IDFC SECURITIES

Pharmaceuticals

Appreciating INR – Emerging earnings risk

26 April 2017

BSE Sensex: 30133

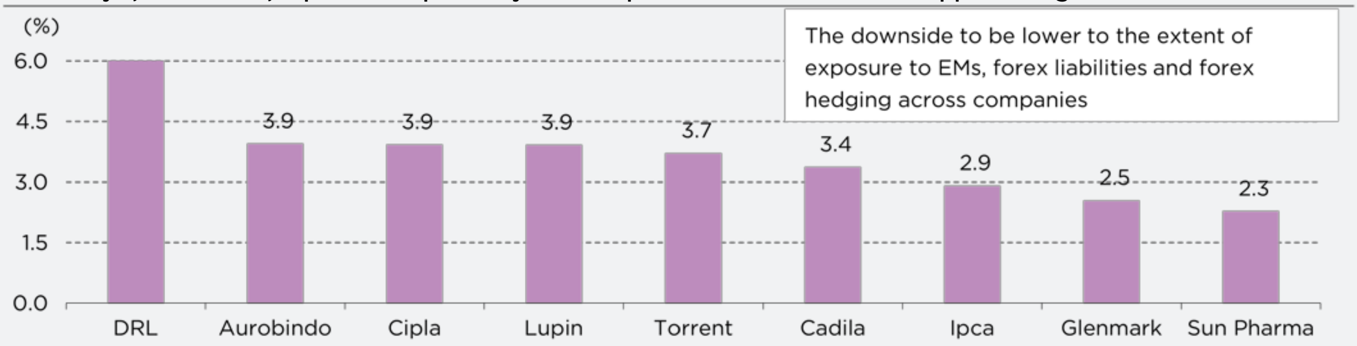
Our analysis of the effect of INR appreciation on Indian pharma companies throws up uneven results. With >50% of Indian pharma's revenues (45-100% across the listed universe) accruing from exports (primarily USD denominated), INR appreciation (up ~5% in the past three months) exposes Indian pharma companies to potential losses. Companies that have higher exposure to the US/EU markets and with predominantly India-based manufacturing activities (Dr Reddy's and Cadila) stand to lose more than those with overseas manufacturing assets (Sun Pharma – Taro/ Mutual). However, forex-related losses might not be uniform given the divergent business models (geographical presence). Developed market currency losses might be partially mitigated by a strong EM front-end presence (e.g., Cipla, Glenmark, Dr Reddy's, etc) as most EM currencies have also been strengthening vs the USD. Overall, assuming an average USD/INR realisation of 65 for FY18E, we see 3-4% downside to our current PBT estimates (based on USD/INR of 67) across companies. In our coverage universe, we expect Dr Reddy's, Aurobindo, Cipla and Lupin, to be impacted the most from a stronger INR.

Appreciation of the INR, a trend reversal after seven years of depreciation: Against an average realisation of ~INR67/USD for FY17, the INR has appreciated ~5% since Jan 2017 to INR64.6/USD currently. Notably, the INR had depreciated continuously against the USD, from ~Rs45.6 in FY11 to ~Rs67.1 in FY17, Our channel checks suggest that most pharma companies have significantly light hedges for FY18-19 net export earnings. Given that consensus earnings estimates are still factoring in reasonably higher currency exchange rates (IDFC estimate of INR67/USD for FY17/FY18), it may result in earnings downgrades for pharma companies over the next few quarters if the INR continues to remain at this level.

Divergent business models; varying currency impact: Companies with a higher proportion of sales from formulation/API exports to the US/EU and India-focused manufacturing activities stand to be the most impacted. Losses will, however, be limited in EM formulation sales as the ongoing appreciation in EM currencies versus the USD will boost USD-denominated sales growth in these geographies. Also, realisation losses would be partially offset by lower imported raw material costs, R&D spend (a significant portion denominated in USD) and SG&A spend. Further, there will be a positive impact (likely to manifest itself more in the balance sheet than the P&L) due to the MTM forex gains across companies like Lupin, Cipla & Aurobindo have taken forex-denominated debt in the past few years to fund overseas acquisitions.

Buy into weakness: We believe that while some near-term headwinds such as potential INR appreciation, regulatory uncertainty in India and the US along with the slow pace of big-ticket ANDA approvals are still there, the medium- to long-term fundamental drivers for the generic (domestic as well exports) business remain broadly intact. With valuation excesses gradually waning and the worst of the USFDA regulatory challenges likely behind us and with the sector PE now closer to the relatively stable multiples observed over FY11-14, we believe that the Indian pharma sector is now beginning to present interesting buying opportunities from a 6-12 month perspective. We believe that improving revenue growth should drive 17% earnings CAGR over FY17-19E with growth picking up through the quarters. Given the expected pickup in earnings, valuations are beginning to look attractive at 15-19x FY19E earnings. Our top picks are Aurobindo, Glenmark, Sun and Torrent.

