Prabhudas Lilladher

Glaxo Smithkline Pharma

Margin improvement

Q1CY08 Result Update

April 21, 2008

Rating	Market Performer
Price	Rs1,020
Target Price	Rs1,136
Implied Upside	11.3%
Sensex	16,739

(Prices as on April 21, 2008)

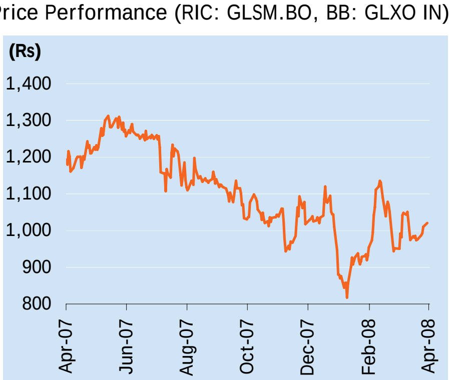
Trading Data	
Market Cap. (Rs bn)	86.4
Shares o/s (m)	84.7
Free Float	49.3%
Avg. Daily Vol ('000)	87.7
Avg. Daily Value (Rs m)	83.3

Major Shareholders	
Promoters	50.7%
Foreign	14.4%
Domestic Inst.	16.4%
Public & Others	18.5%

Stock Performance

(%)	1M	6M	12M
Absolute	7.2	(1.3)	(13.0)
Relative	(5.7)	5.7	(35.5)

Price Performance (RIC: GLSM.BO, BB: GLXO IN)



Source: Bloomberg

- **Results:** Glaxo SmithKline Pharma's (GSK) Q1CY08 results were better than our expectations. Net sales declined by 1% YoY from Rs4.22bn to Rs4.18bn (we expected Rs4.28bn), mainly due to hiving-off its fine chemicals business (FCB) during the year. However, the business on one-on-one basis grew by 5.3% during the quarter. The company's EBIDTA margin improved by 30bps from 36.1% to 36.4% YoY (we expected 34.2%) due to decline in material cost. Material cost declined by 110bps from 40.4% to 39.3% of net sales due to hiving-off of low margin fine chemicals business during the year. Personnel expenses increased marginally by 10bps from 9.5% to 9.6% of net sales. Other expenses increased by 70bps from 14.0% to 14.7% due to lower sales growth. GSK's net profit improved by 9% YoY from Rs1.11bn to Rs1.21bn due to improvement in margin and lower tax rate (we expected Rs1.13bn).
- **Capex update:** There is no major capex for GSK as it has restructured its manufacturing activities. However, the normal capex would be Rs200-300m per annum.
- **Valuation:** We expect the company to report 7% CAGR in net sales and 13% CAGR in net profit over CY07-09. We also expect its EBIDTA margin to improve from 34.1% in CY07 to 35.5% in CY09 due to the hiving-off low margin animal healthcare (AHC) and FCB.

  At the CMP of Rs1020, the stock trades at 19.2x CY08E EPS of Rs53.0 and 17.1x CY09E EPS of Rs59.8. We maintain Market Performer rating on the scrip with a price target of Rs1,136 (19x CY09 earnings) over the next 12 months, which is an upside of 11.4% over the CMP.

Key financials (Y/e Dec)	CY06	CY07A/E	CY08E	CY09E
Revenue (Rs m)	15,530	15,771	16,670	18,099
Growth (%)	*4.6*	*1.6*	*5.7*	*8.6*
EBITDA (Rs m)	5,019	5,375	5,835	6,432
PAT (Rs m)	3,618	3,997	4,491	5,062
EPS (Rs)	42.7	47.2	53.0	59.8
Growth (%)	*18.1*	*10.5*	*12.3*	*12.7*
Net DPS (Rs)	31.0	36.0	25.0	30.0

Source: Company Data; PL Research

Profitability & valuation	CY06	CY07A/E	CY08E	CY09E
EBITDA margin (%)	*32.3*	*34.1*	*35.0*	*35.5*
RoE (%)	*50.9*	*41.8*	*30.3*	*30.0*
RoCE (%)	*34.5*	*31.7*	*31.3*	*31.2*
EV / sales (x)	5.6	5.5	5.2	4.8
EV / EBITDA (x)	17.2	16.1	14.8	13.4
PE (x)	23.9	21.6	19.2	17.1
P / BV (x)	7.2	6.3	5.5	4.9
Net dividend yield (%)	*3.0*	*3.5*	*2.4*	*2.9*

