

Lupin

STOCK INFO. BLOOMBERG
BSE Sensex: 7,935 LPC IN
REUTERS CODE
S&P CNX: 2,395 LUPN.BO

20 October 2005

Buy

Rs736

Previous Recommendation: Buy

		YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
		END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
Equity Shares (m)	40.1	03/05E	12,611	863	21.5	-35.6	34.2	6.0	18.8	13.3	2.7	26.5
52-Week Range	832/484	03/06E	16,345	2,009	50.0	132.6	14.7	4.6	35.5	28.5	1.9	11.7
1,6,12 Rel. Perf. (%)	3/9/-25	03/07E	18,329	2,505	62.4	24.7	11.8	3.5	33.9	32.7	1.7	9.7
M.Cap. (Rs b)	29.5											
M.Cap. (US\$ b)	0.7											

Lupin 2QFY06 results (standalone) were below our estimates as EBITDA margins improved only by 590bp to 16.6%. However, stand-alone EBITDA margins do not fully reflect upsides from Ceftriaxone as some portion of profits are booked in its 100% subsidiary. Key highlights of result include:

- Net sales grew by 34.1% YoY to Rs4.05b, primarily driven by launch of ceftriaxone in US market, steady *Suprax* sales. Sales growth would have been higher but for lower offtake of Lisinopril API in USA and reduction in prices of finished dosages in the domestic market by NPPA.
- Lupin could garner only 22-25% market share in ceftriaxone (where price erosion was 65-70%) despite having the first mover advantage (along with Sandoz) in form of day-one launch.
- Net profit growth of 158.4% to Rs452m (v/s our expectation of Rs551m) was pulled down by higher tax provisioning at 24.8% of PBT (v/s 9.3% in 2QFY05).

Valuations at 14.7x FY06E earnings and 11.8x FY07E EPS do not fully reflect the gradual improvement in the underlying fundamentals (bottoming out of Pen-G business, pick up in *Suprax* business, recovery in regulated market API sales and an expanding US generics pipeline). We re-iterate our **Buy** recommendation with a price target of Rs875 (~14x FY07E EPS).

QUARTERLY PERFORMANCE (STANDALONE)									(Rs Million)	
Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales	2,903	3,020	2,796	2,893	3,521	4,051	3,985	3,770	11,611	15,327
YoY Change (%)	9.8	-12.6	9.9	7.2	21.3	34.1	42.5	30.3	3.7	32.0
Total Expenditure	2,530	2,696	2,416	2,699	2,903	3,378	3,273	3,166	10,341	12,720
EBITDA	373	325	379	193	618	673	712	604	1,270	2,607
Margins (%)	12.8	10.7	13.6	6.7	17.5	16.6	17.9	16.0	10.9	17.0
Depreciation	79	81	82	90	91	98	97	101	332	387
Interest	71	62	71	69	65	64	55	53	273	237
Other Income	39	12	35	102	130	89	50	26	188	295
PBT	262	193	261	137	591	601	610	475	853	2,277
Tax	55	18	16	-81	160	149	57	45	9	410
Rate (%)	21.2	9.3	6.2	-58.8	27.0	24.8	9.3	9.4	1.1	18.0
Profit after Tax	206	175	245	217	432	452	553	431	844	1,867
YoY Change (%)	-26.4	-66.2	-38.8	-27.0	109.1	158.4	125.7	98.2	-43.6	121.3
Margins (%)	7.1	5.8	8.8	7.5	12.3	11.2	13.9	11.4	7.3	12.2

E: MOST Estimates

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Launch of ceftriaxone in US props up sales

Net sales grew by 34.1% YoY to Rs4.05b, primarily driven by launch of ceftriaxone in US market. Sales growth would have been higher but for lower offtake of Lisinopril API in USA and reduction in prices of finished dosages in the domestic market by NPPA.

BUSINESS BREAK UP – STANDALONE (RS M)

	2QFY06	2QFY05	YOY (%)	1QFY06	QOQ (%)
APIs					
India	596	376	58.5	443	34.5
Exports	1,228	1,205	1.9	1,175	4.5
Regulated markets	466	514	-9.3	452	3.1
Unregulated markets	762	691	10.3	723	5.4
Total API sales	1,824	1,581	15.4	1,618	12.7
% of sales	43.8	49.9		44.6	
Formulations					
India	1,713	1,489	15.0	1,601	7.0
Exports	627	96	553.1	411	52.6
Regulated markets	514	12	4183.3	280	83.6
Unregulated markets	113	84	34.5	131	-13.7
Total Formulation sales	2,340	1,585	47.6	2,012	16.3
% of sales	56.2	50.1		55.4	
Total Sales	4,164	3,166	31.5	3,630	14.7

