

April 9, 2020

Pharma stocks poised for re-rating amid panic...

Amid Covid-19 pandemic panic that has taken a heavy toll on most sectors in the Indian markets, most pharma companies withstood the carnage while some, in fact, delivered positive returns during this period. Most sectors continued to suffer on account of unprecedented lockdowns and limited business continuity plans (BCPs) besides a bleak demand outlook. The cases of Covid-19 are still increasing with significant velocity in many parts of the world. There is significant uncertainty as to when things will normalise. **However, in pharma, barring few supply related disturbances, we do not envisage material earnings impact in FY21. Also, note that in this unprecedented global lockdown, pharma and healthcare services, being at the top layer of essential services, remain exempted everywhere.** Now that Chinese supply lines for key starting materials (KSM) and APIs are crawling back to normal, the supply side issues are slowly waning. Overall, we expect hindrances to persist for the next two to three months only with full normalcy from Q2FY21 onwards. **Our FY21 earnings estimates for I-direct coverage universe are unlikely to change materially as will be FY22 estimates as there is no change in visibility aspect. However, we expect a multiple re-rating in some stocks, especially for those with 1) stable earnings visibility, 2) no balance sheet stress and strong return ratios, 3) having strong presence in some critical segments, besides 4) decent ESG quotient.**

On the business front, despite the nationwide lockdown, domestic growth is expected to remain more or less stable. Exports growth, barring for one or two months due to congestion in all major ports globally, is also expected to remain strong due to 1) currency benefit, 2) slowdown in competition due to delay in new approvals that will be beneficial for existing players and 3) expected demand continuum across the world despite Covid-19. Some windfall is also expected in some critical products- a case in point is Hydroxychloroquine, a malaria drug that is likely to be repurposed as a prophylaxis for Covid-19 treatment in some cases. Profitability is also likely to improve due to cooling off of raw material prices (crude based solvents) and continuous focus on cost rationalisation and MR productivity. Improving operating leverage is also likely to contribute to margin expansion. The companies are also moderating their capex plans to focus on better RoCE.

In the following discussion, we briefly touch upon some initial takeaways from the discussions / comments from the managements of respective sub-segments.

Domestic formulations – The demand in the domestic market is normal as of now but movements of MRs are restricted. To address this, companies are using telephonic and digital marketing channels to push products. We believe domestic growth is likely to emanate from price hikes and volume increase (albeit on lower base). However, nationwide lockdown/curfew can still lead to supply related issues such as availability of packing materials etc. Delay in new launches may also impact overall growth. We expect normalised growth from Q2FY21 onwards.

Export formulations – Till date the shipments are normal even in the worst impacted countries. However, a complete lockdown or restriction on any international trade may impact businesses in future. The beneficial impact of sharp rupee depreciation may take some time to soak in.

Stock Performance

Company	Return (%)				Mcap
	1M	3M	YTD	1Y	
Sun Pharma.Ind	9	-1	1	-6	104776
Dr Reddy's Labs	16	27	28	33	61197
Div's Lab.	-3	18	18	29	57579
Torrent Pharma.	16	37	38	42	42938
Cipla	18	11	8	-2	41340
Biocon	6	16	11	8	39288
Abbott	12	37	34	139	37146
Cadila Health.	31	35	38	2	35816
Lupin	6	-7	-8	-11	31964
Aurobindo Pharr	-14	-3	-4	-44	25673
Ipca Labs.	12	35	42	72	20424
Pfizer	-4	6	1	29	19443
Apollo Hospitals	-25	-14	-12	2	17585
Sanofi	-4	6	4	24	16736
Alembic Pharmε	3	16	13	20	12081
Ajanta Pharma	-6	34	40	34	11933
Syngene Int.	-7	-12	-15	-6	10844
Natco Pharma	-4	-4	-3	2	10473
Fortis Health	-17	-8	-7	-9	9309
Glenmark Pharm	-16	-31	-33	-64	6591
Narayana Hruda	-13	-20	-10	28	5662
Jubilant Life	-32	-40	-39	-54	5178
Aster DM	-37	-38	-38	-36	4958
FDC Ltd	-14	0	-2	24	3552
Indoco Remedie	-4	27	19	13	2108
Hikal	-23	-24	-22	-50	1104
Hester Bio	-32	-31	-31	-28	850
Healthcare Glob	-37	-33	-33	-66	623
Shalby Ltd	-34	-43	-44	-62	564
NGL Fine-Chem	-19	-31	-24	-27	200

