Dr Lal Path Labs

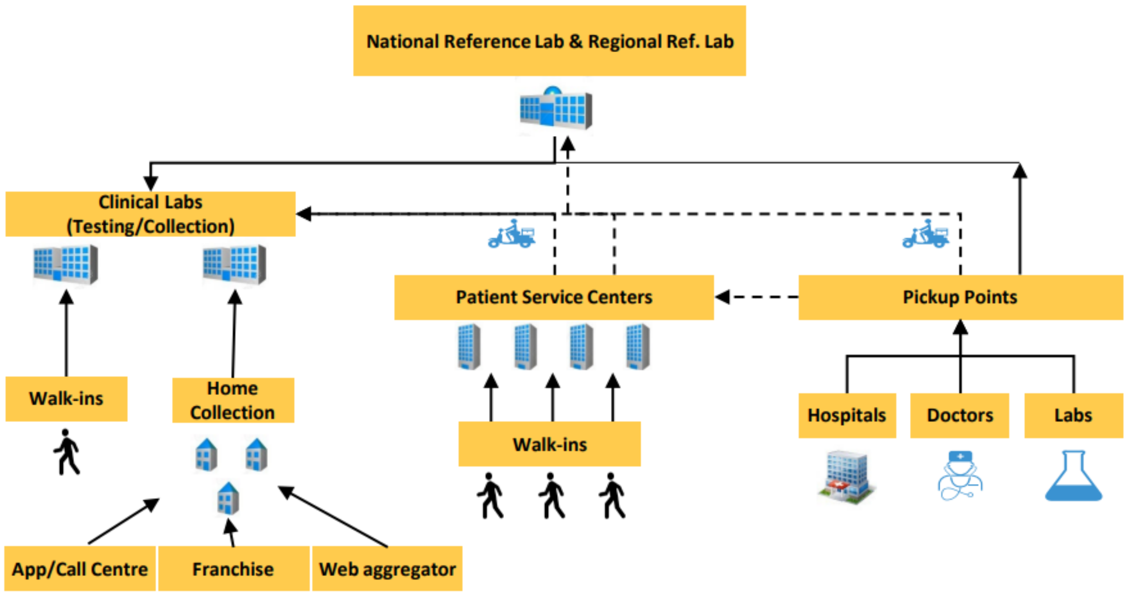
Company History and Business Model

Late Dr. Major SK Lal and the current chairman Dr. Arvind Lal had entered into a partnership to commence business under the name of Central Clinical Laboratory which later in Feb 14, 1995 was incorporated into Dr Lal Path Labs Private Limited. 20 years later on Aug 19, 2015 the company went public and was registered as "Dr Lal Path Labs Ltd."

Indian Diagnostic Industry which is valued at Rs ~70000 Cr is highly fragmented with hospital-based labs accounting for 37%, standalone diagnostic centers accounting for 46%, regional labs accounting for 11% & national chains like Dr Lal Path Labs accounting for 6%. National chains accounting for mere 6% of the total Rs 70000 Cr in an industry that is growing at 14-16% *(Source: Fortune India)* indicates that there is large headroom to grow.

Dr Lal Path Labs operates via the "Hub and Spoke" model. The components of hub and spoke model typically consist of National Reference Laboratory, Regional Reference Laboratory, Clinical Laboratory, Patient Service Centers (PSCs), and Pickup Points (PPs). PSCs and PPs collect samples and send them to satellite labs for testing purposes. Most of the PSCs & PPs are franchisee owned as franchisee is cost effective compared to owning the infrastructure.

Exhibit no. 1



Promoter and Management

Dr Arvind Lal is the promoter and chairman of the company. He is seen participating in capital allocation decisions as major business operations are professionally run.

Om Manchanda is the current MD and is having very rich experience of ~32 years working in companies like Ranbaxy and HUL. He has been associated with Dr Lal Path Labs for over 17 years. "Swasthfit" which is a wellness package was introduced under his leadership which now contributes to ~18% of top line and is a high margin test for the company.

