16 AUG 2017 | Quarterly Update

AUROBINDO PHARMA

PHARMACEUTICALS

BUY

Target Price: Rs 825

Q1 better than peers; Sevelamer to drive earnings

Gross margin improved 50 bps QoQ and EBITDA margin 170 bps QoQ on 8% QoQ growth in US sales and improving revenue mix (higher formulations and lower API/ ARV sales). However, PAT declined 11% YoY/ 3% QoQ on higher depreciation due to commissioning of new units. Despite high single digit to low double digit price erosion, the company expects US business to grow on the back of new launches/ capacity and ramp-up of Sevelamer franchise (OS^ and tablets with USD 116 mn in FY18 sales and over ~75% margin).

We maintain **BUY** with TP of Rs 825 (17x FY19E EPS), as we expect growth to pick up with improving execution (R&D), launch momentum with increased capacity in H2FY18 and lower concentration risk. Outstanding Form 483 on unit IV injectable unit remains a concern.

CMP	: Rs 683
Potential Upside	: 21%

MARKET DATA

No. of Shares	: 586 mn
Free Float	: 48%
Market Cap	: Rs 400 bn
52-week High / Low	: Rs 895 / Rs 504
Avg. Daily vol. (6mth)	: 3.2 mn shares
Bloomberg Code	: ARBP IB Equity
Promoters Holding	: 52%
FII / DII	: 20% / 14%

- **Steady US sales growth despite headwinds:** US business (46% of revenue) grew 3% YoY/ 8% QoQ at USD 263 mn on limited competition launch of gStrattera, gEpzicom, Sevelamer OS and market share gains in gValcyte, gNexium. US oral solid business (~70% of US revenue) declined 3% YoY due to price erosion in select products. Injectable franchise grew 5% YoY at USD 36 mn (vs. USD 42 mn in Q4'17) on lack of approvals post 483 on Unit IV. EU business (25% of sales) grew 10% YoY (grew 8% ex-Generis acquisition). EU sales grew 17.7% YoY on constant currency basis and registered low double digit EBITDA margin (vs. -10% EBITDA margin when acquired). ARV business declined 19% YoY. API revenue also declined 15% YoY QoQ, as sales was impacted by GST implementation and deferment of sale of certain products
- **Strong margin performance:** Gross margin improved 274 bps YoY/50% QoQ at 59.3% on better revenue mix. EBITDA margin also improved ~170 bps QoQ (contracted 70 bps YoY) at 22.9% on lower other expenses (23% of Q1'18 sales vs. 24.8% of Q4'17 sales). Adj. PAT of Rs 5.24 bn (-10% YoY) was 5% below our estimate on higher depreciation expense of Rs 1.3 bn in Q1FY18 (vs. Rs 1 bn in Q4'17) with commissioning of new facilities

Financial summary (Consolidated)

Y/E March	FY16	FY17	FY18E	FY19E
Sales (Rs mn)	137,024	148,424	172,983	189,778
Adj PAT (Rs mn)	20,475	22,926	26,277	28,428
Con. EPS* (Rs)	-	-	44.3	49.6
EPS (Rs)	35.0	39.1	44.8	48.5
Change YOY (%)	26.2	11.8	14.6	8.2
P/E (x)	19.5	17.5	15.2	14.1
RoE (%)	32.9	27.5	25.7	22.9
RoCE (%)	27.1	25.7	27.0	25.1
EV/E (x)	13.7	12.2	10.4	9.4
DPS (Rs)	2.5	2.5	2.5	2.5

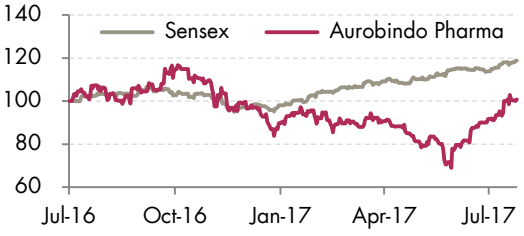
Source: *Consensus broker estimates, Company, Axis Capital

^OS: Oral Suspension

Key drivers

Growth (%)	FY17	FY18E	FY19E
US	9	23	9
Europe	5	24	7
EBITDA margin	23.1	23.6	22.9
core-EPS	12	15	8