Source: Company/Motilal Oswal Securities

- Regulated markets continued to witness strong momentum in sales with growth of 86% YoY driven by launch of Ceftriaxone sales in US market and steady offtake of *Suprax* in the US market. *Suprax* continued with steady performance with sales of about US\$3m during the quarter. *Suprax* sales are expected to pick up in 2H FY06 during the winter season in US. One of the company's key US customers lowered the off-take of Lisinopril API resulting in lower sales of the product.
- Sales in domestic market grew by 25.5% to Rs2.3b, driven by 65% growth in API sales to Rs596m and 15.8% growth in formulation sales to Rs1.7b. Growth in domestic market was partly curtailed due to reduction in prices of finished dosages in the domestic market by NPPA, due to which the company has taken a hit of about Rs.65mn in domestic sales.
- Unregulated markets grew by 12.9% to Rs875m driven by stabilization in prices of Pen-G based products. On the contract manufacturing side, Lupin started supplying cephalosporin API to its partners as a part of its long-

term agreement. Also, it started servicing anti-TB order of the Global Drug Foundation.

Ceftriaxone performance below expectations

Lupin has not disclosed actual Ceftriaxone sales, but has indicated that the product suffered a 65-70% price erosion and Lupin's partner (Baxter) commanded about 20-25% market share. Sandoz has garnered more market share than Baxter. This has resulted in lower than expected margin expansion for the quarter. We expect further price erosion as more players enter the market in the coming months. The company has booked about 2 months of Ceftriaxone sales since the product was launched in July-05. We believe that Lupin's Ceftriaxone sales may start tapering off post 3QFY06. Lupin has also supplied some quantity of Ceftriaxone API to Baxter for the latter's delivery system.

Small beginnings in CRAMS

Lupin has made a small beginning in the contract manufacturing space by commencing supplies of Cephalosporins to its partner (DSM). It expects to work with both, innovators and large generic companies. It plans to target large volume products for its generic partners and the custom chemical synthesis (CCS) route for its partnership with the innovators.

Margins expansion driven by Ceftriaxone

EBITDA margins during the quarter improved by 590bp to 16.6% driven by launch of high margins Ceftriaxone in US market and stabilization of prices of Pen-G based products. EBITDA margins expansion was curtailed due to hit on account of NPPA mandated price cuts (~Rs65m) and forex loss (~Rs18m). Going forward, we expect EBITDA margins to stabilize at current level as any gains of improvement in Lisinopril will be negated by higher R&D spend on account of increase in ANDA filings during the year. The company intends to spend about Rs.1.1bn on R&D for FY06 (it has already spent Rs.420mn in 1H FY06). Hence, we are likely to see higher R&D expenses in H2FY06 affecting margins in the short-term. We believe that these investments will bear fruit in the coming years.

Adjusted net profit grew by 158%

Improvement in EBITDA margin led to a sharp 158.4% increase in adjusted PAT (stand alone) to Rs452m. Any impact of higher other income was more than negated by higher tax provisioning. Tax provisioning at 24.8% of PBT (v/s 9.3% in 2QFY05) was higher due to lower Lisinopril sales (which are effected through EoU). The company has indicated that going forward, the tax rate is likely to come down as it has converted some more units to EoU. It also expects to recoup Lisinopril sales in the coming quarters, which will also help in reducing the effective tax rate.

FCCB proceeds to fund inorganic growth

Lupin intends to raise about \$100mn through a proposed FCCB issue. It has indicated that the proceeds of the issue will be primarily utilized for inorganic expansions with target markets being USA and Europe. Part of the issue proceeds will be also used to fund the company's Rs.1.2bn capex. We believe that since the company does not have a significant presence in Europe, the acquisition will be targeted at European players. It is pertinent to note that many generic players (including most of the Indian companies) are looking at acquisitions to boost their generic businesses. The need to resort to inorganic growth has been accentuated by the recent consolidation in the global generics space with Teva and Sandoz announcing significantly large acquisitions. This implies that, in their quest for inorganic growth, generic players may end acquiring expensive assets (resulting in extended paybacks). We do not rule out this possibility in Lupin's case also.

Expect more NDDS out-licensing deals

Lupin has already out-licensed one NDDS product and expects to out-license another 1-2 products in FY06, which will result in up-front payment by the partners. We believe that, although the up-front payments may not be very significant (given Lupin's size); this is a long-term positive for the company.

