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Natco Pharma Ltd.

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Strong revenue visibility with superior margins

Natco Pharma Ltd. is a vertically integrated pharmaceutical company with focus on niche therapeutic areas and complex products in Finished Dosage Formulations (FDF) and Active Pharmaceutical Ingredients (APIs). Natco has six manufacturing facilities spread across India with dedicated modern research laboratories and capabilities in new drug development. The Company is a leading player in India's generic oncology space.

Investment Rationale

Key US launches to drive the international formulations revenue growth:

The company has filed a total of 37 ANDAs, of which 24 (including 15 para-IVs) are awaiting approval from the USFDA. Majority of these drugs are high value complex generics (USD12bn market size) like Copaxone, Fosrenol, Vidaza, Gleevec, etc. and face limited competition. The company will launch 1-2 large products every year in the US which will drive the majority of revenues and profits in the medium term. In the near term, pending approvals such as Copaxone (market size USD 3.8 bn), Tamiflu (market size USD 500 mn), Gilenya (market size USD 1.3 bn), Revlimid (market size USD 974 mn) and several other smaller launches will boost the revenues and the margins. Going forward, we expect the company to file 7-8 ANDAs annually and grow at a CAGR of 84.7% over FY15-18E in the US international formulations.

Oncology and gSovaldi will drive domestic growth: Natco is a strong player in the domestic oncology segment and this segment contributed 51% to domestic formulations revenues in FY15. Natco addresses a significant portion of the oncology market in India which is pegged at Rs. 2,500 crores. The company has progressively widened its oncology product range from 6 in 2004 to 24 in 2015. Natco has also expanded into hepatology/virology therapeutic space and has developed a basket of products, which is expected to be launched in the near term. Further, we expect gSovaldi (first ever generic version of Sovaldi for Hepatitis C manufactured by Gilead Sciences Inc) to contribute Rs. 170-200cr to revenues in FY16E and progressively higher in FY17E, thus complementing domestic formulations growth. Further, the increased spending on Oncology space (which is not a crowded market) leaves a huge headroom for growth.

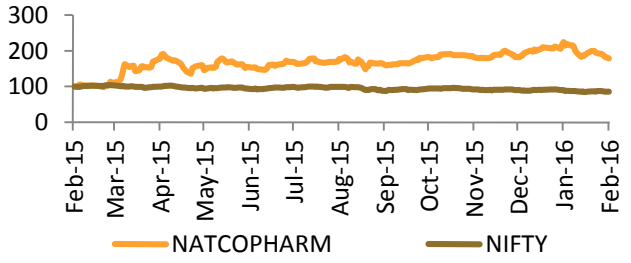
Valuation: We expect Natco's revenue and adj. PAT to grow at a CAGR of 37.7% & 51.6% respectively over FY15-18E. We further expect improvement in operating margins by 880bps to 34.7% on account of key launches (more than 50% of the filings in the pipeline are Para IV and FTF opportunities) in FY17E and increased revenues from oncology and gSovaldi sales in domestic market. Hence, we initiate Natco with BUY rating with a TP of Rs. 599 at 20x FY18E earnings.

Market Data	
Rating	**BUY**
CMP (Rs.)	497
Target (Rs.)	599
Potential Upside	20.5%
Duration	Long Term
Face Value (Rs.)	2
52 week H/L (Rs.)	624/266
Adj. all time High (Rs.)	624
Decline from 52WH (%)	25.5
Rise from 52WL (%)	87
Beta	-0.40
Mkt. Cap (Rs.Cr)	8,664

Fiscal Year Ended

Y/E	FY15	FY16E	FY17E	FY18E
Net sales (Rs.Cr)	825	1,034	1,671	2,154
Adj. Net profit (Rs.Cr)	150	164	377	521
Adj. EPS (Rs.)	45.1	9.4	21.6	29.9
P/E (x)	46.8	52.8	23.0	16.6
P/BV (x)	8.2	6.5	5.2	4.1
ROE (%)	19.1	15.0	25.1	27.5

