Company Focus

7 March 2008 | 8 pages

Ranbaxy (RANB.BO)

Target price change ☑

Buy: Multiple Positives; Raising Target Price to Rs545/share

- **Raising our target price to Rs545** — We roll over to 20xMarch'09E FDEPS to value its core business and value to its patent challenge pipeline at Rs100/share. Adjusted for NPV of certain FTF upsides, Ranbaxy trades at 18x CY08E FDEPS, attractive in light of its strong growth prospects
- **Poised for better times** — Ranbaxy's strong guidance for CY08 indicates that it is well set to continue the recovery that commenced last year. A strong FTF pipeline, tie-ups to augment its product pipeline and leverage its strong front end, and efforts to move to a more capital efficient model make us positive on Ranbaxy's short as well as long-term prospects.
- **Improving business profile** — Ranbaxy's improving business profile is reflected in: 1) a rising share in high margin emerging market sales; 2) tie-ups to enhance pipeline in niches like biogenerics, oncology & peptides; 3) integration & rapid scale up of Terapia; 4) robust growth in base US business; 5) Strong Para IV pipeline with exclusivities for Valtrex, Tamsulosin & Lipitor.
- **Patent Challenge Pipeline** — We expect Ranbaxy to keep seeking options in line with its target of one FTF launch every year – adding up to a sizeable cash flow stream. It has 30-32 P-IVs with 18 potential FTFs (cum. mkt: US$27bn) and has cemented upsides in CY08 (Imitrex), CY09 (Valtrex) & CY10/11 (Flomax, Lipitor) – cumulative NPV of US$730m. Post these wins, we expect the street to build in some value for the rest of its FTF pipeline as well
- **NCE R&D de-merger** — Ranbaxy's board has approved the de-merger of the NCE research unit of the company. We believe this would lead to an accretion of c7% (net of tax) to our CY08E EPS (pre de-merger)

Buy/Medium Risk	1M
Price (05 Mar 08)	Rs453.60
Target price	Rs545.00
from Rs505.00	
Expected share price return	20.1%
Expected dividend yield	1.1%
Expected total return	**21.3%**
Market Cap	Rs169,263M
	US$4,211M

Price Performance (RIC: RANB.BO, BB: RBXY IN)

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	2,617	7.03	-62.6	64.6	6.9	10.6	1.3
2006A	5,103	12.76	81.7	35.5	7.0	20.3	1.9
2007E	7,863	19.67	54.1	23.1	6.0	28.1	1.9
2008E	8,704	21.77	10.7	20.8	5.2	26.7	2.0
2009E	11,228	28.08	29.0	16.2	4.3	29.2	2.2

Source: Powered by dataCentral

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	64.6	35.5	23.1	20.8	16.2
EV/EBITDA adjusted (x)	53.0	22.4	20.4	14.5	11.7
P/BV (x)	6.9	7.0	6.0	5.2	4.3
Dividend yield (%)	1.3	1.9	1.9	2.0	2.2
Per Share Data (Rs)					
EPS adjusted	7.03	12.76	19.67	21.77	28.08
EPS reported	7.03	12.76	19.67	21.77	28.08
BVPS	65.70	64.68	75.31	87.52	104.97
DPS	6.00	8.50	8.50	9.00	10.00
Profit & Loss (RsM)					
Net sales	53,131	61,382	69,427	78,045	90,542
Operating expenses	-51,149	-54,452	-61,674	-66,834	-76,654
EBIT	**1,982**	**6,930**	**7,753**	**11,211**	**13,888**
Net interest expense	-671	-1,036	-1,443	-1,364	-1,280
Non-operating/exceptionals	633	616	3,661	1,238	1,672
Pre-tax profit	**1,944**	**6,510**	**9,971**	**11,085**	**14,281**
Tax	698	-1,357	-2,070	-2,328	-2,999
Extraord./Min.Int./Pref.div.	-25	-50	-38	-53	-53
Reported net income	**2,617**	**5,103**	**7,863**	**8,704**	**11,228**
Adjusted earnings	2,617	5,103	7,863	8,704	11,228
Adjusted EBITDA	3,427	8,773	9,981	13,916	16,911
Growth Rates (%)					
Sales	-2.5	15.5	13.1	12.4	16.0
EBIT adjusted	-77.4	249.6	11.9	44.6	23.9
EBITDA adjusted	-65.7	156.0	13.8	39.4	21.5
EPS adjusted	-62.6	81.7	54.1	10.7	29.0
Cash Flow (RsM)					
Operating cash flow	**3,771**	**3,512**	**13,834**	**11,304**	**13,645**
Depreciation/amortization	1,445	1,843	2,228	2,706	3,022
Net working capital	-746	-4,492	2,262	-1,522	-1,939
Investing cash flow	**-8,381**	**-19,931**	**-8,349**	**-3,665**	**-7,764**
Capital expenditure	-9,275	-4,358	-4,763	-2,435	-3,275
Acquisitions/disposals	712	-15,803	-3,512	-270	-3,451
Financing cash flow	**7,460**	**15,128**	**-7,085**	**-7,289**	**-5,530**
Borrowings	11,622	19,544	-2,030	-2,100	0
Dividends paid	-3,612	-3,611	-3,612	-3,825	-4,250
Change in cash	**2,851**	**-1,291**	**-1,600**	**351**	**351**
Balance Sheet (RsM)					
Total assets	**59,687**	**84,001**	**88,573**	**95,705**	**107,101**
Cash & cash equivalent	2,430	2,951	1,000	1,000	1,000
Accounts receivable	11,404	15,716	14,264	16,791	19,526
Net fixed assets	26,187	42,534	45,421	45,502	46,106
Total liabilities	**35,051**	**57,808**	**58,091**	**60,290**	**64,653**
Accounts payable	7,714	8,128	8,323	10,925	12,704
Total Debt	20,043	39,556	37,526	35,426	35,426
Shareholders' funds	**24,636**	**26,193**	**30,482**	**35,415**	**42,447**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	6.4	14.3	14.4	17.8	18.7
ROE adjusted	10.6	20.3	28.1	26.7	29.2
ROIC adjusted	6.8	10.2	8.8	13.4	15.8
Net debt to equity	71.5	139.8	119.8	97.2	81.1
Total debt to capital	44.9	60.2	55.2	50.0	45.5

