Edel Investment Research **BUY**

Natco Pharma Ltd : Company Update

Growth triggers: diversification, high-value pipeline **CMP: INR 788** **Target Price: INR 995**

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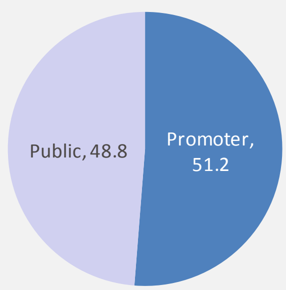
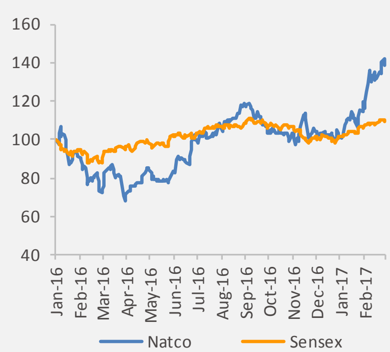
Bloomberg:	NTCPH:IN
52-week range (INR):	794 / 390
Share in issue (Crs):	17
M cap (INR Crs):	13,843
Avg. Daily Vol. BSE/NSE ('000):	35

SHARE HOLDING PATTERN AS ON





Date: 22nd March 2017

Natco Pharmaceuticals (Natco) is a R&D focused player with strong focus on oncology and hepatology. The company is a market leader in the domestic generic oncology space with 23% market share. Although its domestic business remains a cash cow, we envisage its US business, wherein it has some very interesting niche filings, to be a major growth driver. This could aid the company deliver extraordinary growth and cash flow over the next several years. Additionally, expansion in new lucrative therapies such as cardiology and diabetes on the domestic front and geographical expansion in developing markets are bound to sustain Natco's long-term narrative. We believe management's strong focus on R&D and emphasis on difficult-to-manufacture products will contribute substantially to the company's growth and margins, and the stock will continue to command a premium in the pharma space. We initiate coverage with 'BUY'.

Robust domestic portfolio, expansion in lucrative therapies to sustain growth momentum

Natco's domestic revenue has catapulted 5x over the past 4 years ending FY17 driven by its robust oncology and Hepatitis C product portfolio. Moreover, anticipated launch of the latest Hepatitis C drug (Epclusa) in India in H1FY18 along with expansion of its domestic market presence with introduction of specialised products focused primarily on diabetes and cardiology are additional sweeteners. Anchored by these potent catalysts, the company envisages its domestic business to scale up rapidly and clock INR1,000crore annual revenue by FY18 end.

Developing market expansion to enhance revenue

The company has already made filings in over 22 developing countries (of the over 100 countries) in which it holds licences to market Gilead's Hepatitis C portfolio. We anticipate humungous growth opportunity for Natco as 86% of Hepatitis C cases in these developing markets are unattended. Additionally, post setting up of its front-end presence in these countries, the company has the option of introducing its oncology line, which could further burnish its prospects. Ergo, we estimate developing markets to contribute up to INR260crore to its FY19 top line.

Niche opportunities in US to deliver extraordinary growth

Natco has a strong US pipeline including multi-billion dollar opportunities such as Copaxone and Revlimid. Further, consistent realisations from pipeline drugs such as gTamiflu capsule, Budesonide and Armodafinil in FY17 will help the company sustain over 25% average annual growth. With 75-days of exclusivity and 40-45% price erosion, the company has captured 80% of gTamiflu market, adding an estimated 22% to FY17 top line. Moreover, with an estimated ~7 launches over the next 6-15 months in US, including gCopaxone 20mg (& probably 40mg launch), gTracleer, gVidaza and gFosrenol, Natco is poised for an eventful FY18 and FY19 in international markets. Post factoring in competitive intensity in its product pipeline and uncertainty associated with their marketing approvals, we have valued the overall US opportunity pipeline at INR404/share.

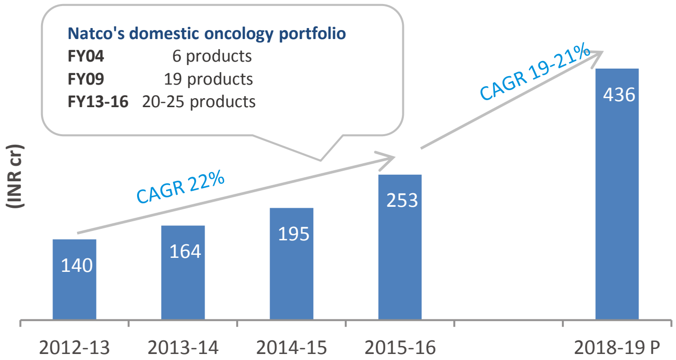
Valuations

In our view, Natco is headed for exciting times ahead, with multiple launches lined up in the US, EU, India and developing markets. Ergo, we expect stable cash flows, margin improvement and steady growth in the domestic market. Our earnings estimate for FY17, FY18 and FY19 are INR22, INR31 and INR33 per share, respectively. We value the company's base business at 18x FY19E earnings of INR32.8/share, while the expected launches in the US & EU are valued at INR404/share. We maintain our **"BUY"** recommendation on the stock, with a target price of INR995/share.

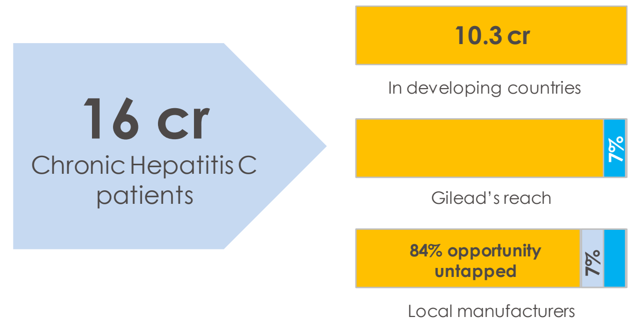
Year to March (INR cr)	FY15	FY16	FY17E	FY18E	FY19E
Revenue	840	1,142	1,836	2,434	2,584
Revenue Growth (%)	11%	36%	61%	33%	6%
EBITDA	227	270	565	799	848
Net Profit	164	155	375	541	571
Profit Growth (%)	33%	-5%	142%	44%	6%
Shares Outstanding (cr)	17	17	17	17	17
Diluted EPS (INR)	9	9	22	31	33
EPS Growth (%)	33%	-5%	142%	44%	6%
Diluted P/E (x)	92.4	88.5	36.6	25.4	24.0
EV/EBITDA (x)	61.7	51.2	24.5	17.0	15.5
RoE (%)	21%	14%	25%	28%	23%
RoCE (%)	18%	18%	32%	36%	30%

Focus Charts

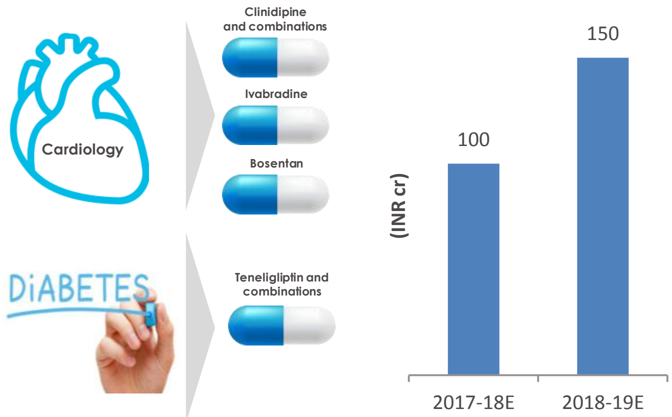
Growth trajectory of domestic oncology to remain steep



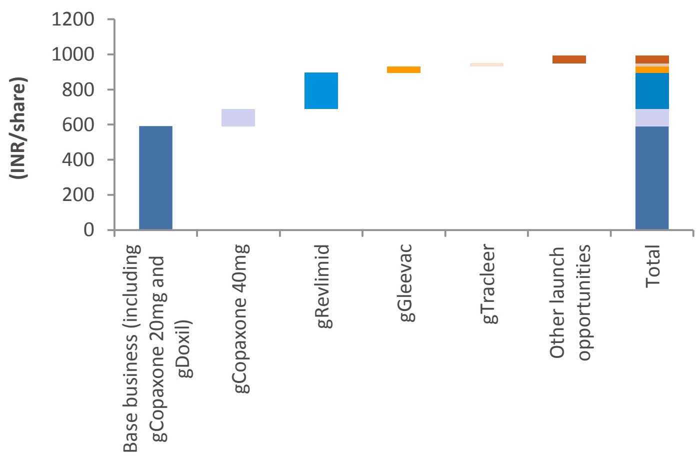
Considerable Hepatitis C opportunity in developing markets



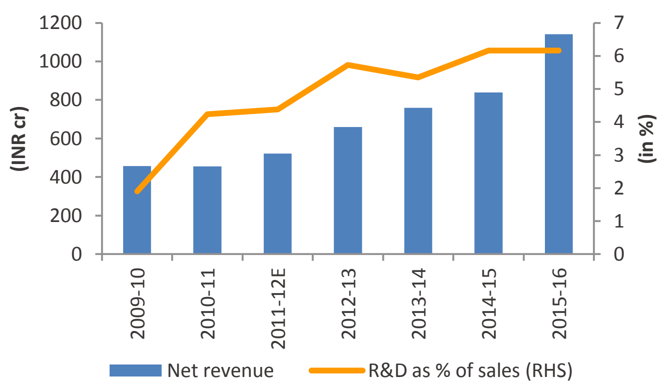
New therapy areas to top up existing revenues



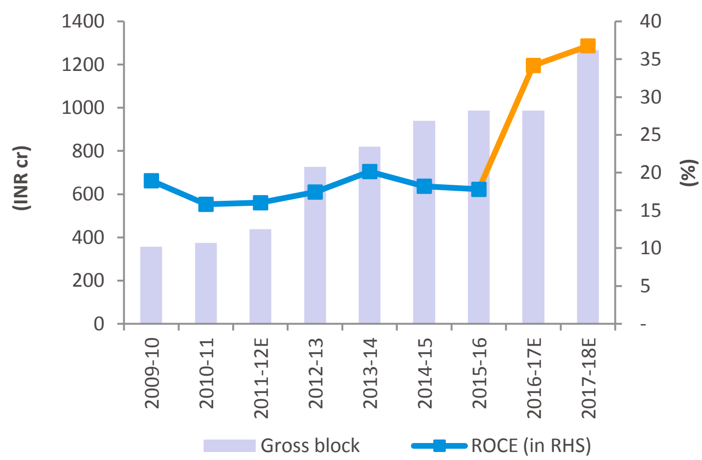
Niche pipeline adds to base business valuations



Soaring R&D spending in niche areas to help sustain revenue growth



Capex expected to convert into better returns



Source: Company, Edel Invest Research

The future performance of Natco will reflect fruits of its core research and development strategy over the past decade. Several favourable tailwinds such as strong positioning in domestic market segments, diversification along therapy areas as well as geographically, and low-competition high-margin product pipeline in the US can pave way for strong upswing in its revenues. Topline growth of 31% coupled with significant operating margin improvement should result in a high 54% CAGR bottomline growth from FY16 to FY19E and will support high multiple.

