Ankur Drugs and Pharmaceuticals

BUY

MF Global
Private Client Group

CMP : Rs.346
Target : Rs.620

Ankur Drugs and Pharmaceuticals (ADPL) has emerged as a leading contract manufacturer of formulations in all the forms like tablets, capsules, dry syrups, liquids, injectibles, ointments, capsules and effervescent tablets. Its state-of-the-art manufacturing plant at Baddi has commenced production in Oct'07. While it has already been catering to most of the domestic pharma companies, in near future we expect it to also enlist couple of multi-national pharmaceutical companies to its client list. The key growth drivers will be increased volumes, strong order book, higher margin from sterile products and consolidation. We recommend a BUY on the stock with a price target of Rs.620 over 12-months period.

Key highlights

Leading contract manufacturer – With merger of Vaibhav Healthcare and expansion of second unit at Baddi, ADPL would become a leading contract manufacturer catering to most of the major pharma companies. Increase in installed capacity and higher utilization will drive its top line growth. Two of the three facilities are located at Baddi, which are eligible for excise duty exemption and income tax benefits.

Sales to grow at a CAGR of 75% – We anticipate sales to grow at a CAGR of 75% during FY07-FY010E on back of healthy order book, higher capacity utilization and rising volumes. Incremental sales from the new units are expected to generate Rs.2 bn, contributing 25% to the top-line in FY09E.

Getting into high-margin products – ADPL also plans to foray into manufacturing of injectables. It has also signed a agreement with Labtec of Germany and APR of Switzerland for exclusive intellectual property rights for Rapid Film Technology and skin patches. Both these businesses have high margins and would be the future growth drivers for the company.

Valuations

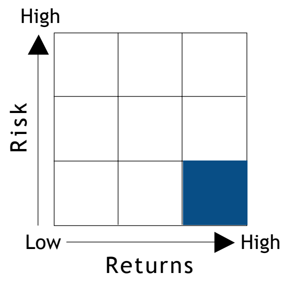
The stock at the current market price of Rs.350 trades at 14.3x FY08E and 8.4x FY09E earnings. Equity dilution on account of merger and conversion of FCCB will restrict the EPS growth in FY08. However there would be an upside in FY09 due to synergies creeping in from the merger with Vaibhav Healthcare and the commissioning of new facility at Baddi. We believe that overall growth in domestic market and fiscal benefits from the new facilities will improve earnings to Rs.24.4 and Rs.41.8 in FY08E and FY09E, respectively. It trades at 7.7x FY09E EV/EBITDA. We are optimistic on the growth prospects and expect the stock to trade at more than 15x forward earnings due to scaling up of operations and healthy return ratios. We initiate coverage on the stock with a **BUY** recommendation. Our price target of Rs.620 discounts one-year forward earnings by 15x.

Valuation summary

Y/E, 31st March	FY07E	FY08E	FY09E	FY10E
Revenues (Rs. mn)	**2,764**	**6,884**	**11,058**	**14,836**
Adj PAT (Rs. mn)	278	636	1,083	1,525
Adj EPS (Rs.)	**26.0**	**24.4**	**41.8**	**58.9**
EPS growth (%)	76.7	(6.2)	71.1	40.8
P/E (x)	**13.4**	**14.3**	**8.4**	**5.9**
Dividend yield (%)	0.3	0.6	0.6	0.6
RoCE (%)	**14.4**	**18.3**	**21.2**	**24.4**
RoNW (%)	52.7	29.2	26.4	28.5
P/BV (x)	**4.9**	**2.5**	**2.0**	**1.5**
EV/EBITDA (x)	17.9	12.7	7.7	5.6
EV/sales (x)	**2.3**	**1.8**	**1.2**	**0.9**

Source: Company, MF Global PCG Research

Risk Return Matrix



Indices

Sensex	20,207
Nifty	6,080

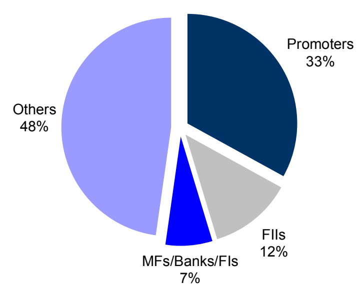
Stock Data

BSE Code	531683
NSE Code	ANKURDRUGS
Bloomberg	MRP@IN
Reuters	ANDP.BO
Shares Issued (mn)	10.7
Market Cap (Rs mn)	3,682
52 Wk H/L (Rs)	487/138
Face Value (Rs)	10
Avg. daily vol. (12-mths)	47,479

