Saturday 9 December 2006

Cipla Ltd

Cipla announced its Q2FY07 result with Y-o-Y sales growth of 33%, EBITDA growth of 28%, and net profit growth of 47%. The EBITDA was lower on Y-o-Y comparison due to a change in the product mix, resulting in higher material costs as a percentage of sales.

API exports remained the major driver with Y-o-Y growth of 120%. The growth is partly due to: (1) API sales of Sertraline to Teva under 180-day exclusivity; and (2) a lower base effect in the corresponding quarter last year. While formulations sales reported a modest 13% growth, the segment is suppose to grow at 20% p.a in the future.

Cipla's outlook remains robust based on: (1) increasing sales to US partners for the US generics markets; (2) improving CFC-free inhaler sales in European markets; and (3) a ramp up in the anti-AIDS drug sales as Cipla focuses on the PEPFAR programme.

Valuations

	Particulars	2007	2008	2009	2010	2011
	Sales	35,126.40	42,151.68	50,582.02	60,698.42	72,838.10
	EBT Margin	25%	25%	25%	25%	25%
	EBT Margin	8,781.60	10,537.92	12,645.50	15,174.60	18,209.53
Add:	DEPRECIATION	1,685.00	1,985.00	2,285.00	2,510.00	2,735.00
		10,466.60	**12,522.92**	**14,930.50**	**17,684.60**	**20,944.53**
Less:	CAPEX	2,000.00	2,000.00	2,000.00	1,500.00	1,500.00
	WORKING CAPITAL	1,062.48	1,405.06	1,686.07	2,023.28	2,427.94
		3,062.48	3,405.06	3,686.07	3,523.28	3,927.94
	FCFF	**7,404.12**	**9,117.86**	**11,244.44**	**14,161.32**	**17,016.59**
	Discounted FCFF	6,640.47	7,334.04	8,111.72	9,162.30	9,874.11
	Terminal Value					190,301.12
	Total DCF Value	**231,423.77**				
	Less: Market Value of Debt	4,689.10				
	Add: Cash	444.80				
	Enterprise Value	**227,179.47**				
	Total Shares	**777.00**				
	Share Price	**292.38**				

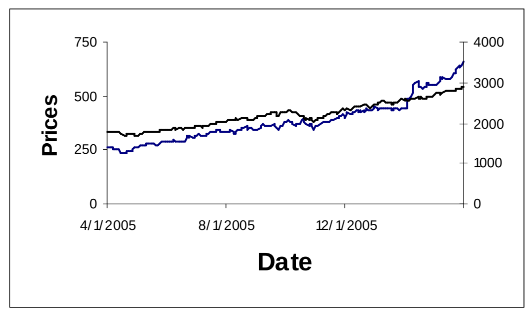
Beta	0.76
Risk Free Rate	8%
Risk Premium	7.00%
Terminal Value	12.95%
After Tax Cost of Debt	5.90%
Debt/Equity Ratio	19.00%
WACC	11.55%

Market Performer

Rs.247
09th December 2006

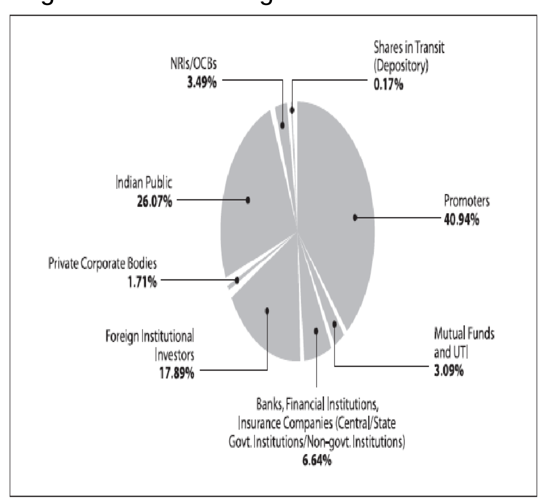
Price Target:
Rs.292

Reuters: CIPLA.BO
Figure: Cipla v/s Nifty
(1 Year)



(Source: NSE Data)

Figure: Shareholding Pattern



A check on Fundamentals

The company is trading at 33.7x 2006 earnings and 26.9x 2007 earnings. At the present level of activities we maintain that the company is a 'Market Performer' and recommend a 'Hold' on the stock.

