InCred PMS

Healthcare BULLETIN

The Stagflation Scenario
How our Healthcare Portfolio can sidestep the challenges

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Through this edition, we want to address investors' concerns about investing in equity in recent times and how we at InCred believe that such concerns can be sidestepped.

The 3 major concerns that investors may have while investing in equities today are:

A) Interest rates are going to increase – the past decade has seen easing monetary policies across the globe which led many corporate to the lever and engage in capacity creation with low-cost money. However, as the interest rates may increase going forward, the fear that investors have today is what happens to companies that have a sizable debt on their balance sheet and their financial cost goes up.

B) High inflation would lead to lower corporate margins – Supply bottlenecks and a glut of liquidity has resulted in higher inflation in commodity and material prices. These often act as input costs for many organizations and hence, the fear is what happens to corporate EBITDA* and gross margins as these higher costs impact the cost of production or service.

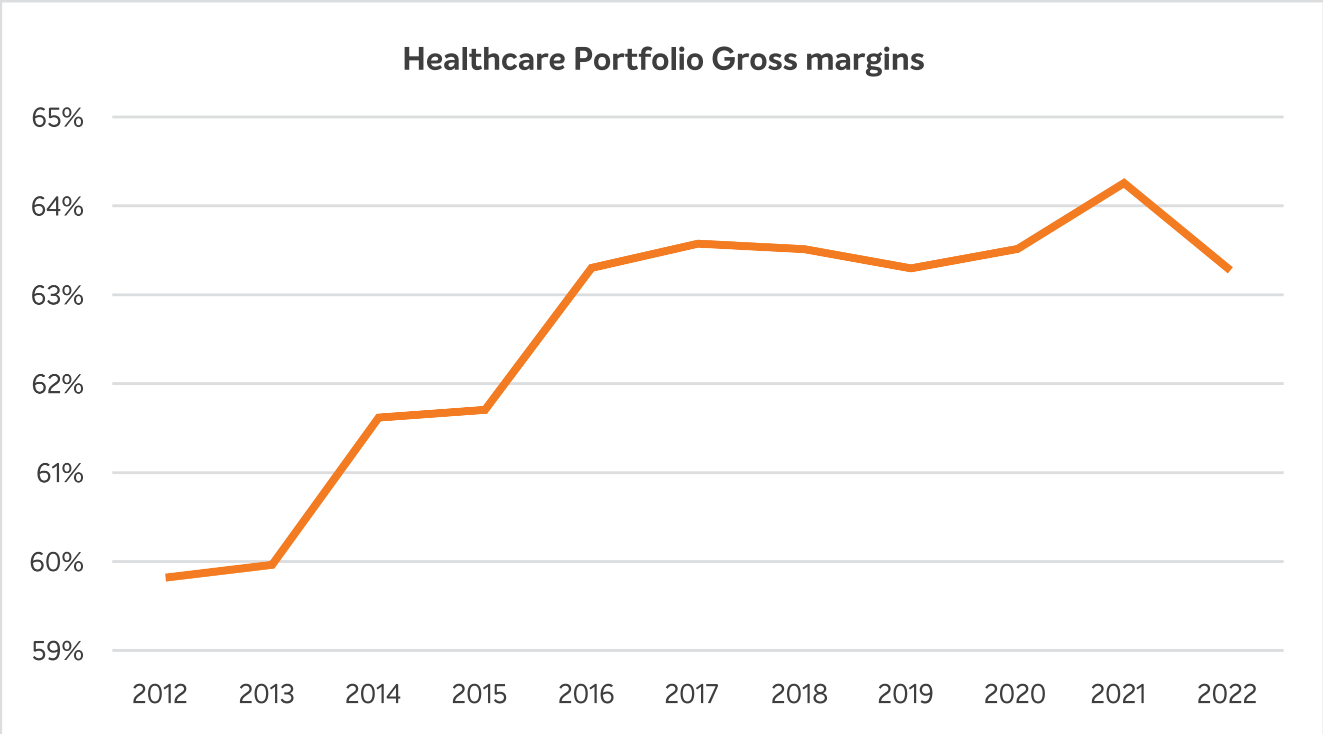
C) Demand destruction as prices rise – In case the companies decide to pass on the cost inflation, partially or fully, to end consumers, higher prices may result in lower demand. The fear of the investor is, therefore, would we see volume contraction or stagnation as demand is destroyed.

