InCred PMS

Healthcare BULLETIN

Healthcare's subdued performance over past 2 years and outlook

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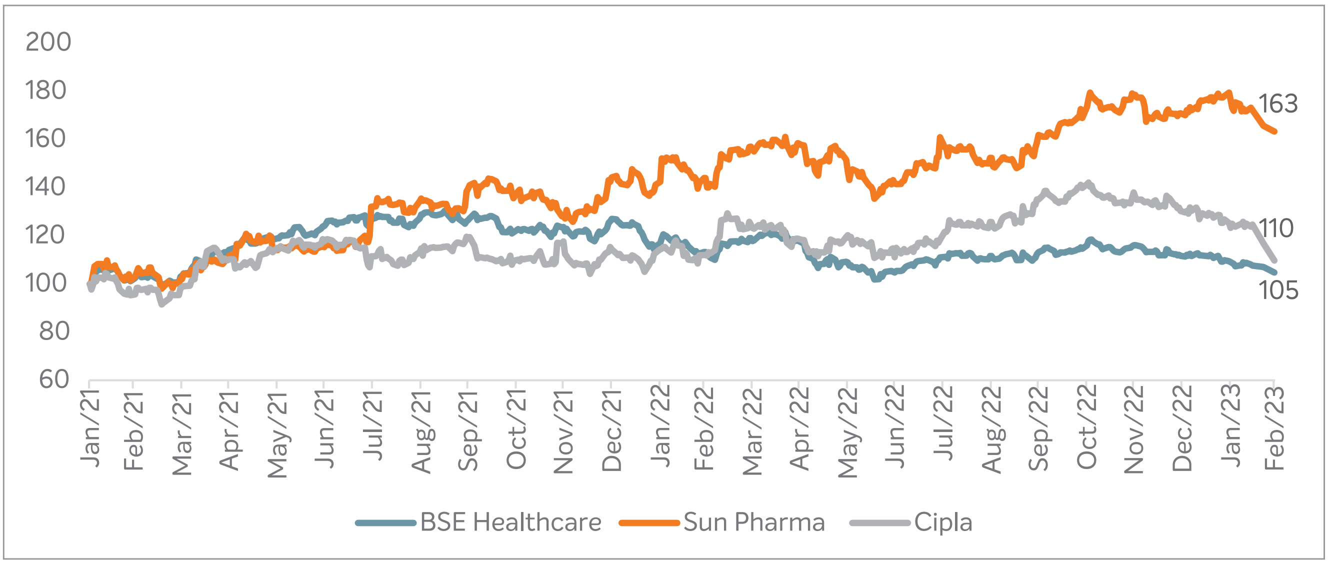
The BSE Healthcare index is flat over the past 2 years with almost nil returns for investors. While a couple of the largest weight stocks like Sun Pharma and Cipla have delivered 63% and 10% returns over the same period, most of the other stocks are largely flat or down over the same period. The InCred Healthcare PMS has performed in line with the index (post fees and charges) but we do not own some of the best performing large caps due to our thesis that US dependent businesses would experience bouts of upswings and downswings which are difficult to predict and time.