Strong product pipeline:
During the past two years, Cipla has filed 658 DMFs and 71 ANDAs. The company has also secured 170 marketing authorizations in Europe, 4,000 product registrations globally and 7000 pending approvals.

Aggressive capex plan:
Cipla recently raised US$170mn through a GDR issue for financing future capex for its facilities at Goa, Kurkumbh, Bangalore and for acquisitions in niche segment. In our view , Cipla is trying to shed its conservative approach and being more aggressive in its capex to take advantage of the opportunities.

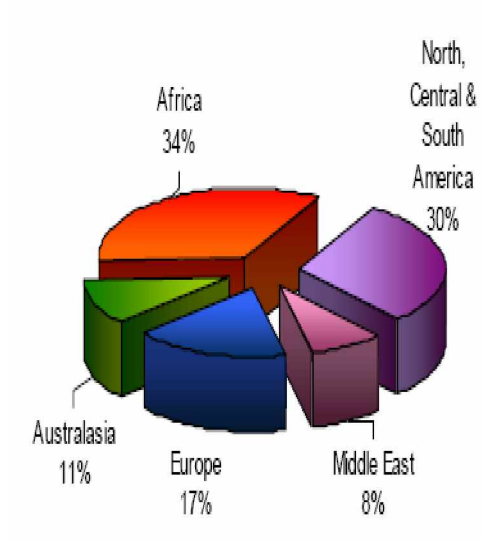
Exports: API drives growth
Exports grew by 37% and now account for 50% of total sales. While formulations exports grew by a modest 13%, API exports grew by 120%.

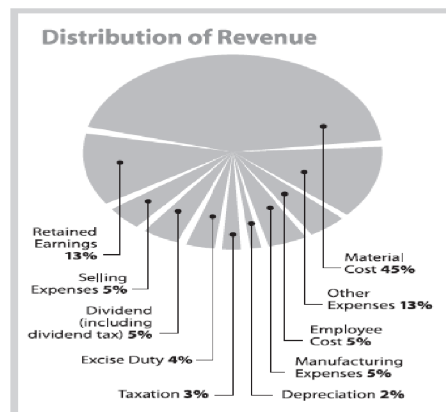
Higher contribution in Domestic Market to Total Revenues
Cipla has notched up a strong performance in the domestic market; sales are up 22% YoY i.e. double the overall industry growth. This growth has been backed by growth in major domestic segments like anti-asthmatics, anti-HIV, cardiovascular and anti-biotics and bacterial segment.

Domestic business reports robust growth
As expected, domestic formulations grew by 22% Y-o-Y. This quarter, sales may have been helped by a surge in demand for anti-infectives owing to disease like chikun gunya and dengue in various states across the nation. Cipla is the market leader in quinolones.

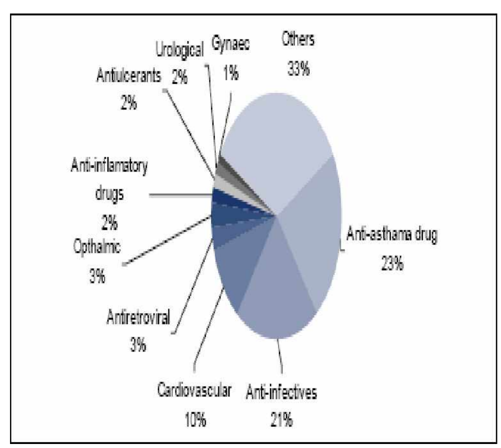
Given the growth estimates, we say that the EBT would be increasing at the rate of 15% over the next five years. The CAPEX is expected to grow by Rs.2000 crores every year for the next 3 years and then for the next 2 years it is expected to grow at Rs.1500 crores.

