Gland Pharma Ltd

Weak Q2; focus on improving growth in medium term

Pharmaceuticals	Sharekhan code: GLAND
Reco/View: Buy ↔	CMP: Rs. 1,899
	Price Target: Rs. 2,260 ↓

↑ 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
Updated Oct 08, 2022

44.83

Severe Risk

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

Source: Morningstar

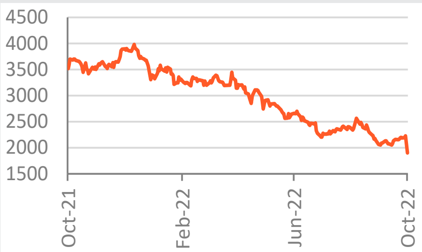
Company details

Market cap:	Rs. 31,268 cr
52-week high/low:	Rs. 4,060/1,880
NSE volume: (No of shares)	3.1 lakh
BSE code:	543245
NSE code:	GLAND
Free float: (No of shares)	6.9 cr

Shareholding (%)

Promoters	57.9
FII	6.4
DII	21.9
Others	13.84

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-7.9	-16.0	-40.9	-46.1
Relative to Sensex	-12.5	-19.8	-44.8	-43.8

Sharekhan Research, Bloomberg

Summary

- Gland reported another weak quarter in Q2FY23 affected by muted performance across geographies. Core markets marginally grew by 3%, RoW declined by 3% while India business was down by 42% y-o-y which led to 3% y-o-y decline in revenue to Rs. 1,044.4 crore.
- Gross/EBITDA margins fell by 124/644 bps y-o-y impacted by decline in revenue, unfavourable geography and product mix, pricing pressures in some products and higher employee expenses. PAT declined by 20.2% y-o-y to Rs. 241.2 crore.
- Despite near-term headwinds due volume decline in the US and cost inflation, the medium-term prospects are intact led by a strong product pipeline and entry into newer markets.
- Stock has corrected by 41% in the past six months and currently trades at 29.8x/23.6x its FY2023E/FY2024E EPS, which factors in near-term headwinds. We retain a Buy recommendation on Gland Pharma (Gland) with a revised PT of Rs. 2,260.

Gland Pharma Limited's (Gland's) Q2FY23 performance was impacted by unfavourable geographical and product mix, pricing pressure in some products, input cost inflation and lower volume due to delay in material supplies. The revenues declined by 3% y-o-y while the PAT declined by 20.2% y-o-y to Rs. 1,044 crore and Rs. 241 crore, respectively. EBITDA margins of 28.4% contracted by 644 bps y-o-y while gross margin declined by 124 bps y-o-y to 50.3%. Core markets (US, Europe, Canada, and Australia) registered a growth of 3% y-o-y, India revenue was down by 42% y-o-y, while Rest of the World (RoW) declined by 3% y-o-y. Total R&D expense for Q2FY23 was Rs. 41.4 crore, while the capex incurred was Rs. 41.1 crore. During Q2FY23, the company filed six ANDAs, three DMFs and received 6 ANDA approvals. In the short term, the management envisages certain challenges to stay while the long-term growth levers are intact.

Key positives

- RoW markets grew by 124% q-o-q aided by recovery in key market in MENA.
- With initial quantities of stopper expected in November 2022, management expects the stopper shortage situation to normalise by Q1FY2024.

Key negatives

- India business revenue declined by 42% y-o-y on a high base of Q2FY2022
- Gross/EBITDA margin were down by 124/644 bps y-o-y to 50.3%/28.4%, respectively.
- Working capital and average cash conversion cycle increased y-o-y due to increased receivables and inventory.

Management Commentary

- The management has withdrawn its FY2023 sales and margin guidance owing to continued challenges on multiple fronts leading to low visibility on timelines to normalcy. However, medium-term growth prospects are intact led by Gland's presence in low competition injectable segment, strong pipeline and entry into newer markets.
- Margins are expected to be ~30.5-31% in H2FY2023, up from 29.8% in H1FY2023, aided by easing supply-side challenges and lower freight costs with increased mix of sea shipments.
- China remains a key geographic focus for Gland with the company filing eight products in China in Q2FY2023 and expects two approvals in 2HFY23.
- For FY2023, the company plans to invest Rs. 300-350 crore in capex, which would be utilized towards expansion of the Pashamylaram and Vizag API facility and for routine maintenance capex.
- As of H1FY23, Gland and its partners had 322 ANDA filings in the US, of which 259 were approved and 63 are pending approval.

