Strides Arcolab Ltd

Imbibing the growth DNA

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BUY

Strides Arcolab Ltd.: Initiating Coverage

Imbibing the growth DNA

CMP: INR 876 **Target: INR 1031**

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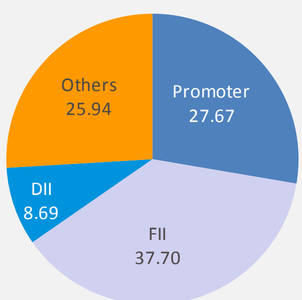
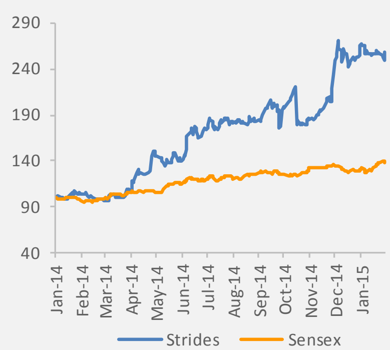
Bloomberg:	**STR:IN**
52-week range (INR):	998 / 310
Share in issue (Crs):	5.9
M cap (INR crs):	5,404
Avg. Daily Vol. BSE/NSE :(‘000):	556

SHARE HOLDING PATTERN (%)





Date: 10th February, 2014

Strides Arcolab (STAR) has metamorphosised from a predominantly injectable-focused company into a niche pharmaceutical generic player. With an unequivocal strategy to deepen its branded generic presence in the lucrative African market, turn the tap off unremunerative operations (anti-TB drugs) and not sacrifice profitability in pursuit of market share in the institutional segment, the company’s profitability has catapulted substantially from low double digits to 20% plus currently. Moreover, merger of Shasun Pharmaceuticals (Shasun) has accorded STAR a vertically integrated conglomerate status, which will enable it to pare sourcing costs meaningully, besides giving it access to the former’s fomidable products pipeline in the US market. Improving contribution of the high margin African branded business, uptick in the domestic branded market via Bafna Pharmaceutical’s domestic portfolio acquisition along with incremental benefits from vertical integration amply equip the company to garner higher profitability and imparts commendable growth visibility going forward.

Shasun acquistion a game changer: To derive significant synergy benefits

STAR, in a bid for vertical integration in the highly competitive formulations market (ex. injectable), acquired Shasun, a leading API manufacturer. The combined entity is envisaged to derive substantial operating and business synergies: (1) vertical integration to aid institutional business, yeilding higher market share; (2) enhanced product pipeline of non-overlapping molecules in niche and complex segments; and (3) operating synergies will catapult margin.

Branded business: Potent growth catalyst

The branded generic business contributes 24% to STAR’s overall revenue, wherein it generates 73% of overall revenue from the lucarative African market and balance from India. It is one of the most successful Indian companies in the African market with a pan-Africa footprint. Currently, the African pharmaceutical market is estimated to be ~USD 23 bn, clocking a CAGR of 10.6% to USD 45 bn by 2020, with the ~USD 8 bn Sub-Saharan African (SSA) pharmaceutical market expected to post fastest growth. Significant capacity addition in these high growth countries will not only enable STAR to cater to the rising demand for drugs from this region, but also ensure that 70% of the company’s products are locally manufactured once all its plants are commissioned, offering it a distinct cost advantage vis a vis other players. STAR has sharpened focus on the branded business, which will help it grow at a sustainable and profitable rate.

Valuations

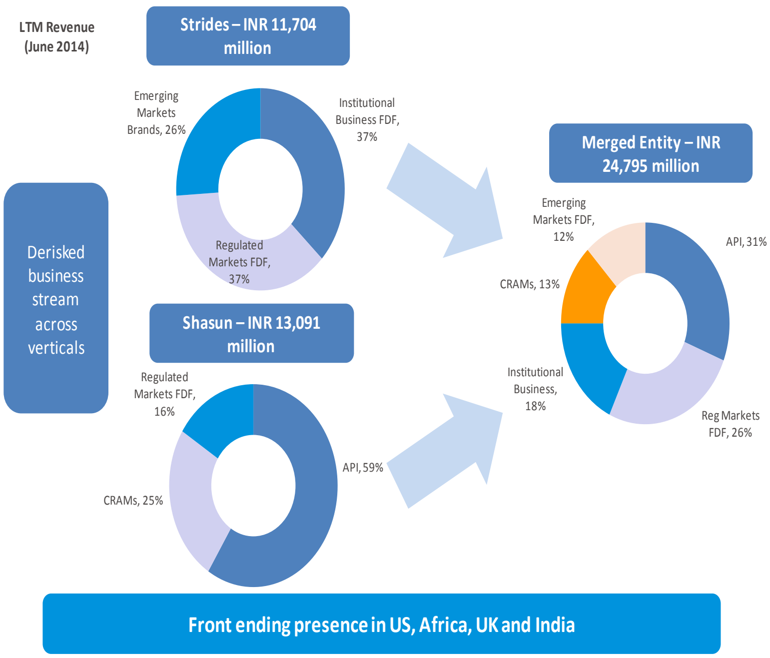
The stock is currently trading at 17.6x FY17E core earnings versus historical average of 21x one year forward earnings. We value STAR at 19x FY17E earnings, INR 49.6/share, on account of the anticipated improvement in margins of the combined entity bolstered by superior product mix, vertical integration and estimated pick up in the regulated market business. We further value the cash in escrow accounts from the Mylan deal at INR89/share. We initiate coverage on the stock with **“BUY”** and target price of INR1031/share.

Year to March (INR Crs.)	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Revenue	2,550	2,307	1,341	1,217	2,896	3,354
Revenue Growth (%)	50.4%	-9.5%	-41.9%	-9.3%	138.0%	15.8%
EBITDA	513	606	252	237	467	624
Net Profit	234	847	(233)	920	270	399
Profit Growth (%)	62.2%	30.4%	-59.4%	57.1%	64.3%	47.7%
Shares Outstanding (crs.)	6.0	6.0	6.0	6.0	8.1	8.1
EPS (INR)	33.2	43.3	17.6	27.6	33.5	49.5
Diluted EPS (INR)	33.2	43.3	17.6	27.6	33.5	49.5
EPS Growth (%)	62.2%	30.4%	-59.4%	57.1%	21.5%	47.7%
Diluted P/E (x)	26.4	20.2	49.8	5.7	26.1	17.7
EV/EBITDA (x)	14.7	11.0	21.9	22.8	16.6	12.0
RoE (%)	13.3%	14.7%	6.6%	14.2%	17.9%	20.1%

*FY14: 15 month period; CY11 includes Ascent & Agila; CY12 includes Agila

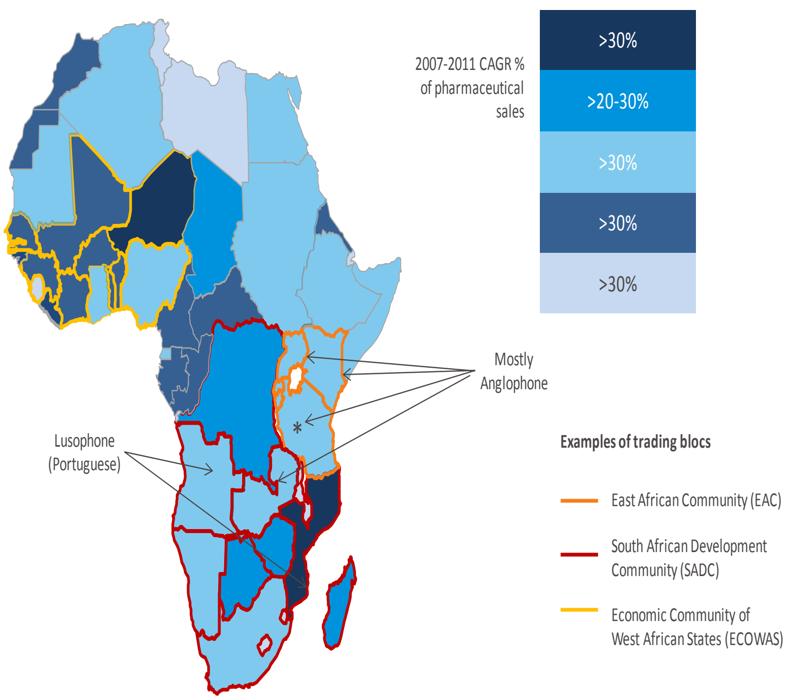
Focus Charts: Story in a nutshell

Merged entity creates a diversified business with vertical integration

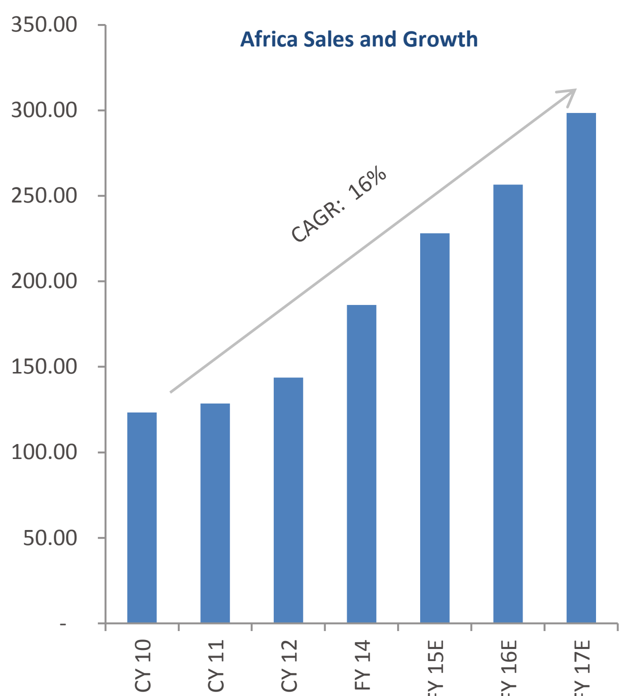


Company	Scale	Vertical Integration
AUROBINDO	✓✓	✓✓
aspen	✓✓	✗
Cipla	✓✓	✓✓
HETERO	✓✓	✓✓
Mylan	✓✓	✓✓
Strides	✓	✗
Strides + Shasun	✓✓	✓✓

STAR's African business outperforming African pharmaceutical market growth



* Tanzania is in both the EAC and the SADC.



