Event Update

Aurobindo Pharma

10 September 2018

Reuters: ARBP.NS; Bloomberg: ARBP IN

Acquires Dermatology and Oral Solids Businesses Of Sandoz

Aurobindo Pharma's (APL) acquisition of Sandoz's product portfolio (dermatology and oral solids) for US$900mn will fetch a similar amount in incremental sales (30% from dermatology products and the rest from oral solids) in the first full year post transaction closure (six to nine months from the announcement). The transaction values the portfolio at 1x sales and 4x-5x EBITDA. The valuation is apparently attractive, but the acquired product portfolio's sales are rapidly declining. The acquisition is in line with APL's history of acquiring commoditised assets and executing them profitably. The acquisition has both strategic benefits and will also be tactically accretive to earnings imminently.

Key positives from the acquisition

1) **Our estimates indicate that the acquisition price is significantly lower than the net replacement value for any new player who wishes to pursue the same for approval.**
2) **APL gets know-how of developing dermatology products including some complex ones without incrementally investing in the same. About one-third of the dermatology products inherited from the transaction have two or less competitors.**
3) **Gets ready access to an experienced sales force which allows it to reach out to dermatologists that contribute to a significant majority of prescriptions in the space.**
4) **Gets access to manufacturing capacities (dermatology and oral solids) which are currently under-utilised.**
5) **Expands manufacturing footprint in the US, which is important looking at rising impetus on local manufacturing in the US.**
6) **Access to low-cost funding allows APL to generate earnings accretion from the transaction.**
7) **Existing EBITDA margins are strong and at par with company margins. The margins will deteriorate with incremental competition, but APL has two years lead to establish supply chain efficiencies and restructure existing operations**

Key challenges

1) **A large part of the oral solid portfolio is commoditised and has a median competitive intensity of seven players per molecule. Hence, it will be a challenge for APL to turn this around. 70% of US$900mn sales will be derived from the oral solids portfolio.**
2) **The dermatology portfolio is attractive now, but it is expected to decline every year as there is rising competitive intensity with every passing year. The pace of decline in the dermatology portfolio is the key uncertainty that APL has assumed through the transaction.**
3) **About one-fifth of the oral solids portfolio has two or less competitors and hence represents a potentially declining market.**
4) **APL's balance sheet will be significantly leveraged post acquisition (debt-to-equity ratio of 0.6-0.7).**

Federal Trade Commission (FTC)-related divestments: Out of 300 products acquired, we see APL having a presence in 50 of those molecules and hence these can potentially become candidates for divestment. The overlap exists entirely in oral solids and not in topicals.

Outlook and valuation: We have revised our earnings estimates for APL to include the recent acquisition (Sandoz portfolio and Apotex business in Europe). We assume transaction closure timeline as early FY20 for European operations of Apotex and Sandoz portfolio. Based on our revised EPS estimate for FY20 (Rs54), we have revised our target price for APL to Rs864 (from Rs764 earlier) which is based on 16x P/E multiple on FY20E earnings. We have also downgraded our rating on APL to Accumulate (from Buy earlier) as the stock price has run up sharply.

ACCUMULATE

Sector: Pharmaceuticals

CMP: Rs801

Target Price: Rs864

Upside: 8%

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Key Data

Current Shares O/S (mn)	585.9
Mkt Cap (Rsbn/US$bn)	469.2/6.5
52 Wk H / L (Rs)	827/527
Daily Vol. (3M NSE Avg.)	3,548,208

Price Performance (%)

	1 M	6 M	1 Yr
Aurobindo Pharma	31.1	35.2	8.4
Nifty Index	1.4	13.3	16.7

Source: Bloomberg

Exhibit 1: Key financials

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Net sales	1,39,552	1,50,899	1,64,998	1,75,629	2,56,511
EBITDA	31,881	34,343	37,885	38,263	57,345
Net profit	20,221	22,962	24,198	23,485	31,580
EPS (Rs)	34.6	39.3	41.4	40.1	54.0
EPS growth (%)	*28.5*	*13.7*	*5.3*	*(2.9)*	*34.4*
EBITDA margin (%)	*22.8*	*22.8*	*23.0*	*21.8*	*22.4*
P/E (x)	23.2	20.4	19.4	20.0	14.8
P/BV (x)	6.4	5.0	4.0	3.4	2.8
EV/EBITDA (x)	15.9	14.4	13.2	12.8	9.3
RoCE (%)	*39.5*	*35.4*	*28.1*	*23.3*	*19.8*
RoE (%)	*27.7*	*24.5*	*20.7*	*16.9*	*18.8*