Niche capability, strong domestic distribution, and front-end partnerships with leading global players

	FY16	FY17E	FY18E	FY19E
Revenue	1,142	1,836	2,434	2,584
EBITDA	270	565	799	848
EBITDA Margin	23.6%	30.8%	32.8%	32.8%
PAT	155	375	541	571

High capacity addition and improved cash flows to generate strong returns

	FY16	FY17E	FY18E	FY19E
RoACE (%)	14.4	25.3	28.2	23.3
CFO	102	280	414	604

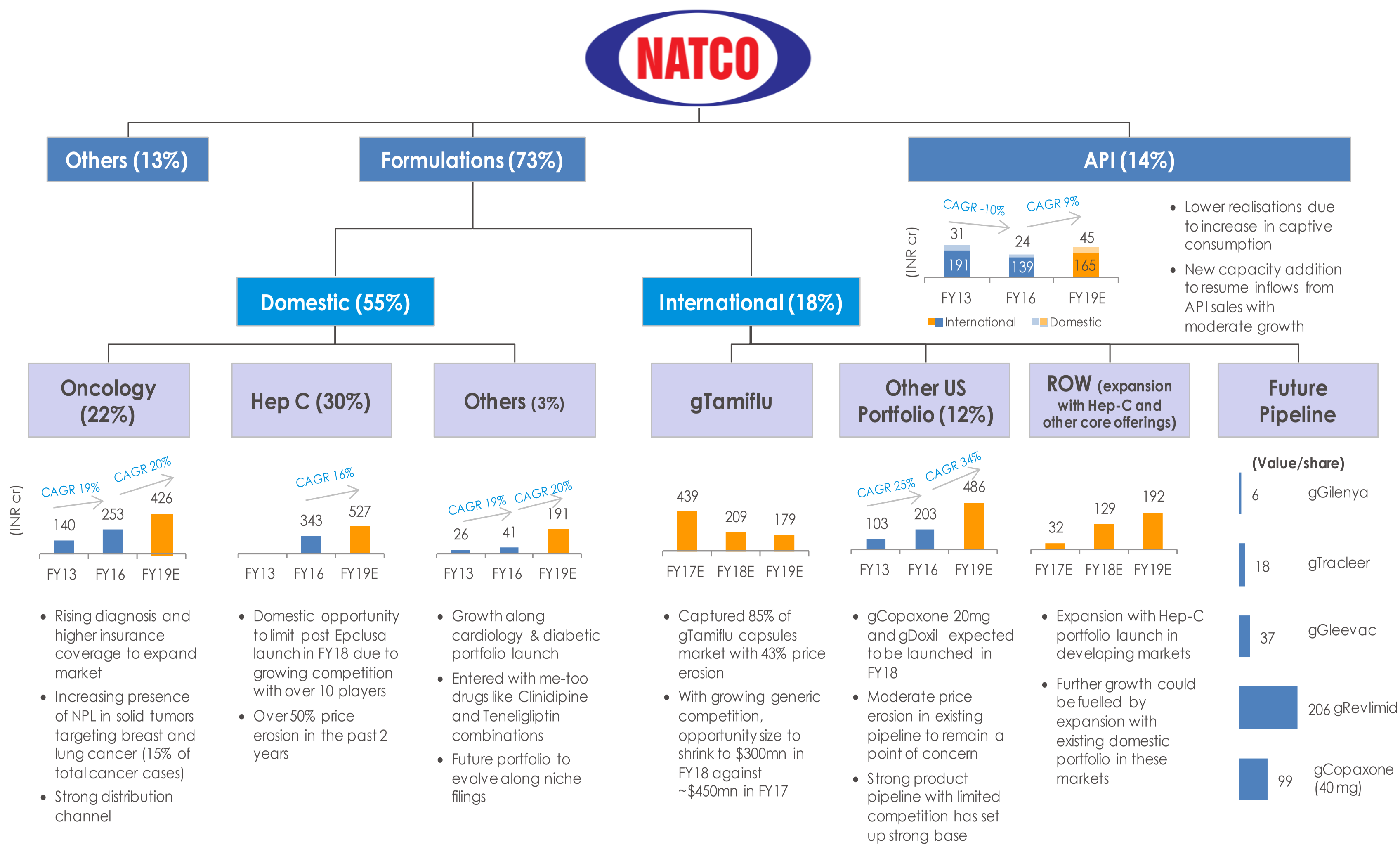
Backward integration and high margin portfolio potent bottom-line boosters

	Multiple	Price Target
Natco	18x P/E	995
	22x P/E	1,126

Entry = INR 788 + **PAT CAGR of 54% over FY16-FY19E on existing business and definite launches** + **US product pipeline valuation of INR404/share**

Total Return of 27%

Story in a Nutshell



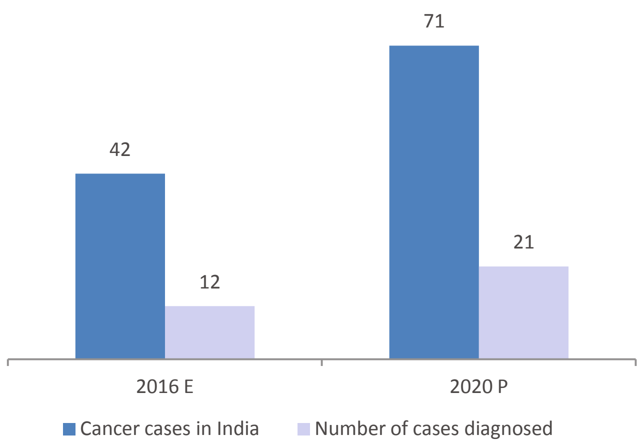
I.) Oncology: Top line backbone

Domestic oncology industry (22% of revenue)

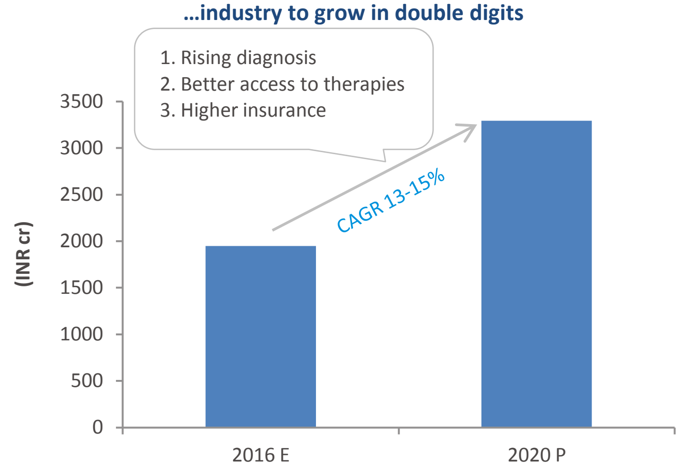
AIOCD AWACS estimates peg the domestic oncology segment at INR2,150 crore (MAT value for December 2016), growing at a robust 14% annually for the past two years. The domestic industry can be broadly sub-segmented into hematology and solid tumours.

Hematology	Solid Tumors
• Cancer that begins in blood-forming tissue, such as the bone marrow; also known as blood cancer • Examples include leukemia, lymphoma, multiple myeloma • Key drugs - Bortezomib, Imatinib Mesylate - **contributing more than 55% to Natco's Oncology portfolio**	• Growth of abnormal lumps of cells in different organs which hinder functioning; when malignant, they are called cancers • Named after organs they impact such as lung cancer or breast cancer • Key drugs - Paclitaxel, Gefitinib, Trastuzumab, Erlotinib - **contributing about 40-45% to Natco's oncology portfolio**

With diagnosis expected to improve…

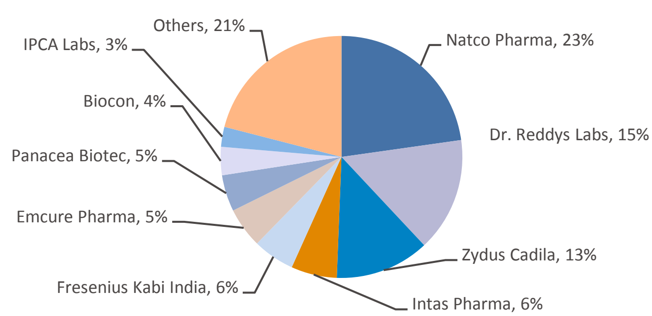


…industry to grow in double digits



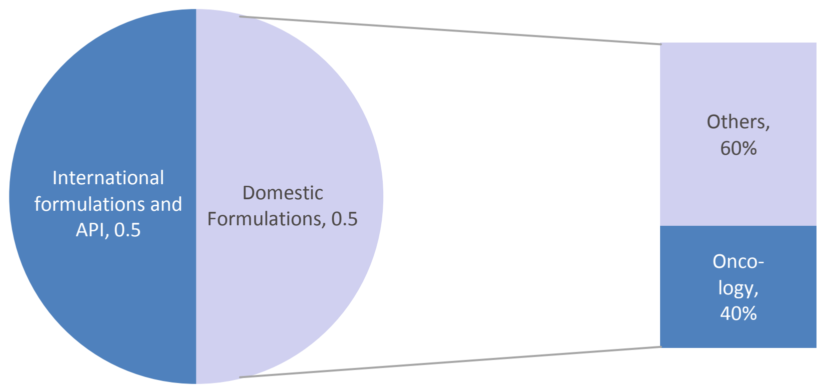
Source: Indian Council of Medical Research (ICMR), Edel Invest Research

Natco: the market leader in domestic oncology segment



Note: Only companies above 2% market share are mentioned;
'Others' include Pfizer, RPG LifeSciences, Cipla, Sun Pharma and Roche (Innovator) with market share of less than 2% each
Source: AIOCD AWACS, Edelweiss Research

Oncology comprises one-fifth of Natco's top line...

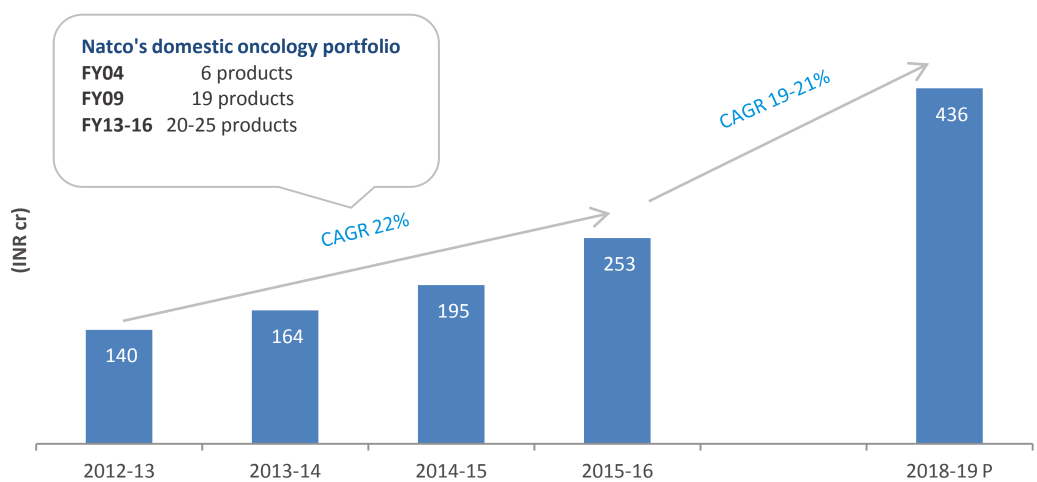


Source: Company reports, Edel Invest Research

Natco's debut in oncology in January 2003 was via launch of generic version of Imatinib Mesylate—a life saving drug used in the treatment of chronic myeloid leukemia (CML) under the *Veenat* brand. Over the past 4 years, the company's oncology revenue has outstripped the domestic oncology market with expansion of its portfolio via drug additions as well as enhancing depth through effective distribution channels.

Though the company is present prominently in haematology, it is also increasing presence in the solid tumours segment targeting breast and lung cancers (together, breast and lung cancer constitute 18% of cancer cases in India).

.....with growth to continue at a staggering pace

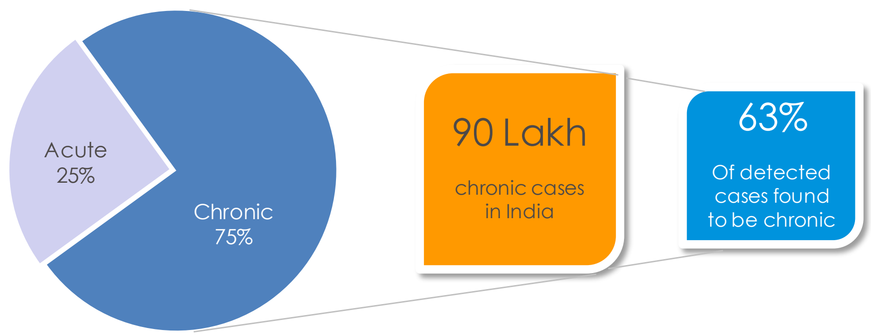


Source: Company reports, Edel Invest Research

II.) Hepatitis C: The long-term growth narrative (30% of revenue)

Hepatitis C is a viral infection of the liver which has impacted 16crore people globally with more than 60% being in low and middle income countries. It could be acute as well as chronic in nature with acute cases falling in the low-risk category. However, up to 85% patients are diagnosed with chronic infection, which if left untreated for several years, could lead to liver cancer and cirrhosis. Despite high prevalence of the disease, most people infected with the virus remain unaware of the infection resulting in 7lakh death cases annually.

