HDFC securities
INSTITUTIONAL RESEARCH

Pharma

Indian Pharma: Flight to Safety

Relative stability, reasonable valuations

Our positive stance on Indian pharma is premised on sector's relative resilience to Covid disruption, favorable currency tailwinds and stable outlook for India and US business. India growth has picked up (~10% growth for IPM as of MAT Mar'20) and we forecast 11% growth for covered companies over the next two years. US pricing environment continues to remain benign and the regulatory challenges are well understood. The pharma sector is up ~1% YTD and has outperformed the Nifty Index by 28%. We prefer stocks with high India exposure as it offers greater earnings visibility, supported by reasonable valuations. Reiterate Buy on Cipla. Downgrade Dr. Reddy's to Reduce.

India business accounts for ~ 70 %+ of EV for Cipla and Lupin

In order to assess the proportion of India business embedded in the current valuation, we thought it's prudent to breakdown the enterprise value of each company and ascertain the contribution of each business to the overall EV. We calculate the business/geography wise EV and group them into - India, other businesses (aggregated) and the US (residual). Based on the current market cap and our analysis, India accounts for almost ~70% of the current valuation for Cipla (72%), Lupin (77%) and Torrent (66%). At the same time, the implied one year forward EV/EBIDTA multiple for the US business is sub-4x for Cipla and Lupin and 10x+ for Sun, Dr. Reddy's and Torrent.

Sector margins are expected to be resilient

The efforts to rationalise fixed overheads and calibrate R&D spends are likely to continue. Most companies have guided for tighter cost control. Dr. Reddy's and Cipla have already demonstrated this (+5-6% CAGR in fixed overheads over FY17-20). Lupin has guided for an improvement in cost structure which will aid margins in the next two years. These initiatives, along with INR depreciation are likely to cushion the margins for the sector in the near to medium term. We factor sector EBIDTA margins to improve by ~170ps from 20.7% in FY20 to 22.4% in FY22.

Covid-19 impact and earnings sensitivity

We factor the Covid led disruption (raw material supply issues, plant shutdown, logistic issues) in our Q4FY20 and Q1FY21 estimates. This, along with sharp EM currency depreciation offsets the upside from INR depreciation. We build USD/INR rate of Rs 73-74 (from 71) in our model for the next two years. We factor above and tweak our earnings by 0-5% for FY21/22. In the event of extended lockdown (1.5 months), our earnings sensitivity suggests 7-11% impact on FY21 EPS estimates.

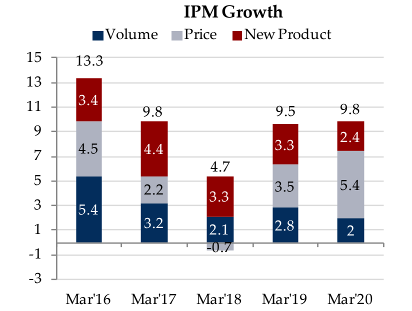
Key takeaways from Management interaction on Covid-19 update

a) Resumption of raw material supplies from China; b) Regulated markets are currently not impacted; c) India business is impacted due to lower manufacturing (mobility constraints) and logistics issues.

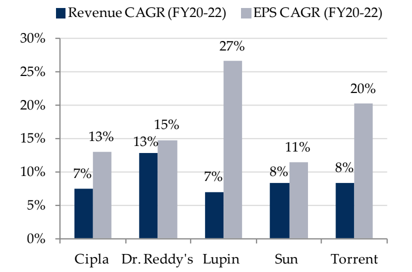
Valuation and Risks

The sector trades at ~23x one year forward, 10% below its 5 year historical average. The sector premium to Nifty is at 35% vs. (5 year avg of 38%). Key risks: a) extended lockdown can impact demand and manufacturing; b) Delay in US FDA plant resolution due to travel advisory; c) EM markets currency risks and subdued demand; d) delay in key approvals.

