Orchid Chemicals & Pharmaceuticals Ltd.

Annual Report 2012-13

Forward-looking statements

In this Annual Report, we have disclosed forward-looking information to enable investors to comprehend our prospects and take investment decisions. This report and other statements - written and oral – that we periodically make contain forward looking statements that set out anticipated results based on the management's plans and assumptions. We have tried wherever possible to identify such statements by using words such as 'anticipate', 'estimate', 'expects', 'projects', 'intends', 'plans', 'believes', and words of similar substance in connection with any discussion of future performance. We cannot guarantee that these forward-looking statements will be realised, although we believe we have been prudent in assumptions. The achievements of results are subject to risks, uncertainties, and even inaccurate assumptions. Should known or unknown risks or uncertainties materialise, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated, or projected. Readers should keep this in mind. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

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Management Discussion & Analysis

INDUSTRY PERCEPTION

Indian Pharmaceutical Industry - Overview

- The Indian Pharmaceutical Industry (IPM) stands at USD 12 billion as of 2013 (estimated), compared to USD 10.9 billion in 2012 (USD 1=INR 60). The IPM has experienced a slowdown this year with its growth going down to 9.8% from 16.6% in 2012. From 2010 to 2012, the IPM had a CAGR of approximately 15%.
- The IPM growth rate has declined after November 2012 from an average of 16% to 8%. This slowdown can be attributed to the following:
  - The National Pharmaceutical Pricing Policy (NPPP) being announced towards the end of 2012,
  - Higher growths for the corresponding quarters and months in the previous year,
  - The NPPP implementation and the subsequent price corrections leading to a low uptake among the stockiest in Q2 of 2013.
- The top 10 therapy areas of the IPM contribute to approximately 90% of the IPM sales.
- Chronic therapies (cardio, gastro, CNS and anti-diabetic) have been outperforming the market for the past four years and have grown at a rate of 14%, faster than acute therapies (anti-infectives, respiratory, pain and gynecology) which grew at 9.6%. The contribution of chronic therapies to the IPM has gone up from 27% in 2010 to 30% in 2013. Growth in the acute segment will be driven by Tier III cities and rural penetration.

Global Pharmaceutical Industry

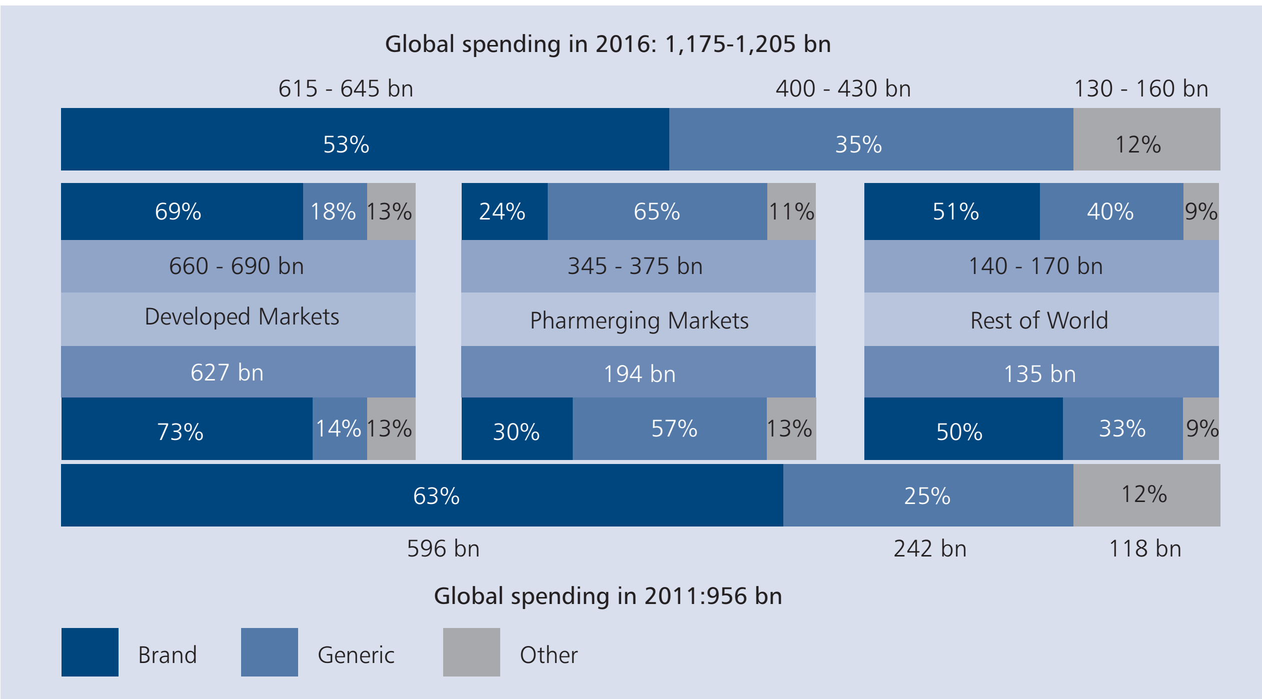
The global pharmaceutical industry stands at USD 956 billion as of 2011 and is expected to grow to USD 1.2 trillion by 2016 at a CAGR of 4.7%. Growth will be driven by low-cost factors, increasing prevalence of disease and rise in per capita income. This growth is coming mainly from market expansion in the leading emerging countries and from generics.

