11 June 2019
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JM FINANCIAL

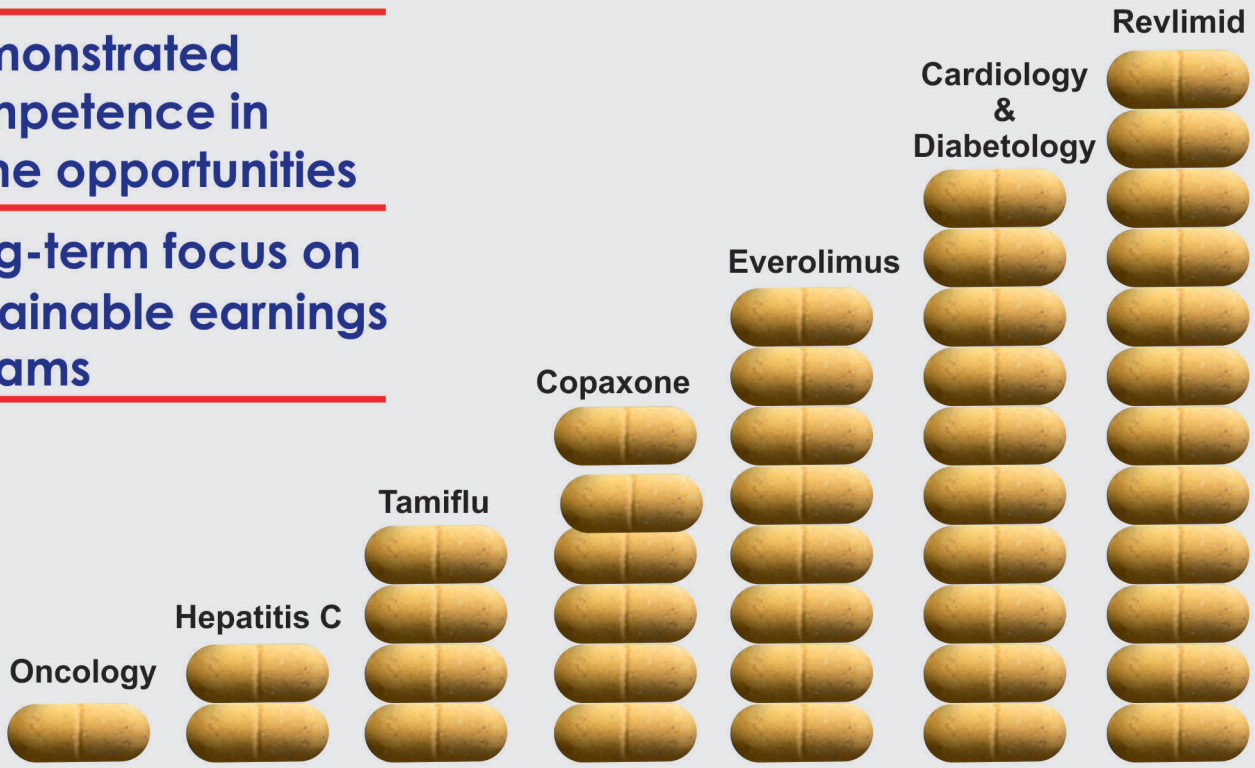
Natco Pharma

Strategic Reset Underway

Leadership in domestic oncology

Demonstrated competence in niche opportunities

Long-term focus on sustainable earnings streams



Initiate with BUY, TP of INR 640, 17% upside

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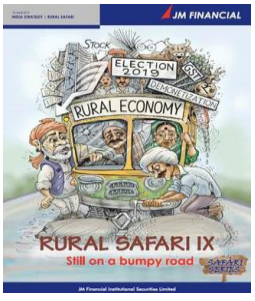

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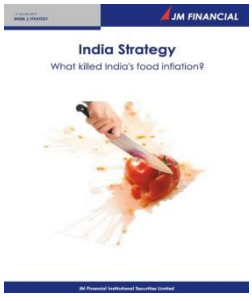

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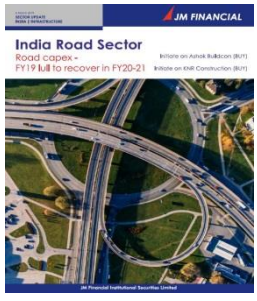


India Road Sector

India Specialty Chemicals

Natco Pharma

Strategic Reset Underway: Compelling Investment Case

We initiate coverage on Natco Pharma with a BUY rating and a target price of INR 640. Natco has embarked on a new journey in our view. Natco 2.0 intends to rely increasingly on a more diversified earnings stream. Reduced volatility and low vulnerability to large US opportunities seem to be the thrust of current management initiatives. While remaining sharply focused on monetizing large opportunities in the US, Natco in its new avatar will be relying on multiple pillars of growth.

Natco is an outlier among peers on multiple fronts: a) Best-in-class margin profile (FY20E EBITDA Margin & Net Profit Margin at 33.6% & 28.1%) b) A risk mitigated business model with its marketing partner in US being responsible for litigations and ANDA filing & c) Strong balance sheet

Natco has delivered an impressive performance in the last 5 years with FY14-FY19 Revenue/EBITDA/PAT CAGR at 23%/35%/44% on the back of robust growth in the domestic Hepatitis C franchise and contribution from gTamiflu, gCopaxone & gDoxil. While growth in FY20 is expected to be muted, multiple near-term catalysts including the much-awaited approval for gRevlimid, favourable outcomes in litigations involving domestic launches of Valsac (c. INR 1200 mn) & gBrilinta (c. INR 1500 mn) and strong offtake of first generic launches in key international markets (Brazil & Canada) pose significant upside risks. Given Natco's strong pipeline in high-barrier complex generics and track record of identifying and exploiting niche opportunities so often, we believe that the CMP does not capture any potential upside to Natco's base earnings (Earnings excluding profit share from niche US launches) and offers an attractive entry point.

Strategic reset & diversification to aid earnings stability: Natco has embarked on a new path to reduce its reliance on big-ticket US launches and achieve a more stable revenue mix. Natco is now focusing on leveraging its strong portfolio for rapid growth in Brazil & Canada besides the domestic market. Natco entered the high-growth chronic therapeutic areas of cardiology & diabetology in the domestic market in 2017 and should achieve reasonable scale over the next two years. Natco's agrochem venture complements its differentiated R&D-driven approach and will be a key growth lever post-FY21.

First generic launches of Tamiflu & Copaxone 40 mg/ml validate R&D capabilities: After being the first to launch gTamiflu, Natco became the first to launch gCopaxone 40mg/mL, beating the likes of Sandoz and Dr Reddy's to it, which validates its R&D strengths. Natco has 20 Para IV opportunities in its pipeline, including gRevlimid, which is its largest opportunity to date and is expected to contribute peak sales of c. USD 280 mn and support its strong growth in the US beyond FY22.

Market leader in domestic Oncology & Gastro Hepatology: Natco is the market leader in the domestic oncology segment with over 20% market share. The under-penetration in the segment provides Natco with a long runway for growth. Natco was among the first few players to introduce generic Hepatitis C drugs licensed from Gilead Sciences in the domestic market and currently occupies the top spot across the Hepatitis C class of drugs in India.

Rewards meaningfully exceed risks @ CMP: At c.16x FY20E earnings, Natco is trading at c.40% discount to its 5-year average trading range. We believe that the current valuations barely price in the base earnings with the value of Natco's US portfolio and pipeline with strong launch and earnings visibility not factored in. Given Natco's strong domestic business, robust balance sheet, increasing focus in new markets and maturing R&D pipeline, risk-reward is extremely favourable. Initiate with BUY with a Mar'20 TP of INR 640.

Recommendation and Price Target	
Current Reco	BUY
Current Price Target (12M)	640
Upside/(Downside)	17%

Key Data – NTCPH IN	
Current Market Price	INR547
Market cap (bn)	INR100.1/US$1.4
Free Float	44%
Shares in issue (mn)	179.7
Diluted share (mn)	182.5
3-mon avg daily val (mn)	INR172.4/US$2.5
52-week range	849/480
Sensex/Nifty	39,785/11,923
INR/US	69.7

Price Performance			
%	1M	6M	12M
Absolute	1.0	-21.2	-30.5
Relative*	-4.9	-30.8	-38.0

*To the BSE Sensex

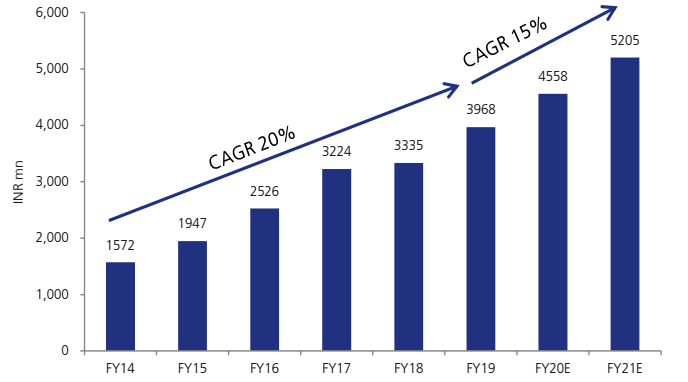
Financial Summary					(INR mn)
Y/E March	FY17A	FY18A	FY19A	FY20E	FY21E
Net Sales	20,650	22,020	20,945	22,259	25,021
Sales Growth (%)	80.9	6.6	-4.9	6.3	12.4
EBITDA	6,834	9,284	7,948	7,486	8,796
EBITDA Margin (%)	33.1	42.2	37.9	33.6	35.2
Adjusted Net Profit	4,861	6,962	6,444	6,265	7,305
Diluted EPS (INR)	27.9	38.8	35.0	34.3	40.0
Diluted EPS Growth (%)	206.4	38.9	-9.6	-2.0	16.6
ROIC (%)	31.1	32.3	21.8	17.4	18.3
ROE (%)	33.0	29.5	19.6	16.7	16.9
P/E (x)	19.6	14.1	15.6	15.9	13.7
P/B (x)	5.8	3.2	2.9	2.5	2.2
EV/EBITDA (x)	14.6	9.9	11.5	12.0	9.9
Dividend Yield (%)	1.2	1.5	1.2	0.9	0.9

Source: Company data, JM Financial. Note: Valuations as of 10/Jun/2019

JM Financial Research is also available on: Bloomberg - JMFR <GO>, Thomson Publisher & Reuters, S&P Capital IQ, FactSet & Visible Alpha
You can also access our portal: www.jmflresearch.com
Please see Appendix I at the end of this report for Important Disclosures and Disclaimers and Research Analyst Certification.

