

Ipca Laboratories

BSE Sensex
26,272

S&P CNX
7,831

CMP: INR728
TP: INR930
Buy

Stock Info

Bloomberg	IPCA IN
Equity Shares (m)	126.2
52-Week Range (INR)	907/609
1, 6, 12 Rel. Per (%)	-16/-29/-15
M.Cap. (INR b)	105.6
M.Cap. (USD b)	1.8

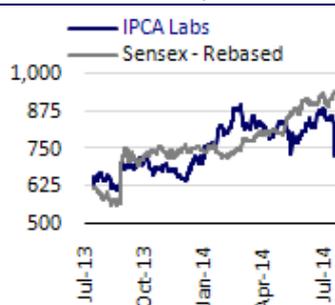
Financial Snapshot (INR Million)

Y/E March	2015E	2016E	2017E
Net Sales	35,499	41,531	50,546
EBITDA	7,831	9,329	11,880
Adj PAT	5,048	6,036	7,821
EPS (INR)	40.0	47.8	62.0
Growth (%)	6	20	30
BV/Share	189	230	283
RoE (%)	23.2	22.8	24.2
RoCE (%)	26.5	26.7	28.8
P/E (x)	18.2	15.2	11.7
P/BV (x)	3.8	3.2	2.6

Shareholding pattern (%)

As on	Jun-14	Mar-14	Jun-13
Promoter	45.9	45.9	45.9
DII	11.0	11.5	13.5
FII	25.3	25.3	23.0
Others	17.9	17.4	17.7

Note: FII Includes depository receipts

Stock Performance (1-year)


To voluntarily stop supplies to US

Sharp cut in EPS, but management's track record gives us comfort

- Voluntary stoppage of API supplies to the US would impact formulations sales, significantly.
- We estimate 18-20% earnings cut due to loss of sales and other remediation costs.
- Presence in products that suit IPCA's capabilities and its past record of swift US FDA resolution give us comfort, despite massive earnings cuts.

Voluntary stoppage of API supplies to US to impact formulations sales

IPCA has voluntarily stopped shipment from its API facility in Ratlam, India post the observations (form 483) listed by the US FDA in its recent inspection. IPCA received six observations, of which two relate to data integrity. This development will also have an impact on the formulations plants (Indore SEZ and Silvassa), which source majority of the APIs from the Ratlam site. The US market contributed ~10% to FY14 sales (INR3b).

Estimate 18-20% earnings cut due to loss of sales and other remediation costs

IPCA expects no sales in the US from September 2014 till the time the US FDA issues are resolved. It expects to resolve these issues over the next 4-6 months. We estimate cumulative sales loss of USD41m/62m/49m for FY15/FY16/FY17, which includes loss of current sales and delay in new launches. In addition, we build in remediation costs that IPCA would have to incur until resolution of the issue. We estimate 18%/20%/15% cut in earnings for FY15/FY16/FY17.

Presence in products that suit IPCA's capabilities and past record of swift US FDA resolution gives us comfort despite massive earnings cuts

IPCA's stock price declined over 15% today, partly reflecting the potential cut in earnings due to this development. Despite the significant earnings cut, we maintain our **Buy** rating. We draw comfort from (a) swift resolution of US FDA issues at Indore SEZ within 10 months, and (b) high probability of IPCA regaining lost market share, as these are high volume/mature products, making it difficult for competition to match IPCA's scale. We build in a gradual recovery in the US, starting 2HFY16 and expect FY17 to be a normalized year of operations. We move our valuations and target price to FY17. Our revised target price is INR930 (15x FY17E EPS). Key risk to our call is escalation of current observations to import alert or warning letter status.

