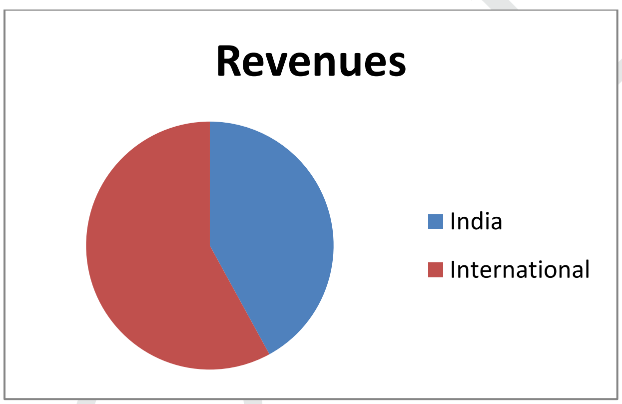
Alembic Pharma

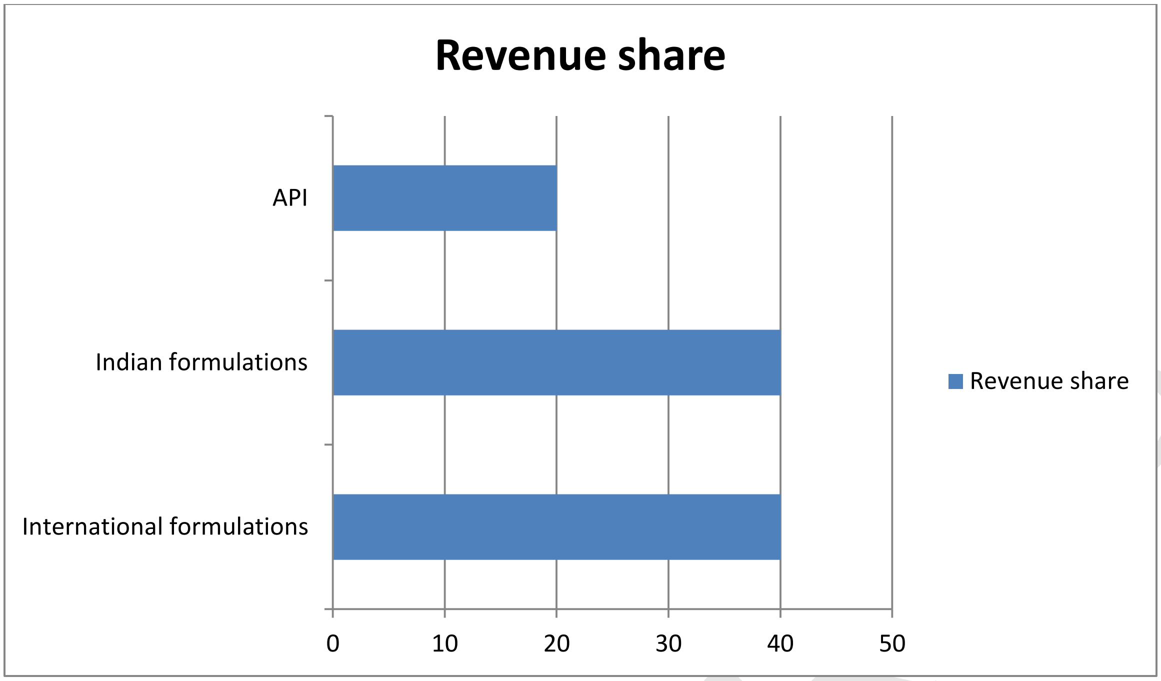
About the company: Alembic Pharma is a vertically integrated Pharma company in India with operations across the globe. The main business consists of formulations and API and FD, Over the years the company has transformed its business model from an acute therapy manufacturer to chronic therapy with higher margin products.