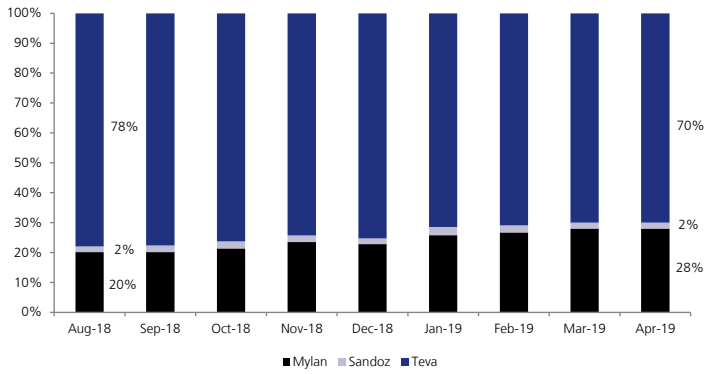
Focus Charts

Exhibit 1. Sustained double-digit growth in domestic oncology



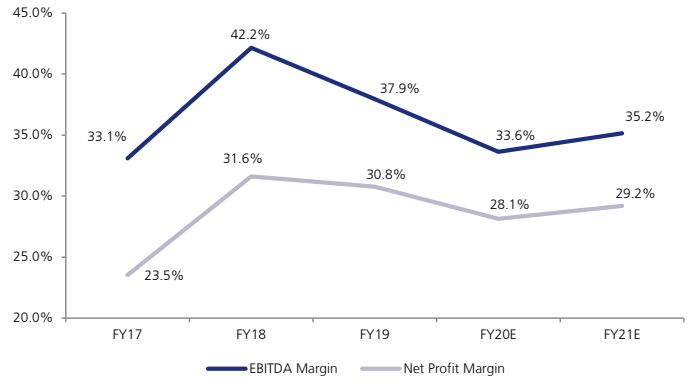
Source: Company, JM Financial

Exhibit 2. Mylan-Natco gaining market share in gCopaxone 40 mg/ml



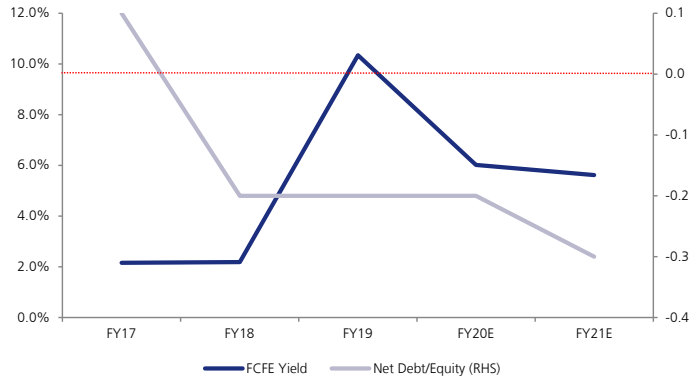
Source: Bloomberg, JM Financial

Exhibit 3. Best-in-class Margin Profile



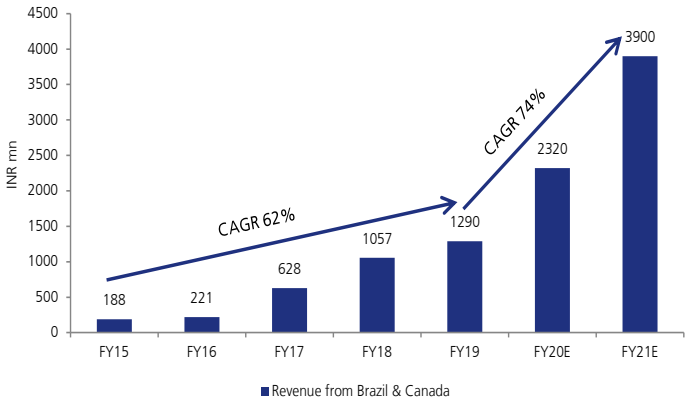
Source: Company, JM Financial

Exhibit 4. Strong Balance Sheet



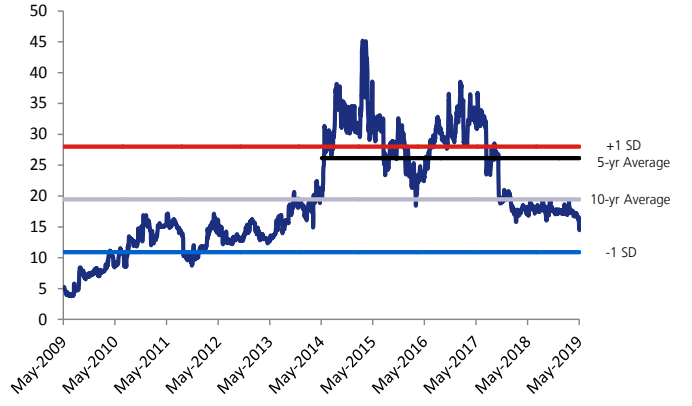
Source: Company, JM Financial

Exhibit 5. Brazil & Canada set to witness rapid expansion



Source: Company, JM Financial

Exhibit 6. Valuations more attractive than ever

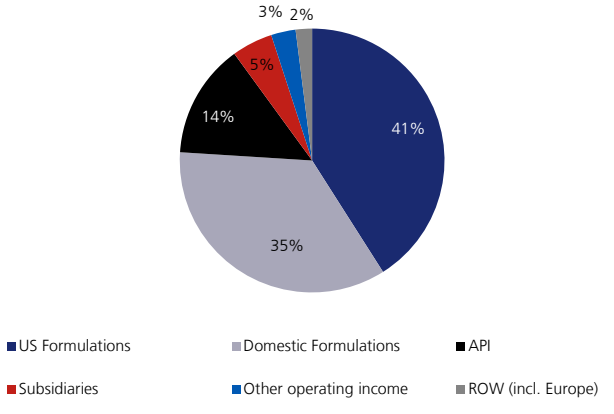


Source: Bloomberg, JM Financial

Investment Thesis

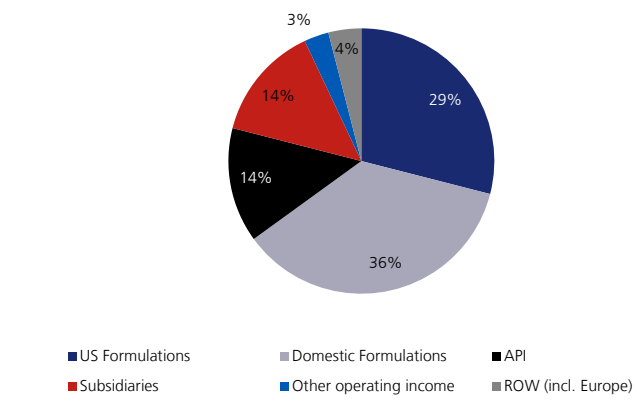
- **Long-term focus on sustainable earnings streams:** Natco's earnings have reflected volatility over the past 3 years owing to the reliance on a few major Para IV & Para III opportunities in the US. In its post-Tamiflu & post-Copaxone avatar, which collectively accounted for c.25% of overall revenue in FY19, Natco has embarked on a new path by increasing focus on international markets (Brazil & Canada) and by diversifying into the niche agrichemical business. In the long-term, Natco is expected to achieve a more stable revenue mix with domestic formulations, ROW brand formulations, API and the agrichemical business collectively accounting for c.80% of overall revenue. We expect c.70% of Natco's FY21E revenue to be generated outside the US.
- **Clinical focus on limited competition opportunities:** Natco is not a me-too Indian pharma firm and has adopted a differentiated path unlike its peers by focusing on limited competition opportunities. After being the first to launch gTamiflu in US, Natco became the first to launch gCopaxone 40mg/mL, beating the likes of Sandoz and Dr Reddy's to it, which validates its R&D strengths. Natco's model of risk-sharing by forging front-end partnerships with the larger players in the US and its ability to successfully challenge innovators in the domestic market have enabled it to stay away from commoditized generics and single-mindedly focus on high-margin opportunities. Natco needs to be looked at afresh given its credible technology platform, differentiated R&D-driven approach and its strategy of combining niche opportunites and high value bets with sustainable earnings streams in new markets.
- **Strong US pipeline offers significant upside potential:** Natco has 20 Para IV opportunities in its pipeline, including gRevlimid, which is its largest opportunity to date and is expected to contribute peak sales of USD 283mn and support its strong growth in the US beyond FY22. Natco does not have the baggage of a large base business in the US and its pipeline value exceeds its current US run-rate (ex-Copaxone & ex-Tamiflu).
- **Domestic oncology opportunity yet to be fully tapped into:** Natco is the market leader in the domestic oncology segment with c.20% market share. The under-penetration in the segment and the expected increase in the number of new cancer cases are expected to provide Natco with a long runway for growth. We expect Natco to continue its industry-leading growth trajectory with domestic oncology revenue expected to grow at a CAGR of 15% over FY19-FY21.
- **Valuations more attractive than ever**: At c.16x FY20E earnings, Natco is trading at c.40% discount to its 5-year average trading range. Given Natco's strong domestic business, robust balance sheet, increasing focus in new markets and maturing R&D pipeline, risk-reward is extremely favourable. Initiate with BUY with a Mar'20 TP of INR 640.

Exhibit 7. FY19 Revenue Mix by Business Segment



Source: Company, JM Financial

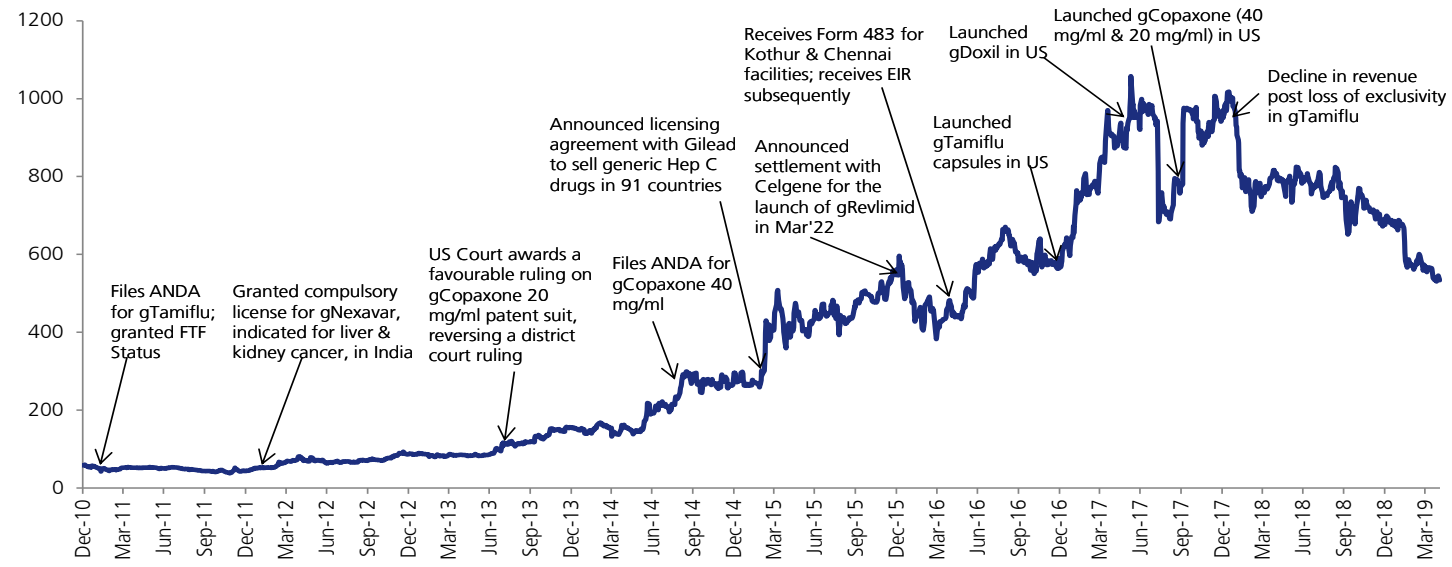
Exhibit 8. FY21E Revenue Mix by Business Segment



Source: Company, JM Financial

The Story So Far

Exhibit 9. Natco's share price performance & key triggers



Source: Company, JM Financial, Bloomberg

Natco's share price performance has been shaped by few major drivers including gTamiflu & gCopaxone over the last 3 years and its domestic oncology & Hepatitis C franchise during the earlier part of the decade. The vagaries of the stock reflect the uncertainty surrounding Para IV litigations and the vitality of FTF exclusivity in the US. While exclusivity in gTamiflu resulted in windfall gains and the loss of exclusivity had an equally marked impact, delayed approval or simultaneous approvals to multiple filers have often acted as impediments to gaining meaningful market share in case of other opportunities (E.g.: gNuvigil & gEntocort). Natco now seeks to address this uncertainty surrounding its US Para IV pipeline by increasing its focus on domestic and key subsidiary markets.

Share price performance has largely been driven by few high-value opportunities

Natco had announced its arrival on the big stage in Feb 2011 with its ANDA for Roche's blockbuster drug, Tamiflu, in partnership with Alvogen and by achieving First-to-File status. Natco's first major success in a domestic patent lawsuit came in Mar 2012 when it was granted a compulsory license, first-of-its-kind, for Bayer's Nexavar, the first-line treatment for liver and kidney cancer. While Natco subsequently emerged as the largest player in domestic oncology on the back of steady growth in the segment, Natco's Hepatitis C franchise witnessed non-linear growth post its licensing agreement with Gilead in Mar 2015 for gSovaldi and gHarvoni in 91 developing countries. Natco registered 5x growth in revenue from its Hepatitis C franchise in FY16.

With the launch of gTamiflu capsules in Dec 2016, Natco's second breakout moment came immediately after in FY17 with a 6x jump in US revenue. While the launch of gDoxil helped partially offset the seasonality in gTamiflu sales, the earlier-than-expected at-risk launch of gCopaxone in Oct 2017 provided the much needed boost in FY18. However, increased competition post the loss of exclusivity in gTamiflu, sharp price cuts in gCopaxone by partner Mylan and the increasing pricing pressure in the domestic Hepatitis C segment weighed on the stock in FY19.

While growth in FY20 is expected to be muted, key near-term catalysts include the much-awaited approval for gRevlimid, favourable outcomes in litigations involving domestic launches of Valsac (c. INR 1200 mn) & gBrilinta (c. INR 1500 mn) and strong offtake of first generic launches in key international markets (Brazil & Canada).

Domestic Formulations: The bedrock of stable growth

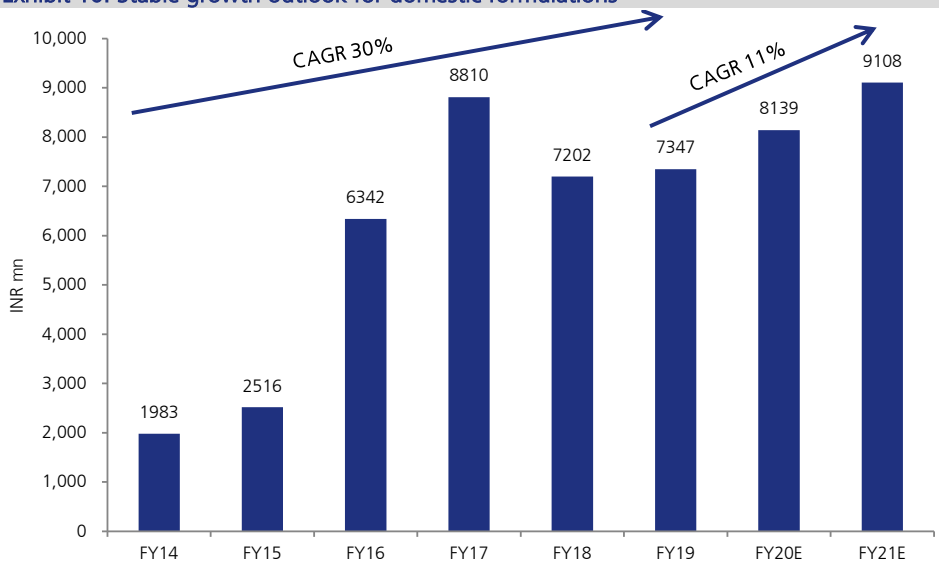
After having sold off a basket of specialty brands to Sun Pharma in 1998, Natco re-entered the domestic market with the launch of its flagship oncology brand, Veenat (Imatinib Mesylate). Since then, it has significantly scaled up its domestic business which contributed INR 7.4bn (c. 35% of overall revenue) in FY19. Currently, Natco's domestic business is mainly driven by two segments – Oncology and Hepatology – with a specialist sales force of c.350 personnel and over 400 distributors. Third party sales currently account for c.11% of domestic formulations revenue. Natco is a leader in the oncology space with c.20% share in in its operated portfolio and a total of 29 products in the market. Natco's domestic formulations revenue grew at a CAGR of 64% over FY14-FY17, driven by the launch of Hepatitis C drugs (licensed from Gilead) in India, generating revenue of c. INR 4.8bn in FY17, although the Hepatitis C contribution has declined since then owing to increased competition and pricing pressure in the domestic market.

