

Initiating Coverage

Strides Arcolab Ltd. (STAR IN)

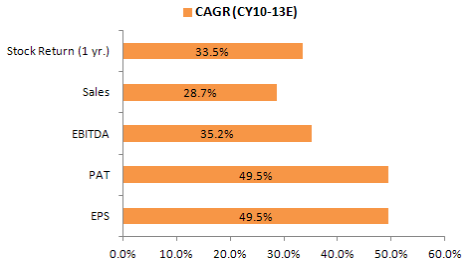
January 30, 2012

Industry **Pharmaceuticals**

Ready for a big stride in global injectables

BUY (CMP: ₹ 507)

Mkt Cap ₹ 29.6bn; USD592mn



Strides Arcolab (Strides) is a specialty injectable player with decent presence in the branded generic space. Strides has emerged as one of the competitive suppliers of injectables globally, led by its rapid expansion of global injectable filings (especially in advanced markets like the US and Europe), multiple expansion of regulatory approved capacities and simultaneous distribution pacts with global leaders like Pfizer, Glaxo, etc. Moreover, the strategic divestment of relatively low-margin pharma business improves overall profitability and reduces all balance sheet concerns of higher debt and FCCB repayment. Going forward, we estimate Strides' continuing business EBITDA and profit will deliver over 3x growth each during CY10-13E. We initiate coverage with a BUY recommendation with a Target Price of ₹ 653, implying an upside of 29%.

Price	507
Target Price	653
Expected share price return	28.8%
Expected dividend yield	1.0
Expected total return	29.8%

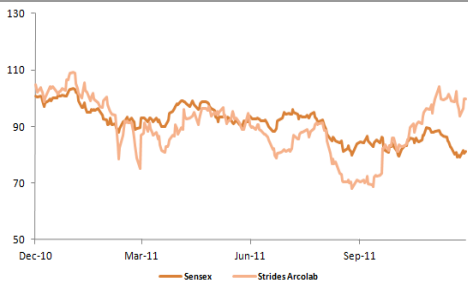
Divestment of Ascent Pharma improves profitability and deleverages balance sheet

Strides has divested its 94% shareholding in its Australian subsidiary - Ascent Pharmahealth (Ascent Pharma) to Watson Pharma for a cash consideration of US\$ 393mn. With this divestment, Strides' revenue contribution from high-margin specialty injectables operation will jump from 43% in CY11 to over 70% in CY12, resulting in an improvement in Strides' overall profitability. With the sale proceeds of the business, Strides repays debt worth \$250mn (i.e. ~50% of outstanding), which ultimately will improve the debt/equity position from ~2x in CY11 to 0.7x in CY12 and 0.6x in CY13.

Market Data

Market Cap (₹ mn)	₹. 29.6bn/ US\$592mn
Share Cap (mn)	58.4
52 wk High/Low (₹)	523 /276
Avg. Volume (weekly)	2.2mn

(Price Performance (RIC:STAR.BO, BB: STR IN))

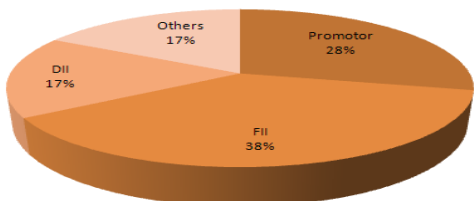


Specialty injectables drive value growth

Strides' specialty injectable operation is the core focus area of Strides Arcolab, which got strengthened (and accounts >70% of total sales) on the divestment of Ascent Pharma. We believe injectables will drive value growth for the company, led by its preparedness in terms of healthy product filings for regulated markets, timely expansion of facilities and well laid distribution pacts with global marketing leaders like Pfizer, Glaxo, etc. Also, robust global injectable opportunities (of over \$200bn) with limited competition and minimal pricing pressure will augur well for Strides. We estimate Strides' injectable sales will grow at CAGR of 37% over CY10-13E to ₹17.6bn, resulting in margin expansion of ~500bps.

Shareholding Pattern

(As on 30th Dec 2011) (%)



Unprecedented drug shortages in the US multiply opportunity in injectables

The drug shortages in the US have increased three fold from 61 molecules under shortage in 2005 to 178 molecules in 2010 and 168 molecules as of October 2011. Of the total molecules under shortage, injectables represent the largest chunk with 83% (i.e. 139 nos.) in 2011 that jumped from 43% in 2006. The annual value of drugs under shortage in the US rose to US\$ 4.2bn in 2011. Out of Strides' 53 USFDA injectable approvals, 20 injectables are currently in the list of shortages in US market with a potential market of over \$ 1000mn. Incidentally, the shortages have been triggered by closure of plants (due to regulatory issues in manufacturing) and the revival of which are not anticipated within the next 12 months.

Financials (₹ Mn)	CY11e	CY12e	CY13e
Revenue (Excl. Ascent)	16630.0	19343.7	23725.7
Growth %	49.5	16.3	22.7
EBITDA (Excl. Ascent)	3715.7	4623.2	5765.3
EBITDA margin %	22.3	23.9	24.3
Rep.PAT (Excl. Ascent)	1310.6	2408.0	3270.9
Growth %	33.8	83.7	35.8
EPS (₹) (Excl. Ascent)	22.5	41.3	56.0
EV/EBITDA	10.6	7.0	5.2
EV/Sales	2.1	1.7	1.3
ROE %	12.6	44.2	13.7
ROCE %	10.7	12.1	14.4
P/E (x)	19.0	3.2	9.0

3x growth in EPS over CY10-13, healthy balance sheet; "BUY" with TP ₹ 653/share

Powered by robust specialty injectable growth, strategic divestment of low-margin pharma business and consequent improvement in overall profitability, we expect Strides to deliver >3x growth in its continuing business EBITDA and profits over CY10-CY13E to ₹ 5.76bn and ₹ 3.27bn, respectively. Further, the strong free cash flow generation (i.e.>21bn over CY10-13E) improves balance sheet health. Hence, we initiate coverage with a BUY recommendation with a Target Price of ₹ 653, implying an upside of 29%.

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INVESTMENT SUMMARY

Divestment of Ascent Pharma improves profitability as well as financial health

Strides has divested its 94% shareholding in its Australian subsidiary - Ascent Pharmahealth - with operations in Australia and Southeast Asia, to Watson Pharma for a cash consideration of US\$ 393mn. With the divestment of Ascent Pharma, Strides' revenue contribution from high-margin specialty injectables operation would jump from 43% in CY11 to over 70% in CY12, resulting in an improvement in Strides' overall profitability.

Strides expects to repay the debt worth \$250 (including the FCCB redemption amount worth \$116, which is due in Jun 2012) out of the total proceed from the divestment Ascent Pharma. As a result, the ultimate debt/equity position will improve from ~2x in CY11 to 0.7x in CY12 and 0.6x in CY13.

Specialty injectable is a niche market and offers huge global opportunity

The inherent characteristics of injectables like complex manufacturing process, high cGMP & FDA regulatory standards, difficulty in developing and sourcing complex APIs, and complex marketing channels develop high entry barriers for the injectable business. Hence, limited competition and minimal price erosion after patent expiries make the injectable business a niche business opportunity with better profitability compared to oral products.

Incidentally, the potential global injectable market is valued over \$200bn, of which the generic injectable market valued at ~\$25bn and expected to grow at a compounded annual growth of 10% over the next few years to reach \$35bn by 2015. More than the quantum of opportunity, it is the limited price erosion after patent expiries and limited suppliers make injectables as a profitable opportunity.

Healthy basket of product pipeline

Strides has rapidly expanded its US ANDA filings over the past six years to 188 in 2011 comprising of over 120 injectables product filings. It has track record of filing average 35 ANDAs annually in the last three years. Going forward, it expects to file >30 ANDAs for products: (i) which are short supplied; (ii) whose patents expire in the near term; and (iii) which are difficult to manufacture.

So far, Strides has received the USFDA approval for 53 injectable products, out of which it has commercialized about 40 products (and most of those commercialization happened in Q4CY11). Additionally, the company holds over 900 filings in the specialties space for emerging injectable markets.

Well laid distribution pacts with global leaders

Strides' rapid expansion of injectable product basket and simultaneous distribution pacts with global leaders like Pfizer (targeting the Oncology market of various advanced markets including the US, EU, Japan, etc.), GlaxoSmithkline (targeting the oncology space of various emerging markets), Sagent (targeting the US injectable), Teva, Sandoz, etc. provide an edge over its peers in the global generic injectables market.

We believe Strides' supply/distribution pacts with global leaders help it exploit the huge global injectable opportunity by leveraging their marketing muscle in complex field of injectables. More so, the supply pacts enhance capacity utilization, which benefits Strides in terms of operating leverage and enhances profitability.

With rapid ANDA filing and approvals, Strides has already earned licensing income over \$200mn from the above said pacts over the last five years but the key benefits

of the associations would flow mainly from commercialization of products from CY12 onwards.

Unprecedented drug shortages in the US multiply business injectables opportunity

Recently, the drug shortages in the US have reached to its unprecedented levels by tripling from 61 molecules under shortage in 2005 to 178 molecules in 2010 and 168 molecules as of October 2011. Of the total reported molecules under shortage, injectables represent the largest chunk with 83% (i.e. 139 nos.) in 2011 that jumped from 43% in 2006.

In value terms, annual sales of 168 molecules under shortage in 2011 have increased at CAGR of 7% from US\$3bn in 2006 to US\$ 4.2bn in 2011. Incidentally, shortages have been triggered by closure of plants (due to regulatory issues in manufacturing) and the revival of which are not anticipated within the next 12 months period.

Considering such a record high level of shortage in injectables in the US and Strides' preparedness in terms of widened injectable basket, expanded facilities (by ~2.5x) and distribution pacts with global leaders, we believe the company is all set to capitalize on opportunities created by drug shortage.

