

Strides Arcolab Ltd

BUY

CMP (Rs)	336.65
Target price (Rs)	421.00
Potential upside	25.1%

Stock data

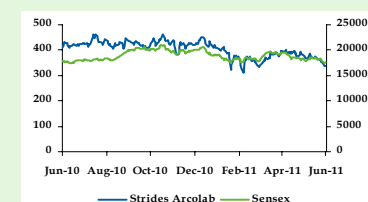
No. of shares (cr)	5.77
FV (Rs)	10
Market cap (Rs cr)	1,942
52 Wk Hi/low (Rs)	478/302
Avg. daily vol.* (Shrs)	1,23,894
BSE Code	532531
NSE Code	STAR
Bloomberg code	STR IN
Reuters Code	STAR.BO

*BSE 12 monthly average

Shareholding (%)

	Mar-11	YoY Chg
Promoter	28.28	(2.5)
FII's	33.08	24.6
MFs/UTI/Govt.	18.33	(10.7)
Others	20.31	(11.2)

Price performance



Source: Cline, ENAM Direct Research

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At the inception of transforming into a pharma powerhouse Company Background

Strides Arcolab Ltd. (SAL) is a specialty focussed player with equally strong presence in branded generics business.

Investment Argument

- Shot in the arm; sterile and Onco plants approval from US FDA:** SAL over the last month has received 2 US FDA approvals which has laid the road map for stellar revenue growth in the medium term. Despite having 37 approved ANDA's; SAL was able to commercialise only 10 due to capacity constraints. But now with the recent approval, SAL has enough capacity to commercialise the remaining ANDA as well as the future product approvals. Moreover, Onco plant approval will aid SAL to honour its partnership with Pfizer and GSK once the oncology ANDA's get approval. Both these approvals are expected to significantly bolster SAL's revenues and margins (high margin products) over next 2 years.
- Foray into new therapeutic domain lays the foundation for future growth:** SAL with strategic acquisitions and JV's has forayed into niche areas to further consolidate its sterile business as well as get a head-start for future opportunities. Biosimilars, penems, anaesthetic products, peptides and ophthalmic segments are the focus area for SAL going forward. For instance; SAL has acquired Inbiopro targeting biosimilars (opportunity of US\$ 28 bn by 2015).
- Master Move: Partnering Pharma Behemoth's; Pfizer and GSK:** SAL has partnered Pharma giants Pfizer and GSK for marketing its oncology products globally. Deal with Pfizer is for 67 injectables and covers mainly developed markets whereas the deal with GSK pertains for 10 injectables (with option to expand to 45 injectables) to 95 emerging markets. We believe partnering pharma global giants is a master move by SAL; as it provides direct access to wide array of geographies and Pfizer and GSK's extensive distribution network which will provide SAL's product a wider reach and audience.
- With big ticket capex behind; Balance Sheet and cash flows to regain lost vigour:** In order to create world class infrastructure; SAL had invested approx. Rs 844 cr over CY 2006-09. Company is all set to reap the benefits of those investments going forward. Moreover, with only nominal maintenance capex coupled with better cash flows from operations is expected to aid SAL in lowering its high cost debt going forward.

Valuation

We initiate BUY on SAL with a target price of Rs 421 arrived at by EV/EBITDA method (refer valuation for details); a potential upside of 25.1% over a period of 12-15 months.

Financial summary (Consolidated)

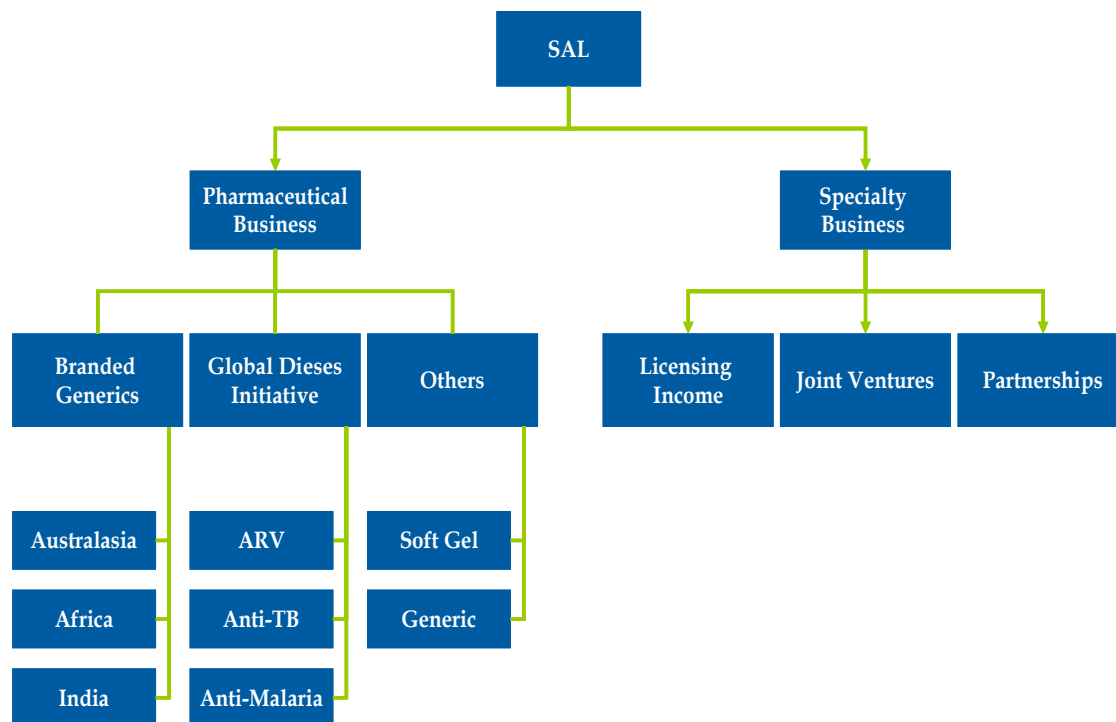
Y/E Dec	Sales (Rs Cr)	EBITDA (Rs Cr)	Adj. PAT (Rs Cr)	EPS (Rs)	Change (YoY %)	P/E (x)	RoE (%)	EV/EBITDA (x)	DPS
2009	1,305	211	52	12.6	NA	21.8	13.1	13.0	1.3
2010	1,696	392	122	26.0	106	17.3	9.6	10.3	1.5
2011E	2,101	452	157	27.3	5	12.4	9.7	8.3	2.0
2012E	2,466	547	226	39.1	43	8.6	12.4	6.6	3.2

Source: Company, ENAM Direct Research

BUSINESS OVERVIEW

Pioneer of sterile products in the Indian market; Strides Arcolab Ltd. (SAL) has a global manufacturing footprint with manufacturing facilities in 14 countries and marketing presence across 75 countries. SAL is currently amongst the largest global manufacturers of sterile injectables, with prime focus and expertise in oncology segment.

