Equity Research

November 14, 2017

BSE Sensex: 32942

ICICI Securities Limited is the author and distributor of this report

Pharmaceuticals

Target price Rs1,002

I-Sec vs Bbg* consensus

(%)	FY18E	FY19E	FY20E
Sales	0.3	(7.4)	(10.4)
Adj. PAT	(30.5)	(17.6)	(15.3)

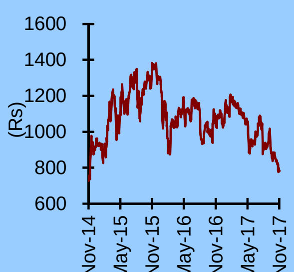
Source: *Bloomberg, I-Sec research

Shareholding pattern

	Mar '17	Jun '17	Sep '17
Promoters	31.1	31.1	31.1
Institutional investors	48.9	49.4	50.2
MFs and UTI	13.5	15.0	16.1
Banks, FI's, Insurance co	2.4	0.6	0.5
FIIs	33.9	33.9	33.6
Others	20.0	19.5	18.7

Source: BSE

Price chart



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INDIA

Strides Shasun Ltd

BUY

Strong earning trajectory at attractive valuations **Rs783**

Reason for report: Initiating coverage

Strides Shasun Ltd (Strides) is a vertically integrated pharma company that is scaling up its formulations business in regulated markets, particularly US and Australia. We expect US revenue to grow at 31.1% CAGR over FY17-20E on the back of complex generics pipeline with 28 pending ANDAs (most being under GDUFA) and ability to garner meaningful market share. Australia business would grow at steady rate (14.7% CAGR) with profitability improvement led by cost optimisation and operating leverage. We are positive on Strides' long-term outlook considering ramp up of US business backed by strong execution, sturdy positioning in less competitive Australian generics market, potential for operating leverage, and attractive valuations (13.2x FY20E).

Our estimates are significantly lower than consensus (15-30% on EPS) and downside looks protected as valuation also appear reasonable on our estimates at 13.2x FY20E EPS vs peers' average of 16.4x FY20E. Hence, we initiate coverage on Strides with a BUY rating and SoTP-based target price of Rs1,002/share, upside potential of 28.2%.

- **Earnings to grow at 61.1% CAGR over FY18-20:** We expect EPS to more than double over FY18-20 with 61.1% CAGR over FY18-20. This would be largely driven by 500bps EBITDA margin expansion and reduction in interest cost as net debt to equity would come down to 0.4x by FY20 from 1x in FY17. Strong earnings growth with reduced capex requirement would result in strong free cashflow generation of ~Rs10bn over FY18-20.
- **Set for another big leap in regulated markets:** Strides had earlier monetised its business in regulated markets of US and Australia. It has now again created strong base for growing fast in these markets. In US, the company has filed 68 ANDAs including complex generics like *Lovaza*, *Potassium Citrate* and would file 15-20 ANDAs every year. Strong execution capability of garnering significant market share would help US revenue clock 31.1% CAGR to US$214mn in FY20E. Australia is a large opportunity with Strides being among top 3 players in limited competition market and we expect 14.7% revenue CAGR over FY17-20 with profitability expansion.
- **API demerger is a value unlocking initiative:** Strides' API business (15.2% of FY17 sales) would be demerged into a separate listed entity (Solara) which will also have human API business of Sequent Scientific. However, Strides would continue to keep captive API manufacturing for vertical integration. This move should improve overall profitability metrics and help in growing the formulation business faster with dedicated focus. We value 60% stake of Strides' shareholders in Solara at Rs72/share.
- **Initiate with BUY:** We initiate coverage with **BUY** and target price of Rs1,002/share (18xSep'19E EPS); Rs72/share for API business. Key downside risks are: regulatory hurdles, currency fluctuations and delay in margin expansion in the Australia.

Market Cap	Rs70bn/US$1.1bn
Reuters/Bloomberg	STSA.BO/STR IN
Shares Outstanding (mn)	89.5
52-week Range (Rs)	1383/776
Free Float (%)	68.9
FII (%)	33.6
Daily Volume (US$'000)	6,469
Absolute Return 3m (%)	(13.6)
Absolute Return 12m (%)	(26.1)
Sensex Return 3m (%)	5.0
Sensex Return 12m (%)	24.4

Year to March	FY17	FY18E	FY19E	FY20E
Net Revenue (Rs mn)	34,834	37,711	40,069	45,219
Net Profit (Rs mn)	2,886	2,036	3,955	5,288
Dil. EPS (Rs)	32.3	22.8	44.2	59.1
% Chg YoY	78.0	(29.4)	94.2	33.7
P/E (x)	24.1	34.2	17.6	13.2
CEPS (Rs)	53.2	44.2	65.7	82.8
EV/EBITDA (x)	15.0	17.2	12.4	9.8
Dividend Yield (%)	0.0	0.0	0.0	0.0
RoCE (%)	7.2	5.8	8.6	10.2
RoE (%)	10.8	7.2	12.6	14.9

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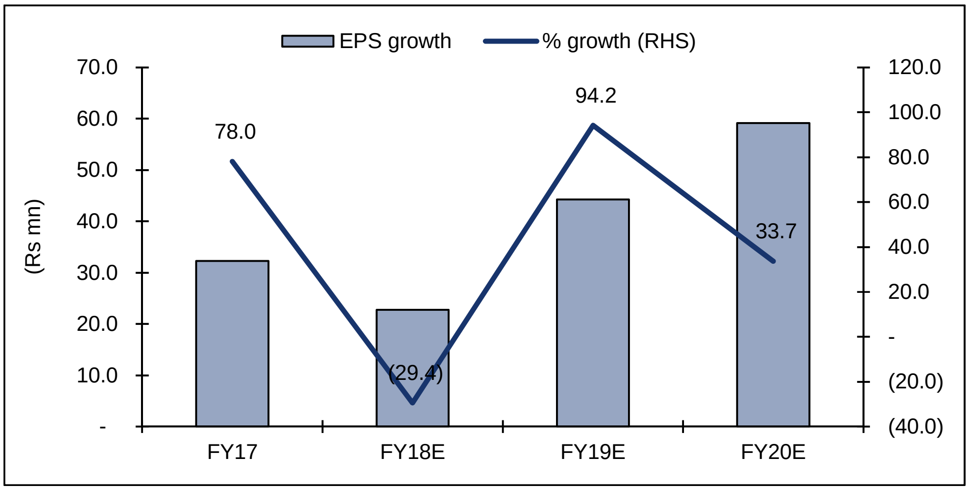
Earnings to grow at 61.1% CAGR over FY18-20

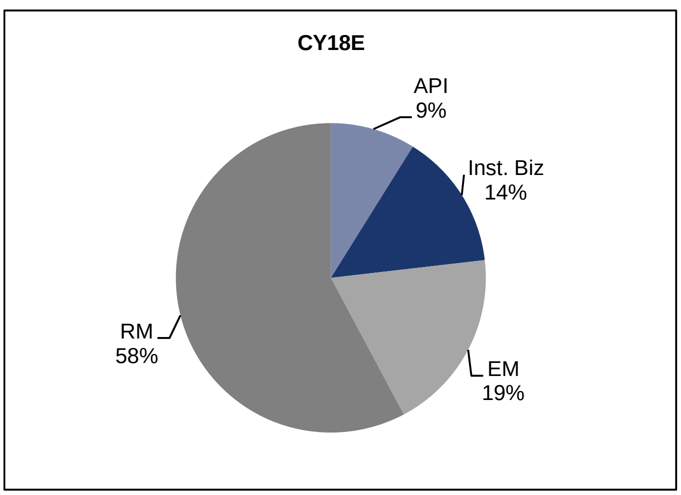
We expect earnings to more than double over FY18-20 with 61.1% CAGR over FY18-20. This would be largely driven by 500bps EBITDA margin expansion on back of demerger of API business, higher revenue growth in regulated markets and operating leverage in regulated markets business. Further, interest cost would also reduce by 30% over FY18-20 as net debt to equity would come down to 0.4x by FY20 from 1x in FY17. However, total revenue growth would be steady at 9.5% over this period as API business would get demerged. Excluding the API business, we expect revenue CAGR of 15%.

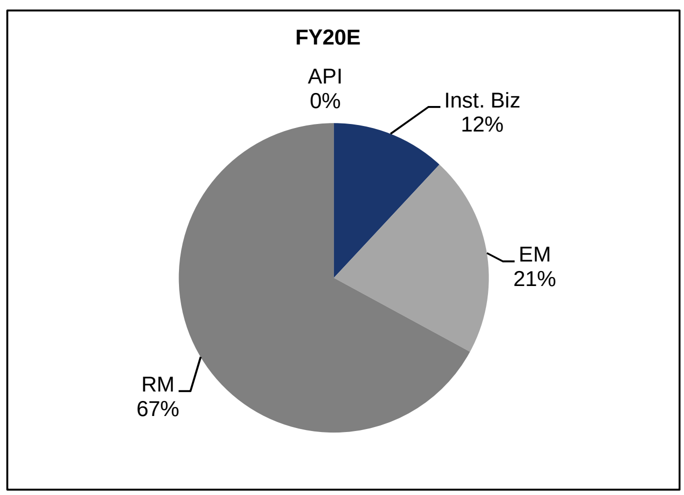
Chart 1: 61.1% CAGR in adjusted EPS over FY18-20



Source: Company data, I-Sec research

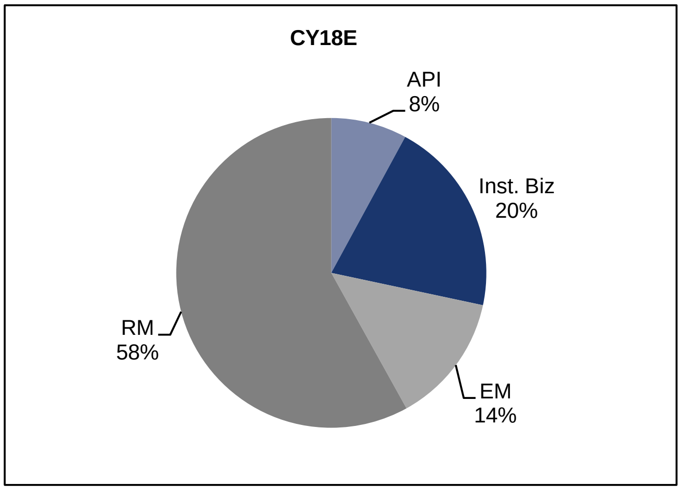
Chart 2: Increase in contribution of regulated markets to total revenue

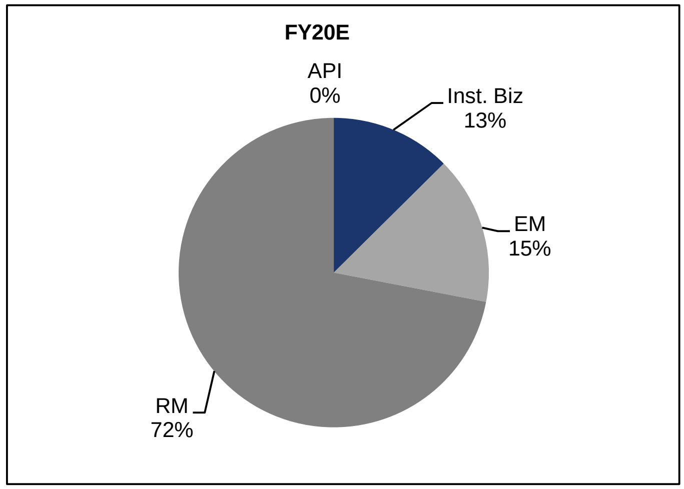




Source: Company data, I-Sec research

Chart 3: Significant increase in EBITDA contribution from regulated markets





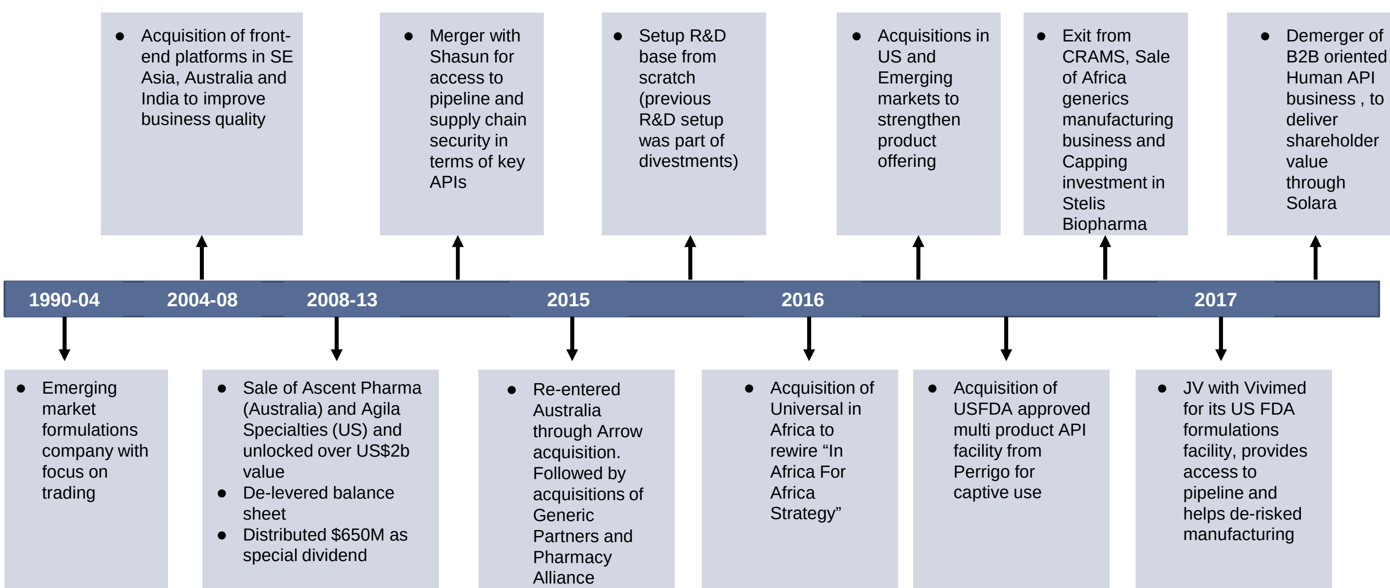
Source: I-Sec research

Creating another big leap in regulated markets

Strides had earlier built strong business franchise in regulated markets, namely US and Australia, and later monetised by selling the businesses at premium valuations. The company has again entered Australia through acquisition of Aspen's generics business and is consolidating its position to become an important player. After selling injectable business in US, the company has built decent pipeline of non-injectable complex generics in US and is set to witness strong traction in financial performance of US business.

