

 **PHARMACEUTICALS**

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Lonza call takeaways: China's API dominance receding

We hosted the Lonza Group on an investor conference call to gain greater insights into the API shortages stemming from China environmental, social and corporate governance (ESG) issues. Lonza is a Swiss-based company with revenues of US\$ 5.5bn and a world leader in the manufacture of active ingredients for pharmaceutical and biotech companies. We provide key call highlights below.

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Multi-year opportunity: China's blue-sky policy has created an abrupt shortage of API supplies globally. Lonza believes the resolution of quality issues in China could be a protracted affair. Over the last 15 months, regulator checks on quality of material from China have also become more stringent. Local regulators are stepping up certification requirements, especially from ESG investors.

Sourcing from China coming off: Over the last two years, Lonza's dependency on sourcing APIs from China has reduced materially due to quality and environmental concerns. The company has switched over to alternate suppliers and brought manufacturing of many critical raw materials inhouse. Its key focus is on security of supplies and it prefers to avoid the spot market entirely.

Cost arbitrage has narrowed vs. western world: Compliance and other costs in China are shooting up and hence the cost arbitrage derived from sourcing supplies from China is narrowing, except for some commodity APIs where the country has a scale advantage.

API price inflation to normalise: API prices are not expected to increase much besides normal price inflation given that most of contracts are for five years or more and have fixed pricing with some inflation variable. Key materials that have seen sharp price increases in recent months include Acetone and Acetonitrile.

Sartan prices largely stable: Impurity profiles are a key concern for biotech companies as the cost of testing them inhouse could be very high. Overall, sartans have not seen substantial prices hikes so far.

Our view: We believe the impact of the API shortage is already in the base for select companies such as Divi's Labs and Dr Reddy's. While volume gains could sustain, API prices have now started to normalise. We remain selective in our picks and prefer Cipla, Aurobindo Pharma and Laurus. Upsides in Divi's could be capped following the recent rally.



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