BP WEALTH

Hikal Ltd

Initiating Coverage

Targeting Profitable growth

December 2018

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Hikal Ltd

Buy

BP WEALTH

Pharmaceuticals & Chemicals | Initiating Coverage — **24th December 2018**

Company Background

Hikal Limited is engaged in manufacturing of various active ingredients, intermediates and R&D services to global pharmaceuticals, animal health, crop protection and specialty chemicals companies. Its segments include: crop protection and pharmaceuticals, which accounted for 58% and 42% respectively, of operating revenues in FY18. The pharma business currently is divided almost equally between generic active pharma ingredients (APIs) and contract research & manufacturing (CRAMs) businesses. Animal health business accounts for 8-10% of overall pharma revenues. In agrochem, 70% of revenues are derived from CRAMs with the remainder from proprietary products. Hikal owns five manufacturing facilities: Taloja, Mahad (Maharashtra), Panoli (Gujarat) Jigani (Karnataka) & an R&D centre at Pune. More than 70% of revenues are derived from export markets mainly Europe, US and Japan.

Investment Rationale

Pharmaceutical Business: Favourable demand from existing products and new introductions to drive growth

The Pharmaceutical business revenue is equally divided into CRAM's and proprietary products (API) business. In the CRAMs segment, the company offers early-stage R&D services such as synthesis, scale-up, API development, stability studies and method development all the way through manufacturing services, ranging from preclinical R&D material for clinical trial purposes and commercial production, Phases I through IV. As part of the proprietary portfolio, the company has filed 3 DMFs in FY18 and guided for 4 to 5 DMF filings in FY19. As on Q2FY19, Hikal has filled 28 DMFs including Pregabalin which is used for neuropathic pain, Sitagliptin which is an anti-diabetic, Quetiapine which is an anti-psychotic and Venlafaxine which is an anti depressant and Vildagliptin is an oral anti-diabetic. On observing all DMF's, we believe Vildagliptin can turn out to be a big revenue opportunity as there are only 5 other DMF fillers-implying limited competition as compared to >20 DMF fillings in the rest of the APIs filled by the company. In the case of Pregabalin for which a DMF was filed in 2014, although the global product launches is expected in December 2018, revenues are gaining momentum with an early launch in the European Union and other semi-regulated markets where the product is off- patent. We expect Pregabalin API to add around Rs450-500mn in FY20-21E for the company and can grow at healthy pace thereafter. The company is the world's largest supplier of Gabapentin (CNS) API with 33-36% market share. Gabapentin contributed around 35-40% of the pharmaceutical segment revenue in FY18. The molecule has shown steady volume growth, despite being off-patent and has supported growth for the company. Going forward, further growth is projected for this API with expected capacity expansion owing to increasing demand from customers. We expect the pharmaceutical business revenue to clock CAGR of 17.7% over FY18-21E,better than 12.2% CAGR over FY14-18, on the back of expected commercialization of 5-6 products and strong volume growth in existing products led by health demand. On the margin front, we expect introduction of high margin products and several cost rationalization initiatives taken at pharmaceutical manufacturing plants to result in margin improvement.

Crop Protection business: Stability in performance is visible

Crop protection business is split between Contract manufacturing for global innovators (CRAMs) which makes up around 70% of the revenue and the Proprietary segment which accounts for the remaining 30%.This segment is dominated only by a few large companies resulting in high concentration. Along with building its own portfolio of products, Hikal also enjoys global and exclusive supplier status for some molecules. As per the management, competition in this segment is lower than pharma, largely due to fewer players and consolidation among large players. The company has enhanced focus on its own products in Agri (versus entire focus on CRAMS earlier) and is beginning to develop some innovative agrochem products too. For crop protection, Hikal has a pipeline of 3-4 products/year, of which 1-2 products would be its own products. Owing to the above factors the management is targeting to achieve 50:50 revenue split between CRAMs and Proprietary products over the coming years. Sales of Thiabendazole, one of the legacy crop protection products showed stable growth in recent year. The product is extremely versatile and is used in both crop protection to control mould and other fungal diseases in fruits and vegetables, as well as an anti-parasitic to control roundworms. It is also used in the materials protection industry to prevent fungal growth. We expect sales of Thiabendazole to grow marginally in the near future. On the specialty chemicals front, Hikal is working on the development of two products with wide usage in the chemical industry. These products have a wide range of applications including that of an antiseptic disinfectant. The company expects to commercialize both these products in the near future. As a part of future strategy, the company is progressing towards more value added products and opening newer and emerging geographies like Russia, Latin America and others where they are gaining traction. New product commercialization will help company to reduce client and product concentration. Moreover, management sounds optimistic about the future demand for the existing product portfolio as well. We expect taking above all into consideration; crop protection business is set to post revenue CAGR of 17.2% over FY18-21E with 51bps improvement in EBITDA margin (20.8% in FY18 vs 21.3% in FY21E).

Stock Rating

BUY	HOLD	SELL
> 15%	-5% to 15%	< -5%

Sector Outlook — **Positive**

Stock

CMP (Rs)	158
Target Price (Rs)	224
BSE code	524735
NSE Symbol	HIKAL
Bloomberg	HKCI IN
Reuters	HIKA.BO

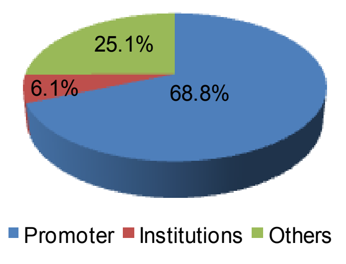
Key Data

Nifty	10,754
52 Week H/L (Rs)	207/130
O/s Shares (Mn)	123
Market Cap (Bn)	19.5
Face Value (Rs)	2

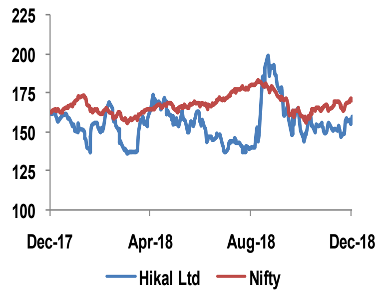
Average volume

3 months	4,07,847
6 months	5,85,561
1 year	3,92,490

Share Holding Pattern (%)



Relative Price Chart



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Financial performance to improve further

Hikal had witnessed strong revenue growth of 14.8% CAGR over FY13 to FY18, whereas profit had grown at 24.8% CAGR over the same period. During this timeframe, the EBITDA margin remained in the range of 19-22%. Chinese supply disturbances in the company's raw materials had impacted the company's gross margins in FY18 (contracted by 374bps vs FY17). However, the management is confident of restoring gross margins to ~50% on a gradual basis on the back of introduction of high margin products and backward integration in some of its products .With improving operating efficiency, we expect the EBITDA margin to expand at a higher rate than the gross margin due to cost rationalization measures taken at pharmaceutical plant along with improving utilization levels. Going ahead, the management expects the tax rate to remain at 32-33% level (We have taken 33%). There has been deterioration in RoE from 16.2% to 12.1% over FY13-18, on the back of slower earnings growth. We expect the return ratios to remain in the range of 15-18%, as growth normalizes. As part of its expansion plan, Hikal has incurred around Rs 4bn in capex during FY13-18 and is in the process of further infusing Rs 3bn in capex over the next 3 years (Incl FY19),which would be majorly directed towards their Panoli plant (Gujarat) in order to further strengthen backward integration facilities. The company expects an asset turnover of around 1.5x-1.75x from the newly built capacities, translating into a blended asset turnover of 1.4x by FY21E, improving from 1.1x in FY18.

We have valued Hikal based on 18x (in line with Cyclically Adjusted Price Earnings (CAPE) 10yr Avg P/E) FY21E earnings and arrive at a target price of Rs 224(potential upside of 42% from CMP) for an investment horizon of 12-15 months.

Why we like this stock & valuation methodology

We expect the company to post 17.5% revenue CAGR over FY18-21E led by commercialization of new products and favourable demand in the existing product portfolio for both businesses. We forecast 137bps EBITDA margin expansion over FY18-21E led by better product mix and operating efficiency on account of higher utilization levels and cost rationalization measures at the Pharma facility. We estimate 25.7% PAT CAGR on the back of better operational performance. Considering the expected strong growth in profitability, healthy balance sheet, improving return ratios and good corporate governance practices, we are optimistic about the long-term growth prospects of the company. At the CMP (Rs 158), the stock is trading at 15.7x its FY20E EPS of Rs 10 and 12.7x its FY21E EPS of Rs 12.4. We initiate coverage on the stock & recommend 'BUY' rating with a target price of Rs 224 per share. Our target price is based on 18x (in line with Cyclically Adjusted Price Earnings (CAPE) 10yr Avg P/E) FY21E earnings.

