Krsnaa Diagnostics
[NSE : KRSNAA](#) | [BSE: 543328](#)

Mini Pitch - Company with a cash rich balance sheet(23% of Market Cap in cash), margin and ROCE expansion coming up, 45% growth in bottomline for 2-3 years in a sector with massive growth and tailwinds available at <11x TTM EV.EBITDA and 7.8x Fwd EV.EBITDA.

The IPO of Krsnaa was oversubscribed by 43 times, and the company went public at a market capitalization of 3200 crores(now 1700 crores). Krsnaa is trading at the cheapest valuations of all the diagnostic companies while at the same time also has much better expansion plans.
IMG

Brief Backdrop of the opportunity

The diagnostic sector has been an interesting one to watch it develop over the past year. The mini Boom & Bust cycle which played out due to the one-off temporary tailwinds due to the Covid-19 pandemic gave a temporary boost to diagnostics by Covid revenues and 2 IPO’s in the sector - 1. Krsnaa Diagnostics & 2. Vijaya Diagnostics. As the revenues from Covid began to falter, a meltdown proceeded in all the diagnostic companies including - Dr. Lal Pathlabs, Metropolis Health, Vijaya Diagnostic(down from IPO), Krsnaa Diagnostics(down from IPO), Thyrocare all down 40-50% off the top. The multiple expansion seemed to have signaled the excess capital inflow into a sector with huge tailwinds and the recent de-expansion in multiple lets us play into it at somewhat depressed valuations.

At the peak of the “boom”, the combined Net Income of the diagnostic sector(Dr. Lal Pathlabs, Metropolis Health, Vijaya Diagnostic, Krsnaa Diagnostics, Thyrocare) for the June quarter was 317 crores. Similarly the peak Market Capitalisation for the same was ~70,000 crores, which means that at its peak the diagnostic sector boasted a peak weighted average valuation of 55x PE(if the single June quarter were multiplied by 4, even though it was clear Covid revenues would run into the ground so I’m actually being generous). The combined market cap of the same 5 is now ~45000 crores.

The contracted Market Capitalisations do not signal the loss of prosperity in the diagnostic sector. The diagnostic industry in India is (now) an attractive play into the fast growing healthcare industry of India. It is expected to grow at low double digits for the next 4 years.

Diagnostic Sector

The diagnostic industry has emerged as an attractive player in India's growing healthcare sector and is one of the fastest growing service segments in the country. The domestic industry is estimated at USD 9.5bn and is expected to grow at a compounded annual growth rate (CAGR) of ~11% over the next five years, largely driven by increase in healthcare spending by aging population, rising income levels, rising awareness for preventive testing, advanced healthcare diagnostic tests offerings, and central government's healthcare measures. Although the Indian diagnostic market is small yet compared to those in developed countries, it is amongst the fastest growing segments in the healthcare market. This segment is currently dominated by high volume/low-cost testing activity by most players. The price of testing has remained flattish for the past few years, so it is mostly volume driven(a little different for Krsnaa, elaborated later).

The industry is largely fragmented and unorganized. The market share is as follows: Unorganized - 47%, Hospital-based lab - 37%, Diagnostic chains - 16%(which is where we are). The industry is shifting away from the unorganized to the larger players.

The Indian diagnostic sector is volume driven garnered through competitive pricing. The reason why much of the industry is unorganized is because the entry barriers to the business are low. It only takes ~2.5 crores to set up one's own diagnostic center. In many instances, the patients are directed to particular diagnostic centers on the recommendation of the doctor(usually to a local operator). This results in a highly disorganized industry. The trend is slowly shifting from disorganized to larger organized chains. This provides a long runway of growth with multiple tailwinds and high growth rates.

The diagnostic sector is also highly asset light in nature and results in operating leverage with scale. There are a few models that are followed including direct association with hospitals directly. Major diagnostic chains have an average ROCE of 25%.

Diagnostic Sector in particular to Krsnaa

This is a company that has over 1800 diagnostic centers in India, spread across 14 states. It started with just 2 radiology labs in 2011.

Krsnaa is not the usual diagnostic chain operation. Rather than focusing on spreading centers in cities, they worked on winning PPP(Private-Public Partnerships) tenders with the government. They win an overwhelming 85% of the tenders that they bid for. The PPP model accounts for 66% of their revenues, the other 33% are also partnerships with Private hospitals.

While all the chains chased the bulk of the revenue pool for diagnostics in India by setting up urban centers(¾ of the diagnostics revenue pool) while rural centers only account for 25%. The government is henceforth pushing rural healthcare in India, a part of which is building up the diagnostic services for the rural population. As mentioned previously, the offer tenders to set up diagnostic centers in association with rural government hospitals. This is inherently asset light in nature as Krsnaa only needs to set up equipment and employees.

The PPP tender is given to the lowest cost bidder for the cheapest tests. Krsnaa has some of the cheapest prices for their centers(40-80% under their mostly urban competition) and therefore win most of their tenders.

The PPP tenders also have a 3-7% annual increase in price, which is much higher than that of the industry which has seen less than 5% increase in prices of the tests.