Bharath Uppiliappan is the current CEO and has prior work stints with HUL, Walmart, Bharti Airtel, Wipro. He has been associated with the company for over 6 years.

Over the years, there have been very prudent capital allocation decisions by the management as free cash is majorly invested back into the company or paid back to shareholders in the form of dividends.

Promoter group owns ~55% of the company & there is no shares which are pledged.

Investment Thesis

Currently, diagnostics is one of the most crowded spaces with many investors concerned about profitability of the industry which is clearly evident from the share price erosion in the last 12 months of many listed players. However, there is one very fundamental concept to understand that diagnostics is very different from the retail industry i.e., customers are price inelastic when it comes to healthcare.

Today's health treatments are evidence based i.e., majority of the patients take these tests in order to undergo various treatments. The overall % of pathology cost to total treatment is not even 10% making customers choose quality over price. Downstream costs & implication on one's life can be much higher if one gets quality deficit in pathology reports. Thus, it is very rare that a customer will choose a particular lab just because they are offering a 50% discount.

While Dr Lal's pricing is ~20% premium compared to standalone centers, it is very competitively priced when compared to major regional & national chains. Dr Lal has built trust by maintaining their quality, accuracy of report & TAT.

Table no. 1

** In million INR*							
Particular	***Mar-17***	***Mar-18***	***Mar-19***	***Mar-20***	***Mar-21***	***Mar-22***	***CAGR (5 Yrs.)***
Profit Before Tax (PBT)	2368	2613	3005	3105	3944	4750	15%
EBITDA (1-Tax)	1838	2057	2395	3157	3897	4886	22%
Total Income	9399	10881	12494	13854	16326	21400	18%
PAT	1539	1711	1992	2259	2916	3448	18%
Net Worth	5980	7950	9510	10540	12760	15435	21%
Retained Earnings	4090	5764	7189	7893	9811	12089	24%
CFO	1713	1971	2185	2839	3982	4467	21%
Net Capex	679	745	426	1067	623	9321	69%
Free Cash Flows	1034	1225	1759	1772	3358	-4854	-236%
EBIT (1-Tax)	1563	1726	2013	2429	3125	3805	19%
Net Fixed Assets	1237	1792	2355	3621	4388	6281	38%
Working Capital	3817	5071	6753	6653	8709	3752	0%
EBITDA Margins	28%	27%	27%	29%	30%	29%	28%
Gross Margins	79%	79%	79%	78%	76%	77%	78%
Post Tax RoCE	26%	22%	21%	23%	24%	20%	23%
** FCF in FY22 is reduced due to acquisition of Suburban which cost ~Rs 925 crores. 4 Yr. CAGR for FCF is 34%* ** Avg. Post Tax RoCE is 23%, EBITDA Margins is 28% & Gross Margins is 78%*							

As evident from the financials above, it has maintained its avg post tax RoCE [(EBIT-Tax)/ (Total Debt + Equity)] at 23%, top line growth at 18%, PAT growth at 18%, and FCF growth at 34% (excluding FY22 numbers due to suburban acquisition).

The company has done many industry firsts in its existence including introduction of thyroid testing, AlloSeq Analysis Software (offers more invasive monitoring for all solid organ transplants – cardiac, liver, lung, kidney), automating the testing process which has helped streamline operations & testing. Dr Lal has the highest number of tests (5000+) which are done in its National Reference Laboratory. Timely introduction of high end tests has allowed it to maintain a superior position compared to standalone centers.

Diagnostics is a volume play & Dr Lal Path Labs has rightly played it out by not increasing the prices of its test since June 2016 with only minor revisions in FY20 **(exhibit no. 2)**. It has absorbed a series of price increases including –

Implementation of GST, higher tax rates in reagents (most important raw material in pathology), inflation, minimum wage hike etc. Whilst not increasing the rates, it has managed to maintain its EBITDA margins at ~27% for the past 6 years. Margins were even greater in FY22 due to realizations from COVID which later moderated as COVID slowed down. This uptick in margins was however time and again communicated by management as unsustainable.

