6th October 2023

ASTRAZENECA PHARMA

Rating: **BUY**

Conviction Rating: ★★★

Price: 4630

Surge Capital Focuses on Six Key Attributes of Long-Term Earnings Growth

- Strong Business Model ✓
- Innovation & Pivot
- Change & External Trend
- Optionalities
- Leadership & Edge
- Stellar Management Execution

Industry:	Pharma
Market Cap:	Rs 11000 Crores
Revenues:	Rs 1066 Crores
Net Profits:	Rs 170 Crores
Net Debt:	-

✓ Indicates attributes present in the stock

Brief Thesis

Astrazeneca Pharma is the listed Indian subsidiary of the big pharma company- Astrazenca Plc.

The company is engaged in manufacturing, marketing & distribution of pharmaceutical products in the Indian and Nepal markets.

The strength of the company's business model lies in the following-

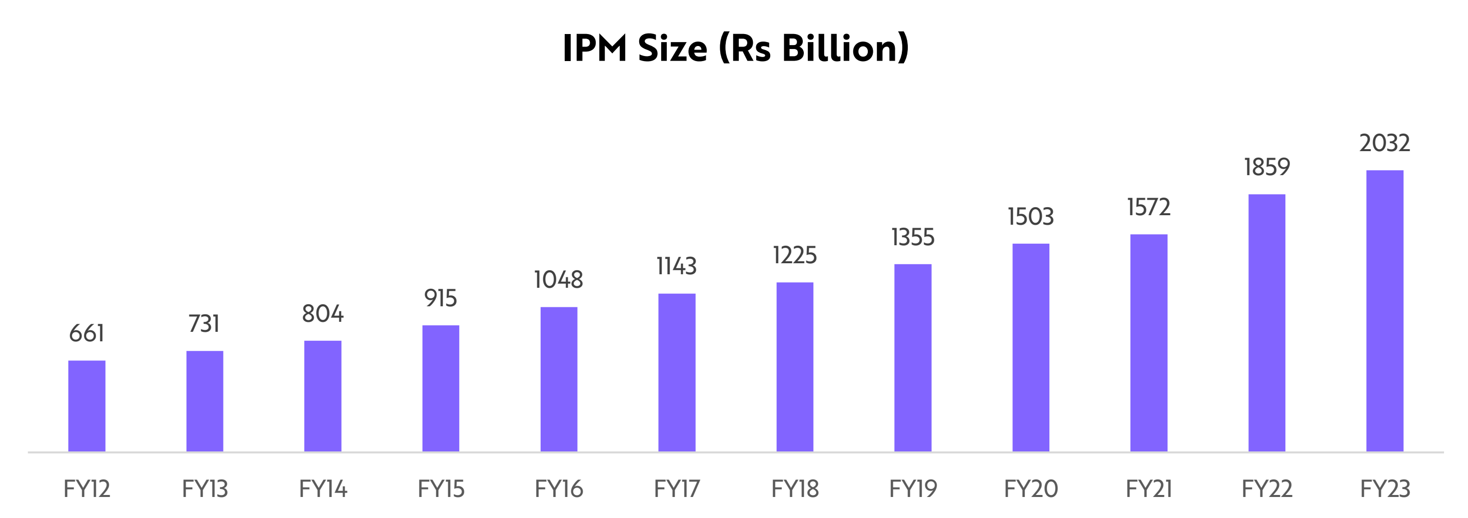
- Pure play domestic focused business
- Optimal Organization Structure
- Innovative & Patented Product Portfolio
- High Operating Leverage

Ankush Agrawal
Digitally signed by Ankush Agrawal
Date: 2023.10.06 15:45:48 +05'30'

Analyst: Ankush Agrawal
ankush@surgecapital.in

Indian Pharmaceutical Market (IPM)

IPM is a large market of ~Rs2 lakh cores; it has grown at ~11% CAGR over last decade and is expected to grow at similar rates over the coming decade as well.



Domestic focused pharma businesses are much better vs export facing businesses-

Domestic Pharma	Remark	Exports Pharma
IPM is a branded generics market wherein prescriptions are given & products are bought under brand names and not the molecule name of the drug.	**Brand Salience**	Most major exports markets are pure generics markets wherein products are sold under their molecule name and thus there is no brand salience.
A decent part of IPM's overall growth every year is on account of pricing growth. Regulations allows companies to take upto 10% price increase every year; also, the drugs under price control are allowed to take annual price increase equal to wholesale-inflation-index. Overall competitive dynamics on the pricing front is also controlled because of the brand salience. In any brand led business, pricing below a certain threshold actually reduces the demand, as cheap product is perceived as inferior & sub-standard.	**Pricing Power**	Non-branded generics led export markets face extreme price competition as without brand salience, price is the only key differentiating factor. And as a result, export facing pharma businesses face pricing degrowth every year.
Domestic pharma is largely a marketing & distribution business with key focus being creation of brands; majority of manufacturing is outsourced by most players. This relatively asset light model couple with above factors of brand salience and pricing power results is very high ROCEs for domestic pharma businesses.	**Return on Capital**	Exports business revolves largely around manufacturing & securing product approvals (including R&D); all of which is highly capital intensive and that coupled with no brand salience & pricing pressures results in very low ROCEs for export facing pharma businesses.

ASTRAZENECA INDIA- Some History & Parent

Astrazeneca India

Markets Served
India & Nepal

Parent
Astrazeneca Plc (UK)

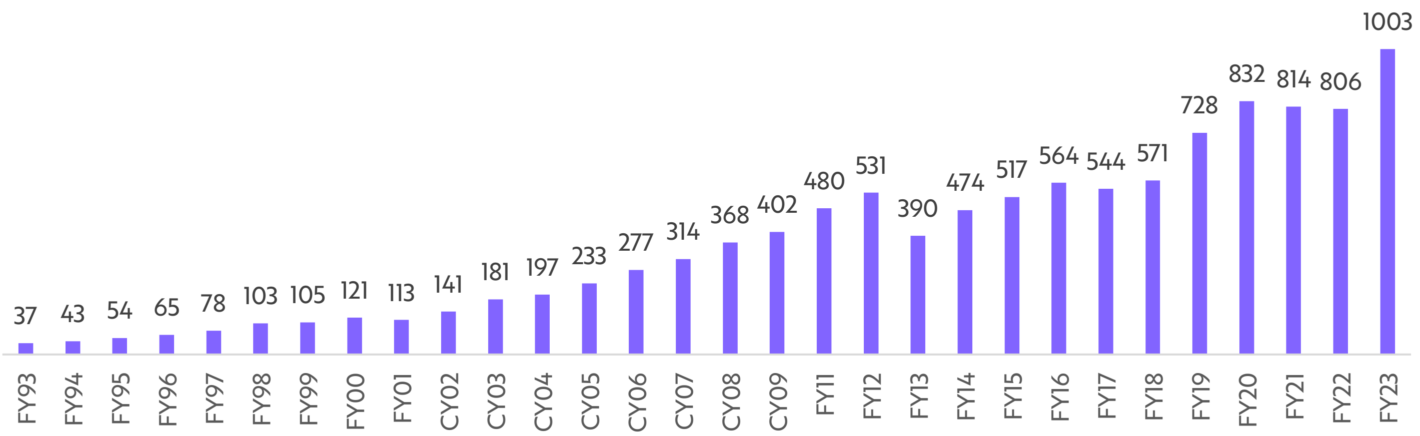
Presence in India
Since 1979

IPM Rank
50th

Parent Stake
75%

Top 10 Brands Revenue Contribution
88%

Astrazeneca India Revenues (Rs crores)



Astrazeneca Plc

Established
1999; through merger of Astra AB and Zeneca Group

Global Rank
9th Largest by Revenues

Annual R&D Spends
~$10 Billion

Global Revenues
$44 Billion

R&D Pipeline
172 Active Projects

Key Global Products
Tagrisso, Lynparza & Imfinzi

STRENGTHS OF ASTRAZENECA's BUSINESS

Domestic Focused + **Optimal Organization Structure** + **Patented Product Portfolio** + **High Operating Leverage**

A. Pure Play Domestic Pharma Business with an Optimal Organization Structure

Most of the listed pharma companies in India are a combination of domestic and exports business, wherein the exports business is mostly a pure generics business and much inferior to a branded domestic pharma business.