The PPP tenders are also given for 7-10 years, which provides long term stable revenue. Krsnaa's first winning tenders took place in 2018, and therefore they have till 2025 to worry about renewal of tenders(which is easily attainable in management's view).

Krsnaa's Competitive Advantage(Moat)

1. Krsnaa has the lowest prices for their tests while maintaining a fairly high OPM of ~30%. They do this by having all their doctors in a single city(Pune, Maharashtra), and having the diagnostic tests sent in online, where it is authorized and examined. The report is made by the professional and sent online. This is a smart way of penetrating Tier 2 & 3 rapidly. This is something that sets apart a major moat for the business.

2. The PPP model(66% of their revenues) is set to do better than the diagnostic industry. The PPP spends by the government are set to grow at mid double digits, and Krsnaa is the only diagnostic company which stands to benefit from this(Thyrocare has exited this business completely). It lets them leverage existing healthcare infra. These revenues are recurring and even looking out decades into the future the tenders are convenient for the government to renew with the same business as seen in the previous renewals. Local players can't underbid Krsnaa because of its lower costs of scale, and lower employee costs. This is a huge moat for the company. No other India wide operation has the tender bagging rate of 80%

3. Krsnaa is set to have significant Operating Leverage to play out in the medium to long term(coming quarters have costs of expansion(fixed costs) and building of new centers in Punjab, India). Headroom for CT scans - 3.2x, MRI's - 2.6x, X-rays - 7.4x(hence their utilization is only 40%). It is clear that there is a disproportionate growth in bottomline over topline. Industry's average capacity utilization is 60% against Krsnaa's 40%.

4. Incredibly strong operating performance over the past years. With the number of centers expanding from 670 from FY18 to 1905 for FY22. Revenue of the PPP centers have grown at 67% over the same time, and Private partnership has grown at 58%.

5. Asset light model lets them scale up very quickly. The company is going to spend 100 crores on capex for building centers in Punjab & Himachal Pradesh, which will increase revenues from the current 430 crores(TTM) to 650 crores in revenue.

6. Huge TAM, they are currently penetrated in only 10% of rural public hospitals.

Numbers Please - Valuation

The Market Capitalization stands at 1700 crores, they hold 380 crores in cash. Enterprise Value stands at 1374 crores. TTM EBITDA stands at 120 crores. Current EV.EBITDA is 11.5(Currently Covid revenues are only 11%).

On a P2P basis -

1. Krsnaa - EV.EBITDA - 11.5, OPM - 30%, ROCE - 22%
2. Vijaya - EV.EBITDA - 20.8, OPM - 44%, ROCE - 26%
3. Dr Lal Pathlabs - EV.EBITDA - 39, OPM - 28%, ROCE -25%
4. Thyrocare - EV.EBITDA - 18.8, OPM - 41%, ROCE - 27%
5. Metropolis - EV.EBITDA - 34, OPM - 30%, ROCE - 29.7%

Krsnaa is clearly the undervalued player here. Some valuation differential is likely to persist on account of depressed margins and ROCE's and PPP model with the government, BUT Krsnaa is trying to increase Private partnerships from 33% to 50%. Catalysts are elaborated upon later,

On a conservative basis, the company is likely to do 600 crores(not too optimistic at all) of revenues(against 430 crores this year) with OPM of 30%(no operating leverage is factored here) leading to EBITDA of 180 crores against 120 crores of this year. They have built up capacities for this growth and I think it can be taken as a base-case scenario. It trades 7.8x fwd EV.EBITDA.

Catalyst

Okay, so the valuation differential is massive, especially considering upcoming growth. But why should the gap get covered? For starters, I don't believe Krsnaa will be rated the same way as other diagnostic companies. The main issue being, Krsnaa is dependent upon the government(partly) and there could be some block up of funds, which leads me to my first point.

1. Guiding increased revenue share from Private partnerships from 33% to 50%.
2. Medium term and Long term operating leverage to be realized by the market.
3. Aggressive Expansion plans.
4. Bottoming out of the whole Diagnostic sector, as mentioned above, is key.

Detriments

1. The PPP model essentially means that the company is working with the government(which is likely the reason for its depressed multiple even P2P) and in India it is considered a handicap for a company. Although the company's receivable days are good(67 days), and there are no instances in the entire past decade, no one puts it above the government to be finicky with payments.

2. Krsnaa's management set itself a target of doubling revenues in 3 years(and tripling bottomline in 3 years) for which they have to double capacities. Their utilisations are already low as mentioned above and they plan on increasing capacities further, which could delay ROCE and Margin expansion by a few quarters. The already low utilisations might be the reason for some of the multiple depression as their ROCE might stay low for a while. Although they plan on entering the B2C model for FY23 which will help with utilisations a bit. Short term margin pressure(Q4 & Q1) is likely to sustain.

3. Even though they work closely with the government hospitals, there is nothing preventing some patients from choosing a different diagnostic center. Although it is unlikely and not a huge issue, it is something to consider.