Strategic inorganic entry into Biosimilars – A long-term growth driver

In December 2010, Strides' wholly-owned subsidiary Agila Specialities entered into an agreement with biotech firm Inbiopro Solutions to acquire 70% stake for ₹ 650mn. The acquisition enables it to access a pipeline of eight products with global sales of over US\$28 billion. Of this, five products are monoclonal antibodies used for treating cancer. The said product pipeline is at its early stages of development; hence, we believe this acquisition is a strategic initiative towards biosimilars and do not expect any commercialization benefit in the next couple of years.

VALUATIONS AND VIEW

Historically, Strides has traded at a significant valuation discount to its peers, led by the concern of over-leveraged (with over 4x Debt/equity) balance sheet, excessive capex in product development and facilities without any commensurate revenue and the concern of FCCBs. However, it witnessed a gradual re-rating in the recent past as its specialty injectables business started gaining momentum in terms of ramp up in licensing income and multiple distribution pacts with global leaders like Pfizer, Glaxo, etc.

Now, with the divestment of relatively less profitable Ascent Pharma at an attractive valuation multiple of about ~20x EV/EBITDA, Strides has improved the overall profitability profile of the company, deleveraged its balance sheet (to ~ 0.7x D/E) and simultaneously availed growth capital for scaling up its global injectable operation. Hence, we believe the divestment is a value accretive transaction, which would result in progressive re-rating for Strides' valuation.

Chart 1: One-year forward PE Band

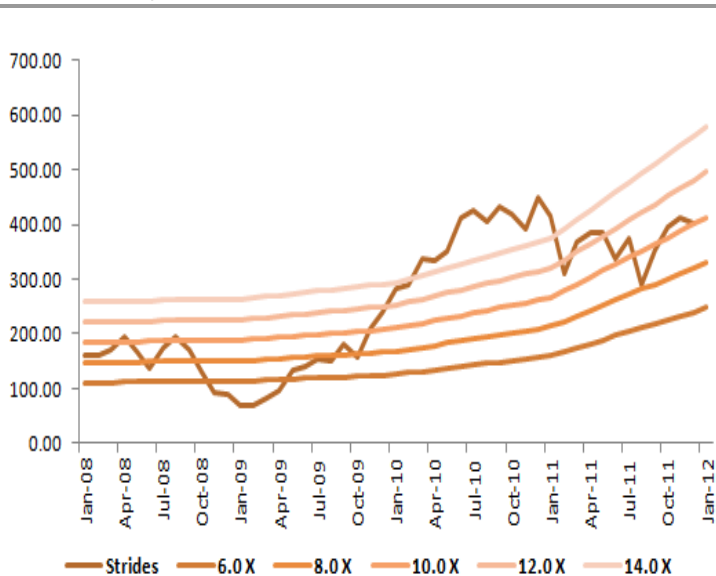
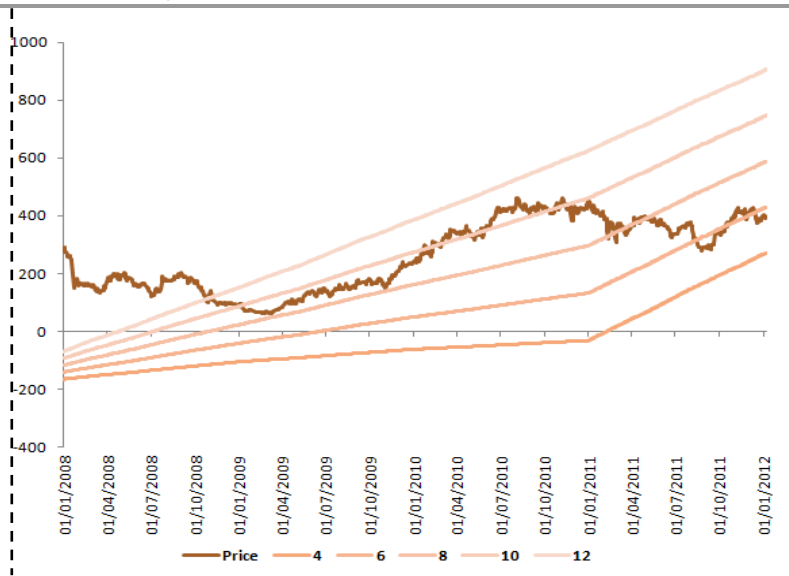


Chart 2: One-year forward DRL EV/EBITDA band



Source: Systematix Institutional Research

With the divestment of non-core Ascent Pharma business, Strides has become the specialty injectable focused player with ready infrastructure of – regulatory approved expanded capacities, multiple distribution pacts with global leaders and a basket of product filings. We expect the company to deliver PAT CAGR of 39% over CY10-13E.

Table 1: Peer Comparison

Companies	Currency	CMP ₹	MCap ₹bn	EPS (₹)		EPS CAGR CY11-13(%)	PE (x)		EV/EBITDA (x)		ROE (%)	
				2012E	2013E		2012E	2013E	2012E	2013E	2012E	2013E
Akorn Inc	INR	562.47	53301	29.2	34.3	42.5	19.5	16.6	10.6	7.2	49.0	38.9
Fresenius Medica	INR	3524.35	1068414	203.4	223.7	11.9	17.4	15.8	9.2	8.4	14.0	14.1
Hikma Pharmaceutical	INR	472.00	91341	31.3	39.2	30.3	18.3	14.8	9.3	7.6	15.6	17.1
Sagent Pharma	INR	1114.11	31043	18.7	86.5	LP	59.7	13.4	24.3	8.5	7.2	22.2
Hospira Inc	INR	1704.04	280568	124.9	152.5	0.6	13.7	11.3	8.8	8.2	12.1	11.5
Industry Avg.							25.7	14.4	12.4	8.0		
Strides Arcolab			28603	41.3	56.0	44.8	12.3	9.0	7.0	5.2	16.7	13.7
Discount to industry average							-52%	-37%	-44%	-35%		

Source: Company and Systematix Institutional Research

Among its peers in global injectables, Strides is expected to deliver strongest EPS growth over the next two years. On the contrary, it trades at about a 40% discount to its global injectable peers. With improved business fundamentals and strong expected earnings growth over the next couple of years, we believe Strides deserves better valuation and would see gradual re-rating in the near term.

Considering its huge investment in capacity expansion, we value Strides based on EV/EBITDA method. Assigning differential EV/EBITDA multiple of 7x to CY13 specialty injectable EBITDA and 5x to CY13 pharma business, we value Strides at ₹ 653/share.

Table 2: Valuation

	CY13e	Target EV/EBITDA(x)	Amt (₹ mn)
Specialty Injectable EBITDA (₹ mn)	4903.8	7	34327
Pharma. business EBITDA (₹ mn)	860.9	5	4305
Target EV of Strides (₹ mn)			38631
Net debt			492
Target market capitalization (₹ mn)			38139
Fair Value/ Share (₹)			653
Upside from CMP of ₹ 507			29

Source: Company and Systematix Institutional Research

Our Target Price of ₹ 653/share discounts Strides' CY13E EPS and EBITDA by 11.7x and 6.7x which would still be at 19% and 16% discount to industry average, respectively.

Though we estimate Strides' fair value at ₹ 653, we get greater comfort from Strides' healthy free cash generation over 21bn over CY12 and CY13. The strategic deployment of such cash flow in the areas of Biosimilar, Specialty injectables and in the development of potential First-to-File product pipeline would further unlock value for share holders in the future.

Hence, we initiate coverage on Strides with a Buy recommendation and a Target Price of ₹ 653, implying an upside of 29% over a period 12 months.

INVESTMENT ARGUMENTS

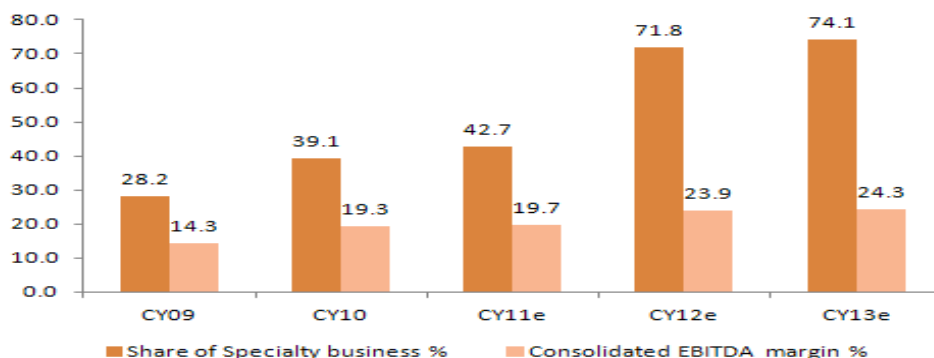
Divestment of Ascent Pharma improves profitability as well as balance sheet:

Australian subsidiary Ascent Pharma sold to Watson for \$393mn: Strides has divested its 94% shareholding in its Australian subsidiary - Ascent Pharmahealth - with operations in Australia and Southeast Asia, to Watson Pharma for a cash consideration of US\$ 393mn. The transaction was closed and Strides realized the cash consideration, simultaneously.

Divestment of Ascent Pharma to enhance earnings profile: Ascent pharma is used to market branded formulations in Australia and Southeast Asia and was the key revenue contributor to Strides' pharma division. In fact, it has contributed about 32% to Strides' consolidated sales in CY11 and was a relatively low-margin operation compared to specialty injectables operation.

With the divestment of Ascent Pharma, Strides' revenue contribution from the high-margin specialty injectables operation would jump up from 43% in CY11 to over 70% in CY12, resulting in an improvement in Strides' overall profitability.