Exhibit no. 2

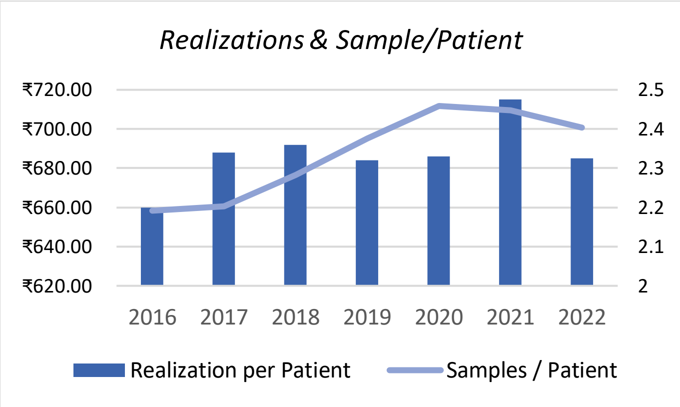
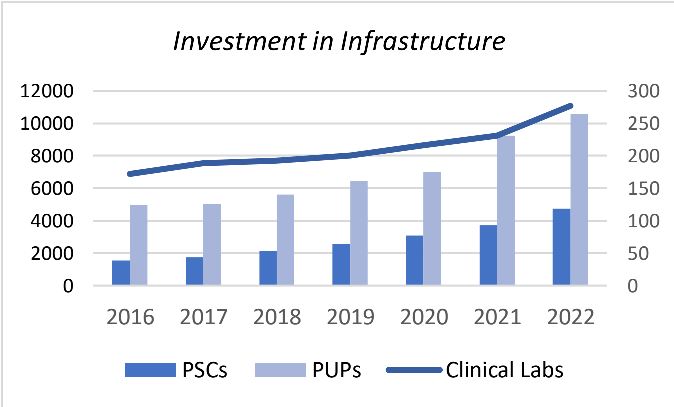


Exhibit no. 3



There have been many cost saving exercises by the management due to which the company has been able to maintain ~27% EBITDA margins whilst avoiding price hikes. The company has been continuously negotiating rent rentals with landlords & have been successful, it started shifting to franchise based expansion rather than owning its own infrastructure which has in turn reduced operating expenses. High volume growth has ensured reducing reagents costs as the company receives discounts based on volumes and high patient volumes ensures that the reagent vendors provide testing machines free of charge which are otherwise rented.

The Diagnostics industry is scheduled for consolidation by larger players as standalone labs are feeling the heat of price pressures due to – implementation of clinical establishment act which mandates labs should be run by a Doctor / Phlebotomist which has leveled the playing ground between national labs & standalone labs. As they are active in only one city / area: patient volumes are not growing after a point of time which is disallowing them to use operating leverage & reduced reagents costs in the business.

Since, industry leader has not increased any meaningful price hikes, standalone centers are finding it difficult to raise the price themselves to cover above mentioned costs allowing gradual shift of market share to organized players.

Daily calibration of machines & high tech investments allow them to stay ahead of the competition. Some of the tech investment aimed at streamlining processes includes - IBEX (AI assisted reporting for Prostate & Breast Cancer), AlloSeq Analysis Software (1st in India to launch this- offers more invasive monitoring for all solid organ transplants – cardiac, liver, lung, kidney), Atellica Data Manager (Improves Quality, TAT), technology transfer from IGIB (Delhi) - which is used for rare genetic diseases etc.

