Q2FY12 Result Update

November 17, 2011

CL recently reported its Q2FY12 results, which were above street estimates. Given below are some of the key highlights, which we came across while reviewing the results.

Key highlights of Q2FY12 results:

- CL reported net sales of Rs.1,731.8 cr, up by 9.6% y-o-y. The domestic business (which accounts for 48% of revenues) grew by 12%, formulation exports (43% revenues) grew by 13.2% and API exports (9% of revenues) degrew by 5%. Margins expanded mainly on account of better product mix, which had lower proportion of anti-retrovirals in formulation exports.
- OPM expanded by 190 bps to 24.6% in Q2FY12 led by higher realizations and reduction in raw material cost. Net profit margins expanded by 110 bps to 17.4% due to higher effective tax rate.

Quarter Financials - Consolidated:

(Rs. in Cr)

Particulars	Q2FY12	Q2FY11	% Chg	Q1FY12	% Chg	Remarks
Domestic Sales	847.0	756.4	12.0%	743.6	13.9%	Reflects the benefits of recent field force addition and entry into newer therapies like neurology, psychiatry and oncology.
Export Sales	911.1	832.2	9.5%	830.2	9.7%	Continue to disappoint with 9.5% y-o-y growth, despite increased contribution from Indore SEZ (Rs.1.5 bn in Q2FY12 vs Rs.1 bn in FY11).
- Formulations	751.6	663.9	13.2%	658.9	14.1%	
- APIs	159.5	168.3	-5.2%	171.3	-6.9%	
Gross Revenues	1758.1	1588.6	10.7%	1573.8	11.7%	
Excise Duty	26.3	8.7	201.5%	23.5	11.8%	Rose due to increase in duty rate by 1% and increase in dutiable clearances
Net Sales	1731.8	1579.9	9.6%	1550.3	11.7%	
Other Operating Income						
- Technology know-how fees	7.8	12.0	-35.1%	9.8	-20.9%	
- Others	38.4	23.5	63.5%	31.3	22.9%	
Total Other Operating Income	46.2	35.5	30.2%	41.1	12.4%	
Total Operating Income	1778.0	1615.4	10.1%	1591.4	11.7%	
Expenditure						
Raw Materials	711.7	748.7	-4.9%	668.2	6.5%	Lower by Rs.37 cr mainly due to improved realizations, reduction in input costs of certain category of products and changes in product mix
Employee Cost	187.5	137.6	36.3%	171.2	9.5%	Rose due to additional manpower at Indore SEZ, annual rise in salaries given to employees
Other Expenditure	441.3	362.5	21.7%	382.4	15.4%	Increased mainly due to increase in factory expenditure, selling expenses and provision for doubtful debts
Total Expenditure	1340.4	1248.8	7.3%	1221.9	9.7%	
Operating Profit	**437.6**	**366.6**	19.4%	**369.5**	18.4%	
OPM %	*24.6%*	*22.7%*		*23.2%*		Expansion in margins was due to better utilization at Indore SEZ, change in product mix and reduction in material cost
Other Income	24.3	16.6	46.1%	24.9	-2.2%	

Interest	2.4	0.3	750.0%	4.3	-44.0%	
Depreciation	65.6	63.9	2.7%	70.3	-6.6%	
Profit before Tax	393.9	319.0	23.5%	319.9	23.1%	
PBTM %	*22.7%*	*20.2%*		*20.6%*		
Tax	85.0	56.0	51.7%	66.6	27.6%	Higher tax due to expiry of tax benefits on some EOUs
Effective Tax Rate %	*21.6%*	*17.6%*		*20.8%*		
Net Profit	**309.0**	**263.0**	17.5%	**253.3**	22.0%	
NPM %	*17.4%*	*16.3%*		*15.9%*		
Equity Capital	160.6	160.6	0.0%	160.6	0.0%	
EPS	**3.8**	**3.3**	17.5%	**3.2**	22.0%	

(Source: Company, HDFC Sec)

Some observations on Q2FY12 results:

- Domestic sales growth was impressive at 12% y-o-y for the quarter with most growth coming from branded generic portfolio with pure generics contributing only 15% growth of total domestic formulation business. Bulk business de-grew 5% owing to cyclicality of the business. The management clarified that it has not supplied olanzapine to Teva.

- Africa business, which contributes about 35-40% of total sales witnessed lower growth due to lower ARV sales in the region. US was up 25% y-o-y while Asia and Middle East grew by 10% and 5% respectively. The other income in Q2FY12 includes forex gain of Rs.14 cr.

- CL expects to maintain its historical product launch run-rate of 30-35 products in domestic markets for FY12 with focus on respiratory and other chronic therapies. The management indicated that it would focus on injectibles in the ant-cancer segment, which contributes 5-6% to sales. CL continues to maintain 70% share in the inhaler segment in India.

- CL has forward contracts of US$190 mn to cover its overseas receivables.

- The management has guided 10-12% sales growth and Operating Margins in the range of 24-25%.

- The management has indicated that as CL has invested significantly in setting up new facilities in the past 3 years this could help in improving margins. Its investment of Rs.9 bn on Indore SEZ (commissioned in 1QFY11) is amongst the largest in an SEZ in Indian Pharma. Cipla is incurring losses on the SEZ as revenues are yet to ramp up to absorb the fixed costs. However, revenues from this facility are ramping up (Rs.3 bn sales for H1FY12 v/s Rs.1 bn for FY11). With the ramp-up in revenues from the facility, the profitability will improve going forward. Management has mentioned that the plant is now approved by all major global regulatory authorities except US FDA (CL has not yet applied for a US FDA inspection of this facility as the Goa facility has enough to cater to the US). It has also indicated that it expects this SEZ to contribute about 10-12% of overall sales by end of FY12.

