

STRIDES SHASUN

PHARMACEUTICALS

BUY

Target Price: Rs 1,030

Q1 margin miss; growth momentum from H2'18

Q1 revenue growth (10% YoY) was in line, but EBITDA declined 34% YoY (37% below our expectations) on lower gross margin of 50.2% (down 260 bps YoY). Gross margin declined due to (1) price erosion in key partnership products in US; delay in its key approvals; (2) PBS[^] impact in Australia; (3) lower growth in India and anti-malaria tender sales. It expects growth and margin to pick up given visibility of (1) key product launches (gLovaza, modified release product) by Q2 and monetization of its ANDA pipeline (60% complex) in US and (2) improved product mix and coverage in Australia, India and Africa.

We cut FY18/19E EPS by 13%/10% and SoTP to Rs 1,030 (16x FY19 EPS + Rs 31 for 40% stake in Stelis R&D + Rs 72 for 60% stake in API co.) vs. Rs 1,130 earlier. Maintain **BUY** on diversified business model and attractive valuations.

CMP : Rs 875
 Potential Upside : 18%

MARKET DATA

No. of Shares : 89 mn
 Free Float : 69%
 Market Cap : Rs 78 bn
 52-week High / Low : Rs 1,259 / Rs 849
 Avg. Daily vol. (6mth) : 2,97,795 shares
 Bloomberg Code : STR IB Equity
 Promoters Holding : 31%
 FII / DII : 35% / 15%

- ◆ **Muted revenue growth (10% YoY):** Regulated market revenues (US and Australia, ~50% of sales) grew 12% YoY but declined 21% QoQ on higher price erosion in partnered products (gVancomycin, gSoma) in US (45% of Regulated market sales) and delay in key product approvals (gLovaza and modified release product) – now expected in Q2. Australia business (~55%) posted strong YoY growth, but declined QoQ due to stocking led by new Pharmaceutical Benefits Scheme (PBS). EM revenue (32% of sales) grew 7% YoY/ 10% QoQ on favorable product mix and market share gains in Africa business offsetting impact of channel destocking in India business. Institutional business (regrouped under EM) rebounded in Q1FY18 driven by the ARV portfolio despite lower anti-malaria tender sales. API business (18% of sales) grew 11% YoY – lower than expected – given delay in partner's launch of Sevelamer
- ◆ **Margins eroded** with Gross margin declining 258 bps YoY/655 bps QoQ to 50.2% due to (1) pricing pressure in US legacy partnered portfolio, (2) lower India sales (channel destocking), (3) adverse product mix in the institutional business with lower sales of higher-margin anti-malarial products. 64% YoY increase in R&D along with negative operating leverage (as costs were steady despite lower sales) pulled EBITDA margin down 638 bps YoY to 10.4%

Financial summary (Consolidated)

Y/E March	FY16	FY17	FY18E	FY19E
Sales (Rs mn)	28,622	34,834	36,310	39,372
Adj PAT (Rs mn)	1,595	3,507	3,813	5,173
Con. EPS* (Rs)	-	-	47.4	66.3
EPS (Rs)	19.9	39.2	42.7	58.0
Change YOY (%)	15.1	96.7	8.9	35.7
P/E (x)	36.3	18.7	20.5	15.1
RoE (%)	8.4	13.1	13.3	16.0
RoCE (%)	8.9	9.8	10.1	12.5
EV/E (x)	23.4	14.7	14.0	11.3
DPS (Rs)	3.9	4.5	7.0	7.0

Key drivers

(%)	FY17	FY18E	FY19E
Revenue growth	22	4	8
Gross margin	55.9	55.0	57.0
EBITDA margin	18.5	18.0	20.2

Price performance



Source: *Consensus broker estimates, Company, Axis Capital
[^]PBS: Pharmaceutical benefit scheme

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- ◆ **Outlook on business segments:** (1) **Regulated markets: US** – While approval momentum has improved (6 approvals received in Q1), growth will be driven by approval for 2 important products expected in Q2 – gLovaza (market size of USD 300 mn), a modified release product (high margin – with limited no of players). **Australia:** Expansion of store coverage accelerated manufacturing out of India operations and new launches to drive volume and margin improvement; (2) **Emerging markets: Africa** – Favorable product mix and improved sales force productivity to drive margin expansion. **India** – Expects normalcy to return in the coming months. Undertaken initiatives to improve sales force productivity and improve operating leverage in the business; (3) **Institutional business:** Expects growth to rebound in anti-malarial business despite lower donor contribution; (4) **API:** Improvement in growth and margin expected post approval of gRenvela by Strides' partner (expected in near term); (5) **R&D (4.5% of Q1 revenue):** 5 filings in Q1FY18 (vs. 9 filings in FY17). On track to file 15-20 products in FY18. Cumulatively, 29 ANDA filings pending approval from USFDA – 62% complex products (see Exhibit 4)

