



IPCA Laboratories Ltd

An earnings-dilutive acquisition

Pharmaceuticals

Sharekhan code: IPCALAB

Reco/View: Hold

CMP: Rs. 741

Price Target: Rs. 790

Upgrade Maintain Downgrade

3R MATRIX

| | + | = | - |
|----------------------|-------|------|-----|
| Right Sector (RS) | Green | Grey | Red |
| Right Quality (RQ) | Green | Grey | Red |
| Right Valuation (RV) | Green | Grey | Red |

+ Positive = Neutral - Negative

What has changed in 3R MATRIX

| | Old | | New |
|----|-------|---|------|
| RS | Green | ↓ | Grey |
| RQ | Grey | ↔ | Grey |
| RV | Grey | ↔ | Grey |

ESG Disclosure Score NEW

ESG RISK RATING
Updated Mar 08, 2023 **32.31**

High Risk

| NEGL | LOW | MED | HIGH | SEVERE |
|------|-------|-------|-------|--------|
| 0-10 | 10-20 | 20-30 | 30-40 | 40+ |

Source: Morningstar

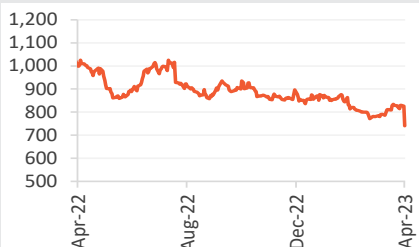
Company details

| | |
|-------------------------------|----------------|
| Market cap: | Rs. 18,871 cr |
| 52-week high/low: | Rs. 1037 / 740 |
| NSE volume: (No of shares) | 79.2 lakh |
| BSE code: | 524494 |
| NSE code: | IPCALAB |
| Free float: (No of shares) | 6.8 cr |

Shareholding (%)

| | |
|-----------|------|
| Promoters | 46.3 |
| FII | 10.6 |
| DII | 34.1 |
| Others | 9.1 |

Price chart



Price performance

| (%) | 1m | 3m | 6m | 12m |
|--------------------|------|-------|-------|-------|
| Absolute | -5.2 | -14.1 | -20.1 | -25.8 |
| Relative to Sensex | -9.7 | -13.9 | -21.1 | -32.1 |

Sharekhan Research, Bloomberg

Summary

- IPCA Laboratories has agreed to acquire a 33.4% stake in Unichem Laboratories Ltd and an additional 26% shareholding through a public offer at Rs. 440 per share, which will amount to a total consideration of ~ Rs. 1,840 crore.
- The deal has taken place at ~ 2.3x Unichem's LTM sales of Rs. 1,311 crore and at an exorbitant EV/EBITDA of ~ 512x its LTM EBITDA of Rs. 6 crore, ending Dec 22.
- The acquisition will help IPCA Labs to gain entry in the lucrative yet competitive market of the US with the help of Unichem's regulatory compliant facilities. However, we also believe the acquisition will be earnings dilutive over short – medium term, for combined entity.
- At CMP, the stock trades at higher levels at 24.1x/18.8x its FY24E/FY25E EPS compared to the peers trading at an average 20.8x/17.2x multiples on their FY24E and FY25E EPS. Hence, we maintain HOLD rating on the shares with a changed PT of Rs. 790.

IPCA Labs has agreed to acquire majority stake in Unichem Labs for a total consideration of Rs. 1,840 crore, at 2.3x Unichem Labs's LTM sales of Rs. 1,311 crore and at an exorbitant EV/EBITDA of ~ 512x its LTM EBITDA of Rs. 6 crore, ending December 2022. The acquisition is expected to help IPCA Labs foray into a lucrative, yet highly competitive US market, with the help of Unichem's regulatory compliant facilities. However, it can also be mulled that the US market is competitive and can thus further stress IPCA's margins. Nevertheless, IPCA's management is confident of generating Rs. 300 crore of EBITDA from Unichem Labs on a revenue of Rs. 1700-1800 crore by FY25E-FY26E through cost synergies, cross market expansions, etc. We believe that the combined profitability on a pro-forma basis will get diluted over short – medium term unless the tall targets in terms of EBITDA and revenue for Unichem Labs can be attained by IPCA's management.