- Decent pipeline of ~70 ANDA filings including ~30 pending approval (including complex generics) and recent launches of *generic Lovaza and Potassium citrate* would help clock 31.1% revenue CAGR over FY17-20E in US.
- Strong positioning in Australian market being among top three players, exclusive tie-up with the largest Australian distributor and increasing pharmacy reach would aid mid-teens revenue growth with potential for margin expansion from operating leverage.
- Regulated markets (US, Australia and EU) business contributes ~50% to total revenue and would be key growth driver with 19.5% revenue CAGR.

Chart 4: Evolution of Strides

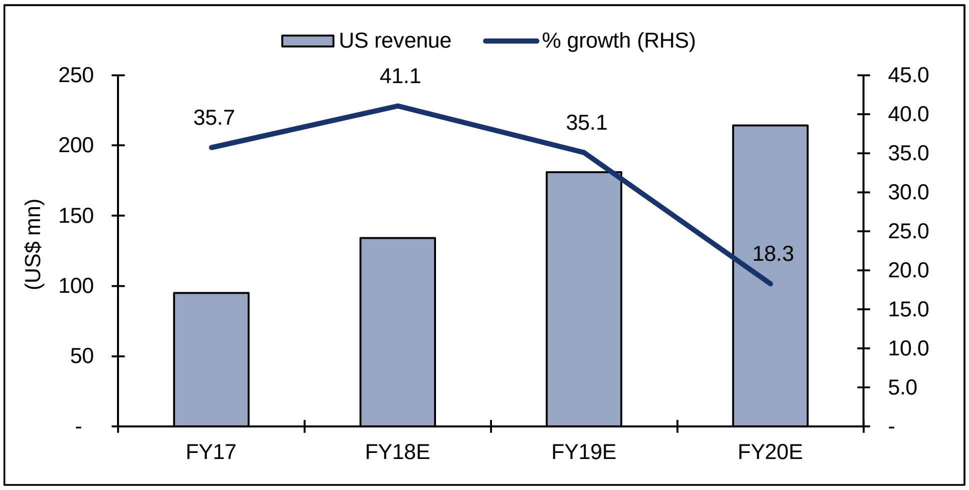


Source: Company data, I-Sec research

US – strong execution capability to drive strong growth

Strides has developed a pipeline of total 68 ANDA filings, of which 28 are pending for approval. Most of these filings have been made in last 3-4 years, after sale of Agila (sterile injectable business in US). Management focus has been on building product portfolio in niche and complex generics and hence, about half of pending filings of the portfolio comprise topicals, softgels and modified release dosages. We believe Strides is well positioned to witness strong growth in US with 28 ANDAs pending for final approval in complex generics and clear FDA status with all manufacturing plants being approved by USFDA. We expect US revenue to more than double in next three years and clock 31.1% CAGR over FY17-20 to US$214mn led by new product launches and capability of garnering meaningful market share.

Chart 5: US revenue to more than double over FY17-20

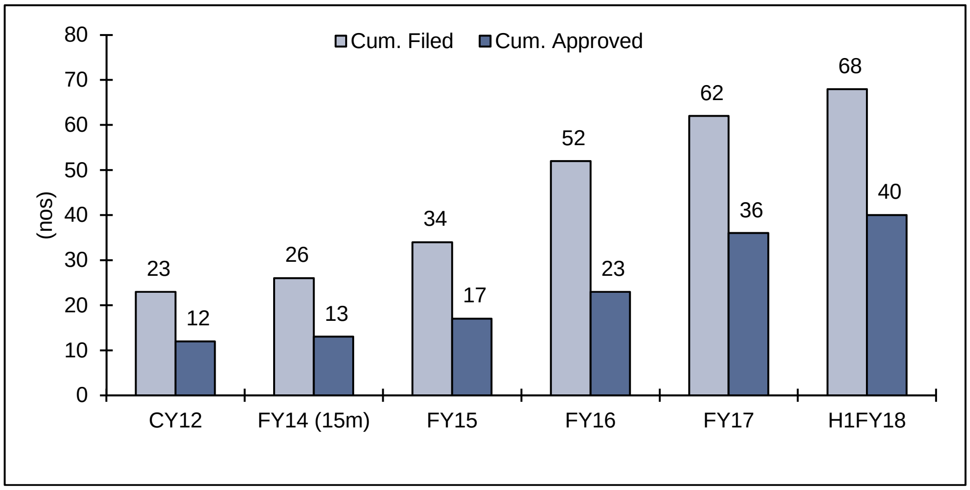


Source: Company data, I-Sec research

Building complex generic product portfolio

The focus of the management is on developing niche and complex generic portfolio where competition would be limited and company can look for meaningful market share. The company has re-built its R&D team after sale of injectable business in CY13. It has created a team of over 500 scientists. It has developed capabilities across multiple delivery and dosages such as orals, topicals, soft gels, creams, liquids, modified release formats and tablets. The company has 28 ANDAs pending for approval and most of these filings are post GDUFA which would ensure approval in relatively lesser time. More than half of these pending filings are in complex space such as modified release format, topicals, soft gels and para IVs. Management expects 20+ approvals over next 12 months and is targeting to file 15-20 ANDAs per year over next 2-3 years. Recent approvals for *generic Lovaza and Potassium citrate* would drive growth in near to mid-term and new launches going forward would help in sustaining strong growth.

Chart 6: ANDA filings and approvals history



Source: Company data, I-Sec research

Strong execution capability

The company has demonstrated strong execution capability in terms of garnering substantial market share in several products and maintaining clear FDA status consistently. All manufacturing plants and R&D centres are approved by USFDA and recent inspections have also been completed and cleared smoothly. Further, the company has been able to garner significant market share in several products and maintain high market share for a decent timeframe. We believe it can get sizeable market share in recently launched key products like *generic Lovaza and Potassium citrate.*

Table 1: Market share in key products

Molecule	Brand Name	Market Share	No of Players	Current Rank
Abacavir	Ziagen	10%	6	4
Acarbose	Precose	20%	7	2
Benzonatate	Tessalon	20%	8	2
Calcitrol	Rocaltrol	15%	6	3
Carisoprodol	Soma	96%	16	1
Dutasteride	Avodart	20%	11	1
Ergocalciferol	Vitamin D	10%	13	1
Methoxsalen	Oxsoralen-Ultra	30%	4	2
Ranitidine	Zantac	21%	5	3
Vancomycin	Vancocin	55%	5	1

Source: Bloomberg, Company data, I-Sec research

Table 2: Clear FDA status

Location	Inspection status
Bangalore	Inspected in May-17. Form 483 issued with 3 observations. Few product approvals received post inspection.
	Inspected in Jun-16. No form 483 issued
	Inspected in Feb-16. Form 483 was issued. EIR issued in Jun-16
	Inspected in Aug-14. Form 483 was issued. VAI status at closure of inspection
	Inspected in Dec-13. Form 483 was issued. NAI status at closure of inspection
	Inspected in Jul-11. No form 483 issued. NAI status at closure of inspection
Beltapharm Milan, Italy	Inspected in May-15. No Form 483 was issued
	Inspected in Jun-13. No form 483 issued
Chennai (JV with Vivimed)	Inspected in Nov-16. No form 483 issued
	Inspected in Jun-15. VAI Status on facility post inspection

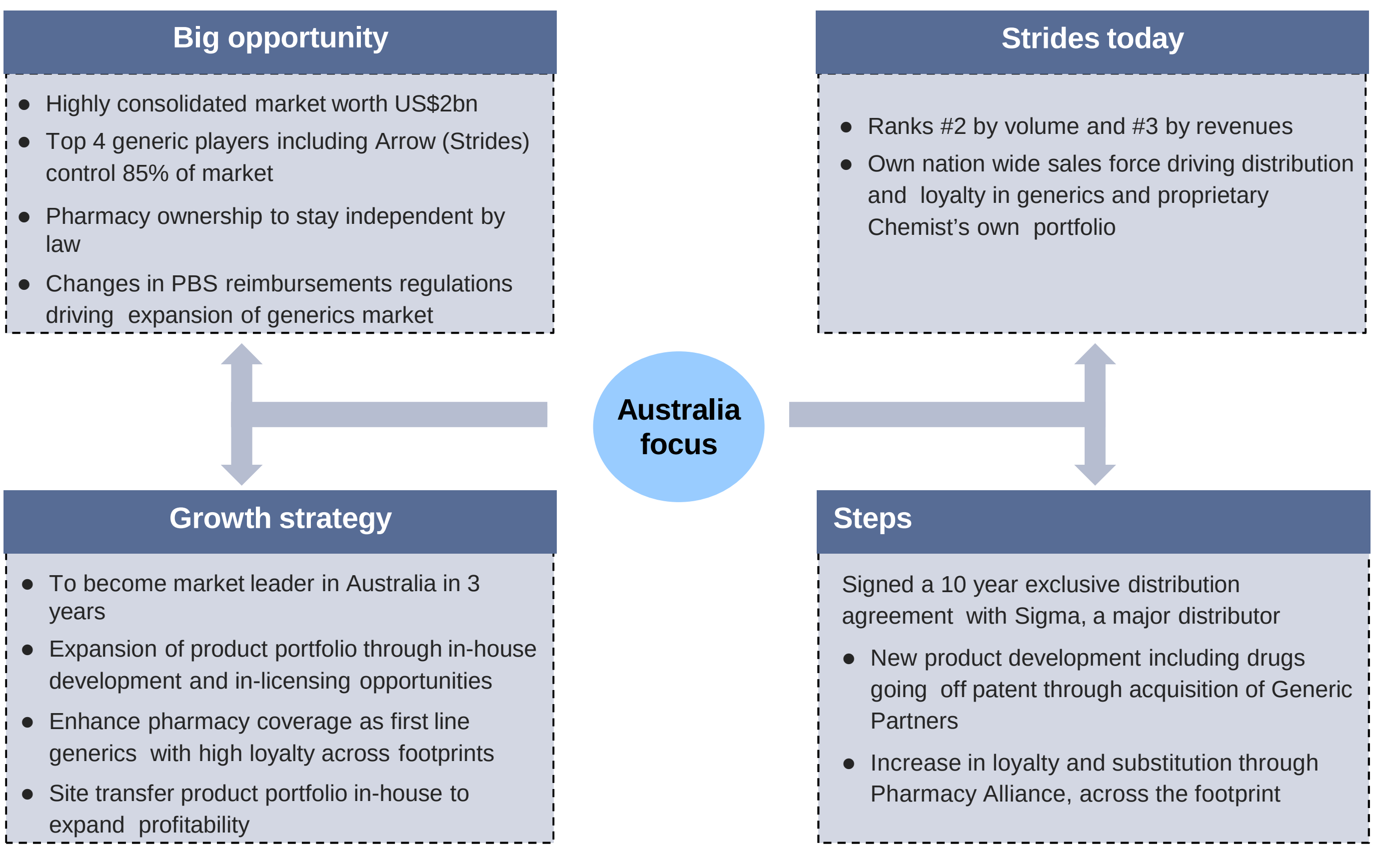
Source: USFDA, Company data, I-Sec research

Developing solid franchise in Australia

After exiting Australian market in CY12 by sale of business to Watson, Strides has re-entered this market in a big way through inorganic route. It acquired the generic business of Aspen Pharmacare (Arrow Pharma) in Australia and got 20%+ market share straight away as Aspen was among top three generic players in Australia. This acquisition helped Strides become the third largest generic player in the geography and get access to 130 commercialised products. Post this acquisition, Strides also acquired controlling stake in Generic Partners (GP) and Amneal's Australian business to strengthen its position further in Australia.