Company	CMP (Rs)	Reco.	TP (Rs)
Cipla	492	Buy	570
Dr. Reddy's	3,583	REDUCE	3,330
Lupin	700	Add	720
Sun	417	Add	450
Torrent	2,361	Add	2,405



Source: AIOCD AWACS, HDFC sec Inst Research



Source: HDFC sec Inst Research

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Key takeaways from Management interactions - Covid-19 update

	Sun Pharma	Dr. Reddy's	Cipla	Lupin	Torrent Pharma
Raw material sourcing from China	**China supplies have resumed partially. Input cost for certain raw materials have increased but will not have material impact	**Raw material being sourced from China (~10% direct dependency). Supplies have resumed since 3 weeks **Expect RM cost for solvent (8-10% of RM) and catalyst to decline if crude remains at current level **Could have negative impact on margins due to higher logistics cost	**Cipla has adequate inventory. Supplies from China have also commenced. Do not see disruption in supplies or input cost	**China supplies have resumed and don't see any bottleneck. Direct sourcing was limited and will not see impact on input cost.	**No direct exposure to China for RM. Indirect exposure also remains limited **No issues on logistics front faced yet
US/EU Logistics impact	**No major impact in US/EU. Pharma is considered as an essential item and hence no issues faced	**Warehouse and supply chains in US & Germany are currently operational **Delayed shipments might impact the US markets (2-5% impact at max) **EU market (Germany, UK, France, Italy, Spain) have been impacted, with Italy impacted the most (small % of revenue)	**US and EU supplies have not seen any disruption	**No issues in logistics faced in EU or US. Inventory of 5 months+ in US	****Germany:** 4Q was guided to remain weak irrespective of COVID-19. No major disruption for 1QFY21 is witnessed till date
Manufacturing impact	**Company is holding inventory till May. Mobility constraint is an issue.	**Plants were completely operational till 23rd March **Manufacturing would continue but on rotational shit basis (50% of the staff)	**Lockdown has impacted manufacturing in some parts of the country. Expects it to normalise as logistics issues are resolved by government	**Manufacturing is continuing in lockdown. Logistics is an issue due to transportation. Manpower attendance is not an issue.	NA
India outlook	**India growth outlook remains unchanged	**Business remains normal with no major uptick. However, certain products are witnessing higher growth	**Better clarity will emerge after few weeks	**India growth should continue despite lockdown	**Manufacturing continues as regular. No impact of lockdown
EM market/ currency	**Exposure to 80 countries and hence do not hedge EM currencies	**Russian business (10-11% of revenue) is not impacted much. However, depreciation of currency will have negative impact as billing and SG&A is done in Ruble (~50% of exposure)	**CGA business (5% of revenues) is USD denominated. South Africa business (13% of revenues) will be impacted due to currency. Outstanding receivables hedges: 627 mn Rand and USD222mn. Outstanding cashflow hedges: USD109mn and 212mn Rand	**Brazil, Mexico - Shutdown has impacted growth but will not move the needle in terms of overall growth. EM currency impact will be there as this is not hedged	****Brazil:** Company remains hedged till Sept'21 for BRL-USD and USD-INR
API business	**API is for captive consumption. Do not see any material change in revenue trend	**Short term benefits with higher order inflows. However, 2-3% impact on margins due to higher logistics cost **Indian pharma sector could benefit in long run with clients opting to de-risk from Chinese and Italian suppliers.	**Do not see major short term disruption. Too early to comment on longer term impact.	**API is largely for internal consumption hence no material impact	NA

Source: HDFC sec Inst Research

Earnings sensitivity to Covid-19

- We factor the Covid led disruption (raw material supply issues, plant shutdown and logistic issues) in our Q4FY20 and Q1FY21 estimates. In the event of extended lockdown (1.5 months), our earnings sensitivity suggests ~7-11% impact on FY21 estimates. In this scenario, we assume lower impact on regulated markets given higher inventory levels (5+ months in US) and lower logistic issues (Green lanes in EU and US for essential commodities). However, the India business can get impacted due to: a) lower manufacturing (plant utilisation between 25-50%) led by mobility constraints; b) logistic issues which can impact distribution. We build impact on revenues and EBIDTA on account of the above.