- Acquisition at exorbitant valuation:** IPCA Laboratories has agreed to acquire 33.4% shareholding in Unichem Laboratories Ltd. and additional 26.0% shareholding through public offer at Rs. 440 per share, which will amount to a total consideration of Rs. 1,840 crore. The deal has taken place at ~ 2.3x Unichem's LTM sales of Rs. 1,311 crore and at an exorbitant EV/EBITDA of ~ 512x its LTM EBITDA of Rs. 6 crore, ending December 2022.
- Acquisition to enlarge IPCA's presence in the US:** IPCA Laboratories draws ~ 48% of the revenue from other exports destinations such as Europe, Africa, Americas, Asia, CIS, and Australia than the US. The US facilities of Unichem are CGMP compliant as per the USFDA, EU and other regulators, which are located in Goa, Ghaziabad, and Baddi and API facilities are located at Roha, Pithampur, and Kolhapur. The acquisition will help IPCA Labs to enter the US with the help of Unichem's regulatory compliant facilities.
- Unichem Labs incurring consecutive EBITDA losses for past 3 quarters:** The target, Unichem Labs has been incurring EBITDA losses over the last 3 quarters, consecutively. The company attributed the decline in profits to pricing erosion amidst inventory de-stocking in the US generics business, unfavourable products mix, increased price levels in intermediates, and higher freight costs. Unichem Labs draws ~ 81% of its revenue from the international formulations segment (nearly ~ 88.0% from formulations) and ~ 12% of sales from APIs. Unichem has recently completed its 3-year capex cycle for formulations, APIs, and its R&D centres. The US segment contributes ~59% of its sales, as of FY22. However, the current weak financials of Unichem Labs indicate a likely dilution in earnings for the combined entity on a pro-forma basis. Unless there is a stark improvement in the earnings of Unichem, the acquisition will be earnings dilutive for IPCA Labs over short to medium term.

Our Call

We believe that the acquisition of Unichem Labs by IPCA Labs is strategic, as it will enable a re-entry for IPCA Labs in the US market, from which IPCA Labs had been away, as its 3 facilities have been under the import alert from the US, since FY14. However, we also believe that the acquisition is being done at an exorbitant valuation considering the weakening financial of Unichem Labs over the last 3 quarters, consecutively due to competitive intensity in the US and cost rise. We maintain our overall revenue and earnings growth estimates for IPCA Labs at 11.4% and 3.4% CAGR, respectively over FY2022-FY2025E. We are not incorporating any pro-forma financials of the combined entity in the financials of IPCA Labs until the deal gets through. However, we lower the valuation multiple and arrive at PT of Rs. 790 from Rs. 909 before and maintain Hold rating on shares. At CMP, the stock trades at higher levels of 24.1x/18.8x its FY24E/FY25E EPS, respectively, when compared with peers trading at an average 20.8x/17.2x their FY24E and FY25E EPS.

Key Risks

Delays in the resolution of USFDA issues at its plants and heightened competitive pressures in the US.

Valuation (Consolidated)*

| Particulars | FY2021 | FY2022 | FY2023E | FY2024E | FY2025E |
|-------------------|---------|---------|---------|---------|---------|
| Net sales | 5,420.0 | 5,829.8 | 6,170.0 | 7,017.0 | 8,069.6 |
| EBITDA Margin (%) | 28.5 | 22.5 | 15.3 | 18.5 | 20.0 |
| Adj. PAT | 1,141.1 | 903.2 | 529.1 | 774.7 | 997 |
| Adj. EPS (Rs) | 45.2 | 35.8 | 21.0 | 30.7 | 39.5 |
| PER (x) | 16.4 | 20.7 | 35.3 | 24.1 | 18.8 |
| EV/EBITDA (x) | 12.1 | 14.5 | 19.4 | 13.8 | 10.6 |
| ROCE (%) | 29.3 | 19.5 | 11.9 | 15.5 | 17.8 |
| RONW (%) | 27.6 | 17.9 | 8.9 | 12.1 | 13.7 |

Source: Company; Sharekhan estimates

*Does not include Unichem Labs' proforma financials.

