Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Laurus Labs Ltd

Weak Q4; medium-term prospects dim

Pharmaceuticals	Sharekhan code: LAURUSLABS

Reco/View: Hold	↔	CMP: **Rs. 308**	Price Target: **Rs. 338**	↓

↑ 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	36.83
Updated Dec 08, 2022	

High Risk

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

Source: Morningstar

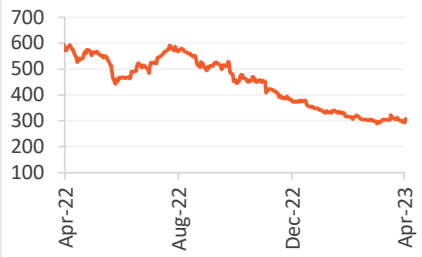
Company details

Market cap:	Rs. 15,731 cr
52-week high/low:	Rs. 606/279
NSE volume: (No of shares)	158.5 lakh
BSE code:	540222
NSE code:	LAURUSLABS
Free float: (No of shares)	39.1 cr

Shareholding (%)

Promoters	27.2
FII	22.4
DII	9.7
Others	40.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	6.2	-10.0	-32.4	-46.2
Relative to Sensex	0.1	-13.0	-34.3	-52.5

Sharekhan Research, Bloomberg

Summary

- Q4FY2023 numbers were far below expectations, with sales and net profit lagging by ~10% and ~46%, respectively. Sharper-than-anticipated fall in CDMO/ custom synthesis and generic FDF revenue, an unfavorable product mix and operating de-leverage affected performance.
- The company expects FY2024E to be the year of consolidation, as a large purchase order – the Paxlovid supply contract – gets completed, owing to which we expect CDMO and custom synthesis revenues to decline over FY2023-FY2025E.
- Yet, a strong growth in generic API and Bio businesses and a gradual recovery in generic FDF business would offset the fall in the CDMO/ custom synthesis biz; partially offset by unfavorable products mix and operating de-leverage over FY2023-FY2025E.
- Stock trades at a higher valuation of ~ 24.9x/17.7x its FY2024E/FY2025E earnings estimates as compared to ~ 21.0x/18.0 FY2024E/FY2025E estimates for its peers. Hence, we maintain Hold on Laurus with a revised PT of Rs. 338 (vs. Rs. 368 earlier).

Laurus' revenues and profitability far lagged expectations in Q4FY2023 and FY2023 owing to a sharper-than-expected fall in the custom synthesis/ contract development and manufacturing organization (CDMO) and generic fixed dosage formulations (FDF) businesses. The company posted a 26.4% EBITDA margin for FY2023 versus the management's guidance of ~28%, internal estimate of ~25% and street's estimate of ~24.6%. The weak show was due to lower procurement from global agencies and adverse pricing, affecting generic FDF's sales as nearly 60% of generic FDF's revenue comes from anti-retroviral (ARV) formulations and as a large purchase order has been over in the CDMO synthesis business. This led to the product mix favoring low-value generic API business, thereby leading to a decline in gross and EBITDA margin by 235 bps y-o-y (-373 bps q-o-q) and 716 bps y-o-y (-545 bps q-o-q), respectively, in Q4FY2023 and by 148 bps and 246 bps y-o-y, respectively, in FY2023. This led to the company posting a 54.6% y-o-y (-48.0% q-o-q) decline in net profit to Rs. 105.3 crore in Q4FY2023 and by 4.7% y-o-y to Rs. 793 crore in FY2023. We anticipate that the custom synthesis and CDMO segment will witness a decline over FY2023-FY2025E due to completion of supply contract towards Paxlovid, while other segments such as generic API and Bio segments will grow while generic FDF sees gradual recovery over the same period. Given a likely adverse product mix, margins would decline in FY2024E y-o-y, only to improve gradually from FY2025E.

Key positives

- Company has bagged a supply contract from Global Fund for ARV drugs to be supplied over CY2023-CY2025 from Q1FY2024.

Key negatives

- Generic FDF revenue declined 39% y-o-y for FY2023 due to less procurement and adverse pricing in ARV formulations.
- Completion of a large purchase order in the CDMO/custom synthesis business likely that of Paxlovid and, therefore, an anticipated fall in its revenue over FY2023-FY2025E will lead to an unfavorable product mix and pressurise profitability in FY2024E onwards.

