Laurus Labs

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Power of execution and operating leverage

1QFY21 one-offs are <5% of PAT with HCQS and favourable currency offset by Covid-induced costs. We substantially upgrade FY21/22 EPS to Rs63/Rs74 from Rs38/Rs41 owing to 5 factors. (i) incremental projects in CRAMS. (ii) EFV API sales uptick and customer wins in non-ARV APIs with 20% capacity expansion underway. (iii) EU formulations' contract wins. (iv) 520bps/600bps FY21/22 EBITDAM upgrade on mix-accretion/operating leverage. (v) FCF generation leading to debt reduction. Annual FY21/22 capex guidance remains Rs3-3.5bn despite sales upgrade. FY20-23 growth would be ARV-led, with both formulations and APIs forming 55% of FY23 sales. But we see CRAMS/non-ARV growing disproportionately beyond FY23, leading to mix accretion. This would drive re-rating from current 13x FY22 EPS to 17x (last 12M average: 16x) implied on our revised TP of Rs1,295 TP (Rs687 earlier). Our FY22 post-tax RoCE is 20%, but valuation discount to API names like Divis is warranted given sizeable ARV exposure.

Exhibit 1: Positive surprise in all major segments ex-oncology APIs; exceptional HCQS sales contribution was limited to Rs450-470mn

Laurus - segmental (Rs mn)	1QFY21	Ambit	vs. Ambit	1QFY20	% YoY	4QFY20	% QoQ
Anti-viral APIs	3,360	2,808	20%	2,830	19%	2,728	23%
Oncology APIs	510	531	-4%	450	13%	591	-14%
Other APIs	1,350	440	207%	435	210%	920	47%
Synthesis	1,000	681	47%	730	37%	1,479	-32%
Formulations	3,520	2,756	28%	1,060	232%	2,673	32%
Total	**9,740**	**7,215**	**35%**	**5,505**	**77%**	**8,391**	**16%**

Source: Company, Ambit Capital research

Management commentary upbeat for all segments

ARV APIs – we expect sales reversion to FY18 levels in FY22

Volumes have been healthy in ARV APIs, with higher contribution from EFV and TDF active ingredients. Volume uptick in the near term could stem from near-term supply disruption, while second-line ARV APIs would also start contributing to sales from 2HFY20. DMFs have been filed and reviewed by global authorities for the latter, with approvals waiting in the wings. Since EFV-to-DTG transition in ARV APIs over the last 2 years, volumes for EFV have dropped by 60%. But Laurus' volume share drop has been contained owing to market share gains. External volumes for DTG commenced only in 4QFY20 and the company expects to gain volume share in the molecule.

Oncology APIs – guidance upbeat despite benign volumes in recent quarters

Outlook for the segment communicated in the earnings call is positive as management expects to gain market share in top 2-3 molecules in the coming quarters.

Other APIs – robust order book leads to considerable sales upgrade

Top line growth in 1QFY21 was driven by both new order wins from existing relationships and increase in number of customers. Moreover, customer concentration is not an issue while the company has sufficient capacities, including dedicated blocks to meet and increase its order book in FY21/22.

Formulations – on track to realize broad based growth across markets

- **ARV** – growth drivers include recent approval for TLE400/TLE600 and capacity expansion via de-bottlenecking that would be completed in the coming quarters. In overall API formulations, share of TLD and EFV based formulations in 1L regime will continue to be in 70/30 ratio, while market size of the former would touch USD1bn. Capacity constraint would not be an issue in TLE400, in which there is a transition underway from TLE600 and is recommended for pregnant women.

Stock Information

Bloomberg Code:	LAURUS IN
CMP (Rs):	933
TP (Rs):	1,295
Mcap (Rs bn/US$ bn):	100/1.3
3M ADV (Rs mn/US$ mn):	1,388/18.6

Stock Performance (%)

	1M	3M	12M	YTD
Absolute	77	82	180	159
Rel. to Sensex	73	71	179	168

Key financials (Rs bn)

	FY21E	FY22E	FY23E
Revenue	38	43	48
EBITDA	11	13	14
EPS (Rs)	64	74	86

Source: Company, Ambit Capital research

Acronyms

KSM – key starting material, LMIC – low and middle income countries, ARV – anti retroviral, 1L – first line, EFV – efavirenz, TDF – tenofovir, DTG – dolutegravir

Research Analysts

Nikhil Mathur, CFA
nikhil.mathur@ambit.co
Tel: +91 22 6623 3220

Kushagra Bhattar
kushagra.bhattar@ambit.co
Tel: +91 22 6623 3062

- **North America –** market share in pregabalin continues in mid-teens and we expect 2-3 launches every year over FY20-23. Laurus has filed total 26 ANDAs with 9 holding first-to-file status, while three products have been commercialized till date. In Canada, the company has 5 approvals and has launched 3 products, with management communicating intention of launching 2 more in FY21.
- **Europe –** currently 2 products have been commercialized in the region and guidance is for more product launches in the coming quarters.

Synthesis – optimistic outlook driven by new customer wins

Growth in the segment is being driven by increase in number of customers served and subsequent rise in project in development stages. Total number of active projects in the CDMO division currently stands at 47, with CRAMS for generic APIs being one of the key growth drivers for the company. Management highlighted strong order book for FY21 and beyond in the earnings conference call, with no exceptional stocking at customers' end in generics APIs in 1QFY21.

Exhibit 2: We have raised our revenue estimates for other APIs and formulations aggressively, while oncology is the only space where revision has been negative

Sales (Rs mn)	New estimates		Old estimates		Change	
	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
API	19,960	22,419	18,378	19,408	9%	16%
- ARV	11,898	13,830	11,559	12,310	3%	12%
- Oncology	2,319	2,510	2,648	2,861	-12%	-12%
- Others	5,744	6,080	4,170	4,237	38%	44%
Formulations	13,736	15,836	12,075	13,487	14%	17%
Synthesis	4,740	5,425	4,425	4,939	7%	10%
Total	**38,436**	**43,680**	**34,878**	**37,834**	**10%**	**15%**

Source: Company, Ambit Capital research

Exhibit 3: Formulations would continue to be the largest growth driver over FY20-23, followed by Synthesis

Sales (Rs mn)	FY21E	FY22E	FY23E	Remarks
API	19,960	22,419	22,915	
- ARV	11,898	13,830	13,830	Growth rebound will stem from supplementary ARV tenders in South Africa; FY21/22 sales upgrade is owing to better than expected EFV sales reversion
- Oncology	2,319	2,510	2,710	FY20 drag was predominantly due to gemcitabine intermediate supply issue; growth reversal on the cards as backward integration into KSMs/intermediates is now complete
- Other APIs	5,250	5,648	5,986	This includes products like metformin and other anti-diabetes, cardiac and proton pump inhibitors We upgrade sales owing to new order wins and broader trend of Chinese API transition to India likely to benefit Laurus
- Hep-C	494	432	389	In midst of a structural decline owing to competitive pressures
Formulations	13,736	15,836	19,057	FY20-23 growth would largely stem from ARV LMIC formulations' sales moving up from USD90mn to USD140mn; sales upgrade is due to new contract wins in EU formulations
Synthesis	4,740	5,425	6,184	Total customers are >20, with top 5 constituting 60% of segmental revenue; business has been transferred to a wholly owned subsidiary, while the company initiated new projects with the total currently standing at 47
Total	**38,436**	**43,680**	**48,156**	
Growth %				
API	23%	12%	2%	
- ARV	15%	16%	0%	
- Oncology	10%	8%	8%	
- Other APIs	62%	8%	6%	
- Hep-C	-7%	-13%	-10%	
Formulations	66%	15%	20%	
Synthesis	23%	14%	14%	
Total	**36%**	**14%**	**10%**	

Source: Company, Ambit Capital research

Quantum jump in our margin estimates

A key highlight in the 1QFY21 earnings call was that majority of margin expansion stemmed from volume uptick, with positive currency benefits limited to 2ppt in 410bps QoQ gross margin expansion. Consequently, we substantially raise our EBITDA margin estimate by 524bps/600bps in FY21/22, which gets backed by sales upgrade in higher-margin segments like formulations and synthesis. The company has reduced its dependence on Chinese inputs from 70% to 50-55% over the last 2-3 years, which in our view boosts its cost leadership. Hence, we see volume gains and margins as sticky through FY21. Further, our estimates factor in 19% FY20-23 sales CAGR, while employee/other expenses increase would be disproportionately low at 12%/10%.