Business Overview



Source: Company

Noteworthy points

- SAL has one of the largest Lyophilization (freeze drying) capacities globally
- SAL is one amongst the top 5 leading global manufacturer of soft gelatine capsules
- SAL has partnered global behemoths like Pfizer, GSK, Sandoz and Teva
- SAL through its subsidiary is amongst top 3 generic player in Australian and leader in Singaporean markets
- SAL has earned contractual obligations from the elite global aid and charitable org. like UNICEF, PEPFAR and Clinton Foundation amongst others.

Speciality Pharmaceuticals

- Therapeutic segments: SAL manufactures injectables across varied therapeutic areas of Anti-Infective (AI), oncology, analgesic, anti-thrombotic, Central Nervous System (CNS) and Gastroenterology.
- High margin segment: Sales from the speciality business account for approx. 39% of total sales and 57% of total EBITDA as on CY 2010.
- Drug development plan: SAL mainly focuses on developing those products that feature amongst the US list of shortage drugs or complex products, which aid in attaining critical mass, face less competition and earn better margins.
- Focus on speciality business: Of the 153 ANDAs filed, 115 cater to speciality business which depicts this business holds the onus of future growth for SAL.
- Re-branding: SAL recently announced the re-branding of the speciality business under the brand name of Agila Specialties.

Branded Generics

SAL markets branded generics in Australasia, Africa, India and others.

Australasia:

1) Australia

SAL operates through its subsidiary Ascent Pharma-health (94% owned, listed on ASX); is the 4th largest generic player in the continent.

SAL recently privatized Ascent Pharma by acquiring additional stake of approx. 34%.

Approx. 400 generic drugs, OTCs, skincare and a few consumer products are marketed in Australia; and supplied from SAL's facility in Singapore. More than 60 generic products are registered in Australia.

2) Singapore and other South East Asian countries:

SAL is the largest and leading generic player in Singapore and also has active presence in several S.E. Asian countries like Sri Lanka, Vietnam, Myanmar, Philippines, and Cambodia.

Africa:

- **Presence:** SAL’s footprint in this geography covers almost the entire region with presence in [West and French Africa](#).
- **Product Profile:** Over [300 products](#) are registered across the African markets and portfolio includes mix of generics, OTC products and branded drugs.
- **2-prong business strategy:** One being [direct presence](#) in certain markets and second being through participation in [tender business](#).
- **Manufacturing facilities:** Demand for drugs is met from 3 dedicated facilities; [one in Nigeria and 2 in India](#).

India:

SAL created a foothold in the Indian front-end operations with the acquisition of the branded business of [Grandix in 2007](#).

SAL caters to the domestic market via 2 divisions - [Grandix and Ray of Life \(ROL\)](#).

The drugs in [diabetes, cardiovascular, neurology and female healthcare](#) are being marketed under the Grandix brand while the drugs in [oncology, nephrology and high-end anti-biologics](#) are being marketed under the Ray of Life brand.

Grandix markets [well-known brand Renerve](#) through its 400-man field force and has annual sales of over [Rs 250 mn](#) whereas ROL markets specialized hospital products.

Global disease initiatives:

SAL is a significant player in the international field of tenders for disease initiatives.

SAL supplies drugs in the ARV, TB and malaria (ATM) segment to global procurement agencies such as [UNICTAID, PEPFAR](#) (US President’s Emergency plan for AIDS Relief) and [Clinton Foundation](#).

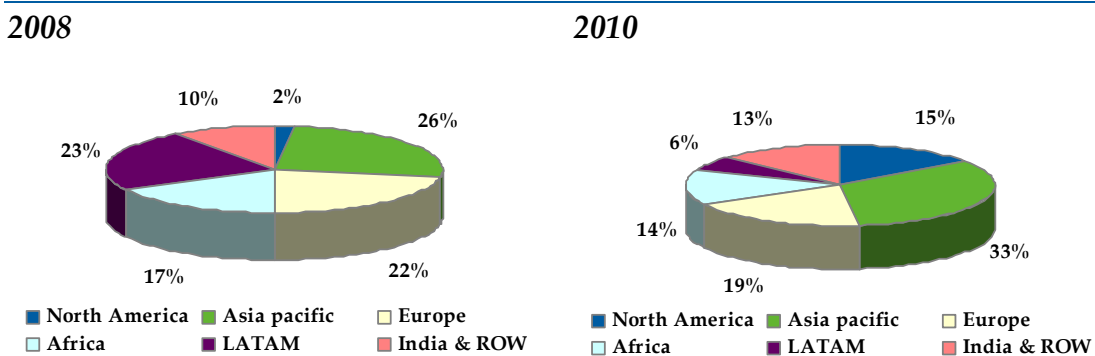
It has presence across [27 countries worldwide](#).

ARV	ANTI-TB	ANTI-Malaria
38 ANDA’s filed of which 17 ANDA approvals by US FDA under the PEPFAR programme	Technical and marketing alliance with Big pharma for supply of anti-TB products	Oseltamivir (Starflu) has been pre-qualified by the WHO. SAL only the 2nd Co. globally to receive it.
7 ARV drugs have been pre-qualified by WHO	2 products pre-qualified by WHO in association with Big pharma	Partnership with the Ministry of Health, India; in control of H1N1
Partnership with Clinton Foundation for supply of AIDS (ARV) drugs		5 different Anti-malarial products

Soft Gels:

- **Facility:** SAL owns one of the largest soft gel capacities in the world. In Bangalore’s oral drug facility; SAL has 5 dedicated lines focussed on soft gels.
- **Therapeutic segments:** It caters to a range of therapeutic segments such as neutraceuticals, generics, specialty OTCs and Immuno-suppressants. SAL is among the few soft gel manufacturers focusing on the prescription drug domain.

Revenue from US has leap-frogged over 3 years; SAL has managed a diversified revenue segmentation thereby de-risking its business



Source: Company

INVESTMENT RATIONALE

SAL is on the verge of entering a phase of high growth which will propel the company's financials and aid SAL to position itself amongst the top domestic pharma players. From a pure play branded generic player it has transformed itself to a Specialty focused company.

SAL's business is expected to manifold backed by exponential growth from its Specialty business and stable growth from its Pharmaceutical business.

Specialty business: Jewel amongst all pharmaceutical product class

Sterile injectables space presents very unique, dynamic and vast opportunity for players catering to this niche space. The prime reason being this segment has been marred with several and severe constraints which have left this segment devoid from steep competition. We will examine each distinguished constraints and their consequent impact on specialty segment.

