InCred PMS

INCRED HEALTHCARE PORTFOLIO

Aditya Khemka

Principal Officer/Portfolio Manager

- Over 16 years experience in healthcare businesses and investments. Rich global working experience in the US, EU, Latin America and in India
- Has performed various roles like member of the treasury department of the company managing debt, working capital and financial due diligence of acquisitions target in Glenmark (2006-2007), institutional equities analyst for Lehman, Nomura and Ambit Capital (2008-2015) and Healthcare fund manager for DSP (2015-2020)
- Qualifications - MSc. (Finance), PGDM (MDI, Gurgaon), CIIA (UK), CFA (ICFAI)
- Has formulated and executed a product strategy in DSP that drove alpha over the benchmark in 18 months with low churn and highest Sharpe ratio amongst peers
- Believes in bottom-up research and understanding the source of cash flows and their sustainability

Secular vs. Cyclical - Story with Different Endings

An average Large cap Indian Pharma company in FY22

In Rs.	Indian business	US business	API/ROW	Consolidated
Revenue	30.0	50.0	20.0	100.0
EBITDA	12.0	5.0	5.0	22.0
Depreciation	0.5	6.0	0.5	7.0
Interest income	2.0	-	0.5	2.5
Interest expense	-	5.0	-	5.0
PBT	13.5	-6.0	5.0	12.5
Tax	2.0	-	1.0	3.0
PAT	11.5	-6.0	4.0	9.5
Capital Employed	25.0	50.0	25.0	100.0
RoE	46%	-12%	16%	10%
Multiple at CMP	**20 PE**			
Price of stock	**190.00**	**(20x9.5)**		

Same example without US business in FY22

In Rs.	Indian business	US business	API/ROW	Consolidated
Revenue	30.0		20.0	50.0
EBITDA	12.0		5.0	17.0
Depreciation	0.5		0.5	1.0
Interest income	2.0		0.5	2.5
Interest expense	-		-	-
PBT	13.5		5.0	18.5
Tax	2.0		1.0	3.0
PAT	11.5		4.0	15.5
Capital Employed	25.0		25.0	50.0
RoE	46%		16%	31%
Multiple at CMP	**25 PE**	(higher due to >30% ROE)		
Price of stock	**387.50**	**(25x15.5)**		

Source: Internal Compilation

- The Indian Pharma Market (IPM) is a secularly growing segment with extremely high RoE due to the brands owned by pharma companies. We expect the market to continue to grow at 8%-10% in sales and mid to high teens in profits
- US generic market has gone through an earnings downcycle over past 4 years and has seen signs of earnings recovery. Better pricing and gain in volumes as competition may get crowded out would lead to better RoE of the business in coming years
- A 'valuation-gap' exists today in many companies where the poor RoE of US business is suppressing the overall RoE and valuation multiples. We expect this to reverse as US generic profitability improves
- We believe the consolidated valuation as of now lends a negative valuation to the capital guzzler (US generics) implying that this business may never turn positive and losses in the business may compound over time. This is highly unlikely and also unreasoable

Current valuations imply a negative valuation for the US generics business. Giving a '0' value to this lossmaking business and ascribing higher multiple to the stable domestic business (with higher RoCE) may translate to meaningful upside in relevant stocks.

IPCA Investment Strategy

(INRm)	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Domestic Sales	9,294	11,287	11,667	13,886	14,254	16,468	19,126	24,510
PAT	1859	2257	2333	2777	2851	3294	3825	5825
Domestic EPS	14.8	17.9	18.5	22.0	22.6	26.1	30.4	46.0
ex-DF sales	23,524	20,127	17,004	17,681	18,324	20,989	27,361	32,059
PAT	2931	281	-1402	-771	-710	854	2787	6800
ex-DF EPS	23.3	2.2	-11.1	-6.1	-5.6	6.8	22.1	46.5
Total EPS	38.0	20.1	7.4	15.9	17.0	32.9	52.5	92.5

- IPCA stock price fell ~50% by Aug-17 from highs of Feb-14 due to import alert in US business
- While overall EPS for FY16 came in at Rs 7.4 (Rs 38 in FY14), the domestic business continued to deliver ~11% earnings CAGR. It was the ex-DF business which contributed negatively to the earnings
- Our investment thesis was built around high conviction in the domestic business and international business to cut losses eventually. Domestic business delivered 13% earnings CAGR for FY16-18 while international business (ex-US) reached pre-import alert profitability. IPCA significantly cut opex for its US biz during this time. Stock was up 3x in Mar-20 from the lows of Mar-16

Source: Internal Compilation

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Why Indian Healthcare ?

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Unbranded Generics
Pricing pressure easing & RoE's seeing revival

- Pricing pressure easing in US market as companies start optimizing their portfolios (price erosion now at 4% vs 17% in 2017)
- China which is largely dominated by MNCs (~85% ms) is now looking at Indian companies to introduce generics (China market size USD150bn)

Branded Generics
High margin, low capex & steady cash flow business

- Branded generics has high sustainable cash flows, low capex & high RoE with high barriers to entry (8-10% growth & 40%-80% RoE)
- Increasing lifestyle related diseases, better diagnostics and affordability driven by Ayushman Bharat (affordability to expand from 150-200m individuals to 500-600m individuals over time)

APIs/CDMO/CMO
'China + 1' a huge boost to API players

- Anti-China rhetoric could play out well for Indian API players. China exports ~USD 30bn worth of APIs vs ~USD 4bn from India. A 10% shift in demand can double India's API industry size
- Given noncompliance to ESG and recent supply disruptions, Big Pharma is also looking at diversifying sourcing beyond China

Hospitals
Capex phase largely over; time to monetize

- Indian hospital players have incurred huge capex to increase capacity which is coming to an end (Mature hospitals RoE at ~20% vsconsolidated 4%-12%)
- This may lead to better margins, cash flows and lower debt resulting in re-rating of the business

