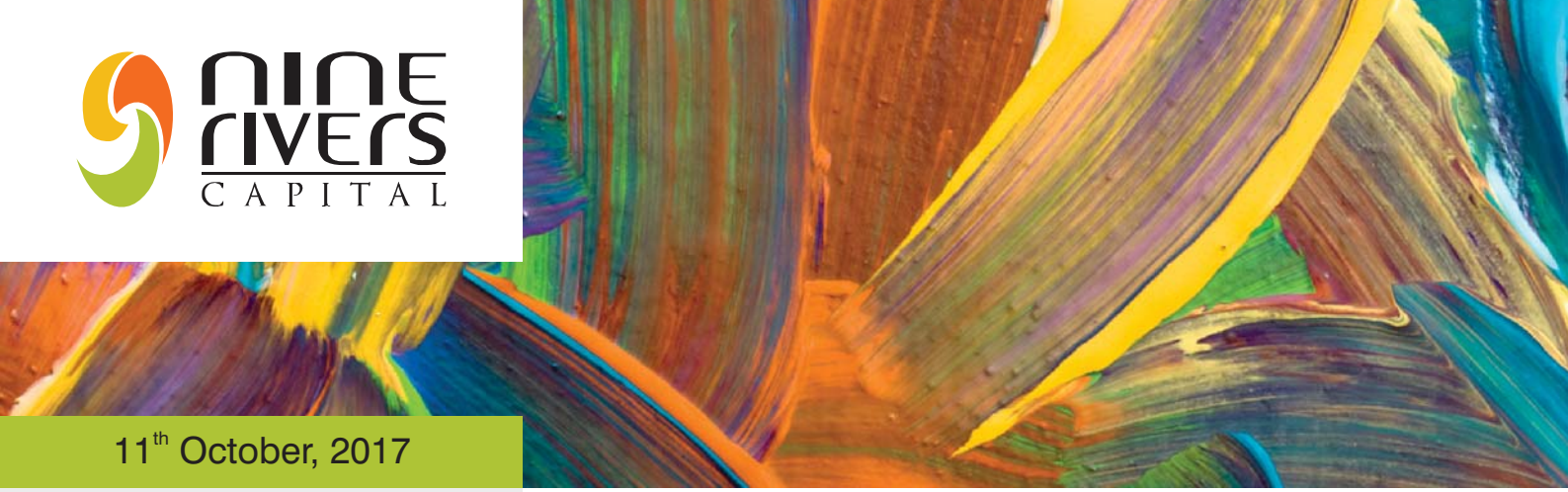
NINE RIVERS CAPITAL



11th October, 2017

Aurum Small Cap Opportunities & Aurum Growth Portfolio

19th Quarterly Update – QE September 2017

Dear Investor,

Over the last six quarters we have shared our thoughts on the disruptive changes that are happening in India and that are likely to have significant impact on our socio economic fabric in coming years. A lot of what we had envisaged has started to play out and impact the life of masses for good or otherwise. Be it the confluence of Jan Dhan, Aadhar & Mobile (JAM) enabling effective delivery of benefits through DBT, rapid entrenchment of solar power on the back of plummeting capital cost or automation leading to growth without jobs. It is in the context of the latter that we started looking for credible options that the Government of the day is pursuing (or can pursue) to ensure social welfare of the masses.

In this update, we wish to share our thoughts on one of the key programs of the Government to make healthcare affordable for the masses i.e; the **Jan Aushadhi** scheme. Recent policy initiative of the government such as, capping prices of medical devices like stents and knee implants is aimed at containing the unbridled profiteering in the healthcare sector. Further, the advisory on prescribing generic drugs was a step in the same direction. We believe, Jan Aushadhi scheme, if rolled out aggressively, can have far reaching impact on the way healthcare is dispensed in the country.

To validate our desk research, we decided to visit a few Jan Aushadhi (JA) stores in Mumbai and asked for 20 commonly prescribed medications. As provided in **Table I** below, medicine at Jan Aushadi stores are available at a discount of 50-90%, with the aggregate discount working out to ~75%!

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Table I

Drug (Generic Name)	Therapy	General Pharmacy Price (INR)	Jan Aushadhi Pharmacy Price (INR)	Price Difference
Atorvastatin 40 mg	CVS	188	15.9	~10x
Amoxycillin Trihydrate Cap 500 mg	Antibiotic	60	35	~2x
Povidone Iodine Ointment	Antiseptic	99	14.5	~6x
Loperamide Cap 2 mg	Anti Diarrhea	18	6.16	~3x
Fusidic Acid Cr. 2%	Antibiotic	210	52	~4x
Paracetamol 500 mg	Pain relief	13.4	4.51	~3x
Voglibose 0.2 mg	Diabetes	80	9.61	~8x
Arthemether 80 mg & Lumefantrine 480 mg	Malaria	139	56	~2.5x
Olesartan Medoxomil 40 mg	Blood pressure	163	26.71	~5x
Metformin 500 mg	Diabetes	15	5.15	~3x

In such a scenario, assuming, quality being the same and availability & accessibility not being an issue, where would you buy your medicines from? A general pharmacy store or a Jan Aushadhi store?

