Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Laurus Labs Ltd

Q2 misses mark; margin guidance cut to 20%

Pharmaceuticals	Sharekhan code: LAURUSLABS

Reco/View: Reduce	↔	CMP: Rs. 400	Price Target: Rs. 293	↔

↑ 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

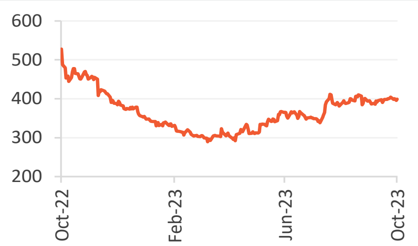
Company details

Market cap:	Rs. 21,546 cr
52-week high/low:	Rs. 530/279
NSE volume: (No of shares)	25.0 lakh
BSE code:	540222
NSE code:	LAURUSLABS
Free float: (No of shares)	39.2 cr

Shareholding (%)

Promoters	27.2
FII	23.3
DII	5.3
Others	44.2

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-0.5	12.0	29.7	-25.6
Relative to Sensex	1.6	15.1	20.0	-36.1

Sharekhan Research, Bloomberg

Summary

- Q2FY24 witnessed a sequential recovery but numbers were below our estimates on all fronts with sales missing our estimates by 11% to Rs 1224 crore, EBITDA missing our estimates by 24% to 188 crore and PAT missing our estimates by 54% to Rs 39 crore.
- Laurus sales were largely impacted by 69% decline in CDMO business owing to high base. Ex. of High base PO, CDMO sales grew by 18% y-o-y. A decline in CDMO business and higher other expenses led to EBITDA Margin of 15%, 269 bps below our estimates.
- The management continues to expect FY24E as a year of consolidation on account of higher orders executed in FY23 in the CDMO business resulting in lower product mix and impacting EBITDA margin. On account of lower visibility in CDMO sales, the management has lowered EBITDA guidance to 20% for FY24E (earlier guided 25% in FY25E)
- Stock trades at higher valuation of 113.93x/38.23x its FY24E/FY25E EPS hence we maintain Reduce with our earlier PT of Rs. 293.

Laurus' revenues and profitability continued to lag the estimates in Q2FY2024 also, owing to operational deleverage largely due to a material drop in CDMO sales, lower other API sales and a decline in ARV APIs owing to price fall in ARV portfolio over last year. Consolidated revenues fell 22.3% y-o-y (3.6% q-o-q) to INR 1,224 crore (versus our estimate of Rs. 1,381 crore) The decline in revenue was due to 69% y-o-y (-10.4% q-o-q) decline in custom synthesis or CDMO business revenue (30% of revenue) and 38% y-o-y (0.8% q-o-q) decline in generic Others API revenue (11% of revenue) and 9% y-o-y (-8.6% decline in q-o-q) decline in ARV API (30% of sales) which was partially offset by 151 % y-o-y (122% q-o-q) rise in Oncology API (10% of revenue) ,123% y-o-y (16.5% q-o-q) rise in FDF segment (27% of revenue) and 44% y-o-y (-22% q-o-q decline)in Laurus Bio. Gross Margins decreased by 260 bps y-o-y (+190 bps q-o-q) to 52.5% due to lower products mix y-o-y, adversely impacted by the CDMO business. EBITDA margins reduced 1314 bps y-o-y (124 bps q-o-q) to 15.3% (vs. our estimate of 18%). Net profits declined 83.2% y-o-y (46.8% q-o-q) to Rs. 39 crore (vs. our estimate of Rs. 86 crore) as margins fell drastically, despite stable depreciation and finance cost and lower Tax rate of 27% (vs 30% in Q1FY24 and 29% in Q2FY23). We believe that in FY24E the company will have continued lower operating profitability owing to higher base in the CDMO business and ongoing CAPEX with which will affect returns ratios.

Key positives

- Company is witnessing a huge order traction in the oncology API segment and has one of the largest capacities to fulfill demand.
- ARV API contribution lowered to 49% and it is expected to remain lower. The growth in API and FDF is expected from non-ARV business.

Key negatives

- ARV API and generic FDF sales nearing its peak, which will put pressure on the topline in the near term.
- CDMO business is expected to decline owing to higher base, which will put pressure on the margins.

Management Commentary

- Company continues to invest in the diversified portfolio where CDMO sales to be driven by human health, Animal health and crop science products which to support growth momentum in FY25E. The management expects new capacities added in FY23 to get commercialised from FY25E.