Exhibit 4: Operating leverage benefits were substantial in 1QFY21 despite Rs300mn higher operating expenses owing to freight and other Covid-related expenses

Laurus - adjusted (Rs mn)	1QFY21	Ambit	vs. Ambit	1QFY20	% YoY	4QFY20	% QoQ	Consensus	vs. cons.
Sales	9,743	7,215	35%	5,506	77%	8,391	16%	7,285	34%
Gross profit	5,283	3,680	44%	2,760	91%	4,208	26%		
- margin	54%	51%	322bps	50%	409bps	50%	407bps		
EBITDA	2,783	1,501	85%	833	234%	1,918	45%	1,458	91%
- margin	29%	21%	776bps	15%	1344bps	23%	571bps	20%	855bps
EPS	16.1	5.3	206%	1.4	1038%	10.3	56%	5.7	180%

Source: Company, Ambit Capital research

Exhibit 5: Despite certain exceptional costs, Laurus reported considerable EBITDAM expansion due to which we raise our margin estimates for FY21/22

Rs mn	New estimates		Old estimates		Change	
	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Rating	**BUY**		**BUY**		**INCREASE**	
Target price (Rs)	**1295**		**687**		**89%**	
Exchange rate (Rs/US$)	74.8	74.8	74.6	74.6	0%	0%
Revenue	38,436	43,680	34,878	37,834	10%	15%
EBITDA (underlying)	11,046	12,669	8,197	8,723	35%	45%
EBITDA margin (%)	29%	29%	24%	23%	524bps	595bps
PAT (underlying)	6,785	7,954	4,043	4,364	68%	82%
EPS underlying (Rs)	63	74	38	41	68%	82%

Source: Company, Ambit Capital research

Exhibit 6: Mix-accretive growth and positive operating leverage would ensure EBITDAM margin sustenance in the range of 29-30% over FY20-22

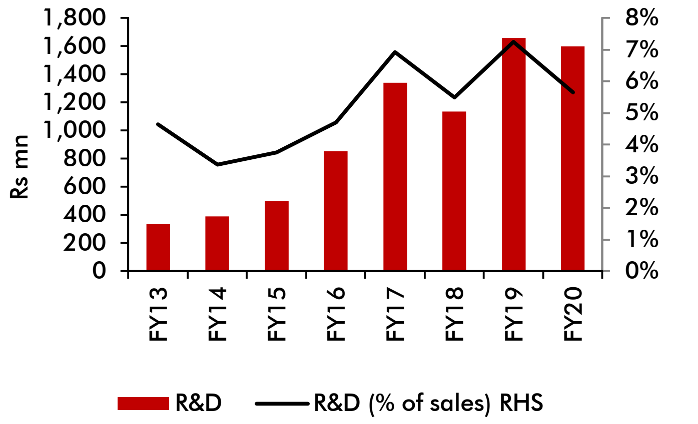
Laurus consolidated (Rs mn)	FY19	FY20E	FY21E	FY22E	Comments
Revenue	**22,919**	**28,317**	**38,436**	**43,680**	
- % growth (yoy)		24%	36%	14%	
COGS	(12,356)	(14,134)	(18,147)	(20,570)	
Gross profit	**10,563**	**14,183**	**20,290**	**23,110**	
- margin %	46%	50%	53%	53%	Growth segments in formulations, synthesis and oncology APIs will aid margins, while sales growth rebound in ARV APIs would partially dilute the mix.
Employee expenses	(2,892)	(3,449)	(3,862)	(4,326)	
- % of sales	13%	12%	10%	10%	Historically, employee cost as percentage of sales has been in the range 10-12%; we expect partial abatement in employee expense towards the top end of the historical range.
Other expenses	(4,111)	(5,089)	(5,381)	(6,115)	Fixed costs would be absorbed better as gross block turns improves, while capex need would be lower vs. FY16-19; Covid-19 induced cost savings factored in FY21 estimates.
- % of sales	18%	18%	14%	14%	
EBITDA (underlying)	**3,560**	**5,645**	**11,046**	**12,669**	
- margin %	16%	20%	29%	29%	Uptrend largely due to gross margin accretion and operating leverage benefits.
D&A	(1,642)	(1,873)	(2,029)	(2,277)	
- % of gross block	8%	8%	8%	8%	
Other income	162	59	101	195	
Interest exp.	(882)	(896)	(844)	(886)	Working capital days would continue to be elevated; thereby de-leveraging would be steady rather than aggressive.
Tax	(260)	(383)	(1,489)	(1,746)	
Effective tax rate (%)	22%	13%	18%	18%	
PAT (underlying)	**938**	**2,553**	**6,785**	**7,954**	
Other assumptions					
Working capital days	144	139	143	146	Working capital days would be extended due to low inventory turns in formulations
Capex	(2,543)	(2,222)	(3,200)	(3,000)	No change in capex guidance
- % of sales	11%	8%	8%	7%	
Net debt	11,038	11,439	10,824	6,923	

Source: Company, Ambit Capital research

Balance sheet concerns waning sharply

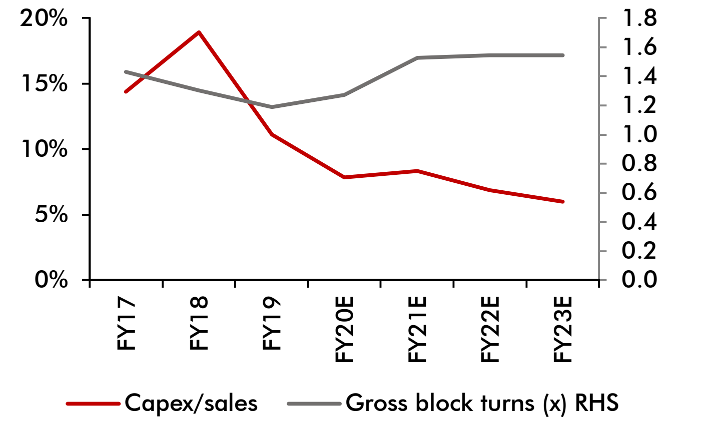
Some capex initiatives currently underway from a 12-18 month horizon include API and formulations capacity increases by 20% and 80%, respectively. Also, Rs600mn formulations de-bottlenecking initiatives would be completed in the next 2-3 quarters, which would aid growth in 2HFY21. However, we see annual capex levels stable in the range Rs3-3.5bn over FY20-22 and estimate positive FCF of Rs1.4bn/Rs4.8bn in FY21/22 after including interest costs. Consequently, net debt would trend down to Rs6.9bn in FY22 vs Rs11.4bn in FY20, with net debt/EBITDA ratio at 0.5x in FY22. Also, we see limited balance sheet risks from incremental capex initiatives as a large part of these are brownfield expansions with limited regulatory and commercialization delay risks.

