

Wockhardt

Rs331

UPGRADE TO OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs36bn; US\$773m

Analyst: Nitin Agarwal, (91-22-6638 3395; nitinagarwal@sski.co.in)
Result: Q4CY06
Comment: Results in line; All negatives priced in
Last report: 26 Oct 2006 (Price Rs394; Recommendation: Neutral)

Key financials

Year to 31 Dec (Rs m)	Net Sales	% change yoy	Net profit	EPS (Rs)	% change yoy	PER(x)
CY05	14,131	14.1	2,571	21.5	20.4	15.4
CY06	17,282	22.3	2,543	21.3	-1.1	15.6
CY07E	22,962	32.9	2,910	24.3	14.4	13.6
CY08E	26,030	13.4	3,469	29.0	19.2	11.4

Wockhardt's Q4CY06 are in largely line with expectations with revenues at Rs5264m and EBITDA margins of 23.2% (post R&D capitalization). Wockhardt has capitalized Rs170m of R&D expenses during the quarter. India continues to be the key growth driver with 22% growth along with healthy growth in EU. Biotech and US business are performing below expectations. Management has indicated that the insulin issue has been resolved and the product will be relaunched in domestic markets over next few weeks. Going forward, management is confident of a turnaround in US business on the back of 7 new approvals in 1HCY07 and 30 new filings with a fair proportion of complex products. For CY07, Wockhardt has guided for \$500m plus sales and 16-18% net profit margins. Wockhardt aims to be \$1bn company by 2009 with 16-18% net profit margins. We have upgraded our CY07 estimates by 3.4% and introduced CY08 estimates. Currently, Wockhardt is trading at 13.6xCY07E and 11.4xCY08E (adjusted for R&D capitalized) at a sharp discount to peers. While Wockhardt does face organic growth challenges, we believe that current price is discounting all the negative news and risk-reward ratio is favourable at current valuations. The stock is likely to get re-rated on back of steady performance over next 1-2 quarters given the improving outlook across most segments. Upgrade to Outperformer with a 12-month price target of Rs420 (17.3xCY07E and 14.6xCY08E earnings - adjusted for R&D capitalized).

□ Key highlights – Growth driven by Domestic and European business

- In line with our estimates, revenues grew 44% on a yoy basis on the back of consolidation of Pinewood and Dumex acquisitions. Organic growth was 16% driven by continued strong growth in EU and domestic business. US and biopharma business continue to disappoint.
- Domestic formulations grew by 21% yoy on the back of consolidation of Dumex business. The Dumex business has broken even within six months of the acquisition and is expected to generate ~10% EBITDA margins in current year. Overall, the company is targeting 20%+ growth in the business during the current year with 7 new product launches in the first half.
- The EU business has grown strongly with a 97% growth yoy primarily on the back of Pinewood acquisition. On a like to like basis the business grew 15% yoy which is very positive given the challenging market conditions in UK and Germany. The company has guided to similar growth rates for the current years on the back of recovery in German markets. Wockhardt is working on enhancing value creation from the Pinewood business and is targeting a 200bps improvement in the EBITDA margin in the Pinewood business.

- The US business continues to be soft and grew 15% yoy. Wockhardt has been restructuring its US business and the results are likely to be visible in the current year. The company has 25+ ANDAs pending approval with another 30 filings planned for the current year. Management is very optimistic about the quality of the ANDA filings given its focus on NDDS, Steriles and complex APIs. In CY06, the company has filed 2-3 NDDS ANDAs and 12-14 steriles and is targeting similar filing in the current year. Wockhardt has guided for a 50%+ growth rate in the US business for CY07.
- Biopharma segment continues to disappoint with overall CY06 sales of Rs55-60cr against the target of Rs100cr. The company is targeting Insulin sales in non-regulated markets to be the key growth driver for the biotech segment. The company is also seeking to launch Glargine in the domestic market in the second half of the year. We believe the Biopharma sales will continue to be sluggish for the next few quarters.

We maintain that Wockhardt continues to face challenges in accelerating its organic growth. While the India business and EU have performed ahead of expectations, US and Biopharma continue to disappoint. The expected turnaround in US business will be a key trigger for accelerating organic growth.

We estimate 33% and 13.5% growth in revenues in CY07 and CY08 respectively.

