investor's eye

Index

United Phosphorus

Ugly Duckling

Stock Ideas

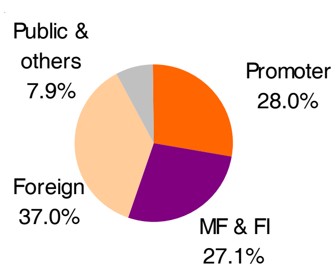
A global agrochemical play

Buy; CMP: Rs163

Company details

Price target:	Rs225
Market cap:	Rs7,143 cr
52-week high/low:	Rs353/73
NSE volume: (No of shares)	12.2 lakh
BSE code:	512070
NSE code:	UNIPHOS
Sharekhan code:	UNIPHOS
Free float: (No of shares)	31.7 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	0.7	1.0	85.4	2.2
Relative to Sensex	-1.9	-13.0	4.5	-7.3

Key points

- **Wide product portfolio, diversified target markets:** United Phosphorous Ltd (UPL)'s diversified product portfolio, strong distribution network and presence across geographies make it a good investment play in the agrochemical space. UPL derives its revenues from various geographies across the world, with India contributing around one-fifth of the revenues. Such well-diversified client markets act as a natural hedge for the company during times of slowdown or drought in any particular region.
- **Huge opportunities for crop protection products:** Globally, the agrochemical industry is divided into products protected by patents and generic products. With a significant number of agrochemicals going off patent in the next couple of years, opportunities for global generic players like UPL are likely to be immense. UPL has a strong pipeline of products in the generic crop protection space. Domestically too, in view of the increasing focus on improving productivity and the lower penetration of agrochemicals in the country, the demand for crop protection products is likely to remain buoyant going forward.
- **Margin expansion to boost earnings:** UPL has achieved a stupendous 37% revenue growth (CAGR) over FY2005-09, though we expect its revenue growth to moderate in future (13% CAGR during FY2009-11E) due to lower average realisations globally. However, we expect the OPM to improve by 80 basis points on the back of a lower raw material cost and improved profitability of the recently acquired entity, Cerexagri. Moreover, UPL plans to take advantage of its low-cost base in India and shift home some of the global manufacturing processes from its high-cost manufacturing destinations like Australia and Argentina. As a result, the net profit is estimated to grow at a CAGR of 28% during FY2009-11.
- **Stock at discount to its average multiple:** Despite its strong positioning in the crop protection market and the healthy growth in its earnings, UPL trades at a huge discount to its one-year forward average EV/EBITDA multiple of 9.4x, leaving scope for substantial upside. Moreover, we have not factored in any possible upside from its seed business that is currently margin dilutive but is expected to witness improvement in profitability. At the current market price of Rs163, the stock is discounting its FY2010E and FY2011E EPS at 10.7x and 8.8x respectively. We initiate coverage on UPL with a Buy recommendation. We arrive at a price target of Rs225 after valuing the company at 8.5x its FY2011E EV/EBITDA, which is at ~10% discount to its historical average.

Consolidated	FY2007	FY2008	FY2009	FY2010E	FY2011E
Net sales (Rs cr)	2449.8	3730.6	4931.7	5678.1	6335.7
Adj net profit (Rs cr)	265.6	372.3	475.2	645.9	783.3
No of shares(cr)	18.8	22.0	44.0	44.0	44.0
Fully diluted EPS (Rs)	15.0	12.8	11.0	14.5	17.5
% y-o-y change	*30.2*	*-15.2*	*-13.5*	*31.0*	*20.9*
PER (x)	21.6	25.5	14.7	10.7	8.8
P/BV (x)	4.1	3.2	2.7	2.3	1.9
EV/EBIDTA (x)	12.9	11.1	8.9	7.9	6.4
RoCE (%)	12.0	14.9	16.6	16.3	18.4
RoNW (%)	18.9	12.5	18.6	21.1	21.1

Company background

Incorporated in 1969 UPL is a leading global producer of crop protection products, intermediates, specialty chemicals and other industrial chemicals. UPL has its presence across value-added agricultural inputs, ranging from seeds to crop protection products, and post-harvest activities. UPL offers a wide range of products including insecticides, fungicides, herbicides, fumigants and rodenticides. The company operates across continents and has a customer base in 86 countries. UPL ranks amongst the top five post-patent agrochemical manufacturers in the world.

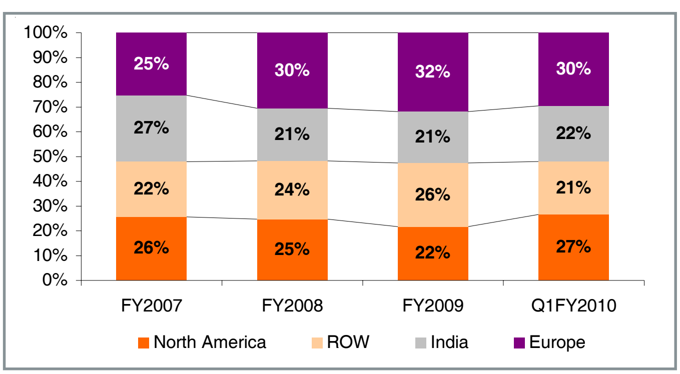
Investment arguments

Wide product portfolio, diversified target markets

UPL has a diversified business model, in terms of both geographies and products. The company is a leading global producer of crop protection products, intermediates, specialty chemicals and other industrial chemicals. It offers a wide range of products including insecticides, fungicides, herbicides, fumigants and rodenticides. Moreover, with its recent acquisition of Advanta Netherlands Holdings BV (Advanta), UPL has now introduced seeds in its product portfolio and sells Advanta's products through its distribution network.