Revision in estimates – We have reduced our earnings estimates for FY2023 and FY2024 to factor in weak performance in Q2FY2023 and lower than earlier expect OPM. We have introduced FY2025E earnings estimates through this note.

Our Call

Valuation – Retain Buy with a revised price target of Rs. 2,260: Gland reported yet another weak quarter with revenue and PAT down by 3% and 20%, respectively. Unfavourable geographical and product mix, supply-side constraints, cost inflation and overall weak macro-economic sentiments dragged performance. However, the challenges are expected to be transient in nature and medium-term prospects are intact led by a strong product pipeline and entry into newer markets. Stock price has corrected by ~41% in last six months due to said challenges which the management expects to ease out gradually and could support growth in the medium. At the CMP, the stock trades at 29.8x/23.6x its FY2023E/FY2024E EPS. With a favourable risk-reward after sharp correction in the recent past and expected good growth in the medium term we retain our Buy recommendation on the stock with a revised PT of Rs. 2,260.

Key Risks

1) Delay in key product approvals; 2) any adverse change in the regulatory landscape; and 3) adverse forex movements.

Valuation (Consolidated) Rs cr

Particulars	FY2021	FY2022	FY2023E	FY2024E	FY2025E
Total Sales	3462.9	4400.7	4312.7	5116.5	5869.3
OPM (%)	37.6	34.3	30.2	32.0	32.5
Reported PAT	997.0	1211.7	1040.5	1313.8	1525.3
EPS (Rs)	61.1	74.2	63.7	80.5	93.4
PER (x)	31.1	25.6	29.8	23.6	20.3
EV/Ebidta (x)	19.5	16.0	17.8	14.0	11.7
P/BV (x)	5.3	4.3	3.8	3.3	2.9
ROCE (%)	22.4	22.4	16.9	18.3	18.4
RONW (%)	16.9	16.9	12.8	14.0	14.1

Source: Company; Sharekhan estimates

Another weak quarter - Revenue/PAT down by 3%/20% y-o-y, respectively:

As anticipated, Gland Pharma's revenues declined by 3.3% y-o-y to Rs. 1,044.4 crore with core markets of USA, Europe, Canada, and Australia, growing by 3% y-o-y to Rs. 747.5 crore, India revenues fell by 42% y-o-y to Rs. 72.6 crore while Rest of the World (RoW) declining by 3% y-o-y to Rs. 224.3 crore. EBITDA margin at 28.4% contracted by 644 bps y-o-y impacted by decline in revenues, unfavourable geography and product mix, higher employee expenses coupled with a 124 bps y-o-y decline in gross margin to 50.3%. The EBITDA stood at Rs. 296.9 crore, reporting a decline of 21.2% y-o-y. In-line with decline in EBITDA, PAT declined by 20.2% y-o-y to Rs. 241.2 crore. Total R&D expenses for Q2FY23 was Rs. 41.4 crore which is 4.0% of revenue, while the capex incurred was Rs. 41.1 crore. In Q2FY23, the company filed six ANDAs, three DMFs and received six ANDA approvals. For H1FY2023, revenue declined by 14.9% y-o-y to Rs. 1,901.3 crore while PAT fell by 27.9% y-o-y to Rs. 470.4 crore and EBITDA margin contracted by 657 bps y-o-y to 29.8%.

