Q2FY12 Result Update

November 16, 2011

SPIL recently reported reported better-than-expected Q2FY12 results aided by strong performance of its US subsidiary Taro Pharma, who faced by limited competition in a few products, recorded market share gains and forex gains. Given below are some of the key highlights, which we came across while reviewing the results.

Key highlights of Q2FY12 results:

- SPIL posted the strong growth in top line and bottom-line for Q2FY12, on the back of improved performance across the business coupled with robust performance from Taro business. However, the results are not strictly comparable as the corresponding previous period includes non-recurring sales and Taro financials for only 10 days.

- Taro's 34% revenue growth for the quarter reflects the company's ability to deliver on its dominant derma portfolio where it has seen some market share gains. Gross margins stood significantly higher, at 81% (87% ex Taro), and reflects the increase in quarter end valuation of inventory, led mainly by a depreciating rupee.

- SPIL recorded an OPM of 41.4%, a y-o-y rise of 630 bps led by led by better margins at Taro and lower raw material costs from the higher value of the closing stock held in foreign countries due to exchange gains.

- During the quarter SPIL booked healthy other income of Rs.76.5 cr and Rs.41.7 cr of net interest income. Net Profit grew by 18.7% y-o-y led to better margins at Taro and forex gains of US$16 mn. However, SPIL booked forex losses pertaining to subsidiaries outside US.

Quarter Financials - Consolidated:

(Rs. in Cr)

Particulars	Q2FY12	Q2FY11	% Chg	Q1FY12	% Chg	Remarks
Net Sales	1894.6	1331.4	42.3%	1635.7	15.8%	Largely driven by Taro (33% of the total sales) and favorable currency
Expenditure						
Raw Materials	363.9	379.4	-4.1%	407.1	-10.6%	Drop aided by inventory valuation impact due to depreciating rupee.
Employees Cost	272.7	145.6	87.3%	278.6	-2.1%	
Other Expenditure	474.0	339.4	39.7%	402.6	17.7%	
Total Exp	1110.6	864.4	28.5%	1088.3	2.0%	
Operating Profit	**784.0**	**467.0**	67.9%	**547.4**	43.2%	
OPM %	*41.4%*	*35.1%*		*33.5%*		Expanded on account of lower R&D and SG&A costs from Taro as well as currency depreciation during the quarter
Net Interest income	41.7	36.8	13.4%	31.6	32.2%	
Other income	76.5	55.6	37.7%	65.3		
Depreciation	66.8	35.2	89.8%	64.7	3.2%	
PBT	835.5	524.2	59.4%	579.6	44.2%	
PBTM %	*44.1%*	*39.4%*		*35.4%*	24.5%	
Tax	128.1	17.2	644.3%	14.3	797.7%	
Effective Tax Rate %	*15.3%*	*3.3%*		*2.5%*		
PAT	707.4	507.0	39.5%	565.3	25.1%	
Minority Interest	109.7	3.4	3155.2%	64.3	70.6%	
Net Profit	**597.7**	**503.7**	18.7%	**501.0**	19.3%	
NPM %	*31.5%*	*37.8%*		*30.6%*		PAT margins fell y-o-y due to higher tax rate and high minority interest on account

						of Taro consolidation
Equity	103.6	103.6	0.0%	103.6	0.0%	
EPS	**5.8**	**4.9**	18.7%	**4.8**	19.3%	

(Source: Company, HDFC Sec)

Some observations on Q2FY12 results:

Sales Break up:

