SURGE CAPITAL

31st May 2022

NATCO PHARMA

Rating: Conviction Rating:

BUY ★★

Price: 675

Surge Capital is focused 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 12,317 Crores
Revenues:	Rs 1944 Crores
Net Profits:	Rs 170 Crores
Net Debt:	-

✓ *Indicates attributes present in the stock*

Brief Thesis

Natco is a pharma company with a very niche & differentiated business model of focusing on opportunities that either difficult to manufacture or market due to complex legal or regulatory challenges.

Our bet here is on a management who has a mindset of going after large optionalities and has a proven track record of delivering on the same; at a time when their biggest optionality of Revlimid is expected to play out in near-medium term.

Revlimid is one of the top-5 selling drugs in the world with global sales of ~$13 billion and US sales of ~$8 billion. Natco has a very advantageous position to be the 1st generic company to launch the same in the US markets and will continue to enjoy this advantageous position till FY26.

Ankush Agrawal

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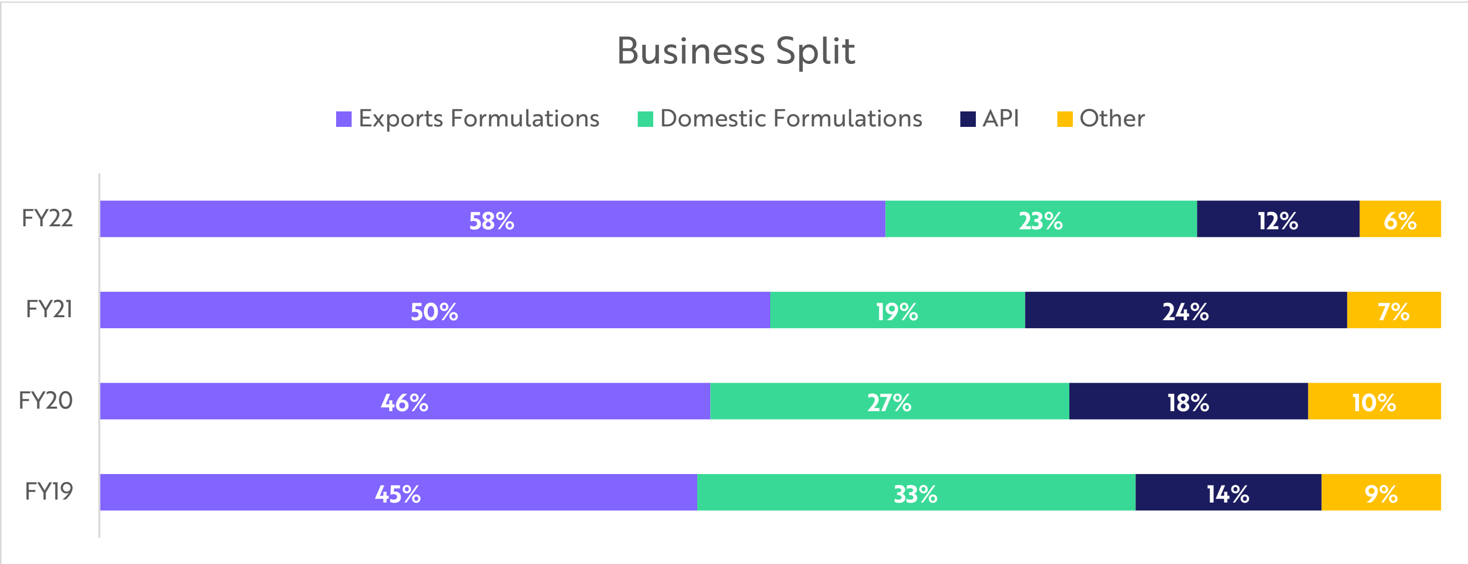
Business Model- Innovation Challenger

Natco is a generic formulations business spread across domestic and international markets of US, Canada, Brazil and Australia. Natco primarily looks to market products wherein the entry barriers are high; either due to complexity in manufacturing or complexity in bringing the product to the market in terms of legal & patent challenges.

The entire thought behind such a strategy is to avoid competing in highly competitive & less profitable products and instead investing in opportunities wherein pay-off could be material if successful. The primary way Natco does this is by challenging patents. And it has done this across its business verticals of Domestic as well as Exports.

In management's own words-

"The business is to challenge patents and provide affordable products"



Exports Business

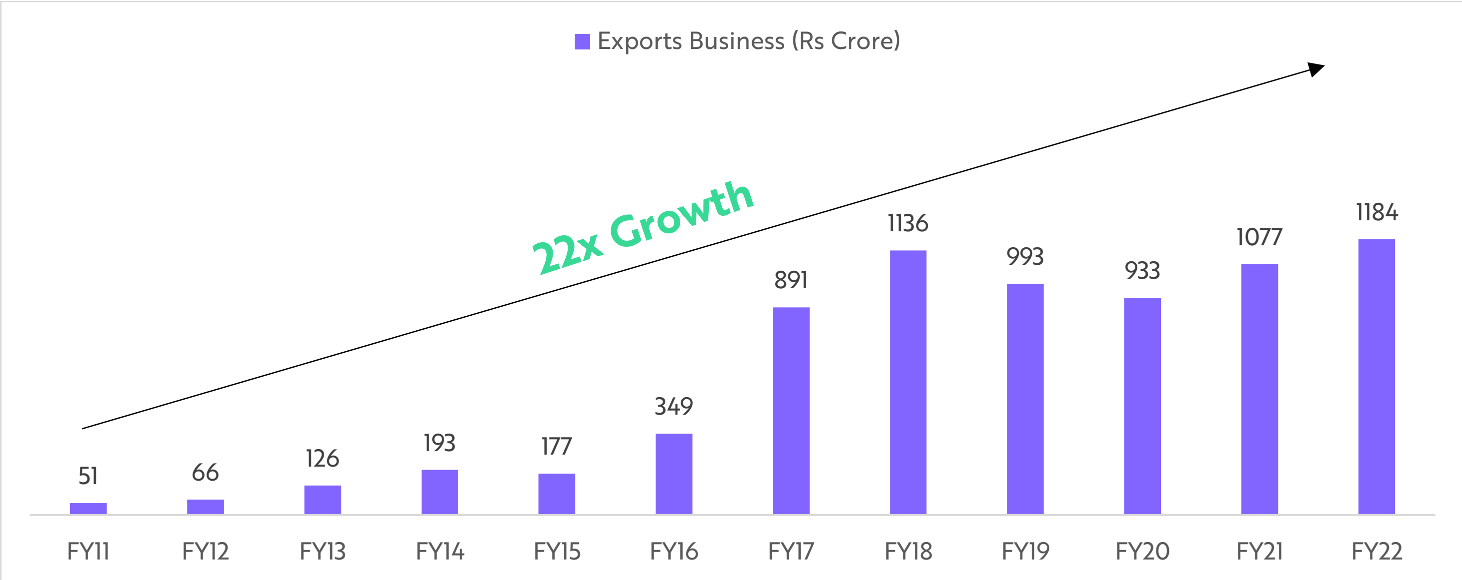
For Natco, the exports business is primarily driven by the US market, which is the largest and most profitable pharma market in the world. Plus, US markets has a well laid out process through which Natco can capitalize on its strategy of challenging patents.

