Alembic Pharma Ltd (APL) - Stock Update

February 24, 2014

Scrip Code	Industry	CMP	Recommended Action	Target	Time Horizon
ALEPHAEQNR	Pharmaceuticals	Rs.246.65	Buy at CMP and add on dips to Rs.215-Rs.222	Rs.274	1-2 quarters

Better than expected Q3FY14 numbers

APL reported better-than-expected Q3FY14 results led by strong performance in formulations segment. Given below are some of the key highlights, which we came across while reviewing the results and some other developments.

Quarter Financials- Consolidated:

(Rs. in Cr)

Particulars	Q3FY14	Q3FY13	% Chg	Q2FY14	% Chg	Q1FY14	% Chg	Q4FY13	% Chg
Gross Sales									
- Domestic	274.9	254.7	7.9%	286.6	-4.1%	244.0	17.4%	236.2	3.3%
- Exports	211.8	117.4	80.5%	201.1	5.3%	184.8	8.8%	142.1	30.0%
Total	486.7	372.1	30.8%	487.7	-0.2%	428.8	13.7%	378.4	13.3%
Excise Duty	1.9	3.3	-42.5%	1.8	5.6%	2.2	-18.8%	1.8	22.5%
Net Sales	484.9	368.8	31.5%	485.9	-0.2%	426.6	13.9%	376.6	13.3%
Other operating income	0.8	0.4	77.3%	0.5	69.6%	0.6	-19.3%	1.5	-62.0%
Total Operating Income	485.7	369.2	31.5%	486.4	-0.1%	427.2	13.9%	378.1	13.0%
Expenditure									
Raw Materials	151.4	124.2	21.9%	137.6	10.0%	136.0	1.2%	108.1	25.8%
Decrease/(increase) in stock-in-trade & W-I-P	-24.2	-22.2	9.0%	-7.4	225.8%	-13.0	-42.9%	25.5	-151.1%
Purchase of traded goods	48.0	48.7	-1.4%	59.3	-19.1%	49.5	19.8%	33.5	47.8%
Employees Cost	64.2	49.5	29.6%	59.3	8.2%	56.4	5.2%	50.8	11.0%
R&D Expenditure	29.0	21.7	33.6%	33.8	-14.2%	22.4	50.9%	22.0	1.9%
Excise Duty	0.8	-3.0	-125.2%	2.1	-63.5%	0.8	163.3%	1.7	-53.8%
Other Expenditure	114.3	81.0	41.0%	108.9	4.9%	103.7	5.1%	70.9	46.2%
Total Opex	383.4	299.9	27.9%	393.7	-2.6%	355.7	10.7%	312.5	13.8%
Operating Profit	**102.2**	**69.4**	47.4%	**92.7**	10.3%	**71.5**	29.7%	**65.6**	9.0%
OPM %	*21.1%*	*18.8%*		*19.1%*		*16.8%*		*17.4%*	
Other Income	0.2	3.5	-94.2%	0.2	0.0%	0.0	900.0%	0.1	-71.4%
Interest Exps	3.5	3.9	-10.3%	2.6	35.4%	1.5	74.8%	1.8	-19.7%
Depreciation	10.1	8.9	14.4%	9.9	2.7%	9.5	3.4%	8.6	10.3%
Profit after interest and dep before exceptional items	88.8	60.1	47.8%	80.5	10.4%	60.5	33.0%	55.2	9.6%
PBTM %	*18.3%*	*16.3%*		*16.6%*		*14.2%*		*14.7%*	
Tax	22.9	11.8	93.7%	18.9	21.5%	13.9	36.0%	11.5	20.2%
Effective Tax Rate %	*25.8%*	*19.7%*		*23.4%*		*22.9%*		*20.9%*	
PAT	**65.9**	**48.3**	36.6%	**61.6**	7.0%	**46.6**	32.2%	**43.7**	6.8%
PATM %	*13.6%*	*13.1%*		*12.7%*		*10.9%*		*11.6%*	

Equity Capital	37.7	37.7	0.0%	37.7	0.0%	37.7	0.0%	37.7	0.0%
EPS	**3.5**	**2.6**	36.6%	**3.3**	7.0%	**2.5**	32.2%	**2.3**	6.8%

(Source: Company, HDFC sec)

Some observations on Q3FY14 results:

Break up of Revenue:

Particulars	Q3FY14	Q3FY13	% Chg	Q2FY14	% Chg	Q1FY14	% Chg	Q4FY13	% Chg
Formulations									
- Branded Domestic	229.6	199.9	14.9%	241.0	-4.7%	195.8	23.1%	182.3	7.4%
- Generic & NSA	27.4	27.8	-1.4%	33.8	-18.9%	25.4	32.9%	25.2	0.9%
- Branded International	19.7	15.0	31.3%	14.0	40.7%	12.2	14.7%	12.9	103.8%
- International Generics	129.6	61.1	112.1%	113.7	14.0%	85.5	33.0%	77.7	156.5%
Total Formulation Sales	**406.3**	**303.8**	33.7%	**402.5**	0.9%	**318.9**	26.2%	**298.0**	142.0%
API Sales	75.6	67.0	12.8%	78.2	-3.3%	107.0	-26.9%	78.7	135.4%
Export Incentives	4.8	1.3	269.2%	6.6	-27.3%	2.9	127.6%	1.7	475.8%
Total Sales	**486.7**	**372.1**	30.8%	**487.3**	-0.1%	**428.8**	13.6%	**378.4**	142.1%

(Source: Company, HDFC sec)

Other Highlights:

- Net sales up 31% y-o-y at Rs.486.7 cr. India Branded formulations sales up by 15% for the quarter at Rs.229.6 cr against Rs.200 cr in Q3FY13. International generics sales were up 112% y-o-y in Q3FY14 at Rs.129.6 cr. API recorded sales of Rs.75.6 cr in Q3FY14 against Rs.67 cr in Q3FY13, growth of 12.8% y-o-y.

- Share of Specialty segment went up to 52% in Q3 FY 14 from 45% in Q3 FY 13. Growth of 22% in Specialty business came in due to various therapies like Ophthalmology 47% growth, Cardio 34% growth, Nephrology/ Urology 26% growth, Anti Diabetic 28% growth, Gynecology with 30%, Gastro with 14% growth and Orthopedics with 8% growth. Acute business remained stagnant with 9% growth in Cough and Cold and degrowth of 6 % in Anti infective due to NLEM impact. Share of Business on Anti-Infective have gone down to 35% in Q3 FY14 from 41% in Q3 FY13 of total India formulation sales. Share of cough and cold have also gone down to 13% Q3 FY14 from 14% in Q3 FY13 of India formulation sales.

- APL has grown faster than the industry in November MAT 2013 in all categories (except Cold and cough, anti infectives and orthopaedic). However as the latter categories form a big chunk of the total sales, its market share has improved by 1 bps to 1.76% y-o-y. However the mix is now inclined to better value added and higher margin products.

- Operating margins in Q3FY14 expanded by 230 bps y-o-y to 21.1% mainly due to better product mix and increased generic sales in international markets. The company is executing structural changes in its portfolio, increasing the formulation contribution and concentrating only on select high margin APIs.

- Net profit after tax up by 37% for the quarter at Rs. 659 million vis-à-vis Rs. 483 million in corresponding quarter last year.

- R & D expense for Q3FY14 is Rs.29 cr representing 6% of sales as against Rs.21.7 cr of sales in Q3FY13.

- During the quarter 1 ANDA was filed. Cumulative filing of ANDA/NDA stood at 60. APL received 1 ANDA approval during Q3FY14 taking cumulative approvals to 31 (which includes 4 tentative approvals). During the quarter 2 DMFs were filed and cumulative filings of DMFs stood at 64.

- The APL management has increased its guidance of growth in the domestic market from 15% to a range of 15-18%, though it has refrained from giving growth guidance for the international generics business considering the robust growth seen this fiscal. The management expects at least 25% CAGR in topline over the next 3 years, with margin sustaining at 20% plus. The management is confident of maintaining the current momentum in the international business and doesn't foresee de-growth in the same.

- Desvenlafaxine ramp-up is much lower than expectations, but the management expect things to improve going forward as the company has started seeing follow-up demand.

- Capex for the next 2 years is expected at Rs.100 cr mainly on account of maintenance capex.

- APL plans to enter front-end business in the US market in future and expects entry by the end of FY15.

- The management has indicated launch of at least 8-10 products in the US market for the next 2-3 years

- According to management, new pricing policy is likely to have negative impact of Rs.20-25 cr (2-2.5% of domestic formulations) on FY14 domestic formulations.

- Despite aggressive growth and its relative small size, the company has delivered solid balance sheet performance. APL has already reduced its net Debt/Equity ratio to 0.3x at end of FY13 from 1.2x in FY11.

- Domestic market is a key driver for the growth of company; it grew 13.2% y-o-y in FY13 & contributed ~58% of total revenue. Management expects this business to surpass the industry average growth of 14-15% y-o-y for next few years. In the last 2-3 years, company has focused on the chronic therapies including Cardio, Diabetology, Gynaec and Ophthalmic. This has resulted in healthy growth of more than 25-30% growth in chronic portfolio, which currently contributes almost 50% of domestic formulation business.

Concerns

- APL has been a late entrant in tapping the opportunities in the Regulated markets. Hence, intense competitive pressures could impact its performance.