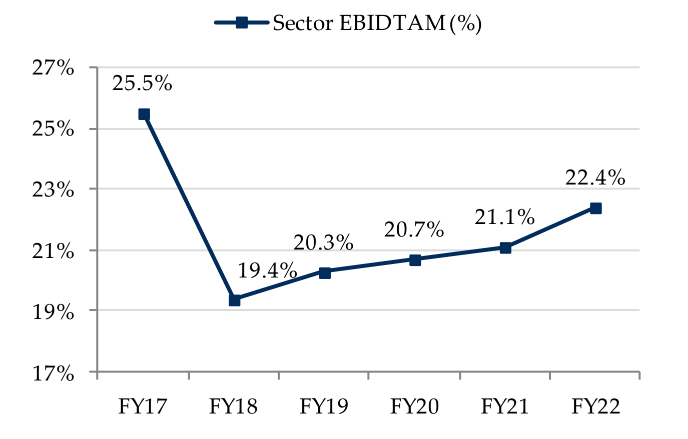
Company (Rs bn)	Current FY21 estimates			Lockdown impact		
	Revenue	EBITDA	PAT	Revenue	EBITDA	PAT
Sun	353	77	45	(2.5)	(5.8)	(8.1)
Dr Reddy's	184	42	24	(1.9)	(4.7)	(6.6)
Torrent	85	23	11	(2.5)	(4.2)	(6.9)
Cipla	180	35	18	(2.5)	(5.7)	(8.2)
Lupin	167	28	13	(2.5)	(8.0)	(10.8)

Source: HDFC sec Inst Research, Scenario: Lockdown is extended for 1.5 months

Sector margins are expected to be resilient over FY20-22

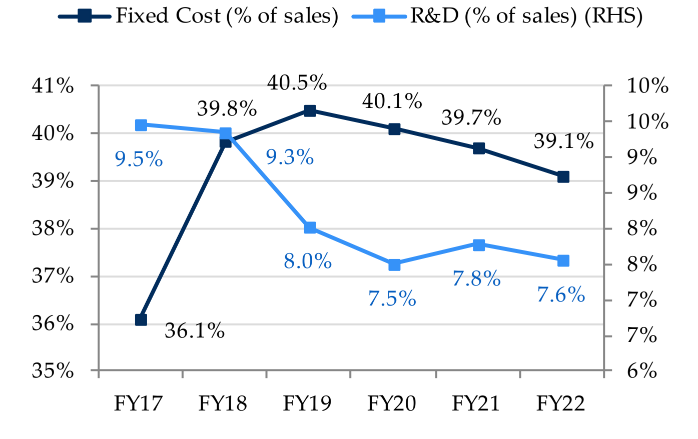
- We factor sector EBIDTA margins to improve from 20.7% in FY20 to 22.4% in FY22. The impact of covid is partially offset by sharp INR depreciation. Moreover, the efforts to rationalise fixed overheads and calibrate R&D spends are expected to continue. Reddy's (ahead of peers) and Cipla have successfully demonstrated this and these initiatives are reflected in their EBIDTA margin improvement. Lupin has guided for tighter cost control (streamlining R&D and other overheads, Japan divestiture), which is likely to aid margins over the next two years. Sun has invested significantly in building specialty pipeline and the costs are reflected in P&L. With most assets now commercialised, we expect margins to improve as the launches gain market share.

We expect ~170bps EBIDTA margin expansion to 22.4% over FY20-22….



Source: Company, HDFC sec Inst Research

….led by cost control initiatives across companies



Source: Company, HDFC sec Inst Research

India accounts for ~70%+ of valuation for Cipla and Lupin

Implied one year forward EV/EBIDTA for US business is 2x for Cipla, 4x for Lupin and 10x for Sun

- In order to assess the proportion of India business value embedded in the current valuation, we thought it's prudent to breakdown the enterprise value of each company and ascertain the contribution of each business to the overall EV. We calculate the business/geography wise EV and group them into - India, other businesses (aggregated) and the US (residual). Based on the current market cap and our analysis, India accounts for almost 70%+ of the current valuation for Cipla (72%), Lupin (77%) and Torrent (66%). At the same time, the implied one year forward EV/EBIDTA multiple for US is 2x for Cipla, 4x for Lupin and 10x for Sun.
- In our exercise, we assume business wise EBIDTA margins and then assign target multiple to each region based on margin and return profile. We assign highest multiple (14-16x) for India business which offers good growth visibility and profitability. The branded generic business in Emerging markets (South Africa, Russia, Brazil) are assigned multiple of (7-11x) in line with local peers in the respective region. The inherent currency risk in these markets, is factored in the discount over India multiple. RoW / others multiple in the below table is a blended multiple for EM markets/others/API businesses. US business multiple is derived based on the residual EV. EBIDTA assumptions for all the businesses are post R&D cost allocation.