Increased US filings to boost presence

Lupin has recently received ANDA approvals for Lisinopril and Cephalexin suspension. The company intends to sell these products in the US generic markets under its own label. Also, sales in US markets are expected to get boost from higher Suprax sales at about US\$15m in FY06 (1HFY06-US\$6.4m) and improvement in Lisinopril sales during the year. It expects to launch about 6-8 new products in the US in FY07 (about 15 ANDA filings are planned in FY06). It is also targeting some launches in Europe.

Valuations do not fully factor in the positives

Despite a gradual improvement in the underlying fundamentals (bottoming out of Pen-G business, pick up in Suprax prescription share, recovery in regulated market API sales and an expanding US generics pipeline), Lupin's valuations continue to be low, due to the sharp YoY dips in profits in past quarters. Valuations of 14.7x FY06E and 11.8x FY07E earnings do not fully reflect the above positives. We expect a gradual expansion in valuations as the generics story begins to unfold over the next couple of quarters. We re-iterate our **Buy** recommendation with a price target of Rs875, an upside of 19%.

Lupin: an investment profile

Company description

Lupin is a second-tier Pharma company that is actively targeting the regulated generics markets. Historically strong in the anti-TB segment, it has, over the years, built up expertise in fermentation-based products and segments like cephalosporins, prils and statins. It is now fully-integrated, with manufacturing capabilities in APIs and formulations and a direct marketing presence in the target markets.

Key investment arguments

- Only player worldwide with ceftriaxone approval – US\$700m opportunity.
- In the process of building a strong pipeline for the US market through aggressive filings – benefit over 2-years
- Pediatric opportunity (Suprax), statins offer significant potential upsides that are not factored into our estimates.

Key investment risks

- Short-term financial performance would remain under pressure given slow scale up in US business and ramp up of R&D and regulatory filing costs.
- Higher-than-expected competition for *ceftriaxone* would be a negative for growth rates and profitability.
- Commodity-like nature of its developing markets business could lead to volatility in earnings.

Recent developments

- Entered into strategic alliance with Kyowa Pharma, Japan, for marketing Lupin's product in Japan
- Entered into strategic alliance with Aspen Pharma, for marketing anti-TB products in South Africa

Valuation and view

- Multiples of 14.7x FY06E and 11.8x FY07E earnings do not fully reflect the positives. Least expensive among peers.
- Re-iterate **Buy** with price target of Rs875 (~14x FY07E earnings).

Sector view

- Regulated markets would remain the key sales and profit drivers in the medium term. Europe is expected to emerge as the next growth opportunity, particularly for companies with a direct marketing presence.
- FY05 and FY06 to be years of consolidation in terms of profitability, as companies divert efficiency gains towards seeding their regulated markets and R&D initiatives.
- We are overweight on companies that are towards the end of the investment phase, with benefits expected to start coming in from the next fiscal.

COMPARATIVE VALUATIONS

		LUPIN	SUN PHARMA	WOCK-HARDT
P/E(x)	FY06E	14.7	23.0	18.4
	FY07E	11.8	19.0	15.0
P/BV(x)	FY06E	4.6	7.2	5.4
	FY07E	3.6	5.5	4.2
EV/Sales(x)	FY06E	1.9	7.4	3.3
	FY07E	1.7	6.1	3.1
EV/EBITDA(x)	FY06E	11.6	20.6	14.2
	FY07E	9.6	16.5	12.7

SHAREHOLDING PATTERN (%)

	SEP05	JUN.05	SEP04
Promoters	52.5	52.5	51.5
Domestic Institutions	8.3	7.3	5.5
FII's/FDIs	24.4	26.6	29.4
Others	14.9	13.6	13.6

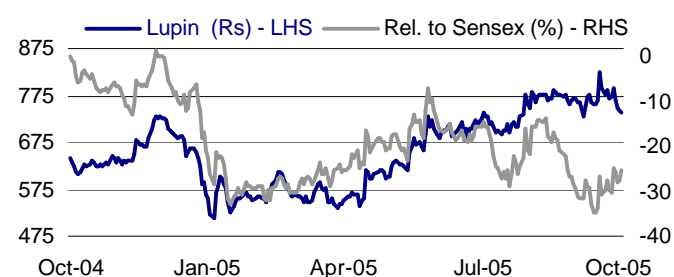
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY05	50.0	47.8	4.7
FY06	62.4	54.3	14.9

