# Laurus Labs Limited

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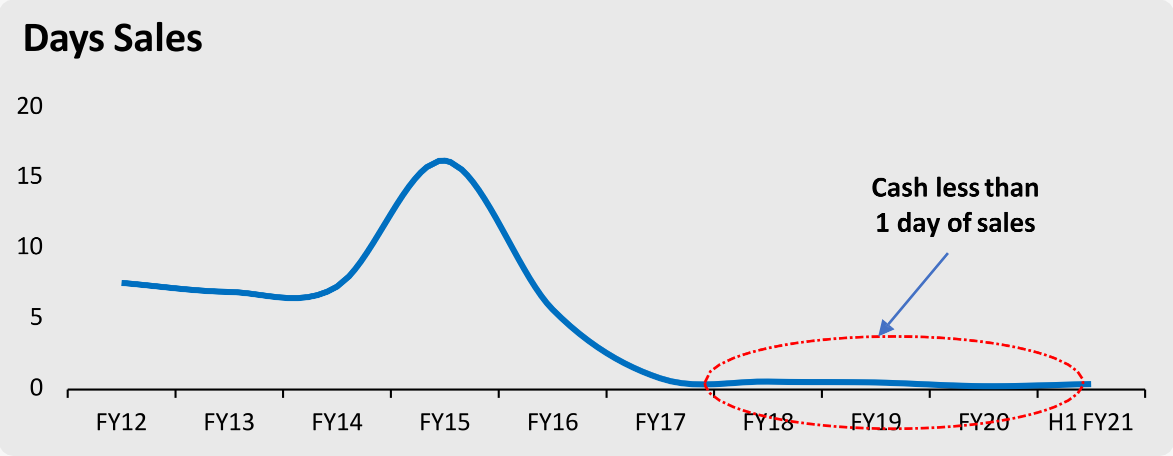
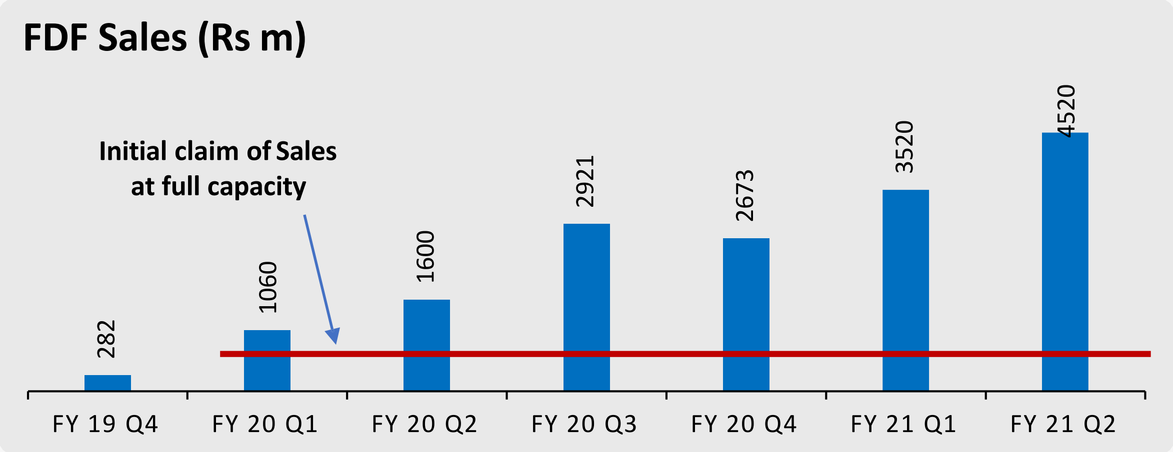
# Key Points

Laurus Labs is rapidly transitioning from a 1 segment API company into a diversified pharma company at a frenetic pace. While the P&L ramp up is admirable, we highlight some "grey" areas in Balance Sheet numbers and management commentary on business and strategy.

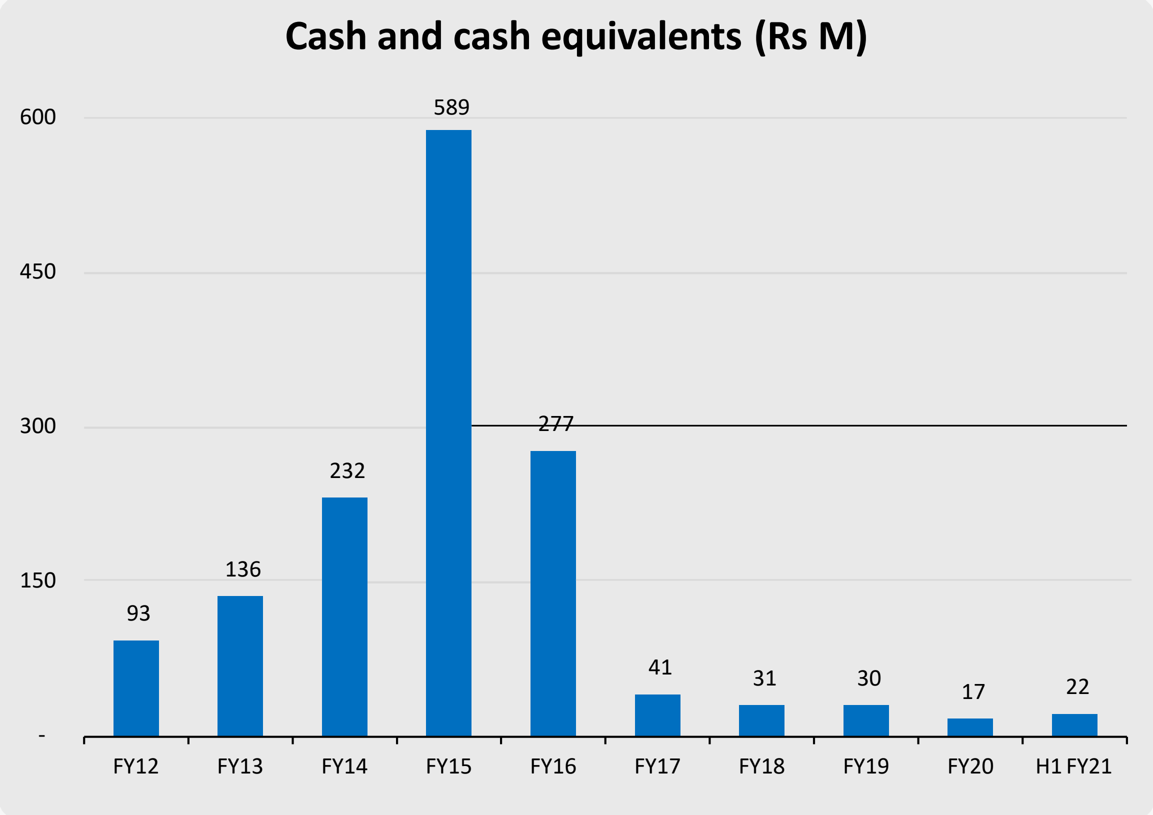
- Highly unusual cash strategy, which requires better explanation from the management.
- In most of the post IPO history, Laurus appears to have gone through tight liquidity situation. The domestic payable and receivable days have been volatile and high while the international dealings have been managed well.
- In FDF business, the key driver of the remarkable turnaround in Laurus' fortunes, sustainability of ARV formulations growth is questionable.
- The statement made regarding Capex for FY21 on 31 Jul'20 (Q1 FY21 call) extremely odd; management reiterated Rs 300 crore as FY21 Capex guidance, whereas by Sep'20 it incurred Rs 262 crore in Capex. On 31 Jul, the management would have surely known Rs 300 crore would be overshot significantly.
- As shown in the chart of FDF sales, it seems that the product mix changed dramatically or the pricing shot up or the geographical mix changed leading to meteoric rise in sales.