Source: Company, Nirmal Bang Institutional Equities Research

Transaction details

APL has entered into a definitive agreement with the US-based Sandoz Inc. to acquire the latter's dermatology and oral solids businesses for an upfront purchase price of US$0.9bn in cash including potential upside in near-term earn-out and additional potential earn-out on the product pipeline in later years. The acquired businesses are expected to register sales amounting to US$900mn (12 months post deal closure) and margins in line with existing consolidated margins of APL. The acquisition gives APL access to 300 products (dermatology and oral solids). Around one-third of the acquired products are topical, while the rest are oral solids. In terms of value, 30% of the acquired product portfolio's sales come from dermatology products. FTC may require APL to divest certain products as a condition for deal closure. **Our analysis suggests that APL and Sandoz have an overlap in around 50 products, which are all oral solids and largely commoditised.** There is no overlap in topical portfolio. APL gains three manufacturing facilities at Hicksville - NY (Derma) Melville,- NY(Derma) Wilson and NC (OSD). All these facilities have significant under-utilised capacities.

Is the valuation attractive?

Apparently the deal appears to be a steal as it values the divested portfolio of products at 1x sales and 4-5x EBITDA, which is way below the acquisition multiples we have seen in the past. Lupin paid 9x sales for Gavis and Cipla paid 2.5x sales for Invagen. The deal was also well contested with several private equity players and a Chinese player also in the fray. While the valuation is attractive on the face of it, the acquired assets represent some challenges and the primary one being that the portfolio is expected to witness rising competitive intensity over time leading to deterioration of margins and rapidly declining sales. APL may look at managing the challenge through building supply chain efficiency and leveraging the assets it has secured for expanding the revenue stream. The potential reasons behind APL bidding more aggressively than the others could be its successful track record of turning around marginally profitable or loss-making assets. APL has traditionally been a volume player and it has the knack of executing a commoditised portfolio.

Will the margins sustain?

The margins of the acquired businesses will be comparable to existing business margins of APL (approximately 20%) in the first full year of operations post deal closure. The deal is expected to close in the next six to nine months. The manufacturing assets currently operate at lower capacity utilisation which when leveraged fully will aid margins. In addition it also gains access to a sales force which gives it access to health care practitioners who are responsible for a significant majority of prescriptions in the dermatology space. The branded presence may be leveraged for in-licensing brands and support in-house 505 (b) (2) efforts in dermatology.

Our net replacement value estimate suggests that valuation is fair

APL has acquired a portfolio comprising 300 products which include authorised generics, in-licensed assets and filed/approved ANDAs. Looking at the transaction from a net replacement value perspective, we find the valuation reasonable and should give APL the strength to compete even in a commoditised environment. The acquisition gives APL immediate access to 300 products, which otherwise would have taken it around 8-10 years to file (based on the historical filing trend) and a cumulative R&D expenditure of close to Rs40bn (US$600mn). In addition, it would have invested a similar amount as capex for setting up the manufacturing facilities.

Impact on APL's earnings performance

The deal will be significantly accretive in the first full year of operation itself. The acquired business will have EBITDA margin in line with existing consolidated margin. Competitive pressure is likely to increase with time and exert pressure on margins. While new competition will lead to margin pressure, APL has two years from now to start making efforts and restructure the operations to ensure that the business margins remain on track. We believe APL can sustainably enjoy 18%-20% EBITDA margin from the acquired businesses through gradual restructuring and building supply chain efficiency. We expect the cost of funding the acquisitions to be around 3% - 4%. We have factored in 24% EBITDA margin from the acquired businesses in FY20E, which should erode to 18% in FY21E.

Exhibit 2: Overlap of Sandoz and APL's product portfolios

Form	Route	Overlap with APL
Tablets	Oral	38
Tablets	Delayed release	1
Tablets	Extended release	-
Suspension	Oral	4
Suspension	Inhalation	-
Capsules	Oral	5
Capsules	Delayed release	1
Capsules	Extended release	-
Lotion, cream, ointment, gel	-	-
Injectable	-	4
Solution	-	1
Others	-	-
Total	**-**	**54**

