Company In-Depth

29 April 2007 | 10 pages

Ranbaxy (RANB.BO)

Buy: More than Half Full

Rating change ☐
Target price change ☐
Estimate change ☑

- **Maintain Buy (1M)** — as Ranbaxy delivered in-line 1Q results and raised CY06 sales growth guidance to 20%, dispelling slowdown concerns. Key positives include efforts to augment its pipeline, effective integration of Terapia & R&D progress. While we are cautious on forex impact and issues at its Paonta & Ohm facilities, at 2.6xCY07E sales, we believe the glass is more than half full.

- **Steady 1Q** — while seasonally weak, 1Q results had some encouraging signs in terms of strong sales growth across markets (23% YoY overall) and the 110bps margin expansion despite rupee appreciation. PAT grew 79% YoY, also buoyed by forex gains of Rs559m on mark to market of forex debt. We expect successive quarters to be stronger, as sales and margins gain momentum over the year

- **Positive signs** — Besides the higher sales guidance, we are enthused by Ranbaxy's progress in strengthening its business by a) growing share of high margin emerging market sales (>50%); b) tie-ups to enhance pipeline in niches like biogenerics, oncology & peptides; c) Fast integration & scale-up of Terapia; d) validation of its R&D effort (expanded GSK arrangement & the PPD deal).

- **Revising estimates** — We have lowered our CY07-08 EPS estimates by c10%, as we factor in more aggressive rupee appreciation; our CY07 sales growth estimate is at 16% vs. the 20% guidance. We introduce CY09E estimates and forecast a 29% CAGR in FDEPS over CY06-09E. Our target price remains unchanged at Rs505, as we roll forward to 3xFY08E (from Dec'07E earlier) sales.

- **A top pick** – one of the few globally diversified & integrated generic companies, it has sufficient room to cut costs and leverage to improve profits as sales grow.

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

Buy/Medium Risk	1M
Price (27 Apr 07)	Rs369.95
Target price	Rs505.00
Expected share price return	36.5%
Expected dividend yield	1.4%
Expected total return	**37.9%**
Market Cap	Rs137,940M
	US$3,391M

Price Performance (RIC: RANB.BO, BB: RBXY IN)

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	2,617	7.03	-62.6	52.7	5.6	10.6	1.6
2006A	5,151	12.89	83.5	28.7	5.7	20.4	2.3
2007E	7,186	17.98	39.5	20.6	5.0	25.8	2.3
2008E	8,835	22.11	23.0	16.7	4.3	27.4	2.4
2009E	11,118	27.83	25.8	13.3	3.2	27.6	2.7

Source: Powered by dataCentral

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	52.7	28.7	20.6	16.7	13.3
EV/EBITDA adjusted (x)	43.9	17.4	15.2	12.3	10.2
P/BV (x)	5.6	5.7	5.0	4.3	3.2
Dividend yield (%)	1.6	2.3	2.3	2.4	2.7
Per Share Data (Rs)					
EPS adjusted	7.03	12.89	17.98	22.11	27.83
EPS reported	7.03	12.89	17.98	22.11	27.83
BVPS	65.70	65.20	74.24	86.89	114.72
DPS	6.00	8.50	8.50	9.00	10.00
Profit & Loss (RsM)					
Net sales	53,131	61,340	71,097	83,565	97,119
Operating expenses	-51,149	-53,818	-61,875	-72,170	-83,066
EBIT	**1,982**	**7,522**	**9,222**	**11,396**	**14,053**
Net interest expense	-671	-1,080	-1,147	-1,108	-943
Non-operating/exceptionals	633	123	974	767	784
Pre-tax profit	**1,944**	**6,565**	**9,049**	**11,055**	**13,894**
Tax	698	-1,361	-1,810	-2,167	-2,723
Extraord./Min.Int./Pref.div.	-25	-53	-53	-53	-53
Reported net income	**2,617**	**5,151**	**7,186**	**8,835**	**11,118**
Adjusted earnings	2,617	5,151	7,186	8,835	11,118
Adjusted EBITDA	3,426	9,433	11,397	14,108	16,773
Growth Rates (%)					
Sales	-2.5	15.5	15.9	17.5	16.2
EBIT adjusted	-77.5	279.6	22.6	23.6	23.3
EBITDA adjusted	-65.8	175.3	20.8	23.8	18.9
EPS adjusted	-62.6	83.5	39.5	23.0	25.8
Cash Flow (RsM)					
Operating cash flow	**3,470**	**7,527**	**8,372**	**9,023**	**28,417**
Depreciation/amortization	1,445	1,911	2,175	2,712	2,719
Net working capital	-934	412	-1,042	-2,577	14,526
Investing cash flow	**-8,310**	**-21,618**	**-5,349**	**-2,790**	**4,670**
Capital expenditure	-9,204	-19,942	-4,863	-2,575	-2,450
Acquisitions/disposals	712	-803	-162	814	322
Financing cash flow	**7,460**	**11,932**	**-3,819**	**-6,990**	**-36,368**
Borrowings	11,622	16,583	900	-2,100	-35,425
Dividends paid	-3,612	-3,571	-3,571	-3,781	0
Change in cash	**2,620**	**-2,159**	**-796**	**-757**	**-3,281**
Balance Sheet (RsM)					
Total assets	**59,637**	**82,673**	**90,510**	**97,184**	**106,163**
Cash & cash equivalent	2,430	1,000	1,000	1,000	1,000
Accounts receivable	11,404	13,363	15,191	17,902	20,837
Net fixed assets	26,187	44,569	47,608	47,822	47,904
Total liabilities	**35,001**	**56,405**	**60,574**	**62,142**	**59,949**
Accounts payable	7,714	8,163	9,884	11,764	13,896
Total Debt	20,043	36,626	37,526	35,426	32,426
Shareholders' funds	**24,636**	**26,269**	**29,936**	**35,043**	**46,214**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	6.4	15.4	16.0	16.9	17.3
ROE adjusted	10.6	20.4	25.8	27.4	27.6
ROIC adjusted	6.8	11.4	11.3	13.2	15.0
Net debt to equity	71.5	135.6	122.0	98.2	68.0
Total debt to capital	44.9	58.2	55.6	50.3	41.2

