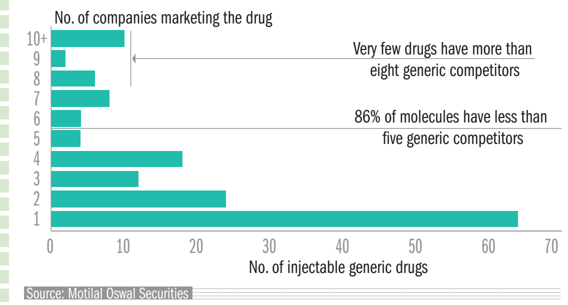
Booster dose

STRIDES ARCOLAB IS BANKING ON NEW LAUNCHES IN STERILE INJECTABLES TO DELIVER PROFITS AND DRIVE DOWN ITS DEBT BURDEN

Low on competition, high on profits

Limited competition in injectable drugs ensures higher margins in the specialty business



Kripa Mahalingam

In 2010, Bangalore-based Strides Arcolab was chosen as Pfizer's preferred partner. Earlier, in 2008, GlaxoSmithKline chose Strides to be its preferred partner. To get such a stamp of approval from two of the biggest global pharma giants, Strides Arcolab must be doing something right. It turns out the company has invested significantly both in world-class manufacturing capabilities and a comprehensive product portfolio in sterile injectables (drugs that are administered into the body using a needle and syringe, or an intravenous set). As sterile injectables require complex manufacturing processes it is not as competitive as other segments in the pharma business. With two FDA-approved manufacturing facilities in Bangalore, Strides' specialties (injectables) business seems ready to take off. The specialties business, which contributes 39 per cent to revenues (Rs 1,696 crore), is expected to grow at 45 per cent in 2011.

The company has built up a strong product pipeline with 36 product approvals worth $700 million and 117 filings waiting for regulatory approval. And it is this product pipeline that the company and institutional investors are betting on to drive its revenue growth and generate strong cash flows in the next couple of years. Strong cash flows are required not only to reduce the debt it had taken to fund its expansion plans but also beef up its balance sheet. Right now, the company is sitting on a fair amount of goodwill on its books (40 per cent of its balance sheet and higher than its entire net worth). The company is looking to amortise some part of its goodwill once its cash flows improve, thereby strengthening its balance sheet. But more on that later. With strong earnings growth of 49 per cent expected over the next two years, Strides Arcolab is definitely at an inflection point right now, making it a stock to watch out for in the pharma mid-cap space.

THE INJECTABLE SPACE

The global injectables market is estimated to be around $200 billion and is growing at about 11 per cent every year, with the US being the largest market for sterile injectables (about 40 per cent). The generic (off-patent) injectables market is pegged at $20 billion and is expected to grow to $30-33 billion by 2015 as some blockbuster drugs go off patent. Strides specialises in penicillin and penems (antibiotics used to treat infections) as well as oncological (cancer-related) products, which usually face compartively lower price erosion (60-70 per cent) after the patents expire compared to other generic drugs (85-90 per cent). If that's not enough, the stringent regulatory norms have put some existing players out of business. "Half the global assets are under regulatory challenges as regulatory oversight has increased dramatically in recent times," says Arun Kumar, vice chairman and MD, Strides Arcolab. "As a consequence, the number of players in the sterile injectables space has reduced. About 65 per cent of global drug shortages are in the sterile injectable space due to scarcity of assets." Hence, limited competition and shortages in the segment make it very profitable for existing players such as Strides (*See chart: Low on competition, high on profits*). For instance, while the pharma business enjoyed an operating margin of 11.12 per cent during the March 2011 quarter, the operating margins of its specialties business was way ahead at 30.11 per cent during the same period. Being a high margin business, sterile injectables already contribute the bulk of the operating profits (at 57 per cent) despite a lower revenue contribution (39 per cent).

