

MCGS 1Q2023 Alert – Net Profit Miss on Higher COGS as Revenue Tops Estimate; Reiterate Market Perform

- **Medicare Group (MCGS) 1Q2023 net profit rose 9.4% to QR18.8mn YoY but declined 18.7% QoQ, missing our estimate of QR22.3mn by 16.0%. A jump in cost of sales by 11.5% YoY (6.8% sequentially) to QR82.8mn, primarily driven by an unanticipated 18.3% YoY (18.4% QoQ) spike in medications and surgical costs, saw its GP margin shrinking to 35.3% from 36.7% in 1Q2022 (4Q2022: 39.2%); gross margin came in lower than our modeled estimate. This could be due to an unfavorable sales mix induced by the World Cup (explained below) and/or inflationary pressures that have been pervasive globally. MCGS had averaged a GP margin of 38.0% for the past eight quarters. For the rest of the other line item items, our under-forecasting of G&A expenses vs. other income had an almost perfect offsetting effect. Finance costs came in line with expectations.**
- **MCGS's revenue rose 9.1% YoY and 0.5% QoQ to QR128.1mn, in sync with our expectations of QR126.3mn (variation of 1.4%).** While 1Q is traditionally weaker than the preceding 4Q, the sequential 0.5% marginal increase in revenue registered in 1Q2023 was due to demand – primarily elective procedures as per management's guidance – that was pushed out from 4Q2022 during World Cup into 1Q2023. All else being equal, we do not see this repeating in future. However, this positive top-line surprise did not translate to stronger net profit as would be the case given MCGS's high operating leverage.
- **We reiterate our Market Perform rating** and we put our TP under review. We see the stock trading sideways for the foreseeable future given that across assets, yields are relatively more attractive. However, **we expect MCGS to get a cash windfall after the Court of Appeal upheld a judgement in its favor of QR130.7mn against the National Health Insurance Company on 24 January.** MCGS had written down QR76.2mn of the original QR114.1mn receivable but the court ruling implies that MCGS will receive an additional QR16.6mn in interest and damages. We will try to get guidance from management on when it expects to receive a payment from Seha. As far as we can tell, there has not been any change to the Seha receivable provisioning in 1Q2023 from 4Q2022, nor has management recognized an additional receivable with respect to the QR16.6mn in interest and damages that MCGS was awarded. In our earnings [preview](#), we had indicated the possibility of MCGS management writing back the amount originally written down as per IFRS principles. It seems management chose to walk the prudent path but we will seek more color.
- **We see several tailwinds and headwinds canceling out each other to render a relatively neutral prognosis on MCGS's near-term outlook.** In the short- to medium-term, we see the following variables driving the outlook: muted bed growth due to suspended bed-expansion plans, superior service level & product quality, favorable public health policy, increased healthcare spend, low beta, tariff controls and increasing competition from both the private and public players. In the medium- to longer-term, things are encouraging with some of the following factors expected to become more dominant in shaping prospects: an above-average population growth, disease burden and expected change in the composition of expats (to a more white-collar workforce).

| Recommendations | |
|---|----------------------|
| <i>Based on the range for the upside / downside offered by the 12-month target price of a stock versus the current market price</i> | |
| OUTPERFORM | Greater than +20% |
| ACCUMULATE | Between +10% to +20% |
| MARKET PERFORM | Between -10% to +10% |
| REDUCE | Between -10% to -20% |
| UNDERPERFORM | Lower than -20% |

| Risk Ratings | |
|--|-----------------------------------|
| <i>Reflecting historic and expected price volatility versus the local market average and qualitative risk analysis of fundamentals</i> | |
| R-1 | Significantly lower than average |
| R-2 | Lower than average |
| R-3 | Medium / In-line with the average |
| R-4 | Above average |
| R-5 | Significantly above average |

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