

## COMPANY NOTE

Target | Estimate Change

India | Healthcare | Pharmaceuticals

14 August 2017

# Jefferies

## Strides Arcolab (STR IN) 1Q18: Weak quarter; Expect recovery ahead

### Key Takeaway

**STR reported weak 1Q18 as approval delays, mix and operating leverage drove 700bps margin miss. Mgmt though guided for a sharp recovery from 2Q and maintained c20% revenue and earnings growth guidance. Key product launches from 2Q and better mix in institutional in 2H are the key drivers. We reduce our EPS by 8% to factor approval risks but still expect 18% growth in FY18. STR is trading at 13x FY19 PE (25% sector discount). Retain Buy with revised Rs 1,100 PT.**

**Weak quarter led by sharp margins drop** - Strides reported weak 1Q18 with revenues 8% and margins 700bps below expectation. Revenue miss was across businesses led by Regulated markets, which was down 21% QoQ. The key miss was margins with gross and EBITDA margins 600/700bps below expectation. Mgmt indicated that gross margins were impacted by mix, forex, pricing pressure in US and GST impact. It indicated that, while overall price erosion has been mid-single digit, it is led by partnered products.

**Strong guidance going forward** - Despite the weak quarter, management maintained its guidance of 20% growth in both revenues and earnings. Mgmt emphasized that the miss in the quarter was the result of negative operating leverage led by product delays. It expects this to recover sharply going ahead led by new launches. It has started supplying Sevelamer API to partner in 2Q. It expects to launch gLovaza and one more modified release product in 2Q itself. Further anti-malaria sales will improve in 2H driving improved margins.

**Expect strong recovery ahead; Valuations lend comfort** - We expect growth and margins to recover going forward. Peer commentary indicates that Sevelamer supplies will start from 2Q driving growth and margin. Additionally, mgmt comments that they have indication of two key approvals in 2Q that provide comfort on growth. The stock after recent correction is trading at 12.8x FY19 PE, a 20% discount to peers. Given the strong recovery ahead and the 29% EPS CAGR over FY17-20, we retain Buy.

### Valuation/Risks

We adjust our estimates for the quarter miss. Our FY18/19 EPS falls by 8%. Our FY18 growth at 18% is below mgmt guidance of 20% as we risk adjust for approval delays. The stock is trading at 13x FY19 PE, a 25% discount to sector. Given the strong recovery expectation and lack of facility issues we believe this will narrow. Retain Buy with lowered TP of Rs 1100, valuing it at 16x FY19 PE, a slight discount to sector valuation. Key risk: approval delay.

INR	Prev.	2016A	Prev.	2017A	Prev.	2018E	Prev.	2019E
Rev. (MM)	--	28,621.9	--	34,834.2	42,681.9	40,631.0	51,298.9	48,770.0
EV/Rev		3.6x		3.0x		2.6x		2.1x
EBITDA (MM)	--	4,139.7	--	6,428.2	8,487.6	7,985.4	11,034.2	10,411.5
EV/EBITDA		25.1x		16.2x		13.0x		10.0x
Net Profit Adjusted	--	1,595.1	--	3,506.8	4,487.0	4,141.2	6,598.6	6,088.5
BV/Share	--	330.36	--	336.90	384.31	380.65	454.02	444.98
P/B		2.6x		2.6x		2.3x		2.0x
Dividend	--	0.00	--	4.50	7.53	6.95	11.07	10.21
Div. Yield		0.00%		0.51%		0.79%		1.17%
<b>EPS Adjusted</b>								
FY Mar	--	19.83	--	39.25	50.22	46.35	73.85	68.15
FY P/E		44.1x		22.3x		18.9x		12.8x

