

## Health is Wealth – Why we like the Indian Pharmaceuticals Industry

The Indian Pharmaceuticals industry is a story of volumes and affordable healthcare delivery through cheaper generic medicines both onshore and offshore. Whilst the industry has come to prominence through its dominance in the generics segment of the value chain, Indian pharmaceutical companies have been major spenders on R&D leading to a large portfolio of patents.

### Industry Overview:

**Size:** Industry is expected to grow at a **CAGR of ~13%** to reach **~\$70b by 2020**. India is the second largest contributor of global biotech and pharmaceutical workforce. The revenue breakdown is **70%** from **generic** drugs, **21%** from **over-the-counter** medicines and **9%** from **patented drugs**.

**Exports:** Indian pharmaceutical sector is estimated to account for **3.6%** (as of 2016) of the global pharmaceutical industry in **value** terms and **10%** in **volume** terms. India's pharmaceutical exports stood at **US\$ 16.84b in FY17** and expected to reach **US\$ 20b by FY20**. India accounts for **20% of global exports in generics**.

### Growth Drivers for the Sector:

- **Government Initiatives:** Indian Government unveiled 'Pharma Vision 2020' aimed at making India a global leader in end-to-end drug manufacturing and has significantly reduced approval time for new facilities to boost investments.
- **Patent Protection:** The introduction of product patents in India in 2005 gave a boost to the discovery of new drugs. India has reiterated its commitment to IP protection.
- **R&D Spend:** India's top 10 Pharma companies have been continuously growing R&D expenditure as a percentage of sales. For example, Lupin Limited spent ~13.5% of its sales in R&D in FY17 to remain competitive in the patented drug market.
- **Patent Expiry:** About 120 drugs are expected to go off patent over the next 10 years with expected worldwide revenue between US\$ 80b and 250b.
- **Cost Competitive:** **Cost** of production in India is **2/3<sup>rd</sup> that of the US**. Labor cost is half and cost of setting up the plant is 40% lower than western countries. With an aging world and a global push by governments to reduce the costs of healthcare, this makes Indian pharmaceuticals very attractive.

### Opportunities:

- **USFDA Approved Units:** India has the 2<sup>nd</sup> largest number of USFDA-approved manufacturing plants outside the US. It has 2,633 FDA-approved drug products and has over 546 USFDA-approved company sites, the highest number outside the US.
- **Rapid Urbanization and improving quality of life:** Rising incomes is expected to drive 73m households to the middle class over the next 10 years. Over 650m people are expected to be covered by health insurance by 2020. Further, Government-sponsored programs are being set up to provide health benefits to over 380m people below poverty line in 2018.

- **Industry Consolidation:** Some of the larger players are perennially on the lookout for targets to acquire to increase their product portfolio and inorganically grow. Some of the largest M&A deals in India have come from this sector with Sun Pharma's acquisition of Ranbaxy in 2015 the prime example.

### **Sun Pharmaceuticals**

Sun Pharma is our largest position in the India Avenue Equity Fund at around 6.4%. We articulate why this is the case below.

Sun Pharma is the largest Indian and 5<sup>th</sup> largest generic Pharma company in the world. Whilst generics have historically driven most of its revenues, Sun Pharma is moving their business model further towards specialty or branded drugs. They have invested over \$3bn in R&D and currently working on 4 specialty assets. Other generic manufacturers are now starting to follow.

The company has a market cap of US\$19bn and sum of the parts valuation suggests that the US business, which generates US\$2.5bn in revenues, is not being valued given the FDA issues. Sun Pharma's balance sheet is also very strong with US\$1.5bn in cash (strongest Pharma in India) and valuations for the company are at 17-18x FY20. The US FDA recently approved production on a specialty line for the treatment of Psoriasis, developed in partnership with Merck, is expected to be launched in early FY19. This is a high margin business compared to the generic sector and is expected to play out over the next few years.

Sun Pharma is also a prime example of commitment to business and sound corporate governance. This has been demonstrated by the founder of the company, Mr. Dilip Shanghvi who stepped down from the Chairmanship to bring ex-Teva (Largest generic drug manufacturer in the world) President & CEO Mr. Israel Makov for his expertise specifically with the developed markets where Sun Pharma earns majority of its revenues from.

Currently, health care is our second largest sector in the portfolio at around 14%, which includes names like Cipla, Lupin, Natco Pharma and Aurobindo Pharma.

### **Diversification benefits to Australian Investors:**

The Australian pharmaceutical majors have had a focus on patented drug business that is highly profitable if the various clinical trials are successful after years of Research and Development. The entire timeline for a success rate of 0.1% is around 10-15 years depending on the new chemical entity under research.

On the contrary, the generics business is a proven high-volume business which depends on the efficiency of manufacturing and distribution of drugs / chemical entities which have gone off patent. Over 70% of the revenue contribution for Indian pharmaceutical companies is from Generics business contrary to Australian companies.

This provides good diversification to Australian investors who are either invested in Australian Pharmaceutical stocks or are not invested in this segment due to the nature of highly uncertain returns. It adds a greater certainty of cash flows generated from developed markets and the growing middle class in the emerging markets.

**Conclusion:**

The sector has been a significant underperformer over the last few years as pricing erosion in generics as well as FDA issues has impacted the sector. However, this ignores the opportunities and long-term growth drivers of the sector and the current pricing makes the sector very attractive. India's first mover advantage in the International Pharmaceutical Industry has meant they have developed approved facilities, R&D expertise, efficient supply chains, global reach and required international filing to bank on the opportunity to be part of affordable healthcare policies being advocated by first world Governments. We feel India is on the cusp of being the global leader in Pharmaceuticals by addressing the quality concerns and pricing concerns of the Governments world over.