One year Price Chart



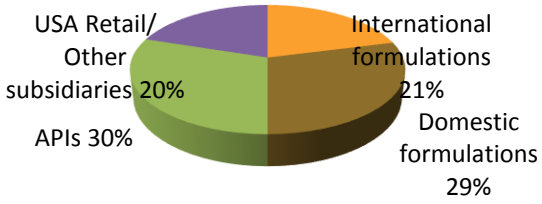
Shareholding Pattern	Dec-15	Sep-15	Chg.
Promoters (%)	51.3	51.3	0.0
FII (%)	20.5	10.8	9.7
DII (%)	5.8	5.9	(0.1)
Others (%)	22.3	32	(9.7)

Company overview

Natco has a strong position in domestic oncology segment along with presence in Gastroenterology and Orthopedics.

Natco Pharma Ltd. is a vertically integrated pharmaceutical company with focus on niche therapeutic areas and complex products in Finished Dosage Formulations (FDF) and Active Pharmaceutical Ingredients (APIs). The company has a diversified business model with presence across segments including Domestic & International formulations, API manufacturing and drug discovery products which are marketed in 40 countries. The company has a strong position in domestic oncology segment along with presence in Gastroenterology and Orthopedics. USFDA has already inspected its formulations facility at Kothur (Telangana) in May 2014 and API facility at Mekaguda (Telangana) in Nov 2014. Further, the management expects USFDA audit to take place at other facilities in the near term.

Segment wise revenue break-up (FY15)



Source: Company, In-house research

gSovaldi will drive the domestic growth

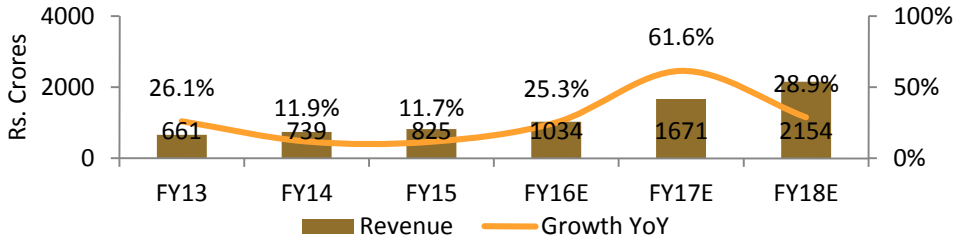
We expect, Sofosbuvir to be the key driver for its domestic and emerging markets growth in near term.

The company launched the Sofosbuvir (first ever generic version of Sovaldi manufactured by Gilead Sciences Inc.), the blockbuster drug used to treat chronic Hepatitis C in India and Nepal in March 2015 under the brand HEPCINAT (Rs 63 Crore during Q2FY16 with own brand contributing Rs 40 Crores). Natco signed a non-exclusive licensing agreement with Gilead Sciences to manufacture and market generic versions of chronic Hepatitis-C medicines in 101 developing countries. Recently, Natco has also launched a combination drug Harvoni (Sofosbuvir + Ledipasvir). In FY16, we expect gSovaldi and Harvoni together to contribute Rs. 170-200 cr annually to revenues. We expect, Sofosbuvir to be the key driver for its domestic and emerging markets growth in near term.

Further, the company's product pipeline consists of drugs used for curing various types of cancers - blood, lung, liver, kidney, breast, brain, ovary and prostate. Natco pioneered the launch of several generic versions of drugs in the domestic oncology segment and holds a leading position in their operated portfolios. It marketed 24 products in the Indian market during FY2014-15; its key products (Rs. 10 Crore brands) comprises of Geftinat, Erlonat, Veenat, Sorafenat and Lenalid. Apart from oncology, the company enjoys presence in neuro-psychiatry, gastroenterology, orthopaedic and anti-asthmatic spaces and it has also forayed into the hepatology/virology therapeutic space.

We expect domestic formulations to grow at a CAGR of 48.6% over FY15-18E on account of new launches and strong revenues from gSovaldi.

Domestic Formulations to grow at a CAGR of 48.6% during FY15-18E



Source: Company, In-house research

International Formulations revenue to grow at a CAGR of 84.7% over FY15-18E

International formulations business accounted for 21% of Natco's total revenues in FY15. In the international market, the cproducts span across several therapeutic segments namely oncology, gastrointestinal, central nervous system, etc.

