07 July 2021

Corporates

JSC Evex Hospitals
Georgia, Healthcare Services

SCOPE BB STABLE

Corporate profile

JSC Evex Hospitals (Evex) is a subsidiary of the Georgian Healthcare Group (GHG). Evex operates 17 hospitals located in major regional cities in Georgia. GHG acquires new healthcare facilities and renovates existing ones to enlarge its network and create a wide range of high-quality medical services across its hospitals.

Key metrics

			Scope estimates		
Scope credit ratios	2019	2020	2021E	2022E	2023E
EBITDA/interest cover	2.8x	2.5x	2.9x	3.4x	3.9x
Scope-adjusted debt (SaD)/EBITDA	3.5x	3.9x	3.2x	3.1x	2.7x
Scope-adjusted funds from operations/SaD	23%	13%	23%	25%	29%
Free operating cash flow/SaD	8%	23%	4%	9%	15%

Rating rationale

Our affirmation of Evex's rating is driven by solid operating cash flow generation and conservative liquidity management. The rating continues to be constrained by limited scale and high dependence on government-funded revenue streams.

Evex’s business risk profile (assessed at BB) remains dominant in the fragmented Georgian healthcare service industry, with around 18% of the market by number of hospital beds and around 20% of the market by sales, while its market position remains constrained by a relatively limited addressable market. Despite negative top-line performance in 2020, we believe organic growth from ramped-up hospitals along with increased utilisation levels and the ability to control direct salary rates will help the company achieve mid-single-digit revenue growth and protect cash flow generation during the next few years.

Although several safety and regulatory standards that have been introduced on the market have added to Evex's competitive advantage in this fragmented market, we believe that efforts to reform healthcare reimbursement, prices, and access in the coming years will be incremental rather than dramatic. However, we underscore that Evex has significant risk due to its continued high dependence on government-funded revenue streams, as any changes to its reimbursement portfolio or prices could have a significant adverse effect on the company's business performance (credit-negative social ESG factor).

Evex’s financial risk profile (assessed at BB) is supported by comfortable operating profitability, reflected in substantial cash flow generation. Operating cash flow is expected to be weaker in 2021 as a result of the collection period for lower revenues generated during the 2020 lockdown, but annual expected capex in the low double-digit million range continues to be valid, and this will still provide an additional benefit to financial flexibility. Our rating case presumes that leverage will gradually return to around 3.0x.

Evex has adequate liquidity. Committed credit lines are limited. Nevertheless, a significant cash buffer of GEL 67m and high EBITDA cash conversion, reflected in expected positive free operating cash flow, should be sufficient to fully cover (re-)financing needs.

Ratings & Outlook

Corporate rating	BB/Stable
Senior unsecured rating	BB

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Related methodology

Corporate Rating Methodology: February 2020

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We have not made any explicit adjustments to supplementary rating drivers. While the medium-term strategy that Georgia Capital (GC), the ultimate owner of Evex, has publicly communicated raises concerns about a potential upstream dividend burden on Evex should GC dispose one of its dividend-paying divisions, we believe that relatively high contributions to the parent will likely move with operating results and will not have a significant negative impact on financial metrics.

Outlook and rating-change drivers

Stable Outlook

The Stable Outlook reflects our expectation that resumed elective care treatments and organic growth of ramped-up hospitals will rebound sales while SaD/EBITDA remains below 4.0x on a sustained basis.

Rating upside

A positive rating action could be warranted if SaD/EBITDA (Scope-adjusted figures) consistently trends below 3x. A decrease in leverage could be achieved by increasing profitability via organic growth, limited capex, and lower intercompany loan levels, all of which are in the company's explicit financial targets. However, a positive rating action is deemed to be unlikely in the foreseeable future given the company's scope and outreach in the emerging market that is the Republic of Georgia (rated BB/Negative at Scope).

Rating downside

A negative rating action could result from a deterioration in credit metrics, as indicated by free operating cash flow below 5% and SaD/EBITDA of above 4x on a sustained basis, or a shift to a more aggressive financial policy. Weak financial performance could be triggered by an adverse change in regulations, which would put operating profitability under pressure, or higher-than-expected dividend payouts.