16 crore Hep C cases



Source: Edel Invest Research

Evolution of treatment options

Initially, a few treatment options were available for Hepatitis C, which were characterised by low efficacy and high side effects. In December 2013, Gilead Sciences (Gilead) made a breakthrough in the treatment of Hepatitis C with the launch of its nucleotide polymerase inhibitor sofosbuvir (Sovaldi), followed by the launch of its combination drug Harvoni (sofosbuvir + ledipasvir) in October 2014.

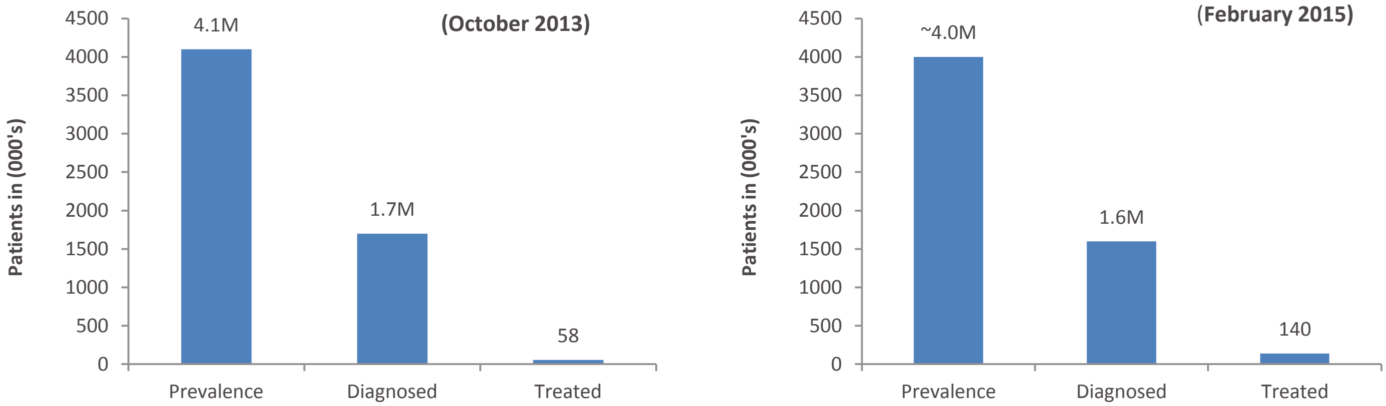
Efficacy comparison between different Hepatitis C drugs

	Pegylated interferon + ribavarin (up to 2011)	Protese inhibitors (2011 onwards)	Sofosbuvir and its combinations (from 2013)
Cure Rate	40-50%	~75%	90-95%
Treatment duration	48 weeks	48 weeks	12/24 weeks
Side-effects	High-with use of interferon	High-with use of interferon	Low-without interferon

Source: Edel Invest Research

Due to its distinct advantage over existing treatment options, there was significant increase in its penetration despite high prices (USD84,000 for Sovaldi and USD94,500 for Harvoni for a 12-week course). This was evident from rising penetration of treatment from 3% of the diagnosed population in 2013 to 9% in 2015 in the US.

Significant uptick witnessed in number of Hepatitis C cases treated



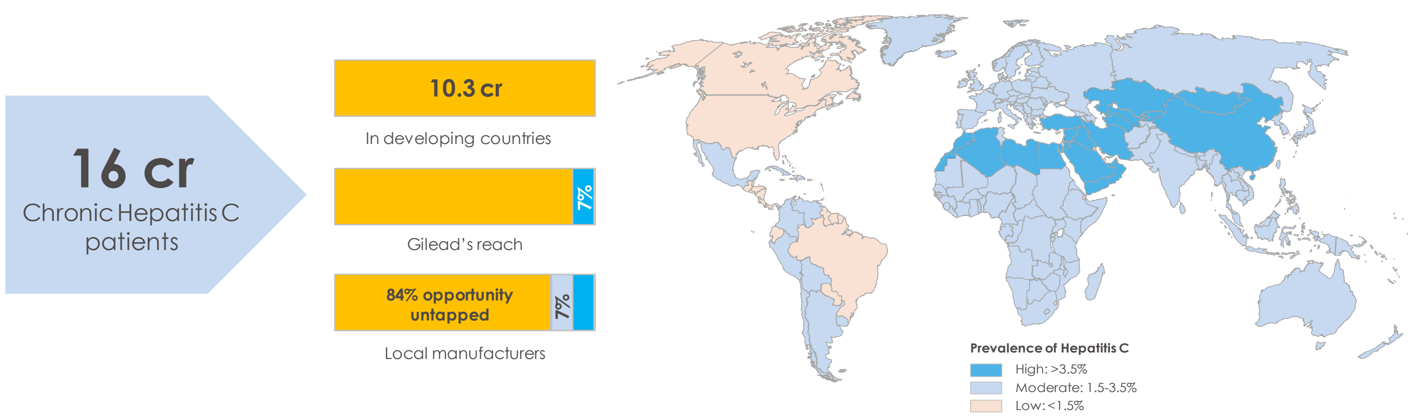
Source: Company reports, Edel Invest Research

Emerging market opportunity

Natco received the license to manufacture and market Gilead's Hepatitis C medicines portfolio of Sofosbuvir, the combination drug Sofosbuvir+Ledipasvir, and Daclatasvir in 101 developing countries. In return, they would pay royalty of about 7% to Gilead on sales.

Cumulatively, these countries have an estimated 10.3crore Hepatitis C cases, accounting for 64% of the total diseased population. With Gilead having reached only 0.73crore (7%) of such population and local pharmaceutical companies addressing another 7%, 86% of the Hepatitis C cases in developing markets remain open for these companies to cater to.

High prevalence of Hepatitis C cases in developing markets



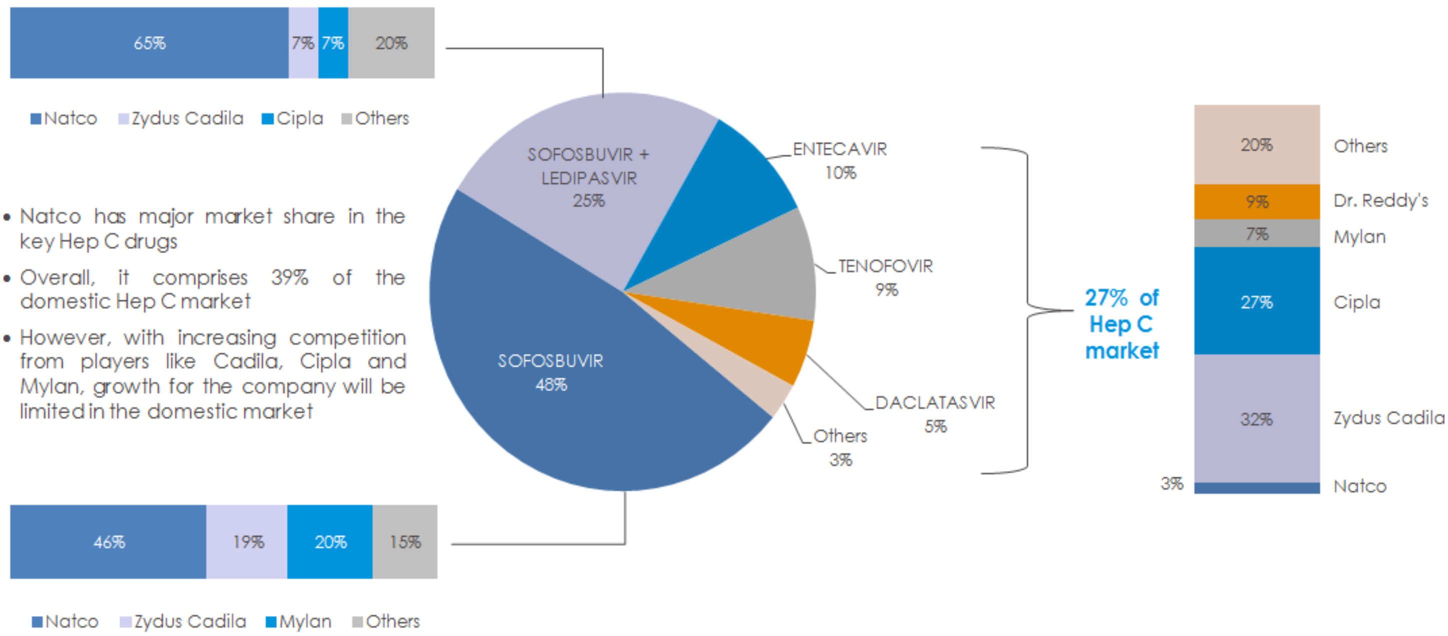
Source: Edel Invest Research

Factors bolstering Natco's lead

1. **First-mover advantage:** Natco is among the first generic manufacturers to launch Gilead's Hepatitis C portfolio in India, giving it a substantial market share of over 40%.

2. **Natural entry barrier:** Natco sources API for Sofosbuvir from a third party API manufacturer Laurus Labs with exclusive partnership, while the finished product is manufactured in Natco's plants at multiple locations in India—Kothur (Telangana), Guwahati and Dehradun. This provided the company exclusive access to large volumes of API, while others either sourced it from Natco or took time to develop the API for captive consumption, creating a natural entry barrier for other potential entrants.

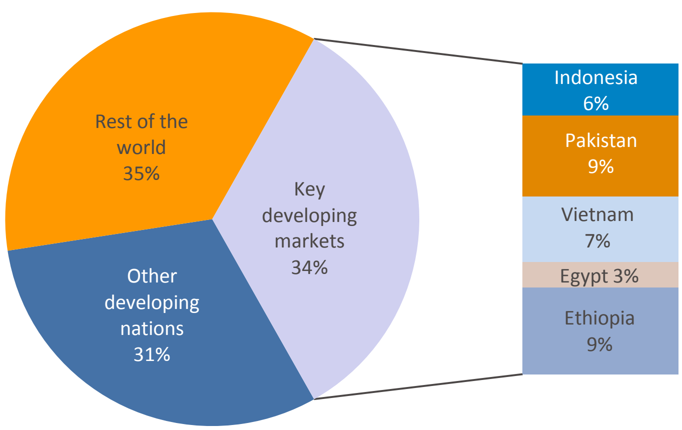
Hepatitis C: While new players in the domestic block creep in sales.....

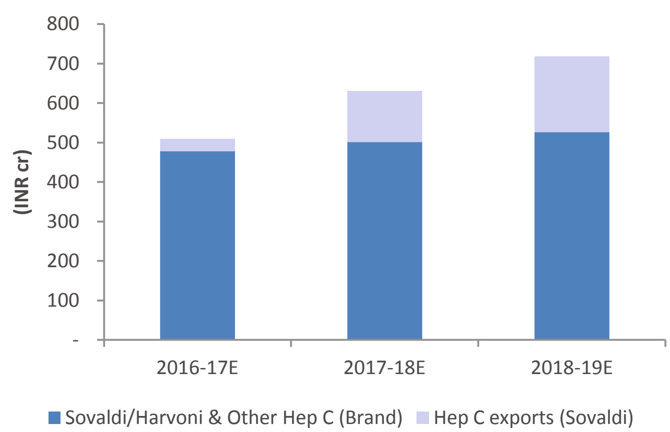


Source: AIOCD AWACS, Edel Invest Research

Despite subsequent entry of 7-9 players in the Hepatitis C drug market, Natco remains the undisputed leader with 39% market share. However, with rising competition and over 50% dip in prices since launch, further upside for this segment remains bleak. In fact, Natco's realisations from the domestic Hepatitis C business are expected to see only 5% upside on an annual basis for FY18 and FY19 on back on Epclusa launch (last of Hepatitis C products licensed from Gilead) till the market settles to a sustainable price level.

