

SELL

TP: Rs 2,700 | ▼ 15%

ALKEM LABS

| Pharmaceuticals

| 14 November 2022

Near-term outlook weak – cut to SELL

- Revenue grew 10% YoY to Rs 31bn in Q2 led by India business, but US price erosion continued to weigh on margins
- Margin guidance pared given US market challenges, though cost initiatives could save Rs 2bn-2.5bn over 12M
- We cut FY23/FY24 EBITDA 12%/18% and our TP to Rs 2,700 (vs. Rs 3,220); downgrade from HOLD to SELL

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India business fuels growth led by acute therapies: Alkem reported 10% YoY revenue growth in Q2FY23 to Rs 30.8bn. India sales climbed 13%, outperforming the domestic market (+8%), led by price hikes, launches and volume gains. The company did well in acute therapies such as anti-infectives (+8% YoY), gastrointestinal (+23%), vitamins, minerals & nutrients (VMN: +12%), and pain management (+19%). Both anti-infectives and VMN were up against a high Covid-led base of last year. Anti-diabetes revenue in the chronic space grew 30% YoY led by launches such as Sitagliptin. The acute/chronic mix stood at 84%/16%.

Persistent challenges in US market: US business clocked in at US\$ 74mn in Q2 (+5.5% QoQ constant currency), but continued to face substantial pricing pressure, which depleted both gross (-470bps YoY to 57.6%) and EBITDA margins (-760bps YoY to 14.7%). Management intends to hold back capital allocation for the US market in light of the challenges to growth.

Margin guidance cut: Management has reduced its guided EBITDA margin range by ~100bps to 15-15.5% for FY23 (11.6% reported in H1). This is entirely attributed to the US business as Alkem expects healthy domestic margins where higher raw material prices are likely to be offset by a better product mix. To promote margin expansion, the company is undertaking cost-saving initiatives in areas such as network optimisation and restructuring. Management estimates savings of Rs 2bn-2.5bn from these measures over the next 12 months.

Downgrade to SELL: Relentless price erosion in the US market and elevated input cost, along with higher marketing spends, continue to take a toll on margins. We expect sluggish US business as investments are recalibrated amid challenges to growth. Further, baking in the softer margin guidance, we cut our FY23/FY24 EBITDA estimates by 12%/18%. Our TP consequently reduces to Rs 2,700 (vs. Rs 3,220), based on an unchanged 15x FY24E EV/EBITDA – a discount of 15% to the stock’s 5Y average. Given 15% downside potential from the current stock price, we downgrade our rating from HOLD to SELL.

Key changes

Target	Rating
▼	▼

Ticker/Price	ALKEM IN/Rs 3,173
Market cap	US\$ 4.7bn
Free float	39%
3M ADV	US\$ 4.3mn
52wk high/low	Rs 3,786/Rs 2,828
Promoter/FPI/DII	59%/5%/14%

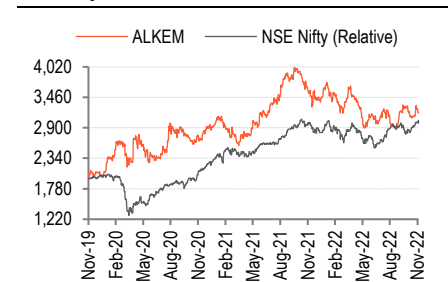
Source: NSE | Price as of 11 Nov 2022

Key financials

Y/E 31 Mar	FY22A	FY23E	FY24E
Total revenue (Rs mn)	1,06,342	1,18,315	1,32,831
EBITDA (Rs mn)	20,529	17,490	20,825
Adj. net profit (Rs mn)	16,606	12,988	15,782
Adj. EPS (Rs)	138.9	108.6	132.0
Consensus EPS (Rs)	138.9	117.0	149.4
Adj. ROAE (%)	24.4	16.7	17.9
Adj. P/E (x)	22.8	29.2	24.0
EV/EBITDA (x)	18.5	21.5	18.0
Adj. EPS growth (%)	4.8	(21.8)	21.5

