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a relationship beyond broking

Institutional Equities

STRIDES ARCOLABS
TAKING LARGE STRIDES

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Initiating Coverage

Strides Arcolab

16 December 2014

Reuters: STAR.BO Bloomberg: STR IN

Taking Large Strides

We believe that investors' concerns over Strides Arcolab's (SAL) residual business model- post divestment of the injectables business to Mylan - are highly unwarranted. On the contrary, we believe SAL has built (and continues to build) strong capabilities (organic as well as inorganic) over the past few years to deliver a robust 50% earnings CAGR over FY15E-FY17E. In our view, SAL presents a right mix of robust growth, improved return ratios and a strong balance sheet, which not many peers offer currently. We believe Shasun's merger with SAL is a great fit for the latter, which along with robust growth in the US and African business, is likely to propel its stock's performance in the medium term and reduce the valuation gap with peers. We have assigned Buy rating to SAL with a target price of Rs1,136, valuing the stock at 18xFY17E EPS of Rs59.6 and added NPV (net present value) of Rs63/share for US$140mn of cash to be received.

Shasun's merger likely to strengthen SAL's business model: We believe Shasun's merger with SAL significantly strengthens the latter's business model and will bring in great deal of synergy. In our view, SAL has multiple levers to drive value from this merger like: a) Shasun will add vertical integration benefits, primarily on the institutional business side (around 55% of its revenue came from the API segment in FY14); SAL, on the other hand, is not vertically integrated, b) Shasun has an impressive, but an under-exploited infrastructure (USFDA-approved finished dosage facility, two API facilities and one CRAMS facility) which is expected to improve, given SAL's better execution capability, c) Rationalisation of Shasun's UK CRAMS business (EBITDA margin of <5% in FY14 and loss-making in 1HFY15) to significantly boost margins - our interactions with the management indicates that SAL is thinking likewise, and d) The merger offers additional synergies in revenue (wider geographic reach, cross-leveraging existing relationships) as well as costs (workforce optimisation, reduced capex and research and development or R&D spending). The R&D pipeline for the combined entity is also robust with more than 100 filings likely in the US over the next two-three years; current pipeline has only one product overlap.

Multiple business drivers: We expect SAL (excluding Shasun) to post a 29% CAGR over FY15E-FY17E, led by US business (higher product approvals plus interesting launches including generics Lovaza, Avodart and Combivir), African business (field force plus geography addition and manufacturing set-up in the region) and institutional business (led by recently won anti-malarial tender plus optionality from Sovaldi and MMV contract). Shasun, on the other hand, is likely to clock in a 13% CAGR over FY15E-FY17E, led by API supplies of generics Renvela, Renagel, Welchol and Celebrex in FY16. With a better product mix (higher Africa, US and vertically integrated institutional business) we expect SAL's margins to improve 250bps over FY15E-FY17E. Shasun's margins are also likely to improve 330bps over FY15E-FY17E, led by a better product mix (gradual reduction in UK CRAMS business and launch of high-margin APIs).

Strong balance sheet, improved return ratios to narrow valuation discount: SAL has a debt-free balance sheet (repaid from the proceeds of Agila divestment to Mylan and Ascent Pharma to Watson). Even assuming Shasun's debt of ~US$100mn, the combined entity will not have a net D/E ratio of more than 0.5x in FY16E. Further, with expansion in margins, we expect RoE/RoCE to improve from 14%/12%, respectively, in FY15E to 23%/18%, respectively, in FY17E, which should drive a re-rating of SAL. Current valuation at 14xFY17E EPS (excluding cash NPV) is at a discount to peers, which we believe will narrow down. A sum of US$100mn in escrow account (to be received after four years, NPV of Rs41) plus US$40mn tax holdback to be received in a year (NPV of Rs22/share), Sovaldi and MMV contracts are expected to cushion the downside in stock price, if any.

Y/E March (Rsmn)	CY12	FY14 (15M)	FY15E	FY16E (*)	FY17E (*)
Revenue	9,618	13,410	12,332	33,929	38,944
YoY (%)	*(62.3)*	*39.4*	*(8.0)*	*175.1*	*14.8*
EBITDA	1,006	2,234	2,466	5,421	6,916
EBITDA (%)	*10.5*	*16.7*	*20.0*	*16.0*	*17.8*
Reported PAT	8,462	17,667	9,075	3,480	4,805
Adj. PAT	123	(2,062)	1,575	3,480	4,805
YoY (%)	(93.0)	(1,780.2)	(176.4)	120.9	38.1
Fully DEPS	143.9	296.6	152.4	43.2	59.6
Adj. EPS	2.1	(34.6)	26.4	43.2	59.6
RoE (%)	*0.7*	*(13.6)*	*14.2*	*22.3*	*22.5*
RoCE (%)	*1.8*	*6.2*	*11.9*	*18.4*	*17.6*
P/E (x)	425.9	(25.7)	33.6	20.6	14.9
EV/EBITDA (x)	66.2	25.1	22.8	15.0	11.5

Note: (*) includes Shasun merger; Source: Company, Nirmal Bang Institutional Equities Research

BUY

Sector: Pharmaceuticals

CMP: Rs889

Target Price: Rs1,136

Upside: 28%

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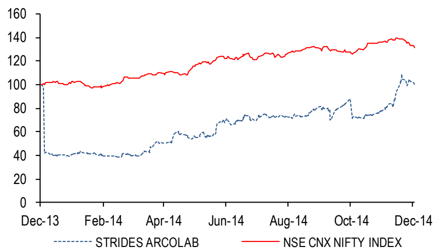
Key Data

Current Shares O/S (mn)	59.6
Mkt Cap (Rsbn/US$mn)	53.5/843.5
52 Wk H / L (Rs)	999/269
Daily Vol. (3M NSE Avg.)	690,337

Share holding (%)	4QFY14	1QFY15	2QFY15
Promoter	27.7	27.7	27.7
FII	54.1	49.0	43.1
DII	2.1	5.1	7.2
Corporate	3.7	3.2	4.1
General Public	12.0	15.1	18.0

One-Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Strides Arclolab	28.3	61.5	164.6
Nifty Index	(3.8)	7.1	31.1

Source: Bloomberg

We believe Shasun is a perfect match

We believe Shasun's merger significantly strengthens SAL's business model and will bring in great deal of synergy. In our view, SAL has multiple levers to drive value from this merger as discussed below:

Vertically integrated model

Shasun derived around ~55% of its revenue from API business in FY14 and has around 43 commercialised DMFs (drug master files) and another 23 under development. It is among the global leaders in Ibuprofen and a key supplier of Ranitidine and Gabapentin worldwide. Shasun's facilities are World Health Organisation (WHO) as well as USFDA-approved, and the company - through its in-house technology - is well placed to accelerate DMF filings for the institutional business. SAL, on the other hand, sources its APIs from third parties. Compared to peers like Aurobindo Pharma, Cipla, Hetero Drugs and Mylan - which are vertically integrated - SAL, so far, has been a fringe player in the institutional business because of relatively lower margins with the market being largely tender-based. Hence, with an integrated model, we believe the ramp-up can be much faster. Notably, Shasun already has a DMF filed for Tenofovir (anti-retroviral drug) and has commercialised Cyclosrine (anti-tuberculosis drug, one of the two suppliers approved by WHO).

