COMPANY UPDATE

SEARL

Eminent script presenting succulent return of 52%

Equity Research | Pharmaceutical |Monday, 4 September, 2019

We initiate our coverage on The Searle Company Limited (SEARL) with a DCF based Jun-20 TP of Rs.188 which provides an upside potential of 48%. A dividend yield of 4%, if incorporated gives a total return of 52%

Despite challenging macroeconomic conditions, the company has managed to grow its revenues and earnings at a 5-year CAGR of 21% and 42% respectively

Going forward, we expect the company's revenues to grow at a 5-year CAGR of 29% amid increase in prices along with volumetric growth, and subsequently 5-yr projected earnings CAGR at a robust 36% respectively. We expect earnings in FY19 to clock-in at PKR 2,814mn i.e. EPS of PKR 13.25. The stock is currently trading at a FY19 PE of 9.62x

Industry Overview

The size of the pharmaceutical industry in Pakistan is currently approximately US$3.1 billion, with an annual growth rate of approximately 15%. There are more than 700 pharmaceutical manufacturing units in Pakistan, exporting products worth over US$200 million to more than 60 countries. The outlook for the industry remains positive, which is encouraging for the Company's future aspirations & growth.

The recent economic conditions have raised challenges in the industry as a whole. It is a fact hidden from none that the chemical industry of Pakistan has capacity constraints to develop the basic components required for the manufacturing of drugs. Therefore, the industry resorts to imports of raw materials. Due to this significant dependability, fluctuation in exchange rates coupled with stiff price regulations directly affects the product margins and consequent commercial feasibility. The Pakistani rupee has recently experienced double-digit depreciation of approximately 33%, which has put pharma industry under immense pressure.

Furthermore, due to the overly regulated drug pricing mechanism, volatility in retail prices is a concern of paramount importance for the pharmaceutical sector as a whole. Delays in new product approvals also pose key threats for the industry as a whole. However, with the change in the recent political scenario, we will have to wait to assess future economic trends and modify our strategy.

The industry was facing serious economic challenges in its strive to produce quality drugs at affordable prices for the patients in Pakistan. The cost of production of the local Pharma industry had increased manifold since 2018 due to an unprecedented decrease in value of rupee as compared to the dollar while keeping in view the fact that up to 90% raw material of the industry was imported. Electricity tariff increased by 45%, the natural gas bill increased by 65% while diesel price also increased by 95% as all these factors also directly affect the cost of production of pharmaceutical manufacturers.

Keeping in view the difficulties of the pharma manufacturers government ordered a on January 11, 2019 allowed a 15 percent price increase for all medicines (9 percent allowed for life saving medicines). This price hike was a breath of fresh air for the industry as price controls on the pharmaceutical sector have been in place since as early as 2001 and has been a long-standing problem for the sector.

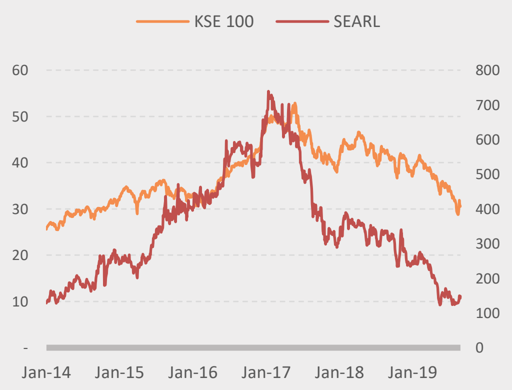
Key Statistics

TP - Jun 20	**188**
LDCP	127
Upside (%)	48
Current Mkt. Cap ('mn)	27,067
KSE Symbol	SEARL
Beta	1.38
52-Week High	349
52-Week Low	117
30-Day Moving Average	137
180-Day Moving Average	171
Avg Vol (90 Day)	890,808
Avg Vol (10 Day)	1,169,080
Float ('000)	95,591
% Held by Insiders	55
% Held by Institutions/Individuals	45

