Sharekhan by BNP PARIBAS

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Zydus Lifesciences Ltd

Q1 operationally in line; healthy growth outlook

Pharmaceuticals	Sharekhan code: ZYDUSLIFE

Reco/View: Buy	↔	CMP: **Rs. 365**	Price Target: **Rs. 440**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

Stock Update

Result Update

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 41.35

Updated Feb 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. 36,910 cr
52-week high/low:	Rs. 590 / 319.4
NSE volume: (No of shares)	19.4 lakh
BSE code:	532321
NSE code:	ZYDUSLIFE
Free float: (No of shares)	25.7 cr

Shareholding (%)

Promoters	74.9
FII	4.1
DII	11.8
Others	9.25

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-0.3	10.6	-9.1	-36.9
Relative to Sensex	-8.3	2.2	-8.9	-44.7

Sharekhan Research, Bloomberg

Summary

- We retain our Buy recommendation on Zydus Lifesciences with an unchanged PT of Rs. 440.
- Q1FY23 margins contracted to reflect elevated cost pressures with the gross margins also declining. The topline staged a steady growth y-o-y pointing at an improvement. Overall the results are operationally in line with the estimates.
- Zydus sees US growth to improve materially in FY2024, driven by expected new launches and ramp-up in the recent launches, while FY23 could witness a slower growth momentum.
- The India business to outpace the industry's growth over the medium to long term, backed by market share gains in key therapy areas, new launches, focus on brand building, and growth in the base business.

Zydus Lifesciences Limited (Zydus) Q1FY23 margins contracted to reflect elevated cost pressures with the gross margins also declining. The topline staged a steady growth y-o-y pointing at an improvement. Overall the results are operationally in line with the estimates while a higher other income resulted in PAT coming ahead of estimates. Going ahead, the management sees healthy growth prospects for India in the medium to long term, while US business is expected to stage a single digit growth in FY23. Over the long term, prospects are bright, driven by growth from IP-driven products and biosimilars. Near-term growth is expected to be slow for the US impacted by price erosion and heightened cost inflationary pressures, which gradually would be offset to a certain extent by the new launches.

Key positives

- Excluding Covid products, India formulations business reported strong 12% y-o-y growth.
- Emerging market formulations business grew by 14% because of growth across geographies.

Key negatives

- The operating margins contracted by 273 bps y-o-y.
- Form 483 being issues to Moraiya plant post inspection by USFDA, leading to delay in product launches.

Management Commentary

- Management expects India business to outpace the industry's growth over the medium to long term, backed by market share gains in key therapy areas, new launches, focus on brand building, and growth in the base business. While in short term the performance is expected to be in line with the industry
- US business growth is expected to be slower due to price erosion, which is expected to sustain and management expects US sales to grow in single digits for FY2023. However, a strong product pipeline for the US, including specialty and injectables, would be long-term drivers.
- The USFDA inspected the Moraiya plant in between 26 July to 5 August 2022 and the inspection ended with Form 483 and 4 observations. The delay in clearance could slow down the new products launches especially in the transdermal space.

Revision in estimates – Zydus' Q1FY23 margins contracted reflecting elevated cost pressures with the gross margins also declining. The topline staged a steady growth y-o-y pointing at an improvement. Overall, the results are operationally in line with the estimates while a higher other income resulted in PAT coming ahead of estimates. Basis this we have fine-tuned our estimates for FY23E and Fy24E.

Our Call

Valuation – Retain Buy with unchanged PT of Rs. 440: Zydus sees US growth to improve materially in FY2024, driven by expected new launches and ramp-up in the recent launches, while FY23 could witness a slower growth momentum. On the other hand, India business, backed by growth in the existing business and new product launches, is expected to outpace the industry's growth over the medium to long term. Over the long term, IP-driven products and specialty products provide sizeable growth opportunities. At the CMP, the stock trades at 17.5x/15x its FY2023E/FY2024E. We retain our Buy recommendation on the stock with an unchanged PT of Rs. 440.

Key Risks

1) Price erosion in the US generics business could hurt performance. 2) A delay in the resolution of USFDA issues at the Moraiya plant. 3) Forex volatility could affect earnings.

