

Strides Arcolab Limited (STRARC)

₹ 333

Focus on specialities to drive growth...

Strides Arcolab (SAL) is a mid-sized pharmaceutical company with a strong presence in sterile injectables (specialties), branded generics and soft gelatine capsules across all geographies. Since 2008 it has gone through some structural changes to improve profitability by concentrating more on specialties to be sold in the developed markets and products that are in short supply, particularly in the US. Recent deals with leading MNCs such as GSK and Pfizer have vindicated the new focus. Supplies to these deals along with monetisation of the US ANDA pipeline are expected boost margins and improve cash flows. We expect revenues and PAT to grow at a CAGR of 20% and 46% to ₹ 2538 crore and ₹ 261 crore, respectively, in CY10-12E. We are initiating coverage on the stock with a BUY rating.

Specialties division to drive overall growth

We expect the specialty business to grow at a CAGR of 34% to ₹ 1231 crore in CY10-12E driven by limited competition in the generic injectable space, in general, and oncology, in particular, impending patent cliff and likely approval for the new facilities near Bangalore. This will also improve the margins as injectables and oncology, in particular, fetch better margins. We expect the specialty business as percentage of revenues to improve from 39% in CY10 to 49% in CY12E.

Focus on drugs in short supply

SAL has been consciously focusing on niche products that are in short supplies as per the USFDA and various agencies data. We believe this step will expedite the approval process for SAL's products and facilities and will also strengthen the relationship with MNCs. The recent special case approval for anti-bacterial Vancomycin is a classic example for this. So far, SAL has received approvals for 33 ANDAs, of which 13 are from the shortage list.

Valuations

We believe SAL has achieved the required capabilities to push into the high-margin injectables business especially in regulated markets. The focus on niche segments such as oncology augurs well in the long run, particularly when it comes to catering to the requirements of the likes of Pfizer and GSK. We expect the company to improve on its leverage in the coming periods once the MNC deals and the new capacity utilisation run in full flow. We have valued the stock at ₹ 393 based on 9x CY12E EPS of ₹ 43.7.

Exhibit 1: Valuation Metrics

	CY08	CY09	CY10	CY11E	CY12E
Total Revenues (₹ crore)	1,020.3	1,328.3	1,761.1	2,154.9	2,537.8
EBITDA (₹ crore)	69.5	210.5	391.8	450.7	558.3
Net Profit (₹ crore)	108.0	109.7	122.5	181.8	261.4
EPS (₹)	18.0	18.3	20.5	30.4	43.7
P/E (x)	18.5	18.2	16.3	11.0	7.6
Price / Book (x)	4.8	2.4	1.6	1.3	1.2
EV/EBITDA (x)	46.6	16.0	9.4	8.5	5.7
RoCE (%)	1.6	6.3	9.2	9.5	12.4
RoNW (%)	26.0	13.2	9.5	12.3	15.3

Source: Company, ICICIdirect.com Research

RATING MATRIX	
Rating	: Buy
Target	: ₹ 393
Target Period	: 12-15 months
Potential Upside	: 18%

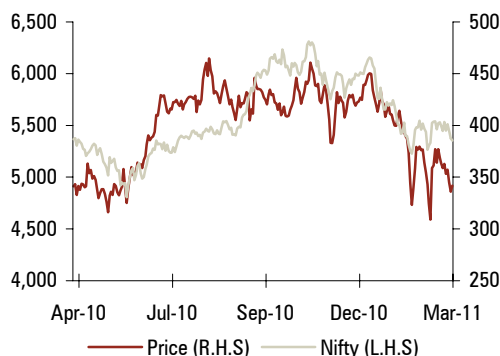
YoY Growth (%)				
(YoY Growth)	CY09	CY10	CY11E	CY12E
Total Revenues	30.2	32.6	22.4	17.8
EBITDA	203.0	86.1	15.0	23.9
Net Profit	1.6	11.7	48.5	43.7
EPS (Rs)	1.6	11.7	48.5	43.7

Current & target multiple				
	CY09	CY10	CY11E	CY12E
P/E	18.2	16.3	11.0	7.6
EV / EBITDA	16.0	9.4	8.5	5.7
P/BV	2.4	1.6	1.3	1.2
Target P/E	21.4	19.2	12.9	9.0
Target EV / EBITDA	17.7	10.3	9.3	6.4
Target P/BV	2.8	1.8	1.6	1.4

Stock Data	
Bloomberg/Reuters Code	STRIN / STAR.NS
Sensex	17,816.3
Average volumes	183,284
Market Cap (₹ crore)	1,993.4
52 week H/L	465 / 309
Equity Capital (₹ crore)	59.9
Promoter's Stake (%)	27.9
FII Holding (%)	32.1
DII Holding (%)	18.0

Comparative return matrix (%)				
Return %	1M	3M	6M	12M
Strides Arcolab	(10.6)	(21.7)	(24.6)	(0.9)
Aurobindo Pharma	(10.0)	(23.7)	(6.4)	7.3

Price movement



Analyst's name

Siddhant Khandekar
 siddhant.khandekar@icicisecurities.com

Krishna Kiran Konduri
 krishna.konduri@icicisecurities.com

Share holding pattern (Q4CY10)

Shareholder	Holding (%)
Promoter	27.9
Institutional Investors	50.1
Other Investors	5.3
General Public	16.7

Company background

Strides Arcolab (SAL) is a mid-sized pharmaceutical company with a strong presence in oral branded generics, sterile products and soft gelatine capsules. It was incorporated in 1990 by first generation entrepreneur Arun Kumar in Bangalore. SAL is among the top five soft gelatine capsule manufacturers and has one of the largest lyophilisation (freeze drying) capacities in the world. The company sells its products across 75 countries through its distribution and sales network, which consists of 732 sales and marketing personnel located in sales offices globally. The total employee count stands at ~3000 people.

The company owns 14 manufacturing facilities across six locations in India, Singapore, Nigeria, Poland, Italy and Brazil. SAL's manufacturing facilities have been approved by several leading regulatory agencies like USFDA, UKMHRA, WHO, Health Canada, MCC South Africa, ANVISA Brazil, HAS Singapore, etc. After the recent restructuring, SAL's business can be broadly classified into pharmaceuticals and speciality business.

SAL manufactures speciality products across various therapies including anti-infective, oncology, analgesic, anti-thrombotic, central nervous system (CNS) and gastroenterology (GI). These products are primarily marketed in advanced countries. Sales from the sterile business accounted for nearly 39% of total sales and 57% of total EBITDA in CY10. It has entered into supply agreements with the leading MNCs such as Pfizer and GSK. SAL recently announced the re-branding of the speciality business under the brand name "Agila Specialties".

The pharma business accounts for nearly 61% of total sales and 43% of total EBITDA in CY10. The business is further divided into branded generics, soft gels and global disease initiative business. These products are marketed in both developed and emerging markets. SAL markets branded generics in Australia, Africa and in the domestic market. The global disease initiative business mainly comprises supplies to various agencies to counter AIDs, TB and Malaria (ATM) in various markets. SAL filed 153 ANDAs (sterile and pharma business) with the USFDA and received approvals for 53 products. Total 115 ANDA filings were in the sterile business and it received approvals for 33. In the branded generic space, it filed more than 300 products registration in Africa, 60 in Australia and 400 in eight South East Asian markets.

Promoter and FI & MFs holding trend (%)

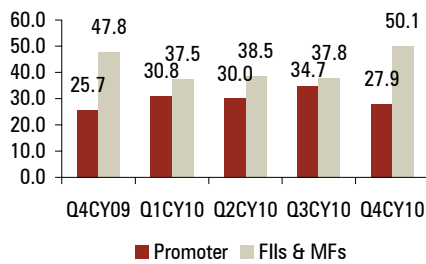
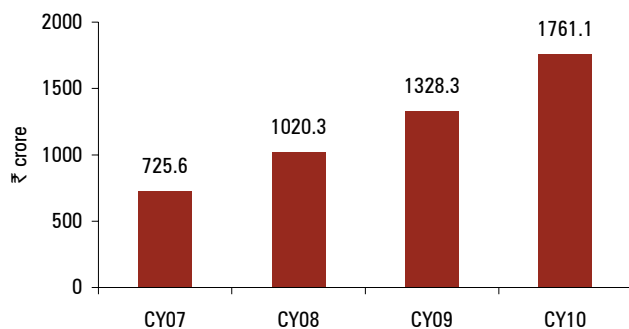
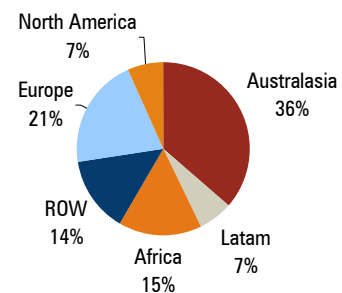


