**Alembic Pharmaceuticals (ALPM) – Stock story**

**Background**

* Alembic Pharma was established in 1907 by Amin family as Alembic Ltd for manufacturing of tinctures and alcohol. Starting 1940, Alembic Pharma transformed in to a Pharma focused company engaged in manufacturing of cough syrups, vitamins, tonics and sulphur drugs.
* Until 2010 Alembic was a pure domestic focused company focussed on acute segment, but post demerger of company’s core Pharma business (now Alembic Pharma or ALPM) from Alembic Ltd, ALPM transformed into an aggressive and focused company steered by Mr Pranav Amin (son of Mr Chirayu Amin). They started focussing on regulated market exports (US and Europe) and chronic therapies in domestic market.
* Promoter shareholding 73% (no pledge, c. 29.5% held by Alembic Limited (also listed)), DIIs 7.8%, FIIs 9.6%, Others 9.6%
* Promoters also hold other businesses in the Group viz
  + Chemicals business (though Paushak Limited, a listed firm),
  + Alembic Limited (listed), hold co for Alembic Pharma and Paushak, and into business of APIs (in a very small way) and real estate
  + Nirayu Limited into engineering solutions business of the group and investment products
  + Shreno Limited which houses the printing/packaging business of the group

**Main Products/Segments/Markets/Customers**

* The Company primarily a domestic focussed company until 2010 and has over the years diversified into the formulations export market. The formulations exports have increased from 28% in FY15 to 52% currently primarily driven by US generics. Overall, formulations are 84% of sales while balance 16% is APIs.

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| **Topline Rs crs** | **FY20** | **% age** | **FY 19** | **FY 18** | **FY 17** | **FY 16** | **FY 15** | **% age** | **FY 15-20 CAGR** |
| **Formulations** |  |  |  |  |  |  |  |  |  |
| - US generics | 1,976 | 43% | 1,288 | 920 | 919 | 1,228 | 316 | 15% | 44% |
| - RoW generics | 497 | 11% | 494 | 286 | 320 | 234 | 266 | 13% | 13% |
| - India branded generics | 1,425 | 31% | 1,380 | 1,270 | 1,250 | 1,180 | 1,100 | 54% | 5% |
| **API** | 708 | 15% | 771 | 651 | 640 | 525 | 367 | 18% | 14% |
| **Total** | **4,606** |  | **3,933** | **3,127** | **3,129** | **3,167** | **2,049** |  | **18%** |

Business wise summary is captured below:

US formulations business

* Though ALPM is a late entrant in the US business, they have grown very well in US generics business (c. 44% CAGR over FY 15-20) and now contribute 43% to total turnover of the company.
* Over the last 3 years, the Company has incurred large capex c. INR 20 bn to build formulation facilities focussed on US markets (fixed asset base effectively becoming a 3x of Rs 700 crs in FY 16) and has simultaneously incurred significant R&D expenditure of c. INR 21bn to build a diversified product pipeline in the US (R&D expenditure almost equal to the net profits of the Company in the same period FY 16 – 19 c. INR 21bn). Monetisation of this pipeline is expected from FY 22 onwards. To achieve this, the company has built:

1. Large ANDA filings resulting in a diverse portfolio for the market across oral solids, injectables, oncology, dermatology, ophthalmology, biologics and NCE (compared to largely oral solids 5 years back). There has been a significant increase in ANDA filings, approvals and product launches over last 3-5 years as shown below. Going forward, filings expected in Injectables, ophthalmic, oncology @ c. 25-30 filings every year

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| --- | --- | --- | --- | --- | --- | --- |
| **Yearly data** | **FY 20** | **FY 19** | **FY 18** | **FY 17** | **FY 16** | **FY 15** |
| ANDA filings | 22 | 29 | 37 (Orit acq 11)# | 19 | 8 | 7 |
| ANDA approvals | 30 | 19 | 18 (Orit acq 7) | 5 | 10 | 7 |
| Product launches | 19 | 9 | 13 | 3 | 11 | 5 |

*\*Including tentative approvals*

*# ALPM had acquired US based Orit Laboratories LLC in 2017 which is focused on developing and filing oral solid and liquid products.*