Capital allocation is perhaps the deciding factor of a business's success and that is where management of Dr Lal Path Labs has stood out. Some bolt on acquisitions include - Acquired 70% stake in Central Path labs Private Ltd (Central Lab, Indore) to strengthen the footmark in Madhya Pradesh, 100% stake in Shree Computerized Pathology Labs in Yawatmal, Modern Diagnostics & Lab in Sangli to strengthen footmark in Maharashtra, 100% stake in Bindish Diagnostic Laboratory, and 70% stake in ChanRe Diagnostics to strengthen Bengaluru, and acquisition of Suburban Diagnostics for ~Rs 925 crores to strengthen foot in Mumbai and west.

Suburban acquisition is an important event. Management was planning for inorganic growth since FY17 for western and southern regions as organic forays in those regions did not yield positive outcome. While the asset acquisition has not yet been working as the management would have liked, however seeing past execution capabilities by the management gives us comfort.

Overall, diagnostics is a scalable business with plenty of headroom to grow. High level execution & maintaining discipline will allow Dr Lal Path Labs to garner more market share going forward.

Anti-Thesis

Dr Lal's acquisition of Suburban has not yielded results as the management would have wanted. Sharp contraction in covid revenue, margins and longer than expected timeline to streamline suburban operations has resulted in slower growth.

High growth of FY22 revenue was largely in account of COVID testing which has drastically reduced in FY23. This would mean that there is a strong possibility of degrowth in revenue due to the high base of FY22. (Which is clearly evident from Q1&Q2FY23 numbers.)

Diagnostic Industry is expected to grow at 14-16% compounding rates till FY26 making it an attractive industry. Due to this attractiveness, a lot of competitors have entered the space. Competition today is somewhat different from what was back in FY16. Back in FY16, major competition was from players who were backed by PE money, whilst this time major competition are from hospitals, pharma companies & conglomerate corporations with deep pocketed resources to spend. While Dr Lal successfully mitigated risks emerging due to high competition back in FY16, its execution to avoid margin erosion in the current environment is yet to be seen.

Doctor recommendation is one of the biggest moats in the industry & pharma companies such as Mankind Pharma and Lupin Diagnostics can leverage their doctor connections to garner a foothold.

There have been numerous instances where the government has kept a price cap on key tests some of which include tuberculosis, RT PCR etc. In a scenario where there is a price cap in some high revenue tests, it can be detrimental for the industry as a whole.

Whilst the management has demonstrated very good execution skills so far, management's inability to scale Suburban's asset to company level EBITDA of 27% might prove this acquisition to be very costly.

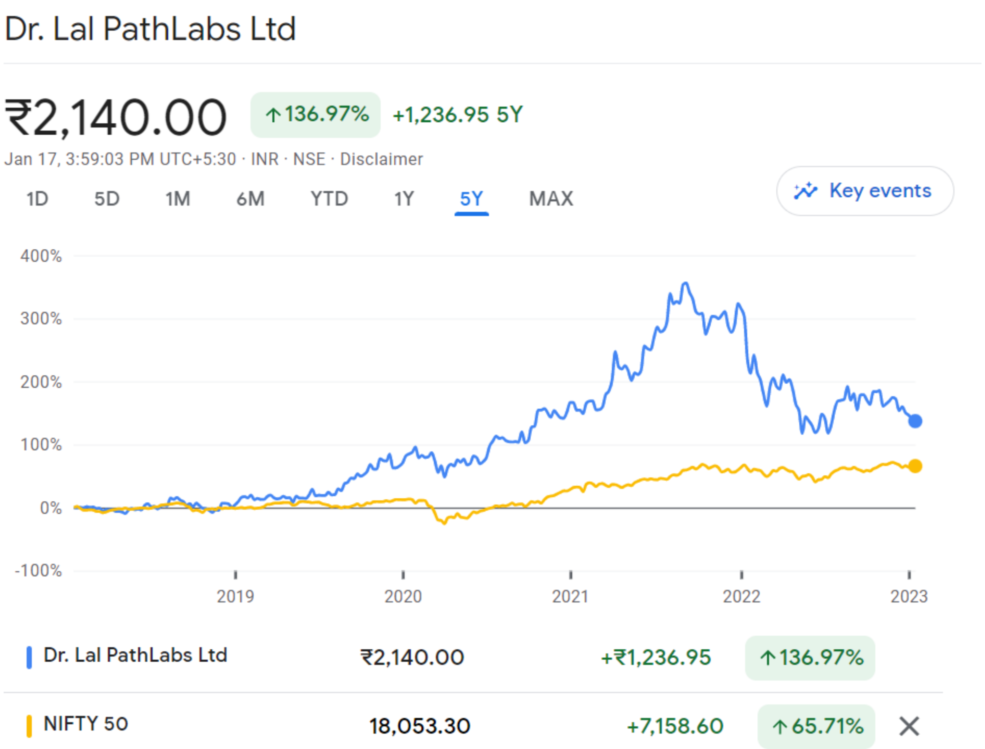
Market Performance in the past 1 year (Exhibit no. 4) & 5 years (Exhibit no. 5)