Source: Medicaid, Nirmal Bang Institutional Equities Research

Exhibit 3: Change in estimates

(Rsmn)	New estimates		Old estimates		*Change (%)*	
	FY19E	FY20E	FY19E	FY20E	*FY19E*	*FY20E*
Net sales	1,75,629	2,56,511	1,76,780	1,85,054	*(0.7)*	*38.6*
EBITDA	38,263	57,345	40,105	40,315	*(4.6)*	*42.2*
Margin (%)	*21.8*	*22.4*	*21.4*	*19.7*	*39 bps*	*266 bps*
PAT	23,485	31,580	25,646	27,938	*(8.4)*	*13.0*
Margin (%)	*13.4*	*12.3*	*14.6*	*13.8*	*(123) bps*	*(149) bps*
EPS (Rs)	40.1	54.0	43.8	47.7	*(8.4)*	*13.0*

Source: Company, Nirmal Bang Institutional Equities Research

Financial statement

Exhibit 4: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Net sales	**1,39,552**	**1,50,899**	**1,64,998**	**1,75,629**	**2,56,511**
% growth	*15.1*	*8.1*	*9.3*	*6.4*	*46.1*
Raw material costs	61,621	64,343	67,527	72,654	1,07,510
Staff costs	15,426	17,678	21,308	23,652	35,520
R&D expenses	4,699	5,430	6,665	6,918	10,154
Other expenditure	25,925	29,106	31,612	34,141	45,981
Total expenditure	1,07,671	1,16,556	1,27,113	1,37,366	1,99,166
EBITDA	**31,881**	**34,343**	**37,885**	**38,263**	**57,345**
% growth	*24.4*	*7.7*	*10.3*	*1.0*	*49.9*
EBITDA margin (%)	*22.8*	*22.8*	*23.0*	*21.8*	*22.4*
Other income	2,038	1,159	1,020	1,540	2,003
Interest costs	2,567	667	777	1,182	4,421
Gross profit	77,931	86,556	97,471	1,02,975	1,49,000
% growth	*17.8*	*11.1*	*12.6*	*5.6*	*44.7*
Depreciation	3,924	4,276	5,580	6,473	11,911
PBT & exceptional items	**27,429**	**30,558**	**32,381**	**32,148**	**43,015**
Exceptional Items	-	-	-	900	1,000
Profit before tax	**27,429**	**30,558**	**32,381**	**31,248**	**42,015**
% growth	*26.5*	*11.4*	*6.0*	*(0.7)*	*33.8*
Tax	7,207	7,596	8,183	7,763	10,435
Effective tax rate (%)	*26.3*	*24.9*	*25.3*	*24.1*	*24.3*
Share of MI and associates	30	5	34	3	3
PAT after share of MI & associates	**20,251**	**22,967**	**24,232**	**23,488**	**31,582**
% growth	*28.7*	*13.6*	*5.4*	*(2.9)*	*34.5*
EPS (Rs)	34.6	39.3	41.4	40.1	54.0
% growth	*28.5*	*13.7*	*5.3*	*(2.9)*	*34.4*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Equity	585	586	586	586	586
Reserves	72,288	93,133	1,16,218	1,37,978	1,67,833
Net worth	72,873	93,719	1,16,804	1,38,564	1,68,419
Minority interest	26	21	18	18	18
Net deferred tax liabilities	240	493	2,353	2,353	2,353
Short-term loans	36,727	29,027	40,313	43,229	63,789
Long-term loans	7,428	1,814	4,512	4,061	72,255
Other non-current Liabilities	234	391	559	559	559
Liabilities	**1,17,527**	**1,25,465**	**1,64,559**	**1,88,784**	**3,07,392**
Net block	33,804	40,831	47,366	54,893	1,01,831
CWIP	8,359	12,374	13,995	14,995	15,995
Intangible assets & goodwill	8,115	9,715	19,676	19,676	19,676
Other non-current assets	5,980	7,514	8,136	8,136	8,136
Inventories	40,561	43,305	58,584	63,032	93,272
Debtors	46,067	27,653	30,844	32,864	48,232
Cash	8,003	5,135	12,616	25,033	72,730
Other current assets	8,313	15,968	19,835	19,835	19,835
Total current assets	1,02,944	92,062	1,21,879	1,40,763	2,34,068
Creditors	24,570	21,547	26,274	28,269	41,831
Other current liabilities	17,105	15,482	20,218	21,411	30,483
Total current liabilities	41,675	37,029	46,492	49,680	72,315
Net current assets	61,268	55,033	75,386	91,083	1,61,753
Total assets	**1,17,527**	**1,25,466**	**1,64,560**	**1,88,784**	**3,07,392**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Cash flow

