

Laurus Labs Limited

IPO Note – Valuations expensive; Neutral

Laurus Labs is a Hyderabad based company engaged in manufacturing of Active Pharma Ingredients (API). Company derives 80% of its revenues from exports while rest comes from the domestic markets. Its client base features companies like Cipla, Natco, Mylan, etc. API is its largest segment which contributes 92% of the revenues while rest 8% comes from its Synthesis and Ingredients business.

Investment rationale – 1) Company operates its API business model with a niche focus on select therapeutic segments. This makes it a specialist API manufacturer in a few therapeutic segments. 2) Laurus intends to enter in the US market with its own products in FY2019E which is a right strategy considering most domestic pharma companies currently derive significant revenues from the US market. 3) Promoters strong entrepreneurial capability which is reflected in Laurus' top line CAGR of ~40% since inception 4) Company spends ~4-5% of sales on R&D which may see a healthy product pipeline in future.

Investment concerns – 1) Large portion (62%) of its business comes from supply of Anti Retroviral (ARV) APIs to pharma companies. These pharma companies receive contracts through competitive tenders every 3 years from govt. agencies and one of its customers (Aspen) has indicted of lower prices of ARV tenders. We believe that ARV is a volume based competitive business with no significant pricing power 2) Company has high client concentration risk with a top 10 and top 3 clients contributing 80% and 40% of revenues respectively. 3) Laurus operates a low margin business with high working capital requirement and low asset turnover ratio which has impacted its return ratios. 4) Its current capacity utilization is at ~70% and company is undertaking capex to add new API facility in CY2017 which may weaken its return ratios going ahead.

Valuations and outlook: On FY2016's PAT of ₹133.3cr, the issue, at its upper band, is priced at P/E of 32x which looks expensive. Accounting for FY2017E PAT, the valuation still looks high at P/E of 28x. We believe that this kind of valuation is commanded by domestic pharma companies who have branded formulations business, healthy product pipeline and strong return ratios. **Considering Laurus' 1) high client concentration, 2) low pricing power 3) asset heavy model and 4) high valuation, we rate this IPO as Neutral.**

Key Financials

| Y/E March (₹ cr) | FY2014 | FY2015 | FY2016 | 1HFY17 |
|-------------------|--------------|--------------|--------------|------------|
| Net Sales | 1,160 | 1,327 | 1,784 | 930 |
| % chg | | 14.4 | 34.5 | - |
| Net Profit | 97 | 68 | 133 | 77 |
| % chg | | (29.9) | 95.3 | - |
| OPM (%) | 18.0 | 15.1 | 20.9 | 21.2 |
| EPS (₹) | 9.8 | 6.9 | 13.4 | 7.6 |
| P/E (x) | 43.5 | 61.8 | 31.9 | - |
| P/BV (x) | 11.8 | 5.9 | 5.0 | - |
| RoE (%) | 27.1 | 9.4 | 15.6 | - |
| RoCE (%) | 20.5 | 9.5 | 15.6 | - |
| EV/Sales (x) | 4.1 | 3.7 | 2.9 | - |
| EV/EBITDA (x) | 22.5 | 24.5 | 13.8 | - |

Source: Company, Angel Research

NEUTRAL

Issue Open: December 06, 2016
 Issue Close: December 08, 2016

Issue Details

| |
|--|
| Face Value: ₹10 |
| Present Eq. Paid up Capital: ₹98.7cr (September 2016) |
| Offer for Sale: 2.41cr Shares |
| Fresh issue: *70.4 lakh -**70.1 lakh shares |
| Post Eq. Paid up Capital: ₹105.8cr |
| Issue size (amount): *₹1,327cr -**1,332 cr (Up to ₹12.5cr of this offer is reserved for employees) |
| Price Band: ₹426-428 |
| Lot Size: 35 shares and in multiple thereafter |
| Post-issue implied mkt. cap: *₹4,506.6cr - **₹4,526.4cr |
| Promoters holding Pre-Issue: 32.8% |
| Promoters holding Post-Issue: 30.6% |
| *Calculated on lower price band |
| ** Calculated on upper price band |

