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Granules India Ltd.

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CRAMS & OTC products to be the game changer

Granules India (Granules) is an integrated Indian pharmaceutical company. It manufactures Finished Dosages (FDs), Pharmaceutical Formulation Intermediates (PFIs) and Active Pharmaceutical Ingredients (APIs). It caters to more than 300 clients (including some of the prominent branded and generic players) across 75 nations.

Investment Rationale

Omnichem JV and Auctus to drive the APIs revenue growth: Granules has acquired Auctus Pharma, a manufacturer of active pharmaceutical ingredients (API) for Rs 120 cr. This acquisition has added 12 more APIs to existing catalogue across different therapeutic segments. It has further helped in diversifying its product portfolio by providing access to potentially higher margin products with focus on development of new APIs (through in-house R&D). While Auctus Pharma was a loss-making entity at the time of acquisition, Granules changed the mix towards high margin product portfolio. Importantly, stellar growth will be witnessed from FY18 onwards owing to the higher numbers of filings from Auctus. Granules has 22 regulatory filings under this division which include 8 European filings, 4 USDMFs, 3 South Korean DMFs, 3 IDL China, 2 Health Canada, 1 Italy and 1 Spain. We expect the API segment to grow at a CAGR of 9% over FY16-18E on account of its leadership position in top-5 molecules coupled with Auctus portfolio which has enabled new launches in complex product segment.

OTC launches to drive FDs growth in US: With increasing emphasis on finished dosage (FD), the company has acquired a FD facility in Virginia to introduce value added products and formulation of complex molecules. This acquisition will also help Granules in filing own ANDAs in the US market. Interestingly, it aims to file 12-14 complex ANDAs over the next 2-5 years. It has four product approvals for the US market including the recent approval for Ibuprofen ANDA. This has further strengthened company's core business and enabled it to increase product offerings to customers in the US.

Increasing demand from global players to drive the PFIs revenues: The company has the largest PFI facility in the world with an industry-leading batch size of six tons (one of the largest single-site FD facilities in the world) backed by increased capacity of API over the years. This provides significant edge over competitors as it helps in reducing production costs. It files own ANDAs and dossiers which enable customers to quickly enter a market instead of filing their own applications.

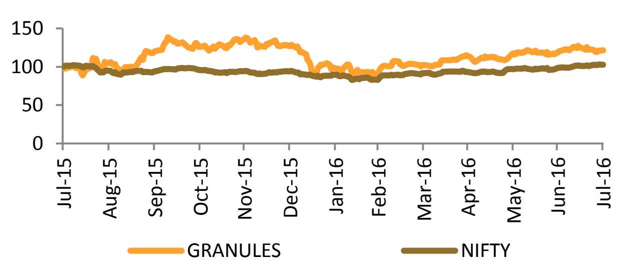
Valuation: We expect revenue and PAT to grow at a CAGR of 20.8% & 39.8% respectively over FY16-18E. Further, EBITDA margins are expected to improve by 270bps on account of ramp up in PFIs production and limited competition launches. Hence, we initiate Granules with a BUY rating with a TP of Rs.166 based on 15.5x FY18E EPS.

Market Data	
Rating	**BUY**
CMP (Rs.)	142
Target (Rs.)	166
Potential Upside	16%
Duration	Long Term
Face Value (Rs.)	1
52 week H/L (Rs.)	164/101
Adj. all time High (Rs.)	164
Decline from 52WH (%)	15
Rise from 52WL (%)	41
Beta	
Mkt. Cap (Rs.Cr)	3,085

Fiscal Year Ended

Y/E	FY15	FY16	FY17E	FY18E
Net sales (Rs.Cr)	1,294	1,431	1,639	2,088
Net profit (Rs.Cr)	91	118	150	232
EPS (Rs.)	4.5	5.5	6.9	10.7
P/E (x)	32.0	26.1	20.6	13.3
P/BV (x)	6.7	4.8	4.0	3.1
ROE (%)	23.1	22.1	21.3	26.5