....developing market opportunities to increase inflows from Hepatitis C exports





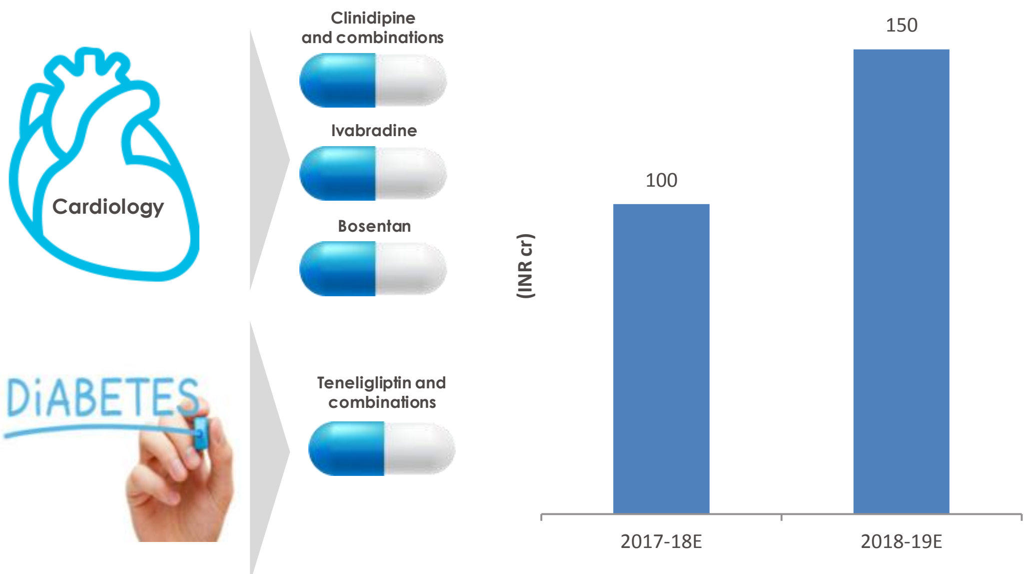
Source: Company reports, Edel Invest Research

Among licensed countries for penetration, Indonesia, Pakistan, Vietnam and Ethiopia cumulatively account for one-third of the potential. Hence, Natco's market share can catapult via quick penetration in these countries. Having filed for approvals in over 23 countries, Natco is estimated to quickly tap developing markets. However, with no local front end, revenue addition from these markets is likely to be sluggish.

III.) Diversification to cardiology and diabetes: New growth avenue

Natco is looking to expand its domestic market presence with introduction of specialised products focused primarily on diabetes and cardiology. At the onset, the company has launched a me-too portfolio with compounds of Clinidipine and Teneligliptin, Bosentan and Ivabradine. Although Teneligliptin is an estimated INR1,200crore market, high price competition from Glenmark (60% price cut; from INR45 to INR20) followed by Cadila (another 65% price cut; from INR20 to INR7) has left the market with low margins. Further, prominent presence of over 10 players in Clinidipine renders the market highly competitive. Yet, large market size of these compounds gives a good entry point to Natco, which is targeting ~INR100crore annual revenues from the segment in FY18.

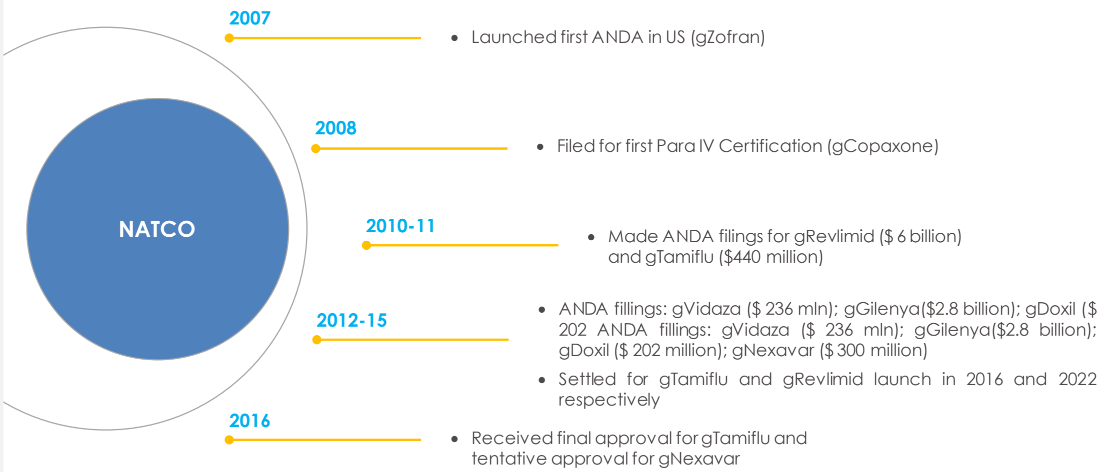
Revenues to top up by venturing into new therapy areas



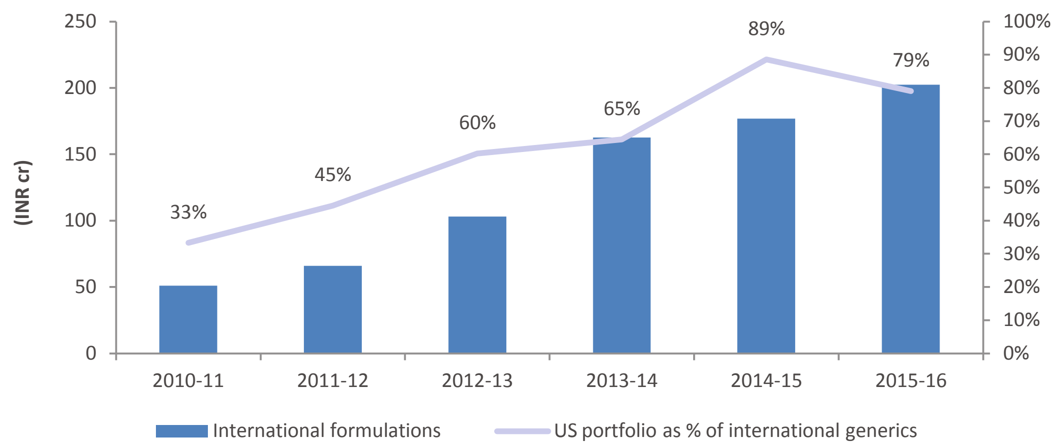
Source: Company reports, Edel Invest Research

IV.) International generics

Niche fillings in oncology marked Natco's entry in the US market.



Strong growth marked by niche launches in US



Source: Company reports, Edel Invest Research

Front-end partnership strategy helped de-risk litigation expenses

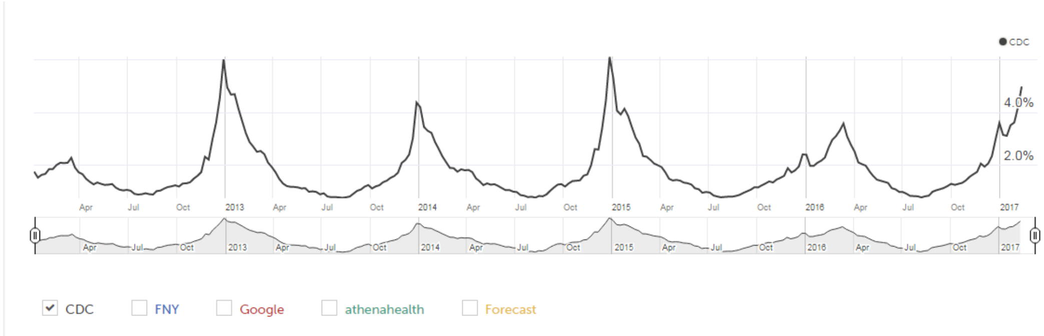
Despite a strong US pipeline, most of Natco's filings are via its front-end partners in the US such as Mylan, Lupin, Actavis and Breckenridge. While this strategy leaves the company with 30-40% share, there is no litigation risk. Considering that about 80% of the company's product pipeline is under patent, we see this strategy by the company as a big positive with no requirement for contingencies. Going forward, the company is looking to increase revenue share by taking up some part of the litigation risk. Considering its historical success rate, this could add to Natco's revenue at a low incremental risk.

Addressing some high-value opportunities

a.) Tamiflu (anti-viral – Influenza A & B)

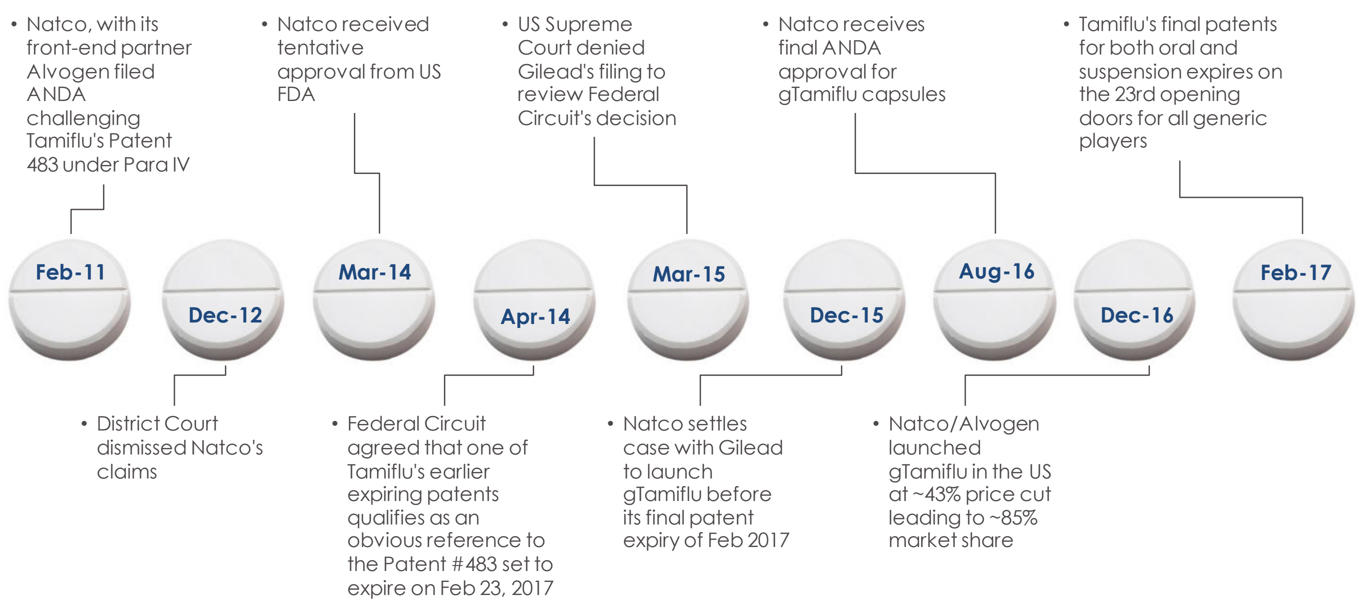
Tamiflu is an anti-viral for the treatment and prevention of influenza A and B, with US sales of USD750mn (~60% capsule; 40% suspension). It was developed by Gilead Sciences, which granted Roche exclusive right to manufacture and sell Tamiflu worldwide. Flu or influenza being a seasonal outburst in the US, is looked at a seasonal level. Primarily, December- March are peak flu months.

Flu trend in the US market



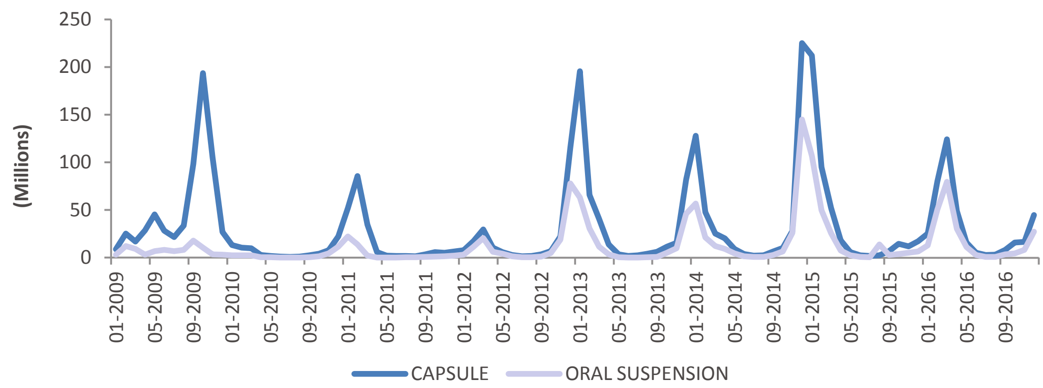
Source: Edel Invest Research

Natco's journey with Tamiflu so far



Source: Company reports, Edel Invest Research

Tamiflu sales fluctuate across seasons making it difficult to estimate future market size



