Company Focus

7 March 2008 | 12 pages

Cadila Healthcare (CADI.BO)

Upgrade to Buy: Protonix Pain Is in the Price

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

- **Upgrade to Buy with TP of Rs364** — Post the significant correction on Teva's 'at risk' launch of generic *Protonix* (pantoprazole) – a key, albeit finite, source of earnings for Cadila. Cadila continues to build a sustainable global generic business, with presence in France, Brazil & India – making it less dependent on the difficult US / UK markets. Our primary concern on Cadila was the high value being ascribed to the pantoprazole earnings; with this situation having corrected itself, we turn positive.
- **Protonix in the price** — After Teva and Sun launched generic pantoprazole at risk in the US market, Cadila has corrected significantly (down 20% over last 6x months) & now trades at 11x FY09E FDEPS (excluding any upside from pantoprazole). Moreover, Cadila's management has indicated that only 20 tonnes out of the 120 tonnes market for pantoprazole API goes to the US market and is at risk of early impairment.
- **Robust growth in key markets** — Cadila's India sales have grown 16% YoY in 9MFY08 (v/s 9% CAGR in FY03-07) and we expect this momentum to sustain over the next 3 years. At the same time, with the French operations having turned profitable & Brazil & US having attained critical size, we expect international markets to start contributing meaningfully to profits as well. Overall, we expect impressive earnings (excluding pantoprazole) growth of 28% CAGR over FY07-10E
- **Coverage shift** — From hereon, Chirag Dagli has primary coverage of this stock.

Buy/Medium Risk	**1M**
from Sell/Low Risk	
Price (05 Mar 08)	Rs246.00
Target price	Rs364.00
from Rs335.00	
Expected share price return	48.0%
Expected dividend yield	1.4%
Expected total return	**49.4%**
Market Cap	Rs30,901M
	US$769M

Price Performance (RIC: CADI.BO, BB: CDH IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	1,524	12.13	25.4	20.3	4.4	23.7	1.2
2007A	2,338	18.61	53.4	13.2	3.6	29.9	1.4
2008E	2,632	20.95	12.6	11.7	2.9	27.3	1.6
2009E	3,380	26.91	28.4	9.1	2.3	28.2	1.6
2010E	4,141	32.96	22.5	7.5	1.8	27.4	1.6

Source: Powered by dataCentral

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

Prashant Nair, CFA[1]
+91-22-6631-9855
prashant.nair@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)	20.3	13.2	11.7	9.1	7.5
EV/EBITDA adjusted (x)	12.0	9.9	8.0	6.4	5.0
P/BV (x)	4.4	3.6	2.9	2.3	1.8
Dividend yield (%)	1.2	1.4	1.6	1.6	1.6
Per Share Data (Rs)					
EPS adjusted	12.13	18.61	20.95	26.91	32.96
EPS reported	12.13	18.61	20.95	26.91	32.96
BVPS	55.64	68.91	84.67	106.40	134.17
DPS	3.00	3.50	4.00	4.00	4.00
Profit & Loss (RsM)					
Net sales	14,845	18,288	23,360	27,389	31,683
Operating expenses	-12,747	-15,590	-19,978	-23,264	-26,609
EBIT	**2,098**	**2,698**	**3,382**	**4,125**	**5,074**
Net interest expense	-251	-223	-253	-135	-243
Non-operating/exceptionals	-79	264	29	28	27
Pre-tax profit	**1,768**	**2,739**	**3,158**	**4,018**	**4,858**
Tax	-243	-324	-522	-634	-713
Extraord./Min.Int./Pref.div.	-1	-77	-4	-4	-4
Reported net income	**1,524**	**2,338**	**2,632**	**3,380**	**4,141**
Adjusted earnings	1,524	2,338	2,632	3,380	4,141
Adjusted EBITDA	2,877	3,521	4,344	5,153	6,142
Growth Rates (%)					
Sales	16.2	23.2	27.7	17.3	15.7
EBIT adjusted	22.5	28.6	25.3	22.0	23.0
EBITDA adjusted	18.5	22.4	23.4	18.6	19.2
EPS adjusted	25.4	53.4	12.6	28.4	22.5
Cash Flow (RsM)					
Operating cash flow	**1,044**	**2,207**	**3,062**	**3,727**	**4,483**
Depreciation/amortization	779	823	963	1,028	1,068
Net working capital	-1,352	-763	-536	-685	-730
Investing cash flow	**-1,401**	**-1,674**	**-850**	**-850**	**-850**
Capital expenditure	-1,155	-1,876	-850	-850	-850
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**116**	**-295**	**-652**	**-652**	**-652**
Borrowings	597	103	0	0	0
Dividends paid	-481	-398	-652	-652	-652
Change in cash	**-241**	**238**	**1,561**	**2,225**	**2,981**
Balance Sheet (RsM)					
Total assets	**15,534**	**19,915**	**23,461**	**27,402**	**32,183**
Cash & cash equivalent	438	990	2,551	4,776	7,757
Accounts receivable	1,990	2,784	3,504	4,108	4,752
Net fixed assets	8,329	9,783	9,670	9,492	9,274
Total liabilities	**8,538**	**11,118**	**12,680**	**13,889**	**15,177**
Accounts payable	2,404	4,588	5,840	6,847	7,921
Total Debt	4,432	4,535	4,535	4,535	4,535
Shareholders' funds	**6,996**	**8,797**	**10,781**	**13,514**	**17,006**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	19.4	19.3	18.6	18.8	19.4
ROE adjusted	23.7	29.9	27.3	28.2	27.4
ROIC adjusted	16.7	18.2	19.8	23.0	27.5
Net debt to equity	57.1	40.3	18.4	-1.8	-18.9
Total debt to capital	38.8	34.0	29.6	25.1	21.1