Particulars	Q2FY12	Q2FY11	% Chg	Q1FY12	% Chg	Remarks
India Formulations	704.6	610.5	15.4%	638.5	10.4%	Grew despite discontinued third-party manufacturing business. Adjusting for third-party sales, domestic revenues grew by 18.3% y-o-y
US Formulations	799.1	451.1	77.1%	622.0	28.5%	Taro consolidation (assumed 78% revenue accretion from US), US base biz strong, High FTF Eloxatin sales in Q2FY11
RoW Formulations	256.7	138.8	85.0%	252.1	1.8%	Growth was largely contributed by Taro's sales in the emerging markets, excluding which the underlying growth stands at 20%+ y-o-y.
Total Formulations	**1760.4**	**1200.4**	46.7%	**1512.6**	16.4%	
Bulk	160.3	149.1	7.5%	147.6	8.6%	
Others	0.4	3.3	-87.4%	0.2	156.3%	
Total Sales	**1921.1**	**1352.7**	42.0%	**1660.4**	15.7%	Ex-Taro biz declined due to higher base of Eloxatin.
R&D Expenditure as % of Sales	4.9%	5.6%	-13.7%	5.6%	-13.1%	
Total R&D Expenditure	93.3	76.2	22.5%	92.8	0.6%	
Capital	4.3	4.2	1.9%	4.3	-0.2%	
Revenue	89.1	72.0	23.7%	88.5	0.6%	

(Source: Company)

Other Highlights:

- SPIL holds 4.4% market share in the highly competitive Indian Branded Generics market, as per latest AIOCD report. Overall, the company is ranked no. 1 based on share of prescriptions with 7 classes of specialists: psychiatrists, neurologists, cardiologists, ophthalmologists, orthopedics, gastroenterologists and consulting physicians. 10 key products were launched during the quarter.

- The management expects to maintain its growth rate, driven by new product launches and has guided for 20-30 products to be launched in FY2012. It remains progressive on its chronic therapies and has identified them as the growth drivers for the Indian market.

- During the quarter, SPIL lost the patent litigation for generic Eloxatin to Sanofi Aventis. Earlier, it had been blocked from selling the colorectal generic drug through a lawsuit by the innovator Company.

- Taro's net sales for Jul-Sept quarter stood at US$138 mn, a growth of 34% y-o-y, fuelled by limited competition in a few products and a favorable market situation overall. However, the company has cautioned that this may not be sustainable. Net profit for the quarter stood at US$59 mn, significantly higher when compared to the same quarter last year. The Taro management has indicated that the R&D expenses will get normalized for the full year and return to the same levels of FY2011 at 9%. R&D expenses were 5% for the current quarter. Further, the management has also indicated that they are likely to witness pricing pressures in few products due to increasing competition and that the sales of such products are non-recurring in nature.

- On October 19, 2011 SPIL proposed to acquire all of the outstanding shares of Taro currently not held by it or its affiliates at US$24.5 per share. It currently holds 66% stake in Taro.

- Sale of generic formulations in markets outside of India and US accounted for US$175 million in Q2FY12, now accounting for 42% of sales. Taro sales outside US are included in the current quarter but only 10% included in Q2 of last year. Excluding this, underlying sales growth is in excess of 20% in the quarter.

- On September 19, 2011, SPIL announced that the USFDA has informed Sun Pharmaceutical Industries, Inc., its wholly owned subsidiary, that after a June 2011 re-inspection of its Cranbury, New Jersey, US manufacturing facility, the site has an acceptable regulatory status. Therefore, the issues noted in the August 25, 2010 warning letter are considered to be resolved. Caraco, wholly owned by SPIL, continues to work with consultants to resolve the issues raised by the USFDA at its Detroit plant.

- In Q2FY12, ANDAs for 5 products have been filed, 4 by SPIL (now includes Caraco) and 1 by Taro. Counting these, cumulatively ANDAs for 383 products have been filed by SPIL and Taro with the USFDA. ANDAs for 6 products received approvals in the first quarter taking the total number of approvals to 238. Counting these, ANDAs for 150 products now await USFDA approval, including 18 tentative approvals. The products approval in this quarter includes generic Gemzar and generic Diuril.

- A cumulative of 210 DMF / CEP applications have been made, with 138 approved so far. The total number of patent applications submitted now stands at 551 with 254 patents granted so far.

