Natco Pharma

Top league player

Natco Pharma is a Hyderabad based pharma company with focus on limited competition and high margin products. It has presence in domestic and global markets and has two main business segments i.e. API and Formulations.

Niche therapeutic play in domestic formulations: In the domestic formulations business (57% of revenues), Natco focuses on oncology and Hepatitis C segments. The oncology segment continues do as market dynamics favor while Hepatitis C franchisee is expected to grow by ~20% rate over next couple of years due to huge cost advantage. Owing to this, we expect 24% CAGR in domestic formulations over FY16-FY19E.

Export formulations to grow 4.0x in next two years: Natco's export formulations revenue is set to grow at a CAGR of 64% over FY16-FY19E. The company has already monetized some niche ANDAs in FY17E and a few more ANDAs are due for launches over next two years. This is expected to see 4.0x growth in export formulations by FY19E.

Copaxone approval remains a near term trigger: Natco and its marketing partner Mylan believe that they are the FTF filers on multiple sclerosis drug Copaxone 40mg (annual sales of $3.3bn). The US District Court has already invalidated several patents on this drug. The verdict on one of the patents is due by May 2017. A favorable verdict will raise hopes of launching generic Copaxone 40mg. We believe that Copaxone 40mg is a ~₹400-500cr revenues opportunity during 180-day period for Natco Pharma.

Revlimid opportunity significantly big: Natco has settled litigation regarding multiple myeloma drug Revlimid (US sales of $4.4bn) with its innovator Celgene. The company will be able to launch this drug in 2022 and it will certainly be a large opportunity considering the size of the drug.

Outlook and Valuation: Natco's topline and bottomline is set to grow at 36% and 61% CAGR over FY16-FY19E due to 1) strong performance of domestic formulations and 2) monetization of high value ANDAs. The stock at the CMP of ₹769 is trading at P/E of 21.2x of FY2019E EPS of ₹37. This is 15% discount to its 3 year average P/E multiple of 26x. **We initiate coverage on Natco Pharma with buy rating and SOTP value of ₹926 (₹890 base on 24xFY19E EPS + Revlimid NPV at ₹37.) implying 18% upside from current level.**

Key Financials (Consolidated)

Y/E March (₹ cr)	FY15	FY16	FY17E	FY18E	FY19E
Net Sales	**825**	**1,142**	**2,090**	**2,335**	**2,869**
% chg	*11.7*	*38.3*	*83.1*	*11.7*	*22.9*
Net Profit	**213**	**270**	**670**	**622**	**972**
% chg	*19.0*	*26.4*	*148.4*	*(7.2)*	*56.3*
OPM (%)	25.9	23.6	32.1	26.6	33.9
EPS (₹)	**8.1**	**8.9**	**26.8**	**23.2**	**37.1**
P/E (x)	94.9	86.3	28.6	33.2	20.7
P/BV (x)	15.1	10.3	8.1	7.0	5.7
RoE (%)	15.9	12.0	28.4	21.1	27.7
RoCE (%)	14.3	15.5	33.5	25.8	34.5
EV/Sales (x)	16.6	11.8	6.5	5.8	4.6
EV/EBITDA (x)	64.2	49.9	20.2	21.7	13.7

Source: Company, Angel Research; Note: CMP as of March 7, 2017

BUY

CMP	₹786
Target Price	₹926
Investment Period	12 Months

Stock Info	
Sector	Pharma
Market Cap (₹ cr)	13,397
Net Debt (₹ cr)	98
Beta	0.6
52 Week High / Low	830/390
Avg. Daily Volume	52,582
Face Value (₹)	2
BSE Sensex	29,000
Nifty	8,947
Reuters Code	NATP NS
Bloomberg Code	NTCPH IN

Shareholding Pattern (%)	
Promoters	51.2
MF / Banks / Indian FIs	12.2
FII / NRIs / OCBs	17.4
Indian Public / Others	19.3

Abs. (%)	3m	1yr	3yr
Sensex	8.4	17.8	32.2
Natco Pharma	28.4	58.2	349.3

Price Chart

Source: Company, Angel Research

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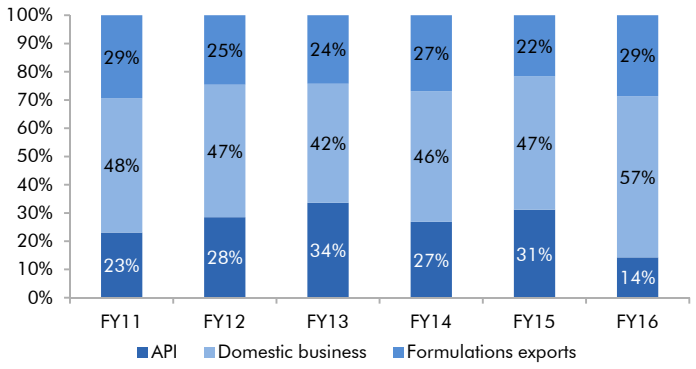
Company background

Natco Pharma is a Hyderabad based R&D driven organization. The company has presence in domestic as well as global markets, and has two main business segments i.e. API and Formulations. It has seven manufacturing facilities, which are approved by various drug regulatory authorities, and the prominent ones include USFDA, WHO GMP, ANVISA. Natco's logistics network in India is well-knit with about 150 marketing personnel and distributors at strategic points to ensure product availability pan-India.

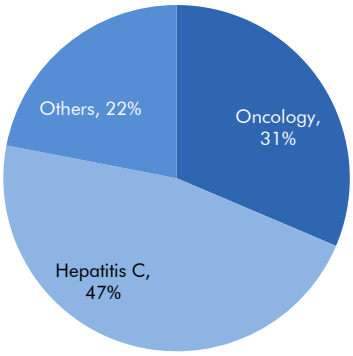
The company mainly operates in the niche therapeutic segments i.e. Oncology and Hepatitis C. Natco was earlier a pure oncology player in the domestic market, however in 2015, the company forayed in the Hepatitis C segment, diversifying its domestic operations. Further in 2017, company has forayed in Diabetology and Cardiology. In the domestic markets, company mainly focuses on limited competition products with high margin. Natco is ranked among leaders in oncology segment, while in Hepatitis C; it has been able to grow faster than its competitors due to the early mover's advantage. In the overseas markets, company is present in US, Canada, Europe, Australia, Brazil, etc In the US, company focuses on limited competition products and has partnered with several Indian as well as overseas partners, which help it mitigate risk and launch products.