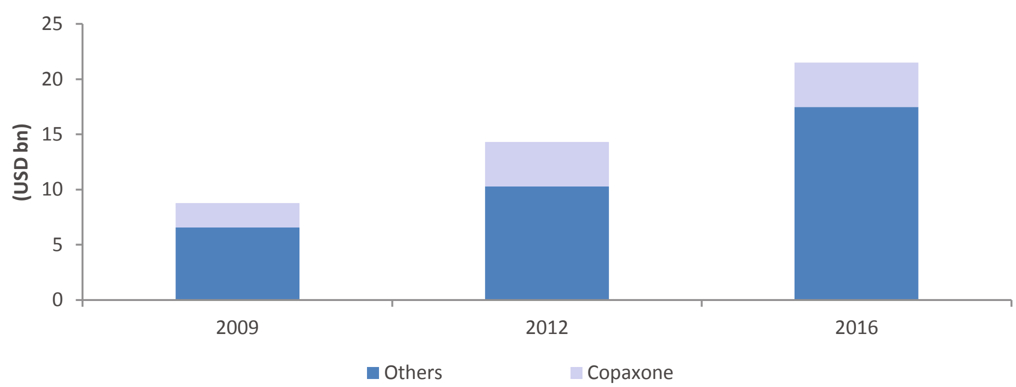
Source: Edel Invest Research

With competition expected to hit prices, gTamiflu market is expected to shrink to ~USD300mn (including capsule and suspension) in FY18 season, reducing the opportunity size for Natco compared to FY17 season (~450mn capsule sales). This, coupled with lower market share, will restrict the drug's contribution to Natco's revenue to ~INR200crore in FY18 against an estimated INR440crore in FY17.

b.) Copaxone (Glatiramer Acetate)

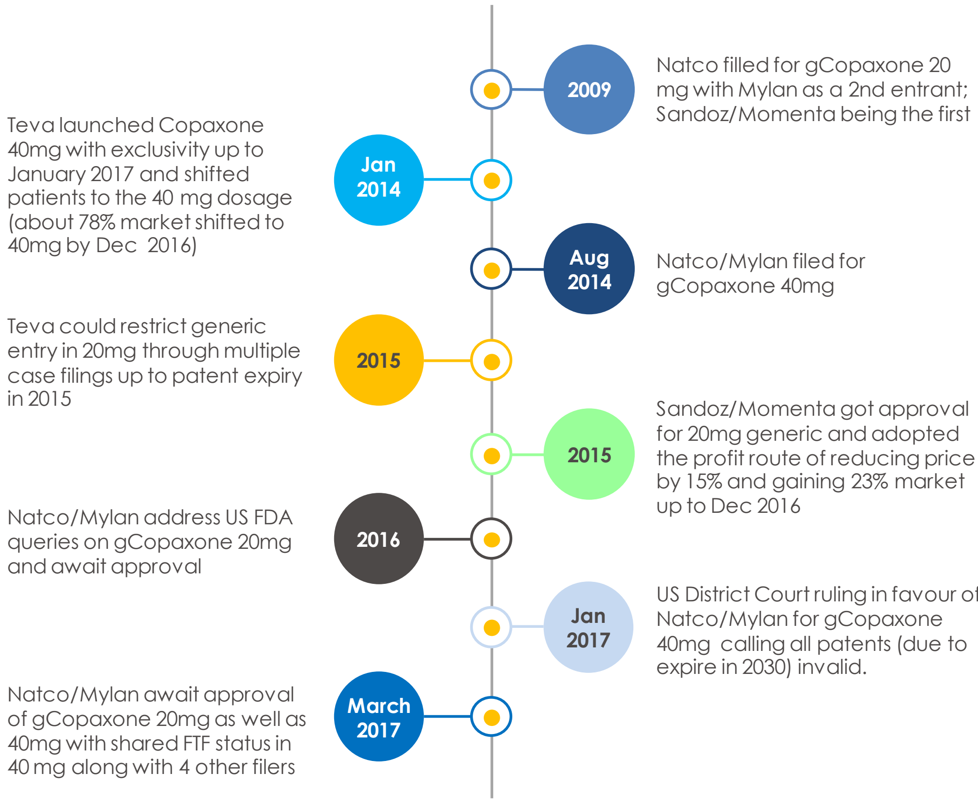
Multiple Scerosis (MS) is a USD15bn market globally with Copaxone being the leading drug with a market share of ~19%. Though the share has dipped over the past few years with the launch of competing products such as Tecfidera in 2015, the drug continues to maintain leadership in the global MS market.

Copaxone remains market leader despite stagnant sales



Source: Edel Invest Research

Series of events delays and turns around Copaxone generic opportunity for Natco



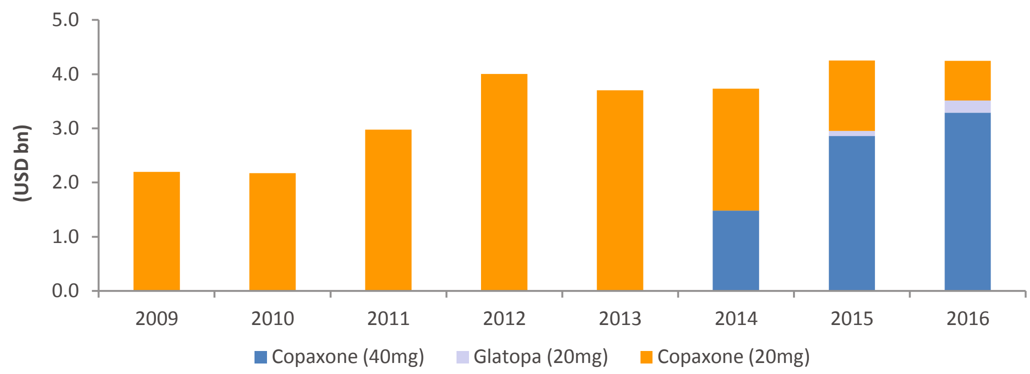
With 40mg taking over, Teva makes going tougher for generics

While approvals are expected to come for Mylan in Q4FY17 (20mg), the shrunken market for the dosage makes 40mg approval more lucrative. Although the district court ruling has been in favour of Mylan, Teva is expected to move to higher courts. Considering this, post USFDA approval, Natco/Mylan will launch the drug, but at risk.

Sandoz/Momenta launch gives strategy cues for Natco/Mylan

Considering low competition for Copaxone 20mg in the near term, Sandoz/Momenta opted for high margin strategy against high market share and captured 23% of Copaxone 20mg market with 15% price cut. On similar lines, we expect Natco/Mylan to operate at not more than 30% price erosion, capturing about 30% of the market.

Introduction of 40mg left little for Sandoz/Momenta's Glatopa

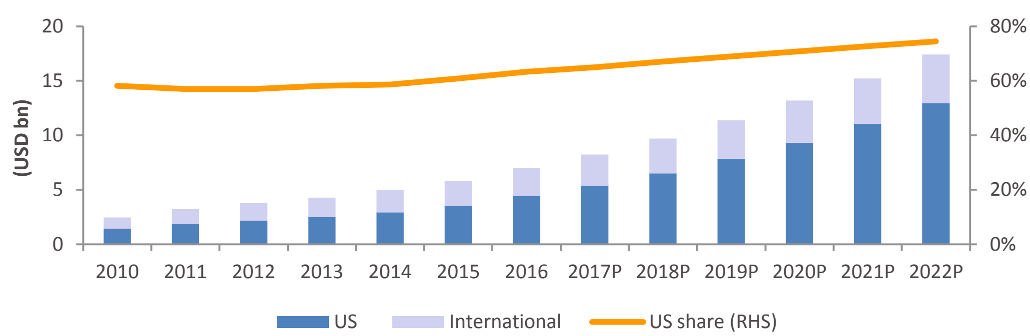


Source: Edel Invest Research

c.) Revlimid (Oncology – Multiple Myeloma)

Revlimid, a multiple myeloma treatment, is the largest drug for Celegene with global sales of ~USD7bn and US sales ~USD4.4bn. It is covered by 22 patents listed in the orange book, last of which is expected to expire in April 2027.

Consistent uptick in Revlimid's annual sales through a decade



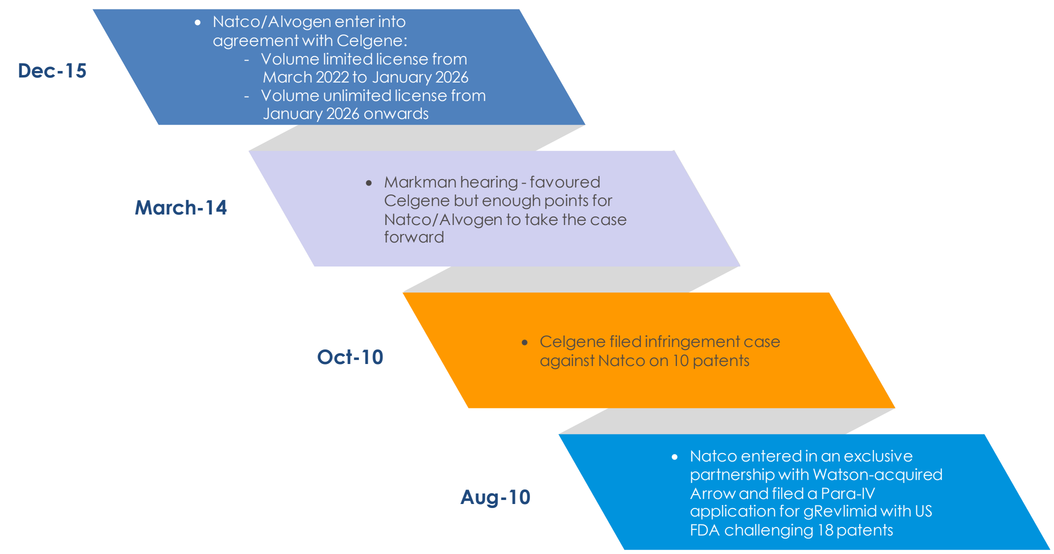
Source: Edel Invest Research

REMS model: Restricted distribution system makes it difficult to procure samples for ANDA

Revlimid is sold in the US under a programme called "Revlimid REMS" (REMS = Risk Evaluation and Mitigation Strategy), to avoid embroyo-fetal exposure. Under this programme, the prescriber and the pharmacist need to get certified with Celgene to prescribe and sell the drug, respectively, and also patients need to enrol in the programme and agree to comply with the requirements of the Revlimid REMS programme.

As a consequence, the REMS model restricts the distribution system of the drug, thereby making it difficult for generic players to procure samples for conducting bioequivalence studies required to file ANDA.

Natco: First mover advantage in Revlimid

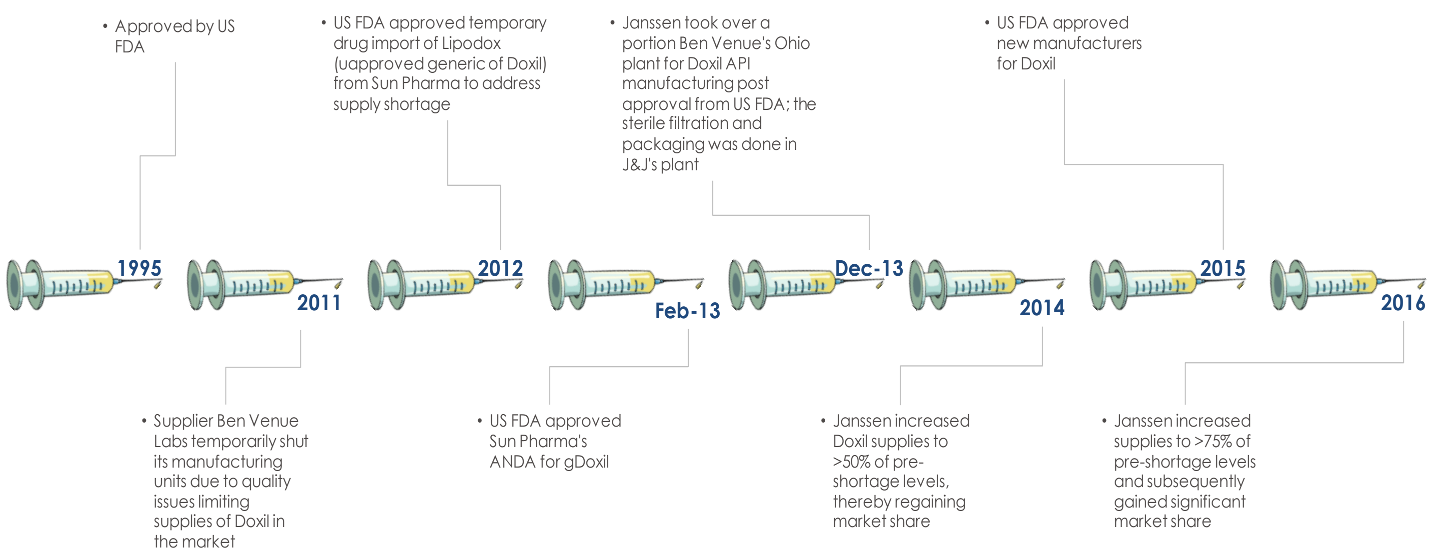


Further, in case any other generic player gets approval to launch of gRevlimid before Natco, the launch date for Natco will also be advanced. Certainty about launch, though in limited quantity, aids in realising higher value from Revlimid at INR206/share.