Exhibit 1: SAL to be vertically integrated post Shasun merger

Company	Scale	Vertical integration
Aurobindo Pharma	✓✓	✓✓
Aspen	✓✓	×
Cipla	✓✓	✓✓
Hetero Drugs	✓✓	✓✓
Mylan	✓✓	✓✓
SAL	✓	×
SAL+Shasun	✓✓	✓✓

Source: Industry, Nirmal Bang Institutional Equities Research

Impressive infrastructure of Shasun, but under-exploited

We believe Shasun has an impressive infrastructure, but is under-exploited. The company has one USFDA-approved finished dosage facility, two USFDA-approved API facilities and one USFDA-approved CRAMS facility. Large investments in creating infrastructure (fixed asset base of ~Rs9.2bn, annual R&D spending of US$5mn-US$7mn) has driven net D/E ratio to 1.85x as of end-June 2014. Also, a major portion of Shasun's product pipeline is futuristic and is yet to reap the benefits – the company has around 80-85 products in its pipeline to be filed over the next two-three years (largely in niche domains like extended release tablets, OTC etc) which will significantly strengthen SAL's thin pipeline. SAL, on the other hand, has proven execution skills with strong market share in some of its products already launched (~40%-50% market share in Vancocin and Methoxsalen).

Exhibit 2: Complementary strengths

	SAL	Shasun	Merged entity
Formulation development R&D scientists	110	106	216
Process chemistry R&D scientists	0	187	187
Manufacturing staff and other employees	1,500	2,100	3,600
Formulation facilities – USFDA-approved	2	1	3
API facilities – USFDA-approved	0	2	2
CRAMS facilities – USFDA-approved	0	1	1
Emerging market facilities	6	0	6

Source: Company, Nirmal Bang Institutional Equities Research

Rationalisation of UK CRAMS business to be margin accretive

Our interactions with the management indicates that SAL intends to gradually discontinue Shasun's UK CRAMS business (sold through Shasun Pharma Solutions or SPSL- erstwhile Rhodia) which has sub-optimal margins currently (<5% in FY14 and loss-making in 1HFY15). UK CRAMS business constituted almost one-fourth of Shasun's revenue in FY14, but the segment reported a decline of around 8%YoY because of a 'Black Box Warning' on one of its key products called Incivek (Telaprevir), that SPSL was supplying to Vertex Pharmaceuticals (VPL). VPL recently announced its intention to discontinue the sale of Invicek and, therefore, we believe margin expansion in UK CRAMS business in the medium term is off the hook and, therefore, the discontinuation makes sense because the capacities can be utilised for SAL products. As per SAL's management, excluding UK CRAMS business, Shasun's margins should normalise at 13%-14%.

Other operational synergies

Shasun's merger with SAL offers additional synergy in revenue (wider geographic reach, cross-leveraging existing relationships) as well as costs (workforce optimisation, reduced capex and R&D spending). Compared to peers, Shasun has a relatively bloated cost base even as gross margin is largely comparable. The two companies also have a fairly complementary R&D pipeline with only one product overlap. SAL's R&D pipeline is largely focused on dermatology and soft gel space, while Shasun has a strong extended-release and OTC product pipeline.

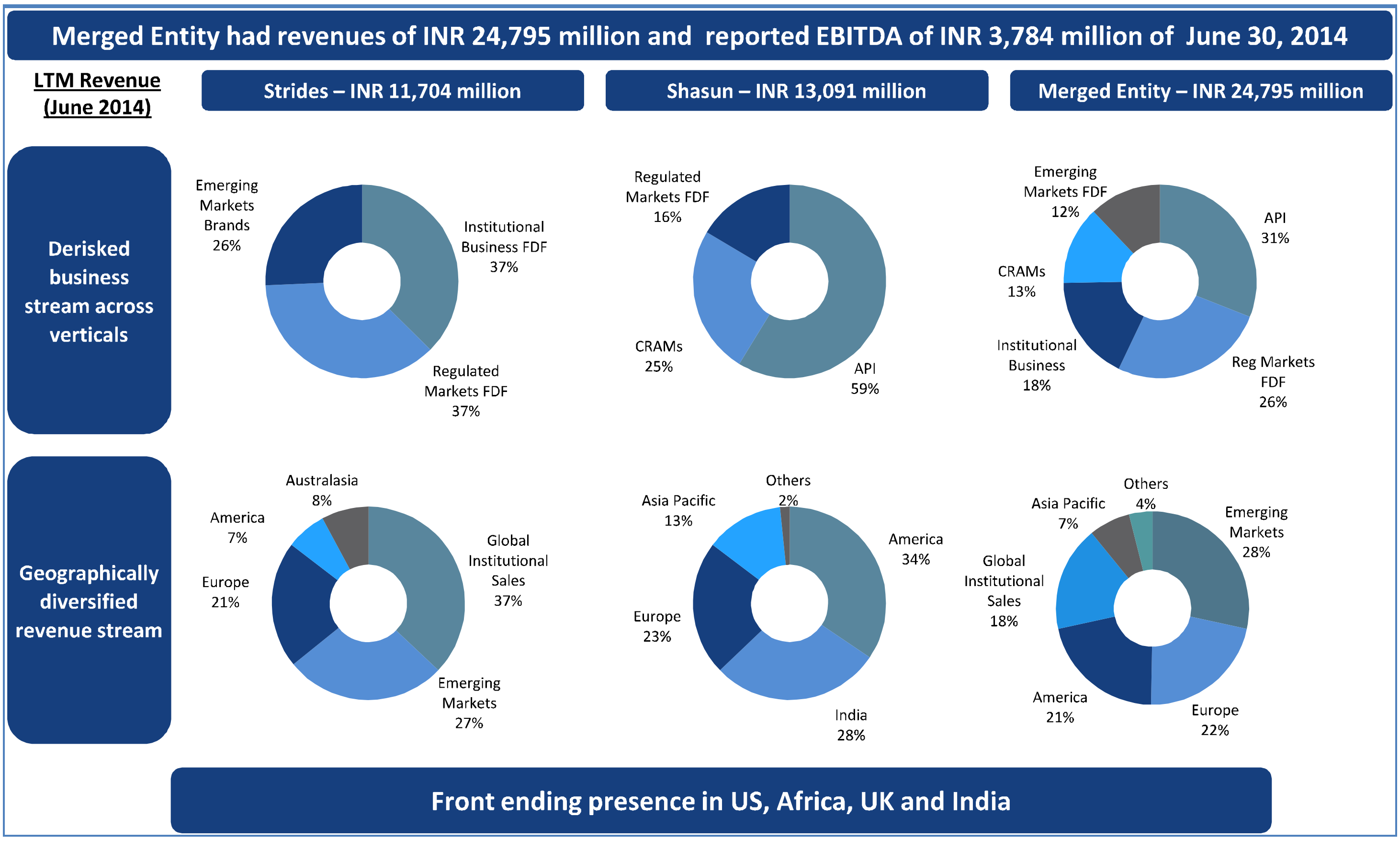
Exhibit 3: Combined entity to have a strong pipeline in the US