Dr Reddy's, Aurobindo, Cipla and Lupin likely to be impacted the most from the appreciating INR



Source: IDFC Securities Research

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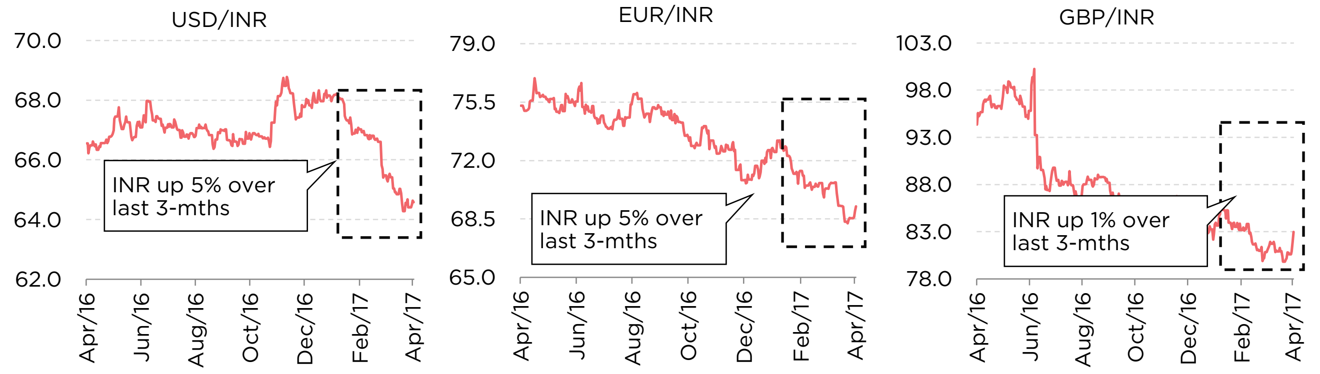
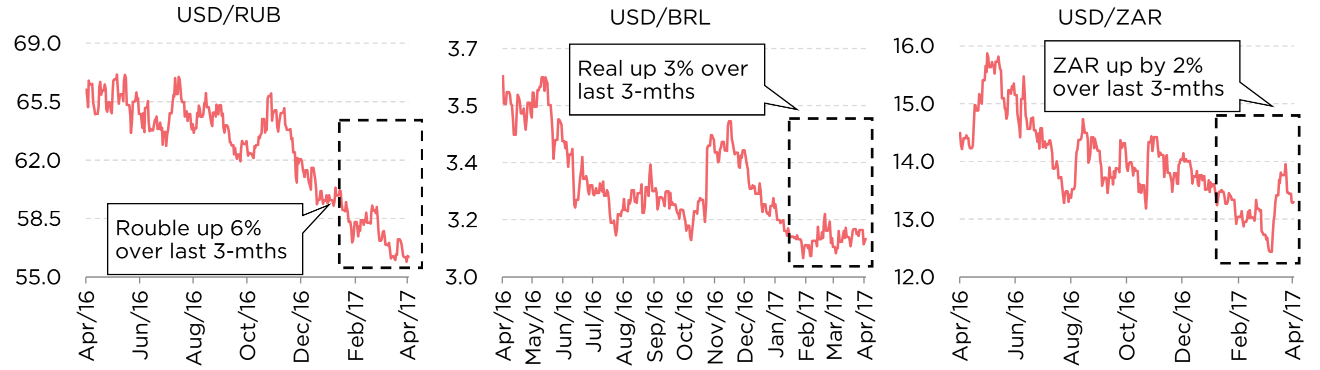
Indian Rupee (INR): Appreciating times

Exhibit 1: INR has appreciated by 5%, 5% & 1% in the past three months against the USD, Euro & GBP, respectively



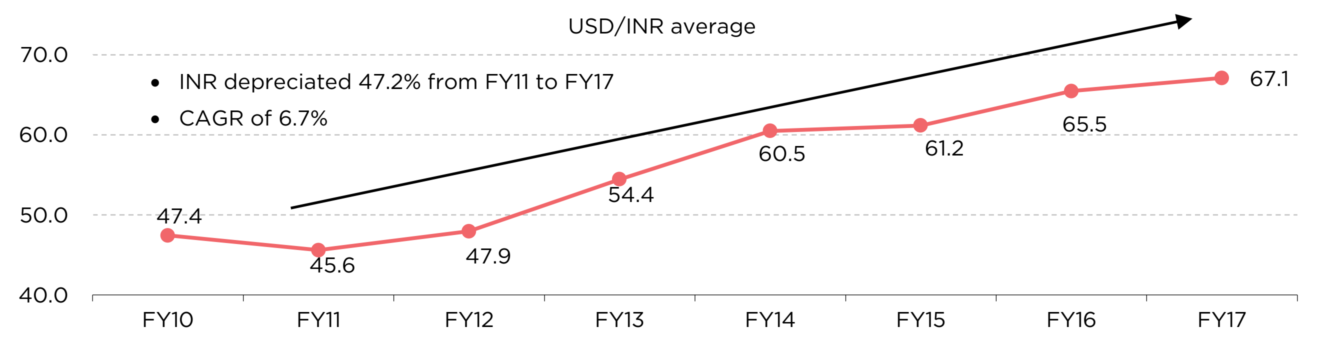
Source: Bloomberg, IDFC Securities Research

Exhibit 2: EM peers, e.g., Rouble, Real & ZAR, have appreciated by 6%, 3% & 2% in the past 3 months against USD



