

RESEARCH

Pharmaceuticals

Multiyear earnings upcycle in sight; prefer Cipla, Aurobindo, Laurus

SUMMARY

Pharmaceuticals

Pharma valuations have course corrected in last 6M/3M with BSE healthcare index underperforming Nifty by 20%/11% due to sector rotation amid receding Covid headwinds and reemergence of FDA risk while earnings were resilient. Q3FY21 was better than expected for our universe with revenue/EBITDA rising 12%/34% YoY, partly from cost savings. We expect multiyear earnings upcycle in the sector (US/India growth, increased CDMO upside) and believe ROIC would surpass FY15 levels of 29%, supporting a rerating.

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TOP PICKS

LARGE-CAP IDEAS

Company	Rating	Target
Cipla	Buy	1,000
GAIL	Buy	160
Petronet LNG	Buy	330
TCS	Buy	3,710
Tech Mahindra	Buy	1,130

MID-CAP IDEAS

Company	Rating	Target
Alkem Labs	Buy	3,750
Greenply Industries	Buy	195
Laurus Labs	Buy	480
Transport Corp	Buy	330
Mahanagar Gas	Sell	750

Source: BOBCAPS Research

DAILY MACRO INDICATORS

Indicator	Current	2D (%)	1M (%)	12M (%)
US 10Y yield (%)	1.53	(6bps)	36bps	72bps
India 10Y yield (%)	6.21	(1bps)	14bps	14bps
USD/INR	72.93	0.4	0	1.6
Brent Crude (US\$/bbl)	67.52	(1.1)	13.8	81.4
Dow	31,833	0.1	2.2	27.2
Shanghai	3,359	(1.8)	(3.9)	12.1
Sensex	51,025	1.2	0.6	43.2
India FII (US\$ mn)	8 Mar	MTD	CYTD	FYTD
FII-D	(172.1)	(937.1)	(2,421.3)	(6,514.9)
FII-E	(164.7)	585.3	5,579.1	35,554.9

Source: Bank of Baroda Economics Research

BOBCAPS Research

research@bobcaps.in



PHARMACEUTICALS

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Vivek Kumar | Saad Shaikh

research@bobcaps.in

Earnings momentum strong; FY22 to be tepid: Optically, the sector's FY22 EBITDA margin could be muted at 25% (26% in FY21) as 80% of A&P and R&D spending cuts are likely to be reversed. On the whole, we believe a rising specialty mix in the US (for Cipla, Sun – SUNP, Aurobindo – ARBP and Dr Reddy's – DRRD) and operating leverage in India can add ~400bps to margins over FY20-FY23, aiding a 17% CAGR in EPS for our universe.

Physical FDA inspection a key monitorable: Restoration of full-blown FDA inspections will be crucial to stock performance in CY21. In Feb'21 the FDA inspected units of Shilpa Medicare (import alert) and Alembic Pharma F3 (ALPM; five observations). It is still early to call this a big setback for the sector. We expect a benign regulatory environment with announcement from FDA's India head that the regulator may grant approval without inspection if a drug belongs to an already approved profile or if manufacturer has a solid cGMP record – firms with completed CAPA and pending inspections (Cipla, ARBP, SUNP) could benefit.

Biosimilars, API/KSM import substitution to propel India pharma to US\$ 130bn by 2030: Indian pharma has clocked a ~13% CAGR in the last two decades (~11% in the domestic market, ~16% in export markets), aided by leadership in generics supply. FICCI estimates that the Indian pharma industry could log a ~12% CAGR over 2020-30, rising from US\$ 41.7bn to US\$ 130bn.

Stocks to BUY: With the course correction in stocks in the last six months (BSE HC underperforming Nifty by 20%), several companies are trading close to historical EV/EBITDA (of 13x, i.e. 15% below the 8Y mean). Over three years, we are more positive on Cipla (TP: Rs 1,000), ARBP (TP: Rs 1,100) and Laurus (TP: Rs 480) on improving fundamentals, mix change and valuation merit. We also prefer Alkem, Ajanta Pharma (AJP), ALPM and Eris. ADD Divi's (DIVI), SUNP, DRRD, Lupin (LPC).

RECOMMENDATION SNAPSHOT

Ticker	Price	Target	Rating
AJP IN	1,782	2,100	BUY
ALPM IN	938	1,230	BUY
ALKEM IN	2,772	3,750	BUY
ARBP IN	853	1,100	BUY
CIPLA IN	797	1,000	BUY
DIVI IN	3,503	3,700	ADD
DRRD IN	4,448	5,200	ADD
ERIS IN	585	730	BUY
LAURUS IN	347	480	BUY
LPC IN	1,032	1,070	ADD
SUNP IN	613	630	ADD

Price & Target in Rupees

SECTOR VS BROADER INDICES

Index (%)	1Y	6M	3M	1M
Nifty Pharma	56	7	(2)	(5)
BSE Healthcare	58	14	1	(2)
Nifty 50	44	34	12	0
Sensex	43	34	11	(1)

Source: NSE, BSE



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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)

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