Source: Bloomberg

Global Indices Performance

Company	Return (%)				
	1M	3M	YTD	1Y	3Y
S&P 500 Pharm Ir	-4	-7	-8	1	7
NASDAQ Biotech	-7	-8	-9	-3	5
S&P Pharmaceuti	-12	-19	-21	-14	-5
DJ Pharma and Bi	-5	-8	-8	0	6
DJ STOXX Healthc	-3	-7	-6	9	7
MSCI World Pharr	-4	-7	-7	5	8
NSE Pharma	5	6	5	-8	-9

Source: Bloomberg

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API/ CRAMs players – On the back of recurring issues in China like shutdown due to environmental concerns earlier and now due to Covid-19, most formulation manufacturers have started looking at India as an alternative source of APIs. This bodes well for API players. For discretionary CRAMs, however, the de-stocking at the client's level is likely to impact near-term spending of large pharma companies in early stage innovative products.

Raw materials – Due to the steep decline in Covid-19 cases in China and restoration of manufacturing (except from Hubei province where manufacturing has just began), supplies of raw materials are about to normalise. Raw material prices are also cooling off though they are still higher than historical levels. However, certain supply chain issues such as heavy congestion at major ports in China for disinfection of ships are likely to persist, thus causing delays in consignments.

Notwithstanding the out and out PE expansion, we prefer a stock specific approach. We categorised pharma coverage companies into following – India specific branded generic players, blended model with higher India branded contribution followed by US and other export destinations, blended model with higher US generics exports followed by India branded contribution and API and CRAMs players.

In our order of preference, we prefer India specific branded players on the back of 9-10% expected growth momentum without much sweat and BS pressure, favourable market dynamics with doctor prescription stickiness to the fore and lower perceived risk factors. **MNCs such as Abbott India, Sanofi and Pfizer are our preferred picks in this category.**

We also prefer blended model with higher India branded contribution followed by US and other export destinations where India remains the main growth engine and other geographies as auxiliary engines. This category also includes cases in which there could be windfall gain opportunities such as the latest case of first generic approval by the USFDA to Cipla's inhalation product, 'albuterol sulfate' (Proventil HFA) metered dose inhaler that is used to treat bronchospasm amid rise in demand for albuterol products during the ongoing Covid-19 pandemic. **Ipca Labs, Ajanta Pharma, Torrent and Cipla are our preferred picks from this category.**

Thirdly, we prefer B2B players like API and CRAMs manufacturing on account of a better regulatory track record, client validation and long term supply agreement with marquee customers and frontloading of capex with specific order book. **Divi's Labs, Syngene and Hikal are our top picks from this category.**

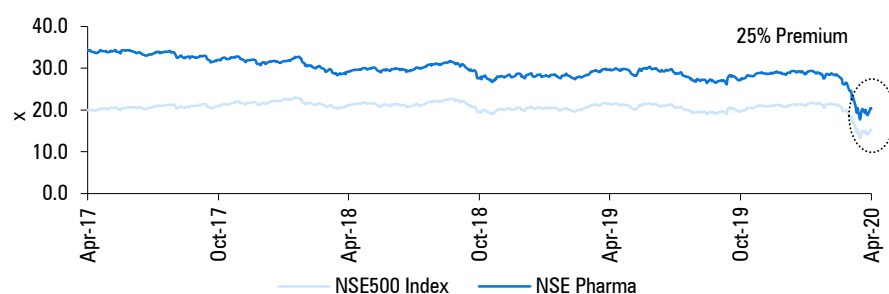
We remain neutral on US focused generic players and companies with blended model with higher US generics exposure as we believe the regulatory overhang, higher competition and weaker pricing power continue to act as a major headwind with lower or higher degree in the near term.

Exhibit 1: Change in valuation

Company	CMP	FY22E EPS (₹)	Multiple		Target Price		Rating	
			Old	New	Old	New	Old	New
Abbott India	17929	469	36	40	16880	18755	BUY	HOLD
Ajanta	1450	77	20	22	1525	1700	BUY	BUY
Alembic	638	31	20	22	620	685	HOLD	HOLD
Auro	455	56	8	9	435	500	HOLD	HOLD
Cadila	373	21	15	18	285	375	HOLD	HOLD
Cipla	564	28	18	22	490	610	HOLD	HOLD
Divi's	2225	71	28	30	1990	2130	HOLD	HOLD
Dr Reddy's	3740	181	20	22	3520	3980	HOLD	HOLD
Ipca	1612	79	20	24	1560	1900	BUY	BUY
Lupin	733	31	18	24	675	745	HOLD	HOLD
Pfizer Ltd	4320	159	30	35	4775	5570	BUY	BUY
Sanofi India	7394	220	35	40	7715	8815	HOLD	BUY
Sun	455	23	20	22	460	510	Hold	HOLD
Torrent	2444	92	22	26	2020	2395	HOLD	HOLD

