Surya Narayan Patra

Orchid Chemicals & Pharmaceuticals Ltd

(Rs 210, FY09 - PE 8.9x, Buy with a price target of Rs 283)

Business Background

Orchid Chemicals & Pharmaceuticals Ltd. is an integrated pharmaceutical company with core competencies in the development and manufacture of Active Pharmaceutical Ingredients (APIs) and Finished Dosage Forms as well as in drug discovery.

The scientific and technical strengths of the company, particularly in the cephalosporin injectable space, have strengthened its foot hold in the USA – the largest market in the world. With the early mover advantage in the anti-infectives segment has provided long-term exclusive marketing alliances with reputed global companies such as Apotex, Actavis, Dava, Hospira etc. Having established strong base in US cephalosporin segment, the company is spreading its wings to other regulated markets like Europe and Canada. Further the company is progressing well in the non-penicilin, non-cephalosporin (**NPNC**) and drug discovery front.

Orchid Holds a healthy market in US cephalosporins injectables

Orchid is sole generic supplier of Cefoxitin and Cefazolin in the USA by capturing market share of 50% and 85% respectively.

Driven by its early mover advantage and marketing alliances with leading global players, Orchid has captured healthy market shares in the intensely competitive US market. It is the sole generic supplier of Cefoxitin and Cefazolin in the USA by capturing market share of 50% and 85% respectively. Also it maintained its market share over 20% for products like - Ceftriaxone and Cefprozil. All these products were launched in FY2006. The healthy market shares achieved by Orchid indicate the strength of Orchid and its marketing partners in the USA market.

Big Product launches to boost US revenue

Orchid witnessed about 17% growth in its US revenue to Rs283 crore in FY2007, despite no significant new launches made by the company in the USA during the year. But the company would see robust growth in the high margin US business, driven by new product launches like – Cefepime, Cefdinir and Tazobactum + Piperacillin (Tazo-Pip) during FY08E-FY09E.

New product opportunities for Orchid

Products	Market Size ($mn)	Expected Revenue ($mn) FY08E	FY09E	Status of Launch
Cefdinir tablet	450	6.5	8.1	Launched
Cefdinir suspension	400	5.8	7.2	Launched
Cefepime injection	190	19.2	21.9	Launched
Tazobactum+Piperacilin	250*	4.3	10.3	Awaiting approval

Source: Company and Reliance Money Research
Note: targetable market size for Orchid, otherwise market size is $480mn*

Cefepime and Cefedinir would contribute incremental revenue of $31.4 million and $37.4 million during FY08 and FY09 respectively.

During June 2007, the company launched the first generic of Cefepime (with branded market size of $190 million) in US market and captured 50% market share as it is the only generic supplier. Subsequently during late July it launched Cefedinir (with branded market size of $850 million) and there are just 3 generic competitors in the market. With relatively lesser competition prevailing for the products, the price erosion caused

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by generic entry is also less. We estimate these two products itself would contribute incremental revenue of $31.4 million and $37.4 million during FY08E and FY09E respectively. These new launches would add fresh revenue of about $10mn in the September 2007 quarter result.

Also the company is confident of launching the Tazobactum + Piperacillin (market size of $480 million) in shortly in US, but we have safely assumed a January 2008 launch in our estimates. The USFDA has already approved its active pharmaceutical ingredient (API) plant at Aurangabad which manufactures Tazobactum + Piperacillin API. Now Orchid is awaiting USFDA approval for the formulation product. Again the competition for the product would be minimal as only one generic competitor is expected for the product. Similarly, Ceftiofur (a veterinary product with market size $140 million) represents a niche opportunity for Orchid as it is a complex, difficult to manufacture product and will thus have limited competition. The product approval is expected in the beginning of CY2008, we have safely assumed revenues from Ceftiofur to start flowing only in from FY2009.