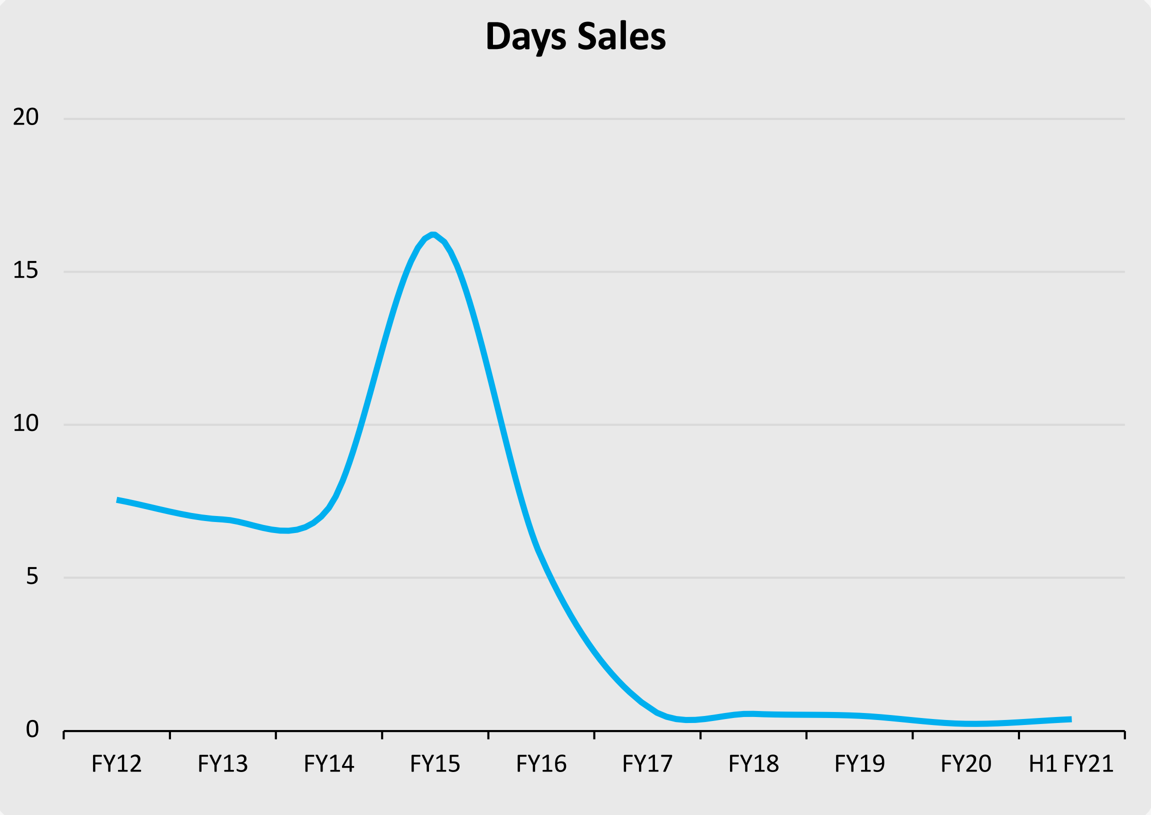


# Cash and Cash Equivalent Abnormally Low

- Since Mar’17, Laurus’s Balance Sheet shows cash which is equivalent to less than 1 day of sales
- Note, till FY16, this metric was in reasonable range, at around 1 week or more of collections
- The one major event which occurred in FY17 was the IPO and listing of Laurus. The Cash policy seems to have changed post IPO

