SMART SYNC SERVICES
RIA No. INA000007881

The Titan Strategy

Gujarat Themis Biosyn Limited

Smart Sync Services' Small-Cap picks

GUJARAT THEMIS BIOSYN LTD.

A Research Report

A SEBI Registered Investment Advisory Firm

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SERVICES
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Gujarat Themis Biosyn Ltd

A Fast growing Bio-Pharma intermediate manufacturer.

Rating: **Buy**
Holding Period: Min. 4-6 Quarter
Return Potential: 30% to 50%
CMP: *Rs. 105 / share*
Market Cap: Rs. 1,170 *Cr*

The transition from a one-trick pony to an API powerhouse

Founded in 1981, Gujarat Themis Biosyn is one of the pioneers of manufacturing complex intermediates like Rifamycin -S & O through the process of fermentation. The company has gradually transformed from a sick company in 2009 to one of the biggest wealth creators of the past decade. Our investment rationale includes its competency in the fermentation manufacturing process, ambitious growth plans are visible from its capex figures, strong balance sheet to service the capex through internal accruals as well as expected improvement in its current valuations owing to an expensive listing of its peer i.e. Concord Biotech Ltd

Strong competitive advantages & Tailwinds: The company has more than 50% share in the two niche intermediates which have operating margins of 40-50% leading to very high returns on capital. The end-user industry is expected to grow at a decent pace owing to government initiatives for the eradication of Tuberculosis. Further, the company is incurring a massive capex of INR 200 Crs which will not only allow it to improve its business model by reducing the dependence on two intermediates in the form of forward integrating into APIs (i.e. the final products) but also improve its growth prospects due to higher reinvestment in the core business.

Risks: Small scale of operations, high client concentration risks, lack of immediate growth prospects owing to full utilization of the current capacity & certain other red flags are some of the glaring risks in our thesis.

After careful deliberation of the positives & negatives, we initiate a buy coverage on the stock.

FINANCIALS	JUNE 2023
P/E	20.2
ROCE	61.1 %
ROE	45.9 %
OPM JUNE 23	47 %
DEBT TO EQUITY	0.38
ENTERPRISE VALUE	₹ 1,162 CR.
NO. OF EQUITY SHARES	1.45 CR.

SHAREHOLDINNG PATTERN	JUNE 2023
PROMOTERS	75.00%
FII	0.01%
DII	0.03%
PUBLIC	24.95%

PERIOD	PROFIT GROWTH	STOCK PRICE GROWTH
10 YRS	50%	51%
5 YRS	72%	85%
3 YRS	36%	65%
TTM/1YR	20%	61%

Disclaimer

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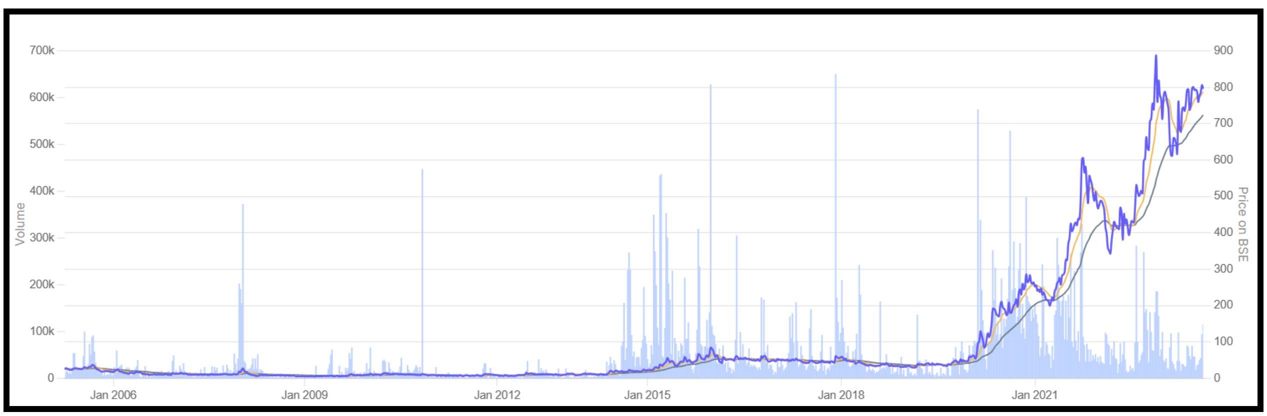
Introduction

