2QFY08 Results Update
SECTOR: PHARMACEUTICALS

Nicholas Piramal

STOCK INFO.	BLOOMBERG
BSE Sensex: 19,243	NP IN
	REUTERS CODE
S&P CNX: 5,702	NICH.BO

26 October 2007

Buy

Previous Recommendation: Buy

Rs305

Equity Shares (m)	209.0
52-Week Range	321/195
1,6,12 Rel. Perf. (%)	-2/-13/-19
M.Cap. (Rs b)	63.7
M.Cap. (US$ b)	1.6

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/07A	24,202	2,319	11.0	85.4	27.8	6.1	23.1	19.8	2.9	21.0
03/08E	28,630	2,973	14.2	29.7	21.4	4.8	24.9	19.9	2.4	14.9
03/09E	31,583	3,448	16.5	16.0	18.5	4.1	23.8	20.2	2.2	12.9

Nicholas Piramal 2QFY08 results were above our estimates. Key highlights:

- Net sales were up 15.6% YoY to Rs7.6b driven by a 22% growth in CRAMS business to Rs3.4b. PAT grew by 33.4% to Rs873m partly boosted by fiscal benefits from tax-free zones.
- **CRAMS business gaining traction -** Two new contracts have been commercialized from India in 2Q. The Fortune-500 contract will start contributing from 2HFY08 onwards. Management has also indicated that 3 products from Avecia's 17 Phase-III products have received regulatory clearance.
- **Increases guidance** – Management has revised its FY08 guidance indicating EPS of Rs17.5 (earlier Rs17). However, it has downgraded its top-line growth expectations to 20% as compared to the earlier 25% due to the lower than anticipated sales in the domestic business.

We expect NPIL to emerge as one of the key players in the Indian CRAMS space. The proposed NCE de-merger will have a positive impact on NPIL's financials and can also potentially unlock value for shareholders (albeit in the long-term). We have upgraded our EPS estimates (pre-NCE demerger) by 8% and 2% respectively for FY08E and FY09E. NPIL is currently valued at 21.4x FY08E and 18.5x FY09E earnings pre-NCE demerger. Adjusted for NCE demerger, the stock is valued at 15x FY08E and 13.2x FY09E earnings. We believe that valuations do not fully reflect the scaling up of the CRAMS business and the expected benefits from acquired companies. Maintain **Buy**.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY07				FY08				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales	**5,226**	**6,547**	**6,495**	**6,452**	**6,081**	**7,566**	**7,591**	**7,312**	**24,719**	**28,630**
YoY Change (%)	*31.2*	*79.3*	*61.3*	*52.9*	*16.4*	*15.6*	*16.9*	*13.3*	*55.0*	*15.8*
Total Expenditure	4,348	5,409	5,525	5,603	5,240	6,317	6,375	6,045	20,885	23,977
EBITDA	**877**	**1,138**	**971**	**849**	**841**	**1,249**	**1,217**	**1,267**	**3,835**	**4,653**
Margins (%)	*16.8*	*17.4*	*14.9*	*13.2*	*13.8*	*16.5*	*16.0*	*17.3*	*15.5*	*16.3*
Depreciation	228	244	222	158	249	263	285	317	818	1,114
Interest	46	76	88	96	111	111	115	122	305	459
Other Income	0	2	2	54	20	80	103	21	58	224
PBT before EO Expense	**604**	**820**	**663**	**649**	**500**	**955**	**920**	**849**	**2,770**	**3,304**
Extra-Ord Expense	0	-76	-2	12	3	27	0	0	43	30
PBT after EO Expense	**604**	**896**	**665**	**638**	**497**	**928**	**920**	**849**	**2,727**	**3,273**
Tax	13	172	59	-2	18	127	85	73	**231**	**303**
Deferred Tax	51	9	51	36	45	-47	8	22	158	27
Rate (%)	*10.7*	*20.2*	*16.5*	*5.3*	*12.7*	*8.6*	*10.1*	*11.2*	*14.3*	*10.1*
PAT	**539**	**715**	**556**	**604**	**434**	**848**	**827**	**754**	**2,338**	**2,943**
Less: Minority Interest	1	0	0	0	0	0	0	0	1	0
Reported PAT	**539**	**715**	**556**	**604**	**434**	**848**	**827**	**754**	**2,337**	**2,943**
Adj PAT	**539**	**654**	**554**	**615**	**437**	**872**	**827**	**754**	**2,374**	**2,970**
YoY Change (%)	*11.9*	*22.8*	*129.9*	*318.8*	*-18.8*	*33.3*	*49.3*	*22.8*	*87.0*	*25.1*

E: MOSt Estimates; Quarterly numbers don't add up to full year numbers due to restatement

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Traction in CRAMS, Phensedyl recovery drive revenue growth

Net sales were up 15.6% YoY to Rs7.6b (vs est. of Rs6.98b) driven by a 22% growth in CRAMS business to Rs3.4b. Two new contracts have started contributing to CRAMS exports from India along with existing AMO & Allergan contracts, taking India CRAMS sales to Rs694m (up 342% on a low base). Branded formulation revenues in India grew by 13.2% as Phensedyl sales seem to have recovered post resumption of normal Codeine supplies from the government.