Book Building

| | |
|-------------------|--------------|
| QIBs | 50% of issue |
| Non-Institutional | 15% of issue |
| Retail | 35% of issue |

Post Issue Shareholding Pattern

| | |
|-----------------------------|------|
| Promoters Group | 30.6 |
| DII's/FII's/Public & Others | 69.4 |

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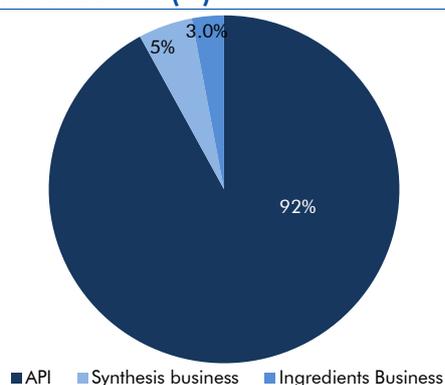
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Company background

Laurus Labs is an Active pharma ingredient (API) oriented leading research and development driven pharmaceutical company in India. Company sells its products in 32 countries and has 5 manufacturing capacities. Its clients are well known names from the pharma industry such as Aspen Pharmacare, Aurobindo Pharma, Cipla, Mylan, NATCO Pharma, Strides Shasun, etc. Top 10 / top 3 clients contribute 80% / 30% of total revenues. Company has four business segments namely Generics – APIs, Generics – FDFs (finished dosage forms), Synthesis and Ingredients. API business contributes 92% of total revenues while company is yet to record revenues in its FDF business. Synthesis business contributes 5% of total revenues and rest 3% come from Ingredients Business. In its API business, company has focus on Anti-retro Viral APIs (ARV), Oncology APIs (anti-cancer) and Hepatitis-C APIs.

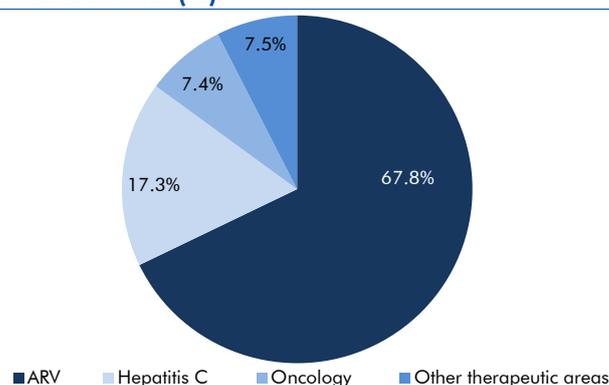
Company intends to move in formulations business and has made significant investments in new facilities for the same. It has filed 2 ANDAs and expects to generate revenues in the next two years (FY-2019E). Company currently operates kilo lab (capacity of 4.6KL) and three manufacturing facilities (aggregate capacity of 1,833.6 KL) in Visakhapatnam. Of these, 2 facilities manufacture APIs and ingredients and third facility manufactures APIs and FDFs. Company through acquisition of Sriam Labs, operates two other manufacturing facilities in Bibinagar and Visakhapatnam for the manufacturing of APIs and intermediates. Company is process of setting up two additional manufacturing facilities in Visakhapatnam of which one will operational in December 2016 while construction will begin at the other facility in CY2017.

Exhibit 1: Revenue mix (%)



Source: Company, Angel Research

Exhibit 2: API mix (%)



Source: Company, Angel Research

Issue details

Through this IPO, some existing shareholders (Aptuit, Bluewater, FIL Capital Management and Fidelity India Principals) are selling their stake in the company. Aptuit is selling its entire shareholding while other shareholders are selling their partial stake.

