

Q3FY17 Review- Weakening structural dynamics; valuations factor in negatives for time being

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- **Our Emkay Pharma universe saw revenue growth of 11% YoY and 2% QoQ, EBITDA growth was 11% YoY and 3% QoQ whereas APAT remained flat on YoY basis and declined by 2% sequentially.**
- **The key underlying thread in Q3 was the higher than expected pricing pressure as well as increasing R&D spend rate by Indian pharma companies as they embarked upon product development & filings.**
- **Ipca (IPCA), Lupin (LPC) and Dr Reddy's (DRRD) reported stronger than expected Q3 results though there remain significant doubts over the sustainability of the performance.**
- **On the other hand Aurobindo (ARBP), Cadila (CDH) and Torrent (TRP) reported weaker than expected numbers.**
- **Clearly the following broad trends articulated by us over the past one year are quite evident from the results season just gone by -**
 - The ongoing consolidation amongst pharma wholesalers/PBMs (McKesson with Walmart latest one) and fragmenting of market shares of top generic companies is a trend that can have only one consequence, which is a higher competitive intensity.
 - Even if the recent pricing pressure abates, which looks likely given recent commentary by CVS Caremark, the fact that there is greater frequency of higher price declines i.e.10-12% now Vs an earlier 5-7% itself lends higher risk to industry earnings.
 - Thus while the structural industry dynamics seem to be weakening, we believe ongoing PE de-rating may see some respite over the next 2-3 quarters as most of the sector bad news seems factored in for the time being.
- **Our top sector picks are ARBP (BUY, TP Rs860), GRAN (BUY, TP Rs.152), CIPLA (ACCUMULATE, TP Rs.640), and SUNP (ACCUMULATE, TP Rs.750).**

Results Review- Summary

Company	Net sales (Rs mn)			Growth		EBITDA (Rs mn)			Growth		EBITDA margins (%)			Growth (bps)		APAT (Rs mn)			Growth	
	Q3FY17	Q2FY17	Q3FY16	YoY	QoQ	Q3FY17	Q2FY17	Q3FY16	YoY	QoQ	Q3FY17	Q2FY17	Q3FY16	YoY	QoQ	Q3FY17	Q2FY17	Q3FY16	YoY	QoQ
Aurobindo Pharma	39062	37755	35056	11%	3%	9248	9292	8177	13%	0%	24%	25%	23%	35	-94	5896	5857	5286	12%	1%
Cadila Healthcare	23638	24035	24089	-2%	-2%	4043	5160	5918	-32%	-22%	17%	21%	25%	-746	-436	2672	3186	4381	-39%	-16%
Cipla	36472	37510	31510	16%	-3%	6777	6807	4630	46%	0%	19%	18%	15%	389	43	2908	3543	2606	12%	-18%
Dr. Reddy's Lab	37065	35857	39679	-7%	3%	8526	6367	10393	-18%	34%	23%	18%	26%	-319	525	4701	3295	6450	-27%	43%
Glenmark Pharma	25350	22241	17783	43%	14%	10410	6838	5326	95%	52%	41%	31%	30%	1112	1032	7530	4587	3582	110%	64%
Granules India	3595	3638	3250	11%	-1%	763	741	654	17%	3%	21%	20%	20%	112	86	391	408	292	34%	-4%
Ipca Lab	7507	8851	6943	8%	-15%	1104	1280	894	24%	-14%	15%	14%	13%	183	24	453	471	272	67%	-4%
Lupin	44829	42905	35477	26%	4%	12158	10281	8461	44%	18%	27%	24%	24%	327	316	6307	6622	5246	20%	-5%
Sun Pharma	79127	77814	71223	11%	2%	24531	28079	22456	9%	-13%	31%	36%	32%	-53	-508	14718	18753	15449	-5%	-22%
Torrent Pharma	14430	14290	15420	-6%	1%	3160	3300	6180	-49%	-4%	22%	23%	40%	-1818	-119	2290	2070	4840	-53%	11%
Total	321274	314950	288987	11%	2%	84550	81847	76341	11%	3%	26%	26%	26%	-10	-33	50626	51820	50869	0%	-2%