In US, if a generic player believes that its product does not infringe on the innovator's patents or it believes that the innovator's patents are not valid or enforceable, it can make a Para IV filing. The innovator in this case has 45 days to challenge/sue the Generic company for its patents. Based on the outcome of such a patent case either by court or mutual settlement, the FDA then approves/disapproves the generic company's product. The first generic company that makes a Para-IV filing and clears the patent litigation gets 180 days exclusivity; and this is called an FTF filing (First-to-File). This exclusivity ensures that such generic company is the first company to market the generic version of the drug before everyone else and thus is able to garner large market share.

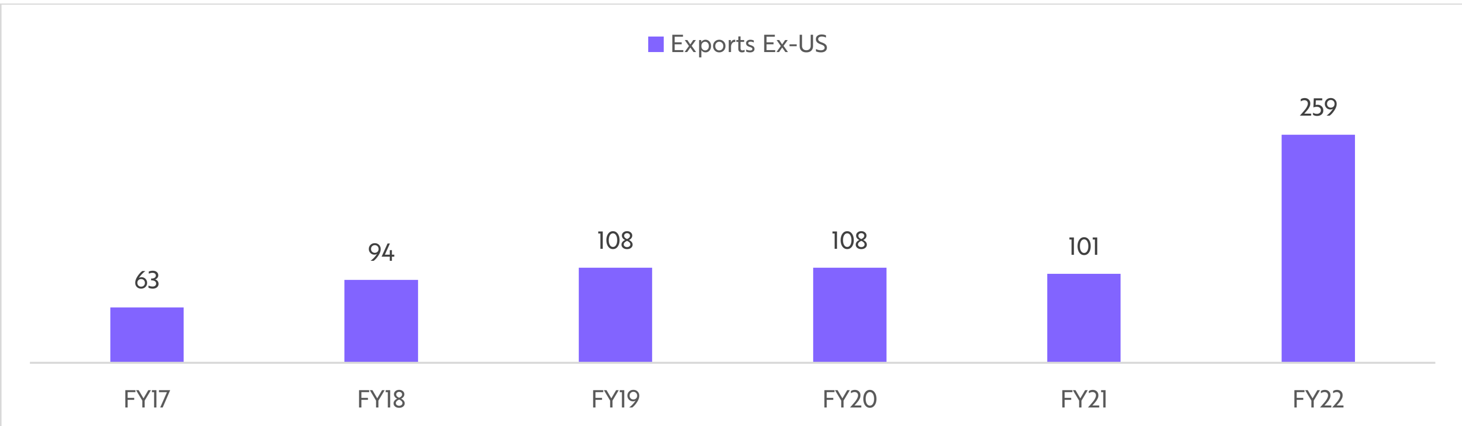
Natco has multiple times proven its ability to capitalize on complex & difficult opportunities in the US. Some of its key products in the US market are-

Product	Remark
Revlimid	First company to successfully challenge and settle with Innovator on ~$8 billion product.
Copaxone	Natco is among the only two players other than the Innovator in the market. It was the 1st generic for the 40mg version and currently has ~40-50% market share.
Tamiflu	Natco was the 1st generic with FTF status. At the time of launch in 2016 it was a $500 million opportunity.
Fosrenol	Natco is the only company apart from Innovator and Innovator's authorized generic to have an approval for this product.
Nexavar	Natco is the 1st generic with FTF status. Launched in June'22.

On the back of its strategy of pure focus on such niche & differentiated products, Natco has been able to scale up its business quite well here.



With success in the US markets, Natco has overtime replicated this strategy in other international markets as well, primarily- Canada, Brazil and Australia. And it has started seeing good traction in some of these markets on the back of some of the recent big launches like Revlimid (1st generic) in Canada. As per management, as of Q4FY22 these international markets have now grown to Rs80-100 crores per quarter business.



Domestic Business

Here as well, Natco has used the same playbook of going after complex, difficult to enter and patented products. And it has a proven track record of doing it-

2011

Natco had applied to Bayer for a license to manufacture & sell its cancer drug Nexavar, which Bayer rejected. Owing to this, Natco challenged Bayer's patent by invoking section 92 of The Patent Act, 1970, that allows a 3rd party to make use of a patent without the permission of the patent holder if certain conditions are fulfilled. In 2012, Natco became the first company (probably the only one till now) in India to receive a compulsory license against a patent and was able to add the generic version of Nexavar to its oncology basket of products.

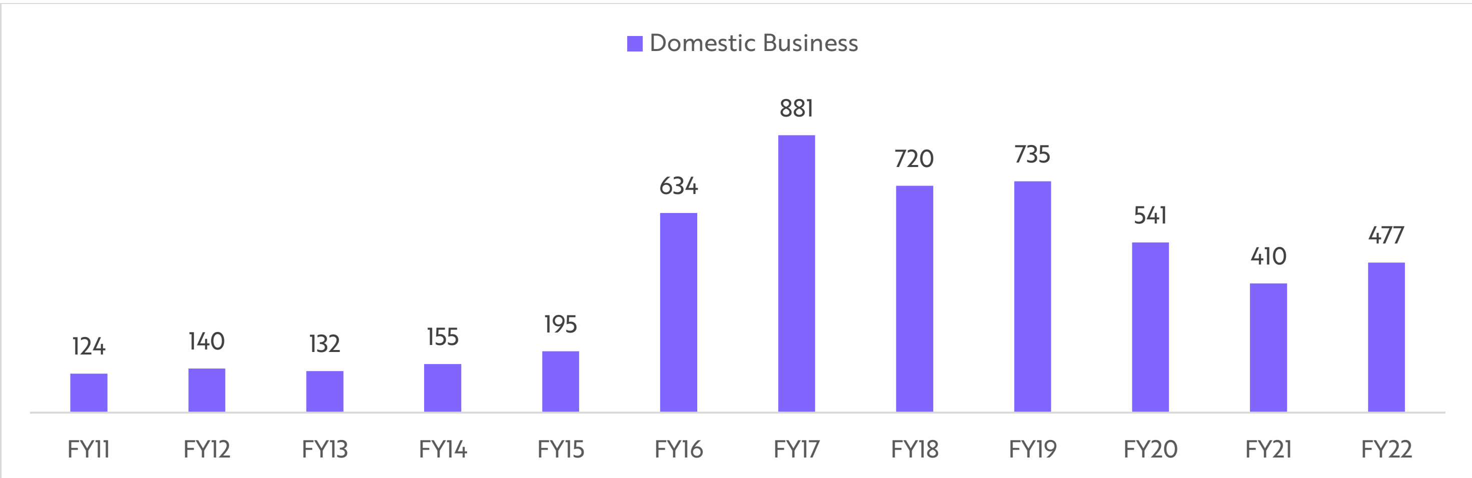
2015

Natco entered the Hepatology segment when it launched 3 key products in the segment that it in-licensed from Gilead and Bristol Myers Squibb. Natco was able to quickly capture 60% of the market through these products as it was an early entrant and also because it was able to establish a strategic tie-up with Laurus Labs for quick & competitive access to key APIs (raw materials for drugs).