Valuation (Consolidated) Rs cr

Particulars	FY2021	FY2022	FY2023E	FY2024E
Net sales	14,403.5	15,265.2	16,472.7	18,015.4
Operating Profit	3,387.1	3,340.7	3,432.4	3,874.0
OPM (%)	23.5	21.9	20.8	21.5
Adjusted Net profit	2,359.3	2,082.7	2,141.7	2,484.3
EPS (Rs)	23.0	20.3	20.9	24.3
PER (x)	15.8	17.9	17.5	15.0
EV/EBITDA (x)	12.5	12.1	11.4	9.5
RoCE (%)	13.3	12.2	11.3	12.0
RoNW(%)	18.2	12.3	11.5	12.2

Source: Company; Sharekhan estimates

Operating performance in-line with estimates

Zydus' Q1FY23 margins contracted reflecting elevated cost pressures with the gross margins also declining. The topline staged a steady growth y-o-y pointing at an improvement. Overall the results are operationally in line with the estimates while a higher other income resulted in PAT coming ahead of estimates. The revenues at Rs 4073 cr grew 1.2% y-o-y backed by a 9.2% y-o-y growth in the US formulations market, while the emerging market formulations grew by 13.9% y-o-y. The India business recorded a decline of 6.5% y-o-y on the back of 17.1% y-o-y drop in the formulations revenues while the consumer business recorded a growth of 18% y-o-y. The operating margins at 20.5% (as against estimates of 20.8%) contracted by 273bps y-o-y attributable to a gross margins contraction of 290 bps y-o-y, pointing at elevated costs pressures. The Operating profits at 833 cr was down 11% Y-o-y and was in line with the estimate of Rs 812 cr. The other income almost doubled to Rs 66 cr Y-o-y basis and consequently the PAT at Rs 526.6 crore declined by 6.8% y-o-y and was ahead of the estimates.

Q1FY2023 Conference Call Highlights

- **Healthy growth outlook for US business:** US sales for Q1FY23 stood at Rs 1559.20 cr, which is a growth of 9% y-o-y and 9.5% q-o-q. During Q1FY2023, Zydus witnessed competitive pressures in the US business and the price erosion was to the extent of 2.5% higher sequentially, though which was offset by a growth in the base business and new product launches. Going ahead, over the long term, the company sees a healthy outlook for the US. Growth would be backed by strong product launch pipeline, which would include new chemical entities (NCEs) and specialty products including injectables to be launched over the next two years. Zydus Life has plans to launch around 30 new products per year in the US markets and this could enable it to offset the pricing pressures. Further, the company has lined two high-value products to be launched in US markets in 2HFY2023. Also the company has plans to launch gRevlimid in the US markets though the time lines depend on the receipt of the final approval. Further, over the next one year, Zydus has lined up 2-3 potential high-value launches in US markets, which provide ample growth visibility. Moreover, in Q1, the company has filed for eight ANDA and has received approvals for seven products. amongs the filling three products are under the CGT (Competitive generic Therapies). Zydus Life has launched 89 new products in the US in Q1 and in the past, has launched a sizeable new product portfolio in US markets, which is expected to ramp up going ahead and aid topline growth. The company has also lined up biosimilars to be launched in US markets, though timelines are not known and are likely to be in or beyond FY2024. Cumulatively, a strong product pipeline would enable Zydus to offset the effect of price erosion, albeit substantial high-value product launches are likely over the medium to long term with material growth expected in FY2024.
- **Emphasis on sizeable specialty/injectables franchise bodes well and could fuel growth:** Zydus is looking to grow its complex injectables portfolio over the next 3-4 years. Zydus is in for clinical trials for Saroglitazar MG (Orphan Drug Designation from USFDA) for two indications – Primary Biliary Cholangitis (PBC) and NASH and expects Saroglitzar MG to be launched for PBC in the US by 2025, while that for NASH indication is expected to be by 2027 or 2028. The company has launched Desidustat in the India market and the same is expected to ramp up going ahead. In addition to this, there are two other NCEs (ZY19489 and ZYIL1), which are in the pipeline. Apart for NCEs, it is also building a pipeline of biosimilars with pegfilgrastim getting approved in Russia and gradually being expanded to other geographies. Overall, in the next three years, the company expects 3-4 biosimilars to come up for approval, which could fuel growth. Moreover, Zydus has commenced rolling submission for its specialty product CUTX-101 and is expecting approval for a module soon. In addition to this, it has a slew of products in various stages in the specialty segment/505 (b) (2) route, which has significant growth potential. In the long term, focusing on IP-driven products and focus on injectables could be the key growth drivers for Zydus.
- **Robust outlook for domestic formulation business over the medium to long term:** Zydus's domestic formulation business recorded a double-digit decline of 17.1% y-o-y for Q1 due largely attributable to the high base due to the covid-led demand in Q1FY22. The consumer business staged a strong double-digit growth of 18% y-o-y and cumulatively, the India business reported a decline of 6.5% y-o-y to Rs 1816.7

cr. Going ahead, the domestic formulation business is expected to sustain strong growth traction and the company expects to outpace the industry's growth in the medium to long term. The differentiated product portfolio, focus on products going off patent in diabetes and cardiology space along with a focus on other therapy areas of women's health and respiratory would drive the growth. The company in the India markets is present largely in the branded generic space which is highly competitive. Hence in the short term, the management expects to perform in line with the industry growth.

