

HOLD

TP: Rs 4,000 | ▲ 14%

ALKEM LABS

| Pharmaceuticals

| 05 February 2022

Strong domestic growth; weak margins

- Robust traction in India formulations (+20% YoY) during Q3, partly offset by a 7% decline in US generic revenue
- Reversal of SG&A savings hit EBITDA margin; management expects continued headwinds to impact Q4 gross margin by ~3%
- Reiterate HOLD with a lower TP of Rs 4,000 (vs. Rs 4,250) as we roll valuations over and pare our EV/EBITDA multiple to 17x (vs. 19x)

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India-led growth recovery helped by acute portfolio: Alkem reported 13% YoY growth in Q3FY22 revenue led by better traction in India formulations (+20% YoY, ~70% of sales), partially offset by a decline in US generics (-7% YoY, 22% of sales). The ROW market contributed 8% of revenue and grew 25% YoY. India formulations growth was aided by recovery in acute therapy segments such as anti-infectives, vitamins, minerals & nutrients, gastrointestinal and pain management, together with Covid-19 tailwinds. The trade generics business witnessed traction in 9MFY22 despite the disadvantage of a high base effect.

US pricing pressure affects growth: The US generics business declined 6% QoQ to US\$ 77mn in Q3 on account of significant pricing pressure on the base business. This was mitigated to some extent by product launches.

Steep rise in SG&A expense dampens EBITDA margin: Gross margin for the quarter was stable at 61.9% (+25bps YoY, -30bps QoQ), but a steep rise in overhead costs caused EBITDA margin to shrink 380bps YoY (-330bps QoQ) to 19%. SG&A expense ex-R&D increased by 42% YoY to 19% of revenue vs. 15% YoY. Management has guided for a ~3% negative impact on the Q4 gross margin due to continued headwinds. Margin contraction as well as lower non-operating income resulted in a Q3 PBT decline of 15% YoY (-20% QoQ). Deferred tax benefits due to restructuring of the US business stood at Rs 1.6bn, aiding a 17% YoY rise in PAT.

Retain HOLD: We reduce our FY22-FY24 EBITDA margin estimates by 100bps in light of management's gross margin guidance and a weaker overall outlook for Q4FY22. We also roll valuations over to FY24 and pare our target EV/EBITDA multiple to 17x (implied P/E of 21x) from 19x earlier given margin weakness, the rise in cost of goods sold and a lack of growth drivers in the US generics business over the near-to-medium term. Our TP thus declines to Rs 4,000 (from Rs 4,250); maintain HOLD.

Key changes

Target	Rating
▼	◀ ▶

Ticker/Price	ALKEM IN/Rs 3,514
Market cap	US\$ 5.6bn
Free float	39%
3M ADV	US\$ 6.5mn
52wk high/low	Rs 4,070/Rs 2,540
Promoter/FPI/DII	59%/5%/14%

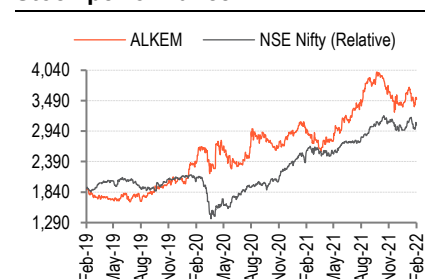
Source: NSE | Price as of 4 Feb 2022

Key financials

Y/E 31 Mar	FY21A	FY22E	FY23E
Total revenue (Rs mn)	92,336	1,06,093	1,19,218
EBITDA (Rs mn)	23,110	20,898	24,380
Adj. net profit (Rs mn)	19,536	17,988	19,622
Adj. EPS (Rs)	163.4	150.5	164.1
Consensus EPS (Rs)	163.4	144.3	161.7
Adj. ROAE (%)	34.0	25.9	23.4
Adj. P/E (x)	21.5	23.4	21.4
EV/EBITDA (x)	18.3	20.1	16.7
Adj. EPS growth (%)	73.3	(7.9)	9.1