Change in earnings estimate

Company	FY17E			FY18E		
	Before	After	% change	Before	After	% change
Aurobindo Pharma	42.7	41.5	-3%	49.8	47.2	-5%
Cadila Healthcare	14.6	12.8	-12%	17.6	16.2	-8%
Cipla	19.8	17.4	-12%	28.3	23.4	-17%
Dr. Reddy's Lab	95.6	95	-1%	141.5	132	-7%
Glenmark Pharma	42	57.6	37%	52.7	47	-11%
Granules India	6.8	6.9	1%	10.6	8.9	-16%
Ipca Lab	16.9	15.1	-11%	23.8	20.8	-13%
Lupin	61.3	63.8	4%	74.1	69.5	-6%
Sun Pharma	30.5	29.8	-2%	31.9	31.1	-3%
Torrent Pharma	54.1	54	0%	65.3	59.5	-9%

Valuation Summary

Company	Price (Rs)	Mkt cap (Rs bn)	Reco	Target Price	Sales			Growth			EBITDA			Growth			EPS			Growth		
					FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19
Aurobindo Pharma	686	401	Buy	860	156164	181097	195853	12%	16%	8%	37936	42911	48264	18%	13%	12%	42	47	54	19%	14%	13%
Cadila Healthcare	440	450	Hold	353	96979	117256	135772	-1%	21%	16%	19779	26791	31940	-14%	35%	19%	13	16	20	-17%	27%	21%
Cipla	593	477	Accumulate	640	149564	172147	199873	9%	15%	16%	27059	32242	40530	-3%	19%	26%	17	23	32	-19%	35%	37%
Dr. Reddy's Lab	2894	479	Hold	3300	142484	163467	188079	-8%	15%	15%	28808	39651	47302	-27%	38%	19%	95	132	166	-35%	39%	26%
Glenmark Pharma	950	268	Accumulate	1013	97591	103379	119799	28%	6%	16%	26501	23162	27303	64%	-13%	18%	58	47	56	81%	-18%	20%
Granules India	131	29	Buy	152	14231	18418	22334	0%	29%	21%	2912	3891	4946	5%	34%	27%	7	9	12	27%	28%	32%
Ipca Lab	554	70	Reduce	440	32265	36718	41115	12%	14%	12%	4616	5538	6347	35%	20%	15%	15	21	24	44%	37%	18%
Lupin	1471	664	Hold	1580	176842	200267	225650	24%	13%	13%	47425	53150	60985	26%	12%	15%	64	70	79	27%	9%	14%
Sun Pharma	673	1615	Accumulate	750	320890	340268	387521	14%	6%	14%	107500	106485	116283	27%	-1%	9%	30	31	34	33%	4%	10%
Torrent Pharma	1310	222	Reduce	1339	59116	68000	78042	-11%	15%	15%	13894	15831	19650	-49%	14%	24%	54	59	74	-53%	10%	25%

Company	EBITDA margin			PAT margin			ROE			ROCE			P/E			EV/EBITDA		
	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19	FY17	FY18	FY19
Aurobindo Pharma	24.3%	23.7%	24.6%	15.5%	15.3%	16.0%	29.7%	26.2%	23.5%	27.3%	27.0%	26.8%	16.5	14.5	12.8	11.4	9.9	8.4
Cadila Healthcare	20.4%	22.8%	23.5%	13.2%	14.1%	14.8%	22.4%	23.9%	24.3%	18.0%	20.0%	20.9%	34.4	27.2	22.4	24.2	18.0	15.1
Cipla	18.1%	18.7%	20.3%	9.6%	10.9%	12.9%	11.2%	13.6%	16.5%	10.6%	12.9%	16.2%	34.1	25.4	18.5	18.7	15.5	12.0
Dr. Reddy's Lab	20.2%	24.3%	25.1%	10.9%	13.4%	14.6%	12.5%	16.7%	18.5%	11.3%	17.1%	19.4%	30.5	22.0	17.5	17.7	12.7	10.4
Glenmark Pharma	27.2%	22.4%	22.8%	16.7%	12.8%	13.3%	32.4%	20.9%	20.7%	27.6%	20.8%	22.3%	16.5	20.2	16.9	11.1	12.8	10.7
Granules India	20.5%	21.1%	22.1%	9.2%	8.9%	9.8%	20.1%	20.3%	23.0%	17.5%	18.0%	20.3%	18.9	14.7	11.2	11.4	9.3	7.0
Ipca Lab	14.3%	15.1%	15.4%	5.9%	7.1%	7.5%	8.2%	10.7%	11.9%	9.8%	11.3%	12.4%	36.6	26.6	22.6	16.7	14.0	12.3
Lupin	26.8%	26.5%	27.0%	16.3%	15.7%	15.9%	23.6%	21.2%	20.1%	20.7%	20.3%	20.7%	23.0	21.2	18.6	15.6	13.3	11.2
Sun Pharma	33.5%	31.3%	30.0%	25.2%	24.0%	23.0%	20.5%	18.0%	16.8%	20.1%	17.6%	16.8%	22.6	21.6	19.7	14.1	13.7	11.9
Torrent Pharma	23.5%	23.3%	25.2%	15.5%	14.8%	16.1%	24.6%	22.9%	24.3%	20.7%	20.5%	23.4%	24.3	22.0	17.6	16.4	14.2	11.4