Company is also raising ₹300cr by selling fresh shares which will be used to repay its debt and for general corporate purpose.

Exhibit 3: Pre and Post-IPO shareholding of selling shareholders

| Selling shareholders | Pre-issue shares held | Percentage of pre-issue capital | Post issue | Percentage of post- issue capital |
|---------------------------|-----------------------|---------------------------------|------------|-----------------------------------|
| Aptuit | 9,040,240 | 9.15% | 0 | 0.00% |
| Bluewater | 29,989,596 | 30.37% | 20,989,596 | 19.85% |
| FIL Capital Management | 18,265,612 | 18.50% | 12,237,612 | 11.57% |
| Fidelity India Principals | 118,752 | 0.12% | 79,552 | 0.08% |
| Total | 57,414,200 | 58.14% | 33,306,760 | 31.49% |

Source: Company, Angel Research

Objects of the offer

- Achieve the benefits of listing of the equity shares on the stock exchanges
- Pre-payment of term loans
- General corporate purposes

Investment Rationale

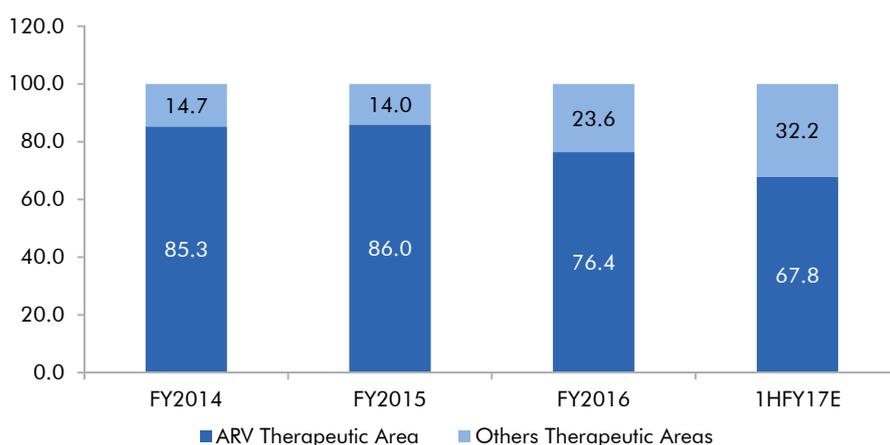
Operating in niche API segments: Laurus labs operates in a niche API segment with focus on Anti Retroviral (ARV), Hepatitis C and Oncology therapeutics segment. API segment contributes 92% of its total revenues. Within API segment, ARV is the largest segment which contributes 68% of the total API segment's revenues while rest of the segment revenues come from Hepatitis C and Oncology APIs.

ARV segment has shown a 2 year CAGR of 16% from FY2014-FY2016. This is mainly due to the increased Anti Retroviral therapies in the African region and increase in number of patients undergoing treatment. At the end of 2015, ~17 million people were receiving Anti Retroviral therapy of the total 36.7 million people living with HIV globally, representing approximately 46% of the total HIV population. Company believes that there are near term opportunities for the US and European markets.

The company also makes APIs for Hepatitis C which has exhibited strong growth rates. The prevalence of Hepatitis C is mostly seen in the South Asia and North Africa which makes nearly 80% of global Hepatitis C burden. Laurus has arrangement to manufacture and sell Hepatitis C APIs with NATCO, who commands a 38.5% share of the Indian Hepatitis C market. Company also has agreement with Gilead Sciences and Bristol-Myers for Hepatitis C API supply in the international markets.

In the Oncology API, its portfolio consists of 15 active DMFs and supplies Oncology APIs to global generic multinational pharmaceutical companies. Globally, Oncology is one of the largest therapeutic segments and is expected to grow ~7% to 8% between 2015 and 2020E to reach a value of US\$152 billion.