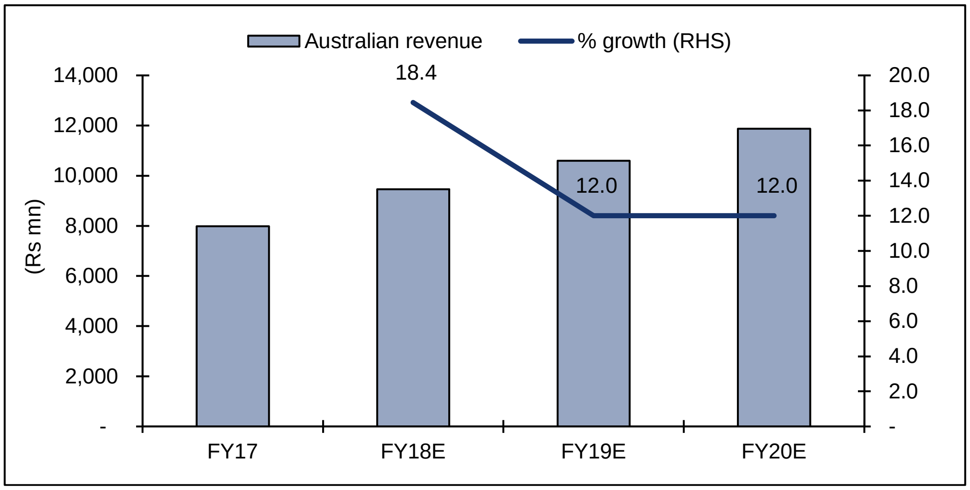
The company has also entered a ten-year distribution agreement with large pharmacy chain, Pharmacy Alliance, which has a network of about 600 pharmacies in Australia, and has signed an exclusive agreement with largest wholesaler Sigma in Australia. We believe these initiatives would help Strides strengthen its presence further in this market and gain market share. We expect revenue from Australian business to clock 13.3% CAGR over FY17-20 with gradual improvement in profitability margin through operating leverage.

Chart 7: Strategic focus on Australian business



Source: Company data, I-Sec research

Chart 8: Steady revenue growth momentum in Australia

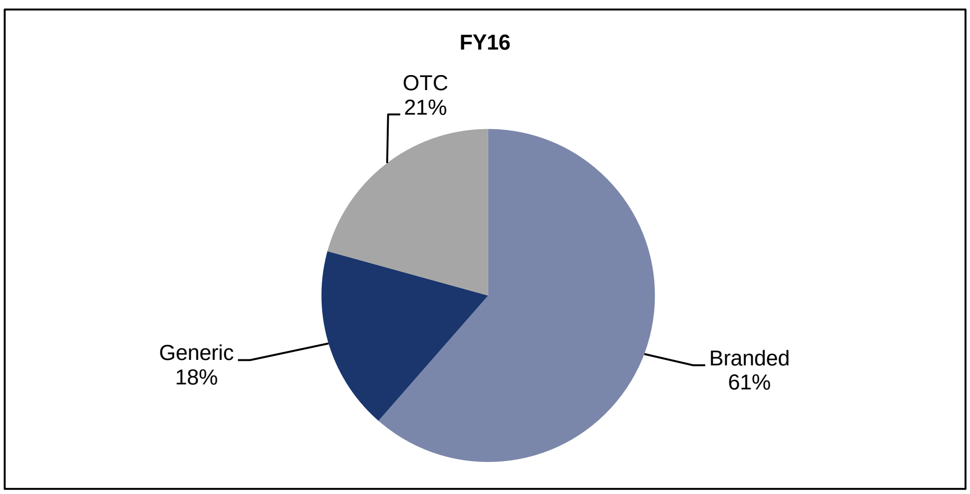


Source: Company data, I-Sec research

Favourable market dynamics in Australia

The pharmaceutical market of Australia was estimated at US$13.5bn in CY16 and is expected to grow at 0-3% over next five years largely driven by increase in generic penetration, better access to pharmaceutical products, launch of new drugs. The generic drug market size is ~US$2bn in Australia and is highly consolidated with top three players having ~75% market share. Strides (Arrow) is the third largest player in terms of value. The generic penetration is relatively lower in Australia at ~60% due to reimbursement by PBS (Pharmaceutical Benefits Scheme) for branded drugs. PBS is a part of universal health system of Government in Australia which provides subsidised medicines at affordable prices to local people and most of the drug sales happen through this route. The generic penetration is expected to rise going forward as list of medicines under PBS scheme are expected to be brought down by government to promote generics. Large part of growth in Australian pharma market would be led by generics.

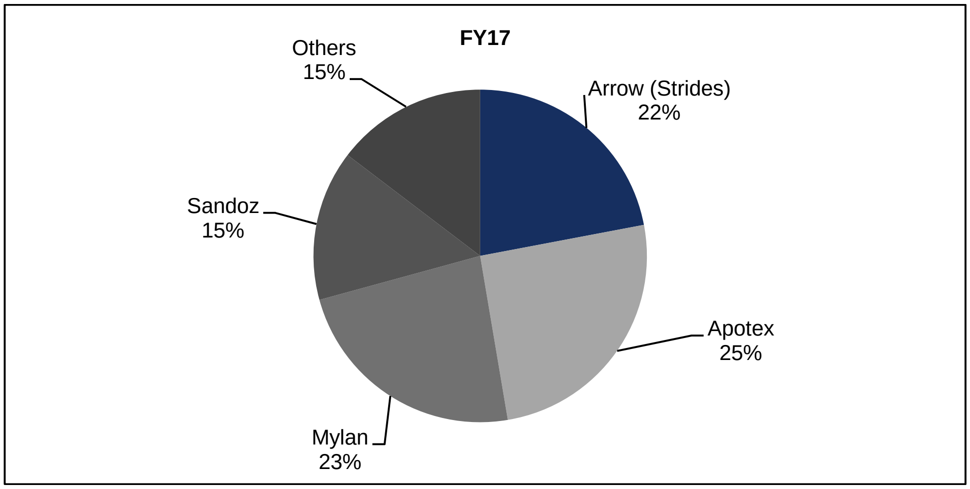
Chart 9: Composition of Australian pharma market



Source: Company data, I-Sec research

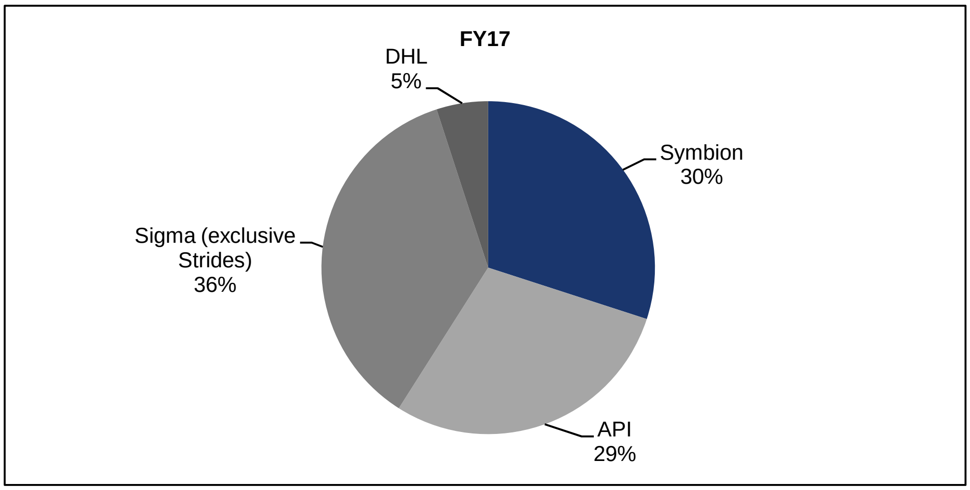
Australian pharma market is highly concentrated with just four pharma companies having ~85% market share in generics market and three wholesalers (distributors) supplying to PBS. These wholesalers prefer to work with manufacturers who can offer wide range of products and hence, the entry barrier exists for new players. There are over 5,000 pharmacies in Australia and these pharmacies are tied up with one of the three wholesalers. Strides has entered a ten-year exclusive agreement with Sigma, the largest wholesaler in terms of market share.

Chart 10: Market share of key generic companies in Australia



Source: Company data, Industry, I-Sec research

Chart 11: Market share of key wholesalers in generic market



Source: Company data, Industry, I-Sec research

Entered several acquisitions and partnerships to strengthen base

Strides has ventured into several M&As and partnerships to create solid base in Australia in terms for product development, manufacturing and marketing. The entry into this geography was made through acquisition of generic business of Aspen (Arrow) for ~AUS$380mn in May'15. This facilitated immediate entry with ready product basket and distribution arrangement. Post this, it acquired controlling stake in Generic Partners (GP) to gain access to latter's developmental and registration capabilities. GP had basket of more than 100 products including 47 commercialised, 22 pending for approval, and pipeline of 32 products. GP is a B2B player with customer base of top five generic pharma companies including Arrow. Recently, Strides acquired Australian operations of Amneal Pharma to improve upon product offerings and market share.

For distribution, Strides has entered an exclusive arrangement with Sigma, the largest wholesaler in Australia with market share of ~36%. In addition, the company has entered a ten-year supply agreement with the major pharmacy chain, Pharmacy Alliance, to fortify the supply chain. Pharmacy Alliance has ~10% of the total pharmacies in Australia which would help in improving the scale of business for Strides.

Table 3: Strengthening presence in Australia

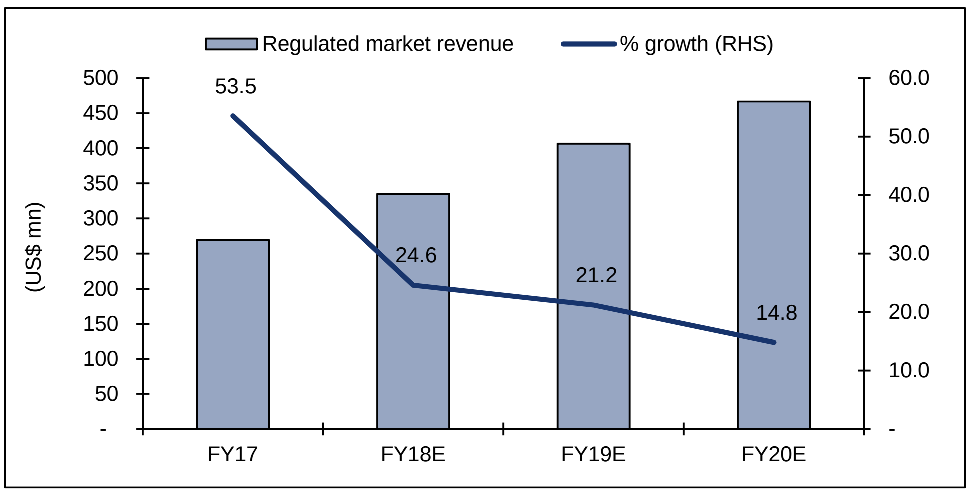
Date	Target	Stake	Amount	Rationale
31-Aug-17	Amneal Pharmaceuticals LLC	100%	AUD17mn	Vertical integration into the Arrow's front-end would deliver improved operating leverage.
8-Feb-16	Generic Partners Holdings Co Pty Ltd	51%	AUD15mn	Access to 47 commercialised marketing authorizations making with a portfolio of over 180 molecules and provides access 22 registrations pending approval with TGA with a pipeline of 32 molecules including host of drugs going off patent in future.
21-May-15	Aspen Pharmacare Holdings Ltd	100%	AUD380mn	The business, which will operate under the Arrow Pharmaceuticals brand, will sell ~140 generic Rx drugs and an extensive range of OTC products.

Source: Company data, I-Sec research

Regulated markets revenue to grow strong

We expect total revenue from regulated markets to clock 20.1% CAGR over FY17-20 to US$467mn led by strong growth in US generics. We estimate 31.1% CAGR in US revenue to US$214mn led by recently launched *generic Lovaza and Potassium citrate* with limited competition and launch of 8-10 new products every year. Australia and EU revenue would register steady 14.7% and 9.6% CAGRs respectively over FY17-20. We see upside in growth in Australia if the company is able to increase the market share higher than our expectations which the company is aiming for.

Chart 12: Regulated markets revenue to clock 20.4% CAGR

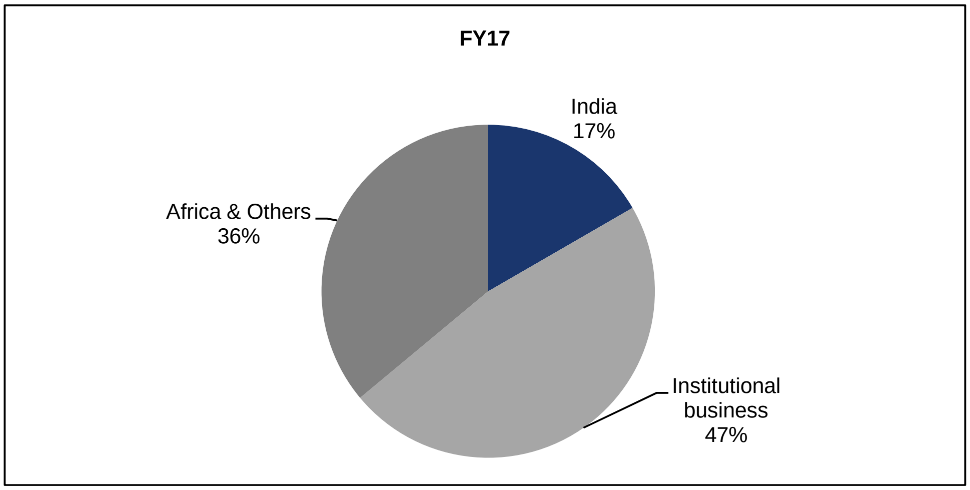


Source: Company data, I-Sec research

Emerging markets business on stable growth path

Strides' emerging markets business consists of India, Africa and institutional supplies (largely in Africa) and contributes ~36% to total revenue. The focus of the company is on branded formulations in India and Africa as the generic business in Africa has already been divested. We expect emerging markets revenue to see steady growth in mid-teens with improving profitability considering branded business and management's focus on margin improvement after building decent scale from organic and inorganic means.