- ◆ **IPCA Labs acquiring Unichem Labs at exorbitant valuation:** IPCA Laboratories has agreed to acquire 33.4% shareholding in Unichem Laboratories Ltd. and additional 26.0% shareholding through public offer at Rs. 440 per share, which will amount to a total consideration of Rs. 1,840 crore. The deal has taken place at ~ 2.3x Unichem's LTM sales of Rs. 1,311 crore and an exorbitant EV/EBITDA of ~ 512x its LTM EBITDA of Rs. 6 crore, ending Dec 22. The acquisition is being funded through IPCA Labs' internal accruals. The transaction is subject to approval from the Competition Commission of India (CCI). Unichem Laboratories draws major share of the revenue from the US, which is at ~ 59% of its revenue, as of FY22.
- ◆ **Acquisition will help IPCA Labs to have a market presence in the US:** IPCA Laboratories draw ~ 48% of the revenue from other exports destinations such as Europe, Africa, Americas, Asia, CIS, and Australia than the US. The US facilities, of Unichem are CGMP compliant as per the USFDA, EU and other regulators, which are located in Goa, Ghaziabad, and Baddi and API facilities are located at Roha, Pithampur, and Kolhapur. Unichem's formulation capacity is at ~ 13.3 billion tablets p.a. As of date, Unichem Labs has ~ 37 ANDAs approved in the US market. The acquisition will help IPCA Labs to have a market presence in the US.
- ◆ **Unichem Labs incurring EBITDA losses for past 3 quarters:** The target, Unichem Labs has been incurring EBITDA losses over the last 3 quarters, consecutively. The company attributed the decline in profits to pricing erosion amid inventory de-stocking in the US generics business, unfavourable products mix, increased price levels in intermediates, and higher freight costs. Unichem Labs draws ~ 81.0% of its revenue from the international formulations segment (nearly ~ 88.0% from formulations) and 12.0% of sales from APIs. Unichem has recently completed its 3 years capex cycle for formulations, APIs, and its R&D centres. The US segment contributes ~ 59% of its sales, as of FY22. However, the current weak financial performance of Unichem Labs indicate likely dilution in earnings for the combined entity on a pro-forma basis. Unless there is a stark improvement in the earnings of Unichem, the acquisition will be earnings dilutive for IPCA Labs over short to medium term.

Financials of Unichem Labs (Consolidated)

| Particulars | Rs cr | | | | |
|-------------|--------|--------|--------|--------|--------|
| | Q3FY23 | Q2FY23 | Q1FY23 | Q4FY22 | Q3FY22 |
| Revenue | 302 | 329 | 310 | 370 | 311 |
| EBITDA | -43 | -18 | -1 | 68 | -1 |
| PAT | -64 | -71 | -23 | 71 | -14 |

Source: Company, Sharekhan Research

Concall highlights:

- ◆ Both IPCA Labs and Unichem will remain separately listed.
- ◆ EV/EBITDA of 10x on FY25E-FY26E seems expensive for the highly competitive US market.
- ◆ EBITDA of Rs. 300 Cr for Unichem Labs achievable through large cost synergies.
- ◆ Major objective behind expensive buy was good assets and market cross offerings with branded products for RoW.
- ◆ IPCA Labs' US based plants' utilisation at very low currently. Unichem's Goa 2 plant's utilisation would be 20-30%.
- ◆ Management control will be with IPCA Labs after the acquisition goes through.
- ◆ Company can increase its shareholding in Unichem through other than public offer route in the future.
- ◆ Emerging market margin wise more profitable as well as CDMO business.
- ◆ **Funding for acquisition:** The acquisition will be funded through retained earnings of IPCA Labs.

