IPCA Laboratories Ltd (NSE Code: IPCALAB) – Alpha/Alpha + stock recommendation for Nov'12

Content Index

Dear Members,

In the global pharmaceutical market, India has a share of just 3% by value; however what is important is that India is recognized as one of the leading global players with large number of drug master files and dossier registrations for Active Pharmaceutical Ingredients (APIs) and formulations with manufacturing facilities approved by regulatory authorities of the developed countries.

We believe the value share of Indian pharmaceutical industry can increase substantially over the next 5-10 years with Indian companies focusing on global generic and API business, R&D activities and contract research and manufacturing alliances. India is also fast emerging as a preferred low cost pharmaceuticals manufacturing location.

At the same time, several large selling drugs going off-patent over next few years and increasing use of pharmaceutical generics in developed markets to reduce healthcare cost will provide attractive growth opportunities to generics manufacturers and thus Indian pharmaceutical industry is poised for an accelerated growth in the coming years.

IPCA Laboratories (NSE Code – IPCALAB) – Established in 1949 (since 1975 under present management), IPCA is one of India's better managed mid-sized pharmaceutical companies. It has presence in Domestic branded formulations, Global branded and generic formulations, and Global APIs. IPCA's core business strategy is to leverage its strength in manufacturing API to develop vertically integrated and highly competitive formulations. Most of the company's formulations are backed by its own APIs.

Before we discuss the finer details, here's a brief snapshot:

- Market capitalization – Rs 5,615 cr.
- Debt equity ratio – 0.48; Long term debt equity ratio – 0.26
- Average cash flows from operations (post tax) for the last 5 years – Rs 150.37 cr.
- Average Net profit for the last 5 years – Rs 200 cr.
- Long standing dividend history (more than 15 years) with a reasonable 15-20% dividend payout.

Investment Snapshot (As on 25th Nov'12)

Recommendation – Buy

Portfolio Allocation Strategy –

1. Start with ~5% portfolio allocation in the range of 430-450.
2. We may consider increasing allocation to 8-10% in case of a correction to around 350-375.

Profit Booking – Refer Alpha/Alpha + weekly

Current Market Price – Rs 444.80

BSE Code – 524494; **NSE Code** – IPCALAB

Bloomberg Code – IPCA: IN

Market capitalization – Rs 5,615 cr.

Total Equity shares – 12.61 cr.

Face Value – Rs 2.00

52 Weeks High/Low – Rs 495/ Rs 245

Promoter's holding – 45.91%

IPCA Laboratories Ltd – An Introduction

IPCA is a fully-integrated (fully integrated pharmaceutical companies are the ones that manufacture formulations backed by their own APIs) Indian pharmaceutical company manufacturing over 350 formulations and 80 APIs for various therapeutic segments.

The company has presence in the following three segments:

1. Domestic branded formulations,
2. Global branded and generic formulations, and
3. Global APIs (active pharmaceutical ingredients)

It is one of the world's largest manufacturers and suppliers of over a dozen APIs. These are produced right from the basic stage at manufacturing facilities endorsed by the world's most discerning drug regulatory authorities like US-FDA, UK-MHRA, EDQM-Europe, WHO-Geneva and many more.

IPCA is a therapy leader in India for anti-malarials with a market-share of over 34% with a fast expanding presence in the international market as well. It has successfully leveraged its global strength in anti-malarial APIs and is the only company having WHO prequalification for both API and formulation to participate in global institutional business in malaria endemic countries. IPCA also leads in DMARDs (Disease Modifying Anti-Rheumatic Drugs) treatment for rheumatoid arthritis.

IPCA has leading brands in 5 therapeutic areas, with 4 of their branded formulations being ranked among the Top-300 Indian brands by ORG-IMS. Also, its international client roster includes global pharmaceutical giants like AstraZeneca, GlaxoSmithKline, Merck, Roche and Sanofi Aventis; most of whom they have been partnering for many years now.

Manufacturing Locations

Manufacturing facilities – Formulations		
Location	**Dosage Form**	**Approvals/Inspections**
Athal, Silvassa	Tablets & Capsules	UK-MHRA, TGA-Australia, MCC-South Africa, HPB-Canada, WHO-Geneva
Ratlam, Madhya Pradesh	Tablets, Liquids, Injectables & Ointments	MCC-South Africa
Kandla, Gujarat	Betalactum – Tablets, Capsules and Dry Syrups	UK-MHRA, MCC-South Africa
Silvassa	Tablets & Capsules	UK-MHRA, US-FDA, TGA-Australia, HPB-Canada
Dehradun, Uttaranchal	Tablets & Cephalosporin Injectables	WHO-GMP
Indore (SEZ), Madhya Pradesh	Tablets & Capsules	UK-MHRA, US-FDA (Pending)
Sikkim	Tablets & Capsules	GMP

Manufacturing facilities – Active Pharmaceutical Ingredients (APIs)	
Location	**Approvals/Inspections**
Ratlam, Madhya Pradesh	US-FDA, TGA-Australia, EDQM, Danish Regulatory Authority, PMDA-Japan, WHO-Geneva
Indore, Madhya Pradesh	WHO-GMP
Ankleshwar, Gujarat	PMDA-Japan
Aurangabad, Maharashtra	WHO-GMP

Besides the above manufacturing facilities for Formulations and APIs, the company is in the process of setting up a new green field API manufacturing facility at Village Ranu, District Vadodara, Gujarat.

