

Sector: Pharmaceuticals
Result Update

	Change
Reco: Hold	↔
CMP: Rs. 532	
Price Target: Rs. 575	↑

↑ Upgrade ↔ No change ↓ Downgrade

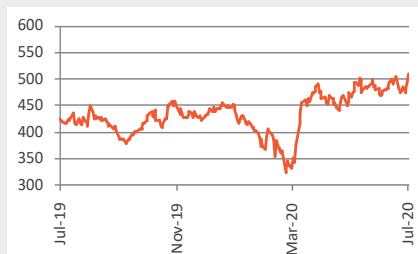
Company details

Market cap:	Rs. 127,581 cr
52-week high/low:	Rs. 541 / 315
NSE volume: (No of shares)	113 lakh
BSE code:	524715
NSE code:	SUNPHARMA
Sharekhan code:	SUNPHARMA
Free float: (No of shares)	109.0 cr

Shareholding (%)

Promoters	54.6
FII	14.3
DII	19.1
Others	12.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	13.6	14.4	22.5	25.1
Relative to Sensex	5.9	2.9	30.2	24.8

Sharekhan Research, Bloomberg

Sun Pharmaceuticals Industries Limited (Sun Pharma) reported a healthy performance for Q1FY2021. Revenue for the quarter stood at Rs. 7,585 crore and is down 9.4% y-o-y. The decline can largely be attributed to a drop in overall exports business, while India revenue increased by 3.2% y-o-y, aided by strong growth in chronic therapies. The bulk drug/API business revenue at Rs. 553.7 croresurgedby 20% y-o-y. Operating profit margin (OPM) for the quarter stood at 23.3%, almost flat y-o-y, but was ahead of estimates. Higher staff cost almost offset the benefits of 340 bps y-o-y expansion in gross margin and lower other expenses. Operating profit for the quarter declined by 8.5% y-o-y. Sun Pharma reported a one-time expense of Rs. 3,633 crore towards provision for settlement of all multi-year investigations towards subsidiary company, Taro Pharmaceuticals, in the US. Adjusted PAT after minority interest stood at Rs. 1,898 crore, up 43% y-o-y, ahead of estimates. The US business is witnessing increased competitive pressures, leading to sustained price erosion. Moreover, two of the company's brands in US are confronting severe demand challenges, as these medicines are given under medical supervision; and in light of COVID-19 pandemic, patient footfalls have dropped. Management expects demand to revive gradually. On the other hand, the domestic business is expected to grow at a healthy pace, backed by new launches and growth in the chronic portfolio, which has sticky demand. Given near-term uncertainties, growth prospects could be impacted. With the remedial process at Halol plant complete, USFDA approval for the plant would be a key monitorable aspect along with pickup in US specialty business.

Key positives

- Domestic formulations business grew by 3.2% y-o-y for Q1FY2021, as compared to industry-wide drop of 6%.
- Gross margin expanded by 340 bps y-o-y, aided by better product mix.

Key negatives

- US business revenue at Rs. 2,136.4 crore declined by 27.5% y-o-y, marred by sustained competitive pressures.
- Other expenses were lower in Q1FY2021 and management has stated that savings in other expenses would not be sustained going ahead as the marketing activity picks up with easing of the lockdown. Therefore, operating expenses could rise.
- Management is eyeing higher R&D spends going ahead, which could impact profitability.

Our Call

Valuation - Maintain Hold with a revised PT of Rs. 575: Sun Pharma is confronting issues in US markets pertaining to pricing erosion, which management believes would sustain at least in the near to medium term. This coupled with slow pace of the US specialty business and higher specialty promotional spends is likely to have its impact on the company's performance. Further, the US business is languishing on account of lack of new product launches. USFDA clearance of Halol plant is yet to come. Domestic formulations business is likely to witness steady growth, driven by chronic therapy demand. During the global crisis triggered by COVID-19, pharmaceutical companies have emerged strongly as they offer visibility for earnings growth and, hence, have been in flavor. Consequently, the multiples have been re-rated. Sun Pharma has reported a healthy performance for the quarter; and based on this, we have fine-tuned our earnings estimates for FY2021/FY2022 and have moderately increased our target multiples. However, uncertainties persisting around the US business and India business (acute therapy) could impact the growth prospects. Consequently, we hold back from taking a constructive view on the company and retain our Hold recommendation with a revised PT of Rs. 575.