Only the MNC pharma companies and two domestic companies are pure play domestic branded plays available.

Within the MNCs, many of them have a structural issue of additional unlisted subsidiaries of the parent which results in lack of full support from the parent in terms of new products-

	Abbott	Pfizer	Novartis
Presence in India Since	1944	1950	1996
Parent Stake in Listed Entity	75%	64%	71%
Other Subsidiaries of Parent	**Abbott Healthcare Pvt Ltd-** Covers various therapeutic areas like CNS, derma, gastro etc There is a segmentation of which therapeutic areas will be covered by this entity and the listed entity. **Abbott Nutrition-** Deals in nutrition products like Pediasure.	**Pfizer Healthcare India Pvt Ltd-** Covers major therapeutic area of Oncology and all Oncology & hospital medicines are sold through this subsidiary	**Novartis Healthcare Pvt Ltd-** Innovative & patented products of the parent are launched through this entity

	Astrazeneca	GSK Pharma	P&G Health
Presence in India Since	1979	1924	1967
Parent Stake in Listed Entity	75%	75%	52%
Other Subsidiaries of Parent	**Astrazeneca India Pvt Ltd-** Hosts its global centers of R&D, IT and Business services. Entire operational business is done through the listed entity only.	No other subsidiary of parent	Parent group has other listed & unlisted subsidiaries like P&G Hygiene & Health and Gillette. But they are in different line of business.

Not only does Astrazeneca's Indian listed entity has full access to parent's new product pipeline,

- It does not pay any royalty to the parent entity.
- It also receives reimbursement from the parent entity for certain costs incurred towards marketing & promotion of newly launched products as the trademarks of these products are held by the parent entity.

In case of domestic companies there are only two pure play domestic branded plays-

- **Eris Lifesciences**- Growth has stagnated for the company and thus it is going after inorganic route to grow, and that has resulted in a bloated balancesheet and poor ROCEs.
- **Mankind Pharma**- Recently listed company with decent growth; but Astrazeneca should deliver much higher growth than this.

B. Innovative & High Growth Product Portfolio

A decade back or so, Astrazeneca India's product portfolio was entirely branded generics without much access to parent's new product pipeline.

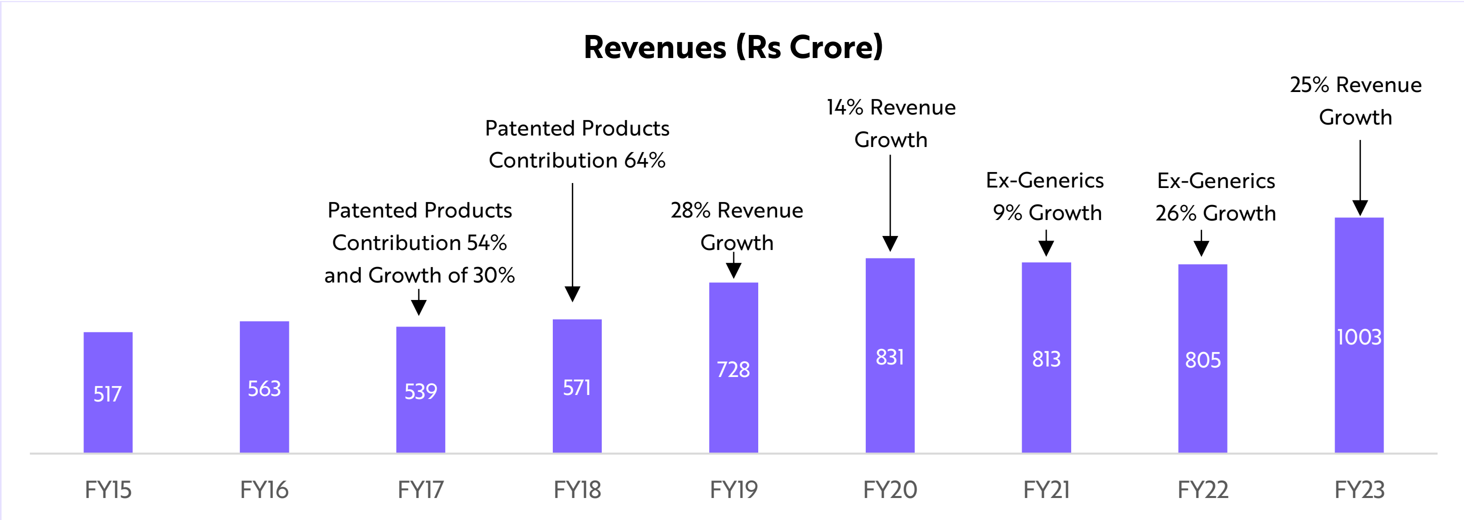
But overtime the parent has aligned the Indian entity with its global R&D & launch pipeline such that all its new products are being launched in India and that too in sync with global launch in the major markets.

Snippet from FY15 annual report-

Outlook

During the Financial Year 2015-16, along with existing portfolio of products, the company will consider to execute on strategies to set the ground to align with AstraZeneca's global pipeline of innovative medicines, subject to conduct of clinical trials, regulatory approvals and reasonable commercial viability. The key focus to be in the Therapeutic Areas of Diabetes, Cardiovascular, Oncology, Respiratory and Infection.

As a result of this strategic change, Indian entity's product portfolio has increasingly comprised of innovative & patented products; and that has led to increased growth rates for the company over last 5-6 years-



(Company faced generic competition in its two major products (~40% of revenues) over FY20-FY22 and that affected the overall growth during this period; however underlying growth (ex-these two products) was quite strong)

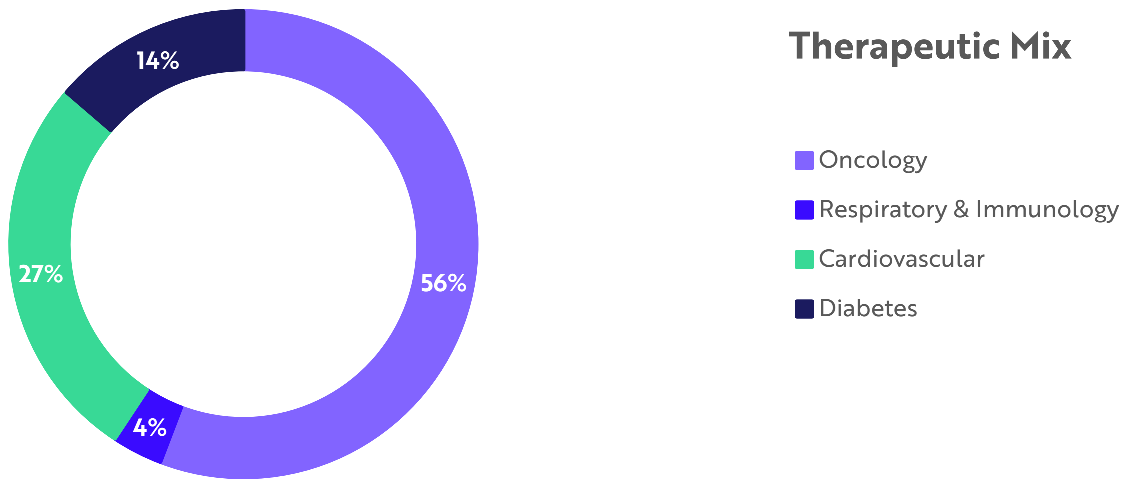
Majority of Astrazeneca India's current product portfolio comprises of innovative, patented & market leading brands-

Product	Launch	% of FY23 Revenues	Remark
Tagrisso	2017	23.3%	Patented & No.1 Lung Cancer Brand
Brilinta	2012	15.2%	Lost Patent in 2019; Market leader with ~20% Market Share
Lynparza	2019	13.8%	Patented & No. 1 Ovarian Cancer Brand
IMFINZI	2019	10.7%	Patented
Forxiga	2015	7.3%	Lost Patent over 2020-2021
Zoladex	2002	5.1%	Only brand for the molecule in India
Crestor	2009	4.3%	-
Seloken	2003	3.2%	-
Xigduo/XR	2018	2.8%	-
Betaloc	-	2.4%	-
Symbicort	2008	2.1%	-
Others	-	9.9%	-

75% of the product portfolio is either patented, or has only lost patent in recent years but is still market leader & growing

Old stable & non-growing portfolio

Multiple recently launched patented products that are growing very fast.