Also, it is important to note here that IPCA had received the US-FDA approval for oral solid dosage formulations manufacturing facility situated at Indore (SEZ), Madhya Pradesh and was expected to manufacture and commercialize formulations for the US market from its Indore (SEZ) manufacturing unit FY 14 onwards; however during the course of the internal quality assurance review, the Company noticed a few non-conformances at the said manufacturing unit and voluntarily referred those to the US-FDA and the same is under discussion with them for an appropriate resolution.

As per the management, they now expect a delay of 2-3 quarters before they start commercializing formulations manufactured at Indore (SEZ) for US market.

Revenue break-up

IPCA has a strong presence in domestic formulations market, however it is also among the top 10 pharmaceutical exporters from India and now derives ~60% of its revenue from exports.

	Domestic Formulations	Domestic API	Total Domestic Sales	Domestic Sales as a % of Net Sales	Export Formulations	Export API	Total Export Sales	Exports as a % of Net Sales	Net total Sales
FY 12	753.41	143.86	897.27	39.02%	996.14	405.83	1401.97	60.98%	2299.24
FY 11	695.66	145.08	840.74	45.06%	691.71	333.47	1025.18	54.94%	1865.92
FY 10	597.84	141.63	739.47	47.85%	489.15	316.93	806.08	52.15%	1545.55
FY 09	476.59	108.34	584.93	46.23%	437.17	243.22	680.39	53.77%	1265.32
FY 08	431.85	74.09	505.94	48.55%	342.00	194.26	536.26	51.45%	1042.2
FY 07	354.03	70.65	424.68	46.71%	273.21	211.25	484.46	53.29%	909.14

Continent-wise exports							
	Europe	Americas	CIS	Asia (excluding India)	Africa	Australasia	Total
FY 12	444.84	288.98	107.74	143.3	377.32	39.79	1401.97
FY 11	387.99	210.98	77.94	111.57	204.55	32.15	1025.18
FY 10	365.9	155.17	68.76	94.41	106.46	15.38	806.08
FY 09	255.95	92.27	103.87	88.47	127.89	11.94	680.39
FY 08	254.85	56.68	56.84	76.42	82.4	9.07	536.26
FY 07	215.27	52.56	70.84	66.88	69.9	9.01	484.46

What will drive the growth of IPCA over the next 3 years or so?

We believe IPCA is well placed for ~20-25% annualized growth over the next 3 years or so. We derive our optimism from the fact that management has guided for ~16-18% Domestic formulations business growth, while on the other hand we expect significant increase in business from USA (post US FDA approval for Indore SEZ) and from the institutional anti-malaria business which the company aims to scale up to 1000 crores in next 3-4 years from 300 crores at the end of FY 12.

Domestic Formulations business of IPCA

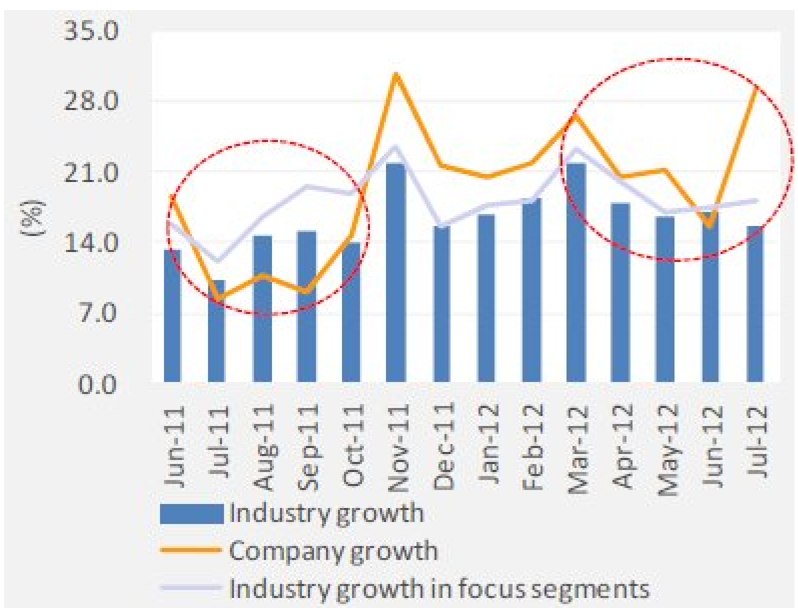
2011-12	Revenue Contribution of various Therapeutic Segments	2010-11
Domestic		Domestic
26%	Cardiovasculars & Anti-Diabetics	27%
30%	Non-Steroidal Anti Inflammatory Drugs (NSAID)	28%
17%	Anti-Malarials	17%
7%	Anti-Bacterials	8%
6%	Gastro-Intestinal (GI) Products	6%
3%	Neuro Psychiatry	4%
4%	Cough Preparations	4%
3%	Dermatology	4%
1%	Urology	-
2%	Neutraceuticals	1%
1%	Others	1%
100%	Total	100%