**BUY**

Price target INR1,100.00  
(from INR1,220.00)  
Price INR874.80^

### Financial Summary

Net Debt (MM): INR25,834.4

### Market Data

52 Week Range: INR1,274.70 - INR848.00

Total Entprs. Value (MM): INR104.0BN

Market Cap. (MM): INR78.1BN

Shares Out. (MM): 89.3

Float (MM): 44.0

Avg. Daily Vol.: 302,792

**Piyush Nahar** \*

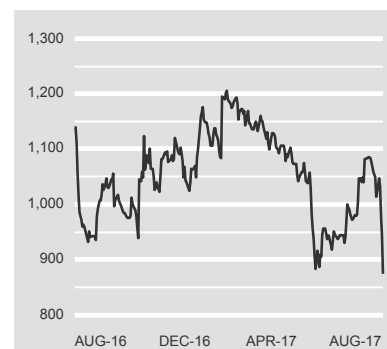
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### Price Performance



^Prior trading day's closing price unless otherwise noted.

## Key highlights from Call

- US business – Price erosion in own portfolio has been in low single digit
  - Partnered products saw sharp price erosion
  - Direct market products saw some impact QoQ due to channel filing in 4Q but the company continues to gain market share
    - Ranitidine – mkt share up to 30%
    - Dutasteride – up to 26% from 16%
    - Buspirone – mkt share at 11%
  - It expects to launch 2 key products in US in 2Q18 – Lovaza and one modified release
- It has supplied Sevelamer to at least one customer in 2Q18
- Net debt increased by Rs 1bn to Rs 22.5bn led by Perrigo transaction and JV
- It expects a strong recovery in 2Q and expect business to be back on track in 2H
- It maintained its guidance of 20% growth on both topline and profits
- Institutional business had inferior mix as anti-malaria suppliers were lower
- Anti-malaria tender is down 20-25% and the re-bidding is in September
- Gross margin decline in the quarter was mix of Price erosion in partnered products, forex, GST and mix
- It expects the impact of pricing and forex on gross margins to be offset by operating leverage and new launches at EBITDA level
- R&D will remain at current levels going forward

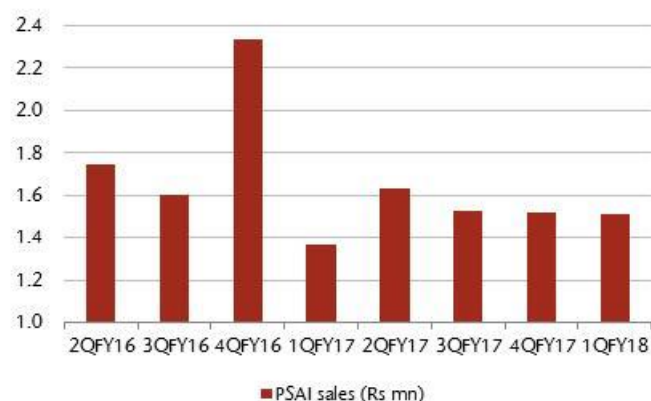
### Exhibit 1: Regulated market growth was muted due to pricing impact in partner products



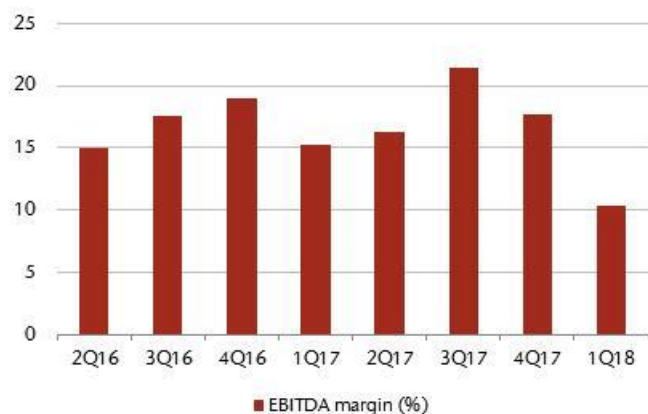
Source: Jefferies estimates, company data

