Financial Express, Delhi
Monday 7th December 2015, Page: 10
Width: 33.64 cms, Height: 25.95 cms, a3r, Ref: pmin.2015-12-07.23.42

M&As to drive growth in pharma sector

Regulatory challenges notwithstanding, an earnings CAGR of 24% estimated for FY15-18

PHARMA SECTOR

Acquisition-led growth, regulatory risks to drive near-term sentiment

PRODUCT launches in US markets and synergies from recent acquisitions are set to drive sector earnings at a CAGR of 24% in FY15-18e (estimates), following a CAGR (compound annual growth rate) of 18% over the past three years. Indian pharmaceutical companies will continue to use their underleveraged balance sheets to pursue inorganic growth by acquiring assets in both the Indian and US markets. While regulatory risks will remain a sector overhang, the risk-reward profile appears favourable, with current valuations discounting recent moves by the FDA (S&P BSE Healthcare underperformed BSE Sensex by c.10% in last 3M).

Initiating with Buy on Sun, Lupin, Cipla, Glenmark, Torrent; Sell on Dr. Reddy's

We initiate coverage with a Buy rating on Sun (PER of 22x, lower than historical multiple mainly on account of impending FDA issues), Lupin (PER of 23x, to factor in higher growth trajectory), Cipla (PER of 21x, discount to Sun and Lupin to factor in continuing front-end investments), Glenmark (PER of 21x, at c.5-10% discount to Sun and Lupin) and Torrent Pharma (PER of 20x, at c.5-15% discount to Sun and Lupin); a Sell rating on Dr. Reddy's (PER of 18x to factor in USFDA warning letter on three of its plants); and a Hold rating on Cadila (PER of 18x to factor in delays in approvals for Moraiya plant). All our target prices are based on PER (x) assigned to our FY18 recurring earnings forecast plus relevant one-offs on a cash basis.

Regulatory risks appear highest for Dr. Reddy's

While Dr. Reddy's (US sales 44%) has received a warning letter for two of its bulk drug and one oncology formulation plant, Sun and Cadila have seen a slower pace of approvals in FY16 due to observations issued for their USFDA formulation plants in India (Halol and Moraiya). US sales, which represent the highest proportion (c.30%-45%) of sales for Indian pharma companies, will likely see sluggish growth rates as the ANDA approvals for Dr. Reddy's, Sun and Cadila could be delayed, leading to downside risk to consensus earnings for these companies. We see low risk to our earnings forecasts for Sun as we do not factor in new approvals for Halol until 4QFY17.

Low leverage and low dividend payouts expected to drive acquisitions

We expect Indian companies to capitalise on their low leverage by seeking inorganic growth opportunities, mainly in regulated markets like the US, to add to and diversify their existing portfolios, while also acquiring front-end businesses in emerging markets. Sun, Lupin, Dr. Reddy's and Cipla look set to take the lead in seeking acquisitions globally. Consequently, we expect Sun, Lupin and Cipla to deliver the highest earnings growth in the sector. With organic growth capped for Dr. Reddy's due to existing US FDA regulatory issues, it could be aggressive in seeking acquisitions globally. We believe acquiring assets at reasonable multiples will remain a challenge and payback periods may get stretched if integration synergies are delayed.

Demographics to drive IPM, product launches to fuel US generic sales: We forecast a c.12-15% CAGR in the Indian pharma market over the next five years and anticipate key product launches such as generic Gleevec (Sun), generic Glumetza (Lupin), generic Zetia (Glenmark) and generic Asacol HD (Cadila).

Executive summary

- Acquisition-led growth supported by balance sheet strength
- USFDA actions are NOT generic regulatory sector risk
- Regulatory risks for Dr. Reddy's are higher than for Sun and Cadila

Acquisition-led growth to emerge as key sector theme: A confluence of factors, ranging from strong balance sheets following several years of robust cash flow generation to confidence in successfully integrating acquisitions, is set to drive an even faster pace of M&A activity in the sector. As M&A continues, the recent acquisition multiples could set the benchmark for secondary market valuations. US sales contribute c.30-50% of sales for most large Indian companies; others with lower US exposure are adding to their presence in this market by acquiring assets (Cipla—Invagen and Exelan). While non-US markets like Japan, Latam and the EU are large, every company has a different strategy in these markets, as they continue to pose challenges in relation to entry, regulation and currency volatility.

Regulatory challenges notwithstanding, we estimate that current business operations should drive an EPS CAGR of 24% for the sector for FY15-18E. The big outperformance should be from Sun (26.3% EPS CAGR in FY15-18E) and Lupin. We see downside risk to the consensus earnings of Dr. Reddy's, which faces headwinds in the US. Acquisitions by Indian pharma companies (with a few exceptions) have a payback period of 5-7 years under modest growth assumptions (Sun—Taro, Torrent—Elder).

