

## Disappointment continues; Downgrade to Reduce

August 16, 2010

### REDUCE

Price	Target Price
<b>Rs315</b>	<b>Rs313</b>
<b>Sensex</b>	<b>18,167</b>

#### Price Performance

(%)	1M	3M	6M	12M
Absolute	(4)	0	1	10
Rel. to Sensex	(6)	(5)	(10)	(6)

Source: Bloomberg

#### Stock Details

Sector	Pharmaceuticals
Reuters	CIPL.BO
Bloomberg	CIPLA@IN
Equity Capital (Rs mn)	1606
Face Value (Rs)	2
No of shares o/s (mn)	803
52 Week H/L (Rs)	363/251
Market Cap (Rs bn/USD mn)	253/5,407
Daily Avg Vol (No of shares)	1118176
Daily Avg Turnover (US\$ mn)	7.7

#### Shareholding Pattern (%)

	J'10	M'10	D'09
Promoters	36.8	36.8	36.8
FII/NRI	20.3	21.0	21.6
Institutions	17.5	16.6	16.7
Private Corp	3.9	3.9	3.3
Public	21.5	21.7	21.7

Source: Capitaline

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- Cipla's Q1FY11 numbers below expectations on all fronts with a) Sales grew by 7.3% to Rs14.3bn; b) OPM contracted by 220bps to 24.6% & c) APAT at Rs2.7bn, up 2%
- Sub-par domestic performance; structural issues in the domestic market
- Moderate outlook; no near term catalyst
- Tweaking earnings by 4/4.5% for FY11/12E; downgrade to Reduce

#### Revenue growth of 7.3% below expectations; structural issues in the domestic market

Lower than expected growth in domestic formulation (3% vs. est. of 10%) and muted performance in API business resulted 7.3% growth vs. est. of 12% growth in the top-line. Export formulation business for the quarter grew by 14.5% to Rs6.3bn (19% in US\$) driven by 9% growth in respiratory (shipment of Salbutamol inhaler in UK) and 19% growth in ARV business. The subdued performance in the domestic market is largely driven by divestment of I-pill (impacted 2% growth) and decline in the generic business (c 15% of the revenue). Cipla has got a structural issue with regard to domestic market and are of the opinion that company will not be able to grow more than 11-12% in the domestic market for at least next 2-3 years. This is because of the fact that 50% of its domestic portfolio which is on the active promotion is growing in the range of 18-20% (ahead of market growth). However, the balance 50% of the domestic business comprises of mature brands (35% of domestic revenue; promoted through contractual field force) such as Ciplox, Norflox, Novamox, etc and generic products (15% of domestic revenue; pushed through distributors and retail stores) is either de-growing or barely holding its revenue. This is impacting the overall growth of the company in the domestic market. Going forward, management has indicated 10-11% growth in the domestic formulation market. In the export formulation business, company is looking to launch Salmeterol inhaler in some of the EU markets (total market size-US\$150mn) and Seroflo (Salmeterol plus Fluticasone) inhaler in South African market (~US\$15-20mn market). Management has indicated that they will start getting approval for combination inhalers in some of the EU markets from FY12E onwards.

#### Adverse product mix and Lower Tech income impacted margins

Operating income for the quarter was flat at Rs3.65bn (est. of R3.83bn). Operating margins for the quarter contracted by 220bps to 24.6% because of a) adverse product mix (RM cost increased by 120bps; lower contribution of domestic formulation sales) b) 38% decline in technology income to Rs159mn and c) adverse currency movement. Operating margins have also been impacted because of 45% increase in employee cost as a) company has increased 300 field personnel in domestic market b) commercialize the Indore SEZ and c) reclassification of contract worker at Goa facilities.

#### Financials

YE-	Net	EBITDA		EPS	EPS	RoE	EV/			
Mar	Sales	(Core)	(%)	APAT	(Rs)	% chg	(%)	P/E	EBITDA	P/BV
FY09	52,343	12,218	23.3	9,719	12.1	53.2	19.0	28.0	28.7	6.3
FY10	56,300	14,237	25.3	10,709	13.3	10.2	21.3	25.4	23.4	4.7
FY11E	62,490	15,922	25.5	11,855	14.8	10.7	19.1	23.0	20.2	4.1
FY12E	70,360	18,084	25.7	13,949	17.4	17.7	19.6	19.5	17.5	3.6

**APAT at Rs2.7bn was below our expectations of Rs2.9bn**

Despite higher other income (up by 40%), lower interest cost (down by 99%) and lower tax provision (17.6% of PBT vs. 18.7% of PBT in Q1FY10), APAT grew by 2% to Rs2.7bn. The growth in the APAT was impacted because of 20% increase in depreciation cost on account of commercialization of Indore SEZ facility.

