

**BUY**

TP: Rs 3,600 | ▲ 31%

**ALKEM LABS**

Pharmaceuticals

06 November 2020

## H1 gross margin beat sustainable; FCF to support re-rating

Alkem Labs posted a Q2 EBITDA beat of 12% led by lower SGA spends (-29% YoY) while sales were in line. Gross margin was healthy at 60.5% and EBITDA margin was at 25.4%. Part of cost savings are structural and hence H2 margins could expand further YoY. India trade generics grew a strong >20% YoY. US sales declined 4% QoQ. Alkem is cautiously optimistic of achieving early double-digit growth for India sales in H2 and is confident of >150bps EBITDA margin expansion in three years. Retain BUY; Sep'21 TP unchanged at Rs 3,600.

Vivek Kumar

research@bobcaps.in

**Trade generics continue to grow >20% YoY; India/US set to rebound:** Growth in the trade generics business remains strong and prescription sales have rebounded sequentially, leading to slight moderation in generics share to 27% (from 28% in Q1). This is expected to normalise to 20% levels by Q4. India sales were flat YoY but Alkem expects 8-10% growth in H2. US sales fell QoQ to US\$ 85mn on fewer launches and incremental competition in Q1 rollouts. Sales should pick up in H2 – management retains its 20% US growth guidance for FY21. Over FY20-FY23, we expect a US/India sales CAGR of 17%/8%.

Ticker/Price	ALKEM IN/Rs 2,753
Market cap	US\$ 4.4bn
Shares o/s	120mn
3M ADV	US\$ 8.0mn
52wk high/low	Rs 3,090/Rs 1,881
Promoter/FPI/DII	62%/4%/11%

Source: NSE

**Gross margin sustainable; promotion spends to remain below pre-Covid levels:** Q2 gross margin at 60.5% (62% in H1 adj. for one-time research income) was in line but down QoQ due to recovery in acute portfolio growth. Chronic business remains slow. Alkem stated that it can sustain ~62% gross margins in coming quarters. SGA spends are tracking below pre-Covid levels due to structural savings, implying healthy EBITDA margins in H2 (guided for 23% in FY21).

## STOCK PERFORMANCE



Source: NSE

**Earnings call highlights:** (1) Market share gains by companies in larger brands during Covid unlikely to reverse soon, drastic drop in vitamins portfolio (H1: 20% growth) not expected. (2) RM prices stable in Q2; should stay benign for next few months. (3) Capex for next three years at ~Rs 3.5bn annually.

## KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	73,558	82,983	91,288	101,943	113,526
EBITDA (Rs mn)	11,135	14,730	20,767	21,621	24,768
Adj. net profit (Rs mn)	7,298	11,270	15,960	16,662	19,276
Adj. EPS (Rs)	61.0	94.3	133.5	139.4	161.2
Adj. EPS growth (%)	15.7	54.4	41.6	4.4	15.7
Adj. ROAE (%)	16.3	22.7	27.4	23.6	22.8
Adj. P/E (x)	45.1	29.2	20.6	19.8	17.1
EV/EBITDA (x)	29.6	22.4	15.9	15.1	12.7

Source: Company, BOBCAPS Research

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**FIG 1 – QUARTERLY PERFORMANCE**

