IDFC | INSTITUTIONAL SECURITIES
India Research

Strides Arcolab

Rs423

Pharmaceuticals

Taking big strides

Mkt Cap: Rs19.6bn; US$436m

Reason for report: Initiating Coverage | **OUTPERFORMER**

Strides Arcolab (Strides) has superb capabilities in the niche steriles (injectables) space – reflected in its ability to garner ~US$100m upfront licensing income from Big Pharma. With 98 sterile ANDAs already filed, 80 new filings planned over CY10-11 and only three ANDAs commercialized due to capacity constraints, Strides is at the tipping point of its growth trajectory as it gets USFDA approval for the new steriles facilities. However, the Rs10.7bn cash outflow over CY10-11 will strain an already stretched balance sheet (net gearing of 1.3x as of CY09; Rs10bn of goodwill against net worth of Rs8bn) in the near term and will require $75m-100m of fund raise. We expect 42% earnings CAGR for Strides over CY09-11 led by licensing income gains, which will help maintain net gearing at manageable levels. While the leveraged balance sheet and relatively limited execution track record pose risks, we believe increasing visibility on the potential of steriles franchise and possible value unlocking in non-steriles business will lead to a re-rating of the stock. Initiating coverage with Outperformer and a 12-month price target of Rs586.

Ready to take off: With a posse of ANDAs filings across oncology, penems, cephalosporins, ophthalmology, peptides, ophthalmology, etc already done/ in process as well as partnered out to global majors like Pfizer and GSK, Strides has laid the foundation for an enviable global injectables franchise. Strides has capabilities in place for producing seven injectable forms. With ~10x capacity likely to be opertionalized soon, we expect Strides' sterile business to grow 3.25x over CY09-11. Non-steriles business will see 9% CAGR over the period.

Margin expansion ahead: Sharp revenue pick-up in the fixed cost-intensive injectables segment as well as focus on profitability improvement in non-steriles would drive a 570bp expansion in base EBITDA to 12.3% in CY11E. Further, with Rs2.5bn per year of licensing income over CY10-11E, overall margins are expected to expand by 750bp to 21.8% in CY11. We estimate Strides to generate ~Rs9bn of operating profit over CY10-11.

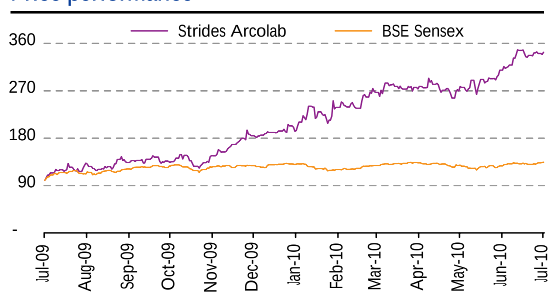
Balance sheet concerns unlikely to trump medium-term story: An investment of >Rs8bn in building world-class injectable units despite a limited earnings base has stretched Strides' balance sheet. However, capex is largely behind and steriles business is set to generate significant value with FDA approval for large units leading to a flurry of product launches. While funding the recent big buyouts ($192m cash outflow over CY10-11) is a challenge, we expect the stock to gradually re-rate as earnings traction starts becoming visible.

Key valuation metrics

Year to 31 March	CY07	CY08	CY09	CY10E	CY11E
Net sales (Rs m)	7,443	10,203	13,047	18,435	23,008
Adj. net profit (Rs m)	(365)	226	983	1,604	2,203
Shares in issue (m)*	35	40	40	46	46
Adj. EPS (Rs)	(10.4)	5.7	24.4	34.6	47.5
% growth	*(190.6)*	*(154.2)*	*332.1*	*41.5*	*37.3*
PE (x)	n/a	74.8	17.3	12.2	8.9
Price/ Book (x)	5.1	2.8	1.6	1.6	1.4
EV/ EBITDA (x)	(115.2)	44.8	17.8	10.6	9.0
RoE (%)	(10.1)	5.1	11.7	13.9	16.7
RoCE (%)	(4.4)	1.6	5.9	10.0	10.9

** Assuming warrant conversion*

Price performance



Bloomberg: STR IN	**6m avg daily vol. (m): 0.67**
1-yr High/ Low (Rs): 439/98	**Free Float (%): 69.2**

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Content

INVESTMENT ARGUMENT

- **With a strategy of singularly focusing on becoming a leading player in the niche steriles arena, Strides is a unique model in Indian pharma industry**
- **Strides is approaching tipping point of its growth trajectory with capacities set to grow 10x; a large pipeline of filings also poised to receive approval**
- **Record ANDA filings in CY09; Strides guides for a 200+ impressive ANDA portfolio by CY11**
- **With its attractive product portfolio, Strides a partner of choice for global pharma players like Pfizer, GSK, Aspen, etc; licensing income from these partnerships to boost profitability going forward**
- **Post restructuring, investors can easily track Strides' different business units; management has flexibility on capital-raising in business units**

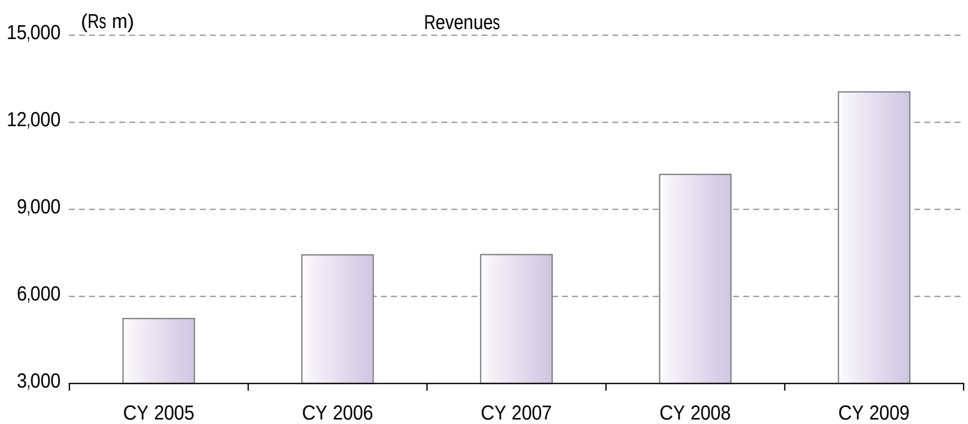
Strides Arcolab: A promising business model

Strides, established in 1990, has shown 26% revenue CAGR over the last four years, to Rs13bn in CY09. Strides is headed by Mr Arun Kumar, a first generation entrepreneur, supported by an experienced management team based out of Bangalore. Over the years, Strides has aggressively invested in building capacities – as reflected in 3x growth in gross block over CY05-09. As a result, Strides has a significantly strained balance sheet with net debt of US$303m and net gearing of ~1.3x as on 31 December 2009.

However, most of the large-ticket capex is behind, and significant new capacities (~10x increase; expected to be USFDA approved in 2010) are on the anvil with a large pipeline of regulatory filings poised for approval in key markets. In this backdrop, we believe Strides is now approaching a tipping point in its growth trajectory.

Strides has manufacturing footprint across 14 sites globally and marketing presence across 75 countries

Exhibit 1: Strides revenues have registered a CAGR of 26% over the last four years



Source: Company

Strides has a global manufacturing footprint with operations across 14 sites in Asia, Latin America and Europe, and marketing presence across 75 countries. The company has undergone 15 successful inspections by USFDA/ EMEA/ PIC over the last 12 months including a recent inspection of the sterile site.

Strides' attractive product portfolio has made it a partner of choice for global pharma players

❑ Focus on niche product development and manufacturing

Since inception, Strides has had a clear focus on niche segments – as reflected in its decision to build soft gel capabilities in the orals space during the initial phase, followed by injectables (steriles) in the later phase of growth. Unlike most other peers, Strides does not have API integration and instead relies on its expertise of complex formulation delivery technologies to create competitive advantage across products. Typically, Strides focuses on formulations where API costs are less than 30% of the overall formulation cost – and which significantly reduces the importance of API backward integration.

Barring its limited presence in the branded formulations space in Australia, South East Asia, India and Africa, Strides has remained focused largely on product development and manufacturing of niche drugs while entering into marketing tie-ups across geographies. Strides' attractive product portfolio has made it a partner of choice for global pharma players like Pfizer, GSK, Aspen, etc. Licensing income from these partnerships has enabled Strides to bankroll its R&D expenditure in the past years, thereby enabling it to invest aggressively in building its future product pipeline.

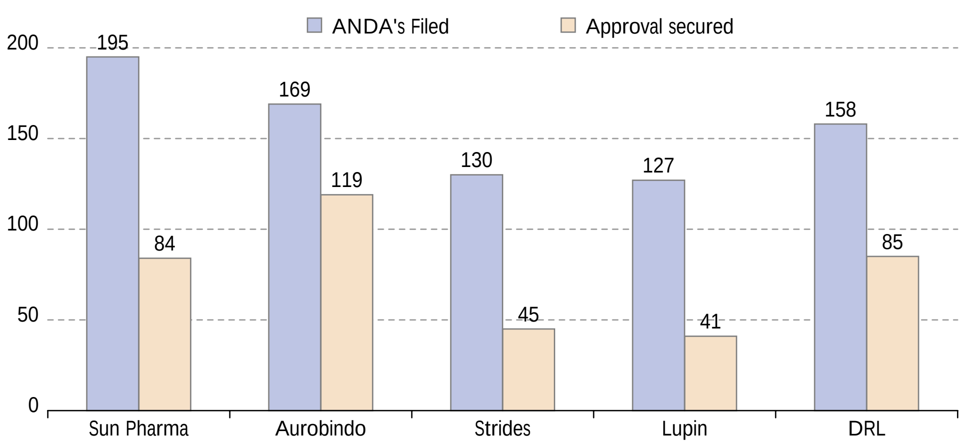
Strides has filed 130 ANDAs including 98 steriles with the USFDA – the highest in the Indian pharma industry…

❑ An impressive US ANDA filings portfolio

Currently, Strides has filed 130 ANDAs including 98 steriles with the USFDA (51 ANDAs filed in 2009) – the highest in the Indian pharma industry. Till date, Strides has received approval for 45 ANDAs. This filings data compares favorably with peers, and clearly underlines the value of IP that Strides has attained. Strides management targets to file 40 sterile ANDAs each for the next two years – thereby creating a potential injectable ANDA portfolio of ~200 products. According to the management, Strides' cumulative ANDA filings portfolio now addresses up to US$12.6bn of the market opportunity.

… and till date has received approval for 45 ANDAs

Exhibit 2: Strides – summary of ANDA filings



Source: IDFC Securities Research

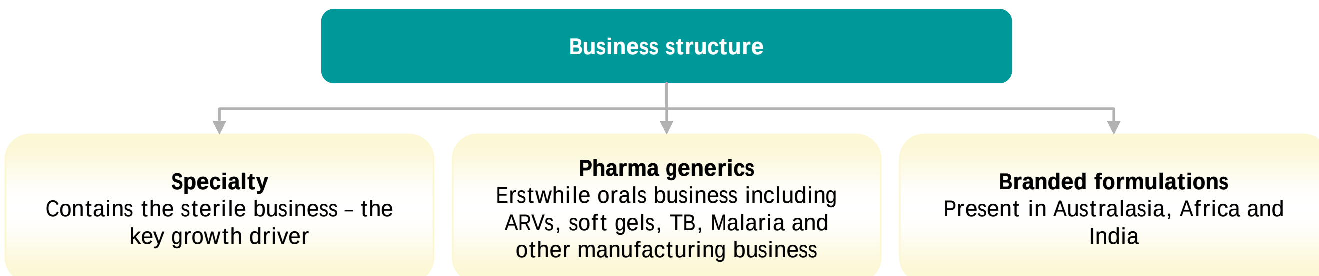
Besides being investor-friendly, a simple business structure gives management flexibility to pursue a differing strategy across units

❑ Recent restructuring to create a simplified business structure

Till recently, Strides had a relatively complex corporate structure with a string of JVs across geographies and multiple subsidiaries. In 2009, the management undertook a business restructuring exercise to consolidate several subsidiaries as well as to split the business across three key divisions – specialty, pharma generics and branded formulations (refer to the following exhibit). Earlier in November 2007, Strides had sold its Latin American business to Aspen as part of the strategy to streamline the business and generate cash to fund future growth.