The company has 3 manufacturing units across Gujarat (USFDA approved) and 1 facility in Sikkim (Not approved USFDA site) the Sikkim plant had operated at a full capacity catering services to the domestic market as there is no USFDA approval for the facility . The company has been under scanner from the USFDA and has not received any form 483 as such which shows its strict adherence to the policies with international standards and thus provides a cushion among peers.

Business model of the company: The Company manufactures formulations, generics and API and has registered DMF facilities. The company caters to the domestic, Phamerging and regulated markets, The Company being a exporter derives 58% of the revenues from the international market and 42% from India



In this the share of USA stands at 74% and other markets stand at just 26% , The major revenues coming from the US market is a cause of concern for the company as it includes risk as well .



The company is mainly deriving revenues from 2 verticals the International formulations and Indian formulations.

Indian Formulations : In the domestic market the company sells formulations and the main focus remains on Cardiology , diabetes , Gynecology and Ophthalmology . The company's products consists of 40 brands and are manufactured in house at Sikkim facility which was fully operational in the year 2017 The company marketed throughout with a Pan India presence and has a field force of 3800 Medical representatives . The company this year has launches 40 products across SKU's .

International Generics: The companies main markets are USA , Europe , Canada , South Africa and Australia . The company has a front end team in the USA and have secures all the required regulatory clearance in the US. The company created a product basket of 29 and derived a 50mn$ revenue in 1st year of operations.

The company entered into a Joint Venture with a Algerian company ADWIYA MAMI SARL (one of largest distributors of pharma product in Algeria and possess a Oral formulation factory) the market size of Algerian market is US$ 3.4 bn out of which 70% revenues are from generics.

API : The 3 API units have successfully completed the USFDA audits the company had spent Capex to an additional growing business . The company has commissioned 2 new API blocks at Karkhadi and Panelav .

Pipeline of filed ANDA :

USA - The Company has filed 95 ANDA, 52 have been approved and 37 products have been launched. Which is considered to be the major market for the company.

Cumulative DMF filings - 84

Other major markets and filings :

Europe : Filings 21 , Approved - 18 , Product launches - 13 .

Canada : Filings -21, Approvals - 16 , Product launches -12 .

The company has set an ambitious target of filing 100 ANDA starting from 2018, Which we believe would pay off in 2 years after listing .

Research and Development: The company is very aggressive at research and believes in new product research would benefit the company in the long term, The company like its bigger player peers spends over 10% of its sales into Research. In the year 2017 the company has spent nearly 470 Crores in research.

There are 45 molecules in development stage and a 25% of the research activities are done by outsourcing. The company has made a Research and development investment of 1193 Crores for the past 5 years.

Management team :

The company is headed by **Chirayu Amin** - Chairman & CEO of Alembic Pharma and holds shares worth 2.4 % of the company and drives a salary of 25.93 Crores 3.56% on NP , This FY there was a -19.61 % increase in salary of Chirayu Amin .

The % increase in the median remuneration of the employees - 15.82% on a company payroll of 8825 employees.

Chirayu Amin holds directorship in 7 companies, and 13 committee membership.

Pranav Amin Managing director , alembic Pharma . He holds shares worth 0.54% of the company and draws a salary of 10.96 cr with an increase of 7.37% this FY .

Holds 2 other directorship in companies

Shaunak Amin , Managing director holds 0.53% of the company draws a salary of 10.96Cr with an increase this FY of 8.02% holds directorship in other 3 companies

There are 23 entities / companies in total holding 72.68% of the company with Shreno ltd holding major - 9.74% and Whitefield chemtech - 9.7% as of date march 2017.

Related Party Transactions: Related party transactions is of a great concern to minority shareholders as management give orders, purchase products, gives loans to related party or associate companies which may be fatal to the balance sheet of the parent company if not impacting in large amount but the overall transactions calculated in 5 years period or 10 years can have a huge impact on the reserves of the company.