Key Risks

- Regulatory compliance risk including delay in product approvals.
- Currency risk.
- Negative outcome of ongoing litigations in the US with regards to price collusion.

Valuation (Consolidated)

Particulars	FY2018	FY2019	FY2020	FY2021E	FY2022E
Net sales	26605.8	29065.9	32837.5	36162.7	39234.8
Operating profit	5724.4	6307.6	6989.8	8208.9	9141.7
OPM(%)	21.5%	21.7%	21.3%	22.7%	23.3%
Adj. PAT	3228.4	3879.8	4025.6	5182.3	6254.7
EPS (Rs.)	13.5	16.2	16.8	21.6	26.1
PER (x)	39.5	32.9	31.7	24.6	20.4
EV/EBIDTA(x)	22.5	20.8	18.6	15.4	13.2
ROCE (%)	9.5	10.0	9.6	12.0	12.2
RONW (%)	8.4	9.4	8.9	11.2	12.0

Source: Company; Sharekhan estimates

Healthy operating performance: Sun Pharma reported decent performance for the quarter. Revenue at Rs. 7,585 cr declined by 9.4% y-o-y because of a 15% decline in exports revenue due to continued weakness in the US business. Revenue from the domestic business grew by 3.2% y-o-y, which partly offset the decline in exports revenue. Operating profit stood at Rs. 1,764 crore, down 8.5% y-o-y. Operating profit margin (OPM) at 23.3% was almost flat y-o-y. A 340 bps increase in gross margin (attributable to better product mix) and lower other expenses (due to reduced marketing and travelling expense) were partly offset by increased employee cost. OPM was higher than estimates. During the quarter, the company reported a one-time exceptional expense of Rs. 3,633 crore towards provision for settlement of all multi-year investigations at the Department of Justice by subsidiary company, Taro Pharmaceuticals. Adjusted PAT after minority interest at Rs. 1,898 crore increased by 43% y-o-y, ahead of estimates. PAT before minority interest and share of profit came in Rs. 1,124.7 crore.

Sustained pricing pressures in the US business; Slower pick-up in specialty business to impact US business growth: Sun Pharma's US business has recorded a decline of 27.5% y-o-y for the quarter to Rs. 2,136 crore. The US generic business is witnessing heightened competitive pressures in the form of sustained price erosion. Management has stated that it does not see pricing pressures abating, at least in the near term or until the COVID-19 impact subsides. As the company has a strong product pipeline/ANDAs filed or awaiting approvals, sustained competitive pressures do not augur well and point at growth challenges. The specialty business in US markets, which consists of products such as Ilumya and Cequa, was progressing well and had attained traction during pre-COVID times. However, due to COVID-19 pandemic, demand has been severely hit as these medicines are given under medical administration and patients' footfalls have dropped, leading to a drop in the quantum of prescription. Sun Pharma sees this as a phenomenon under the COVID-19 pandemic and expects demand to revive gradually as the situation improves. Consequently, with the base business under pressure, due to the continued price erosion and slow progress of the specialty business, Sun Pharma's US business is expected to be under stress and points towards sustained uncertainties around growth prospects.

Domestic formulations to drive growth, albeit over the long term: Sun Pharma's India formulations business continued its growth trajectory in uncertain times as well. The segment reported revenue of Rs. 2,388 crore for Q1FY2021, translating into 3.2% y-o-y growth. The India business is equally split between chronic and acute segments. Strong growth in the chronic segment led to revenue growth in Indian operations. The acute segment's sales were severely impacted due to low prescriptions. However, with few doctors resuming clinics in select areas, the prescriptions might resume, but they are expected to be below the historic run rate as patient footfalls are likely to be quiet low. Management has indicated that this would be a short-lived phenomenon as demand would pick up once elective surgeries commence and doctors across the nation resume clinics. Moreover, Sun Pharma has launched 10 new products in the Indian markets in Q1FY2021 and has plans to launch few more products during the remainder of the year. Management sees the domestic formulations business to grow strongly, albeit over the medium to long term. The company has increased its field force during the previous quarter with an objective to expand its reach and deepen its penetration. Collectively, these factors would drive growth in the domestic business.