Exhibit 1: Muted growth across segments

(Rs mn)	% of Q1FY18 sales	Q1FY17	Q4FY17	Q1FY18	% YoY growth	% QoQ growth
Regulated markets	50	3,706	5,267	4,147	12%	-21%
Emerging markets	32	2,526	2,446	2,697	7%	10%
PSAI	18	1,369	1,517	1,514	11%	0%
Total revenues		7,601	9,230	8,358	10%	-9%

Source: Company, Note: PSAI: Pharma Services and Active Ingredient.

** Institutional business now combined in emerging markets segment

Exhibit 2: Lower gross margin & higher SG&A led to weak EBITDA margin

(Rs mn)	Q1'17	Q4'17	Q1'18	YoY (%)	QoQ (%)
Total Revenue	7,895	8,884	8,418	7	(5)
Gross profit	4,166	5,041	4,225	1	(16)
Gross margin (%)	52.8	56.7	50.2	-258 bps	-655 bps
Staff expenses	1,282	1,524	1,465	14	(4)
% to sales	16	17	17	116 bps	24 bps
SG&A	1,561	1,947	1,887	21	(3)
% to sales	20	22	22	264 bps	50 bps
EBITDA	1,323	1,569	873	(34)	(44)
EBITDA margin (%)	16.8	17.7	10.4	-638 bps	-729 bps
Depreciation	424	529	511	21	(3)
Interest	559	592	640	14	8
Other Income	208	731	361	74	(51)
PBT (before exceptional items)	547	1,179	82	(85)	(93)
Exceptional Items from intregation	(117)	350	(27)	-	-
Tax	88	175	(33)	(138)	(119)
Minority Interest	65	189	83		
Reported PAT	260	1,123	6	(98)	(100)

Source: Company

Exhibit 3: Exceptional items impacting PBT

(Rs mn)	Q1'17	Q4'17	Q1'18	YoY (%)	QoQ (%)
EBITDA	1,323	1,569	873	(34)	(44)
PBT (before exceptional items)	547	1,179	82	(85)	(93)
Exceptional Items	(117)	350	(27)		
Exchange fluctuation (loss) / gain	(47)	290	44		
Merger and acquisition costs	(46)	(70)	(27)		
Recovery of loans & advances written off in earlier years	49	(52)	-		
Aligning policies on Shasun merger	-	-	-		
Fair valuation of derivative instruments	-	(63)	(44)		
Net gain / (loss) on discontinued businesses	(73)	325	-		
Write off/ Provision of assets (net)	-	-	-		
Impairment of Goodwill	-	(79)	-		
Interest Income	-	-	-		
PBT (post exceptional items)	430	1,529	55	(87)	(96)
PAT (before minorities)	326	1,312	88	(73)	(93)
Minority Interest	65	189	83		
Reported PAT	260	1,123	6	(98)	(100)

Source: Company, Axis Capital

Exhibit 4: 29 Pending ANDA's – USD 9.6 bn market opportunity (62% complex products)

Dosage Formats	Pending ANDA approvals
Topicals	7
Modified Release Tablets	3
Soft Gelatin Capsules	2
Hard Gelatin Capsules	5
Tablets	11
Others	1
Total pending ANDA's	29

Source: Axis Capital, Company

Exhibit 5: Restructuring activities – Key data points

Demerger of API facility	
Turnover	Rs. 7,122 mn (23% of consolidated turnover)
Change in Shareholding pattern	None
Exchange/Share Ratio	Strides shareholder will 1 equity share of Rs 10 each of Solara Active Pharma sciences (resultant entity); for every 6 equity shares of Strides. Sequent Scientific shareholder - 1 share of Rs 10 each of Solara; for every 25 shares of Sequent.
Listing will be sought for resulting Entity	Yes
Exiting Africa Generics	
Turnover	Rs. 1,377 mn (4% of consolidated turnover)
Date of completion	4th May 2017
Cash Consideration	Rs 1,087 mn
Details of Buyer	Sold to current management led by Mr Sinhue Noronha (CEO - Emerging Markets)
Related Party Transaction	No
Additional Information	Divestment of business through a combination of share sale and slump sale
Exiting Probiotic Business	
Turnover	Rs. 15 mn (0.005% of consolidated turnover)
Date of completion	4th May 2017
Cash Consideration	Rs 1,02.4 mn
Details of Buyer	Promoter group entity
Related Party Transaction	Yes - At arms length

