

Company Flash

25 April 2007 | 7 pages

Glenmark Pharmaceuticals (GLEN.BO)

Buy: Strong Quarter, Ahead of Expectations

- Maintain Buy (1M) rating** — as Glenmark reported excellent 4Q & FY07 results, and raised its FY08 net profit guidance for the base business by 18%. It also guided to 48% CAGR in base business PAT over FY07-09E and 2 R&D licensing deals over FY08. We rate Glenmark as the best play on innovative R&D among Indian companies with a favorable risk reward profile over the next 9-12 mnths.
- Results ahead of expectations** — Strong traction in the US & Latam markets drove sales growth and margin expansion in FY07, especially in 2HFY07. While 4Q numbers are not comparable YoY, for FY07, Glenmark reported 60% and 185% growth in sales and PAT, respectively, and R&D income of Rs1.4bn.
- R&D risk – rising or falling?** — Glenmark's pipeline has grown to 6 NCEs (all in the clinic by 2QFY08), with 2 licensed out. It also has 1 in-licensed NCE from Napo and its tie-up with Dyax would add 3 new biological entities to its pipeline. With the growing, more diversified pipeline and cash flow from milestones, we believe that at a business level Glenmark has de-risked its R&D to some extent.
- Status quo on Oglemilast** — Glenmark has received the non clinical data that the FDA required in order to allow large-scale phase II trials. The data is being compiled and Forest would approach the FDA soon. Forest also provided no color in its earnings call, but has maintained its FY08 royalty payout guidance.
- Risk reward in favor of investors** — as we expect low probability of adverse R&D news flow over the next 9-12 months. Upside catalysts, however, exist in the form of potential licensing deals, acquisitions and base business traction.

Buy/Medium Risk	1M
Price (25 Apr 07)	Rs677.30
Target price	Rs759.00
Expected share price return	12.1%
Expected dividend yield	0.2%
Expected total return	12.2%
Market Cap	Rs81,487M US\$1,999M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	1,063	8.16	133.3	83.0	26.2	40.3	0.1
2006A	872	6.48	-20.6	104.6	21.6	25.7	0.1
2007E	3,033	22.64	249.5	29.9	12.2	58.7	0.1
2008E	5,562	41.51	83.4	16.3	6.7	59.7	0.2
2009E	6,751	50.38	21.4	13.4	4.3	44.1	0.2

Source: Powered by dataCentral

See Appendix A-1 for Analyst Certification and important disclosures.

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Figure 1. Earnings Summary (Rupees in Million, Percent)

Year Ended March 31	1Q FY07	2Q FY07	3QFY07	4Q FY07	% Ch QoQ	FY06	FY07	% ch YoY	CIR Comments
Gross Sales	1,916	2,557	3,066	3,486	13.7	7,310	11,025	50.8	Excellent growth across markets (barring India), especially in formulations sales to the USA and Latin America
Excise Duty	73	88	81	95	17.7	623	350	(43.8)	Excise duty savings on shifting part of Indian operations to Baddi
Net sales	1,842	2,469	2,985	3,391	13.6	6,687	10,675	59.6	
Milestone Payments	-	-	1,395	-	nm	266	1,395		Guidance of US\$69m milestone payments in FY08E and FY09E
Net Revenue	1,842	2,469	4,380	3,391	(22.6)	6,952	12,070	73.6	
Material cost	584	807	854	998	16.9	2,451	3,231	31.8	Sequential increase due to the higher share of Latin American sales, where margins are lower currently
<i>% of Net Sales</i>	<i>31.7</i>	<i>32.7</i>	<i>28.6</i>	<i>29.4</i>	<i>83 bps</i>	<i>36.7</i>	<i>30.3</i>	<i>-638 bps</i>	
Staff cost	349.2	376.6	370.5	408.6	10.3	939.5	1,504.9	60.2	Investment in the front end in key target markets
Other exp	587.9	684.9	827.8	973.4	17.6	2,190.1	3,053.7	39.4	Continued investment in R&D – innovative and generics
Total Expenditure	1,521	1,869	2,052	2,380	16.0	5,580	7,790	39.6	
EBITDA (Excl'd milestones)	321	601	933	1,010	8.3	1,106	2,885	160.8	Strong traction in profitability in Latam and US markets
<i>EBITDA Margins (%)</i>	<i>17.4</i>	<i>24.3</i>	<i>31.2</i>	<i>29.8</i>	<i>-145 bps</i>	<i>16.5</i>	<i>27.0</i>	<i>1048 bps</i>	Operating leverage in play; we expect margins of the base business to stabilize in the 26-28% range
EBITDA (Including Milestones)	321	601	2,328	1,010	(56.6)	1,372	4,280	212	
Interest	70	87	100	147	46.5	147	404	174.4	
Depreciation	86	98	118	124	4.3	232	426	83.5	
Other income	45	29	31	77	151.1	128	161	25.3	
PBT	210	444	2,140	817	(61.8)	1,121	3,611	222.2	
Tax	23	42	250	184	(26.3)	241	500	107.4	
<i>Effective Tax rate</i>	<i>11.1</i>	<i>9.6</i>	<i>11.7</i>	<i>22.5</i>	<i>1086 bps</i>	<i>21.5</i>	<i>13.8</i>	<i>-766 bps</i>	Shift to Baddi for Indian operations leads to lower effective tax rate
Net Profit	187	402	1,890	633	(66.5)	880	3,111	253.6	
Net Profit (Excl. Milestones)	187	402	658	633	(3.8)	671	1,909	184.4	Strong ramp up; we believe 2H levels is the base now, on which we expect strong growth going forward.