◆ **Rationale for acquisition:**

- o The acquisition is in line with the company's strategy to carry out product enhancements in the chosen growth markets. IPCA has strength in APIs with backward integration in it that can enhance Unichem's global generic portfolio's value through market share gain and cost efficiencies and competitiveness.
- o Unichem Labs has 76 ANDAs in the US, out of which 54 are registered products and 44 are being marketed in the US with good market share gains likely. The company has filed 78 APIs DMFs as well, in the US. Another 10-12 products they can market in the US. IPCA Labs can help Unichem to enter into markets where IPCA Labs has a strong presence such as in Europe, Australia, and New Zealand, etc.
- o IPCA also looks forward to market Unichem's branded formulation products registered in the Rest of the World (RoW) markets. The companies are facing headwinds in the US. Unichem has good compliance track record and despite headwinds should get 15-17% CAGR growth over the next 2-3 years with capacity being in place.
- o IPCA Labs believe that Unichem's assets are worth Rs. 1,400 Cr and Net Working Capital (NWC) of Rs. 950 crore is available as well, so around Rs. 2,500 Cr of assets are available with Unichem. Sales are low currently. Also, over the next 2 Years, outlook is strong with additional capacity in place. On the products side, 10-12 of Unichem's products have a good market share which can be capitalised for growth.

◆ **Turnaround rationale for Unichem:**

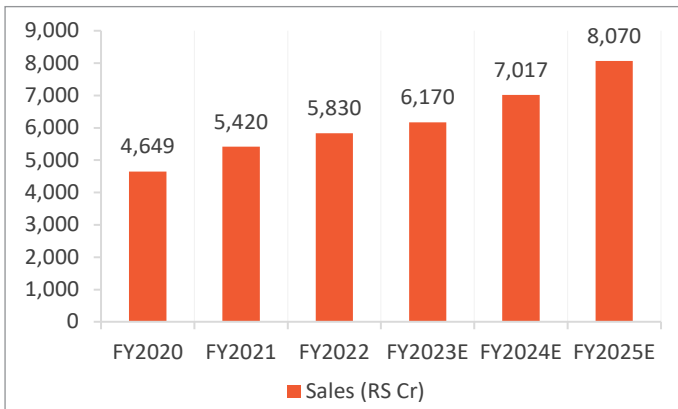
- o Unichem has higher overheads and IPCA Labs looks forward to cost optimization for it. Unichem's API scale is smaller and hence costs are high. With synergy, the cost optimization is possible.
- o IPCA Labs' API team has been working on it. Backward integration and intermediates can be made available by IPCA Labs to Unichem at lower costs and thereby IPCA intends to optimize operating margins for Unichem. Unichem's order book is strong which has started growing from Q4FY23 onwards, which can help with utilisation. Then rationalization of operating costs can enhance returns.
- o IPCA Labs expects that over the next 2 years, Unichem can generate Rs. 300 Cr of EBITDA by FY25E-FY26E on revenue target of Rs. 1700 -1800 Cr by FY25E-FY26E. Top 10 products of Unichem contribute 70-75% revenue in the US revenue, which have strong market share and can be expanded further.

◆ **Status of existing plants of IPCA Labs:** There is a status quo on the USFDA sites of IPCA Labs with no developments as of yet.

◆ IPCA to Unichem and vice versa the products can be shifted between the combined facilities.

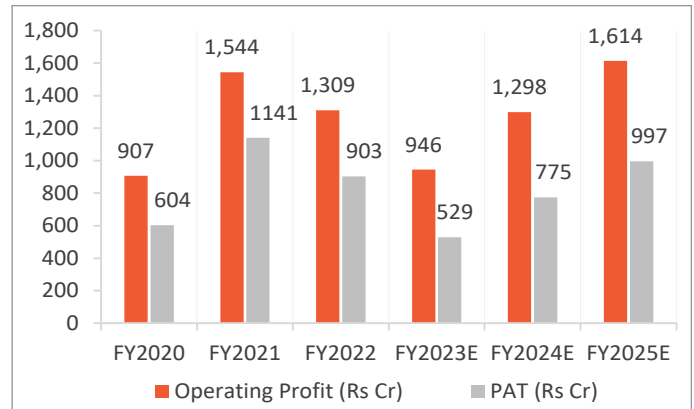
Financials in charts

Sales Trends



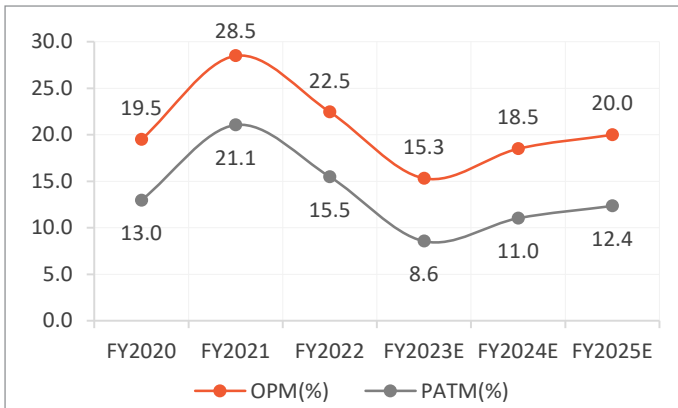
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



