Initiating Coverage | Sector: Pharmaceuticals

Strides Arcolab

On target

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Strides Arcolab: On target

Glossary

Lyophilization: Lyophilization (also known as freeze-drying) is a dehydration process typically used to preserve a perishable substance or make the material more convenient for transport. Pharmaceutical companies often use freeze-drying to increase the shelf life of products, such as vaccines and other injectables.

Oncology: Oncology is a branch of medicine that deals with tumors (cancer).

Peptides: Peptides are short polymers of amino acids linked by peptide bonds. They have the same chemical structure as proteins, but are shorter in length.

Controlled substance: A controlled substance is generally a drug or chemical whose manufacture, possession and use are regulated by a government. This may include illegal drugs and prescription medications like psychoactive substances.

Penems, Penicillins, Cephalosporins: These are various classes of antibiotic medicines.

Ophthalmology: Ophthalmology is the branch of medicine that deals with the anatomy, physiology and diseases of the eye.

Strides Arcolab

BSE SENSEX	S&P CNX	BLOOMBERG	REUTERS
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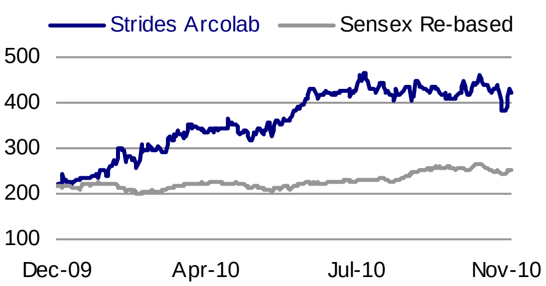
Rs420 Buy

Y/E DECEMBER	2009	2010	2011E	2012E
Net Sales (Rs b)	13.0	18.2	23.5	26.3
EBITDA (Rs b)	1.9	3.3	4.2	4.8
Adj. NP (Rs b)	0.6	1.6	2.2	2.5
EPS (Rs)	11.2	30.0	41.1	46.4
EPS Growth (%)	-314.4	166.6	37.1	13.0
BV/Share (Rs)	88.0	136.7	155.6	172.6
P/E (x)	37.3	14.0	10.2	9.0
P/BV (x)	4.8	3.1	2.7	2.4
EV/EBITDA (x)	16.4	9.5	7.8	6.9
EV/Sales (x)	2.3	1.7	1.4	1.2
RoCE (%)	8.1	11.2	12.0	12.5
RoE (%)	9.9	14.6	14.8	14.8

KEY FINANCIALS	
Shares Outstanding (m)	55.7
Market Cap (Rs b)	23.4
Market Cap (US$ b)	0.5
Past 3 yrs. Sales Growth (%)	20.6
Past 3 yrs. NP Growth (%)	21.9
Dividend Payout (%)	0.5
Dividend Yield (%)	0.0

STOCK DATA	
52-W High/Low Range (Rs)	478/215
Major Shareholders (as of September 2010)	(%)
Promoter	34.7
Domestic Inst	10.4
Foreign	35.4
Others	19.5
Average Daily Turnover	
Volume ('000 shares)	560.7
Value (Rs million)	193.6
1/6/12 Month Rel. Performance (%)	-1/0/77
1/6/12 Month Abs. Performance (%)	-3/16/93

STOCK PERFORMANCE (1 YEAR)



On target

Strides Arcolab is set to transform itself from a general formulations player to a large supplier of specialty products from India. A strong product portfolio, ramp-up of recently expanded capacity and marketing tie-ups with Pfizer and GSK will drive 60% EPS CAGR over CY09-12. Buy with a target price of Rs557, a 33% upside.

Transformation into a specialty company

Strides is set to catapult into a specialty company with revenue contribution from this segment to go up from 27% in CY09 to 45% in CY12. Strides has developed expertise and is an early entrant in low competition, hence more profitable, niche segments in the sterile injectable (SI) space.

Products, marketing tie-ups, manufacturing capacities to drive growth

The company has an impressive product pipeline in the specialty segment: it has 104 ANDA filings and 73 ANDAs awaiting approval. Besides, large manufacturing capacities (Rs15b capex over CY06-09) are in place to support a revenue scale-up and best-in-class marketing partners like Pfizer and GSK will lead to sustainable revenue growth. We expect the specialty business to post 46% CAGR over CY09-12. Licensing income from its partners will contribute US$175m over CY10-12, improving EBITDA margins and return ratios.

Gearing to fall from 2.6x in CY09 to 1.1x in CY12

The company's internal cash flow and debt refinancing will fund its financial commitments of ~US$250m by CY12. Debt is expected to be stagnant at Rs16b over CY10-12, reducing gearing from 2.6x in CY09 to 1.1x in CY12. Interest coverage ratio will almost double from 1.8x to 3.4x during the period.

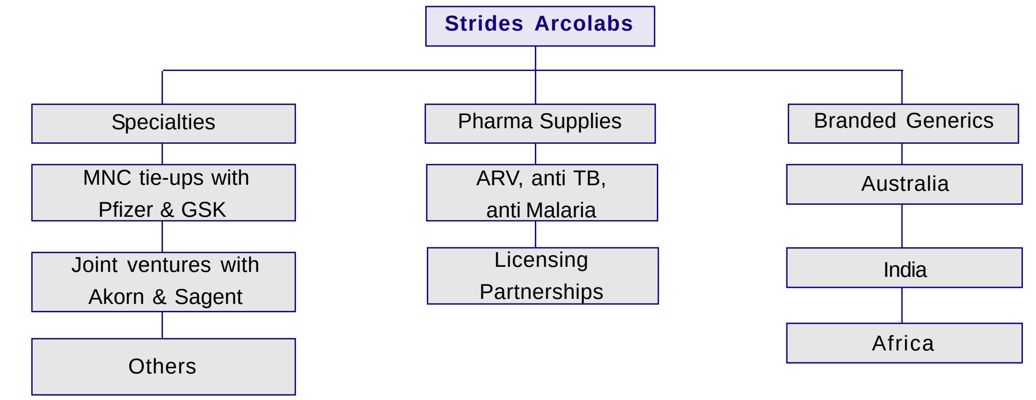
CY09-12 EPS CAGR of 60%, target price Rs557, Buy

We estimate Strides will post earnings CAGR of 60% over CY09-12, led by ramp-up in revenues from the SI segment and core EBITDA margin expansion in line with a changing product mix and higher capacity utilization. Return ratios are set to improve over CY09-12 and gearing will decline from 2.6x in CY09 to 1.1x in CY12. Given the expected growth in earnings and improving business fundamentals, we believe the stock will offer impressive returns. We initiate coverage with a **Buy** recommendation and target price of Rs557 (12x CY12E EPS), an upside of 33%.

Business model

Established in 1990, Strides is an integrated manufacturer and exporter of finished pharmaceutical dosage forms, both branded and generic with 14 manufacturing facilities in six countries. It has collaborations with five of the top 10 global pharmaceutical players and a presence in over 75 countries. Strides recently reorganized its business into three divisions, specialties, pharmaceuticals and branded generics.

Business model



Source: Company/MOSL

Specialties: the core business

Strides is targeting specialty pharmaceuticals, comprising SIs, as a core business. The company has developed manufacturing infrastructure in this segment, including one of the largest lyophilization capacities in the world. The product pipeline includes 104 product filings in regulated markets and over 100 are being developed. The product portfolio includes therapeutic areas like high potency drugs (oncology, peptides and controlled substances), antibiotics, penems, penicillins, cephalosporins and ophthalmics. Strides has tied up with Pfizer to market its products in regulated markets, and with GSK, to market them in emerging markets. It gets meaningful licensing income from the deals.

Pharma supplies: a legacy business

This business includes non-injectable products sold through its partners, in regulated and semi-regulated markets. It has taken global disease initiatives under which it supplies anti-retrovirals, anti-malaria and anti-TB drugs under programs funded by agencies like UNITAID and PEPFAR.

Branded generics

Strides has a direct marketing presence in a few countries where it sells branded generic products. Australasia is its largest geography followed by Africa and India. It made acquisitions in this segment to establish or expand its presence in some geographies.

Promoter background

Arun Kumar

Arun Kumar is Strides' Managing Director and Vice-chairman of the board of directors. He is a promoter and one of the founders of the company. He began his career in the exports department of Bombay Drugs House Ltd. He was General Manager of British Pharmaceuticals Laboratories Ltd and has substantial experience in the national and international pharmaceutical market.

KR Ravishankar

KR Ravishankar is a Non-executive director of Strides. He was an entrepreneur before he joined the board and has nearly two decades of experience in the pharmaceutical industry. In 1988, he started Caryl Pharma, which later merged with Strides. He has experience in manufacturing operations, marketing and finance and has been on the board since March 1994.

Transformation into a specialty company

Strides is set to catapult into a specialty company with contribution from this segment to go up from 27% in CY09 to 45% in CY12. Strides has developed expertise and is an early entrant in lucrative niche segments in the sterile injectable space. The segment offers a favorable market opportunity because of its large market size, low competition and limited global manufacturing capacities.

