Lincoln Pharmaceuticals (NSE Code: LINCOLN) – Alpha/Alpha + stock report for Sep'17

Content Index

Company Snapshot (30th Sep'17)

Rating – Positive – 3% weightage; this is not an investment advice (refer rating interpretation), the rating is only for indicative purpose and please take your own decision regarding the same.

CMP – 160.05 (BSE); 160.35 (NSE) **Dividend yield** – 0.75%

BSE Code – 531633; **NSE Code** – LINCOLN

Market capitalization – Rs 320.00 cr. **Total Equity shares** – 2.00 cr.

Face Value – Rs 10.00 **52 Weeks High/Low** – Rs 256.20/148.00

Particulars (in cr.)	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17
Income from operations	176.5	187.57	194.70	210.49	266.07	400.15	360.64
Gross profit	61.89	64.85	67.63	70.71	86.51	122.7	143.55
Gross profit margin (%)	35.07%	34.57%	34.74%	33.59%	32.51%	30.66%	39.80%
Op expenses as % of revenue	-29.67%	-27.37%	-26.78%	-24.06%	-22.89%	-20.53%	-26.91%
Operating Profit	9.53	13.51	15.48	20.07	25.61	40.54	46.49
Operating profit margin (%)	5.40%	7.20%	7.95%	9.53%	9.63%	10.13%	12.89%
Other Income							
Interest income and other income	2.95	2.45	4.42	2.49	5.41	4.31	2.64
Exchange rate difference	0.35	0.91	1.98		1.77	3.05	0.25
Finance charge	-4.98	-7.6	-7.84	-6.97	-8.38	-9.96	-6.99
Depreciation	-1.66	-1.93	-2.65	-3.53	-4.57	-4.86	-5.54
Profit Before tax (PBT)	6.19	7.34	11.39	12.06	19.84	33.08	36.85
Profit After tax (PAT)	4.16	5.12	9.66	10.65	15.01	23.68	27.06

Introduction

Lincoln Pharmaceuticals Ltd (LPL) was set up in 1979 and has been engaged in manufacturing and trading of pharmaceutical formulations in the domestic market and the markets of Africa, South East Asia and Central America.

The company is promoted by Mr. Mahendra Patel (MD) and his brother Mr. Rajnikant Patel (Jt. MD). Both have over 3 decades of experience in the Pharmaceutical industry. Further, Mr. Munjal Patel (Son of Mr. Mahendra Patel) and Mr. Aashish Patel (Son of Mr. Rajnikant Patel) were inducted into the board of directors in FY 15.

LPL has a subsidiary by the name Lincoln Parenteral Ltd and LPL holds 98.58% stake in the latter. Lincoln Parenteral is engaged in manufacturing of formulations in dry powder, liquid injectibles, and syrup variants.

Both the company and its subsidiary are engaged in manufacturing of pharmaceuticals formulations in categories such as anti-infective, anti-malaria, anti-diabetic, gynaecology products, vitamins, minerals and anti-oxidants etc.

The company's manufacturing units are WHO-GMP certified and its R&D Center is approved by the Govt. of India.

We believe company is gradually seeing signs of transformation with increasing focus on R&D, launch of new branded products and NDDS (new drug delivery system) products, increasing focus on exports and discontinuation of low-margin contract manufacturing.

As per the management, Tanzania issue also stands resolved with company discontinuing the banned product and resuming sales of other products to the country.

Lastly, with around 40% correction in stock price (from peak levels) the valuations seem reasonable around 12 times FY 17 consolidated earnings.

Understanding Business and Company

As mentioned above, LPL is engaged is manufacturing and sales of pharmaceutical formulations in domestic markets and semi-regulated markets of Africa, South East Asia and Central America.

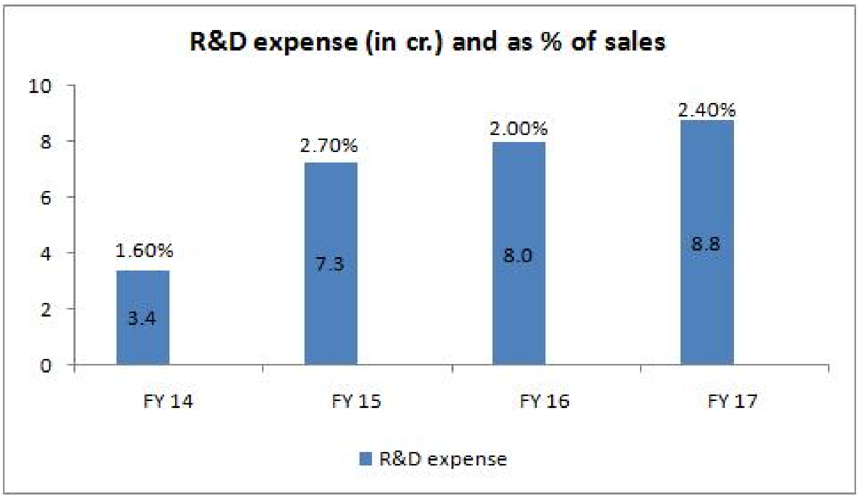
In the domestic markets the company has decent presence in around 20 states of the country and as per AIOCD data for August 2017 it is ranked amongst the top 80 companies.