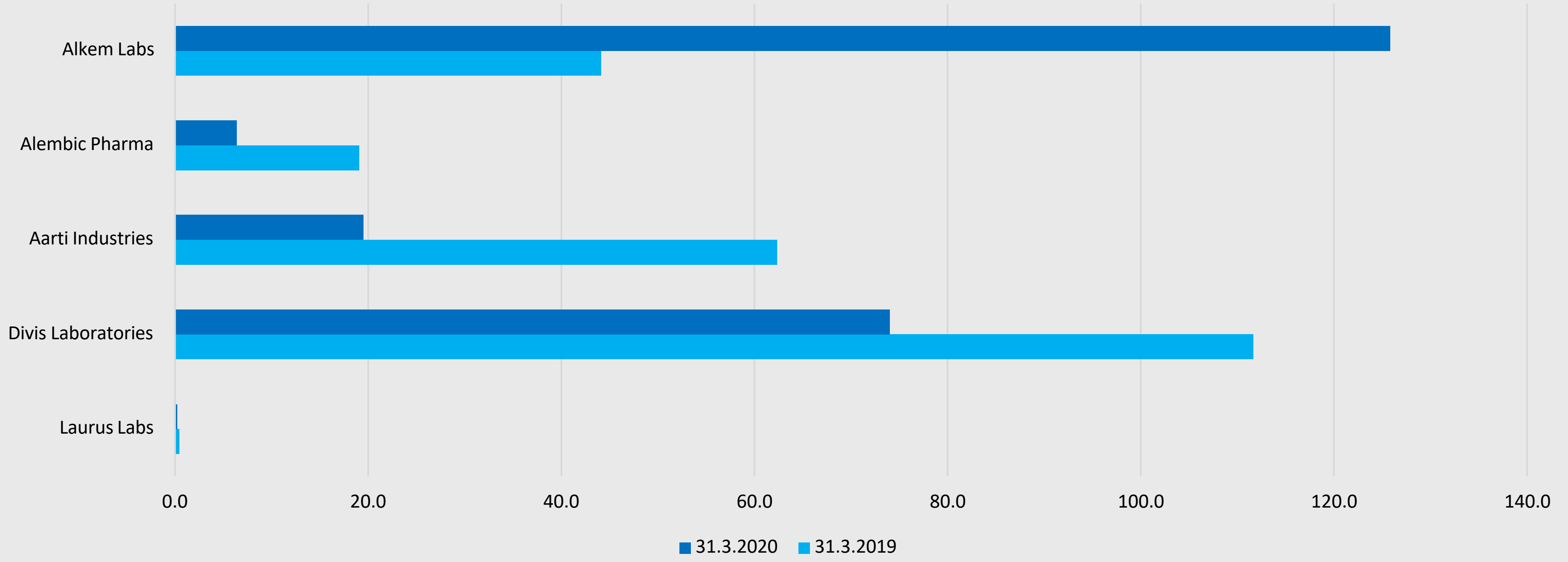


# Peers, other Listed Companies have Higher Cash

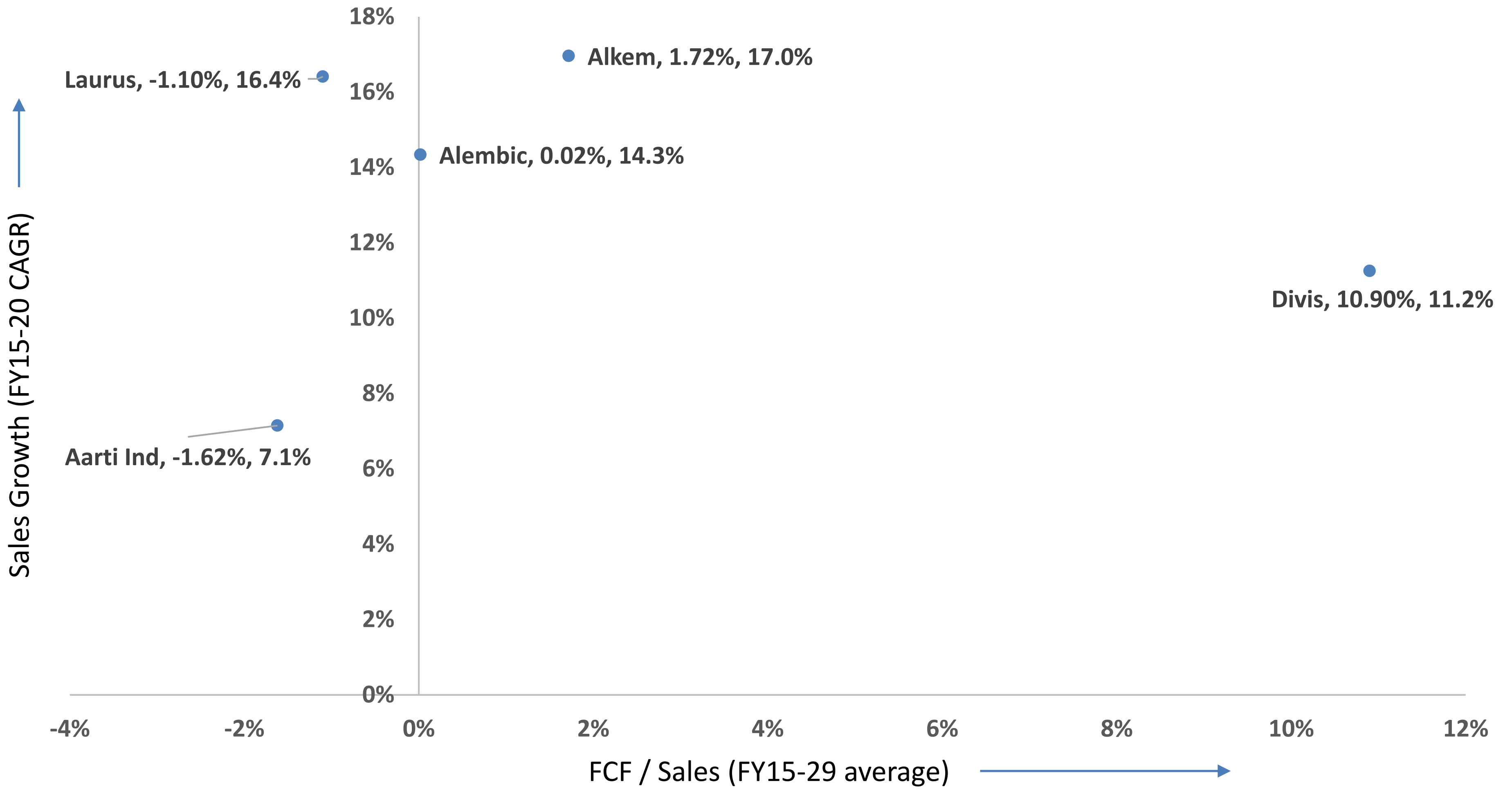
- Immediate pharma peers have cash equivalent to 20 days or more of sales
- Listed companies **in general… (we ran a query across sectors using MCAP as a filter and found that few companies such as Amara Raja batteries, SAIL, Tube investments have low level of cash, but not to the extent of Laurus)**