The company has adopted a strategy to expand its US presence through differentiated product pipeline of niche and complex products. As opposed to market generic me-too products, the company opted to be present in the generic space with complex products addressing niche therapeutic areas with growth potential. In addition, Natco partnered with global pharmaceutical players to market products which had limited competition opportunity. Partnerships with well-known global pharmaceutical companies, who typically handle front-end marketing and litigation challenges in the USA (partner undertakes the responsibility of lengthy and complex litigation, regulatory issues and securing the ANDA approval), enables the company to focus on its core activity of research and manufacturing.

Majority of the drugs pending approval are high value complex generics (USD12bn market size) like Copaxone, Fosrenol, Vidaza, Gleevec, etc.

The company has filed a total of 37 ANDAs, of which 24 (including 15 para-IVs) are awaiting approval from USFDA. Majority of these drugs are high value complex generics (USD12bn market size) like Copaxone, Fosrenol, Vidaza, Gleevec, etc. and face limited competition. The company will launch 1-2 large products every year in the US which will drive the majority of revenues and profits in the medium term. In the near term, pending approvals such as Copaxone (market size USD 3.8 bn), Tamiflu (market size USD 500 mn), Gilenya (market size USD 1.3 bn), Revlimid (market size USD 974 mn) and several other smaller launches will boost the revenues and the margins. Going forward, we expect a few approvals to come through in the current and next fiscal and the company to file 7-8 ANDAs annually.

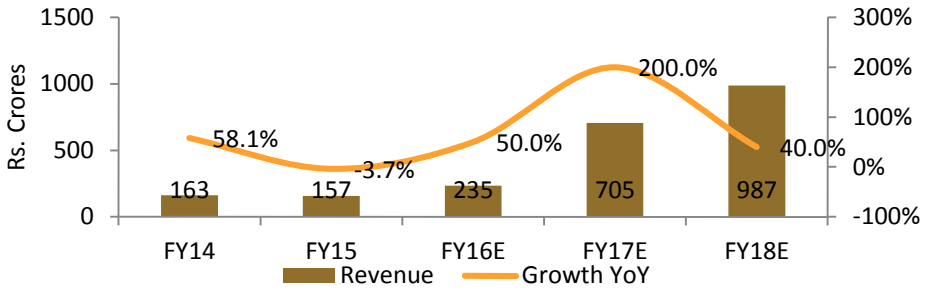
We expect international formulations business to grow at a CAGR of 84.7% over FY15-18E given the key launches in the near term and a robust pipeline of products to sustain the revenue growth momentum in the coming years.

Key Brands	Molecule	Indication	Filing type	Mkt. size (USD mn)
Copaxone 20	Glatiramer	Multiple Sclerosis	Para IV	2,354
Copaxone 40	Glatiramer	Multiple Sclerosis	Para IV	1,516
Gilenya	Fingolimod	Multiple Sclerosis	Para IV	1,322
Tamiflu	Oseltamivir	Influenza	Para IV	519
Treanda	Bendamustine	Leukemia	Para IV	675
Revlimid	Lenalidomid	Myloma	Para IV	974
Jevtana	Cabazitaxel	Prostate Cancer	Para IV	118
Nuvugil	Armodafinil	Antidepressant	Para IV	449
Fosrenol	Lanthanum	End stage renal	Para IV	114
Nexavar	Tosylate	Anti-cancer	Para IV	42
Tykerb	Lapatinib	Anti-cancer	Para IV	87
Tracleer	Bosentan	Hypertension	Para III	47
Entocort	Budesonide	Crohns disease	Para III	494
Vidaza	Azacitidine	Myeldysplastic	Para III	280

Source: Company, In-house research

The company has filed gSovaldi in 8-9 countries and launched the drug in Nepal and few smaller countries in Africa

International formulations to grow at a CAGR of 84.7% during FY15-18E



Source: Company, In-house research

RoW: New launches in EU and gSovaldi launch in EMs to drive the growth

Natco follows a similar strategy of partnership based model in Europe. Beyond USA and Europe, Natco has expanded its global footprint to countries like Brazil (Natco Farma Do Brazil), Canada (Natco Pharma Inc), Australia (Natco Pharma Australia Pty) and South- East Asia (Natco Asia Pte Ltd., Singapore). The company has filed gSovaldi in 8-9 countries and launched the drug in Nepal and few smaller countries in Africa. Natco also operates a retail pharmacy in the US. In FY15, revenue from the pharmacy and its subsidiaries contributed 20% to total sales and incurred a loss of 21 crores. The subsidiaries are expected to deliver better performance and achieve break-even once the approvals gather pace in near term.