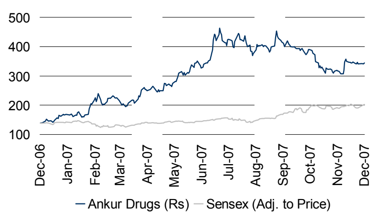
Absolute Returns (%)

	1 m	3 m	12 m
Absolute	8.8	(14.1)	148.9
Rel. to Sensex	2.0	(31.0)	103.1

Shareholding Pattern



Ankur Drugs Vs Sensex (Adj)



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Initiating Coverage

December 31, 2007

Company profile

Ankur Drugs And Pharma (ADPL) was incorporated during 1995 under the name Mridol Pharmaceuticals Limited (MPL). Initially the company embarked upon a project for manufacturing of Empty Hard Gelatin Capsules (EHGC) with an installed capacity of 1306 mn capsules per annum and blister packaging facilities with capacity of 454 mn per annum. Due to various technical reasons, the EHGC project faced certain bottlenecks and the production was discontinued. Later the management changed the focus and commenced its operations as a formulator (third party contract manufacturing/job work) on behalf of other pharma companies. Since the promoters were not able to run the company efficiently, Mr. Purnandu Jain who is presently the chairman of the company took over the control and management of the company by acquiring the complete equity stake from the original promoters. The focus was on efficient process development that would increase its margins and profitability. With manufacturing located at Baddi (two units) and Daman (one unit), today Ankur is a successful manufacturer of more than 400 different formulations in various forms viz Tablets, Capsules, Dry Syrups and Liquid Orals. We believe that a strategic alignment of the business model along with vision of the management has led to a successful turnaround to a profitable venture today and has made Ankur the biggest player in contract manufacturing.

An opportune shift to contract manufacturing model and managements focus on efficient process development has made it one of the largest contract manufacturer

Investment rationale

Aims to be the biggest player in contract manufacturing

ADPL has set-up state-of-the-art manufacturing facilities at Daman (Union Territory) and Baddi–(Himachal Pradesh) to cater to the requirements of leading domestic pharmaceutical companies. It has installed fully automated machines to enhance efficiency and also reduce its overhead costs. It has also developed a dedicated facility to manufacture effervescent tablets; we expect good upside from this business, due to negligible competition. The amalgamation with Vaibhav Healthcare, a group company, effective April 2006, is likely to bring in synergies – in terms of economies of scale and substantially reduce the overheads. The increase in global outsourcing by MNC pharmaceutical majors for formulations is also likely to benefit the company. With low cost of operations, creation of large capacities and high level of automation, ADPL is poised for rapid growth in contract manufacturing. Contract manufacturing has become the growth driver for Indian pharmaceutical companies. ADPL has entered into outsourcing contracts with the leading domestic pharma companies and is also in the process of roping in multi-nationals. This will ensure optimum utilisation of the facilities set-up by ADPL.

With integration of all three units at Baddi and one at Daman, ADPL would be the largest player in contract manufacturing

Expansion of existing business at Baddi

The company has spent Rs.2 bn in setting up a new manufacturing unit and upgrading the existing unit at Baddi. The new unit is set up specially to cater to new products like Rapid Film and Skin Patches. The addition of this new facility would increase ADPL's capacity by two times the size of its current capacity. Earlier it had two units till the end of FY06 with a gross block of Rs.600mn. It has incurred approximately Rs1.6bn for the new unit Baddi while another Rs0.4bn has been spent on upgradation of existing units. We have assumed 60% capacity utilization of this new plant in FY09.