Muted performance in core markets in Q2

Gland's core markets which consist of the US, Europe, Australia, and Canada delivered muted performance in Q2FY2023, with revenue growth at 3% y-o-y and 6% q-o-q to Rs. 747.5 crore impacted by steep competition in new launches and a higher base of Q2FY2022. Core markets collectively contributed ~72% to the overall revenue in Q2FY2023 against 67% in Q2FY2022. During the quarter, direct sale to US customers stood at Rs. 598.4 crore and to Indian customers for the US markets stood at Rs. 75.4 crore, totaling Rs. 673.8 crore. Total sales to the US grew by 5% y-o-y and 6% q-o-q. Revenue from other regulated markets declined 9% y-o-y and grew 10% q-o-q. 6 product SKUs (2 molecules) were launched in 2QFY23 with the key launch of Bumetanide in the US market. In 1HFY23, Gland launched 20 products, while in 2HFY23, it has planned 25 launches (9 launches in Q3FY23 and 16 in Q4FY23). The company has guided for 25-30 launches in FY24. As of H1FY23, Gland and its partners had 322 ANDA filings in the US, of which 259 were approved and 63 are pending approval. The company expects ANDA filings to accelerate in H2FY2023. Collectively, a strong product launch pipeline bodes well and provides ample growth visibility.

Sequential growth in RoW markets; China remains key focus area

RoW sales grew by 124% q-o-q to Rs. 224.3 crore (declined 3% y-o-y), as the material supply issues started to improve and the company has been building sufficient inventory, along with qualifying alternate suppliers. The contribution from RoW markets remained stable at 21% with key ROW markets continuing to be MENA, LatAM and APAC. Gland registered Esomeprazole Sodium, Melphalan Hydrochloride and Labetalol Hydrochloride in new geographies such as Q2FY2023. As per the management, higher air freight costs have reduced the company's pricing advantage and also put pressure on RoW margins which declined to 25% in 2QFY23 from 35% in 1QFY23. China remains a key geographic focus for Gland with the company filing eight products in China in Q2FY2023 and expects two approvals in 2HFY23. Additionally, the company aims to file six products in FY2024. Gland is also expanding its penetration in the RoW markets such as South Africa and Kazakhstan to further aid growth.

India recovering on q-o-q basis

India business revenues, contributing 7% to overall sales (down from 12% in Q2FY2022), came in at Rs. 72.6 crore in Q2FY2023. Revenue declined steeply by 42% y-o-y impacted by a high base of Q2FY2022 due to COVID-related revenue in that quarter and higher input costs due to supply-side challenges for the core portfolio which impacted sales conversion. However, on a sequential basis, revenue was up by 42% as insulin line modifications were completed and the line was available for commercial production during the quarter. The company made product dispatches during the second half of the quarter.

Continued R&D spends

R&D expenses for the quarter stood at Rs. 41.4 crore, translating to 4% of overall sales for the quarter. During the quarter, Gland filed for six ANDAs, three DMFs and received 6 ANDA approvals. Going forward, the company has guided for 4-5% R&D spends (as % of revenue).

Higher capex expected in H2

The total capex incurred in Q2FY2023 was Rs. 41.1 crore and in H1FY2023 was Rs. 82.5 crore. For FY2023, the company plans to invest Rs. 300-350 crore in capex which would be utilized towards expansion of the Pashamylaram and Vizag API facility and for routine maintenance capex. The management has also indicated that capex in FY2024 is likely to be higher on a y-o-y basis.