NPNCs pipeline strengthen earnings visibility

Already formed marketing alliances for 20 non-Penicillin, non-Cephalosporin (NPNC) products in the USA and Europe with three prominent players, Actavis, Stada (Dava) and Par Pharma.

Orchid has so far been focusing on manufacturing of oral and sterile Cephalosporins, of late it has diversified into the non-antibiotic segment and identified a product basket of over 80 products across various therapeutic segments. The company has also formed marketing alliances for 20 non-Penicillin, non-Cephalosporin (NPNC) products in the USA and Europe with three prominent players, Actavis, Stada (Dava) and Par Pharma. These 20 products represent a combined market opportunity of over $17 billion in the USA and of over $3 billion in Europe. Orchid has already filed ten ANDAs in this space with the US FDA and has even received approval for one ANDA for Terbinafine. We expect the product approvals to trickle through in FY2008 and FY2009. As of now we have factored the upside from Terbinafine launch but the likely NPNC product approvals & launch in due course would strengthen our estimates further.

Foray into European and Canada to widen revenue base

With facilities approved by the respective regulatory authorities and marketing alliance in place, Orchid is likely to replicate its US success story in Canada and Europe.

Having established a strong foot hold in US hospital segment, the company looks forward to widen its revenue base to other regulated markets like Canada and Europe. With facilities approved by the respective regulatory authorities and marketing alliance in place, Orchid is likely to replicate its US success story in Canada and Europe.

In the early FY2008, the company has already ventured into Canada market with the approval of two products (like - Ceftriaxone and Cefoxitin) marketing alliance with Actavis (the leading generic player in Canada with strong presence in Canadian hospital segment). We estimate these two products would add $14.0 million in FY2008 and $26.2 million in FY2009. Further, the company has filed application for 4 more products representing a combined market size of $100 million.

Also the company is well set to enter the Europe market with its formfacilities approved by UK Medicines and Healthcare Regulatory Agency and marketing alliances with Actavis. The company expects to launch Tazo-Pip formulation shortly on approval of the product in Europe. Tazo-Pip will be a big opportunity for Orchid in Europe as the company will be one amongst the three manufacturers of the product in the market. We expect the European business to generate $8 million in FY2008 and $26.2 million in FY2009.

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Q1FY08 Performance - Standalon results

(Rs. Mn.)	Q1FY2007	Q1FY2008	Growth%	FY06	FY07	Growth%
Net Sales	2017.1	2382.0	18.1	8734.6	9129.2	4.5
Expenditure	1437.0	1759.8	22.5	6141.8	6231.1	1.5
Operating profit	580.1	622.2	7.2	2592.7	2898.1	11.8
OPM%	28.8	26.1		29.7	31.7	
Other Income	7.8	531.6	6707.0	13.3	15.6	17.5
Interest	220.3	164.8	-25.2	870.1	983.1	13.0
Depreciation	193.2	229.9	19.0	829.8	824.7	-0.6
PBT	174.4	759.1	335.3	906.1	1105.9	22.1
Taxes	28.5	246.1	763.5	77.1	139.6	81.1
PAT	145.9	513.0	251.6	829.0	966.3	16.6
Equity Capital	658.1	658.2		646.2	658.2	
EPS	2.2	7.8	251.5	12.8	14.7	14.4

Source: Company and Reliance Money Research

OPM witnessed 270 basis point decline due to Rs100mn incremental cost incurred on FTF filings and Rs 90 mn realisation loss on receivables during the quarter.

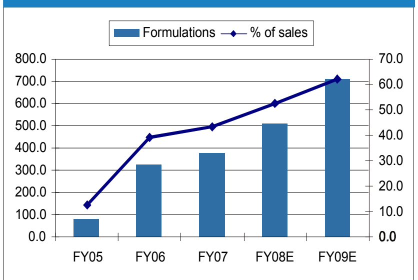
Orchid.s top line grew by 18.1% year on year (yoy) to Rs2382 mn in Q1FY2008. The OPM witnessed 270 basis point decline due to Rs100mn incremental cost incurred on FTF filings and Rs 90 mn realisation loss on receivables during the quarter. On discounting the one time hits, the margin has really expanded by 530 basis point to 34.1%.

