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Lupin Ltd.

F1Q Miss; Washout F1H18 – OW for Growth Thereafter

✔ Stock Rating | ◉ Industry View | ◎ Price Target
 Overweight | In-Line | Rs1,224.00

New approvals in the US remain key to US sales ramp-up. This should pick up in F2H18 and accelerate in F2019. The complex injectable and respiratory pipeline is developing well for launch in F2020 and beyond. This and inexpensive valuation drives our OW rating.

WHAT'S CHANGED	Lupin Ltd.	From	To
	Price Target	Rs1,472.00	Rs1,224.00
	F18e and F19e EPS		-34% and -21%

Model changes: We have cut our F2018 and F2019 net profit estimates 33.8% and 20.8%, respectively, to account for lower US business (F1Q reset, gGlumetza decline), adverse FX impact, and lower margins. We reduce our price target to Rs1,224, reflecting our estimate cuts and a marginally higher target multiple of 20x (was 19x), reflecting progress in global biosimilars and complex pipeline in the US.

Management guidance: Single-digit decline in top line in F2018 owing to pressure on US business, a few challenges in EMs, and FX. Gross margin is expected to be 67-68% and EBITDA margin 21-23% (vs. earlier guidance for 26-28% given three months back). The revised guidance assumes recent INR/USD appreciation, US erosion, and impact from Goods and Services Tax (GST). Overall US sales are expected to post a double-digit decline. But GAVIS sales should rise to \$200mn in F18 (\$110 mn in F17). R&D spending is expected to remain at a quarterly run rate of Rs5bn (versus Rs23 bln in F17). For details of F1Q18 results, see inside.

US business: Was down 15.7% sequentially, largely because of gGlumetza erosion (aggressive AG). Excluding metformins, base business was up 11% qoq (gMinastrin largely flat). F2Q18 will erode a bit more, before growth resumes via new launches – hydrocodone APAP, potassium Cl, gTamiflu, gFosrenol, and levothyroxine. Key launches for F19 include gRenaxa, minocycline, and Moxeza, along with a few derma and possible mesalamine launches (gApriso, gLialda – pending FDA query). Sevelamer could still be a relevant opportunity in F19/20.

Complex product pipeline update: Respiratory – gProair (target action date is September 2017) launch is possible in F20, gSpirivio (PK study complete, PD ongoing, filing end of F18) and Advair (delay by 2-3 months, pending PD studies, filing in early F19). It targets gRisperdal Consta filing in F19 and launch in F21. gSymbiort and gQvar are presently in development stage.

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Lupin Ltd. (LUPN.NS, LPC IN)

India Healthcare / India

Stock Rating	Overweight
Industry View	In-Line
Price target	Rs1,224.00
Up/downside to price target (%)	23
Shr price, close (Aug 3, 2017)	Rs993.40
52-Week Range	Rs1,745.00-1,016.10
Sh out, dil, curr (mn)	452
Mkt cap, curr (mn)	Rs448,619
EV, curr (mn)	Rs527,480
Avg daily trading value (mn)	Rs0

Fiscal Year Ending	03/17	03/18e	03/19e	03/20e
ModelWare EPS (Rs)	55.64	44.51	61.19	73.90
Prior ModelWare EPS (Rs)	56.77	67.39	77.46	-
Consensus EPS (Rs)§	62.94	58.83	69.55	75.94
Revenue, net (Rs mn)	174,94	171,98	190,93	216,63
	3	9	8	0
EBITDA (Rs mn)	44,932	37,975	47,744	57,294
ModelWare net inc (Rs mn)	25,100	20,099	27,634	33,372
P/E	25.9	22.3	16.2	13.4
P/BV	4.8	2.9	2.5	2.2
RNOA (%)	13.1	8.8	14.7	17.9
ROE (%)	22.5	14.9	18.2	18.9
EV/EBITDA	16.2	12.2	9.2	7.2
Div yld (%)	0.4	0.6	0.6	0.6
FCF yld ratio (%)	(1.5)	15.0	5.5	6.3
Leverage (EOP) (%)	58.2	8.5	(5.7)	(17.8)

