Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Gland Pharma

Strong headwinds to margins, downgrade to HOLD

Pharmaceuticals	Sharekhan code: GLAND

Reco/View: Hold	↔	CMP: **Rs. 1,575**	Price Target: **Rs. 1,689**	↓

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX

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 44.8

Updated Jul 05, 2021

Severe Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 25,938 cr
52-week high/low:	Rs. 4063 / 1553
NSE volume: (No of shares)	3.6 lakh
BSE code:	543245
NSE code:	GLAND
Free float: (No of shares)	6.9 cr

Shareholding (%)

Promoters	57.9
FII	6.1
DII	21.9
Others	14.11

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	1.1	-9.3	-26.8	-51.3
Relative to Sensex	5.8	-13.3	-39.1	-54.7

Sharekhan Research, Bloomberg

Summary

- We downgrade our rating on Gland Pharma to Hold from Buy and reduce the price target (PT) to Rs. 1,689 (from Rs. 2,260 earlier), as we believe the company is likely to witness margin headwinds over the short-medium term.
- However, the company's management believes the materials' supply timelines have improved and now gives it better visibility in Q3FY2023. We believe this should help it to somewhat maintain margins over the short-medium term, albeit, at lower levels than before.
- Increased competition in the US and resultant price erosion are expected to continue to affect its volumes and gross margins over the short-medium term.
- We believe although the recent acquisition in Europe is accretive at the top line, it will prove EBITDA dilutive – partially offset by any synergy gains, post the integration.

Gland Pharma is expected to continue to face margin headwinds due to supply constraints for some of its components, partial dependency on China for its APIs, price erosions, and loss of sales volumes in recent product launches, with increased competition in injectables and rise in other costs such as freight costs that may continue to put downward pressure on the company's margins over the next few quarters. Additionally, the company's recent acquisition in Europe is likely to be margin dilutive.

- **Heightened levels of competition persisting in the U.S.:** Increased competition in the US and resultant price erosion affected its volumes and gross margins in H1FY2023. Management believes it is trying to gain a new set of clients for the same product or molecule to be able to grow in the U.S. We believe the revenue growth potential is lackluster in the short–medium term without visible robust client additions.
- **Management witnessing supply constraints easing up in a few components:** Management believes the materials' supply timelines have improved and now give it better visibility in Q3FY2023. However, we believe the current price increases in China-sourced active pharmaceutical ingredients (APIs) and higher transportation costs may continue to hinder the company's financial performance over the short term-medium term.
- **Acquisition of Cenexi CMO business in Europe to be margin dilutive:** The company has recently acquired Cenexi, which is into CDMO services in Europe. However, we believe the acquisition will be accretive on the topline, but it will prove EBITDA dilutive – partially offset by any synergy gains, post the integration.

Our Call

Valuation: Gland Pharma has a very formidable business moat reflecting in the strong EBITDA margin of 30-35% it has been commanding, as it operates in a highly specialised, complex, and a niche segment of the pharma market i.e., injectables CDMO services for global pharma players. However, we believe supply constraints for some of its components, partial dependency on China for its APIs, price erosions, and loss of sales volumes in recent product launches with increased competition and rise in other costs such as freight costs may continue to put downward pressure on the company's margins over the next few quarters. Therefore, we now expect the company's earnings to post a 10% CAGR over FY2022-FY2025E (vs. 21% CAGR estimated before). The stock has fallen by 17% since its Q2FY2023 update. At the CMP, the stock trades at 21.5x/15.8x its FY2024E/FY2025E EPS, indicating somewhat fair valuation levels. We value the company's shares at 17.6x (27% discount to its two-years' historical PE), while applying it on FY2025E EPS. As such, we reduce the price target (PT) to Rs. 1,689 and downgrade the rating from Buy to Hold as, at the CMP, the stock indicates an upside potential of 11.1% only.