- **COVID Vaccine updates:** The company has commercialized three vaccines till date. These include a rabbies vaccine and a flu vaccine. All the three vaccines offer a material and addressable market size and three years down the line the management expects a material contribution to come in from these vaccines segment. Globally the company plans to tap the tenders route for the vaccines and aims for a 10-15% of the market share, dependuponp on the pricing and other parameters.
- **Regulatory aspects:** The company's Maraiya plant was inspected by the USFDA between 26th July to 5th August 2022. The inspection ended with 4 observations and a form 483 being issued with no data integrity issues. The company has 5 products filed from the Moraiya plant and out of that approval for 4 is withheld due to the plant under a warning letter. Once cleared the company would be able to launch ale 4 transdermal products in the Us markets.
- **Outlook:** Backed by a strong outlook, management sees India's business to outpace the industry's growth in the medium to long term, while US revenue is expected to report single-digit growth in FY2023. Further, sustained pricing pressures and higher costs are likely to impact the margin trajectory and management has guided for EBITDA margin at 20% plus, which is lower as compared to 21.9% reported in FY2022.

Results (Consolidated) Rs cr

Particulars	Q1FY23	Q1FY22	Y-o-Y %	Q4FY22	Q-o-Q %
Total Operating revenues	4,072.7	4,025.4	1.2	4,072.7	0.0
Operating profit	833.0	933.0	-10.7	833.0	0.0
Other Income	65.9	31.6	108.5	65.9	0.0
EBITDA	898.9	964.6	-6.8	898.9	0.0
Interest	34.3	27.3	25.6	34.3	0.0
Depreciation	180.7	182.7	-1.1	180.7	0.0
PBT	683.9	754.6	-9.4	683.9	0.0
Taxes	118.4	141.5	-16.3	118.4	0.0
PAT	565.5	613.1	-7.8	565.5	0.0
Adjusted PAT	529.5	564.8	-6.3	529.5	0.0
Margins			BPS		BPS
OPM %	20.5	23.2	-272.5	20.5	0.0
PATM %	13.0	14.0	-103.0	13.0	0.0
Tax rate %	17.3	18.8	-144	17.3	0.0

Source: Company; Sharekhan Research

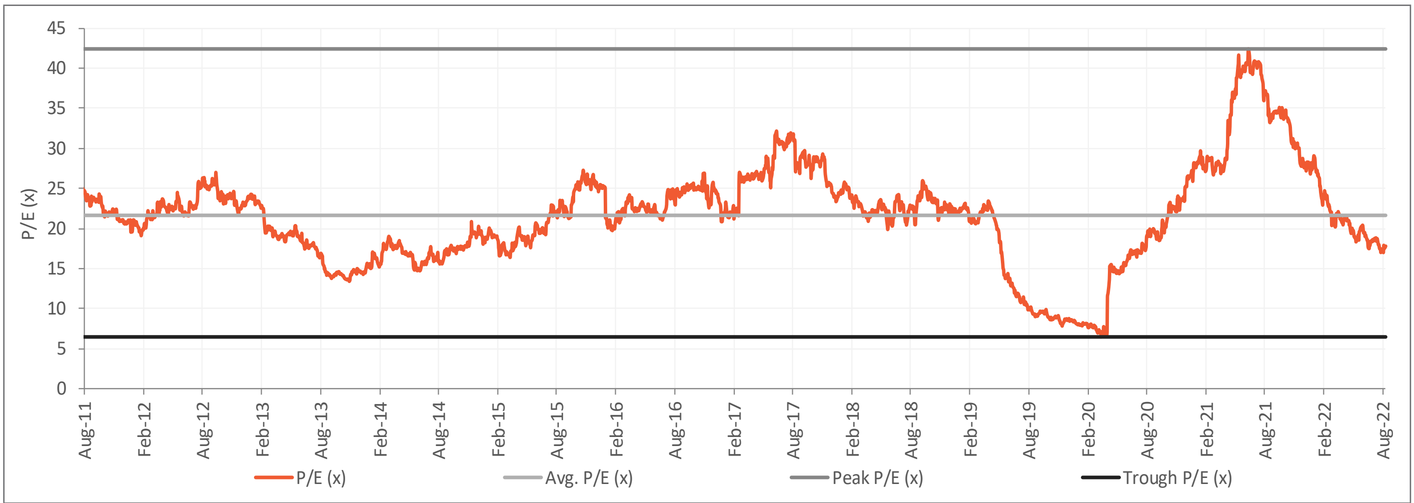
Outlook and Valuation

- **Sector View – Growth momentum to improve:** Indian pharmaceutical companies are better placed to harness opportunities and register 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 pharmaceutical companies.