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Multiple Triggers

We are raising our target price for Ranbaxy to Rs545/share as we roll over to 20xMarch'09E FDEPS to value its core business & assign a value of Rs100/share to its patent challenge pipeline. Adjusted for NPV of certain FTF upsides, Ranbaxy trades at 18x CY08E FDEPS, which is attractive in light of the strong growth prospects. We maintain our Buy and re-iterate Ranbaxy as our top pick in our generic coverage universe.

Target price hike reflects growing optimism

We are raising our target price for Ranbaxy by 8% to Rs545/share, reflecting our growing optimism on the company's business.

We have been using the EV/Sales methodology to value Ranbaxy as we believed that the company's cost structure and profitability were not normalised and thus did not reflect the fair value of the company's business. However, over the past two years, the company has improved its EBIDTA margins significantly by 793 bps (CY05-07) through a combination of cost cutting and improving product and market mix. With the company deciding to hive off its NCE R&D unit into a separate company, we believe that the cost structure is now more aligned with that of most generic companies. As such, we shift once again to the P/E v/s earnings CAGR methodology to value Ranbaxy.

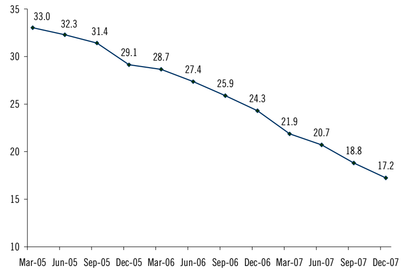
- **Valuing core generics business at Rs445/share**: We value the company's core generics business at 20x 12-month forward (March '09E) earnings in line with the multiple that we use for frontline Indian pharma companies. At 20xMarch'09E earnings, we arrive at a value of Rs445/share for the base generics business.
- **Valuing P-IV/FTF pipeline at Rs100/share**: We also assign a probability adjusted NPV for the company's impressive patent challenge pipeline. Ranbaxy has 30-32 Para-IV filings with 18 potential FTF opportunities (cum. market: US$27bn), which it has been trying to monetize this by entering into settlements/AG deals with innovators and is now in a position to ensure at least one such upside to earnings each year – adding up to a sizeable cash flow stream. It has already cemented upsides in CY08 (Imitrex), CY09 (Valtrex, Flomax) and CY10/11 (Lipitor). These opportunities themselves add up to an NPV of US$874 through settlements or litigation wins. We also build in some additional value for the rest of its FTF pipeline after adjusting it by a probability factor of 20%. Cumulatively, we arrive at a per share value of Rs100/share for Ranbaxy's patent challenge pipeline.

Figure 1. FTF Pipeline/ Opportunities (Rs)

Product	Launch	NPV /share
Lipitor	Apr-10	44
Valtrex	Nov-09	19
Flomax	Mar-10	12
Imitrex	Dec-08	6
Other FTFs (16 products)	Mar-10	19
Total Pipeline		**100**

Source: Citi Investment Research

Figure 2. FII holding in Ranbaxy (%)



Source: Company Reports

Cumulatively, we arrive at a revised target price of Rs545/share for Ranbaxy.