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or +852-2501-2791

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Protonix in the Price

We upgrade Cadila to Buy, Medium Risk from Sell, Low Risk with a revised target price of Rs364/share, post the significant correction on Teva's 'at risk' launch of generic *Protonix* (pantaprazole) – a key, albeit finite, source of earnings for Cadila. At the same time, the company continues to build a sustainable global generic business, with presence in France, Brazil & India – making it less dependent on the difficult US / UK markets. Our primary concern on Cadila was the high value being ascribed to the pantaprazole earnings; with this situation having corrected itself, we turn positive. We however increase our risk rating to Medium in order to account for the significant challenges in the generics business.

What has changed?

We upgrade Cadila Healthcare from Sell, Low Risk (3L) to Buy, Medium Risk (1M) with a revised target price of Rs364/share, based on the following factors:

- **Recent correction factors in the worst**: The stock has corrected (down 20%) in the last 6 months underperforming both the Sensex (by 25%) as well as the CIR Pharma index (25%) after Teva and Sun launched generic pantoprazole at risk in the US market – given that Cadila had a JV with the innovator to supply key intermediates for the product. The stock now trades at 11x FY09E FDEPS (excluding any upside from pantoprazole). Moreover, Cadila's management has indicated that only 20 tonnes out of the 120 tonnes market for pantaprazole API goes to the US market and is at risk of early impairment.

- **Building a sustainable generics model**: Cadila's exposure to India (60% of FY08 revenues) and Brazil (5% of FY09 revenue) and relatively lower exposure to the tough US generic market augurs well for near term earnings visibility. Besides, operations in France have also turned around and are likely to start contributing meaningfully to the bottom line.

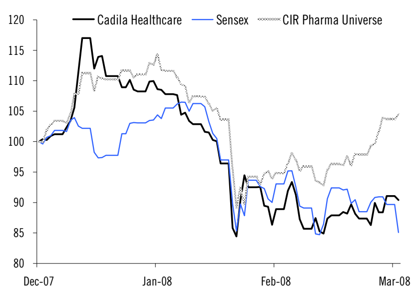
Our prime concern on the stock related to the high valuations being ascribed to a finite earnings stream (pantoprazole intermediate supplies) – with this having disappeared, we upgrade to Buy, Medium Risk, with a revised target price of Rs364/share.