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Buy: More than Half Full

Ranbaxy delivered in-line 1Q results and raised CY06 sales growth guidance to 20%, dispelling slowdown concerns. Key positives over the last few months include efforts to augment its pipeline, effective integration of Terapia & R&D progress. While we are cautious on the rupee appreciation impact and issues at its Paonta & Ohm facilities, at 21xCY07E EPS & 2.6xCY07E sales, we believe the glass is more than half full. We have lowered our CY07-08 earnings estimates by c10%, as we build in a more aggressive rupee appreciation trend going forward, and forecast a 29% FDEPS CAGR over CY07-09E. We believe that Ranbaxy is one of the few globally diversified and integrated generic companies in the world. We maintain our Buy (1M) rating with a price target of Rs505/ share.

Ranbaxy Laboratories – Result Snapshot (Rupees in Millions)

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

Year to 31st December	1Q CY06	1Q CY07	% Ch YoY	4QCY06	% Ch QoQ	CIR Comments
Sales	12,753	15,644	22.7	17,077	(8.4)	
Excise Duty	122	109	(10.7)	102	6.9	
Net sales	**12,631**	**15,535**	**23.0**	**16,975**	**(8.5)**	**Strong growth across most markets; company has revised CY07 growth guidance to 20% in dollar terms**
Other Operating Income	291	286	(1.7)	794	(64.0)	Includes net forex gain of US$1.5m
Total Net revenues	12,922	15,821	22.4	17,769	(11.0)	
Cost of sales	6,855	8,367	22.1	9,131	(8.4)	
Gross Profit	6,067	7,454	22.9	8,638	(13.7)	Gross margin trend expected to improve over the next few quarters, as efforts to improve process efficiencies etc start bearing fruit towards the latter part of CY07
Gross margins (Net sales -RM costs)	*47.0*	*47.1*	*16 bps*	*48.6*	*-150 bps*	
SG&A	3,915	4,735	20.9	4,749	(0.3)	Terapia acquisition has added to SG&A cost; as % of sales, expected to decline over the full year
as a % of sales	*31.0*	*30.5*	*-52 bps*	*28.0*	*250 bps*	
R&D	729	811	11.2	1,224	(33.7)	R&D spend to increase to CY05 levels (US$100m) in CY07
as a % of sales	*5.8*	*5.2*	*-55 bps*	*7.2*	*-199 bps*	
EBITDA	**1,423**	**1,908**	**34.1**	**2,665**	**(28.4)**	**Margin improvement is in line with expectations; impressive given the rupee appreciation trend**
EBITDA Margin (%)	*11.0*	*12.1*	*105 bps*	*15.0*	*-294 bps*	
Depreciation and Amortization	427	557	30.4	531	4.9	Higher amortization and deprecation on the Terapia acquisition
Interest Cost	257	313	21.8	247	26.7	
Forex (Gain)/Loss	(59)	(559)	nm	(460)	22	Mark to market profit on outstanding FCCBs
Other Income	55	45	(18.2)	24	87.5	
PBT	**853**	**1,642**	**92.5**	**2,371**	**(30.7)**	
Tax	135	355	163.0	512	(30.7)	
Tax Rate	*15.8*	*21.6*	*579 bps*	*21.6*	*3 bps*	
PAT	718	1,287	79.2	1,859	(30.8)	
Minorities	4	11	175.0	26	(57.7)	
Recurring Net Income	**714**	**1,276**	**78.7**	**1,833**	**(30.4)**	**In line with estimates, we expect momentum to pick up over the next few quarters**
Exceptional	-	-	nm	-	nm	
Reported Net Income	714	1,276	78.7	1,833	(30.4)	