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
736	875	18.9	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
Net Sales	10,179	12,152	12,611	16,345	18,329
Change (%)	5.5	19.4	3.8	29.6	12.1
Total Expenditure	8,402	9,896	11,334	13,616	15,169
EBITDA	1,778	2,256	1,278	2,728	3,161
Margin (%)	17.5	18.6	10.1	16.7	17.2
Depreciation	256	295	336	387	419
Int. and Finance Charges	646	563	283	237	123
Other Income - Rec.	132	514	234	295	337
PBT before EO item	1,007	1,911	893	2,399	2,955
EO Expense/(Income)	14	509	0	0	0
PBT after EO item	993	1,402	893	2,399	2,955
Tax	241	554	26	384	443
Tax Rate (%)	20.6	36.9	2.9	16.0	15.0
Reported PAT	753	848	867	2,015	2,512
PAT Adj for EO items	764	1,357	867	2,015	2,512
Change (%)	-24.2	77.7	-36.1	132.3	24.7
Less: Minority Interest	9	16	4	6	7
Adj Net Profit	755	1340	863	2009	2505

CONSOLIDATED BALANCE SHEET (Rs Million)					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
Equity Share Capital	401	401	401	401	401
Total Reserves	3,362	3,906	4,492	6,047	7,957
Net Worth	3,764	4,308	4,894	6,448	8,358
Minority Interest	-8	8	12	18	25
Deferred liabilities	896	942	935	1,535	1,337
Total Loans	6,677	3,948	4,572	2,633	1,431
Capital Employed	11,328	9,206	10,413	10,634	11,151
Gross Block	6,004	6,600	7,347	8,700	9,300
Less: Accum. Deprn.	1,107	1,390	1,718	2,113	2,532
Net Fixed Assets	4,897	5,211	5,629	6,587	6,769
Capital WIP	107	172	698	275	200
Investments	37	26	26	58	389
Curr. Assets	9,060	6,891	7,189	7,843	8,645
Inventory	1,602	2,310	2,615	2,868	3,244
Account Receivables	4,216	2,276	2,550	2,911	3,264
Cash and Bank Balance	193	302	271	358	402
Others	3,048	2,004	1,754	1,706	1,735
Curr. Liability & Prov.	2,772	3,094	3,130	4,129	4,851
Account Payables	2,196	2,386	2,714	3,154	3,611
Provisions	576	708	416	975	1,240
Net Current Assets	6,288	3,797	4,059	3,714	3,794
Appl. of Funds	11,328	9,206	10,413	10,634	11,152

E: MOSI Estimates

RATIOS					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
Basic (Rs)					
EPS	18.8	33.4	21.5	50.0	62.4
Cash EPS	25.2	40.8	29.9	59.7	72.8
BV/Share	93.5	107.1	121.7	160.4	208.0
DPS	5.0	6.5	6.9	10.0	13.1
Payout (%)	30.8	34.7	36.6	22.5	23.7
Valuation (x)					
P/E	39.1	22.0	34.2	14.7	11.8
Cash P/E	29.2	18.1	24.6	12.3	10.1
P/BV	7.9	6.9	6.0	4.6	3.5
EV/Sales	3.5	2.7	2.7	1.9	1.7
EV/EBITDA	20.3	14.7	26.5	11.7	9.7
Dividend Yield (%)	0.7	0.9	0.9	1.4	1.8
Return Ratios (%)					
RoE	21.4	33.3	18.8	35.5	33.9
RoCE	16.5	26.5	13.3	28.5	32.7
Working Capital Ratios					
Asset Turnover (x)	0.9	1.3	1.2	1.5	1.6
Debtor (Days)	142	68	74	65	65
Inventory (Days)	57	69	76	64	65
Working Capital Turnover (Day)	225	114	117	83	76
Leverage Ratio					
Debt/Equity	1.8	0.9	0.9	0.4	0.2

CASH FLOW STATEMENT (Rs Million)					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
Oper. Profit/(Loss) before Tax	1,778	2,256	1,278	2,728	3,161
Interest/Dividends Recd.	132	514	234	295	337
Direct Taxes Paid	-179	-508	-33	217	-641
(Inc)/Dec in WC	-663	2,599	-293	433	-36
EO expense	14	509	0	0	0
CF from Operating incl EO	1,053	4,351	1,186	3,673	2,820
(inc)/dec in FA	-598	-674	-1,281	-922	-525
(Pur)/Sale of Investments	19	10	0	-31	-332
CF from investments	-580	-663	-1,281	-954	-857
Issue of Shares	-70	7	40	0	0
(Inc)/Dec in Debt	374	-2,729	624	-1,940	-1,202
Interest Paid	-646	-563	-283	-237	-123
Dividend Paid	-232	-294	-317	-454	-595
CF from Fin. Activity	-573	-3,580	64	-2,631	-1,920
Inc/Dec of Cash	-100	108	-31	88	43
Add: Beginning Balance	293	193	302	271	358
Closing Balance	193	302	271	359	401

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Disclosure of Interest Statement	Lupin
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
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