Exhibit 2: Sales grew at CAGR of 34% of in CY07-10



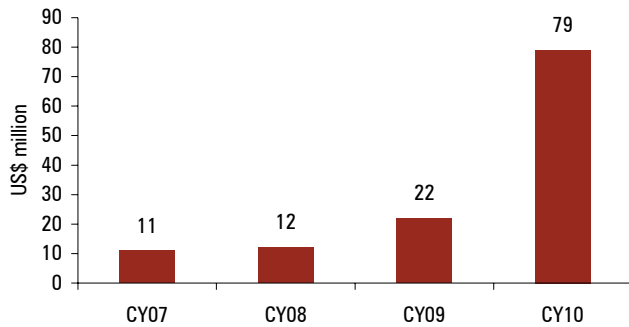
Source: Company, ICICIdirect.com, Research

Exhibit 3: CY10 Geographical break-up



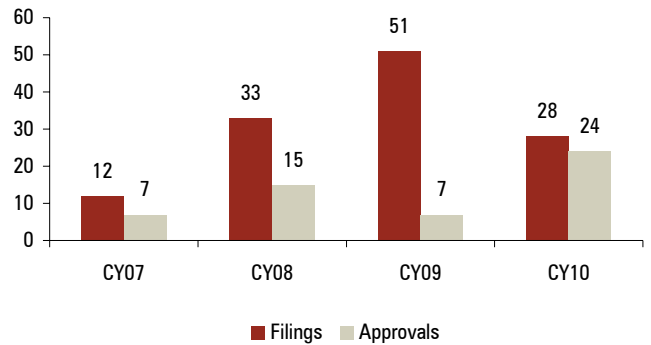
Source: Company, ICICIdirect.com, Research

Exhibit 4: Growing licensing income



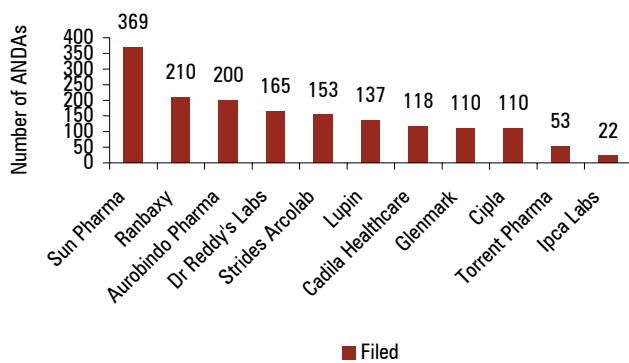
Source: Company, ICICIdirect.com, Research

Exhibit 5: ANDA pipeline



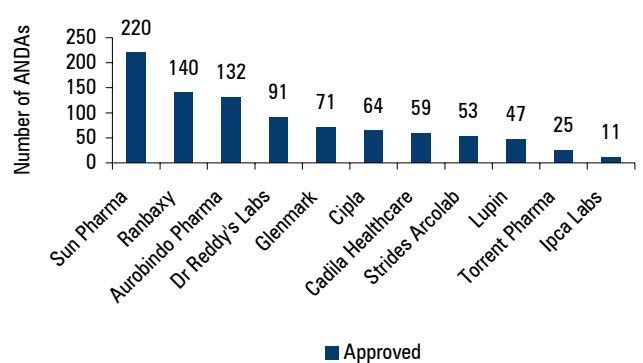
Source: Company, ICICIdirect.com, Research

Exhibit 6: ANDA filed by leading Indian companies



Source: Company, ICICIdirect.com, Research

Exhibit 7: ANDA approvals for Indian companies



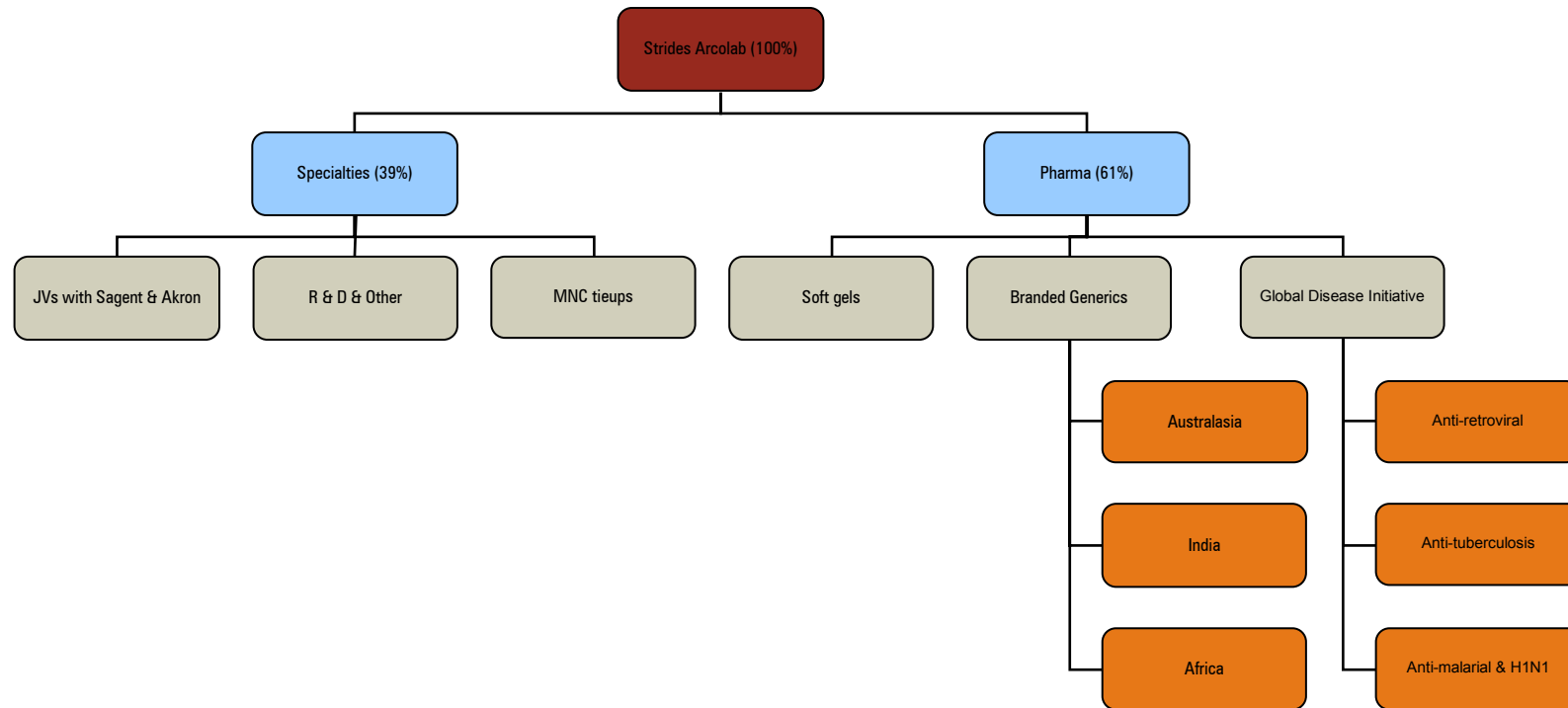
Source: Company, ICICIdirect.com, Research

Exhibit 8: Manufacturing facilities

Manufacturing Facility	Country	Approvals
Pharmaceuticals Business		
Oral Dosage Forms -I	India	UKMHRA, USFDA, TGA Australia, MCC South Africa, ANVISA Brazil, WHO Geneva and ISO 14001
Oral Dosage Forms -II	India	NA
Oral Dosage Forms -III	India	NA
Beltapharm	Italy	EU
Drug House of Australia	Singapore	HAS Singapore
Strides Vital Nigeria	Nigeria	NAFDAC
Specialised Sterile Product Business		
Cephalosporins facility	India	USFDA, TGA Australia, UKMHRA and ANVISA, Brazil
Beta-Lactams facility	India	USFDA, TGA Australia, UKMHRA, MCC South Africa and ANVISA, Brazil
Sterile Products Division-I	India	USFDA, TGA Australia, UKMHRA, Health Canada, WHO Geneva and ANVISA, Brazil
Sterile Products Division-II	India	USFDA, TGA Australia, UKMHRA, NDA Uganda and ANVISA, Brazil
Onco Therapies	India	TGA Australia, UKMHRA and ANVISA, Brazil
Strides Arcolab Polska	Poland	EU
Penems Facility	Brazil	ANVISA Brazil and UKMHRA
Penicillins Facility	Brazil	ANVISA Brazil