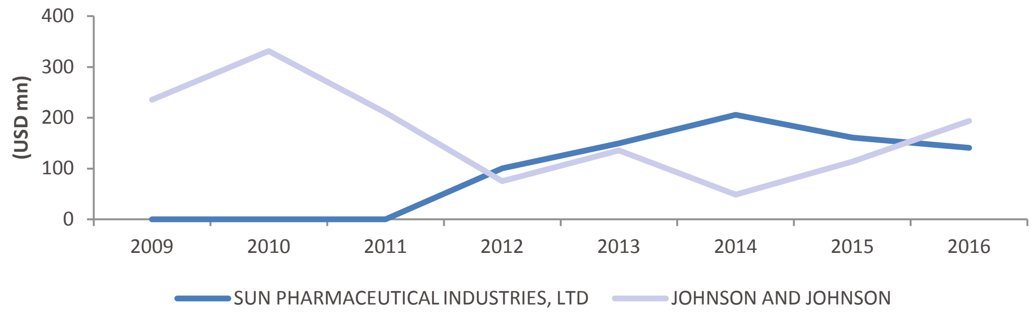
d.) Doxil (Oncology - Doxorubicin HCL Liposomal)

Doxil is a USD335mn chemotherapy drug in the US. While doxorubicin HCL has been in the market since 1980, the Liposomal version was launched by Janssen R&D in 1995 and 2000 (higher strength) giving favourable toxicity profiles, better cardiac safety and less side effects, making it favourable for all patients, especially those with cardiac arrest risk.

With supply limitations, Doxorubicin HCL Liposomal has had a curvy ride over the past two decades



In the two-player market with limited supply, significant opportunity awaits for Natco



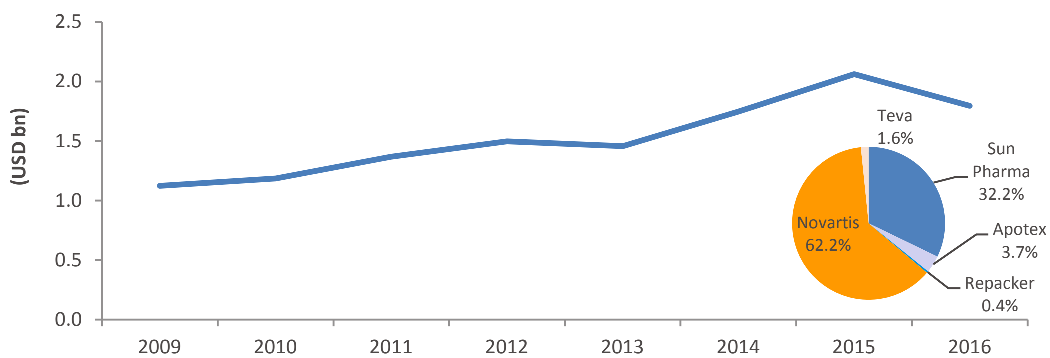
Source: Edel Invest Research

Natco has filed ANDA for gDoxil with its marketing partner Dr. Reddy's. Several other players such as Teva and Actavis have also made filings, making it a potential 5-player market in the medium term. Yet, with the approval expected to come by FY18 and single-digit price erosion by Sun Pharma so far, Natco is in a good position to leverage on the opportunity.

e.) Gleevac (Oncology - Imatinib)

Gleevac manufactured by Novartis is indicated for treatment of chronic myeloid leukaemia. Post generic entry in the drug from 2016, the market size fell by 13% with initial price erosion of less than 10%. However, as other generic players joined the market, the drug price eroded by ~40% by CY16 end still making a USD1.6bn opportunity for Natco. Yet, considering high generic filings for the drug, we expect limited opportunity gain with steep price erosion over the next 2 years. With an expected entry in FY19, we peg this opportunity at INR37/share.

Generic competitors took over 40% of Gleevac's market share



Source: Edel Invest Research

f.) Bosentan (Tracleer)

Tracleer is the first Endothelin Receptor Antagonist (ERA) approved by the USFDA for the treatment of pulmonary arterial hypertension (PAH). The drug has an estimated market size of USD1.6bn. It had no generic competition in the US up to 2016 even after losing patent protection in 2015. However, it has faced severe competition in European markets and from alternate ERAs with the leading being Gilead's Letairis. To protect its sales from generic competition, Acetelion launched Opsumit in the market as an upgraded drug for the treatment of PAH. Since its launch in October 2013, Opsumit has taken over Tracleer, contributing about USD1bn to the company's revenue.

The arrival of Opsumit insulates Actelion against future lost sales from Tracleer because it offers solid efficacy, including a statistically significant 45% reduction in mortality events and a 50% reduced risk of PAH related deaths and hospitalization. Importantly, unlike Tracleer, Opsumit will not have a black-box warning against liver damage.

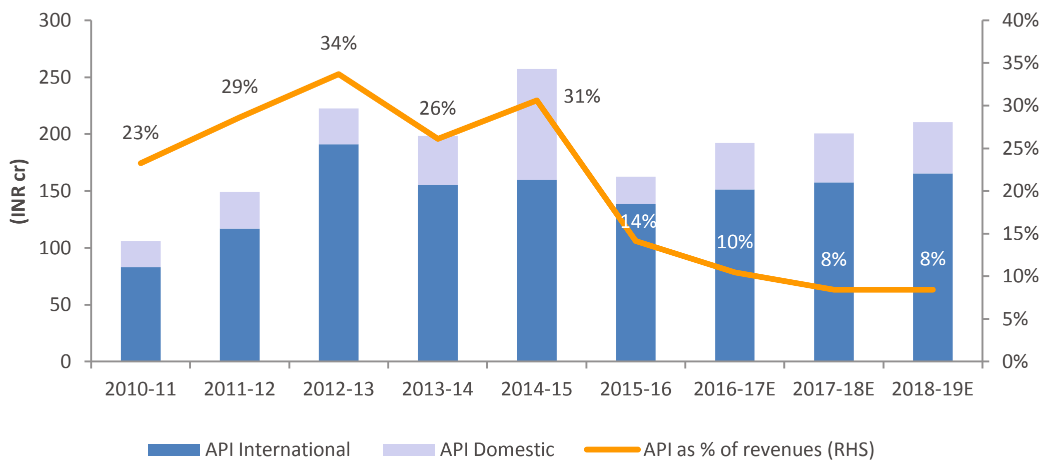
Considering the above scenario, the market opportunity for Natco in this drug is estimated at INR18.5/share.

V.) API to show steady growth

API sales have historically contributed a substantial 34% to Natco's revenues in FY13 with significant contribution from international sales. The company's API exports are primarily focused on US, EU, Canada, Latin America, Middle East and South East Asia.

However, total API contributed ~14% to revenue in FY16, of which major contribution was from API exports (~12% of sales). Over the past 3 years, APIs revenue contribution has reduced with steep growth in formulations. Additionally, rise in captive consumption has reduced overall realisations from APIs. Natco currently has 33 DMF filings in the US and several more under development.

With API sales remaining range-bound, its contribution to revenue kept shrinking



Source: Company reports, Edel Invest Research

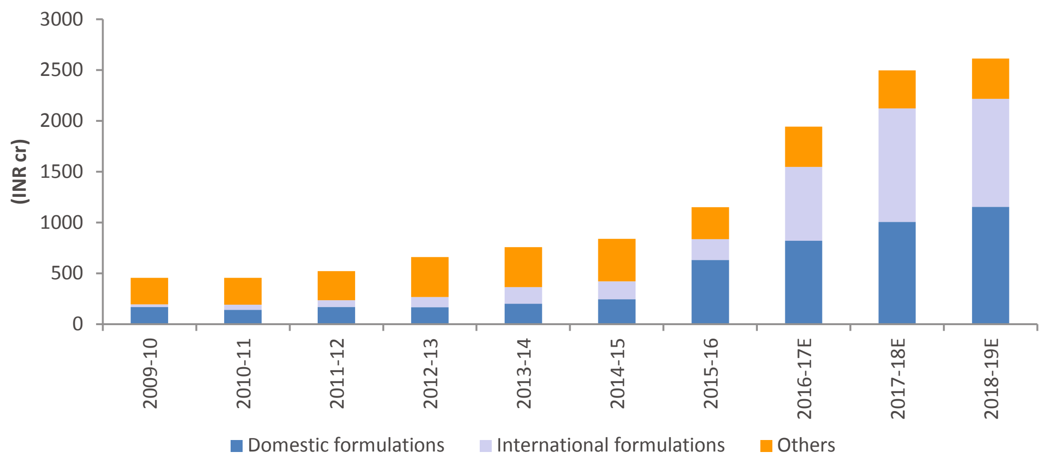
Going forward, Natco expects to maintain 9% growth in API exports, predominantly on account of augmenting capacities in API and formulation, which will include expansion as well as upgradation of existing facilities. The company is setting up a new facility in Vizag for the US market at a cost of INR150crore (for Phase I). It is also expanding API facilities in Mekaguda and Chennai along with its formulation facility at Kothur. It is also upgrading its facilities at Dehradun and Guwahati to keep pace with growth in the domestic business.

Financial Outlook

Spurt in domestic and international formulations to boost revenue

Natco's revenue growth trajectory has been robust with a 5-year CAGR of 20% on account of steep growth in its oncology and Hepatitis C portfolio in the domestic market and its complex drug portfolio in international markets (largely US). Going forward, we expect growth to be led by international generic launches with support from steady growth in the company's domestic portfolio.

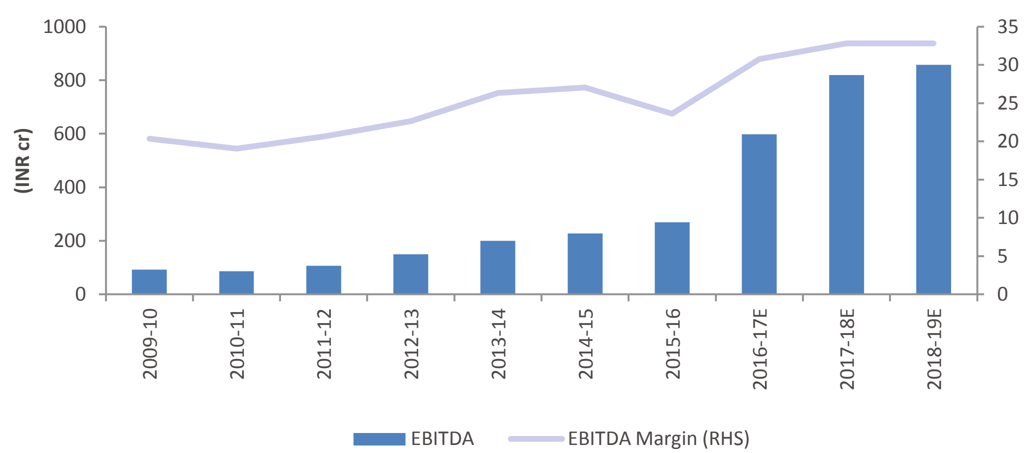
Strong revenue growth due to higher inflows from International formulations



Source: Company, Edel Invest Research

Margin to expand riding improving product mix

With improving product mix along niche formulations, Natco's product pipeline is expected to contribute steeply not only its top line, but also to margins. Being an early entrant in drugs with patent expiries, the company is well placed to carve in high margins despite rising competitive intensity in international markets, especially the US.

