

Sector Update

Weak Q2 despite favourable currency movement

Pharma

Q2FY2019 results preview

Expect weak operating performance: We expect the pharma sector to report a weak operating performance in Q2FY2019 due to 1) continuing pricing pressure in the U.S. coupled with high base of U.S. generics business; 2) muted domestic business growth on account of high base led by GST-led channel refilling and 3) increased raw-material cost due to supply disruption from China. We expect our pharma coverage universe to report sales growth of 8.3% (growth led by favourable INR movement). Operating profit margin is expected to decline by 0.5 BPS to 22% and profit is expected to decline by 4.6%.

U.S. and domestic businesses to remain muted due to high base: We feel the U.S. generic business will continue to witness pressure due to pricing, led by increased competition on account of faster ANDA approval by the USFDA. Moreover, domestic business is expected to see muted growth due to GST-led channel filling in Q2FY2018 (thus creating a high base). Hence, we expect Q2FY2019 for both these businesses to remain muted. Only solace during the quarter will be favourable INR movement (~9% depreciation during the quarter), which will help some recovery in ROW/EM businesses.

Outlook – Challenges persist but see improving trend:

The sector continues to grapple with challenges given pricing pressure in the U.S. business, stringent USFDA regulations and increased raw-material costs due to supply disruption from China for key APIs. However, there are signs of easing out of pricing pressure in the U.S. Currency movement would help mitigate some of the margin pressure. Thus, we have a Neutral stance on the sector now and see opportunity in some select quality companies.

Valuation: Even after the rally of the past few months, valuation multiples of some of the pharma companies under our coverage are still trading close to long-term average multiples due to de-rating of the past two years. Though the risk of earnings downgrade still persists, given near-term challenges, we see opportunity to invest in select quality companies. Within our coverage universe, we prefer Biocon, Divis and Sun Pharma as investment options.

Preferred Picks in the sector: Biocon, Divis and Sun Pharma

Earnings outperformers in Q2FY2019: Divis and Sun Pharma

Earnings laggards in Q2FY2019: Aurobindo, Cadila, Glenmark, Lupin and Torrent Pharma

Q2FY2019 results estimates

Rs cr

Companies	Net sales				OPM (%)		BPS	BPS	Adjusted PAT			
	Q2FY19E	Q2FY18	YoY %	QoQ %	Q2FY19E	Q2FY18	YoY	QoQ	Q2FY19E	Q2FY18	YoY %	QoQ %
Under coverage												
Aurobindo	4714.0	4436.0	6.3	10.9	18.9	25.2	-631.1	53.9	600.0	780.3	-23.1	14.6
Cadila	3093.0	3234.0	-4.4	8.1	21.8	26.5	-470.7	41.1	386.0	503.0	-23.3	9.0
Cipla	4401.4	4082.4	7.8	11.7	19.4	19.7	-33.7	92.6	450.4	437.2	3.0	15.8
Divis	1068.2	890.2	20.0	7.3	37.3	31.1	616.7	195.0	272.5	195.8	39.2	13.9
Glenmark	2372.4	2256.6	5.1	9.5	16.7	17.2	-48.2	71.1	167.0	214.0	-22.0	24.3
Lupin	3969.0	3952.0	0.4	2.9	14.8	21.6	-682.5	109.5	299.0	453.0	-34.0	47.7
Sun Pharma	7560.0	6650.0	13.7	4.7	22.6	20.7	190.8	35.3	1100.1	1001.7	9.8	12.1
Torrent Pharma	1884.8	1429.0	31.9	0.7	24.8	23.0	174.9	-70.9	166.5	204.0	-18.4	2.1
Total - A	29062.8	26930.2	7.9	7.0	20.5	22.3	-173.7	57.1	3441.5	3789.0	-9.2	15.2
Under soft coverage												
Biocon	1154.0	968.6	19.1	2.7	21.4	18.8	255.0	6.7	123.0	89.0	38.2	2.5
Dr Reddy's Lab	3750.0	3559.8	5.3	0.4	18.5	18.8	-26.6	-203.7	356.1	296.2	20.2	-23.9
Laurus Labs	592.5	539.0	9.9	9.9	15.7	20.8	-504.9	86.9	24.5	48.4	-49.4	55.1
Natco	512.0	426.7	20.0	-4.9	38.0	28.4	967.0	-237.4	150.0	84.0	78.6	-17.8
Suven	172.5	115.5	49.4	-10.0	35.9	37.8	-187.6	128.3	37.1	26.6	39.6	-4.6
Total - B	6181.0	5609.6	10.2	0.8	23.4	21.7	172.6	-149.1	690.7	544.2	26.9	-16.3
Grand Total (A+B)	35243.8	32539.8	8.3	5.9	22.0	22.0	-0.5	18.9	4132.2	4333.1	-4.6	8.4

Valuation

Companies	CMP (Rs)	Reco	EPS (Rs)			P/E (X)			Price target (Rs)
			FY18	FY19E	FY20E	FY18	FY19E	FY20E	
Aurobindo	744	Buy	41.6	54.4	74.5	17.9	13.7	10.0	895
Cadila	377	Buy	17.3	18.9	24.8	21.7	19.9	15.2	450
Cipla	639	Buy	17.6	24.5	34.7	36.3	26.1	18.4	720
Divis	1273	Buy	33.0	46.0	58.8	38.5	27.7	21.7	1670
Glenmark	585	Hold	26.2	33.1	44.2	22.4	17.7	13.2	780
Lupin	839	Reduce	32.5	32.7	40.1	25.8	25.7	20.9	UR
Sun Pharma	598	Buy	13.0	19.4	28.6	46.1	30.9	20.9	765
Torrent Pharma	1595	Buy	42.8	64.5	86.6	37.2	24.7	18.4	2000

Key expectations in Q2FY2019 results

Companies	Expectation
Aurobindo	New launches and currency depreciation to aid sales, but y-o-y decline in operating profit and net profit is due to high base from gRenvela sales in Q2FY2018 and increased raw-material (RM) cost.
Cadila	Weak y-o-y performance is mainly due to high base on account of gLialda. However, we shall see q-o-q improvement led by new launches such as own Asacol HD, gToprol and favourable currency.
Cipla	Domestic business to remain flat due to high base in Q2FY2018; U.S. business to remain under pressure despite new launches due to product rationalisation; Margins to remain under pressure due to increased RM cost.
Divis	Recovery in overall profitability led by reduction in remediation expenses after clearance of Vizag Unit-2.
Glenmark	Lack of new launches in the U.S.; high base in domestic business coupled with increased RM cost to impact overall performance.
Lupin	Competition in its exclusive products (gGlumetza and gFortamet) and lack of new launches will impact the U.S. business; Domestic business will be muted due to high base; increased RM cost to impact operating margin and profitability.
Sun Pharma	Stable performance in the U.S. and currency to support earnings growth; Operating performance to improve due to improving U.S. sales and no remediation costs.
Torrent Pharma	Unichem acquisition to aid sales growth, however high interest cost due to acquisition-related debt and high depreciation cost to dent profitability.
Biocon	Ramp up in biologic sales and strong contract research growth will help earnings growth and improve operating performance.
Dr Reddy's Lab	Sales growth can mainly be attributed to favourable currency; domestic and U.S. business to remain flat; low tax outflow to drive profit growth.
Laurus Labs	Though favourable currency will aid sales growth, increased RM cost will affect operating performance adversely.
Natco	Copaxone profit sharing to start reflecting from the current quarter, leading to overall strong performance along with regular business.
Suven	Core CRAMS and speciality business coupled with repeat orders to result in a strong quarter.

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