

NATCO PHARMA

PHARMACEUTICALS

09 NOV 2017

Quarterly Update

BUY

Target Price: Rs 1,150

Robust on strong execution; gCopaxone ahead

Though Q2 revenue declined 9% YoY (on a high base), EBITDA and PAT grew 16% and 27% led by higher-margin limited-competition product gDoxil in US. We expect strong PAT growth of 113% in H2 driven by gCopaxone, gDoxil, gTamiflu OS[^]. Expect strong FCF of Rs 4.4 bn in FY18 and Rs 6.1 bn in FY19. We raise FY18E EPS by 36% to factor in an additional quarter sales of gCopaxone 40 mg (previously built in Q4'18 launch). Revise **SOTP to Rs 1,150** as we roll forward to 20x Sep'19E EPS + Rs 124 for R&D pipeline (vs. 20x FY19E EPS +Rs 118 for R&D pipeline, earlier). **Maintain BUY.**

While Natco's large fundraise (Rs 15 bn) announcement comes as a surprise to us, we believe, this will help accelerate its complex generics pipeline (with focus on chemistry, peptides & injectables) and expand its India and RoW market footprint, given its strong execution track record.

CMP : Rs 955
Potential Upside : 20%

MARKET DATA

No. of Shares : 174mn
Free Float : 49%
Market Cap : Rs166bn
52-week High / Low : Rs1,080 / Rs495
Avg. Daily vol. (6mth) : 4,53,857 shares
Bloomberg Code : NTCPH IB Equity
Promoters Holding : 51%
FII / DII : 22% / 5%

- ♦ **Revenue growth muted but...:** Revenue declined 9% YoY on 6% YoY decline in export formulations (despite gDoxil) given high base of Q2FY17 (led by gTamiflu supplies) and 2% decline in domestic formulations. Domestic oncology (incl. C&D#) sales growth rebounded to 26% YoY, but domestic Hep-C sales declined 16% YoY due to pricing pressure (despite volume growth). Export formulations sale at Rs 1.27 bn was driven by profit share of Rs 600 mn – primarily driven by gDoxil. API sales grew 23% YoY led by 41% YoY growth in exports API
- ♦ **...margins improve strongly driven by gDoxil:** We highlight 12.8 pp and 6.1 pp improvement in gross and EBITDA margins given gTamiflu supplies in Q2FY17 (for which profits were booked subsequently from Q3FY17). Thus, despite 26% YoY increase in staff expenses, EBITDA grew 16% YoY. Normalized tax rate of 21.3% (but lower vs. 26.2% in Q2FY17) led to 26% YoY increase in PAT
- ♦ **US scale-up is well underway led by gCopaxone, gDoxil, gTamiflu OS:** We expect revenue of USD 19 mn/ USD 32 mn for gCopaxone 20mg, USD 109 mn/USD 107 mn for gCopaxone 40mg, USD 13 mn/ USD 14 mn for gDoxil in H2FY18/FY19. Expect revenue of gTamiflu OS at USD 14 mn in H2FY18.

Financial summary (Consolidated)

Y/E March	FY17	FY18E	FY19E	FY20E
Sales (Rs mn)	20,650	27,436	29,891	31,500
Adj PAT (Rs mn)	4,860	9,693	9,664	10,002
Con. EPS* (Rs)	-	29.4	41.7	48.1
EPS (Rs)	27.9	55.5	55.4	57.3
Change YOY (%)	213.2	99.4	(0.3)	3.5
P/E (x)	34.3	17.2	17.2	16.7
RoE (%)	33.0	46.3	32.5	26.4
RoCE (%)	38.9	53.7	39.0	31.6
EV/E (x)	24.6	12.5	12.3	12.1
DPS (Rs)	3.0	4.0	4.0	4.0

Source: *Consensus broker estimates, Company, Axis Capital

[^]OS- Oral suspension #C&D- Cardio and Diabetology

Key drivers

Growth (%)	FY17	FY18E	FY19E
US (USD mn)	104	223	206
US growth (%)	292	114	(8)
India (%)	33	(5)	23
EBITDA margin (%)	33.1	48.1	43.3

Price performance

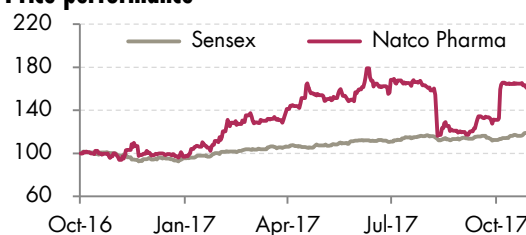


Exhibit 1: Subdued growth on a high gTamiflu base

(Rs mn)	Q2'17	Q1'18	Q2'18	YoY (%)	QoQ (%)
Domestic formulations	2,167	1,821	2,134	(2)	17
Oncology	774	730	973	26	33
Hep-C	1,124	845	948	(16)	12
B2B Business	268	246	213	(21)	(13)
Export Formulations	1,354	1,338	1,268	(6)	(5)
Total Profit share		900	600		
Total Formulation	3,521	3,159	3,402	(3)	8
Total API Sales	476	863	584	23	(32)
Total Revenue	4,709	4,452	4,266	(9)	(4)

