

## Alkem Laboratories

### IPO Note – Valuation provides little comfort

Alkem Laboratories (Alkem) is among the largest companies in the Indian formulation market, having a market share of 3.6%. The company is the fifth largest pharmaceutical company in India by domestic sales. Currently, domestic markets constitute around 75% of its sales; while in terms of exports, the company is at a relatively nascent stage vis-a-vis its peers. In exports (predominately US), the company is expanding through both the inorganic and the organic route. Alkem has 16 manufacturing units, 14 in India and 2 in the US; of which, 5 are USFDA, TGA and UK-MHRA approved.

**Established Market Leadership in Domestic formulation market:** Alkem is one of India's leading pharmaceutical companies in the domestic formulation market. Domestic formulations constitute around ~75% of the company's overall sales. The company ranks fifth in the Indian pharmaceutical market. Its most significant therapeutic areas accounted for 80.7% of its total sales in the domestic market in FY2015. Its revenues from domestic operations grew at a CAGR of 17.6% over FY2011 to FY2015.

**Expanding in export markets:** Although a late entrant in the export markets, ~25% of Alkem's sales are contributed by exports. The company has expanded internationally through organic growth and through certain strategic acquisitions. The US market is its key focus market (accounting for ~70% of its exports) in terms of its international operations. The revenues from its international operations have grown at a CAGR of 45.7% between FY2011 and FY2015. The contribution of revenues from international operations to overall revenues has grown from 12.6% in FY2011 to 25.3% FY2015.

**Outlook and Valuation:** In our view, the company is comparable only to mid-cap companies like IPCA Laboratories (IPCA) in terms of size and profitability. While the company is growing at a robust pace of >20%, its low profitability is a cause of concern. Also, a major part of the profitability is being accrued from other income and aided by low taxation. On an average, the company's other income accounts for around ~30-35% of PBT, while tax as % of PBT has been at 5% levels over the years. Thus, on a like-to-like basis IPCA has a more superior business quality and we therefore believe that Alkem should trade at a discount to companies like IPCA Labs. Adjusting for other income, the PE of Alkem stands at 17.3x-17.8x its FY2016E earnings and 3.3x-3.4x its FY2016E P/BV (at the lower and upper end of the price band respectively). We believe that the valuation leaves little scope for further appreciation in the stock price in the near term. Hence, **we recommend an "Avoid" on the issue.**

#### Key Financials

Y/E March (₹ cr)	FY2013	FY2014	FY2015	FY2016E
<b>Net Sales</b>	<b>2,417</b>	<b>3,033</b>	<b>3,701</b>	<b>4,960</b>
% chg	22.5	25.5	22.0	34.0
<b>Net Profit</b>	<b>384</b>	<b>436</b>	<b>463</b>	<b>785</b>
% chg	(5.7)	13.6	6.3	69.5
OPM (%)	32.1	36.4	38.7	65.6
<b>EPS (₹)</b>	<b>11.8</b>	<b>10.5</b>	<b>10.8</b>	<b>15.5</b>
P/E (x)	32.7	28.8	27.1	16.0
P/BV (x)	19.2	18.3	16.6	23.4
RoE (%)	9.7	9.1	10.0	17.4
EV/Sales (x)	5.8	4.9	4.2	3.4
EV/EBITDA (x)	4.8	4.0	3.1	2.3

Source: Company, Angel Research; Note: \*EPS and other valuation parameters is based on upper price band