Key Constraints	Consequent impact	Conclusion
A) Manufacturing Facilities:		
i) Complex process. ii) Highly capital intensive. iii) High plant set-up gestation period.	This primarily results in high entry barriers. Rules out small player's entry into this niche space.	Competition gets limited.
B) Products:		
i) Complex products hard to replicate. ii) Securing product approvals is a time consuming affair. iii) R&D investment requirement is significant.	Players become vary due to high R&D investments. Moreover, limited player's have capabilities to produce such complex products.	Minimal competition across products. Product prices remain intact.
C) Approvals:		
1) Due to complexities; product and plant approvals take longer than usual time. 2) Limited US FDA approved plants.	High entry barriers for new players. Heavy reliance on CRAMS to suffice demand. Demand-supply gap widens.	Results in elevated drug shortages. Supply scarcity results in stable product prices. Players with approvals rule the roost.
D) End Users:		
Products are generally sold to hospitals & clinics often under contracts negotiated by Group Purchasing Organization's (GPO).	Difficult to penetrate; needs hospital focused pharma companies.	Acts as another entry barrier. Results in lower competition.

Consequently, unlike the formulations and API space which is blemished with cut-throat competition; sterile space remains devoid of competition severity.

Compared to the solid generic market, which can see as many as 10 or more versions of a product on the market after a 180-day exclusivity window, just 1 or 2 manufacturers received Abbreviated New Drug Application (ANDA) approvals for more than half of the injectables generic approved from 2003 until 2008.

86% of molecules in sterile injectables space have fewer than 5 competitors.

Unlike the norm; where drugs going off-patent lose anywhere between 3/4th & more of their price with entry of generic players; sterile products due to lack of competition and capacity and product shortages do not lose as much value. Rather in special cases even generic sterile products experience price enhancement due to demand supply mismatch. E.g. Vancomycin injections during previous quarter.

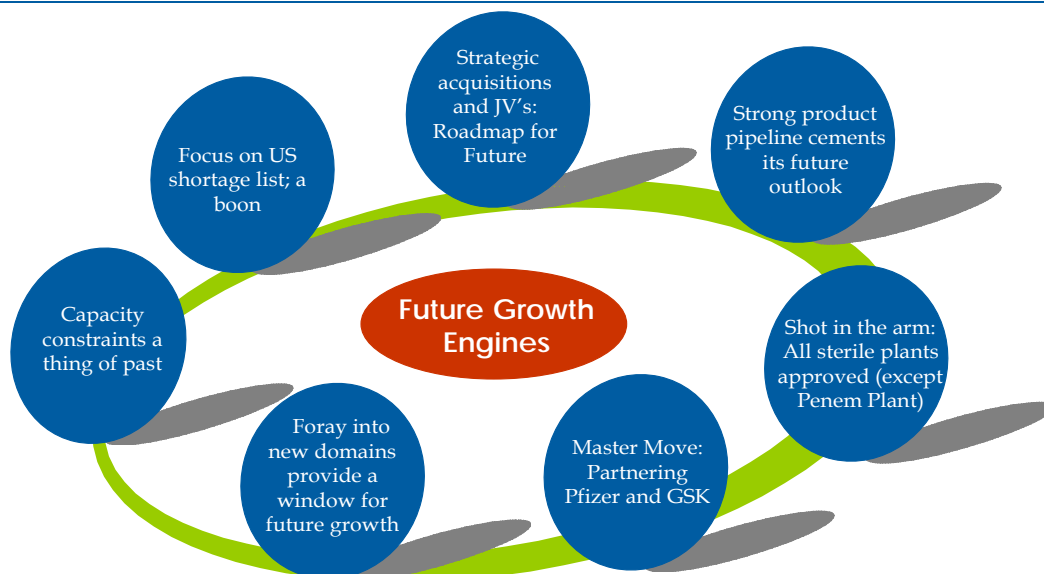
Generic Injectables Market Size and Opportunity

Global injectables industry	
Size as on 2009	US\$ 200 bn
Exp. growth (CAGR over next 3 years)	12%
Dominant market regions and share	US & EU with combined market share of 72%

Global generic injectables industry	
Size as on 2009	US\$ 20 bn (10% of Global injectables industry)
Size as on 2015	US\$30 bn - US\$ 33 bn

SAL had identified the underlying opportunity in Specialty business and is currently a formidable global sterile player. We outline the growth engines which will drive SAL's sterile business going forward.

Growth Drivers for Specialty business

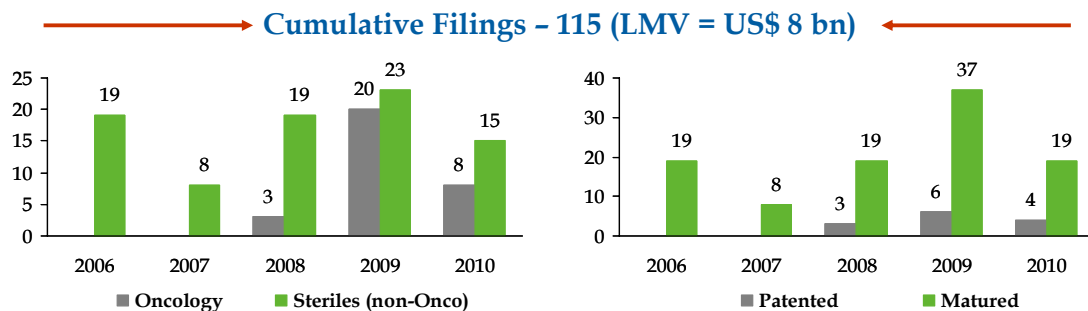


Source: Company

SAL owns one of the strongest and largest sterile ANDA pipeline in US

SAL currently has cumulative filings of 153 ANDA pending approval of which 115 cater to sterile segment (75% of total filings). This lays the perfect roadmap whereby SAL will emerge as a major sterile player in the coming years.

ANDA filings and approvals have gained immense traction over last 2 years

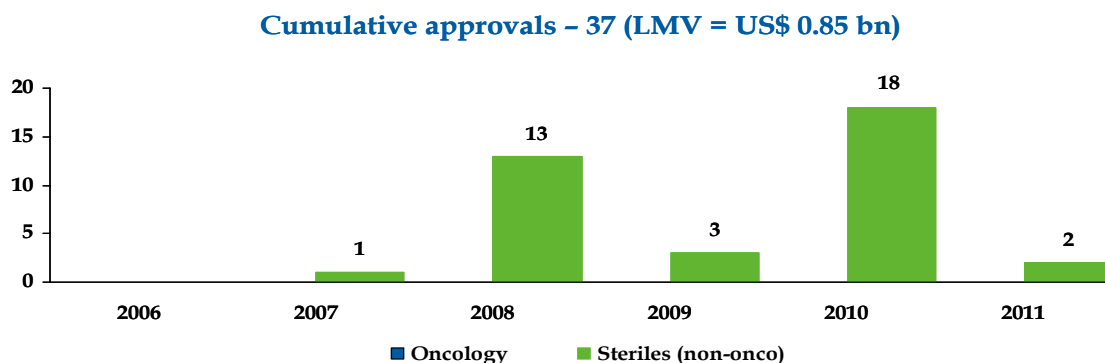


Source: Company

Noteworthy points depicted from the table above:

- 1) Excellent R&D team and extensive investments paying rich dividend;
- 2) Over the last 3 years; SAL has extended its capabilities to extremely complex and hard to replicate oncology products (margins even better than non-oncology sterile products).
- 3) Company is targeting high value products evident from the LMV of these filings which stands at US\$ 8 bn.