2017

Natco entered the Cardiology & Diabetology segment in the domestic market with the same strategy. It has already launched a few products in this segment, some of which are first time launch in India and has already challenged patented drugs in the segment from the likes of Astrazeneca (Brilinta & Farxiga) and Bristol Myers Squibb (Apixaban).

In domestic business, Natco's primary focus has been on the high value and less competitive Oncology (cancer related) products wherein the company has a history of challenging innovator's patents to launch generic versions of oncology drugs at affordable prices for the first time in India. Natco is the leader in the domestic oncology space with ~20% market share.



Stellar Management

In our understanding, for any business to capitalize on such large pay-off bets- Optionalities; on a regular basis, it is very important to have a management that has a right mindset and ability to do so.

We look for following three key qualitative attributes in identifying such managements-

- Management should not be someone who is comfortable with status quo; they should be open to identify & execute on Optionalities.
- Management needs to understand probabilistic and optionality thinking, which is all about Risk:Reward balance.
- Management should also have the bandwidth to execute such opportunities like access to capital or an inside view of a new opportunity.

Natco's focus on investing in these Optionalities is a direct result of its promoters- Nannapaneni's; who have focused on optionalities not only in the US markets, but also in every business segment that they have ventured, including the Domestic Formulations earlier and now the Agrochemicals segment (discussed later).

NATCO'S MANAGEMENT

V.C NANNAPANENI

CHAIRMAN AND MANAGING DIRECTOR

Holds a Masters degree in Pharmaceutical Administration from the Long Island University, USA

Over 4 decades of experience in the pharmaceutical industry

RAJEEV NANNAPANENI

VICE CHAIRMAN & CEO

Holds a Bachelors degree in Quantitative Economics and History from Tufts University, Boston, USA

Has over 20 years of experience in the pharmaceutical industry

Some snippets from Natco's FY14 annual report, wherein the management provides their thoughts on business strategy-

At Natco, we have transformed our perception of litigation prone intellectual property from one of risk to one of opportunity through the following initiatives:

- Engaged with larger partners like Mylan, Helm, Actavis, Alvogen, Breckenridge, Dr Reddy's and Lupin, companies possessing a deep insight into global legal procedures and protocols, making it possible to draw on their rich experience to succeed
- Entered de-risked arrangements where the litigation expenses are borne largely by our partners in exchange for pre-decided profit-sharing percentages
- Structured its product pipeline around the understanding that the upside generated from favourable orders would far outweigh the downsides arising out of unfavourable decisions

At Natco, we have responded to the need to grow our US presence through the following differentiating initiatives:

- The Company has selected to be present in niche therapeutic areas with growing potential
- The Company has selected to address growing opportunities through ANDA filings in complex products
- The Company has selected to introduce products extending well beyond the classification of commodity, marked by value-addition and technology barriers
- The Company has selected to strengthen its price-value proposition by addressing relatively unmet patient needs and a competitive pricing strategy

The result of this approach is that in the event of relatively low success following product launch, the Company would at worst be able to report flat growth; the upside of such a strategy is that success would bring high value, strengthening the Company's financials. As proof, the Company grew its US formulation export revenues from ₹62 crore in 2012-13 to ₹105 crore in 2013-14.

Nannapaneni's have at several occasions made it clear that this is what they want to do and that they not only understand the risk:reward dynamics of such a business model, but are also comfortable with the same.

In Early Years (2010)

Natco was just a small company with <1000 crores of market cap; but it was pursuing litigation on several large opportunities like Copaxone which was a $3.4 billion drug at that time. In order to finance the litigation for such massive opportunities and to address adverse impact of such litigations, Natco settled for lower profit sharing of ~30-33% with its marketing partners against the typical 50%, such that a large part of such risks was borne by Natco's marketing partners.

Size of opportunities that Natco was targeting in 2013-

A summary of these opportunities is given below :

Product	Armodafinil	Glatiramer Acetate	Lanthanum Carbonate	Lapatinib Ditosylate	Lenalidomide	Oseltamivir Phosphate
Current Mkt Size (USD mn)	400	3400	115	125	3000	485
Partner	Breckinridge	Mylan	Lupin	Lupin	Watson	Alvogen
FTF / Para IV	Para IV	Para IV	Shared FTF	Sole FTF	Sole FTF	Sole FTF

Last Few Years

As Natco as a company has grown in size, it is now entering into a larger 50% profit sharing deals with its marketing partners for newer opportunities like Imbruvica (>$3 Billion opportunity).

In Future

Natco has recently bought a front-end marketing presence in the US markets. The purpose here is to capitalize on these optionalities directly without a partner. And thus capture the entire 100% upside in these opportunities.

Snippet from Q4FY21 Concall-

Rajeev Nannapaneni: It will take three to four years Nitin because all of them are partnered out, so all the good ones are partnered out in the near terms, so I think pipeline we are getting in 26, 27, 28, and 29 that is where the impact of the front end is, but we have got to start somewhere. It is a chicken and egg, so you have got to start somewhere. So one decision I made for sure is that we want content in the US clearly. I think at least for the simpler tablet product. Complex generics we can always partner out with someone else because of the cost and the investment involved in doing these generics, but for the typical chemical tablet type of products we need to do our own front end. I think that the opinion that we have so I think we want to do it, but the benefit of that as you rightly said will not play out now, but you know you have to start somewhere right. So you cannot run away from it. My view is this is the simplest way to increase profits right instead of giving away 50% of something just own 100% of something of a smart filing and you get that extra bump, so I think that is where we are.

Above steps are a clear indication that management clearly understand the Risk:Reward dynamics and are looking to capture a larger pie of the profits from the opportunities as Natco's risk bearing capacity increases.

