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Stock Update

Result Update

Granules India Ltd

Healthy Q1; not yet fully out of the woods

Pharmaceuticals	Sharekhan code: GRANULES
Reco/View: Hold ↔	CMP: **Rs. 302**
	Price Target: **Rs. 332** ↑

↑ 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 45.37

Updated July 08, 2022

Severe Risk

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

Source: Morningstar

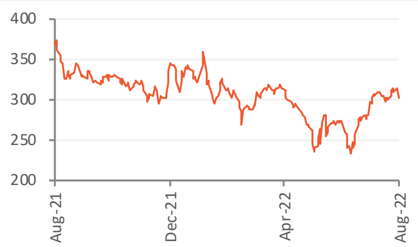
Company details

Market cap:	Rs. 7,489 cr
52-week high/low:	Rs. 405 / 232
NSE volume: (No of shares)	20.4 lakh
BSE code:	532482
NSE code:	GRANULES
Free float: (No of shares)	14.3 cr

Shareholding (%)

Promoters	42.0
FII	23.0
DII	4.3
Others	30.7

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	8.2	15.5	-3.1	-18.3
Relative to Sensex	0.2	-1232	-3.0	-26.1

Sharekhan Research, Bloomberg

Summary

- We retain Hold recommendation on Granules a with revised PT of Rs. 332
- Granules reported a healthy quarterly performance with revenues staging a strong double-digit growth on a y-o-y basis.
- Granules is witnessing pressures that, have impacted the performance of the company in the near past, though the cost pressures have stabilized, but the costs still are at elevated levels and are likely to gradually cool off, hence a material improvement is still at a distance
- The board of directors has approved a buyback amounting to 2.52% of the paid-up equity capital at a price of Rs 400 per share for an aggregate amount not exceeding Rs 250 cr. The issue would be through the tendering route and promoters could also participate.

Granules India Limited (Granules) Granules reported a healthy performance for Q1FY23 and the results were ahead of estimates. The performance reflected the strong double-digit growth in the PFI and FD segment leading to benefits of operating leverage. Thus, the PAT grew in mid - single digits on a y-o-y basis and were ahead of estimates. Elevated cost pressures led to an 460 bps y-o-y decline in gross margins, which resulted in 296 bps yoy decline in OPM's. Going ahead, the growth prospects are likely to be muted due to persisting challenges, including elevated costs and pricing pressures in the US. The management expects the pressures to be stabilizing now and then gradually cool off, which points at a meaningful recovery being still at a distance.

Key positives

- The PFI and FD segment sales reported a strong double-digit growth of 38% and 20% y-o-y
- Share of revenues from non-core molecules grew to 18% versus 17% in Q1FY22

Key negatives

- Gross margins contracted by 460 bps y-o-y due to increased raw material cost, logistics costs and adverse mix
- Operating margins contracted by 296 bps y-o-yy-o-y due to gross margins contraction

Management Commentary

- Cost pressures and hindrances like elevated raw material prices and logistics costs, time lag to pass on higher raw material prices, and pricing pressures in the US, though are stabilizing but have not yet fully abated.
- Granules has embarked on a transformational journey that could bear fruits over the long term, while headwinds would overweigh the financial performance in the near to medium term.
- The board of directors has approved a buyback of 62.5 lakh equity shares (~2.52% of the paid-up equity capital) at a price of Rs 400 per share (premium of 27% over the closing price as on 8th August 2022) for an aggregate amount not exceeding Rs 250 cr. The issues would be through the tendering route and promoters could also participate.

Revision in estimates – Granules reported a healthy performance for Q1FY23 and the results were ahead of estimates. The performance reflected the strong double-digit growth in the PFI and FD segment leading to benefits of operating leverage. Thus the PAT grew in mid – the single digits on a y-o-yy-o-y basis and were ahead of estimates. Basis this and the management commentary we have fine-tuned our estimates for FY23E/FY24E.

Our Call

Valuation – Not yet fully out of the woods; Retain Hold: Granules is witnessing pressures that has impacted the performance of the company in the near past. Going ahead, the management sees these cost pressures stabilizing, though a material cooling off is likely over a period of time. Granules has also embarked on a transformation journey and the fruits of this are expected over the long term. Basis the management assessment, though the cost pressures have stabilized, but the costs still are at elevated levels and are likely to gradually cool off, hence a material improvement is still at a distance. At CMP, the stock is trading at 14.5x/11.5x its FY23E and FY24E EPS. Further basis the above we retain Hold recommendation a with revised PT of Rs. 332.

