JB Chemicals & Pharmaceuticals

Ugly Duckling

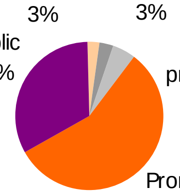
Steady growth, attractive valuations

Buy; CMP: Rs99

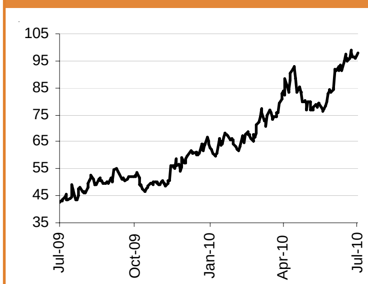
Company details

Price target:	Rs138
Market cap:	Rs847 cr
52-week high/low:	Rs105/42
NSE volume: (No of shares)	1.8 lakh
BSE code:	506943
NSE code:	JBCHEPHARM
Sharekhan code:	JBCHEM
Free float: (No of shares)	3.8 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	18.1	19.0	59.3	133.7
Relative to Sensex	17.2	14.8	49.7	93.1

Key points

- **Steady growth in core business:** JB Chemicals & Pharmaceuticals Ltd (JBCPL), a well-known name in the formulation and OTC markets of India, is set to show a steady growth in its domestic and international businesses on the back a deeper penetration of the existing markets (prescription sales in India and aggressive sales promotion in Russia/CIS), entry into newer markets (emerging countries like South Africa, Venezuela, Romania, Australia) and la unch of new products. Consequently, we expect its core business to grow at a compounded annual growth rate (CAGR) of 14.5% over FY2010-12, driven by a CAGR of 17.5% in its domestic formulation business and a 12.8% CAGR in its international operations.
- **CRAMS—untapped opportunity:** The company is actively pursuing opportunities in the contract research and manufacturing services (CRAMS) segment as all of its manufacturing facilities are approved by the authorities of leading regulated markets, eg USFDA, UK MHRA and TGA (Australia). However, it would take three to four years before the CRAMS business begins to make any significant contribution to its overall revenues.
- **Strong free cash flow and de-leveraged balance sheet:** Given the strong free cash flow of close to Rs100 crore annually, a low debt-equity ratio of 0.2x and a limited capital expenditure (capex), the company is well placed to pursue inorganic opportunities. Though the receivable days in its Russian operations seem to be relatively higher (about 160 days), the company is quite confident about the quality of the receivables and we do not expect any significant negative surprise in terms of write-offs.
- **Earnings growth at CAGR of 13.5%:** After a tepid performance over FY2007-09, FY2010 set a base for a turn-around in its business. We expect JBCPL's net sales to rise at a 15.8% CAGR driven by a 14.5% CAGR in the core business and the incremental opportunities in the CRAMS space. A robust growth in the top line would lead to a 13.5% CAGR in the consolidated profit.
- **Discounted valuations, Buy:** Considering the double-digit growth in its revenues and the earnings from its core business, its strong free cash flows and healthy return ratios (18-20%), the company is trading at an attractive valuation of 6x FY2012 earnings (which is at a 20-25% discount to both the comparable companies' valuations and its long-term mean valuation of 8.5x one-year forward earnings). We initiate coverage on the stock with a "Buy" recommendation and price target of Rs138 (8.5x FY2012 earnings).