Investment Rationale

Shasun merger a significant game changer

STAR's profit mix, prior to the Agila sale, was skewed towards the injectable business, which did not require an API plant set up as these products have minuscule API content. With favourable market factors such as limited competition and shortage in the market, the company was able to cover its costs optimally with substantially higher profitability compared to an oral product. However, post divestment of Agila, STAR's remaining business of formulation orals and topicals required it to be backward integrated to remain competitive in the space.

In its endeavour to be vertically integrated in the highly competitive formulations market (ex. injectable), STAR merged with Shasun Pharmaceuticals (Shasun), a leading API manufacturer. The combined might of the two entities is envisaged to render the following operating and business synergies:

1. *Institutional business to benefit from vertical integration, resulting in higher market share.*
2. *Enhanced product pipeline of non-overlapping molecules in niche and complex segments.*
3. *Margin to get a potent shot in the arm.*

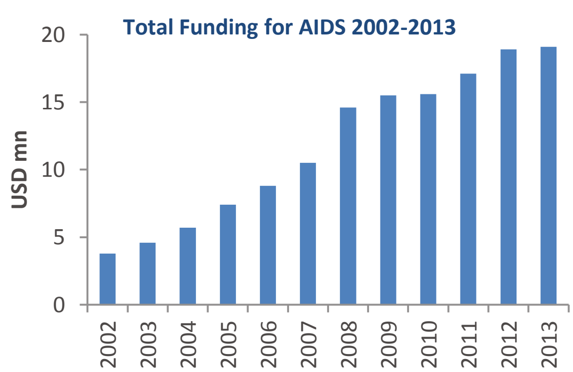
Synergy No. 1: *Vertical integration to spur institutional business, leading to higher market share*

STAR is among the few pharmaceutical companies operating in the institutional business run by various international funding agencies (Global Fund, President's Emergency Plan for AIDS Relief (PEPFAR), USAID, World Bank, PMI & DFID, Clinton Health Access Initiative (CHAI)) that procure drugs for distribution in Africa and other low and middle income countries (LMICs) supplying formulations for both anti-retroviral (ARV) and anti-malarial.

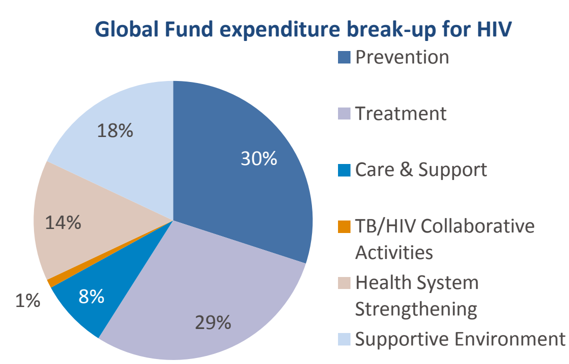
With STAR being the sole player in the ARV segment that was not backward integrated, the merger with Shasun will enable it to become vertically integrated in the segment and in turn garner higher market share. Accordingly, the company expects revenue from the business to catapult from USD50mn currently to USD200-250mn over the next 3-4 years.

a) ARV business: Expansion of ART to propel opportunity

Global funding for AIDS amounted to USD19.1bn in 2013, with PEPFAR and Global Fund accounting for majority of the funding, contributing ~USD 6.3 bn and USD 3 bn (signed funding), respectively, in 2013. According to Global Fund, ~29% of its funding is expended on treatment, including medicines.



Source: UNAIDS



Source: Global Fund

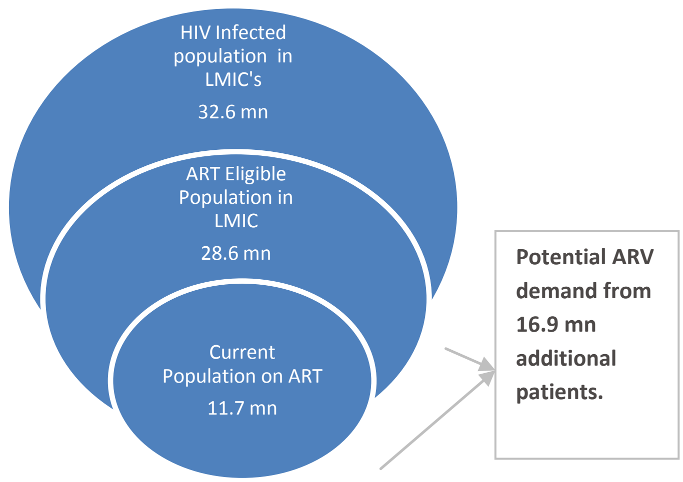
In 2013, WHO revised its guidelines for use of Anti-Retroviral Therapy (ART) in HIV patients, thus increasing the threshold requirement for eligibility of ARTs and allowing for treatment in the earlier stage of the disease. As a result, the population eligible for receiving treatment has jumped to 28.6 mn patients in 2013 from 15.9 mn, ~87% (earlier ~49%) of the estimated 32.6 mn infected population in LMICs in 2013.

Currently, with only ~11.7 mn patients receiving ART in LMICs, WHO estimates a huge upside in the number of patients on ART, anticipating to reach 16.8 mn patients by 2016. Accordingly, this is expected to translate into significant ARV demand over 2013-16. The ARV market, estimated at USD 987 mn in 2012 (as per Global Price Reporting Mechanism, which represents 75% of the market), is expected to grow substantially over 2013-16 on account of these revised guidelines.

Snapshot of WHO guidelines changes

	2010 guidelines	2013 guidelines
Adults and adolescents living with HIV	<350 CD4 cells/mm3	<500 CD4 cells/mm3
Children living with HIV	<24 months old: all 2-5 years old: <750 CD4 cells/mm3 or 25%	<5 years old: all
Pregnant women living with HIV	No specific provision	All
People coinfected with TB and HIV	All	All
People coinfected with HIV and hepatitis B	All with chronic active hepatitis	All with chronic severe liver disease
Serodiscordant couples	No specific provision	All

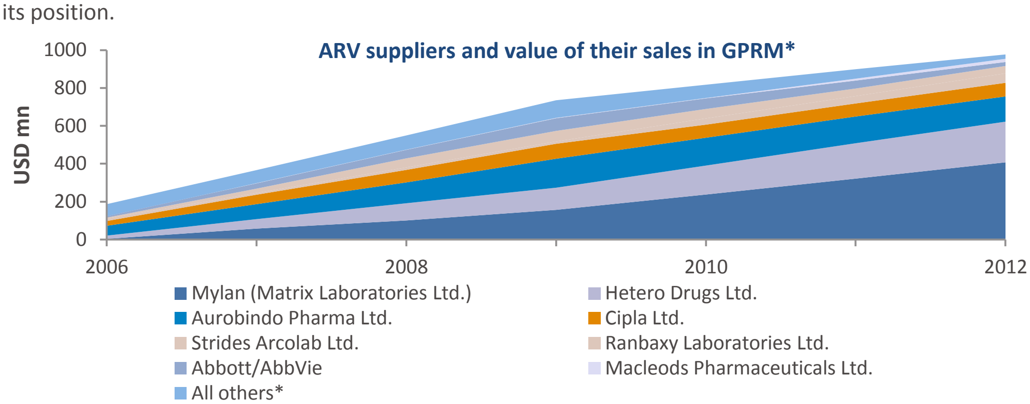
Impact of change in guidelines



Source: WHO

STAR's gain: Robust ARV demand, stable funding, expanding product basket, tech tie ups to boost revenue

STAR is currently a fringe player in this market, with ~5% share as of 2012 and has 19 PEPFAR filings with 16 tentative approvals as well as 20 pre-qualifications under WHO. In addition, the company is focusing on production and supply of new ARVs that are difficult to manufacture, further strengthening its position.



Source: WHO

Note:*GPRM: Global Price Reporting Mechanism.

Besides the buoyant demand for ARVs over the medium term, the company's merger with Shasun is an incremental positive, offering a dual benefit:

- It gives additional head room to boost volumes without compromising on profitability on the back of backward integration.
- Shasun already has an API plant approved by the USFDA and WHO; enabling STAR to immediately add it as an API source for its ARV portfoliopost development of the API's.

While the merger's integration benefits will accrue only in FY17E, the robust ARV demand coupled with stable funding and expanding product basket along with recent product technology tie ups with Gilead for Sovaldi & Harvoni, Emtricitabine and Tenofovir Alafenamide, lend comfort on a steady revenue stream from the ARV business over the medium term.

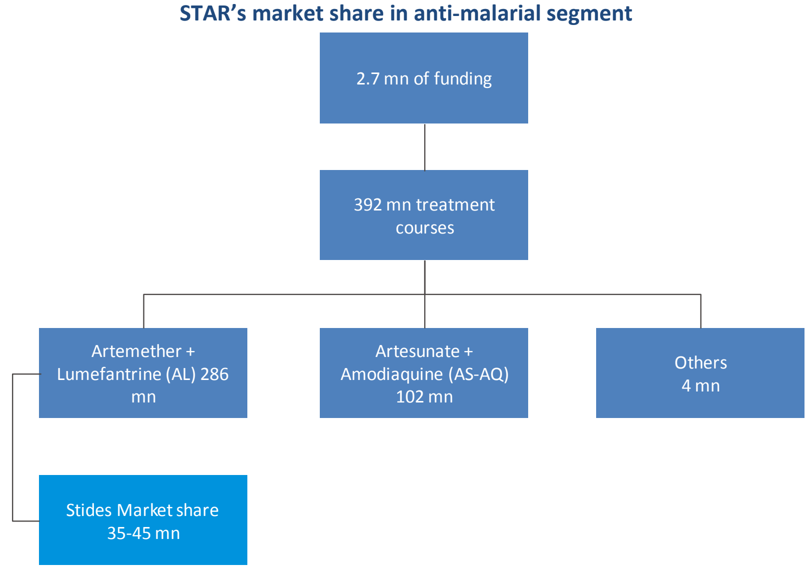
b) Anti-malaria: An incremental opportunity

Other than the ARV business, which currently is the major piece of the institutional business, the company has also recently received WHO pre-qualification for Artemether + Lumefantrine (AL), a high margin business. However, we believe Shasun's integration will not majorly impact this business, other than probably as a risk mitigating strategy in case of a problem with the preferred source. *(refer to Annexure I for further details)*

STAR's gain: Potent margin booster

STAR received WHO pre-qualification for AL (accounts for 73% of the 392 mn doses of ACT drugs procured in 2013) in 2013, and has already won a tender from the Global Fund, which is a 2-year contract. The company will supply 35-45 mn doses, which translate into a volume market share of 12-16% of the AL market and revenue of USD 25-30 mn per annum for STAR. Supplies for the same commenced in Q3FY15.