**Exhibit 3: Emerging markets sale impacted due to GST and exit from Africa generic-generic business**

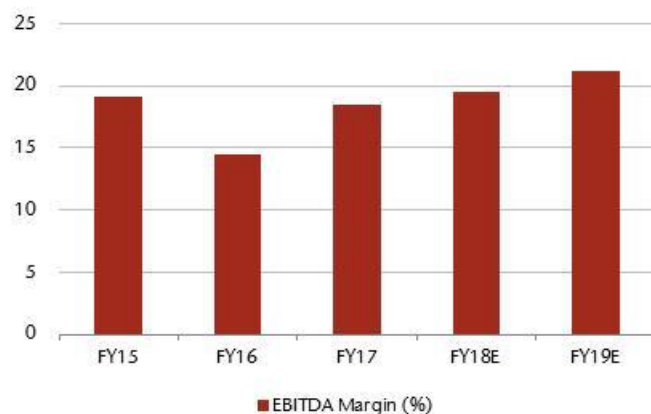
Source: Jefferies estimates, company data

**Exhibit 4: PSAI sales impacted by approval delays**

Source: Jefferies estimates, company data

**Exhibit 5: EBITDA margin impacted by negative operating leverage**

Source: Jefferies, company data

**Exhibit 6: Margins expected to improve led by new launches and ramp-up of revenues**

Source: Jefferies estimates, company data

**Exhibit 7: Changes in estimates**

(in Rs mn)	Old		New			% Change	
	FY18E	FY19E	FY18E	FY19E	FY20E	FY18E	FY19E
Sales	42,682	51,299	40,631	48,770	54,712	-5%	-5%
EBITDA	8,488	11,034	7,985	10,412	11,821	-6%	-6%
OP margin	20%	22%	20%	21%	22%	-35 bps	-65 bps
Net profit (adj)	4,487	6,599	4,141	6,088	7,530	-8%	-8%
NP margin	11%	13%	10%	12%	14%	-81 bps	-52 bps
EPS (adj)	50.2	73.9	46.4	68.1	84.3	-8%	-8%
EPS growth	28%	47%	18%	47%	24%	-10 bps	00 bps
ROE	14.5	18.1	13.5	17.0	17.8	-98 bps	-109 bps

Source: Jefferies estimates, company data

**Exhibit 8: Strides 12-month forward PE below long term average**

Source: Factset, Jefferies estimates

**Exhibit 9: Valuation table**

Company	BB Ticker	Market Cap (Rs bn)	TP (Rs)	CMP (Rs)	Rating	P/E (x)			P/B (x)			FY16-19 CAGR (%)	
						FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	Sales	EPS
Sun Pharma	SUNP IN	23.8	410	450	HOLD	15.6	19.4	14.8	3.0	2.6	2.2	4.9	5.9
Lupin	LPC IN	8.9	850	941	UNPF	15.7	21.8	17.5	2.8	2.5	2.2	9.4	3.2
Cipla	CIPLA IN	6.8	510	541	HOLD	43.2	34.1	27.5	3.4	3.0	2.7	12.0	29.9
Dr Reddy's	DRRD IN	6.7	2,150	2011	UNPF	27.8	27.7	24.5	2.7	2.5	2.2	6.3	20.7
Aurobindo	ARBP IN	5.3	800	705	BUY	17.9	16.2	13.5	4.4	3.5	2.9	9.5	13.4
Torrent	TRP IN	3.4	NC	1216	NC	22.1	22.1	22.6	4.8	4.1	3.5	8.1	7.4
Glenmark	GNP IN	2.9	NC	617	NC	19.0	19.0	15.2	3.5	2.9	2.4	6.4	13.5
Natco	NTCPH IN	2.5	950	699	BUY	25.1	24.3	13.2	7.3	6.0	4.8	8.3	25.5
Divi's Laboratories	DIVI IN	2.5	NC	627	NC	15.7	15.7	17.1	3.1	3.0	2.7	1.8	0.8
Alembic Pharma	ALPM IN	1.7	NC	515	NC	24.1	24.1	23.1	5.1	4.2	3.6	7.7	8.8
Syngene	SYNG IN	1.5	520	449	HOLD	31.2	31.2	33.0	6.4	5.3	4.4	14.9	8.3
Strides	STR IN	1.4	1220	875	BUY	19.6	22.3	16.1	2.4	2.1	1.8	19.0	16.7
IPCA Labs	IPCA IN	1.0	NA	409	NC	26.6	26.6	19.0	2.1	1.9	1.7	8.5	24.1
Laurus Labs	LAURUS IN	0.9	630	543	BUY	25.8	30.0	21.9	4.3	3.7	3.0	20.2	18.9
Shilpa Medicare	SLPA IN	0.8	NA	569	NC	42.9	42.9	23.5	5.0	4.2	3.4	20.8	36.6