Source: Company *Export Formulations includes US, Canada, Brazil

Exhibit 2: Strong YoY margin improvement driven by gDoxil

(Rs mn)	Q2'17	Q1'18	Q2'18	YoY (%)	QoQ (%)
Revenues	4,679	4,453	4,267	(9)	(4)
Gross Profit	2,841	3,359	3,138	10	(7)
Gross Profit margin (%)	60.7	75.4	73.5	1282 bps	-189 bps
Staff	585	631	736	26	17
Staff as % of Sales	12.5	14.2	17.2	475 bps	308 bps
SGA	1,208	1,361	1,183	(2)	(13)
SGA as % of Sales	25.8	30.6	27.7	191 bps	-284 bps
EBITDA	1,048	1,367	1,219	16	(11)
EBITDA margin (%)	22.4	30.7	28.6	617 bps	-213 bps
Interest	42	39	42	-	8
Depreciation	141	150	160	13	7
Other Income	32	34	55	73	62
PBT	897	1,212	1,072	20	(12)
Tax	235	275	228	(3)	(17)
Tax rate	26.2	22.7	21.3	-490 bps	-142 bps
Minority Interest	(3)	(3)	(4)	21	33
Reported PAT	665	940	848	27	(10)

Source: Company

Exhibit 3: Natco has received a spate of approvals/launches in the US in recent quarters

Date Approved	Brand Name	Generic	Market Size (USD mn)	No of Players	Comments
3.8.2016	Tamiflu	Oseltamivir Phosphate Capsules	403	3	Natco launched the product in Dec'16
24.11.2016	Entocort	Budesonide Capsules	370	4	4 generic players
29.11.2016	Nuvugil	Armodafinil Tablets	480	5	5 generic players
06.01.2017	Treanda	Bendamustine Hydrochloride	133	11	Natco will have shared FTF with 10 other players who have settled for launch in Nov'19
16.05.2017	Doxil	Doxorubicin Hcl	196	1	Natco (partner Dr Reddy) have launched the product
23.06.2017	Vidaza	Azacitidine for Injection	188	5	Natco (partner Breckenridge) have launched the product
31.08.2017	Fosrenol	Lanthanum Carbonate	122	1 (AG)	Natco (partner Lupin) received 1st generic approval and have launched the product .
03.10.2017	Copaxone	Glatiramer Acetate 20 mg	704	1	Natco (partner Mylan) have launched the product
03.10.2017	Copaxone	Glatiramer Acetate 40 mg	2,840	0	Natco (partner Mylan) have launched the product at risk

Source: Company, USFDA

Exhibit 4: US scale-up to continue to be driven by complex generics

Brand name	API	Market size (USD mn)	Expected launch date	USD mn				
				FY16	FY17	FY18	FY19	FY20
Copaxone 20 mg	Glatiramer Acetate	700	Oct-17	-	-	19	32	21
Copaxone 40mg	Glatiramer Acetate	2,840	Oct-17	-	-	109	107	75
Tamiflu	Oseltamivir Phosphate	500	Dec-16	-	76	16	5	5
Tamiflu suspension	Oseltamivir Phosphate	213	Nov-17	-	-	14	3	3
Doxil (liposome inj)	Doxorubicin hydrochloride	196	May-17	-	-	19	14	10
Fosrenol	Lanthanum Carbonate	120	Sep-17	-	-	9	5	2
Vidaza	Azacitidine	203	H2FY18	-	-	6	9	6
Gleevec	Imatinib Mesylate	2,000	FY19	-	-	-	4	3
Tracleer	Bosentan	368	FY19	-	-	-	3	1
Others					5	10	4	2
New product revenue				-	81	201	185	160
Base US Revenue				27	24	22	21	20
Total US revenues				27	104	223	206	180

Source: Company, Axis Capital, ** built in incremental generic competition in gCopaxone in FY19

Exhibit 5: We value Natco's R&D pipeline at Rs 124 per share

Products	Therapy	Para IV/FTF	Other filers	Expected launch date	Probability	Sales* (USD mn)	Revenue stream	DCF (Rs/ Sh)
Revlimid	Oncology	Sole FTF	4 (DRRD, CDH, CIPLA, Alvogen)	Mar-22	100%	7,112	sustainable	118
Nexavar	Oncology	Sole FTF	Teva	Jan-20	100%	331	one-time	5
Others (6 Products)								1
Total option value								124

Source: Company, Axis Capital

Financial summary (Consolidated)

Profit & loss (Rs mn)