Figure 1. Stock Performance

	Absolute	Relative to Sensex	Relative to CIR pharma
1 Month	2%	11%	-8%
3 Month	-10%	6%	-13%
6 Month	-20%	-25%	-25%
9 Month	-22%	-34%	-26%
12 Months	-15%	-36%	-28%

Source: Powered by dataCentral

Figure 2. Cadila – Price Performance



Source: Citi Investment Research

Protonix pain … in the price

The Cadila stock has corrected significantly on the back of approvals for Teva and Sun Pharma to sell generic versions of Protonix (pantaprazole) in the US market. Cadila has a highly profitable joint venture (JV) with the innovator (Nycomed – formerly Altana) to supply intermediates for Protonix. As such, a generic entry in Protonix could significantly impair the company's profitability and growth prospects.

The story so far

Teva and Sun Pharma had challenged the Protonix patents and, on expiry of their 30 month stays, received final approval from the US FDA to launch their generic versions of the product. With a US court also denying Wyeth / Nycomed's bid for a preliminary injunction, the generic companies were free to launch the product "at risk" – implying an early end to patent protection and erosion of price and the innovator's market share. Teva launched the product at risk in January 2008 (although it has stopped supplies since then) and Sun Pharma followed suit after Wyeth launched an authorized generic.

What is at stake for Cadila?

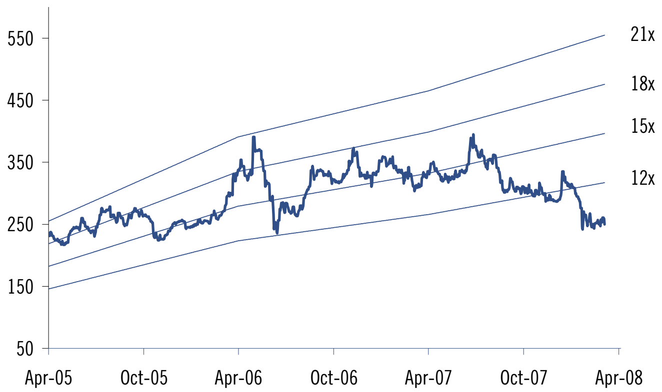
The 50:50 JV with Nycomed is a highly profitable venture for Cadila and has significantly propped up the company's profitability and return ratios. Although it contributes marginally to the company's revenues (c 5% in FY07), net margins are very high (79% in FY07), leading to it forming a significant part of Cadila's bottomline. The JV formed 31% of Cadila's net profit in FY07. As such, any impairment of this business would have a significant negative impact on the company's financials.

The Cadila's management at an earnings call indicated that the US accounted for only 20 tonnes out of the total 120 tonnes market for pantoprazole – and was therefore at risk of early genericisation. Also, It could also potentially become the sole supplier in Europe (1 of 2 now) & was in discussions to add more products to the JV. This appears better than the high risk scenario we had envisaged although we find it highly unlikely that the JV would be able to maintain its current high profitability post genericisation.

All in the price....

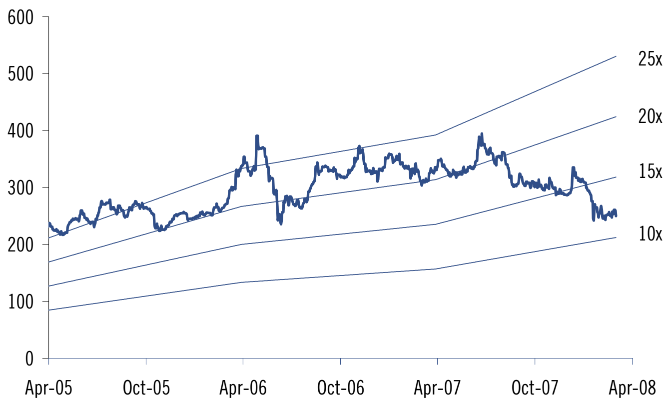
Valuations at 11x FY09 FD EPS excluding the Nycomed JV are comforting and leave limited downside in case of a potential launch of generic *Protonix*. We believe, at the current price the value of Protonix is already zero and expect no further decline on this count. We had valued Cadila's share of the JV earnings at Rs16/share, which we maintain given that there would only be a maximum of two generic players in the market over the next year.

