Pharmaceuticals

Spotlight on non-US centric players

In the past two years US-centric players have seen dramatic erosion in base business on account of, by now, familiar reasons of steep fall in generic prices fueled by buyer consolidation, accelerated FDA approvals and persistent regulatory woes. At a structural level, we believe the low hanging fruit in US generics market has been plucked and a challenging path lies ahead; this is evident from the efforts of several companies who have ramped up spending on R&D to create a specialty pipeline. Such an approach requires a different R&D mindset, large upfront investments with price dynamics still playing a part post launch. Even so, success in specialty cum complex generics is not assured as innovators are fiercely protective of long standing franchises and attempt to shift patients to follow-on brand or different dosage form to protect respective brands. While large Indian companies, say those with more than US$500mn US business have felt the pinch and focused on specialty pipeline, several smaller players are still in the investment stage in US, ploughing money on R&D and facilities; in other words, gross and EBIDTA margin are still attractive enough to warrant such investments.

In contrast, companies with dominant non-US revenue streams do not carry the volatility associated with US exposure. While we remain cognizant that revenue and margin delta garnered in US is unavailable anywhere else, the earnings (and valuation) comfort derived from a steady India/emerging market portfolio covers up for the lower absolute profit. Moreover, we reckon India branded business would offer one of the best margin profiles backed by longevity of brands. Although last several years have seen disruption in the form of GST, FDC ban and price control, we believe domestic market carries an inherent 8-10% growth potential. In this report, we profile two such companies with strong domestic businesses whose earnings can act as a cushion in difficult times thereby offering support to valuations.

Ajanta Pharma: Earnings may well have marked a bottom

Ajanta Pharma has been impacted by sharp slowdown in the institutional business which saw revenue decline from ~Rs4.5bn in FY17 to Rs1.4bn in 9m FY19. Company expects institutional business to remain largely flat as funding would be stagnant at lower levels over next 1-2 years. However, domestic business comprising largely of chronic therapies like derma, cardio, pain and ophthalmology remains on a firm footing driven by volume growth coupled with new launches. US business will see robust increase on a low base of Rs2.8bn backed by R&D at ~9% of sales. Margin is expected to improve from next fiscal as revenues revive from a 2-year slowdown which would translate in to a 20% PAT CAGR and valuation of 18x FY21 PE.

IPCA Labs: India, branded exports to drive growth

IPCA remains on track to close out FY19 on a robust note as business rebounded in Q3 after a lackluster H1. While institutional business remains hobbled and US FDA woes persists, we believe rest of the segments-India, international generics and international branded can clock healthy growth in the range of 10-14%. Company expressed optimism about start of Global Fund business while malaria dispersible tablets and injectables can add to instituional sales. We expect margin to improve over next two years as revenue delta can be at least 2-3ppts higher than corresponding operating costs. Stock has rerated to 18x FY21 PE since Q3 results but is backed by solid earnings visibility.

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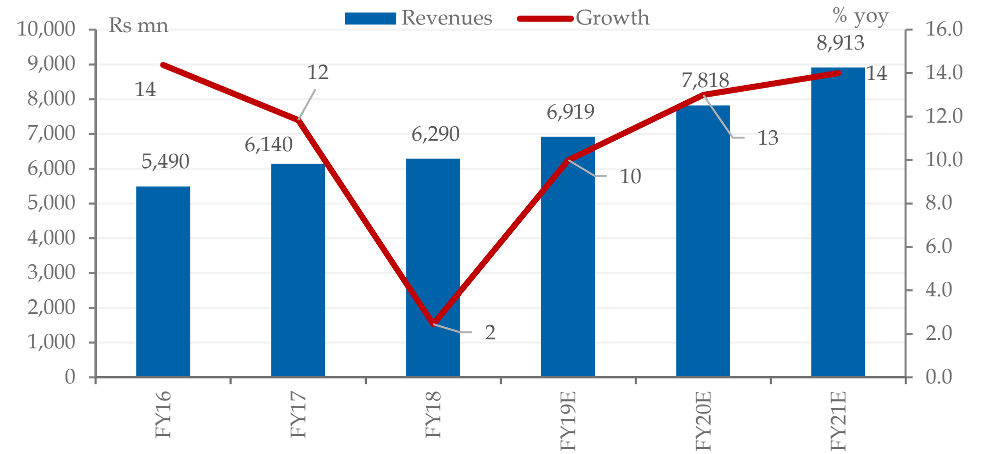
AJANTA PHARMA (CMP RS1,028, 18X FY21 PE)