Sales Distribution





Therapeutic revenue mix



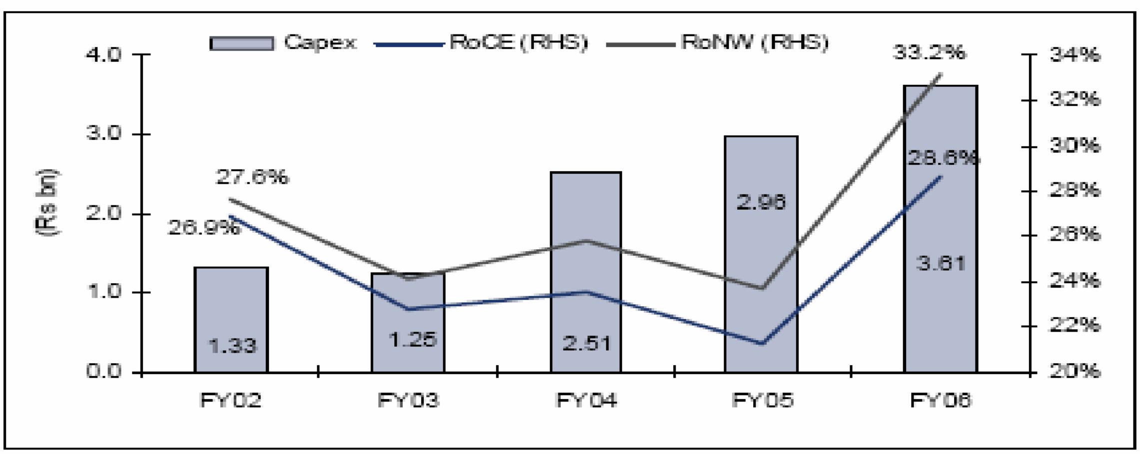
Key Estimates

(Year ending March 31)

	FY05	FY06	FY07E	FY08E	FY09E
Per Share Data (Rs)					
EPS(Basic Recurring)	4.5	8.0	10.0	12.0	14.5
Diluted Recurring EPS	4.5	8.0	10.0	12.0	14.5
Recurring Cash EPS	5.2	9.0	11.3	13.4	16.1
Dividend per share (DPS)	1.5	2.3	3.2	4.2	5.5
Book Value per share (BV)	21.1	26.8	43.4	51.1	60.2
Growth Ratios (%)					
Operating Income	17.2	32.2	22.3	20.2	19.0
EBITDA	19.6	54.4	23.4	19.3	17.0
Recurring Net Income	11.5	75.3	25.5	19.9	21.4
Diluted Recurring EPS	11.5	75.3	25.5	19.9	21.4
Diluted Recurring CEPS	14.3	71.3	25.4	18.7	20.3
Valuation Ratio (x)					
PER	56.0	31.9	25.4	21.2	17.5
P/CEPS	48.4	28.3	22.5	19.0	15.8
P/BV	12.0	9.5	5.9	5.0	4.2
EV / EBITDA	39.7	26.1	20.6	17.2	14.7
EV / Operating Income	8.8	6.8	5.4	4.5	3.7
EV / Operating FCF	118.9	83.7	39.2	35.9	29.0
Return/Profitability Ratio (%)					
Recurring Net Income Margins	15.5	20.5	20.8	20.8	21.2
RoCE	21.2	28.6	26.2	25.1	26.0
RoNW	23.7	33.2	28.5	25.3	26.1
Dividend Payout Ratio	34.0	28.7	32.0	35.0	38.0
Dividend Yield	0.6	0.9	1.3	1.6	2.2
EBITDA Margins	22.2	26.0	26.2	26.0	25.6

Source: Company data, i-SEC Research

Increasing CAPEX and Return Ratios



Source: Company data, i-SEC Research

A Look in the Market

What is driving growth in the Indian Pharma market in 2006?

