Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

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 36.18

Updated July 08, 2022

High Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 34,763 cr
52-week high/low:	Rs. 864 / 503
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	9.2	3.9	-15.3	-28.1
Relative to Sensex	1.2	-4.4	-15.1	-36.0

Sharekhan Research, Bloomberg

Aurobindo Pharma Ltd

Weak Q1; Cost pressures to stay

Pharmaceuticals	Sharekhan code: AUROPHARMA

Reco/View: Hold ↔	CMP: **Rs. 593**	Price Target: **Rs. 640** ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Aurobindo Pharma Limited (Aurobindo) reported a weak performance for Q1FY2023, marred by soaring cost pressures, which resulted in steep gross margin contraction. Q1FY2023 results missed estimates.
- Management sees performance to be under stress at least for the near term due to overall elevated cost pressures and sustained higher freight cost in the US business.
- US business staged high single-digit growth, driven by pick up in volume across segments, thus providing growth visibility ahead.
- We retain our Hold recommendation on the stock with a revised PT of Rs. 640.

Aurobindo Pharma Limited (Aurobindo) reported a weak performance for the quarter, marred by soaring cost pressures, which resulted in steep gross margin contraction. With marketing and selling expenses normalising, other expenses have also inched up and added to margin pressures. Overall, results missed estimates. Management commentary pointed towards apparent cost pressures and uncertainties such as moderate price erosion in the US and cost pressures, which could play dampeners in the near to medium term. A revival is likely to commence from Q3FY2023, though clarity is yet to emerge and a meaningful revival is still at a distance. 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 key growth drivers.

Key positives

- US sales staged 11% y-o-y growth, backed by volume growth across segments.
- Sales from growth markets surged by 30.8% y-o-y, while sales from ARV's formulations were up 28% y-o-y.

Key negatives

- Gross margin declined by 480 bps y-o-y because of heightened cost pressures.
- Following the gross margin contraction and increased other expenses, OPM contracted by 574 bps y-o-y and missed estimates.

Management Commentary

- The outlook for US sales (constituting ~50% of sales) is healthy over the long term, but concerns around pricing pressures and elevated cost pressures are expected to sustain at least over the next 1-2 quarters and this could keep the margins stressed
- Management has retained its guidance of achieving sales worth $650 million-700 million from injectables over the next three years, backed by a strong product pipeline, which could enable it to partly offset the impact of the price erosion in injectables.
- The elevated raw material costs and price erosion in US markets, along with higher energy costs and freight costs have dented the OPM's in Q1. going ahead the management expects the price erosion to stay at current levels and expects some improvement to be reflected in Q3FY23 onwards.

Revision in estimates – Aurobindo reported a weak performance for the quarter, marred by soaring cost pressures, which resulted in steep gross margin contraction. Results missed estimates. However, the US business has staged high single-digit growth, backed by volume growth across segments, which provides growth visibility ahead and this bodes well. Based on this and weak operating performance, we have fine-tuned our estimates for FY2023E and FY2024E.

Our Call

Valuation – Cost pressures apparent; Retain Hold: Aurobindo reported a weak performance for the quarter, marred by soaring cost pressures, which resulted in steep gross margin contraction. With marketing and selling expenses normalising, other expenses have also inched up and added to margin pressures. Going ahead, management sees performance to be under stress with cost pressures staying at elevated levels and sustained higher freight cost in the US business, which accounts for around half of overall sales. The product launch momentum is expected to pick up over the medium to long term; however, cost concerns could overweigh in the near term. European sales are stagnating and material improvement is expected by FY2024/FY2025. At the CMP, the stock is trading at a valuation of 12.8x/10.2x its FY2023E/FY2024E EPS. Given the likely sustained cost pressures and uncertainties, we retain our Hold recommendation on the stock with a revised PT of Rs. 640.