Source: Company Reports and Citigroup Investment Research

Figure 2. Sales Summary (Rupees in Million, Percent)

Year Ended March 31	1Q FY07	2Q FY07	3QFY07	4Q FY07	% Ch QoQ	FY06	FY07	% ch YoY	CIR Comments
Formulations									
USA	231	338	835	803	(3.8)	572	2,208	286.0	Significant scale up over the last two quarters on the back of consistent product launches; 13 products in the market now and expects to get 6-7 approvals in Q1FY08.
<i>% of total Formulations</i>	<i>13.9</i>	<i>15.1</i>	<i>31.2</i>	<i>25.7</i>		<i>9.0</i>	<i>22.7</i>		
Latin America	202	268	292	676	131.4	764	1,421	85.9	Strong traction in 4Q on the back of step up in product launches and sales of existing products
<i>% of total Formulations</i>	<i>12.2</i>	<i>12.0</i>	<i>10.9</i>	<i>21.6</i>		<i>12.1</i>	<i>14.6</i>		
Rest of World	366	525	425	454	6.8	1,056	1,789	69.3	62 registrations filed in Q4 and received 147 approvals across various markets.
<i>% of total Formulations</i>	<i>22.1</i>	<i>23.4</i>	<i>15.9</i>	<i>14.5</i>		<i>16.7</i>	<i>18.4</i>		
India	861	1,108	1,123	1,197	6.5	3,937	4,290	9.0	High inventory levels in the trade pipeline restricts growth, despite robust 22% YoY growth as per ORG IMS
<i>% of total Formulations</i>	<i>51.9</i>	<i>49.5</i>	<i>42.0</i>	<i>38.2</i>		<i>62.2</i>	<i>44.2</i>		
Total Formulations	1,660	2,240	2,676	3,130	17.0	6,329	9,706	53.4	All round growth – the business has stepped up to a new level over the last four quarters
<i>% of Total revenue</i>	<i>86.7</i>	<i>87.6</i>	<i>60.0</i>	<i>89.8</i>		<i>83.5</i>	<i>78.2</i>		
API	255	317	390	356	(8.7)	981	1,318	34.4	Steady performance; focus is shifting towards more captive consumption to feed the growing formulations business
<i>% of Total revenue</i>	<i>13.3</i>	<i>12.4</i>	<i>8.7</i>	<i>10.2</i>		<i>12.9</i>	<i>10.6</i>		
Consolidated Revenue from Business	1,916	2,557	3,066	3,486	13.7	7,310	11,025	50.8	
Out licensing revenues	-	-	1,395	-		266	1,395	425.2	
<i>% of Total revenue</i>	<i>-</i>	<i>-</i>	<i>31.3</i>	<i>-</i>		<i>3.5</i>	<i>11.2</i>		
Consolidated Revenue	1,916	2,557	4,461	3,486	(21.9)	7,576	12,420	63.9	

Source: Company Reports and Citigroup Investment Research

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Company description

Glenmark Pharmaceuticals is a fully integrated research-based pharmaceutical company, with a business model spanning drug discovery research, APIs and formulations in the domestic and international markets. It operates in more than 65 countries, including the regulated markets of the US and Europe, with around 50% of its revenues coming from overseas markets. The company came into the limelight in September 2004 after it licensed out the US market rights of its first new chemical entity (NCE), GRC-3886, to Forest Laboratories.