Source: Company, ICICIdirect.com Research

Exhibit 9: Business overview

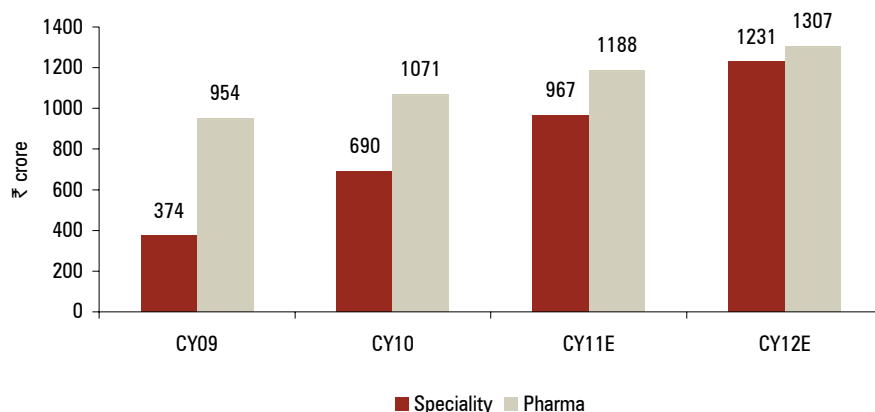


Source: Company, ICICIdirect.com Research

Investment Rationale

We expect total revenues to grow at CAGR of 20% in CY10-12E to ₹ 2538 crore. Revenues will be mainly driven by higher growth in the speciality business. This is on account of incremental ANDA filings for this segment, the Pfizer and GSK deal and also commissioning of new facilities subject to approval. In the pharma space, we expect partial defocus on global disease initiative business. At the same time, we expect good traction from branded generics in countries like Australia.

Exhibit 10: Speciality business to grow faster than pharma business



Source: Company, ICICIdirect.com Research

Speciality Injectables business to be main growth driver

The speciality business of SAL grew ~ 85% in CY10. This was mainly on account of higher licensing income as the company signed a supply agreement with Pfizer. This deal was second of its kind after the GSK deal that was struck in CY08. The supplies for both deals are expected to start in the current year. Overall, we expect the percentage of speciality to total revenue to improve from 39% in CY10 to 49% in CY12E. This business is expected to grow at a CAGR of 34% to ₹ 1231 crore in CY10-12E.

Generic injectable industry to grow at a CAGR of 12%

The size of the global injectable industry is estimated to be ~US\$200 billion (2009 estimates). It is expected to grow at a CAGR of 12% in the next three years. The US and EU together account for almost ~72% of the injectable industry. The generic injectable segment accounts for nearly 10% i.e. US\$20 billion.

With many blockbuster drugs set to lose exclusivity in the next four years, the generic injectable industry is estimated to reach US\$30-33 billion in size by 2015. Injectables are used in specific range of therapy areas i.e. oncology, anti-infectives, cardiovascular, renal, nutrition, etc. Many drugs in biotechnology and oncology are available in injectable forms only. As per IMS, injectable oncology drugs worth US\$9 billion are set to lose exclusivity by 2015, thus opening up huge opportunities for generic players. On bio-similars, advanced markets are yet to prepare regulatory standards that are expected to come out in the near future. This will benefit generic players in general and SAL in particular.

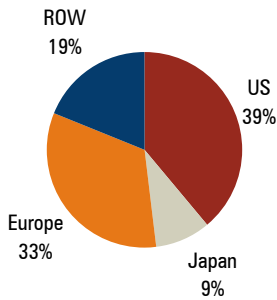
Generic injectables market is worth US\$20 billion

Injectable oncology worth US\$9 billion will go off patent by 2015

Injectables business is capital intensive

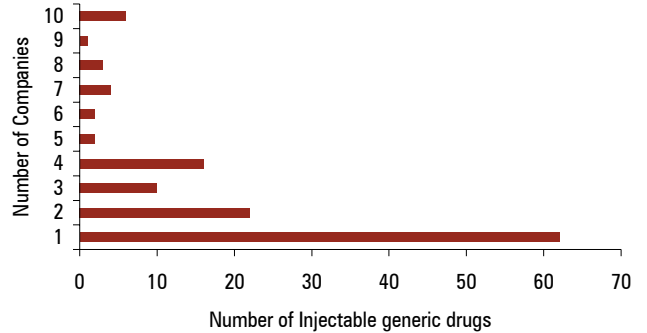
As injectables are not consumed like oral dosages, these are more difficult to formulate and need multiple technologies and delivery platforms. The injectable industry is also capital intensive. Due to these high entry barriers, competition in the injectable industry is normally less compared to oral dosage forms. On account of limited competition, the price erosion in case of generic injectables is limited resulting into higher EBITDA margins when compared to oral generics. More than 50% of generic injectables that have been approved by the USFDA since 2004 have just one or two competitors.

Exhibit 11: Advanced markets have majority share



Source: Company, ICICIdirect.com, Research

Exhibit 12: Injectables to face less competition



Source: Company, ICICIdirect.com, Research

Specialty business is EBITDA accretive

Transforming into specialty player

Till 2008, the focus of SAL was mainly on the pharma business. After assessing various growth options, the company decided to focus on drugs that were in shortage as per various regulatory records from the developed markets. Since a majority of shortage drugs in advanced markets were specialty injectables and there were global constraints for facility approvals for such drugs, this encouraged SAL to move towards specialty injectables. It has increased its installed capacity by ~5x for lyophilisation units and by ~10x for liquid units in the last two years. SAL plans to become one of the leading generic sterile players in the global pharma market. The company manufactures injectables in major therapeutic segments including oncology, anti-infectives and biologics. It develops the products and out-licenses to global players. Sales from the specialty business accounted for 39% of total revenues while at the EBITDA level it accounted for 57% of the total EBITDA. The growth drivers of SAL’s Agila business are as follows-

Focus on drugs shortage in US market

According to data from the American Society Health-System Pharmacists and the USFDA, in 2010 there were about 178 drugs in shortage throughout the US. Of this, 102 drugs were steriles. A similar trend was seen in the last four or five years. SAL has identified the drugs that are in that list with a substantial market size and started developing the same. SAL’s ANDA pipeline is a mix of generic and Para III products. Hitherto, it has filed 113 ANDAs in steriles with the USFDA and received approvals for 33 products. Of these 33, 13 are in the shortage list with a combined market value of ~US\$450 million. In the last two years, SAL has got highest number of ANDA approvals in the sterile space. However, due to capacity constraints, SAL was unable to launch these products.

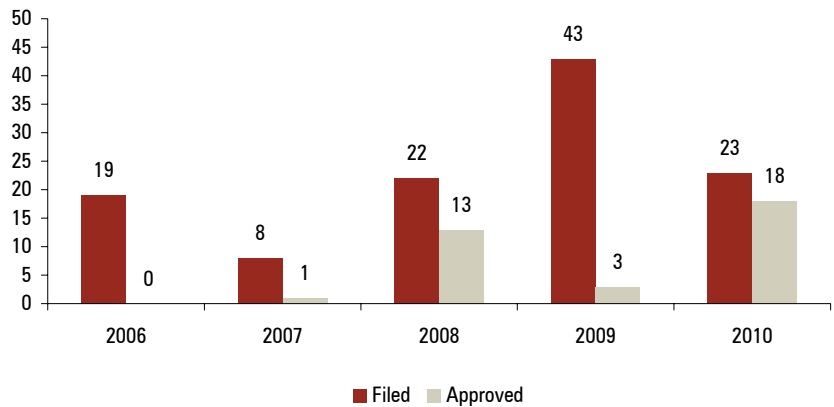
Market size of 13 drugs from the shortage list is US\$450 million

Exhibit 13: Drugs on shortage list for which SAL has received approvals from USFDA

Dexamethasone Sodium Phosphate injection	Ondansetron Hydrochloride Injection
Fosphenytoin Sodium injection	Rifampin Injection
Granisetron Hydrochloride injection	Rocuronium Bromide injection
Ketorolac Tromethamine injection	Torbramycin Sulfate injection
Labetalol Hydrochloride injection	Vancomycin Hydrochloride injection
Mesna Injection	Vecuronium Bromide injection
Midazolam Hydrochloride injection	

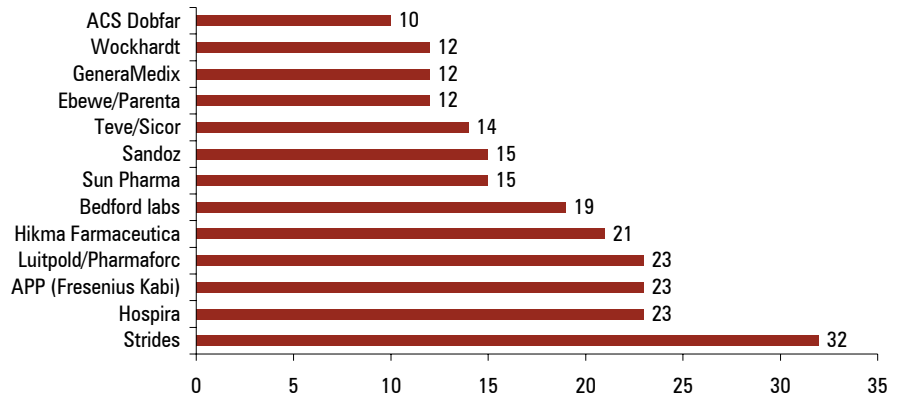
Source: American Society Health-System Pharmacists, USFDA, ICICIdirect.com Research

Exhibit 14: ANDA filings & approvals in sterile division



Source: Company, ICICIdirect.com Research

Exhibit 15: SAL received highest number of ANDA approvals in sterile space in 2008-10



Source: Company, ICICIdirect.com Research

Change in game plan

Till 2008, SAL used to out-license the drug at the initial stage of development only. This used to yield lower licensing income as it was linked with higher risk and lower chances of commercialisation. The company formed two joint ventures with US-based companies Akron Inc and Sagent Pharma in the initial phase. SAL used to get floor price and 50% of equity share.