Rating drivers

Positive rating drivers	Negative rating drivers
• Market-leading position in referral hospitals in Georgian healthcare market • Underlying healthcare services market has low cyclicality and is protected • Comparatively high operating margins • Modest leverage	• Low number of outpatients per capita compared to peer countries • Weak diversification, with all operations in Georgia and only in one industry • Unstable regulatory framework (credit-negative ESG factor) • Substantial dividend payments limiting room for active deleveraging

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• SaD/EBITDA (Scope-adjusted figures) consistently trends below 3x. However, a positive rating action is deemed to be unlikely in the foreseeable future given the company's scope and outreach in the emerging market that is the Republic of Georgia (rated BB/Negative at Scope)	• FOCF below 5% on a sustained basis • SaD/EBITDA above 4x • Aggressive financial policy

Financial overview

			Scope estimates		
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA/interest cover	2.8x	2.5x	2.9x	3.4x	3.9x
SaD/EBITDA	3.5x	3.9x	3.2x	3.1x	2.7x
Scope-adjusted FFO/SaD	23%	13%	23%	25%	29%
FOCF/SaD	8%	23%	4%	9%	15%
Scope-adjusted EBITDA in GEL m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
EBITDA	82	57	71	76	84
Capitalised software development costs	-6	-6	-5	-4	-4
Other	-1	1	0	0	0
Scope-adjusted EBITDA	75	53	66	72	80
Scope-adjusted funds from operations in GEL m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Scope-adjusted EBITDA	75	53	66	72	80
less: (net) cash interest as per cash flow statement	-27	-23	-23	-21	-21
less: cash tax paid as per cash flow statement	0	0	0	0	0
Other	0	0	0	0	0
Scope-adjusted FFO	48	29	44	51	59
Scope-adjusted debt in GEL m	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Reported gross financial debt	265	264	254	229	219
Cash, cash equivalents	-5	-67	-50	-14	-6
Pension adjustments	5	5	5	5	6
Operating lease obligations	0	0	0	0	0
SaD	266	203	209	220	219

Business risk profile (BB)

Credit-supportive industry risk

Evex's business risk benefits from the underlying healthcare service industry's low cyclicality, medium barriers to entry, and low substitution risk.

Market dominance in Georgian healthcare industry

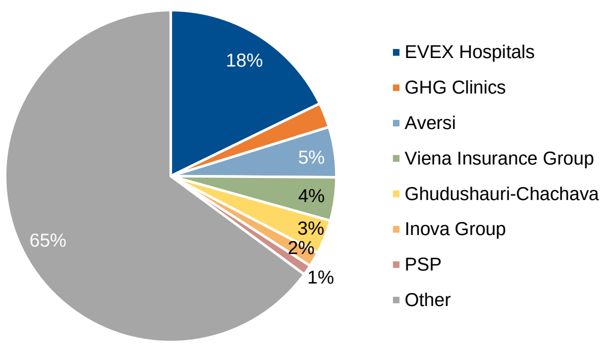
Evex remains dominant in the fragmented Georgian healthcare service industry, with around 18% of the market by number of clinical beds and around 20% of the market by sales, while its market position remains constrained by a relatively limited addressable market. Negative organic growth of around 6% in 2020 was the result of limited inpatient admissions and postponed elective care during lockdown, particularly in Q2 2020. Sales recovered during the second half of 2020 despite a suspension of guarantee letters for government-funded elective treatments. On the other hand, top-line growth was negatively affected by the disposal of the High Technology Medical Centre (HTMC) and the Fifth Clinical Hospital.

Top-line growth constrained by Covid-19 pandemic and regulatory changes

In 2021 the company's top line will benefit from: i) pent-up demand for elective procedures, which was partially confirmed by Q1 results; ii) organic growth of mature hospitals; and iii) increased utilisation.

