

Biocon

STOCK INFO.	BLOOMBERG
BSE Sensex: 8,122	BIOS IN
	REUTERS CODE
S&P CNX: 2,468	BION.BO

19 October 2005

Buy

Rs495

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)	100.0	03/05A	7,126	1,976	19.8	42.5	25.1	6.7	26.7	25.8	6.7	21.4
52-Week Range	555/392	03/06E	9,167	2,258	22.6	14.3	21.9	5.4	24.7	25.0	5.3	17.6
1,6,12 Rel. Perf. (%)	10/-7/-46	03/07E	11,257	2,858	28.6	26.6	17.3	4.4	25.1	25.3	4.1	13.4
M.Cap. (Rs b)	49.5											
M.Cap. (US\$ b)	1.1											

Biocon's 2QFY06 result continues to be disappointing, as pricing pressure took a heavy toll on its profitability. Key highlights of results are:

- Net sales grew by 7.8% at Rs2.0b, due to continuing pressure in the European statins market and an 8% decline in enzyme sales. Research services revenues grew by 53.6% YoY partly cushioning the adverse performance of bio-pharma and enzymes division.
- EBITDA margins declined, by 370bps YoY to 29.4%, due to lower realizations in statins and higher domestic revenues.
- Net profit declined 22% YoY (to Rs435m) as a result of margin decline, higher depreciation (higher by 56%), lower other income (lower by 67%) and higher tax provisioning (17.9% of PBT v/s 6.5% in 2QFY05).
- Biocon has initiated process of registration of *Insugen* in over 40 countries in Europe, Latin America, Middle East and Asia.
- On research front, its oral insulin is on track to file an IND with USFDA by end of FY06. Also, its anti EGFR monoclonal anti-body, for treatment of head and neck cancer, is in the final stages of Phase-IIb clinical trials and expects to file for fast track approval in India by end of FY06.

The stock currently trades at 21.9x FY06E and 17.3x FY07E earnings, which is not cheap. Over the long term however, the Insulin opportunity, opening up of the US market and any success in its drug discovery efforts would help improve growth rates. Maintain **Buy**.

CONSOLIDATED QUARTERLY PERFORMANCE

(Rs Million)

	FY05				FY06				FY05	FY06E
Y/E MARCH (RS M)	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales	1,742	1,861	1,777	1,746	1,740	2,006	2,307	3,109	7,126	9,167
YoY Change (%)	62.2	24.0	27.9	20.8	-0.1	7.8	29.8	78.1	31.8	357.1
Total Expenditure	1,206	1,245	1,181	1,255	1,235	1,416	1,623	2,130	4,887	6,404
EBITDA	536	616	596	490	505	589	684	979	2,239	2,762
Margins (%)	30.8	33.1	33.6	28.1	29.0	29.4	29.7	31.5	31.4	30.1
Depreciation	46	47	62	69	71	74	105	145	223	395
Interest	7	6	5	2	3	2	3	6	20	13
Other Income	37	34	48	37	18	11	37	69	156	135
PBT	520	597	578	456	449	525	613	897	2,151	2,488
Tax	34	39	75	34	66	94	49	21	186	230
Rate (%)	6.5	6.5	13.0	7.4	14.8	17.9	8.0	2.3	8.6	9.3
Minority Interest	0	-4	0	-1	-5	-4	0	0	-10	-9
PAT	486	562	503	424	387	435	564	876	1,975	2,267
YoY Change (%)	112.2	50.4	43.7	-2.3	-20.3	-22.6	12.2	106.7	42.5	420.7
Margins (%)	27.9	30.2	28.3	24.3	22.3	21.7	24.4	28.2	27.7	24.7

E: MOST Estimates

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Pressure on realizations stunts topline ...

Consolidated revenues grew 7.8% YoY in 2QFY06, driven by lower realizations on statins in Europe, decline in enzyme business and higher depreciation and tax provisions. Bio-pharmaceutical sales increased only 6.1% reflecting the intense competition for statins in Europe. Research services revenues grew by 53.6% YoY partly cushioning the adverse performance of bio-pharmaceutical and enzymes division.

