Pharma Sector

5 Bets for Tactical Buy

Edelweiss Professional Investor Research

The novel coronavirus, or COVID-19, pandemic has caused severe supply-side disruptions in various sectors, earnings will be cut by 10-15%. Pharma as a sector has emerged as a strong contender to drive the next leg of rally, whenever it comes. In anticipation, pharma stocks have seen a huge run up in the last 10 days. This is not just true for India, but globally too pharma companies has performed well. While in the short term, most companies will bounce back from the last 5 year of underperformance, this time around, the leader will be different. Hence, you need to choose your stocks carefully. Following are the strong **Tactical Buy** (long term potential also) with strong catalysts.

I. Ajanta Pharma – A turnaround story

Revival in the Africa business – Ajanta Pharma's Africa business has been de-growing over the last 3 year (-9% CAGR over FY17-19). For 9MFY20, the company reported 19% growth. We expect growth to sustain ~10-15% over the next 2 years.

US business ramping up sharply – Within 4 years, the US generics business has ramped up to $70m from $2m. We expect the US business to ramp up to $100m by FY22, based on market share gains and new launches.

India business gradually recovers – India business saw 23% CAGR from FY12 to FY16. Due to regulatory changes in the dermatology business, the company has seen lower growth (just 6% CAGR) over the last 3 years. But the 11% CAGR in 9MFY20 suggests improvement in the India business.

Revival in all 3 geographies will lead to margin expansion and improvement in return ratios – We expect margin to improve to 31% by FY22 from 27% in FY19.

Valuation: We expect FY20/21/22 EPS of INR 53/70/83, respectively. At its April 8 closing price of INR 1,367.5, the stock trades at 23/19/16x FY20/21/22E P/E and FY22E RoCE of 20%.

What will makes us change our view – Degrowth in the Africa business. We are quite comfortable with its US/India growth numbers. We expect Africa to grow by 12% over the next 2 years.

II. Abbott India – A CAGR story

Strong track record – Abbott India has seen strong sales growth (organic: 15% CAGR; inorganic: 18%) in the last 10 years compared to an average 11% growth by other Indian pharmaceutical players. This has been driven by strong execution and acquisition of Piramal Healthcare's domestic formulation business in May 2010.

Strong product portfolio – The company has a presence in high growth therapeutic categories – gastro, CNS (central nervous system), vaccines, OTC (Digene kind) and gynaecology – which led to better-than-industry growth.

Pure play India story – Abbott is pure play domestic story. It does face US Food & Drug Administration (USFDA) related inspection risk, which plagues other pharma players.

Valuation: We expect FY20/21/22E EPS of INR 313/360/416. At its April 8 closing price of INR 17,481, the stock trades at 56/49/42x FY20/FY21/FY22E P/E and FY22E RoCE of 23%.

What will make us change our view – The Indian government periodically issues a price cap on certain essential drugs. About 40% of Abbott's portfolio falls under Drug Price Control Orders (DPCO), so any incremental coverage would pose a risk to earnings.

Date: April 09, 2020

III. Dr Reddy's Laboratories – New management, new story

India business is a key focus now – Despite its strong innovation capabilities since inception, Dr Reddy's Laboratories doesn't even fall in the top 10 domestic formulation players. Its India business was never a focus area for the management, which led to market share loss over a period of time. But for the new management, India will be a key focus area. It recently acquired a large portfolio from a competitor.

US business has some near-term catalysts – gNuvaRing ($800m, sole player post launch) H2FY21, gCopaxone ($4,000m, 3 player market) H2FY21 and recently acquired portfolio in the US.

Change of guard has started bearing fruits – DRL always had the highest SG&A (selling, general and administrative) expense, at 30%, compare to the industry average of 20%. However, in the last 1 year, SG&A expense has fallen to 23-24% levels, which has led to a 300 bps improvement in EBITDA margin on a 9MFY20 versus 9MFY19 basis.

Valuation: We expect FY20/21/FY22 EPS of INR 120/150/174. At its April 8 closing price of INR 3,683, the stock trades at 31/25/22x FY20/21/22E P/E and FY22E RoCE of 20%.

What will make us change our view – Any delay in gCopaxone launch can impact FY22E earnings significantly. Also, any USFDA issue with its Bachupally facility.

IV. Biocon – Participant of mega theme – biosimilar, also TINA

Global biosimilar market will grow 3x in next 5 years – The total biosimilar market size was pegged at $20bn in 2019 by various studies. The same is expected to touch $60bn by 2025, the highest growth category for pharma companies globally.

Biocon has proven its mettle by launching Pegfilgrastim ($4bn) in the US last year. Last month, it received approval for Lantus ($6bn).

Biosimilar is sticky business unlike generics – Historical data from Inflectra/Remsima (Remicade), Benepali (Enbrel), which has been launched in the last 4 years, has seen stable to increasing market share with manageable pricing risks.