Domestic branded formulations is a critical aspect of the company's operations, representing 33% of total sales and ~35-40% of operating profit. IPCA derives more than 56% of its revenue from the chronic therapy segments of Pain management, Cardiovascular and Anti-Diabetics while Anti-Malaria is another important segment, though seasonal in nature.

Particulars (in cr.)	FY 12	FY 11	FY 10	FY 09	FY 08	FY 07	FY 06	FY 05	FY 04	FY 03
Domestic Formulations Sales	753.41	695.66	597.84	476.59	431.85	354.03	291.31	211.15	192.23	155.23
Growth over previous year (%)	8.30%	16.36%	25.44%	10.36%	21.98%	21.53%	37.96%	9.84%	23.84%	

During the last 5-7 years IPCA's domestic formulations business growth has been much better than the overall industry growth, however FY12 wasn't so good (8% growth versus historical track of 17-20%) due to low seasonal pick up in anti-malaria segment and instability in business caused by higher attrition in field force and reorganization of divisions.

As per the management they have initiated various corrective steps during the fiscal to restore higher stability in field force. Few such measures include increase in entry level salaries, and roll back of few new divisions to refocus on vital segments and restore growth traction. These steps have resulted in lower attrition rate and as can be observed from the below illustration growth has started to recover since January 2012.



Source: AIOCD AWACs, Company

This strong recovery has been led by higher growth in chronic therapies including anti-rheumatoid (25-30% growth), cardiovascular and anti-diabetic (16-17% growth) segment and further 30% growth in the cough and cold segment.

As per the various reports the company is likely to sustain its 16-17% growth momentum beyond FY13, which should drive higher field force productivity over the long term. This continued traction will be primarily led by:

- Focus on high-growth chronic segments of pain management and CVS,
- Continued investments in high value brands such as Zerodol and HCQS, and
- Higher growth in new anti-malaria treatments

The company has been increasingly focusing on higher growth chronic segments of pain management and CVS, which contribute 56% to total domestic sales. IPCA's pain management franchise, growing at 25% CAGR over FY09-12, is the largest contributor to domestic growth.

Pain management segment – IPCA has built a creditable brand in the rheumatoid arthritis segment with the Zerodol brand growing at 35-40%. Zerodol has ramped up from Rs 32 crore sales in FY08 to Rs 170 crore in FY12, as per AIOCD. It is among the Top 300 brands with 30% market share in the covered molecule market. IPCA also has been successful in scaling up other brands such as HCQS, Saaz, and Folitrax, which is rendering higher growth to the pain management segment.

The segment of CVS and diabetes, the second largest (26% of domestic sales), is also clocking a steady growth of 14-15%, though lower than the market growth.

	% Mix	FY11		FY12		Jul MAT 2012	
		IPCA growth	Market growth	IPCA growth	Market growth	IPCA growth	Market growth
CVS	26.0	16.4	17.6	14.1	20.7	13.9	21.3
Pain management	30.0	34.0	13.1	30.3	14.0	27.0	14.5
Anti-malarials	17.0	25.7	14.4	10.7	9.4	15.2	14.3
Anti-bacterials	7.0	9.7	12.3	1.7	11.1	9.0	12.0
Gastro-int. products	6.0	17.7	14.7	24.0	13.3	25.4	15.4
Cough preparations	4.0	26.8	14.3	34.8	14.2	38.9	13.1
Neuropsychiatry	3.0	11.7	14.8	(5.8)	15.0	0.1	15.8
Dermatology	3.0	25.6	13.3	17.8	18.1	14.9	20.4
Total		22.2	14.8	18.1	16.0	19.8	17.1

Source: AIOCD AWACs, Edelweiss

Anti-malaria segment – Though IPCA's dependence on the anti-malaria segment has reduced from 25% of domestic sales in FY04 to 17% in FY12, nevertheless, it remains a critical part of the company's domestic portfolio, and will continue to remain its mainstay given its dominant leadership in the market (46% market share) and global strength in anti-malarial APIs.

Moreover, anti-malaria growth is seasonal (peak season from July-September with onset of monsoon) and dependent on monsoon, however, IPCA has been able to grow ahead of the covered market by focusing on new treatments where growth is higher than traditional treatments.