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
EBIT	29,996	31,276	33,189	32,462	46,467
(Inc.)/dec. in working capital	(9,804)	3,367	(12,872)	(3,280)	(22,973)
Cash flow from operations	**20,191**	**34,643**	**20,318**	**29,181**	**23,495**
Other income	(2,038)	(1,159)	(1,020)	(1,540)	(2,003)
Other expenses	238	253	1,860	900	1,000
Depreciation	3,924	4,276	5,580	6,473	11,911
Tax paid (-)	(7,207)	(7,596)	(8,183)	(7,763)	(10,435)
Net cash from operations	**15,108**	**30,417**	**18,554**	**27,251**	**23,968**
Capital expenditure (-)	(14,984)	(16,917)	(23,698)	(15,000)	(59,850)
Net cash after capex	**124**	**13,501**	**(5,144)**	**12,251**	**(35,882)**
Other investment activities	**1,170**	**(375)**	**398**	**1,540**	**2,003**
Cash from financial activities	**2,218**	**(15,994)**	**12,228**	**(1,374)**	**81,576**
Opening cash balance	4,491	8,003	5,135	12,616	25,033
Closing cash balance	8,003	5,134	12,616	25,033	72,730
Change in cash balance	3,512	(2,868)	7,482	12,417	47,697

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Key ratios

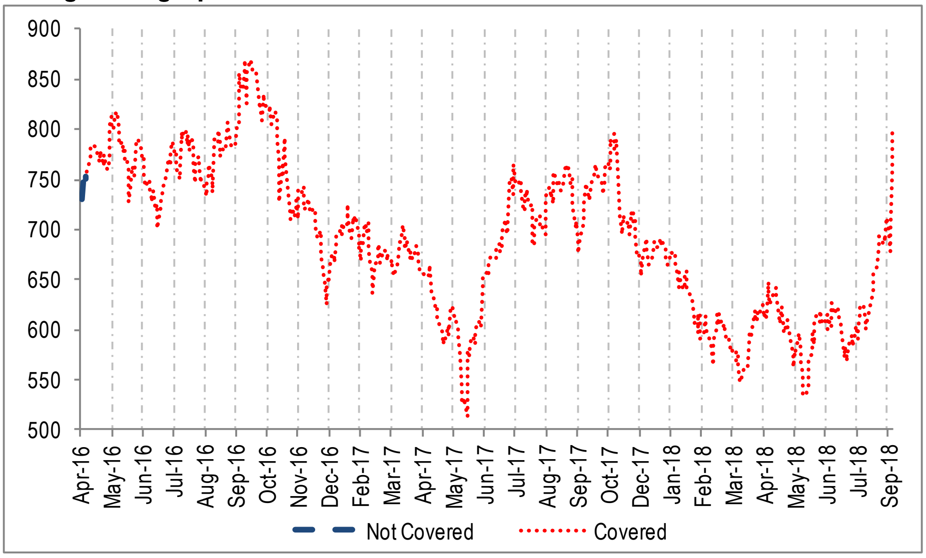
Y/E March	FY16	FY17	FY18	FY19E	FY20E
Profitability & return ratios					
EBITDA margin (%)	22.8	22.8	23.0	21.8	22.4
EBIT margin (%)	21.5	20.7	20.1	18.5	18.1
Net profit margin (%)	14.5	15.2	14.7	13.4	12.3
RoE (%)	27.7	24.5	20.7	16.9	18.8
RoCE (%)	39.5	35.4	28.1	23.3	19.8
Working capital & liquidity ratios					
Receivables (days)	106.5	89.2	64.7	66.2	57.7
Inventory (days)	226.7	237.9	275.4	305.5	265.3
Payables (days)	133.2	130.8	129.2	137.0	119.0
Current ratio (x)	2.5	2.5	2.6	2.8	3.2
Quick ratio (x)	1.5	1.3	1.4	1.6	1.9
Valuation ratios					
EV/sales (x)	3.6	3.3	3.0	2.8	2.1
EV/EBITDA (x)	15.9	14.4	13.2	12.8	9.3
P/E (x)	23.2	20.4	19.4	20.0	14.8
P/BV (x)	6.4	5.0	4.0	3.4	2.8

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
7 April 2016	Buy	746	894
31 May 2016	Buy	754	900
24 August 2016	Buy	737	900
17 November 2016	Buy	714	920
10 February 2017	Buy	679	920
31 May 2017	Buy	580	704
29 June 2017	Accumulate	675	704
19 July 2017	Accumulate	778	819
10 August 2017	Buy	685	819
10 November 2017	Accumulate	789	818
8 February 2017	Buy	616	792
29 May 2018	Buy	579	764
13 August 2018	Buy	610	764
10 September 2018	Accumulate	801	864

Rating track graph



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SELL < -5%

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