June 13, 2024

Company Report | Sector: Pharmaceuticals

Sequent Scientific

Mgmt meeting KTAs; recovery underway, U/G to ADD

We met Sequent Scientific to better assess the recovery trajectory in animal health across API and formulation segments. Company appears upbeat on API business as price erosion run its course; efforts also underway to ensure increased sourcing from the same customer. In formulations, Turkey appears stable after price hikes and company is expecting growth after a period of macro-led disruption. Domestic business was impacted by stoppage of Zoetis product distribution and whose resumption should add to ex-Zoetis growth. Overall, we reckon pressure on revenue (due to demand shortfall and portfolio rationalization) and margin has likely ended though we await signs of traction in API and scale up in formulations. Believe worst may have ended even as it may be too early for signs for earnings upgrades. We roll over to FY26 estimate and upgrade to ADD from Neutral with revised TP Rs145, based on a trimmed multiple of ~30x (earlier 35x) as we base target on a normalized year of earnings.

API business – in recovery mode after a 4-year long drawdown

API business is in the revival mode after a 4-year long drawdown in which revenue has shrunk ~20% from their normalized peak in FY20 (and even more from one-off levels seen in pandemic). We reckon most of the decline has been on account of price compression. To recap, API sales to regulated markets of US & Europe account for 67% of revenues while rest is to emerging markets. Company has made efforts to embed itself in supplying more products to each regulated market customer as also adding new customers and products; albeit the former – increased API supplies to same customer – has likely more room to grow followed by new launches. API business which performed well in Q4 FY24 is still lumpy in nature and even though price erosion has stabilized, inflection point could be still some time away in clocking quarterly Rs1bn in sales.

Formulations – manufacturing rationalization, Turkey demand key

Sequent's export formulation business has gone through disruption from 1) demand slowdown in key markets like Europe and 2) currency volatility in Turkey. Europe recovered in FY24 on the back of pivot towards higher margin/growth products in Spain along with increase in distribution business in Benelux countries. Company expects Europe business to clock moderate growth (given the mature nature of underlying market) on FY24 base. Turkey business has been severely impacted by currency and hyperinflation in the past few years. As the macro normalizes (stable currency in last few months), company believes Turkey is poised to grow especially on back of two price hikes implemented in FY24. Manufacturing footprint has been rationalized with shutdown of German and Tarapur (API/intermediates) facilities that should contribute to cost savings.

India – resumption of Zoetis product distribution to lift growth

India business at 8% of revenue was affected by non-availability of Zoetis product for distribution. We understand Zoetis would likely resume the distribution arrangement soon which should bolster the domestic business. Separately, company has ramped up MR force in India that would support scale up of ex-Zoetis business that has been clocking healthy mid-teens growth.

Growth to be a key driver of margin between FY24-26

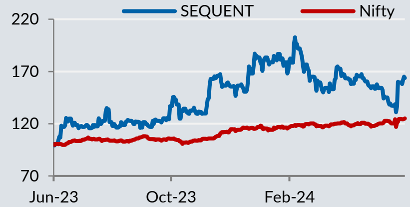
Gross margin has recovered largely on back of lower input costs and some benefit from product rationalization as Sequent exited low end commodity businesses in Europe. It has also run a cost optimization program in API which has resulted in improved EBIDTA. Overall, we reckon the benefit from cost rationalization and procurement savings have played out and further margin improvement would be an outcome of expected better revenue growth over next 2 years.

Reco	:	**ADD**
CMP	:	Rs 123
Target Price	:	Rs 145
Potential Return	:	+18%

Stock data (as on June 13, 2024)

Nifty	23,399
52 Week h/l (Rs)	156 / 75
Market cap (Rs/USD mn)	31049 / 372
Outstanding Shares (mn)	249
6m Avg t/o (Rs mn):	310
Div yield (%):	-
Bloomberg code:	SEQ IN
NSE code:	SEQUENT

Stock performance



	1M	3M	1Y
Absolute return	6.7%	8.0%	63.7%

Shareholding pattern (As of Mar'24 end)

