Sun Pharmaceuticals

Absolute : Reduce
Relative : Underweight

Annual Report Analysis | **Regular Coverage**

Leap towards specialty; monetization distant – maintain REDUCE

Pharmaceuticals

Rating Information	
Price (Rs)	474
Target Price (Rs)	472
Target Date	31st Dec'18
Target Set On	13th Aug'17
Implied yrs of growth (DCF)	20
Fair Value (DCF)	433
Fair Value (DDM)	115
Ind Benchmark	BSETHC
Model Portfolio Position	NA

Stock Information	
Market Cap (Rs Mn)	11,37,843
Free Float (%)	45.62 %
52 Wk H/L (Rs)	818.5/432.7
Avg Daily Volume (1yr)	46,06,952
Avg Daily Value (Rs Mn)	2,940.9
Equity Cap (Rs Mn)	2,399
Face Value (Rs)	1
Bloomberg Code	SUNP IN

Ownership	Recent	3M	12M
Promoters	54.4%	0.0%	-0.6%
DII	11.6%	-0.6%	2.9%
FII	21.1%	-0.2%	-5.2%
Public	13.0%	0.9%	2.9%

Price %	1M	3M	12M
Absolute	-6.3%	-6.0%	-39.4%
Vs Industry	-1.4%	-1.5%	-20.1%
LUPIN	-2.2%	-15.6%	-36.7%
DRREDDY	-1.9%	-13.8%	-29.9%

Consolidated Quarterly EPS forecast

Rs/Share	1Q	2Q	3Q	4Q
EPS (17A)	8.5	9.3	6.1	5.1
EPS (18E)	2.2	3.9	4.2	4.2

Sun Pharmaceutical's (SUNP) FY17 Annual Report emphasizes the company's efforts on building its specialty pipeline; while this is encouraging, SUNP's high initial investments (development costs, sales force build-up) would keep its near-term earnings muted. Meanwhile, management commentary suggests no medium-term respite from competitive pressures in the US. We retain REDUCE on the stock with a Dec'18 TP of Rs 472, derived by assigning 23x P/E (unchanged) and valuing the *Tildrakizumab* opportunity at Rs 25/share.

Spiraling contingent liability led by tax disallowances: Contingent liabilities jumped from Rs 39bn in FY16 to Rs 69bn in FY17 largely due to tax disallowances (~Rs 31bn in FY16 vs. Rs 56.7bn in FY17). The company's tax rate remained low at ~13% (FY16: ~14%) vs. cash tax of 23%/30% in FY16/FY17. While the effective tax remains low, in tandem with previous years, management expects an increase in tax expenses going forward.

Acquisitions and collaborations in FY17: SUNP acquired 14 brands from Novartis, the Russia-based JSC Biosintez and rights to proprietary-niche molecules during the year, for a total deal consideration of US$ 528mn. Novartis' brands and the Russian acquisition were undertaken to expand footprint in strategic geographies, while molecule acquisitions to strengthen the specialty pipeline.

FY18 guidance points to a lower topline: FY18 is likely to be a challenging year for SUNP. The company expects a single-digit decline in its consolidated revenues for FY18 over FY17. Consolidated R&D investments for FY18 would be about 9-10% of revenues. Additionally, the company expects the tax rate to gradually increase over the next few years while capex for FY18E is estimated at US$ 350mn.

Despite these challenges, SUNP continues to invest in enhancing its global specialty and complex generics pipeline. Investments would also continue for setting up the requisite front-end capabilities for the specialty business in the US.

Other key highlights from the Annual Report:

- SUNP has recorded US$ 80mn (included in other operating income) towards *Tildrakizumab* European rights out-licensing to Almirall S.A.
- Other expenses were down 8.3% largely due to forex gains of Rs 3.7bn vs. forex losses of Rs 2.9bn in FY16E.
- SUNP's top-10 products in India contribute 18% of its domestic revenues.
- Dusa, Cranbury, Chattem, Pharmalucence and OHM facilities were inspected during FY17. All received EIR except Cranbury (one observation).