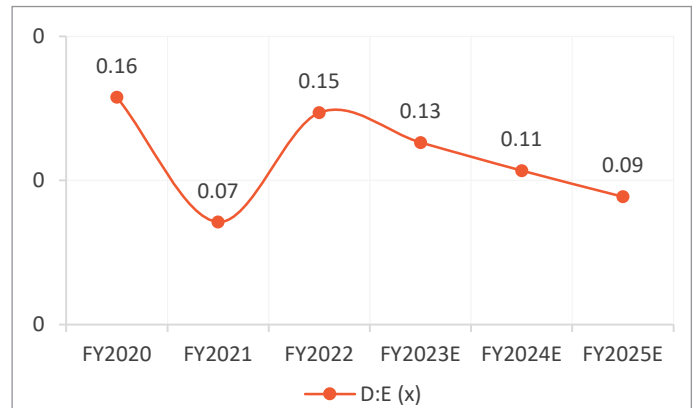
Source: Company, Sharekhan Research

Margin Trends



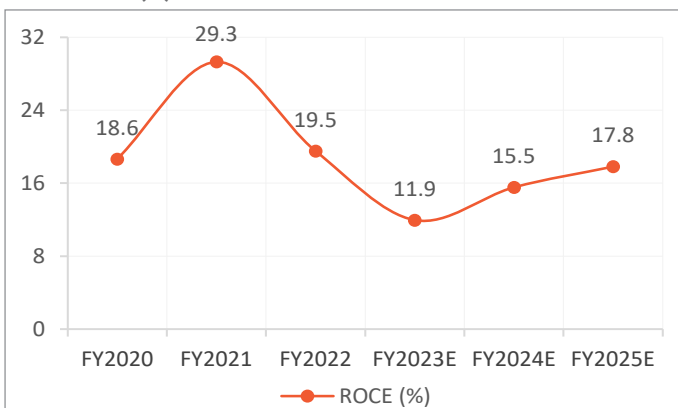
Source: Company, Sharekhan Research

Improving Leverage (D:E)



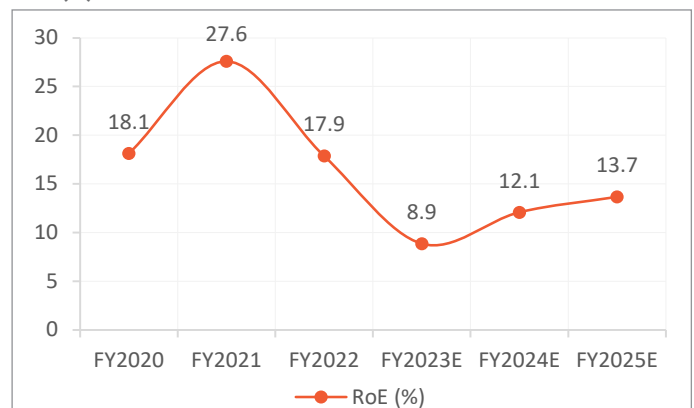
Source: Company, Sharekhan Research

RoCE Trend (%)



Source: Company, Sharekhan Research

RoE (%) Trends



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Regulatory concerns and pricing erosion prove a hurdle over short-medium term

Over the years, Indian pharmaceutical companies have established themselves as a dependable source for global pharmaceutical companies. A confluence of other factors, including a focus on specialty/complex products in addition to emerging opportunities in the API space, would be key growth drivers in the long term. However, the ongoing USFDA plant inspections and a few companies being issued Form 483 with observations points to apparent regulatory concerns. We believe that in the near term, based on the headwinds that may drag the performance, especially in the API and CDMO space and for large pharma players seeing USFDA OAI or WL status on their facilities, we have a Neutral view of the sector.