Excerpts from company meeting

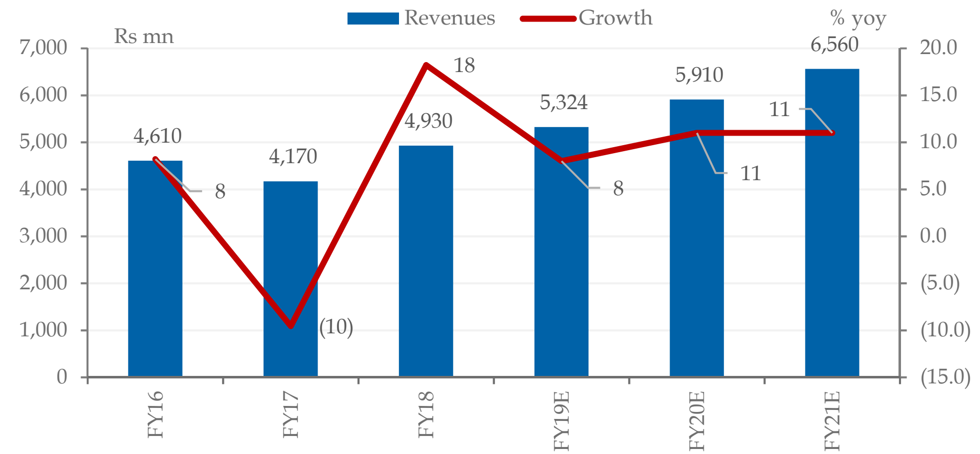
- US business has witnessed good growth and got decent approvals in the past few months; many approvals are Day 1 launches which may eventually become a 5-player market
- 100% of API is outsourced and company feels no difference about whether API is obtained in-house or bought out; do not subscribe to the view that API integration is necessary for being cost competitive
- Company believes 13-14% growth in domestic business is likely over next 2 years after a 10% rise in FY19. Ophthalmology: AJP is the 3rd largest and is in close competition with second ranked player so growth would be moderate. Cardio: company introducing new products but segment is subject to government intervention though it can still grow at early to mid-teens. India pipeline is healthy with some products filed with DGCI and others under development. Domestic growth is driven by volumes (70-80%), new product launches (10-15%) and price increase linked to WPI. Company sells through a sales force of 3,000 MRs and has not added to MR strength in past 4 years.
- In dermatology, sales decline has been halted and expectation is for growth on the current reduced base
- Company's 3 products are in NLEM while 14-15% business is under price control in India
- Africa institutional business would be similar to FY19 levels in next fiscal; company saw funding cut in the sector for the first time with decline spread across all segments like ARV, malaria. Most of the players experienced a sharp volume decline along with price erosion due to reentry of older player. AJP institutional business is all anti-malaria with no ARV contribution.
- Africa institutional tender was allocated in Nov' 2017 for a period of 3 years but volumes are offered every year; no new players have entered in the tender market except reentry of some of the older companies
- In Africa, two large countries have exited the malaria tender including Nigeria which is the largest constituent of the tender. Private Nigerian market is served by established players with robust sales which would be difficult to upend in a short term
- Company expects institutional funding to remain at same level for the next 2 years. New players have come in malaria dispersible tablets.
- Absolute R&D cost is Rs1.7bn of which 60% is for US and rest for India and EM; India requires sizable R&D as many of the products introduced have a first mover advantage and company undertakes BA/BE study for every product.
- Management expects margin to improve over next two years as new facilities Dahej (for US and Emerging markets) and Guwahati (mainly for India) scale up resulting in operating leverage benefits
- Company has maintained a clean slate on the regulatory side with Jan' 17-Jan' 19 period alone seeing 4 FDA inspections of which three for Dahej got EIRs and 4th audit also resolved quickly; company ensures identical standards across all plants irrespective of whether formulations supplied to US or otherwise.
- AJP is open to buying brands in existing therapies or newer areas but not companies or manufacturing facilities.