Source: Company Data; PL Research

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Highlights

Lower sales growth

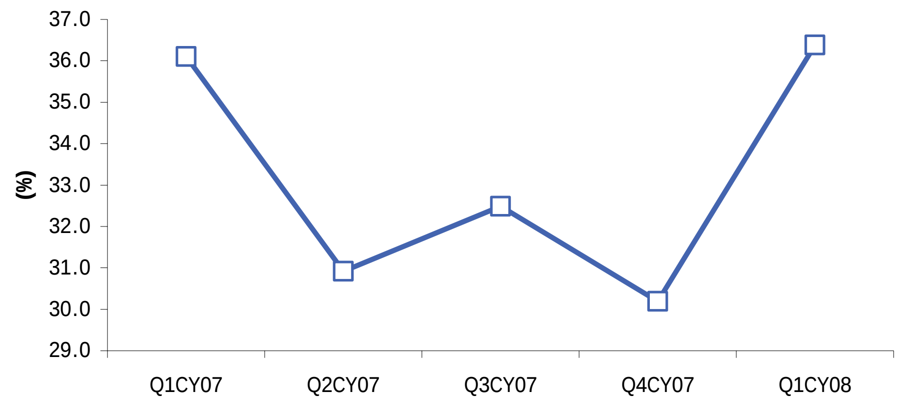
For Q1CY08, GSK's net sales declined by 1% YoY from Rs4.22bn to Rs4.18bn. The lower sales growth can be attributed to restructuring during the year. In September 2007, GSK sold its FCB to Thermo Electron for Rs1.81bn, net of incidental expenses to sales. However, the continuing business (excluding FCB) grew by 5.3% during the quarter. Sales were also affected by the pipeline inventory adjustments in March 2008, in view of reduction in excise duty from 16% to 8% on the formulations. The company intends to pass the benefit of reduction in excise duty across the portfolio. Sales and profits for the quarter were driven by the sales of priority products, which registered 9% growth during the quarter.

Margins improved by 30bps

GSK's EBIDTA margin improved by 30bps from 36.1% to 36.4% YoY. The company's material cost declined by 110bps from 40.4% to 39.3% of net sales due to hiving of low margin FCB during the year. Personnel expenses were marginally up by 10bps from 9.5% to 9.6% of net sales. Other expenses increased by 70bps from 14.0% to 14.7% of net sales due to the lower sales growth.

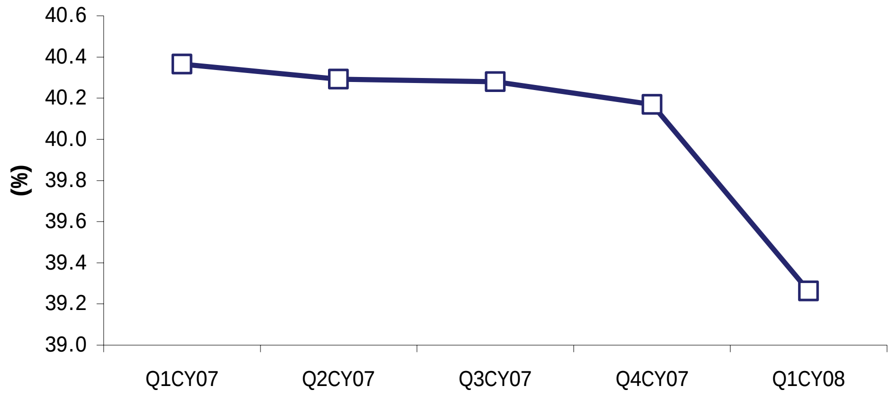
The company's material cost and EBIDTA margin over the last five quarters are shown in the following graphs:

EBITDA margin



Source: Company Data, PL Research

Material cost as % of sales



Source: Company Data, PL Research

As seen from the above graphs, the material cost of GSK declined from 40.4% in Q1CY07 to 40.2% in Q4CY07, indicating that the company is keeping a tight control over material cost. Material cost dropped by 90bps QoQ to 39.3% in Q1CY08. The company's EBIDTA margin had dropped from 36.1% in Q1CY07 to 30.2% in Q4CY07, but has improved by 620bps QoQ to 36.4% in Q1CY08. However, the margin for all four quarters in CY07 was over 30% indicating the stability of the company's business.

PAT improved 9% YoY

GSK's other income, including treasury income, grew by 70% from Rs200m to Rs341m. The company's depreciation was maintained at Rs37m. Its PBT for the quarter grew by 8% from Rs1.69bn to Rs1.83bn on one-on-one basis. PBT growth was 12.1% during the quarter. Effective tax rate declined from 34.0% to 33.6% of PBT. This has resulted in 9% improvement in PAT from Rs1.11bn to Rs1.21bn.