Key Financials							
YE March (Rs. mn)	**FY15**	**FY16**	**FY17**	**FY18**	**FY19E**	**FY20E**	**FY21E**
Revenue	**8,719**	**9,256**	**10,139**	**13,001**	**15,392**	**17,977**	**21,085**
Revenue Growth (Y-oY)	*5.1%*	*6.2%*	*9.5%*	*28.2%*	*18.4%*	*16.8%*	*17.3%*
EBITDA	**1,825**	**1,809**	**1,972**	**2,417**	**2,961**	**3,532**	**4,210**
EBITDA Growth (Y-o-Y)	*(2.6%)*	*(0.9%)*	*9.0%*	*22.6%*	*22.5%*	*19.3%*	*19.2%*
Net Profit	**405**	**413**	**707**	**772**	**999**	**1,237**	**1,533**
Net Profit Growth (Y-o-Y)	*(36.8%)*	*2.0%*	*71.0%*	*9.3%*	*29.4%*	*23.8%*	*23.9%*
Diluted EPS	**3.3**	**3.4**	**5.7**	**6.3**	**8.1**	**10.0**	**12.4**
Diluted EPS Growth (Y-o-Y)	*-36.8%*	*2.0%*	*71.0%*	*9.3%*	*29.4%*	*23.8%*	*23.9%*
No of Diluted shares (mn)	**123**	**123**	**123**	**123**	**123**	**123**	**123**
Key Ratios							
EBITDA (%)	**20.9%**	**19.5%**	**19.4%**	**18.6%**	**19.2%**	**19.6%**	**20.0%**
NPM (%)	4.6%	4.5%	7.0%	5.9%	6.5%	6.9%	7.3%
RoE (%)	**7.8%**	**7.5%**	**12.1%**	**12.1%**	**14.1%**	**15.5%**	**16.8%**
RoCE (%)	12.6%	11.3%	11.2%	12.3%	14.3%	16.7%	18.4%
Tax Rate %	**32.3%**	**22.5%**	**15.1%**	**30.7%**	**33.0%**	**33.0%**	**33.0%**
Book Value Per share (Rs.)	43.3	45.8	49.1	54.3	60.8	69.0	79.0
Valuation Ratios							
P/E (x)	**48.1x**	**47.2x**	**27.6x**	**25.2x**	**19.5x**	**15.7x**	**12.7x**
EV/EBITDA	13.0x	13.3x	12.6x	10.3x	8.3x	7.0x	5.6x
P/BV (x)	**3.7x**	**3.4x**	**3.2x**	**2.9x**	**2.6x**	**2.3x**	**2.0x**
Market Cap. / Sales (x)	2.2x	2.1x	1.9x	1.5x	1.3x	1.1x	0.9x

Source: Company, BP Equities Research

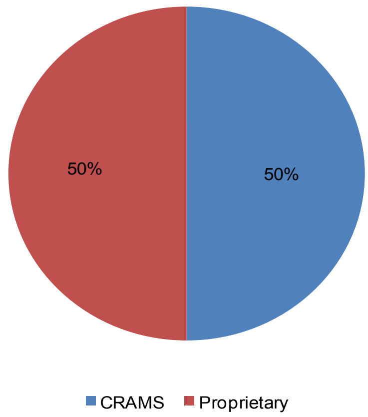
Investment Rationale

Pharmaceutical business: Favourable demand from existing products and new introductions to drive growth

The Pharmaceutical business revenue is equally divided into CRAM's and proprietary products (API) business. In the CRAMs segment, the company offers early-stage R&D services such as synthesis, scale-up, API development, stability studies and method development all the way through manufacturing services, ranging from preclinical R&D material for clinical trial purposes and commercial production, Phases I through IV. As part of the proprietary portfolio, the company has filed 3 DMFs in FY18 and guided for 4 to 5 DMF filings in FY19.

As on Q2FY19, Hikal has filled 28 DMFs including Pregabalin which is used for neuropathic pain, Sitagliptin which is an anti-diabetic, Quetiapine which is an anti-psychotic and Venlafaxine which is an anti depressant and Vildagliptin is an oral anti-diabetic. On observing all DMF's, we believe Vildagliptin can turn out to be a big revenue opportunity as there are only 5 other DMF fillers-implying limited competition as compared to >20 DMF fillings in the remainder of the APIs filled by the company.

Revenue Breakup in %



DMF#	SUBMIT DATE	SUBJECT	DMF FILLERS
14182	6/1/1999	PENTOXIFYLLINE	10
16060	7/24/2002	GABAPENTIN	14
16476	3/13/2003	BUPROPION HYDROCHLORIDE	32
16710	7/15/2003	ONDANSETRON HYDROCHLORIDE USP	20
18815	9/15/2005	GEMFIBROZIL API	20
18829	9/3/2005	ONDANSETRON USP	20
19019	12/8/2005	TRIPROLIDINE HYDROCHLORIDE API	13
19104	1/10/2006	LEVETIRACETAM API	35
22956	7/18/2009	VENLAFAXINE HYDROCHLORIDE API	44
23567	2/22/2010	MEMANTINE HYDROCHLORIDE USP	29
24087	8/18/2010	QUETIAPINE FUMARATE API	46
27611	9/30/2013	DONEPEZIL HYDROCHLORIDE API	30
28025	2/18/2014	VENLAFAXINE BASE	46
28335	5/24/2014	GABEPENTIN (A01804)	29
28421	6/21/2014	BUPROPION HYDROCHLORIDE USP [PROCESS-2]	32
28663	9/19/2014	PREGABALIN USP	40
29688	8/12/2015	PREGABALIN (PROCESS-II)	40
29933	10/14/2015	VILDAGLIPTIN	6
30345	2/25/2016	LACOSAMIDE	22
30433	3/22/2016	OLMESARTAN MEDOXOMIL	40
30456	3/29/2016	VALACYCLOVIR HYDROCHLORID USP	19
31579	3/17/2017	SITAGLIPTIN PHOSPHATE	34
31613	3/25/2017	DABIGATRAN ETEXILATE MESYLATE	26
31875	6/29/2017	BUTORPHANOL TARTRATE	8
31971	7/29/2017	CELECOXIB	26
32364	12/29/2017	APIXABAN	28
32570	9/12/2018	EMPAGLIFLOZIN	21
32571	4/30/2018	DAPAGLIFLOZIN (Dapagliflozin Propanediol Monohydrate)	19

Source: USFDA, BP Equity Research

As on Q2FY19, Hikal has filled 28 DMFs and expect to file 4-5 DMFs every year

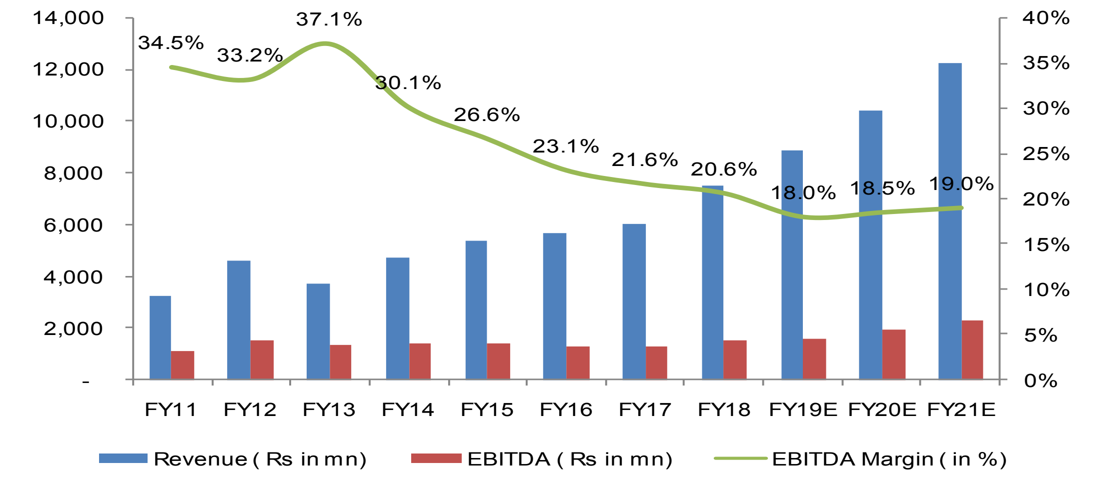
The company is the world's largest supplier of Gabapentin (CNS) API with 33-36% market share. Gabapentin contributes around 35-40% of the pharmaceutical segment revenue. The molecule has shown steady volume growth, despite being off-patent and has supported growth for the company. Going forward, further growth is projected for this API with expected capacity expansion owing to increasing demand from customers.

In the case of Pregabalin for which a DMF was filed in 2014, although the global product launch is expected in December 2018, revenues are gaining momentum with an early launch in the European Union and other semi-regulated markets where the product is off- patent. We expect Pregabalin API to add around Rs450-500mn in FY20-21E for the company and can grow at healthy pace thereafter.

The three-pronged strategy for API development (already generic, to be generic and future generic) will help generate revenues in the short-term, as well as build a pipeline from a long-term perspective. Hikal continues to work on implementing new technologies and develop innovative processes that will differentiate the company from other API suppliers.

Going forth, Hikal will file DMFs with novel processes having identified 6-8 new products for generic development. Furthermore it intends to file 4-5 DMFs to develop a healthy pipeline of commercial APIs every year. The products selected will be a combination of client requirements and niche molecules where the company has a definitive technology edge, to gain market share backed by our expertise in advanced chemistry and backward integration.

Revenue expected to accelerate and margin to stabilize with some improvement



Source: Company, BP Equity Research

What led to decline in EBITDA margin?

During FY14, one of the major client had made changes in the contract (3 products) . As per the earlier contract, the client used to provide raw material for manufacturing API to Hikal on a cost plus basis, with Hikal converting it into APIs. As per the changes, Hikal needed to prepare APIs by sourcing from the intermediate suppliers, which then resulted in a sharp fall in the EBITDA margin. However, the management believes that this was a one time event and future occurrence is unlikely.

