

# Solara Active Pharma Sciences

NOT RATED

## Pure API play

In light of environmental issues in China, the API market place is likely to present an enormous opportunity for established Indian API manufacturers. The global API market is close to US\$ 160bn with China having a 30%+ market share, while India is at 8-10%. Solara is one of the leading API manufacturers in India having the capability to benefit from this opportunity due to a large API portfolio of 50+ molecules.

After de-merging from its parent entities, Strides and Sequent, the company has outperformed its FY19 guidance of 20% top line and EBITDA growth by a big margin. FY19 performance has been stellar with 35/59% revenue/EBITDA growth (proforma). We expect Solara to maintain ~16/21% revenue/EBITDA CAGR over FY19-21E. Recently, Solara announced capital infusion of Rs 4.6bn to build engines for growth beyond FY21E. In our view, it is an ideal stock to invest in a pure-play API story emerging in India. At CMP, the stock is trading at 16.4/10.2x FY20/21E EPS, a ~30% discount to the sector-avg. We assign a fair value of Rs 650 (15x FY21E EPS).

- **Robust API portfolio:** Solara has 50+ molecules in its API portfolio, comprising of high volume APIs like Ibuprofen, Gabapentin, and Ranitidine; niche products like Patinomar, and Oseltamivir; and products with CGT potential like Zileuton, Mesna, and Colestipol. The company is one of the largest suppliers of Ibuprofen API globally and is also growing its presence in Ranitidine and Gabapentin molecules. The recent growth in revenues is driven by improved traction in Ibuprofen as well as new product introductions like Patinomar. It aims to file 10+ DMFs every year with new products ramping up to ~15% of sales by FY21 (low single digit now).

- **Large API capacities to support growth:** Solara has 4 large API facilities in India. The recently added Ambarnath plant is at 30% utilization and its scale-up could drive both revenue and profitability for Solara. The company is also setting up a greenfield unit at Vizag. The phase I of this unit will cost Rs 2.5bn over FY19-20E. The unit will be commercialized by FY21E.
- **Fund-raise to build more capabilities:** In Feb-19, Solara announced fundraising of Rs 4.6bn in equity through warrants issued to promoters and a private investor, TPG group. The promoter will invest Rs 2.6bn at Rs 400/sh while TPG will invest Rs 2bn at Rs 500/sh. The funds are likely to be used to reduce debt by Rs 1.5-2bn and support capacity addition (organically or inorganically).
- **Improving fundamentals:** With debt reduction of Rs 2bn, we expect a 40% decrease in interest cost by FY21E. This, coupled with a 16/21% revenue/EBITDA CAGR over FY19-21E will enable PAT to jump >2x. Adjusting for the Rs 3.6bn goodwill, RoIC will be in high-teens (~17%) by FY21E. A focus on lucrative APIs and CRAMS is likely to improve business fundamentals further, beyond FY21E.

### Financial Summary

(Rs mn)	FY18	FY19P	FY20E	FY21E
Net Sales	5,210	13,867	16,079	18,559
EBITDA	625	2,208	2,633	3,207
APAT	60	671	946	1,518
Adj. EPS (Rs)	2.4	26.0	26.9	43.1
P/E (x)	182.6	17.0	16.4	10.2
Adj. RoE (%)	2.9	13.4	10.9	12.6
Adj. RoIC (%)	6.3	14.1	15.6	16.8

Source: Company, HDFC sec Inst Research

INDUSTRY	PHARMA
<b>CMP (as on 21 Jun 2019)</b>	<b>Rs 442</b>
<b>Fair Value</b>	<b>Rs 650</b>
Nifty	11,724
Sensex	39,194
<b>KEY STOCK DATA</b>	
Bloomberg	SOLARA IN
No. of Shares (mn)	26
MCap (Rs bn) / (\$ mn)	11/164
6m avg traded value (Rs mn)	33
<b>STOCK PERFORMANCE (%)</b>	
<b>52 Week high / low</b>	<b>Rs 492/134</b>
	3M 6M 12M
Absolute (%)	(0.9) 45.2 -
Relative (%)	(3.0) 35.5 -
<b>SHAREHOLDING PATTERN (%)</b>	
	Dec-18 Mar-19
Promoters	37.90 45.07
FIs & Local MFs	9.08 2.58
FPIs	16.24 17.36
Public & Others	36.78 34.99
Pledged Shares*	3.05 2.78
Source : BSE, % of total	

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**Of the US\$ 160bn global API market, 40% is outsourced to third-party manufacturers**

**China is the leading API manufacturer with 30%+ market share. India is at 8-10% share**

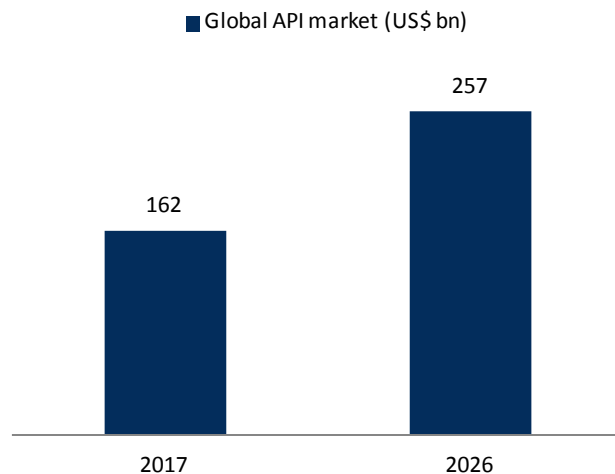
**The recent issues related to environmental concerns in China have opened up the API market further for Indian players**

**Solara is best-placed to gain from this opportunity, given its cost-efficient capabilities, expanded capacities, strong customer relations, and healthy DMF filing track record**

### API market: Sizeable, and growing

- Globally, the API market is close to ~US\$ 160bn in size, 60% of this is used for captive API consumption and 40% is outsourced to third-party manufacturers. China has 30%+ market share while India is at only 8% in terms of value. This market is growing at 6% CAGR and is likely to reach ~US\$ 260bn by 2026.
- The key Indian players in API production are Aurobindo, Dr Reddy's, Lupin and Alembic. There are several API focused companies which operate as third-party manufacturers including Divi's Labs, Jubilant Life, MSN, Laurus Labs, SMS Pharma, Solara, IOL, Granules India, and Neuland Labs.
- There are two key opportunities in the API space for Indian players: (1) Shortages led by China due to plant shutdowns or raw material unavailability, and (2) niche complex molecules which are low in volumes and could prove to be expensive for generic formulation players to invest in captive API units as complex approvals are difficult to come by.

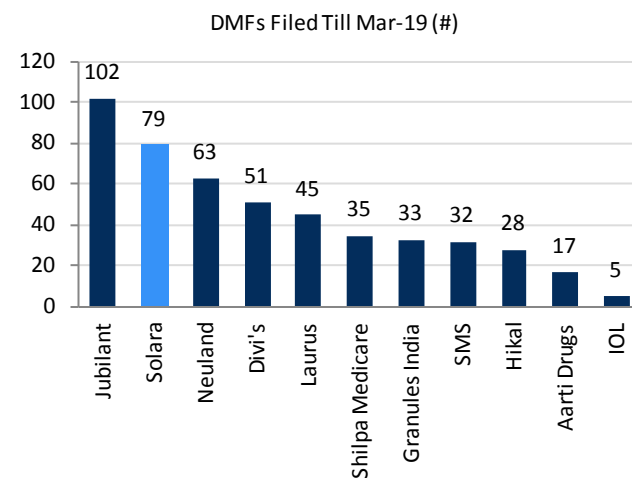
### Global API market (US\$ bn) – 5-6% CAGR



Source: Company, HDFC sec Inst Research

- One of the largest API portfolios:** Solara has demonstrated its cost-efficient API manufacturing capabilities in high volume molecules like Ibuprofen, Gabapentin, Praziquantel, and Ranitidine. It has also successfully commercialized complex molecules like Oseltamivir and Colesevelam. In total, the company has 50+ molecules in its portfolio and it is likely to file 10 new products every year. It is one of the largest portfolios among Indian cos.
- We have analyzed Solara's DMF filings and categorized them in four segments – (1) High volume APIs, (2) Low volume APIs, (3) APIs with patent protection in the US, and (4) APIs with CGT potential. The findings suggest that, apart from current APIs which generate significant revenues for Solara (Ibuprofen, Gabapentin, Praziquantel, Ranitidine, Venlafaxine, and Oseltamivir), there are several APIs where Solara could scale up its existing capabilities.