Diagnostics
Low penetration to benefit organized players

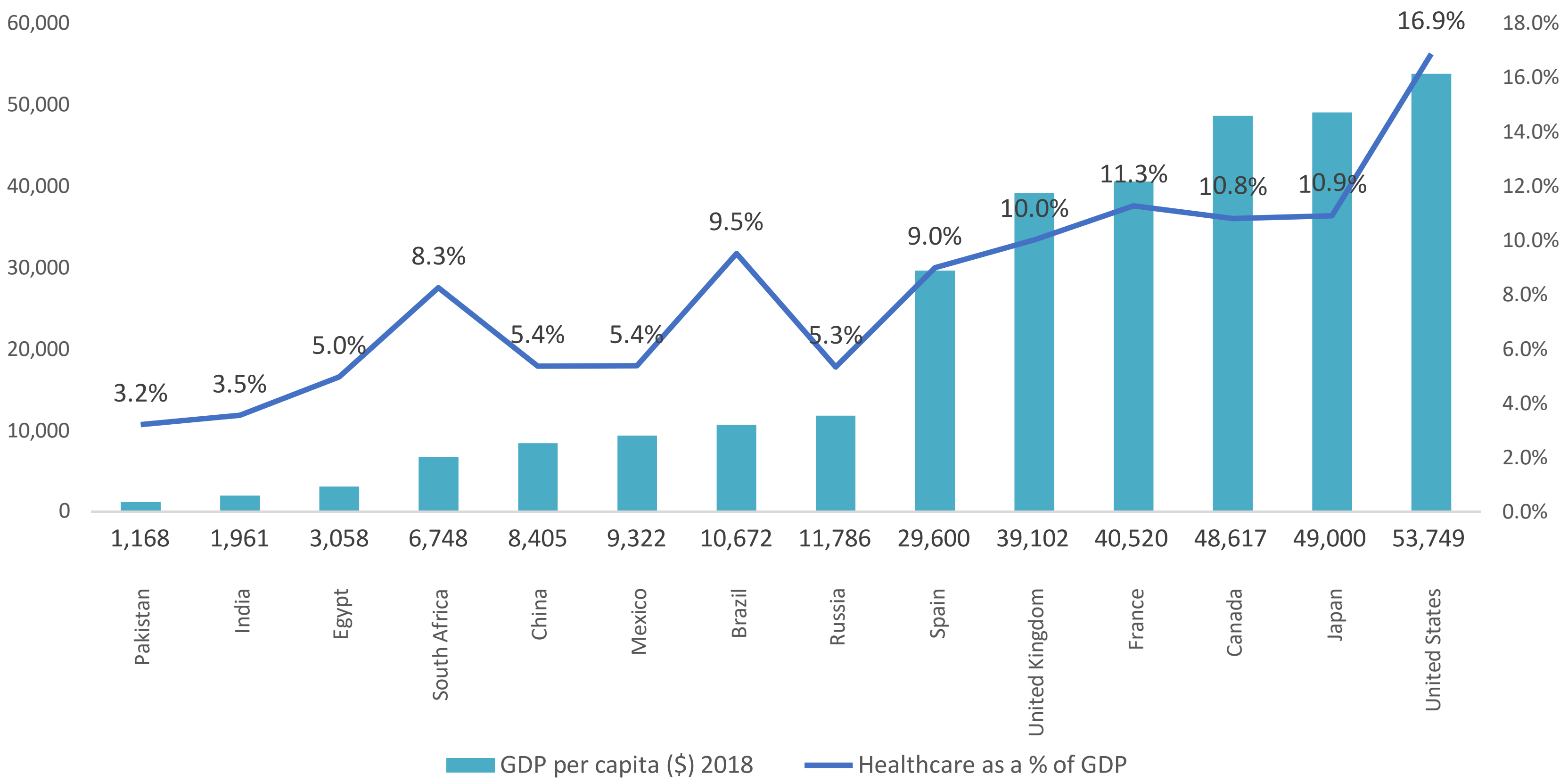
- Diagnostics is 85% unorganized. With increase in health awareness, the organized players are expected to benefit the most
- Broader market growing at 10% pa and organized gaining share. High RoE and low reinvestment needs

Source: IQVIA, KPMG report, Internal

GDP & Healthcare

We observe that as GDP per capita increases, healthcare spend increases significantly. Developed economies have a very expenditure on Healthcare as % of GDP vs developing economies.

This gives us comfort that there is significant headroom for growth in this sector for India.



Source: World Bank

GDP & Healthcare

GDP per capita: USD 2,000

India

Healthcare spend per capita: USD73

15 yrs at 10% GDP growth

GDP per capita: USD 9,000

Brazil

Healthcare spend per capita: USD848

For India to equal Brazil's healthcare per capita spend, the industry must grow at 18% over the next 15 years