Enhanced Regulated Market FDF Portfolio and Access to Pipeline of Complex Extended Release Products

USFDA	Approved	Filed	Pipeline	Total	Filing 2015	Launched	Partnered
SGC	2	5	1	8	-	2	-
Extended Release	-	2	32	34	1	-	13
Creams and Ointments	1	1	8	10	2	1	-
Suspension	-	-	6	6	-	-	-
OTC	3	3	7	13	2	3	-
505 (b(2))	-	-	1	1	-	-	-
FTF	-	1	1	2	1	-	-
Other	11	17	58	80	11	8	7
Total	17	29	114	160	17	14	20
PEPFAR	16	2	-	18	-	-	-

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: SAL + Shasun – Profile



Source: Company, Nirmal Bang Institutional Equities Research

Shasun merger to lead to a dilution of around 35% in Strides Arcolab's equity

For merging Shasun with itself, SAL is allotting the shareholders 5 shares of the company for every 16 held in Shasun, which will expand the current equity base of the company from 59.5mn shares to 80.5mn shares, implying a dilution of ~35%. Post merger, SAL promoters will hold around 24.9% stake in the company, while Shasun promoters (also to be classified under promoters) will hold around 9.2% stake, taking the total promoter shareholding in the company to around 34.1%.

Exhibit 5: Shareholding details – Pre and post merger

SAL – Total number of shares (mn)	59.57
Of which	
Promoter holding (mn)	16.48
(in %)	*27.67*
Non-promoter holding (mn)	43.08
(In %)	*72.32*
For every 16 shares of Shasun, an investor gets 5 shares of SAL	
Additional shares to be issued of SAL (mn)	21.01
New equity base of SAL (mn)	80.57
SAL promoter holding (post-Shasun merger - in %)	*20.46*
SAL promoter holding through direct holding in Shasun (post merger in %)	*0.34*
SAL promoter through direct holding in Shasun assuming conversion of warrants (post-merger - in %)	*4.11*
Shasun promoter holding (post-merger - in %)	*9.21*
Total promoter holding (in %)	*34.12*

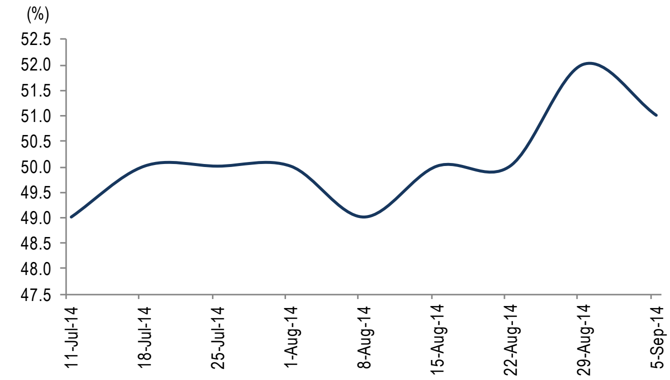
Source: Company, Nirmal Bang Institutional Equities Research

US story yet to play out

Post sale of injectable business to Mylan, SAL is left with a thin pipeline in the US (29 filings, 17 approved) of solid oral dosages (largely in dermatology and soft gel segments). The management's efforts are centered at rebuilding the US franchise - over the past few months, the company brought back most of its partnered products (through the money received from Agila sale) as well as commissioned a new R&D facility for the US market. SAL also set up its own front-end in the US (in January2014) and all products (barring Vancocin) are now commercialised on its own.

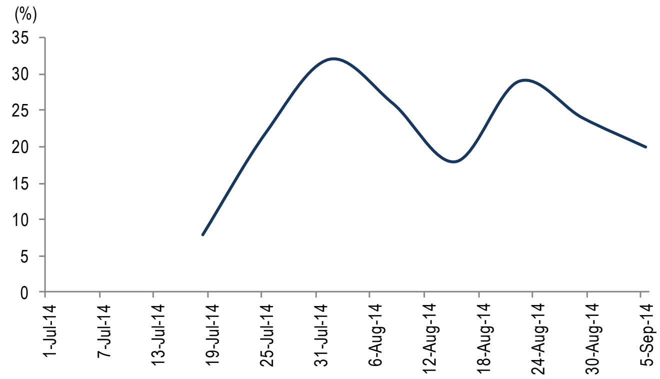
A major portion of current sales (~US$14mn in 15MFY14) is driven by Vancocin, where SAL (along with its partner Alvogen) enjoys around 45%-50% market share (we believe Vancocin contributed around US$6mn-US$8mn in 15MFY14) and the share has largely been stable for the past 8-10 quarters. However, post recent plant approvals - at Bangalore (re-inspected in April 2014 with no 483s) and Milan, Italy (approved in September 2013) – there has been a spurt in product approvals with five approvals in 1HFY15, including some limited competition products like Methoxsalen, Tacrolimus and Imiquimod.

Exhibit 6: Stable market share in Vancomycin



Source: Industry, Nirmal Bang Institutional Equities Research

Exhibit 7: Market share in Methoxsalen– relatively erratic because of authorised generic



Source: Industry, Nirmal Bang Institutional Equities Research

Exhibit 8: Interesting products launched in recent past

Approval date	Brand	Molecule	Brand (US$mn)	Timeline	Competition	Potential revenue p.a. (US$mn)
6 June 2014	Oxsoralen	Methoxsalen	13.6	Launched	1	4.0
25 June 2014	Aldara	Imiquimod	140	Launched	6	2.1
23 July 2014	Prograf	Tacrolimus	676	2HFY15	6	14.0
26 August 2014	Buspar	Buspirone	65	Launched	8	0.7

Source: Industry, Nirmal Bang Institutional Equities Research

SAL has historically focused only on injectable filings owing to which the rest of the pipeline remained slim. The company intends to ramp this up significantly - it has given guidance of filing 9-10 products in 2HFY15 and step this up to 15-20 filings from FY16 onwards as development work progresses in the recently commissioned R&D facility. The pipeline will get a significant boost from Shasun, which is likely to file around 20 products from FY16 onwards, which will take the total filings to around 35-40 for the next couple of years for the merged entity. We expect this segment (excluding Shasun) to grow from US$13mn in 5MFY14 to US$73mn in FY17E, as the company commercialises some lucrative products like Combivir, Lovaza and Avodart.