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| **US ANDAs (cumulative data)** | **FY 20** | **FY 19** | **FY 18** | **FY 17** | **FY 16** | **FY 15** | **FY 14** |
| Cumulative filings | 183 | 161 | 132 | 95 | 76 | 68 | 61 |
| Cumulative approvals (incl tentative)# | 119 | 89 | 70 | 52 | 47 | 37 | 31 |
| -Oral solids | *100* |  |  |  |  |  |  |
| -Opthalmic | *11* |  |  |  |  |  |  |
| -Derma | *8* |  |  |  |  |  |  |
| Total product launches | 76 | 57 | 48 | 37 | 34 | 26 | 21 |
| Cumulative DMFs | 109 | 100 | 94 | 84 | 81 | 72 |  |
| No of launches through US front end (cumulative) | 69 | 46 | 38 | 20 | 11 | ? | ? |

*#Break up of earlier years not available*

1. Established a front-end team in US compared to earlier model of sale through partnership which resulted in significant loss of profits (estimated to be between c. 30%-50% share of marketing partner) and also gives better control over launch timing and pricing. They started this in 2015 and now more than 90% drugs are sold through their own front end (Of the 76 launched products as of FY 20 end, 69 products are through US front end and 7 products on partner label).
2. Established supply chain capabilities which has a track record of on-time delivery and ability to capitalize on any opportunities arising from short term shortage opportunities – have shown good progress on this so far by capitalizing on the sartans and other opportunities.

Also, their track record with US FDA has been quite clean.

RoW formulations business

* Presence in Europe, Canada, Australia, Brazil and South Africa contributing to 11% of total turnover of the Company.
* This business is driven by partnership – long term client relationships.
* This business has seen slowdown in FY 20 numbers as many countries went through serialisation requirements\* which required complex changes to manufacturing and distribution systems.

\* *Serialisation means assigning a unique serial number to each saleable unit which is linked to information about the product’s origin, batch number and expiration date. Serialization helps in reducing counterfeiting and also helps to quickly remove recalled and defective products.*

* The introduction of serialisation in the EU from Feb’19 posed some manufacturing challenges and this led to a slowdown especially in Europe, which the management expects to sort by end of FY 20 and reflect in numbers FY 21 onwards. They had a lot of pending orders which should be rolled out over next couple of months in FY 21.
* Success in this business will continue to be driven by new launches and strong client relationships.

India business

* ALPM was earlier a dominant player in the acute products segment in India (anti-infective, analgesic and cough and cold therapies), and has over the years, shifted its focus to chronic therapeutic segments.
* Current portfolio mix: 58% Speciality, 32% Acute and 10% Vet.
* Growth expected from Speciality, which makes up c. 93% of new launches, with a strong focus on cardiology, diabetes, gynaecology and ophthalmology.
* 5 brands in Top 300; Market share in India pharma c. 1.6%
* Marketing team of over 5000 field representatives
* Total brands 185, 14% product portfolio is in NLEM
* Prescriber base increased c. 9% from 1.68 Lakhs in March 18 to 1.79 Lakhs in March 19.
* ALPM has implemented a changed strategy over the last 1 year in the domestic market
  + Trade channels used to get discounts from the company for institutional sales which were getting misused and ALPM decided to clamp down on the discounts from Q4 FY 20 onwards. They want to push sales through prescriptions rather than by the stockists.
  + As a result, despite prescriber base growth, primary sales have not grown as much. They expect this to grow from Q1 FY 21 onwards and this needs to be watched out for.
  + ALPM views this as a high RoCE business but with limited growth opportunities c. 10-15% growth.

API business

* Inhouse API development for vertical integration. C. 40% captive, rest is external sales
* Investing in plants to create additional capacities
* 104 DMF filings including 4 filed in FY 20
* About 80% of their drugs are backward integrated. But as they move forward, they expect this %age to reduce as their newer filings in injectables, ophthalmology and dermatology will not be as backward integrated.
* Reduction in API business in FY 20 is due to a one-off contract manufacturing contract last year with a customer. Other than this, business has grown YoY and expected to grow c. 15-20% in FY 21.

Out-licensing

ALPM’s associate company - Rhizen Pharmaceuticals SA has out licenced novel molecule (Umbralicib i.e. TGR 1202) to TG Theraputics, USA which is used for treatment of rare forms of blood cancer. Recent clinical data was robust and needs to be watched.