Source: Company, Bloomberg, BOBCAPS Research

Stock performance



Source: NSE



Fig 1 – Quarterly performance

(Rs mn)	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	H1FY23	H1FY22	YoY (%)
Net Sales	30,794	28,000	10.0	25,764	19.5	56,558	55,314	2.2
EBITDA	4,539	6,244	(27.3)	2,032	123.3	6,572	12,172	(46.0)
Depreciation	774	728	6.3	763	-	1,537	1,434	-
EBIT	3,765	5,516	(31.7)	1,270	-	5,035	10,739	(53)
Interest	249	120	107.6	265	(6.2)	514	248	-
Other Income	507	420	20.8	514	21%	1,021	886	-
PBT	4,023	5,815	(30.8)	1,519	164.9	5,542	11,377	(51.3)
Less: Taxation	546	230	-	204	-	751	989	-
Less: Minority Interest	169	143	-	38	-	207	264	-
Recurring PAT	3,308	5,443	(39.2)	1,276	159.2	4,585	10,124	(54.7)
Exceptional items	0	0	-	0	-	0	0	-
Reported PAT	3,308	5,443	(39.2)	1,276	159.2	4,585	10,124	(54.7)
Key Ratios (%)			(bps)		(bps)			(bps)
Gross Margin	57.6	62.2	(468)	57.5	8	57.5	61.1	(357)
EBITDA Margin	14.7	22.3	(756)	7.9	685	11.6	22.0	(1,039)
Tax / PBT	13.6	4.0	-	13.5	-	13.5	8.7	-
NPM	10.7	19.4	(869)	5.0	579	8.1	18.3	-
EPS (Rs)	27.7	45.5	-	10.7	-	38.4	84.7	-

Source: Company, BOBCAPS Research

Fig 2 – Revenue mix

(Rs mn)	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	H1FY23	H1FY22	YoY (%)
India	22,161	19,605	13.0	17,815	24.4	39,976	38,702	3.3
US	6,040	6,097	(0.9)	5,565	8.5	11,605	12,140	(4.4)
RoW	2,251	1,954	15.2	2,039	10.4	4,290	3,814	12.5
Net Sales	30,452	27,656	10.1	25,419	19.8	55,871	54,656	2.2
USDINR	81.3	74.1	9.7	79.0	2.9	80.2	73.9	8.4
US revenue (US\$ mn)	74	82	(9.7)	70	5.5	145	164	(11.8)

Source: Company, BOBCAPS Research

Earnings call takeaways

- **New launches and volume gains fuel India business:** Alkem continued to outperform the Indian pharma market (IPM) with 13.2% YoY growth in domestic business during Q2FY23 (vs. 8.2% for IPM), clocking market share gains across acute therapies, as well as anti-diabetes and urology in chronic areas.
 - **Acute (84% of revenue):** Acute therapies such as anti-infectives, gastrointestinal, VMN and pain management led the outperformance during the quarter.
 - **Chronic (16% of revenue):** Anti-diabetes led by the Sitagliptin launch grew at a strong 29.5% YoY (vs. 7.8% market growth) while urology, too, performed well. The company is growing off a small base in chronic therapies, led by product launches and better execution.
 - **Trade generics:** Management does not anticipate substantial impact from new entrants in the trade generics business on account of its competencies, such as distribution relationships and team penetration. The entry of new competition could be on account of the government's policy push, changing purchase patterns with opening of new stores, or demand from tier-3/4 towns.
 - **Price hike:** Price hikes contributed significantly to India business growth in Q2 vs. Q1.
- **Continued challenges in US business:** The US business continues to face significant pricing pressure, in line with the entire industry. Alkem had one shared-exclusivity product launch in the US market during Q2, but this didn't contribute much to revenue or margins. The company was able to only have a limited launch of gPradaxa because of supply chain issues. There are two generics in the market for the product as of now. Management intends to hold back capital allocation to the US market in light of the challenging market situation, which we expect will impact its earlier revenue growth guidance.
- **No respite from margin pressure...:** Alkem is facing sustained pressure from US price erosion and elevated raw material costs. Anti-infectives, which contribute 37-40% of the company's India business, continue to see high input prices compared to pre-Covid levels, especially for penicillin, causing a ~2% impact on gross margin. Management, however, believes prices will come down going ahead.

EBITDA margin contracted 760bps YoY in Q2 due to a lower gross margin (-470bps YoY) and higher overheads. Sequentially, gross margin was flat and EBITDA margin improved 685bps on the back of savings in overheads, employee cost and R&D cost as a percentage of revenue. The company did incur additional expenses towards new launches (especially Sitagliptin) in Q1.

- **...leading to a guidance cut:** Management expects to miss its earlier EBITDA margin guidance by ~100bps and has now guided for a 15-15.5% range for FY23 (11.6% reported in H1). This is entirely attributed to the US business as Alkem expects healthy domestic margins where higher raw material prices are likely to be offset by a better product mix. To promote margin expansion, the company is undertaking cost-saving initiatives in areas such as network optimisation and

restructuring. Management estimates savings of Rs 2bn-2.5bn from these measures over the next 12 months.