Exhibit 1: Evolution of business mix (%)



Source: Company, Angel Research

Exhibit 2: Domestic business mix



Source: Company, Angel Research

Exhibit 3: Manufacturing facilities

Facility	Segment	Regulatory Approvals	Therapeutic capability
*Kothur	Formulations	USFDA, WHO GMP, ANVISA	Oncology, Gastroenterology CNS, Cardiology
Visakhapatnam	Formulations	Under construction	Oncology, CNS, Cardiology, Diabetology,
Mekaguda	Chemical API	USFDA, WHO GMP	API
Chennai	Chemical API	WHO GMP	API
Nagarjuna Sagar	Formulations	WHO GMP	Oncology, Antibiotics, Antiviral
Dehradun Unit 6	Formulations	WHO GMP	Oncology & Antiviral
Dehradun Unit 7	Formulations	WHO GMP, EU GMP	Oncology
Guwahati	Formulations	GMP	Gastroenterology

*Source: Company, Angel Research, *Kothur facility was audited by USFDA in January 2017 and has received 6 observations*

Investment Rationale

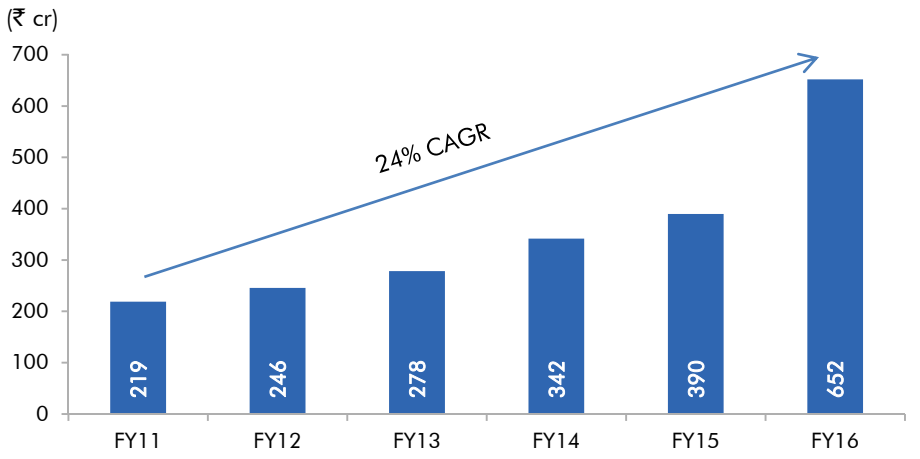
Natco is a top league player in the domestic formulations market: Natco, over the last decade has emerged as a top league player in the niche therapeutic segments in the domestic market. The company was present in multiple therapeutic segments earlier, however, due to its poor financial performance; it sold its domestic finished formulations business to Sun Pharma in 1988. Further, in 1999, the company had taken to recourse to debt restructuring post which company focused to improve the financial health of the company by reducing the debt and raising equity. This has helped the company to become viable in long term.

Its fortunes changed in FY2003 with the launch of generics of Imatinib Mesylate, Zoledronic Acid and Letrozole – drugs used in cancer therapy. Natco was the first company to launch these medicines at affordable prices in India, which quickly helped it to become a leader in the oncology therapy segment.

Further in FY2015, company expanded its therapeutic reach by launching Hepatitis C drugs in India at affordable prices. Here too, company was first one to bring affordable quality Hepatitis C medicines in India. This clearly proved to be a successful move and company quickly grabbed the number one position in the Hepatitis C segment.

Natco's story has been of the specialty drugs instead of me-too drugs. Company now has total ~28 brands in its portfolio, which has limited competition and healthy margins. These complex drugs have enabled the company to gain the market share and drive its top-line growth. This can clearly be seen in its domestic revenue performance, which has grown at a CAGR of 24% over FY2011-16.

Exhibit 4: Domestic formulations has grown at 24% CAGR (FY11-FY16)



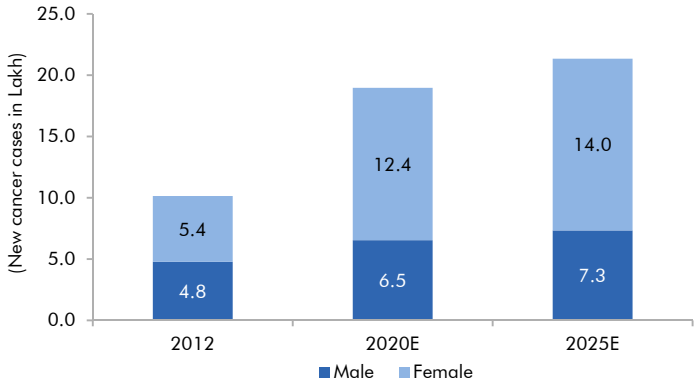
Source: Company, Angel Research

Oncology segment – Strong growth drivers in place: Oncology is one of the leading therapeutic segments in the domestic markets as well as globally. Total number of cancer cases in India is estimated to be 25 lakhs, while every year ~10 lakh new cases are registered. This burden is expected to increase to ~21 lakh new cases by 2025 indicating that the demand for anti-cancer drugs would increase going ahead. The domestic oncology market in value terms was

~₹2,000cr in FY2013, which is expected to grow at ~18% CAGR to reach ~₹3,800cr in FY2017.

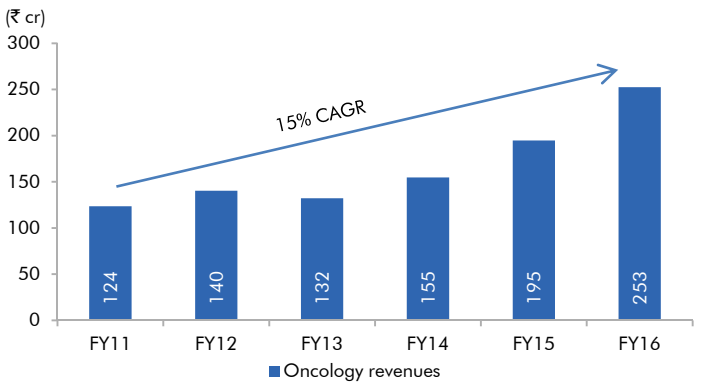
The rising cancer coverage by insurance companies, increasing affordability of the cancer medicines, rise in the specialty hospitals, etc. are the major growth drivers for the anti-cancer medicine in India.

Exhibit 5: India – Growing cancer burden



Source: GLOBOCAN 2012, Angel Research

Exhibit 6: Natco has scaled up its oncology business



Source: Company, Angel Research

Natco holds ~30% market share in targeted cancer therapies: Broadly, cancer therapies can be classified in several subtypes i.e. 1) Radiation, 2) Chemotherapy, 3) Targeted Therapies, 4) Surgery, and 5) Biologics. Natco competes in targeted anti-cancer therapies segment, which is pegged to have a size of ~₹800cr. Of this, Natco holds ~30% market share.

The domestic anti-cancer market is fragmented in nature and has several players. Chemotherapy was the preferred route for cancer treatment earlier, however combination therapies are on rise due to their effectiveness, and targeted therapy has found a good application in this. Targeted therapies are economical and come with lesser side effects, hence, gaining traction in India. While the use of biologics is expected to increase in future, at the current juncture biologics are not affordable for the masses.