Domestic sales accounted for 68% of the sales of the company in FY 17 and the contribution has been gradually coming down with higher growth being reported in export markets.

In India, till FY 16 LPL was selling its own branded products and at the same time contract manufacturing at its units for other companies; however given the better demand outlook for its formulations product portfolio, in FY 17 it embarked on a strategic decision to defocus the contract manufacturing business. As per the management, by the end of FY 18, they will entirely discontinue the contract manufacturing business.

In fact, the decline in sales in FY 17 can be attributed to lower contract manufacturing sales; however at the same time the gross margins of the company have expanded.

Since few years, the company has also been upping the R&D expense and focusing on new launches and new NDDS. Since FY 14, the R&D expense by the company has increased by 158% and as a % of sales it has increased from 1.6% to 2.4%.



Source: Lincoln Pharma's Investor Presentation

On the back of higher R&D, the company plans to launch numerous NDDS based products in India. Some of the notable recent launches include Art-Luton spray, Domi-up spray and Namcold DX. For instance, until now Ondansetron formulation (Domi-up) was available in the form of tablet, syrup and injectable in India; however LPL is the first company to have introduced the formulation as oral spray in India.

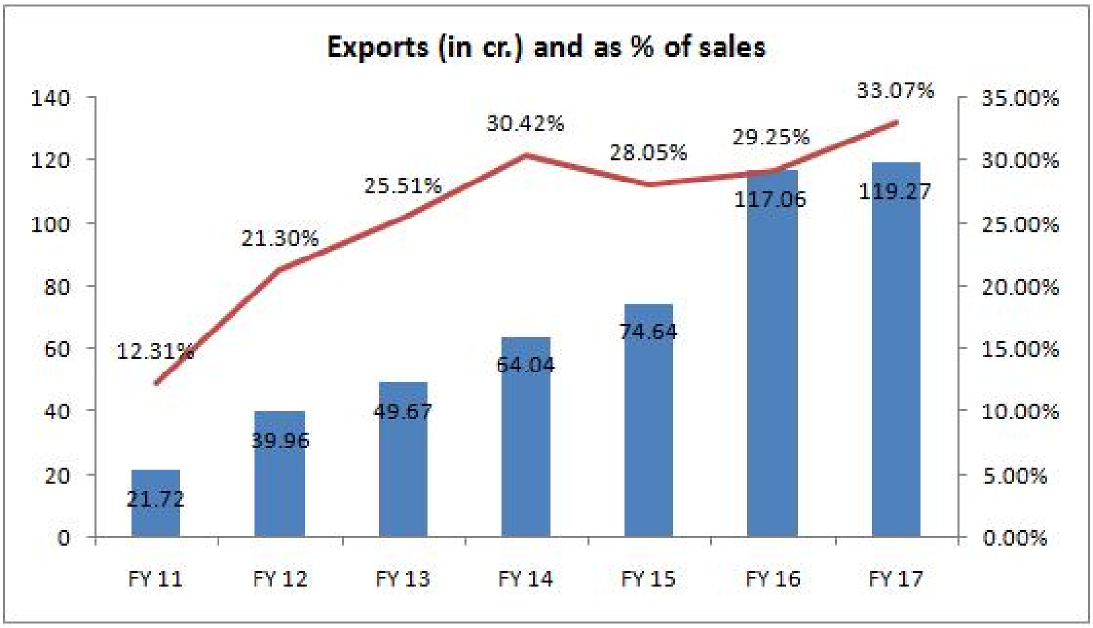
Source: Lincoln Pharma's Investor Presentation

Similarly, company's Art-Luton spray is a unique delivery system for accurate 25mg delivery of micronized progesterone. The company's formulation is dispensed in the form of mist, while the other alternatives are in the form of tablets, capsules and injections which are supposedly less effective in terms of delivery and convenience.

In FY 17 the company launched 28 new products with 3 being first time in India.

Exports – As far as Exports are concerned, the company has presence in more than 60 countries encompassing Africa, Central America and South East Asia. As per the management Africa accounts for bulk of the exports, followed by Asia and Central America.