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework

§ = Consensus data is provided by Thomson Reuters Estimates

e = Morgan Stanley Research estimates

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Exhibit 1: Financial Summary

Income Statement

Income Stat. (Rs mn) YE Mar 31	2,017	2018E	2019E	2020E
Net sales	171,198	169,589	188,538	214,230
Other Operating Income	3,745	2,400	2,400	2,400
Total revenues	174,943	171,989	190,938	216,630
Cost of Goods Sold	60,511	62,716	63,817	72,052
Gross Profit	114,432	109,273	127,122	144,577
R&D Expenses	23,101	20,983	23,867	26,862
Personnel Costs	28,495	30,775	33,852	35,883
SG&A	17,904	19,541	21,658	24,538
Operating Profit	44,932	37,975	47,744	57,294
Non-Operating Income	1,065	1,200	1,300	1,400
EBITDA	45,997	39,175	49,044	58,694
Interest Expenses	1,525	1,951	1,398	1,077
Depreciation & Amortization	9,122	9,516	10,816	11,916
Pretax Profit	35,349	27,708	36,831	45,701
Income Tax	9,785	7,620	9,208	12,339
Minority Interest	(11)	(11)	(11)	(11)
Net Profit	25,575	20,099	27,634	33,372
<i>Effective Tax Rate</i>	28%	28%	25%	27%
<i>EPS</i>	56.6	44.5	61.2	73.9
<i>DPS</i>	5.5	5.5	5.5	5.5

Balance Sheet

Balance Sheet (Rs mn)	2,017	2018E	2019E	2020E
Equity Capital	903	903	903	903
Reserves & Surplus	134,073	151,266	175,993	206,460
<i>Networth</i>	134,976	152,169	176,897	207,363
Debt	79,521	72,653	65,653	58,653
Total	218,389	228,704	246,421	269,877
Net Block	87,229	86,925	86,109	81,194
Capital WIP	21,331	15,000	10,000	10,000
Net Fixed Assets	108,560	101,925	96,109	91,194
Goodwill on consolidation	23,100	23,100	23,100	23,100
Investments	220	20	20	20
Cash & Cash Equivalents	6,818	65,657	81,745	101,620
Inventories	36,423	35,340	39,234	44,513
Receivables	43,073	37,696	41,849	47,481
Loans & Advances	41,445	13,759	15,275	17,330
<i>Current Assets</i>	120,941	86,795	96,358	109,324
Less: Current Liabilities & Provisions	41,250	48,794	50,912	55,382
Total	218,389	228,704	246,421	269,877

Source: Company data, Morgan Stanley Research (E) estimates

Cash Flow	2017E	2018E	2019E
Profit after tax	25,575	20,099	27,634
Add : Depreciation	9,122	9,516	10,816
Extraordinary Items	-	-	-
Net change in Wrk capital	(14,800)	41,690	(7,445)
Net cash from operations	19,462	71,293	30,994
Capital Expenditure/Acq	(26,589)	(2,881)	(5,000)
Dec/(Inc) in Investments	(77)	200	-
Net cash from Investing	(26,665)	(2,681)	(5,000)
Issue of equity shares	1,510	(0)	(0)
Dividends paid including dividend tax	-2,906	-2,906	-2,906
Net cash from financing	-1,396	-2,906	-2,906
Net Inc/(Dec) in Net Debt	8,600	(65,706)	(23,088)
Opening Net Debt	63,267	72,703	6,996
Closing Net Debt	72,703	6,996	(16,092)

Ratios	2017E	2018E	2019E
Profitability Ratios			
Gross Margin	65.4%	63.5%	66.6%
Operating Margin	25.7%	22.1%	25.0%
Valuation Ratios			
P/BV	3.3	3.0	2.5
EV/EBITDA	7.5	7.1	5.2
Leverage Ratios			
Net Debt/Equity	0.54	0.05	(0.09)
Total Debt/Equity	0.59	0.48	0.37
Turnover Ratios			
Inventory (days of net sales)	60	60	60
Receivables (days of net sales)	41	41	41
Cash cycle (days of net sales)	101	101	101
Net working capital (x net sales)	151	125	80