Global brand spending is forecasted to increase from USD 596 billion in 2011 to USD 615–645 billion in 2016. The US share of global spending will decline from 41% in 2006 to 31% in 2016, while the European share of spending will decline from 26% to 18%. Meanwhile, the leading emerging countries will account for 30% of global spending in 2016 from 14% in 2006.

Global Generics Market: Branded products accounted for nearly two-thirds of global pharmaceutical spending in 2011. However, as patents expire in developed markets, that share is expected to decline. Spending on generic drugs is driving most of the growth in the leading emerging markets, which will contribute to the increase in the share of generic spending. Global generic spending is expected to increase from ~USD 242 billion in 2011 to USD 400–430 billion by 2016, of which USD 224–244 billion (70%) of the increase is from low-cost generics in emerging markets.

US Generics Market: The US is the world's largest generics market, estimated at USD 73 billion as of 2011 and is expected to grow to USD 107 billion by 2016 at a CAGR of 7.9%. Drugs worth USD 90 billion are going off patent between 2011 and 2015. The US government's healthcare bill provides affordable healthcare to 33 million previously un-insured Americans, which means increased use of generic drugs due to cost and viability factor, accelerating generic growth in the coming years. Moreover, as of 2011, 75% American prescriptions are for generic drugs, which is a positive sign for the generics market.

EU Generics Market: The European generics market is valued at USD 40-45 billion as of 2011 and is expected to



Global Pharmaceutical (Branded and Generic) Sales (2011 and 2016).

grow to USD 60-65 billion by 2016 at a CAGR of 7 to 8%. It is expected that, in the near future, there will not be any significant increase in the share of innovative medicines as governments in Central Europe (Poland, Romania, Bulgaria, Hungary, Slovakia and Czech Republic) have been promoting generic consumption, resulting in limited expenditure on branded medicines. Moreover, with an ageing population and member states' healthcare budget under pressure, generic medicines are now a key element of sustainable healthcare.

Japanese Generics Market: As of 2011, this market is valued at USD ~8 billion and is expected to reach ~USD 13 billion by 2016 at a CAGR of 10%. The government in Japan has taken several initiatives to ensure growth and promotion of generics industry in the country aimed at reducing healthcare expenditure. Japan's generic market constitutes 22.8% of its pharmaceutical market (volume-wise) (in 2011) but the implementation of numerous supportive measures in 2012 – including additional premiums for practices that prescribe generics – will see this figure rise to approximately 60% by 2017. Moreover, strong promotional activities, numerous impending drug patent expiries and Japan's ageing population are expected to drive growth. Further, the bilateral free-trade agreement signed in February 2011 (the FTA will abolish 90% of trade duties for 10 years) will provide a stimulus for exports to Japan.