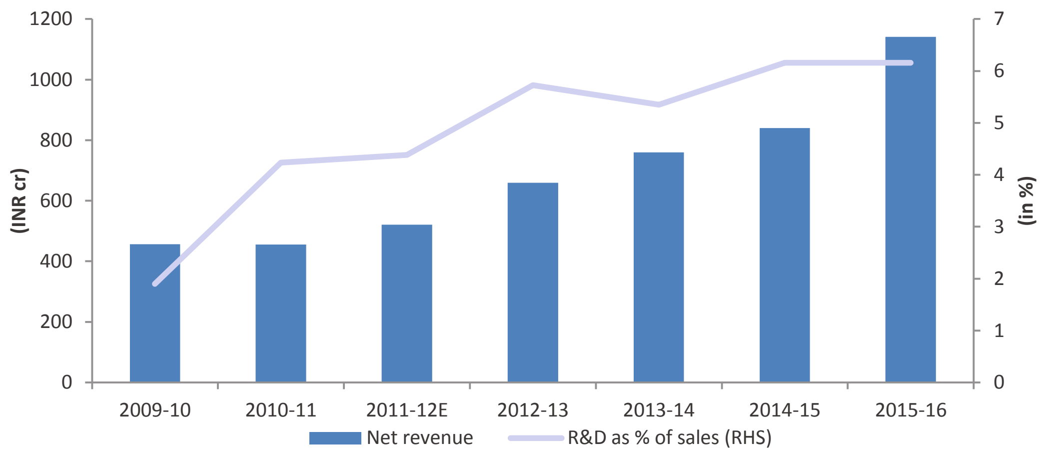


Source: Company, Edel Invest Research

Consistent increase in R&D indicates promising pipeline

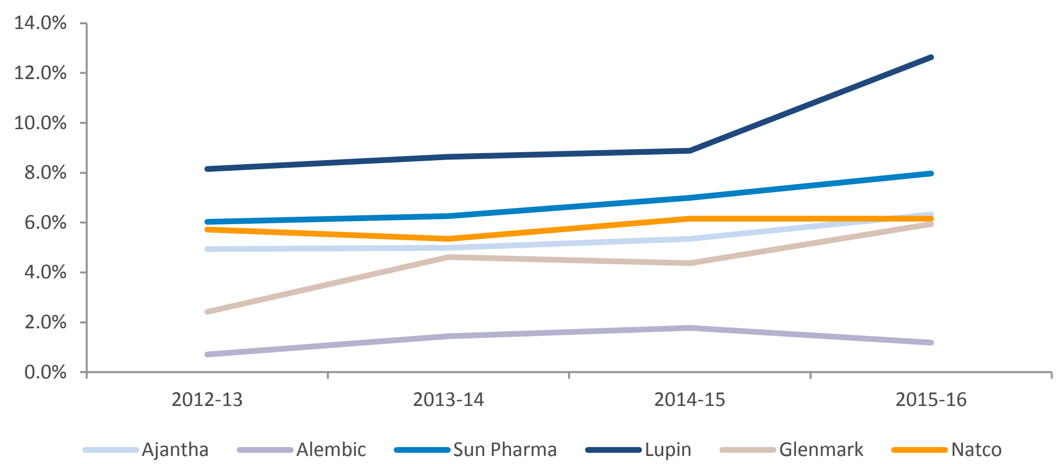
Natco's R&D as a percentage of sales has increased from 2% to more than 6%, clocking robust 40% CAGR. We expect this spending to convert into a strong pipeline for the company, making it a long term growth player in the Indian pharmaceutical industry.

Growth in R&D/Sales from 2% to 6% levels



Source: Company, Edel Invest Research

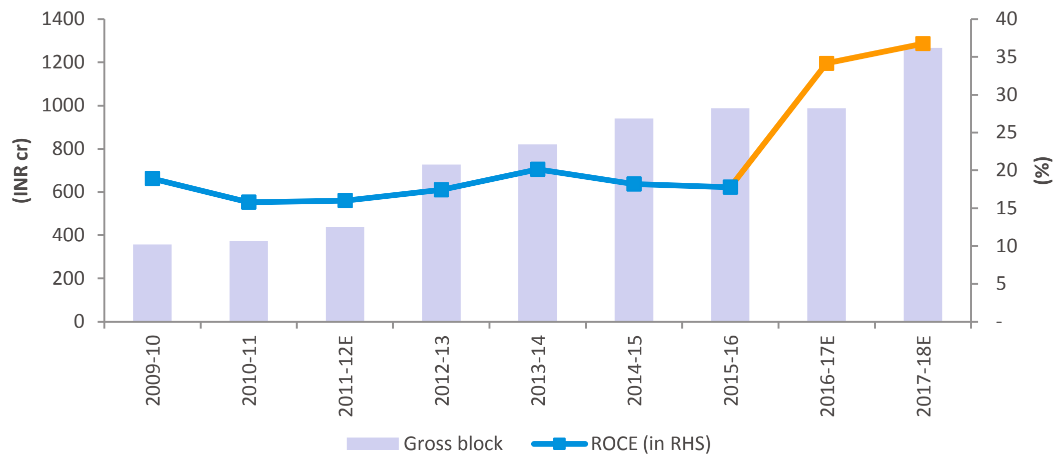
Natco's R&D spending is closer to the highest in industry



Source: Company, Edel Invest Research

Capex expected to contribute to higher returns

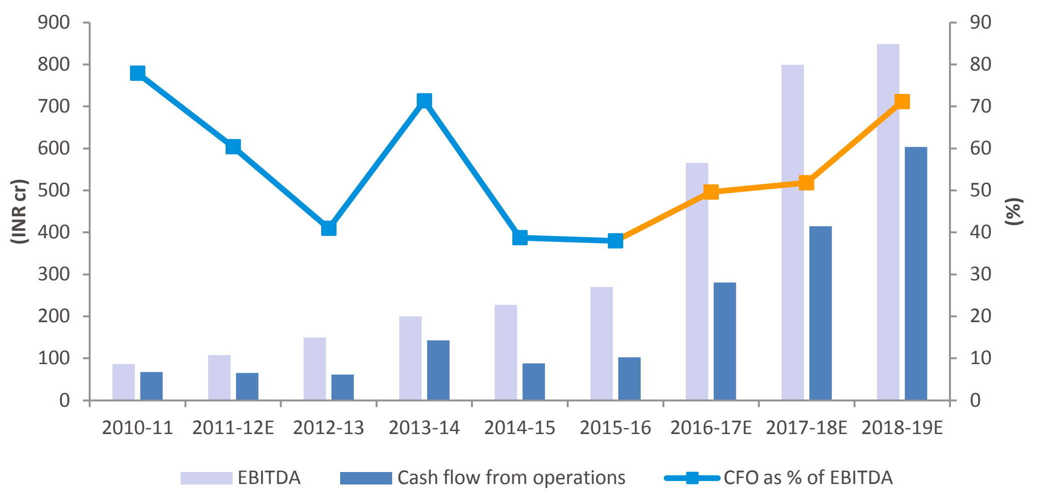
Natco has a capex plan of about INR260crore in FY17 on its Vizag facility to increase capacity and continue catering to direct API sales and captive consumption demand. Despite increasing gross block, we expect the company's RoCE to rise to ~35% on back of high margin product launches expected in the US.



Source: Company, Edel Invest Research

Operating efficiency to boost cash flows

Steep growth in EBITDA is estimated to culminate into higher cash flow for Natco. Further, operational efficiency is reflected in significant rise in operating cash flows as a percentage of sales, which is expected to grow from the current 50% to beyond 70%.

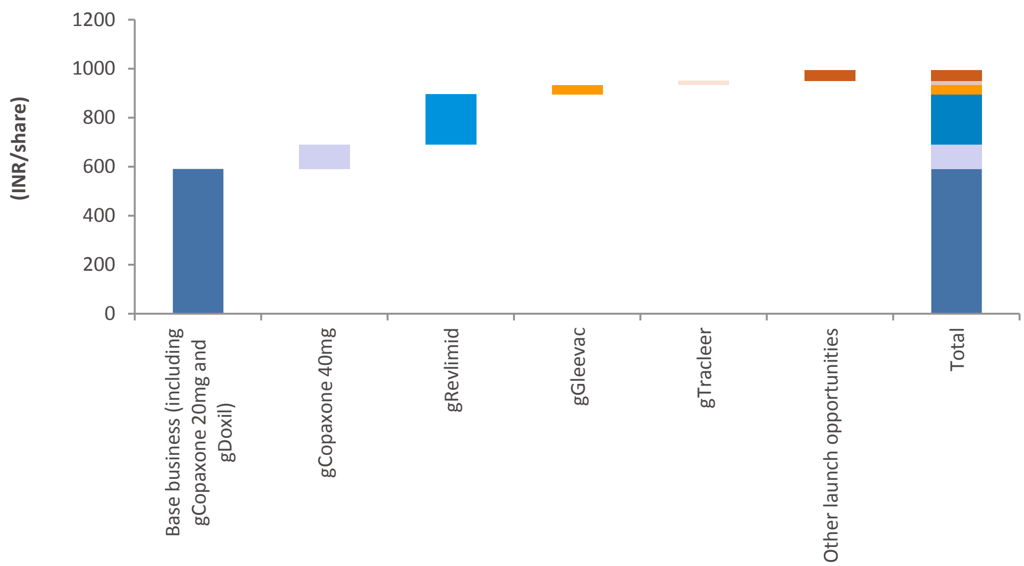


Source: Company, Edel Invest Research

Valuation

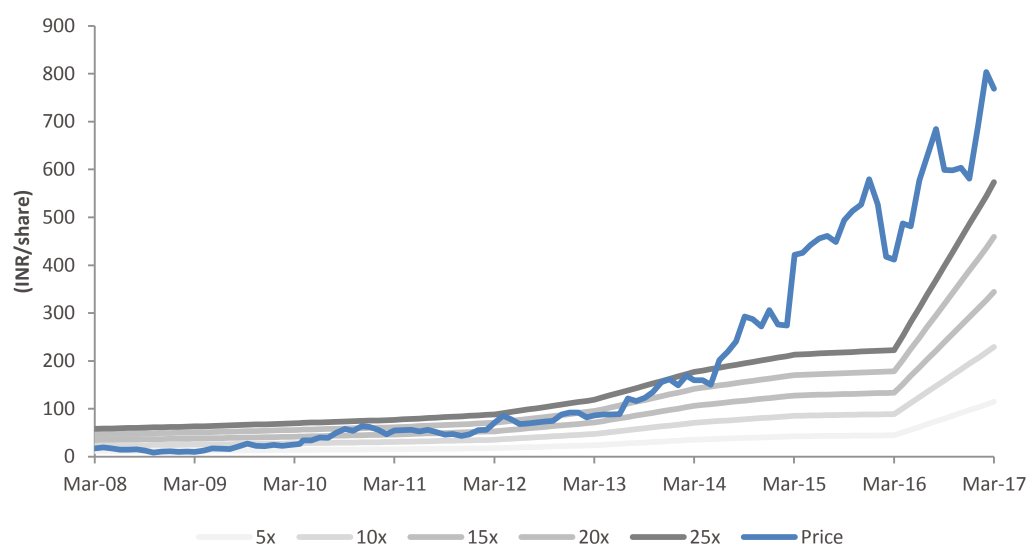
Diversification across therapy areas in the domestic market, expansion across developing market geographies and multiple launches lined up in the US will drive earnings CAGR of 31% over FY16-FY19E. Ergo, we expect stable cash flows and margin improvement with promising product pipeline and in-line capacity expansion. Our earnings estimate for FY17, FY18 and FY19 are INR22, INR31 and INR33 per share, respectively. We value the company's base business at 18x FY19E earnings of INR32.8/share, while the expected launches in the US & EU are valued at INR404/share. We maintain our **"BUY"** recommendation on the stock, with a target price of INR995/share.

Niche filling opportunities add to valuations above base business



Source: Edel Invest Research

PE bands



Source: Company, Edel Invest Research

Peer Comparison

Company	PER				EV/EBITDA				P/Sales				P/BV			
	FY16	FY17E	FY18E	FY19E	FY16	FY17E	FY18E	FY19E	FY16	FY17E	FY18E	FY19E	FY16	FY17E	FY18E	FY19E
Natco Pharma	92	32	29	23	54	23	20	16	13	7	6	5	12	8	7	5
Alembic Pharma	15	27	21	18	11	17	14	12	3	4	3	3	8	6	5	40
Ajanta Pharma	42	31	28	23	27	22	20	17	9	8	7	6	14	10	8	6

Company	ROE (%)			RoCE (%)			Asset Turnover (x)		
	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
Natco Pharma	19	21	14	20	18	18	0.7	0.7	0.7
Alembic Pharma	40	36	58	39	39	61	2.5	2.1	2.2
Ajanta Pharma	47	43	40	54	56	50	1.9	1.8	1.6

Company	Sales Growth (%)			EBITDA Margin (%)			R&D/Sales (%)		
	FY14	FY15	FY16	FY14	FY15	FY16	FY14	FY15	FY16
Natco Pharma	12	12	38	25	26	24	5.4	6.2	6.2
Alembic Pharma	23	10	53	19	20	32	1.4	1.8	1.2
Ajanta Pharma	30	22	17	31	35	34	5.0	5.4	6.3

Company Overview

Natco, incorporated in September 1981 by Mr. V.C Nannapaneni, commenced operations as a contract manufacturer for various companies in the pharmaceutical industry including Ranbaxy Laboratories, Cadila, John Wyeth India, among others. The company has the distinction of introducing the time release technology in India and manufactured formulations in conventional as well as sustained release forms. By 1994, export of formulations accounted for 50% of the company's turnover. In 1995, 3 group companies merged with the parent company to form Natco.