### DMFs Filed By Major Indian API Companies



Source: US FDA, HDFC sec Inst Research

**Currently, Solara is one of the largest suppliers of Ibuprofen API globally. It has maintained long-term contracts with modest price hikes despite the sharp surge in API prices for Ibuprofen following the shutdown of BASF's plant**

**Apart from Ibuprofen, Solara is a key supplier of several high-volume APIs which are indicated as the first-line treatment**

## #1: High Volume APIs

**Ibuprofen (pain):** A nonsteroidal anti-inflammatory (NSAID) indicated for relieving pain caused by various conditions like headache, dental pain, muscle aches, and arthritis. It is also used during fever, common cold, or flu.

- Solara is currently one of the largest suppliers of Ibuprofen API with more than 5,000MT capacity and has long-term contracts with most of its clients. The biggest clients include one of the innovators and Strides.
- Since Jun-18, Ibuprofen API prices have surged from ~US\$ 10 to US\$ 17-18 per kg on the back of global shortage in the product. The shortage was driven by the shutdown of BASF's key plant in the US, which is the world's largest Ibuprofen supplier.
- However, Solara abstained from taking sharp price hikes and supplied Ibuprofen API to its long-term customers at US\$ 12-14 per kg. While this restricted potential revenue surge in the short-term, Solara retained long-term customers.
- Historically, the Ibuprofen formulation market at US\$ 1.1bn has grown at a CAGR of ~3% over 2014-18. We believe the market will continue to grow at low single digits over the next few years.
- Additionally, Solara intends to supply various derivatives of Ibuprofen which will differentiate its product offerings as well as improve business mix as these derivatives would be higher-margin compared to the plain-vanilla APIs.

**Other high-volume products:** Solara is a key global supplier for several high-volume products, most of which are indicated as the first-line treatment for their symptoms.

- **Ranitidine (gastro):** An H2 blocker, it works by reducing the amount of acid in the stomach, indicated to prevent and treat heartburn and other symptoms caused by acid indigestion. The global formulations market for Ranitidine at US\$ 2.9bn has grown at ~9% CAGR over 2014-18. We believe the market will continue growing at high single-digits over the coming years. The third party API market is between Rs 5 to 10bn in size. The leading Indian players include Jubilant Life, while Strides is expected to ramp up sales of Ranitidine in multiple dosages and forms. This will lead to healthy revenue growth for Solara, which is Strides' largest API supplier.
- **Gabapentin (neuro/CNS):** An anticonvulsant or antiepileptic drug indicated with other medications for prevention and control of seizures, it is also used to relieve nerve pain following shingles. Formulation market has grown at ~8% CAGR to US\$ 10.1bn over the last 4 years. Expect similar growth for the API market. The global third party demand for Gabapentin APIs is higher than 10,000MTs. Divi's is one of the largest suppliers of Gabapentin APIs and is likely to have a 40% market share in regulated markets. We believe Solara has a lot of scope to expand its presence.
- **Praziquantel (Anti-worm):** It is a prescription drug used as anti-worm medication. It prevents newly hatched insect larvae (worms) from growing or multiplying in the body. Praziquantel is used to treat infections caused by Schistosoma worms, which enter the body through skin that has come into contact with contaminated water. It is also one of the high volume APIs with more than 1,000MT third-party demand. We believe Solara has a dedicated block for this molecule as well and generates more than Rs 2bn revenues in a year.

**Among high-volume APIs, Solara has the potential to expand its presence further in key molecules like Gabapentin, Ranitidine, Levetiracetam, and Pantoprazole**

**Solara has several lucrative niche products in its portfolio which are lower volume and higher in margins. These include Oseltamivir, Ursodeoxycholic acid, Cinacalcet, Aprepitant, and Pitavastatin**

### High Volume APIs (More than 1,000MT global requirement)

Molecule	Brand Name	Price (US\$/kg)	Market size (Rs bn)	Comment
Ibuprofen		13	>10	Solara is one of the biggest suppliers
Gabapentin		42	>10	Potential to expand presence
Acyclovir Sodium	Zovirax	60	>10	Chinese suppliers dominate this market.
Ranitidine Hydrochloride	Zantac	30	5-10	Potential to expand presence
Levetiracetam	Keppra	90	5-10	Potential to expand presence
Carisoprodol Usp	Soma	33	1-5	Value-wise small molecule
Mefenamic Acid	Ponstel	11	<1	Value-wise small molecule
Albendazole	Albenza	32	1-5	Value-wise small molecule
Tenofovir Disoproxil Fumarate	Viread	206	>10	Laurus is one of the biggest suppliers (40%)
Pantoprazole Sodium	Protonix	200	>10	Potential to expand presence
Naproxen Sodium		40	>10	Divi's is one of the largest suppliers (60%)
Zidovudine	Retrovir	200	>10	Chinese players dominate the market

Source: US FDA, HDFC sec Inst Research

### #2: Low Volume APIs

**Niche APIs:** Solara has filed DMFs for multiple niche APIs which have either recently genericized or are yet to go generic. Some of the key APIs in this category include Sevelamer (Renvela), Oseltamivir (Tamiflu), and Colesevelam (Welchol). A higher contribution of these APIs will lead to improved product mix and expand margins.

- **Oseltamivir Phosphate:** It is an antiviral medication used to treat and prevent influenza A and influenza B (flu). Many medical organizations recommend it to people who have complications or are at a high risk of complications within 48 hours of first symptoms of infection. This product became generic in the US three years back and has created an opportunity for third-party manufacturers like Solara who have tie-ups with several generic players. We believe it is also a sizable product for Solara in terms of revenues.

- **Ursodeoxycholic acid:** Also known as ursodiol, it is one of the secondary bile acids which are metabolic byproducts of intestinal bacteria. It is used to reduce gallstone formation and for the treatment of primary biliary cholangitis. We believe the demand for this API is more than 500MT and is being sold at US\$ 375-380/kg. Some of the Chinese suppliers are likely to be dominating this market.
- Other high-value, niche APIs in Solara's portfolio include Cinacalcet, Aprepitant, and Pitavastatin Calcium. We believe in many of these API, Solara has a large scope to scale up over the next few years as more genericization is expected to take place in regulated markets.

***Solara has the potential to expand its presence in key niche APIs like Aprepitant, Ketoprofen, Celecoxib, and Pitavastatin***

***It has already established a significant presence in molecules like Venlafaxine, Sevelamer, Colesevelam, and Oseltamivir***