Purchase of fixed assets from associates for 2.93 cr, The value of the deal is not precisely known and as to what sort of assets is not clearly provided

There is a Rent paid to associates of 5.67 Crores up from previous year of 3.70 not known if the company has taken up any new rental facility if not the jump of the rent is not justifiable .

Dividend paid of 50 Crores? Can be to the companies holding shares in the company as mentioned earlier the company has totally 23 entities invested and a promoter holding of 72 .68%

The promoters relative are receiving dividends more than 10% individually , As mentioned Smt Malikka amin received a dividend of 1.20Cr , SHri Udit Amin 0.40CR Ms Yera Amin 0.43% , others 0.63%

Outstanding balances from creditors at 13.79 CR , Deposits given 9.5r Cr , Debtors balance of 3.55 Cr . Outstanding amounts from related party

The company is having a Cash balance of 153 Cr and an Interest income of just 0.92 Lakhs which is looking a bit weird, even with a 5% interest rate it should be earning more than specified.

The company has a total permanent employee base of 8825 and employee benefit expense accounts 557 Crores, We get a per employee cost of 630000 /Yr need more clarity on this part of the P&L account. Out of 527 Crores only 18.72 is paid as Provision towards provident fund and 11.79 towards staff welfare expenses.

Financials: In this section I have dealt with Pharma Company differently as Pharma companies are different from their other regular manufacturing counterparts who do not involve into much of Research and development and moreover the sector too being a little complicated. I have used a 3 module valuation where on the

1. Cash flow and Balance sheet view of the company

2. Working capital and ratio analysis
3. Private market value or a VC based valuation

Balance sheet view and Cash flow analysis of the company

Revenue growth - 5 Year CAGR 16.42%

Profit growth - 5 Year CAGR 25.38 %

ROE - 5 year CAGR 38.5 %

The company's revenues have been growing steadily YOY along with good return Ratios. The company spends money for Research and development which may suppress the bottom-line in the short term but when everything goes well the pay offs are good.

C**ash Flows analysis:** The Cash flows is a very important parameter in a Pharmaceutical company where we would want to know if its facing financing troubles or able to collect cash .

The company has been generating good Free Cash flows . The company makes a 10% + spend on Research and development expense and post which the company has been able to generate free cash flows , We will see some very important Cash flow ratios in the next part to see its Cash flow ability. There was a Capex for near 900 Cr this year which was funded by internal accruals and reduced cash balances.

The company made a 525 Cr PBT and a Operating Cash flow of 406 Cr before taxes which means the company has been able to recover 77% of its Cash without too much getting stuck in the Working capital

Balance sheet Strength:

Reserves - 31,163 Cr

Long term Borrowing - company is Debt free .

Cash holdings - 153 Cr. Which I feel is ample to run its operations, There was a previous 439 Cr which major part was used to fund the capex.

Company has a WIP of 369 Crores until which the estimated project to finish and profits to start flowing from 2 + years after the commissioning, until which Losses are magnified and depreciation costs would be higher which would suppress earnings.

The company has made investments in associates and JV partners to a tune of total around 50 cr .

The 2017 balance sheet looks clear and has reduced cash from the books due to capex being made with a gloomy and cloudy environment for the Pharma companies and global challenges and domestic pricing issues I think we would need another 2 years to 3 to see the capex to start producing a stream of revenues for the company

Working capital and Ratio Analysis Valuation:

The idea behind WC and Ratio analysis is to see how the operational functions of the company are , We will not be very certain to predict the cash flows of the company and other models of valuing (DCF , EPV) the company would be misleading according to me . Cash conversion is another way to gauge the power of suppliers.

Cash conversion cycle

Average cash conversion cycle is - 64 days (average of 5 previous years)

Peers Cash conversion cycle: Sun pharma - 160 days, Natco pharma - 200 days +

Cadila health care - 90 days. Lupin - 120 days + days

Most of large cap peers are having a higher cash conversion cycle when compared to alembic pharma which can be a reason that 77% of the PBT are converted into cash which is a good sign of Buyers Power.

