

Lupin Ltd.

Margin miss with reset in gross margins; limited catalysts in the near term

Lupin's results were below expectations despite an in-line revenue performance due to deterioration in gross margins. LPC reported revenue of Rs39.7bn with 4% QoQ growth in US but lower-than-expected India performance. However, the gross margin declined by ~250bps QoQ despite the improvement in the US business with LPC indicating these levels as the new normal going forward. While management highlighted some impact from FX losses in the Dec quarter, the EBITDA margin of 17.3% (on Rs6.9bn vs. estimated Rs7.7-8.3bn) is concerning, particularly given the ramp-up in the specialty business spend expected over the next few quarters. Reported PAT at Rs2.2bn (vs. JPMe Rs3.6bn/street Rs4.2bn) was impacted by the deferred tax impact after US tax reforms. While LPC's commentary improved on the US (pricing stabilizing, 10+ launches in 4Q FY18), FY19 will remain a challenging year with the Warning Letter, increasing spending on the specialty business, and large products in the US being backend weighted.

- US commentary improving but meaning launches still a few quarters away.** LPC indicated stabilization in the erosion trend, with expectations of prices bottoming out this year. Management highlighted stabilization in metformin share, improvement in the generic launch pipeline (10+ launches in 4QFY18 with few meaningful products), and ramp-up in branded franchise. LPC expects to complete remediation by Apr-May 18 and indicated its aim to resolve WL by CY18 end. On large products, LPC indicated some delay in Levothyroxine (middle of this year vs. previous guidance of end FY18) and does not see the WL impacting gRanexa commercialization as it is approaching the FDA with a full assessment of the approved product to address any queries. While the stabilization of the US business is a good sign, we believe there is still risk to the existing business from erosion in Metformin, generic entry in Methergine (not in our estimates), and delays in key launches.
- Margin improvement likely to be tough.** In our view, improvement from LPC's 19.5% margin seen in 9M FY18 will be tough over the next few quarters given: a) meaningful launches getting delayed implies limited scope for GM improvement; b) R&D/sales guidance at 12.2% indicated flat spending given expectations of revenue growth in FY19 (Bloomberg); c) higher employee costs related to the specialty business (MR increase from 70 to 125 people); and d) incremental SG&A expenses over the next two quarters for the upcoming Solosec launch in 1Q FY19.

Lupin Ltd. (Reuters: LUPN.NS, Bloomberg: LPC IN)

Rs in mn, year-end Mar	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue (Rs mn)	137,579	171,198	153,943	166,475	189,288
EBITDA (Rs mn)	36,854	44,931	30,003	33,164	40,290
Net Profit (Rs mn)	22,607	25,575	13,253	15,703	20,587
EPS (Rs)	49.93	56.46	29.26	34.67	45.45
DPS (Rs)	7.46	7.48	4.09	4.85	6.36
EPS Growth	(6.2%)	13.1%	(48.2%)	18.5%	31.1%
EBITDA Margin	26.8%	26.2%	19.5%	19.9%	21.3%
ROCE	15.5%	12.7%	6.1%	7.0%	8.8%
ROE	22.6%	20.7%	9.4%	10.3%	12.3%
P/E (x)	16.0	14.2	27.4	23.1	17.6

Source: Company data, Bloomberg, J.P. Morgan estimates.

Neutral

LUPN.NS, LPC IN

Price: Rs800.90

▼ **Price Target: Rs820.00**
 Previous: Rs860.00

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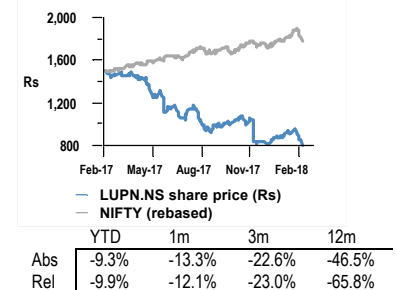
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Price Performance



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Key catalysts for the stock price:

- Lower-than-expected erosion in key products and base business
- Progress of new launches in the US and pricing trend in key products
- Improvement in growth trend in India

Upside risks to our view:

- Faster approval of the Gavis pending pipeline
- Big-ticket approval for the US Generic business
- Margin higher than expected due to large launches or lower expenses