### Low Volume APIs (Volume requirement <1,000MT)

Molecule	Brand Name	Price (US\$/kg)	Market size (Rs bn)	Comment
Ketoprofen Usp	Ketoprofen	78	1-5	Potential to expand presence
Celecoxib Usp	Celebrex	80	5-10	Potential to expand presence
Venlafaxine Hydrochloride	Pristiq	100	5-10	Solara has a significant presence
Ursodeoxycholic Acid	Actigall	377	5-10	Chinese players dominate the market
Loratadine	Claritin	370	5-10	Not a growing molecule
Labetalol Hydrochloride	Trandate	140	1-5	
Nizatidine	Axid	173	1-5	
Sevelamer Carbonate	Renvela	127	1-5	Solara has a significant presence
Colesevelam Hydrochloride	Welchol	171	1-5	Solara has a significant presence
Indomethacin Sodium	Indocin	83		Value-wise small molecule
Chlorthalidone Usp	No brand present	190	<1	
Oseltamivir Phosphate	Tamiflu	2000	10>	Solara has a significant presence
Meprobamate		180	<1	
Olanzapine	Zyprexa	130	<1	
Flecainide Acetate	Tambocor	350	<1	Low volume molecule
Cetirizine Dihydrochloride		280	<1	Not many Indian players present
Ertapenem Sodium	Invanz	458	<1	Low volume molecule
Clomipramine Hcl Usp	Anafranil	350	<1	Low volume molecule
Felbamate	Felbatol	410	<1	Low volume molecule
Tioconazole	Vagistat-1	440	<1	Low volume molecule
Chlorpromazine Hydrochloride	Thorazine	70		Value-wise small molecule
Quinapril Hydrochloride	Accupril	600	<1	Low volume molecule
Cinacalcet Hydrochloride	Sensipar	2700	>1	Low volume molecule
Flucytosine Usp	Ancobon	1500	>1	Low volume molecule
Aprepitant	Emend	20000	5-10	Good opportunity to scale up
Midazolam	Seizalam	3000	>1	Low volume molecule
Succinylcholine Chloride	Quelicin	800	<1	Low volume molecule
Pitavastatin Calcium	Livalo	20000	1-5	Solara has presence
Methoxsalen Usp	Oxalararen ultra	850	<1	Low volume molecule
Imiquimod	Zyclara	3000	>1	Low volume molecule
Ethacrynic Acid Usp	Edecrin	4000	>1	Low volume molecule
Etomidate	Amidate	22000	>1	Low volume molecule
Lurasidone Hydrochloride	Latuda	2173	>1	Low volume molecule

Source: US FDA, HDFC sec Inst Research

***Of the molecules filed by Solara and currently under patent protection, we believe Posaconazole, Patiromer Sorbitex, and Pregabalin can face generic penetration by FY21-22E***

***Solara's portfolio has 4 CGT molecules which have less than 2 generic players in the market***

### #3: Patent-protected molecules

- We have found close to 10 molecules in Solara's portfolio which are likely to see patent expiration over the next 4-5 years in the US market. We believe some of these molecules are likely to be key drivers of new molecule growth for Solara over the next two years. We expect generic penetration in Patiromer Sorbitex Calcium, Pregabalin, and Posaconazole by FY21-22E. The management has also said that they have tied-up with formulation players for day-1 launches in some of the products, which will have some profit-sharing agreement.

### #4: Molecules with CGT potential

- There are at least four molecules in Solara's portfolio which are listed on the CGT list of USFDA. The patents have expired for all these four molecules but there are less than 2 generic players in the market. In terms of value and volume, these molecules are really small and could not earn much for Solara unless it ties with formulations players for sharing the profits.

#### Patent Protected Molecules

Molecule	Brand Name	Patent expiry
Patiromer Sorbitex Calcium	Veltassa	2020-2025
Efinaconazole	Jublia	2030
Posaconazole	Noxafil	2019-July
Dabigatran Etexilate Mesylate	Pradaxa	2021-2027
Mirabegron	Myrbetriq	
Colchicine	Colcrys	2023
Rifaximin	Xifaxan	2024
Pregabalin	Lyrica	2019-June
Milnacipran Hydrochloride	Savella	2021

Source: US FDA, HDFC sec Inst Research

#### Molecules with CGT potential

Molecule	Brand Name	Generic (Yes/No)	Players	Patent expiry
Colestipol	Colestid	Yes	1	Yes
Zileuton	Zyflo	Yes	1	Yes
Mesna	Mesnex	No		Yes
Cycloserine	Seromycin	No		Yes

Source: US FDA, HDFC sec Inst Research



**Solara acquired 4 large-scale API facilities, two each from Sequent and Strides, post the de-merger in FY18.**

**Subsequently, it also acquired Strides' Ambernath facility in FY19**

**At present, 4 out of 5 plants are operating at optimal levels while the Ambernath facility is at 30% utilization rate. Solara has the required capacity to support growth till FY21E and is building a greenfield facility to drive revenues beyond FY21E**

**For its CRAMS business, the company is open to inorganic opportunities to scale up in regulated markets. We believe this segment will start contributing meaningfully to revenues from FY22E**

## Manufacturing and R&D landscape

### Large API capacities:

- There were a total of 4 large-scale API capacities with Solara post its de-merger till FY18. It added the Ambernath plant from Strides in FY19. This plant was owned by Perrigo previously and is operating at only 30% utilization levels. The other plants are largely operating at optimal utilization. 4 out of the 5 plants are approved by USFDA. The company is expanding its existing capacities by spending Rs 1bn a year and has also committed to investing Rs 2.5bn in setting up a greenfield unit at Vizag by the end of FY20. It is likely to get commercialized by FY21E.
- We believe Solara has enough capacities to maintain 20% revenue growth over the next two years and Vizag could help it to maintain the momentum beyond FY21E.

### Manufacturing and R&D landscape:

Acquisition mode	Location	Function	Approvals
Sequent	Mangaluru, Karnataka	API	TGA, WHO, USFDA
Sequent	Mysuru, Karnataka	API	cGMP
Strides	Puducherry	API (Ibuprofen)	USFDA, PMDA, EU, cGMP
Strides	Cuddalore, Tamil Nadu	API	USFDA, PMDA, EU, cGMP
Strides	Ambernath	API	USFDA, PMDA, EU, cGMP
Greenfield	Atchutapuram	API	
Sovinzen	Bangalore, Karnataka	R&D	
Strides	Chennai, Tamil Nadu	R&D	

**CRAMS:** Solara has two dedicated R&D facilities to support its CRAMS business, one in Bangalore and the other in Chennai.

- The company aims to gain traction in the CRAMS business by FY21E and is also open to making lucrative acquisitions for this segment to achieve a ramp up sooner. Its key focus area for the CRAMS business lies in the regulated markets.
- Solara will also increase its R&D spend on growing its CRAMS business. The R&D spending has increased from Rs 103mn in FY18 to Rs 448mn in FY19P. We expect the company to maintain R&D to sales at ~3.5% over the next few years.

### Multi-purpose API And Intermediate Facility At Ambernath



Source: Company, HDFC sec Inst Research

***In Feb-19, Solara announced capital infusion of Rs 4.6bn by way of issuing 10.5mn equity shares***

***These funds will be used for setting up a large-scale greenfield manufacturing facility, setting up of backward integration for key APIs, inorganic opportunities in the CRAMS business, and reduction of debt (Rs 2bn debt reduction in our view)***

***As of May-19, the co has received a consideration of Rs 1.5bn***

***Post completion, the company will turn net-cash (FY20E). Promoter holding will increase to 45%***

## Fund-raise to build more capabilities

In Feb-19, Solara announced that the company will raise an aggregate of Rs 4.6bn over a period of 18 months from the Promoter's group and TPG Ltd (a PE investor).

### Following are the terms of the fundraising:

- The Promoter's group will infuse Rs 2.6bn for 6.5mn warrants at Rs 400/sh.
- TPG will infuse Rs 2bn for 4.0mn warrants at Rs 500/sh.
- The PE investor will have no special rights. However, it will receive one seat at the Board of Solara.

### Application of the funds:

- Setting up of a large-scale Greenfield manufacturing facility in Atchutapuram, Vizag (no additional leverage required).
- Setting up backward integration for key APIs.
- Certain inorganic opportunities, likely within the CRAMS business.
- Reduction in existing debt (we believe ~Rs 2bn will be used to pay-off existing debt).

### Implications of the fundraise

- On the Balance Sheet: Solara will be using ~Rs 2bn to repay existing debt, which will turn Solara into a net-cash company by FY20E.
- On the Income Statement: Reduction in debt will lead to finance cost savings and improve EPS by Rs 8.2 FY21E (20% of our EPS estimate of Rs 41.8).
- On shareholding: Promoter shareholding will increase from 38% (Dec-18) to 45% post completion of the fundraise.

### Progress so far:

- As of May-19, Solara has completed the allotment of 1.1mn shares on conversion of an equivalent number of warrants to the promoter's group. The preliminary consideration received thus far is Rs 1.5bn.