Exhibit 1: Domestic business to sport steady growth



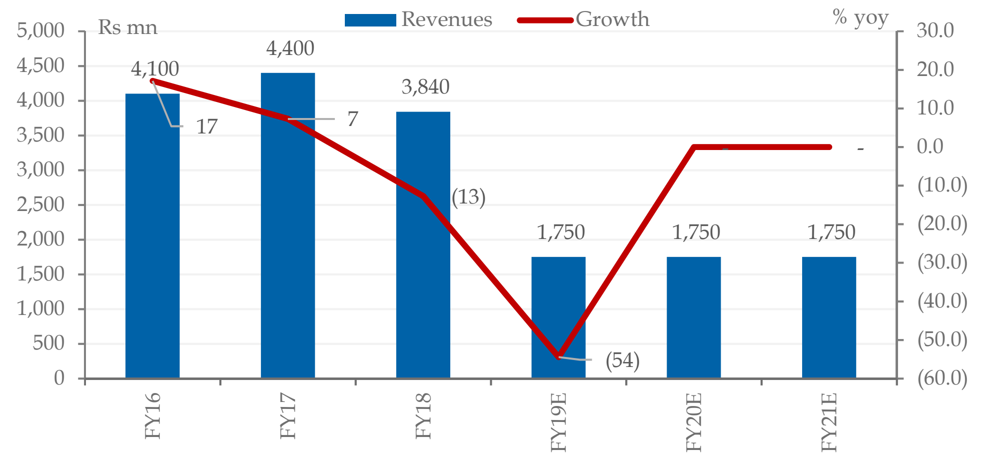
Source: Company, YES Sec - Research

Exhibit 3: Trend in Asia branded sales



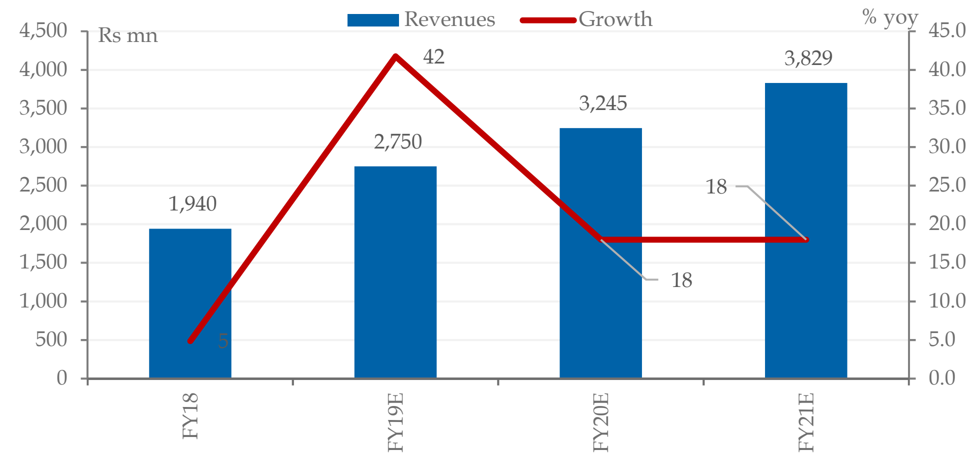
Source: Company, YES Sec - Research, Bloomberg

Exhibit 2: Institutional business to remain flat



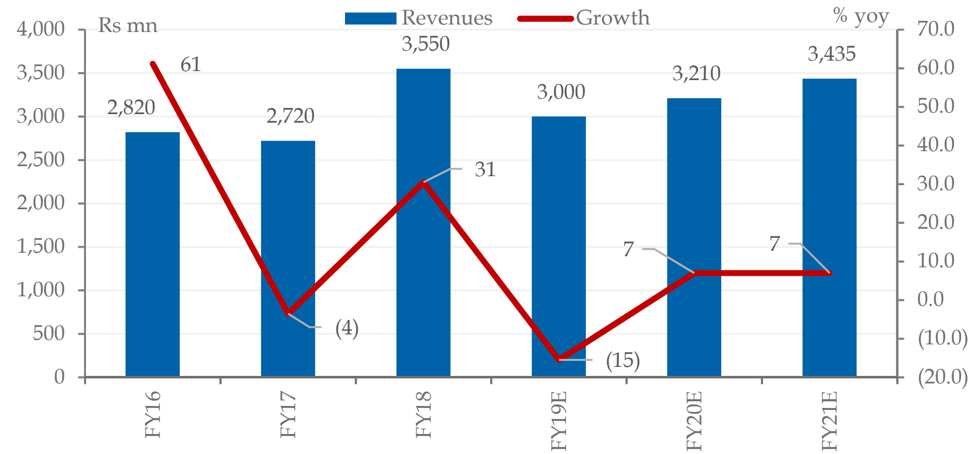
Source: Company, YES Sec - Research, Bloomberg