Price performance



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- **Sequential increase in net debt to USD 560 mn in Q1FY18:** Net debt increased sequentially to USD 560.1 mn (USD 439 mn in Mar'17) largely led by the acquisition in Portugal for USD 145mn and capex of USD 40mn. It expects net debt to be lower than USD 475 mn at end FY18 ex- acquisitions (to enhance market penetration (east EU) or business platforms)
- **Key concall highlights: (1) US:** It received final approval for 17 ANDA (16 orals and 1 injectable). Additionally, it launched 15 products in Q1'18 (including 3 injectables during the quarter); **(2) Injectables:** Despite 5% YoY growth in Q1, It expects 40-45% growth in injectables segment in FY18. **USFDA update:** ARBP's response to the form 483 observations on its Unit IV facility (inspected in May'17) under review by the USFDA; **(3) EU:** Cumulatively transferred manufacturing of 71 products to India; target to cumulatively transfer 112 products from Europe to India (of total 180-200 marketed products); **(4) R&D** to increase progressively to 5% of FY18 sales and ~6% in FY19 (vs. 4.4% in Q1FY18, 3.6% in FY17); could be higher at ~7-8% for a year towards Biosimilar R&D and **(5) Tax rate:** 27% in FY18

Exhibit 1: Sequential margin improvement was led by better business mix

(Rs mn)	Q1'17	Q4'17	Q1'18	YoY (%)	QoQ (%)
Net revenue	37,666	36,416	36,788	(2)	1
Gross margin (%)	56.5	58.7	59.3	274 bps	55 bps
Employee Expenses	4,321	4,635	4,902	13	6
% of revenue	11	13	13	185 bps	60 bps
Other Expenses	8,086	9,041	8,492	5	(6)
% of revenue	21	25	23	162 bps	-174 bps
EBITDA	**8,890**	**7,712**	**8,416**	**(5)**	**9**
EBITDA margin (%)	**23.6**	**21.2**	**22.9**	**-72 bps**	**170 bps**
Other income	159	218	221	39	2
Forex (gain)/ loss	(70)	(190)	77	(209)	(140)
Depreciation	1,062	1,001	1,312	23	31
Interest	206	143	169	(18)	18
PBT	7,850	6,977	7,080	(10)	1
Tax	2,008	1,172	1,910	(4.9)	63.0
Tax rate	26	17	27	139 bps	1018 bps
Reported PAT	**5,850**	**5,324**	**5,185**	**(11)**	**(3)**
Adj. PAT*	**5,800**	**5,556**	**5,243**	**(10)**	**(6)**

Source: Company As per Ind-AS

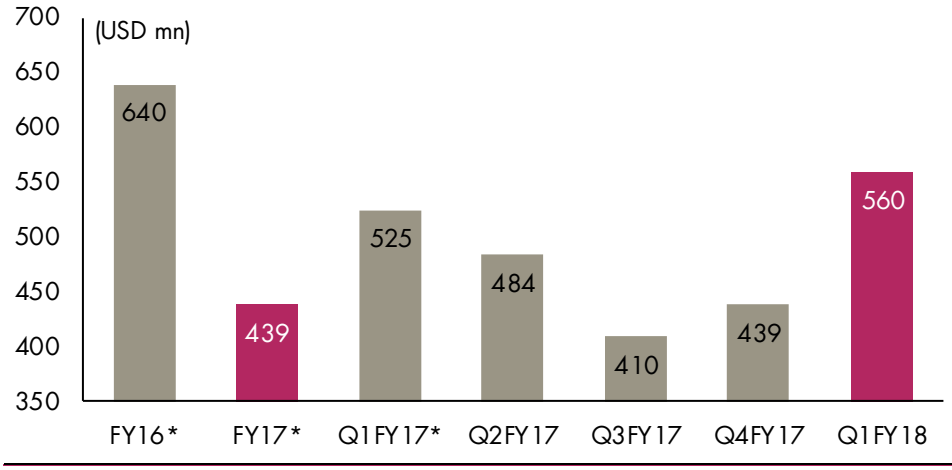
*PAT adjusted for forex *Q4'17 EBITDA/ PAT also adjusted for one time Rs 500mn inventory write off

Exhibit 2: US business driven by new launches

(Rs mn)	Q1'17	Q4'17	Q1'18	YoY (%)	QoQ (%)
US (USD mn)	255	243	263	3	8
US	17,039	16,432	16,949	(1)	3
Europe	8,312	7,772	9,176	10	18
ARV	3,030	2,619	2,446	(19)	(7)
RoW	1,940	1,971	1,939	(0)	(2)
Formulations	**30,321**	**28,794**	**30,510**	**1**	**6**
API	**7,346**	**7,627**	**6,251**	**(15)**	**(18)**
Gross revenue	**37,667**	**36,415**	**36,789**	**(2)**	**1**