Given the volatility surrounding its Para IV pipeline and the increasing competitive and pricing pressures in US, Natco increased its focus and resource allocation to grow in India by expanding capacity at its Guwahati & Dehradun facilities as well as by launching the Cardiology and Diabetology (CnD) division in early 2017, where it intends to introduce niche products in the market over the next 2 years and generate revenue of INR 1.5bn by FY22. Natco's Pharma Specialties division, which includes its Hepatology and its Orthopaedics portfolio, is expected to stabilize going forward aided by new launches and an emerging portfolio of Hepatitis B drugs. The management expects the Pharma Specialties division to contribute INR 4bn by FY22.

Domestic formulations to emerge as the largest business segment by FY20

We expect domestic formulations revenue to grow at a CAGR of 11% over FY19-FY21 aided by strong double-digit growth in domestic oncology, increasing traction in Cardiology and Diabetology and stabilization in the Specialties division.

Exhibit 10. Stable growth outlook for domestic formulations



Source: Company, JM Financial

Domestic Oncology: Surface barely scratched

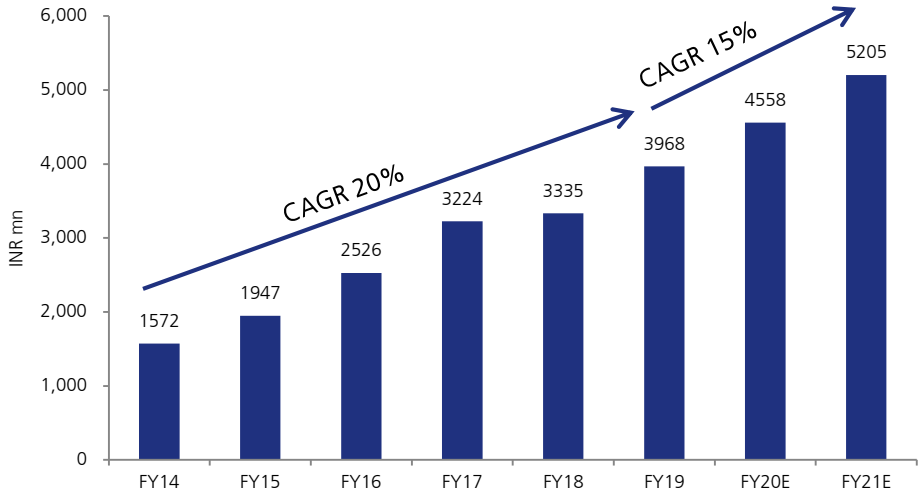
Natco forayed into the Indian oncology market in 2003 with the launch of the first generic alternative for Novartis's Gleevec (Imanitib Mesylate) under the Veenat brand. Since then, Natco has significantly ramped up sales from this segment through expansion of its portfolio from 6 products in FY04 to 29 products in FY19 which includes 6 brands (Veenat, Lenalid, Erlonat, Geftinat, Sorafenat and Bortenat) with over INR 100mn of annual sales.

Natco is currently the market leader (c.20% market share) in the domestic oncology market, with sales supported by a specialised field force of over 75 sales representatives and a strong distribution network. Oncology is one of the fastest growing and one of the most lucrative therapeutic areas in the Indian pharma market due to limited competition, high manufacturing complexity and very high margins (c.90% Gross Margin).

Natco's oncology segment posted a CAGR of 20% over FY14-FY19 and is expected to post a CAGR of 15% over FY19-FY21, driven by increasing market penetration and its strong product portfolio.

Domestic oncology segment characterized by limited competition and very high margins

Exhibit 11. Oncology a strong growth driver for Natco



Source: Company, JM Financial

Natco currently has a portfolio of 29 brands across two segments: hematology (13 brands) and solid tumors (16 brands). Although the company primarily operates in hematology, it is increasing its presence in the solid tumours segment, targeting the therapeutic areas of breast and lung cancers. Natco intends to build a full-fledged Bone Marrow Transplant (BMT) portfolio in India and has already launched Thiotepa, India's first generic BMT product.

Exhibit 12. Natco's top oncology brands (INR 100mn+ annual sales)

Natco Brand	Innovator Brand	Molecule	Indication
Veenat	Gleevec	Imatinib Mesylate	Chronic Myeloid Leukemia
Lenalid	Revlimid	Lenalidomide	Multiple Myeloma
Bortenat	Velcade	Bortezomib	Multiple Myeloma
Erlonat	Tarceva	Erlotinib	Lung and Pancreatic Cancer
Geftinat	Iressa	Gefitinib	Lung Cancer
Sorafenat	Nexavar	Sorafenib	Liver and Kidney Cancer

Source: Company, JM Financial

Globally, oncology is the largest therapeutic area by medicine spending. The global market for oncology therapeutic medicines was valued at USD 104bn in 2017 and is expected to grow at a CAGR of 12.2% to reach USD 233bn by 2024. The sales of oncology drugs in 2024 are expected to be more than the combined sales of the next four top therapeutic areas. Emerging markets are growing at a much faster pace (c.17% YoY in 2017) with increased adoption and usage of medicines aiding strong volume growth.

Exhibit 13. Top 10 Therapeutic areas by medicine spending

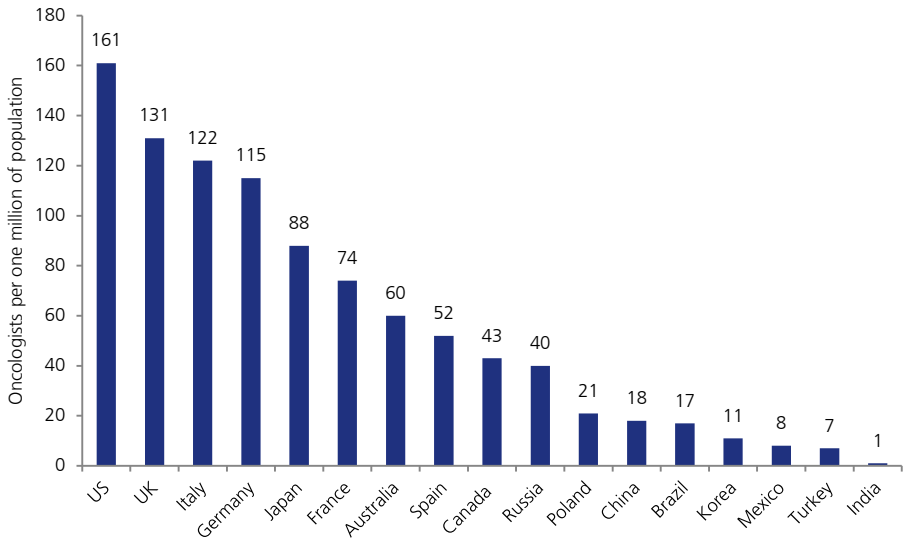
Therapy Area	Global Sales (USD bn)		CAGR %	Global Market Share (%)	
	2017	2024E		2017	2024E
Oncology	104	233	12.2	12.6	18.6
Anti-diabetics	46	59	3.7	5.6	4.8
Anti-rheumatics	56	57	0.2	6.8	4.5
Vaccines	28	45	7.1	3.4	3.6
Anti-virals	42	40	-0.9	5.1	3.2
Immunosuppressants	14	38	15.7	1.7	3
Bronchodilators	27	32	2.5	3.3	2.6
Dermatologicals	13	30	13	1.6	2.4
Sensory Organs	22	27	3.2	2.6	2.2
Anti-hypertensives	23	24	0.8	2.8	2

Source: Evaluate Pharma

Rising cancer incidence and limited access to treatment offer long runway for growth

The oncology market in India remains largely underpenetrated given the prohibitive treatment costs, lack of access to diagnosis and treatment as well as low awareness. Access to specialist care remains extremely limited with oncologists per capita in India being one of the lowest in the world. Low awareness and low affordability have resulted in only 12.5% of patients opting for treatment in early stages with c.70% of the patients seeking treatment at the terminal stage.

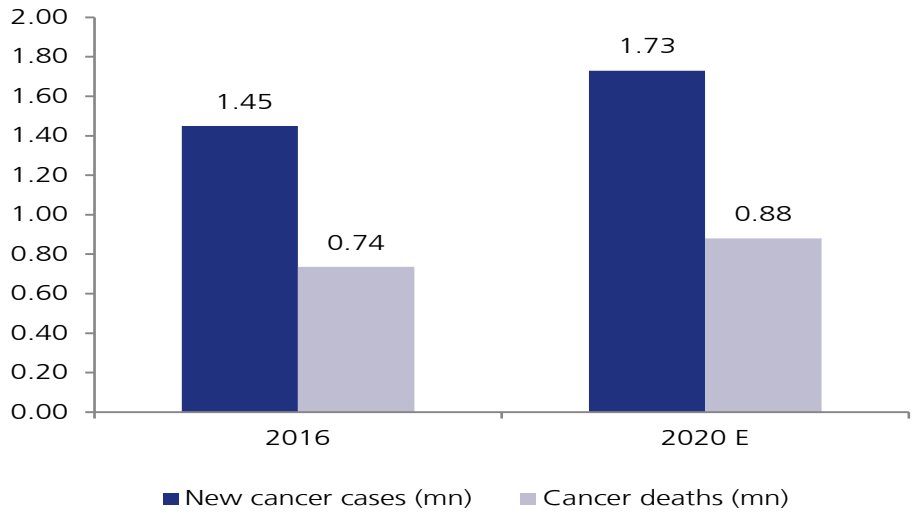
Exhibit 14. Oncologists per capita in India one of the lowest in the world



Source: IQVIA

Cancer is the second most common cause of death in India. The Indian Council of Medical Research has estimated that by 2020, the total number of new cancer cases is likely to reach nearly 1.73mn (up from 1.45mn in 2016) and over 0.88mn (up from 0.74mn in 2016) are expected to succumb by 2020. Cervix and breast cancers in women and oral cavity and lung cancers in men are the leading causes of fatalities and together account for c. 50% of cancer-related deaths in India. However, due to deficiencies in data collection and screening, the actual cancer incidence in India is expected to be much higher (c.150-200 per 1,00,000 people) as compared to the reported incidence (c.106 per 1,00,000 people in 2016).

Exhibit 15. Cancer incidence in India increasing



Source: Indian Council of Medical Research

The Indian oncology market was valued at c. INR 38bn in 2017 and is estimated to have grown by c.11% in 2018. With increasing exposure to risk factors (tobacco use, pollution and sedentary lifestyle), increasing affordability (owing to rising incomes and insurance penetration), gradual improvements in access (diagnosis and treatment) and greater awareness, the Indian cancer drug market is expected to continue to grow in double-digits (c.13-15%) over the medium-term.

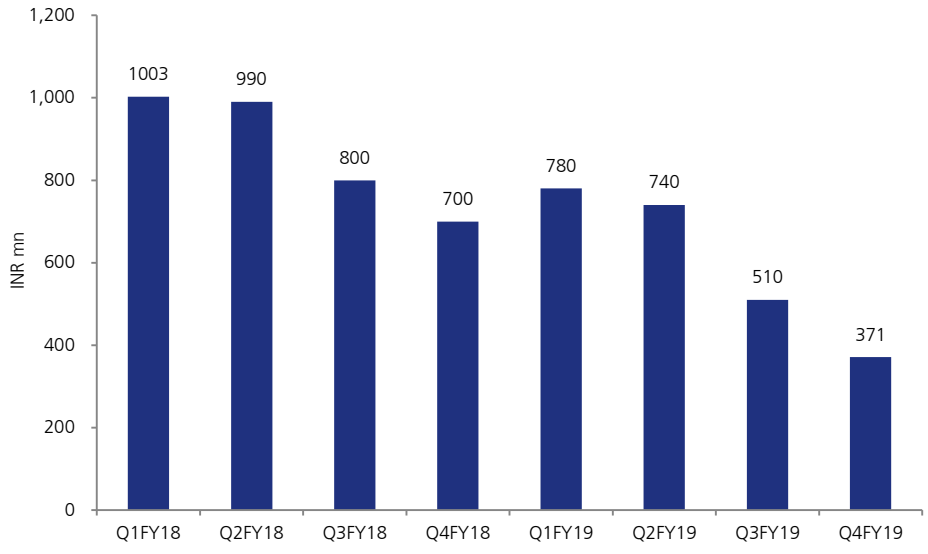
Gastro Hepatology: Focus shifts to international markets

Natco established its presence in the Hepatitis C segment in 2015 by being the first company in India to launch the generic version of Gilead's Sovaldi (Sofosbuvir) under the Hepcinat brand and currently occupies the top spot across the Hepatitis C class of drugs in India with its sales and marketing efforts supported by a sales force of 120 representatives. Natco, along with partner Laurus Labs, was one of the 11 players that entered into a non-exclusive licensing agreement in 2015 to manufacture and market Gilead's Hepatitis C portfolio in 91 developing countries (subsequently extended to 105 countries with a target population of c. 100mn people). Moreover, Natco entered into an agreement with Bristol Myers Squibb for the sale of the generic version of Daklinza (Daclatasvir) in 112 developing countries. Natco was also among the first few players to launch the generic version of Gilead's Harvoni (Ledipasvir+Sofosbuvir) in 2015 under the Hepcinat LP brand in India. Natco's partnership with Laurus offered it adequate access to API, while other players had to rely on external sources or develop API in-house, giving Natco a significant competitive advantage. Natco witnessed a 5x growth in Hepatitis C revenue in FY16 to INR 3.5bn with its 3 brands capturing c.60% of the market.