Exhibit 4: API business mix has changed over the years



Source: Company, Angel Research

Possible formulations foray, but too early to price in: Company intends to move in the formulations business and has started to research on possible ANDAs that it may file and launch in future. As of now, company has 2 ANDAs filed and it expects to receive USFDA approval in FY2018E and a possible launch in FY2019E. However, this in our opinion is too early to price in. We also believe that lot of Indian companies are already present in the USA with their own front ends and huge operational scale. We believe most pharma companies which entered in the US market have now moved towards complex products as low value ANDAs have seen huge competition and steep price erosion.

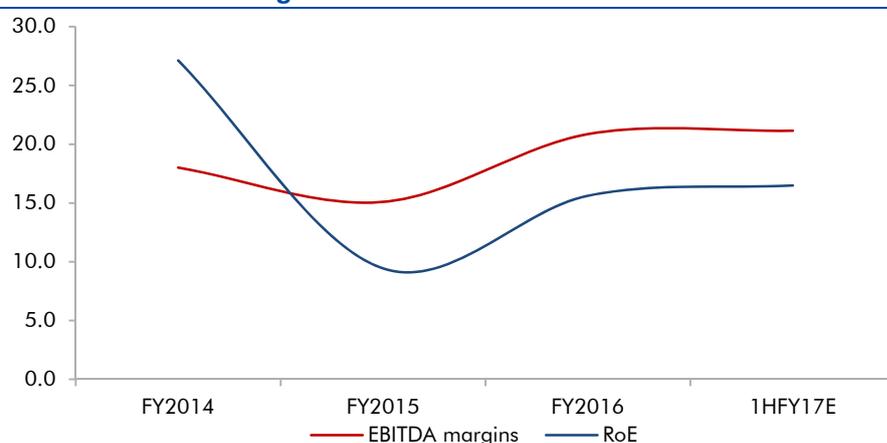
The company's one of the plant has recently undergone an USFDA audit and has received minor process related observation. While management believes that this can be resolved in few weeks, an escalation of the same may be negative for its US plans in near term.

High working capital requirement: Laurus has seen rise in its working capital cycle in last two years and the same has affected its return ratios. In FY2014 company's working capital cycle was ~110 days which increased to ~177 days in FY2016. Most of this has come due to the rise in the inventories. Company has said that the cycle is expected to remain at ~180 days going ahead. In our opinion, this is at an elevated level and may impact its future return ratios.

Recent financial performance: In the first half of the current fiscal, Laurus reported healthy set of numbers. In H1FY2017, Laurus reported ₹939.6cr in revenues vs. ₹1,783.8cr in FY2016. The raw material costs as percent of sales stood at 53.3% in H1FY2017 compared to 56.5% in FY2016 indicating decline in the input costs. EBITDA came in at ₹196.7cr and EBITDA margins were at 21.2% vs. 20.9% in FY2016. Its PAT stood at ₹75.1cr vs. ₹132.6cr in FY2016 indicating company reported strong profitability in the first half the current fiscal.

Overall, company has seen improvement in the profitability in the last three years with EBITDA margins moving from 18.0% in FY2014 to 21.2% in H1FY2017. Company indicates that ~20.0% EBITDA margin level is sustainable going ahead. Its return on equity stood at 27.1% in FY2014 but decline in FY2015 to 9.4% but has recovered to ~16% in H1FY2017.

Exhibit 5: EBITDA margins and RoE ratios since FY2014



Source: Company, Angel Research

Outlook and Valuation:

On FY2016's PAT of ₹133.3cr, the issue, at its upper band, is priced at P/E of 32x which looks expensive. Accounting for FY2017E PAT, the valuation still looks high at P/E of 28x. We believe that this kind of valuation is commanded by domestic pharma companies who have branded formulations business, healthy product pipeline and strong return ratios. **Considering Laurus' 1) high client concentration, 2) low pricing power 3) asset heavy model and 4) high valuation, we rate this IPO as Neutral.**

Upside risks

Early approval and launch of ANDAs: The increased momentum in the ANDA filing may be positive for the company as the company will be able to start its formulations business earlier than expected.

