Company

23 July 2009 | 9 pages

Biocon (BION.BO)

Equity

Sell: Inline Numbers, Mixed Signals

- **Mixed Signals** — While 1QFY10 results were inline with expectations, trends remain mixed. Rapid growth in research services and improved margins (Biocon & Axicorp) augurs well but do not dilute concerns over a subdued biopharma biz. and higher tax rate. While Biocon continues to build structural long term drivers (biosimilars deal with Mylan being the latest), we remain concerned over its ability to deliver sustained growth in the near to medium term. We maintain a Sell/High Risk (3H) rating.
- **Inline 1QFY10** — Headline numbers are skewed by the acquisition of Axicorp and high MTM forex losses last year. Ex-Axicorp, sales and recurring PAT grew 16% and 33% respectively. EBIDTA margins (ex-Axicorp) expanded 830bps YoY on faster research services growth, weaker INR, cost reduction efforts, and switch to low cost captive power. A sharp increase in depreciation (+28% YoY) and effective tax rate (up to 18.8% from 4%) restricted recurring PAT growth.
- **The Good & The Bad** — Research services biz grew 55% YoY, with higher margins (up 1,800bps YoY) driven by the BMS contract, weaker INR, and low base, contributing to higher overall margins. However, low growth in biopharma (9% YoY, 7% QoQ), despite commencement of mycophenolate mofetil API supplies to its partners for the US, is disappointing. The tax rate (18.8% vs. 4.1%) is also higher on more supplies to Indian partners and lack of forex MTM tax shield.
- **Other Takeaways** — 1) Human insulin deal with Bayer for China terminated; 2) Oral insulin in phase 3 trials in India – to file IND in US shortly; 3) Tacrolimus opportunity likely to be pushed to 2012; 4) Likely to receive licensing income from Mylan later this fiscal year on IP transfer (not in our estimates); and 5) R&D, depreciation & interest cost likely to trend higher.

Sell/High Risk	**3H**
Price (23 Jul 09)	Rs219.05
Target price	Rs140.00
Expected share price return	-36.1%
Expected dividend yield	1.0%
Expected total return	**-35.0%**
Market Cap	Rs43,810M
	US$905M

Price Performance (RIC: BION.BO, BB: BIOS IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	2,003	10.01	15.1	21.9	4.1	20.5	0.7
2008A	2,160	10.80	7.9	20.3	3.0	16.9	1.1
2009E	2,109	10.54	-2.4	20.8	2.8	13.7	1.0
2010E	2,312	11.56	9.6	18.9	2.5	14.0	1.1
2011E	2,409	12.04	4.2	18.2	2.3	13.3	1.1

Source: Powered by dataCentral

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

Sell: Inline Numbers, Mixed Signals

While 1QFY10 results were inline with expectations, trends remain mixed. Rapid growth in research services and improved margins (Biocon & Axicorp) augurs well but do not dilute concerns over a subdued biopharma biz. and higher tax rate. While Biocon continues to build structural long term drivers (biosimilars deal with Mylan being the latest), we remain concerned over its ability to deliver sustained growth in the near to medium term. We maintain our Sell/High Risk (3H) recommendation.

1QFY10 Results Snapshot

Note: Consolidated numbers are skewed by the acquisition of Axicorp (low margin distribution business) last year. Please refer to Figure 3 for a breakdown of numbers between Biocon & Axicorp.

Figure 1. Biocon – 1QFY10 Earnings Summary (RsM, %)