Exhibit 7: Considerable investments into R&D over the last 5 years are now bearing fruit



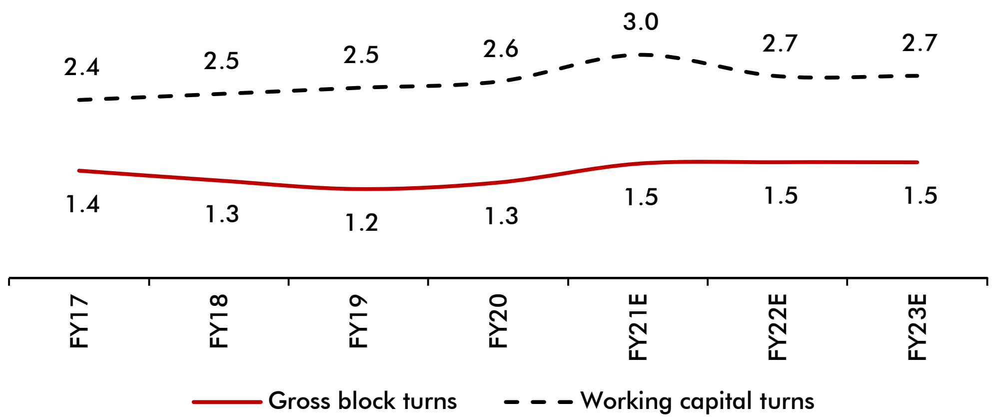
Source: Company, Ambit Capital research

Exhibit 8: Capex is on a downward trajectory now as percentage of sales



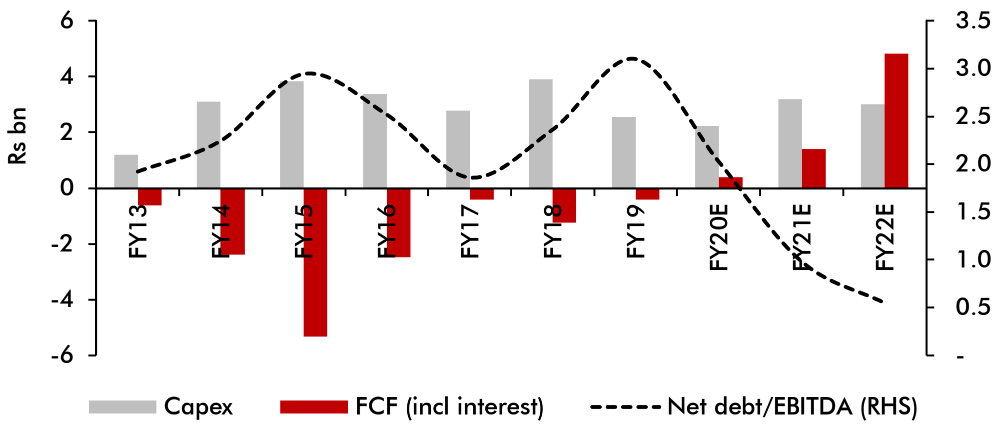
Source: Company, Ambit Capital research

Exhibit 9: Incremental capex would be brownfield, leading to improvement in gross block turns; non-ARV formulations growth reversal would boost working capital turns in FY21, but would eventually be stable at 2.7x levels



Source: Company, Ambit Capital research

Exhibit 10: Absolute capex would remain stable in FY21/22, while FCF including interest cost is rising now



Source: Company, Ambit Capital research

Exhibit 11: We envisage future capex as largely brownfield as most facilities hold considerable capacity expansion scope

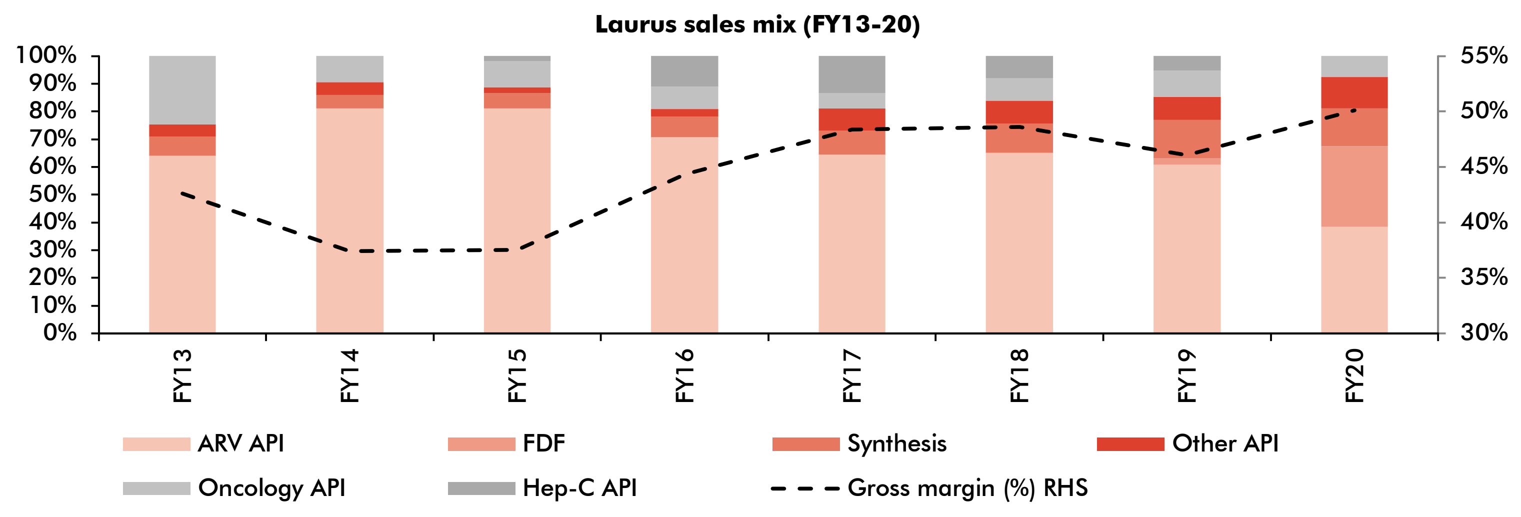
Facility	Location	Commencement of operations	Key products/customers	Capacity	Remarks
Kilo Lab	Shamirpet, Telangana	-	Pre-commercialisation activities for APIs, ingredients, custom synthesis and contract manufacturing	43 reactors and a capacity of 4.3 Kilo Litres (KL)	-
Unit 1	Vishakhapatnam	2007	API; includes capacity for ingredients, synthesis and contract manufacturing	319 reactors with 1,180 KL capacity	Almost fully utilized
Unit 2	APIIC, Achutapuram, Visakhapatnam (SEZ)	2017	FDF and API	FDF: 5bn tablets/capsules API: 12 reactors with 83 KL	**Scope for expansion**: >2x the current capacity of drug product and drug substance
Unit 3	Vishakhapatnam	2015	API; includes capacity for ingredients, synthesis and contract manufacturing	227 reactors with 1,752 KL capacity	Mainly API heavy, especially oncology APIs and Lamivudine; scope for miniscule expansion
Unit 4	APIIC, Achutapuram, Visakhapatnam	2018	API; includes capacity for ingredients, synthesis and contract manufacturing	32 reactors with 85 KL	**Significant scope for expansion** given only 20-30% capacity utilization currently; new ARV APIs are being manufactured at this site
Unit 5	Vishakhapatnam (SEZ)	2017	Dedicated hormone and steroid facility for Aspen	46 reactors with 125 KL	**Scope for expansion**: capacity can be expanded by almost 100%
Unit 6	APIIC, Achutapuram, Visakhapatnam	2018	APIs (largely manufacturing intermediates for captive consumption)	45 reactors with 261 KL	**Scope for expansion**: >3x the current capacity

Source: Company, Ambit Capital research

Mix upgrade was underway even before upbeat 1QFY21 commentary

Formulations' sales share increased from nil in FY18 to 29% of total sales in FY20 driven by order wins for TLD in the LMIC market and commercialization of R&D initiatives in Europe, Canada and the US. So, Laurus' mix is upgrading, evident from 4ppt gross margin expansion to 50% in FY20. ARV API sales recorded 17% decline in FY20 due to ARV treatment regime shift from EFV to DTG. However, high ARV incidence markets like South Africa continue to be predominantly on EFV line of treatment, while even pregnant women are recommended this regime.