Innovative & Patented products have two advantages-

- **High Growth Rates**
  These products are either the very first drugs to address a particular disease or a substantial improvement over existing drugs for treating a disease and thus have a non-line growth trajectory as the adoption increases.

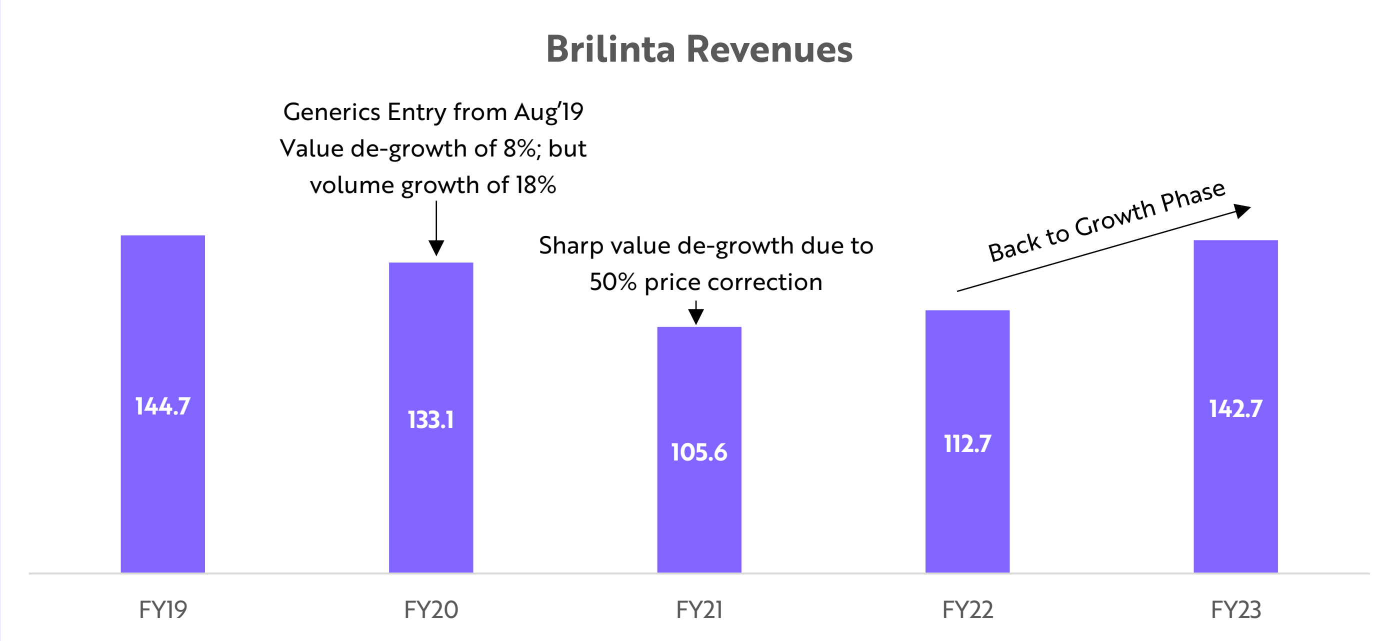
  Growth trajectory of some of the recent launches-

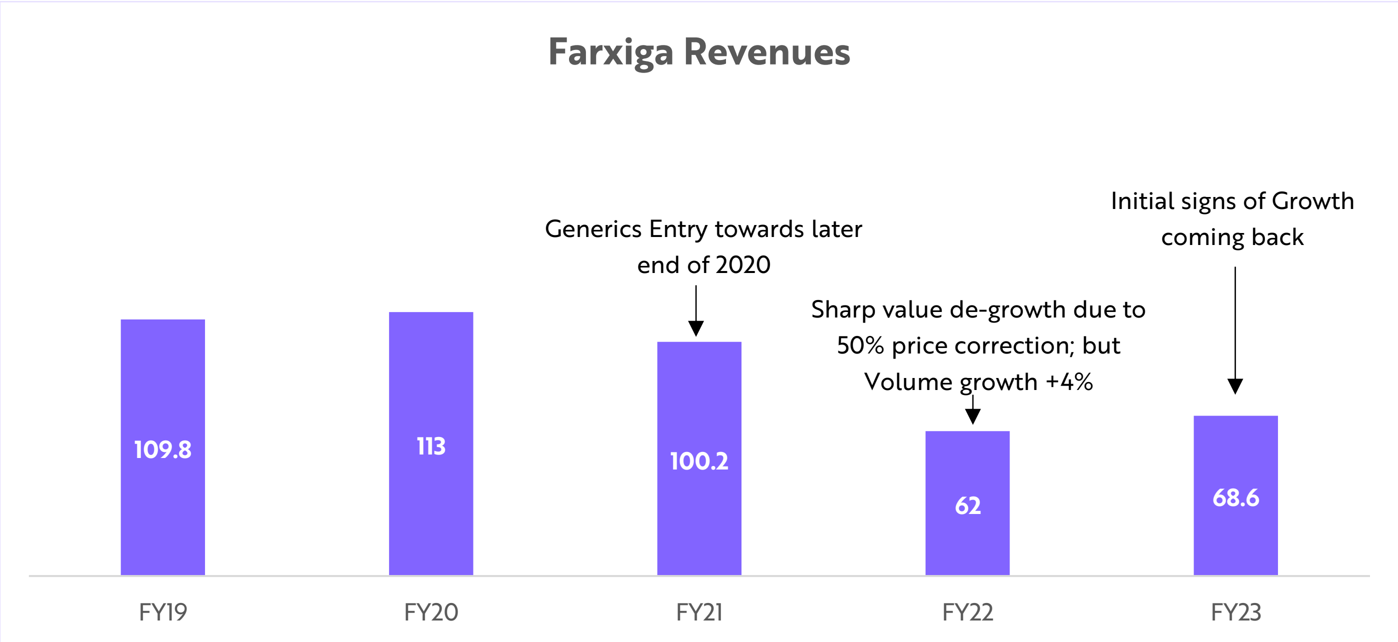
Product Revenues	Launch Period	FY19	FY20	FY21	FY22	FY23
Tagrisso	2017	48.2	93.1	121.5	167.5	219.1
Growth %			*93%*	*31%*	*38%*	*29%*
Lynparza	2019	-	25.7	49.7	84.4	130
Growth %				*93%*	*70%*	*55%*
Imfinzi	2019	-	-	15.1	35.3	100.7
Growth %					*134%*	*185%*
Calquence *(Growth %)*	2020				*61%*	*87%*
Fasenra *(Growth %)*	2021					*320%*

- **Brand Recall & Market Leadership**
  India being a branded generics market, leadership is an outcome of brand recall given that pricing is broadly similar for most brands.

  In such a scenario, having a first mover advantage of establishing a brand during the patent period provides for a big advantage, which allows for market leadership & sustained growth even after the product becomes generic.

