IPCA Laboratories Ltd. (Ipca) (CMP: Rs.269.40)

Q2FY12 Result Update

November 9, 2011

HDFC Sec Scrip code	Industry	CMP (Rs.)	Recommended Action	Price Band (Rs.)	Sequential Targets (Rs.)	Time Horizon
IPCLABEQNR	Pharmaceuticals	Rs.269.40	Buy on dips	Rs.237 to Rs.251	Rs.290 & Rs.303	1 quarter

Ipca recently reported its Q2FY12 results that were in line with street estimates. Given below are some of the key highlights, which we came across while reviewing the results.

Key highlights of Q2FY12 results:

- IPCA reported better-than-expected sales at Rs.636.9 cr, up by 19.7% y-o-y, driven by formulation exports and better Sterling and Euro realisation, despite single-digit growth in domestic formulations. API segment external sales continued to moderate due to more captive consumption. Overall contribution from the formulation segment improved to ~79% of sales (77% in Q2FY11). However, EBITDA margins rose to 25.6% due to lower staff cost and better product mix.

- Net Profit degrew by 17.1% y-o-y from Rs.94 cr to Rs.78 cr in Q2FY12 on account of forex loss of Rs.27.2 cr, (MTM losses of ECB loans of US$55 mn) excluding which profit would stand at Rs.105.1 cr up by 11.8% y-o-y. Net profit margins fell sharply by 570 bps to 12.6%.

Quarterly Financials:

(Rs. in Cr)

Particulars	Q2FY12	Q2FY11	% Chg	Q1FY12	% Chg	Remarks
Gross Sales	636.9	531.9	19.7%	542.5	17.4%	
Excise Duty	18.9	17.6	7.3%	16.1	17.3%	
Net Sales	618.0	514.3	20.2%	526.3	17.4%	Sales largely in line but India disappointed with a mere 3% growth. Exports were strong on account of higher tender sales.
Other Operating Income	5.5	4.0	37.0%	3.6	53.5%	
Total Income	623.5	518.3	20.3%	529.9	17.7%	
Expenditure						
Raw Material Consumed	227.2	184.3	23.3%	199.0	14.2%	
Stock Adjustment	-5.2	-2.0	167.7%	-11.3	-54.0%	
Purchase of Finished Goods	21.5	22.1	-2.8%	22.7	-5.3%	
Employee Expenses	72.8	70.0	4.0%	83.6	-12.9%	Employee cost as a percentage of sales declined by 180 bps on the back of a reversal of incentives to MRs to the tune of Rs.6 cr
Other Expenses	149.2	125.9	18.5%	140.8	6.0%	
Total Expenditure	465.5	400.3	16.3%	434.7	7.1%	Overall cost pressures due to higher travelling, factory charges, fuel and power, marketing and other costs
EBIDTA	**158.0**	**118.0**	33.9%	**95.2**	66.0%	
EBIDTA Margin%	*25.6%*	*22.9%*		*18.1%*		Margins surprised from favourable currency and lower staff cost despite lower growth in the domestic formulation business on the back of higher margins from the generic business.
Other Income	2.6	2.7	-2.6%	2.6	2.7	
Interest	11.8	8.2	44.1%	11.8	8.2	
(Profit)/Loss on Forex Transaction	27.2	-28.8	-194.1%	27.2	-28.8	
Depreciation	17.6	13.7	28.5%	17.6	13.7	
PBT	104.2	127.7	-18.4%	104.2	127.7	
PBTM%	*16.9%*	*24.8%*		*16.9%*	*24.8%*	
Tax	26.2	33.7	-22.2%	26.2	33.7	

Effective Tax Rate%	*25.2%*	*26.4%*		*25.2%*	*26.4%*	
Net Profit	**78.0**	**94.0**	-17.1%	**61.7**	26.4%	Forex loss of Rs.27.2 cr led to 17.1% y-o-y fall in bottomline
NPM%	*12.6%*	*18.3%*		*11.7%*		
EPS	**6.2**	**7.5**	-17.4%	**4.9**	26.4%	

(Source: Company, HDFC Sec)

Some observations on Q2FY12 results:

Sales Break up: **(Rs. in Cr)**

Particulars	Q2FY12	Q2FY11	% Chg	Q1FY12	% Chg	Remarks
Formulations						
- Domestic	229.2	221.9	3.3%	189.0	21.3%	Domestic growth in the quarter was muted due to weak anti-malarial season, weakness in anti-infectives and dermatology. Most of key therapy segments like Pain management, cough and cold, etc grew 18-25%.
- Export	260.5	175.1	48.8%	206.6	26.1%	Strong growth led by tender business of Rs.91 cr (Rs.26 cr in Q2FY11) largely led by a 73% growth in the US business.
Total	489.7	397.0	23.3%	395.6	23.8%	
APIs						
- Domestic	35.6	40.8	-12.8%	40.7	-12.5%	De-growth in domestic API sales was on account of higher captive consumption. And due to supply constraints in Artemisinin.
- Export	92.7	76.4	21.3%	90.1	2.9%	Latin America reported strong performance as the sales grew 102% y-o-y to Rs.7.2 cr, while CIS grew by 19% to Rs.39 cr. South East Asia witnessed growth of 27% y-o-y, Western Africa grew strongly at 51% but the Middle East continued to de-grow by 19% due to the political unrest in Sudan and Yemen on a y-o-y basis. Robust growth despite impact of currency depreciation not reflected in Q2FY12.
Total	128.3	117.3	9.4%	130.8	-1.9%	
Total Sales	**618.0**	**514.3**	20.2%	**526.3**	17.4%	

(Source: Company)

Other Highlights:

- Formulations business grew 23.3% y-o-y in Q2FY12 (contributed 79%) to Rs.489.7 cr driven by:
  - Export formulations (contributed 37%) which grew by 49% to Rs.2.6 bn on back of Anti-malarial institutional business - up 242% to Rs.90.8 cr
  - Promotional business remained flat at Rs.44.6 cr, due to no shipments to Sudan and Yemen because of political turbulence.
  - Domestic formulations (contributed 42%) grew at a lower rate of 3.3% y-o-y to Rs.229.2 cr in Q2FY12. As per AIOCD data, anti-malarial and anti-infective witnessed de-growth of 5% and 6% YoY during the quarter. Its leading brand Lariago fell by 30% in the quarter under review.
  - Lower growth was mainly due to decline in Anti bacterial and anti-malarial portfolio led by adverse market condition, new divisionalisation and higher attrition rate

- API grew by 9% to Rs.128.3 cr (contributed 21% to overall sales).

- Tender sales at Rs.91 cr was strong, partly because of higher prices in the quarter on account of higher raw material prices. IPCA is waiting for pre-qualification approval for artesunate + amodiaquine combination as well, which could come by Q4FY12.

- In H1FY12, Ipca witnessed degrowth in anti-malarial (down 1%), anti-bacterial (down 14%), neurology and dermatology (down 6%). However, Nephrology, Cough & Cold, Nutraceuticals and CVS did well witnessing growth of 55%, 40%, 32% and 4% respectively.

- Ipca expects 67% of the portfolio to come under price control if the new draft policy is implemented. The largest impact is likely to be in the two leadership categories – rheumatoid arthritis and anti-malarials. The management has indicated that the overall price reduction may be to the tune of 2-3%. Older products like Lariago (chloroquine) could see a price increase as it is among the lowest-priced brands in the market. Zerodol (aceclofenac) combinations will be affected by this price control, though overall the Zerodol franchise is not at a price premium. The management has indicated that the impact would be neutral if the new draft pricing policy comes into existence.

- Ipca has so far filed 24 ANDAs with the USFDA and received approval for 11 ANDAs. Of this, eight products were launched. It is planning to file 12-15 ANDAs in the current fiscal post the Indore facility approval. Due to capacity constraints, it was unable to fulfill the existing products demand.

- Ipca is awaiting USFDA approval for its Indore SEZ (expected by Q4FY12). Once approved, the facility would cater to the US generic market and could post sales of Rs.300-350 cr. Further, Ipca has received approval from the WHO for its anti-malarial product, making the company eligible to participate in the global tender worth US$300mn along with three other players.

- During the quarter, Ipca's wholly owned subsidiary Ipca UK acquired 100% shareholding of Onyx Research Chemicals Ltd, UK holding company of Onyx Scientific Ltd, UK.

- The Board has decided to merge Tonira Pharma Ltd. with itself w.e.f, April 1, 2011. The shares exchange ratio fixed has been fixed at 6:100. NO effect of the merger has been given in Q2FY12 results.

Guidance:

- Management maintained its guidance of 18-20% growth for FY12. Despite lower domestic formulation growth guidance of ~9% (earlier 16-18%), the company expects ~100bps EBITDA margin improvement for FY12, largely led favourable Re/US$. Anti malarial business could grow from Rs.1.2 bn in FY11 to Rs.2.5 bn (from earlier guidance of Rs.2 bn) in FY12E and with the prequalification of Artisunate, Ipca plans to participate in the rest of the 20% of anti malarial tender business (total market US$250-300 mn). CIS growth guidance maintained at 25-30% for FY12. Institutional anti-malarial sales guided at ~Rs.250 cr for FY12 and ~Rs.300 cr for FY13. Margins in this business are in the 23-25% level. WHO prequalification for artesunate-amodiaquine (AS-AQ) could potentially add Rs.50 cr to this in FY13.

