

ALKEM LABORATORIES

PHARMACEUTICALS

BUY

Target Price: Rs 2,100

Subdued Q4; recovery from Q2FY18

Revenue was in line but EBITDA at Rs 1.49bn was 27% below estimate due to higher other expense on launch of OTC division in India (launched Pregakem and Tiger balm). De-growth in anti-infective (~40% of domestic sales) led to modest 7% YoY domestic growth. It outpaced domestic market growth across its key segments; however, it expects Q1'18 to be challenging for domestic business ahead of GST rollout. US (up 19% YoY vs. our estimate of 15%) continue to scale up.

To factor in soft Q1'18 and increasing sector headwinds, we cut FY18 EPS by ~12% and TP to Rs 2,100 (21x FY19E EPS) vs. Rs 2,200 earlier. Maintain **BUY**, as Alkem remains in a sweet spot to deliver steady growth along with margin improvement on its strong positioning (brands, sales force) in domestic market and expected scale-up in US. Also, its strong C/F and B/S (net cash of Rs 7.2 bn) enable acquisitions.

CMP : Rs 1,866
Potential Upside : 13%

MARKET DATA

No. of Shares : 120 mn
Free Float : 33%
Market Cap : Rs 223 bn
52-week High / Low : Rs 2,238 / Rs 1,200
Avg. Daily vol. (6mth) : 50,622 shares
Bloomberg Code : ALKEM IB Equity
Promoters Holding : 67%
FII / DII : 4% / 3%

- ◆ **Expects soft Q1 ahead of GST rollout:** India business (69% of sales) grew modest 7% YoY on de-growth in anti-infective segment – the largest therapy segment for Alkem (~40% of domestic sales). Alkem (industry leader) in all its key segments (anti-infective, gastro, pain, vitamins) continued to outpace domestic market growth and even in emerging chronic segments like cardio, anti-diabetic, neuro (outperformed IPM growth by as much as ~1,260 bps; see exhibit 3 for details). However, it expects Q1FY18 to be challenging on channel destocking ahead of GST roll-out. Alkem (and pharma body) has appealed to the government to allow for price increases after GST, as effective indirect taxes under GST regime are higher by 2.5% at 12% vs. 9.5% currently.
- ◆ **Scale-up in US continues:** US sales (~23% of revenue) of USD 43 mn grew 19% YoY driven by market share gains in the existing products as well contribution from new product launches – 7 new launches during FY17. Management expects to maintain its ANDA filing momentum, and expects to file 12-15 ANDA's in FY18 (vs. 14 filings in FY17). Targets high single digit launches in FY18. We expect 16% CAGR over FY17-19 in US revenue led by 59 ANDA awaiting approval (incl 7 TA), with ~30% of filings under GDUFA with known target action dates.

Financial summary (Consolidated)

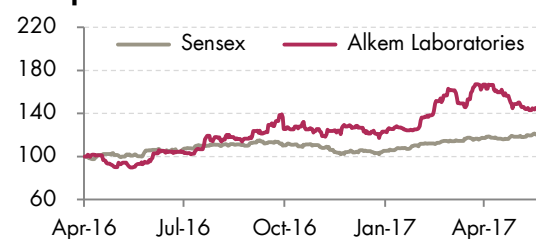
Y/E March	FY16	FY17	FY18E	FY19E
Sales (Rs mn)	49,886	57,812	64,192	74,355
Adj PAT (Rs mn)	8,250	8,920	8,753	11,954
Con. EPS* (Rs)	-	-	82.3	100.5
EPS (Rs)	69.0	74.6	73.2	100.0
Change YOY (%)	110.7	8.1	(1.9)	36.6
P/E (x)	27.0	25.0	25.5	18.7
RoE (%)	24.6	21.9	18.1	21.0
RoCE (%)	22.5	20.6	20.7	22.6
EV/E (x)	25.7	22.4	19.6	15.7
DPS (Rs)	12.7	15.0	13.5	14.5