TREND IN PRODUCT MIX (RS M)

	2QFY08	2QFY07	% YOY	1QFY08	% QOQ
Branded Formulations	3,543	3,130	13.2	2,907	21.8
CMG Sales	3,423	2,801	22.2	2,627	30.3
PDS	315	300	5.1	324	(2.9)
PMS	2,222	1,704	30.4	1,661	33.8
MMBB	599	550	8.9	406	47.5
CMO	286	247		235	
Pathlabs	312	176	76.9	252	23.7
Others	289	440	(34.3)	295	(2.0)
Total	**7,566**	**6,547**	**15.6**	**6,081**	**24.4**

Source: Company

EBITDA margins declined 110bp to 16.5% impacted by higher material consumption and partly due to currency appreciation. However, EBITDA margins were better than our estimates of 15.3%. PAT grew by 33.4% to Rs873m (vs est. of Rs585m) partly boosted by fiscal benefits from tax-free zones.

Raises Guidance for FY08

Management has revised its FY08 guidance indicating EPS of Rs17.5 (earlier Rs17). However, it has downgraded its top-line growth expectations to 20% as compared to the earlier 25% due to the lower than anticipated sales in the domestic business. This implies a better margin profile as some of the high margin contracts have started contributing to revenues from 2Q onwards. The revised EPS guidance is after taking into effect the proposed NCE Research hive-off, which is likely to add Rs3/share to the EPS. The table below indicates NPIL's guidance for FY08E:

GUIDANCE

PARAMETER	GUIDANCE	
	PREVIOUS	REVISED
Sales Growth (%)	25.0	20.0
EBITDA Margins (%) excl. NCE Research Spend	17.7	18.7
Capex (Rs m)	1,500	1,500
EPS (Rs/share)	17.0	17.5

Source: Company

CRAMS business gaining traction

We are witnessing increased traction in NPIL's CRAMS business. The company has already announced six contracts till date and in addition it has signed a few more contracts, which have not been made public due to confidentiality reasons. It has also made two international acquisitions in this space in the last 21 months. We believe that it has one of the strongest CRAMS pipelines, which will bring in long-term benefits. We expect long-term annuity based revenues from NPIL's CRAMS business in the coming years since these contracts will be valid for at least five years. We estimate 25-30% EBITDA margins and net margins of 20+% for the company from such contracts for patented products. Custom Manufacturing revenues (i.e. AMO & Allergan) from Indian facilities have started ramping up. For FY08E, CRAMS business from Indian facilities is expected to grow by more than 100% to over Rs2b.

CRAMS PIPELINE

BUSINESS	PDS					PMS		
SEGMENT	PRE-CLINICAL	PHASE-I	PHASE-II	PHASE-III	TOTAL	LAUNCHED (< 5 YEARS)	LAUNCHED (> 5 YEARS)	TOTAL
2006	8	23	42	9	82	9	16	25
2007	11	26	44	12	93	12	39	51
1H-2008	12	28	63	17	120	12	40	52

Source: Company

CRAMS business has long gestation period

The CRAMS business has a long gestation period since the Indian CRAMS industry is still evolving. Hence, potential customers take a long time to award contracts. Secondly, as a test case, the initial off-take by the customer may not be very high. It should also be noted that post the announcement of the contract it takes at least 18-24 months for the supplies to begin. This is due to the time-consuming registration process with various countries before which supplies cannot commence.

Avecia turnaround achieved, strengthening pipeline will bring-in long-term benefits

NPIL has achieved a turnaround (at net level) for Avecia operations led by better capacity utilization, efficient sourcing of inputs and rationalization of fixed costs. We believe that this is a positive development as Avecia will be contributing positively to the consolidated earnings. The full impact of restructuring and turnaround would be realized in FY08E.

We believe that the Avecia acquisition is significant for NPIL, which in one stroke strengthens its CRAMS pipeline, adds new clients and gives it access to critical technologies. Avecia Pharmaceuticals is a custom manufacturing player focused on providing custom chemical synthesis (CCS) and manufacturing services for the innovator pharmaceutical and biotechnology companies. The business includes early/late-stage and launched products for clients based in UK and North America. The reconfigured asset base will include access to leading early phase assets, including nearly 100 early-phase and launched products.