Plant capacity details

Capacities (in mn. Nos)	Actuals 2006-07	Actuals 2007-08	Estimated 2008-09
VAIBHAV			
Baddi – General Block I			
Capsules	375	375	500
Tablets	3,000	3,000	6,000
Liquid Orals	30	30	30
Baddi – General Block II			
Capsules (to be operational from Jan'08)	–	600	9,000
Tablets (to be operational from Jan'08)	–	3,000	6,000
Liquid Orals (to be operational from Jan'08)	–	90	90
Baddi – Beta Block			
Capsules	336	1,248	1,500
(additional capacity has been added w.e.f. Oct'07 however installed capacity has been shown on yearly basis)			
Tablets	480	480	500
Dry Syrup	48	48	50
(additional capacity of 24 mn have been added in Mar'07)			
Baddi – Cepha Block			
Capsules	144	144	144
Tablets	480	480	480
Dry Syrup/Insta Use	24	48	48
(Insta use line will be operational from Oct'07)			
ANKUR			
Baddi – General Block			
Capsules	–	912	2,400
Tablets	–	9,000	20,800
Liquid Injectibles	–	138	210
Effervescents	–	300	300
Ointments	–	30	30
Baddi – Cepha Block			
Capsules	–	312	312
Tablets	–	1,200	1,800
Dry Powder	–	115	115
Dry Syrup	–	30	30
Baddi – Beta Block			
Capsules	–	–	600
Tablets	–	–	900
Liquid Orals	–	–	30
Daman - General Block			
Capsules	180	180	180
Tablets	1,200	1,200	1,200
Liquid Orals	24	24	24
Daman – Beta Block			
Capsules	90	90	360
Tablets	360	360	360
Dry Syrup	12	12	12

Source: Company, MF Global PCG Research

Plant details

Baddi Plant Unit 1 – Started with a capital Investment of USD 30 mn. It has received WHO/ GMP approvals. Plant commissioned in June 2005. It currently has three blocks i,e, General Block, Cephalosporin Block and Betalactum Block.

Baddi Plant Unit 2 – ADPL has committed a capital Investment of USD 40 mn. It is designed as per USFDA/MHRA standards. It has setup a dedicated a Cephalosporin Block, which would manufacture tablets, capsules, dry powder injectibles and dry syrups. It has also setup a dedicated General Block to manufacture injectibles, tablets capsules creams, gel and effervescent tablets. For this unit ADPL has tied up with Bassaire of UK for technical and architectural support. This would help it get the required approvals faster.

Daman Plant – This consists of General and Betalactum block, which manufactures tablets, capsules dry syrups and liquid orals.

Enhanced capacity, increase in efficiency to drive growth

The company's manufacturing facilities are of international standards. Initially the company is expected to secure orders from MNC for their requirements for unregulated markets. But subsequently the relationship will facilitate its entry into regulated markets also. We would see an increased outsourcing of more and more pharma products from India due to cost advantage and increasing pressure from US Federal Government and other European Governments on MNC pharma companies to bring down the drug prices and promote generics. Foray into injectables, increased capacity in tablets, capsules and dry syrups, broader portfolio of medicines, high level of automation will improve operating efficiency leading to better operating margins.

Large scale production and foray into high margin products would improve efficiency leading to better OPM

We expect ADPL's new capacity to receive UK MHRA approval in FY09 and USFDA approval in FY10, as the infrastructure is in compliance with the requisite quality standards. However, we have not factored any earnings upside from this likely approval in our estimates.

ADPL has increased the manufacturing capacity across all product segments i.e., tablets, capsules, liquids and dry syrup in FY07. All these capacities are likely to contribute significantly towards the growth in FY08 and FY09.

Passing on tax benefits to obtain bigger order and larger clientele

ADPL's both plants in Baddi are eligible for 100% excise duty exemption for 10 years and 100% income-tax exemption for 5 years from the first year of production. The company is well placed to capture the rising demand in the domestic market, which is growing at 15-20%. Indian MNCs (Ranbaxy, Cipla, Dr. Reddy) and subsidiaries of MNC pharmaceutical companies (Glaxo, Novaritis etc) also plan to leverage cost-efficiencies of contract manufacturers, who have plants located in regions offering tax breaks. The company plans to maintain the current EBIDTA margin of 15-16% and pass on the gains from tax and excise duty benefits to the clients. ADPL's policy of passing on gains from tax breaks will help the company bag bigger orders from existing clients and also secure new clients. As the order size increases the marginal cost factor comes into play which help contract manufacturers bring down their fixed overheads, which constitute a significant portion of the cost structure.