Gujarat Themis Biosyn Limited (GTBL), a Gujarat-based Pharmaceutical company was incorporated in 1981 and commenced production in August 1985. The company was subsequently taken over in June 1991 by the Yuhan Group, South Korea and Pharmaceutical Business Group (India) Ltd. (PBG); a unique consortium of five competing drug companies - Themis Medicare Ltd (TML), Kopran Ltd., Anant & CoCadila HealthCare Ltd. (Zydus) and Lyka Labs Ltd. It is being actively managed by Themis Medicare Ltd. (JV Company of Gedeon Richter Ltd, Hungary) since 2007.

The company's journey has been chaotic in the past two decades where the company has gone down from becoming a sick company in 2009 which led to a management takeover by Themis Medicare turning the company into a positive net worth company in 2017.

Since then the company has never looked back & has transformed into one of the biggest wealth creators of the past decade growing its share price at an astonishing CAGR of 51%!



But the first question that comes to an investor's mind is..what led to this massive transformation that led to such returns, especially in the past 3-5 years?

<u>The transformation:</u> *Shift from Contract manufacturing (Job work) to Market sales model*

Rs Cr	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23
Sales	**30**	**31**	**33**	**36**	**39**	**41**	**85**	**91**	**115**	**149**
% Growth YOY		*4%*	*4%*	*9%*	*9%*	*6%*	*107%*	*6%*	*27%*	*30%*
EBITDA	**6**	**7**	**6**	**6**	**6**	**7**	**32**	**40**	**58**	**74**
EBITDA Margin	*21%*	*21%*	*19%*	*17%*	*16%*	*18%*	*37%*	*45%*	*51%*	*50%*

The company was reeling in losses around the 2009 period wherein it was declared a sick company, however, Themis Medicare Ltd. (another listed company) came to its rescue by assuming control of the entire business's operation. During this period, the company came into an agreement with Lupin Ltd. to do contract manufacturing work for the company wherein, Lupin gave the company loans to build infrastructure & supplied raw materials on which it provided a fixed conversion charge to Gujarat Themis for conversion of the material into Rifaycin S (an intermediate later used by Lupin). The company was successful in doing this activity thanks to the technology know-how in the form of a partnership with Yuhan Corporation (which was later terminated in FY21-22)
This arrangement helped the company get out of trouble & become a positive net-worth company.

	Mar 2012	Mar 2013	Mar 2014	Mar 2015	Mar 2016	Mar 2017	Mar 2018	Mar 2019	Mar 2020	Mar 2021	Mar 2022	Mar 2023
Share Capital +	12	7	7	7	7	7	7	7	7	7	7	7
Reserves	-25	-17	-13	-8	-3	1	5	11	35	63	96	142

However, the company made a valiant decision to supply this intermediate along with Riyamycin-O (a new intermediate) directly at market prices by procuring raw materials by themselves from the market.

This shift in business model was coincidentally followed by a boom in drug prices (owing to a drastic reduction in competition from China owing to higher fuel prices to produce the product coupled with high freight costs) which led to extraordinary returns to its shareholders.

But all this is in the past..what lies ahead is the key question, which we will address, but before we discuss why we like the company at current valuations, lets understand the business in greater depth.

About the Company

The company is the leading domestic producer of API intermediates namely~ **Rifamycin S and Rifamycin O** using a complex production process called fermentation. The company's plant is located in Vapi, Gujarat.

Product portfolio

A) Rifamycin S - It is an intermediate used for the treatment of several types of bacterial infections, including tuberculosis, Mycobacterium avium complex, leprosy, and Legionnaires' disease.