Leadership across Hepatitis C class of drugs in India

Despite low prevalence of Hepatitis C (0.9%), India accounts for a significant share of global Hepatitis C infections owing to its large population. c.12 million people in India are affected by Hepatitis C. However, with increased competition (entry of c. 8-9 players including Cadila, Cipla & Strides) and pricing pressure (over 50% decline in prices since launch) in the domestic market, Natco's Hepatitis C franchise has been under pressure over the past 2 years. Moreover, unlike other therapies, Hepatitis C drugs do not offer opportunities for repeat sales. We expect domestic Hepatology revenue to stabilize in FY20 and to be mainly driven by the first-generic launch of Hepcinat Plus (Sofosbuvir+Daclatasvir) and by Natco's emerging Hepatitis B portfolio. Given the increased competitive intensity in the domestic market, Natco is now aggressively focusing on leveraging its strong Hepatitis C portfolio in other developing nations with significant growth potential. Besides the access to developing countries via agreements with Gilead & Bristol Myers Squibb, Natco has received approvals for its Hepatitis C drugs in 14 countries.

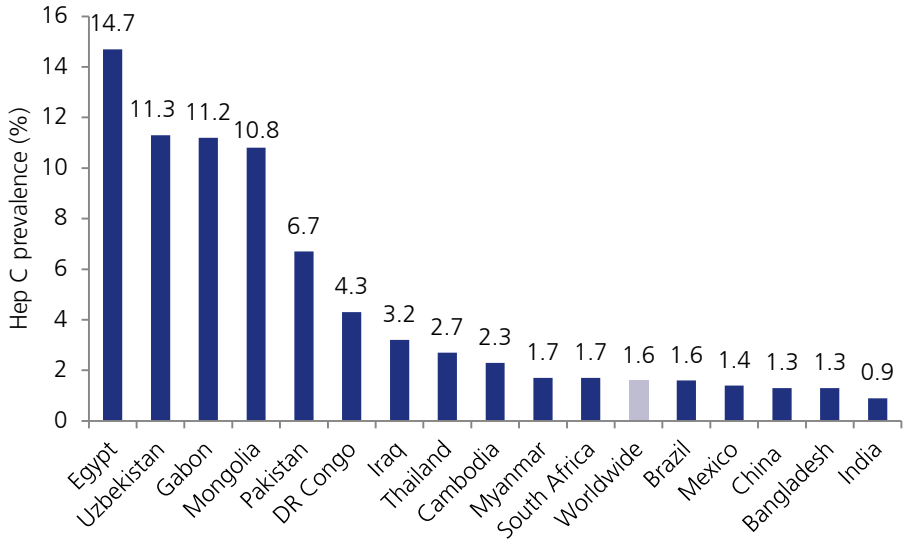
Exhibit 16. Domestic Hepatitis C segment facing increased competition



Source: Company, JM Financial

The global prevalence of Hepatitis C is estimated to be c.1.6%. Developing nations other than India account for c.60% of global Hepatitis C infections. Moreover, Hepatitis C prevalence in other developing nations is much higher than that in India.

Exhibit 17. Hepatitis C prevalence in other developing nations higher than that in India



Source: European Association for the Study of the Liver

Increasing presence in other developing nations with strong growth potential

Exhibit 18. Natco's Hepatitis C brands

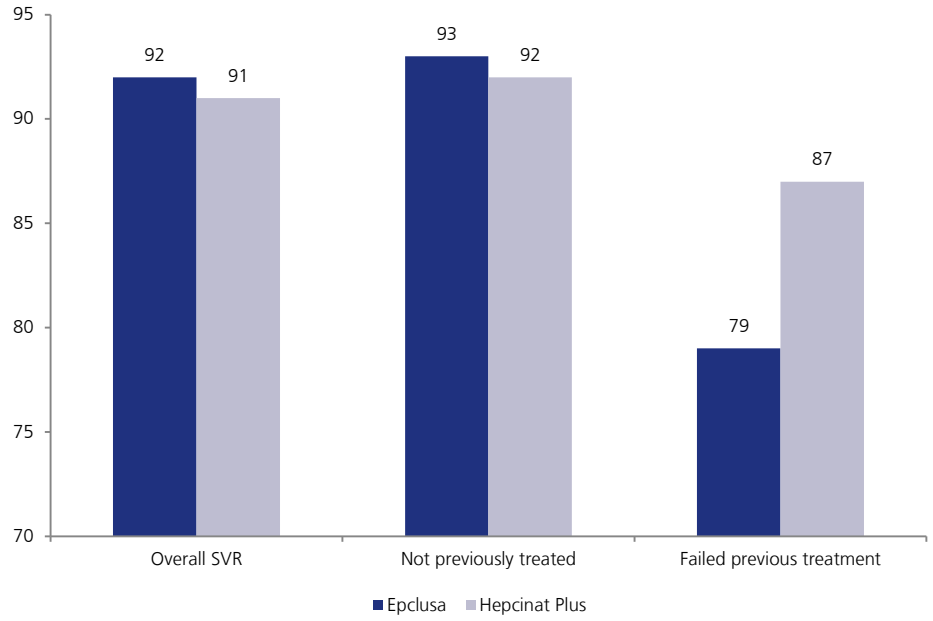
Natco Brand	Innovator Brand	Molecule
Hepcinat	Sovaldi	Sofosbuvir
Hepcinat LP	Harvoni	Ledipasvir/Sofosbuvir
Natdac	Daklinza	Daclatasvir
Velpanat	Epclusa	Sofosbuvir + Velapatasvir
Hepcinat Plus	Darvoni	Sofosbuvir + Daclatasvir

Source: JM Financial, Company

Natco launched the first generic version of Sofosbuvir+Daclatasvir in India under its Hepcinat Plus brand in July 2018. The fixed dose combination of Sofosbuvir+Daclatasvir was first developed by Bangladesh-based Beacon Pharma under the Darvoni brand. Hepcinat Plus is the cheapest available drug for the treatment of all 6 genotypes of Hepatitis C.

The cure rate of a drug indicated for Hepatitis C is measured in terms of SVR12, the sustained virological response measured 12 weeks after the end of treatment. 100% SVR12 indicates no detectable amount of Hepatitis C virus is present in the blood. Hepatitis C genotype 3 is the most difficult genotype to treat. Gilead's Epclusa, currently considered to be the most effective treatment for genotype 3 (92% cure rate), was the first FDA approved drug to treat all genotypes of Hepatitis C. Exhibit 19 indicates that Hepcinat Plus is as effective as Epclusa in patients who have not been previously treated. In case of patients who failed previous treatment, Hepcinat Plus is far superior. Mavyret, the first treatment of 8 weeks duration for all Hepatitis C genotypes, was approved by FDA in 2017. Clinical trials conducted by Abbvie, the manufacturer of Mavyret, indicated that the cure rate of Mavyret for genotype 3 was lower than that of Hepcinat Plus even after 12 weeks. For genotypes 2, 5 and 6, the cure rates with Sofosbuvir+Daclatasvir were 100% and for genotype 1, the cure rate with 12 weeks treatment of Sofosbuvir+Daclatasvir was 97% (comparable to Harvoni, the most effective treatment for genotype 1). For genotype 4, the cure rate was 95%.Given that the combination of Sofosbuvir+Daclatasvir is still under clinical trials in most countries, Natco enjoys first-mover advantage in India and other developing countries.

Exhibit 19. SVR12 for Genotype 3 with Epclusa & Hepcinat Plus (Sofosbuvir+Daclatasvir)

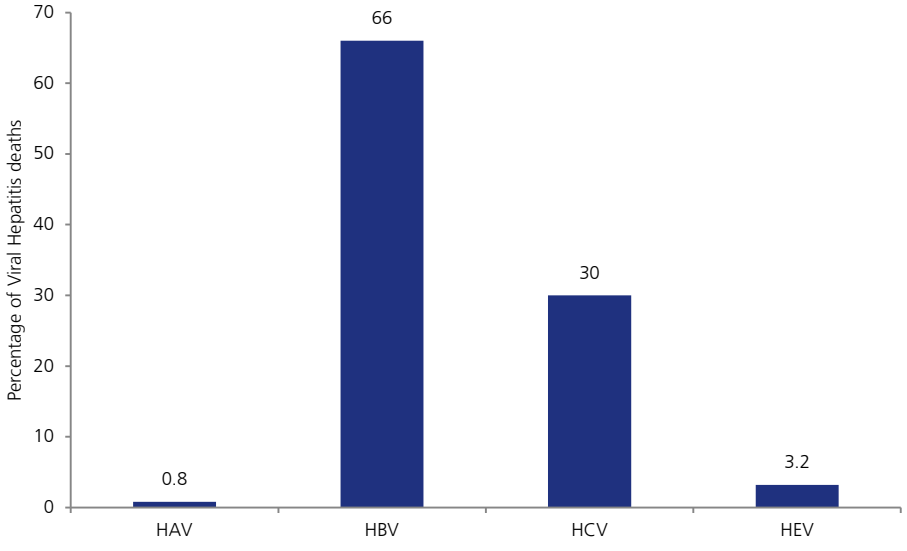


Source: European Association for the Study of the Liver

First-mover advantage in Hepatitis B and new treatment regimen for Hepatitis C

Natco launched the first-generic version of Tenofovir Alafenamide for the treatment of Hepatitis B, under the brand Tafnat and under license from Gilead, in India in Dec 2017.This was the third major launch in Natco's emerging Hepatitis B portfolio which already comprises Teravir (Tenofovir) and X-Vir (Entecavir). The Hepatitis B opportunity for Natco is expected to be much larger as compared to Hepatitis C owing to the much greater global prevalence of Hepatitis B (3.6% vs 1.6% for Hepatitis C). Moreover, most viral Hepatitis deaths result from late complications of Hepatitis B.

Exhibit 20. Most viral Hepatitis deaths resulting from late complications of Hepatitis B



Source: WHO

Cardiology and Diabetology: Poised to achieve scale

Natco had launched its Cardiology and Diabetology (CnD) division in early 2017 as part of its strategy to expand its domestic footprint. The selection of Cardiology (2nd largest) and Diabetology (4th largest) segments was driven by these segments being among the largest and fastest growing therapeutic segments in India. Although Natco entered the market with the launch of large commoditised products (Clinidipine, Bosentan, Teneligliptin and Ivabradin), it is expected to launch niche products with high entry barriers over the next 2 years which could potentially contribute INR 1.5bn of annualised revenue by FY22. Natco had launched the first Argatroban injection and Dabigatran in 2017 for the treatment of patients with thrombosis syndrome. Natco's strong CnD field force of c.125 sales representatives is expected to help it achieve scale in these high-growth chronic segments.

Cardiology has the second largest share (c.12%) in the Indian pharma market and had posted a growth of c.12% in CY18. Cardio vascular disease (CVD) is the leading cause of death in India with the age-standardized deaths per 1,00,000 people resulting from CVD in India (272) being higher than the global average (235). Diabetology has the fourth largest share (c.9%) in the Indian pharma market and had posted a growth of c.13% in CY18. The number of diabetics in India is estimated to be c.70mn. India has the second highest number of patients with Type-2 diabetes in the world.

Cardiology & Diabetology among the largest and fastest growing therapies in India

Natco's approach to its domestic CnD division has been similar to its approach to the developed markets with a clear focus on limited-competition high-value bets. Natco is willing to face legal risks resulting from patent challenges given its strong track record of successfully challenging innovators in the domestic market. Two major recent CnD launches which are currently under litigation include Valsac (c. INR 1200 mn) and gBrilinta (c. INR 1500mn).

Natco had launched the generic version of Novartis' Vymada (Valsartan-Sacubitril) in Jan 2019 under the brand Valsac. While Lupin and Cipla have launched the authorized generics for Vymada at the innovator price, Natco had launched Valsac at a 40% discount to Vymada. Valsac is now under litigation with Novartis being granted an injunction against Natco. The earliest Vymada patent expiry is due in 2023. Natco's gBrilinta (Ticagrelor) launch has faced litigation challenge from innovator AstraZeneca with the court granting an injunction against the sale of the generic version in May 2018. AstraZeneca has also filed similar lawsuits against Dr Reddy's and Micro Labs. Ticagrelor is a two-player market including the innovator and Sun Pharma (authorized generic). Natco expects a favourable outcome in at least one of the two litigations in CY19. With both Valsac and gBrilinta being high-margin products and meaningful opportunities, a favourable outcome could offer significant value addition to Natco's CnD division.

Brazil & Canada: The new frontiers

Post its strategic reset and given its long-term goal of achieving c.80% of revenue outside US, Natco expects its main international markets of Brazil and Canada to be the key earnings drivers over the next 2 years. Natco operates through its subsidiaries in Brazil, Canada, Singapore and Australia. Natco's Kothur facility has been approved by the Brazilian Health Regulatory Agency (ANVISA) and Health Canada. Natco's subsidiaries in Singapore and Australia currently account for less than 10% of its overall revenue from subsidiaries.

