Disclaimer :- This was originally published on 1st July 2019 and is part of our Q1FY20 letter. Link to the letter here

Sequent Scientific

Many Indian companies have created large Human Pharma businesses out of India. However, other than Hester Bio Sciences (focus on Animal and Poultry vaccines), there are no Pharma companies with a global footprint out of India focusing on Animal Health. Sequent's strategy is to create an Integrated (formulations + API) Animal Health care company out of India.

In buying Sequent, we are also aligning interests with an entrepreneur (Arun Kumar) with a strong track record of value creation in Pharmaceuticals and Life Sciences.

Animal Health is an attractive business segment. Compared to Human Health (USD 1000 Bn), Animal Health is a much smaller market (USD 42 Bn), with favourable implications for competitive intensity. However, leading Animal Health care companies have margins which are significantly higher than leading Human Health care companies. Animal drugs/products in the Developed markets are primarily sold as Branded products, which need to be prescribed by Vets, akin to how drugs are sold in India. Most Human Pharma products are primarily sold as Generics. Animal Healthcare requires limited innovation or new product development as the goal is not to prolong life but more to enhance productivity/safety of Animals. Hence, R&D expenses are much lower vs. Human Generics. At the same, regulatory scrutiny is intense.

It takes time to build an Animal Health business organically and reach meaningful scale. Existing brands and relationships are moats to be overcome by a new entrant. Hence, M&A for a new entrant as a way to achieve scale cannot be wished away. Product registrations are required by country, front end relationships need to be created with vets in each market. While an M&A led strategy is inherently risky, there are examples of Management teams that have made it work and created significant value by being disciplined on acquisition prices paid and through a process of rapid integration.

Over the past five years, Sequent has been transformed into a focused Animal Healthcare franchise.

- Sequent was a portfolio of unrelated businesses prior to 2014 with Animal Health ~38% of revenue. All non-Animal Health businesses have either been divested (Specialty Chemicals, Women Health), demerged into other companies (Human API) or shut down (Penems).
- API Facilities were upgraded for compliance with developed world regulatory standards.
- Formulations: Over 9 acquisitions (of which 3 were material) have been completed. Acquisitions were of sub scale businesses where promoters lacked Capital for growth, but had access to registrations, distribution and/or manufacturing facilities. Sequent has invested growth capital in the Businesses and ensured that erstwhile promoters retain some minority stake for continued engagement. Sequent now is present in over 100 markets across the world and has Manufacturing sites not only India, but also Brazil, Germany, Spain and Turkey which provide local market proximity and a de-risked manufacturing footprint.

Sequent's API facilities in Visakhapatnam are a hugely advantaged Asset in today's environment.

- Sequent already supplies APIs to the top 10 Animal Health care companies globally, is the only USDFA approved uniquely Animal API facility in India and has the highest number of Animal API filings in the US amongst all API players globally.

- The upgradation of Infrastructure and compliance standards in Sequent's API facilities has coincided with tail winds of increased FDA scrutiny on API players , China's crack down on pollution and US China trade and geopolitical tensions. Many API players in China have to invest in zero liquid discharge facilities which reduce their historical cost advantage over India. Geopolitical issues are making US companies look to diversify their sourcing from China.
- When supply stability is threatened, supply availability becomes paramount and pricing is secondary. This has created a significant opportunity for Sequent to gain market share in APIs with developed world companies while earning its fair share of the margin in the entire value chain

After 5 years of grind, we believe Sequent earnings/cash flows are now poised to break out over next few years. The API business should deliver very strong cash flows in the short term with Formulations picking up pace in about 2 years