*EBITDA – earnings before interest, taxes, depreciation, and amortization

We take cognizance of these potential issues in our investing journey, and we believe our Healthcare Portfolio is able to sidestep these concerns. In Our view:

A) InCred Healthcare Portfolio on a weighted average basis has a net debt / EBITDA ratio of 0.24 and net debt/equity of 0.07 (FY22 reported data). We have invested in companies that are either asset-light (branded generics/diagnostics) or are not highly leveraged in asset-intensive businesses like hospitals and contract manufacturing. Hence, from a sensitivity to rising interest rates perspective, the portfolio is largely insulated.

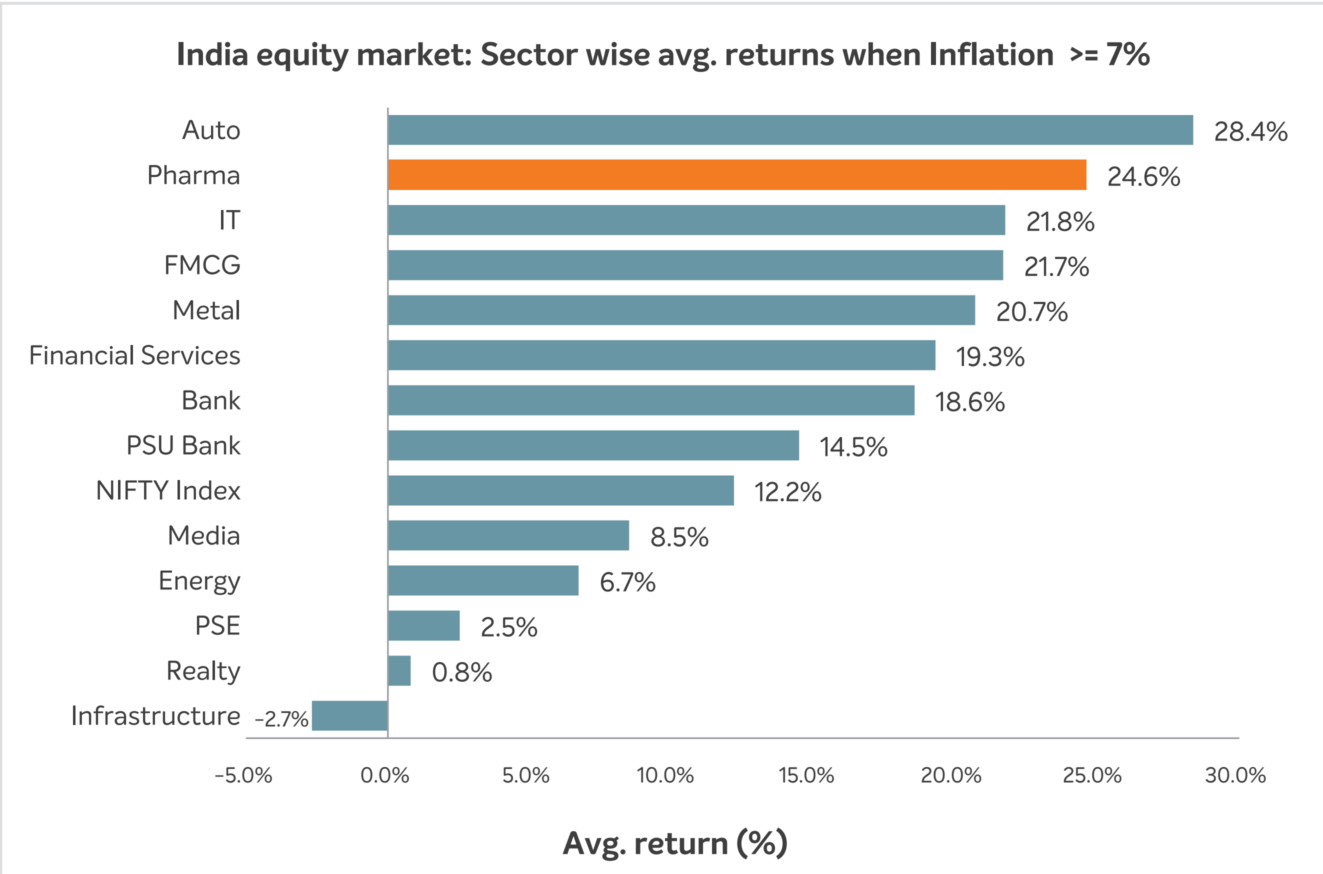
B) We own businesses that have exhibited pricing power and hence might be able to pass on the increase in costs. We substantiate this by illustrating the gross margins at a portfolio level over the past decade.