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Key takeaways from conference call

- **FDA observations:** The US FDA inspected IPCA's Ratlam-based API facility over 14-18 July 2014. The inspection culminated in a six-point observation letter. The management indicated that of the six, two points were on data integrity problems identified in certain batches analyzed.
- **Consultants:** IPCA has hired Lachman Consultants to resolve the issues raised by the FDA. As per their advice, the company has chosen to cease US sales until receipt of an Establishment Information Report (EIR). The turnaround indicated by the consultants is 4-6 months.
- **Business impact:** Currently, the US contributes revenues of INR2.96b: (1) INR2.04b from US generics formulations, (2) INR570m from direct API sales to the US, and (3) INR350m from API sales to Indian customers who sell in the US. However, IPCA has one month's inventory, which will be sold in the market. The impacted business has higher EBITDA margins than company's overall margins. Further, the consultants have been retained with ~USD1m in fees.
- **Regaining market share:** The management indicated that these are typically high-volume, mature products where IPCA has the highest market share. It would be difficult for competitors to match IPCA's scale. Hence, the management is capable of regaining lost market share quickly post resolution.
- **Resolution underway:** IPCA has been automating most of its production processes, which has been part of the capex guidance as well. Once it achieves the targeted level of automation, the management believes that most of the issues raised in the 483 will be resolved.
- **Filing and launch timelines delayed:** The management indicated that ANDA filing and launches would be delayed until resolution of the issues. However, they also indicated that the development work on ANDAs would continue and filings are likely to be bunched up in FY16.
- **No penalty provisions in supply agreements:** IPCA's agreements with customers do not have any penalty provisions in case of discontinuation of supplies.

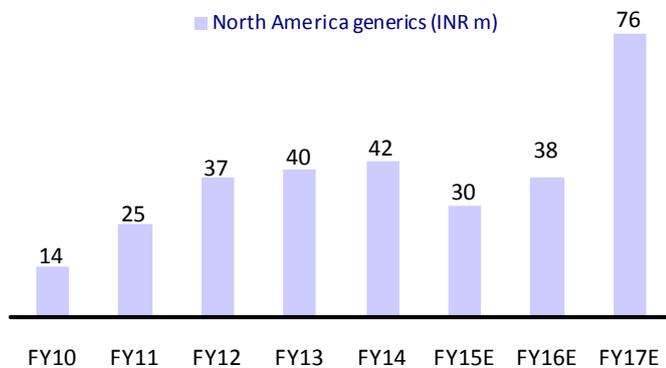
History of enforcement actions taken by the FDA

Company	FDA Action	Unit	Nature of facility	Date of action	Date of resolution	Resolution in (months)	MOSL Comments
Sun Pharma	Import Alert	Karkhadi, Gujarat	API	13-Mar-14	x	NA	Negligible revenue impact
IPCA Labs	Form '483	Ratlam, MP	API	18-Jul-14	x	NA	API revenues worth INR920m affected. Due to backward integrated nature of operations, INR2b worth of US revenues also impacted.
Ranbaxy	Ban	Taonsa	API	24-Jan-14	x	NA	Facility faced observations in Sept-12 and Dec-12 inspections as well. Certain issues raised then remained unsolved in the recent audits.