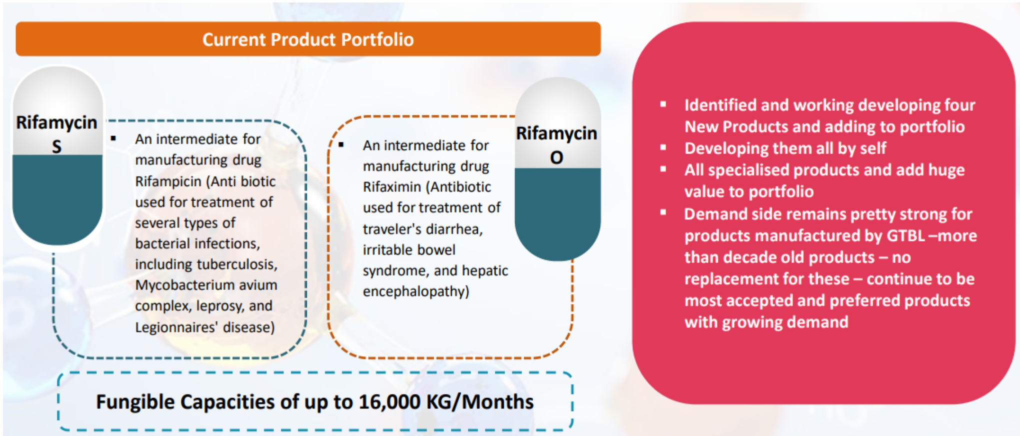
   The intermediate was majorly used for the manufacturing of Rifampicin, where the company has more than 50% domestic market share for the sales of this intermediate to the biggest player in the industry, i.e. Lupin Pharmaceuticals. The company however expects increased demand for the usage of the intermediate in Rifapentine (another API), which the company even plans to manufacture completely by itself in the future (rather than only making raw materials).

   The company has a fungible capacity of around 120,000 Kg per annum.

B) Rifamycin O- It is an intermediate to manufacture a medicine called Rifaximin, which is used for the treatment of diarrhea, irritable bowel syndrome, and hepatic encephalopathy.

   The company started producing this drug around 2019, & it has played a major role in the company's success since then by reducing the dependence on Rifa-S. The major customer of this intermediate is 'Optrix Labs' (an Optimus group company)

   The company's capacity for the particular product stands at around 72,000 Kg per annum.



C) New products under development:-
The company through its new "200 Crs ambitious capex" plans on adding several APIs in its product portfolio (vs intermediates)
Some of the APIs which the company mentioned in its environmental clearance proposal include:

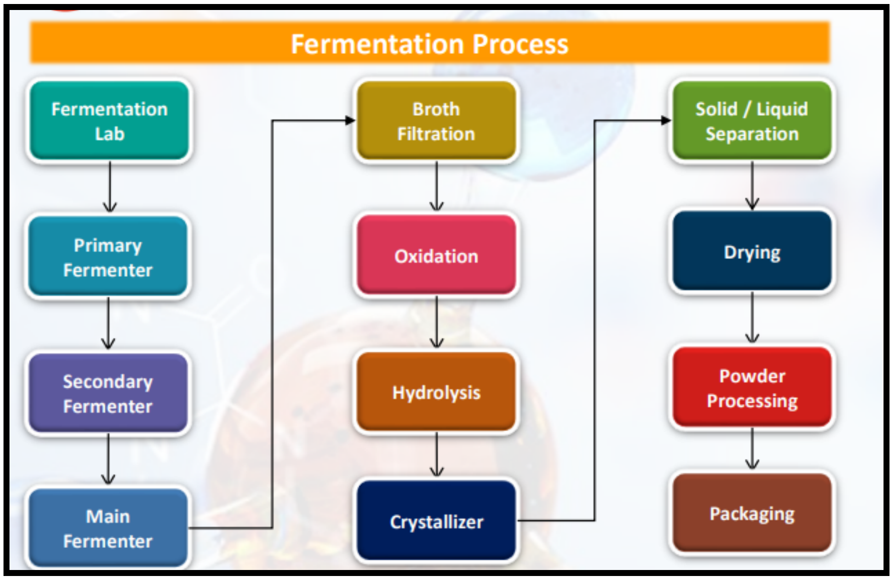
1) Vancomycin HCl: It is used to treat colitis (inflammation of the intestine caused by certain bacteria) that may occur after antibiotic treatment by killing the bacteria in the intestines.
2) Daptomycin: Daptomycin injections are used to treat certain blood infections or serious skin infections caused by bacteria in adults and children 1 year of age and older.

