Investment Memo - Dr Lal Path Labs

Mcap (Rs bn)	**152**	**Price (INR)**	**1,824**
Promoter shareholding	**55%**	**Trailing P/E (TTM)**	**53.0**
5yr average post-tax ROCE (ex-cash)	**62**	**Date**	**21st March 2023**

Note: We have adjusted P/E for Rs480 mn annual amortization expense

In this note we examine whether Dr. Lal Path Labs and other well run incumbent diagnostic chains would be able to bear (or not) the intense competitive onslaught which is on right now.

In our view, current worries around deteriorating competitive profile of the Indian diagnostics industry have created a buying opportunity as we believe that: a) D to C players which are seen as the most threatening don't have a business model as of now which can create a significant threat in the long term, b) 'Offline first' players anyways have been coming in and going out since 2015; hence we don't see them as incremental competitive threat. We see a good investment opportunity in Dr Lals; the stock should give 15-20% CAGR returns in the coming 3-5 years.

A. D to C challengers who seem the most menacing don't have a business model as of now to pose a long-term threat to well-entrenched incumbents

In our view, current business model which major disrupters (e-comm companies) are following led by selling mainly health packages and offering huge discounts would not be able to create a significant impact for incumbents, in the long term. However, if some of these players pivot their business model so as to start addressing the acute/chronic testing market (which is ~85-90% of the pathology market), then in the long term they could present credible competition. The process of tapping acute market is slow as the business is built brick (small local territory) by brick, by engaging with influencers (doctors) and franchisee channel. Hence, if some of the new players are willing to undergo a 10-15 year grind, then they could threaten the incumbents in the long term.

We divide our thesis into 2 parts. In the first part, we present our views on why we think the D to C business in its current avatar can't pose a long-term threat to incumbent national chains. Our rationale is the following:

1. **Customer acquisition cost is very high.** Also, it would need to be paid multiple times for the same customer. As per our channel checks, customer acquisition cost through online channels (Google, Facebook etc) is to the tune of Rs800-1200 per customer (who is looking for a preventive health package), which is almost equal to the AOV (average order value) of health package portfolio of D to C companies. CAC for acute business is lower, however, paybacks are same as in the case of health packages. Also, its not like once CAC is paid, most of the customers can be retained. Given that: a. frequency of testing is maybe once a year, b. customers are spoilt for choice given multiple players offering discounts at any time, and c. customer is habitual to discounts, in our view, the customer will shop around again for the lowest priced test when he goes for testing and hence a company will have to spend again (cash backs, discounts, maybe pay Google again) to retain that customer. Hence, in our view, customer acquisition cost will remain high for the next few years unless:
    a. There is consolidation (some players shut down business and only 1-2 remain) as discounting and associated customer hopping would continue till the time multiple e-comm players are in land grab mode. Also, in the event of consolidation, remaining

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platforms would become large enough (in terms of brand/size) to acquire customers organically.

b. Large platforms are able to cross-sell and hence able to apportion CAC over multiple businesses (pharmacy, diagnostics, doctor consultations etc).