SAL investments are paying rich dividends; ANDA approvals picking pace



Source: Company

Noteworthy points depicted from the table above:

- 1) Targeting drugs which feature amongst the US shortage list aids in earning faster than normal approvals. **Approx. 13 of the 37 approvals target the US shortage list.**
- 2) **37 approvals aggregate to total LMV of just US\$ 0.85 bn.** It can be safely assumed that remaining ANDA approvals are expected to be of higher LMV's especially the Oncology filings. These will collectively propel revenue growth over the medium term.

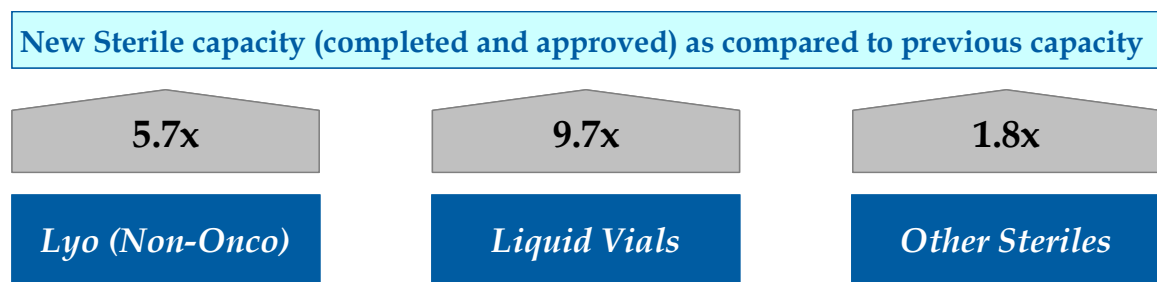
Management expects approx. 20 ANDA approvals in CY 2011. Moreover, recent plant approvals by US FDA ensure that all the approved drugs get commercialized by end of CY 2011. The full year impact on revenues will be experienced in CY 2012. Thus, we believe SAL is entering a phase of high growth from hereon.

Moreover, the pipeline will not run dry with these filings; as SAL is planning to file another 80 ANDA's over the next 2 years; with over 3/4th focusing on sterile segment. Thus, long term outlook for the company continues to stay robust.

Capacity Constraint: A thing of past

Once SAL zeroed in on this niche segment; they significantly bolstered their sterile manufacturing capacities for future growth prospects. SAL made capital investments to the tune of Rs 844 cr during CY 2006-2009 as upfront investment to create high quality manufacturing capacities for the complex sterile products.

Foreseeing the future demand; SAL increased its Sterile capabilities by manifold



Source: Company

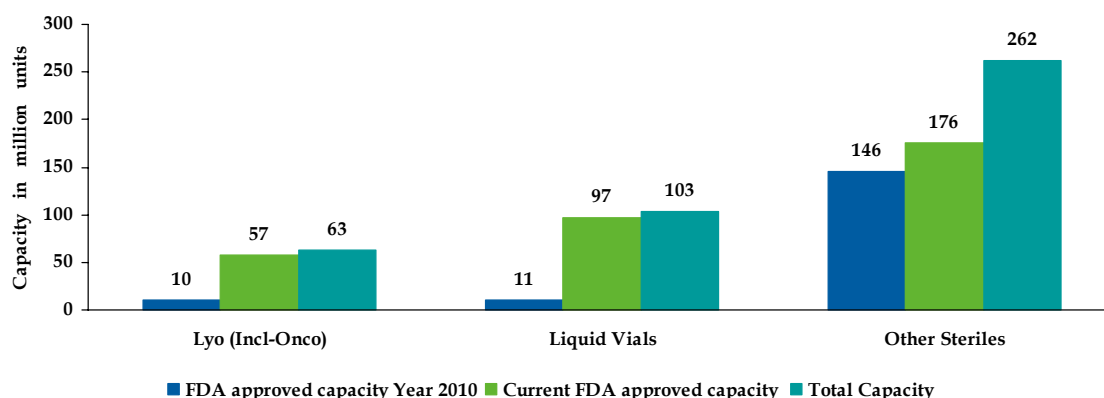
Currently SAL has approx. 37 ANDA approvals but was able to commercialize only 10 of them. Even commercializing 10 ANDA had SAL's approved sterile plants operating at approx. 100% capacity utilization levels. The slow pace of product commercialization can be attributed to capacity constraints faced by SAL.

However, on 18th April 2011; SAL received US FDA approval for its New Sterile injectables facility in Bengaluru, India.

Furthermore, on 02 May 2011, SAL received US FDA approval for its Oncology facility, in Bengaluru, India.

With this approval, total approved capacity strength of SAL's sterile plants has increased to;

SAL has created one of the largest US FDA approved Sterile capacity in the world



Source: Company

Decisive victory: SAL achieved US FDA approval for all its 5 sterile plants in India

Manufacturing site particulars	Existing facilities			New facilities			Poland	
	Sterile	Penicillins	Cephalosporins	Steriles	Penicillins/ Penems	Oncology		
Location	Bangalore India	Bangalore India	Bangalore India	Bangalore India	Campos Brazil	Bangalore India	Warsaw Poland	
USFDA approval status	Plant	✓	✓	✓	Awaited	✓	Primary focus on European Market EU approved Plant	
	Products	✓	Awaited	Awaited	✓	Awaited		
Total capacity (mn units)	64	33	44	140	66	25	56	
Filings (US)	Nos	53	8	5	17	2	30	N.A.
Approvals (US)	Nos	37*	Nil	Nil	37*	Nil	Nil	N.A.
Commercialized (US)	Nos	10	Nil	Nil	Nil	Nil	Nil	N.A.

* All FDA approved products can be moved from one FDA approved plant to another in 30-120 days

Twin Magic to propel revenue and margins

A) US FDA approval for the Bengaluru Sterile Plant 2 negates the prevailing capacity constraints

Despite having 37 approved ANDA's in its product basket; due to unavailability of approved capacity, SAL initially was compelled to only commercialize 3 of these products. However, US FDA approval for SAL's Plant 2 unlocks significant sterile capacities for SAL.