The restructuring exercise has rendered an overall simplified corporate structure for Strides. This, we believe, will enable investors to track the progress of different business groups and gives leeway to the management to pursue differing strategies for these three fairly different businesses.

Exhibit 3: Strides – business structure post the recent restructuring

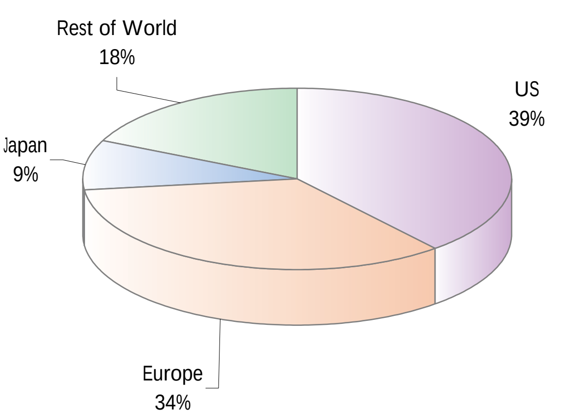


Source: Company, IDFC Securities Research

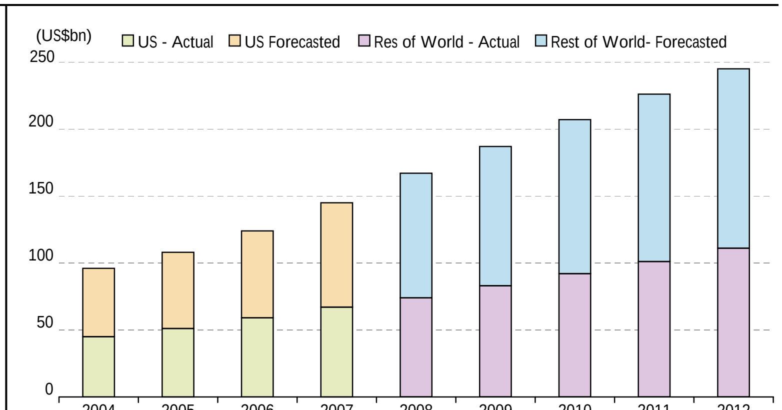
Steriles: The jewel in the crown

Globally, the injectables market is estimated at $173bn with potential CAGR of 11% over FY08-12. The injectable generics market is estimated to be $15bn and expected to grow at 10% per annum. Among therapies, oncology injectables are a key segment with $9 bn worth of drugs expected to go off-patent by 2015.

Exhibit 4: Injecitbles market – sales by region



Growth looking one way – up



Source: Company, IDFC Securities Research

Steriles – one of the most attractive niches in the global pharma place

Given the complexities of manufacturing high-potency oncology injectables, there are relatively limited manufacturers of these drugs globally and hence they possess significant pricing power. This is reflected in Strides' belief that it can generate 25-30% operating margins in this segment on a sustainable basis.

Yet another indicator of the attractiveness of this space is the relatively high valuations attached to the recent M&A deals that have happened in the space.

❑ Strides – aiming high in the steriles arena

Strides aims to become one of the most competitive generic steriles players in the global pharma market. It is focused on developing and manufacturing steriles covering a fairly wide spectrum of therapeutic areas with specific focus on cephalosporins, penems, penicillin, oncology, ophthalmology and peptides along with emerging areas like vaccines and biosimilars.

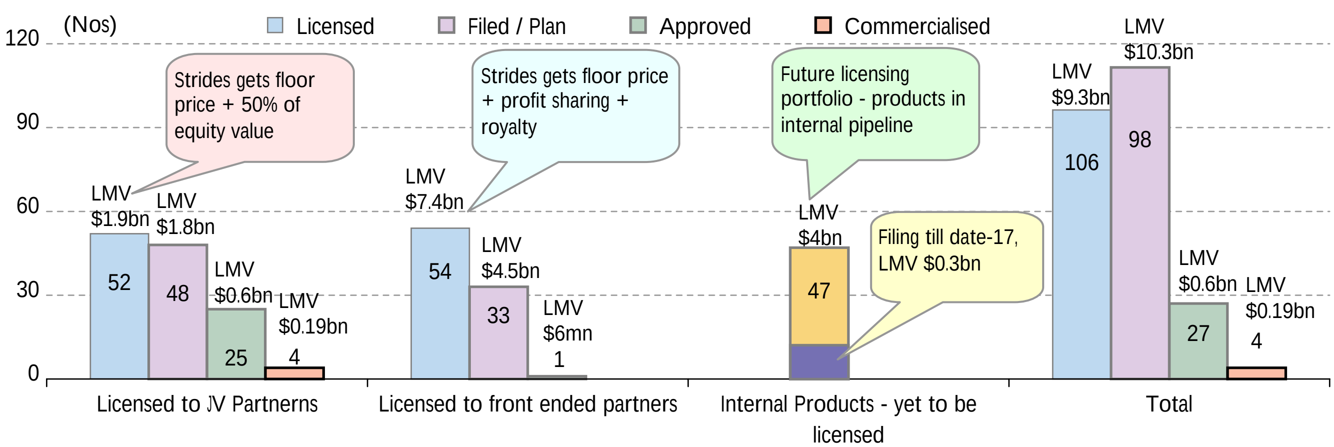
Evolution of steriles business model

Strides' steriles business model endorses a domain strategy with focus on comprehensive product portfolios in specific therapies

Strides' steriles business model has evolved significantly over the years and now focuses on developing comprehensive product portfolios in specific therapies. Thus, Strides has actively endorsed a "domain strategy" as against generally filing sterile ANDAs across the therapy spectrum. The domain strategy revolves around focusing on select therapies and then developing an entire suite of products that covers at least 80-90% of that therapy.

Along with the product selection strategy, Strides' front-end strategy has also undergone a transformation. In the early phase, Strides partnered with two relatively small US firms (Akorn and Sagent) for marketing its sterile ANDAs. Strides formed two 50:50 marketing JVs with these companies and committed to transfer ~50 ANDAs to these two entities. All these products have been filed and approvals have now begun to flow in. However, under the domain strategy, Strides seeks to outlicense the entire "domain" to a global pharma player that has an interest in the therapy and can thereby garner a significant market share.

Exhibit 5: Strides' evolving business model



Source: Company, IDFC Securities Research

After deals with Pfizer and GSK in oncology, Strides looking for partnerships in ophthalmology and peptides

In line with this strategy, Strides has partnered with Pfizer and GSK in oncology therapy over the last few years and now seeks to partner out some more domains like ophthalmology and peptides. Most of these deals involve significant upfront licensing fees as well as minimum market share guarantees as also share of profits unlike the plain vanilla contract manufacturing deal. In our view, these commercial terms reflect Strides' ability to negotiate these deals from a position of strength – an affirmation of the value attached by partners to Strides' product portfolio.

Going forward, Strides may seek to create its own front-end across key markets once it has acquired a critical mass of ANDA filings/ approvals.

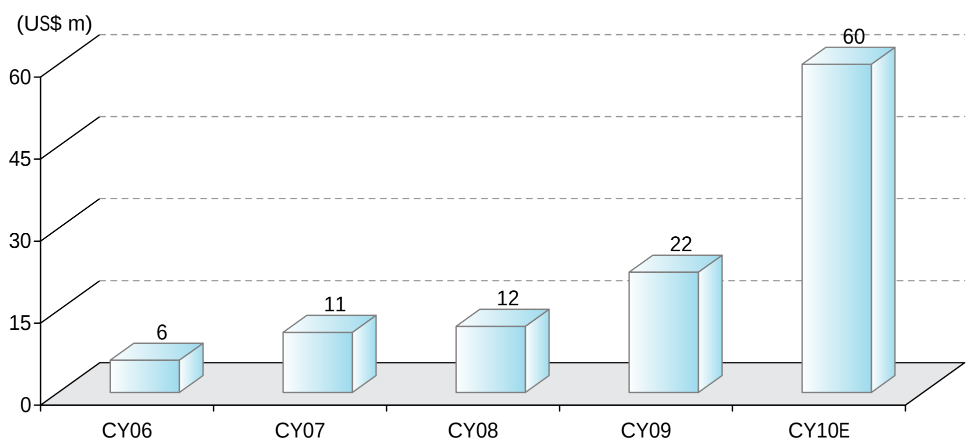
❑ Licensing income – integral to Strides' partnering model

Given its partnering model, licensing income has been an integral component of Strides' business model. It has enabled Strides to invest aggressively in building an enviable steriles ANDA portfolio despite the relatively limited cash generation from its fledgling pharma business over this period. Strides has spent Rs1.2bn on R&D over the last two years.

Over CY07-09, licensing income grew ~4x to $22m. Strides expects licensing income to grow 172% to $60m for CY10 (we estimated $55mn licensing income) and sustain at these levels in the coming few years.

Strides expects licensing income to grow 172% to $60m for CY10

Exhibit 6: Licensing income on the rise



Source: IDFC Securities Research

❑ Big pharma deals underline Strides' sterile credentials

We see the deals with Pfizer and GSK as a vindication of Strides' strong positioning in global sterile injectables

Pfizer Deal: Pfizer recently extended its licensing and supply arrangement with Strides for other geographies and a larger number of products. As per the new agreement, Strides will license and supply up to 38 generic oncology products to Pfizer for markets in EU, Canada, Australia, New Zealand, Japan and Korea. This agreement also includes supplies of niche sterile injectables for the US market. Pfizer intends to commercialize these finished dosage forms through its Established Products Business Unit.

Pfizer has another similar agreement with Strides, under which Pfizer would source 40 generic products (primarily oncology injectables) from Strides and Onco Therapies (a 50: 50 JV between Aspen and Strides), and market them in the US. These drugs cover ~60% of the US$9bn oncology injectables likely to go off patent by 2015.

Strides is a powerhouse in the steriles injectables arena

- *Pfizer looked at more than 100 companies before settling on the deal with Strides*
- *We view this as a beginning of a partnership and look at Strides as a strong anchor point*

- David Simmons, President and GM, Established Products Unit, Pfizer

Strides to likely receive an upfront licensing fee, milestone payments as well as share of revenues for deals with Pfizer

The first drug as part of this agreement is expected to be launched by 2HCY10. Under the arrangement, Strides will likely receive an upfront licensing fee, milestone payments as well as share of revenues. The company has not shared the financial details of this transaction but we expect payments to be quite substantial based on the US$110m received by Aurobindo Pharma as part of its deal with Pfizer for 60-70 products, primarily oral formulations, partnered out to Pfizer across the US, EU as well as multiple emerging markets.

Notably, Pfizer intends to be among the top five injectables players globally over the next five years and has the capability to meet this aspiration. Therefore, this deal may lead to significant recurring revenues for Strides (apart from the upfront payments) going forward as it benefits from the higher market share garnered by Pfizer across multiple partnered products.

Strides to receive a share of profits and licensing fee for deal with GSK

GSK Deal: In 2008, Strides entered into a licensing and supply agreement with GSK Plc, wherein Onco Therapies Private Limited would first supply 10 injectable products (primarily oncology) meant for 95 emerging countries across the world. GSK will register the drugs in these countries and will undertake their distribution and commercialization. In return, Strides is liable to receive a share of profits and licensing fee. The first drugs from this partnership are likely to be commercialized in 2010. This partnership may be extended going forward.