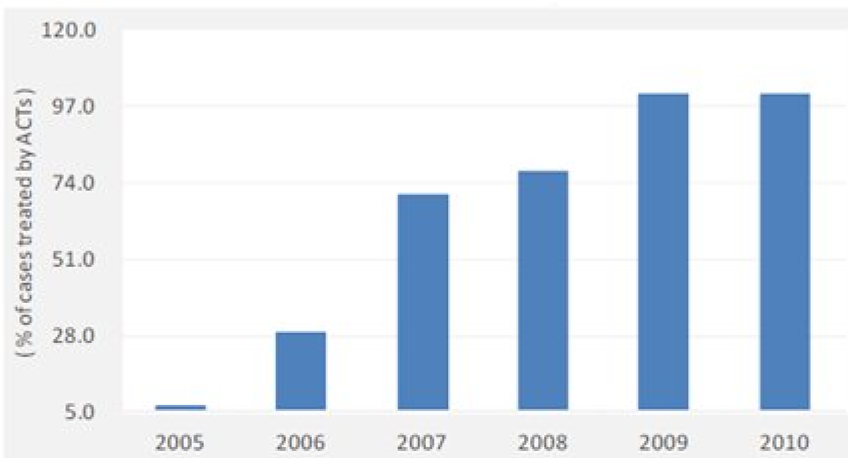
Rapither and Larinate brands (based on ACT), within the anti-malaria segment, are growing at 36% and 27%, respectively, while Lariago's (traditional drug) growth has come off to 1.2% in FY12 from 35% in FY09.

Different treatments within anti-malaria segment										
			Growth (%)							
			FY 09		FY 10		FY 11		FY 12	
Brand	Molecule	Market Share (%)	IPCA	Industry	IPCA	Industry	IPCA	Industry	IPCA	Industry
Lariago	Chloroquine	77	35.4	19.6	12.4	6.3	11.7	2.6	1.2	-9.2
Rapither-AB	Artemether	53	94.6	19.1	69.4	37.6	18.4	9.7	35.6	14
Larinate	Artesunate	26	64.1	50.3	13	12.5	71.4	4.8	27.7	23.9

Source: AIOCD AWACs, Edelweiss

It is important to note here that the number of reported cases of Falciparum malaria is increasing in India and treatment is gradually shifting to use of Artemether-based combination therapy (ACT).

As per WHO statistics, 52% of total reported malaria cases in 2010 were caused by P. Falciparum. Further, the number of Falciparum cases treated using combination therapies has gradually increased to 100% of cases diagnosed from earlier ~20%.



Source: WHO (India epidemic profile)

While focus on new treatments is driving higher growth, it is also contributing to higher margins as realizations are significantly higher than traditional treatment. Treatment cost for traditional Vivax malaria is Rs 10 versus cost of Rs 200 for treatment of malaria caused by Falciparum.

The Institutional Anti-Malaria business

IPCA is one of the few players that supplies anti-malaria formulations (Artemisinin-based combination therapy or ACTs) under tenders floated by global funding programmes such as Global Fund (largest financier of malaria control programmes worldwide, providing 51% of all international funding), UNITAID (key financer under AMFm programme), Bill and Melinda Gates Foundation, DFID (United Kingdom department for international development), PMI (US President's malaria initiative), World Bank, and others.

Artemisinin combination therapies (Artemether and Artesunate are the derivatives of Artemisinin) provide an inexpensive, short-course treatment with a high cure rate and good tolerability that reduce transmission and protect against the development of parasite resistance. Thus, these are promising drugs for use as part of ACT programmes.

It is important to note here that IPCA is the only player with prequalification for API as well as formulation, which offers it a unique opportunity to leverage cost competitiveness and gain market share from other suppliers and as a result of the same it has been able to successfully leverage its global API strength to create a sustainable franchise in this segment and has ramped up sales from Rs 27.6 crore in FY10 to almost Rs 300 crore in FY12.

A key driver of this incremental growth has been the company's participation under **AMFm programme** (discussed later in the report) managed by Global Fund to provide affordable ACTs to public and private sector markets under the co-pay system. This programme has budgeted funding of USD 21.6 crore over CY11-12 and IPCA has already garnered ~20% market share for supplies of Artemether-Lumefrantine (AL) formulations.

IPCA further aims to scale up its franchise to Rs 500 crore by FY14 end aided by supplies of Artesunate-Amodiaquine (AS-AQ) drug for which the company recently received WHO pre-qualification (only generic company apart from the innovator).

As per the management, this new fixed dose combination drug will be an additional source of revenue and is estimated to attain potential sales of Rs 60 crore with supplies commencing from FY14.