One year Price Chart

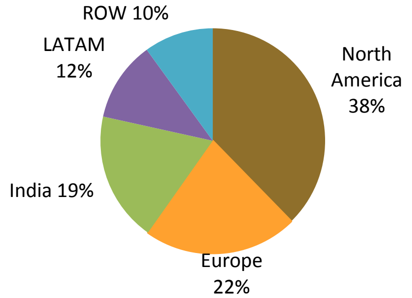


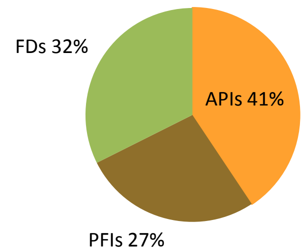
Shareholding Pattern	Mar-16	Dec-15	Chg.
Promoters (%)	51.1	51.1	0.0
Public (%)	48.9	48.9	0.0

Company Overview

Based out of Hyderabad, Granules India (incorporated in 1991) is an integrated Indian pharmaceutical company. It manufactures Finished Dosages (FDs), Pharmaceutical Formulation Intermediates (PFIs) and Active Pharmaceutical Ingredients (APIs). It caters to more than 300 customers (include some of the large branded and generics players) across 75 nations. Regulated markets of North America and Europe account for 60% of overall revenue, while the rest comes from Latin America, India and RoW countries.

Geography wise revenue breakup (FY16) | **Business break-up**





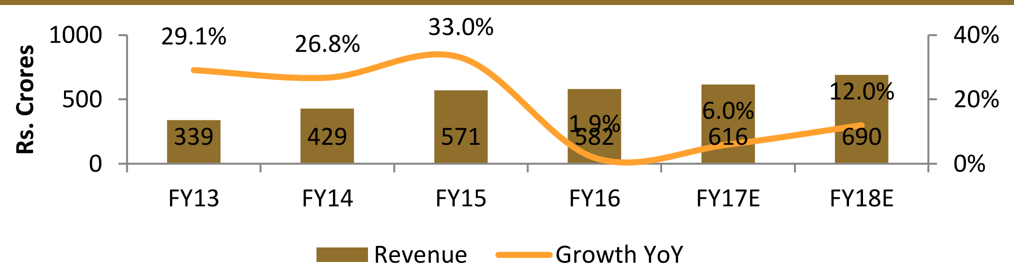
Source: Company, In-house research

APIs revenue to be strengthened by Auctus acquisition

Granules is one of the largest producers of APIs and is a global leader in Ibuprofen, Paracetamol, Metformin, Guaifenesin and Methocarbamol. Despite being in a commoditized business, its API business grew at a CAGR of 22% over FY12-16 due to continuous enhancement in manufacturing processes and economies of scale.

In Nov-13, the company acquired Auctus Pharma, a manufacturer of active pharmaceutical ingredients (API) for Rs 120cr. This acquisition has added 12 more APIs to existing catalogue across different therapeutic segments. Further, it would help in diversifying its product portfolio by getting access to potentially higher margin products with focus on development of new APIs through in-house R&D. While Auctus Pharma was a loss-making entity at the time of acquisition, Granules modified the product mix in order to make it high margin business. Importantly, stellar growth will be witnessed from FY18 onwards owing to the higher numbers of filings from Auctus. The company has 22 regulatory filings under this division which include 8 European filings, 4 USDMFs, 3 South Korean DMFs, 3 IDL China, 2 Health Canada, 1 Italy and 1 Spain. We expect APIs to grow at a CAGR of 9% over FY16-18E on account of its leadership position in its top-5 molecules coupled with Auctus portfolio and 6-8 new filings in FY17.

APIs business to grow at a CAGR of 9% during FY16-18E



Source: Company, In-house research

US to drive the revenue growth of finished dosages

The manufacture of finished dosages (FDs) represents the apex of the value chain. The company has increased its production from 3.5 bn tablets in FY12 to 6 bn tablets in FY16. The business accounts for 32% of the company's revenue. The FDs segment has grown at a CAGR of 25% over FY12-16 on account of strong contract manufacturing orders from global innovators & large generic players (half of this business was driven by CMO contracts) and US product launches. It has four product approvals for the US market including the recent approval for Ibuprofen ANDA for 400 mg, 600 mg and 800 mg tablets. This has further strengthened company's core business and enabled it to increase product offerings to customers in the US. The company has already started sales of this product and expects them to ramp up steadily in future.