Figure 3. Cadila P/E bands



Source: Citi Investment Research

Figure 4. Cadila P/E bands (ex-Protonix)



Source: Citi Investment Research

Generics – building a sustainable business

Cadila has taken several small steps to build its generics business and is now present in the markets of India, the USA, Brazil and France. While the Indian formulations and consumer business provides steady growth and cash flows, US and Brazil provide acceleration to the growth in generic business. In France, Cadila has now started making profits after some hiccups over the last 2 years. Efforts in Japan are nascent, however ahead of competition. We believe that Japan could be a long term growth driver given the low generic penetration in the market and pro-generic outlook of the government due to the increasing healthcare costs.

Figure 5. Cadila – Snapshot of the Generic Business

Geography	Revenue Mix (FY08E)	So far	What next?	CIR Comments
India Formulations and API	50.8%	9% CAGR over FY03-07	growth to accelerate to 16% over FY07-10E	Strong franchise in India with presence in CVS, CNS, Pain etc. Chronic accounts for c27% of domestic formulations
France	7.8%	Turned profitable in 2Q FY08	Expect improved profitability on revenue scale up to start contributing to overall profitability	Front end presence and the tie up with Evolupharm gives an assured customer
Brazil	5.1%	Small base until FY07; Nikkho acquisition provides a boost	Strong growth of +30% in the Brazilian market;	Acquisition of Nikkho to provide critical mass and front end capabilities
US	6.9%	Strong momentum	Momentum to continue on product launches	Distribution tie up with Mallinckrodt helps pushing more products
Japan	0.0%	Nascent stage	Long term growth driver	JV with Nippon

Source: Company Reports and Citi Investment Research

Brazil – inorganic boost

Cadila acquired Nikkho in Brazil for US$30m. As part of the acquisition, Cadila has got a manufacturing plant, sales force of 125 people and product basket of 13 branded generic products across various therapies like general medicine, pediatrics, gynecology, neurology, gastroenterology, otolaryngology, respiratory and dermatology. Nikkho also has about 50 registered brands which are yet to be launched. Nikkho recorded sales of US$26m in CY06 and is a profitable operation at the EBITDA and net level. Cadila has paid 1.4x EV/Sales and will fund this acquisition through debt.

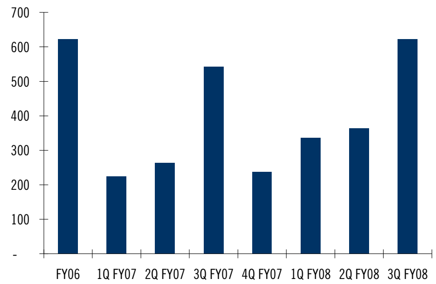
We believe that Brazil is a difficult market to operate in due to the presence of large number of domestic manufacturers of which 4 large producers account for c80% of the generic market. Moreover, the local manufacturers have the local know how of dealing with bureaucracy and the local government also favours them. As such the tough operating environment acts as an entry barrier for other players. Among the Indian companies, Ranbaxy and Glenmark have a significant front end presence in Brazil.

Cadila was selling about 13 non branded generic products in Brazil. Nikkho will provide a boost to Cadila's effort to grow in this fast growing US$500m market and give access to relationship with 60,000 medical practitioners in Brazil. It will also allow Cadila to tap other markets in Latin America over the longer term. We believe, Brazil is a key market for generics and Nikkho will stand Cadila in good stead.

France – on the mend

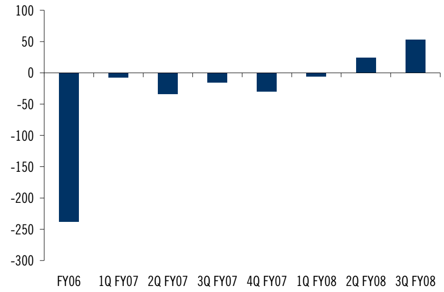
After selling the branded generic business in FY06, Cadila focused on the generic business only in France. Its agreement with Evolupharm provided access to >2000 pharmacies in France and thereby providing a large buyer for Cadila's products. Since then, the operations have shown a turnaround and has achieved break even in 2QFY08. We believe that as the revenues scale up it will improve profitability and start contributing meaningfully to consolidated profitability. Overall, Cadila now sells 25 products in France.

