Granules India Ltd.

25 March, 2014

Granules India, promoted by Mr C Krishna Prasad, is a pharmaceutical manufacturing company headquartered in Hyderabad, India. It is a leading manufacturer of API's, PFI's and finished dosages, and has 6 manufacturing units, apart from one additional being constructed. Five of these facilities are fully owned, and two are part of JV's. Granules was established in 1991, and in 2000 merged with Triton (established in 1984).

Over the years the Company has been moving up the value curve. The Company started with manufacturing API's, then added granulation on an outsourced basis, and after expanding its manufacturing integration, now sells finished dosage formulations, PFI's as well as API's. The Company received its first formulations ANDA in FY10.

Now the Company is moving towards manufacturing more complex and high yielding products, as evidenced by the JVs' it has entered into as well as the Auctus acquisition it recently made.

Investment rationale

Auctus acquisition and JV with Ajinomoto OmniChem – to drive future growth and profitability

Granules recently acquired Auctus, which manufactures products that generate high margins. In the future, we expect that Granules management can leverage its own strengths and derive significant additional synergies from Auctus operations.

Granules has also entered into a 50:50 JV with OmniChem (a subsidiary of Ajiniomoto OmniChem) Belgium. Ajiniomoto OmniChem currently manufactures complex API's for various drug manufacturers, mainly in Europe. In the future the JV will supply complex drugs that yield high margins to several companies in Europe.

In sum, in the near future we expect Granules turnover, profits and more importantly profitability margins to significantly expand. This could lead to a rerating of the stock, and we opine that over the medium term this stock could be a multi bagger from current levels.

Low Valuation

Granules is currently trading at Rs 260 per share, at a valuation of 8x TTM P/E, 6x cash earnings and less than 2x book value. We find that this significantly undervalues the Companys' existing businesses and future potential.

Recommendation

Taking into consideration the existing cheap valuation, the expected margin and turnover increase accruing from upcoming developments, we recommend to buy the stock with an outperform rating.

Recommendation : Buy

Company Data	
MCAP	525 crore
P/E (x)	8 x
EPS (TTM)	32.53
D/E	0.95
52 week hi/low	294 / 90
BSE Code	532482
NSE Code	Granules
Reuters	GRAN.NS
Bloomberg	GRAN

Shareholding Pattern	
Promoters	51.04%
Institutions	1.62%
FII	1.54%
DII	0.08%
Non Institutions	49.42%
Bodies Corporate	3.12%
Custodians	0.10%

Income Statement

(in Cr.)	Dec-13	Sep-13	Jun-13	Mar-13
Revenue	262.1	239	208.7	178.9
Other Income	0.3	0.4	1.7	1.0
Total Income	262.4	239.4	210.4	179.9
Expenditure	-217.1	-203.8	-179.8	-153.8
Interest	-4.3	-4.1	-3.4	-3.9
PBDT	41.0	31.4	27.1	22.2
Depreciation	-6.6	-5.4	-5.0	-5.5
PBT	34.3	26	22.1	16.6
Tax	-11.3	-8.8	-7.4	-5.5
Net Profit	22.9	17.2	14.7	11
EPS	11.3	8.5	7.32	5.5
CEPS	14.6	11.1	9.8	8.25
OPM %	17.2	14.9	14.6	14.6
NPM %	8.7	72	7	6.2

About Granules

Granules India is a leading manufacturer of several key drugs such as Paracetamol, Ibuprofen, Metformin etc and their derivatives, and has sales in 60 countries across the world. The Company is able to offer an extensive range of products and flexibility to customers due its complete integration in the manufacturing process (from API's, PFI's to finished dosages), JV tie ups, regulatory approvals as well as its own portfolio of ANDA's (3 approved products and 1 under approval).

5 of the 6 plants in operation (sixth one being an intermediate plant, does not require USFDA approval) have USFDA approvals - the most stringent in the world, apart from a variety of other approvals depending on customers' requirements.

At the moment, the Company is more focussed on manufacturing high volume but low margin products. It should be noted that even in this space, Granules margins are higher than its peers. This is due to the Companys' unrelenting focus on operational efficiencies and its large manufacturing facilities.

It is the largest PFI manufacturer in the world. The Gagillapur facility has one of the largest single-site Finished Dosage capacities in the world with automated processes, robust infrastructure and efficient quality systems. Its API facilities in Bonthapally possess among the largest single-site capacities in the world.

In 2006, Granules formed a joint venture with Hubei Biocause in China, a premier Ibuprofen manufacturer with a facility in Jingmen, China. This was done primarily to ensure supply of raw materials to support Granules increased finished dosage sales of Ibuprofen.

Over the years the Company has been moving up the value curve. The Company started with manufacturing API's, then added granulation on an outsourced basis, and after expanding its manufacturing integration, now sells finished dosage formulations, PFI's as well as API's. The Company received its first formulations ANDA in FY10.

Now the Company is moving towards manufacturing more complex and high yielding products, as evidenced by the JV with Ajinimoto OmniChem of Belgium 2011 it has entered into in 2011, as well as the Auctus acquisition it recently made.