The Emerging markets (China, Brazil, Russia, India, Mexico, Turkey, Poland, Venezuela, Argentina, Indonesia, South Africa, Thailand, Romania, Egypt, Ukraine, Pakistan and Vietnam) in descending order of market size, have a total market size of about USD 57 billion (2011) and are expected to outgrow USA (at ~USD 115 billion) by 2016 at a CAGR of 15.1%. The RoW market constitutes USD 40-45 billion (as of 2011) of the generics drug market.

Global CRAMS Market: The global pharmaceutical outsourcing market was estimated at USD 65-70 billion as of 2011 and is expected to reach USD 90 billion by 2015, growing at 6.5% annually over the four-year period.

FINANCIAL REVIEW

The Company had extended its financial year (FY 2012-13) by 6 months to September 30, 2013. Hence Financial Year 2012-13 is of 18 months from April 1, 2012 to September 30, 2013.

In 2012-13, Orchid delivered a moderate performance in revenues, with a Loss of Rs 530.23 cores as against a Profit of Rs 103.11 cores in the previous year 2011-12, trying to recover from the adverse events of 2011-12 such as closure of Alathur plant for more than one month, fire accident at R&D centre at Shozhanganallur etc.

A) Profit and loss account

Revenue

Revenue increased from Rs 1792.14 crores in the year 2011-12 to Rs 1946.35 crores in 2012-13. This performance was largely due to continuing supply of APIs to Hospira, contractual business with other large global pharmaceutical players in regulated markets namely, Europe and Japan and contribution from Karalex Pharma, a front end marketing organisation in the US.

Profitability

The EBIDTA stood at Rs 169.62 cores for the financial year 2012-13 as against Rs 411.73 cores for the financial year 2011-12. After providing tax expense, PAT (Loss) stood at Rs 530.23 cores for 2012-2013 as compared to PAT (Profit) of Rs 103.11 cores for the previous financial year. This decline in profit was due to lesser capacity utilisation on account of Working Capital constraints caused by API plant closure at Alathur and higher interest costs.

Expenditure

Total operational costs were Rs 581.41 cores in 2012-13 as against Rs 439.91 cores for 2011-12 owing to an extended financial year.

Power and fuel expenses retained at the same levels on an annualised basis at Rs 121.72 cores in 2012-2013 as compared to Rs 85.72 cores in 2011-2012.

Material costs marginally increased from Rs 785.86 cores in 2011-2012 to Rs 958.27 cores in 2012-13 despite a decrease in production volumes and raw materials consumption owing to closure of Alathur plant for more than one month during the year. The cost was primarily due to inflationary pressures.

Employee costs marginally increased to Rs 237.05 cores in 2012-13 as compared to Rs 154.65 cores in 2011-12 on an annualised basis.

Interest and finance charges increased from Rs 179.05 cores in 2011-2012 to Rs 520.38 cores in 2012-2013, due to a rise in borrowings coupled with a steep rise in interest rates and finance charges.

Depreciation and amortisation expenses stood at Rs 243.87 cores in 2012-2013 as compared to Rs 149.06 cores in 2011-2012 resulting in a marginal increase on an annualised basis.

B) Balance sheet

The capital employed in the business decreased about 35 % from Rs 2399.38 cores as on March 31, 2012 to Rs 1553.07 cores as on September 30, 2013. This decrease was mainly due to the net loss of Rs 530.23 cores for Financial year 2012-13 and unamortised loss of Rs 128 cores on account of restatement of foreign currency loans for financial year 2012-13 grouped under Reserves as per Accounting Standards.

Reserves

Balance in the reserve and surplus account stood at Rs 417.71 cores as on September 30, 2013 as against Rs 1075.87 cores as on March 31, 2012.