““This collaboration gives us access to a renewable, high quality and competitively priced source of branded pharmaceuticals in high demand therapeutic areas. Aspen, through its own pipeline and that of its joint venture with Strides has a product portfolio of over 450 molecules and 1200 products which complements our own product portfolio and will enable us to deliver more medicines of value to more patients in these countries.” –

Andrew Witty, CEO – GSK, on the deal

❑ A strong R&D set-up at the core of Strides’ business model

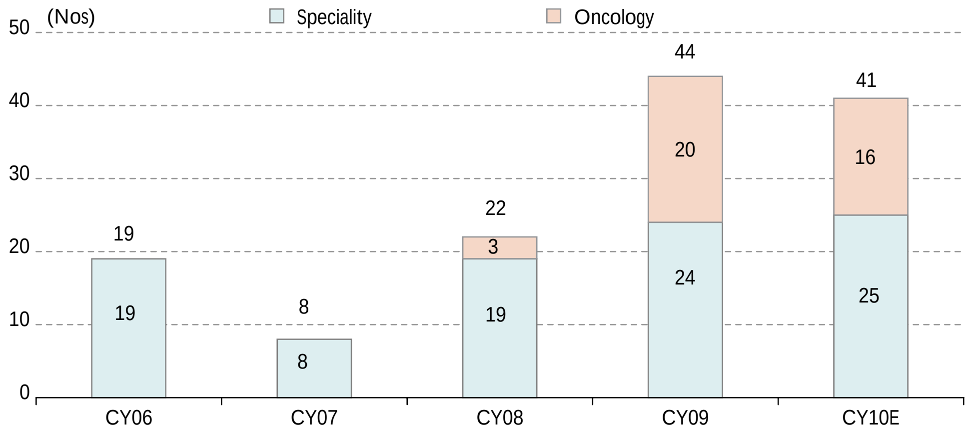
Strides has been developing 120+ products annually…

Strides’ highly efficient R&D set-up has been a vital ingredient of its steriles capability build-up. This has enabled Strides to file a phenomenal 66 sterile ANDAs over 2008-09 (44 ANDAs in 2009 alone), and at significantly lower cost levels aided by the fact that sterile ANDA filings do not require BA/ BE trials (which reduces development expenses). The success so far continues to give Strides the confidence to develop 120+ products annually – translating into 40+ filings in a year.

Till Q1CY10, Strides has filed 98 sterile ANDAs and the management looks to file 40 sterile ANDAs each for the next two years – thereby creating a potential injectable ANDA portfolio of ~200 products. The management indicates that 40% of the incremental ANDA filings for CY10 would be in the oncology segment and the remaining in other specialty businesses.

...translating into 40+ filings in a year

Exhibit 7: Sterlites – superior R&D capabilites to drive 40+ filings each year hereon



Source: Company, IDFC Securities Research

❑ ...backed by the right processes to secure approvals

Strong capabilities in assessment/ evaluation of IP/ regulatory filings through ECTD route give Strides an edge over peers

According to Orange Book, Strides received 15 sterile ANDA approvals – among the highest and on par with TEVA/ Sicor – in CY08. The management believes that Strides' strong capabilities in assessment/ evaluation of IP/ regulatory filings, as also ability to achieve quick turnaround by filings through the electronic route (ECTD route), give it an edge over peers in terms of receiving the targeted approvals.

Exhibit 8: Strides received among the highest sterile ANDA approvals in CY08

Company	2007	2008	Total
Teva/ Sicor	11	15	26
Bedford labs	8	13	21
APP	12	7	19
Hospira/ Mayne Pharma	7	10	17
Akorn/ Strides	**1**	**15**	**16**
General Medix	8	5	13
Sun Pharma	2	10	12
Baxter	3	5	8
Ebewe/Parenta	2	5	7
Sandoz	5	1	6
American Regen/Luitpold	1	4	5
Watson	3	2	5
Apotex Corp	2	2	4
Orchid	1	3	4
Bioniche	0	1	1

Source: Orange Book, Company

While Strides could secure only seven ANDA approvals in CY09 due to delays at the FDA's end, the company remains confident of getting ~25 approvals in CY10.

❑ ANDA filings growing in scale and scope...

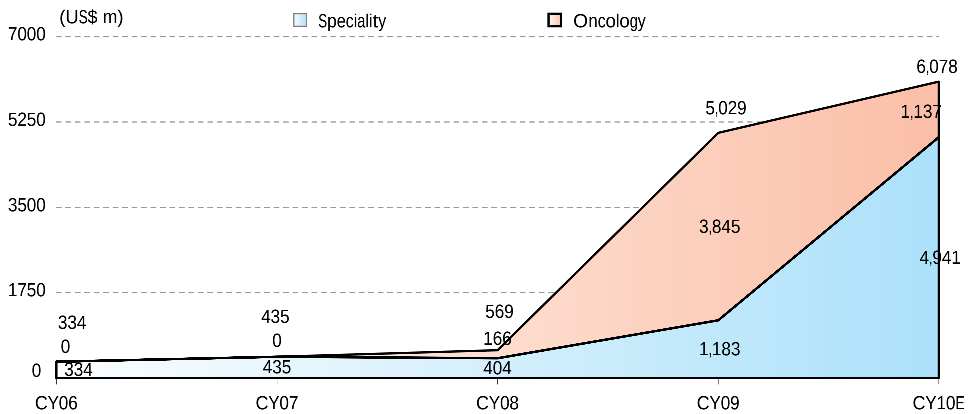
Strides has a promising business model with huge scale-up potential

While Strides' 49 ANDA filings in 2006-08 addressed a cumulative market size of ~$1.4bn, the opportunity expanded to $5bn with 44 ANDA filings in CY09. In CY10, Strides seeks to file 41 ANDAs with an incremental underlying market opportunity of $6bn. This trend clearly reflects the tremendous scale-up potential in Strides' business model. In line with Strides' strategy of targeting one therapy area at a time, oncology accounted for ~80% of the local market value (LMV) of CY09 filings. In

In CY10, Strides seeks to file 41 ANDAs with an incremental underlying market opportunity of $6bn

CY10, Strides would file ANDAs across other specialties, primarily ophthalmology in addition to some more oncology ANDAs.

Exhibit 9: Addressable market size of filings has significantly expanded



Source: IDFC Securities Research, Company, IMS

❑ ANDA approvals beginning to flow…

Strides' guidance of ~25 ANDA approvals in 2010 appears to be on track with seven approvals in Q1CY10

Given the prevailing median ANDA approval time of around 28 months, Strides should begin to see a spate of ANDA approvals Q3CY10 onwards. In line with this view, the management has guided to ~25 ANDA approvals in 2010. Strides seems to be on track as it has already received ten approvals till date in CY10, one of the highest for any Indian pharma company this year.

Exhibit 10: Some recent ANDA approvals secured by Strides

Date	Details of approvals received in CY10 till date	Estimated IMS Sales
May-18-2010	Receives tentative approval of Abacavir Sulfate Tablets under PEPFAR	n.a.
May-13-2010	Receives approval of VECURONIUM BROMIDE FOR INJECTION	US$10m
May-12-2010	Receives approval of BACITRACIN FOR INJECTION.	US$32m
April-22-2010	Strides granted tentative approval of adenosine injection	US$125m
April-21-2010	Strides receives approval of METOPROLOL TARTRATE INJECTION. Expected to be launched shortly	US$13m
April-19-2010	Strides secures approval for MENSA injection	US$12m
April-14-2010	Strides receives approval of Granisetron Hydrochloride Injection	n.a.
Feb-09-2010	Strides receives approval of Labetalol Hydrochloride Injection	n.a.

Source: Company, IDFC Securities Research

Strides' sterile filings in the US*

ANDAs filed	98
ANDAs approved	27
ANDAs commercialized	4

*Source: Company, *as of July 2010*

❑ …but sales ramp-up impacted by capacity constraints

Till date, Strides has obtained approval for 27 sterile ANDAs but has commercialized only three of these products including Vancomycin, Rifampicin and Azithromycin. The slow pace of product commercialization can be attributed to capacity constraints.

Currently, Strides has seven sterile manufacturing facilities across Bangalore, Poland and Brazil. Among these, only one facility SPD-I (Bangalore) is USFDA approved and also has products approved by the FDA. This is Strides' oldest and smallest FDA approved injectable facility, and is running to capacity. The Cephalosporin and Betalactam facilities are approved by FDA but Strides is awaiting approval for products that are scheduled to be manufactured in these geographies.

On the other hand, four of Strides' largest sterile facilities are awaiting FDA inspection/ approval. This includes SPD-II (~10x vial capacity and 4x lyophilization capacity as compared to SPD-I), a dedicated oncology sterile plant, penicillin and penems plant in Campos (recently bought from Campos) as well as a steriles plant in Poland (with capabilities for manufacturing controlled substances).

Exhibit 11: Strides – large injectables capacities

Plant	Location	Products	US FDA	PIC	TGA	Health Canada	MHRA	ANVISA	EU	Big Pharma	Generic Players
Sterile products division - I	Bangalore, India	Sterile liquid vials									
		Sterile dry powder vials									
		Lyophilization									
		Pre filled syringes									
		Ampoules									
Cephalosporins facility	Bangalore, India	Dry powder vials									
Beta lactams facility	Bangalore, India	Dry powder vials									
Onoclogy facility (New facility)	Bangalore, India	Sterile liquid vials									
		Sterile dry powder vials									
		Lyophilization									
		Pre filled syringes									
		Ampoules									
		Tabs, SGC and HGC									
Sterile products division - II (New facility)	Bangalore, India	Sterile liquid vials									
		Sterile dry powder vials									
		Lyophilization									
		Suspension dosages									
Sterile products & Controlled substances (Acquired)	Warsaw, Poland	Ampoules									
		Lyophilization									
		Liquid vials									
		Pre filled syringes									
Penems & Penicillins facility (Acquired)	Campos, Brazil	Dry powder Vials									

Approved facilities | US FDA approvable facility | US FDA to be invited for inspection

Source: Company, IDFC Securities Research

❑ FDA inspections/ approvals – key triggers to monitor

New capacities expected to be operational from CY11

Given the serious capacity constraints faced by Strides, FDA approvals for the SPD-II plant and oncology plant in Bangalore in particular, along with the Polish and Brazilian facilities, are vital to revenue growth in the key US market in the near term. These approvals will significantly enhance Strides' overall USFDA approved capacities in lyophilization and vials besides adding capabilities to supply penicillin and penems in USA.

Exhibit 12: Significant new capacity for liquid injectables to come on stream by end-2010E

(m doses)	Existing capacity	Expanded capacity
Lyophilization (non-oncology products)	10	56
Lyophilization (oncology)	0	7
Liquid vials	11	103
Liquid vials (oncology)	0	16
Pre-filled syringes	9	29

Source: Company

Strides aims to sell controlled substances from Polish plant to cater to demand in EU markets

The Polish plant has undertaken a significant expansion by adding lyophilization, pre-filled syringes as well as liquid vials to the existing ampoules manufacturing lines. Strides primarily aims to sell controlled substances from this plant to cater to the demand in EU markets. The plant has been partly dedicated to a global pharma major for select products.

The management remains hopeful of a USFDA inspection and approval sometime during 2011, leading to significant expansion in capacity to service the key US market going forward. We see successful US FDA approval to be a key near-term trigger for the stock and have assumed commercialization of 27 new products in 2010-11 in our estimates. A delay in these approvals remains a key risk to our near-term earnings.

❑ Strides' commercialization performance so far is encouraging

Limited capacity at USFDA approved facilities prevent commercializing of more products and sales ramp-up of commercialized ones

Till date, Strides has obtained approval for 27 sterile ANDAs and has commercialized three of these products including Vancomycin, Rifampicin and Azithromycin. Limited capacity at its existing USFDA approved facilities has prevented Strides from commercializing more products as well as ramp up sales of the already commercialized ones. More importantly, products launched via Strides have achieved commendable market share in a short span, which in our view reflects management's ability to successfully commercialize products.