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	FY2022	FY2023E	FY2024E
Total Income	24774.6	23455.5	25065.8	27067.5
Operating profits	5333.4	4386.8	4511.8	5413.5
OPM (%)	21.5	18.7	18.0	20.0
Adj. PAT	2474	2736	2717	3407
EPS (Rs.)	42.2	46.7	46.4	58.1
PER (x)	14.0	12.7	12.8	10.2
EV/EBITDA (x)	6.2	7.6	6.0	4.4
ROCE (%)	18.6	12.9	12.1	14.1
RONW (%)	12.8	11.8	10.5	11.9

Source: Company; Sharekhan estimates

High-cost pressures impact margins

Aurobindo reported a weak performance for the quarter, marred by soaring cost pressures, which resulted in steep gross margin contraction. With marketing and selling expenses normalizing, other expenses have also inched up and added to margin pressures. Overall, results missed estimates. Consolidated revenue at Rs. 6,236 crore grew 9.4% and are largely in line with estimates. Topline growth was supported by 11% y-o-y growth in the US revenue, while EM sales were up 31% y-o-y and ARV formulations grew 28% due to a low base. Operating profit at Rs. 964 crore declined 20% y-o-y, while operating profit margin (OPM) at 15.5% contracted by 575 bps y-o-y, attributable to a 480-bps y-o-y gross margin contraction. Other income for the quarter declined by 40% y-o-y to Rs. 40.6 crore. Consequently, PAT stood at Rs. 520 crore, down 32% y-o-y and missed estimates.

Q1FY2023 Conference Call Highlights

- **Price erosion in the US moderates, strong new launch momentum to drive growth:** US accounts for around half of Aurobindo's overall revenue. US sales for the quarter grew by 11% y-o-y to Rs. 2,971 crore and were driven by higher volumes across the base business, well supported by new launches. However, during the quarter, price erosion in the US markets cooled off substantially as it stood at 3% on a sequential basis. Going ahead, management expects price erosion to stay at current levels. With the new launch, momentum is gradually gaining pace after it has slowed down in the pandemic years; but going ahead, management sees improvement; and this could enable the company to offset the impact of price erosion. Overall, Aurobindo's US business is expected to stabilise and gain traction, given price erosion trends normalise. Moreover, the company has a strong product pipeline for US markets, with 516 ANDA approvals and 35 tentative approvals. In Q1FY2023, the company received 10 ANDA approvals, including four injectable products and has launched seven products in Q1FY2023 with five of them being injectables. Moreover, the filling pipeline for Aurobindo is strong as the company looks to file for ~50 new products per year. Overall, moderation in price erosion, volume growth in the base business picking up, and strong new product pipeline would be the key factors driving growth of the US business.

- **Europe business to remain soft in the near term:** EU formulations revenue dropped 2.2% y-o-y to Rs. 1,548.1 crore. Though Europe revenue was stagnating over the past few quarters, the reason for the decline in revenue in Q1 was due to adverse currency movements, while in constant currency terms, Europe revenue grew by 5.5% y-o-y. While the filling pipeline for the European region is strong, the full effect of the new launches or revival in the base business is likely sometime in FY2024, which is likely to be a year of substantial growth. Growth here is likely to be driven by new product launches and better geographic penetration. Moreover, the biosimilars portfolio is expected to add to Europe's sales growth. The company is constructing a new plant at Vizag for biosimilars for Europe and expects filings to start by FY2023-end/FY2024, with likely launches in subsequent years subject to receipt of approvals.

- **Specialty basket, including injectables and biosimilars gradually gaining traction:** Aurobindo has set its eyes on the high-margin injectables business and sees it as one of the key growth levers. Management sees improving traction for injectables and biosimilars. The company has built a strong presence in injectables across various therapy areas, including oncology, and various delivery systems such as liquid and lyophilised vials, bag, ampoules, and pre-filled syringes and has strong manufacturing and execution capabilities as well. In addition, the company has a sturdy pipeline in injectables in the US, and expects to launch 10-15 new products in the injectables space in FY2023, which would ramp up in FY2024. Further the new injectable plant at Vizag is expected to start validation rounds in Q4 and the filling is likely to start in Q1/Q2 of FY2024 with products launches likely by the end of FY2024. Management looks to utilise this plan to make molecules with higher demand. Overall, Aurobindo has retained its guidance and expects to achieve a turnover of $650 million-700 million by FY2024 from injectables and sees FY2023 and FY2024 as years of double-digit growth. In addition to injectables, the company is actively scaling up its capabilities in biosimilars as well. Aurobindo has recently filed its second biosimilar product in the oncology space in Europe and UK and has recently filed for the third product in UK markets. Next year, the company plans to file five new products in the UK/EU and 2-3 products in US markets. In the long term, injectables and biosimilars could be the key growth drivers for Aurobindo.