Exhibit no. 4

The past 1 year has not been rewarding for investors invested in Dr Lal Path Labs. The main reason behind this is the revenue de growth that is currently happening in FY23. FY22 experienced abnormal growth in revenues & margins due to covid testing which was a one off event. Whilst Dr Lal's management had repeatedly stressed upon the fact that covid revenues were one offs and were not sustainable, markets got really excited back in FY22 and pushed the stock to above Rs 4000. And it was only a matter of time when reality hit & covid revenues started to fall. Fall in covid revenues resulted in far more decline in share price compared to revenues.

Investors investing in equity markets should generally have a time horizon greater than 3-5 Yrs. The reason being every business might have some periods of underperformance, and staying invested for greater time frames such as 5 years rewards investors who have invested in great quality franchises as it averages all the good and bad performances & the rewarding part about investing in high quality companies is that they tend to come out stronger after a bad phase.

Exhibit no. 5



Investors who stayed invested in Dr Lal Path Labs for time frames of 5 years benefitted largely and were able to compound their wealth at 19% excluding the dividends despite it falling ~36% in the past 1 year. This is because markets may remain irrational in the short term, but in the long run stocks always follow their fundamentals. And since Dr Lal's fundamentals as seen in **Table no. 1** has been really impressive, thus the share price reflected the same in the long term.

Market Consensus

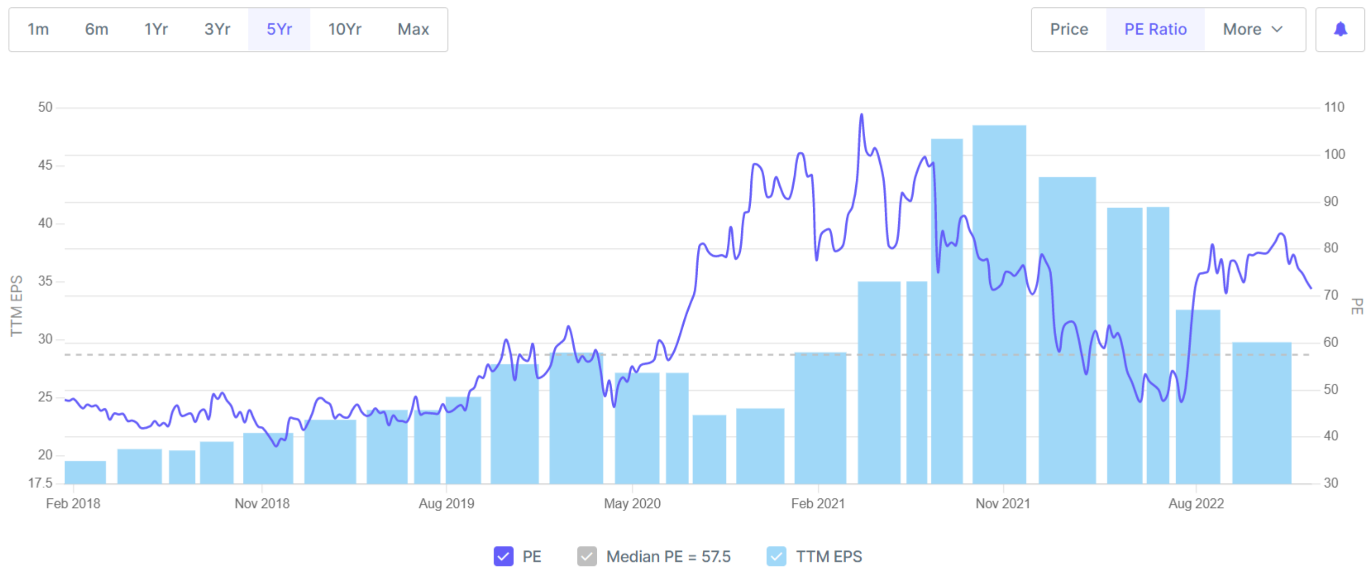
There are a total of 21 Analysts covering the stock *(Source: Investing.com)* and out of them - 12 have a sell rating, 3 are neutral & 6 have a buy rating.

