry of healthcare services has relatively favourable credit characteristics in our view, with low cyclicality, medium entry barriers, and medium substitution risk. This translates into an overall industry risk rating of A. Regarding competitive position, Evex's market shares and comparatively high operating margins provide the strongest rating support. With about GEL 300m in revenues expected for 2019, the company holds more than 20% of the Georgian market. Sales and capacity utilisation of beds are already expected to grow significantly in 2019 after the recent modernisation and expansion programme. This makes it likely that market share will continue to rise, helping Evex to maintain its strong national lead.

With a 2018 EBITDA margin of about 28% (28% in the first quarter of 2019), Evex's operating profitability not only compares well to domestic peers but also to much larger international ones, such as Mediclinic or Helios. Evex's strong profitability reflects its scale as well as looser regulations in Georgia compared to those in Western markets.

Ratings & Outlook

Corporate ratings	BB/Stable
Short-term rating	-
Senior unsecured rating	BB

Analysts

Olaf Tölke
+49 69 6677389 11
o.toelke@scoperatings.com

Related methodology

Corporate Rating Methodology

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Tel. +49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Tel. +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Evex's diversification is less favourable than that of larger multinational consumer goods peers, given its focus on one country and one industry (healthcare). This might improve in the future following plans to increase the sales share of 'medical tourism', by attracting wealthy patients from neighbouring countries such as Armenia and Azerbaijan. However, this business will take years to gain relevance – currently it represents less than 5% of company sales. The company's diversification within hospitals is good: its treatment area exposure is much stronger than domestic peers'. Evex is presently most exposed to the Georgian state in terms of the payor structure. Georgia's national healthcare insurance, UHC, accounts for about two-thirds of Evex's annual revenues. This is credit-positive due to regulatory transparency and the state's ability to pay, assuming the country's positive economic development is sustained. However, management is seeking to expand its private sector exposure as this would accelerate cash inflow and decrease dependence on UHC.

Evex's **financial risk profile** (rated BB) is the same quality as its business risk profile. The company's solid operating profitability, with an EBITDA margin of about 28%, is likely to enable significant free cash flow generation in 2019. This was not the case in the last three years due to the modernisation and expansion programme. In 2018, capex of about GEL 50m (compared to an annual maintenance capex of about GEL 10m) resulted in negative free operating cash flow of GEL -12m. Consistently negative working capital via high receivables is the result of the delayed payment policy of state insurance (five months) – the negative aspect of UHC dependence. In 2018, credit metrics were thus depressed but still reflect a low BB credit quality on average. Due to a 20% increase in EBITDA over 2017, leverage as expressed by Scope-adjusted debt/EBITDA was 3.3x.

Evex's liquidity in the recent past has barely covered short-term debt. There are no committed credit lines, which appears to be in line with other Georgian companies we have rated recently. This is due to 2018 being Evex's first year as a stand-alone company and liquidity having been addressed by its parent beforehand. We believe there is a good chance for substantial free cash flow in the future and, with it, adequate liquidity levels. Evex's short-term debt maturities stand at about GEL 20m. This is likely to reduce in the future given a successful bond placement, which we expect to replace several amortising bank loans.

For 2019, we expect strong revenue growth, already confirmed by the 16% growth rate in the first quarter. This is likely to lead to a parallel increase in operating profits, resulting in a stable underlying EBITDA margin of about 28% for full-year 2019. Together with the normalisation of capex (GEL 12m assumed for 2019), this translates into free cash flow of about GEL 40m in our base case. This will enable significant deleveraging, making strong progress in 2019 credit metrics likely.

Our projections on financial metrics for the next two years are conservative, reflecting the evolving dynamics of both the country of Georgia and the healthcare services sector.

Among the **supplementary ratings drivers**, we do not expect financial policy to be an issue. Evex is fully owned by GHG, which is focused on deleveraging and reaching a leverage of 2x by the end of 2020. We have assumed zero dividend payments for 2019 and 2020 because GHG has no dividend expectations. Transparency is satisfactory, in our view, given Evex's recent carve-out from GHG.

We have calculated a recovery rate of about 60% for GEL 90m senior unsecured bond (existing bank loans are ranked ahead) in a hypothetical case of default.