2. **Business model based on: a) predominantly selling health packages, b) only D to C and home collections can't create good competitive positioning in the long term:** As per our understanding 70-80% of sales of online players come from preventive packages. This is both on account of compulsion (consumers take the buying decision and hence D to C model works) as well as economics (need higher AOVs to offset high cost of operation). We see the following problems in this business model:
    a. Online preventive package business attracts discount seeking customers who are difficult to retain given the frequency of testing is only 1-1.5X per person per year and customer is spoilt for choice with multiple platforms outdoing each other on discounts.
    b. Preventive package business is also led by an 'underlying prescription' which could be either: 1. Doctor generated – for example a person experiencing sudden weight loss would call up family physician who would prescribe multiple tests. The consumer would choose a bundled package which would include all those tests plus a few more for maybe lower price than if he would have ordered specific tests ala carte, 2. Self-generated – for example, a person experiencing breathlessness while climbing stairs could want to get tested for heart related parameters particularly if there is history of heart related ailments in the family; this kind of customer would independently chose a diagnostics vendor. Hence, in our view, a significant part of the business of preventive packages is also linked to doctor prescription. This also explains the reason behind significant growth (~25% CAGR in sales in FY20-23) of health package business of Dr Lal despite much higher prices versus online competition. In our view, without connect with doctors, through the franchisee channel, for D to C players, a part of the preventive package market is also not addressable.
    c. As per our understanding, preventive package business does not help to create a brand which could be used to increase traction in acute business. This is evident from Thyrocare's performance in FY2017-2020 (post listing). Thyrocare was the pioneer in introducing preventive packages and it offered them at a steep discount to national chains. The only difference between Thyrocare's erstwhile business model and the current D to C players is the fact that D to C players are approaching customers online while Thyrocare did the same offline, through its own and franchisee channel. Inspite of that, it was not able to build credible competition to national chains as evidenced by pathology sales growth of ~12% (from FY17 after it got listed to FY20) versus ~13% CAGR growth in case of Dr Lal. Also, Thyrocare's growth kept on petering down in FY19 and FY20 while Dr Lal was able to report consistent growth. We would presume that it was struggling to compete before it was sold to Pharmeasy. Even on the preventive package side Dr Lal's sales were almost 1.7X of Thyrocare in FY22 (implying maybe same volumes as Thyrocare's sales are net of franchisee commissions); this is despite Thyrocare's first mover advantage and cheaper prices in this segment. Also, in our view, with Thyrocare now trying to change its business model to look more like the national chains is an admission of the fact that earlier business model was not as good. Hence in our view, D to C players would also face a tough challenge in expanding in the acute segment with the current business model.

(Rs mn)	2017	2018	2019	2020	CAGR (%)
Thyrocare					
Sales (diagnostics total)	2,871	3,318	3,703	3,991	12%
Growth yoy (%)		16	12	8	
Sales (preventive package)	1,365	1,569	1,748	1,797	10%
Sales (acute)	1,506	1,749	1,954	2,195	13%
Dr Lal					
Sales (total)	9,124	10,569	12,034	13,304	13%
Growth yoy (%)		16	14	11	
Sales (preventive package)				1,996	

d. In our view, D to C players will find it hard to build a franchisee channel which is necessary for building acute business. There is significant channel conflict as prices online are much cheaper (see exhibit below) than if the customer were to go to the franchisee as franchisee commission (~30% of the MRP) needs to be accounted for. As per our understanding, price difference is mainly account of the fact that online platforms are not charging (or charging nominal amount of Rs20-50 per order) for home collection (they incur Rs200-300 per order which includes home collection as well as mid mile cost) even on low value tests (Rs600 odd MRP and below) and on high value tests (> ~Rs600) there is no home collection charge as of now. If they were to charge fully for home collection, then including this charge pricing for the customer could be roughly similar between online and franchisee channel. So, before trying to build franchisee network, DtoC players need to align this channel conflict by start charging for home collection (Rs250-300 per order) so as to bring price parity between offline and online prices; otherwise, franchisee channel would be hard to build.

    i. On the health packages side, DtoC players have resolved channel conflict (prices are much lower online versus offline) by creating seemingly different (by cosmetically changing 3-4 tests) packages in the offline channel. The changes make the package seem different on paper while not driving meaningfully different clinical outcomes for customers. For example, in the exhibit below, one can see that health package of Pharmeasy available online costing Rs1049 includes 90 tests while the Gold Package available offline costs much higher and includes lower number of tests.