Without much cash getting stuck in the Working capital Alembic is able to convert most of its Profits to cash which is a healthy sign for any company.

Ratio analysis: There is no specific model to do a valuation but a valuation method should handle valuation as to minimize errors and thus ratio analysis shows us the exact quantitative factors in a company's operations. These are some important ratios I use when valuing companies.

Margins analysis:

OPM margins have been steady around average 18% leaving one year 2016 where the margins were 29.6 % that is because the company's Day one launch of drug gAbilify which boosted margins and revenues It's a o one off event which should not be considered

Net margins - The net margins have been steady around 12-16% except for the previous year which was high.

The margins being steady implies that we do not see much of a volatility in its Raw materials and other costs and the company is maintaining margins which seems to be a good parameter.

Debt / Equity Ratio - Nil

I**nterest coverage ratio** - No debt taken this is a very important parameter to check the debt servicing capacity of the company.

Fixed Asset Turnover ratio - 3.2 times the ratio is used to gauge the sales derived with the amount of assets used, the higher the ratio the better. When a company plans to double sales with asset turnover of 1 then it would require additional assets to produce the sales whereas the company with a 2 times ratio would require lesser of the assets to produce higher sales .

Inventory Turnover- 1.5 times The higher the inventory turnover ratio the better as to a company's WC cycle and shows Alembic is able to have a good CCC .

FCF / Sales - 8% One of our most sort ratios to analyze the companies Cash flows A company with 5% > in is a cash cow shows how much sales the company is converting as cash flows .

Cash conversion cycle : This parameter contains another 3 important ratios

1. Receivables turnover
2. Inventory turnover
3. Payables turnover

As discussed earlier the company with all 3 has a average 60 days .

P/E ratio - 23 times The company growing at more than 20% looks reasonable P/E as Pharma is a defensive sector and not much cyclical .

P/Cash flows : The company is available at 10 times cash flows from peers such as Sun Pharma - 19 x cash flows , Cadila - 26.5 x , Natco Pharma - 165 x on this parameter peer basis it looks cheap and anything below 10 x looks attractive in a pharma sector .

Return Ratios

ROE - 23% FY 2017

Return on invested capital - 5 year average 33% , Incremental capital invested into the company at this rate would be great . If a company invests excess cash at 33% then I would better avoid being paid dividends then to grow my capital .

With dividend payout ratio at around 18%, 82% being invested at a higher return is a good option.

With the above ratio analysis the company seems to be growing well with good return ratios, the company creates value only when its Return on capital is higher than Cost of capital. So with peer valuations too the company seems to be cheaper.

My estimate would be if the capex starts to pay off in 3 years and then FCF would improve which in turn can expand earnings with growth. Thus I have a 3 + long years view on the company, once when the company finishes all the major capex then I feel the P/CF would be well above the present 10 x , When FCF starts to pay off the company would be re-rated and P/E to expand.

The present earnings being 403.16 Cr , We are positive that the earnings can expand with higher sales growth after a more clear picture emerges from the US regulations and domestic pricing issues .