Strong visibility on commercialization of oncology pipeline in Brazil & Canada

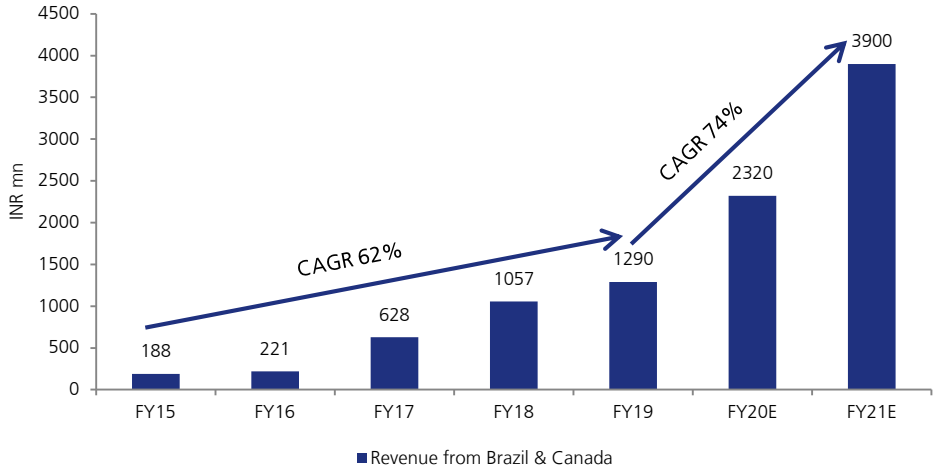
Natco had entered the Brazil market in 2011 and has made 9 oncology filings with ANVISA. However, it achieved its first major breakthrough in Brazil in 2018 with an approval for its first generic version of Letrozole. Natco subsequently received an approval for first-generic version of Everolimus which is expected to generate annualized sales of c. USD 15mn. With the major challenge of gaining product approval from ANVISA now addressed, visibility with respect to approvals of major first-generic oncology filings is increasing. Natco's Brazil subsidiary achieved break even in FY19 and is expected to generate revenue of c. INR 1.3bn in FY20.

Natco had entered Canada in 2012 and has a portfolio comprising a mix of in-house and in-licensed products. Natco has an established front-end network in Canada with its strategy revolving around leveraging its strong US portfolio in the Canadian market. The Canada portfolio comprises 16 products including gTamiflu, gGleevec & gZofran. Natco expects two first-generic approvals in Canada and revenue of c. INR 1bn in FY20.

Natco has made 2 product filings in China and is expected to file more products in FY20. Natco has entered into partnerships with 2 companies in the Chinese market for product filings and front-end distribution and expects to receive its first approval in FY22.

Besides its subsidiary markets, Natco has operations in Europe (mainly UK and Germany) as well as emerging markets such as Vietnam, Mongolia, Myanmar, Venezuela and several other Asian countries. In these RoW markets, Natco mainly operates through JVs or supply agreements with local players and global distributors. Natco's operations in RoW markets are centred around its Hepatitis C and oncology portfolio. Natco is currently working on establishing new channels to drive Hepatitis C sales in these markets. Natco has limited its market penetration in Europe to only a few select products through its marketing partners.

Exhibit 21. Brazil & Canada operations set to witness rapid expansion



Source: Company, JM Financial

Agrochem Foray: Entry into niche molecules to bear fruit

Natco announced its foray into the niche agrichemical business in Jan 2019 with a green-field manufacturing facility in Nellore. Natco has earmarked INR 1bn for the facility which will manufacture agrichemical technical and formulation products. The facility is expected to be commissioned by the end of CY19. Post the completion of field trials and the receipt of regulatory approvals, the facility is expected to be commercialized by FY22. Natco expects the agrichemical business to generate revenue of INR 2bn in FY22.

Natco's agrochem foray is part of its strategy of diversifying its business by reducing the reliance on its US portfolio, identifying opportunities in emerging markets and bringing in new streams of revenue. Natco's skillset in pharma, from a chemistry perspective, offers it a significant competitive advantage in agrochem. Given Natco's track record of identifying niche opportunities in pharma, its niche agrochem venture complements its differentiated R&D platform.

Agrochem foray complements Natco's differentiated R&D platform and skillset in chemistry

In line with its core product strategy, Natco aims to focus on high-margin, difficult to source agrichemical technical products with high manufacturing complexity. Recognising that the agrochem business is a distribution game with distributors having significant bargaining power, Natco is already working with partners to establish a front-end distribution network. The partnership is expected to aid Natco in making inroads into the segment by reaching out to farmers directly.

India's agrichemical industry, including exports, was valued at USD 4.1bn in FY16 and is expected to double in size by FY25 to USD 8.1bn. Natco is expected to focus on products losing patent protection over the next 5 years. Off-patent products account for c.82% of the global agrichemical market. With multiple products coming off-patent over the next few years, the share of off-patent products is expected to increase further.

Exhibit 22. Agrochem Active Ingredients Losing Patent Protection over 2019-2026

Bixafen	Flubendiamide	Mandipropamid	Pyroxsulam
Chlorantraniliprole	Fluopicolide	Penflufen	Sedaxane
Cyantraniliprole	Fluopyram	Penthiopyrad	Thiencarbazone-Methyl
Cyprosulfamide	Fluxapyroxad	Pinoxaden	Valifenalate
Fenpyrazamine	Isopyrazam	Pyriofenone	

Source: Enigma Marketing Research

Natco's Para IV Opportunities: US pipeline underappreciated

Natco has been a late entrant in the US generics space with sales of under USD 20mn until FY16. However, the launch of gTamiflu in Dec'16 (in partnership with Alvogen) and the launch of gCopaxone (in partnership with Mylan) in Oct'17 catapulted Natco into the league of companies with significant US presence. While gTamiflu was the major contributor in FY17 (c. USD 95mn) and FY18 (c. USD 60mn) with gDoxil and gFosrenol also aiding growth, gCopaxone (c. USD 60mn) has been the key growth driver in FY19 and is expected to be the major contributor in FY20-21. Natco has a strong pipeline of 38 approved ANDAs with 20 Para IVs yet to be launched. Natco's Para IV pipeline, the value of which exceeds its current US run-rate (ex-Tamiflu & ex-Copaxone), includes gRevlimid which is its largest opportunity to date and is expected to contribute peak sales of USD 283mn and support its strong growth in the US beyond FY22. An approval for gRevlimid is expected to be received in CY19. Natco is expected to receive final approval for gNexavar (Para IV, Tentative Approval) in H2FY21. gAfinitor and gTreanda are the other two Para IV launches expected in FY22.

Value of Para IV pipeline exceeds current US run-rate (ex-Tamiflu & ex-Copaxone)

Exhibit 23. Natco's major US launches

Innovator Brand	Molecule	Indication	Para IV	Para III
Copaxone	Glatiramer Acetate	Multiple Sclerosis	✔	
Tamiflu	Oseltamivir Phosphate	Influenza	✔	
Doxil	Doxorubicin Hydrochloride	Ovarian Cancer		✔
Vidaza	Azacitidine	Blood Cancer		✔
Fosrenol	Lanthanum Carbonate	Chronic Kidney Disease	✔	
Nuvigil	Armodafinil	Narcolepsy	✔	
Entocort	Budesonide	Crohn's disease		✔

Source: Company, JM Financial

Exhibit 24. Natco's Para IV pipeline

Innovator Brand	Molecule	Indication	US market size (USD mn)
Revlimid	Lenalidomide	Multiple Myeloma	6469
Imbruvica	Ibrutinib	Chronic Lymphocytic Leukemia	2968
Zytiga	Abiraterone Acetate	Prostate cancer	1771
Gilenya	Fingolimod	Multiple Sclerosis	1765
Pomalyst	Pomalidomide	Multiple Myeloma	1391
Aubagio	Teriflunomide	Multiple Sclerosis	1294
Eliquis	Apixaban	Anticoagulant	979
Afinitor	Everolimus (higher strength)	Kidney Cancer	929
Kyprolis	Carfilzomib	Multiple Myeloma	586
Tracleer	Bosentan (lower strength)	Pulmonary arterial hypertension	268
Tarceva	Erlotinib	Pancreatic Cancer	228
Nexavar	Sorafenib	Liver Cancer	216
Jevtana	Cabazitaxel	Prostate cancer	200
Zortress	Everolimus	Kidney Transplant	145
Treanda	Bendamustine Hydrochloride	Chronic Lymphocytic Leukemia	133
Sovaldi	Sofosbuvir	Anti-Viral / Hep C	130
Tykerb	Lapatinib Ditosylate	Breast Cancer	100

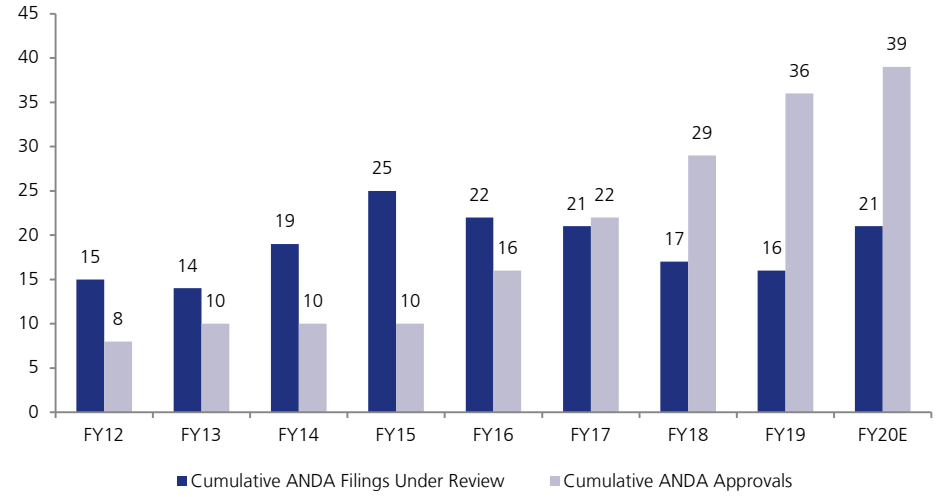
Source: Company, JM Financial

Natco has successfully implemented a partnership strategy to expand its US formulations business. Besides product specific partnerships with global generic players at different stages of a potential ANDA filing, Natco enters into de-risking arrangements with marketing partners whereby the partner bears the responsibility of litigation and the regulatory process to secure ANDA approval. In some cases, it enters into profit sharing arrangements with its front-end partners to participate in the upside as witnessed in gTamiflu (Alvogen), gDoxil (Dr Reddy's) and gCopaxone (Mylan).

Partnership strategy in US aids de-risking litigations & the ANDA approval process

Natco has recently made significant investments (c. INR 2.5bn) towards building a formulations plant in Visakhapatnam SEZ, with both cyto and non-cyto orals capability, in order to de-risk its main formulations plant at Kothur. The plant is currently undergoing plant validation and is expected to be a key contributor of incremental filings for US and other regulated markets. The facility is expected to be commercialized in FY20. The management has guided for 8 ANDA filings in FY20 including 3 niche filings.

Exhibit 25. Cumulative ANDA approvals & filings



Source: Company, JM Financial; Note: Approvals include Tentative Approvals

Copaxone: Making steady gains

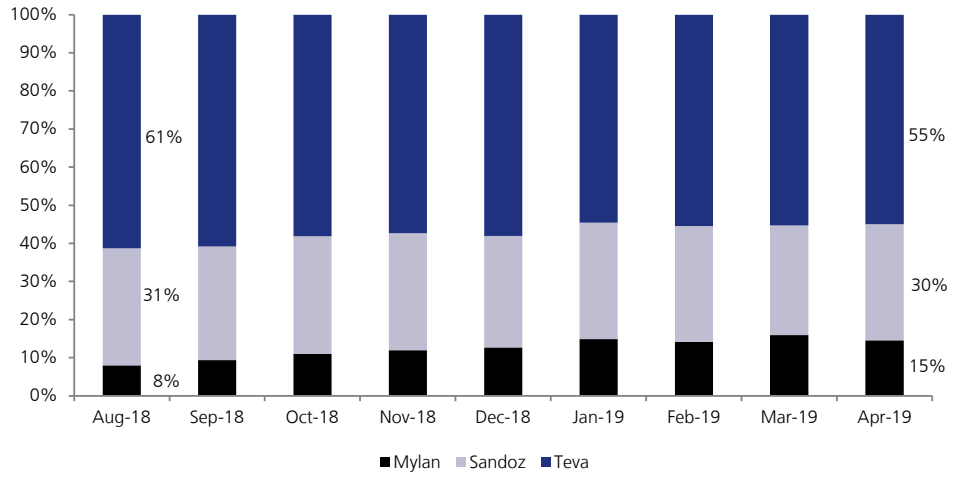
Teva's Copaxone is the most prescribed multiple sclerosis (MS) treatment for relapsing forms of MS in the US with annual brand sales of c. USD 700mn for the 20 mg/mL dose and USD 2.8bn for the 40 mg/mL dose. Natco's partner, Mylan, had launched the generic versions of Teva's Copaxone (both 40 mg/mL and 20 mg/mL versions) in the US market in early Oct 2017 after being the first player to receive approval for gCopaxone 40 mg/mL ANDA. For the 20mg/mL version, Sandoz was the first generic player to have received USFDA approval; it launched the drug in June 2015 and currently has c.30% market share.

gCopaxone to be the largest revenue contributor in FY20 & FY21

Teva successfully converted over 80% of the overall US Copaxone prescriptions to the 40 mg/mL version (launched in Jan 2014) backed by its lower pricing (supported by payer access and patient support activities) as compared to the 20 mg/mL version and higher patient convenience given that it is a 3-times-a-week injection vs the once-daily 20 mg/mL injection.