PharmEasy: Comparison of online and offline pricing in Mumbai

(Rs)	Home coll. charge	Online price	Total online price	Offline
CBC(24)	50	349	399	500
HBA1C(2)	50	399	449	500
TSH (T3,T4,UTSH) (3)	50	399	449	500
Liver Panel (LFT)(12)	50	499	549	790
Healthy 2023 full body package (90 tests)	-	1,049	1,049	
Gold Health Package (63 tests)				1,599
Diamond Health Package (94 tests)				2,499

Note: Number in brackets is the number of tests

e. Only depending on home collection model can impede growth in the long term as a phlebo's utilisation is much lower and hence growth in the long term implies that one has to maintain and grow an army of phlebos. There are 2 problems with that:
    i. Typically a phlebo is paid Rs25-30k per month for 25 days, for work from 6 a.m to 10-11.am. As per our channel checks, a phlebo who does home collection is able to collect 5-10 samples a day. In an offline set up the same phlebo is able to collect 40-50 samples a day and hence utilisation is much higher. In our view, utilisation of phlebos can't be improved in a health package dominated home-collection business as most of the health packages contain lipid and sugar tests which can be done only in the morning as fasting is required.
    ii. As per our channel checks, there is shortage of phlebos in the market, as of now.
f. In our view, offline channel (franchisee run collection points) is a must if any company wants to build a large diagnostics business as.
    i. It allows better apportionment of costs and hence better unit cost economics in the long term as infra remains the same while volumes increase in the long term. Also, there are other benefits like better utilisation of phlebos and other HR, as pointed out above.
    ii. It allows aggregation of volumes from across B to B and B to C segments.
    iii. It allows the company to expand distribution/reach without putting up its own capital (in case of franchisee operations). Also, cost of operation is lower versus the company putting up its own collection points.
g. Without volumes from acute business which can only come through a robust franchisee channel, D to C players might not be able to build sufficient scale required to threaten some of the well-managed incumbents or build a good business model in the long term. Diagnostics is a business of scale/volumes. Hence, a company needs to aggregate samples from all the available channels and tests rather than restricting to a particular channel or particular kind of test. As per our channel checks, none of the D to C players have been able to crack acute testing business. In our view, a business model, which as of now, precludes most of acute/chronic (contributes 85-90% of industry sales) testing is not well placed to build enough scale to be able to challenge the national chains.
h. Our conversations with few of the online players suggest that: 1) most of the players are now trying to move (steps already taken by a few players) away from discount led positioning to the one where positioning would be based on quality of testing, shorter TATs etc etc, 2) they have also started building offline presence through a network of collection points (Pharmeasy seems to be most advanced in this respect).

Our estimated P&L for a D to C diagnostics player on per order basis (Rs)

		Comments
Revenue per order	800	70% portfolio is preventive (realz Rs800-1000) and 30% chronic/acute (Rs500)
COGS	240	30% of sales
Home collection and mid mile c	300	Cost incurred to bring the sample to the lab
Customer support cost	30	Call center cost; 5-10% of order have enquiries
Lab processing cost	125	
Marketing cost	250	20% of the customers are acquired from google/facebook (CAC Rs1000). ATL is also included here
HO cost	160	Rs500 mn of corporate overheads for a Rs2.5 bn topline business.
EBITDA	-305	

In the second part of our thesis, we present our views on the offline first challengers (pathology business launched by pharma companies and hospital chains). Our views are the following.

1. **Diagnostics is not a low entry barrier business**. In our view, diagnostics is a high entry barrier business. Barriers are low from capital point of view; however, that is not the main barrier. In our view, diagnostics is a service business and hence the main entry barriers are:
    a. Connect with the doctor via franchisee channel is the only way a diagnostic company can build acute business. This is a slow and painstaking process. In our view, diagnostics business model can't be built without acute business.
    b. Systems/processes developed over a period of time which enable thousands of employees to deliver flawless service with minimal errors. This becomes even more important if a company is running the business through a franchisee channel as quality control becomes a problem. A franchisee would like to reduce his cost to the minimum possible (compromise on quality of HR/Infra); hence, there should be processes in place to check and report if quality of service being delivered is as per laid down standards. Just for a perspective, typically the national chains prefer to do home collection through their own phlebos rather than the franchisee as quality of phlebo is very important as he is the one interacting with the customer.

