Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Aurobindo Pharma Ltd

Weak Q3; improved outlook

Pharmaceuticals	Sharekhan code: AUROPHARMA
Reco/View: **Buy** ↔	CMP: **Rs. 685** | Price Target: **Rs. 875** ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING	35.76
Updated Oct 08, 2021	

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

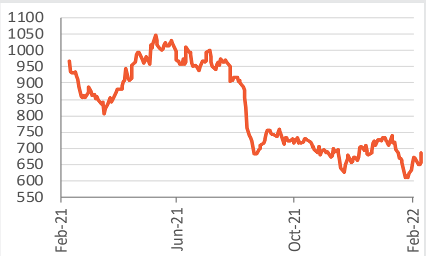
Company details

Market cap:	Rs. 40,125 cr
52-week high/low:	Rs. 1,064 / 590
NSE volume: (No of shares)	31.9 lakh
BSE code:	524804
NSE code:	AUROPHARMA
Free float: (No of shares)	28.2 cr

Shareholding (%)

Promoters	51.8
FII	25.4
DII	12.6
Others	10.19

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-7.2	-2.1	-22.1	-29.2
Relative to Sensex	-4.7	0.2	-30.1	-44.1

Sharekhan Research, Bloomberg

Summary

- Aurobindo Pharma clocked weak numbers for Q3FY22 that missed estimates due to sustained high cost pressures.
- Over the long term, a sturdy product pipeline in the US, focus on growing injectables business and building a strong portfolio of specialty products including biosimilars would be the key growth drivers.
- Aurobindo is eyeing a foray in the domestic markets as well and is targeting revenues of RS 1000 cr over the first three years
- A possible de-merger of the injectables business could provide value unlocking opportunities. Hence, we retain a Buy recommendation with unchanged PT of Rs. 875.

Aurobindo Pharma (Aurobindo) clocked weak numbers for Q3FY22 that missed estimates due to sustained high cost pressures. The numbers are not comparable due to divesture of the Natrol business. Consolidated revenues declined by 5.7% y-o-y to Rs. 6,002 crore, backed by a 13.4% dip in US formulations, while the Europe sales rose by 1.4%. API sales were up 48% y-o-y due to a strong demand for few products. A 530 bps y-o-y fall in gross margins resulted in a 460 bps y-o-y dip in OPM. Adjusted PAT at Rs. 596 crore declined by 31.9% y-o-y. The management has shared a healthy outlook for the US as well as European business and expects the trend to stabilise over the next two quarters. Over the long term, a sturdy product pipeline in the US, focus on growing injectables business and building a strong portfolio of specialty products including biosimilars would be the key growth drivers.

Key positives

- API sales surged by 48% y-o-y backed by a sturdy 77% growth in Betalactum products.
- Aurobindo aims to enter the domestic formulations markets and targets Rs. 1,000 crore in revenues over the next three years.

Key negatives

- Sales of anti-retrovirals declined by 65% y-o-y due to higher stocking in past quarters.
- Delays for regulatory inspections / clearance

Management Commentary

- The outlook for US sales (constituting ~50% of sales) is healthy and the management expects the concerns around pricing pressures, higher channel inventories to abate gradually over the next 1-2 quarters. The company has filed for 10 ANDAs and a 505-B-2 NDA with the USFDA and has launched seven products including four injectables.
- The management has retained its guidance of achieving $650-700 million of sales from the injectables over the next 3 years backed by a strong product pipeline.
- Management expects the demand trends across markets to improve hereon, while the cost pressures too are expected to ease out. Thus it expects Q3FY22 performance to bottom out and see stabilization over the next 1-2 quarters.

Revision in estimates – Q3FY22 results were weak and below estimates and factoring in this we have marginally cut our estimates for FY23E/FY24E by around 5% each.

Our Call

Valuation – Maintain Buy with unchanged PT of Rs. 875: The management has shared a healthy growth outlook across business and sees the Q3 earnings to bottom out, expecting stabilization in the subsequent quarters. Substantial new product fillings in 2HFY23 would accelerate the growth momentum in FY24. In the long term, a sturdy product pipeline in the US, focus on growing the injectables business and building a strong portfolio of specialty products including biosimilars would be key growth drivers. At CMP, the stock is trading at a valuation of 13.6x/10.9x/ 9.5x its FY22E/FY23E/FY24E EPS, which is attractive and provides comfort. A possible de-merger of the injectables business could provide value unlocking opportunities. Hence we retain a Buy recommendation with unchanged PT of Rs. 875.