Specialty segment to contribute 45% revenues by CY12

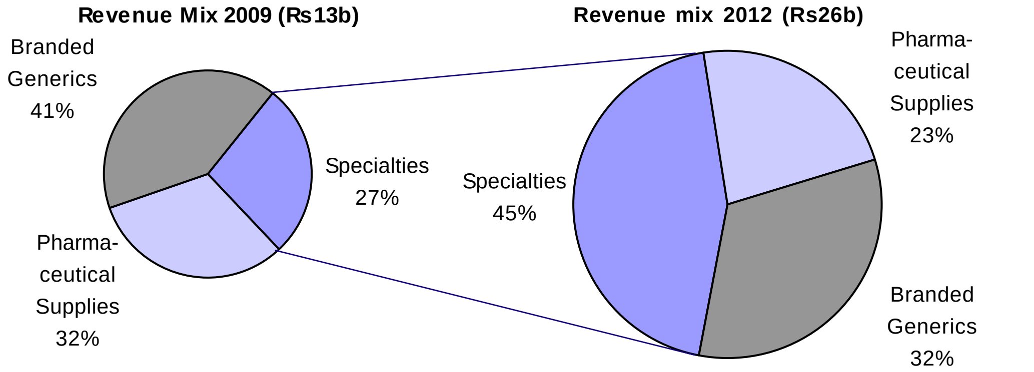
Strides' specialty segment is likely to post 46% revenue CAGR over CY09-12 against 16% for other businesses

Strides' revenue from the specialty segment is likely to post 46% CAGR over CY09-12 against 16% CAGR for other businesses. Strides is set to emerge as one of the largest suppliers of SIs from India due to its expertise in the segment. The specialty segment offers it operating margins of 20-25% while its other buinesses offer margins of 10-15%.

Few global companies have expertise in the specialty injectables space

A long gestation period for development of a large basket of products and complex manufacturing processes are entry barriers to the segment. Few global companies have the expertise in this space. Strides is set to leverage its strength and benefit from this opportunity.

Share of specialty revenues ramping-up



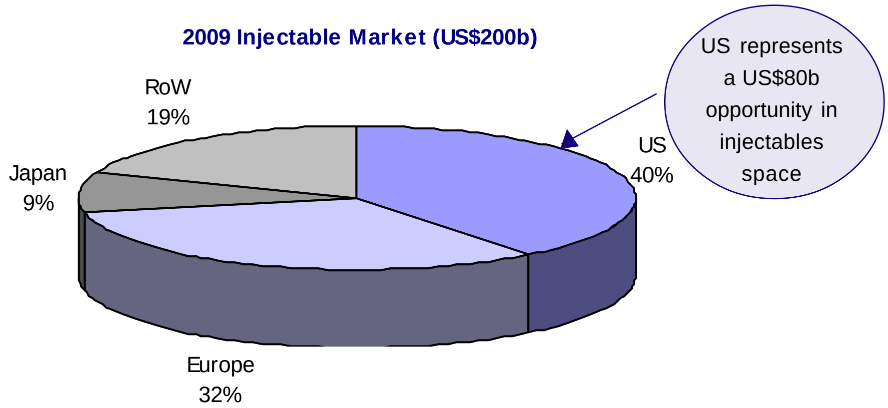
Source: Company/MOSL

Favorable market opportunity

Large market size

Regulated markets comprise about four-fifths of the global injectable market, valued at US$200b. The US dominates the space, contributing ~40% of revenue.

Attractive market opportunity



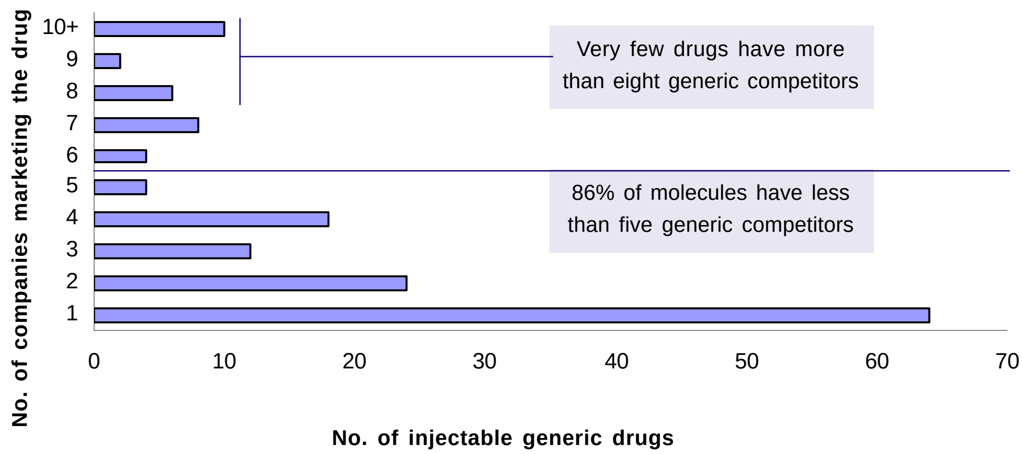
Source: Company/MOSL

Low competition

Low competition in the generic injectables segment has resulted in limited pricing pressure and better profitability for existing players

Low competition in the generic injectables segment has resulted in limited pricing pressure and better profitability for existing players. Even in the US, the largest market for generic injectables, competition is low. For more than half the injectable generics approved since 2004, only a couple of manufacturers have received ANDA approval and 86% of molecules have less than five generic competitors. Only 10 drugs have attracted 8 or more competitors. Most SIs, which are part of the generic injectables segment, are in niche areas and attract little competition.

Low competition ensures better profitability



Source: Company/MOSL

Limited manufacturing capacity

It takes long to set up regulatory-approved manufacturing facilities for injectables, which has led to increasing reliance by innovator companies on players like Strides

There are limited global injectable manufacturing capacities, particularly for lyophilized products. It takes longer to set up regulatory-approved manufacturing facilities for injectables. This has led to increasing reliance by innovator companies on players like Strides, which have demonstrated expertise and capacities in this space.

Products, marketing tie-ups, manufacturing capacities to drive growth

Strides has developed a product pipeline targeting generic and patented products with an opportunity size of US$11b

Strides has developed a product pipeline targeting generic and patented products with an opportunity size of US$11b. Besides, a large product pipeline is awaiting commercialization and licensing. Marketing tie-ups with Pfizer and GSK for global markets offer formidable distribution. Strides has invested Rs15b over CY06-09 to build manufacturing capacities which will help to capitalize the opportunity.

One of the largest product pipelines in the injectable segment

Strides has created a large product pipeline in the injectable segment. The product pipeline includes therapeutic segments like oncology, controlled substances, hormones, penems, penicillins and opthalmalogy. The company, which started filing products in regulated markets in 2006, filed a record 44 sterile ANDAs in 2009.

Early entry in the segment gives Strides an edge

Strides has gained a significant time-to-market advantage as it started developing and filing SI products in 2006. We believe large global MNCs tied up with Strides mainly because of its established product pipeline.

Large product basket: 99 ANDAs filed so far

	2006	2007	2008	2009	2010YTD
Filed in 2006	Filings: 19	Approvals: 1	Approvals: 13 Commercialised: 1	Approvals: 2 Commercialised: 2	Approvals: 1
Filed in 2007		Filings: 8		Approvals: 1 Commercialised: 1	Approvals: 3
Filed in 2008			Filings: 22		Approvals: 9
Filed in 2009				Filings: 44	Approvals: 1

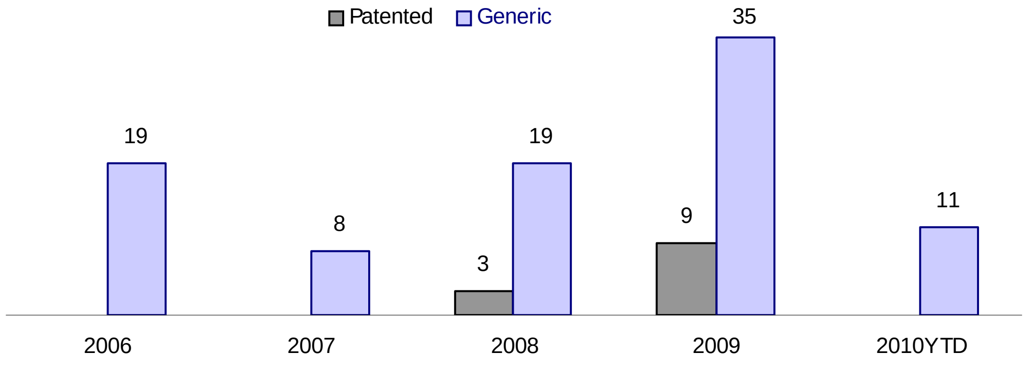
Source: Company/MOSL

Product pipeline targets generic as well as patented products

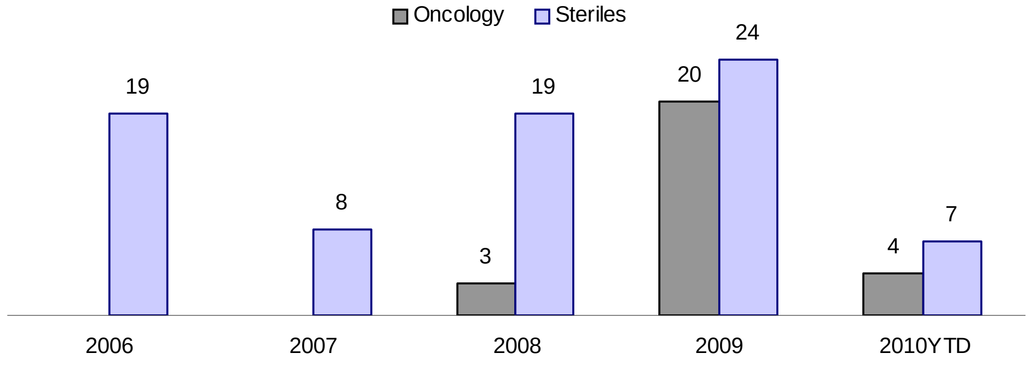
Out of 104 product filings, 92 are off-patent and can be launched as soon as approvals are received

Strides' product pipeline targets a mix of generic and patented products. Out of 104 product filings, 92 are off-patent and can be launched as soon as approvals are received. Other products are likely to go off-patent over next 3-4 years, offering visibility of new launches. About 27 products filed are in niche and lucrative oncology segment. The company will receive approvals for its oncology pipeline by mid-2011.

