InCred PMS

# Healthcare BULLETIN

## *The Price Increase Puzzle – An Outlook for Domestic Branded Margins In FY23*

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In our previous communication, we had discussed the potential margin pressures on API manufacturers and the high likelihood of them passing it on to the customers with a lag as contracts come up for renewal. Hence, the next logical question is that as and when the API prices are increased, would the end sellers (branded and unbranded generic companies) witness gross margin pressures.

We would like to highlight here the recent news flow dated 27th March 2022 that the National Pharma Pricing Authority has allowed the industry to take up to a 10.8% price increase in medicines under the National List of Essential Medicines (NLEM). (source: https://www.deccanherald.com/state/bitter-pill-essential-drugs-to-be-10-costlier-soon-1095004.html) The NLEM list of drugs covers almost 25% of the Indian pharma market as per the latest industry estimates. On the remainder 75% of the market, the pharma companies are always allowed to take up to 10% price increase in any given year.

The historical trend has been that almost all pharma companies take the maximum allowed price increase in products that fall under NLEM and on the non NLEM products, the average price increase tends to be in the range of 3% to 8% on a portfolio basis. The extent of price increase taken in a non NLEM portfolio is largely determined by a) dominance of the brand in the therapy area and b) competitive product pricing action.

## The Profit and loss structure of an average Indian Pharmaco

For this discussion, we assume a pharmaco that does only the India business and has no vertical integration into APIs.

| Particular | Amount (Rs) | Nature of cost | Notes |
|---|---|---|---|
| Revenue | 100.0 | - | - |
| CoGS | 30.0 | Variable | API cost is ~20% of CoGS |
| Gross Profit | 70.0 | - | - |
| Employee Expenses | 20.0 | Semi Variable | 50% of employee cost is variable |
| Other Expenses | 25.0 | Semi Variable | 50% of other expenses are variable |
| EBITDA | 25.0 | - | - |
| EBITDA margin % | 25.0% | - | - |

Source: Company, InCred PMS Research

| Restated P&L excluding organic growth | Amount (Rs) |
|---|---|
| Revenue | 108.0 |
| CoGS | 31.5 |
| Gross Profit | 76.5 |
| Employee Expenses | 20.8 |
| Other Expenses | 26.0 |
| EBITDA | 29.7 |
| EBITDA margin % | 27.5% |

Source: Company, InCred PMS Research

As seen above, with the set of assumptions that we made, an 8% price increase is likely to lead to an ~20% jump in absolute EBITDA of the India business after adjusting for inflation in API costs and other expenses like power/freight, etc. Now our assumptions are purely based on a set of averages that we got from the industry. For each real pharma cos, these numbers can be different and hence lead to a different result. Further, the above P&L is that of the India business of a company, the impact of the same dynamics on unbranded businesses like the US generic business is likely to be very different.

In InCred Healthcare PMS, we have >40% allocation in companies where domestic business cash flow is larger than other businesses. Hence, we believe that our portfolio is well-positioned to benefit from the price increases that these pharma companies would be able to take starting April 2022.

## Case Study on RPG Life Sciences
## An MNC in Indian disguise

RPG Life Sciences started doing business in India as a joint venture with GD Searle in 1968. GD Searle was later acquired by Pfizer and the JV interest was sold to RPG in 1993. Since then, the management of RPG group had been passively managing the business as the focus of the group management was on other businesses of the group.

However, the product portfolio to date is dominated by legacy MNC brands and the management of the company was changed in 2018, when Yugal Sikri was appointed Managing Director of the company. Since then, RPG Life sciences have expanded their EBITDA margins from 9% in FY17 to 20% in FY22. The RoE of the company has also expanded from 8% to 20% over the same period.

However, in our opinion, the company has retained its MNC DNA where the dominant business is domestic and promotion practices are largely ethical and sanitary.

- We estimate a PAT CAGR of 36% over FY21-24E. At CMP the stock trades at 5.8x FY24E EV/EBITDA we value the company at 8x EV/EBITDA.

## The business model

RPG is largely focused on India business which contributes ~63% to sales. It also has a presence in the export formulation which contributes ~20% to sales and a balance of 20% from API. Even in the export formulation, it is present primarily in the branded generic segment.

In the India business, RPG is the leader in some of the molecules with a strong brand franchise. Being part of a large conglomerate group, the promoters did not focus on scaling-up RPG's business and EBITDA margins remained significantly low (5-6% range). In FY17-18 company appointed Mr. Yugal Sikri (vast experience in global pharma companies like Pfizer, GSK, Novartis) as MD. Yugal was instrumental in changing the promotion practices and product portfolio of the company to make it more relevant to the current market landscape.

## Way forward

Company is now focused on new launches, improving MR productivity, rejuvenating product portfolio, controlling costs, etc. In FY22, RPG touched MR productivity of INR 6mn/medical representative with domestic sales of INR2.9bn. This evidences phenomenal brand equity in the market place. Other companies that have been able to achieve such MR productivity with a acute heavy portfolio are clocking sales of INR40bn to 75bn. Scale aids reported MR productivity. RPG also has launched biosimilars in India and again one of the smallest companies in India to venture in to branded biosimilar sales.

In 4QFY22 conference call, RPG management commented that their domestic EBITDA margins are at 18%, while the corporate average is at 19.8%. This implies that because the company has ventured in to chronic therapies and biosimilars in India, the current profitability is suppressed. The MR productivity of INR6mn also attests to higher profitability in legacy segments (acute). Hence, we believe as the company scales up its chronic and biosimilar revenues, it is likely to witness strong operating leverage in the domestic business.

The management has also commented that the company has taken a portfolio wide price increase of more than 8% in April 2022. Using similar assumptions as we have detailed in our price increase primer above, we believe RPG could see an EBITDA growth of 24% in FY23 YoY largely driven by this price increase. The growth could be higher or lower than our expectation depending on what happens with raw material prices hereon.

## Our investment thesis

We expect a strong recovery in domestic sales posts Covid-19 impact in FY21. Management has guided for launching of new products and expanding reach. In the export business, the company is looking to expand its geographical presence and launch more products in existing geographies.

RoE is likely to improve by 440bp over FY21 to FY24E to 19.6% and FCF of INR 672mn in FY24E from INR 498mn in FY21.

We estimate a PAT CAGR of 36% over FY21-24E. At CMP the stock trades at 5.8x FY24E EV/EBITDA we value the company at 8x EV/EBITDA. Our reverse DCF suggests that the current enterprise value is justified if the company shows 0% top line growth till FY30 and 0% terminal growth post that. However, we expect double digit growth from RPG life sciences in foreseeable future and terminal growth of at least 5% (given inflation and branded nature of the business). We allocate ~7% of our portfolio weight to RPG Life sciences in the InCred Healthcare PMS.

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