Earlier, the out-licensing model fetched lower yields

Drugs from Akron JV were sold to Pfizer

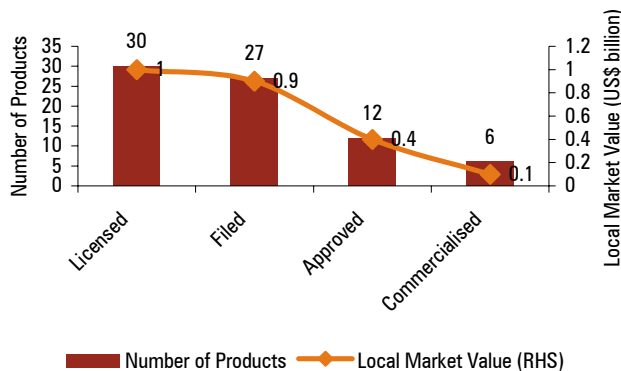
Pre 2008 Scenario

- Used to license drugs in initial stage of development
- Developing products with JV partners
- Targeting drugs, which have average market size of US\$25 million

Akron Strides JV: SAL and Akron set up a 50:50 joint venture 'Akron Strides' in 2004. Under the JV, Strides would develop, manufacture and supply products to Akron while Akron would market these products in the US market. The JV developed 22 generic injectable drugs. It filed ANDAs for all 22 drugs and received approvals for 16. Recently, the JV has sold these products to Pfizer for a consideration of US\$63 million. Of this, Strides received US\$28 million. The transaction is expected to get closed by the end of March 2011. From April 1, 2011 onwards, Strides will be supplying the drugs directly to Pfizer.

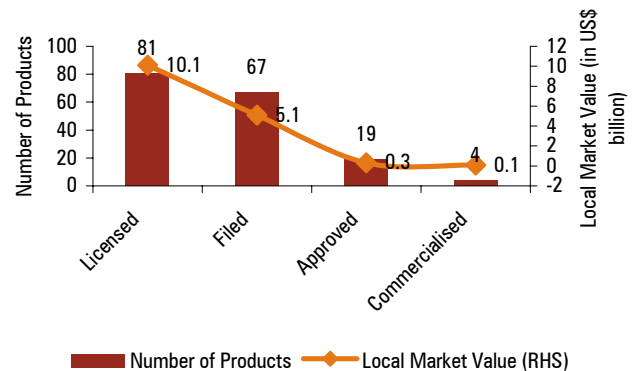
Sagent Strides JV: In 2007, Sagent and Strides entered into a 50:50 JV to develop 30 injectable products. Strides would develop, manufacture and supply products to Sagent while Sagent would market these products in the US market. So far, the JV has filed 27 ANDAs with USFDA, received approvals for 12 products and launched six products. The potential market size of these 30 molecules is around US\$1 billion.

Exhibit 16: Licensing pipeline prior to 2008



Source: Company, ICICIdirect.com, Research

Exhibit 17: Licensing pipeline post 2008



Source: Company, ICICIdirect.com, Research

Changed strategy since 2008 and started out-licensing at last stage of development

Post 2008 Scenario

- Developing own R&D pipeline only
- Out-licensing to leading MNCs
- Targeting drugs that have average market size of US\$150 million

Deal with GSK can be expanded from 10 to 45 oncology injectables

From 2008, the company changed its strategy and started out-licensing at the last stage of the development process. This resulted into higher licensing income as chances of commercialisation would be higher. SAL also changed its strategy in terms of identifying drugs for development. The company used to develop drugs with an average market size of US\$25 million. Since 2008, they started developing drugs with average market size of US\$150 million. The change in strategy has boosted licensing income from US\$6 million in CY06 to US\$79 million in CY10.

SAL signed two major licensing agreements with leading MNCs players like GSK (June 2008) and Pfizer (January 2010). Under these deals, Strides will get floor price, profit sharing and also royalty.

GlaxoSmithKline deal: SAL signed an agreement with GlaxoSmithKline in 2008 to supply 10 oncology injectables through its subsidiary Onco Therapies. The deal can be expanded to 45 products. Under the agreement, SAL will out-license intellectual property and supply finished dosage formulations to GSK while GSK will market these products in 95 emerging markets excluding Saharan Africa and India. SAL will get development cost from GSK in addition to sharing profits for the commercialisation of the products. The first product from this deal is expected to be launched in the first half of the current year.

Deal with Pfizer to cover 45 products, majority from the oncology space

Pfizer deal: In January 2010, SAL signed an agreement with Pfizer to supply 40 off-patented products, majority of them oncology injectables. These products will be marketed in the US by Pfizer. Later in May 2010, Pfizer signed two more agreements with Strides to market these products in the EU, Canada, Australia, New Zealand, Japan and Korea. These agreements will expire on different dates in 2019, 2024 and 2025. Further, for the US market it has extended its product basket to 45 products from earlier 40 products. The first product from this deal is expected to be launched in the first half of the current year. Adding the 22 products sold by Akron Strides JV to Pfizer, the total product basket for Pfizer stands at 67.

Beside Pfizer and GSK, SAL has also out-licensed molecules to other players like Aspen, Sandoz and Teva since 2008. Till date, the company out-licensed around 81 products that have a potential market size of US\$10.1 billion.

Approval for oncology facility to be key trigger

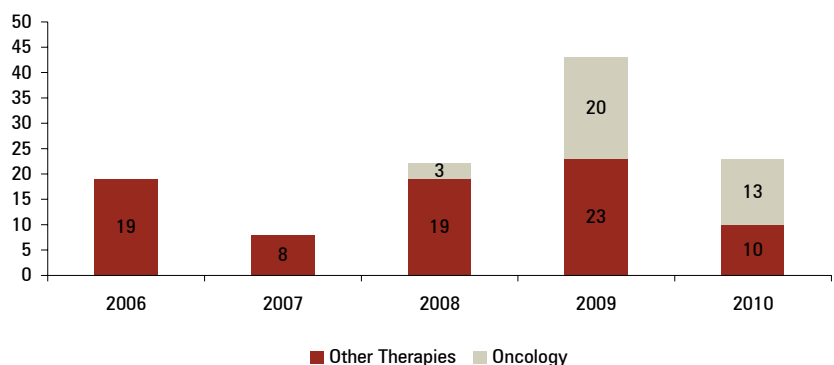
Most drugs used for treatment of cancer are injectables. The gestation period for setting up manufacturing facilities for oncology products, getting approval from regulatory agencies and commercialisation can take nearly seven to eight years, which is longer compared to four or five years for other therapies. As a longer gestation period results into high entry barriers, there are comparatively fewer players operating in this therapy. Thus, in case of oncology, the price erosion post patent is arrested to 50-55% as compared to 90-95% for other therapies.

Oncology products have high entry barriers

In the last fiscal, SAL acquired 100% stake in its two 50:50 JVs Onco Therapies (OTL) and Onco Laboratories (OLL) by paying ~ US\$120 million to JV partner Aspen Inc. OTL has set up a new manufacturing facility for oncology products near Bangalore, which is yet to get approval from the USFDA. We expect the company to get approval for this facility in the current year from USFDA. So far, it has filed ANDAs for 36 oncology products. Of this, 13 products are currently under patent protection. USFDA approval for this facility will be a key trigger, going ahead, as the deal with Pfizer consists of a majority of injectables from this facility.

