Company Focus

24 October 2007 | 9 pages

Cipla (CIPL.BO)

Sell: High 2Q PAT – One-offs Driven Mirage

- **Maintain Sell (3L)** — as 2Q PAT was driven by one-off items. The core business continues to be hit by rupee appreciation, stiff competition & adverse shift in product mix. We retain our estimates & view that Cipla's supply-based model is vulnerable in the changing industry environment. The recent bounce in the stock (up 10% over the last week) is another good exit opportunity.
- **One-off boost** — 2Q was buoyed by a quarterly skew in licensing income – Rs413m vs. Rs113m in 1Q – which would normalize in 2H. Core profitability remained under pressure with EBIDTA margins declining 697bps YoY despite the 20% YoY growth in sales. The management has maintained its 10-12% sales growth & lower EBIDTA margins guidance for FY08.
- **Sales growing, but mix worries** — Sales growth was robust at 20% in 2QFY08; however, we believe it would be difficult for Cipla to grow FY08 revenues by more than 12% in the absence of any exclusivity supplies to partners. Moreover, with a large part of the growth coming from lower margin ARV sales to less regulated markets, we expect the pressure on margins to sustain.
- **We expect multiple contraction** — Cipla's valuations are not attractive relative to the value add in the business. With growth rates tapering off & capital efficiency under pressure, we believe current multiples will not sustain. While exclusivity opportunities for its partners could provide the occasional surprise, we note that these are unsustainable & should not affect valuations materially.

Sell/Low Risk	3L
Price (24 Oct 07)	Rs196.60
Target price	Rs165.00
Expected share price return	-16.1%
Expected dividend yield	1.2%
Expected total return	**-14.9%**
Market Cap	Rs152,815M
	US$3,860M

Price Performance (RIC: CIPL.BO, BB: CIPLA IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	6,076	8.11	48.4	24.3	7.4	34.4	1.1
2007A	6,680	8.59	6.0	22.9	4.7	25.6	1.0
2008E	6,163	7.93	-7.7	24.8	4.2	17.9	1.2
2009E	6,672	8.58	8.3	22.9	3.7	17.2	1.3
2010E	7,476	9.62	12.0	20.4	3.3	17.2	1.4

Source: Powered by dataCentral

Prashant Nair, CFA[1]
+91-22-6631-9855
prashant.nair@citi.com

Chirag Dagli[1]
+91-22-6631-9874
chirag.dagli@citi.com

Akshay Rai[1]
akshay.rai@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	24.3	22.9	24.8	22.9	20.4
EV/EBITDA adjusted (x)	23.3	18.1	19.0	17.2	15.4
P/BV (x)	7.4	4.7	4.2	3.7	3.3
Dividend yield (%)	1.1	1.0	1.2	1.3	1.4
Per Share Data (Rs)					
EPS adjusted	8.11	8.59	7.93	8.58	9.62
EPS reported	8.11	8.59	7.93	8.58	9.62
BVPS	26.46	41.63	46.99	52.77	59.24
DPS	2.07	2.00	2.30	2.49	2.79
Profit & Loss (RsM)					
Net sales	29,753	35,620	39,726	44,822	50,668
Operating expenses	-23,862	-28,140	-33,040	-37,487	-42,517
EBIT	**5,891**	**7,480**	**6,686**	**7,334**	**8,151**
Net interest expense	-114	-70	-62	-88	-58
Non-operating/exceptionals	380	658	847	841	968
Pre-tax profit	**6,157**	**8,069**	**7,471**	**8,088**	**9,061**
Tax	-1,022	-1,400	-1,307	-1,415	-1,586
Extraord./Min.Int./Pref.div.	942	11	0	0	0
Reported net income	**6,076**	**6,680**	**6,163**	**6,672**	**7,476**
Adjusted earnings	6,076	6,680	6,163	6,672	7,476
Adjusted EBITDA	6,693	8,514	7,995	8,923	9,936
Growth Rates (%)					
Sales	32.0	19.7	11.5	12.8	13.0
EBIT adjusted	33.8	27.0	-10.6	9.7	11.1
EBITDA adjusted	35.1	27.2	-6.1	11.6	11.3
EPS adjusted	48.4	6.0	-7.7	8.3	12.0
Cash Flow (RsM)					
Operating cash flow	**2,743**	**2,621**	**5,883**	**6,373**	**6,557**
Depreciation/amortization	802	1,034	1,310	1,589	1,785
Net working capital	-4,135	-5,093	-1,590	-1,889	-2,703
Investing cash flow	**-3,652**	**-5,146**	**-3,886**	**-4,705**	**-3,513**
Capital expenditure	-3,610	-4,192	-4,500	-5,000	-3,000
Acquisitions/disposals	-41	-954	614	295	-513
Financing cash flow	**1,850**	**3,166**	**-2,015**	**-2,832**	**-4,209**
Borrowings	2,777	-3,454	0	514	-600
Dividends paid	-1,773	-1,819	-2,015	-2,182	-2,445
Change in cash	**942**	**641**	**-18**	**-1,165**	**-1,165**
Balance Sheet (RsM)					
Total assets	**34,583**	**44,137**	**49,332**	**55,309**	**61,240**
Cash & cash equivalent	669	2,493	1,064	770	1,282
Accounts receivable	8,760	10,288	10,945	13,257	14,367
Net fixed assets	11,436	14,613	17,803	21,214	22,429
Total liabilities	**14,751**	**11,775**	**12,803**	**14,290**	**15,189**
Accounts payable	8,132	7,130	7,985	8,707	9,898
Total Debt	4,689	1,236	1,236	1,750	1,150
Shareholders' funds	**19,833**	**32,363**	**36,529**	**41,020**	**46,051**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	22.5	23.9	20.1	19.9	19.6
ROE adjusted	34.4	25.6	17.9	17.2	17.2
ROIC adjusted	22.7	21.3	15.4	14.6	14.6
Net debt to equity	20.3	-3.9	0.5	2.4	-0.3
Total debt to capital	19.1	3.7	3.3	4.1	2.4