Promoter	52.8%
FII+DII	13.8%
Others	33.4%

∆ in stance

(1-Yr)	New	Old
Rating	ADD	NEUTRAL
Target Price	145	91

∆ in earnings estimates

	FY25e	FY26e
EPS (New)	2.0	4.8
EPS (Old)	2.6	-
% change	-22.9%	-

Financial Summary

(Rs mn)	FY24	FY25E	FY26E
Net Revenue	13,697	14,742	16,463
YoY Growth	(3.6)	7.6	11.7
EBIDTA	914	1,818	2,609
YoY Growth	42.5	98.9	43.5
PAT	(359)	498	1,184
YoY Growth	(70.4)	-	137.7
ROE	2.6	9.9	17.0
EPS	-1.4	2.0	4.8
P/E	-	61.2	25.8
P/B	26.4	28.4	33.2
EV/EBITDA	34.7	17.3	11.7

BHAVESH GANDHI
Lead Analyst
bhavesh.gandhi@ysil.in

Highlights of company meeting

Below we share key highlights of our interaction with the company:

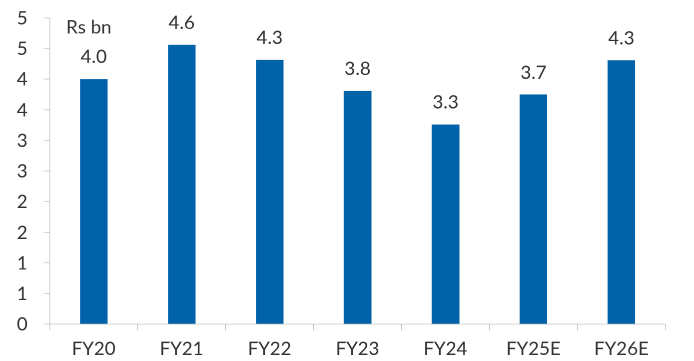
- Reiterate margin and growth guidance given earlier of low to early teens exit in Q4 FY25; confident of improving growth in current year
- Most of the decline in API revenue over last 4 years is due to price erosion; would be higher in terms of volume supplies compared to FY20
- Efforts under way to position Sequent as a primary supplier and ensure same customer increases API sourcing in terms of number of products bought
- Plan to foray into US using hitherto acquired German site are now on the back burner; sold off the German facility to rationalize manufacturing footprint
- Turkey – have taken price hikes which have been well accepted by the market; working on using Turkey as a base to supply to other neighbouring markets now that economy/macro appear stable
- Turkey is fast becoming an export hub, which provides a natural forex hedge for imports apart from accelerating revenues.
- India - non availability of an imported product from Zoetis has impacted distribution sales. Product availability will be normalised in H2 and expect to get back to growth and lift revenues. Non-Zoetis business continues to show robust growth.
- Completed MR hiring in domestic market and FY25 would see productivity ramp up of the newly added employees
- Have seen new players with pharma background enter animal health and do good ramp up on back of rapid and large scale hiring of field force
- Looking to build companion animal segment outside India which would utilize the front-end infrastructure in major markets; albeit the foray and its impact would take time with no major impact on near term opex
- PE promoter is fully onboard with management thinking and backs its execution; there is no looming timeline for stake monetization
- Cognizant of debt ratios and not doing any major capex in the next 1 year

Worst of the disruption, price compression behind; Upgrade to ADD with triggers spread out

Post the episode of elevated input costs and demand destruction, along with steps taken to improve profitability leads us to believe worst of margin and earnings performance is behind. That said, upgrade cycle may not start immediately as inflection point in API still appears some time away. We roll over to FY26 estimate which appears a more normalized representation of underlying steady state deliverables (~mid-teens growth and mid to high teens margin) and hence trim multiple to sync with normalized earnings. Upgrade to ADD with revised TP Rs145, based on 30x (earlier 35x) FY26 EPS. Key risk to our constructive view is deceleration in API business, inability to increase API supplies to same customer and large sized M&A that would lead to increased leverage.