A large pipeline of generic products offers immediate revenue visibility (no. of ANDAs filed)



Good product mix offers better upside and sustainable growth (no. ANDAs filed)



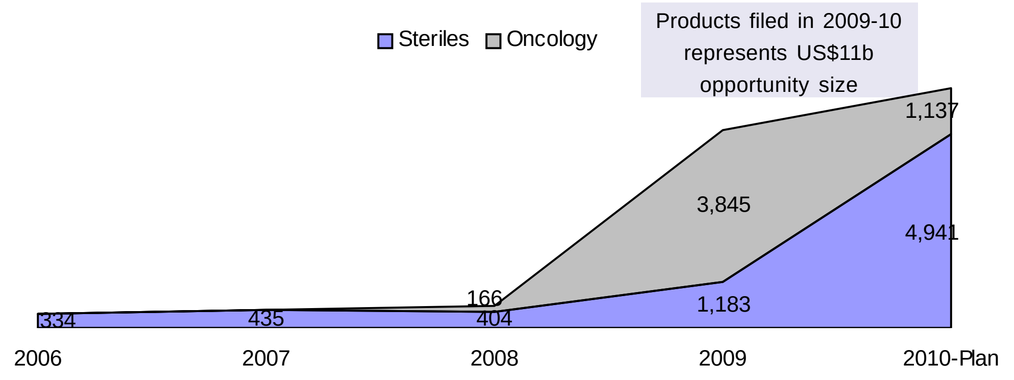
Source: Company/MOSL

Product pipeline targets large market opportunity

We feel the size of the opportunity (US$11b) will fall when some patented products lose exclusivity, though the fall will not be significant considering limited competition in the segment

Strides' product pipeline in the SI segment targets an overall market opportunity of US$11.2b, including product filings planned for CY10. We feel the size of the opportunity will fall when some patented products lose exclusivity, though the fall will not be significant considering limited competition in the segment.

Market value of products filed (US$ m)



Source: Company/MOSL

Strides' ANDA filing rate is 4-5x higher than its peers: It filed a record 44 ANDAs in the SI segment in 2009 and it received 14 approvals in 2010, the highest in the industry

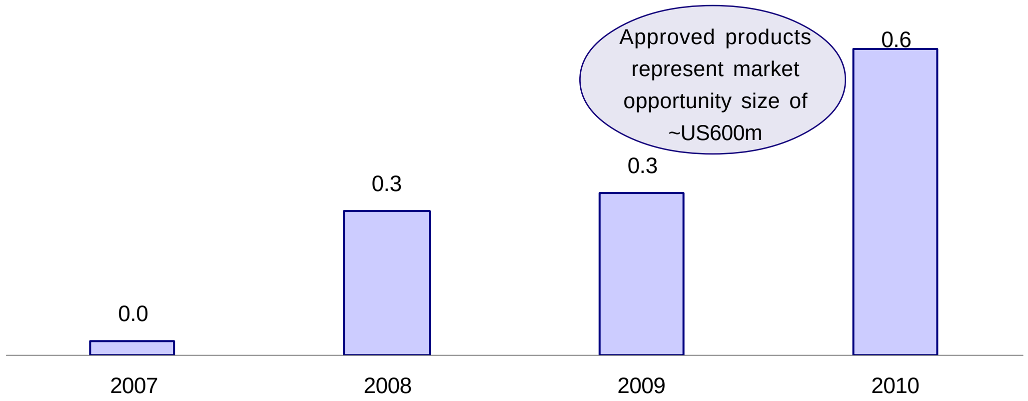
Capabilities facilitate more filings than peers

Expertise in the SI segment has enabled Strides to file products faster than its peers. Its ANDA filing rate is 4-5x higher than its peers. The company filed a record 44 ANDAs in the SI segment in 2009. In 2010, Strides has so far got 14 approvals, which is the highest in the industry.

Most approved products in the sterile segment yet to be commercialized

Due to capacity constraints, Strides has been able to commercialize only four of its 31 approved products in the sterile segment. We expect a significant ramp-up in revenue after commercialization of most of the approved products as they are off-patent and address a market opportunity of ~US$600m.

Market size of opportunity for approved products (US$ b)



Source: Company/MOSL

When Strides launches products in the US through its arrangement with Pfizer, it will be able to corner better market share, helped by Pfizer's strong distribution network and brand equity

Good market share

Out of the four commercialized products, Strides and its marketing partner have garnered between 15% and 20% market share in three. So far the products have been launched through JV partners. When Strides launches products in the US through its arrangement with Pfizer, it will be able to corner better market share, helped by Pfizer's strong distribution network and brand equity.

Market share in the US

	Vancomycin	Rifampicin	Azithromycin
Addressable market value (US$ m)	157	8	28
No of players	6	3	6
Filing year	2006	2006	2007
Approval date	Dec-08	May-08	Mar-09
Commercialization date	Feb-09	Jun-08	Apr-09
Market share (%)	15	52	18

Source: Company/MOSL

Large product line under development, can be out-licensed

Strides has over 100 products in various stages of development

Strides has over 100 products in various stages of development. Of these, 40 are in an advanced stage of development and can be out-licensed to existing or new partners for various geographies. One of the key differentiating factors of the new deals will be the better monetization of product IPs as Strides plans to out-license new products only when they are in advanced stages of development to derive better value.

Partnership model enables strong front-end in global markets

Strides' JV with Akorn and with Sagent in the US and its marketing arrangement with Pfizer and with GSK have given it an edge over its competitors

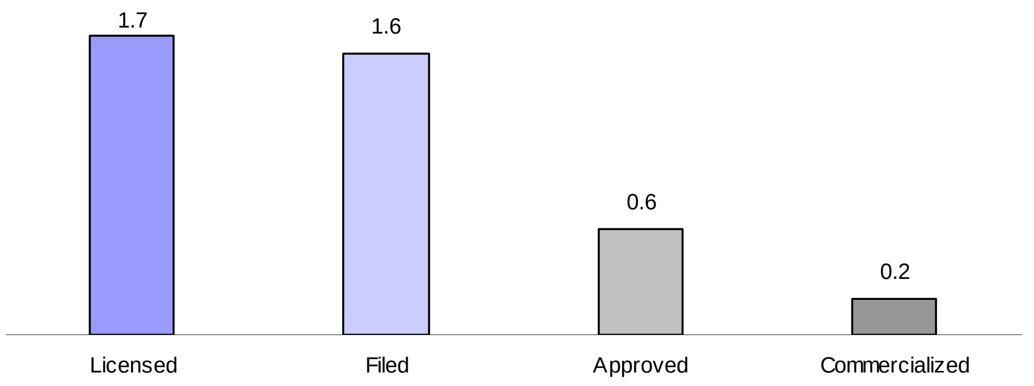
Strides' JV with Akorn and with Sagent in the US and its marketing arrangement with Pfizer and with GSK have given it extensive distribution and an edge over its competitors.The licensing income has enhanced Strides' profitability and we believe the scope of the supply agreements can be expanded.

Joint ventures to ramp-up revenue in near term

Fifty-two injectable products have been licensed to JV partners with an addressable market opportunity of US$1.7b

The company's joint ventures with Akorn and Sagent develop, make and market injectables in the US. Strides has filed 45 products with the US FDA under these JVs and received 25 approvals. The JVs have launched four products due to capacity constraints. Fifty-two injectable products have been licensed to JV partners with an addressable market opportunity of US$1.7b. We believe the JVs will initially ramp-up the specialty segment.

JVs products target Local Market Value of US$1.7b



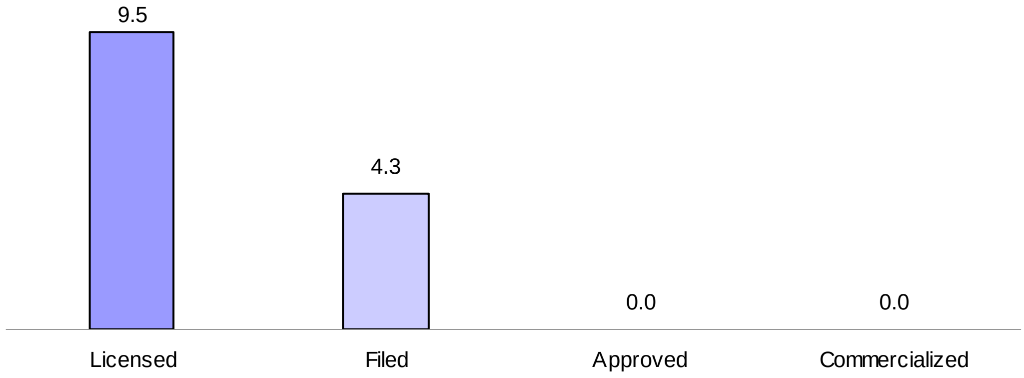
Source: Company/MOSL

Supply arrangements, the key long term driver

Strides has supply agreements with two of the world's largest MNCs for major global markets

Strides signed a supply agreement with two of the world's largest MNCs for major global markets. Its agreement with GSK is for 95 emerging markets and the agreement with Pfizer is for major regulated markets. Licensed products target US$9.5b global opportunity. We think Strides is in a sweet spot as it can leverage the full potential of its specialty product pipeline due to these partners' strong global distribution networks.