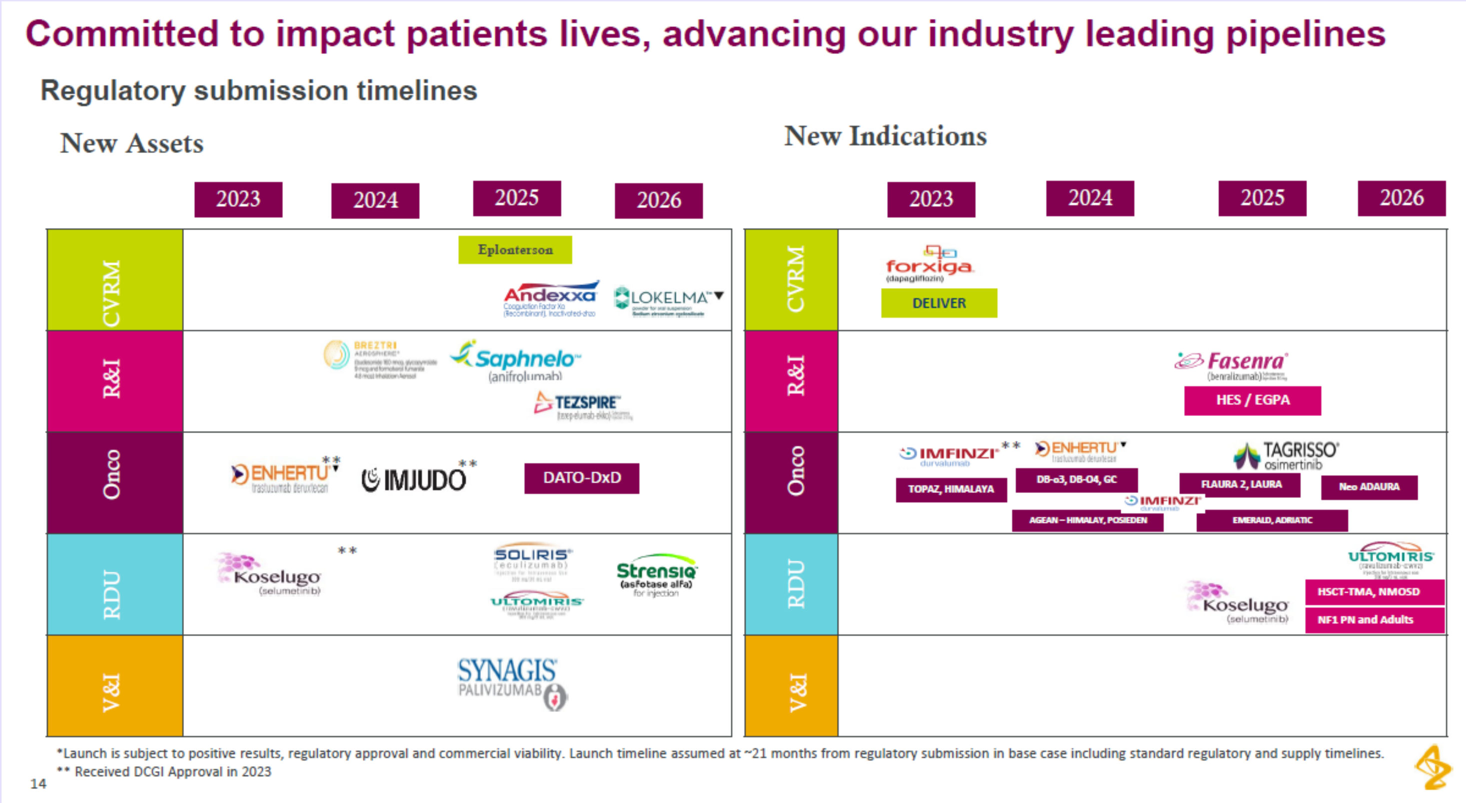
Consider the following examples of two products that saw generic competition-





Given that Astrazeneca's all new launches are innovative & patented products, it will continue to accrue these benefits of high growth & market leading brands in the long run.

The company currently has a strong pipeline of 15 new products launches (and new indications for existing products) across all therapeutic areas over next 3-4 years;



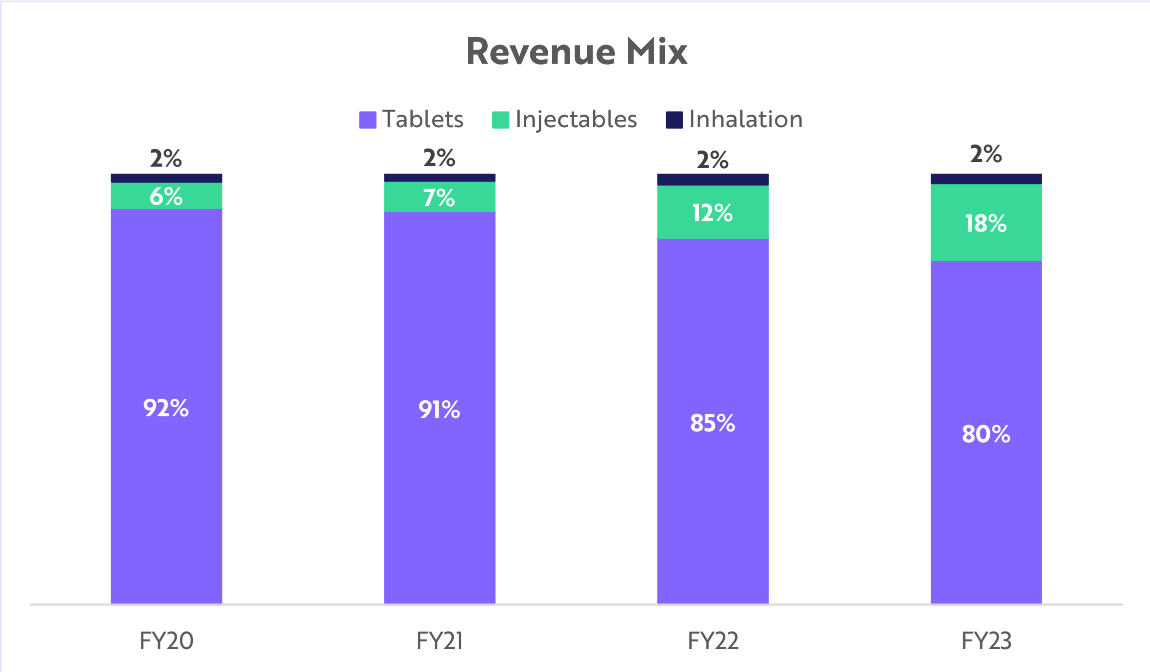
The company is now launching complex & high-end products as well-

1. In 2021, it launched its 1st biologic product under the brand- Fasenra for treating asthma.

2. Launch of Rare Disease Portfolio
   - Astrazeneca Plc acquired Alexion Pharma for $39 billion in 2021.
   - Alexion specializes in development of drugs for rare diseases.
   - India is among the first few Asian markets wherein the parent has started launching products from Alexion's portfolio.
   - The first product- Koselugo was launched in India in August 2023 and the pipeline highlighted above for next 3-4 years includes many of Alexion's products.