New oncology facility awaiting USFDA approval

Exhibit 18: ANDA filing break-up between oncology and other therapies



Source: Company, ICICIdirect.com Research

Capacity utilisation for injectables is still less than 20%

USFDA approval status for various manufacturing facilities

	Year
Sterile Product Division I	209
Penicillin	2008
Cephalosporin	2009
Oncology plant	Approval awaited
	Received approval for one product
Sterile Product Division II	

Site Transfer will be triggered by USFDA approval

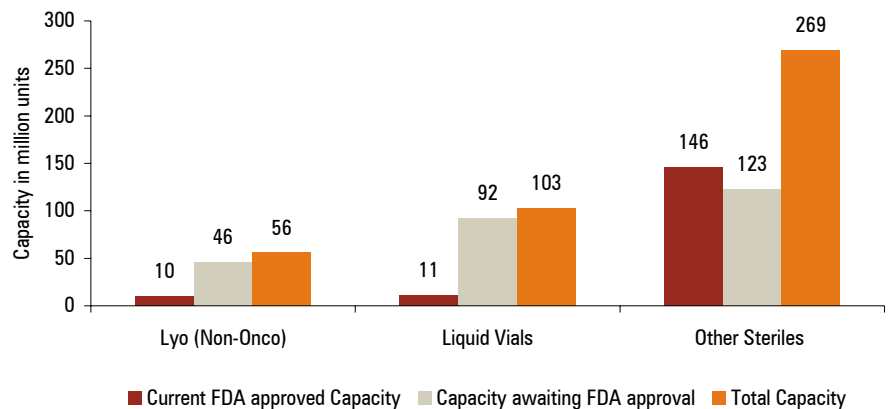
	Sterile Facility	
	Existing	New
USFDA Approval - Plant	Yes	Awaited
USFDA Approval - Products	Yes	Yes
Total Capacity (in Million Units)	64	140
Filings	54	15
Approvals	35	1

Once SPD II get approval SAL will file for site transfers

Huge capacity awaiting USFDA nod

In the last two years, SAL expanded its capacity through greenfield and brownfield expansions by spending nearly ₹ 1300 crore. It set up two manufacturing facilities for oncology and other therapies near Bangalore. Its lyophilised vials (non-oncology) capacity has been expanded by nearly fivefold to 56 million units and liquid vials capacity has been expanded by tenfold to 103 million units. Capacity for other steriles increased from 146 million units to 269 million units. The overall current capacity utilisation of injectables manufacturing facilities is less than 20% as new manufacturing facilities are yet to receive approval from various regulatory authorities. Despite a robust product pipeline, SAL launched only 10 products in the US market due to capacity constraints.

Exhibit 19: USFDA approval for manufacturing facilities to be key trigger



Source: Company, ICICIdirect.com Research

USFDA approval for the sterile product division II (SPD II) facility is also a key development to watch out for. This facility is also awaiting USFDA inspection since May 2010. The company is currently marketing a shortage drug Vancomycin injection in the US market, which is manufactured at SPD I. Due to a shortage in supply of this drug, the USFDA has inspected SPD II and given approval for the facility to manufacture this particular drug only. SAL expects to receive approval for the entire facility in the first half of the current year. Once it gets approval for the entire plant, it will file site transfer for products that have received approvals till date. It would take just 30 days to get approval from the day of filing. The transfer of Vancomycin injection to SPD II will release approximately 70% of installed capacity of SPD I facility. SAL is planning to launch new products in the US market using SPD I capacity.

Entry into biosimilars space

In December 2010, SAL's wholly-owned subsidiary Agila Specialities entered into an agreement with biotech firm Inbiopro Solutions to acquire 70% stake for ₹ 65 crore. The acquisition enables it to access a pipeline of eight products with global sales of over US\$28 billion. Of this, five products are used for treating Cancer. Commercialization of these products is expected to begin in 2013. To start with, SAL is planning to launch these drugs in India, Canada, Asia, UK, Turkey, Indonesia, UK and Brazil.

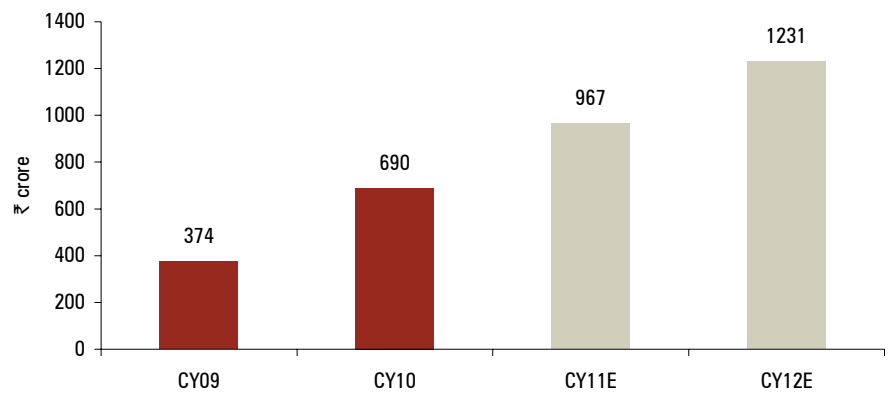
Total 57 products are in an advanced stage of development

Robust product pipeline under development

SAL has identified over 100 drugs that are currently in various stages of development. More than 57 are in advanced stages of development. This can be out-licensed to existing or new customers for marketing in both developing and developed markets. The market size of these 57 products is estimated to be around US\$7 billion. As these products are set to get out-licensed in the last stage of development, SAL will fetch higher licensing income. We expect licensing income to be in the range of US\$50-60 million, going ahead.

With all key drivers in place, we expect the contribution from the speciality segment to go up from 28% in CY09 to 49% in CY12E. Sales from this segment are expected to grow at a CAGR of 34% to ₹ 1231 crore in CY10-12E.

Exhibit 20: Speciality to grow at CAGR of 34% in CY10-12E



Source: Company, ICICIdirect.com Research

Pharma business to support growth

The pharma business comprises nearly 61% of total revenues. It offers a wide range of products across several major therapeutic categories, including antibiotics, TB, anti-bacterials, HIV/AIDS and malaria drugs. SAL’s pharma business is further divided into branded generics, soft gels and global disease initiative business. Although the pharma business constitutes almost 61% of sales, its contribution to EBITDA remains at 43%. The normal EBITDA margins for pharma are in the range of 13-16%. We expect pharma to grow at a CAGR of 10% driven by Australasian and African businesses. This segment will not be the growth engine for the company but will generate steady cash flows on account of some strategic changes.

Branded generics

The company markets branded generics in Australasia, Africa and domestic market. The branded generic business contributed ~US\$170 million (₹ 765 crore) to the topline in CY10.

In the Australasia market, it operates through subsidiary Ascent Pharmahealth, a leading pharmaceutical generic and consumer health company listed on the Australian stock exchange. This group caters to the Asia Pacific region. Ascent owns a manufacturing facility in Jurong, Singapore. Ascent sells over 400 drugs encompassing generic pharmaceuticals, OTC and skincare products, products with well established consumer brands and organic skincare products in eight countries. More than 60 generic products are registered in Australia.

The pharma business will grow at a CAGR of 10% in CY10-12E

Sales of Ascent grew by 44% YoY in CY10

Ascent recently signed an agreement with Pfizer to sell off-patented products in Australia. In terms of market share, Ascent is the fifth largest player in Australia and largest player in Singapore. Strides plans to de-list Ascent by increasing its stake from 60.3% to 94%, by April 2011. The Australasia business grew 44% YoY to ₹ 576 crore in CY10.

The Asia Pacific pharma industry will grow 13% YoY

Charting a solid ~13% CAGR throughout 2009-2012, the Asia Pacific pharmaceutical market is looking at the next wave in evolution. Long-term usage of multiple and specialised drugs, an ever increasing aging population, shorter life expectancy, early chronic disease diagnosis and major drug patent expiries are key contributing factors leading governments to favour production and prescription of generics. The Asia Pacific region has the potential to account for ~28% of the total global pharmaceutical market and generate \$260 billion revenue by the end of 2012, according to market research firm Frost & Sullivan.

Australian generic market have high entry barrier

While other countries in Asia Pacific focus on growing its generics manufacturing capabilities, Australia's high entry cost and stringent regulations discourage new players from entering the market with the intention of mass volume generics production. However, Australia presents a lucrative market for the marketing and distribution of new generic drugs for the established players as the government looks to generics as a form of cost reduction and opportunities open up as patents expire.

SAL is a leading player in the West and French African region with a good presence via manufacturing and marketing. The African business is being catered to by one dedicated facility in Lagos, Nigeria and two facilities in India. Over 300 products are registered across African markets. The product range encompasses branded generics, commodity generics and OTC products through a dedicated sales team and through partnership with local distributors.

African business grew by 50% YoY in CY10

The West African market is the largest block in the African contingent covering one-third of the overall population. The market offers good potential as it is a blend of poor sub-Saharan countries as well oil rich countries such as Nigeria. This region is growing at 8-10% annually. The Africa business grew by 50% YoY to ₹ 135 crore YoY.