Chart 3: Disposal of lower margin Ascent Pharma improves overall profitability

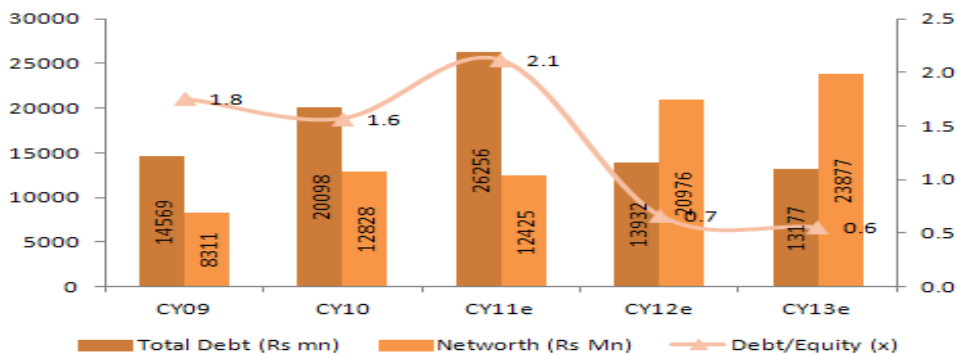


Source: Systematix Institutional Research

Strengthen balance sheet position: Strides expects to repay debt worth \$250 (including FCCB redemption amount worth \$116, which is due in Jun 2012) out of the total proceed from the divestment of Ascent Pharma.

Such debt repayment would reduce its debt burden by about 50% from the current outstanding debt of \$525mn. On the other hand, estimated profit of ₹ 7.3bn from the disposal of Ascent Pharma boosts the company's networth by ~70% to ₹ 20.35bn. Hence, the ultimate debt/equity position will improve from ~2x in CY11 to 0.7x in CY12 and 0.6x in CY13.

Chart 4: Sale proceeds of Ascent Pharma deleverage Strides' Balance Sheet



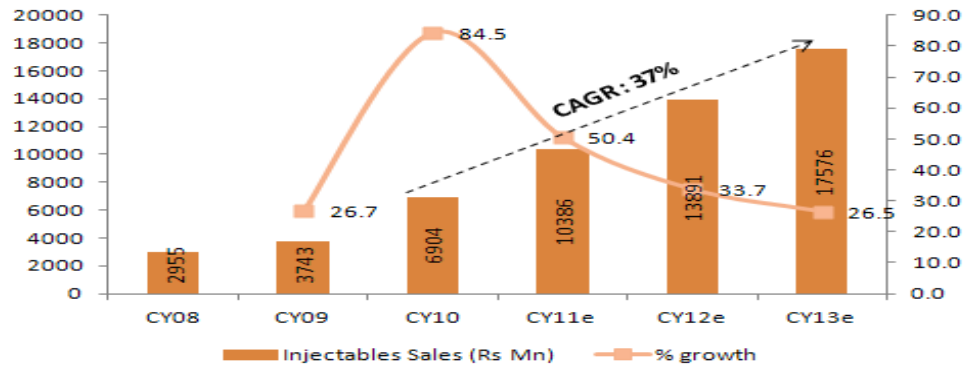
Source: Systematix Institutional Research

We believe the divestment of Ascent Pharma is a strategic move by Strides as it enhances its core focus on the better margin specialty injectables business and simultaneously the divestment reduces all its balance sheet concerns. The transaction led cash flow further facilitates Strides to scale up its specialty business and unlocks significant value.

Specialty injectables drive value growth

The specialty injectable operation is the core focus area of Strides Arcolab, which got even strengthened on the divestment of Ascent Pharma. We expect the injectables will drive value growth for the company led by the robust opportunity in the global generic injectables, the inherent nature of the specialty injectables (i.e. limited competition, better profitability, minimal pricing pressure, high entry barriers, etc.), healthy basket of the product pipeline for regulated markets and well laid distribution pacts with global marketing leaders. Moreover, the recent/ongoing scenario of peak drug shortages in the injectable space in the US (over last decade) provides the most suitable time for Strides’ injectable operation. We estimate the Strides injectable business (that grew at a CAGR of 53% over CY08-10) will deliver a compounded annual growth of 37% over CY10-13e, thereby expanding margin by ~500bps and strengthening of balance sheet over the said period.

Chart 5: Healthy sales growth in Injectables

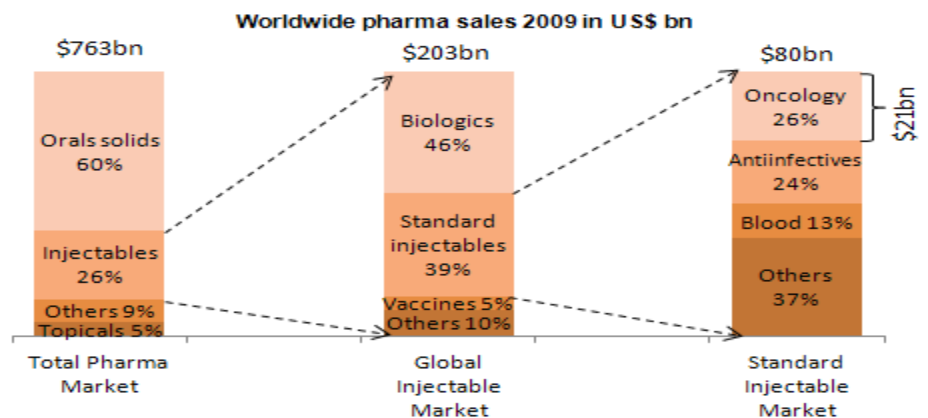


Source: Systematix Institutional Research

Robust opportunity in the global injectable market

The specialty injectables offer huge value opportunity for players like Strides Arcolab (who has strategically developed its injectable product basket, expanded its manufacturing capability rapidly and obtained required facility approvals from advanced market regulators) with a huge market potential of >\$200bn (representing ~26% of the global pharma market) as of 2009 and growing at a CAGR of 10-12%.

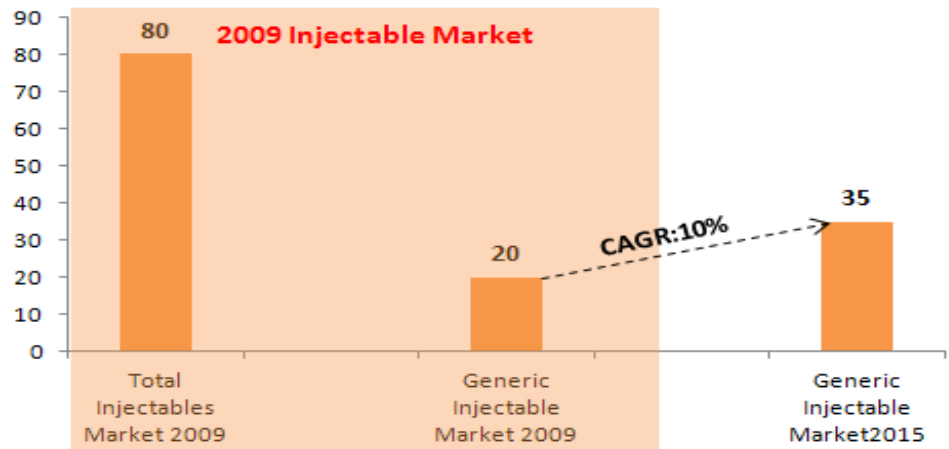
Chart 6: Huge opportunity in injectables



Source: Systematix Institutional Research

Out of the total potential injectable market, the target market for Strides stands at \$80bn (i.e about 39% of total injectable market) as of 2009, as the biologic products hold the largest chunk (~46%) of the injectable market, which enjoys product exclusivity even after years of patent expiry due to the regulatory hurdles.

Chart 7: Generic injectables market grows at 10% CAGR to reach \$35bn



Source: Systematix Institutional Research

So far as the generic injectable market is concerned, it is currently valued at ~\$25bn and is expected to grow at a compounded annual growth of 10% over the next few years to reach \$35bn by 2015, led by increasing patent expiries over the next few years in the injectable space and the limited price erosion for these products.

Chart 8: Geographic mix of Injectable market

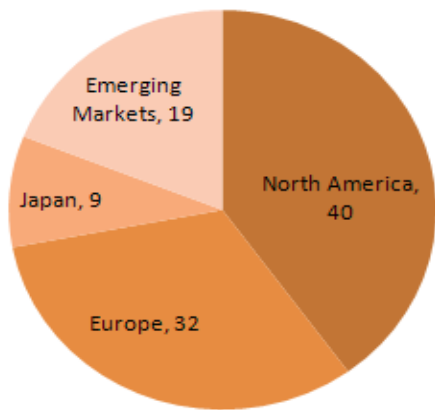
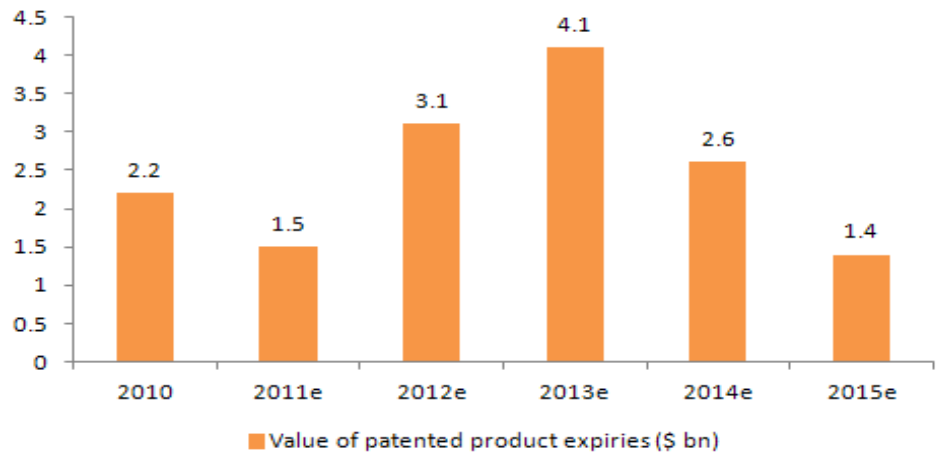


Chart 9: Patent expiries (in the US) enrich opportunities in generic injectables



Source: Systematix Institutional Research

Geographically, the US is the largest injectables market with market share of 40% followed by Europe (32%) and Japan (9%).

Injectables: A niche business segment

The inherent characteristics of injectables like complex manufacturing process, high cGMP & FDA regulatory standards, difficulty in developing and sourcing complex APIs and complex marketing channels develop high entry barriers for the injectable business. Hence, limited competition and minimal price erosion after patent expiries make the injectable business a niche business opportunity with better profitability compared to oral products.