Manufacturing plants

|  |  |  |
| --- | --- | --- |
| **Formulation** | **Dosage form** | **Audit / filing status** |
| Panelav F1 | Oral solid | Oct 18 last inspection, recent Form 483, As per mgmt. procedural observations, response submitted, expecting EIR |
| Panelav F2 | Oncology oral solid | Jun 19 last inspection, EIR held |
| Oncology injectables | H2 FY 21 expected filings |
| Karkhadi F3 | Injectable and ophthalmic | 1st ANDA filed in Q4 FY 20, inspection expected by Q4 FY21 end |
| Jarod F4 | Oral solid | H1 FY 21 expected filings |
| Karkhadi Aleor JV | Dermatology | Jan 20 last inspection, no observation (capitalized on 01.01.19 so will contribute to expenses hence forth)-annual opex c. INR 65 crs, Dep 24 crs |
| **API** |  |  |
| Panelav API 1 & 2 |  | Dec'18 last inspection |
| Karkhadi API 3 |  | Jan'20 last inspection (doubling API capacity) |

R&D capabilities with 3 centres at Vadodara, Hyderabad and USA, with 1200+ employees

**Bullish Viewpoints**

US generics

* FY 21 should continue to benefit from sartans shortage (expected for atleast 3-6 months) and shortage of other products like azithromycin (supposedly used for treating Covid-19 (not proven) - ALPM started selling Azithromycin April-20 onwards. They have somehow been quite nimble in their supply chain and managed such opportunities quite well. As per them, such shortage opportunities keep coming up in US business and they will aim to capture such opportunities in future as well.
* FY 22 onwards should benefit in a large way from the large capex and R&D filings done over last few years.
* Strong R&D capabilities, large capacities, venturing into complex segments with front end in place in US and supply chain capabilities to profit from shortage opportunities – should give uptick to margin.
* R&D expenses as % of Sales should reduce from FY 22 onwards

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| --- | --- | --- | --- | --- | --- | --- | --- |
| **Rs crs** | **FY 21** | **FY 20** | **FY 19** | **FY 18** | **FY 17** | **FY 16** | **FY 15** |
| R&D spends | c. INR 700 crs expected | 645 | 500 | 410 | 430 | 320 | 130 |
| As % of sales |  | 14.0% | 12.7% | 13.1% | 13.7% | 10.1% | 6.3% |

* Capex should also reduce going forward to c. INR 300-350 crs FY 22 onwards (compared to c. INR 500-700 crs last 3 years) thereby increasing free cash flow

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| --- | --- | --- | --- | --- | --- | --- |
| **Rs crs** | **FY 20** | **FY 19** | **FY 18** | **FY 17** | **FY 16** | **FY 15** |
| Capex | 697 | 626 | 604 | 491 | 309 | 213 |

FY 21 capex expected at c. 700 crs including maintenance capex c. INR 300-350 crs, Project opex related to plants F2 and F3 to be capitalized c. INR 250 crs.

India business:

* Currently, domestic pharma industry contributes to over 4% to India’s GDP, against global average of 9%. This is expected to improve in the next five years from National Health Protection Scheme (NHPS)/Ayushman Bharat.
* ALPM specific challenges on channel discounts etc expected to sort out from Q1 FY 21 onwards.

API business

* Supply disruption in China - (due to environmental concerns, now coronavirus) leading to higher pressure on diversification of supplier base – this is likely to shift demand to India

Overall, the Company has a strong RoCE at 23%, RoE at 24% despite significant capex (which is yet to yield results) and expected to further improve going forward.

**Bearish Viewpoints**

* Late entrant into US markets and hence intense competition intensity can impact profits
  + This was a concern in 2012/13 as well when they started US operations but ALPM has performed well so far.
  + Risk increases with concentration – Top 5 products make up 35% of US sales
* Increase in competition leading to correction in sartan pricing which can lead to correction in margins – these have been a reason for higher margins recently.
* China supply issues – ALPM has c. 80% captive APIs for their ANDAs (though this may reduce going forward as they expand their product portfolio). They usually keep 2 API suppliers for their ANDAs and have started building a KSM plant too. In the short term they keep higher inventory of KSM to avoid shortages. This remains a key risk and needs to be watched out.
* Regulatory risk - US FDA/others- Good track record so far but remains a key risk going forward.
* Litigation risk
* Currency risk – Conservative hedging practices followed thus far
* India business – risk of price cut announcements by govt / Risk from Janaushadhi stores leading to pricing pressures in India
* Post commissioning of new plants, depreciation and opex can put pressure on margins, till sales pick up
  + Company intends to declare CoD when they are in a position to launch the product (i.e. post ANDA approval, FDA inspection etc) and therefore will try and minimize this impact – this is line with practice followed by other companies. In the short-term (even without commercial use) plants would get depreciated with time, but since it is a non-cash item, it is not so much of a concern.
* Portfolio concentration is significant - Top 5 products contribute 47% of sales & top 5 customers contribute 37%