Jan Aushadhi (JA), a historical perspective

Jan Aushadhi as a concept was launched in 2008 by the then government. The idea was to make relatively cheaper generic-generic medicine widely available across the country. It was dependant on supply of medicine by Central Public Sector Units (CPSU). As is often the case, the scheme floundered on the back of;

- Poor rollout (157 stores, March 2012)
- Limited & irregular supply of medicine
- Lack of publicity.

JA got a 3rd lease of life in FY15. Let us call this **Jan Aushadhi 3.0** . The Salient Features of JA 3.0 are:

- In JA 3.0, there is a strong emphasis on quality. Drugs are procured through a tendering process wherein only WHO GMP compliant manufacturers can participate. Further, a premium of up to 10% can be paid to manufacturers who have other accreditations such as US FDA approval.
- Drugs are tested at central laboratory for quality before dispatch to franchisee centres
- Total of ~600 commonly used drugs are sought to be made available. Currently, 300 drugs are generally available
- Franchisees are on centralised billing, ordering, payment system provided by Bureau of Pharma PSUs of India, implementing authority of JA scheme.
- Franchisee margin is 20%

Our JA 3.0 experience & observation

Our visit to a few JA stores in Mumbai threw up interesting observations. The key take aways are summarized below:

Table II

	General Pharmacy	Jan Aushadhi Store
Product Availability	Good	Moderate
Product Price	Market Price (MRP)	50-90% discount to general pharmacy
Accessibility	Easy accessibility	Very sparse, difficult to locate
Non Pharma Products	Well stocked	Non-pharma products allowed. Selective stocking
Suppliers	Mostly private sector	Mostly govt. co.s (IDPL), along with smaller manufacturers from pvt. Sector
Retailer Margin (% of MRP)	15-20	20
Store Ambience	Good to pleasant	Pleasant (not a hole in the wall experience)

In JA 3.0, there is a strong emphasis on quality. Drugs are procured through a tendering process wherein only WHO GMP compliant manufacturers can participate

- Billing, inventory, payment system provided by Bureau of Pharma PSUs of India
- As mentioned above, about 50% of commonly used drugs were not available / stocked out
- Steady flow of customers when the JA store was located near a medical facility
  - ✓ We observed about 10 prescription sales in 30 min, @1 pm
  - ✓ Some new customer, some old
- New customers were pleasantly surprised by the pricing as well as interaction with store staff. We observed, medicines for chronic diseases (diabetes, blood pressure, cardio, etc) are selling better than those for acute diseases
- JA stores were also selling non pharmaceutical stuff (which is permitted) and some branded generics (from what we understand, it is not permitted but due to unavailability there may be a need to stock essentials from other sources)
- Most of the manufactures were either government companies (mainly IDPL, Bengal Chemical) or relatively small private sector pharma companies. Participation by top tier pharma companies is still not visible though we are given to understand that they do participate in JA tenders sporadically
- Our impression is that patients are either generally unaware or not yet actively seeking out JA stores

Current Status of JA rollout

- ✓ Currently there are about 2,000 stores, of which 1,700 were added in the last 15-18 months.
- ✓ Plan is to ramp it up to 3,000 stores by Dec 2017
- ✓ Supply side constraints remain
- ✓ Participation by top tier pharma companies is still marginal

We strongly believe that a robust roll out of JA 3.0 would require the following three elements to be aced, namely; *Quality, Convenience & Price*

The Road to Success for JA 3.0

Current impact of the ~2,000 JA stores is still insignificant and miniscule and has gone completely unnoticed. We strongly believe that a robust roll out of JA 3.0 would require the following three elements to be aced, namely; *Quality, Convenience & Price*.

1. **Quality:** These being health related products, quality standards would have to be *'never in doubt'* status. While participation of government companies is helpful, in the longer run, participation by top tier domestic private companies would be essential.
2. **Convenience:** *Availability* of medicine and *accessibility* of stores would be essential. Accessibility would be possible only when the number of JA stores go up significantly, (from ~3,000 stores in Dec 17) to about 80,000 stores in the next 5 years, which is ~10% of current pharmacy store strength. Availability of medicine would be possible when the top tier companies participate in the program and a robust supply chain logistics is established at the back end.
3. **Price:** Affordability is also a very important element as that would benefit and attract a larger sections of the society. At some point, there is also a case for Government to look at re-imbursement of drug costs into Aadhar linked accounts of the poorer sections of the society.

JA 3.0 – How does it impact the Indian pharmaceutical industry

The Indian pharma industry has two legs, namely; US generics & domestic (branded) generics. The ~ INR 100,000 cr (~USD 16 b) domestic pharma market is dominated by branded generics, and growing @12-15% annually.

There are about 10,000 manufacturers/trade generics and ~800,000 pharmacies. The hinterland is largely dominated by 2nd and 3rd tier pharma companies and trade generics, often supplying drugs of uncertain quality. It is estimated that these companies have ~50% of domestic market share.