Source: Company

Exhibit 3: Net debt increased by ~USD 130 mn led by the Generis acquisition in Portugal



Source: Company, Axis Capital *Note FY16 debt adjusted for bill-discounting (as per Ind-As); Q1FY17 adjusted for debt factoring of USD 150 mn

Conference call highlights

Guidance

- **US:** Expects growth to continue despite continuing price erosion. Expects high single digit to low double digit pricing erosion in FY18
  - **Injectables:** Maintains 40-45% growth in FY18
- **R&D:** Expects R&D to increase progressively to 5% of FY18 sales and ~6% in FY19 (vs. 4.4% in Q1FY18, 3.6% in FY17); could be higher ~7-8% of sales for a year, once it initiates clinical trials for Biosimilar
- **Tax rate:** 27% in FY18 (3 new plants commissioned/getting commissioned in near term located in SEZ's – Unit X; to provide tax benefits from FY19)
- **Balance sheet:** Expects net debt to be below USD 475 mn at end FY18 (net debt increased sequentially to USD 560 mn in Q1FY18 vs. USD 439 mn in Q4FY17, largely led by the acquisition in Portugal for USD 145 mn and capex of USD 40 mn). It does not account for any acquisitions which could be done to enhance market penetration (east EU) or business platforms

US business (46% of sales; USD 263 mn flat YoY/ +8% QoQ in USD terms):

- **Oral solids (~70% of business):** Declined 3% YoY in Q1 due to price erosion in select products. Sales grew 11%QoQ and witnessed no incremental sequential pricing erosion. Expects high single digit to low double digit pricing erosion in FY18 (vs. earlier guidance of 7-8% YoY price erosion in FY18). 12 additional launches in Q1 (24 launches in FY17), key gRenvela (Sevelamer) tablets launched in Q2 (launched on approval), gRenvela – Oral Suspension – ~1 month sales accounted for in Q1
- **Injectables:** Grew 5% YoY at USD 36 mn in Q1'17 (vs. USD 42 mn in Q4'17). 3 additional launches in Q1 (11 launches in FY17). ARBP filed 4 ANDA's in Q1 (12 filings in Q4'17). ARBP has launched pantoprazole injection, while launch of Vancomycin injection is still few quarters away
- **Natrol:** Guided for launch of key products towards end FY18. No pricing pressure seen in Natrol business
- **Portfolio concentration:** Top 25 products constitute 37% of sales in Q1FY18 vs. 44% in Q1FY17
- **Glsosulfan Blue:** Settled its litigation with Mylan, however, does not expect re-launch, in the near term
- **Mucinex –** Key strength has been launched by ARBP – will gradually ramp up
- **Vancomycin:** Launch towards end FY18
- **gFortamet**: Litigation ongoing with the innovator; negotiating with innovator for an earlier launch – 30 month stay gets over in 2019
- **USFDA inspection update**: ARBP's response to the form 483 observations on its Unit IV facility (inspected in May'17) still under review by the USFDA. Aurobindo yet to receive EIR or a new product approval (post inspection) from this facility

EU business (25% of sales): Europe revenue increased 10% YoY/ 18% QoQ with acquisition of Generis (Portugal). Excluding acquired Generis (Portugal business), Europe business grew 8% YoY. On constant currency basis, EU formulation sales grew 17.7% YoY.

- **Profitability:** Low double digit EBITDA margin in Europe business (vs. -10% EBITDA margin when acquired)
- It cumulatively transferred manufacturing of 71 products from Europe to India till date (vs. 69 products till Mar'17). Expects to cumulatively transfer 112 products from Europe to India (of total 180-200 marketed products

ARV: Declined 16% YoY in constant currency terms. Revenue declined as it is a lumpy, tender based business. ARBP is now focused on improving profitability in the business. Seeing aggressive pricing from peers. Expects approval for Dolutegravir in the near term

API reported 15% YoY/18% QoQ decline in revenue. API sales were impacted due to GST implementation and deferment of certain products sale