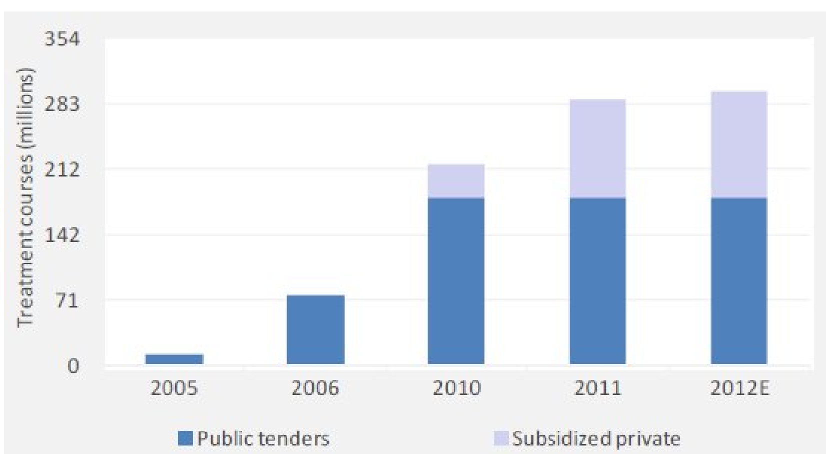
Global funding for malaria control – As per the various reports international funding for malaria control (currently at ~USD2bn per annum) is projected to remain stable over the next two-three years.

However, it is short of the amount required for complete intervention (annual requirement for malaria control is pegged at USD 5bn per annum under GMAP), thereby creating a funding gap. Thus, various funding programmes are increasingly seeking cost saving measures so that more can be done with existing funds. Majority potential savings will come from reduction in treatment and diagnostics costs and hence there is continuous pressure to procure drugs at lower prices, where IPCA is benefiting as its backward integration enables it to price aggressively and gain higher market share under global tenders.

IPCA is also ideally positioned as it is the only generic that has approvals for both Artemisinin-based combination drugs that are dominating the market. AL accounts for two thirds of the market largely procured by public sector, while AS-AQ fixed dose combination is supplied largely to French speaking African markets.

As can be observed from the below illustration, the demand for combination therapies is rising due to high spread of resistance to Artemisinin-based mono-therapies. The number of ACT treatments has increased from 1.1 crore in 2006 to 21.6 crore in 2010, and is estimated to increase to 29.5 crore by the end of 2012 (incremental demand coming largely from AMFm programme).

With increase in use of ACTs, we estimate overall demand to remain buoyant over the long term, thereby rendering sustainable growth to IPCA's institutional business.



Source: WHO

What is AMFm programme? – AMFm program is an innovative financing mechanism, promoted by Global Fund to provide access to artemisinin based combination therapy (ACTs) for effective control of malaria. ACTs are being recommended as first line treatment for P. Falciparum malaria as there is an increase in resistance to older medicines such as Chloroquine (cost of treatment is USD 0.10) and artemisinin based mono-therapies. However, cost of ACT treatment is higher than the traditional drugs (average cost at USD 6-8 in private market), that limits its usage.

It is important to note here that of the total diagnosed cases of malaria in 2010, only 20% were treated by ACTs (216 million). Moreover, 60% of total drugs are accessed through private where ACTs account for 5% of total treatments provided. However, there is an increasing urgency to reduce usage of artemisinin based mono-therapies as these are developing resistance for malaria which would render artemisinin based compounds ineffective.

Thus, in order to withdraw or restrict use of mono-therapies, AMFm was initiated to expand access to ACTs by making these drugs more affordable to patients. The global fund negotiates drug prices with manufacturers to reduce prices to USD 1 per treatment from earlier USD 6-8 per treatment.

The Global fund, through AMFm, pays a larger proportion of reduced price directly to manufacturer, thereby further reducing the cost to first line buyers (FLBs or wholesalers) in private market. The FLBs pay the remainder price directly to manufacturer. This is referred as a buyer co-payment mechanism.

Thus cost of treatment to patient is reduced from USD 1 to USD 0.05 making ACTs as most affordable treatment. Total funds available under AMFm are USD 216mn funded by UNITAID, Bill Gates Foundation and UK government. Thus the implementation is limited to select countries. However, with success of the program to ACT compliance, it is likely to see continued funding over next two-three years.

New investments in Anti-Malaria business – IPCA's strategy is to expand its presence further into the value chain of Artemisinin-based drugs and it plans to initiate development and approval of Artesunate Injectables as a major treatment line for hospitalized patients in African markets. The company is developing this compound for access programme led by MMV (Medicine Venture for Malaria), which will address potential market of USD 20-25mn through supplies to 15-20 countries.

IPCA has already chalked CAPEX of Rs 50 crore to set up the Injectables formulation facility at Ratlam and plans to file the dossier for approval by FY14. Post approval, the company expects to commercialize the product by end FY15. It expects the product to contribute sales of Rs 75-80 crore per annum.