Management Commentary

- Revenue from the animal CDMO business expected to realise from H2FY2024.
- For FY2023, capacity utilisation was 55-60%, indicating spare capacity.
- A large pharmaceutical project was executed and will not be adding to sales in FY2024E.
- Q4FY2023 was affected by the completion of a large purchase order in Q3FY2023 and higher upfront cost of capex and R&D projects.
- Management has made significant investments to expand into the non-ARV business, with total commissioned capacity of ~ 10 billion tablets per year and this brownfield capacity is expected to be used more in FY2024, as better demand emerges for the ARV and CMO segments, as well as key product approvals come in from the US, Europe, and Canada.

Revision in estimates – As we anticipate a fall in CDMO and custom synthesis business segment's revenue, owing to the completion of a large purchase order in Q3FY3023 towards Paxlovid, partially offset by slower growth in generic FDF and bio businesses, we estimate total revenue to grow at ~ 7.0% CAGR over FY2023-FY2025E. Moreover, we factor in fall in margins up-to FY2025E over FY2023, due to adverse products mix towards generic APIs and expected slower recovery in capacity utilisation and weakness in pricing of ARVs. We expect earnings to grow at ~ 9.0% CAGR over FY2023-FY2025E.

Our Call

Maintain Hold with a revised PT of Rs. 338: Laurus massively underperformed in Q4FY2023 missing both internal and street estimates. Revenue and profitability lagged by ~10.0% and ~46.0%, respectively. At the same time, the stock has corrected by ~48% over the past year. The company is seeing capacity under-utilisation due to newly commissioned formulation capacity due to lower demand for ARVs from global agencies and a fall in pricing due to competition. Additionally, its high-value CDMO and custom synthesis segment is expected to post decline in revenue over FY2023-FY2025E, owing to completion of a large purchase order towards Paxlovid. At the same time, we believe the company will see a fall in profitability in FY2024E y-o-y and gradually witness an uptick in it over FY2024E to FY2025E due to improved capacity utilisation, eventually. Stock trades at a higher valuation of ~ 24.9x/17.7x its FY2024E/FY2025E earnings estimates as compared to ~ 21.0x/18.0 FY2024E/FY2025E estimates for its peers. Hence, we maintain Hold on Laurus with a revised PT of Rs. 338 (vs. Rs. 368 earlier).

Key Risks

Delays in product approvals or any negative outcome of facility inspection by the USFDA can affect earnings prospects.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E	FY25E
Sales	4813.5	4935.6	6040.6	6041.4	6959.0
EBITDA	1,551	1,422	1,592	1,416	1,776
OPM(%)	32.2	28.8	26.4	23.4	25.5
PAT	983.8	832.4	793.4	670.4	940.0
NPM (%)	20.4	16.9	13.1	11.1	13.5
EPS	18.3	15.4	14.6	12.4	17.3
P/E	16.8	20.0	21.0	24.9	17.7
EV/EBIDTA	12.0	13.1	11.7	13.1	10.5
ROE (%)	37.8	24.8	19.6	9.7	18.9
ROCE (%)	34.4	23.0	21.1	15.2	17.0

Source: Company; Sharekhan estimates

Weak Q4 - Revenues fell by 3.1% y-o-y

Laurus reported consolidated total revenue decline of 3.1% y-o-y to Rs. 1,380.9 crore (vs. internal estimate of Rs. 1,536.0 crore) due to revenue of the CDMO custom synthesis segment and generic finished dosage formulation (FDF) segment declining by 36.7% y-o-y and 20.0% y-o-y, respectively. A decline in the CDMO/ custom synthesis segment was due to a high base effect with the completion of a large purchase order in Q3FY2023. At the same time, weak demand, and pricing in anti-retrovirals (ARVs) led to a decline in the generic FDF segment's revenue. Nevertheless, revenue of low-margin generic APIs increased at a stronger pace of 32.5% y-o-y, led by equally strong growth in oncology APIs, other APIs, and ARV API sales.

FY2023 sales performance: Revenues increased 22.4% y-o-y to Rs. 6,041.0 crore. This was driven by a 28% y-o-y rise in generic API revenue (43% of revenue), 136% y-o-y rise in custom synthesis revenue (36%), and 25% y-o-y rise in bio revenues (2%) – partially offset by a 39% y-o-y decline in the generic FDF business revenue (19%). FDF revenues declined due to less procurement from global agencies and adverse pricing. Nearly 60% of the revenue in generic FDF comes from ARV formulations. Nevertheless, given that ARV sales are recovering since Q2FY2023, the company has signed a supply contract with Global Fund for ARV drugs for 2023-2025 and it is expected to further improve going forward. We anticipate a 10% CAGR rise in generic FDF sales over FY2023-FY2025E. With increasing CMO opportunities in high-growth APIs and for ARV APIs, we factor in a 36.6% CAGR rise in generic APIs' sales over FY2023-FY2025E. As a large purchase order is over in the CDMO synthesis business, partially offset by expected new wins from global clients, over the medium term, we factor in a 26% CAGR fall in revenue over FY2023-FY2025E in it. Moreover, we factor in a 20.0% CAGR rise in the bio business, driven by a strong recovery in it and expansion of services and manufacturing capacity in it.

