AXIS CAPITAL

01 JUL 2015 | Company Report

STRIDES ARCOLAB

PHARMACEUTICALS

BUY

Target Price: Rs 1,400

Ready for next leg of growth

After successfully selling out businesses (Australia generics in Jan'12 and US Injectables in Feb'13) and distributing healthy dividends to shareholders, Strides is focusing on building its base business in US, Africa and Institutional tenders. Acquisition of Shasun Pharma (secured supply chain) and Arrow in Australia (high margin business) will drive scalability. Hence we expect the company to now focus on cash generation/profitability to reduce high debt (due to M&A) and create shareholder value.

We expect 58% EPS CAGR over FY15-17 and RoE to improve to 26% in FY17 (15% in FY15). In FY18 (post integration), we expect sustainable EPS growth of 25-30% with improving RoEs. **Initiate with BUY** with TP of Rs 1,400 [Rs 1,346 for base business at 20x FY17 EPS and Rs 54 for R&D (Stelis)].

CMP	: Rs 1,111
Potential Upside	: 26%

MARKET DATA

No. of Shares	: 60 mn
Free Float	: 72%
Market Cap	: Rs 66 bn
52-week High / Low	: Rs 1,269 / Rs 530
Avg. Daily vol. (6mth)	: 685,767 shares
Bloomberg Code	: STR IB Equity
Promoters Holding	: 28%
FII / DII	: 38% / 9%

- **Strides building steady base business** in (1) **US** via limited but niche R&D (derma, soft-gels, etc); (2) **Africa** via increasing local presence and branded business and (3) **Institutional tenders** in ARV, anti-malaria, Sovaldi. We note Strides focus on profitability has led to improvement in EBITDA margin to 21% in FY15 from 17% in FY14. While Strides has witnessed mixed response in US, we expect market share to improve with increasing portfolio/ pipeline (20 ANDA filings in FY16 vs. 6 in FY15; 35-40 from FY17)
- **Shasun merger (awaiting approvals) provides vertical integration benefits** implying better cost synergies and scale to strengthen Institutional and US business. Strides plans to improve Shasun's profitability by shifting focus of its API business from volume to value and forward integration. Also, since Strides outsources API from third parties, integration would help in de-risking given increasing USFDA issues in the sector
- **Australia acquisition to improve margin** and is expected to be EPS accretive from year 1 (higher EBITDA margin of 31% vs. 14-15%% of Strides+Shasun). While some pricing headwinds could restrict revenue growth, healthy margin could continue given strong pipeline and site transfer of products to lower cost base in India

Financial summary (Consolidated)

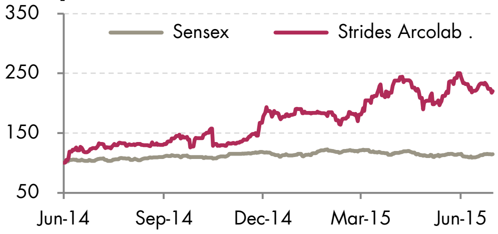
Y/E March	FY14#	FY15	FY16E	FY17E
Sales (Rs mn)	13,410	12,188	33,646	43,040
Adj PAT (Rs mn)	774	1,599	3,440	5,384
Con. EPS* (Rs)	-	-	46.0	70.6
EPS (Rs)	10.5	26.8	43.0	67.3
Change YOY (%)	328.0	220.2	60.4	56.5
P/E (x)	99.6	37.9	25.7	16.4
RoE (%)	4.1	14.9	23.1	25.9
RoCE (%)	7.3	13.9	16.0	17.2
EV/E (x)	28.0	27.0	15.2	10.0
DPS (Rs)	406.7	108.0	3.5	5.3

Source: *Consensus broker estimates, Company, Axis Capital
Note: # FY14 data is for 15 months

Key drivers

(%)	FY14	FY15	FY16E	FY17E
Revenue growth	39	(9)	176	28
Gross margin	47	54	53	54
EBITDA margin	17	21	18	20
Net Debt/ Equity	(23)	16	170	105

Price performance



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Executive summary

Strides, after successfully selling out businesses — (1) Australia generics to Actavis in Jan '12 for USD 393mn (21x EV/ EBITDA) and (2) injectables to Mylan in Feb '13 for USD 1,750mn (23x EV/ EBITDA) — has focused in building its base business in the US, Africa and Institutional tenders.

Strides - small but moving fast in right direction with focus on profitability

- **Regulated markets led by US**
  - 5% YoY growth in FY15; US saw 26% YoY
  - US: limited but niche R&D focus : derma, soft-gels, etc
  - Set up its own front-end in US and UK for better market share
  - 2 USFDA approved formulations facilities – Bangalore and Milan
- **Emerging markets:** Focus on Africa's branded generic (gx) markets
  - Strong 41% YoY growth despite adverse currency movement
  - Increasing local presence in Africa (three-fourth share, remaining one-fourth is India) - six manufacturing plants in Africa and employs 450 people
  - Focus to increase current 35% of revenue share in branded gx market
  - portfolio of over 900 product registrations; pipeline of over 300 products to be launched over 2014–2018
- **Institutional business:** Need for vertical integration to scale up
  - 16% YoY growth (half year impact of AMFM tenders)
  - Antiretroviral (ARV) represents 67%; remaining by anti-malaria
  - among the few WHO pre-qualified suppliers; among the seven pre-qualified suppliers for the global fund-managed AMFM program (anti- malaria)

Strides focus on profitability in its businesses has led to improvement in EBITDA margin to 21% in FY15 from 17% in FY14

Shasun merger to strengthen key business segments

To strengthen its back-end manufacturing in institutional business and enhance R&D pipeline in the US, it announced merger with Shasun in Sep'14 (approvals from court, FIPB and RBI awaited) by diluting 26% equity. Approval process expected to complete by Q2/Q3FY16; merger effective from 1 April 2015.

- **US:** Secures supply chain and enrich R&D pipeline
  - Merged entity to leverage Shasun's API manufacturing capacities and align focus with formulations portfolio and pipeline
  - While Strides' filings are in areas like derma, soft-gel, etc; Shasun has modified release products
  - As Strides outsources API from third parties, integration with Shasun API facilities would help in de-risking, given increasing USFDA issues
  - Amongst the global leaders in Ibuprofen and key suppliers of Ranitidine and Gabapentin; Shift in focus from volume to value and forward integration
- **Institutional business:** Vertical integration to provide scale and cost benefits
  - Strides gets access to Shasun's USFDA/WHO-approved finished dosage and API plant (one finished dosage, two API, one CRAMS) which would help it to scale operations
  - Strides EBITDA margin in ARV business was low-to-mid teens owing to lack of vertical integration – merged entity would see better EBITDA margin
  - Technology available in-house to accelerate filings of DMF for the API required for institutional business (DMF filed for Tenofovir, Cycloscrine already commercialised)

Shasun merger to secure Strides supply chain (API) for US and Institutional business

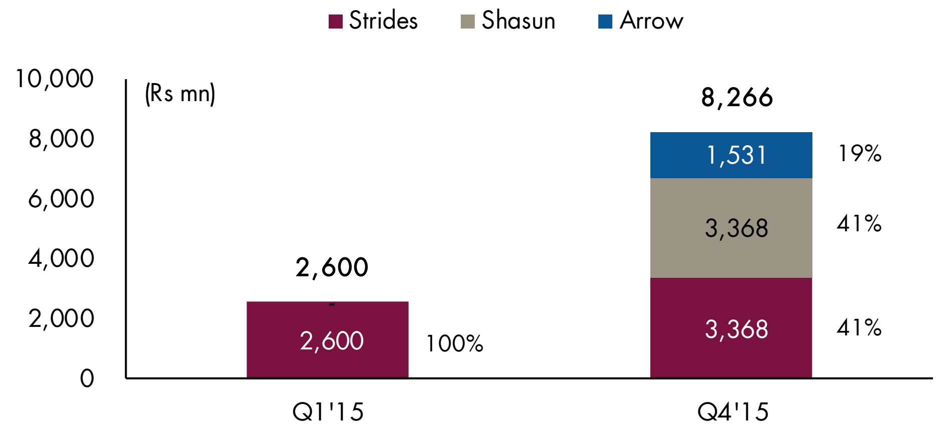
Australia acquisition – to add scale with a focus on profitability

With three years of non-compete clause getting over, Strides announced acquisition of Aspen's Australia generic business in May '15 to add scale with a focus on profitability.

