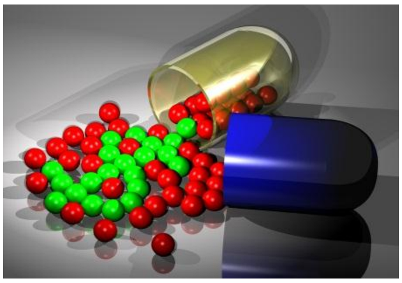
25 May 2015



BUY

TP: INR 1,515.00

▲ 29.5%

Strides Arcolab

STR IN

Q4 in line; business model strengthening – BUY

STR's Q4FY15 earnings were broadly in line with expectations, adjusting for unrealised interest income and merger expenses. While the base business continues to deliver strong growth, we believe Shasun's merger (which fills in key portfolio gaps) and integration of the Arrow portfolio (establishes presence in Australia) will strengthen STR's business model significantly. Factoring in the Arrow acquisition, we upgrade our FY17 EPS by 18% and our Mar'16 TP to Rs 1,515 (from Rs 1355). Maintain BUY.

- **In-line Q4:** STR's Q4FY15 earnings were largely in line at the operating level. The company reported strong growth in regulated markets (+20% QoQ) led by the US (five launches in FY15) and EMs (+25% QoQ driven by Africa on product launches and increased sales force). However, the institutional business, which is typically lumpy in nature, was down 23% QoQ. Reported PAT (Rs 345mn vs. RCMLe of Rs 450mn) was hit by non-recognition of accrued interest (Rs 87mn) and merger-related expenses (Rs 16mn).

- **PBS price cuts unlikely to hurt margins, per management:** Management highlighted that PBS (Pharmaceuticals benefit scheme) price cuts in Australia (latest round of cuts in Apr'15 of ~18.6% for the industry) is unlikely to impact margins for the acquired Arrow portfolio, since most of the value erosion is borne by pharmacies. Additionally, the erosion would be more than offset by value growth.

- **Acquisition factored in; upgrade FY17 EPS by 18%:** Given the price cuts, we expect STR's portfolio to see a moderate 5% CAGR in revenues over the next two years, with similar level of margins. Assuming 5.5% interest on an additional debt of US$ 250mn to fund the Arrow acquisition (balance to be funded from cash on books), we expect the deal to add 18% to STR's FY17E EPS. We upgrade our Mar'16 TP to Rs 1,515 (from Rs 1,355 earlier), valuing the base business at 16x Mar'16 EPS and adding the NPV value of cash and Sovaldi.

Financial Highlights

Y/E 31 Mar	CY13A	FY14A	FY15P	FY16E	FY17E
Revenue (INR mln)	9,618	13,410	12,189	36,079	46,078
EBITDA (INR mln)	1,006	2,234	2,438	6,348	8,991
Adjusted net profit (INR mln)	123	(2,062)	1,548	3,363	5,694
Adjusted EPS (INR)	2.1	(34.6)	26.0	41.7	70.7
Adjusted EPS growth (%)	(93.0)	(1758.8)	(175.0)	60.6	69.3
DPS (INR)	2.0	505.0	107.0	1.5	1.5
ROIC (%)	1.9	(18.9)	15.0	14.4	12.7
Adjusted ROAE (%)	0.7	(13.6)	13.9	21.7	26.3
Adjusted P/E (x)	560.6	(33.8)	45.0	28.0	16.6
EV/EBITDA (x)	93.0	37.6	29.9	11.5	11.1
P/BV (x)	3.4	6.9	5.7	5.0	3.9

Source: Company, Bloomberg, RCML Research

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PRICE CLOSE (25 May 15)
INR 1,170.10