We believe that this acquisition will add about Rs.4bn in revenues to NPIL's CRAMS turnover for FY08E. It will now ensure that NPIL has presence in the entire product development and manufacturing chain of the CRAMS business - starting from CCS to APIs and on to formulations. It gives NPIL access to:

1. Existing clients of Avecia (including pharmaceutical and biotech companies)
2. The CCS and manufacturing contracts of Avecia (worth about Rs.2.9bn in sales). It should be noted that NPIL currently does not have a strong CCS pipeline.
3. Critical technologies like fermentation, biotransformation, chiral synthesis and high potency substances (NPIL currently does not have expertise in these areas).
4. It also gets access to the process R&D team of Avecia which includes 53 PhDs.

NPIL's contract manufacturing pipeline (consisting of all announced contracts and all acquisitions) will have peak revenues of about $170-200m at full ramp-up of contracts (expected by FY09E). This does not include contracts, which have not been made public. Our estimates do not include the potential upsides from a possible increase in capacity utilization at the U.K. facility (current capacity utilization is about 50-60%).

Revising estimates

In line with the company's guidance revision, we have revised our EPS estimates upwards for FY08E and FY09E by 8% and 2% respectively.

REVISED FORECAST (RS M)

	FY08E			FY09E		
	REV	OLD	CHG (%)	REV	OLD	CHG (%)
Net Sales	28,630	28,104	1.9	31,583	31,181	1.3
Net Profit	2,973	2,739	8.6	3,448	3,386	1.8
EPS (Rs)	14.2	13.1	8.6	16.5	16.2	1.8

Note: Our estimates are pre-NCE demerger.

Source: Motilal Oswal Securities

Investment concerns

Mass market initiatives may drag profitability in short-term

NPIL has commenced its Healthcare Initiative (in Apr-06) to access the unexplored Class 4 & rural markets. It has recruited a sales force of about 300 MRs for promoting its products in these markets which accounts for about 20-25% of the total pharmaceutical market in the country. The product portfolio will include acute therapy brands in the anti-infective, GI and pain management categories. The company plans to invest about Rs300m over the next two years for this initiative.

As NPIL's Healthcare Initiative is focusing on acute therapy products in the Class 4 & rural segments, we believe that this business will enjoy lower margins as compared to the company's existing domestic formulations business. As the scale-up in this business will be gradual (Rs110m sales in FY07), we expect a marginal hit to NPIL's overall margins. A significant increase in revenues from these markets can pressurize margins but will result in significant increase in volumes as these are under-penetrated markets.

New drug policy still remains uncertain

We believe that the biggest risk to our positive stance on NPIL could be the implementation of the new pharmaceutical policy in the current form. The new policy proposes to significantly increase the span of control by bringing in additional 354 drugs under price control. This could severely impact the profitability of Pfizer's domestic business. Industry has taken strong objection to the proposed policy and we believe that the policy is unlikely to be implemented in the current form. Given the strong opposition from the industry, the government has formed a Group on Ministers (GoM), which would give final recommendations to the government regarding the new pharmaceutical policy. However, the uncertainty related to this will remain till the government finally notifies the new pharmaceutical policy.

Valuation and outlook

We expect NPIL's performance to show a significant improvement from FY08E onwards led mainly by:

1) Consolidation of acquired companies (i.e. Avecia & Morpeth)
2) Ramp-up in supplies to AMO & Allergan
3) Commencement of supplies under other contracts
4) Full impact of excise and income tax benefits due to commissioning of NPIL's Baddi facility

We believe that NPIL's CRAMS business is gaining increased traction with more products being added to its CRAMS portfolio. We expect NPIL to emerge as one of the key players in the Indian CRAMS space. The proposed NCE de-merger will have a positive impact on NPIL's financials and can also potentially unlock value for shareholders (albeit in the long-term). We have upgraded our EPS estimates (pre-NCE demerger) by 8% and 2% respectively for FY08E and FY09E. NPIL is currently valued at 21.4x FY08E and 18.5x FY09E earnings pre-NCE demerger. Adjusted for NCE demerger, the stock is valued at 15x FY08E and 13.2x FY09E earnings. We believe that valuations do not fully reflect the scaling up of the CRAMS business and the expected benefits from acquired companies. Maintain **Buy** with revised price target of Rs340 (pre NCE-demerger).