Profitability hit with a change in product mix: As revenues of the high-value generic FDF and custom synthesis segments declined in FY2023 and Q4FY2023, the company has seen its gross margins falling by 235 bps y-o-y (-373 bps q-o-q) to 49.7% in Q4FY2023 and by 148 bps y-o-y to 54.1% in FY2023. At the same time, the company is suffering EBITDA margin headwinds as a result of expensing pre-capacity and R&D investments. This led to the company posting a 54.6% y-o-y (-48.0% q-o-q) decline in net profit to Rs. 105.3 crore in Q4FY2023 and by 4.7% y-o-y to Rs. 793 crore in FY2023. Capacity utilisation is at ~ 55-60% after commissioning of brownfield FDF facility of ~ 10 bn tablets p.a, indicating spare capacity, while generic FDFs (ARV formulation) procurement and pricing are lower. Animal health CDMO-related income is expected to be realised in H2FY2024, while demand for other categories is expected to shape up in FY2024, it will be a year of consolidation for the company. Hence, we factor in flat revenue growth in FY2024E and 28% y-o-y growth in revenues in FY2025E with capacity utilisation rising across segments. However, since FY2024E will be flat revenue growth with the product mix continuing to favour low-value generic APIs segment, we anticipate EBITDA margin will be lower at 19.7% in FY2024E and expand to 26.4% in FY25E with improved sales and operating leverage.

Conference call highlights:

- **Outlook:** FY2024 will be a year of consolidation as the new capacity is to be utilised from H2FY2024. The company expects to focus on raw-material pricing, process improvement, and in-house manufacturing to impact margins favourably. EBITDA margin are expected not to fall below 20-21%. Effective Tax Rate (ETR) will rise as the company is moving to a new regimen. ARV prices have bottomed out and may stabilise going forward. The company is expensing its pre-operative newly commissioned capacity expenses; hence, it is leading to adverse impact on margins. The current capacity is expected to be utilised fully by FY2025, and the company may continue to invest in FY2025 as well. The CDMO and bio segments together are likely to reach 50% of revenue over the long term (five years).
- Company is on track for its diversification, especially in the high-value segment such as CDMO and custom synthesis business.
- Revenue from animal CDMO business expected to be realised from H2FY2024.

- The company is on track to deliver capex plans to drive long-term growth.
- The company has invested on increasing its API capacity by 30% y-o-y in FY2023. These are ready to ramp up. The company's investments in CDMO are also to likely capture high-value opportunities and is progressing well.
- Q4FY2023 was affected by the completion of a large purchase order in Q3FY2023 and higher upfront cost of capex and R&D projects.
- From FY2018 to FY2023, non-ARV increased from 27% of revenue to 50%.
- Company is experiencing softer demand for ARVs and weak pricing due to competitive intensity.
- Implemented rationalisation measures are expected to ensure improvement in profitability in ARV, APIs, and formulations.
- Company has filed 13 dossiers in developed markets.
- In the US, the company continues to gain market share in select products, but it believes U.S. contribution is not high. Cumulatively, it has 37 ANDAs filings, of which 14 are final approvals and the remaining are tentative approvals.
- Company continues to deepen contract manufacturing relationships in advanced countries and expects more volumes from it in the coming quarters.
- Company has invested significantly to expand into the non-ARV business, with total commissioned capacity of 10 billion units per annum and these brownfield capacities are expected to start getting utilised more in FY2024 as better demand emerges for ARV and CMO segments and due to key product approvals across the US, Europe, and Canada.
- R&D spends was 3.5% of sales.
- During FY2023, the company filed its first NDA for a novel pediatric HIV product.
- Sterile R&D Lab is working on several priority projects.
- Around 60 products are in the R&D pipeline with a total market size of USD40 billion.
- Generic API grew strongly in FY2023, supported by CMO opportunity in APIs and non-ARV and oncology APIs.
- ARV-API segment grew on account of low base effect due to channel de-stocking. The company maintains a large market share in it.
- Share of the non-ARV revenue is expected to rise to 50% over the long term.
- For FY2023, capacity utilisation was ~ 55-60%, indicating spare capacity.
- One of the large pharma projects has been executed and will not be adding to sales in FY2024E.
- Growth will be driven by adding more pharma partner clients.
- Generic FDF sales are not high in the US
- ARV-related revenue was ~ 60% and the rest came from non-ARVs.
- Gross margins were lower due to weak pricing for ARV, APIs, and formulations. However, with cost rationalisation, the company expects margins to improve.
- New capacity of ~10 billion tablets – 50% utilisation currently and may increase to ~70% by the end of FY2024.