Valuation: We expect FY20/21/22 EPS of INR 7.5/10.2/13.4. At its April 8 closing price of INR 327, the stock trade at 43/32/24x FY20/21/22E P/E and FY22E RoCE of 12%. The lower RoCE is due to its huge Malaysian facility.

What will make us change our view – Any facility related USFDA action, which is difficult to pre-empt.

V. Laurus Labs – A classic investment story

Large capex is over – The company has spent INR 900 crore over the last 3 years to build capacity, which has led to negative free cash flow. We expect the company to start generating free cash flow from FY21.

Business will shift from API to formulation – Formulation will account for 30% of overall sales in FY20E compare to just 3% in FY19. This will boost return ratios and provide long-term visibility compare to API (active pharmaceutical ingredients), which are opportunistic/cyclical in nature.

Growth at a reasonable price – Earnings will shoot up to INR 34 per share in FY21E from INR 9 per share in FY19. The stock currently trades at 12x FY21E P/E. RoCE is seen improving to 13% in FY21E from 6% in FY19.

Valuation: We expect FY20/21/22 EPS of INR 24/34/37. At its April 8 closing price of INR 391, the stock trades at 17/12/11x FY20/21/22E P/E and FY22E RoCE of 14%.

What will make us change our view – Our margin assumption for FY21/22 is 22%. Any pricing pressure in API/formulation can impact EPS significantly.

Edelweiss Broking Limited, Edelweiss House, Off, CST Road, Kolivery Village, MMRDA Area, Kalina, Santacruz East, Mumbai, Maharashtra 400098

Vinay Khattar
Head Research
vinay.khattar@edelweissfin.com

Disclaimer

Edelweiss Broking Limited ("EBL" or "Research Entity") is regulated by the Securities and Exchange Board of India ("SEBI") and is licensed to carry on the business of broking, depository services and related activities. The business of EBL and its Associates (list available on www.edelweissfin.com) are organized around five broad business groups – Credit including Housing and SME Finance, Commodities, Financial Markets, Asset Management and Life Insurance.

Broking services offered by Edelweiss Broking Limited under SEBI Registration No.: INZ000005231; Name of the Compliance Officer: Mr. Brijmohan Bohra, Email ID: complianceofficer.ebl@edelweissfin.com Corporate Office: Edelweiss House, Off CST Road, Kalina, Mumbai - 400098; Tel. 18001023335/022-42722200/022-40094279

This Report has been prepared by Edelweiss Broking Limited in the capacity of a Research Analyst having SEBI Registration No.INH000000172 and distributed as per SEBI (Research Analysts) Regulations 2014. This report does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. The information contained herein is from publicly available data or other sources believed to be reliable. This report is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this report should make such investigation as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult his own advisors to determine the merits and risks of such investment. The investment discussed or views expressed may not be suitable for all investors.

This information is strictly confidential and is being furnished to you solely for your information. This information should not be reproduced or redistributed or passed on directly or indirectly in any form to any other person or published, copied, in whole or in part, for any purpose. This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject EBL and associates / group companies to any registration or licensing requirements within such jurisdiction. The distribution of this report in certain jurisdictions may be restricted by law, and persons in whose possession this report comes, should observe, any such restrictions. The information given in this report is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. EBL reserves the right to make modifications and alterations to this statement as may be required from time to time. EBL or any of its associates / group companies shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. EBL is committed to providing independent and transparent recommendation to its clients. Neither EBL nor any of its associates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including loss of revenue or lost profits that may arise from or in connection with the use of the information. Our proprietary trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein. Past performance is not necessarily a guide to future performance .The disclosures of interest statements incorporated in this report are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report. The information provided in these reports remains, unless otherwise stated, the copyright of EBL. All layout, design, original artwork, concepts and other Intellectual Properties, remains the property and copyright of EBL and may not be used in any form or for any purpose whatsoever by any party without the express written permission of the copyright holders.

EBL shall not be liable for any delay or any other interruption which may occur in presenting the data due to any reason including network (Internet) reasons or snags in the system, break down of the system or any other equipment, server breakdown, maintenance shutdown, breakdown of communication services or inability of the EBL to present the data. In no event shall EBL be liable for any damages, including without limitation direct or indirect, special, incidental, or consequential damages, losses or expenses arising in connection with the data presented by the EBL through this report.
We offer our research services to clients as well as our prospects. Though this report is disseminated to all the customers simultaneously, not all customers may receive this report at the same time. We will not treat recipients as customers by virtue of their receiving this report.

EBL and its associates, officer, directors, and employees, research analyst (including relatives) worldwide may: (a) from time to time, have long or short positions in, and buy or sell the securities thereof, of company(ies), mentioned herein or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the subject company/company(ies) discussed herein or act as advisor or lender/borrower to such company(ies) or have other potential/material conflict of interest with respect to any recommendation and related information and opinions at the time of publication of research report or at the time of public appearance. EBL may have proprietary long/short position in the above mentioned scrip(s) and therefore should be considered as interested. The views provided herein are general in nature and do not consider risk appetite or investment objective of any particular investor; readers are requested to take independent professional advice before investing. This should not be construed as invitation or solicitation to do business with EBL.