Exhibit 4: US sales to clock 19% CAGR



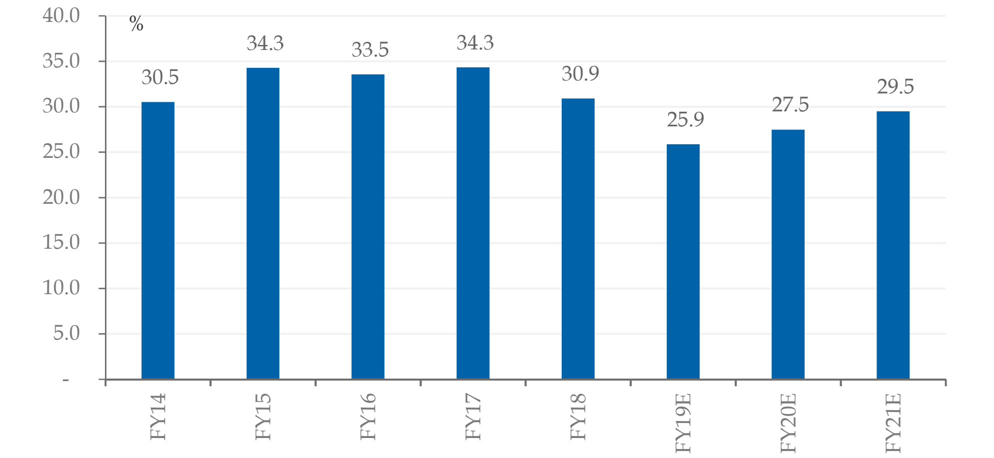
Source: Company, YES Sec - Research, Bloomberg