Ranbaxy	Import Alert	Mohali	Formulations	13-Sep-13	x	NA	~17-18 ANDAs filed from this plant. Will dent outlook for topline growth and margin improvement. This unit was setup after Daiichi Sankyo took over.
Strides Arcolab	Warning Letter	Bangalore	Injectable form	11-Sep-13	x	NA	Contributes 25% of Agila sales. Unclear about the impact on Agila-Mylar deal.
Wockhardt	Import Alert	Waluj, India	Formulations	24-May-13	x	NA	Significant GMP violations, allegations of withholding truthful information, delayed and limited the inspection. Sales impact of USD100m, 23 pending ANDAs affected.
Jubilant Life Sciences	Warning Letter	Canada	Formulations	27-Feb-13	x	NA	Significant deviations from GMP. sales impact of USD 10m, EBITDA impact of USD 2-3m. Responded in 15 days. Awaiting FDA's response.
Dr. Reddy's	Import Alert	Mexico	API	6-Jul-11	27-Jul-12	12.9	Impacted USD30m of sales p.a. until resolution
Cadila	Warning Letter	Moraiya	Formulations	6-Jun-11	17-Jul-12	13.6	Pre-inspection warning letter for the injectable plant but affected approvals from the oral solids plant too. Resolved subsequently.
Aurobindo	Warning Letter	Unit III	Formulations	23-May-11	4-Jun-12	12.6	GMP violations relating to packaging procedures which were resolved eventually.
Aurobindo	Import Alert	Unit VI	Formulations	27-Feb-11	28-Mar-13	25.3	GMP violations relating to packaging procedures. Impacted sales of USD35m p.a. until resolution.
Sun Pharma	Warning Letter	Able Labs		31-Aug-10	19-Sep-11	12.8	Observations included failure to comply with GMP guidelines. Hired consultants to resolve issues.
Ranbaxy	Warning Letter	Ohm Labs	Formulations	24-Dec-09	x	NA	Significant deviations from GMP for the unit manufacturing liquid products. Unit subsequently closed down.
Sun Pharma	Product Seizure	Michigan, Caraco	Formulations	26-Jun-09	28-Aug-12	38.6	Significant deviations from GMP despite repeated warnings. Impacted sales of USD100m p.a. and key product Prandin. Resolution reached; 3 products manufactured.
Lupin	Warning Letter	Mandideep	Formulations	14-May-09	20-Jan-10	8.4	FDA observed 15 manufacturing deficiencies, which were successfully resolved.
Cipla	Form '483	Bangalore	API	20-Apr-09	31-Aug-09	4.4	Minor observations raised which were resolved without any major issues
Ranbaxy	AIP	Paonta Sahib	Formulations	26-Feb-09	x	NA	Data integrity issues, AIP invoked by US FDA/DoJ
Taro Pharma	Warning Letter	Brampton, Canada	Formulations	5-Feb-09	25-Apr-11	27.0	Observations included failure to complete investigations of quality issues in a timely manner. Hired consultants to resolve issues.
Ranbaxy	Warning Letter	Batamandi	API	17-Sep-08	x	NA	Significant deviations from GMP. Stopped US supplies.
Ranbaxy	Import Alert	Dewas	Formulations	17-Sep-08	x	NA	Significant deviations from GMP despite repeated warnings. Sales impact from Dewas + Paonta Sahib is USD 400m. Signed consent decree and paid fine of USD500m.