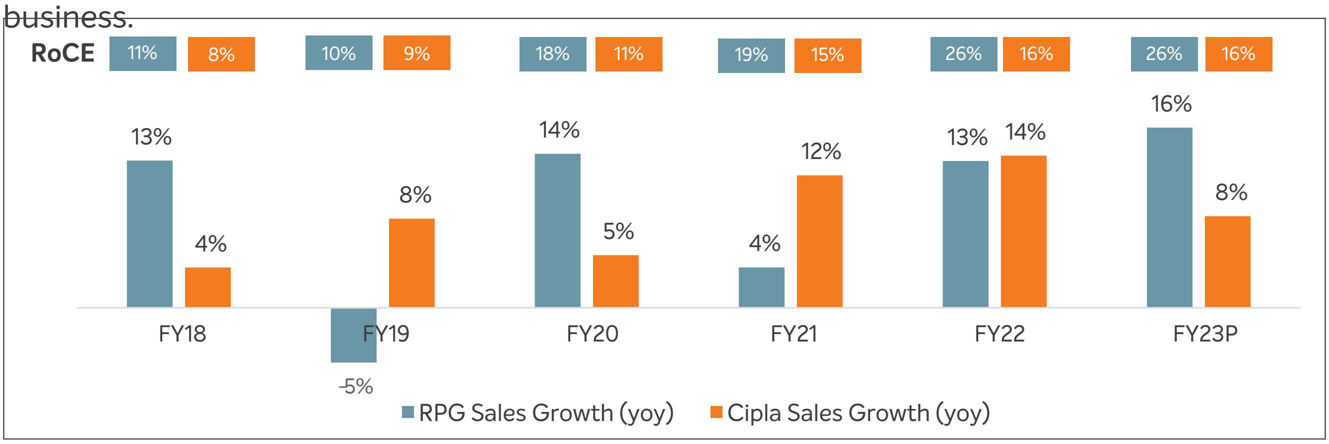


Note: Price taken from 31st Jan'21 to 28th Feb'23

Market cap wise		
	Fund	BSE Healthcare
Large cap	14%	48%
Mid cap	25%	33%
Small cap	62%	19%

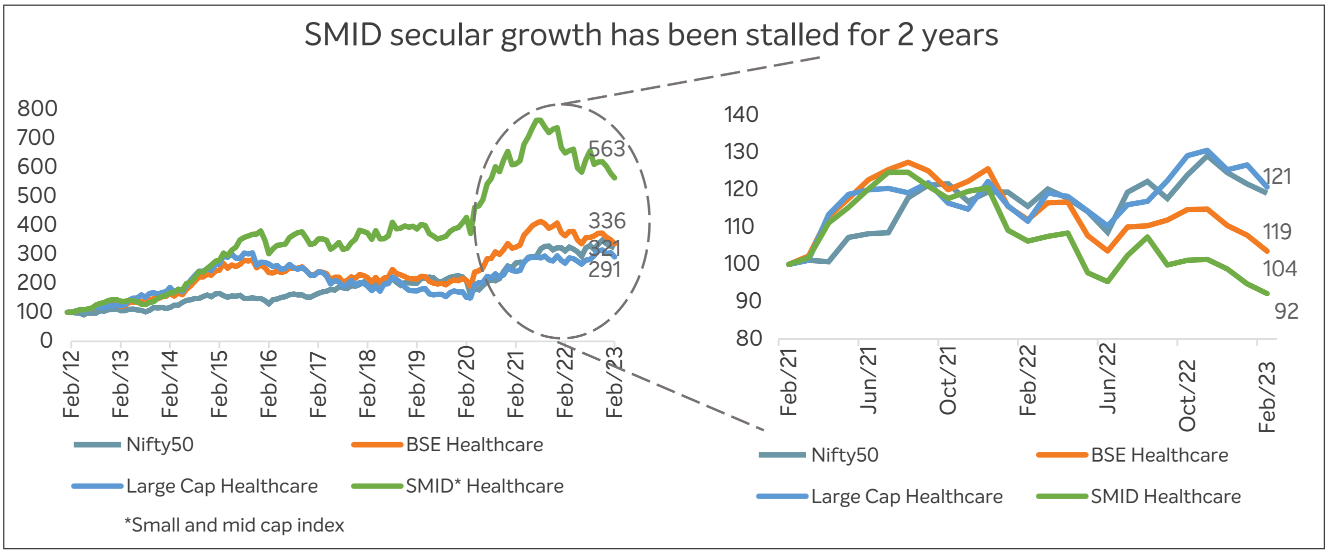
Where our conviction lies and why?

Our conviction lies in mostly branded generic companies, hospitals, diagnostics and API/CDMO (Contract Development and Manufacturing Organization) companies. Most of these stocks tend to be small and midcap as these are branded businesses and cannot be scaled up in a short span of time. However, because their products are branded in nature, these businesses have higher return ratios, more consistent growth, reasonable valuations, and less leverage than some of the larger companies that are focused on the unbranded generic (US and EU pharma) business. As can be seen from the below illustration, RPG has a much better RoCE (Return on capital employed) profile vs Cipla and has demonstrated higher growth over the last 5 years. Despite a better business model (high branded mix) and superior return on capital, RPG is trading at 21x TTM P/E vs Cipla trading at 27x. It is worthwhile to note that, re-investment needs in RPG are much lower vs Cipla. While RPG has to use cash generated to further strengthen its brand portfolio, Cipla needs to continuously invest in its generics business in order to grow on its large base and overcome price erosion in US business.