INFORMATION TECHNOLOGY

Information Technology plays a business-critical role in a knowledge intensive sector like pharmaceuticals in enhancing its competitive edge.

At Orchid, IT integrates operations and processes across plants, corporate office and regional offices, providing real-time data for informed decision-making and increasing people productivity.

A number of Information Technology policies & process have been automated leading to lower manual intervention, thereby enhancing service levels to users. Orchid continues to incorporate Information Technology developments in its business processes to derive higher levels of productivity and operational excellence.

HUMAN RESOURCES/INDUSTRIAL RELATIONS

Orchid's HR function is aligned with the overall growth vision of the Company and continuously works on areas such as recruitment and selection policies, disciplinary procedures, reward/recognition policies, learning and development policies and all round employee development.

Orchid provides a safe and rewarding environment that attracts and retains a talented team and where employees are engaged in delivering exceptional results to the customers and investors. Orchid is strengthening the motivation and engagement of employees by examining, developing and introducing a consistent employment value proposition to the existing and prospective employees. The key objective is to align the selection, talent management, employee engagement and recognition processes to drive the corporate growth objectives.

Several new initiatives were introduced during 2012-13 leading to better inter-personal relationship between employees and helped bring in a cohesive focus on individual career development.

During the financial year, Orchid maintained a cordial industrial relationship environment at all the manufacturing units of the Company.

As at September 30, 2013, Orchid has approximately 2,800 permanent employees, which included corporate and managerial staff, sales staff and staff located at our manufacturing facilities, including our subsidiaries creating momentum and driving the Company's competitive advantage. They have been striving to meet the expectations of the customers and creating wealth for investors.

RISKS AND CONCERNS

All businesses are subject to internal as well as external risks. The internal risks are controllable risks and Orchid has identified such risks and formulated such actions to mitigate the effect of such risks. The external risks like change in government policies etc are not within the control of the Company. Particularly the global as well as the Indian Pharmaceutical industry continues to be regulated by various regulatory agencies. Stringent regulatory norms, delay in obtaining regulatory approvals for key products, patent litigations, currency fluctuations, pricing guidelines in the domestic market are certain risks that can affect the Company's business.

Orchid's integrated risk management approach comprises prudential norms, structured reporting and controls. This approach conforms to the Company's strategic direction and is consistent with stakeholders' desired total returns, credit rating and risk appetite.

Review of compliance monitoring systems, account risk management system in the business units, periodic assessment of regulatory compliance, risk assessments in multiple areas such as talent management, information security and intellectual property are done regularly. The risk management activities also include assessment and review of financial risks such as currency risks, credit risks and liquidity.

INTERNAL AUDIT AND CONTROL

Orchid believes that sound internal control systems are necessary prerequisite to good governance. The management is committed to ensuring an effective internal control environment, commensurate with the size and complexity of the business, which provides assurance on the efficiency of the Company's operations and the security of its assets.

Orchid's internal control systems and procedures are designed to enable the reliable reporting of financial statements, reporting timely feedback on the achievement of operational or strategic goals and ensure compliance with laws and regulations. In addition to the statutory audit, the financial and operating controls at various locations of the Company are reviewed by internal auditors who report significant findings to the Audit Committee of the Board. Compliance with various laws and regulations are also monitored.

CAUTIONARY STATEMENT

Statements in the Management Discussion and Analysis describing the Company's objectives, projections, estimate, expectations may be "forward looking statements" within the meaning of applicable securities laws and regulations. Actual results could differ materially from those expressed or implied. Important factors that could make a difference to the Company's operations include, among others, economic conditions affecting demand/supply and price conditions in the domestic and overseas markets in which the Company operates, changes in the Government regulations, tax laws and other statutes and incidental factors.

Directors' Report

Dear Members,

Your Directors takes pleasure in presenting the report on business and operations of your Company along with the audited statement of accounts for the financial year ended September 30, 2013.