Exhibit 13: Strides' product launches in the US

Particulars	Vancomycin	Rifampicin	Azithromycin
Local market value (US$ m)	185	8	28
Addressable market value (US$ m)	157	8	28
No. of players	6	3	6
Leader	Hospira	Strides	FK
Filing	2006	2006	2007
Approval	Dec-08	May-08	Mar-09
Commercialized	Feb-09	Jun-08	Apr-09
Acquired market share (%)	16	51	5
Estimated market share (in next 12 months) (%)	35+	51+	20+

Source: Company

❑ Recent transactions to add further momentum

Two large ticket transactions in the steriles space, though it leads to short-term pressure on balance sheet

Recently, Strides has undertaken two large ticket transactions in the steriles space which will further enhance its overall competitiveness. Notably, this will entail some near-term pressure on cash flows as well as balance sheet as Strides envisages a cash outgo of ~$190m over March'10-April'11. These acquisitions include buyback of Aspen's 50% stake in the Oncology JV as well as purchase of the penicillin and penems plant (based in Campos, Brazil) from Aspen.

Strides has bought back Aspen's 50% stake in the oncology JV for $117m

Buyback of Aspen's stake in the Oncology JV

- In April 2010, Strides acquired a 50% stake from its partner Aspen Pharmacare in each of their two oncology JVs for a total consideration of US$117m. The paid consideration would entitle Strides for Aspen's share in the manufacturing unit Onco Therapies, Bangalore, and the IP unit, Onco Laboratories, Cyprus. Strides has to pay this amount over a period of time till April 2011 and these payments are closely linked to the potential licensing payments on the oncology portfolio.
- This 50:50 JV was formed in November 2007 to set up an oncology business.
- Towards this purpose, the JV paid $32.5m to Strides for acquisition of the under-construction oncology plant. Additionally, Aspen separately got into an agreement with another Strides Arcolab subsidiary (Powercliff) which held all the IP related to oncology product development, to acquire a 50% stake for $25.75m. Effectively, Aspen invested $42m to acquire a 50% stake in the entire oncology business including the manufacturing plant and IP. This equity infusion bankrolled the developed of Strides' oncology business, which is now one of its key growth drivers.
- As per the agreement, Strides would continue to license its present/ future oncology products to Aspen-owned Pharmacare in certain geographies.
- Strides would also continue to license products to GlaxoSmithKline for its emerging markets and to Pfizer for the US market.

Strides recently acquired Aspen's penem and penicillin manufacturing facility in Brazil for a net consideration of $75m

Acquisition of Penems and Penicillin manufacturing facility, Campos

- In March 2010, Strides entered into an arrangement with Aspen to acquire Aspen's Penem and Penicillin manufacturing facility (at Campos, Brazil), related products and IP for a net cash consideration of US$75m (after adjusting for including $10m working capital. Strides' 49% equity investment in the Latin American holding company "Pharmalatina" formed part of the total consideration paid for this asset. The deal is likely to be closed in 2HCY10. Strides will make the payment over a 12-14 month period ending April 2011.
- The plant already supplies products to the Brazilian market and generates revenues of ~$40m p.a. Strides, given the huge potential of the Brazilian market, expects to significantly ramp-up Brazilian revenues much beyond these levels.
- This facility was divested to Aspen by Strides way back in 2007, along with the other business, when the company exited the entire Latin American operations due to financial stress. The plant was under construction at that point of time. Aspen paid $45m to Strides as well as infused another $94m in the business to meet Strides' payment commitments.
- Strides' decision to buy back this facility was driven by the strategic consideration of having penems/ penicillin injectables as part of its comprehensive sterile portfolio offering proposition. Strides believed it would have taken it at least 3-4 years and higher expenses to build a facility and IP to match Campos.
- With this facility, Strides is one of the few players in the world to have comprehensive penems manufacturing capabilities. Campos facility has already filed for penems across developed markets including USA and EU, and has also entered into global marketing arrangements with a Big Pharma player for some of these products. Approved by all other regulatory authorities, the plant is awaiting US FDA inspection.

♦ While the Brazilian market sales will start accruing to Strides immediately upon the deal closure, the big sales boost will come from the launch of penems in regulated markets of EU from 2011 onwards and the US thereafter.

❑ Steriles – getting off the block

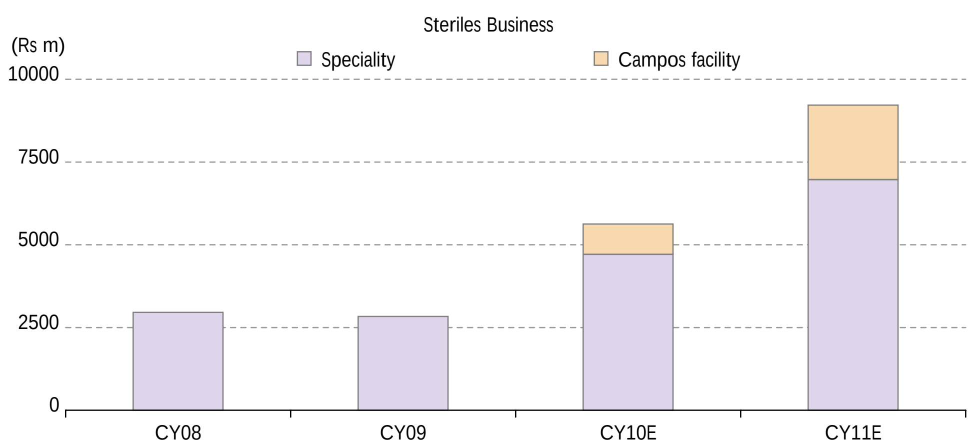
We expect traction in Steriles revenues as new FDA approved facilities come on stream and more ANDA approvals are secured

While licensing income (~Rs2.5bn per annum) will be a significant component of steriles revenues over CY10-11, non-licensing revenues will start to pick up H2CY10 onwards with the expected FDA approvals for Strides' various injectable facilities (primarily SPD-II and OTL) combined with a flurry of ANDA approvals.

We expect Strides to launch 27 new products in the US, including several oncology products, over CY10-11 subject to the USFDA approval for its SPD-II plant. Strides will also commence EU sales from Q3CY10. Additionally, there will be a significant ramp-up in sales even in RoW geographies as the newly commissioned plants start contributing to these geographies. The non-licensing income will be further boosted by contribution from the Campos facility. Overall, we expect non-licensing sterile revenues to grow >3x from $60m in CY09 to $205m in 2011.

Any delay in USFDA approval for SPD-II remains a key risk to CY11 earnings growth in view of the capacity constraint in existing USFDA-approved facilities.

Exhibit 14: Sterlite's business to grow 3.25x over CY09-11E



Source: IDFC Securities Research

Other businesses: Playing second fiddle for now

Other businesses include Strides' branded generics as well as its legacy oral formulations manufacturing operations (pharma), which generated ~Rs9.5bn sales in CY09. While we expect steriles to remain the primary growth driver, Strides remains reasonably positive on the growth possibilities and profitability improvement potential in the non-sterile businesses too. Strides has recently inducted a new COO for the non-steriles business with a view to accelerate growth. The company is unlikely to invest incrementally in these businesses and will focus on improving the operational performance given that they operate at ~12% EBITDA margins. Overall, we expect 11% CAGR in these segments over CY10-12 with a 50bp improvement in EBITDA margins by CY11.

Pharma business

Pharma operations comprise oral products across AIDS, TB and Malarial therapies

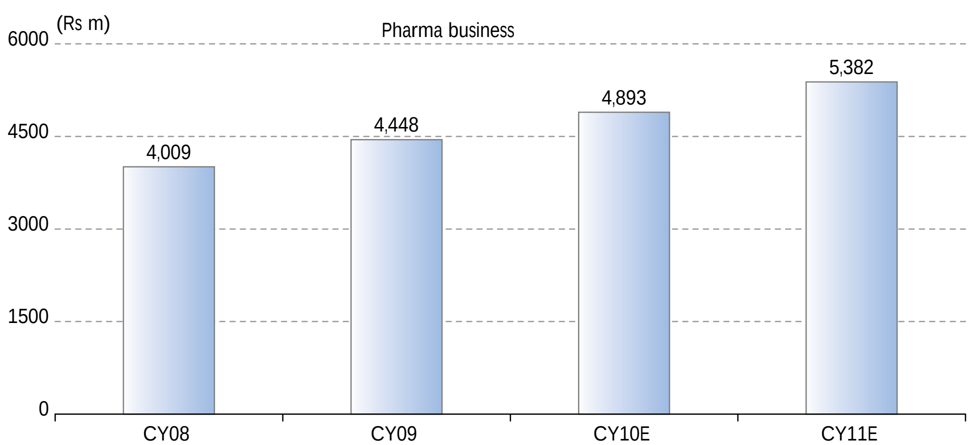
A key growth driver before Strides built up its branded formulations and injectables business, the pharma operations largely comprise oral products across AIDS, TB and Malarial therapies. Strides has contractual agreements with global aid and charitable organizations like UNICEF, PEPFAR, Clinton Foundation as well as a JV with Sandoz for TB products, which provides growth visibility. The pharma operations grew by 11%yoy to Rs4.4bn in CY09.

In this business, Strides had taken a major strategic call by aggressively investing in the OTC soft gelatin business in the US in 1999 and also buying out a large soft gelatin manufacturing plant in the geography. However, the business never took off and Strides had to eventually close down the US soft gelatin plant in 2007 at a significant charge of Rs522m – which, combined with working capital challenges in Latin American business, exerted pressure on the company over CY05-07.

On the manufacturing front, this division has soft gel capacity based in Bangalore and a semi-solids facility in Milan, Italy. Strides' growth agenda for this business involves developing products in niche segments like vitamin analogues, immunosuppressant, hormones, etc and licensing products to large global players.

Strides' plans for pharma business involve developing products in niche segments and licensing product therapies

Exhibit 15: Pharma business to see 10% CAGR over CY09-11E



Source: IDFC Securities Research

In particular, Strides is quite positive on the potential of soft gelatin prescription products (as against OTC products in earlier years) like calcitriol, cyclosporine, dutasteride, lovaza, etc which it hopes to progressively start launching from 2HCY10. Strides has recently obtained FDA approval for generic Cellcept capsules, an immunosuppressant drug, which marks its first big-ticket drug approval in this segment. This momentum should build up with the expected approval for more niche products going forward. While Strides remains positive on the outlook for pharma business, it is not looking to incrementally invest in this business.

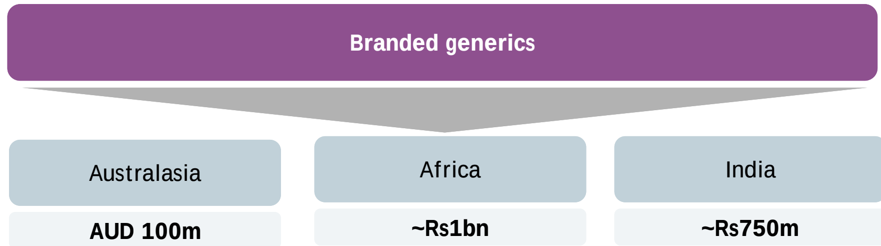
Branded generics

We estimate branded generics business to have sales of ~Rs6.5bn per annum with 10-11% EBITDA margins

Strides' branded generics business spans Australasia, Africa and India with Australasia being the key market. We estimate this business to have sales of ~Rs6.5bn per annum with 10-11% EBITDA margins. Given that Strides is not vertically integrated, it leads to subdued profitability for the company compared to other

Indian peers. Barring the new division launched recently in India, branded generics business does not entirely leverage Strides' core competency of manufacturing complex injectable products.