With the increasing emphasis on finished dosage, the company has acquired a FD facility in Virginia to introduce value added form of existing products and to concentrate into formulation R&D of complex molecules. This will enable the company to file own ANDAs in the US market as it aims to file 12-14 complex ANDAs over the next 2-5 years.

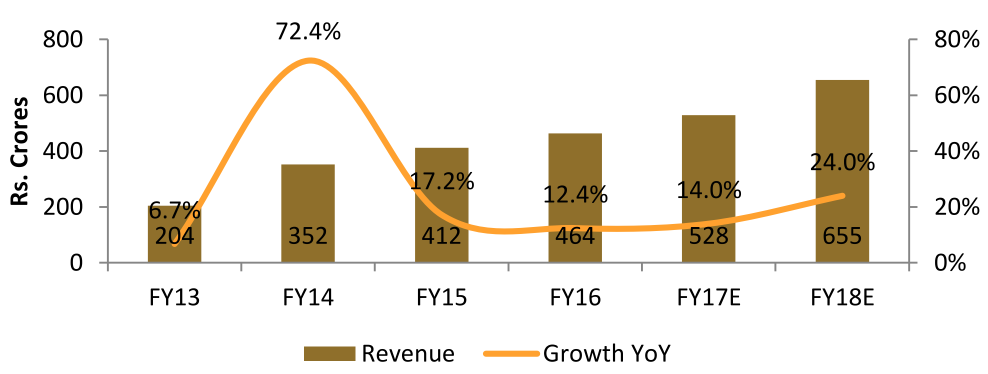
OTC business to be the growth driver in long term

Granules has ventured into manufacturing and marketing of OTC products by extending core business along with existing products in North American markets. The company has adopted a focused approach towards marketing of OTC products directly to retail outlets in the US. It is continuously increasing product offering by introducing new OTC products, however significant contribution from OTC (currently Granules has approval for 3 OTC product) will be realized from FY18 onwards.

Recently, the US subsidiary of Granules entered into an agreement with Par Pharmaceutical to market generic version of OTC omeprazole and sodium bicarbonate in North America. This exclusive tie-up can strengthen OTC product basket and add USD 4-5mn to overall revenue. The incremental filings from acquired Virginia facility and ramp up in existing OTC products are likely to drive the company's long term growth.

We expect the company's Finished Dosage revenue to grow at a CAGR of 19% over FY16-18E on account of increasing wallet share from existing customers along with addition of new customers.

Finished Dosage revenue to grow at 19% CAGR over FY16-18E



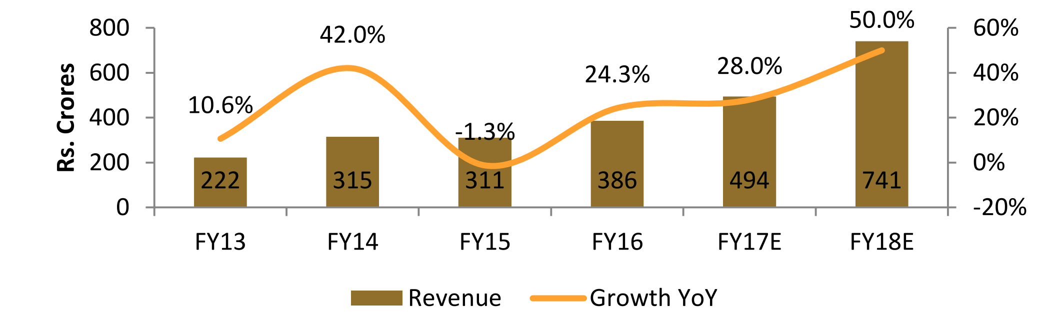
Source: Company, In-house research

PFIs to grow at CAGR of 39% over FY16-18E

Granules has pioneered the concept of commercializing PFIs. In the early part of the 1990's, it believed that most of the manufacturers were not efficiently producing PFIs and thus, entered this particular business segment. These products had to be tested individually, which raised the expenses for the manufacturers. In turn, the customers had to buy them at higher prices. This subsequently reduced the returns on investments for the manufacturers as 80% of the total cost of a finished dosage is accounted up to the process of PFI manufacturing.