Key Risks

Delay in resolution of USFDA issues and product approvals; change in regulatory landscape; and negative outcome of key facility inspection by USFDA can affect earnings prospects.

Valuation (Consolidated) Rs cr

Particulars	FY2021	FY2022E	FY2023E	FY2024E
Total Income	24774.6	24251.7	26670.6	29052.8
Operating profits	5333.4	4874.6	5867.5	6624.0
OPM (%)	21.5	20.1	22.0	22.8
Adj. PAT	2474	2943	3670	4210
EPS (Rs.)	42.2	50.2	62.6	71.8
PER (x)	16.2	13.6	10.9	9.5
EV/Ebidta (x)	7.2	7.3	5.3	4.1
ROCE (%)	18.6	14.8	17.4	18.0
RONW (%)	12.8	12.6	13.9	14.0

Source: Company; Sharekhan estimates

Weak Quarter; operating profits miss estimates due to higher costs: Aurobindo reported a weak performance for the quarter and the results are below the estimates due to a lower-than-estimated operating performance. The numbers are not comparable due to the divesture of Natrol business. Consolidated revenues at Rs. 6,002 crore declined by 5.7% y-o-y and were marginally below estimates. While US sales declined by 13.4% y-o-y while the Europe sales were flat reporting a 1.4% y-o-y increase ARV sales declined by 65% y-o-y. The operating profits at Rs. 1016 crore declined by 25.7% y-o-y, lagging estimates. OPM at 16.9% contracted by 460 bps y-o-y. The contraction in the gross margins to the tune of 530 bps y-o-y led to OPM contraction. Higher prices for some of the key raw materials and other costs impacted the margins, which were below the estimates. Aurobindo reported a onetime exceptional income amounting to over Rs. 34.79 crore, which includes Rs. 115.67 crore towards sales and lease-back of group real estate assets while Rs. 80.88 crore went towards the impairment charge. Adjusting for the one offs and tracking the operating performance, the PAT for the quarter at Rs. 569.5 crore declined by 31.9% y-o-y and missed estimates.

Q3FY2022 Conference call highlights

- **US sales decline in double digits; management expects gradual improvement:** The US accounts for around half of the company's overall revenues of the Aurobindo. US sales for Q3FY2022 have dropped by 13.5% y-o-y to Rs. 2745 crore, while sequentially as well the sales declined by 7.5%. A combination of factors which include price erosion, higher channel stocks in generics and higher input costs affected the overall US performance. Going ahead the management expects price erosion to stabilise in subsequent quarters as the channel inventories are likely to normalize at the industry levels, in the next 1-2 quarters. Also Aurobindo expects some easing of costs in the coming quarters. While the new launch, the momentum is currently slower, but going ahead the management sees this improving and this could enable the company to offset the impact of price erosion (which stood at 9% for the (9mFY22). Overall Aurobindo's US business is expected to bottom out and stabilise over the next 1-2 quarters. Post the 2HFy23 the company has planned to a strong product launch pipeline, which would yield benefits in FY2024, which is likely to be a year of strong growth for US business.

- **Europe business to remain soft in the near term, material growth likely in FY24:** The EU formulations revenues were almost flat growing 1.4% y-o-y to Rs. 1694 crore. Europe revenues have been stagnating over the past 2 quarters in absolute terms. The management expects uncertainties to stay in the Europe business over the next few quarters and sees FY2024 to be a year of substantial growth, which is likely to be driven by new product launches and better geographic penetration. Also the biosimilars portfolio is expected to add to Europe sales growth. The company is constructing a new plant at Vizag for Biosimilars for Europe and expects filings to start in end of FY23, with likely launches in FY24.

- **Strong product pipeline for the US:** in Q3FY22 Aurobindo has received approvals for 4 ANDA's including one injectable product. It has filed 10 ANDAs including three Injectables with the USFDA in Q3FY22 and another 505(b) (2) NDA was also filed. During the Q3FY22, the company has launched 7 new products including four injectables in the US markets. As of Q3FY22 on a cumulative basis, the company has filed 719 ANDAs with USFDA and received approval for 524 ANDAs including 30 tentative approvals. Collectively, a strong overall new product pipeline bodes well as it could drive the revenue growth and also help offset the pricing erosion in the US generics.