Q1FY2021 Conference Call Highlights:

- ♦ Sun Pharma's branded formulations business in India recorded revenue of Rs. 2,388 crore for Q1FY2021, up 3% y-o-y and accounted for 32% of sales.
- ♦ Sun Pharma's market share in India stood at 8.2% as of Q1FY2021, as per AIOCD AWACS MAT June 2020 report. The company has launched 10 new products in the Indian market during the quarter.
- ♦ US business sales (including Taro) stood at Rs. 2,136 crore, registering a decline by 27.5% y-o-y for Q1FY2020. The numbers are not comparable as the corresponding quarter reflected a one-time contribution from a special business.
- ♦ Revenue of emerging markets stood at Rs. 1,316 crore, down 2.4% y-o-y. Sales across all regions in the emerging market were weak.
- ♦ Revenue from Rest of the World (ROW) markets stood at Rs. 1,030 crore, down 11% y-o-y, primarily due to a drop in the tender business in the South African markets.

- ◆ Revenue from the API business stood at Rs. 553.7 crore, up sharply by 20% y-o-y. Management has mentioned that it would evaluate performance-linked incentive schemes provided by the Government of India for expanding the API business.
- ◆ R&D spends during the quarter stood at Rs. 421crore, 5.6% of sales. This compares with Rs. 422crore in the corresponding quarter, translating to around 5.1% of sales. Other expenses for the quarter have declined by 170 bps due to savings in marketing, selling, and travelling expenses. Management expects costs to normalise as the situation improves.
- ◆ Sun Pharma has commenced clinical trials of two COVID-19 products for India. It will possibly announce the results of the two studies after two quarters.
- ◆ Sun Pharma has a strong product pipeline in US markets in the generic space with 95 ANDAs awaiting approval from USFDA (including 20 ANDAs with tentative approvals). In Q1FY2021, the company filed 7 ANDAs and received approvals for 8 ANDAs. In addition to this, the company has 55 approved NDAs and 6 NDAs are awaiting USFDA approval.
- ◆ Sun Pharma's Halol plant is classified as Official Action Indicated (OAI) by the USFDA and, consequently, new approvals have been stopped from the plant. Management has done the remediation process and has submitted the responses to the USFDA. A revert from the regulator is awaited.

Results

					Rs cr
Particulars	Q1FY2021	Q1FY2020	YoY %	Q4FY2020	QoQ %
Total sales	7,585.3	8,374.4	-9.4	8,184.9	-7.3
Operating profit	1,764.7	1,928.2	-8.5	1,505.1	17.2
Other Income	153.8	213.0	-27.8	102.2	50.4
EBITDA	1,918.4	2,141.3	-10.4	1,607.3	19.4
Interest	52.0	104.1	-50.1	51.8	0.3
Depreciation	495.9	457.1	8.5	575.4	-13.8
PBT	1,370.6	1,580.1	-13.3	980.2	39.8
Taxes	245.9	146.1	68.4	83.1	196.0
Adjusted PAT (after minority interest)	1,898.9	1,324.8	43.3	802.6	136.6
Exceptional expense	3,554.1	0.0	-	402.7	782.6
Reported PAT	-1,655.3	1,324.8	-224.9	399.9	-513.9
Margin			BPS		BPS
OPM %	23.3	23.0	24	18.4	488