- Strides announced acquisition of generic business of Arrow Pharma from Aspen Australia (revenue: USD 95 mn with EBITDA margins of 31%) for ~USD 300 mn (EV/sales: 3x; EV/EBITDA: 10x)
- While some pricing pressure could constrain margins, management expects the deal to be EPS accretive from year 1 (acquired business EBITDA margin is 31% vs. 14-15% of Strides+Shasun).
- Also, Strides could site transfer majority of the products over next 12-18 months and achieve significant material cost reductions (given its facilities are also approved by Australian regulators and lead time is lower)
- Arrow owns IP for 70% of products in Australia. Strides could use these IP to file in other emerging markets
- Re-builds old management team with proven track record (Ascent) – as the Arrow will be led by Dennis Bastas, the previous founder and CEO of Ascent

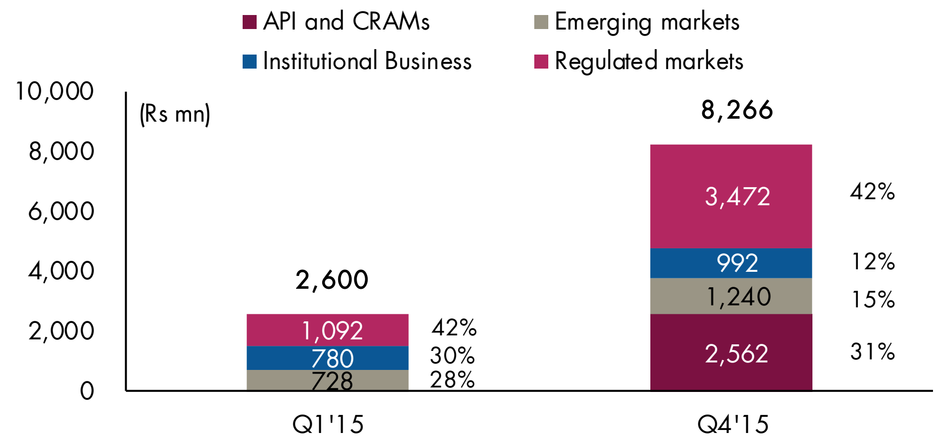
Strides' past experience and strong relationship in Australia to help Arrow Pharma to grow profitably

Exhibit 1: Scale-up in revenues via proposed Shasun merger and Arrow acquisition…



Source: Company

Exhibit 2: …resulting in higher share in regulated and API/CRAMs business



Source: Company

Strides – building businesses with focus on profitability

Strides focus on improving profitability via improving product mix and market mix across its key businesses – regulated market (driven by the US), Africa (driven by branded generics) and institutional (driven by anti-malaria tenders) has led to improvement in gross margin. Thus despite increase in front-end costs and R&D expense, Strides has seen EBITDA margin expansion (see Exhibit 3).

Strides to focus on improving profitability via improving product mix and market mix across its key businesses

Exhibit 3: Sharp improvement in margin given focus on improving product/market mix

(Rs mn)	FY14*	FY15
Revenue	13,410	12,188
% growth	39	(9)
Gross margin (%)	47	54
EBITDA	2,234	2,519
EBITDA margin (%)	17	21
PAT	774	1,599
% growth	531	106

Source: Company Note: * FY14 data is for 15 months

Regulated market (~35% of FY15 revenues): Strides plans to expand US (26% of FY15 revenues) and UK (14% of FY15 revenues) in regulated generics markets given its own front-end. While Strides grew 5% YoY in FY15 revenues to Rs 4.2 bn, its US revenues grew 26% YoY to Rs 1.1bn (USD 18mn).

US: Small but moving fast, in right direction: We note that Stride's ex-injectable filings had lagged focus as Strides was building an injectable portfolio (Ajila) which was divested to Mylan for USD 1.75 bn in Feb'13. Post Agila sell-off, Strides was left with sales of <USD 15 mn (cumulative ANDA filing of 23, 14 approved). Also, the company had no front-end in US and was distributing through partners like Alvogen.

Over the past two years, Strides has renewed its focus on US (ex-injectables). Investments have been towards three aspects – set-up of own front-end, enhancing R&D pipeline and manufacturing:

- **Set-up of own front-end:** Strides has bought back most of its partnered products (through the money received from Agila sale) and set up its own front-end and migrated all products (except Vancocin) to own distribution. This provides the company better understanding of the demand-supply situation and pricing scenario. While Strides has witnessed a mixed response in gaining market share in the US, we expect it to improve with increasing portfolio/ pipeline (as the company expects to increase ANDA filing from 6 in FY15 to 20 in FY16 and over 35-40 from FY17).
- **R&D capabilities:** Strides has commissioned a new generics R&D facility (at Bengaluru). Management's focus is on creating a portfolio of niche products. Current portfolio/pipeline mostly has derma, soft-gels, Para IVs, etc., where competition is limited.
- **Manufacturing – vertical integration, maintaining cGMP compliance**: Strides has two USFDA approved plants – Bengaluru (India) and Milan (Italy) – with capabilities in soft/hard gelatin capsules, tablets, sachets, semi solids (derma products), and creams. While Milan (specialty dermatology) facility has been recently approved (Sep'13), the Bengaluru facility was re-inspected in April'14

While Strides has witnessed a mixed response in the US, we expect market share to improve with increasing portfolio/ pipeline without any Form 483 observations. Both these plants are operating at 60-70% utilization and can support manufacturing requirements for medium term, limiting capex needs.

While approvals have started, execution in gaining market holds the key

Strides currently has 17 products in market with revenue of USD 18 mn in FY15; 17 ANDAs are pending approval (6 ANDAs filed in FY15, including 2 FTFs). Management's focus is on creating a portfolio of niche products. Current portfolio/pipeline mostly has derma, soft-gels, etc., where competition is limited

- **Vancomycin**: Largest product for Strides in US (antibiotic; ~USD 10 mn annual revenue for Strides). Strides got approval three years back (Apr'12) and markets through partner (Alvogen). Strides was able to quickly ramp up market share (currently ~50%) despite 3-4 peers. We believe this was partially led by soft-gel technology being niche and partly strong supply management
- **Methoxsalen (Oxsoralen)**: Another soft-gel approval for Strides (Jun '14). Methoxsalen is a derma product indicated for Psoriasis. Strides currently distribute the product through its own front-end. Strides was first generic entrant and has quickly garnered 29% market share (May '15) within 3-4 months of launch. It was able to maintain market share despite entry of second generic entrant
- **Lamivudine; Zidovudine (Combivir):** Strides has recently received approval for gCombivir (May'15). Combivir (USD 120 mn annual market) is an ARV indicated for HIV AIDS. Strides is the sixth generic entrant (Lupin, Aurobindo and Teva being market leaders). We expect this could be a decent opportunity for Strides (annual revenue: USD 3-4 mn; assuming 25% rebate/discount and 4-5% market share) given limited competition

Vancomycin and Methoxsalen (both soft gels) are key products for Strides in US with strong market share

Exhibit 4: Product approvals in niche segments; market share gains has seen mixed response due to small portfolio

Approval date	generic	IMS Revenue (USD mn)	existing competition	potential revenues (annualised)	treatment	Market share in May'15
Earlier						
4/11/2012	Vancomycin	332	4	10-12	Anti-biotic - Gram-positive bacteria - Capsule	48-51%
FY15						
6-Jun-14	Methoxsalen	14	0	2.5	Derma - psoriasis - soft gels	29.3%
25-Jun-14	Imiquimod	140	7	1.1	derma - cream from Italy facility	1%
23-Jul-14	Tacrolimus	676	6	4.2	Immuno suppressant	-
26-Aug-14	Buspirone	65	8	1.8	Anxiety	-
16-Dec-14	Calcitriol	50	4	1.4	Vitamin D capsule	3-4%
FY16						
15-Apr-15	Polyethylene Glycol	20	na	0.6	Bowel clearance	-
15-May-15	Lamivudine and Zidovudine Tablets	120	5	3.4	Antiretroviral	-

Source: Bloomberg, USFDA, Axis Capital

Exhibit 5: Strides is expected to monetize couple of large opportunities in US in the near to medium term

Brand	Molecule	Revenue (USD mn)	Patent exclusivity	Potential launch	Existing competition
Avodart (GSK)	Dutasteride	500	20th Nov' 15	2HFY16/1HFY17	1 FA (Barr), 7 TA
Lovaza (GSK)	Omega 3	850	10th Apr' 17	2HFY16	3

Source: USFDA, Axis Capital

Emerging markets (~33% of FY15 revenue): Robust growth

Strides emerging market business has presence in India (one-fourth of revenue) and Africa (three-fourth). The company's focus is on having product portfolio of local relevance supported by regional manufacturing hub and distribution/marketing team in Africa. Over the past 7-8 years, Strides has built a reasonable presence in Africa (with six manufacturing facilities in Africa). Also, the company targets Russia/CIS and MENA/Gulf countries as future markets. Strides reported revenues of Rs 4.1 bn in FY15 (+41% YoY) despite adverse currency movements.