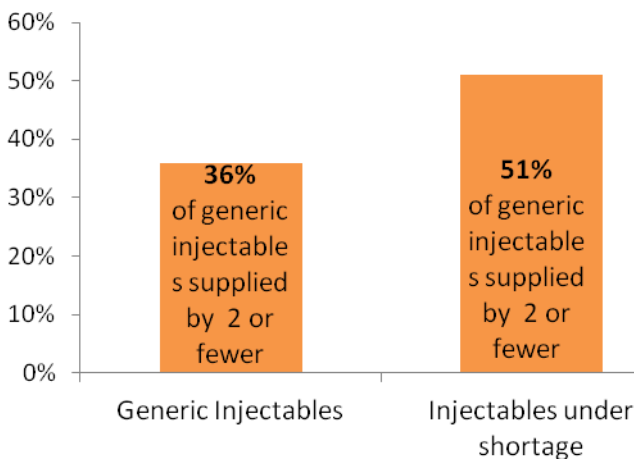
Chart 10:



Source: Systematix Institutional Research

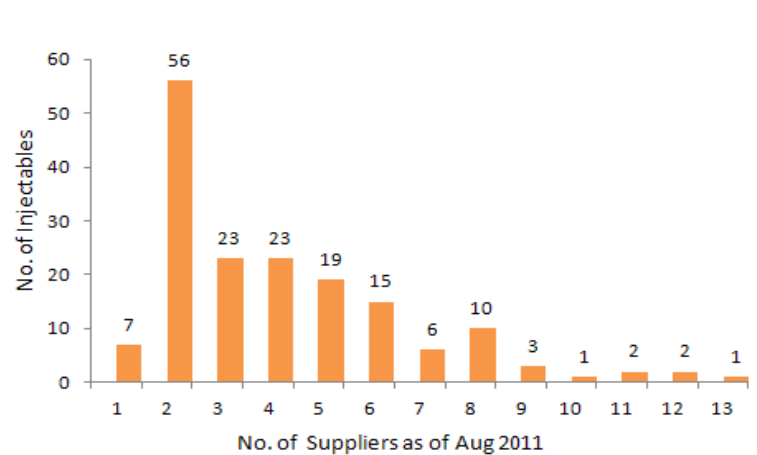
As compared to the oral drug industry, injectables face less competition, which can be evidenced from the fact that 36% of the generic injectable molecules have two or fewer suppliers. For injectables that are under shortage, 51% of the products are supplied by two or fewer suppliers and two-thirds have three or fewer suppliers.

Chart 11: Concentration over injectable supplies



Source: US FDA and Systematix Institutional Research

Chart 12: Majority of injectables are supplied by few players



Source: US FDA and Systematix Institutional Research

Healthy basket of product pipeline

Strides has enhanced its focus on specialty pharma since 2006 and developed basket of niche sterile injectable product since then. Globally, it has over 900 filings in the specialities space out of which it has received approvals for >500 products. The product pipeline includes therapeutic segments like oncology, controlled substances, hormones, penems, penicillins and ophthalmology.

To be specific for the US market, the company has rapidly expanded its ANDA filings over past six years to 188 in 2011 comprising of over 120 injectables product filings. It has track record of filing average 35 ANDAs annually in the last three years. Going forward, it expects to file >30 ANDAs for products: (i) which are short supplied; (ii) whose patents expire in the near term; and (iii) which are difficult to manufacture.

So far, Strides has received the USFDA approval for 53 injectable products, out of which it has commercialized about 40 products (and most of those commercialization happened in Q4CY11).

Chart 13: Cumulative sterile ANDA filing & approval in US

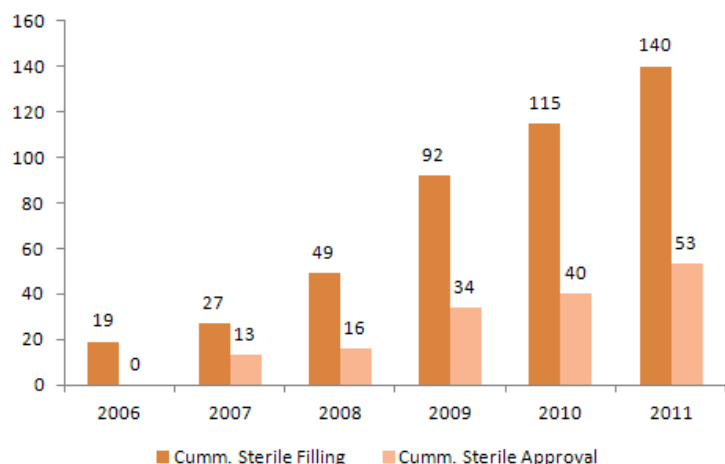
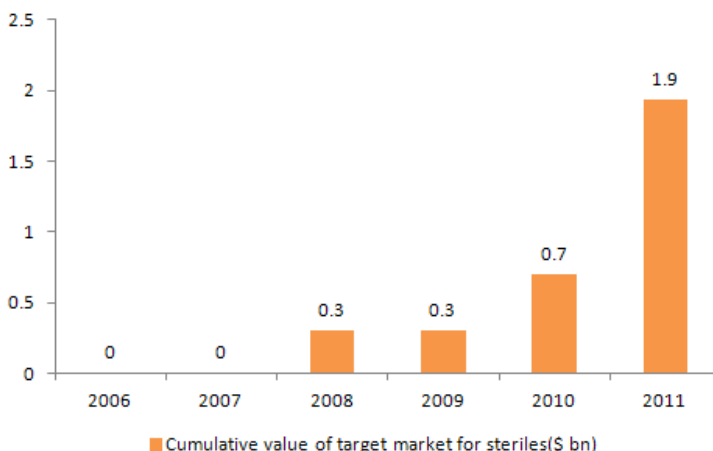


Chart 14: Ramp up in the value of product approval



Source: Company and Systematix Institutional Research

Table 3: Focused ramp up in injectable product filings

	Filings			Approval		
	Steriles	Oncology	Total	Steriles	Oncology	Total
USA	91	31	122	47	6	53
Europe	27	21	48	8	2	10
Australia	18	8	26	14	0	14
South Africa	66	5	71	25	0	25
Canada	20	0	20	19	0	19
New Zealand	1	2	3	1	0	1
Africa	145	4	149	119	0	119
Latin America	181	2	183	151	0	151
ROW	211	85	296	109	11	120
Total	760	158	918	493	19	512

Source: Company and Systematix Institutional Research

Well laid distribution pacts with global leaders

Strides' rapid expansion of injectable product basket and simultaneous distribution pacts with global leaders like Pfizer (targeting the Oncology market of various advanced markets including the US, EU, Japan, etc.), GlaxoSmithkline (targeting the oncology space of various emerging markets), Sagent (targeting the US injectable), Teva, Sandoz, etc. provide itself an edge over its peers in the world of generic injectables.

We believe Strides' supply/distribution pacts with global leaders help it exploit the huge global injectable opportunity by leveraging their marketing muscle in complex field of injectables. More so, the supply pacts enhance capacity utilization, which benefits Strides in terms of operating leverage and enhances profitability.

Pfizer deal targeting regulated market oncology space: Strides signed an exclusive marketing agreement with Pfizer in January 2010, as per which the latter will commercialize 40 generic oncology products in the US, manufactured and supplied by Strides. Subsequently, in May 2010, Strides and Pfizer signed another deal (on a co-exclusive basis) 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.

GSK deal targeting emerging market oncology space: Strides signed a supply pact with GSK in July 2008 to supply 10 oncology injectable products (expandable to 45 products), to be marketed by GSK in 95 emerging markets.

Also, Strides has a JV with US-based Sagent to develop, manufacture and market 25 specialty injectables in the US market. Similarly, it has product development & distribution pacts with Teva, Sandoz, Apotex, Aspen, etc. These deals are based on licensing income for Strides on product approval and revenue/profit sharing on commercialization of products basis. **With rapid ANDA filing and approvals, Strides has already earned licensing income over \$200mn from the above said pacts over the last five years but the key benefits of the associations would flow mainly from commercialization of products CY12 onwards.**

Additionally, in order to tap the Brazil hospital market, Strides has set up a joint venture with BioChimico Industria Farmaceutica – an 85-year old pharma player dedicated exclusively to Brazil hospital markets - to jointly market drugs for the hospital market. As per the deal, Strides will manufacture and supply high-end injectables from its Campos facility and BioChimico will supply anaesthetic products from its facilities in Rio di Janeiro for marketing in the Brazil hospital market.

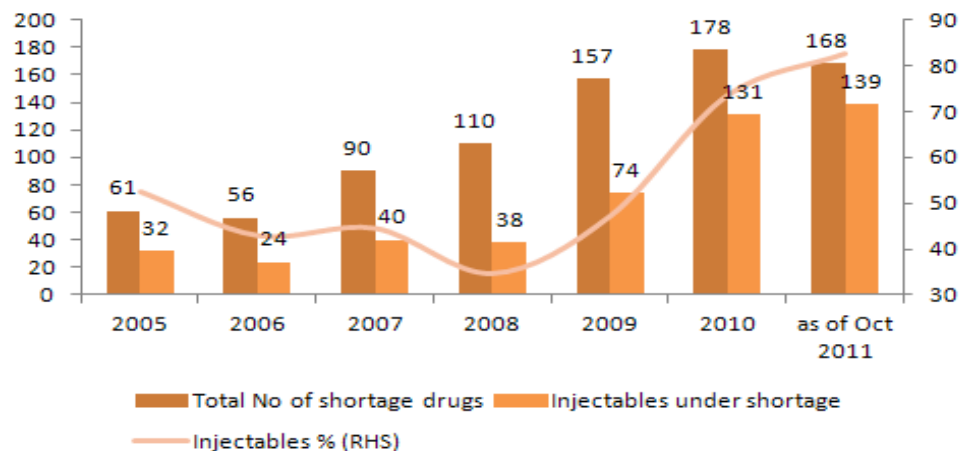
We believe, the above said commercialization pacts with multiple global leaders for various markets would help it penetrate deep into the complex and niche business environment of specialty injectables.