Source: Company; Sharekhan Research

Revenue Mix

					Rs cr
Particulars	Q1FY2021	Q1FY2020	YoY %	Q4FY2020	QoQ %
Formulations	6870.9	7768.8	-11.6	7552.9	-9.0
India	2388.4	2313.7	3.2	2364.8	1.0
US	2136.4	2947.4	-27.5	2712.9	-21.2
Emerging Market	1316.1	1348.6	-2.4	1354.0	-2.8
ROW	1030.0	1159.1	-11.1	1121.2	-8.1
API	553.7	461.2	20.1	483.4	14.5
Others	42.6	29.3	45.2	41.7	2.0
Total	7467.2	8259.3	-9.6	8078.0	-7.6
Other Op Inc	118.1	115.1	2.6	106.9	10.5
Total Sales	7585.3	8374.4	-9.4	8184.9	-7.3

Source: Company; Sharekhan Research

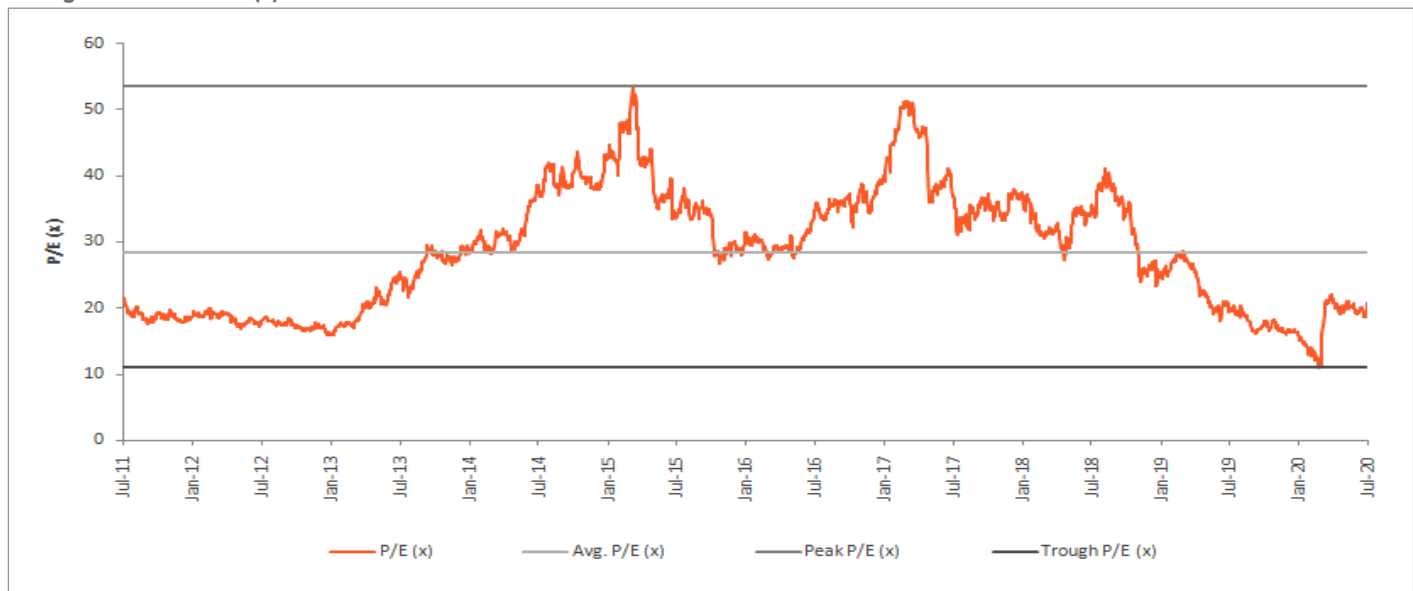
Outlook

Sun Pharma is a leading pharmaceutical company with a global presence. The company manufactures medicines covering a broad spectrum of chronic and acute therapies, which include generics, branded generics, and complex drugs. India and US are the key markets for the company and constitute around 60% of the total topline. Sun Pharma is witnessing sustained competitive pressures in the US markets, which are unlikely to abate in the near to medium term. Moreover, due to COVID-19 related disruptions, traction in the US specialty business is likely to be impacted, though it would recover gradually as the situation improves with the relaxation of the lockdown. Collectively, these point at persisting uncertainties in the US business. Domestic formulations is on a strong footing as the chronic portfolio (50% of India sales) has reported healthy growth. The acute portion of the portfolio has been impacted by COVID-19 related issues, leading to lower demand in the immediate future. However, management sees the domestic formulations business to bounce back over the medium to long term, backed by new launches and gradual improvement. Collectively, with uncertainties persisting around the growth prospects in the US and India businesses, we refrain from taking a constructive view on the stock. We expect Sun Pharma's topline/PAT to report a CAGR of 9%/24% over FY2020-FY2022.