No Change in Estimates

Consolidated Financials

Rs. Mn YE Mar	FY17A	FY18E	FY19E	FY20E
Sales	3,15,577	2,84,510	3,36,024	3,82,798
EBITDA	1,00,893	61,586	85,322	1,02,049
Depreciation	12,648	13,991	15,193	16,353
Interest Expense	3,998	2,870	2,247	2,217
Other Income	6,232	5,515	6,009	7,276
Reported PAT	69,644	25,407	53,158	66,392
Recurring PAT	69,644	34,912	53,158	66,392
Total Equity	3,66,397	3,85,859	4,26,579	4,77,437
Gross Debt	80,910	78,910	74,910	70,910
Cash	1,53,717	1,76,774	2,08,872	2,46,627
Rs Per Share	**FY17A**	**FY18E**	**FY19E**	**FY20E**
Earnings	29.0	14.6	22.2	27.7
Book Value	153	161	178	199
Dividends	5.8	2.1	4.4	5.5
FCFF	25.3	13.9	21.0	24.6
P/E (x)	15.5	30.9	20.3	16.3
P/B (x)	2.9	2.8	2.5	2.3
EV/EBITDA (x)	10.0	16.0	11.1	8.9
ROE (%)	20 %	9 %	13 %	15 %
Core ROIC (%)	26 %	13 %	20 %	20 %
EBITDA Margin (%)	32 %	22 %	25 %	27 %
Net Margin (%)	22 %	12 %	16 %	17 %

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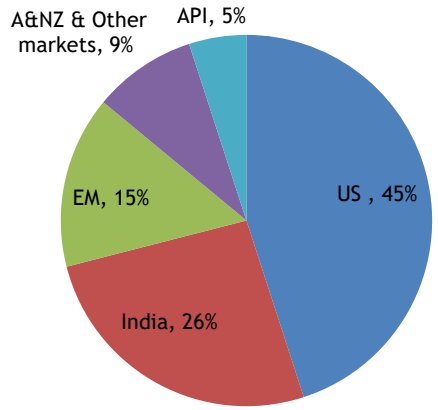
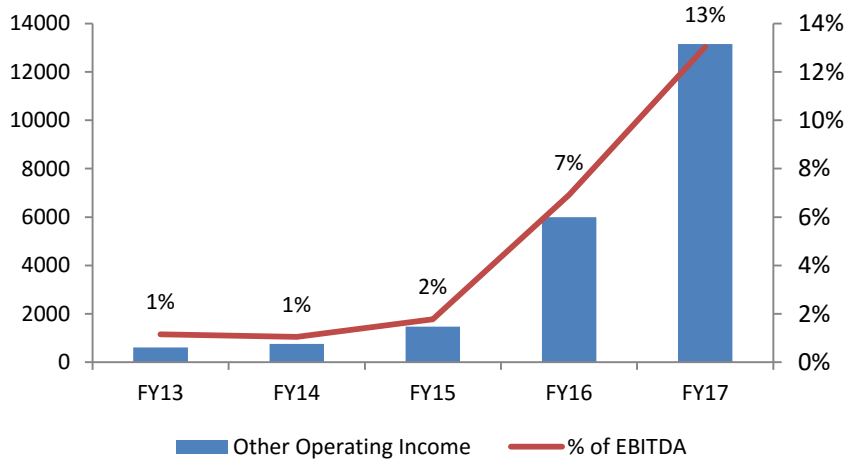
Exhibit 1: Geographical revenue break-up for FY17



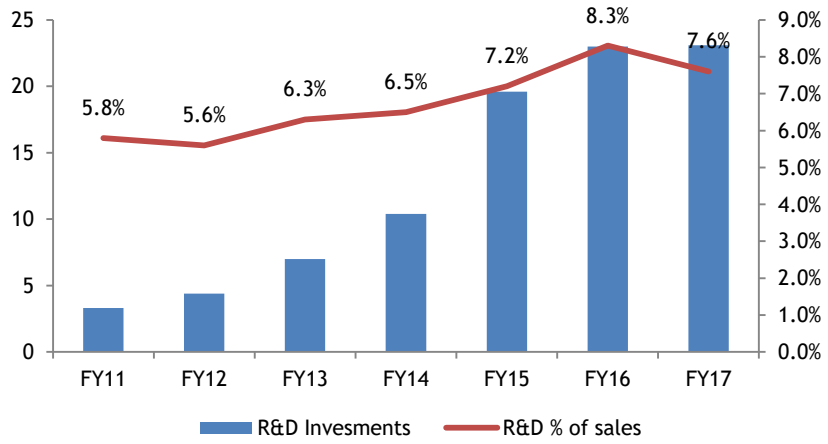
Source: Company, Equirus Research

Exhibit 2: Other operating income in FY17 includes one-time royalty payment of US$ 80mn