Source: US FDA, Company, Industry, MOSL

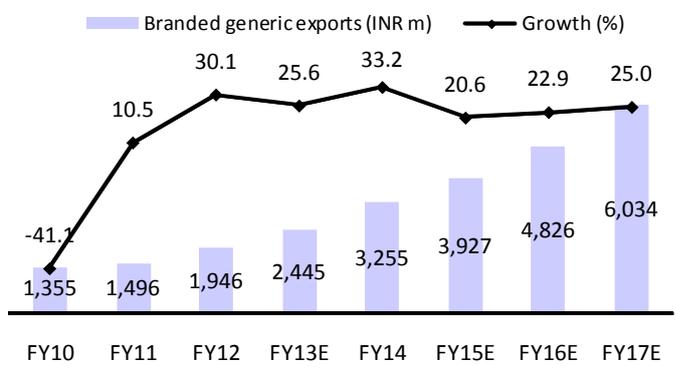
Story in charts

Medium term impact in N America; recovery likely in FY17



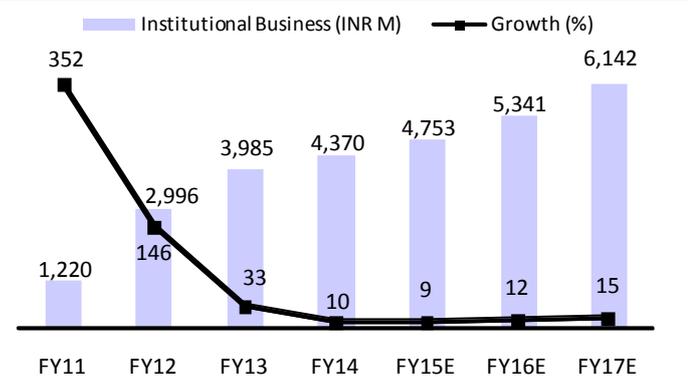
Source: Company, MOSL

Branded generics to continue to grow on a small base



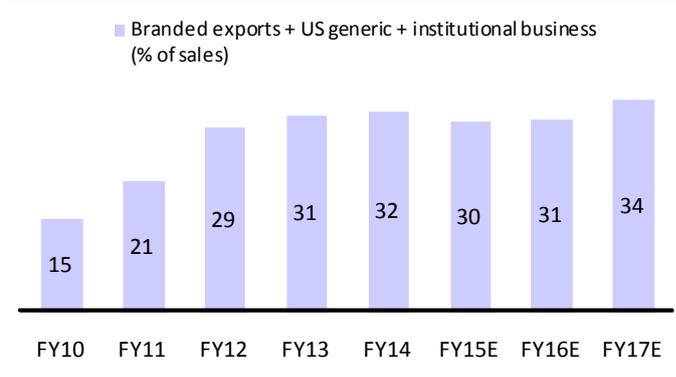
Source: Company, MOSL

Institutional business growth to moderate due to base effect



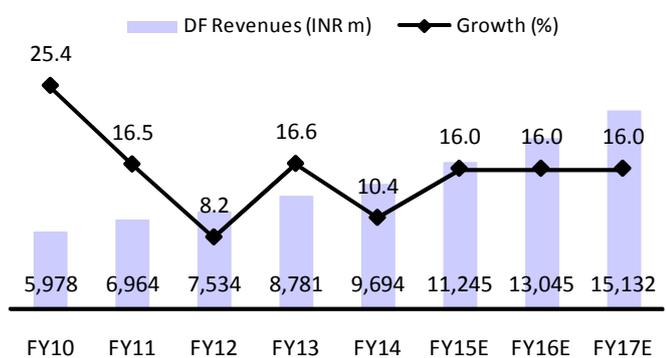
Source: Company, MOSL

Expect improvement in sales mix, despite USFDA bottleneck



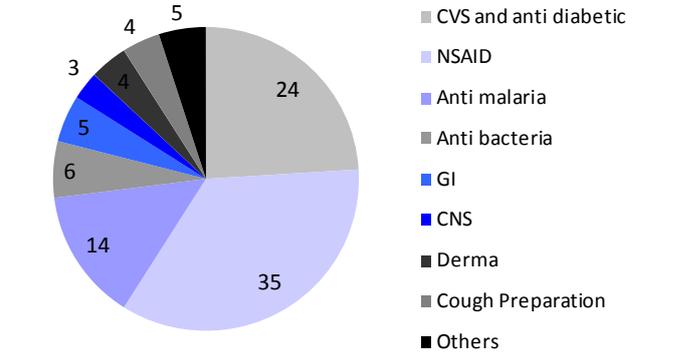
Source: Company, MOSL

India formulations growth to pick up as market normalizes...



Source: Company, MOSL

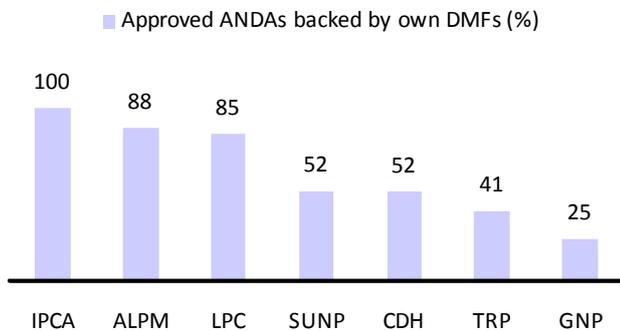
...with dependence on anti-malaria reducing to 14%