JVs products target Local Market Value of US$9.5b



Source: Company/MOSL

As per Strides' agreement with Pfizer it will commercialize 40 off-patent SI and oral products, supplied by Strides, in the US

Pfizer deal targets regulated market: The Pfizer agreement, signed in January 2010, can transform Strides into a larger supplier of oncology products in regulated markets. As per the agreement, Pfizer will commercialize 40 off-patent SI and oral products, supplied by Strides, in the US. Most of the products are injectable cancer medicines.

In May 2010, Strides and Pfizer signed another deal for 38 oncology products to be supplied to other regulated markets such as Europe, Canada, Australia, New Zealand, Japan and Korea. These agreements cover total 45 products. Strides expects product supplies under this deal to start in 1QCY11 and to commercialize all licensed products by CY13.

Strides entered into an agreement with GSK to supply 10 oncology injectable products to be marketed by GSK in 95 emerging markets

GSK supply arrangement targets fast growing emerging markets: Strides entered into an agreement with GSK in July 2008 to supply 10 oncology injectable products (expandable to 45 products), to be marketed by GSK in 95 emerging markets. The first product under this agreement is due to be launched in 2011. We think revenue from the deal will ramp-up slowly given the branded, generic nature of the markets. However, this can become a large opportunity for Strides given the highly profitable therapeutic segment of oncology and possible expansion of the deal to include more products.

We believe these supply arrangements have given Strides a strong distribution front-end in global markets to leverage its capabilities in the specialty segment. We think that besides driving revenue growth, the supplies will enhance capacity utilization, giving Strides the benefit of operating leverage and enhance profitability.

Salient features of the agreements with big pharma companies

- One time licensing fees for acquiring marketing authorizations.
- Strides gets floor price, which will cover the cost of production;
- Strides is entitled to receive a share in profits from product sales by partners;
- Strides to get royalty from partners under certain contracts;
- Contract with Pfizer for the US market is on an exclusive basis, which means that neither Strides can sell these products in the US nor can Strides supply the products to other companies for sale in the US;
- Contracts for all other geographies are on a co-exclusive basis, which means Strides as well as its marketing partners can sell the products;

Through its partnership-based model, Strides earned US$22m in CY09 as licensing income and will book ~US$60m in CY10

Licensing income improves profitability, resources

Through its partnership-based model, Strides earned US$22m in CY09 as licensing income and will book ~US$60m in CY10. It indicated that based on the product pipeline, annual licensing income of US$50m-60m would be sustainable over the next couple of years. The licensing income is expected to be used to fulfill Strides' financial obligations.

Strides has also changed its strategy to out-license products. It will out-license products when they are in an advanced stage of development/approval so that they can fetch optimal value.

Strides invested Rs15b on its specialty injectables manufacturing capacities over the past four years and four of its plants await US FDA approval

Manufacturing capabilities, infrastructure facilitates ramp up

Strides has one of the best and the largest manufacturing infrastructures for SIs. It invested Rs15b in specialty segment manufacturing capacities over the past four years and four of its plants await US FDA approval. It has one of the largest lyophilization (freeze drying) capacities in the world.

Large capacity expansion in recent times

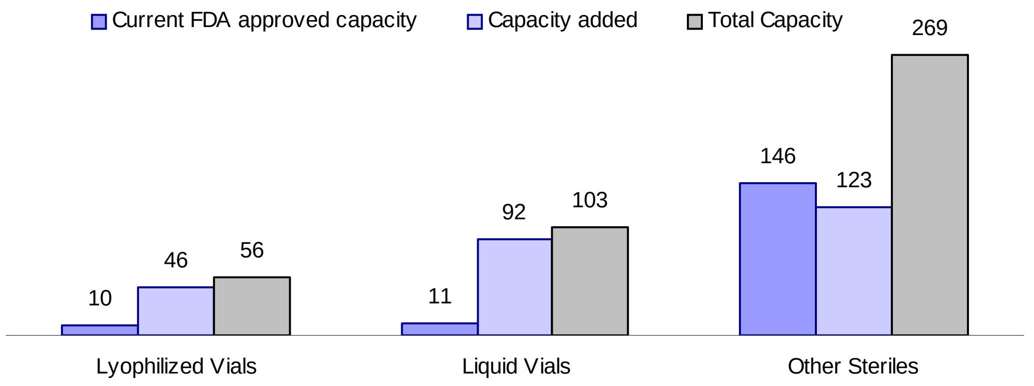
Strides has undertaken large capacity expansion in major areas. Its capacity to make lyophilized vials (non-oncology) expanded from 10m to 56m units and that of liquid vials expanded 9.4x from 11m to 103m units. Capacities for other sterile forms have almost doubled to 269m units from 146m units.

Capacity as per dosage formats (units m)

Format	Facility	USFDA Approved Capacity	Total Capacity
Lyo (non-oncology)	SPD I	10	10
	SPD II	-	40
	SPD III	-	6
Pre-filled syringe	SPD I	9	9
	SPD III	-	18
	Oncology	-	2
Liquid vials	SPD I	11	11
	SPD II	-	70
	SPD III	-	6
	Oncology	-	16
Ampoules	SPD I	20	20
	SPD III	26	26
Lyo (oncology)	Oncology	-	7
DPP (non-pen & ceph)	SPD I	14	14
	SPD II	-	30
DPP (penicillins)	Betalactum	33	33
	Penicillin Block	-	33
DPP (cephalosporins)	Cepha Block	44	44
DPP (penems)	Penem Block	-	33
Total Units		**167**	**428**

Source: Company/MOSL

Significant capacity expansion (units m)



Source: Company/MOSL

Regulatory compliance

Strides' zero-observation track record in all US FDA inspections, indicates stringent standards in complying with regulatory norms

Strides maintains stringent standards to comply with regulatory norms at its manufacturing facilities. This is evident from its zero-observation track record in all US FDA inspections so far. Strides has undergone 15 inspections by the US FDA/EMEA/PIC over the past year across all its facilities.

Clean history of regulatory compliance

Plant	Year	FDA Audit Observation
Sterile Product Division - I	2007	None
	2009	None
Penicillin	2008	None
Cephalosporin	2009	None

Source: Company/MOSL

Four of Strides' manufacturing units await US FDA approval… We believe after US FDA approval, Strides will be able to ramp-up revenue from sterile injectables

Four units await US FDA approval: Four of Strides' manufacturing units are awaiting US FDA approval, two in Bangalore, one in Brazil and one in Poland. Most of the expansion has been at these facilities. We believe after US FDA approval, Strides will be able to ramp-up revenue in the sterile segment rapidly. The capacities have been approved by other regulatory authorities.

Other businesses to perform well

Pharma supplies - a legacy business

Strides has the world's second largest manufacturing capacity for soft-gelatin capsules, with facilities in India and Italy

Strides' legacy business is pharmaceutical supplies, which includes selling non-specialty products through its partners. It has also taken global disease initiatives under which it supplies anti-retrovirals, anti-malaria and anti-TB drugs to programs funded by agencies such as UNITAID, PEPFAR and the Clinton Foundation.

Strides, a leading global manufacturer of soft-gelatin capsules, has filed 36 ANDAs so far, of which 20 have been approved. It has the world's second largest manufacturing capacity for such capsules, with facilities in India and Italy. Half the revenue in the segment comes from global disease initiatives, which is a low margin, high volume business for Strides.

Branded generics

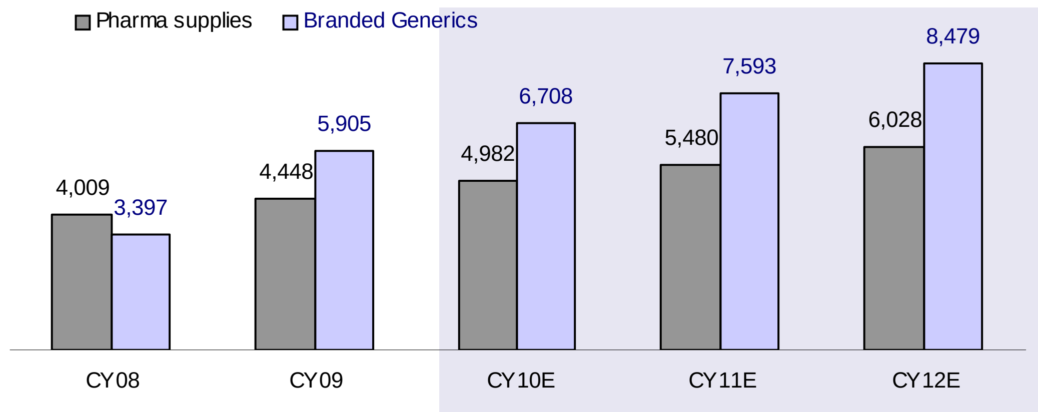
Strides' subsidiary, Ascent Pharma, conducts operations in Australasia, where it markets generic pharmaceuticals, OTC and skin-care products

Strides' CY09 revenue from branded generics was ~Rs6b. Australasia, which contributes ~70% of the revenue, is Strides' largest market, followed by Africa and India. Strides' 60%-owned subsidiary, Ascent Pharma, conducts operations in Australasia, where it markets generic pharmaceuticals, OTC and skincare products. Strides plans to acquire the remaining stake in Ascent Pharma and will shift production of five products from Australia to India to improve margins.