Volume growth coming back
In the 12 months ending June, the Indian pharma market grew 19% YoY driven by a strong reversal in volume growth. After declining for three consecutive half years, 9% volume growth has driven growth in 1H06. Price declines have stopped from 2005 and added 2% to growth. New product introduction was the dominant growth driver in 2004-05 but is fast losing importance.

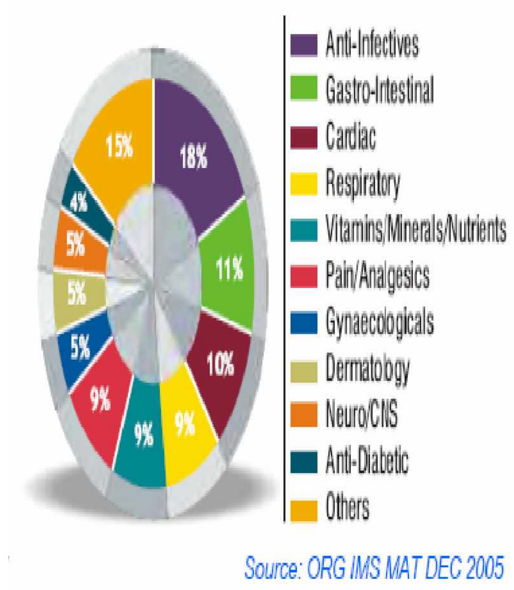
Rural markets are driving the volume revival
Rural India, with 36% growth, is the new growth engine. Three other segments of the market grew an uninspiring 10-13%. We think increased distribution focus from companies will continue, but income levels in rural India could change annually. This makes growth forecasts for 2007 even more difficult. Our base-case assumption is for 12-14% growth in 2007.

Growth is well diversified across therapeutic segments
In 2005, there was only one segment – cardiac – that grew in double digits, whereas in 2006 every single segment among the top 10 is growing in double digits. The top segments accounting for 29% of the Indian pharma market are growing faster than the market average and pulling up the growth rate.

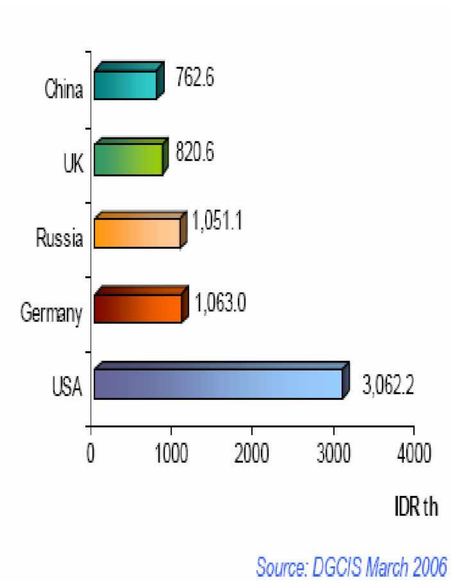
Company-specific performance comments
Companies with a higher focus on acute illnesses and better rural market penetration have gained the most in this rebound. Ranbaxy and Nicholas Piramal lead the pack, while Cipla grew less than the market.

Pharmaceutical Export
India's pharmaceutical exports were valued at USD1.76bn in 2005, an increase of 84.2% over the previous year. Leading destinations for India's pharmaceutical includes the USA, which accounted for USD 3.06mn of exports in 2005, while UK and Germany were the leading EU destinations, each accounting for USD 821th and USD 1.1mn respectively.