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)	Q2FY21E	Var. (%)	H1FY21	H1FY20	YoY (%)
<b>Net Sales</b>	<b>23,628</b>	<b>22,640</b>	<b>4.4</b>	<b>20,034</b>	<b>17.9</b>	<b>23,887</b>	<b>(1.1)</b>	<b>43,662</b>	<b>41,135</b>	<b>6.1</b>
<b>EBITDA</b>	<b>6,005</b>	<b>4,526</b>	<b>32.7</b>	<b>5,331</b>	<b>12.6</b>	<b>5,344</b>	<b>12.4</b>	<b>11,336</b>	<b>7,172</b>	<b>58.1</b>
Depreciation	702	564	-	668	-	592	-	1,370	1,122	-
EBIT	5,303	3,962	33.8	4,663	13.7	4,752	-	9,966	6,050	64.7
Interest	180	178	-	171	-	250	-	351	339	-
Other Income	355	314	-	435	-	435	-	790	489	-
<b>PBT</b>	<b>5,478</b>	<b>4,099</b>	<b>33.6</b>	<b>4,927</b>	<b>11.2</b>	<b>4,937</b>	<b>-</b>	<b>10,405</b>	<b>6,201</b>	<b>67.8</b>
Less: Taxation	662	293	-	696	-	691	-	1,358	520	-
Less: Minority Interest	95	97	-	12	-	12	-	106	115	-
<b>Recurring PAT</b>	<b>4,721</b>	<b>3,709</b>	<b>27.3</b>	<b>4,219</b>	<b>11.9</b>	<b>4,234</b>	<b>11.5</b>	<b>8,940</b>	<b>5,565</b>	<b>60.6</b>
Exceptional items	0	0	-	0	-	0	-	0	0	-
<b>Reported PAT</b>	<b>4,721</b>	<b>3,709</b>	<b>27.3</b>	<b>4,219</b>	<b>11.9</b>	<b>4,234</b>	<b>11.5</b>	<b>8,940</b>	<b>5,565</b>	<b>60.6</b>
<b>Key Ratios (%)</b>										
Gross Margin	60.5	60.1	-	63.4	-	61.0	-	61.8	60.7	-
EBITDA Margin	25.4	20.0	-	26.6	-	22.4	-	26.0	17.4	-
Tax / PBT	12.1	7.2	-	14.1	-	14.0	-	13.1	8.4	-
NPM	20.0	16.4	-	21.1	-	17.7	-	20.5	13.5	-
<b>EPS (Rs)</b>	<b>39.5</b>	<b>31.0</b>	<b>-</b>	<b>35.3</b>	<b>-</b>	<b>35.4</b>	<b>-</b>	<b>74.8</b>	<b>46.6</b>	<b>-</b>

Source: Company, BOBCAPS Research

**FIG 2 – SEGMENT SALES**

(Rs mn)	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)	Q2FY21E	Var. (%)	H1FY21	H1FY20	YoY (%)
<b>Formulations</b>										
India	15,574	15,503	0.5	11,550	34.8	15,708	(0.9)	27,124	27,725	(2.2)
US	6,258	5,370	16.5	6,664	(6.1)	6,660	(6.0)	12,922	10,187	26.8
RoW	1,532	1,321	16.0	1,189	28.8	1,519	0.8	2,721	2,416	12.6
<b>Net Sales</b>	<b>23,364</b>	<b>22,194</b>	<b>5.3</b>	<b>19,403</b>	<b>20.4</b>	<b>23,887</b>	<b>(2.2)</b>	<b>42,767</b>	<b>40,328</b>	<b>6.0</b>
INR/US\$	74	71	3.5	75	(2.0)	74	-	74	71	5.3
US sales in \$ terms	85	76	12.6	89	(4.2)	91	-	174	144	20.4

Source: Company, BOBCAPS Research

### Valuation methodology

Alkem delivered a strong beat on EBITDA margins in FY20 (up >250bps YoY). We continue to believe that the company’s profit base has moved up sustainably given its focus on raising the high-margin acute mix, increasing marketing efficiency and driving operating leverage in the US from new launches. This coupled with sustained ROIC of >35% (vs. ~23% over FY18-FY20) and strong FCF of Rs 40bn over the next three years (vs. Rs 10bn in the last five years) should support expansion in one-year forward EV/EBITDA multiples closer to the three-year mean of 19x from ~15x currently.

We expect 21% EBITDA growth over the next two years. While we increase our FY21 earnings estimate by 9% following the strong H1 margin beat that was led by cost control, we believe two-thirds of the cost savings could reverse as competitors ramp up intensity of promotional activity for the India business. Hence, our FY22-FY23 EPS estimates remain unchanged. We maintain our Sep’21 target price of Rs 3,600, based on an unchanged target EV/EBITDA multiple of 19x (implied P/E of 24x). Retain BUY.