Figure 6. Revenue in France (Rs m)



Source: Citi Investment Research

Figure 7. Net Profit in France (Rs m)

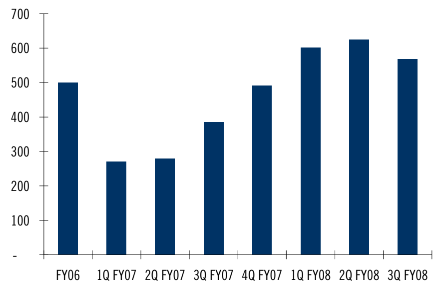


Source: Citi Investment Research

US Generics – gathering momentum

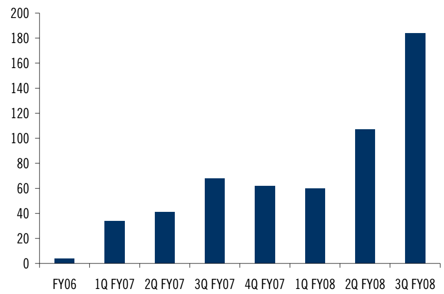
Cadila started its US operation in FY06 and has since then steadily grown this business. Cadila has a distribution tie up with Mallinckrodt for the US market and has identified close to 60 products for the market. Products are sold under joint label the Mallinckrodt and Cadila share the revenues and profits. We believe, this strategy allows Cadila to focus on manufacturing and push a larger number of products into the market and on a much lower cost base. However, Cadila also does sell on its own to some customers.

Figure 8. Revenue in US (Rs m)



Source: Company Reports and CIR

Figure 9 Net Profit in US (Rs m)



Source: Company Reports and CIR

We note that all the products that Cadila sells currently in the US market are high competitive products with most of them having 8-10 other generic companies. As such, we are cautious about the non differentiated portfolio/ vanilla generic nature of Cadila's portfolio in a competitive market like the US. Moreover, Cadila has also not been successful in any Para IV opportunities, which remain instrumental in augmenting cash flows for the US market.

Lack of differentiation in the portfolio as seen from the large number of competitors in most of the products

Figure 10. Cadila – US Generics Portfolio

Product	Brand	Number of players (number of Indian players)
Amlodipine Besylate	Norvasc	22 (6)
Atenolol	Tenormin	16 (2)
Azathioprine	Imuran	4 (0)
Benzonatate	Tessalon	5 (0)
Carvedilol	Coreg	16 (6)
Clindamycin Hydrochloride	Cleocin	6 (1)
Haloperidol	Haldol	4 (0)
Hydroxychloroquine Sulfate	Plaquenil	6 (0)
Meloxicam	Mobic	23 (6)
Metformin Hydrochloride	Fortamet	21 (6)
Naproxen	Naprosyn	12 (1)
Paroxetine Hydrochloride	Paxil	7 (2)
Ribavirin	Rebetol	5 (0)
Sertraline Hydrochloride	Zoloft	19 (6)
Simvastatin	Zocor	10 (4)
Warfarin Sodium	Coumadin	7 (0)
Zonisimide	Zonegran	17 (4)

Source: Citi Investment Research

Mayne JV for oncology – on course, but guidance is aggressive

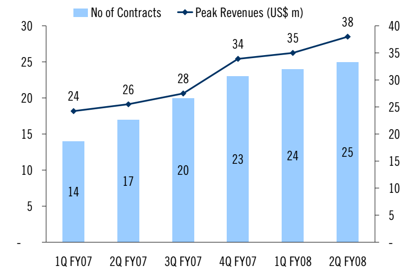
Cadila's JV with Mayne for oncology drugs is on course with filings being made currently. The management has indicated that the plant will be ready by end of FY08 and the revenues to start flowing from FY09 onwards.

The management has guided that the Mayne JV will make for the loss of earnings due to the patent expiry of Protonix in 2010. We remain skeptical about this as the Protonix JV is a high margin business and the Mayne JV being a generic business will have to earn a lot more in terms of revenues to attain the same level of profits.

CRAMS – still early days!

Cadila ventured into CRAMS in FY05. Despite bagging several small contracts, it does not have any significantly large contract (except the JV with Nycomed) that can have a meaningful impact on its earnings. As at the end of 2Q FY08, it had 24 contracts with peak revenue potential of US$ 35m which is c6% of FY08E revenues.