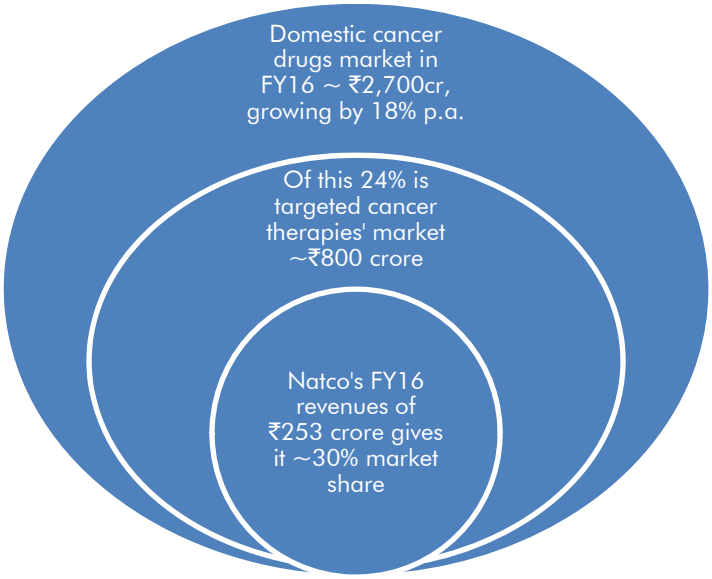
Over last few years, India has adopted a compulsory license route to bring the life saving medicines in India. Natco was the first company to receive a compulsory license for Bayer HealthCare AG's lung cancer drug Nexavar (Sorafenib) in India. Natco currently has a product basket of more than 25 drugs in Oncology segment. This segment has grown at a 5 year CAGR of 15.4% to reach ₹253cr in FY2016.

Exhibit 7: Natco's ₹10cr anti-cancer brands

Product	Therapeutic segment
Geftinat	Lung cancer
Erlonat	Lung cancer
Veenat	Chronic Myeloid Leukemia
Sorafenat	Liver and kidney cancer
Lenalid	Multiple Myeloma

Source: Company, Angel Research

Exhibit 8: Natco holds 30% market share in its targeted Onco therapies



Source: Company, Angel Research

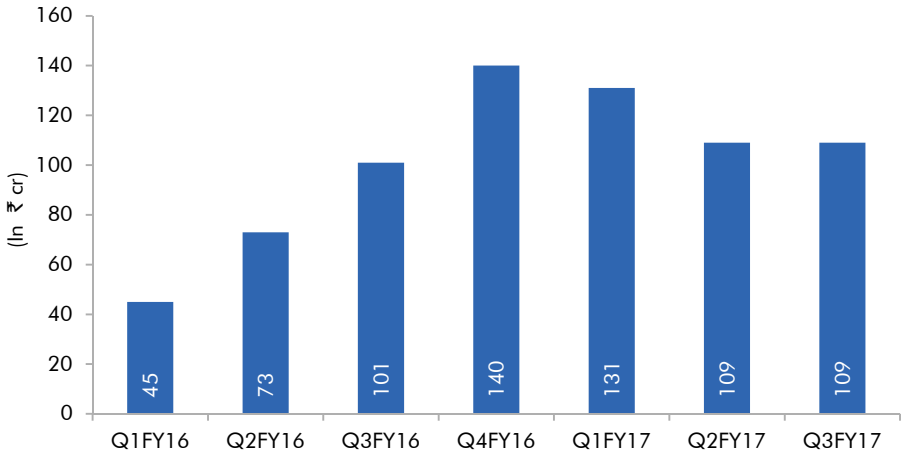
Hepatitis C franchisee has witnessed rapid growth: To diversify its business in other therapeutic segments, Natco forayed into Hepatitis C segment by launching three drugs namely 1) Hepcinat (generic Sofosbuvir), 2) Hepcinat LP (generic of Sofosbuvir+Ledipasvir combination), and 3) Natdac (generic Daclatasvir). For Hepcinat, Natco received a license from Gilead Sciences while for Natdac it has a license from Bristol-Myers Squibb This proved successful, as Natco reported revenue of ₹340cr from this franchisee in FY2016. In the first full year of operations, Hepatitis C franchisee outsized the revenue from Oncology segment, indicating strong future potential. Company is also expected to launch generics of another blockbuster Hepatitis- C drug Epclusa, which has better cure rate.

Natco has grown despite competition in Hepatitis C: Gilead Sciences has signed a non-exclusive licensing agreement with several generic pharma companies in 2015 to manufacture and market generics of Sofosbuvir and Ledipasvir in more than 100 countries. Gilead will receive royalty payment on these sales of these products. For Daclatasvir too, the innovator company (Bristol-Myers Squibb) has signed an agreement with several generic pharma companies including Natco to market and sell generic of Daclatasvir in 112 countries. Despite this competition, Natco has emerged the biggest beneficiary due to its front end capabilities, first mover's advantage and strong brand name.

Why we think Hepatitis C has robust future? Hepatitis C is a liver disease caused by the Hepatitis C virus (HCV). Globally, ~150 million people are believed to be infected by HCV and every year ~7 lakh people die due to this disease. While antiviral medicines have high cure rates (as high as ~90%) against HCV infection, the access to treatment is a major concern area. HCV is found worldwide, however Africa and Central and East Asia are the most affected areas.

In the domestic market, the growth in Natco's Hepatitis C franchisee revenue has been positively surprising. During the first 9 months of FY2017, Hepatitis C branded formulations have grown to ₹359cr, surpassing FY2016 full year revenue of ₹340cr. The company believes that the franchisee is likely to be ₹600cr-700cr in the next two years, implying 2.0x revenue potential from this segment going ahead.

Exhibit 9: Natco has seen fast ramp up in Hepatitis C franchisee



Source: Company, Angel Research

The existing Hepatitis C drugs launched by innovators such as Gilead's Sovaldi and Harvoni and Bristol-Myers Squibb's Daclatasvir (Daklinza) cost $84,600, $94,500 and $63,000 respectively for full treatment in the United States. The generics of these products are available at almost 99% discount to the innovator's costs. This is very promising for Natco Pharma, which has already showcased its capabilities to manufacture and market Hepatitis C drugs. It has required license for generics of Sofosbuvir / Ledipasvir / Daclatasvir and is in the process to take the drug to 10-12 countries. Worldwide, Hepatitis C market was estimated to be ~$11.81bn in 2015, which is expected to grow at a CAGR of 15% to reach ~$27.63bn by 2021. This indicates that Hepatitis C franchisee has a very strong future going ahead.

Launch of cardio and diabetology divisions to give more upside in revenues: Recently, company has launched two new divisions i.e. Cardiology and Diabetology. It aims to launch first time generics in this portfolio over the next 18 months, which we believe would be limited competition products that would help to bring a sizable contribution in the domestic business mix. Company has indicated that it has 7-8 products in sight and a proper execution of these products would give additional revenues of ₹150-200cr annually (~20% of FY2017E domestic business mix). This will be strongly positive for its domestic portfolio.