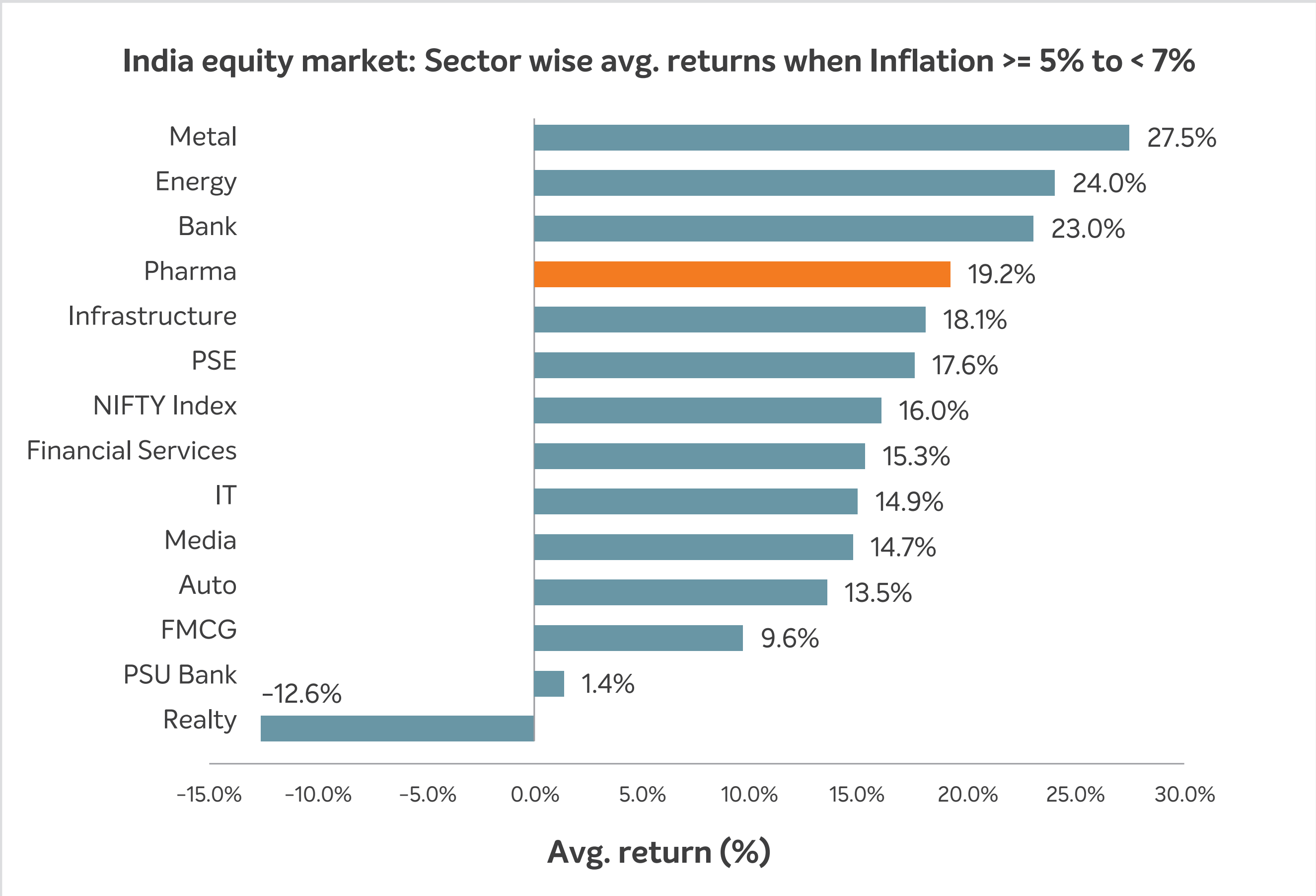


Source: Company data, Internal Analysis
Gross margin for Healthcare Portfolio is calculated as the weighted average of the gross margins of all portfolio companies.
Historical data from FY12 to FY22 (all actuals reported by the company).

*Past performance is not an indication of future results

C) Healthcare is largely price inelastic and non-discretionary consumption and hence demand destruction is unlikely to be material. Historically, the healthcare business has been inelastic to macro volatility. Data suggests that in periods of moderate to high inflation, healthcare is a top quartile performer over the last 20 years.