Investment thesis

We have a Buy/Medium Risk (1M) rating on Glenmark with a target price of Rs759. Our positive outlook takes into consideration the following: a) R&D pipeline has broadened with six molecules expected by the company to be in the clinic by mid-CY07; b) With 2 molecules licensed out, the R&D option value or value at risk is now spread across two molecules; c) the base business has witnessed significant traction, especially in the USA and Latin America; d) potential risk triggers still appear some way off, while potential nearer-term catalysts exist – especially in the form of a fresh R&D outlicensing deal. We believe that with the faster than expected scale-up in the base business, the option value built into the stock for its R&D efforts (primarily Oglemilast & GRC-8200) has fallen. The risk reward, we believe, is in favor of investors, as the potential risk triggers that could lead to partial or full erosion of the option value appear some way off, while there remain potential upside catalysts over the next few months.

Valuation

We use sum of the parts to value the stock, valuing the R&D deals and the base business separately. We believe probability-adjusted DCF is appropriate to calculate the option value from Oglemilast and GRC-8200 as it captures the reducing probability of success as the molecules progress on the clinical path. We have used the licensing deal with Forest Laboratories for the US market as a benchmark as well as a 13% discount rate (in-line with Glenmark's WACC) following our adjustment for the higher-risk income streams by probability of success. We arrive at a value of Rs229/share for Oglemilast. We use a similar approach for GRC-8200 and arrive at a value of Rs87/share. We value Glenmark's base business (excluding R&D income) on P/E in view of the healthy growth expected in earnings. Our valuation is based on 20x March 2008E earnings, which is at a premium to the range that we use for other mid-sized pharma companies. We believe Glenmark deserves a premium given its higher value addition in its business and the ability to execute and leverage its assets. Based on 20x March 2008E earnings, we value Glenmark's base business at Rs443/share. This takes the total valuation of the company to Rs759/share.

Risks

We rate Glenmark as Medium Risk, even though Glenmark's risk rating according to our quantitative model is Low, as we believe the element of R&D related option value built into the stock warrants a higher risk rating. The main downside risks to our target price and estimates include: (1) Glenmark's efforts to build its own front-end in regulated markets could prove to be a drag on earnings if it is unable to effectively execute its plans; (2) growing competition, rapid price erosion and fragmented market share are risks that are inherent to the generics business; and (3) the failure of Oglemilast or GRC-8200 could lead to the R&D milestone payments getting taken off our estimates. If any of these

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factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

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Appendix A-1

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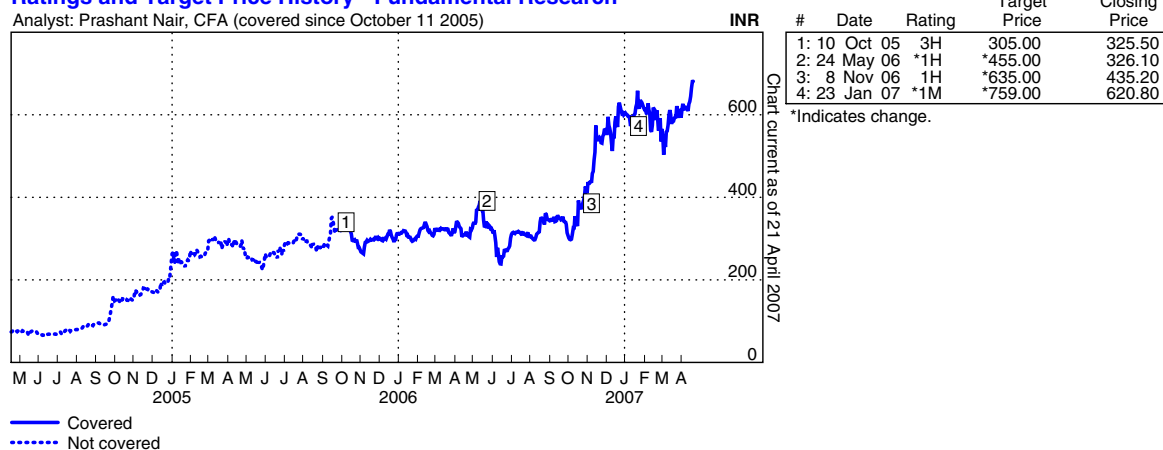
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Analyst: Prashant Nair, CFA (covered since October 11 2005)



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