Domestic formulations set to cross ₹1,000cr mark in FY2018E: We believe that domestic formulations business is likely to cross ₹1,000cr mark in FY2018E owing to strong sales from Hepatitis C and Oncology segments. In the first nine months of FY2017, company reported ₹664cr of domestic revenue v/s. FY2016 domestic revenue of ₹652cr. We expect a CAGR of 21% and 26% in oncology and Hepatitis C revenues respectively over FY2016-19E period indicating strong domestic revenues going ahead.

Export formulations to thrive with monetization of R&D pipeline:

Natco has been able to grow its export formulations business from ₹24cr in FY2010 to ₹231cr in FY2016. This translates in revenue CAGR of 46% during this period. Within this, US formulation is the major part of its exports revenues. In the US, the company has filed a pipeline of complex products, which has limited competition and high revenue potential. This pipeline is at an interesting point with few drugs nearing monetization, indicating that its formulations exports are expected to receive a strong upward thrust in the next two years.

Natco, realizing the importance of niche products, started to file low competition (Abbreviated New Drug Applications) ANDAs in 2004. Currently it has ANDA pipeline of 40 ANDAs by 3QFY2017, which does not look rich in volumes compared its larger peers. However, this pipeline is one of the best in the industry in value terms (~$16.3bn). This is due to its continued focus on complex products with limited competition. The company has total 19 Para IVs, which represents sales of ~$13.4bn of innovator's brands, indicating an opportunity to grab huge revenues going ahead.

Exhibit 10: Natco's pipeline is nearing monetisation over next 3-4 years

Innovator brand name	Size in $ bn	Patent expiry / Launch
Entocort	370	Launched
Nuvugil	482	Launched
Tracleer	487.5	Patent expired, not launched yet
Vidaza	240	2017
Doxil	200	2017
Zortress	60	2017
Copaxone	4300	2018
Gleevec	2,533	2019
Gilenya	1800	2019
Tarceva	564	2020
Tykerb	74	2021
Jevtana	137	2021
Nexavar	300	2022
Fosrenol	118	2024
Treanda	710	2026
Revlimid	6,800	2027

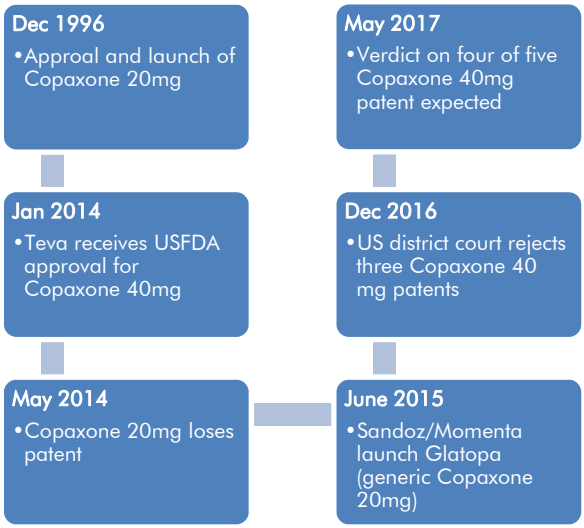
Source: Company, Angel Research

Copaxone 40mg likely to be launched in FY2018: Copaxone (glatiramer acetate injection) is an immunomodulator drug (acts on immune system) used to treat multiple sclerosis. This is a blockbuster product of Israeli pharma company Teva, and had annual sales of ~$4.3bn in 2016. This drug was earlier available in 20mg formulations, which lost the patent in 2015 after which generic drug - Glatopa was launched by Sandoz/Momenta in June 2015. However, Teva received approval for its 40mg formulation in 2014 and was able to move 80-85% patients from Copaxone-20mg to Copaxone-40 mg prescription. This has reduced the size for Copaxone-20mg drastically. Natco along with its US partner Mylan believe that they have a FTF on Copaxone 40mg. The drug is protected by five method of use patents.

The 40mg formulation is yet to go off patent and Teva is fiercely trying to keep the generics away from entering in Copaxone-40mg. Its efforts were, however, wasted after the United States District Court for the District of Delaware has issued a decision that 3 out of 4 patents on Copaxone 40m are unpatentable. The ruling on the fourth patent is expected on May 16, 2017. The fourth patent is expected to expire in 2030. A positive verdict on May-2017 is likely to see generic companies (most possibly Natco/Mylan) launch Copaxone 40mg in the US markets without waiting for expiry of 5th patent (at risk launch) and thereby monetizing its FTF opportunity. The precursor for this is an approval for Copaxone 20mg ANDA, which company is optimistic to receive very soon. The fifth patent is also a method of use patent and invalidation of four patents will boost the confidence of generic companies to launch the drug at risk.

If Natco is able to launch Copaxone 40mg, it will be Natco's biggest launch so far. Just to give a glimpse of this opportunity, Natco Natco reported ₹277cr quarterly revenues in US from its recently launched generic of Tamiflu. This revenue was higher than its full year export revenue in FY2016. The innovator's drug recorded sales of ~$400mn in US. By this comparison, Copaxone 40mg is a much larger drug. We believe that the company would be able to launch Copaxone 40mg in FY2018E and would be a massive opportunity for the company, as it will scale up its business significantly.

Exhibit 11: Copaxone journey so far



Source: Company, Angel Research

Revlimid – Natco's most promising generic: Natco Pharma had challenged certain patents of a blockbuster multiple myeloma drug Revlimid (lenalidomide), which is manufactured by a US company Celgene. The case, however, got settled in December 2015 with Celgene allowing Natco to sell unlimited quantity of generic Revlimid from April 2027. Additionally Natco has also received a volume limited license to sell generic Revlimid from March 2022. The company would be able to sell mid-single-digit percentage of the total lenalidomide capsules dispensed in the United States during the first full year of entry. Gradually, company can increase volumes until March 2025 but should not exceed 1/3rd of the total lenalidomide capsules dispensed in the U.S. in the final year of the volume-limited license under

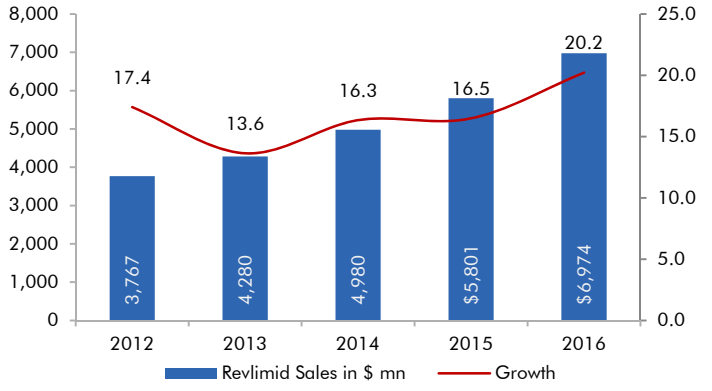
this agreement. From January 31st 2026, Natco can sell unlimited quantities of generic Revlimid.