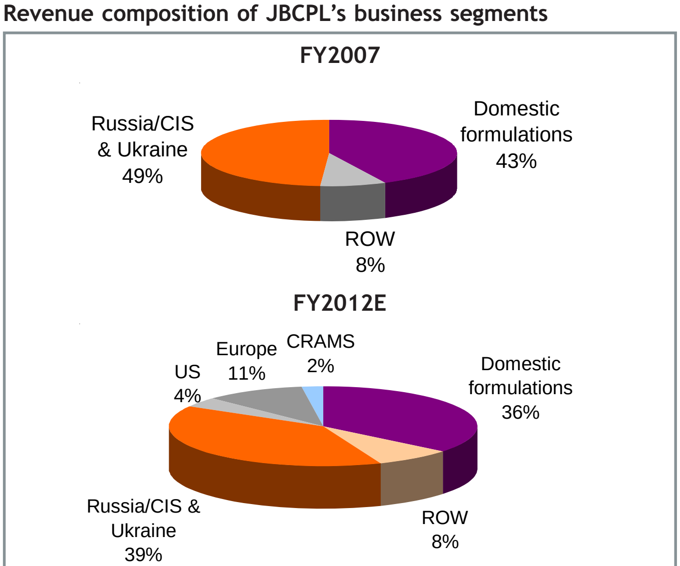
Key financials	FY2008	FY2009	FY2010	FY2011E	FY2012E
Net sales (Rs cr)	562.4	717.1	741	859.1	993.5
Adjusted net profit (Rs cr)	45.4	98.4	106.5	114.8	137.2
EPS (Rs)	5.4	11.7	12.6	13.6	16.3
PER (x)	18.7	8.6	7.9	7.4	6.2
EV/EBIDTA (x)	16.6	7.7	6.0	5.3	4.3
Book value (Rs/share)	53.7	55.6	67.4	82	95.9
P/BV (x)	1.9	1.8	1.5	1.2	1.0
Mcap/sales	1.5	1.2	1.1	1.0	0.9
RoCE (%)	9.4	18.5	21.0	19.6	20.3
RoNW (%)	10.4	21.4	20.5	18.2	18.3

Company background

JBCPL—run by first-generation entrepreneur JB Mody—is a closely held family company. It is involved in the manufacturing and marketing of pharmaceutical formulations, active pharmaceutical ingredients (APIs), herbal remedies and radio diagnostics in India and abroad. JBCPL has got a strong presence in the domestic as well as the Russian and Commonwealth of Independent States (CIS) markets. It has got strong growth initiatives to operate in the semi-regulated markets like Latin America, South-East Asia, West Asia and Africa, and earns more than 50% of its revenues from the export markets.

Its product portfolio consists of various dosage forms, herbal remedies, diagnostics, generic drugs and APIs. Some of the products within these categories enjoy leadership position in the Indian and foreign markets. With a strong base of 11 state-of-the-art manufacturing units (including tablet and API plants approved by the US Food and Drug Administration [USFDA], UK Medicines and Healthcare products Regulatory Agency [UK MHRA] and Therapeutic Goods Administration [TGA, Australi]) and two DSTC approved research and development (R&D) centres, the company has entered a dynamic phase of expansion into newer and faster growing therapeutic segments, such as anti-diabetics, central nervous system (CNS) and respiratory. Its product portfolio includes Doktor Mom, Metrogyl, Rantac (a Ranitidine-based formulation) and Nicardia (a cardiac care medicine).

Revenue composition of JBCPL's business segments



Investment arguments

Core business has strong potential

JBCPL's core business comprising formulations in India and over-the-counter (OTC) products in Russia/CIS has seen stupendous success due to the company's focus on niche specialties and brand building. Propelled by a ramp-up in the field force and aggressive promotion plans the core business is expected to provide a steady cash flow to the company.

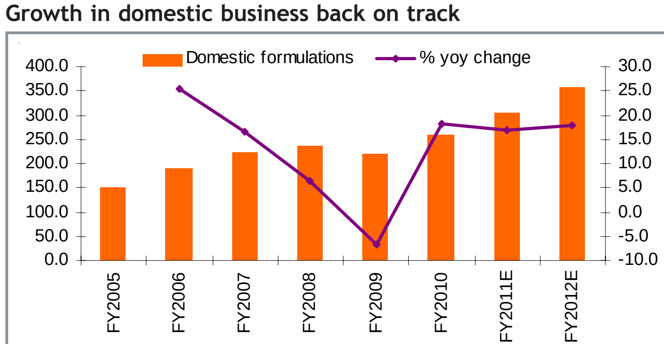
Focus on domestic markets to continue

The domestic market remains the core business of the company by reporting a steady growth in the revenues as well as in prescription generation. With a strong presence in the anti-infective segment and increasing thrust on the lifestyle segments like cardiovascular system (CVS) and orthopedic, and niche segments like radiology, JBCPL is one of the faster growing players in the domestic market. In fact, the company successfully scaled up its domestic formulation business at a CAGR of 11% over FY2005-10, in line with the industry trend.

JBCPL's focus brands grew by 18.2% in FY2010 owing to the re-orientation of the field force and the rationalisation of the product portfolio. The rationalisation of the product portfolio, the consolidation of the Lekar and Auster divisions, the rationalisation and re-orientation of the field force and the active promotion of the focused products are some of the steps taken that are expected to deliver the target growth in the near future.