- **Specialty basket – Injectables & biosimilars to gain traction gradually:** Aurobindo has set its eyes on the high-margins injectables business and sees it as one of the key growth levers. For Q3FY22, revenues from injectables, though were down 7% y-o-y to $63 million, the management sees the traction improving. The company has built a strong presence in injectables across various therapy areas including oncology and various delivery systems such as liquid & lyophilised vials, bag, ampoules and pre filled syringes and has a strong manufacturing and execution capabilities as well. In addition, the company has a sturdy pipeline in the injectables in the US and expects to launch 10-15 new products in the injectables space in FY23, which would ramp up in FY24. The global injectables sales for the quarter stand at ~ $100 million and Aurobindo has retained its guidance and expects to achieve a turnover of ~$650-700 million in the next three years by FY2024 from the injectables. In addition to injectables, the company is actively scaling up its capabilities in the biosimilars as well. It has recently filed its second biosimilar product in oncology space in the Europe markets and has three more in the development pipeline. In the long term, injectables and Biosimilars could be the key growth drivers for Aurobindo.

- **Foray into Indian formulations markets:** Aurobindo is now looking to enter the domestic formulations markets by extending its product portfolio in India. Though the timelines for the foray are not yet disclosed by the management, but it is targeting revenues of Rs. 1000 crore over the first three years of the foray
- **Anti-retroviral (ARV):** The revenues from the segment declined sharply by 65% y-o-y to Rs. 155 crore attributable to the higher stocking on advanced procurement in previous year due to possibilities of COVID-19 led uncertainties. However the revenues have staged a sequential improvement of 7% and the management sees the trends to improve in the coming quarters.
- **Regulatory updates:** Aurobindo's three plants are currently under the USFDA audits. Unit -1 which was re-inspected and was issued a warning letter. The Company's US plant, which is a fairly small plant is also undergoing a re-inspection and the management expects a warning letter to be issued. But being an old plant the company has initiated a transfer of assets from that plant. Also, Plant 5, which is the Steriles API plant is undergoing an audit and the outcome of the inspection is awaited. For the balance plants the company is under discussion with the USFDA. Also, all plants of Eugia (an injectables and specialty business) are due for an inspection.

Result Consolidated Rs cr

Particulars	Q3FY2022	Q3FY2021	y-o-y %	Q2FY2022	QoQ%
Total Income	6002.2	6364.9	-5.7	5941.9	1.0%
Operating profit	1016.3	1368.6	-25.7	1186.7	-14.4%
Other income	45.2	72.8	-37.9	94.7	-52.2%
EBIDTA	1061.5	1441.4	-26.4	1281.4	-17.2%
Interest	16.1	19.5	-17.2	10.4	54.8%
Depreciation	299.1	276.5	8.1	294.2	1.6%
PBT	746.3	1145.4	-34.8	976.8	-23.6%
Tax	189.5	355.1	-46.6	270.9	-30.1%
Adjusted PAT	569.5	836.3	-31.9	696.7	-18.3%
Reported PAT	604.3	3650.1	-83.4	696.7	-13.3%
Adj. EPS (Rs.)	9.8	14.3	-31.9	11.9	-18.3%
Margins			**bps**		**bps**
OPM (%)	16.9	21.5	-457	20.0	-304
Adj PAT margin (%)	9.5	13.1	-365	11.7	-224
Tax rate (%)	25.4	31.0	-561	27.7	-235

Source: Company; Sharekhan Research

Revenue mix Rs cr

Particulars	Q3FY2022	Q3FY2021	y-o-y %	Q2FY2022	QoQ%
USA	2745.2	3171.6	(13.4)	2967.6	(7.5)
Europe	1694.3	1671.2	1.4	1662.3	1.9
Growth Markets	397.0	396.2	0.2	386.3	2.8
ARV	155.7	443.4	(64.9)	145.0	7.4
Formulations	**4992.2**	**5682.4**	**(12.1)**	**5161.2**	**(3.3)**
Betalactum	683.8	386.8	76.8	420.8	62.5
Non Betalactum	326.2	295.6	10.4	359.8	(9.3)
API	**1010.0**	**682.4**	**48.0**	**780.6**	**29.4**
Gross Sales	**6002.2**	**6364.8**	**(5.7)**	**5941.8**	**1.0**
Dossier Income	0.0	0.6	-	0.0	-
Net Sales	**6002.2**	**6365.4**	**(5.7)**	**5941.8**	**1.0**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector outlook – Improved growth prospects

Indian pharmaceutical companies are better-placed to harness opportunities and clock a healthy growth going ahead. Indian companies are among the most competitive ones globally and hold a sizeable market share in most developed as well as other markets. Moreover, other factors such as easing of pricing pressures (especially in the US generics market), rise in product approvals and plant resolutions by the USFDA coupled with strong growth prospects in domestic markets and emerging opportunities in the API space would be the key growth drivers. This would be complemented by the strong capabilities developed by Indian companies (leading to a shift towards complex molecules, biosimilars) and the commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for pharma companies.