Key Risks

A delay in product approvals or the negative outcome of facility inspections by the USFDA can affect future earnings prospects, and delay easing off of the input prices.

Valuation (Consolidated) Rs cr

Particulars	FY2021	FY2022	FY2023E	FY2024E
Net Sales	3237.5	3764.9	4255.7	4940.7
EBIDTA	855.2	722.2	880.9	1077.1
OPM (%)	26.4	19.2	20.7	21.8
Reported PAT	549.5	412.8	514.9	656.3
EPS (Rs)	22.2	16.7	20.8	26.6
PER (x)	13.6	18.1	14.5	11.4
EV/Ebidta (x)	9.3	11.3	8.9	7.0
ROCE (%)	25.0	15.7	17.9	20.3
RONW (%)	25.3	16.0	17.3	18.8

Source: Company; Sharekhan estimates

Healthy operating performance: Granules reported a healthy performance for Q1FY23 and the results were ahead of estimates. The performance reflected the strong double-digit growth in the PFI and FD segment leading to benefits of operating leverage. Thus the PAT grew in mid - single digits on a y-o-y basis and was ahead of estimates. Sales for the quarter grew 20% y-o-yy-o-y to Rs 1020 crore and were ahead of estimates. The API and the PFI segment sales growth moderated due to a high base in Q1Y22, while the PFI and FD segments registered a 38% y-o-yy-o-y and 21% y-o-yy-o-y growth respectively. Operating profit at Rs 211.5 cr was up 5% y-o-yy-o-y. The gross margins contracted sharply by 460 bps y-o-y leading to a 296 bps y-o-y contraction in the OPMS to 20.7%, but were ahead of estimates. The tax rate for the quarter stood at 23.1% v/s 26.2% in Q1FY22. Consequently, the PAT at RS 127.6 cr was higher at 6% y-o-yand was ahead of estimates.

Q1FY2023 Concall highlights

- **Not yet fully out of the woods, expect gradual improvement:** Granules reported a healthy performance for the quarter with the revenues staging a strong double-digit growth on a y-o-y basis. The 20% revenue growth was largely supported by a 38% y-o-y growth in the PFI segment while the FD segment growth stood at 20% y-o-yy-o-y. Geography wise, all the regions reported healthy growth with Europe reporting strong growth and the share of revenues increased from 16.8% y-o-yy-o-y to 22.5% for Q1FY23. The gross margins however contracted sharply by 460 bps y-o-yy-o-y reflecting the input cost pressures as well as elevated freight and logistics costs which were accompanied by pricing pressures in the US markets. However, the management has shared an encouraging outlook going ahead and expects the situation to improve gradually. While the revenue growth has been strong, the costs across the board though have stabilized at higher levels, have not been cooling off. The management sees the reduction in the input prices gradually going ahead as the US markets, which is almost half of the overall revenues and still witnessing pricing pressures as well as logistic issues. While the performance has been improved on the revenues front, the costs pressures have not yet abated, and the management expects a gradual improvement in the performance, pointing at a possibly slower revival. A meaningful revival still seems far away

- **Capex guidance retained:** For FY2022, the company has incurred a capex of ~Rs. 397 crore towards the MUPS block and Vizag Expansion and in Q1FY23 the company has incurred RS 83 crore of capex. Granules has guided for a capex of Rs. 600 crore in the next two years which include the setting up new facilities as well as de-bottlenecking existing facilities. Also the capex spends could be spread across the API as well as finished dosage segments as well. With the raw material headwinds, the management would now be investing Rs. 150 crore towards green initiatives and expansion in the API/KSMs. This has been done with an objective to significantly reduce the dependence on China so as to avoid contingencies. However, benefits will accrue in the future . Therefore, Granules expects the Capex to help it tide over raw material procurement challenges, but the benefits could be accrued over the next two years.