Unprecedented drug shortages in the US multiply business opportunity in injectables

Injectable shortage at its peak: In the recent periods, the drug shortages in the US have reached to its unprecedented levels by tripling from 61 molecules under shortage in 2005 to 178 molecules in 2010 and 168 molecule as of October 2011. Of the total reported molecules under shortage, injectables represent the largest chunk with 83% (i.e. 139 nos.) in 2011 that jumped from 43% in 2006.

Therapeutically, oncology is the largest effected therapy with 16% coverage of the shortage molecules. Five therapy areas covering oncology, anti infectives, cardiovascular, central nervous system and pain account for 63% of the total number of products in the shortage list.

Chart 15: Drug shortages in US tripled and share of injectables jumps up to over 80% over last 5 years



Source: USFDA, US ASHP & Systematix Institutional Research

Drug shortage brings additional opportunity: In value terms, annual sales of 168 molecules under shortage in 2011 have increased at CAGR of 7% from US\$3bn in 2006 to US\$ 4.2bn in 2011. Considering such a record high level of shortage in injectables in the US and Strides' preparedness in terms of widened injectable basket, expanded facilities and distribution pacts with global leaders, we believe Stride is at its opportune time to make the maximum out of drug shortage opportunity. More than business opportunity, the drug shortage helps Strides to get fast track USFDA approval for its injectable filings. In fact, it has got the USFDA approvals for its injectables within 12-15 months of filings against current trend of >24 month of filing for normal generic drugs.

Out of its 53 injectable USFDA approvals, 20 injectables are currently in the list of shortages in US market with total market size of over \$ 1000mn.

Table 4: Strides' injectable products under shortage in US

Injectables	US Mkt. size (\$ mn)	Injectables	US Mkt. size (\$ mn)
Tobramycin	21	Vecuronium Bromide	10
Fosphenytoin	15	Rocuronium Bromide	59
Ondansetron	243	Lidocaine HCL	30
Famotidine	8	Midazolam Hydrochloride	82
Vancomycin HCL	150	Levofloxacin	158
Azithromycin	46	paclitaxel	48
Labetalol Hydrochloride	11	Bupivacaine Hydrochloride	29
Granisetron Hydrochloride	26	Doxorubicin Injection	17
Mesna	12	Carboplatin	35
Metoprolol Tartrate	13	fludarabine phosphate	15

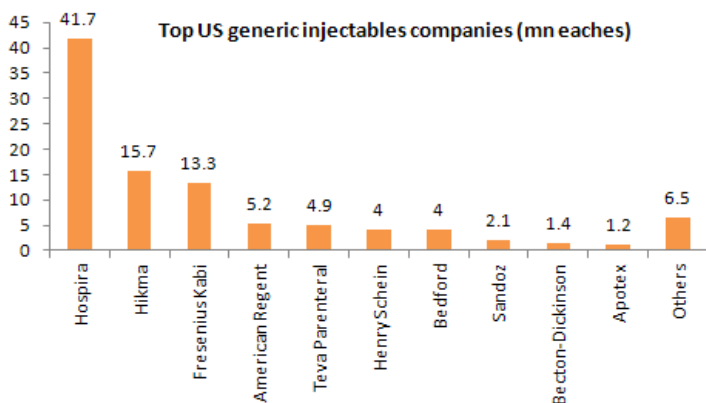
Total market values Strides' injectables those are currently under shortage is \$ 1028mn

Source: US ASHP and Systematix Institutional Research

What exacerbated drug shortage to historic high? Historically, the key reasons for drug shortage were due to the product discontinuation of older and less profitable drugs (most of which were injectables) apart from manufacturing issues led by either regulatory requirement or problem in raw material sourcing.

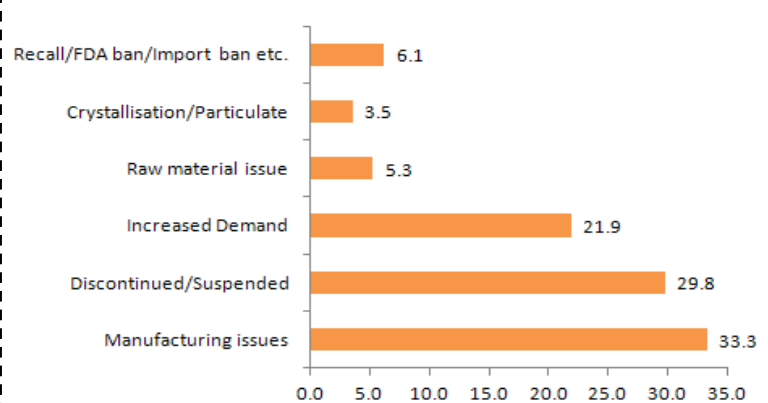
Though the above cited reasons caused drug shortages, the broader reason being the consolidation of generic injectable production in the hands of a few manufacturers like –APP Pharmaceuticals, Bedford, Hospira and Teva—who in turn have experienced both increased demand for drugs and production ‘problems’. In fact, the issue of drug shortage was exacerbated in 2010, with the product contamination issue leading to the closure of key plants of Hospira and Bedford Laboratories (100% subsidiary of Boehringer Ingelheim).

Chart 16: Injectable supply in US is highly concentrated



Source: IMS Health MAT 6/2010.

Chart: Key reasons for ms



Source: IMS Health MAT 6/2010

How long the drug shortage opportunity to last? The reason behind the drug shortage in the recent period was the closure of Hospira’s Rocky Mount facility and Clayton facility, Bedford Laboratories’ Ohio based facility, Luitpold’s injectable facility, etc. The key contributor to the issue is the closure of Hospira’s Rocky Mount facility.

Incidentally, Hospira is the leader in the US generic injectables market with over 40% market share in volume terms and the Rocky Mount facility is its largest injectable facility, which accounts for 25% of Hospira’s nearly \$4 billion in annual revenue.

In fact, subsequent to the FDA warning letter to its Rocky mount facility in April 2010, Hospira took required remedial measures but failed resolve the cGMP quality issues. The FDA, with a need to resolve Hospira’s facility issue as well as the drug shortage, inspected the Rocky Mount facility twice in Jun2011 and Aug2011 but still found regulatory loopholes. Hence, Hospira has taken up aggressive corrective plan with a capex of ~\$250mn. **We optimistically believe Hospira would take 9-12 months period to resolve its Rocky Mount facility issues.**

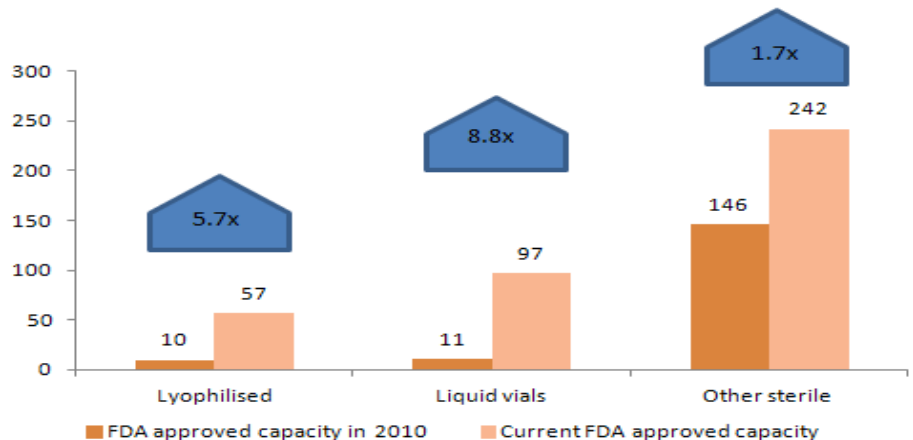
Similarly, **Bedford Laboratories announced that its injectable facility (that makes a number of cancer drugs from its Ohio-based facility) needs "major reconstruction" that may stretch ~9 months** and no products manufactured in their Ohio facility will be available before the fourth quarter of 2012.

Hence, we believe the intensity of drug shortage will remain intact throughout 2012, which will help Strides to ramp up its injectable supply to the regulated market (specifically the US and Europe) in the near term. Subsequently, in the mid-long term, it can exploit its rapidly expanding product basket coupled with supply pacts with global leaders to scale up its specialty injectable business.

Well set to exploit the shortages with expanded manufacturing capacity

Strides, in line with its strategic enhanced focus towards specialized injectables, has expanded its sterile manufacturing capacities multifold with an investment of about \$440mn over 2009-2011, most of which got USFDA certification during 2011. Such capacity expansion would provide great relief to Strides as it was suffering from capacity constraint.

Chart 17: Multifold Capacity expansion



Source: Company Presentation, Systematix Institutional Research

Table 5: USFDA approval status of Strides' injectable facilities

Plant	Year	Approval Status
Sterile Product Division -I	2007, 2009, Dec 2011	Approved
Penicillin	2008	Approved
Cephalosporin	2009	Approved
Sterile Product Division -II	Apr-11	Approved
Oncology	May-11	Approved
Penems	Inspection by H2'2011	

Source: Company and Systematix Institutional Research

With the said expansion, Strides undertakes its specialized injectable manufacturing by eight global manufacturing plants including five in India, two in Brazil and one in Poland. Also with the expansion, it holds one of the largest lyophilization (freeze-drying) capacities in the world.

Now it has manufacturing capability for the entire range sterile injectables like lyophilized vials, liquid vials, dry powder vials, pre filled syringes, ampoules and devices.

Considering the timely expansion of facilities and successful transfer of products from its constraint capacity to newly approved facility, continued momentum of product approvals and unprecedented drug shortage in the US, we believe Strides will deliver a compounded annual growth of 35-40% over 2010 to 2012 to ₹ 18.3bn in 2012.

No major Capex plan: With the above said facility expansion of about \$440mn over 2009-2011, Strides has completed its capex phase.