Performance

Your Company has extended its Financial Year 2012-13 by a period of six months i.e., up to September 30, 2013 and accordingly has prepared its Financial Statements for a period of 18 months i.e. from April 1, 2012 to September 30, 2013. The highlights of the financial results for the year 2012 – 2013 are given below:

(Rs cores)

Particulars	18 months ended 30.09.2013	Year ended 31.03.2012
Sales & Operating Income	1906.58	1736.33
Other Income	39.77	55.81
Total Expenditure	1776.74	1380.41
Gross profit	169.61	411.73
Interest & Finance Charges	520.38	179.05
Gross Profit after Interest but before Depreciation and Taxation	(350.77)	232.68
Depreciation	243.86	149.05
Profit / (Loss) before Tax, exceptional and extraordinary items	(594.63)	83.62
Exceptional Item	51.11	83.88
Profit / (Loss) Before Tax and Extraordinary item	(543.52)	(0.26)
Extraordinary items	-	(80.00)
Profit Before Tax	(543.52)	79.74
Provision for Taxation		
- Current & Deferred Tax	(13.29)	(23.37)
Profit / (Loss) after Tax	(530.23)	103.11

During the financial year 2012-13, your Company achieved a turnover and operating income of Rs 1906.58 crores (Rs 1736.33 crores in 2011-12). The gross profit before interest, depreciation and taxes stood at Rs 169.61 crores, 8.90% of turnover (Rs 411.73 crores (23.71% of turnover) in 2011-12). After providing for interest expense of Rs 520.38 crores (Rs 179.05 crores previous fiscal), depreciation of Rs 243.86 crores (Rs 149.05 crores previous fiscal), Exceptional item Rs 51.11 crores (Rs 83.88 crores previous fiscal) and Extraordinary item Nil [(Rs 80) crores previous fiscal], the Loss before tax of the Company was Rs 543.52 crores [Rs 79.74 crores (Profit) previous fiscal]. The net loss after tax stood at Rs 530.23 crores (the net profit after tax was Rs 103.11 in the previous fiscal).

Business Overview

During the year your Company recorded a slow growth, recovering from the issues faced in previous financial year - closure of Alathur plant for a period of more than a month on account of an order from Tamil Nadu Pollution Control Board (TNPCB), and liquidity constraints on account of redemption of outstanding FCCBs in February 2012. Despite the tough liquidity and working capital constraints, your Company managed to sustain sales and operating profitability denoting the basic strength of the business. Orchid initiated a process of restructuring its debt and accordingly made a reference to the Corporate Debt Restructuring (CDR) cell. Once CDR process is completed there would be an ease in flow of working capital through rescheduled loan repayment, funding of interest by banks and reduction in rate of interest which would help the Company in improving its performance.

Your Company is planning to launch some new products in the next financial year for the EU and US markets, which are expected to aid in strengthening the revenue/profitability streams of the Company going forward.

Corporate Debt Restructure (CDR)

The Company was admitted for Corporate Debt Restructuring process in August 2013 by the CDR Empowered Group (CDR EG) with requisite support from Banks.

Your Company had entered into a Business Transfer Agreement (BTA) in August 2012 with Hospira Healthcare India Private Limited, a subsidiary of Hospira Inc., USA, for the sale and transfer of the Company's Penicillin and Penem API Business together with its manufacturing facilities in Aurangabad and associated Research and Development Unit situated in Shozhanganallur. Your Company obtained the requisite approvals for this transaction as follows – Shareholders approval in October 2012, Competition Commission of India (CCI) clearance in December 2012 and the Foreign Investment Promotion Board (FIPB) clearance in January 2013. Subsequently, the initial consideration of USD 202.50 million was enhanced to USD217.50 million for transfer of additional portion of land and building at R&D Centre Shozhanganallur.

As the Company is admitted for CDR process, the consummation of BTA has been added as a part of the CDR process. The final CDR package is under preparation and expected to be completed in December 2013.