TREND IN PRODUCT MIX (RS.M)

SALES TREND	2QFY06	2QFY05	GR.(YOY)	1QFY06	GR.(QOQ)
Bio-Pharma.	1,560	1,470	6.1	1,350	15.6
% of sales	77.6	79.0		77.6	
Enzymes	220	240	(8.3)	200	10.0
% of sales	10.9	12.9		11.5	
Contract Res. Fees	230	150	53.6	190	21.5
% of sales	11.5	8.1		10.9	
Total	2,010	1,860	8.1	1,740	15.6

Source: Company/Motilal Oswal Securities

Biopharmaceuticals hit the most

The statins business in Europe continues to be under severe competitive pressures, which is the main reason for the company's modest revenue growth. Biocon management has indicated that it expects statin prices in Europe to stabilize in the near future. It also expects to commence statin supplies to USA from 4QFY06 onwards. The company has invested significantly (approximately Rs.4.0bn) in new capacities to exploit the opening of the Simvastatin and Pravastatin market in USA. The company maintains that despite the large number of filings for statins in USA, many players may not receive US FDA approvals on time to address the statins opportunity. We however, believe that competition in statins is here to stay and expect no respite over the next year as more players enter the fray.

... and keeps margins under pressure

The impact of lower realizations is clearly visible at the EBIDTA level as EBIDTA margins declined by 370bp YoY 29.4%. Biocon's management had guided in the past that margins would be lower in FY06, on account of a spike in R&D spend towards its new drug discovery efforts.

Although the company's planned new capacities would start commercial production in FY06, we expect the benefits to be offset by continued pricing pressure and higher R&D spend.

Building future growth engines – visibility still poor

While statins represent a large medium-term growth opportunity for Biocon, the cash flows generated from this business would enable Biocon to build strengths in other biopharmaceutical products (immuno-suppressants and anti-diabetes) as well as its own drug discovery and contract research efforts. The company's efforts to launch human insulin in India and in unregulated markets as well as a supply tie up with Bristol Myers Squibb (for the latter's NDDS version) are also likely to scale up over the next couple of years.

The company has also made considerable progress on the research front, with the knowledge gained through its custom and clinical research activities coming in handy in its own efforts to develop non-infringing processes. Biocon also has its own R&D program focusing on improving efficiencies and developing new biological entities (NBEs). The company is conducting Phase II B studies of its drug (TheraCIM) for treatment of head and neck cancers and expects to receive Fast Track approval for the same. Biocon expects each indication to represent a Rs1b opportunity in India alone. The R&D partnerships with players like Nobex and Vaccinex is likely to leverage Biocon's scale-up and manufacturing expertise for biotech products. Although , progress on any of these fronts could lead to higher growth and a re-rating, the visibility on these is still poor.

Benefits of capacity expansion to be visible only in FY07

Biocon's new Statins facility is likely to be fully commissioned in H2FY06. However, US patents on Simvastatin and Pravastatin are expiring in CY06 and hence the full benefits of the expanded capacity are likely to accrue only in FY07. In the intermediate period, we expect the company's new facilities to cater to markets in EU.

Long-term generic pipeline is exciting

Biocon has already received U.S. FDA acceptance for its Pravastatin, Simvastatin, Lovastatin and Pioglitazone manufacturing facilities. This acceptance will permit Biocon to access the US\$ 6bn market slated to go off patent in the United States in CY06. We believe that this development has long-term positive implications for Biocon. The company is already selling Pravastatin and Simvastatin in Europe and commands a market share of about 20% and 40% respectively. However, it should be noted that competition in the US Statins market will be severe as a large number of generic players are expected to enter the market post patent expiry.

