<u>LUPIN – A BEND IN THE ROAD IS NOT THE END OF THE ROAD</u>

Have been tracking Lupin for many years & have remained invested. There have been plenty of ups & downs over the years, the prevailing narrative is that the management has disappointed in execution & Lupin has lost its rigor and is severely underperforming vs other pharma cos. I partially agree to this thesis, the list of disappointments is many, what's gone underappreciated is, if we look beyond the hood of reported nos till date, management is committed to scaling up profitably & lack of intent & energy cant certainly be a reason to write them off.

1. Specialty - outcomes (good money spent in R&D + acquiring assets + front force costs in US) have been way below par. On one hand, I do complement the management strategy of walking on the tough path of trying to make a mark in US specialty. I think Sun + Lupin both understood that to be a serious player in US, and to fructify their longer term scaling plans, they will have to bear serious pain on this. They had the Balance Sheet strength & cash flows, and in my view they took the right call. Now it's not great for us short sighted investors (has not worked out well for me so far), next 2-3 year earnings & ROCE get affected', but this is precisely the reason why they have achieved this level of scale over past 2 decades. The good news is Lupin has shown its willingness to take correction action & adapt, has cut down its specialty operation in the last few quarters, are open to selling Solosec, which means the drag on margins from this area is no longer going to be there.
2. US FDA – Lupin went from having among the best track record upto 2015-2016 vs its peers, to an average or subpar track record today. This clearly was a big disappointment in hindsight. Hopefully, we are at the end of the tunnel on this. Further disappointments can't be ruled out, but are unlikely. It's a matter of time before we get good news here (trigger).
3. US portfolio – their approval on albuterol, filing of Spiriva, looking at their pipeline in general, R&D strength of Lupin is above par. 1 year forward PE can't capture this. Unlike say a Cipla which is heavily focused on inhalation, Lupin's approach vs its peers, for US is to have a relatively more broad diversified array of plays. Whether it is complex generics or inhalation or biosimilar assets or upcoming complex injectable pipeline, I like their approach to diversify risk and not be overly dependent on a few products/areas. This bodes well for a Long Term investor. High spending on R&D is needed, and it does not shun away from taking pragmatic favourable risk reward large value bets and spending money on it. The intent to grow in US is clearly there. I am not in the 'Buy Indian only Pharma stories & ignore export' camp. Cycles peers. Thankfully, they have taken course correction and seem to be balancing their energies when it comes to the US vs India trade-off. I feel we will see acquisitions soon when it comes to the Indian market for Lupin.

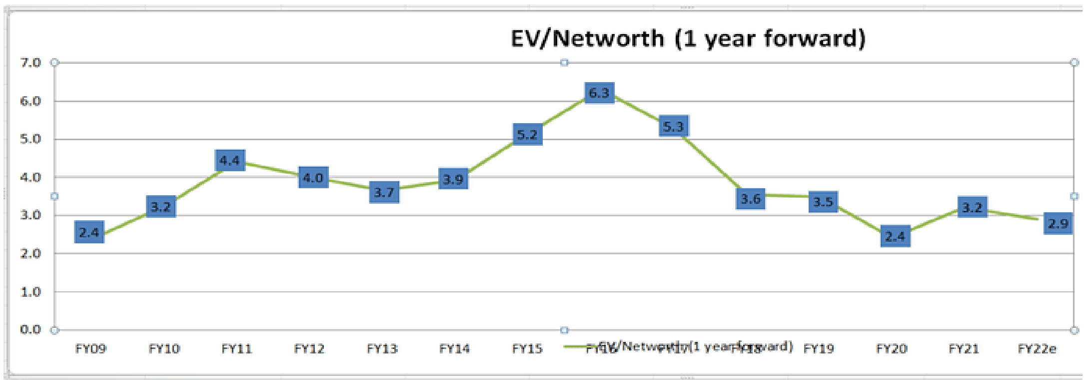
Reported nos of Lupin in recent years is not much to talk about. US sales has been flat, margins have been compressed, earnings growth has just not been there. R&D spending, lack of growth, rising overheads, underutilized capacity is curbing profits/Roic.
Looking beyond reported nos:

1. Divested Japan operation, lightened BS. Sound capital allocation policies overall.
2. Shown its mettle in moving up the value chain and ability to get really tough approvals like Albuterol. Spiriva approval (CY22e) can be a big trigger, a high value complex product.
3. Course corrected on US specialty spends.
4. Renewed focus on India. Launch of new products. Have the scale to drive faster growth.
5. Very conservative on accounting, timely write-offs taken. Pharma only business for the promoters, have rubbished the recent news around them exiting.

Have shown an 'ability to suffer' mindset keeping LT goals in mind.

Margin expansion potential – Given the underutilized capacity, Gross block build up w/out subsequent sales, there is good headroom for margins to go up over time as growth comes. Management at different times have given various indications for what margins can be down the road. 21-22% to 25-26%, from a thread of interviews & concalls. Currently at 16-17%. Historically, Lupin enjoyed 24-28% margins between FY13-FY17. That was the period when they were riding high on exclusive US products with high profitability. Extent of upside will be contingent on what margins they eventually post as operating leverage comes.

Nice set up at the current juncture for triggers/earnings to play out over the next 3 years.
US FDA plants resolution(will aid in margin expansion as it makes it easier on the supply chain), new Indian launches, Spiriva approval, ramp up of albuterol, US generics pricing pressure curtailing, margin expansion potential with time, inorganic moves, recent diagnostics entry(good one I feel). They have also upped the management bandwidth with some key hires made over past 2 years (Check announcements).



Given the cyclicality of nos in Largecap Pharma due to volatile profits, a good way to check valuation on cos is EV/Book. PEs can get misleading here. (930 cmp, taken Kotak estimates for FY22 & FY23)

Regards,
Anubhav Goel

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