□ **EBITDA margin –boosted by partial capitalization of R&D costs**

- Wockhardt's operating margins for Q4CY06 are 23.2% on the back of capitalization of Rs170m of R&D costs. Adjusted for this capitalization the margins are at 20%, 100bps lower yoy.
- Consolidated margins have been subdued by lower margins in the Pinewood and Dumex businesses which Wockhardt has acquired during the current year.
- During the current year, Wockhardt is targeting 200bps improvement in Pinewood and 10% improvement in Dumex business which will drive growth in overall margins.
- On the back of these improvements, we are estimating a 60bps improvement in EBITDA margins in CY07

□ **Net profit of Rs. 871m for Q4CY06; Impacted by higher interest outgo**

- Wockhardt registered Rs 871 m of net profit for the quarter, 17.3% higher than last year. However, accounting for the net impact of the lower R&D costs (R&D costs – tax shield lost), the profits are boosted by Rs140m on account of change in R&D accounting.
- We have adjusted our net profit estimates for the R&D capitalization by Rs580m for CY07 and CY08 respectively. (Rs700m R&D capitalization; 17% tax rate)

□ **Other highlights of the analyst meet**

- The company has indicated that it has managed to resolve the Insulin controversy and will be entering the market again over the next few weeks
- For CY07, the company is targeting \$500m plus revenues and 16-18% net profit margins
- By CY09, the company targets to be a \$1bn company with inorganic growth accounting for ~1/3 of sales. The company hopes to maintain net profit margins at 16-18%
- Management has highlighted its capability to successfully create value out of acquisitions over the years

Valuations and view

Wockhardt's current quarter performance has not thrown up any major surprises. The key positives include the good performance in the domestic and EU businesses as well as management's confidence in creating value from the recent acquisitions and turning around the US operations. Given the continued sluggishness in biopharma business, we believe US business holds the key to Wockhardt's growth. Managements' conviction in their ANDA pipeline and future filings is positive. We have upgraded our CY07 estimates by 3.4% and introduced CY08 estimates. Currently, Wockhardt is trading at 13.6xCY07E and 11.4xCY08E (adjusted for R&D capitalized) at a sharp discount to peers. While Wockhardt does face organic growth challenges, we believe that current price is discounting all the negative news and risk-reward ratio is favourable at current valuations. The stock is likely to get re-rated on back of healthy performance over the next 1-2 quarters given the improving outlook across most segments. Upgrade to Outperformer with a 12-month price target of Rs420 (17.3xCY07E and 14.6xCY08E earnings adjusted for R&D capitalized).

Quarterly results

Year to Dec 31 (Rs m)	Q4CY05	CY05	Q1CY06	Q2CY06	Q3CY06	Q4CY06	CY06E	CY07E	CY08E
Net Sales	3,662	14,131	3,510	4,127	4,377	5,264	17,282	22,962	26,030
Operating Expenses	2,812	10,844	2,705	3,115	3,406	4,042	13,280	17,505	19,842
Cost of Sales	1,340	5,771	1,286	1,572	1,735	2,115	7,459	10,080	11,294
COGS (%)	36.6	40.8	36.6	38.1	39.6	40.2	43.2	43.9	43.4
Salary costs	531	1,859	552	563	595	822	2,532	3,397	3,839
SG&A	779	2,531	754	822	907	975	2,679	3,295	3,830
R&D	162	683	113	158	169	130	610	732	878
EBITDA	850	3,287	805	1,012	971	1,222	4,002	5,457	6,188
EBITDA (%)	23.2	23.3	22.9	24.5	22.2	23.2	23.2	23.8	23.8
Other Income	27	180	33	18	61	78	190	150	150
Depreciation	98	426	128	140	141	212	621	950	1,000
Interest	(51)	95	(77)	(6)	(5)	115	26	400	400
PBT	830	2,945	787	896	896	973	3,545	4,257	4,938
Provision for Taxation	101	374	95	147	156	101	529	766	889
Minority Interest									
PAT	729	2,571	88	749	740	872	2,412	3,491	4,049
Extraordinary			(604)				(604)		
Adjusted PAT			692	749	740	872	3,016	3,491	4,049
R&D capitalized			115	115	170	170	570	700	700
Adjusted for R&D capitalized	729	2,571	596	653	599	730	2,543	2,910	3,469
yoy growth (%)									
Net Sales						43.7	22.3	32.9	13.4
EBITDA						43.7	21.8	36.4	13.4
Net Profit						19.6	(6.2)	44.7	16.0
Adjusted Net Profit (adjusted for R&D capitalized)						0.2	(1.1)	14.4	19.2

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1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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