### Implications Of The Fundraise

	Before	After
Net Debt (Rs bn)	3.63	(0.24)
Total no of shares (mn)	24.7	35.2
Shares held by Promoter (mn)	9.4	15.9
Promoter holding (%)	37.90	45.07

Source: Company, HDFC sec Inst Research



**Solara has reported a stellar performance in FY19P with 35/59% YoY revenue/EBITDA growth (proforma nos)**

**Each quarter of FY19 has also grown consistently at 20%+ YoY, reaching quarterly revenue of Rs 3.9bn by 4QFY19**

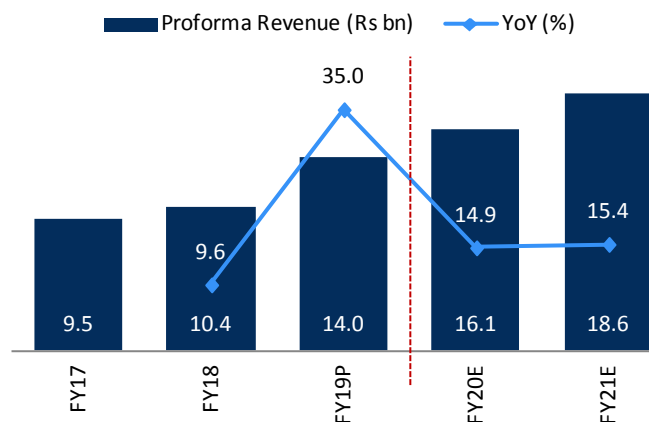
**We believe the company can comfortably achieve our estimate of ~16% CAGR in revenue over FY19-21E on the back of new product launches (supported by 10+ DMF filings yearly), continued growth in the base business, and scale up in the newly acquired Ambernath facility**

## Improving fundamentals

### Strong revenue growth over the last 2 years

- FY19 was the first full year of operations for Solara and on reported numbers, revenue at Rs 13.9bn grew 166% YoY.
- On proforma numbers, revenue grew 35% YoY (22% CAGR over FY17-19P) and was driven by new product launches, growth in the base business aided by the favourable market for Ibuprofen API, and higher capacity utilization with the acquisition of the Ambernath plant.
- The co is operating at optimal capacity utilization in its 4 key plants whereas the newly commissioned facility at Ambernath (FY19) is at ~30% utilization.

### Expect ~16% Revenue CAGR Over FY19-21E

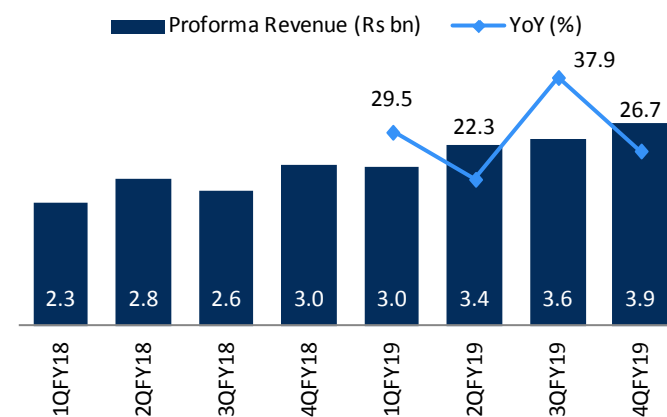


Source: Company, HDFC sec Inst Research

### A healthy outlook on the revenue growth momentum

- Key products like Ibuprofen, Gabapentin, and Ranitidine forming the base business will continue to grow at a stable rate of 8-10% over the coming years owing to favourable market conditions and long-term contracts with key clients.
- Additionally, Solara filed 9 DMFs during FY19 (50+ cumulatively till date) and aims to file 10+ DMFs annually going ahead, which will drive new product launches.
- Moreover, the Ambernath facility is expected to reach 50/80% capacity utilization by FY20/21E while the others will continue at optimal levels.
- These factors will enable Solara to comfortably achieve ~16% revenue CAGR over FY19-21E. Greenfield expansion at Atchutapuram will get commissioned by FY21E and drive growth thereon.

### Robust Quarterly YoY Growth Over FY19P



Source: Company, HDFC sec Inst Research

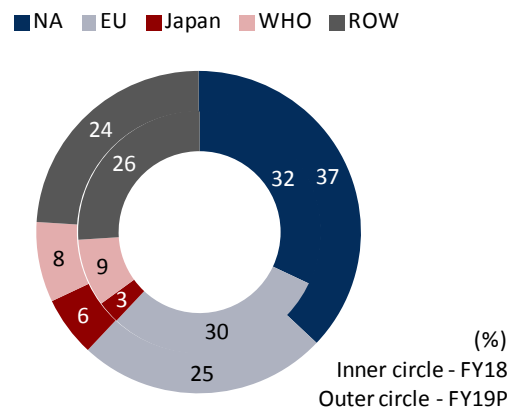
**Regulated markets of US, EU, Japan and WHO account for 76% of Solara's revenue (FY19P). The US is the biggest geography within this segment**

**Solara's biggest client is Strides, which accounts for less than 25% of total revenue (FY19P)**

**Solara has filed 9 DMFs in FY19 and 50+ DMFs cumulatively till Mar-19. The co aims to file 10+ DMFs annually over the next two years**

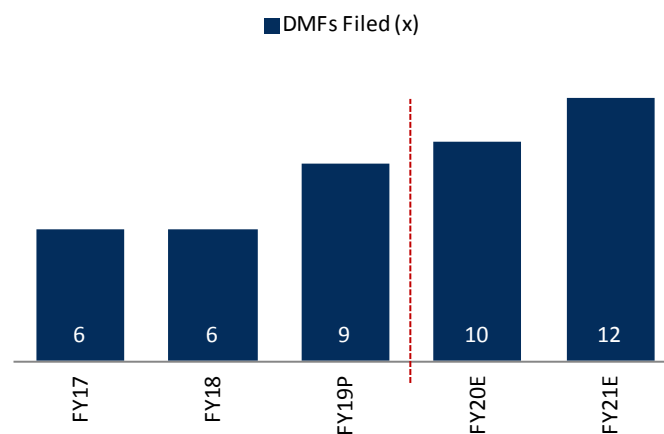
**Robust R&D pipeline to expand the current range of product offerings**

## Regulated Markets: 76% Of Revenue In FY19P



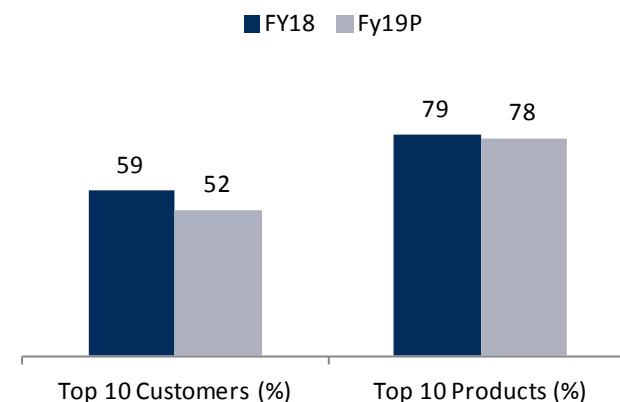
Source: Company, HDFC sec Inst Research

## Favourable Filings Track Record



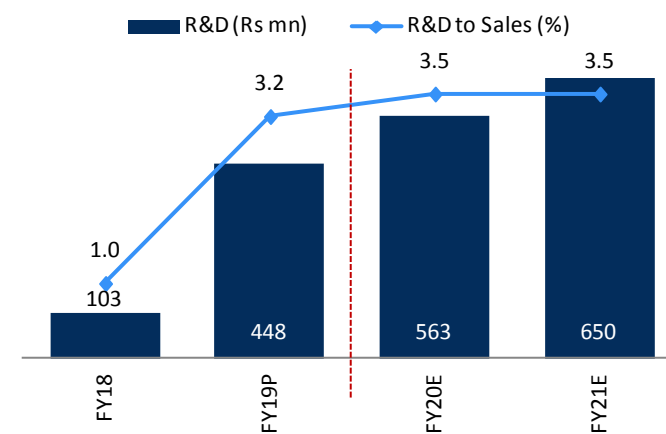
Source: Company, HDFC sec Inst Research

## Reducing Concentration Risk (% of sales)



Source: Company, HDFC sec Inst Research

## R&D Spend To Ramp Up Further



Source: Company, HDFC sec Inst Research

**Synergy benefits from the merger of Sequent's and Strides' business units, as well as cost reduction initiatives have led to a 140bps YoY improvement in gross margin for Solara in FY19P**