In terms of target markets, UPL has presence across continents and derives its revenues from various geographies across the world, with India contributing around one-fifth of its total revenues (as on June 30, 2009). The largest contribution comes from the European region, which is also the most profitable region for the company. Such diversified client markets act as a natural hedge for the company during times of a slowdown in any particular region. Thus, we see limited impact of the ongoing drought condition in India on the financial performance of the company.

Region-wise beak-up of revenues



Huge opportunities in the crop protection market

UPL is among the top five players in the global agrochemical and crop protection market. Globally, the agrochemical industry is divided into products protected by patents and products where the patents have expired (generic products). With a significant number of products going off patent in the next couple of years, opportunities for global generic players like UPL are likely to be immense.

Globally, the main agrochemical product segments like herbicides contributed around 50% of the industry's revenues in 2007, followed by insecticides and fungicides, which make equal revenue contribution for the rest. Currently, the generic players have ~40% market share. This share is likely to increase going forward as products worth ~$4 billion (in revenue) are likely to come up for patent expiry between 2009 and 2014.

Though globally the generic crop protection market is huge and throws up enough opportunities, the industry is highly regulated by specific and separate registration processes in different countries and is subject to various environmental and safety legislations. Consequently, the higher regulatory requirements make the entry into this space tough and unattractive for the new entrants. This augurs well for established players like UPL.

On the domestic front too, the government's focus will remain on improving productivity to increase the agricultural output in order to keep pace with the growing population. With lesser land available for cultivation, the only way to increase output now is to improve productivity. As per the data available, in India the consumption of agrochemicals in terms of per kilogram per hectare is as low as 0.5 in India as against 5.0 in the UK, 7.0 in the USA and 14.0 in China. This clearly indicates the huge opportunity available at home as the penetration of agrochemicals in the country remains low.

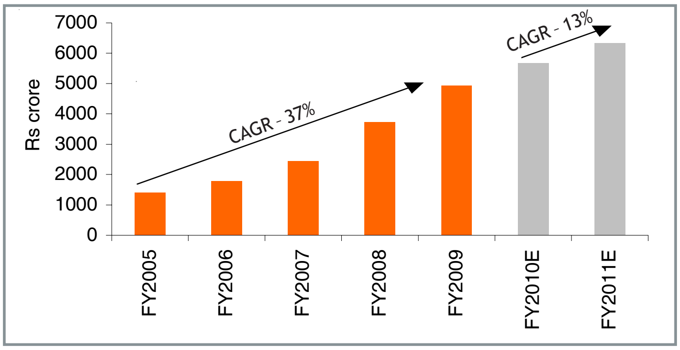
Lower revenue growth but margin expansion to boost bottom line

During FY2005-09, UPL's top line and bottom line grew at a compounded annual growth rate (CAGR) of 37% and 32% respectively on account of a number of acquisitions done by the company over the period. However, we expect the pace of revenue growth to moderate significantly (13% CAGR during FY2009-11) on account of lower realisations globally. The average realisations are expected to decline largely due to the partial pass-through of the steep drop in the input cost. Moreover, the sharp exchange rate fluctuations too are likely to have a bearing on the revenue growth of the company. In addition, we have factored in our estimates marginal revenues from the company's newly started seed business (based on the arrangement between UPL and Advanta). This shall partially offset the decline expected in the revenues on account of the lower average realisation.

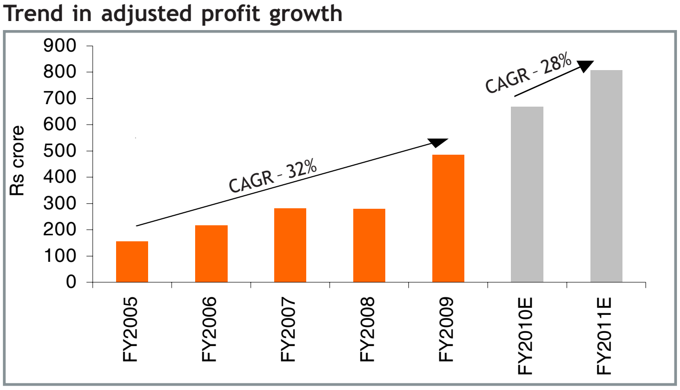
Importantly, despite a slower growth in the top line, we expect UPL's bottom line to grow at a CAGR of 28% during FY2009-11. The higher growth in the bottom line would be driven by the expansion in the company's operating profit margin (OPM) led by a lower raw material cost, lower restructuring expenses and benefits of integration of Cerexagri with the company.

UPL's margins took a hit in FY2009 due to the restructuring cost incurred on account of the Cerexagri acquisition. We expect the restructuring expense to continue till H1FY2010 after which the margin is likely to expand following the completion of the Cerexagri integration. Furthermore, the benefits of a lower raw material cost are likely to trickle in in the coming quarters as the high cost inventory runs off.