Going forward, the company is planning to introduce new products in the domestic market through both internal and in-licencing arrangements. The diagnostic division, which offers niche contrast media products, grew by 17%, driving the overall growth in the domestic market. The revenues of the domestic business, which contributes about 35% of the company's total sales, are likely to grow at a 17.5% CAGR over FY2010-12, above the average industry growth rate of 15%.

Growth in domestic business back on track



Focus on brand building

JBCPL's domestic market strategy is focused on building brands and is in contrast with the "new product launch" focus of most of its peers. We believe JBCPL's focus on brand building will be a competitive advantage in the intellectual property era wherein there will be limited new product launching opportunities and building brands will be the key to a player's success. A field force of over 800 persons has been deployed across five strategic business units; this team is focused on the mass-market drugs and primarily targets general practitioners. The company is also in the process of ramping up its field force by adding 200 more people in FY2011 to tap the growing opportunities in the rural market.

Strong sales force

Marketing division	Sales force	Coverage
Unique	400	GPs
Zephyr	70	Neurologists and psychiatrists
Auster	200	Cardiologists, gastroenterologists and orthopedics
Contrast Media	25	Radiologists and cardiologists
Lekar Healthcare	170	GPs, gastroenterologists and orthopedics

Five products contribute over 80% of the total domestic revenues

Brands	Therapeutic segment
Doktor Mom	Herbal
Metrogyl	dental
Rantac	GI
Nicardia	CVS
OF	Anti-biotic

Second pillar of growth: Russia/CIS markets

Russia is one of the largest markets for JBCPL with the majority of the company's revenues coming from the Russian and CIS markets (which amount for over 65% of its total export business). Despite the competition and pricing pressure, the company has maintained its leadership position in this market by strengthening its direct presence here. This reflects JBCPL's continuous investment in brand building to enhance its market share.

JBCPL has established a wholly-owned subsidiary in Russia which operates as a local marketing and warehousing facility. We expect this to increase its business in Russia by enabling it to reach out to smaller dealers and distributors, and to manage its receivables and inventory better. JBCPL is present in the hospital, ethical and OTC divisions of these markets. In FY2010, the company made 126 product registration applications in these countries while about 130 more product registration applications are planned for submission during FY2011. JBCPL plans to launch at least four new products in the Russian/CIS region and to aggressively promote its products and expand its field force in Russia in FY2011. The company also plans to increase its marketing activities in Russia/CIS to achieve a 12% CAGR over FY2010-12.

OTC segment contributes 70% of the revenues

Brands	Therapeutic segment
Doktor Mom*	Herbal
Metrogyl	Dental
Dicloran Plus Gel	NSAID
Unispaz	Analgesic
Jocet	Cough syrup

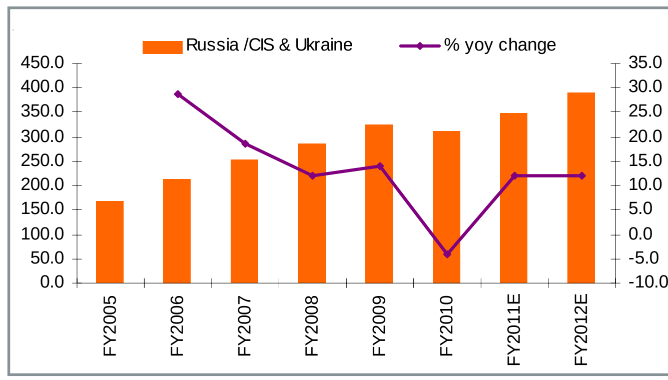
*Doktor Mom contributes about 30% of CIS revenues

Brands to be launched in FY2011

Brands	Therapeutic segment
Unispaz*	OTC
Unihexol	Contrast media
Unispaz-N	Anti-spasmodic
Rinza	Throat lozenges

*Already launched

Inventory rationalisation in FY2010 led to pressure on receivables



OTC market grew by 8% in 2009 in CEE countries

In the last few years the economies of the Central and Eastern European (CEE) countries (Russia, Poland, Ukraine, Bulgaria, Romania, Hungary, the Czech Republic, Slovakia, Slovenia and Croatia) have expanded very dramatically. The favourable economic situation, the rising wages and the increasing affluence in these countries, and the changing lifestyles that prompt people to take better care of their health and appearance accelerated the growth of the OTC market in the CEE region.