In India, Strides' two business divisions are Grandix and Ray of Life. Grandix, which was acquired two years ago, operates in five South Indian states and covers the therapeutic areas of diabetes, CVS, neurology and female healthcare. The recently launched Ray of Life covers critical-care oncology products.

In Africa, Strides markets generic and branded products and has one manufacturing facilities in Nigeria, and two in India. Its CY09 revenue from the African business was Rs1b.

Pharmaceutical supplies and branded generics businesses to grow steadily (Rs m)



Source: Company/MOSL

Financials: set to improve

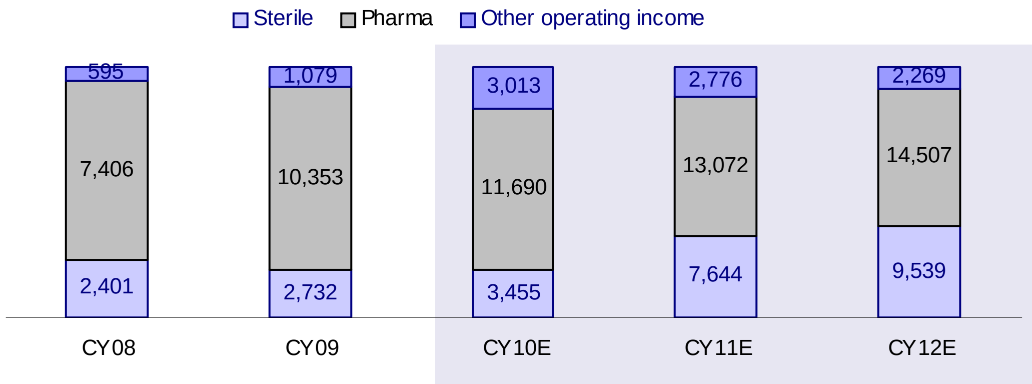
We expect Strides to post earnings of 60% CAGR over CY09-12

We expect Strides to post earnings of 60% CAGR over CY09-12 led by licensing income (US$175 cumulative over CY10-12), a ramp-up in revenues from the sterile segment and core EBITDA margin expansion due to a favorable shift in the sales mix coupled with higher capacity utilization. Return ratios are set to improve with RoCE of 12.5% and RoE of 15% up from 8% and 10% respectively in CY09. Debt is expected to be stagnant at Rs16b over CY10-12, reducing gearing from 2.6x in CY09 to 1.1x in CY12.

Revenue likely to double over CY09-12, CAGR of 26%

Strides is likely to post robust top-line growth of 26% CAGR over CY09-12 led by licensing income from partners and a ramp-up in sales of the sterile segment.

Revenue to double due to the specialty business (Rs m)



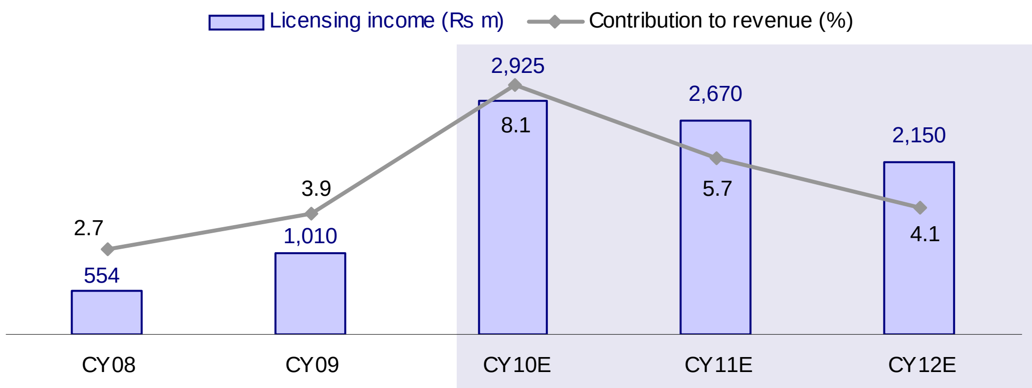
Source: Company/MOSL

Licensing income sustainable over the next few years

Strides earned licensing income of ~US$58m during 9MCY10, which is sustainable in future

Strides received a large sum in licensing income from its partners in CY10, which will be recognized as revenue after it achieves certain milestones related to product development and regulatory approvals. Strides is likely to receive the equal amount in CY11 from its MNC partners. We expect licensing income received in CY10-11 to be recognized over CY10-12. The company earned licensing income of ~US$58m during 9MCY10. The licensing income is sustainable in future due to a development pipeline of over 100 products, which has not been licensed to a partner.

Licensing income to sustain for a couple of years



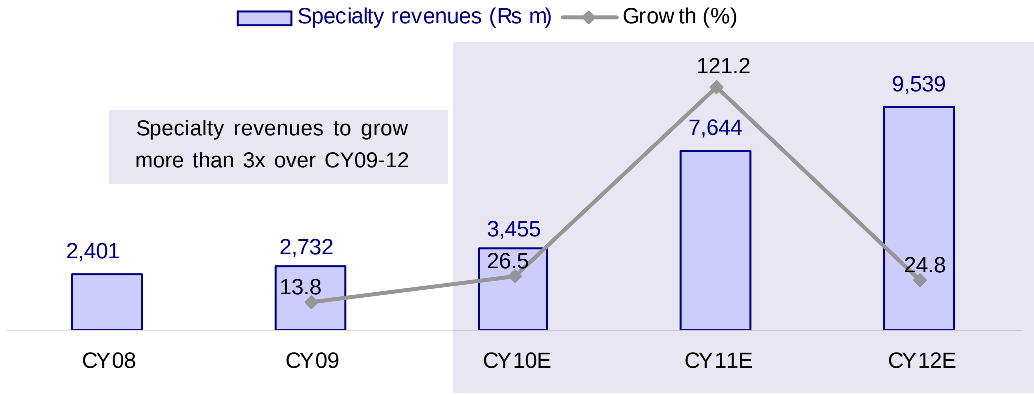
Source: Company/MOSL

Specialty business set to perform impressively

The specialty injectables segment is likely to post sales CAGR of 52% over CY09-12 and we expect revenue from the business to expand from CY11

The specialty segment is likely to post sales CAGR of 52% over CY09-12 at Rs9.5b. We expect revenue from the business to expand from CY11, when most of the approved products, pending commercialization due to capacity constraints, will generate revenue. Strides has launched only four products in the US out of 31 approved ones. We expect commercialization of most of the products in CY11. Besides, supply arrangements with Pfizer and GSK will also begin to contribute revenue from CY11.

Specialty business set to post robust growth



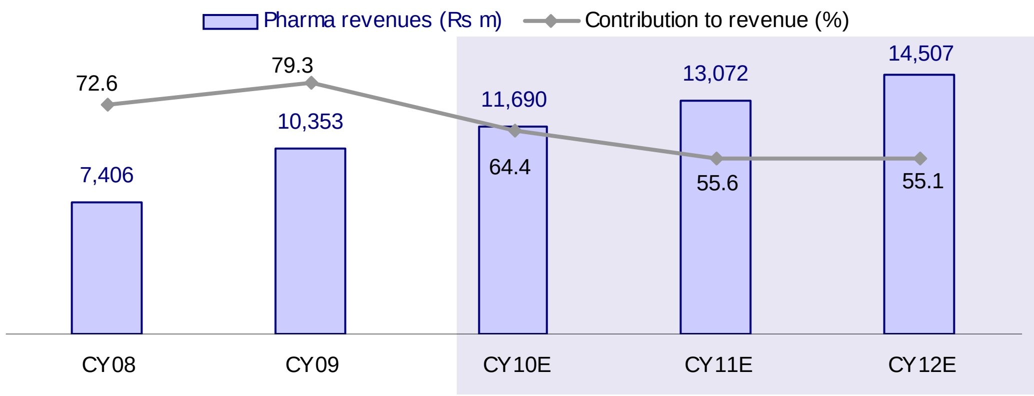
Source: Company/MOSL

Pharma business' contribution to overall revenue to fall considerably

The contribution of the pharma business to revenue will fall from ~80% in CY09 to 55% in CY12

We expect the pharmaceutical business to post 12% revenue CAGR over CY09-12 led by the branded generic segment. The contribution of this business to revenue will fall from ~80% in CY09 to 55% in CY12.