## AVOID

Issue Open: December 8, 2015  
 Issue Close: December 10, 2015

#### Issue Details

Face Value: ₹2

Present Eq. Paid up Capital: ₹239cr

Offer Sale: 1.28cr Shares

Post Eq. Paid up Capital: ₹239cr

Issue (amount): ₹1,311-1,350cr

Price Band: ₹1020-1050

Post-issue implied mkt. cap ₹12,196cr\*-  
 12,554cr\*\*

Note: \*at Lower price band and \*\*Upper price band

#### Book Building

QIBs	50%
Non-Institutional	15%
Retail	35%

#### Post Issue Shareholding Pattern(%)

Promoters Group	66.2
MF/Banks/Indian Fls/FIIs/Public & Others	33.8

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## Company background

Established in 1973 in Patna, Alkem is present in acute and chronic therapeutic segments. The company has extensive brand share in therapeutic areas in domestic market in anti-infectives, gastro-intestinal, pain and analgesics, and vitamins, minerals and nutrients. These therapeutic areas accounted for 80.7% of the company's total sales in the domestic market in FY2015. It has a portfolio of 800 brands and has 14 manufacturing facilities across 7 locations in India and 2 in the US. For FY2015, Alkem was the fifth largest pharmaceutical company in India by domestic sales. In the US, it has filed 69 abbreviated new drug applications (ANDAs; of which 21 have received final approval and 30 are Para-IV including first-to-file [FTF]).

Alkem has also expanded through the inorganic route, having acquired Ascend in July 2010, which provided it with the commercial platform for the world's largest drug market, the US. Further, in December 2012, it acquired manufacturing assets from Norac Inc in the US, focused primarily on manufacturing specialty active pharmaceutical ingredients (APIs) and providing contract research and manufacturing services. Earlier in June 2009, it had acquired a majority stake in Pharmacor Pty Ltd to enter the Australian market. Pharmacor targets individual pharmacies, pharmacy groups, pharmacy co-ops, aged care and hospitals to offer prescription drugs and over-the-counter generic medicines. Two months ago, it acquired a formulation manufacturing facility from Long Pharmaceuticals LLC in the US that has semi-solids, liquid and nasal formulation manufacturing capabilities.

### Issue details

Alkem is coming out with an initial public offering (IPO) to raise ₹1,311-1,350cr from the equity market at a price band of ₹1,020-1,050/equity share. Through the IPO, the company proposes to offer 1.29cr equity shares for sale by promoter and other selling shareholders. Since the offer is being made through offer for sale, the proceeds from the offer will be remitted to the respective shareholders. The company will not receive any proceeds from the offer.

### Exhibit 1: Shareholding pattern

Particulars	Pre-Issue		Post-Issue	
	No. of shares	(%)	No. of shares	(%)
Promoter group	84,735,715.5	70.87	79,187,899.5	66.23
Others	34,829,284.5	29.13	40,377,100.5	33.77
Total	119,565,000	100.0	119,565,000	100.0

Source: Company, Angel Research

## Key investment rationale

### Established Market Leadership in Indian markets

Alkem is one of India's leading pharmaceutical companies in the domestic formulations markets; domestic formulations constitute around ~75% of its overall sales. The company's most significant therapeutic areas in the domestic market are anti-infectives, gastro-intestinal, pain and analgesics, and vitamins, minerals and

nutrients. These therapeutic areas accounted for 80.7% of its total sales in the domestic market for FY2015. In these categories, the company has a leadership position, ie the company has a market share of 11.2% in anti-infectives, and is ranked third in terms of market share for both the gastro-intestinal (with a market share of 5.6%) and pain/analgesics (with a market share of 5.0%) therapeutic areas. The top 20 brands of the company account for around 55% of its domestic revenues. Alkem has a strong marketing and distribution network in India comprising of a field force of 5,856 medical representatives.

According to IMS Health, the company was the third-fastest growing company in terms of sales during FY2011-15 and is among the ten largest pharmaceutical companies in the Indian domestic formulations market. The net revenues from the company's domestic operations grew at a CAGR of 17.6% over FY2011 to FY2015.