During the quarter, the company gained Rs 528.6mn as translation gain on its outstanding FCCB, supported by which the net profit jumped up by 251.7% to Rs513 mn during the quarter. But on adjusting the impact of forex gain on FCCB, associated tax on that and forex loss on receivables due to rupee apreciation the company saw 81.8% growth during the quarter.

Business outlook and valuation

During FY07, the company witnessed marginal growth due to lack of product introduction. But with FY2007 over, Orchid's lean phase seems to be getting over. Going forward, especially from FY2008 onwards, we believe the company will grow by leaps and bounds, with its big launches in the USA and entry into Europe. The fresh revenue coming from recent launch of Cefepime and Cefdinir would boost the earnings Q2FY08 onwards. Subsequently, the launch of Tazobactum + Piperacillin in USA and Europe and its increasing penetration into Canada and Europe woud ensure robust growth in FY07-FY09. We estimate the revenue to grow at CAGR of 14.4% during FY07-09E.

Ramp up in Formulation Sales



Rising revenue flow from Regulated markets to expand margins by 310 bp over FY2007-09E

Over the years, Orchid has transformed itself from a mere bulk drugs player for the unregulated markets to a leading exporter of formulations that too to the regulated markets of the USA and Europe. The contribution of formulations has expanded from 12.4% in FY2005 to over 43% in FY2007, whereas the contribution from advanced markets has grown from 20.1% in FY2005 to 42.4% in FY2007. We expect this proportion to improve going forward, with the contribution from the formulations going up to 62% in FY2009 and the share of advanced markets rising to 52% in also FY2009. This transformation will reflect in Orchid's OPM, which is expected to expand by 310 basis points over FY2007-09.

Steady OPM Expansion

Source: Reliance Money Research

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Financial Estimates - Standalone

	FY2007	FY2008E	FY2009E
Total operating income (Rs Cr)	912.9	1019.6	1193.9
Operating profit (Rs Cr)	289.8	341.6	415.2
OPM (%)	31.7	33.5	34.8
PAT (Rs Cr)	96.6	148.7	225.4
EPS	14.7	16.4	23.6
P/E (x) at Rs 210	14.3	12.8	8.9

Source: Reliance Money Research

In view of the bright prospects for the company, we give a Buy call with a price target of Rs 283.

With increasing revenue and margin expansion we estimate the Orchid's net profit to expand at a CAGR of 52.4% to Rs225.4 crore in FY2009, translating into earnings of Rs23.6 per share in FY2009. At the current market price of Rs210, Orchid is quoting at 8.9x its estimated FY2009 earnings. In view of the bright prospects for the company, we give a Buy call with a price target of Rs 283. At our target price the stock would be valued at 12x FY09E.

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Profit & loss statement (Rs Cr.)

Year to Mar	FY2006	FY2007	FY2008E	FY2009E
Net Sales	873.5	912.9	1,019.6	1,193.9
% Growth	28.9	4.5	11.7	17.1
EBIDTA	259.3	289.8	341.6	415.2
% Growth	59.8	11.8	17.9	21.6
Other Income	1.3	1.6	2.0	2.4
Interest	87.0	98.3	57.8	46.4
Depreciation	83.0	82.5	109.0	111.0
PBT	90.6	110.6	176.8	260.3
% Growth	213.4	22.1	59.9	47.2
Tax	1.8	1.7	16.0	22.9
Deferred Tax	5.9	12.3	12.0	12.0
Adj PAT	82.9	96.6	148.7	225.4
% Growth	167.3	16.6	53.9	51.5
Dividend (%)	40.0	34.2	44.7	30.0
EPS (Rs)	12.8	14.7	16.4	23.6
BVPS (Rs)	121.5	76.2	159.2	181.8