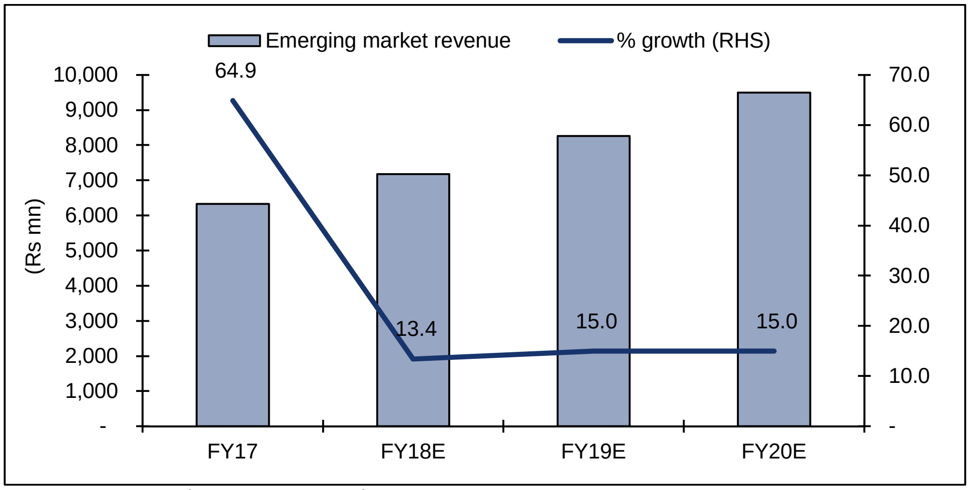
Chart 13: Break-up of Emerging markets business (pie chart)



Source: Company data, I-Sec research

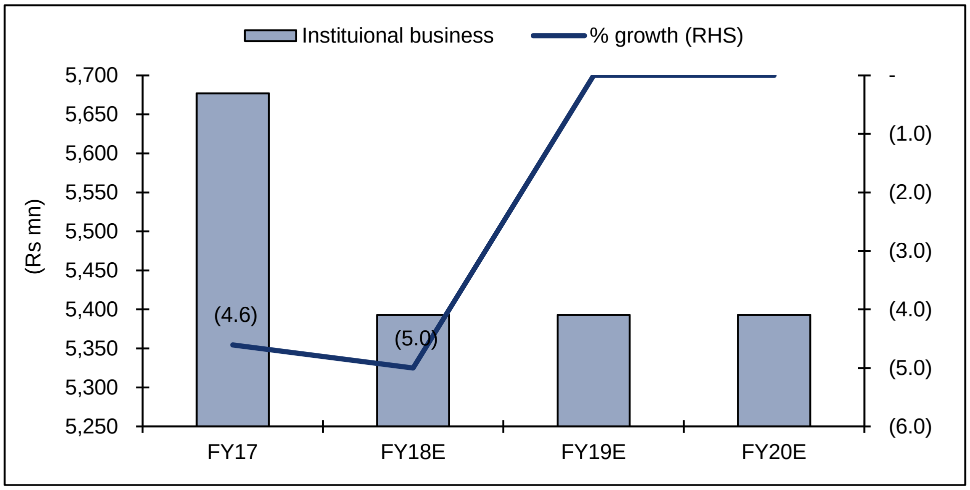
We expect revenue from emerging markets and institutional business to clock 7.4% CAGR over FY17-20. The lower growth rate is mainly due to our assumption of flattish institutional business, though, we expect 14.5% CAGR in branded emerging markets business.

Chart 14: Steady growth momentum in emerging markets (India + Africa)



Source: Company data, I-Sec research

Chart 15: Institutional business to remain largely flattish



Source: Company data, I-Sec research

We expect emerging markets business growth would be broad based across India and Africa. The company has built India branded business through organic and inorganic means. Strides' focus is largely on chronic therapies in India such as anti-diabetes, CNS, cardiac, women healthcare, pain, and this would help it grow faster than the industry. In terms of distribution reach, the company has built field force strength of 750 MRs, relation with ~3,500 stockists and reach to over 80,000 doctors. It made the following acquisitions to scale up India business portfolio and distribution reach:

- Acquired seven brands from J&J in derma, pain and antiemetic segments and acquired majority stake in Medispan's domestic branded business with presence in nutritional, probiotic and gastro segments for an undisclosed sum. The combined sales of both these acquisitions were Rs320mn in FY16.
- Acquired CNS division (Solus and Solus care) of erstwhile Ranbaxy from Sun Pharma for Rs1.7bn along with the associated employees in Sep'15. The annual sales of brands under these divisions stood at Rs920mn as per IMS Jul'15 data.
- Acquired majority stake (74%) in India branded generics business of Bafna Pharmaceuticals in Jul'14 for a consideration of Rs481mn. This acquisition provided global rights to Bafna's flagship brand Raricap which had annual revenue of Rs200mn and strengthened women and child care portfolio of Strides.

In Africa, Strides is present in both the branded and generics market and has been growing at faster than the industry growth rate. Within Africa, the company has footprint in 40+ countries and is a well-established player in West Africa. It has built a field force of 250 MRs who are covering about 30,000 doctors. In terms of product pipeline, Strides already has 750 product registrations and a pipeline of 500 additional product registrations. The strategy of the management is to focus on brands driven chronic therapies to gain leadership position in key therapies in Sub-Saharan African branded generic market. Strides exited the generic business in Africa and expanded footprint in East Africa through following transactions:

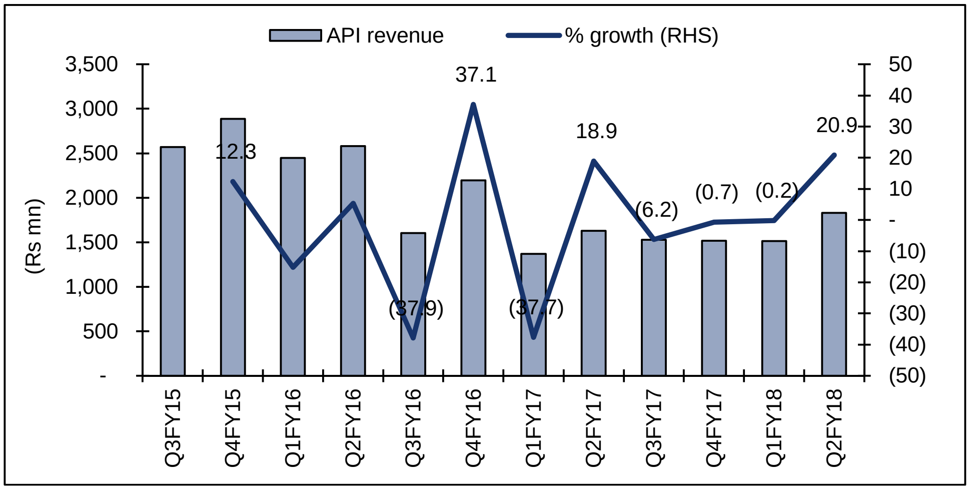
- The company divested the generic business in Africa recently including six facilities and would now focus on branded business. The divested business had revenue of US$21mn with EBITDA of US$1.4mn and was sold for US$16mn in cash deal.

- To expand into East Africa, Strides acquired controlling (51%) stake in Universal Corporation in Feb'16 for a consideration of US$11mn. Universal Corporation is Nairobi-based manufacturing and marketing company and has strong presence in the East Africa. It has front-end business and has supply contracts with key donor agencies. Further, Universal's facility is one of the only two WHO Pre-Qualified sites in Sub–Saharan Africa, other than South Africa.

API demerger is a value unlocking initiative

API business contributed 15.2% to total revenue in FY17 and 18.2% in H1FY18. The company announced demerger of third party API business into a separate listed entity (Solara) along with the human API business of Sequent Scientific. Strides would continue to keep captive API manufacturing for vertical integration status and the focus of the company would be largely on B2C segment. We believe this move would improve overall profitability metrics of Strides and help in growing the formulation business faster with dedicated focus.

Chart 16: API business revenue trend



Source: Company data, I-Sec research

The API business of Strides had basically come from Shasun merger which got merged in FY16. The company has strong track record of compliance and the facilities are approved by USFDA. The API portfolio of Strides included several high value products such as sevelamer (*Renvela*) which had annual market size of US$1.8bn+ for formulation products. Strides is one of the five large companies who supply *Ibuprofen* API to US market and holds strong market share in this product. We believe this demerger would enable the company to have dedicated focus on both the business verticals (formulations and APIs) separately and would lead to improvement in growth trajectory. We value API business at R72/share for Strides shareholders based on 8xSep'19E EBITDA.

Table 4: Valuation of API business for Strides shareholders

(Rs mn)	FY18E	FY19E	FY20E
Revenue	**10,138**	**11,993**	**13,391**
Strides	6,688	8,026	8,828
Sequent	3,450	3,968	4,563
EBITDA	**1,521**	**1,799**	**2,009**
Sep'19 EBITDA			1,904
Target EV/EBITDA (x)			8
EV			15,230
Less: Debt			4,500
Mkt Cap			10,730
Strides' stake in Solara 60%			6,438
No of shares			89
Value per share (Rs)			**72**

Source: Company data, I-Sec research

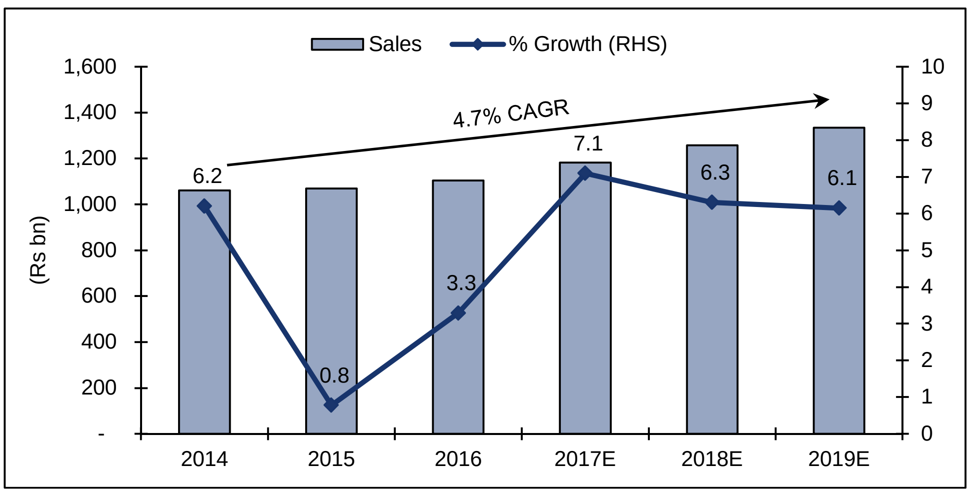
Pharmaceuticals Industry

- We believe increased regulatory issues pertaining to USFDA and NLEM are temporary hiccups for growth and expect recovery once base stabilises in FY17 on the back of faster ANDA approvals in the US and recovery in domestic branded formulations business.
- Clearance in 483 observations and limited instances of warning letters or import alerts in CY16-YTD indicate increased regulatory compliance by the companies, hence potential for growth recovery.
- Mergers and Acquisitions (M&A) would continue to be in focus for large players to achieve scale, access to new technologies/portfolio, and growth.

Global pharma market to clock 4.7% CAGR

Pharmaceutical is one of the largest industries globally in terms of size (over US$1tn) and involves considerable technical, research and development expertise. The market size of global pharmaceutical industry was estimated at US$1.06tn in CY14 and is expected to clock 4.7% CAGR over CY14-19 to reach to US$1.33tn. Growth would be driven by launch of new innovative products, increasing generic penetration in regulated markets, and strong growth in emerging markets. Biosimilars would be the new long-term growth area for global generic pharmaceutical companies as this is still an untapped opportunity and competition would be limited due to the complexity involved.

Chart 17: Global pharma market growth trend

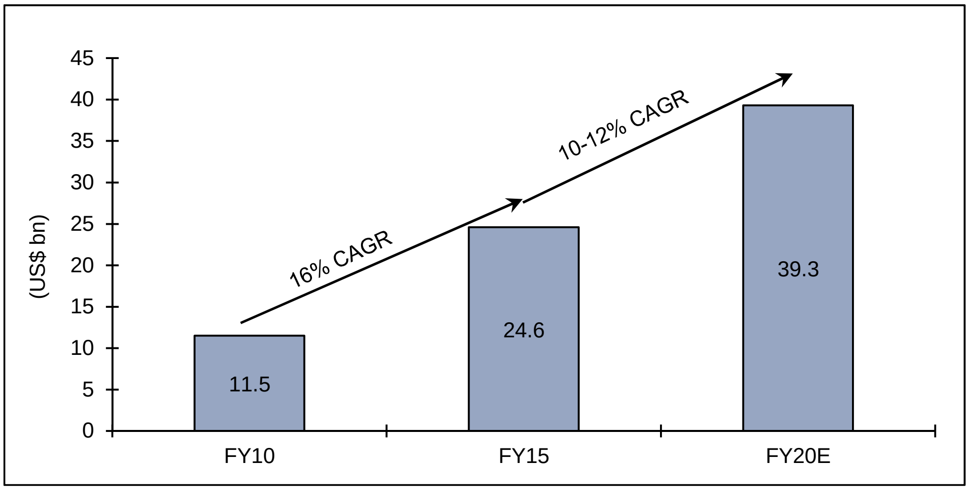


Source: Industry data, I-Sec research.