Key Risks

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

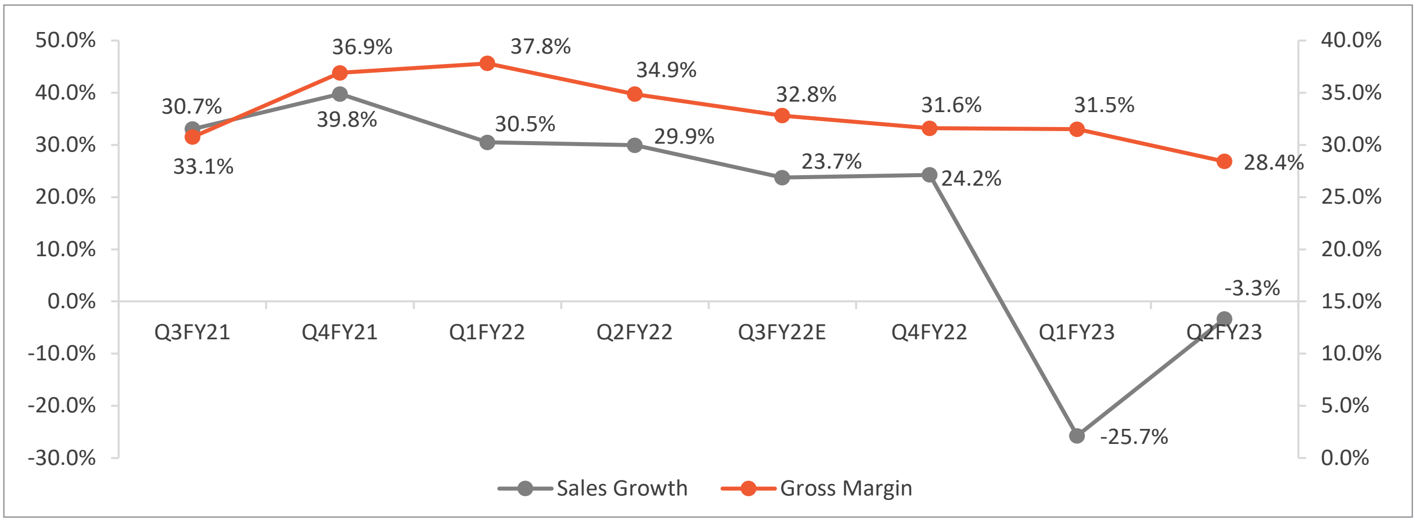
Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E	FY25E
Net Sales	3462.9	4400.7	4343.7	5046.4	7041.1
EBIDTA	1437.0	1734.1	1595.6	1782.5	2378.0
OPM (%)	37.6	34.3	29.0	28.0	28.0
Adjusted PAT	997.0	1211.7	1069.5	1195.3	1622.7
Adj. EPS (Rs.)	61.1	74.2	65.5	73.2	99.4
PER (x)	25.8	21.2	24.0	21.5	15.8
EV/EBITDA (x)	15.8	13.0	13.9	11.9	8.8
ROCE (%)	22.4	22.4	17.5	17.2	20.1
RONW (%)	16.9	16.9	13.1	12.9	15.0

Source: Company; Sharekhan estimates

- **Recent price changes in China-sourced APIs and increased freight costs to prove headwinds:** The company operates in an industry with lower levels of competition, which acts as a competitive advantage for it. However, at the same time, it has its own set of concerns such as 100% of revenue coming from only injectables, dependency on few customers for nearly ~ 50% of their revenue. Moreover, it has high reliance on China for its API sourcing, which can be 40-50% of its total raw materials cost as well. Over H1FY2023, the company has witnessed a decline in its revenue and EBITDA margin on a y-o-y basis, caused by supply constraints, price erosions in recent launches (which led to fall in sales volumes), and increased other costs. The company's fixed assets turnover declined to 2.4x in H1FY2023 from 3.4x for H1FY2022, as a result. It is believed that the current price increases in China-sourced APIs and higher transportation costs may continue to hinder the company's financial performance over the short-medium term.
- **Management witnessing supply constraints easing up:** Management believes the materials' supply timelines have improved and now gives it better visibility in Q3FY2023. Moreover, the company is building inventory to support sales volume growth in the quarters ahead. With normalisation of inventory of the critical materials such as syringes and rubber stoppers etc., which need to be USFDA approved as being sourced from the US, management believes freight costs will reduce over the short-medium term. However, we believe this should help it to somewhat maintain margins – partially offset by continued elevated raw materials and transport costs likely in the near term due to geopolitical situation and China's COVID-19 scare. The company intends to resolve the issue of supply constraints over the long term by having several alternative sources for most of the components of the products, especially for key products. However, adding alternative sources of supply elevates costs.
- **Heightened levels of competition persisting in the U.S.:** The company is entirely dependent on generic injectables business. Increased competition in the U.S. and resultant price erosion affects its volumes and gross margins. The U.S. contributes a major share of the international revenue. Management believes it is trying to gain a new set clients for the same product or molecule to be able to grow in the U.S. However, given the complex nature of the injectable business and long incubation time needed before commercialisation of a product, we believe it will take medium-long term to impact volumes and margins favourably. So, we believe the revenue growth potential is lacklustre in the short-medium term, while new clients get added over a medium-long term.
- **Acquisition of Cenexi CDMO business in Europe to be margin dilutive:** The company has recently acquired Cenexi, which is into CDMO services with expertise in sterile products and operating in ampoules, PFS and vials, and complex formulations. The acquisition is expected to help Gland Pharma to expand in the European market in line with its strategic roadmap of building European manufacturing presence in sterile injectables. However, we believe the acquisition will be accretive on the topline, but it will prove EBITDA dilutive, partially offset by any synergy gains, post the integration.

