Sharekhan by BNP PARIBAS

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Aurobindo Pharma Ltd

Continued weak profitability in Q3; Cost pressures to stay

Pharmaceuticals	Sharekhan code: AUROPHARMA		
Reco/View: Hold ↔	CMP: **Rs. 469**	Price Target: **Rs. 516** ↓	

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Aurobindo Pharma Limited (Aurobindo) reported improved performance for the quarter compared with Q2FY2023 on the sales front. However, concerns surrounding cost pressures continued, which resulted in a 6.1% y-o-y decline in EBITDA to Rs. 954.4 crore, while EBITDA margins contracted by 204 bps y-o-y to 14.9%.
- The company's injectables revenue share increased sharply though to 28.6% of the U.S. revenue in Q3FY2023 from 22.5% of the U.S. revenue in Q2FY2023 and 24.9% in Q3FY2022.
- Results on the profitability side missed internal and consensus estimates massively.
- We believe the company is yet to show steady improvement in its profitability and until then we will retain our Hold rating on it. The company' shares are trading at 11.9x/10.1x its FY2024E/FY2025E EPS.

Aurobindo Pharma Limited (Aurobindo) reported an improved performance for the quarter vs. Q2FY2023 on the sales front. However, concerns surrounding cost pressures continued, which resulted in a 6.1% y-o-y decline in EBITDA to Rs. 954.4 crore, while EBITDA margins contracted by 204 bps y-o-y to 14.9%. This can be attributed to increased R&D spend. Positively though, the company's gross margin stabilized with around 34-bps y-o-y rise and a 64-bps q-o-q decline in it to 54.6%, which indicates stabilization of raw-material concerns and improved products mix y-o-y. However, q-o-q decline in gross margins even though marginally, indicates likely pricing pressure despite a strong 11.6% q-o-q rise in revenue. The company's injectables revenue share increased sharply to 28.6% of the US revenue in Q3FY2023 from 22.5% of the US revenue in Q2FY2023 and 24.9% in Q3FY2022. Results on the profitability side missed internal and consensus estimates, massively, though. We believe the company is yet to show steady improvement in its profitability and until then we will retain the Hold rating on it.

Key positives

- Revenue growth improved on account of growth across markets.
- Gross margin stabilized both y-o-y and q-o-q likely due to normalisation of raw-materials cost and improved products mix.

Key negatives

- Following the increase in other expenses, EBITDA margin contracted by 204 bps y-o-y and missed estimates on the profitability front with a wider margin.

Management Commentary

- Management believes Q3FY2023 witnessed good recovery q-o-q. It was a good quarter on all fronts, be it demand, volume, or pricing, due to seasonality, in terms of antibiotic products and stable pricing.
- The present trend is expected to continue in the next FY as well. Logistics costs are at a better pricing level, q-o-q, and YTD. Management believes product pricing changes will be there, but the company sees a stable pricing environment going forward.
- In Q2FY2023, the company had stated that NDAs of 40 products are slated to be commercialised, which can bring in incremental revenue of USD50mn over the next 12 months. The injectables business has improved, and management expects it to continue with volume growth and stable pricing likely in it. The company has launched six injectable products and is expected to drive double-digit growth in the segment.

Revision in estimates – We estimate its sales to grow at 8.9% and earnings to report at 17.5% CAGR over FY2023-FY2025E.

Our Call

Valuation – Cost pressures continue to be a concern; Retain Hold: Aurobindo posted a better quarter in terms of sales growth, with strong growth seen across markets both y-o-y and q-o-q. At the same time, its injectables sales have improved drastically. This coupled with raw-material cost stability, seen y-o-y and q-o-q, has led to stable gross margins for the respective periods. However, increased other expenses due to higher R&D on biosimilar products and other costs have continued to lead to margin contraction in this quarter, however, at a slower pace than in Q2FY2023. As there has been an improvement in sales across markets and gross profitability seems to have stabilised, we introduce FY2025 and estimate an 8.9% and 17.5% CAGR in its sales and earnings, respectively, over FY2023-FY2025E. At the CMP, the stock is trading at a valuation of 11.9x/10.1x its FY2024E/FY2025E EPS. Given the likely sustained cost pressures and uncertainties on profitability ends, we retain our Hold recommendation on the stock with a revised price target (PT) of Rs. 516.