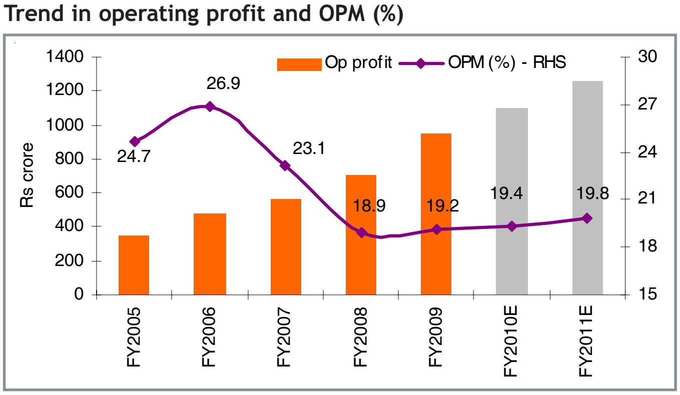
Trend in top line growth



Trend in adjusted profit growth



Trend in operating profit and OPM (%)



In Q1FY2010, UPL registered a 26% year-on-year (y-o-y) increase in its revenues on account of a Rs77-crore income booked from the newly started seed business. However, the company booked no profits on the same. As a result, the OPM stood reduced at 18.7% in the first quarter. Importantly, excluding this the OPM for the quarter stood at 19.7%.

Inorganic growth strategy

Over the years, UPL has adopted the strategy of growing inorganically and emerged as a global player. UPL has acquired 21 companies in the past 20 years, thereby growing exponentially with the help of this strategy. Consequently, during FY2005-09, UPL's top line and bottom line grew at a stupendous CAGR of 37% and 32% respectively. Moreover, UPL's acquisitions like Cerexagri and stake in Advanta have added significant value in terms of allowing it to expand/enter into newer geographies and introduce new products in its portfolio.

With a sizeable amount of cash sitting on its balance sheet and a comfortable leverage position (net debt to equity of 0.6x), the company is currently scouting for acquisitions worldwide, as indicated by the management. We believe this could be the potential trigger for the next upmove in the stock.

Company name	Location	Year of acquisition
MTM Agro	UK	1994
Agrodan	Denmark	1996
Devrinol	USA	1996
Surflan	USA	2004
Ultra Blazer	Worldwide	2004
Lenacil	Europe	2004
Ag Value Inc	USA	2005
SWAL	India	2006
Reposo	Argentina	2006
Advanta B.V.	Netherlands	2006
Crop Serve	South Africa	2006
Asulam, Trichlorfon and ODM	Worldwide	2006
Bensulfuron-methyl	Worldwide	2006
Propanil	Worldwide	2006
Cerexagri	Worldwide	2007
Super Tin, Vendex (Du Pont)	Worldwide	2007
Icona	Argentina	2007
Evofarms	Colombia	2008

Investment concerns

Rupee's appreciation

UPL derives majority of its revenues from its overseas subsidiaries. Hence, it runs the risk of sharp currency fluctuations, which are likely to affect its revenues. A significant appreciation in the rupee could hamper the company's top line growth.

Delay in monsoon may affect demand

The company caters to the agriculture sector, which is highly dependent on the rains in India as well as globally. A weaker monsoon in India could threaten the domestic demand, thereby affecting UPL's domestic revenues. However, India contributes around one-fifth of the company's total revenues and has a limited impact on its financial performance.

High cost acquisition could affect balance sheet

The company has followed the strategy of growing inorganically in the past to expand its business and is currently scouting for more good acquisition opportunities. As on March 31, 2009, the company had comfortable net debt-to-equity position of 0.6x at the consolidated level. However, a high cost acquisition may lead the company to excessively leverage its balance sheet.

Fall in agro commodity prices

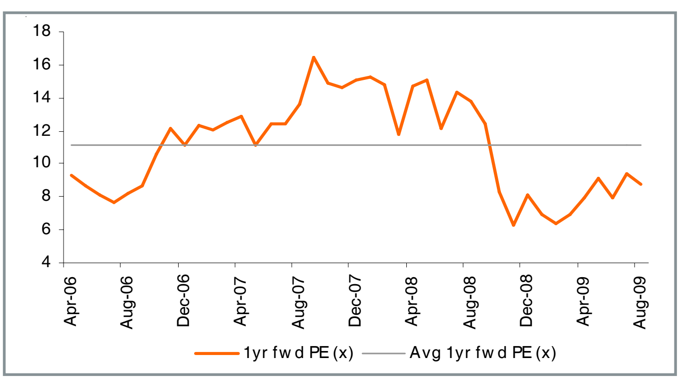
A sharp fall in agro commodity prices domestically as well as globally may hamper the demand for crop protection products, thereby affecting the company's top line.

Valuation

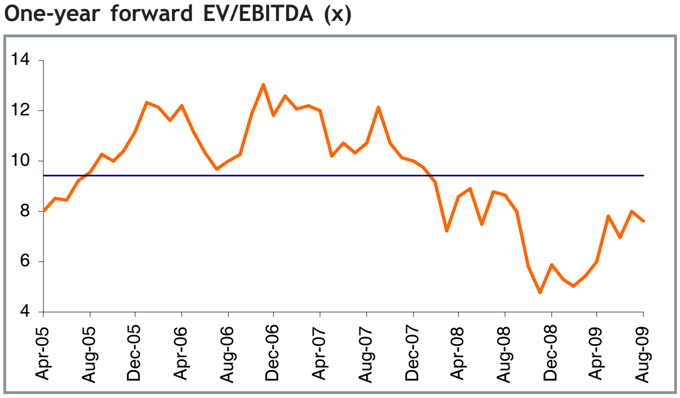
We believe UPL's diversified product portfolio, strong distribution network and presence across geographies make it a good investment play in the agrochemical space. Despite its strong positioning in the crop protection market and the healthy growth in its earnings, UPL trades at a substantial discount to its one-year forward average enterprise value (EV)/earnings before interest, tax, deprecation and amortisation (EBITDA) multiple of 9.4x, leaving scope for substantial upside. Moreover, we have not factored in any possible upside from its seed business (in arrangement with Advanta), which is currently margin dilutive but is expected to witness an improvement in profitability going ahead.