Results (Consolidated) **Rs cr**

Particulars	Q4FY23	Q4FY22	Y-o-Y %	Q3FY23	Q-o-Q %
Total Sales	1,380.9	1,424.8	-3.1%	1,544.8	-10.6
Expenditure	1,095.4	1,028.12	6.5	1,141.3	-4.0
EBITDA	**285.5**	**396.7**	**-28.0**	**403.6**	**-29.2**
Depreciation	87.0	65.7	32.4	84.4	3.0
EBIT	**198.5**	**331.0**	**-40.0**	**319.1**	**-37.8**
Interest	53.1	30.6	73.8	42.7	24.3
Other income	1.7	1.3	32.6	1.4	19.6
PBT	**147.1**	**301.7**	**-51.2**	**277.9**	**-47.0**
Taxes	39.9	69.8	-42.8	74.8	-46.7
PAT before share of associates	**107.2**	**231.9**	**-53.8**	**203.1**	**-47.2**
Share of associates	**-1.97**	**-0.18**	**NM**	**-0.52**	**NM**
Reported PAT	**105.3**	**231.7**	**-54.6**	**202.5**	**-48.0**
EPS (Rs.)	**1.9**	**4.3**	**-55.6**	**3.8**	**-49.5**
Margins (%)			**BPS**		**BPS**
GPM	49.7	52.0	-235	53.4	-373
EBITDA	20.7	27.8	-716	26.1	-545
NPM	7.8	16.3	-851	13.1	-538
ETR	27.1	23.1	398	26.9	20

Source: Company; Sharekhan Research

Particulars	Q4FY23	Q4FY22	Y-o-Y %	Q3FY23	Q-o-Q %
ARV-API	350	296	18.0	373	-6.2
Oncology-API	129	70	83.4	76	69.5
Other API	236	172	36.6	183	28.6
Synthesis	228	360	-36.7	642	-64.5
Generic FDF	393	491	-20.0	249	57.8
Laurus Bio	46	35	31.4	22	109.1
Total	**1,381**	**1,425**	**-3.1**	**1,545**	**-10.6**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Regulatory concerns and pricing erosion prove a hurdle over the short-medium term

Over the years, Indian pharmaceutical companies have established themselves as a dependable source for global pharma companies. The confluence of other factors, including a focus on specialty/complex products in addition to emerging opportunities in the API space, would be key growth drivers over the long term. However, ongoing USFDA plant inspections and a few companies being issued Form 483 with observations point at apparent regulatory concerns. We believe in the near term, based on the headwinds that may drag the performance, especially in the API and CDMO space and for large pharma players seeing USFDA OAI or WL status on their facilities, we have a Neutral view of the sector.

■ Company Outlook – Currently to witness margin pressure

Growth prospects across the synthesis and FDF business are strong and are well backed by improving demand and capacity expansion plans in the medium to long term. The company is enhancing its current portfolio, stepping up R&D activity, and strengthening and expanding manufacturing capabilities. Further, Laurus has doubled its formulations capacities so as to cater to surging demand. The management is confident of sustaining the strong growth momentum. Further, over the long term, Laurus is in the process of diversifying into non-ARV-APIs of cardiology and diabetology segments and is in the process of reducing dependence on the ARV segment. In addition, the synthesis business is expected to grow strongly in the next two years with sustained new client additions, growth in the existing business, likely commercialisation of new products, and capacity expansion. The management is quite optimistic about the performance of the synthesis division and sees this as one of the key growth drivers. Laurus Bio is also expected to grow substantially and would make the company a fully integrated player in the pharmaceutical space. However, channel de-stocking for ARVs and input cost pressures could act as transient issues, and management has witnessed the green shoots of the trend normalising for the ARV business.