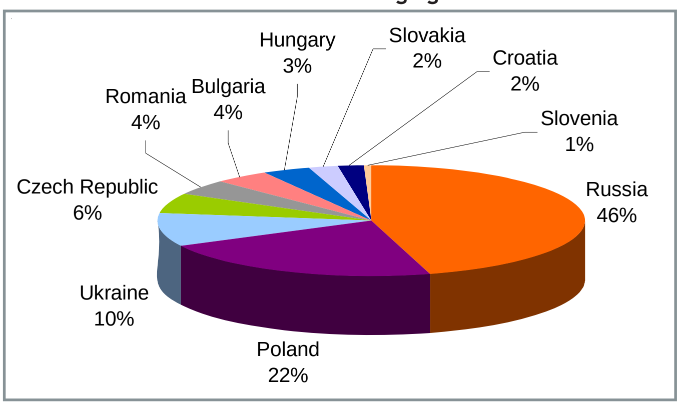
In 2008 the OTC market grew by 26% and was worth €9.2 billion. The global financial crisis resulted in a reduction in demand for the OTC products, as people tried to limit their spending on products like dietary supplements and OTC drugs. However, despite this the overall OTC product market in the region grew by 8-9% to approximately €10 billion in 2009. This is mainly because in Russia (the largest market of the region) the OTC product market recorded a growth in FY2009. In the first half of 2009, the OTC market in Russia grew by around 28% in rouble terms. This, in our view, shows that despite the recent global financial crisis, the Russian market should also grow rapidly in the near future owing to a high demand for OTC products.

Russia dominates the OTC market

Last year, Russia accounted for almost half of the OTC market value. Poland was the second largest OTC market in the region, with a share of over 22% as a percentage of the total sales. Ukraine had a share of around 10% whereas for the Czech Republic the figure was close to 6%. The Russian OTC market has expanded at an average pace of 25% per year over the last five years.

One of the factors that influence the growth of the OTC product market is the nature of the regulations pertaining to the distribution of such products in individual countries. In none of the countries of the CEE region are there restrictions on the sale of dietary supplements in general stores, which are always subject to laws on foodstuffs rather than those pertaining to pharmaceuticals. This reinforces our confidence in the company's approach towards the Russian market.

Growth chart of OTC market in emerging countries



USFDA approved plants: open lucrative CRAMS opportunity

With a strong base of 11 state-of-the-art manufacturing units (including tablet and API plants approved by the USFDA, UK MHRA and TGA [Australia] amongst others) and two DSTC approved R&D centres, the company has entered a dynamic phase of expansion into newer and faster growing therapeutic segments, such as anti-diabetics, CNS and respiratory. Its R&D activities focus on the development of novel drug delivery systems, new chemical entities, abbreviated new drug applications (ANDAs) and herbal products.

JBCPL has entered into new contracts with British and Australian companies for the supply of their private label lozenges and the company is expected to commence the supply of the same in this fiscal. Further, its regulatory complaint plants make them partners of choice amongst the Big Pharma. It is agressively exploring new site transfers and CRAMS projects for leading multinationals (MNCs). Although the company remains conservative about its guidance from the CRAMS business, yet we believe that the key orders from the Big Pharma would up the ante for JBCPL and act as a re-rating factor in the long run.

ROW markets: New growth drivers to propel growth

The company defines the rest of the world (ROW) markets as opportunity based business. Here it focuses on supplying niche lozenges used in the treatment of allergy, anti-tobacco etc to a few large MNCs in the UK and Australia. The company has identified Brazil, Australia, Venezuela, South Africa and other Latin American countries as future growth drivers in this business segment. It is already in the process of hiring country managers for the respective offices. It also has in place a state-of-the-art lozenge manufacturing facility approved by various regulatory authorities and is evaluating inorganic options for a faster growth in these markets.

JBCPL launched 14 new products across the ROW markets in FY2010. It has also identified herbal and ethical formulations for launch in central European countries and has set up a wholly-owned subsidiary in Romania. We expect this initiative to create value over the medium to long term. We believe that the company is on the right path and its focus on the above-mentioned high-growth markets would catapult it to a higher growth orbit in the next two to three years. With adequate capacity and contracts in place, the ROW business of JBCPL is expected to grow at a steady 12% CAGR over FY2010-12.