The process of expanding the Panoli facility for API manufacturing would help the company in de-risking its Bengaluru plant for manufacturing APIs. The Strategy of a two-site production base woukd enable the company to cater to increased volumes and offer a wider range of products. The company has guided capex of around Rs 1.25-1.5bn (50% of overall capex) over 2-3 years in pharmaceutical segment.

We expect the pharmaceutical business revenue to clock CAGR of 17.7% over FY18-21E,better than 12.2% CAGR over FY14-18, on the back of expected commercialization of 5-6 products and strong volume growth in existing products led by health demand. On the margin front, we expect introduction of high margin products and several cost rationalization initiatives taken at pharmaceutical manufacturing plants to result in margin improvement.

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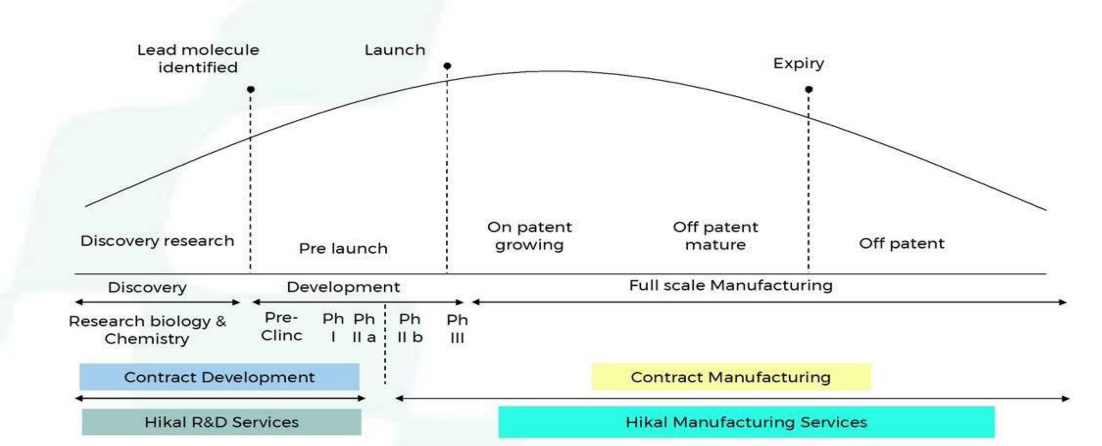
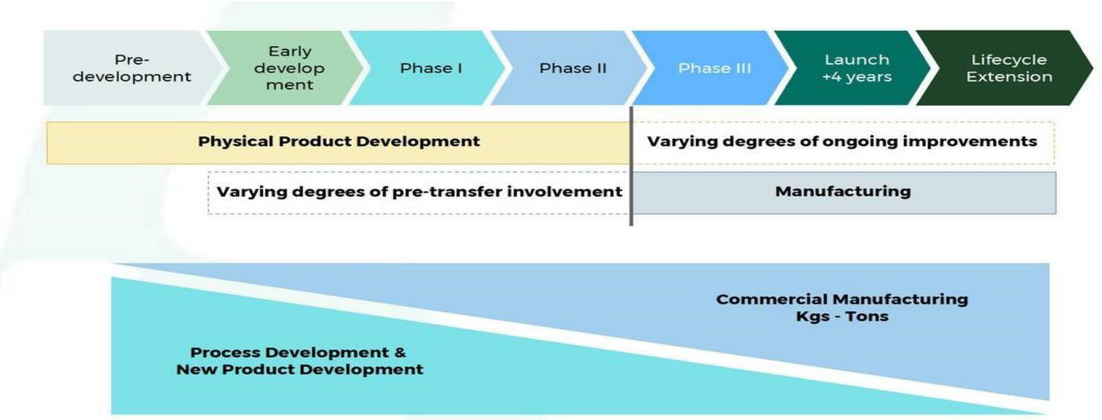
Value chain



Source: Company

Contract Development & Manufacturing



Source: Company

Strong Regulatory Track record

2004	USFDA approval of Bangalore Pharmaceutical manufacturing site
2008	Second successful US FDA Audit of Bangalore facility
2011	Bangalore clears its 3rd successful US FDA audit
2012	Panoli certified by the USFDA
2012	Panoli & Bangalore sites receive PDMA approval
2013	Panoli & Bangalore Pharma sites are EU Audited
2014	Successfully completed EDQM (European Directorate for Quality of Medicines}
2014	Audit at Bangalore site 4th Successful US FDA audit for Bangalore facility
2017	5th Successful US FDA audit for Bangalore facility
2018	2nd Successful PMDA approval for Bangalore facility

Source: Company, BP Equity Research

Compliance track record remain strong as their facilities are inspected by global innovators on regular basis give less room for regulatory lapses.

Entering into animal healthcare space to provide further diversification

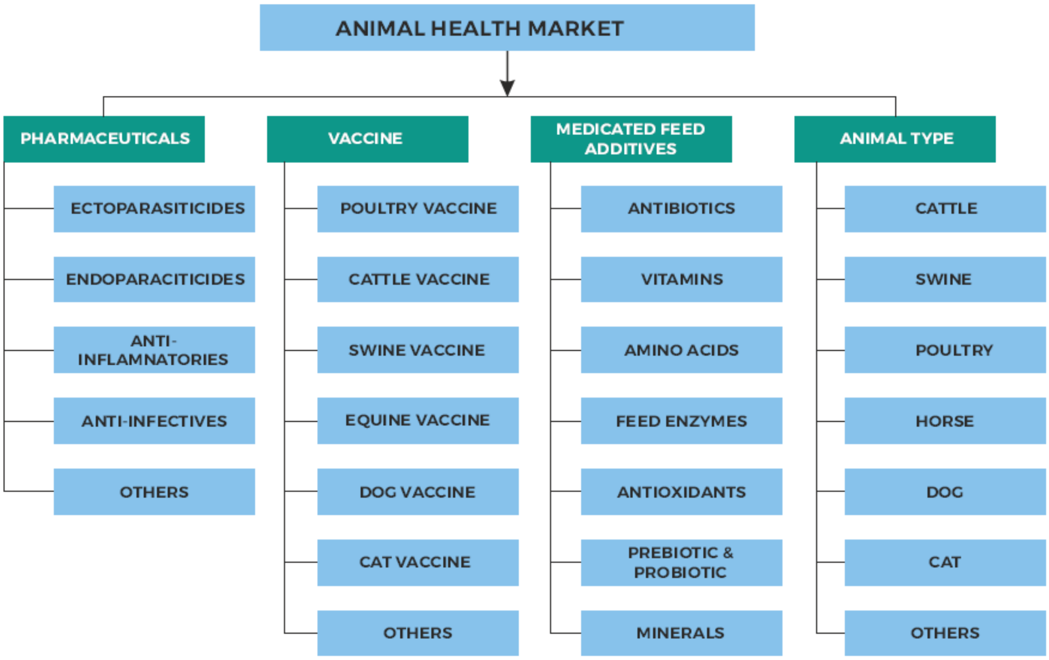
Animal healthcare also remains in focus, though it is not reported as separate segment yet (products are reported under their respective segments currently). The Segment revenue is currently 8-10% of overall pharma revenue and the management expects it to grow at better rate than the company's growth. Flexibility of the facility and chemistry competencys (through R&D) are suitable for value based services in this fast growing market. The company has been investing in its Animal Health business since the last few years and plans to do so in the coming years as well. As part of the future strategy, the company also plans to treat this business as a separate unit, as it requires a focused effort. It started off with four clients that rank among the top 8 global animal health companies in the world, and are in active discussions with the remaining. We believe, that the company would continue to add new clients and develop a pipeline in the coming years.

Under an exclusive manufacturing contract with a leading US based veterinary drug innovator ,the company manufactures a non-antibiotic veterinary drug API that is used to prevent coccidiosis, a disease that threatens newly arrived cattle that often have a compromised immune system. Hikal had invested significantly to expand capacity for this product and is expected to substantially increase volumes going forward.

The company has also developed two APIs in this segment. One of them has a dual application and is also used as a human health product. Additionally, they have also filled a US DMF this year and realized revenue for sales of the product during FY18. For the second product, the company has submitted its first US Vet Master File (VMF) on Nov 18. Hikal has developed several advanced intermediates for some of the new generation ectoparasitic (Anti Tick) APIs ,which are already seeing interest from several customers globally and is expected to commercialize these products in the near future. Due to limited historical data , we have not forecasted animal healthcare contribution separately.
As per an industry report, the global animal health market was valued at US$32bn in 2016 and is expected to reach US$53bn by 2025 expanding at a CAGR of 5.6% from 2017 to 2025.