Africa: Building strong local presence to grow branded generics business

Strides Africa has footprints across 27 Sub-Saharan African countries and emerging markets with focus on branded generic pharmaceutical and OTC products. It has a comprehensive portfolio of over 900 product registrations across these markets and a robust pipeline of over 300 products that will be launched over 2014–2018. Product selection is skewed towards non-price sensitive therapeutic segments - life threatening, lifestyle, life longevity and women's healthcare with focus on identifying unmet needs and providing product solutions. 35% of the revenue is derived from highly profitable branded Rx business and the balance from the generics business.

Strong local presence: Strides has six manufacturing plants in Africa and employs 450 people in Africa across manufacturing, scientific affairs, sales and marketing, and back office support. Functionally, the business has three regions – (a) West Africa – Nigeria, Ghana, (b) French Africa – 10 French-speaking countries and (c) Other Africa – other African countries. The French African business, which is a mix of branded, generic and opportunistic business, is the fastest growing and most profitable business. Strides continued strong performance in French Africa through significant investments in sales force, headcount up 60% over last year and sales from newly-commissioned manufacturing facilities.

Local manufacturing presence to benefit - preferential local treatment such as government buying, price advantage, tax concessions, and regulatory fast tracking

Branded generics: Strides is increasing focus in branded business from predominant generic business. Strides aims to expand field force to 1,000 people over next 5-6 years (from 220 currently). Also, the company aims to increase field force productivity to USD 100,000 (from USD 85,000 – 90,000 currently) through continuous training inputs, sales force automation tool, high quality sales and promotion and engrossed doctor engagement.

Generics and manufacturing business: Strides, over the years, has built a strong local business driven by basic principle of "in Africa, for Africa". This business depends on capacity availability and price sensitivity. Thus, Strides has built local manufacturing presence in key geographies to benefit from FDI-related preferential local treatment such as government buying, price advantage, tax concessions, and regulatory fast tracking. Also, the company has set up its own subsidiary to reduce the distributor level. Strides aims to utilize in house procurement expertise and preferential raw material supply from group companies so as to manufacture quality generics at low costs. Also, generics business enhances visibility of Strides' label (among medical profession and consumers) leading to stronger brand equity.

Africa market: CAGR at 15-16% over 2003-13

Africa's pharma industry has witnessed CAGR of ~15-16% over 2003-13 to reach USD 20.8 bn in 2013 (USD 4.7 bn in 2003). As per the industry, the market will be worth USD 40-65 bn by 2020. The growth is being driven by three key factors (refer exhibit 6):

- **Urbanization**: Africa's population is undergoing a massive shift. By 2025, 40% of economic growth is expected to come from 30 cities with population of >2mn; of which 22 cities will have GDP in excess of USD 20 bn. These cities enjoy better logistics infrastructure and healthcare capabilities and urban households have more purchasing power and are quicker to adopt modern medicines
- **Increasing healthcare capacity:** Over 2005-12, 70,000 new hospital beds, 16,000 doctors and 60,000 nurses were added. Healthcare provision is becoming more efficient through initiatives such as Mozambique's switch to specialist nurse anesthetists and South Africa's use of nurses to initiate antiretroviral drug therapy. The introduction of innovative delivery models is increasing capacity still further

Africa market growth momentum to continue given increasing urbanization led by few cities driving GDP growth

Exhibit 6: Strides maps out strategies to key attributes required to grow Africa business

Attribute	Importance	Stride's strategy
Focus on pockets of growth	Growth driven by specific cities rather than counties	Focus on West/French Africa
Build strong local teams		Ramping up field force; currently 220; expects to reach 500-600 in 3-4 years; 1000 in 5-6 years
Forge partnerships	Market fragmented across many countries/regulators; partner brings in expertise of local market	Forging local partnership for distribution, supplies
Address supply and distribution challenges	Regulations are evolving, transport and logistics infrastructure is patchy and lead times can be long	Has set up six local plants to get pricing benefits and preferential supplies

Source: Industry, Axis Capital

- **Changing business environment**: Various local governments are supporting their local industry. Governments have introduced price controls and import restrictions to encourage domestic drug manufacture and tightened laws on import, wholesale, and retail margins. They also require country-specific labeling to reduce counterfeiting and parallel imports. We note pharmacy chains are consolidating as horizontal and vertical integration is on the rise and manufacturing is expanding. A flurry of mergers and acquisitions, joint ventures, strategic alliances, partnerships and private-equity deals are further expanding Africa's markets.

India: Acquired growth, focused on select therapies

Strides made its entry into Indian retail market through the acquisition of Grandix Pharmaceuticals Ltd (Rs 1 bn; 2x EV/sales). Grandix had a significant presence in the South and Central India. Recently, Strides acquired domestic branded business of Bafna Pharmaceuticals (FY14 revenue: Rs 246 mn; 2.6x EV/ Sales). Bafna acquisition made Strides a pan-India player (barring a few north-east states, Rajasthan and J&K). Also, it provided Strides with Raricap, the eighth-largest Oral Haematinic segment brand in India with revenue of ~Rs 200 mn.

The current portfolio is focused on high growth areas of health supplements (vitamin), women's healthcare, anti-diabetic, etc. The company has two major brands – "Renerve" (acquired from Grandix; in nutrients segment) and Raricap.

Exhibit 7: Focused on select therapies…

	MAT (Rs mn)		YoY growth	% of	Market share
Segment	May'15	May'14	(%)	revenue	May'15
Nutrients	781	629	24	59	2.0%
Gynaecology#	351	382	(8)	26	1.7%
Anti-diabetic	67	54	23	5	0.2%
Pain	57	74	(23)	4	0.2%
Total	1,335	1,227	9	100	

Source: Axis Capital, AIOCD: All Indian Origin Chemists & Distributors Ltd, Note: # Anaemia in pregnancy

~75% of India business driven by 2 brands – Renerve and Raricap

Exhibit 8: …driven by two key acquired brands

		MAT (Rs mn)		YoY growth	% of
Brand	Segment	May'15	May'14	(%)	revenue
Renerve	Vitamins	672	548	23	50
Raricap	Gynaecology#	318	334	(5)	24
Cognix Plus	Vitamins	80	59	35	6
Iscept	Anti-diabetic	29	29	1	2
Others		237	257	(8)	18
Total		1,335	1,227	9	100

Source: Axis Capital, AIOCD: All Indian Origin Chemists & Distributors Ltd, Note: # Anaemia in pregnancy

We expect growth to be driven by cross-selling of "Renerve" portfolio in new geographies and leveraging expanded field force of 700+ (as part of Bafna acquisition; pre-Bafna field force was ~400).

Institutional business (~32% of FY15 revenues): Building businesses

Strides sells HIV, malaria and tuberculosis medicines to Africa-based government programs backed by large donor agencies like UNITAID, Global Drug Facility, PEPFAR and Clinton Foundation, PFSCM, IDA, UNICEF, WHO, AMFm, GIZ, PAHO and MSF. ARVs contribute ~67% of its institutional revenue while anti-malarial drugs contribute balance. Strides' institutional business reported FY15 revenues of Rs 3.9 bn (+16% YoY). While antiretroviral business delivered a flat performance, growth was driven by first full year of anti-malarial business (despite delay in orders due to change in procurement mechanism).

ARVs: The company has 18 PEPFAR (President's Emergency Plan for AIDS Relief) filings (17 tentative approvals) and over 555 dossiers globally, with 360 product registrations in more than 50 countries including Africa, LatAm and Asia. Oral dosage facility in India (at Bengaluru) is pre-qualified by WHO and USFDA (for ARVs under the PEPFAR program).