Both these products offer a good opportunity to scale the business owing to the lack of any domestic producers in the market other than 'Concord Biotech Ltd.' which is expected to be listed on the stock exchange in the current month.

Key Positive Triggers

1) **Strong Entry Barriers owing to the complex chemistry:**

The company manufactures its process through a complex process called Fermentation.



(*source: investor presentation)*

About fermentation~

- A wide array of microorganisms such as bacteria, yeast, fungi, and streptomycetes have been used in fermentation to produce different types of molecules
- Fermentation products can be naturally derived as well as semi-synthetically processed with a combination of fermentation and chemical synthesis.

Why is this so complex? Well, dealing with microorganisms is a very tough process requiring lots of trial & error along with competency. The fermentation plants owing to the risks of contamination from these organisms need to go through a rigorous environmental clearance process.

Semi-Synthesis (using a mix of fermentation as well as chemical synthesis) is seeing growing impetus, however, It involves several steps such as strain selection, fermentation process selection, scale-up, biological purification, chemical synthesis, etc., thus requiring multidisciplinary expertise.

Further, the initial costs of producing the capacity are very high which becomes a major burden given the difficulty of economically scaling up the plants & long gestation period of the investments.

Because of these reasons, even established players like Lupin don't completely eliminate sourcing from a smaller player like Gujarat Themis Biosyn.

What are the positive trends in this chemistry?

- **Systematic Strain Improvement:** A key goal in the fermentation API industry is yield improvement to lower production costs. While media and process optimization enables an incremental increase in yield, strain improvement of the expression systems offers substantial cost and time advantages. While in the past, companies have used random mutagenesis and pathway engineering to improve strains, advancements in metabolic and genetic engineering are allowing for an optimized, scalable, and empirical approach. There is increasing availability of gene-editing technologies such as CRISPR, high throughput DNA sequencing, and automation to engineer producer strains, which can shorten the fermentation process, reduce impurities, and improve scalability
- **China's Dominance Being Replaced by India's Growth** China has traditionally dominated the small molecule fermentation APIs market and accounted for nearly 70% of the global market supply until 2021 However, several API manufacturing units were **shut down with the growing environmental and quality concerns**, thus creating an opportunity for India to revive its fermentation API industry. A combination of the China Plus One strategy and conducive Indian government policies such as the PLI Scheme and bulk drug parks scheme is rapidly expanding India's capability in the key fermentation products to meet global needs

How does this impact the company in terms of margins? The company's margins are far superior to any other pharma company, which is partly due to the lower competition post-China's reduced supplies, however, the other important reason in our view is that -

"The starting materials for fermentation are low-cost and often agricultural waste/ by-products that can be recycled. Fermentation in comparison to chemical synthesis does not involve using as many harmful or toxic solvents or chemical raw materials, thereby avoiding producing dangerous waste" (Source: Concord Biotech DRHP)

2) Ambitious capex to improve the business profile:

The company is undergoing a capex of INR 200 Crs for

i) 2 new pilot R&D plants & an R&D lab (Capex~42 Crs)

ii) Phase1- fermentation capacity (Capex ~ 80 Crs)

iii) API block (Capex ~ 80 Crs)

The company is expecting to commission this capex through internal accruals with an overall payback period of 3-4 years.

The R&D labs are expected to come live in Q2FY24 & the Fermentation capacity (which is expected to double the current capacity) will come online in Q1FY25.