Source: Bloomberg, IDFC Securities Research

Exhibit 3: INR has started to appreciate in FY18 after a steady depreciation over FY11-17



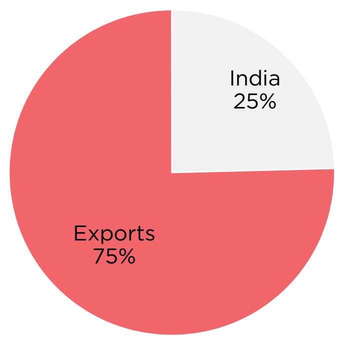
Source: Company, IDFC Securities Research

Indian Pharma: Opportunity in adversity

Exhibit 4: Appreciating INR will hurt Indian pharma earnings

Source: IDFC Securities Research

Exhibit 5: Exports are ~75% of Indian Pharma sales…



Source: Company, IDFC Securities Research

Exhibit 6: …45-100% of sales for our generic universe

Source: Company, IDFC Securities Research
*Note: * = Not rated*

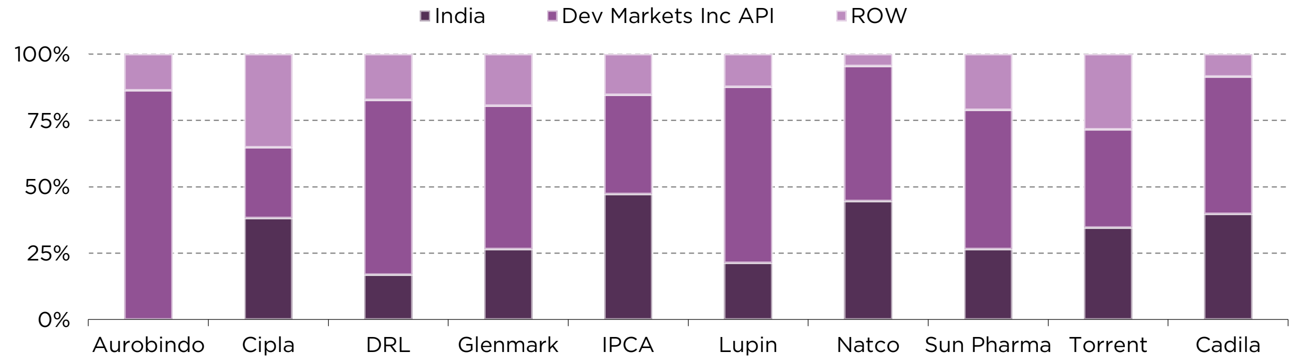
Forex loss: Not an even playing field

Exhibit 7: Not all exports are equal

Export segment	Forex loss*	Comments
US/EU formulation exports – supplies from India-based manufacturing units	****	• Companies capture maximum loss given USD/EURO denominated revenues and costs largely in INR
		• Dr Reddy's, Lupin and Cadila have the highest exposure to this segment
API exports – supplies from India-based manufacturing units	***	• Pricing is USD denominated, leading to significant realisation loss; however, the commodity nature of the business may eventually lead to some price improvement
US/EU formulation exports – supplies from manufacturing units based in overseas markets	***	• Revenues and costs both denominated in USD
		• Forex loss limited to translation loss on profit/value addition
		• >50% of Sun Pharma's US revenues (e.g., Taro, DUSA, Mutual Pharma, Absorica) come from overseas facilities.
		• Lupin (through Gavis) and Cipla (through Invagen) also have a US manufacturing presence; Aurobindo, Cadila and DRL also have manufacturing footprints in the US
Emerging market revenues – distributor model	**	• Typically, exports are billed in USD terms; however, given the sharp appreciation in most EM currencies, distributors will either need to hike prices significantly in local markets or absorb a significant margin squeeze
Emerging market revenues – front-end presence	*	• Revenues and operating costs effectively realised in local currency
		• If we assume flat drug prices, the sharp appreciation in most EM currencies versus the USD as well as the INR will lead to higher USD denominated revenues/profit; to neutralise any material loss vis-à-vis the INR – Cipla, Lupin, Glenmark, Torrent, etc, have some proportion of their revenues in this segment

*Source: IDFC Securities Research; Note: Higher number of * denotes higher loss*

Exhibit 8: Divergence in revenue mix (FY18E) and currency volatility across regions to lead to uneven forex impact



Source: Company, IDFC Securities Research

We expect companies with a higher proportion of sales from formulation and API exports to the US/EU and India-focused manufacturing activities to be impacted by the appreciating currency.

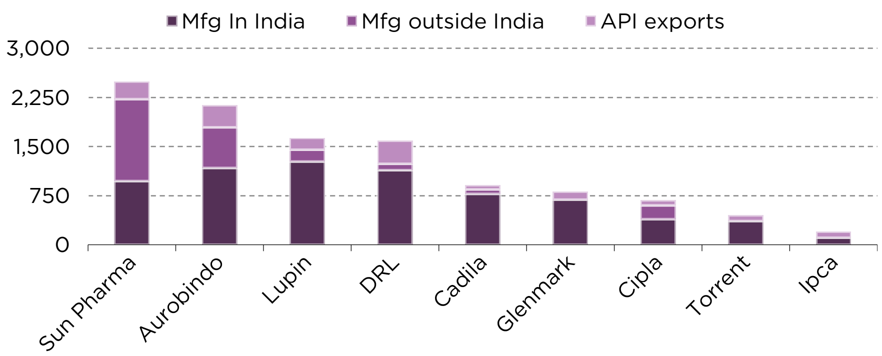
Losses will, however, be limited in EM formulation sales as the appreciation in local currency versus the USD as well as the INR will aid USD-denominated sales growth in these geographies.