Outlook

The Outlook is Stable and reflects our expectation that Evex can maintain a funds from operations (FFO)/Scope-adjusted debt (SaD) of above 30% without SaD/EBITDA significantly exceeding 3x. A positive rating action could be warranted by an FFO/SaD of above 35% and a SaD/EBITDA of below 3x, both on a sustained basis. A negative rating action could result from an FFO/SaD of below 15% and a SaD/EBITDA of above 4x, both also on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Market leader for referral hospitals in Georgia • Underlying healthcare services market of low-cyclical and relatively protected nature • Comparatively high operating margins • Immediate potential to generate free operating cash flow	• Fragmented and evolving market with comparatively low outpatient visits • Weak overall diversification • Negative free operating cash flow

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Critical size and diversification • FFO/SaD >35%; SaD/EBITDA <3x	• Potential acquisition • FFO/SaD <15%; SaD/EBITDA >4x

Financial overview

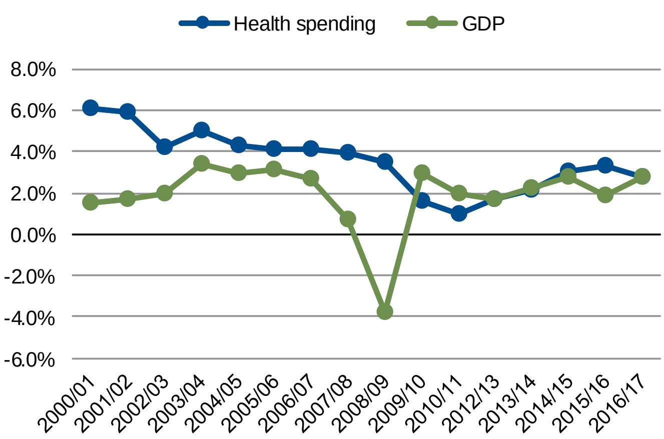
			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
EBITDA/interest cover (x)	4x	4x	4x	5x
SaD/EBITDA	3.6	3.3x	2.7x	2.1x
Scope-adjusted FFO/SaD	21%	25%	27%	36%
FOCF/SaD	-12%	-8%	17%	27%
Scope-adjusted EBITDA in GEL m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	62	74	86	91
Operating lease payments in respective year	1	1	1	1
Other items	0	0	0	0
Scope-adjusted EBITDA	63	75	87	92
Scope-adjusted funds from operations in GEL m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	62	74	86	91
less: (net) cash interest as per cash flow statement	-12	-19	-22	-19
less: cash tax paid as per cash flow statement	0	0	-1	-1
add: depreciation component, operating leases	0	0	0	0
Scope-adjusted funds from operations	50	55	63	71
Scope-adjusted debt in GEL m	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	252	255	237	195
less: cash, cash equivalents	-29	-14	-14	-17
Cash not accessible	0	0	0	0
add: pension adjustment	0	0	5	10
add: operating lease obligations	6	7	8	9
Other items	0	0	0	0
Scope-adjusted debt	229	247	236	197

Business risk profile

Supportive industry risk

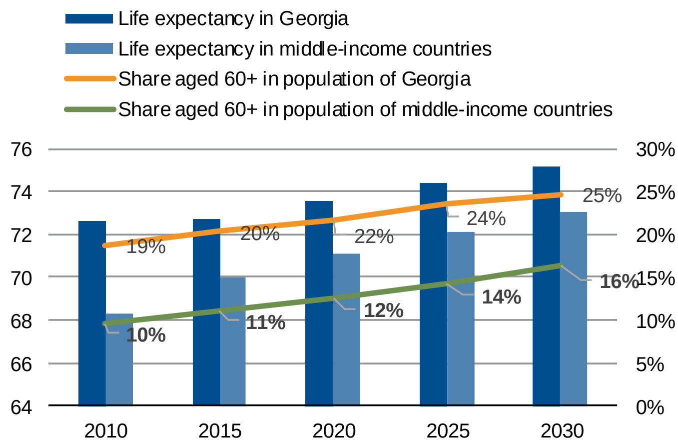
We consider the company's underlying sector of healthcare services to be very credit-supportive. This follows our evaluation of long-term spending patterns in healthcare compared to gross domestic production, as depicted below for OECD countries. In addition, we believe the industry has medium entry barriers and low substitution risk (i.e. low likelihood of the healthcare segment's obsolescence).