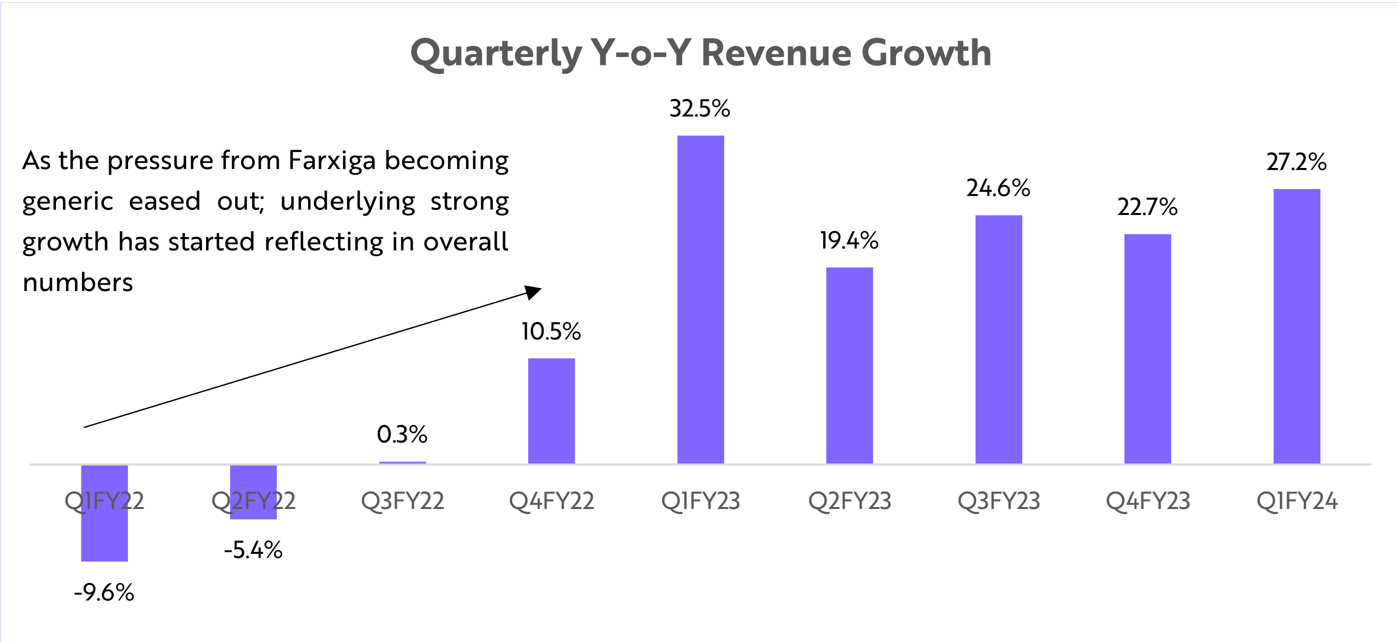
   Snippet from FY23 annual report-

> options. Following the global acquisition of Alexion in 2021, we have expanded our portfolio to bring innovative therapies for rare diseases to the Indian market. As a result of this strategic acquisition, India stands among the first few countries in Asia to offer rare disease therapies from the esteemed Alexion portfolio. One such



Share of Injectables has 3x in last 4-years

All this reflects in the strong growth that the company has been delivering over last several quarters-



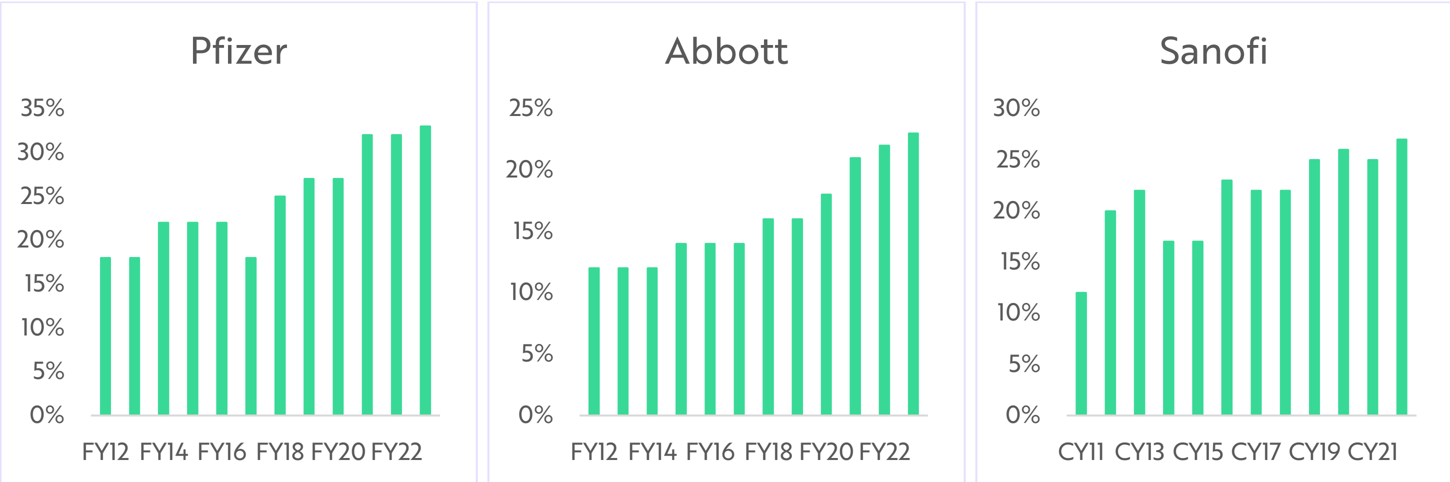
C. High Operating Leverage

Domestic pharma is largely a marketing & distribution business wherein most of the manufacturing is outsourced.

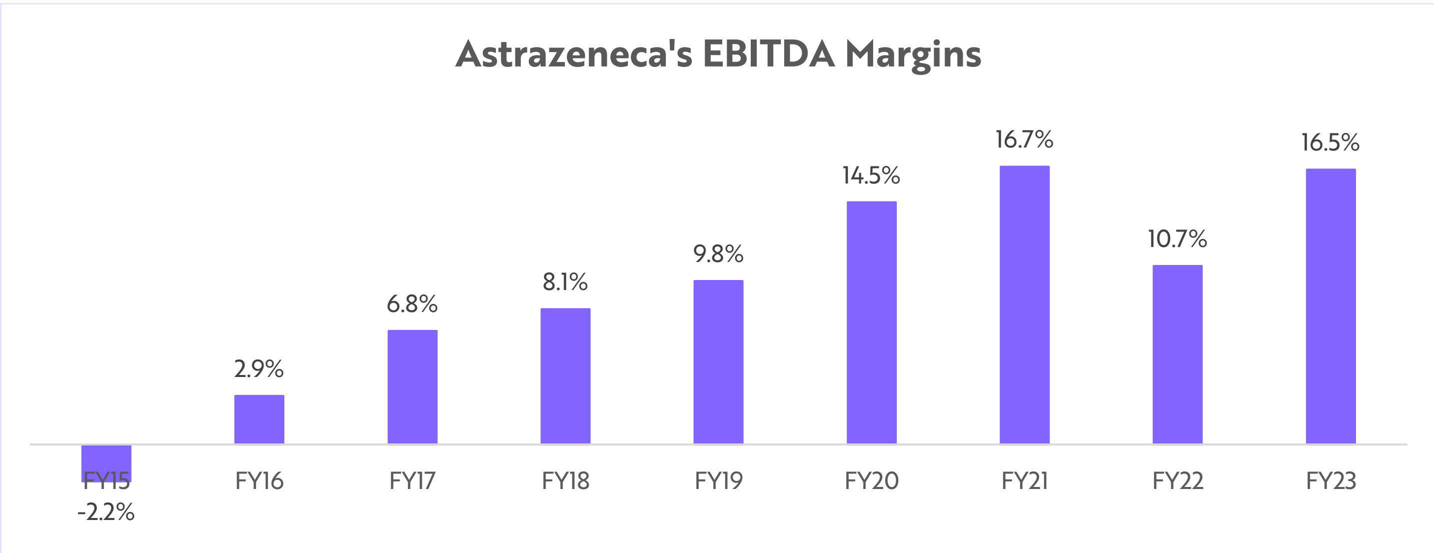
Same is the case with Astrazeneca wherein ~2/3rd of its products are imported from parent entities (low volume patented products) and only high volume & non-patented products are manufactured in-house.