Source: Company, Equirus securities

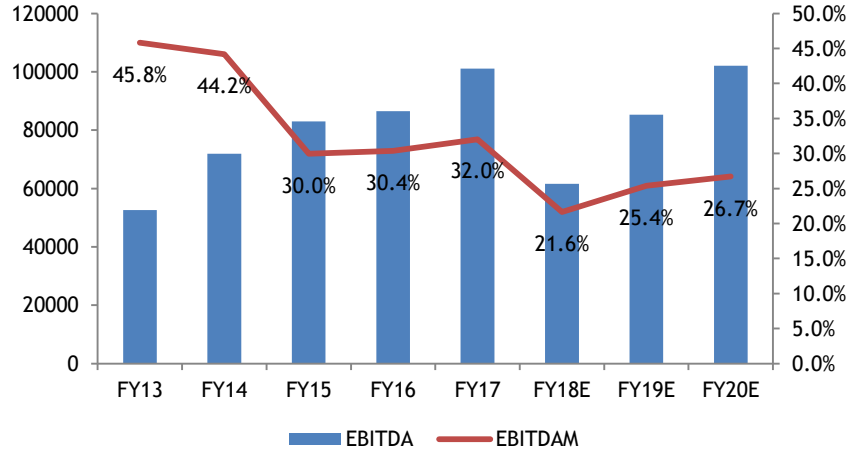
Exhibit 3: R&D spends increasing owing to complex and specialty pipeline



**SUNP indicated that from FY18, R&D spend could be as high as 9-10% of net sales*

Source: Company, Equirus Research

Exhibit 4: EBITDAM to remain under pressure owing to high R&D, setting up requisite front-end for specialty and headwinds in US generics pricing



Source: Company, Equirus Research

Exhibit 5: US revenues breakup; SUNP base business declining

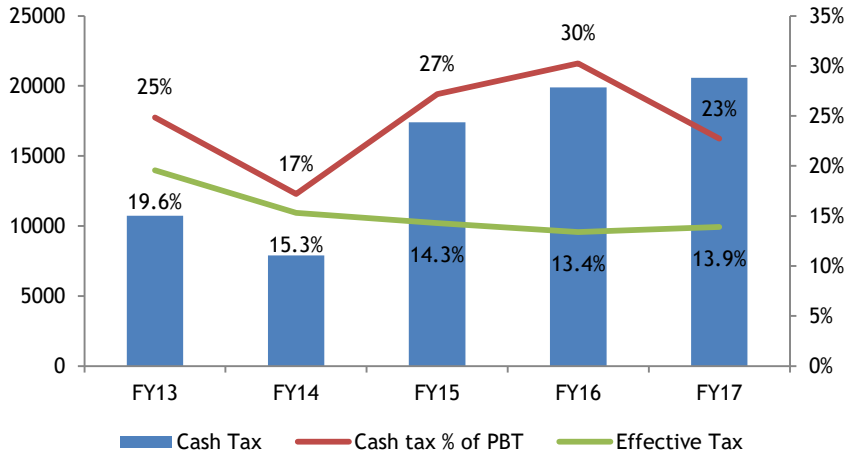
(USD mn)

Particulars	FY15	FY16	FY17
DUSA	110	103	137
Mutual	97	34	48
Pharmalucence	18	25	28
Taro	777	865	785
Gleevec	0	90	210
Olmesartan franchise	0	0	90
Sun Base business	**1241**	**948**	**752**
Total US sales	2244	2066	2051

Source: Company, Equirus Research

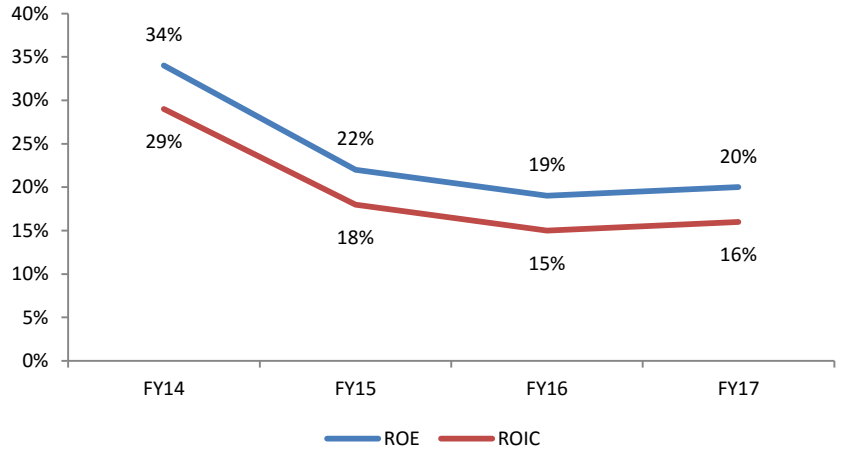
Exhibit 6: Cash tax continues to be significantly higher than effective tax

(Rs. Mn)



Source: Company, Equirus Research

Exhibit 7: ROE and ROIC deteriorate following Ranbaxy acquisition



Source: Company, Equirus Research

Exhibit 7: Contingent liability largely related to income tax due to disallowances