Figure 1: Low macro-economic cyclicality



Source: OECD Health Statistics

Figure 2: Conductive age structure



Source: World Bank

Low cyclicality

We consider healthcare services to have low cyclicality. This is intuitively confirmed by the two main drivers of healthcare spending: the ageing population and lifestyle-related factors such as convenience, low physical activity and obesity rates. All are independent of GDP-related factors and have resulted in rising healthcare spending since around 2000.

Medium entry barriers

Entry barriers in this sector are medium, in our view. While it is technically possible to enter the healthcare services market – as evidenced by new small players in nursing care or medical laboratories – large organisations and hospitals continue to dominate. Regulatory hurdles, high capital and knowledge intensity, and scarcity of space for facilities in high-density areas have proven to be effective market entry barriers.

Low substitution risk

We believe sector replacement risk in healthcare services is low. Today, it is difficult to imagine alternative treatments to those provided in hospitals and nursing homes. While traditional large-family structures or a tendency to 'go back to nature' could theoretically provide an alternative, we believe this is unlikely.

Figure 2: Scope industry-risk matrix, healthcare services

Cyclicality	Barriers to entry		
	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Source: Scope

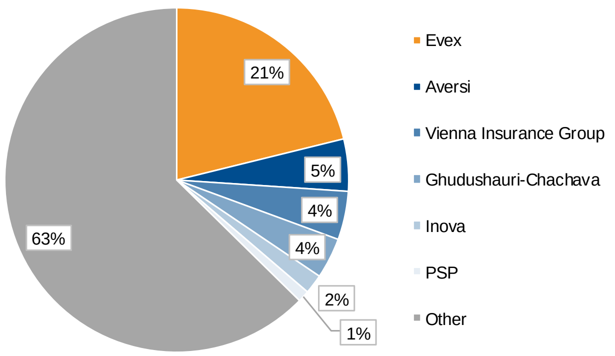
Competitive position

High market shares

Evex leads the Georgian healthcare service industry, with more than 20% of the market by number of clinical beds (see chart 3). The closest domestic competitor, Aversi, holds only 5%. Evex's competitive position is supported by several factors:

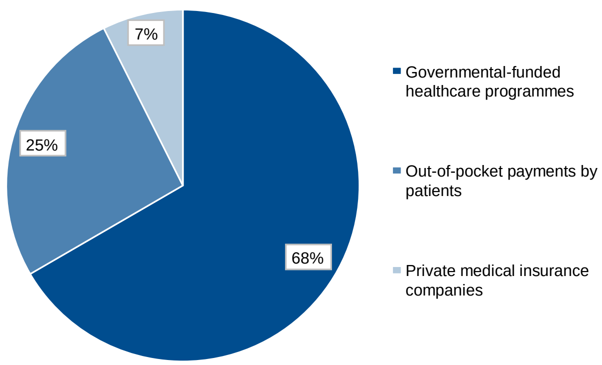
- **Positioning of the hospitals chain.** Evex has 18 referral hospitals in major cities that offer the complete treatment option, ranging from local physicians in polyclinics and community clinics, to referral hospitals. Facilities have been thoroughly modernised and equipped with state-of-the-art technology. Evex claims that waiting times are limited for new patients, helped by its larger size domestically and room for growth in utilisation rates.
- **Strong government ties.** Government business provides reliable revenue streams and regulatory transparency, comprising more than 60% of hospital revenue.
- **Ageing population in Georgia.** The share of those aged 60+ in Georgia is increasing along with life expectancy, opening the doors for longer and more intense treatments.
- **Measures to mitigate skills shortage.** Georgian healthcare services is facing a skills shortage for doctors, nurses and other healthcare professionals. Evex's own nursing college and residency program allows it to source specialists in fields affected by a lack of qualified personnel.

Figure 2: Leading market shares per clinical bed



Source: GHG

Figure 3: Dominating government-funded business



Source: GHG

Evex plays a major role in Georgia's healthcare services market given its significant scale and wide range of healthcare services. The company has also managed to dominate the market at a rapid pace – from about a 5% share seven years ago, to the biggest player in Georgian healthcare services by far.

Weak diversification

However, Evex is small in an international context. With a focus on one region and one industry so far, the company's diversification is weaker than that of larger multinational healthcare services companies.

