FIRST LIGHT

22 March 2022

RESEARCH

Pharmaceuticals

Valuations slump as Covid fears ebb; prefer resilient models

SUMMARY

Pharmaceuticals

- Return of higher operating costs as global economies reopen and rationalisation of growth guidance have undermined pharma valuations
- Near-normalisation across economies removes the fear psychosis that motivates investment into defensive sectors such as pharma
- SUNP, DIVI, CIPLA, ARBP and ERIS remain our top picks given resilient portfolios and hence valuations; we upgrade LPC from SELL to HOLD

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Daily macro indicators

Indicator	17-Mar	18-Mar	Chg (%)
US 10Y yield (%)	2.17	2.15	(2)
India 10Y yield (%)	6.79	6.78	(1)
USD/INR	76.27	75.81	0.6
Brent Crude (US$/bbl)	106.6	107.9	1.2
Dow	34,481	34,755	0.8
Hang Seng	21,501	21,412	(0.4)
Sensex	56,817	57,864	1.8
India FII (US$ mn)	**14-Mar**	**15-Mar**	**Chg ($ mn)**
FII-D	21.6	(25.4)	(47.0)
FII-E	126.9	(144.4)	(271.3)

Source: Bank of Baroda Economics Research

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PHARMACEUTICALS

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- **Near-normalisation across economies removes the fear psychosis that motivates investment into defensive sectors such as pharma**
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Fall in Nifty Pharma forward P/E more than twice that of fall in Pharma index: The Nifty Pharma index has declined 9% vs. a 21% drop in its one-year forward P/E valuation since hitting a peak in Aug'21. The decline stretches across stocks and market capitalisations, barring a few exceptions such as SUNP, DIVI, LAURUS and ERIS in our coverage universe. We note that in Aug'21 the Nifty Pharma index achieved its highest one-year forward P/E of 28.2x since FY17, which was followed by its steepest decline to 14.7x within five months.

Perceived value diminished as economies started opening up: The precipitous decline in the Pharma index from its five-year peak began as India (and the world) started to emerge from the worst of the Covid-19 second wave. The index briefly paused at 1+sigma (Fig 1) away from its normalised forward multiple of 18-20x during the third pandemic wave and started declining to normal levels in Q4FY22. We believe that investors' perception of pharma stock value started to wane once lockdowns were eased. Further, assumptions that the worst of the pandemic was behind us after the second wave were proved correct by the milder Omicron impact.

Declining fear factor, tepid guidance exposes quality of earnings: With growing vaccinated populations and lower Covid hospitalisations, countries globally have begun returning to normalcy. Alongside the waning Covid threat perception, Indian pharma players reported sequential tepid earnings growth in Q2 and Q3 of FY22, while rationalisation of management guidance revealed the limitations of their extraordinary pandemic-led growth. The return of higher operating costs as A&P, travel and other spends revived post pandemic also dented profitability. These factors have led to a reduction in investments and gradual profit booking in the pharma sector.

Remain positive on SUNP, DIVI, CIPLA, ARBP and ERIS: We remain positive on our top picks as their valuations look relatively resilient due to lower sales/margin volatility, near-normalisation of key export economies and recovery in India business. We also upgrade LPC to HOLD (from SELL) as the stock correction post a disappointing Q3FY22 appears overstated. We maintain our TP of Rs 815 set at 11x FY24E EPS – a 30% discount to the average multiple of frontline stocks SUNP, DRRD, CIPLA.

Recommendation snapshot

Ticker	Price	Target	Rating
AJP IN	1,941	2,655	BUY
ALKEM IN	3,439	4,000	HOLD
ALPM IN	726	905	BUY
ARBP IN	640	850	BUY
CIPLA IN	1,049	1,160	BUY
DIVI IN	4,504	5,250	BUY
DRRD IN	4,042	4,700	HOLD
ERIS IN	715	890	BUY
LAURUS IN	581	570	HOLD
LPC IN	765	815	HOLD
SUNP IN	912	1,045	BUY

Price & Target in Rupees | Price as of 17 Mar 2022

Disclaimer

Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

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