**Improving mix (higher contribution from niche APIs) and setting up of backward integration will drive further margin expansion over FY19-21E**

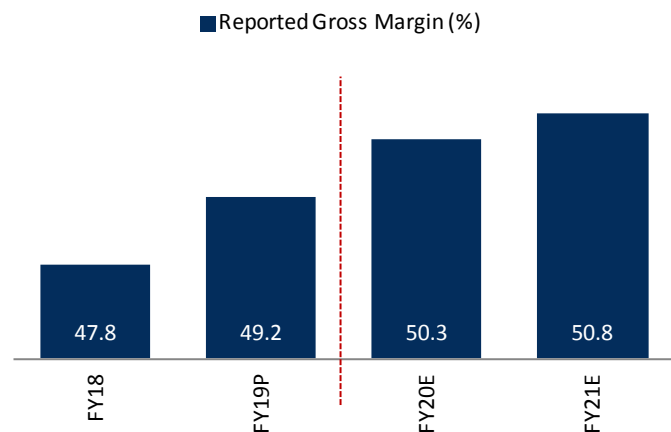
**The EBITDA margin was subdued due to restructuring activities in FY18. However, synergy benefits and absence of the one-off restructuring costs led to a 250bps YoY increase in FY19P**

**Going ahead, we believe oplev and cost rationalization will expand margins further, despite increased R&D spend and employee costs**

## Gross Profit Margin

- Solara has achieved a 140bps YoY improvement in gross margin over FY19P owing to synergy benefits and cost reduction initiatives, which will continue over the next two years.
- Additionally, with an aim to file 10+ DMFs annually, Solara will achieve a healthy rate of new product launches.
- As the contribution of more lucrative molecules (like niche APIs, Ibuprofen derivatives, etc.) increases, product mix will improve over FY20-21E.
- The company is also looking to set up backward integration for some key molecules which will lead to additional savings in RM cost.
- We expect further expansion of ~160bps in gross margin over FY19-21E.

## Improving Product Mix & Backward Integration To Drive Gross Margin

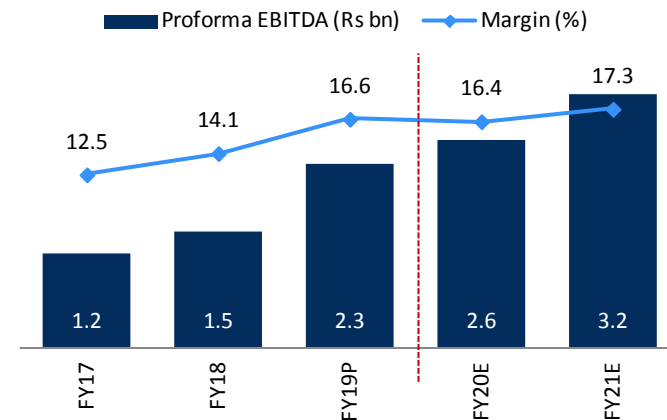


Source: Company, HDFC sec Inst Research

## EBITDA margin

- Owing to higher operating expenses led by restructuring activities and commissioning of the new facility, EBITDA margin remained subdued in FY18 (14%). However, benefits from synergies between the Strides and Sequent businesses forming Solara and absence of restructuring costs have enabled a 390bps expansion in EBITDA margin (+250bps in proforma numbers) during FY19P.
- R&D (3.2% of sales) will remain heightened to support DMF filings, whereas employee cost could increase owing to capacity expansions and ramp up in CRAMS. However, improvement in product mix coupled with oplev and cost-saving initiatives will drive 140bps margin expansion to 17.3% (reported) over FY19-21E in our view.

## EBITDA Margin: Expect a ~140bps Expansion Over FY19-21E



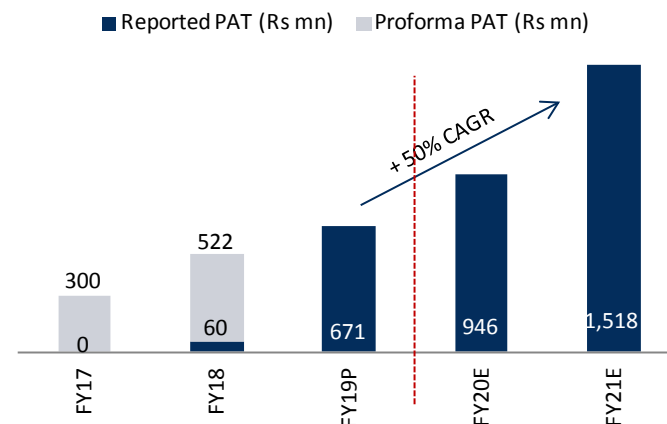
Source: Company, HDFC sec Inst Research

***The key growth drivers for earnings over FY19-21E apart from the strong operating performance are: (1) reduced interest cost following debt reduction, and (2) carried-forward losses which leave effective tax rate at single-digits***

### Earnings to double in two years

- The reduction in debt following the recent fundraise (and also aided by healthy FCF) will reduce interest costs by ~40% over FY19-21E. This would boost the EPS by ~Rs 8.2 in FY21E (20% of our estimate).
- Additionally, the co has ~Rs 2bn of carried-forward losses, which will keep effective tax rates at single digits over FY20-21E.
- Considering this, we model a 50% CAGR in PAT over FY19-21E.

### PAT: 50% CAGR In Proforma PAT Over FY17-19P



Source: Company, HDFC sec Inst Research

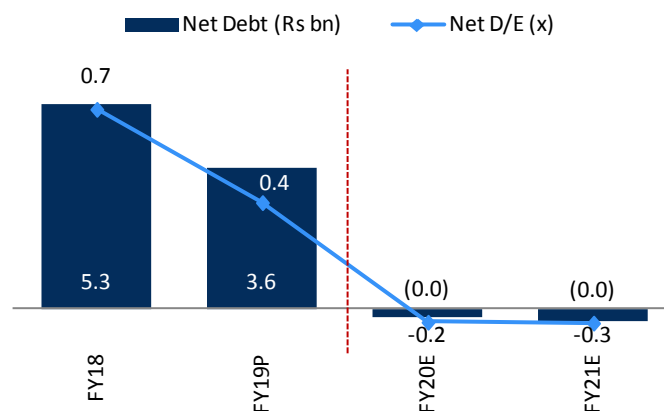
**While Solara's balance sheet remains elevated due to the merger-related goodwill (Rs 3.6bn), we expect net debt of Rs 3.6bn as of FY19P will be relinquished with the recently raised funds and continued operating cashflows by FY20E**

**While Solara's greenfield expansion in Vizag will require capex of ~Rs 2.5bn, and the co has also indicated its willingness to go for inorganic growth in the CRAMS business, we believe incremental capex would be limited over FY19-21E and the requirements would be fulfilled by the recent fundraise as well as internal accruals**

## Improving Balance Sheet

- The merger of Strides' and Sequent's business units to form Solara led to the creation of a Rs 3.6bn goodwill (not subject to amortization, will only be tested for impairment), thereby inflating the BS.
- The merger also led to the acquisition of a high level of debt, which stands at Rs 4.4bn as of FY19P (net debt at Rs 3.6bn). However, the recent fundraising activities will inject Rs 4.6bn cash in the books, part of it (~Rs 2bn in our view) will be used to repay debt. Subsequently, Solara will become net-cash by FY20E.