Revlimid is one of the most expensive drugs with a single pill priced at ~$634 and full treatment cost running more than $100,000 per patient. The company has also an immense pricing power and the pill has seen 1.6x increase in price since 2008. Revlimid holds dominant market share in the multiple myeloma treatment (~50%). This has resulted in Revlimid's annual sales surging by 17% to reach $6.8bn in 2016. This blockbuster drug is likely to lose patent in 2026.

Why Revlimid is a promising opportunity for Natco? Revlimid, by its sheer size, is one of the top ten best selling drugs in the US. The drug is expected to clock more than $10bn in its peak revenues. Worldwide this drug has reported total sales of $6.9bn in 2016, of which $4.4bn came from US alone. The Revlimid sales are increasing at a CAGR of ~17%, indicating that US sales of Revlimid will cross $7bn-$8bn making this even bigger opportunity for the generic players like Natco. This indicates huge windfall gains for Natco once it starts selling generic of Revlimid in 2022. At 7% market share and 70% price erosion, Natco will be able to generate annual Revlimid sale of ~₹1100cr.

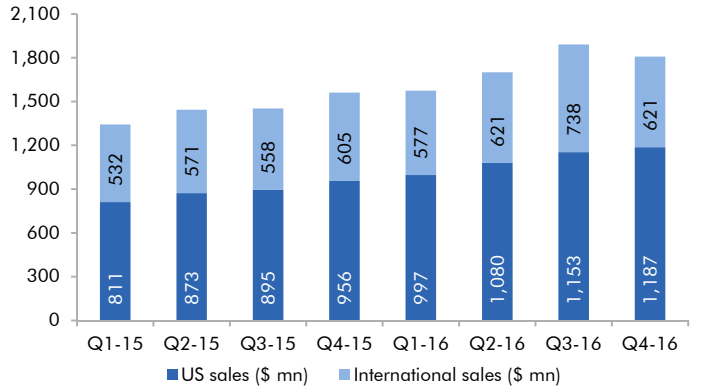
Natco believes that the drug could be launched early if more companies file for the lenalidomide ANDA. Dr. Reddy's Laboratories has already filed an ANDA for Revlimid, however, Natco has FTF for this drug. Revlimid is a complex biologic with an orphan drug status. The complex biologic means that making the copy of this drug is very difficult. This is very positive for Natco Pharma, as after losing patents, lenalidomide may still remain a limited competition drug giving strong revenue contribution.

Exhibit 12: Revlimid is a $7bn drug...



Source: Company, Angel Research

Exhibit 13: ...and US alone contributes ~2/3rd of sales



Source: Company, Angel Research

Differentiated R&D strategy: Natco has adopted a different approach in its research than its peers. While the Indian companies were busy in entering me-too products in domestic markets and growing their ANDA pipeline, Natco decided to focus on niche, limited competition products. In the domestic markets, it focused on oncology products first and then entered the Hepatitis C drugs. In the international markets, where one needs 1) strong front end capabilities and 2) ability to take risk, company adopted a strategy to partner with bigger generic companies. This has helped Natco in minimizing the legal risk. Company has collaboration with companies, such as, Mylan, Breckenridge, Alvogen, Actavis and Lupin.

Natco has currently total 43 ANDAs and the pipeline is not big compared to its peers, however, of its 43 ANDAs, 19 are the Para-IVs which have addressable size of ~$13.4bn, which speaks about its differentiated approach. We believe that Natco's US formulations business has multifold growth opportunity going ahead, as between FY2018 and FY2022, lot of products are likely to be launched.

Exhibit 14: Natco's marketing partners

Innovator brand	Size in $ mn	Marketing partner
*Tamiflu	403	Alvogen
Doxil	200	Dr. Reddy's lab
Copaxone	4300	Mylan
Tykerb	74	Lupin
Fosrenol	118	Lupin
Revlimid	6,800	Watson

*Source: Company, Angel Research, *already launched*

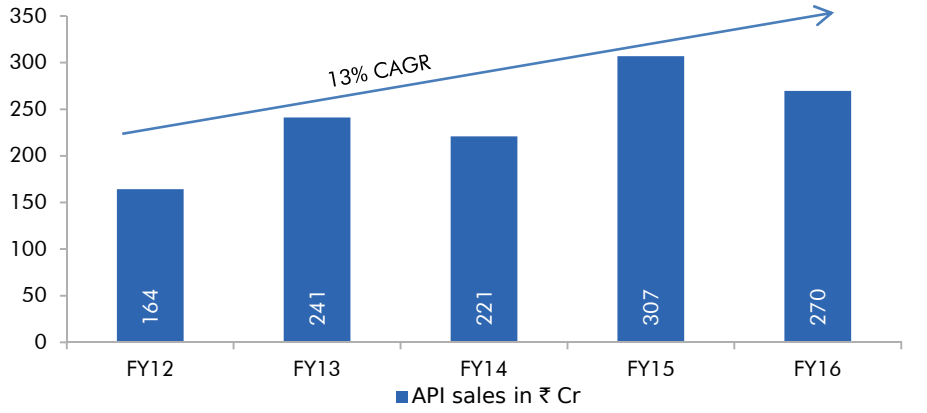
Natco's other business: Natco has operations in Europe, Canada, Brazil, etc. which together contributed ~15% of the total revenues. This business is growing at ~6% CAGR over the period of FY2011-16. The company has indicated of continuing its strategy of focusing on the US business as its ANDA pipeline is expected to fire up in next three to four years.

In the US business, Natco had earlier acquired retail pharmacies as a preferred option to grow US business. However, with the change in strategy, company has sold two retail pharmacies in the US. With this, the contribution of pharmacies in total revenues has come down from ~12% in FY2016 to <5% in FY2017. This is expected to go down further with stronger contribution from the formulations business.

Capacity augmentation in API business: Natco has an API business, which contributed 23% of its revenues in FY2016. Company uses APIs for domestic consumption as well as to supply to its domestic and international customers. The 80-90% of the API turnover is generated through exports, while rest comes from the domestic customers. In FY2013, API business contributed 36% of its total revenues, however, with remarkable growth in the formulation business; contribution of API has come down gradually. By 9MFY2017, API business contributed ~ 9% of the total revenues. We believe that this trend is likely to continue with launch of two new therapeutic divisions in India and launches of high value generics in the US.

Natco's management believes that its API business has a strong potential, as it fits in its value chain by means of backward integration for its formulations business. With the new product launches over next few years, company is augmenting its API manufacturing capacity at its Manali & Mekaguda locations which will continue to supply APIs to its formulations business as well as for third party sales to external customers.