Exports from India growing in double-digits

Industry data suggests that exports of pharmaceutical products from India have registered a 16% CAGR (in value terms) over FY10-15 and are expected to clock ~12% CAGR over FY15-20. Growth would be driven largely by the US generics business on account vast potential (patent expiries, launch of speciality products and increasing generic penetration). Apart from the US, growth would be driven from fast-growing emerging markets and outsourcing opportunities in APIs. Over CY15-17, drugs worth ~US$72bn are expected to go off-patent in the US, thus providing growth opportunities for generics players.

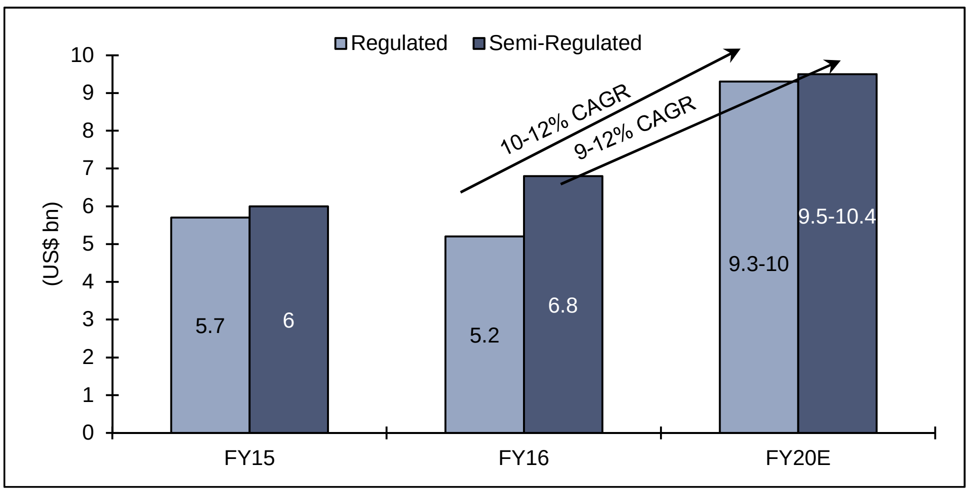
Chart 18: Exports – Growth trend



Source: Industry data, I-Sec research.

Export (mainly formulation exports) to regulated markets would be a major focus area for the companies considering the size and potential of the market. As per industry reports, formulation exports to regulated markets from India are expected to grow at 10-12% and that to semi-regulated markets to clock 9-12% CAGR over FY16-20.

Chart 19: Export to regulated and semi-regulated markets

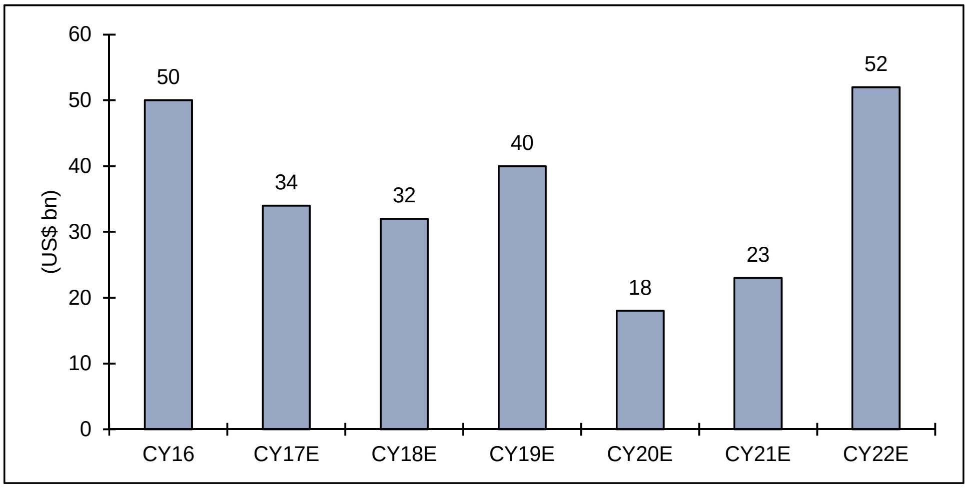


Source: Industry data, I-Sec research

US generics – Large opportunity

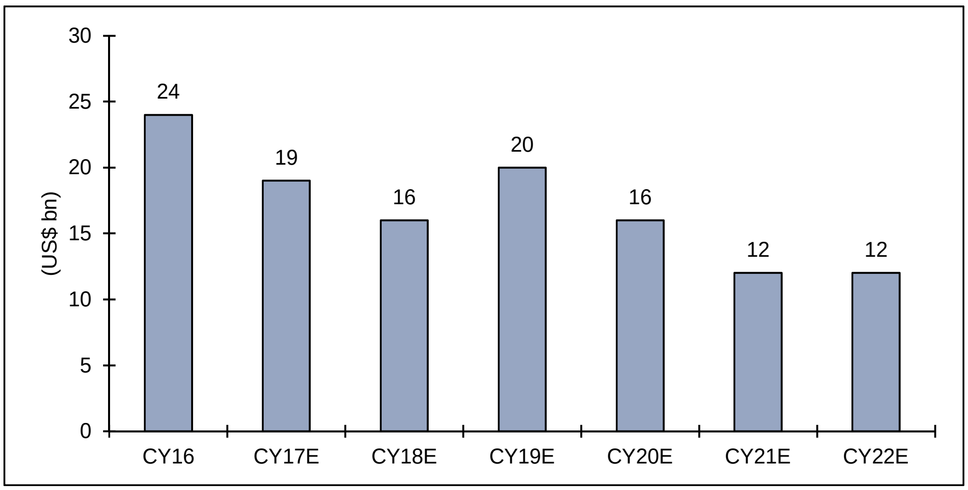
As per industry reports, the size of US pharmaceutical market stood at ~US$462bn in CY16, and the same is expected to clock 6-9% CAGR to US$645bn-675bn over CY16-21, aided by an ageing population, healthcare reforms and the focus on speciality drugs for complex diseases. In addition, the US was the top destination for pharma exports in FY16 with ~30% share of pharma exports from India, amounting to US$5.1bn. The US generics market was worth ~US$70bn in CY16 and is expected to grow driven by a huge number of patent expiries and increasing generics penetration.

Chart 20: Value of patent expiries



Source: Industry data, I-Sec research.

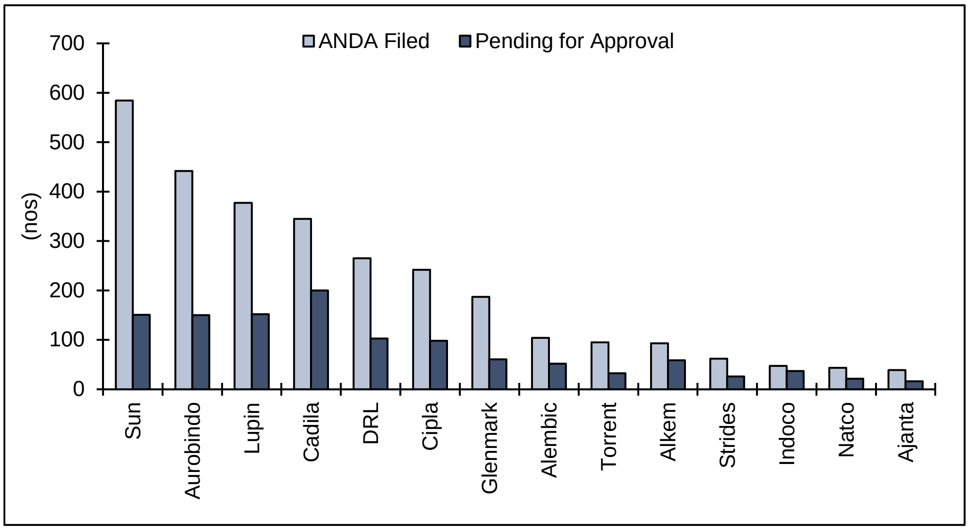
Chart 21: Expected loss of sale post expiries



Source: Industry data, I-Sec research.

Indian generics companies are well positioned to harvest the aforementioned opportunity considering the strong ANDA pipeline already in place, focus on complex and differentiated product filings, and the past successes in garnering a meaningful market share.

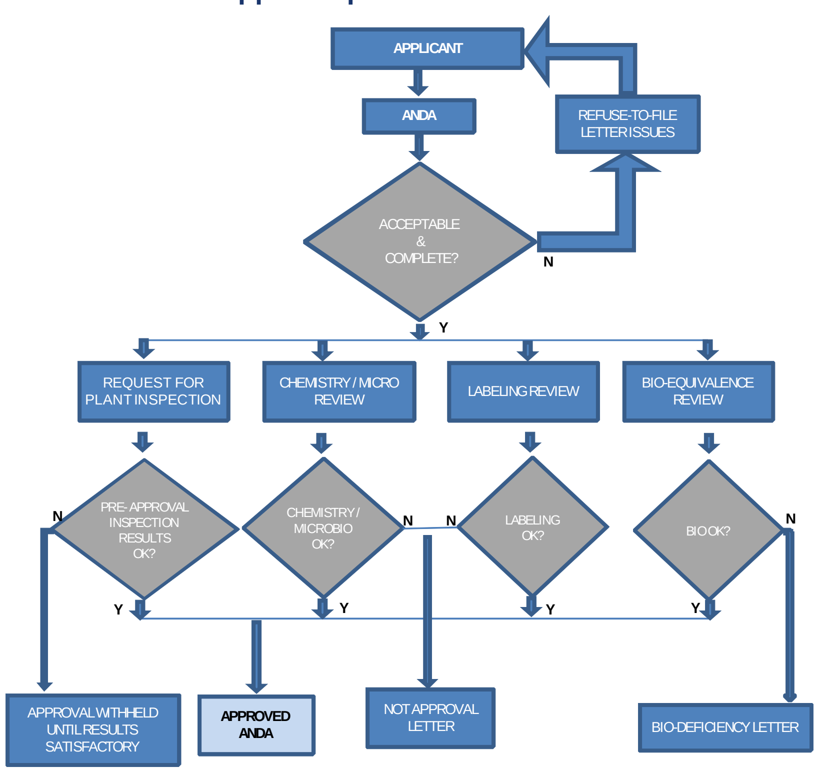
Chart 22: Strong ANDA pipeline



Source: Industry data, I-Sec research.

The ANDA approval-process time has considerably lengthened in the past few years due to huge backlog at the USFDA and increasing regulatory non-compliances. The average length for an ANDA approval has increased to more than four years now. However, with the introduction of GDUFA fees and increased resources at USFDA, the duration is expected to decline to 15-18 months for review of ANDAs. We believe filing for differentiated products and complex generics would be the main growth and profitability driver in future due to limited competition.

Chart 23: ANDA approval process



Source: Industry data, I-Sec research.

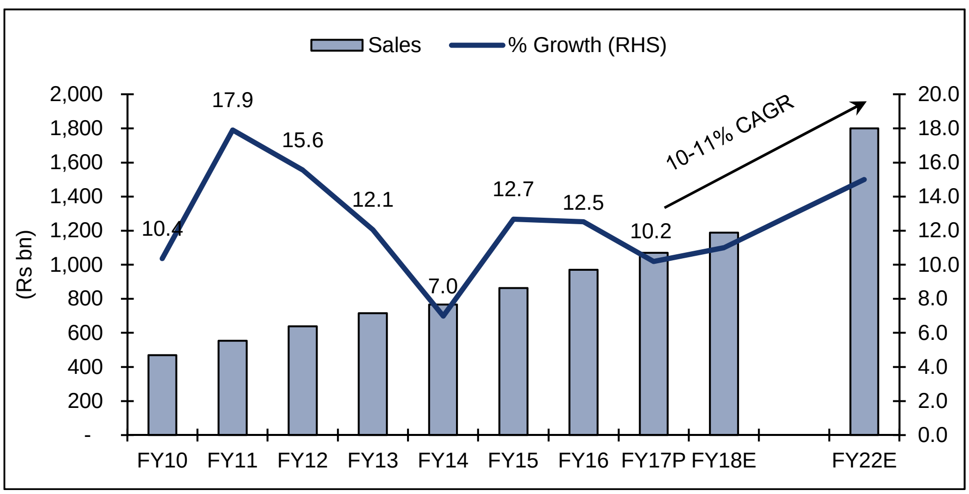
India formulations industry going through regulatory challenges

- The branded formulations business in India has a structurally strong business model, sustainable revenue stream from established brands, a growing population base, strong R&D capabilities and a high degree of profitability.
- Regulatory challenges have risen in the recent past in terms of growing list of NLEM (products under price control) and the ongoing issue of FDC (Fixed Dose Combinations) ban. However, we believe these are temporary hiccups and would settle to a new base in FY17.
- We expect the approximate mid-teen revenue growth to continue, considering increasing urbanisation leading to chronic diseases, greater awareness and rising healthcare spend.

Structurally positive business model

We expect the steady growth momentum in the Indian pharmaceutical market (domestic formulations) to continue, boosted by the rising share of chronic categories in lifestyle disorders, mounting per-capita income, rising share of medical expenditure in consumer spend and volume growth. Overall, we expect revenues of the Indian pharmaceutical sector to register 10-11% CAGR over FY17-22, to over Rs1.8tn, in line with its past average (except CY13, which was hit by implementation of the new drug-pricing policy). Key growth driver would be the increasing incidence of chronic diseases.