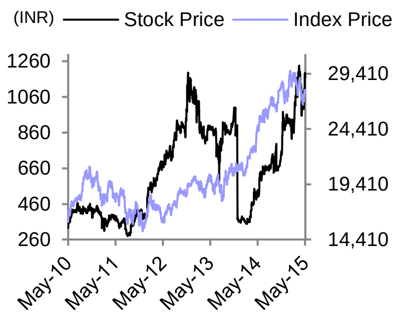
MARKET CAP
INR 69.8 bln
USD 1.1 bln

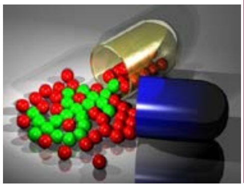
SHARES O/S
59.6 mln

FREE FLOAT
28.5%

3M AVG DAILY VOLUME/VALUE
0.9 mln / USD 14.6 mln

52 WK HIGH	52 WK LOW
INR 1,249.00	INR 428.91



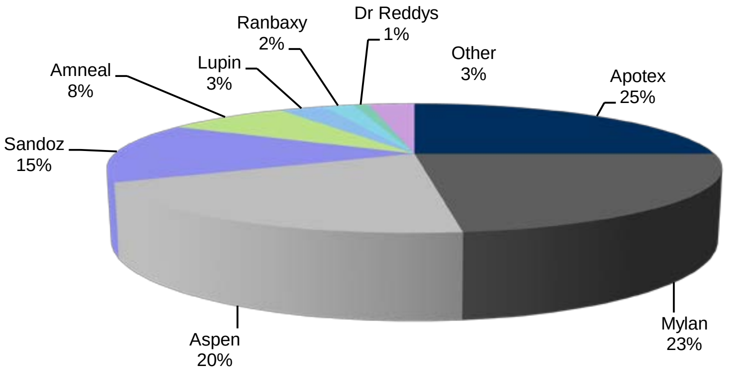


Re-entering Australia via Aspen

Acquires Aspen's generic business for AUD 265mn

STR is set to acquire Aspen's generic business (Arrow Pharmaceuticals) and some of its branded pharma assets (total portfolio: 130 products) for AUD 265mn (~US$ 208mn). The Australian generic pharma market (valued at US$ 600mn-700mn) is highly concentrated as the top five generic companies supply 90% of all generic drugs, while three wholesalers cater to the entire generic market. Pricing in the market is fairly reasonable (avg. generic price/drug is 2.5x UK average). Unlike other regulated markets, the top generic players are each aligned to the top wholesalers (Arrow is a preferred supplier to Sigma) and relationships play a key role in this business.

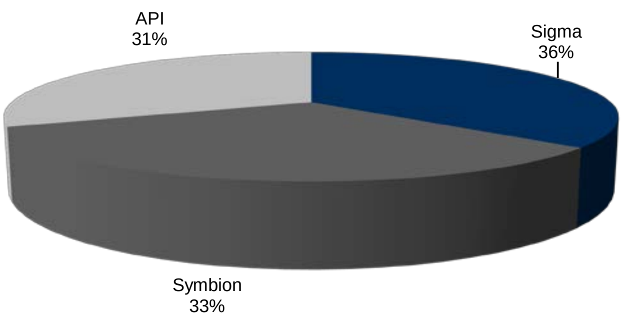
Fig 1 - Generic market share in Australia



Source: RCML Research, Company

The Australian generic pharma market has top five generic players supplying 90% of generic drugs and only three wholesalers catering to generic market

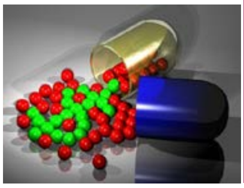
Fig 2 - Wholesaler market share in Australia



Source: RCML Research, Company

Deal reasonably valued

With the acquired portfolio clocking revenues/EBITDA of ~US$ 83mn/~US$ 20mn (as of June'14), the implied transaction value is 2.5x EV/sales and 10.4x EV/EBITDA. STR will also acquire six more brands (revenue/ EBITDA: US$ 12mn/10mn) for US$ 92mn or at 7.7x EV/sales and 9.2x EV/EBITDA. The deal, expected to close by Q2FY16, is reasonably valued in our view given that STR had sold its Australasia generics business to Watson in Jan'12 for US$ 393mn at 4.3x EV/sales and ~22x EV/EBITDA (Mayne-Hospira deal valued at ~16x EV/EBITDA).



PBS price cuts unlikely to impact generic companies

The STR management believes price cuts under PBS (Pharmaceuticals benefit scheme) are unlikely to hurt margins as most of the value erosion is borne by pharmacies. Further, value erosion due to PBS price cuts is more than offset by volume growth (generic penetration has risen from 30% in 2002 to 75-80% currently). As per Aspen, the recent PBS price cut in Apr'15 is likely to impact ~102 industry molecules (72 for Aspen) with a ~18.6% price cut for the industry (and 17.6% for Aspen). Notably, despite the price cuts, the acquired portfolio has sustained margins at ~30% for last seven years.