Strategic investment in Biotech Labs, South Africa

JBCPL made a strategic investment of USD5.1 million in Biotech Laboratories (Pty) Ltd (Biotech) in 2007 to take advantage of the growing opportunities in South Africa. With this investment, the company owns 49% of the equity of Biotech and enjoys the Black Economic Empowered (BEE) status. The BEE status bestowed on Biotech by the South African government allows it to secure government tenders. These tenders form a major part of Biotech's generic business in South Africa.

JBCPL expects this acquisition to enable it to gain access to the rest of the African market. Additionally, it would be able to access the dossiers acquired by Biotech and manufacture them selectively from its Indian operations. Further, this investment has also helped to launch ethical and OTC ranges of products, including the "Doktor Mom" series, in this market. JBCPL plans to source 15 new products from Biotech out of which three are expected to be commercialised in FY2011. Biotech has a strong product pipeline of developments and registrations too.

Regulated markets: Waiting to blossom

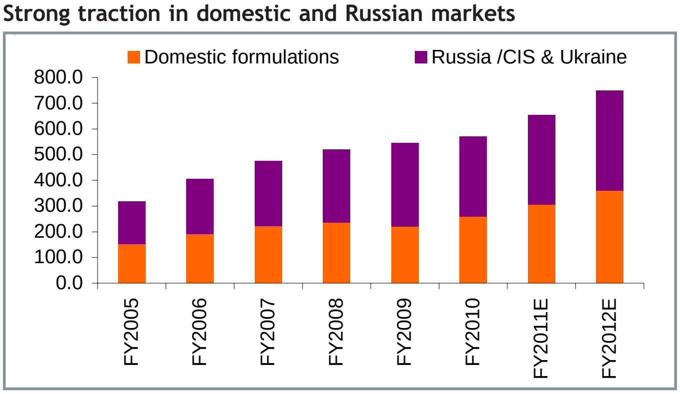
JBCPL is a late entrant in the regulated markets where it has launched only one product, Cetirizine HCL tablets (sales of about $1.4 billon prior to becoming an OTC product), in FY2010. It is awaiting approval for two more ANDA commercialisation in FY2011 and plans to file at least four ANDAs in the next two to three years in different therapy areas of anti-hypertensive, biologics, anti-allergy etc. We expect the US market to contribute $5 million in FY2011 and $8 million in FY2012.

Financial overview

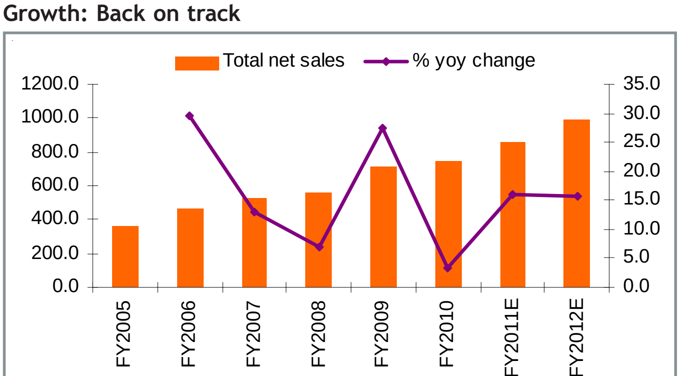
Accelerating sales: Expect a revenue CAGR of 15.8% over FY2010-12

JBCPL's net sales grew at a CAGR of 15% over FY2006-09 with an acceleration in growth on a year-on-year (y-o-y) basis. According to the management, with its export initiatives bearing fruit, JBCPL has entered a new growth phase from FY2010 which will get reflected as a considerably stronger financial performance in the coming years. We expect the company's revenues to grow at a CAGR of 15.8% over FY2010-12, driven by the Russian/CIS exports and the robust sales of its domestic formulations. The contribution from the international markets is projected to rise to 63% of its total sales in FY2011 as compared to 58% in FY2008. We expect the growth traction to set in in the US markets and in the CRAMS business only after FY2011. In the interim, the domestic and Russian markets would register a growth in higher teens during FY2011.

