MARKETS

Why Sun missed the pharma rally: the answer is hidden in a bet many failed — speciality drugs

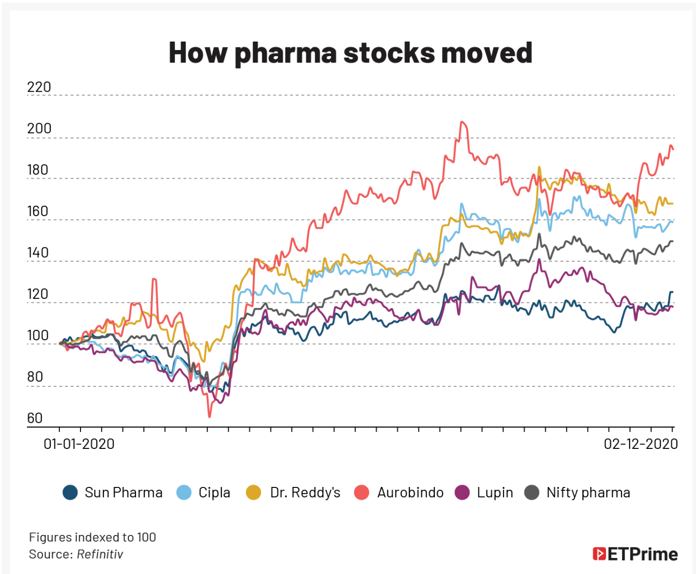
Dilip Shanghvi, founder and managing director, Sun Pharmaceuticals

Synopsis

Sun Pharma is the only Indian company to have made some inroads into speciality drugs. What worries investors is high investments and uncertainties over ramp up in revenue. The stock can still see upside because of its current valuations, strong India business, and any positive surprises in US generic business. But it is crucial that its speciality bet pays off.

pharmaceutical industry. The stocks of **pharma companies** have been on a tear since the beginning of the Covid-19 crisis. The Nifty Pharma index has doubled from its lows in March 2020.

But the narrative is different for **Sun Pharmaceutical** Industries, India's largest pharma company. The company has underperformed its peers such as Dr. Reddy's Laboratories, Cipla, and Aurobindo Pharma as well as the Nifty Pharma index.



So, what is weighing on the **Sun Pharma** stock?

For the last five years, trouble has been surrounding Sun Pharma from all sides. The list is long:

- Persistent quality-compliance issues at its key manufacturing facility at **Halol**, Gujarat
- Price erosion in the US
- Integration of Ranbaxy
- Corporate-governance lapses in India
- Generic drugs price-fixing issue in the US
- And the need for higher investments to build the speciality drugs franchise.

While pricing pressures in the US impacted all generic pharma companies, other issues were specific to Sun Pharma. The earnings growth of the company has been

BACK TO TOP

years. Net profit of the company declined from INR4,546 crore in FY16 to INR3,765 crore in FY20.

Currently, one major factor that is an overhang on the company is uncertainties around its speciality drugs business.

So far in the calendar year 2020, return on Sun Pharma's shares has been -36%, compared with 61% returns given by Dr. Reddy's and 18% by Cipla.

Return on stocks

	Sun Pharma	Cipla	Dr. Reddy's	Aurobindo	Lupin	Nifty Pharma
2016	-23.09	-12.19	-0.92	-23.36	-18.74	-14.18
2017	-29.89	-5.73	-21.33	-20.9	-51.38	-19.59
2018	-46.97	-19.12	-14.03	-15.45	-53.36	-25.87
2019	-46.38	-25.12	-4.83	-47.12	-57.58	-32.79
2020*	-35.98	18.04	61.27	1.47	-50.06	-1.04

*Data is till November 27, 2020
Figures in percent
Source: *Refinitiv*
ETPrime

BY
Isha Trivedi

8 MINS READ

Dec 3, 2020, 05:54 AM IST

Share This Article

GIFT ARTICLE FONT SIZE SAVE COMMENT

The bet on speciality drugs

A few years ago, many leading pharma companies tried to get into the speciality drugs business. The idea was to move up the pharma value chain. But it is a difficult business that requires significant investments and carries higher risks. Hence most companies, including Dr. Reddy's, Cipla, and Glenmark Pharmaceuticals, have re-evaluated their strategies for speciality drugs. We have already told you about it **here.**

Sun Pharma started investing in its speciality business around 2013-14 and made several acquisitions to create its current portfolio. According to some estimates, the company has invested around USD2 billion in the speciality drugs business so far.

Sun Pharma is the only Indian company to have made some inroads into speciality drugs with a portfolio of nine products commercialised in the US market. Its product basket comprises Ilumya, **Cequa**, Absorica, LevulanKerastick, Odomzo, Yonsa, Bromsite, Xelpros, and Infugem.

BACK TO TOP

severe plaque psoriasis; Absorica, used to treat severe nodular acne; and Cequa, used to treat dry eyes.

The company remains committed to scaling up the speciality business, but what worries investors is consistent high investments in this franchise and uncertainties over a meaningful ramp up in revenue.

"The ramp up in Ilumya has been slower than expected in the US since its launch in 2018. The competition in this category of drugs is high with big players such as Johnson and Johnson, Novartis, Eli Lily having strong muscle and hence gaining market share can be difficult for Sun Pharma," says a fund manager on condition of anonymity.