Hence, in our view, entry barriers in the business are high and hence new players will have to go through the same slow grind as incumbents in building the business.

2. **In the offline world also, probability of building business through discounts is low.** Had that been the case, the market would have consolidated long back. We base our opinion on the following observations:
    a. Diagnostics market witnessed hyper competition (maybe to a lesser degree versus now) around 2016 when Dr Lal listed, when PE funds invested into small/regional players in the hope of scaling up the business and listing at the same multiples as Dr Lal's. Spearhead of all these companies was discounts funded by PE money. However, in our view, none of these companies have been able to make a mark.
    b. Had discounts worked, actually it would have worked in the favor of incumbents as they could have expanded without spending huge sums of money (giving discounts is much cheaper compared to funds required for inorganic growth). As per our understanding, some of the national chains have experimented with 'discounting' as a strategy while entering new regions but it has not worked. Also, as pointed out

earlier as well, Thyrocare's business model based on discounts was also not able to find significant traction.

3. Some of the 'offline first' players might start following strategies of 'online first' players wrt keeping lower prices online versus offline channel to hit sales targets. In our view, that would compromise the business model in the long term and hence some of the offline challengers also might lose their way before they could come to a position where they could start threatening strong incumbents. Our channel checks indicate that for the national chains' online pricing is same as offline and including home collection charge (Rs100 as of now for low value tests) it is actually higher than franchisee channel.

In our view, whether the business model is 'online first' or 'offline first', companies who are willing to dig in their heels and build the business brick by brick would be able to build a business model that could challenge the incumbents, however, it would take time and maybe the time for the debate on whether the challengers will impact the business of strong incumbents is few years later; as of now the business models that online companies have built look incomplete and do not pose a significant long term threat. Maybe in a few years business models of some of these challengers would evolve to solve the issues we have highlighted above and then maybe they could pose a tough challenge.

B. Current hyper-competition could accelerate market share shift from a. weaker regional players and b. standalone labs, thereby allowing Dr Lals to continue reporting 12-15% CAGR growth.

In our view, COVID provided a lifeline to weaker players in the diagnostics market. With covid tailwinds going away and competition becoming even more aggressive (pricing is flat for the last five years for Dr Lal), we see market share shifting from weaker players to stronger players. Strong players like Dr Lal's could gain in the following manner.

- Acquisition opportunities would increase. As per our understanding, COVID related testing provided huge boost to small diagnostics players. This is evident if one sees financials of Suburban labs which Dr Lal acquired in FY22. It made EBITDA margin of only 4.5% in FY19 after significant years of operation; EBITDA margin increased to ~20% in FY21 with sales almost doubling due to COVID related testing. With COVID tailwind gone, some of the weaker players (small labs and regional players) could be struggling given the hyper competition in the market as of now. In our view, this would increase opportunity for stronger companies to grow inorganically.
- Some of the standalone labs could cede market share given deteriorating economics (pricing flat for the last 5-6 years) of the business. In our view, not all the standalone labs are weak; some of them are led by very experienced doctors whose opinion is valued by doctor community and hence they would always command some market share. However, some of the weak standalone or regional labs could cede market share to dominant players. Given that standalone/regional labs account for 47% and 11% of the diagnostics market in India, versus 5% share of national chains, there is significant scope to gain share from weak competition.

How do we reconcile the slowdown in growth and lower margins reported by Dr Lal with our view?

Investors have been focussing on the following data points reported by Dr Lal's which seem to suggest that the company is getting impacted by change in competitive environment of the industry.