The company has the largest PFI facility in the world with an industry-leading batch size of six tons (one of the largest single-site FD facilities in the world) backed by increased capacity of API over the years. This provides significant edge over competitors as it helps in reducing production costs. It files its own ANDAs and dossiers which enable customers to quickly enter a market instead of filing their own applications. The company produces PFIs that are taken from drums to hoppers directly and from there, these ingredients are compressed into tablets and delivered to customers. Increasing demand for PFIs is driven by reduction of vendor development cost, lower testing costs and saving of time & technical resources.

PFIs to grow at a CAGR of 39% over FY16-18E



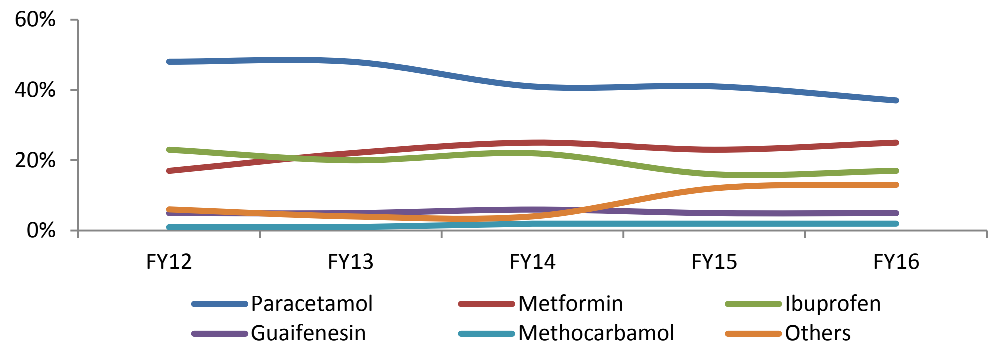
Source: Company, In-house research

Foray into CRAMS through Omnichem JV

Granules-Omnichem is a 50:50 JV between Granules and Ajinomoto Omnichem of Belgium, which is a 100% subsidiary of Ajinomoto of Japan. This JV allows Granules to enter the high-margin CRAMS market without any major investments in R&D. Omnichem JV not only allows it to manufacture high-value intermediates, but also helps in the transition from a commoditised player to high quality CRAMS player as partner provides support in quality, engineering and technology transfer related matters. Omnichem, a division of Ajinimoto, works with global pharmaceutical companies and makes patent protected products for regulated markets. Going forward, as the products go off-patent customers attempt to retain market share by shifting to a cost-effective environment and it augurs well for Granules' expertise in efficient manufacturing.

The JV has a dedicated manufacturing facility for high-value active pharmaceutical ingredients (APIs) and already started commercial operations in FY16. The company is currently working on 4-5 products and expects USFDA approvals from FY18. Till the facility gets regulatory approvals it will produce API intermediates for JV partner and is expected to add more than Rs 200cr to revenues in FY17. Post approvals, the JV will produce APIs for global innovators and branded companies.

Top molecules revenue share over FY12-16



Source: Company, In-house research

Capacity expansion

In order to de-bottleneck capacity constraint at API level, in FY16 the company has increased the Paracetamol capacity at its Bonthapally plant by 3,000 TPA. Further, it is enhancing Metformin capacity (contributes around 25% to total revenue) from 2,000 TPA to 9,000 TPA in two phases (first phase is 3,500 TPA and the second phase will go up by another 3,500 TPA, ending in FY19). Moreover, first phase validations will start in Q3FY17.