Valuation

Maintain Hold with a revised PT of Rs. 575: Sun Pharma is confronting issues in the US relating to pricing erosion, which management believes would sustain at least in the near to medium term. This coupled with the slow pace of the US specialty business and higher specialty promotional spends is likely to have its impact on the company's performance. Further, the US business is languishing on account of lack of new product launches, as the USFDA's clearance of Halol plant is yet to come. Domestic formulations business is likely to witness steady growth, driven by chronic therapy demand. Amidst the global crisis triggered by COVID-19, pharmaceutical companies have emerged strongly, as they offer visibility for earnings growth and, hence, have been in flavour. Consequently, the multiples have been re-rated. Sun Pharma has reported a healthy performance for Q1FY2021; and based on this, we have fine-tuned our earnings estimates for FY2021/FY2022 and have moderately increased our target multiples. However, uncertainties persisting around the US business and India business (acute therapy) could impact the growth prospects. Consequently, we hold back from taking a constructive view on the company and retain our Hold recommendation on the stock with a revised PT of Rs. 575.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E			EV / EBITDA			RoE (%)		
				FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
Sun Pharma	532.0	239.9	127,581.0	31.7	24.6	20.4	18.6	15.4	13.2	8.9	11.2	12.0
AurobindoPharma	875.0	58.6	51,243.0	17.6	16.6	15.7	11.1	9.9	8.6	19.0	16.9	15.4

Source: Company, Sharekhan estimates

About company

Sun Pharma is the fourth largest specialty generic pharmaceutical company in the world. Founded in 1983, Sun Pharma has grown to become India's largest pharmaceutical company with global revenue of over \$4 billion. The company manufactures and markets a large basket of pharmaceutical formulations, covering a broad spectrum of chronic and acute therapies, which includes generics, branded generics, complex or difficult-to-make technology intensive products, over-the-counter (OTC) products, anti-retroviral (ARVs), active pharmaceutical ingredients (APIs), and intermediates. The company's global presence is supported by over 40 manufacturing facilities. India and the US are predominant markets, accounting for nearly 65% of revenue.

Investment theme

Sun Pharma's performance in the recent past has been under stress on account of competitive pressures in the US (especially in core business and key products) and higher research/marketing expenditure on the US specialty business. Moreover, lack of a major product approval for the US generic market led to significant erosion in earnings. Sun Pharmastill faces pending litigation case in the US for pricing collusion. This coupled with higher specialty promotional spends and increased R&D spends is likely to pose challenges to earnings growth. We feel FY2020 will reflect full impact of increased cost structure (on account of specialty pipeline build-up). Moreover, lack of new product launches in the US would restrict growth.

Key Risks

1) Regulatory compliance risk; 2) Delay in product approvals; 3) Currency risk; 4) Worsening of corporate governance issues; and 5) Negative outcome of ongoing litigations in the US with regards to price collusion.

Additional Data

Key management personnel

Israel Makov	Chairman
Dilip S. Shanghvi	Managing Director
Sudhir V. Valia	Whole-time Director
Abhay Gandhi	CEO, North America
C. S. Muralidharan	Chief Financial Officer
S. Kalyanasundaram	Head - India and Emerging Markets

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	5.88
2	ICICI Prudential Asset Management	3.22
3	Vanguard Group Plc	1.62
4	Reliance Capital Trustee Co Ltd	1.46
5	SBI Funds Management Pvt Ltd	1.06
6	Lakshdeep Investments and Finance	1.31
7	Republic of Singapore	1.29
8	BlackRock Inc	1.01
9	Norges Bank	0.91
10	Aditya Birla Sunlife Asset Management Co	0.74

Source: Bloomberg

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