Exhibit 9: Medium-term product pipeline is strong

Brand	Molecule	Brand (US$mn)	Timeline	Competition	Potential revenue p.a. (US$mn)
Combivir	Lamivudine+Zidovudine	250	2HFY15	6	5
Rocaltrol	Calcitriol	60	FY15	5	1.8
Avodart	Dutasteride	500	FY17	6 to 8	7.5
Lovaza	Omega 3	850	FY17	4 to 6	32

Source: Company, Industry, Nirmal Bang Institutional Equities Research

Additionally, Shasun brings along some interesting DMF filings in the US including Sevelemar Hydrochloride and Sevelemar Carbonate (combined brand size of ~US$900mn-US$950mn), which we believe can add ~Rs600mn to the revenue base at significantly higher margins in FY16.

Exhibit 10: DMF filings

	Brand	Market size (US$mn)	Revenue p.a (US$mn)	Potential launch
Milnacipran HCl	Savella	105	0.5	Unknown
Sevelamer HCl	Renagel	180	2.0	FY16
Sevelamer Carbonate	Renvela	700	7.9	FY16
Colesevelam	Welchol	360	1.8	FY16
Pregablin	Lyrica	2200	8.8	2018
Celecoxib	Celebrex	2440	9.8	End FY15/early FY16

Source: Company, Industry, Nirmal Bang Institutional Equities Research

Business In Emerging Markets Set To Grow Exponentially

Africa is the market under focus

SAL's business in emerging markets (EM) is largely focused on Africa and India, with the former constituting around 70% of its EM revenue. Around 35% of its revenue in this region comes from branded generic portfolio and the rest from generic-generic segment. Africa was one of the initial markets which SAL forayed into and, therefore, one of the focus regions for the company, given a well-established base. The company operates in around 27 countries of Sub-Saharan Africa, mostly in West and French Africa and has a portfolio of branded generics and OTC products with over 900 product registrations and another 300 in the pipeline (to be launched between 2014-18), mostly in oral, injectable and topical dosage forms. It has own front-end sales and marketing personnel in a few markets, while it deals with local distributors in others.

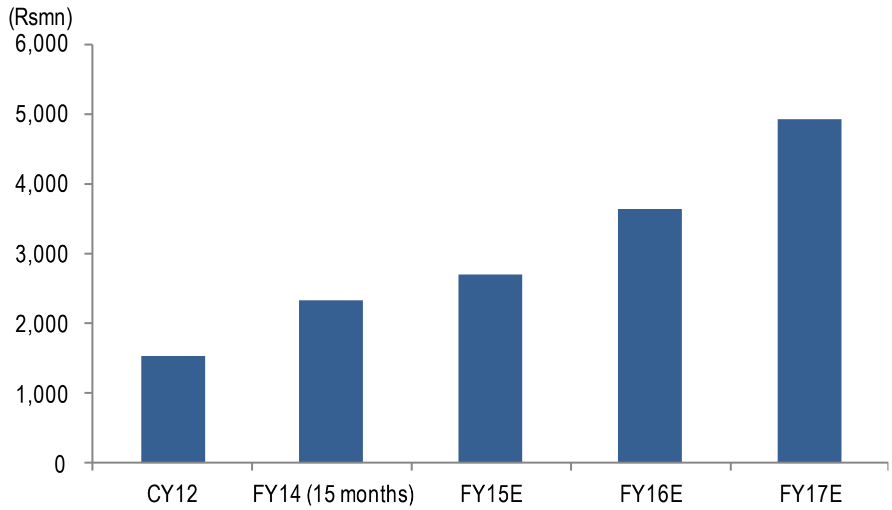
Exhibit 11: SAL has limited its presence largely to West and French Africa

Source: Company, Nirmal Bang Institutional Equities Research

SAL has an aggressive roadmap for Africa

SAL has charted an aggressive roadmap for this geography - in FY14, it expanded into five additional countries, increased its sales force by around 100 in this region (current strength is 200 people-strong field force) and it intends to further increase this to 1,000 over the next three-five years (of which around 100 will be added by FY15-end). Further, the company is setting up manufacturing facilities in Sudan, Cameroon, and Mozambique and packaging facilities in Botswana and Namibia for faster registrations/approvals and to meet the requirements of mandatory local packaging. The company expects around 70% of its sales to come from Africa over the next two-three years. Additionally, it is also emphasizing the improvement in productivity of its sales force and intends to take it to US$100,000/person per annum, implying more than a 20% growth over the next three-four years. We expect this business to post a 35%CAGR over FY15-FY17E.

Exhibit 12: We expect African branded business to be key growth driver

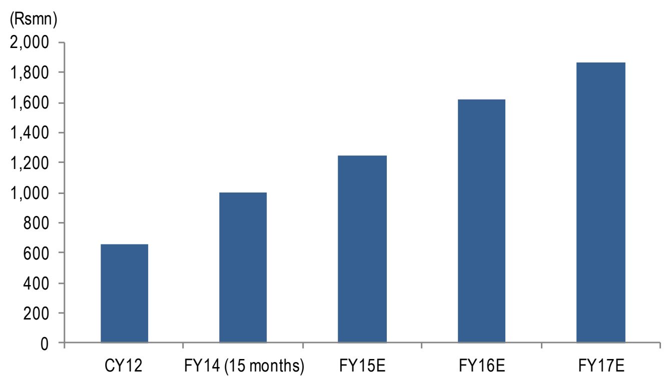


Source: Company, Nirmal Bang Institutional Equities Research

India growth likely to be steady

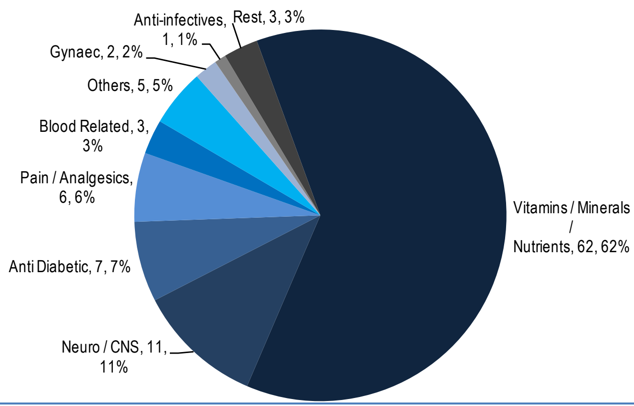
SAL's domestic presence is largely built through the inorganic route and mainly focused on CNS, diabetes, women's health, cardiac care and pain management therapies. The company acquired Renerve brand from Grandix in 2007 (for Rs1bn, at around 2x EV/sales) and the entire Renerve family currently constitutes around 45%-50% of its domestic sales. The focus was so far limited to five states in the southern and western parts of the country, but with the recent acquisition of domestic branded business of Bafna Pharmaceuticals with revenue of Rs246mn (EV of Rs650mn, EV/sales of 2.6x) including its flagship brand Raricap, the company will have a pan-India presence (except in Rajasthan and Jammu & Kashmir) and a field force of ~600-700 medical representatives or MRs (from around 300-400 MRs earlier). Raricap has annual sales of Rs200mn and has posted a 64%CAGR over the past three years. With a small base and wider market reach (post Bafna's branded business acquisition), we expect this business to post a 22%CAGR over FY15E-FY17E.

