

Cipla

HOLD

Downgrade from BUY

Rs253

Pharmaceuticals

Sluggish gait

Reason for report: Recommendation change

Earnings revision

(%)	FY08E	FY09E
Sales	↓ 6.8	↓ 8.6
EBITDA	↓ 23.4	↓ 21.0
EPS	↓ 16.6	↓ 15.0

Shareholding pattern

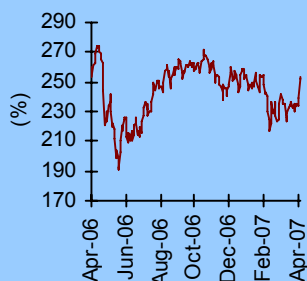
	Sep '06	Dec '06	Mar '07
Promoters	39.4	39.4	39.4
Institutional investors	27.2	27.8	28.2
MFs and UTI	3.8	3.4	3.3
Insurance Cos.	7.3	8.1	8.1
FII	16.2	16.4	16.8
Others	33.4	32.8	32.5

Source: NSE

Cipla's Q4FY07 results were disappointing with recurring net profits declining 34% YoY to Rs1.26bn, significantly below our and Street estimates. This was mainly on account of much lower exports and EBITDA margin (which dipped to a four-year low of 15.7%). The decline in EBITDA margin was due to worsening revenue mix and higher costs as regards R&D, power & fuel and one-time repairs. Besides, the company has given a growth guidance of 10-12% sales and sustaining margins at FY07 levels, implying a 10-12% YoY EPS growth in FY08E. Consequently, we have downgraded EPS estimates 17% & 15% in FY08E & FY09E respectively. We have also lowered fair value estimate to Rs240/share from Rs327/share. Though Cipla's business model is low-risk, the earnings volatility in the recent past and reclusive management (leading to lack of visibility) are two main concerns. We downgrade the stock to HOLD from Buy on the back of above mentioned factors and expensive valuations (FY08E P/E of 25x).

- ▶ **Disappointing Q4FY07 results.** Cipla's consolidated recurring net profits dipped 34% YoY to Rs1.26bn in Q4FY07 against our 22% growth estimates. This stark difference is attributable to 27% dip in API exports and lower-than-expected dosage form exports, which grew just 17% YoY versus 30%+ average in the past seven quarters, resulting in almost flat exports at Rs5.3bn. Domestic sales growth was healthy at 14% to Rs4bn. EBITDA margin crashed 814bps to a four-year low of 15.7% on account of poor sales mix (rapid growth in low-margin anti-retroviral) and significantly higher costs as regards R&D, power & fuel and one-time repair.
- ▶ **Low-risk, robust business model.** Cipla's business model is based on partnerships, its core strength in chemistry and strong operating & cost discipline. It has not ventured into risky businesses such as NCE/NDDS research and generics (para IVs). While this has helped the company contain risks, it has also resulted in earnings volatility due to dynamic, competitive landscape. Consequently, we expect deceleration in EPS CAGR to 21% in FY07-09E versus 36% in FY05-07.
- ▶ **Downgrade to HOLD.** Our argument is not just based on Q4FY07 disappointing results; we downgrade Cipla to HOLD from BUY due to the underlying earnings volatility, reclusive management and lack of visibility on strategy plans, and expensive valuations at FY08E P/E of 25x.

Price chart



Market Cap	Rs197bn/US\$4.8bn	Year to Mar	FY06	FY07P	FY08E	FY09E
Reuters/Bloomberg	CIPL.BO/CIPLA IN	Revenue (Rs mn)	29,814	35,787	40,856	47,658
Shares Outstanding (mn)	777	Net Income (Rs mn)	6,182	6,528	7,763	9,599
52-week Range (Rs)	275/191	EPS (Rs)	8.0	8.4	10.0	12.3
Free Float (%)	60.6	% Chg YoY	75.3	5.6	18.9	23.7
FII (%)	16.8	P/E (x)	31.8	30.1	25.3	20.5
Daily Volume (US\$/000)	5,800	CEPS (Rs)	9.0	9.7	11.6	14.2
Absolute Return 3m (%)	1.9	EV/E (x)	26.0	23.9	20.6	16.9
Absolute Return 12m (%)	(3.5)	Dividend Yield (%)	0.9	1.0	1.2	1.4
Sensex Return 3m (%)	0.1	RoCE (%)	28.6	22.2	21.4	22.6
Sensex Return 12m (%)	19.2	RoE (%)	33.2	24.2	21.7	22.9

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Earnings revision

Key reasons for earnings downgrade are:

- Cipla, possibly for the first time ever, disclosed earnings guidance – FY08 sales growth at 10-12% and maintaining FY08 margins at FY07 levels (EBITDA at 23% and NPM at 18.5% of sales). This implies a PAT growth of 10-12% YoY in FY08E. This growth is less than half of past two years' average of 36%. Hence, we are downgrading FY08 and FY09 earnings.
- A 27% YoY decline in API exports in Q4FY07 versus our estimate of 20% growth. We were aware that Cipla's growth would be muted given the high base of API supplies (sertralin and finasteride) to its partner Teva in FY06. Despite this, in the first nine months of FY07, the company recorded a healthy 14% rise in API exports. Consequently, we have reduced our API exports forecast for the next two years.
- Dosage form exports grew only 17% YoY compared with 30-35% growth band achieved in the first nine months of FY07 and FY06. Hence, we have trimmed our FY08 and FY09 growth estimates.
- EBITDA margin crashed to a four-year low of 15.7% on account of: i) poor sales mix as contribution from low-margin products increased (e.g. anti-retroviral), ii) significantly higher investments in product filings and bio-studies for the developed markets (though this is positive from a medium-term perspective, it will pressurise margins in the interim), iii) one-time repair costs and iv) higher power & fuel and travel expenditure. As a result, we have downgraded EBITDA margin estimates to 23-24% in the next two years from 25-26%.

Consequently, we have downgraded EPS estimates 17% & 15% in FY08E & FY09E respectively. Based on the above mentioned factor, deceleration in EPS CAGR (21% during FY07-09E versus 36% during FY05-07) and likely worsening of investor perception, we have cut fair value estimate to Rs240/share (by applying eight-year average one-year forward P/E at 24x to FY08 EPS) from Rs327/share.

Table 1: Earnings revision

(Rs mn)

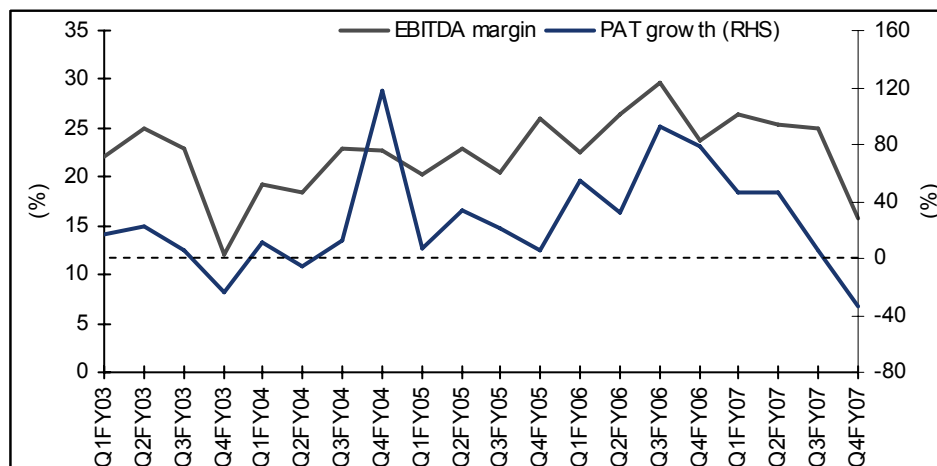
	FY08E			FY09E		
	Old	Revised	% chg	Old	Revised	% chg
Operating Income	43,825	40,856	(6.8)	52,170	47,658	(8.6)
EBITDA	12,368	9,474	(23.4)	14,497	11,450	(21.0)
PAT	9,306	7,763	(16.6)	11,294	9,599	(15.0)
EPS (Rs)	12.0	10.0	(16.6)	14.5	12.3	(15.0)

Source: i-SEC Research

Earnings growth and margin volatility

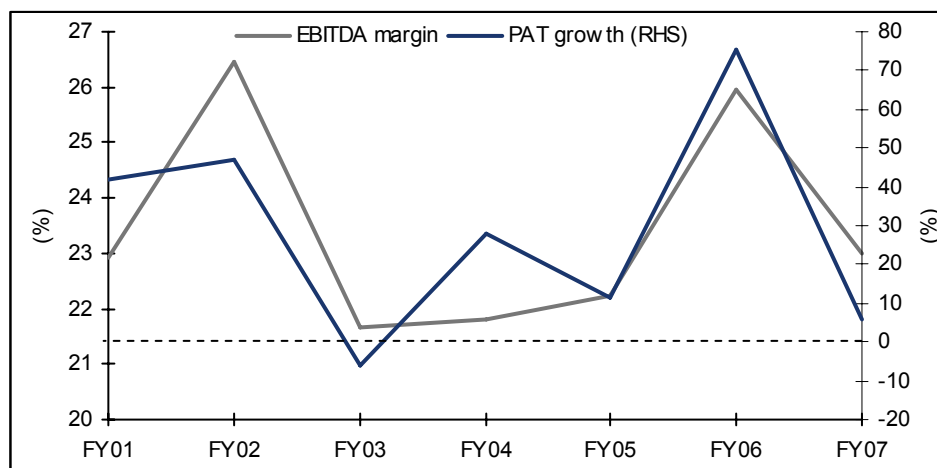
Despite a low-risk business model, Cipla's recurring PAT growth and EBITDA margin have been volatile in the past (Chart 1 and 2). This combined with reclusive management makes it difficult to predict future earnings with confidence – Q4FY07 results are case in point.

