

**BUY**

TP: Rs 2,870 | ▲ 15%

**ALKEM LABS**

Pharmaceuticals

07 February 2020

## Solid beat – moving to street-high TP of Rs 2,870

Alkem Labs reported a 24% EBITDA beat in Q3 driven by better gross margins (product mix, soft RM prices). India sales rose 14% YoY; US sales grew 8% QoQ to US\$ 82mn. A focus on strengthening the high-margin India portfolio should drive low double-digit growth in coming years, alongside benefits from US operating leverage. In the mid-term, Alkem expect 20% EBITDA margins (from c.18%). We raise FY21/FY22 EPS by 6%, increase our target EV/EBITDA multiple to 17x vs. 14x leading to Mar'21 TP of Rs 2,870 (implied 24x P/E).

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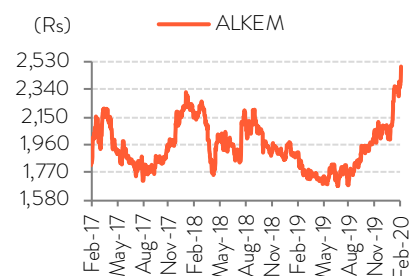
**24% EBITDA beat, India and US sales steady:** Q3 EBITDA was up 45% YoY led by 450bps expansion in gross margin to 61.8%. EBITDA margins stood at 20.8% vs. our estimate of 17.2%, partially driven by cost control. Q3/9M India sales growth was better than estimates at 14%/15% YoY (in 9M, acute was up 13% and chronic 21%). US commentary is stable with guidance for good growth over FY20 – we expect US\$ 400mn in US sales by FY22 (14% CAGR).

|                  |                   |
|------------------|-------------------|
| Ticker/Price     | ALKEM IN/Rs 2,503 |
| Market cap       | US\$ 4.2bn        |
| Shares o/s       | 120mn             |
| 3M ADV           | US\$ 2.5mn        |
| 52wk high/low    | Rs 2,558/Rs 1,660 |
| Promoter/FPI/DII | 66%/2%/5%         |

Source: NSE

**Scope for rerating; TP raised to Rs 2,870:** We believe Alkem's profitability base has moved up – evident from the beat over the last three quarters, which has led us to cumulatively upgrade EBITDA by 9-10% and margins by 100bps for FY20-FY22. This momentum should sustain given a focus on raising the high-margin acute mix, increasing MR efficiency and driving operating leverage in the US (see our Jul'19 initiation). Coupled with ROIC of >30% from FY21E (vs. ~20% in FY18-FY19) and strong FCF, we expect one-year forward EV/EBITDA multiples to move closer to the 3Y mean of 19x from c.14.8x.

## STOCK PERFORMANCE



**Earnings call highlights:** (1) Trade margin capping, if implemented, will be therapy-wise. (2) Direct dependency on Chinese API is 5%; stock currently at 1-1.5 months. (3) Expect addition of 300 to the ~11,000 field force in FY21. (4) FY21 capex and tax guided at Rs 4bn and 10% respectively.

## KEY FINANCIALS

| Y/E 31 Mar              | FY18A  | FY19A  | FY20E  | FY21E  | FY22E   |
|-------------------------|--------|--------|--------|--------|---------|
| Total revenue (Rs mn)   | 64,218 | 73,558 | 82,607 | 92,525 | 103,306 |
| EBITDA (Rs mn)          | 10,284 | 11,135 | 14,255 | 16,779 | 19,480  |
| Adj. net profit (Rs mn) | 6,309  | 7,298  | 11,238 | 13,387 | 14,392  |
| Adj. EPS (Rs)           | 52.8   | 61.0   | 94.0   | 112.0  | 120.4   |
| Adj. EPS growth (%)     | (29.3) | 15.7   | 54.0   | 19.1   | 7.5     |
| Adj. ROAE (%)           | 15.8   | 16.3   | 21.8   | 21.9   | 20.1    |
| Adj. P/E (x)            | 47.4   | 41.0   | 26.6   | 22.3   | 20.8    |
| EV/EBITDA (x)           | 28.9   | 26.9   | 21.1   | 17.6   | 14.8    |

Source: Company, BOBCAPS Research

**BOB Capital Markets Ltd is a wholly owned subsidiary of Bank of Baroda**

Important disclosures, including any required research certifications, are provided at the end of this report.