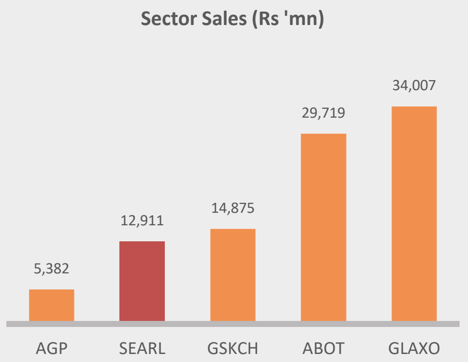
Symbol	**P/E**
GLAXO	9.62
AGP	9.54
ABOT	12.08
GSKCH	16.38
Peer Average	**11.91**
SEARL	9.62
Discount (%)	**19.21**

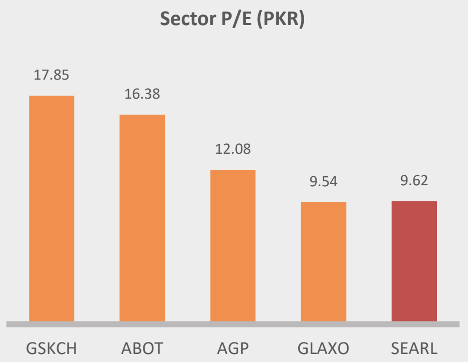
Source: ACPL Research, Company Financials

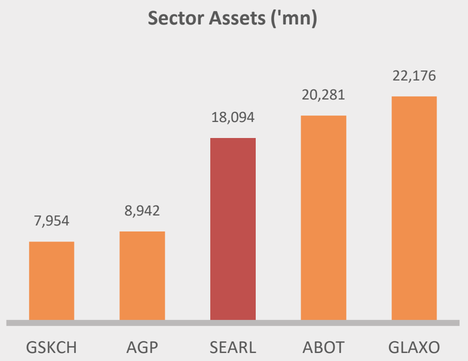
SEARL vs KSE 100 index

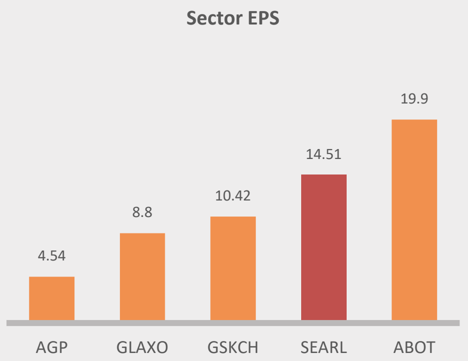


Saif Ali
Phone: (+92) 42 38302028; Ext: 116
Email: saif.ali@abbasiandcompany.com









Sources: ACPL Research, Company Financials

Companies have thus been unable to increase prices, in response to rising costs, due to factors such as rupee devaluation, rising inflation, etc. This has resulted in MNCs winding up operations in the country. On top of this price increase, it was also established previously that medicine prices would be linked to the Consumer Price Index (CPI). Non-essential medicines would be allowed an annual increase of 70 percent of the CPI, whereas all other medicine prices would be permitted 100 percent increase every year.

(BusinessRecorder)

Sector Overview

Altogether 12 companies are listed on the Pakistan Stock Exchange in the Pharmaceutical Sector. But for the sake of this study, we'll only be discussing a few when comparing their financial performance with SEARL.

The sector has a total Market capitalization of 158 billion rupees and weighs about 11% in the KSE-100 index. Only 5 companies including SEARL fall under the ambit of KSE-100 index.

SEARL when compared with the other five companies has the lowest P/E ratio and the second highest earnings per share. Furthermore, it is the second most valued company in this sector as per market capitalization.

Company Overview

SEARL is a leading pharmaceutical company of Pakistan providing medicine for cough and muscle relaxants as well as manufacturing ORS, cardiovascular, analgesic, gastrointestinal and antibiotic medicine. The company's main focus is to provide treatment for chronic diseases which consequently led to a bigger customer base.

SEARL is part of a well-known group, International Brands Limited (IBL). The company was a subsidiary of G.D Searle & Co., USA until it was acquired by IBL in 1993. IBL's principal business activities include marketing, selling and distribution of health care products.

Searle has been fortunate enough to have featured twice in Forbes's list "200 best companies under a billion". In year 2017, it was the only company of Pakistan origin from the pharmaceutical sector amongst five other companies to have featured in that list. Year 2018 was no different and Searle once again made its mark. But this time around only three local companies made it to that list. It is pertinent to mention that SEARL has now become the 3rd largest pharmaceutical company in Pakistan by volume and 5th largest by value.