SAL has already applied for site transfers and within a month's time will start receiving necessary clearance for launching its 37 approved ANDA's (1 approved ANDA is still covered under patent regime) from the new plant. SAL plans to commercialize all of the remaining 27 products by 2H CY 2011 from the newly approved sterile plant. Even post commercialization of all the 37 products; Plant 2 will be operating at 45-50% capacity utilization rates; which indicate SAL has enough firepower for future product approvals. The LMV of the remaining 27 products to be commercialized from this newly approved plant amounts to US\$7.2 bn.

This is expected to significantly bolster SAL's revenues. Moreover, margins are expected to expand on account of higher revenue from high margin sterile space.

B) Shot in the arm: Recent oncology plant approval

Segment Brief: Cancer is a leading cause of death worldwide. Annual global cancer deaths number about 7.6 mn and are expected to surge to 17 mn by 2030 [Source: WHO]. Oncology segment is an extremely niche segment marred by manufacturing complexities and severe challenges in replicating its products.

Global opportunity: Global cancer drugs sales are expected to grow at 12-15% CAGR, reaching US\$75 bn -US\$80 bn by 2012 [Source: IMS Health]. Between 2009 & 2015; approx. US\$10 bn in annual originator sales of oncology injectables is expected to lose patent protection; thereby providing huge opportunities for generic players like SAL.

Rationale for SAL's focus: Almost 35% of the injectable generics approved in the US from 2003 to 2008 are used in cancer therapy (Source: Espicom). Moreover, the top 10 generic players in the oncology market enjoyed a market share of 70% in 2009. Thus SAL's idea of emerging as a global injectable player would not have succeeded without accessing oncology segment (low volume high margin segment).

SAL with its rich and diverse R&D capabilities has filed for approx. 32 Oncology ANDA in US over the last 3 years and is building capabilities to file over 100 oncology products in the coming years. With the US FDA approval for its Oncology plant; we believe with every ANDA approvals (catering to oncology segment); revenues and especially margins are

expected to significantly strengthen going forward. However, major impact from this segment is expected from CY 2012 onwards.

Multiple benefits flow by focusing on US drug shortage list

Considering production complexities, relatively long manufacturing lead time and lack of competition adversely affects the demand supply proposition for sterile products. This is made evident by the yearly disclosure by US FDA through its list of drug shortages.

Year	No. of drug shortages (A)	No. of sterile drugs in shortage (B)	B/A
2008	110	39	39%
2009	157	73	46%
2010	178	102	57%

Source: US FDA, company

As can be gauged from the above table; sterile products year after year continue to dominate the US drugs shortage list with the stark reality; % is increasing with each passing year.

SAL identified this space as an opportunity and already has approx. 13 approved ANDA (LMV of US\$ 450 mn) which target the US Shortage list.

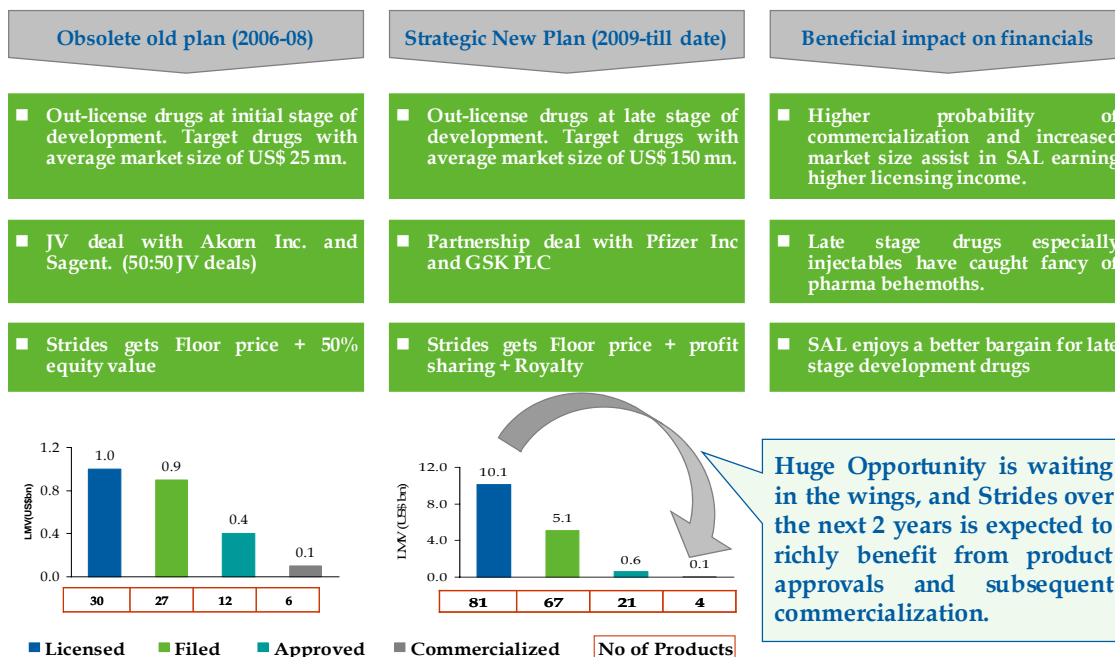
Companies such as SAL are important for US FDA; as they help bridge the existing demand-supply gap for such drugs featuring in shortage list.

Benefits for SAL:

- Aids in quick approvals from US FDA for products targeting drug shortages; and consequently the plants via which the drugs will be manufactured.
- Demand-supply gap ensures pricing power for producers like SAL
- Low competition for the drug aids SAL in gaining substantial market share. For instance, Rifampicin (features amongst drug shortages) had only 2 competitors; one being SAL. Thus SAL earned market share of 52% for the drug.

We believe, SAL will continue to pursue opportunities targeting US drug shortage list going forward which offers lucrative options for the company.

Strategic change in business plan adds financial impetus and augments outlook



Source: Company

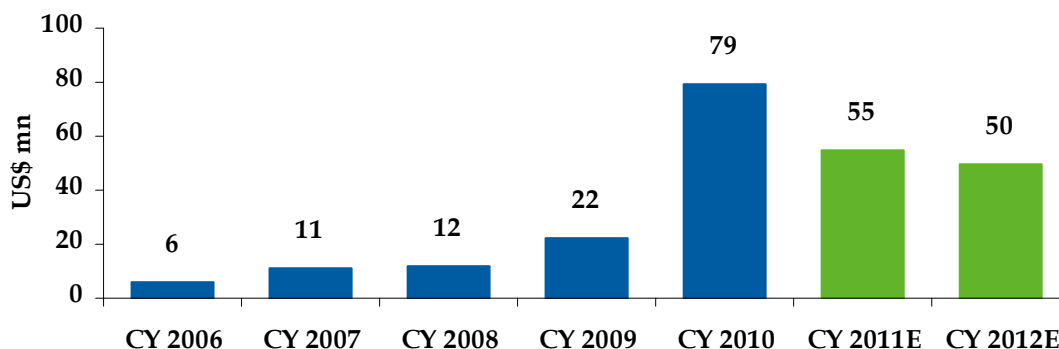
Change in business plan has ensured SAL gaining higher licensing income

As can be determined from the chart below; SAL in the initial phase (CY 2006-2008) used to earn low licensing income primarily because of out-licensing drugs in early stage development. Post the initial phase, SAL earned higher licensing income backed by change in business plan.