Exhibit 16: Branded generics (geography-wise)



Source: Company, IDFC-SSKI Research

Australasia – Strides' largest branded market

Future pipeline under registration and development includes all major product launches across the region through 2014

Strides operates in the Australasian geographies via its 57% stake in Ascent Pharma Health (APH), an ASX listed company. APH is a leading Australasian supplier of generic pharmaceuticals and over-the-counter health products. APH is one of the top five generics companies in Australia and now the largest company in Singapore (post Green Cross Pharma acquisition). Australasia region is the key branded market for Strides with presence in Australia, Singapore and five other emerging South East Asian markets with a manufacturing facility in Singapore. Ascent has 60+ generic medicines registered in Australia and 400+ prescription and OTC products registered across multiple South East Asian countries. Strides' believes its future pipeline under registration and development includes all major product launches across the region through 2014.

There were two landmark events for APH in CY09. First, APH catapulted to the top position in Singapore generic pharmaceutical markets marked via acquisition of Green Cross Pharma. Ascent operates in Singapore via its wholly-owned subsidiary Drug Houses of Australia (DHA), which the company had acquired from Strides Arcolab as part of its Asian growth strategy in July 2008. Green Cross acquisition, in our view, positions APH in a commendable position with >20% market share in Singapore. Green Cross, with government tenders as its primary revenue source, perfectly complements DHA which derives majority of its revenues from private pharmaceutical sales, thereby ensuring steady revenue steams.

APH, in October 2009, also signed a distribution and services agreement with Pfizer Australia to promote the latter's established off-patent medicines to pharmacies in Australia. This, we believe, would help APH engage with a broader range of customers while servicing Pfizer's product portfolio as also help it promote alongside its own generic medicine portfolio – thereby optimally utilizing its field force.

Ascent clocked a remarkable 43%yoy growth (to AUD105m) in CY09 despite tough operating conditions in Australia due to PBS reforms and contracting Asian markets post the global financial crisis. The management attributes the strong growth in CY09 primarily to new product launches and incremental market share garnered on existing products via ramp-up in field force and innovative marketing strategies.

Strides has expressed an intent to acquire the remaining stake in APH to make a 100% owned entity. At CMP, this may cost the company ~AUD29m.

Strides has sales of ~Rs1bn in the African geography

Africa – portfolio a mix of generics and branded products

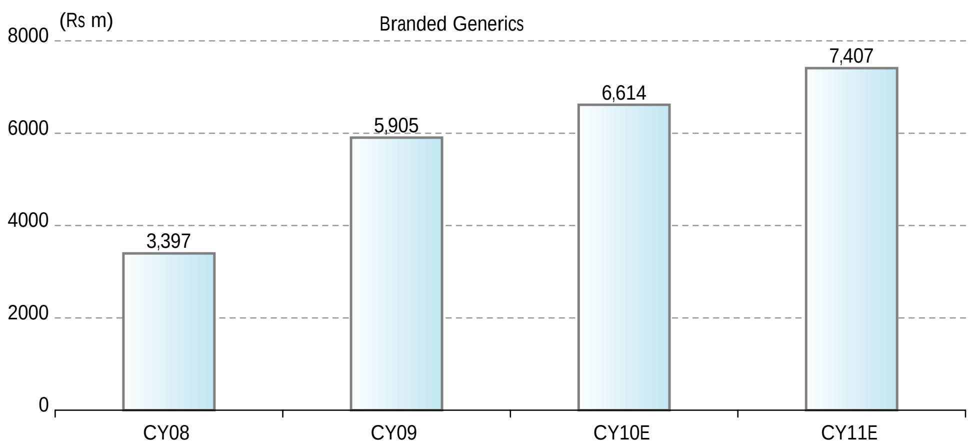
Currently, Strides' footprint in this geography spans West Africa, French Africa and Other Africa with sales of ~Rs1bn in CY09. While Strides has direct presence in some markets, it participates only in tender business in some others. Strides has 300+ registrations and the portfolio includes a mix of generics as well as branded products. The company has three dedicated manufacturing sites including a recently commissioned one in Lagos, Nigeria.

India – looks promising

Target therapy segments for India business include neuropathy, cardiovascular, female healthcare, anti-diabetics, pain management and neutraceuticals

This is a relatively new business and was launched through the Rs1bn acquisition of Grandix two years ago. Grandix currently generates revenues of ~Rs75m with a 400-people strong sales team and is focused on Southern India. Target therapy segments for the business include neuropathy, cardiovascular, female healthcare, anti-diabetics, pain management and neutraceuticals. Additionally, Strides has recently launched a specialty division catering to hospitals to leverage its injectables portfolio. Given Strides' extensive injectables portfolio, we see promise in the business.

Exhibit 17: Branded generics revenues to grow 1.25x over CY09-11E



Source: IDFC Securities Research

A simplified business structure to facilitate value unlocking in pharma and branded formulations divisions

❑ Expect partial/ full divestment of stakes in these entities

The restructuring exercise to align the business across three distinct groups, we believe, paves the way for Strides to enhance its focus on the specialty business and unlock value in the pharma as well as branded formulations business. Further, the management concedes that restructuring of business operations provides options to explore strategic options across different businesses. As has been speculated in the media for a while now, we anticipate partial/ full divestment of stake in one or more of these divisions over the next few quarters/ years. This will also enable Strides to reduce the gearing on its balance sheet.

"Steriles will be our engine of growth. If you want to be aggressive in steriles, it cannot be through organic growth only. The growth opportunity with investments, especially through inorganic route, is high in this domain."

- Arun Kumar, Vice Chairman and Group CEO, Strides Arcolab

Financial Analysis

- **With likely USFDA approval for its new injectables facilities, we expect 33% CAGR in Strides' consolidated revenues over CY09-11**
- **Driven by significant licensing income gains, EBITDA to grow at a much faster pace with 64% CAGR estimated over CY09-11**
- **Excluding licensing income, margins to expand by 570bp over the period**
- **PAT to register 42% CAGR over CY10-11E, moderated by higher interest and depreciation charges**
- **Cash outflow of $238m over CY10-11 on account of recent Aspen buy-outs and FCCB redemption; though unlikely to be a concern, it could strain the balance sheet in the near term**

❑ Expect 33% revenue CAGR over CY09-11

With 27 already approved ANDAs and 30 new approvals likely over CY10-11, we expect strong revenue traction for Strides

Strides' revenues registered an impressive 26% CAGR over the last four years. However, we believe the best lies ahead with Strides securing the much-awaited USFDA approval of SPD-II and Oncotherapeutics facilities along with USFDA approval for the Polish and Brazilian units. USFDA approval for SPD-II will see Strides injectable liquids and lyophilizaiton capacity increase 10x and 4x respectively. Given that Strides has recently got a host of regulatory approvals from other non-US regulators for these facilities, the non-US sales from the plants will start scaling up.

With Strides anticipating ~30 new ANDA approvals over CY10-11 (including significant proportion of oncology products) and having commercialized only three of the 27 already approved ANDAs, Strides' non-licensing revenues from sterile segment are set to explode with the USFDA approval for these facilities. Strides' strong performance in the three commercialized ANDAs further enhances our comfort in its ability to successfully commercialize the portfolio and drive growth.

Revenues will get a further boost from the recently acquired Campos facility, which currently generates ~$40m/ annum in revenues. Additionally, we expect Strides to book substantial licensing income over CY10-11.

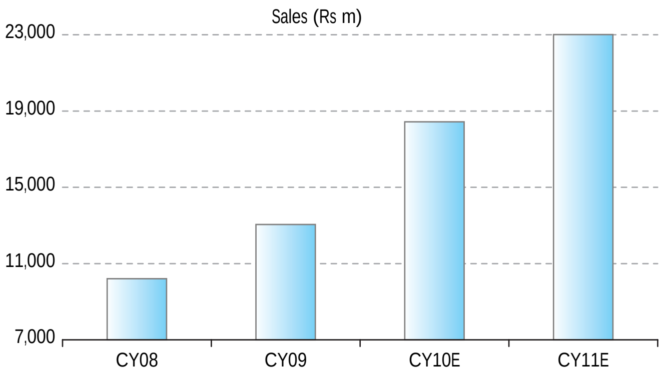
Exhibit 18: Strides' growth currently constrained by limited USFDA approved facilities

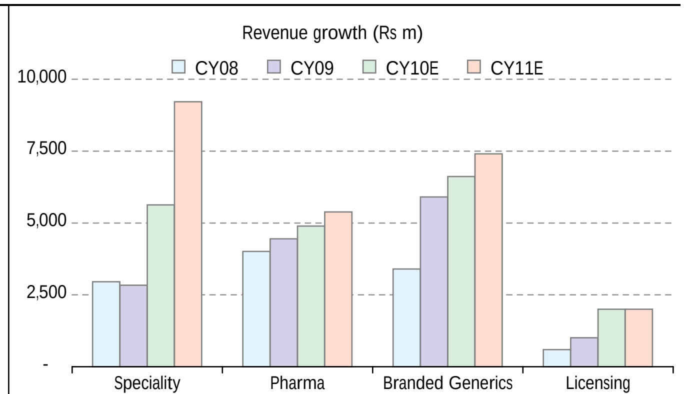
FDA approval status	Facility	Capex incurred (Rs m)	Utilization for regulated markets
FDA approved facilities	Steriles 1 - Bangalore	408	95
	Penicillin - Bangalore	82	20
	Cephalosporins - Bangalore	335	20
Facilities awaiting FDA approval	Steriles 2 - Bangalore	1688	0
	Oncology - Bangalore	1430	0
	Poland	1045	12
	Campos, Brazil	2893	0

Source: IDFC Securities Research

Overall, we expect 33% CAGR in Strides revenues over CY09-11 on the back of a rapidly growing steriles business and steady increase in licensing income. We expect share of steriles business to steadily rise from 21% in CY09 to 41% by CY11 owing to an expected ramp-up in US FDA approved capacities and contribution from Campos.

Exhibit 19: Higher contribution from sterile business and licensing income to drive 64%CAGR in EBITDA over CY09-11E



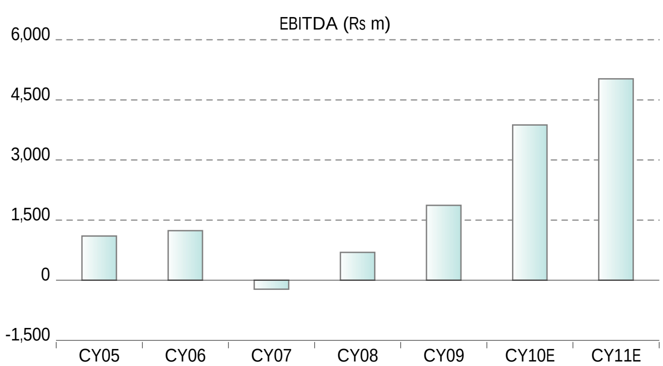


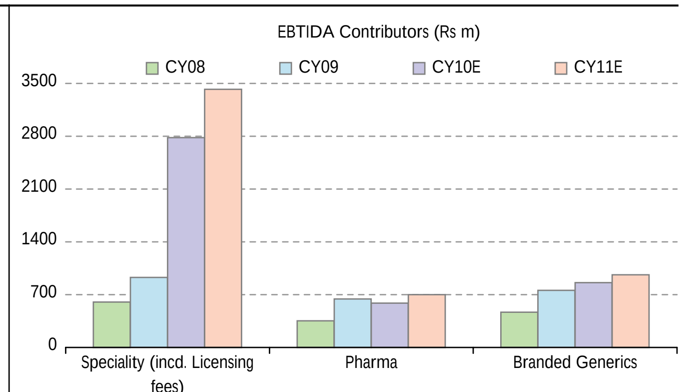
Source: IDFC Securities Research

❑ Licensing income to boost operating profitability

Strides' operating profits registered a muted 14% CAGR over the last four years as compared to 26% CAGR in revenues. During this period, Strides has been in an aggressive investment mode – particularly in the steriles business. Given that steriles revenues have yet to pick up and growth was relatively modest in the pharma and branded formulations business, EBITDA growth has lagged revenue growth. EBITDA growth has been further impacted by growing R&D spends and limited licensing income generation over this period.