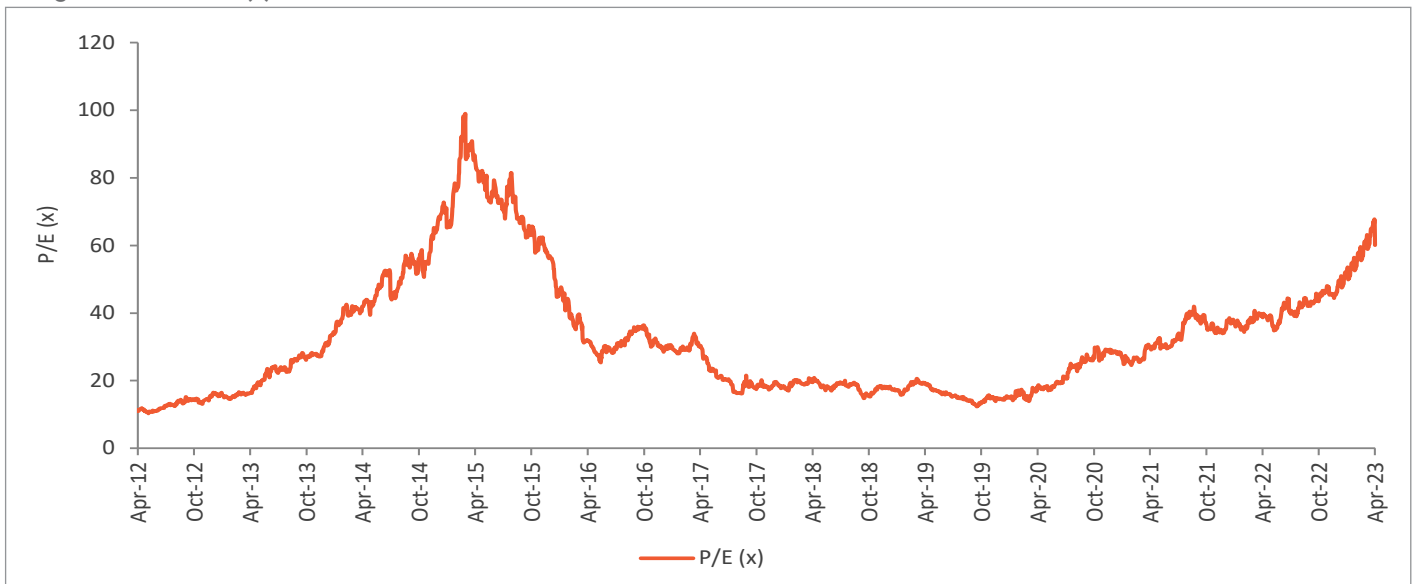
■ Company outlook - Short term headwinds exist with dilutive acquisition and likely slower growth in revenue in the near term

Ipsca is a fully-integrated Indian pharmaceutical company, manufacturing a wide array of formulations and APIs for various therapeutic segments. The domestic formulations business is expected to grow at a healthy pace and is likely to be a key growth driver for the company. Expected improvement in formulations business, increased opportunities in the API space, and healthy traction from the institutional segment indicate strong earnings potential for the company over the medium-long term. In the near term, however, emerging cost pressures due to higher raw-material and logistics costs and time lag to pass on the price increase to customers coupled with de-stocking in key markets of Europe are expected to drag down growth. Consequently, while near-term growth seems to moderate, long-term growth levers are intact.

■ Valuation - Retain Hold with a changed PT of Rs 790

We believe that the acquisition of Unichem Labs by IPCA Labs is strategic, as it will enable a re-entry for IPCA Labs in the US market, from which IPCA Labs had been away, as its 3 facilities have been under the import alert from the US, since FY14. However, we also believe that the acquisition is being done at an exorbitant valuation considering the hi weakening financials of Unichem Labs over the last 3 quarters, consecutively due to competitive intensity in the US and cost rise. We maintain our overall revenue and earnings growth estimates for IPCA Labs at 11.4% and 3.4% CAGR, respectively over FY2022-FY2025E. We are not incorporating any pro-forma financials of the combined entity in the financials of IPCA Labs until the deal gets through. However, we lower the valuation multiple and arrive at PT of Rs. 790 from Rs. 909 before and maintain Hold rating on shares. At CMP, the stock trades at higher levels of 24.1x/18.8x its FY24E/FY25E EPS, respectively, when compared with peers trading at an average 20.8x/17.2x their FY24E and FY25E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