### **Expanding in Export markets**

Although a late entrant in the exports market, exports now account for ~25% of Alkem's sales. Alkem has expanded internationally through both organic growth and through certain strategic acquisitions. The US market is the key focus market (accounting for ~70% of its exports) for its international operations. It markets and sells products in the US under the brand name Ascend to major pharmacy chains' stores, wholesalers, managed care companies, distributors, food and grocery stores and pharmaceutical retailers. Ascend currently sells 17 products in the market, out of which 12 are its own products and 5 are in-licensed from third parties. The revenues from its international operations have grown at a CAGR of 45.7% between FY2011 and FY2015. The contribution of net revenues from international operations to overall revenues has grown from 12.6% in FY2011 to 25.3% in 2015.

The company's largest facility servicing the US market is in Daman, which was last inspected by the USFDA in 2013. Another US servicing facility in Baddi has received Establishment Inspection Report in Oct-Nov 2015, which means it can continue supplying to the US market. Overall the company has three USFDA approved facilities in India and two in the US.

### **Research and development skills**

Alkem has employed 483 scientists working on various drug products and substances in India and the US. The research and development department carries out process development, formulation development and analytical research for domestic and international markets. The company has a strong pipeline of products under development for its focused markets. It has a robust ANDA pipeline with cumulative filing of 69, with 45 ANDAs pending for approval. Alkem has 30 para IV filings which include FTFs as well. The company spent 4.5% of its net sales towards R&D in FY2015.

## Valuation

Alkem is valued at a P/E multiple of 15.5x-16.0x its FY2016E EPS at the lower and upper ends of the price band, respectively. In our view, the company is comparable only to mid-cap companies like IPCA in terms of size and profitability. However the profitability of the company in the recent past has been subject to variations owing to its investments in infrastructure and building man power in Indian markets. This is evident from the OPM of the company coming in at 10.8% in FY2015 from 16.9% in FY2013 and the ROE consequently dropping from 22.4% in FY2013 to 16.6% in FY2015. However, 1HFY2016 has seen a recovery in the operating performance with the OPM expanding to 16.5%, thus moving back to earlier levels.

The growth of the company is robust at >20%, while its low profitability in the recent past is a cause of concern. Also, a major part of the company's profitability is being accrued by other income and low taxation. On an average, the company has other income of around ~30-35% of PBT, while tax as % of PBT has been at 5%. Thus, on a like -to-like basis, IPCA, which in our coverage is the closest comparison, has a more superior business quality. Thus we would like to get more comfort on profitability improvement and sustenance of the same for Alkem. We believe that the stock should trade at a discount to companies like IPCA Labs( which trade at 18x one year forward normalized earnings). Adjusting for other income, we believe that the PE of the company is 17.3x-17.8x its FY2016E earnings and 3.3x-3.4x its FY2016E P/BV (at the upper and lower end of the price band respectively). We believe that the valuation leaves little scope for further appreciation in the stock price in the near term.

Hence, **we recommend an "Avoid" on the issue.** Investors could consider waiting for a possible correction in the stock price post the listing of the IPO.

## Risks for the company

- Any adverse outcome of inspection of the USFDA approved sites could affect the financials of the company and hamper future growth and profitability.
- Domestic formulations constitute 75% of total sales, with Alkem's top 20 brands accounting for 55% of domestic sales. Thus, inclusion of its key brands under NLEM could severely impact its revenues and profitability.

