InCred PMS

Healthcare BULLETIN

PERFORMANCE & POTENTIAL
analysis of a pharma business bucket

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The Indian domestic business has been a secular and profitable business for Indian Pharma companies. Over the past 2 years, we have seen capital allocation being diverted more towards the Indian Pharma business versus exports earlier. One of the key reasons behind this diversion has been the secular performance of Indian Pharma business, the other reason is the subdued performance of the export business.

We highlight below some of the key acquisitions that have been announced over last 12 months in the Indian Pharma space:

Date	Acquirer	Target	EV/Sales multiple (TTM)
26-01-2022	JB Chemicals & Pharmaceuticals	Azmarda	3.9
28-02-2022	Mankind Pharma	Panacea	7.1
01-04-2022	Dr. Reddy's Laboratories	Novartis brand	3.4
02-04-2022	Lupin	Anglo French	3.4
03-04-2022	JB Chemicals & Pharmaceuticals	Sanzyme	3.2
30-06-2022	JB Chemicals & Pharmaceuticals	Dr Reddy	3.0
27-09-2022	Torrent Pharma	Curatio	8.3
		Average	**4.6**

Source: Bloomberg, internal research. TTM: Trailing Twelve Month

As noted in the above table, the average EV/Sales multiple for these acquisitions have been ~4.2. When we apply the average deal multiple to current branded generic sales of existing Indian Pharma companies, we find that the current EV of these companies falls significantly short of the valuation of the branded generic business.

Top Holdings	Branded Generic Sales* (FY22) (INR mn)	Average EV/Sales multiple (TTM)	Implied EV of Branded Generic business (INR mn)	Current EV#	Delta
FDC	13,040	4.6	60,195	35,229	71%
Indoco Remedies	9,201	4.6	42,474	32,948	29%
RPG Life Sciences	3,120	4.6	14,403	11,741	23%
Lupin	84,045	4.6	3,87,967	3,21,463	21%
Ajanta Pharma	23,880	4.6	1,10,235	1,06,362	4%

Source: Company reports, Internal research. TTM: Trailing Twelve Month

**Branded generic sales includes sales in branded pharmaceuticals markets such as India, Southeast Asia, Middle East Asia, North Africa, Eastern Europe, Russia/CIS, Ukraine, and Latin America.*

#As of 28th Sep 2022; EV: Enterprise Value

While this exercise suggests that the consolidated intrinsic value of these companies could be significantly higher than their current EV, we believe that there are valid reasons why the consolidated EV isn't equal or higher than branded generic EV for these companies.

- Allocation of capital to a subscale and/or unprofitable unbranded generic business
- Cannibalization of cash flows of domestic business by the capital-intensive unbranded business
- Suppression in consolidated RoE and free cash flow by the unbranded generic business

What can trigger the re-rating in such stocks:

- A recovery in profitability of the unbranded generic business
- A significant reduction in capital allocation to unbranded business
- Restructuring of the consolidated entity to spin off the less profitable businesses.

Why are we bullish on branded generics:

Branded generics carry a ~48% weight in the InCred Healthcare PMS portfolio vs 22% in the index (as on 28th September). We allocate significantly higher capital to branded generics as we believe that the intrinsic value of these businesses is significantly higher than the consolidated EV at current market price. It is difficult to estimate when and how the re-rating would happen for these companies, however, there are clear signs of better capital allocation across the board, which in our view is the stepping stone.

Further, in an inflationary environment, we assess that branded generics can pass on the cost pressure by taking price increases. In April of 2022, the NPPA (National Pharmaceutical Pricing Authority) allowed a 10.7% price increase for products that are under price control. This percentage is essentially the average WPI between Jan 2021 – Dec 2021.

Date	WPI %	Date	WPI %
Jan-21	2.51	Jul-21	11.57
Feb-21	4.83	Aug-21	11.64
Mar-21	7.89	Sep-21	11.8
Apr-21	10.74	Oct-21	13.83
May-21	12.94	Nov-21	14.87
Jun-21	12.07	Dec-21	14.27
Average		**10.7**	

Source: https://eaindustry.nic.in/wpi_press_release_archive.asp

Most of the branded generic companies have taken the full price increase in their price-controlled portfolio in April 2022. The increase in non-price-controlled portfolio is likely to vary from 5%-8% depending on company and product portfolios and will be spread through the year. Hence, the weighted price increase for FY23 would be around 6%-10% varying from company to company in our assessment.

Meanwhile, we are noticing a dip in the cost of factors of production in China and India such as coal prices, freight charges etc. Hence, starting 2QFY23, we could be looking at a situation where price increases would start reflecting the top line, but costs would begin to recede from the peak.

Further, come April 2023, the average WPI of Jan 2022-Dec 2022 would be announced by NPPA as the price hike allowed in price-controlled products. Thus far, from Jan 2022 – Aug 2022, the average WPI is at 14.4%.

Date	WPI %	Date	WPI %
Jan-22	13.68	May-22	16.63
Feb-22	13.43	Jun-22	15.18
Mar-22	14.63	Jul-22	13.93
Apr-22	15.38	Aug-22	12.41
Average		**14.4**	

Source: https://eaindustry.nic.in/wpi_press_release_archive.asp

Hence, in FY23 and more so in FY24 (assuming costs do not flare up again due to macroeconomics or geopolitics), we will see margins improving as costs taper down and prices go up. This is just a timing mismatch and not profiteering, in our belief.

Here is an illustration to explain the potential EBITDA Growth of the India business with an approximated timeline:

Non Covid India business P&L (INR mn)	FY22	FY23e	FY24e	Remarks
Sales	100.0	112.0	127.7	Only non-Covid sales are considered. The deviation between expected growth and actual reported growth for 1QFY23 and 2QFY23 would be largely due to Covid sales done in 1HFY22.
Total Growth (a+b)	10.0%	12.0%	14.0%	Total growth in sum of price + volume growth
Growth in volume (a)	6.0%	6.0%	6.0%	IPM has historically reported volume growth of 5%-7%. This is largely 2% population growth, 2%-3% penetration and 1%-2% new products.
Growth in price (b)	4.0%	6.0%	8.0%	Growth in price is blended of price-controlled and non-price-controlled products.
Cost of goods	40.0	43.7	48.1	Inflation in cost of goods is assumed at volume growth + 0.5* price growth. The assumption being that most of the raw material price inflation is already behind in FY22.
Gross profit	60.0	68.3	79.5	-
Gross margin	60.0%	61.0%	62.3%	-
Other Costs	35.0	39.2	43.9	Increase in other costs is kept 12%. Semi variable costs will grow alongside volume and fixed costs will grow at inflation.
EBITDA	25.0	29.1	35.6	-
EBITDA Growth (%)	-	16.4	22.3	19.3 % Annualized Growth
EBITDA margin	25.0%	26.0%	27.9%	-

Source: IPM – India Pharmaceutical Market, EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization

In conclusion, our bullish stance on branded generics stems from the following factors:

a) Inherently a branded business with high customer loyalty, rich cash flows, high RoE, and low capital intensity.

b) Ability to pass on cost pressure to consumers by increasing prices within the framework provided by the Government.

c) FY23 and FY24 are likely to be years of low to mid teen top line growth driven by price increases and would lead to higher operating margins.

d) The Intrinsic value of the branded generics business as implied by mergers and acquisitions seen over the past 12 months, leads us to believe that there is margin of safety in these investments.

e) Key risks to our thesis is another bout of supply bottlenecks or increases in factors of production due to macroeconomic or geopolitical reasons.

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