AGP plant visit – Nutraceutical expansion a near term respite

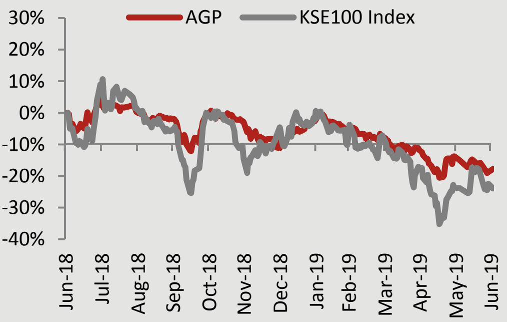
Wednesday, July 03, 2019

AGP Limited Performance

	3M	6M	12M
Absolute %	-13%	-15%	-21%
Relative to KSE %	-4%	-6%	-5%

Source: PSX, BMA Research

AGP vs. KSE100 relative chart



Source: BMA Research

- **BMA Capital organized plant-site visit of AGP Limited (AGP) Plant-I situated at SITE, Karachi to get a first-hand experience of its manufacturing facility and gain useful insights and technical knowhow of the processes involved.**
- **Key takeaways include: (i) utilization of existing facility to expand footprint, and (ii) earlier than expected execution of nutraceutical venture.**
- **Devaluation of the currency (14% since Dec'18) has led to costlier APIs (42-45% of total cost) that may remain key challenges for the company, in our view.**
- **The price increase announced by Drug Regulatory Authority of Pakistan (DRAP) in 1QCY19 along with upcoming annual increment based on FY19 CPI should help partially shield against margin erosion.**
- **In terms of valuations, the stock appears at a 19% premium to sector average despite 18% fall in stock price of AGP in the past 3-mths eyeing margin suppression hangover, in our view. AGP currently trades at a P/E of 16.6x on projected CY19E earnings of Rs4.0-4.2/sh**

On grounds of AGP plant: BMA Capital organized plant-site visit of AGP Limited (AGP) Plant-I situated at SITE, Karachi to get a first-hand experience of its manufacturing facility and gain useful insights and technical knowhow of the processes involved.

Simple process but requires stringent quality measures: The rather simplified manufacturing process of medicines requires utmost attention to providing a impurity free environment that begins from the raw material storage to packaging of the final product. The manufacturing facility is well equipped for the production of wide variety of dosage forms including tablets, capsules, syrup, suspension, and injectables. Active Pharmaceutical Ingredients (APIs) are the primary raw material that makes up to 42-45% of the total cost that are usually imported from China, India, and European region. Excipients such as starches, sucrose and packaging make up minimal costs towards production. Quality testing is emphasized at all stages of production from API down to post packaging shelf life tested via simulation at various climatic conditions. Resulting product quality has been at par with international standards and should help attain compliance with WHO standards.

Deval remains a bane to near-term profitability: With regards to the current PKR devaluation and its implications, the company had prudently maintained raw material inventory of more than four months vis-à-vis average inventory of two and a half months that shielded AGP from aggressive margin attrition. However, in absence of aggressive price hikes, latest result for the quarter carried exchange loss impact to the tune of PKR50mn. The recent 15% hike in prices announced by Drug Regulatory Authority of Pakistan (DRAP) in 1QCY19 and the annual CPI linked increments for FY19 should help shield against rapid margin erosion, in our view. To recall, ~30% of its portfolio classifies among National Essential Medicine List (NEML) (annual increment at 70% of CPI) while remaining ~70% classifies as other drugs (annual increment at 100% of CPI).

Future plans

#1 Encouraging prospects in the medium term: The company intends to introduce six new products in CY19 to continue on its growth strategy. Furthermore, the export market is currently being explored with Kenya emerging as a potential market. The company has already sent its products for audit that has been completed allowing AGP to proceed further. Although Kenya's pharmaceutical market is expected to grow at 12% per annum, we believe AGP's penetration to the market might remain stable.

#2 Operational streamlining and nutraceutical expansion on the horizon: The company intends to expand its operations at the facility by utilizing the existing office space. A

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separate office wing, currently under construction, should be functional by 1HCY20 paving way for expansion of the facility. Among its prior plans for expansion to nutraceuticals, the company had attained a purpose-built facility for PKR152mn putting it ahead of track. The plant is expected to come online by 4QCY19 according to the management and help widen its current portfolio. With expansion plans of nutraceuticals plant ahead of track and expansion of existing facility on the cards, the company is likely to enjoy topline growth in low teens over the next two years.

Valuation are expensive: AGP currently trades at a P/E of 16.6x on projected CY19E earnings of Rs4.0-4.2/sh, which is at 19% premium to sector average despite 18% fall in stock price of AGP in the past 3-mths given concerns over margin suppression. We expect the company's earnings to improve in coming years as the company is able to gradually pass on the devaluation impact and improve its market share.

Key risks include: (i) Rupee depreciation, (ii) larger quantum of low margin institutional orders, (iii) delay in planned product launches, and (iv) unprecedented rise in API prices.

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Buy	>20% expected total return
Neutral	0%-20% expected total return
Underperform	<0% expected total return

*Total stock return = capital gain + dividend yield

Old rating system

Overweight	Total stock return > expected market return + 2%
Marketweight	Expected market return ± 2%
Underweight	Total stock return < expected market return - 2%

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)