Global Animal Health Market Overview

The animal healthcare market is broadly divided into the below segments



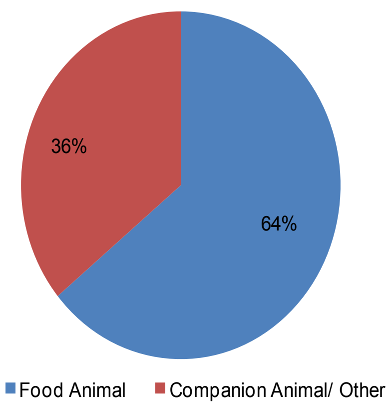
Source: Company

Animal Healthcare by Animal Type:

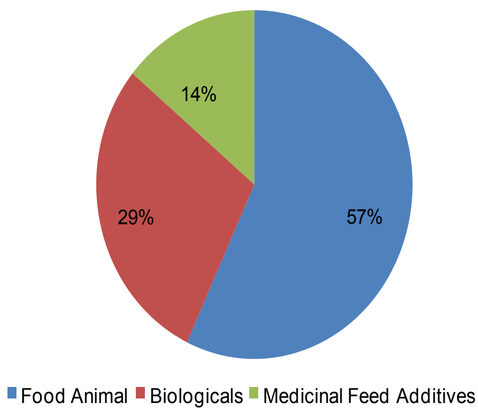
Burgeoning demand for animal protein due to increasing consumption of meat is a major growth rendering factor for the farm animal market size. With the objective to scale up production of healthy animals, the use of various animal healthcare products such as drugs, biological and medicated feed additives has been increasing considerably. Along with the ever-growing population, the demand for animal meat will certainly rise n the years to come , resulting in market growth.

The companion animal healthcare markets is positioned to expand rapidly over the coming years. Globally, pet adoption rates are soaring as people opt increasingly for animal companionship. With rising disposable incomes of pet owners, spending on pet healthcare should increase more than ever before.

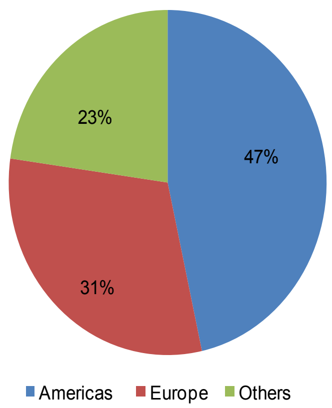
Species Sales Split



Product Group Sales Split



Regional Sales Split



Source: Company AR

Animal Healthcare by Region:

The European animal healthcare market accounted for more than 31% of the industry revenue in 2016. The regional industry participants are significantly spending on R&D activities to develop better animal healthcare solutions. The UK was amongst the leading regional animal healthcare market in 2016. Restriction on the use of antimicrobials should hamper the industry growth over the forecasted period.

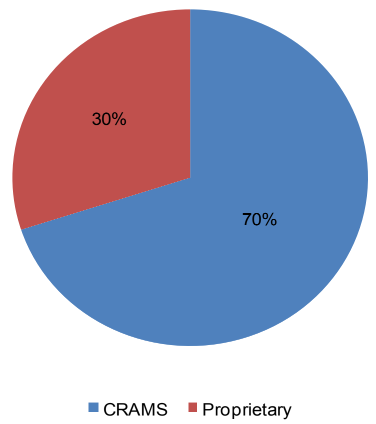
Extensive animal husbandry practices fuel Indian market growth. The country is home to more than 10% of the global livestock population and ranks among the largest producers of cattle, chicken and fish. Rising awareness about animal health should boost demand for animal healthcare products. Many industry players are venturing into this market with an objective to explore and exploit lucrative growth opportunities.

The Chinese market is projected to grow at over 10% CAGR over the next few years. Favourable government initiatives regarding pet keeping, increasing disease awareness among pet owners and advances in new product development should drive regional industry growth.

Crop Protection business: Stability in performance is visible

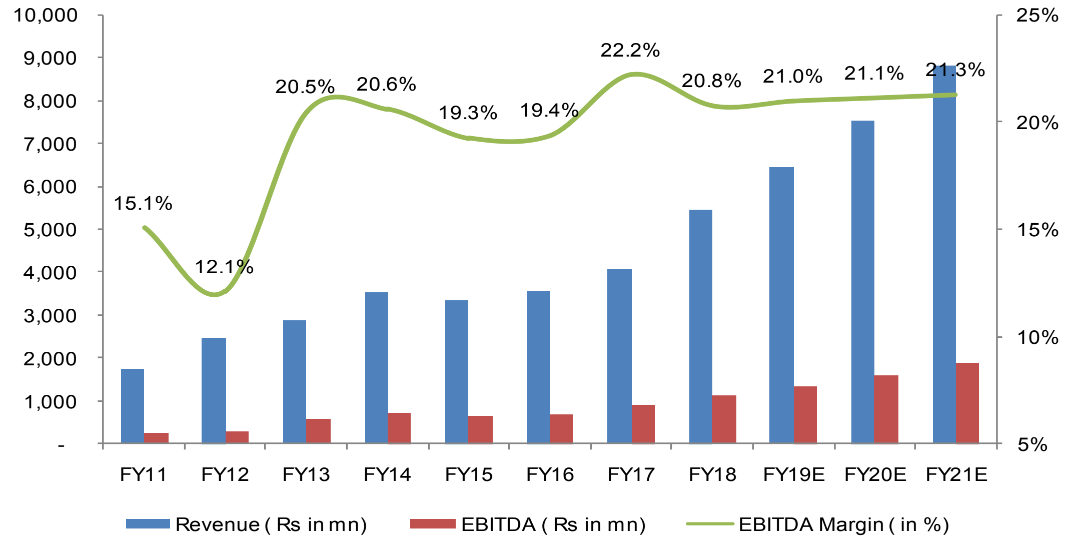
Crop protection business is split between Contract manufacturing for global innovators (CRAMs) which makes up around 70% of the revenue and the Proprietary segment which accounts for the remaining 30%.This segment is dominated only by a few large companies resulting in high concentration. Along with building its own portfolio of products, Hikal also enjoys global and exclusive supplier status for some molecules. As per the management, competition in this segment is lower than pharma, largely due to fewer players and consolidation among large players. The company has enhanced focus on its own products in Agri (versus entire focus on CRAMS earlier) and is beginning to develop some innovative agrochem products too. For crop protection, Hikal has a pipeline of 3-4 products/year, of which 1-2 products would be its own products. Owing to the above factors the management is targeting to achieve a 50:50 revenue split between CRAMs and Proprietary products over the coming years.

Revenue Breakup in %



Sales of Thiabendazole, one of the legacy crop protection products showed stable growth in recent year. The product is extremely versatile and is used in both crop protection to control mould and other fungal diseases in fruits and vegetables, as well as an anti-parasitic to control roundworms. It is also used in the materials protection industry to prevent fungal growth. We expect sales of Thiabendazole to grow marginally in the near future.

Revenue expected to accelerate and margin to stabilize with some improvement



Source: Company, BP Equities Research

As per the management, competition in this segment is lower than pharma mainly due to fewer players and consolidation among large players.

During FY18, Hikal commissioned a new state of the art plant at it's Mahad site to manufacture an advanced intermediate for a key herbicide for one of the global innovator customers. The company executed the full scale commercial manufacture of that complex and large-volume on-patent product to fulfill the customers demand in the first year of commercialization. The customer has the forecasted volume demand for the coming years and has awarded an exclusive supply contract for making the precursor of the product. This underscores the project management and technological capability skills of the company.

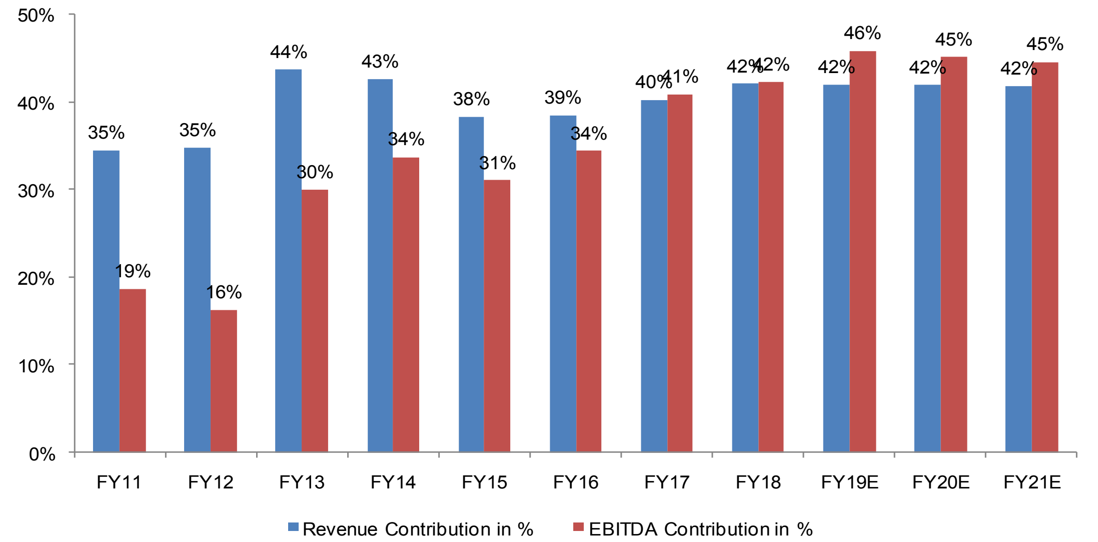
As part of a redefined strategy in the crop protection division, Hikal has entered into the biocides and specialty chemicals businesses in order to diversify into new and allied business areas. The company has also hired a leading global consultant to assist in identifying opportunities in this segment, which is allied to it's current business as there are significant opportunities in diversifying the company's base business from a customer and product perspective.

At the R&T centre in Pune the company is developing and scaling up new products for its future growth in crop protection, biocides and specialty chemicals product portfolios. The company has several new products in the pipeline, each of which has the potential to provide significant growth in the years to come.