To put things in perspective, about 10 year ago, it is estimated that there were about 20,000 manufacturers and the 2nd & 3rd tier manufacturer & trade generics had 75% market share. JA 3.0's successful roll out can significantly change the dynamics of the domestic pharmaceutical sector, accelerating industry consolidation, with the biggest beneficiary being the consumer.

We envisage the following in the wake of a successful JA 3.0 rollout

- **Existential crisis for Small Manufacturers / Trade Generics:** There are about 10,000 manufactures in India, a large number of them make products of varying and uncertain quality. As per reports, only 1600 of them are WHO GMP (manufacturing) compliant. These small manufacture / trade generics enjoy ~50% market share of domestic pharma market and sell mostly in the hinterland or smaller towns. As per JA regulations, only WHO GMP complaint facilities can participate in the drug tender. Further, application of Bio Availability /Bio Equivalence studies to production batches will ensure that only the fittest survive. We believe, that the non-WHO GMP compliant manufacturers will face existential crisis and will continue to cede market share to larger pharma companies or to JA franchisee.

As per reports, only 1,600 of the 10,000 pharma manufacturers are WHO GMP compliant

- **Market Share expansion opportunity for top tier pharma companies:** The market ceded by non WHO GMP compliant players is likely to migrate over 5-10 years to top 500 pharma companies. These organized players, however, do not yet have enough penetration in the hinterland markets and therefore would need to actively participate in JA 3.0.

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Table III

INR	General Pharmacy	JA Scheme	Comments
Sale Price (MRP)	100	50	50% discount
Retailer / Dist. Margin	20	8	20%
Net Revenue to Co.	80	42	Ignoring tax
Mnf. Expense	32	32	Same for both
Gross Margin	48	10	
Sales & Marketing (25% of net revenue)	20	0	Not applicable to sales through JA
Other Operating Expense (10% of net revenue)	8	2	
Ebidta to Co.	20	8	
Ebidta Margin	25%	19%	

We believe, participation by private sector drug companies in JA scheme would be a profitable venture. As would be obvious from **Table III** above, for drug companies, the absolute EBITDA from participating in JA would be lower vis a vis general market (INR 20 vs INR 8). However, in % terms, the decline is more muted, from ~25% to 19%, given that significant cost elements (SG&A) would be taken out of the cost.

- **General Pharmacist – the middle way:** Apart from not being aware of JA per se, patients are also not sure of quality of the products being supplied under JA scheme. However, if the top tier companies were to supply drugs through the JA scheme, the question of product quality will be decisively put to rest. If that were to happen, patients would be loath to pay @2x-3x for medicines purchased from general pharmacy stores over JA store prices. The buying pattern would then gradually shift from general pharmacy stores to JA stores. This is of course subject to easy availability and access.

A shift in purchase of chronic drugs to JA stores can have a disproportionate impact on the profitability of pharma companies in the long term

- **Sales & Marketing Teams at Big Pharma – maybe at risk:** If in the medium to long term, JA rollout is successful, then generic drug prescription can be a reality, both in urban and hinterland markets. This would negate the requirement for large sales & marketing teams to promote branded generics.
- **Product Shift – profitability at risk:** Initial purchase pattern at JA stores are skewed towards chronic disease (diabetes, cardiac, blood pressure). These are also the most profitable and sticky prescription drug for pharma companies. A shift in purchase of chronic drugs to JA stores can have a disproportionate impact on the profitability of pharma companies in the long term.
- **Emergence of new breed of manufacturing companies:** Going forward, there is a possibility of the emergence of companies whose business model is centered around quality manufacturing and participation in the JA generic-generic product market. A few examples would be Akums (www.akums.in) and Granules India (www.granulesindia.com)

Conclusion

The success of the JA 3.0 would also substantially depend on participation by top tier companies and a robust back end to service the sales channels

The JA 3.0 scheme seems well fleshed out. The success of the JA 3.0 would also substantially depend on participation by top tier companies and a robust back end to service the sales channels. As and when, it reaches a critical mass of ~80,000 stores, the impact of the same would be felt in the system. At that point, it could well be selling disproportionately higher volume (>10%), at half the value of the open market! However, this roll out, if it proceeds well, will take a minimum of 3-5 years. During this period we expect;

- Aggressive consolidation at the lower end of domestic pharma companies
- Significant curtailment of supply of spurious or poor quality drugs in the system
- Decline in the EBITDA margin (%) of top tier pharma companies accompanied by robust volume & actual ebidta growth, in range of 15-20% CAGR.

Thus, overall, it would be good for consumers and health of the domestic pharma industry. Anything beyond 5 years would be anybody's guess.

Conclusion

In the past 6 months we have sold 3 companies, which had breached our sell price guard rail. A few more may follow suit. On the buy side, we are completing the research process and waiting for stocks prices to come to our comfort zone. Given the frothy state of the market, it is taking us about 4-5 months to construct new portfolios. Thus, on an aggregate basis, there is significant cash in our system. If we continue to be innovative, patient and disciplined, we believe, market will continue to give us opportunities to invest in good quality companies at reasonable valuations.

Warm regards,

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