Underowned

Notwithstanding recent buoyancy, Ranbaxy has seen its stock price decline 28% since Jan '05 in absolute terms & underperform the BSE Sensex by 71%, bringing valuations to reasonable levels. Moreover, we highlight that ownership levels are very low, with foreign institutional holdings having fallen from 23% in March'05 to 14% in Dec'07 – at a time when the broader Indian market has seen record FII inflows. As such, we believe that Ranbaxy is a good defensive even from the technical perspective with limited downside on any FII sell off in India.

Ranbaxy

Company description

Ranbaxy is a leading domestic pharmaceutical company with a strong export business complementing its domestic business. It has a vision of becoming a leading generics pharmaceutical company in the global market and, in the long term, a research-led pharmaceutical company. The company already has a presence in several countries, and has developed a complex business model, perhaps the first of its kind in a developing country. Over the past few years, Ranbaxy has grown rapidly and established itself firmly as a leading generics company globally. While the core pharmaceutical business is growing, it has also invested in R&D. The company also has a strong chemicals and animal healthcare business in India.

Investment strategy

We rate Ranbaxy Buy (1M) with a target price of Rs545 (v/s Rs505/share earlier). Ranbaxy is among the few globally diversified and integrated generics companies in the world. The stock has been a major underperformer over the last few years, in the process pulling valuations back to historical lows. Besides attractive valuations, our favorable view on the stock stems from an improving generic portfolio (incl. a strong FTF pipeline), improving sales mix, visible restructuring benefits & greater focus on the core generics business. Finally, as a well diversified global player, Ranbaxy would benefit not only from the off patent cycle in the US & growing genericisation in Europe, but also from the higher growth rates in emerging markets.

Valuation

We had used EV/Sales (3x 12 month forward revenues) to value Ranbaxy as we believe that its cost structure and profitability were not normalised and thus did not reflect the fair value of its business. However, over the past two years, the company has improved its EBIDTA margins significantly by 793 bps (CY05-07) through cost cutting and improving product and market mix. I decided to hive off its NCE R&D unit into a separate company, leading us to believe that the cost structure is now more aligned with that of most generic companies. As such, we shift once again to the P/E v/s earnings CAGR methodology to value Ranbaxy's core business, as we do in the case of most stocks in the Indian pharmaceutical sector. We also add an additional value for the company's impressive patent challenge pipeline on which we have a lot more visibility now than earlier. We value the core generics business (excluding exclusivity upsides) at 20x 12-month forward (March '09E) earnings in line with the multiple that we use for frontline Indian pharma companies such as Glenmark & Cipla. At 20xMarch'09E earnings, we arrive at a value of Rs445/share for the base generics business. We value the company's patent challenge pipeline using a probability-adjusted NPV approach – yielding a value of Rs100/share. Cumulatively, we arrive at a target price of Rs545/share for Ranbaxy.

Risks

We rate Ranbaxy Medium Risk based on our quantitative risk-rating system. The key downside risks that could impede the stock from reaching our target price: 1) Intensifying pricing pressure in the US and European markets; 2) The company paying high multiples to acquire more businesses; and 3) if fears of pricing pressure in Romania play out, the company's Terapia business could face some strain on profitability.

Appendix A-1

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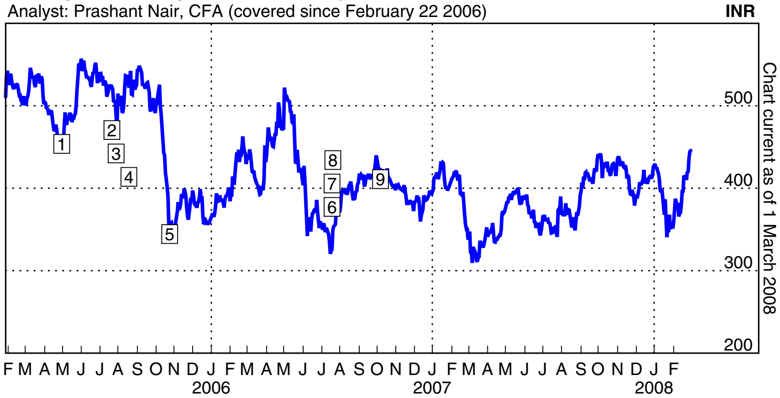
Ranbaxy (RANB.BO)
Ratings and Target Price History - Fundamental Research
Analyst: Prashant Nair, CFA (covered since February 22 2006)



#	Date	Rating	Target Price	Closing Price
1:	29 Apr 05	3M	*422.50	456.42
2:	21 Jul 05	3M	*407.50	522.97
3:	28 Jul 05	3M	407.50	NA
4:	18 Aug 05	3M	*385.00	522.05
5:	25 Oct 05	3M	*363.00	344.40
6:	19 Jul 06	*1M	*402.00	325.90
7:	19 Jul 06	1M	402.00	325.90
8:	20 Jul 06	1M	402.00	349.90
9:	6 Oct 06	1M	*505.00	422.35

*Indicates change.

Covered
Not covered
Rating/target price changes above reflect Eastern Standard Time

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