Key Risks

Delay in the 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 (Rs. crore)	FY2021	FY2022	FY2023E	FY2024E	FY2025E
Total Income	24774.6	23455.5	24552.1	25688.0	29140.1
Operating profit	5333.4	4386.8	3599.3	4033.0	4575.0
OPM (%)	21.5	18.7	14.7	15.7	15.7
Adj. PAT	2474	2736	1974	2299	2724
EPS (Rs.)	42.2	46.7	33.7	39.2	46.5
PER (x)	11.1	10.0	13.9	11.9	10.1
EV/EBITDA (x)	4.9	6.0	5.7	4.5	3.4
ROCE (%)	18.6	12.9	9.3	10.4	11.3
RONW (%)	12.8	11.8	7.8	8.4	9.2

Source: Company; Sharekhan estimates

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 Dec 08, 2022				36.18
High Risk				
NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

Company details

Market cap:	Rs. 24,471 cr
52-week high/low:	Rs. 728 / 397
NSE volume: (No of shares)	99.5 lakh
BSE code:	524804
NSE code:	AUROPHARMA
Free float: (No of shares)	28.2 cr

Shareholding (%)

Promoters	51.8
FII	22.3
DII	14.9
Others	10.96

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	4.7	-1.9	-18.6	-33.1
Relative to Sensex	3.7	-2.8	-21.0	-37.4

Sharekhan Research, Bloomberg

Elevated costs continue to pressure profitability: Aurobindo reported an improved performance for the quarter vs. Q2FY2023 on the sales front; however, concerns surrounding cost pressures continued, which resulted in a 6.1% y-o-y decline in EBITDA to Rs. 954.4 crore, while EBITDA margin contracted by 204 bps y-o-y to 14.9%. This can be attributed to increased R&D spend. Positively though, the company's gross margins stabilised with around 34 bps y-o-y rise and a 64 bps q-o-q decline in it to 54.6%, which indicates stabilisation of raw-materials concerns and improved products mix y-o-y. However, q-o-q decline in gross margins, even though marginally, indicates likely pricing pressure despite strong 11.6% q-o-q rise in revenue. The company's injectables revenue share increased sharply to 28.6% of the US revenue in Q3FY2023 from 22.5% of the US revenue in Q2FY2023 and 24.9% in Q3FY2022. Though, results on the profitability side missed internal and consensus estimates massively. Consolidated revenue was at Rs. 6,407.1 crore, which grew by 6.7% y-o-y and was largely in line with estimates. Topline growth was supported by 9.3% y-o-y growth in the US revenue (47% of revenue), while growth markets (8%) were up 25.7% y-o-y and ARV formulations (4%) grew 61.3%. Other income for the quarter increased by 78% y-o-y to Rs. 80.5 crore, while finance costs rose by 178.7% y-o-y to Rs. 45 crore. Consequently, PAT stood at Rs. 491 crore, down 18.7% y-o-y and missed estimates.

Strong product pipeline: The company has received final approval for 15 ANDAs, including four injectables from the USFDA during the quarter. Moreover, the company has filed 11 ANDAs, including two injectables with the USFDA, and launched 11 new products, including six injectables in Q3FY2023. In total, the company has 767 ANDAs with 542 ANDAs, including 97 injectable products, standing approved, and remaining being tentative or under review, as of Q3FY2023. A large share of the approved ANDAs is for CNS, CVS, oncology, and hormones segments, which indicates the complexity of the products in the pipeline.