Year to 31st March	1QFY09	1QFY10	*% Ch YoY*	4QFY09	*% Ch QoQ*
Biopharma	2,212	2,405	*8.7*	2,242	*7.3*
Axicorp - acquired		1,891	*nm*	1,742	*8.6*
Contract Research	427	663	*55.1*	679	*(2.4)*
Total Revenues	**2,639**	**4,959**	***87.9***	**4,663**	***6.3***
RM Costs	1,354	2,891	*113.5*	2,790	*3.6*
as a % of sales	*51.3*	*58.3*	*700 bps*	*59.8*	*-153 bps*
Staff costs	313	526	*68.1*	448	*17.4*
as a % of sales	*11.9*	*10.6*	*-125 bps*	*9.6*	*100 bps*
Others	287	329	*14.6*	324	*1.5*
as a % of sales	*10.9*	*6.6*	*-424 bps*	*6.9*	*-31 bps*
R&D	109	200	*83.5*	202	*(1.0)*
as a % of sales	*4.1*	*4.0*	*-10 bps*	*4.3*	*-30 bps*
Total Expenditure	2,063	**3,946**	*91.3*	**3,764**	***4.8***
EBITDA	**576**	**1,013**	***75.9***	**899**	***12.7***
EBITDA Margins	***21.8***	***20.4***	***-139 bps***	***19.3***	***115 bps***
EBITDA - excl Axicorp	576	925	*60.6*	893	*3.6*
EBITDA Margins	*21.8*	*30.1*	*833 bps*	*30.6*	*-42 bps*
Depreciation	253	324	*28.1*	307	*5.5*
Interest	37	56	*51.4*	62	*(9.7)*
Other Income	126	94	*(25.4)*	31	*206.0*
PBT	412	727	*76.5*	561	*29.7*
Taxes	17	137	*705.9*	(16)	*(967.1)*
Effective tax rate	*4.1*	*18.8*	*1,472 bps*	*(2.8)*	*2,166 bps*
PAT	395	590	*49.4*	577	*2.3*
Minority Interest/Other	(10)	14	*(240.0)*	86	*(83.7)*
Recurring PAT	**405**	**576**	***42.3***	**491**	***17.4***
Add: EO items (net of Tax)	(255)	-	*(100.0)*	(242)	*(100.0)*
Reported PAT	150	576	*284.5*	249	*131.5*

CIRA Comments

Recurring PAT inline with expectations

Tepid growth in biopharma sales (YoY & QoQ) is surprising given supplies of mycophenolate mofetil – reflects that the rest of the biz continues to struggle

Biocon supplies to 3 out of 6 generic players in myco mofetil – despite this, revenue growth is subdued – however, it appears to have helped improve margins

Headline margin numbers are skewed by acquisition of Axicorp (distribution biz – low margin)

Ex-Axicorp, margins (gross & EBIDTA) have improved on the back of faster growth in research services (commencement of the BMS contract), cost reduction & shift to lower cost grid power

Axicorp margins higher at 4.9% (positive surprise)

Higher depreciation on account of the capex incurred (largely in Syngene) last year

Effective tax rate likely to remain at similar level (negative surprise) due to higher share of API sales to Indian companies (who then formulate & export). Lack of tax shield on MTM forex losses (available last year) will also push effective tax rate higher

Source: Company Reports, Citi Investment Research and Analysis Estimates

Contract research margins up YoY on a weaker INR & ramp up in revenues. However, margins have remained flat over the last three quarters

Biopharma margins not comparable YoY due to Axicorp acquisition – trading biz with <5% margins

Figure 2. Biocon – Segmental EBITDA (RsM, %)

Year to 31st March	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10
BioPharma	820	1,010	1,182	1,114	1,176
EBITDA Margin (%)	*37.1%*	*25.9%*	*31.5%*	*28.0%*	*27.4%*
Contract Research	89	100	228	262	258
EBITDA Margin (%)	*20.8%*	*18.8%*	*37.5%*	*38.6%*	*38.9%*
Total	334	374	457	478	324
Unallocated Corporate Expense	576	735	952	899	1,109
EBITDA	**820**	**1,010**	**1,182**	**1,114**	**1,176**

Source: Company Reports, Citi Investment Research and Analysis

Tepid growth in biopharma revenues YoY despite commencement of myco mofetil supplies to partners in the US & sharp INR depreciation (c.17% YoY)

Margin expansion (ex-Axicorp) largely driven by lower RM costs (higher share of research services) & reduced power cost (switch over to grid power from captive generation)

Axicorp margins a positive surprise – the business had sub 2% margins in FY09

Depreciation & interest cost likely to inch up in rest of the year due to capex incurred