Outlook

GSK's future performance is likely to improve due to the hiving-off its AHC and FCB. The company can now concentrate on its pharma business alone. It has plans to export Betamethasone API for its global requirements. The company is currently conducting eight clinical trials (covering 10% of the global patients enrolled) for its parent company in India. Going further, both these businesses are likely to grow. Sales growth is likely to pick-up from Q2CY08 onwards, as the excise-related pipeline inventory adjustments are over.

GSK has launched two new innovative vaccines in the domestic market – Boostrix (for newborn babies) and Infanrix (for children over seven years). These vaccines are used in routine immunisation in over 100 developed and developing countries. These vaccines have an advantage over the existing vaccines, as they give more comfort to children due to reduced pain, fever and swelling. These are likely to be future growth drivers for the company.

The new products launched during CY07 Arixta (anti-thrombosis) and Cardez (CVS) have been well accepted by doctors. GSK is looking at in-licensing and alliance opportunities to drive topline.

The company has plans to introduce Tykerb, breast cancer drug, and Rotarix, rotavirus vaccine, in the current year. These products are expected to be the future growth drivers. The company is likely to price Rotarix at a relatively cheaper price in India, which could be at a discount to the global price. GSK has a strong field force of 2,200 people and hence will have wider reach.

Concerns

The government has plans to increase the number of drugs under price control from 74 to 354, based on the WHO list of essential drugs. Currently, the company derives around 28% of its sales from price-controlled products. The inclusion of additional products under DPCO would affect sales and profitability of the company.

Valuation

We expect the company to report 7% CAGR in net sales and 13% CAGR in net profit over CY07-09. We also expect the company's EBIDTA margin to improve from 34.1% in CY07 to 35.5% in CY09 due to the overall reduction in expenses. We expect material cost to decline from 39.8% in CY07 to 39.6% in CY08 and then to 39.5% in CY09, due to the change in product mix and high margin new products. We expect new products to contribute Rs325m in CY08 and Rs590m in CY09.

GSK is a debt-free company and hence will be able to sustain itself in bad times. We expect the company's RoE to decline from 41.8% in CY07 to 30.0% in CY09. Its RoCE is also likely to decline marginally from 31.7% in CY07 to 31.2% in CY09.

At the CMP of Rs1,020, the stock trades at 19.2x CY08E EPS of Rs53.0 and 17.1x CY09E EPS of Rs59.8. We maintain Market Performer rating for the scrip with a price target of Rs1,136 (19x CY09 earnings) over the next 12 months, which is an upside of 11.4% over the CMP.

Q1CY08 result overview *(Rs m)*

Y/e Dec	Q1CY08	Q1CY07	YoY gr. (%)	Q4CY07	QoQ gr. (%)
Net sales	**4,181**	**4,215**	*(0.8)*	**3,393**	*23.2*
Expenditure					
Raw materials	1,642	1,701	*(3.5)*	1,363	*20.5*
as % of net sales	*39.3*	*40.4*		*40.2*	
Personnel expenses	403	402	*0.2*	288	*39.8*
as % of net sales	*9.6*	*9.5*		*8.5*	
Other expenses	615	590	*4.3*	718	*(14.2)*
as % of net sales	*14.7*	*14.0*		*21.1*	
Total expenditure	2,660	2,693	*(1.2)*	2,369	*12.3*
OPBDIT	**1,521**	**1,522**	*(0.0)*	**1,024**	*48.5*
OP margin (%)	*36.4*	*36.1*		*30.2*	
Other income	341	200	*70.4*	287	*18.9*
PBDIT	**1,862**	**1,722**	*8.2*	**1,311**	*42.0*
Depreciation	37	37	-	50	*(26.3)*
Interest	-	-	*NA*	-	*NA*
PBT	**1,825**	**1,685**	*8.3*	**1,261**	*44.8*
Prov. for tax	613	573	*7.0*	432	*41.9*
% of PBT	*33.6*	*34.0*		*34.3*	
PAT	**1,212**	**1,112**	*9.0*	**829**	*46.3*
Extra-ordinary item	-	-	*NA*	(20)	*NA*
Reported PAT	**1,212**	**1,112**	*9.0*	**809**	*49.8*

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PL's Recommendation Nomenclature

BUY	:	> 15% Outperformance to BSE Sensex	**Outperformer** (OP)	:	5 to 15% Outperformance to Sensex
Market Performer (MP)	:	-5 to 5% of Sensex Movement	**Underperformer** (UP)	:	-5 to -15% of Underperformace to Sensex
Sell	:	<-15% Relative to Sensex			
Not Rated (NR)	:	No specific call on the stock	**Under Review** (UR)	:	Rating likely to change shortly