Regulatory Filings and Approvals

In the generic formulations domain, Orchid's cumulative Abbreviated New Drug Application (ANDA) filings for the US market stood at 43. This includes 8 Para IV FTF (First-To-File) filings. The break-up of the total ANDA filings is 13 in Cephalosporins segment and 30 in NPNC space. Few more ANDAs which are in the later stages of development are expected to be filed in the ensuing quarters.

In the European Union (EU) region, the cumulative count of Marketing Authorisation (MA) filings stood at 30. The break-up of the total MA filings is 15 in the Cephalosporin segment and 15 in the NPNC segment.

In the API (Active Pharmaceutical Ingredients) domain, Orchid increased its cumulative filings of its US DMF count to 90. The break-up of the total filings is 28 in the Cephalosporin Segment, 47 in NPNC segment, 2 in the Betalactam segment and 13 in the Carbapenems segment. In the European market space the cumulative filings of COS (Certificate of Suitability) count remained at 21 which includes 14 in cephalosporin segment, 6 in NPNC segment and 1 in the betalactam segment. With staunch efforts on product development, the count of filing and approval is set to increase in the current financial year.

Dividend

Due to losses incurred by the Company during the financial year 2012-13, your Directors express their inability to recommend any dividend to the equity shareholders.

Awards

During the year, your Company was conferred with the following awards:

- Top Indian Public Limited Company in Patent at the 5th National Intellectual Property Award 2013, organised by CII in partnership with the Department of Industrial Policy & Promotion and Indian Intellectual Property Office, Government of India.
- EXIM Achievement Award 2012 for meritorious export performance by The Tamil Chamber of Commerce, Chennai.

Intellectual Property Rights

During the year, Orchid continued to accelerate the IPR work on a number of products. The total number of patent applications filed by Orchid in various national and international patent offices so far was 931 (including Process, formulation, NCE, NDDS, biotech and Generics). As of September 30, 2013, 731 patent applications have been published while 210 patents have been granted cumulatively.

Employees Stock Option Plan

The details of options granted to employees under the ORCHID ESOP 2010, ORCHID ESOP – DIRECTORS 2011, Orchid ESOP – Senior Management 2011 schemes and the status of such options as on September 30, 2013 are given in Annexure IV to this Report.

Your Company formulated a stock option plan viz., Orchid - ESOP 2010 Scheme for grant of 10,00,000 options to the employees of the Company including whole-time Director(s) of the Company but excluding the Promoter Directors. The said scheme was approved by the shareholders at the Annual General Meeting held on July 21, 2010. Your Company granted 9,01,000 options during the year 2010-11. Pursuant to exercise of options by the employees, 10,000 equity shares of Rs 10/- each were issued during the year and as at September 30, 2013, the outstanding options yet to be exercised under the said scheme is 5,09,500.

Your Company has also formulated the following schemes which were approved by the shareholders at the Annual General Meeting held on July 29, 2011.

- **Orchid ESOP** – Directors 2011 Scheme – grant of 5,00,000 options to the directors of the Company including whole-time directors but excluding promoter director. Your Company granted 3,00,000 options during the year 2011-12 and as at September 30, 2013, the outstanding options yet to be exercised under the said scheme is 1,00,000.
- **Orchid ESOP** – Senior Management 2011 Scheme - grant of 10,00,000 options to the employees in the grade of Senior Manager and above out of which 7,50,000 options are ear marked to the employees of Orchid and 2,50,000 options to the employees of various subsidiary companies of Orchid, either in India or abroad. Your Company granted 42,700 options during the year 2011-12 and as at September 30, 2013, the outstanding options yet to be exercised under the said scheme are 42,700.

Associate

Allecra Therapeutics GmbH, Germany

With a view to enter into drug discovery in the areas of obesity, CNS and other therapeutic areas in response to potential MNC interest, Orchid decided to invest in Allecra Therapeutics GmbH (Allecra) and presently holds 20.65% stake in the Company. Allecra is a drug development company based in Germany focused on clinically differentiated products and shall develop unique products for novel treatments to combat multi drug resistant bacterial infections.