Steady outlook for India drives valuation

Company	Consol EV (Rs bn)	Domestic				ROW/API/Others		USA		Comments
		Revenue (Rs bn)	EBIDTA Margin (%)*	EV/ EBIDTA (x)	% of EV	EV/ EBIDTA (x)	% of EV	Implied EV/EBIDTA (x)	% of EV	
Cipla	433	79	28.5	14.0	72	8.1	26	1.9	1	Trade generics account for ~20% of India sales hence discount to peers. EM, South Africa and API businesses (74% of RoW/others) have higher than corporate average margins.
Dr. Reddy's	626	37	28.0	14.0	23	9.7	18	13.4	59	Higher proportion of acute portfolio (~50%) in India and hence discount to peers. Russia and PSAI (28% of RoW/others) have margins above corporate average.
Lupin	353	64	28.5	15.0	77	7.4	10	4.1	13	Strong India franchise with dominant chronic portfolio (~56%). US margins are slightly below corporate average given higher allocation of R&D cost and muted topline. Brazil is loss making. API and Europe have lower than corporate average margins.
Sun	1,000	116	31.5	15.0	54	7.7	19	9.5	27	Market leader in India and in key therapies of Cardiac, CNS, Pain. Expects double digit growth to continue in India.
Torrent	434	44	40.5	16.0	66	11.2	20	41.4	13	Chronic focused portfolio in India (~53%). Expects to outperform IPM by 100-200bps. Germany (~32% of RoW/others) is a high ROCE business given it has negative working capital. Brazil (~25% of RoW/others) is branded generic market with margins similar to corporate average. US business is impacted due to WL at Indrad and OAI at Dahej.

Source: Company, HDFC sec Inst Research, based on FY22 estimates, * post R&D

Key catalysts to monitor

We outline the list of catalysts for the stocks under our coverage over the next two years.

	FY21	FY22	Beyond
Cipla	gAdvair filing in 1QFY21 Approval of Proventil in 2HFY21 Launch of IV Tramadol in US Filing of another respiratory product	Ramp-up of Tramadol, Zemdri in the US Resolution of warning letter at Goa	Approval for gAdvair Launch of other respiratory products Filing of other inhalers
Dr. Reddy's	Closure of Wockhardt portfolio Approval of gNuvaring and gCopaxone Peg-Filgrastim filling in the US by partner Progress on Revlimid Resolution of warning letter at Srikakulam	Approval for complex injectables in US Rituximab filing in US Ramp-up in China business	Approvals for biosimilars
Lupin	Ramp up Solosec, Levothyroxine Approval for gProAir Launch of bEnbrel and bNeulasta in US gSpiriva litigation outcome Facility resolution – Goa, Indore, Mandideep, Somerset	Filing of bEnbrel in US gFostair launch in EU Ramp-up in NaMuscla in EU EBIDTA margin improvement Progress on gAdvair	Filing of gAdvair Approval for gBrovana Approval for Biosimilars Approval for complex injectables
Sun	Ramp up of Ilumya and Cequa Outcome of SEBI probe on whistle blower complaint Drug price fixing probe in the US	Progress on Ilumya trials for Psoriatic arthritis Resolution of warning letter at Halol	Breakeven in specialty portfolio
Torrent	Revenue traction in Unichem portfolio Resolution on Dahej OAI status Further reduction in debt	Complex filings in Derma Resolution f warning letter at Indrad	Progress on NCE molecules

Source: HDFC sec Inst Research

Earnings estimate revision and rating change

Company	Old TP (Rs)	Revised TP (Rs)
Cipla	495	570
Dr. Reddy's	3,270	3,330
Lupin	690	720
Sun	450	450
Torrent	2,405	2,405

We tweak our earnings estimates to factor currency depreciation and Covid led disruption. We model USD/INR rate of Rs 73 for FY21 and Rs 74 for FY22 (from 71 earlier). We lower our EM growth expectation on back of sharp currency depreciation in these markets. We limit the impact of covid to our Q4FY20 and Q1FY21 estimates. We increase our earnings by 0-5% for FY21/22. We have increased our target price for Cipla by 15% as we factor gAdvair opportunity post the completition of Phase III trials. Our revised target price is Rs 570 which is SOTP of base business (Rs 540) + gAdvair opportunity of Rs 30/share.