## Cash and Cash Equivalent + Current Investments as Days Sales



# FCF to Sales metric

- **Laurus' performance shows up as better than Aarti on FCF/Sales interplay. Alkem and Divis are far better on this metric**



# What should be a Healthy Cash Policy?

We asked a few CFOs & Bankers on their views on ideal levels of cash buffers to be maintained

| Policy Suggested by CFOs | For Laurus |
|---|---|
| 1 month of WC requirement as buffer cash | 2253 |
| 1 quarter of debt servicing requirement | 601 |
| **Total Cash For Prudent Liquidity Management** | **Rs 2854m** |

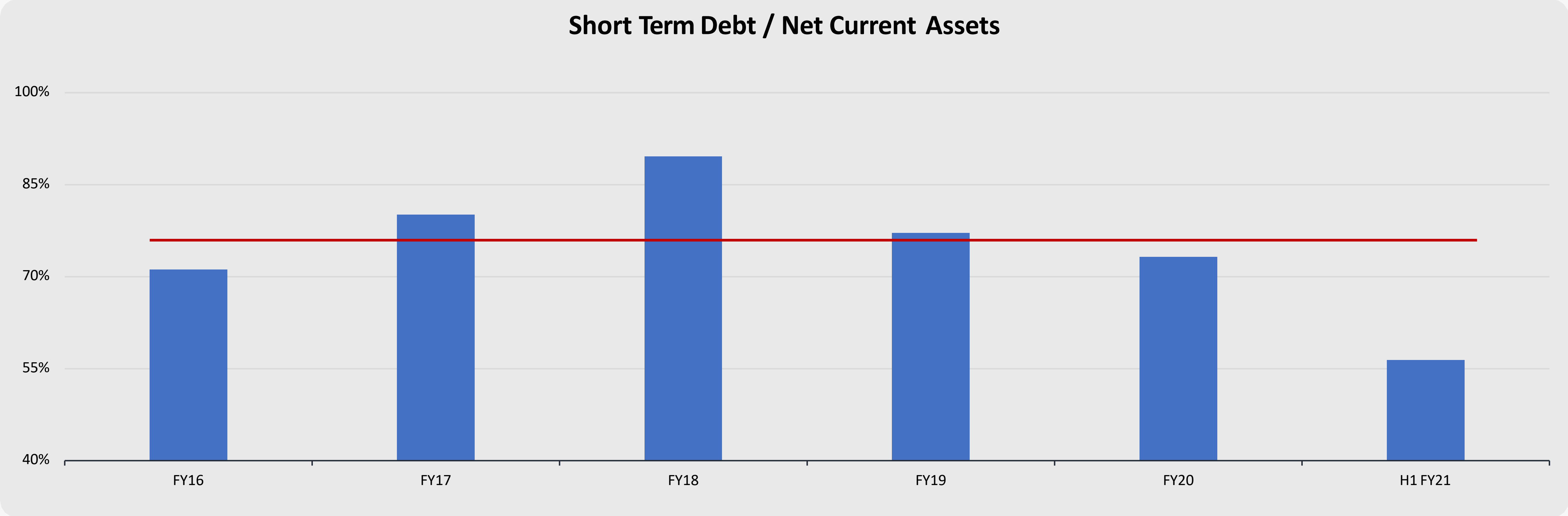
- Laurus needs to have close to Rs 3B of Cash/Current Investments to avoid liquidity crunch. We understand it is possible to have very low or even negative cash balances, depending on cash management policy wrt OD accounts. However, the point is – if this was the best policy, most companies would be following it, which is not the case.
- Banker feedback is that they would like to see more cash as well. Keeping such low cash, to possibly minimize finance costs, is too aggressive.

# Is Tight Liquidity Behind the Unusual Cash Policy?

DART

## We find cash position of Laurus was highly stretched over FY17-20

- For most of the period shown in the chart, Laurus was skirting the limit of borrowing capability to finance working capital requirements.
- The situation has improved in 1H FY21, however, the sharp escalation announced in Capex may divert the cash generated.



# Stress in Working Capital Cycle

- There is heavy stress visible in the working capital cycle as well
- While forex receivables and payables are in reasonable range, domestic receivables and payable cycle appears heavily stretched

| | FY16 | FY17 | FY18 | FY19 | FY20 |
|---|---|---|---|---|---|
| Forex Payable Days | 94 | 85 | 50 | 116 | 78 |
| Domestic Payable Days | 78 | 130 | 304 | 174 | 225 |
| Overall Payable Days | 90 | 96 | 105 | 141 | 138 |
| | | | | | |
| Forex Receivable Days | 45 | 89 | 77 | 91 | 90 |
| Domestic Receivable Days | 118 | 117 | 124 | 137 | 124 |
| Overall Receivable Days | 91 | 109 | 104 | 116 | 105 |