As the plant was set-up in June 2005 the benefits would be available to the company till 2015

Entry into a new and unique product – 'Rapid Film and Transdermal Patches' will be future growth driver

ADPL has signed a agreement with Labtec, Germany and APR, Switzerland for exclusive intellectual property rights for novel Technology. For the requisite machines and equipments, it has tied up with "Optimags" and "Seibler" of Germany. This is a new line of business for the company; ADPL will be the first company to launch these products in India and other countries in neighboring regions and will have exclusive manufacturing and marketing rights for 15 years. Rapid film is a new concept in oral dosage form of medication. This drug offers a fast dissolving oral film adhesive with many unique features. The drug is dissolved in a thin film of water-soluble polymers. When the film is placed on the tongue, it comes in contact with saliva there by releasing the drug particles. The basic concept is that it releases the drug in the mouth and initiates gastrointestinal absorption within no time. This product is superior to other products in the same segment and is conducive to all age groups. This drug has huge demand in Europe and ADPL being the only manufacturer in India, is expected to enjoy good margins. With diversified product range, the dependence on any one product will be minimized.

Advantages over conventional oral dosage form (Rapid Film)

- Easy to use
- No difficulty in swallowing
- High Acceptance among all age groups
- No water or liquid required to swallow
- Once taken cannot be spit
- Low cost still more effective

ADPL has also entered into tie-up for technology for exclusive manufacturing and marketing of "Fantanyl" and "Cold Fleece – Transdermal Patches" in India and neighboring countries like Bangladesh, Pakistan, Nepal, Afghanistan and other South East Asian countries. Transdermal Patch is a unique dosage form, which gives an edge over other dosage forms where a continuous follow up is not required. Under this new concept the drug is not dependant on external factors such as repetitive oral medication etc. In this form of treatment the drug is absorbed transdermally i,e, through skin within a specified period of time. The dosage depends on the strength of the drug and the purpose of application. The patch is applied with the help of skin friendly material on the skin where the drug is released slowly and steadily throughout the period of application.

Advantages over conventional oral dosage form (Transdermal Patches)

- Easy to use
- Drug is released while patient is sleeping/working slowly and steadily
- One patch can be used for 24 hours
- High Patient compliance
- Bioequivalent to other dosage forms
- Low cost still more effective

The market size of these products and patches in European countries was approximately Rs.15 bn in 2006. The commercial production of these products would start in January 2008. We expect these new products to contribute Rs500mn in FY09. ADPL is likely to enter into co-marketing arrangement with other pharma companies to market these products, as it does not have the requisite infrastructure. As per the term of the agreement ADPL has paid around Rs.10 mn for technology of these products and has agreed to pay 3-5% royalty on sales to technology partner.

Moving up the value chain through injectables

ADPL has also ventured into manufacturing of cephalosporin injectables (sterile), which earns better margins than the current products. The manufacturing process of injectables (sterile) is a complex procedure and involves higher fixed overheads and higher receivables. Due to these reasons and stiff competition, pharmaceutical companies opt for outsourcing sterile cephalosporin, which is an economically beneficial option for the domestic market.

ADPL has forayed into high margin Cephalosporin Injectables at the new unit at Baddi

Marquee client list

Major clients are Ranbaxy Laboratories, Cipla, Makers Laboratories, Lyka Labs, Novartis, Elder Pharma, Torrent Pharma, Sandoz India Pvt. Ltd., Hetero Healthcare, Morepen Lab, Shreya Life Sciences, Marksons Pharma, Khandelwal Labs, Synthiko Formulations, Parenteral Drugs, etc. The company derives around 42% of its revenues from Ranbaxy alone and has a high level of dependence. With addition of few MNC companies in the list in near future we expect the client profile to get diversified and it would also enable geographical de-risking.

Major MNCs and large domestic pharma companies will ensure steady order flow to the company

A unique facility geared towards capturing opportunities

ADPL currently manufactures price-controlled products at Daman. As these price-controlled products are sold at MRP plus excise duty, they can be manufactured at Daman (Daman facility do not have excise exemptions).

It has set up its new facility at Baddi to offer excise free benefits to the clients. The company has entered into a technical arrangement with Bassaire, a leading consulting firm in the UK, for technical, engineering and architectural support for its Baddi project. The Baddi plant has world-class facilities and will be US FDA-compliant. ADPL has plans to rope in leading multi-national pharmaceutical companies to do contract manufacturing for their requirements from this plant. Discussions are at an advanced stage with some leading MNCs. On successful completion of the expansion at Baddi facility, ADPL's capacity would more than double and the company would become the largest contract manufacturer in India.