The company has one plant situated in Karachi and two plants in Lahore. Whereas, Searle Bioscience Private Limited (subsidiary) has a Nextar Plant in Port Qasim. Moreover, Searle Laboratories Private Limited (subsidiary) has a facility in Lahore. Company's portfolio includes three major division; Pharma, Consumer Health and Nutrition. Pharmaceutical range include therapeutic areas such as cardiovascular, cold & cough, diabetes, infant formula, pro-biotic and antibiotics.

On the domestic front, the company is currently in the process of establishing the country's first FDA plant. Nexter Pharma is setting up the plant and it will further take 2 years for FDA approval. When approved it will open new horizons and will help boost exports. Presently, company is exporting to 8 countries. In future the company seeks to expand it to more than 50 countries.

(Company Financials, 2018)

Business Segments

Searle primarily operates in two segments - pharmaceuticals and consumer healthcare. The former accounts for around 90% of the total sales. However, both segments have been growing astoundingly. As of 9MFY19, the consumer healthcare segment has grown by 32% YoY. Much like its peers, Searle has been continually enhancing its consumer healthcare segment. Revenues from this segment, although showing nominal growth, have come to form a larger share of revenues. Consumer healthcare formed over 10% of revenues in 9MFY19, as opposed to 9% in SPLY.

Financial Performance

Despite high import costs amid massive currency devaluation, political and geopolitical unrests, company's 9MFY19 Gross Margin only slightly reduced by 2ppts YoY to 34% from 36%. Also, operating and net margins for 9MFY19 have both reduced by 6ppts and 7ppts YoY to 23% and 20% from 29% and 27% in SPLY.

The company posted a Profit after Tax of PKR 2,081mn (EPS: PKR 9.80) in 9MFY19, down by 17% YoY. This decline came on the back of Pak Rupee depreciation of 19% YoY against USD and stiff price regulations. On a quarterly basis, earnings arrived at PKR 625mn (EPS: PKR 2.95) in 3QFY19, down by 9.9% YoY.

Total sales of the company during 9MFY19 increased by 14% YoY, clocking-in at PKR 11.5bn. This consists of local sales of PKR 10bn (up by 8% YoY) and export sales of PKR 1.5bn (up by 26% YoY). Company's exports stand at around 13% of total sales. However, sales from toll manufacturing arrived at PKR 221mn (down by 11%). In 3QFY19, net sales swelled up by 14% YoY. The increase in sales growth can also be attributed to domestic volume growth due to expanding doctor coverage.

Other income during 9MFY19 witnessed a decline of 4% YoY on the back of reduced dividend from its subsidiaries.

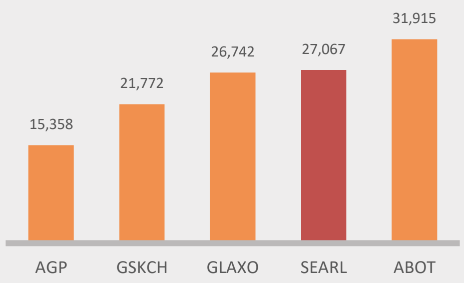
The unprecedented Monetary Policy Rate hike of upto 750 bps since Dec'17 has almost doubled the finance cost of the company in 9MFY19. Despite company's low debt to equity ratio which currently stands at 22% profitability of the company has contracted. While estimating earning of FY19, we have assumed that there will be no further policy rate hike as it has almost peaked out at 13.25% and from this point forward it is expected to gradually decrease.

Going forward we expect company's FY19 Revenues to clock in at PKR 14bn a 10% YoY growth. Gross Margin to more or less stay the same in FY19A, as we feel that 15% hike in the prices of local medicines along with Federal Budget 2019-20's new measure to reduce custom duty on 18 raw material items will help sustain margins and nullify the impact of rupee devaluation.