Exhibit 5: Africa branded to grow in single digits



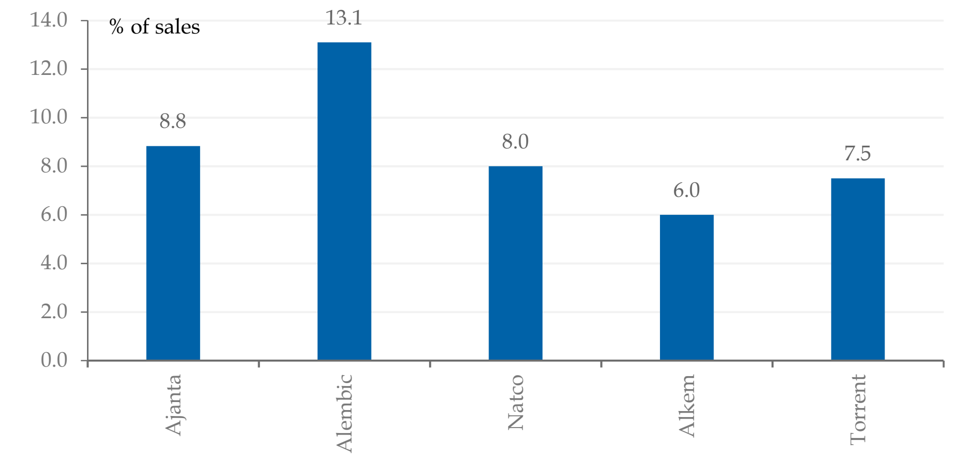
Source: Company, YES Sec - Research

Exhibit 7: Operating margin seen near 30% in 2 years



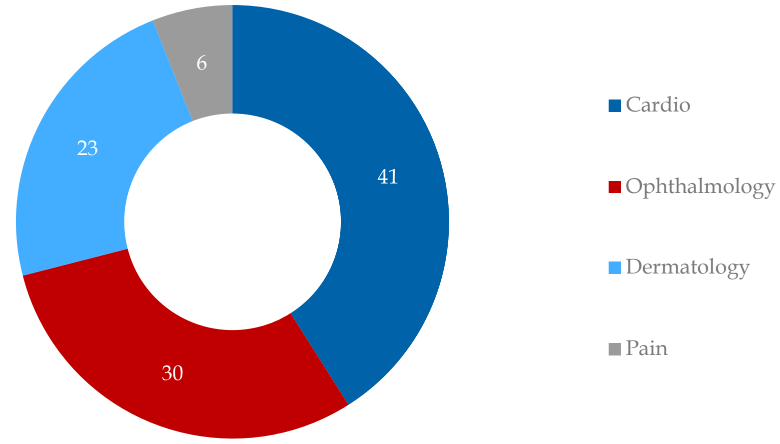
Source: Company, YES Sec - Research

Exhibit 6: R&D spend in comparison to peers



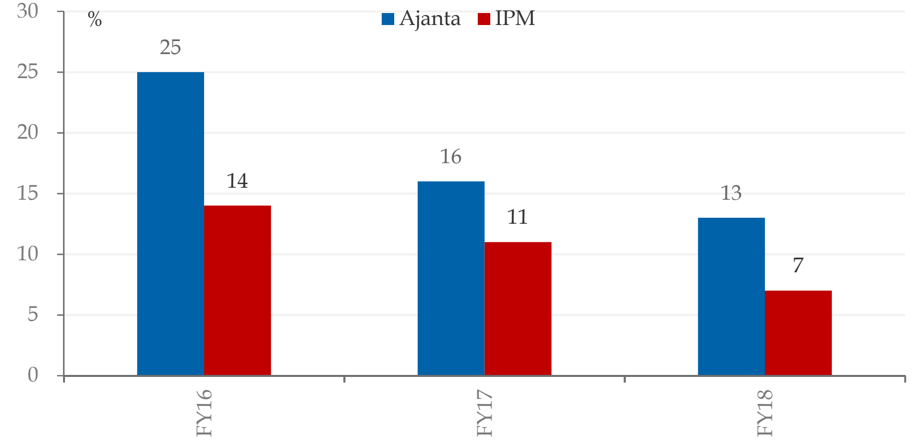
Source: Company, YES Sec - Research

Exhibit 8: Domestic therapy wise share, % (IMS MAT Dec' 18)