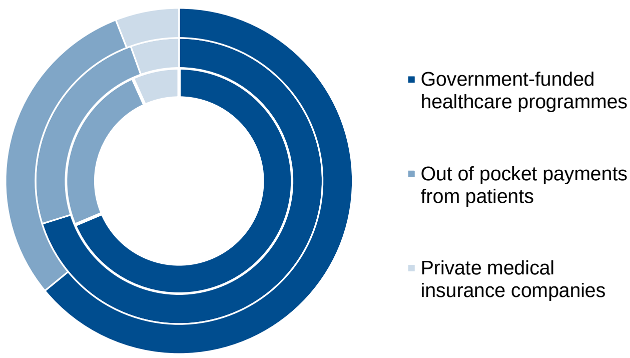
Although several safety and regulatory standards that have been introduced on the market have added to Evex's competitive advantage in this fragmented market, we believe that efforts to reform healthcare reimbursement, prices, and access in the coming years will be incremental rather than dramatic. However, we see significant risk due to Evex's continued high dependence on government-funded revenue streams, as any turbulence or changes in its reimbursement portfolio or prices could have a significant adverse effect on the company's business performance.

Figure 1: Shares of Georgian healthcare service market[1] in 2020



Source: Evex, Scope

Figure 2: Evex's revenue stream diversification (inner circle-Dec 2019, middle circle-Dec 2020, outer circle-Dec 2023)



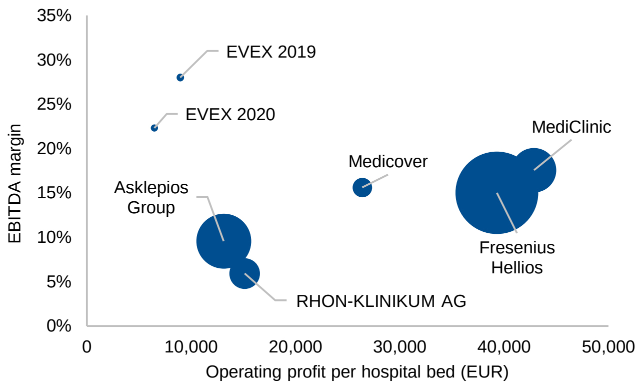
Source: Evex, Scope

Diversification is weakest component of business risk profile

Geographical diversification remains the main constraint for Evex's business risk profile as the company only operates in one country and one industry. In addition, increased dependence on government-funded healthcare programmes in 2020 further limits diversification. We do not expect any significant changes in revenue-stream diversification in the medium term.

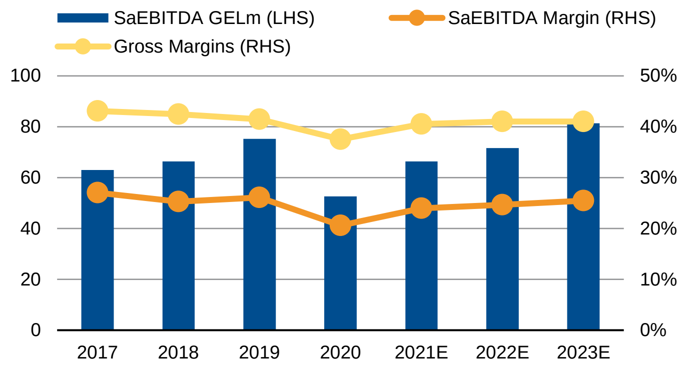
[1] Per hospital beds

Figure 3: Healthcare service providers



Source: Evex, Scope

Figure 4: Evex's operating performance



Source: Evex, Scope estimates

Solid profitability impacted by Covid-19 pandemic in short term

Despite higher-than-expected materials costs reflecting local currency exchange-rate depreciation as well as increased consumption of medical disposables and personal protective equipment at healthcare facilities due to Covid-19, the company managed to maintain an EBITDA margin of above 20% as we anticipated in our last base case, thanks to its ability to control direct salary costs. More visible adverse effects (organic growth, EBITDA margins, profit per hospital bed) on Evex's operating performance during the pandemic underscores once again that the Georgian healthcare market is less robust than more mature European markets. Yet we believe that Evex will be able to bring profitability margins back to normal, near 25%, in the short-to-medium term, as already indicated by its Q1 2021 performance. This is mainly due to expected organic growth from mature hospitals along with increased utilisation levels and the ability to control direct salary rates as fixed direct personnel costs decrease.