Q3FY2023 Conference Call Highlights

- **US outlook:** Q3FY2023 witnessed good recovery sequentially. It was a good quarter on all fronts, be it demand, volume, or pricing, due to seasonality, in terms of antibiotic products and stable pricing. The present trend is expected to continue in the next FY as well. Logistics costs are at a better pricing level, QoQ and YTD. Management believes product pricing changes will be there, but the company sees a stable pricing environment going forward. In Q2FY2023, the company had stated that NDAs of 40 products are slated to be commercialised, which can bring in incremental revenue of USD 50 mn over the next 12 months. The injectables business has improved, and management expects it to continue with volume growth and stable pricing likely. The company has launched six injectable products and is expected to drive double-digit growth in the segment. Amphotericin B Liposome for injection, 50 mg was launched on January 23. The first two quarters witnessed high pricing and competitive pressures. Though volumes have improved in the quarter, as regulatory issues with competitors are leading to improved performance for Aurobindo. USFDA approval is in place for Linaclotide, however, as it has got the settlement from the originator; it cannot commercialise it in the immediate future. Commercialisation for the product is likely in the medium term.
- **R&D spend to increase:** R&D increased to Rs. 415 crore (6.5% of revenue vs. Rs. 276 crore or 4.8% of revenue in Q2FY2023) due to biosimilar products in the pipeline. Phase III biosimilars programmes are ongoing, including that for 3 products, out of that one product is likely to reach the closure soon. Increased R&D spend is likely to continue for another 6-7 quarters, while these products remain in clinical trials and mature over a period. R&D spend is expected to be at 6.0-6.5% of sales over the short-medium term.
- **Carving out the API unit to enhance operating efficiencies:** Aurobindo is proposing to transfer its non-antibiotic division business to Auro Pharma India Pvt. Ltd., a wholly owned subsidiary of Aurobindo. It is intended to bring all regulatory active pharmaceutical ingredients (API) units under one controlling entity to mitigate risks concerned with regulatory concerns and profitability. It is expected to add to shareholder's value. It may also look at a strategic alliance to be able to enhance value to the shareholders.
- **Regulatory compliance:** In the formulations segment, management does not have any concerns with respect to regulatory compliance.
- **Biosimilars:** Management states that there are two biosimilar products in the pipeline. GMPA inspection is pending with respect to an oncology product in EMEA, MHRA, and Health Canada. FY2025 will be the period by which antibody oncology products commercialise across markets. The first biosimilar is likely in FY2025 in the US as well. The company has incorporated a biosimilar subsidiary in the US to scale it up and become cost competitive, including the CMO opportunity for lower-income and middle-income countries.

Other highlights

- Capital WIP is Rs. 4,200 crore – China plant is almost completed and manufacturing plant at Vizag is ongoing. It is expected to commission from FY2024.
- Buyback decision is likely in the board meeting of the company in May 2023. Changes in the Article of Association (AOA) have been made to be able to accommodate the buyback.
- Generic Revlimid – Q3FY2024 will be the launch period.
- FCF generation – New products, including biosimilars, to generate FCF from FY2025. In FY2024, the company intends to generate FCF as not many new greenfield projects are there.

Results (Consolidated) Rs cr

Particulars	Q3FY23	Q3FY22	YoY %	Q2FY23	QoQ%
Total Income	6,407.1	6,002.2	6.7	5,739.4	11.6%
Operating expenditure	5,452.7	4,986.0	9.4	4,902.5	11.2%
EBITDA	954.4	1,016.3	-6.1	836.9	14.0%
Depreciation	321.4	299.1	7.5	298.1	7.8%
EBIT	633.0	717.2	-11.7	538.8	17.5%
Interest	45.0	16.1	178.7	25.3	77.8%
Other income	80.5	45.2	78.0	57.2	40.8%
PBT	668.6	746.3	-10.4	570.7	17.2%
Tax	189.1	189.5	-0.2	113.0	67.4%
MI and Income from Associates	-0.6	7.1	NM	1.2	NM
Adjusted PAT	478.9	624.1	-23.3	364.3	31.5%
Exceptional Items	-12.1	-19.8	-38.6	-46.1	-73.7%
Reported PAT	491.0	604.3	-18.7	410.4	19.7%
Margins			**BPS**		**BPS**
EBIDTA margin (%)	14.9	16.9	-204	14.6	31
EBIT (%)	9.9	11.9	-207	9.4	49
Adj PAT margin (%)	7.5	10.4	-292	6.3	113
Tax rate (%)	28.3	25.4	289	19.8	849