- **Margin Outlook:** OPM for Q1FY2023 contracted by 574 bps y-o-y, backed by a 480-bps contraction in gross margins. elevated raw-material costs and price erosion in US markets along with higher energy costs and freight costs have dented OPM in Q1. Going ahead, management expects price erosion to stay at current levels at least for the next quarter and expects some improvement to be reflected in Q3FY2023, through clarity around the same is yet to emerge.

Results (Consolidated) Rs cr

Particulars	Q1FY23	Q1FY22	YoY %	Q4FY22	QoQ%
Total Income	6235.9	5702.0	9.4	5809.4	7.3%
Operating expenditure	5271.2	4492.6	17.3	4835.0	9.0%
Operating profit	964.7	1209.4	-20.2	974.4	-1.0%
Other income	40.6	81.3	-50.1	29.2	39.2%
EBITDA	1005.3	1290.7	-22.1	1003.6	0.2%
Interest	14.6	12.9	13.6	9.2	58.8%
Depreciation	279.5	279.7	-0.1	253.6	10.2%
PBT	711.2	998.1	-28.7	740.8	-4.0%
Tax	158.6	247.7	-36.0	17.5	806.9%
Adjusted PAT	520.4	770.0	-32.4	719.2	-27.6%
Margins			**BPS**		**BPS**
OPM (%)	15.5	21.2	-574	16.8	-130
EBIDTA margin (%)	16.1	22.6	-651	17.3	-115
Adj. PAT margin (%)	8.3	13.5	-516	12.4	-403
Tax rate (%)	22.3	24.8	-252	2.4	1994

Source: Company; Sharekhan Research

Revenue mix Rs cr

Particulars	Q1FY23	Q1FY22	YoY %	Q4FY22	QoQ%
USA	2971.1	2681.2	10.8	2728.1	8.9
Europe	1548.1	1582.9	(2.2)	1540.7	0.5
Growth Markets	430.6	329.3	30.8	391.3	10.0
ARV	379.6	296.4	28.1	235.9	60.9
Formulations	**5329.4**	**4889.8**	**9.0**	**4896.0**	**8.9**
Betalactums	551.4	383.6	43.7	594.2	(7.2)
Non Betalactums	355.1	428.3	(17.1)	318.7	11.4
API	**906.5**	**811.9**	**11.7**	**912.9**	**(0.7)**
Gross Sales	**6235.9**	**5701.7**	**9.4**	**5808.9**	**7.4**
Dossier Income	0.0	0.2	-	0.4	-
Net Sales	**6235.9**	**5701.9**	**9.4**	**5809.3**	**7.3**

Source: Sharekhan Research; Company; Numbers adjusted for Natrol divestment

Outlook and Valuation

■ Sector View – Improved growth prospects

Indian pharmaceutical companies are better placed to harness opportunities and reported 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 key growth drivers. This would be complemented by strong capabilities developed by Indian companies (leading to a shift towards complex molecules and 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