- **US ANDA filings/approvals:** In Q2, Alkem filed 3 (6 in H1) abbreviated new drug applications (ANDA) in the US and received 4 approvals (8 in H1), including 2 (3 in H1) tentative approvals. As on Sep'22, Alkem's cumulative filings stand at 167 ANDAs and 2 new drug applications (NDA). Of these, the company has received approvals for 128 ANDAs (including 15 tentative approvals) and 2 NDAs. A total of 39 ANDAs are pending approval.
- **Regulatory update:** Two of the company's facilities have outstanding observations by the USFDA – at Indore, Madhya Pradesh, (one observation in Jul'22) and St. Louis, US (three in Nov'22). The company has filed a response for the Indore facility and is in the process of replying to the regulator for the St. Louis facility.
- **Forex loss:** There was some forex loss in Q2 on account of Chile operations, but this was far less than the previous quarter, per management.
- **High API import exposure to China:** Direct import dependency on China is 10-12%, but indirect dependency through active pharma ingredient (API) suppliers is 65-70%.
- **Field force expansion:** Alkem has 11, 000 marketing representatives (MR) at present, after adding ~1,000 in the last 12 months. Newly added MRs take roughly 2.5-3 years to reach breakeven. Current productivity per MR in acute therapies is Rs 0.65mn and in chronic therapies is Rs 0.38-0.39mn. Given the new additions, the focus now is to improve productivity.
- **R&D spend:** R&D spend is guided to remain at 5-6% of revenue for the current and next year.
- **Healthy cash on balance sheet:** Alkem has net cash of Rs 13.5bn on its balance sheet as on 30 September 2022. The company intends to grow organically as far as possible.

Valuation methodology

Relentless price erosion in the US market and elevated input cost, along with higher marketing spends, continue to take a toll on margins. We expect sluggish US business as investments are recalibrated amid challenges to growth. Further, baking in the softer margin guidance, we cut our FY23/FY24 EBITDA estimates by 12%/18%. Our TP consequently reduces to Rs 2,700 (vs. Rs 3,220), based on an unchanged 15x FY24E EV/EBITDA – a discount of 15% to the stock’s five-year average. Given 15% downside potential from the current stock price, we downgrade our rating from HOLD to SELL.

Fig 3 – Revised estimates

(Rs bn)	New		Old		Change (%)	
	FY23E	FY24E	FY23E	FY24E	F23E	FY24E
Revenue	118.3	132.8	121.4	136.1	(2.5)	(2.4)
EBITDA	17.5	20.8	20.0	25.3	(12.4)	(17.7)
EBITDA Margin (%)	14.8	15.7	16.4	18.6	(166bps)	(292bps)
EPS (Rs)	109	132	123	166	(11.8)	(20.6)

Source: BOBCAPS Research

Fig 4 – Key assumptions

Revenue (Rs bn)	FY22A	FY23E	FY24E
US	74.0	82.4	92.0
India	23.3	25.6	29.4
ROW	7.8	9.0	9.8
Other operating income	1.2	1.4	1.5

Source: Company, BOBCAPS Research

Fig 5 – Peer comparison

Company	Ticker	Rating	Target Price (Rs)	Revenue CAGR FY22-24E (%)	EV/EBITDA (x)		ROCE (%)		Target EV/EBITDA (x)
					FY23E	FY24E	FY23E	FY24E	
Ajanta Pharma	AJP IN	HOLD	1,470	5.6	11.3	10.1	21.2	21.3	12.0
Alembic Pharma	ALPM IN	HOLD	770	14.6	8.6	7.5	12.4	16.0	11.0
Alkem Labs	ALKEM IN	SELL	2,700	0.7	21.7	18.2	15.5	17.5	15.0

Source: BOBCAPS Research

Key risks

Key upside risks to our estimates are:

- **Uptick in domestic business:** Alkem draws ~70% of its revenue from domestic formulations, primarily from acute therapies apart from a growing chronic business. An uptick in chronic business and outperformance in the acute segment would pose upside risks to our estimates.
- **Policy announcement on trade generics:** The government’s push towards reducing healthcare costs by promoting trade generics would help Alkem as it is a leader in the space.
- **Above-expected US performance:** Easing pricing pressure and more launches than expected in the US market could boost performance beyond estimates.