Guidance:

- FY12 capex would be at Rs.450 cr.

- Guidance for 28-30% growth in revenue was reiterated by the management.

- The JV with MSD will start product launches only after two - three years.

- Taro has indicated that in the ensuing quarters of FY12, R&D spend will increase and consequently margins could dip from here on. Also, Taro has indicated that it expects heightened competitive intensity in the derma segment, a dominant category for Taro.

- Organic growth is on track and the management of SPIL is scouting for opportunities for inorganic growth in US or other big emerging market with more than US$1 bn cash on books.

- Taxotere launch in US is expected in mid May 2012.

Concerns

- Increasing R&D expenditure at Taro (~7% in H1CY11 vs 8-9% in the previous quarters) and other administrative and selling expenses can put pressure on margins going ahead. The management has also indicated for heightened competition intensity in the derma category.

- Caraco's process of compliance with the US FDA's requirement could take longer than expected.

- Any product approval delays, unfavorable litigation outcomes (including Protonix) and potential future adverse inspections from USFDA could be key risks to SPIL's growth.

- SPIL is impacted by forex fluctuations, as it exports 53-54% of its sales and has presence abroad through subsidiaries/other infrastructure.

Conclusion & Recommendation

Q2FY12 results are not strictly comparable to the same quarter last year as Q2FY11 included only 10 days of Taro's numbers. 77% revenue growth logged by formulations business in the US should be taken into account, considering the significant non-recurring sales made by the company in Q2FY12. Besides, Taro has posted an exceptionally good performance in the US in Q2FY12, which by the management's own expectation may not be sustainable.

Taro's improved performance has been aided by forex gains impacting revenues, lower spending on research and development and short-term opportunities in the market. These may not be sustainable in the subsequent quarters. That is why despite Taro's stellar performance, the management has not made any upward revision in its annual guidance of 28-30% growth in revenues.

The company based its guidance for FY12, factoring the expected growth from Taro without adding revenues from its facilities under remediation. In case, Caraco's remediation procedure gets completed before the end of FY12, it could provide some added upside to revenues from the US.

Improving performance of Taro, sustained growth in the domestic business, faster resolution of Caraco issues, healthy pipeline of products and pick-up in revenues from overseas markets, outside the US, are the drivers for growth, going ahead.

Given the stellar performance by Taro, we are revising our FY12 estimates upwards and introducing FY13 estimates. At the CMP of Rs.505.05, the stock is trading at 21.7x its FY13E earnings of Rs.23.3.

In our Q1FY12 result update dated August 4, 2011, we had stated that the stock could trade in the Rs.474 to Rs.556 band for the next quarter. Post the issue of the report, the stock made a low of Rs.448.2 on October 10, 2011 and a high of Rs.530 on September 9, 2011.

We feel that the stock could trade in the Rs.465 (20x FY13E EPS) to Rs.535 (23x FY13E EPS) band for the next quarter.

Financial Estimates:

Particulars (Rs in Crs)	FY09	FY10	FY11	FY12 (OE)*	FY12 (RE)*	FY13 (E)*
Operating income	4272.3	4007.5	5721.4	7248.6	7336.3	8253.3
PBIDT	1863.9	1362.8	1967.2	2364.4	2568.4	2773.0
PBIDTM (%)	43.6%	34.0%	34.4%	32.6%	35.0%	33.6%
Profit after Tax	1817.7	1351.1	1816.1	2133.7	2238.6	2409.9
PATM (%)	42.5%	33.7%	31.7%	29.4%	30.5%	29.2%
EPS	17.6	13.0	17.5	20.6	21.6	23.3
P/E (x)	28.8	38.7	28.8	24.5	23.4	21.7

* - Quick Estimates, OE - Original Estimates, RE - Revised Estimates (**Source:** Annual Report, HDFC Sec Estimates)

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