In the domestic market, it sells products through two divisions- Grandix and Ray of Life. The drugs in diabetes, cardiovascular, neurology and female healthcare are being marketed under the Grandix brand. Strides acquired Grandix Pharma in 2007 for ₹ 48 crore.

Indian business de-grew on account of inventory clean up

Ray Of life is an initiative of Strides (launched in December 2009) to focus on the emerging unmet need for quality critical care in India with specialised hospital products leveraging Strides' large portfolio in its specialty division. Drugs in oncology, nephrology and high-end anti-biologics are being marketed under the Ray of Life brand. In CY10, the Indian business de-grew 19% to ₹ 59 crore. De-growth was attributable to inventory pipeline clean-up and defocus on certain non-profitable areas.

Global disease initiatives

SAL is a major player in the field of global tenders for disease initiatives. Strides supplies drugs in the anti-retroviral, tuberculosis and malaria (ATM) segment to global procurement agencies such as UNICTAID, PEPFAR (US President's Emergency plan for AIDS Relief) and Clinton Foundation. Its oral dosage facility at Bangalore is pre-qualified by WHO for anti-retrovirals (ARVs) and anti-tuberculosis and by the USFDA for ARVs under the PEPFAR programme.

SAL will be selective for global tenders

SAL has received approval for 16 ANDAs under the PEPFAR programme. SAL was the only player other than Innovator to receive license from the Indian government to manufacture Starflu-Oseltamivir to control the swine flu outbreak in 2009. Most of these initiatives are tender based and, hence, not commercially viable. The company is not a fully integrated API to formulation player and has limited competitive advantage. Hence, going forward, we see some kind of de-focus in these areas as the company will look at maintaining overall profitability.

Soft gels

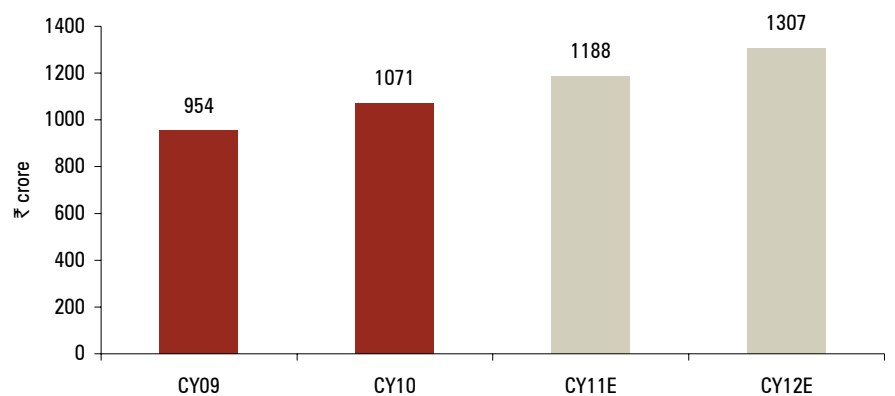
SAL is a leading soft gel manufacture

SAL owns one of the largest soft gel capacities in the world with five dedicated lines in the oral drug facility in Bangalore. Its produces are a range of soft gel products from neutraceuticals to generics, specialty OTCs and immuno-suppressants. SAL is among the few soft gel manufacturers focusing on the prescription drug domain.

SAL obtained its first FDA approval for a soft gel product Ergocalciferol in August 2010. Ergocalciferol is a synthetic calcium regulator for oral administration and it is prescribed for treatment of hypoparathyroidism and hypophosphatemia. According to IMS data, the total US market for Ergocalciferol soft gel capsules was approximately US\$62.9 million in 2009, a growth of 72% over 2008 sales. The product is marketed and sold by Paddock Laboratories under a profit share partnership.

We expect the pharma business to be a steady revenue generator with stable and visible cash flows. We also expect this segment to go through certain structural changes such as gradual de-focus on the ATM segment, ramp up in branded generics segment of Australasia and Africa and a combination of ramp up and defocus in India. We expect sales from the pharma segment to grow at a CAGR of 10% to ₹ 1307 crore in CY10-12E. At the same time, on account of a planned defocus on certain sub segments, the percentage of the pharma segment will come down to 51% by CY12E from 61% in CY10.

Exhibit 21: Pharma business to grow at CAGR of 10% in CY10-12E



Source: Company, ICICIdirect.com Research

Raised ₹ 455 crore through QIP for retiring high cost debt and consideration for Brazil JV buy out

Debt

Redemption of FCCBs due in June 2012

The debts have gone up from ₹ 1300 crore in CY08 to ₹ 2010 crore in CY10 to fund expansion plans, acquisition of the Brazilian business and for acquisition of the remaining 50% stake in the Oncology JV from Aspen. As debt is ballooning, the company recently raised ₹ 455 crore via issue of share under qualified institutional placement (QIP). It issued ~1.07 crore shares at ₹ 423.55 per share. The current debt to equity is at 1.6x. We expect it to come down to 1.0x by CY12E. On the other hand, we expect sales from specialities to grow at a faster pace compared to pharma that will improve the EBITDA, going ahead. We expect the debt to EBITDA to come down from 5.1x in CY10 to 3.1x in CY12E.

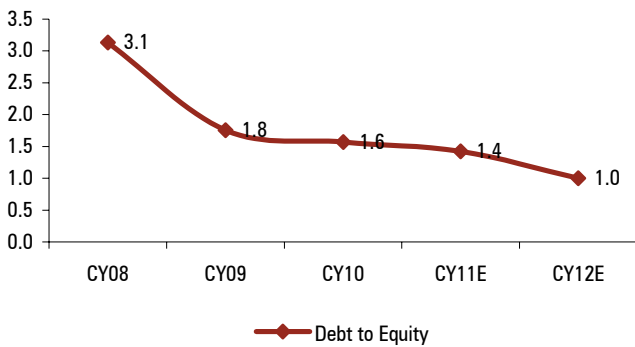
Exhibit 22: FCCB position

FCCBs	Conversion Price	FCCBs Out standing	Fx Rate 1\$=₹	Underlying Shares Out standing	Coupon Rate on Redemption
US\$ 100 million	₹ 461	US\$ 80 million	40.7	7.06 million	45.06%

Source: Company, ICICIdirect.com Research

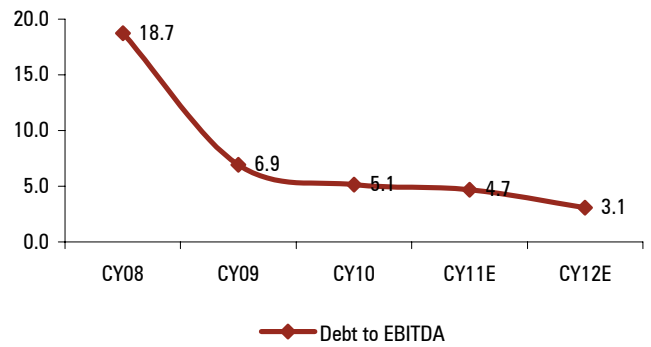
SAL raised FCCB debt of US\$100 million in 2007 to fund its expansion plans. As the RBI permitted buy back of FCCBs in CY09, it has bought back FCCBs worth US\$20 million. The company has provided YTM till date. Taking into account the 45% premium on redemption of US\$80 million FCCBs with conversion price of ₹ 461, we have factored in the redemption scenario for our CY12 estimates.

Exhibit 23: Debt / equity ratio to improve by CY12E



Source: Company, ICICIdirect.com, Research

Exhibit 24: Debt / EBITDA ratio to improve by CY12E



Source: Company, ICICIdirect.com, Research

Larger goodwill on books

Strides has goodwill of ₹ 1476 crore on its books, which is higher than its total shareholder funds and accounts for 41% of total assets. This is on account of consolidation of its Australian subsidiary Ascent Pharmahealth and buyout of Oncology JVs.

Risk & concerns

Regulatory approval delay for product, facilities may result in lower sales

A significant portion of SAL's sales are expected to be driven by new product launches in the international markets. Any unanticipated delays in receiving necessary approvals could alter our future estimates. The company is awaiting USFDA inspection for oncology and SPD II facilities since May 2010. A delay in approval from the USFDA would delay the potential sales.

Any changes in deal structure may alter future estimates

SAL is the only back-end player and marketing will be done by its partners like Pfizer, GSK and Aspen. A change in any of these deal structures could significantly alter the financial estimates.

Not vertically integrated

SAL imports a major part of its APIs requirement as it does not have API manufacturing capacities. Any unavailability of raw materials and sharp increase in prices could hurt EBITDA margins.