The company is building its pipeline of immunosuppressants and has filed DMFs for Mycophenolate Mofetil and Tacrolimus. We believe that immunosuppressants will be key growth drivers for the company in the long-term (beyond FY07).

Specialty pipeline is also being strengthened

Biocon expects to enter the specialty segment of the pharmaceutical market by developing proprietary products based on its developmental efforts with Monoclonal Antibodies (Mab). Its JV with a Cuban organization focuses on developing products using Mab. It is currently working on developing Mab for the immunosuppressant, arthritis and cancer segments. The JV has a pipeline of three Mab and three anti-cancer vaccines.

It has completed Phase-II(a) studies for developing a Mab product for head and neck cancer. It has already commenced Phase-II(b) trials for this product in India.

Insulin can be a very big long-term opportunity

Biocon has signed a non-exclusive agreement with BMS for supply of r-Human Insulin for the latter's NDDS insulin. This is a 9-year deal with commercial supplies to BMS

expected to commence after two years. Biocon has already supplied sample quantities of Insulin to BMS. It has also filed a DMF for Insulin with the US FDA.

The company has entered into a co-development partnership arrangement with Nobex USA, to develop oral insulin. The arrangement includes sharing of IPR and marketing rights between the two partners. The company expects a minimum development time-line of 2 years for establishing the proof-of-concept. Nobex will be using its proprietary technology to modify Biocon's insulin to develop the oral dosage form. Biocon intends to file an IND application by the end of the year, with the US FDA for commencing clinical trials for oral insulin.

Biocon is also simultaneously targeting launch of generic insulin in regulated markets post-CY06. It has already filed a DMF for insulin with the US FDA and expects to introduce the product in the US market through the 505(b)(2) route. The company will have to conduct limited clinical trials for this product. We believe that the regulatory environment for biotech products (like insulin) is gradually becoming favourable for generic companies. Regulators in both, Europe and USA, have indicated their willingness to frame detailed guidelines for approving generic biotech products.

The company has launched generic insulin in about 8 non-regulated markets till date and has about 40 registrations pending in other non-regulated markets. It has already launched its insulin in the domestic market under the "Insugen" brand. We do not expect Biocon to garner a significant market share in the domestic insulin market in the short-term since leading players like Novo Nordisk and Eli Lilly are well entrenched in the market. However, export of insulin to non-regulated markets will bring in long-term benefits to the company.

The global insulin market is currently worth \$ 4-5bn and can be a very big opportunity for generic suppliers like Biocon post-2006.

Syngene's operations are being ramped up

Syngene's new research facility was inaugurated last year and we expect a significant ramp-up in Syngene's operations (albeit on a lower base). The company has added many new clients including Novartis and Merck. Syngene has 6 of the top 10 global pharmaceutical companies as its clients.

Valuation and view

Biocon is expected to face competition and the rising costs of building an innovation-oriented business puts a lot of strain on profitability. The stock trades at 21.9x FY06E and 17.3x FY07E earnings, which is not cheap. Over the long term however, the insulin opportunity, opening up of the US market and any success in its drug discovery efforts would help improve growth rates. Thus, although the stock may underperform in the near term, we re-iterate our **Buy** recommendation with a 12 month price target of Rs520.

Biocon: an investment profile

Company description

Biocon is an integrated biotechnology company. With over 25 years of expertise in fermentation technology, it has built a strong presence in lucrative high growth segments like statins, immuno-suppressants and anti-diabetes.

Key investment arguments

- Strong expertise in fermentation process, decision to stay out of formulations in regulated markets make it best positioned to capitalize on statins opportunity.
- Healthy growth and cash flows to enable scale up of initiatives that would drive growth post 2007.

Key investment risks

- Fall in prices of Simvastatin and Pravastatin would result in lower profitability for Biocon.
- Operating at full capacity; any delay in capacity expansion or stabilizing production at the new plant would result in loss of a big market opportunity.
- Atorvastatin going off-patent earlier than expected would result in cannibalization of other statins, resulting in lower profitability for Biocon.