The major reason for this high capex in the R&D block is to create a CGMP-compliant plant which will help in the quick commercialization of the API.

> So that's all the products that are being developed at a lab scale can be actually scaled up from these particular pilot plants and also filed for regulatory filing. Because as Mr. Anand said, the cost of putting up a fermentation facility in phase one is about INR80 crores. And we have got three phases to go through after that. So we would like to make sure that we have maximum filings from our CGMP pilot before we move to the large scale commercial.

(Source: Q4FY23 concall)

The company if able to successfully register its new products, will see strong reinvestment opportunities which is visible from the management's long-term plan of commencing additional 2-phases of fermentation capacity post the scale-up of the current capex.

The major benefits of this capex will also come from its ability to forward integrate & produce APIs by itself as well as diversify its revenues profile & reduce the dependence on its 2 clients which currently form the entire revenues.

Further, the management's increased focus on Semi-Synthetic drugs can be a huge opportunity in the future as the R&D plant scales up owing to its existing fermentation capabilities.

"*semi-synthetic APIs are fully backward integrated with in-house fermentation-based APIs as key starting materials.*" (Source; Concord biotech DRHP)

3) Strong near-term tailwinds that can boost the company's valuation multiples:

Firstly, on the business side, the company sees strong tailwinds in its Rifa-S product owing to:

- Strong initiatives taken by the governments to eradicate TB.
- Change in WHO regulations regarding the preference for 3HP rifapentine-based treatment as compared to the current prevailing Rifampicin-based treatment. This is a major development for the business as Rifa-S will be required as an intermediate for the new drug where the dosage required is high, & the conversion ratio of Rifa-S to Rifapentine is low, which will lead to higher volumes.
- Increase in production capacity (+40%) by Lupin in anticipation of demand bores well for the company (Source: Lupin's AR 2023)
- The company saw poor volumes in FY 23 for the Rifa-S intermediates owing to slow tenders for TB medicines. However, the company kept running its plant at full utilization levels, & has developed substantial inventory in anticipation of higher demand in FY24 which should lead to a decent growth in revenues.

> **Enhancing Accessibility of Tuberculosis Treatment**
>
> Lupin has achieved significant progress in producing and distributing tuberculosis (TB) treatment, particularly in low- and middle-income countries. With multiple state-of-the-art facilities dedicated to Anti-TB products, we are one of the largest manufacturers of Rifampicin, Pyrazinamide and Ethambutol APIs. Furthermore, to curb the increasing prevalence of TB in these countries, we have expanded our production capacities in Aurangabad. This allows us to produce 40% more batches from our dedicated Anti-TB formulation blocks.

Source:
https://www.impaact4tb.org/wp-content/uploads/2020/04/5T-eng-DDI-Drugs-Drug-Interactions-Art_RB16.pdf

Secondly, We believe that the **listing of Concord Biotech can be a good trigger for short-term stock price growth.**

Rationale: Concord Biotech is expected to be listed at a price/Earnings (P/E) multiple band of 32-40 times (FY23 earnings). This is in stark contrast to the valuation multiples of Gujarat Themis Biosyn i.e. P/E multiple of 20X (FY23 earnings).

Both these companies are involved in Fermentation chemistry & are foraying into the same products i.e. Vancomycin HCl & Daptomycin (Concord's proposed capacity is 10 & 2 MTPA respectively) which makes them a listed peer (even management stated Concord to be one of their peers in the space in AGM-2022).

Now, although the business model & past track record of Concord Biotech is far superior to Gujarat Themis Biosyn, we believe there exists a chance of possible rerating of the valuations of Gujarat Themis Biosyn owing to increased perception of its valuation multiple.

(Note: This can act as a short-term trigger in favor of the company, however, it is the operational performance that will guide the share price in the long term)

Lastly, several other caveats like a Lower free float in the shares (owing to 75% promoter holding) & the expected listing of the stock in the NSE (which will lead to higher volumes being traded & greater discovery) can also boost its stock price.