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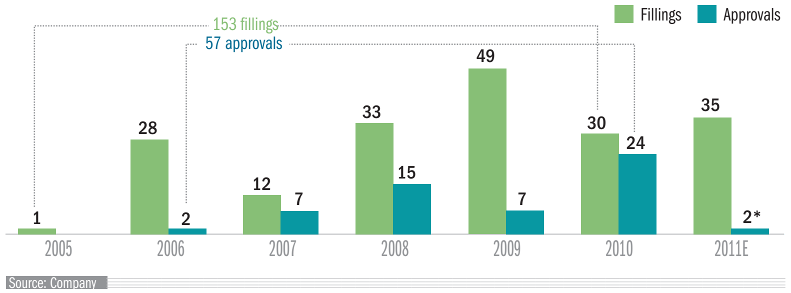
CAPACITY IS EVERYTHING

The company invested Rs 1,500 crore in the last 3-4 years to significantly increase its capacity in the sterile injectables space. In fact, in 2010, Strides got product approvals for 35 products but could launch only ten products due to capacity constraints. By the time 2011 is over, all that is expected to change. "All approved products will be launched by the end of this year," says Strides'

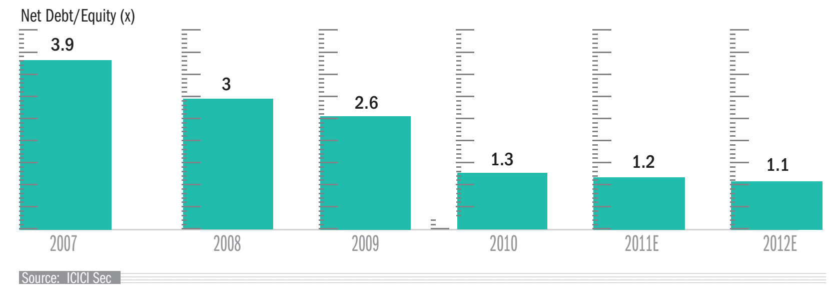
Robust pipeline

The company's strong product pipeline will help sustain its new launches and revenue growth momentum



Lighter burden

Improving cash flows in CY11 is expected to make the company's debt more manageable



Kumar. "We will be launching close to 50 products in 2011, which includes the balance 25 products that have already been approved, and 15-20 new products that have been filed for approval. So, the June quarter will be an important one to judge what the future will look like for Strides." According to Macquarie estimates, driven by capacity expansion and new launches, the sterile injectables business is likely to account for 50 per cent of the company's revenues and 68 per cent of its operating profit in 2012. To strengthen its position in the specialties segment, Strides acquired Aspen's (a South African generic player) manufacturing unit in Brazil, for $65 million (Rs 296 crore) in March 2010. It also bought out Aspen's stake in their joint venture for oncology products for $117 million (Rs 523 crore). To fund the buyouts, it tapped into internal accruals and raised around Rs 455 crore through a QIP at Rs 423.55 per share in September 2010 which led to a 22 per cent equity dilution.

PORTFOLIO ADVANTAGE

The company has one of the largest number of ANDA (abbreviated new drug applications) filings at 153, of which 115 are in the sterile injectables space and the balance in pharma(*See chart: Robust pipeline*). According to Amit Shah, analyst at Motilal Oswal Securities, large global multinationals have tied up with Strides mainly because of its established product pipeline. The deal with Pfizer is to commercialise 45 off-patent products, mainly injectable cancer products in developed markets. GSK plans to source ten oncological products for 95 emerging markets from Strides.

In 2010, Strides earned $100 million (around Rs 455 crore and 26 per cent of total reveunes) in licensing income due to these deals. "Licensing income is the security for us that the partner will deliver on what has been agreed to,"CEO Kumar says. "In our partnership model, we don't transfer intellectual property to our partner, so that is the kind of price a partner is willing to pay for our products. You have to understand that he has to generate a lot of sales to make that kind of investment count." In 2011, the company expects $60 million in licensing income.

Strong growth dose

Increasing contribution from the specialty business is expected to deliver higher profits for Strides Arcolab

Rs Cr	CY10	CY11E	CY12E
Sales	1695.84	2161	2591
Change (%)	29.97	27.44	19.9
EBITDA	326.57	447	542
Change (%)	74.61	36.97	21.1
Net Profit	122.44	199	264
Change (%)	11.63	62.54	32.66
EPS	26.11	32.49	44.19
Book Value (Rs)	222.14	263.10	297.98
ROE (%)	11.86	13.22	15.81
P/E @ Rs 363		11.23	8.26