Recent developments

- Biocon Park received approval for SEZ application

Valuation and view

- Revenues and earnings CAGR of 26% and 20%, respectively, expected over FY05-07.
- The stock trades at 21.9x FY06E and 17.3x FY07E earnings, which now factor in a fair share of the negatives.
- Reiterate **Buy** with a long-term price target of Rs520, an upside of 5%.

Sector view

- Regulated markets to remain the key sales and profit drivers in the medium term. Europe to emerge as the next growth driver.
- FY05 and FY06 to be years of consolidation in terms of profitability, as companies divert efficiency gains to seeding regulated market and R&D initiatives.
- We are overweight on companies that are towards the end of the investment phase.

COMPARATIVE VALUATIONS

		BIOCON	CIPLA	DRL
P/E(x)	FY05	21.9	23.7	33.2
	FY06	17.3	21.0	26.0
P/BV(x)	FY05	5.4	6.1	2.7
	FY06	4.4	5.0	2.5
EV/Sales(x)	FY05	5.3	4.2	2.5
	FY06	4.1	3.6	2.1
EV/EBITDA(x)	FY05	17.6	18.4	27.8
	FY06	13.4	15.9	21.8

SHAREHOLDING PATTERN (%)

	SEP.05	JUN.05	SEP.04
Promoters	65.3	65.3	65.6
Domestic Institutions	2.0	1.0	0.9
FII's/FDIs	4.8	4.1	6.7
Others	27.9	29.6	26.9

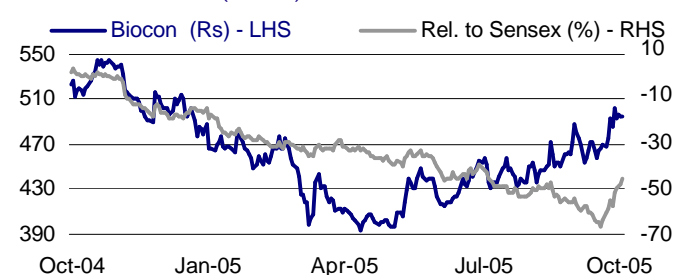
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY05	11.8	11.6	1.7
FY06	13.9	13.5	3.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
495	520	5.1	Buy

STOCK PERFORMANCE (1 YEAR)



CONSOLIDATE INCOME STATEMENT

(Rs Million)

Y/E MARCH	2003	2004	2005	2006E	2007E
Exports	1,077	3,008	3,764	5,105	6,576
Net Domestic Sales	1,462	2,011	2,706	3,078	3,568
Net Sales	2,538	5,019	6,470	8,182	10,144
Contract Research Fees	278	388	656	984	1,113
Net Income	2,816	5,406	7,126	9,167	11,257
Change (%)	71.4	92.0	31.8	28.6	22.8
Total Expenditure	2,092	3,620	4,887	6,404	7,784
EBITDA	725	1,786	2,239	2,762	3,473
Change (%)	93.5	146.6	25.3	23.4	25.7
Margin (%)	25.7	33.0	31.4	30.1	30.9
Depreciation	137	163	223	395	555
Int. and Finance Charges	50	16	20	13	12
Other Income - Rec.	16	9	156	135	214
PBT	553	1,617	2,151	2,488	3,119
Tax	118	230	186	230	261
Tax Rate (%)	21.4	14.2	8.6	9.3	8.4
Minority Interest	0.0	0.0	-10.4	0.0	0.0
Reported PAT	435	1,386	1,976	2,258	2,858
Change (%)	135.3	218.6	41.8	14.9	26.6
Margin (%)	15.5	25.6	27.6	24.6	25.4

E: M OSt Estimates

CONSOLIDATED BALANCE SHEET

(Rs Million)