Source: ICICI Direct Research, Bloomberg

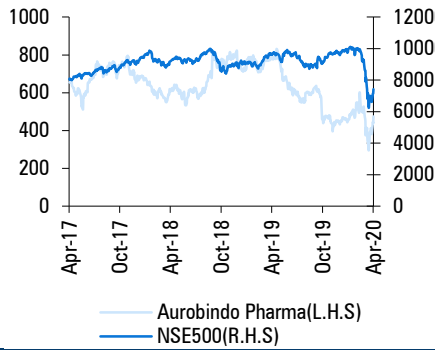
Exhibit 2: One year forward PE



Source: ICICI Direct Research, Bloomberg

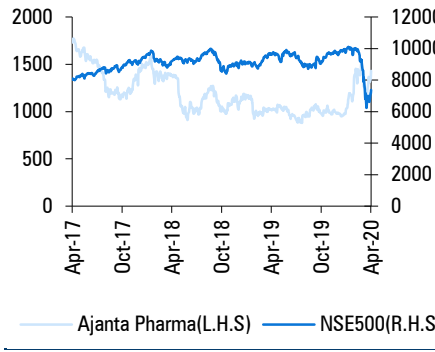
Exhibit 3: Price Charts

Aurobindo Pharma



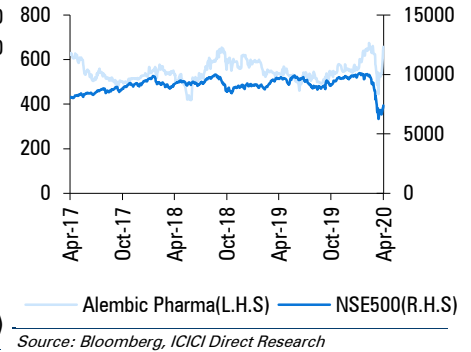
Source: Bloomberg, ICICI Direct Research

Ajanta Pharma



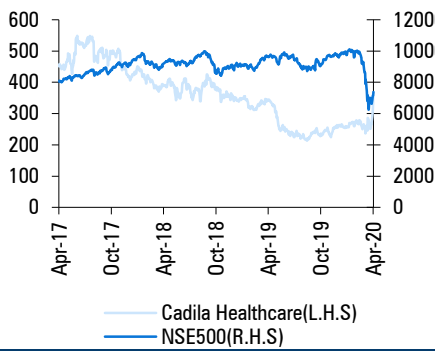
Source: Bloomberg, ICICI Direct Research

Alembic Pharma



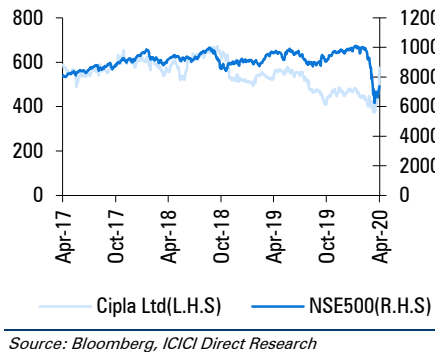
Source: Bloomberg, ICICI Direct Research

Cadila Healthcare



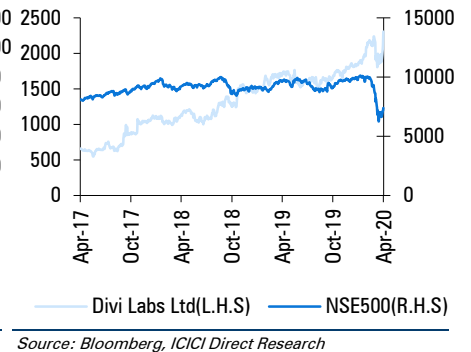
Source: Bloomberg, ICICI Direct Research

Cipla



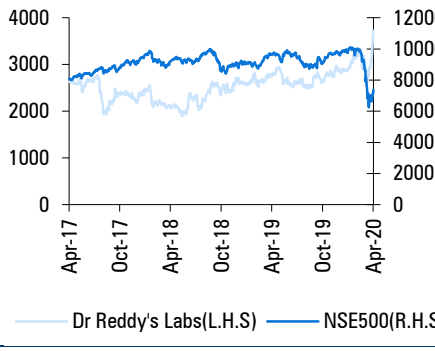
Source: Bloomberg, ICICI Direct Research