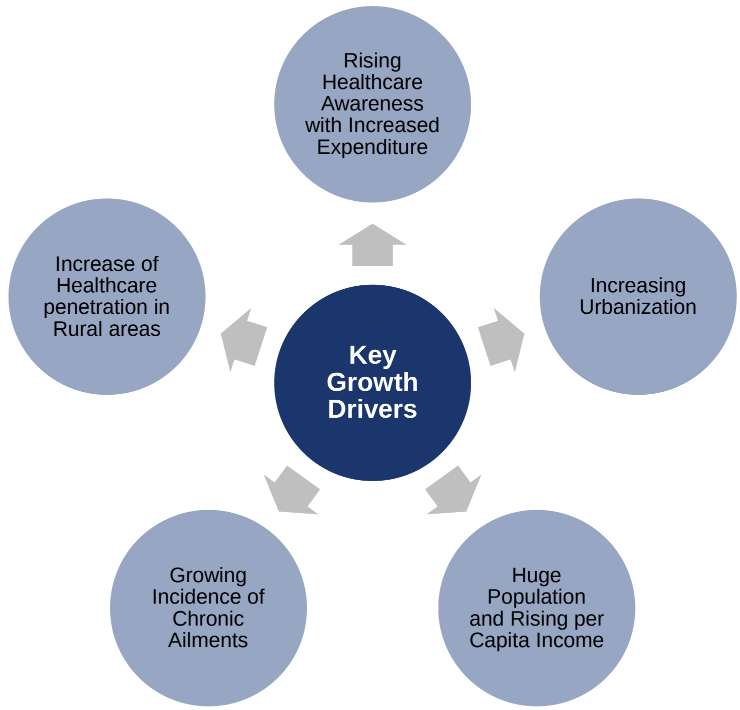
Chart 24: Growth in the Indian pharmaceutical sector



Source: Industry data, I-Sec research

We believe qualitative factors such as increasing healthcare awareness, urbanisation spread, population size, better access to essential medicines, and higher healthcare penetration would play crucial roles in sustaining the strong growth in the domestic pharmaceutical market.

Chart 25: Key growth drivers

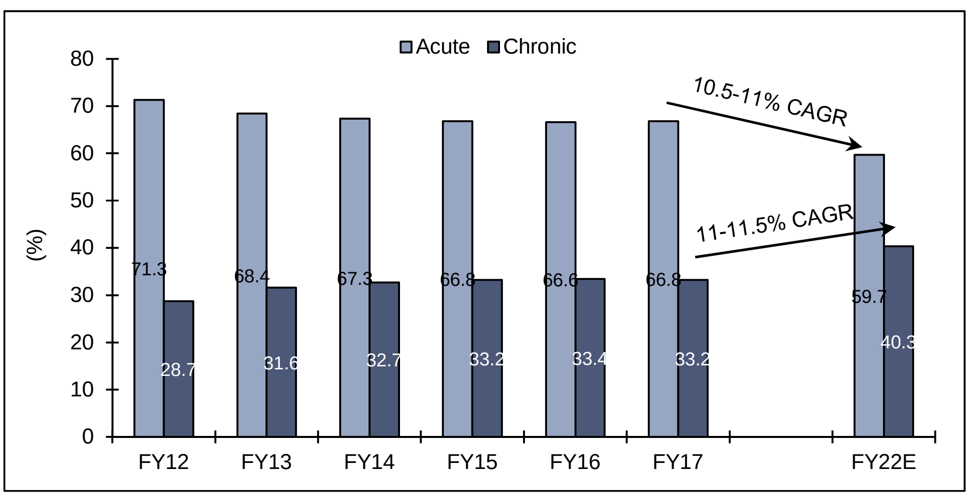


Source: Industry data, I-Sec research

Increasing contribution of the chronic segment, the key driver

Contribution from chronic categories has been rising over the years due to the increasing incidence of lifestyle disorders and urbanisation. The past few years have seen a spiralling up of lifestyle-related disorders such as diabetes, asthma, obesity, certain types of cancer, and cardiovascular and gastrointestinal diseases. Changing lifestyles have also led to a significant rise in cases of high blood pressure and elevated cholesterol levels. The share of chronic categories in the Indian pharma market revenue has moved up from 28.7% in FY12 to 33.2% in FY17, and we expect it to rise to 40.3% by FY22, driven by the high growth.

Chart 26: Increasing contribution from chronic segments



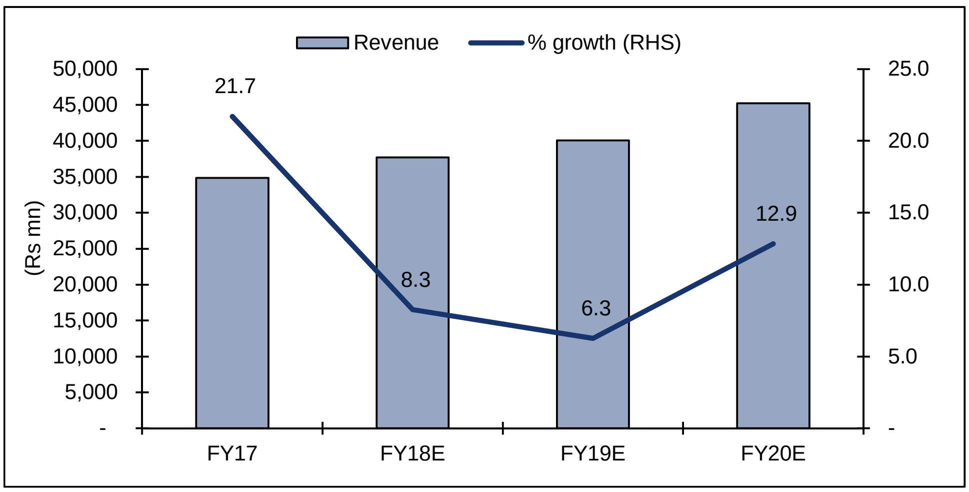
Source: Industry data, I-Sec research.

Financial performance

Expect revenue CAGR of 15% over FY17-20 (excluding API)

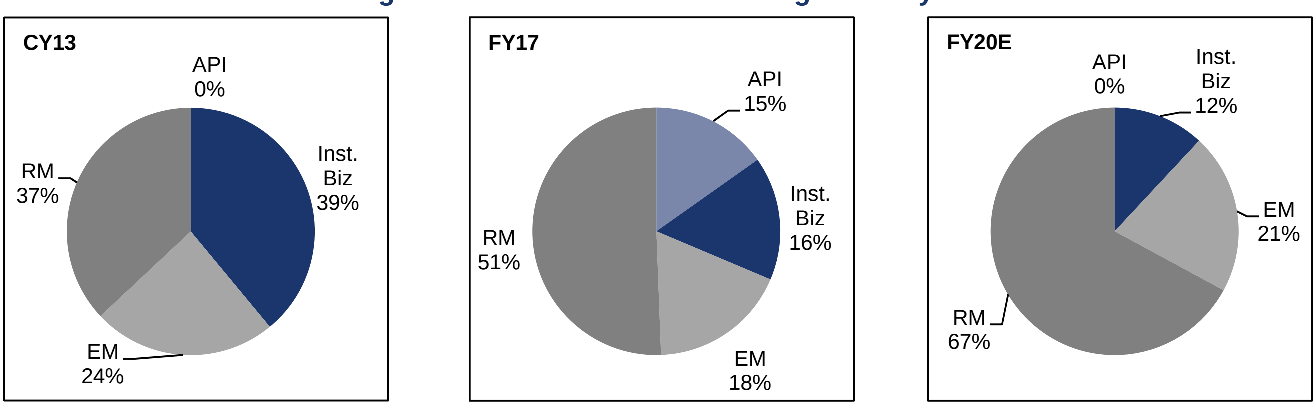
Strides has reported healthy revenue CAGR of 25.4% over FY14-17 on the back of strong performance in the regulated markets which grew 35% during the same tenure. We expect growth momentum to continue going ahead in regulated markets though at a lower rate (19.5% revenue CAGR) over FY17-20 led by continued strong traction in US business (31.1% CAGR led by new launches on low base), Australia business (14.7% CAGR led by acquisition of Generic Partners and increase in market share), and steady growth in EU market (9.6% CAGR led by new product launches). Emerging markets is expected to grow at 7.4% led by steady growth in the Indian and Africa markets. Overall, we expect revenue to clock CAGR of 15% over FY17-20 excluding the API business which is being divested to Solara in FY18. Including the API business, we expect CAGR of 9.1%.

Chart 27: Revenue growth trend



Source: Company data, I-Sec research

Chart 28: Contribution of Regulated business to increase significantly



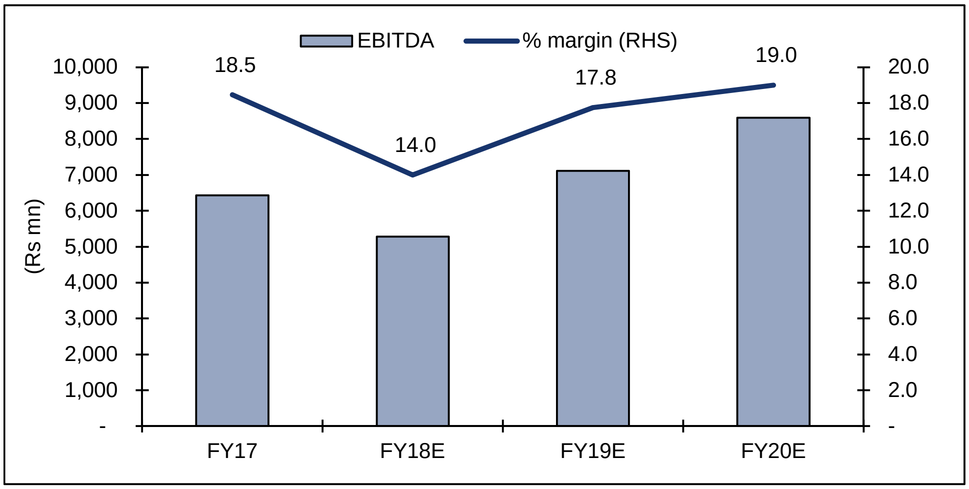
Source: Company data, I-Sec research

EBITDA margin to expand 500bps over FY18-20E

We expect Strides to register 50bps EBITDA margin expansion over FY17-20 to 19%. However, FY18 would witness a drop in margins led by weak institutional business and domestic performance in H1FY18. Over FY18-20E, we expect margin to expand

500bps led by divestment of low margin API business in FY18 and higher growth from regulated markets (US & Australia) which generate higher margins. In absolute terms, we expect EBITDA to clock 27.6% CAGR over FY18-20 to Rs8.6bn.

Chart 29: 500bps expansion in EBITDA margin over FY18-20E

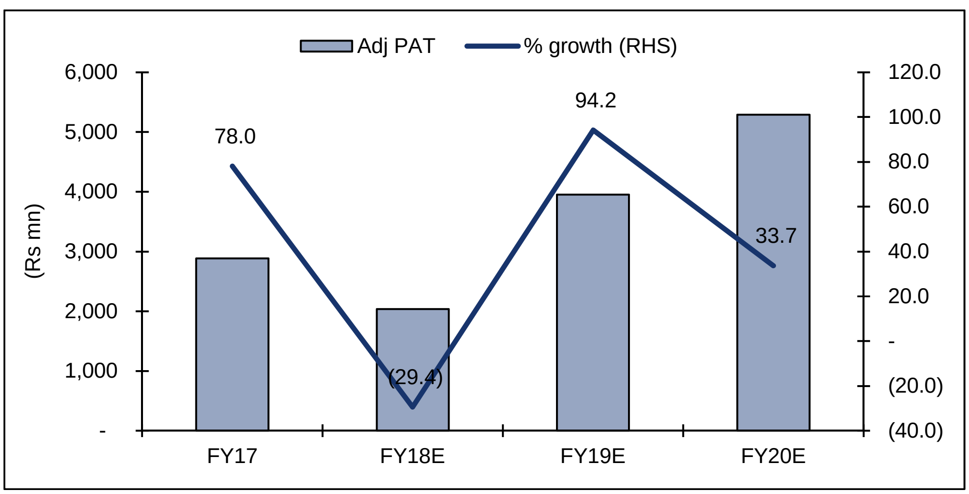


Source: Company data, I-Sec research

Expect adjusted net profit to grow at 61.1% CAGR over FY18-20

Considering the strong revenue growth trajectory and improvement in EBITDA margin, we believe Strides would be able to report healthy bottomline growth of 22.4% over FY17-20E. However, we expect the company to register 61.1% adjusted net profit CAGR over FY18-20 to Rs5.3bn. Net profit margin would also improve 630bps over FY18-20E to 11.7%, aided by EBITDA margin expansion.