Exhibit 20: Strides – expect 64% CAGR in EBITDA over CY09-11E





Source: IDFC Securiites Research

Excluding licensing income, we expect operating margins to expand by 570bp to 12.3% by CY11

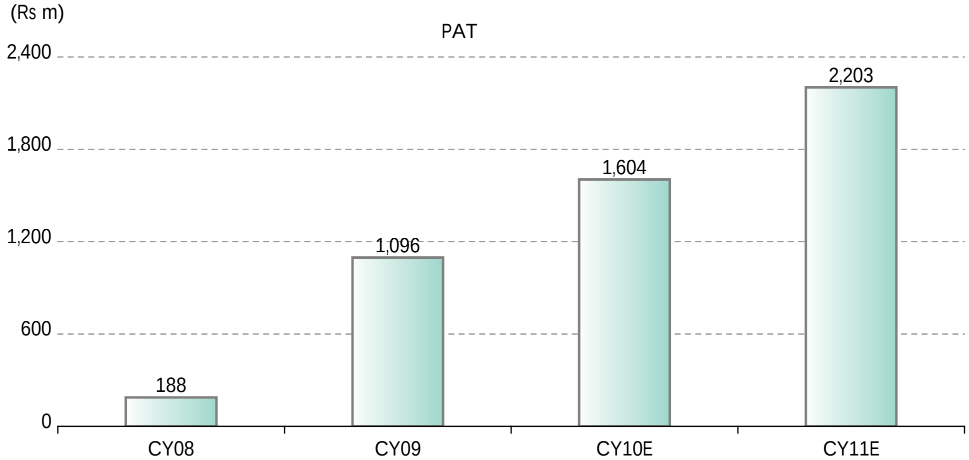
Having said that, we see steady improvement in Strides' operating margins ahead with 64% CAGR in EBITDA over CY09-11E. Higher licensing income (Rs2.5bn each year over CY10-11), coupled with increasing contribution from the high-margin steriles business, should lead to a 750bp expansion in Strides' consolidated operating margins to 21.8% by CY11. Excluding licensing income, we expect operating margins to expand by 570bp to 12.3%. Given that the operational costs of a steriles plant are largely fixed in nature (irrespective of the capacity utilization levels), a pick-up in revenues post FDA approvals will lead to a disproportionate rise in profitability.

❑ Expect 42% CAGR growth in PAT over CY09-11

Given the steep rise in interest costs (near doubling over CY09-11) assuming Strides opts for the debt route to meet its funding requirements as well as higher depreciation charges, we expect 42% CAGR in net profit over CY09-11 to Rs2.2bn.

We expect net profit to rise to Rs2.2bn in CY11

Exhibit 21: Net profit to double over CY09-11E



Source: IDFC Securities Research

❑ Equity structure

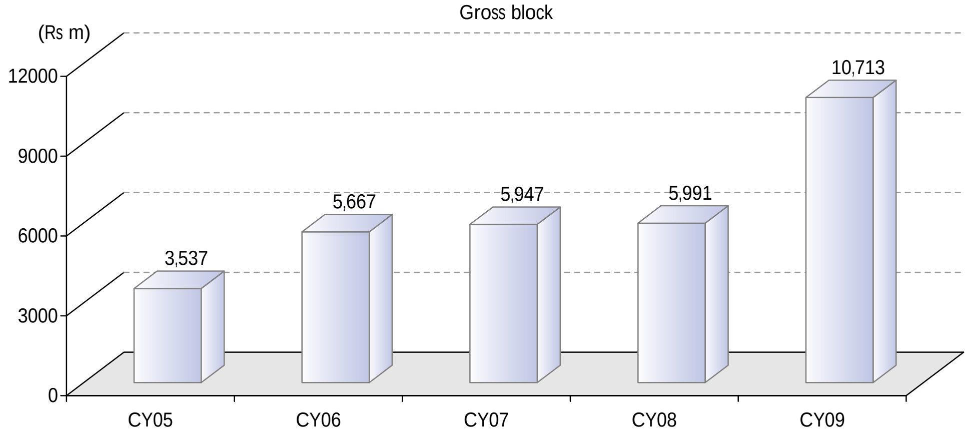
Currently, Strides has 43.2m equity shares outstanding. In May 2009, the company issued 6.2m preferential warrants to the promoter group convertible into shares @Rs91.15/ warrant. Full conversion of the warrants will expand the capital base to 46.4m shares and increase the promoter stake to 36% from 31% currently. If the pending $80m 2012 FCCBs (conversion price of Rs462/share) get fully converted, the fully diluted equity will rise to 53.5m shares.

❑ Gross block grew 3x over CY05-09

Majority of the capex is now behind for Strides

Strides' aggressive growth strategy – involving significant upfront investments primarily on account of the ~Rs5bn spent on steriles facilities – has led to ~3x increase in its gross block in the last four years. Subsequent to operating cash flows lagging the aggressive investments, the company has seen a steep rise in its debt over the period. However, we expect capex (excluding recent asset acquisitions) to sharply moderate (Rs1bn-1.5bn / per annum) going forward as Strides has built up significant capacities that will likely be adequate for the next few years.

Exhibit 22: Gross block expands 3x in four years



Source: IDFC Securities Research, Company

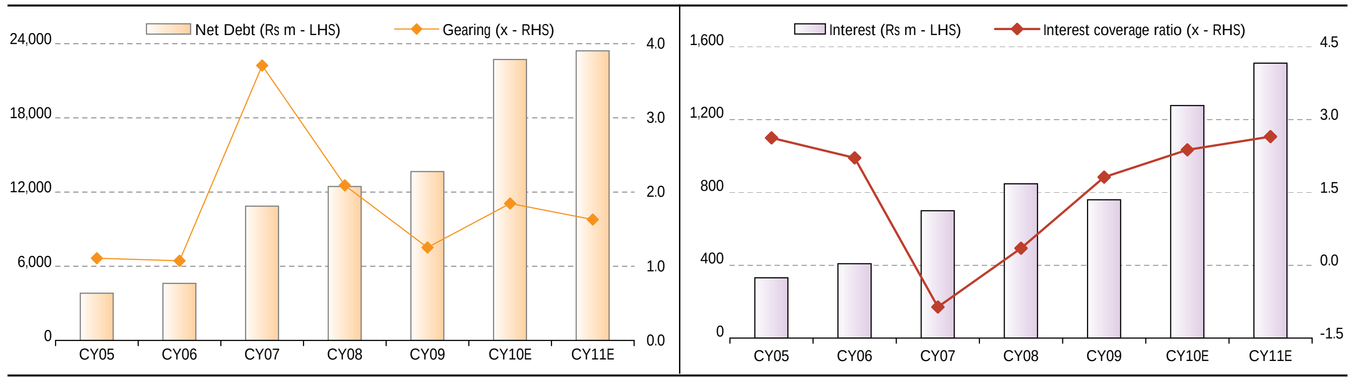
Aggressive upfront investments have strained the balance sheet

Interest costs accounted for a significant 80% of EBITDA generated over CY05-08…

Strides' business model entailed aggressive upfront investments, especially in the steriles business. Given the relatively limited internal cash flow accruals and the company's preference for debt over equity, most of these investments have been funded through debt. Consequently, consolidated net debt ballooned by ~3.6x over CY05-09 to Rs13.6bn (as on 31 December 2009) with FCCBs accounting for Rs7.2bn of this. (Subsequently, Strides has paid $34m of FCCB in April 2010 along with $13m of accumulated interest.)

Increase in debt has not just resulted in a steep decline in Strides' interest coverage ratio from ~2.6x in CY05 to ~0.35x in CY08, but also eroded its profitability. Interest costs accounted for a significant 80% of EBITDA generated over the period.

Exhibit 23: Expect remarkable improvement in interest coverage ratio hereon



Source: IDFC Securities Research

…however, interest coverage ratio has improved from 0.35x in CY08 to 1.8x in CY09, and is likely to go up to 3.3x by CY11

We believe the worst is behind for Strides, and improvement in balance sheet has been amply evident over the past year. Strides' interest coverage ratio has increased from 0.35x in CY08 to 1.8x in CY09 on the back of marked improvement in its operational performance.

More importantly, with majority of the capex behind and steady revenues expected from supply agreements as also a hefty licensing income, we expect interest coverage ratio to improve to ~2.6x by CY11. This is despite $192m of payment obligations over

CY10-11 towards the acquisition of Aspen's Brazilian facility as well as its 50% stake in Oncology business.

Significant contractual commitments…unlikely to be a concern

Exhibit 24: Strides' contractual commitments over CY10-11

Particulars (US$m)	Commitment	Paid as on April 2010	Balance by April 2011
Campos facility	75	30	45
OTL/OLL	117	37	80
FCCB	47	47	0
Total	239	114	125

Source: Company, IDFC Securities Research

Strides has $80m of outstanding FCCBs due for conversion in 2012 on its books

Of the US$40m of FCCBs raised in 2005, Strides recently redeemed US$34m of these on the due date (in April 2010). The total payout for redeeming the bonds, redeemable at a premium of 136.8%, stood at US$46.5m. Strides had earlier bought back US$6m of these FCCBs in 2009. Post redemption of these FCCBs, Strides has outstanding FCCBs worth US$80m of the US$100m raised in 2007 (Strides bought back $20mn of these FCCBs last year). The US$80m FCCB has a conversion price of Rs461.553/share, and if not converted before 27 June 2012, would stand to be redeemable at a premium of 145%.

Strides has to pay the remaining $125m to Aspen by April 2011

Apart from the $80m of FCCB redemption scheduled for 2012, Strides has contractual commitments worth US$192m to be met till April 2011. This includes US$75m scheduled towards acquisition of Campos facility and US$117m towards acquisition of 50% stake in Onco Therapies. Of this amount, Strides has already made a payment of ~$67m by April 2010 and has to pay the remaining $125m till April 2011. In all, we assume that Strides will pay ~$110m to Aspen in CY10 and the remaining in CY11.

Strides' CY10 cash position will be aided by significant upfront licensing fee inflows during the current year but which will be booked as revenues over a period of two years or so. Assuming Rs5bn of licensing income cash inflow over CY10-11 (with Rs4.5bn cash inflow in CY10 itself), our estimates suggest a funding gap of ~Rs9bn over CY10-11 – leading to peak debt of ~Rs22.9bn in CY11.

The management expects to fulfill these commitments through a mix of internal accruals and debt financing. The company has indicated that it will maintain net debt levels at ~Rs17.3bn as of end-CY10 against our estimate of Rs18.8bn. We understand that Strides seeks to raise further FCCBs/ debt to meet this interim funding gap.

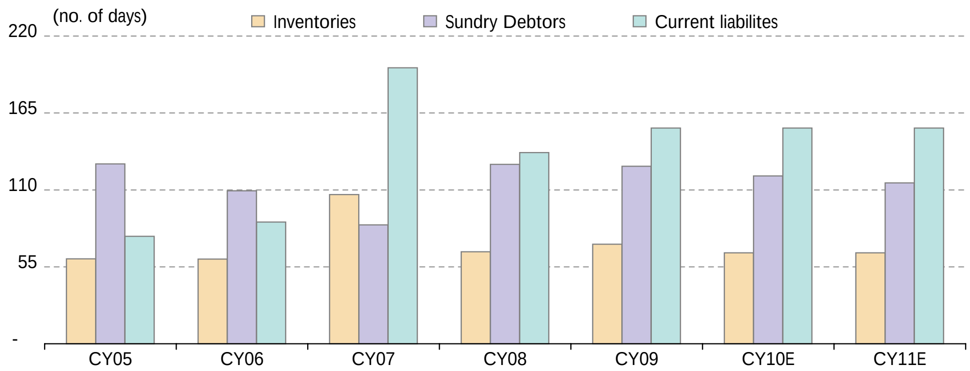
We expect Strides to evaluate strategic options for its non-sterile businesses

Overall, we maintain that over the next 2-3 years, Strides will evaluate opportunities to partially/ fully sell stake in its pharma and branded generics business and focus on the steriles business. This will significantly change the leverage profile of the company and eliminate concerns related to gearing.