Arrow gives ready portfolio, intellectual property rights

Arrow has the third largest market share by value in Australia and gives STR ready access to around 149 molecules, 51 OTC products and a pipeline of 51 products (avg. approval time: 9 months). Importantly, around 70% of its revenue is generated through IP-protected products, which STR can leverage in additional markets. The company expects to site-transfer manufacturing to India (avg. time taken: 6 months) which should help margins in the long term.

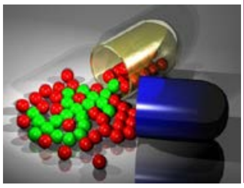
Acquisition to add 18% to FY17E EPS

Given the price cuts, we expect STR's portfolio to see a moderate 5% CAGR in revenues over the next two years, with a similar level of margins. Assuming 5.5% interest on an additional debt of US$ 250mn to fund the Arrow acquisition (balance to be funded from cash on books), we expect the deal to add 18% to STR's FY17E EPS.

Fig 3 - Acquisition factored in – upgrade FY17 earnings by 18%

Earnings change	FY16E			FY17E		
(Rs mn)	Old	New	Var (%)	Old	New	Var (%)
Sales	32,464	36,079	11.1	39,572	46,078	16.4
EBITDA	5,239	6,348	21.2	7,005	8,991	28.3
EBITDA margin (%)	16.1	17.6		17.7	19.5	
PAT	3,305	3,363	1.7	4,820	5,694	18.1

Source: RCML Research, Company



Per Share Data

Y/E 31 Mar (INR)	CY13A	FY14A	FY15P	FY16E	FY17E
Reported EPS	121.1	(39.1)	26.0	41.7	70.7
Adjusted EPS	2.1	(34.6)	26.0	41.7	70.7
DPS	2.0	505.0	107.0	1.5	1.5
BVPS	344.6	169.0	203.9	234.1	303.1

Valuation Ratios

Y/E 31 Mar (x)	CY13A	FY14A	FY15P	FY16E	FY17E
EV/Sales	9.7	6.3	6.0	2.0	2.2
EV/EBITDA	93.0	37.6	29.9	11.5	11.1
Adjusted P/E	560.6	(33.8)	45.0	28.0	16.6
P/BV	3.4	6.9	5.7	5.0	3.9

Financial Ratios

Y/E 31 Mar	CY13A	FY14A	FY15P	FY16E	FY17E
Profitability & Return Ratios (%)					
EBITDA margin	10.5	16.7	20.0	17.6	19.5
EBIT margin	7.3	12.4	15.9	13.7	16.3
Adjusted profit margin	1.3	(15.4)	12.7	9.3	12.4
Adjusted ROAE	0.7	(13.6)	13.9	21.7	26.3
ROCE	1.8	(15.9)	9.5	12.9	12.5
YoY Growth (%)					
Revenue	(62.3)	39.4	(9.1)	196.0	27.7
EBITDA	(79.5)	122.1	9.1	160.4	41.6
Adjusted EPS	(93.0)	(1758.8)	(175.0)	60.6	69.3
Invested capital	(7.2)	(72.9)	19.4	292.0	17.6
Working Capital & Liquidity Ratios					
Receivables (days)	194	115	117	73	107
Inventory (days)	175	84	56	41	54
Payables (days)	222	119	102	65	87
Current ratio (x)	0.8	1.0	1.2	1.1	1.5
Quick ratio (x)	0.1	0.2	0.1	(0.2)	(0.2)
Turnover & Leverage Ratios (x)					
Gross asset turnover	0.6	1.0	1.4	2.0	1.7
Total asset turnover	0.2	0.4	0.6	0.9	0.8
Net interest coverage ratio	1.5	3.4	75.5	5.9	13.3
Adjusted debt/equity	0.7	0.3	0.3	1.6	1.3