Revision in estimates – We believe the company to report lower earnings where sales/EBITDA / PAT is expected to grow at a CAGR of 2/-9%/ -15% respectively as FY24E is expected to be a year of consolidation. We do factor recovery in earnings in FY25E but owing to steep decline in FY24E earnings, we reduced our EPS estimates by 43% in FY24E and 30% in FY25E to Rs 3.5 and 10.5, respectively.

Our Call

View – Maintain Reduce with a PT of Rs. 293: Laurus Labs is grappling with operational deleveraging due to higher base in the CDMO business and huge capacity additions recently. The fall in CDMO segment's revenues is expected to continue over the next 2 quarters, until the large base effect wears out. Despite concerns surrounding the operational de-leverage the company continues to invest in CDMO business which we believe can lead to continued lower than optimum asset churn and thereby continued operating de-leverage and much lower operating profitability in FY24E and FY25E, than anticipated earlier. The company's earnings for Q2FY24 have fared nearly 54% below our estimates. Lower CDMO sales to result in lower margins of 20% in FY24E (earlier guided for 25%). We therefore cut our EPS estimates by 43% and 30% for FY24E and FY25E. Stock trades at an expensive valuation of 113.9x/38.2x its revised FY24E/FY25E estimates, Hence, we maintain our recommendation of Reduce rating with same PT at Rs. 293 (ascribing FY25E PE multiple of 28x).

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	FY23	FY24E	FY25E
Sales	4813.5	4935.6	6040.6	5418.3	6244.3
EBITDA	1,551	1,422	1,592	793	1,313
OPM(%)	32.2	28.8	26.4	14.6	21.0
PAT	983.8	832.4	793.4	190.3	567.1
NPM (%)	20.4	16.9	13.1	3.5	9.1
EPS	18.3	15.4	14.6	3.5	10.5
P/E	21.9	26.0	27.3	113.9	38.2
EV/EBIDTA	15.2	16.6	14.8	29.8	18.0
ROE (%)	37.8	24.8	19.6	9.7	18.9
ROCE (%)	34.4	23.0	21.1	6.4	12.4

Source: Company; Sharekhan estimates

Weak Q2 - Revenues fell by 22% y-o-y owing to higher CDMO base

Laurus reported a decline of 22% y-o-y to Rs. 1,224 crore in consolidated total revenue due to 69% fall in revenues of the CDMO custom synthesis segment and a 38% decline in the sales of Others API. A decline in the CDMO/ custom synthesis segment was due to a high base effect with completion of a large purchase order in Q2FY2023. At the same time, weak demand and pricing in of anti-retrovirals (ARVs) led to a decline of 9% in the ARV API sales. Nevertheless, revenue of high-margin generic oncology APIs increased at a stronger pace of 151% y-o-y and by equally strong growth in the formulations segment. As a large purchase order is over in the CDMO synthesis business, which will be offset by peaking of ARV and formulations business, we factor in a 2% CAGR growth in revenues over FY2023-FY2025E. At the same time, the company is suffering EBITDA margin headwinds as a result of expensing pre-capacity and R&D investments (R&D cost highest at 5% of sales) where margins reported is at 15% (vs our estimates of 18%). Capacity utilisation is at ~ 55-60% after commissioning of brownfield FDF facility of ~10 billion tablets p.a, indicating spare capacities, while generic FDFs (ARV formulation) procurement and pricing are lower. Animal health CDMO-related income is expected to be realized in FY2025E post successful validation in FY24 while demand for other categories is expected to also pick up in FY2025E. Hence, FY24E will be a year of consolidation for the company.

Conference call highlights:

- **Outlook on revenue and profitability:** E-FDF capacity is 10 billion units and is being utilised at 5 billion units and the same is expected to move to seven billion units utilised by the end of FY24E. The FY24 remains the year of consolidation for the company. The company will start supplying Animal health, Human health and crop science products from FY25e. Some projects in the CDMO segment will move into advanced clinical stage giving it higher volumes and some of the large volume APIs in the generic segment will also get commercialized in FY25e. The growth will come from all segments in FY25E. An improvement in profitability is likely from H2FY24 onwards. Raw material prices have softened enough and will be stable at that level. The reasons for margin decline in Q2FY24 was due to lower CDMO sales resulting in operating deleverage. On margins front, the management expects FY24E margins to stable at 20% (25% margins guided earlier) despite recovery in H2FY24E earnings Some of the levers for improved margins is FDF and oncology API order book being good, overall volumes are expected to grow, and raw materials costs softening will reflect in profitability from H2FY24 onwards.
- **Crop science contract:** This is a multiyear contract with partners having large products portfolio, which are patented.
- **Animal Health contract:** Products under validation, supply may begin from FY25E.
- **CDMO assets:** These assets have not been utilised throughout the year. CDMO partners ask them to deliver commercial batches after phase III and before that there is a lot of waiting involved leading to underutilisation. Gross block for CDMO was Rs. 250-300 crore, as of FY23.
- **ARV APIs and FDF:** ARV API order book is strong. ARV Formulations pricing erosion was drastic in FY23 and is now very close to stable. Q2FY24 vs. Q4FY23 formulations volumes improved and pricing erosion was not severe. The company expects the volumes to grow from now on in formulations.