Figure 11. CRAMS Contracts and Peak Revenues (no, US$ m)



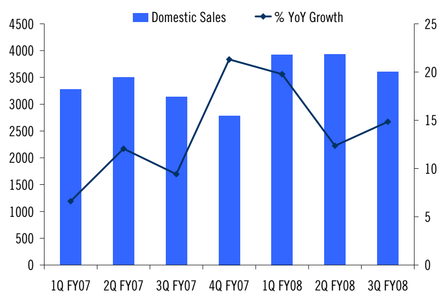
Source: Company Reports

Domestic Business – Accelerating growth

Cadila has been steadily growing it domestic formulation business and the consumer products business. We expect increased momentum in this business in line with the buoyancy in the industry and expect a CAGR of 16% over FY07-10E as against 9% over FY04-07. Besides, in the current environment of an appreciating INR, the domestic business (c60% of FY08 revenues) provides a much higher visibility and stability to Cadila's earnings v/s peers.

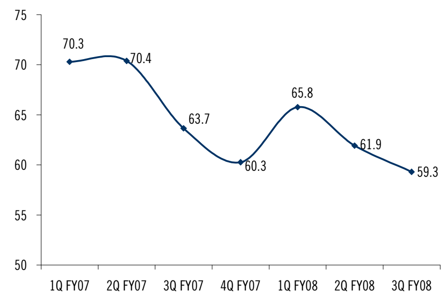
Recently the domestic market has shown good growth, 2Q FY08 growth was muted due to the high base of last year on higher sales due to chikungunya etc

Figure 12. Domestic Sales (Rs m), YoY Growth (%)



Source: Citi Investment Research

Figure 13. Domestic Sales as % of Total Sales



Source: Citi Investment Research

NCE R&D – a potential catalyst

Cadila's innovative R&D efforts have not been in the limelight. It has 5 molecules in its NCE R&D pipeline and its strategy is to take these NCEs till Phase II before looking for a partner. It employs close to 250 scientists for its NCE research in various indications such as diabetes, dyslipidemia, obesity and inflammation. A closer look at its R&D pipeline indicates no likely near term announcement on any development deal.

We have seen a trend recently on the part of Indian companies such as Sun Pharma (SUN.BO - Rs1,319.00; 1L) and Nicholas Piramal (NICH.BO - Rs273.40; 1M) to hive NCE R&D into a separate company. Although Cadila does not appear inclined to separate its NCE R&D effort (it currently spends around 1.5-2% sales on NCE R&D), we believe that the street would start factoring in some value by way of a higher multiple in order to treat it on par with earnings of companies that have taken out the R&D cost from their P&L. Currently we are not giving any value to the R&D program run by Cadila in line with our approach to value only molecules that have been validated by a licensing deal.

Figure 14. Cadila's NCE R&D Pipeline

Compound	Therapeutic category	Status
ZY H 1	Dyslipidemia	Phase II clinical evaluation.
ZY I 1	inflammation and pain	Phase II clinical trials.
ZY O 1	Anti-Obesity	Phase I trials.
ZY H 2	Type 2 diabetes	Phase I trials
ZY H 7	Dyslipidemia and metabolic disorders	IND has been filed

Source: Company Reports and Citi Investment Research

Apart from these 5 molecules, Cadila is also working on 4 other leads for diabetes, arthritis, dyslipidemia and atherosclerotic plaques. Additionally, Cadila is also working on several biological entities for treatment of arthritis, obesity and cardio vascular diseases.

Cadila's NCE effort is reasonable relative to peers given its size. While we do not give an express value to this effort, we believe this may have potential to surprise

Figure 15. Comparison of NCE research divisions of Indian Companies

	No Of Scientists	Absolute FY07 Spend	book value	Pipeline
Nicholas	298	700	900	13
Sun Pharma advanced research		18	546	9
Ranbaxy	300	400	na	8-10
Cadila	250	282	na	5

Source: Company Reports and CIR Estimates

Cadila Healthcare

Cadila Healthcare (Zydus Cadila) is an offshoot of the Cadila group, founded in 1952. It split into Cadila Pharma and Cadila Healthcare in 1995. A leading participant in the Indian market, Cadila consolidated its position with the acquisition of Recon Healthcare (1999) and German Remedies (2001). For the overseas markets, it has adopted a combination of the contract manufacturing and generics strategy. As part of its generics strategy, it acquired Alpharma's arm in France in 2003, and also started filing its own ANDAs and DMFs in the US market. On the contract manufacturing front, it has a profitable JV with Altana, and has recently entered into a series of other smaller contracts.