Source: Citigroup Investment Research

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

	1Q CY06	1Q CY07	% Ch YoY	4QCY06	% Ch QoQ	CIR Comments
Dosages						
India	58	72	25.6	66	9.6	New product launches, greater penetration – we expect above market growth to continue
Europe, CIS and Africa	82	135	65.0	136	(0.5)	Steady growth in W Europe despite pricing pressure; Romania contributes handsomely (up 50%) to growth in overall Europe region; Russia / CIS markets continue with the impressive growth trend (up 61%)
Asia Pacific & Middle East	18	24	33.9	24	1.2	Slow but sure growth in the Japanese market; this could be a big market going forward, with regulations beginning to move in favour of generics
Latin America	9	9	(5.3)	16	(44.7)	
North America	89	91	3.1	114	(19.9)	Seasonally slow quarter, but product approvals have picked up towards the end of the quarter and in April. Growth likely to remain modest in view of the double digit pricing pressure being witnessed in the base business
Total Dosage	**256**	**332**	**29.9**	**356**	**(6.7)**	
API	31	23	(25.8)	26	(11.5)	
Allied Business	-	-	nm	-		
Total Sales	**287**	**355**	**23.9**	**382**	**(7.0)**	
INR	44.4	44.1	(0.8)	44.8	(1.6)	Rupee appreciation has not hit materially in 1Q; we expect this to change going forward

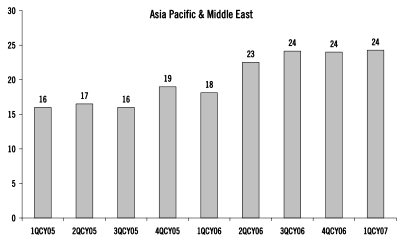
Source: Citigroup Investment Research

Key Takeaways from the Conference Call

- Manufacturing facility related issues – Ranbaxy has had trouble with two of its facilities – at Paonta Sahib (warning letter) and New Jersey (raid by criminal investigators) – with the US FDA. On Paonta Sahib, the management indicated that the inspection in late January went off well and they are awaiting a response from the USFDA. As far as the Ohm Labs facility at New Jersey is concerned, most of the papers that were taken away by the FDA-OCI team have been returned, although there is no word on what the investigation was related to. The latter has been one of the main concerns dogging the Ranbaxy stock in recent times, with the Street worried that this may be on the back of any manufacturing / compliance related issue.

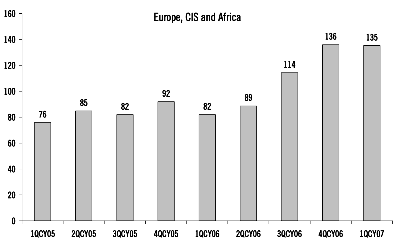
  We however highlight that the company has since then received three approvals from the New Jersey facility – including one for Pravastatin 80mg, with 180 days marketing exclusivity. While we remain cautious on the potential outcome, we believe that the issue is unlikely to be as serious as is being feared, given the steady rate of approvals from this facility. Even on the Paonta Sahib facility, we believe that there is no issue with the API part; it is the formulations segment, where the problems lie. We note that Ranbaxy has already taken initiatives to refile some of the major products that were earlier filed from this facility in its other plants. Thus, we believe that fears of a further slowdown in US sales if the Paonta approval gets delayed are largely unfounded.