Downside risks to our view:

- Delay in approvals of products in the US
- Protracted slowdown in the domestic pharma market
- Regulatory/Litigation risks
- INR appreciation could hurt non-INR revenue

Key financial metrics	FY17	FY18E	FY19E	FY20E
Revenues (LC)	171,198	153,943	166,475	189,288
Revenue growth (%)	24.4	-10.1	8.1	13.7
EBITDA (LC)	44,931	30,003	33,164	40,290
EBITDA margin (%)	26.2	19.5	19.9	21.3
Tax rate (%)	27.7	28.0	26.0	25.0
Net profit (LC)	25,575	13,253	15,703	20,587
EPS (LC)	56.5	29.3	34.7	45.4
EPS growth (%)	13.1	-48.2	18.5	31.1
DPS (LC)	7.5	4.1	4.9	6.4
BVPS (LC)	298.0	322.3	351.1	388.9
Operating cash flow (LC mn)	41,148	33,139	25,321	27,437
Free cash flow (LC mn)	24,521	40,280	11,321	13,437
Interest cover (X)	29.5	15.7	20.3	29.6
Net margin (%)	14.9	8.6	9.4	10.9
Sales/assets (X)	0.9	0.6	0.6	0.7
Debt/equity (%)	0.6	0.5	0.4	0.3
Net debt/equity (%)	0.4	0.2	0.2	0.1
ROE (%)	20.7	9.4	10.3	12.3

Key model assumptions	FY17	FY18E	FY19E	FY20E
USD/INR	65.5	67.1	65.0	65.0
US Revenue Growth	-0.8	36.5	-27.6	2.0
Japan Revenue Growth	5.7	14.7	26.8	12.7

Source: Company data and J.P. Morgan estimates.

Sensitivity analysis

Sensitivity to	EBITDA		EPS	
	FY18E	FY19E	FY18E	FY19E
5% chq in US Generic Revenue	3.5%	3.3%	5.4%	5.0%
5% chq in Japan Revenue	1.3%	1.4%	2.1%	2.1%
1% chq in R&D Expense	5.0%	4.9%	7.6%	7.4%

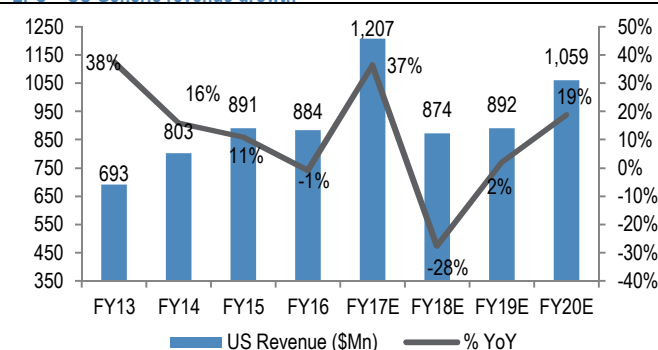
Source: J.P. Morgan estimates.

Valuation and price target basis

Our Mar-19 PT of Rs820 (vs. Rs860 previously as we adjust our estimates) is based on a P/E of 18x, in line with the long-term average of large-cap peers.

Key risks include earlier-than-expected/delays in approvals in the US, regulatory risk, higher-than-expected pricing erosion, currency and execution of M&A.

LPC – US Generic revenue growth



Source: Bloomberg, Company data and J.P. Morgan estimates.

JPM vs. consensus, change in estimates

EPS	FY19E	FY20E
JPM old	36.95	47.62
JPM new	34.7	45.4
% chq	-6.1%	-4.7%
Consensus	44.3	54.3

Source: Bloomberg, J.P. Morgan.