DuPont Analysis

Y/E 31 Mar (%)	CY13A	FY14A	FY15P	FY16E	FY17E
Tax burden (Net income/PBT)	1.7	(224.8)	81.0	82.0	82.0
Interest burden (PBT/EBIT)	1039.2	55.0	98.7	83.2	92.5
EBIT margin (EBIT/Revenue)	7.3	12.4	15.9	13.7	16.3
Asset turnover (Revenue/Avg TA)	19.0	39.1	58.0	93.1	76.1
Leverage (Avg TA/Avg equities)	297.9	226.3	189.4	249.9	279.9
Adjusted ROAE	0.7	(13.6)	13.9	21.7	26.3

Income Statement

Y/E 31 Mar (INR mln)	CY13A	FY14A	FY15P	FY16E	FY17E
Total revenue	**9,618**	**13,410**	**12,189**	**36,079**	**46,078**
EBITDA	1,006	2,234	2,438	6,348	8,991
EBIT	697	1,669	1,936	4,931	7,508
Net interest income/(expenses)	(453)	(486)	(26)	(830)	(565)
Other income/(expenses)	0	0	0	0	0
Exceptional items	7,001	(266)	0	0	0
EBT	245	1,183	1,911	4,101	6,943
Income taxes	(111)	(3,245)	(363)	(738)	(1,250)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	(11)	0	0	0	0
Reported net profit	**7,124**	**(2,328)**	**1,548**	**3,363**	**5,694**
Adjustments	1,339	19,995	7,500	0	0
Adjusted net profit	**123**	**(2,062)**	**1,548**	**3,363**	**5,694**

Balance Sheet

Y/E 31 Mar (INR mln)	CY13A	FY14A	FY15P	FY16E	FY17E
Accounts payables	4,631	2,679	2,782	7,825	9,887
Other current liabilities	4,583	821	821	1,394	1,394
Provisions	1,548	1,155	946	1,035	1,035
Debt funds	15,945	5,466	3,666	26,502	27,302
Other liabilities	0	0	0	0	0
Equity capital	588	596	596	806	806
Reserves & surplus	19,674	9,473	11,551	18,060	23,614
Shareholders' fund	20,262	10,068	12,147	18,865	24,420
Total liabilities and equities	**47,688**	**20,946**	**21,118**	**56,379**	**64,795**
Cash and cash eq.	1,657	2,311	566	(3,256)	(4,786)
Accounts receivables	4,832	3,640	4,174	10,238	16,690
Inventories	4,423	1,760	2,004	6,022	7,684
Other current assets	4,453	2,281	2,672	7,531	9,647
Investments	1	4,430	4,599	4,674	4,674
Net fixed assets	13,264	4,511	5,091	16,357	16,074
CWIP	2,414	995	995	2,137	2,137
Intangible assets	16,903	1,034	1,034	12,534	12,534
Deferred tax assets, net	(272)	(17)	(17)	142	142
Other assets	12	0	0	0	0
Total assets	**47,688**	**20,946**	**21,118**	**56,379**	**64,795**

Cash Flow Statement

Y/E 31 Mar (INR mln)	CY13A	FY14A	FY15P	FY16E	FY17E
Net income + Depreciation	7,432	(1,763)	2,049	4,780	7,177
Interest expenses	453	486	26	830	565
Non-cash adjustments	0	0	0	0	0
Changes in working capital	204	(89)	(1,065)	(4,452)	(8,168)
Other operating cash flows	302	(9,938)	670	174	0
Cash flow from operations	**8,391**	**(11,303)**	**1,680**	**1,332**	**(426)**
Capital expenditures	1,741	27,489	(1,081)	(20,200)	(1,200)
Change in investments	(1)	(4,430)	(169)	0	0
Other investing cash flows	342	602	488	1,094	1,424
Cash flow from investing	**2,083**	**23,662**	**(762)**	**(19,106)**	**224**
Equities issued	0	(1)	0	210	0
Debt raised/repaid	(10,483)	(10,478)	(1,801)	15,763	800
Interest expenses	(794)	(1,089)	(513)	(1,924)	(1,988)
Dividends paid	(136)	(137)	(348)	(139)	(139)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	**(11,413)**	**(11,705)**	**(2,662)**	**13,909**	**(1,328)**
Changes in cash and cash eq	**(940)**	**654**	**(1,745)**	**(3,865)**	**(1,531)**
Closing cash and cash eq	**1,657**	**2,311**	**569**	**(3,298)**	**(4,786)**

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