Anti-malaria: Strides is among the few WHO pre-qualified suppliers and among the seven pre-qualified suppliers for the global fund-managed AMFM program for the arthemeter+lumefantrine (AL) combination drug. Oral dosage facility in India (at Bengaluru) is pre-qualified by WHO. We expect anti-malarial business to drive growth in FY16 as Strides has won 15-20% quota in last AMFM tender (Sept '14) worth ~USD 160-170 mn; supplies begun in Q3FY15 (FY15 revenue: Rs 1.2 bn).

Sovaldi (Sofosbuvir)– expect slow ramp-up

Strides is one of the seven licensees (along with Cadila HC, Cipla, Hetero, Mylan, Ranbaxy/Sun Pharma, Sequent) of Gilead's blockbuster hepatitis-C drug Sofosbuvir (for a royalty payment) in 91 developing countries that have a patient population of almost 100 mn. Sofosbuvir was approved under the trade name Sovaldi by the USFDA in Dec '13 and by the European Commission in Jan '14, and is on track to become one of the best-selling drugs in the world (sales of USD 10.3 bn in 2014). In the US, Gilead sells the drug at USD 84,000/treatment of 12 weeks (i.e. USD 1,000/pill). The company has been following differential pricing across countries; it recently inked a deal to sell the 12-week course at ~USD 51,000 in France and at USD 900 in Egypt.

Strides targets to launch the product in key emerging markets of Indonesia, Egypt, India, Pakistan, and Bangladesh, which have a total patient population of ~50 mn. It has already applied for own product in India (expects to get approval in 2-3 months) and is in process to file in other markets. Meanwhile, Strides is marketing Natco's drug, which has been launched in India.

We expect slow ramp-up (largely based on penetration in key markets, launch timing and price erosion). We believe Strides could reach annual run-rate of USD 20-25 mn over the next 5-6 years. Key assumptions: 10-25% price erosion, 0.6%-1.5% penetration, 10% market share in India; 1-4% market share in other markets; 8% royalty to Gilead. Refer exhibit 9 for details.

We expect slow ramp-up from Solvaldi opportunity given low penetration

Exhibit 9: Key assumptions used for forecasting upsides from Sofosbuvir opportunity

	FY16	FY17	FY18	FY19	FY20	FY21
Price discount (%)	10.0	15.0	20.0	20.0	25.0	25.0
Penetration (%)	0.6	0.7	0.8	1.0	1.2	1.5
Strides Rx (%)						
Direct presence	5.0	8.0	10.0	10.0	10.0	10.0
Partnered presence	-	1.0	1.5	2.5	3.0	4.0
Revenue	**2.7**	**7.1**	**10.2**	**16.0**	**19.8**	**29.3**
Direct presence	2.7	4.8	6.4	8.0	9.0	11.3
Partnered presence	-	2.4	3.8	8.0	10.8	18.0
Revenue attributable to Strides	**2.7**	**6.7**	**9.5**	**14.4**	**17.6**	**25.7**
Direct presence	2.7	4.8	6.4	8.0	9.0	11.3
Partnered presence	-	1.9	3.1	6.4	8.6	14.4
Royalty to Gilead	0.2	0.6	0.8	1.3	1.6	2.3
Total revenue (USD mn)	2.5	6.1	8.7	13.1	16.1	23.3

Source: Axis Capital

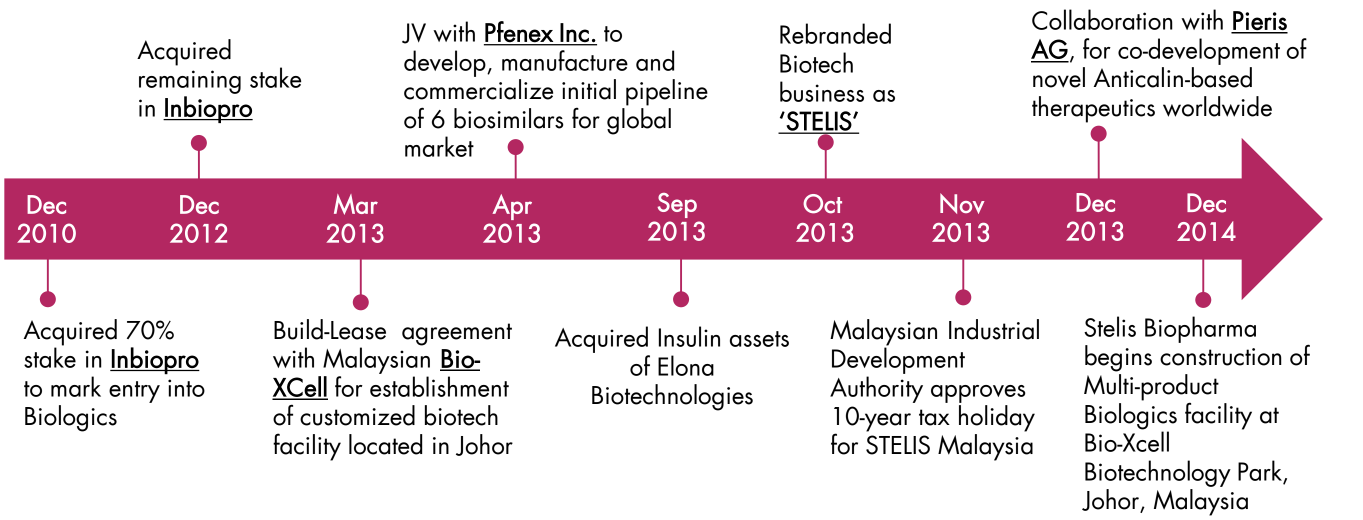
Key collaborations to drive growth

- Agreement with Gilead Sciences to bring generic Sofosbuvir (Sovaldi) and Harvoni to 91 developing countries and expanded to include Investigational Pan-Genotypic Agent
- Agreement with Gilead Sciences to manufacture and distribute Tenofovir Alafenamide (TAF) based HIV treatments in 112 developing countries
- Collaborated with Medicines for Malaria Venture (MMV) for the development of rectal artesunate for pre-referral treatment of children with severe malaria

Stelis Biopharma

- Stelis Biopharma, set up in 2013, is a fully-owned subsidiary of Strides Arcolab
- It is developing both 'biosimilars' and 'novel biotherapeutics' to a regulated market (US/EU) standard for global markets and has an internal pipeline of biosimilars, utilizing the latest bacterial and mammalian expression systems
- It has a pipeline of four molecules with focus on bone health (osteoporosis, osteo-arthritis), ophthalmic and metabolic disorder – of which two products have reached the animal toxicity study stage
- Stelis has seen strategic investment by GMS Holdings of USD 21.9 mn for a 25.1% stake (awaiting FIPB approval)
- Strides and GMS together will invest USD 53.4 mn over the next two years

Exhibit 10: Strides journey into biopharma R&D so far…



Source: Company

Shasun merger: Vertical integration and stronger R&D pipeline

In Sep '14, Strides announced a merger with Shasun Pharma in a share swap deal – five equity shares of Strides for every 16 equity shares held by it in Shasun implying equity dilution of 26% for Shasun. Shasun merger (awaiting approvals) has the following benefits:

- Provides vertical integration benefits implying better cost synergies and scale to strengthen institutional and US business
- Helps to improve Shasun's profitability via shifting focus of its API business from volume to value and forward integration through Strides product selection
- Also, since Strides outsources API from third parties, integration with Shasun API facilities would help in de-risking given increasing USFDA issues in the sector

Vertical integration in institutional business: Shasun API facilities would not only provide cost benefits but also aid scale-up. Strides EBITDA margin in ARV business was low-to-mid teens owing to lack of vertical integration. We expect this to be now in line with peers (see Exhibit 11). Also, Shasun has a strong DMF portfolio (Tenofovir, Cycloserine, etc.) which complements Strides' ARV business. Strides could also leverage Shasun's strong DMFs (43 commercialized and 23 under development). Merged entity can leverage the portfolio to forward integrate into formulations portfolio.

Strides lower EBITDA margin in ARV business owing to lack of vertical integration is likely to recover

Exhibit 11: Merged entity to benefit from vertical integration

Company	Scale	Vertical Integration
Aurobindo	✓✓	✓✓
Aspen	✓✓	✗
Cipla	✓✓	✓✓
Hetero	✓✓	✓✓
Mylan	✓✓	✓✓
Strides	✓	✗
Strides + Shasun	✓✓	✓✓

Source: Company

De-risked business model with significantly enhanced operational infrastructure: Merged entity has three USFDA approved formulations facility (Strides: 2; Shasun: 1) and two API facilities (of Shasun), which would help de-risk the business model and provide spare capacity. Also, the merged entity would have a wider R&D base (300 scientists of Shasun; 110 of Strides).