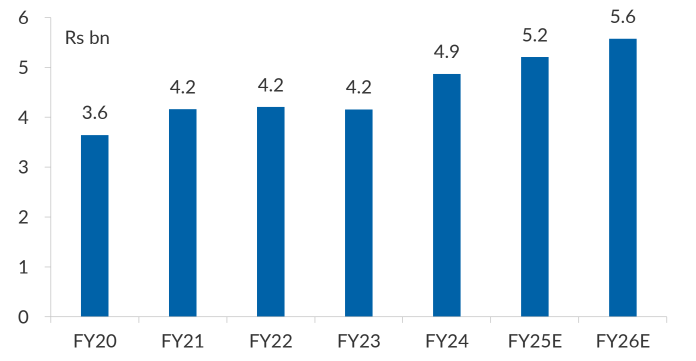
STORY IN CHARTS

Exhibit 1: API – steady recovery seen in FY26



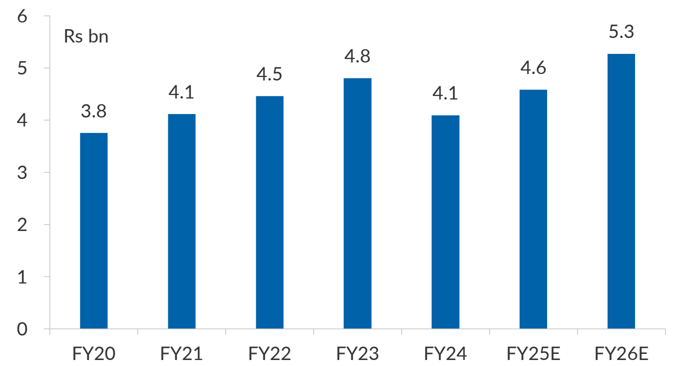
Source: Company, YES Sec

Exhibit 2: Europe – modest growth on strong base



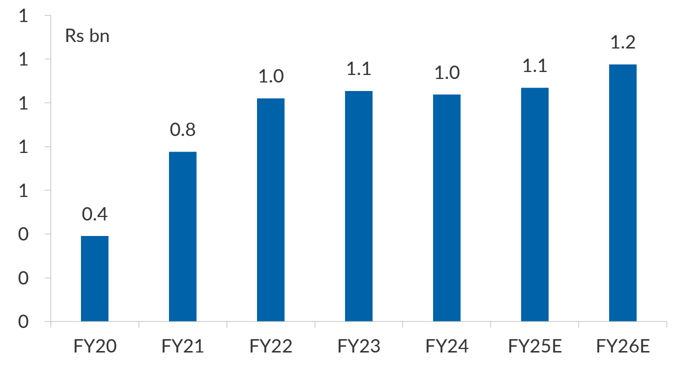
Source: Company, YES Sec

Exhibit 3: Trend in EM revenues



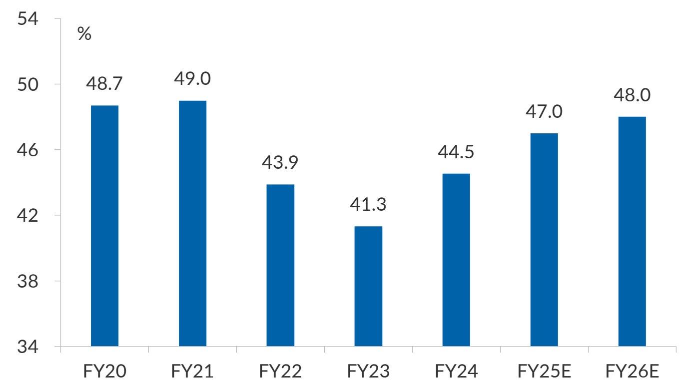
Source: Company, YES Sec

Exhibit 4: India -restart of Zoetis distribution lifts growth



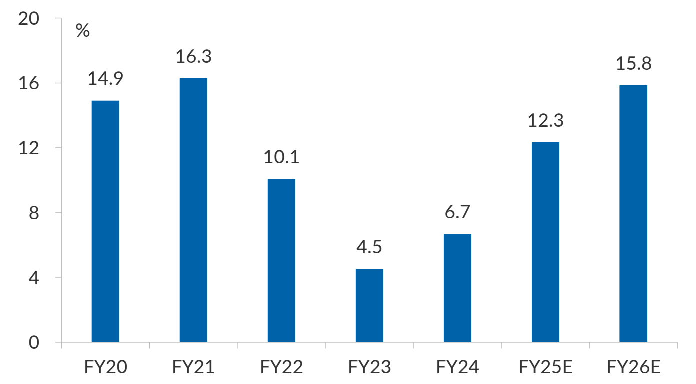
Source: Company, YES Sec

Exhibit 5: Gross margin seen at historic levels in 2 years...