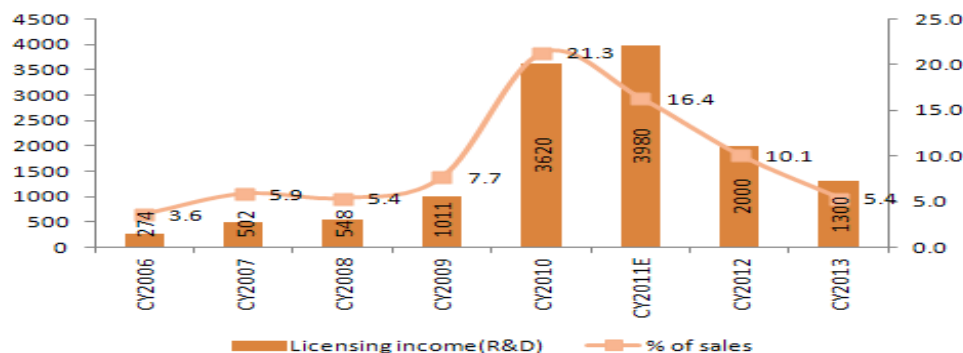
Future capacity augmentation through partnership: However, considering its rapid expansion of product basket and steady growing global injectable demand, it has strategically executed an agreement with Malaysian Bio-Xcell. As per the agreement, Malaysian Bio-Xcell will build a customized facility as designed by Strides for manufacturing biopharmaceuticals and sterile Injectables in the Bio- XCell ecosystem in Johor, Malaysia and will be leased out to Strides on a long-term basis.

Momentum in licensing income may taper off

Supported by its partnership-based model and rapid momentum in the product approvals, Strides has already earned over US\$200m during CY06-CY11 as licensing income. We believe Strides witnessed robust growth in licensing income during 2010 and 2011, mainly led by multiple licensing deals, and healthy momentum in the ANDA filing and approval during 2010-2011.

Going ahead, Strides expects to continue healthy licensing income as it has scope for licensing products for emerging markets, continued product filings (~30 ANDAs per annum in US) and few FTF opportunities in the near future. On the contrary, we conservatively believe that the licensing income would taper off to ~\$40mn in CY12 and \$22mn in CY13 from \$80mn in CY11, as it has already out-licensed products for advanced markets. But, we also believe the decline in licensing income would be more than compensated by ramp up in the product supply supported by expanded capacity.

Chart 18: licensing income to moderate going ahead



Source: company and Systematix Institutional Research

Strategic inorganic entry into Biosimilars – A long-term growth driver

In December 2010, Strides' wholly-owned subsidiary Agila Specialities entered into an agreement with biotech firm Inbiopro Solutions to acquire 70% stake for ₹ 650mn. The acquisition enables it to access a pipeline of eight products with global sales of over US\$28 billion. Of this, five products are monoclonal antibodies used for treating cancer.

A significant portion of Strides' investment (i.e ₹ 650mn) will be used for further development and commercialization of the products, which would ultimately provide Strides an opportunity to generate more licensing income from the Inbiopro product pipeline. In fact, Strides expects to monetize this pipeline through partnership with global pharma majors for regulated markets.

Hence, we believe this acquisition is a strategic initiative towards biosimilars and don't expect any commercialization benefit in the next couple of years.

COMPANY BACKGROUND

Background

After its incorporation as Strides Pharmaceuticals Private Limited in India in 1990, the company changed its name to Strides Arcolab in 1997 and got listed on the NSE in 2000. Strides is headed by Mr Arun Kumar, a first generation entrepreneur, supported by an experienced management team based out of Bangalore.

Strides is one of the leading Indian Pharma companies primarily operating in Specialty injectables and Pharma. With the recent strategic divestment of Ascent Pharma (the branded generic business targeting Australia and South East Asia), the Specialty business become the flagship segment of the company with over 70% revenue contribution.

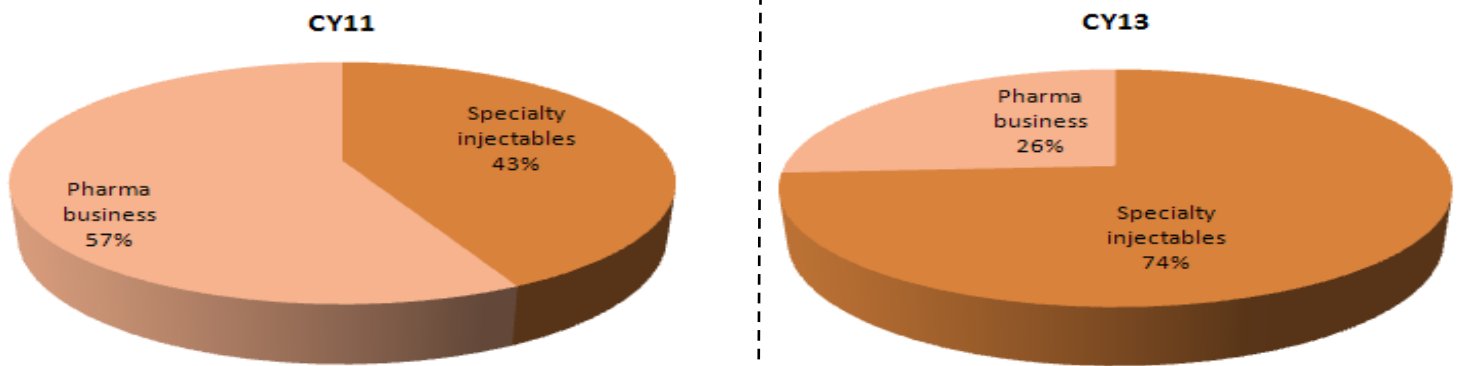
Specialty injectables is the flagship segment of the company: Strides has enhanced its focus on specialty pharma since 2006 and developed basket of niche sterile injectable product since then. Over the last six years, it has rapidly expanded its injectable ANDA filings to 120 injectables for the US market and has over 900 global filings in the specialty space. Simultaneously, it has created state of arts sterile manufacturing capacity and secured required regulatory approvals (like the USFDA, MHRA, TGA, etc.). The company holds one of the largest lyophilization (freeze-drying) capacities in the world. By leveraging its competitive manufacturing base and larger product filings, Strides entered into multiple commercial pacts with global leaders like Pfizer, Glaxo, Teva, Sagent, Sandoz, etc.

Pharma business is a legacy business: The pharmaceutical division is the legacy business of Strides, which includes 1) manufacturing & marketing of branded generic products, 2) supplying ATM (anti-retrovirals, anti-TB and anti-malaria) drugs to programs funded by agencies such as UNITAID, PEPFAR and the Clinton Foundation, and 3) supplying soft-gelatin products. However, with the strategic divestment of Ascent Pharma, the share of pharma business will reduce to 30% in CY12 from 57% in CY11. Its pharmaceutical business offers a wide range of products across therapeutic categories, including antibiotics, oncology, anti-bacterials, HIV/AIDS and malaria drugs. It is one of the leading manufacturers of Soft Gelatin capsules in the world.

The company operates 13 manufacturing facilities across five locations in India, Nigeria, Poland, Brazil and Italy. While eight plants cater to injectables, the remaining five are used for manufacturing of generic pharmaceuticals and soft gelatin capsules. Many of these facilities have been approved by foreign regulatory authorities, including the USFDA, MHRA and MCA in the the UK, TGA in Australia, ANVISA in Brazil and Health Canada in Canada.

Its dedicated R&D facility, Strides Technology and Research, located in Bengaluru, commenced operations in March 2005 and currently employs ~350 scientists.

Chart 19: Specialty injectables dominates Strides business mix with the divestment of Ascent Pharma



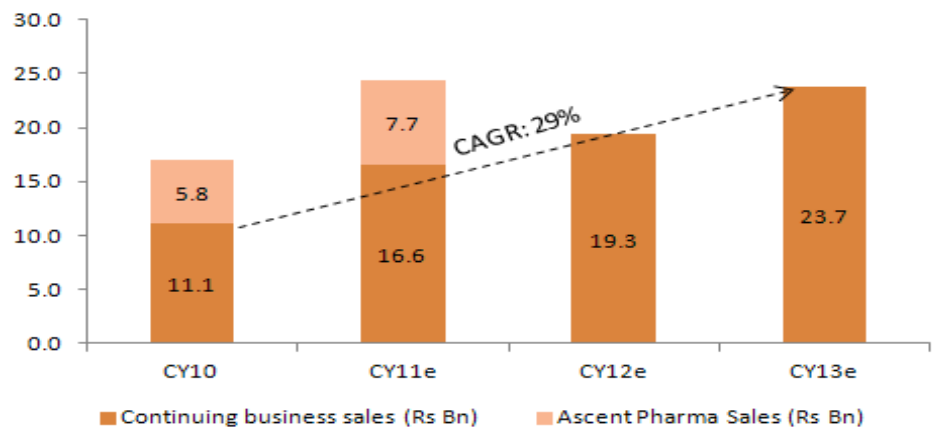
Source: Company and Systematix Institutional Research

FINANCIALS AND EARNINGS OUTLOOK

Sales to grow at 29% CAGR in CY10-13E

Strides, supported by 1) its steady progress in the pharma business, 2) strategic diversification towards specialty injectables with a rapid expansion of product basket and 3) ramp up in licensing income flowing from product out-licensing, delivered a compounded annual growth of 26% over CY07-CY10. Going ahead, we expect Strides' specialty business will deliver robust growth, which will more than compensate the lowering licensing income. Moreover, the strategic divestment of Ascent pharma enhanced the earning profile of Strides' overall business. Hence, irrespective of the divestment of the Ascent pharma, we estimate Strides' consolidated profits to grow at a CAGR of 45% over CY10-13.