Higher tax rate YoY due to increased sales to domestic customers (not tax exempt even from EOUs) & absence of forex MTM losses (acted as a tax shield last year)

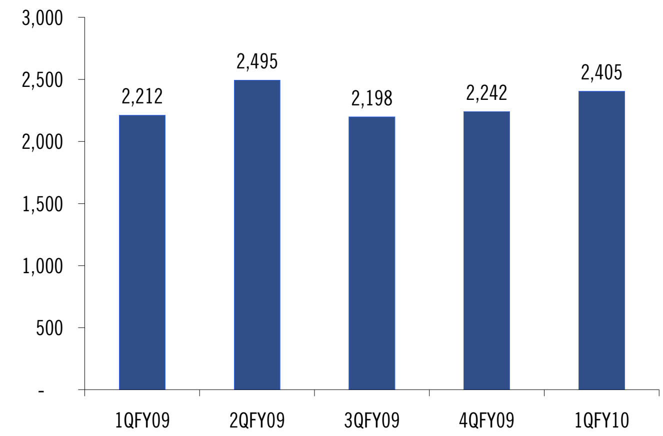
Figure 3. Biocon, Axicorp – 1QFY10 P&L Breakup (RsM, %)

	1QFY09	1QFY10			
	Biocon	Biocon	*% Ch YoY*	Axicorp	Combined
Bio Pharma sales	2,212	2,405	*8.7*	1,891	4,296
Contract Research Services	427	663	*55.3*	-	663
Total Operational Income	**2,639**	**3,068**	***16.3***	**1,891**	**4,959**
Material Costs	1,354	1,352	*(0.1)*	1,539	2,891
as a % of Bio Pharma sales	*61.2*	*56.2*	*-500 bps*	*81.4*	*67.3*
Staff Costs	313	375	*19.8*	151	526
as a % of sales	*11.9*	*12.2*	*36 bps*	*8.0*	*10.6*
Other Expenses	287	220	*(23.3)*	109	329
as a % of sales	*10.9*	*7.2*	*-371 bps*	*5.8*	*6.6*
R&D	109	200	*83.5*	-	200
Total Expenditure	2,063	2,147	*4.1*	1,799	3,946
EBITDA	**576**	**921**	***60.0***	**92**	**1,013**
EBITDA Margins	***21.8***	***30.0***	***820 bps***	***4.9***	***20.4***
Depreciation	253	314	*24.1*	10	324
Interest	37	50	*35.1*	6	56
Other Income	126	90	*(28.6)*	4	94
PBT	412	647	*57.1*	80	727
Taxes	17	108	*535.3*	29	137
Effective tax rate	*4.1*	*16.7*	*1,256 bps*	*36.3*	*18.8*
PAT	395	539	*36.5*	51	590
Minority Interest/Other	(10)	-	*(100.0)*	14	14
Recurring PAT	**405**	**539**	***33.2***	**37**	**576**
Add: EO items (net of Tax)	(255)	-	*(100.0)*	-	-
Reported PAT	150	539	*259.8*	37	576

Source: Company Reports, Citi Investment Research and Analysis

Update on Key Segments

Figure 4. Biopharma Revenues (Rs m)