**FIG 3 – REVISED ESTIMATES**

(Rs bn)	New			Old			Change (%)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
Sales	91.3	101.9	113.5	91.3	101.9	113.5	0.0	0.0	0.0
EBITDA	20.8	21.6	24.8	19.3	21.6	24.8	7.5	(0.1)	(0.0)
EBITDA margin (%)	22.7	21.2	21.8	21.2	21.2	21.8	158bps	(1bps)	(1bps)
EPS (Rs)	133	139	161	123	139	161	8.7	0.3	0.3

Source: Company, BOBCAPS Research

**FIG 4 – 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 26% 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. Further, any slowdown in IPM growth and delay in new launches can 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 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)	FY19A	FY20A	FY21E	FY22E	FY23E
<b>Total revenue</b>	<b>73,558</b>	<b>82,983</b>	<b>91,288</b>	<b>101,943</b>	<b>113,526</b>
EBITDA	11,135	14,730	20,767	21,621	24,768
Depreciation	1,932	2,526	2,557	2,872	3,222
EBIT	9,203	12,204	18,210	18,749	21,546
Net interest income/(expenses)	(546)	(650)	(998)	(998)	(998)
Other income/(expenses)	582	1,043	1,656	2,228	2,857
Exceptional items	0	0	0	0	0
EBT	9,239	12,598	18,868	19,979	23,405
Income taxes	1,810	1,105	2,642	2,997	3,745
Extraordinary items	307	0	0	0	0
Min. int./Inc. from associates	131	222	267	320	384
<b>Reported net profit</b>	<b>7,605</b>	<b>11,270</b>	<b>15,960</b>	<b>16,662</b>	<b>19,276</b>
Adjustments	307	0	0	0	0
<b>Adjusted net profit</b>	<b>7,298</b>	<b>11,270</b>	<b>15,960</b>	<b>16,662</b>	<b>19,276</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	9,622	9,541	12,350	13,791	15,358
Other current liabilities	4,435	6,010	7,212	8,054	8,969
Provisions	3,275	4,067	4,474	4,997	5,564
Debt funds	9,025	16,628	16,628	16,628	16,628
Other liabilities	0	0	0	0	0
Equity capital	239	239	239	239	239
Reserves & surplus	48,407	53,363	65,601	78,378	93,158
Shareholders' fund	48,646	53,602	65,840	78,617	93,397
<b>Total liabilities and equities</b>	<b>75,003</b>	<b>89,848</b>	<b>106,505</b>	<b>122,086</b>	<b>139,917</b>
Cash and cash eq.	6,615	10,922	25,252	33,177	43,218
Accounts receivables	12,484	16,494	17,290	19,308	21,502
Inventories	14,998	18,188	19,266	21,515	23,959
Other current assets	7,669	9,180	10,819	12,081	13,454
Investments	3,236	2,614	2,614	2,614	2,614
Net fixed assets	25,072	28,821	30,264	32,392	34,170
CWIP	4,930	3,630	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>75,004</b>	<b>89,848</b>	<b>106,505</b>	<b>122,086</b>	<b>139,917</b>

Source: Company, BOBCAPS Research

### Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	9,537	13,796	18,517	19,534	22,498
Interest expenses	546	650	998	998	998
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,411)	(6,425)	906	(2,724)	(2,961)
Other operating cash flows	0	0	0	0	0
<b>Cash flow from operations</b>	<b>8,671</b>	<b>8,021</b>	<b>20,420</b>	<b>17,808</b>	<b>20,534</b>
Capital expenditures	(3,991)	(4,500)	(4,000)	(5,000)	(5,000)
Change in investments	1,207	622	0	0	0
Other investing cash flows	0	0	0	0	0
<b>Cash flow from investing</b>	<b>(2,784)</b>	<b>(3,878)</b>	<b>(4,000)</b>	<b>(5,000)</b>	<b>(5,000)</b>
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(925)	7,603	0	0	0
Interest expenses	(546)	(650)	(998)	(998)	(998)
Dividends paid	(1,702)	(2,628)	(3,722)	(3,886)	(4,495)
Other financing cash flows	(1,868)	(4,161)	2,630	0	0
<b>Cash flow from financing</b>	<b>(5,040)</b>	<b>164</b>	<b>(2,090)</b>	<b>(4,883)</b>	<b>(5,493)</b>
<b>Changes in cash and cash eq.</b>	<b>847</b>	<b>4,308</b>	<b>14,330</b>	<b>7,924</b>	<b>10,042</b>
<b>Closing cash and cash eq.</b>	<b>6,614</b>	<b>10,922</b>	<b>25,252</b>	<b>33,177</b>	<b>43,218</b>

### Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	63.6	94.3	133.5	139.4	161.2
Adjusted EPS	61.0	94.3	133.5	139.4	161.2
Dividend per share	12.2	18.9	26.7	27.9	32.2
Book value per share	395.8	436.0	538.3	645.2	768.8

### Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	4.5	4.0	3.6	3.2	2.8
EV/EBITDA	29.6	22.4	15.9	15.1	12.7
Adjusted P/E	45.1	29.2	20.6	19.8	17.1
P/BV	7.0	6.3	5.1	4.3	3.6

### DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	79.0	89.5	84.6	83.4	82.4
Interest burden (PBT/EBIT)	100.4	103.2	103.6	106.6	108.6
EBIT margin (EBIT/Revenue)	12.5	14.7	19.9	18.4	19.0
Asset turnover (Revenue/Avg TA)	33.2	32.4	29.9	28.7	27.7
Leverage (Avg TA/Avg Equity)	1.2	1.3	1.3	1.3	1.2
Adjusted ROAE	16.3	22.7	27.4	23.6	22.8

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

**Ratio Analysis**

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
<b>YoY growth (%)</b>					
Revenue	14.5	12.8	10.0	11.7	11.4
EBITDA	8.3	32.3	41.0	4.1	14.6
Adjusted EPS	15.7	54.4	41.6	4.4	15.7
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	15.1	17.8	22.7	21.2	21.8
EBIT margin	12.5	14.7	19.9	18.4	19.0
Adjusted profit margin	9.9	13.6	17.5	16.3	17.0
Adjusted ROAE	16.3	22.7	27.4	23.6	22.8
ROCE	17.6	20.7	26.0	23.6	23.8
<b>Working capital days (days)</b>					
Receivables	63	73	70	70	70
Inventory	75	81	78	78	78
Payables	48	42	50	50	50
<b>Ratios (x)</b>					
Gross asset turnover	2.4	2.4	2.4	2.3	2.3
Current ratio	2.4	2.8	3.0	3.2	3.4
Net interest coverage ratio	16.9	18.8	18.3	18.8	21.6
Adjusted debt/equity	0.0	0.1	(0.2)	(0.2)	(0.3)

Source: Company, BOBCAPS Research

## Disclaimer

### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

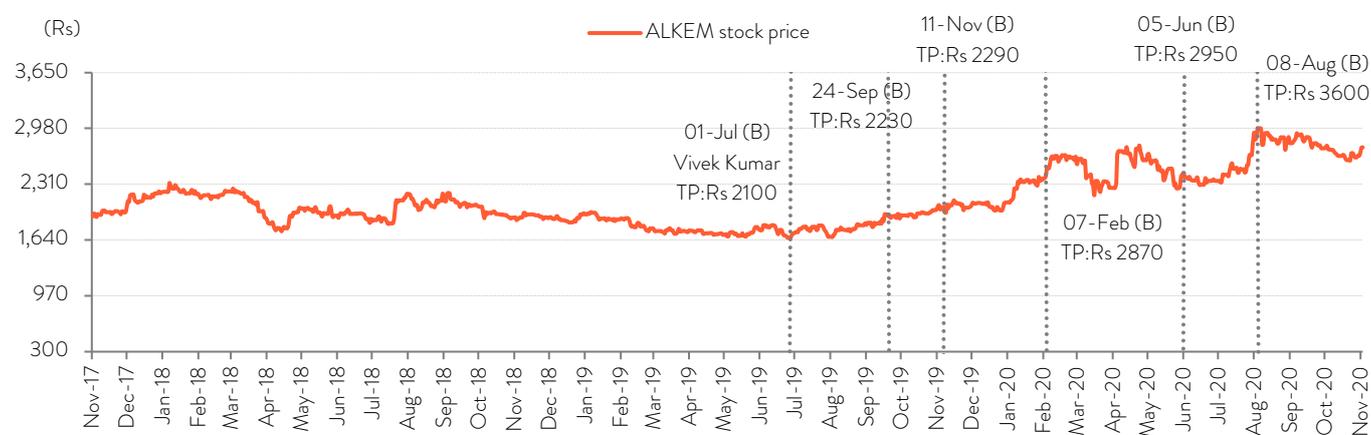
**ADD** – Expected return from >+5% to +15%

**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)

### RATINGS AND TARGET PRICE (3-YEAR HISTORY): ALKEM LABS (ALKEM IN)



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

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