UHC has been the main revenue contributor since 2017, at about two-thirds of total sales. Out-of-pocket payments grew to 25% in 2018 from 24% in the year before.

Evex is actively seeking to reduce its dependence on UHC by expanding in the outpatient and planned medical services markets. The latter are funded by either the patients themselves or private insurance.

Evex's wide-ranging and diversified medical treatment structures are credit-positive, offsetting some of the negative diversification aspects mentioned above:

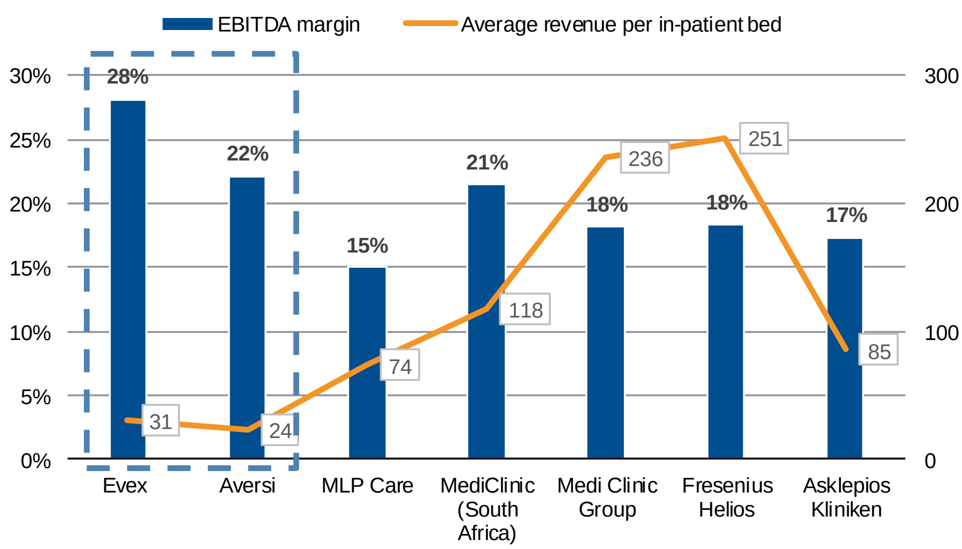
- **Cardiology.** Evex's division is the largest and most modern in Georgia. Cardiovascular diseases are by far the leading cause of death in the country.
- **Liver transplants.** The company has been a pioneer and the main service provider in this treatment area since 2014.
- **Oncology.** Evex's oncology centre is the largest in Kutaisi. Cancer is the second-leading cause of death after cardiovascular diseases in Georgia, according to the National Centre for Disease Control and Public Health.
- **Bone marrow transplants.** The service was only available in Georgia from 2018. Patients diagnosed with leukaemia, severe blood diseases or multiple myeloma previously had been treated abroad.
- **Ophthalmology**. Six months after Evex launched its ophthalmology department in 2018, its market share rose to 15% from just under 3%.

In the last three years, Evex has invested in upgrading hospital infrastructure and improving customer service. This has helped to recapture domestic patients who would otherwise have travelled abroad for treatment. Now, Evex even attracts patients from outside of Georgia. Its main priority is to raise awareness among post-Soviet neighbouring countries, thereby competing with Turkish hospitals. While medical tourism can mitigate the sole exposure to Georgia, we believe it could be up to five years before this revenue share becomes significant. Currently, only 1% of revenues stem from international patients.

High profitability

Evex has comparatively high profitability (28% EBITDA margin in 2018), both locally (Aversi) and compared to European peers (Helios and Asklepios, two German hospital operators) as shown in chart 5 below. We believe this is explained by i) Evex's significant scale locally; and ii) more lax regulations in Georgia's healthcare market relative to those internationally. Evex achieved EBITDA margins in excess of 25% in the last three years, even when capacity utilisation was low due to heavy infrastructure spending between 2015 and 2018.