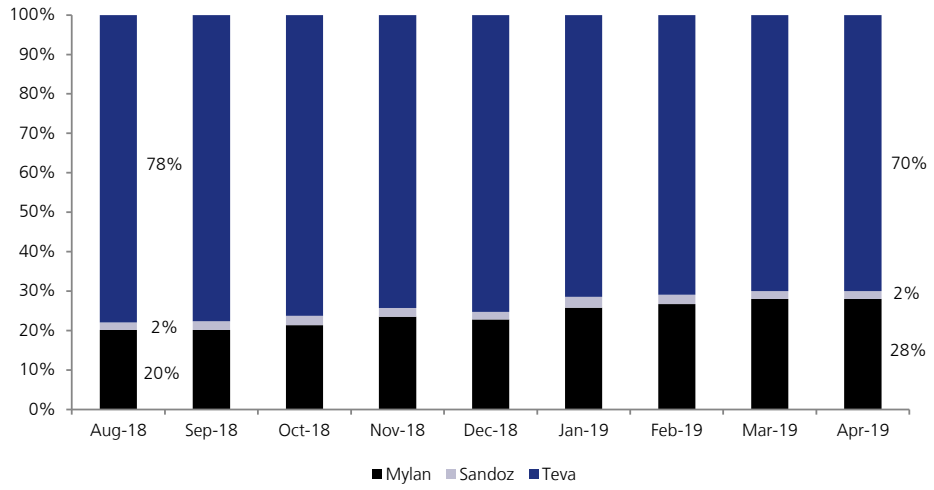
Mylan/Natco's sales have ramped up slowly given that Copaxone is an injectable for which patients initially require external training and support. Generating awareness about interchangeability required considerable marketing support. Moreover, owing to Teva's aggressive arrangements with buyer groups, Mylan had found it difficult to convince buyer groups to accept higher volumes and had to offer steep discounts (c.60%) to push sales. Post price cuts in July 2018, Mylan/Natco has been gaining market share steadily in both 40 mg/mL and 20 mg/mL versions.

Exhibit 26. Copaxone 20 mg/ml TRx market share



Source: Bloomberg, JM Financial

Exhibit 27. Copaxone 40 mg/ml TRx market share



Source: Bloomberg, JM Financial

Despite the prevalence of cheaper and convenient oral treatments for multiple sclerosis such as Tecfidera (Biogen), Gilenya (Novartis) and Aubagio (Sanofi), Copaxone has been able to maintain its leadership position due to its superior safety and efficacy profile. Dr Reddy's, Amneal, Pfizer/Synthon and Biocon/Apotex are among the filers for both versions of gCopaxone. While Synthon had received an approval for its generic 40 mg/mL version in Europe in Oct 2017, Teva's patents were upheld in Europe in April 2019. Dr Reddy's has received additional queries from the FDA and is not expected to receive an approval in FY20. Biocon/Apotex's response to the FDA's CRL has been delayed and an approval in CY19 seems unlikely. Amneal has not guided for a CY19 launch. Given that Sandoz, which had launched the generic 40 mg/mL version in Feb 2018, has struggled to gain market share in 40 mg/mL (currently c.2%), we expect Mylan/Natco to hold on to their market share in 40 mg/mL (c.28%) in FY20 and expect a marginal decline (c.3%) in market share in FY21.

Copaxone to continue to largely be a 3-player market in FY20

Exhibit 28. gCopaxone 40 mg/ml projections for Natco

	FY20	FY21	FY22
Brand sales	2,777	2,777	2,777
Price erosion	70%	70%	70%
Mylan/Natco's Market share	28%	25%	20%
Sales (USDmn)	233	208	167
Margin	70%	70%	70%
Profit (USDmn)	163	146	117
Natco's share	30%	30%	30%
Natco's Profit Share (USDmn)	49	44	35

Source: JM Financial

Exhibit 29. gCopaxone 20 mg/ml projections for Natco

	FY20	FY21	FY22
Brand sales	700	700	700
Price erosion	70%	70%	70%
Mylan/Natco's Market share	18%	15%	10%
Sales (USDmn)	38	32	21
Margin	70%	70%	70%
Profit (USDmn)	26	22	15
Natco's share	30%	30%	30%
Natco's Profit Share (USDmn)	8	7	4

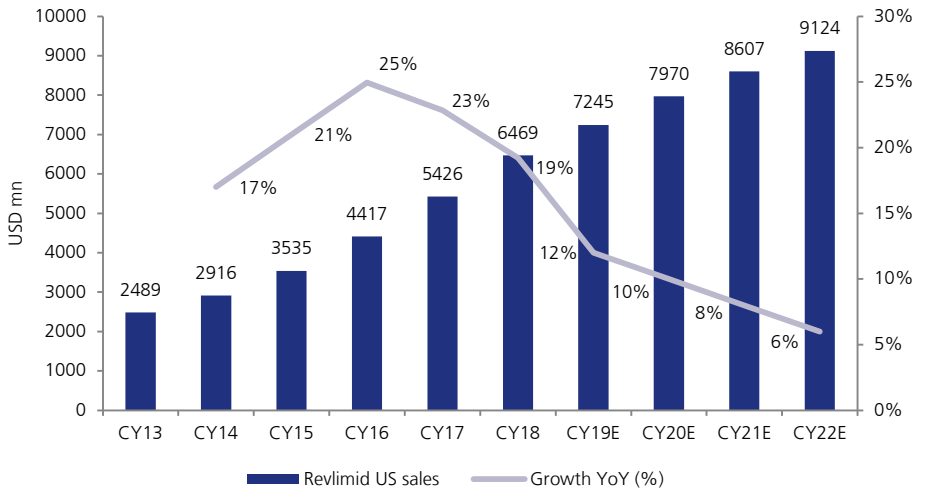
Source: JM Financial

We expect Natco's profit share from gCopaxone 40mg/mL and gCopaxone 20mg/mL to be USD 49mn and USD 8mn respectively, in FY20. We arrive at a fair value of INR 46 for gCopaxone 40mg/ml and INR 8 for the 20 mg/mL version.

Revlimid: Blockbuster waiting in the wings

Celgene's Revlimid, an oral immunomodulatory drug, is the most widely used first- and second-line multiple myeloma therapy and had recorded US sales of c. USD 6.5bn in 2018, posting a CAGR of 21% over 2013-2018 and making it the biggest opportunity in Natco's US pipeline.

Exhibit 30. Revlimid's growth trajectory in US



Source: Company, JM Financial

gRevlimid - Natco's largest Para IV opportunity - to be a strong growth driver beyond FY22

Revlimid (Lenalidomide) is sold in the US through certified pharmacies under the Risk Evaluation and Mitigation Strategy (REMS) program, to avoid embryo-fetal exposure to Lenalidomide, making it difficult to source the samples to carry-out bioequivalence (BE) studies required to develop and file an ANDA for the product and, thereby, limiting competition. Moreover, Revlimid is a complex drug that is difficult to replicate.

In Dec 2015, Celgene settled ongoing litigations with Natco/Allergan and as part of the settlement agreed to allow Natco/Allergan to start selling gRevlimid in Mar 2022, although volumes would be restricted to a mid-single digit percentage of overall US volumes in the first year which would gradually be relaxed every 12 months until Mar 2025, and will be restricted to one-third of overall US volumes until Jan 2026, after which Natco/Allergan will be eligible to sell unlimited volumes. Patents covering Revlimid in the US expire in Apr 2027. Natco's ability to market gRevlimid in the US is now contingent on USFDA approval for its ANDA. Although Natco had partnered with Allergan to market the drug, following the sale of Allergan's generics business to Teva in 2015, Teva will be marketing the product in the US while Allergan will be retaining 50% of Teva's future revenues from gRevlimid.

Dr Reddy's, Mylan, Alvogen, Apotex and Sun Pharma are known to be the other players with gRevlimid in their pipeline. Mylan had sued Celgene in Apr 2014 for refusing to sell sufficient samples of Revlimid and Thalomid capsules needed for BE studies to develop the drug, alleging anti-competitive behaviour. Following this, the Federal Trade Commission filed an amicus brief in favour of Mylan. A separate class action suit has also been filed by insurers & buyers against Celgene for denying samples to generic drug makers. Decisions in Mylan's anti-trust lawsuit and the class action suit are pending. In Feb 2019, the U.S. Patent and Trademark Office dismissed Dr Reddy's bid to invalidate 3 key Revlimid patents expiring in 2023. Celgene has also sued Apotex and Sun Pharma seeking to block their entry before the expiry of the 3 patents. While the litigation is ongoing, chances of a generic launch by Dr Reddy's or other challengers before 2023 are slim. Moreover, any generic entry before 2026 could enable Natco to launch without restrictions on volumes depending on the terms of its settlement. In March 2019, Celgene entered into a settlement, similar to that with Natco, with Alvogen. However, under the terms of the settlement, Alvogen can only launch sometime after the Mar 2022 date granted to Natco.

Natco is expected to receive approval in CY19. We expect Natco to achieve a peak profit share of USD 283mn from gRevlimid. We value the gRevlimid opportunity at INR 143/share.

Exhibit 31. gRevlimid Projections for Natco

	FY22	FY23	FY24	FY25	FY26	FY27	FY28
Revlimid US sales (US mn)	8,737	8,737	8,737	8,737	8,737	8,737	8,737
Price erosion	25%	30%	40%	50%	60%	70%	80%
Teva/Natco's Market share	5%	15%	22%	27%	30%	25%	20%
Sales (USDmn)	27	917	1,153	1,179	1,048	655	349
Margin	80%	80%	80%	80%	75%	65%	60%
Profit (USDmn)	22	734	923	944	786	426	210
Natco's share	30%	30%	30%	30%	30%	30%	30%
Natco's Profit Share (USDmn)	7	220	277	283	236	128	63

Source: JM Financial

Natco's R&D capabilities: A Class Apart

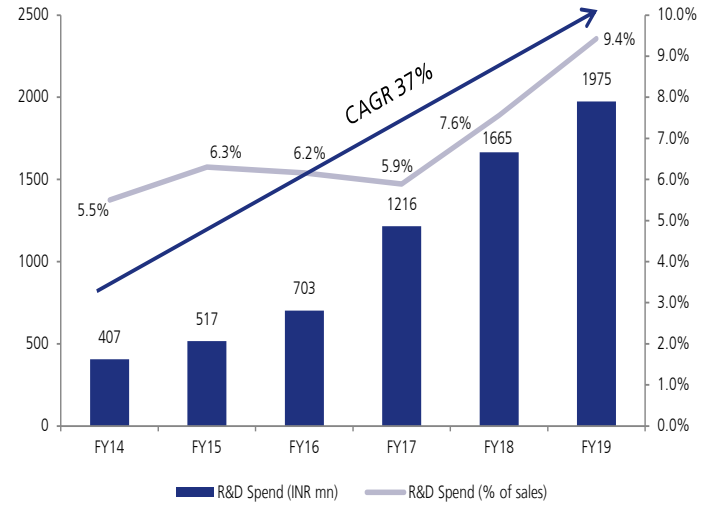
Natco has adopted a differentiated approach towards R&D vis-à-vis its peers, focusing on niche, limited competition products, which is reflected in the fact that c.50% of its ANDA filings are Para IV filings. Natco's R&D strengths are also validated by the fact that it was the first player to launch generics for Tamiflu capsules and gCopaxone 40mg/mL injectables in the US and by the willingness of major global pharma players to tie-up with Natco to market its products in the US. Natco's R&D infrastructure comprises over 40 laboratories across two research facilities employing c.440 scientists with capabilities across synthetic chemistry, biotech & fermentation, nano pharmaceuticals, new drug discovery and cell biology.

Natco's R&D spend grew at a CAGR of 37% over FY14-FY19. Natco's R&D spend increased to 9.4% of sales in FY19 with its strong balance sheet offering adequate room to spend aggressively on complex generic opportunities. While US filings were a major focus area earlier (c.50% of R&D spend), Natco is now increasing its R&D focus on India (c.50%) and other emerging markets (c.20%). Going forward, Natco's R&D strategy for the US market will be driven by identifying big-ticket opportunities along the lines of Copaxone and Revlimid. A major recent big-ticket filing was gImbruvica (Ibrutinib; USD 3bn) which was filed in Jan 2019 in partnership with Alvogen and could potentially be granted FTF exclusivity.

A comparison of Natco's R&D spend with that of other Indian pharma firms with strong R&D focus indicates that Natco's R&D engine is far more efficient with the ability to crack high-value complex generic opportunities with lower R&D outlay. Two key components of Natco's superior technology and R&D platform are its effective R&D filters resulting in the identification of high-value bets and its decision to play to its R&D strengths in the US with its marketing partner bearing the responsibility of litigation and ANDA filing. The backward integration for critical APIs (c.60% of ANDAs including all Para IVs) is a significant competitive advantage for Natco.

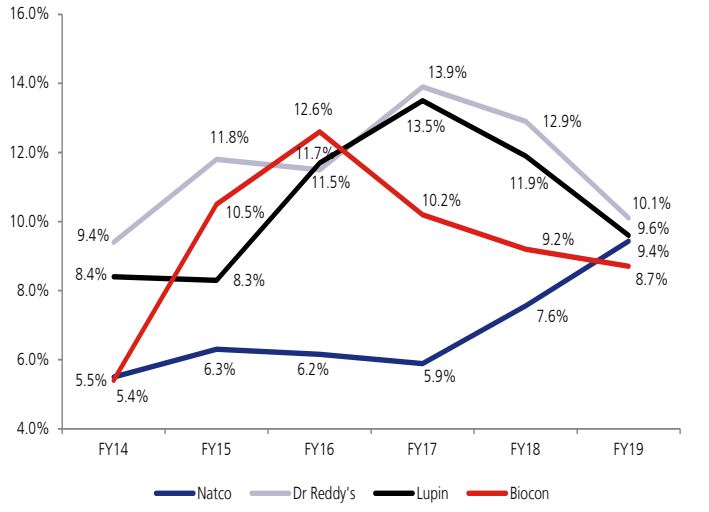
Natco's willingness to make risky bets and its ability to successfully challenge innovators in the domestic market provide it with a head start in both domestic and international markets. Natco's Para IV filings for gRevlimid, gTarceva, gJevtana, gAfinitor, gNexavar, gTreanda, gKyprolis, gPomalyst and gVidaza (Para III), which are all part of its domestic oncology portfolio, and its Para IV filing for gSovaldi, part of its Hepatitis C portfolio, demonstrate its strong ability to leverage its portfolio in international markets. Natco has filed 9 drugs from its domestic oncology portfolio in Brazil and has received approvals for two drugs (Letrozole & Everolimus).