**FIG 1 – QUARTERLY PERFORMANCE**

| (Rs mn)                 | Q3FY20        | Q3FY19        | YoY (%)     | Q2FY20        | QoQ (%)      | Q3FY20E       | Var. (%)    | 9MFY20        | 9MFY19        | YoY (%)     |
|-------------------------|---------------|---------------|-------------|---------------|--------------|---------------|-------------|---------------|---------------|-------------|
| <b>Net Sales</b>        | <b>21,818</b> | <b>19,250</b> | <b>13.3</b> | <b>22,640</b> | <b>(3.6)</b> | <b>21,219</b> | <b>2.8</b>  | <b>62,953</b> | <b>55,134</b> | <b>14.2</b> |
| <b>EBITDA</b>           | <b>4,533</b>  | <b>3,118</b>  | <b>45.4</b> | <b>4,526</b>  | <b>0.2</b>   | <b>3,650</b>  | <b>24.2</b> | <b>11,705</b> | <b>8,902</b>  | <b>31.5</b> |
| Depreciation            | 594           | 477           | -           | 564           | -            | 580           | -           | 1,716         | 1,359         | -           |
| EBIT                    | 3,939         | 2,641         | 49.2        | 3,962         | (0.6)        | 3,070         | -           | 9,989         | 7,543         | 32.4        |
| Interest                | 170           | 154           | -           | 178           | -            | 120           | -           | 509           | 480           | -           |
| Other Income            | 279           | 94            | -           | 314           | -            | 94            | -           | 768           | 496           | -           |
| <b>PBT</b>              | <b>4,048</b>  | <b>2,581</b>  | <b>56.9</b> | <b>4,099</b>  | <b>(1.2)</b> | <b>3,044</b>  | <b>-</b>    | <b>10,249</b> | <b>7,558</b>  | <b>35.6</b> |
| Less: Taxation          | 147           | 526           | -           | 293           | -            | 609           | -           | 667           | 1,527         | -           |
| Less: Minority Interest | 80            | 29            | -           | 97            | -            | 0             | -           | 195           | 100           | -           |
| <b>Recurring PAT</b>    | <b>3,822</b>  | <b>2,026</b>  | <b>88.7</b> | <b>3,709</b>  | <b>3.0</b>   | <b>2,435</b>  | <b>56.9</b> | <b>9,387</b>  | <b>5,932</b>  | <b>58.2</b> |
| Exceptional items       | 0             | 0             | -           | 0             | -            | 0             | -           | 0             | 0             | -           |
| <b>Reported PAT</b>     | <b>3,822</b>  | <b>2,026</b>  | <b>88.7</b> | <b>3,709</b>  | <b>3.0</b>   | <b>2,435</b>  | <b>56.9</b> | <b>9,387</b>  | <b>5,932</b>  | <b>58.2</b> |
| <b>Key Ratios (%)</b>   |               |               |             |               |              |               |             |               |               |             |
| Gross Margin            | 61.8          | 57.2          |             | 60.1          |              | 59.0          |             | 61.1          | 59.1          |             |
| EBITDA Margin           | 20.8          | 16.2          |             | 20.0          |              | 17.2          |             | 18.6          | 16.1          |             |
| Tax / PBT               | 3.6           | 20.4          |             | 7.2           |              | 20.0          |             | 6.5           | 20.2          |             |
| NPM                     | 17.5          | 10.5          |             | 16.4          |              | 11.5          |             | 14.9          | 10.8          |             |
| <b>EPS (Rs)</b>         | <b>32.0</b>   | <b>16.9</b>   |             | <b>31.0</b>   |              | <b>20.4</b>   |             | <b>78.5</b>   | <b>49.6</b>   |             |