- **Above-expected margins:** Prudent cost management could alleviate margin pressure, taking profitability ahead of estimates.
- **Adverse currency movement:** Sharp INR depreciation against the USD represents an upside risk to our expectations.

Sector recommendation snapshot

Company	Ticker	Market Cap (US\$ bn)	Price (Rs)	Target (Rs)	Rating
Ajanta Pharma	AJP IN	2.0	1,258	1,470	HOLD
Alembic Pharma	ALPM IN	1.6	639	770	HOLD
Alkem Labs	ALKEM IN	4.7	3,173	2,700	SELL
Aurobindo Pharma	ARBP IN	3.5	489	695	BUY
Cipla	CIPLA IN	11.2	1,121	1,320	BUY
Divi's Labs	DIVI IN	10.7	3,271	3,450	HOLD
Dr Reddy's Labs	DRRD IN	9.3	4,539	4,700	HOLD
Eris Lifesciences	ERIS IN	1.2	707	970	BUY
Glenmark Life Sciences	GLS IN	0.6	427	535	BUY
Laurus Labs	LAURUS IN	3.0	455	540	HOLD
Lupin	LPC IN	4.2	747	700	HOLD
Sun Pharma	SUNP IN	30.1	1,014	1,100	HOLD

Source: BOBCAPS Research, NSE | Price as of 11 Nov 2022

Financials

Income Statement

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22A	FY23E	FY24E
Total revenue	83,439	88,650	1,06,342	1,18,315	1,32,831
EBITDA	14,731	19,423	20,529	17,490	20,825
Depreciation	2,526	2,746	3,040	3,187	3,467
EBIT	12,205	16,678	17,489	14,303	17,358
Net interest inc./(exp.)	(650)	(589)	(524)	(961)	(768)
Other inc./(exp.)	1,043	2,332	1,627	2,065	2,343
Exceptional items	0	0	0	0	0
EBT	12,598	18,421	18,592	15,407	18,933
Income taxes	1,105	2,243	1,640	2,003	2,651
Extraordinary items	0	0	(150)	0	0
Min. int./Inc. from assoc.	222	328	347	416	500
Reported net profit	11,271	15,850	16,456	12,988	15,782
Adjustments	0	0	(150)	0	0
Adjusted net profit	11,271	15,850	16,606	12,988	15,782

Balance Sheet

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22A	FY23E	FY24E
Accounts payables	9,541	10,694	11,734	14,419	16,188
Other current liabilities	6,010	7,343	7,739	9,357	10,505
Provisions	4,067	4,874	6,064	6,746	7,574
Debt funds	16,628	16,702	26,682	21,346	17,076
Other liabilities	0	0	0	0	0
Equity capital	239	239	239	239	239
Reserves & surplus	53,363	64,262	75,142	84,344	95,525
Shareholders' fund	53,602	64,501	75,381	84,583	95,765
Total liab. and equities	89,848	1,04,113	1,27,599	1,36,450	1,47,108
Cash and cash eq.	10,922	19,905	25,786	29,762	39,721
Accounts receivables	16,494	16,072	18,846	22,430	25,182
Inventories	18,188	23,124	30,055	32,043	30,578
Other current assets	9,180	10,072	16,790	15,789	15,100
Investments	2,614	3,328	3,710	3,710	3,710
Net fixed assets	28,821	27,679	29,017	29,830	30,363
CWIP	3,630	3,933	3,395	2,886	2,453
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	89,848	1,04,113	1,27,599	1,36,450	1,47,108

Cash Flows

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22A	FY23E	FY24E
Cash flow from operations	8,022	17,070	6,223	17,550	23,164
Capital expenditures	(4,500)	(4,000)	(5,000)	(4,000)	(4,000)
Change in investments	622	(714)	(382)	0	0
Other investing cash flows	0	0	0	0	0
Cash flow from investing	(3,878)	(4,714)	(5,382)	(4,000)	(4,000)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	7,602	75	9,980	(5,336)	(4,269)
Interest expenses	(650)	(589)	(524)	(961)	(768)
Dividends paid	(3,485)	(4,182)	(4,739)	(3,786)	(4,601)
Other financing cash flows	(3,304)	1,323	324	509	433
Cash flow from financing	164	(3,373)	5,040	(9,574)	(9,205)
Chg in cash & cash eq.	4,308	8,982	5,881	3,976	9,959
Closing cash & cash eq.	10,923	19,905	25,786	29,762	39,721

Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22A	FY23E	FY24E
Reported EPS	94.3	132.6	137.6	108.6	132.0
Adjusted EPS	94.3	132.6	138.9	108.6	132.0
Dividend per share	25.0	30.0	34.0	27.2	33.0
Book value per share	436.0	524.4	613.0	690.0	783.5

Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22A	FY23E	FY24E
EV/Sales	4.6	4.3	3.6	3.2	2.8
EV/EBITDA	25.8	19.6	18.5	21.5	18.0
Adjusted P/E	33.7	23.9	22.8	29.2	24.0
P/BV	7.3	6.1	5.2	4.6	4.1

DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22A	FY23E	FY24E
Tax burden (Net profit/PBT)	89.5	86.0	89.3	84.3	83.4
Interest burden (PBT/EBIT)	103.2	110.5	106.3	107.7	109.1
EBIT margin (EBIT/Revenue)	14.6	18.8	16.4	12.1	13.1
Asset turnover (Rev./Avg TA)	32.6	29.3	29.0	28.4	30.4
Leverage (Avg TA/Avg Equity)	1.3	1.3	1.3	1.3	1.2
Adjusted ROAE	22.7	27.6	24.4	16.7	17.9

Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22A	FY23E	FY24E
YoY growth (%)					
Revenue	13.4	6.2	20.0	11.3	12.3
EBITDA	32.1	31.9	5.7	(14.8)	19.1
Adjusted EPS	54.1	40.6	4.8	(21.8)	21.5
Profitability & Return ratios (%)					
EBITDA margin	17.7	21.9	19.3	14.8	15.7
EBIT margin	14.6	18.8	16.4	12.1	13.1
Adjusted profit margin	13.5	17.9	15.6	11.0	11.9
Adjusted ROAE	22.7	27.6	24.4	16.7	17.9
ROCE	20.7	25.1	20.9	15.7	18.0
Working capital days (days)					
Receivables	72	66	65	70	70
Inventory	80	95	103	100	85
Payables	42	44	40	45	45
Ratios (x)					
Gross asset turnover	2.4	2.3	2.4	2.5	2.6
Current ratio	2.8	3.0	3.6	3.3	3.2
Net interest coverage ratio	18.8	28.3	33.4	14.9	22.6
Adjusted debt/equity	0.1	(0.1)	0.0	(0.1)	(0.3)

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

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Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

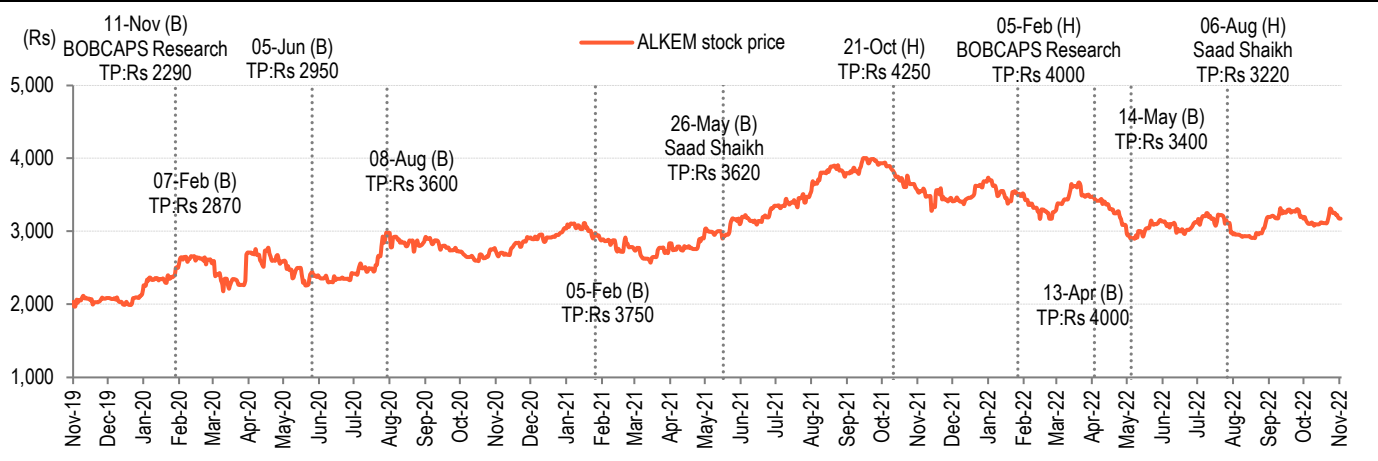
HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

Ratings and Target Price (3-year history): ALKEM LABS (ALKEM IN)



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

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