Y/E MARCH	2003	2004	2005	2006E	2007E
Equity Share Capital	18	500	500	500	500
Revaluation Reserves	19	16	16	14	13
Other Reserves	1,303	5,115	6,894	8,642	10,853
Net Worth	1,340	5,631	7,410	9,156	11,366
Loans	686	647	760	465	435
Minority Interest	0	0	10	10	10
Deferred liabilities	143	177	230	380	549
Capital Employed	2,169	6,454	8,410	10,011	12,360
Gross Block	1,735	2,146	5,956	7,644	8,644
Less: Accum. Deprn.	376	538	762	1,150	1,707
Net Fixed Assets	1,359	1,607	5,194	6,494	6,937
Capital WIP	80	586	586	750	500
Investments	50	221	2,350	1,380	3,289
Curr. Assets	1,410	5,441	2,770	3,764	4,542
Inventory	479	857	740	1,372	1,643
Account Receivables	753	1,188	1,830	1,963	2,386
Cash and Bank Balance	26	3,169	30	105	133
Loans & Advances	151	227	170	324	380
Curr. Liability & Prov.	730	1,403	2,490	2,378	2,907
Account Payables	696	1,252	2,225	1,864	2,256
Provisions	34	152	265	514	651
Net Current Assets	680	4,038	280	1,387	1,635
Appl. of Funds	2,169	6,453	8,410	10,011	12,360

E: M OSt Estimates

RATIOS

Y/E MARCH	2003	2004	2005	2006E	2007E
Basic (Rs) EPS	118.4	13.9	19.8	22.6	28.6
Cash EPS	155.8	15.5	22.0	26.5	34.1
BV/Share	359.5	56.1	73.9	91.4	113.5
DPS	0.0	1.0	1.9	4.5	5.7
Payout (%)	0.0	8.1	10.7	22.6	22.6
Valuation					
P/E	4.2	35.7	25.1	21.9	17.3
Cash P/E	3.2	32.0	22.5	18.7	14.5
P/BV	1.4	8.8	6.7	5.4	4.4
EV/Sales	17.8	8.7	6.7	5.3	4.1
EV/EBITDA	69.2	26.2	21.4	17.6	13.4
Dividend Yield (%)	0.0	0.2	0.4	0.9	1.2
Return Ratios (%)					
RoE	32.5	24.6	26.7	24.7	25.1
RoCE	27.8	25.3	25.8	25.0	25.3
Working Capital Ratios					
Asset Turnover (x)	13	0.8	0.8	0.9	0.9
Debtor (Days)	98	80	94	78	77
Inventory (Days)	62	58	38	55	53
Working Capital (Days)	85	59	13	51	49

Leverage Ratio

Current ratio	19	3.9	1.1	1.6	1.6
Debt/Equity	0.5	0.1	0.1	0.1	0.0

E: M OSt Estimates

CONSOLIDATED CASH FLOW STATEMENT

(Rs Million)

Y/E MARCH	2003	2004	2005	2006E	2007E
Oper. Profit/(Loss) before	725	1,786	2,239	2,762	3,473
Interest/Dividends Recd.	16	9	156	135	214
Direct Taxes Paid	-84	-197	-133	-81	-91
(Inc)/Dec in WC	-196	-215	618	-1,031	-221
CF from Operations	461	1,384	2,881	1,786	3,374
EO items					
CF from Operating incl EO items					
(Incr)/Dec in FA	-401	-917	-3,810	-1,860	-748
(Pur)/Sale of Investments	-50	-171	-2,129	970	-1,909
CF from investments	-451	-1,089	-5,938	-889	-2,657
Issue of Shares	30	3,017	0	0	0
(Inc)/Dec in Debt	18	-39	151	-297	-32
Interest Paid	-50	-16	-20	-13	-12
Dividend Paid	0	-113	-212	-511	-646
CF from Fin. Activity	-2	2,849	-81	-821	-690
Inc/Dec of Cash	8	3,144	-3,139	76	27
Add: Beginning Balance	19	26	3,169	30	105
Closing Balance	26	3,171	30	106	133

E: M OSt Estimates

N O T E S

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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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