In our talks with the management, exports seem to be the focus area as the margins are better and also the fact that off-late a lot of issues like price control, ban on FDC drugs (fixed dosage combination), sale of generic drugs, etc have cropped up in the domestic market.



Source: Lincoln Pharma's Annual Reports

The contribution from exports has already increased from around 12% of sales in FY 11 to 33% in FY 17 and the management believes that this might further increase to 50% by FY 21.

As per the management, in the last 2 years they have expanded their presence in more than 13 countries and have been continuously seeking new product registrations.

Tanzania issue – In Jan'16 LPL was banned by Tanzanian Authorities as one of the injections supplied by the company had caused an adverse effect in the patient.

As per our talks with the management, the injection had to be given under the supervision of the Doctor and the company had mentioned the necessary precautions to be taken. However, since then company has discontinued the sale of the product and similar such risky products and has resumed supplies of other products to Tanzania.

In fact, Tanzania continues to be one of the major export destinations for the company.

Promoters/Management

LPL is an owner-operated business with Mr. Mahendra Patel (MD) and his brother Mr. Rajnikant Patel (Jt. MD) helming the affairs of the company. Both have over 3 decades of experience in the Pharmaceutical industry.

While Mr. Mahendra Patel looks after corporate planning strategies and corporate finance, Mr. Rajnikant Patel is responsible for manufacturing and marketing activities.

Further, Mr. Munjal Patel (Son of Mr. Mahendra Patel) and Mr. Aashish Patel (Son of Mr. Rajnikant Patel) were inducted into the board of directors in FY 15.

On the front of rationality and transparency, company has started coming out with quarterly business presentations and there seems to be an attempt at sharing more details about the company. Further, loans and advances to other parties have come down from their peak levels.

In Jan'17, ICRA revised the outlook on the credit rating of the company from negative to stable.

Shareholding pattern (as reported on BSE)

	Jun'17	Mar'17	Dec'16
Promoter and Promoter Group	**33.18%**	**33.18%**	**33.18%**
India	33.18%	33.18%	33.18%
Foreign			
Public	**66.82%**	**66.82%**	**66.82%**
Total	**2,00,00,000**	**2,00,00,000**	**2,00,00,000**

In small/mid cap companies, it's important as an investor that the promoters hold reasonably high stake and in the case of LPL, promoters hold 33.18% stake in the company. Generally, we like promoter holding of 50% or more; therefore 33% is slightly low in our view and it will be important to watch out for any reduction in stake by the promoters.

Looking at the pattern of promoter holding for the last few years, while there hasn't been decline in absolute number of shares held by the promoters their holding got diluted due to preferential issue of warrants between FY 08 and FY 11.

So, while the promoters had 40% stake (30 lakh shares) in the company as at Mar'08, their holding got diluted to 24.54% (40 lakh shares) by the end of Mar'11. Mar'11 onwards they kept on increasing their holding in the company through market purchases and the same increased to 36.54% (59.60 lakh shares) by the end of Mar'15. Recently, in FY 17 their holding again got diluted to 33.18% (66.35 lakh shares) on account of conversion of warrants. The recent conversion of warrants has been after a gap of 6 years and we hope in the interest of minority shareholders there are no major preferential allotments in future.

As on 30th Jun'17, the major shareholders of the company and their stakes are as below:

Name of the shareholder	Category	% stake in Lincoln Pharma
Promoters and PAC	Promoters	33.18%
Kishor M. Shah	Chairman	2.39%
Sanjay Amin	Public	2.06%
Sonali Amin	Public	2.06%
Piyush Patel	Public	2.19%

Kaushal Patel	Public	2.06%
Kamlesh Patel	Public	2.06%
Bharatbhai Patel	Public	2.06%
Hareshbhai Patel	Public	2.07%
Sharad Kanyalal Shah	Public	1.75%
Vraj Dyes and Drugs Pvt. Ltd.	Public	1.09%
Digital Biotec Pvt. Ltd.	Public	7.00%

Lincoln Pharmaceuticals – Performance Snapshot

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Source: Lincoln Pharma ARs

LPL's performance has been good and seen a gradual improvement on various metrics over the last few years.

Since FY 12, i.e. in the last 5 years the sales of the company have grown at a rate of 15% on annualized basis. The growth rate from FY 12 to FY 16 was around 21% CAGR; however the sales of the company dipped in FY 17 and that's primarily on account of reduced focus on contract manufacturing business. Therefore, the sales growth rate would have been higher had company not started defocusing on contract manufacturing sales in FY 17.

For the same period the export sales of the company increased from Rs 40 crore to Rs 120 crore, thus registering 25% CAGR in sales.

On the front of margins, the company's gross margins have hovered largely in the range of 32-35%; the same dipped to around 30.55% in FY 16; it was also the year when the sales of the company rose sharply and most probably it could be on account of higher focus on contract manufacturing. In FY 17 company's gross margins improved to 40% while the sales dipped as the company focused more on its own brands than manufacturing for other companies.