Realisation losses will be partially offset by lower imported raw material costs, R&D spend (a significant portion denominated in USD) and SG&A spend.

Exports from India-based manufacturing units to be most impacted

Indian Pharma's currency losses would primarily come from revenues from developed markets, i.e., the US and EU, where the currencies have sharply depreciated against the INR. Even in this segment, exports from domestic facilities will result in maximum losses.

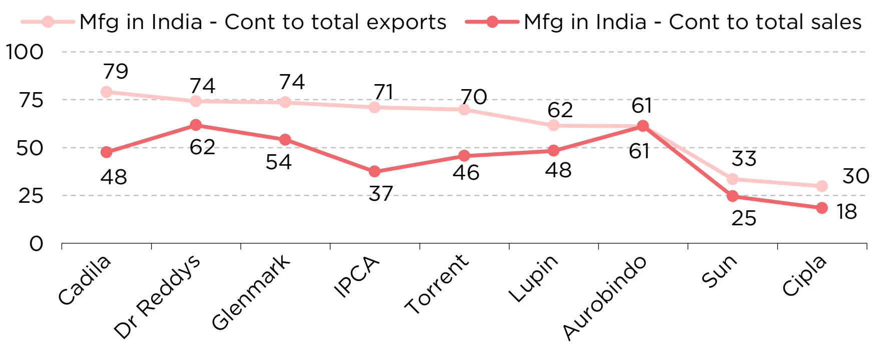
Exhibit 9: Export revenues (FY18E) from US/EU markets (including API) – the biggest losses



- Sun, the biggest player in this segment, but >50% of its US revenues are supplied from overseas facilities
- Apart from Sun, Aurobindo, Lupin and Dr Reddy's, have the highest exposure to this segment

Source: Company, IDFC Securities Research

Exhibit 10: Contribution of export revenues (FY18E) for US/EU market (including API) with India manufacturing



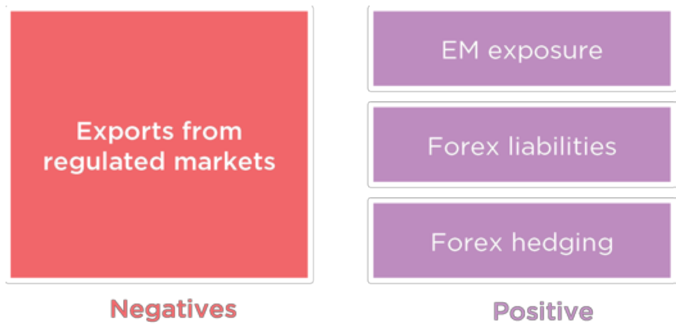
- Cadila, Dr Reddy's, Glenmark, Ipca and Torrent have the highest exposure in terms of contribution of developed market export revenues supplied from Indian facilities
- For Sun, the contribution is muted on account of Taro/ URL/ DUSA/ Ranbaxy, which have US-based plants, likewise, for Cipla the contribution is from Invagen.

Source: Company, IDFC Securities Research

Factors that might mitigate the impact of the INR appreciation

The forex losses emanating from regulated market exports will be neutralised to some extent by the appreciation of EM currencies vs the USD, restatement of forex-denominated liabilities as well as USD hedges taken at higher levels. The extent of these mitigating factors will vary across companies.