Source: Company, Bloomberg, BOBCAPS Research

Stock performance



Source: NSE



Fig 1 – Quarterly performance

(Rs mn)	Q3FY22	Q3FY21	YoY (%)	Q2FY22	QoQ (%)	9MFY21	9MFY20	YoY (%)
Net Sales	26,190	23,181	13.0	28,000	(6.5)	81,503	66,843	21.9
EBITDA	4,985	5,291	(5.8)	6,244	(20.2)	17,157	16,627	3.2
Depreciation	775	690	-	728	-	2,208	2,060	-
EBIT	4,210	4,601	(8.5)	5,516	-	14,949	14,567	2.6
Interest	106	131	(19.1)	120	-	354	482	-
Other Income	535	964	(44.5)	420	(44)	1,421	1,754	-
PBT	4,639	5,434	(14.6)	5,815	(20.2)	16,016	15,839	1.1
Less: Taxation	(694)	796	-	230	-	295	2,154	-
Less: Minority Interest	77	129	-	143	-	341	235	-
Recurring PAT	5,257	4,510	16.6	5,443	(3.4)	15,380	13,450	14.4
Exceptional items	0	0	-	0	-	0	0	-
Reported PAT	5,257	4,510	16.6	5,443	(3.4)	15,380	13,450	14.4
Key Ratios (%)			(bps)		(bps)			(bps)
Gross Margin	61.9	61.7	24	62.2	(29)	61.4	61.8	(40)
EBITDA Margin	19.0	22.8	(379)	22.3	(327)	21.1	24.9	(382)
Tax / PBT	(15.0)	14.6	-	4.0	-	1.8	13.6	-
NPM	20.1	19.5	62	19.4	63	18.9	20.1	-
EPS (Rs)	44.0	37.7	-	45.5	-	128.7	112.5	-

Source: Company, BOBCAPS Research

Fig 2 – Segmental performance

(Rs mn)	Q3FY22	Q3FY21	YoY (%)	Q2FY22	QoQ (%)	9MFY21	9MFY20	YoY (%)
Formulations								
India	18,156	15,140	19.9	19,605	(7.4)	56,858	42,264	34.5
US	5,731	6,156	(6.9)	6,097	(6.0)	17,871	19,078	(6.3)
RoW	1,978	1,582	25.0	1,954	1.2	5,792	4,303	34.6
Net Sales	25,865	22,878	13.1	27,656	(6.5)	80,521	65,645	22.7
USDINR	74	74	0.8	74	0.0	74	74	0
US revenue (US\$ mn)	77	84	(7.6)	82	(6.0)	242	258	(6.0)

Source: Company, BOBCAPS Research

Earnings call highlights

- **India formulations:** Alkem's India formulations business grew 20% YoY in Q3FY22 and 35% in 9MFY22 due to tailwinds in acute therapy segments, benefits of the third Covid-19 wave and a lower base. Among therapeutic areas, the VMN (vitamins, minerals and nutrients) and gastrointestinal segments contributed the most. All Alkem's mega brands outperformed peers in respective segments and retained leadership positions. The trade generics business maintained growth traction in Q3 and 9M despite the disadvantage of a higher base in FY21. Alkem forayed into the respiratory segment with the introduction of its Pulmocare division.
- **RM cost:** In spite of raw material price hikes globally, management expects to maintain a flat gross margin in FY22 while revenue is guided to grow 30% YoY. During Q3, a better product mix and higher contribution from India helped to reduce the impact of high RM costs, especially in anti-inflammation therapeutic areas.
- **US tax benefits:** A tax credit due to restructuring of the US business shored up Alkem's PAT growth to 17% YoY in Q3FY22. US generic revenue declined 10% (in CC) YoY to US\$ 77mn due to a continued slowdown in product launches. The company filed one ANDA and received six approvals in Q3. Management remains concerned over price erosion in the base portfolio and the lack of new launches.
- **ROW markets:** ROW business grew 25% YoY in Q3 due to strong sales in Australia, the Philippines, Chile and Kazakhstan.
- **New Indore plant:** Management indicated that approval of the Indore plant is pending as it awaits USFDA inspection.
- **Tax guidance:** Management has guided for an effective tax rate of 3.5-4% in FY22 and 10-12% in FY23 as continued restructuring of assets in the US would lead to deferred tax benefits.
- **Capex:** No major capex is planned in the medium term given ample unutilised capacity. Alkem is planning an outlay of Rs 4bn-4.5bn in FY23.