**Revenue Break-up**

	Q1FY11	Q1FY10	Growth	Q4FY10	Growth
Domestic	6716	6519	3.0%	5688	18.1%
Total Exports	7659	6876	11.4%	7602	0.7%
Export Formulation	6257	5472	14.4%	6139	1.9%
API	1402	1404	-0.2%	1463	-4.2%
Total sales	14374	13395	7.3%	13290	8.2%
Technology Fees	159	257	-38.1%	136	17.3%
Other operating income	365	251	45.4%	437	-16.4%
Total Income inc. ope. Inc.	14898	13902	7.2%	13862	7.5%

**Moderate outlook; Aerosol opportunity in EU is still 15-18 months away**

The management has guided for 8-10% growth in revenue driven by 10% growth in domestic business, 10-12% growth in export business and Rs2.2bn from other operating income (Rs1.0-1.5bn from technical fees). The supply of Salbutamol inhaler to UK has already started and company is looking to launch Seroflo inhaler in South Africa (US\$15-20mn market) and Salmeterol inhaler in some of the EU markets (total market size of US\$150mn in EU zone). Though inhalers for US and EU could be a large opportunity but given the regulatory framework, this opportunity is still 15-18 months away.

**Lowering earnings by 4% and 4.5%, downgrade to Reduce**

Cipla's performance was below market as well as our expectations. Company has disappointed on all the front such as a) sub-optimal domestic performance, b) sharp decline in tech fees c) margin contraction in core business (ex-other operating income) and d) moderate outlook for FY11E. Owing to poor performance and muted outlook, we are lowering our earning estimates by 4% and 4.5% to Rs14.8/Rs17.4 for FY11E/FY12E respectively. Lowering target price Rs313 (18x FY12E) and downgrading to Reduce from Hold rating. A large out-licensing deal or earlier than expected launch of combination inhalers can be potential risks to our call.

## Quarterly financials

Rs mn	Q1FY10	Q2FY10	Q3FY10	Q4FY10	Q1FY11	YoY (%)	QoQ (%)
<b>Revenue</b>	<b>13,760</b>	<b>14,429</b>	<b>14,385</b>	<b>13,747</b>	<b>14,798</b>	<b>7.5</b>	<b>7.6</b>
Expenditure	10,075	10,620	10,586	11,167	11,292	12.1	1.1
<i>as % of sales</i>	73.2	73.6	73.6	81.2	76.3		
Consumption of RM	6,067	6,396	6,248	6,108	6,702	10.5	9.7
<i>as % of sales</i>	44.1	44.3	43.4	44.4	45.3		
Employee Cost	950	864	890	999	1,376	44.8	37.8
<i>as % of sales</i>	6.9	6.0	6.2	7.3	9.3		
Other expenditure	3,059	3,361	3,449	4,060	3,214	5.1	(20.8)
<i>as % of sales</i>	22.2	23.3	24.0	29.5	21.7		
<i>Forex (loss)/ gain</i>	<i>-270.0</i>	<i>75.0</i>	<i>-240.0</i>	<i>-200.0</i>	<i>-140.0</i>		
<b>EBITDA</b>	<b>3,685</b>	<b>3,733</b>	<b>4,039</b>	<b>2,780</b>	<b>3,646</b>	<b>(1.1)</b>	<b>31.2</b>
Depreciation	458	478	457	495	548	19.7	10.8
EBIT	3,227	3,255	3,582	2,285	3,098	(4.0)	35.6
Other Income	120	128	178	451	168	39.9	(62.8)
Interest	105	84	44	5	1	(98.9)	(76.1)
PBT	3,242	3,300	3,717	2,731	3,264	0.7	19.5
Total Tax	606	604	630	760	575	(5.2)	(24.4)
<b>Adjusted PAT</b>	<b>2,636</b>	<b>2,696</b>	<b>3,087</b>	<b>2,285</b>	<b>2,690</b>	<b>2.0</b>	<b>17.7</b>
(Profit)/loss from JV's/Ass/MI							
APAT after MI	2,636	2,696	3,087	2,285	2,690	2.0	17.7
EO items (Net of Tax)	-219	62	-197	471	-116		(124.5)
Reported PAT	2,417	2,757	2,890	2,755	2,574	6.5	(6.6)
<b>AEPS</b>	<b>3.3</b>	<b>3.4</b>	<b>3.8</b>	<b>2.8</b>	<b>3.3</b>	<b>2.0</b>	<b>17.7</b>
<b>Margins (%)</b>						<b>(bps)</b>	<b>(bps)</b>
EBIDTA	26.8	25.9	28.1	20.2	24.6	(214)	442
EBIT	23.5	22.6	24.9	16.6	20.9	(252)	431
EBT	23.6	22.9	25.8	19.9	22.1	(150)	219
PAT	19.2	18.7	21.5	16.6	18.2	(98)	156
Effective Tax rate	18.7	18.3	16.9	27.8	17.6	(110)	-1023