- **Transformation 2.0 Journey to propel Granules to next level of growth, benefits look distant:** Granules' management has charted out a roadmap where it intends to transform the business to the next level. The plan would be focusing on R&D, technology, and sustainability around API PFI and FD business. A chunk of the R&D investments would be focused on backward integration with an objective to reduce dependence on imports across the core and key molecules including Para Amino Phenol (PAP). In addition to this, the company also aims to propel growth through a focus on the Europe LATAM and US markets. Also focus on creating systems for internal process, with an aim for sustainable growth bodes well and is a part of the transformation journey. The management sees this as an ongoing exercise and expects benefits to be visible on a sequential basis in the subsequent quarters, though material benefits are expected over the long term.

- **Buy Back:** The board of directors have approved a buy back of 62.5 lakh equity shares (~2.52% of the paid up equity capital) at a price of Rs 400 per share (which is a premium of 27% over the last closing price as on 8th August 2022) for an aggregate amount not exceeding Rs 250 cr. The record date for the buy back is 23 August 2022. The issues would be through the tendering route and the buy back is proposed to be undertaken from the equity shareholders of the company with the promoters also participating in the issue.
- **Segmental revenue mix:** Granules' PFI segment's sales stages a strong growth of 38% y-o-y while the FD segment sales grew 20% y-o-y. Overall the share of revenues from the PFI segment grew to 23.2% as compared to 20.2% in Q1FY22 while the share of revenues from the FD segment was almost stable. The API sales grew at a slow pace of 4% y-o-y due to a high base effect.
- **Molecule-wise mix:** the share of revenues from the non-core molecules expanded by 1% to 18% as compared to 17% in Q1fy22
- **R&D expenses:** Granules incurred an expense of Rs. 32 crore on the R&D for Q1FY23, translating to 3.1% of the sales. In Q1Fy23 the company has filed 5 ANDA's and 2 DMF in the US and has received one approval each in the US, EU and Canada
- **Outlook:** Granules management has retained its revenue guidance of 20% CAGR going ahead. On the cost front the pressures are yet to abate fully and a gradual improvement could be expected. Given the existing situation at the end user markets, the company is now focusing on reducing the working capital levels, especially the inventory and receivables which were on the higher side. This the management aims to achieve with a focus on higher cash generation and also expects to improve the debt levels.

Results (Consolidated) **Rs cr**

Particulars	Q1FY23	Q1FY22	Y-o-Y %	Q4FY22	QoQ %
Total Income	1019.6	849.8	20.0	1030.0	-1.0
Expenditure	808.1	648.4	24.6	837.3	-3.5
Operating profit	211.5	201.4	5.0	192.7	9.8
Other income	4.7	7.6	-38.7	4.0	17.9
EBIDTA	216.2	209.0	3.4	196.7	9.9
Interest	6.9	6.8	2.1	6.4	9.0
Depreciation	43.4	39.4	10.1	40.2	7.9
PBT	165.9	162.9	1.8	150.1	10.5
Tax	38.3	42.7	-10.2	39.1	-2.1
Adjusted PAT	127.6	120.2	6.1	111.0	14.9
Margins			**BPS**		**BPS**
OPM (%)	20.7	23.7	-295.7	18.7	203.6
EBIDTA margin (%)	21.2	24.6	-339.5	19.1	210.9
Net profit margin (%)	12.5	14.1	-163.1	10.8	173.6

Source: Company; Sharekhan Research

Outlook and Valuation

Sector View – Growth momentum to improve

Indian pharmaceutical companies are better placed to harness opportunities and report 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 and 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 pharmaceutical companies.

Company Outlook – Cost pressures yet to abate

Granules is a fully-integrated pharmaceutical company with a presence across the API-PFI-FD value chain. Over a long-term period, the company's growth levers are intact and this bodes well. However, in the near term, there have been severe headwinds that have emerged and could substantially overweigh on the performance, especially in FY22. Though FY23 could stage an improvement, regaining normalcy i.e. previous period margins and growth, apparently is a challenge. As the raw material prices are looking up coupled with higher and firm logistics costs, the price increase is inevitable, though the channel de-stocking across the segments could act as a dampener. Therefore, as the markets open and COVID cases ease out, the business would evolve towards to new normal and this could moderate the growth prospects. Though Granules is taking measures such as a change in the capex composition to reduce dependence on China, and initiating a price hike across customers, these could take a while to be reflected in the financials, clearly pointing at near-term challenges. We believe the revival remains a key monitorable. However, positives which include the commissioning of the MUPS block, product pipeline across regions could support growth. We believe that new product launches in the US, tapping new geographies and augmented capacities will support the base as well as emerging business. Further, over five years, the company plans to get in the complex molecule space, which would drive growth.