Figure 5: Industry-leading margins



Source: Scope

Financial risk profile

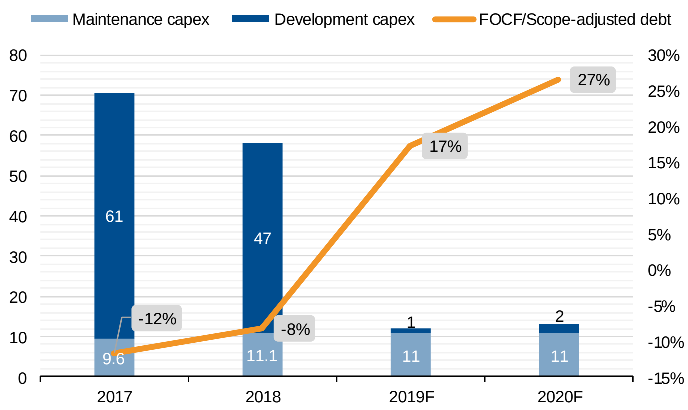
Healthy credit metrics; free cash flow to turn positive in 2019

Despite solid operating profitability (EBITDA margin of about 28% and annual sales growth of 13%), free cash flows were negative in 2018. This was caused – as in the two years before – by Evex's three-year capital expenditure programme to modernise and expand the company's facilities. In addition, negative working capital absorption was high in 2018, with increased receivables due to the government's delayed payment policy. Other credit metrics remained at healthy levels, as demonstrated by an FFO/SaD of close to 30% in 2018 and by leverage as expressed by SaD/EBITDA of 3.3x.

To mitigate the effect from the high capex in 2018, owners increased equity by GEL 20m, which contributed to a GEL 14m deleveraging (on a net-debt basis). In our view, this exemplified the strong commitment by owners to keep credit metrics under control during the expansion programme. Management's conservative financial policy is also reflected in no dividend payments being scheduled for now.

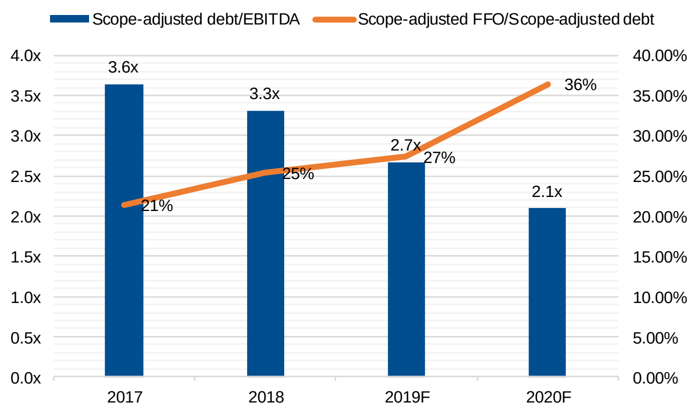
We expect significant improvements in credit metrics already in 2019. This is supported both by rising EBITDA – following strong organic growth, mainly via the gradual ramp-up of the new regional hospital and Tbilisi referral hospital – and by the strong likely recovery in free cash flow in 2019, predominantly due to a normalisation in capex after the investment programme ended in 2018. All are likely to lead to stronger credit metrics in 2019 and 2020.

Figure 4: Significant rise in free cash flows expected



Source: Scope

Figure 5: Selected Scope metrics



Source: Scope

Liquidity expected to improve

Short-term maturities from Evex's amortising bank loans were about GEL 20m in 2017, which still affected 2018 liquidity very negatively as there were no committed lines. Free cash flow was also negative due to Evex's capex programme. We project strong and positive free cash flows in 2019, which are likely to lead to adequate liquidity levels. In addition, all bank loans are guaranteed by the parent.

Evex has covenants from Propaco, EBRD and IFC. All are complied with and we expect no change for 2019. Evex has a limited operational forex exposure, while one sizeable loan (GEL 62m, about 25% of total financial debt) from Propaco is denominated in US dollars.

We also estimate recovery values to bond holders in a hypothetical case of default. We have calculated about a 60% recovery rate for the GEL 90m senior unsecured bond (existing bank loans and vendor loans are secured), based on a distressed EBITDA of about GEL 38m and an exit multiple of four. While this would technically result in a one-notch uplift for the bond compared to the issuer rating, we have decided not to apply it.

This is based on the risk of an appreciation in foreign-currency denominated debt, and the heightened risk of bankruptcy resolution in Georgia as an emerging market. In addition, we conclude future issue of senior unsecured bond in the range of GEL 100m to refinance existing bank loans wouldn't be notched.

Outlook

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Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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