STAR's market share in anti-malarial segment



Source: Company, Edel Invest Research.

Since margin in the anti-malaria business is higher than the company average margin, commencement of supplies for this product will boost consolidated EBITDA margin substantially. We believe Shasun may be added as a third API source and thus may not help improve margin, but would act as a risk mitigation strategy in case of a problem with the preferred source.

Additionally, the company has recently inked a collaborative agreement with MMV for the development of rectal artesunate for pre-referral treatment of children with severe malaria. With no rectal artesunate product currently in the market, the project, funded by UNITAID, is targeting a WHO-prequalification of a rectal artesunate product by 2016. Being one of only 2 players (along with Cipla) that have been selected for this project, it could translate into a lucrative opportunity for the company over the long term.

Synergy 2: *Enhanced product pipeline of non-overlapping molecules*

STAR initially ventured into regulated markets (37% of FY14 revenues) of US, EU, Australasia and South Africa with a focus on niche therapies and molecules via the partnership model. While the partner held the IP and distribution rights, STAR was responsible solely for the manufacture of products, leading to low margin in this segment. However, over the past three years, in a bid to improve profitability, the company established a front-end presence in the US and UK. Ergo, it bought back its portfolio of key products from its partners in the US to sell them under its own label.

STAR has filed 31 ANDAs as of date, of which 16 are pending approval. Of the 15 approvals received, 12 have been commercialised so far, with the company commanding a market share of 15-25% in each product. Vancomycin Oral (the company's only partnered product in the US through Alvogen) is its most successful product in the US, where it commands a leading market position in a 6-player market.

There has been a dearth of filings in the US market given the sale of its R&D facility as part of the Agila sale to Mylan. However, with its new state-of-the-art R&D facility coming on stream last quarter, the company is expected to gain traction in filings going forward with ~10 filings in the current fiscal, expected to ramp up to ~20-25 filings per year going forward.

STAR's gain: Robust US pipeline, enhanced focus on niche products

Although the company has a presence across a wide range of therapies, its strategy is to focus on drugs with differentiated delivery models such as soft gels, sachets, creams and ointments, among others. In addition, the company is focusing on niche/legacy products that are low volume/high profitability molecules with limited market size and competition.

With the merger with Shasun, STAR gets access to an established US business along with an extensive pipeline of products that has a similar strategy of focusing on molecules with differentiated delivery mechanisms without causing an overlap in STAR's existing pipeline.

The company is expected to scale up its regulated markets business further riding various synergies that will accrue in the combined entity:

- ~16% of Shasun's current revenues come from its US formulations business (including contract manufacturing), where the company has commercialised three products via partnerships.
- In addition, the company has a strong pipeline of non-overlapping products, mostly in the extended/modified release domain, which complements STAR's strategy of focusing on differentiated delivery molecules.
- Shasun has already filed 11 ANDAs in the modified release domain and has a pipeline of 30 products in this space.
- The combined entity will have an extensive pipeline of 160 formulations under development for the US market.

Enhanced FDF pipeline

USFDA	Approved	Filed	Pipeline	Total	Filing 2015	Launched	Partnered
SGC	2	5	1	8	-	2	-
Extended Release	-	2	32	34	1	-	13
Creams and Ointments	1	1	8	10	2	1	-
Suspension	-	-	6	6	-	-	-
OTC	3	3	7	13	2	3	-
505 (b(2))	-	-	1	1	-	-	-
FTF	-	1	1	2	1	-	-
Other	11	17	58	80	11	8	7
Total	17	29	114	160	17	14	20
PEPFAR	16	2	-	18	-	-	-

Source: Company, Edel Invest Research.

- The company will now have three USFDA approved formulations facilities (including one from Shasun).
- Two state-of-the-art R&D centres with a total strength of ~400 scientists.
- Portfolio of 43 commercialised DMFs and additional 23 DMFs under development.
- The merged entity will help leverage Shasun's API capabilities to become more competitive in regulated markets.

The merged entity's robust pipeline for the US market, focus on niche segments, improved competitive strength riding vertical integration and moving to a front-end distribution in the US and UK renders robust visibility on high revenue growth and margin improvement going forward. We expect the regulated markets business for the combined entity to report a CAGR of 17.3% over FY14-17E.

Synergy 3: *Operating synergies to propel margin*

STAR's amalgamation with Shasun will lead to a vertically integrated enterprise with the following margin levers at its disposal:

- STAR's institutional business is expected to be the biggest beneficiary of the merger with Shasun, with margin set to improve substantially in its ARV business on account of backward integration for its products, bringing it closer to company level margin.
- Shasun's UK CRAMS business is an overhang on the company's margins. Given STAR's promoters' proven track record of turning around businesses, a potential turnaround in this business could lead to an uptick in margin by 300-400 bps on Shasun's current EBITDA of ~10%.
- The combined entity will have operational synergies in the form of workforce optimisation, cost savings in R&D and corporate expenses as well as reduced capex due to combined facilities, which will ensure margin expansion at the consolidated level.

With a proven track record of STAR's promoters in integrating businesses and the operating synergies expected to kick in for the combined entity, we expect the company's margin to improve from ~16.1% in FY16E to ~18.5% in FY17E.

Branded business: Mainstay for future growth

STAR's branded generic business contributes 24% to overall revenues, where it generates 73% of overall branded generic revenues from Africa and balance from India, with presence across therapies, particularly diabetes and other life-style therapies. While the company is one of the most successful Indian companies in the African market with pan-Africa presence, it has been a late entrant in the Indian market. Its branded business is currently a key focus area which will help it grow at a sustainable and profitable pace.

Africa: Changing track

STAR's African operations form the mainstay of STAR's branded business, contributing 73% to branded sales. The company has a strong positioning in Sub Saharan Africa, primarily Francophone (French speaking) and West Africa, where it is among the top 5 players. It initially ventured into the African market with trading of pharmaceutical products in 1990 and over the years established a local manufacturing set up along with building an extensive portfolio of products while expanding its footprint across the continent. Today, it is one of the biggest pan-African pharmaceutical manufacturers with a well established front-end presence across 27 Sub-Saharan African countries.

Evolution of African Operations

1990-2007

First Steps
- Strides set foot in the African continent with trading activities in Nigeria ,Ghana & Sudan.
- Expanded into Francophone markets through generics business in Cameroon

2008

Consolidation of the Generic Business
- Commissioned its first manufacturing site in Africa (Nigeria)
- Initiated the East Africa operations in the generic space with a portfolio of 60 registered products

Foray into Brands business
- Initiated brand marketing business in Francophone countries with a portfolio of 12 products
- Appointed a strategic distributor in France to cater to brands business

2009-2011

Scale up of Brands business
- Operated brands business in Nigeria & 10 French African Countries with 50 medical Reps

Expansion in New Markets
- Entry strategy into MENA region through Iraq with over 40 products.

Created sizeable generic business
- Portfolio of 5 products in the $ 1 Mn club

2012-13

Regional Expansion
- Set up owned distribution operations in Cameroon, Burkina, Congo.
- Initiated setting up of manufacturing facilities at Bangalore , Namibia, Botswana, Sudan & Cameroon.
- Proparco participated in 20% Equity of Africa business
- Diversified the Brands business portfolio by adding products for treatment of niche therapeutic segments, particularly, Anti Diabetic & Anti hypertensive.

2014

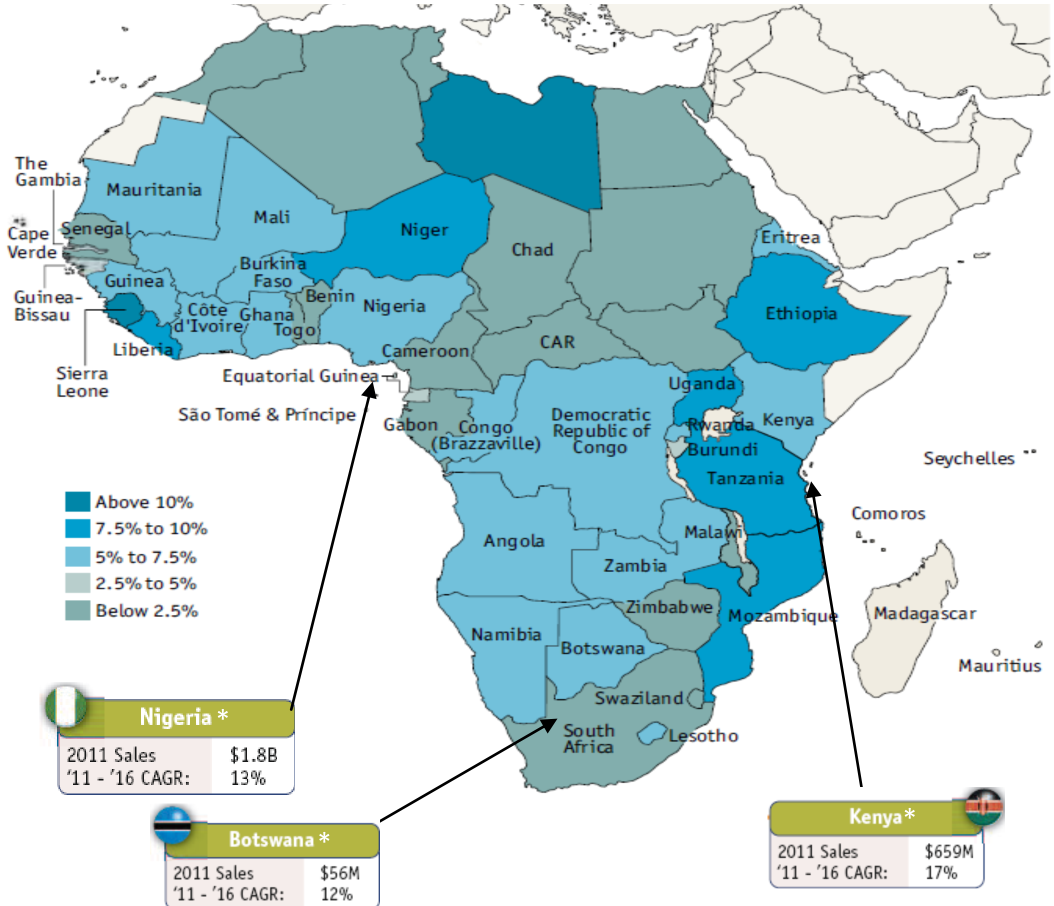
Towards Leadership position
- Commissioned manufacturing facilities at Bangalore , Namibia, Botswana, Sudan & started construction of plant at Cameroon
- Acquired Proparco' s 20% stake .
- Strengthened the brands business with 200 MR's in Africa.