As a result, all MNC pharma companies have historically seen strong operating leverage with increasing scale of operations-

MNC Pharma EBITDA margins over the years-



Same has been the case with Astrazeneca as well wherein it has seen sharp improvements in margins over the years-



A quick peer comparison provides us some idea of where these margins are headed-

ABBOTT	FY21	FY22	FY23
Gross Margins	44.0%	44.0%	43.0%
Employee Exp	11.0%	12.0%	11.0%
Other Exp	10.0%	11.0%	10.0%
EBITDA %	*23.0%*	*21.0%*	*22.0%*

GLAXO	FY21	FY22	FY23
Gross Margins	52.4%	54.1%	56.5%
Employee Exp	21.1%	18.7%	18.4%
Other Exp	10.8%	12.2%	13.4%
EBITDA %	20.5%	23.3%	24.7%

SANOFI	FY21	FY22	FY23
Gross Margins	52.9%	52.8%	54.0%
Employee Exp	15.9%	14.7%	14.7%
Other Exp	12.3%	12.4%	13.9%
EBITDA %	24.7%	25.8%	25.4%

PFIZER	FY21	FY22	FY23
Gross Margins	61.4%	61.2%	61.6%
Employee Exp	16.2%	15.5%	13.7%
Other Exp	13.4%	13.7%	14.5%
EBITDA %	31.8%	32.0%	33.4%

P&G	FY21	FY22	FY23
Gross Margins	58.8%	60.0%	70.6%
Employee Exp	15.3%	15.1%	16.8%
Other Exp	19.1%	20.9%	27.4%
EBITDA %	24.4%	24.1%	26.4%

ASTRA	FY21	FY22	FY23
Gross Margins	61.7%	59.3%	62.7%
Employee Exp	27.0%	28.6%	25.8%
Other Exp	18.1%	20.0%	20.4%
EBITDA %	16.7%	10.7%	16.5%

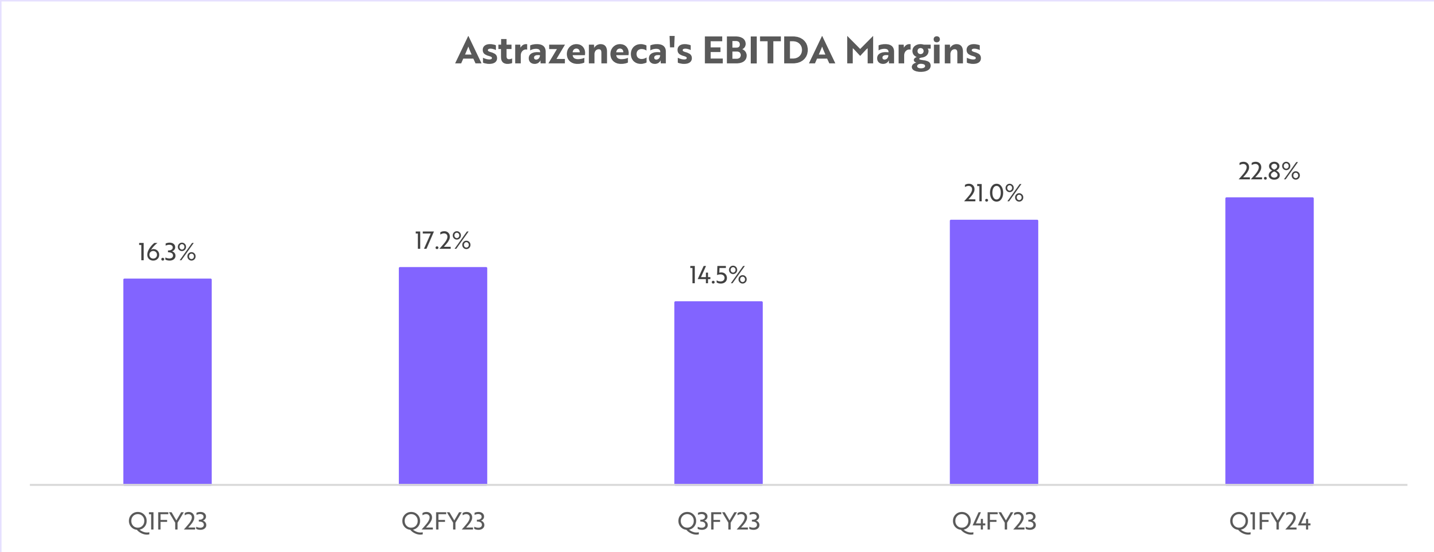
Employee + Other Expense %	Revenue Base	FY21	FY22	FY23
Abbott	~5400 crores	21.0%	23.0%	21.0%
Glaxo	~3200 crores	31.9%	30.9%	31.8%
Sanofi	~2800 crores	28.2%	27.1%	28.6%
Pfizer	~2300 crores	29.6%	29.2%	28.2%
P&G Health	~1200 crores	34.3%	35.9%	44.2%
Astrazeneca	~1000 crores	45.1%	48.6%	46.3%

Better absorption of cost base at higher scale of operations

Based on above and considering the fact that Astrazeneca has one of the highest gross margins among its peers (due to the nature of product portfolio), **we believe that the company can achieve 30%+ EBITDA margins in medium term.**

Also, there is a possibility that even the company's gross margins might improve due to the launch of the complex & rare disease portfolio; and that can further add to EBITDA margins.

Astrazeneca's margins in the recent quarters have already crossed 20%;



Expectations Going Ahead

We believe that over the medium term, Astrazeneca on the back of its strong business model can deliver high double digit revenue growth, making it the fastest growing domestic pharma business and that coupled with margins expansion will result in non-linear growth in profits.

We have bought the stock at a market cap of ~Rs11,000 crores which is ~64x its normalized TTM profits. The valuation might look optically high, but MNC pharma has always received FMCG type valuations in our market.

Stocks like Sanofi, Pfizer, Glaxo have always traded at 30-35x multiple with zero revenue growth, whereas Abbott with high single digit revenue growth has traded at 40-50x multiple.

Astrazeneca has growth rate double than that of Abbott and thus we don't see any reason why it would trade cheap.