Strong traction in domestic and Russian markets



Growth: Back on track

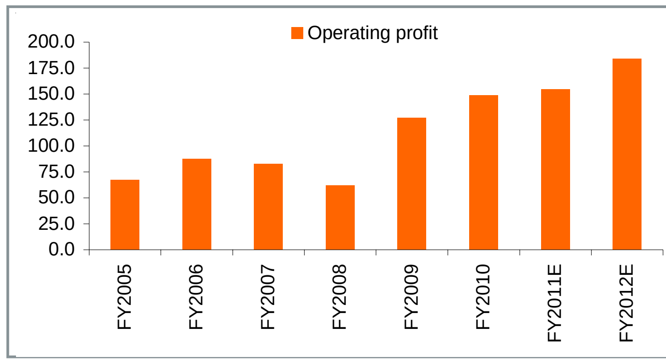


Operating margin to consolidate over FY2010-12

The company's operating profit margin (OPM) has improved in the last two years (though on a lower base; as the same had earlier been fluctuating due to a sharp variance in the input cost and the other expenses). This, we believe, is a healthy trend.

Driven by the strong revenues coming from the domestic and Russian markets (triggered by the healthy sales of the OTC products and formulations) with outstanding margins and the initiatives toward backward integration, we believe JBCPL's margins will consolidate in future. In view of the increasing revenues, a better product mix with a larger export component and a focus on cost-efficiency measures, JBCPL's OPM is projected to improve from 11% in FY2008 to 18.5% in FY2012.

Improving profitability at operating level

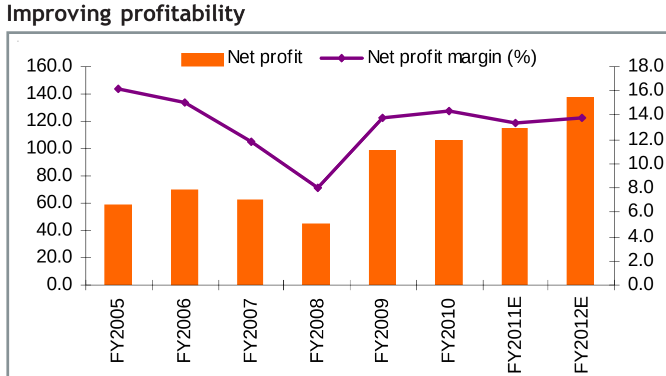


PAT to grow at 13.5% CAGR over FY2010-12

The improved sales mix and the cost-efficient measures at the operating level would lead to an increase in the OPM, thereby boosting the company's profitability. Going forward, considering the marked improvement in the operational performance, the newer market opportunities like South Africa, Venezuela, Romania and Australia amongst others, and the lucrative CRAMS opportunity, we forecast the adjusted net earnings of the company will grow at a CAGR of 13.5% during CY2010-12.

An overall improvement in its profitability and a strong earnings growth, without any significant increase in the

Improving profitability



capital employed to enhance the return ratios, would help the company to rationalise its fixed costs and to improve its profitability.

Investment phase gone by...

The financial year 2006-07 was a period of investment for JBCPL—during this period it made significant investments in manufacturing, market access, acquisition and people. In this year, the company had to incur a higher than expected financing cost to set up a new unit at Panoli. Further, it had to face the brunt of exchange losses from exports due to an appreciation in the rupee against the dollar. With the investment phase over, JBCPL is all set to reap the benefits through deeper penetration of the existing markets, entry into newer markets and new product launches.

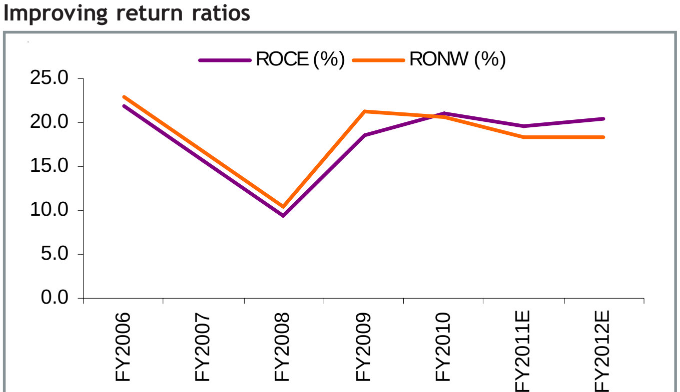
Strong balance sheet supports capex plans

JBCPL's majority capex was completed in FY2007-08. Now, the company plans to invest about Rs40 crore (funded through internal accruals) in the following: (1) modernisation and efficiency enhancement of the formulation facilities at Kadaiya and Panoli; (2) new R&D activities to facilitate the filing of new product registration applications in the key markets; and (3) expansion of the field force to strengthen its rural marketing initiatives in India as well as to increase its marketing activities in Russia/CIS to provide additional impetus to its marketing plans. It has also approved the acquisition of 10 acres of land at a pharmaceutical special economic zone at Panoli to set up a formulation unit. The plant is expected to be functional by the end of FY2013.