Source: Company

Exhibit 6: Strides has gained market share in gAvodart, gRanitidine

Approval date	Brand	Generic	IMS Revenue (USD mn)	Existing competition	Market Share (%)							
					Jun'16	Sep'16	Dec'16	Mar'17	Apr'17	May'17	Jun'17	
11-Apr-14	Vancocin	Vancomycin	332	5	50%	50%	49%	49%	48%	47%	47%	
6-Jun-14	Oxsoralen	Methoxsalen	14	2	44%	42%	31%	33%	33%	39%	36%	
16-Dec-14	Rocaltrol	Calcitriol	50	4	10%	13%	13%	15%	14%	13%	11%	
15-May-15	Combivir	Lamivudine and Zidovudine Tablets	120	8	23%	23%	23%	19%	21%	21%	20%	
30-Jul-15	Tessalon	Benzonatate	41	8	13%	17%	19%	18%	19%	18%	18%	
21-Nov-15	Avodart	Dutasteride	470	12	14%	14%	13%	18%	19%	21%	26%	
16-Nov-15	Soma (250 mg)	Carisoprodol tablets	250	1	50%	70%	79%	84%	85%	87%	87%	
24-Aug-16	-	Ranitidine Tablets	125	8	-	-	3%	14%	15%	17%	18%	

Source: Bloomberg

Conference call highlights and our view

Guidance

- ◆ Expects 20% YoY growth in revenue and 20% YoY growth in PAT in FY18

Regulated markets (50% of Q1 sales, +12% YoY/-21% QoQ):

- ◆ **Australia – steady quarter:** Witnessed double digit growth in revenue in Q1FY18
 - Launched 3 new products during Q1FY18
 - Increased its distribution footprint covering 1,000 stores (~20% of market of total 5,200 stores) vs. ~600 pharmacies in Q4FY17
 - Expansion of store coverage, accelerated manufacturing out of India operations and new launches to drive volume and margin improvement
- ◆ **North America:**
- ◆ **Pricing erosion:** Witnessed mid-single digit price erosion in overall North America business
 - **Legacy partnered products (50% of business):** Witnessed severe pricing erosion, while market share was intact
 - **Direct portfolio (50% of business):** Witnessed low single digit price erosion in Q1FY18. Increased market share in key products, Ranitidine – first fully integrated product; market share 21% vs. 18% in Q4. Dutasteride – increased market share 26% vs. 13% in Q4
- ◆ **Delay in key approvals due to procedural issues:** Expected approval for 2 important products that did not come through in Q1– gIlova (market size of USD 300 mn), a modified release product (high margin), with limited no of players. Expect approvals in Q2FY18, with no outstanding queries from the USFDA.
 - Key filings currently pending approval from USFDA are legacy filings
 - Slower ramp-up in OTC business (received approvals for 1 ANDA in Q1) in US, as retailers stock their inventories only twice each year. Expect to gain market share on next restocking
- ◆ Strides received 6 approvals in Q1 – Cetirizine Softgel Capsules (USD 60 mn market), Promethazine Hydrochloride Tablets (USD 17 mn market), Amantadine Hydrochloride Tablets (USD 22 mn market), Amantadine Hydrochloride Capsules (USD 25 mn market), Ibuprofen Tablets (USD 520 mn market) and Memantine hydrochloride Tablets (USD 60 mn market)

Emerging Markets (incl. institutional business): 32% of Q4 sales, +37% YoY◆ **India:**

- Impacted due to channel destocking ahead of GST rollout
- Expects normalcy to return in the coming months
- Proactively taken initiatives to improve sales force productivity and improve operating leverage in the business.

◆ **Africa:**

- Brands business had a strong growth this quarter, as key brands continued to gain strength and primary sales (selling-in) was on track with secondary sales (selling-out)
- Favorable product mix and improved sales force productivity helped in margin expansion
- Key brands in Africa continue to improve their market share – Rerve (32%), Combiart (6.9%), Solcer (7.8%)

◆ **Institutional sales:**

- Sales rebounded in Q1FY18 driven by the Anti – Retroviral (ARV) portfolio.
- However, Institutional business margin in Q1FY18 was impacted by adverse product mix, with lower contribution from higher-margin institutional anti-Malarial tender business (Strides maintained its market share but the program witnessed lower donor contribution)
- Kenyan facility (UCL) successfully completed a WHO regulatory inspection during Q1FY18 and continues to enjoy WHO approved status; being among the few such facilities in Africa. The program to add new products to the portfolio continued, which will drive growth further in the East African market. Transfer of current institutional products to this facility is on track and supplies are expected to commence from H2 FY 18.

