A look under the HOOD – Wednesday 7th October

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Summary:

- Pharmaceutical manufacturer producing active pharmaceutical ingredients (APIs) and supplying to global pharma companies
- Around 35 years old and was publicly listed ~25 years ago
- Client base in North America, Europe and Japan
- ~1,000 employees across three manufacturing sites, head office and a research facility in Hyderabad, plus two regional sales offices in Tokyo and New Jersey
- Two business verticals: Custom Manufacturing Solutions (CMS) and Generic Drug Substances (GDS)
- Long track record of FDA compliance with no reported issues.

Market Opportunity:

- Health Care sector, and pharma within that, in India is very large, but Indian API industry is yet to mature.
    - Currently a ~$10bn space with plenty of room to grow
- Changing global trade dynamics could offer India's API space some tailwinds, winning some of China's market share.
- Despite a difficult year across sectors, APIs have performed well – demand is steady.
- Government are incentivising companies to 'Make in India' which is opening up additional opportunities.

India vs China:

- In the 80s and early 90s, India was completely self-sustainable but as China began offering better value there was a gradual shift away from Indian materials.
- Neuland produce around 70 APIs commercially, and around a dozen of these have competition from China where they can deliver them for 15-20% less.
- But there are challenges with Chinese suppliers: lack of transparency, failing to commit to prices etc. Around the Beijing Olympics in 2008, the Chinese government cracked down on pollution, negatively impacting API producers and causing supply chain issues.
- India has language to its advantage, doing business in English. As API production becomes a more complex process and buyers seek a more collaborative relationship, a language barrier can raise additional challenges.
- Whilst the quality from China is good, the lack of transparency and information is becoming increasingly frustrating to clients.

Product linked incentives:

- As Neuland operates in a quality conscious market (Europe, Japan and North America), it cannot participate in the PLI scheme (which focuses on products made for domestic consumption).

- However, there has been a resurgence of chemical manufacturers in India over the past two years, now only sourcing 25% of materials from China. They are seeing a shift away from China irrespective of the scheme. Neuland dependence on China was ~65% two years back.

Direction of growth:

- Saw strong performance in FY17 followed by two difficult years in FY18 and FY19
  - CMS, a relatively newer vertical, has exhibited more volatility over the past few years whilst they build out their base. Worked to Neuland's favour in FY17 but suffered in FY18 and FY19.
- Have always been optimistic about its potential. New projects are being added, and as molecules are commercialised, profits kick in. Seeing a lot of sustainable growth in this side of the business.
- EBITDA margins are now back to optimal level (15-17%).
- Forward looking: global offices, R&D facility with over 300 employees – fixed costs are high. As the company grows, operating leverage will increase. Should see Neuland grow to a 20% EBITDA margin business.
- Whilst they can't rule out surprises, they are resilient enough to absorb them.

Competition:

- Europe is the biggest threat to India's API space. Hold a lot of market share and could gain even more from China.
- Less threat from Vietnam/Bangladesh due to high level of regulation required.

Regulatory risk:

- One small mistake can have a domino effect on the business.
- The challenge comes in managing this risk, particularly in India where attrition can be high. Neuland's response is to be overly paranoid – conduct surprise audits, have an ex-FDA inspector working as a consultant, are willing to hold back shipments if they are not confident on the quality.
- All of Neuland's sites operate under FDA guidelines. Dual-quality creates confusion and a poor culture.

Conclusion:

- Commoditisation of APIs is going to become more difficult over time as specifications and quality expectations increase.
- Neuland's niche is to focus more on innovation:
  - Building this type of business can be slower and more volatile – a significant level of trust is required, facilities and track record must be impeccable – but in the long run it is sticker and more profitable.
- The key will be finding the balance between contract manufacturing and generics.