On the specialty chemicals front, Hikal is working on the development of two products with wide usage in the chemical industry. These products have a wide range of applications including that of an antiseptic disinfectant. The company expects to commercialize both these products in the near future. As a part of the future strategy, the company is progressing towards more value added products and opening newer and emerging geographies like Russia, Latin America and others where they are gaining traction. New product commercialization will help the company to reduce client and product concentration. Moreover, the management seems optimistic about the future demand for the existing product portfolio as well. Considering the aforementioned factors, we expect the crop protection business to post revenue CAGR of 17.2% over FY18-21E with 51bps improvement in EBITDA margins (20.8% in FY18 vs 21.3% in FY21e).

Progressing towards more value added products and opening newer and emerging geographies like Russia, Latin America and others where they are gaining traction

Contribution to revenue and operating profit to remain at same level



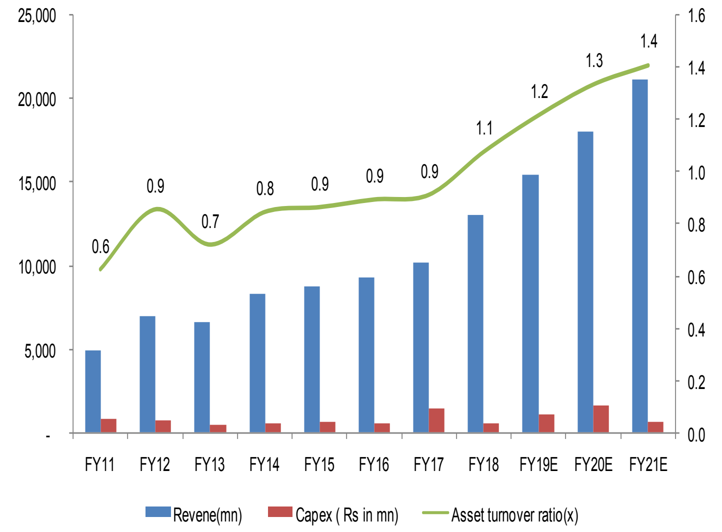
Source: Company, BP Equities Research

Financial performance to improve further

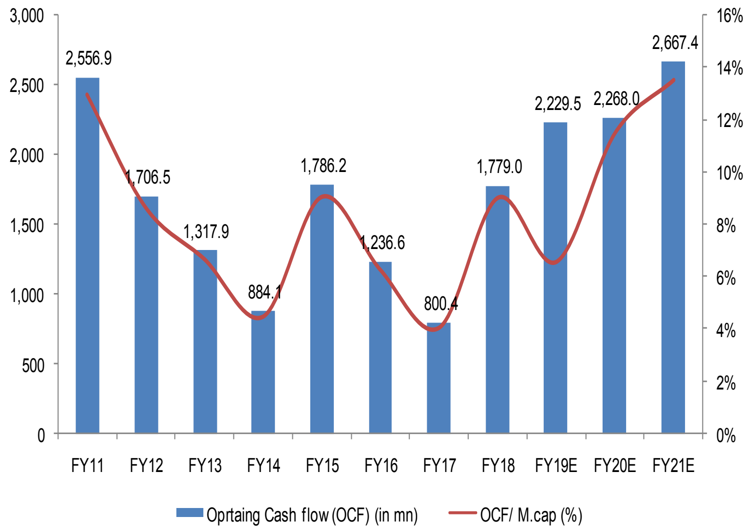
Hikal had witnessed strong revenue growth of 14.8% CAGR over FY13 to FY18 , whereas profit had grown at 24.8% CAGR over the same period . During this timeframe, the EBITDA margin remained in the range of 19-22%. Chinese supply disturbances in the company's raw materials had impacted the company's gross margins in FY18 (contracted by 374bps vs FY17). However, the management is confident of restoring gross margins to ~50% on a gradual basis on the back of introduction of high margin products and backward integration in some of its products .With improving operating efficiency, we expect the EBITDA margin to expand at a higher rate than the gross margin due to cost rationalization measures taken at pharmaceutical plant along with improving utilization levels. Going ahead, the management expects the tax rate to remain at 32-33% level (We have taken 33%). There has been a deterioration in RoE from 16.2% to 12.1% over FY13-18,on the back of slower earnings growth. We expect the return ratios to remain in the range of 15-18%, as growth normalizes. As part of its expansion plan, Hikal has incurred around Rs 4bn in capex during FY13-18 and is in the process of further infusing Rs 3bn in capex over the next 3 years (Incl FY19),which would be majorly directed towards their Panoli plant (Gujarat) in order to further strengthen backward integration facilities. The company expects an asset turnover of around 1.5x-1.75x from the newly built capacities, translating into a blended asset turnover of 1.4x by FY21E,improving from 1.1x in FY18.