Source: Jefferies estimates, company data

Prices as on 11<sup>th</sup> Aug, 2017

## FINANCIALS

**Exhibit 10: Income Statement**

Rs mn	FY15	FY16	FY17E	FY18E	FY19E
<b>Net Sales</b>	<b>11,958</b>	<b>28,622</b>	<b>34,834</b>	<b>40,631</b>	<b>48,770</b>
<i>Change (%)</i>	7.0	139.3	21.7	16.6	20.0
Material Cost	5,573	15,023	15,362	18,323	21,024
Employee Cost	1,636	3,577	5,881	6,420	7,704
SG&A	2,067	5,125	5,802	6,314	7,627
R&D Expenses	394	757	1,361	1,587	2,003
<b>EBITDA</b>	<b>2,289</b>	<b>4,140</b>	<b>6,428</b>	<b>7,985</b>	<b>10,412</b>
<i>% of net sales</i>	19.1	14.5	18.5	19.7	21.3
Depreciation	640	1,313	1,872	2,130	2,459
Interest	474	1,682	2,269	2,935	2,935
Other Income	386	921	1,686	1,947	2,141
<b>PBT</b>	<b>1,560</b>	<b>2,067</b>	<b>3,973</b>	<b>4,868</b>	<b>7,159</b>
EO Income / (Exp)	(74)	(414)	(1,006)	-	-
Tax	5	47	-4	-4	-4
<i>Rate (%)</i>	1,476	425	470	730	1,074
	95	21	12	15	15
<b>PAT</b>	<b>5</b>	<b>1,181</b>	<b>2,501</b>	<b>4,141</b>	<b>6,088</b>
Adjusted PAT	79	1,595	3,507	4,141	6,088
<i>change (%)</i>	108.9	1,931.6	119.8	18.1	47.0

Source: Jefferies estimates, company data

**Exhibit 11: Balance Sheet**

Rs mn	FY15	FY16	FY17E	FY18E	FY19E
Share Capital	783	1,396	2,534	2,534	2,534
Reserves	10,853	25,685	26,210	29,730	34,906
<b>Net Worth</b>	<b>11,636</b>	<b>27,081</b>	<b>28,744</b>	<b>32,264</b>	<b>37,440</b>
Deferred Tax Lia	-	473	756	756	756
Loans	8,917	37,883	41,925	41,925	41,925
<b>Capital Employed</b>	<b>20,553</b>	<b>65,436</b>	<b>71,425</b>	<b>74,945</b>	<b>80,121</b>
Gross Fixed Assets	9,437	27,853	31,784	32,784	33,784
Less: Depreciation	3,792	9,742	11,613	13,743	16,201
<b>Net Fixed Assets</b>	<b>5,645</b>	<b>18,112</b>	<b>20,171</b>	<b>19,042</b>	<b>17,583</b>
Capital WIP	1,456	2,942	2,045	2,045	2,045
Intangible assets under development	256	5,361	5,753	5,753	5,753
Goodwill on consolidation	1,368	9,267	9,670	9,670	9,670
Investments	6,300	12,663	15,246	15,246	15,246
Deferred Tax Asset	54	347	200	200	200
<b>Current Assets</b>	<b>9,782</b>	<b>25,885</b>	<b>27,987</b>	<b>33,879</b>	<b>42,257</b>
Inventory	2,077	6,131	7,380	8,608	10,332
Debtors	3,900	10,330	9,971	12,186	15,295
Cash & Bank Balance	1,469	3,116	3,295	5,743	9,288
Loans & Advances	2,336	6,308	7,342	7,342	7,342
<b>Current Liabilities</b>	<b>4,308</b>	<b>9,140</b>	<b>9,647</b>	<b>10,889</b>	<b>12,633</b>
Creditors	2,344	7,754	7,465	8,708	10,452
Other Liabilities	989	1,092	1,751	1,751	1,751
Provisions	974	294	430	430	430
<b>Net Current Assets</b>	<b>5,474</b>	<b>16,745</b>	<b>18,340</b>	<b>22,990</b>	<b>29,624</b>
<b>Appl. Of fund</b>	<b>20,553</b>	<b>65,436</b>	<b>71,425</b>	<b>74,945</b>	<b>80,121</b>