Chart 30: PAT to more than double over FY18-20

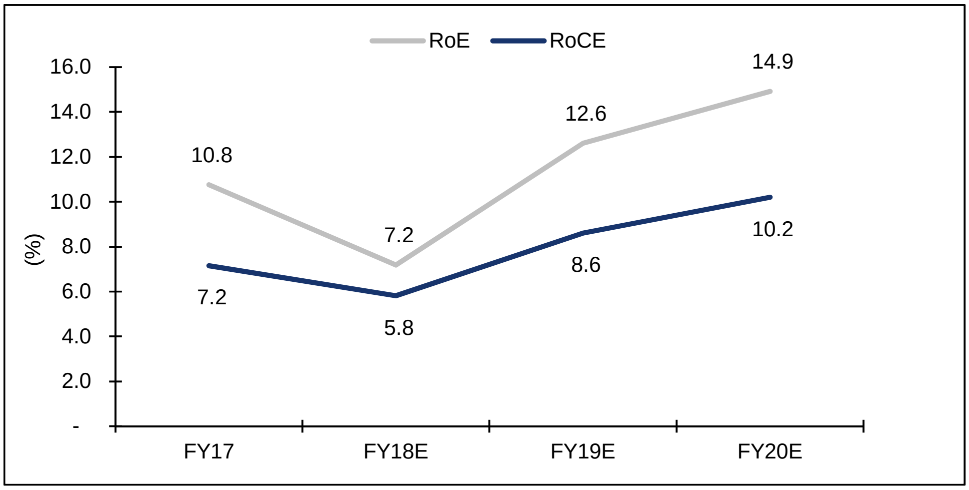


Source: Company data, I-Sec research

Expect strong improvement in return ratios

RoE and RoCE decreased significantly in FY15 post its sale of Ascent Pharma (Australia) and Agilia Specialities (US). However, return ratios have steadily improved thereafter. Post its divestment of the API business to Solara in FY18 the ratios would witness a small fall but is expected to grow. RoE would fall to 7.2% in FY18 from 10.8% in FY17 but recover to 14.9% by FY20 with profit growth rate led by strong performance in the regulated markets. RoCE and RoIC would also improve to 10.2% and 13.4% by FY20 from 5.8% and 7.7% in FY18 as we expect debt repayment over the next three years and higher growth in more profitable businesses.

Chart 31: Return ratios to improve

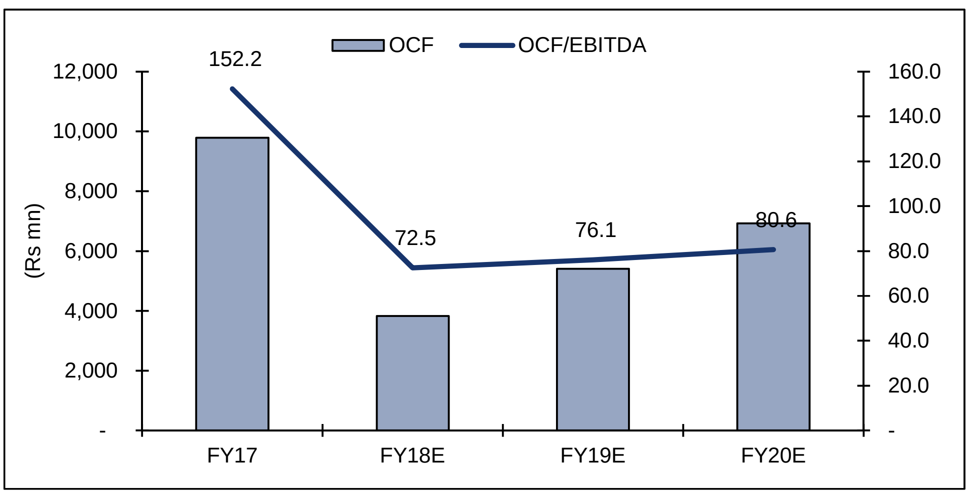


Source: Company data, I-Sec research

Strong free cashflow generation

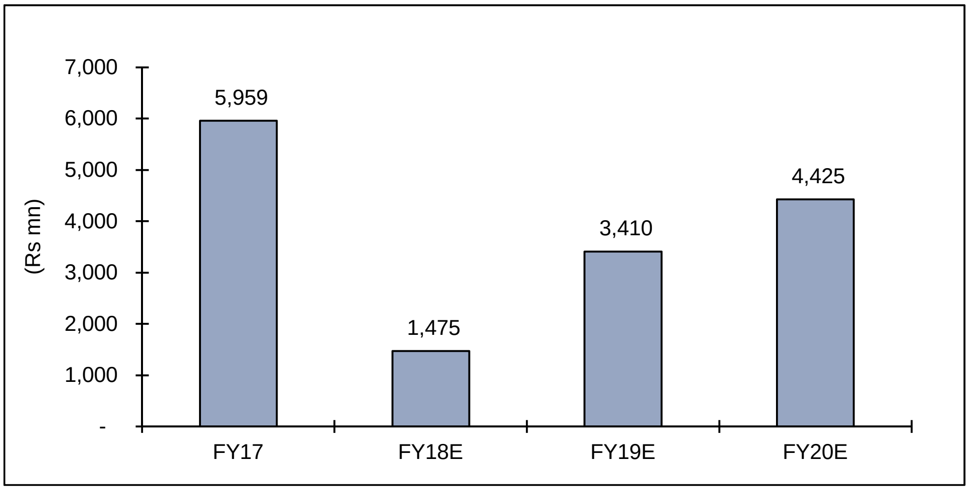
Considering the steady revenue growth trajectory, improving EBITDA margin and stable working capital cycle, we believe Strides would see strong growth in operating cashflow (OCF) and free cashflow (FCF). We expect OCF to clock 34.5% CAGR over FY18-20 to Rs6.9bn in FY20 and the ratio of OCF to EBITDA to remain stable over 70%. The company would be spending about Rs6.9bn as capex over the next three years, largely for maintenance capex. We expect FCF generation of ~Rs10bnbn over FY18-20.

Chart 32: OCF/EBITDA to be strong



Source: Company data, I-Sec research

Chart 33: Strong free cashflow generation



Source: Company data, I-Sec research

Key assumptions

Increasing genericisation in the US coupled with expiring patents on new products and higher ANDA approvals from the USFDA post GDUFA-II implementation would lead to strong growth in the market at the low base of the company. Higher genericisation in the Australian market and its alliance with local pharmacies coupled with recent acquisition would pave way for sustainable growth in that geography. Strong growth in regulated markets along with steady growth in the Europe, emerging markets and its institutional business would help the company's revenues to register CAGR of 15% over FY17-20 (Ex-API business). We expect EBITDA margin to recover to 19% from a drop to 14% in FY18 led by higher profitability from the regulated markets business and exit from low margin API business.

Table 5: Key assumptions

(Rs mn)

	FY17	FY18E	FY19E	FY20E	Comments
PSAI/API	5,336	3,344	-	-	To be demerged into Salora wef 1st Oct 2017
Emer Mkt & Institutional	12,007	12,573	13,650	14,888	Emerging market to grow at 15% CAGR and Institutional business to remain flattish
Regulated markets	17,762	21,794	26,420	30,331	Strong growth to be led by US and Australia
Net revenue	**34,834**	**37,711**	**40,069**	**45,219**	
EBITDA	6,429	5,280	7,112	8,592	
EBITDA margin (%)	18.5	14.0	17.8	19.0	Higher growth in regulated markets and demerger of API business to lead margin expansion
PBT	2,971	2,592	4,850	6,418	
PBT Margin (%)	8.5	6.9	12.1	14.2	
Tax rate (%)	15.8	15.0	15.0	15.0	Management commentary
PAT	2,886	2,036	3,955	5,288	
PAT Margin (%)	8.3	5.4	9.9	11.7	PAT margin expansion led by EBITDA margin increase
Capex	3,828	2,350	2,000	2,500	

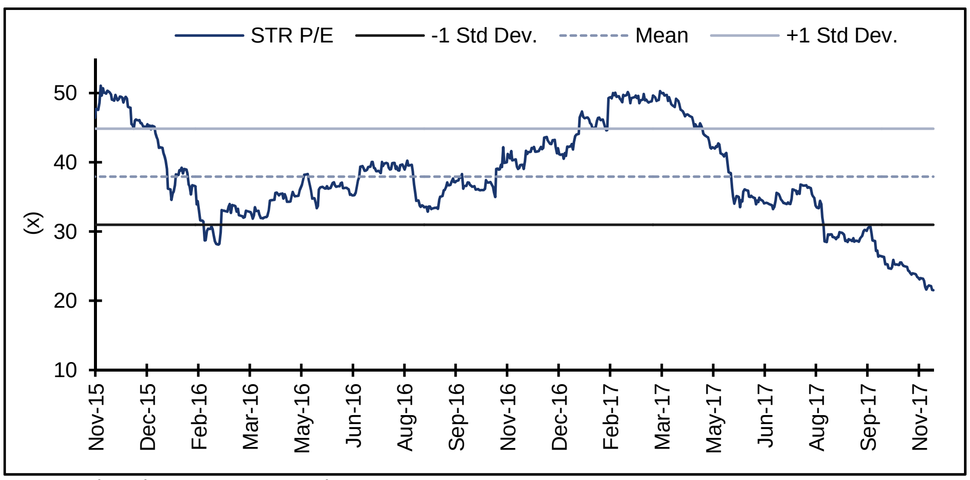
Source: Company data, I-Sec research

Valuations and risks

We expect Strides' earnings to clock CAGR of 61.1% over FY18-20 driven by revenue CAGR of 9.5% and EBITDA margin expansion from 14% in FY18 to 19% in FY20. Further, RoE and RoCE would improve significantly considering huge PAT growth and demerger of API business. We believe the valuation has upside potential considering the company's clear USFDA records, new launches and low base to drive strong growth in US, pick up in the Australia business post its acquisition of Generics Partners and Arrow's pact with Pharmacy Alliance.

The stock currently trades at attractive valuations of 17.7x FY19E and 13.2x FY20E earnings and EV/EBITDA multiple of 12.4x FY19E and 9.8x FY20E. The stock has traded at an average P/E of 38x 1-year forward earnings over past two years and has recently fallen due to weak H1FY18 performance and industry concern for US generic pricing. Our estimates are significantly lower than consensus (15-30% on EPS) and downside looks protected as valuation also appear reasonable on our estimates at 13.2x FY20E EPS vs peers' average of 16.4x FY20E. Hence, we initiate coverage on Strides with a BUY rating and SoTP-based target price of Rs1,002/share, upside potential of 28.2%. We value the stock at P/E of 18xSep'19E EPS of continuing business and Rs72/share for value in API business (Salora – 60% stake for Strides' shareholders) based on 8xSep'19E EBITDA.

Chart 34: 1-year forward P/E



Source: Bloomberg, I-Sec research

Table 6: Comparative valuations

Company	CMP (Rs)	M-Cap (Rs bn)	Revenue CAGR % (FY18-FY20)	EV/Sales (x) FY19E	EV/Sales (x) FY20E	EBITDA CAGR % (FY18-FY20)	EV/EBITDA (x) FY19E	EV/EBITDA (x) FY20E	EPS CAGR (%) (FY18-FY20)	P/E (x) FY19E	P/E (x) FY20E
Alembic	516	97	15.6	2.6	2.2	23.9	11.7	9.5	25.1	18.1	15.2
Alkem	1,995	239	14.5	3.2	2.7	22.3	16.8	13.9	26.4	20.7	17.3
Aurobindo	709	415	8.3	2.3	2.0	7.2	9.7	8.4	9.5	14.6	13.2
Cadila	448	459	11.5	3.6	3.1	10.1	14.5	12.2	11.6	19.2	16.4
Cipla	605	487	12.8	2.7	2.5	17.4	13.3	11.8	23.1	23.6	19.4
Dr Reddy's	2,337	388	11.9	2.5	2.2	23.2	12.6	10.7	36.8	20.3	16.8
Glenmark	587	166	8.9	1.9	1.7	9.1	9.4	8.0	12.2	15.4	12.9
Lupin	840	379	11.4	2.4	2.0	18.3	11.0	8.8	22.8	19.2	15.2
Natco	932	163	11.3	5.2	4.8	7.4	13.0	13.1	10.0	18.0	18.5
Shilpa Medicare	642	51	23.5	4.8	3.9	29.5	17.6	13.9	38.3	21.7	17.9
Sun	526	1,262	12.8	3.4	2.9	23.4	13.6	11.0	27.5	21.6	18.3
Torrent Pharma	1,258	213	13.6	3.0	2.6	16.2	12.9	10.9	23.3	18.9	15.8
Strides Shasun	**782**	**70**	**9.5**	**2.2**	**1.9**	**27.6**	**12.4**	**9.8**	**61.1**	**17.7**	**13.2**

Company	ROE (%) FY19E	ROE (%) FY20E	ROCE (%) FY19E	ROCE (%) FY20E	ROIC (%) FY19E	ROIC (%) FY20E	EBITDA Margin (%) FY19E	EBITDA Margin (%) FY20E	Net D/E (x) FY19E	Net D/E (x) FY20E
Alembic	22.3	22.3	20.1	20.9	20.5	22.2	22.4	23.1	(0.0)	0.1
Alkem	20.7	21.1	18.9	19.9	18.2	20.0	18.8	19.5	(0.0)	(0.1)
Aurobindo	21.9	20.0	19.0	18.5	21.4	22.3	23.2	23.5	(0.0)	(0.2)
Cadila	25.0	24.2	18.9	20.3	19.3	21.3	25.0	25.4	0.1	(0.0)
Cipla	13.9	14.9	11.2	12.6	11.9	13.8	20.4	21.1	0.0	(0.1)
Dr Reddy's	13.5	14.6	12.5	13.6	12.4	13.6	19.8	20.7	0.1	0.0
Glenmark	18.2	18.5	12.6	13.5	14.4	15.5	20.7	21.2	0.4	0.3
Lupin	12.5	14.2	9.1	11.0	10.2	12.4	21.7	23.4	0.2	0.1
Natco	34.6	26.3	33.5	25.8	39.3	35.5	40.2	36.9	(0.2)	(0.3)
Shilpa Medicare	20.2	20.3	16.4	16.9	19.6	20.6	27.3	28.0	(0.0)	(0.1)
Sun	14.0	14.7	11.2	12.0	14.8	16.7	24.9	26.2	(0.3)	(0.4)
Torrent Pharma	21.0	21.7	17.1	18.9	20.3	22.7	23.6	23.8	(0.0)	(0.1)
Strides Shasun	**12.6**	**14.9**	**8.6**	**10.2**	**11.3**	**13.4**	**17.8**	**19.0**	**0.6**	**0.4**

Source: I-Sec research

Risks

Regulatory hurdles

USFDA has become stringent in its inspection over the past few years. Currently all Strides facilities are approved; however, several of its facilities are due for inspection. Any non-compliance could lead to a disruption to supplies in US which is a key growth market for the company.