Source: Company, MOSL

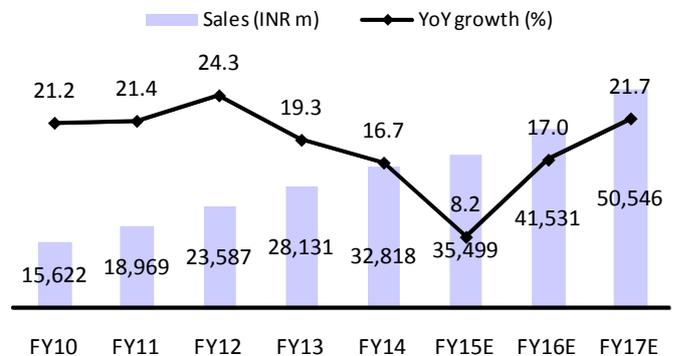
Story in charts

One of the most backward integrated player in the US



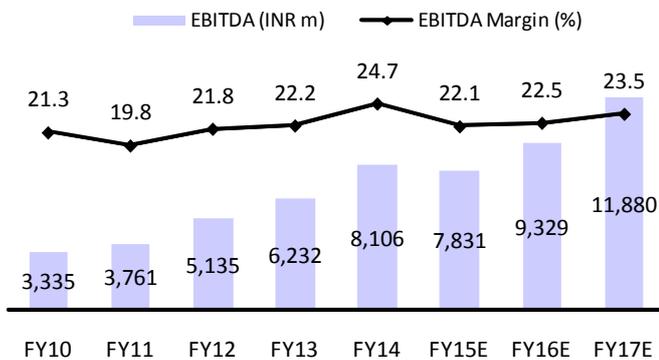
Source: Company, MOSL

Revenue growth to dip in FY15; likely to pick up thereafter



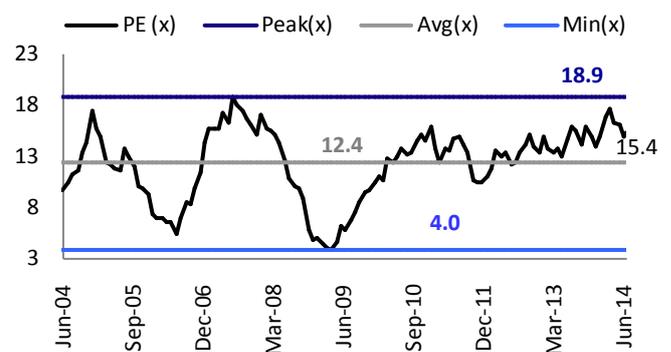
Source: Company, MOSL

Profitability to improve, aided by improving sales mix



Source: Company, MOSL

One-year forward PE chart



Source: USFDA, MOSL

Financials and valuations

Income statement				(INR Million)		
Y/E March	2012	2013	2014	2015E	2016E	2017E
Net Sales	23,587	28,131	32,818	35,499	41,531	50,546
Change (%)	24	19	17	8	17	22
EBITDA	5,135	6,232	8,106	7,831	9,329	11,880
EBITDA Margin (%)	21.8	22.2	24.7	22.1	22.5	23.5
Depreciation	671	867	1,031	1,266	1,536	1,826
EBIT	4,464	5,365	7,074	6,565	7,793	10,055
Interest	413	334	269	285	285	285
Other Income	-408	-488	-500	362	434	521
Extraordinary items	0	0	0	0	0	0
PBT	3,643	4,543	6,306	6,642	7,942	10,291
Tax	881	1,299	1,524	1,594	1,906	2,470
Tax Rate (%)	24.2	28.6	24.2	24.0	24.0	24.0
Min. Int. & Assoc. Share	0	0	0	0	0	0
Reported PAT	2,762	3,243	4,782	5,048	6,036	7,821
Adjusted PAT	2,762	3,243	4,782	5,048	6,036	7,821
Change (%)	5	17	47	6	20	30
Margins (%)	12	12	15	14	15	15

Balance sheet				(INR Million)		
Y/E March	2012	2013	2014	2015E	2016E	2017E
Share Capital	252	252	252	252	252	252
Reserves	12,288	15,285	19,344	23,635	28,766	35,414
Net Worth	12,540	15,538	19,597	23,887	29,018	35,666
Debt	5,326	5,234	4,379	4,379	4,379	4,379
Deferred Tax	932	1,304	1,471	1,604	1,763	1,969
Total Capital Employed	18,798	22,075	25,447	29,871	35,160	42,014
Gross Fixed Assets	13,150	15,555	18,976	23,976	28,976	33,976
Less: Acc Depreciation	3,945	4,748	5,785	7,051	8,586	10,412
Net Fixed Assets	9,205	10,806	13,192	16,925	20,390	23,564
Capital WIP	945	1,292	1,649	1,649	1,649	1,649
Investments	341	90	92	92	92	92
Current Assets	12,547	14,545	16,827	17,433	20,368	25,716
Inventory	6,699	7,410	8,476	9,049	10,578	12,874
Debtors	3,491	4,178	4,495	4,953	5,901	7,454
Cash & Bank	122	582	763	382	215	644
Loans & Adv, Others	2,235	2,374	3,093	3,048	3,674	4,743
Curr Liabs & Provns	4,475	4,894	6,656	6,572	7,683	9,351
Curr. Liabilities	4,099	4,351	5,950	5,906	6,903	8,402
Provisions	377	544	706	667	779	949
Net Current Assets	8,071	9,651	10,171	10,860	12,685	16,365
Total Assets	18,798	22,075	25,447	29,871	35,160	42,014