Working capital – partnering deals to aid improvement

Strides' net working capital (excluding cash) has been quite erratic over the last few years, which has put pressure on cash flows.

Exhibit 25: Working capital cycle – erratic in the past; now stabilizing



Source: IDFC Securities Research

We expect net working capital to stay constant at 11-12% of sales over CY10-12

Notably, Strides' Latin American business had run into problems primarily due to the high working capital requirements. With a combination of long transit time of goods from India to Brazil as well as the long credit periods in Brazil, debtor days in the geography had shot upwards of 240 days – thereby putting significant strain on cash flows and the balance sheet. In 2007, Strides was compelled to sell off 50% stake in this business, which was its crown jewel at that point of time.

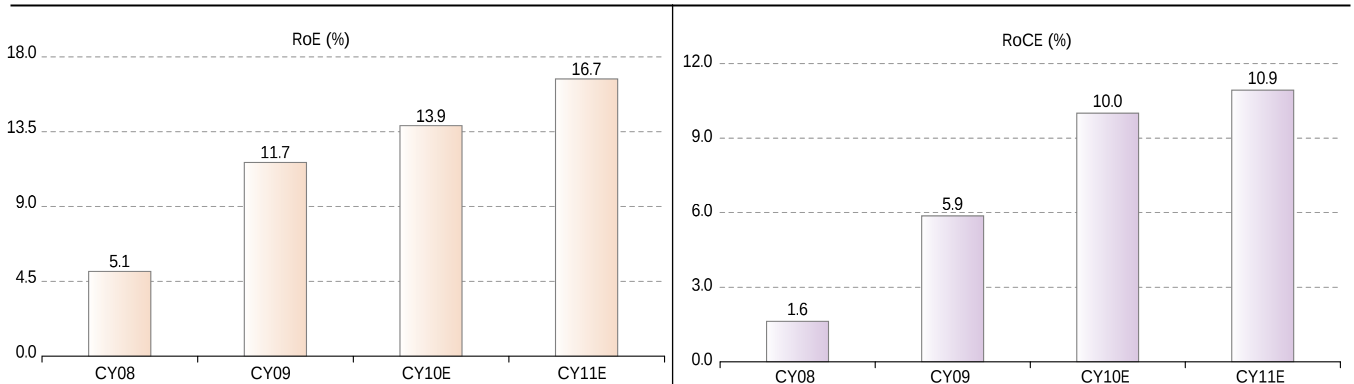
Over the last couple of years, Strides' debtor days have shot up significantly to 127-128 days as it has sought to increase the scope and scale of its business. However, with the initiation of supplies to Pfizer, etc under the partnership agreements with much superior payment terms, Strides expects debtor days to start declining going forward. This should alleviate the pressure on working capital needs going forward. We expect net working capital to stay constant at 11-12% of sales over CY10-12E.

❑ Return ratios – on the mend

With bulk of the capex and acquisitions behind, RoE and RoCE should expand sharply from CY12

As of CY09, Strides reported RoE of 11.7% and RoCE of 5.9%. Return ratios are strained due to significant underutilization in the big ticket injectable facilities as they await FDA approval and product commercialization. However, we expect noticeable improvement in RoE by CY11 with the likely FDA plant approvals in 2HCY10 as also significant licensing income. RoCE would also expand to ~11% by CY11E but not materially due to Strides' recent big ticket acquisitions from Aspen. With bulk of the capex and acquisitions behind, RoE and RoCE should expand sharply from CY12.

Exhibit 26: Return ratios poised for steady expansion



Source: IDFC Securities Research

VALUATIONS & VIEW

- **With 98 sterile ANDAs already filed and another ~80 filings planned, Strides is one of the most competitive sterile players in the global pharma space**
- **Growing visibility on the potential of steriles business, along with the Pfizer deal, has triggered a re-rating. But we believe the best is yet to come**
- **We value the sterile business at 3x CY11E sales in line with global comparables and the non-sterile business at 1.3x CY11E sales**
- **Initiating coverage with Outperformer and an 12-month price target of Rs586**

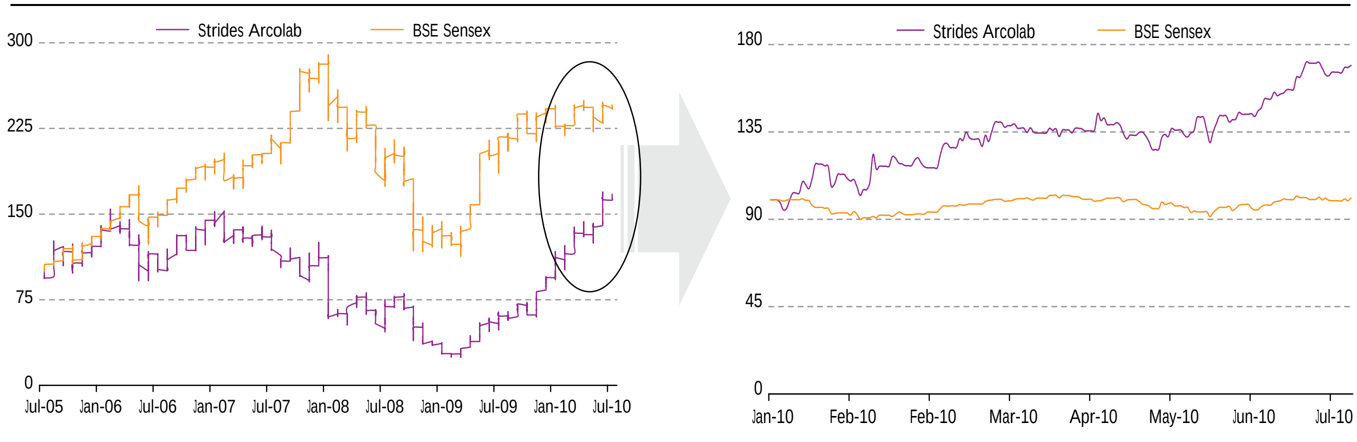
❑ After prolonged underperformance, a turnaround in the offing...

The deal with Pfizer brought Strides stock into the limelight

Prior to its dramatic outperformance vis-à-vis the market since October 2009, the stock had significantly underperformed for a prolonged period of time. This underperformance can be explained by Strides' inability to ramp up its non-steriles business as it continued to invest aggressively in laying the foundation of the steriles portfolio. This muted operational performance, coupled with Strides' mounting debt, gave rise to concerns on its ability to survive the turbulent phase.

The market began to take notice of Strides' sterile capabilities only after its deal with Pfizer in February 2010. This partnership, with visibility of ~$100m of potential licensing fee from Big Pharma (as guided by the company), has underlined the value of Strides' sterile capabilities and has been a key driver for the stock's outperformance.

Exhibit 27: Post a prolonged underperformance, Strides has turned the corner



Source: IDFC Securities Research

With best-in-class steriles business, Strides ripe for further re-rating

With its best-in-class steriles business readying for take off with the much-awaited FDA approvals for its multiple facilities, Strides' earnings trajectory is set to transform in the coming period. Over CY09-11, we expect 42% CAGR in earnings driven by scale-up in steriles business as well as improvement in non-steriles business. While licensing income will drive steriles growth over CY09-11, significant pick-up in steriles product revenues from 2HCY10 onwards will take over thereafter.

With bulk of the capex already behind, the expected earnings scale-up over the next few years will progressively repair the balance sheet and address investor concerns related to a stretched balance sheet. In the medium term, we also expect Strides to undertake partial/ full divestment of its non-sterile businesses, which should further alleviate balance sheet concerns. A successful execution of this roadmap, we believe, will lead to further re-rating of the stock.

❑ Valuing the steriles business

We find EV/ Sales a more apt metric to value Strides

Steriles business, Strides' primary growth driver, is in early stages of commercialization with the full impact of the investments in capex and pipeline development likely to be visible only from H2CY11. Therefore, profitability of non-licensing business will be significantly subdued over the next couple of years due to the high fixed costs involved in running the multiple sterile facilities. In the interim, licensing income will be the primary contributor to revenues and profitability over CY10-11, and gradually decline as a proportion as product revenues scale up. In this context, we believe Strides' steriles business should be valued on EV/ Sales basis as against the conventional metric of P/E multiple used for valuing most other mature pharmaceutical businesses.

Given that there are no relevant benchmarks for operational steriles-only businesses in India, transaction multiples in the recent global sterile business M&A deals as well as valuations of listed global sterile focused players like Hospira serve as a reference point for valuing Strides' steriles business.

Listed global peers

Strides growing much faster than Hospira – a global comparable business

- Prominent global peers with a significant proportion of injectable businesses include Hospira, Sandoz, Teva (Sicor), APP, Fresenius, Bedford, etc. However, barring Hospira (with ~65% injectables business), injectables per se is not a very significant proportion of overall business for most other listed players, which makes it difficult to assess the valuation of their injectables businesses.
- Hospira is one of the largest global injectable steriles players with ~$2.5bn of sterile product sales (65% of overall business).The stock trades 2.7x EV/ Sales (CY09) and 2.5x EV/ Sales (CY11E) with 5% revenue CAGR over CY09-11E, and at 10x CY10E and 9x CY11E EV/ EBITDA.

We expect 80% CAGR in revenues from Strides' injectables business over CY09-11 to US$205m by CY11 and thereafter growth in high double digits over the next few years – at a significantly faster rate than Hospira.

Recent M&A deals

Exhibit 28: Recent deals in injectables space

Benchmark valuations	EV/Sales (x)
Sandoz-EBEWE	4.41
Hospira – Orchid	5.50
Average multiple	**4.96**

Source: IDFC Securities Research, Industry

This suggests a valuation range between 2.5-5.0x EV/ Sales for valuing Strides' injectables business. Given the quality of Strides' injectables portfolio filings, wide range of world class manufacturing assets, strong partnerships with multiple Big Pharma players and explosive growth potential, we value Strides' injectables business at 3x EV / Sales (CY11E) – implying an EV of $781m (Rs35.2bn).

❑ Valuing the non-injectables business

We arrive at an EV of Rs14.7bn for the non-injectables business

We estimate that Strides' non-injectable business will generate Rs11.3bn in sales with 11.6% EBITDA margins in CY11E. Strides is seeking to aggressively ramp up this business, especially with the anticipated launch of niche soft gelatin prescription products, immunosuppressant products as well as some other niche products in the US market. Also, focus would be on profitability enhancement in the branded formulations business. This may lead to earnings upsides in this segment. Given Strides' relatively weaker margin profile in the oral formulations business compared to most other Indian peers, we value it at 1.3x EV/ Sales (~40% discount to peers like Ipca Labs and Torrent Pharma). This implies an EV of Rs14.7bn for the non-injectables business.

Exhibit 29: Valuing Strides in context to recent deals in injectables space

Valuations based on CY11 financials	(in Rs bn)
Target EV for injectables business	35.2
Target EV for non-injectables business	14.7
Implied overall Enterprise Value	49.8
Debt by CY11	22.9
Implied Market Cap	**27.0**
Implied fair value per share	**586**

Source: IDFC Securities Research

❑ Initiating coverage with a price target of Rs586/share

At our target price, Strides will trade at 8.9x CY11E and 9.0x CY11 EV/EBITDA

We initiate coverage on Strides with a 12-month price target of Rs586/ share, implying an upside of 39% from the current market price. At our target price, Strides will trade at 8.9x CY11E and 9.0x CY11 EV/EBITDA without accounting for any dilution from fresh equity/ quasi equity fund raising. Faster-than-anticipated ANDA approvals and incremental licensing deals will be the key upside triggers.