Nicholas Piramal: an investment profile

Company description

Nicholas Piramal (NPIL) is one of the best plays on custom manufacturing and the domestic opportunity post 2005. The company's approach to the domestic and export markets is unique among Indian mid-tier companies. NPIL has leveraged its strength in manufacturing and relationships with global majors to position itself as a 'partner of choice' for innovator companies across the product life cycle and value chain.

Key investment arguments

- Differentiated business model focused on aggressive execution enables it to achieve healthy growth at much lower risk levels than its peers.
- Pioneer in custom manufacturing; positioned as 'partner of choice' for multi-national innovator companies.
- One of the best prepared amongst Indian pharma companies to leverage the pharmaceutical outsourcing opportunity.

Key investment risks

- Execution risks in CRAMS business and inability to fully utilize large capacities of acquired companies.
- NPIL's mass-market initiatives could be drag on margins in short-term.
- Regulatory issues in form of government mandated price control.

Recent developments

- NIL

Valuation and view

- Has consistently been a step ahead of its peers through its aggressive execution within a differentiated framework - only custom manufacturing play among large cap pharma stocks.
- Visible earnings power is higher than reported earnings due to time lag between bagging a contract and its execution – thus inflating P/E multiples.
- Valuations of 21.4x FY08E and 18.5x FY09E EPS do not fully reflect the potential of the CRAMS opportunity and scale-up due to large acquisitions. Maintain **Buy** with revised target price of Rs340.

Sector view

- Regulated markets would remain the key sales and profit drivers in the medium term.
- We are overweight on companies that are towards the end of the investment phase.

COMPARATIVE VALUATIONS

		NPIL	CIPLA	SUN PHARMA
P/E (x)	FY08E	21.4	23.4	24.5
	FY09E	18.5	19.6	20.5
P/BV (x)	FY08E	4.8	3.9	4.5
	FY09E	4.1	3.3	3.8
EV/Sales (x)	FY08E	2.4	3.6	7.5
	FY09E	2.2	3.1	6.1
EV/EBITDA (x)	FY08E	14.9	18.0	21.1
	FY09E	12.9	15.4	17.5

SHAREHOLDING PATTERN (%)

	SEP-07	JUN-07	SEP-06
Promoter	39.4	39.4	39.4
Domestic Inst	13.4	12.6	11.1
Foreign	18.1	20.3	21.1
Others	29.1	27.7	28.4

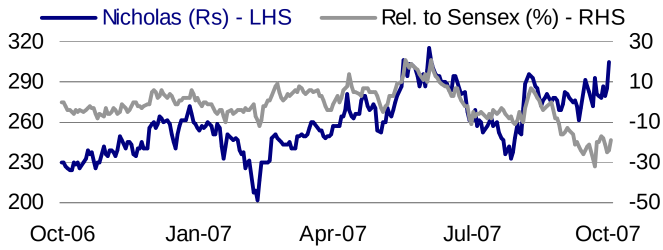
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	14.2	14.5	-2.2
FY09	16.5	18.1	-8.6

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
305	340	11.5	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)

Y/E MARCH	2005	2006	2007	2008E	2009E
Net Sales	**13,082**	**15,825**	**24,202**	**28,630**	**31,583**
Change (%)	*-6.0*	*21.0*	*52.9*	*18.3*	*10.3*
Total Expenditure	11,388	13,849	20,885	23,977	26,282
EBITDA	**1,694**	**1,976**	**3,317**	**4,653**	**5,301**
Margin (%)	*12.9*	*12.5*	*13.7*	*16.3*	*16.8*
Depreciation	524	688	818	1,114	1,259
Int. and Finance Charges	192	173	305	459	445
Other Income - Rec.	335	401	521	224	235
PBT before EO Expense	**1,312**	**1,517**	**2,715**	**3,304**	**3,831**
EO (Inc)/Exp	-796	33	43	0	0
PBT after EO Expense	**2,108**	**1,484**	**2,672**	**3,304**	**3,831**
Tax	465	238	389	330	383
Tax Rate (%)	*22.0*	*16.0*	*14.6*	*10.0*	*10.0*
Reported PAT	**1,643**	**1,246**	**2,283**	**2,973**	**3,448**
PAT Adj for EO Items	**1,023**	**1,273**	**2,320**	**2,973**	**3,448**
Change (%)	*-54.8*	*24.5*	*82.2*	*28.2*	*16.0*
Margin (%)	*7.8*	*8.0*	*9.6*	*10.4*	*10.9*
Less: Mionrity Int. & Others	3	4	1	0	0
Adj Net Profit	**1,020**	**1,269**	**2,319**	**2,973**	**3,448**

BALANCE SHEET (Rs Million)