Sales growth and gross margins %



Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Better growth prospects

The Indian Pharma market (IPM) is growing with increased consumer spend and awareness. Additionally, Indian pharmaceutical players with a large market share in IPM and a strong pipeline of speciality products will help them gain market share in the U.S. and thereby partially offset any impact of competitive pricing pressure in the U.S. Moreover, other factors such as faster product approvals and resolutions by the USFDA regards to plant observations 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, 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-medium term outlook weakens

Near-medium term outlook of the company is weak owing to supply-side constraints, cost inflation, and overall weak macro-economic sentiments. 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. Moreover, the company has acquired a CDMO services company in Europe to build its presence in the European market, which can be margin dilutive – partially offset by synergy gains. The company is backing on its strong product pipeline and entry into newer markets to aid growth in the medium-long term though. Margins are expected to improve aided by easing supply-side challenges and lower freight costs over the medium-long term.

■ Valuation - Downgrade to HOLD with a revised price target of Rs. 1,689

Gland Pharma has a very formidable business moat reflecting in the strong EBITDA margin of 30-35% it has been commanding, as it operates in a highly specialised, complex, and a niche segment of the pharma market i.e., injectables CDMO services for global pharma players. However, we believe supply constraints for some of its components, partial dependency on China for its APIs, price erosions, and loss of sales volumes in recent product launches with increased competition and rise in other costs such as freight costs may continue to put downward pressure on the company's margins over the next few quarters. Therefore, we now expect the company's earnings to post a 10% CAGR over FY2022-FY2025E (vs. 21% CAGR estimated before). The stock has fallen by 17% since its Q2FY2023 update. At the CMP, the stock trades at 21.5x/15.8x its FY2024E/FY2025E EPS, indicating somewhat fair valuation levels. We value the company's shares at 17.6x (27% discount to its two-years' historical PE), while applying it on FY2025E EPS. As such, we reduce the PT to Rs. 1,689 and downgrade the rating from Buy to Hold as, at the CMP, the stock indicates an upside potential of 11.1% only.

Peer Comparison

Companies	CMP (Rs/ Share)	O/S Shares (Crs)	Mcap (Rs Cr)	P/E (x)			EV / EBITDA (x)			RoE (%)		
				FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Gland Pharma	1575.0	16.5	25,938.4	24.0	21.5	15.8	13.9	11.9	8.8	13.1	12.9	15.0
Cipla	1086.0	80.7	87,630.1	29.2	23.3	19.2	17.8	14.4	11.9	14.2	15.5	16.1
Dr Reddy's	4,257.8	16.6	70,867.3	20.5	16.8	14.4	11.5	9.7	7.8	17.3	18.5	18.5

Source: Company; Sharekhan Research

About 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 also. However, we believe supply constraints for some of its components, partial dependency on China for its APIs, price erosions and loss of sales volumes in recent product launches with increased competition and rise in other costs such as freight costs may continue to put downward pressure on the company's margins over the next few quarters.

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 and Chief Executive Officer
Ravi Shekhar Mitra	Chief Financial Officer
Sampath Kumar Pallerlamudi	Company Secretary and Compliance Officer

Source: BSE; Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Mirae Asset Global Investments	3.90
2	Axis Asset Management Co Ltd.	2.92
3	ICICI Prudential AMC	2.68
4	RP Advisory Services	2.61
5	Nippon Life India AMC	2.27
6	Nicomac Machinery	2.05
7	Aditya Birla Sun Life AMC	1.45
8	Nicomac Machinery Pvt Ltd.	1.19
9	RP Advisory	1.14
10	UTI AMC	1.14

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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