Source: World Bank

Healthcare Growth Faster Than Economy

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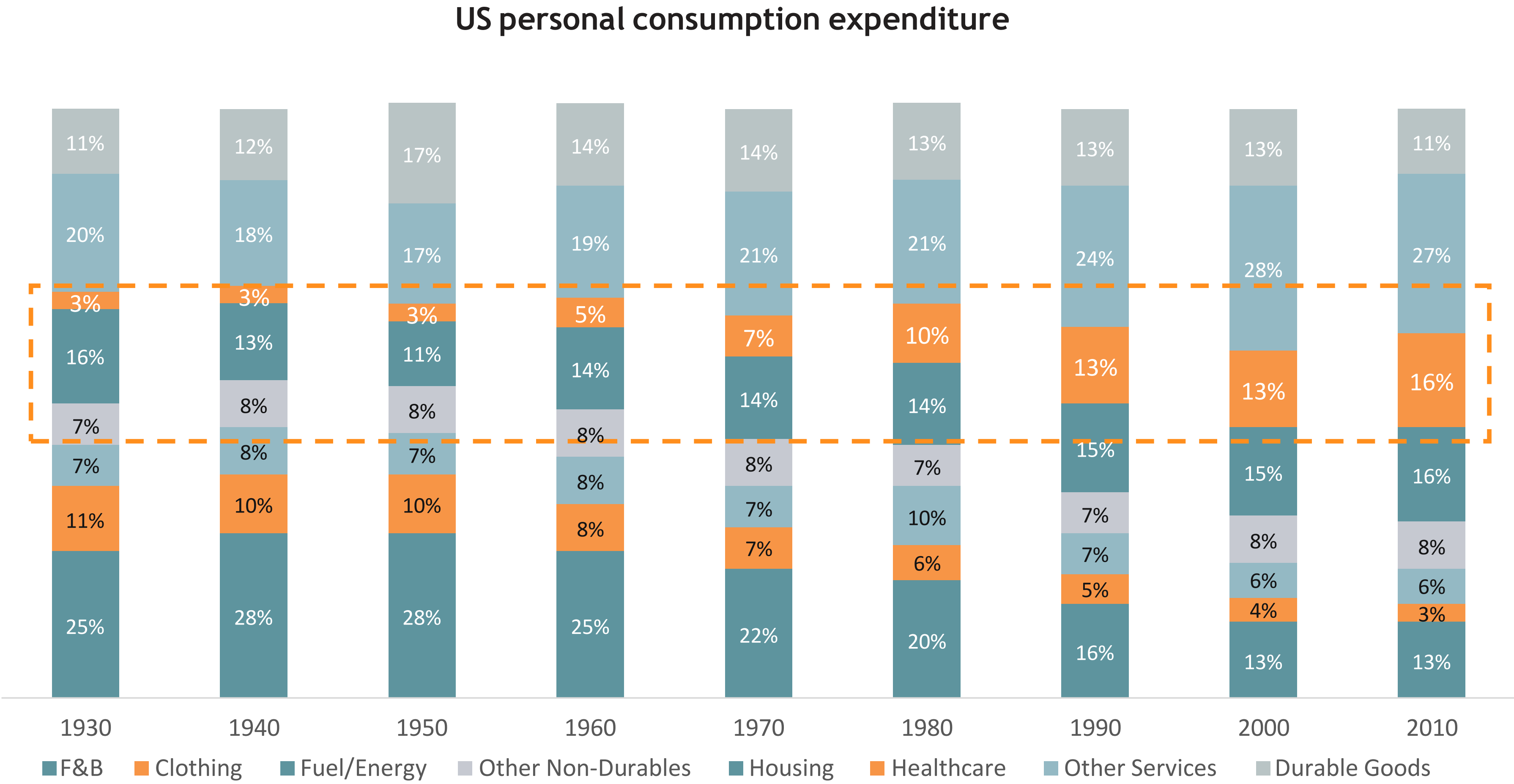
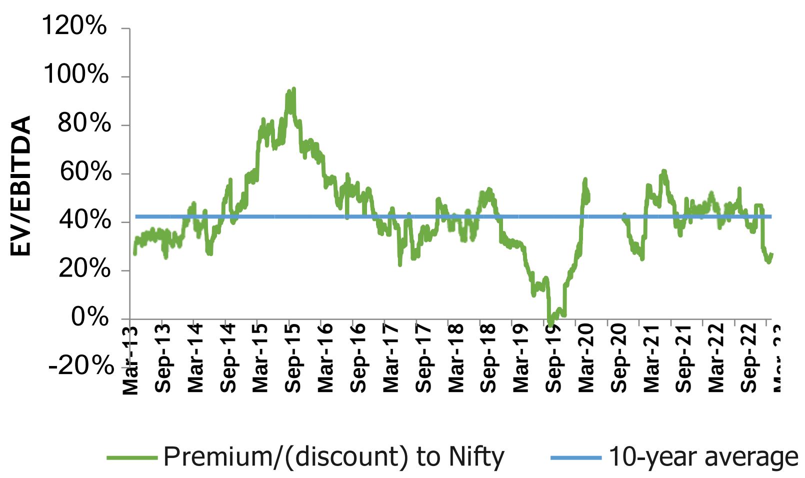


- In the US, Healthcare grew much faster than other sectors over the last century
- India current healthcare spend per capita is 3.5% of the GDP per capita which is where the US was in 1930s-1950s. We see huge runway for growth in healthcare as GDP per capita rises over the next few decades.

Source: Industry

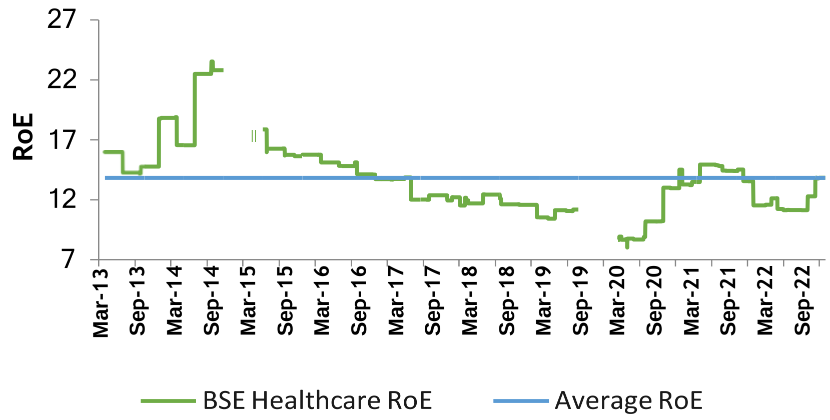
Valuations below 10-yr average



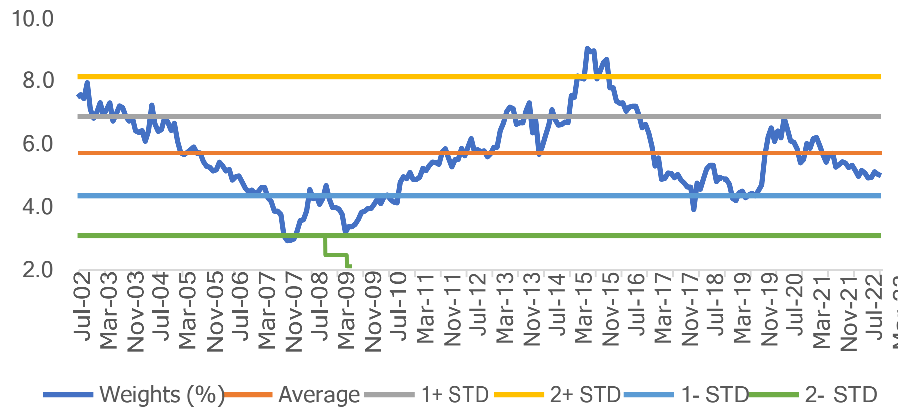
Trading at 27% premium to Nifty vs 10--yr avg. of 42%

Trading at 39% premium to Nifty vs 10-yr average of 62% and peak premium of 143%

Improvement in business and ROE may lead earnings growth and rerating of the sector going forward