At the current market price of Rs163, the stock is discounting its FY2010E and FY2011E earnings per share (EPS) at 10.7x and 8.8x respectively. We initiate coverage on UPL with a Buy recommendation. We arrive at a price target of Rs225 after valuing the company at 8.5x its FY2011E EV/EBITDA, which is at ~10% discount to its historical average and offers 38% upside from the current levels.

One-year forward PE (x)



One-year forward EV/EBITDA (x)



Financials

Profit & Loss statement Rs (cr)

Particulars	FY07	FY08	FY09	FY10E	FY11E
Net sales	**2449.8**	**3730.6**	**4931.7**	**5678.1**	**6335.7**
Operating profit	567.1	705.5	944.9	1099.9	1255.5
Other income	21.2	31.1	41.8	40.0	75.0
EBIDTA	588.3	736.7	986.7	1139.9	1330.5
Interest	104.6	168.8	291.9	159.1	164.7
Depreciation	165.6	152.2	192.7	202.6	222.1
Exceptional items	7.6	114.4	10.1	0.0	0.0
PBT	310.4	301.3	492.1	778.2	943.7
Tax	52.5	42.4	26.9	132.3	160.4
PAT (after minority int)	257.9	257.9	465.1	645.9	783.3
RPAT	282.1	280.1	485.1	667.9	807.4
Adj. PAT (after minority int)	**265.6**	**372.3**	**475.2**	**645.9**	**783.3**
EPS	15.0	12.8	11.0	15.2	18.4
Fully diluted EPS	**15.0**	**12.8**	**11.0**	**14.5**	**17.5**
BV	79.8	101.9	59.3	71.9	87.1

Balance Sheet Rs (cr)

Particulars	FY07	FY08	FY09	FY10E	FY11E
Equity share capital	37.5	43.9	87.9	87.9	87.9
Reserves and surplus	1457.9	2194.0	2516.7	3071.2	3741.2
Shareholders' funds	1495.4	2238.0	2604.6	3159.1	3829.1
Total debt	1959.3	1568.3	2072.3	2472.3	2072.3
Deferred payment liabilities	69.5	86.2	86.2	86.2	86.2
Deferred tax liabilities	5.0	25.4	25.4	25.4	25.4
Minority interest	4.9	6.0	6.0	6.0	6.0
Total liabilities	**3533.9**	**3923.8**	**4794.4**	**5748.9**	**6018.9**
Fixed assets	694.9	810.4	976.0	1073.3	1051.3
Goodwill	397.2	469.3	469.3	469.3	469.3
Intangibles	781.5	319.6	319.6	319.6	319.6
Investments	391.0	757.0	757.0	757.0	757.0
Deferred tax assets	2.2	56.3	56.3	56.3	56.3
Net current assets	1266.5	1510.8	2215.8	3073.0	3365.0
Misc expenditure	0.7	0.5	0.5	0.5	0.5
Total assets	**3533.9**	**3923.8**	**4794.4**	**5748.9**	**6018.9**

Key ratios

Particulars	FY07	FY08	FY09	FY10E	FY11E
OPM (%)	23.1	18.9	19.2	19.4	19.8
EBIDTAM (%)	24.0	19.7	20.0	20.1	21.0
PATM (%)	10.8	10.0	9.6	11.4	12.4
Net debt / Equity (x)	1.0	0.5	0.6	0.6	0.4
RoCE (%)	12.0	14.9	16.6	16.3	18.4
RoNW (%)	18.9	12.5	18.6	21.1	21.1

Valuation

Particulars	FY07	FY08	FY09	FY10E	FY11E
Fully diluted EPS (Rs)	15.0	12.8	11.0	14.5	17.5
PER (x)	21.6	25.5	14.7	10.7	8.8
P/BV (x)	4.1	3.2	2.7	2.3	1.9
EV/EBIDTA (x)	12.9	11.1	8.9	7.9	6.4

Logistics

Sector Update

Recovery in container volume

Key points

- Total cargo at major ports in July 2009 reported a decline of 1% year on year (yoy) and 4.2% month on month (mom) mainly due to 27% year-on-year (y-o-y) decline in cargo at Kolkata port. Year to date i.e. April to July 2009 cargo reported a flattish growth of 1.7% yoy to 180 million tonne (MT).
- However, port container volume is in recovery mode and has reported a growth of 3.5% yoy and 8.5% mom after a sharp y-o-y fall in three consecutive months—March, April and May 2009—which augurs well for container freight station (CFS) players.
- Improving container cargo volume augurs well for logistics majors like Gateway Distriparks Ltd (GDL) and Container Corporation of India (Concor). We prefer GDL due to its higher-than-average valuation discount to the market leader Concor and due to expected improvement in profitability from rail operations.

Total cargo at major ports decline 1% yoy and 4.2% mom…

The total cargo volume at major ports reported a fall in July 2009 mainly due to 27% y-o-y decline in cargo volume at Kolkata port. However Paradip (+12.5%), Chennai (+6.2%), Tuticorin (+40.3%), Mumbai (+4.1%) and Kandla (+4.1%) reported growth in their cargo traffic. Year to date i.e. April to July 2009 total cargo reported a flattish growth of 1.7% yoy to 180MT however it missed the Indian Port Association's target of 189.6MT by 5%.