Table 1: Indian Pharma: Valuation Summary

	Mcap		P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
	CMP	\$Mn	CY18/FY19E	CY19/FY20E	CY18/FY19E	CY19/FY20E	CY18/FY19E	CY19/FY20E	CY18/FY19E	CY19/FY20E
Sun Pharma	552	20,606	30.1	23.6	19.9	15.9	3.2	2.9	11.9	13.5
Dr Reddy's	2,096	5,409	16.3	12.7	9.1	7.1	2.3	2.0	15.1	16.9
Aurobindo	597	5,443	13.2	11.8	11.6	9.9	2.5	2.1	20.4	18.9
Lupin	801	5,635	23.1	17.6	11.8	9.5	2.3	2.1	10.3	12.3
Cipla	564	7,070	21.0	17.6	9.1	7.6	2.9	2.6	15.0	15.7
Cadila	405	6,445	22.3	20.0	15.3	13.5	4.3	3.7	20.8	19.9
Glenmark	571	2,509	15.4	13.3	10.1	8.7	2.4	2.1	16.6	16.6
Alkem	2,145	3,992	25.1	21.6	20.1	17.1	4.2	3.6	18.1	17.9

Source: Company reports, J.P. Morgan estimates.

Analyst Call Highlights

Warning Letter – Remediation to be completed in 1Q FY19: Lupin management noted that it had engaged with consultants to help resolve the two key issues of invalidated OOS results without adequate investigation and hold-time studies assessment. The company has also engaged with separate consultants on remediation, training employees and doing work on improving the investigation being done. Management highlighted good progress on reviewing facilities with two updates sent to the agency so far. The company has guided to completing the remediation work by April-May and then will approach the USFDA with a focus on being accurate vs. expediting the review process. The remediation cost incurred so far is not substantial and part of other expenses in the quarter.

Looking at pipeline for the US: LPC indicated a strong launch pipeline with an increasing focus on complex generics - 8-10 injectables, a couple of inhalation and one biosimilar product being launched every year. Management highlighted several meaningful opportunities in the next 12-18 months, including Tamiflu, Axiron, Levothyroxine, Ranexa. On Ranexa (filed from WL facility), the company has received final approval from FDA and proactively approaching the agency with a full assessment of the product to ensure timely commercialization of this FTF opportunity. Levothyroxine approval has been delayed by a few months with LPC indicating a response to IR and launch timeline in the middle of this year. **On injectables**, Lupin has filed for four products in 3Q FY18 and hopes to launch them in FY19. The injectable plant is ready and will start taking exhibit batches in the next few months. However, complex injectables will be filed from FY20 onwards (from Nanomi). **Biosimilars** are in the early stages with LPC likely to be a second wave player in the US. It is looking at launch in FY23-25 in the US, which would mostly be products going off-patent at that point. On Etarnecept, the company is looking at filing the product in Japan by the end of FY18 and in Europe in 1Q FY19 with launch in next 15-18 months. The product is a good sized opportunity for the company in Japan despite having two players already in the market, but is exploring partners given RA and psoriasis salesforce required to market the product. **On inhalation pipeline**, gAlbuterol, which was filed in January 2017, is on track with the FDA and looking at approval in 2018 or early CY19 with launch in FY20. LPC also filed gPulmicort with the FDA. Its development of Tritoprium is completing Phase 3 studies with filing expected in the next two quarters. On gAdvair management noted that there are challenges with the product and continues to work getting the PK studies right (as seen in recent CRLs).

Specialty pipeline – All efforts on Solosec launch: While ramp-up of Methergine has been strong, there is risk emerging of potential generic entry. There was an increasing focus on the upcoming Solosec launch with the expenses related to the launch flowing through from the Dec quarter (small expense in the quarter). Management guided to the costs increasing in the coming quarters as the field force increases and the commercial infrastructure is set up for 1Q FY19 launch. LPC has validated the product in the last two months, manufactured launch quantities, and will start working up the trade channel/distributors in 1Q FY19. Management noted that the market access team is working with all major accounts to get access and start promoting the product. The incremental expenditure over the next few quarters related to this business will keep margins under pressure.

Other details: 1) India growth was 7.8% but LFL (adjusted for GST treatment) the growth was 11% with management seeing 15% growth in prescriptions. LPC also indicated that margins for India business would be in the 25-30% range. 2) One-off impact of Rs.361mn on re-measurement of deferred tax assets and liabilities post enactment of new US tax law with LPC indicating some more impact in 4Q FY18. 3) Impact of FX loss of Rs.821mn in 3Q FY18 across various cost items. 4) Normalized EBITDA margin excluding the FX impact was 20.8%, in line with FY18 guidance range of 21%-23%. 5) Capex guidance was Rs.8-10bn fr FY19.