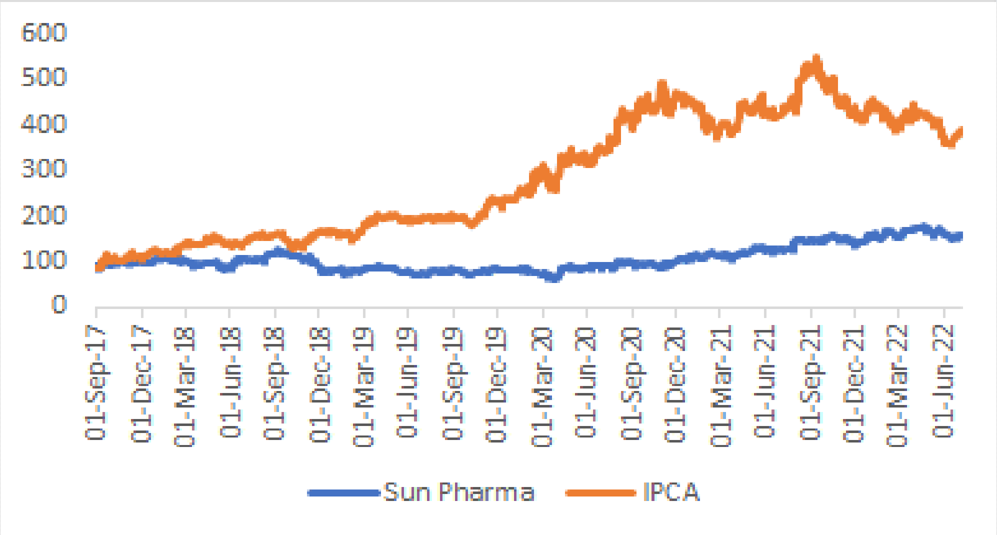
Healthcare Weight in NSE 500 (m-o-m) in %



Source: Bloomberg | Data as on 31st March 2023 | * EBITDA – Earnings before Interest, Taxation, Depreciation and Amortization

Large is not necessarily safe – Sun Pharma vs Ipca Labs

Ipca's share price outperformance…



…and better fundamentals

	Sun Pharma	Ipca
Revenue CAGR (FY17- 2)	4%	13%
EBITDA CAGR (FY17- 2)	0.6%	25%
PAT CAGR (FY17- 2)	2%	35%
Adj. RoE FY17	29%	8%
Adj. RoE FY22	16%	16%

It's not just the scale but sustainability of earnings. Even after stellar outperformance, Ipca Labs market cap is <1/5 of Sun Pharma

In our assessment, IPCAs generic business contributed less than 10% to the total EBITDA in FY22 while for Sun Pharma (incl. US specialty) the contribution is ~40%.

Source: Bloomberg

Past performance may or may not be sustained in the future and is no guarantee of future results.

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Healthcare not a Sectoral Call

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Is a Healthcare PMS allocation a sectoral call? – We believe NOT.

How much should one allocate? – 10%-15% of equity portfolio is justified.

- Healthcare portfolio offers a solution that invests in 5 baskets of businesses.
- Upon closer examination, one can deduce that the portfolio in itself is a multi-cap diversified equity portfolio with exposure to 5 segments. The only difference is that consumption in healthcare in non-discretionary and secularly growing, whereas for these analogies, consumption is discretionary.

discretionary.

% of portfolio in	Same economic model as*	Avg. Of competing funds (%)	BSE Healthcare (%)	Incred Healthcare PMS (%)
Hospitals	Branded Apparel Retail	14.7	15.9	18.4
Diagnostics	Quick service Restaurants	2.3	3.0	11.6
Generics	Metals and commodity	45.3	48.4	5.0
API	Chemicals, Industries	8.4	16.7	18.4
Branded Generics	FMCG	24.3	16.0	39.0
Others		5.2	-	7.6
Grand Total		100	100	100

Capitalisation	Weight
Large Cap	~20%
Mid Cap	30%-40%
Small Cap	40%-50%

Healthcare is a sector in India, where the companies that you invest, are globally competitive.

Data Source: Computation: Internal. *Segments defined by InCred Healthcare Fund Manager
*To read on our thesis for like-to-like comparison, please refer slide 12. The above comparison is being provided for informational purposes, for model client vis-a-vis thematic mutual funds following healthcare and pharma theme as on 31st March 2023.
The comparison is being provided for said 5 different healthcare sector
segments, as defined by Fund Manager, to depict overweight/underweight stance under InCred Healthcare portfolio

Our thesis for like-to-like comparison

Hospitals	We believe that hospital companies work on similar business model as apparel retail segment, where hospitals have to open new units, track performance of existing hospitals and have similar economics as retail stores
Diagnostics	Just like QSR companies where per store economics, opening of new stores, etc. matter, diagnostic companies too have to open new centers, expand into newer markets
Unbranded Generics	In unbranded generics demand supply determines the price, and hence we believe these companies do not have pricing power; similar to metals and commodity companies
API	Similar to industrials, API companies have huge capacity, higher utilization improves operational efficiencies, scope for China +1 strategy, have global cost leadership
Branded Generics	Branded generics is being considered like FMCG, as patients tend to prefer brands of reputed companies, have large distribution channel, have pricing power, marketing and promotional activities can drive sales

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OCF Correlation	DRL	Torrent	Divis	Apollo Hospitals	Dr Lal	HUL	Ultratech Cement	Infosys
DRL	1.00	0.87	0.85	0.79	0.81	0.73	0.78	0.78
Torrent	0.87	1.00	0.71	0.61	0.64	0.55	0.57	0.60
Divis	0.85	0.71	1.00	0.86	0.96	0.89	0.92	0.91
Apollo Hospitals	0.79	0.61	0.86	1.00	0.93	0.93	0.95	0.92
DrLal	0.81	0.64	0.96	0.93	1.00	0.97	0.95	0.98
HUL	0.73	0.55	0.89	0.93	0.97	1.00	0.92	0.98
Ultratech Cement	0.78	0.57	0.92	0.95	0.95	0.92	1.00	0.94
Infosys	0.78	0.60	0.91	0.92	0.98	0.98	0.94	1.00