Valuation methodology

We reduce our FY22-FY24 EBITDA margin estimates by 100bps each in light of management's gross margin guidance and a weaker overall outlook for Q4FY22. We also roll valuations over to FY24 and pare our target EV/EBITDA multiple to 17x (implied P/E of 21x) from 19x earlier given margin weakness, the rise in cost of goods sold and a lack of growth drivers in the US generics business over the near-to-medium term. Our TP thus declines to Rs 4,000 (from Rs 4,250); maintain HOLD.

Fig 3 – Revised estimates

(Rs bn)	New			Old			Change (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Sales	106.1	119.2	132.6	102.0	114.9	128.0	4.0	3.8	3.6
EBITDA	20.9	24.4	27.9	21.1	24.7	28.3	(1.0)	(1.2)	(1.3)
EBITDA margin (%)	19.7	20.5	21.1	20.7	21.5	22.1	(99bps)	(103bps)	(105bps)
EPS (Rs)	150.5	164.1	187.7	134.3	160.3	188.0	12.1	2.4	(0.1)

Source: BOBCAPS Research

Fig 4 – Key assumptions

Revenue (Rs bn)	FY21	FY22E	FY23E	FY24E
Domestic	57.0	71.5	80.4	89.4
US revenues (Rs mn)	28.2	25.7	29.0	32.4
Non - US revenues	5.8	7.5	8.3	9.1
OOI	1.4	1.4	1.5	1.7

Source: Company, BOBCAPS Research

Fig 5 – Peer comparison

Company	Ticker	Rating	Target Price (Rs)	EBITDA CAGR FY21-24E (%)	EV/EBITDA		ROE (%)		Target P/E (x)
					FY22E	FY23E	FY22E	FY23E	
Ajanta Pharma	AJP IN	BUY	2,655	9.7	15.0	13.5	22.1	21.0	17.0
Alkem Labs	ALKEM IN	HOLD	4,000	6.5	16.4	14.3	23.4	22.4	17.0
Alembic Pharma	ALPM	BUY	980	3.5	9.2	8.2	14.1	16.2	13.0
Aggregate			-	-	13.5	12.0	19.9	19.8	15.7

Source: BOBCAPS Research

Key risks

- **Regulatory action and slowdown in India formulation business:** Alkem's current portfolio under NLEM is meaningfully higher than the market. That said, 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:** Disruptive regulatory action in trade generics could be a key risk to the stock since this accounts for 15% of overall domestic sales. Further, any slowdown in Indian pharma market growth and delay in new launches can affect earnings.
- **Poor US execution:** 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 Alkem's top 5 products for the US market could be potential threats to earnings.

Sector recommendation snapshot

Company	Ticker	Market Cap (US\$ bn)	Price (Rs)	Target (Rs)	Rating
Ajanta Pharma	AJP IN	2.5	2,118	2,655	BUY
Alembic Pharma	ALPM IN	2.0	748	980	BUY
Alkem Labs	ALKEM IN	5.6	3,514	4,000	HOLD
Aurobindo Pharma	ARBP IN	5.2	663	886	BUY
Cipla	CIPLA IN	10.2	946	1,160	BUY
Divi's Labs	DIVI IN	15.3	4,305	5,540	HOLD
Dr Reddy's Labs	DRRD IN	9.7	4,352	4,700	HOLD
Eris Lifesciences	ERIS IN	1.3	716	890	BUY
Laurus Labs	LAURUS IN	3.8	529	570	HOLD
Lupin	LPC IN	5.3	872	1,045	HOLD
Sun Pharma	SUNP IN	28.7	894	1,045	BUY