Source: Jefferies estimates, company data

**Exhibit 12: Cash flow statement**

(Rs mn)	FY15	FY16	FY17E	FY18E	FY19E
PAT	16	1,595	3,507	4,141	6,089
Depreciation	640	1,313	1,872	2,130	2,459
Interest Exp	474	1,682	2,269	2,935	2,935
Other Income	386	921	1,686	1,947	2,141
Change in Wkg Capital	-1,050	-4,981	-1,269	-2,201	-3,089
<b>CF from Op Activities</b>	<b>-305</b>	<b>-1,313</b>	<b>4,693</b>	<b>5,057</b>	<b>6,252</b>
Change in Fixed Assets	-2,826	-22,530	-3,828	-1,000	-1,000
Change in Investments	-1,870	-6,205	-2,584	0	0
Other Income	386	921	1,686	1,947	2,141
<b>CF from Investing Activities</b>	<b>-4,310</b>	<b>-27,814</b>	<b>-4,726</b>	<b>947</b>	<b>1,141</b>
Change in equity	1,198	10,067	-2,579	0	0
Changes in debt	3,451	21,571	4,042	0	0
Interest Exp	-474	-1,682	-2,269	-2,935	-2,935
Dividend paid	-402	0	-402	-621	-913
Others					
<b>CF from Financing Activities</b>	<b>3,772</b>	<b>29,956</b>	<b>-1,209</b>	<b>-3,556</b>	<b>-3,848</b>
<b>Net change in Cash</b>	<b>-843</b>	<b>829</b>	<b>-1,242</b>	<b>2,448</b>	<b>3,545</b>

Source: Jefferies estimates, company data

**Exhibit 13: Key Ratios**

	FY15	FY16	FY17E	FY18E	FY19E
<b>Basic (Rs)</b>					
EPS	1.3	19.8	39.2	46.4	68.1
BPS	192	330	337	381	445
DPS	85.7	-	4.5	6.9	10.2
Payout (%) *	6,506.0	-	11.5	15.0	15.0
					51
<b>Valuation (X)</b>					
P/E	664.4	44.1	22.3	18.9	12.8
P/B	4.6	2.6	2.6	2.3	2.0
EV/EBITDA	44.1	24.4	15.7	12.6	9.7
EV/Sales	8.4	3.5	2.9	2.5	2.1
Dividend Yield (%)	9.8	-	0.5	0.8	1.2
<b>Profit Ratios (%)</b>					
RoE	11.3	6.0	12.9	13.5	17.0
RoCE	12.4	5.7	8.6	10.8	14.3
<b>Turnover Ratios</b>					
Debtor Days	119	132	104	109	114
Inventory Days	136	149	175	171	179
Creditor Days	112	140	129	129	133
Net Debt to Equity	0.16	0.85	0.95	0.76	0.55

Source: Jefferies estimates, company data

## Company Description

Strides Arcolab Ltd. manufactures a variety of pharmaceutical and dosage products that are distributed internationally. The Company's product portfolio includes gel capsules, steroids, cephalosporins, antibiotics, vitamins, and analgesics. Strides Arcolab also operates a contract research and manufacturing division.