Capex of Rs 3bn is funded through Debt and internal accruals at equal proportion

Ongoing capex expect to generate 1.5x-1.75x Asset turnover

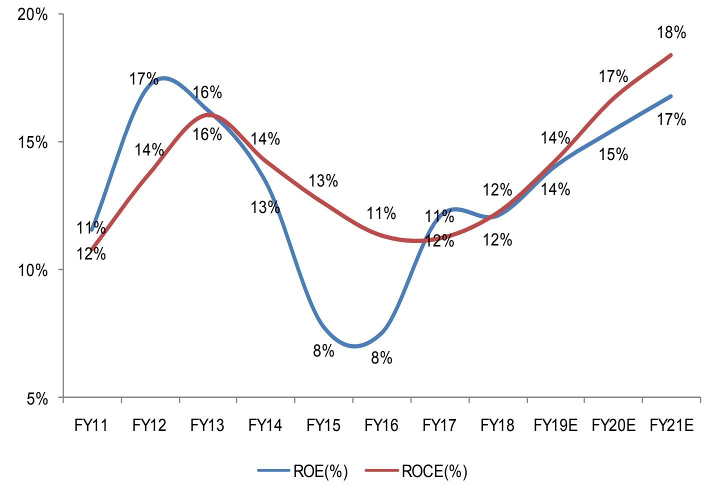


Operating cash flow to remain at elevated level

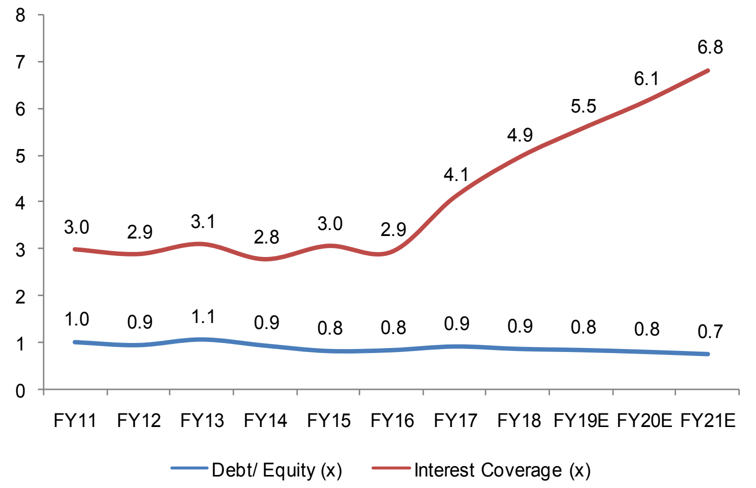


Source: Company, BP Equities Research

Margin profile to improve further



Comfortable financial leverage ratios

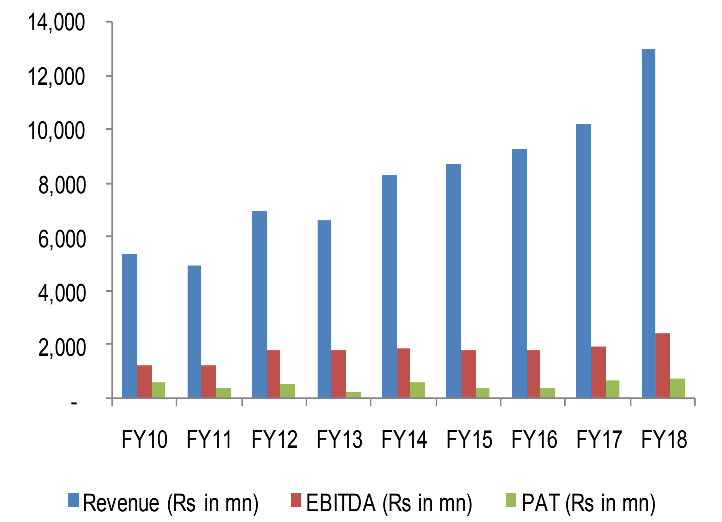


Source: Company, BP Equities Research

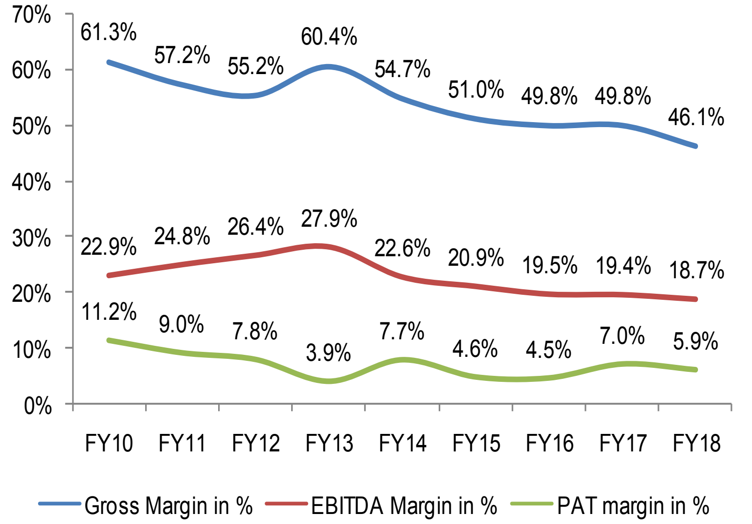
Company Background

Hikal Limited was incorporated on July 8, 1988 as a private limited company with the name Hikal Chemicals Industries Private limited, by the Hiremath family and Surajmukhi Investments & Finance Limited, a wholly-owned subsidiary of Kalyani Steels Limited as the shareholders. Subsequently in 2000, the name was changed to Hikal Limited,while the company got listed in 1995. The company started commercial production in 1991 at Mahad (Maharashtra) facility for manufacturing intermediates for dyes, pharmaceuticals and agrochemicals. The plant at Taloja (Maharashtra) was built in technical collaboration with Merck and is the only fully-integrated plant to produce Thiabendazole in the world. The facility at Panoli (Gujarat) was acquired from Novartis in 2000 and produces key intermediates and regulatory starting materials for the pharmaceutical industry and is US FDA certified for advanced intermediates. The Jigani (Karnataka) facility manufactures key APIs for the pharmaceutical industry and has been approved by the US FDA, PMDA (Japan) and the European Union Authorities. Hikal is expanding its facilities at Panoli to include manufacturing of APIs and specialised biocides and fungicides for the crop protection sector. The company has a research and development centre in Pune, which provides end-to-end services from custom synthesis, analytical development and scale up from development to commercial manufacturing.

Operational Performance trend

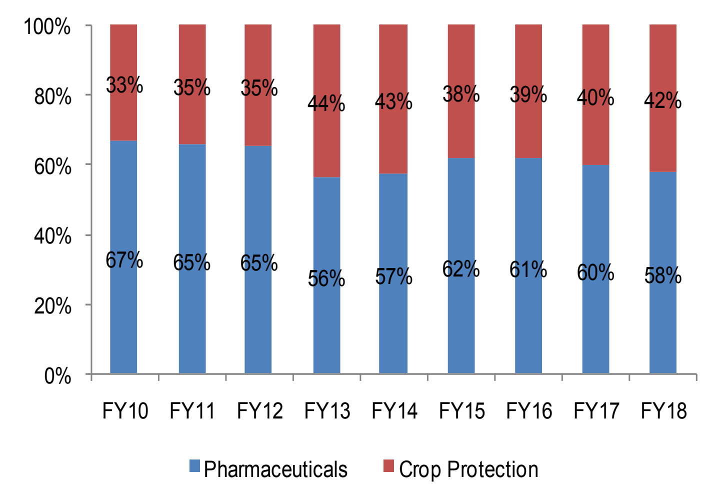


Margin profile trend

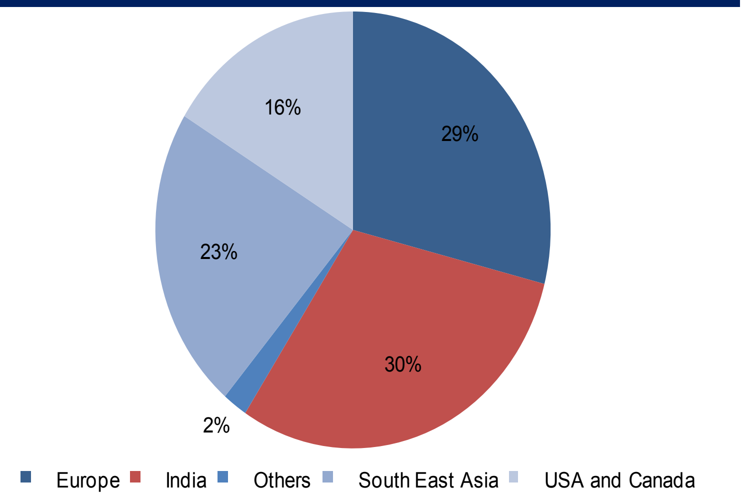


Source: Company, BP Equities Research

Segment wise Revenue contribution



Geography wise revenue breakup



Source: Company, BP Equities Research

Key Milestones	
1988	Hikal Is Incorporated
1991	First manufacturing site at Mahad begins operations -signed a long term supply agreement with Hoescht India
1997	Manufacturing of the Active Ingredient for Merck begins at Taloja site
2000	Hikal acquires manufacturing site from Novartis in Panoli, Gujarat
2001	Acquired R&D and manufacturing site in Bangalore. Hikal enters the pharma business
2003	First new API plant commissioned at Bangalore. Multi purpose Pharmaceutical intermediate plant commissioned at Panoli.
2006	Signed long term supply contract with global innovator company for commercial supply of API's
2007	Signed long term contract API manufacturing supply agreement with a leading Animal health company
2008	IFC(world bank) invests 8.27% equity into company
2009	Acoris (Research & Development Center) becomes operational
2009	Signed long term supply contract for an on patent molecules with a global crop protection innovator company
2013	Signed long term supply agreement for human health products with a global biopharmaceutical company
2014	Pharmaceutical sites, Panoli & Bangalore received EU GMP approval
2015	New development Launch plant in Bangalore successfully commission for new products from the pharmaceutical Division
2015	Company successfully commissioned CO generation Plant and Biomass at all sites as part of its sustainability program
2017	Successfully commissioned a new, state of the art plant at Mahad for a leading global crop protection innovator company

Source: Company, BP Equities Research

Hikal Ltd - Management Committee Details

Name	Designation	Details
Jai Hiremath	Chairman and Managing Director	He has over 36 years of experience in the fine chemicals and pharmaceuticals industry. He developed Hikal into one of the leading global contract development and manufacturing companies. A Chartered Accountant from the Institute of Chartered accountants in England and Wales, he is a 2004 alumnus of Harvard University, USA.
Sameer Hiremath	President and Joint Managing Director	He oversees the day-to-day operations of the company which includes Research & Technology, Manufacturing Operations, and Sales & Marketing. He has over 20 years of experience in technical plant operations, business development, and corporate strategy. He has held several key positions at Hikal, including that of Executive Director. He holds a degree in Chemical Engineering from Pune University and an MBA and MS degree in Information Technology from Boston University, USA.
Sham Wahalekar	Senior Vice President - Finance and Company Secretary	He has over 40 years of experience in finance and secretarial functions at Hikal. He has completed his M. Com. (Hons) and holds a degree in Law. He is also a member of the Institute of Company Secretaries of India. He is responsible for finance, legal compliance, and the corporate secretarial functions at Hikal.
Manoj Mehrotra	President – Pharmaceuticals	He has over 30 years of experience in the fine chemicals and pharmaceuticals industry. He did his B.Tech (Hons) in Chemical Engineering from IIT Kharagpur and MBA from XLRI, Jamshedpur. In his last assignment at Dr. Reddy's Laboratories, he was the global head of the Custom Pharmaceutical Services (CPS) business. Earlier, Mr Mehrotra worked in companies such as Thermax and SRF Limited. In SRF, his last role was strategizing and growing the fluoro-specialty business. He is responsible for strategy, sales, and operations of the Pharmaceuticals division at Hikal.
Kumar Inamdar	President – Crop Protection	He has over 27 years of experience in sales, marketing, procurement, and general administration in the fine chemicals, agrochemicals, and medical device industries. He completed his BE in Chemical Engineering from Gujarat University and MBA from Pune University. He has worked in several companies including Tata Limited, Lupin, and Bilag Industries. At Hikal, Mr. Inamdar is responsible for the strategy, sales, and operations of the Crop Protection division and also oversees the procurement function for the company.
Dr. Sudhir Nambiar	President – Research & Technology	He has over 26 years of experience in the area of process research, development of APIs, lifecycle management of molecules, process safety, regulatory and technology across several industries. He is a Ph.D. in Synthetic Organic Chemistry from the University of Louisville, Kentucky and he did his post-doctorate from the University of Montreal. He has completed the Senior Leadership program from Harvard Business School. In his last assignment at Dr. Reddy's Laboratories, he was the Senior VP & Global Head of API – R&D. Prior to Dr. Reddy's Laboratories, he was the Managing Director of AstraZeneca India Pvt. Ltd. where he was responsible for the day-to-day operations of the company as well as being accountable for research, business services, governance and administration. At Hikal, Dr Nambiar is responsible for the Research and Technology initiatives with a focus on driving innovation through chemistry.