Source: SPARK capital research

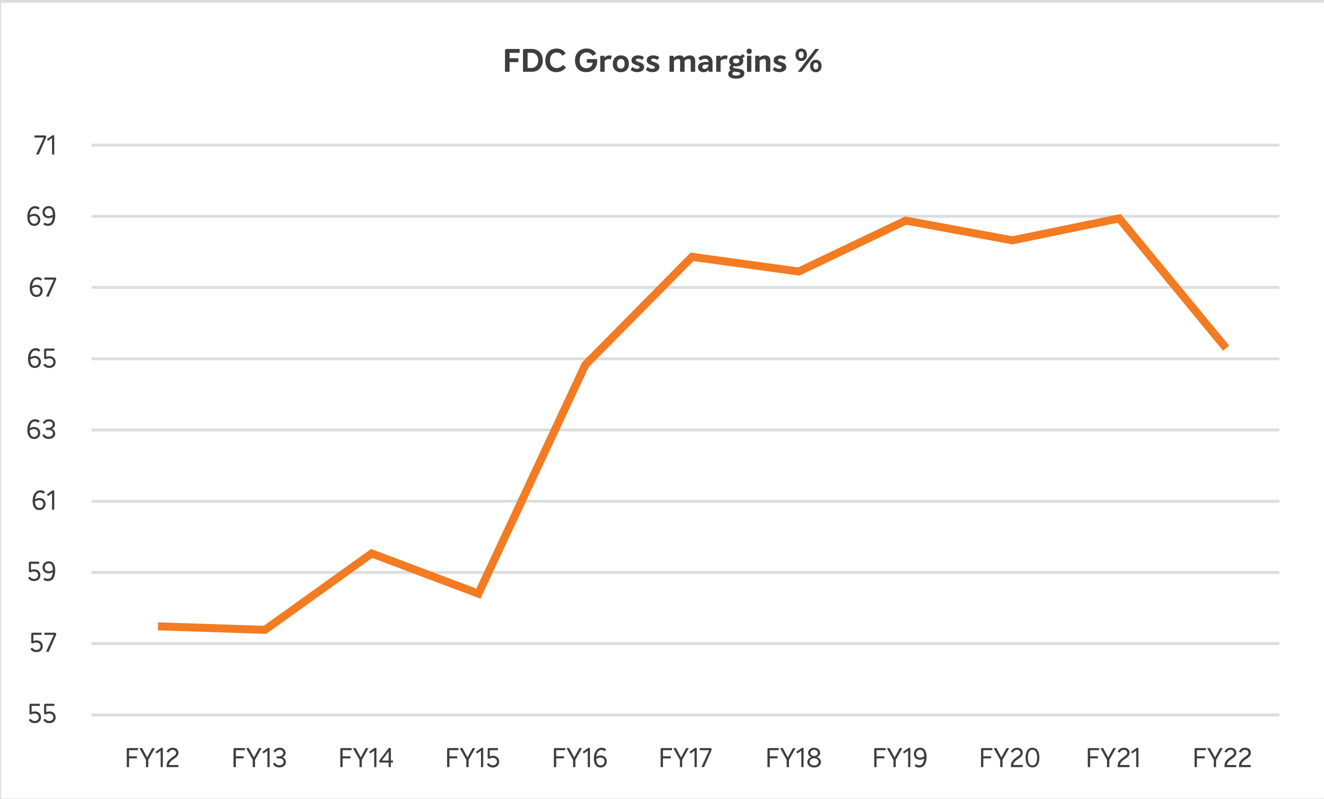
In conclusion, we believe that the InCred Healthcare Portfolio provides an opportunity to invest in companies that are likely to weather the macro headwind that our economy might face.

Case study on FDC Limited - Fairdeal Corporation Ltd

FDC is a branded generic company and sourced 90% of its consolidated revenues from domestic branded generic business in FY22. The other 10% of revenue comes from US formulations and API (Active Pharmaceutical Ingredient) sales combined.