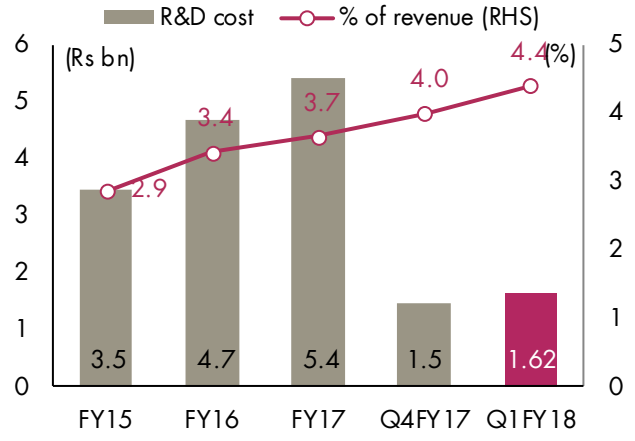
R&D: The cost was Rs 1.62 bn (4.4% of Q1'18 sales) vs. Rs 1.46 bn (4% of Q4'17 sales). ARBP filed 13 ANDAs (9 in orals and 4 in injectables) in Q1 (vs. 31 in FY17: 19 oral and 12 injectable/opthal)

- Expects R&D to increase progressively: Expects 5% in FY18, ~6% in FY19 given increase in expenditure towards liposomal, peptides and biosimilar products

P&L

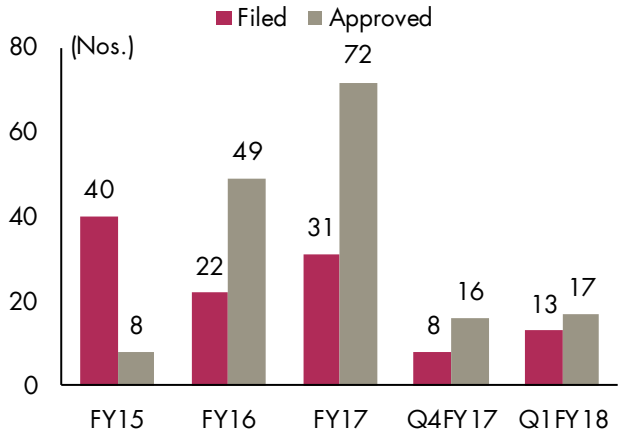
- Gross margin improvement in Q1FY18 driven by change in portfolio mix
- Higher depreciation (Rs 1.3 bn in Q1'18 vs. Rs 1 bn in Q4'17) owing to commissioning of Unit XVI, Vizag facility. To remain at current levels for rest of FY18. Depreciation to creep up further in FY19 with commissioning of Unit X facility

Exhibit 4: R&D expense expected to increase to ~5%...



Source: Company

Exhibit 5: ...to support continued filing momentum



Source: Company

Exhibit 6: Facility-wise ANDA filings

	Filed				Approved				Pending			
	Mar-16	Sep-16	Mar-17	Jun-17	Mar-16	Sep-16	Mar-17	Jun-17	Mar-16	Sep-16	Mar-17	Jun-17
Total Orals	309	317	325	332	202	227	251	265	107	88	74	67
Unit VII (SEZ)	148	155	158	159	69	89	108	122	79	66	50	37
Total Injectables	70	75	82	87	30	38	44	45	40	37	38	42
Unit IV	67	71	78	83	30	38	43	44	37	33	35	39
Total	**379**	**412**	**429**	**442**	**232**	**284**	**314**	**329**	**147**	**126**	**115**	**113**

Source: Company Note: 329 approvals includes 37 TAs

Exhibit 7: Regained some market share in Valcyte; increased traction in gNexium, gStrattera

Generic name	Brand name	Brand sales / market size (USD mn)	#No. of players	Market share					
				Sept'16	Dec'16	Mar'17	Apr'17	May'17	Jun'17
Rosuvastatin Calcium*	Crestor	6,780	9	9%	10%	16%	13%	15%	15%
Abacavir Sulfate, Lamivudine	Epzicom	388	4	-	-	-	1%	6%	11%
Pantoprazole Sodium. Inj.	Protonix	94	3	7%	5%	9%	15%	10%	6%
Atomoxetine Hcl*	Strattera	1,000	4	-	-	-	-	0%	15%
Valganciclovir	Valcyte	440	4	10%	29%	22%	24%	26%	27%
Isosulfan Blue	Lymphazurin	57	2	53%	71%	3%	0%	0%	0%
Esomeprazole	Nexium	2,200	6	-	0%	0%	1%	2%	7%
Aripiprazole	Abilify	4,764	7	7%	5%	2%	2%	2%	2%
Entecavir	Baraclude	206	4	43%	34%	35%	38%	38%	39%
Eptifibatide Inj.	Integrilin	137	2	55%	48%	47%	45%	41%	44%
Cefixime OS	Suprax	80	2	23%	27%	27%	27%	28%	31%
Duloxetine*	Cymbalta	5,100	16	24%	25%	26%	26%	26%	25%
Valsartan+HCTZ	Diovan HCT	1,700	8	31%	33%	32%	32%	32%	32%

