Company

29 June 2010 | 7 pages

Aurobindo Pharma (ARBN.BO)

Equity

Buy: Concerns Receding; Re-rating Looks a Matter of Time

- **Going Strong** — We spoke to the Aurobindo Pharma (ARBN) management to get an update on the biz. Besides robust sales growth and operating leverage upside, we expect further progress on supply deals for global markets in FY11. Concerns over debt and equity dilution also appear overdone. Given these and 30% EPS CAGR (FY10-12E), it looks attractive at 9xFY11E EPS and due to re-rate. Buy.
- **Strong FY11 despite Higher Overheads** — We expect a scale-up in supply to Pfizer (esp. in Europe) and growing traction in own global operations to drive growth and margins, despite higher overheads on the SEZ (Rs150m/qtr) & CRAMS (cRs100-150m). Execution of some pending orders (1bn tablets on capacity choking at Unit III) would lead to a strong 1Q and, while 2Q may be subdued (overheads on new SEZ), 2H should be healthy, as SEZ sales pick and tax benefits accrue.
- **Headway on Licensing Deals** — Besides higher supplies to Pfizer, we expect ARBN to make some progress in an effort to gain more large partners. It is in talks with 2-3 global players for similar (albeit at a smaller scale) tie-ups and believes this could bear fruit soon. This would not only add to revenues but also reduce dependence on Pfizer, providing more comfort to investors.
- **B/S Concerns Receding** — ARBN's net D/E is down to 1.1x (Mar 10) & is set to dip further as cash flows & net worth rise. The FCCBs due in Aug 10 (US$23m) are in the money & would add to equity (2.2m shares) on conversion. The FCCBs due in May 11 are out of the money & may see an outflow (cS$200m), if not converted. ARBN will be able to redeem these, if needed, thru internal accruals & an ECB (US$125m) it intends to raise soon. Equity dilution risk appears low. Capex would be limited from here on (cRs5-5.5bn over FY11-12E) & largely funded internally.
- **Should Re-Rate** — ARBN trades at a c50% discount to the average P/E multiple of our coverage universe – an offshoot of its checkered track record & B/S concerns. With the latter receding & clear signs of sustainable earnings momentum, we believe it is only a matter of time before it re-rates to a higher range.

Buy/Medium Risk	1M
Price (29 Jun 10)	Rs895.40
Target price	Rs1,340.00
Expected share price return	49.7%
Expected dividend yield	0.5%
Expected total return	**50.2%**
Market Cap	Rs50,548M US$1,094M

Price Performance (RIC: ARBN.BO, BB: ARBP IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2008A	1,900	28.10	-5.5	31.9	4.3	18.9	0.4
2009A	2,410	37.28	32.7	24.0	3.9	20.4	0.5
2010E	4,868	75.13	101.5	11.9	2.7	31.7	0.5
2011E	6,554	101.17	34.6	8.9	2.0	29.7	0.5
2012E	8,193	126.46	25.0	7.1	1.5	24.9	0.5

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	31.9	24.0	11.9	8.9	7.1
EV/EBITDA adjusted (x)	18.7	13.4	8.8	6.8	5.3
P/BV (x)	4.3	3.9	2.7	2.0	1.5
Dividend yield (%)	0.4	0.5	0.5	0.5	0.5
Per Share Data (Rs)					
EPS adjusted	28.10	37.28	75.13	101.17	126.46
EPS reported	35.27	15.51	86.96	104.17	126.46
BVPS	209.08	230.89	328.26	442.64	616.95
DPS	3.27	4.50	4.50	4.50	4.50
Profit & Loss (RsM)					
Net sales	24,465	30,773	35,754	44,719	52,170
Operating expenses	-21,952	-26,885	-29,016	-35,838	-41,428
EBIT	**2,513**	**3,888**	**6,738**	**8,880**	**10,742**
Net interest expense	-694	-932	-678	-692	-765
Non-operating/exceptionals	1,098	-1,740	1,484	464	137
Pre-tax profit	**2,918**	**1,216**	**7,544**	**8,652**	**10,114**
Tax	-536	-214	-1,914	-1,904	-1,922
Extraord./Min.Int./Pref.div.	3	0	3	0	0
Reported net income	**2,385**	**1,003**	**5,634**	**6,749**	**8,193**
Adjusted earnings	1,900	2,410	4,868	6,554	8,193
Adjusted EBITDA	3,517	5,164	8,232	10,533	12,552
Growth Rates (%)					
Sales	14.5	25.8	16.2	25.1	16.7
EBIT adjusted	16.5	54.7	73.3	31.8	21.0
EBITDA adjusted	11.5	46.8	59.4	28.0	19.2
EPS adjusted	-5.5	32.7	101.5	34.6	25.0
Cash Flow (RsM)					
Operating cash flow	**1,587**	**1,360**	**4,691**	**4,014**	**6,443**
Depreciation/amortization	1,004	1,276	1,493	1,653	1,810
Net working capital	-1,272	-3,340	-1,339	-4,110	-3,559
Investing cash flow	**-750**	**-4,063**	**-4,952**	**-4,000**	**-3,000**
Capital expenditure	-2,463	-4,830	-4,952	-4,000	-3,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-2,176**	**1,650**	**-1,130**	**-349**	**-2,682**
Borrowings	-1,409	2,867	-837	-42	-2,341
Dividends paid	-157	-393	-293	-307	-341
Change in cash	**-1,348**	**-1,387**	**-1,391**	**-335**	**761**
Balance Sheet (RsM)					
Total assets	**36,345**	**42,265**	**47,913**	**55,365**	**61,992**
Cash & cash equivalent	2,826	1,277	728	393	1,154
Accounts receivable	6,650	8,898	9,560	11,639	13,579
Net fixed assets	15,149	19,351	22,809	25,156	26,346
Total liabilities	**25,073**	**29,821**	**29,579**	**29,489**	**21,980**
Accounts payable	5,546	5,435	6,728	7,964	9,005
Total Debt	18,470	23,330	21,546	20,125	11,500
Shareholders' funds	**11,272**	**12,444**	**18,334**	**25,876**	**40,012**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.4	16.8	23.0	23.6	24.1
ROE adjusted	18.9	20.4	31.7	29.7	24.9
ROIC adjusted	7.6	11.7	12.7	16.0	17.9
Net debt to equity	138.8	177.2	113.5	76.3	25.9
Total debt to capital	62.1	65.2	54.0	43.7	22.3