Pharmaceutical business to contribute less in future



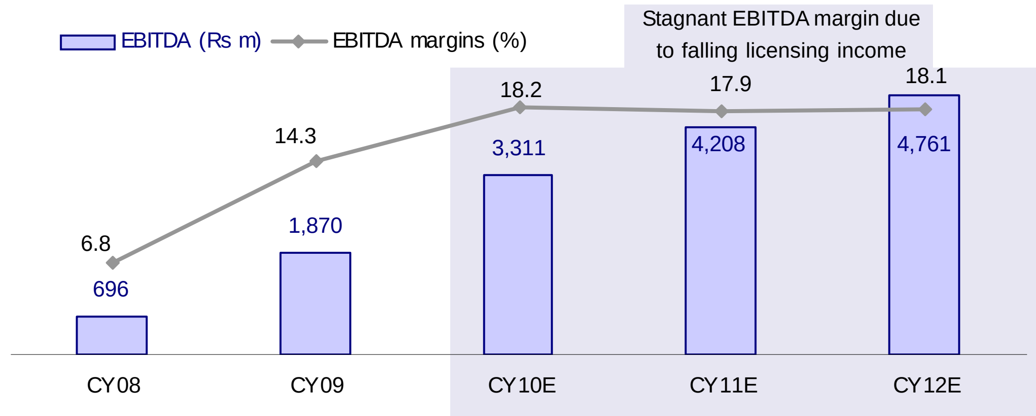
Source: Company/MOSL

Favorable product mix, operating leverage to lead EBITDA growth

We expect Strides to post EBITDA of 37% CAGR over CY09-12 led mainly by higher licensing and development income

We expect EBITDA to post 37% CAGR over CY09-12 led mainly by higher licensing and development income, which is a high-margin revenue stream. Besides, a favorable product mix will boost EBITDA margins. Strides will also benefit from operating leverage as revenues ramp up. We expect Strides to post EBITDA margins of 18.1% in CY12, up from 14.3% in CY09.

Better revenue mix leads to EBITDA margin expansion



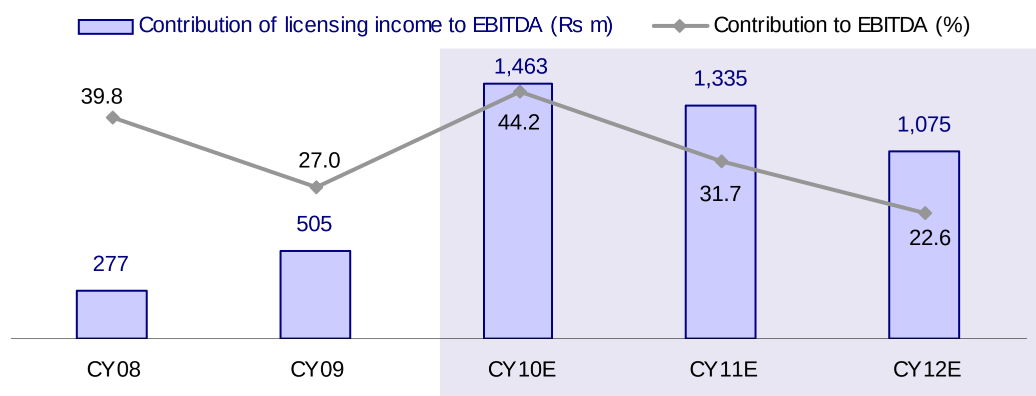
Source: Company/MOSL

Licensing income a leading contributor to margin expansion

Strides' licensing income will be a big driver of EBITDA growth and margin expansion

Strides' licensing income, which has a margin of ~50%, will be a big driver of EBITDA growth and margin expansion. Though licensing income contributes only 4-8% to revenue, contribution to EBITDA is 23-44%.

Licensing income boosts overall margins



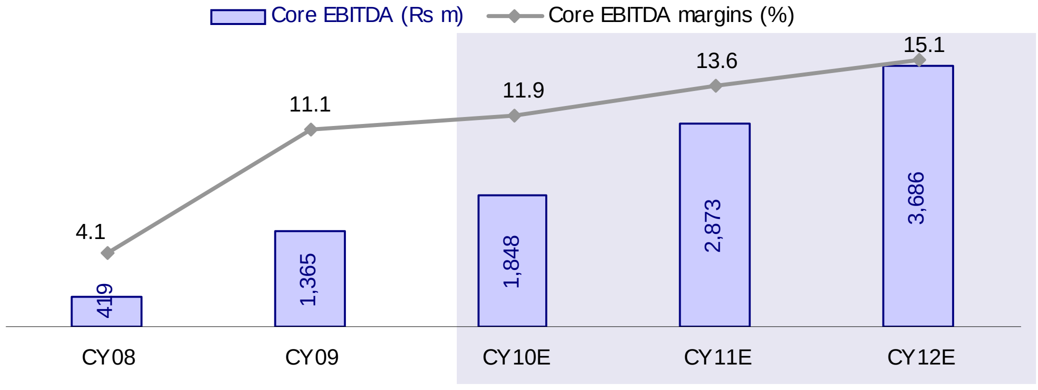
Source: Company/MOSL

Favorable product mix, operating leverage to expand core EBITDA margins

We expect the contribution of the specialty business to core business sales to rise from 23% in CY09 to 40% in CY12

We expect core EBITDA of 39% CAGR over CY09-12. We believe core EBITDA margins (excluding licensing income) are set to improve from 11.1% in CY09 to 15.1% in CY12. The expansion will be led by a better product mix in favor of the specialty segment and the benefit of operating leverage. We expect the contribution of the specialty business to core business sales to rise from 23% in CY09 to 40% in CY12. Besides, large manufacturing capacities are lying idle pending US FDA inspection and approval. The facilities belong to the specialty business and typically have a higher fixed-cost percentage. Once they contribute to revenue, Strides will benefit from the operating leverage.

Core EBITDA margins set to improve with sterile ramp-up



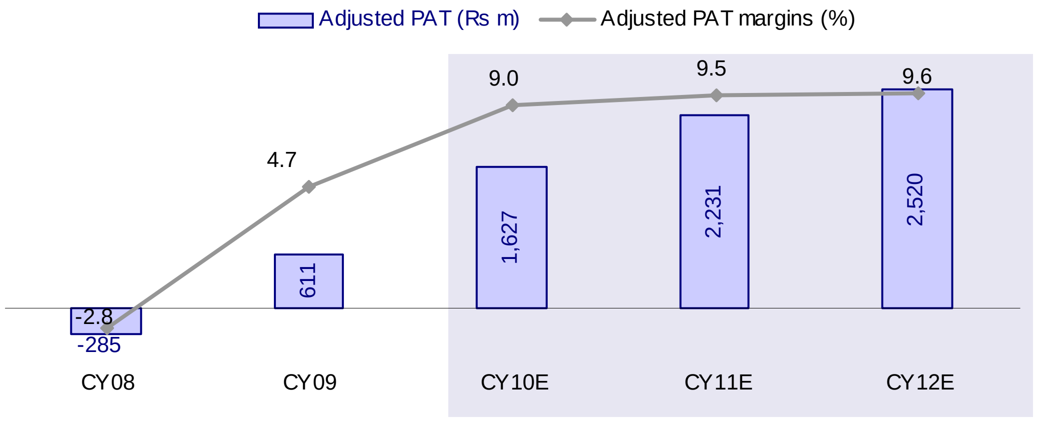
Core EBITDA excludes other operating income *Source: Company/MOSL*

Adjusted PAT expected to grow 4x

We estimate adjusted PAT of 60% CAGR over CY09-12

We estimate adjusted PAT of 60% CAGR over CY09-12 . The performance will be led mainly by robust sales growth, higher licensing, expansion in EBITDA margins and a low base in CY09. CY09 adjusted PAT was very low due to higher interest costs (on borrowed funds to set-up new capacities) which were 55% of EBIT. Going forward, interest costs will pressurize margins but the adverse impact on adjusted PAT will incrementally fall.

Adjusted PAT to increase 4x on a low base



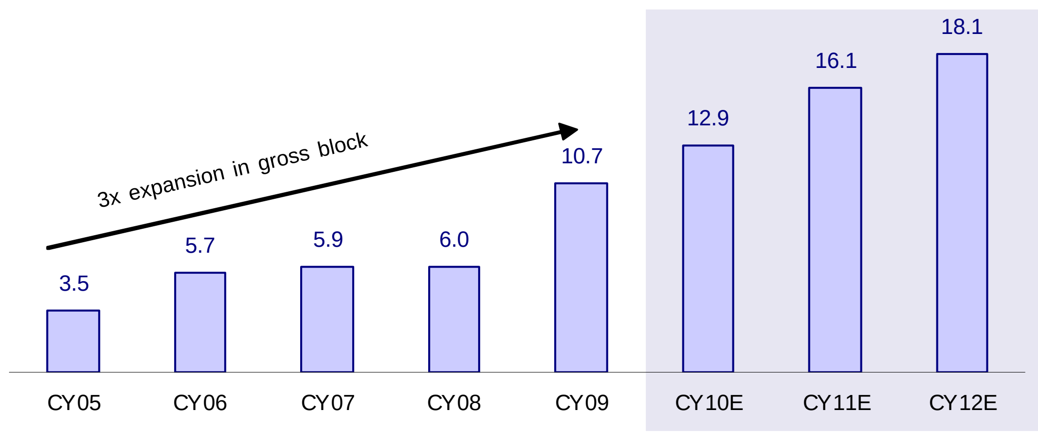
Source: Company/MOSL

High spend on manufacturing capacities

The gross block in the past five years grew 3x from Rs3.5b in CY09 to Rs10.7b in CY12 and we expect it to expand to Rs18b in CY12

Over the past few years Strides has spent large sums on building/acquiring manufacturing facilities, mainly in the specialty segment. The gross block in the past five years grew 3x from Rs3.5b in CY09 to Rs10.7b in CY12. Gross block will expand to Rs18b in CY12.