Source: Company, BOBCAPS Research

**FIG 2 – SEGMENT SALES**

| (Rs mn)             | Q3FY20        | Q3FY19        | YoY (%)     | Q2FY20        | QoQ (%)      | Q3FY20E       | Var. (%)   | 9MFY20        | 9MFY19        | YoY (%)     |
|---------------------|---------------|---------------|-------------|---------------|--------------|---------------|------------|---------------|---------------|-------------|
| <b>Formulations</b> |               |               |             |               |              |               |            |               |               |             |
| India               | 14,239        | 12,475        | 14.1        | 15,503        | (8.2)        | 14,094        | 1.0        | 41,964        | 36,565        | 14.8        |
| US                  | 5,837         | 5,182         | 12.6        | 5,370         | 8.7          | 5,600         | 4.2        | 16,024        | 14,144        | 13.3        |
| RoW                 | 1,416         | 1,350         | 4.9         | 1,321         | 7.2          | 1,526         | (7.2)      | 3,832         | 3,676         | 4.2         |
| <b>Net Sales</b>    | <b>21,492</b> | <b>19,007</b> | <b>13.1</b> | <b>22,194</b> | <b>(3.2)</b> | <b>21,219</b> | <b>1.3</b> | <b>61,820</b> | <b>54,385</b> | <b>13.7</b> |

Source: Company, BOBCAPS Research

## Valuation methodology

Alkem’s consecutive margin beat over the last three quarters implies that profitability in the India and US businesses continues to improve ahead of expectations. This is evident from our upgrades to EBITDA and margins by 9-10% and 100bps (75% in gross margin & 25% in SG&A cost) respectively since we **initiated coverage in Jul’19**.

We believe Alkem’s profitability base has moved up and should sustain given a focus on raising the high-margin acute mix, increasing MR efficiency and driving operating leverage in the US from new launches. This coupled with ROIC of >30% from FY21E (vs. ~20% in FY18-FY19) and strong FCF should lend strong support for expansion in one-year forward EV/EBITDA multiples closer to the three-year mean of 19x from ~14.8x currently.

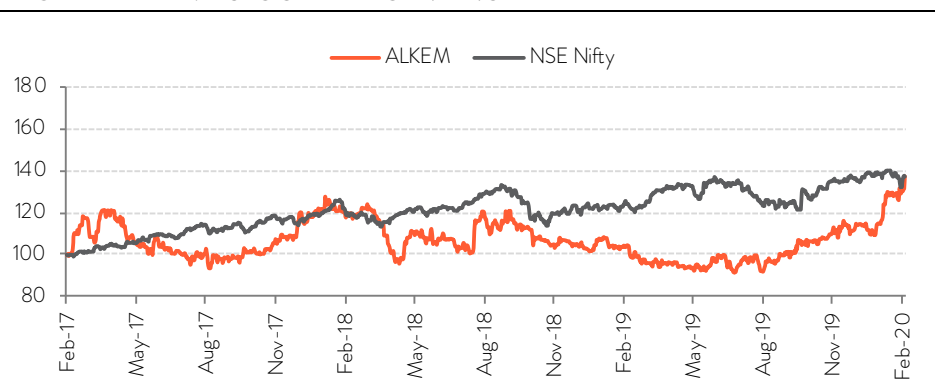
We raise our FY20-FY22 EPS estimates by 5-6% following the 9MFY20 beat, assuming improved profitability in both India and US businesses (expect >17% EBITDA growth over the next two years.) Retain BUY as we raise our target price to Rs 2,870 (from Rs 2,290) on resetting our target EV/EBITDA multiple to 17x from 14x (implied P/E of 24x) and rolling valuations forward to Mar’22. Our revised FY20/FY21/FY22 EPS estimates stand at Rs 94/Rs 112/Rs 120.