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Aurobindo Pharma

Company description

Aurobindo Pharma is an Indian pharma company targeting global generics. It has traditionally had a strong presence in the cephalosporin and ARV segments but has expanded its product basket recently. It is fully integrated and owns one of largest manufacturing bases (14 plants) and portfolios of products amongst Indian companies.

Investment strategy

We rate Aurobindo Pharma Buy/Medium Risk, given improving fundamentals and attractive valuations (c50% disc to the sector). We believe APL is much better placed to leverage its large backend infrastructure and product basket. A multiple-market supply deal with Pfizer and critical scale in its own operations in key markets would drive revenues. Rising capacity utilization and better product mix (higher share of formulations) would drive sustained margin expansion and drive 23% and 30% CAGRs (FY10-12E) in EBIDTA and PAT respectively. Moreover, rising cash generation and lower capex going forward will also enable APL to lower debt and alleviate balance sheet concerns.

Valuation

We value Aurobindo using a sum of the parts approach. Given that pharma is a growth sector, we use P/E as our primary method to value the base business of pharma companies. We value Aurobindo's core earnings on 14x 12m forward FDEPS - a 30% discount to the target multiple of 20x that we use for sector leaders such as Cipla and DRL. We believe that the discount is justified at this point, given the possibility of equity dilution (to redeem FCCBs in case they do not get converted), risk of an appreciating rupee (c20-25% net exposure) and higher customer concentration (the Pfizer deal). At 14x June '11E EPS we value Aurobindo's core business at Rs1250/sh. We also value Aurobindo's dossier licensing income at 5x. We believe the lower multiple captures the fact that this income stream may not be recurring, at current levels, over the longer term. At 5x June '11 estimates, we value Aurobindo's dossier licensing income at Rs90/sh. Cumulatively, we arrive at our target price of Rs1,340/sh.

Risks

We rate Aurobindo Medium Risk, in line with our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks that could impede the stock from reaching our target price include (1) Fresh equity dilution if FCCBs do not get converted; (2) Execution hiccups in the supply deal with Pfizer; (3) Currency Risk - an appreciating INR would be structurally negative.

Appendix A-1

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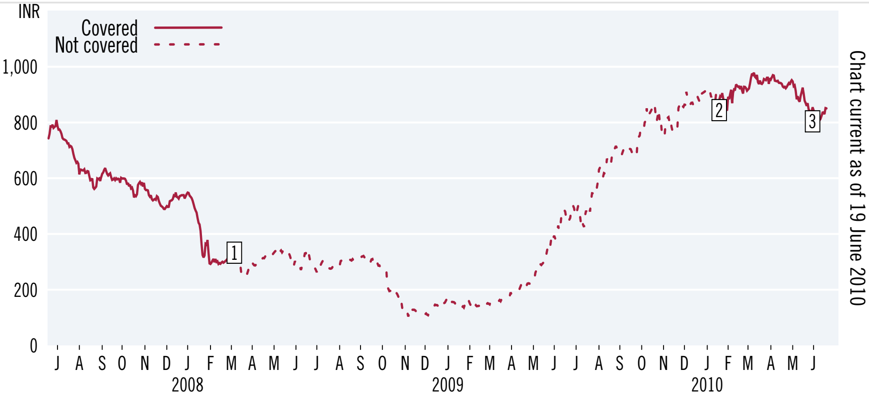
Aurobindo Pharma (ARBN.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Prashant Nair, CFA
Covered since January 19 2010



	Date	Rating	Target Price	Closing Price
1	6-Mar-08	Coverage suspended		
2	19-Jan-10	*1M	*1,350.00	879.85
3	30-May-10	1M	*1,340.00	839.55

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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