**Exhibit 12: Laurus' sales mix has skewed from ARV APIs to synthesis and formulations over the last 5 years, which has resulted in structural gross margin uptrend **



Source: Company, Ambit Capital research

Exhibit 13: Considerable formulations growth has stemmed from TLD orders in LMIC

Sales (Rs mn)	FY18	FY19	FY20	Remarks
API	18,361	19,432	16,214	
- ARV	13,353	13,952	10,330	Decline due to EFV-to-DTG transition.
- Oncology	1,625	2,182	2,106	Muted FY20 due to backward integration initiatives.
- Other APIs	1,714	2,101	3,244	Anti-diabetes, proton pump inhibitors, cardiac uptake.
- Hep-C	1,669	1,197	533	Declining trend in-line with Natco's sales progression.
Formulations	52	545	8,253	LMIC tenders wins in FY20 for TLD.
Synthesis	2,144	3,342	4,588	Aspen contract ramp-up and other customer gains.
Total	**20,557**	**23,319**	**29,055**	
Growth %				
API	6%	6%	-17%	
- ARV	9%	4%	-26%	
- Oncology	51%	34%	-3%	
- Other APIs	14%	23%	54%	
- Hep-C	-33%	-28%	-55%	
Formulations		958%	1413%	
Synthesis	32%	56%	37%	
Total	**9%**	**13%**	**25%**	

Source: Company, Ambit Capital research

Exhibit 14: Laurus' strategic actions have revolved around both new product developments and establishing customer relationships across various business verticals

Year	Generic APIs	Generics Formulations	Synthesis/Ingredients
FY20/21	▪ EFV-to-DTG transition underway ▪ Completed backward integration in gemcitabine onco API	▪ Initiated TLD supplies for the Global Fund tender ▪ Reached high-teens market share in pregabalin in the US	▪ Synthesis business transferred to a wholly owned subsidiary
FY19	▪ Completed validation for 2L ARV and key diabetes APIs ▪ WHO approval received for DTG/3TC	▪ Commenced EU supplies and metformin to the US ▪ Transferred TLD ANDA to CASI and received USD2mn (additional USD1mn dependent on milestones) ▪ Partnership with the Global Fund for 3.5 years ▪ Filed TLE combinations with USFDA and WHO	▪ Commenced supplies from unit V to Aspen in synthesis
FY18	▪ API unit from Sriam Labs acquired	▪ Generics capacity expansion to 5bn units completed ▪ ANDA approval received for TDF	▪ Inaugurated unit IV for synthesis (international partner - C2 Pharma) and ingredients
FY17	▪ Hep-C tie-up with Natco established	▪ Entered into marketing partnership with Dr. Reddy's in the US for ARV formulations	▪ Signed agreement for clinical phase and commercial supplies advancement for onco NCE
FY16	▪ Licenses obtained from Gilead, Viiv, BMS	▪ Initiated development for 22 products	▪ Established Laurus Synthesis in the US

Source: Company, Ambit Capital research

TP increase stems from earnings upgrades and structural mix transformation

We substantially upgrade FY21/22 EPS to Rs63/Rs74 from Rs38/Rs41, owing to: (i) incremental projects in CRAMS; (ii) EFV API sales uptick and customer wins in non-ARV APIs with 20% capacity expansion underway; (iii) EU formulations' contract wins; (iv) 520bps/600bps FY21/22 EBITDAM upgrade owing to mix-accretion/operating leverage; (v) FCF generation leading to debt reduction.

Meanwhile in the preceding section, we discussed initiatives that the company has undertaken to de-risk the business model from heavy dependence on ARV. The segment could face disruption from development of alternative regimes that completely eradicate HIV. Our terminal growth of 3.5% in our DCF-based valuation factors eventuality of ARV business exhibiting terminal decline 15 years from now as more effective regimes could be developed or HIV eradication owing to better awareness is also a development that cannot be ruled out.

We estimate current super normally high growth phase to end in FY23, with our PAT CAGR being 53%. Post FY23, we are factoring a more subdued 10% sales CAGR over FY23-26, which is premised on higher growth in non-ARV segments and flat to low single digit growth in ARV.

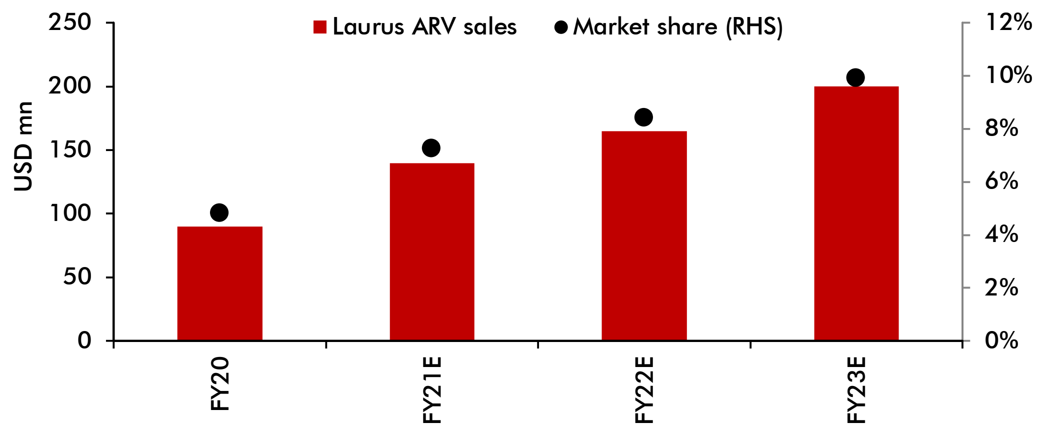
However, despite top line growth tapering in the 3-year period following FY23, mix-accretion would continue and post-tax RoCE would have attained 20% levels. Hence, we expect Laurus to re-rate from current 13x FY22 EPS to 17x, implied on our revised Rs1,295 TP (previous TP: Rs687). The stock currently trades at 23x 1-year forward P/E with last 12-month average being 16x.

Exhibit 15: We expect ART coverage to touch 90% by end-FY25, which translates into 7% patient volume CAGR; pricing would continue to be under pressure as DTG regimen aims to lower PPPY to USD75

GA LMIC market	FY16	FY17	FY18	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E
Market size (USD bn)	1,628	1,723	1,760	1,813	1,867	1,923	1,962	2,021	2,081	2,144
- growth % YoY	**6%**	**6%**	**2%**	**3%**	**3%**	**3%**	**2%**	**3%**	**3%**	**3%**
PLHIV (mn)	26	26	26	26	27	27	27	27	28	28
- ART coverage	49%	54%	59%	63%	67%	72%	76%	81%	85%	89%
Patients on ART (mn)	13	14	15	17	18	19	21	22	24	25
- growth % YoY		**11%**	**8%**	**8%**	**8%**	**8%**	**7%**	**7%**	**6%**	**6%**
Pricing 1L - adults (USD, PPPY)	104	94	87	83	79	75	71	68	66	64
- change % YoY		**-10%**	**-7%**	**-5%**	**-5%**	**-5%**	**-5%**	**-4%**	**-3%**	**-3%**