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High 2Q PAT – One-offs Driven Mirage

We maintain our Sell/Low Risk (3L) rating on Cipla, as 2QFY08 PAT was largely driven by one-off items. The core business continues to be hit by rupee appreciation, stiff competition & adverse shift in product mix. We retain our estimates & view that Cipla's supply-based model is vulnerable in the changing industry environment. With growth rates tapering off & capital efficiency under pressure, we believe current multiples will not sustain. While exclusivity opportunities for its partners could provide the occasional surprise, we note that these are unsustainable & should not affect valuations materially. The recent bounce in the stock (up 10% over the last week) is another good exit opportunity.

Strong 2Q PAT – Boosted by One-offs

Figure 1. Cipla – 2QFY08 Results Snapshot (Rupees in Millions)

Year to 31 March	2Q FY07	2Q FY08	% Ch YoY	1Q FY08	% Ch QoQ	CIR Comments
Sales	8,841	10,570	19.6	9,073	16.5	Robust growth in formulation exports
Excise Duty	(192)	(191)	(0.4)	(270)	(29.3)	
Net Sales	**8,650**	**10,379**	**20.0**	**8,803**	**17.9**	
Other Operating Income	311	605	94.1	216	180.4	Higher technical know-how fees – a quarterly skew
Net Revenues	8,961	10,984	22.6	9,018	21.8	
Expenditure	(6,685)	(8,744)	30.8	(7,411)	18.0	Staff costs increase set off by lower other expenditure
Operating profits	**2,276**	**2,240**	**(1.6)**	**1,607**	**39.4**	**Burgeoning fixed costs coupled with change in product mix in favour of low gross margin product sales take a toll on margins. But for very high technology know-how income during the quarter, margins would have been much lower**
OPM (%)	*25.4*	*20.4*	*-500 bps*	*17.8*	*258 bps*	
OPM (%) – excl tech know-how income	*24.3*	*17.3*	*-697 bps*	*16.8*	*51 bps*	
Interest	(16)	(24)	51.9	(8)	189.0	
Depreciation	(245)	(328)	33.7	(303)	8.3	Commissioning of the Patalganga EOU
Other income	190	418	120.2	185	125.6	Forex gain of Rs200m
PBT	2,205	2,307	4.6	1,482	55.7	
Tax	(403)	(401)	(0.4)	(284)	41.2	
Tax rate (%)	*18.3*	*17.4*	*-87 bps*	*19.2*	*-179 bps*	*Lower tax rate due to tax incentives available to EOUs and at Baddi*
Net profit	**1,803**	**1,906**	**5.7**	**1,198**	**59.2**	
Net margin (%)	*20.8*	*18.4*	*-248 bps*	*13.6*	*476 bps*	

Source: Company Reports and Citi Investment Research

Figure 2. Cipla – Revenue Breakdown (Rupees in Millions)