*OCF- Operating Cash Flow

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Healthcare outperformance

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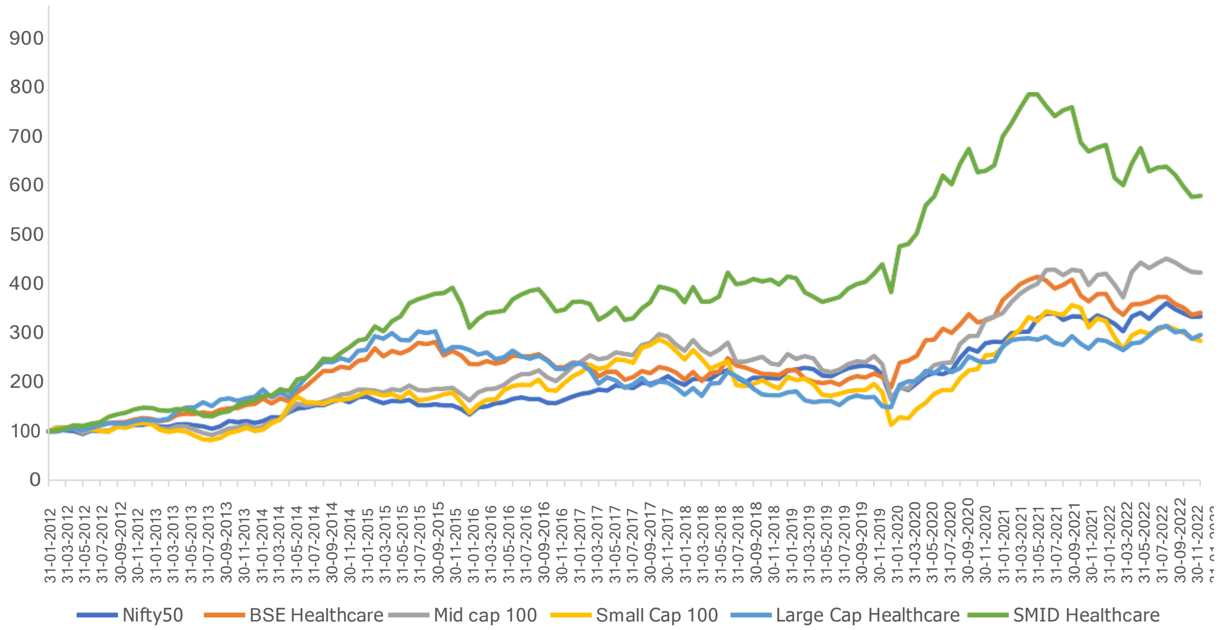
Is a Healthcare PMS allocation a tactical call? – We believe NOT.

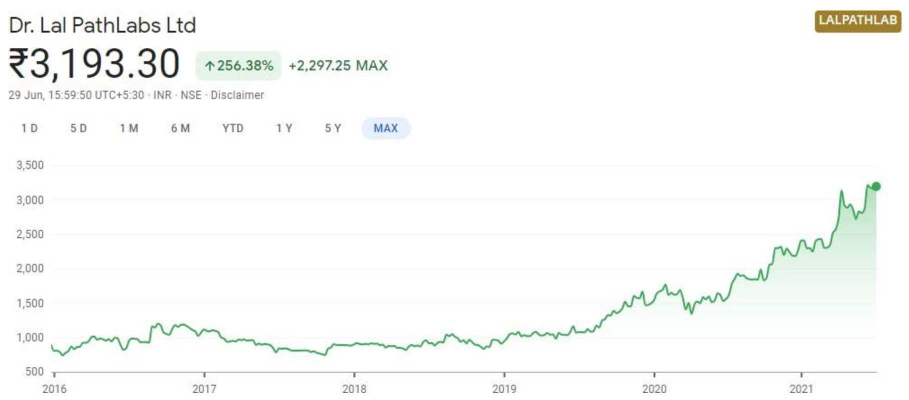


- Since 2012, the BSE Healthcare Index has outperformed Nifty by ~8%
- Large cap healthcare companies underperformed both Nifty50 (-38%) as well as BSE healthcare (-45% annualized) during the same period.
- SMID Healthcare stocks led the pharma rally as they outperformed Nifty50 by 245% and BSE Healthcare by 238% during the same period.

