IDFC SECURITIES

Strides Shasun

Good quarter; Pickup Ahead

OUTPERFORMER

RESULT NOTE

31 October 2017

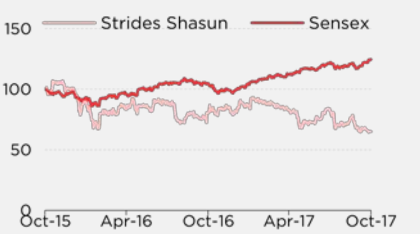
BSE Sensex: 33213

Sector: Pharmaceuticals

Stock data

CMP (Rs)	827
Mkt Cap (Rs bn/USD m)	74.0 /1,143
Target Price (Rs)	961
Change in TP (%)	-3.4
Potential from CMP (%)	16.2
Earnings change (%)	
FY18E	-21.2
FY19E	-16.2
Bloomberg code	STR IN
1-yr high/low (Rs)	1,275/802
6-mth avg. daily volumes (m)	0.4
6-mth avg. daily traded value (Rsm/USDm)	392.6/6.1
Shares outstanding (m)	89.5
Free float (%)	68.9
Promoter holding (%)	31.1

Price performance – relative & absolute



(%)	3-mth	6-mth	1-yr
STR IN	(21.9)	(22.9)	(20.6)
BSE Sensex	2.1	11.0	18.9

Q2FY18 result highlights

- Cons. revenues came in at Rs9.95bn (+18% qoq), above est of Rs8.87bn. Regulated markets revenues came at Rs5bn (+21% qoq) vs est of Rs4.4bn, EMs at Rs3.2bn (+17% qoq) vs est of Rs3bn and PSAI at Rs1.8bn (+20% qoq) vs est of Rs1.55bn.
- Led by higher revenues reported EBITDA came in higher at Rs1.3bn (+50% qoq) vs est of Rs1.17bn. EBITDA margins came at 13.2% inline with our est. GMs at 51.4% (50.2% in Q1) were inline with our est. EBITDA was impacted by ~161mn on account of the investment made in the consumer healthcare business.
- Other income stood lower at Rs223mn vs est of Rs400m. Tax rate came in higher at 17.8% vs Rs33m tax credit in Q1FY18.
- Consequently continuing business PAT came at Rs278mn vs est of Rs245m.

Key positives: higher revenue across markets, inline Gross margins

Key negatives: lower other income, higher tax rate

Impact on financials: We have reduced FY18/FY19 EBITDA by 12%/4% and PAT estimates by 21%/16% to account for moderation in EBITDA margins and higher net interest costs.

Valuations & view

Over the last few quarters, Strides 2.0 has fine-tuned its business model to enhance focus on key geographies of US and Australia formulations. Recently announced corporate actions will create a more focussed, profitable B2C business model with reduced leverage and results should be visible over the next 6m once these transactions such as the API business divestment close. Given the high depreciation / interest charges, the expected pickup in EBITDA growth will drive accelerated earnings growth from H2FY18 onwards. Maintain Outperformer with a TP of Rs961 (18x FY19e plus Rs110/share value for the stake in the demerged PSAI entity).

Key financials (quarterly)

(Rs m)	Q2FY17	Q1FY17	Q2FY18	% ch qoq	% ch yoy	% var from est
Net sales	8,720	8,418	9,956	18.3	14.2	12.2
EBITDA	1,539	873	1,311	50.3	-14.8	12.2
OPM (%)	17.7	10.4	13.2	280.5	-25.4	0.0
Other inc.	546	361	223	-38.3	-59.2	-44.3
Interest	580	640	619	-3.4	6.7	3.1
Dep. & Amort.	444	511	543	6.2	22.4	4.4
PBT	1,061	82	372	356.1	-64.9	-17.0
PAT	931	84	278	228.9	-70.2	13.3
Reported PAT	809	57	139	142.6	-82.8	-43.3
EPS (Rs)	10.4	0.9	3.1	228.9	-70.2	13.3

