

**BUY**

TP: Rs 2,100 | ▲ 19%

**ALKEM LABS**

Pharmaceuticals

13 August 2019

## Good Q1, guiding for better margins ahead; retain BUY

Alkem Labs reported a good Q1FY20 with an 11% EBITDA beat owing to gross margin expansion and better cost control. India grew 12% YoY and US sales held steady QoQ at US\$ 69mn. Alkem's secondary growth trend is tracking strong at 18.7% (vs. 10.4% for IPM), indicative of a better Q2. Management expects volume growth recovery for the industry from Jul/Aug'19, doesn't see any disruption in its trade generic business (15% of sales), and retains 120bps margin expansion guidance for FY20 led by better operating leverage.

Vivek Kumar

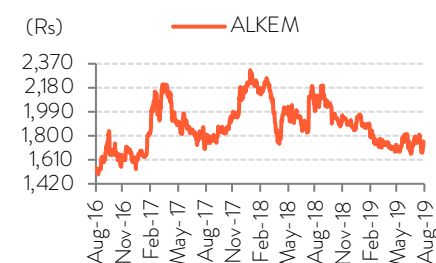
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**In-line India growth, gross margin expands:** Q1 domestic formulation growth was in line at 12% YoY (volumes up 4%, price 5%, new product 2.7%), with normalised GRx business (15% of sales). We believe better competitiveness in the high-margin acute portfolio, growth in the chronic mix and higher MR productivity along with softening API prices aided the 140bps gross margin expansion. Alkem sees scope for further gross margin gains in coming quarters from API price tailwinds. The company's secondary growth trend is better than IPM (for anti-infective 22%, gastro 17.5%). The chronic portfolio continues to see traction with 27% growth in CVS, 36% in anti-diabetic and 14% in CNS.

Ticker/Price	ALKEM IN/Rs 1,763
Market cap	US\$ 3.0bn
Shares o/s	120mn
3M ADV	US\$ 0.7mn
52wk high/low	Rs 1,844/Rs 1,660
Promoter/FPI/DII	66%/2%/5%

Source: NSE

### STOCK PERFORMANCE



Source: NSE

**Steady US sales, control cost and 11% EBITDA beat:** US sales at US\$ 69mn were steady QoQ (+9% YoY). We expect the current quarterly run-rate to improve with scale-up in existing products (gVesicare, Ampyra) and the Sensipar launch. We expect US\$ 311mn in FY20 US sales. Part of the EBITDA beat is due to operating leverage/cost control which should continue.

**Other key highlights:** (1) Alkem expects volume growth recovery to 4.5% for industry from Aug'19 from flattish trend till June. (2) Current MR strength at 10,000 (vs. 9,000 in Mar'19) – no further addition expected in FY20. (3) Tax rate of 13-14% for FY20. (4) Baddi unit EIR (4 observations issued in May'19).

### KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Adj. net profit (Rs mn)	6,309	7,298	8,962	11,133	13,306
Adj. EPS (Rs)	52.8	61.0	75.0	93.1	111.3
Adj. EPS growth (%)	(29.3)	15.7	22.8	24.2	19.5
Adj. ROAE (%)	15.8	16.3	17.7	19.0	19.6
Adj. P/E (x)	33.4	28.9	23.5	18.9	15.8
EV/EBITDA (x)	20.5	19.1	16.2	13.0	10.9

Source: Company, BOBCAPS Research

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**FIG 1 – QUARTERLY PERFORMANCE**