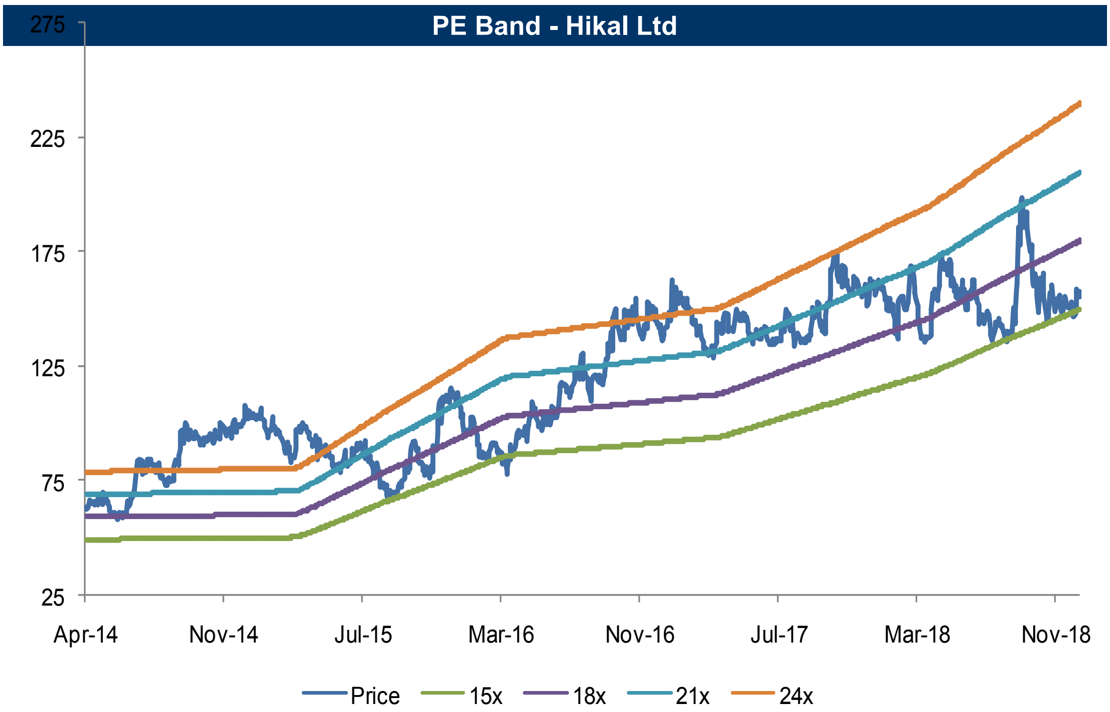
Source: Company, BP Equities Research

⇒ Peer group comparison

Company	CMP	M Cap	P/E		EPS		EV/EBITDA		RoE (%)	
	(Rs.)	(Rs. Bn)	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
Hikal	158	20	15.7	12.7	10.0	12.4	7.0	5.6	15.5	16.8
PI Industries*	839	116	22.9	19.5	36.6	43.1	15.9	13.7	20.3	20.1
Suven Life Sciences	229	29	18.9	16.6	12.1	13.9	11.3	10.7	16.4	16.7
Divis Laboratories*	1513	402	27.2	24.3	55.6	62.1	18.2	16.1	19.8	20.1

*Source: BP Equities Research, * Bloomberg estimate*

⇒ PE Band



Source: BP Equities Research, Ace Equity

⇒ **Key Risks and Concerns:**

Regulatory risk

Issues raised by the USFDA and other global regulatory authorities can have a detrimental impact on the company's revenue and profitability. Any changes in the law or regulation made by the government or regulatory authorities can substantially increase the cost of operations and reduce profitability. However, strong historical track record on compliance gives us comfort on the regulatory front.

Foreign exchange risk

The company profitability is exposed to adverse movement in foreign exchange as more than 70% of the revenues are derived from exports. Hikal enjoys some natural hedge from its imports (~50% of raw materials) as well as foreign currency debt, though it still remains exposed to adverse movement in currency.

Product and Client concentration

The crop protection and pharmaceuticals business are based on loan term contracts with clients. A muted forecast (due to macro conditions) by clients will certainly affect revenues. Based on the company's experience of such risks, they have expanded their client base and diversified the product portfolio across regions to mitigate risk.

Exposed to adverse raw material price movement

Hikal's operations remain exposed to adverse movement in raw material movement as the contracts are generally of fixed price nature with the raw material escalation clause beyond the agreed levels. In the past, it has been able to get price increases as evident in FY2018 margins, which remained stable despite an increase in raw material prices owing to production issues in China. The company also started backward integration in few products to keep it insulated from supply side disruptions.

Valuation & Outlook

Valuation	Basis	FY19E	FY20E	FY21E
Hikal Ltd				
EPS		8	10	12
Growth in EPS (YoY %)		29%	24%	24%
Implied PE		19.5	15.7	12.7
Assigned PE	(18x PE)			18
Target Price				**224**
(Implied PEG Ratio considering next 3 years: 0.7)				
CMP				158
Upside Potential (%)				**42%**

Source: Company, BP Equities Research

We have valued Hikal based on 18x (in line with Cyclically Adjusted Price Earnings (CAPE) 10yr Avg P/E) FY21E earnings and arrive at a target price of Rs 224(potential upside of 42% from CMP) for an investment horizon of 12-15 months.

We expect the company to post 17.5% revenue CAGR over FY18-21E led by commercialization of new products and favourable demand in the existing product portfolio for both businesses. We forecast 137bps EBITDA margin expansion over FY18-21E led by better product mix and operating efficiency on account of higher utilization levels and cost rationalization measures at the Pharma facility. We estimate 25.7% PAT CAGR on the back of better operational performance. Considering the expected strong growth in profitability, healthy balance sheet, improving return ratios and good corporate governance practices, we are optimistic about the long-term growth prospects of the company. At the CMP (Rs 160), the stock is trading at 15.7x its FY20E EPS of Rs 10 and 12.7x its FY21E EPS of Rs 12.4. We initiate coverage on the stock & recommend 'BUY' rating with a target price of Rs 224 per share. Our target price is based on 18x (in line with Cyclically Adjusted Price Earnings (CAPE) 10yr Avg P/E) FY21E earnings.

Profit & Loss A/c (Consolidated)							
YE March (Rs. mn)	FY15	FY16	FY17	FY18	FY19E	FY20E	FY21E
Revenue	**8,719**	**9,256**	**10,139**	**12,961**	**15,392**	**17,977**	**21,085**
Growth %	*5.1%*	*6.2%*	*9.5%*	*27.8%*	*18.8%*	*16.8%*	*17.3%*
Total Revenue	**8,719**	**9,256**	**10,139**	**12,961**	**15,392**	**17,977**	**21,085**
Less:							
Raw Material Consumed	4,271	4,649	5,089	6,989	8,259	9,597	11,228
Employee Cost	892	1,081	1,167	1,281	1,473	1,694	1,948
Other Expenses	1,730	1,718	1,912	2,274	2,701	3,154	3,699
Total Operating Expenditure	**6,893**	**7,447**	**8,167**	**10,544**	**12,432**	**14,445**	**16,875**
EBITDA	**1,825**	**1,809**	**1,972**	**2,417**	**2,961**	**3,532**	**4,210**
Growth %	*-2.6%*	*-0.9%*	*9.0%*	*22.6%*	*22.5%*	*19.3%*	*19.2%*
Less: Depreciation	642	673	691	856	975	1,149	1,342
EBIT	**1,183**	**1,137**	**1,281**	**1,561**	**1,985**	**2,383**	**2,868**
Growth %	*-10.5%*	*-4.0%*	*12.7%*	*21.9%*	*27.1%*	*20.0%*	*20.3%*
Interest Paid	600	622	483	491	534	577	620
Non-operating Income	16	18	34	45	40	40	40
Extraordinary Income	0	0	0	0	0	0	0
Profit Before tax	**599**	**533**	**832**	**1,115**	**1,491**	**1,846**	**2,288**
Tax	193	120	125	343	492	609	755
Net Profit	**405**	**413**	**707**	**772**	**999**	**1,237**	**1,533**
Adjusted Profit	**405**	**413**	**707**	**772**	**999**	**1,237**	**1,533**
Reported Diluted EPS Rs	**3.3**	**3.4**	**5.7**	**6.3**	**8.1**	**10.0**	**12.4**
Growth %	*-36.8%*	*2.0%*	*71.0%*	*9.3%*	*29.4%*	*23.8%*	*23.9%*
Adjusted Diluted EPS Rs	**3.3**	**3.4**	**5.7**	**6.3**	**8.1**	**10.0**	**12.4**
Growth %	*-36.8%*	*2.0%*	*71.0%*	*9.3%*	*29.4%*	*23.8%*	*23.9%*

Source: Company, BP Equities Research

Common Sized Profit & Loss Account							
YE March (Rs. mn)	FY15	FY16	FY17	FY18	FY19E	FY20E	FY21E
Total Revenues	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
Less:							
Raw Material Consumed	49.0%	50.2%	50.2%	53.9%	53.7%	53.4%	53.3%
Employee Cost	10.2%	11.7%	11.5%	9.9%	9.6%	9.4%	9.2%
Other Expenses	19.8%	18.6%	18.9%	17.5%	17.5%	17.5%	17.5%
Total Operating Expenditure	**79.1%**	**80.5%**	**80.6%**	**81.3%**	**80.8%**	**80.4%**	**80.0%**
EBITDA	**20.9%**	**19.5%**	**19.4%**	**18.7%**	**19.2%**	**19.6%**	**20.0%**
Depreciation	7.4%	7.3%	6.8%	6.6%	6.3%	6.4%	6.4%
Interest Paid	6.9%	6.7%	4.8%	3.8%	3.5%	3.2%	2.9%
Non-operating Income	0.2%	0.2%	0.3%	0.3%	0.3%	0.2%	0.2%
Extraordinary Items	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Profit Before Tax	**6.9%**	**5.8%**	**8.2%**	**8.6%**	**9.7%**	**10.3%**	**10.9%**
Current tax	2.2%	1.3%	1.2%	2.6%	3.2%	3.4%	3.6%
Profit After Tax	**4.6%**	**4.5%**	**7.0%**	**6.0%**	**6.5%**	**6.9%**	**7.3%**
Adjusted Profit	**4.6%**	**4.5%**	**7.0%**	**6.0%**	**6.5%**	**6.9%**	**7.3%**