Since Strides outsources API from third parties, integration with Shasun API facilities would help in de-risking given increasing USFDA issues

Exhibit 12: Merged entity to have significantly enhanced infrastructure

	Strides	Shasun	Merged entity
Formulation Development R&D Scientists	110	106	216
Process Chemistry R&D Scientists	-	187	187
Manufacturing and other employee	2,100	2,100	4,200
FDF facilities – USFDA approved	2	1	3
API facilities – USFDA approved	-	2	2
CRAMS facilities – USFDA approved	-	1	1
Emerging market facilities	6	-	6

Source: Company

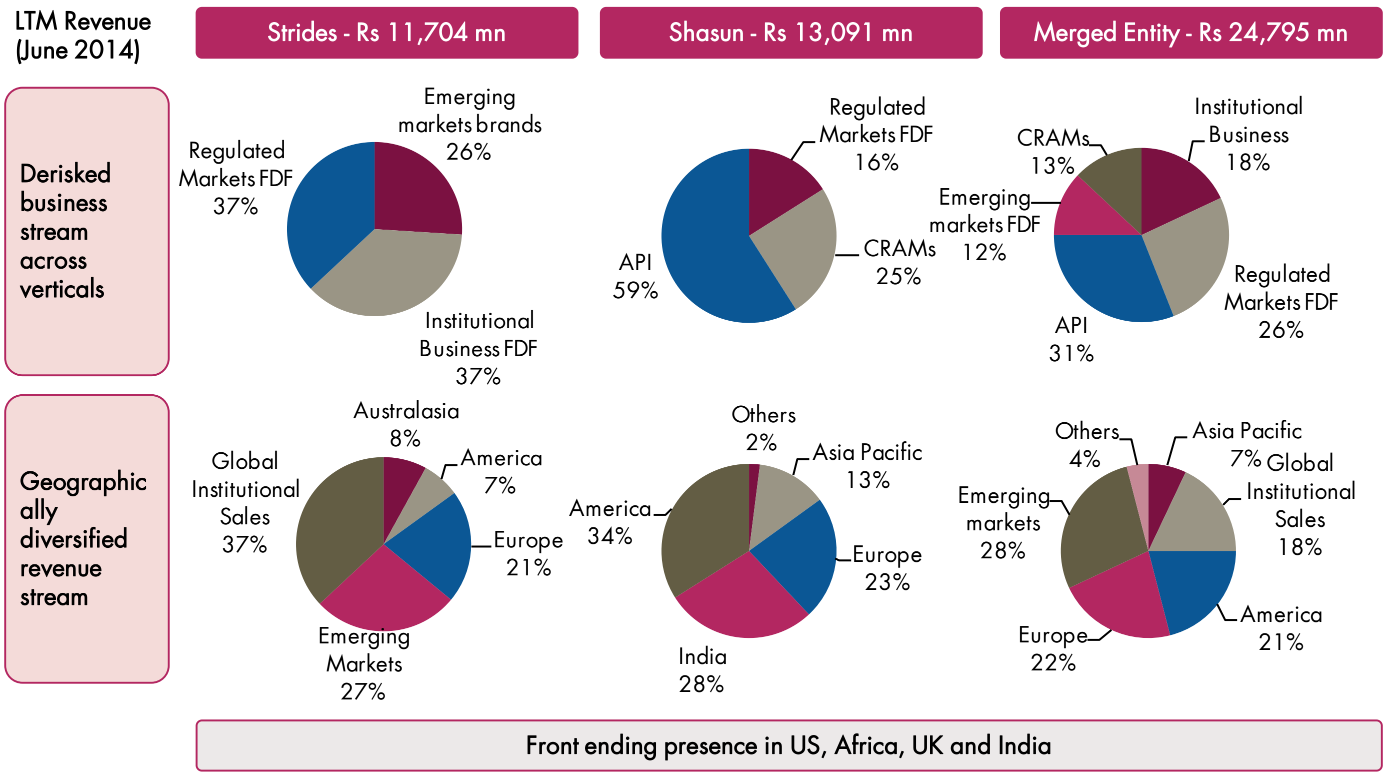
Rich pipeline of formulations portfolio in regulated markets: The merged entity has 17 approved ANDAs (29 pending approvals). This includes 12 ANDA filings from Shasun. While Strides' filings are in areas like derma, soft-gel etc., Shasun has modified release products. The merged entity has ~114 products under development which are niche filings with limited competition (in extended release, SGC, creams/ointments and suspension areas). Also, the expanded portfolio would facilitate front-end in the US.

Exhibit 13: Merged entity to benefit from enhanced regulated market portfolio/pipeline

USFDA filings	Approved	Pending	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; Note: SGC stands for Soft gels capsules

Exhibit 14: Merged entity to also have diversified revenue stream across geographies



Source: Company

Multiple levers for margin expansion: Strides expects to improve margins via shifting focus of its API business from volume to value and forward integration.

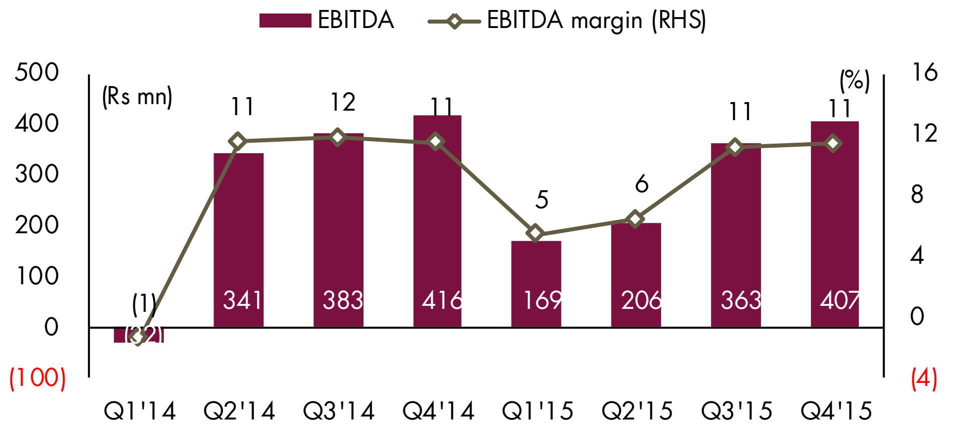
Exhibit 15: Weak portfolio results in lower gross margin and higher operating costs

(Rs mn)	FY13	FY14	FY15
Revenue	10,848	12,127	13,166
% growth	2	12	9
Gross margin (%)	50	50	48
Staff cost	1,866	2,163	2,364
% of revenue	17	18	18
Other expenses	2,351	2,663	2,852
% of revenue	22	22	22
EBITDA	1,172	1,191	1,145
EBITDA margin (%)	11	10	9
PAT	532	332	208
% growth	(54)	(38)	(37)

Source: Company

Shasun's weak gross margin and higher overheads has led to low EBITDA margin

Exhibit 16: Shasun has started witnessing margin recovery



Source: Company

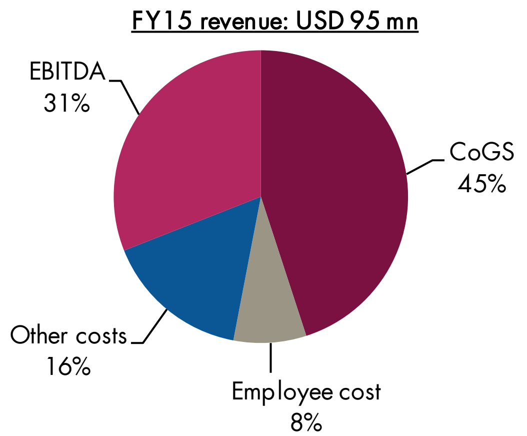
Margin recovery led by improved profitability in UK CRAMS and formulations growth seen in last two quarters

Australia: Re-entry into known market with leadership position

With three years of non-compete clause getting over (Ascent divesture to Watson in Jan'12; for USD 393 mn; EV/ EBITDA: 21x), Strides in May '15 announced acquisition of generic assets of Arrow Pharma – Aspen Australia (revenue: USD 95 mn with 31% EBITDA margins) for ~USD 300 mn (EV/ sales: 3x; EV/ EBITDA: 10x). Strides expects acquisition to be funded through debt and internal accruals. Management expects the deal to be EPS accretive from year 1 of operations (acquired business EBITDA margin is 31% vs. 14-15% of Strides+Shasun). We have assumed consolidation of Arrow from 1st October 2015. Also, Aspen's leadership position (third-largest by market share; second-largest by portfolio range) and Stride's understanding of Australian market adds to business rationale.

