Apex Healthcare's long-term prospects remain promising

Affin Hwang Capital / The Edge Financial Daily
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Apex Healthcare Bhd
(March 25, RM9.16)
Maintain hold with a target price (TP) of RM8.81: Apex's earnings could likely be weaker in the coming quarters. The fourth quarter of financial year 2018 (4Q18) profit before tax (PBT) contracted by 0.4 percentage point (ppt) year-on-year (y-o-y) and 1 ppt quarter-on-quarter, impacted by start-up and related costs from its new oral solid-dosage plant, SPP NOVO.

Moreover, we understand that it can only commence selling the products manufactured by SPP NOVO after receiving approval from the National Pharmaceutical Regulatory Agency (NPRA), the latest by late-2Q19.

Also, it has already fully used its reinvestment allowance, hence the effective tax rate will normalise to previous levels of circa 24-25% onwards (2018: 15%).

In the long term, we believe its prospects will remain intact, underpinned by:

(i) SPP NOVO, where the potential capacity of its oral solid production may quadruple existing capacity;

(ii) The continuous expansion of its portfolio of group-branded products, which enjoy higher margins; and,

(iii) Its growing orthopaedic devices manufacturing business.

We lower our earnings estimates by 15-24% for 2019-21E (estimate) to account for the start-up expenses for SPP NOVO. While we remain upbeat on Apex's long-term prospects, the group's near-term earnings are expected to show weakness given the estimated one-two years' gestation period for SPP NOVO.

Given the estimated lower payout and the recent surge in share price, the dividend yields are not attractive at the current level of 1.5-1.9% for 2019-21E.

The key upside risks are lower-than-expected start-up expenses and the shorter-than-expected gestation period for SPP NOVO.

The key downside risks are higher-than-expected start-up expenses and product recall risk.

To recap, Apex's 4Q18 revenue grew 7% y-o-y but PBT only grew 2% y-o-y mainly due to a lower margin as it started recognising start-up costs from SPP NOVO. Nonetheless, 4Q18's core net profit rose by a much greater extent of 31% y-o-y, primarily boosted by the reinvestment allowance arising from its investment in SPP NOVO.

However, the management has clarified that the group has already fully utilised the reinvestment allowance in 2017 and 2018 when it reported lower effective tax rates of 21% and 15% respectively.

As a result, the effective tax rate is expected to normalise to previous levels of about 24-25% from 2019 onwards. Without the support from the reinvestment allowance, we expect the additional cost from the new plant to impact its bottom line directly.

The construction of SPP NOVO was completed in end-2018 and received the certificate of practical completion and certificate of completion and compliance on Oct 31 and Dec 21 2018 respectively.

The final hurdle will be the NPRA inspection. Despite the commencement of start-up and recognition of additional expenses since 4Q18, we understand that the group will only be allowed to start selling the products manufactured by SPP NOVO after receiving approval from the NPRA, expected at the latest by late-2Q19.

The estimated total start-up cost is about RM12 million for 2019E (estimate) and it is targeted to break even by end-2020.

Given the: i) additional start-up expenses; ii) later-than-expected kick-start of sales from SPP NOVO; and, (iii) absence of the reinvestment allowance, we expect some margin pressure and anticipate a y-o-y decline in 2019E earnings, especially in 1H19.

The group, which did not have any borrowing over the past six years, began to undertake new loans of RM30 million to finance its new factory in 4Q18. While we are not concerned over the financing (as it is still sitting firmly in a net cash position of RM81.2 million or 44 sen per share as at end-2018, we think that it could potentially set aside cash flows for expansion rather than to reward shareholders. Hence, we reduced our dividend payout assumption to 32% (from 40% previously), in line with its three-year average historical payout. Given the estimated lower payout and the recent surge in its share price, the dividend yields are not very attractive at the current level of 1.5-1.9% for 2019-21E.

We lower our earnings estimates by 15-24% for 2019-21E to account for the start-up expenses for SPP NOVO. While we look forward to the contribution from SPP NOVO and remain upbeat on Apex's long-term prospects, we expect the group's near-term earnings to show weakness given the estimated one-two years' gestation period for SPP NOVO.

Apex's share price has rallied 91% since October 2017 to an all-time high post-announcement of its 4Q18 results and three-for-one bonus issue plan.

We downgrade our call on Apex Healthcare to "hold" from "buy" with a lower TP of RM8.81 from RM10.34, based on an unchanged 2019E per earnings ratio of 20 times. — *Affin Hwang Capital*, March 25

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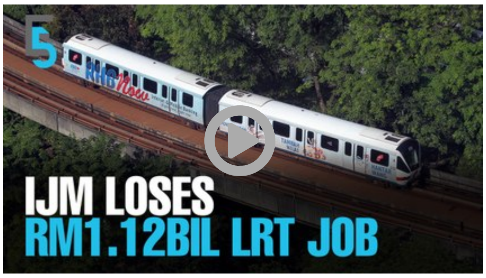

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