Ratio Analysis

Year to Mar	FY2006	FY2007	FY2008E	FY2009E
OPM %	29.7	31.7	33.5	34.8
NPM %	9.5	10.6	14.6	18.9
ROE %	10.6	19.3	10.3	13.0
ROCE %	9.4	9.4	10.9	13.1
Int. Cover (x)	3.0	3.0	5.9	9.0
D/E (x)	1.3	3.3	0.4	0.3
Asset Turnover (x)	0.4	0.4	0.5	0.5
Debtors Days	146.1	152.1	155.0	160.0
Inventory Days	194.6	251.4	255.0	260.0
Valuation ratios				
P/CF per share (x)	8.2	7.7	7.4	6.0
EV/EBIDTA (x)	9.2	10.0	7.3	5.9
EV/Sales (x)	9.2	10.0	7.3	5.9
Mkt Cap/Sales(x)	1.6	1.5	1.9	1.7
CEPS (Rs)	25.7	27.2	28.5	35.2
P/ BV (x)	1.7	2.8	1.3	1.2

Source: Reliance Money Research

Balance sheet (Rs Cr.)

Year to Mar	FY2006	FY2007	FY2008E	FY2009E
Equity Capital	64.6	65.8	90.5	95.5
Reserves	720.4	435.4	1,351.2	1,641.4
Networth	785.0	501.3	1,441.8	1,737.0
Secured loans	826.6	689.7	528.0	418.0
Unsecured loans	201.7	942.2	80.0	70.0
Total loans	1,028.2	1,631.9	608.0	488.0
Deffered Tax Liab	80.1	92.4	104.4	116.4
Total Liability	1,893.3	2,225.5	2,154.2	2,341.4
Net Block	1,159.1	1,532.9	1,543.8	1,472.8
Investments	98.2	115.7	115.7	115.7
Inventory	438.1	602.3	678.5	812.3
Debtors	328.8	364.3	412.4	499.9
Cash balance	4.9	105.6	32.0	48.7
Other CA	98.5	131.6	146.2	171.8
Current Liabilities	211.1	594.5	743.1	746.7
Provisions	29.6	38.9	36.2	38.0
NCA	629.6	570.2	489.8	748.0
Misc Exp	6.4	6.7	4.8	4.8
Total Assets	1,893.3	2,225.5	2,154.2	2,341.4

Cash Flow Statement (Rs Cr.)

Year to Mar	FY2006	FY2007	FY2008E	FY2009E
PAT	82.9	96.6	148.7	225.4
Depreciation	83.0	82.5	109.0	111.0
Change in WC	(249.2)	(201.0)	6.9	(241.5)
Operating CF	5.9	110.8	350.5	176.1
Capex	(179.7)	(462.1)	(120.0)	(40.0)
Misc Exp	(18.3)	(29.7)	-	-
Investing CF	(198.0)	(491.8)	(120.0)	(40.0)
Equity	256.0	(356.7)	823.6	101.3
Dividends	(15.6)	(22.5)	(31.8)	(33.5)
Debt	(345.4)	(1,067.1)	(1,023.9)	(120.0)
Investments	27.0	17.5	-	-
Financing CF	(78.0)	(1,428.9)	(232.1)	(52.2)
Net Change	(270.1)	(1,809.9)	(1.6)	83.9
Opening Cash	7.3	4.9	105.6	32.0
Closing Cash	4.9	105.6	32.0	48.7

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Equities: Trading through Reliance Securities Limited | NSE SEBI Registration Number Capital Market :- INB 231234833 |
BSE SEBI Registration Number Capital Market :- INB 011234839 | NSE SEBI Registration Number Derivatives :- INF 231234833
Commodities : Trading through Reliance Commodities Limited | MCX member code: 29030 | NCDEX member code: NCDEX-CO-05-00647|
NMCE member code: CL0120 Mutual Funds : Reliance Securities Limited | AMFI ARN No.29889