## Fundraise And Internal Accruals To Relinquish Net Debt By FY20E

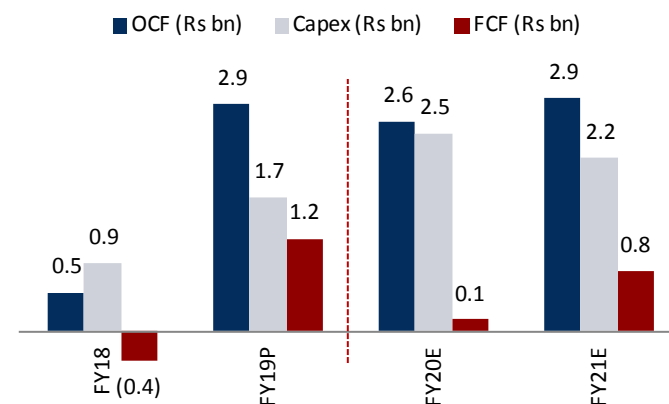


Source: Company, HDFC sec Inst Research

## FCFs to show uptick in FY21E

- Following the strong improvement in operating performance and limited capex needs owing to additional capacity with the recently acquired Ambarnath plant, FCF has seen a healthy turnaround from Rs -364mn in FY18 to Rs 1.7bn in FY19P.
- We believe the capex needs would remain low over the next few years with only one Greenfield expansion (Atchutapuram facility) planned as of now, whereas the co could go for acquisitions to boost its CRAMS business. This would be funded by a part of the funds raised recently.

## Healthy FCF To Be Maintained



Source: Company, HDFC sec Inst Research



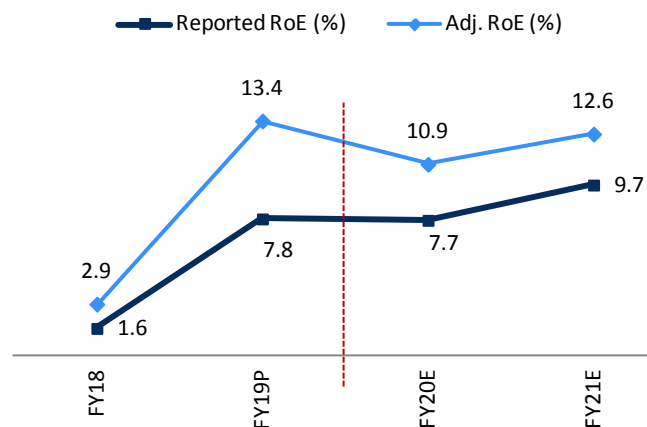
**While operating performance will remain robust over FY19-21E, inflated equity capital following the fundraise will pressurize return ratios**

**Solara is trading at a discount of 30% to our coverage universe. Given the high visibility on growth over the next two years, improving balance sheet, and clean regulatory compliance, we believe the stock is bound to re-rate in the near-term**

### Return ratios improving

- Adjusting for goodwill, RoE came in at 2.9% for FY18. The robust performance in FY19P has boosted Adj. RoE to 13.4% for the year. Going ahead, with the expectation of ~50% PAT CAGR, we believe the co will achieve double-digit RoE despite the fundraising activities (which will inflate equity).

### Goodwill Suppressing RoE

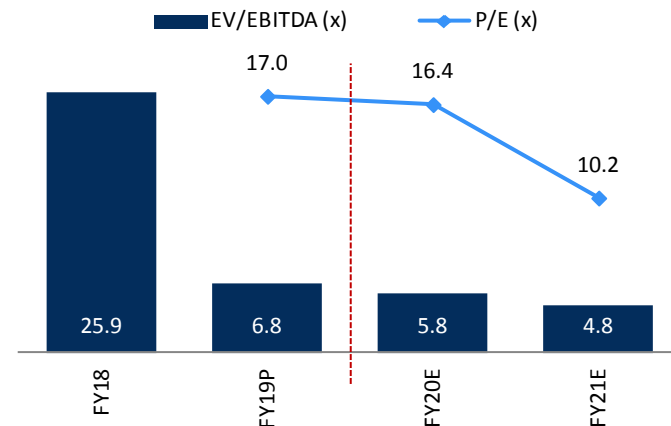


Source: Company, HDFC sec Inst Research

### Re-rating likely

- At CMP, the stock trades 16.4/10.2 FY20/21E EPS. Given its steady base business and high visibility on improving operating performance, we believe the stock will re-rate and move closer to its peer-set average of 15x.
- While we don't actively cover Solara, we assign a multiple of 15x and arrive at a Fair Value of Rs 650/sh. Solara looks best-placed in the pure-play API Pharma space.

### Lucrative Valuations: ~30% Discount To Peers



Source: Company, HDFC sec Inst Research

## A Glance At The Trailing 4 Quarters

### Quarterly Financials Snapshot (Standalone)

Particulars (Rs mn)	4QFY19	YoY (%)	QoQ (%)	3QFY19	2QFY19	1QFY19
<b>Net Sales</b>	<b>3,853</b>	<b>26.7</b>	<b>8.2</b>	<b>3,562</b>	<b>3,423</b>	<b>3,028</b>
Material Expenses	2,014	29.9	14.7	1,755	1,761	1,518
Employee Expenses	483		(1.0)	487	461	428
R&D	136	403.7	30.8	104	111	97
Other Operating Expenses	574	(44.5)	(3.6)	596	610	524
<b>EBITDA</b>	<b>647</b>	<b>50.3</b>	<b>4.3</b>	<b>620</b>	<b>481</b>	<b>461</b>
Depreciation	234	33.0	10.3	212	194	191
<b>EBIT</b>	<b>413</b>	<b>62.4</b>	<b>1.2</b>	<b>408</b>	<b>287</b>	<b>270</b>
Other Income	66			39	14	5
Interest Cost	217			225	199	182
<b>PBT</b>	<b>262</b>	<b>99.7</b>	<b>18.3</b>	<b>221</b>	<b>102</b>	<b>92</b>
Tax	(0)			-	6	-
<b>PAT</b>	<b>262</b>	<b>138.2</b>	<b>18.5</b>	<b>221</b>	<b>96</b>	<b>92</b>

Source: Company, HDFC sec Inst Research

### Margin Analysis

	4QFY19	YoY (bps)	QoQ (bps)	3QFY19	2QFY19	1QFY19
Material Expenses % Net Sales	52.3	131	299	49.3	51.4	50.1
Employee Expenses % Net Sales	12.5		(116)	13.7	13.5	14.1
R&D % Net Sales	3.5	264	61	2.9	3.2	3.2
Other Expenses % Net Sales	14.9		(182)	16.7	17.8	17.3
<b>EBITDA Margin (%)</b>	<b>16.8</b>	<b>264</b>	<b>(62)</b>	<b>17.4</b>	<b>14.1</b>	<b>15.2</b>
Tax Rate (%)	(0.2)	(1,618)	(15)	-	6.2	-
<b>APAT Margin (%)</b>	<b>6.8</b>	<b>318</b>	<b>59</b>	<b>6.2</b>	<b>2.8</b>	<b>3.1</b>

Source: Company, HDFC sec Inst Research

*Solara has grown at strong double-digits YoY over the previous four quarters*

*R&D spend has also been increasing consistently, now at 3.5% of sales*

*Finance cost will reduce as debt is reduced owing to recently raised funds*

*Carried forward losses will reduce tax expense, thus improving earnings over the next few years*

## Key Management

Director	Designation	Description
Jitesh Devendra	CEO	Jitesh has more than 20 years' experience and has led the North America API business as well as managed the Formulations P&L business of erstwhile Shasun Pharmaceuticals Limited, which got merged with Strides Shasun Limited. Jitesh has been responsible for P&L business for North America and Europe Finished Dosage Form (Regulated Markets-Region 1) and overall responsible for API business P&L.
Hariharan S.	CFO	Hariharan is a Cost Accountant with rich and varied experience of more than 30 years in the field of Corporate Finance, Accounts and Strategic planning. He played a vital role in the merger process of Shasun Pharmaceuticals Ltd. with Strides Shasun Limited.
Sreenivasa Reddy B.	COO	Sreeni has over 24 years of experience in Pharmaceutical Manufacturing, Technology Transfer, Project Management in setting up facilities, Quality Assurance, Plant operations, and Sales & Marketing.