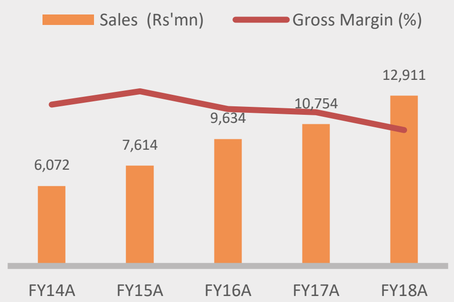
Furthermore, a rapidly growing population and the government's initiative to provide national health coverage and increase the number of hospitals nationwide are also going to help boost sales. Earlier, sehat-insaf card scheme was launched by the KPK provincial government (now federal government) under which each person was entitled to get health insurance coverage of up to 300,000 rupees annually. It is expected that the same policy will be replicated nationwide. This facility when launched will not only enable poor families to get high-quality medical treatment and medicine in government and private hospitals but help boost sales of all the pharma companies' as well.

Key Statistics

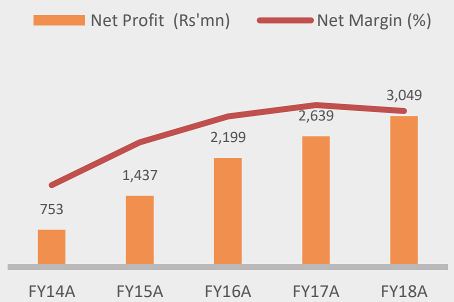
Sector Mkt Cap (Rs 'bn)



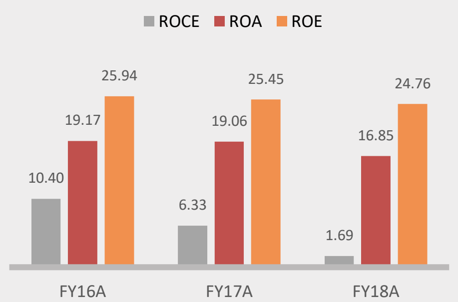
Sales vs Gross Margins



Net Profit vs Net Margins

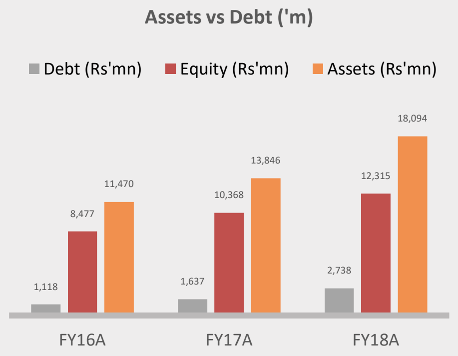


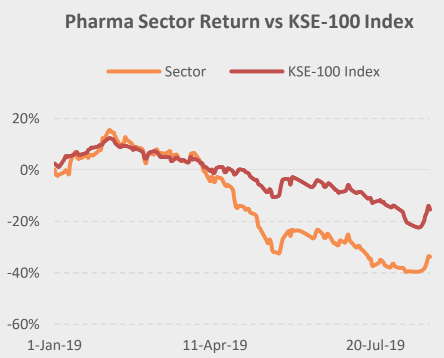
Key Investment Ratios

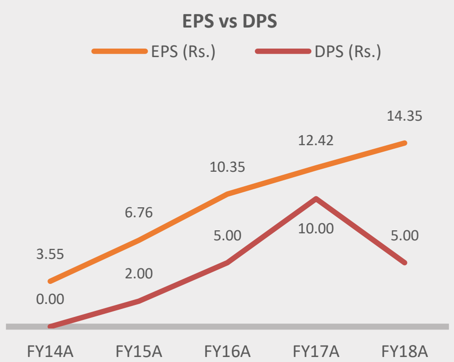


Sources: ACPL Research, Company Financials

Key Statistics







Sources: ACPL Research, Company Financials

OBS Pakistan (Private) Ltd.

SEARL through a notification to PSX has expressed its intention to indirectly/directly acquire OBS Pakistan (Private) Ltd. (formerly known as MSD- Merck Sharp and Dohme Pakistan Ltd). OBS Pakistan is a subsidiary of OBS Group (9th largest pharma company in Pakistan by value) and is one of Pakistan's leading corporations in the healthcare segment with a strong presence in Pakistan and Sri Lanka.

