12 Minutes of Fame!

Daily wage earners in India work 7 days a week, because even one day-off for them means no money made that day. Some developed countries on the other hand have been piloting 4-day weeks. Two ends of the spectrum, right? Maybe not. Because there is an even lighter job out there that requires, wait-for-it, just 12 minutes of work a day! Isn't that incredible? A dream role if there was one? The name of the job is Medical Representative, or MR for short. The MR's role is typically to pitch new medicines to doctors, so that the doctors may start prescribing these new meds to all their patients. Here's how an MR's day tends to look like:

- Start at 8 am if not earlier, at the clinic of the first doctor.
- Average wait times in-between patients and other competing MRs tend to be around 1 hour.
- Every 1 hour, the MR gets exactly 1 minute of the doctor's time to pitch their product.
- If the doctor is busy or preoccupied or uninterested, too bad.
- And then it is on to the next doctor, who might be far away - so the long commute, traffic, the crowds etc.
- The day should ideally end at 8 pm, but often extends longer.
- Sometimes the shift can be from 8 pm to 8 am as well!
- 12 hours on the job, and 1 minute with 12 doctors each equals "only" 12 minutes of work every day.

Dream job? It's not a bad job, but certainly a tough one, and is representative of the front lines of most pharma companies. The group founder of one of our investee companies, the late Mr. UN Mehta, was an MR for Swiss pharma giant Sandoz. After working for 17 years, he quit his job and established Trinity Laboratories in 1959. The business did not pick up much as Mr. Mehta's deteriorating health prevented him from focusing on it fully. In 1971, he relaunched the business as Torrent Pharma also bringing in his elder son Sudhir - who at the time was in his second year of graduation. Mr. Sudhir's father didn't induct him with a red carpet though. He instead made Sudhir work as an MR, thereby needing him to visit countless doctors for years across the length and breadth of India, with the experience teaching him first-hand, the challenges as well as opportunities in the sector.

Torrent Pharma today is among the most successful chronic-therapy driven domestic franchises in India. It has leveraged its robust relationships with specialist doctors and is now the 6th largest pharma company in the country versus being 17th a decade ago. Torrent ranks among the top-5 players in India in the cardiovascular, CNS (Central Nervous System), gastro-intestinal and vitamin segments. The company has smartly integrated strategic acquisitions (select brands from Elder Pharma in 2014, Unichem's domestic portfolio in 2017, Curatio - ongoing), consistently outpaced general Indian pharma growth and delivered class-leading MR productivity. It exports to more than 70 countries, including the US - where it has run into compliance-related challenges, Brazil - where it is the largest Indian pharma company currently and Germany where it acquired Heumann Pharma in 2005. But a little about the Indian pharma industry itself first, with relevant references to Torrent peppered along the way.

Indian pharma is massive, and yet tiny. How's that possible? Because it is massive in the generics segment, while hardly featuring in the innovator category. Innovator pharma companies are those that innovate and *invent* drugs to treat illnesses. Generics companies on the other hand are somewhat like legalized copy-cats. India supplies a substantial chunk of global generics demand. India also produces 50% of global vaccine supply and has exported COVID vaccines to 101 countries. So the country's pharma contribution is clearly very large. Why is this? Because India has some exceptional chemistry skills, with the ability to reverse engineer complex compounds and provide them to the world at a substantially lower cost.

Now what does the addressable pharma landscape look like? The global pharma market is about ~USD 1.4 trillion, of which the US alone is ~45% or ~USD 630bn. Only ~USD 50bn of this are generics, not because of lower volume, but rather because of lower value i.e., innovator drugs are far costlier than comparable generics. Once innovator drugs go off-patent, it is common for prices to drop by 80-90% even. Of the USD 50bn, India would be supplying about USD 10bn worth of generics annually to the US. To the rest of the world, including EU and Japan which are the other large markets, India supplies another ~USD 15bn, taking the total to ~USD 25bn a year. While these are exports

of generics, the domestic Indian pharma market is another ~USD 25bn in annual revenues, with the domestic piece growing in double digits (amongst the world's fastest), so the size of the entire India pharma pie today is ~USD 50bn, give or take.