Source: *Consensus broker estimates, Company, Axis Capita;

Key drivers

YoY growth	FY17	FY18E	FY19E
India formulations	16	10	15
US formulations	21	13	20
Gross margin (%)	62.0	62.0	62.3
EBITDA margin (%)	17.1	17.5	18.8

Price performance



(...continued from page 1)

Alkem filed 13 ANDA and received 5 approvals (incl 1 tentative) in Q4 (vs. 1 filing and 5 approvals in 9MFY17, 12 ANDA filings and 12 approvals in FY16)

- ◆ **Gross margin stable, but higher other expenses weighed EBITDA margin down:** Gross margin improved marginally by 67 bps YoY/-35 bps QoQ at 63.2%. However, higher other expenses (33% of Q4'17 sales vs. 32% in Q4'16) led to ~160 bps YoY decline in EBITDA margin. Other expenses were higher due to costs related to launch of its OTC division in India (launched Pregakem and Tiger balm) and higher marketing costs on channel destocking. R&D expense at Rs 915 mn was 7.3% of sales in Q4FY17 (vs. 7.6% in Q4'16, 5.5% in FY17). Positive effective tax (aided by deferred tax) in Q4'17 led to reported PAT at Rs 1.37 bn (58% YoY, 12% below our estimate)
- ◆ **Other conference call highlights:** (1) Management guided for **R&D expense** at 6% of sales in FY18 (vs. 5.5% in FY17), (2) **Tax rate:** Expects effective tax rate to be closer to MAT level (~20%) in FY18 on expiration of excise benefits at one of its sites and 12-15% effective tax in FY19 (production at new facility that has excise benefits which would come online in FY18), (3) **Capex:** Expects investment of Rs 6 bn in FY18 for increasing capacities for international and domestic markets. Capex for FY17 was Rs 6.0 bn, (4) **USFDA update:** All 6 facilities were inspected by USFDA over past 2 years and have received EIR, and (5) **Net cash** balance of ~Rs 7.2 bn as of end FY17

Exhibit 1: Strong growth in US business in Q4'17

(Rs mn)	% of Q4'17 Sales	Q4'16	Q3'17	Q4'17	YoY (%)	QoQ (%)
India formulations	69%	8,004	10,298	8,563	7	(17)
International	31%	3,364	4,324	3,853	15	(11)
US	23%	2,434	3,385	2,907	19	(14)
~US (USD mn)		36	50	43	19	(14)
Non-US	8%	930	939	946	2	1
Total		11,368	14,622	12,416	9	(15)

Source: Company

Exhibit 2: While gross margin was stable, EBITDA margin hit by higher other expense

(Rs mn)	Q4'16	Q3'17	Q4'17	YoY (%)	QoQ (%)
Revenues	11,486	14,819	12,514	9	(16)
Gross Profit	7,180	9,414	7,906	10	(16)
Gross Profit margin (%)	62.5	63.5	63.2	67 bps	-35 bps
Staff	1,915	2,710	2,285	19	(16)
Staff as % of Sales	17	18	18	159 bps	-3 bps
R&D	870	851	915	5	8
R&D as % of Sales	7.6	5.7	7.3	-26 bps	157 bps
Other expenses	3,706	4,023	4,129	11	3
Other exp as % of Sales	32.3	27.1	33.0	72 bps	584 bps
EBITDA	1,559	2,681	1,493	(4)	(44)
EBITDA margin (%)	13.6	18.1	11.9	-164 bps	-617 bps
Interest	101	117	115	14	(2)
Depreciation	242	264	264	9	-
Other Income	1,036	254	246	(76)	(3)
PBT	2,252	2,554	1,361	(40)	(47)
Tax	1,387	192	(9)	(101)	(105)
Tax rate	61.6	7.5	(0.7)	-6225 bps	-817 bps
Reported PAT	867	2,334	1,370	58	(41)