- Ipca expects the tender business to scale up to Rs.400-500 cr once it receives the pre-qualification of Artisunate from the WHO. The total market for tender business is US$250 mn of which Artemether Lumefantrine forms 85% and the remaining 15% is constituted by Artisunate. Further, it also has 2-3 more combination products in its pipeline which could drive future growth.

- The management expects the domestic formulations business to recover from Q3FY12, though overall full-year growth could remain below 10%. Ipca expects some reduction in prices in rheumatoid arthritis segment (brands HCQS, Folitrax, Saaz), which could be offset by price rises in anti-malarials (brand Lariago).
- Management has guided for 25.5% tax rate in FY12, expecting utilisation of tax credits in the coming quarters.

- Ipca has hedged US$138 mn (~50% of its exports over the next 18 months). Around US$29 mn are hedged till March 2012 at Rs.47.39/$ and around US$100 mn are hedged till March 2013 at Rs.48.31/$.

- For Indore SEZ, the management is hopeful of a plant inspection/approval by H2FY12, which could enable a sharp scale-up in the US business from FY13.

Concerns

- Ipca derives ~50-55% of its revenues from its export business. Any appreciation of Rupee vs USD could result in adverse impact on margins.

- Despite rising contribution from exports, the domestic market will continue to contribute major chunk to the company's overall Net Sales going ahead. This would make the company vulnerable to any changes in the DPCO. Currently 7-8% of Ipca's revenues are under DPCO. However, under the new draft policy, ~67% of Ipca's portfolio comes under the purview.

- Ipca could also face volatility in margins due to seasonality (especially for its antimalarial drugs) and changing product mix.

- Continued delay in approval of its Indore SEZ plant from the USFDA could put our estimates at risk.

- Higher-than-anticipated price erosion in Ipca's generic API business, could impact profitability.
- Ipca could face margin pressure due to addition to field force not being productive immediately. Also increase in power and fuel cost could add pressure on margins.

Conclusion & Recommendation

Ipca reported strong results for Q2FY12. The highlight of the quarter was the significant improvement in EBITDA margin (~250 bps higher y-o-y) mainly on account of lower employee costs and favourable currency movements. However, Net Profit margins were impacted on account of Rs.27.2 cr worth force related losses. Export formulations drove strong growth for Ipca during the quarter, while, domestic formulations growth continued to remain weak. While slower domestic business could affect near-term profitability, we expect robust anti-malarial tender business and export business to compensate partially. The potential upsides from anti-malarial tender business and USFDA approval for Indore make the stock attractive.

Over the medium term as the Indore SEZ is likely to open new revenue channels in the USA along with the normalisation in the Russian and CIS markets, revenues are set to rise further. Further, the WHO pre-qualification of Artimether could leverage its API capabilities going ahead.

In our Q1FY12 result update, we had recommended investors to buy the stock between Rs.263 and Rs.284 for a target of Rs.315. Post the issue of the report, the stock touched a low of Rs.230.2 on October 4, 2011 and made a high of Rs.331.95 on August 22, 2011. At the CMP of Rs.267.15, the stock is trading at 10.2x FY13E EPS of Rs.26.

We are revising our FY12 estimates upwards and introducing FY13 estimates. We think till the catalyst of USFDA approval for Indore SEZ comes in, the stock could get lower valuations.

We think investors could look at buying the stock between Rs.237 to Rs.251 (9.1x to 9.7x FY13E EPS) for the sequential targets of Rs.290 and Rs.303 (11.1x and 11.7x FY13E EPS) over the next quarter.

Financial Estimates:

Particulars (Rs in Crs)	FY09	FY10	FY11	FY12 (OE)*	FY12 (RE)*	FY13 (E)*
Operating income	1283.8	1559.55	1882.54	2181.4	2247.0	2589.1
PBIDT	178.8	329.8	419.6	423.2	473.4	550.1
PBIDTM (%)	22.8%	22.6%	20.4%	19.4%	21.1%	21.2%
Profit after Tax	100.8	205.4	262.7	263.9	276.1	331.4
PATM (%)	7.9%	13.2%	14.0%	12.1%	12.3%	12.8%
EPS	8.0	16.4	20.9	21.0	22.0	26.4
P/E (x)	33.6	16.5	12.9	12.8	12.3	10.2

* - Quick Estimates, OE - Original Estimates, RE - Revised Estimates (**Source:** Annual Report, HDFC Sec Estimates)

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