Exhibit 11: EM exposure + forex liabilities + hedging to mitigate forex gains

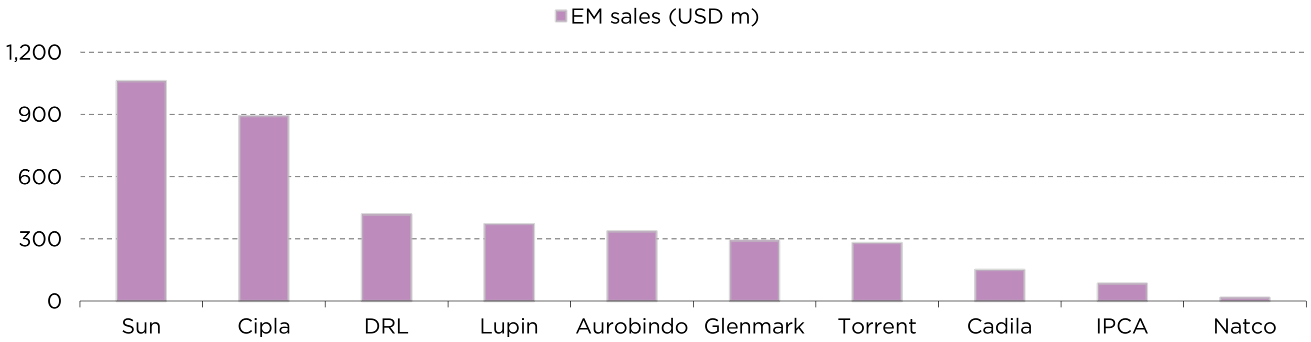


Source: Company, IDFC Securities Research

❑ EM exposure – The safety factor to currency losses

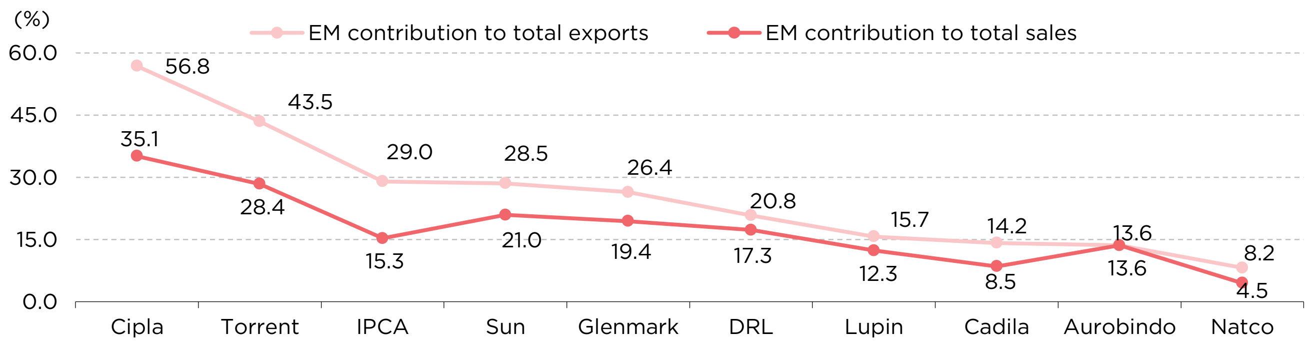
Apart from the impact of stronger EM currencies (versus the USD) on profitability, and hence the P&L, companies may be helped by the significant gains related to translation of EM market subsidiaries in the balance sheet.

Exhibit 12: Export revenues (FY18E) from emerging markets to reduce forex losses



Source: Company, IDFC Securities Research

Exhibit 13: Export revenues (FY18E) from emerging markets – forex gains



Source: Company, IDFC Securities Research

Exhibit 14: Key Emerging Market exposure among Indian companies

Companies	Countries	FY16 revenues (Rs bn)	% of total FY16 revenues
Torrent	Brazil	6	13
DRL	Russia	11	10
	CIS	4	5
Glenmark	Russia	2	5
	Venezuela	2	5
	Brazil	3	4
Cipla	South Africa	15	10
Ipca	CIS	1	5

Source: Company, IDFC Securities Research

❑ Forex liabilities – To help

In general, debt levels across the space have gone up in the past couple of years due to increased M&A activity as well as aggressive capex spend. We estimate that barring Torrent (which raised INR debt to fund its Elder Pharma acquisition), the bulk of the debt (>80% in most instances) across companies is forex-denominated given that it is significantly cheaper than domestic debt and acts as a natural hedge for export revenues. Notably, a stronger INR against the USD will lead to restatement of this forex debt and MTM forex gains. However, depending on the accounting treatment followed by the company, the MTM gains will either be accounted in the balance sheet or will flow through the P/L. To the extent, these MTM gains, which may be flowing through to the P&L, may increase earnings volatility.

Aurobindo, Lupin, Cipla and Glenmark have the highest level of debt among peers. Lupin and Cipla have made big ticket acquisitions, e.g., GAVIS (US$880m) and Invagen/Exelan (US$550m), respectively, which have increased their forex liabilities. Given the growing aggression of Indian generics in the M&A space and availability of fairly low cost forex debt, there may be more instances of increase in M&A-driven debt in the Indian Pharma industry.

Exhibit 15: MTM gains on forex denominated debt to temper the losses on appreciating currency

Net debt	Net debt FY18E (Rs m)	80% is foreign debt	USD m @ Rs 67	MTM gain @ 64	Net debt	Net worth
Aurobindo Pharma	39,402	31,521	470	1,411	37,990	118,098
Lupin	39,193	31,355	468	1,404	37,789	156,188
Glenmark Pharma	25,853	20,683	309	926	24,927	59,030
Cipla	21,602	17,282	258	774	20,828	152,062
Cadila	11,456	9,165	137	410	11,045	78,213
Torrent Pharma	9,684	1,937 (*)	29	87	9,597	48,529
Dr Reddy's Lab	7,798	6,238	93	279	7,519	140,782
IPCA Laboratories	5,827	4,662	70	209	5,618	26,487

Source: Company, IDFC Securities Research, (- assumed 20% as foreign debt)*

Sensitivity analysis of INR appreciation across Indian Pharma

If the INR continues to stay stronger, we estimate that there could be a potential impact of ~2.3%-6% (at INR65/USD) on FY18E PBT for Indian pharma companies with DRL being the most impacted at 6% (on account of lower base for FY18) followed by Aurobindo, Cipla and Lupin at 3.9% each.