- **Dependency on top 5 brands still high:** Over the past 3-4 years the top 5 brands have contributed ~40% to the total sales. So de-growth in any of these brands could adversely impact its financials and profitability.

- **Forex fluctuations:** ~43% of APL's sales comes through exports and any adverse foreign currency fluctuations could affect its earnings.

- **New pricing policy:** The management indicated that with the coverage of new products in the acute therapy segment, the percentage of products under the DPCO could increase to 35% and this in turn could hurt its financials.

- **Falling API sales:** APL's API sales has been falling continuously over the last few quarters due to competition from China and other sources. This has impacted the API exports, which is also showing de-growth. However APL is making conscious efforts of exiting low margin API sales and instead concentrating on captive consumption (to increase to 50% over 3-5 years from current 30%) and/or tying up with ANDA & DMF holders for improving the margin profile of its API business.

- The company has one approved formulation facility from USFDA (US) and MHRA (UK). Any adverse regulatory decision on this plant could massively impact the company's international business prospects.

Conclusion & Recommendation

APL reported sales growth of 31.5% y-o-y to Rs 484.3 cr in Q3FY14, which was above the expectations. Higher sales are attributed to the increased supply from its fully functional Panelav facility which eased the supply constraints.

APL, a decade old pharmaceutical company, is a leader in several sub-segments of the Anti-Infective Therapeutic segment. APL, over the last two to three years, has invested heavily to build a huge pipeline of products for the regulated markets and increase its revenue share in total consolidated revenues. Furthermore, now with greater focus on the chronic segments of the domestic market APL is expected to expand its operating margins by changing its product mix. APL is expected to generate strong operating cash flows, and with no major capex planned, it could reduce its leverage and in turn improve its profitability, which makes it a good value play.

It has recently launched Dermatology portfolio and expects to launch overall 25-30 products every year in the domestic segment. It also plans to add some new products to its respiratory segment. APL has a pipeline of ANDA. The company has already built infrastructure conforming to the International standards. This is expected to aid the company tap opportunities in the CRAMS segment.

30% of its API capacity is currently used for captive formulations and APL plans to take only high margin API orders. The regulated generics business has lifted the performance in recent times and is expected to continue to do so in the foreseeable future.

To ramp up revenues, the company is banking on expansion of its manufacturing capacities which cater to the international business and its generic version of Pfizer's drug Pristiq to gain traction in the US though the drug has recently lost market share. It is also looking at setting up a second US FDA approved facility in India to derisk its business.

We are revising our FY14 and FY15 estimates upwards given strong 9MFY14 numbers. At the CMP of Rs.246.65, the stock is trading at 20.6x FY14RE EPS of Rs.12 and 18.3x FY15RE EPS of Rs.13.4.

APLs' domestic Specialty portfolio grew by ~24% CAGR over FY08-13, which resulted in Specialty's contribution to total domestic sales increase to 46% in FY13 (50% in 9MFY14) from negligible levels in 2007. Following the transformation of its domestic portfolio and increasing thrust on exports, APL's stock has been rerated over the past few quarters and may continue to get rerated (albeit at a slower pace).

In our earlier stock updated dated October 4, 2013, we had recommended investors to buy the stock at the then CMP of Rs.142.2 and add on dips to Rs.124-136 for a target of Rs.167 over 1-2 quarters. Post the issue of the report, the stock made a low of Rs.146.75 on October 7, 2013 and achieved the target on October 10, 2013. It made a lifetime high of Rs.253.8 on February 21, 2014.

We feel investors could buy the stock at the CMP and add on dips between Rs.215 – Rs.222 (14.5-15x FY15RE EPS) for a target of Rs.274 (18.5x FY15RE EPS) over the next 1-2 quarters.

Financial Estimates - Consolidated:

Particulars	FY11	FY12	FY13	FY14 (OE)*	FY14 (RE)*	FY15 (OE)*	FY15 (RE)*
Operating Income	1202.1	1466.4	1517.3	1737.3	1820.7	1980.5	2148.4
PBIDT	160.3	220.4	252.0	312.7	345.9	352.5	416.8
PBIDTM%	*13.3%*	*15.0%*	*16.6%*	*18.0%*	*19.0%*	*17.8%*	*19.4%*
PAT	85.4	130.1	165.3	208.5	225.8	233.7	253.5
PATM%	*7.1%*	*8.9%*	*10.9%*	*12.0%*	*12.4%*	*11.8%*	11.8%
EPS	4.5	6.9	8.8	11.1	12.0	12.4	13.4
PE (x)	54.4	35.7	28.1	22.3	20.6	19.9	18.3

* OE- Original Estimates, RE- Revised Estimates

(Source: Annual Report, HDFC sec Estimates)

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