SAL has 52 drugs in late stage development with LMV of approx. US\$ 7 bn which will be probable out-licensing candidates in the medium term.

We believe licensing income earned by SAL will be US\$ 55 mn and US\$ 50 mn for CY 2011 and CY 2012 respectively; slightly lower than the peaked income earned in CY 2010.

Licensing Income



Source: Company

Master Move: Partnering Pharma Behemoth's; Pfizer and GSK

Imp Details	Deal with Pfizer	Deal with GSK
No. of Products	67 off-patented products, 40 of them are oncology injectables. (LMV of US\$19.5 bn). [22 products are from SAL's JV from Akorn]	10 oncology injectables which can be expanded to 45 products.
Products approved	19 non-Oncology products (16 from SAL's JV from Akorn)	Approvals are being sought across markets.
Regions	Pfizer will market these products in the US, EU, Canada, Australia, New Zealand, Japan and Korea.	GSK will market products in 95 emerging markets excluding Saharan Africa and India
Revenues	Strides gets Floor price + profit sharing + Royalty	Strides gets Floor price + profit sharing + Royalty
Revenues will kick in	2H CY 2011	3Q CY 2011

With the Oncology plant approval by US FDA; we will see significant traction in revenues and margins once all the oncology product approvals occur. SAL is expected to achieve peak sales from these products in CY 2013. Already in Mar 2011, SAL has received EU approval for an oncology drug; Carboplatin with a market size of US\$ 138 mn.

We believe partnering pharma global giants is a master move by SAL; as it provides direct access to wide array of geographies and Pfizer and GSK's extensive distribution network which will provide SAL's product a wider reach and audience. SAL would have found it extremely difficult to market products all by itself in such a broad manner; moreover it would have been a very costly affair. Both these agreements not only provide credibility to SAL R&D efforts and product pipeline but are expected to generate substantial revenues and profitability over the next 2-3 years.

JV with Sagent on growth path; Pfizer takes over products from JV with Akorn

In its endeavor to succeed in the US markets; SAL had formed 2 JV's; with Sagent Inc. and other with Akorn Inc. Both these JV's were 50:50 partnerships and for drugs at initial stage of development.

JV with Sagent Inc.: At the dawn on high growth over next 2 years

No. of products	ANDA filed	Approved	Commercialised	To be commercialised
30	27	13	6	7

SAL is expected to launch the balance 7 approved products from the newly approved facility in current year. Moreover, approx. 8-10 of the ANDA filed are expected to receive approval in CY 2011. Thus, SAL is expected to significantly benefit from its JV with Sagent over next 2 years.

JV with Akorn: At the fag end of relations with SAL

JV with Akorn will possibly get dissolved by end of 1H CY 2011 with the stake sale in the JV to Pfizer. SAL has recorded part licensing income from the stake sale in the JV with Akorn to Pfizer. The remainder is expected to be received in 1H CY 2011; post which the JV will cease to exist.

Of the 22 products transferred to Pfizer; 16 are approved ANDA with LMV of US\$ 500 mn.

We believe Pfizer with its strong distribution network will help SAL achieve higher profits for these drugs going forward.

Foray into new therapeutic domain lays the foundation for future growth

SAL has not remained docile post its deals with Pfizer and GSK; rather it has focused on broadening its product offerings and further consolidating its sterile business. It has identified few distinct therapeutic areas such as bio-generics, penems, anaesthetics and ophthalmic amongst others.

Strategic JV and acquisitions by SAL to create its presence in these niche segments

Biogenerics: In Dec 2010, SAL's wholly-owned subsidiary Agila Specialities acquired 70% of Bangalore based biotech firm; Inbiopro Solutions.

Market: Partnering with biotech Co's is a key source of innovation for big pharma Co's as approx. 75% of phase II, III and pre-registration innovative drugs are of biotech origin.

Biotech drugs accounted for 31% of the 100 best-selling pharmaceuticals in 2009. This share is expected to increase to 48% by 2016.

Rationale for acquisition: Although generic specialty injectables and biosimilars are very different businesses, there is obvious overlap, starting with the complexity of the manufacturing and ending with the distribution channels, largely hospitals and clinics. Given the similarities, having experience in generic injectables would be a plus in the race to reach the market with biosimilars.

Market opportunity: Between 2010 and 2015 about US\$47 bn in proprietary biologic drugs are estimated to lose patent protection.

Regulatory pathway for biosimilars already exists in Europe and, in the US; provisions for biosimilars are currently under debate by the US Congress. If biosimilar legislation is approved in the US, it would open the door to low-cost versions of drugs.

Opportunity for SAL: The Inbiopro acquisition gives SAL a 3-year head start in the biogeneric space, which is characterised by specialized expertise in recombinant DNA technology and manufacturing process development. This acquisition enables direct access to a pipeline of 8 products with global sales of over US\$28 bn. Of this, 5 products are used for treating Cancer, thereby further strengthening SAL's oncology portfolio. Commercialization of at least 2 products is expected to begin in CY 2013. This segment is expected to significantly augment revenue and margins in the long term.

Penems: SAL acquired back its Campos facility in Brazil (expected US FDA inspection in 2H FY 2011) from Aspen which is dedicated in manufacturing Penems and Penicillin's. With this acquisition; SAL gets direct access to Penems which constitute a key domain in order to provide a complete portfolio of sterile products. Carbapenem currently is a limited competition opportunity (approx. US\$2 bn market size) with attractive margins. The Campos facility is awaiting US FDA approval (UK MHRA approved). SAL has already filed ANDA for 2 penem products of the 4 products currently marketed in the world. These 2 drugs have already been out-licensed to pharma biggies for US & Canada markets. Commercial launch post approvals would be major growth driver.

Anaesthetics: SAL entered into JV with BioChimico (Brazil) where SAL will be a 52% partner in JV and will target the Brazilian hospital segment. BioChimico is one of the dominant hospital players in Brazil with leadership position in anaesthetics. SAL's product portfolio is devoid of anaesthetic domain and thus this JV helps SAL to broaden its product portfolio. The JV further complements SAL's existing licensing and supply arrangements with Aspen Pharma to fully tap the Brazilian hospital market opportunity.

More over, backed by the suave in-house R&D capabilities; SAL is also foraying into other sterile domains such as ophthalmic and pursuing the niche peptides segment.