Source: Company, IDFC Securities Research

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Exhibit 1: Quarterly Result (consolidated)

(Rs m)	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Comments
Net Sales	**8,720**	**9,339**	**8,884**	**8,418**	**9,956**	Higher than est led by higher revenues across markets
Expenses						
Cost of sales	3,739	4,021	3,844	4,193	4,837	GMs came in line with our est
SG&A expenses	3,441	3,341	3,471	3,351	3,807	Higher than est
Total Expenses	7,181	7,362	7,315	7,545	8,645	
EBITDA	**1,539**	**1,977**	**1,569**	**873**	**1,311**	Higher than est led by higher revenues
OPM (%)	*17.7*	*21.2*	*17.7*	*10.4*	*13.2*	Inline with est
Other Income	546	262	731	361	223	Lower than est
Interest	580	570	592	640	619	Higher than est
Depreciation	444	494	529	511	543	
Forex gain						
PBT	**1,061**	**1,176**	**1,178**	**82**	**372**	
Current Tax	129	81	175	(33)	42	We est 14%
Tax Rate (%)	*13.7*	*4.0*	*11.7*	*(61.3)*	*17.8*	
Minority interest	1.0	88.5	(6.9)	30.6	53.0	
PAT	**931**	**1,006**	**1,011**	**84**	**278**	Inline with est
Extraordinary expenses						
Extraordinary Income	(122)	868	308	(27)	(139)	
Reported PAT	**809**	**1,874**	**1,319**	**57**	**139**	
% chg yoy						
Sales	**24.2**	**7.7**	**(11.3)**	**6.6**	**14.2**	
EBITDA	**46.8**	**29.8**	**(17.2)**	**(34.0)**	**(14.8)**	
Interest	71.8	5.6	(9.1)	14.5	6.7	
Depreciation	21.9	22.7	12.8	20.8	22.4	
PBT	**131.4**	**74.2**	**(10.8)**	**(85.1)**	**(64.9)**	
PAT	197.7	71.7	(17.5)	(81.6)	(70.2)	
Reported PAT	**1.9**	**2.2**	**0.4**	**(0.8)**	**(0.8)**	
EPS						
Equity	89.4	89.4	89.4	89.4	89.4	
EPS	10.4	11.3	11.3	0.9	3.1	

Source: Company, IDFC Securities Research

Other key highlights

Exhibit 2: Quarterly Revenues

	Q1FY17	Q2FY17	Q1FY18	Q2FY18	yoy (%)	qoq (%)
Regulated markets	3,706	4,453	4,147	5,025	12.8	21.2
Emerging business	2,526	3,167	2,697	3,152	(0.5)	16.9
PSAI	1,369	835	1,514	1,830	119.2	20.9
Total revs	**7,601**	**8,455**	**8,358**	**10,007**	**18.4**	**19.7**

Source: Company, IDFC Securities Research

❑ Regulated Markets

- Regulated Markets - Strides reported Rs5.03bn (up 13%/21% yoy/qoq) revenues ahead of our est of Rs4.4bn.
- The growth in the regulated market driven by scale-up in the recently launched products in US as also scale-up in some key mature drugs. This helped to neutralize the impact of the price erosion especially in the partnered products.
- Australia too witnessed growth of low double digit in value and volume terms led by the expansion of the product portfolio and distribution reach. The company continues to remains very bullish on the outlook for the business in Australia as it has undertaken multiple initiatives to drive growth in that geography