4) Strong Balance sheet & competent management group:

The company has been able to tackle the difficulties in its business successfully thanks to the efforts of Themis Medicare which owns a 23% direct stake in the business & controls the day-to-day operations, with the remaining 51% being held by the Pharmaceutical business group- a unique consortium between Themis Medicare Ltd (TML), Kopran Ltd., Anant & CoCadila HealthCare Ltd. (Zydus) and Lyka Labs Ltd.

The company's long-term partnership with Lupin has helped in dominating the TB medicine market with Lupin being one of the largest players in the industry.

In terms of the balance sheet, the company has been able to create strong reserves through the extraordinary growth it witnessed post-FY19, & although some part of this might have been temporary (maybe due to abnormal realizations), the company is using these funds to create a sustainable & strong business model through forward integration into API's. The best part about this expansion is that the company is not incurring any debt for the 200 Crs capex & the entire capex will be funded through internal accruals.

Owing to the company's strong margins of around 40-50%, the company is able to maintain ROCE> 40%. Now we at SSS believe, that part of the reason for these extraordinary returns on capital is the lower incremental capital deployed in the business coupled with the majority of returns coming from an increase in operating margins, i.e. there are high probability that the Returns in capital will decrease substantially in the coming years owing to - A) higher invested capital in the form of its 200 Crs capex & B) lower margins owing to higher R&D, regulatory, human capital & other related expenses coupled with possibility of lower realizations due to higher competition.

But, for a company to achieve growth, there are two levers -

A) ROCE% (which we believe will trend downwards) &
B) Reinvestment rate (which will increase owing to the new capex program)

Therefore, due to these characteristics, the balance sheet will remain solid & at the same time, the company's business model will actually become more resilient & grow at faster rate despite the optically lower returns on capital (ROCE%).

	Mar 2012	Mar 2013	Mar 2014	Mar 2015	Mar 2016	Mar 2017	Mar 2018	Mar 2019	Mar 2020	Mar 2021	Mar 2022	Mar 2023
Share Capital +	12	7	7	7	7	7	7	7	7	7	7	7
Reserves	-25	-17	-13	-8	-3	1	5	11	35	63	96	142
Borrowings +	11	11	9	6	3	4	1	6	8	5	1	0
Other Liabilities +	20	17	13	9	8	9	8	8	14	14	18	17
Total Liabilities	**17**	**18**	**16**	**15**	**15**	**21**	**20**	**33**	**64**	**88**	**122**	**166**
Fixed Assets +	11	12	11	10	9	11	11	15	17	19	19	33
CWIP	1	0	0	0	0	0	0	1	0	2	13	21
Investments	0	0	0	0	0	0	0	0	0	0	0	0
Other Assets +	6	6	5	5	5	11	10	17	47	67	90	113

Negatives

1) High client & supplier concentration risk:

*"The company caters to only two customers, i.e., Lupin Limited, contributing 44% of the sales, and Optrix Laboratories Private Limited, contributing the balance 56% of sales. The company has a '**take or pay' agreement with Optrix Laboratories Private Limited**, which is renewed annually, and has a **contract with Lupin Limited for five years**, hence concentration risk is mitigated to an extent. However, any major setback in the financial profile of these clients can significantly impact the growth of GTBL."* (extract: Credit rating reports)

Although the company claims to have onboarded 3-4 new clients in the business, their contribution so far has been very less.

This dependence is one of the major risks in the business as the company is a supplier of 'intermediates', & any plans of these two players to start producing these intermediates in-house can have a catastrophic effect on the company's operations.

This concern is very valid considering Lupin's existing presence in fermentation chemistry.

Further, if Lupin's own competitive positioning deteriorates owing to the emergence of competition from China as well other Indian players like Macleods-which is adding a 200 MTPA rifamycin (intermediate) capacity in Jammu under the PLI scheme for Captive consumption (i.e. it is doing backward integration), which can impose significant competition to Lupin in the Tuberculosis treatment market.