Source: Company, BP Equities Research

Cash Flows (Consolidated)							
YE March (Rs. Mn)	**FY15**	**FY16**	**FY17**	**FY18**	**FY19E**	**FY20E**	**FY21E**
PAT	**405.1**	**413.2**	**706.7**	**772.3**	**999.1**	**1,237.1**	**1,533.2**
(Less)/Add: Extraordinary Income/Expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Less: Non Operating Income	(15.8)	(18.4)	(34.4)	(44.6)	(40.0)	(40.0)	(40.0)
Add: Depreciation	641.8	672.8	691.4	855.9	975.4	1,149.1	1,342.0
Add: Interest Paid	600.5	621.9	482.7	491.2	534.0	576.8	619.6
Tax Adjustment	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating Profit before Working Capital Changes	**1,631.6**	**1,689.4**	**1,846.5**	**2,074.7**	**2,468.5**	**2,922.9**	**3,454.7**
(Inc)/Dec in Current Assets	(297.8)	54.8	(1,468.2)	(890.6)	(754.5)	(801.8)	(964.0)
Inc/(Dec) in Current Liabilities	479.1	(736.0)	146.8	989.6	1,084.0	751.2	903.5
Changes in Inventory	(26.6)	228.4	275.3	(394.7)	(568.5)	(604.3)	(726.8)
Net Cash Generated From Operations	**1,786.2**	**1,236.6**	**800.4**	**1,779.0**	**2,229.5**	**2,268.0**	**2,667.4**
Cash Flow from Investing Activities							
(Inc)/Dec in Fixed Assets	(640.1)	(511.1)	4,096.8	(508.6)	(1,100.0)	(1,600.0)	(600.0)
(Inc)/Dec in Capital Work In Progress	(4.9)	(44.6)	41.9	(535.7)	0.0	0.0	0.0
(Inc)/Dec in Investment (Strategic)	(202.2)	(285.3)	584.7	(392.2)	(97.2)	(106.9)	(117.6)
(Inc)/Dec in Investment (Others)	0.0	0.0	(5.0)	10.2	0.0	0.0	0.0
Add: Non Operating Income	15.8	18.4	34.4	44.6	40.0	40.0	40.0
(Inc)/Dec in Intangible Assets	0.0	0.0	(8.2)	(15.5)	0.0	0.0	0.0
Net Cash Flow from/(used in) Investing Activities	**(831.5)**	**(822.6)**	**4,744.5**	**(1,397.2)**	**(1,157.2)**	**(1,666.9)**	**(677.6)**
Cash Flow from Financing Activities							
Inc/(Dec) in Total Loans	(411.0)	361.4	456.5	345.2	500.0	500.0	500.0
Inc/(Dec) in Reserves & Surplus	(6.1)	24.4	(157.8)	19.7	(82.2)	0.0	0.0
Inc/(Dec) in Equity	0.0	0.0	0.0	0.0	82.2	0.0	0.0
Dividend Paid	(123.3)	(123.3)	(148.0)	(148.0)	(191.4)	(237.0)	(293.7)
Less: Interest Paid	(600.5)	(621.9)	(482.7)	(491.2)	(534.0)	(576.8)	(619.6)
Adjustments	46.2	0.0	(5,239.7)	0.0	(0.0)	0.0	0.0
Exceptional Item	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Cash Flow from Financing Activities	**(1,094.7)**	**(359.3)**	**(5,571.8)**	**(274.2)**	**(225.4)**	**(313.8)**	**(413.3)**
Net Inc/Dec in cash equivalents	**(140.0)**	**54.6**	**(26.9)**	**107.6**	**846.9**	**287.3**	**1,576.4**
Opening Balance	**276.9**	**136.9**	**191.6**	**164.7**	**272.2**	**1,119.1**	**1,406.4**
Closing Balance Cash and Cash Equivalents	**136.9**	**191.6**	**164.7**	**272.2**	**1,119.1**	**1,406.4**	**2,982.8**

Source: Company, BP Equities Research

Balance Sheet (Consolidated)							
YE March(Rs. mn)	**FY15**	**FY16**	**FY17**	**FY18**	**FY19E**	**FY20E**	**FY21E**
Liabilities							
Equity Capital	164	164	164	164	247	247	247
Reserves & Surplus	5,170	5,485	5,886	6,530	7,255	8,255	9,495
Equity	**5,335**	**5,649**	**6,050**	**6,694**	**7,502**	**8,502**	**9,741**
Net Worth	**5,335**	**5,649**	**6,050**	**6,694**	**7,502**	**8,502**	**9,741**
Minority Interest							
Net Deferred tax liability/(Asset)	402	403	41	152	152	152	152
Total Loans	**4,325**	**4,685**	**5,504**	**5,738**	**6,238**	**6,738**	**7,238**
Capital Employed	**10,062**	**10,737**	**11,595**	**12,584**	**13,891**	**15,392**	**17,131**
Assets							
Gross Block	10,960	11,472	7,375	7,883	8,983	10,583	11,183
Less: Depreciation	4,567	5,240	691	1,547	2,523	3,672	5,014
Net Block	**6,394**	**6,232**	**6,683**	**6,336**	**6,461**	**6,911**	**6,170**
Capital WIP	617	661	619	1,155	1,155	1,155	1,155
Investments	**879**	**1,165**	**580**	**972**	**1,069**	**1,176**	**1,294**
Others - A	31	31	36	26	26	26	26
Current Assets							
Inventories	3,140	2,911	2,636	3,031	3,599	4,203	4,930
Sundry Debtors	1,280	1,123	2,565	2,874	3,413	3,986	4,675
Cash and Bank Balance	137	192	165	272	1,119	1,406	2,983
Current Investments	0	0	0	0	0	0	0
Loans and Advances	350	574	595	1,139	1,353	1,580	1,853
Other Current Assets	224	102	107	145	147	148	150
Total Current Assets	**5,130**	**4,902**	**6,068**	**7,461**	**9,631**	**11,324**	**14,591**
Less: Current Liabilities & Provisions							
Sundry Creditors	1,371	1,278	1,304	1,645	2,402	2,806	3,291
Provisions	303	355	337	605	719	839	985
Other Current Liabilities	1,315	620	759	1,139	1,353	1,580	1,854
Total Current Liabilities & Provisions	**2,990**	**2,254**	**2,401**	**3,390**	**4,474**	**5,225**	**6,129**
Capital Applied	**10,062**	**10,737**	**11,595**	**12,584**	**13,891**	**15,392**	**17,131**

Source: Company, BP Equities Research

Key Ratios (Consolidated)							
YE March (Rs. mn)	**FY15**	**FY16**	**FY17**	**FY18**	**FY19E**	**FY20E**	**FY21E**
Key Operating Ratios							
EBITDA Margin (%)	20.9%	19.5%	19.4%	18.7%	19.2%	19.6%	20.0%
Tax / PBT (%)	32.3%	22.5%	15.1%	30.7%	33.0%	33.0%	33.0%
Net Profit Margin (%)	4.6%	4.5%	7.0%	6.0%	6.5%	6.9%	7.3%
RoE (%)	7.8%	7.5%	12.1%	12.1%	14.1%	15.5%	16.8%
RoCE (%)	12.6%	11.3%	11.2%	12.3%	14.3%	16.7%	18.4%
Current Ratio (x)	1.7x	2.2x	2.5x	2.2x	2.2x	2.2x	2.4x
Dividend Payout (%)	30.4%	29.8%	20.9%	19.2%	19.2%	19.2%	19.2%
Book Value Per Share (Rs.)	43.3	45.8	49.1	54.3	60.8	69.0	79.0
Financial Leverage Ratios							
Debt/ Equity (x)	0.8x	0.8x	0.9x	0.9x	0.8x	0.8x	0.7x
Interest Coverage (x)	3.0x	2.9x	4.1x	4.9x	5.5x	6.1x	6.8x
Growth Indicators %							
Growth in Gross Block (%)	(0.7%)	(2.5%)	7.2%	(5.2%)	2.0%	7.0%	(10.7%)
Sales Growth (%)	5.1%	6.2%	9.5%	27.8%	18.8%	16.8%	17.3%
EBITDA Growth (%)	(2.6%)	(0.9%)	9.0%	22.6%	22.5%	19.3%	19.2%
Net Profit Growth (%)	(36.8%)	2.0%	71.0%	9.3%	29.4%	23.8%	23.9%
Diluted EPS Growth (%)	(36.8%)	2.0%	71.0%	9.3%	29.4%	23.8%	23.9%
Turnover Ratios							
Debtors Days	54	44	92	81	81	81	81
Creditors Days	57	50	58	57	57	57	57
Inventory Days	131	115	95	85	85	85	85

Source: Company, BP Equities Research

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Disclaimer Appendix

Analyst (s) holding in the Stock : Nil

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