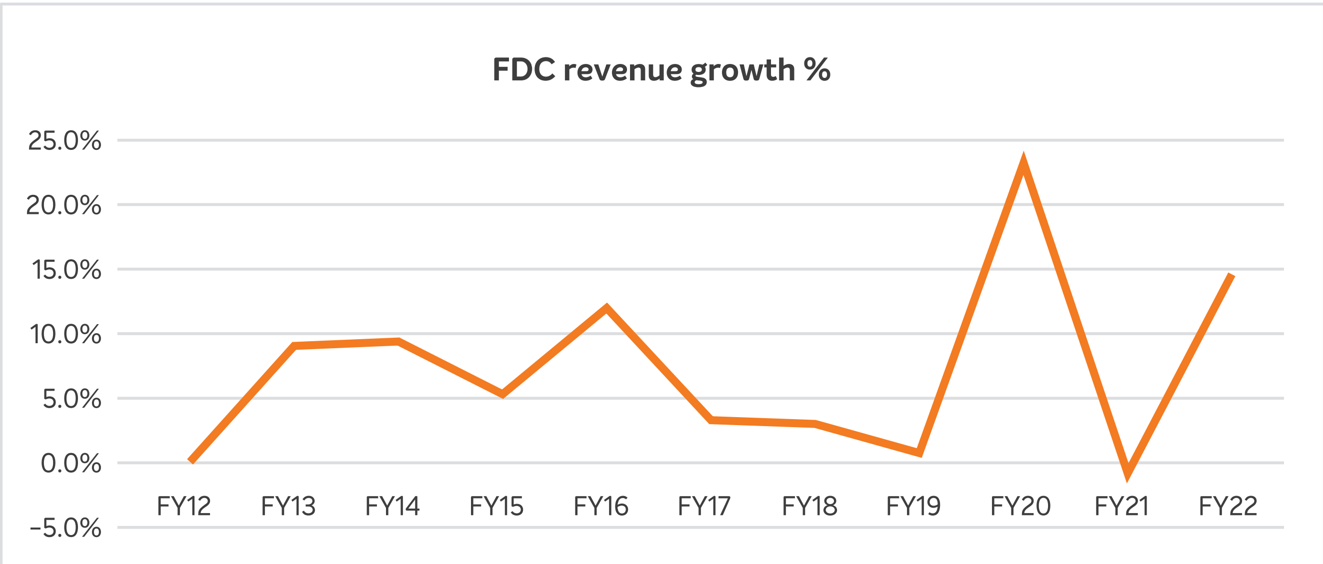
We believe that FDC would-be a beneficiary of rising interest rates. The company has a net cash of INR8.8bn (22% of market cap) on its balance sheet as of FY22. FDC earned INR 761 mn in FY22 from gains on investments, dividends and interest income i.e. a yield of 8% p.a. As interest rates rise, FDC is likely to make higher yields on its short-term deposits and liquid investments which form the lion share of the net cash on the balance sheet.

FDC has historically exhibited a high ability to pass on costs to consumers as evidenced by stable and growing gross margins over a decade.



Source: Company data, InCred PMS – Historical data from FY12 to FY22

As seen above, the company has historically seen a period of gross margin dips in FY15, FY18, FY20 and now FY22 over the past decade. However, on the previous three occasions, the company has been able to pass on the cost pressure to its consumers through product/business mix or price increases. We believe that the trend may sustain in FY23 and FDC may likely witness a recovery in gross margins in FY23 which would also flow down to expansion of EBITDA margins. The company has taken full 10.77% price increase in the NLEM (National List of Essential Medicines) portfolio of India business and up to 10% price hike in non NLEM portfolio. On an overall basis, the company has guided to a 7%-8% price hike in India business for FY23. We estimate that FDC's gross margins would expand by at least 100bps in FY23 over FY22. This reiterates our view that branded businesses of India and emerging markets are more resilient and robust than unbranded generic pharma businesses of the US/EU.



Source: Company data, Internal Analysis

FDC has compounded its top line at 8% CAGR (compound annual growth rate) over the past decade. While there are variations in growth from year to year, it is important to observe that the variations do not correlate with economic upcycles or downcycles and are more unsystematic risk of the business than systematic or driven by market risk.

Our investment rationale

- We expect an 11% top-line CAGR in FY22-24E and an EBITDA CAGR of 27% over the same period for FDC. The expansion in margins might be driven by a 200bps improvement in gross margins which would be a result of business mix and price increases.
- We expect an operating cash flow yield and free cash flow yield of 11.5% and 10% in FY24 as all capex projects may be over and business might have completely normalized.
- We expect RoIC (Return on Invested Capital) to improve from 11% in FY22 to 15.5% in FY24 driven by higher asset utilization and resolution of revenue cost mismatch in exports.
- At CMP (Current Market Price), FDC trades at 13x trailing EV/EBITDA. We do not see a material risk to valuation multiples given

  a) High cash on books (22% of market cap)

  b) Improvement in RoIC of 450bps in 2 years

  c) High cash flow yields

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