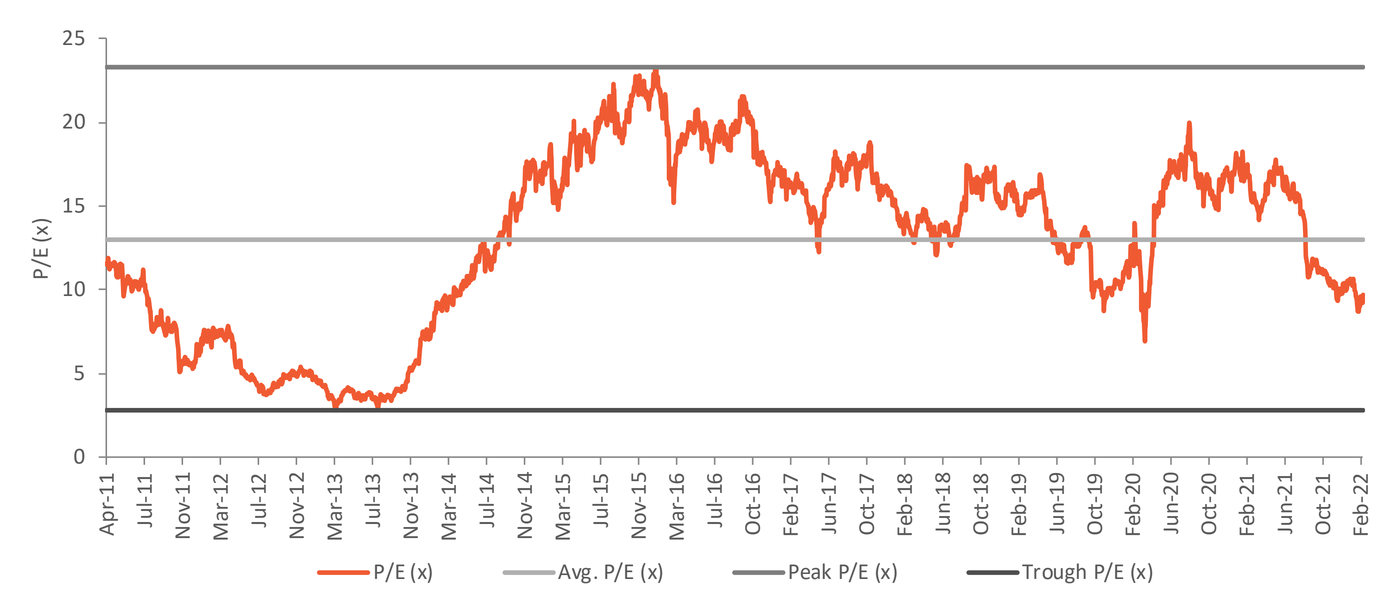
■ Company outlook – Uncertainties likely to abate, though gradually

Over the long term a healthy growth outlook exists for the US business driven by an improving traction from the generic Injectables space (with comparatively low competition), a sturdy product pipeline and expected traction in the recently launched products. However, headwinds are there for US business in the form of price erosion and inventory buildup across channels in the industry, which the management expects to ease out gradually in subsequent quarters. While the strong product pipeline planned for the US could enable partly mitigation of price erosion, the higher channel stocks are likely to pressurize the topline growth until the stocks normalize. The European business has a healthy growth outlook backed by product portfolio expansion and expanding geographic reach, however some moderation in growth is expected and FY24 is expected to post a strong growth backed by product portfolio expansion and tapping new geographies. However, Aurobindo is awaiting USFDA clearance for its plants, of which three are undergoing the inspection now. A successful resolution of USFDA observations would be a key monitor able and a trigger for earnings upgrade. Over the long term, Aurobindo is looking to build a presence in the specialty segment which includes areas of injectables, biosimilars, oncology inhalers, transdermal patches amongst others which is likely to support growth. Also a possible demerger of injectables business could provide value unlocking opportunity.