Source: Company; Sharekhan Research

Revenue mix Rs cr

Particulars	Q3FY23	Q3FY22	YoY %	Q2FY23	QoQ%
USA	3,001.2	2,745.2	9.3	2,637.6	13.8
Europe	1,701.2	1,694.3	0.4	1,516.2	12.2
Growth Markets	498.9	397.0	25.7	451.9	10.4
ARV	251.2	155.7	61.3	164.3	52.9
Formulations	**5,453**	**4,992.2**	**9.2**	**4,770.0**	**14.3**
Beta lactams	623	683.8	(8.9)	635.8	(2.0)
Non-Beta lactams	332	326.2	1.6	333.6	(0.6)
API	**955**	**1,010.0**	**(5.5)**	**969.4**	**(1.5)**
Gross Sales	**6,407**	**6,002.2**	**6.7**	**5,739.4**	**11.6**
Dossier Income	0.0	0.0	-	0.0	-
Net Sales	**6,407**	**6,002.2**	**6.7**	**5,739.4**	**11.6**

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

Outlook and Valuation

■ Sector View – Multiple growth engines ahead

The India Pharmaceutical 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 specialty products will help them gain market share in the US, thereby partially offsetting any impact of competitive pricing pressure in the US. 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 the 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 – 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 partly enable 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 a 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 continue to be a concern; Retain Hold

Aurobindo posted a better quarter in terms of sales growth, with strong growth seen across markets both y-o-y YoY and q-o-q. At the same time, its injectables sales have improved drastically. This coupled with raw-material cost stability, seen y-o-y and q-o-q, has led to stable gross margins for the respective periods. However, increased other expenses due to higher R&D on biosimilar products and other costs have continued to lead to margin contraction in this quarter, however, at a slower pace than in Q2FY2023. As there has been an improvement in sales across markets and gross profitability seems to have stabilised, we introduce FY2025 and estimate an 8.9% and 17.5% CAGR in its sales and earnings, respectively, over FY2023-FY2025E. At the CMP, the stock is trading at a valuation of 11.9x/10.1x its FY2024E/FY2025E EPS. Given the likely sustained cost pressures and uncertainties on profitability ends, we retain our Hold recommendation on the stock with a revised PT of Rs. 516.

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV/EBIDTA (x)			RoE (%)		
				FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
AurobindoPharma	468.9	58.6	31,107.0	13.9	11.9	10.1	5.7	4.5	3.4	7.8	8.4	9.2
Divis Laboratories	2,811.3	26.5	98,972	38.2	34.1	28.4	24.8	20.8	17.2	14.9	15.0	15.8

Source: Company, Sharekhan estimates

About company

Hyderabad-based Aurobindo was incorporated in 1986 and manufactures generic formulations and 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 is one of the largest pharma players with a large share of revenue from the US with one of the highest ANDA filings. However, it is grappling with the pricing pressure in its OSD segment, wherein it has a stronghold. Nevertheless, it is seeing an uptick in its complex and specialty injectables revenue share in the US. With an increased share of the injectables and biosimilar products revenue, it should be able to stabilise its margins over the medium term. However, currently, it is experiencing margin pressures due to increased expenses and uneven sales growth.

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

Mr. K. Ragunathan	Chairperson
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 shareholders

Sr. No.	Holder Name	Holding (%)
1	LIFE INSURANCE CORPORATION OF INDIA	5.57
2	HDFC TRUSTEE COMPANY LTD.	2.94
3	MIRAE ASSET EMERGING BLUECHIP FUND	1.69
4	BNP PARIBAS ARBITRAGE	1.22
5	INVESCO PACIFIC FUND (U.K.)	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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