Sticking to the export market for a moment - selling generics to the US gave Indian pharma giants access to the largest market, while Americans in-turn got access to affordable medication. The United States Food and Drug Administration (USFDA) had shortened product approval timelines in 2015 leading to intense competition as many players started getting approvals. On average, the price of the second generic launch was discounted by ~50% compared to the brand, while the third and fourth launches saw discounts of ~75% and ~90%, respectively. This impacted well-established Indian players, but not everyone. Late entrants to the US market like Torrent Pharma benefited from expedited approvals, but the coast wasn't entirely clear. Substantial buyer consolidation took place in the US, with just 4 distributors (Walgreens Boots Alliance Development, Red Oak, EconDisk and ClaurusONE) accumulating over 90% market share amongst themselves. Their consolidated purchasing power and negotiating strength resulted in price erosion of ~15-20% p.a. for many US generic drugs. Barring an event like the Covid-19 pandemic (where product availability takes precedence over pricing), such erosion could continue as generic pharma companies selling in the US will likely remain price-takers.

It wasn't just the pricing issues of the last few years that have been challenging, however. The bar of regulations and compliance requirements in developed countries is set very high - especially in the US, as dictated by the USFDA. In the earlier part of the last two decades, to grow quickly, minimize costs and maximize profits, some companies paid less attention to regulations than they perhaps should have. The USFDA became particularly strict in 2015, and those who were following the trends would remember terms like *Form 483*, *Warning Letter* and *Import Alert* becoming part of daily conversation. What are these? A *Form 483* is issued to the manufacturer after inspection if an investigator observes any conditions violating FDA norms. The company has 15 days to respond to the FDA's assertions on lapses with Corrective and Preventive Actions (CAPAs). If the FDA is satisfied with the CAPAs, it clears the facility for manufacturing. If not, it may issue a *Warning Letter* and/or *Import Alert*. A *Warning Letter* meant existing business could go on uninterrupted, but no new product approvals would be granted until the issues were fixed. This would clearly impact long term growth if left unresolved. An *Import Alert* was the severest of the lot, which meant the US would stop importing all products from the specific plant which received this violation report.

India has the highest number of USFDA-approved plants outside the US and hence tends to get scrutinized more. Various Indian pharma stocks continued to take a beating for the better part of 5 years, with the Nifty pharma index falling nearly 50% from Aug 2015 to Feb 2020. Companies that had most of their revenues coming from the US were impacted the most. Some companies also ended up paying huge fines - often 100s of millions of dollars - apart from recalling certain products and constantly being asked to improve their manufacturing processes and facilities. Although in-person USFDA inspections had paused briefly during the pandemic, they are back on track over the last 12 months or so, with priority accorded to plants previously flagged for compliance issues and which are now ready for re-inspection. To reduce the associated uncertainty, companies have begun filing for product approvals from dual sites, or even transferring production of key products to approved plants. For instance, Torrent derives ~18% of its sales from the US market. The best-case scenario would be the successful resolution of Torrent's two plants at Indrad (contributes >50% of Torrent's US revenue) and Dahej, which have received USFDA observations. No doubt such clearance would create an earnings upside optionality. But this outcome cannot be presumed. To hence improve profitability in Torrent's depressed US business, the company is evaluating a) pruning the US portfolio from ~50 products to ~15-20 by discontinuing low-margin products, and/or b) site-transferring meaningful products from the Indrad facility to Dahej, if say the Indrad plant receives a USFDA *Import Alert* and the Dahej plant gets a green signal. A relatively more drastic step would be to fully discontinue the US business altogether. This could still improve overall profitability by saving 25-50% of R&D costs, and these manufacturing facilities could be repurposed for in-sourcing products for other markets.

Ironically, for many Indian companies with US generics businesses, their silver lining has been the success they've found in India, in the branded generics market. Within generics, there are two types – generic generics, and branded

generics. The former as the name suggests, are truly generic, both, in form and in nomenclature. For example, paracetamol would be sold as paracetamol itself, by various companies, and the packaging would read "Paracetamol by Novartis", or "Paracetamol by Pfizer". The chemical composition of each would be similar and contain the same active ingredients. Branded generics on the other hand, are also generic drugs but those which have been given a proprietary market name. For instance, paracetamol is sold by GlaxoSmithKline as Crocin in India and as Panadol outside the country, while the branded version of Johnson & Johnson's paracetamol is Tylenol. Typically, generic generics tend to be common in developed markets like the US and Western Europe, while branded generics are common in emerging markets. For most Indian companies, a robust domestic business contributes ~35-40% to revenues and serves as a stabilizing force, bolstering overall earnings (margins of ~25-40%, high asset turns, low working capital and high ROCEs) and facilitating investments overseas.