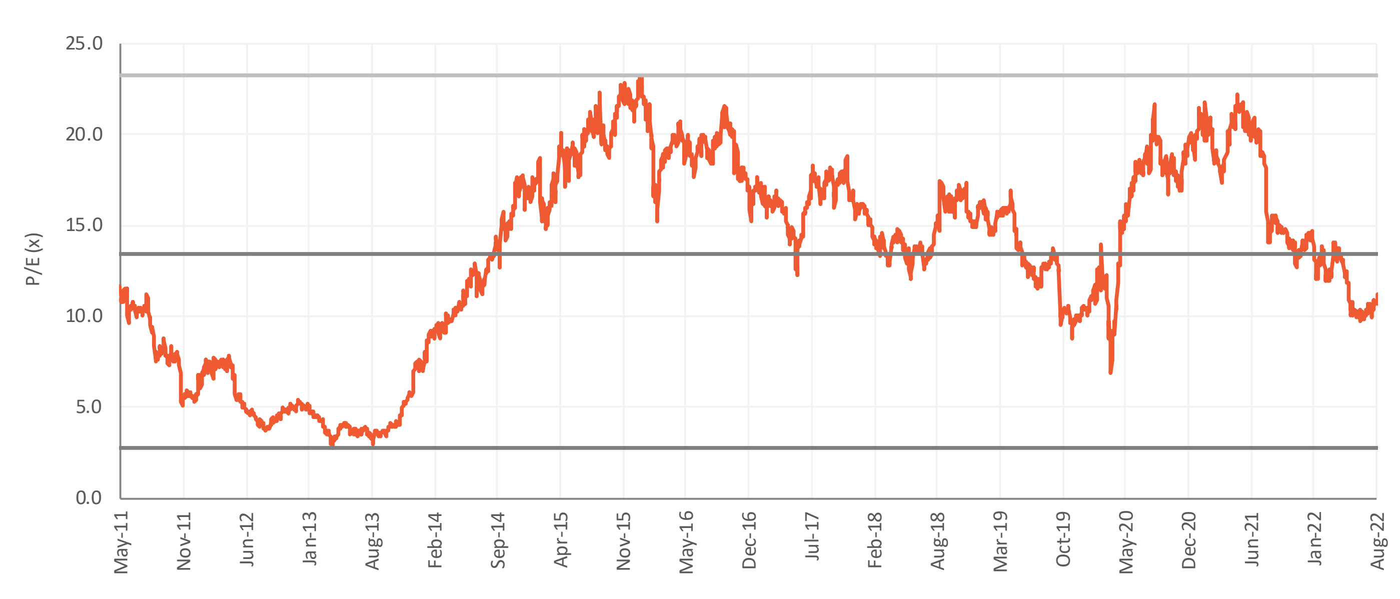
■ Company Outlook – Uncertainties likely to stay in the near term

Over the long term, a healthy growth outlook exists for the US business, driven by 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 for the US business are in the form of price erosion and inventory buildup across channels in the industry, which management believes would ease out gradually in the subsequent quarters. While the strong product pipeline planned for the US could enable partly mitigation of price erosion, higher channel stocks are likely to pressurise topline growth until the stocks normalise. 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 FY2024 is expected to post strong growth, backed by product portfolio expansion and tapping new geographies. However, Aurobindo is awaiting USFDA clearance for its plants and a successful resolution of USFDA observations would be a key monitorable and trigger for earnings upgrade. Over the long term, Aurobindo is looking to build its presence in the specialty segment, which includes areas of injectables, biosimilars, oncology inhalers, and transdermal patches among others, which is likely to support growth. Moreover, a possible demerger of the injectables business could provide value unlocking opportunity. However, in the medium term, challenges in the form of price erosion and cost pressures are likely to stay and could overweigh on margin performance.

■ Valuation – Valuation –Cost pressures apparent; Retain Hold

Aurobindo reported a weak performance for the quarter, marred by soaring cost pressures, which resulted in steep gross margin contraction. With marketing and selling expenses normalising, other expenses have also inched up and added to margin pressures. Going ahead, management sees performance to be under stress with cost pressures staying at elevated levels and sustained higher freight cost in the US business, which accounts for around half of overall sales. The product launch momentum is expected to pick up over the medium to long term; however, cost concerns could overweigh in the near term. European sales are stagnating and material improvement is expected by FY2024/FY2025. At the CMP, the stock is trading at a valuation of 12.8x/10.2x its FY2023E/FY2024E EPS. Given the likely sustained cost pressures and uncertainties, we retain our Hold recommendation on the stock with a revised PT of Rs. 640.

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/EBIDTA (x)			RoE (%)		
				FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
AurobindoPharma	531.0	58.6	31,107.0	11.4	10.1	8.4	6.8	4.5	3.2	11.8	11.9	12.6
Divis Laboratories	3,728.0	26.5	98,972	33.4	36.7	31.9	24.1	25.4	21.7	25.2	19.5	19.0

Source: Company, Sharekhan estimates

About 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 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 adversely impact performance 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.
N. Govindarajan	Managing Director
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	5.67
2	Axis Clinicals Ltd	3.0
3	Vanguard Group Inc/The	1.59
4	BlackRock Inc	1.34
5	Dimensional Fund Advisors LP	1.13
6	SBI Funds Management Pvt Ltd	0.94
7	ICICI Prudential Life Insurance Co	0.69
8	Norges Bank	0.49
9	IDFC Mutual Fund/India	0.44
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

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by BNP PARIBAS

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