

BUY

TP: Rs 3,600 | ▲ 21%

ALKEM LABS

Pharmaceuticals

08 August 2020

Gross margin beat sustainable; stronger FCF to support rerating

Alkem Labs posted a solid Q1 EBITDA beat led partly by one-offs: (1) Rs 260mn research milestone, (2) lower SGA spends (-41% YoY). Ex-milestone income, gross margin was healthy at 62%; EBITDA margin was at 25.5% but will taper as promotion spends normalise by Q3. India trade generics grew a strong >30% YoY; US sales grew 7% QoQ. Gross margin across businesses improved in Q1 and Alkem is confident of >100bps EBITDA margin expansion in 2-3 years. We raise FY21/FY22 EPS 7-9% and roll to a Sep'21 TP of Rs 3,600 (vs. Rs 2,950).

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India trade generics up >30% YoY, US outperforms: Alkem's trade generics business has rebounded in Q1 to 28% of sales – we expect this to normalise to 20% levels as prescription sales resume. India sales declined 6% YoY (Rx: -15%, trade generics: +30%). Sequential growth in US sales of US\$ 90mn was led by first-wave launches while the base portfolio was stable. Over FY20-FY22, we expect a sales CAGR of 17% in the US and 6% in India (2% in FY21).

Ticker/Price	ALKEM IN/Rs 2,982
Market cap	US\$ 4.8bn
Shares o/s	120mn
3M ADV	US\$ 7.8mn
52wk high/low	Rs 3,090/Rs 1,703
Promoter/FPI/DII	62%/4%/11%

Source: NSE

Adj. gross margin sustainable but promotion spends to normalise by Q3: Q1 gross margin trend of 63.4% was above estimates aided by a higher India chronic mix and favourable US mix. Alkem stated that it can sustain 62% gross margins in the coming quarter (vs. 60% earlier). SGA spends declined as interactions were halted during the lockdown; some promotional spends have resumed in Q2 but full normalisation is likely by Q3, depending on competitor activity level.

STOCK PERFORMANCE



Source: NSE

Earnings call highlights: (1) Will continue to raise or sustain resources for larger brands in a post-Covid world. (2) Capex for next three years at ~Rs 3.5bn annually. (3) Trump executive order aimed at big pharma and not really impactful for generics. (4) Targeting 10 launches and 12-15 filings in the US in FY21. (5) India sales growth guided at 3-5% in FY21; tax rate 12-15%. (6) US filings total 148 ANDAs (incl. 2 NDAs) with 50% yet to be commercialised.

KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20P	FY21E	FY22E	FY23E
Total revenue (Rs mn)	73,558	82,983	91,288	101,943	113,526
EBITDA (Rs mn)	11,135	14,730	19,325	21,635	24,774
Adj. net profit (Rs mn)	7,298	11,270	14,686	16,615	19,221
Adj. EPS (Rs)	61.0	94.3	122.8	139.0	160.8
Adj. EPS growth (%)	15.7	54.4	30.3	13.1	15.7
Adj. ROAE (%)	16.3	22.7	25.4	23.8	23.0
Adj. P/E (x)	48.8	31.6	24.3	21.5	18.5
EV/EBITDA (x)	32.1	24.3	18.6	16.4	13.9

Source: Company, BOBCAPS Research

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FIG 1 – QUARTERLY PERFORMANCE

(Rs mn)	Q1FY21	Q1FY20	YoY (%)	Q4FY20	QoQ (%)	Q1FY21E	Var. (%)	FY20	FY19	YoY (%)
Net Sales	20,034	18,495	8.3	20,490	(2.2)	20,656	(3.0)	83,443	73,676	13.3
EBITDA	5,331	2,646	101.5	3,030	75.9	3,204	66.4	14,735	11,253	30.9
Depreciation	668	558	-	810	-	575	-	2,526	1,932	-
EBIT	4,663	2,088	123.3	2,220	110.0	2,630	-	12,209	9,321	31.0
Interest	171	161	-	141	-	200	-	650	546	-
Other Income	435	175	-	275	-	338	-	1,043	773	-
PBT	4,927	2,102	134.4	2,354	109.3	2,767	-	12,603	9,547	32.0
Less: Taxation	696	227	-	438	-	332	-	1,105	1,810	-
Less: Minority Interest	12	18	-	28	-	40	-	222	131	-
Recurring PAT	4,219	1,857	127.2	1,889	123.4	2,395	76.2	11,276	7,607	48.2
Exceptional items	0	0	-	0	-	0	-	0	0	-
Reported PAT	4,219	1,857	127.2	1,889	123.4	2,395	76.2	11,276	7,607	48.2
Key Ratios (%)										
Gross Margin	63.4	61.5	-	56.3	-	61.0	-	59.9	58.9	-
EBITDA Margin	26.6	14.3	-	14.8	-	15.5	-	17.7	15.3	-
Tax / PBT	14.1	10.8	-	18.6	-	12.0	-	8.8	19.0	-
NPM	21.1	10.0	-	9.2	-	11.6	-	13.5	10.3	-
EPS (Rs)	35.3	15.5	-	15.8	-	20.0	-	94.3	63.6	-