Name			Dec'16	Sept'16	Dec'15	% Chg YoY	% Chg QoQ	Actual v/s Expect	Comments
Aurobindo Pharma								↔	Revenues in line but minor miss across EBITDA and Net income. EBITDA margins came lower by c120bps as compared to our estimates. Net debt levels have fallen from USD640mn in March 2016 to USD410mn; however debt to trend higher given recent M&A/in-license deals. Concall commentary suggested severe pricing pressure in oral solids (down 7% QoQ and over 13% YoY). Injectables likely to be the bright spot in an otherwise increasingly competitive space; guidance stands at 40-50% CAGR over next 2-3 years which will help support overall US revenue growth of c12-14%. We value ARBP at 16x FY19E EPS of Rs.54 and have buy rating on the stock with target price of Rs.860/share.
CMP(Rs)	686	Net Sales (Rs mn)	39,062	37,755	35,056	11.4%	3.5%		
Mkt Cap (Rs bn)	401	EBITDA (Rs mn)	9,248	9,292	8,177	13.1%	-0.5%		
Reco	Buy	EBITDA Margin (%)	23.7	24.6	23.3	35 bps	-94 bps		
Target Price (Rs)	860	PAT (Rs mn)	5,896	5,857	5,286	11.5%	0.7%		
% Upside	25%	EPS (Rs)	10.1	10.0	9.0	11.5%	0.7%		
Cadila Healthcare								↓	Overall results disappointing with margins down to over a 3 year low and recovery in still atleast 2-3 quarters away. Sharp decline in US revenues does raise questions over pricing pressure in the base business. Operating costs seem to be depressed in view of poor topline performance. Expect costs to rise as revenues bottom out, raising questions on the full benefit from the expected operating leverage from CDH's large ANDA pipeline. We have hold rating on the stock and value CDH at 18x FY19E EPS of Rs19.6/ share and target price of Rs.353/share.
CMP(Rs)	440	Net Sales (Rs mn)	23,638	24,035	24,089	-1.9%	-1.7%		
Mkt Cap (Rs bn)	450	EBITDA (Rs mn)	4,043	5,160	5,918	-31.7%	-21.6%		
Reco	Hold	EBITDA Margin (%)	17.1	21.5	24.6	-746 bps	-436 bps		
Target Price (Rs)	353	PAT (Rs mn)	2,672	3,186	4,381	-39.0%	-16.1%		
% Upside	-20%	EPS (Rs)	2.6	3.1	4.3	-39.0%	-16.1%		
Cipla								↔	Overall results were in line with the highlight being stronger EBITDA margins at 18.6% (estimate 17.2%). Lower R&D run rate at Rs 2.3bn down 23% QoQ was a factor but potential tailwinds from stronger India revenues (high margin geography) held back by demonetization blues. Next few quarters a bit bumpy as few key launches expected in Q4 pushed out to mid FY18. Moreover management believes if GST on schedule for 1st July, likely to cause atleast couple of quarters of disruption in the India business. Investing momentum continues towards strong launch pipeline from FY19 onwards. We value CIPLA 20x FY19E EPS of Rs.32/share and have target price of Rs.640/share.
CMP(Rs)	593	Net Sales (Rs mn)	36,472	37,510	31,510	15.7%	-2.8%		
Mkt Cap (Rs bn)	477	EBITDA (Rs mn)	6,777	6,807	4,630	46.4%	-0.4%		
Reco	Accumulate	EBITDA Margin (%)	18.6	18.1	14.7	389 bps	43 bps		
Target Price (Rs)	640	PAT (Rs mn)	2,908	3,543	2,606	11.6%	-17.9%		
% Upside	8%	EPS (Rs)	3.6	4.4	3.2	11.6%	-17.9%		