(Rs mn)	Q1FY20	Q1FY19	YoY (%)	Q4FY19	QoQ (%)	Q1FY20E	Var. (%)
<b>Net Sales</b>	<b>18,495</b>	<b>16,695</b>	<b>10.8</b>	<b>18,542</b>	<b>(0.3)</b>	<b>18,619</b>	<b>(0.7)</b>
<b>EBITDA</b>	<b>2,646</b>	<b>2,142</b>	<b>23.5</b>	<b>2,351</b>	<b>12.5</b>	<b>2,379</b>	<b>11.2</b>
Depreciation	558	425	-	573	-	580	-
<b>EBIT</b>	<b>2,088</b>	<b>1,718</b>	<b>21.5</b>	<b>1,778</b>	<b>17.4</b>	<b>1,799</b>	<b>-</b>
Interest	161	163	-	66	-	120	-
Other Income	175	163	-	277	-	150	-
<b>PBT</b>	<b>2,102</b>	<b>1,718</b>	<b>22.4</b>	<b>1,989</b>	<b>5.7</b>	<b>1,829</b>	<b>14.9</b>
Less: Taxation	227	345	-	283	-	366	-
Less: Minority Interest	18	11	-	31	-	0	-
<b>Recurring PAT</b>	<b>1,857</b>	<b>1,362</b>	<b>36.4</b>	<b>1,675</b>	<b>10.9</b>	<b>1,463</b>	<b>26.9</b>
Exceptional items	0	0	-	0	-	0	-
<b>Reported PAT</b>	<b>1,857</b>	<b>1,362</b>	<b>36.4</b>	<b>1,675</b>	<b>10.9</b>	<b>1,463</b>	<b>26.9</b>
<b>Key Ratios (%)</b>							
Gross Margin	61.5	60.1	-	58.2	-	59.0	-
EBITDA Margin	14.3	12.8	-	12.7	-	12.8	-
Tax / PBT	10.8	20.1	-	14.2	-	20.0	-
NPM	10.0	8.2	-	9.0	-	7.9	-
EPS (Rs)	15.5	11.4	-	14.0	-	12.2	-

Source: Company, BOBCAPS Research

**FIG 2 – SEGMENT SALES**

(Rs mn)	Q1FY20	Q1FY19	YoY (%)	Q4FY19	QoQ (%)	Q1FY20E	Var. (%)
<b>Formulations</b>							
India	12,222	10,906	12.1	12,176	0.4	12,176	0.4
US	4,817	4,237	13.7	4,822	(0.1)	5,040	(4.4)
RoW	1,095	1,242	(11.8)	1,275	(14.1)	1,403	(22.0)
<b>Net Sales</b>	<b>18,134</b>	<b>16,385</b>	<b>10.7</b>	<b>18,273</b>	<b>(0.8)</b>	<b>18,619</b>	<b>(2.6)</b>

Source: Company, BOBCAPS Research

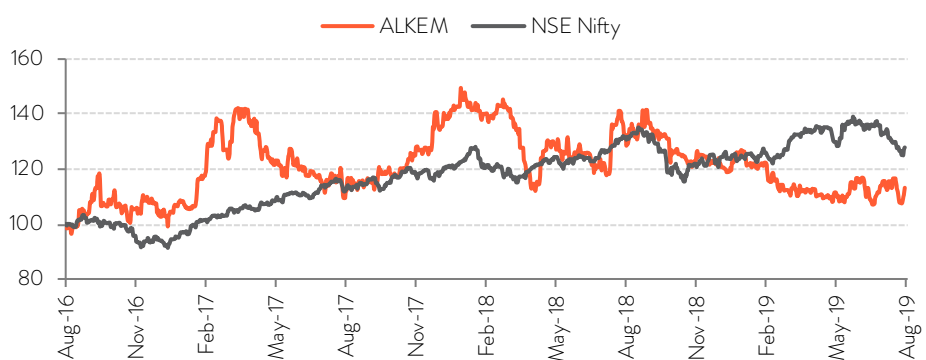
### Valuation methodology

We continue to expect 24% EPS growth over the next two years and retain our FY20/FY21 EPS estimates of Rs 75/Rs 93. Alkem is currently trading at 19x FY21E P/E and 13x EV/EBITDA, which is ~30% below the three-year mean.

We like Alkem based on (1) recovery in India formulation business margins led by the high-margin acute portfolio and emerging chronic sales, (2) strong operating leverage in the US from new launches (expect 4x margin jump from current low single digits), together with an improving pipeline, (3) easing of US facility concentration risk, (4) reversal of the negative earnings growth trend over the next two years, and (5) capex moderation driving >29% ROIC in two years.