Financial risk profile (BB)

Scope adjustments and assumptions

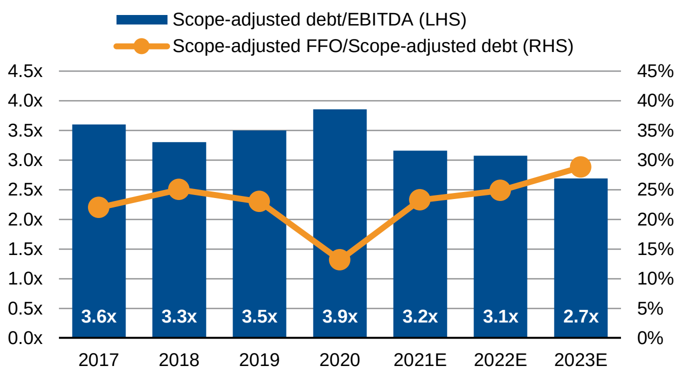
Our financial projections are mainly based on the following assumptions:

- We expect revenues to rebound by around 15% to GEL 277m in FY 2021. Going forward, mid-single-digit percentage growth on top line despite potential divestitures of some hospitals.
- We expect EVEX's capital spending to stay near GEL 20m over the next three years.
- No acquisitions are expected. No material disposals are expected – maximum of GEL 10m in line with its portfolio-optimisation strategy to divest assets with low returns.
- We expect dividend payments of 70-90% of net profit as a result of a change in ownership.
- Pension provisions of GEL 5m were added to SaD, reflecting legislative changes that the Georgian government initiated in 2019 for pension payments.
- EBITDA was adjusted by capitalised software development costs

Financial risk profile affirmed at BB

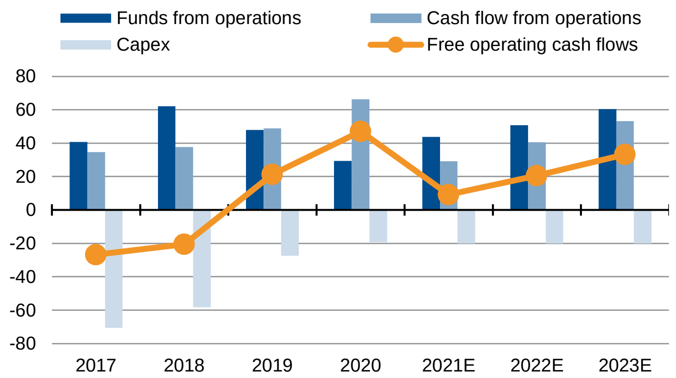
Evex's financial risk profile is comparable to its business risk profile from a ratings perspective. 2020 financial results remained in comfortable territory despite an anticipated decline due to the double blow of regulatory changes and the Covid-19 pandemic. Deteriorated operating performance benefited from higher cash conversion rates and a significantly larger cash cushion from received cash proceeds of GEL 32.8m after the disposal of hospitals generating low returns.

Figure 5: Leverage



Source: Evex, Scope estimates

Figure 6: Cash flow generation (GELm)



Source: Evex, Scope estimates

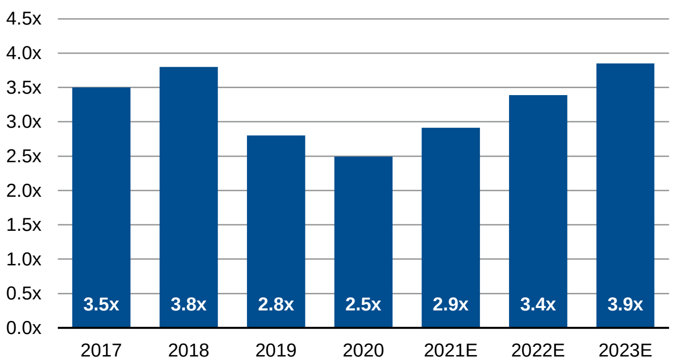
Comfortable credit metrics despite weaker performance in 2020

Operating cash flow is expected to be weaker in 2021 as a result of the collection period for lower revenues generated during the 2020 lockdown, but annual expected capex in the low double-digit million range (GEL 15-20m) continues to be valid, and this will still provide an additional benefit in deleveraging with free operating cash flows. Our rating case presumes that leverage will gradually return to around 3.0x (2021E: 3.2x 2022E: 3.1x).