**Interesting Viewpoints/Things to keep in mind**

* The management has shown a decent track record so far. There were concerns earlier as well – on their ability to grow US business despite late entry to US markets, on the ability to set up their own front end in US, on risk of litigation in US markets etc which they have managed really well.
* US FDA clearance for F1 to be watched out for.
* Developments on sartans – new competition etc to be watched out for.
* Operating leverage will kick in as capacity utilisation on new capex increases

**Barriers to Entry**

* Complex R&D skills
* Large capex requirements
* Strong supply chain and marketing setup in US

**Business Model**

*Elaborated under various heads*

**Valuation Model**

* Assuming US sales pick up and 3 years from now ALPM touches fixed asset asset turnover at c. 4x, expected sales c. Rs 14000 crs
* Assumed normalized EBITDA Margin of c. 20% (vs 26% in FY 20, no operating leverage benefit assumed and sartan margin also adjusted) = INR 2700 crs
* Less: Depreciation c. INR 300 crs (vs c. 150 crs currently as CoD not done for new projects)
* Less: Interest c. 120 crs (c. 1500 crs \* 8%)
* PBT INR 2300 crs
* PAT @ 75% = INR 1700 crs, EPS c. 91
* At P/E c. 25 (from currently PE = 16, on improvement in FCF, RoE) Price Rs 2300 over say next 3 years thereby giving CAGR of c. 40% (if this happens over 4 years it will be a 30% CAGR)
* Even if they achieve sales lower than estimated c. 14000 crs sales, it should get compensated by a higher margin versus than what is assumed above.
* On technical also, it is looking strong on charts, having broken its all-time highs.

**Current Market/Industry Trends**

* China supply disruptions is a multi‐year business opportunity for APIs
* US generic pricing pressure to be watched. Tracking drugs in shortage helps from a pricing perspective. Sartans shortage has contributed over last 1 year and is expected for another 3-6 months (as per mgmt.).

**Corporate Governance Scan**

1. Auditor is not a top 4 auditor but a known firm - KS Aiyar & Co
2. Concern on treatment of minority shareholders – there were concerns when a demerger was done way back in 2010/11 – seems to have got better with Pranav coming in.
3. Promoters are named in Panama papers case.
4. All R&D expenses is expensed – which is a good practice (except Aleor Derma which is a 60% subsidiary of ALPM). On a consolidated basis, ALPM is carrying c. INR 210 crs of intangible R&D as of FY 19 end.
5. Promoter remuneration is high at c. 10-13% of PAT

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| **INR m** | **FY 15** | **FY 16** | **FY 17** | **FY 18** | **FY 19** |
| Promoter remuneration | 25 | 30 | 48 | 53 | 52 |
| PAT | 283 | 720 | 403 | 413 | 584 |
| Remuneration as % of PAT | 9% | 4% | 12% | 13% | 9% |

Of FY 19 remuneration of c. Rs 52 crs, c. Rs 24 crs is salary and balance Rs 28 crs is commission linked to net profits.

**Forensic Scan/Red Flags**

Related party transactions details summarized below:

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| --- | --- | --- | --- |
| **Important related party txns (Rs crs)** | **FY 19** | **FY 18** | **FY 17** |
| **ALEMBIC Ltd (Hold co)** | | | |
| Purchase of goods | 52 | 50 | 54 |
| Sale of goods | 3 | 2 | 3 |
| Reimbrsement of expenses | 11 | 1 | -1 |
| Rent paid | 8 | 6 | 5 |
| Receiving services | 11 | 8 | 3 |
| Deposit returned / (given) | 10 | -3 | -1 |
| Dividend | 22 | 22 | 22 |
| **NIRAYU** | | | |
| Dividend | 20 | 5 | 6 |
| **SHRENO PUBLICATION** | | | |
| Purchase of goods | 23 | 6 | 0 |
| Purchase of fixed assets | 19 | 4 | 3 |
| Receiving services | 0 | 4 | 4 |
| Dividend | 0 | 8 | 7 |
| Corp guarantee given | 0 |  | 10 |
| **SIERRA Investments Pvt Ltd/AG Research/Whitefield Chemtech / Promoter individuals** | | | |
| Purchase of goods | 0 | 11 | 16 |
| Receiving services |  | 4 |  |
| Dividend |  | 17 | 17 |
| Total (excl dividend/loan/deposit/CG) | 126 | 96 | 88 |

Total annual related party transactions are to the order of c. 100-125 crs. Of this c. Rs 50 crs seems to be regular annual purchase of APIs from Alembic Limited. Few points to note:

1. Alembic Limited is a listed entity and has operating profits c. 5-15% over past few years and does not seem to be a significant cause of concern.
2. Need to check financials of Shreno publications – the other major related party – not able to download from ROC.
3. ALPM’s RPT before FY 17 is not available and I have sought the same from the company.

