Life Sciences and Accounting Discoveries

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Pharma has been the flavour of the stock markets recently. While working on an India focused pharma company, we observed that the company had higher margins compared to its peers but when investigated further, we found that such high margins were actually aided by aggressive accounting assumptions and unsustainable tax advantage. In the below article, we discuss certain quality of earnings related issues we observed while going through this company:

1. Aggressive amortization of Intangibles

Company earlier used to amortize the brands and trademark over a useful life of 10 years. However, on transitioning to IND AS in 2018, it started amortizing brands and trademarks over a 50-year period (this happened in its first full year reporting post IPO). More so, this coincided with a large acquisition – its biggest so far. This led us to dig deeper into it and analyse the same in detail.

Upon comparing company's amortization policy to peers, we observed that most of the peers amortized their brand/trademarks over a useful life of around 10 years.

So, why would a company amortize it over 50 years? Do its drugs/products have better market position than peers? Data suggests that none of the company's drugs are or have been market leader and generally have had a market share in single digits (and some are even losing market share).

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Hence, the amortization policy looks aggressive and this has resulted in superior reported operating margins (higher by ~5-6% percentage points), and profit before tax (higher by ~15-18%) as illustrated below:

Particulars (Figures are in INR millions)	2016	2017	2018	2019	2020
Gross Carrying amount of Brand/Trademark	2.0	330.9	6,280.2	6,280.2	7,240.4
Less: Amortization	1.0	21.2	73.4	199.2	331.2
Net Carrying amount	1.0	309.7	6,206.8	6,081.0	6,909.2
Total Intangibles	7.0	1,156.0	7,184.8	7,072.0	7,919.4
Brand/Trademark as %age of Intangibles	13.8%	26.8%	86.4%	86.0%	87.2%
Impact of Change in Useful Life:					
- Amortization using 50 years	na	na	125.6	125.6	144.8
- Amortization using 10 years	na	na	628.0	628.0	724.0
Additional amortization required	na	na	502.4	502.4	579.2
Impact of additional amortization:					
- Operating Margins would have been lower by (per points)	na	na	-6.1%	-5.2%	-5.5%
- Profit before tax would have been lower by	na	na	-15.9%	-15.9%	-17.5%

Source: Company Financials, Multi-Act Research

2. Tax exemption boost to profits

Company's manufacturing unit enjoys tax incentives (100% rebate for income tax till FY 24, indirect tax benefits till FY 25). Since 2013, company is shifting its manufacturing from third parties to this unit, it has increased the part of revenue eligible for this incentive. This has resulted in lower effective tax rate at ~10% in recent years compared to corporate tax rate of 35% (reduced to 25% in FY 20).

Consequently, company's operating margin and PAT are boosted as shown below:

Particulars (Figures are in INR millions)	2013	2014	2015	2016	2017	2018	2019	2020	
Indirect Tax Incentive	0.9	3.7	72.5	124.6	191.9	278.9	145.2	158.8	
Income Tax Incentive	2.4	17.1	126.7	275.7	565.0	864.0	760.2	824.6	
Total Incentive	3.3	20.8	199.1	400.2	756.8	1,143.0	905.4	983.4	
Operating Margin - Reported	21.0%	18.5%	19.7%	26.3%	34.6%	36.2%	31.9%	30.1%	
Operating Margin (without incentives)	20.9%	18.4%	18.3%	24.2%	31.9%	32.9%	30.4%	28.6%	
Change	0.0%	-0.1%	-1.3%	-2.1%	-2.7%	-3.4%	-1.5%	-1.5%	
									Total
PAT	582.0	704.2	892.3	1,363.1	2,398.2	2,965.1	2,901.2	2,965.0	14,771
PAT adjusted for incentives (approx)	578.7	683.4	693.2	962.9	1,641.4	1,822.1	1,995.8	1,981.6	10,359
Change	-0.6%	-3.0%	-22.3%	-29.4%	-31.6%	-38.5%	-31.2%	-33.2%	-29.9%

Source: Company financials, Multi-Act Research

Note: Actual income tax incentive before 2018 is not available. When the contribution from this facility was lower, effective tax rate was ~30%. We have used this as proxy to calculate income tax benefit related to prior years.