We thus retain our Sep'20 SOTP-based target price of Rs 2,100 (14x EV/EBITDA, implied P/E of 21x). Maintain BUY.

**FIG 3 – RELATIVE STOCK PERFORMANCE**



Source: NSE

### Key risks

- Regulatory action and slowdown in India formulation business:** Expansion of NLEM coverage and the FDC ban in 2018 affected industry growth. The NLEM order has hit most large brands in the acute segment, taking the share of Alkem’s price-controlled portfolio to 30% of its domestic formulation business vs. 17% for IPM.

While Alkem’s current portfolio under NLEM is meaningfully higher than the market, any further regulatory action in the acute segment is unlikely to have much bearing on financials. Also, Alkem has a minor presence in the chronic segment with smaller brands and negligible price leadership. Disruption in the trade generics business due to regulatory action could also be a key risk to the stock since this accounts for 15% of overall domestic sales. Also, any slowdown in IPM growth and delay in new launches can adversely affect earnings.

- **Poor US execution:** We expect the US market to contribute meaningfully to profitability in the coming years – up from 3% of FY19 EBITDA to 8% in FY21 (or 30% of incremental EBITDA). Any delay in key launches, surprise new competition in niche products, regulatory action on manufacturing facilities (Daman, Baddi, St. Louis), and above-expected price erosion in the top 5 products could be potential threats to earnings.

## FINANCIALS

### Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
<b>Total revenue</b>	<b>64,218</b>	<b>73,558</b>	<b>82,096</b>	<b>91,948</b>	<b>102,662</b>
EBITDA	10,284	11,135	13,055	15,688	18,395
EBIT	8,854	9,203	11,021	13,387	15,810
Net interest income/(expenses)	(553)	(546)	(542)	(542)	(542)
Other income/(expenses)	960	582	920	1,307	1,647
Exceptional items	0	0	0	0	0
EBT	9,260	9,239	11,399	14,152	16,916
Income taxes	2,876	1,810	2,280	2,830	3,383
Extraordinary items	0	307	0	0	0
Min. int./Inc. from associates	75	131	157	189	226
<b>Reported net profit</b>	<b>6,309</b>	<b>7,605</b>	<b>8,962</b>	<b>11,133</b>	<b>13,306</b>
Adjustments	0	307	0	0	0
<b>Adjusted net profit</b>	<b>6,309</b>	<b>7,298</b>	<b>8,962</b>	<b>11,133</b>	<b>13,306</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	9,607	9,622	11,106	12,439	13,889
Other current liabilities	4,487	4,435	6,486	7,264	8,111
Provisions	2,742	3,275	3,655	4,094	4,571
Debt funds	9,950	9,025	9,025	9,025	9,025
Other liabilities	0	0	0	0	0
Equity capital	239	239	239	239	239
Reserves & surplus	43,075	48,407	55,279	63,816	74,019
Shareholders' fund	43,314	48,646	55,518	64,055	74,259
<b>Total liabilities and equities</b>	<b>70,100</b>	<b>75,003</b>	<b>85,791</b>	<b>96,878</b>	<b>109,854</b>
Cash and cash eq.	5,768	6,615	13,189	17,678	22,911
Accounts receivables	10,805	12,484	14,438	16,171	18,055
Inventories	14,422	14,998	16,659	18,659	20,833
Other current assets	8,016	7,669	9,729	10,897	12,166
Investments	4,443	3,236	3,236	3,236	3,236
Net fixed assets	22,836	25,072	27,538	29,237	31,652
CWIP	3,810	4,930	1,000	1,000	1,000
Intangible assets	0	0	0	0	0
Deferred tax assets, net	0	0	0	0	0
Other assets	0	0	0	0	0
<b>Total assets</b>	<b>70,099</b>	<b>75,004</b>	<b>85,791</b>	<b>96,878</b>	<b>109,854</b>