Delay in profitability improvement in regulated markets

We have assumed >14% EBITDA margin in the company's regulated market FY18 onwards considering strong growth in these markets on a low base. Any delay in new product launches would adversely affect its profitability and in turn impact its growth trajectory.

Currency volatility

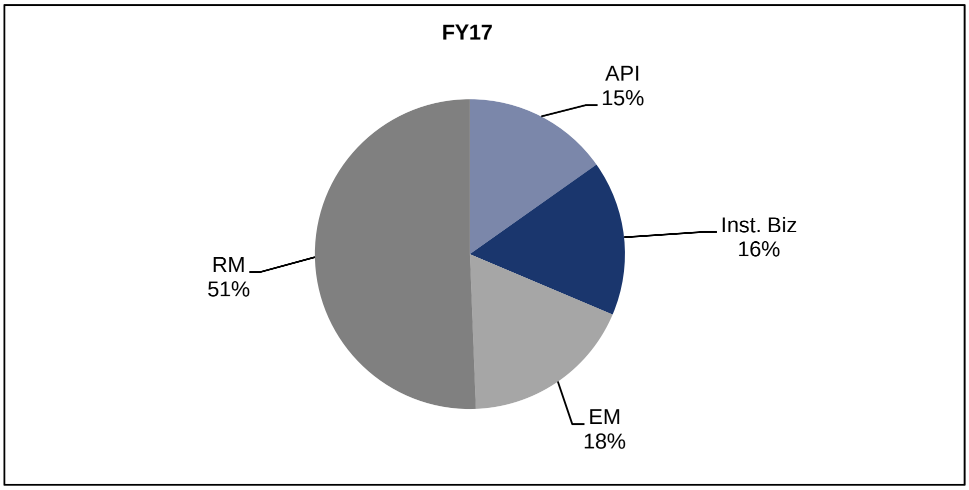
Strides generates more than 85% of its revenues from exports, hence adverse volatility in the currency markets would negatively impact the financials.

Company background and key management personnel

Company profile

Strides Ltd. was incorporated in 1990 as Strides Arcolab Ltd in Bangalore. It was launched the formulations business for emerging market with third-party manufacturing. Post divestment of Ascent (Australia's branded business) in 2012 and Agila (injectables vertical) in 2013, the company entered a restructuring phase post which it has emerged as a diversified, vertically integrated, global pharmaceutical company.

Chart 35: Revenue mix



Source: Company data, I-Sec research

Currently, it focuses on developing niche and complex pharmaceutical products across a wide dosage format for regulated and emerging markets. The company has a portfolio of 26 approved products in the US spanning across soft gel capsules, hard gel capsules, tablets, liquids, creams and ointments, modified and extended release products. The company has undergone several successful inspections from different regulatory bodies around the world highlighting their strong adherence to compliance and quality.

Table 7: Key management personnel

Name	Designation	Background
Mr. Arun Kumar	Founder, Chairman	Has moved to a Non-Executive position effective May 18, 2017. He has been on the Board since inception of the Company in 1990. He holds a degree in Commerce. He was earlier the General Manager of British Pharmaceuticals Limited.
Mr. Shashank Sinha	Managing Director	He completed his MBA from IIM-Lucknow post engineering. He is associated with the company since 2016 and was appointed to the board in May'17. He has a variety of work experience and developed business acumen working at Huhtamaki Oyj, Godrej Consumer, Sara Lee, Reckitt Benckiser and Navis Capital.
Mr. Badree Komandur	Executive director	As a CA, CS, CWA he brings immense financial expertise to the company since Feb'10 when he joined as Group CFO. In May'17, he was appointed to board bringing in 15 years of experience at IT and engineering companies.
Mr. Ramaraju P.V.S	Chief Operating Officer	He has over 23 years of experience in the pharmaceutical industry and specialises in Manufacturing, Quality, Engineering, Sourcing, Warehouse, Distribution, and Planning & Accounts Functions. He is associated with the company for ten years and has led several successful inspections.

Source: Company

Financials

Table 8: Profit and Loss statement

(Rs mn, year ending Mar 31)

	FY16	FY17	FY18E	FY19E	FY20E
PSAI/API	7,314	5,336	3,344	-	-
Emer Mkt & Insti. Biz	9,790	12,007	12,573	13,650	14,888
Regulated markets	11,395	17,762	21,794	26,420	30,331
Net Sales	**28,622**	**34,834**	**37,711**	**40,069**	**45,219**
Less:					
Cost of material consumed	15,023	15,362	17,536	17,029	18,766
Employee cost	3,577	5,881	6,411	6,712	7,461
R&D cost	757	1,361	1,697	2,003	2,261
Others	5,125	5,801	6,788	7,212	8,139
Total Operating Expenses	**24,482**	**28,406**	**32,431**	**32,957**	**36,627**
EBITDA	**4,140**	**6,429**	**5,280**	**7,112**	**8,592**
Depreciation	1,313	1,872	1,914	1,917	2,119
Other income	874	1,689	1,141	1,211	1,289
EBIT	**3,701**	**6,247**	**4,506**	**6,407**	**7,761**
Less: Financial expenses	1,682	2,269	1,914	1,557	1,343
Recurring Pre-tax Income	**1,606**	**2,971**	**2,592**	**4,850**	**6,418**
Less: Taxation	425	470	389	727	963
Less: Minority Interest	(135)	462	167	167	167
Add: Profit/Loss from discontinued operations	(231)	1,959	-	-	-
Net Income (Adjusted)	**1,621**	**2,886**	**2,036**	**3,955**	**5,288**
Extraordinary Items	(414)	(1,006)	-	-	-
Reported Net Income	**1,085**	**3,998**	**2,036**	**3,955**	**5,288**

Source: Company data, I-Sec research

Table 9: Balance sheet

(Rs mn, year ending Mar 31)

	FY16	FY17	FY18E	FY19E	FY20E
ASSETS					
Current Assets, Loan & Advances					
Current investments	12,138	12,795	12,795	12,795	12,795
Inventories	6,131	7,380	8,426	8,562	9,516
Sundry debtors	10,330	9,971	10,794	11,469	12,943
Cash and bank balances	3,046	3,223	1,954	1,890	2,681
Loans and advances	128	86	93	99	112
Other current assets	5,621	6,922	7,479	7,936	8,934
Total Current Assets	**37,394**	**40,377**	**41,542**	**42,752**	**46,981**
Current Liabilities & Provisions					
Trade payables	7,754	7,457	8,512	8,266	9,109
Provisions and other liabilities	4,306	9,253	9,959	10,538	11,802
Total Current Liabilities & Provisions	**12,060**	**16,709**	**18,470**	**18,804**	**20,911**
Net Current Assets	**25,334**	**23,667**	**23,071**	**23,948**	**26,070**
Investments	**525**	**2,451**	**2,451**	**2,451**	**2,451**
Fixed Assets					
Tangible Assets	9,561	9,783	6,469	6,552	6,933
Intangible assets	14,067	16,142	16,142	16,142	16,142
Goodwill	9,267	9,670	9,670	9,670	9,670
Total fixed assets	**32,895**	**35,594**	**32,280**	**32,363**	**32,744**
CWIP	**2,787**	**2,045**	**2,045**	**2,045**	**2,045**
Miscellaneous Expenses not written off	-	-	-	-	-
Total Assets	**61,541**	**63,757**	**59,847**	**60,807**	**63,310**
LIABILITIES AND SHAREHOLDERS' EQUITY					
Shareholders Fund					
Equity share capital	893	894	894	894	894
Reserves and surplus	25,685	26,210	28,752	32,233	36,888
Total Shareholders Fund	**26,579**	**27,104**	**29,647**	**33,128**	**37,782**
Borrowings					
Long term	26,270	16,377	10,877	8,877	6,877
Short term	7,005	13,940	12,440	11,440	10,440
Total Borrowings	**33,275**	**30,317**	**23,317**	**20,317**	**17,317**
Deferred Tax Liability	**(502)**	**88**	**88**	**88**	**88**
Minority interest	**502**	**1,640**	**1,807**	**1,974**	**2,142**
Other long term liabilities	**1,688**	**4,608**	**4,989**	**5,301**	**5,982**
Total Liabilities & Shareholders' Equity	**61,541**	**63,757**	**59,847**	**60,807**	**63,310**

Source: Company data, I-Sec research

Table 10: Cashflow statement

(Rs mn, year ending Mar 31)

	FY16	FY17	FY18E	FY19E	FY20E
Cash Flow from Operating Activities					
PBT	1,606	2,971	2,592	4,850	6,418
Add: Depreciation	1,313	1,872	1,914	1,917	2,119
Less: Taxes	(608)	(478)	(389)	(727)	(963)
Operating Cash Flow Before Working Capital change (a)	**2,311**	**4,365**	**4,118**	**6,039**	**7,575**
Changes in Working Capital					
(Increase) / Decrease Trade & Other receivables	(6,658)	359	(823)	(675)	(1,474)
(Increase) / Decrease Inventories	(4,055)	(1,249)	(1,046)	(137)	(954)
Increase / (Decrease) Trade Payables	5,408	(297)	1,055	(246)	843
Others	(3,317)	6,609	522	428	935
Working Capital Inflow / (Outflow) (b)	**(8,621)**	**5,422**	**(292)**	**(629)**	**(650)**
Net Cash flow from Operating Activities (a) + (b)	**(6,310)**	**9,787**	**3,825**	**5,410**	**6,925**
Cash Flow from Capital commitments (c)	**(28,595)**	**(3,828)**	**(2,350)**	**(2,000)**	**(2,500)**
Free Cash flow after capital commitments (a) + (b) + (c)	**(34,906)**	**5,959**	**1,475**	**3,410**	**4,425**
Cash Flow from Investing Activities					
Purchase of Investments	(5,980)	(2,583)	-	-	-
Other non operating income	-	-	-	-	-
Net Cash flow from Investing Activities (d)	**(5,980)**	**(2,583)**	**-**	**-**	**-**
Cash Flow from Financing Activities					
Increase in Share capital	13,106	58	-	-	-
Proceeds from fresh borrowings	28,715	(2,958)	(7,000)	(3,000)	(3,000)
Dividend paid including tax and others	(260)	(451)	(244)	(474)	(634)
Net Cash flow from Financing Activities (e)	**41,560**	**(3,351)**	**(7,244)**	**(3,474)**	**(3,634)**
Miscellaneous Items (f)	980	153	4,500	-	-
Total Increase / (Decrease) in Cash (a) + (b) + (c) +(d) + (e) + (f)	1,655	178	(1,269)	(64)	791
Opening Cash and Bank balance	1,391	3,046	3,223	1,954	1,890
Closing Cash and Bank balance	3,046	3,223	1,954	1,890	2,681
Increase / (Decrease) in Cash and Bank balance	**1,655**	**178**	**(1,269)**	**(64)**	**791**

Source: Company data, I-Sec research

Table 11: Key ratios

(Rs mn, year ending Mar 31)

	FY16	FY17	FY18E	FY19E	FY20E
Per Share Data (Rs)					
EPS	18.1	32.3	22.8	44.2	59.1
Cash EPS	32.8	53.2	44.2	65.7	82.8
Dividend per share (DPS)	2.9	5.0	2.7	5.3	7.1
Book Value per share (BV)	297.2	303.1	331.5	370.5	422.5
Growth (%)					
Net Sales	139.3	21.7	8.3	6.3	12.9
EBITDA	80.9	55.3	(17.9)	34.7	20.8
PAT		78.0	(29.4)	94.2	33.7
Cash EPS		62.2	(17.0)	48.6	26.2
Valuation Ratios (x)					
P/E	43.1	24.2	34.3	17.7	13.2
P/CEPS	23.8	14.7	17.7	11.9	9.4
P/BV	2.6	2.6	2.4	2.1	1.9
EV / EBITDA	24.2	15.1	17.3	12.4	9.8
EV / Sales	3.5	2.8	2.4	2.2	1.9
Operating Ratio					
Raw Material / Sales (%)	52.5	44.1	46.5	42.5	41.5
Employee cost / Sales (%)	12.5	16.9	17.0	16.8	16.5
R&D / Sales (%)	2.6	3.9	4.5	5.0	5.0
SG&A / Sales (%)	17.9	16.7	18.0	18.0	18.0
Effective Tax Rate (%)	26.4	15.8	15.0	15.0	15.0
Working Capital (days)	75.2	95.4	99.6	102.6	102.0
Inventory Turnover (days)	61.2	86.8	88.9	94.1	90.1
Receivables (days)	89.3	106.4	100.5	101.4	98.5
Payables (days)	75.3	97.7	89.9	92.9	86.6
Net D/E Ratio (x)	0.3	1.1	1.0	0.7	0.6
Return/Profitability Ratio (%)					
Net Income Margins (Adjusted)	5.7	8.3	5.4	9.9	11.7
RoACE	4.1	7.2	5.8	8.6	10.2
RoAE	8.5	10.8	7.2	12.6	14.9
Dividend Payout	0.4	0.6	0.3	0.7	0.9
Dividend Yield	0.0	0.0	0.0	0.0	0.0
EBITDA Margins	14.5	18.5	14.0	17.8	19.0

Source: Company data, I-Sec research

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