Exhibit 13: Domestic business growth to be steady



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 14: Domestic business – Therapy wise break-up



Source: Industry, Nirmal Bang Institutional Equities Research

Institutional business – Steady business, huge option value

SAL's institutional business includes sales of HIV, malaria and tuberculosis medicines to government programmes backed by large donor agencies. The company is among the few WHO prequalified suppliers and one among the seven prequalified suppliers for global fund-managed AMFm programme for arthemeter+lumefantrine (AL) combination drug (an artemisinin combination therapy or ACT-based anti-malarial drug in Africa; market size of ~US$300mn). As the market is largely tender-based/funding-driven, profitability is generally low but post Shasun merger, the company will be among the few vertically integrated players which will allow it to bid aggressively in tenders with relatively better margins.

Currently, around 80% of its institutional business is driven by ARV drugs, while the rest is driven by anti-malarials and anti-tuberculosis segments. The company has 19 PEPFAR (President's Emergency Plan for AIDS Relief) filings (16 tentative approvals) and over 555 dossiers globally, with 360 product registrations in more than 50 countries including Africa, LatAm and Asia. Given its focus now on profitability, the company is defocusing on low-margin contracts in this segment.

Anti-malarial business to pick up post approval for AS-AL

SAL has been recently prequalified by WHO (World Health Organization) for AS-AL (Arthemeter-Lumafantrine) combination, as a result of which it secured around 20% in a two-year tender worth ~US$250mn. The supply is likely to commence from 2HFY15 and we expect this to be a key revenue as well as profitability driver over the next couple of years. To refresh, Ipca Laboratories – led by its vertically integrated model – is able to garner around 22%-23% margins from this product. Overall, we expect institutional segment to post a 24%CAGR over FY15E-FY17E, primarily led by AL even as we expect the ARV business to grow only at a 10%CAGR.

Recent developments on Sovaldi and MMV contracts are key positives; Sovaldi has huge optionality

In September 2014, Gilead licensed its blockbuster Hepatitis-C drug Sovaldi (Sofosbuvir) in 91 developing countries (represents almost 100mn patients) including India to seven players including SAL. Under the terms of the agreement, Gilead will transfer all the required technology required to produce for both API and finished product in return for royalty payment. SAL is free to decide its own pricing for the product.

Sofosbuvir was approved under the trade name Sovaldi by the USFDA in December 2013 and by the European Commission in January 2014 and is on track to become one of the best-selling drugs in the world (more than US$11bn in annual sales). Gilead sells the drug at US$84,000/treatment of 12 weeks, at US$1,000/pill in the US. The company has been following differential pricing across countries - it recently inked a deal with France to sell the 12-week course at about US$51,000, while it has agreed to sell the drug at US$900 for a 12-week treatment in Egypt. SAL's management expects the drug to be launched in various countries in the range of US$1,000-US$2,000 per treatment by various players, which implies a US$100mn target opportunity (assuming SAL is able to target even 0.1% or 100,000 patients). For calculation purposes, we have assumed Sovaldi prices in Egypt as reference price, which gives us a US$90mn opportunity for SAL.

Exhibit 15: Sovaldi has huge optionality

No. of patients	100mn
% share of patients to be treated with generics	*1%*
Patients to be treated by generics	1mn
Cost of treatment	US$900 for 12-week treatment or US$300/month
SAL's share @ 10% (total 7 players)	US$90mn

Source: Industry, Nirmal Bang Institutional Equities Research

MMV (Medicines for Malaria Venture) contract can be a potential growth driver

MMV has signed a collaboration agreement with two Indian companies – Cipla and SAL - for the development of rectal artesunate or pre-referral treatment of children with severe malaria. The project is funded by UNITAD and is aimed to develop a rectal artesunate product for submission to WHO prequalification. SAL will develop the product building on the clinical studies of the TDR programme. Total funding for the project will be around US$100mn. MMV aims to achieve WHO prequalification for the product by 2016.

It is currently estimated that there are 5.6mn cases of severe malaria each year which result in around 0.63mn deaths, mostly of children under the age of five. Trials conducted by the WHO on 17,000 patients in Bangladesh, Ghana and Tanzania demonstrated that in cases of severe malaria, which cannot be treated orally and by injections, a single dose of this medicine substantially reduces the chances of death or permanent disability. Currently, there is no medicine under this product category.

We currently do not have any estimates from both these agreements, but like to point out that a launch will positively impact SAL's earnings.

We expect a 29% revenue CAGR over FY15E-FY17E excluding Shasun

Excluding Shasun, we expect SAL to clock in 29% revenue CAGR over FY15E-FY17E, primarily led by a 30%CAGR in regulated markets, a 24% CAGR in institutional business and a 31%CAGR in emerging markets. Regulated market growth will be primarily driven by the US (expect a 63% CAGR over FY15E-FY17E), while institutional business growth will be driven by anti-malarial contracts won recently. After the recent addition of manufacturing facilities as well as the sales force, we expect the African business to deliver a 35%CAGR, driving overall emerging market growth higher. We expect Shasun to report a 13%CAGR over FY15E-FY17E, led by API supply of generic Renagel, Renvela, Celebrex and Welchol. Our numbers do not factor in any upside from Sovaldi and MMV contracts.

Exhibit 16: SAL's revenue profile

(Rsmn)	CY12	FY14 (15 months)	*Growth (%)*	FY15E	*Growth (%)*	FY16E	*Growth (%)*	FY17E	*Growth (%)*
Regulated markets	**3,560**	**5,060**	***42.1***	**4,865**	***(3.9)***	**5,778**	***18.8***	**8,269**	***43.1***
US	*448*	*780*	*74.1*	1,655	*112.2*	2,247	*35.8*	4,385	*95.2*
EU & others	*3,112*	*4,280*	*37.5*	3,210	*(25.0)*	3,531	*10.0*	3,884	*10.0*
Institutional business	**3,520**	**5,336**	***51.6***	**3,574**	***(33.0)***	**5,014**	***40.3***	**5,515**	***10.0***
Anti-malarials	-	-	-	374	-	1,494	*300.0*	1,643	*10.0*
Anti-retrovirals, others	*3,520*	*5,336*	*51.6*	3,200	***(40.0)***	3,520	*10.0*	3,872	*10.0*
Emerging business	**2,179**	**3,351**	***53.8***	**3,943**	***17.7***	**5,263**	***33.5***	**6,781**	***28.8***
Africa	*1,526*	*2,345*	*53.7*	2,697	*15.0*	3,641	*35.0*	4,915	*35.0*
India	*653*	*1,006*	*54.1*	1247	*23.9*	1,623	*30.2*	1,866	*15.0*
Base business	*653*	*1,006*	*54.1*	1107	*10.0*	1,273	*15.0*	1,463	*15.0*
Raricap	-	-	-	140	-	350	*150.0*	402.5	*15.0*
Total	**9,259**	**13,747**	*48.5*	**12,382**	*(9.9)*	**16,055**	*29.7*	**20,565**	*28.1*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 17: Shasun revenue profile