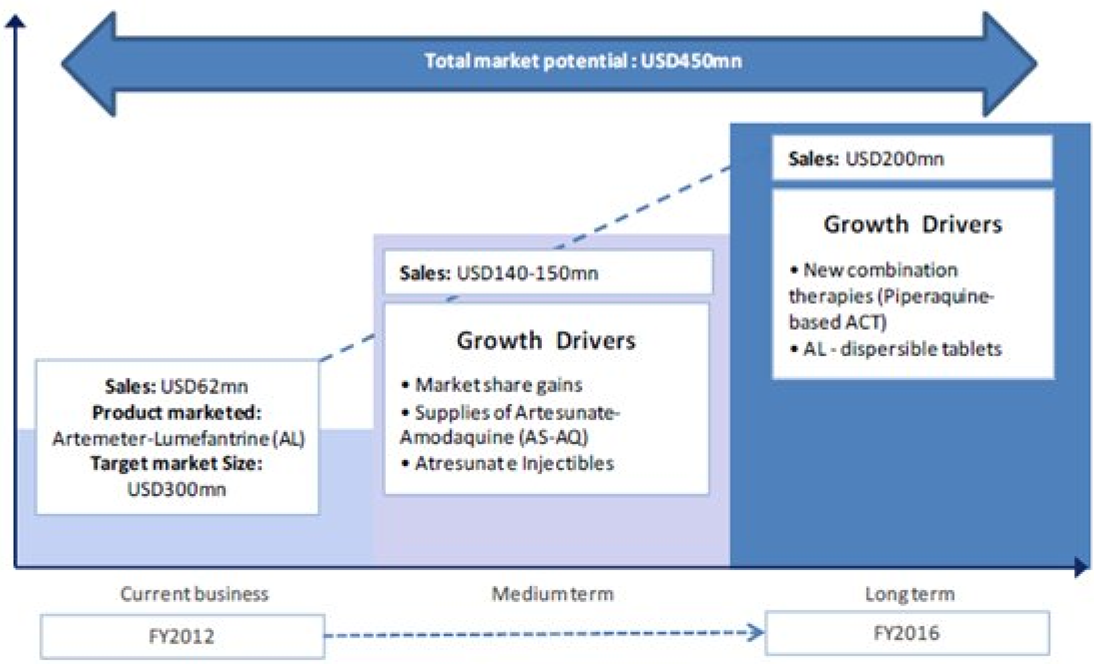
Molecule name	Potential market size (USD mn)	No of players	Commer-cialization	Potenital sales accretion to IPCA (INR mn)
Artemether Lumefantrine (20/120mg)	300	Novartis (60% MS), IPCA (20% MS), Sanofi (5% MS), Cipla and Ajanta (15% MS)	Commer-cialized	3,800
Artemether Lumefantrine (20/120mg) dispersible tablets	60-70	Novartis (60% MS)	FY15	500-600
Artesunate - Amodiaquine fixed dose compbination (AS-AQ)	50	Novartis (90% MS), Sanofi (10% MS in french speaking african countries)	FY14 (Received approval in FY13)	600
Artesunate Injectibles	20-25	Guilin	FY15	750-800
Total	**430-445**			**7,000-8,000**

Source: Company, Edelweiss

Apart from Injectables, IPCA also plans to get approval for Artemether Lumefantrine (20/120mg) dispersible tablets (brand name Coartem) which will be an additional stream of revenue. The AL dispersible tablets are specifically used by pediatric population (with 5kg to <35Kg body weight). These dispersible tablets, compared to the current tablet (that needs to be crushed for administration in children), are easy to administer and are widely acceptable for infants, enhancing treatment compliance. The potential market for these tablets is USD60-70mn and Novartis is the innovator and only supplier in this segment.

Other opportunities targeted include Piperaquine-based ACT or Artesun – Plus (generic name Dihydroartemisinin and Piperaquine phosphate) indicated for treatment of both Falciparum and Vivax malaria.

With these opportunities, along with scale up of existing ACT drugs (AL and AS-AQ) under global tenders, IPCA's management has set a target of Rs 1000 crore sales (in next 3-4 years) from the current Rs 300 crore (FY12).



Source: Company, Edelweiss

US Generics – The new growth driver

Exports to American Continent			
	APIs & Intermediates	Formulations	Total
FY 12	111.01	177.97	288.98
FY 11	95.07	115.91	210.98
FY 10	88.81	66.36	155.17
FY 09	68.03	24.24	92.27
FY 08	53.29	3.13	56.68
FY 07	51.37	1.19	52.56

Investments in US are a critical part of IPCA's international strategy and will be accretive to the company's overall growth over the long term. The company has made significant investments in manufacturing capability and development of filings, and should benefit post USFDA approval of the plant at Indore SEZ.

As per the management, post approval, IPCA plans to scale up the business at a much faster rate and has visibility to add incremental Rs 400-500 crore from the facility over the next three-four years.

In US, the company has cumulatively filed 35 ANDAs (including 8 filings in FY13) till date and has approvals for 12 products. Of these, currently only eight products are marketed. However, the company is building a strong pipeline (35-40 products under development) with increased pace of filings largely from the new facility (Indore SEZ). Most of these filings will be backed by own APIs and leverages on existing strengths in pain management and cardiovascular segments.

Apart from new approvals, the company has also filed for site transfer of six-seven products from the Silvassa facility, which is currently running at full capacity, and where IPCA has not been able to service the potential demand. As per the management, with these site transfers it will be able to fulfill incremental demand worth 100-120 crores.