> **Fermentation Experts**
>
> We are the global experts in fermentation technology-based pharma products. Coupled with a strong handle over enzymatic technologies, it enables us to introduce new products in the market. We continue to invest ahead of the curve to advance our API R&D platform. This expertise gives us unmatched capabilities in manufacturing Rifa-based products including Rifampicin, Rifapentine and Rifabutin, used in the treatment of tuberculosis.

> We intend to manufacture APIs at the facilities in Jammu and Dahej as part of our efforts to further control raw material input and reduce reliance on third-party suppliers. Our upcoming facility in Jammu is for fermentation-based production of rifampicin, an API primarily used in treating TB, has also been approved under the first production-linked incentive scheme ("**PLI Scheme**"), and we have been approved under the second PLI Scheme for manufacturing anti-diabetic, anti-infective, and cardiovascular products, launched by the Department of Pharmaceuticals, Indian Ministry of Chemicals and Fertilisers. The PLI Schemes entitle eligible manufacturers to

(Source: Macleods DRHP)

Based on our understanding from different sources, Lupin holds a contract with the patent owner of the API wherein Lupin supplies at least 50% of the overall requirements of the company, & Lupin, being one of the biggest players will definitely get a share of the new tenders for the medication.

However, this remains a major risk in the business model which the company is trying to address through its forward integration initiatives in the form of entry into API.

Similarly, the company also has raw material supplier concentration risk:

" The supplier profile of the company also remained concentrated, with the top 10 suppliers contributing 83% of the total purchases in FY23 vis-à-vis 70% of the total purchases in FY22" (Source: Credit rating)

2) **Uncertainty of the future growth:**
Current capacity is running at close to 100% utilization levels,, thus short-term revenue growth might be muted despite an entry in the API segment in the coming year. Further, the scale-up of the new API block can take 2-3 years before generating any cashflows, while any competition from China on the Rifamycin side can badly hurt the company's realizations leading to lower sales from the existing intermediates business.

   Rifamycin S is a tender-based business that can have lumpy demand based on the Government spending (as seen in FY23 revenue degrowth)

   The company's current margins seem extremely high owing to the lower book value of gross block leading to lower depreciation expenses along with lower employee benefit expenses & R&D spending.

   We believe that due to the commissioning of new capex, there will be a mismatch in the form of lower cashflows coming from that business & higher expenses being reported for the same owing to higher R&D, depreciation & employee expenses which can depress the company's profits in the next 1-2 years if the ramp-up gets delayed. Although, the company is able to address the problem partly in the form of no debt (leading to no fixed finance costs) & capex being commissioned in a phased manner, which will cause lower stress on the margins.

3) Certain Red Flags:

Potential Conflict of Interest: The company as per its latest proposal for environmental compliance regarding its new capex mentioned that it is stopping/transferring the production of 'Lovastatine boronate intermediate & transfer it to Themis Medicare (the promoter entity) has started producing the same product!

This highlights the possible conflict of interest that can arise in the future because of the presence of both entities in the same industry.

Poor Cashflow conversion: The company owing to the elongated working capital cycle (led by very high inventory days in the recent year), has seen poor PAT to CFO conversion. Although this is partly due to the nature of operations (led by servicing of only 2 clients), this is still a major forensic accounting-related risk that one needs to be mindful of given the strong expected cash outflows in investing activities that the company plans to incur in the coming period.

	Mar 2012	Mar 2013	Mar 2014	Mar 2015	Mar 2016	Mar 2017	Mar 2018	Mar 2019	Mar 2020	Mar 2021	Mar 2022	Mar 2023
Debtor Days	109	37	15	28	24	71	26	52	87	59	80	44
Inventory Days	88	58					78		194	144	255	201
Days Payable	737	1,498					947		240	84	145	131

Regular Changes in the top management: The company has seen several changes in the management & ownership structure like:

- Mr. Rajneesh Anand, President & CEO of the Company stepped down with effect from 7th August 2014 & Mr. Tapas Guha was appointed as CEO of the Company with effect from 7th August 2014.
- Mr. Jagadish G. Kaujalgi, Chief Executive Officer of Gujarat Themis Biosyn Ltd tendered his resignation with effect from 10th July 2022 & Mr. Tapas Guha Thakurata was again appointed as CEO on 5th January 2023.
- Ending the Joint venture with Yuhan Corporation Ltd. in 2022, which led to a buyout of the 26.5% shareholding by the Pharmaceutical Business group which increased its total ownership to 51%.