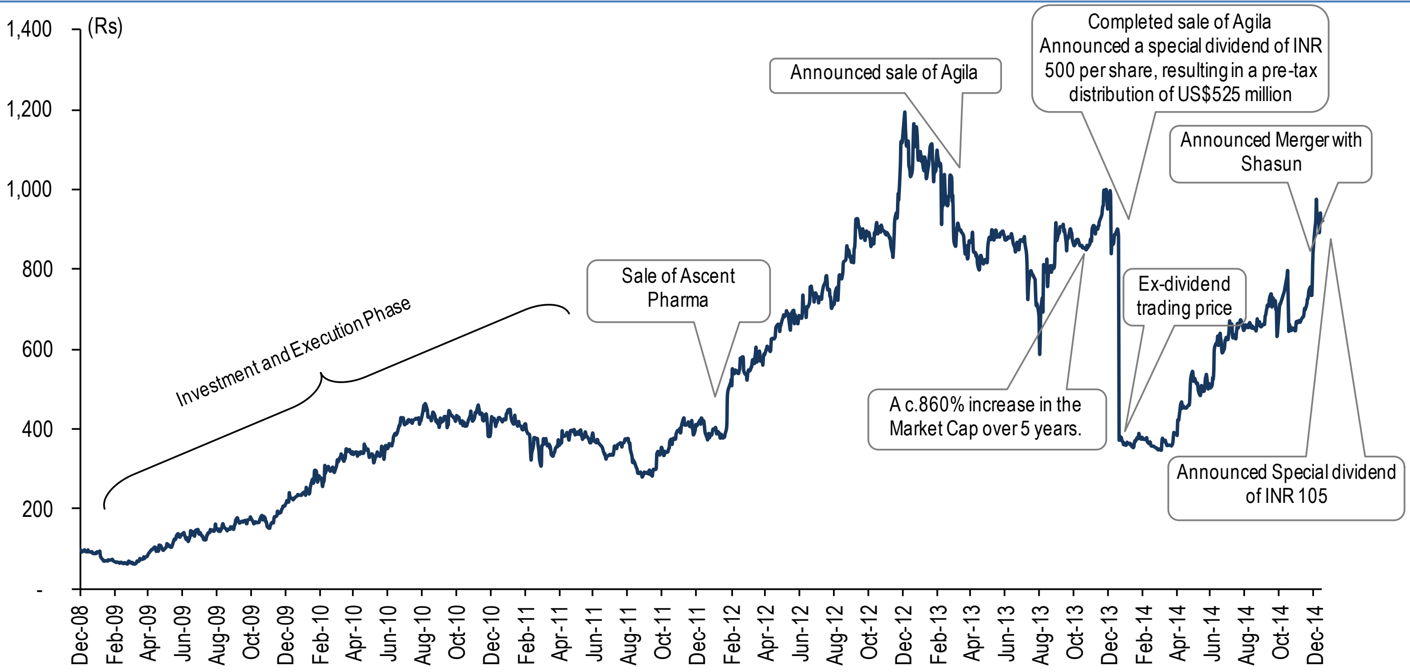
Revenue break-up (Rsmn)	FY14	FY15E	*Growth (%)*	FY16E	*Growth (%)*	FY17E	*Growth (%)*
Formulation sales	2,591	3,797	*46.5*	**4,367**	*15.0*	**5,022**	*15.0*
API sales	6,670	8,045	*20.6*	**10,572**	*31.4*	**10,440**	*(1.2)*
CRAM sales	2,866	2,600	*(9.3)*	**3,000**	*15.4*	**3,000**	*0.0*
Total	12,127	14,442	*19.1*	**17,939**	*24.2*	**18,462**	*2.9*

Source: Company, Nirmal Bang Institutional Equities Research

Valuation

Historically, SAL's stock price has been significantly influenced by corporate developments (sale of Agila to Mylan, sale of Ascent Pharma to Watson, announcement of special dividends, merger of Shasun etc) owing to which the past P/E trend is very erratic. For analysis purposes, we look at the trend post 2012 (after the announcement of sale of Agila to Mylan) and believe the stock price underperformance in CY13 reflects investor concerns about the strength of the base business post divestment of Agila (injectable) business to Mylan. However, the base business has started gathering pace and it is likely to continue with the company strengthening its position in various niche businesses that it created over the past couple of years.