- CFC-free Inhalers remain a key long-term trigger for CL. CL has filed for 11 different inhalers in Europe with 6 pending regulatory approvals. Its overall inhaler capacity is amongst the top 5 globally. It has already commercialized some of its inhalers in UK, Germany, Spain and Portugal. It has received approval for Salmeterol inhaler in UK and Germany. CL has launched its combination inhalers in Russia, CIS and South African markets. Management expects its full range of inhalers to be commercialized in Europe over the next 2-3 years and expects a total of 3-6 players for each product in this category implying that this will be a low-competition, high-margin opportunity. A combination inhaler launch in EU is still a year away. Inhalers form 15-20% of its export sales. The management believes that the EU regulatory framework is more challenging as rules and regulations are more skewed in favour of originators there.

- The government has recently released the draft of the National Pharmaceuticals Pricing Policy, 2011 (NPPP). It has invited comments from the industry and other sources by 30-Nov-2011 on the draft. The policy proposes a significant increase in span of price control from current 20% to ~60%, restricting pricing to the weighted average of the top 3 brands and allowing inflation-linked price increases. While the policy is yet to be implemented, the impact of the policy (in its current form) could be adverse for large players like CL in the short-term. If implemented in the current form, CL's domestic formulation revenues is expected to be impacted by ~2-3% (Rs.0.7-1 bn) which could flow through directly up to the PBT level thus impacting FY13 EPS.

- The management believes that products in new therapeutic areas would be key in expanding its business in conventional markets. The management, however, believes that ARV tender business is one-off and will not be consistent in each quarter. Partnerships deals could benefit in US in FY12.

Concerns

- Strengthening of rupee could result in lower realisations from exports.
- The NPPA has raised a demand of about Rs.12 bn on CL for alleged overcharging of certain drugs. In the worst-case scenario, if CL loses the court case, it will strain the cashflow and impact profitability.
- Low growth in demand in domestic space could impact its overall revenue growth.
- Consolidation in the global generic space can have an adverse impact on the upside from the partnership model adopted by the company.
- Delayed product approval / launch of new products.
- Delay in ramp up of sales from Indore SEZ facility could impact growth in sales and margins.

Conclusion & Recommendation

CL’s Q2FY12 numbers were above expectations. Revenues were driven by 9% growth in exports & 12% growth in domestic business. The management has attributed improvement in margins to improved realizations, reduction in input costs of certain category of products, and changes in product mix. Higher gross margins reported in current quarter may not sustainable.

For the export market, CL has a strong pipeline - 64 ANDAs approved, 46 pending approval and ~50 under registration, with 22 partners in the US. Similarly, it has 410 products for the EU market, at various stages of registration, with over 50 partners. The company has launched four inhalers in EU and six more products under development. With improving utilisation at the Indore SEZ and lower contribution from the weak-margin ARV business, a gradual uptick is expected in the operating margins.

CL's CFC-free inhaler pipeline is likely to gradually get commercialized in Europe and upsides from high-margin opportunities like Seretide can potentially come through over the next 2-years. Its large manufacturing infrastructure, strong chemistry skills and huge inhaler capacity make it a partner of choice for global MNCs that are ramping up their generics and emerging market presence.

The management believes that FY12 would be a better year for the company as contribution from its Indore SEZ will improve (from 10% to 15%), and sales of its inhaler exports business is also expected to grow.

CL remains one of the best largecap Pharma picks from a medium term perspective. Near term triggers were so far lacking for the stock (as Indore SEZ takes time to ramp up and inhaler sales to US / EU could take time to increase). However, Q2FY12 results provide a hope for growth rates accelerating from hereon. Announcement of contract manufacturing tie-up with large MNCs from its Indore SEZ could be a positive trigger for the stock; however it’s timing is uncertain.

In our results review for Q1FY12 dated August 17, 2011, we had stated that the stock could trade in the Rs.270-Rs.312 band for the next quarter. Post that the scrip touched a low of Rs.273.6 on September 6, 2011 and a high of Rs.313.05 on November 16, 2011. We are maintaining our FY12 estimates (though operating profit could be higher than estimates) and introducing FY13 estimates. At the CMP, the stock is trading at 18.8x FY13E EPS of Rs.16.5.

We think that the stock could trade in the Rs.290 - 330 (18 – 20.5x FY13E EPS) band for the next quarter.

Financial Estimates:

Particulars (Rs in Crs)	FY09	FY10	FY11	FY12 (E)*	FY13 (E)*
Operating income	4960.6	5358.1	6318.0	7115.9	7898.6
PBIDT	1036.1	1360.2	1337.5	1523.4	1761.4
PBIDTM (%)	20.9%	25.4%	21.2%	21.4%	22.3%
Profit after Tax	776.8	1082.0	967.1	1130.8	1295.4
PATM (%)	15.7%	20.2%	15.3%	15.9%	16.4%
EPS	10.0	13.5	12.0	14.0	16.1
P/E (x)	31.2	23.1	25.9	22.2	19.3

* - Quick Estimates

(**Source:** Annual Report, HDFC Sec Estimates)

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