Particulars	2015	2016	2017
Income Tax on account of Disallowances / Additions	**26707**	**30916**	**56713**
Drug Price Equalisation Account [DPEA] on account of demand towards unintended benefits enjoyed by the Group	3248	3326	3488
Excise duty on account of valuation/cenvat credit	624	2025	4548
Others	3849	3253	4629
Total	34428	39520	69378

** ~82% of contingent liability is related to income tax on account of disallowance*

Source: Company, Equirus Research

Key highlights from MD discussion

- Owing to multiple headwinds - ranging from US channel consolidation and increasing competitive intensity to government interventions - the need to constantly move up the value chain has become imperative.
- US, the largest revenue contributor for SUNP, faced increased pricing pressure driven by customer consolidation and higher competitive intensity. Adding to the pressure were delays in anticipated product approvals from Halol driven by cGMP compliance remediation efforts at the facility.
- Pricing pressure owing to channel consolidation and increasing competitive intensity weighed on Taro's revenues.
- Emerging markets posted 26% growth led by improvement in the underlying business and stable currencies. Growth was broad-based across emerging markets.
- R&D spends were at 7.6% of sales with the trend likely to continue ahead. SUNP would continue to invest in its specialty pipeline and requisite front-end capabilities for this business in US.
- The specialty business is in an evolutionary stage and doesn't generate enough revenues to commensurate investments.

Closure of Detroit and Wixom facilities to vacate consent decree

- Following the closure of the Detroit facility in FY15, SUNP entered into discussions with the FDA to the vacate consent decree. As of Mar'16, the District Court had lifted consent decree for the facility.
- Later in Feb'17, SUNP notified FDA of its intentions to cease distribution from its Wixom facility from 30 Jun'17. Following the closure of this facility, SUNP would initiate discussions with the FDA to vacate the consent decree for this plant too.

Specialty pipeline

- ***Bromsite*** 0.075% solution was approved and subsequently commercialized in Nov'16. The product is gradually ramping up market share. As per IMS, *Bromiste* sales currently stand at US$ 11mn/month.
- ***Tildrakizumab*** was acquired from Merck in 2014. In 2016, SUNP announced positive results in phase-3 clinical trials for plaque psoriasis. Later in Jul'16, it announced a licensing agreement with Almirall S.A (Spain) for development and commercialization of *Tildra* for psoriasis in Europe. The product is awaiting approvals from the USFDA and the European regulatory body.
- **InfuSMART technology:** SUNP announced the launch of Gemcitabine InfuSMART technology - where oncology products are developed in ready-to-administer bags - in Europe.
- ***Elepsia*** also in-licensed *ELEPSIA XRTM* (*Levetiracetam* extended release tablets) from SPARC. *ELEPSIA XRTM* was approved by the USFDA in Mar'15. However, in Sep' 15, SPARC received a complete response letter (CRL) from the USFDA rescinding its earlier approval owing to Halol USFDA issues. SUNP is currently in the process of de-risking these filings by transferring them to alternate facilities.
- ***Seciera*:** In Oct'16, SUNP announced the acquisition of Ocular Technologies (Ocular), which entitled the company exclusive worldwide rights to *Seciera* (cyclosporine A, 0.09% ophthalmic solution) targeted at dry eye disease. Subsequently, SUNP announced successful phase-3 confirmatory clinical trial results for *Seciera*. SUNP is expected to file this product with the USFDA by Q3FY18.
- ***Odomzo*:** During the year, SUNP acquired a branded oncology product, *Odomzo* (Sonidegib), from Novartis, which was approved by the USFDA in Jul'15. *Odomzo* is a hedgehog pathway inhibitor indicated for the treatment of adult patients with locally advanced basal cell carcinoma (laBCC) that has recurred following surgery or radiation therapy, or those who are not candidates for surgery or radiation therapy. This acquisition has the potential to leverage and expand relationships that the Dusa sales team has with dermatologists treating common pre-cancerous skin conditions. As per IMS, *Odomzo* is currently clocking revenues of US$ 2mn/month.
- **MM-II:** During the year, SUNP entered into an exclusive worldwide licensing deal to further develop MM-II, a novel pharmaceutical candidate for the treatment of pain in osteoarthritis. MM-II is a non-opioid product that leverages the physical properties of proprietary liposomes to lubricate arthritic knee joints, thereby reducing friction and wear and leading to reduction in joint pain.

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- ADD: ATR >= 5% but less than Ke over investment horizon
- REDUCE: ATR >= negative 10% but <5% over investment horizon
- SHORT: ATR < negative 10% over investment horizon

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- OVERWEIGHT: Likely to outperform the benchmark by at least 5% over investment horizon
- BENCHMARK: likely to perform in line with the benchmark

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