The stake sale, by OBS Group, is aligned with the group's restructuring strategy, having recently sold its holding in AGP Pharmaceutical to Aitken Stuart Pakistan (Private) Limited. However, given this acquisition is still in early stages, we will await further details before incorporating into our estimates.

Future Outlook

Going forward, we strongly believe that this steadfast performance will continue. Sales will proliferate at a 5-year CAGR of 29%. Whereas earnings will grow at a 5-year CAGR of 36%. This can be backed by the fact that the government is fully committed in supporting local manufacturing industry be it pharma or any other industry. The recent price hike of 15 percent for all medicines (9 percent for life saving medicines) is expected to boast well for the local pharma industry as a whole. Government initiative of Sehat Insaf cards will also play a pivotal role in broadening the scope of all local pharma manufacturers.

Valuation

SEARL is currently trading at FY20E PE of 7.68x respectively. Furthermore, the script is trading at an CY20E P/B of 1.68x which offers a significant discount of 56% relative to its historical 5-year average of 4.35x. We have a BUY stance on the script with a DCF based Jun-20 TP of Rs.188 which provides an upside potential of 48% a dividend yield of 4% if incorporated makes the total return of 52%.

Key Risks to Valuation

- More than expected devaluation of PKR
- More than expected hike in the prices of raw material
- More than expected hike in energy, gas or fuel cost
- Less than expected growth in demand

Key Ratios

Profitability Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
GP Margin	%	40.80	44.18	39.69	38.86	34.37	33.69	34.91	35.95	36.04	36.07
NP Margin	%	12.41	18.87	22.83	24.54	23.62	19.81	21.88	22.88	22.84	22.65
OP Margin	%	9.53	15.54	9.70	6.25	1.62	1.38	2.53	3.52	3.57	3.59
ROE	%	22.74	29.65	25.94	25.45	24.76	20.09	21.88	23.34	23.80	24.15
ROCE	%	14.24	21.29	10.40	6.33	1.69	1.26	2.35	3.42	3.60	3.76
ROA	%	12.01	18.00	19.17	19.06	16.85	13.07	14.88	16.42	17.17	17.77

Liquidity Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
Current	x	1.32	1.75	2.20	2.63	2.11	2.56	2.74	2.91	3.07	3.23
Acid-test	x	0.10	0.17	0.13	0.19	0.21	0.66	0.75	0.80	0.83	0.86

Activity Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
Inventory Turnover	x	7.54	8.35	8.82	9.69	7.72	6.52	7.39	7.68	7.76	7.78
Inventory Days		81.80	78.27	68.62	61.63	72.08	84.42	75.87	74.22	73.56	73.41
Receivables Days		12.57	14.39	9.13	17.82	29.12	16.61	16.61	16.61	16.61	16.61
Payables Days		124.53	138.87	111.68	96.58	123.26	123.26	123.26	123.26	123.26	123.26
Operating Cycle		-30.17	-46.21	-33.93	-17.13	-22.06	-22.23	-30.79	-32.44	-33.10	-33.25

Investment Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
EPS	Rs.	3.55	6.76	10.35	12.42	14.35	13.25	16.60	20.60	24.50	29.08
DPS	Rs.	0.00	2.00	5.00	10.00	5.00	5.30	6.64	8.24	9.80	11.63
Div. Yield	%	0.00	1.57	3.92	7.85	3.92	4.16	5.21	6.47	7.69	9.13
Dividend Cover	x	0.00	3.38	2.07	1.24	2.87	2.50	2.50	2.50	2.50	2.50
BVPS	Rs.	15.59	22.81	39.91	48.81	57.97	65.92	75.88	88.24	102.94	120.38
Payout	%	0.00	29.57	48.30	80.50	34.83	40.00	40.00	40.00	40.00	40.00
Retention	%	100.00	70.43	51.70	19.50	65.17	60.00	60.00	60.00	60.00	60.00
No. of Shares	'mn	212.43	212.43	212.43	212.43	212.43	212.43	212.43	212.43	212.43	212.43
P/E		35.94	18.84	12.31	10.26	8.88	9.62	7.68	6.19	5.20	4.38
Sales per share		28.58	35.84	45.35	50.62	60.78	66.88	75.88	90.02	107.30	128.36
P/BV		8.17	5.59	3.19	2.61	2.20	1.93	1.68	1.44	1.24	1.06
Price to Sales		4.46	3.56	2.81	2.52	2.10	1.91	1.68	1.42	1.19	0.99