The Indian market is somewhat unique in its medicinal demand compared to more developed markets. In the latter, the share of chronic medicines tends to be ~65%, while the share of acute medicines would be ~35%. *Acute* conditions are severe and sudden, like a broken bone or a common cold. A *chronic* condition, by contrast, is a long-developing syndrome, such as osteoporosis or cardiovascular disease. In India, the chronic to acute share is reverse, ~35% to 65%, and likely to move towards the global average over time. While it is nothing to be proud about, Indians too are seeing the impact of more and more lifestyle related diseases (stress et al.). Seen purely from the commercial lens of a pharma company however, this means stickier revenues, as by definition, chronic patients will come back to buy the same medicines over and over for years together. So even if the India pharma market grows at say ~9-10% p.a., the chronic segment is likely to grow faster at say ~12-13% p.a., while the acute segment might grow ~7-8% p.a. Notably, the chronic segment has long been dominated by a select group of formidable players, including Torrent Pharma.

While growing fast is no doubt critical to any pharma company, doing so profitably is just as important, if not more. Two key factors underlie this: a) the size of the pharma company's MR team, and b) their productivity. The key metric to gauge productivity is 'sales per MR', which is influenced by various factors, including the company's acute/chronic mix, the therapy mix of its product offerings, the portfolio size, and the speed of new product launches. Torrent pharma with a >85% focus on chronic and sub-chronic therapies in the India market has the best MR productivity amongst Indian companies at >INR 1 million (~USD 12,000) per month. Torrent has added more than 1,000 MRs in their India business (ex-Curatio) during 9MFY23 (~30% organic expansion), of which 150-170 reps have been housed in a marketing division. These MRs will tap the general physician (GP) channel where the company currently covers only <10,000 doctors out of the ~250,000 doctors in India. This MR expansion will likely drive better volume growth, given that GPs already prescribe Torrent's leading products. The rest of the field force addition will help Torrent drive growth in new launches and strengthen the base India business.

Torrent has also been successful at growing inorganically in the past. Most recently (Sep 2022), Torrent acquired 100% of skincare manufacturer Curatio Healthcare at a somewhat expensive 8.8x EV/Sales. Post-acquisition, Torrent will become a top 10 player in the dermatology segment, and the leader in the cosmetic dermatology space (~85% of its derma portfolio is cosmetic derma). Currently, derma therapies bring only 3% to Torrent's topline. Curatio has a wide footprint among pediatricians and dermatologists; hence, cross-selling would be long-term beneficial. Going by Torrent's past acquisition successes, synergies should be tangible, and likely reflected by FY25. For instance, Torrent turned around Unichem's MR productivity from INR 3 mn prior to acquisition to INR 6 mn and boosted margins from ~15-18% to ~22-25%.

Many Indian pharma companies also export to other Emerging Markets (EMs), given similarities with the Indian market. How? Because EMs too tend to be dominated by branded generic medicines driven by out-of-pocket expenses. These EMs offer high profitability, require lower capital expenditure, and generate good returns. Around ~10% of Torrent's revenues come from Brazil. With ~88% of this coming from branded generics, and growth substantially higher than the local market growth, there is reason to believe that the successful India model is being replicated well there too. Torrent is now the biggest Indian pharma company in Brazil by revenues, contributing to >65% of sales by all Indian companies there.

What are the key risks to our Torrent thesis? One is the possibility of price controls by the Indian government such as for medicines deemed essential. However, Torrent enjoys strong pricing power compared with its peers, and ~90% of its India portfolio is not covered under the govt.'s National List of Essential Medicines (NLEM). Another risk is the delay in securing USFDA approvals, but as explained above, the company can take a series of steps to mitigate such impact. At ~30%, Torrent has one of the highest margins within the industry. These margins can expand further through price hikes in India/Brazil, by enhancing the profitability of the Curatio portfolio, by reducing plant-related remediation costs and with the expected launch of new products from the USFDA affected plants. The promoters currently own >70% of the business, and succession plans are in place, given the third generation of the business is already deeply involved. Given the strong business model, high capital efficiency (ROCE>25%) and growth prospects, the stock isn't cheap at ~30x FY25 P/E. However, if you've been reading *Access India* regularly, you know our investment philosophy is to look through near-term apparent over-valuation and focus on long-term sustainable growth and quality potential. While there is a long way to go, the company is on the right track, one-day, nay, 12-minutes at a time.

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Data sources: publicly available media articles, sector reports.

Prior Editions of Access India Equity Insights:

1. Scaling New Heights (link)
2. Changing the stars (link)
3. An electrifying perspective (link)
4. Building with APLomb (link)
5. cARPU diem (link)
6. All's Well That Trends Well (link)
7. 'Foods' for Thought (link)
8. EV Wonder (link)
9. Forest or Trees (link)

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