Data from Jan-12 to March-23

Source: Investing.com

Cyclicality Only In One Domain



**OCF CV -OPERATING CASH FLOW, COEFFICIENT OF VARIATION*

Source: Investing.com

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US: A Treadmill Segment

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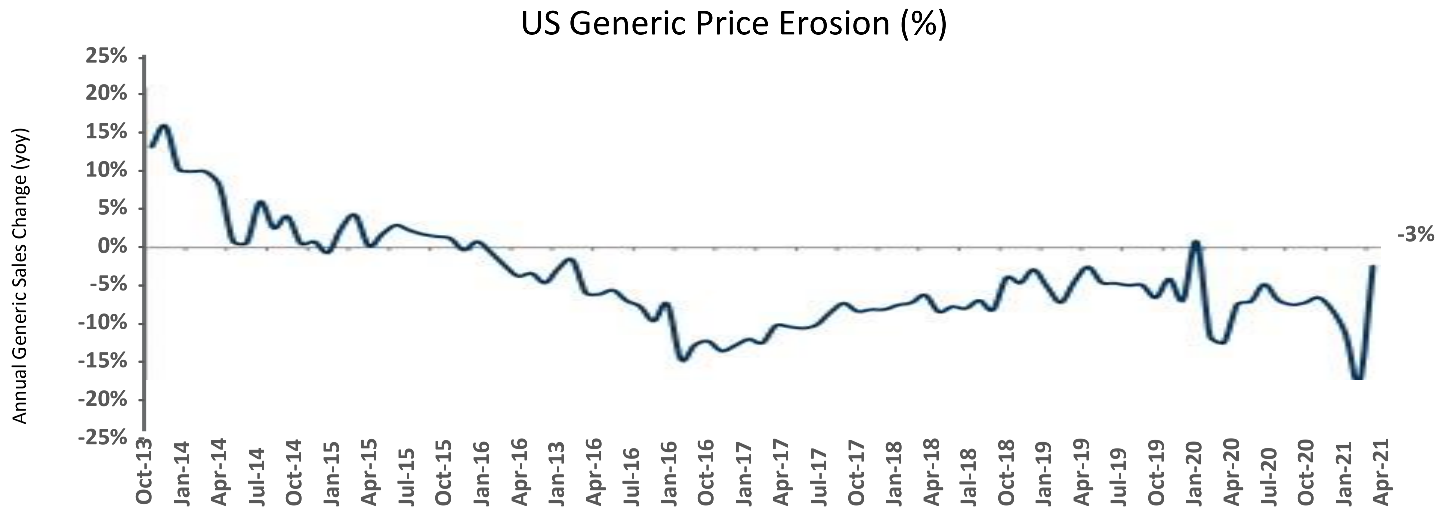
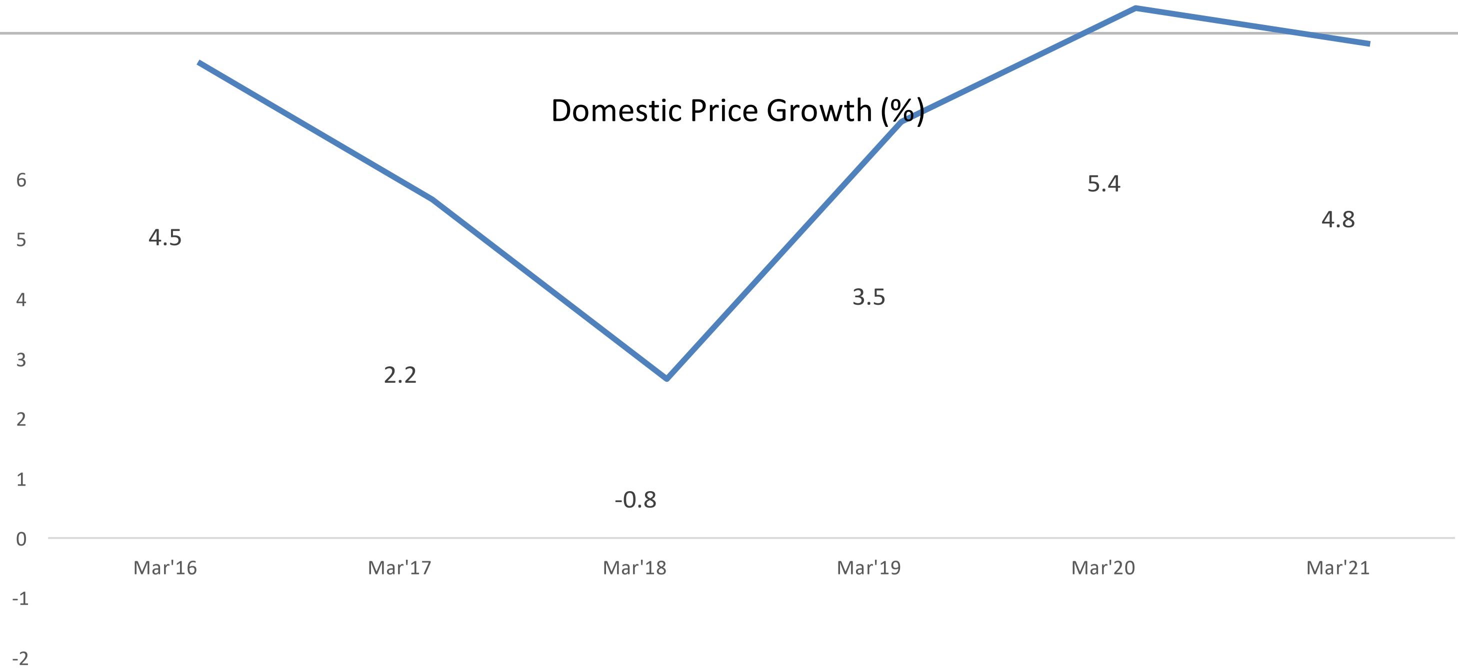


Source: IQVIA



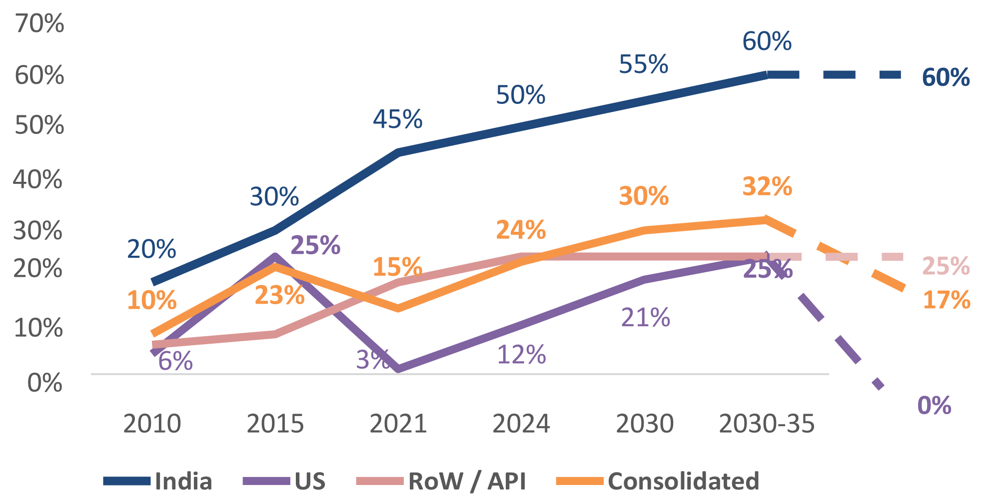
Source: AIOCD

- Many investors believe that healthcare is a cyclical play taking cues from the upcycle between 2009-2015 and the downcycle thereafter. We dig deeper and try to address the concern!

- **What happened?** We discern that downcycle post 2015 started when US business RoEs reached ~25% levels. This is when the industry attracted high level of competition. Consequently, RoEs started to plummet, with US RoEs dropping to ~3% levels in FY21. Thus, BSE Healthcare peak RoE of 23% in FY15 fell to 15% in FY21

- **How is it different this time?** We notice that, while in 2015, RoEs of India business stood at ~30%, they were much better in FY21 (~45%) and we expect them to peak out at ~60% levels somewhere around FY30-35.
  We also expect US to improve from ~3% to ~25% by then

- **How it matters?** With increased RoEs from India business, the consolidated RoE uptick this time may be much more immune. Thus, when US RoEs reach ~25% in 2030-35, and start to see a downcycle, the subsequent RoE impact may be much lower. According to our estimates, even if US RoEs go to zero, the overall RoEs might still be ~17% (~15% in FY21). <u>*Even in a worst case scenario, RoEs should be better than what they are today!*</u>