Gross block trebles over CY05-09 (Rs b)



Source: Company/MOSL

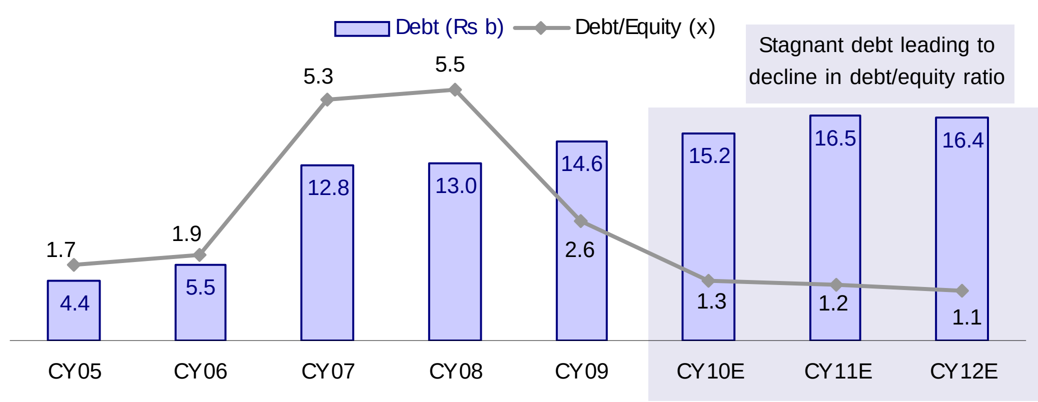
High debt on books

Higher infrastructure spends, not commensurate with revenue and internal cash-flow generation, led to the ballooning of debt

Higher infrastructure spends, not commensurate with revenue and internal cash-flow generation, led to the ballooning of debt. Debt increased significantly from Rs4.4b in CY05 to Rs14.6b in CY09 and the debt/equity ratio rose from 1.7x in CY05 to 2.6x in CY09.

However, we expect debt to stabilize at Rs16b through CY12 and debt/equity ratio to fall to 1.1x as future financial commitments are financed mainly through internal cash-flow.

Debt/equity ratio to fall even though absolute debt stays at the same level



Source: Company/MOSL

Future financial commitments not a concern

We believe Strides will meet its obligations through internal accruals and by refinancing existing debt

Strides has ~US$250m in financial commitments related to various events through CY12. We believe that due to an improving base business, rising licensing income and lower capex, going forward, Strides will meet its obligations through internal accruals and by refinancing existing debt. We estimate overall debt will be constant through CY12.

Summary of financial obligations

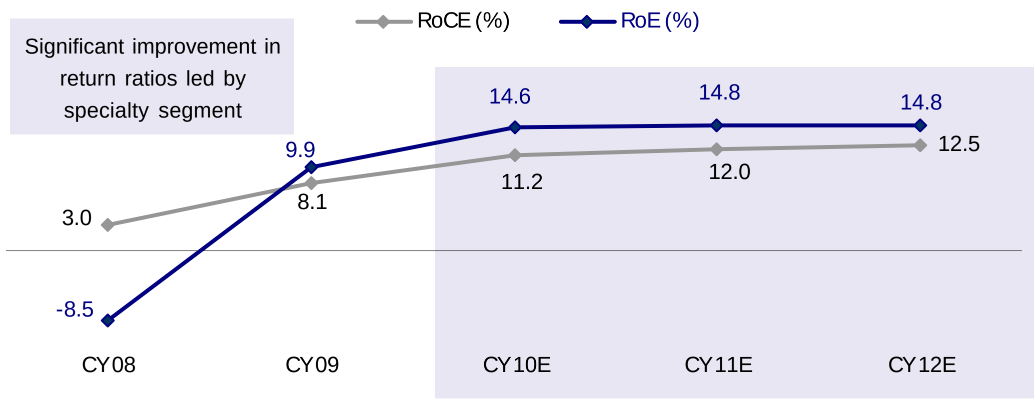
1) In March 2010 Strides entered into an agreement with Aspen to acquire Aspen's penems and penicillin manufacturing plants in Campos, Brazil for US$65m and Aspen's 50% stake in an oncology JV between Strides and Aspen for US$117m. Out of this consideration of US$182m, Strides has made payment of US$67m. The rest is payable by March 2011.
2) Strides raised FCCBs worth US$140m over 2005-07 to fund growth initiatives. Out of this, the first FCCB, worth US$40m, was redeemed in April 2010 along with YTM. Out of the remaining FCCBs worth US$100m, Strides has bought back FCCBs worth US$20m. The remaining FCCBs, worth US$80m, are due for redemption in June 2012. The conversion price of these outstanding FCCBs is Rs461.6/share, which is above the existing market price. In case the FCCBs are redeemed, Strides will have to pay US$116m including YTM. (Our financial estimates assume redemption of the FCCBs).
3) In 2005, Strides issued Cumulative Redeemable Preference shares worth Rs492m, which will be due for redemption in 2012, along with a seven-year cumulative premium. The total redemption amount is ~US$16m.

Return ratios set to improve

We estimate Strides' RoCE and RoE will improve to 12.5% and 14.8% respectively by CY12 from 8.1% and 9.9% respectively in CY09

Owing to the improvement in profitability and the benefit of operating leverage, Strides' return ratios are set to improve, going forward. Strides' RoCE and RoE were 8.1% and 9.9% in CY09 respectively. We estimate RoCE and RoE will improve to 12.5% and 14.8% respectively by CY12.

Return ratios move into double digits



Source: Company/MOSL

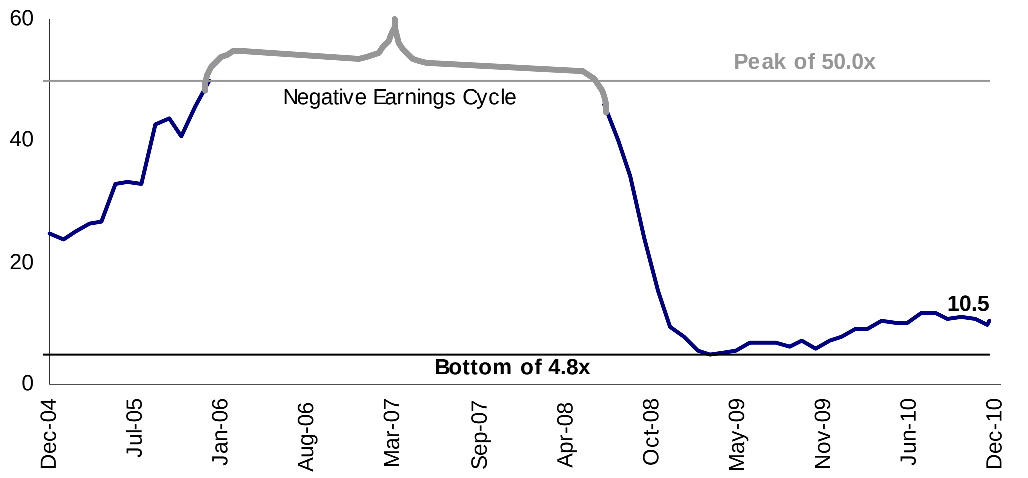
Valuation and view

Strides is set to transform itself from a formulation player to a large supplier of specialty products from India. Strides' strength lies in its broad SI product portfolio, which has enabled it to tie-up with large MNCs like Pfizer and GSK. We believe Strides' expertise in the specialty segment and its formidable product pipeline augur well for it.

We initiate coverage with a Buy recommendation and target price of Rs557, an upside of 33%

We expect Strides to post revenue of 26% CAGR and earnings CAGR of 60% over CY09-12 led by higher licensing income and revenue from the specialty segment. We expect stable earnings in the coming years and improved profitability. Strides has historically traded at an average PE of 10.5x. With improved business fundamentals and strong expected earnings growth over the next couple of years, we believe the stock deserves better valuation. We initiate coverage with a **Buy** recommendation and target price of Rs557 (12x CY12E EPS), an upside of 33%.

Attractive valuations despite recent run-up



Source: Company/MOSL

Peer valuation

Historically, Strides has traded at a significant valuation discount to its peers… but we believe the valuation gap will contract going forward

Historically, Strides has traded at a significant valuation discount to its peers. The discount was justified given the company's low profitability (losses in CY07 and CY08), concerns about high debt with a with debt/equity ratio of 5.5x. However, with the improving business outlook, receding concerns over debt, and earnings visibility after the MNC deals, we believe the valuation gap will contract.