Risk Reward

Pipeline Execution Is the Key Valuation Driver



Source: Thomson Reuters, Morgan Stanley Research estimates

Price Target **Rs1,224**

Base case, P/E

Bull **Rs1,498**

Sum-of-the parts

Stronger base business, driven by better-than-expected performance in the US, India (Rs184/share), NDDS/biologicals portfolio (Rs36/share), and one-off large opportunity (Rs54/share).

Base **Rs1,224**

20x Mar F19e EPS

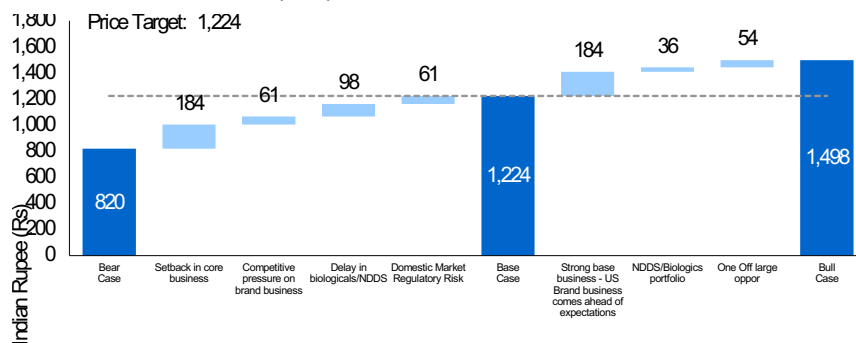
4.5% sales growth for the base business and 3.9% EPS growth over the next two years (F2018-19e). We apply a P/E multiple of 20x to our F2019 EPS estimate of Rs61.2.

Bear **Rs820**

Sum-of-the- parts

Setback in core business (Rs184/share), competitive pressure in branded business (Rs61/share), IPR risk (Rs98/ share) and domestic market regulatory risk (Rs61/share).

Exhibit 2: Bear to Bull: Multiple Upside Drivers



Source: Morgan Stanley Research estimates

Why Overweight

- Strong earnings recovery in F19e, driven by EM, Japan, and the EU, plus strong US business (new FTF launches, complex OSD should make up for erosion of gGlumetza and gFortamet). In the medium to long term, the US pipeline's potential appears attractive.
- Fully integrated business model with strong API capabilities and marketing and distribution in several country markets.
- Based on our new estimates, P/E looks reasonable at 22.3x F2018e and 16.2x F2019e EPS, especially considering the medium- to long-term potential of the US pipeline and IPR.

Key Value Drivers

- Regulated geographies: Market share gains for existing portfolio, new launches, and EU scale-up.
- Execution on niche therapies, ophthalmics, derma, respiratory, biosimilars, NDDS.
- Domestic market: Entry into newer/more-lucrative therapy areas, including critical care, women's health, and oncology.

Potential Catalysts

- Faster GAVIS ramp (e.g., Methergine).
- Development/regulatory progress of 505(b)(2) candidates/inhaler pipeline in US and Enbrel biosimilar in the EU/Japan.
- Price-volume/market share sustainability in gFortamet, gGlumetza.
- Key pending US approvals/launches – gRenvela/Renagel, Tamiflu, Lialda, Coreg CR.
- Sales ramp-up in EU, Australia/New Zealand, Japan.

Risks to Achieving Price Target

- FDA actions (such as Import Alerts, Warnings Letters) or adverse regulatory action in EMs (price controls).
- Delay in approvals, value-dilutive M&A, setback in NCE/NDDS research, FX volatility.
- Intense competition in key products, especially gFortamet, and gGlumetza.