Source: Company, YES Sec

Exhibit 6: ...and so would EBIDTA margin



Source: Company, YES Sec

FINANCIALS

Exhibit 7: Balance sheet

Y/e 31 Mar (Rs m)	FY22	FY23	FY24	FY25E	FY26E
Equity capital	497	499	499	499	499
Reserves	6,427	6,489	6,067	6,597	7,813
Net worth	**6,924**	**6,988**	**6,566**	**7,096**	**8,312**
Debt	480	504	564	564	564
Minority interest	1,830	2,416	1,936	1,636	1,336
Def.tax lia	158	123	69	69	69
Total liabilities	**9,392**	**10,031**	**9,134**	**9,364**	**10,280**
Goodwill	1,853	2,400	2,349	2,349	2,349
Fixed assets	3,813	4,206	3,729	3,592	3,404
Investments	590	333	313	313	313
Net working capital	**2,844**	**2,638**	**1,959**	**2,327**	**3,430**
Inventories	3,480	3,461	3,462	3,726	4,162
Sundry debtors	3,292	3,410	3,356	3,612	4,034
Cash	704	409	725	885	1,451
Other current assets	488	610	685	590	659
ST borrowings	(2,006)	(2,238)	(3,159)	(3,159)	(3,159)
Sundry creditors	(2,580)	(2,434)	(2,603)	(2,801)	(3,128)
Other current liabilities	(535)	(579)	(509)	(526)	(588)
Def tax assets	292	454	784	784	784
Total assets	**9,392**	**10,031**	**9,134**	**9,364**	**10,280**

Exhibit 8: Income statement

Y/e 31 Mar (Rs m)	FY22	FY23	FY24	FY25E	FY26E
Revenue	14,128	14,209	13,697	14,742	16,463
Operating profit	**1,423**	**641**	**914**	**1,818**	**2,609**
Depreciation	(511)	(557)	(615)	(638)	(688)
Interest expense	(158)	(355)	(481)	(431)	(404)
Other income	45	64	110	110	110
Profit before tax	**800**	**(207)**	**(73)**	**858**	**1,627**
Taxes	(82)	157	250	(155)	(293)
Adj Profit	**718**	**(50)**	**178**	**704**	**1,334**
MI	(38)	8	(63)	(63)	(63)
Exceptional	63	(816)	(252)	0	0
ESOP cost	(329)	(354)	(222)	(111)	(56)
Net profit	**414**	**(1,211)**	**(359)**	**530**	**1,216**

Exhibit 9: Cash flow statement

Y/e 31 Mar (Rs m)	FY22	FY23	FY24	FY25E	FY26E
Profit before tax	800	(207)	(73)	858	1,627
Depreciation	511	557	615	638	688
Def.taxes (net)	1	(197)	(384)	-	-
Tax paid	(82)	157	250	(155)	(293)
Working capital ∆	(231)	(90)	995	(208)	(537)
Other operating items	(304)	(1,162)	(537)	(174)	(118)
Operating cashflow	695	(941)	868	960	1,366
Capital expenditure	(512)	(1,497)	(88)	(500)	(500)
Free cash flow	**183**	**(2,438)**	**780**	**460**	**866**
Equity raised	(766)	1,275	(63)	-	-
MI	(7)	24	60	-	-
Investments	330	257	20	-	-
Debt financing/disposal	346	586	(480)	(300)	(300)
Dividends	-	-	-	-	-
Net ∆ in cash	**86**	**(295)**	**316**	**160**	**566**

Exhibit 10: Du Pont Analysis

Y/e 31 Mar (Rs m)	FY22	FY23	FY24	FY25E	FY26E
Tax burden (x)	0.90	0.24	-2.44	0.82	0.82
Interest burden (x)	0.84	-1.39	-0.18	0.67	0.80
EBIT margin (x)	0.07	0.01	0.03	0.09	0.12
Asset turnover (x)	1.16	1.15	1.11	1.18	1.23
Financial leverage (x)	1.71	1.78	1.82	1.83	1.74
RoE (%)	**10.1**	**(0.7)**	**2.6**	**10.3**	**17.3**