Source: Company, BOBCAPS Research

FIG 2 – SEGMENT SALES

(Rs mn)	Q1FY21	Q1FY20	YoY (%)	Q4FY20	QoQ (%)	Q1FY21E	Var. (%)	FY20	FY19	YoY (%)
Formulations										
India	11,550	12,222	(5.5)	12,576	(8.2)	12,830	(10.0)	54,540	48,741	11.9
US	6,664	4,817	38.3	6,068	9.8	6,512	2.3	22,092	18,966	16.5
RoW	1,189	1,095	8.6	1,455	(18.3)	1,314	(9.5)	5,287	4,951	6.8
Net Sales	19,403	18,134	7.0	20,099	(3.5)	20,656	(6.1)	81,919	72,658	12.7

Source: Company, BOBCAPS Research

Valuation methodology

Alkem has delivered a strong beat on EBITDA margins in FY20 (up >250bps YoY). We continue to believe that the company’s profit base has moved up sustainably given its focus on raising the high-margin acute mix, increasing marketing efficiency and driving operating leverage in the US from new launches. This coupled with ROIC of >35% from FY22E (vs. ~23% over FY18-FY20) and strong FCF of Rs 40bn over the next three years (vs. Rs 10bn in the last five years) should support expansion in one-year forward EV/EBITDA multiples closer to the three-year mean of 19x from ~15x currently.

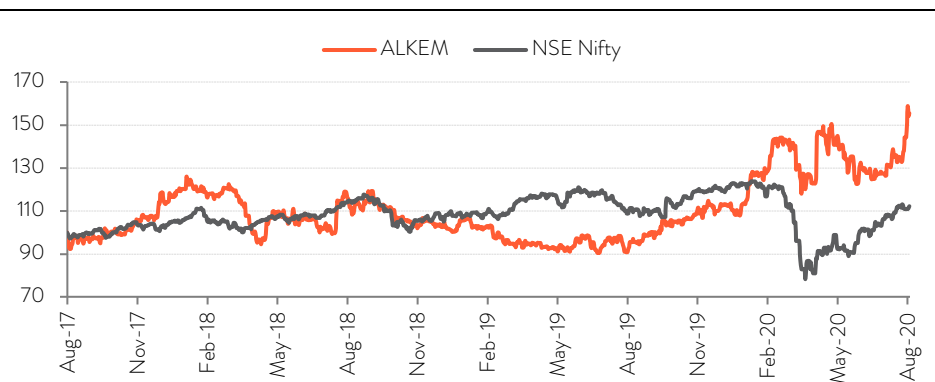
We expect 21% EBITDA growth over the next two years and raise our FY21-FY22 EPS estimates by 7-9% led by improved profitability for both India and US businesses. Retain BUY as we raise our target price to Rs 3,600 (from Rs 2,950), based on a revised target EV/EBITDA multiple of 19x (17x earlier) – implied P/E of 24x (23x earlier). Our new FY21/FY22 EPS estimates stand at Rs 123/Rs 139.

FIG 3 – REVISED ESTIMATES

(Rs bn)	New		Old		Change (%)	
	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Sales	91	102	95	106	(3.8)	(3.8)
EBITDA	19	22	18	21	8.6	5.5
EBITDA margin (%)	21.2	21.2	18.8	19.4	241bps	187bps
EPS (Rs)	123	139	113	130	9.1	7.1

Source: Company, BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- **Regulatory action and slowdown in India formulation business:** Expansion of NLEM coverage and the FDC ban in 2018 affected industry growth. The NLEM order has hit most large brands in the acute segment, taking the share of Alkem's price-controlled portfolio to 26% of its domestic formulation business vs. 17% for IPM. While Alkem's current portfolio under NLEM is meaningfully higher than the market, any further regulatory action in the acute segment is unlikely to have much bearing on financials. Also, Alkem has a minor presence in the chronic segment with smaller brands and negligible price leadership.