Source: Company

### Attractive Valuation

- Solara is currently valued at a steep discount compared to its peers. The average P/E, EV/EBITDA, and P/S comes to 22.3, 11.7, and 2.3 respectively. Solara is 24%, 42%, and 65% below the average on these parameters.
- As expected in our earlier two notes on Solara, the management has decided is committed to reduce the debt using some of the funds raised through warrants. We believe it will have positive impact on both earnings and valuations.
- With debt reduction of Rs 2bn, we expect a 40% decrease in interest cost by FY21E. This, coupled with a 16/21% revenue/EBITDA CAGR over FY19-21E will enable PAT to jump >2x. Adjusting for the Rs 3.6bn goodwill, return ratios will be in high-teens by FY21E. A focus on lucrative APIs and CRAMS is likely to improve business fundamentals further, beyond FY21E. **While we don't actively cover the stock, we arrive at a fair value of Rs 650 (15x FY21E EPS).**

### Peer Set Comparison

	CMP (Rs/sh)	Mkt Cap (Rs bn)	Revenue (Rs bn)	EBITDA Margin (%)	Net Debt (Rs bn)	Net Debt/ EBITDA	EPS (Rs)	ROE (%)	P/E (x)	EV/EBITDA (x)	P/S (x)
Divi's Labs	1,547	411	49.46	37.8	(19.55)	(1.0)	48.8	20.1	31.7	20.9	8.3
Dishman Pharma	221	36	20.59	26.8	6.20	1.1	16.7	15.4	13.2	7.6	1.7
Laurus Labs	332	35	22.92	15.5	9.40	2.6	10.7	6.2	31.1	12.6	1.5
Suven Life	270	34	6.64	24.2	(2.07)	(1.3)	6.8	10.9	39.6	20.1	5.2
Shilpa Medicare	348	28	7.33	21.2	0.73	0.5	13.8	9.4	25.3	18.7	3.9
Granules India	93	24	22.79	16.8	8.44	2.2	9.3	16.7	10.0	8.4	1.0
Hikal	169	21	15.90	18.8	5.68	1.9	8.4	13.6	20.2	8.9	1.3
Aarti Drugs	518	12	15.61	13.3	4.66	2.2	38.6	16.5	13.4	8.0	0.8
<b>Solara</b>	<b>442</b>	<b>11</b>	<b>13.87</b>	<b>15.9</b>	<b>3.63</b>	<b>1.64</b>	<b>26.0</b>	<b>13.4</b>	<b>17.0</b>	<b>6.8</b>	<b>0.8</b>
IOL Chemicals	189	11	16.85	24.3	2.28	0.6	41.7	49.9	4.5	3.2	0.6
Morepen Labs	17	8	7.69	8.8	(0.21)	(0.3)	0.6	11.4	26.4	11.0	1.0
Neuland	521	7	6.67	8.8	1.64	2.8	12.8	2.6	40.7	14.3	1.0
SMS Pharma	55	5	4.65	19.4	1.15	1.3	4.8	11.8	11.4	6.4	1.0

Source: Company, HDFC sec Inst Research

All numbers are based on FY19 data and CMP as on 21<sup>st</sup> June 2019.

## Peer Set Comparison

	Mcap (Rs bn)	CMP (Rs/sh)	Reco	TP/FV	Adj EPS (Rs/sh)				P/E (x)				RoE (%)			
					FY18	FY19P	FY20E	FY21E	FY18	FY19P	FY20E	FY21E	FY18	FY19P	FY20E	FY21E
Sun Pharma	918	383	BUY	600	12.7	14.9	19.2	25.5	30.2	25.7	20.0	15.0	8.2	9.0	10.6	12.8
Cipla	444	552	BUY	625	18.6	19.1	21.1	28.4	29.7	28.9	26.1	19.4	11.2	10.5	10.7	12.9
Dr Reddy's Labs	424	2,552	BUY	3,320	59.2	104.9	125.8	147.0	43.1	24.3	20.3	17.4	7.8	13.1	13.9	14.1
Divi's Labs	411	1,547	SELL	1,445	32.4	48.8	56.7	65.6	47.8	31.7	27.3	23.6	15.2	20.1	20.4	20.8
Aurobindo Pharma	353	602	BUY	800	41.7	42.9	49.3	53.2	14.4	14.0	12.2	11.3	23.2	19.7	18.9	17.2
Lupin	322	713	BUY	930	38.2	16.4	27.3	42.1	18.7	43.4	26.1	16.9	12.8	5.4	8.7	12.3
Torrent Pharma	254	1,501	NEU	1,745	37.0	40.1	52.9	72.8	40.6	37.4	28.3	20.6	14.0	14.5	17.7	20.9
Cadila Healthcare	241	235	NEU	285	12.7	11.1	12.0	15.7	18.6	21.1	19.7	15.0	16.5	11.9	11.2	13.2
Alkem Laboratories	210	1,760	BUY	2,250	57.6	64.7	79.5	102.1	30.6	27.2	22.1	17.2	14.8	15.0	16.4	18.5
Abbott India	181	8,504	NR	8,950	188.8	211.9	248.6	299.6	45.0	40.1	34.2	28.4	26.1	24.3	24.1	24.5
Glenmark	141	500	BUY	730	17.5	27.4	31.2	37.3	28.6	18.3	16.0	13.4	9.4	13.3	13.8	14.5
Alembic Pharma	90	479	NEU	570	21.9	25.8	25.1	31.6	21.9	18.6	19.1	15.2	20.0	19.7	16.4	18.1
Jubilant Life Sciences	75	472	BUY	1,005	45.5	53.8	60.2	76.2	10.4	8.8	7.8	6.2	19.3	19.3	18.3	19.6
Strides Pharma	37	409	BUY	570	13.2	6.9	29.3	35.7	31.1	59.5	13.9	11.4	2.9	2.3	9.5	10.7
Dishman Carbogen Amcis	36	221	BUY	400	13.2	16.7	20.5	26.5	16.7	13.2	10.7	8.3	14.6	15.4	15.7	17.2
Laurus Labs	35	332	BUY	535	15.8	10.7	17.0	29.4	21.0	31.1	19.5	11.3	11.9	6.2	10.8	16.7
Suven Life Sciences	34	270	NR	465	9.7	6.8	9.1	10.7	27.8	39.6	29.8	25.2	17.2	10.9	13.2	13.9
J B Chemicals & Pharmaceuticals	30	374	NR	470	16.6	24.1	28.8	34.6	22.6	15.5	13.0	10.8	9.9	13.3	14.7	15.6
Granules India	24	93	BUY	170	5.2	9.3	11.4	13.9	17.9	10.0	8.2	6.7	12.0	16.7	17.5	18.5
<b>Solara</b>	<b>11</b>	<b>442</b>	<b>NR</b>	<b>650</b>	<b>2.4</b>	<b>26.0</b>	<b>26.9</b>	<b>43.1</b>	<b>182.6</b>	<b>17.0</b>	<b>16.4</b>	<b>10.2</b>	<b>2.9</b>	<b>13.4</b>	<b>10.9</b>	<b>12.6</b>
Neuland Labs	7	521	BUY	920	10.8	12.8	32.1	65.8	48.2	40.7	16.3	7.9	2.2	2.6	5.7	10.9

Source: HDFC sec Inst Research



## Income Statement (Consolidated)

Year ending March (Rs mn)	FY18	FY19P	FY20E	FY21E
<b>Net Revenues</b>	<b>5,210</b>	<b>13,867</b>	<b>16,079</b>	<b>18,559</b>
<b>Growth (%)</b>		<b>166.2</b>	<b>16.0</b>	<b>15.4</b>
Material Expenses	2,718	7,048	7,991	9,131
Employee Expenses	685	1,858	2,187	2,505
Other Operating Expenses	1,181	2,752	3,268	3,717
<b>EBITDA</b>	<b>625</b>	<b>2,208</b>	<b>2,633</b>	<b>3,207</b>
<b>EBITDA Margin (%)</b>	<b>12.0</b>	<b>15.9</b>	<b>16.4</b>	<b>17.3</b>
<b>EBITDA Growth (%)</b>		<b>253.3</b>	<b>19.2</b>	<b>21.8</b>
Depreciation	340	831	942	1,144
<b>EBIT</b>	<b>285</b>	<b>1,377</b>	<b>1,691</b>	<b>2,063</b>
Other Income (Including EO Items)	25	124	45	45
Interest	251	824	780	510
<b>PBT</b>	<b>58</b>	<b>677</b>	<b>956</b>	<b>1,598</b>
Tax (Incl Deferred)	(1)	6	10	80
<b>RPAT</b>	<b>60</b>	<b>671</b>	<b>946</b>	<b>1,518</b>
Minority Interest	0	0	0	0
<b>APAT</b>	<b>60</b>	<b>671</b>	<b>946</b>	<b>1,518</b>
<b>APAT Growth (%)</b>		<b>1,024.0</b>	<b>41.0</b>	<b>60.4</b>
<b>Adjusted EPS (Rs)</b>	<b>2.4</b>	<b>26.0</b>	<b>26.9</b>	<b>43.1</b>