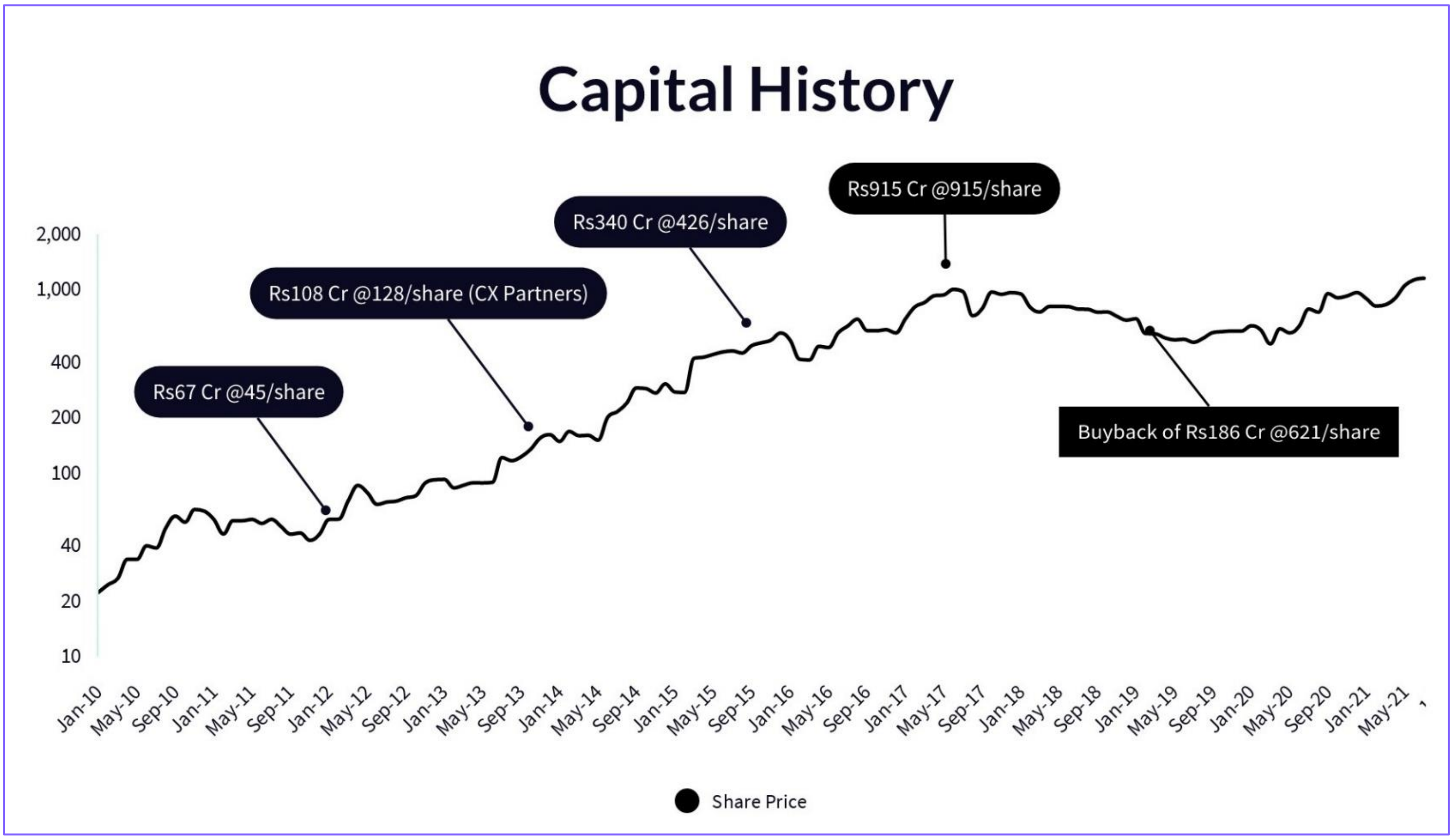
Snippet from Q4FY19 Concall-

Rahul Jagwani: Yes is there something specific we need so much cash for?

Rajeev Nannapaneni: I like to take very high amount of risk, so when I do project initiatives we take a lot of projects where four years, five years or seven years sort of payoff and I like to keep our company in a way where we always have cash on books. We use some of the cash to do buyback and some of it was used for dividend. If you want me to say whether I am going to get rid of cash and give everything back to shareholders at this time the answer is no. I do not intend to do that. I think I want to keep the cash for me to make these high risk investments and may be if there is a huge opportunity that comes in the next few years may be we can use that cash for an acquisition or a new business idea. For now we would like to keep the money. I do not want to give it away.

Rajeev Nannapaneni's astuteness is also proven by how he has used capital markets to Natco's advantage.

If one looks at the capital history of Natco over last 10 years, the company has raised fresh capital four times and each time the capital raise was at opportunistic time when the stock was at new highs. Similarly, when the stock was stagnant and was trending lower over the last 3 years, the company did a buyback at an opportunistic time at lower levels.



Another Interesting Highlight

When the company raised capital from CX Partners in 2013, it also signed an upside sharing agreement with the investor such that if Natco is able to deliver a return greater than certain IRR, then the investor (CX Partner) will share a part of such extra returns. And this sharing was not with the management in their personal capacity, but with the company. Natco actually received Rs48 crores in FY20, when CX partners fully exited the company.

Revlimid Optionality

Key Facts

- Revlimid is an oral drug used for treatment of multiple myeloma (a form of cancer).
- It was first made available in US in 2005 by Celgene (now part of BMS- Bristol Myers Squibb)
- The product has patent protection till 2027.
- It is one of the top selling drugs globally with 2021 sales of ~$13 billion. US sales are ~$8 billion.
- BMS has settled with nearly 10 generic pharma companies, under which there would be a staggered entry of generic players from Mar'22.
- Under the settlement, each generic player has been provided certain volume limits of how much they can sell each year, that will increase every 12 months till 2025. From 2026, generic players can sell without volume limits.

Revlimid is a unique generic situation. Typically, when a drug goes off-patent, we first see the FTF Para-IV holder enter the market and leverage their 180 days exclusivity. During this exclusivity period, the price erosion for the drug is not large as there is only the innovator and the FTF generic player who is there in the market. Only when the 180 days exclusivity expires and when multiple generic players enter the market is when there is a large price erosion and thus a sharp reduction in drug's market size.

However, in case of Revlimid, the generic competition entry is defined by volume limits and thus the typical strategy of lower pricing to get a larger market share will not work here. And thus, there is a reasonable probability that Revlimid will not see large price erosions and will continue to remain a large market opportunity for coming years till 2026, which is when everyone can sell without volume limits.

This is something that BMS is also expecting. In their Q4-2021 concall, BMS stated that although there is some uncertainty due to on-going litigations, they don't expect a sharp reduction in their Revlimid sales. They expect it to be an annual stepdown of ~$2-2.5 billion per year. This is in-line in with increasing volume limits of generic players and thus a lower market share of BMS.

This bodes very well for Natco; it can look to leverage this large existing ~$8 billion Revlimid market (which ideally should not contract much) for next 4 years. Plus, Natco has a very advantageous position to capture the Revlimid opportunity-

- Natco was the first company to settle with Celegene back in 2015 and has a FTF Para-IV on major strengths of Revlimid (5-10-15-25 mg)
- Natco (through its partner Teva) launched Revlimid in the 1st week of March'22; other generic players will enter in a staggered manner only from September'22.
- Volume limits for Natco are much higher from other generic players. Natco will start with a limit of mid-single digit % of total capsules dispensed in US in the 1st year, and the same will increase to 33% by 2025.