Disruption in the trade generics business due to regulatory action could also be a key risk to the stock since this accounts for 15% of overall domestic sales. Further, any slowdown in IPM growth and delay in new launches can affect earnings.

- **Poor US execution:** We expect the US market to contribute meaningfully to profitability in the coming years – up from 3% of FY19 EBITDA to 8% in FY21 (or 30% of incremental EBITDA). Any delay in key launches, surprise competition in niche products, regulatory action on manufacturing facilities (Daman, Baddi, St. Louis), and above-expected price erosion in the top 5 products could be potential threats to earnings.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20P	FY21E	FY22E	FY23E
Total revenue	73,558	82,983	91,288	101,943	113,526
EBITDA	11,135	14,730	19,325	21,635	24,774
Depreciation	1,932	2,526	2,557	2,872	3,222
EBIT	9,203	12,204	16,768	18,763	21,552
Net interest income/(expenses)	(546)	(650)	(998)	(998)	(998)
Other income/(expenses)	582	1,043	1,617	2,158	2,784
Exceptional items	0	0	0	0	0
EBT	9,239	12,598	17,387	19,924	23,339
Income taxes	1,810	1,105	2,434	2,989	3,734
Extraordinary items	307	0	0	0	0
Min. int./Inc. from associates	131	222	267	320	384
Reported net profit	7,605	11,270	14,686	16,615	19,221
Adjustments	307	0	0	0	0
Adjusted net profit	7,298	11,270	14,686	16,615	19,221

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20P	FY21E	FY22E	FY23E
Accounts payables	9,622	9,541	12,350	13,791	15,358
Other current liabilities	4,435	6,010	7,212	8,054	8,969
Provisions	3,275	4,067	4,474	4,997	5,564
Debt funds	9,025	16,628	16,628	16,628	16,628
Other liabilities	0	0	0	0	0
Equity capital	239	239	239	239	239
Reserves & surplus	48,407	53,363	64,624	77,365	92,103
Shareholders' fund	48,646	53,602	64,864	77,604	92,343
Total liabilities and equities	75,003	89,848	105,528	121,074	138,862
Cash and cash eq.	6,615	10,922	24,276	32,164	42,164
Accounts receivables	12,484	16,494	17,290	19,308	21,502
Inventories	14,998	18,188	19,266	21,515	23,959
Other current assets	7,669	9,180	10,819	12,081	13,454
Investments	3,236	2,614	2,614	2,614	2,614
Net fixed assets	25,072	28,821	30,264	32,392	34,170
CWIP	4,930	3,630	1,000	1,000	1,000
Intangible assets	0	0	0	0	0
Deferred tax assets, net	0	0	0	0	0
Other assets	0	0	0	0	0
Total assets	75,004	89,848	105,528	121,074	138,862

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20P	FY21E	FY22E	FY23E
Net income + Depreciation	9,537	13,796	17,243	19,487	22,443
Interest expenses	546	650	998	998	998
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,411)	(6,425)	906	(2,724)	(2,961)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	8,671	8,021	19,146	17,761	20,479
Capital expenditures	(3,991)	(4,500)	(4,000)	(5,000)	(5,000)
Change in investments	1,207	622	0	0	0
Other investing cash flows	0	0	0	0	0
Cash flow from investing	(2,784)	(3,878)	(4,000)	(5,000)	(5,000)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(925)	7,603	0	0	0
Interest expenses	(546)	(650)	(998)	(998)	(998)
Dividends paid	(1,702)	(2,628)	(3,425)	(3,875)	(4,482)
Other financing cash flows	(1,868)	(4,161)	2,630	0	0
Cash flow from financing	(5,040)	164	(1,793)	(4,872)	(5,480)
Changes in cash and cash eq.	847	4,308	13,354	7,889	9,999
Closing cash and cash eq.	6,614	10,922	24,276	32,164	42,164