Source: Company, Edel Invest Research.

African opportunity: Similar to early India

Currently, the African pharmaceutical market is estimated to be ~USD 23 bn, expected to clock a CAGR of 10.6% to reach USD 45 bn by 2020, with the ~USD 8 bn Sub-Saharan African (SSA) pharmaceutical market expected to post fastest growth. According to The Economist's Intelligence Unit, SSA countries such as Sierra Leone, Ethiopia, Liberia, Mozambique and Uganda are set to clock the fastest economic growth globally over the next few years, leading to increased healthcare spending, in turn, giving an impetus to pharmaceutical growth in these regions. In addition, pharmaceutical markets of Nigeria, Kenya and Botswana are expected to register robust sales growth over the next few years on account of increasing insurance coverage, rise of private-public partnerships in healthcare and investments in healthcare infrastructure.

Real GDP growth of key countries (2012-16 forecast)



Source: Economist intellegence unit, IMS.

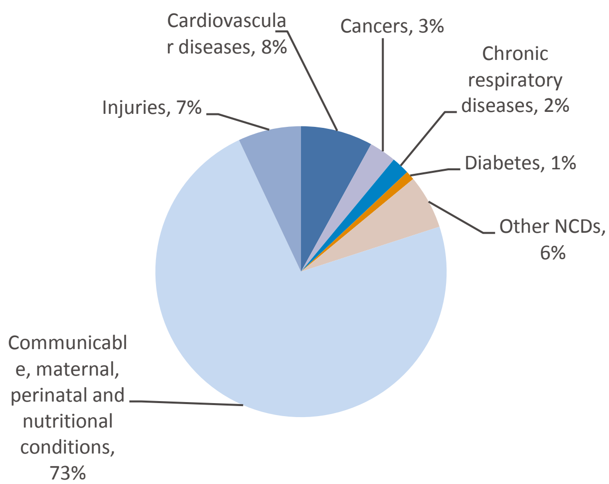
*Note: Figures indicate pharmaceutical market size & growth.

Expect shift to more lucrative life-style diseases

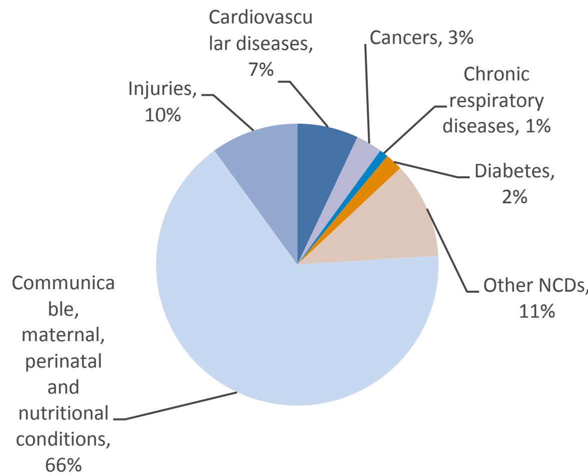
Although Africa has the world's highest burden of infectious diseases, the region's disease profile is slowly shifting to non-communicable diseases (NCD) as a result of the changing economic profile and lifestyle patterns. While infectious diseases such as HIV, TB and malaria remain the primary cause of death in Africa, WHO estimates that NCD deaths will clock the fastest growth in Africa at 20% between 2010 and 2020 versus global growth of 10% and by 2030, NCDs will surpass all other diseases as the most common cause of death. The prevalence of NCDs is already increasing in SSA, which has the largest proportion of people with hypertension in the world and the second highest age standardised death rate from diabetes. Additionally, NCDs are now being declared a national priority in countries like Kenya and Botswana, leading to health budgets being slowly directed towards NCDs as opposed to the previous decade where majority of health budgets were directed towards communicable diseases.

Cases of NCD deaths lower in less developed African countries….

Causes of death in Central African Republic

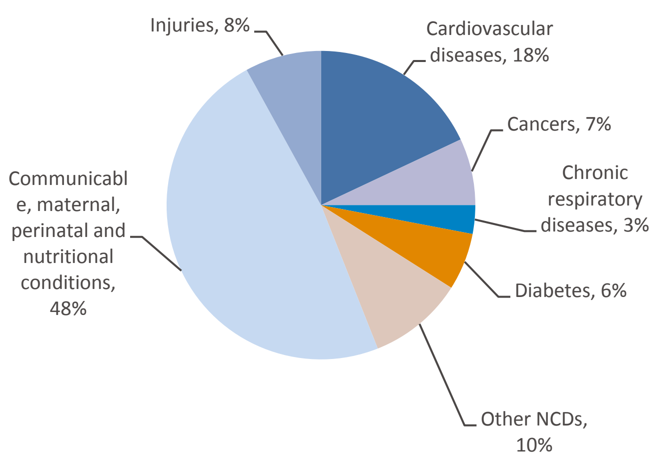


Causes of death in Nigeria

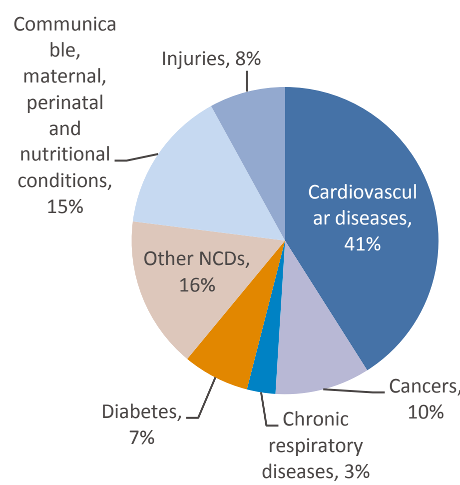


…while it is much higher in developed African countries

Causes of death in South Africa



Causes of death in Algeria



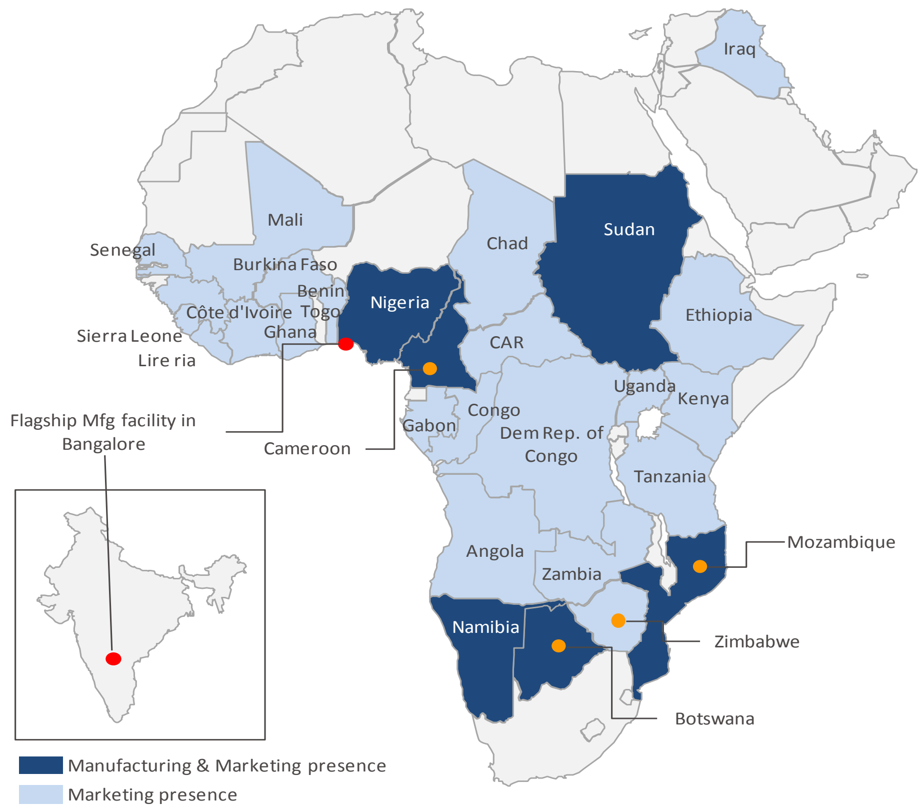
Source: WHO

STAR: An early mover

Given the fragmented nature of the Africa market, few MNCs such as Sanofi, Merck and Novartis have been able to successfully set up a pan-African presence with local manufacturing. Local players are generally restricted to a particular national market only and often fail to meet International GMP standards, leading to ~70% of drugs being imported from India and China.

STAR has an established manufacturing presence in Lagos, Nigeria, since 2008 and has recently commissioned packing units in Namibia and Botswana, along with a dedicated facility in Bengaluru, India, for its African operations. In addition, the company expects its manufacturing facilities in Cameroon and Sudan to come on stream within the next six months, while its plant in Mozambique is expected to be commissioned over the next one year. The capacity addition in these high growth countries will not only enable it to cater to the rising demand for drugs from this region, but also ensure that 70% of the company's products are locally manufactured once all its plants are commissioned, offering it a distinct cost advantage vis a vis other players.

STAR's African Presence

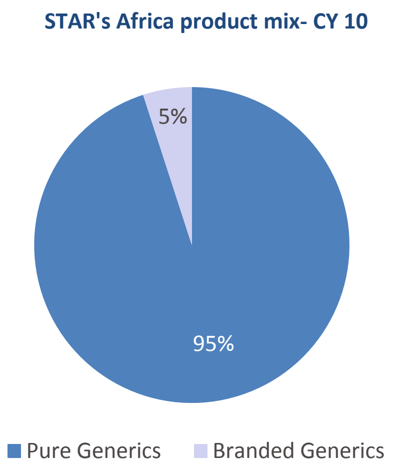


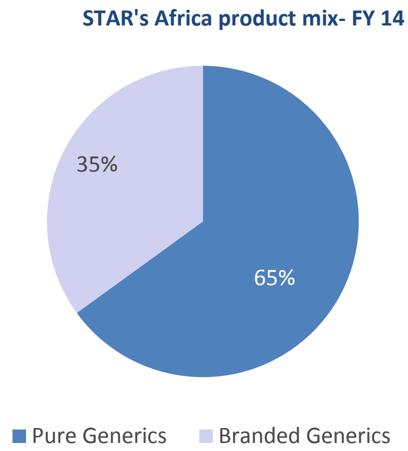
Source: Company, Edel Invest Research.