Source: Company

Exhibit 3: Alkem has been gaining market share in its key therapy areas

% Market Share	% of FY17 sales	FY14	FY15	FY16	FY17
Anti-Infectives	41%	9.6%	9.9%	9.6%	10.1%
Gastro Intestinal	18%	4.6%	4.9%	4.8%	5.5%
Vitamins	13%	4.9%	5.1%	5.1%	5.2%
Pain	8%	3.7%	3.7%	3.6%	4.0%

Source: AIOCD, Axis Capital

Conference call highlights

Guidance

- ◆ High single digit number of launches in the US in FY18 (7 in FY17)
- ◆ 12-15 ANDA filings in FY18 (14 in FY17)
- ◆ R&D expense at 6% of sales in FY18
- ◆ Expects margin to improve from Q2FY18
- ◆ **Tax rate:** Expects effective tax rate closer to MAT level (~20%) in FY18 on expiration of excise benefits at one of its sites and 12-15% tax rate in FY19 (production at new facility that has excise benefits which would come online in FY18)
- ◆ **Capex:** Expects investment of Rs 6 bn in FY18 for increasing capacities for international and domestic markets. Capex for FY17 was Rs 6.0 bn

India formulations (69% of Q4 revenue, Rs 8.6 bn, +7% YoY)

- ◆ Traditionally, Q4 is not a strong quarter for the domestic business due to channel destocking in the end of each fiscal
- ◆ Witnessed decline in anti-infective segment (in line with the overall market)– the largest therapy segment for the company. Anti-infective segment revenue declined partly due to demonetization

- ◆ GST Impact – effective indirect taxes under proposed regime higher by 2.5% at 12% vs. 9.5% currently. The Pharma association has appealed to government to allow for price increases after the rollout of GST
- ◆ Expects Q1FY18 to be challenging on channel destocking ahead of GST rollout
- ◆ OTC: Will take few years to build brands, and would incur spends towards mass media advertisement
- ◆ Trade generics account for over 10% of Alkem's India revenue
- ◆ Generic-generic: Indian Medical Association has clarified that doctors can write the brand name along with generic name

US business (23% of revenue; USD 50 mn; +30% YoY)

- ◆ Alkem has not seen much impact from pricing pressure and continues to grow market share across its key products. Launched 7 products in the US in FY17 – 5 in-house and 2 in-licensed. Guided for high single digit number of launches in FY18
- ◆ Targets 12 to 15 ANDA filings for FY18 (14 filings in FY17)
- ◆ **glidocaine**: Launched in Q1FY18 from its St Louis facility

USFDA update: All its 6 facilities were inspected by the USFDA over the past 2 years and have received EIR.

Other International markets: Focus markets of Australia, Chile and Kazakhstan continue to grow higher. Alkem is also rationalizing the number of markets it is present in, as well as its B2B portfolio

R&D update (7.3% of sales in Q4FY17; 7.6% in Q4'16, 5.5% in FY17) – Alkem filed 13 ANDA and received 5 approvals (including 1 tentative approval) in Q4 (vs. 1 filings and 5 approvals in 9MFY17; filed 12 and got 12 approvals in FY16); Alkem filed 14 ANDA in FY17 (in line with 12-15 filings guidance). Alkem has 91 ANDA filings with 39 approvals (incl. 7 TAs) and 52 pending approvals

P&L and balance sheet highlights

- ◆ **Tax rate:** Expects effective tax rate closer to MAT level (~20%) in FY18 on expiration of excise benefits at one of its sites and 12-15% tax rate in FY19 (production at new facility that has excise benefits which would come online in FY18).
- ◆ Net cash balance of ~Rs 7.2 bn as of end FY17
- ◆ Expects margin to improve from Q2FY18

Exhibit 4: Growth across brands has been steady in FY17

	FY14	FY15	FY16	FY17
Top 10 Brands	2	23	6	16
11 to 25 Brands	10	17	14	16
26 to 50 Brands	16	16	14	13