Total cargo at major ports

Particulars	Mar-09	Apr-09	May-09	Jun-09	Jul-09
KOLKATA	4519	3812	3690	3677	3433
% growth (yoy)	*-21*	*-15*	*-22*	*-19*	*-27*
% growth (mom)		*-16*	*-3*	*0*	*-7*
PARADIP	5129	5007	4161	5001	4041
% growth (yoy)	*30.5*	*29.2*	*10.8*	*36.1*	*12.5*
% growth (mom)		*-2.4*	*-16.9*	*20.2*	*-19.2*
VISAKHAPATNAM	5975	5068	6019	5637	5418
% growth (yoy)	*-8.3*	*-12.9*	*7.2*	*0.3*	*-4.3*
% growth (mom)		*-15.2*	*18.8*	*-6.3*	*-3.9*
CHENNAI	6821	4725	4349	5065	5478
% growth (yoy)	*25.5*	*-0.6*	*-12.8*	*4.4*	*6.2*
% growth (mom)		*-30.7*	*-8.0*	*16.5*	*8.2*
TUTICORIN	2651	1874	1869	1942	2202
% growth (yoy)	*30.5*	*11.2*	*-4.6*	*5.7*	*40.3*
% growth (mom)		*-29.3*	*-0.3*	*3.9*	*13.4*
COCHIN	1246	1013	1186	1380	1039
% growth (yoy)	*2.8*	*-27.8*	*1.5*	*11.6*	*-21.9*
% growth (mom)		*-18.7*	*17.1*	*16.4*	*-24.7*
NEW MANGALORE	3078	2998	2915	3112	3295
% growth (yoy)	*-3.3*	*23.4*	*-1.4*	*12.8*	*-8.5*
% growth (mom)		*-2.6*	*-2.8*	*6.8*	*5.9*
MUMBAI	4432	4055	4337	4512	4542
% growth (yoy)	*-11.8*	*-15.5*	*3.9*	*4.3*	*4.1*
% growth (mom)		*-8.5*	*7.0*	*4.0*	*0.7*
JNPT	5090	4874	5207	4880	5027
% growth (yoy)	*-3.8*	*-4.8*	*1.4*	*1.9*	*-1.3*
% growth (mom)		*-4.2*	*6.8*	*-6.3*	*3.0*
KANDLA	5825	5388	5996	7423	6989
% growth (yoy)	*-0.9*	*-4.7*	*-10.1*	*25.0*	*6.7*
% growth (mom)		*-7.5*	*11.3*	*23.8*	*-5.8*
TOTAL	50279	45410	45755	45424	43505
% growth (yoy)	*1.1*	*-1.2*	*-1.1*	*8.6*	*-1.0*
% growth (mom)	*15.9*	*-9.7*	*0.8*	*-0.7*	*-4.2*

Source: IPA, Sharekhan reasearch

However container volume shows an improving trend…

The aggregate container volume in July 2009 reported a rise of 3.5% yoy as against a flat volume growth in June 2009 and a de-growth of 17.1% and 17.6% in April and May 2009 respectively. The improvement in volume is seen from June 2009. The sequential improvement in container traffic is positive for CFS players. The growth in container volume is mainly on the back of increase in import volume while export volume remained subdued.

We believe, GDL in the near term will report healthy volume growth from the launch of its new inland container deposits (ICD) in Ludhiana and improving utilisation in rail business. Additionally, the company has reported marginal profit in rail operations in July 2009 as against loss in the previous quarters. We believe the valuation gap between GDL and Concor would narrow down in subsequent quarters, as GDL's rail business no longer remains a burden on its earnings.

We recommend a positive outlook on GDL in the near term on the back of its improving container volume and expected improvement in profitability from rail operation.

Container volume at major ports

In '000 Teu	Mar-09	Apr-09	May-09	Jun-09	Jul-09
CHENNAI	91	88	87	98	110
% growth (yoy)	*-15.4*	*-17.6*	*-17.1*	*0.9*	*2.0*
% growth (mom)	*16.7*	*-3.3*	*-1.1*	*12.6*	*12.4*
J.N.P.T.	333	315	329	328	352
% growth (yoy)	*-13.1*	*-13.7*	*-17.1*	*0.9*	*-1.4*
% growth (mom)	*28.6*	*-5.4*	*4.4*	*-0.3*	*7.3*
ALL PORTS	543	519	536	559	606
% growth (yoy)	*-15.4*	*-17.6*	*-17.1*	*0.9*	*3.5*
% growth (mom)	*22.9*	*-4.4*	*3.3*	*4.3*	*8.5*

Source: IPA, Sharekhan Research

Commodity wise performance at various ports...

Iron ore, container and other cargo reported increase in volume in July 2009, however coal, crude oil and fertiliser volumes were subdued for the month.

During the month iron ore was the top-performing commodity, whereas coal was the worst performing commodity. After reporting a de-growth in April and May 2009, container traffic have now returned to a positive growth of 3% and 4% yoy in June 2009 and July 2009 respectively, which augurs well for CFS operators like Concor and GDL.