Model Changes

We have cut our net profit estimates 33.8% for F2018 and 20.8% for F2019: This reflects:

- Lower US sales owing to higher competition/rebates in gGlumetza;
- Slower-than-expected ramp-up in GAVIS business;
- Slower US sales growth in view of continuing pricing pressure from channel consolidation, lack or delay in new approvals;
- FX impact from INR appreciation;
- Slowdown in Indian business (GST impact); and
- Japanese business (increase in co-payments and annual price cuts).

Please refer to the exhibit below.

Exhibit 3: What's Changed

What's changed

Rs bln	FY18E			FY19E		
	New	Old	% Change	New	Old	% Change
Net Revenues	172.0	187.4	-8.2%	190.9	210.6	-9.3%
Operating profits	38.0	49.4	-23.1%	47.7	56.0	-14.7%
<i>Margins</i>	22.1%	26.3%	-4.3%	25.0%	26.6%	-1.6%
Net profits	20.1	30.4	-33.8%	27.6	34.9	-20.8%
<i>Margins</i>	11.7%	16.2%	-4.5%	14.5%	16.6%	-2.1%

Source: Morgan Stanley Research (E) estimates

F1Q Miss: Lupin reported sales of Rs38.6bn, down 12.8% yoy (9% qoq), largely reflecting weak US business (gGlumetza erosion), Indian business (GST impact), Japan (annual price revisions, higher co-pays) and RoW (seasonality, tender). OPM expanded 1.5ppts sequentially (9.6ppts contraction yoy) negative operating leverage, lower gross margins and FX, partially offset by lower R&D expenditure. Net profit was Rs3.6bn (vs. our estimate of Rs6.1bn), down 45.7% qoq and 59.4% yoy.

Exhibit 4: F1Q Results Summary

(Rs mn) (period ending)	F1Q18 Jun-17	F1Q17 Jun-16	%chg YoY	F4Q17 Mar-17	%chg QoQ	Morgan Stanley est.
Sales (Net)	38,068	43,136	-11.7%	41,619	-8.5%	
Other Operating Income	628	1,259	-50.1%	914	-31.4%	
Total Revenues	38,696	44,394	-12.8%	42,533	-9.0%	42,785
Material Cost	12,326	12,719	-3.1%	11,851	4.0%	
Staff Costs	7,180	7,059	1.7%	7,078	1.4%	
R&D Expenditure	4,999	4,994	0.1%	6,709	-25.5%	
Other Expenditure	11,506	11,535	-0.3%	15,791	-27.1%	
Total Expenditure	31,012	31,314	-1.0%	34,719	-10.7%	
Operating profit	7,684	13,080	-41.3%	7,814	-1.7%	11124
Other Income	320	826	-61.3%	453	-29.5%	
EBITDA	8,003	13,907	-42.4%	8,267	-3.2%	
Interest (Net)	439	320	37.3%	406	8.1%	
Depreciation	2,605	2,027	28.5%	2,674	-2.6%	
PBT and Extra-ordinaries	4,959	11,560	-57.1%	5,187	-4.4%	
Tax	1,368	2,734	-50.0%	1,367	0.1%	
Core PAT	3,591	8,825	-59.3%	3,820	-6.0%	6227
Minority interest and share of ic	11	6	65.6%	18	-40.4%	
Reported PAT	3,581	8,819	-59.4%	3,802	-5.8%	6187
Adj. PAT	3,581	8,819	-59.4%	6,600	-45.7%	
GPM	68.1%	71.3%	-3.2%	72.1%	-4.0%	
OPM	19.9%	29.5%	-9.6%	18.4%	1.5%	26.0%
NPM	9.3%	19.9%	-10.6%	8.9%	0.3%	14.5%
Effective tax rate	27.6%	23.7%	3.9%	26.4%	1.2%	