Manufacturing Units

Value Chain	Facility Location	Approvals
API	Bonthapally	U.S. FDA, EDQM, WHO GMP, ISO 14001:2004, OHSAS 18001:2007
	Jeedimetla	U.S. FDA, KFDA, TGA, EDQM
	Jingmen, China (Biocause JV)	U.S. FDA, MHRA, EDQM, TGA, KFDA, Health Canada
	Vizag	U.S. FDA, EDQM, KFDA, WHO GMP, Health Canada
	Vizag SEZ (Omnichem JV - CRAMs)	
PFI	Gagillapur	U.S. FDA, EDQM, TGA, GHCA
	Jeedimetla	HHA (Germany)
	Gagillapur	U.S. FDA, TGA, GHCA
	Virginia, the USA	Yet to be applied
API Intermediates	Bonthapally (Auctus)	N.A.

Source: Company

Key Risks:

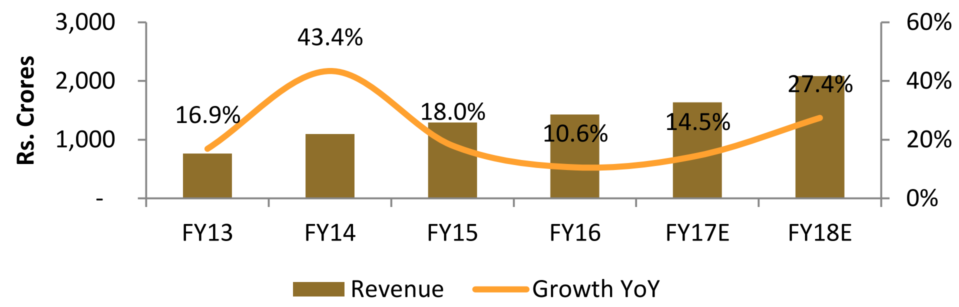
- Delay in product launch due to regulatory risks
- Pricing pressure on existing products

Financials

Revenue to grow at CAGR of 20.8% with EBITDA margin expansion of 270 bps

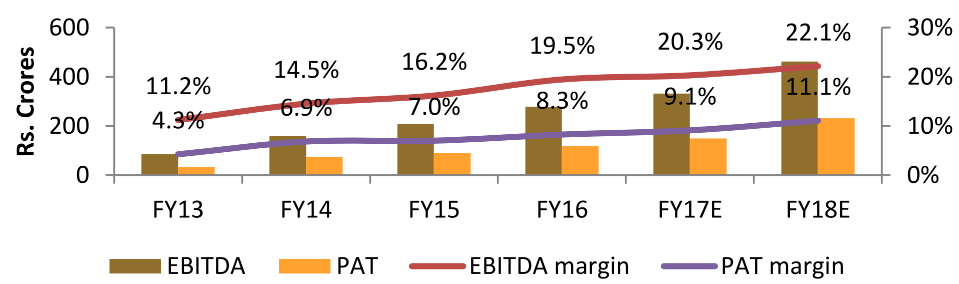
We expect revenue to grow at a CAGR of 20.8% over FY16-18E on account of three factors: 1) scale up in API revenue driven by Auctus and Omnichem JV 2) optimum utilization of capacities on account of increasing demand in PFIs 3) ramp up in OTC production with existing FDs. Hence, we expect 270 bps improvement in EBITDA margin over FY16-18E led by backward integration & shift in product mix towards limited competition launches.

Revenue to grow at a CAGR of 20.8% over FY16-18E



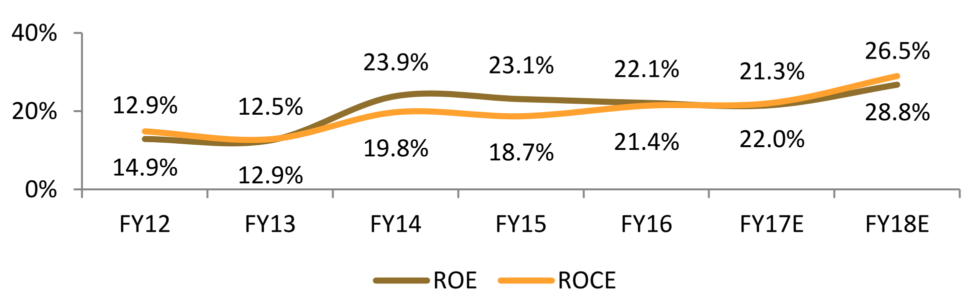
Source: Company, In-house research

EBITDA & PAT margin to improve by 270 bps and 280 bps respectively



Source: Company, In-house research

Return ratios trend



Source: Company, In-house research

FUNDSINDIA

Profit & Loss Account (Consolidated)