Improvement in working capital: If Laurus sees improvement in its working capital, return ratios will also improve accordingly. This will be positive for the company.

Income Statement

| Y/E March (₹ cr) | FY2014 | FY2015 | FY2016 | 1HFY17 |
|--------------------------------------|--------------|--------------|--------------|-------------|
| Total operating income | 1,160 | 1,327 | 1,784 | 930 |
| % chg | | 14.4 | 34.5 | |
| Total Expenditure | 951 | 1,126 | 1,412 | 733 |
| Cost of Materials | 726 | 828 | 1,008 | 495 |
| Personnel | 104 | 133 | 190 | 118 |
| Others Expenses | 121 | 165 | 214 | 120 |
| EBITDA | 209 | 200 | 372 | 197 |
| % chg | | (4.2) | 85.9 | (47.2) |
| (% of Net Sales) | 18.0 | 15.1 | 20.9 | 21.2 |
| Depreciation & Amortisation | 33 | 62 | 92 | 54 |
| EBIT | 176 | 139 | 280 | 143 |
| % chg | | (21.2) | 101.9 | |
| (% of Net Sales) | 15.2 | 10.5 | 15.7 | 15.4 |
| Interest & other Charges | 64 | 106 | 120 | 53 |
| Other Income | 9 | 34 | 8 | 12 |
| (% of PBT) | 7.3 | 51.2 | 4.5 | 11.9 |
| Share in profit of Associates | - | - | - | - |
| Recurring PBT | 121 | 67 | 168 | 102 |
| % chg | | (44.9) | 151.7 | |
| Prior Period & Extraord Exp./ (Inc.) | - | - | - | - |
| PBT (reported) | 121 | 67 | 168 | 102 |
| Tax | 24 | (2) | 35 | 26 |
| (% of PBT) | 19.6 | (2.3) | 20.6 | 25.2 |
| PAT (reported) | 97 | 68 | 133 | 76.6 |
| Add: Share of earnings of associate | - | 0 | (0) | (1.5) |
| Less: Minority interest (MI) | - | - | - | - |
| PAT after MI (reported) | 97 | 68 | 133 | 75 |
| ADJ. PAT | 97 | 68 | 133 | 75 |
| % chg | | (29.7) | 94.0 | |
| (% of Net Sales) | 8.4 | 5.2 | 7.4 | 8.1 |
| Basic EPS (₹) | 9.8 | 6.9 | 13.4 | 7.6 |
| Fully Diluted EPS (₹) | 9.8 | 6.9 | 13.4 | 7.6 |
| % chg | | (29.7) | 94.0 | |

Balance Sheet

| Y/E March (₹ cr) | FY2014 | FY2015 | FY2016 | 1HFY17 |
|-----------------------------|------------|--------------|--------------|--------------|
| SOURCES OF FUNDS | | | | |
| Equity Share Capital | 78 | 82 | 82 | 99 |
| Reserves & Surplus | 281 | 640 | 769 | 830 |
| Shareholders' Funds | 358 | 722 | 852 | 929 |
| Minority Interest | - | - | - | - |
| Total Loans | 500 | 735 | 942 | 859 |
| Deferred Tax Liability | 12 | 10 | 45 | 60 |
| Total Liabilities | 871 | 1,468 | 1,839 | 1,847 |
| APPLICATION OF FUNDS | | | | |
| Net Block | 494 | 795 | 1,079 | 1,052 |
| Intangible assets | 5 | 6 | 6 | 7 |
| Capital Work-in-Progress | 116 | 110 | 70 | 216 |
| Goodwill on consolidation | 0 | - | - | - |
| Long-term loans and adv. | 69 | 94 | 129 | 152 |
| Investments | - | 7 | 7 | 6 |
| Other non-current assets | 15 | 14 | 9 | 14 |
| Current Assets | 575 | 862 | 1,003 | 1,134 |
| Inventories | 328 | 475 | 487 | 521 |
| Sundry Debtors | 195 | 285 | 445 | 533 |
| Cash | 23 | 59 | 28 | 14 |
| Loans & Advances | 25 | 31 | 30 | 39 |
| Other Assets | 4 | 12 | 13 | 26 |
| Current liabilities | 403 | 421 | 464 | 733 |
| Net Current Assets | 172 | 442 | 539 | 401 |
| Deferred Tax Asset | - | - | - | - |
| Mis. Exp. not written off | - | - | - | - |
| Total Assets | 871 | 1,468 | 1,839 | 1,847 |