Lupin – Sales Breakdown

(Rs mn)	F1Q18	F1Q17	%chg YoY	F4Q17	%chg QoQ
Formulations	35,275	40,453	-12.8%	38,804	-9.1%
US (including IP)	16,018	21,886	-26.8%	19,007	-15.7%
EMEA (inc EU, South Africa)	2,259	2,194	3.0%	3,012	-25.0%
India	9,324	9,499	-1.8%	8,788	6.1%
APAC (Japan)	5,989	5,416	10.6%	6,118	-2.1%
LATAM	1,269	1,089	16.5%	1,269	0.0%
Rest of world	416	369	12.7%	610	-31.8%
API	2,793	2,966	-5.8%	2,815	-0.8%
Total net sales	38,068	43,419	-12.3%	41,619	-8.5%

Source: Company Data, Morgan Stanley Research

Valuation

Our new price target is Rs1,224 (down 16.8% from Rs1,472): We value the stock at 20x F2019e EPS. The reduction in our price target is driven by lower F2019e EPS, which is partially offset by a 5% increase in our target P/E multiple to 20x (from 19x).

Our target multiple of 20x is in line with the current industry multiple (derated in the last two years). We believe this is an appropriate multiple in view of:

- Strong fundamentals with globally diversified fully integrated business model, plus diversification into niche therapies, including ophthalmologics, dermatology and respiratory care;
- Investment in complex R&D projects including injectables, inhalation/respiratory and biosimilars;
- The outlook for a sharp earnings ramp-up from F19 onwards, primarily led by US business, where the branded business is steadily scaling up and the product pipeline is deepening;
- Improving earnings quality, led by declining profit concentration from gGlumetza/Fortamet.
- Good visibility for niche generic launches for the next few years from F19 onwards.

Versus:

- Continuing pricing pressure from ongoing channel consolidation in the US generic market;
- FX/regulatory risk in EMs, especially India (drug price control, GST impact, etc.).
- Some profit concentration in gGlumetza and gFortamet.

We remain OW on Lupin: We cite the outlook for strong recovery in the US business in F19 and F20; a gradual ramp in the GAVIS business (including branded); Indian business bouncing back in 2HF18; and steady growth in Japanese and European businesses (biosimilars and neurology), along with cheap valuation.

The stock has pulled back ~59% from its Sep-15 peak: The Sensex is up 15% over this period. The steep correction reflects:

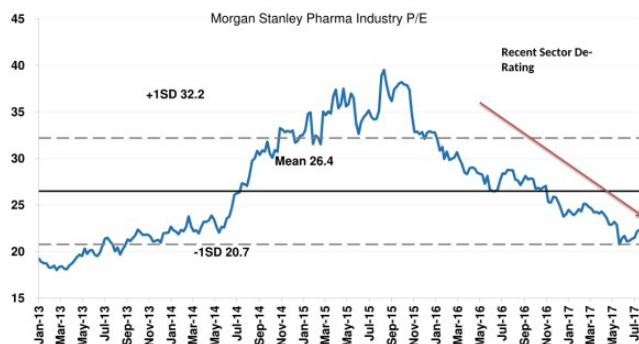
- Worsening industry dynamics in the US, driven by pricing pressure and higher competitive intensity;
- Delay in key product launches for Lupin;
- Delay in GAVIS ramp-up, and
- Erosion in gGlumetza and gFortamet owing to new entrants.

What's in the price: We believe that industry risks, including full impact of gGlumetza erosion, are now largely factored in.

What's not in the price: F19 growth and complex injectable/inhalation pipeline along with upside led by a couple of First-To-Files on exclusive products.

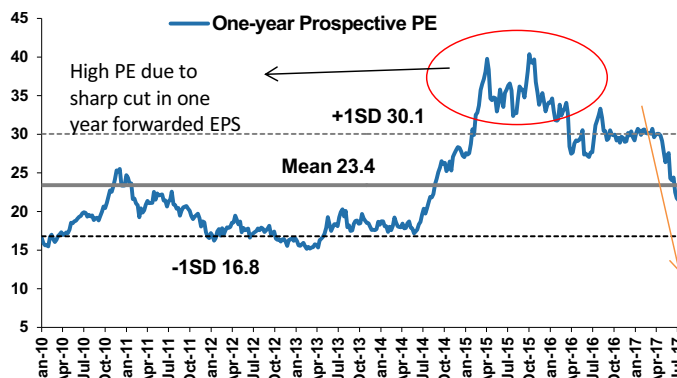
Current P/Es are 22.3x for F18e and 16.2x for F2019e.