Source: Company, HDFC sec Inst Research

## Balance Sheet (Consolidated)

As at March (Rs mn)	FY18	FY19P	FY20E	FY21E
<b>SOURCES OF FUNDS</b>				
Share Capital - Equity	247	258	352	352
Reserves	7,393	9,301	14,588	15,892
<b>Total Shareholders' Funds</b>	<b>7,640</b>	<b>9,559</b>	<b>14,939</b>	<b>16,244</b>
Long Term Debt	2,429	2,250	1,250	1,225
Short Term Debt	3,302	2,145	2,155	2,165
<b>Total Debt</b>	<b>5,731</b>	<b>4,394</b>	<b>3,404</b>	<b>3,389</b>
Net Deferred Taxes	484	328	328	328
Long Term Provisions & Others	238	865	964	1,049
<b>TOTAL SOURCES OF FUNDS</b>	<b>14,137</b>	<b>15,189</b>	<b>19,680</b>	<b>21,055</b>
<b>APPLICATION OF FUNDS</b>				
Net Block	6,041	7,204	8,512	9,618
CWIP	715	404	650	575
Goodwill & Intangibles	4,593	4,615	4,615	4,615
Investments	233	299	299	299
LT Loans & Advances	554	533	525	575
<b>Total Non-current Assets</b>	<b>12,136</b>	<b>13,054</b>	<b>14,600</b>	<b>15,681</b>
Inventories	1,877	2,204	2,518	2,877
Debtors	2,625	2,888	3,436	4,068
Other Current Assets	1,106	689	799	922
Cash & Equivalents	470	765	3,623	3,684
<b>Total Current Assets</b>	<b>6,078</b>	<b>6,546</b>	<b>10,375</b>	<b>11,551</b>
Creditors	3,129	2,444	3,065	3,627
Other Current Liabilities & Provns	949	1,967	2,231	2,550
<b>Total Current Liabilities</b>	<b>4,077</b>	<b>4,410</b>	<b>5,296</b>	<b>6,177</b>
<b>Net Current Assets</b>	<b>2,001</b>	<b>2,135</b>	<b>5,080</b>	<b>5,373</b>
<b>TOTAL APPLICATION OF FUNDS</b>	<b>14,137</b>	<b>15,189</b>	<b>19,680</b>	<b>21,055</b>

Source: Company, HDFC sec Inst Research

## Cash Flow

Year ending March (Rs mn)	FY18	FY19P	FY20E	FY21E
Reported PBT	2	677	956	1,597
Non-operating & EO items	31	(280)	(45)	(45)
Interest expenses	229	824	780	510
Depreciation	367	831	942	1,144
Working Capital Change	(108)	808	20	(197)
Tax Paid	(29)	(6)	(10)	(80)
<b>OPERATING CASH FLOW ( a )</b>	<b>492</b>	<b>2,854</b>	<b>2,644</b>	<b>2,929</b>
Capex	(856)	(1,683)	(2,496)	(2,175)
Free cash flow (FCF)	(364)	1,171	148	754
Investments	-	-	-	-
Non-operating Income	2	(65)	-	-
<b>INVESTING CASH FLOW ( b )</b>	<b>(855)</b>	<b>(1,748)</b>	<b>(2,496)</b>	<b>(2,175)</b>
Debt Issuance/(Repaid)	898	(1,336)	(990)	(15)
Interest Expenses	(220)	(700)	(735)	(465)
FCFE	315	(931)	(1,577)	274
Share Capital Issuance	0	11	4,710	-
Dividend	-	77	(155)	(213)
Others	145	-	(120)	-
<b>FINANCING CASH FLOW ( c )</b>	<b>822</b>	<b>(1,949)</b>	<b>2,710</b>	<b>(692)</b>
<b>NET CASH FLOW (a+b+c)</b>	<b>460</b>	<b>(843)</b>	<b>2,858</b>	<b>61</b>
EO Items, Others	11			
<b>Closing Cash &amp; Equivalents</b>	<b>470</b>	<b>(373)</b>	<b>3,623</b>	<b>3,684</b>

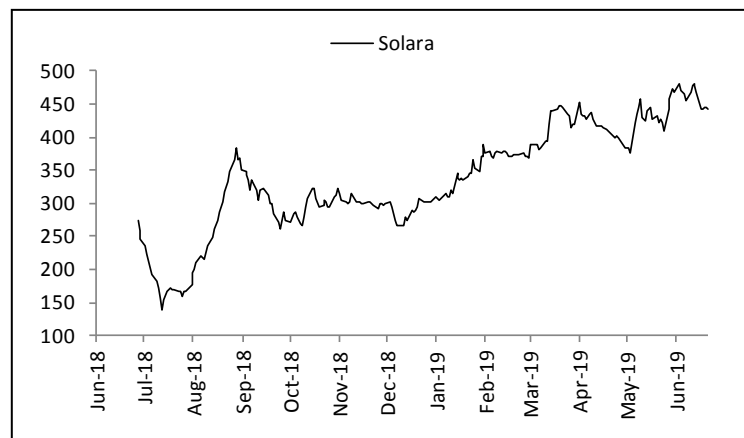
Source: Company, HDFC sec Inst Research

## Key Ratios

	FY18	FY19P	FY20E	FY21E
<b>PROFITABILITY (%)</b>				
GPM	47.8	49.2	50.3	50.8
EBITDA Margin	12.0	15.9	16.4	17.3
APAT Margin	1.1	4.8	5.9	8.2
Adj. RoE	2.9	13.4	10.9	12.6
Adj. RoIC (or Core RoCE)	6.3	14.1	15.6	16.8
Adj. RoCE	6.0	13.4	12.5	12.1
<b>EFFICIENCY</b>				
Tax Rate (%)	(2.4)	0.9	1.0	5.0
Fixed Asset Turnover (x)	0.8	1.7	1.5	1.5
Inventory (days)	131.5	58.0	57.2	56.6
Debtors (days)	183.9	76.0	78.0	80.0
Other Current Assets (days)	77.5	18.1	18.1	18.1
Payables (days)	219.2	64.3	69.6	71.3
Other Current Liab & Provns (days)	66.5	51.8	50.6	50.1
Cash Conversion Cycle (days)	107.2	36.1	33.1	33.2
Debt/EBITDA (x)	9.2	2.0	1.3	1.1
Net D/E (x)	0.7	0.4	(0.0)	(0.0)
Interest Coverage (x)	1.1	1.7	2.2	4.0
<b>PER SHARE DATA (Rs)</b>				
EPS	2.4	26.0	26.9	43.1
Dividend	-	5.0	5.0	5.0
Book Value	309.7	370.9	424.7	461.8
<b>VALUATION</b>				
P/E (x)	182.6	17.0	16.4	10.2
P/BV (x)	1.4	1.2	1.0	1.0
EV/EBITDA (x)	25.9	6.8	5.8	4.8
EV/Revenues (x)	3.1	1.1	1.0	0.8
OCF/EV (%)	3.0	19.0	17.2	19.2
FCF/EV (%)	(2.3)	7.8	1.0	4.9
FCFE/Mkt Cap (%)	2.9	(8.2)	(10.1)	1.8
Dividend Yield (%)	-	1.1	1.1	1.1

Source: Company, HDFC sec Inst Research

## 1YR PRICE MOVEMENT



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