US market

- The growth in the US market was driven by new product launches in the current quarter and also by maintaining / increasing its market share in the existing products like Ranitidine (27%; inched upto 30% currently), Dutastertide (34%), Ergocalciferol (44%), Lamivudine Zidovudine (19%) and Methoxsalen (34%). Company expects to replicate similar performance in some more of its vertically integrated ANDAs in the future
- Going forward, the management expects the US business hit to quarterly run-rate of $45-50mn for by Q4FY18 driven by gLovaza and Potassium Citrate ER (scaling up well and market size is $110mn). Q2FY18 had only one month of sales and the full benefit of these two product launches will be visible from Q3FY18 onwards.
- Omega 3 Acid Ethyl Esters (gLovaza) softgel capsules – Launched in a marketing arrangement with Par Pharma. The management believes that this marketing arrangement can provide it with exclusive access to over 25% market share in the US market in Q3FY18. The market size of the product is $250mn and there are currently 4 players in the market. The agreement protects Strides' profitability from any sharp erosion in pricing while ensuring a fair share of the profitability.
- During the quarter, the company has got approval for 2 products in US taking the total approvals at 8 for 1HFY18. The pickup in the couple of OTC approvals will be relatively more gradual compared to the Rx drugs as highlighted in Q1FY18.
- On the filing front, Strides made 1 filings in Q2FY18 vs 5 in Q1FY18 taking the total filing to 6 for 1HFY18. It had made 8 ANDA filings in FY17. The cumulative filings stood at 68 as of now. It has now 28 ANDAs pending with the FDA having total addressable market size of $12bn. As highlighted in Q1FY18 these filings include 2 soft gels, 7 Topicals, 3 modified release, 11 tablets and 5 hard gelatin capsules. The management highlighted that half of its portfolio will not see much competition.
- With the R&D infrastructure now in place, the company is aiming to materially ramp-up its filings going forward now and continues with its guidance of 15-20 ANDAs filings in FY18 spread across multiple dosage formats.
- Given the reducing approval timelines at the FDA's end for recent filings, the company remains confident of getting 15-20 approvals annually over the medium term.
- During the quarter, the company spent Rs380mn (+9% yoy) flat qoq as compared to Rs373mn in Q1FY18. R&D spends were Rs1.36bn in FY17 (+80% yoy).
- As highlighted in Q1FY18 the company believes that its R&D spends will peak at Rs1.5bn-2bn (excluding the Biotech spend) 90% of which would be allocated to regulated markets with major focus on niche and complex filings

Australian Market

- Australian market posted a low double digit growth (both in value and volume terms) in the current quarter compared to slight reduction in qoq sales in Q1FY18 due to pre-stocking in Q4 in anticipation of the PBS price cuts.
- During the quarter, Strides launched 7 new products compared to 3 new products launches in

Q1FY18. The company launched 20 new drugs in FY17. The company expects further expansion in the portfolio aided by new products from Generic Partners.

- On the distribution side, Strides continues to gain enhanced distribution access post the distribution tie-up with the Pharmacy Alliance. Strides now is the frontline generic supplier in >1000 pharmacies and continues to work on expanding its distribution footprint. In the current quarter it has further added 50 more pharmacies. This distribution strength is a major competitive advantage for Strides.
- As previously announced the company has acquired the Australian operations of Amneal Pharma. The acquisition is expected to add AUD25mn in revenues, improves the generics market share from 20% to 22% and adds 200 new first line stores there by expanding the first line pharmacy coverage to 1200+ stores. It has 100+ molecules in common with the Arrow portfolio and adds 13 another unique molecules to the Arrow product portfolio. All the Amneal Pharma products will be sold under the Arrow brand
- The current quarter does not includes the consolidation of Amneal pharma revenues. It is expected to be consolidated going forward.
- Going forward, the company is now focussing on ensuring better compliance for Arrow products at store level and on enhanced backward integration of the product portfolio. Till now the company has made 12 site transfers applications to the TGA of which 10 have been approved. Company expects that material gains from this backward integration should be visible in the coming quarters. This will be an important tool for Strides to effectively mitigate the impact of PBS imposed price cuts.
- The management indicted that it has mitigated the biannual PBS impact led by new product introduction, supplier negotiations and led by effective price management. Also a part of the portfolio of the company is not under the PBS impact which includes the chemist own business and the branded business which has further helped to mitigate the PBS impact. Going forward with the expected synergies of cost savings resulting from the site transfers will further aid to it.
- Mgt had earlier guided that the Australian business is currently doing revenues of around US$45m on a quarterly basis from the earlier run rate of ~US$22m around the time of the Aspen business acquisition. The management highlighted that it is led by the volume growth and the market share gains in the Australian market it is able to maintain EBITDA at an absolute level however the margins level have come off since the time of the acquisitions. The company is also building on the OTC portfolio. However, given the opportunities for shifting production to India as well as supplying larger number of products across pharmacies, management remains positive on increasing profitability over the medium term.