**FIG 3 – REVISED ESTIMATES**

| (Rs bn)           | New   |       |       | Old   |       |       | Change (%) |       |       |
|-------------------|-------|-------|-------|-------|-------|-------|------------|-------|-------|
|                   | FY20E | FY21E | FY22E | FY20E | FY21E | FY22E | FY20E      | FY21E | FY22E |
| Sales             | 82.6  | 92.5  | 103.3 | 82.1  | 91.9  | 102.7 | 0.6        | 0.6   | 0.6   |
| EBITDA            | 14.3  | 16.8  | 19.5  | 13.3  | 16.0  | 18.7  | 7.0        | 5.1   | 4.2   |
| EBITDA margin (%) | 17.3  | 18.1  | 18.9  | 16.2  | 17.4  | 18.2  | 103bps     | 78bps | 65bps |
| EPS (Rs)          | 94    | 112   | 120   | 86    | 105   | 114   | 9.5        | 6.2   | 5.2   |

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. 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>82,607</b> | <b>92,525</b> | <b>103,306</b> |
| EBITDA                         | 10,284        | 11,135        | 14,255        | 16,779        | 19,480         |
| Depreciation                   | 1,430         | 1,932         | 2,034         | 2,301         | 2,585          |
| EBIT                           | 8,854         | 9,203         | 12,222        | 14,478        | 16,895         |
| Net interest income/(expenses) | (553)         | (546)         | (572)         | (602)         | (602)          |
| Other income/(expenses)        | 960           | 582           | 1,011         | 1,550         | 1,979          |
| Exceptional items              | 0             | 0             | 0             | 0             | 0              |
| EBT                            | 9,260         | 9,239         | 12,662        | 15,427        | 18,273         |
| Income taxes                   | 2,876         | 1,810         | 1,266         | 1,851         | 3,655          |
| 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>11,238</b> | <b>13,387</b> | <b>14,392</b>  |
| Adjustments                    | 0             | 307           | 0             | 0             | 0              |
| <b>Adjusted net profit</b>     | <b>6,309</b>  | <b>7,298</b>  | <b>11,238</b> | <b>13,387</b> | <b>14,392</b>  |

### Balance Sheet

| Y/E 31 Mar (Rs mn)                    | FY18A         | FY19A         | FY20E         | FY21E          | FY22E          |
|---------------------------------------|---------------|---------------|---------------|----------------|----------------|
| Accounts payables                     | 9,607         | 9,622         | 11,176        | 12,517         | 13,976         |
| Other current liabilities             | 4,487         | 4,435         | 6,527         | 7,310          | 8,162          |
| Provisions                            | 2,742         | 3,275         | 3,678         | 4,119          | 4,599          |
| Debt funds                            | 9,950         | 9,025         | 10,025        | 10,025         | 10,025         |
| Other liabilities                     | 0             | 0             | 0             | 0              | 0              |
| Equity capital                        | 239           | 239           | 239           | 239            | 239            |
| Reserves & surplus                    | 43,075        | 48,407        | 57,025        | 67,290         | 78,326         |
| Shareholders' fund                    | 43,314        | 48,646        | 57,264        | 67,529         | 78,565         |
| <b>Total liabilities and equities</b> | <b>70,100</b> | <b>75,003</b> | <b>88,669</b> | <b>101,501</b> | <b>115,327</b> |
| Cash and cash eq.                     | 5,768         | 6,615         | 15,813        | 22,014         | 28,063         |
| Accounts receivables                  | 10,805        | 12,484        | 14,528        | 16,272         | 18,169         |
| Inventories                           | 14,422        | 14,998        | 16,763        | 18,776         | 20,964         |
| Other current assets                  | 8,016         | 7,669         | 9,790         | 10,965         | 12,243         |
| 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>88,669</b> | <b>101,501</b> | <b>115,327</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          | 13,272         | 15,688         | 16,977         |
| Interest expenses                   | 553            | 546            | 572            | 602            | 602            |
| Non-cash adjustments                | 0              | 0              | 0              | 0              | 0              |
| Changes in working capital          | (1,500)        | (1,411)        | (1,883)        | (2,365)        | (2,571)        |
| Other operating cash flows          | 0              | 0              | 0              | 0              | 0              |
| <b>Cash flow from operations</b>    | <b>6,793</b>   | <b>8,671</b>   | <b>11,961</b>  | <b>13,925</b>  | <b>15,007</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)          | 1,000          | 0              | 0              |
| Interest expenses                   | (553)          | (546)          | (572)          | (602)          | (602)          |
| Dividends paid                      | (2,180)        | (1,702)        | (2,621)        | (3,122)        | (3,356)        |
| 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>1,737</b>   | <b>(3,723)</b> | <b>(3,958)</b> |
| <b>Changes in cash and cash eq.</b> | <b>1,776</b>   | <b>847</b>     | <b>9,198</b>   | <b>6,201</b>   | <b>6,049</b>   |
| <b>Closing cash and cash eq.</b>    | <b>5,768</b>   | <b>6,614</b>   | <b>15,813</b>  | <b>22,014</b>  | <b>28,063</b>  |