■ Valuation – Maintain Buy with unchanged PT of Rs. 875

Q3FY22 results have been weak PAT declined in double digits due to elevated cost pressures. Going ahead, the management sees this quarter as a possible bottoming out and aims to stabilise the performance in the coming 1-2 quarters, post which a strong growth is expected. Headwinds in the US business in the form of price erosion, higher channel stocks are likely to ease off and product launch momentum is also expected to pick up over FY23-FY24. The European sales though are stagnating in absolute terms, but the company expects to file two biosimilars in FY23 for Europe and this coupled with product portfolio expansion would drive the European sales growth. Aurobindo has also expressed its plans to enter the domestic markets and has targeted a revenue of Rs. 1000 crore over the first three years, though the timelines for the foray are not yet disclosed. On the cost pressures the management expects the same to ease out over the next 2 quarters. Aurobindo's Q3FY22 results were weak and below estimates and factoring in this we have marginally cut our estimates for FY23E/FY24E by ~5% each. At CMP, the stock is trading at a valuation of 13.6x/10.9x/ 9.5x its FY22E/FY23E/FY24E EPS, which is attractive and provides comfort. A possible de-merger of the injectables business could provide value unlocking opportunities, while a healthy commentary bodes well. Hence we retain our Buy recommendation on the stock with an unchanged PT of Rs. 875.

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 (x)			EV/EBITDA (x)			RoE (%)		
				FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
AurobindoPharma	685.0	58.6	40,125.0	13.6	10.9	9.5	7.3	5.3	4.1	12.6	13.9	14.0
Lupin	807.0	45.2	36,664.0	30.1	27.4	22.9	15.9	12.6	10.2	8.8	9.0	9.9
Dr Reddy's	4,374.0	16.6	72,790.0	37.2	26.4	19.5	14.7	13.7	10.7	11.1	14.4	17.5

Source: Company, Sharekhan estimates

About the company

Hyderabad-based Aurobindo was incorporated in 1986 and manufactures generic formulations and active pharmaceutical ingredients (APIs). Aurobindo generates 90% of its sales from international markets. The company currently holds a strong position in the US, where it is the fifth largest generic pharmaceutical company as per the IMS National Prescription Audit, measured by total prescriptions dispensed for the 12 months ending June 2018. The company also holds a strong position in many European countries, including France and Italy, where it ranks among the largest generic companies. Aurobindo is a vertically integrated company, meeting around 70% of its API requirements in-house. Aurobindo has 26 manufacturing facilities for its API and formulations businesses, which have requisite approvals from various regulatory authorities, including the USFDA, U.K. MHRA, Japan PMDA, WHO, Health Canada, MCC South Africa and ANVISA Brazil. Recently, Aurobindo entered Poland and the Czech Republic with the acquisition of Apotex's commercial operations. The company also strengthened its US presence with the acquisition of dermatology and oral solid businesses from Sandoz.

Investment theme

Aurobindo has one of the best product approval rates and launch pipelines in the US Despite pricing pressures, the company is one of the few companies able to mitigate this risk due to continuous product launches and approvals. The company is currently grappling through a USFDA scrutiny at its various plants. Continued regulatory concerns are likely to impact performance adversely going ahead, as more than 50% of the company's fillings are from plants that are under USFDA scrutiny.

Key Risks

- Delay in product approvals; change in regulatory landscape; and negative outcome of key facility inspections by the USFDA can affect earnings prospects.

Additional Data

Key management personnel

K Nithyananda Reddy	Vice - Chairman, Whole-time Director, promoter.
P.V. Ramaprasad Reddy	Non-executive Director, Promoter
Santhanam Subramanian	Chief Financial Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Co Ltd	5.7
2	Axis Clinicals Ltd	3.0
3	Vanguard Group Inc/The	1.6
4	BlackRock Inc	1.3
5	Dimensional Fund Advisors LP	1.1
6	SBI Funds Management Pvt Ltd	0.9
7	ICICI Prudential Life Insurance Co	0.7
8	Norges Bank	0.5
9	IDFC Mutual Fund/India	0.4
10	Invesco Ltd	0.4

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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Registered Office: Sharekhan Limited, 10th Floor, Beta Building, Lodha iThink Techno Campus, Off. JVLR, Opp. Kanjurmarg Railway Station, Kanjurmarg (East), Mumbai – 400042, Maharashtra. Tel: 022 - 61150000. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183;