Cash Flow Statement

| Y/E March (₹ cr) | FY14 | FY15 | FY16 | 1H1FY17 |
|----------------------------------|--------------|--------------|--------------|--------------|
| Profit before tax | 121 | 67 | 168 | 102 |
| Depreciation | 33 | 62 | 92 | 54 |
| Change in Working Capital | (59) | (251) | (148) | (71) |
| Interest / Dividend (Net) | 48 | 84 | 101 | 47 |
| Direct taxes paid | (23) | (17) | (33) | (13) |
| Others | 2 | (9) | 13 | (1) |
| Cash Flow from Operations | 121 | (65) | 193 | 119 |
| (Inc.)/ Dec. in Fixed Assets | (309) | (383) | (337) | (177) |
| (Inc.)/ Dec. in Investments | (3) | (14) | 12 | 1 |
| Cash Flow from Investing | (312) | (397) | (325) | (176) |
| Issue of Equity | - | - | - | - |
| Inc./(Dec.) in loans | 250 | 274 | 205 | 97 |
| Finance costs | (51) | (84) | (103) | (47) |
| Others | 12 | 315 | 18 | 8 |
| Cash Flow from Financing | 211 | 505 | 120 | 58 |
| Inc./(Dec.) in Cash | 21 | 44 | (12) | 1 |
| Opening Cash balances | 3 | 15 | 40 | 13 |
| Closing Cash balances | 23 | 59 | 28 | 14 |

Key Ratios

| Y/E March | FY2014 | FY2015 | FY2016 |
|----------------------------|--------|--------|--------|
| Valuation Ratio (x) | | | |
| P/E (on FDEPS) | 43.5 | 61.8 | 31.9 |
| P/CEPS | 32.5 | 32.6 | 18.8 |
| P/BV | 11.8 | 5.9 | 5.0 |
| Dividend yield (%) | 0.0 | 0.0 | 0.0 |
| EV/Sales | 4.1 | 3.7 | 2.9 |
| EV/EBITDA | 22.5 | 24.5 | 13.8 |
| EV / Total Assets | 3.69 | 2.59 | 2.23 |
| Per Share Data (₹) | | | |
| EPS (Basic) | 9.8 | 6.9 | 13.4 |
| EPS (fully diluted) | 9.8 | 6.9 | 13.4 |
| Cash EPS | 13.2 | 13.1 | 22.8 |
| DPS | 0.0 | 0.0 | 0.0 |
| Book Value | 36.3 | 73.1 | 86.3 |
| Returns (%) | | | |
| ROCE | 20.5 | 9.5 | 15.6 |
| Angel ROIC (Pre-tax) | 21.1 | 10.0 | 15.9 |
| ROE | 27.1 | 9.5 | 15.6 |
| Turnover ratios (x) | | | |
| Asset Turnover (Net Block) | 2.3 | 1.7 | 1.7 |
| Inventory / Sales (days) | 165 | 210 | 176 |
| Receivables (days) | 61 | 78 | 91 |
| Payables (days) | 114 | 102 | 90 |
| WC cycle (ex-cash) (days) | 112 | 186 | 177 |

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