Analyst estimates of peak sales for Ilumya range from USD300 million to USD400 million over the next two-three years. However, the company is conducting clinical trials for additional indications of the drug, which, if successful, may improve revenue potential in the longer run.

In FY20, Ilumya had global sales of USD94 million. The company's total speciality drugs sales worldwide last fiscal were USD429 million, accounting for 9% of its consolidated revenue.

Abhay Gandhi, head of North America business at Sun Pharma said during the FY20 earnings call that the company has made significant investment on Ilumya, not only on the marketing side, but also on doing different clinical trials to improve the label of the product.

"The investment is definitely heavy on this product. Currently, if we look at the sales versus expenses, the product is not profitable, but we feel that with the ramping up of the business, we should be able to absorb these costs and hopefully churn profits going ahead," Gandhi had said.

Although sales of speciality drugs were impacted in the early part of the current year due to the pandemic, they have been recovering in recent months. However, expected to face generic competition this month, which could affect margins and overall performance of the speciality business.

> **"The speciality business has been an overhang on the company's stock but the market is not fully valuing its India business potential."**
>
> *— A fund manager*

According to a note by brokerage firm PhillipCapital, "Sun Pharma's efforts to de-risk its leading brand Absorica (scheduled to go generic in December 2020) by converting patients to its lower-dose version was largely hampered by the Covid disruption, as they saw lower-than-expected 20% conversion by end of Q2FY21. But we believe that potential generic impact ahead and gradual conversion to Absorica LD is largely built in the price."

Meanwhile, Cequa sales have recovered to pre-Covid-19 levels, and the company expects further traction going forward due to its direct-to-consumer marketing efforts. However, this drug may also face competition in the near future, which could hamper growth.

Other issues

The company's generics-drugs business in the US has been subdued due to price erosion, which has been particularly high in the dermatology space.

Consolidation in the distribution channel and rising competition have increased pricing pressure and returns on capital employed have reduced. Sun Pharma's total US sales have declined from INR13,517 crore in FY16 to INR10,543 crore in FY20.

To add to the woes, its Halol manufacturing facility, which was under a warning letter from the US Food and Drug Administration (**US FDA**) from 2015 to 2018, has again received eight observations relating to deviations from good manufacturing practices from

BACK TO TOP

action indicated" in March this year, which means the US regulator will put on hold product approvals from this plant.

The company has 92 abbreviated new drug applications (ANDAs) pending with the USFDA, but approval timelines are uncertain for a significant number of products filed from the Halol unit.

Sun Pharma says it expects two-three generic drug approvals in the US every quarter, which makes it 8-12 products in a year. This is far less than 30 generic drug approvals expected for Dr. Reddy's in the current year.

An analyst says there is no visibility on any big-ticket product approval from the company's generic pipeline and even after Halol issues get resolved, it is unlikely that the generics business in the US can move the needle.

All is not lost

The biggest strength for Sun Pharma is its INR10,000 crore India business, which is expected to see steady growth and margins. It is the largest player in the domestic market, and has recently increased its field force to penetrate further.

Another fund manager says, "The speciality business has been an overhang on the company's stock but the market is not fully valuing its India business potential. At the current valuation, it is cheaper and can see upside because of its strong India business and any positive surprises in generic and speciality business in the US."

BACK TO TOP

The Indian branded generics business has high operating margins of 30-35% and the company expects revenue growth to be in line or higher than industry average.

With challenges in the US business mounting, Sun Pharma had in the last two to three years shifted its focus to India and other emerging markets. The US market contributed over 50% to its revenue in FY16, but accounted for 33% in FY20. Meanwhile, the share of the India business in its total revenue increased from 25% in FY16 to 30% in FY20.

Although uncertainties around speciality drugs remain, the downside risks from here on seem limited and hence most analysts have a buy recommendation on the company's stock.

BACK TO TOP

the last few years on the speciality front will now start to fructify as revenue from these drugs picks up.

"In our view, the operating leverage from the ramp up in the speciality business can drive meaningful margin expansion, even after building in a continued increase in R&D. Sun Pharma's valuation, at a 13x EV/Ebitda, does not factor in the ~14% FY21E-23E Ebitda CAGR (assuming a 26% R&D increase) and visibility for speciality-business-driven growth," brokerage firm JP Morgan said in a report.

However, the company will have to continuously look at adding more products to its speciality basket through acquisitions or in-licensing to gain scale in this business. This means by the time one or two products become profitable, the company will be investing again in new product additions, which may keep a check on profitability.

"Sun Pharma has taken a 10-to-20-years call to become a strong speciality generic global company, and in order to get there, it will have to go through the phases of volatility in its profits because it will have to keep in-licensing new assets for the speciality business. The strategy makes sense in the long term but the investment horizon of investors needs to match the horizon of the promoters," says Aditya Khemka, fund manager at InCred AMC.

The company has the past record of turning around businesses and a strong balance sheet to pursue organic as well as inorganic growth opportunities. Now it is critical for Sun Pharma to win the speciality drugs game.

(*Data support by Rochelle Britto*)

(*Graphics by Mohammad Arshad*)

The latest from ET Prime is now on Telegram. To subscribe to our Telegram newsletter click here.

BACK TO TOP