Commodity wise performance (million tonne)

Particulars	Mar-09	Apr-09	May-09	Jun-09	Jul-09
POL/ Crude	16.9	13.7	13.9	15.3	13.9
% growth (yoy)	*4.3*	*2.2*	*-1.4*	*12.5*	*-4.1*
% growth (mom)	*11.9*	*-18.9*	*1.5*	*10.1*	*-9.2*
Iron ore	8.9	8.6	8.7	6.3	6.6
% growth (yoy)	*-13.6*	*-12.2*	*-2.2*	*5.0*	*6.5*
% growth (mom)	*-11.9*	*-3.4*	*1.2*	*-27.6*	*4.8*
Fertilizer	1.2	1.1	1.4	1.5	1.4
% growth (yoy)	*0*	*0*	*0*	*0*	*-13*
% growth (mom)	*0*	*-50*	*27*	*7*	*-7*
Coal (Thermal+Coking)	6.7	7.8	6.3	5.8	4.9
% growth (yoy)	*22*	*39*	*-5*	*-5*	*-22*
% growth (mom)	*20*	*16*	*-19*	*-8*	*-16*
Container (tonnage)	10	7.6	7.8	8.1	8.6
% growth (yoy)	*10*	*-10*	*-7*	*3*	*4*
% growth (mom)	*64*	*-24*	*3*	*4*	*6*
Other cargo	8	6.5	7.7	8.5	8.1
% growth (yoy)	*0*	*-16*	*15*	*23*	*16*
% growth (mom)	*38*	*-19*	*18*	*10*	*-5*

Source: IPA, Sharekhan Reasearch

Outlook and view

We believe, with improvement in container volume the near-term outlook for CFS players is positive. We recommend a positive outlook on GDL in the near term on the back of improving container volume and expected improvement in profitability from rail operations. The stock is currently trading at consensus price/earnings (PE) of 9.7x based on FY2011E earnings and at a discount of 38% to the market leader Concor.

Relative valuation

Company	EV/EBITDA (x)		P/E (x)		P/BV (x)		ROE (%)		ROA (%)	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
Gateway Distriparks	7.3	6.2	12.9	9.7	1.5	1.4	11.9	14.1	8.8	10.9
Concor	13.5	11.6	18.3	15.7	3.6	3.1	20.5	20.2	17.4	17.0
Arshiya International	5.6	6.2	14.2	9.8	-	-	6.8	7.1	-	-
All Cargo Global Logistic	8.4	7.5	14.0	13.1	2.1	1.9	19.9	17.9	13.5	12.5

Source: Bloomberg

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

Cipla

Viewpoint

Revenue growth to taper in FY2010

CMP: Rs270

We attended the annual general meeting of Cipla recently. We present below the highlights of the same.

Key points

- The management has guided towards a lower revenue growth of 10-12% for FY2010 on the back of a higher export base. Cipla registered a growth of 24.6% in its revenues during FY2009, boosted by the significant contributions from new product launches. The guidance provided by the management indicates that there would be a slowdown in the growth in the coming quarters. The company has retained its number one position in the domestic market.
- Cipla plans to raise Rs1,500 crore (approximately 11% equity dilution at a price of Rs270). The company intends to use the funds to reduce the short-term debt raised to meet working capital requirements in the past couple of years and to fund some of its new projects in the next two years. Cipla has earmarked a capital expenditure (capex) of Rs500-600 crore for the next two years; this includes the investment in the Indore special economic zone (SEZ), which is expected to be complete by the end of CY2009.
- The technical know-how fees doubled in FY2009 to Rs218 crore from Rs153.4 crore in FY2008, contributing 24.3% to the total profit before tax. With substantial investments in research and development (R&D; 5.1% of sales in FY2009), Cipla expects this trend to continue.
- Cipla's inhaler technology is, in our view, the its key strength that differentiates it from several other generic companies. It is working on nine CFC-free inhalers of which certain products have completed clinical trials and are in final stages of regulatory approvals. The company expects to launch these in FY2011-12 in the European market. The launch of various types of inhalers would lead to a huge uptick in Cipla's revenues and margins.
- Cipla is exploring joint ventures/strategic alliances in niche segments to build its presence in newer segments like biotechnology and biosimilars with a Chinese player. The company expects to be marketing at least one or two biotech products across the world in the next two years.
- Cipla significantly reduced its forward USD sold position by the end of FY2009 and has created forward USD bought position that it did not have at the end of FY2008. It has increased its open position in receivables so it will be hurt by an appreciating rupee. About USD96 million worth of contracts are outstanding. We believe that the losses arising from them could be covered by gains from revaluation of receivables.
- As per the consensus estimates, at the current market price of Rs270, Cipla is currently trading at 19.1x FY2010E earnings and of 17.0x FY2011 earnings. We feel that the stock is richly valued considering the limited near-term visibility of the future growth opportunities.

Cipla to focus on organic growth

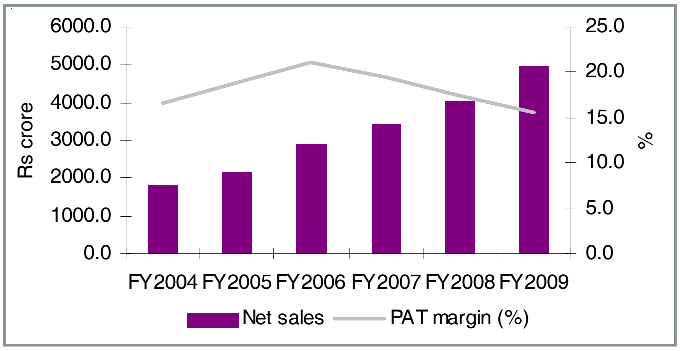
Cipla maintains its organic growth strategy and believes that fostering strategic alliances and partnerships is the best way forward for the company. Cipla's continued success in its overseas business has been largely due to its strategy in forming strategic alliances with partners all over the globe who assist with the registration process and help market Cipla's products internationally. This strategy has de-risked Cipla's business model by negating the need to incur front-end marketing investments in various international markets.

Guidance of 10-12% revenue growth for FY2010

The management has guided towards a lower revenue growth of 10-12% for FY2010 on the back of higher export base. While the company maintains its strong focus on the domestic market, in which it is ranked number one (as per ORG-IMS), Cipla is also eyeing significant growth opportunities in the international markets. Exports constituted around 55% of its revenues in FY2009 and the management believes that it may scale higher in FY2010, implying a stronger growth in the export markets.