Exhibit 18: Stock price trend over the years

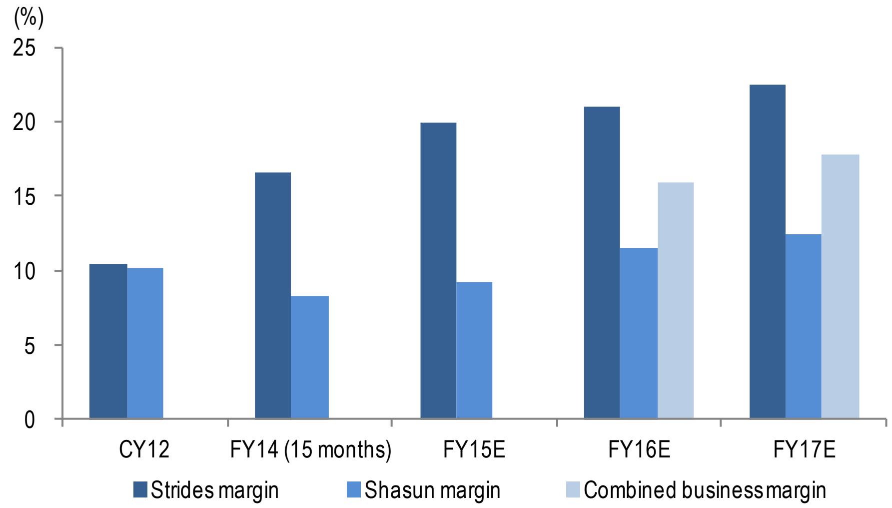


Source: Bloomberg, Nirmal Bang Institutional Equities Research

Valuation to catch up with RoE/RoCE expansion

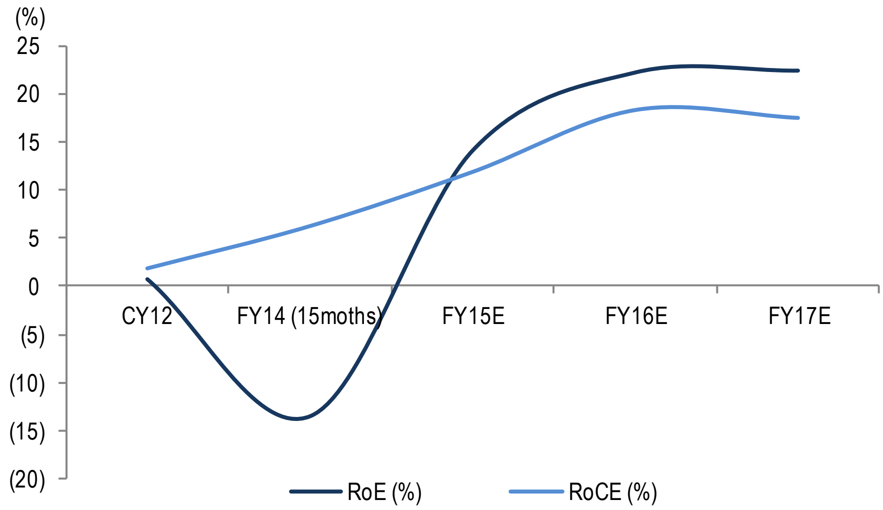
Driven by a better product mix (higher US, Africa revenue; lower ARV), high-margin product launches in the US (Lovaza, Avodart, Combivir) and vertical integration benefits, we expect SAL's margins (excluding Shasun) to improve 250bps over FY15E-FY17E. US and Africa (above company average margins) are high-margin geographies for SAL followed by anti-malaria business (company-level margins), while domestic and ARV businesses have sub-optimal margins. Shasun's margins, on the other hand, are likely to benefit from a better product mix (gradual reduction in UK CRAMS business and launch of high-margin APIs) and a 330bps improvement over FY15E-FY17E. Combined, we expect overall margins to fall from 20% to 16% in FY16 (because of Shasun merger) before improving to 17.8% in FY17E. Given that SAL is largely done with capex and Shasun's facilities are under-exploited, we do not expect major capex going forward. Coupled with a strong base business growth, we expect RoE/RoCE to improve from 14%/12%, respectively, in FY15E to 23%/18%, respectively, in FY17E. Consequently, we expect the company's valuation gap with peers to narrow down. We have valued SAL stock at 18xFY17E EPS of Rs59.6 and added another Rs63/share for US$140mn cash to be received in the future in order to arrive at a target price of Rs1,136, implying a 28% upside from the CMP.

Exhibit 19: Significant scope for margin expansion



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 20: Return ratios to scale higher



Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 21: Target price calculation

Base business EPS (FY17E) (Rs)	**59.6**
Target multiple (x)	**18x**
Base business value (Rs) (A)	**1,073**
NPV value of cash	
Tax holdback (one year)	
US$mn	40
Rsmn	2,400
Dividend distribution tax @ 18% (Rs)	432
Available for distribution (Rs)	1,968
No of shares (post dilution) (mn)	81
Dividend per share (Rs)	**24**
Discounting at 12% for one year (Rs)	22
Escrow account amount to be received in four years	
US$mn	100
Rsmn	6,000
Dividend distribution tax @ 18% (Rs)	1,080
Available for distribution (Rs)	4,920
No. of shares (post dilution) (mn)	81
Dividend per share	61
Discounting at 12% for 3.5 years (Rs)	41
Total NPV (B) (Rs)	**63**
Target price (A+B)	**1,136**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 22: Valuation table

Company name	*EPS (%)*	PE (x)			EV/EBITDA (x)			P/BV (x)			*RoE (%)*			*RoCE (%)*		
	CAGR FY15E-FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	*FY15E*	*FY16E*	*FY17E*	*FY15E*	*FY16E*	*FY17E*
Aurobindo Pharma	*14.8*	19.8	17.1	15.0	13.7	11.8	10.1	6.0	4.5	3.5	*35.6*	*29.9*	*25.9*	*26.4*	*26.2*	*25.8*
Cadila	*25.5*	29.8	22.9	18.9	21.7	17.0	14.0	7.3	5.9	4.7	*27.2*	*28.4*	*27.6*	*19.5*	*22.1*	*23.0*
Cipla	*30.2*	39.2	28.6	23.2	22.0	17.2	14.4	4.5	3.9	3.4	*11.9*	*14.6*	*15.7*	*14.4*	*17.6*	*19.2*
Divis Labs	*21.6*	25.8	21.3	17.4	19.2	16.1	13.4	6.5	5.4	4.5	*27.3*	*27.8*	*28.4*	*31.6*	*32.4*	*33.0*
Ipca Labs	*32.8*	21.4	16.4	12.1	13.7	10.8	8.1	3.9	3.3	2.7	*20.1*	*21.8*	*24.2*	*20.1*	*21.8*	*24.2*
Glenmark Pharma	*29.0*	26.8	20.5	16.1	15.8	12.7	10.3	5.6	4.4	3.4	*23.5*	*24.1*	*24.0*	*20.0*	*22.5*	*24.1*
Jubilant Lifescience	*378.2*	125.3	8.6	5.5	8.3	5.6	4.5	0.8	0.7	0.7	*0.6*	*8.8*	*12.6*	*4.8*	*9.5*	*11.9*
Lupin	*16.3*	26.9	23.1	19.9	16.5	14.2	12.1	7.2	5.8	4.7	*30.3*	*27.8*	*26.1*	*40.1*	*37.3*	*35.0*
Natco Pharma	*23.8*	35.2	28.5	22.9	22.6	18.8	15.6	5.5	4.8	4.0	*16.8*	*18.0*	*19.1*	*16.5*	*17.9*	*19.4*
Sun Pharma	*16.8*	28.3	24.6	20.7	20.3	17.7	14.6	7.4	6.0	4.9	*29.1*	*27.0*	*26.2*	*29.1*	*26.7*	*26.1*
Torrent Pharma	*11.4*	24.1	22.9	19.4	17.0	14.6	12.7	7.2	5.6	4.5	*34.3*	*27.5*	*25.7*	*24.9*	*21.9*	*22.8*
Dr Reddys	*16.8*	23.4	19.9	17.1	16.0	13.7	12.0	5.0	4.1	3.4	*23.0*	*22.3*	*21.6*	*16.0*	*17.0*	*17.9*
Strides	***50.2***	**33.6**	**20.6**	**14.9**	**22.8**	**15.0**	**11.5**	**4.3**	**3.8**	**3.0**	***14.2***	***22.3***	***22.5***	***11.9***	***18.4***	***17.6***

Source: Company, Nirmal Bang Institutional Equities Research

Risks

- A large part of our Buy thesis is based on merger synergy with Shasun and improvement in the base business of both the companies. Failure to realise any of this can be a significant risk to our estimates.
- SAL derives almost 90% of its revenue from exports with no forex hedging. Any adverse movement in the Indian rupee/US dollar rate can significantly impact earnings.