## Financial

## Income Statement

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
<b>Net Sales</b>	<b>52,343</b>	<b>56,300</b>	<b>62,490</b>	<b>70,360</b>
<i>Growth (%)</i>	24.2	7.6	11.0	12.6
<b>Expenditure</b>	<b>40,125</b>	<b>42,063</b>	<b>46,568</b>	<b>52,276</b>
Raw Materials	23,474	24,818	27,474	30,826
SGA	10,166	13,542	11,672	13,086
Employee Cost	2,714	3,703	3,232	3,642
Other Exp	3,771	0	4,190	4,722
<b>EBITDA</b>	<b>12,218</b>	<b>14,237</b>	<b>15,922</b>	<b>18,084</b>
<i>Growth (%)</i>	46.9	16.5	11.8	13.6
<b>EBITDA margin (%)</b>	<b>23.3</b>	<b>25.3</b>	<b>25.5</b>	<b>25.7</b>
Depreciation	1,518	1,888	2,175	2,413
<b>EBIT</b>	<b>10,700</b>	<b>12,350</b>	<b>13,747</b>	<b>15,671</b>
<b>EBIT margin (%)</b>	<b>20.4</b>	<b>21.9</b>	<b>22.0</b>	<b>22.3</b>
Other Income	918	877	1,072	1,135
Interest expenses	329	237	0	0
<b>PBT</b>	<b>8,955</b>	<b>13,305</b>	<b>14,819</b>	<b>16,806</b>
Tax	1,245	2,485	2,964	2,857
<i>Effective tax rate (%)</i>	13.9	18.7	20.0	17.0
<b>Adjusted PAT</b>	<b>9,719</b>	<b>10,709</b>	<b>11,855</b>	<b>13,949</b>
(Profit)/loss from JV's/Ass/MI	0	0	0	0
<b>Adjusted PAT after MI</b>	<b>9,719</b>	<b>10,709</b>	<b>11,855</b>	<b>13,949</b>
<i>Growth (%)</i>	53.2	10.2	10.7	17.7
<b>Net Margin (%)</b>	<b>18.6</b>	<b>19.0</b>	<b>19.0</b>	<b>19.8</b>
E/O items	-2,333	315	0	0
<b>Reported PAT</b>	<b>7,710</b>	<b>10,820</b>	<b>11,855</b>	<b>13,949</b>
<i>Growth (%)</i>	21.6	40.3	9.6	17.7

## Cash Flow

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
<b>PBT (Ex-Other income)</b>	<b>8,038</b>	<b>12,428</b>	<b>13,747</b>	<b>15,671</b>
Depreciation	1,518	1,888	2,175	2,413
Interest Provided	329	237	0	0
Other Non-Cash items	0	0	0	0
Chg in working cap	-5,829	-513	-3,843	-5,211
Tax paid	-1,095	-2,485	-2,964	-2,857
<b>Operating Cashflow</b>	<b>2,961</b>	<b>11,555</b>	<b>9,115</b>	<b>10,016</b>
Capital expenditure	-6,161	-4,678	-5,000	-4,000
<b>Free Cash Flow</b>	<b>-3,200</b>	<b>6,877</b>	<b>4,115</b>	<b>6,016</b>
Other income	918	877	1,072	1,135
Investments	134	0	0	0
<b>Investing Cashflow</b>	<b>-5,109</b>	<b>-3,801</b>	<b>-3,928</b>	<b>-2,865</b>
Equity Capital Raised	35	6,760	0	0
Loans Taken / (Repaid)	3,998	-6,300	-3,000	0
Interest Paid	-329	-237	0	0
Dividend paid (incl tax)	-1,819	-3,165	-3,468	-4,080
Income from investments	0	0	0	0
Others	0	0	0	0
<b>Financing Cashflow</b>	<b>1,885</b>	<b>-2,941</b>	<b>-6,468</b>	<b>-4,080</b>
<b>Net chg in cash</b>	<b>-264</b>	<b>4,812</b>	<b>-1,281</b>	<b>3,071</b>
Opening cash position	797	533	5,345	4,065
<b>Closing cash position</b>	<b>533</b>	<b>5,345</b>	<b>4,065</b>	<b>7,135</b>