Future drivers

Auctus acquisition

Granules recently acquired Auctus India, manufacturer of a range of APIs' in niche, high yielding segments such as anti-histamine, anti-fungal, anti-ulcer, anti-hypertensive, etc. We believe that synergies that can be derived from this acquisition have the potential to be a game changer for Granules.

Auctus under its previous management suffered from poor operational efficiencies and sales strategies. The Company was dependant on traders for its sourcing as well as sales. Due to inadequate investments the Company was operating at inefficient levels. On the flip side, the Company has a very strong product portfolio, and very importantly, has recently received approvals from the USFDA and EDQM. Given Granules experience and expertise in running multiple, large capacity facilities, its vast sales network (60 countries, 300 plus customers across the globe), we opine that Granules will easily streamline and overcome Auctus's operational shortcomings, and integrate the company into its own to derive maximum benefits from this merger.

In our interactions with the Company management, they indicated that the primary driver for buying Auctus is to be able to expand into niche premium categories through Auctus' existing product line up.

In the short-term, Granules will be focusing on improving the operations at Auctus. This will happen throughout FY15 after which we anticipate benefits starting to accrue. As Auctus operations improve, we can expect filing for new ANDAs in FY15. Granules plans to use the Auctus' strong product portfolio for captive consumption to in turn expand its finished dosages into niche offerings. Granules management has already identified the key APIs' they plan to prioritize into production.

In sum, towards the end of FY15 we anticipate significant benefits accruing to Granules.

This acquisition has added 13 new generic molecules to Granules existing total of 5. Of these 13 molecules, DMFs of 4 have already been received. Granules intends to extend some of these acquired molecules into the formulations space, thereby increasing value addition.

At the time of the takeover, Auctus turnover was approximately Rs 115 crore per annum, and had a net loss of Rs 40 lacs p.a. Granules paid Rs 120 crore for Auctus, and funded the deal using a mix of internal accruals (25%) and bank debt (75%).

JV with Ajinimoto OmniChem

Granules has entered into another JV with Ajinomoto OmniChem, Belgium in 2011. A facility is under construction in Vizag, India for the same.

Ajinimoto OmniChem is a high-end CRAMS manufacturer, which focuses on working with clients from late trial stages through to commercialization of drugs under development. The Company is primarily focussed in Europe, and has expertise in complex technologies including Azidation, Catalytic hydrogenation, Chiral chemistry, Hydride reductions, Organometallic chemistry, Enzymatic reaction etc., among others.

The JV will focus on manufacturing products for OmniChem's customers as they go off-patent. The JVs' concentration will be on producing second generation manufacturing processes with patent holding customers and then implementing them. The idea is to enable patent owners to retain volumes when products go off-patent, instead of losing market share to generic players.

We expect validation trials to start in May 2014. While it will take another 2 years to get the inspections and certifications in order, Granules can sell intermediates to deliver some revenue in the interim. We expect the JV to start selling high margin APIs beginning FY18.

The value of Omnichem JV comes from the more complex and higher margin products that it would make for larger pharmaceutical players (GSK and others). Such advanced technologies would help Granules to win bigger and more lucrative clients in the years to come. Granules would also look to devise cheaper methods of making these same APIs so as to add value to the brand owning customers and to improving its own margins. Considering the fact that this facility will almost exclusively be used to manufacture drugs that are going off patent, we expect the JV to generate very healthy margins, and have a ready market as the JV partner already has existing relationships with the patent holders.

Recommendation

Granules should deliver more than 20% compounded revenue growth over T+3 years. It is already funded for this growth and no equity dilution would be required. Its margins would improve in the interim and PAT growth would be higher than revenue growth.

Granules is currently trading at Rs 260 per share, at a valuation of less than 8x TTM P/E, 6x cash earnings and less than 2x book value. The current Mcap is approx Rs 525 cr. 9M FY14 EBITDA is already over Rs 90 cr, and we anticipate FY14 EBITDA to exceed Rs 130 cr. PAT for 9M FY14 is over Rs 50 cr.

The Company has grown its cash profit from Rs. 16 cr in FY07 to Rs. 56 cr in FY13. The Company has been cash flow positive since FY10. EBITDA increased from Rs. 61 cr in FY10 to Rs. 83 cr in FY13 (FY13 was poor due to late commissioning of production facilities).

Given the future prospects and low current valuations, we recommend to buy with an outperform rating.

Risks to our assumptions

Plant approvals

As with all pharmaceutical plants that export medicines, approvals have to be awarded and sustained over time. In the recent past, we have witnessed a flurry of adverse inspections reports in various Indian pharmaceutical plants. Any such adverse reports may affect goodwill, turnover and profitability for Granules.

However, in the course of our interaction with the management and plant visit, we were walked through the top management credentials, and got a very positive impression. We found the Granules staff and management to be very competent and well prepared for the future. The plant visit was revealing. Plants were clean and staff seemed compliant with all the GMP, safety and operating protocols.

Currency fluctuations

As we anticipate export earnings to be a major driver of top and bottom lines for the Company, adverse currency movements can impact financial performance of the Company in the future.

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