Figure 3. Asia Pacific Sales (US$m)



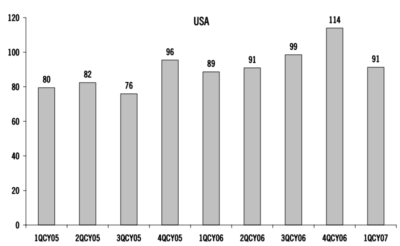
Source: Company Reports

Figure 4. Europe, CIS and Africa Sales (US$m)



Source: Company Reports

Figure 5. US Sales (US$m)



Source: Company

- Focus on emerging markets – through increasing product registrations and marketing efforts has started paying off, with share of emerging markets increasing to over 50% of overall revenues. Key growth markets include India, Russia / CIS and Romania (partly through the Terapia acquisition). With the Be-Tabs acquisition in South Africa expected to be closed by May, this trend is expected to continue going forward. We believe this augurs well for Ranbaxy, given that EBIDTA margins are higher and more stable in these markets. Over the next few years, we expect Ranbaxy's EBIDTA margins to gradually improve as the geographic mix continues to improve.

- Developed markets remain challenging – the pricing pressure in the US market as well as some of the Western European markets shows no signs of abating. The management indicated double digit price erosion in the base business in US, with new products facing as high as 99%+ price erosion on day one of patent expiry. While the adverse trend in the US market is driven by growing competition, regulatory and government pressures have been pulling prices down in the markets of UK, France and Germany – as there appears to be a shift in preference from high priced branded generics to low priced commodity generics in these markets. While this would hurt Ranbaxy to some extent in UK and delay the ramp up in profitability of France, the management expects this trend to benefit them in Germany. In the latter market, Ranbaxy has been focused at the lower end from the very beginning and has recently got 11 products listed with the largest health insurance company (AOK) in this market. We expect Ranbaxy to offset the pricing pressure in these markets through launch of new products through its own organic pipeline as well as partnerships with other companies. Improving margins would however remain a challenge going forward as well.

- US First to File Opportunities – Ranbaxy announced that it believes it is first to file a patent challenge on 20 products in the US, with a cumulative innovator market size of cUS$25bn. With simvastatin upside having come through in CY06, pravastatin upside coming through in CY07E and the rest of the FTFs evenly spaced out, the management expressed confidence that they would have at least one such launch / settlement income every year to top up their core business profits. One of the FTF opportunities clearly is Lipitor, where the nearest opportunity could be in the Canadian market, where Ranbaxy won the case in the lower court and Pfizer has appealed. Lipitor has sales of US$800m in Canada, and if successfully launched, this could be a big upside for Ranbaxy. We however highlight that such upsides are one-off as well as uncertain, and we would refrain from assigning a multiple to such earnings, even when they are certain.

- Pipeline augmenting measures – Ranbaxy has taken several initiatives to augment its pipeline, both internally as well as through partnerships – as it aims to leverage its strong distribution franchise by pushing through more and a wide variety of products into different markets. To this end, it has commenced ANDA filings in penems and limuses, which should translate into revenues from CY09. Besides, it has also entered into a series of partnerships to fill in some gaps in its portfolio and gain access to niche segments. These include: a) Zenotech – for biogenerics; starting with GCSF; b) Jupiter Biosciences – for peptide drugs (innovator market size of US$9bn);

c) Ipca Labs – for another set of products. The management expects to file products from the Zenotech and Jupiter agreements over CY07-08 in emerging markets and over CY08-09 in regulated markets. We view these arrangements positively as they allow Ranbaxy to leverage its front end network much better without doing all the major investment of its own.

- NCE efforts make some progress – Ranbaxy has expanded the scope of its NDDR tie up with GSK, by entering into a multi-year collaboration that gives it expanded drug development responsibilities and significant financial benefits. As part of this arrangement, the joint team has identified a compound for COPD which will be taken up to proof of concept stage by Ranbaxy. Ranbaxy stands to get milestone payments up to US$100m and double digit royalties on world wide sales, if the product is successfully launched by GSK. In another encouraging development, the company outlicensed a novel statin NCE to PPD Inc, USA, a leading global CRO. This also involves potential milestone payments and royalties, if successfully launched. While the timing and probability of success in these initiatives is difficult to establish, these developments have once again lent some credibility to Ranbaxy's NCE efforts – and this validation would come in handy, in case the company moves ahead with any plan to restructure / spin off its innovative R&D program.

Revising Estimates

We lower our CY07-08E earnings estimates by c.10% each, as we build in a more aggressive rupee appreciation trend going forward. Our sales growth estimate is at 16% for CY07 as against the 20% growth guidance provided by the company. We also introduce CY09 estimates and forecast 17% and 29% CAGR in revenues and earnings respectively over CY06-09E

Ranbaxy

Company description

Ranbaxy is a leading domestic pharmaceutical company with a strong export business complementing the domestic business. It has a vision of becoming a leading generics pharmaceutical company in the global market and, in the long term, a research-led pharmaceutical company. The company already has a presence in several countries, and has developed a complex business model, perhaps the first of its kind from a developing country. Over the past few years, Ranbaxy has grown rapidly and established itself firmly as a leading generics company globally. While the core pharmaceutical business is growing, the company has also invested in R&D. The company also has a strong chemicals and animal healthcare business in India.