Source: AIOCD

Exhibit 5: Cardiac/ anti-Diabetic segments continued to grow in Q4; anti-infective impacted by demonetization in Q4

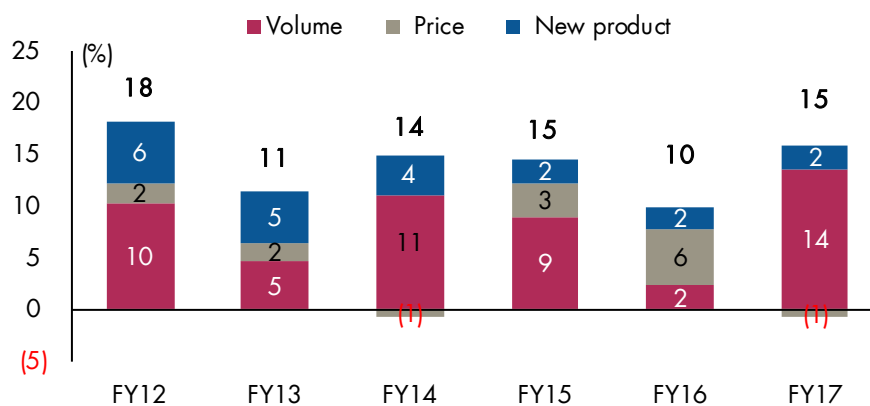
YoY growth	% Sales	FY15	FY16	FY17	Q1'17	Q2'17	Q3'17	Q4'17
Anti-Infectives	41%	14%	6%	10%	1%	17%	0.3%	0.4%
Gastro Intestinal	18%	24%	13%	26%	14%	19%	25%	19%
Vitamins	13%	18%	12%	14%	4%	4%	17%	9%
Pain	8%	12%	7%	24%	7%	29%	24%	12%
Neuro	5%	-4%	22%	18%	29%	4%	9%	11%
Derma	3%	21%	20%	3%	8%	1%	18%	-6%
Respiratory	3%	12%	8%	8%	-6%	28%	1%	-6%
Cardiac	3%	24%	23%	21%	8%	9%	23%	22%
Anti-Diabetic	3%	45%	26%	44%	26%	26%	39%	41%
Gynaecological	3%	-12%	22%	11%	12%	2%	5%	12%
Total (Rs bn)	39	15%	10%	15%	6%	15%	10%	8%

Source: AIOCD, AIOCD –All India Organization of Chemists & Distributors

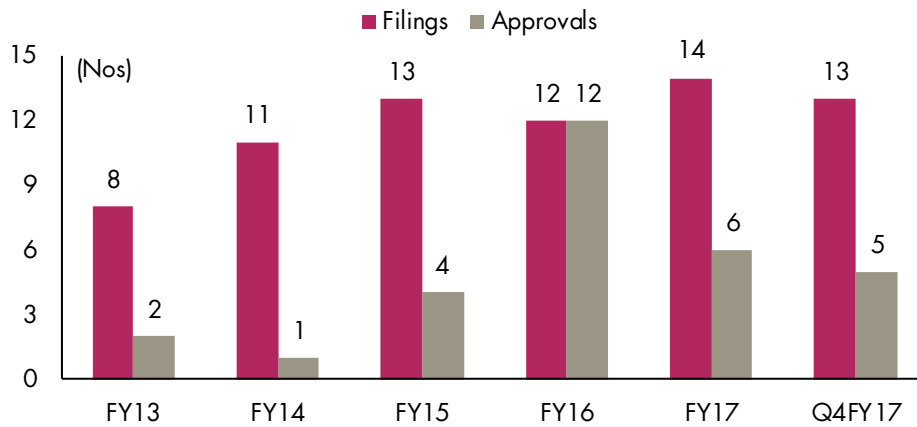
Exhibit 6: Top 10 brands continued to grow in FY17