Source:Bloomberg

NOT A PRIORITY

Meanwhile, Strides' legacy pharma business (including branded generics), which contributes 61 per cent to sales, is expected to grow by 10 per cent on an average every year in the near term. The branded generic business contributed 46 per cent to overall revenues in 2010, with the bulk of it coming from subsidiary, Ascent Pharma, which clocked revenues of Rs 584 crore. Strides has a presence across Australasia (through Ascent Pharma), Africa and India. Eventually, Strides would like to emerge as a pure-play sterile injectables player. This means both its pharma business and branded generic assets will be up for sale in the next couple of years. Kumar explains, "By 2015, we will be a pure-play injectables company. So, we have a good four years to decide what is the right time to sell, till then we will focus on growing the injectables business."

DEBT BURDEN

Strides had to take on considerable debt to beef up its manufacturing capabilities. Its debt increased from Rs 1,277 crore in 2007 to Rs 2,009 crore in 2010 (debt equity ratio of 1.3x). The company has to repay Rs 300 crore of term loans in 2011, which it hopes to meet from internal accruals and licensing income. The company generated around Rs 363 crore from operations in 2010 and expects cash generation to be higher in 2011, driven by a spurt in revenues of the injectable business. Strides also has Foreign Currency Convertible Bonds (FCCBs) of around Rs 520 crore coming up for conversion in June 2012. The conversion price is set at Rs 461.6 per share as against the current market price of Rs 363. If the stock price continues to trade below the conversion price at the time of maturity, the company is confident of meeting its commitment through internal accruals. Agrees Siddhant Khandekar, analyst, ICICI Securities, "We expect to see a drastic improvement in the company's leverage in the coming years once the licensing deals gather momentum and capacity utilisation improves." (*See chart: Lighter burden*).

RESTRUCTURING A MAZE

In 2009, as part of a restructuring exercise, the company revalued some of the assets and created a business restructuring reserve of Rs 702 crore, out of the surpluses arising from the revaluation. The company maintains the fair valuation was done in line with International Financial Reporting Standards to reflect the true value of the business. In 2009, Strides also opted to write off Rs 420 crore worth of expenses against the surplus credited to business restructuring reserve (BRR), which raised concerns among investors as it meant it was overstating profits to that extent. "Writing off anything against reserves is not good accounting practice," says Manoj Bahety, analyst, Edelweiss Securities. The company's CFO T S Rangan says that only the expenses pertaining to the restructuring were written off against the BRR. "It was not as though the company was using the BRR to write an item off the P&L [profit and loss] account," he says. Strides has about Rs 240 crore of BRR unutilised on its balance sheet, effectively boosting its net worth by that amount. The company also has a significant amount of goodwill – Rs 1,457 crore as against a net worth of Rs 1,223 crore – on its balance sheet, which is a cause for concern but the company is not worried. "More than two-thirds of the goodwill on books can be attributed to the specialty business, so chances of impairment are low," Rangan says. "Our improving core operations will lead to better cash flows, so goodwill will be an insignificant item on the balance sheet in 1-2 years time. As and when we generate more operational income over the years, it will give us the flexibility to amortise goodwill in the P&L account."

By 2015, we will be a pure-play injectables company

Arun Kumar, vice-chairman & MD

SHOT OR NO SHOT

Strides' revenues have grown by an average 32 per cent during the last two years (2009-10). Net profit growth (at around 7 per cent) has been muted during the same period owing to high interest costs. With the new plants starting to function, overall capacity utilisation is expected to improve, leading to better operating margins. Operating margins are expected to improve from 14.34 per cent in 2009 to 20.91 per cent in 2012. So profit growth is likely to compound at 49 per cent over 2011-12, against an equally impressive revenue growth of 24 per cent (*See chart: Strong growth dose*).

Strides is looking to not only bring down its debt, but also amortise some of its goodwill as its profitability improves. Institutional investors have flocked to the stock thanks to its growth prospects. FIIs hold 33.08 per cent stake, while mutual funds and insurance companies own about 18.33 per cent. Execution of its planned product launches and financial discipline will be the key to a re-rating.

The stock currently trades at 11.23 times and 8.26 times estimated 2011 and 2012 earnings. Most analysts have a buy on it, with an average price target of Rs 495. It definitely looks like Strides will bring some gains to your portfolio over the next two years. Buy at current levels. ◻