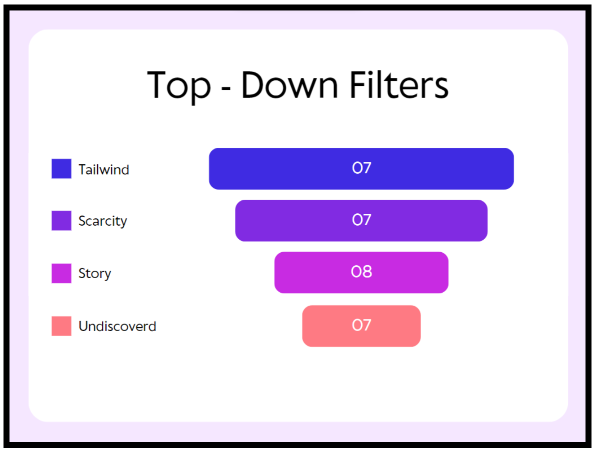
Closing Thoughts

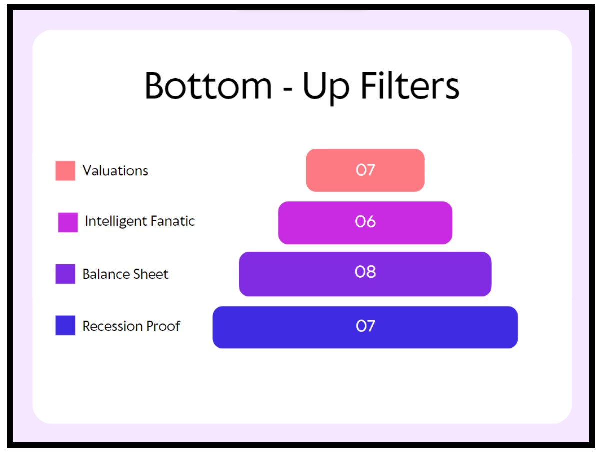
Given the current valuation of 1100 Crores, our outlook for the stock is optimistic, fueled by a combination of robust tailwinds, ambitious capital expenditure plans, and an enhanced market perception subsequent to the listing of Concord Biotech. It is worth highlighting that Concord Biotech's forthcoming listing is anticipated to transpire at a price-to-earnings (PE) multiple of 33, while Gujarat Themis is currently trading at a PE multiple of around 20. When considering the ongoing capital expenditure strategies and the potential for a PE rerating, we envisage a substantial upside potential ranging from 30% to 50% in relation to the prevailing levels. This projection is underpinned by the synergistic impact of favourable market dynamics, strategic investments, and the comparative valuation dynamics with Concord Biotech and Gujarat Themis.

However, we have also tried to highlight the company's major risks like risks of slow scale-up of the business, high dependence on 2 companies & certain other red flags. Nonetheless, investing solely based on a rear-view mirror (i.e. past performance) might restrict us from investing in several potential turnaround opportunities or fixate on the winners of the past. Therefore, we believe that investing should be looked at as a moving picture rather than a still one with a greater focus on future prospects.

Scoring based on Ian Cassel Framework

Based on our Ian Cassel Framework wherein we rank 100 companies in our small-cap watchlist on 8 parameters, Gujarat Themis Biosyn Ltd emerged in the **top decile of our rankings**, because of which we feel that the stock has a high probability of delivering good results in the next 3 years time frame.





Final Score: 57

Any company scoring **above 50** deserves attention for possible consideration

Please note, as small caps usually have vulnerability to some 'unknowns', investment should be considered keeping in mind the risk profile of the investor. Gujarat Themis Biosyn being a 1000 Crs company is definitely a risky investment.