Evolving with change in market dynamics

STAR's African portfolio initially comprised only pure generics, which was a high competition, low margin business. Additionally, the company was present predominantly in acute therapies, since the disease burden of communicable diseases has been the highest in this region. However, with the rising incidence of chronic, NCD, STAR has also revamped its business model and product mix, introducing its own brands in Francophone African countries in collaboration with Proparco, a French development organization that acquired 20% stake in the business for USD 12.5 mn in CY12.

With a focus on lifestyle and life threatening diseases like diabetes and hypertension, the company has increased the proportion of branded generics from 5% to 35% of its portfolio currently. While STAR is creating a new portfolio specifically for Africa, it is also introducing some of its Indian brands in those markets. A case in point is Renerve, STAR's flagship Indian brand for diabetic neuropathy, which has garnered ~USD 5 mn sales in its first year of launch in Africa. Currently, the company has 300 products in the market with 900 registrations. Recognizing the lucrative African opportunity, the company re-acquired the 20% stake from Proparco in Q1FY15 using the proceeds from Agila and now owns 100% of the business.





Source: Company, Edel Invest Research.

STAR's African sales have outpaced growth in the African market with a CAGR of 24% over FY10-14, attributable solely to the scale up in the branded business, with generic sales remaining flat in absolute terms. While the company has ventured into 5 new countries in Africa in the last year, it is also looking to significantly expand its field force from 200 medical representatives to 1,000 over the next 3-4 years, (100 reps expected in next six months). With the current per person productivity estimated at ~USD 100000, this business could witness substantial traction over the medium term on account of increasing field force.

Additionally, margins have expanded substantially from single/low double digits to company level margins led by improving product mix and are expected to improve further as the proportion of branded drugs increases in the portfolio. With the African pharmaceutical market set to be the second fastest growing market, STAR's local manufacturing, pan-African presence and favourable product basket place it in a favourable spot to tap this lucrative opportunity. We expect African business to clock CAGR of 17.0% over FY14-17E, with majority of growth coming from the branded--CAGR of 40.6% over FY14-17E.

India: Bafna JV a key strategic fit

STAR is a relatively new player in the Indian branded space and has grown inorganically via acquisitions in the domestic market. The company ventured into the Indian market in 2007 with the acquisition of Grandix Pharmaceuticals, which had a presence in South India and a diverse portfolio of products across chronic therapies like diabetes, cardiovascular and CNS, among others. Its key brand Renerve, a vitamin B12 supplement to treat deficiency caused by diabetes and other diseases, has a leading market position in its segment.

STAR's strategy in the domestic market is focused on building a niche therapy business riding acquisition of brands and products which have potential to grow faster than the market and become market leaders in their respective therapies along with helping the company gain pan-India coverage.

In line with this strategy, the company acquired majority stake in the Indian business of Bafna Pharmaceuticals in 2014 for a cash consideration of INR 48 crs. The business is being transferred to an SPV, where STAR has 74% stake while Bafna holds the balance 26% stake as well as retains manufacturing rights.

It added another star brand Raricap (80-85% of Bafna's Indian sales), the eight largest in oral Haematinic segment in India, with a CAGR of 64% over the past 3 years, to its portfolio. Together, Renerve and Raricap account for ~70% of STAR's Indian business.
The acquisition of Bafna Pharmaceutial's domestic business is thus in line with STAR's strategy of acquiring strong brands and also gives it an opportunity to market its existing products pan-India (except J&K and Rajasthan) via Bafna's established distribution set up. With this acquisition, the company has almost doubled its field force from 300-350 currently to ~700.

Sales from this segment have posted CAGR of 21% over FY10-14, albeit on a low base. With Raricap as well as an extensive distribution set up, we expect sales to register CAGR of 39.2% over FY 14-17E.

Valuations

STAR has metamorphosised from a predominantly injectable-focused company into a niche pharmaceutical generic player. With an unequivocal strategy to deepen its branded generic presence in the lucrative African market, turn the tap off unremunerative operations (anti-TB drugs) and not sacrifice profitability in pursuit of market share in the institutional segment, the company's profitability has catapulted substantially from low double digits to 20% plus currently.

Moreover, with Shasun now on board, STAR has become a vertically integrated conglomerate, which will enable it to pare sourcing costs, besides opening the doors to the former's vast pipeline of products in the US market. We believe this amalgamation will help the company improve its margins further. STAR's promoters' amply proved credentials in turning around businesses anchor our confidence that they will work their magic in Shasun's UK business as well, which could spur the combined entity's profitability meaningfully.

The improving contribution of high margin African branded business, uptick in the domestic branded market through the acquisition of Bafna Pharmaceutical's domestic portfolio along with incremental benefits from vertical integration amply equip the company to garner higher profitability and imparts commendable growth visibility going forward.

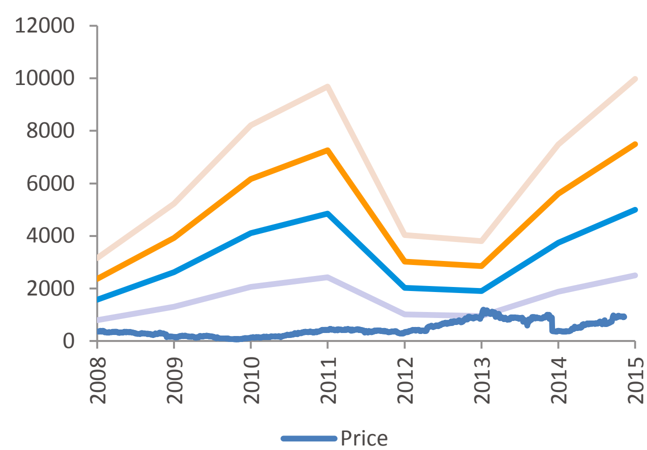
STAR's pharma business clocked earnings CAGR of 17.2% over CY08-14 with margin improving to ~20% from low double digits earlier. We estimate earnings to catapult to ~19.6% CAGR over FY14-17E riding the sustained thrust on branded business and improvement in market share in the tender business.

With a product pipeline of ~160 drugs under development and anticipated increase in filing rates in the US to 20-25 per annum, we expect regulated markets to eventually be major growth contributors along with the African branded business.

The stock is currently trading at 17.6x FY17E core earnings versus historical average of 21x one year forward earnings. We value STAR at 19x FY17E earnings, INR 49.6/share, on account of expected improvement in margin of the combined entity aided by better product mix, vertical integration and anticipated pick up in regulated market business. We further value the cash in escrow accounts from the Mylan deal at INR 89/share. We initiate coverage on the stock with "BUY" rating and a target price of INR 1031/share.

One Year Forward PE Band

One Year Forward EV/EBITDA Band



Risks

Currency Risk

Over ~90% of the combined entity revenues are from the export markets, and this contribution is expected to rise further. Any adverse movements in currency could impact our earnings estimates.

Regulatory Risk

With the high incidence of USFDA scrutiny on compliance of cGMP of Indian plants, any action by the USFDA on the company might derail its growth plans

Delay in integration/regulatory clearance

Any delay in getting the regulatory clearance or integration related issues, while amalgamating Shasun with STAR, would have an adverse impact on our earnings estimates

Slowdown in funding for institutional business

Any slowdown in funding by global donor agencies for procurement of ARV and Anti-Malaria drugs would have an adverse impact on our estimates.

Company Description

Incorporated in 1990, Strides Arcolab Ltd (STAR) was initially set up by first generation entrepreneur Arun Kumar as Strides Pharmaceuticals Pvt Ltd, a trading entity that exported pharmaceutical products to African countries. Over time, the company set up its own formulations plant, scaling up its manufacturing base through acquisitions to produce steriles and soft gels along with ARV, anti-malarial and anti-tuberculosis drugs which were supplied to donor agencies. Through a series of investments and partnerships, the company expanded its global manufacturing footprint to Latin America and Europe as well as tied-up with leading global players like Pfizer, Novartis, GlaxoSmithKline and Teva to manufacture drugs for them for sale in various regulated markets.

In the mid 2000’s, STAR decided to foray into the branded pharmaceuticals space in Australasia as well as India. With the acquisition of Singapore Based Drug House of Australia as well as Ascent Pharmaceuticals (4th largest generic company in Australia), STAR consolidated its position as one of the largest players in the Australasian region. At the same time, the company also forayed into the Indian branded market with the acquisition of Grandix pharmaceuticals, which had a diverse portfolio of products focused on chronic therapies. Simultaneously, the company was focusing on scaling up its injectable business, which it rebranded as Agila, by creating an extensive pipeline of products such as oncolytics, penems, penicillin, cephalosporins, and ophthalmics which were out-licensed to various global players.

The substantial R&D spend on Agila as well as the numerous acquisitions undertaken by the company led to a disproportionate rise in debt for STAR, causing it to exit its various global operations and restructure its business. STAR had been successful in building a strong franchise in both Agila as well as its Australasian business, enabling it to command a significant premium while divesting these two business verticals. In 2012, the company divested its entire stake in Acent Pharmaceuticals to Watson Pharmaceuticals (now Actavis) for USUSD 393 mn, valuing the business at 2.5x sales. The proceeds of this sale were primarily used to pay off the debt.