Name			Dec'16	Sept'16	Dec'15	% Chg YoY	% Chg QoQ	Actual v/s Expect	Comments
Dr. Reddy's Lab								↔	Q3 revenues in line with estimates with margin surprise driven by currency benefit across CIS/EMs as well as PSAI business Q3 margin surprise was led by the generics business (83% of revenues), where GMs (Gross Margins) were up nearly 200bps QoQ. DRRD commentary suggests some of the margin expansion may just be passing with multiple headwinds through Q4FY17/Q1FY18. Concall commentary suggested stable and sustainable gross margins closer to c55% (59% in Q3FY2017). Strong earnings in Q3 anchors our FY17 earnings but FY17-19 EPS CAGR of 33% includes US revenues CAGR of 10% which still has many uncertainties. We value DRRD at 20x FY19E EPS of Rs.165 with target price of Rs.3, 300/share.
CMP(Rs)	2,894	Net Sales (Rs mn)	37,065	35,857	39,679	-6.6%	3.4%		
Mkt Cap (Rs bn)	479	EBITDA (Rs mn)	8,526	6,367	10,393	-18.0%	33.9%		
Reco	Hold	EBITDA Margin (%)	23.0	17.8	26.2	-319 bps	525 bps		
Target Price (Rs)	3,300	PAT (Rs mn)	4,701	3,295	6,450	-27.1%	42.7%		
% Upside	14%	EPS (Rs)	28.4	19.9	37.8	-25.0%	42.7%		
Glenmark Pharma								↑	Q3 saw a strong performance with overall revenue growth of 43% YoY with bulk of the growth expected to be gZetia led while we estimate overall ex-gZetia revenue growth to be c17% YoY. India revenues at Rs5.1bn posted a far subdued 6% YoY growth which we expect to normalize to c15-18% from Q1FY18 onwards. LATAM revenues were down 23% YoY at Rs947mn, primarily due to withdrawal from Venezuela. Given strong gZetia cash flows, the extent of consequential debt reduction over the next few quarters is to be closely monitored. We expect net debt to reduce to Rs26.8bn by March 2017 vs September 2016 debt level of Rs36.7bn. We value GNP at 18x FY19E EPS of Rs.56/share.
CMP(Rs)	950	Net Sales (Rs mn)	25,350	22,241	17,783	42.6%	14.0%		
Mkt Cap (Rs bn)	268	EBITDA (Rs mn)	10,410	6,838	5,326	95.5%	52.2%		
Reco	Accumulate	EBITDA Margin (%)	41.1	30.7	29.9	1,112 bps	1,032 bps		
Target Price (Rs)	1,013	PAT (Rs mn)	7,530	4,587	3,582	110.2%	64.2%		
% Upside	7%	EPS (Rs)	26.7	16.3	12.7	110.2%	64.2%		
Granules India								↔	Capacity bottlenecks likely to be resolved shortly with expansion of API capacity for Metformin, Guaifenesin and Paracetamol which should be completed by end FY17 with revenues reflected from Q2FY18. As a result we see a 28% revenue CAGR from the 3 molecules between FY17-FY19. In addition we additional revenues from a new oncology API block from FY19 onwards though the full impact of this plant would be reflected from FY20 onwards. GRAN has scheduled overall capex of nearly Rs9bn for FY17 and FY18 of which about Rs2.5bn has been spent till date with the rest to be spent over the next 5 quarters. We value GRAN at 13x FY19E EPS of Rs.11.7/share
CMP(Rs)	131	Net Sales (Rs mn)	3,595	3,638	3,250	10.6%	-1.2%		
Mkt Cap (Rs bn)	29	EBITDA (Rs mn)	763	741	654	16.8%	3.0%		
Reco	Buy	EBITDA Margin (%)	21.2	20.4	20.1	112 bps	86 bps		
Target Price (Rs)	152	PAT (Rs mn)	391	408	292	33.7%	-4.1%		
% Upside	16%	EPS (Rs)	1.9	2.0	1.4	33.7%	-4.1%		