The company has entered into a technical arrangement with Bassaire for engineering and architectural support which would help to get US FDA approval fast

ADPL would be the first company in Asia to have Zenchetta-processing equipment for effervescent tablets, which uses single-pot technology. With this equipment installed, it would be in a position to undertake contract manufacturing of any type of formulations. Since global pharmaceutical companies mostly use such sophisticated technology and equipment, they would have give preference for outsourcing from ADPL.

Merger of Vaibhav Healthcare to add economies of scale

ADPL's group company, Vaibhav Healthcare Pvt. Ltd. (VHPL) has been amalgamated with the company with effect from 1st April 2006. The swap ratio has been fixed at one share of ADPL for every six shares of VHPL. Against 30 mn shares of VHPL outstanding, 5 mn shares of ADPL will be issued. Transfer pricing was fixed at Rs 23.3 a VHPL share (the ADPL share price was Rs 140 on 31st March 2006). For FY06, VHPL had reported net profit of Rs.12.6mn on income of Rs.383.9 mn. Hence, the said transfer was effective at 1.8x sales and 2.2x VHPL's book value.

The high court approval for the merger with Vaibhav Healthcare has been received and the company would report consolidated numbers from Q3FY08 results

Financials

For the first six months ADPL has achieved a top-line of Rs.1.9 bn. In H1FY08 the net sales grew by 64% and net profit grew by 39%. However, the operating margins showed a declining trend due to competitiveness in the market. Also ADPL passed on some of the excise benefits that it received from Baddi to its clients. But we believe that post expansion and commissioning of new plant, the economies of scale would set in and the margins would expand. Secondly the company also plans to foray into injectables and other high margin products, which would enable margin expansion. We expect EBIDTA margins to expand by 100bps in FY09.

(Rs. mn)	H1 FY08	H1 FY07	% yoy	FY07	FY06	% yoy
Sales	1,997	1,219	63.8	2,763	1,362	102.8
Expenditure	1,720	1,032	66.6	2,347	1,132	107.4
Operating profit	278	187	48.4	417	231	80.6
Interest	68	33	108.6	83	52	58.3
Depreciation	13	13	(1.6)	26	25	4.4
Other income	1	0	50	1	1	90.8
PBT	198	142	39.1	308	154	100.5
Tax	18	13	41.1	28	41	(32.1)
Net profit	179	129	38.9	280	113	149

Source: Company, MF Global PCG Research

Concerns

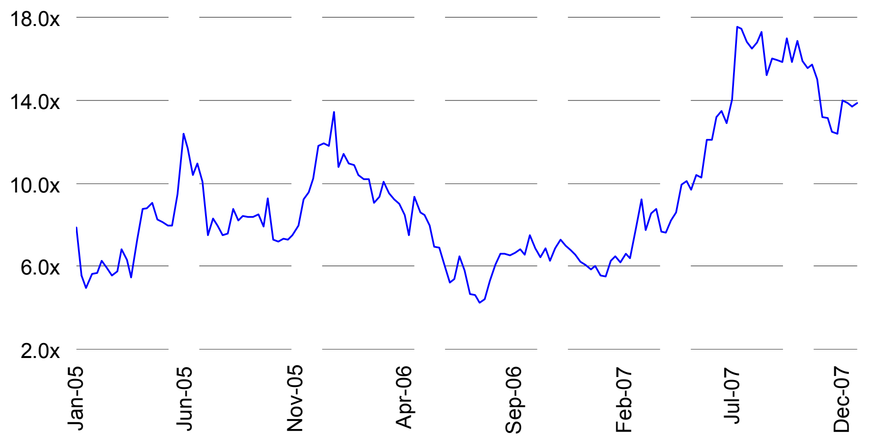
Steep equity dilution – The Company has raised approximately Rs.2.5bn for the expansion of a new unit at Baddi. This is done through a mixture of both debt and equity. Equity capital of Ankur is expected to rise from steeply from Rs.9.5 mn to Rs.25.8 mn. However the net profit is also expected to grow at a CAGR of 88% over three years. Hense equity dilution does not seem to be concern from a long-term perspective.

Execution risk – The new unit at Baddi is almost double the size of the existing plant. The company has been already been supplying to the pharma companies but this new unit is a specialized unit with focus on the export markets. Here it plans to make rapid films and skin patches. Ankur's performance would depend on it ability to secure orders on consistent basis for these products.