Chart 20: Continuing business Sales to grow at 29% CAGR in CY10-13E

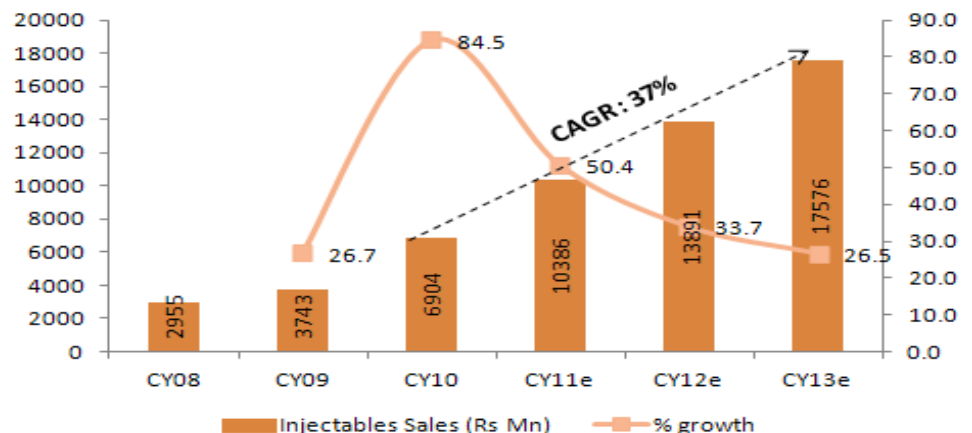


Source: Systematix Institutional Research

Ramp up in specialty injectables to drive growth

Strides has already developed a product basket of 140 sterile injectables, out of which 53 products have already been approved and about 40 are commercially launched (most of which happened just recently in Q4CY11). Also, it has well laid distribution pacts with global leaders, timely facility expansions and unprecedented injectable shortage in the US to result in stronger growth in Strides injectables sales in the near future. We estimate Strides' injectables will grow at a CAGR of 37% over CY10-13E to ₹ 17.6bn.

Chart 21: Robust growth in specialty injectables

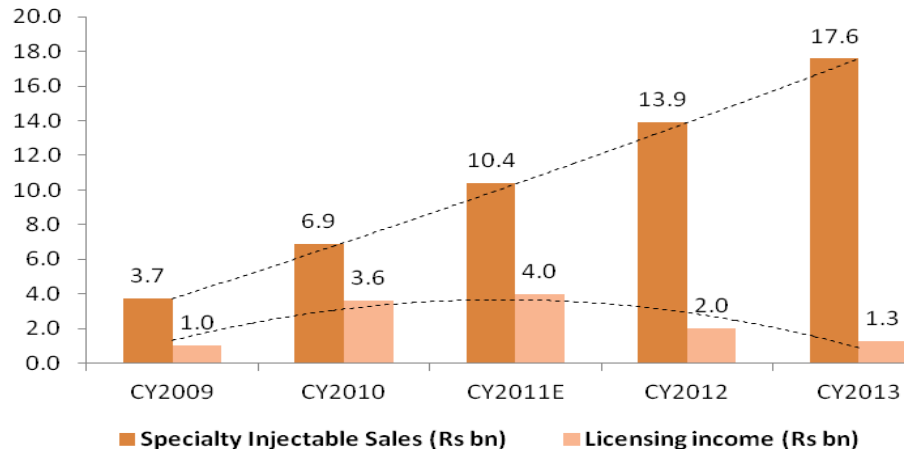


Source: Systematix Institutional Research

Lowering licensing income to be well compensated by rapid injectable growth

The rapid filing of the injectables across regulated and emerging markets and simultaneous multiple out-licensing pacts with global leaders boosted the licensing income (which largely flows with the regulatory approval of product) for Strides during CY07-CY11, setting in an initial growth momentum for the specialty injectable sales. However, we expect the licensing income to taper off in the subsequent period but that would be well compensated by stronger injectables sales on commercial supply approved products.

Chart 22: Specialty Injectables sales Vs Licensing income

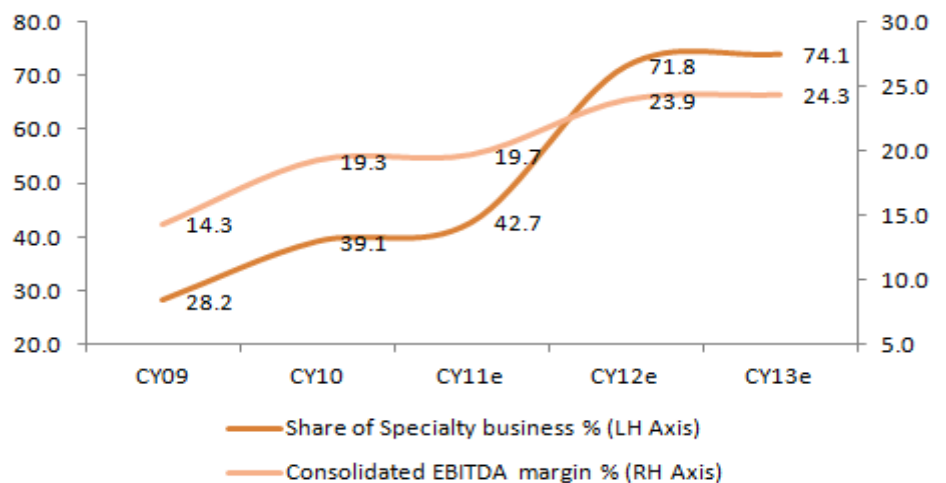


Source: Systematix Institutional Research

Divestment of Ascent Pharma and consequent improving product mix lead to 35% CAGR for EBITDA

We expect Strides to post a margin expansion of ~500bps over CY10-13E to 24.3%, mainly by led improving product mix towards better margin specialty business consequent to the divestment of Ascent Pharma and improving asset utilization of its recently approved sterile and oncology facilities on the commencement of commercial supply of injectables to the US. Hence, we estimate Strides' continuing business EBITDA will grow at a CAGR of 35% over CY10-13E to ₹ 5765mn.

Chart 23: Increasing injectables contribution boost margin

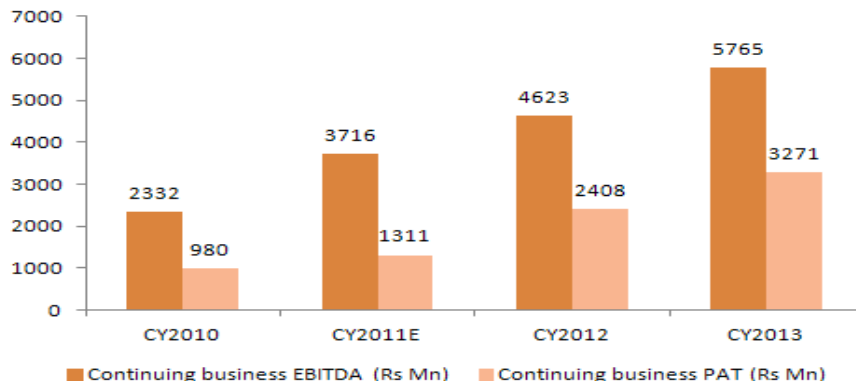


Source: Systematix Institutional Research

~3x growth in net earnings over CY10-13E

Considering stronger growth in the specialty injectables, strategic divestment of Asent pharma and consequent expansion in margin coupled with the deleveraging of balance sheet, we estimate both EBITDA and net profit of Strides' continuing business will grow by over 3x during CY10-13E to `5.77bn and `3.27bn, respectively in CY13E.

Chart 24: Continuing business to deliver >3x growth in EBITDA & PAT over CY10-13E



Source: Systematix Institutional Research

Improving balance sheet position

Completes CAPEX cycle in CY11; no major capex ahead

With a capex of about \$440mn (largely towards the facility expansion for the specialty injection) over CY09-11, Strides completes its capex cycle in CY11 and no major capex is likely in the near future.

Improvement in operating efficiency

Strides has recently commenced the commercial supply of about 25 injectables including high value oncology products for the US market under its licensing pacts from its newly approved facilities. Also, it has about 124 ANDAs awaiting approval, which will improve operating efficiency of Strides. Hence, we estimate the ATO (asset turn over) will improve from 1.2x in CY09 to 1.6x in CY13.

Steady progress in return ratios: Steady earnings growth and improving capital efficiency will enable Stride to deliver a progressive improvement in both ROCE and ROE over CY10-13E.

Chart 25: Improvement in operating efficiency

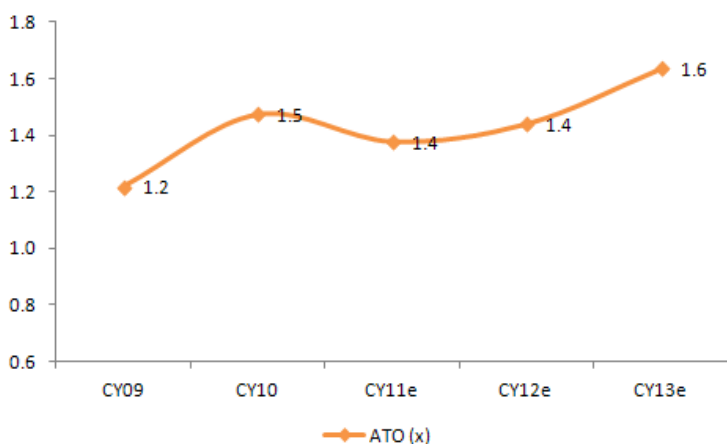
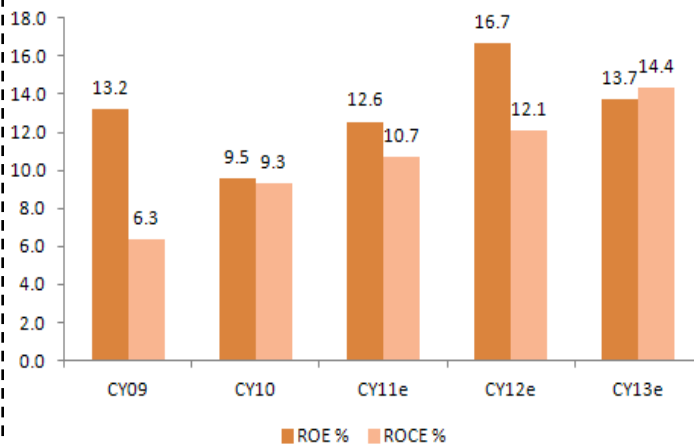