Exhibit 16: Dr Reddy's, Aurobindo, Cipla and Lupin to be affected the most from the strengthening INR

FY18	Total revs ($ m)	US+EU Revs ($ m)	NFE % of total revenues	NFE US ($ m)	FY18E PBT (Rs bn)	65	63	61
DRL	2,414	1,414	31.9	771	26	(6.0)	(12.1)	(18.1)
Aurobindo	2,467	1,657	29.4	725	37	(3.9)	(7.9)	(11.8)
Cipla	2,542	1,086	19.5	495	25	(3.9)	(7.8)	(11.8)
Lupin	2,910	1,544	27.0	785	40	(3.9)	(7.8)	(11.7)
Torrent	987	408	25.0	247	13	(3.7)	(7.4)	(11.1)
Cadila	1,737	879	23.8	413	25	(3.4)	(6.7)	(10.1)
Ipca	545	156	11.4	62	4	(2.9)	(5.8)	(8.7)
Glenmark	1,479	750	18.0	266	21	(2.5)	(5.1)	(7.6)
Sun Pharma	4,985	2,359	22.2	1,107	97	(2.3)	(4.6)	(6.8)

Source: Company, IDFC Securities Research; Note: Assuming USD/INR – 67

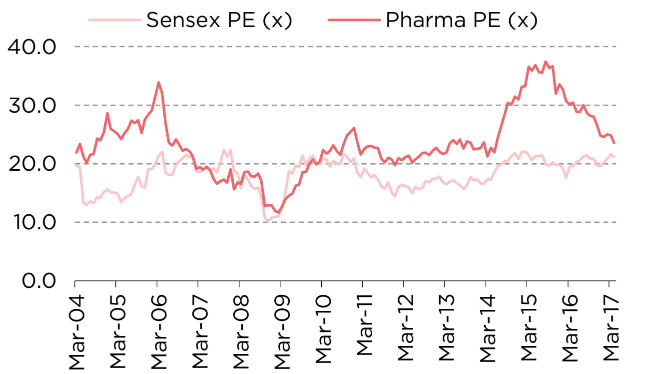
❑ Key assumptions for net foreign exchange calculations

- These calculations include losses from currency movements in exports to regulated markets but do not include the potential gains that will emerge from an appreciating currency movement in emerging markets; we have effectively assumed EM revenues to be forex neutral
- The computations also do not take into account any mark to mark losses on forex liabilities or translation gains/losses related to forex subsidiary balance sheets
- FY18 upside computations assume zero hedging in the year; hedging at higher levels will reduce the potential losses
- API exports – Companies retain only 50% of the currency gains while the remaining is passed on to customers
- COGS – Imported RM as % of sales assumed to be flat over FY16-18
- Staff costs and SG&A costs across developed/emerging market subsidiaries split in the proportion of revenues across markets

Valuations and view: Nearing a buying zone

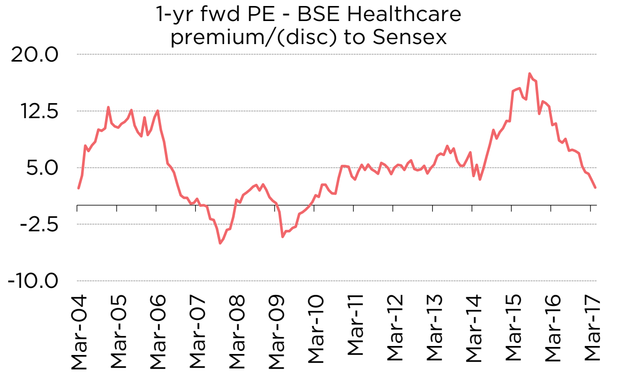
The Indian Pharma sector has been through a turbulent phase over the past few quarters as it has been buffeted by a host of adverse developments across both the domestic and the export fronts. After a dream run over 2013-15, wherein the BSE Healthcare Index outperformed the markets by 73%, the healthcare index has underperformed the Sensex by 22% over the past 12 months. Post this correction, the sector PE multiples are back to the normalized levels that the sector has traded in the past.