For US, IPCA has adopted the strategy of selling products via the partnership model. This enables it to leverage the supply chain and distribution capability of partners, while IPCA leverages on cost competitiveness to gain higher market share.

Products marketed	No of players	API
Allopurinol	8	Own
Atenolol	13	Own
Chloroquine Phosphate	4	Own
Furosemide	14	Own
Hydrochlorothiazide	19	Own
Hydroxychloroquine Sulfate	7	Own
Metoprolol Tartrate	14	Own
Propranolol Hydrochloride	16	Own

Source: Company, FDA

Consider this: The management of IPCA claims a market share of 25-27% in most of the above mentioned products (through partners) and aims to scale it up to 50% post Indore SEZ commercialization, just on the basis of its cost competitiveness.

Performance Snapshot

Particulars (in cr.)	Mar'12	Mar'11	Mar'10	Mar'09	Mar'08	Mar'07	Mar'06	Mar'05
Revenue from Operations	2329.37	1881.1	1552.74	1273.36	1056.35	921.11	751.35	682.21
Operating profit	513.48	375.73	331.89	267.8	183.63	191.77	118.92	124.81
Operating profit margin (%)	22.04%	19.97%	21.37%	21.03%	17.38%	20.82%	15.83%	18.29%
Other Income	12.92	8.51	6.21	2.21	2.81	3.73	1.94	3.23
Finance cost	39.36	28.45	25.83	30.39	20.08	22.12	14.09	10.93
Depreciation	65.31	55.43	46.33	39.28	32.21	29.16	24.6	19.01
Profit before tax and foreign exchange (gain)/loss net	421.73	300.36	265.94	200.34	134.15	144.22	82.17	98.1
Foreign Exchange (Gain)/Loss Net	52.79	-43.34	-5.79	75.69	-42.72	-6.18	3.78	-3.45
Profit Before Tax	368.94	343.7	271.73	124.65	176.87	150.4	78.39	101.55
Tax	88.77	78.37	62.54	23.24	35.75	29.01	14.41	23.83
Profit After Tax	280.17	265.33	209.19	101.41	141.12	121.39	63.98	77.72
PAT Margin (%)	11.96%	14.04%	13.42%	7.95%	13.32%	13.13%	8.49%	11.34%
Cash flow from operations	182.97	186.12	166.49	124.59	91.7	92.38	110.58	53.28
Return on Average Equity	24.19%	27.51%	27.64%	16.27%	25.80%	27.84%	17.69%	25.35%

ROE and growth – As can be observed from the above illustration, the company's performance has been very good over the years and consistently delivered return on equity in excess of 25% without employing excessive leverage.

Further, irrespective of base effect, the company has consistently been recording ~20% growth in sales turnover and profits.

Operating margins – Regarding margins, there's been a gradual expansion in operating profit margins of the company from ~18% to around 22%. As per the management, they expect a further improvement in operating margins of the company by ~200-250 bps on the back of improved business mix with higher contribution of domestic formulations business, institutional anti-malaria exports and own API backed US generics.

Cash Flows – As can be observed above, IPCA has consistently been generating positive cash flows from operations and to a large extent in line with reported profits. The same has enabled the company expand its manufacturing locations at regular intervals while maintaining a very low debt equity ratio of less than 0.5.

Foreign exchange hedging policy of the company – Since the company derives ~60% of its revenue from exports; IPCA typically follows a policy of hedging 40-45% of its net exports over 18 months. However, with the current volatility in currency, it has decided to take forward covers for the next six months only. As on June 30, 2012, the company has outstanding forward cover of USD 70-75mn with an average rate of INR 48.5/49 to USD. During the June quarter, the company provided hedges losses at an average rate of INR 55.6/USD. We believe, going forward if the INR remains at around current levels, IPCA will capture the full benefits of currency depreciation.

Operating efficiency

	Net Sales (cr.)	Avg. Capital Employed (cr.)	Avg. Working Capital (cr.)	ROE	OPM (%)	Capital Turnover	Sales to Working Capital	Debt Equity ratio
FY 06	751.35	570.56	210.47	17.69%	15.83%	1.31	3.56	0.51
FY 07	921.11	653.89	231.97	27.84%	20.82%	1.41	3.97	0.49
FY 08	1056.35	842.85	328.18	25.80%	17.38%	1.25	3.22	0.58
FY 09	1273.36	1024.71	419.86	16.27%	21.03%	1.24	3.03	0.70
FY 10	1552.74	1208.78	528.32	27.64%	21.37%	1.28	2.94	0.52
FY 11	1881.10	1456.44	673.67	27.51%	19.97%	1.29	2.79	0.50
FY 12	2329.37	1723.55	777.88	24.19%	22.04%	1.35	2.99	0.48

As can be noticed from the above table, the good point about IPCA's performance has been an overall consistency and improvement in operating and capital allocation efficiency.

With every passing year the company has been generating higher sales and profits for every single rupee employed in the business.