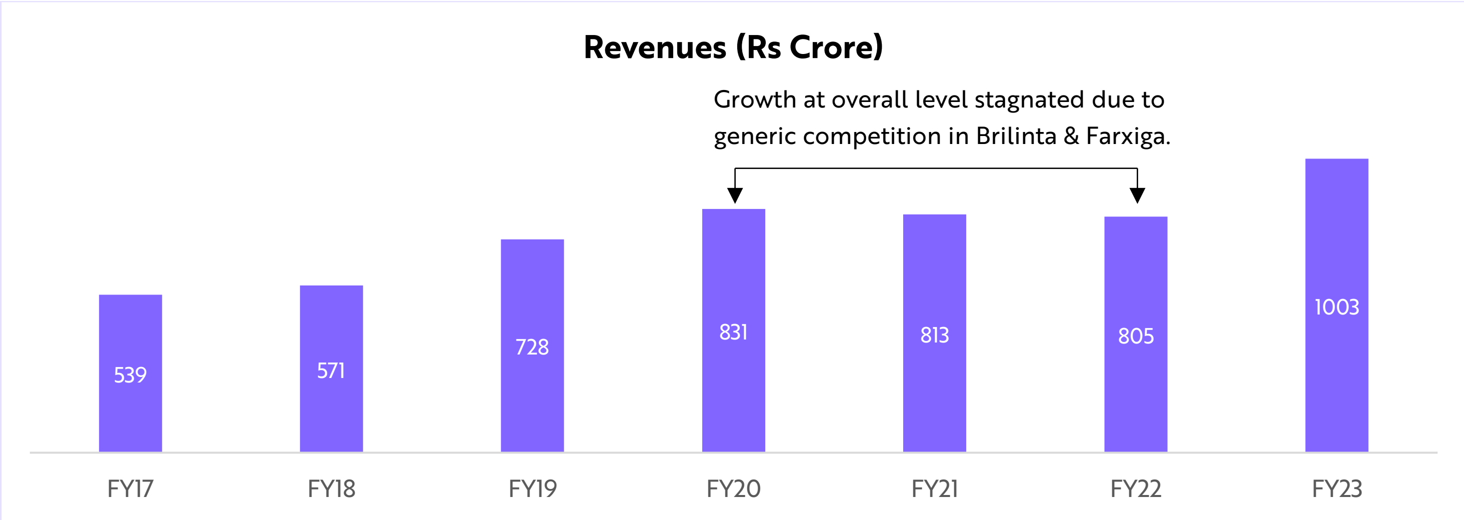
RISKS

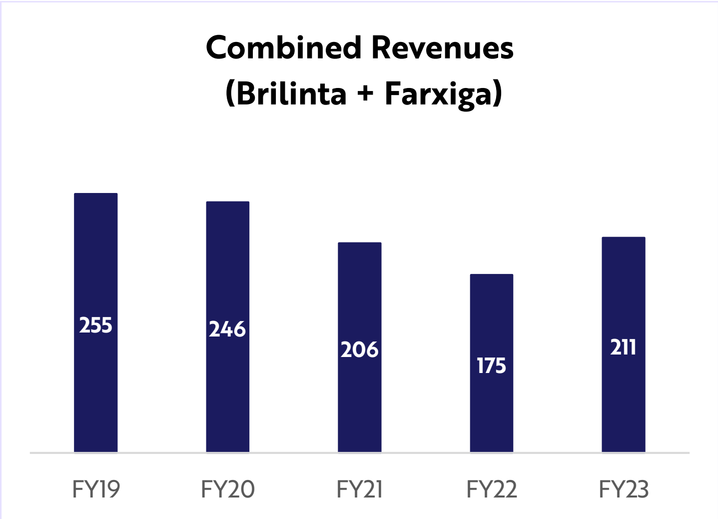
A. Patent Expiry & Generic Competition

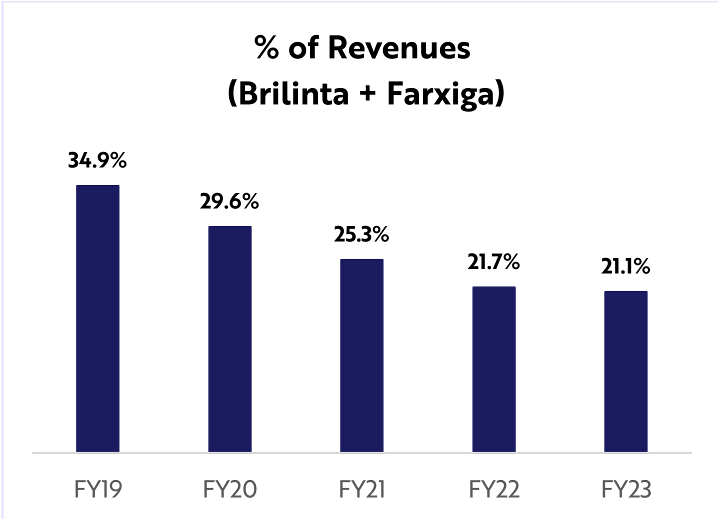
Having a patented product portfolio has its upside (as discussed earlier), but it also comes with its downside of eventual patent expiry & generic competition.

Astrazeneca has faced this challenge in the recent past wherein its two top products- Brilinta and Forxiga saw entry of generic competition in FY20 & FY21.

These two products together contributed ~40% of company's revenues in FY19 and thus impacted company's growth over FY20-FY22.







(Note: Astrazeneca had entered into distribution agreements with the likes of Sun Pharma & Abbott for the underlying molecules of Brilinta & Forxiga (Ticagrelor & Dapaglifozin). Revenues from those distribution agreements are not captured in above revenues of Brilinta & Forxiga as they were sold under different brand names; and those revenues become zero when the products went generic. So, the actual impact of these two products going generic was much larger that what is reflected in numbers of the core brands of Brilinta & Farxiga)

If we look at company's current product portfolio, we have three major products that are under patent protection-

- **Tagrisso:** 23% of revenues
- **Lynparza:** 14% of revenues
- **Imfinzi**: 11% of revenues

~50% of Overall Revenues

Establishing when the patents of these products will expire is difficult given that the Indian entity does not share these details and a search on India's patent registry is never conclusive.

We monitor imminent risk of generics in these products by collating data from three different sources-

Global Patent Expiry

Astrazeneca Plc publishes a full report on patent expiry timelines of its products across major markets of US, China, EU and Japan.

Working with the info that Indian entity over the years has been aligned in terms of key regulatory timelines, we can assume that patent expiry in India for these products will be on similar timelines as some of these major markets.

Monthly IPM Data

Tracking of monthly IPM data published by IQVIA provides an early signal of de-growth which indicates entry of generics.

Channel Checks

Channel checks (online & offline) helps figure out any patent challenge case or if any generic for these products are available.

These three sources had helped us in our earlier investment in Astrazeneca. It allowed us to figure out early, the imminent risk of Brilinta & Farxiga facing generic competition and led us to exit our position at near highs in late 2020.

Based on evaluation of these sources,

No Risk

Tagrisso and Imfinzi

~35% of Revenues

- Patents for both these products runs towards the end of this decade in all major markets.
- There is no red flag in IPM data for these products
- Channel checks indicate no patent challenge case or any generic competition

Imminent Risk

Lynparza

~15% of Revenues

- Patents for Lynparza have started expiring in major markets
- IPM data has indicated erratic degrowth in months of June & August for this product
- Channel checks indicates that Natco has launched a generic of Lynparza.

(Natco has been the primary generic competitor for Astrazeneca; even in case of Farxiga, it was Natco who went and challenged Astrazeneca's patent for this product and even launched the product at risk)

Patent expiry timeline-

Key marketed products	Description	US	China	EU[1]	Japan
Lynparza[7] (olaparib)	An oral poly ADP-ribose polymerase (PARP) inhibitor that blocks DNA damage response (DDR) in cells/tumours harbouring a deficiency in homologous recombination repair, such as mutations in BRCA1 and/or BRCA2. It is indicated for platinum-sensitive relapsed ovarian cancer, regardless of BRCA status, 1st-line maintenance treatment of BRCA-mutated (BRCAm) advanced ovarian cancer, for germline BRCAm (gBRCAm) HER2-negative, metastatic breast cancer and for gBRCAm metastatic pancreatic cancer.	2022–2024, 2028*, 2024–2031	2021–2024, 2024–2029	2021–2029, 2024–2029	2021–2029, 2024–2034

But even if the generic risk in Lynparza plays out, we are not too concerned. It will put some pressure on growth rates in near term, but-

- Contribution of this product is relatively controlled at ~15% vs say the last patent risk situation over FY20-FY22 when 40% of revenues faced generic competition; and even then Astrazeneca was still able to hold onto its overall revenues.
- Underlying growth from other products like Tagrisso and Imfinzi is quite strong
- Further both Brilinta & Farxiga (~23% of revenues combined) are now back into growth phase vs de-growth over last few years, so that would also support growth.

This early warning system will allow us to manage our risk and avoid any major de-growth surprises in the future.

B. Change in Organization Structure

As we have discussed earlier, Astrazeneca has a very good structure wherein there is no other unlisted subsidiary of the parent, listed entity gets full access to parent's product pipeline, parent does not charge any royalty and even reimburses some of the marketing expenditure.

Any change in this beneficial structure can be a risk for the company.

In the past, the parent has tried to do some under-handed stuff in trying to delist the company; following is a brief about the same-

- July'2004, proposed a delisting offer at Rs165. Price discovered in the market was Rs600 and thus rejected by the parent.
- July'2010, again proposed a delisting offer at a price band of Rs576-1152, which was rejected by the shareholders.

- May'2013, Parent announced an OFS at Rs470 to meet the minimum public shareholding norm (parent till then held 90% shareholding and earlier delisting offers were to avoid this dilution of stake)
- Elliott Management run by famous US based activist fund manager- Paul Singer, came and acquired 94% of the OFS at a higher price of Rs620.
- April'2014, Parent again calls of delisting of the company and is able to secure shareholder approval with the help of Elliott (as Elliott held the majority of non-promoter shareholding)
- September'2015, SAT orders hold on delisting as remaining minority shareholder protested and went to SEBI & courts.