Exhibit 15: API revenues have grown at 13% CAGR

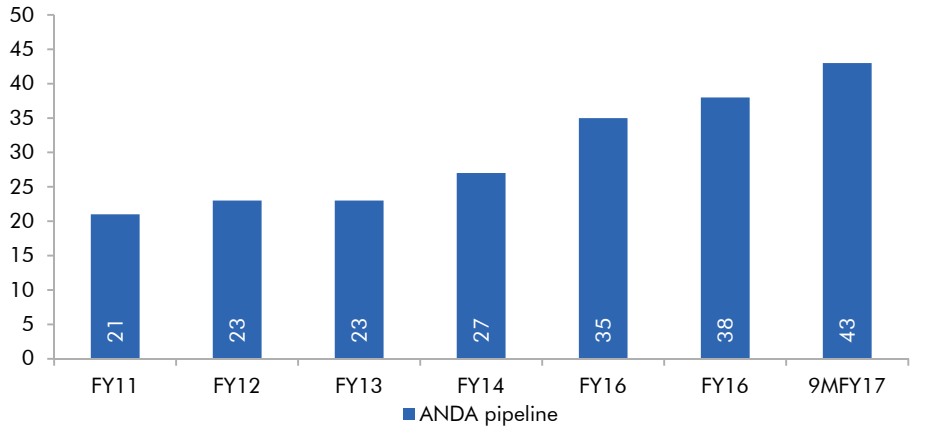


Source: Company, Angel Research

Addition of new formulations capacity to boost ANDA pipeline: Natco Pharma is setting up a new formulations facility at Visakhapatnam (Vizag). This facility is expected to be operational in June 2017. This facility holds key for Natco's incremental fillings going ahead. This is a major capacity expansion program for the company aimed to support its growing US business. Management has indicated that it will start filling ANDAs from this facility in early 2017.

The company, during the period of FY2011-9MFY2017, made only 22 filings and expects to file more than 10 ANDAs per year once Vizag capacity is ready. So this facility is extremely important to support Natco's growing US business.

Exhibit 16: Natco filed only 22 ANDAs between FY11-9MFY17



Source: Company, Angel Research

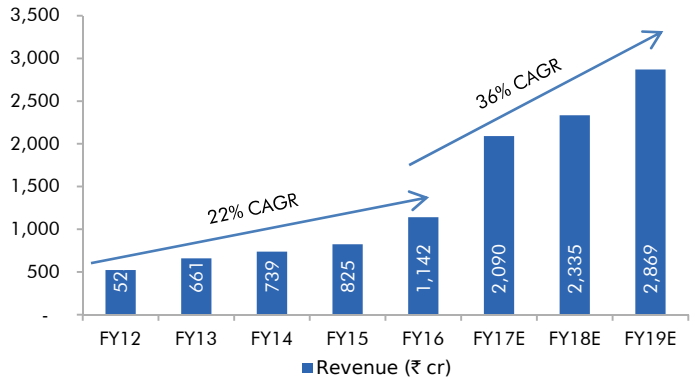
Expansion of Dehradun and Guwahati facilities to enable incremental product launches: Natco is also in process of upgrading its existing formulations facilities at Dehradun and Guwahati. Once completed, these upgraded capacities will support its domestic formulations business. The augmentation of the Dehradun and Guwahati capacities will support its entry in the diabetology and cardiology divisions. The total capex on these facilities is expected to be ~₹40cr.

Track record of compliant facilities – We observe that the recently issued 483s on its facilities had minor observations and has not escalated to warning alert. In March 2016, USFDA issued observations on two of its facilities i.e. Manali (API)

and Kothur (Formulations). The inspections at these facilities were triggered due to generic of Doxil. Both facilities received EIR however Kothur facility was again inspected (GMP purpose) in January-2017 and received 6 observations. Company has indicated that these observations are correctable in nature (no data integrity issues) and hence, escalation is not expected. Company has indicated that it is not expecting any USFDA inspection on formulations side, except for Vizag. On API side, there could be inspection this year.

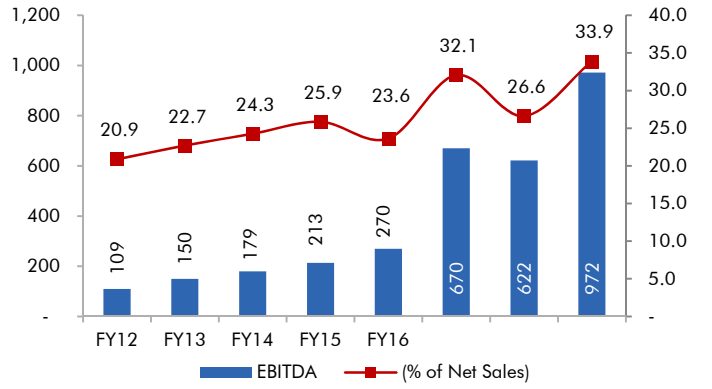
Financial performance: Over the last 5 years (FY2012-16), company has seen 2.2x growth in its top-line, which exhibits a healthy 21.5% CAGR. During this period, Natco has also seen strong improvement in its EBITDA margins due to 1) focus on niche therapeutic segments, 2) improving product mix, and 3) growing domestic branded business. Owing to this, its operating margins have increased from 20.9% in FY2012 to 23.6% in FY2016. With the addition of the two new franchisees, the margins are likely to go up from here as well. During the FY2012-16 period, its bottom-line has seen 2.6x growth, which works out to be an attractive 27.5% CAGR.

Exhibit 17: Revenue to grow at 36% over FY16-FY19E



Source: Company, Angel Research

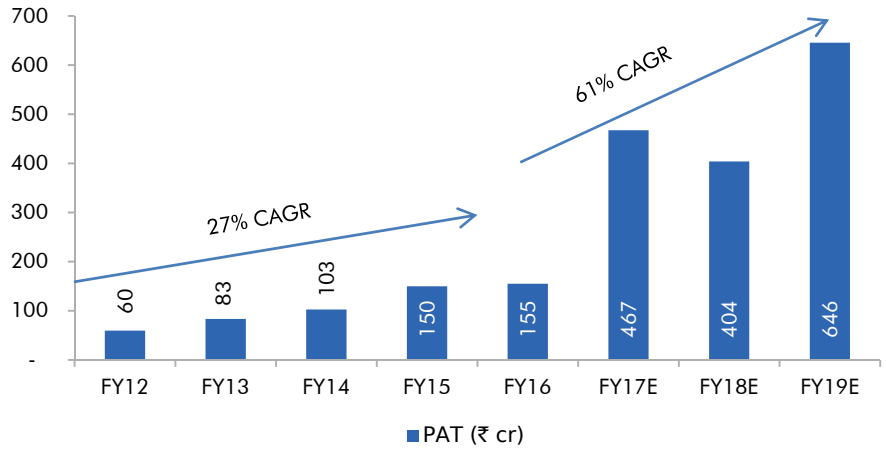
Exhibit 18: Operating margins set to improve



Source: Company, Angel Research

We believe that due to the favorable dynamics, Natco's growth rates are likely to accelerate even higher with export formulations seeing huge 64% CAGR in revenues over FY16-19E. This will mainly be due to launch of Copaxone 20 mg and 40 mg which are likely to see high revenue contribution in FY18E and FY19E. The FY17E revenue has already seen huge growth due to the contribution of export formulations (mainly due to generic Tamiflu). We have also incorporated revenues from generic Entocort and generic Nuvugil which already have been launched. We also expect generic Vidaza and generic Doxil revenues in FY18E.