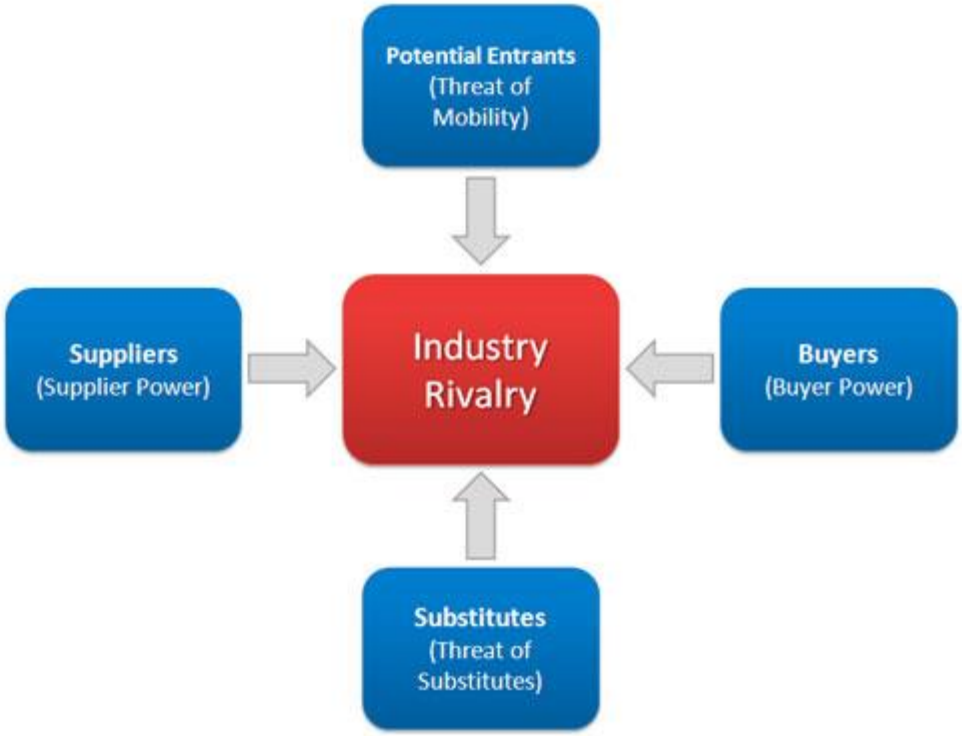
The company has a good streamline of ANDA to be filed and has moved away from acute therapy to chronic therapy and have invested in R&D niche products

On a absolute basis the company can be valued and earnings to be 30 Per share of earnings with a P/E of 30 the stock per share price can be around 900 .

Private Buy Out

What will a private investor payout for a Large-Cap pharma company?

The company's operations and revenues are mainly in the US and derive major revenues.



When a company is being taken over, If we were to be a private investor in the company buying the full company what would we expect a basic model we is Porters 5 forces use to value a company's competitive advantage .

Competition in the industry : The company where it operates is highly competitive , Being a generic company the company does not have any strong MOAT as to safe guard its revenue stream as competition is very high in the industry. It's an ultimate "Winners take it all "

Potential entrants: The company is in a field which has a very high regulations and norms as it deals with drugs , Alembic pharma is a Large cap company with 10,000 Cr Mcap , A company to enter and to replicate the same would need very huge capital expenditure and Know-how including all the years of Research expertise . Yet we cannot certainly say there will be no entrants but there can be but with high gestation period the sector already being too competitive currently.

Buyer Power: The company sells products to distributors in US , India and through direct sales channels as it has a good field force , Currently in US the Generics wholesalers have been consolidating and thus I think there is purchase power to the buyers of the product which too is a sign of weak competitive advantage.

Substitutes Threat of substitutes : Pharma companies are highly regulated yet there are substitute players which we call un-organized or the ones without licensing who make drugs without any regulations and another threat is peers , A generic company as name suggests does not have that special advantage like an innovator company who have drugs patented for a number of years and thus can expect a steady stream of cash flows , *Generics are called Copy cats* who make drugs after the patent is expired so once when patent goes off any company having the specific formula and license to manufacture a generic can launch the product which drives prices of the drugs very low. Ex: Paracetamol, Almost most of the companies make this product so sales depend on prices and incentives to Doctors and Chemists and drug store. This is a potential threat to a generic company.

Supplier Power: Raw materials mainly constitute of chemicals and other drug making substance where the company is captively consuming formulations that goes into Finished dosages , Hence supplier power does not affect too much .

Valuations to buy Alembic Pharma as a Pvt buyer :

Private market value can be termed as "Intrinsic value + Premium for control "

Market cap - 9300 Cr*

Enterprise Value - 9258 CR (No debt)

Earnings - 406 Cr

Capitalization rate for Alembic pharma - 4.35% What the company as a whole is yielding.