While everyone is concerned with increased competition in the sector, high valuations, deep price cuts offered by new players etc, what is under appreciated is the quality of earnings, no corporate governance issues, stability in gross margins, regular dividend payments, healthy compounding of profits, and excellent management execution combined with good capital allocation decisions. Dr Lal has on average converted 94% of its profit into cash flows (a trait found in very few companies).

Valuations

Entry valuations do matter in investing & getting entry valuations correct results in decent 18-20% compounding in longer term time frames. There are multiple things that need to be considered while doing valuations, some of which include – growth rates of the industry, current market share of the company, how big is the addressable market etc. In our research, we have seen that markets tend to give premium valuations to companies which have demonstrated the following points – zero corporate governance issues, high RoCE, prudent capital allocation decisions, high cash flow conversion from net profits, and very large headroom to grow from current base.

Exhibit no. 6



Dr Lal Path Labs is currently trading at ~70x TTM PE **(refer Exhibit no. 6)**. Whilst the stock has corrected nearly 50% from the top, it still may seem expensive to a lot of investors. Part of stretched PE multiples is due to tapering off of covid profits in the trailing twelve months. However, current entry valuations seems to have factored in the one off event & new entrants entering diagnostics space. Dr Lal checks all the boxes of being a well-run company & **Table no. 1** gives us comfort with the supporting financials.

We are definitely not an advocate of Buy at Any Price (BAAP) and would have avoided investing in Dr Lal Path Labs when it was soaring due to non-sustainable revenues which were clearly highlighted by the management. One important mistake that we avoid is buying a company during peak margins & peak valuations. This is a lethal combination of capital erosion. However, we do see value in the current market price & if Dr lal is able to avoid margin & revenue erosion post FY23, it would in turn be valued at premium compared against other listed players in the space. Since the current PE ratio is nearing the median 5 Yr median PE, this might be a good entry point following tranches based investing *(investing style wherein investing in a stock is done in tranches to benefit from declines in share prices)*. Currently, the entire street is against investing in diagnostics & generally it is observed that investing during these times supported by thesis plays out really well given fundamentals & competitive advantages do not deteriorate.

The company is asset light which will allow operating leverage to kick in very soon. With its acquisition of suburban, it will now have access to western regions of the country. An investor investing in the company should be monitoring quarterly results to find out if it is able to sustain the current margins. Margin & revenue contraction post FY23 (as FY23 would already have factored in one off revenues & margin improvement on account of COVID) would signal exit from the stock as anti-thesis of price erosion would play out which would reduce profitability and de rate the stock further. Dr Lal Path Labs currently does not fall in the category of buy & hold, and it should be monitored on a quarterly basis to have a better understanding of the business.

Disclaimers –

Analyst covering this company have financial interest in the company & views can be biased.