Financials

Exhibit 23: Income statement

Y/E March (Rsmn)	CY12	FY14(*)	FY15E	FY16E(**)	FY17E(**)
Net sales (incl. other oper. income)	9,618	13,410	12,332	33,929	38,944
% growth	*(62.3)*	*39.4*	*(8.0)*	*175.1*	*14.8*
Raw material costs	(4,918)	(7,147)	(6,043)	(16,645)	(18,848)
Manufacturing expenses	(808)	(940)	(987)	(1,279)	(1,639)
Staff costs	(1,203)	(1,572)	(1,480)	(5,148)	(5,781)
Other expenses	(1,682)	(1,517)	(1,357)	(5,436)	(5,761)
Total expenditure	(8,612)	(11,175)	(9,866)	(28,508)	(32,028)
EBITDA	1,006	2,234	2,466	5,421	6,916
% growth	*(79.5)*	*122.1*	*10.4*	*119.8*	*27.6*
EBITDA margin (%)	*10.5*	*16.7*	*20.0*	*16.0*	*17.8*
Other income	342	602	493	980	1170
Interest costs	(794)	(1,089)	(513)	(1,067)	(1,067)
Gross profit	553	1,748	2,447	5,334	7,019
% growth	*(83.1)*	*215.9*	*40.0*	*118.0*	*31.6*
Depreciation	(309)	(565)	(502)	(1,091)	(1,160)
Profit before tax	245	1,183	1,945	4,244	5,860
% growth	*(89.0)*	*383.3*	*64.4*	*118.2*	*38.1*
Exceptional item	7,001	(266)	0	0	0
Tax	(111)	(3,245)	(370)	(764)	(1,055)
Effective tax rate (%)	*1.5*	*353.7*	*19.0*	*18.0*	*18.0*
Minority interest	(10.5)	0.1	-	-	-
Discontinued Operations	1,339	19,995	7,500	0.0	0.0
Net profit	8,462	17,667	9,075	3,480	4,805
% growth	*277.0*	*108.8*	*(48.6)*	*(61.7)*	*38.1*
Adjusted Net profit	123	(2,062)	1,575	3,480	4,805
% growth	*(93.0)*	*(1,780.2)*	*(176.4)*	*120.9*	*38.1*

(*)15months (**) includes Shasun merger

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 24: Cash flow

Y/E March (Rsmn)	CY12	FY14(*)	FY15E	FY16E(**)	FY17E(**)
EBIT	697	1,669	1,965	4,330	5,757
(Inc.)/dec. in working capital	204	(89)	(1,137)	(2,626)	(3,180)
Cash flow from operations	**901**	**1,580**	**828**	**1,705**	**2,576**
Other income	342	602	493	980	1,170
Depreciation	309	565	502	1,091	1,160
Interest paid (-)	(794)	(1,089)	(513)	(1,067)	(1,067)
Tax paid (-)	(111)	(3,245)	(370)	(764)	(1,055)
Dividends paid (-)	(136)	(137)	(348)	(139)	(139)
Extraordinary items		(34,846)	(6,830)	0	0
Net cash from operations	**510**	**(36,569)**	**(6,238)**	**1,805**	**2,645**
Capital expenditure (-)	1,741	27,489	(1,081)	(1,200)	(1,200)
Net cash after capex	**2,251**	**(9,080)**	**(7,319)**	**605**	**1,445**
Inc./(dec.) in short-term borrowing	(848)	(3,753)	1,000	(150)	-
Inc./(dec.) in long-term borrowing	(9,635)	(6,725)	(2,801)	-	-
Inc./(dec.) in borrowings	(10,483)	(10,478)	(1,801)	(150)	-
(Inc.)/dec. in investments	(1)	(4,430)	(169)	-	-
Equity issue/(Buyback)	-	(1)	-	210	-
Cash from financial activities	**(10,483)**	**(14,909)**	**(1,970)**	**60**	**0**
Others	7,767	24,650	7,500	-	-
Opening cash	2,123	1,657	2,311	697	1,362
Closing cash	1,657	2,311	523	1,362	2,807
Change in cash	(465)	654	(1,788)	665	1,445

(*)15months (**) includes Shasun merger

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 25: Balance sheet

Y/E March (Rsmn)	CY12	FY14(*)	FY15E	FY16E(**)	FY17E(**)
Equity	588	596	596	806	806
Reserves	19,674	9,473	11,579	18,205	22,870
Net worth	20,262	10,068	12,174	19,010	23,676
Short-term loans	5,999	2,246	3,246	7,674	7,674
Long-term loans	9,946	3,221	420	2,916	2,916
Total loans	15,945	5,466	3,666	10,590	10,590
Deferred tax liability	272	17	17	-	-
Minority interest	719	757	757	757	757
Liabilities	**37,197**	**16,308**	**16,613**	**30,357**	**35,022**
Gross block	18,240	8,039	9,120	18,987	20,187
Depreciation	4,976	3,528	4,030	9,804	10,963
Net block	13,264	4,511	5,091	9,183	9,224
Capital work-in-progress	2,414	995	995	2,137	2,137
Goodwill	16,903	1,034	1,034	1,034	1,034
Deferred tax asset	-	-	-	142	142
Long-term investments	1	4,430	4,599	4,674	4,674
Inventories	4,423	1,760	2,027	5,676	6,503
Debtors	4,832	3,640	4,223	9,050	11,331
Cash	1,657	2,311	523	1,362	2,807
Other current assets	4,465	2,281	2,703	7,030	8,117
Total current assets	15,378	9,992	9,477	23,118	28,759
Creditors	4,631	2,679	2,814	7,502	8,518
Other current liabilities	6,132	1,976	1,767	2,429	2,429
Total current liabilities	10,762	4,655	4,582	9,930	10,946
Net current assets	4,615	5,338	4,895	13,187	17,812
Total assets	**37,197**	**16,308**	**16,613**	**30,357**	**35,022**

(*)15months (**) includes Shasun merger

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 26: Key ratios

Y/E March	CY12	FY14(*)	FY15E	FY16E(**)	FY17E(**)
Per share (Rs)					
Reported EPS	143.9	296.6	152.4	43.2	59.6
Adjusted EPS	2.1	(34.6)	26.4	43.2	59.6
DPS	2.0	505.0	107.0	2.0	2.0
BV/share	344.6	169.0	204.4	235.9	293.8
Dividend payout (%)	2.3	590.9	117.0	2.3	2.3
Performance ratios (%)					
RoE	0.7	(13.6)	14.2	22.3	22.5
RoCE	1.8	6.2	11.9	18.4	17.6
Valuation ratios (x)					
P/E	425.9	(25.7)	33.6	20.6	14.9
P/BV	2.6	5.3	4.3	3.8	3.0
EV/net sales	6.9	4.2	4.6	2.4	2.0
EV/EBITDA	66.2	25.1	22.8	15.0	11.5
Efficiency ratios					
Asset turnover (x)	0.5	1.5	1.2	1.6	1.7
Working capital/sales (x)	0.9	0.4	0.5	0.4	0.4
Receivable days	183	99	125	97	106
Inventory days	168	48	60	61	61
Payable days	344	137	170	165	165

(*)15months (**) includes Shasun merger

Source: Company, Nirmal Bang Institutional Equities Research

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

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