Name			Dec'16	Sept'16	Dec'15	% Chg YoY	% Chg QoQ	Actual v/s Expect	Comments
IPCA Lab								↑	Revenue growth healthy at 8.3% in Q3 given multiple headwinds. Revenues underpinned by API revenue which grew 16% YoY to 1.6bn while domestic formulations was subdued at 9% to Rs 3.3bn. The impact of de-monetization measures as well as frequent NPPA price revisions coupled with FDC ban earlier clearly showing in overall domestic numbers. Formulations exports nearly flat at just 3% YoY growth to Rs2.3bn. IPCA intends to re-start its US filings in FY18 with around 8-10 ANDA's, R&D expected to creep up to c5% from under 4% currently. We value IPCA at 18x FY19E EPS of Rs.24.5/share and have reduce rating on the stock.
CMP(Rs)	554	Net Sales (Rs mn)	7,507	8,851	6,943	8.1%	-15.2%		
Mkt Cap (Rs bn)	70	EBITDA (Rs mn)	1,104	1,280	894	23.5%	-13.8%		
Reco	Reduce	EBITDA Margin (%)	14.7	14.5	12.9	183 bps	24 bps		
Target Price (Rs)	440	PAT (Rs mn)	453	471	272	66.7%	-3.9%		
% Upside	-21%	EPS (Rs)	3.6	3.7	2.2	66.7%	-3.9%		
Lupin								↑	Q3 outperformance was largely Glumetza driven which accounted for a bulk of the sequential increase in US revenues to cUSD26mn. Strong EBITDA margin expansion by 320bps QoQ was also helped by a decline in QoQ R&D runrate by 10% to Rs6.6bn. Concall commentary suggested that price damage in Fortamet franchise with Mylan's launch fully reflected in Q3 numbers which means, we should see an equally strong Q4. Risks to Metformin portfolio are on the anvil with AG scheduled soon to launch Glumetza and with Teva and Sun expected to launch Glumetza by mid FY18. We value LPC at 20x FY19E EPS of Rs.79/share with target price of Rs.1580/share.
CMP(Rs)	1,471	Net Sales (Rs mn)	44,829	42,905	35,477	26.4%	4.5%		
Mkt Cap (Rs bn)	664	EBITDA (Rs mn)	12,158	10,281	8,461	43.7%	18.3%		
Reco	Hold	EBITDA Margin (%)	27.1	24.0	23.8	327 bps	316 bps		
Target Price (Rs)	1,580	PAT (Rs mn)	6,307	6,622	5,246	20.2%	-4.8%		
% Upside	7%	EPS (Rs)	14.0	14.7	11.6	20.2%	-4.8%		
Sun Pharma								↓	Overall revenues in line with expectations but EBITDA/EBITDA margins were 10%/300bps lower. If not for lower QoQ operating costs, margins would have been crushed far more. India branded business also reported soft revenue growth of 5% YoY. US revenues were impacted by lower supplies, attributed to seasonality by the mgmt. Lower Gleevec revenues sequentially were offset by launch of Olmesartan authorized generics (AG) in Q3. Our analysis of the Q3 numbers after adjusting for high value/one-off launches (Gleevec, AG) indicates a potential base business erosion of atleast USD20-30mn QoQ (Exhibit 4) after factoring seasonality etc. We value SUNP at 22x FY19E EPS of Rs.34/share and target price of Rs.750/share.
CMP(Rs)	673	Net Sales (Rs mn)	79,127	77,814	71,223	11.1%	1.7%		
Mkt Cap (Rs bn)	1,615	EBITDA (Rs mn)	24,531	28,079	22,456	9.2%	-12.6%		
Reco	Accumulate	EBITDA Margin (%)	31.0	36.1	31.5	-53 bps	-508 bps		
Target Price (Rs)	750	PAT (Rs mn)	14,718	18,753	15,449	-4.7%	-21.5%		
% Upside	11%	EPS (Rs)	6.1	7.8	6.4	-4.7%	-21.5%		

Name		Dec'16	Sept'16	Dec'15	% Chg YoY	% Chg QoQ	Actual v/s Expect	Comments
Torrent Pharma							↔	Q3 earnings saw gross margins (GMs) fall about 400bps QoQ driven by higher pricing pressure in the US (21% of revenues) mainly in gAbilify and write-offs associated with closure of operations in Romania. While GMs to reverse about 200bps in coming quarters as impact of business closure fades, the US business looks likely to continue to remain under pressure with visibility poor on new launches required to boost US revenue growth. We estimate US revenue growth in FY19 at 32%, however this could come under pressure if certain high value launches like gRenagel are further delayed beyond FY19. We value TRP at 18x FY19E EPS of Rs.74/share.
CMP(Rs)	1,310	Net Sales (Rs mn)	14,430	14,290	15,420	-6.4%	1.0%	
Mkt Cap (Rs bn)	222	EBITDA (Rs mn)	3,160	3,300	6,180	-48.9%	-4.2%	
Reco	Reduce	EBITDA Margin (%)	21.9	23.1	40.1	-1,818 bps	-119 bps	
Target Price (Rs)	1,339	PAT (Rs mn)	2,290	2,070	4,840	-52.7%	10.6%	
% Upside	2%	EPS (Rs)	13.5	12.2	28.6	-52.7%	10.6%	

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