Divis Lab



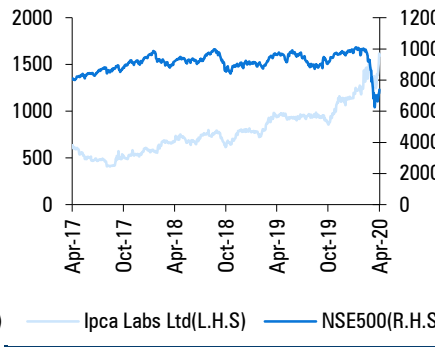
Source: Bloomberg, ICICI Direct Research

Dr Reddys'



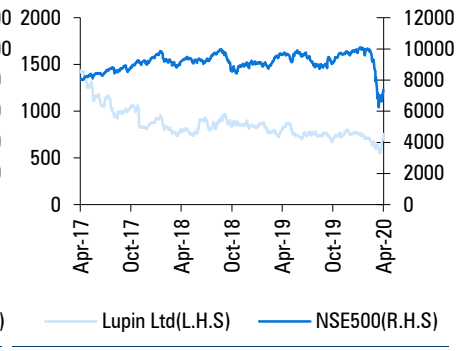
Source: Bloomberg, ICICI Direct Research

Ipca Labs



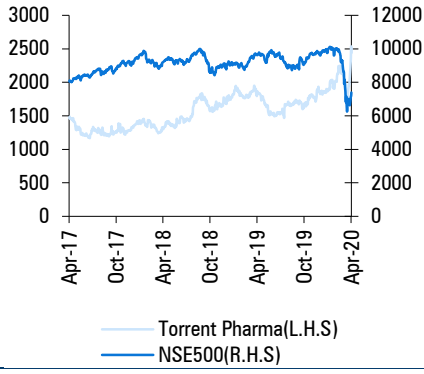
Source: Bloomberg, ICICI Direct Research

Lupin



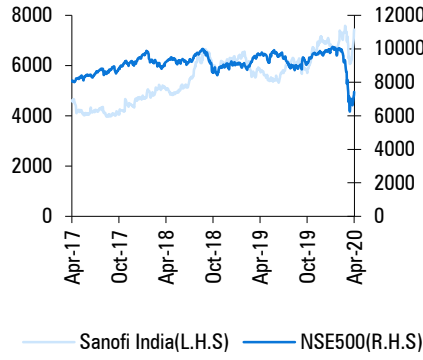
Source: Bloomberg, ICICI Direct Research

Torrent



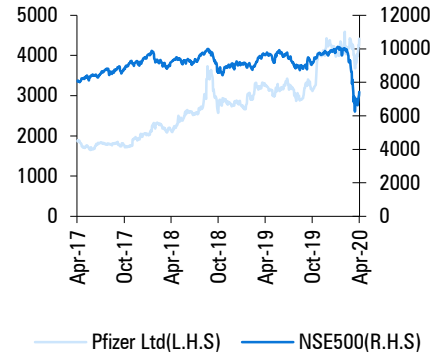
Source: Bloomberg, ICICI Direct Research

Sanofi India



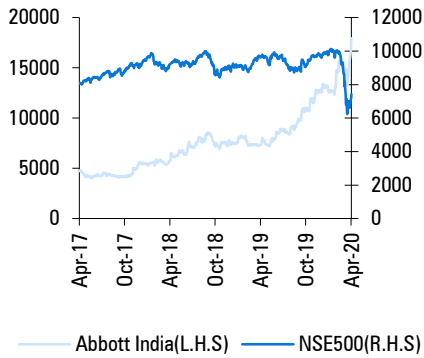
Source: Bloomberg, ICICI Direct Research

Pfizer Ltd



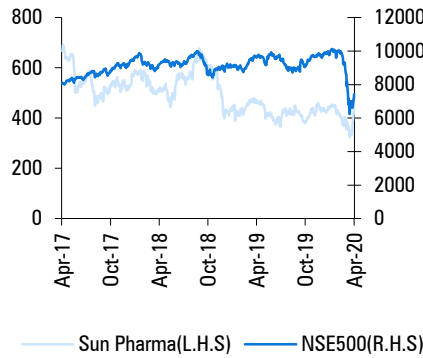
Source: Bloomberg, ICICI Direct Research

Abbott India



Source: Bloomberg, ICICI Direct Research

Sun Pharma



Source: Bloomberg, ICICI Direct Research

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Sell: <-15%



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