Emerging Markets (including institutional business)

- Revs at Rs3.15bn were up 17% qoq (Rs2.7mn in Q1FY18) vs our estimates of Rs3bn.
- African brand business grew well during the quarter (mid-teens growth) with market share gains across key brands. The management indicated that the sales footprint is now being expanded into East Africa pivoting around the Kenyan (UCL) platform. It is focusing on replication the successful model of Western Africa in expanding it East Africa business. East Africa is a tougher market compared to Western African market.
- India business also rebounded in the current quarter which was impacted by the destocking on account of the GST implementation in Q1FY18
- On the institutional side, business growth was softer led by the weakness in the procurement by the global donor agencies and postponement of anti-malaria tender. With new malaria tenders (3 year tenders) likely to be finalized only in Q3FY18, this business will likely stay soft for next couple of quarters. Mgt had previously cited that while they won ~20% of the FY18 malaria tender, the donor funding is down 40-50% for FY18 which has reduced the size of the tender market
- The company is on track for the local manufacturing of institutional products in Africa at its recently acquired Universal Corporation facility and backward integration into API is expected to provide

better visibility with the donor agencies. In line with the same the Universal Corporation has received the GMP status for its Kenyan facility from WHO. The site transfers of the institutional products is on track with the first set of filings done with WHO and supplies expected to commence from 2HFY18.

- On the ARV business outlook, mgt had guided in Q1FY18 that expect to be a competitive player in some of the newer drugs which are likely to be approved by the donors in coming years.

Consumer Healthcare (CHC) business

- Strides has started to invest for building the consumer healthcare franchise both in the US and in India. In the recent past the company had acquired the CHC brands in the US including Jointflex, Fergon, Vanquish and Pedicare
- It has also setup greenfield business in India, supported by an independent sales force and launched the Nixit brand (smoking cessation category)
- The EBITDA in the current quarter was impacted by Rs161mn on account of these investments. However going forward the management expects the impact to taper off going forward as the branded business revenue starts to gather momentum.

API business

- The PSAI business grew 21% to Rs1.8bn (Rs1.5bn in Q1FY18) vs our estimates of Rs1.6bn.
- The management highlighted that adverse product mix during the current quarter impacted the margins for the business
- On Sevelamer Carbonate, mgt expects supplies to pick up which should also drive up the profitability of this business
- In view of the challenges being faced by the business, the company has opted to demerger this business into a separately listed company. The details of the proposed transaction are included later in the note.

Other points

- In Q1FY18, 4 facilities (API cum formulations) have undergone FDA inspection (May 2017) of which three facilities were issued no observations while the Bangalore facility was issued Form 483 with 3 observations. In the current quarter Strides has received EIR for the Bangalore facility.
- Singapore formulation facility (meant for regulated markets) expected to go on-stream in H2FY18
- As of Sept17 the net debt has increased by ~Rs2bn qoq to Rs24.6bn. The increase is primarily on account of Rs1.75bn payments to complete the Perrigo and Vivimed transactions. The debt includes the PSAI segment debt of Rs4.5bn.
- Going forward as highlighted earlier, debt levels are expected to stay steady and potentially reduce given the relatively limited capex plans ($15-20m per annum over next 2 years).
- Post the demerger of the PSAI business, the debt should come down by further ~Rs4.5bn. Mgt is comfortable with the current net debt levels of ~3x debt / EBITDA and is aiming to bring it down further to ~2.5x over the next 4-6 quarters.