# Finance Cost Reducing but Higher than Peers

- The aggressive cash management policy does not necessarily translate into a financing cost lesser than peers, but this has improved in 1HFY21
- The cost has come down though. It was as high as 17% in FY15 and 13% in FY16

**Average Cost of Finance**

| | FY16 | FY17 | FY18 | FY19 | FY20 | 1HFY21 |
|---|---|---|---|---|---|---|
| Laurus Labs | 11.7% | 9.5% | 9.6% | 9.4% | 8% | 5.5% |
| Divis Laboratories | 5.8% | 2.7% | 4.1% | 8.8% | 5.2% | 2.3% |
| Aarti Industries | 8.8% | 7.8% | 9.1% | 6.4% | 7.1% | 4.% |
| Alembic Pharma | 5.2% | 0.9% | 2.3% | 2.0% | 2.0% | 1.9% |
| Alkem Labs | 7.3% | 7.2% | 6.1% | 5.1% | 5.0% | 2.5% |

***Unsecured ST loan taken in FY20 was again for Working Capital***

# Latest Credit Rating is for Enhanced Limits

- In quarterly calls, the management has been guiding towards reduced or flat debt levels
- In Q4 FY19, the company said LT debt would go to zero in 4 years
- Then in Q2 FY21, it has sharply increased capex plan, but says will keep debt constant and fund capex from internal accruals
- Yet we see enhanced limits in latest Credit Rating, as on Jun'20

**Laurus Labs Limited**

June 30, 2020

**Ratings**

| **Facilities** | **Amount (Rs. crore)** | **Rating1** | **Rating Action** |
|---|---|---|---|
| **Long term Bank Facilities** | 1291.81 (enhanced from 1048.57) | **CARE AA-; Stable (Double A Minus; Outlook - Stable)** | Reaffirmed |
| **Short term Bank Facilities** | 373.2 (enhanced from 313.2) | **CARE A1+ (A One Plus)** | Reaffirmed |
| **Total Facilities** | **1665.01 (One Thousand Six hundred and Sixty five and one lakh only)** | | |
| Short-term –Commercial paper* | 200.00 | **CARE A1+ (A One Plus)** | Reaffirmed |

**carved out of the sanctioned working capital limits of the company.*

# Insights from Management Calls

# Can we Trust the Management Commentary?

## Q1 FY21 Call (31 Jul, 20)

Q

**What is the risk which you see if at all any over the next two, three years for the company?**

Co

**:** There is no capacity risk. We have annual capacities. There is no product risk. There is no regulatory risk we believe. There is no customer risk.

**Management has made bold statements time and again – Could this be over confidence?**

- No pharma company can claim immunity from product or capacity risk (failing a regulatory inspection is always a possibility).
- When Top 10% customers contribute to 62% of revenue, hard to understand a statement which says ‘no customer risk’. What happens if a key customer runs into financial strain or simply switches supplier?

# FDF Growth Explanation

**Much of the explosive growth for Laurus has come from the FDF business. We highlight our rationale on this business and few key questions.**

## Q4 FY19 Call (3 May, 2019)

Co

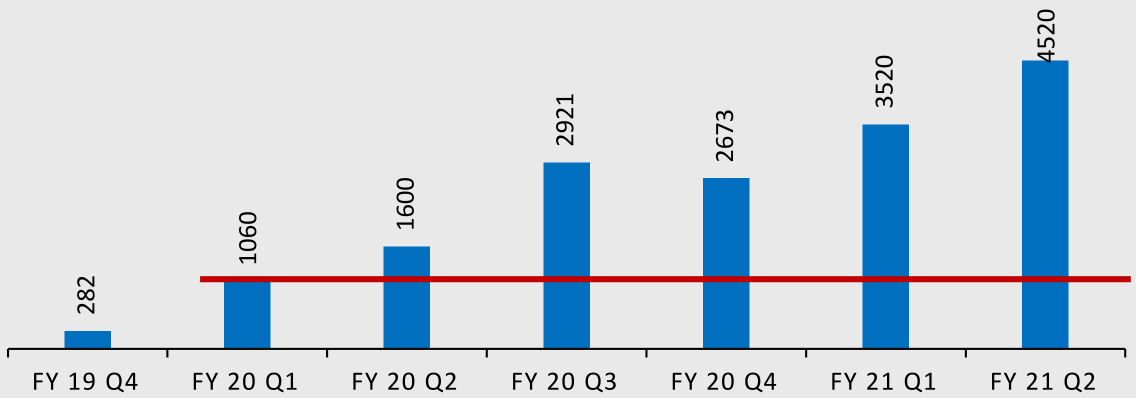
**In FDF we have installed capacity of 5 billion units, currently we are at 25% of capacity utilization.**

- Sales from FDF business was Rs 282 m in Q4 FY19. If we take that as sales at 25% capacity utilization, then FDF sales at peak capacity utilization would be Rs 100 crore per quarter
- **How was the excess managed?**

We believe that there was a significant change in product mix – Efavirenz and Lamivudine were older products with low MSP vs Tenofovir or combination products like TLE, TLD, TEE have higher MSP.

2nd explanation could be that price hikes were taken by the management and change in dispensing method (as highlighted in 2QFY21 call) led to higher stocking. But again prices have been competitive.

**FDF Sales (Rs m)**



# FDF Growth Explanation

## Q4 FY19 Call .. continued

Q

**Year-on-year on an average we are seeing pricing come down. Do you see a funding related pressure and how do you see the pricing for these combinations, formulations evolving? What is the order of the price erosion that you see on the formulations ARV LMIC formulations is it 8%, 9% or is it more than that?**

Co

No I would say any price drop will be very, very gradual and we do not expect below 5% price drop.

**Media reports at similar time periods as the call above suggested a far stronger price erosion. Example:**

- South Africa's public sector will save US$326 million over the next three years as a result of competitive tendering exercise that pushed the price of a fixed combination of tenofovir, lamivudine and dolutegravir down to $65 a year.