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20P	FY21E	FY22E	FY23E
Reported EPS	63.6	94.3	122.8	139.0	160.8
Adjusted EPS	61.0	94.3	122.8	139.0	160.8
Dividend per share	12.2	18.9	24.6	27.8	32.2
Book value per share	395.8	436.0	530.2	636.7	760.0

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20P	FY21E	FY22E	FY23E
EV/Sales	4.9	4.3	3.9	3.5	3.0
EV/EBITDA	32.1	24.3	18.6	16.4	13.9
Adjusted P/E	48.8	31.6	24.3	21.5	18.5
P/BV	7.5	6.8	5.6	4.7	3.9

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20P	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	79.0	89.5	84.5	83.4	82.4
Interest burden (PBT/EBIT)	100.4	103.2	103.7	106.2	108.3
EBIT margin (EBIT/Revenue)	12.5	14.7	18.4	18.4	19.0
Asset turnover (Revenue/Avg TA)	33.2	32.4	30.1	29.0	27.9
Leverage (Avg TA/Avg Equity)	1.2	1.3	1.3	1.3	1.2
Adjusted ROAE	16.3	22.7	25.4	23.8	23.0

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY19A	FY20P	FY21E	FY22E	FY23E
YoY growth (%)					
Revenue	14.5	12.8	10.0	11.7	11.4
EBITDA	8.3	32.3	31.2	12.0	14.5
Adjusted EPS	15.7	54.4	30.3	13.1	15.7
Profitability & Return ratios (%)					
EBITDA margin	15.1	17.8	21.2	21.2	21.8
EBIT margin	12.5	14.7	18.4	18.4	19.0
Adjusted profit margin	9.9	13.6	16.1	16.3	16.9
Adjusted ROAE	16.3	22.7	25.4	23.8	23.0
ROCE	17.6	20.7	24.2	23.8	24.0
Working capital days (days)					
Receivables	63	73	70	70	70
Inventory	75	81	78	78	78
Payables	48	42	50	50	50
Ratios (x)					
Gross asset turnover	2.4	2.4	2.4	2.3	2.3
Current ratio	2.4	2.8	3.0	3.2	3.4
Net interest coverage ratio	16.9	18.8	16.8	18.8	21.6
Adjusted debt/equity	0.0	0.1	(0.1)	(0.2)	(0.3)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

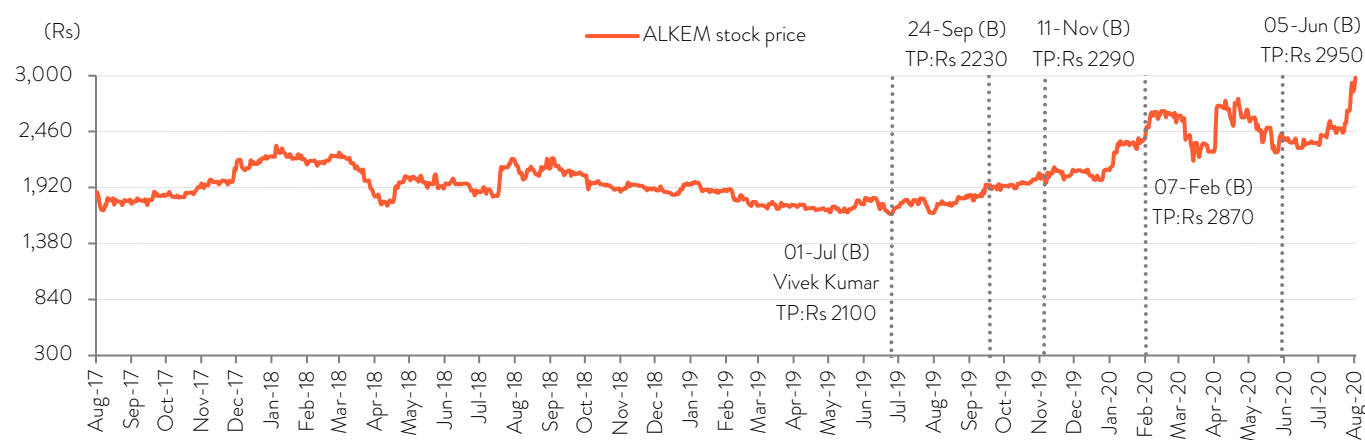
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

RATINGS AND TARGET PRICE (3-YEAR HISTORY): ALKEM LABS (ALKEM IN)



B – Buy, A – Add, R – Reduce, S – Sell

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