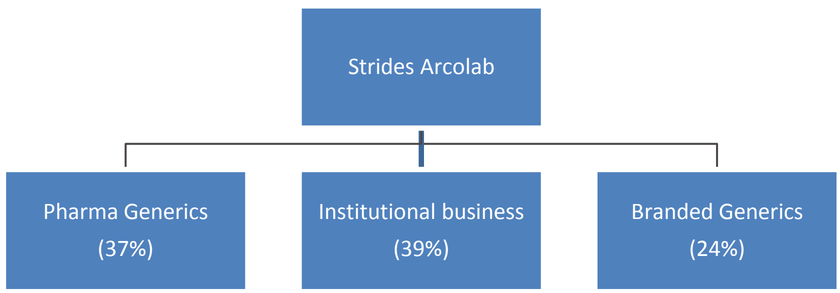
Additionally, while the injectables business was a highly profitable business for STAR given the shortage scenario created by regulatory hurdles plaguing other players, the company expected that the situation would not be sustainable over the longer term. Accordingly, in Dec 2013, STAR sold its Agila operations to Mylan for USD 1.5 bn, valuing the business at ~6x sales. Mylan had held back an additional USD 250 mn of payment, contingent on the outcome of the warning letter situation faced by one of the Agila facilities. In September 2014, Mylan made a final payment of USD 150 mn to STAR from the holdback. The proceeds of sale were used to pay off debt as well as distribute a special dividend to its shareholders amounting to USD 625 mn. The company also has 2 escrow accounts:- a regulatory escrow of USD 40 mn which STAR expects to receive this year and a tax escrow of USD 100 mn which will be payable to the company after 4 years post completion of the deal.

Post the reorganization of its operations, STAR currently operates in three business verticals. Its pharma generics business (38% contribution to revenues in FY14), which caters to the regulated markets, focuses on niche molecules and differentiated delivery products such as soft gels, where the company has the distinction of being among the world's top 5 soft gelatin capsule manufacturers. The company’s institutional business (39% contribution to revenues in FY14) comprises of ARV and anti-malarial drug sales to global funding agencies such as PEPFAR and Global Fund, while its branded business (24% contribution to revenues in FY14) comprises of sale of branded generics in Africa and India. While STAR is currently a fringe player in India, it is among the largest pan-African players with a local manufacturing set-up. The company has 2 US FDA approved manufacturing plants in Bangalore and Italy, and has recently set up 3 manufacturing facilities and 2 packing units in Africa in addition to its plant in Nigeria.

STAR has also set-up Stelis Biopharma, its biogenerics subsidiary to manufacture biosimilars as well as biobetters. The company has a JV with Pfenex Inc to develop, manufacture and commercialize an initial pipeline of six biosimilar products for the global market as well as collaboration with Pieris AG, for clinical development and commercialisation of multiple novel Anticalin-based protein therapeutics worldwide. STAR has an agreement Bio-XCell for the establishment of a customized biotech facility in Malaysia, which has commenced construction this quarter and is expected to go on stream over the next 2-3 years. In September 2014, Jordan based GMS Holdings acquired 25.1% stake in Stelis with an initial investment of USD 8.5 mn and further USD 13.4mn of investment to be received in tranches over the next 2 years.

In a bid to create a vertically integrated pharmaceutical company, STAR announced a merger with Shasun Pharmaceuticals in September 2014, enabling STAR to leverage on Shasun's strong API capabilities to become backward integrated. The transaction is expected in close in FY16E, catapulting the combined entity to among the top 15 Indian listed companies by revenue.

Business Model



Source: Company, Edel Invest Research.

Corporate Milestones

1990-94

Creation
- Founded in 1990 as a finished dosage formulation company focused on Africa

1994-03

Specialised manufacturing
- Commenced manufacturing of steriles, soft gelatin capsules and anti-retroviral and tuberculosis
- Bolt-on acquisitions of manufacturing capacity
- Listed on the BSE and NSE

2004-08

Front-end acquisitions and R&D pipeline
- Acquisition and integration of front-end platforms in Southeast Asia (DHA), Australia (Ascent) and India (Grandix)
- Significant investment in building R&D pipeline for regulated markets (Pharma and Steriles)

2008-12

Regulated markets
- Restructured into Pharma and Specialties
- Commercial partnerships with global pharma for regulated markets
- Launched its first product in the US market
- Foray into the biologics space

2012-13

Monetizing significant value creation
- Sale of Ascent Pharma, its generic pharmaceutical operations in Australia and Southeast Asia to Watson Pharmaceuticals for AU$375 million
- Sale of Agila Specialties entities, its global injectable business to Mylan Inc. for an aggregate enterprise value of up to US$ 1.75 billion

2013-14

Dividend Distribution
- Distributed dividends of INR 500 per share on 10th Dec '13 and INR 105 per share on 7th Oct '14, total pay-out of USD 655 Mn (INR 605 per share)
- Announced merger of Strides & Shasun through an approved Scheme of Arrangement
- GMS holdings to invest USD 21.9 Mn for a 25.1% stake in Stelis Biopharma

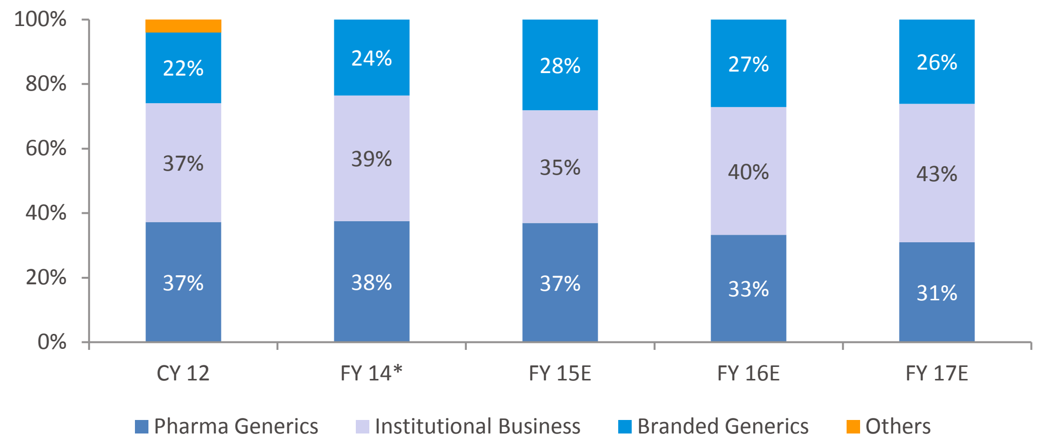
Management Profile

Name	Designation	Description
Mr. Arun Kumar	*Founder and Group CEO*	Mr. Arun is the Founder and Promoter Director of the Company and has been on the Board as Managing Director since its inception in 1990. His in-depth knowledge of the pharmaceutical industry and astute business acumen has seen Strides make path breaking forays in the industry. Mr. Arun was earlier General Manager of British Pharmaceuticals Limited.
Badree Komandur	*CFO and Company Secretary*	Badree joined Strides in March 2010. As the Chief Financial Officer of the Company. Prior to this, he held the position of Executive Vice President – Finance in Strides. Before joining Strides, Badree handled varied roles before reaching the position of Vice President - Finance in his 12 year stint in Wipro. Badree holds a degree in Commerce and membership with various accounting bodies such as ICAI, ICSI and ICMA
Joe Thomas	*Chief Corporate Development Officer*	Joe has worked with Strides for over 6 years and has over 28 years' experience in Business Development, Strategy formulation and Global Marketing. From his previous roles in The STC of India, Procter & Gamble Asia Pacific and BioServe Biotechnologies, he brings a broad and in-depth domain knowledge in Life Sciences (Pharma Biotech and OTC Health) and Strategic and General Management expertise. He is a Post Graduate in Chemistry with a diploma in Foreign Trade.
Mohan Kumar	*CEO – Pharma*	Mohan has over 35 years of Operational and Commercial experience in the Pharmaceutical Industry both in India and overseas. He has been with Strides since its inception in 1990. Between 2000 and 2004, Mohan spearheaded our entry into LATAM and headed the Strides Brazilian operations including manufacturing. He holds a Bachelor's degree in Science from the University of Kerala with a Post Graduate Diploma in Business Administration from the University of Calicut

Financial Analysis

Near term growth to be driven by Africa (Institutional & Branded)

STAR Pharma business (ex Agila & Ascent) revenues have grown at a CAGR of ~17.2% over CY08-FY14 backed by steady growth across all the segments. Going forward, we expect that the growth would be mainly driven by the Branded and Institutional Africa business. The growth in the Institutional business is expected to be more back-ended, as it is majorly contingent upon Shasun integration and receiving pre-qualifications from the WHO for the manufacture of APIs, which we believe would start by the end of FY16E.

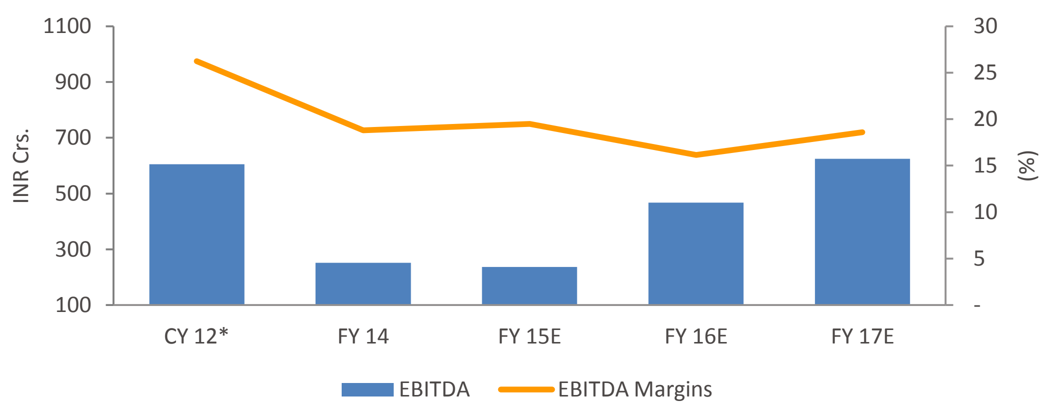


*Note: Change in Accounting year

Source: Company, Edel Invest Research.

Margins to improve post integration

STAR has improved its EBITDA margins substantially in the pharma business from low double digits in 2010 to the current run rate of ~ 20%, on the back of discontinuance of non-profitable business and reduction in costs. The company's margins for the combined entity post integration with Shasun is expected to drop to ~16% in FY16, before recovering to ~19% in FY17E as STAR uses Shasun's facility for backward integration. As per the company, over the next 2-3 years, the margins for the combined entity is expected to get back to STAR's current margin of over 20% and move to 25% going forward.