As far as EBITDA margins are concerned, the same have also improved from earlier levels of 7-8% to around 12-13% as at Mar'17. Expansion in margins can largely be attributed to economies of scale, because as the sales of the company expanded its operating expenses didn't expand at the same pace and contributed towards margin expansion.

Important Numbers	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17
ROAE (%)	10.83%	6.50%	11.36%	11.32%	14.29%	19.39%	16.74%
Cash Flows from operations	-36.8	4.61	-18.93	-1.24	18.99	34.55	17.64
Net Working capital	35.97	37.85	39.7	38.7	95.57	77.99	94.97
Working capital as % of sales	20.38%	20.18%	20.39%	18.39%	35.92%	19.49%	26.33%
Net Debt	32.94	48.62	60.45	57.67	64.98	65.4	43.73
Debt to Equity ratio	0.60	0.81	0.85	0.69	0.69	0.59	0.34

Source: Lincoln Pharma ARs

What is good to note about the performance of the company is that since the last 5-6 years the absolute debt on the balance sheet of the company hasn't increased much and this is despite the fact that it has spent more than 70-80 crore on fixed asset expansion. Thus, with increasing sales and expanding operating margins, its finance cost has more or less remained same.

So, with expanding sales and margins and more or less constant finance cost, over the last 5 years the net profit of the company has increased from Rs 5.12 crore to Rs 27 crore while the EPS has increased from Rs 3.04/- per share to Rs 13.53/- per share.

The return ratios of the company have also improved from 10-11% to around current levels of 15-20%. FY 17 has seen reduction in ROAE to 16.74% on account of issue of shares by the company resulting in expanded capital base. As per the management they have raised money as they are contemplating setting up a US FDA compliant unit in near future. They already have land in place for the proposed unit.

We believe overall performance of the company has been good; however dilution of equity is a matter of concern. Early in 2010-11 and before, company used to dilute equity quite frequently while the recent dilution has been after a much larger gap of 6-7 years.

Considering robust balance sheet and low leverage, we hope management doesn't resort to further equity dilution in near future as that will be detrimental to the interests of shareholders.

Valuations

At around current price of 160 the market capitalization of the company is Rs 320 crore and enterprise value is around Rs 370 crore.

For FY 17 the company recorded net profit of Rs 27 crore and EBIT of Rs 40.94 crore. Statistically speaking, post the recent 40% correction in stock price, we find the valuations of the company reasonable with PE ratio of 11.85 and EV/EBIT of 9.03.

The company has also been paying dividend since few years now and the stock currently offers dividend yield of around 0.75%.

If the company is able to improve its performance without diluting equity any further, we believe there's potential for re-rating in the valuations of the company.

Dividend Policy

Dividend Payout					
	FY 13	**FY 14**	**FY 15**	**FY 16**	**FY 17**
Dividend (Rs. Per share	0.60	0.60	1.00	1.00	1.20
Dividend Payout ratio	10.13%	9.19%	10.87%	6.89%	8.87%

LPL has been consistently paying dividends since more than 10 years now. Earlier the dividend payout ratio used to be higher; however since the last five years now the company has been maintaining payout ratio at around 10%.

Considering company's upcoming expansion plans, we believe 10% dividend payout is adequate.

Risks & Concerns

Domestically a lot of issues have cropped up on the regulatory and the pricing front and the same could impact the profitability and growth of the company.

In the past the company has faced ban from Tanzanian authorities. Any such ban from any other country will not only impact sales and profitability but will also impact the reputation of the company.

On the export front, company may have to face issues like non-availability of currency with African countries, currency fluctuation, etc and can impact the business of the company.

The equity holding of promoters is slightly low at around 33% and one will have to be watchful of any stake sale by the promoters.

In the past the promoters have diluted equity at regular intervals. If they continue to do so, the valuations of the company may go down further and equity dilution in general will also be detrimental to the interests of shareholders.

Disclosure: I don't have any investment in Lincoln Pharma and have not traded in the stock in the last 30 days.

Best Regards,

Ekansh Mittal
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Rating Interpretation

Positive – Expected return of ~15% + on annualized basis in medium to long term for investment recommendations and in short term for Special situations
Neutral – Expected Absolute return in the range of +/- 15%
Negative – Expected Absolute return of over -15%
Coverage closure – No further update on the stock
% weightage – allocation in the subject stock with respect to equity investments

Short term – Less than 1 year
Medium term – Greater than 1 year and less than 3 years
Long term – Greater than 3 years

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Analyst ownership of the stock: No

Details of Associates: Not Applicable

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