Exhibit 32. Sharp growth in Natco's R&D Spend



Source: Company, JM Financial

Exhibit 33. R&D Spend: Natco vs Peers with strong R&D Focus

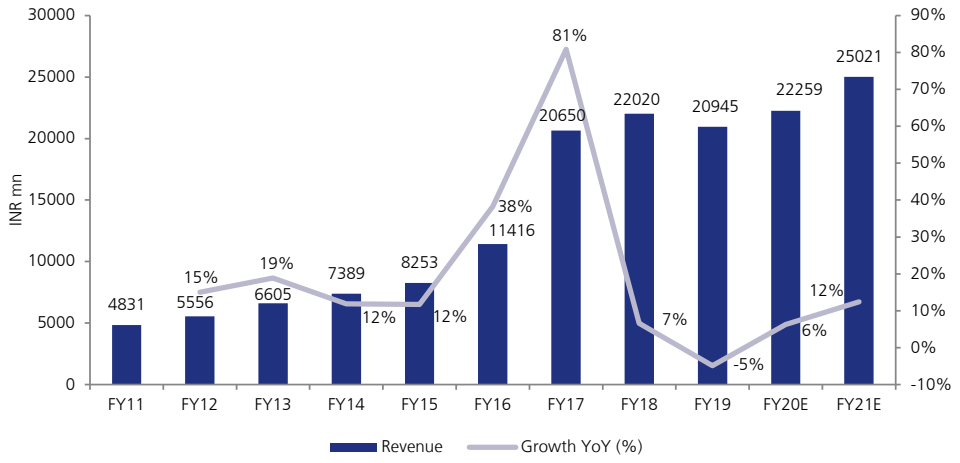


Source: Company, JM Financial

Financial Analysis

While revenue growth in FY20 is expected to be muted with 8 new product launches in India, 4 in international markets (ex-US) and 3 new launches in US expected to offset the decline in contribution from gTamiflu, we expect Natco to revert to a double-digit growth trajectory in FY21 aided by strong double-digit growth in domestic oncology and strong offtake of first-generic launches in Brazil & Canada. We expect the contribution from gCopaxone to be flat in FY20 (USD 57mn) and to marginally decline in FY21 (USD 51mn).

Exhibit 34. Revenue expected to be back on double-digit growth trajectory in FY21

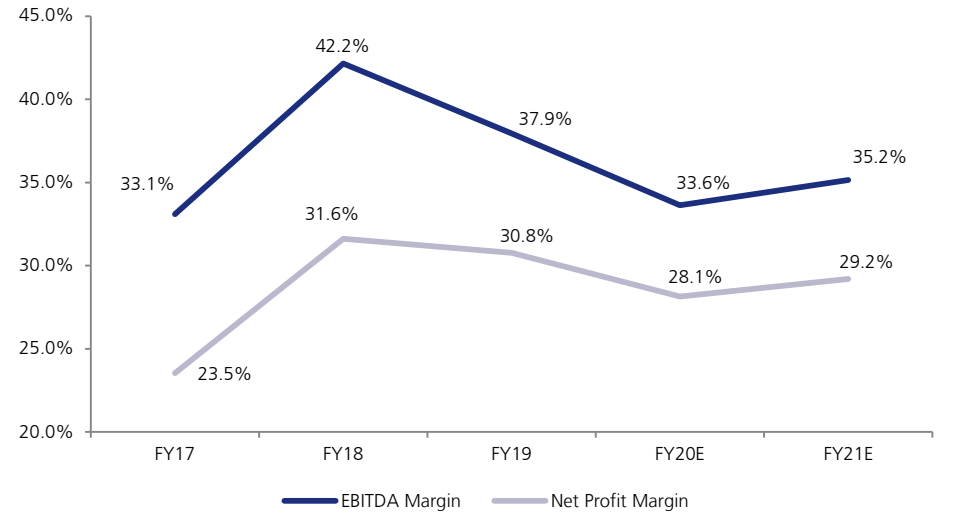


Source: Company, JM Financial

EBITDA margin is expected to compress by 430 bps in FY20 owing to the decline in contribution from high-margin (c.70%) gTamiflu. We expect margins to recover in FY21 aided by strong growth in Brazil & domestic oncology (margins much higher than corporate average). We expect return ratios to remain above 15% levels in FY20 and to recover to 16%+ in FY21.

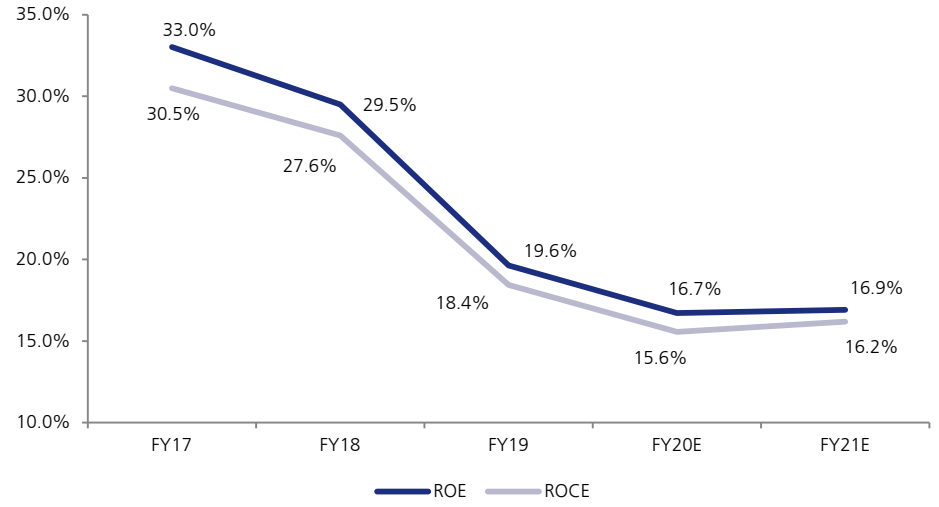
Revenue growth, margins & return ratios expected to recover in FY21

Exhibit 35. Margin recovery expected in FY21



Source: Company, JM Financial

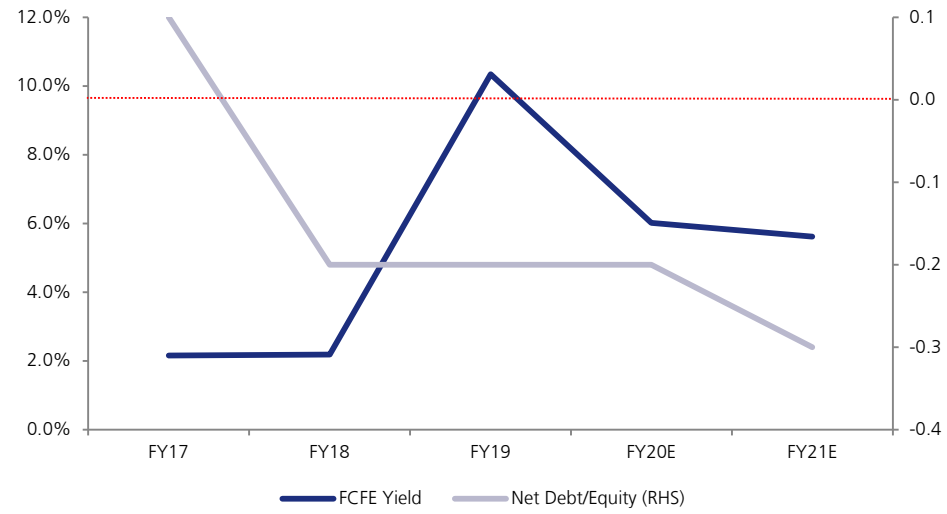
Exhibit 36. Return ratios to remain healthy



Source: Company, JM Financial

Natco is debt-free with its Capex being funded with internal accruals. Despite significant Capex (c. INR 3.5bn) expected to be incurred on the upcoming Visakhapatnam and agrochem facilities in FY20 & FY21, we expect Natco's balance sheet to remain strong.

Exhibit 37. Strong FCFE Yield & Balance Sheet

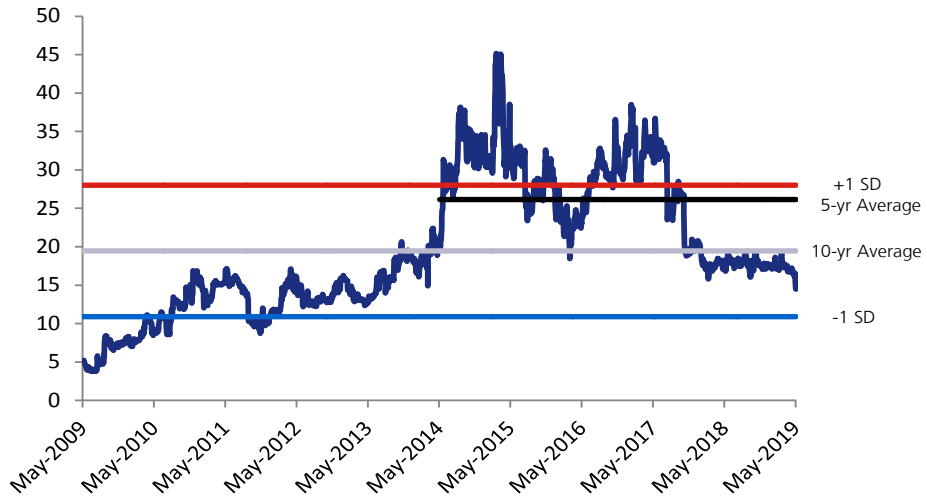


Source: Company, JM Financial

Valuation

Natco is currently trading below its 10-year average trading range and at c.40% discount to its 5-year trading range. We believe that the current valuations barely price in the base earnings (Earnings excluding profit share from niche US launches) with the value of Natco's US portfolio and pipeline not factored in. Given Natco's track record of identifying and exploiting niche opportunities, we believe that the CMP does not capture any potential upside to Natco's base earnings and offers an attractive entry point.

Exhibit 38. Valuations more attractive than ever



Source: Bloomberg, JM Financial

Risk-reward extremely favourable with base earnings barely priced in and valuations at 10-year low

We value Natco's base business at 19x FY21E earnings; its 10-year average trading range. We arrive at an NPV-based value of INR 143/share for the Revlimid opportunity and INR 54/share for the Copaxone portfolio (40 mg/ml+20mg/ml). We estimate the value of Natco's pipeline with near-term launch visibility (Afinitor, Nexavar & Treanda) at INR 15/share. Initiate with BUY with a Mar'20 TP of INR 640.

Exhibit 39. Natco Valuation

FY21E Base Earnings	22.5
Target Multiple on FY21E Base Earnings	19
Base business Value	428
Revlimid	143
Copaxone 40 mg/ml	46
Copaxone 20 mg/ml	8
Others (Afinitor, Nexavar & Treanda)	15
Fair Value (Mar'20)	**640**

Source: JM Financial

Exhibit 40. Peer Comparison

Company	Mkt Cap (Rs bn)	CMP (Rs)	PE (x)			EV/EBITDA (x)			ROE (%)		
			FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E
Alkem Laboratories*	215	1797	34.0	22.0	17.8	21.0	15.4	12.8	13.5	16.6	17.9
Ajanta Pharma*	89	1020	23.2	20.8	17.4	15.5	13.9	11.7	18.1	17.6	18.3
Glenmark Pharma*	150	533	16.9	15.9	13.2	11.3	9.5	8.3	15.4	14.3	15.2
Torrent Pharma	257	1522	35.8	26.8	20.3	14.8	12.8	10.6	15.4	18.8	21.0
Alembic Pharma	94	501	16.1	15.1	14.3	11.6	10.4	9.2	23.8	21.1	18.9
Strides Pharma	38	429	11.8	13.9	10.1	13.6	8.8	6.5	12.7	10.0	12.4
Average			23.0	19.1	15.5	14.6	11.8	9.9	16.5	16.4	17.3
Natco Pharma	100	547	15.6	15.9	13.7	11.5	12.0	9.9	19.6	16.7	16.9

Source: JM Financial, Bloomberg; *Bloomberg Consensus Estimates; Note: Valuations as of 10/Jun/2019

Company Background

Established in 1981 and headquartered in Hyderabad, Natco Pharma is a vertically integrated R&D-driven pharma company engaged in the development, manufacture and marketing of finished dosage formulations and active pharmaceutical ingredients. Natco also offers contract manufacturing services to other leading pharma firms in India. Natco has two well-equipped research centres and seven manufacturing facilities (five formulations and two API) with a formulations facility in Visakhapatnam and an agrochem facility in Nellore currently under development. In India, it is the market leader in oncology and gastro hepatology. Natco entered the domestic cardiology and diabetology segments in 2017. In US, Natco is focused on niche and difficult-to-make complex generics with recent launches such as gTamiflu and gCopaxone highlighting its R&D capabilities. It partners with top generic companies such as Mylan and Teva in the US which de-risks its business and allows it to focus on its core R&D and manufacturing strengths while leaving litigation and marketing to its partners. Natco markets its products in more than 40 countries and operates through its subsidiaries in Brazil, Canada, Singapore and Australia.