While most generic players have stated that their launch & volume % are confidential, Alvogen (2nd player to settle with Celgene) has stated the following-

Alvogen's Mar'19 Settlement:

"Alvogen can sell volume limited amount of generic in US beginning on a **confidential date that is some time after March'22 volume limited license date that Celgene previously provided to Natco**."

"For each consecutive 12 months following the volume limited entry, the volume limited % increase gradually to **no more than a single digit % in the final volume-limited period**."

Other Settlements:

Dr. Reddy (Sep'20)

"Volume limited entry sometime after March'22 data that Celgene previously provided to Natco. Date & Volume percentages are confidential."

Cipla (Dec'20)

"Volume limited entry sometime after March'22 data that Celgene previously provided to Natco. Date & Volume percentages are confidential."

Sun Pharma (Jun'21)

"Celgene will grant Sun Pharma a license to manufacture and Sell certain limited quantity of generic lenalidomide capsules in the US beginning on a confidential date that is sometime after March'22. It will also allow Sun Pharma to sell an unlimited quantity of generic lenalidomide in US beginning January 31, 2026."

Torrent Pharma (Q2FY22 Concall)

Torrent Pharma said that they have reached a settlement with Celgene for Revlimid. Declined to disclose launch timeline.

Lupin (Q3FY22 Concall)

Lupin said that they have settled. But they see risk in launching a limited quantity authorized generic and will look to launch in FY25.

The sense we get from all these statements is that sequentially the settlements done by Celgene/BMS are inferior to earlier settlements or atleast with that of Natco's settlement. And either way, all generic players will compete primarily with BMS to secure their market share upto the defined volume limits and not among each other.

In Q4FY22 results, we got an initial sense of how large Revlimid could be for Natco.

Particular	Rs Crore	Remark
Q4FY22 Profit Before Tax	-49.6	-
Add: One-off write offs	278	Natco wrote-off some Covid related inventory (Rs232 crores) & receivables (Rs46 crores)
Normal PBT	228.4	-
Less: Tax @25%	57.1	-
Normal PAT	171	-
Less: Base Business PAT	60	Management mentioned in the Concall that Base business does ~Rs50-60 crores PAT per quarter.
Profit Share from Revlimid in Q4FY22	111	Management mentioned that they had transferred entire volume that they are allowed to sell in the 1st year to Teva in Q3FY22 itself and whatever we see in Q4FY22 is pure profit share. Natco has a ~30-33% profit share with its partner Teva.
Expected 1st year profits from Revlimid. (Q4FY22 profit divided by 30%)	371	Management mentioned in the concall that in Q4, Teva has only sold ~30% of quantities and remaining 70% will be sold in FY23.
Annual PAT from Base Business	240	Rs60 crores x 4
Annual Profits for Natco	611	-

The way Revlimid will play out for Natco is that, it will transfer its volume quota for each year (revised every Q4) to Teva upfront and then will book profit share based on how much Teva will sell in each of the quarters.

Management has mentioned in the concall that a large part of 1st year volumes will be sold in Q1FY23 and then it will taper off over Q2 & Q3 and then again, a bump up from Q4 based on revised volume limits. This pattern is something that BMS has also talked about in its concalls-

> "On generic entry, we expect sales variability quarter to quarter based on the timing of how generic competitors fulfill their annual volumes."- **Q4 2020 BMS Concall**
>
> "Revlimid Generic entry in the US was later than expected and so far at a modest pace. We expect favourability we saw in Q1 to reverse in Q2."- **Q1 2021 BMS Concall**

Our core thesis on Natco is that if Natco stands to make ~371 crores in 1st year of Revlimid when its volume is limited to mid-single digit %, then in coming years when its volume limits expand multifold to 33% over three revisions (Mar'23, Mar'24 and Mar'25), ie. 4-6x expansion in volumes, then the quantum of money that Natco can make is huge. This obviously comes with some caveats if the overall market formation for Revlimid is not what we expect (discussed later).

Additional Optionalities

1. Leveraging Cashflows from Revlimid

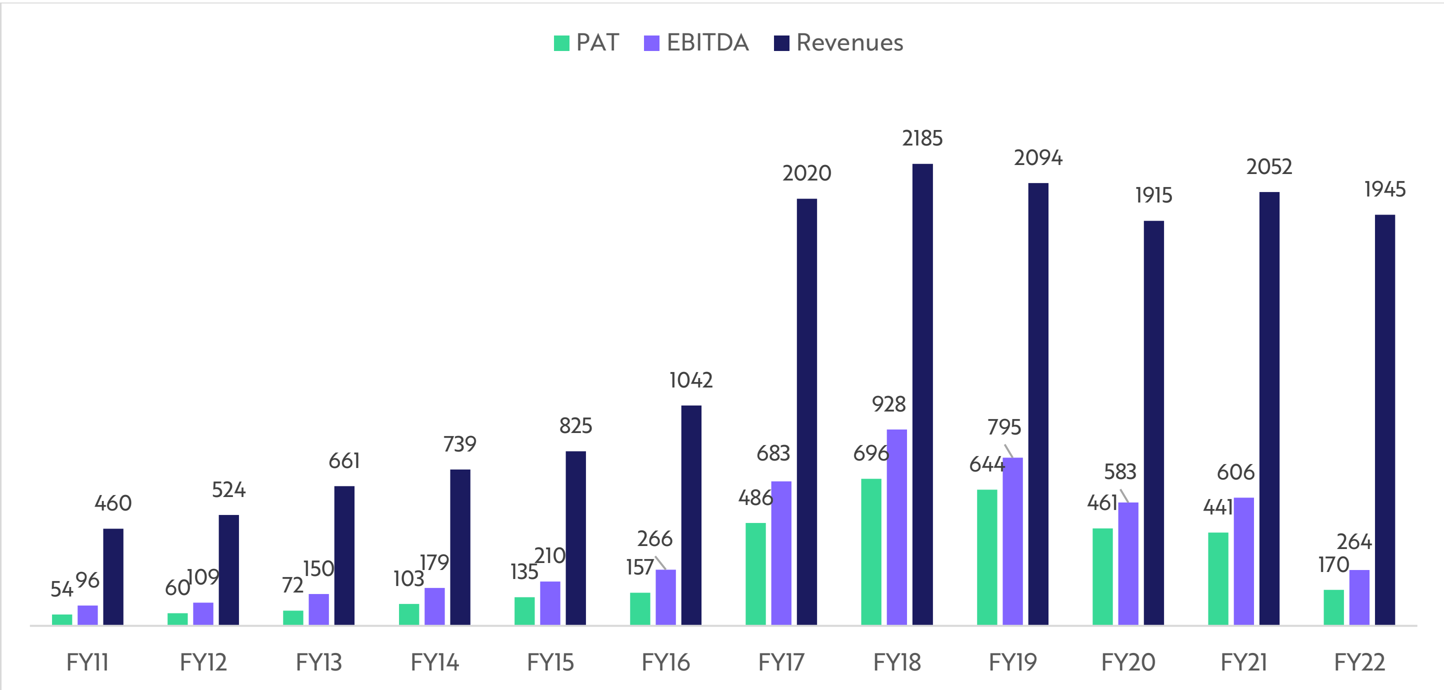
Natco currently has ~800 crores in Cash. With Revlimid, the amount of cashflows that Natco will accumulate will be huge. And such high cashflows in the hands of an astute management like Mr.Rajeev Nannapaneni is all that one needs for new optionalities to play out.