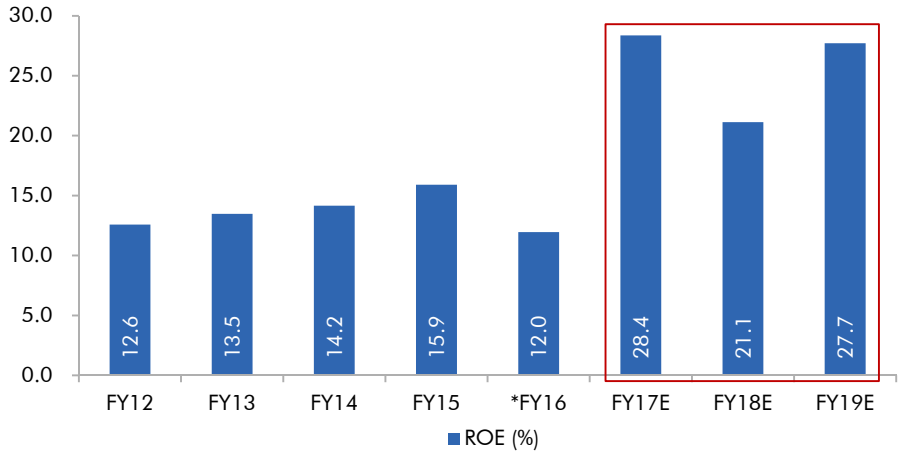
Exhibit 19: PAT to grow at 61% over FY16-FY19E



Source: Company, Angel Research

Healthy balance sheet, RoE profile to improve: Since FY13, the company has been able to strengthen its balance sheet with repayment of debt. The debt to equity ratio which stood at 0.63x in FY13 has come down to almost nil in FY16. The continues to maintain conservative approach to keep lower debt to equity. In FY15, company raised ₹350cr through QIP route to augment its capacities. While this led to equity dilution and declined its RoE, the substantial growth in next few years is expected to boost its RoE profile.

Exhibit 20: Healthy RoE expansion over FY17E-FY19E



Source: Company, Angel Research

Outlook and Valuation

Natco's topline and bottomline is set to grow at 36% and 61% CAGR over FY16-FY19E due to 1) strong performance of domestic formulations and 2) monetization of high value ANDAs. We believe that Natco is also set to see margin expansion on the back of improving product mix (higher hepatitis sales in domestic business) and launch of high value, low competition ANDAs. We expect FY19E revenue at ₹2,869cr and PAT of ₹644cr.

The stock at the CMP of ₹786 is trading at P/E of 21.2x of FY2019E EPS of ₹37. This is ~15% discount to its 3 year average P/E multiple of 26x. We value Natco based on SOTP approach, which yields a total value of Natco's shares to be ₹926 (base business ₹890 + Revlimid opportunity ₹37). Our valuations stems from below rationale:

1) We value Natco's base at ₹ 890 (24.0x of its FY19E EPS of ₹37) assuming 1) Natco receives final approval for its Copaxone 20mg ANDA, 2) Teva's final patent on Copaxone 40mg is rejected by the Patent Office, 3) Natco receives final approval for its Copaxone 40mg ANDA, and 4) Natco's marketing partner, Mylan launches generic Copaxone 20mg and 40 mg in the US in FY18E. We also consider Natco's 1) Niche segment focused domestic business, 2) strong track record of execution of strategy, 3) high growth rates going during the forecast period, 4) improving RoE profile, and 5) ANDA pipeline focusing on low competition/high margin products.

2) We have also considered generic Revlimid in valuation, as Natco's agreement with Celgene indicates that Natco has secured a significant big opportunity between FY2022E-27E. We derive generic Revlimid NPV to be ₹37 applying 60% probability of discount. From our interaction with the company, we understand that there is also a probability of Natco launching this drug earlier in the market if more companies file Revlimid ANDAs. Dr. Reddy's have filed ANDA of Revlimid. Entry of more competitors in Revlimid ANDA may trigger early launch by Natco.

Risks to Our Estimates

- An unfavorable facility inspection from USFDA or other major regulatory body, leading to significant delay of product exports.
- Failure to get USFDA approval for Copaxone (20mg and 40 mg) and Revlimid would lead to decline in its financial performance and stock valuation.
- Company has indicate of at-risk launch if dynamics favor, however an unsuccessful at-risk launch of Copaxone would severely erode its financial performance at it would involve a litigation and possible penalty payment to the innovator.
- Decline in Hepatitis C revenues due to increased competition in the domestic markets.

Income statement

Y/E March (₹ cr)	FY14	FY15	FY16	FY17E	FY18E	FY19E
Total operating income	**739**	**825**	**1,142**	**2,090**	**2,335**	**2,869**
% chg	*11.9*	*11.7*	*38.3*	*83.1*	*11.7*	*22.9*
Total Expenditure	**560**	**612**	**872**	**1,420**	**1,713**	**1,897**
Cost of Materials	233	242	341	651	746	844
Personnel	113	137	187	229	296	353
Others Expenses	214	233	344	541	672	700
EBITDA	**179**	**213**	**270**	**670**	**622**	**972**
% chg	*19.6*	*19.0*	*26.4*	*148.4*	*(7.2)*	*56.3*
(% of Net Sales)	*24.3*	*25.9*	*23.6*	*32.1*	*26.6*	*33.9*
Depreciation& Amort.	30	47	51	58	82	105
EBIT	**149**	**166**	**219**	**612**	**540**	**867**
% chg	*16.5*	*11.6*	*31.7*	*179.9*	*(11.9)*	*60.5*
(% of Net Sales)	*20.2*	*20.1*	*19.2*	*29.3*	*23.1*	*30.2*
Interest & other Charges	37	32	23	16	20	20
Other Income	17	15	11	20	24	24
(% of PBT)	*13.0*	*10.0*	*5.2*	*3.3*	*4.4*	*2.8*
Share in profit of Ass.	-	-	-	-	-	-
Recurring PBT	**129**	**149**	**207**	**617**	**544**	**871**
% chg	*26.1*	*4.1*	*53.9*	*198.4*	*(11.8)*	*60.1*
Prior Period & Extra. Exp.	-	15	-	-	-	-
PBT (reported)	**129**	**134**	**207**	**617**	**544**	**871**
Tax	*31*	*4*	*53*	*151*	*141*	*226*
(% of PBT)	*23.9*	*2.9*	*25.6*	*24.4*	*26.0*	*26.0*
PAT (reported)	**98**	**130**	**154**	**466**	**402**	**644**
Add: Share of earnings of ass.						
Less: Minority interest (MI)	(5)	(4)	(1)	(1)	(1)	(1)
PAT after MI (reported)	**103**	**135**	**155**	**467**	**404**	**646**
ADJ. PAT	**103**	**150**	**155**	**467**	**404**	**646**
% chg	*23.1*	*45.8*	*3.6*	*201.2*	*(13.6)*	*59.9*
(% of Net Sales)	*13.9*	*18.1*	*13.6*	*22.4*	*17.3*	*22.5*
Basic EPS (₹)	**31.1**	**8.1**	**8.9**	**26.8**	**23.2**	**37.1**
Fully Diluted EPS (₹)	**31.1**	**8.1**	**8.9**	**26.8**	**23.2**	**37.1**
% chg	*23.1*	*45.8*	*3.6*	*201.2*	*(13.6)*	*59.9*