Why haven't we outperformed the index by a higher margin?

Since the fund was launched in Feb 2021, we have seen a risk aversion in the capital markets driven by various factors including but not limited to higher interest rates, higher inflation, raw material and logistic constraints, oil price spikes etc. All these factors have led the larger cap healthcare stocks to perform better than small and mid-cap peers regardless of the quality of the underlying business and the sustainability of its cash flows.



We note that the underperformance of small and midcap healthcare companies vs large cap over the past 2 years is a technical deviation from the longer-term trend where over the past 10 years the former has outperformed the latter by more than 250%.

It is therefore a point to be noted that InCred Healthcare fund despite being ~86% small and midcap has outperformed the BSE Healthcare Index (48% large cap) post fees and charges over the last 2 years of existence.

What is the outlook for our fund?

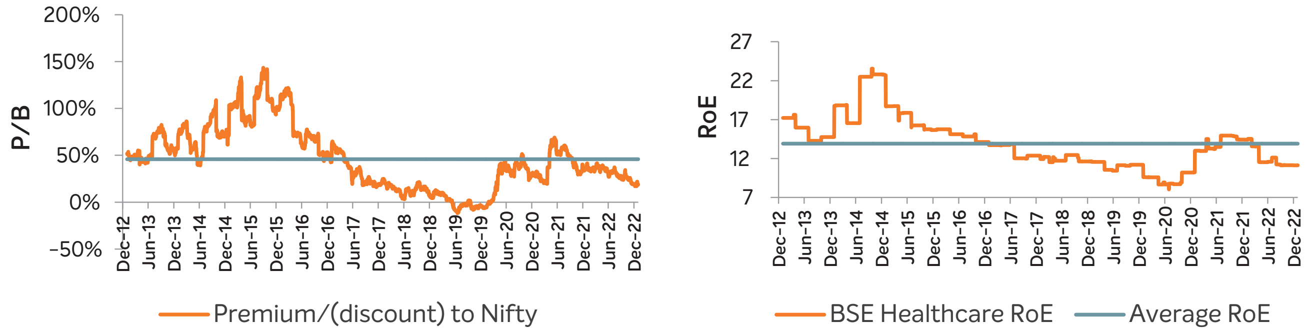
We believe that whatever could have gone wrong in the macros in the past 2 years has gone wrong. In our assessment, the worst is in the price for most of our holdings and things are likely to improve from here on. At a fund level (ex-Insurance and cash), we have seen double digit sales CAGR in FY22 and FY23. However, the PAT CAGR has been low single digits due to inflationary pressures. However, our channel checks suggest that these pressures are easing and hence in FY24, while top line growth may be low teens over FY23, bottom line growth could be in high twenties driven by easing costs.

INRm	FY22E	FY23E	FY24E	3-yr CAGR
Total Sales	**34,869**	**38,217**	**42,772**	**11%**
Growth yoy (%)	12.5%	9.6%	11.9%	-
EBITDA	**6,515**	**6,750**	**8,330**	**9%**
Growth yoy (%)	2.2%	3.6%	23.4%	-
EBITDA Margin (%)	18.7%	17.7%	19.5%	-
PAT	**3,184**	**3,152**	**4,243**	**12%**
Growth yoy (%)	5.1%	-1.0%	34.6%	-
PAT Margin (%)	9.1%	8.2%	9.9%	-

What should investors do?

We encourage our investors to add on to their holdings / top up given the outlook is healthy and prices are suppressed. Healthcare is a non-discretionary expenditure and is likely to exhibit healthy volume growth going forward as it has done in the past. The best time to invest in a fund is when the price to book and RoE of its benchmark is below long term averages. We are at such a juncture in healthcare today.

Valuations and margins are below long term averages



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