Further, since the company has been generating good cash flows from operations, they have been able to maintain low leverage while still carry out requisite expansion every year.

CAPEX plans

As per the management total CAPEX (capacity expansion) is projected to be Rs 250-260 crore for FY13 and would include investments into a) Two API plants at Baroda, b) R&D centre and new corporate centre, c) Artemisinin extraction plant (to produce 10mn tonnes of Artemisinin), d) Artesunate Injectables facility and d) maintenance.

CAPEX planned for FY 13	
Particulars	**INR (crore)**
2 API Plants (Baroda)	80
R&D Centre and Corporate Headquarters	50
Artesunate Injectables Plant (Ratlam)	50
Maintenance CAPEX	80
Total	260

Source: Company

Management has indicated that their planned CAPEX for FY 14 would include further scaling up of API capacities, with two additional plants in FY13, given the strong pipeline for commercialization, largely for captive consumption. Moreover, it also plans to expand Indore SEZ, in anticipation of a scale-up in US market.

Considering the fact that IPCA has been generating good cash flows, we believe it should not face any issues in carrying out the planned expansions while maintaining a healthy balance sheet.

Decent promoter holding

	Sep'12	Jun'12	Mar'12	Dec'11	Sep'11
Promoter and Promoter Group	**45.91%**	**45.91%**	**46.01%**	**46.05%**	**46.05%**
India	45.91%	45.91%	46.01%	46.05%	46.05%
Foreign					
Public	**54.09%**	**54.09%**	**53.99%**	**53.95%**	**53.95%**
Institutions	33.79%	31.85%	31.59%	31.46%	32.05%
FII	12.30%	10.49%	9.39%	8.70%	9.84%
DII	21.49%	21.36%	22.20%	22.76%	22.21%
Non-Institutions	20.30%	22.24%	22.40%	22.49%	21.90%
Bodies Corporate	8.11%	9.98%	10.19%	10.16%	10.12%
Custodians					
Total	**12,61,50,359**	**12,61,50,359**	**12,58,27,655**	**12,57,06,405**	**12,57,06,405**

The current management has been the part of IPCA since 1975 and with 46% stake in the company its interests are well aligned with the public shareholders of the company.

Dividend Policy

Dividend Payout ratio						
	Mar'07	**Mar'08**	**Mar'09**	**Mar'10**	**Mar'11**	**Mar'12**
Dividend Payout ratio	15.34%	14.20%	30.25%	16.74%	15.15%	14.38%

The company has been consistently paying dividends since the last 15 years and more. Further, as can be observed from the above illustration the dividend payout has approximately been 15% each year.

We believe 15% payout is very reasonable as the company has been able to maintain a healthy mix of debt and equity and consistently delivered return on equity in excess of 20%.

Valuations

As has been observed in the previous few sections, IPCA has been very efficient with capital allocation, delivered consistently high return on shareholder's funds and has developed certain strengths/capabilities which should help the company extend advantage over its peers and grow at a much higher pace in comparison to the industry in the therapeutic segments it operates in.

IPCA's biggest strength is its strategy to invest in businesses that leverage its competitive positioning around key APIs. This renders higher and steady ROEs of 20-25% on incremental investments, while maintaining high margins.

We believe that this low risk or conservative strategy gives a higher predictability to cash flows which is a positive. However, it does not restrict the management from investing in future growth opportunities. Thus, a balance of steady businesses and new platform mix will render a sustainable earnings growth momentum over the long term.

As far as valuations are concerned, IPCA is currently available at a market cap of Rs 5,500 and holds around 550 crore debt in the balance sheet. For FY 13, we expect the company to record Operating profit (EBITDA) of ~650 crores.

Considering the operating performance of the company, efficient capital allocation and overall growth prospects we believe the valuations are in the fair zone with enterprise value at ~9 times FY 13 (E) operating profit.

This is not to say that the stock cannot witness any short term corrections, however 10-15% correction to ~Rs 370-380 will make the stock even more attractive for long term investment.

In view of the same, we would suggest an initial portfolio allocation of 5% with further increase in allocation to 8-10% in case of a correction to Rs 360-380.

Risks & Concerns

Domestic market forms a critical part of the company's total business and contributes ~40% to its operating profits as well. It offers higher margins due to a strong brand leadership in key segments including pain management and anti-malaria. Thus, any sluggishness in growth or execution issues such as those experienced in FY 12 could have a material impact on overall earnings growth and valuations.

The other major concern is the delay in US-FDA approval for the plant at Indore SEZ. The company is already running its Silvassa plant at full capacity and any major delay in approval for Indore plant can limit the growth of US generic business of IPCA.

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Katalyst Wealth **Alpha/Alpha + Portfolio** service is focused on helping individual investors/institutions beat market returns by a wide margin without taking large risks through in-depth research, analysis and follow up on the stock.

For more information on **IPCA Laboratories Ltd**, discuss with **Ekansh Mittal**

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