Y/E (Rs. Cr)	FY15	FY16	FY17E	FY18E
Total operating Income	**1,294**	**1,431**	**1,639**	**2,088**
Raw Material cost	747	758	855	1,064
Employee cost	107	125	144	177
Other operating expenses	230	269	309	384
EBITDA	**209**	**278**	**333**	**462**
Depreciation	53	64	80	97
EBIT	**157**	**214**	**253**	**365**
Interest cost	32	40	35	30
Other Income	4	6	5	5
Profit before tax	**128**	**180**	**224**	**341**
Tax	37	62	74	109
Profit after tax	**91**	**118**	**150**	**232**
Minority Interests	-	-	-	-
P/L from Associates	-	-	-	-
Adjusted PAT	**91**	**118**	**150**	**232**
E/o income / (Expense)	-	-	-	-
Reported PAT	**91**	**118**	**150**	**232**

Balance Sheet (Consolidated)

Y/E (Rs. Cr)	FY15	FY16	FY17E	FY18E
Paid up capital	20	22	22	22
Reserves and Surplus	411	617	749	959
Net worth	**431**	**639**	**770**	**981**
Minority interest	-	27	27	27
Total Debt	482	474	414	354
Other non-current liabilities	53	63	64	64
Total Liabilities	**967**	**1,204**	**1,275**	**1,427**
Total fixed assets	679	745	865	918
Capital WIP	-	-	-	-
Goodwill	-	-	-	-
Investments	0	0	0	0
Net Current assets	264	442	392	489
Deferred tax assets (net)	-	-	-	-
Other non-current assets	24	16	18	20
Total Assets	**967**	**1,204**	**1,275**	**1,427**

Cash Flow Statement (Consolidated)

Y/E (Rs. Cr)	FY15	FY16	FY17E	FY18E
Pretax profit	**128**	**180**	**223**	**341**
Depreciation	53	64	80	97
Chg. in Working Capital	(31)	(92)	(48)	(107)
Others	33	40	29	24
Tax paid	(32)	(49)	(74)	(109)
Cash flow from operating activities	**150**	**144**	**211**	**246**
Capital expenditure	(148)	(135)	(200)	(150)
Chg. in investments	-	-	-	-
Other investing cashflow	3	7	5	5
Cash flow from investing activities	**(146)**	**(128)**	**(195)**	**(145)**
Equity raised/(repaid)	1	133	-	-
Debt raised/(repaid)	34	(41)	(60)	(60)
Dividend paid	(8)	(23)	(18)	(21)
Other financing activities	(8)	(8)	(35)	(30)
Cash flow from financing activities	**19**	**61**	**(113)**	**(110)**
Net chg in cash	24	77	(97)	(9)

Key Ratios (Consolidated)

Y/E	FY15	FY16	FY17E	FY18E
Growth (%)				
Net Sales	18.0	10.6	14.5	27.4
EBITDA	31.2	33.0	19.5	38.9
Net profit	20.8	30.3	26.5	54.5
Margin (%)				
EBITDA	16.2	19.5	20.3	22.1
EBIT	12.1	15.0	15.4	17.5
NPM	7.0	8.3	9.1	11.1
Return Ratios (%)				
RoE	23.1	22.1	21.3	26.5
RoCE	18.7	21.4	22.0	28.8
Per share data (Rs.)				
EPS	4.5	5.5	6.9	10.7
DPS	0.5	0.6	0.7	0.8
Valuation(x)				
P/E	32.0	26.1	20.6	13.3
EV/EBITDA	15.9	12.4	10.5	7.4
EV/Net Sales	2.6	2.4	2.1	1.6
P/B	6.7	4.8	4.0	3.1
Turnover Ratios (x)				
Net Sales/GFA	1.5	1.5	1.4	1.6
Sales/Total Assets	1.2	1.1	1.1	1.3

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.

***** Granules is a small-cap company

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