Europe

The company sells products in UK and Germany through distribution arrangements with business partners. Natco is expected to launch 2 products, gGleevec (USD 1.5 bn market size) and gTreanda (USD 180 mn market size) in near term which will enable it to capture significant market share.

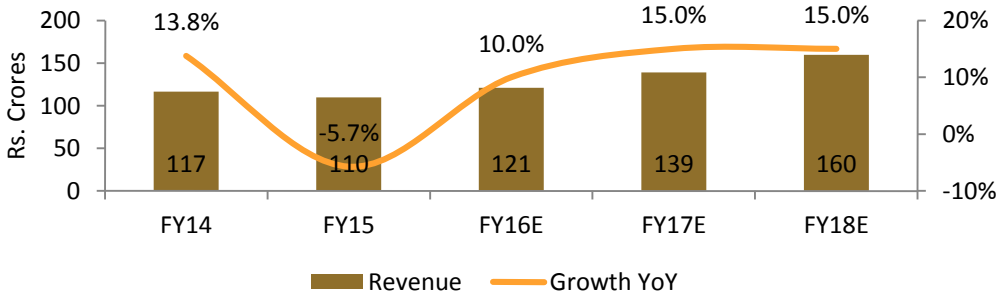
Brazil

The Company commenced operations in 2011 and has filed 12 products with ANVISA (Brazilian regulatory authority), which are at various stages of approval (some approvals could materialize in FY17 and FY18). Natco plans to file limited high value niche molecules on an ongoing basis in coming years and expects 3 approvals in near term.

Canada:

The Company had received Drug Establishment License in 2015 and submitted 11 applications to provincial formularies. In addition, the company has created a pipeline of niche products to be launched over the next 2-3 years.

US retail and subsidiaries revenue to grow steadily



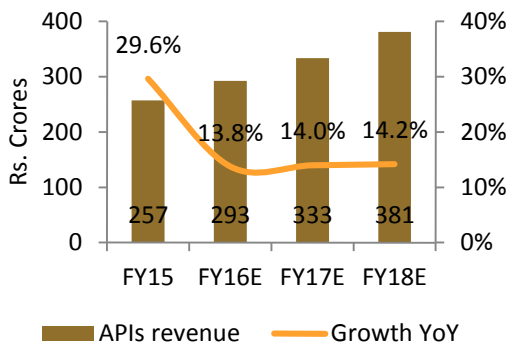
Source: Company, In-house research

The Company has a portfolio of 31 USDMFs (Drug Master Files) and robust pipeline of over 15 products under various stages of development.

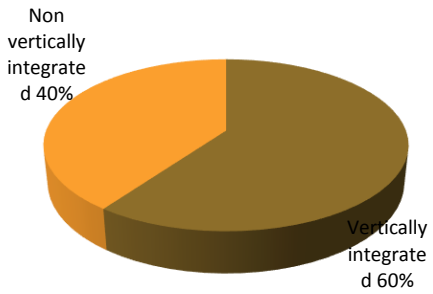
Strong In-House API Development

The Company manufactures API for sales in the domestic and international markets, apart from captive consumption. APIs contributed 30% to total revenues in FY15 and its consumption is increasing following new product launches. The Company continues to enjoy credibility as a quality API supplier to end-users by supplying new APIs with minimal gestation periods. The Company has a portfolio of 31 USDMFs (Drug Master Files) and robust pipeline of over 15 products under various stages of development with focus on complex molecules in oncology and CNS segments.

APIs Revenue



Backward Integration in critical APIs (FY15)



Source: Company, In-house research

Research & Development Capabilities

The company exhibits strong R&D capabilities as demonstrated by its complex and niche product filings in formulations and API segment. The Company annually spends 6-7% of revenues on R&D, and is currently engaged in discovery and development of drugs that include NRC-AN-019 (brain tumour, pancreatic cancer and CML) and NRC-2694 (Breast Cancer); NRC-019 has received orphan drug status in USA.