Exhibit 30: Comparative valuations

Company	CMP	P/E (x)			EV/EBITDA (x)		
	(Rs)	FY10	FY11E	FY12E	FY10	FY11E	FY12E
Cipla	336	26.5	22.7	18.8	18.8	16.6	14.0
Dr Reddy's Laboratories	1,455	25.3	19.6	16.6	17.5	12.7	10.6
Ipca Laboratories	298	18.2	14.9	12.3	13.0	10.6	8.8
Lupin	1,880	24.2	20.0	16.9	18.2	14.5	12.0
Strides Arcolabs*	423	17.3	12.2	8.9	17.8	10.6	9.0
Sun Pharma	1,742	26.7	24.3	20.7	23.5	21.4	17.1
Torrent Pharma	571	20.9	15.3	12.1	14.9	12.2	9.4

Source: IDFC Securities Research, CY*

Key Risks

❑ Significant amount of goodwill on the balance sheet

Strides has Rs10bn worth of goodwill (against net worth of Rs8bn) on its books as on 31 December 2009 across various businesses and geographies with Rs5.9bn of goodwill attributable to injectables business (SSPL) and another ~Rs3bn goodwill attributable to Australasia assets. Any deterioration of business outlook in either of these businesses may trigger a significant impairment of goodwill, which may lead to sharp erosion of the consolidated net worth.

❑ Significant payment obligations over the CY10-12

Strides has to pay the remaining $125m to Aspen till April 2011

Strides' recent acquisition of Aspen's stake in Oncology JV as well as Campos plant has resulted into an outflow of $192m, which has strained the balance sheet in the near term. While Strides has partly paid off this amount, it still needs to pay $125m over CY10-11. Additionally, Strides has $80m of FCCBs (redemption price ~$120m) due for conversion in June 2012. If these FCCBs do not convert, it will imply another significant cash outflow in CY12, and further impairment of the balance sheet.

❑ Significant delay in USFDA approval for sterile plants

Given that Strides' current USFDA-approved facilities are running to capacity and as many as four plants are awaiting USFDA inspection and approval, future revenue growth is highly dependent on ability to secure USFDA approval for the facilities. We have assumed an approval in H2CY10, at least for the two Bangalore facilities. Any disappointment on this front will significantly impact estimates.

❑ Potential disruption in partnering deals

Strides' partnership deals with Big Pharma companies, especially Pfizer, are integral to its growth strategy. Any disruption in these deals will significantly impact Strides' future growth outlook.

Annexure

❑ 2009 – Business reorganization

During 2009, Strides undertook a comprehensive business restructuring exercise to reorganize the overall operations along three clear business lines including specialties (injectables), pharmaceuticals and branded generics.

As part of this court-approved scheme of restructuring,

- Strides merged four of its subsidiaries with itself
- Fairly valued some of the assets of the company
- Created a reserve for business restructuring out of any surpluses arising from these revaluations
- Transferred the specialties business (injectables business) along with R&D to SSPL (Strides Specialty Private Limited) , a wholly owned subsidiary

The details of the net surplus created by revaluation of assets as part of the scheme which was transferred to the business restructuring reserve are as follows:

Amount credited to BRR

Particulars	(Rs m)
Investment in SSPL (injectable business) – reflected in goodwill	5,856
Land	754
Machineries	281
Others	146
Net Amount credited to BRR	7,038

Source: IDFC Securities Research, Company

During the year, Strides also opted to write off Rs4.2bn worth of expenses against the surplus credited to BRR. As a result of these accounting treatments in the restructuring exercise, Strides had a balance of Rs2.8bn in BRR at the end of the year, thereby effectively boosting the net-worth by that amount.

The key items of write-off

Particulars	(Rs m)
Impairment of Fixed Assets	73
Impairment of Goodwill	1,935
Impairment of Current Assets	903
Amortization of brands	115
Compensation in respect of product returns and early termination of procurement contract	365
Deferred Employee Compensation (including cost under ESOP)	678
Restructuring and other expenses	117
Total expenses debited to BRR	4,185

Source: IDFC-Securities Research, Company

❑ 2007 – a year of complex transactions

Earlier in 2007, a cash-strapped Strides undertook a series of transactions, primarily with Aspen, to streamline its business and generate funds for growth. These transactions broadly included:

- Divestment of 50% stake (later increased to 51%) in its Latin American holding company to Aspen for a net consideration of $45m. Aspen also infused a further sum of $94m in the business towards meeting the financial obligations of the holding company. In 2008, Aspen entered into an agreement with Strides to buy a call option for Strides' residual 49% stake in the holding company at $80m. Till 2009, Strides was carrying 49% of its residual investment in this holding company at $70m. As part of the overall consideration paid by Strides for its recent buyback of Campos facility, which was part of the holding company assets, Aspen exercised this option at zero value.
- Forming a 50:50 JV with Aspen for developing the oncology business. Aspen effectively paid $42m cash towards buying stake in the JV while Strides contributed IP and manufacturing assets. During Q2CY10, Strides announced its intent to buy back Aspen's 50% stake in the JV for $117m, reflecting the value created by the JV primarily through a mega partnering deal with Pfizer.
- Shut down of the soft gelatin manufacturing facility in the US. It involved a charge of Rs522m during the year.

❑ Recent M&A deals in injectables space

- ***Hospira-Orchid deal:*** Hospira recently paid US$400m (~5.5x revenues) to buy out Orchid Pharma's injectables business (primarily cephalosporin and betalactams) including the manufacturing plant and related IP. We estimate Orchid had 37 ANDA filings for these products including orals and injectables. Strides believes that its ANDA filings/ approvals include almost all the injectable products that formed part of this transaction including the much-vaunted Tazo Pip. Further, these cephalosporin and betalactams filings are only one component of Strides' overall ANDA filings portfolio. Incidentally, Strides currently sells Tazo Pip in EU markets and has also filed the ANDA for the US market.
- ***Novartis-EBEWE deal:*** Earlier in the year, Novartis signed a definitive agreement with EBEWE Pharma to acquire the latter's specialty generic injectables business for an all cash consideration of EUR 925m (US$1.2bn). EBEWE Pharma recorded $272m of sales and $77m of operating income for 2008. This valued EBEWE at 4.8x sales on trailing basis. Novartis will acquire the research, development and manufacturing assets of this business, including tangible assets along with a production site in Austria, as well as intellectual property and related expertise.

Income statement

Year to Dec 31 (Rs m)	CY07	CY08	CY09	CY10E	CY11E
Net sales	**7,443**	**10,203**	**13,047**	**18,435**	**23,008**
% growth	*0.2*	*37.1*	*27.9*	*41.3*	*24.8*
Operating expenses	7,667	9,507	11,178	14,561	17,983
EBITDA	**(224)**	**696**	**1,869**	**3,874**	**5,025**
% growth	*(118.1)*	*(410.5)*	*168.4*	*107.3*	*29.7*
Other income	1,254	193	236	200	200
Net interest	(699)	(847)	(759)	(1,277)	(1,510)
Depreciation	377	401	492	841	1,028
Pre-tax profit	(209)	296	1,315	1,957	2,687
Deferred Tax	(67)	(24)	(61)	0	0
Current Tax	238	131	280	352	484
Profit after tax	**(380)**	**188**	**1,096**	**1,604**	**2,203**
Minorities	169	1,803	2,585	2,585	2,585
Non-recurring items	0	853	114	0	0
Net profit after non-recurring items	(365)	1,080	1,096	1,604	2,203
% growth	*(190.7)*	*(395.8)*	*1.5*	*46.4*	*37.3*

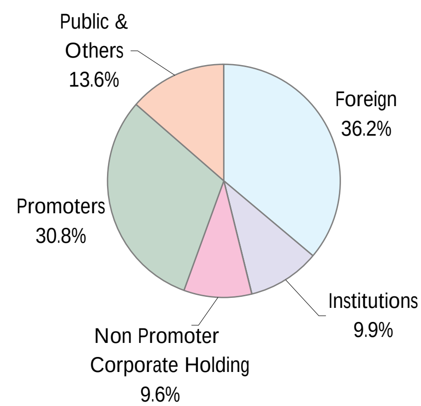
Key ratios

Year to Dec 31 (Rs m)	CY07	CY08	CY09	CY10E	CY11E
EBITDA margin (%)	(3.0)	6.8	14.3	21.0	21.8
EBIT margin (%)	(8.1)	2.9	10.6	16.5	17.4
PAT margin (%)	(4.9)	2.2	7.5	8.7	9.6
RoE (%)	(10.1)	5.1	11.7	13.9	16.7
RoCE (%)	(4.4)	1.6	5.9	10.0	10.9
Gearing (x)	4.4	2.2	1.3	1.6	1.7

Valuations

Year to Dec 31 (Rs m)	CY07	CY08	CY09	CY10E	CY11E
Reported EPS (Rs)	(10.4)	27.0	27.3	34.6	47.5
Adj. EPS (Rs)	(10.4)	5.7	24.4	34.6	47.5
PER (x)	n/a	74.8	17.3	12.2	8.9
Price/Book (x)	5.1	2.8	1.6	1.6	1.4
EV/Net sales (x)	3.5	3.1	2.5	2.2	2.0
EV/EBITDA (x)	(115.2)	44.8	17.8	10.6	9.0
EV/CE (x)	1.6	1.6	1.2	1.2	1.1

Shareholding pattern



As of March 2010

Balance sheet

Year to Dec 31 (Rs m)	CY07	CY08	CY09	CY10E	CY11E
Paid-up capital	842	892	894	894	894
Reserves & surplus	1,924	3,262	7,417	8,782	10,692
Total shareholders' equity	2,929	5,956	10,896	12,261	14,170
Total current liabilities	3,720	3,599	5,056	8,732	8,664
Total Debt	12,774	13,020	14,568	19,568	23,568
Deferred tax liabilities	107	87	34	34	34
Other non-current liabilities	801	611	1,744	1,528	1,966
Total liabilities	17,402	17,317	21,402	29,862	34,232
Total equity & liabilities	**20,331**	**23,273**	**32,298**	**42,122**	**48,402**
Net fixed assets	7,428	6,385	9,319	17,200	20,862
Investments	19	3,464	3,414	3,414	3,414
Total current assets	7,353	7,475	9,460	11,404	14,022
Deferred tax assets	3	43	11	11	11
Other non-current assets	5,527	5,905	10,094	10,094	10,094
Working capital	3,633	3,876	4,404	2,672	5,359
Total assets	**20,331**	**23,273**	**32,297**	**42,122**	**48,402**

Cash flow statement

Year to Dec 31 (Rs m)	CY07	CY08	CY09	CY10	CY11E
Pre-tax profit	(209)	296	1,315	1,957	2,687
Depreciation	377	401	492	841	1,028
Chg in Working capital	348	(1,591)	(186)	1,561	(2,735)
Total tax paid	(238)	(131)	(280)	(352)	(484)
Ext ord. Items & others	325	(190)	1,133	(216)	439
Operating cash Inflow	602	(1,216)	2,475	3,790	935
Capital expenditure	(5,821)	264	(7,614)	(8,722)	(4,690)
Free cash flow (a+b)	(5,219)	(952)	(5,139)	(4,932)	(3,755)
Chg in investments	(4)	(3,445)	50	-	-
Debt raised/(repaid)	7,255	246	1,548	5,000	4,000
Capital raised/(repaid)	1	50	2	-	-
Dividend (incl. tax)	(131)	(7)	-	-	-
Misc	(883)	2,759	3,883	(239)	(294)
Net chg in cash	1,018	(1,348)	344	(171)	(49)

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Explanation of Ratings:

1. Outperformer: More than 5% to Index
2. Neutral: Within 0-5% to Index
3. Underperformer: Less than 5% to Index

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