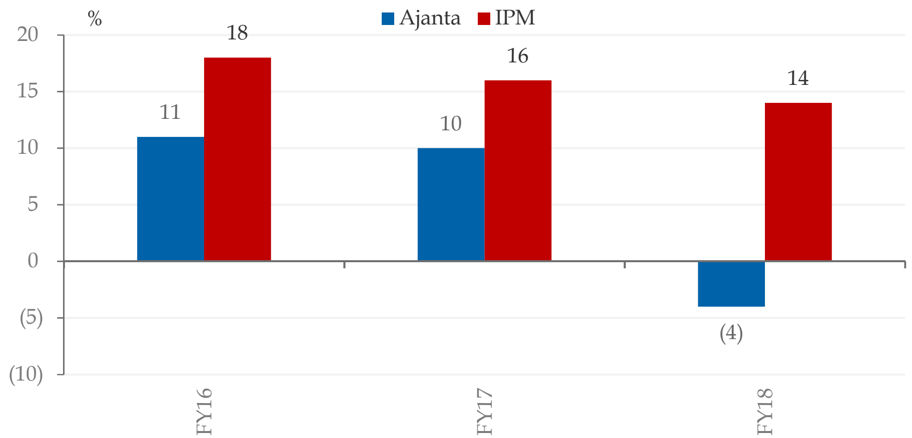
Source: Company, YES Sec - Research

Exhibit 9: Ophthalmology: consistent market leading growth



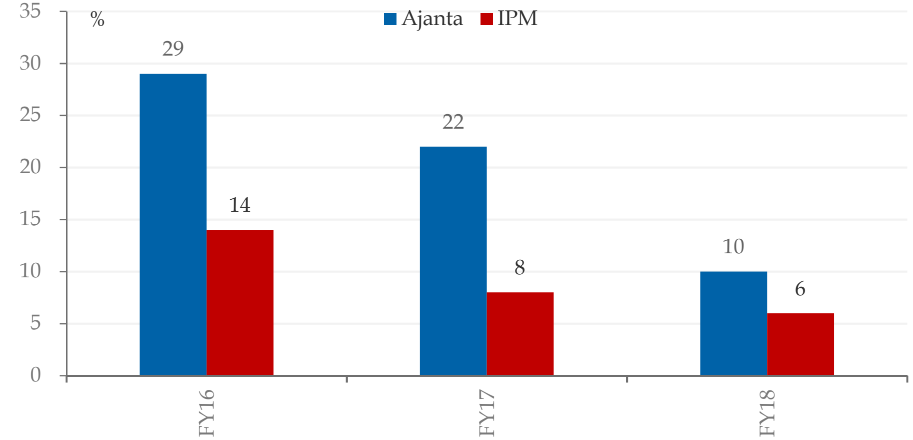
Source: Company, YES Sec - Research

Exhibit 10: Derma has underperformed market



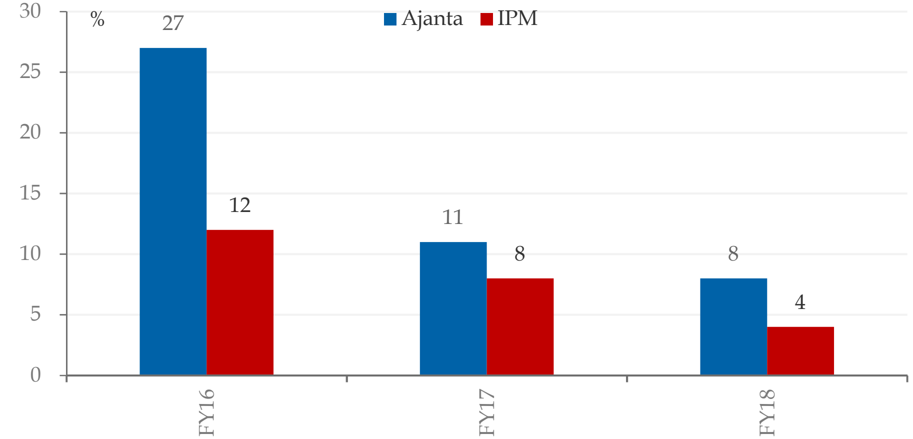
Source: Company, YES Sec - Research

Exhibit 11: Cardiology: strong delta to IPM



Source: Company, YES Sec - Research

Exhibit 12: Pain management growth vs IPM



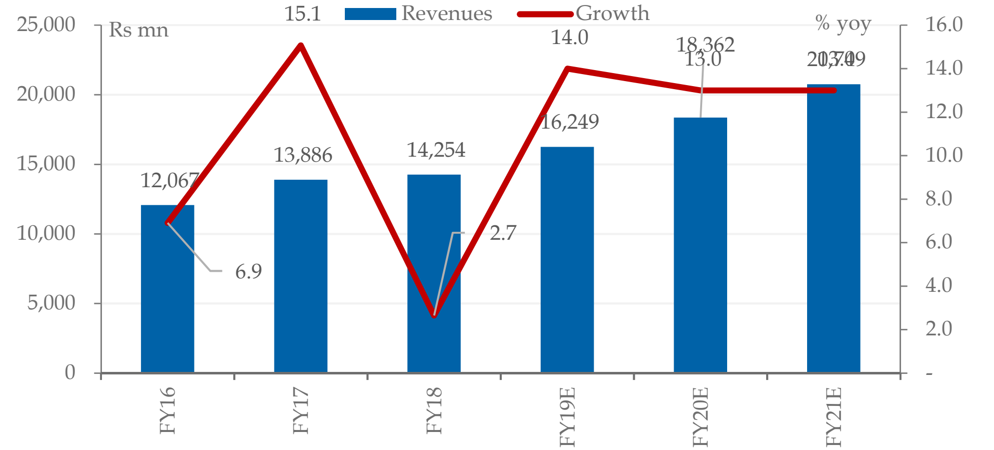
Source: Company, YES Sec - Research

IPCA LABS (CMP RS897, 18X FY21 PE)