Acquisition of high margin Australia generic unit would result in better EBITDA margin (17-18% vs. 14-15% for Strides+ Shasun)

Exhibit 17: Arrow Pharma enjoys high FY15 EBITDA margin

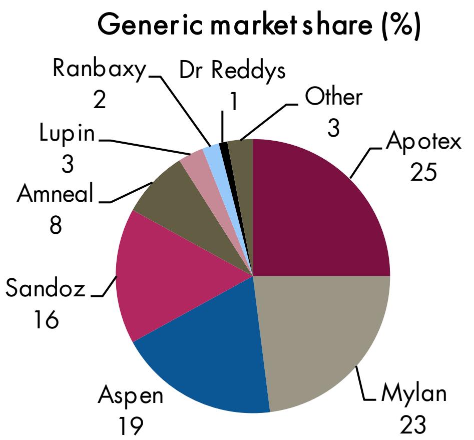


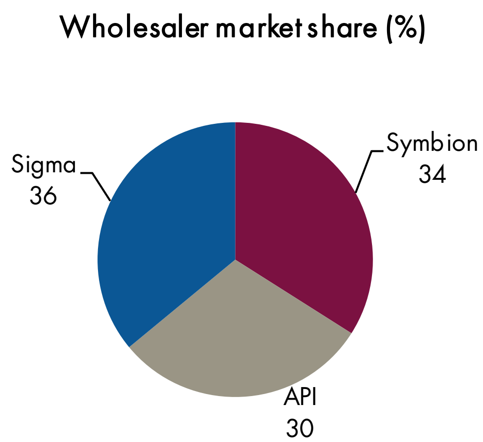
Source: Company, Axis Capital estimates

Strides gets ready platform in Australia

- Australian generic market (worth ~USD 700 mn currently) is highly concentrated (~90% market share with the top-5 players) with high entry barriers. Arrow Pharmaceutical (the acquired business) is one of the top-2 generic players by product range and top-3 generic players by value (Apotex is No. 1 and Mylan is No. 2)

Exhibit 18: High concentration in Australia 's generic market (in terms of generic players and wholesalers)





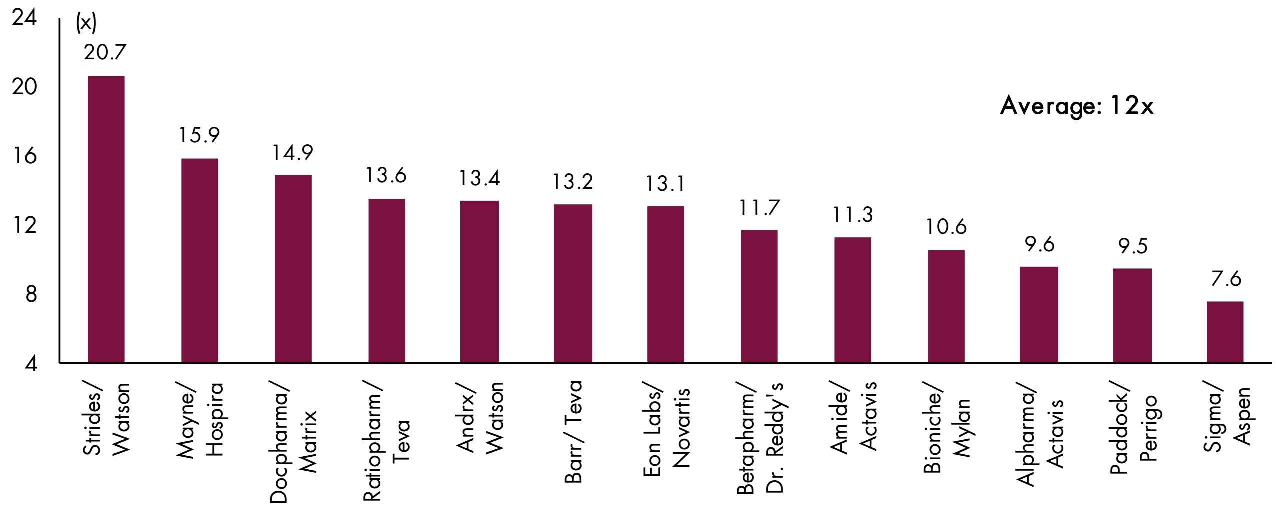
Source: Company

- Strong distribution network (third-largest by number of pharmacy customers; preferred generic drug partner to Sigma, the largest pharmacy wholesaler by market share in Australia)
- Strong portfolio and pipeline (149 commercialized molecules; additional 51 under development). Full product range ensures single supply relationship with pharmacy; tail range of products provides sustainable profitability due to low competition
- Access to established OTC brand – Chemists' Own – Preferred OTC range in 20% of pharmacies in Australia with 51 products (95 SKUs)
- Re-builds old management team with proven track record (Ascent) – as the Arrow business will be led by Dennis Bastas, the previous founder and CEO of Ascent and Andrew Burgess, ex-CFO of Ascent will be new CFO of Arrow

Focus remains on profitability despite ongoing pricing headwinds

- The recent 18% price cut by Pharmaceutical Benefit Scheme (PBS) is likely to impact generic players by about 3% as major impact is expected to be felt by pharmacies, as per management.
- While some pricing headwinds could constrain revenue growth, we expect healthy margins to continue given strong pipeline and its ability to site transfer majority of the products to lower cost base in India over next 12-18 months.

Exhibit 19: Strides has been able to buy Arrow at reasonable valuations (~10x EV/ EVITDA vs average of 12x)



Source: Company

Management focused on creating shareholder value

Management has focused on creating shareholder value and distributing the gains amongst the shareholders.

- Strides has distributed Rs 605/sh (USD 655 mn) over FY14 and 15
- Strides expects to get USD 60-70 mn from tax escrow (out of USD 100 mn) by Dec 2017 and another USD 40 mn if remedial costs at Agila facility is within USD 60 mn (already provisioned) over next 6 months

Exhibit 20: Significant amount paid as dividend to shareholders from the Agila sale proceeds

	USD mn	Axis Comments
Deal value (including USD 250 mn of contingent payment)	1,850	
Forfeited amount	(100)	
Net deal value	1,750	
Remedial measure cost charged off	60	To meet remedial measures at Bengaluru injectable facility
Asset buy-back from partners/ JVs	90	Buy-back of IPs, distribution rights etc. from partners/JVs to be given to Mylan
Tax escrow	100	Maintained by Mylan; to settle any prior period tax claims; management expects to get USD 60-70 mn from this escrow
Regulatory escrow	40	Maintained by Mylan; to meet remedial measure costs over and above USD 60 mn; management expects some refund from this escrow as well
Debt repayment	300	
Tax payment	180-200	
Dividend payment (in two tranches)	655	Rs 605 (500+105) per share
Cash retained	100	
Others (payment to employees, transaction cost etc.)	200-225	

Source: Company

Exhibit 21: Strides key management has significant work experience

Name	Designation	Background
Mr. Arun Kumar	Founder & Group CEO	Managing Director since inception in 1990
Mr. Badree Komandur	CFO & Company Secretary	Joined Strides in Mar-2010; over 20 years of experience
Mr. Mohan Kumar	CEO – Pharma	Joined Strides in May-2013; over 33 years of experience
Mr. Sinhue Noronha	CEO - Africa Operations	Joined Strides in Apr-2010; over 34 years of experience
Mr. Subroto Banerjee	President – Brands India	Joined Strides in Mar-2012; over 28 years of experience
Mr. Joe Thomas	CEO, Stelis Biopharma	Joined Strides in Jan-2012; over 31 years of experience