Key Risks:

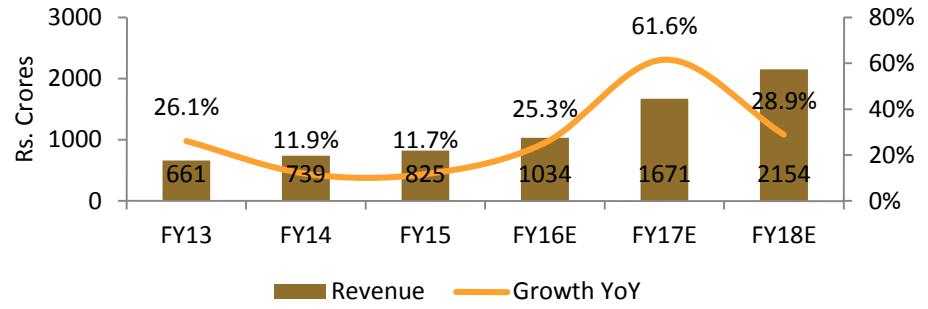
- Delay in key ANDA approvals from USFDA.
- Any adverse movement of global currencies vs INR.
- USFDA scrutiny against the company's manufacturing plants regarding cGMP practices.

Financials

Revenue to grow at a CAGR of 37.7% with EBITDA margin expansion of 880bps

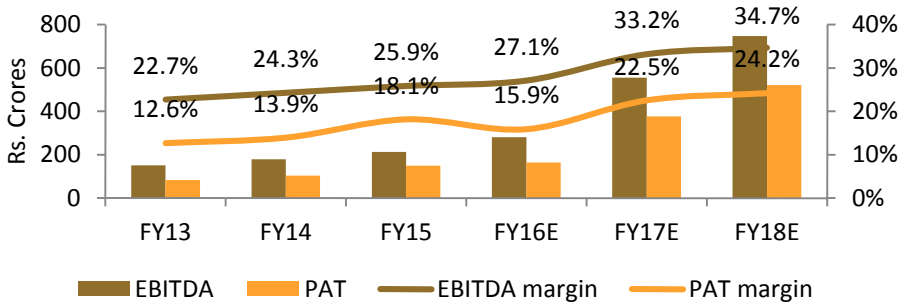
We expect Natco's revenue to grow at a CAGR of 37.7%, driven by key launches in international formulations, sustainable revenues from gSovaldi coupled with domestic formulations growth led by new launches in oncology. Hence, we expect EBITDA and adj. PAT to grow at a CAGR of 51.9% and 51.6% respectively and margins to expand by 880bps, 610bps over FY15-18E.

Revenue to grow at a CAGR of 37.7% over FY15-18E



Source: Company, In-house research

EBITDA & adj. PAT margin to improve by 880bps and 610bps respectively over FY15-18E

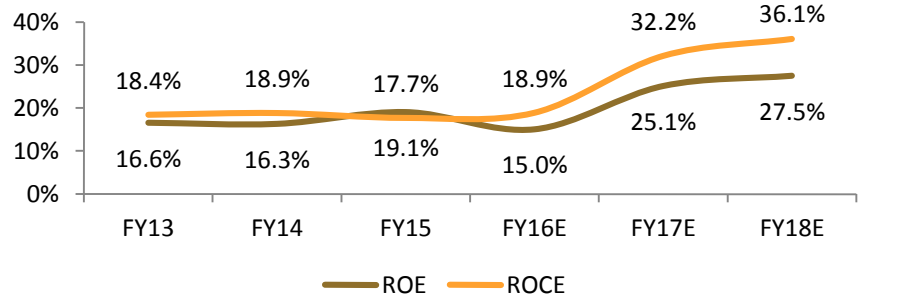


Source: Company, In-house research

Return ratios to improve significantly

We expect Natco's return ratios to improve drastically on account of contribution from high margin new launches in the US and increased contribution from domestic formulations oncology segment.