Pharma Outperformed During High Inflation

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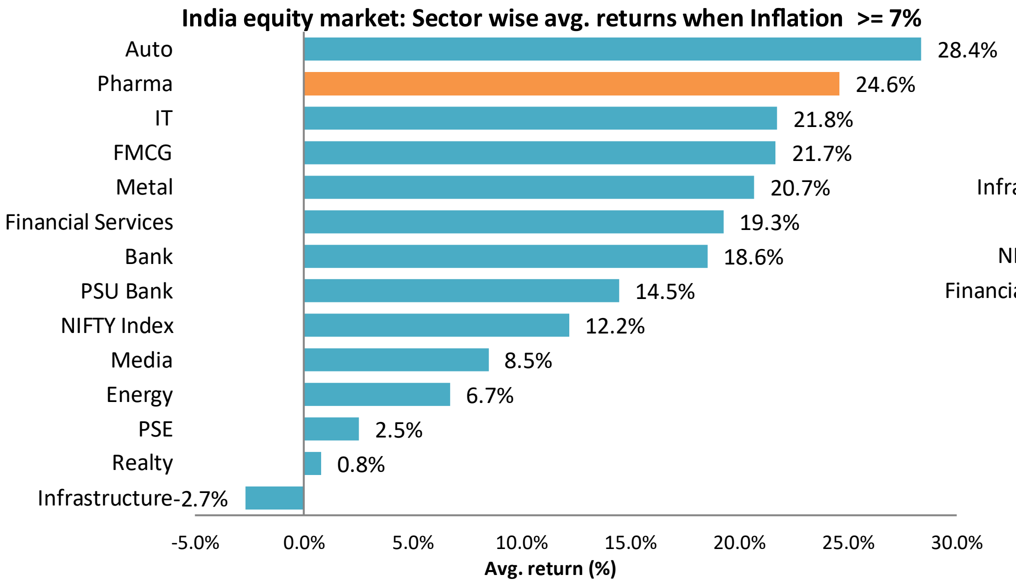