Overall we believe, SAL is investing significantly in new areas and paving way for unswerving future growth.

Pharmaceutical business: steady growth segment for SAL

SAL's pharma business is further divided into branded generics, soft gels and global disease initiative business. Sterile segment will be the growth engine for the company whereas Pharma business will generate steady cash flows for SAL.

Branded Generics:

Australasia: SAL intends to further leverage its leadership position in Singapore and is taking necessary steps to consolidate its holding in Ascent Pharma, Australia. SAL's product pipeline includes all major patent expiries across the region till 2014. Moreover, SAL intends to shift production of Australian products to India thereby achieving better margins for those products from utilizing low cost domestic manufacturing facilities. We believe, Australasia will continue to grow at approx. 15% CAGR over next 2 years.

India: SAL has restructured its strategy for the Indian markets. They have exited markets which did not make economic sense whereas planning to foray into newer geographies (Venture into Western and Central Indian regions from its current exposure limited to Southern regions). Company also intends to form a strong Medical Representative team (from current 550 to 1,000 over next 2 years) in order to promote its products across the target regions. Although currently contribution of Indian business is limited; we believe the next couple of years; revenue from India is expected to triple on back of its low base.

Africa: SAL is a leading player in the West and French African region with a product portfolio of 300 drugs. SAL has strategically focused its business by being present in one of the most populous region; The West Africa (1/3rd of overall African population). This region is growing at 8-10% p.a. We expect SAL's African business to grow at 12-15% CAGR over next 2 years.

Global Disease Initiative:

SAL assumes this business to be a stable growth segment. GDI is a tender driven business which encounters cut-throat competition. Thus, manufacturing cost plays a pivotal role in deciding segmental margins. SAL lacks backward integration (devoid of API capabilities) and thus faces margin pressures from this business segment. Consequently, SAL does not intend to invest money in this business currently and is content with the stable growth from this segment going forward.

Soft gels

SAL has approx. 15 soft gel products awaiting regulatory approval. 3-4 products are likely to receive approval in CY 2011 and the remainder over the period of next 2 years. SAL obtained its 1st FDA approval for Ergocalciferol in Aug 2010 prescribed for treatment of hypoparathyroidism & hypophosphatemia with total US market of approx. US\$62.9 mn in 2009 (+72% y-o-y). The product is marketed and sold by Paddock Labs under a profit share partnership with SAL thereby expected to deliver strong growth in medium term.

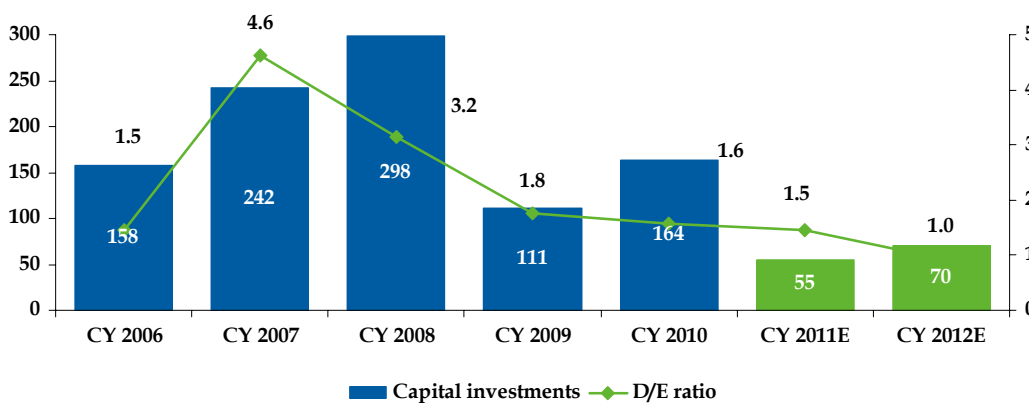
Thus, we believe over all Pharmaceutical segment will generate moderate growth in the medium term.

With big ticket capex behind; Balance Sheet and cash flows to regain lost vigour

With the capex cycle now behind the company, SAL is expected to spend approx. Rs 100 cr as maintenance during CY2011 and CY2012, significantly less than the Rs 844 cr spent during CY2006-09.

Moreover, improving cash flow generation and QIP proceeds (Rs 455 cr) has given SAL the scope to further lower its leverage over next 2 years.

With capex easing out; and higher cash flows from operations; D/E ratio is expected to trend further South



Source: Company

SAL over the past 2 years has built financial capabilities and is competent to address upcoming important financial commitment over next 2 years. The most prominent being the FCCB pay-off in CY 2012 to the tune of US\$ 120 mn (approx. Rs 540 cr).

As on CY 2010; SAL already had approx. Rs. 330 cr as cash and bank balances. Moreover, higher cash flows from operations and lower capex requirements over the next 2 years will further augment SAL’s cash positions and aid them in fulfilling their commitments. We believe by CY 2012; SAL will be in a position to bring down its D/E to 1 which considering the torrid phase of CY 2008-2009 is remarkable.

Thus, we believe SAL has significantly improved its stretched Balance Sheet and over next 2 years we believe the Balance Sheet will further stabilize and strengthen.

VALUATIONS

We expect SAL's revenues & profitability to significantly expand primarily driven by robust performance from its specialty business coupled with stable growth from its pharmaceutical business. The shift in the revenue mix in favour of specialty business will not only propel revenues but will also significantly expand margins going forward.

Business Valuation

Given its current leverage position; we value SAL based on an EV/EBITDA methodology. Specialty business and pharmaceutical business are distinctly different and thus we believe both the businesses deserve separate multiples. Consequently we assign separate multiples to Specialty business and Pharmaceutical business.

International Injectables focussed companies enjoy better EV/EBITDA multiples than SAL; with recent plant approvals we believe the gap will gradually narrow down going forward

Companies*	SALES			EBITDA			EV/EBITDA		
	CY 2010	CY 2011E	CY 2012E	CY 2010	CY 2011E	CY 2012E	CY 2010	CY 2011E	CY 2012E
Strides Arcolab	1,696	2,220	2,677	396	468	598	10.33	8.30	6.6
Hospira Inc.	17,823	18,873	20,161	3,571	5,142	5,783	13.29	9.03	8.04
Hikma Inc.	3,326	4,192	4,936	822	897	1,087	14.14	14.21	11.72
Akorn Inc	393	530	717	74	130	160	28.51	20.76	16.81

* Except for Strides; all other companies figures have been converted into INR cr assuming USD/INR rate of 45.5

Source: Bloomberg and ENAM Direct

We assign higher multiple to Specialty segment mainly backed by;

- 1) **Premium segment; premium valuations:** Lack of competition, product shortages, few players, niche therapeutic areas, complex products and manufacturing techniques, long gestation period and capital intensive business; in all Specialty segment is in all sense a specialised business arena and due to its niche features earns high margins for its players as compared to conventional pharmaceutical business (such as formulations and API's).
- 2) **SAL's positioning as a front-runner global specialty player:** SAL's strong injectables portfolio and improved revenue and margin visibility post plant approvals from US FDA paves the way for higher multiples for its Specialty business.