YoY / Products	% Sales	FY13	FY14	FY15	FY16	FY17
Clavam	7%	10%	19%	10%	6%	16%
Pan	6%	5%	8%	24%	14%	26%
Pan D	5%	11%	17%	33%	13%	30%
Taxim O	6%	4%	-6%	11%	9%	4%
Taxim	5%	-3%	-1%	19%	-14%	-6%
Xone	3%	21%	0%	7%	5%	15%
Gemcal	3%	8%	3%	32%	4%	20%
A To Z INs	2%	1%	11%	6%	17%	25%
Sumo	2%	15%	6%	12%	-3%	26%
Ondem	2%	15%	3%	20%	11%	14%
Top 10 Brand	40%	N.A	7%	17%	5%	16%
Total (Rs bn)	33.8	11%	14%	15%	10%	15%

Source: AIOCD, AIOCD –All India Organization of Chemists & Distributors

Exhibit 7: Strong 14% YoY volume growth in FY17


Source: AIOCD

Exhibit 8: Alkem filed 13 ANDA in Q4, guided for 10 to 12 filings in FY18


Source: Company

Exhibit 9: Increased market share in Linezolid (gZyvox) tablets; maintained share in Mycophenolate OS

Product name	Brand/mkt size (USD mn)	No. of generics	Market share (%)							
			Sep-15	Dec-15	Mar-16	May-16	Jun-16	Sep-16	Dec-16	Mar-17
Mycophenolate oral susp.	50	None	58	62	66	66	67	69	72	75
Silver sulfadiazine	50	3	38	40	40	40	40	41	42	41
Methadone	61	5	33	31	32	27	25	21	19	19
Benzonatate	40	9	72	66	49	44	45	43	43	42
Linezolid	448	10			3	3	4	12	11	20
Ibuprofen	50	More than 10	12	12	11	10	9	9	9	11
Gabapentin	200	More than 10	10	10	9	13	14	16	10	10

Source: Company, Bloomberg, Axis Capital

Profit & loss (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Net sales	49,886	57,812	64,192	74,355
Other operating income	593	713	1,000	1,200
Total operating income	50,479	58,525	65,192	75,555
Cost of goods sold	(19,639)	(22,215)	(24,773)	(28,522)
Gross profit	30,841	36,310	40,419	47,033
<i>Gross margin (%)</i>	<i>61.8</i>	<i>62.8</i>	<i>63.0</i>	<i>63.3</i>
Total operating expenses	(22,308)	(26,320)	(29,010)	(32,867)
EBITDA	8,533	9,990	11,409	14,167
<i>EBITDA margin (%)</i>	<i>17.1</i>	<i>17.3</i>	<i>17.8</i>	<i>19.1</i>
Depreciation	(933)	(1,012)	(1,128)	(1,326)
EBIT	7,599	8,978	10,280	12,841
Net interest	(712)	(452)	(458)	(360)
Other income	2,397	1,120	1,400	1,547
Profit before tax	9,284	9,646	11,223	14,028
Total taxation	(928)	(600)	(2,245)	(1,824)
<i>Tax rate (%)</i>	<i>10.0</i>	<i>6.2</i>	<i>20.0</i>	<i>13.0</i>
Profit after tax	8,356	9,047	8,978	12,204
Minorities	(106)	(126)	(225)	(250)
Profit/ Loss associate co(s)	-	-	-	-
Adjusted net profit	8,250	8,920	8,753	11,954
<i>Adj. PAT margin (%)</i>	<i>16.5</i>	<i>15.4</i>	<i>13.6</i>	<i>16.1</i>
Net non-recurring items	(834)	-	-	-
Reported net profit	7,416	8,920	8,753	11,954