Year to 31 March	2Q FY07	2Q FY08	% Ch YoY	1Q FY08	% Ch QoQ	CIR Comments
Domestic	4,444	5,094	14.6	5,054	0.8	Sales growth back on track after a muted 1Q
% of Total Revenues	*48.6*	*45.6*	*-297 bps*	*54.4*	*-882 bps*	
Exports	4,397	5,476	24.5	4,019	36.3	Strong growth despite rupee appreciation, on higher registrations
% of Total Revenues	*48.0*	*49.0*	*96 bps*	*43.3*	*573 bps*	
Formulations	2,800	4,059	45.0	3,203	26.7	Growth driven by Africa & Europe – mainly ARVs, asthma & malarials
APIs	1,597	1,417	(11.3)	816	73.7	
Sales	**8,841**	**10,570**	**19.6**	**9,073**	**16.5**	
Tech know-how/fees	136	413	204.9	113	264.6	
Others	176	191	8.7	102	87.0	
Other operating income	311	605	94.1	216	180.4	Significantly higher technical know-how fees – a quarterly skew that would get corrected over the next two quarters
% of Total Revenues	*3.4*	*5.4*	*201 bps*	*2.3*	*309 bps*	
Total Revenues	**9,153**	**11,175**	**22.1**	**9,288**	**20.3**	

Source: Company Reports and Citi Investment Research

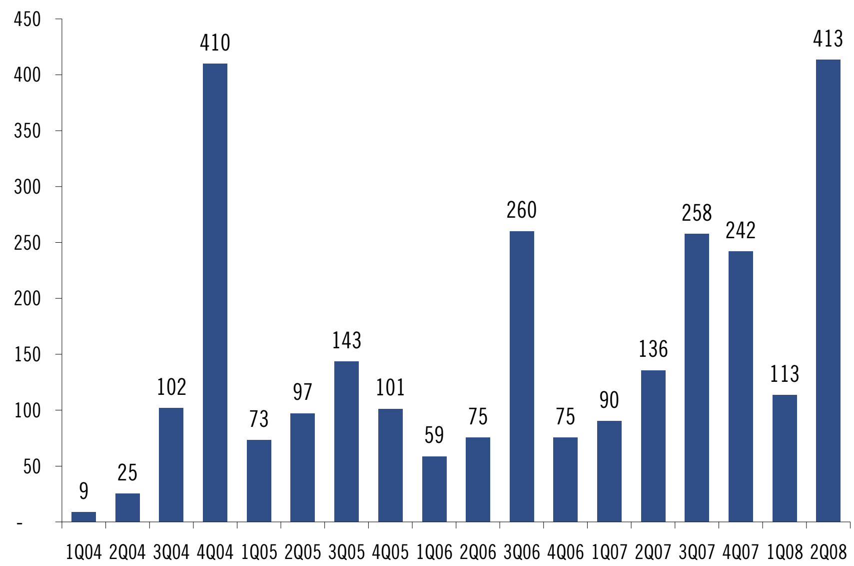
Figure 3. Cipla – Cost Breakdown (Rupees in Millions)

Year to 31 March	2Q FY07	2Q FY08	% Ch YoY	1Q FY08	% Ch QoQ	CIR Comments
Net Sales	8,650	10,379	20.0	8,803	17.9	
Consumption of Raw Materials	4,106	5,480	33.4	4,492	22.0	Change in product mix in favour of low margin ARVs as against high margin sales to partners in regulated markets during exclusivity period in 2Q FY07
% of Net sales	*47.5*	*52.8*	*532 bps*	*51.0*	*176 bps*	
Staff Cost	439	529	20.6	646	(18.1)	Annual increments and increase in manpower
% of Net sales	*5.1*	*5.1*	*3 bps*	*7.3*	*-224 bps*	
Other Expenses	2,140	2,735	27.8	2,274	20.3	Increased fixed cost on the Patalganga EOU; higher advertising spend, travel & sales expenditure
% of Net sales	*24.7*	*26.4*	*161 bps*	*25.8*	*53 bps*	
Total Expenditure	**6,685**	**8,744**	**30.8**	**7,411**	**18.0**	**Burgeoning fixed costs coupled with low gross margin product sales**
% of Net sales	*77.3*	*84.2*	*695 bps*	*84.2*	*5 bps*	

Source: Company Reports and Citi Investment Research

High Technology Income in 2Q is unsustainable in our view – this income has historically been quite volatile across quarters

