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भारत सरकार

Business Line, Delhi
Monday 10th February 2014, Page: 2
Width: 26.92 cms, Height: 15.92 cms, a4r, Ref: pmin.2014-02-10.23.13

GSK Pharma

Good health comes at a cost

The parent is making an open offer at ₹3,100. But investors can sell the stock in the market

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Pharma companies with an overseas presence continued their winning streak in 2013, driven by healthy growth in exports and a weak rupee.

However, the performance of domestic market-focussed multinational companies remained sedate due to price cuts following implementation of the new drug pricing policy.

GlaxoSmithKline Pharma (GSK) is one such company. Its net profit slumped over 12 per cent in the nine months ended September 2013. Despite the poor show, GSK's stock has gained 35 per cent in the last one year.

This was aided by the open offer announcement in December 2013 by its parent GSK Plc to acquire 24.3 per cent stake in the Indian subsidiary at ₹3,100 a share. This was a 26 per cent premium to the last closing price, valuing the stock almost 39 times its 2014-15 earnings. Since then, the stock has gained over 21 per cent compared with an 8 per cent gain for the BSE Healthcare Index. The open offer which was scheduled to commence last week has been postponed and may is expected commence soon. There has been no confirmation from the company yet. At the current price of ₹2,975, the stock trades over 38 times its 2014 expected earnings, translating into a 100 per cent premium to the BSE Healthcare Index.

Weak fundamentals

Given the price cuts in key brands, competition from mid-tier players and dependence on the low-margin branded generics segment, the weakness in GSK's operating margin may not abate soon. Its lacklustre fundamentals may not justify the current valuations. Tendering shares in an open offer will attract short-term capital gains tax at the slab rate you fall under, if you have held it for less than a year.

In case the shares tendered have been held by you for a year or more, long-term capital gains tax at 10 per cent (without indexation) will apply.

Selling in the open market enjoys favourable tax treatment — 15 per cent on short-term capital gains and exemption on long-term capital gains.

With the current market price of the GSK stock just 4 per cent lower than the open offer price, investors can sell their holdings in the open market to maximise returns. GSK Pharma's operating margin has declined steadily in the last two years — slipping from 36 per cent in 2010 to 21 per cent during January-September 2013.

In the light of the slowdown in launch of innovative drugs by its parent, GSK Pharma is aggressively building its branded generics portfolio. But branded generic drugs being highly competitive with multiple players, margins are lower in this segment. With the parent pipeline drying, GSK Pharma continues to rely on the branded generics business to sustain growth.

This unfavourable change in revenue mix has led to a sharp decline in operating margin, which is unlikely to scale up to the erstwhile 30 per cent-plus levels for at least the next one-to-two years.

Under pressure Steep cuts in drug prices are eating into profits
NUI7711/SHUTTERSTOCK.COM

Price cuts

Further, steep cut in prices of key brands as mandated by the new drug pricing policy has added to the company's margin pressure. The retail price of GSK's high-margin anti-infective drug Augmentin has been slashed by over 46 per cent. In the listed space, GSK Pharma has been impacted the most by the new drug pricing policy. Along with revenue loss on account of the price cuts, the strike by drug dealers demanding higher margins compounded the company's woes.

Though the company has now sorted out issues with dealers, margin pressure may continue given the intense competition in the branded generics segment.

GSK imports a fifth of its raw material and traded goods; a weak rupee will further hurt margins.

The key risk to this call may be the launch of innovative products from the parent portfolio over the next two-three years.

However, with the Indian market being highly fragmented and competitive, brand-building entails a lot of time and effort and hence this may not benefit much in the short term.

GSK's top selling drug Augmentin took 12 years to garner ₹100 crore in revenue. Also, the launch of innovative drugs from the parent's pipeline may come under the compulsory licensing regime. This can pose a serious threat to the innovator's pricing power and market share.

- Expensive valuation
- Challenges in the domestic market
- Regulatory threat

Did you know?

A pack of six Augmentin Duo 625 tablets which retailed at ₹219.6 earlier now sells at ₹141.5