USFDA actions are NOT generic regulatory sector risk

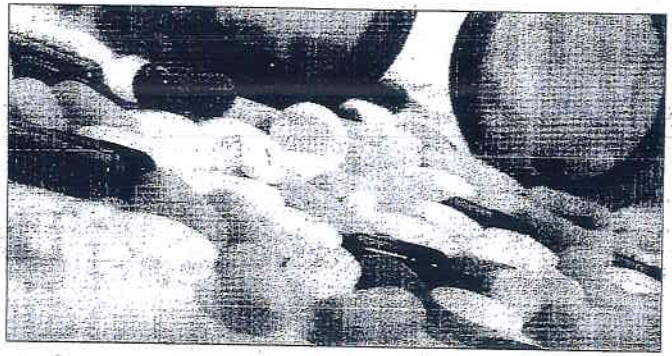
Following recent US FDA actions on Indian pharma manufacturing units, investors fear a generic regulatory risk for the sector. Our report should allay investor fears: not all 483 observation letters turn into warning letters, and not all warning letters turn into import alerts. Also, on most occasions, further USFDA actions have been initiated within a year of the issuance of 483 observations and warning letters.

Regulatory risks for Dr. Reddy's are higher than for Sun and Cadila. In November 2015, the USFDA issued warning letters for three of Dr. Reddy's Indian manufacturing sites. The US contributes 44% of Dr. Reddy's sales and we believe that delays in the resolution of the issues at these plants will have an impact on new approvals, putting pressure on consensus sales and earnings. Currently, the status of Sun's USFDA plant at Halol in Gujarat is Official Action Initiated; this plant has not seen any ANDA approvals for about a year. Sun transferred generic Gleevec from its Halol plant to another facility outside India. We see low risk to our earnings forecasts for Sun Pharma, as we do not factor in new approvals for Halol until Q3FY17. Sun and Cadila received 483 observations at the plants in September 2014.

Valuation based on PER, risks mainly relate to market growth

We have used PER as our principal valuation matrix for the sector. The critical parameter is our assessment of each company's ability to enhance growth in key markets (US and India). We also consider the potential for growth beyond FY18 that will be derived from acquisitions made in the past 1-2 years, as well as the historical valuation ranges, before arriving at the appropriate multiple for each stock. Our assessment suggests that Sun and Lupin are well entrenched in these key markets and have demonstrated above-industry growth rates; we therefore estimate that they should be able to sustain current one year forward multiples of 20x-24x. This is also premised on our EPS CAGR forecasts of 18-26% (FY15-18e) for the two companies. For companies constrained by low growth and ongoing regulatory issues, we have factored in a marginal discount to historical trading averages.

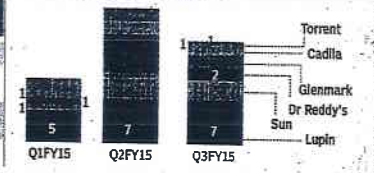
—Deutsche Bank



Key acquisitions in India

Sun Pharma	Ranbaxy	2.2x
Torrent	Elder	5x-6x
Abbott	Piramal	c.9x
Strides Acrolab	Ranbaxy's CNS unit	1x
Dr. Reddy's Labs	UCB India	5.3x

ANDA approvals CY2015



Recent FDA actions

Dr. Reddy's	Srikakulam	Warning Letter	Dec 14-Jan-15	Nov-15	11 months
Cadila Healthcare	Moraiya	Warning Letter	03-Feb-11	21-Jun-11	138
Lupin	Mandideep	Warning Letter	12-Nov-08	07-May-09	176
Ranbaxy	Dewas	Warning Letter	12-Feb-08	16-Sep-08	217
Ranbaxy	Paonta Sahib	Warning Letter	07-Mar-08	16-Sep-08	193
Strides	Agila (Bangalore)	Warning Letter	27-Jun-13	09-Sep-13	74
Sun Pharma	Karkhadi	Warning Letter	16-Nov-13	07-May-14	172
Sun Pharma	Cranbury	Warning Letter	28-Apr-10	25-Aug-10	119
Wockhardt	Chikalthana	Warning Letter	31-Jul-13	25-Nov-13	117
Wockhardt	Waluj	Warning Letter	22-Mar-13	18-Jul-13	118
Aurobindo	Unit III	Warning Letter	24-Sep-10	20-May-11	238
Aurobindo	Unit VI	Warning Letter	22-Dec-10	20-May-11	149
Unca	Pithampur2	Import Alert	19-Dec-14	24-Mar-15	95
Ipca	Ratlam	Import Alert	18-Jul-14	23-Jan-15	189
Ranbaxy	Toansa	Import Alert	11-Jan-14	23-Jan-14	12
Ranbaxy	Mohali	Import Alert	26-Sep-12	16-Sep-13	355

Source: US FDA, Deutsche Bank and Company