ROE and ROCE to improve by 840bps and 1840bps over FY15-18E



Source: Company, In-house research

Profit & Loss Account (Consolidated)

Y/E (Rs. Cr)	FY15	FY16E	FY17E	FY18E
Total operating Income	**825**	**1,034**	**1,671**	**2,154**
Raw Material cost	242	288	382	472
Employee cost	137	172	259	323
Other operating expenses	233	294	475	612
EBITDA	**213**	**280**	**555**	**747**
Depreciation	47	57	66	75
EBIT	166	224	489	673
Other income	**15**	**19**	**21**	**23**
Interest cost	32	14	7	-
Profit before tax	**149**	**228**	**502**	**695**
Tax	4	64	126	174
Profit after tax	**145**	**164**	**377**	**521**
Minority Interests	(4)	-	-	-
P/L from Associates	-	-	-	-
Adjusted PAT	**150**	**164**	**377**	**521**
E/o income / (Expense)	15	-	-	-
Reported PAT	**165**	**164**	**377**	**521**

Balance Sheet (Consolidated)

Y/E (Rs. Cr)	FY15	FY16E	FY17E	FY18E
Paid up capital	33	35	35	35
Reserves and Surplus	813	1,294	1,629	2,087
Net worth	846	1,329	1,663	2,122
Minority interest	5	5	5	5
Total Debt	266	111	56	-
Other non-current liabilities	22	23	24	26
Total Liabilities	**1,139**	**1,468**	**1,749**	**2,153**
Total fixed assets	**839**	**942**	**1,057**	**1,182**
Investments	2	2	2	2
Net Current assets	238	460	624	899
Other non-current assets	61	64	67	70
Total Assets	**1,139**	**1,468**	**1,749**	**2,153**

Cash Flow Statement (Consolidated)

Y/E (Rs. Cr)	FY15	FY16E	FY17E	FY18E
Pretax profit	**134**	**228**	**502**	**695**
Depreciation	47	57	66	75
Chg. in Working Capital	(86)	(69)	(150)	(129)
Others	(7)	-	-	-
Tax paid	(24)	(64)	(126)	(174)
Cash flow from operating activities	**65**	**152**	**293**	**468**
Capital expenditure	(119)	(160)	(180)	(200)
Chg. in investments	3	-	-	-
Cash flow from investing activities	**(117)**	**(160)**	**(180)**	**(200)**
Equity raised/(repaid)	-	339	-	-
Debt raised/(repaid)	79	(155)	(55)	(56)
Dividend paid	(20)	(21)	(42)	(63)
Other financing activities	-	-	-	-
Cash flow from financing activities	**59**	**163**	**(97)**	**(119)**
Net chg in cash	7	155	16	149

Key Ratios (Consolidated)

Y/E	FY15	FY16E	FY17E	FY18E
Growth (%)				
Net Sales	11.7	25.3	61.6	28.9
EBITDA	19.0	31.3	98.0	34.7
Net profit	45.8	9.5	129.7	38.4
Margin (%)				
EBITDA	25.9	27.1	33.2	34.7
EBIT	21.9	23.4	30.5	32.3
NPM	18.1	15.9	22.5	24.2
Return Ratios (%)				
RoE	19.1	15.0	25.1	27.5
RoCE	17.7	18.9	32.2	36.1
Per share data				
Adj. EPS	45.1	9.4	21.6	29.9
DPS	5.0	1.0	2.0	3.0
Valuation(x)				
P/E	46.8	52.8	23.0	16.6
EV/EBITDA	34.0	30.7	15.4	11.2
EV/Net Sales	8.8	8.3	5.1	3.9
P/B	8.2	6.5	5.2	4.1
Turnover Ratios (x)				
Net Sales/GFA	0.9	1.0	1.3	1.5
Sales/Total Assets	0.6	0.7	0.9	0.9

Rating criteria

Large Cap.	Return	Mid/Small Cap.	Return
Buy	More than equal to 10%.	**Buy**	More than equal to 15%
Hold	Upside or downside is less than 10%	**Accumulate***	Upside between 10% & 15%
Reduce	Less than equal to -10%	**Hold**	Between 0% & 10%
		Reduce/sell	Less than 0%

* To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

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