Cipla registered a growth of 24.6% in its revenues during FY2010, boosted by the significant contributions from new product launches. The guidance provided by the management indicates that there would be a slowdown in the growth in the coming quarters.

Declining profit margins



To raise Rs1,500 crore by equity dilution

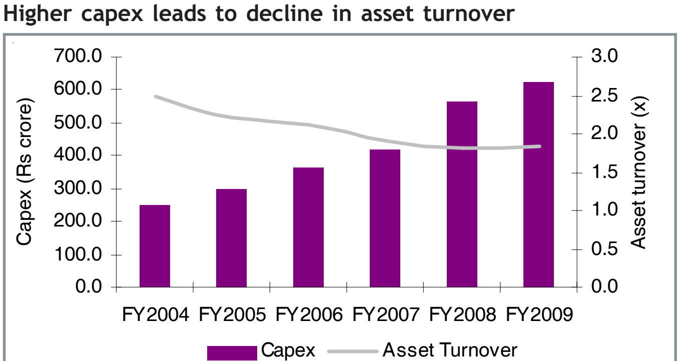
Cipla plans to raise Rs1,500 crore (approximately 11% equity dilution at a price of Rs270). The company intends to use the funds to reduce the short-term debt raised to meet its working capital requirements in the past couple of years and also to fund some of its new projects in the next two years.

Capex plans reduced to Rs500-600 crore

Cipla has earmarked a capex of Rs500-600 crore for the next two years, including the investment in the Indore SEZ. The company has already commenced the commercial production at its Rs310-crore facility in Sikkim for manufacture of formulations. Work in an Indore-based SEZ facility in which Cipla plans to invest Rs300 crore is under way and is expected to be complete by the end of CY2009. Overall, the company has already undertaken capex of Rs1,900 crore over the past three years in fixed assets, mainly to expand in order to meet increased demand. It has already invested Rs800 crore in FY2009 alone. However, the firm's Goa SEZ is still stuck as the state government passed a stop-work order in 2008 after deciding to impose a statewide ban on SEZs.

Even though the capex is making Cipla's business model increasingly capital intensive, leading to lower asset turnover ratios and declining productivity of assets, it is indicative of the management's strong outlook for the future.

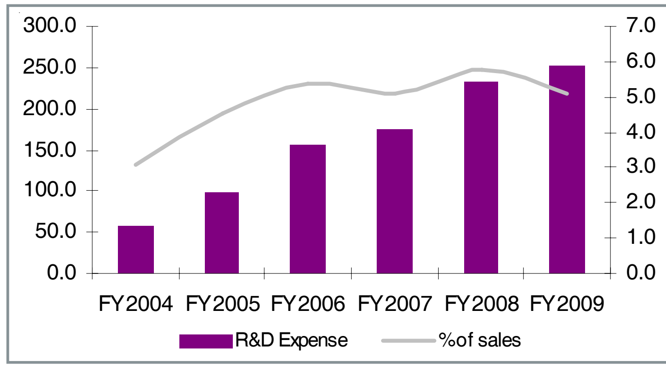
Higher capex leads to decline in asset turnover



Technology know-how fees—a steady cash cow

Cipla provides technical expertise for the development of products to its international partners and receives technical know-how fees. With substantial investments in R&D (5.1% of sales in FY2009), the technical know-how fees has become a significant component of Cipla's total income. The technical know-how fees doubled in FY2009 to Rs218 crore from Rs153.4 crore in FY2008, contributing 24.3% to the total profit before tax of the company. The management has already received Rs27 crore in technical know-how fees in the first three months of FY2010 and based on its product pipeline it expects this trend to continue.

Increasing R&D expenses



Rich product pipeline for the regulated markets

Cipla has tie-ups with 21 players in the USA for marketing 118 abbreviated new drug applications (ANDAs) of which 36 have been approved and 23 products have already been launched in the USA. These players include Watson, Teva, Eon Labs, Morton Grove, Pentech, Akorn, Medpoint and Paddock. Akorn seems to be one of the more active partners as it has announced as many as four product partnerships with Cipla including an organ transplant rejection drug (USD750-million market, likely launch in 2010), an inhaled drug (USD200-million market; likely launch in 2010) and one oral antibiotic (Vancomycin; USD200 million market). Further, Cipla's various US partners are currently in litigation with innovator companies and some of these litigations are in the appeal stage. The launch of a number of Cipla's products would largely depend on the outcome of the litigation matters.

In Europe, Cipla has made 410 filings till date, has received 292 approvals and has launched 51 products so far. Thus large number of products are currently under registration and will be launched in the subsequent years.

CFC inhalers—a huge opportunity

Cipla's inhaler technology is, in our view, the key strength that differentiates it from several other generic companies.

Being the second largest manufacturer of inhalers in the world, Cipla is likely to be a key beneficiary of the opening up of the generic market for inhalers in Europe. The expansion of capacities (1.5x capacity expansion in the last five years) in the inhaler segment is indicative of the huge opportunity that awaits Cipla. Overall, the company is working on nine CFC-free inhalers of which certain products have completed clinical trials and are in final stages of regulatory approvals. The company expects to launch these in FY2011-12 in the European market.

The global inhaler market is currently estimated at USD12 billion a year and is a high-margin business, with lower generic competition. Cipla is the first company outside the USA and Europe to market CFC-free inhalers. The launch of various types of inhalers would lead to a huge uptick in Cipla's revenues and margins.