Balance sheet (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Paid-up capital	239	239	239	239
Reserves & surplus	36,681	44,437	51,577	61,798
Net worth	36,920	44,676	51,816	62,037
Borrowing	5,876	6,539	5,039	3,539
Other non-current liabilities	866	1,139	1,304	1,493
Total liabilities	44,612	53,507	59,311	68,221
Gross fixed assets	16,220	20,963	26,963	32,963
Less: Depreciation	-	-	-	-
Net fixed assets	16,220	20,963	26,963	32,963
Add: Capital WIP	-	-	-	-
Total fixed assets	16,220	20,963	26,963	32,963
Total Investment	5,086	5,530	5,805	6,108
Inventory	9,094	12,060	12,711	14,460
Debtors	5,675	7,136	7,965	9,062
Cash & bank	7,809	3,993	2,581	3,307
Loans & advances	99	154	174	198
Current liabilities	10,734	12,173	13,722	15,822
Net current assets	14,211	14,054	12,983	14,931
Other non-current assets	9,096	12,960	13,560	14,219
Total assets	44,612	53,507	59,311	68,221

Source: Company, Axis Capital

Cash flow (Rs mn)

Y/E March	FY16	FY17	FY18E	FY19E
Profit before tax	9,284	9,646	11,223	14,028
Depreciation & Amortisation	933	1,012	1,128	1,326
<i>Chg in working capital</i>	<i>137</i>	<i>(3,490)</i>	<i>(1,169)</i>	<i>(2,201)</i>
Cash flow from operations	7,019	4,570	7,995	9,160
<i>Capital expenditure</i>	<i>(2,572)</i>	<i>(6,000)</i>	<i>(6,000)</i>	<i>(6,000)</i>
Cash flow from investing	(983)	(4,880)	(4,600)	(4,453)
<i>Equity raised/ (repaid)</i>	<i>-</i>	<i>-</i>	<i>-</i>	<i>-</i>
<i>Debt raised/ (repaid)</i>	<i>(6,710)</i>	<i>663</i>	<i>(1,500)</i>	<i>(1,500)</i>
<i>Dividend paid</i>	<i>(1,845)</i>	<i>(2,161)</i>	<i>(1,945)</i>	<i>(2,089)</i>
Cash flow from financing	(9,268)	(1,949)	(3,902)	(3,949)
Net chg in cash	(3,232)	(2,259)	(506)	758

Key ratios

Y/E March	FY16	FY17	FY18E	FY19E
OPERATIONAL				
FDEPS (Rs)	69.0	74.6	73.2	100.0
CEPS (Rs)	69.8	83.1	82.6	111.1
DPS (Rs)	12.7	15.0	13.5	14.5
Dividend payout ratio (%)	20.5	20.1	18.4	14.5
GROWTH				
Net sales (%)	36.2	15.9	11.0	15.8
EBITDA (%)	102.3	17.1	14.2	24.2
Adj net profit (%)	110.7	8.1	(1.9)	36.6
FDEPS (%)	110.7	8.1	(1.9)	36.6
PERFORMANCE				
RoE (%)	24.6	21.9	18.1	21.0
RoCE (%)	22.5	20.6	20.7	22.6
EFFICIENCY				
Asset turnover (x)	1.5	1.5	1.3	1.3
Sales/ total assets (x)	0.9	1.0	0.9	0.9
Working capital/ sales (x)	0.1	0.1	0.2	0.1
Receivable days	41.5	45.1	45.3	44.5
Inventory days	79.1	90.7	86.3	86.0
Payable days	50.5	55.8	55.2	55.0
FINANCIAL STABILITY				
Total debt/ equity (x)	0.2	0.2	0.1	0.1
Net debt/ equity (x)	(0.1)	-	-	-
Current ratio (x)	2.3	2.2	1.9	1.9
Interest cover (x)	10.7	19.9	22.5	35.7
VALUATION				
PE (x)	27.0	25.0	25.5	18.7
EV/ EBITDA (x)	25.7	22.4	19.6	15.7
EV/ Net sales (x)	4.4	3.9	3.5	3.0
PB (x)	6.0	5.0	4.3	3.6
Dividend yield (%)	0.7	0.8	0.7	0.8
Free cash flow yield (%)	-	-	-	-

Source: Company, Axis Capital

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BUY	More than 10%
HOLD	Between 10% and -10%
SELL	Less than -10%

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