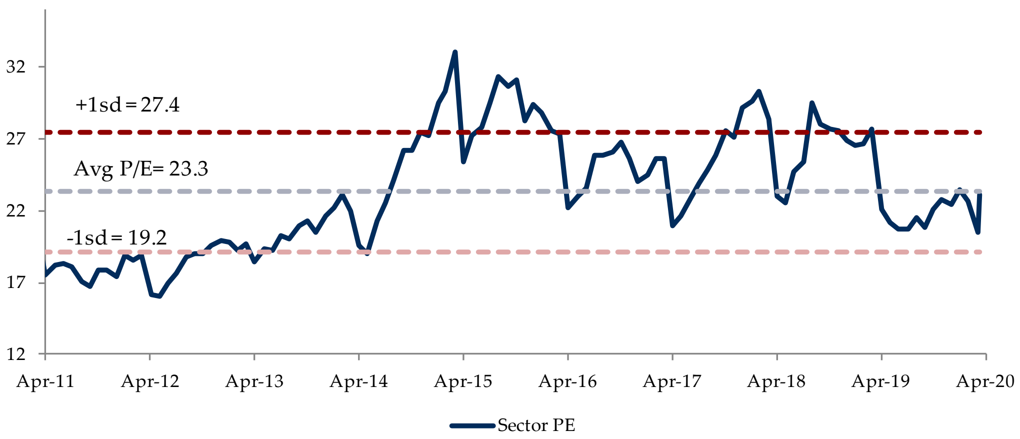
We downgrade Dr. Reddy's to Reduce. While Dr. Reddy's has a rich pipeline of products for the US market, approval and launch timeline for key products - gNuvaring and gCopaxone does remain elusive. Despite factoring in these launches along with sustenance of good performance in non US markets and margin expansion as per company outlook, upside is appears priced in. Our target price of Rs3,300 is based on 19x FY22 EPS.

Valuation

At 23x, Indian pharma sector is trading in line with 10-year average PER

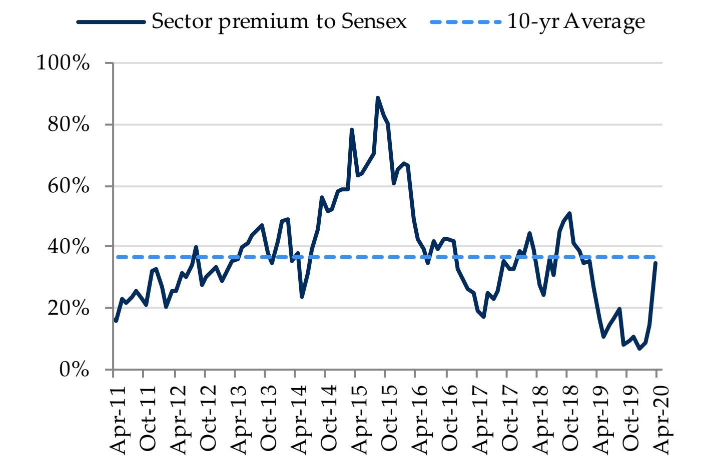
The BSE healthcare Index is trading at ~23x one year forward PE, which is at ~10% discount to its five year average. However the relative premium to Nifty has increased sharply to ~35% from ~15% in the last one year. The premium is now close to its 10 year average of 38%. The relative resilience of sector to covid disruption, stable outlook for India and US business are the key reasons for the increase in the premium. We believe the sector is poised for 15% earnings CAGR over the next two years. In our view the earnings revision cycle is nearing bottom and there is limited scope for valuations to deteriorate.

BSE Healthcare Index is trading at one year forward PE of 23x



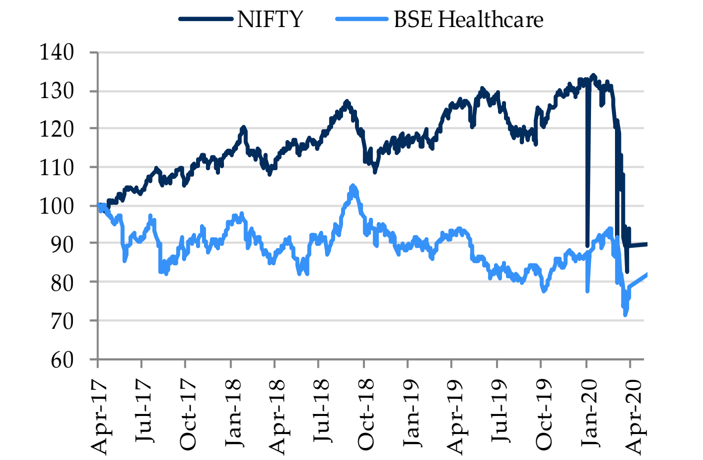
Source: Bloomberg, HDFC sec Inst research