Source: Bloomberg, Company, Axis Capital; *sold through partner Citron Pharma (acquired by Rising Pharma)

Exhibit 8: R&D investments for the future

Key areas of Investments	No of products under development	Market Opportunity	Key initiatives
Biosimilars	13	>USD 40 bn	♦ Acquired 5 biosimilar products from TL Biopharma with cumulative market size of over USD 25 bn. Lead molecule - Avastin (Bevacizumab) to enter clinical trials in 2018 ♦ Commissioning a new Biosimilars manufacturing (both drug product and finished drug product manufacturing) unit in FY18
Depot injections	4	USD 3 bn	♦ Dedicated manufacturing equipment are on order for installation at the Hyderabad based injectables unit - estimated to be installed by Nov 2017 ♦ Scale-up batches planned for the last quarter of 2017. Exhibit batches are likely to be produced starting first quarter of 2018
Dermatology,	18	USD 4.3bn	♦ Built a new R&D and cGMP manufacturing facility for specialty generics in Durham, North Carolina - to be functional in Aug 2017 ♦ Clinical trials (PK and PD bioequivalence), for the 1st MDI product is likely to be taken up in early 2018 ♦ PD bioequivalence (VCA study), for the 1st topical derma product is likely to be undertaken in late 2017. The first clinical trial for topical product is likely to be initiated in the latter half of 2018. ♦ Plans to start product filings by late CY2017
Inhalers	6	USD 8.6 bn	
Nasal sprays	7	USD 0.9 bn	
Oncology & Hormonal products	66 (58 oncology +8 hormonal)	USD 40 bn	♦ Oncology API, Formulation facilities for oral solid dosage and injectable forms have been commissioned -Regulatory inspections scheduled in FY18, expected to commence manufacturing from FY19 ♦ Expects to take exhibit batches for 20 -22 products annually over the next 2-3 years (vs 10 products in FY17) ♦ Expects to file at least 15 products in FY18 (vs 2 US filings in FY17)
Peptides	9	USD 3 bn	♦ Already developed technologies for 20 peptides (APIs) ♦ Presently developing 5 microsphere and liposomal injectable products - at least 2 of which are expected to be filed in 2017-18
Penems	4	USD 500 mn	♦ Filed 4 penem injectable products in the regulated markets as well as in key emerging markets ♦ Received approval for 1 ANDA in March 2017, and launched in Apr 2017
Pneumococcal conjugate vaccine (PCV)		USD 6 bn	♦ Phase I study is expected to start by Dec 2017 - post approval from National Regulatory Authority ♦ Initiated dialogue with the WHO PQ team at Geneva to finalize the clinical trials as per WHO recommendations. ♦ Construction of the commercial plant is under progress and is expected to be ready by end of 2018.

Source: Company, Axis Capital

Financial summary (Consolidated)

Profit & loss (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Net sales	137,024	148,424	172,983	189,778
Other operating income	2,529	2,475	2,600	2,700
Total operating income	**139,552**	**150,899**	**175,583**	**192,478**
Cost of goods sold	(61,621)	(64,343)	(71,885)	(79,546)
Gross profit	77,931	86,556	103,698	112,932
Gross margin (%)	*56.9*	*58.3*	*59.9*	*59.5*
Total operating expenses	(46,050)	(51,713)	(62,286)	(68,813)
EBITDA	**31,881**	**34,843**	**41,413**	**44,119**
EBITDA margin (%)	*23.3*	*23.5*	*23.9*	*23.2*
Depreciation	(3,924)	(4,276)	(5,361)	(6,057)
EBIT	**27,957**	**30,567**	**36,052**	**38,062**
Net interest	(927)	(667)	(824)	(646)
Other income	701	538	700	910
Profit before tax	**27,652**	**30,468**	**35,927**	**38,326**
Total taxation	(7,207)	(7,597)	(9,700)	(9,965)
Tax rate (%)	*26.1*	*24.9*	*27.0*	*26.0*
Profit after tax	20,445	22,871	26,227	28,362
Minorities	15	5	(5)	6
Profit/ Loss associate co(s)	15	50	55	61
Adjusted net profit	20,475	22,926	26,277	28,428
Adj. PAT margin (%)	*14.9*	*15.4*	*15.2*	*15.0*
Net non-recurring items	(224)	91	-	-
Reported net profit	20,251	23,017	26,277	28,428

