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# HEALTHCARE

## *The Indian API (Active pharmaceutical ingredient) saga from Bust to Boom*

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Historically, most Indian Pharma companies came into existence by starting off as an API manufacturers . During the 1980s, India was the largest manufacturer and exporter of raw materials and API. However, when China started competing with lower pollution controls and capital and revenue subsidies in 1990s, the Indian API industry fell sick as the customer base shifted by and large to the cheaper Chinese manufacturers .

## The Indian API industry – is on a revival path

Over the last 4-5 years, we have begun to see a turnaround in the Indian API industry with the players who managed to survive the last 3 decades of intense competition from China. These companies survived for 30 years because they either had a differentiated product portfolio or were fiercely cost-competitive compared to their Chinese counterparts.

However, since 2017-2018, China has also implemented pollution controls across industrial parks and provinces to achieve their carbon emission goals. This added to the existing inflation in Chinese labor/power cost all of which are critical inputs in manufacturing raw materials and API. Hence, we are currently witnessing a plethora of Capex in the Indian API industry. Customers of the Chinese API seem to be looking for an alternate supplier to de-risk their supply chains. Further, the geopolitical narrative necessitates a diversification of Chinese pharma supply as a national security measure.

## Why did the Indian API stocks do well and then tumble?

Many API stocks gave manifold returns in 9MFY21. However, subsequently, we have seen the same stocks declining anywhere between 25% to 75% over the last 2-3 quarters of FY22. We believe there are 2 fundamental factors that led to this:

a) Inventory rationalization at the customer's end; b) margin pressure as input costs rise.

## Will the trend of lower margins/volume growth sustain?

We believe it is unlikely that margin pressures and low volume growth would sustain. API companies generally work on a cost-plus model but get bound in annual/semi-annual contracts with their customers where prices tend to be fixed over the tenure. Hence, the price pass on eventually happens albeit with a lag. Volume growth in the last 2-3 quarters has been lower due to the high base of last year. However, in the coming year, volume growth may likely normalize as the current base of volume is lower than normal (inventory destocking).

# How is the InCred Healthcare Portfolio positioned?

We are optimistic about the API business over the next 3-5 years. We believe that the Capex cycle may coincide with high volume growth and price stability once margins are normalized (likely sometime in 1QFY23-2QFY23). At InCred Healthcare PMS, we are overweight the sector with 21% of our fund deployed in the space vs 16% for the benchmark.

# What are the risks to our thesis?

With a new surge of Covid related restrictions in China, we could potentially see another round of price increases and supply bottlenecks in raw materials from China. However, we believe that now the industry is relatively more prepared for such shocks than last year and the worst is already in the price. However, we cannot rule out a delay in the normalization of margins if another supply shock of raw materials were to set in the near future.

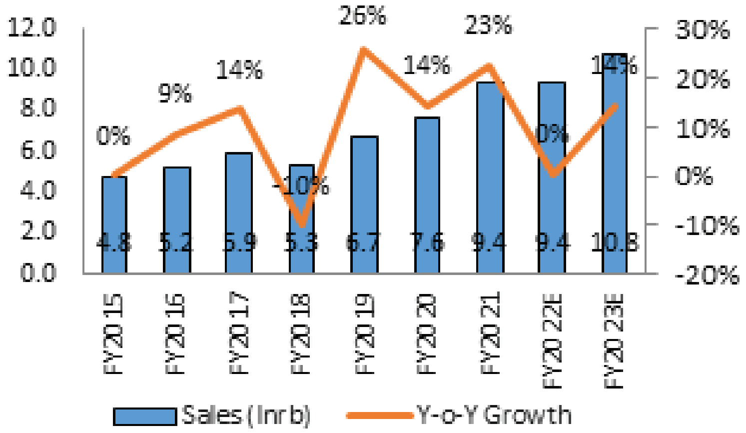
# Case study of Neuland Labs

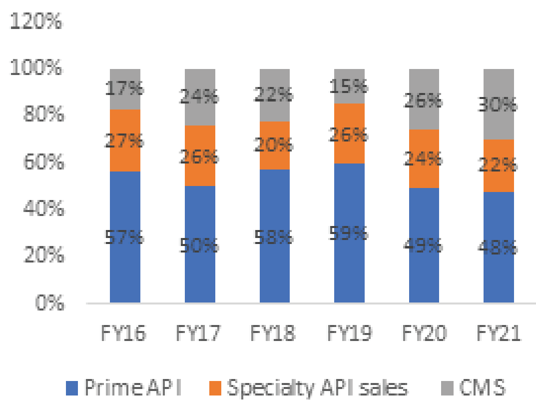
Neuland Labs is a pure-play API manufacturer for several domestic and international pharmaceutical companies. The company has two USFDA- approved facilities that manufacture over 75 APIs addressing 36 therapies. NLL's APIs are primarily marketed in highly regulated markets such as the US, Europe, and Japan (accounting for over 75% of its sales).

Revenue has grown at a CAGR of 13 % over FY16-FY21. The company has three business segments, namely

1) prime API
2) niche API
3) CMS (Commercial + development).

Over the years, NLL has shifted its focus from the high-volume, low-margin segment (Prime API) to high-margin complex products (niche API/CMS). The revenue contribution from the prime API segment reduced to 46% in FY21 from 54% in FY16. Contribution from niche APIs has been in the range of 21%-25% between FY16-21 while CMS revenues have increased to 30% in FY21 from 17% in FY16.




Source: InCred PMS Research team

Margins are expected to improve (~15% in 9MFY22) on the back of a strong order book, better traction in the GDS business, cost optimization measures, and improved product and revenue mix within CMS business.

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We believe Neuland is in a sweet spot given that global and Indian pharma players are looking at the China+1 strategy for sourcing raw material. To cater to the increased demand, the company has invested in additional capacities (Unit-3) which will provide for strong growth over the next few years. Over the last 4 years, the company has added 27 molecules in its CMS segment (57 in 3QFY19 to 81 in 3QFY22) across the pre-clinical to development and commercial stage. Hence, Neuland is also a second derivative play on pharmaceutical innovators.

Like any other API company, Neuland too is seeing an escalation in RM pricing which has led to margin contraction. However, we believe this impact is transient in nature. API companies are bound by contractual agreements which restrict them from taking immediate price hikes. However, once the contracts are renewed, the increase in raw material costs is fully / partially passed on. We expect Neuland's profitability to improve hereon given the increased focus on specialty APIs, cost rationalization initiatives, and better product mix in the CMS business.

Neuland is trading at 7x FY24E EV/EBITDA. We value the stock at 12x EV/EBITDA to capture the revival in margins and better product mix going ahead. We see that Custom Synthesis players in India/Internationally are trading at >20x EV/EBITDA. We value Neuland at a discount due to exposure to generic APIs which trade at a much lower multiple.