Enterprise value / EBITDA - 15 x (Sun pharma - 20 x , Lupin - 16 X)

Drugs approved & Drugs in pipeline -52, 95 has been filed till date and gAbilify was a day 1 launch and a star drug where the company netted 400 Crores in Year 2016 in that particular drug , We don't know the exact investment into that drug.

The company has identified and mentioned that it would be filing 100 ANDA from year 2018, The capex for plants already been made up to 900 Cr , These molecules once when launched will be the revenue driver for the company .

Like any other company selling a product, Pharma companies products are its molecules and finished dosages, thus each molecule has a sale value and a market sale, Oncology molecules have higher margins then lifestyle related molecules Alembic is having said to develop complex molecules in Oncology space.

We cannot obtain full information to individual molecules in ANDA filed by the company thus a little difficult in estimating the exact revenues. We go by DMF filed by the company as to which molecules the company intends to manufacture. Some drugs which are blockbuster can be obtained in this from USFDA Site

Example: Drug named ARIPIPRAZOLE , The drug has been Patented by **OTSUKA** , The company has 209 patents for the drug in different specifications and variations , Patent expired on October 20 2014 post which the generic version was launched and Alembic Pharma was able to launch it day 1 which had given a boost to the topline and bottom-line of the company . Other companies too like Sun pharma received tentative approvals but denied ANDA due to USFDA regulatory reasons.

Companies with more ANDA will set to benefit as Blockbuster molecules like gAbilify can boost the company's revenues. These are more like Odd events some drug gives 1:5 odds and some 1:2 odds so more ANDA by a company the higher the cushion or MOS . Research and expense costs are SUNK COSTS which we have to live with when investing in a pharma company.

So large pharma companies like (Alembic, Sun , Lupin) have sustainable cash flows to keep filing ANDA and invest in research for a blockbuster molecule as some blockbuster drugs will be a huge payoff to the companies. So alembic pharma is a one such company.

The sales are expected to increase with number of Pipeline of drugs after receiving necessary approvals, expecting steady Cash flows in the future.

Free cash flows - 850 Cr in 5 years (With revenue growth and a reasonable capex expected cash flows)

With a P/S ratio of 10 times the stock would be worth 750 + * (Calculated on a Operating Cash flow basis)

Enterprise value : On an absolute basis the company worth 9300 Cr and with a capitalization rate of 4.35% with much risk involved in future as to the uncertainty in its Research developments paying off . The company has Intangible assets worth 27 Cr which is negligible.

We believe the ANDA pipeline is getting robust and from 2018 the company intends to file more ANDA and its developing NCE in Oncology which is a very Niche space and if goes through can be a rewarding payoff.

Conclusion:

With a 9300 Cr value currently and certain headwinds with USA regulators and Indian pricing authority (3 large brands of alembic included in price cut) the company can have de-growth in the near term as to revenues under pressure and margins affecting due to R&D expenses .

Believing that Major news is still to be factored and discounted into the stock price, So there can be a potential downside when all news factors in thus we hold as a private player to buy.

9300 Cr with a lower capitalization rate seems irrational investment in terms of opportunity cost but revenues, Cash flows, Margins are set to improve from 2019 being a private buyer I would asses that an EV of 7500 Cr to 8000 Cr would build in a Margin of safety as to more Headwinds in near future . On a EV/EBITDA basis too I feel 15x a bit expensive.

End of report

*This report is prepared by **Ragavendhra Perumall, Independent Investor** as part of internal study for our company Qualtrus Investments (Registration in process)*

The report is for educative purpose and not a recommendation to BUY/SELL

Disclaimer: I am not registered with SEBI, Applied for RA

Please consult your investment advisor before taking any action

Sources of inputs :

Annual reports of Alembic pharma, Con call transcript of Alembic pharma

Sun pharma, Morningstar.in, Screener.in, Pharmacompass.com, Orange book USFDA

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