Table 2: LPC: 3Q FY18 Summary

Rs MM, YE Mar.	3QFY18	3QFY17	% YoY	2QFY18	% QoQ	9MFY18	9MFY17	% YoY
India	10,688.0	9,912.0	7.8	11,593.0	(7.8)	22,281.0	29,369.0	(24.1)
US	14,321.0	21,755.0	(34.2)	13,611.0	5.2	27,932.0	63,619.0	(56.1)
APAC	6,742.0	5,601.0	20.4	6,357.0	6.1	2,939.5	3,872.7	(24.1)
EMEA	2,721.0	2,555.0	16.2	2,758.0	(1.3)	10,598.5	13,092.0	(19.0)
LatAm	1,481.0	1,175.0	26.0	1,395.0	6.2	2,539.5	3,231.3	(21.4)
RoW	371.0	367.0	1.1	378.0	(1.9)	749.0	1,131.0	(33.8)
API	2,680.0	2,684.0	(0.1)	2,650.0	1.1	5,330.0	8,569.0	(37.8)
Net Revenues	39,003.6	44,049.4	(11.5)	38,741.6	0.7	77,745.2	129,579.2	(40.0)
Total income	39,756.2	44,828.7	(11.3)	39,519.6	0.6	79,275.8	132,410.3	(40.1)
Gross Profit	25,829.3	31,813.0	(18.8)	26,654.3	(3.1)	52,483.6	94,246.8	(44.3)
Gross Margin (%)	65.0	71.0	(2.5)	67.4		66.2	71.2	
EBITDA	6,883.4	12,158.3	(43.4)	8,530.5	(19.3)	15,413.9	35,546.9	(56.6)
EBITDA Margin (%)	17.3	27.1		21.6		19.4	26.8	
PBT	3,824.1	10,425.7	(63.3)	6,069.9	(37.0)	9,894.0	30,162.2	(67.2)
PBT Margin (%)	9.6	23.3		15.4		12.5	22.8	
Tax Expense	1,607.7	4,094.8	(60.7)	1,540.6	4.4	3,148.3	8,418.3	(62.6)
Tax Rate (%)	42.0	39.3		25.4		31.8	27.9	
Profit after tax	2,217.3	6,331.1	(65.0)	4,550.1	(51.3)	6,767.4	21,772.5	(68.9)
PAT Margin (%)	5.6	14.1		11.5		8.5	16.4	
Key Costs								
Cost of sales	13,926.9	13,015.7	7.0	12,865.3	8.3	24,658.2	38,163.5	(35.4)
as % of revenues	35.7	29.5		33.2		31.7	29.5	
Employees cost	6,930.7	7,311.5	(5.2)	7,249.6	(4.4)	14,180.3	21,466.9	(33.9)
as % of revenues	17.8	16.6		18.7		18.2	16.6	
R&D Expenses	4,757.1	5,681.7	(16.3)	4,739.0	0.4	9,496.1	16,391.7	(42.1)
as % of revenues	12.2	12.9		12.2		12.2	12.6	

Source: Company reports.

Investment Thesis, Valuation and Risks

Lupin Ltd. (Neutral; Price Target: Rs820.00)

Investment Thesis

Lupin's US business has been impacted by competition in the large products in its portfolio. However, there are expectations of an earnings recovery from the Sept-17 quarter lows with a pick-up in launches including some meaningful opportunities. The Warning Letter to Goa and Indore Unit II will delay approvals by 12-18 months and has increased uncertainty on earnings recovery. While there are approvals expected from other facilities, the timely launch of these products and an update on resolution of the Warning Letter will be key triggers for the stock. The monetization

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of its complex products beyond FY19 should help support earnings growth over the long term.

Valuation

Our Mar-19 PT of Rs820 is based on a P/E of 18x, in line with the long-term average of large-cap peers.

Risks to Rating and Price Target

Key upside risks include faster resolution of Warning Letter accelerating approvals, accretive business development opportunities and a faster-than-expected ramp-up of approvals in the US and Japan. Downside risks include delays in approvals for the other facilities for the US, regulatory risk and a slow ramp-up of sales in Gavis.