Key business higlights

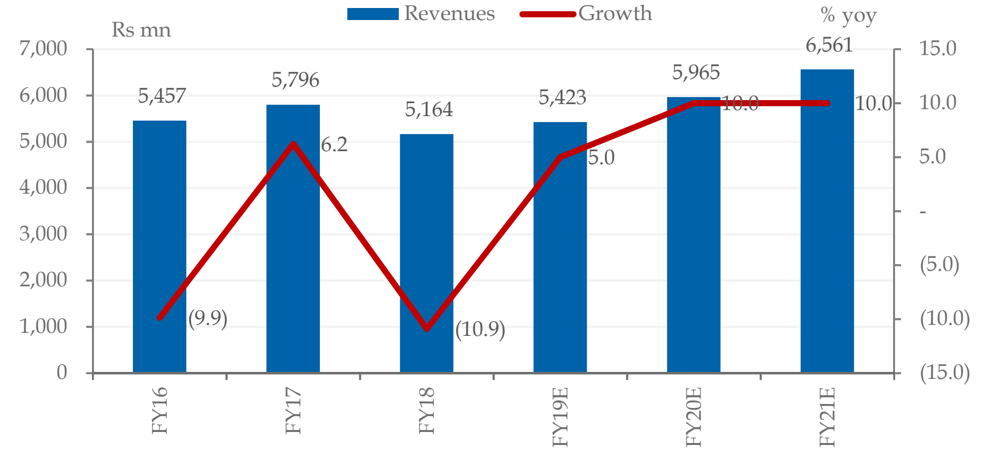
- ✓ Company is in continuous engagement with FDA and management believes inspection can happen in the next fiscal; IPCA working on partnerships for 2 FDA exempted products
- ✓ We expect 15% growth in FY19 branded exports and would be a steady business
- ✓ Domestic market sales growth seen at 14% while margin at 18.5% in FY19; we factor in similar growth for next two years
- ✓ IPCA enjoys ~60% share in Rheumatoid Arthritis in domestic market while overall pain management products have also grown by 22% in 9m FY19; it is undertaking clinical trials on 2 products as per regulatory requirements
- ✓ IPCA is one of the large suppliers of Valsartan and it has supplied to non-US, non-EU markets; API price realizations have been better and even on FY19 base, API business can grow at 20% in the next fiscal
- ✓ Decline in UK generics business is on account of serialization technology being implemented across EU which entails a lot of changes at the line level; albeit such an impact would end in Q4 itself
- ✓ Institutional business can be uneven depending on dispatch schedule, shipments can be lumpy and tender execution varies on quarterly basis; company on track for Rs1.8bn FY19 sales as guided earlier
- ✓ Company has complete plant clearance from Global Fund and once procurement commences, IPCA would start supplies; it sees substantial growth in dispersible tablets and injectable supplies. In Q3 call, management believes Rs700-800mn injectables sales business over next two years is possible based on plant capacities
- ✓ R&D has come down to 3% of sales as US business is non-existent; as inspection commences, research costs would go up to 4% of revenues
- ✓ Remediation cost stood at Rs600mn in FY19 which pertains to data verification of past 6 years for 2 plants; company completed the task and believes remedial costs unlikely to recur in FY20
- ✓ API availability issue from China has eased somewhat though prices still remain elevated
- ✓ Acquired subsidiary US-based Bayshore clocked sales of US$10mn and is profitable at the net level
- ✓ Significant operating leverage exists in the business and company expects margin to improve on back of increased capacity utilization
- ✓ We have not factored any revenues from US business as meaningful contribution is unlikely by FY21 even if inspection occurs over next few months
- ✓ About 55% of business comprises of branded formulations accounted by India (45%) and exports (10%); branded share has risen from 52% in FY16 to estimated 58% in FY21 driven by India
- ✓ We expect ~11% revenue CAGR over FY19-21E vs 9% rise in operating costs which should translate in to healthy margin prognosis; moreover, unlike US market, competitive dynamics do not shift quickly in emerging markets as approvals take longer time which creates a more sustainable earnings platform; retain positive stance on the stock, available at 18x FY21 PE