| Companies | CMP (Rs / Share) | O/S Shares (Cr) | Mcap (Rs Cr) | P/E (x) | | | EV / EBITDA (x) | | | RoE (%) | | |
|---------------------------|------------------|-----------------|--------------|---------|-------|-------|-----------------|-------|-------|---------|-------|-------|
| | | | | FY23 | FY24E | FY25E | FY23 | FY24E | FY25E | FY23 | FY24E | FY25E |
| IPCA Labs | 741 | 12.6 | 18,871 | 35.3 | 24.1 | 18.8 | 19.4 | 13.8 | 10.6 | 8.9 | 12.1 | 13.7 |
| Caplin Point Laboratories | 656 | 7.6 | 4,937 | 12.9 | 11.2 | 9.3 | 8.8 | 7.1 | 5.6 | 23.1 | 21.8 | 21.7 |

Source: Company; Sharekhan Research

About company

Ipca is a fully integrated Indian pharmaceutical company manufacturing more than 350 formulations and 80 APIs for various therapeutic segments. Ipca is a therapy leader in India for anti-malaria with a market share of over 34% and a fast-growing presence in the international market as well. The company has leading brands in five therapeutic areas, with three of its branded formulations being ranked among the top-300 Indian brands by ORG-IMS. Ipca's APIs and formulations are produced at manufacturing facilities approved by leading drug regulatory authorities, including USFDA, UK-Medicines, Healthcare Regulatory Agency (MHRA), South Africa-Medicines Control Council (MCC), Brazil-Brazilian National Health Vigilance Agency (ANVISA), and Australia-Therapeutic Goods Administration (TGA) with operations in more than 100 countries.

Investment theme

Strong growth in the domestic formulation business coupled with increased opportunities in the API space and additional business from the institutional segment indicate strong earnings potential over the next 2-3 years. We feel most headwinds that impacted the company's sales and profitability (except for import alert from USFDA) are now behind it. Management is also evaluating new therapeutic areas that would boost the company's overall growth. In addition, Ipca is implementing de-bottlenecking plans for its API facilities to ease capacity constraints. Further, Ipca is setting up new API capacities at Dewas and is looking to build the Nobel Expochem plant into a KSM plant. Collectively, incremental capacities are coming on stream and would fuel growth, though over the long term.

Key Risks

1) Lack/delay of clearance by other drug regulators would impact the export business outlook; 2) Addition of drugs in NLEM list could hurt the domestic business.

Additional Data

Key management personnel

| | |
|-----------------|---|
| Premchand Godha | Chairman and Managing Director |
| Ajit Kumar Jain | Joint Managing Director |
| Harish Kamath | Corporate Counsel and Company Secretary |

Source: Company

Top 10 shareholders

| Sr. No. | Holder Name | Holding (%) |
|---------|------------------------------------|-------------|
| 1 | DSP Investment Managers Pvt Ltd | 5.3 |
| 2 | HDFC AMC | 5.24 |
| 3 | Kotak Mahindra AMC | 2.63 |
| 4 | ICICI Prudential AMC | 2.45 |
| 5 | Nippon Life India Asset Management | 2.21 |
| 6 | Mirae Asset Global Investments | 2.08 |
| 7 | HDFC Life Insurance Co Ltd | 2.03 |
| 8 | Axis AMC | 1.77 |
| 9 | Vanguard Group Inc | 1.7 |
| 10 | UTI AMC | 1.67 |

Source: Bloomberg

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Understanding the Sharekhan 3R Matrix

| Right Sector | |
|-----------------|--|
| Positive | Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies |
| Neutral | Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies |
| Negative | Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability. |
| Right Quality | |
| Positive | Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance. |
| Neutral | Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable |
| Negative | Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and deteriorating balance sheet |
| Right Valuation | |
| Positive | Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment. |
| Neutral | Trading at par to historical valuations and having limited scope of expansion in valuation multiples. |
| Negative | Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple. |

Source: Sharekhan Research

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