Gearing Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
Debt to Equity	%	49	30	13	16	22	20	17	15	13	11
Interest Cover	x	0.25	0.15	0.05	0.02	0.00	0.00	0.00	0.00	0.00	0.00

Source: ACPL Research, Company Financials

Financial Projections

Rupees' millions	**FY14A**	**FY15A**	**FY16A**	**FY17A**	**FY18A**	**FY19E**	**FY20E**	**FY21E**	**FY22E**	**FY23E**
Net sales	6,072	7,614	9,634	10,754	12,911	14,207	16,118	19,122	22,793	27,267
Cost of sales	- 3,595	- 4,250	- 5,811	- 6,574	- 8,474	- 9,421	- 10,492	- 12,247	- 14,580	- 17,431
Gross profit	**2,477**	**3,363**	**3,824**	**4,179**	**4,437**	**4,787**	**5,627**	**6,875**	**8,214**	**9,836**
Dist. Cost	- 1,577	- 1,830	- 2,420	- 2,645	- 3,150	- 3,501	- 3,983	- 4,736	- 5,653	- 6,766
Admin exp	- 203	- 202	- 281	- 684	- 900	- 921	- 1,044	- 1,239	- 1,477	- 1,767
Other expenses	- 119	- 148	- 188	- 179	- 178	- 169	- 192	- 228	- 271	- 324
Operating Profit	**578**	**1,183**	**934**	**672**	**210**	**196**	**408**	**673**	**813**	**978**
Other income	593	806	1,806	2,329	3,228	3,176	3,618	4,219	4,924	5,754
Finance cost	- 213	- 190	- 110	- 126	- 205	- 404	- 307	- 277	- 247	- 217
Profit before taxation	**958**	**1,799**	**2,630**	**2,875**	**3,233**	**2,968**	**3,720**	**4,615**	**5,491**	**6,515**
Taxation	- 205	- 362	- 431	- 236	- 184	- 154	- 193	- 240	- 286	- 339
Profit after taxation	**753**	**1,437**	**2,199**	**2,639**	**3,049**	**2,814**	**3,526**	**4,375**	**5,205**	**6,177**
EPS	**3.55**	**6.76**	**10.35**	**12.42**	**14.35**	**13.25**	**16.60**	**20.60**	**24.50**	**29.08**

Source: ACPL Research, Company Financials

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DEFINITION OF TERMS

TP	Target Price	CAGR	Compound Annual Growth Rate	FCF	Free Cash Flows
FCFE	Free Cash Flows to Equity	FCFF	Free Cash Flows to Firm	DCF	Discounted Cash Flows
PE	Price to Earnings Ratio	PB	Price to Book Ratio	BVPS	Book Value Per Share
EPS	Earnings Per Share	DPS	Dividend Per Share	ROE	Return of Equity
ROA	Return on Assets	SOTP	Sum of the Parts	LDCP	Last Day Closing Price

VALUATION METHODOLOGY

To arrive at our Target Price, Abbasi & Company (Private) Limited uses different valuation methods which include:

I. Discounted Cash Flow Model
II. Dividend Discount Model
III. Relative Valuation Model
IV. Sum of Parts Valuation

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Stock Rating	Expected Total Return
BUY	Greater than 15%
HOLD	Between -5% to 15%
SELL	Less than and equal to -5%

Sector Rating	Sector Outlook
Overweight	Positive
Market Weight	Neutral
Underweight	Negative

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RESEARCH DEPARTMENT
6 - Shadman, Lahore
Phone: (+92) 42 38302028; Ext 116, 117
Email: research@abbasiandcompany.com
web: www.abbasiandcompany.com

HEAD OFFICE
6 - Shadman, Lahore
Phone: (+92) 42 38302028
Email: info@abbasiandcompany.com
web: www.abbasiandcompany.com

BRANCH OFFICE
42 - Mall Road, Lahore
Phone: (+92) 42 37320707
Email: info@abbasiandcompany.com
web: www.abbasiandcompany.com