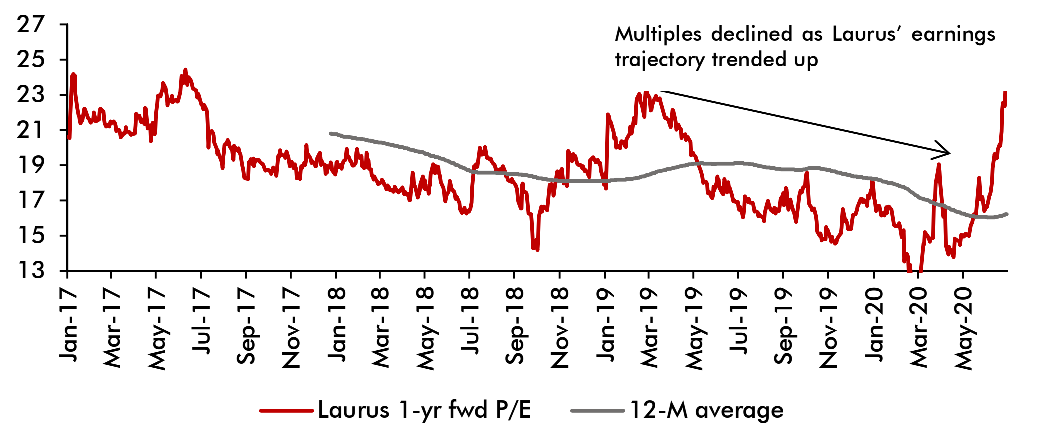
Source: Clinton Health Access Initiative, Ambit Capital research; Note: Acronyms – GA: generic-accessible, LMIC: low- and middle-income countries, PLHIV: people living with HIV, ART: antiretroviral therapy, PPPY: per patient per year

Exhibit 16: We are factoring 10% market share for Laurus in FY23, but do not expect aggressive capital allocation once these market share levels are attained



Source: Company, Ambit Capital research

Exhibit 17: Laurus trades at 23x 1-year forward P/E with last 12-month average being 16x; currently multiple is optically high as earnings upgrades are yet to reflect



Source: Bloomberg, Company, Ambit Capital research

Exhibit 18: Margin accretion over the next 10 years would stem from higher growth in non-ARV segments

Parameter	FY20-24E	FY24-29E	FY29-34E	FY16-20	Remarks
Sales CAGR	17%	13%	11%	12%	Long-term growth hinges on product launches in regulated markets in areas like oncology, anti-diabetes
EBITDA margin (average)	28%	32%	30%	19%	General uptrend in EBITDA margin as Laurus further forward integrates into formulations
Capex/sales (average)	7%	5%	5%	14%	Ratio would improve as formulations usually generate 2x gross block turns
Pre-tax CFO/EBITDA (average)	81%	93%	93%	83%	Improvement in the longer-term as mix skews towards Synthesis/non-ARV formulations and APIs
Gross block turns (average)	1.5	1.7	2.0	1.4	Gross block turns would trend up as mix transitions towards high margin non-ARV segments
WACC	13%				
- Cost of equity	15%				
- Cost of debt (post-tax)	7%				
- Target D/E	35%				Laurus does not aim to lower debt materially as considerable growth opportunities are available
Terminal growth	3.5%				Terminal growth would be lower due to exports heavy business and contribution from ARV
Implied valuations	**FY20**	**FY21E**	**FY22E**	**FY23E**	
EV/sales	5.2	3.8	3.4	3.1	
EV/EBITDA	26.1	13.3	11.6	10.3	
P/E	54.2	20.4	17.4	15.1	
P/B	7.8	5.8	4.5	3.6	

Source: Company, Ambit Capital research

Exhibit 19: Laurus is trading at a significant discount to the sector median; we see a case of multiple re-rating given industry leading 49% FY20-22 EBITDA CAGR trajectory

Companies	Mcap	Ambit's Stance	TP	Upside	EV/EBITDA (x)			P/E (x)			CAGR (FY20-22E)			RoE (%)			Net Debt/ EBITDA (x)
	US$ mn	BUY/SELL	Rs	%	FY20	FY21E	FY22E	FY20	FY21E	FY22E	Sales	EBITDA	EPS	FY20	FY21E	FY22E	FY20
Pharma																	
Sun	17,027	NR	-	-	18	16	14	29	27	22	9%	11%	15%	10%	10%	11%	(0.5)
Dr. Reddy's*	10,030	BUY	5,099	13%	21	15	13	38	28	24	11%	24%	27%	13%	17%	17%	(0.1)
Cipla*	7,750	BUY	701	-3%	19	17	14	38	33	25	8%	17%	23%	10%	11%	13%	0.2
Aurobindo	6,840	NR	-	-	12	10	9	19	16	15	10%	11%	13%	18%	17%	16%	0.6
Torrent*	6,016	SELL	2,166	-19%	23	21	20	48	41	33	7%	9%	20%	20%	21%	22%	2.6
Lupin*	5,604	BUY	1,001	8%	18	16	12	50	33	23	9%	25%	46%	6%	10%	13%	0.7
Cadila*	5,307	SELL	302	-22%	16	16	15	27	25	23	6%	5%	8%	13%	13%	13%	2.1
Alkem*	4,248	BUY	2,842	7%	22	20	17	28	27	21	8%	16%	15%	13%	17%	16%	0.3
Median					**19**	**16**	**14**	**33**	**27**	**23**	**9%**	**13%**	**18%**	**13%**	**15%**	**14%**	**0.7**
Pharma mid/small caps																	
Ipca	3,161	NR	-	-	25	21	18	37	30	25	15%	18%	20%	19%	19%	19%	0.0
Alembic Pharma	2,479	NR	-	-	18	15	15	25	21	21	14%	11%	7%	24%	24%	20%	1.4
Natco*	1,902	BUY	805	3%	23	21	15	31	29	20	14%	27%	24%	13%	12%	16%	0.4
Ajanta	1,898	NR	-	-	20	18	15	33	28	23	12%	14%	18%	18%	18%	19%	(0.2)
Glenmark	1,704	NR	-	-	10	9	8	18	16	13	9%	14%	14%	12%	12%	13%	2.0
Laurus*	1,335	BUY	1,280	37%	19	10	9	39	15	13	24%	49%	75%	15%	32%	29%	1.7
Granules	902	NR	-	-	13	10	9	21	16	13	16%	23%	23%	20%	21%	22%	1.3
Shilpa	599	NR	-	-	33	18	15	30	24	20	22%	48%	72%	12%	13%	14%	1.3
Strides	521	NR	-	-	9	9	7	16	15	11	12%	11%	30%	8%	10%	13%	3.5
Median					**18**	**10**	**9**	**30**	**21**	**20**	**14%**	**18%**	**23%**	**15%**	**18%**	**19%**	**1.3**

*Source: Company, Bloomberg, Ambit Capital research; Note: * Denotes companies under coverage*

Over the last 10-years, a couple of large-cap names that have emerged as consistent compounders include Divis and Biocon. Both the companies opted for unique business models unlike their large-cap peers. Biocon has deployed considerable capital in developing its biosimilars capabilities, while Divis has continued to scale up its core API capabilities and has stayed away from forward integrating into formulations.

In Biocon's case, sales growth has been in high teens though FCF generation has been absent over the last 3 years. In the case of Divis, growth has been low but cash generation has been quite superior. Either of the business models has led to sustained premium valuations despite exports heavy business models of both. In the longer term, Laurus can continue to re-rate if it's able to sharply scale up in businesses ex-ARV. This can be achieved on the back of its R&D and manufacturing capabilities.

Exhibit 20: Valuation of evolution of companies like Biocon and Divis over the last 10 years indicates that premium valuations are a function of unique product development and manufacturing expertise

Parameters	Biocon			Divis		
	FY10-12	FY13-16	FY17-20	FY10-12	FY13-16	FY17-20*
Strategic proposition	**Complex pipeline (biosimilars) development via R&D capabilities**			**Focus largely on generating scale in APIs; no forward integration strategy**		
Sales CAGR	-6%	10%	18%	41%	21%	10%
Avg. gross margin (%)	54%	59%	64%	63%	62%	64%
Avg. EBITDA margin (%)	4%	23%	24%	39%	38%	33%
Cum. FCF/sales	17%	-11%	-6%	13%	14%	12%
Avg. Pre-tax RoCE	18%	17%	13%	30%	34%	26%
Avg. P/E	16.8	16.9	36.0	19.3	20.3	24.2

*Source: ACE Equity, Company, Ambit Capital research; Note: * Sales has been annualized based on 9MFY20 trends, while 1HFY20 figures have been considered for other parameters*

Risks appear to be largely under control

- **China supply issues of the past and current COVID-19 outbreak:** We estimate that Laurus' dependence on Chinese imports is in the range 50-60%, which was 70% a couple of years back. It appears that the company has inventories for the next 4-5 weeks, but an elongated shutdown could considerably impact sales in 1QFY21. On a structural note, the company has backward integrated further into intermediates and APIs following supply and pricing disruption in FY19. But, the company still depends on Chinese imports considerably and any untoward supply shock can exert considerable drag on both sales and margins.
- **Negative operating leverage could be pronounced owing to capex needs:** Laurus' capex as percentage of sales would trend down from 19%/11% in FY18/19 to average 9% over FY20-22. Extended commissioning timelines could generate considerable opex without commensurate sales.
- **Steeper-than-expected pricing erosion in ARV:** Funding constraints have exerted considerable pressure on pricing over the last 3 years. We do build in pricing decline in the range of 4-5% over the next 5 years as part of our base case. However, exaggerated pricing declines could hamper overall market growth considerably.