Mr. Rajeev Nannapaneni has highlighted two key areas wherein he wants to invest these cashflows-

A. Large in-organic acquisition to strengthen Natco's base business

Natco's business is primarily driven by a small number of large products/opportunities. However, there is one major issue with a business driven by such large opportunities which is that in early periods, one makes a lot of money however after a point there is a dramatic tapering off in the business that these opportunities deliver (discussed in detail in risks section) and thus the base business for Natco ie. the business that is stable and no degrowing in nature is relatively small.

This makes Natco's performance quite lumpy. First part of lumpiness comes from the sharp spike that Natco witness when one of its big opportunities materializes and second part of lumpiness comes when such opportunity tapers off. And this is clearly visible in Natco's financial performance over the years-



Natco's management is cognizant of this and thus wants to build a base business such that atleast there is some downside cushion when such big opportunities taper off.

Snippet Q3FY21 Concall-

Ankush Agrawal: Okay, fine. Secondly, Sir, how do you see the long-term sustainability of the business model that you operate on? I mean we typically go for big opportunities wherein at the time of launch, we get a huge jump in our business and then over time, it's kind of falls. So has the business size is growing up, every time you will need a bigger opportunity to not just to get back on the old revenue but to even grow over that. So how do you see that playing out over a long term as your business size grows? Do you see a hindrance over there?

Rajeev Nannapaneni: I think it is a challenge because our strength has always been delivering the niches. So I think the niche business will also have its own value. I think as you rightly said, there are huge upside that you get. And I think that is the basic DNA of the company. So we continue to do that. But having said that, we are very cognizant of building the base business. I think that is why we have been working very hard to diversify the portfolio in domestic by adding agro. So we are doing this foreign sub so that we can diversify revenues. So foreign subs are now representing almost 7% to 8% of revenue in this quarter. So we are trying to diversify revenue so that the dependence on the one-offs will be less. But I think over a period of time, we will be able to achieve that. I think it would not happen overnight. I mean, I can be honest with you there. But I think the endeavor is to do that. I think endeavor is to build a base business, which is always steady and then the upside gets added on the top. I mean that is the objective.

Such an inorganic acquisition will help in two ways. Firstly, it will provide a good jump to Natco's current business size and secondly, a large base business will help reduce volatility in Natco's financial performance and that will contribute positively to Natco's valuations.

"We are very clear that we want to do one large acquisition. We are looking at both domestic & exports. And thus will strengthen the base business"- Q4FY22 Concall

B. Investing in More Revlimid Type Jackpot Ideas

Mr. Rajeev Nannapaneni believes that all they need is 3-4 jackpot opportunities and that takes care of the entire decade. In last decade, it was Copaxone, Tamiflu, Doxil, Fosrenol and Hep C (domestic market).

Product	Launch	Size At Launch
Copaxone	Oct'17	~$4 billion
Tamiflu	Dec'16	>$500 million
Doxil	Aug'17	>$190 million
Fosrenol	Aug'17	>$120 million
Hep C	2015	Natco did >Rs500 crore Sales in FY17

In Q4FY22 concall, he stated that for next 10-years, he has visibility of 5-6 years wherein they will have such jackpots opportunities in play. For the rest, he wants to pull out atleast another 2-3 Revlimid kind of opportunities for Natco. And that is where they will use cash in the short run- investing into R&D of more interesting ideas.

For current decade, Natco has some products already in pipeline with large opportunity size-

Product	Opportunity Size	Remark
Pomalyst (Pomalidomide)	>$1 billion	Partnered with Breckenridge. Settled with Celegene.
Kyprolis (Carfilzomob)	~$700 million	Settled. Sole FTF in 1 Strength. Shared FTF in 2 other Strengths. Launch in 2027
Imbruvica (Ibrutinib)	>$3 billion	Partnered with Alvogen. Received unfavourable ruling from court in Aug'21.
Revlimid	>$8 billion	Launched in Mar'22 (discussed earlier)
Everolimus	~$1 billion	Launched various versions over the course of 2021

2. Foray into Agrochemicals

Natco is looking to replicate its playbook of going after complex and high entry barrier products in domestic agro-chemicals space.

"Business model we have adopted in Agro is similar to what we do in Pharma. We do products where we believe we have a technology advantage and that you are able to start first. 2nd is to do patent challenge. We are not a big fan of doing cost competition."- Q3FY20 Concall

It has already established manufacturing capacities for the same and has been seeding market with some smaller commodity products to create a distribution reach.

The first major product that Natco has targeted here is CTPR. This is a technical product (like an API) that is used by FMC (large global agro-chem company) in some of its major products. Natco has already received approval for this product and it has a domestic market size of ~2000 crores.

Natco was earlier going to launch this product in 2021, however it could not receive a favorable ruling from the court against the patent litigation brought by FMC.

CTPR's product patent is expected to expire in Aug'22 and Natco was expected to launch the same in Aug'22. However, FMC has now sued NATCO for a process patent that will expire only in Dec'25, in order to stop Natco from launching in Aug'22.

Natco's management has stated that their process does not infringe FMC's manufacturing process and is looking to launch the product in Aug'22 when product patent expires.

We are relatively confident that Natco will be able to create a good business out of agro-chemicals and it will be another growth trigger in near term; primarily on the back of its past track record in doing the same across various businesses & geographies and management capability. It already has a pipeline of 3 niche products including CTPR.

Agro-chemical will add to Natco's base business given that here Natco is going B2C, wherein it will market products under its own brand, much like domestic pharma business and thus it would be a sticky business.

Expectations Ahead

Our bet at the moment on Natco is largely short-medium term wherein we expect to benefit from strong growth that Natco should deliver on the back of Revlimid and on top of that, the upside that would come from Inorganic acquisition and Agro-chem business. We have bought Natco at ~12000 crores market cap, with expectation of ~600 crores of FY23 profit ie. a 20x multiple. At this level the downside looks low, it is only the upside that might not play out if Natco is unable to grow its Revlimid profits from FY23 base.

Based on whatever we have read around how the market for Revlimid would shape up, either from the innovator-BMS and other generic players; there is a decent probability that Natco would see increased profits from Revlimid in coming years, largely because the volume limits will expand materially.

Risks:

A. Revlimid Market Formation

Our primary assumption on Revlimid is that the generic players due to their volume limits will keep price sanity and that the overall market size of Revlimid will not contract much. However, BMS is currently fighting litigations with multiple generic players and in any such litigation if BMS's patents are proven invalid, then Revlimid would become a full generic market and would see entry of 100s of players and the overall size of the opportunity will collapse.