Investment thesis

We rate Ranbaxy Buy (1M) with a target price of Rs505/share. We believe the stock price now factors in most negatives - viz. difficult global market dynamics, manufacturing related issues with the FDA, slowdown in product approvals. Moreover, we believe that these negatives and the declining stock price mask the positive steps that Ranbaxy has been taking since the beginning of CY06 to effect a turnaround in its fortunes. Benefits of its restructuring initiatives were visible in CY06 and in 1QCY07 results, the EU foray has gained momentum with a series of acquisitions and revenues should scale up faster once the manufacturing issues are resolved. In the interim, we expect strong earnings momentum driven by exclusivity launch of Pravastatin 80mg to provide support to stock valuations and restrict downside

Valuation

We prefer to value Ranbaxy using EV/Sales methodology to reflect a much fairer value of Ranbaxy's business today. We believe that Ranbaxy's current cost structure and profitability are not normalized. Its cost structure is highly fixed-cost oriented and is a legacy of the heady days of very high profitability in global generics. We believe this is being corrected now, and the benefits of the aggressive cost reduction initiatives have started coming through in the financials in CY06. With its presence across multiple geographies and wide basket of products, we believe the business is not fairly valued at 2.6x CY07E sales – this is primarily on account of profitability being under par. A large part of the costs are discretionary and related to pipeline building measures for future growth, which do not contribute to revenues in the near term. Our fair value multiple of 3xMarch'08E (Sept'07E earlier) EV/Sales is at a discount to its peers such as Cipla and Sun and towards the lower end of the company's EV/Sales range of 2-4.6x over the past five years. Because the company is still emerging from a period of poor sales growth and sub-optimal profitability, we will wait for growth to return before applying a higher multiple. At 3xMarch'08E EV/Sales, our target price is Rs505/share.

Risks

We rate Ranbaxy Medium Risk based on our quantitative risk-rating system. The key upside risks to our target price include: (1) New ANDA approvals above the expected three to four per quarter; (2) Upside from pravastatin 80mg being higher than we expected (3) News on the NCE development program; and (5) Any new paragraph IV challenges. The key downside risks include: (1) Intensifying pricing pressure in the US and European markets; (2) The company paying high multiples to acquire more businesses in Europe and USA; and (3) Inability to resolve the manufacturing issues with the US FDA soon.

Appendix A-1

Analyst Certification

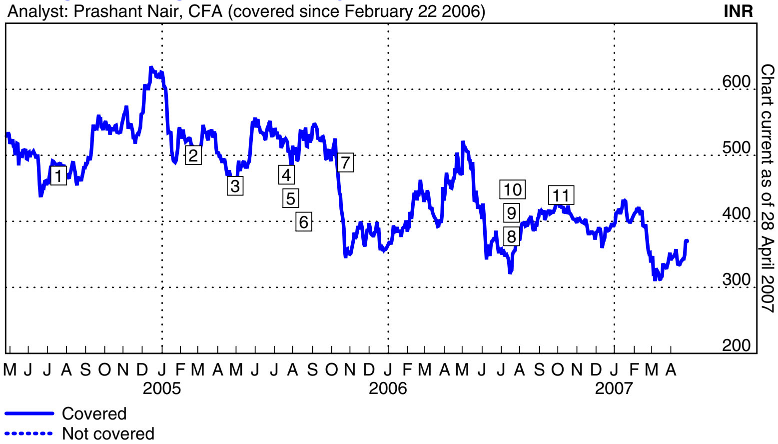
I, Prashant Nair, CFA, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Ranbaxy (RANB.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since February 22 2006)



#	Date	Rating	Target Price	Closing Price
1:	20 Jul 04	*3M	1,025.00	486.90
2:	22 Feb 05	3M	*935.00	506.55
3:	29 Apr 05	3M	*845.00	456.42
4:	21 Jul 05	3M	*815.00	522.97
5:	28 Jul 05	3M	*407.50	NA
6:	18 Aug 05	3M	*385.00	522.05
7:	25 Oct 05	3M	*363.00	344.40
8:	19 Jul 06	*1M	*402.00	325.90
9:	19 Jul 06	1M	402.00	325.90
10:	20 Jul 06	1M	402.00	349.90
11:	6 Oct 06	1M	*505.00	422.35

*Indicates change.

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India -- Asia Pacific (130)	58%	14%	28%
% of companies in each rating category that are investment banking clients	42%	50%	42%

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