Exhibit 21: TP goes down to Rs1,086 if average capex/sales ratio is 3% higher vs our current estimate

TP (Rs)	Sensitivity to capex/sales		
	FY20-24E	FY24-29E	FY29-34E
1,295	7%	5%	5%
1,225	7%	6%	6%
1,155	8%	7%	7%
1,086	8%	8%	8%

Source: Company, Ambit Capital research

HAWK scores – Above sector average

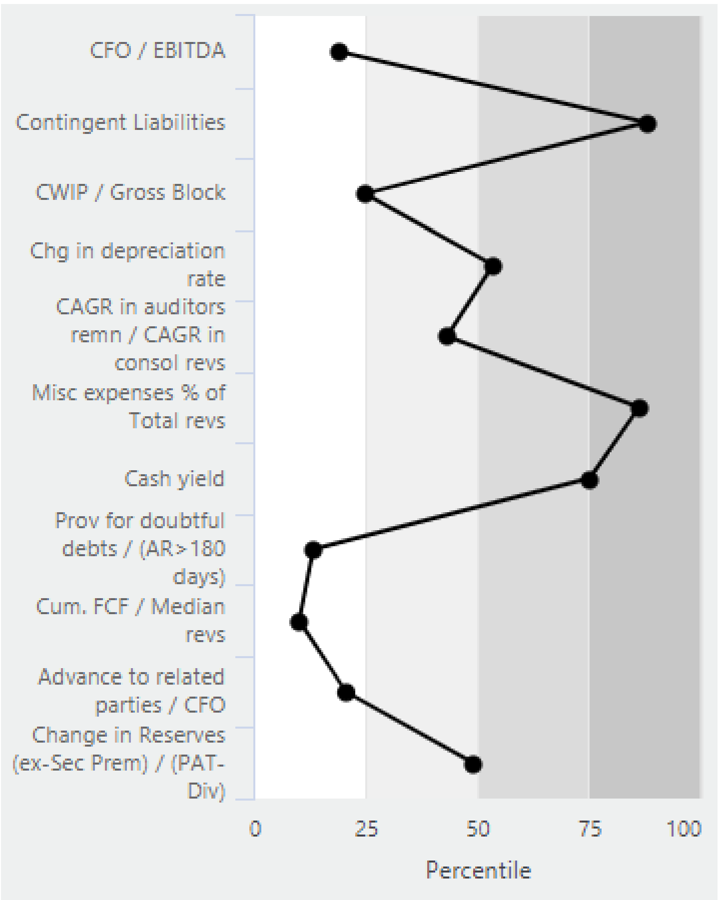
On our proprietary forensic score framework, Laurus appears in the Zone of "Safety" in 2019. Laurus' score improved to D5 in 2019 vs. D6 in 2018. Consequently, the company scores higher than the median accounting score for its sector as well the large universe (BSE500 companies). On greatness, Laurus' score deteriorated to 42% in 2019 vs. 50% in the year before. Laurus' greatness score has been sub-50% over 2015-19 and consequently its greatness score percentile is lower than the median score for its sector as well as the larger universe (BSE500 companies).

Key contributors to accounting score and comparison to peers

Laurus features in D5 decile on our accounting framework, which is the Zone of "Safety". Key contributors to its relatively strong accounting score include: (i) continuous reduction in contingent liabilities; (ii) stable cash yield; and (iv) relatively less volatile depreciation rate. In comparison with peers, Laurus scores above median accounting score, indicating above par accounting quality vs. peers.

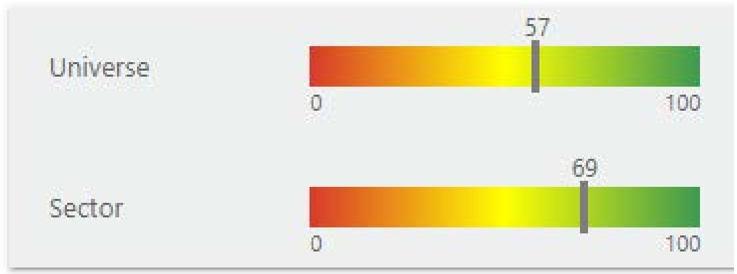
We note that Laurus scores low on a few parameters including: (i) low CFO to EBITDA ratio; (ii) FCF to sales ratio; and (iii) higher CWIP to gross block ratio. We don't expect any deterioration in accounting score further, considering stronger balance sheet in FY20 and largely stable business mix.

Forensic accounting score contributors



Source: Ambit HAWK

Forensic score percentile to larger universe and sector

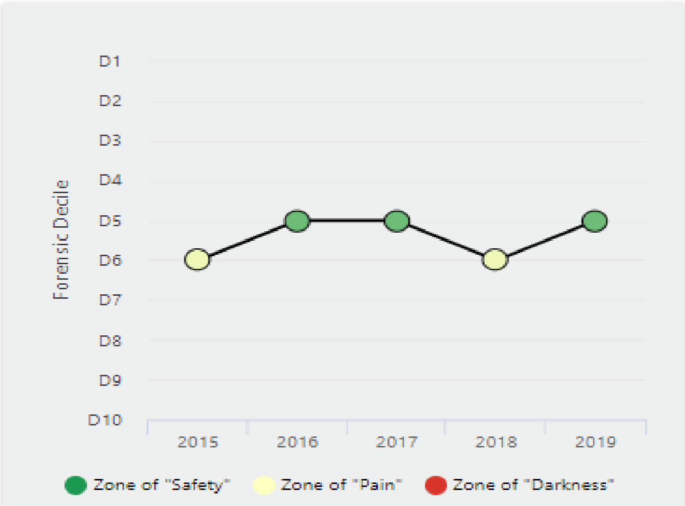


Source: Ambit HAWK

Comments on evolution of accounting score

Laurus' score has largely been in the Zone of "Safety" (i.e. D1 to D5 deciles) over 2015-19. It is pertinent to note here that our framework consists of multiple ratios including CWIP/gross block and cumulative FCF/median sales which assess companies' accounting quality capital deployment. Owing to the nature of the pharma business, these companies might get inadvertently penalised on our framework, especially on CWIP/gross block and cumulative FCF/median sales.