Valuation – Not yet fully out of the woods; Retain Hold

Granules is witnessing pressures that, have impacted the performance of the company in the near past. Continued channel de-stocking and price erosion at the US business, elevated raw material prices and logistics costs, over-dependence on China for raw material imports, and time lag to pass on the increased raw material prices were the key factors impacting the growth. Going ahead, the management sees these cost pressures stabilizing, though a material cooling off is not visible, which Granules expects going ahead gradually. While the topline momentum looks healthy, the cost pressures could drag the performance until it abates materially. Granules has also embarked on a transformation journey encompassing three key areas of R&D (with a focus on backward integration), technology and sustainability. Though fruits of these are expected over the long term. Basis the management assessment, the costs still are at elevated levels, des and are likely to gradually cool off. Granules reported a healthy performance for Q1FY23 and the results were ahead of estimates. The performance reflected the strong double digit growth in the PFI and FD segment leading to benefits of operating leverage. Thus the PAT grew in mid - single digits on a y-o-yy-o-y basis and were ahead of estimates. However, as the cost pressures still stay at elevated levels while the pricing pressures in the US markets, are also yet to reduce, and hence a material improvement is still at a distance. Basis the Q1FY23 we have fine-tuned our estimates for FY23E/FY24E. At CMP, the stock is trading at 14.5x/11.5x its FY23E and FY24E EPS. Further basis the above we retain Hold recommendation with revised PT of Rs. 332

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
Granules India	302.0	24.7	7,489	18.1	14.5	11.4	11.3	8.9	7.0	16.0	17.3	18.8
Laurus Labs	559.0	53.2	30,022	35.7	24.3	18.4	22.1	15.0	11.6	21.6	26.4	27.6

Source: Company, Sharekhan estimates

About company

Granules is a vertically integrated pharmaceutical company, headquartered in Hyderabad, India. The company manufactures Active Pharmaceutical Ingredients (APIs) – 29.7% of sales, Pharmaceutical Formulation Intermediates (PFIs) – 20.2% of sales and Finished Dosages (FDs) – 50.1% of sales and supplies them to both regulated and semi-regulated markets. The regulated markets constitute around 73% of revenues, while LATAM accounts for 11% of revenues and RoW markets constitute around 16% of revenues.

Investment theme

Granules is a fully-integrated pharmaceutical company with a presence across the API-PFI-FD value chain. Over a long term period the company's growth levers are intact and this bodes well. However, in the near term there have been severe headwinds that could substantially overwh on the financial performance. Though FY23 could stage an improvement, but regaining normalcy i.e. previous period margins and growth, apparently is a challenge. As the raw material prices are looking up coupled with higher and firm logistics costs, the price increase is inevitable, though the channel de-stocking across the segments could act as a dampener. Therefore, as the markets open up and Covid cases ease out, the business would evolve towards to new normal and this could moderate the growth prospects. Though Granules is taking measures to reduce dependence on China, initiating a price hike across customers, these could take a while to be reflected in the financials, clearly pointing at near-term challenges. We believe the revival remains a key monitorable. However, positives which include the commissioning of the MUPS block, product pipeline across regions could support growth and We believe that new product launches in the US, tapping new geographies, and augmented capacities will support the base business as well as an emerging business.

Key Risks

- Delay in product approvals or negative outcomes of facility inspection by the USFDA can affect future earnings prospects.
- Delay in product launches in the US
- Adverse outcome of USFDA inspection at manufacturing facility also poses risk.

Additional Data

Key management personnel

Mr. Krishna Prasad Chigurupati	Chairman and Managing Director
Ms. Priyanka Chigurupati	Executive Director of Granules Pharmaceuticals Inc
Mr. Sandip Neogi	Chief Financial Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	3.07
2	Norges Bank	3.04
3	GOVERNMENT PENSION FUND - GLOBAL	2.99
4	Vangaurd Group Inc	1.91
5	Mahima Stocks Pvt Ltd	1.66
6	TYCHE INVESTMENTS PVT LTD	1.47
7	Dimensional Fund Advisors LLP	1.41
8	BlackRock Inc	1.09
9	DNB Asia	0.37
10	State Street Corp	0.45

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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