**Consolidated Profit & Loss Statement**

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E
Gross sales	2,028	2,497	3,138	3,818	5,140
Less: Excise duty	55	80	105	117	180
Net sales	1,973	2,417	3,033	3,701	4,960
Other operating income	187.9	245.1	258.1	268.3	268.3
<b>Total operating income</b>	<b>2,161</b>	<b>2,662</b>	<b>3,291</b>	<b>3,970</b>	<b>5,228</b>
% chg	19.2	23.2	23.6	20.6	31.7
Total expenditure	1,640	2,133	2,716	3,302	4,193
Net raw materials	834	1,056	1,386	1,691	1,977
Personnel	303	412	532	638	853
Other	503	665	799	974	1,363
<b>EBITDA</b>	<b>333</b>	<b>285</b>	<b>317</b>	<b>400</b>	<b>767</b>
(% of Net Sales)	16.9	11.8	10.5	10.8	15.5
Depreciation & amortisation	29	40	52	70	82
Interest & other charges	58	88	93	81	81
Other income	0	-	0	0	-
(% of PBT)	0	-	0	0	-
Share in profit of Associates	-	-	-	-	-
<b>Recurring PBT</b>	<b>434</b>	<b>402</b>	<b>430</b>	<b>517</b>	<b>872</b>
% chg					
Extraordinary expense/(Inc.)	-	-	-	-	-
<b>PBT (reported)</b>	<b>434</b>	<b>402</b>	<b>430</b>	<b>517</b>	<b>872</b>
Tax	28	18	(5)	54	87
(% of PBT)	6.3	4.5	(1.3)	10.5	10.0
<b>PAT (reported)</b>	<b>406</b>	<b>384</b>	<b>436</b>	<b>463</b>	<b>785</b>
Add: Share of earnings of asso.	-	-	-	-	-
Less: Minority interest (MI)	(1)	-	-	-	-
Prior period items	-	-	-	-	-
<b>PAT after MI (reported)</b>	<b>407</b>	<b>384</b>	<b>436</b>	<b>463</b>	<b>785</b>
<b>ADJ. PAT</b>	<b>407</b>	<b>384</b>	<b>436</b>	<b>463</b>	<b>785</b>
% chg	37.5	(5.7)	13.6	6.3	69.5
(% of Net Sales)	20.6	15.9	14.4	12.5	15.8
<b>Basic EPS (₹)</b>	<b>34.0</b>	<b>32.1</b>	<b>36.4</b>	<b>38.7</b>	<b>65.6</b>
<b>Fully Diluted EPS (₹)</b>	<b>34.0</b>	<b>32.1</b>	<b>36.4</b>	<b>38.7</b>	<b>65.6</b>
% chg	37.5	(5.7)	13.6	6.3	69.5

Note: \*EPS calculation is based on Pre IPO outstanding shares

**Consolidated Balance Sheet**

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E
<b>SOURCES OF FUNDS</b>					
Equity share capital	12.0	12.0	12.0	23.9	23.9
Preference Capital	-	-	-	-	-
Reserves & surplus	1,802	2,160	2,567	2,971	3,699
<b>Shareholders funds</b>	<b>1,814</b>	<b>2,172</b>	<b>2,579</b>	<b>2,995</b>	<b>3,723</b>
Minority Interest	0.2			89.2	89.2
Other Long Term Liabilities	0.2	12.3	7.8	5.1	5.1
Long Term Provisions	185.2	49.5	47.4	71.7	71.7
Total loans	309	256	232	33	33.4
Deferred tax liability	33	47	39	90	90.1
<b>Total liabilities</b>	<b>2,342</b>	<b>2,536</b>	<b>2,906</b>	<b>3,285</b>	<b>3,924</b>
<b>APPLICATION OF FUNDS</b>					
Net block	674	896	980	1,143	1,261
Capital work-in-progress	-	-	-	-	-
Goodwill	245	176	190	342	342
Long Term Loans and Advances	259	339	418	542	542
<b>Investments</b>	<b>299</b>	<b>410</b>	<b>338</b>	<b>420</b>	<b>420</b>
Current assets	1,302	2,156	1,602	2,344	3,088
Cash	514	995	206	791	901
Loans & advances	97	133	126	130	282
Other	691	1,028	1,270	1,423	1,905
Current liabilities	1,114	1,735	1,406	2,012	2,403
<b>Net current assets</b>	<b>189</b>	<b>421</b>	<b>197</b>	<b>332</b>	<b>685</b>
Other non-current assets	677	293	783	506	675
<b>Total assets</b>	<b>2,342</b>	<b>2,536</b>	<b>2,906</b>	<b>3,285</b>	<b>3,924</b>