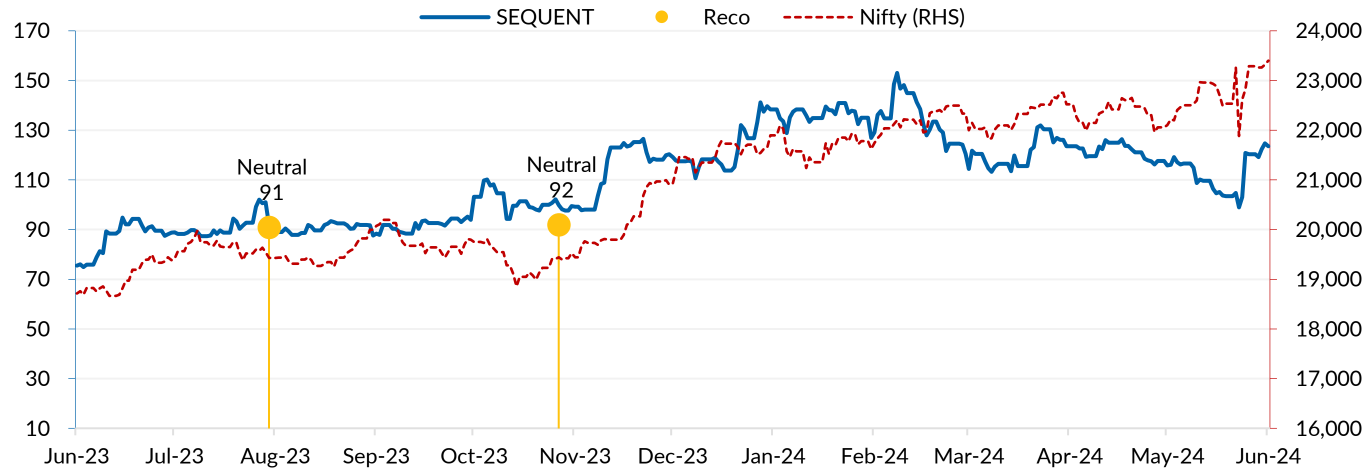
Exhibit 11: Ratio analysis

Y/e 31 Mar	FY22	FY23	FY24	FY25E	FY26E
Growth matrix (%)					
Revenue growth	3.8	0.6	(3.6)	7.6	11.7
Op profit growth	(35.8)	(54.9)	42.5	98.9	43.5
EBIT growth	(46.7)	(84.5)	174.9	216.0	57.5
Net profit growth	(56.7)	(392.9)	(70.4)	(247.7)	129.3
Profitability ratios (%)					
OPM	10.1	4.5	6.7	12.3	15.8
EBIT margin	6.8	1.0	3.0	8.7	12.3
Net profit margin	5.1	(0.4)	1.3	4.8	8.1
RoCE	10.2	1.5	4.3	13.9	20.7
RoNW	10.1	(0.7)	2.6	10.3	17.3
RoA	5.9	(0.4)	1.4	5.6	10.0
Per share ratios					
EPS	1.7	(4.9)	(1.4)	2.1	4.9

Sequent Scientific

Y/e 31 Mar	FY22	FY23	FY24	FY25E	FY26E
Dividend per share	0.0	0.0	0.0	0.0	0.0
Cash EPS	3.7	(2.6)	1.0	4.7	7.6
Book value per share	27.9	28.0	26.3	28.4	33.3
Valuation ratios (x)					
P/E	73.7	(25.2)	(84.9)	57.5	25.1
P/BV	4.4	4.4	4.6	4.3	3.7
M Cap/Sales	2.2	2.1	2.2	2.1	1.9
EV/EBIDTA	22.2	50.7	34.7	17.2	11.6
Payout (%)					
Tax payout	10.3	75.9	344.4	18.0	18.0
Dividend payout	0.0	0.0	0.0	0.0	0.0
Liquidity ratios					
Debtor days	85	88	89	89	89
Inventory days	90	89	92	92	92
Creditor days	67	63	69	69	69
Leverage ratios					
Interest coverage	6.1	0.4	0.8	3.0	5.0
Net debt / equity	0.2	0.3	0.2	0.1	(0.0)
Net debt / op. profit	0.8	3.1	1.3	0.4	(0.0)

Recommendation Tracker



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Correspondence Address: : 7th Floor, Urmi Estate Tower A, Ganpatrao Kadam Marg, Opp. Peninsula Business Park, Lower Parel (West), Mumbai – 400 013, Maharashtra, India.

research@ysil.in I Website: www.yesinvest.in

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Details of Compliance Officer: Name: Aditya Goenka, **Email id:** compliance@ysil.in, **Contact No:** 022- 65078127 (Extn: 718127)

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Sequent Scientific

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