Also, if existing generic players who have settled, does not show price prudence, then that also can be detrimental.

B. Business Model Issue

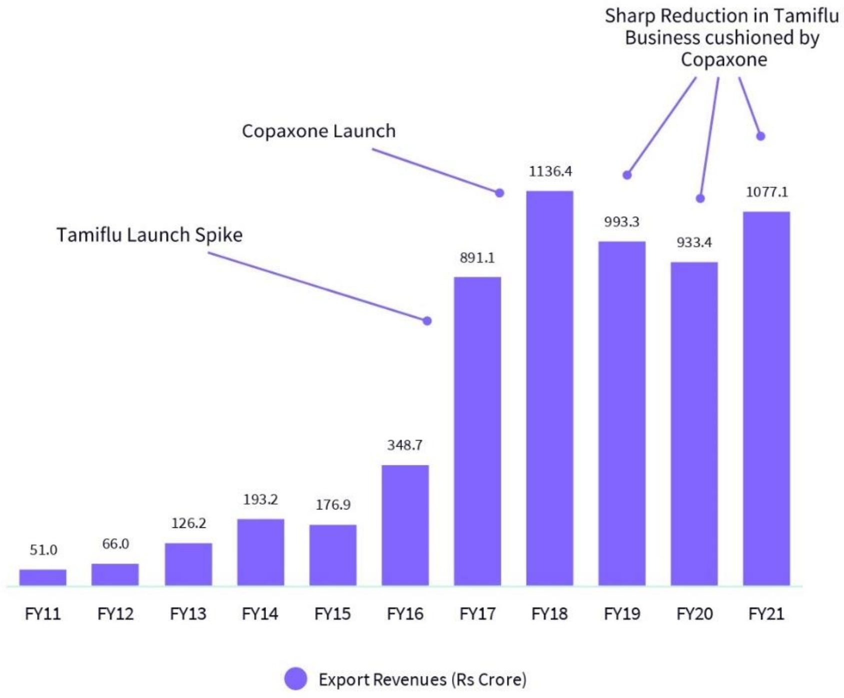
In any business competition is something that one cannot run away from. Even though the competition might not come now or in near term, but eventually competition always come.

Natco's business model primarily relies on capitalizing on few bigger opportunities wherein it can beat the competition in terms of early entry. However, Natco can never keep competition at bay forever, other players eventually do enter the space. Either because the 180 days FTF exclusivity expires or because others are also able to challenge the patent or some other thing.

This puts Natco's business model in a tough spot, wherein even though it sees sharp upside in the initial periods of new opportunity, it also has to face the dramatic reduction of such opportunity when competition arises. This effect is more pronounced for Natco given that its business is concentrated in few opportunities that are extremely large in size.

And thus, unless Natco can compensate an outgoing opportunity with a new even larger opportunity, it will see a major decline in business.

This is something we have seen play out for Natco in last couple of years in exports business-



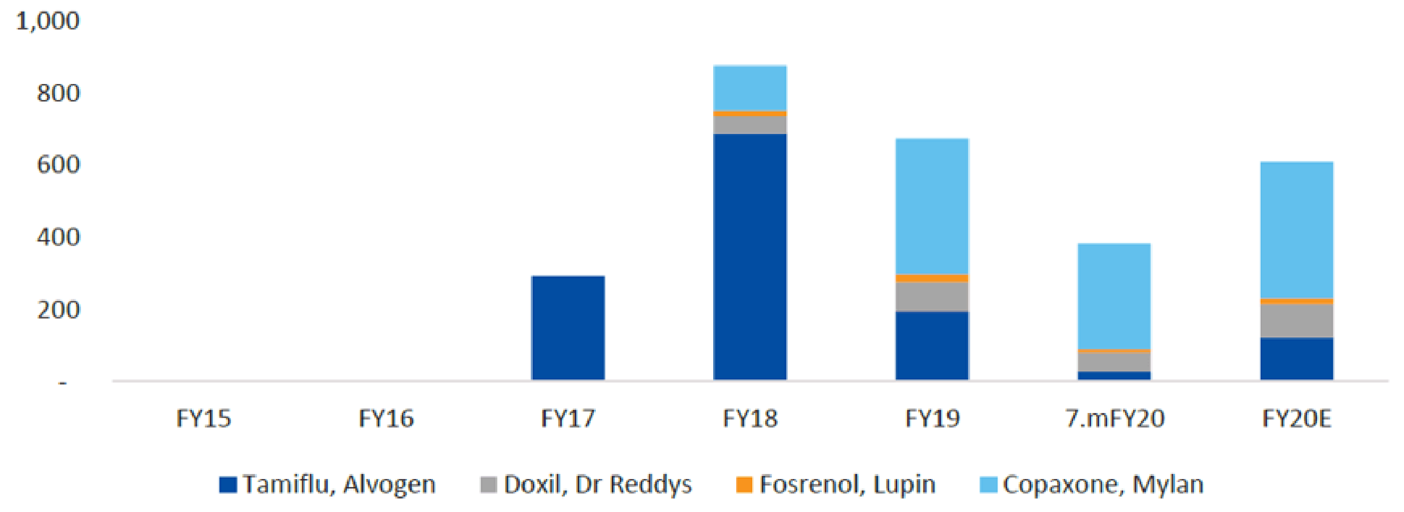
1. In FY17, Natco saw huge spike in US revenues due to the launch of gTamiflu (>$500 million opportunity) with FTF status ie. 180 days exclusivity.