Y/E MARCH	2005	2006	2007	2008E	2009E
Equity Share Capital	380	418	418	418	418
Preference Share Capital	534	534	384	384	384
Reserves	4,620	9,192	10,060	12,948	15,174
Net Worth	**5,533**	**10,144**	**10,862**	**13,750**	**15,975**
Minority Interest	41	30	5	5	5
Deferred Liabilities	596	836	893	920	952
Total Loans	3,680	3,114	6,392	6,724	6,000
Capital Employed	**9,850**	**14,124**	**18,152**	**21,399**	**22,932**
Gross Block	8,026	12,601	16,013	18,113	19,113
Less: Accum. Deprn.	1,799	3,951	4,308	5,422	6,681
Net Fixed Assets	**6,227**	**8,650**	**11,705**	**12,691**	**12,431**
Capital WIP	1,052	1,768	533	555	435
Investments	37	287	287	287	287
Curr. Assets	**5,656**	**7,759**	**10,494**	**14,879**	**17,404**
Inventory	2,705	2,776	4,402	6,403	7,063
Account Receivables	1,460	2,429	3,673	4,839	6,264
Cash and Bank Balance	155	953	506	987	1,137
Others	1,336	1,601	1,912	2,650	2,940
Curr. Liability & Prov.	**3,121**	**4,340**	**4,866**	**7,013**	**7,625**
Account Payables	2,317	3,277	4,551	5,593	6,205
Provisions	804	1,064	316	1,420	1,420
Net Current Assets	**2,535**	**3,419**	**5,628**	**7,866**	**9,779**
Appl. of Funds	**9,850**	**14,124**	**18,152**	**21,399**	**22,933**

E: MOSt Estimates

RATIOS

Y/E MARCH	2005	2006	2007	2008E	2009E
Basic (Rs)					
EPS	**5.2**	**5.9**	**11.0**	**14.2**	**16.5**
Cash EPS	8.1	9.4	15.0	19.6	22.5
BV/Share	26.3	46.0	50.1	64.0	74.6
DPS	3.0	3.0	3.5	4.0	5.0
Payout (%)	41.5	60.0	37.8	32.9	35.5
Valuation (x)					
P/E		51.5	27.8	21.4	18.5
Cash P/E		32.6	20.3	15.6	13.5
P/BV		6.6	6.1	4.8	4.1
EV/Sales		4.2	2.9	2.4	2.2
EV/EBITDA		33.3	21.0	14.9	12.9
Dividend Yield (%)		1.0	1.1	1.3	1.6
Return Ratios (%)					
RoE	22.5	17.4	23.1	24.9	23.8
RoCE	17.3	15.0	19.8	19.9	20.2
Working Capital Ratios					
Asset Turnover (x)	1.3	1.1	1.3	1.3	1.4
Debtor (Days)	41	56	55	62	72
Inventory (Days)	75	64	66	82	82
Working Capital (Days)	71	79	85	100	113
Leverage Ratio (x)					
Current Ratio	1.8	1.8	2.2	2.1	2.3
Debt/Equity	0.7	0.3	0.6	0.5	0.4

CASH FLOW STATEMENT (Rs Million)

Y/E MARCH	2005	2006	2007	2008E	2009E
Oper. Profit/(Loss) before Ta:	1,694	1,976	3,317	4,653	5,301
Interest/Dividends Recd.	335	401	521	224	235
Direct Taxes Paid	-248	2	-332	-303	-352
(Inc)/Dec in WC	213	-86	-2,656	-1,757	-1,763
CF from Operations	**1,994**	**2,293**	**851**	**2,817**	**3,422**
EO Expense/(income)	-796	33	43	0	0
CF frm Op. incl EO Exp.	**2,790**	**2,260**	**808**	**2,817**	**3,422**
(Inc)/Dec in FA	-2,126	-3,828	-2,638	-2,123	-880
(Pur)/Sale of Investments	15	-250	0	0	0
CF from Investments	**-2,112**	**-4,078**	**-2,638**	**-2,123**	**-880**
Issue of Shares	-9	4,112	-150	0	0
Inc/(Dec) in Debt	107	-577	2,701	1,224	-724
Interest Paid	-192	-173	-305	-459	-445
Dividend Paid	-682	-747	-864	-978	-1,223
CF from Fin. Activity	**-777**	**2,615**	**1,383**	**-213**	**-2,392**
Inc/Dec of Cash	**-99**	**798**	**-447**	**481**	**150**
Add: Beginning Balance	254	155	953	506	987
Closing Balance	**155**	**953**	**506**	**987**	**1,137**

NOTES

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Disclosure of Interest Statement	Nicholas Piramal
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No