Source: Company, BOBCAPS Research

### Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	7,740	9,537	10,996	13,434	15,891
Interest expenses	553	546	542	542	542
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,500)	(1,411)	(1,761)	(2,350)	(2,555)
Other operating cash flows	0	0	0	0	0
<b>Cash flow from operations</b>	<b>6,793</b>	<b>8,671</b>	<b>9,777</b>	<b>11,626</b>	<b>13,878</b>
Capital expenditures	(6,266)	(3,991)	(4,500)	(4,000)	(5,000)
Change in investments	1,087	1,207	0	0	0
Other investing cash flows	0	0	0	0	0
<b>Cash flow from investing</b>	<b>(5,179)</b>	<b>(2,784)</b>	<b>(4,500)</b>	<b>(4,000)</b>	<b>(5,000)</b>
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	3,411	(925)	0	0	0
Interest expenses	(553)	(546)	(542)	(542)	(542)
Dividends paid	(2,180)	(1,702)	(2,090)	(2,596)	(3,103)
Other financing cash flows	(516)	(1,868)	3,930	0	0
<b>Cash flow from financing</b>	<b>162</b>	<b>(5,040)</b>	<b>1,298</b>	<b>(3,138)</b>	<b>(3,645)</b>
<b>Changes in cash and cash eq.</b>	<b>1,776</b>	<b>847</b>	<b>6,575</b>	<b>4,488</b>	<b>5,233</b>
<b>Closing cash and cash eq.</b>	<b>5,768</b>	<b>6,614</b>	<b>13,190</b>	<b>17,678</b>	<b>22,911</b>

### Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	52.8	63.6	75.0	93.1	111.3
Adjusted EPS	52.8	61.0	75.0	93.1	111.3
Dividend per share	13.0	12.2	15.0	18.6	22.3
Book value per share	352.1	395.8	453.3	524.7	610.1

### Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	3.3	2.9	2.6	2.2	1.9
EV/EBITDA	20.5	19.1	16.2	13.0	10.9
Adjusted P/E	33.4	28.9	23.5	18.9	15.8
P/BV	5.0	4.5	3.9	3.4	2.9

### DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	68.1	79.0	78.6	78.7	78.7
Interest burden (PBT/EBIT)	104.6	100.4	103.4	105.7	107.0
EBIT margin (EBIT/Revenue)	13.8	12.5	13.4	14.6	15.4
Asset turnover (Revenue/Avg TA)	32.5	33.2	33.6	33.4	32.8
Leverage (Avg TA/Avg Equity)	1.2	1.2	1.2	1.2	1.2
Adjusted ROAE	15.8	16.3	17.7	19.0	19.6

Source: Company, BOBCAPS Research | Note: TA = Total Assets

**Ratio Analysis**

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
<b>YoY growth (%)</b>					
Revenue	12.9	14.5	11.6	12.0	11.7
EBITDA	2.9	8.3	17.2	20.2	17.3
Adjusted EPS	(29.3)	15.7	22.8	24.2	19.5
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	16.0	15.1	15.9	17.1	17.9
EBIT margin	13.8	12.5	13.4	14.6	15.4
Adjusted profit margin	9.8	9.9	10.9	12.1	13.0
Adjusted ROAE	15.8	16.3	17.7	19.0	19.6
ROCE	19.9	17.6	19.5	21.4	22.3
<b>Working capital days (days)</b>					
Receivables	62	63	65	65	65
Inventory	83	75	75	75	75
Payables	55	48	50	50	50
<b>Ratios (x)</b>					
Gross asset turnover	2.5	2.4	2.4	2.4	2.4
Current ratio	2.3	2.4	2.5	2.7	2.8
Net interest coverage ratio	16.0	16.9	20.4	24.7	29.2
Adjusted debt/equity	0.0	0.0	(0.1)	(0.2)	(0.2)

Source: Company, BOBCAPS Research

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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)

### HISTORICAL RATINGS AND TARGET PRICE: ALKEM LABS (ALKEM IN)



B – Buy, A – Add, R – Reduce, S – Sell

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