Exhibit 17: Index performance



Source: Company, IDFC Securities Research

Exhibit 18: Index performance – 1 year fwd PE

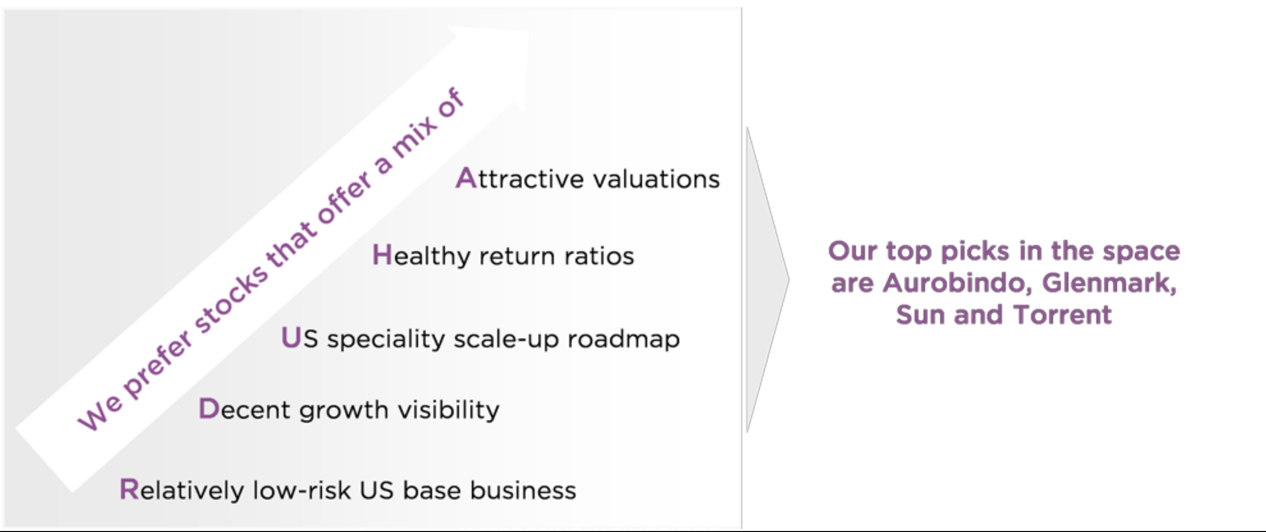


Source: Company, IDFC Securities Research

We believe that while some near-term headwinds such as potential INR appreciation, regulatory uncertainty in India and in the US along with the slow pace of big ticket ANDA approvals are still there, the medium- to long-term fundamental drivers for the generic (domestic as well exports) business remain broadly intact. Ageing populations, growing disease burdens and increasing imperative to cut healthcare costs continue to provide a favourable demand environment for the global generics industry. Indian generics companies continue to be among the best placed to cater to the growing global use of generics medicines.

With valuation excesses gradually waning and the worst of the USFDA regulatory challenges likely behind us and with the sector PE now closer to the relatively stable multiples observed over FY11-14, we believe that the Indian pharma sector is now beginning to present interesting buying opportunities from a 6-12-month perspective. We believe that improving revenue growth should drive 17% earnings CAGR over FY17-19E with growth picking up through the quarters. Given the expected pickup in earnings, valuations are beginning to look attractive at 15-19x FY19E earnings. Our top picks are Aurobindo, Glenmark, Sun and Torrent.

Exhibit 19: Our top picks



Source: Company, IDFC Securities Research

Exhibit 20: Comparative valuations

	Price	Mcap	Reco	TP	EPS (Rs)			EPS CAGR (%)	PE (x)		EV EBITDA (x)		RoE (%)	
	(Rs)	(Rs bn)		(Rs)	FY17	FY18E	FY19E	FY16-19E	FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
Aurobindo Pharma	625	366	OP	873	40.4	45.9	53.6	16.5	13.6	11.7	9.6	8.1	25.6	23.8
Biocon	1,127	225	UP	809	30.1	22.3	33.6	16.5	50.6	33.5	22.6	17.4	8.8	12.2
Cipla	557	448	OP	620	17.6	24.5	31.0	18.3	22.7	18.0	13.5	10.8	13.9	15.4
Dishman Pharma	321	52	OP	288	13.7	16.0	19.0	21.4	20.0	16.9	11.5	9.9	14.8	15.3
Dr Reddy's Lab	2,611	432	UP	3,098	78.4	124.5	163.1	11.4	21.0	16.0	12.0	8.7	15.9	18.2
Glaxosmithkline Pharma	2,561	217	UP	2,008	34.7	50.2	62.6	11.0	51.0	40.9	40.9	31.5	29.2	38.2
Glenmark Pharma	893	252	OP	1,013	54.7	56.3	54.5	28.8	15.9	16.4	11.1	11.3	30.6	23.3
IPCA Laboratories	608	77	OP	548	14.4	24.9	35.0	70.3	24.4	17.4	13.5	10.3	12.4	15.6
Lupin	1,371	618	OP	1,628	62.9	63.8	75.1	15.4	21.5	18.2	13.4	11.3	20.0	19.7
Marksan Pharma	52	21	OP	50	0.7	2.5	3.3	20.2	20.7	15.5	13.6	10.7	20.5	22.9
Natco Pharma	921	160	OP	803	25.7	28.1	30.0	72.5	32.8	30.7	22.0	20.4	25.4	21.9
Sanofi India	4,120	95	OP	5,209	129.2	156.4	178.2	13.9	26.4	23.1	14.4	12.3	19.9	21.1
Strides Arcolab	1,092	98	OP	1,284	35.2	52.1	65.3	33.3	21.0	16.7	14.8	12.3	14.0	15.6
Sun Pharma	643	1,547	OP	720	30.5	30.0	35.1	16.1	21.4	18.3	13.3	10.9	15.6	15.8
Torrent Pharma	1,430	242	OP	1,592	55.9	66.3	80.2	-7.6	21.6	17.8	14.7	12.0	25.2	25.5