Comparative valuation

Company	EPS (Rs)			P/E (x)			EV/EBITDA (x)			RoE (%)		
	FY10	FY11E	FY12E	FY10	FY11E	FY12E	FY10	FY11E	FY12E	FY10	FY11E	FY12E
Strides Arcolab	11.2	30.0	41.1	37.3	14.0	10.2	16.4	9.5	7.8	9.9	14.6	14.8
Biocon	14.2	16.9	20.3	28.2	23.6	19.7	16.8	13.8	12.1	16.1	16.8	17.4
Aurobindo	78.1	90.6	115.5	16.6	14.3	11.2	12.1	10.8	8.6	30.4	24.5	24.0
Orchid Chemicals	0.6	12.2	14.7	-	25.1	20.8	9.3	13.0	10.9	1.5	6.8	7.5

Source: MOSL

Risks and concerns

Regulatory risks

1. If Strides does not get timely approval for its specialty manufacturing facilities and large product pipeline, its revenue could be impacted.
2. With the US FDA becoming stringent in its audit, regulatory issues related to manufacturing capacities such as data filing, cGMP compliance and data maintenance might arise. In the recent past, many leading generic companies faced US FDA compliance issues.

Large goodwill on the books

Strides has goodwill of Rs13.8b on its books against an estimated net worth of Rs13.6b at the end of CY10. The goodwill has been created due to acquisitions in the past and revaluation of its subsidiaries. In case of impairment charges due to negative change in business dynamics, Strides' profitability will be impacted.

Absence of vertical integration

Strides does not have API manufacturing capacities and sources its API requirements from elsewhere. This leaves it exposed to risks like unavailability of raw material and price fluctuations. That is a reason for Strides' volatile margins.

Foreign exchange volatility

Since Strides derives ~90% of its revenue in foreign currency and has large net receivables in foreign currency, hence it is exposed to fluctuations in currency movements. However, to a large extent, Strides has a natural hedge as its imported raw material comprises significant portion of its material costs and it has certain foreign currency debt on its books.

Financials and valuation

Strong top-line growth led by the specialty segment

PAT to grow 4x over CY09-12

Net worth expected to double in three years

Income Statement (Rs Million)

Y/E December	2007	2008	2009	2010E	2011E	2012E
Net Sales	**7,443**	**10,203**	**13,048**	**18,158**	**23,493**	**26,315**
Change (%)	0.2	37.1	27.9	39.2	29.4	12.0
EBITDA	**-224**	**696**	**1,870**	**3,311**	**4,208**	**4,761**
Margin (%)	-3.0	6.8	14.3	18.2	17.9	18.1
Depreciation	364	399	492	649	798	942
EBIT	**-588**	**297**	**1,378**	**2,662**	**3,410**	**3,819**
Int. and Finance Charges	699	847	759	965	1,026	1,132
Other Income - Rec.	139	193	236	264	304	349
PBT before EO Expense	**-1,148**	**-357**	**855**	**1,961**	**2,688**	**3,036**
Extra Ordinary Expense/(Income)	-803	-1,506	-574	0	0	0
PBT after EO Expense	**-346**	**1,149**	**1,429**	**1,961**	**2,688**	**3,036**
Current Tax	238	131	280	490	672	759
Deferred Tax	-67	-24	-61	-157	-215	-243
Tax	171	108	219	333	457	516
Tax Rate (%)	-49.4	9.4	15.3	17.0	17.0	17.0
Less: Minority Interest	-15	-39	114	0	0	0
Net Profit	**-501**	**1,080**	**1,097**	**1,627**	**2,231**	**2,520**
Adj PAT	**-1,701**	**-285**	**611**	**1,627**	**2,231**	**2,520**
Change (%)	-604.7	-83.3	-314.4	166.6	37.1	13.0
Margin (%)	-22.9	-2.8	4.7	9.0	9.5	9.6

Balance Sheet (Rs Million)

Y/E December	2007	2008	2009	2010E	2011E	2012E
Equity Share Capital	846	910	928	1,034	1,034	1,034
Total Reserves	1,730	3,244	7,241	13,105	15,060	16,817
Net Worth	**2,766**	**4,154**	**8,311**	**14,139**	**16,094**	**17,852**
Minority Interest	169	1803	2585	2585	2585	2585
Deferred liabilities	104	44	23	64	64	64
Total Loans	12,774	13,020	14,569	15,249	16,518	16,403
Capital Employed	**15,813**	**19,021**	**25,487**	**32,037**	**35,261**	**36,903**
Gross Block	11,475	11,896	20,807	26,680	29,930	31,930
Less: Accum. Deprn.	1,653	2,200	2,241	2,890	3,687	4,629
Net Fixed Assets	9,822	9,696	18,566	23,790	26,243	27,301
Capital WIP	3,140	2,596	847	1,933	1,933	1,933
Investments	19	3,464	3,414	3,414	3,414	3,414
Curr. Assets	**7,353**	**7,475**	**9,461**	**11,199**	**14,627**	**16,444**
Inventory	2,011	1,731	2,334	2,822	3,689	4,085
Account Receivables	1,603	3,375	4,161	5,104	6,811	7,708
Cash and Bank Balance	1,918	570	912	577	437	369
Loans & Advances	1,821	1,799	2,054	2,697	3,689	4,282
Curr. Liability & Prov.	**4,521**	**4,210**	**6,799**	**8,299**	**10,954**	**12,188**
Account Payables	3,720	3,599	5,057	6,224	8,400	9,552
Provisions	801	611	1,743	2,075	2,554	2,635
Net Current Assets	**2,832**	**3,265**	**2,661**	**2,900**	**3,672**	**4,256**
Appl. of Funds	**15,813**	**19,021**	**25,487**	**32,037**	**35,261**	**36,903**

E: MOSL Estimates

Financials and valuation

Ratios

Valuation remains attractive

Improvemnet in return ratios led by the specialty segment

Y/E December	2007	2008	2009	2010E	2011E	2012E
Basic (Rs)						
EPS	**-31.3**	**-5.2**	**11.2**	**30.0**	**41.1**	**46.4**
Cash EPS	-1.6	16.2	17.1	22.0	29.3	33.5
BV/Share	30.4	45.6	88.0	136.7	155.6	172.6
DPS	0.0	0.0	1.5	2.7	3.8	2.3
Payout (%)	-1.7	0.5	14.4	12.7	12.4	7.2
Valuation (x)						
P/E	-13.4	-80.1	37.3	14.0	10.2	9.0
Cash P/E	-258.5	25.8	24.5	19.1	14.3	12.5
P/BV	13.8	9.2	4.8	3.1	2.7	2.4
EV/Sales	3.7	2.9	2.3	1.7	1.4	1.2
EV/EBITDA	-124.2	42.0	16.4	9.5	7.8	6.9
Dividend Yield (%)	0.0	0.0	0.4	0.6	0.9	0.6
FCF per Share	-47.5	6.2	-40.7	-41.1	-1.0	18.8
Return Ratios (%)						
RoE	-56.7	-8.5	9.9	14.6	14.8	14.8
RoCE	-3.6	3.0	8.1	11.2	12.0	12.5
Working Capital Ratios						
Asset Turnover (x)	0.5	0.5	0.5	0.6	0.7	0.7
Fixed Asset Turnover (x)	0.9	1.0	0.9	0.9	0.9	1.0
Debtor (Days)	79	121	116	103	106	107
Inventory (Days)	99	62	65	57	57	57
Working Capital Turnover (Days)	45	96	49	47	50	54
Leverage Ratio (x)						
Current Ratio	1.6	1.8	1.4	1.3	1.3	1.3
Interest Cover Ratio	-0.8	0.4	1.8	2.8	3.3	3.4
Debt/Equity	5.3	5.5	2.6	1.3	1.2	1.1

Cash Flow Statement (Rs Million)

Rs10b in operating cash flow expected over CY10-12

Y/E December	2007	2008	2009	2010E	2011E	2012E
Oper. Profit/(Loss) before Tax	-224	696	1,870	3,311	4,208	4,761
Interest/Dividends Recd.	139	193	236	264	304	349
Direct Taxes Paid	-263	-168	-240	-293	-457	-516
(Inc)/Dec in WC	1,198	-1,781	946	-574	-912	-652
CF from Operations	**849**	**-1,061**	**2,812**	**2,708**	**3,143**	**3,942**
EO Expense / (Income)	-803	-1,506	-574	0	0	0
CF from Operating incl EO Exp.	**1,652**	**445**	**3,387**	**2,708**	**3,143**	**3,942**
(inc)/dec in FA	-5,676	123	-7,162	-6,959	-3,250	-2,000
(Pur)/Sale of Investments	-4	-3,445	50	0	0	0
CF from Investments	**-5,681**	**-3,321**	**-7,111**	**-6,959**	**-3,250**	**-2,000**
Issue of shares	5	64	18	106	0	0
(Inc)/Dec in Debt	6,897	1,880	2,331	680	1,269	-116
Interest Paid	-699	-847	-759	-965	-1,026	-1,132
Dividend Paid	-9	-5	-174	-206	-276	-182
Others	-624	436	2,651	4,301	0	-580
CF from Fin. Activity	**5,571**	**1,528**	**4,067**	**3,916**	**-33**	**-2,010**
Inc/Dec of Cash	**1,543**	**-1,348**	**342**	**-335**	**-140**	**-68**
Add: Beginning Balance	375	1,918	570	912	577	437
Closing Balance	**1,918**	**570**	**912**	**577**	**437**	**369**

E: MOSL Estimates

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NOTES

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Disclosure of Interest Statement	Strides Arcolab
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No