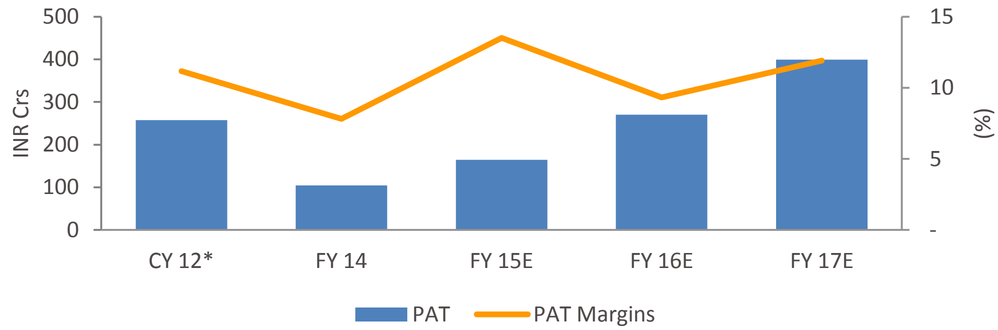


*Note : Includes revenues from Agila

Source: Company, Edel Invest Research.

Profit growth expected to outpace revenue growth

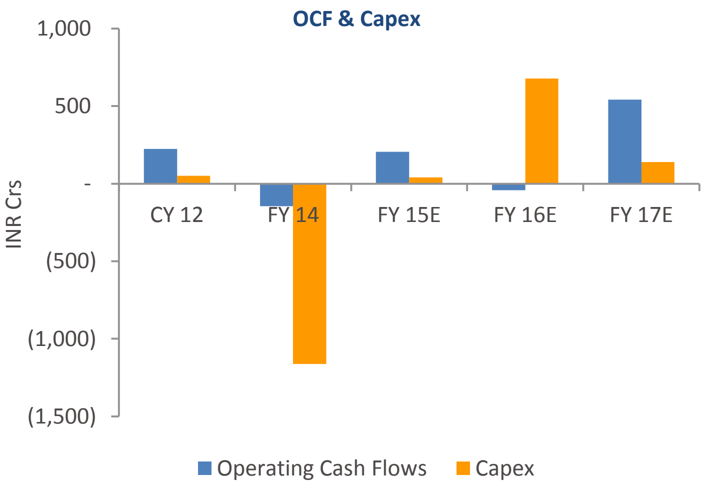
With the improvement in the product/business mix, the company has been able to improve its operating margins substantially, which has trickled down to the bottom line. Going forward, with Shasun's integration, the company expects to get the benefits of vertical integration which would help improve margins further. We expect the bottomline to deliver 56% CAGR over FY14-17E backed by better margins in the institutional segment and higher contribution from the African branded business.

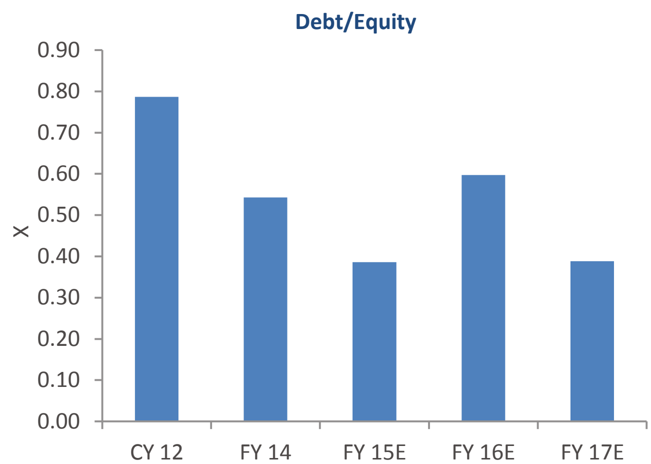


Source: Company, Edel Invest Research.

Continue to remain OCF positive

With the no major capex planned over the next few years and improvement in profitability in the existing pharma business, we expect the company to remain OCF positive over the near future.

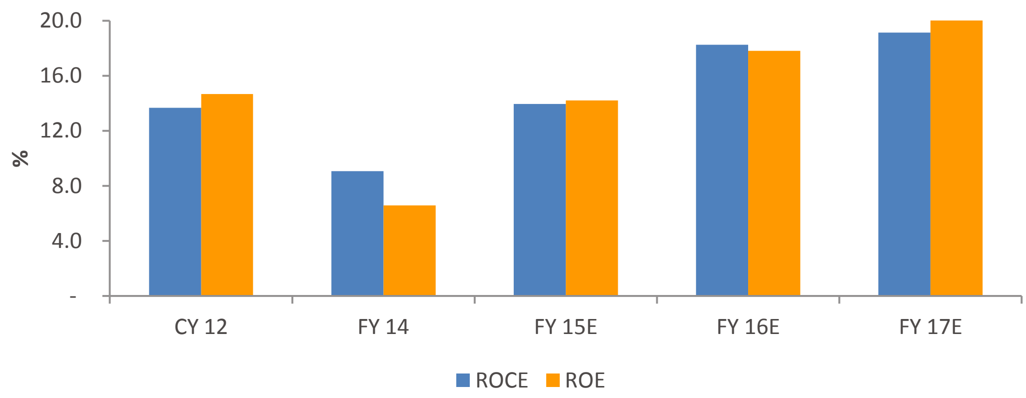




Source: Company, Edel Invest Research.

Return ratios expected to sustain

With no fresh capex planned, higher utilization of assets and improvement in working capital cycle, We expect STAR's RoCE to improve to 18-19%.



Source: Company, Edel Invest Research.

Financials

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Net revenue	2,550	2,307	1,341	1,217	2,896	3,354
Materials costs	1,264	998	715	642	1,494	1,696
Gross profit	1,286	1,309	626	575	1,402	1,658
Employee costs	303	281	157	143	409	451
SG & A Expenses	470	423	217	195	526	583
EBITDA	513	606	252	237	467	624
Depreciation & Amortization	104	109	56	54	123	133
EBIT	409	496	196	184	344	491
Other income	27	28	45	47	67	67
EBIT incl. other income	436	525	241	231	412	559
Interest expenses	190	163	96	35	86	76
Exceptional Items	27	588	(54)	900	-	-
Profit before tax	273	949	92	1,096	325	483
Provision for tax	39	102	325	175	55	83
Net profit	234	847	(233)	920	270	399
Adj. Net Profit	198	258	105	164	270	399
Basic shares outstanding (crs)	5.96	5.96	5.96	5.96	8.06	8.06
EPS (Rs.)	33.2	43.3	17.6	27.6	33.5	49.5
Diluted EPS (Rs.)	33.2	43.3	17.6	27.6	33.5	49.5
Dividend per share (Rs.)	2.0	2.0	505.1	107.0	1.5	1.5

Common Size

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Materials costs	49.6%	43.3%	53.3%	52.8%	51.6%	50.6%
Employee expenses	11.9%	12.2%	11.7%	11.7%	14.1%	13.4%
Manufacturing & Other Expenses	18.4%	18.3%	16.2%	16.0%	18.2%	17.4%
Depreciation	4.1%	4.7%	4.2%	4.4%	4.3%	4.0%
EBITDA margins	20.1%	26.2%	18.8%	19.5%	16.1%	18.6%
EBIT margins	16.0%	21.5%	14.6%	15.1%	11.9%	14.7%
Adj. Net profit margins	7.8%	11.2%	7.8%	13.5%	9.3%	11.9%

Growth Ratios

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Revenues	50.4%	-9.5%	-41.9%	-9.3%	138.0%	15.8%
EBITDA	57.2%	18.0%	-58.4%	-5.9%	97.0%	33.5%
PBT	46.3%	248.2%	-90.3%	1094.4%	-70.3%	48.4%
Adj Net profit	62.2%	30.4%	-59.4%	57.1%	64.3%	47.7%

*FY14: 15 month period; CY11 includes Ascent & Agila; CY12 includes Agila

Balance Sheet

As on 31st March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Equity capital	58	59	60	60	81	81
Reserves & surplus	1,313	1,967	947	1,092	1,640	2,025
Borrowings	2,566	1,594	547	447	1,030	820
Deferred Tax Liabilities (Net)	(13)	27	2	2	(16)	(16)
Minority Interest	46	72	76	76	76	76
Sources of funds	**3,972**	**3,720**	**1,631**	**1,676**	**2,811**	**2,986**
Net Fixed Assets	1,557	1,568	551	537	1,091	1,098
Goodwill	1,983	1,690	103	103	103	103
Investments	-	0	443	443	450	450
Inventories	480	442	176	280	560	651
Sundry debtors	698	664	369	417	808	860
Cash & Bank Balances	260	166	231	258	323	408
Loans and advances	454	266	223	223	497	569
Total current assets	1,892	1,538	999	1,178	2,188	2,489
Sundry creditors and others	1,145	936	356	476	897	1,030
Provisions	326	140	110	110	125	125
Total current liabilities & provisions	1,471	1,076	466	586	1,022	1,155
Net current assets	422	462	534	592	1,166	1,334
Uses of funds	**3,962**	**3,720**	**1,631**	**1,676**	**2,811**	**2,986**
Book value per share (Rs.)	230	340	169	193	214	261

Free cash flow

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Net profit	198	258	105	164	270	399
Add : Depreciation	104	109	56	54	123	133
Others	(220)	(225)	(682)	(912)	19	9
Gross cash flow	82	142	(521)	(694)	412	541
Less: Changes in WC	375	(8)	250	(32)	(509)	(83)
Operating cash flow	457	134	(272)	(726)	(96)	458
Less: Capex	672	51	(1,162)	40	677	140
Free cash flow	(215)	84	890	(766)	(773)	318

CasH Flow Statement

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Cash flow from operations	457	134	(272)	30	(96)	458
Cash Flow from investing activities	(656)	771	4,046	907	(602)	(73)
Cash Flow from financing activities	119	(1,000)	(3,708)	(910)	749	(300)
Capex	672	51	(1,162)	40	677	140
Dividends	2	2	281	776	14	14

*FY14: 15 month period; CY11 includes Ascent & Agila; CY12 includes Agila

Profitability & Efficiency Ratios

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
ROAE (%)	13.3%	14.7%	6.6%	14.2%	17.9%	20.1%
ROACE (%)	11.6%	13.7%	9.1%	14.0%	18.3%	19.2%
ROIC (%)	11.0%	13.6%	9.0%	13.9%	18.3%	19.3%
Inventory day	57	73	84	84	65	66
Debtors days	80	108	140	125	98	91
Payable days	79	101	118	118	95	96
Cash conversion cycle (days)	58	80	106	91	68	61
Current ratio	1.3	1.4	2.1	2.0	2.1	2.2
Debt/Equity	1.9	0.8	0.5	0.4	0.6	0.4