Demerger of the third party API business...

- During the last few interactions the management had indicated that the commodity API business acquired from Shasun was facing challenges on account of lower profitability as well need to upgrade compliance standards from a regulatory aspect. The business required significant upgradation of capabilities from a quality and compliance perspective. While the business had limited synergies with Strides' formulation business, it also posed some risk to the formulation business which was integrated to these API supplies.

- The company has proposed to hive off its commodity business in a separately listed company – to be called SAPS. Further, the human API business from another promoter group company, Sequent Scientific will also get demerged from the company and merged into this new API entity
- While Strides' API business generated revenues of ~Rs5.3bn in FY17, Sequent's Human API business generated ~Rs3bn revenues in FY16. Therefore the combined entity should have revenues > Rs10bn in FY18 and will be a meaningful third party pure play API player. Management sees significant growth prospects for this business over the medium term given the presence of relatively few pure play API players globally along with increasing concerns related to over reliance on Chinese API supplies
- Strides shareholders will get 1 share each of SAPS for every 6 shares of Strides Shasun. Based on the swap ratios, we estimate that Strides' shareholders will own ~60% stake in SAPS.
- The effective date for the transaction is Oct 1, 2017. We estimate the transaction may get closed sometime in H2FY18
- We value this PSAI business at 12x FY19EBITDA which gives us a fair value of 110/share.
- The company has got the approval from the CCI, stock exchanges and SEBI. The company is now awaiting clearance from National Company Law Tribunal and taking shareholder and creditor approval

Income statement

Year to 31 Mar (Rs m)	FY15	FY16	FY17	FY18E	FY19E
Net sales	11,958	28,622	34,834	35,862	39,123
% growth	(10.8)	139.3	21.7	3.0	9.1
Operating expenses	9,670	24,482	28,406	29,919	31,516
EBITDA	2,289	4,140	6,428	5,943	7,606
% change	2.4	80.9	55.3	(7.5)	28.0
Other income	386	874	1,686	1,100	500
Net interest cost	474	1,682	2,269	1,998	1,795
Depreciation	640	1,313	1,872	1,734	1,512
Pre-tax profit	1,560	2,020	3,973	3,312	4,800
Deferred tax	0	144	(189)	0	0
Current tax	532	281	659	397	576
Profit after tax	1,027	1,595	3,503	2,914	4,224
Preference dividend	0	0	0	0	0
Minorities	6	0	4	0	0
Adjusted net profit	1,033	1,595	3,506	2,914	4,224
Non-recurring items	7,267	(645)	953	0	0
Reported net profit	8,300	950	4,459	2,914	4,224
% change	(53.0)	(88.6)	369.4	(34.6)	44.9

Balance sheet

As on 31 Mar (Rs m)	FY15	FY16	FY17	FY18E	FY19E
Paid-up capital	596	894	894	894	894
Preference capital	0	0	0	0	0
Reserves & surplus	10,962	25,685	26,210	28,183	31,360
Shareholders' equity	11,697	27,081	28,744	30,717	33,894
Total current liabilities	8,005	11,707	16,295	16,211	17,686
Total debt	4,768	35,022	34,847	30,347	30,347
Deferred tax liabilities	112	473	756	756	756
Other non-current liabilities	190	294	430	430	430
Total liabilities	13,074	47,495	52,328	47,745	49,219
Total equity & liabilities	24,771	74,576	81,072	78,462	83,113
Net fixed assets	7,032	26,415	27,970	26,736	29,724
Investments	6,683	12,663	15,246	15,246	15,246
Cash	1,474	3,116	3,295	1,583	1,638
Other current assets	8,161	22,769	24,692	25,027	26,635
Deferred tax assets	54	347	200	200	200
Other non-current assets	1,368	9,267	9,670	9,670	9,670
Net working capital	1,630	14,177	11,692	10,399	10,588
Total assets	24,771	74,576	81,072	78,462	83,113