## Balance Sheet

Y/E, Mar (Rs. mn)	FY09	FY10	FY11E	FY12E
Equity share capital	1,555	1,606	1,606	1,606
Reserves & surplus	41,923	56,287	64,674	74,543
<b>Net worth</b>	<b>43,478</b>	<b>57,893</b>	<b>66,280</b>	<b>76,149</b>
<b>Minority Interest</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
Secured Loans	28	28	28	28
Unsecured Loans	9,375	3,075	75	75
<b>Loan Funds</b>	<b>9,402</b>	<b>3,102</b>	<b>102</b>	<b>102</b>
Net deferred tax liability	1,642	1,642	1,642	1,642
<b>Total Liabilities</b>	<b>54,522</b>	<b>62,637</b>	<b>68,024</b>	<b>77,893</b>
Gross Block	26,933	31,601	36,601	40,601
Less: Depreciation	7,008	8,886	11,061	13,473
<b>Net block</b>	<b>19,925</b>	<b>22,715</b>	<b>25,540</b>	<b>27,128</b>
Capital work in progress	3,663	3,663	3,663	3,663
<b>Investment</b>	<b>801</b>	<b>801</b>	<b>801</b>	<b>801</b>
<b>Current Assets</b>	<b>44,179</b>	<b>52,229</b>	<b>56,379</b>	<b>66,089</b>
Inventories	13,983	15,003	16,700	18,819
Sundry debtors	18,529	19,825	22,147	24,958
Cash & bank balance	533	5,345	4,065	7,135
Loans & advances	11,134	12,056	13,468	15,177
Other current assets	0	0	0	0
<b>Current lia &amp; Prov</b>	<b>14,046</b>	<b>16,771</b>	<b>18,359</b>	<b>19,787</b>
Current liabilities	10,129	10,917	11,749	12,650
Provisions	3,917	5,854	6,609	7,137
<b>Net current assets</b>	<b>30,133</b>	<b>35,458</b>	<b>38,020</b>	<b>46,302</b>
Misc. exp & Def. Assets	0	0	0	0
<b>Total Assets</b>	<b>54,522</b>	<b>62,637</b>	<b>68,024</b>	<b>77,893</b>

## Key Ratios

Y/E, Mar	FY09	FY10	FY11E	FY12E
<b>Profitability (%)</b>				
EBITDA Margin	23.3	25.3	25.5	25.7
Net Margin	18.6	19.0	19.0	19.8
ROCE	19.8	20.2	20.9	21.3
ROE	19.0	21.3	19.1	19.6
RoIC	0.0	0.0	0.0	0.0
<b>Per Share Data (Rs)</b>				
EPS	12.1	13.3	14.8	17.4
CEPS	16.9	15.3	17.5	20.4
BVPS	54.1	72.1	82.5	94.8
DPS	2.3	3.9	4.3	5.1
<b>Valuations (x)</b>				
PER	28.0	25.4	23.0	19.5
P/CEPS	19.9	22.0	19.2	16.5
P/BV	6.3	4.7	4.1	3.6
EV / Sales	5.5	5.0	4.5	3.9
EV / EBITDA	28.7	23.4	20.2	17.5
Dividend payout(%)	23.6	25.0	25.0	25.0
<b>Gearing Ratio (x)</b>				
Net Debt/ Equity	0.2	0.0	0.2	0.1
Net Debt/EBIDTA	0.7	-0.2	-0.2	-0.4
Working Cap Cycle (days)	234	233	237	240

**Recommendation History: Cipla – CIPLA IN**

Date	Reports	Reco	CMP	Target
10.05.10	<a href="#">Cipla Q4FY10 Result Update</a>	Hold	342	328
10.03.2010	<a href="#">Generic Pharma Sector Report</a>	Accumulate	314	366

**Recent Research Reports**

Date	Reports	Reco	CMP	Target
13.08.10	<a href="#">Divi's Laboratories Q1FY11 Result Update</a>	Buy	748	852
13.08.10	<a href="#">Dishman Q1FY11 Result Update</a>	Hold	208	224
13.08.10	<a href="#">Ranbaxy Q2CY10 Result Update</a>	Reduce	445	395
11.08.2010	<a href="#">Piramal Healthcare Q1FY11 Result Update</a>	Hold	482	531

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