Chart 1: Quarterly EBITDA margin and YoY PAT growth trend



Source: Company data, i-SEC Research

Chart 2: Yearly EBITDA margin and YoY PAT growth trend



Source: Company data, i-SEC Research

Table 2: Q4FY07 results review*(Rs mn, year ending March 31)*

	Q4FY07	Q4FY06	% chg (YoY)	FY07	FY06	% chg (YoY)
Gross Sales	9,291	8,762	6.0	35,330	30,197	17.0
Excise	219	231	(5.3)	884	1,223	(27.7)
Net Sales	9,071	8,530	6.3	34,447	28,974	18.9
Other Operating Income	313	296	6.0	1,340	839	59.7
Total Operating Income	9,385	8,826	6.3	35,787	29,814	20.0
Raw Materials	4,975	4,116	20.9	17,280	13,174	31.2
Personnel Cost	433	426	1.8	1,843	1,508	22.2
Other Expenses	2,507	2,184	14.8	8,437	7,392	14.1
Total Expenses	7,915	6,725	17.7	27,560	22,073	24.9
EBITDA	1,470	2,101	(30.0)	8,227	7,740	6.3
Interest	13	33	(60.8)	70	114	(39.1)
Depreciation	261	250	4.3	1,041	802	29.8
Other Income	221	170	29.8	811	380	113.6
Recurring pre-tax income	1,417	1,988	(28.7)	7,928	7,204	10.1
Extraordinary items (Net)	-	-	-	80	(106)	-
Taxation	160	80	99.4	1,400	1,022	37.0
Reported Net Income	1,257	1,908	(34.1)	6,608	6,076	8.8
Recurring Net Income	1,257	1,908	(34.1)	6,528	6,182	5.6
Ratios (%)			bps			bps
EBITDA margins	15.7	23.8	(814)	23.0	26.0	(297)
Net profit margins	13.4	21.6	(822)	18.2	20.7	(249)

Source: Company data, i-SEC Research

Table 3: Revenue mix*(Rs mn, year ending March 31)*

	Q4FY07	Q4FY06	% chg (YoY)	FY07	FY06	% chg (YoY)
Domestic sales	3,997	3,495	14.4	17,523	15,027	16.6
Exports - Dosage form	3,879	3,320	16.8	13,062	10,315	26.6
Exports - API	1,415	1,946	(27.3)	4,745	4,855	(2.3)
Total export	5,293	5,266	0.5	17,807	15,170	17.4
Total product sales	9,291	8,762	6.0	35,330	30,197	17.0
Technology/fees	242	62	291.6	766	416	84.2
Others*	71	234	(69.5)	575	528	8.8
Total Gross Revenues	9,604	9,057	6.0	36,671	31,153	17.7
Exports/total product sales (%)	57.0	60.1	(3.1)	50.4	50.3	0.1

Source: Company data, i-SEC Research; * includes income from US partners

Financial Summary

Table 4: Profit and Loss Statement
(Rs mn, year ending March 31)

	FY06	FY07	FY08E	FY09E
Operating Income	29,814	35,787	40,856	47,658
of which Exports sales	15,182	17,807	20,900	25,641
of which Domestic sales	14,631	17,980	19,956	22,018
Operating Expenses	22,073	27,560	31,382	36,208
EBITDA	7,740	8,227	9,474	11,450
% margins	26.0	23.0	23.2	24.0
Depreciation & Amortisation	802	1,041	1,215	1,410
Gross Interest	114	70	77	88
Other Income	380	811	1,171	1,340
Recurring PBT	7,204	7,928	9,353	11,293
Extraordinaries (Net)	(106)	80	-	-
Less: Taxes	1,022	1,400	1,590	1,694
Net Income (Reported)	6,076	6,608	7,763	9,599
Recurring Net Income	6,182	6,528	7,763	9,599

Source: Company data, i-SEC Research

Table 5: Balance Sheet
(Rs mn, year ending March 31)