### Per Share

| Y/E 31 Mar (Rs)      | FY18A | FY19A | FY20E | FY21E | FY22E |
|----------------------|-------|-------|-------|-------|-------|
| Reported EPS         | 52.8  | 63.6  | 94.0  | 112.0 | 120.4 |
| Adjusted EPS         | 52.8  | 61.0  | 94.0  | 112.0 | 120.4 |
| Dividend per share   | 13.0  | 12.2  | 18.8  | 22.4  | 24.1  |
| Book value per share | 352.1 | 395.8 | 467.9 | 553.8 | 646.1 |

### Valuations Ratios

| Y/E 31 Mar (x) | FY18A | FY19A | FY20E | FY21E | FY22E |
|----------------|-------|-------|-------|-------|-------|
| EV/Sales       | 4.6   | 4.1   | 3.6   | 3.2   | 2.8   |
| EV/EBITDA      | 28.9  | 26.9  | 21.1  | 17.6  | 14.8  |
| Adjusted P/E   | 47.4  | 41.0  | 26.6  | 22.3  | 20.8  |
| P/BV           | 7.1   | 6.3   | 5.3   | 4.5   | 3.9   |

### DuPont Analysis

| Y/E 31 Mar (%)                  | FY18A | FY19A | FY20E | FY21E | FY22E |
|---------------------------------|-------|-------|-------|-------|-------|
| Tax burden (Net profit/PBT)     | 68.1  | 79.0  | 88.8  | 86.8  | 78.8  |
| Interest burden (PBT/EBIT)      | 104.6 | 100.4 | 103.6 | 106.6 | 108.2 |
| EBIT margin (EBIT/Revenue)      | 13.8  | 12.5  | 14.8  | 15.6  | 16.4  |
| Asset turnover (Revenue/Avg TA) | 32.5  | 33.2  | 33.1  | 31.9  | 31.1  |
| Leverage (Avg TA/Avg Equity)    | 1.2   | 1.2   | 1.2   | 1.2   | 1.2   |
| Adjusted ROAE                   | 15.8  | 16.3  | 21.8  | 21.9  | 20.1  |

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  | 12.3  | 12.0  | 11.7  |
| EBITDA                                       | 2.9    | 8.3   | 28.0  | 17.7  | 16.1  |
| Adjusted EPS                                 | (29.3) | 15.7  | 54.0  | 19.1  | 7.5   |
| <b>Profitability &amp; Return ratios (%)</b> |        |       |       |       |       |
| EBITDA margin                                | 16.0   | 15.1  | 17.3  | 18.1  | 18.9  |
| EBIT margin                                  | 13.8   | 12.5  | 14.8  | 15.6  | 16.4  |
| Adjusted profit margin                       | 9.8    | 9.9   | 13.6  | 14.5  | 13.9  |
| Adjusted ROAE                                | 15.8   | 16.3  | 21.8  | 21.9  | 20.1  |
| ROCE   | 19.9   | 17.6  | 21.2  | 22.1  | 22.7  |
| <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   | 2.7   | 2.8   | 3.0   |
| Net interest coverage ratio                  | 16.0   | 16.9  | 21.4  | 24.1  | 28.1  |
| Adjusted debt/equity                         | 0.0    | 0.0   | (0.1) | (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)

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



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

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