The company's debt-equity ratio (0.2x in FY2010) and low capex leave a lot of scope for leverage to fund its aggressive expansion plans in the near future. This paves the way for JBCPL to pursue inorganic opportunities. Despite the high receivable days in Russia (about 160 days), the company is confident about the quality of its receivables and we do not expect any significant negative surprise in terms of write-offs.

Further, due to its inventory and debtor realignment exercise in FY2009 the company's working capital cycle has started showing signs of improvement. We expect the company's return ratios to improve going forward on the back of an improved profitability as the company is focusing on niche therapeutic areas. We anticipate a continuous positive free cash flow generation on account of efficient management of working capital. A net debt-equity ratio of 0.2x and positive cash from the operations make JBCPL a safe and attractive investment bet.

Improving return ratios



Key concerns

Adverse currency fluctuations

JBCPL derives over 60% of its revenues from exports and the billing is done largely in euros. In the past the company had faced the brunt of currency fluctuations that had affected its profitability. Although it has fully covered forward contracts at Rs46/dollar to protect its billing, yet adverse fluctuations in the euro would affect its revenues.

High receivable days and over dependence on Russia/CIS

Although it has identified newer growth geographies, yet the Russian/CIS region contributes 65-70% of its total export revenues, clearly reflecting its over-dependence on this region. Given the complex nature of the business in Russia, the company has to bear high receivable days (as high as 160 days in Russia alone). Even though the company is confident about the quality of its receivables, this factor could pose an inherent risk to its cash flows.

Delay in ANDA filing and/or approval

The company is awaiting the regulatory nod for taking its products to the regulated markets. Any delay in obtaining the approval could be a drag on its revenues.

Lower contribution from newly launched products

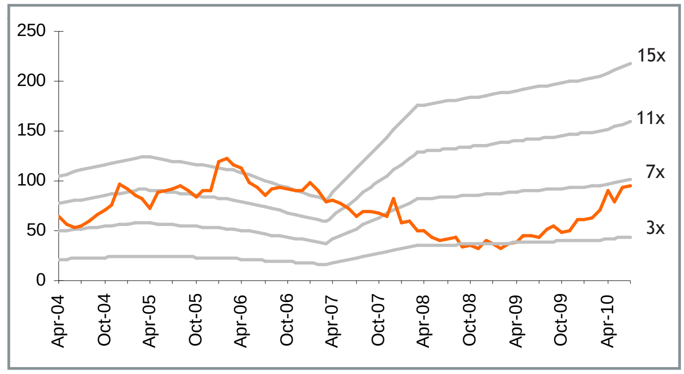
JBCPL focuses on building brands rather than launching a large number of generic products that attract a lot of competition. This is clearly vindicated by the fact that over 80% of its domestic formulation revenues comes from five major brands.

Valuation and view

JBCPL has carved a niche for itself in the OTC space and is transitioning well from a company that was focused on Russia to the one that is entering newer growth areas. The focus on brand building in the OTC market will boost the growth of the company's export division whereas the ramp-up in the domestic segment would lead to a robust growth and higher market share in the domestic business in the medium to long term. The monetisation of a large number of product registrations in the OTC space and the foray in the US and European Union markets with at least two to three product launches in FY2011 along with the potential CRAMS opportunity will drive the growth of the company in the long term.

At the current market price of Rs99, the stock trades at a price/earnings (PE) ratio of 7.3x FY2011E and 6.1x FY2012E earnings. Considering the double digit-growth in the revenues and earnings from its core business, the strong free cash flows and the healthy return ratios (18-20%), the company is trading at an attractive valuation of 6x FY2012 earnings (which is at a 20-25% discount to both the comparable companies' valuations and its long-term mean valuation of 8.5x one-year forward earnings). We initiate coverage on the stock with a "Buy" recommendation and price target of Rs138 (8.5x FY2012 earnings).