	FY06	FY07P	FY08E	FY09E
Assets				
Total Current Assets	22,923	28,255	34,382	42,549
of which cash & cash eqv.	445	866	2,322	3,928
Total Current Liabilities & Provisions	9,082	11,326	13,327	16,070
Net Current Assets	13,841	16,929	21,055	26,478
Investments	224	4,624	5,124	5,924
Net Fixed Assets	11,436	12,395	13,180	13,771
of which Capital Work-in-Progress	870	400	400	400
Total Assets	25,501	33,949	39,360	46,173
Liabilities				
Borrowings	4,689	823	800	750
Deferred Tax Liability	980	980	980	980
Equity Share Capital	600	1,555	1,555	1,555
Face Value per share (Rs)	2	2	2	2
Reserves & Surplus*	19,140	30,499	35,933	42,796
Net Worth	20,812	33,126	38,560	45,423
Total Liabilities	25,501	33,949	39,360	46,173

*excluding revaluation reserves

Source: Company data, i-SEC Research

Table 8: Quarterly trends
(Rs mn, year ending March31)

	Jun-06	Sep-06	Dec-06	Mar-07
Net sales	8,636	8,961	8,805	9,385
% growth (YoY)	30.3	33.4	12.8	6.3
EBITDA	2,289	2,276	2,193	1,470
EBITDA margin (%)	26.5	25.4	24.9	15.7
Other income	140	190	261	221
Extraordinaries (Net)	80	0	0	0
Net profit	1,624	1,803	1,844	1,257

Source: Company data, i-SEC Research

Table 6: Cash Flow Statement
(Rs mn, year ending March 31)

	FY06	FY07P	FY08E	FY09E
Operating Cash flow	6,214	6,758	7,807	9,668
Working Capital Changes	(3,805)	(2,668)	(2,670)	(3,816)
Capital Commitments	3,652	6,400	2,500	2,800
Free Cash Flow	(1,244)	(2,310)	2,637	3,052
Cash flow from Investing Activities	(2,886)	(2,081)	(2,361)	(2,775)
Issue of Share Capital	380	811	1,171	1,340
Buyback of shares	-	955	-	-
Inc (Dec) in Borrowings	2,739	(3,866)	(23)	(50)
Dividend paid	(1,773)	(1,916)	(2,329)	(2,736)
Extraordinary Items	106	80	-	-
Chg. In Cash & Bank balance	291	421	1,456	1,607

Source: Company data, i-SEC Research

Table 7: Key Ratios
(Year ending March 31)

	FY06	FY07P	FY08E	FY09E
Per Share Data (Rs)				
EPS(Basic Recurring)	8.0	8.4	10.0	12.3
Diluted Recurring EPS	8.0	8.4	10.0	12.3
Recurring Cash EPS	9.0	9.7	11.6	14.2
Dividend per share (DPS)	2.3	2.5	3.0	3.5
Book Value per share (BV)	26.8	42.6	49.6	58.4
Growth Ratios (%)				
Operating Income	32.2	20.0	14.2	16.7
EBITDA	54.4	6.3	15.1	20.9
Recurring Net Income	75.3	5.6	18.9	23.7
Diluted Recurring EPS	75.3	5.6	18.9	23.7
Diluted Recurring CEPS	71.3	8.4	18.6	22.6
Valuation Ratios (x)				
P/E	31.8	30.1	25.3	20.5
P/CEPS	28.2	26.0	21.9	17.9
P/BV	9.4	5.9	5.1	4.3
EV / EBITDA	26.0	23.9	20.6	16.9
EV / Operating Income	6.7	5.5	4.8	4.1
EV / Operating FCF	83.4	48.1	38.0	33.1
Operating Ratio				
Raw Material/Sales (%)	45.5	49.2	49.0	49.1
SG&A/Sales (%)	7.0	7.0	7.5	7.6
R&D/Sales (%)	5.2	5.5	5.8	6.0
Other Income / PBT (%)	5.3	10.2	12.5	11.9
Effective Tax Rate (%)	14.2	17.7	17.0	15.0
NWC / Total Assets (%)	52.5	47.3	47.6	48.8
Inventory Turnover (days)	225.1	216.0	220.0	216.6
Receivables (days)	88.4	101.2	109.3	114.1
Payables (days)	84.5	92.9	103.6	109.7
D/E Ratio (%)	27.2	5.4	4.6	3.8
Return/Profitability Ratio (%)				
Recurring Net Income Margins	20.5	17.8	18.5	19.6
RoCE	28.6	22.2	21.4	22.6
RoNW	33.2	24.2	21.7	22.9
Dividend Payout Ratio	28.7	29.4	30.0	28.5
Dividend Yield	0.9	1.0	1.2	1.4
EBITDA Margins	26.0	23.0	23.2	24.0

Source: Company data, i-SEC Research

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