The sector premium to Nifty has converged to 10 yr avg



Source: Bloomberg, HDFC sec Inst Research

The sector underperformance has reduced to 4% in last three years



Source: Bloomberg, HDFC sec Inst Research

Peer set comparison

Domestic	M.Cap (Rs bn)	CMP (Rs./ Sh)	RECO	TP	EV/ EBITDA (X)			ROE			PER(X)			CAGR (FY20E-22E)	
					20E	21E	22E	20E	21E	22E	20E	21E	22E	EPS	Revenue
Cipla	402	492	BUY	570	12.8	12.2	10.2	10.7	9.9	11.0	23.5	22.2	18.3	13.4%	7.5%
Dr. Reddy's	594	3,583	REDUCE	3,330	18.4	14.8	12.4	15.2	14.6	15.8	26.9	25.2	20.4	14.8%	12.8%
Lupin	316	700	ADD	720	14.5	12.7	10.0	7.4	8.4	10.4	30.3	25.3	18.9	26.6%	7.0%
Sun	1000	417	ADD	450	13.2	12.1	10.0	11.0	10.6	11.4	23.1	22.5	18.6	11.4%	8.3%
Torrent	399	2,361	ADD	2,405	20.0	18.1	15.7	18.8	19.8	22.1	42.7	36.8	29.6	20.2%	8.4%
Aurobindo	264	446	NR	NA	6.4	6.0	5.6	17.7	16.4	15.4	9.6	8.9	8.3	7.9%	7.6%
Alkem	278	2,321	NR	NA	20.7	17.8	15.4	19.4	19.1	19.1	24.2	21.0	18.1	15.7%	12.2%
Cadila	317	313	NR	NA	15.8	14.1	13.1	12.4	13.4	13.5	23.0	20.0	18.1	12.6%	7.3%
Glenmark	644	228	NR	NA	5.6	4.9	4.4	11.9	12.3	12.6	8.9	7.6	6.6	15.8%	8.8%
Ipca Labs	193	1,524	NR	NA	21.7	18.3	15.8	18.9	19.2	19.1	29.5	24.1	20.4	20.1%	13.4%
Eris Lifesciences	527	381	NR	NA	14.1	12.6	11.5	24.0	23.0	21.6	16.8	14.7	13.0	14.0%	11.8%

Global	M.Cap (USD bn)	CMP	RECO	TP	EV/ EBITDA (X)			ROE			PER(X)			CAGR (CY19-21E)	
					CY19	CY20E	CY21E	CY19	CY20E	CY21E	CY19	CY20E	CY21E	EPS	Revenue
Generic															
Hikma	6.9	28.5	NR	NA	12.0	11.2	10.4	25.6	16.5	16.7	22.6	18.1	16.5	17.2%	4.7%
Mylan	7.2	14	NR	NA	5.6	5.4	5.0	0.1	18.7	18.7	10.1	3.1	3.0	83.1%	4.9%
Teva	10.4	9.5	NR	NA	7.8	7.7	7.5	-7.0	16.3	16.1	6.5	3.8	3.6	34.3%	0.4%

Source: Bloomberg, HDFC sec Inst Research

HDFC sec vs consensus estimates

Companies	FY21E		FY22E		Comment
	Sales	EPS	Sales	EPS	
Cipla	-1.3	-5.1	-0.9	0.1	We assume tepid growth in the US at 4% over FY20-22e. We factor EBIDTA margin expansion of 110 bps over the next two years.
Dr. Reddy's	-0.2	-4.7	3.0	1.2	Largely in line with consensus as we build approval for gCopaxone and gNuvaring in 2HFY21
Lupin	-1.9	-1.4	-0.3	2.0	In line with consensus, we expect margin expansion of 291bps over the next two years. We forecast US sales to grow at 10% from USD 809mn in FY20 to USD979mn in FY22.
Sun	-0.5	-12.2	0.0	-7.6	We factor slower ramp up for Ilumya (USD 120mn/180mn sales in FY21/22). We factor 3% decline in generic business (inc Taro) over FY20-22e.
Torrent	-4.9	-6.3	-6.3	-6.4	We factor de-growth in the US over the next two years given OAI at Dahej and WL at Indrad.

Source: Bloomberg, HDFC sec Inst Research

Rating Criteria

BUY: >+15% return potential

ADD: +5% to +15% return potential

REDUCE: -10% to +5% return potential

SELL: > 10% Downside return potential

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