Top Therapy Groups in the Indian Pharmaceutical Market by Value Contribution



India's Top 5 Pharmaceutical Export Destinations



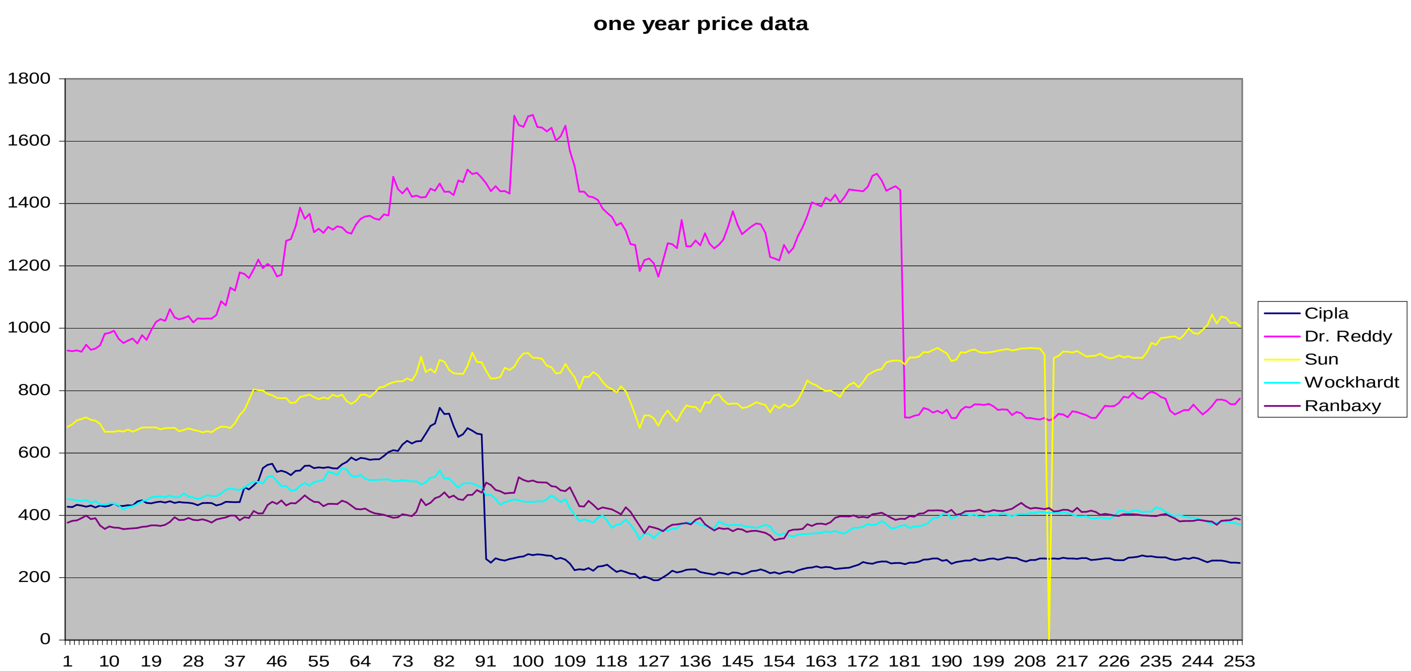
Comparative Matrix

Comparative Analysis:

Company	Rating	Price (Rs)	PER FY07 (x)	PER FY08 (x)	PEG FY08(x)	FY06 EBITDA margins (%)	FY06 EV/E (x)	FY06 RoCE (%)	FY07 Mktcap/ sales (x)	Mkt cap US$mn
Dr. Reddy's	Buy	756	21.2	23.6	0.31	13.8	42.5	5.5	2.6	2,493
Sun Pharma	Buy	922	28.5	23.0	0.98	30.0	35.6	16.3	8.8	3,677
Cipla	**Buy**	**254**	**25.4**	**21.2**	**0.94**	**26.0**	**26.1**	**28.6**	**5.4**	**4,246**
Ranbaxy	Buy	411	25.5	20.9	0.22	5.0	66.0	13.0	2.4	3,295
Wockhardt	Buy	395	16.2	12.8	0.68	23.3	13.7	17.0	2.6	927
Cadila	Buy	331	20.1	16.4	1.11	19.4	15.8	16.0	2.4	895
Glenmark	Buy	349	18.1	14.3	0.15	19.5	34.9	9.7	3.6	891
Alembic	Buy	375	12.0	8.6	0.24	17.2	11.2	13.8	1.4	223
GSK Pharma	Buy	1,228	28.6	24.5	1.47	29.1	23.4	34.5	6.4	2,237
Aventis	Buy	1,651	19.0	16.5	0.82	28.3	15.5	34.0	4.3	818
Average			**22.8**	**19.3**	**0.53**	**18.0**	**35.0**	**14.1**	**3.8**	**19,702**