Other key conference call highlights

- **Near-term outlook weak; medium-term prospects intact:** The management has indicated that the company will not be meeting its earlier guidance of double-digit y-o-y sales growth cumulatively in the last three quarters of FY2023 owing to factors such as lower-than-expected oncology sales and disruption in manufacturing lines due to supply-chain issues and is not giving any further guidance as the market conditions remain volatile. Having said that medium term prospects are intact led by Gland's presence in low competition injectable segment, ability to build economies of scale with a partnership model, entry into newer markets and a strong compliance track record.
- **Gross margin at all-time lows:** Gross margins were down by 609 bps q-o-q and 124 bps y-o-y impacted by unfavourable geographical and product mix as delay in material supplies impacted volumes in certain products. Besides, pricing pressure in some products also dragged margins. The company took a one-time inventory write-off of Rs. 7-8 crore, which further impacted gross margins. As per the management, US gross margins increased 100 bps y-o-y to 58%, gross margins in Canada (2% contribution to sales) have reduced from 88% in Q2FY2022 to 65% in Q2FY2023, while ROW gross margins have declined from 35% to 25% on a y-o-y basis due to higher input and freight costs.
- **Supply challenges easing eventually:** The management indicated that even though disruption in stopper supplies continues, most of the other supply issues, including pre-filled syringes to a large extent, have been resolved and the company saw improvement in supplies in the second half of 2QFY23. The company has added additional supplies for stopper and with initial quantities expected in November 2022, management expects the stopper shortage situation to normalize by Q1FY2024.
- **Higher employee costs in Q2:** The company added ~500 people in Q2FY2023, which led to 23% y-o-y increase in the employee cost. Gland increased its headcount for biologics as well as for its existing operations and also on-boarded certain senior executives during the quarter. The company has also opened new offices in the US and Singapore.
- **Other expenses expected to come down:** The management has guided that with increased mix of sea shipments, freight costs are expected to reduce in the quarters ahead.
- **Biologics CDMO gaining traction:** The company has witnessed significant progress in building internal capabilities in terms of resources and infrastructure for its biosimilar CDMO business and is exploring opportunities for external partnerships. Gland is seeing a lot of interest from existing partners. As per the management, several customer visits have been completed in 1HFY23 and a few of these have moved to the stage of commercial negotiations. In Q2FY2023, operational expenditure in the CDMO business was Rs. 15 crore and depreciation came in at Rs. 6-7 crore. Gland does not expect to incur any additional fixed costs for its biologics CDMO segment, going forward.
- **Profit share stable at 7%:** Profit share contribution in Q2FY23 stood at 7% of sales. In 1HFY22 and 1HFY23, profit share contribution stood at 8% of sales each.
- **Strong cash position:** The company generated Rs. 395.6 crore cash flow from operations during H1FY23. As of September 2022, the company had total Rs. 3,820 crore of cash and bank balances.
- **Higher working capital and cash conversion cycle in Q2:** Working capital stood at Rs. 2,143.6 crore as on September 30, 2022 as compared to Rs. 2,021.7 crore as on 31st March 2022 due to increased inventory levels. Average cash conversion cycle also increased to 231 days for H1FY2023 as compared to 198 days in H1FY2022 due to increased receivables and inventory.

Results (Consolidated) Rs cr

Particulars	Q2FY23	Q2FY22	y-o-y %	Q1FY23	q-o-q %
Total Income	**1,044.4**	**1,080.5**	**-3.3**	**856.9**	**21.9**
Expenditure	747.6	703.8	6.2	587.0	27.4
Operating profit	**296.9**	**376.6**	**-21.2**	**269.9**	**10.0**
Other income	65.6	51.2	28.2	74.4	-11.8
EBIDTA	362.5	427.8	-15.3	344.3	5.3
Interest	1.7	1.0	68.1	0.9	90.6
Depreciation	36.7	26.1	40.5	34.9	5.0
PBT	324.1	400.7	-19.1	308.5	5.1
Tax	82.8	98.6	-16.0	79.3	4.4
Adjusted PAT	**241.2**	**302.1**	**-20.2**	**229.2**	**5.3**
			BPS		**BPS**
OPM (%)	28.4	34.9	-644	31.5	-308
EBIDTA margin (%)	34.7	39.6	-489	40.2	-547
Net profit margin (%)	23.1	28.0	-486	26.7	-365

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Better growth prospects

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), improving 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, biosimilars, and injectables) and commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for Indian pharma companies.

■ Company Outlook – Near-term outlook weak; medium-term prospects intact

For H1FY2023, Gland's revenue/PAT declined by 14.9% /27.9% y-o-y, respectively, while EBITDA margin contracted by 657 bps y-o-y to 29.8% owing to multiple headwinds which dragged the company's performance. Near term outlook of the company is weak owing to supply side constraints, cost inflation and overall weak macro-economic sentiments. Improved demand traction and incremental capacities coming on stream provide ample growth visibility ahead. Moreover, the company is looking to build its presence in the European market through the inorganic route and is open to an acquisition in the complex API space. The company is backing on its strong product pipeline and entry into newer markets to aid growth in the medium to near term. Margins are expected to improve aided by easing supply side challenges and lower freight costs. Revenue and PAT are expected to clock a CAGR of 17% and 21%, respectively over FY2023E-25E.