E: MOSL Estimates

Financials and valuations

Ratios

Y/E March	2012	2013	2014	2015E	2016E	2017E
Basic (INR)						
EPS	21.9	25.7	37.9	40.0	47.8	62.0
Cash EPS	27.2	32.6	46.1	50.0	60.0	76.4
Book Value	99.4	123.1	155.3	189.3	229.9	282.6
DPS	3.7	4.7	5.8	6.0	7.2	9.3
Payout (incl. Div. Tax.)	17.0	18.1	15.4	15.0	15.0	15.0
Valuation(x)						
P/E	33.2	28.2	19.2	18.2	15.2	11.7
Cash P/E	26.7	22.3	15.8	14.5	12.1	9.5
Price / Book Value	7.3	5.9	4.7	3.8	3.2	2.6
EV/Sales	4.1	3.4	2.9	2.7	2.3	1.9
EV/EBITDA	18.8	15.4	11.7	12.2	10.3	8.0
Dividend Yield (%)	0.5	0.6	0.8	0.8	1.0	1.3
Profitability Ratios (%)						
RoE	24.0	23.1	27.2	23.2	22.8	24.2
RoCE	24.1	25.2	29.4	26.5	26.7	28.8
Turnover Ratios (%)						
Asset Turnover (x)	1.8	1.8	1.7	1.5	1.4	1.5
Debtors (No. of Days)	53.6	53.8	49.7	50.6	51.5	53.5
Inventory (No. of Days)	103.7	96.1	94.3	93.0	93.0	93.0
Creditors (No. of Days)	81.1	72.5	87.9	77.9	78.2	79.3
Leverage Ratios (%)						
Net Debt/Equity (x)	0.4	0.3	0.2	0.2	0.2	0.1

Cash flow statement

(INR Million)

Y/E March	2012	2013	2014	2015E	2016E	2017E
OP/(Loss) before Tax	3,643	4,543	6,306	6,642	7,942	10,291
Depreciation	671	867	1,031	1,266	1,536	1,826
Others	0	0	0	0	0	0
Interest	413	334	269	285	285	285
Direct Taxes Paid	-757	-927	-1,357	-1,461	-1,747	-2,264
(Inc)/Dec in Wkg Cap	39	-1,119	-339	-1,070	-1,993	-3,250
CF from Op. Activity	4,010	3,698	5,910	5,661	6,023	6,888
(Inc)/Dec in FA & CWIP	-3,315	-2,752	-3,887	-5,000	-5,000	-5,000
(Pur)/Sale of Invt	68	251	-1	0	0	0
Others	0	0	0	0	0	0
CF from Inv. Activity	-3,247	-2,501	-3,888	-5,000	-5,000	-5,000
Inc/(Dec) in Net Worth	1	0	0	0	0	0
Inc / (Dec) in Debt	25	-93	-854	0	0	0
Interest Paid	-413	-334	-269	-285	-285	-285
Divd Paid (incl Tax)	-468	-589	-738	-757	-905	-1,173
CF from Fin. Activity	-744	-736	-1,841	-1,042	-1,190	-1,458
Inc/(Dec) in Cash	18	461	180	-380	-168	430
Add: Opening Balance	104	122	582	763	382	215
Closing Balance	122	582	763	382	215	644

E: MOSL Estimates

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IPCA LABORATORIES LTD

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