From above it is very clear that the parent colluded with Elliott to get the delisting done; which is clearly a sign of bad corporate governance.

So, one cannot completely rule out any other such event of bad corporate governance in the future; but the possibility is very remote given that parent still owns 75% of the company and thus doing anything to get the 25% remaining beneficial interest of any kind by either doing business in a new company or charging royalty etc does not make operational & compliance sense, especially when they have already seen a failure in the past.

Ratings Explanation:

Buy: Expected total return (price appreciation plus dividend yield) of more than 10% over next 12 months.

Hold: Expected total return (price appreciation plus dividend yield) of +/- 10% over next 12 months.

Exit: No Further Coverage/Update on the stock.

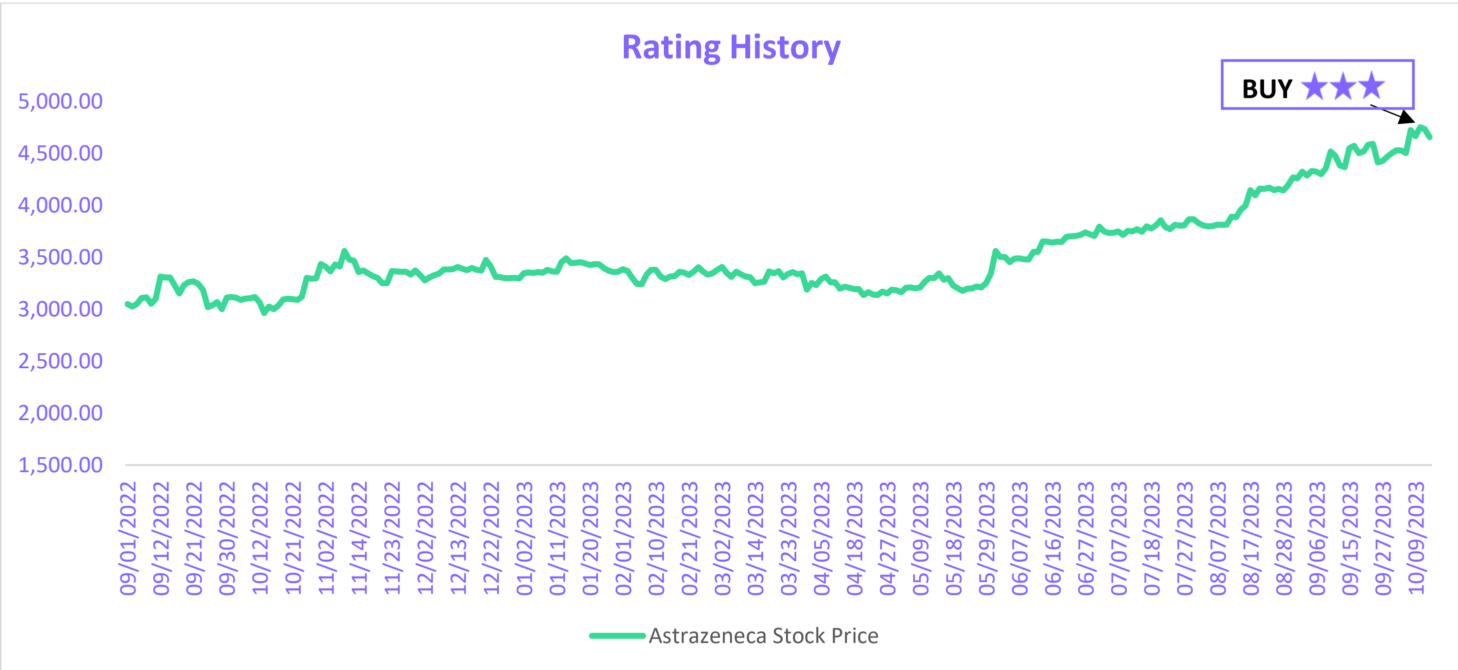
Conviction Rating:

Conviction rating reflects our understanding of return:risk ratio of the underlying stock for next 12 months. The rating is given within a range of 1-5 stars, wherein each higher star reflects a higher return:risk ratio; so, 1 star indicates a low return:risk ratio and 5 star indicates a high return:risk ratio.

The rating is based on our qualitative understanding of how the four factors of- Price Action, Earnings Growth, Valuations & Perception will play out over next 12 months for the stock.

Conviction ratings are to be read along with Buy & Hold ratings and no conviction rating is assigned for stocks with Exit rating.

Note: Ratings are valid till changed.



Note: Above chart indicates ratings assigned (including changes) over the period of coverage of stock.

Disclaimer & Disclosure

Surge Capital is a trade/brand name used by Ankush Agrawal (Individual SEBI Registered Research Analyst INH000008941) to provide equity research services in the Indian Equity Markets.

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Ankush Agrawal/Surge Capital is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form. This document is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The views expressed are those of analyst and the firm may or may not subscribe to all the views expressed therein. The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. Ankush Agrawal/Surge Capital or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. Neither Ankush Agrawal/Surge Capital, nor its employees, agents nor representatives shall be liable for any damages whether direct or indirect, incidental, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information. Ankush Agrawal/Surge Capital or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement.

"Registration granted by SEBI, and certification from NISM in no way guarantee performance of the Research Analyst or provide any assurance of returns to investors"

DISCIPLINARY HISTORY

There are no pending material litigations or legal proceedings against the Research Analyst.

As on date, no penalties / directions have been issued by SEBI under the SEBI Act or Regulations made thereunder against the Research Analyst relating to Research Analyst services.

More details- https://www.surgecapital.in/investor-complaints

TERMS AND CONDITIONS OF RESEARCH SERVICES

The Research Services will be limited to providing independent research recommendation and shall not be involved in any advisory or portfolio allocation services.

"Investments in securities market are subject to market risks. Read all the related documents carefully before investing."

The Research Analyst shall not be responsible for any loss to the Investors.

More details- https://www.surgecapital.in/terms-and-conditions

DETAILS OF ITS ASSOCIATES

No associates

Analyst Certification

Analyst: Ankush Agrawal

Email: ankush@surgecapital.in

Analyst Ownership of Stock: No

The Analyst certify (ies) that he complies with Qualification and Certification requirements of Regulation 7 of SEBI (Research Analyst) Regulations 2014; that are required to be complied with by the individuals registered as Research Analysts under SEBI (Research Analysts) Regulations 2014.

Further, The Analyst certify (ies) that the views expressed herein accurately reflect his (their) personal view(s) about the subject security (ies) and issuer(s) and that no part of his (their) compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report.

Disclosure under SEBI (Research Analyst) Regulations 2014

Whether the research analyst or research entity or its associates or his relative has any financial interest in the subject company and the nature of such financial interest- **No**

Whether the research analyst or research entity or its associates or relatives, have actual/beneficial ownership of one per cent or more securities of the subject company, at the end of the month immediately preceding the date of publication of the research report or date of the public appearance - **No**

Whether the research analyst or research entity or his Associate or his relative, has any other material conflict of interest at the time of publication of the research report or at the time of public appearance - **No**

Whether it or its associates have received any compensation from the subject company in the past twelve months- **No**

Whether it or its associates have managed or co-managed public offering of securities for the subject company in the past twelve months- **No**

Whether it or its associates have received any compensation for investment banking or merchant banking or brokerage services from the subject company in the past twelve months- **No**

Whether it or its associates have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past twelve months- **No**

Whether it or its associates have received any compensation or other benefits from the Subject Company or third party in connection with the research report. - **No**

Whether the research analyst has served as an officer, director or employee of the subject company - **No**

Whether the research analyst or research entity has been engaged in market making activity for the subject company - **No**