Source: Company data, i-SEC Research

One Year Price Data:



SWOT Analysis for Cipla

Strength:
Strong Domestic Business: Cipla ranks #2 in the retail prescription market in India with Rs13.6bn revenues. The company has 18 brands that feature among the top-300 brands in the market. It has a large basket of 1,500 formulations which are distributed throughout the country by 38 sales depots, 2,300 stockists and 110,000 chemists.
The company has a dominant position in anti-asthma and anti-retroviral therapy areas with a whopping 55% and 74% market share respectively.

Key Partnerships with U.S. based companies: Over the past six years, Cipla has partnered 8 leading generics companies in the US for nearly 125 projects (71 ANDAs already filed). Of these only 18-20 ANDAs have been launched, implying a large product basket yet to be commercialised. The two key products launched recently – Setraline (or *Zoloft* in August '06) and Finasteride (or *Proscar* in June '06) – have combined innovator sales of US$3.5bn and for which its partner IVAX – now a part of Teva – has 180-day exclusivity.

Weaknesses:
Impact of IPR regime: With the introduction of the IPR regime from January '05, reverse engineering of the manufacturing process would not be allowed. This means that Indian companies will not be able to copy the innovations for patents filed on or after January 1, 1995. As a result, Cipla's ability to launch new products through reverse engineering would diminish over the next few years and would impact Cipla's profitable domestic business (50% of FY06 sales).

Opportunities:
Biotherapeutics – A new and promising area: Cipla has identified biopharmaceuticals as one of the key growth drivers in the future. In this regard, the company has signed an agreement with Avesthagen (India) in May '04. Avesthagen focuses on research & development, while Cipla would handle marketing and distribution of the biotherapeutic products. The key therapy areas of interest are auto-immune disorders, cardiology and anti-cancer, with the first product likely to hit the market in 3-4 years. We believe that the focus would be on developing generic versions of biotech products or biogenerics, which is estimated to be a US$7-9bn opportunity by '10.

Threats:
Partnership related: Partners being bought over by other companies could lead to potential decline in quantitative offtake and stoppage of new projects. Besides, with respect to litigated products, if the partner loses, the upside to Cipla also reduces as pricing collapses.
Potential de-rating: If Cipla is unable to exploit the huge capacity built-up over time and deliver numbers, the stock could get de-rated considering its top-of-the-line current valuations in the sector.

Analyst Information:

Siddharth Ghaisas	siddharth.ghaisas@spjain.org
Sumit Jain	sumit.jain@spjain.org
Sireesha Rayaprolu	sireesha.rayaprolu@spjain.org
Manu Shrivastav	manu.shrivastav@spjain.org
Rohit Nichani	rohit.nichani@spjain.org
Rohini Sureka	rohini.sureka@spjain.org
Hiral Patel	hiral.patel@spjain.org

Reference:

1. CIPLA annual reports for the year ended 31st March 2006, 2005, 2004.
2. ICICI securities research report on CIPLA.
3. Indian Pharma sector quarterly update by SPAN capital services.
4. Indian Pharmaceutical update by UBS Investment Research.

Disclaimer