Source: IDFC Securities Research, Company; Price as on 26st April

Exhibit 21: Change in estimates

	Old estimates			New estimates			(%) Change		
(Rs m)	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19
Dr Reddy's									
Revenue	143,652	167,008	196,082	143,034	161,771	188,300	(0.4)	(3.1)	(4.0)
EBITDA	26,786	40,039	53,680	26,391	36,621	48,565	(1.5)	(8.5)	(9.5)
EBITDA margins	18.6	24.0	27.4	18.5	22.6	25.8	(10bps)	(140bps)	(160bps)
PAT	13,758	23,308	30,995	13,169	20,608	27,005	(4.3)	(11.6)	(12.9)
EPS	81.9	140.8	187.2	78.4	124.5	163.1	(4.3)	(11.6)	(12.9)
Lupin									
Revenue	177,173	195,606	222,856	177,173	194,257	221,197	0.0	(0.7)	(0.7)
EBITDA	47,550	49,933	57,332	47,550	49,053	56,135	0.0	(1.8)	(2.1)
EBITDA margins	26.8	25.5	25.7	26.8	25.3	25.4	-	(20bps)	(30bps)
PAT	28,357	29,351	34,685	28,357	28,754	33,858	0.0	(2.0)	(2.4)
EPS	62.9	65.1	77.0	62.9	63.8	75.1	0.1	(2.0)	(2.4)

Source: IDFC Securities Research

Q4FY17 – Another muted quarter ahead

Exhibit 22: Quarterly estimates (Q4FY17)

	Net sales (Rs m)		EBITDA (Rs m)		Profit after tax (Rs m)		EBITDA margin (%)	
	Q4FY17E	% chg yoy	Q4FY17E	% chg yoy	Q4FY17E	% chg yoy	Q4FY17E	Q4FY16
Aurobindo	40,110	7.1	9,408	6.60	5,935	5.50	23.5	23.5
Biocon	10,417	7.4	2,428	18.90	1,523	(57.8)	23.3	21.1
Cipla	38,146	17.2	7,178	316.80	3,666	NM	18.8	5.3
Dishman Pharma	4,525	7.2	1,247	19.20	623	24.90	27.6	24.8
Dr Reddy's Lab	37,767	0.5	8,069	3.50	4,255	470.30	21.4	20.8
GlaxoSmithKline	7,615	10.7	1,019	(8.0)	897	(0.2)	13.4	16.1
Glenmark Pharma	28,257	22.5	9,069	129.20	6,167	331.10	32.1	17.2
IPCA Laboratories	7,362	17.9	900	41.60	400	6.10	12.2	10.2
Lupin	45,045	8.0	12,029	(7.8)	6,583	(12.0)	26.7	31.3
Marksans Pharma	2,219	2.4	301	180.10	161	NM	13.6	5
Natco Pharma	5,457	34.1	2,108	127.90	1,404	131.50	38.6	22.7
Sanofi India	5,873	7.9	1,351	4.60	838	4.00	23	23.7
Strides Arcolab	10,005	(0)	2,237	18.00	1,112	15.60	22.4	18.9
Sun Pharma	79,071	6.7	22,316	(3.0)	15,988	(6.7)	28.2	31
Torrent Pharma	14,423	(4)	3,352	(31.2)	2,030	(28.5)	23.2	32.5

Source: Company, IDFC Securities Research

Exhibit 23: Company-wise expectations for Q4FY17

Company	Comments / Key monitorables
Aurobindo	• Expect a steady quarter with 7% yoy EBITDA growth and 5% PAT growth • US sales to inch up marginally qoq to US$267m; Aurobindo has continued to receive a steady stream of new ANDA approvals over the past few quarters, which will enable it to keep up the momentum • Key monitorable will be the update and progress on working capital/debt parameters as also guidance of future launches
Cipla	• Expect significant yoy growth in EBITDA/PAT due to sharply lower base • Key monitorable would be management commentary on US business outlook
Dr Reddy's	• YoY revenue growth will be muted due to a high base, however, net profit would see a significant improvement as Dr Reddy's had taken a Rs4.3bn Venezuela write off in Q4FY16 • We expect marginally softer sequential performance on account of lower US sales (US$240m vs US$246m in Q3FY17) impacted by lower gIsotretonoin sales. EM growth, on the other hand, should be boosted by stronger currency in Russia
Glenmark	• Expect continued strong nos on the back of gZetia FTF launch during the previous quarter • Base should continue to improve steadily aided by the pickup in the US and strengthening in key EM currencies like Rouble • Key monitorable will be change in net debt levels and progress on key WC parameters
Ipca	• Operationally muted quarter with no material qoq improvement in most export segments • Key monitorable will be commentary on institutional malaria business and USFDA remediation status
Lupin	• Expect a reasonably healthy quarter with flat EBITDA qoq, while it is down 8% on account of a higher base; EBITDA growth is assumed to be much better than earlier assessments due to lower-than-expected competition in Glumetza/Fortamet • We have assumed US revs of US$326m (versus US$316m in Q3FY17), however, there could be negative surprises in case there are higher charge backs on Glumetza/Fortamet combined with slower gMinastrin ramp-up • Overall, a key monitorable will be management commentary on US sales outlook given increasing competition on key drugs
Sun Pharma	• A key variable will be Taro's performance as the decline in profitability over past two quarters has raised significant apprehensions on the outlook for Taro's pricing/profitability • Expect 3%/7% yoy decline in EBITDA/PAT • Key monitorable will be commentary on Halol as also on different aspects of specialty strategy
Torrent Pharma	• Expect another muted quarter as there has been no major product launches in the US during the quarter coupled with soft India sales • Key monitorable will be commentary on US sales outlook along with the India/Brazil momentum

Source: IDFC Securities Research

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