Significant topline exposure to exchange rate fluctuations

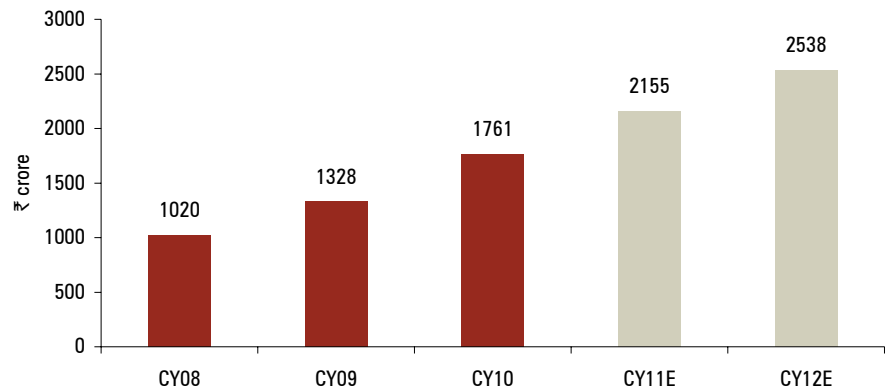
The international business accounted for ~95% of total revenues in CY10. Any sharp currency fluctuations in either of the geographies will hamper the profitability.

Financials

Sales to grow at 20% CAGR in CY10-12E

We expect total revenues to grow at a CAGR of 20% to ₹ 2538 crore in CY10-12E. The growth would be driven by healthy growth in the speciality business, which is expected to grow at a CAGR of 34% to ₹ 1231 crore in CY10-12E. Topline growth will also be complemented by steady growth in the pharma business (CAGR of 10% to ₹ 1307 crore).

Exhibit 25: Sales growth to be driven by speciality business

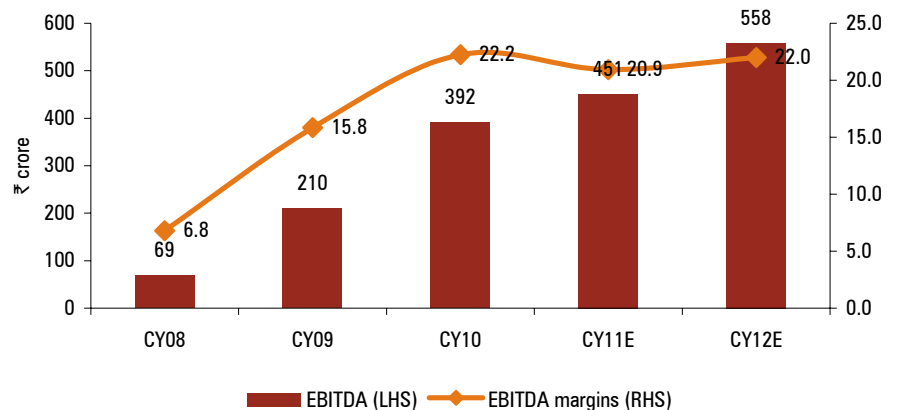


Source: Company, ICICIdirect.com Research

EBITDA margins to be range bound

In CY10, the EBITDA margins were higher by 22.2% compared to 15.8% in CY09 due to higher licensing income of ~US\$80million. However, we expect licensing income to settle down to US\$50-60 million. EBITDA margins are expected to be range bound at 20-22% in CY10-12E. We project EBITDA will grow at a CAGR of 19.4% to ₹ 558 crore.

Exhibit 26: EBITDA margins to stabilise at 20-22% range

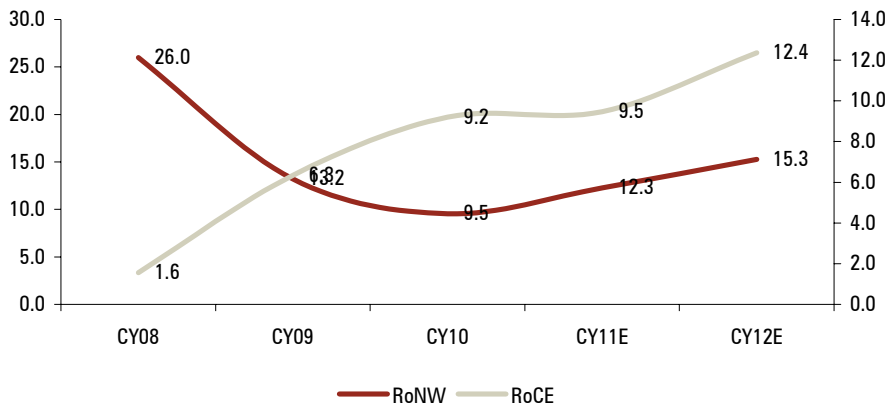


Source: Company, ICICIdirect.com Research

Return ratios to improve, going ahead

We expect the capacity utilisation of the company to improve significantly once it gets USFDA approval for the new facility. This will improve the return ratios, going ahead. We expect RoCE to improve by 320 bps in CY10-12E to 12.4%.

Exhibit 27: Return ratios to improve further on account higher capacity utilisations



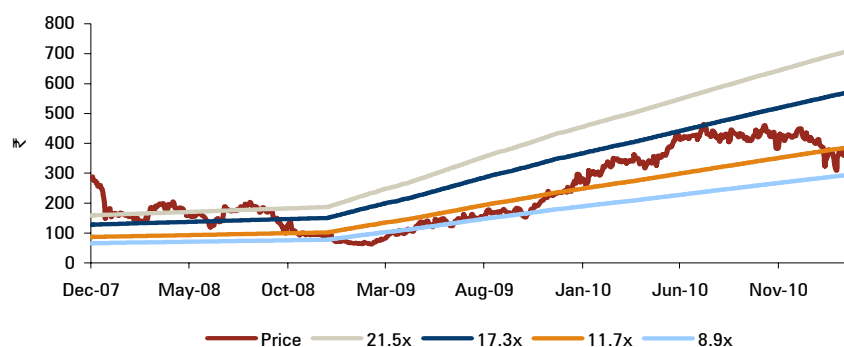
Source: Company, ICICIdirect.com Research

Valuation

The shift of focus from the low margin pharma business to the high margin specialty business will improve the overall profitability and operating cash flows. Supplies to Pfizer and GSK are expected to get kick started in the current year. This will provide further boost to the specialty business. In the pharma space also, we see gradual defocus on the ATM business and good traction from Australasia and Africa and India.

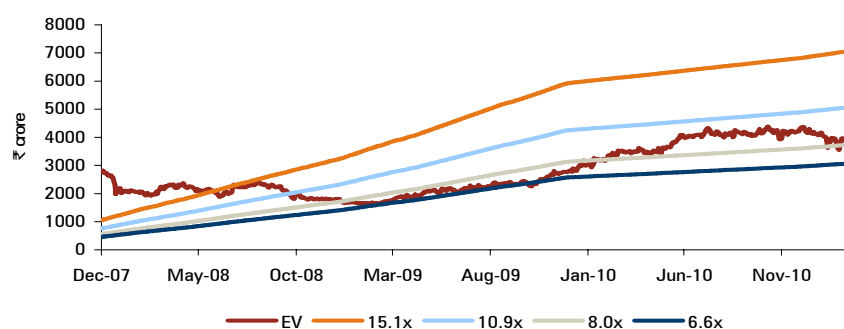
SAL is currently trading at ~11x CY11E EPS of ₹ 30.4 and ~8x CY12E EPS of ₹ 43.7. We believe SAL has achieved the required capabilities to push into the high-margin injectables business especially in regulated markets. The focus on niche segments such as oncology augurs well in the long run particularly when it comes to catering to the requirements of the likes of Pfizer and GSK. We expect a drastic improvement in the leverage situation in the coming periods once the MNC deals and new capacity utilisation runs into full flow. We have valued the stock at ₹ 393 based on 9x CY12E EPS of ₹ 43.7.