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Lupin Ltd.: Summary of Financials

Income Statement						Cash Flow Statement					
	FY16A	FY17A	FY18E	FY19E	FY20E		FY16A	FY17A	FY18E	FY19E	FY20E
Revenue	137,579	171,198	153,943	166,475	189,288	Cash flow from operating activities	(3,824)	41,148	33,139	25,321	27,437
COGS	(43,326)	(50,014)	(52,725)	(56,185)	(62,465)	o/w Depreciation & amortization	4,871	9,122	10,890	12,222	13,602
Gross profit	94,253	121,184	101,217	110,289	126,823	o/w Changes in working capital	(31,264)	5,059	7,059	(4,266)	(8,139)
SG&A	(24,922)	(28,402)	(26,555)	(28,301)	(32,179)	Cash flow from investing activities	(69,617)	(25,287)	7,141	(14,000)	(14,000)
Adj. EBITDA	36,854	44,931	30,003	33,164	40,290	o/w Capital expenditure	(11,681)	(16,634)	(14,000)	(14,000)	(14,000)
D&A	(4,871)	(9,122)	(10,890)	(12,222)	(13,602)	as % of sales	8.5%	9.7%	9.1%	8.4%	7.4%
Adj. EBIT	31,982	35,809	19,113	20,942	26,687	Cash flow from financing activities	58,364	4,332	(14,000)	(13,966)	(14,479)
Net Interest	(595)	(1,525)	(1,912)	(1,637)	(1,362)	o/w Dividends paid	(4,055)	(4,066)	(2,232)	(2,644)	(3,466)
Adj. PBT	33,239	35,349	18,901	21,205	27,425	o/w Shares issued/(repurchased)	2	2	0	0	0
Tax	(10,593)	(9,785)	(5,653)	(5,513)	(6,856)	o/w Net debt issued/(repaid)	-	-	(10,140)	(10,000)	(10,000)
Minority Interest	(88)	(72)	(25)	(25)	(25)	Net change in cash	(15,077)	20,193	26,280	(2,645)	(1,042)
Adj. Net Income	22,607	25,575	13,253	15,703	20,587	Adj. Free cash flow to firm	(15,100)	25,617	20,479	12,532	14,459
Reported EPS	49.93	56.46	29.26	34.67	45.45	y/y Growth	(180.6%)	(269.6%)	(20.1%)	(38.8%)	15.4%
Adj. EPS	49.93	56.46	29.26	34.67	45.45						
DPS	7.46	7.48	4.09	4.85	6.36						
Payout ratio	14.9%	13.2%	14.0%	14.0%	14.0%						
Shares outstanding	453	453	453	453	453						
Balance Sheet						Ratio Analysis					
	FY16A	FY17A	FY18E	FY19E	FY20E		FY16A	FY17A	FY18E	FY19E	FY20E
Cash and cash equivalents	8,218	6,994	33,274	30,629	29,587	Gross margin	68.5%	70.8%	65.8%	66.3%	67.0%
Accounts receivable	45,488	43,073	38,732	41,885	47,625	EBITDA margin	26.8%	26.2%	19.5%	19.9%	21.3%
Inventories	32,737	36,423	32,752	35,418	40,272	EBIT margin	23.2%	20.9%	12.4%	12.6%	14.1%
Other current assets	12,412	11,910	10,726	11,586	13,152	Net profit margin	16.4%	14.9%	8.6%	9.4%	10.9%
Current assets	98,874	119,542	115,483	119,518	130,635	ROE	22.6%	20.7%	9.4%	10.3%	12.3%
PP&E	91,539	108,560	111,670	113,447	113,845	ROA	12.6%	10.4%	5.0%	5.9%	7.4%
LT investments	662	985	985	985	985	ROCE	15.5%	12.7%	6.1%	7.0%	8.8%
Other non current assets	35,174	36,986	36,986	36,986	36,986	SG&A/Sales	18.1%	16.6%	17.3%	17.0%	17.0%
Total assets	226,249	266,073	265,124	270,936	282,451	Net debt/Equity	60.1%	57.3%	28.1%	21.2%	14.0%
Short term borrowings	18,036	23,183	23,043	23,043	23,043	Net debt/EBITDA	182.5%	172.5%	136.9%	101.7%	61.5%
Payables	19,888	25,889	23,280	25,175	28,625	Sales/Assets (x)	0.8	0.7	0.6	0.6	0.7
Other short term liabilities	12,687	12,134	12,605	13,124	13,694	Assets/Equity (x)	1.8	2.0	1.9	1.8	1.7
Current liabilities	50,612	61,206	58,928	61,342	65,362	Interest cover (x)	62.0	29.5	15.7	20.3	29.6
Long-term debt	57,423	61,302	51,302	41,302	31,302	Operating leverage	4.6%	49.0%	462.6%	117.5%	200.2%
Other long term liabilities	6,260	8,244	8,553	8,893	9,266	Tax rate	31.9%	27.7%	29.9%	26.0%	25.0%
Total liabilities	114,294	130,752	118,783	111,536	105,930	Revenue y/y Growth	9.2%	24.4%	(10.1%)	8.1%	13.7%
Shareholders' equity	111,634	134,976	145,996	159,055	176,176	EBITDA y/y Growth	1.8%	21.9%	(33.2%)	10.5%	21.5%
Minority interests	321	345	345	345	345	EPS y/y Growth	(6.2%)	13.1%	(48.2%)	18.5%	31.1%
Total liabilities & equity	226,249	266,073	265,124	270,936	282,451						
BVPS						Valuation					
	FY16A	FY17A	FY18E	FY19E	FY20E		FY16A	FY17A	FY18E	FY19E	FY20E
BVPS	246.55	297.98	322.31	351.14	388.94	P/E (x)	16.0	14.2	27.4	23.1	17.6
y/y Growth	25.5%	20.9%	8.2%	8.9%	10.8%	P/BV (x)	3.2	2.7	2.5	2.3	2.1
Net debt/(cash)	67,241	77,491	41,071	33,716	24,758	EV/EBITDA (x)	11.7	9.8	13.5	12.0	9.6
						Dividend Yield	0.9%	0.9%	0.5%	0.6%	0.8%