## Analyst Certification:

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## Investment Recommendation Record

### (Article 3(1)e and Article 7 of MAR)

Recommendation Published , 13:48 ET. August 13, 2017

Recommendation Distributed , 13:48 ET. August 13, 2017

## Company Specific Disclosures

For Important Disclosure information on companies recommended in this report, please visit our website at [https://javatar.bluematrix.com/sellside/ Disclosures.action](https://javatar.bluematrix.com/sellside/Disclosures.action) or call 212.284.2300.

## Explanation of Jefferies Ratings

Buy - Describes securities that we expect to provide a total return (price appreciation plus yield) of 15% or more within a 12-month period.

Hold - Describes securities that we expect to provide a total return (price appreciation plus yield) of plus 15% or minus 10% within a 12-month period.

Underperform - Describes securities that we expect to provide a total return (price appreciation plus yield) of minus 10% or less within a 12-month period.

The expected total return (price appreciation plus yield) for Buy rated securities with an average security price consistently below \$10 is 20% or more within a 12-month period as these companies are typically more volatile than the overall stock market. For Hold rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is plus or minus 20% within a 12-month period. For Underperform rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is minus 20% or less within a 12-month period.

NR - The investment rating and price target have been temporarily suspended. Such suspensions are in compliance with applicable regulations and/or Jefferies policies.

CS - Coverage Suspended. Jefferies has suspended coverage of this company.

NC - Not covered. Jefferies does not cover this company.

Restricted - Describes issuers where, in conjunction with Jefferies engagement in certain transactions, company policy or applicable securities regulations prohibit certain types of communications, including investment recommendations.

Monitor - Describes securities whose company fundamentals and financials are being monitored, and for which no financial projections or opinions on the investment merits of the company are provided.

## Valuation Methodology

Jefferies' methodology for assigning ratings may include the following: market capitalization, maturity, growth/value, volatility and expected total return over the next 12 months. The price targets are based on several methodologies, which may include, but are not restricted to, analyses of market risk, growth rate, revenue stream, discounted cash flow (DCF), EBITDA, EPS, cash flow (CF), free cash flow (FCF), EV/EBITDA, P/E, PE/growth, P/CF, P/FCF, premium (discount)/average group EV/EBITDA, premium (discount)/average group P/E, sum of the parts, net asset value, dividend returns, and return on equity (ROE) over the next 12 months.

### Jefferies Franchise Picks

Jefferies Franchise Picks include stock selections from among the best stock ideas from our equity analysts over a 12 month period. Stock selection is based on fundamental analysis and may take into account other factors such as analyst conviction, differentiated analysis, a favorable risk/reward ratio and investment themes that Jefferies analysts are recommending. Jefferies Franchise Picks will include only Buy rated stocks and the number