Valuations

We recommend a **BUY** on the stock with minimal down side risk of 9-10%. On the upside the stock could touch Rs.620 in the one year. From here on there would be a consistent growth every quarter as a result of new capacity addition. The stock at the current price of Rs.350 is trading at a P/E of 14.3x FY08E and 8.4x FY09E earnings. Historically the stock has traded in the 9x-to12x PE band. Going forward we see an all round improvement in the financial parameters such as RoCE and RoNW. Our one-year price target of Rs.620 discounts the stock by 15x. The stock looks attractive on other valuation parameters such as EV/EBDITA and Price/BV.

1-year forward P/E multiple



MF Global

Financials

Income statement (Rs mn)	FY07E	FY08E	FY09E	FY10E
Net sales	**2,764**	**6,884**	**11,058**	**14,836**
Raw material expenses	2,290	5,610	8,902	11,951
Employee expenses	–	–	–	–
Other exp	112	275	442	593
Op. profit	**362**	**998**	**1,714**	**2,292**
OPM (%)	*13.1*	*14.5*	*15.5*	*15.5*
Other income	53	6	14	16
Depreciation	25	92	250	267
Interest	84	193	254	318
PBT	**305**	**719**	**1,224**	**1,723**
Taxes	27	83	141	198
PAT	278	636	1,083	1,525
Extraordinary items	–	–	–	–
Adjusted PAT	**278**	**636**	**1,083**	**1,525**
NPM (%)	*10.1*	*9.2*	*9.8*	*10.3*

Balance sheet (Rs mn)	FY07E	FY08E	FY09E	FY10E
Equity capital	**106**	**258**	**258**	**258**
Reserves (incl. pref shares)	649	3,316	4,335	5,795
Networth	**755**	**3,574**	**4,593**	**6,053**
Total debt	2,775	3,660	4,150	3,800
Deferred tax liability	45	71	93	105
Total liabilities	**3,575**	**7,305**	**8,836**	**9,958**
Gross fixed assets	595	3,700	5,000	5,350
Less: Cumulative depn.	108	248	498	766
Net fixed assets	488	3,451	4,501	4,584
Capital W.I.P.	2,030	1,300	350	150
Investments	–	1	1	1
Net current assets	1,058	2,553	3,984	5,223
Total assets	**3,575**	**7,305**	**8,836**	**9,958**

Cash flow (Rs mn)	FY07E	FY08E	FY09E	FY10E
PBT & extraord. items	305	719	1,224	1,723
Add: Int, depn. & other exp.	109	286	504	585
Cash flow from operations	**414**	**1,004**	**1,728**	**2,308**
Net chg in w.cap, tax, int.	707	1,658	1,760	1,786
Net cash flow from op.	**(292)**	**(654)**	**(32)**	**522**
Capital expenditure	1,557	2,375	350	150
Sale / Purchase of inv.	(1)	1	–	–
Net cash from inv.	**(1,557)**	**(2,375)**	**(350)**	**(150)**
Issue of equity & debt	1,867	3,179	490	(350)
Dividend paid	11	52	52	52
Net cash from financing	**1,857**	**3,127**	**438**	**(402)**
Net chg in cash	7	98	56	(30)
Op. cash bal	17	18	139	212
Cl. cash bal	18	139	212	188

Ratios	FY07E	FY08E	FY09E	FY10E
Growth (%)				
Net sales	102.6	149.1	60.6	34.2
Adj PAT	98.9	128.9	70.3	40.7
Adj EPS	76.7	(6.2)	71.1	40.8
Per Share Data (Rs)				
Adj EPS	26.0	24.4	41.8	58.9
Book value	71.6	138.5	178.0	234.6
DPS	1.0	2.0	2.0	2.0
Valuation (x)				
P/E	13.4	14.3	8.4	5.9
P/BV	4.9	2.5	2.0	1.5
EV/EBIDTA	17.9	12.7	7.7	5.6
Performance (%)				
RoCE	14.4	18.3	21.2	24.4
RoNW	52.7	29.2	26.4	28.5

BUY : > 20% **HOLD : > 5-20%** **SELL : < 5%**

Note: Ratings based on expected returns from current market price (on absolute basis).

Analyst Holding in the recommended stock: **NIL**

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