Exhibit 41. Timeline of key events

Year	Event
1981	Incorporated Natco Fine Pharmaceuticals Private Limited
1988	Inaugurated Parenterals manufacturing facility at Nagarajuna Sagar, Telangana
1993	Inaugurated Natco Laboratories Limited (Chemical division), Mekaguda, Telangana
1994	Incorporated Natco Organics Limited in Chennai
1995	Natco Parenterals Limited, Natco Laboratories Limited and Dr. Karanth Pharma Labs Private Limited merged into Natco Pharma Limited
1997	Inaugurated Natco Research Centre, Hyderabad
2003	Launched Oncology division with introduction of flagship brand Veenat (generic Imatinib Mesylate) for the treatment of chronic Myelogenous Leukemia
2007	Approval of first ANDA in the United States
2008	First Paragraph IV Certification application in the United States
	Inaugurated facility at Dehradun, Uttarakhand
2011	Incorporated Natco Brazil
2012	Granted compulsory license from Bayer for patent-protected anti-cancer drug Nexavar (generic Sorafenib) in India
2015	Launched generic Sofosbuvir in India and Nepal for Hepatitis C
	Merged Natco Organics Limited with Natco Pharma
2016	Exited US-based pharmacy business
	Launched gTamiflu capsules in the United States
2017	Launched Cardiology and Diabetology divisions for domestic market
	Launched first generic version of Sofosbuvir/Velpatasvir in Nepal
	Launched gCopaxone (20 mg/ml & 40 mg/ml) in the United States
	Launched gDoxil, a complex drug delivery product, in the United States
	Launched generic Tenofovir in India for Hepatitis B
2018	Launched first generic version of Teriflunomide in India for Multiple Sclerosis
	Launched first generic version of Sofosbuvir/Daclatasvir in India
2019	Announced foray in Agrichemical business with a greenfield facility in Nellore, Andhra Pradesh

Source: Company, JM Financial

Exhibit 42. Manufacturing facilities

Facility	Capabilities	Approvals
Kothur, Telangana	Tablets, capsules, pellets and injectables	USFDA, GMP (DCA), German Health Authority, ANVISA (Brazil)
Nagarjunasagar, Telangana	Ampoules, vials, lyophilized vials, parenterals, sterile dry powders	GMP (DCA)
Pharma City, Dehradun	Tablets, capsules, injectables	GMP (DCA)
UPSIDC Industrial Area, Dehradun	Tablets, capsules	GMP (DCA), Public Health Service of the Netherlands (EU GMP)
Guwahati, Assam	Tablets, capsules	GMP (DCA)
Mekaguda, Telangana	API	USFDA, GMP (DCA), German Health Authority, PMDA Japan, Cofepris (Mexico)
Chennai	API	GMP (Director of Drugs Control), USFDA

Source: Company, JM Financial

Exhibit 43. FDA inspection record of Natco's facilities

Facility	Inspection Date	USFDA Status
Kothur, Telangana	June 2019	9 Form 483 observations; observations procedural in nature
	Jan 2017	6 Form 483 observations; EIR Received in July 2017
	Mar 2016	Minor Form 483 observations; EIR Received in Aug 2016
	May 2014	6 Form 483 observations; EIR Received in Sept 2014
Mekaguda, Telangana	Feb 2018	Zero observations; No Form 483 issued
Chennai	Feb 2016	Minor Form 483 observations; EIR Received in Aug 2016

Source: Company, JM Financial

Exhibit 44. Key Management personnel

Management	Bio
V. C. Nannapaneni, Chairman and Managing Director	Mr. V.C. Nannapaneni has over 42 years of experience in the pharmaceutical Industry. He has more than a decade of experience in various pharmaceutical companies in the US. He holds Bachelors and Master's Degree in Pharmacy from Andhra University, India. He also holds a Master's degree in Pharmaceutical Administration from the Brooklyn College of Pharmacy, USA. Along with general management, he oversees Natco's New Drug Discovery programme
Rajeev Nannapaneni, Vice Chairman and CEO	Mr. Rajeev Nannapaneni joined the company in 2000. He has previously worked at Merrill Lynch and Natco Systems LL.C in USA.. He has experience in General Management & New Business/New Product Development in India and in international markets. He holds a B.A. degree in Quantitative Economics and a B.A. in History from Tufts University, Boston, USA.
Dr. Linga Rao, President - Technical Affairs	Dr.D.Linga Rao has over 39 years of experience in the pharmaceutical industry and has been working with Natco for over 21 years. He has vast experience in various departments including R&D, Quality Control and Quality Assurance. He has previously worked with Indian Drug & Pharmaceuticals Limited (IDPL) & Novochem Laboratories. He holds an M.Sc. in Applied Chemistry (Organic Chemistry) & a Ph.D in Chemistry from JNTU, Hyderabad. He has also undergone training on Applications of High Performance Liquid Chromatography in Singapore.
S. V. V. N. Appa Rao, Chief Financial Officer	S. V. V. N. Appa Rao has been Chief Financial Officer of Natco Pharma Limited since 11-Feb'16. Mr. Rao served as Interim Chief Financial Officer of Natco Pharma Limited from Nov'14-Feb'16 and served as its Vice President of Finance & Accounts until 11-Feb'16. He has over 27 years of experience including 22 years within the Company

Source: Company, JM Financial

Key Risks to our thesis

- **Delayed ramp up in Brazil & Canada:** A delay in the ramp up of new first generic launches in Brazil & Canada and in approvals for new products could have an impact on Natco's expansion plans for these two focus markets.
- **Faster erosion in contribution from gCopaxone**: We expect Copaxone to continue to be a 3 player market and Mylan/Natco to maintain their market share in FY20. However, approvals to Biocon/Apotex and Amneal in H2CY19 could result in faster erosion in contribution from gCopaxone.
- **Earlier than expected generic entry in Revlimid:** While Celgene's litigation with Dr Reddy's is ongoing and the chances of a generic entry before 2023 seem remote, an adverse outcome in the litigation for Celgene and an at-risk launch by Dr Reddy's could embolden other challengers (Apotex & Sun) to seek an entry in the lucrative market. Earlier than expected genericisation of Revlimid will result in faster price erosion and have a material impact on our estimates.
- **Adverse observations and regulatory escalation at Kothur**: Natco has had a clean FDA inspection record at its flagship Kothur formulations facility. While the upcoming Visakhapatnam facility will help de-risk filings from Kothur for the US market, adverse observations and regulatory escalation at Kothur could result in a delay in approval for key ANDA filings.

Financial Tables (Consolidated)

Income Statement					(INR mn)
Y/E March	FY17A	FY18A	FY19A	FY20E	FY21E
Net Sales	20,650	22,020	20,945	22,259	25,021
Sales Growth	80.9%	6.6%	-4.9%	6.3%	12.4%
Other Operating Income	0	0	0	0	0
Total Revenue	**20,650**	**22,020**	**20,945**	**22,259**	**25,021**
Cost of Goods Sold/Op. Exp	5,991	4,111	3,542	3,784	4,203
Personnel Cost	2,432	3,256	3,559	4,130	4,623
Other Expenses	5,393	5,369	5,896	6,858	7,398
EBITDA	**6,834**	**9,284**	**7,948**	**7,486**	**8,796**
EBITDA Margin	33.1%	42.2%	37.9%	33.6%	35.2%
EBITDA Growth	153.4%	35.9%	-14.4%	-5.8%	17.5%
Depn. & Amort.	544	662	810	969	1,137
EBIT	6,290	8,622	7,138	6,517	7,659
Other Income	139	404	1,302	1,684	1,843
Finance Cost	185	154	193	181	143
PBT before Excep. & Forex	6,244	8,872	8,247	8,021	9,359
Excep. & Forex Inc./Loss(-)	0	0	0	0	0
PBT	6,244	8,872	8,247	8,021	9,359
Taxes	1,394	1,920	1,823	1,765	2,059
Extraordinary Inc./Loss(-)	0	0	0	0	0
Assoc. Profit/Min. Int.(-)	11	10	20	9	5
Reported Net Profit	4,861	6,962	6,444	6,265	7,305
Adjusted Net Profit	**4,861**	**6,962**	**6,444**	**6,265**	**7,305**
Net Margin	23.5%	31.6%	30.8%	28.1%	29.2%
Diluted Share Cap. (mn)	174.2	179.7	184.0	182.5	182.5
Diluted EPS (INR)	**27.9**	**38.8**	**35.0**	**34.3**	**40.0**
Diluted EPS Growth	206.4%	38.9%	-9.6%	-2.0%	16.6%
Total Dividend + Tax	1,416	1,817	1,501	1,095	1,095
Dividend Per Share (INR)	6.7	8.4	6.5	4.8	4.8

Source: Company, JM Financial

Cash Flow Statement					(INR mn)
Y/E March	FY17A	FY18A	FY19A	FY20E	FY21E
Profit before Tax	6,244	8,872	8,247	8,021	9,359
Depn. & Amort.	544	662	810	969	1,137
Net Interest Exp. / Inc. (-)	82	-97	-1,109	-1,504	-1,700
Inc (-) / Dec in WCap.	-2,528	-2,946	0	-553	-1,162
Others	374	191	0	0	0
Taxes Paid	-1,258	-2,045	-1,823	-1,765	-2,059
Operating Cash Flow	**3,458**	**4,637**	**6,125**	**5,169**	**5,575**
Capex	-2,792	-4,225	-2,896	-3,520	-3,020
Free Cash Flow	666	412	3,229	1,649	2,555
Inc (-) / Dec in Investments	-75	-285	-1,661	0	0
Others	-127	-6,645	-3,295	1,684	1,843
Investing Cash Flow	**-2,994**	**-11,155**	**-7,852**	**-1,836**	**-1,177**
Inc / Dec (-) in Capital	0	8,956	-775	0	0
Dividend + Tax thereon	-1,409	-1,814	-1,501	-1,095	-1,095
Inc / Dec (-) in Loans	2,074	1,732	5,994	2,863	1,363
Others	-158	-158	-193	-181	-143
Financing Cash Flow	**507**	**8,716**	**3,525**	**1,587**	**125**
Inc / Dec (-) in Cash	**-7**	**-18**	**66**	**1,058**	**1,160**
Opening Cash Balance	242	235	217	283	1,341
Closing Cash Balance	235	217	283	1,341	2,500

Source: Company, JM Financial

Balance Sheet					(INR mn)
Y/E March	FY17A	FY18A	FY19A	FY20E	FY21E
Shareholders' Fund	16,493	30,722	34,890	40,060	46,270
Share Capital	349	369	365	365	365
Reserves & Surplus	16,144	30,353	34,525	39,695	45,905
Preference Share Capital	0	0	0	0	0
Minority Interest	41	38	20	11	6
Total Loans	2,216	1,732	3,863	3,363	1,863
Def. Tax Liab. / Assets (-)	150	139	116	116	116
Total - Equity & Liab.	**18,900**	**32,631**	**38,889**	**43,550**	**48,256**
Net Fixed Assets	11,693	14,986	18,648	21,699	24,082
Gross Fixed Assets	11,456	13,955	16,804	20,304	23,304
Intangible Assets	131	149	196	216	236
Less: Depn. & Amort.	3,257	3,918	4,728	5,697	6,834
Capital WIP	3,363	4,800	6,376	6,876	7,376
Investments	322	6,907	8,633	8,633	8,633
Current Assets	11,161	15,258	15,750	17,571	20,336
Inventories	3,489	4,384	5,290	5,622	6,319
Sundry Debtors	4,752	6,375	5,062	5,379	6,047
Cash & Bank Balances	358	1,837	2,795	3,853	5,012
Loans & Advances	35	45	71	71	71
Other Current Assets	2,527	2,617	2,532	2,646	2,886
Current Liab. & Prov.	4,276	4,520	4,142	4,353	4,795
Current Liabilities	2,635	2,699	2,178	2,314	2,600
Provisions & Others	1,641	1,821	1,964	2,039	2,195
Net Current Assets	6,885	10,738	11,608	13,218	15,540
Total – Assets	**18,900**	**32,631**	**38,889**	**43,550**	**48,256**

Source: Company, JM Financial

Dupont Analysis					
Y/E March	FY17A	FY18A	FY19A	FY20E	FY21E
Net Margin	23.5%	31.6%	30.8%	28.1%	29.2%
Asset Turnover (x)	1.2	0.8	0.6	0.5	0.5
Leverage Factor (x)	1.1	1.1	1.1	1.1	1.1
RoE	33.0%	29.5%	19.6%	16.7%	16.9%

Key Ratios					
Y/E March	FY17A	FY18A	FY19A	FY20E	FY21E
BV/Share (INR)	94.7	171.0	189.6	219.5	253.5
ROIC	31.1%	32.3%	21.8%	17.4%	18.3%
ROE	33.0%	29.5%	19.6%	16.7%	16.9%
Net Debt/Equity (x)	0.1	-0.2	-0.2	-0.2	-0.3
P/E (x)	19.6	14.1	15.6	15.9	13.7
P/B (x)	5.8	3.2	2.9	2.5	2.2
EV/EBITDA (x)	14.6	9.9	11.5	12.0	9.9
EV/Sales (x)	4.8	4.2	4.4	4.0	3.5
Debtor days	84	106	88	88	88
Inventory days	62	73	92	92	92
Creditor days	69	77	61	57	58

Source: Company, JM Financial

APPENDIX I

JM Financial Institutional Securities Limited

(formerly known as JM Financial Securities Limited)

Corporate Identity Number: U67100MH2017PLC296081
Member of BSE Ltd., National Stock Exchange of India Ltd. and Metropolitan Stock Exchange of India Ltd.
SEBI Registration Nos.: Stock Broker - INZ000163434, Research Analyst – INH000000610
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Compliance Officer: Mr. Sunny Shah | Tel: +91 22 6630 3383 | Email: sunny.shah@jmfl.com

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Rating	Meaning
Buy	Total expected returns of more than 15%. Total expected return includes dividend yields.
Hold	Price expected to move in the range of 10% downside to 15% upside from the current market price.
Sell	Price expected to move downwards by more than 10%

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