API: Strides witnessed lower-than-expected off-take for Sevelamer API due to delay in approvals of gRenvela for partners. Expects partners to have approvals in the near term, which will drive stronger growth for the API division

R&D spend for the quarter increased 64% YoY to Rs 377 mn against Rs 228 mn in Q1FY17. The company made 5 filings in Q1FY18, and targets 15 -20 filings in FY18. Cumulatively filed 67 ANDAs till date, with 29 filings pending approval from USFDA. It has received 6 new product approvals FY18 YTD. Expects R&D to continue at current levels (with annual spend capped at USD 30 mn).

Successful completion of USFDA inspection at multiple sites

- ◆ In Q1FY18, 4 facilities (API and formulations) were inspected by the USFDA
- ◆ 3 out of the 4 inspections were completed with zero 483 status
- ◆ The Bangalore facility was issued a form 483 with 3 observations. The observations have been addressed comprehensively and Strides has since received 2 product approvals from the facility

Financials

- ◆ Decline in operating margin on lower sales of higher-margin antimalarial business, lower profit share on partnered products in US (witnessed severe price erosion), USD/INR depreciation, lower India sales (ahead of GST), and seasonality impact (Q4 sees sales of a high margin cold and flu drug in the US)

Strides restructuring activities

Acquisition of Perrigo's USFDA approved API facility in India

- ◆ Strides completed the acquisition of Perrigo's USFDA approved API facility at Ambernath (Maharashtra) for Rs 1 bn (USD 15mn) on April 6, 2017
- ◆ The facility will be used for captive consumption and will supply strategic API for Strides' formulations business. Strides will transfer all key integrated DMF's for captive consumption to the acquired facility

Demerger of API business to Solara Active Pharma Sciences

- ◆ Received key approvals from the Competition Commission of India, stock exchanges and SEBI for demerger of the API business
- ◆ Next step involves seeking clearance from National Company Law Tribunal and taking shareholder and creditor approval. The appointed date for the scheme of the merger is 1st October 2017
- ◆ Equity shares of resultant entity, Solara Active Pharma Sciences, will be listed on BSE and NSE. Strides' shareholders will hold ~60% and Sequent's shareholders will hold ~40% of Solara
- ◆ The share entitlement ratio is arrived at after considering debt of ~Rs 4.25 bn pertaining to Strides' commodity API business and ~Rs 0.75 bn pertaining to Sequent's Human API business

Exhibit 7: Key M&A events in the recent past

Date	Region	Company	Acq value	Acq value (Rs mn)	Rev (Rs mn)
21-May-15	Australia	Arrow	380	17,821	5,628
08-Feb-16	Australia	Generic Partners* (51% stake acquired)	25	1,204	1,873
29-Feb-16	Australia	Pharmacy Alliance	13.99	681	739
	Australia	Total		19,706	8,240
21-Jul-14	India	Bafna Pharma's - India branded (74% stake)		481	200
19-Sep-15	India	Ranbaxy - CNS divisions (Solus & Solus care)		1,650	920
23-Oct-15	India	Brands from J&J / Medispan (51% stake acquired)		-	320
	India	Total		2,131	1,440
			USD mn		
08-Feb-16	Africa (Kenya)	Universal corporation* (51% stake acquired)	14	951	1,522
07-Mar-16	USA, Australia, Middle East	Moberg Pharma* (Sweden) - 3 OTC brands	10	670	409
25-Nov-16	USA, Australia, Middle East	Moberg Pharma* (Sweden) - PediaCare (Pediatric brand)	5	343	402
09-Dec-16	India	Perrigo API (USFDA approved)		1000	738
		TOTAL		23,458	11,611