Balance sheet

Y/E March (₹ cr)	FY14	FY15	FY16	FY17E	FY18E	FY19E
SOURCES OF FUNDS						
Equity Share Capital	33	33	35	35	35	35
Reserves& Surplus	693	813	1,263	1,613	1,876	2,295
Shareholders' Funds	**726**	**846**	**1,298**	**1,648**	**1,911**	**2,330**
Minority Interest	7	5	5	5	5	5
Total Loans	240	312	113	183	183	183
Deferred Tax Liability	43	12	14	14	14	14
Other long term liabilities	1	1	1	1	1	1
Long-term provisions	11	9	12	12	12	12
Total Liabilities	**1,028**	**1,185**	**1,443**	**1,863**	**2,126**	**2,545**
APPLICATION OF FUNDS						
Gross Block	781	886	972	1,202	1,721	2,037
Less: Acc. Depreciation	168	222	268	325	407	512
Net Block	**613**	**664**	**705**	**877**	**1,314**	**1,524**
Intangible assets	**32**	**46**	**9**	**9**	**9**	**9**
Capital work-in-progress	124	129	212	262	(0)	(0)
Non-current investments	2	2	0	0	0	0
Long-term loans and adv.	54	57	62	62	62	62
Other non-current assets	3	4	4	4	4	4
Current Assets	368	483	832	1,296	1,388	1,731
Inventories	181	220	357	573	608	707
Sundry Debtors	119	192	262	481	512	629
Cash	11	13	45	51	61	152
Loans & Advances	54	55	104	136	152	186
Other Assets	3	2	64	56	56	56
Current liabilities	167	199	380	647	651	785
Net Current Assets	**201**	**284**	**452**	**649**	**737**	**946**
Deferred Tax Asset	**-**	**-**	**-**	**-**	**-**	**-**
Misc. Exp. not written off	-	-	-	-	-	-
Total Assets	**1,028**	**1,185**	**1,443**	**1,863**	**2,126**	**2,545**

Cash flow statement

Y/E March (₹ cr)	FY14	FY15	FY16	FY17E	FY18E	FY19E
Profit before tax	129	134	207	617	544	871
Depreciation	30	47	51	58	82	105
Change in Working Capital	(16)	(86)	(150)	(192)	(78)	(118)
Interest / Dividend (Net)	35	30	21	16	20	20
Direct taxes paid	(35)	(24)	(46)	(151)	(141)	(226)
Others	1	(9)	20	-	-	-
Cash Flow from Operations	**144**	**93**	**102**	**348**	**427**	**652**
(Inc.)/ Dec. in Fixed Assets	(106)	(117)	(157)	(280)	(257)	(316)
(Inc.)/ Dec. in Investments	(3)	2	2	(0)	-	-
Cash Flow from Investing	**(109)**	**(115)**	**(155)**	**(280)**	**(257)**	**(316)**
Issue of Equity	109	-	334	-	-	-
Inc./(Dec.) in loans	(91)	71	(199)	70	-	-
Interest paid	(34)	(30)	(25)	(16)	(20)	(20)
Dividend Paid (Incl. Tax)	(18)	(12)	(25)	(116)	(140)	(225)
Effect of currency translation adjustment	0	(5)	(1)	0	0	0
Cash Flow from Financing	**(35)**	**24**	**85**	**(62)**	**(160)**	**(245)**
Inc./(Dec.) in Cash	0	2	32	6	10	91
Opening Cash balances	**11**	**11**	**13**	**45**	**51**	**61**
Closing Cash balances	**11**	**13**	**45**	**51**	**61**	**152**

Key Ratios

Y/E March	FY14	FY15	FY16	FY17E	FY18E	FY19E
Valuation Ratio (x)						
P/E (on FDEPS)	25.3	97.0	88.2	29.3	33.9	21.2
P/CEPS	19.5	71.8	66.4	26.1	28.2	18.2
P/BV	3.6	15.4	10.5	8.3	7.2	5.9
Dividend yield (%)	0.7	0.2	0.2	0.9	1.0	1.7
EV/Sales	18.8	17.0	12.1	6.6	5.9	4.8
EV/EBITDA	77.6	65.6	51.0	20.6	22.2	14.1
EV / Total Assets	13.5	11.8	9.5	7.4	6.5	5.4
Per Share Data (₹)						
EPS (Basic)	31.1	8.1	8.9	26.8	23.2	37.1
EPS (fully diluted)	31.1	8.1	8.9	26.8	23.2	37.1
Cash EPS	40.3	10.9	11.8	30.1	27.9	43.1
DPS	5.9	1.2	1.5	6.8	8.1	13.0
Book Value	219.5	50.9	74.5	94.6	109.7	133.8
Dupont Analysis						
EBIT margin	20.2	20.1	19.2	29.3	23.1	30.2
Tax retention ratio	0.8	1.0	0.7	0.8	0.7	0.7
Asset turnover (x)	0.8	0.7	0.8	1.2	1.1	1.2
ROIC (Post-tax)	11.9	14.1	11.9	26.0	19.7	27.2
Cost of Debt (Post Tax)	0.12	0.10	0.15	0.07	0.08	0.08
Leverage (x)	0.3	0.4	0.1	0.1	0.1	0.0
Operating ROE	15.6	19.0	12.5	28.1	20.9	27.5
Returns (%)						
ROCE	15.4	14.3	15.5	33.5	25.8	34.5
Angel ROIC (Pre-tax)	15.6	14.5	16.0	34.4	26.6	36.7
ROE	14.2	15.9	12.0	28.4	21.1	27.7
Turnover ratios (x)						
Asset Turnover (Gross Block)	0.9	0.9	1.2	1.7	1.4	1.4
Inventory / Sales (days)	89	97	114	100	95	90
Receivables (days)	59	85	84	84	80	80
Payables (days)	54	55	88	80	70	70
WC cycle (ex-cash) (days)	94	127	110	104	105	100
Solvency ratios (x)						
Net debt to equity	0.3	0.4	0.1	0.1	0.1	0.0
Net debt to EBITDA	1.3	1.4	0.2	0.2	0.2	0.0
Interest Coverage (EBIT / Int.)	4.1	5.2	9.6	37.7	26.9	43.2

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1. Financial interest of research analyst or Angel or his Associate or his relative	No
2. Ownership of 1% or more of the stock by research analyst or Angel or associates or relatives	No
3. Served as an officer, director or employee of the company covered under Research	No
4. Broking relationship with company covered under Research	No

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