Balance sheet (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Paid-up capital	585	586	586	586
Reserves & surplus	72,288	93,133	109,995	136,883
Net worth	72,873	93,719	110,581	137,469
Borrowing	44,155	30,841	35,841	25,841
Other non-current liabilities	240	493	493	493
Total liabilities	**117,293**	**125,074**	**146,936**	**163,824**
Gross fixed assets	45,698	56,355	76,580	86,525
Less: Depreciation	(3,901)	(8,017)	(13,378)	(19,434)
Net fixed assets	41,797	48,338	63,202	67,090
Add: Capital WIP	8,481	14,581	16,768	19,283
Total fixed assets	50,278	62,919	79,970	86,374
Total Investment	-	-	-	-
Inventory	40,561	43,305	49,762	54,594
Debtors	46,067	27,653	37,914	41,595
Cash & bank	8,003	5,135	3,904	10,529
Loans & advances	158	166	173	190
Current liabilities	41,909	37,420	48,104	52,774
Net current assets	67,015	62,155	66,965	77,450
Other non-current assets	-	-	-	-
Total assets	**117,293**	**125,074**	**146,936**	**163,824**

Source: Company, Axis Capital

Cash flow (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Profit before tax	27,652	30,468	35,927	38,326
Depreciation & Amortisation	3,924	4,276	5,361	6,057
Chg in working capital	*(11,639)*	*24,844*	*(5,782)*	*(3,590)*
Cash flow from operations	**13,734**	**52,488**	**29,365**	**33,994**
Capital expenditure	*(15,657)*	*(16,846)*	*(20,225)*	*(9,945)*
Cash flow from investing	**(15,657)**	**(16,846)**	**(20,225)**	**(9,945)**
Equity raised/ (repaid)	-	-	-	-
Debt raised/ (repaid)	*6,033*	*(17,279)*	*5,000*	*(10,000)*
Dividend paid	*(1,616)*	*(1,372)*	*(1,763)*	*(1,763)*
Cash flow from financing	**3,654**	**(19,153)**	**2,413**	**(12,409)**
Net chg in cash	1,732	16,489	11,553	11,640

Key ratios

Y/E March	FY16	FY17	FY18E	FY19E
OPERATIONAL				
FDEPS (Rs)	35.0	39.1	44.8	48.5
CEPS (Rs)	41.3	46.6	54.0	58.9
DPS (Rs)	2.5	2.5	2.5	2.5
Dividend payout ratio (%)	7.2	6.4	5.6	5.2
GROWTH				
Net sales (%)	13.1	8.3	16.5	9.7
EBITDA (%)	24.4	9.3	18.9	6.5
Adj net profit (%)	26.5	12.0	14.6	8.2
FDEPS (%)	26.2	11.8	14.6	8.2
PERFORMANCE				
RoE (%)	32.9	27.5	25.7	22.9
RoCE (%)	27.1	25.7	27.0	25.1
EFFICIENCY				
Asset turnover (x)	1.4	1.3	1.3	1.3
Sales/ total assets (x)	1.0	0.9	1.0	0.9
Working capital/ sales (x)	0.4	0.4	0.3	0.3
Receivable days	122.7	68.0	80.0	80.0
Inventory days	137.5	136.2	135.4	134.3
Payable days	83.3	78.3	83.8	83.1
FINANCIAL STABILITY				
Total debt/ equity (x)	0.7	0.4	0.4	0.2
Net debt/ equity (x)	0.6	0.3	0.3	0.1
Current ratio (x)	2.6	2.7	2.4	2.5
Interest cover (x)	30.2	45.8	43.7	58.9
VALUATION				
PE (x)	19.5	17.5	15.2	14.1
EV/ EBITDA (x)	13.7	12.2	10.4	9.4
EV/ Net sales (x)	3.2	2.9	2.5	2.2
PB (x)	5.5	4.3	3.6	2.9
Dividend yield (%)	0.4	0.4	0.4	0.4
Free cash flow yield (%)	(0.5)	8.9	2.3	6.0

Source: Company, Axis Capital

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