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Take Five

Scrip	Reco Date	Reco Price	CMP	Target
♦ Balmer Lawrie	11-Aug-05	400	388	481
♦ Balrampur Chini	03-Aug-05	87	83	110
♦ Emco	26-Aug-05	345	400	450
♦ Navneet	22-Aug-05	284	275	405
♦ Universal Cables	30-Aug-05	123	121	200

Hiran Orgochem

Viewpoint

Run *Hiran* run

Background

Hiran Orgochem is one of the largest domestic manufacturers of the bulk drug—ciprofloxacin. It has manufacturing facilities at Panoli (Ankleshwar) where its plant capacity increased from 480 tonne per annum (TPA) to 960TPA in July 2005. Apart from ciprofloxacin the company also makes a closely related product called enrofloxacin and is also involved in the trading of imported chemicals.

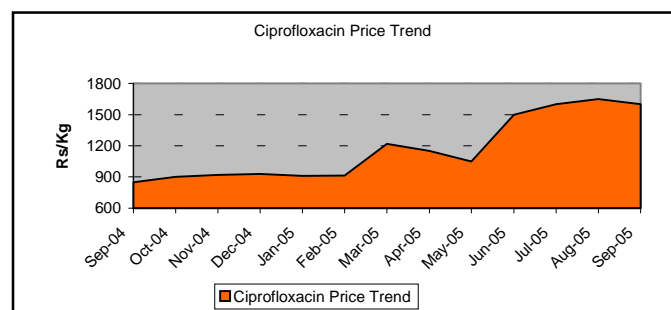
Quarterly financials

The company had net sales of Rs21 crore in Q1FY2006, an increase of 100% over Q1FY2005 primarily due to the doubling of its capacity. The operating profit during the quarter was Rs5 crore as against Rs0.98 crore in Q1FY2005. This resulted in a profit after tax figure of Rs2.82 crore for Q1FY2006.

Rs (cr)	Q1FY06	Q1FY05	% Growth
Net sales	21.01	10.54	99.5
Other income	0.03	0.05	-47.9
Total expenditure	15.93	9.55	66.7
Operating profit	5.09	0.98	417.5
Interest	0.64	0.47	34.6
Depreciation	0.26	0.21	24.2
PBT	4.21	0.35	1117.1
Total tax	1.39	0.15	802.5
PAT	2.82	0.19	1369.3

Ciprofloxacin prices soaring

Ciprofloxacin accounts for over 90% of the production of Hiran Orgochem. Ciprofloxacin is a broad spectrum antibiotic and is used for the first and second lines of therapy. The prices of ciprofloxacin have soared in the past twelve months from Rs850 per kilogram in September 2004 to Rs1, 600 per kilogram at present. The prices of ciprofloxacin in the export market have also risen considerably from USD22 /kilogram in September 2004 to USD38/kilogram currently.



Short supply of raw material DCFA

The price escalation of ciprofloxacin is due to the shortage in the supply of the DCFA, the main raw material used in the manufacture of ciprofloxacin. Four companies worldwide of which three are in China and one in India primarily

manufacture DCFA. The three companies in China have closed temporarily due to environmental norms and are expected to start operating in 6-8 months. As a result this price escalation of ciprofloxacin is expected to remain for about 8-10 months after which the prices are expected to stabilize at around the Rs1, 300 per kilogram mark. Ciprofloxacin is covered under the Drug Price Control Order (DPCO) but the price ceiling is high at Rs4, 000/ kilogram.

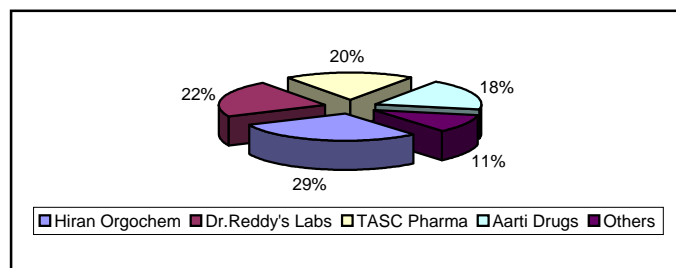
Quarter	Average price (Rs/Kg)
April-June 2004	365
July-Sept 2004	410
Oct-Dec 2004	375
Jan-Mar 2005	345
April-June 2005	420
July-Sept 2005	600

The prices of DCFA have gone up from Rs410 per kilogram to Rs600 per kilogram currently but this price increase is lesser than that of ciprofloxacin. As a result companies manufacturing ciprofloxacin are expected to show greater operating margins in the coming quarters. The other major manufacturers of ciprofloxacin include Aarti Drugs, TASC Pharma and Dr Reddy's Laboratories.

Scaling up of production capacity

Hiran Orgochem has recently doubled its production capacity from 480TPA to 960TPA in July 2005. The effect of this capacity increase is reflected in the net sales in Q1FY2006 that increased by 62% to Rs23 crore from Rs14.5 crore in Q4FY2005. The company has plans to increase the manufacturing capacity to 2,000TPA by the end of the current fiscal. This may be done either organically by setting up a new manufacturing capacity in either Baddi or Jammu and Kashmir or inorganically, by acquiring a sick company. The production scale-up will make Hiran Orgochem the largest manufacturer of ciprofloxacin in India.