Source: BOBCAPS Research, NSE | Price as of 4 Feb 2022

Financials

Income Statement

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24
Total revenue	82,983	92,336	1,06,093	1,19,218	1,32,603
EBITDA	14,730	23,110	20,898	24,380	27,915
Depreciation	2,526	2,746	2,872	3,222	3,572
EBIT	12,204	20,364	18,026	21,158	24,343
Net interest inc./(exp.)	(650)	(589)	(601)	(802)	(802)
Other inc./(exp.)	1,043	2,332	1,722	2,740	3,523
Exceptional items	0	0	0	0	0
EBT	12,598	22,107	19,147	23,097	27,064
Income taxes	1,105	2,243	766	3,003	4,060
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	222	328	393	472	566
Reported net profit	11,270	19,536	17,988	19,622	22,439
Adjustments	0	0	0	0	0
Adjusted net profit	11,270	19,536	17,988	19,622	22,439

Balance Sheet

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24
Accounts payables	9,541	10,694	14,345	16,119	17,929
Other current liabilities	6,010	7,343	8,377	9,414	10,471
Provisions	4,067	4,874	5,613	6,307	7,016
Debt funds	16,628	16,702	13,362	13,362	13,362
Other liabilities	0	0	0	0	0
Equity capital	239	239	239	239	239
Reserves & surplus	53,363	64,262	78,055	93,101	1,10,307
Shareholders' fund	53,602	64,501	78,294	93,340	1,10,547
Total liab. and equities	89,848	1,04,113	1,19,991	1,38,543	1,59,323
Cash and cash eq.	10,922	19,905	30,829	40,795	53,206
Accounts receivables	16,494	16,072	20,083	22,567	25,101
Inventories	18,188	23,124	22,378	25,146	27,969
Other current assets	9,180	10,072	12,566	14,121	15,706
Investments	2,614	3,328	3,328	3,328	3,328
Net fixed assets	28,821	27,679	29,807	31,585	33,013
CWIP	3,630	3,933	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	89,848	1,04,113	1,19,991	1,38,543	1,59,323

Cash Flows

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24
Cash flow from operations	8,021	20,756	21,128	20,344	23,445
Capital expenditures	(4,500)	(4,000)	(5,000)	(5,000)	(5,000)
Change in investments	622	(714)	0	0	0
Other investing cash flows	0	0	0	0	0
Cash flow from investing	(3,878)	(4,714)	(5,000)	(5,000)	(5,000)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	7,603	75	(3,340)	0	0
Interest expenses	(650)	(589)	(601)	(802)	(802)
Dividends paid	(2,628)	(4,556)	(4,195)	(4,576)	(5,233)
Other financing cash flows	(4,161)	(1,990)	2,933	0	0
Cash flow from financing	164	(7,060)	(5,204)	(5,378)	(6,034)
Chg in cash & cash eq.	4,308	8,982	10,925	9,966	12,411
Closing cash & cash eq.	10,922	19,905	30,829	40,795	53,206

Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24
Reported EPS	94.3	163.4	150.5	164.1	187.7
Adjusted EPS	94.3	163.4	150.5	164.1	187.7
Dividend per share	18.9	32.7	30.1	32.8	37.5
Book value per share	436.0	524.4	639.7	765.6	909.5

Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24
EV/Sales	5.1	4.6	4.0	3.4	3.0
EV/EBITDA	28.6	18.3	20.1	16.7	14.2
Adjusted P/E	37.3	21.5	23.4	21.4	18.7
P/BV	8.1	6.7	5.5	4.6	3.9

DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24
Tax burden (Net profit/PBT)	89.5	88.4	93.9	85.0	82.9
Interest burden (PBT/EBIT)	103.2	108.6	106.2	109.2	111.2
EBIT margin (EBIT/Revenue)	14.7	22.1	17.0	17.7	18.4
Asset turnover (Rev./Avg TA)	32.4	30.5	30.7	30.1	28.8
Leverage (Avg TA/Avg Equity)	1.3	1.3	1.2	1.2	1.2
Adjusted ROAE	22.7	34.0	25.9	23.4	22.4

Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24
YoY growth (%)					
Revenue	12.8	11.3	14.9	12.4	11.2
EBITDA	32.3	56.9	(9.6)	16.7	14.5
Adjusted EPS	54.4	73.3	(7.9)	9.1	14.4
Profitability & Return ratios (%)					
EBITDA margin	17.8	25.0	19.7	20.5	21.1
EBIT margin	14.7	22.1	17.0	17.7	18.4
Adjusted profit margin	13.6	21.2	17.0	16.5	16.9
Adjusted ROAE	22.7	34.0	25.9	23.4	22.4
ROCE	20.7	30.0	22.8	24.1	24.2
Working capital days (days)					
Receivables	73	65	70	70	70
Inventory	81	93	78	78	78
Payables	42	43	50	50	50
Ratios (x)					
Gross asset turnover	2.4	2.4	2.4	2.5	2.5
Current ratio	2.8	3.0	3.0	3.2	3.4
Net interest coverage ratio	18.8	34.6	30.0	26.4	30.4
Adjusted debt/equity	0.1	(0.1)	(0.3)	(0.3)	(0.4)

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

Disclaimer

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

BUY – Expected return >+15%

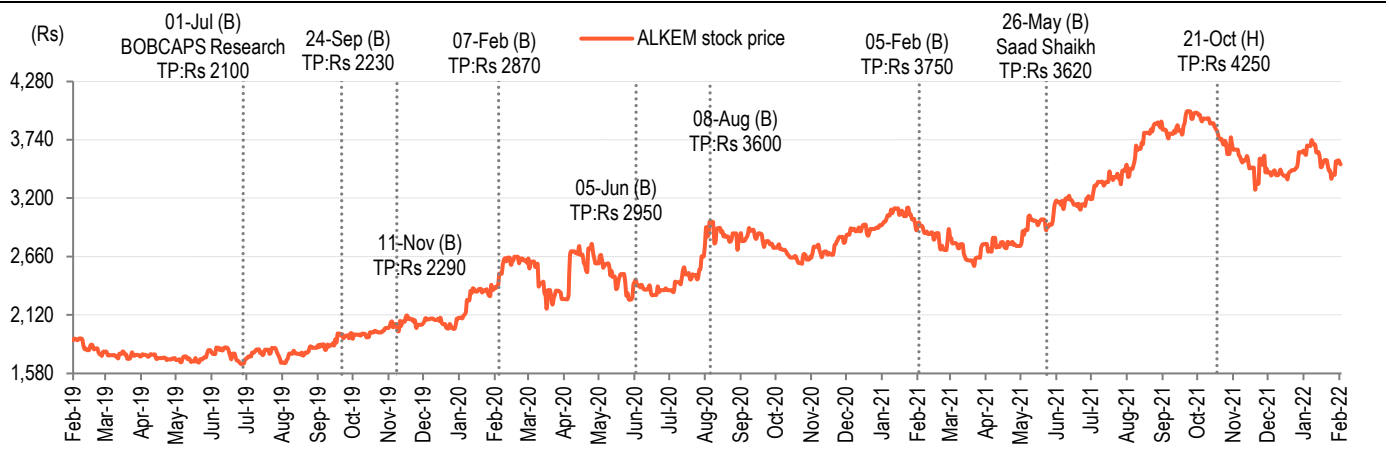
HOLD – Expected return from -6% to +15%

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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