"This needs to be understood from the management as the prices of ARVs in LMIC countries have been down trending. For example: Price of TLE600 has come down from $10/pack in Q1'15 to $6/pack in Q3'18. However, **one interesting trend is that despite falling prices, the overall market continues to grow** albeit, at a low single digit due to large increases in the number of PLHIV on ART. Further, in-line with management commentary, the number of adults on ART has more than tripled since 2010 in some LMICs (source: clintonhealthacesss)"

# FDF Growth Explanation

DART

## Q2 FY20 Call (1 Nov 2019)

Co

**Our capacity utilization is at almost optimum level right now that is good for us for this year as we mentioned in the previous question and we are debottlenecking and adding some capacity by April next year for our FY2021 growth opportunities.**

FDF Sales in Q2 FY20 was Rs 160 crore, which the company is calling ‘optimum’. Quarterly revenue went up to Rs 290 crore in Q3, and Rs 260 crore in Q4, higher by 60-70%. Nameplate capacity as on Mar’20 was still 5B tablets per annum. How did the company achieve rampup in sales? Note, as per Q4 FY19 call, even Rs 100 crore per annum was 100% utilization. **This indicates either higher pricing and higher volume in DTG**

Co

**We have invested Rs.400 crore in the plant, where debottlenecking is putting another Rs.50 crore. Then it will be Rs.450 Crores assets . Probably you can get closer to 2x.**

The de-bottlenecking was supposed to raise capacity to 6B tablets; the company says this meant Rs 900 cr pre annum best case run rate, or about Rs 225 crore per quarter. This would be possible in Q1FY21 as the company is clearly stating. However, the run rate exceeded this significantly. **"So, it is important to understand, how many batches of which products were shipped in LMIC and in regulated markets. Further, what products do they intend to supply in 2H and in which countries. This can give a fair idea of the sustenance of growth”**

# FDF Growth Explanation

## Q3 FY20 Call (31 Jan 2020)

Q

**Based on the guidelines that you have given regarding asset turnover, Rs. 290 Crores seems way beyond what you had indicated as an optimal revenue for the formulation division, so can you please explain that? See for the formulation division, you had indicated earlier that the asset turnover should be around 1.7x for maybe at most 2x, where we are right now I presume it would be close to 3x if you annualize the quarterly number?**

Co

See here you have to consider the API capex, see this is a captive backward integrated project for us, so entire API is what we are using in formulation coming from our own facilities. Where we are not taking any revenue of API in API division, so when it comes to the asset of our ratio, we have to think at API capex as well as the FDF capex.

**"Key question here is if the A/O is 2x, then exactly how much is benefitted from backward integration?**

Q

**Okay I am still not clear about that, but your existing capacity is at 5 billion tablets, right?**

Co

You are right. It is a notional capacity but ARVs doing triple combination, so one tablet is equivalent to 3 dispensing, 3 granulations, where as compression and packing is one so significant capacity will be used for triple combination and we are doing capsules, we are doing tablets for the other markets. Per say, if you convert triple combination as three, we are running around maybe 300-400 million units per month.

"If we are producing 300-400mn units per month and the pricing is competitive, then backward integration and new demand must have led to strong growth. Kindly clarify on new demand generation?"

# FDF Growth Explanation

## Q4 FY20 Call (30 April 2020)

Co

**As we speak we are running at full capacity of formulations.**

In Q2, the company said utilization was optimum. At that time, the sales for the quarter was Rs 160 crore.

Q4 FY20 sales was Rs 267 crore. Q1 FY21 sales was Rs 352 crore. Since the call is happening in Apr’20, Dr Chava may be referring to Rs 350 crore/quarter run rate.

And then in Q2 FY21, the company reported Rs 450 cr+ sales. **So how much can the product mix and geographical mix help in growth going forward?**

# FDF Growth Explanation

## Q2 FY21 Call (30 Oct 2020)

Co

**The growth is coming from these two segments; the growth in patients accessing the ARV treatment and launch of more products in more geographies.**

The company wants to imply that it has not replaced any other supplier in the Tender market, but is grabbing share of incremental sales. **"Which are the geographies where the incremental sales are coming from?**

Co

**In the last 12-months, all these countries and agencies were able to add 3 million new patients into the treatment.**

**Not clear which 12 months is Dr Chava referring to, and what is the source of this data. Publicly available data is only till 2019**

| | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|
| People accessing antiretroviral therapy* | 17.2 | 19.3 | 21.5 | 23.1 | 25.4 |
| Increase | | 2.1 | 2.2 | 1.6 | 2.3 |

Source: UNAIDs

*Annual additions have never crossed 2.3m. Additions for Rolling 12 month ending say Jun'20 crossing 3m (30% growth over best performance) seems unlikely given Covid.*
*At the same time, the math works out with a 3m add, to support Dr Chava's argument that they are grabbing business from new patient adds. 3m added patients represents a new market of USD225m or Rs 1600 crore, assuming USD75 per patient per year. Laurus's run rate on the FDF business is around Rs 1600 cr right now, of which 75% is to LMIC tenders. So Mr Chava's point that we are grabbing share of new patients in HIV works with a 3m number*

# FDF Growth Explanation

## Q2 FY21 Call..continued

Q

**When 3 million new patients got added, what was the base on which it got added?**

Co

These are the new patients who were enrolled to receive antiretroviral treatment

Q

**So what would be the base, I mean, was it annual addition?**

Co

When they are added into the treatment, they continue to be on treatment. So assuming 3 million new patients added, that means there will be 36 million bottles of some kind of treatment is required. That means 3 million into 12 months. So they will need 36 million bottles of some kind of ARV treatment.

***Key Question," Where these patients added – new, pediatric or adult category? Or these patients were added for new indication?***

Co

There is no stocking up. So, whenever the patient comes, instead of he get one pack of 30, he is getting two or three packs of 30, so that you may not come to the dispensary quite often during this crisis. There is no stocking of the inventory.