One-year forward P/E



Peer comparison Rs (crore)

Company	Price (Rs)	Mkt cap (Rs cr)	EPS (Rs)			EPS (CAGR %)	PE (x)		
			FY2010	FY2011E	FY2012E	FY10-12E	FY2010	FY2011E	FY2012E
JB Chemicals	99.0	846.6	12.6	13.6	16.3	13	7.8	7.3	6.1
Unichem	475.0	1712.6	29.8	35.5	45.5	24	15.9	13.4	10.4
Cadila Health	634.1	12981.3	26.1	28.9	34.5	15	24.3	21.9	18.4
Torrent Pharma	575.8	4872.0	27.3	37.0	45.7	29	21.1	15.6	12.6

Financials

Profit & Loss a/c Rs (cr)

Particulars	FY08	FY09	FY10	FY11E	FY12E
Revenues	562.4	717.1	741.0	859.1	993.5
Expenditure	500.6	589.9	592.4	704.5	809.7
Operating profit	61.8	127.1	148.6	154.6	183.8
Other income	15.0	15.8	17.9	20.0	20.0
EBITDA	76.8	142.9	166.5	174.6	203.8
Interest	16.2	12.7	9.1	7.6	6.7
Depreciation	16.9	20.4	21.6	23.5	25.7
PBT	43.7	109.8	135.9	143.5	171.5
Taxes	-1.7	11.3	29.3	28.7	34.3
Net profit	45.4	98.4	106.5	114.8	137.2
EO items	0.0	-72.7	12.2	0.0	0.0
Adjusted PAT	45.4	25.7	118.8	114.8	137.2

Key ratios

Particulars	FY08	FY09	FY10	FY11E	FY12E
OPM (%)	11.0	17.7	20.1	18.0	18.5
EBITDA margin (%)	13.7	19.9	22.5	20.3	20.5
Net profit margin (%)	8.1	13.7	14.4	13.4	13.8
RoCE (%)	9.4	18.5	21.0	19.6	20.3
RoNW (%)	10.4	21.4	20.5	18.2	18.3
Debt/Equity ratio (x)	0.4	0.4	0.2	0.2	0.1
Interest coverage ratio (x)	4.7	11.2	18.4	22.9	30.6

Valuations

Particulars	FY08	FY09	FY10	FY11E	FY12E
Consolidated EPS (Rs)	5.4	11.7	12.6	13.6	16.3
Consolidated PER (x)	18.7	8.6	7.9	7.4	6.2
EV/EBIDTA (x)	16.6	7.7	6.0	5.3	4.3
Price/book value (x)	1.9	1.8	1.5	1.2	1.0
Mcap/sales (x)	1.5	1.2	1.1	1.0	0.9

Balance sheet Rs (cr)

Particulars	FY08	FY09	FY10	FY11E	FY12E
Sources of funds					
Equity capital	16.9	16.9	16.9	16.9	16.9
Reserves and surplus	436.2	452.0	551.3	674.3	791.8
Total shareholder's funds	453.0	468.9	568.1	691.2	808.7
Total borrowings	196.4	178.8	136.8	117.5	102.5
Deferred tax liability	15.5	12.8	15.9	15.9	15.9
Total capital employed	664.9	660.5	720.7	824.6	927.0
Application of funds					
Gross Block	359.9	366.6	386.7	426.7	466.7
Less: Accumulated depreciation	100.6	119.9	139.9	163.4	189.0
Net block	259.3	246.7	246.8	263.3	277.6
Capital WIP	2.3	6.7	0.1	5.0	5.0
Investments	7.5	7.5	24.3	24.3	24.3
Net current assets	395.8	399.6	449.5	532.0	620.1
Total capital deployed	664.9	660.5	720.7	824.6	927.0

Cash flow statement Rs (cr)

Particulars	FY08	FY09	FY10	FY11E	FY12E
Cash flow from operating activities	11.7	68.5	127.4	96.6	98.0
Cash flow from investing activities	-28.1	-11.0	-30.3	-44.9	-40.0
Cash flow from financial activities	17.1	-27.5	-61.7	-39.0	-34.7
Opening cash balance	39.8	40.5	70.5	105.9	118.6
Net change in cash & cash equivalents	0.7	30.1	35.4	12.6	23.2
Closing cash balance	40.5	70.5	105.9	118.6	141.8

The author doesn't hold any investment in any of the companies mentioned in the article.