Forensic accounting score evaluation



Source: Ambit HAWK

Movement in accounting checks

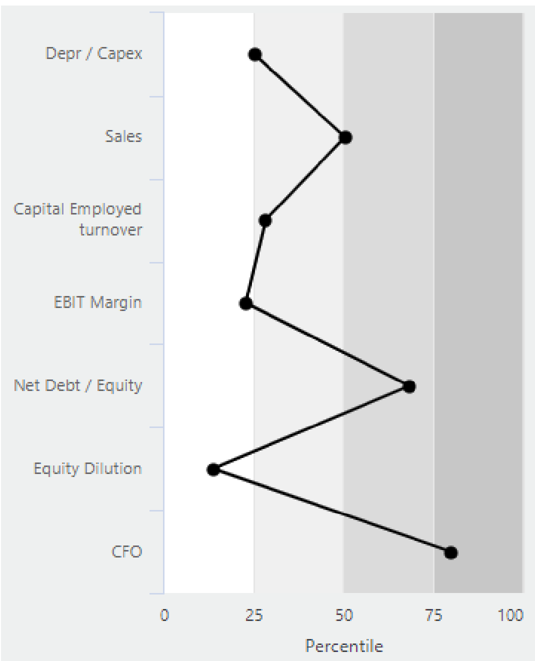
Category	Accounting ratios	FY18	FY19	FY20
P & L mis-statement check	CFO/EBITDA	104%	86%	73%
	Volatility in depreciation rate	-62bps	61bps	0bps
	PFD-% of Debtors more than six months	0%	0%	0%
Balance sheet mis-statement check	Cash yield	4%	5%	4%
	Change in reserves (ex sec-prem)/(PAT ex dividend)	1.0	0.9	0.9
	Cont Liab-% of NW	6%	7%	9%
Pilferage checks	Misc. exps-% of total revs	0%	0%	0%
	Adv. to related parties / CFO	0%	0%	0%
	CWIP: Gross Block	9%	5%	3%
	Cum. FCF/median revs	-79%	-65%	-47%
Audit quality check	CAGR in auditor's remn/CAGR in cons. Rev.	15.1	(1.1)	(0.1)

Source: Company, Ambit Capital research

Evolution of greatness score

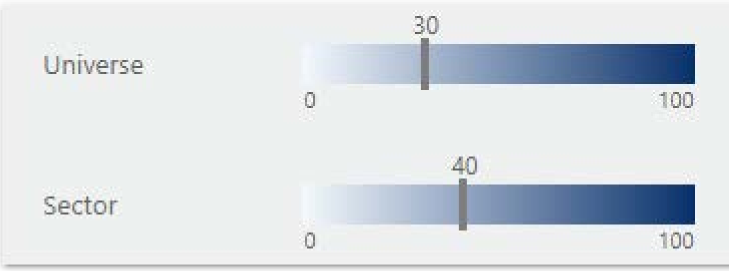
Our greatness framework evaluates companies on drivers of 'Greatness' (e.g. cash generation, incremental capex, efficiency in capital employed turnover etc.). Laurus' greatness score has deteriorated in 2019 and has been sub-50% over 2015-19. This is primarily due to downtrend in EBIT margin till 2019 and subdued capital employed turnover ratio over FY15-19. So, Laurus' performance has been below average when compared to the larger universe (BSE500 companies) and its sector peers.

Greatness score contributors



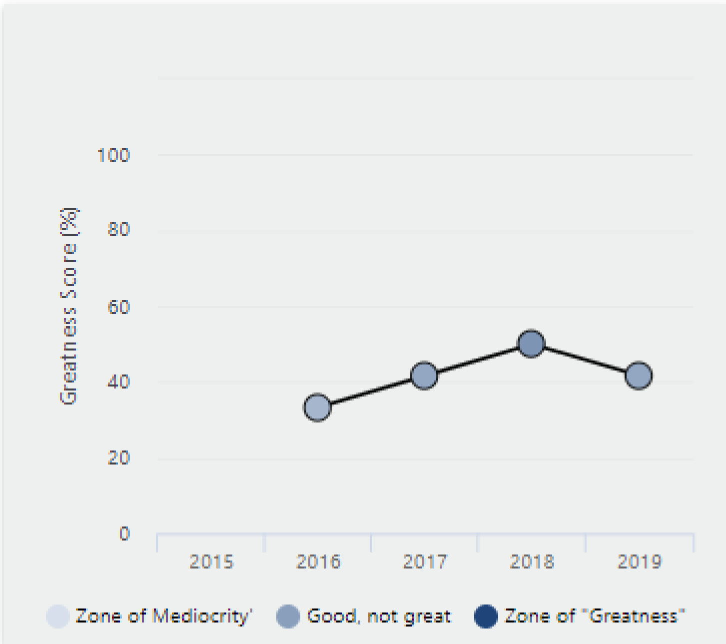
Source: Ambit HAWK

Greatness score percentile to larger universe and sector



Source: Ambit HAWK

Greatness score evolution



Source: Ambit HAWK

Financials

Profit & loss (consolidated)

Year to March (Rs mn)	FY18	FY19	FY20	FY21E	FY22E	FY23E
Share capital	1,060	1,060	1,069	1,069	1,069	1,069
Reserves & surplus	13,766	14,520	16,629	22,627	29,659	37,762
Shareholders' fund	**14,826**	**15,580**	**17,698**	**23,696**	**30,728**	**38,831**
Long term borrowings	1,417	2,587	1,856	1,856	1,856	1,856
Others	855	906	1,026	1,026	1,026	1,026
Non-current liabilities	**2,272**	**3,493**	**2,882**	**2,882**	**2,882**	**2,882**
Short term borrowings	8,382	8,481	9,600	10,800	10,800	9,600
Trade payables	3,123	4,883	6,156	8,356	9,496	10,469
Others	1,563	875	1,167	1,167	1,167	1,167
Current liabilities	**13,069**	**14,239**	**16,924**	**20,324**	**21,463**	**21,237**
Total equity & liabilities	**30,167**	**33,312**	**37,503**	**46,901**	**55,073**	**62,949**
Fixed assets	14,639	16,072	17,068	18,227	18,943	19,471
Capital work-in-progress	1,632	1,096	672	672	672	672
Intangible assets	169	219	195	207	215	221
Loans & advances and investments	273	328	372	372	372	372
Others	979	967	1,076	1,076	1,076	1,076
Non-current assets	**17,691**	**18,682**	**19,383**	**20,554**	**21,277**	**21,811**
Inventories	5,848	6,819	9,052	12,637	14,959	15,832
Trade receivables	5,706	7,099	7,914	10,742	11,967	12,930
Cash and cash equivalents	31	30	17	1,832	5,733	11,240
Loans & advances and others	892	681	1,137	1,137	1,137	1,137
Current assets	**12,476**	**14,630**	**18,121**	**26,348**	**33,796**	**41,138**
Total assets	**30,167**	**33,312**	**37,503**	**46,901**	**55,073**	**62,949**

Source: Company, Ambit Capital research

Profit & loss (consolidated)

Year to March (Rs mn)	FY18	FY19	FY20	FY21E	FY22E	FY23E
Net sales	**20,690**	**22,919**	**28,317**	**38,436**	**43,680**	**48,156**
Gross profit	10,053	10,563	14,183	20,290	23,110	25,834
Employee cost	(2,580)	(2,892)	(3,449)	(3,862)	(4,326)	(4,845)
Other expenses	(3,339)	(4,111)	(5,089)	(5,381)	(6,115)	(6,742)
EBITDA (underlying)	**4,133**	**3,560**	**5,645**	**11,046**	**12,669**	**14,247**
Depreciation	(1,255)	(1,642)	(1,873)	(2,029)	(2,277)	(2,355)
Interest expense	(796)	(882)	(896)	(844)	(886)	(844)
Other income	292	162	59	101	195	410
PBT (reported)	**2,374**	**1,198**	**2,936**	**8,275**	**9,701**	**11,458**
Tax provision	(698)	(260)	(383)	(1,489)	(1,746)	(2,292)
PAT pre-minority (reported)	1,676	938	2,553	6,785	7,954	9,166
PAT (reported)	**1,676**	**938**	**2,553**	**6,785**	**7,954**	**9,166**
PAT (adjusted)	**1,676**	**938**	**2,553**	**6,785**	**7,954**	**9,166**

Source: Company, Ambit Capital research

Per share data (consolidated)