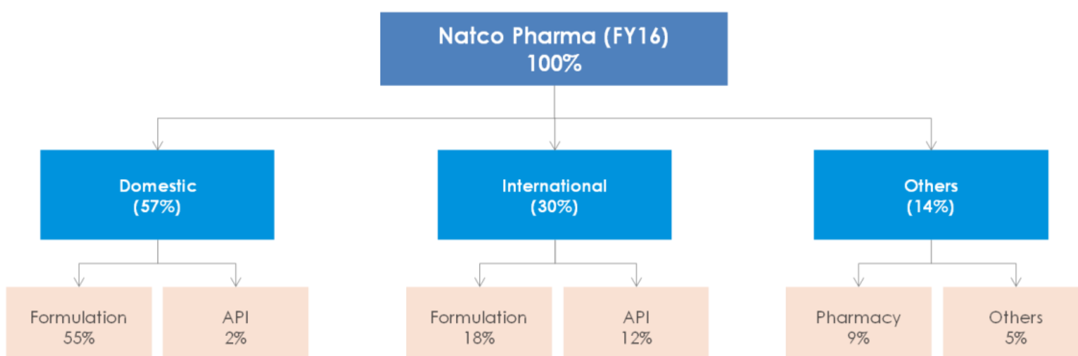
In a bid to diversify its operations, the company invested in various projects in the late 1990s, including a softgel plant in the US and stake in the Krishnapatnam Port project. These led to a disproportionate increase in debt and the company was soon forced to take drastic measures, including divesting stake in Natco Pharma USA and selling off its branded formulations division (40 products accounting for sales of INR53crore) to Sun Pharmaceuticals. These measures, along with a debt restructuring package from IDBI, helped the company turnaround—from a loss making entity to completely wiping out accumulated losses by 2003.

However, the turning point for Natco came in January 2003, when the company entered the oncology segment with the launch of the generic version of Imatinib Mesylate. This was followed by ZOLDONAT and LETRONAT tablets, both cancer therapy drugs. Today, Natco is the leader in the oncology space, with 30% market share in the domestic oncology segment.

While domestic formulations contribute 55% to the company's revenue, international generics make up 18%. Natco has finished dosage manufacturing facilities in Kothur, Dehradun as well as Nagarjuna Sagar. The facility at Kothur has USFDA approval as well as approvals from regulatory authorities of Canada, Portugal, Greece & Germany and is used exclusively for exports to the US/European markets. The Dehradun facility is used for production of domestic formulations and is also being used for exports from 2012. The Nagarjuna Sagar facility is where majority of the contract manufacturing is undertaken.

Natco also manufactures bulk drugs, which account for 14% of revenue (12% international and 2% domestic). The company has 2 API manufacturing facilities—Chennai which is used to manufacture cyto-toxic APIs and Mekaguda which is used for domestic formulations as well as exports. It has established an R&D centre in Hyderabad for synthetic chemistry, biotech & fermentation and it also runs a chain of retail pharmacies in the US which contribute 9% to revenue.

Business Model



Management Profile

Name	Designation	Description
Mr. V.C. Nannapaneni	*Chairman & Managing Director*	Mr. V.C Nannapaneni is Natco's founder and CMD since 1981. His educational qualification includes M.S. (pharmaceutical division). He has 44 years of work experience and has previously worked with Time Cap Lab.
Mr. Rajeev Nannapaneni	*Vice Chairman & Chief Executive Officer*	Mr. Rajeev Nannapaneni, son of Chairman and MD Mr. V.C. Nannapaneni, joined the company in 2000. He holds a B.A. in Quantitative Economics & B.A. in History from Tufts University, USA. He has previously worked with Merill Lynch and Natco Systems LLC in USA.

Financials

Income Statement					(INR cr)
Year to March	**FY15**	**FY16**	**FY17E**	**FY18E**	**FY19E**
Net revenue	840	1,142	1,836	2,434	2,584
Materials costs	242	341	487	597	634
Gross profit	597	800	1,350	1,837	1,951
Employee costs	137	187	210	278	295
R & D Expenses	13	15	28	35	37
SG & A Expenses	221	329	547	725	770
EBITDA	227	270	565	799	848
Depreciation & Amortization	47	51	61	73	81
EBIT	180	219	504	726	767
Other income	19	12	11	11	11
EBIT incl. other income	199	231	515	737	778
Interest expenses	32	23	12	12	12
Profit before tax	168	208	502	725	766
Provision for tax	4	53	128	184	194
Adj. Net profit	164	155	375	541	571
Reported Net Profit	164	155	375	541	571
Basic shares outstanding (cr)	17.42	17.42	17.42	17.42	17.42
EPS (Rs.)	9.4	8.9	21.5	31.0	32.8
Dividend per share (INR)	1.1	1.5	1.5	1.5	1.5
Dividend payout (%)	12.2%	16.9%	7.0%	4.8%	4.6%

Common Size					
Year to March	**FY15**	**FY16**	**FY17E**	**FY18E**	**FY19E**
Materials costs	28.9%	40.6%	57.9%	71.1%	75.5%
Employee expenses	16.3%	22.2%	25.0%	33.1%	35.1%
Manufacturing & Other Expenses	26.3%	39.2%	65.1%	86.3%	91.7%
Research & Development Expenses	1.5%	1.8%	3.3%	4.2%	4.5%
Depreciation	5.6%	4.5%	3.3%	3.0%	3.1%
EBITDA margins	27.1%	23.6%	30.8%	32.8%	32.8%
EBIT margins	21.4%	19.2%	27.5%	29.8%	29.7%
Net profit margins	19.5%	13.6%	20.4%	22.2%	22.1%

Growth Ratios					
Year to March	**FY15**	**FY16**	**FY17E**	**FY18E**	**FY19E**
Revenues	10.6%	35.9%	60.8%	32.6%	6.2%
EBITDA	13.7%	18.7%	109.6%	41.4%	6.2%
PBT	8.7%	24.1%	141.6%	44.2%	5.7%
Net profit	32.6%	-5.2%	141.6%	44.2%	5.7%

Balance Sheet					(INR cr)
As on 31st March	**FY15**	**FY16**	**FY17E**	**FY18E**	**FY19E**
Equity capital	33	35	35	35	35
Reserves & surplus	818	1,268	1,622	2,141	2,690
Borrowings	312	113	113	113	113
Deferred Tax Liabilities (Net)	12	14	14	14	14
Sources of funds	**1,175**	**1,430**	**1,783**	**2,302**	**2,852**
Net Fixed Assets	839	925	1,144	1,221	1,292
Investments	2	21	21	21	21
Inventories	220	357	433	574	609
Sundry debtors	192	262	335	444	472
Cash & Bank Balances	13	26	3	244	673
Loans and advances	118	213	260	345	366
Total current assets	543	858	1,031	1,607	2,120
Sundry creditors and others	198	373	412	546	579
Provisions	11	17	17	17	17
Total current liabilities & provisions	209	390	429	563	597
Net current assets	334	468	602	1,044	1,523
Uses of funds	**1,175**	**1,414**	**1,767**	**2,286**	**2,836**
Book value per share (Rs.)	49	75	95	125	156

Free cash flow

Year to March	FY15	FY16	FY17E	FY18E	FY19E
Net profit	148	155	375	541	571
Add : Depreciation	47	51	61	73	81
Others	(22)	(79)	2	2	2
Gross cash flow	174	127	438	615	654
Less: Changes in WC	(86)	(121)	(157)	(201)	(50)
Operating cash flow	88	6	280	414	604
Less: Capex	125	130	280	150	151
Free cash flow	(37)	(124)	0	264	453

CasH Flow Statement

Year to March	FY15	FY16	FY17E	FY18E	FY19E
Cash flow from operations	88	102	280	414	604
Cash Flow from investing activities	(115)	(175)	(269)	(139)	(140)
Cash Flow from financing activities	29	86	(34)	(34)	(34)
Capex	(125)	(130)	(280)	(150)	(151)
Dividends	(17)	(17)	(22)	(22)	(22)

Profitability & Efficiency Ratios

Year to March	FY15	FY16	FY17E	FY18E	FY19E
ROAE (%)	20.7%	14.4%	25.3%	28.2%	23.3%
ROACE (%)	18.2%	17.8%	32.3%	36.3%	30.4%
ROIC (%)	18.2%	17.7%	32.0%	36.1%	30.2%
Inventory day	87	92	86	86	86
Debtors days	68	73	67	67	67
Payable days	79	91	82	82	82
Cash conversion cycle (days)	75	73	71	71	71
Current ratio	2.6	2.2	2.4	2.9	3.6
Debt/Equity	0.4	0.1	0.1	0.1	0.0

Turnover Ratios

Year to March	FY15E	FY16	FY17E	FY18E	FY19E
Total asset turnover	0.7	0.7	0.9	1.0	0.8
Fixed asset turnover	1.0	1.3	1.8	2.1	2.1
Equity turnover	1.1	1.1	1.2	1.3	1.1

Du Pont Analysis

Year to March	FY15	FY16	FY17E	FY18E	FY19E
NP margin (%)	19.5%	13.6%	20.4%	22.2%	22.1%
Total assets turnover	0.7	0.7	0.9	1.0	0.8
Leverage multiplier	1.6	1.5	1.4	1.3	1.3
ROAE (%)	20.7%	14.4%	25.3%	28.2%	23.3%

Valuation Parameters

Year to March	FY15	FY16	FY17E	FY18E	FY19E
Diluted EPS (Rs.)	9.4	8.9	21.5	31.0	32.8
Y-o-Y growth (%)	32.6%	-5.2%	141.6%	44.2%	5.7%
Diluted PE (x)	92.4	88.5	36.6	25.4	24.0
Price/BV (x)	16.2	10.6	8.3	6.3	5.0
EV/Sales (x)	16.4	11.6	7.3	5.4	4.9
EV/EBITDA (x)	61.7	51.2	24.5	17.0	15.5
Dividend yield (%)	0.1%	0.2%	0.2%	0.2%	0.2%

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Head Research

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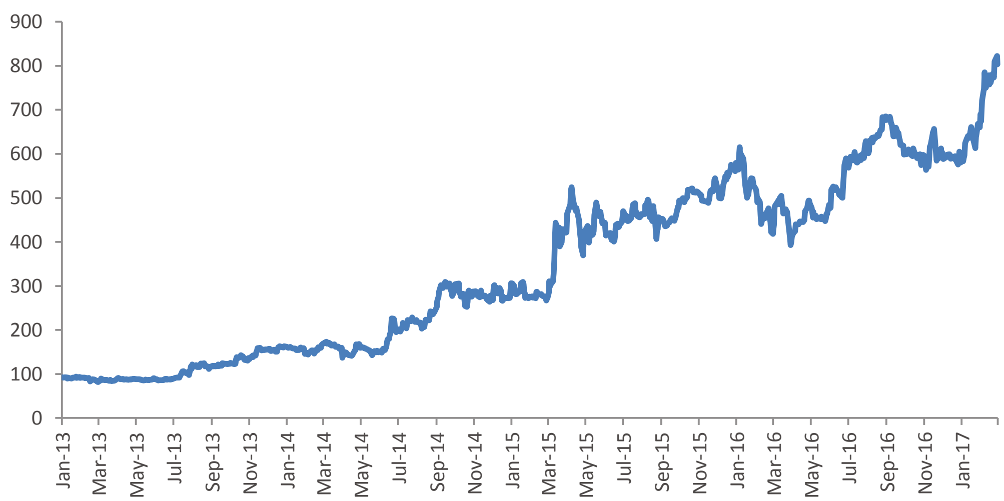
Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate between 5-15% over a 12-month period
Reduce	Return below 5% over a 12-month period

Natco Pharma 5 years price chart



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