■ Valuation – Retain Buy with a revised price target of Rs. 2,260

Gland reported yet another weak quarter with revenue and PAT down by 3% and 20%, respectively. Unfavourable geographical and product mix, supply-side constraints, cost inflation and overall weak macro-economic sentiments dragged performance. However, the challenges are expected to be transient in nature and medium-term prospects are intact led by a strong product pipeline and entry into newer markets. Stock price has corrected by ~41% in last six months due to said challenges which the management expects to ease out gradually and could support growth in the medium. At the CMP, the stock trades at 29.8x/23.6x its FY2023E/FY2024E EPS. With a favourable risk-reward after sharp correction in the recent past and expected good growth in the medium term we retain our Buy recommendation on the stock with a revised PT of Rs. 2,260.

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
Gland Pharma	1899.0	16.5	31,274.3	33.3	33.8	26.5	21.4	21.2	16.5	16.9	14.4	15.6
Cipla	1165.0	80.7	94,000.7	34.3	30.3	23.8	20.4	18.4	14.8	14.6	13.9	15.4
Dr Reddy's	4,501.0	16.6	74,914.3	34.2	25.4	21.1	14.1	12.8	10.4	11.4	14.1	15.2

Source: Company, Sharekhan estimates

About the company

Gland was established in Hyderabad in 1978. The company is a vertically integrated company with capabilities, including internal research and development expertise, robust manufacturing capabilities, a stringent quality assurance system, extensive regulatory experience, and established marketing and distribution relationships. The company has expanded from liquid parenteral to cover other elements of the injectables value chain, including contract development, own development, dossier preparation and filing, technology transfer, and manufacturing across a range of delivery systems. Predominantly, Gland has been focusing on the injectables space with negligible presence in orals. The company focuses on meeting diverse injectables needs with a stable supply of affordable and high-quality products. Gland follows a unique B2B business model and has a successful track record of operating this model across multiple geographies. Gland has a total of seven manufacturing plants with three of them being API plants. Of the balance, two are sterile injectables plant – one each for oncology and ophthalmology.

Investment theme

The injectables space inherently has high entry barriers, thus pointing towards relatively low competition. Gland has extensive and vertically integrated injectable manufacturing capabilities and has a consistent regulatory compliance track record, with no observations received from the USFDA. Improved demand traction and incremental capacities coming on stream provide ample growth visibility ahead. Further, the company follows a unique diversified B2B-led model across markets globally, which partially lowers compliance risk, thus paving the way for faster growth. In domestic markets, Gland follows a B2C model. Gland has an extensive portfolio of complex products, awaiting to be commercialised across markets. The company has an experienced management team and, over the years, has developed strong capabilities, which would enable the company to stage strong growth going ahead. Moreover, the company is looking to build its presence in the European market through the inorganic route and is open to an acquisition in the complex API space. The recent arrangement to manufacture doses of the Sputnik vaccine would just take the company closer to its long-term strategy to enter the lucrative biosimilar space.

Key Risks

1) Delay in key product approvals; 2) any adverse change in the regulatory landscape; and 3) adverse forex movements.

Additional Data

Key management personnel

Yiu Kwan Stanley Lau	Chairman
Srinivas Sadu	Managing Director & Chief Executive Officer
Ravi Shekhar Mitra	Chief Financial Officer
Sampath Kumar Pallerlamudi	Company Secretary & Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Axis Asset Management	3.98
2	Mirae Asset Global Investments	3.86
3	R P Advisory Services	2.61
4	Nicomac Machinery	2.05
5	Nicomac Machinery Pvt Ltd	1.93
6	Nippon Life India Asset Management	1.60
7	ICICI Prudential AMC	1.54
8	Sundaram AMC	1.29
9	R P Advisory	1.14
10	Republic of Singapore	1.05

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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