Source: Company

Financials and Valuations

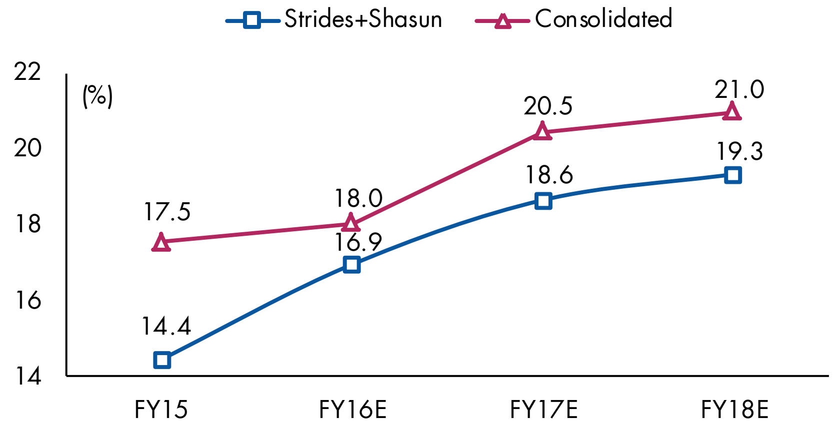
Exhibit 22: Key revenue assumptions

(Rs mn)	% of FY16	FY15	FY16E	FY17E	FY18E
Regulated markets	35	4,255	11,700	17,145	20,359
Regulated markets (USD mn)		*70*	*188*	*272*	*311*
US	14	1,092	4,874	6,575	8,654
US (USD mn)		*18*	*78*	*104*	*132*
EU	6	1,634	2,017	2,215	2,512
EU *(USD mn)*		*27*	*32*	*35*	*38*
UK	2	612	749	907	1,132
UK (USD mn)		*10*	*12*	*14*	*17*
Australia and others	12	917	4,060	7,447	8,061
Australia (USD mn)		*15*	*65*	*118*	*123*
Emerging market	16	4,070	5,291	6,484	7,661
India	4	1,000	1,300	1,495	1,674
Africa	12	3,070	3,991	4,989	5,987
Institutional business	14	3,865	4,808	6,019	7,368
ARV	9	2,642	2,906	3,342	3,843
Sovaldi	0	-	155	384	567
Anti-malaria	5	1,223	1,747	2,293	2,957
API/ CRAMS	33		11,080	12,624	14,228
API	21		7,185	8,196	9,191
CRAMS	12		3,895	4,428	5,037
Crams API UK	10		3,377	3,884	4,466
Others	*2*		*766*	*769*	*773*
Total sales	100	12,190	33,646	43,040	50,389

Source: Company, Axis Capital; Note – assumed Shasun merger effective from 1st April 2015 and Arrow consolidation from 1st October 2015 for our financial projection

US, Africa and Australia are key focus markets

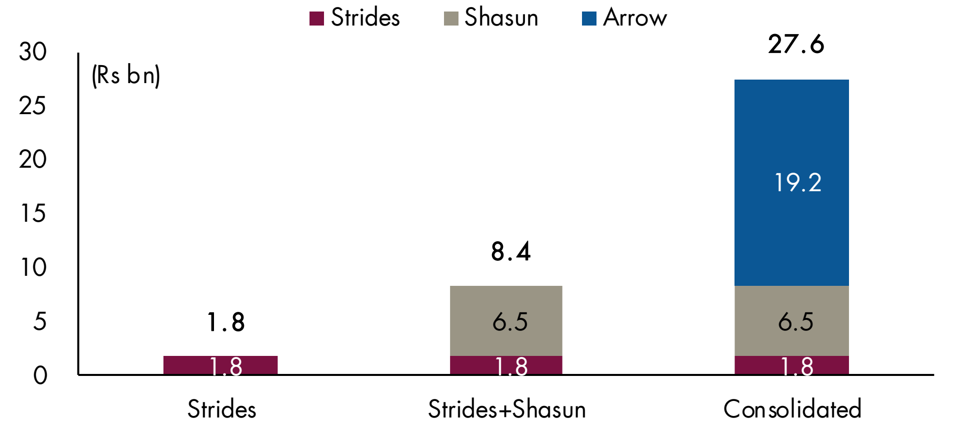
Exhibit 23: Acquisition of Arrow to improve consolidated EBITDA margins…



Source: Company, Axis Capital

Sharp improvement in EBITDA margin from FY17 due to full year impact of Arrow Pharma

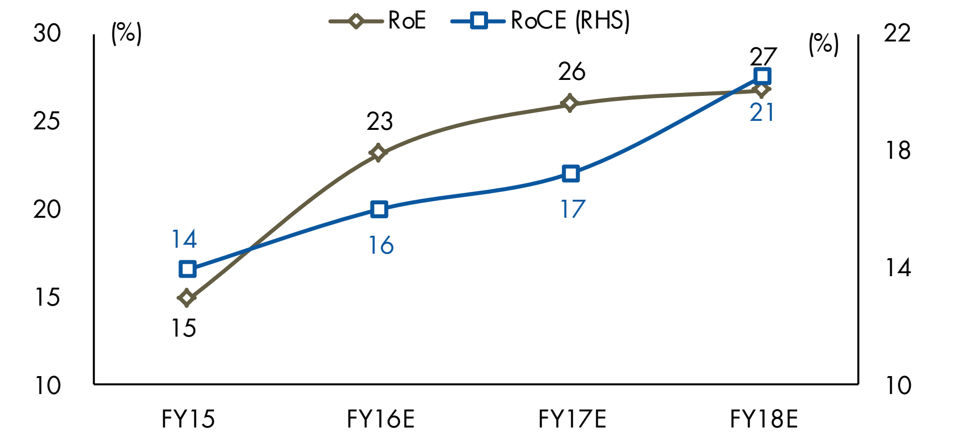
Exhibit 24: … but it has also increased its consolidated net debt (proforma FY15)



Source: Company, Axis Capital

Inorganic growth has led to spike in debt; high gearing (from 0.2x in FY15 to 1.7x in FY16E)

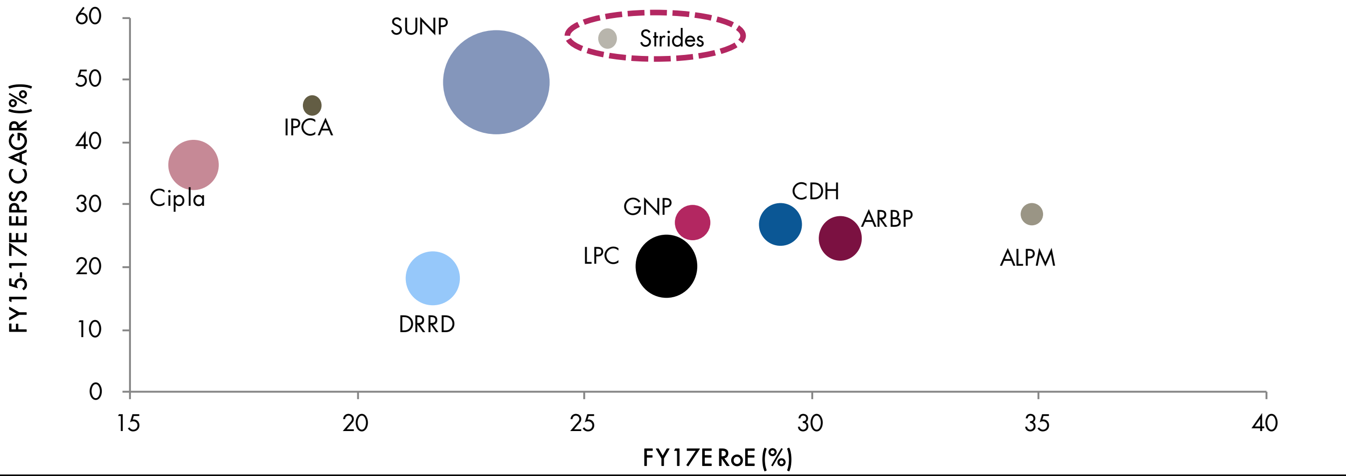
Exhibit 25: Return ratios to improve significantly



Source: Company, Axis Capital

Strides focus on cash generation/ profitability would help in reducing its high debt and improve RoCE

Exhibit 26: In a sweet spot – Strides stands out on RoE-earnings growth profile



Source: Bloomberg, Companies, Axis Capital

Given expectations of strong EPS CAGR and improving RoE/ RoCE, we value Strides with a target price of 1,400/sh (Rs 1,346 for base business valued at 19x FY17 EPS and Rs 54/ sh for 74.9% stake in Stelis R&D unit. With 26% upside, we initiate coverage with BUY.