***Mr Chava was at pains to deny that there was no stocking up going on (since that could imply that the 1H sales growth was not sustainable). But this clearly front loading of demand, and will result in a demand spike which will not repeat***

# Understanding Capex Requirement

## Q4 FY19 Call (3 May, 2019)

Co

Going forward we have a normalized capex plan of around INR 150 to 200 Crores including the maintenance capex and here one more point we need to keep in mind is that we are not planning to do any greenfield expansion, but only on the brownfield expansion.

We are into a steady state right now we expect our capex will be similar to our depreciation.

*At this point the projected capex was around Rs 200 crore per annum*

Co

We have long-term debt of around INR 350 Crores in the next four years time this is going to be zero.

*LT debt was Rs 250 crore as on Mar’19. It was Rs 157 crore on Sep’20. Given the sharp hike in capex plan, it remains to be seen if it can go down to zero by Mar’23. CREDIT RATING in June 20 is for enhanced limits*

## Q1 FY20 Call (5 Aug 2019)

Co

Going forward we expect CAPEX to be in the range of Rs.150 Crores to Rs.200 Crores.

*No change in FY20 capex plan yet*

# Understanding Capex Requirement

## Q3 FY20 Call (31 Jan 2020)

Co

On the capex front, we invested around Rs. 130 Crores for 9 months and we will have a normalized capex of around Rs. 250 Crores in the current year. We will share the guidance for FY2021 capex in our next call.

*The estimate for capex in FY20 was Rs 150-200 cr till Q2. It moved to Rs 250 crore in Q3. First indication that there could be rethink on FY21 capex as well. Finally Rs 237 crore was spent*

## Q4 FY20 Call (30 Apr’20)

Co

For next year the capex will be higher, but we are still finalizing it. It will be more than Rs. 300 Crores.

*The call was on 30th April 2020. On this date the company is saying it does not have a clear handle on FY21 capex?*

## Q1 FY21 Call (31 July 2020)

Co

We will be incurring CAPEX close to Rs.300 crores in this year. All the CAPEX opportunities are Brownfield at this juncture
On the CAPEX front, we invested about Rs.91 crores.

*The tone seems to suggest slight downward revision from what was said in the Q4 call. ‘More than Rs 300 crore’ became ‘close to Rs 300 crore’.*

# Understanding Capex Requirement

## Q2 FY21 Call (30 Oct 2020)

Co We invested about Rs.262 crores in H1FY21.

*This means the company spent Rs 170 crore in Q2 FY21. This was significantly more than the guidance given in Q1.*
*The Q1 call was on 31 July, where the company reiterated a target of Rs 300 crore for the full year 31 July. And then it reaches 90% of that in 2 months? Would it not have known on 31 July that was incurring expense at a run rate far higher than Rs 300 crore*

Co Earlier we had budgeted Rs. 700 crores of CAPEX in FY'21 and '22. We have revised our estimates to Rs.1,200 crores for CAPEX for these two years.

*In the Q4 call on 30th April 2020, the management said FY21 Capex target was still being worked upon. Here it says the company had budgeted a number included FY22 as well.*

Co The company guided to a 2x sales multiple on brownfield Gross Block investment of Rs 300 crore

*Q2 formulation revenue was Rs 452 crore. This suggests Sales/Gross Block ratio of 3.6x. Not clear why the management should guide for 2x on new investment.* ***Also, note, the new capacity is meant mostly for Developed markets, where the realisations are better than LMIC markets. Why then such a sharply lower guidance?***

# Appendices

# Cash + Investment Account Entries

## Laurus

- Laurus has very few entries compared to peers. **Probable reasoning is that the company got listed in 2017 and hence would have higher number of demat shareholders, so no pending dividend. But yes, no cheques' in the system to be encashed, no deposits is unusual.**
- A lien on Rs 1.45m only for LC / BG

| Particulars | March 31, 2020 | March 31, 2019 |
|---|---|---|
| **A) Cash and cash equivalents** | | |
| Balances with banks | | |
| - On current accounts | 14.16 | 28.09 |
| - Deposits with original maturity of less than three months | - | 0.47 |
| Cash on hand | 2.72 | 1.12 |
| **Total** | **16.88** | **29.68** |
| **B) Other balances with banks** | | |
| On deposit accounts | | |
| - Remaining maturity for more than twelve months | 0.93 | 0.27 |
| - Remaining maturity for less than twelve months | 0.52 | 0.53 |
| **Total** | **1.45** | **0.80** |
| Less Amount disclosed under other assets | (0.93) | (0.27) |
| **Total** | **0.52** | **0.53** |

Deposits with a carrying amount of ₹ 1.45 (March 31, 2019: ₹ 0.80) are towards margin money given for letter of credit and bank guarantees.

# Cash + Investment Account Formats

## Alkem

- Alkem has Bank deposits of Rs 8,017 million under lien with banks against Overdraft facilities availed
- Alkem has another Rs 1650m in current investments
- It has a small sum in unpaid dividend account

### 3.9 Cash and cash equivalents

(₹ in million)

| Particulars | As at 31 March 2020 | As at 31 March 2019 |
|---|---|---|
| Cash on hand | 8.1 | 6.1 |
| Cheques and drafts on hand | 151.4 | 81.4 |
| **Balance with banks:** | | |
| In Current accounts | 1,387.0 | 894.2 |
| In Deposit accounts: | | |
| Deposit with original maturity within three months | 212.9 | 1,508.8 |
| **TOTAL** | **1,759.4** | **2,490.5** |

### 3.10 Bank balances other than cash and cash equivalents:

(₹ in million)

| Particulars | As at 31 March 2020 | As at 31 March 2019 |
|---|---|---|
| Unpaid dividend account | 1.2 | 0.8 |
| Bank deposits with maturity within 12 months | 9,161.5 | 4,124.7 |
| **TOTAL** | **9,162.7** | **4,125.5** |

# Cash + Investment Account Formats

## Divis Laboratories

- Divis has Bank deposits of Rs 6,588 million under lien with banks against Overdraft facilities availed
- It has other earmarked deposits

### Note 12: Cash and cash equivalents

| | March 31, 2020 | March 31, 2019 |
|---|---|---|
| Balances with banks | | |
| - in current accounts | 724 | 233 |
| - in term deposit accounts with maturity period not more than three months | 2,001 | - |
| Cash on hand | 63 | 61 |
| **Total cash and cash equivalents*** | **2,788** | **294** |

*There are no repatriation restrictions on cash and cash equivalents as at the end of reporting period and prior period.