■ Valuation – Maintain Hold with a revised PT of Rs. 338

Laurus massively underperformed in Q4FY2023 missing both internal and street estimates. Revenue and profitability lagged by ~10.0% and ~46.0%, respectively. At the same time, the stock has corrected by ~48% over the past year. The company is seeing capacity under-utilisation due to newly commissioned formulation capacity due to lower demand for ARVs from global agencies and a fall in pricing due to competition. Additionally, its high-value CDMO and custom synthesis segment is expected to post decline in revenue over FY2023-FY2025E, owing to completion of a large purchase order towards Paxlovid. At the same time, we believe the company will see a fall in profitability in FY2024E y-o-y and gradually witness an uptick in it over FY2024E to FY2025E due to improved capacity utilisation, eventually. Stock trades at a higher valuation of ~ 24.9x/17.7x its FY2024E/FY2025E earnings estimates as compared to ~ 21.0x/18.0 FY2024E/FY2025E estimates for its peers. Hence, we maintain Hold on Laurus with a revised PT of Rs. 338 (vs. Rs. 368 earlier).

Peer valuation

Particulars	CMP (Rs / Share)	MCAP (Rs Cr)	P/E (x)			EV/EBITDA (x)			RoE (%)		
			FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Laurus Labs	307.6	15,731.0	21.0	24.9	17.7	11.7	13.1	10.5	19.6	9.7	18.9
Divis Labs	3,264.9	86,752.0	44.4	39.6	33.0	29.0	24.5	20.3	14.9	15.0	15.8
Aurobindo Pharma	617.0	36,152.0	18.3	15.7	13.3	8.1	6.6	5.3	7.8	8.4	9.2
IPCA Labs	710.2	18,016.0	33.9	23.1	18.0	18.5	13.2	10.1	8.9	12.1	13.7

Source: Company, Sharekhan estimates

About company

Laurus is a leading research-driven pharmaceutical company, working with nine of the world's top 10 generic pharmaceutical companies in the world. Laurus sells APIs in 56 countries. The company's major focus areas include anti-retroviral, Hepatitis C, and oncology drugs. Oncology is one of its core competencies, where it offers a comprehensive range of APIs in this segment. Laurus is continuously extending its portfolio by focusing on molecules in diabetes, ophthalmology, and cardiovascular therapy areas. Laurus has four distinct business units, namely: Generics API, Generics FDF, Ingredients, and Synthesis.

Investment theme

Built on strong capabilities in chemical development and manufacturing, Laurus has developed a wide range of in-house APIs and intermediates. The company is one of the world's leading suppliers of anti-retroviral APIs and intermediates. The company's low-cost technologies give it an edge over other players. Leveraging on API cost advantage for forward integration into generic formulations (FDF) and capitalising on its leadership position in APIs (in key areas such as oncology, cardiovascular, anti-diabetics, and ophthalmology) with a foray into other regulated markets will drive the company's business over the next couple of years. Moreover, the company is doubling its capacity to support growth in the formulations business, which points towards healthy growth going ahead. Overall, in the wake of an expected robust growth outlook, Laurus has embarked upon a massive capex programme for the next two years, which provides ample growth visibility.

Key Risks

- Slower-than-expected ramp-up in formulations, API, or custom synthesis businesses.
- Reforms in the healthcare industry and uncertainty associated with pharmaceutical pricing could affect growth prospects.

Additional Data

Key management personnel

Dr. Satyanarayana Chava	Founder and CEO
Mr. V Ravi Kumar	Executive Director and CFO
Dr. Lakshmana Rao C V	ED and Head, Quality
G. Venkateswar Reddy	Company Secretary and Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	NSN Holdings	23.04
2	Capital Group Cos Inc.	9.11
3	Amansa Holdings Pvt Ltd.	3.92
4	Ankur Projects Pvt Ltd.	3.25
5	Vanguard Group Inc.	2.56
6	Life Insurance Corp	2.18
7	Barclays Wealth Trustees India Pvt Ltd.	1.86
8	BlackRock Inc.	1.03
9	Mirae Asset Global Investments Co. Ltd.	0.96
10	Kotak Mahindra AMC	0.91

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

Sharekhan

by BNP PARIBAS

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Registered Office: Sharekhan Limited, The Ruby, 18th Floor, 29 Senapati Bapat Marg, Dadar (West), Mumbai – 400 028, Maharashtra, INDIA, Tel: 022 - 67502000/ Fax: 022 - 24327343. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O/ CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183.