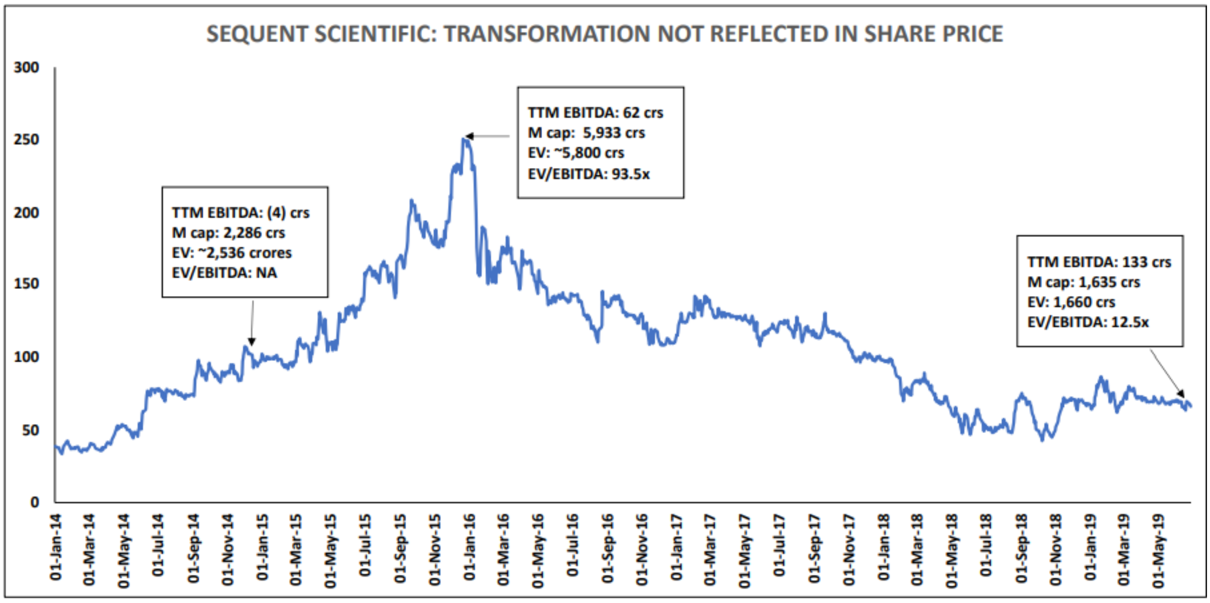
- We expect the API business to register robust top line growth and even stronger bottom-line as lower margin developing world business is replaced with higher margin business from the developed markets. In addition, the API business has significant Operating Leverage. Growth with some pricing power without proportionate increase in Fixed Expenses should translate into a big boost in EBITDA growth.
- The Formulations business is growing at ~10% (constant currency) with some infusion of Working Capital into acquired companies. R&D investments being made (35 products under development), more control on Manufacturing facilities located within the same geography should help step up growth rate over the next few years.

Progress on the transformation is visible in FY 19 results

- API business grew 38% in FY 19 over FY 18. The top 5 customers from Developed markets have grown their API sourcing from Sequent 2.4X in FY 19 over FY 18
- Formulations growth has been steady
- Operating cash flows were 115 Cr in FY 19 compared to 56Cr in FY 18 and –10 Cr in FY 17
- Debt reduced significantly from 5x Debt/EBITDA in FY 16 to 1.5x Debt/EBITDA in FY 19. If monetizable investments are included as Cash equivalents, Sequent is practically debt free with Debt/EBITDA < 0.2x

The company now has a credible global distribution network for formulations which will be enhanced with entry in the US markets by FY 21. The strong cash flows in the API business over next 3 years will help expedite investments in R&D and product filings across multiple geographies leading to strong growth in formulations FY22 onwards. This would make it a very valuable platform for a potential acquirer.

We believe the current stock price is not reflecting the transformation delivered by the management in the last few years, the fact that a lot of the M&A risk is behind us or the prospects for incremental cash flow growth and ROCE. Sequent had a massive stock price run up between 2014- 2016 (see chart below12) perhaps driven by the value creation reputation of Arun Kumar. Despite a confused business portfolio and no profits, the promoters' track record catapulted the stock to a peak Market Cap of 6000 Cr. When the numbers did not live up to the narrative, the stock declined over time. Pessimism often becomes deeply rooted. Even though the numbers are now supporting the growth narrative, there is insufficient interest with very limited Institutional holding or broker coverage. This provides an opportunity to ride both earnings growth and valuation re-rating



Even as the narrative for Sequent is strong, future cash flows will be a function of how well the management team executes in building the Formulations franchise, and also how the sourcing environment for APIs for regulated markets evolves in China (which will influence market share and margins in APIs for Sequent). The competitive moat is not very wide at present, but is being built. We have hence taken our first "foot in the door" position and will build it further over time as we see evidence of execution. Partners interested in a deeper understanding may write to us for a copy of our detailed Investment note.