For Pharma business we provide the conventional multiple similar to ones earned by branded generic players in India.

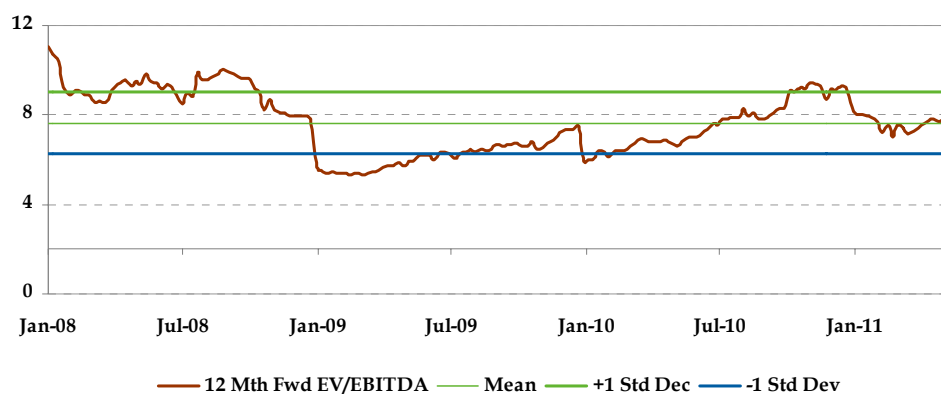
One year forward Price Computation

Methodology	CY 2012E EBITDA (Rs cr)	EV/EBITDA multiple	EV (Rs cr)	Fair Value per share (Rs)
Specialty business	380	8.0	3,039	
Pharma. business	167	6.2	1,038	
Target EV			4,077	
Net debt/cash			(1,332)	
Minority interest			(314)	
Target market capitalization				2,431
Num. of shares (cr)				5.77
Fair Value (Rs)				421.00
CMP (Rs)				336.65
Upside from CMP				25.1%

Source: Bloomberg and ENAM Direct

We arrive at a target price of Rs. 421 per share and thus recommend a buy on SAL with a potential upside of 25.1% over a period of 12-15 months.

12 month Forward EV/EBITDA: at the influx of re-rating



Source: Bloomberg and ENAM Direct

RISKS & CONCERNS

- **Earnings dependence on US FDA approvals:** SAL significantly depends on US FDA approvals for its plants and products. IF US FDA revokes its approval for any of SAL's plants due to non-compliance or other relevant reason; it could significantly dent SAL's earnings outlook and profitability.
- **Adverse exchange rate movements:** Over 3/4th of SAL revenue is generated from exports. Thus significant volatility in exchange rates can negatively impact revenue and profitability.
- **FCCB redemption:** SAL has US\$120 mn (approx. Rs 540 cr) due for payment in 1H 2012. If the company falters to make timely redemption or re-finance the maturing debt; it could have severe repercussions on its financials and increases business risk.

COMPANY FINANCIALS

Income statement (Consolidated)

(Rs Cr)

Y/E Dec	2009	2010	2011E	2012E
Net sales	1,305	1,696	2,101	2,466
Other operating income	24	65	40	47
Total income	1,328	1,761	2,142	2,514
Material Cost	701	806	996	1,156
Employee Cost	181	225	278	324
Other Manufacturing Cost	132	265	321	354
Contribution (%)	24	26	26	27
Advt/Sales/Distrn O/H	104	74	94	131
EBITDA	211	392	452	547
Other income	0	4	3	3
Depreciation	49	64	78	83
Interest	76	147	154	137
Other pre tax	0	0	0	0
Pre-tax profit	85	186	223	331
Tax provision	23	45	47	83
(-) Minority Interests	11	19	19	22
Associates	0	0	0	0
Adjusted PAT	52	122	157	226
E/o income / (Expense)	58	1	14	0
Reported PAT	109	122	171	226

Balance sheet (Consolidated)

(Rs. Cr)

Y/E Dec	2009	2010	2011E	2012E
Total assets	2,550	3,560	3,634	3,648
Gross block	1,071	1,151	1,206	1,276
Net fixed assets	847	853	829	816
CWIP	85	191	191	191
Investments	341	2	2	2
Working capital (excl cash)	175	697	711	782
Cash / Bank balance	91	339	424	379
Others/Def tax assets	1,010	1,477	1,477	1,477
Capital employed	2,550	3,560	3,634	3,648
Equity capital	89	58	58	58
Reserves	1,000	1,488	1,649	1,876
Borrowings	1,457	2,010	1,924	1,711
Others	3	5	3	3

Source: Company and ENAM Direct Research

Key ratios**(%)**

Y/E Dec	2009	2010	2011E	2012E
Sales growth	27.9	30.0	23.9	17.4
OPM	16.1	23.1	21.5	22.2
Operating profit growth	161.6	86.0	15.4	21.1
COGS / Net sales	76.3	73.5	74.5	73.0
Overheads/Net sales	7.8	4.2	4.4	5.2
Depreciation / G. block	4.6	5.6	6.5	6.5
Effective interest rate	-	8%	8%	8%
Net working capital / Net sales (x)	0.2	0.3	0.3	0.3
Net sales / Gross block (x)	1.6	1.5	1.8	2.0
Debt / equity (x)	1.3	1.3	1.1	0.9
Effective tax rate	26.4	24.3	21.0	25.0
RoE	13.1	9.6	9.7	12.4
Payout ratio (Div/NP)	5.5	7.5	7.3	8.2
EPS (Rs.)**	12.6	26.0	27.3	39.1
EPS Growth	NA	106.3	4.9	43.4
CEPS (Rs.)	21.5	39.6	40.8	53.4
DPS (Rs.)	1.3	1.5	2.2	3.2

Cash flow**(Rs Cr)**

Y/E Dec	2009	2010	2011E	2012E
Sources	266	1,180	154	96
Cash profit	245	343	408	468
(-) Dividends	0	8	12	18
Retained earnings	244	335	396	449
Issue of equity	16	471	0	0
Borrowings	142	520	(86)	(213)
Others	(137)	(146)	(156)	(140)
Applications	266	1,180	154	96
Capital expenditure	111	164	55	70
Investments	39	781	0	0
Net current assets	82	2	15	71
Change in cash	34	233	84	(45)

Source: Company and ENAM Direct Research

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- | | |
|-------------------------------------|----|
| 1. Analyst ownership of the stock | No |
| 2. Firm ownership of the stock | No |
| 3. Directors ownership of the stock | No |
| 4. MBD Relationship | No |
| 5. Broking relationship | No |

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