Exhibit 28: P/E band chart (1 year forward)



Source: Company, ICICIdirect.com Research

Exhibit 29: EV/EBITDA band chart (1 year forward)



Source: Company, ICICIdirect.com Research

Exhibit 30: Peer valuation

(CY12/FY13)

	M Cap (₹ cr)	EV/Sales	EV/EBITDA	P/BV	Base PE	RoCE	RoNW
Strides Arcolab	1993.4	1.3	5.7	1.2	10	12.4	15.3
Aurobindo Pharma	5443.2	1.3	5.3	1.6	9	21.6	24.1

Source: Company, ICICIdirect.com Research

Exhibit 31: Profit & loss account

(₹crore)	CY08	CY09	CY10	CY11E	CY12E
Total Revenues	1,020.3	1,328.3	1,761.1	2,154.9	2,537.8
Growth (%)	40.6	30.2	32.6	22.4	17.8
Total Operating Expenditure	950.9	1,117.8	1,369.2	1,704.2	1,979.5
EBITDA	69.5	210.5	391.8	450.7	558.3
Growth (%)	NA	203.0	86.1	15.0	23.9
Depreciation	39.9	49.2	63.9	83.9	100.6
Interest	84.7	75.9	146.6	134.7	118.1
Other Income	106.5	0.0	4.5	4.0	4.0
PBT before Exceptional Items	51.3	85.4	185.8	236.1	343.7
Less: Exceptional Items	(63.5)	(57.5)	(0.6)	-	-
PBT	114.9	142.9	186.4	236.1	343.7
Growth (%)	NA	24.4	30.4	26.7	45.6
Total Tax	10.8	21.9	45.2	49.6	75.6
PAT before MI	104.1	121.0	141.2	186.5	268.1
Minority Interest	(3.9)	11.4	18.7	4.7	6.7
PAT	108.0	109.7	122.5	181.8	261.4
Adjusted PAT	44.4	52.2	121.9	181.8	261.4
Growth (%)	7,520	17.4	133.7	49.2	43.7
EPS	18.0	18.3	20.5	30.4	43.7
EPS (Adjusted)	7.4	8.7	20.4	30.4	43.7

Source: Company, ICICIdirect.com Research

Exhibit 32: Balance Sheet

(₹crore)	CY08	CY09	CY10E	CY11E	CY12E
Equity Capital	40	40	58	60	60
Preference Capital	49	49	-	-	-
ESOP	2	3	2	-	-
Amount pending allotment	-	14	-	-	-
Reserve and Surplus	324	724	1,223	1,424	1,650
Total Shareholders funds	415	831	1,283	1,484	1,710
Total Debt	1,302	1,457	2,010	2,110	1,710
Deferred Tax Liability	9	3	3	3	3
Minority Interest	180	259	272	277	284
Source of Funds	1,906	2,550	3,568	3,874	3,707
Total Gross Block	599	1,071	1,321	1,851	1,951
Less: Acc. Depreciation	220	224	288	372	472
Net Block	379	847	1,033	1,479	1,479
Capital WIP	260	85	11	11	11
Net Fixed Assets	639	932	1,044	1,490	1,490
Goodwill on Consolidation	591	1,009	1,476	1,476	1,476
Other Investments	346	341	-	-	-
Inventory	173	233	312	615	480
Cash	57	91	339	289	513
Debtors	338	416	384	637	753
Loans and Advances	126	175	886	375	225
Total Current Assets	747	946	1,962	2,002	2,035
Creditors	360	506	725	869	1,026
Provisions	61	174	199	235	277
Total Current Liabilities	421	680	924	1,104	1,304
Net Current Assets	326	266	1,038	898	731
Deferred Tax Assets	4	1	-	-	-
Application of Funds	1,906	2,550	3,568	3,874	3,707

Source: Company, ICICIdirect.com Research

Exhibit 33: Cash flow statement

	CY08	CY09	CY10	CY11E	CY12E
Profit after Tax	108	110	122	182	261
Depreciation	40	49	64	84	101
(inc)/dec in Current Assets	-147	-164	-768	-90	191
inc/(dec) in current Liabilities	-31	259	244	180	200
CF from operations	-30	254	-338	356	753
Other Investments	-344	5	341	0	0
Goodwill on Consolidation	-38	-419	-466	0	0
(Purchase)/Sale of Fixed Assets	64	-343	-176	-530	-100
Deferred Tax Liability	-2	-5	0	0	0
CF from investing Activities	-160	-680	-296	-525	-93
Inc / (Dec) in Equity Capital	5	0	18	2	0
Inc / (Dec) in Preference Capital	0	0	-49	0	0
Inc / (Dec) in sec.loan Funds	76	213	296	-100	-200
Inc / (Dec) in unsec.loan Funds	-51	-58	257	200	-200
Dividend & Dividend tax	0	-17	-23	-21	-35
Inc / (Dec) in Sec.Premium Acc	204	-33	400	40	0
CF from Financial Activities	55	461	882	119	-435
Cash generating during the year	-135	34	248	-50	225
Opening cash balance	192	57	91	339	289
Closing cash	57	91	339	289	513

Source: Company, ICICIdirect.com Research

Exhibit 34: DuPont analysis

	CY08	CY09	CY10	CY11E	CY12E
PAT/PBT	94.0	76.7	65.7	77.0	76.1
PBT/EBIT	388.6	88.6	56.8	64.4	75.1
EBIT/Sales	2.9	12.4	19.3	17.3	18.3
Sales/Asset	53.5	51.2	47.5	54.6	67.4
Asset/Equity	458.9	306.8	278.1	261.1	216.8
ROE	26.0	13.2	9.5	12.3	15.3

Source: Company, ICICIdirect.com Research

Exhibit 35: Free Cash Flow

	CY08	CY09	CY10	CY11E	CY12E
Net Profit	108.0	109.7	122.5	181.8	261.4
Depreication	39.9	49.2	63.9	83.9	100.6
Change in the working capital	(178.1)	94.6	(524.1)	90.1	390.9
Capex	64.4	(342.5)	(176.3)	(530.0)	(100.0)
Total	34.1	(89.0)	(514.1)	(174.1)	652.8

Source: Company, ICICIdirect.com Research

Exhibit 36: Key ratios

	CY08	CY09	CY10	CY11E	CY12E
Per Share Data					
					(₹)
EPS	18.0	18.3	20.5	30.4	43.7
EPS (Adjusted)	7.4	8.7	20.4	30.4	43.7
Cash EPS	24.7	26.5	31.1	44.4	60.5
BV	69.4	138.8	214.3	247.9	285.7
Operating profit per share	11.6	35.2	65.5	75.3	93.3
Operating Ratios					
					(%)
EBITDA/Total Revenues	6.8	15.8	22.2	20.9	22.0
PBT/Total Revenues	11.3	10.8	10.6	11.0	13.5
PAT/ Total Revenues	10.6	8.3	7.0	8.4	10.3
Return Ratios					
					(%)
RoNW	26.0	13.2	9.5	12.3	15.3
RoCE	1.6	6.3	9.2	9.5	12.4
RoIC	2.1	9.4	14.3	13.8	20.9
	CY08	CY09	CY10	CY11E	CY12E
Valuation Ratios					
					(x times)
P/E	18.5	18.2	16.3	11.0	7.6
P/E (Adjusted)	44.9	38.2	16.4	11.0	7.6
EV / EBITDA	46.6	16.0	9.4	8.5	5.7
Price to Book Value	4.8	2.4	1.6	1.3	1.2
EV/Total Revenues	3.2	2.5	2.1	1.8	1.3
M Cap/Total Revenues	2.3	1.8	1.3	1.1	0.9
Total Revenues/ Equity	2.5	1.6	1.4	1.5	1.5
Turnover Ratios					
					(x times)
Inventory Turnover	5.5	6.4	6.2	4.6	4.6
Debtors Turnover Ratio	3.0	3.1	4.4	3.3	3.3
Creditors Turnover Ratio	2.8	2.6	2.3	2.4	2.4
Fixed Asset Turnover ratio	2.7	1.6	1.7	1.5	1.7
Solvency Ratios					
					(x times)
Debt / Equity	3.1	1.8	1.6	1.4	1.0
Current Ratio	1.8	1.4	2.1	1.8	1.6
Quick Ratio	1.6	1.3	1.8	1.6	1.2
Debt / EBITDA	18.7	6.9	5.1	4.7	3.1

Source: Company, ICICIdirect.com Research

Glossary

Oncology- Anti-Cancer therapy

Anti-thrombotic- It is a blood thinner drug used in surgeries.

Immunosuppressant- This drug performs immunosuppression of the immune system and used in organ transplant surgeries in particular.

Analgesic- This drug is used for pain management

Hyperparathyroidism- It is an over activity of the parathyroid glands resulting in excess production of parathyroid hormone (PTH). The parathyroid hormone regulates calcium and phosphate levels and helps to maintain these levels.

Hypophosphatemia- It is an electrolyte disturbance in which there is an abnormally low level of phosphate in the blood. The condition has many causes but is most commonly seen when malnourished patients (especially chronic alcoholics) are given large amounts of carbohydrates, which creates a high phosphorus demand by cells, removing phosphate from the blood

Bio-similars- Biosimilars or follow-on biologics are terms used to describe officially-approved subsequent versions of innovator biopharmaceutical products made by a different sponsor following patent and exclusivity expiry on the innovator product. Unlike the more common small-molecule drugs, biologics generally exhibit high molecular complexity and may be quite sensitive to manufacturing process changes.

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 Buy: Between 10% and 20%;
 Add: Up to 10%;
 Reduce: Up to -10%
 Sell: -10% or more;

Pankaj Pandey

Head – Research

pankaj.pandey@icicisecurities.com

**ICICIdirect.com Research Desk,
 ICICI Securities Limited,
 7th Floor, Akruiti Centre Point,
 MIDC Main Road, Marol Naka,
 Andheri (East)
 Mumbai – 400 093**

research@icicidirect.com

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