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SHILPA MEDICARE

Investments in the oncology business and a robust product line will ensure growth for the pharma specialist

CY14 RETURN 128%	NET SALES ₹ 571 CR
STOCK PRICE ₹ 619	NET PROFIT ₹ 75 CR
PE (X) 29	ROE 21%
MARKET CAP ₹ 2,385 CR	ROCE 21%

Note: Market data as on Dec 19, 2014; Financials for FY14; PE trailing 12-month
Source: Ace Equity

SOUMIK KAR

What comes to your mind when you think of Hyderabad? Banjara Hills, the famous *biryani* or the Charminar? For the average Joe on the street, the image could be any of the above. But ask the same question to someone from the financial community, and the one name that anyone would recall would be that of Ramalinga Raju — the tainted erstwhile founder of Satyam Computer Services who had to sell off his baby to Anand Mahindra. At the peak of the Satyam accounting scandal, there was a heated debate among investors and businessmen alike as to which state was home to the most corrupt promoters. Some said it was the erstwhile Andhra Pradesh, some said Gujarat, some felt it was New Delhi and for others it was Mumbai.

But my personal view is that corruption is a universal phenomenon; it's not a geographical attribute but a human trait. Yet, my interactions with investors over the years have revealed that most of them continue to be circumspect about investing in companies that originate from erstwhile Andhra Pradesh, especially from Hyderabad, as these companies do not have an impressive track record in corporate governance. But then, barring a few, how many companies in India have an impeccable record to flaunt?

So, if one weeds out such prejudices and instead focuses on the basic tenets of investing, what would be of relevance is the quantum of wealth a company generates for its investors or shareholders. In other words, it does not matter if a company operates out of any place — may it be Hyderabad or Jhumri Telaiya.

That being the case, my pick this year is a reputed company from the dreaded capital city of Hyderabad. My stock pick for 2015 goes by the name of Shilpa Medicare (SML). The company started its journey in 1987 and went public in 1995, aided by an exceptional team headed by Vishnukant Bhutada. Since its listing, the company has compounded shareholder wealth by nearly 46% every year compared with 14% by the Sensex over the same time period. This Raichur-based bulk drug manufacturer deals in oncology active pharmaceutical ingredients (APIs) and custom synthesis and is a global leader in bile acid derivative APIs. It is also on its course to manufacturing a few high-end anti-retroviral vial drugs (ARVs). The company manufactures and supplies more than 50 oncology and non-oncology APIs across the world, excluding the US.

Today, as a trusted outsourcing supplier and value-add partner, the company is rightly positioned to capitalise on the competitive advantage of the chemical chain of India that has put domestic pharmaceutical companies on the global map. SML has chosen a niche area in the pharma space by focusing on oncology. The global oncology market is estimated at $90 billion and accounts for 20% of new molecule chemical entities worldwide. SML recently commissioned a formulations plant, which is currently undergoing inspections by the US regulators. Gemcitabine is the company's largest product having around 50% market share across the world, while Capectabine holds 40% of the world's market share.

PRUDENT MANAGEMENT

The uniqueness of SML's business model lies in its ability to create trust through long-term partnerships with customers, suppliers and shareholders. Dr Reddy's, Cipla, Sun Pharma, Fresenius Kabi and Intas are some of its key customers. The major attribute of the management is its conservative approach towards financial and operational matters. The capital expenditure plan has been fine-tuned to the cash-generating ability of the company over the past decade. Timely injection of external equity and raising moderate working capital debt too reveal a

Oncology is the fastest growing therapeutic segment, globally

2013-2020 CAGR (%)

11.2	ONCOLOGY
10.4	ANTI-COAGULANTS
9.4	IMMUNOSUPPRESSANTS
8.7	ANTI-DIABETIC
7.3	ANTI-VIRALS
7.1	VACCINES
7.1	BRONCHODILATORS
5.7	ANTI-FIBRINOLYTICS
5.1	DERMA
4.3	MS

Source: Evaluate Pharma, Spark Capital Research prudent financial management approach. The working capital days have improved significantly over the past few years. The company has maintained its average debtor days at 43 days for the past 15 years and only 15 days of inventory is required to be funded by banks, as suppliers are willing to extend long credit to the company based on its goodwill. R&D expenses are around 6-8% of revenue, quite significant for a mid-size company reflecting its commitment towards an R&D-driven future.

STRONG ALLIANCES

Over the years, SML strengthened its relationship with Italian partner Industria Chimica Emiliana (ICE). ICE, along with its subsidiary PCA, is a global leader in biliary derivative APIs — especially Ursodiol (ursodeoxycholic acid). This is a naturally-occurring bile acid found in small quantities in human bile. It suppresses the synthesis and secretion of cholesterol by the liver and inhibits intestinal absorption of cholesterol, and hence is used to treat failure of liver function.

With the intention of capturing the global market, both the companies decided to strengthen their decade-old relationship and established Raichem Medicare. As a part of Raichem Medicare (a 50-50 joint venture between SML and ICE), the company is constructing a ₹1.5-billion facility at Raichur to expand Ursodiol supplies. The facility will have a capacity of 500 tonne a month in its initial phase, up from the present capacity of 200 tonne a month, and can clock revenue of ₹5 billion post one year of full operations. Commercial operations are expected to start in FY16.

Also, the company has signed an agreement with Gilead Sciences to increase access of HIV treatment for global patients. These patented medicines are part of the UN Medicine Patent Pool (MPP) programme, supplied by the innovators for wider reach: willing patent holders enter negotiations to license to the MPP. This means that the patent-holder allows other producers to manufacture and sell low-cost, good quality versions of patented medicine in developing countries, or develop adapted formulations under certain terms and conditions. The company will manufacture five key medicines for sale in 100 countries and is likely to generate revenue of ₹2 billion over the next few years. SML's manufacturing efficiency, superior sourcing advantage and chemistry skills are expected to enhance RoCE.

SWEET PILL

SML is approaching the end of a three-year capex cycle during which the company made significant investments to strengthen its existing oncology API and custom synthesis businesses. The company is preparing to move up the pharma value chain with its investments in formulation facilities. The key growth drivers are going to be the ₹1.8-billion facility at Jadcherla for formulations (including injectables) and a ₹1.2-billion facility at Raichur for expanding supplies of Ursodiol intermediates. Another growth driver in the near-to-medium term is the expected US FDA approval for the company's oncology API facilities in Raichur. It has filed around 14 drug master files and is awaiting final clearance from the FDA for supplying to regulated markets. Exports are around 60% of its total revenue.

In 27 years, SML has demonstrated superior capabilities to win the trust of its customers in the high-demand segment of oncology. With the majority of the capex behind it, the business reflects high visibility of earnings with an element of non-linearity that can surprise our estimates. SML's earnings are expected to grow at 30-35% CAGR over the next few years. With estimated earnings of ₹32 a share for FY16 and ₹42 for FY17, the stock is trading at a multiple of 16.5X for FY16 and 13.5X for FY17. Normally, a company with such a competitive advantage (intellectual property rights) would trade at a much higher valuation. However, I must caution investors regarding future earnings growth being dependent on the US FDA approval for the new plant, as well as movement of rupee against the US dollar. Any material-negative impact on this issue can impact the long-term valuation. OB

The author and his clients have investments in Shilpa Medicare.