Key risks

- Higher-than-expected pricing impact on proposed Australia generics acquisition
- Regulatory overhang given increasing USFDA issues

Exhibit 27: Valuation snapshot – High EPS growth and improving RoEs warrants premium to mid-cap sector average

Company	MCAP (USD bn)	CMP (Rs)	TP (Rs)	Upside (%)	EPS (Rs) FY15	EPS (Rs) FY16E	EPS (Rs) FY17E	EPS CAGR FY15-17E (%)	P/E (x) FY16E	P/E (x) FY17E	RoE (%) FY15E	RoE (%) FY17E
Lupin (LPC)	13.4	1,887	1,940	3	54	63	78	20.1	30	24	30.2	27
Dr. Reddy's (DRRD)	9.5	3,551	4,000	13	130	146	182	18.2	24	20	21.9	22
Cipla	7.8	616	630	2	15	20	27	36.5	31	22	11.2	16
Sun Pharma (SUNP)	33.1	874	1,025	17	18	32	41	49.6	27	21	17.6	23
Large Cap								**35.1**	**28**	**22**	**19.1**	**22**
Cadila (CDH)	5.8	1,797	1,909	6	57	70	91	26.8	26	20	28.9	29
Alembic (ALPM)	2.0	663	520	(22)	15	20	25	28.4	33	27	36.3	35
Glenmark (GNP)	4.4	994	960	(3)	29	35	46	27.2	28	21	25.9	27
Aurobindo (ARBP)	6.7	1,450	1,550	7	55	68	86	24.6	21	17	36.1	31
IPCA	1.4	710	685	(3)	20	29	43	46.0	24	17	12.0	19
Strides (STR)	**1.0**	**1,111**	**1,400**	**26**	**27**	**43**	**67**	**58.4**	**26**	**17**	**12.9**	**26**
Mid Cap								**27**	**24**	**18**	**28**	**28**
Generics Avg								**33**	**27**	**21**	**21**	**24**
Others												
Divi's Lab (DIVI)	3.9	1,876	2,025	8	66	84	107	27	22	18	27	30
GSK Pharma (GLXO)	4.4	3,325	3,005	(10)	50	69	88	33	48	38	27	40

Source: Bloomberg, Companies, Axis Capital, Prices as on June 30, 2015

Financial summary (Consolidated)

Profit & loss (Rs mn)

Y/E March	FY14#	FY15	FY16E	FY17E
Net sales	13,410	12,188	33,646	43,040
Other operating income	-	-	-	-
Total operating income	**13,410**	**12,188**	**33,646**	**43,040**
Cost of goods sold	(7,147)	(5,605)	(15,920)	(19,774)
Gross profit	6,263	6,584	17,725	23,267
Gross margin (%)	*46.7*	*54.0*	*52.7*	*54.1*
Total operating expenses	(4,029)	(4,065)	(11,657)	(14,463)
EBITDA	**2,234**	**2,519**	**6,068**	**8,804**
EBITDA margin (%)	*16.7*	*20.7*	*18.0*	*20.5*
Depreciation	(565)	(640)	(1,167)	(1,317)
EBIT	**1,669**	**1,878**	**4,900**	**7,486**
Net interest	(1,089)	(474)	(1,209)	(1,534)
Other income	602	541	540	680
Profit before tax	**1,183**	**1,945**	**4,232**	**6,633**
Total taxation	(409)	(352)	(791)	(1,248)
Tax rate (%)	*34.5*	*18.1*	*18.7*	*18.8*
Profit after tax	774	1,593	3,440	5,384
Minorities	-	-	-	-
Profit/ Loss associate co(s)	-	6	-	-
Adjusted net profit	774	1,599	3,440	5,384
Adj. PAT margin (%)	*5.8*	*13.1*	*10.2*	*12.5*
Net non-recurring items	(3,102)	(1,197)	-	-
Reported net profit	(2,328)	401	3,440	5,384

Balance sheet (Rs mn)

Y/E March	FY14#	FY15	FY16E	FY17E
Paid-up capital	596	596	796	796
Reserves & surplus	9,473	10,853	17,517	22,411
Net worth	10,825	11,636	18,500	23,393
Borrowing	2,666	8,923	28,169	23,776
Other non-current liabilities	313	352	468	499
Total liabilities	**20,990**	**24,877**	**58,412**	**59,409**
Gross fixed assets	9,073	11,899	40,270	41,420
Less: Depreciation	(3,528)	(4,168)	(10,076)	(11,393)
Net fixed assets	5,545	7,731	30,194	30,027
Add: Capital WIP	995	995	2,137	2,137
Total fixed assets	6,540	8,725	32,331	32,163
Total Investment	4,430	6,300	1,345	1,345
Inventory	1,760	2,077	6,841	7,775
Debtors	3,640	3,900	10,687	11,596
Cash & bank	2,311	1,469	1,993	1,218
Loans & advances	1,230	1,141	2,690	2,657
Current liabilities	7,187	3,966	11,275	11,740
Net current assets	1,890	4,731	11,435	12,042
Other non-current assets	943	1,154	2,027	2,118
Total assets	**20,990**	**24,877**	**58,412**	**59,409**

Source: Company, Axis Capital Note: # FY14 data is for 15 months

Cash flow (Rs mn)

Y/E March	FY14#	FY15	FY16E	FY17E
Profit before tax	1,183	1,945	4,232	6,633
Depreciation & Amortisation	(565)	(640)	(1,167)	(1,317)
Chg in working capital	*(2,607)*	*(3,856)*	*(1,222)*	*(1,444)*
Cash flow from operations	**(2,717)**	**(3,081)**	**3,386**	**5,258**
Capital expenditure	*(4,880)*	*(2,491)*	*(1,150)*	*(1,150)*
Cash flow from investing	**40,771**	**(4,361)**	**3,963**	**(1,150)**
Equity raised/ (repaid)	*259*	-	-	-
Debt raised/ (repaid)	*1,436*	*6,257*	*(6,526)*	*(4,393)*
Dividend paid	*(32,689)*	*(7,533)*	*(328)*	*(491)*
Cash flow from financing	**(33,185)**	**(1,275)**	**(6,854)**	**(4,884)**
Net chg in cash	4,869	(8,717)	495	(776)

Key ratios

Y/E March	FY14#	FY15	FY16E	FY17E
OPERATIONAL				
FDEPS (Rs)	10.5	26.8	43.0	67.3
CEPS (Rs)	(23.8)	17.5	57.6	83.8
DPS (Rs)	406.7	108.0	3.5	5.3
Dividend payout ratio (%)	(1,292.2)	1,604.4	8.1	7.8
GROWTH				
Net sales (%)	11.5	13.6	176.0	27.9
EBITDA (%)	77.7	40.9	140.9	45.1
Adj net profit (%)	404.8	158.0	115.2	56.5
FDEPS (%)	328.0	220.2	60.4	56.5
PERFORMANCE				
RoE (%)	4.1	14.9	23.1	25.9
RoCE (%)	7.3	13.9	16.0	17.2
EFFICIENCY				
Asset turnover (x)	0.5	1.2	1.2	1.0
Sales/ total assets (x)	0.3	0.5	0.8	0.7
Working capital/ sales (x)	-	0.1	0.2	0.2
Receivable days	79.3	116.8	115.9	98.3
Inventory days	46.0	78.4	90.5	82.9
Payable days	70.0	88.5	105.0	87.8
FINANCIAL STABILITY				
Total debt/ equity (x)	0.2	0.8	1.9	1.1
Net debt/ equity (x)	(0.2)	0.2	1.7	1.1
Current ratio (x)	1.3	2.2	2.0	2.0
Interest cover (x)	1.5	4.0	4.1	4.9
VALUATION				
PE (x)	99.6	37.9	25.7	16.4
EV/ EBITDA (x)	28.0	27.0	15.2	10.0
EV/ Net sales (x)	4.7	5.6	2.7	2.1
PB (x)	6.5	5.8	4.9	3.8
Dividend yield (%)	36.6	9.7	0.3	0.5
Free cash flow yield (%)	0.6	(0.1)	-	0.1

Source: Company, Axis Capital Note: # FY14 data is for 15 months

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DEFINITION OF RATINGS	
Ratings	Expected absolute returns over 12 months
BUY	More than 10%
HOLD	Between 10% and -10%
SELL	Less than -10%

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