Source: Company, Axis Capital

Financial summary (Consolidated)**Profit & loss (Rs mn)**

Y/E March	FY16	FY17	FY18E	FY19E
Net sales	28,622	34,834	36,310	39,372
Other operating income	-	-	-	-
Total operating income	28,622	34,834	36,310	39,372
Cost of goods sold	(15,023)	(15,362)	(16,340)	(16,930)
Gross profit	13,599	19,472	19,971	22,442
<i>Gross margin (%)</i>	<i>47.5</i>	<i>55.9</i>	<i>55.0</i>	<i>57.0</i>
Total operating expenses	(9,459)	(13,044)	(13,435)	(14,489)
EBITDA	4,140	6,428	6,536	7,953
<i>EBITDA margin (%)</i>	<i>14.5</i>	<i>18.5</i>	<i>18.0</i>	<i>20.2</i>
Depreciation	(1,313)	(1,872)	(1,628)	(1,722)
EBIT	2,827	4,557	4,908	6,232
Net interest	(1,682)	(2,269)	(1,924)	(1,564)
Other income	921	1,686	1,550	1,560
Profit before tax	2,067	3,973	4,534	6,228
Total taxation	(425)	(470)	(725)	(1,059)
<i>Tax rate (%)</i>	<i>20.5</i>	<i>11.8</i>	<i>16.0</i>	<i>17.0</i>
Profit after tax	1,642	3,503	3,809	5,169
Minorities	(47)	4	4	4
Profit/ Loss associate co(s)	-	-	-	-
Adjusted net profit	1,595	3,507	3,813	5,173
<i>Adj. PAT margin (%)</i>	<i>5.6</i>	<i>10.1</i>	<i>10.5</i>	<i>13.1</i>
Net non-recurring items	(645)	1,020	-	-
Reported net profit	950	4,527	3,813	5,173

Balance sheet (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Paid-up capital	893	894	894	894
Reserves & surplus	25,685	26,210	29,295	33,742
Net worth	26,579	27,104	30,190	34,636
Borrowing	33,475	30,545	24,981	18,981
Other non-current liabilities	2,306	5,612	5,951	6,315
Total liabilities	62,861	64,901	62,762	61,572
Gross fixed assets	36,508	41,270	41,575	45,075
Less: Depreciation	(9,876)	(12,135)	(13,763)	(15,485)
Net fixed assets	26,632	29,135	27,812	29,590
Add: Capital WIP	8,303	7,798	7,511	7,237
Total fixed assets	34,936	36,933	35,323	36,828
Total Investment	12,663	15,246	12,451	7,451
Inventory	6,131	7,380	7,958	8,629
Debtors	10,330	9,971	10,943	11,866
Cash & bank	3,116	3,295	3,368	3,933
Loans & advances	309	513	516	519
Current liabilities	11,715	16,171	16,602	17,688
Net current assets	11,313	9,120	10,937	12,725
Other non-current assets	3,951	3,601	4,052	4,568
Total assets	62,861	64,901	62,762	61,572

Source: Company, Axis Capital

Cash flow (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Profit before tax	2,067	3,973	4,534	6,228
Depreciation & Amortisation	1,313	1,872	1,628	1,722
<i>Chg in working capital</i>	<i>(3,424)</i>	<i>2,371</i>	<i>(1,743)</i>	<i>(1,224)</i>
Cash flow from operations	717	9,282	4,067	5,671
<i>Capital expenditure</i>	<i>(22,950)</i>	<i>(3,330)</i>	<i>(4,000)</i>	<i>(3,500)</i>
Cash flow from investing	(22,284)	(5,914)	(1,205)	1,500
<i>Equity raised/ (repaid)</i>	<i>11,316</i>	<i>1</i>	-	-
<i>Debt raised/ (repaid)</i>	<i>18,917</i>	<i>(2,930)</i>	<i>(5,564)</i>	<i>(6,000)</i>
<i>Dividend paid</i>	<i>436</i>	-	-	-
Cash flow from financing	29,487	(3,414)	(6,296)	(6,732)
Net chg in cash	7,920	(45)	(3,434)	438