EBL or its associates may have received compensation from the subject company in the past 12 months. EBL or its associates may have managed or co-managed public offering of securities for the subject company in the past 12 months. EBL or its associates may have received compensation for investment banking or merchant banking or brokerage services from the subject company in the past 12 months. EBL or its associates may have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months. EBL or its associates have not received any compensation or other benefits from the Subject Company or third party in connection with the research report. Research analyst or his/her relative or EBL's associates may have financial interest in the subject company. EBL, its associates, research analyst and his/her relative may have other potential/material conflict of interest with respect to any recommendation and related information and opinions at the time of publication of research report or at the time of public appearance.
Participants in foreign exchange transactions may incur risks arising from several factors, including the following: (i) exchange rates can be volatile and are subject to large fluctuations; (ii) the value of currencies may be affected by numerous market factors, including world and national economic, political and regulatory events, events in equity and debt markets and changes in interest rates; and (iii) currencies may be subject to devaluation or government imposed exchange controls which could affect the value of the currency. Investors in securities such as ADRs and Currency Derivatives, whose values are affected by the currency of an underlying security, effectively assume currency risk.

Research analyst has served as an officer, director or employee of subject Company: No
EBL has financial interest in the subject companies: No

EBL's Associates may have actual / beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of research report.
Research analyst or his/her relative has actual/beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of research report: No

EBL has actual/beneficial ownership of 1% or more securities of the subject company at the end of the month immediately preceding the date of publication of research report: No
Subject company may have been client during twelve months preceding the date of distribution of the research report.

There were no instances of non-compliance by EBL on any matter related to the capital markets, resulting in significant and material disciplinary action during the last three years.
A graph of daily closing prices of the securities is also available at www.nseindia.com

Analyst Certification:
The analyst for this report certifies that all of the views expressed in this report accurately reflect his or her personal views about the subject company or companies and its or their securities, and no part of his or her compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this report.

Disclaimer

Additional Disclaimer for U.S. Persons

Edelweiss is not a registered broker – dealer under the U.S. Securities Exchange Act of 1934, as amended (the"1934 act") and under applicable state laws in the United States. In addition Edelweiss is not a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act" and together with the 1934 Act, the "Acts), and under applicable state laws in the United States. Accordingly, in the absence of specific exemption under the Acts, any brokerage and investment services provided by Edelweiss, including the products and services described herein are not available to or intended for U.S. persons.

This report does not constitute an offer or invitation to purchase or subscribe for any securities or solicitation of any investments or investment services and/or shall not be considered as an advertisement tool. "U.S. Persons" are generally defined as a natural person, residing in the United States or any entity organized or incorporated under the laws of the United States. US Citizens living abroad may also be deemed "US Persons" under certain rules.

Transactions in securities discussed in this research report should be effected through Edelweiss Financial Services Inc.

Additional Disclaimer for U.K. Persons

The contents of this research report have not been approved by an authorised person within the meaning of the Financial Services and Markets Act 2000 ("FSMA").

In the United Kingdom, this research report is being distributed only to and is directed only at (a) persons who have professional experience in matters relating to investments falling within Article 19(5) of the FSMA (Financial Promotion) Order 2005 (the "Order"); (b) persons falling within Article 49(2)(a) to (d) of the Order (including high net worth companies and unincorporated associations); and (c) any other persons to whom it may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons").

This research report must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this research report relates is available only to relevant persons and will be engaged in only with relevant persons. Any person who is not a relevant person should not act or rely on this research report or any of its contents. This research report must not be distributed, published, reproduced or disclosed (in whole or in part) by recipients to any other person.

Additional Disclaimer for Canadian Persons

Edelweiss is not a registered adviser or dealer under applicable Canadian securities laws nor has it obtained an exemption from the adviser and/or dealer registration requirements under such law. Accordingly, any brokerage and investment services provided by Edelweiss, including the products and services described herein, are not available to or intended for Canadian persons.

This research report and its respective contents do not constitute an offer or invitation to purchase or subscribe for any securities or solicitation of any investments or investment services.

Disclosures under the provisions of SEBI (Research Analysts) Regulations 2014 (Regulations)

Edelweiss Broking Limited ("EBL" or "Research Entity") is regulated by the Securities and Exchange Board of India ("SEBI") and is licensed to carry on the business of broking, depository services and related activities. The business of EBL and its associates are organized around five broad business groups – Credit including Housing and SME Finance, Commodities, Financial Markets, Asset Management and Life Insurance. There were no instances of non-compliance by EBL on any matter related to the capital markets, resulting in significant and material disciplinary action during the last three years. This research report has been prepared and distributed by Edelweiss Broking Limited ("Edelweiss") in the capacity of a Research Analyst as per Regulation 22(1) of SEBI (Research Analysts) Regulations 2014 having SEBI Registration No.INH000000172.