Investment strategy

We rate Cadila Healthcare Buy, Medium Risk (v/s Sell/Low Risk earlier) with a target price of Rs364/share (v/s Rs335/share) as we believe its recent correction post the genericistation of protonix has made valuations undemanding at 11x FY09 FD EPS (excluding Protonix). We believe, Cadila is building a steady and sustainable generics business model with presence in India, France, US and Brazil and some nascent efforts in Japan. Besides, Its NCE R&D effort could bring some upside in case of a move to unlock value in line with some its peers.

Valuation

Our target price for Cadila is Rs 364 (v/s Rs335 earlier). We value Cadila on a sum-of-parts basis by using DCF for the Zydus Altana JV and P/E relative to growth for the rest of the business. We value Cadila's non-Altana business on a P/E basis in view of the healthy growth expected in earnings. We use 16x 12-month forward earnings to value the business - a 20% discount to sector leaders and towards the lower end of our target multiples for our mid cap universe. This is to account for the fact that Cadila's return ratios would be under pressure post the genericisation of Protonix. At 16x March 09E earnings we value the non-Zydus Altana business at Rs346/share (v/s Rs316/share earlier). We value the Zydus Altana JV on DCF given that we expect this business to witness sharp erosion when Protonix goes off patent. We use a three-stage DCF model to value this business with explicit forecasts to FY10, beyond which we assume 95% decline in cash flows (on patent expiry) for one year and 5% terminal growth. Based on the above assumptions and a 12.5% discount rate, we value Cadila's stake in the JV at Rs17/share. We thus arrive at a sum-of-the-parts value of Rs364/share.

Risks

We raise our risk rating for Cadila from Low risk to Medium risk given execution hurdles to plug the earnings gap that the genercisation of Protonix will create for Cadila. This is in contrast to the Low Risk according to our quantitative risk-rating system. The main downside risks to our target price include: 1) Greater-than-anticipated price erosion / competition in the US; and 2) Break-up of any of its alliances. The main upside risks to our target price include: 1) Cadila may be able to bag sizable contract manufacturing deals; 2) Any value accretive acquisition by the company in Europe.

Appendix A-1

Analyst Certification

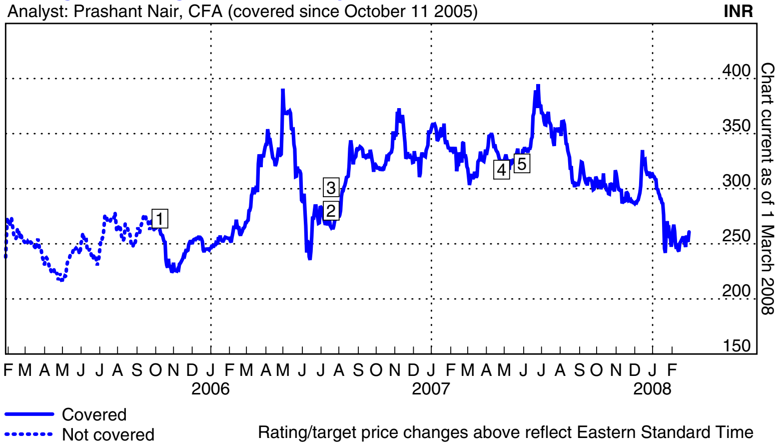
Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Cadila Healthcare (CADI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since October 11 2005)



#	Date	Rating	Target Price	Closing Price
1:	10 Oct 05	3L	208.00	262.50
2:	19 Jul 06	3L	*272.00	264.75
3:	19 Jul 06	3L	272.00	264.75
4:	26 Apr 07	3L	272.00	326.55
5:	30 May 07	3L	*335.00	328.25

*Indicates change.

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