Exhibit 5: One-year Forward P/E Chart for the Indian Pharma Industry



Source: Thomson Reuters, Morgan Stanley Research estimates

Exhibit 6: Lupin – One-year Forward Prospective P/E



Source: Thomson Reuters, Morgan Stanley Research estimates

Bull case value of Rs1,498 (down 16% from Rs1,785)-The cut stems mainly from lower growth expectations for the base business, especially in the US market (Rs184/share, down from Rs221), NDDS/biologicals portfolio (Rs36/share, unchanged), and one-off large opportunity (Rs54/share, unchanged).

Bear case value of Rs820 (down from Rs1,060): Setback in core business (Rs184/share, up from Rs147 owing to higher risks in US, Japanese, and Indian business), competitive pressure in branded business (Rs61/share, down from Rs74, reflecting ramp-up in US brands), IPR risk (Rs98/share, down from Rs118 in view of progression in clinical trials of some of complex assets) and domestic market regulatory risk (Rs61/share, down from Rs74 because some GST impact is already in the price).

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(as of July 31, 2017)

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	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	1150	36%	299	40%	26%	556	37%
Equal-weight/Hold	1413	44%	349	47%	25%	692	46%
Not-Rated/Hold	61	2%	7	1%	11%	10	1%
Underweight/Sell	607	19%	93	12%	15%	242	16%
TOTAL	3,231		748			1500	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

Stock Price, Price Target and Rating History (See Rating Definitions)

Lupin Ltd. (LUPN.NS) - As of 8/3/17 in INR
Industry : India Healthcare

Stock Rating History: 8/1/14 : 0/I

Price Target History: 5/8/14 : 1208; 10/29/14 : 1553; 12/11/14 : 1682; 9/24/15 : 2227; 10/28/15 : 2133;
5/20/16 : 1986; 11/10/16 : 1846; 5/25/17 : 1472

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
 Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) ■
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Ratings/Industry View
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) No Rating Available (NA)
 Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

Effective January 13, 2014, the stocks covered by Morgan Stanley Asia Pacific will be rated relative to the analyst's industry (or industry team's) coverage.

Effective January 13, 2014, the industry view benchmarks for Morgan Stanley Asia Pacific are as follows: relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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INDUSTRY COVERAGE: INDIA HEALTHCARE

COMPANY (TICKER)	RATING (AS OF)	PRICE* (08/03/2017)
Sameer Baisiwala, CFA		
Apollo Hospitals Enterprise Ltd. (APLH.NS)	O (04/27/2017)	Rs1,267.55
Biocon Ltd (BION.NS)	O (04/05/2016)	Rs374.85
Cadila Healthcare Ltd. (CADI.NS)	O (01/29/2016)	Rs546.25
Cipla Ltd. (CIPL.NS)	U (08/13/2013)	Rs557.15
Dr. Reddy's Lab (REDY.NS)	E (11/26/2015)	Rs2,323.95
GlaxoSmithKline Pharma (GLAX.NS)	U (02/28/2013)	Rs2,361.50
Glenmark Pharmaceuticals (GLEN.NS)	E (05/24/2017)	Rs702.30
IPCA Laboratories (IPCA.NS)	E (07/25/2014)	Rs467.95
Lupin Ltd. (LUPN.NS)	O (10/03/2006)	Rs993.40
Narayana Hrudayalaya Ltd (NARY.NS)	E (04/27/2017)	Rs299.05
Sun Pharmaceutical Industries (SUN.NS)	U (05/29/2017)	Rs515.85
Vaibhav Dusad		
Dr. Lal PathLabs Ltd (DLPANS)	U (04/19/2017)	Rs826.05

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* Historical prices are not split adjusted.