Turnover Ratios

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Total asset turnover	0.5	0.5	0.4	0.6	1.0	0.8
Fixed asset turnover	1.6	1.5	1.3	2.2	3.6	3.1
Equity turnover	1.9	1.4	0.9	1.1	2.0	1.8

Du Pont Analysis

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
NP margin (%)	7.8%	11.2%	7.8%	13.5%	9.3%	11.9%
Total assets turnover	0.5	0.5	0.4	0.6	1.0	0.8
Leverage multiplier	3.3	2.9	2.2	1.9	2.0	2.0
ROAE (%)	13.3%	14.7%	6.6%	14.2%	17.9%	20.1%

Valuation Parameters

Year to March	CY11	CY12	FY14*	FY15E	FY16E	FY17E
Diluted EPS (Rs.)	33.2	43.3	17.6	27.6	33.5	49.5
Y-o-Y growth (%)	62.2%	30.4%	-59.4%	57.1%	21.5%	47.7%
Diluted PE (x)	26.4	20.2	49.8	5.7	26.1	17.7
Price/BV (x)	3.8	2.6	5.2	4.5	4.1	3.4
EV/Sales (x)	3.0	2.9	4.1	4.4	2.7	2.2
EV/EBITDA (x)	14.7	11.0	21.9	22.8	16.6	12.0
Dividend yield (%)	0.2%	0.2%	57.7%	12.2%	0.2%	0.2%

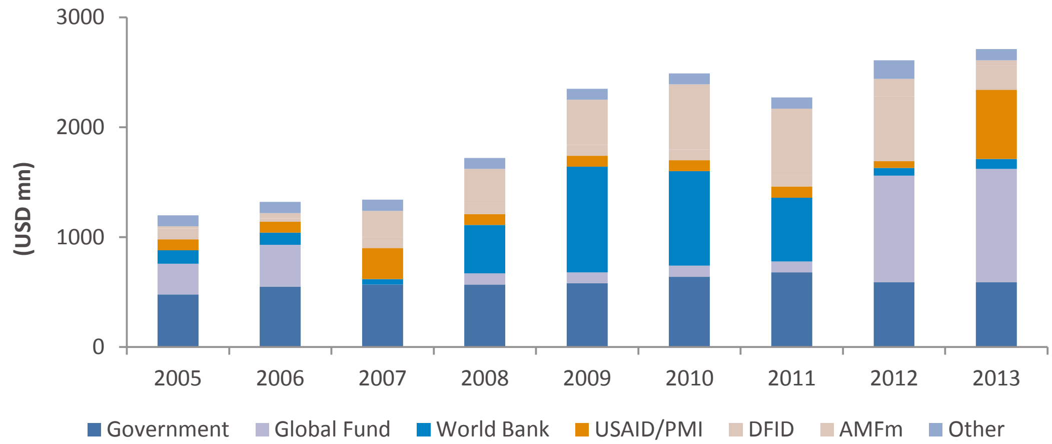
*FY14: 15 month period; CY11 includes Ascent & Agila; CY12 includes Agila

Annexure

What is the anti-malaria business?

Global funding for anti-malaria amounted to USD 2.7 bn in 2013, with 82% of the funding being supported by various funding agencies, while the balance is funded by local governments. As per Global Fund, ~25% of these funds are allocated for treatment, including procurement of medicines from manufacturers through both public and private channels.

Total Funding for Malaria 2005-2013



Source: WHO

Competitive landscape

In 2006, WHO revised its guidelines to recommend Artemisinin-based combination therapy (ACTs) as the first line treatment viz-a-viz mono therapies for uncomplicated malaria caused by P. Falciparum. Currently, WHO has five approved ACTs that have been adopted in 79 of 88 countries where P. Falciparum is endemic.

The ACT market is dominated by a few players, given the complexity of developing Artemisinin based drugs and regulatory requirements in the form of WHO or an equivalent Stringent Regulatory Authority (SRA) qualification.

WHO approved suppliers for ACTs

Artemisinin based combination therapy (ACT)	WHO Pre-qualified Suppliers
Artesunate + Amodiaquine (AS-AQ)	IPCA, Guilin, Ajanta, Cipla, Sanofi
Artemether + Lumefantrine (AL)	Novartis, IPCA, Cipla, Macleods, Mylan, Ajanta, Strides
Artesunate + [Sulfadoxine + Pyrimethamine](AS+SP)	Guilin
Artesunate + Mefloquine (as hydrochloride)(AS+MQ)	Cipla
Artesunate + Pyronaridine tetraphosphate	Shin Poong Pharmaceuticals

Source: WHO

In addition, the procurement policy for anti-malaria drugs by funding agencies has changed recently, wherein the procurement process has become centralized at the agency level opposed to the earlier process of selection of the formulation supplier by individual governments at a country level. Thus, the selection of the supplier as well as pricing is now determined by funding agencies, while countries only pay their part of the contribution, putting all suppliers on an equal footing.

Corporate Factsheet

Promoter Background	Strides Arcolab Ltd (STAR) was founded in 1990 by Mr. Arun Kumar, whose in-depth knowledge of the pharmaceutical industry and astute business acumen has seen STAR make path breaking forays in the industry.
Presence	The company has a front end presence in certain regulated markets like UK and US as well as emerging markets of Africa and India. It is also present in Australasia, Europe and South Africa through partnerships along with supplying formulations via tenders for the African market.
Management Depth	Promoter and Group CEO- Arun Kumar, Chief Corporate development officer- Joe Thomas, CFO and CS- Badree Komandur, Chief HR officer- Sebi Chacko, CEO Pharma- Mohan Kumar, CEO Africa-Sinhue Norhonha, President India Brands- Subroto Banerjee
Business	STAR is a formulations manufacturer with a presence across a wide range of therapies for various geographies. The company also supplies Anti-HIV and Anti-malaria drugs to Africa and other low/middle income countries via tenders.
Corporate Structure	The company has 29 subsidiaries and step down subsidiaries across various countries
Revenue Model (FY 14)	Pharma generics (regulated markets)- 37%, Institutional business (tender based)-39%, Branded generics (Emerging markets)- 24%
Manufacturing Set-up	6 manufacturing facilities, 2 packing units and 1 R&D centre
Key Success Factors	Merger with Shasun will lead to the following business synergies: • Institutional business will benefit from vertical integration • Enhanced product pipeline of non-overlapping molecules in niche and complex segments • Margins of combined entity likely to improve African business to be key growth driver
Credit Rating	Fitch: from BBB+ to A+ on the overall company performance ICRA: Long term debt: A+ and Short term debt: from A2 + to A1+
Corporate Bankers	Axis Bank Ltd, HDFC Bank Ltd, Ratnakar Bank Ltd, Yes Bank Ltd
Auditors	Grant Thornton India, Deloitte Haskins and Sells

Corporate Governance

Cases Against Management/Company	**There are no notable cases against Strides**

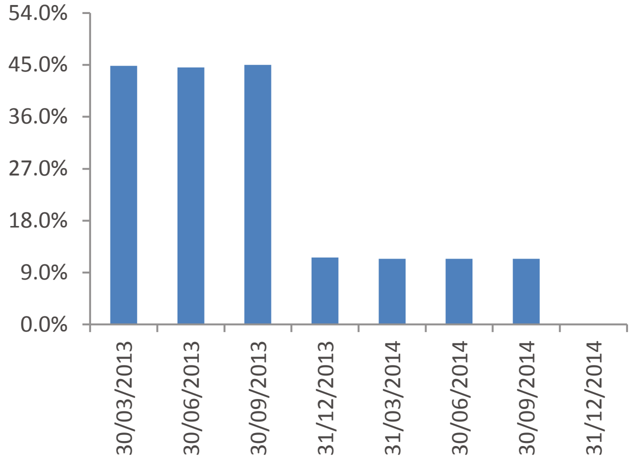
		CY10	CY11	CY12	FY14
Bod/Top management	Total No. of Directors	11	9	9	9
	No. of Independent Directors	6	5	6	4
	No. of changes in Directors over last year	1	1	2	2

Auditors	Current Auditors of the company	Deloitte Haskins & Sells
	Any change in auditors over last five years?	There has been no change in the auditors over the last five years

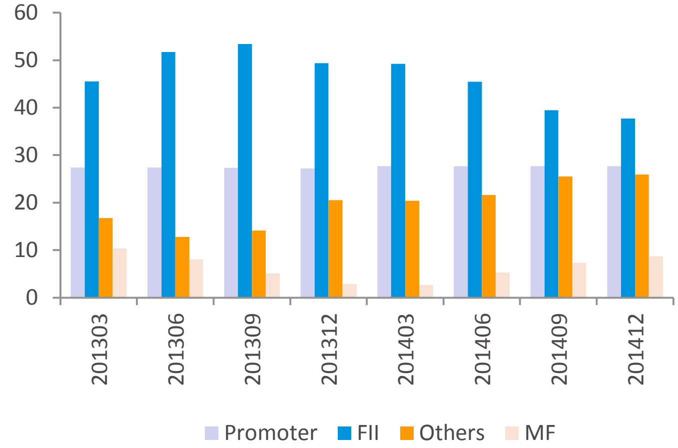
	Committee	Deepak Vaidya	Arun Kumar	S Sridhar	M. R. Umarji	A. K. Nair	P.M. Thampi	Mukul Sarkar	Sangita Reddy	Bharat Shah
Well diversified Board	Audit	Y		Y	Y	Y	Y	Y	Y	Y
	Remuneration	Y			Y	Y	Y			
	Investor Grievance	Y			Y	Y	Y			

	Name	Remuneration	Remuneration as % of PAT	Positions
BOD remuneration as a % of PAT	Arun Kumar	5,57,81,308	5%	Executive Vice Chairman & Managing Director
	Deepak Vaidya	2,60,000	-	Chairman
	M R Umarji	2,20,000	-	Non-Executive Director
	A K Nair	2,40,000	-	Independent Director
	P M Thampi	2,60,000	-	Independent Director
	Mukul Sarkar	2,40,000	-	Nominee Director
	S Sridhar	1,80,000	-	Independent Director

Pledge



Holding Structure



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