Exhibit 13: Healthy domestic growth



Source: Company, YES Sec - Research

Exhibit 15: Trend in international generics revenues

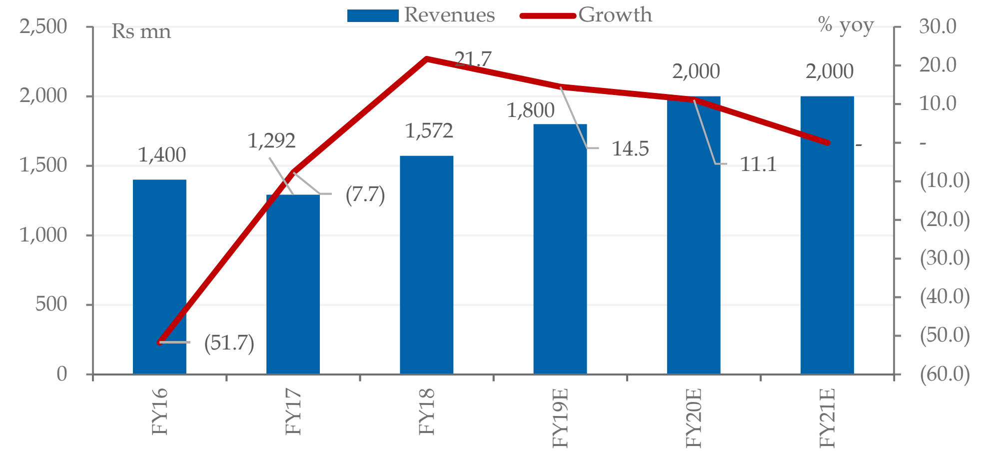


Source: Company, YES Sec - Research

Exhibit 14: International branded to clock steady sales

Source: Company, YES Sec - Research

Exhibit 16: Institutional business: challenges persists



Source: Company, YES Sec - Research

Exhibit 17: Ajanta Pharma – Valuation summary

Y/e 31 Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenues	20,020	21,309	20,423	22,614	25,167
yoy growth (%)	14.5	6.4	-4.2	10.7	11.3
Operating profit	6,872	6,584	5,283	6,214	7,420
OPM (%)	34.3	30.9	25.9	27.5	29.5
PAT	5,072	4,686	3,515	4,241	5,143
yoy growth (%)	22.1	(7.6)	(25.0)	20.7	21.3
EPS (Rs)	57.3	53.0	39.7	48.0	58.2
P/E (x)	17.9	19.4	25.9	21.4	17.7
P/BV (x)	5.8	4.5	4.0	3.6	3.1
EV/EBITDA (x)	12.9	13.4	16.4	13.5	10.9
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0
ROE (%)	36.8	26.0	16.3	17.6	18.7
ROCE (%)	41.4	30.3	20.0	21.0	22.1

Source: Company, YES Sec - Research

Exhibit 18: IPCA Labs – Valuation summary

Y/e 31 Mar (Rs mn)	FY17	FY18	FY19E	FY20E	FY21E
Revenues	31,582	32,192	36,964	41,394	45,186
yoy growth (%)	9.5	1.9	14.8	12.0	9.2
OPM (%)	13.7	13.7	18.9	20.7	21.2
PAT	1,883	2,331	4,385	5,551	6,316
yoy growth (%)	101.9	23.8	88.1	26.6	13.8
EPS (Rs)	14.9	18.5	34.7	44.0	50.0
P/E (x)	60.1	48.6	25.8	20.4	17.9
P/BV (x)	4.6	4.2	3.6	3.1	2.6
EV/EBITDA (x)	26.7	25.7	16.5	12.9	11.0
Debt/Equity (x)	0.2	0.1	0.1	0.1	0.1
ROE (%)	7.9	9.0	15.1	16.4	15.9
ROCE (%)	9.9	10.4	16.5	18.1	17.7

Source: Company, YES Sec - Research

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BUY > 15%

ADD 5% to 15%

HOLD -15% to +5%

SELL > - 15%

NOT RATED

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