Cash flow

Year to 31 Mar (Rs m)	FY15	FY16	FY17	FY18E	FY19E
Pre-tax profit	1,560	2,020	3,973	3,312	4,800
Depreciation	640	1,313	1,872	1,734	1,512
Chg in Working capital	3,968	(10,905)	2,664	(418)	(134)
Total tax paid	(532)	(281)	(659)	(397)	(576)
Net Interest	474	1,682	2,269	1,998	1,795
Others	7,267	(645)	953	0	0
Operating cash flow	12,468	(6,713)	11,208	6,228	7,396
Capital expenditure	(2,500)	(28,595)	(3,828)	(500)	(4,500)
Free cash flow (a+b)	10,442	(33,626)	9,649	7,725	4,691
Chg in investments	(2,252)	(5,980)	(2,584)	0	0
Debt raised/(repaid)	(698)	30,253	(175)	(4,500)	0
Net interest	(474)	(1,682)	(2,269)	(1,998)	(1,795)
Capital raised/(repaid)	1	297	1	0	0
Dividend (incl. tax)	(298)	(732)	(837)	(942)	(1,046)
Other items	(6,472)	14,430	(2,478)	0	0
Net chg in cash	(838)	1,642	179	(1,712)	55

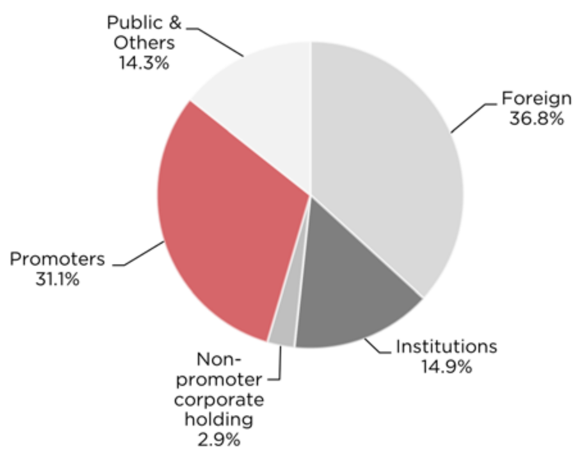
Key ratios

Year to 31 Mar	FY15	FY16	FY17	FY18E	FY19E
EBITDA margin (%)	19.1	14.5	18.5	16.6	19.4
EBIT margin (%)	13.8	9.9	13.1	11.7	15.6
PAT margin (%)	8.6	5.6	10.1	8.1	10.8
RoE (%)	9.2	8.2	12.6	9.8	13.1
RoCE (%)	9.6	7.1	7.1	6.6	9.5
Gearing (x)	0.3	1.2	1.1	0.9	0.8
Net debt/ EBITDA (x)	1.4	7.7	4.9	4.8	3.8
FCF yield (%)	20.2	(47.7)	10.0	7.7	3.9
Dividend yield (%)	0.6	1.0	1.1	1.3	1.4

Valuations

Year to 31 Mar	FY15	FY16	FY17	FY18E	FY19E
Reported EPS (Rs)	139.3	10.6	49.9	32.6	47.2
Adj. EPS (Rs)	17.3	17.9	39.2	32.6	47.2
PE (x)	47.8	46.4	21.1	25.4	17.6
Price/ Book (x)	4.2	2.7	2.6	2.4	2.2
EV/ Net sales (x)	4.4	3.7	3.1	2.9	2.7
EV/ EBITDA (x)	23.1	25.7	16.7	17.6	13.7
EV/ CE (x)	3.1	1.7	1.7	1.7	1.6

Shareholding pattern



As of Jun 17

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