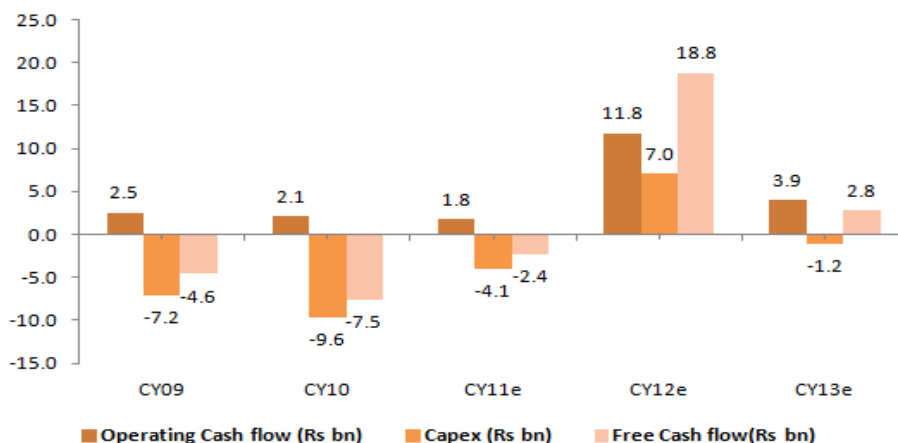
Chart 26: Progressing return ratios



Source: Systematix Institutional Research

Disposal of Ascent Pharma boosts free cash flow: The divestment of Ascent pharma has certainly boosted cash flow substantially in CY12, but strong earnings growth coupled with lower CAPEX helps Strides to improve free cash flow CY12 onwards. We estimate Strides will generate a healthy free cash of ₹21.5bn during CY12-CY13E. Such cash generation will improve Strides' Debt/Equity position from 1.8x in CY10 to 0.6x in CY13.

Chart 27: Free cash generation of ~₹ 21.5bn during CY12 & CY13



Source: Systematix Institutional Research

RISKS

Downside Risks:

Regulatory risks

Strides has developed a basket of complex injectables and multiplied its sterile manufacturing capacity with recent expansions, which is the key growth driver for the company. Any deviation in regulatory requirements in terms of data filing, cGMP compliance, data maintenance, etc. could impact the company's financials adversely.

Foreign exchange volatility

Since Strides derives ~90% of its revenue in foreign currency and has large net receivables in foreign currency, it is exposed to fluctuations in currency movements. Any fluctuation in currency could make its earnings volatile. However, Strides has a natural hedge on its imported raw material to a large extent.

Large goodwill on the books

Strides has accumulated a goodwill of ₹17.2bn (led by multiple business/asset acquisitions) till CY11 on its books, which reduced to ₹ 14.5bn (i.e ~70% of estimated CY12 network) with the divestment of Ascent Pharma. Any deterioration in business outlook of acquired assets could result in impairment charges and negative impact on Strides' profitability.

Absence of vertical integration

Strides is not backward integrated for API manufacturing and sources its API requirements from third parties. Incidentally, injectables API sources are limited. Any delay in raw material sourcing could impact Strides' earnings adversely.

PROFIT & LOSS STATEMENT

(Figures in ₹ Mn.)

Y/E March	CY09	CY10	CY11e	CY12e	CY13e
Net Sales	13047.7	16958.4	24342.0	19343.7	23725.7
% Growth	27.9	30.0	43.5	-20.5	22.7
EBIDTA	1869.3	3266.2	4795.4	4623.2	5765.3
% Growth	168.5	74.7	46.8	-3.6	24.7
Other Income	235.7	697.0	365.1	559.6	567.6
Interest	759.1	1466.5	1905.2	1044.9	988.3
Depreciation	491.9	639.0	985.0	900.5	943.5
PBT before EO	854.1	1857.7	2270.3	3237.3	4401.2
% Growth	LP	117.5	22.2	42.6	36.0
EO	575.3	5.99	-245	9128.7	0
PBT after EO	1429.4	1863.7	2025.3	12366.0	4401.2
Tax	219.0	451.9	408.7	2635.1	1100.3
PAT	1210.4	1411.8	1616.7	9730.9	3300.9
Minority Int. (MI)	113.6	187.3	56.4	458.2	30.0
Reported PAT	1096.8	1224.5	1560.3	9272.8	3270.9
% Growth	1.6	11.6	27.4	494.3	-64.7
Reported EPS	18.8	21.0	26.7	158.9	56.0
Continuing business EPS (Excl. Ascent Pharma)			22.5	41.3	56.0

Source: Company, Systematix Institutional Research

BALANCE SHEET

(Figures in ₹ Mn.)

Y/E March	CY09	CY10	CY11e	CY12e	CY13e
Equity Capital	402.2	577.5	583.7	583.7	583.7
Pref. Capital	491.6	0.0	0.0	0.0	0.0
Application Money	141.5	0.0	0.0	0.0	0.0
Reserves	7240.9	12229.6	11811.1	20361.9	23262.3
Networth	8310.7	12827.9	12425.3	20976.1	23876.5
Secured loans	7787.0	13873.9	20173.4	12080.4	11325.5
Unsecured loans	6781.7	6224.5	6082.6	1851.6	1851.6
Total loans	14568.7	20098.4	26256.0	13932.0	13177.1
Deffered Tax Liab	34.2	46.4	52.5	52.5	52.5
Minority Int.	2585.0	2724.7	379.4	399.4	429.4
Total Liability	25498.6	35697.3	39113.2	35360.0	37535.5
Net Block	9318.8	10440.8	14204.3	8970.5	9202.2
Goodwill	10093.7	14756.4	17194.0	14499.0	14499.0
Investments	3413.6	17.6	23.0	23.0	23.0
Inventory	2334.2	3120.0	4072.2	3066.8	3741.7
Debtors	4506.0	4249.6	6085.5	4835.9	5931.4
Cash balance	912.0	3394.5	5210.6	11013.0	12684.9
Loan & Advances	1750.7	8840.0	1947.4	1547.5	1779.4
Current Liabilities	5098.7	7248.5	7437.8	5910.6	7249.5
Provisions	6841.5	9236.5	9767.0	8738.9	10470.4
NCA	2661.4	10367.5	7548.7	11724.3	13667.1
Deferred tax assets	11.1	15.8	19.5	19.5	19.5
Misc Exp	0.0	99.2	123.7	123.7	124.7
Total Assets	25498.6	35697.3	39113.2	35360.0	37535.5

Source: Company, Systematix Institutional Research

RATIOS

Y/E March	CY09	CY10	CY11e	CY12e	CY13e
OPM %	14.3	19.3	19.7	23.9	24.3
NPM %	8.4	7.2	6.4	47.9	13.8
ROE %	13.2	9.5	12.6	44.2	13.7
ROCE %	6.3	9.3	10.7	12.1	14.4
Int. Cover (x)	2.8	2.7	2.7	5.0	6.4
D/E (x)	1.8	1.6	2.1	0.7	0.6
Asset Turnover (x)	1.2	1.5	1.4	1.4	1.6
Debtors Days	124.3	90.2	90.0	90.0	90.0
Inventory Days	75.2	82.0	75.0	75.0	75.0
Creditors Days	140.7	121.2	110.0	110.0	110.0
Valuation ratios					
P/CF per share (x)	18.4	15.7	11.5	2.9	6.9
EV/Cash Profit (x)	27.0	24.6	19.7	9.7	7.0
EV/EBIDTA (x)	22.9	14.1	10.5	6.9	5.1
EV/Sales (x)	3.3	2.7	2.1	1.7	1.3
Mkt Cap/Sales(x)	2.2	1.7	1.2	1.5	1.2
P/ BV (x)	3.5	2.3	2.3	1.4	1.2
P/E (X)	26.6	23.8	18.7	3.1	8.9

Source: Company, Systematix Institutional Research

CASH FLOW

Y/E March	(Figures in ₹ Mn.)				
	CY09	CY10	CY11e	CY12e	CY13e
PAT	1096.8	1224.5	1560.3	9272.8	3270.9
Depreciation	491.9	639.0	985.0	900.5	943.5
Change in WC	946.4	203.8	-792.5	1626.8	-270.9
Operating CF	2535.2	2067.3	1752.8	11800.1	3943.5
Capex	-7161.5	-9610.1	-4104.1	7028.3	-1175.2
Misc Exp	3626.9	-2858.6	0.0	0.0	0.0
Investing CF	-3534.6	-12468.8	-4104.1	7028.3	-1175.2
Equity	-186.5	4064.8	-140.2	-360.5	0.0
Dividends	-70.6	-106.5	-136.6	-341.5	-341.5
Debt	1548.6	5529.6	4449.6	-12324.0	-754.9
Investments	50.4	3396.0	-5.4	0.0	0.0
Financing CF	1341.9	12884.0	4167.4	-13025.9	-1096.4
Net Change	342.5	2482.5	1816.1	5802.4	1671.9
Opening Cash	569.6	912.0	3394.5	5210.6	11013.0
Closing Cash	912.0	3394.5	5210.6	11013.0	12684.9

Source: Company, Systematix Institutional Research

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Stock Ratings

BUY (B)	The stock's total return is expected to exceed 20% over the next 12 months.
ACCUMULATE (A)	The stock's total return is expected to be within 10-20% over the next 12 months.
HOLD (H)	The stock's total return is expected to be within 0-10% over the next 12 months.
SELL (S)	The stock's total return is expected to give negative returns over the next 12 months.
NOT RATED (NR)	The analyst has no recommendation on the stock under review.

Industry Views

ATTRACTIVE (AT)	Fundamentals/Valuations of the sector are expected to be attractive over the next 12-18 months.
NEUTRAL (NL)	Fundamentals/Valuations of the sector are expected to neither improve nor deteriorate over the next 12-18 months.
CAUTIOUS (CS)	Fundamentals/Valuations of the sector are expected to deteriorate over the next 12-18 months.

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