### Note 13: Bank balances other than cash and cash equivalents

| | March 31, 2020 | March 31, 2019 |
|---|---|---|
| Balances in earmarked accounts with Banks - Unclaimed dividend | 109 | 97 |
| Balances in term deposit accounts with maturity period of more than three months and not more than twelve months: | | |
| - pledged towards margin on Guarantees issued by Bank | 150 | 5,697 |
| - pledged towards overdraft facilities with Banks | 6,588 | 4,432 |
| - other unencumbered deposits | 1,101 | - |
| **Total Bank balances other than cash and cash equivalents** | **7,948** | **10,226** |

# Cash + Investment Account Formats

## Alembic Laboratories

- Alembic Rs 89m in earmarked deposits with banks

### 13 Cash and Cash Equivalents

₹ in Crores

| | As at 31st March, 2020 | As at 31st March, 2019 |
|---|---|---|
| Balances with Banks | 71.48 | 198.84 |
| Cash on hand | 0.36 | 0.23 |
| | **71.84** | **199.07** |

### 14. Bank Balances Other than Cash and Cash Equivalents

₹ in Crores

| | As at 31st March, 2020 | As at 31st March, 2019 |
|---|---|---|
| Earmarked Balance with Bank | | |
| Unpaid Dividend Account | 7.12 | 4.79 |
| Margin Money Deposit Account | 1.78 | 1.76 |
| | **8.91** | **6.55** |

# Cash + Investment Account Formats

## Aarti Industries

- Aarti has Rs 2467 m in bank deposits

### 6. Cash and Cash Equivalents

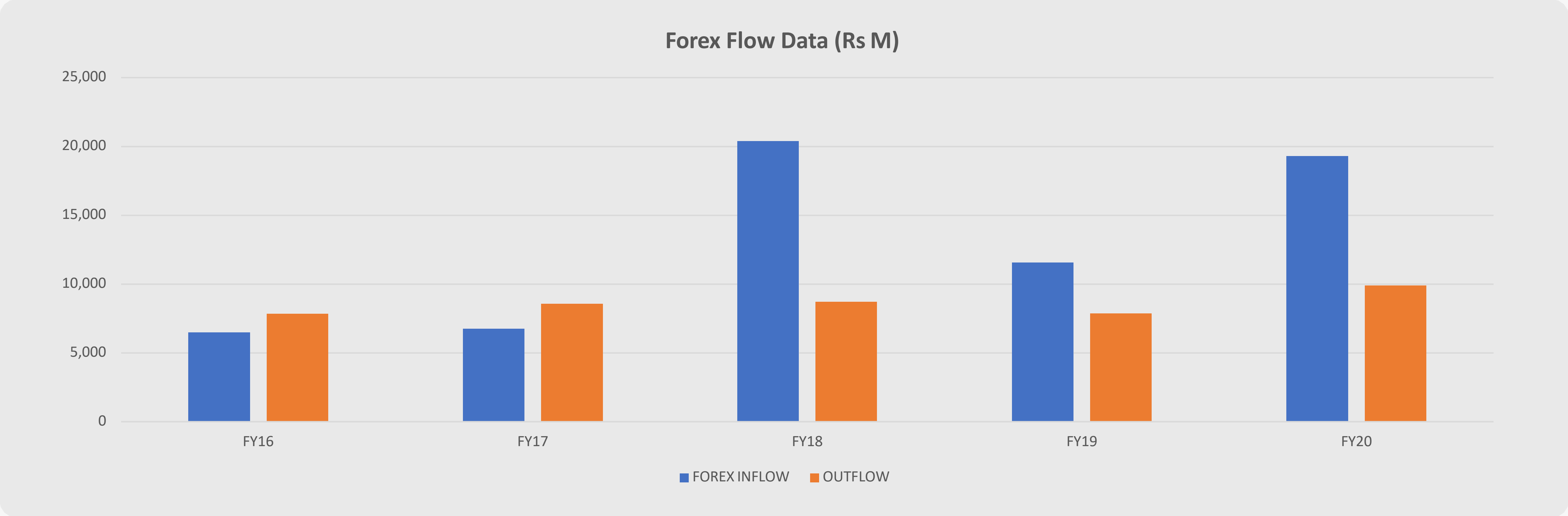
(₹ in Crs)

| Particulars | As at 31st March, 2020 | As at 31st March, 2019 |
|---|---|---|
| Cash on hand | 0.60 | 0.45 |
| Bank balance in Current Accounts | 66.47 | 85.09 |
| Bank balance in Deposit Accounts | 177.89 | 496.39 |
| Earmarked Balances (QIP Proceeds in Liquid Mutual Funds) | NIL | 220.22 |
| Earmarked Balances (Unpaid Dividend Accounts) | 2.33 | 2.05 |
| **Total** | **247.29** | **804.20** |

# Forex Inflow data has an odd value in FY18

Most likely it is an error which got overlooked

- The FY18 Annual Report has a **figure of Rs 2039 crore as forex inflow**, which is almost 100% of that year's sales. As can be seen, it is an outlier
- We think it is an error, but management can be asked to reconfirm



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