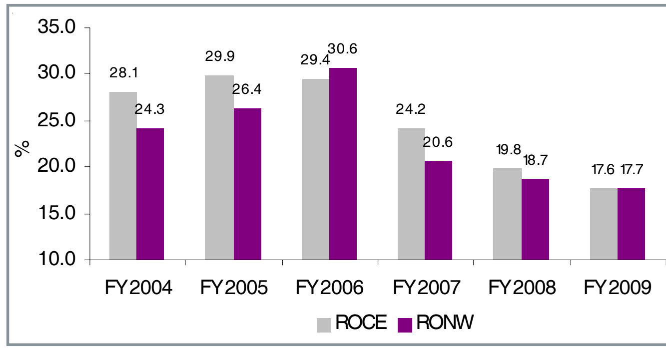
Other highlights of chairman's speech

- Cipla is exploring joint ventures/strategic alliances in niche segments to build its presence in newer segments, like biotechnology and biosimilars, with a Chinese player. The company expects to be marketing at least one or two biotech products across the world in the next two years.
- Cipla has shelved its agreement with Avesthagen for collaborative research on biopharmaceutical products in the areas of autoimmune disorders, cardiology and oncology. The joint venture was working on eight products. However, due to mutual disagreement over the milestone payments the agreement has been terminated.

Outstanding forward contracts worth $96mn

Cipla's earnings were significantly depressed in FY2009 by large losses on foreign exchange (forex) hedges. Cipla had significantly reduced its forward USD sold position by the end of FY2009 and created forward USD bought position that it did not have at the end of FY2008. It has increased its open position in receivables; so it will be hurt by an appreciating rupee. About USD96 million worth of contracts are outstanding. We believe that the losses arising from them could be covered by the gains from the revaluation of receivables.

Declining return ratios



Valuation and view

The guidance provided by the management indicates that there would be a slowdown in the growth in the coming quarters. Further, a lack of visibility of further exclusivity opportunities and a high export base upon which achieving a high growth would be a sizeable challenge indicate that the growth momentum is likely to slow down in the coming quarters. On the brighter side, the CFC-free-inhaler opportunity for Cipla is huge and a scale-up of volumes in this segment could lead to a significant ramp-up in revenues and profits. However, the revenues from this segment would be realised only after a few years, once all the requisite approvals for the various markets come through.

With new capacity added in SEZs, we expect the volume growth to accelerate and reduction in the tax rates going forward. Furthermore, Cipla's margins have expanded over the last two years on account of favourable currency. The management has highlighted the potential for more margin expansion as raw material prices fall and new plants in Indore and Sikkim ramp up capacity utilisation.

As per the consensus estimate, at the current market price of Rs270 Cipla is currently trading at 19.1x FY2010E earnings and of 17.0x FY2011 earnings. We feel that the stock is richly valued considering the limited near-term visibility of its future growth opportunities.

Valuation table

Particulars	FY07	FY08	FY09	FY10E	FY11E
Net sales (Rs cr)	3438.2	4010.4	4960.6	5851.4	6612.5
Net profit (Rs cr)	667.8	701.0	771.0	1096.6	1229.8
Shares in issue (cr)	77.7	77.7	77.7	77.7	77.7
EPS (Rs)	8.6	9.0	9.9	14.1	15.8
PER (x)	31.3	29.8	27.1	19.1	17.0
Book value (Rs/share)	41.6	48.3	55.9	70.3	87.6
Price/BV (x)	6.5	5.6	4.8	3.8	3.1

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

Sharekhan Stock Ideas

Evergreen

Housing Development Finance Corporation
HDFC Bank
Infosys Technologies
Larsen & Toubro
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
Apollo Tyres
Bajaj Auto
Bajaj Finserv
Bajaj Holdings & Investment
Bank of Baroda
Bank of India
Bharat Electronics
Bharat Heavy Electricals
Bharti Airtel
Corporation Bank
Crompton Greaves
Glenmark Pharmaceuticals
Godrej Consumer Products
Grasim Industries
HCL Technologies
Hindustan Unilever
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico
Maruti Suzuki India
Lupin
Piramal Healthcare (Nicholas Piramal India)
Punj Lloyd
Sintex Industries
State Bank of India
Tata Tea
Wipro

Cannonball

Allahabad Bank
Andhra Bank
IDBI Bank
Madras Cements
Phillips Carbon Black
Shree Cement
Tourism Finance Corporation of India

Emerging Star

3i Infotech
Alphageo India
Allied Digital Services
Axis Bank (UTI Bank)
Balrampur Chini Mills
Cadila Healthcare
Emco
Navneet Publications (India)
Network 18 Fincap
Opto Circuits India
Orchid Chemicals & Pharmaceuticals
Patels Airtemp India
Thermax
Zee News

Ugly Duckling

BASF India
Deepak Fertilisers & Petrochemicals Corporation
Genus Power Infrastructures
ICI India
India Cements
Ipca Laboratories
Jaiprakash Associates
Mold-Tek Technologies
Orbit Corporation
Punjab National Bank
Ratnamani Metals and Tubes
Selan Exploration Technology
SEAMEC
Shiv-Vani Oil & Gas Exploration Services
Subros
Sun Pharmaceutical Industries
Torrent Pharmaceuticals
UltraTech Cement
Union Bank of India
United Phosphorus
Zensar Technologies

Vulture's Pick

Esab India
Mahindra Lifespace Developers
Orient Paper and Industries
Unity Infraprojects
Tata Chemicals
WS Industries India