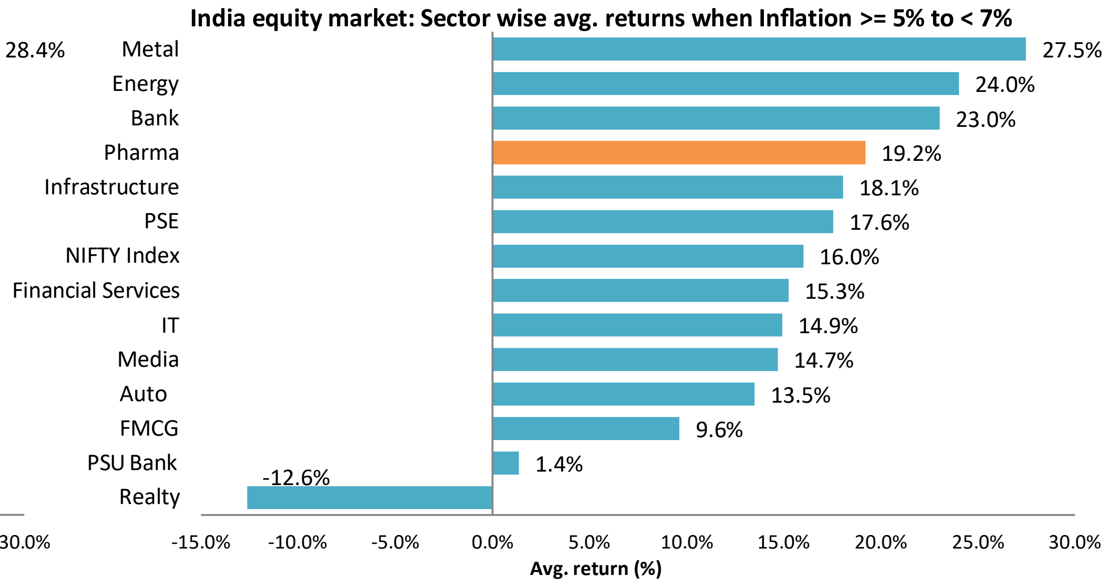

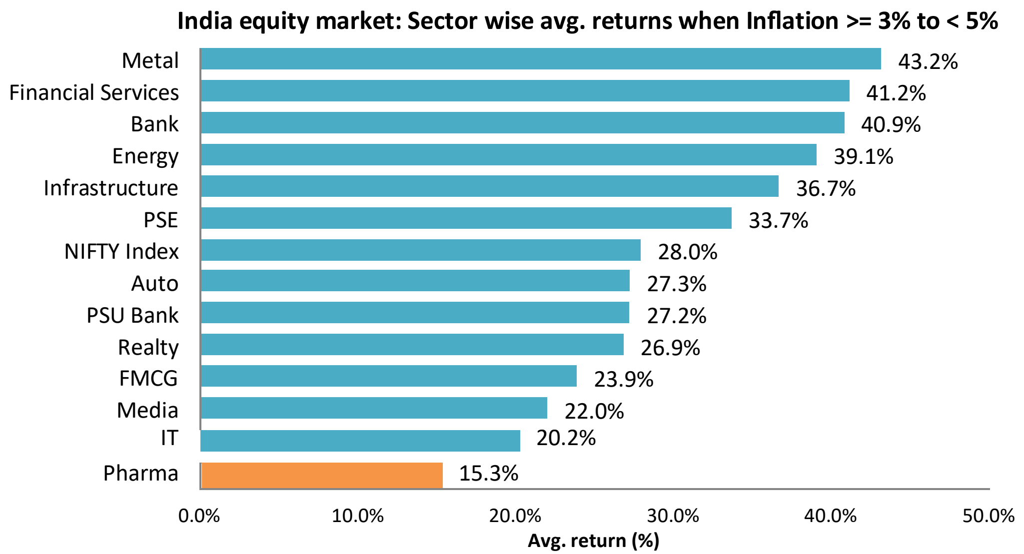

Source: Bloomberg

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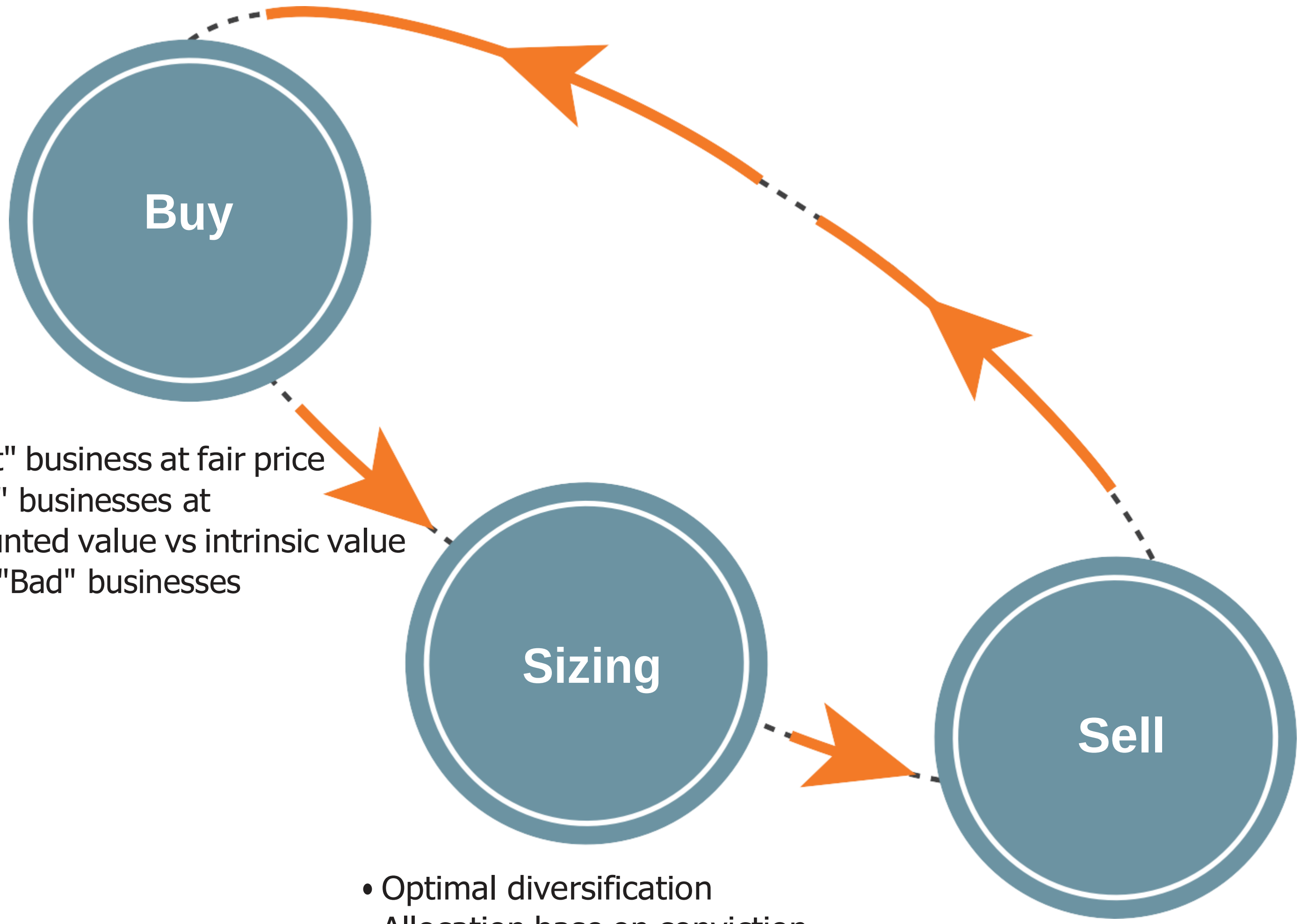
Decision Making Process



- "Great" business at fair price
- "Good" businesses at discounted value vs intrinsic value
- Avoid "Bad" businesses

- Optimal diversification
- Allocation base on conviction

- When incremental Upside-Downside ratio is unfavorable
- When the underlying business starts to deviate from the investment thesis

Framework Examples

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Our Criteria	TORRENT	IPCA	DIVIS	AJANTA	SYNGENE	THYROCARE	JB CHEM	ALKEM	INDOCO
Quantitative									
RoIC v/s WACC	√√√	√√	√√√	√√√	√√	√√√	√√√	√√√	√√
Capital Structure	√√	√√√	√√√	√√√	√√√	√√√	√√√	√√√	√√√
Cash Flow Adequacy	√√√	√√√	√√	√√	√√√	√√√	√√	√√	√√√
Covenants	√√√	√√	√√√	√√√	√√√	√√√	√√√	√√√	√√
Growth	√√√	√√√	√√√	√√√	√√√	√√	√√	√√√	√√
Qualitative									
Competitive Advantage	√√√	√√√	√√√	√√√	√√√	√√	√√	√√	√√√
Pricing Power	√√√	√√√	√√√	√√	√√	-√√	√√	√√	√√
Character of Management	√√	√√√	√√	√√√	√√√	√√	√√√	√√√	√√
Alignment of Interest with Minority	√√√	√√	√√	√√	√√	√√√	√√√	√√	√√√
Dependence of External Variables	√√	√√	√√	√√	√√	√√	√√	√√	√√
Score	**27**	**26**	**26**	**26**	**26**	**21**	**25**	**25**	**24**

Maximum score can be 30

A score of 3 is granted if the company fulfills the Great Business parameters listed in the last slide. A score of 2 is given if the company fulfills the Good Business parameters and -2 is for Bad Business

ROIC : Return on Invested Capital; WACC Weighted Average Cost of Capital. The above examples are for illustration purpose only. The companies mentioned above may or may not form part of the Investment Approach/Fund/Scheme.

Portfolio Fundamentals

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	FY21(Actual)	FY22E	FY23E	FY24E
Total Sales	30,906	34,940	38,591	43,292
Growth yoy (%)		*13.1%*	*10.4%*	*12.2%*
EBITDA	6,183	6,366	6,268	7,909
Growth yoy (%)		*3.0%*	*-1.5%*	*26.2%*
EBITDA Margin (%)	*20.0%*	*18.2%*	*16.2%*	*18.3%*
PAT	2,909	3,086	2,692	3,806
Growth yoy (%)		*6.1%*	*-12.8%*	*41.3%*
PAT Margin (%)	*9.4%*	*8.8%*	*7.0%*	*8.8%*
RoCE	13.6%	13.1%	11.2%	14.5%
Valuation Ratios				
P/B	4.0	3.7	3.5	3.1
EV/Sales	3.1	2.8	2.5	2.2
EV/EBITDA	15.4	15.2	15.3	11.8
P/E	31.5	29.7	34.0	24.1
OCF yield	5.8%	4.1%	4.7%	6.4%
FCFF yield	3.9%	1.6%	1.5%	4.1%

Disclaimer: Expected portfolio fundamentals; Source: Incred AMC research; Portfolio excluding Insurance companies

Portfolio expected to see 11% revenue growth. EBITDA margins to remain flat at ~18%

Portfolio earnings growth expected ~11% CAGR (FY22-24E) with improved ROCE (140 bps) and free cash flow yield of 4.1%

Valuation on forward basis at
P/E 24x2yr forward

EBITDA : Earnings before Interest, Tax, Depreciation and Amortization;
RoCE : Return on Capital Employed;

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Thank You