As can be seen in the table above, excluding these tax incentives, adjusted cumulative PAT (sustainable economic earnings) since 2013 would have been lower by ~30%.

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3. Risky Investments – A Narrow Escape?

Company had a net cash position (FY 19) and it had invested in mutual funds, equity instruments and others. And it also carried some short-term debt in balance sheet as at end of FY 19.

Investments formed ~30-40% of company's net worth (FY 19) and were mainly invested in debt/liquid funds, however noteworthy is a fact that credit risk funds (these are the riskiest among debt fund categories) accounted for ~20-25% of total investment, i.e. ~5-10% of net worth (FY 19).

Further, company had ~60% of its investment in Franklin Templeton MF schemes (Franklin announced voluntary winding up of these schemes in April 2020) at end of FY 19. However, company had a narrow escape as they used the cash and investments to repay the short-term debt and make a share buyback in FY 20. This brought down the total investments to ~6% of net worth in FY20.

Nonetheless, Franklin Templeton's credit risk funds accounted for ~45% of the remaining investments which was ~3% of net worth for FY 20 (refer working below).

Particulars (Figures are in INR millions)	2018	2019	2020
Total Investments	3,654	3,559	780
Investment as %age of Net worth	42.4%	30.9%	6.0%
Mix of investments:			
Equities as %age of Investment	0.8%	1.3%	3.7%
Debt and others as %age of Investment	99.2%	98.7%	96.3%
Yield on Investments	7.4%	7.3%	6.1%
Credit Risk Funds as %age of Total Investments	24.3%	19.2%	44.5%
Credit Risk Funds as %age of Net worth	10.3%	5.9%	2.7%
Franklin Schemes as %age of Total Investments	55.3%	61.9%	44.5%

Note: Franklin schemes above includes investment in credit risk fund, income opportunity fund and short-term income plan. All of these schemes were voluntarily wound up by Franklin Templeton in April, 2020.

Source: Company Financials, Multi-Act Research

Investing the company's treasury investment in credit risk funds just for some additional yield seem aggressive and could impact the shareholder's equity if company suffers a loss on these investments.

4. Higher Expenses (on peer comparison basis)

Company's promotional, selling and distribution expense are significantly higher than peers.
Further, its travelling expenses are also very high, almost twice as compared to peers. Please see the workings below:

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Particulars	Expense as %age of Revenue (2020)			
	Advertisement	Selling & Distribution	Commission	Total Promotional/ Selling Expenses
Company	3.7%	10.2%	1.6%	15.5%
Peer 1	3.6%	0.8%	1.1%	5.4%
Peer 2*	2.6%	3.9%	na	6.5%
Peer 3	4.7%	3.0%	3.4%	11.1%
Peer 4	4.7%	3.0%	1.9%	9.6%
Peer 5	4.2%	2.0%	0.6%	6.8%
Peer Average	4.0%	2.6%	1.7%	7.9%
Excess compared to peers (average)				7.6%

**December ending financials. Figures for calendar year ended 2019 considered.*

Note: Peers report similar expense under different expense group. So, to make it comparable we have combined the above expenses.

Particulars	Travelling Expense as %age of revenue (2020)
Company	7.6%
Peer 1	2.7%
Peer 2*	3.2%
Peer 3	5.1%
Peer 4	2.3%
Peer 5	3.1%
Peer Average	3.3%
Excess compared to peers (average)	4.3%

**December ending financials. Figures for calendar year ended 2019 considered.*

Source: Company, Multi-Act Research

Such high expenses for Company compared to peers is peculiar. Company might be charging some other expense in name of promotional/travelling expense. In past, company has been accused of incentivizing doctors to push its expensive drugs through them.

Note: We have contacted the company to clarify these points, but our queries remained unanswered as yet.

To conclude:

It goes on to suggest that 'reported numbers' should be taken with a pinch of salt in some cases. Minority investors should question whether the reported earnings are true earnings of the company and whether these are sustainable?

Further, in addition to P&L, they should also always focus on Balance Sheet. Having a net cash position is certainly an advantage, but only if it is prudently used in shareholder's interests.

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