1. 3-year organic CAGR of sales was ~10% in 9MFY23 versus ~15% CAGR in sales in FY15-20, which suggests a slowdown. In our view, there could have been loss of business to competition on the wellness tests side and maybe some part in chronic. Despite hyper competition on the wellness side, Dr Lal's health package revenues have almost doubled in FY20-23, growing at

25% CAGR. In our view, the company has gone through the worst phase of competitive intensity and going forward we see intensity reducing led by improving pricing environment as D to C players move towards creating an omni channel network which would require price parity between various channels.

2. Reported EBITDA margin (excluding stock-based compensation and CSR expense) in 3Q23 and 9MFY23 at 22.4% and 23.5% (both pre-INDAS) (reported margins at 24.9% and 26%, respectively) was lower versus 26.6% (pre-INDAS) reported in 9MFY19. As per our estimates, there is 100 bps impact (impact much higher in 3Q23) on account of lower margins in Suburban labs (~13% in 9MFY23). There could be further (can't quantify) impact in 3Q23 on account of opening up of Mumbai reference lab. Rest of the impact could be on account of inability to take price increase due to competition in the market. In our view, pricing led competition has already started ebbing and hence we are looking at flattish to marginally rising margins ahead.

In light of the above factors, we believe that a strong incumbent like Dr Lal's would continue to grow at 12-15% CAGR, with stable margins. The stock is quoting at ~50x FY23 EPS of Rs36, adjusting for Rs480 mn (annual) of amortisation expense on account of acquisition. We find the valuation reasonable in light of expectations of 12-15% CAGR growth in earnings. We see the stock appreciating at 15-20% CAGR in the next 3-5 years with a little bit of tailwind from rise in multiples as current concerns over 'hyper competition' fade away.

Financials

Profit & Loss Statement	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Sales	7,913	9,124	10,569	12,034	13,304	15,813	20,874
Gross Profit	6,184	7,153	8,309	9,410	10,317	11,840	15,851
EBITDA	2,097	2,365	2,640	2,936	3,436	4,363	5,608
PBT	2,007	2,333	2,613	3,006	3,105	3,944	4,749
PAT	1,328	1,542	1,708	1,992	2,259	2,916	3,688
EPS	15.9	18.5	20.5	23.9	27.1	35.0	44.3
Margins (%)							
Gross	78.1	78.4	78.6	78.2	77.5	74.9	75.9
EBITDA	26.5	25.9	25.0	24.4	25.8	27.6	26.9
Important BS items							
Equity	5,095	5,980	7,949	9,510	10,540	12,760	15,435
Debt	-	-	-	-	-	1	3,457
Cash & cash equivalent	2,940	3,456	4,583	6,751	7,334	9,853	6,831
Cash Flow							
Cash Flow from operation	1,469	1,716	1,971	2,185	2,839	3,982	4,467
Capex (including acquisitions)	-441	-516	-625	-420	-1,060	-627	-941
Free Cash Flow	1,027	1,200	1,346	1,765	1,779	3,355	3,526
Return Ratios							
RoAE (%)	31.1	27.8	24.5	22.8	22.5	25.0	26.2
RoACE (post-tax, ex-cash) (%)	64.6	59.2	51.6	55.6	66.6	88.3	47.8

Appendix:

Financials of some of the 'offline first' competitors

(Rs mn)	2018	2019	2020	2021	2022
Pathkind labs					
Revenue	46	425	717	2,088	
COGS	43	148	204	670	
Employee cost	136	280	362	467	
Other expenses	131	412	538	718	
EBITDA	-264	-416	-387	234	
EBITDA (%)			-54	11	
PAT	-297	-467	-443	183	
Redcliffe labs					
Revenue					1,298
COGS					338
Employee cost					419
Other expenses					1,210
EBITDA					-669
PAT					-669
Apollo Diagnostics					
Sales	660	923	1,185	1,748	3,987
EBITDA	-118	-123	103	280	753
EBITDA (%)	-18	-13	9	16	19
Max Diagnostics					
Sales		242	411	659	1,038
EBITDA		2	14	67	13

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