We believe that Evex will focus on organic growth and will only pursue inorganic growth opportunities to a limited extent over the next few years. An expected GEL 10m of cash proceeds from divestitures of hospitals generating low returns will further increase the company's financial flexibility.

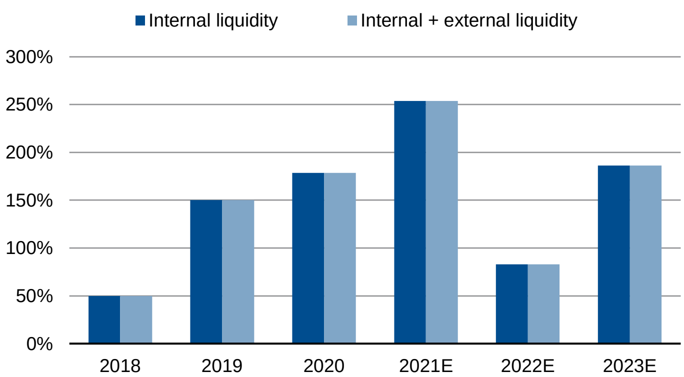
Georgia has relatively high interest rates, and this puts pressure on Evex's EBITDA interest coverage. In addition, interest cover deteriorated in 2020 as a result of unrealised interest proceeds on intercompany loans and remarkably low EBITDA levels. We expect the ratio to remain at a modest level of near 4.0x in 2021-2023, supported by higher EBITDA and anticipated deleveraging.

Figure 7: Interest cover



Source: Evex, Scope estimates

Figure 8: Liquidity profile



Source: Evex, Scope estimates

We consider Evex's liquidity to be adequate. Committed credit lines are limited. Nevertheless, a significant cash buffer of GEL 67m and high EBITDA cash conversion, reflected in expected positive free operating cash flow in 2021-2023, should be sufficient to fully cover (re-)financing needs. Short-term debt is expected to peak in 2022 consisting of GEL 50m senior secured bond and GEL 25m bank debt. While such high debt positions hardly be redeemed from company's operating business, we believe Evex can easily refinance debt with well-established relationship with local banks as well as international financial institutions like the European Bank for Reconstruction and Development and/or still sizable intercompany loans on balance could be claimed if required.

Liquidity remains adequate

In detail:

Position	2021E		2022E	
Unrestricted cash (t-1)	GEL	67m	GEL	50m
Open committed credit lines (t-1)	GEL	0m	GEL	0m
Free operating cash flow[2]	GEL	9m	GEL	21m
Short-term debt (t-1)	GEL	30m	GEL	85m
Coverage		**2.5x**		**0.8x**

We do not expect significant changes in the company's future capital investment programme and/or debt-financed acquisitions. The latter is protected by the wide range of existing financial covenants from Proparco, EBRD, and IFC.

Supplementary rating drivers

Credit-neutral financial policy

Evex's financial policy is credit-neutral for its issuer rating. The medium-term strategy that GC has publicly communicated, which involves plans to divest one of its large portfolio companies, raises concerns about a potential upstream dividend burden on Evex should GC dispose of one of its dividend-paying divisions. Higher-than-expected dividend payments would turn discretionary cash flow negative, limiting room for deleveraging. However, we believe that relatively high contributions to the parent will likely move with operating results and will not have a significant negative impact on financial metrics. This is based on very positive FOCF generation capacity, along with ultimate parent GC's positive track record in conservative management strategies for portfolio companies.

Long-term debt rating

BB rating on Evex's GEL 50m senior unsecured bond

Scope has affirmed the senior unsecured debt at BB including GEL 50m (ISIN GE2700603881-1-02) bond reflecting Scope's expectations about average recovery for senior unsecured debt positions in the hypothetical event of a company default. The recovery analysis is based on a hypothetical default scenario in 2023, which assumes outstanding senior unsecured debt of GEL 50m in addition to GEL 169m in senior secured loans.

[2] Discretionary expansion capex is excluded from the liquidity calculation as these investments are made only if external financing is available.

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