Year to March (Rs)	FY18	FY19	FY20	FY21E	FY22E	FY23E
No. of shares o/s (mn)	106	106	107	107	107	107
EPS (adjusted) basic	15.8	8.8	23.9	63.5	74.4	85.7
EPS (adjusted) diluted	15.7	8.8	23.9	63.5	74.4	85.7
DPS	1.5	1.5	2.5	6.3	7.4	8.6
Dividend payout (%)	10%	17%	10%	10%	10%	10%

Source: Company, Ambit Capital research

Cash flow statement (consolidated)

Year to March (Rs mn)	FY18	FY19	FY20	FY21E	FY22E	FY23E
PBT	2,374	1,198	2,936	8,275	9,701	11,458
Depreciation	1,255	1,642	1,873	2,029	2,277	2,355
Others	910	911	1,059	844	886	844
WC (build)/release	(495)	(520)	(1,998)	(4,213)	(2,407)	(863)
Tax	(619)	(253)	(396)	(1,489)	(1,746)	(2,292)
Cash flow from operations	**3,425**	**2,977**	**3,474**	**5,445**	**8,710**	**11,503**
Capex (net)	(3,911)	(2,543)	(2,222)	(3,200)	(3,000)	(2,889)
Others income/(expenditure)	70	14	11	-	-	-
Cash flow from investments	**(3,842)**	**(2,529)**	**(2,211)**	**(3,200)**	**(3,000)**	**(2,889)**
Proceeds from borrowings	1,372	564	(58)	1,200	-	(1,200)
Issuance/buyback of equity	3	24	26	-	-	-
Interest paid	(761)	(844)	(859)	(844)	(886)	(844)
Dividend paid	(191)	(192)	(386)	(787)	(923)	(1,063)
Cash flow from financing	**422**	**(448)**	**(1,277)**	**(431)**	**(1,809)**	**(3,107)**
Net change in cash	6	0	(14)	1,814	3,902	5,506
FCF	**(1,248)**	**(410)**	**394**	**1,401**	**4,824**	**7,770**

Source: Company, Ambit Capital research

Ratios (consolidated)

Year to March	FY18	FY19	FY20	FY21E	FY22E	FY23E
Revenue growth (%)	7%	11%	24%	36%	14%	10%
EBITDA margin (%)	20%	16%	20%	29%	29%	30%
EBIT margin (%)	14%	8%	13%	23%	24%	25%
Net margin (%)	8%	4%	9%	18%	18%	19%
Gross block turnover (x)	1.3	1.2	1.3	1.5	1.5	1.5
RoCE pre-tax (%)	13%	7%	14%	28%	26%	25%
RoCE post-tax (%)	9%	6%	12%	23%	21%	20%
RoIC pre-tax (%)	13%	7%	14%	28%	29%	31%
RoE (%)	12%	6%	15%	33%	29%	26%
Receivable days	101	113	102	102	100	98
Inventory days	103	109	117	120	125	120
Payable days	55	78	79	79	79	79
Cash conversion cycle	149	144	139	143	146	139
Pre-tax CFO/EBITDA (%)	98%	91%	69%	63%	83%	97%
Net debt / Equity (x)	0.7	0.7	0.6	0.5	0.2	0.0

Source: Company, Ambit Capital research

Valuation ratios (consolidated)

Year to March	FY18	FY19	FY20	FY21E	FY22E	FY23E
P/E (x)	59.0	105.5	38.7	14.6	12.4	10.8
P/B (x)	7.3	6.9	6.1	4.5	3.5	2.8
EV/EBITDA(x)	26.1	30.3	19.1	9.8	8.5	7.6
EV/EBIT(x)	37.4	56.2	28.6	11.9	10.4	9.1

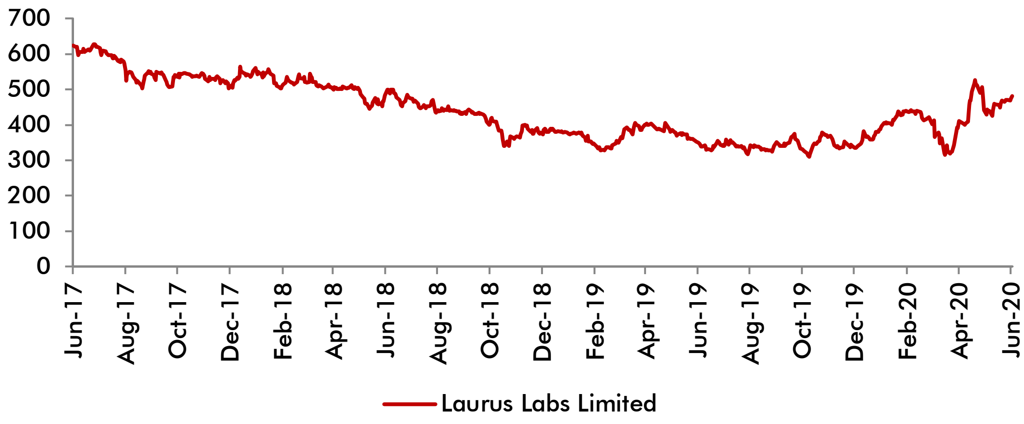
Source: Company, Ambit Capital research

Segmental (consolidated)

Year to March	FY18	FY19	FY20	FY21E	FY22E	FY23E
Rs mn						
API	18,361	19,432	16,214	19,960	22,419	22,915
- ARV	13,353	13,952	10,330	11,898	13,830	13,830
- Oncology	1,625	2,182	2,106	2,319	2,510	2,710
- Other APIs	1,714	2,101	3,244	5,250	5,648	5,986
- Hep-C	1,669	1,197	533	494	432	389
Formulations	52	545	8,253	13,736	15,836	19,057
Synthesis	1,541	2,947	3,851	4,740	5,425	6,184
Ingredients	603					
Total	**20,557**	**22,924**	**28,318**	**38,436**	**43,680**	**48,156**
Growth %						
API	6%	6%	-17%	23%	12%	2%
- ARV	9%	4%	-26%	15%	16%	0%
- Oncology	51%	34%	-3%	10%	8%	8%
- Other APIs	14%	23%	54%	62%	8%	6%
- Hep-C	-33%	-28%	-55%	-7%	-13%	-10%
Formulations		958%	1413%	66%	15%	20%
Synthesis	52%	91%	31%	23%	14%	14%
Ingredients	-1%	-100%	#DIV/0!			
Total	**9%**	**12%**	**24%**	**36%**	**14%**	**10%**
% of sales						
API	89%	85%	57%	52%	51%	48%
- ARV	65%	61%	36%	31%	32%	29%
- Oncology	8%	10%	7%	6%	6%	6%
- Other APIs	8%	9%	11%	14%	13%	12%
- Hep-C	8%	5%	2%	1%	1%	1%
Formulations	0%	2%	29%	36%	36%	40%
Synthesis	7%	13%	14%	12%	12%	13%
Ingredients	3%	0%	0%	0%	0%	0%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Company, Ambit Capital research

Laurus Labs Limited (LAURUS IN, BUY)



Source: Bloomberg, Ambit Capital research

Explanation of Investment Rating - Our target prices are with a 12-month perspective. Returns stated are our internal benchmark

Investment Rating	Expected return (over 12-month)
BUY	We expect this stock to deliver more than 10% returns over the next12 months
SELL	We expect this stock to deliver less than or equal to 10 % returns over the next 12 months
UNDER REVIEW	We have coverage on the stock but we have suspended our estimates, TP and recommendation for the time being
NOT RATED	We do not have any forward-looking estimates, valuation, or recommendation for the stock.
POSITIVE	We have a positive view on the sector and most of stocks under our coverage in the sector are BUYs
NEGATIVE	We have a negative view on the sector and most of stocks under our coverage in the sector are SELLs
NO STANCE	We have forward looking estimates for the stock but we refrain from assigning valuation and recommendation

Note: At certain times the Rating may not be in sync with the description above as the stock prices can be volatile and analysts can take time to react to development.

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Compliance Officer Details: Sanjay Shah, Email id: compliance@ambit.co, Contact Number: 91 22 68601965

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