Source: Company reports and J.P. Morgan estimates.

Note: Rs in millions (except per-share data). Fiscal year ends Mar. o/w - out of which

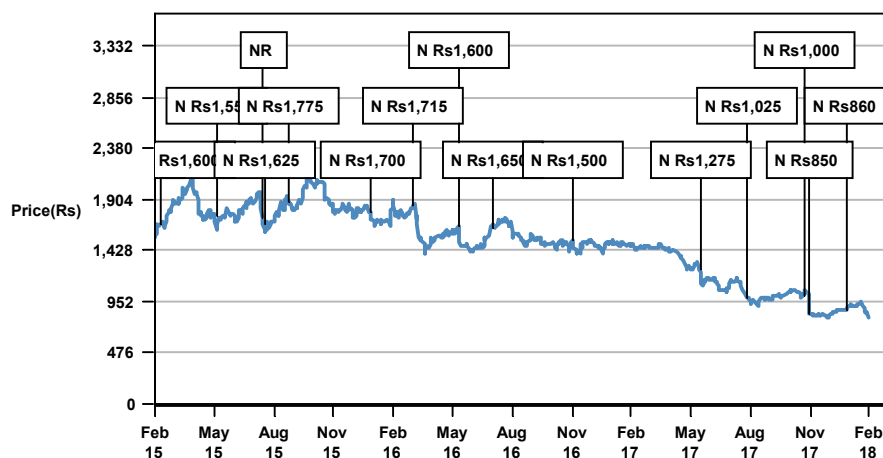
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Lupin Ltd. (LUPN.NS, LPC IN) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
18-Feb-15	N	1681.85	1600.00
14-May-15	N	1748.25	1550.00
23-Jul-15	NR	1728.25	--
27-Jul-15	N	1672.10	1625.00
03-Sep-15	N	1880.40	1775.00
06-Jan-16	N	1783.05	1700.00
11-Mar-16	N	1856.15	1715.00
20-May-16	N	1655.45	1600.00
11-Jul-16	N	1639.15	1650.00
10-Nov-16	N	1529.65	1500.00
25-May-17	N	1250.60	1275.00
03-Aug-17	N	993.40	1025.00
31-Oct-17	N	1001.10	1000.00
08-Nov-17	N	841.25	850.00
03-Jan-18	N	875.15	860.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage May 10, 2007.

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Asia Pacific Equity Research
07 February 2018

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