2. Post 180 days exclusivity the business from Tamiflu saw huge contraction as many players entered the market.

3. Major part of contraction in Tamiflu was cushioned by launch of Copaxone (~$4 billion opportunity) in FY18.

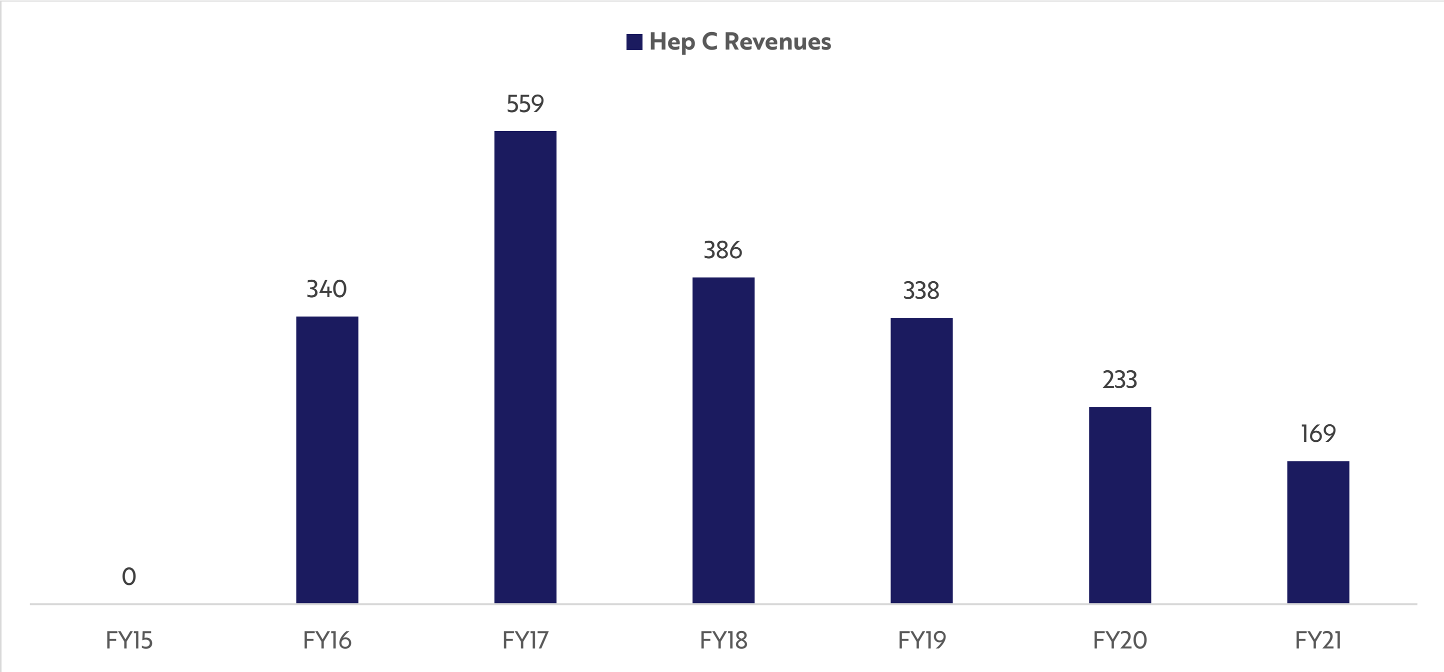
4. But post FY18, Natco has seen slight degrowth in US business as Tamiflu business as continued to degrow while Copaxone is stable.

Figure-19: Indicative contribution of four key drugs



(Edelweiss report highlighting degrowth in Tamiflu which was cushioned by new Launches of Copaxone and Doxil)

In domestic business as well, Natco's Hep C sales have seen similar kind of pattern due to increased competition and also due to the fact that the disease is acute in nature wherein the patient is cured and does not require the drug after initial treatment.



This risk is largely relevant from the long-term perspective and because of this reason alone, we find it difficult to bet on Natco with a long-term view, even though we are quite bullish on the company and its management to create large wealth. In the short-medium term, this affects Natco's valuations. We don't expect any re-rating as such for Natco, given this volatile nature of business, which market is aware of.

However, if Natco is able to create a sizable base business through its inorganic initiatives and/or is able to create some opportunities that can carry Natco post Revlimid, then it would be positive from the valuation perspective and we might consider extending our view to long term here.

C. Other Risks

Natco always have some tail risks attached to the outsized opportunities it chases. Like currently in the agro-chem business, it is facing litigation from FMC wherein if it is not able to win, it would have to write-off ~Rs80 crores of inventory that it has created for this product.

In one of its older US products- Copaxone, Natco & its partner are being sued for some patents by the innovator. In this goes on the wrong side, then there could be possibility of large damages as this product has been in the markets for 5-years already and Natco has generated good business over these years.

In domestic business, Natco took a major call on Covid products, however the same did not play out as expected and company had to take a major write off of ~Rs270 crores. In managements own words, "If you see the money, we made in last 2 years and the write-off, we have not made any money in the domestic business. It's a disaster"

So, some risks to existing base business do exist.

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.

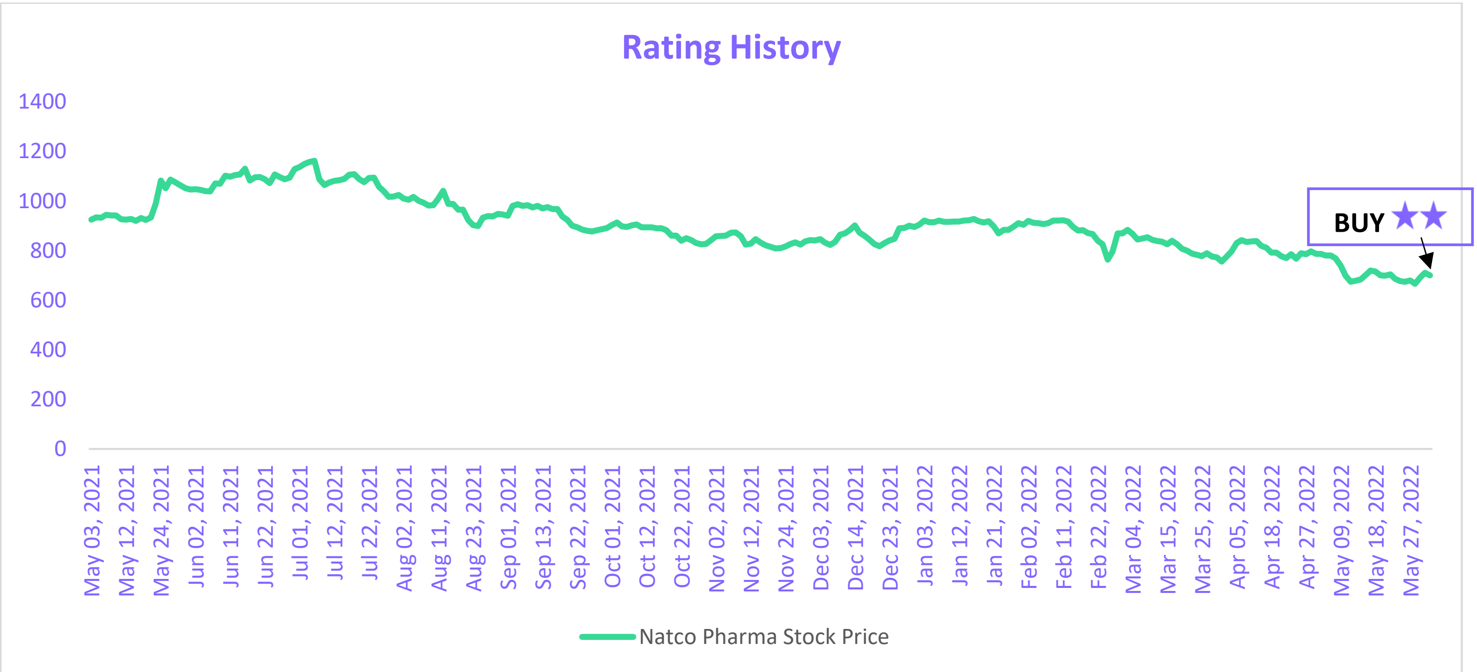
Conviction Rating:

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.

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