Domestic ciprofloxacin production break-up

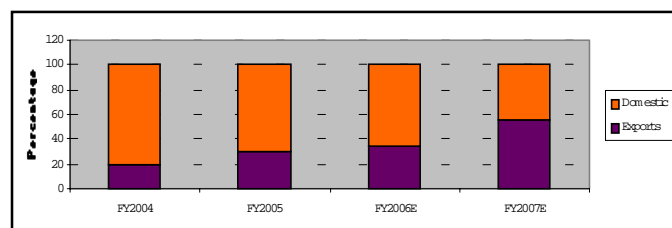


Exports the main focus

The domestic market for ciprofloxacin is estimated at around 2,500TPA while the global market is estimated at around 17,000TPA. Till last year 70% of ciprofloxacin sales of Hiran Orgochem were from the domestic market. However with the increase in production, Hiran will now

be targeting the global market and exports are expected to increase to 55% of its total production by 2007 with Europe being the primary focus for sales.

Sales break-up



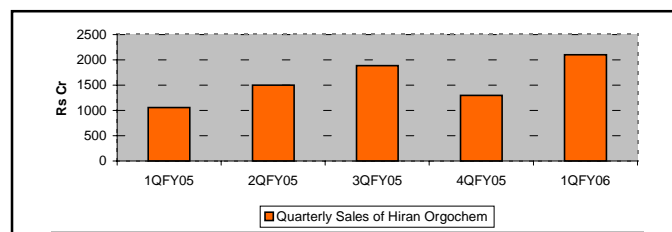
Benefits of backward integration

In the wake of the evident shortage of the raw material, DCFA, Hiran Orgochem has secured its supply of DCFA by signing an agreement with an Indian manufacturer and is well covered for the current year. It is also in the final stages of developing the technology to manufacture DCFA in association with another Indian firm. This development is likely to be completed in 2-4 months after which Hiran Orgochem may be able to source DCFA at a 15% lower cost than the other manufacturers. This may result in the cost reduction of raw materials by at least 8-10%, thus pushing up the operating margins significantly, as the raw material costs constitute about 65% of the sales.

Other initiatives

Apart from the scale-up in the production, Hiran Orgochem is also planning to set up a state-of-the-art research and development center to develop high value specialty chemicals. This will be the field for future diversification for the company. This facility will be set up in stages and will become operational in two years' time.

Quarterly sales of Hiran Orgochem



Financing capital expansion

The company plans to finance the capital expansion by issuing 15 lakh equity shares with a face value of Rs10 at a premium of Rs120 and 2,300,000 optionally fully convertible warrants (OFCWs) at a price of Rs130. This will result in a cash inflow of about Rs49 crore of which Rs20 crore will be used for setting up the new plant, another Rs20 crore will be used for the research and development center and the remaining Rs9 crore will be used for part debt repayment and part working capital financing.

Net effect: improving margins

In FY2005 the company had an operating margin of 9%. With the increase in the price of ciprofloxacin being greater than the increase in the price of DCFA and with the company expected to source the raw material at cheaper rates, we might see these margins increase to 11% in FY2006 and 17% in FY2007. Further the setting up of the new manufacturing plant at Baddi or Jammu and Kashmir will provide exemption from Excise Duty and the tax benefits which coupled with good operating profits may increase the net profit margin from 2.4% in FY2005 to 4.3% in FY2006.

Outlook

As the price of ciprofloxacin has reached the Rs1, 600/ kilogram mark, the revenues for Hiran Orgochem are expected to increase substantially. This increase in the price of ciprofloxacin is a short-term phenomenon and we expect the prices to stabilize to Rs1300/kilogram. As a result we expect the profits to touch Rs19 crore by FY2007 yielding

an EPS of Rs19.8. At the current market price of Rs154, the stock is expected to trade at 7 times its FY2007 earnings estimate. With the margins in the business increasing due to price escalation, backward integration and tax savings, and the capacity increasing fourfold, Hiran Orgochem appears all set to book good profits in the coming quarters.

Valuation table

	FY2004	FY2005	FY2006E	FY2007E
Net profit (Rs cr)	0.82	1.37	3.89	19.91
Shares in issue (cr)	0.42	0.62	1.00	1.00
EPS	1.92	2.19	3.88	19.86
PER (x)	80.05	70.17	39.67	7.75
Book value/ share (BV)	18.33	24.87	68.61	88.47
P/BV	8.40	6.19	2.24	1.74
Cash EPS	3.33	3.66	5.54	21.71
P/cash EPS	46.26	42.10	27.82	7.09
EV/EBIDTA	25.00	21.82	15.60	4.16

The author doesn't hold any investment in any of the companies mentioned in the article.

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Infosys Technologies
Reliance Industries

Apple Green

ACC
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Bharat Bijlee
Container Corporation of India
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