Results (Consolidated) Rs cr

Particulars	Q2FY24	Q2FY23	YoY %	Q1FY24	QoQ %
Total Sales	1,224.5	1,575.9	-22.3	1,181.8	3.6
Expenditure	1,036.6	1,127.0	-8.0	1,015.1	2.1
EBITDA	187.9	448.9	-58.1	166.7	12.7
Depreciation	93.4	81.8	14.1	90.6	3.1
EBIT	94.5	367.1	-74.3	76.2	24.1
Interest	42.4	40.1	5.7	39.2	8.2
Other income	1.8	1.1	60.4	3.6	-50.6
PBT	53.9	328.1	-83.6	40.6	32.8
Taxes	14.6	94.3	-84.5	12.2	19.6
PAT before share of associates	39.3	233.8	-83.2	28.4	38.5
Reported PAT	39.3	233.4	-83.2	26.8	46.8
EPS	0.7	4.3	-83.6	0.5	46.8
Margins			**BPS**		**BPS**
GPM %	50.6	57.6	-698	49.7	89
EBITDA %	15.3	28.5	-1,314	14.1	124
NPM %	3.2	14.8	-1,160	2.3	94
ETR %	27.0	28.7	-170	30.0	-298

Source: Company, Sharekhan Research

Segment revenues Rs cr

Particulars	Q2FY24	Q2FY23	YoY %	Q1FY24	QoQ %
ARV-API	371	408	-9.0	406	-8.6
Oncology-API	120	48	151.1	54	122.4
Other API	138	224	-38.3	137	0.8
Custom Synthesis CDMO	224	720	-68.9	250	-10.4
Generic FDF	332	149	122.8	285	16.5
Laurus Bio	39	27	44.4	50	-22.0
Total	**1,224**	**1,576**	**-22.3**	**1,182**	**3.6**

Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Input cost easing with companies focusing on complex product launches

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. The sector is witnessing easing of input cost like RM costs, freight, power which to aid the sector in expanding margins. The sector is also witnessing easing of price erosion followed by increasing contribution from new product launches. We believe the sector is in sweet spot where it is experiencing healthy product mix and cost rationalisation which increases operational profit of the companies. The sector is mainly a low debt sector and increasing operational profit followed by experiencing advantage of low tax rate due to its operations in the SEZ sector, hence overall, we have a positive view on the sector.

■ Company outlook - Margins to stay under 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. In 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 ARVs. In addition, the synthesis business is expected to grow strongly in the next two years with sustained client additions, growth in 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 - View –Maintain Reduce with a PT of Rs. 293

Laurus Labs is grappling with operational deleveraging due to higher base in the CDMO business and huge capacity additions recently. The fall in CDMO segment's revenues is expected to continue over the next 2 quarters, until the large base effect wears out. Despite concerns surrounding the operational de-leverage the company continues to invest in CDMO business which we believe can lead to continued lower than optimum asset churn and thereby continued operating de-leverage and much lower operating profitability in FY24E and FY25E, than anticipated earlier. The company's earnings for Q2FY24 have fared nearly 54% below our estimates. Lower CDMO sales to result in lower margins of 20% in FY24E (earlier guided for 25%). We therefore cut our EPS estimates by 43% and 30% for FY24E and FY25E. Stock trades at an expensive valuation of 113.9x/38.2x its revised FY24E/FY25E estimates, Hence, we maintain our recommendation of Reduce rating with same PT at Rs. 293 (ascribing FY25E PE multiple of 28x).

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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	NSN Holdings	23.04
2	Capital Group Cos Inc.	9.44
3	Amansa Holdings Pvt Ltd.	4.05
4	Smallcap World Fund Inc/Fund Paren	3.55
5	Ankur Projects Pvt Ltd.	3.25
6	Vanguard Group Inc.	2.72
7	Life Insurance Corp	2.70
8	Tata AIA Life Insurance Co Ltd	1.39
9	Barclays Wealth Trustees India Pvt Ltd.	1.35
10	Leven Holdings	1.24

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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Other registrations of 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.

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