Key ratios

Y/E March	FY16	FY17	FY18E	FY19E
OPERATIONAL				
FDEPS (Rs)	19.9	39.2	42.7	58.0
CEPS (Rs)	28.3	71.5	60.9	77.2
DPS (Rs)	3.9	4.5	7.0	7.0
Dividend payout ratio (%)	32.9	8.9	16.4	12.1
GROWTH				
Net sales (%)	139.3	21.7	4.2	8.4
EBITDA (%)	80.9	55.3	1.7	21.7
Adj net profit (%)	54.4	119.8	8.7	35.7
FDEPS (%)	15.1	96.7	8.9	35.7
PERFORMANCE				
RoE (%)	8.4	13.1	13.3	16.0
RoCE (%)	8.9	9.8	10.1	12.5
EFFICIENCY				
Asset turnover (x)	1.0	0.8	0.8	0.9
Sales/ total assets (x)	0.6	0.4	0.5	0.5
Working capital/ sales (x)	0.2	0.2	0.2	0.2
Receivable days	131.7	104.5	110.0	110.0
Inventory days	91.4	94.8	97.6	100.3
Payable days	115.6	95.9	91.5	94.0
FINANCIAL STABILITY				
Total debt/ equity (x)	1.7	1.1	0.8	0.6
Net debt/ equity (x)	0.9	0.5	0.4	0.3
Current ratio (x)	2.0	1.6	1.7	1.7
Interest cover (x)	1.7	2.0	2.6	4.0
VALUATION				
PE (x)	36.3	18.7	20.5	15.1
EV/ EBITDA (x)	23.4	14.7	14.0	11.3
EV/ Net sales (x)	3.4	2.7	2.5	2.3
PB (x)	2.6	2.9	2.6	2.3
Dividend yield (%)	0.4	0.5	0.8	0.8
Free cash flow yield (%)	(0.3)	0.1	-	-

Source: Company, Axis Capital

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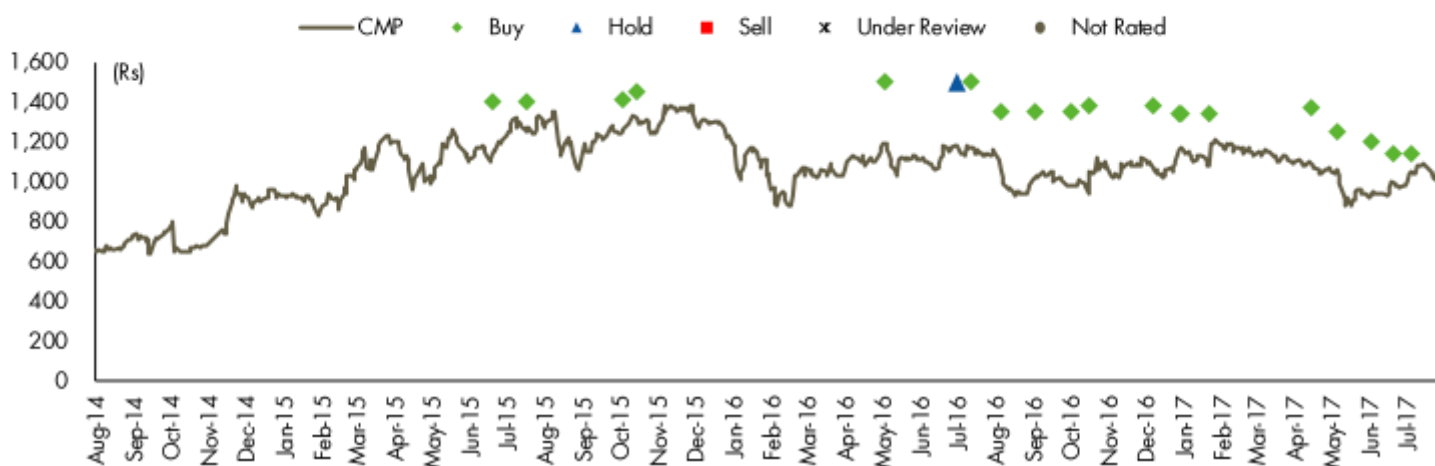
DEFINITION OF RATINGS

Ratings	Expected absolute returns over 12 months
BUY	More than 10%
HOLD	Between 10% and -10%
SELL	Less than -10%

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Strides Shasun (STRA.BO, STR IN) Price and Recommendation History



Date	Target Price	Reco	Date	Target Price	Reco
1-Jul-15	1,400	Buy	19-Dec-16	1,375	Buy
30-Jul-15	1,400	Buy	9-Jan-17	1,340	Buy
16-Oct-15	1,410	Buy	11-Jan-17	1,340	Buy
27-Oct-15	1,450	Buy	3-Feb-17	1,340	Buy
16-May-16	1,500	Buy	26-Apr-17	1,365	Buy
13-Jul-16	1,500	Hold	18-May-17	1,250	Buy
25-Jul-16	1,500	Buy	14-Jun-17	1,200	Buy
17-Aug-16	1,350	Buy	3-Jul-17	1,130	Buy
15-Sep-16	1,350	Buy	17-Jul-17	1,130	Buy
14-Oct-16	1,350	Buy			
28-Oct-16	1,375	Buy			

Source: Axis Capital