Y/E March	FY17	FY18E	FY19E	FY20E
Net sales	20,650	27,436	29,891	31,500
Other operating income	-	-	-	-
Total operating income	20,650	27,436	29,891	31,500
Cost of goods sold	(5,991)	(6,036)	(7,996)	(9,135)
Gross profit	14,659	21,400	21,895	22,365
Gross margin (%)	71.0	78.0	73.3	71.0
Total operating expenses	(7,825)	(8,204)	(8,947)	(9,664)
EBITDA	6,834	13,196	12,948	12,701
EBITDA margin (%)	33.1	48.1	43.3	40.3
Depreciation	(544)	(657)	(796)	(913)
EBIT	6,290	12,540	12,152	11,788
Net interest	(185)	(129)	(84)	(50)
Other income	139	242	546	776
Profit before tax	6,244	12,653	12,614	12,514
Total taxation	(1,395)	(2,973)	(2,964)	(2,525)
Tax rate (%)	22.3	23.5	23.5	20.2
Profit after tax	4,849	9,680	9,650	9,989
Minorities	11	13	13	13
Profit/ Loss associate co(s)	-	-	-	-
Adjusted net profit	4,860	9,693	9,664	10,002
Adj. PAT margin (%)	23.5	35.3	32.3	31.8
Net non-recurring items	-	-	-	-
Reported net profit	4,860	9,693	9,664	10,002

Balance sheet (Rs mn)

Y/E March	FY17	FY18E	FY19E	FY20E
Paid-up capital	349	349	349	349
Reserves & surplus	16,144	25,000	33,825	41,222
Net worth	16,493	25,349	34,174	41,571
Borrowing	2,216	3,213	2,089	1,253
Other non-current liabilities	150	150	150	150
Total liabilities	18,900	28,739	36,427	42,975
Gross fixed assets	11,609	15,870	18,370	20,870
Less: Depreciation	(3,279)	(3,936)	(4,732)	(5,644)
Net fixed assets	8,330	11,934	13,638	15,226
Add: Capital WIP	3,363	3,363	3,363	3,363
Total fixed assets	11,693	15,297	17,001	18,589
Total Investment	322	1,072	2,572	5,572
Inventory	3,489	3,969	5,039	5,506
Debtors	4,752	6,314	6,879	7,249
Cash & bank	358	3,521	7,121	8,672
Loans & advances	35	47	51	53
Current liabilities	4,276	4,838	5,893	6,521
Net current assets	6,885	12,370	16,854	18,814
Other non-current assets	-	-	-	-
Total assets	18,900	28,739	36,427	42,975

Source: Company, Axis Capital

Cash flow (Rs mn)

Y/E March	FY17	FY18E	FY19E	FY20E
Profit before tax	6,244	12,653	12,614	12,514
Depreciation & Amortisation	544	657	796	913
Chg in working capital	(2,528)	(2,322)	(884)	(409)
Cash flow from operations	3,458	7,901	9,100	7,998
Capital expenditure	(2,792)	(3,500)	(3,000)	(3,000)
Cash flow from investing	(2,994)	(4,250)	(4,500)	(6,000)
Equity raised/ (repaid)	-	-	-	-
Debt raised/ (repaid)	(142)	997	(1,125)	(835)
Dividend paid	(1,409)	(838)	(838)	(838)
Cash flow from financing	(1,709)	31	(2,046)	(1,723)
Net chg in cash	(1,245)	3,682	2,554	275

Key ratios

Y/E March	FY17	FY18E	FY19E	FY20E
OPERATIONAL				
FDEPS (Rs)	27.9	55.5	55.4	57.3
CEPS (Rs)	31.0	59.3	59.9	62.5
DPS (Rs)	3.0	4.0	4.0	4.0
Dividend payout ratio (%)	10.8	7.2	7.2	7.0
GROWTH				
Net sales (%)	91.2	32.9	8.9	5.4
EBITDA (%)	157.3	93.1	(1.9)	(1.9)
Adj net profit (%)	213.7	99.4	(0.3)	3.5
FDEPS (%)	213.2	99.4	(0.3)	3.5
PERFORMANCE				
RoE (%)	33.0	46.3	32.5	26.4
RoCE (%)	38.9	53.7	39.0	31.6
EFFICIENCY				
Asset turnover (x)	1.3	1.3	1.2	1.1
Sales/ total assets (x)	1.0	1.0	0.8	0.7
Working capital/ sales (x)	0.3	0.3	0.3	0.3
Receivable days	84.0	84.0	84.0	84.0
Inventory days	92.2	101.7	108.5	106.9
Payable days	69.4	67.8	75.5	77.8
FINANCIAL STABILITY				
Total debt/ equity (x)	0.2	0.2	0.1	-
Net debt/ equity (x)	0.1	(0.1)	(0.3)	(0.3)
Current ratio (x)	2.6	3.6	3.9	3.9
Interest cover (x)	34.0	97.6	145.5	235.2
VALUATION				
PE (x)	34.3	17.2	17.2	16.7
EV/ EBITDA (x)	24.6	12.5	12.3	12.1
EV/ Net sales (x)	8.1	6.0	5.3	4.9
PB (x)	10.1	6.6	4.9	4.0
Dividend yield (%)	0.3	0.4	0.4	0.4
Free cash flow yield (%)	-	-	-	-

Source: Company, Axis Capital

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