Overall, the corporate governance of this company is not the best in class. But at the same time, there are no glaring concerns so far except promoter remuneration (which is an issue in many other mid-size cos too).

**Disclosure(s)**

Invested

**Questions to ponder**

1. Why is their R&D cost so high in comparison to other pharma companies? Is it because of their late entry into US markets leading to consolidation of R&D costs over last few years? And will R&D costs go down as % of sales, as the overall sales increase?
2. Is there any place to track prices of various Sartans?

**Annexure – 1: Financial summary**

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **INR crs** | **FY 11** | **FY 12** | **FY 13** | **FY 14** | **FY 15** | **FY 16** | **FY 17** | **FY 18** | **FY 19** | **FY 20 #** |
| Sales | 1,202 | 1,465 | 1,520 | 1,863 | 2,056 | 3,166 | 3,105 | 3,131 | 3,935 | 4,606 |
| Operating Profit | 160 | 219 | 252 | 358 | 403 | 1,007\* | 616 | 643 | 874 | 1,188 |
| Operating profit % | 13% | 15% | 17% | 19% | 20% | 32% | 20% | 21% | 22% | 26% |
| PAT | 85 | 130 | 165 | 236 | 283 | 720 | 403 | 413 | 584 | 829 |
| PAT margin % | 7% | 9% | 11% | 13% | 14% | 23% | 13% | 13% | 15% | 18% |
| EPS | 4.5 | 6.9 | 8.8 | 12.5 | 15.0 | 38.2 | 21.4 | 21.9 | 31.0 | 44.0 |
| P/E ratio | NA | 7.0 | 12.0 | 22.8 | 30.3 | 15.7 | 29.3 | 25.1 | 17.3 | 17.3 |
| **Balance Sheet** |  |  |  |  |  |  |  |  |  |  |
| Total debt | 328 | 353 | 187 | 109 | 264 | 114 | 89 | 708 | 1,128 | 1,747 |
| Net Worth | 270 | 395 | 503 | 676 | 885 | 1,597 | 1,902 | 2,220 | 2,719 | 3,220 |
| Fixed assets | 298 | 326 | 376 | 418 | 630 | 801 | 1,196 | 2,004 | 2,710 | 3,398 |
| Inventory days | 76 | 60 | 63 | 57 | 62 | 55 | 71 | 80 | 79 | 85 |
| Debtor days | 61 | 50 | 52 | 50 | 56 | 41 | 41 | 50 | 47 | 54 |
| **Cash flows (CF)** |  |  |  |  |  |  |  |  |  |  |
| Operating CF | 95 | 142 | 265 | 240 | 172 | 948 | 329 | 312 | 812 | 449 |
| Investing CF | -57 | -56 | -67 | -81 | -256 | -307 | -486 | -884 | -756 | -732 |
| Financing CF | -47 | -45 | -229 | -151 | 87 | -224 | -129 | 503 | 59 | 155 |
| Net CF | -9 | 41 | -31 | 8 | 3 | 417 | -286 | -69 | 115 | -128 |

*\*Due to a FTF launch – Abilify #Unaudited numbers as of now*

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| **TRENDS:** | **7 YEARS** | **5 YEARS** | **3 YEARS** | **RECENT** |
| Sales CAGR | 15.2% | 16% | 8% | 26% |
| Avg OPM % | 22.1% | 23% | 21% | 26% |
| PAT CAGR | 23.9% | 20% | -7% | 42% |
| Price to Earning | 21.2 | 22.5 | 22.3 | 17.3 |

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| **Dupont** | **FY 11** | **FY 12** | **FY 13** | **FY 14** | **FY 15** | **FY 16** | **FY 17** | **FY 18** | **FY 19** | **FY 20** |
| Net Profit margin | 7% | 9% | 11% | 13% | 14% | 23% | 13% | 13% | 15% | 18% |
| Asset Turnover | 1.4 | 1.5 | 1.4 | 1.6 | 1.4 | 1.5 | 1.2 | 0.9 | 0.9 | 0.8 |
| Leverage | 3.2 | 2.9 | 2.4 | 1.9 | 1.9 | 1.7 | 1.5 | 1.6 | 1.8 | 1.8 |
| **RoE** | **32%** | **39%** | **37%** | **40%** | **36%** | **58%** | **23%** | **20%** | **24%** | **28%** |

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| --- |
| * Decline in asset turnover due to large capex in recent years * Peak profitability in FY 16 due to a FTF launch * Comfortable leverage |