Figure 4. Technology Know-how fees (Rs m) – Steady Annual Growth; Skewed Across Quarters



Source: Company Reports

Cipla

Company description

Cipla is a leading pharmaceutical company in India with a strong and profitable business model. The company has a well-diversified portfolio, without any overdependence on a particular segment. It has developed a strong presence in the export market — both in developed and developing countries — and has products registered in more than 140 countries. Furthermore, it has been at the forefront in reverse engineering the latest drugs and active pharmaceutical ingredients. The company has focused its R&D efforts on profitable projects, and tied up with the local players in various markets to de-risk its business model. However, the company lags its peers in discovery-led research. Cipla's business model also represents a low-risk model with the commensurate returns also being moderate.

Investment strategy

We rate Cipla Sell (3L) with a target price of Rs165/share. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, Cipla could face an increasingly uncertain global environment, if the current consolidation process gathers momentum. Its partners, which appear inherently tied up because of their weak product capabilities, may get acquired and the acquirers may not want to source drugs from Cipla. We think Cipla's business model lacks significant value addition, both in terms of innovative research as well as control over the front end in the US and European generics markets. We believe that any re-rating will be contingent on the company making fresh forays into these areas and / or getting acquired at a significant premium. Since the pricing pressure has not been waning in the US or Europe, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players. Cipla, being one of the weaker parts of the supply chain, will bear the brunt, in our view.

Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs165 is based on 20x September 08E earnings. Historically, the stock has traded at 15-30x forward earnings. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector, justified by the lower value addition to the business (lack of its own front-end in the regulated markets and ownership of IPR). There are few signs of this changing. Our target multiple for Cipla's base business is therefore at a 10% discount to the multiple (20x) that we use for its peers such as Ranbaxy, Dr Reddy's and Sun Pharma. However, while we value the latter's patent challenge opportunities separately from the base business, we are unable to do the same for Cipla, given the lack of information on its tie-ups with different partners. Hence, we apply a higher multiple of 20x to base business earnings to factor in any potential "one-off" upsides that may come through from time to time.

Risks

We rate Cipla as Low Risk, as the company has a steadily growing base business and has a visible earning stream. The ongoing dispute regarding alleged overcharging for seven drugs in the domestic market could result in significant cash outflow as well as could impact future profitability. Global consolidation is a risk to the company's supply based model. The new drug policy, if implemented in the current form could also hurt earnings. Key upside risks to our rating and target price include: a) the company doing better operationally than forecast; b) any move to front-end in target markets could give further support to current high valuations; c) any exclusivity for its partners could also sustain the growth momentum beyond our expectations.

Appendix A-1

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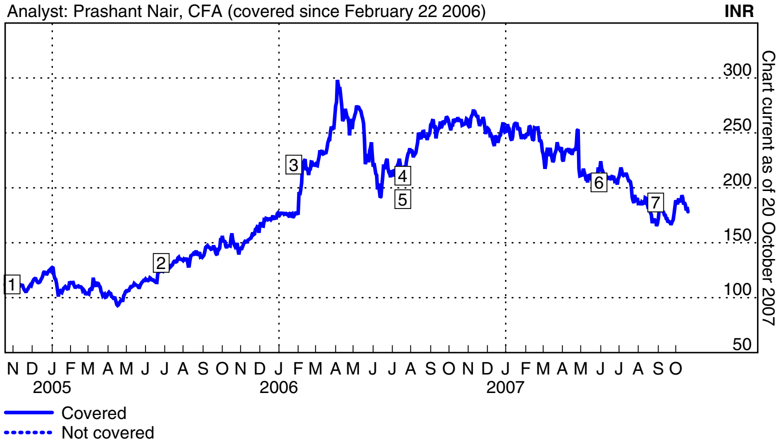
Cipla (CIPL.BO)
Ratings and Target Price History - Fundamental Research
Analyst: Prashant Nair, CFA (covered since February 22 2006)



#	Date	Rating	Target Price	Closing Price
1:	26 Oct 04	3L	*96.00	106.92
2:	27 Jun 05	3L	*116.00	124.12
3:	25 Jan 06	3L	*65.60	174.06
4:	19 Jul 06	3L	*170.00	212.45
5:	19 Jul 06	3L	170.00	212.45
6:	30 May 07	3L	*191.00	214.75
7:	29 Aug 07	3L	*165.00	169.75

*Indicates change.

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