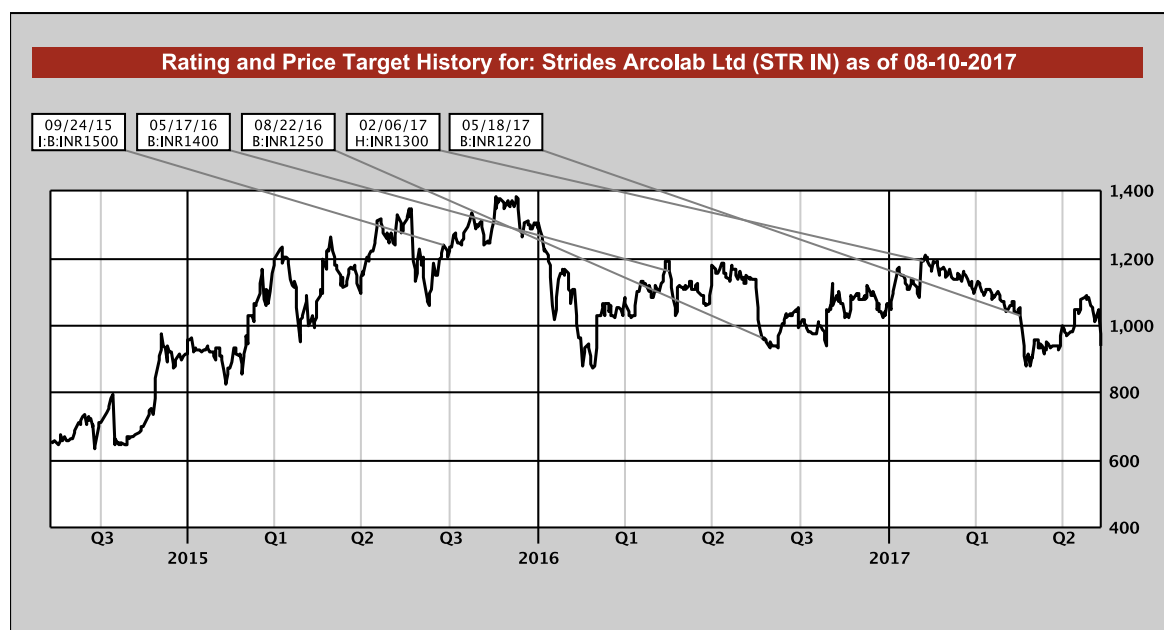
can vary depending on analyst recommendations for inclusion. Stocks will be added as new opportunities arise and removed when the reason for inclusion changes, the stock has met its desired return, if it is no longer rated Buy and/or if it triggers a stop loss. Stocks having 120 day volatility in the bottom quartile of S&P stocks will continue to have a 15% stop loss, and the remainder will have a 20% stop. Franchise Picks are not intended to represent a recommended portfolio of stocks and is not sector based, but we may note where we believe a Pick falls within an investment style such as growth or value.

## Risks which may impede the achievement of our Price Target

This report was prepared for general circulation and does not provide investment recommendations specific to individual investors. As such, the financial instruments discussed in this report may not be suitable for all investors and investors must make their own investment decisions based upon their specific investment objectives and financial situation utilizing their own financial advisors as they deem necessary. Past performance of the financial instruments recommended in this report should not be taken as an indication or guarantee of future results. The price, value of, and income from, any of the financial instruments mentioned in this report can rise as well as fall and may be affected by changes in economic, financial and political factors. If a financial instrument is denominated in a currency other than the investor's home currency, a change in exchange rates may adversely affect the price of, value of, or income derived from the financial instrument described in this report. In addition, investors in securities such as ADRs, whose values are affected by the currency of the underlying security, effectively assume currency risk.

## Other Companies Mentioned in This Report

- Aurobindo Pharma (ARBP IN: INR705.00, BUY)
- Cipla (CIPLA IN: INR541.40, HOLD)
- Dr. Reddy's Laboratories (DRRD IN: INR2,011.35, UNDERPERFORM)
- Laurus Labs Limited (LAURUS IN: INR543.05, BUY)
- Lupin Ltd. (LPC IN: INR940.90, UNDERPERFORM)
- Natco Pharma Limited (NTCPH IN: INR699.10, BUY)
- Sun Pharmaceutical Industries Ltd (SUNP IN: INR450.00, HOLD)
- Syngene International Ltd (SYNG IN: INR448.75, HOLD)



**Notes:** Each box in the Rating and Price Target History chart above represents actions over the past three years in which an analyst initiated on a company, made a change to a rating or price target of a company or discontinued coverage of a company.

### Legend:

I: Initiating Coverage

D: Dropped Coverage

B: Buy

H: Hold

UP: Underperform

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**STR IN**

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**Distribution of Ratings**

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY	1095	50.86%	340	31.05%
HOLD	906	42.08%	180	19.87%
UNDERPERFORM	152	7.06%	17	11.18%

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