- **Company Outlook – Healthy growth outlook:** Over the long term, both geographies – US and India – have a healthy growth outlook. The US business is on a strong footing, helped by a sturdy new product pipeline and ramp-up in recent product launches, which would be long-term growth drivers. The efforts to build up presence in the injectables space would also add to growth albeit over the medium to long term. The India business has a robust growth outlook, backed by a pickup in chronic as well as acute therapies and a few substantial high-value launches lined up. Over the long term, product launches such as Saroglitazar, gRevlimid, and Desidustat offer substantial growth potential. With a substantial reduction in debt, Cadila has strengthened its balance sheet. Management looks to keep an eye on debt reduction going ahead as well. This augurs well and would go towards strengthening the company's financial muscle. Strong earnings prospects, healthy return ratios, and a strengthening balance sheet are key positives for Cadila. In the near term, US growth is expected to moderate, while India and other geographies are likely to stage double-digit growth.

- **Valuation – Retain Buy with unchanged PT of Rs. 440:** Zydus sees US growth to improve materially in FY2024, driven by expected new launches and ramp-up in the recent launches, while FY23 could witness a slower growth momentum. On the other hand, India's business, backed by growth in the existing business and new product launches, is expected to outpace the industry's growth over the medium to long term. Over the long term, IP-driven products and specialty products provide sizeable growth opportunities. Zydus' Q1FY23 margins contracted to reflect elevated cost pressures with the gross margins also declining. The topline staged a steady growth y-o-y pointing at an improvement. Overall the results are operationally in line with the estimates while a higher other income resulted in PAT coming ahead of estimates. Basis this we have fine-tuned our estimates for FY23E and Fy24E. At the CMP, the stock trades at 17.5x/15x its FY2023E/FY2024E. We retain our Buy recommendation on the stock with an unchanged PT of Rs. 440.

One-year forward P/E (x) band



Source: Company, Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV/EBITDA (x)			RoE (%)		
				FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
Zydus Lifescience	365.0	102.4	36,910.0	17.9	17.5	15.0	12.1	11.4	9.5	12.3	11.5	12.2
Cipla	1038.0	80.6	83781.0	30.5	27.0	21.2	18.2	16.4	13.1	14.6	13.9	15.4
Dr Reddy's	4,242.0	16.6	70,607.0	32.3	23.9	13.2	13.2	12.1	9.8	11.4	14.1	15.2

Source: Company, Sharekhan estimates

About company

Zydus Lifescience is one of the leading pharmaceutical companies in India. The company is present across the pharmaceutical value chain of research, development, manufacturing, marketing, and selling of finished dosage human formulations (generics, branded generics, and specialty formulations, including biosimilars and vaccines), active pharmaceutical ingredients (APIs), animal healthcare products, and consumer wellness products. The company has a global presence and sells its products in the US, India, Europe, and emerging markets, including countries in Latin America, Asia Pacific region, and Africa. The company is also engaged in research and development activities focused across the value chain of API process development, generics development for simple as well as differentiated dosage forms such as modified release oral solids, transdermal, topicals and nasals, biologics, vaccines, and new chemical entities (NCE).

Investment theme

Zydus Lifescience is favourably progressing in its efforts to build an alternative growth platform (NCE, biologics, and vaccines) that should start delivering over the medium to long-term and reduce the company's dependence on limited competition assets in the US for its earnings. India business including the consumer wellness segment is likely to grow at a healthy pace, albeit over the medium to long term. Cadila is in a sweet spot, wherein both its geographies have an improved growth outlook. Easing pricing pressures, sturdy new product pipeline, and ramp-up in the recent product launches would be key growth drivers for the US business. The efforts to build up a presence in the injectables space would also add to growth albeit over the medium to long term. India's business is also showing signs of a pick-up in growth momentum, led by a solid presence in the chronic and sub-chronic segments and an improving outlook for the acute segment. Further, COVID-19-related opportunities would add to the growth momentum.

Key Risks

1) Regulatory compliance risk; 2) delay in product approvals; 3) currency risk; and 4) risk concentration in the US portfolio.

Additional Data

Key management personnel

Pankaj R. Patel	Chairman
Dr. Sharvil P. Patel	Managing Director
Mr. Ganesh Nayak	COO & Executive Director
Mr. Nitin Parekh	CFO

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	3.3
2	Kotak Mahindra Asset Management Co	2.24
3	GOVERNMENT PENSION FUND - GLOBAL	1.18
4	Norges Bank	1.18
5	UTI Asset Management Co	0.83
6	Vangaurd Group	0.75
7	Nippon Life Asset Management	0.68
8	Franklin resources	0.48
9	Fund Rock Management	0.46
10	ICICI Prudential Asset Management	0.37

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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