**Consolidated Cash Flow Statement**

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E
Profit before tax	434	402	430	517	872
Depreciation	29	40	52	70	82
(Inc)/Dec in Working Capital	(145)	(59)	(381)	102	(281)
Less: Other income	-	-	-	-	-
Direct taxes paid	31	18	(5)	54	87
<b>Cash Flow from Operations</b>	<b>287</b>	<b>364</b>	<b>107</b>	<b>635</b>	<b>586</b>
(Inc.)/Dec.in Fixed Assets	(248)	(110)	(93)	(816)	(150)
(Inc.)/Dec. in Investments	(261)	(111)	72	(82)	-
Other income	-	-	-	-	-
<b>Cash Flow from Investing</b>	<b>(509)</b>	<b>(221)</b>	<b>(21)</b>	<b>(898)</b>	<b>(150)</b>
Issue of Equity	-	-	-	-	-
Inc./(Dec.) in loans	10	(53)	(23)	(199)	-
Dividend Paid (Incl. Tax)	(21)	(52)	(32)	(57)	(57)
Others	224	443	(821)	1,103	(269)
<b>Cash Flow from Financing</b>	<b>213</b>	<b>338</b>	<b>(876)</b>	<b>847</b>	<b>(326)</b>
Inc./(Dec.) in Cash	(10)	482	(789)	584	110
<b>Opening Cash balances</b>	<b>524</b>	<b>514</b>	<b>995</b>	<b>206</b>	<b>791</b>
<b>Closing Cash balances</b>	<b>514</b>	<b>995</b>	<b>206</b>	<b>791</b>	<b>901</b>

### Key Ratios

Y/E March	FY2012	FY2013	FY2014	FY2015	FY2016E
<b>Valuation Ratio (x)</b>					
P/E (on FDEPS)	30.8	32.7	28.8	27.1	16.0
P/CEPS	28.8	29.6	25.7	23.5	14.5
P/BV	6.9	5.8	4.9	4.2	3.4
Dividend yield (%)	0.1	0.2	0.2	0.2	0.2
EV/Sales	6.2	4.8	4.0	3.1	2.3
EV/EBITDA	36.9	40.5	38.5	28.3	14.6
EV / Total Assets	5.2	4.5	4.2	3.4	2.9
<b>Per Share Data (₹)</b>					
EPS (Basic)	34.0	32.1	36.4	38.7	65.6
EPS (fully diluted)	34.0	32.1	36.4	38.7	65.6
Cash EPS	36.5	35.4	40.8	44.6	72.5
DPS	1.4	2.5	2.5	2.5	2.5
Book Value	151.8	181.7	215.8	250.5	311.4
<b>Returns (%)</b>					
ROCE (Pre-tax)	13.0	9.7	9.1	10.0	17.4
Angel ROIC (Pre-tax)	27.6	16.6	13.7	14.1	28.3
ROE	22.4	19.2	18.3	16.6	23.4
<b>Turnover ratios (x)</b>					
Asset Turnover (Gross Block)	4.8	5.1	5.3	3.7	3.4
Inventory / Sales (days)	40.4	36.0	32.0	31.9	28.1
Receivables (days)	33.9	29.6	28.1	29.2	24.3
Payables (days)	45.7	43.2	44.2	39.7	29.5
WC cycle (ex-cash) (days)	0.6	(61.6)	(32.4)	(21.6)	(23.6)
<b>Solvency ratios (x)</b>					
Net debt to equity	(0.1)	(0.3)	0.0	(0.3)	(0.2)
Net debt to EBITDA	(0.6)	(2.6)	0.1	(1.9)	(1.1)
Interest Coverage (EBIT / Int.)	5.2	2.8	2.8	4.1	8.4

Note: \*EPS and other valuation parameters is based on upper price band

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