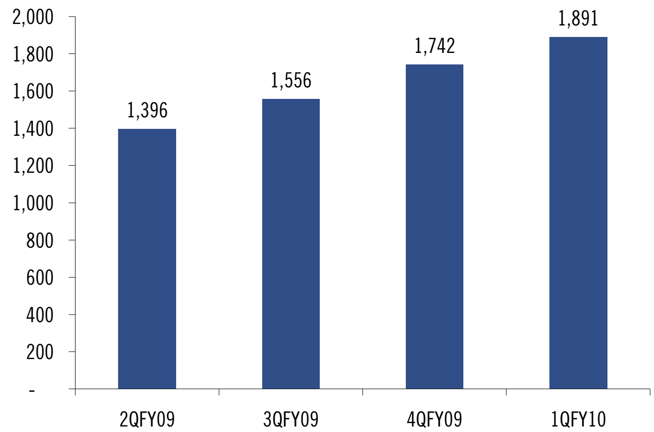


Source: Company Reports, Citi Investment Research and Analysis

CIRA Comments

- Revenues up 9% YoY – subdued despite commencement of mycophenolate mofetil supplies to partners in the US
- **Myco mofetil**: Launched in May-09 – 45% genericisation with six generic players – Biocon supplies to three generic players (does not include Teva)
- Includes licensing income of Rs24m in 1QFY10 vs. nil in 1QFY09
- Branded formulation biz in India (up 50% YoY in 1QFY10) accounts for c.10% of total biopharma sales
- Tacrolimus (potential big launch) unlikely before 2012

Figure 5. Axicorp Revenues (Rs m)

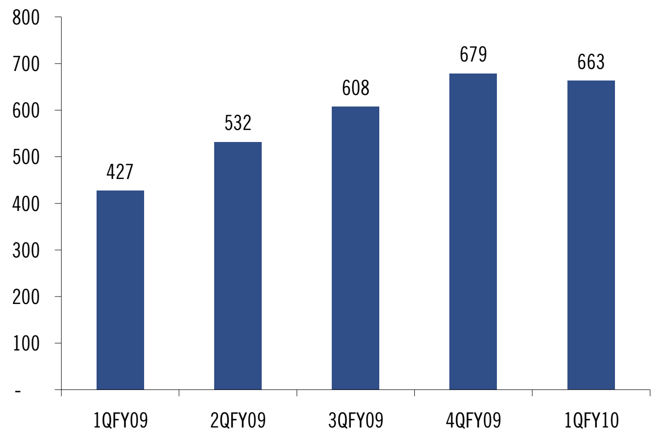


Source: Company Reports, Citi Investment Research and Analysis

CIRA Comments

- Low margin distribution business – Biocon consolidates Axicorp's numbers with a one quarter lag
- Margins appear to have improved (4.9% vs. sub 2% in FY09) – need to watch the trend to see if this is structural or a quarterly aberration
- Commenced metformin supplies for the AOK tender supplies in Germany in June 2009 – not reflected in numbers yet – higher margin than the current business
- Biocon's plan is to leverage Axicorp's distribution capabilities for its biosimilars foray in Europe

Figure 6. Contract Research Revenues (Rs m)



Source: Company Reports, Citi Investment Research and Analysis

CIRA Comments

- Revenues up 55% YoY due to commencement of BMS contract, weaker INR, and the low base last year
- Syngene revenues of Rs580m with EBITDA margins of 37% – higher margins aided by a INR depreciation and commencement of work on the BMS contract
- Management expects growth to be robust given the ramp up in the BMS contract expected over the course of the year

Biocon

Company description

Biocon is an integrated biotechnology company in India that encompasses all three critical stages of drug development - drug discovery, development, and manufacturing and commercialization of biopharmaceuticals and enzymes. With more than 25 years of expertise in fermentation technology, the company has built strong capabilities in high-growth segments like statins, immunosuppressants and anti-diabetes. While statins form the major part of its current business, Biocon is aggressively pursuing the biogenerics opportunity in regulated markets and is also making investments in drug discovery research to build a future pipeline.

Investment strategy

We have a Sell/High Risk (3H) rating on Biocon in view of the nascent nature of longer-term growth initiatives. Despite several initiatives being taken by the company to emerge as a biotechnology major, Biocon remains primarily an API player with high exposure to the statins segment. Unlike other Indian companies, Biocon does not have the requisite breadth in its product portfolio to overcome the pressure on statins and delays in biogenerics launches. The setbacks on pravastatin and simvastatin in the US in CY06 and tacrolimus in CY08 reflect the high sensitivity of Biocon's earnings to a delayed launch and are an indication of the vulnerability of the company's business model. Overall, we expect a 5% CAGR in net profit for Biocon over FY09-11E, even after factoring in the full impact of statin sales in the US market and aggressive ramp-up in research services as well as insulin and BioMAb sales. Valuations appear expensive relative to the growth outlook and the vulnerability of earnings in the near to medium term.

Valuation

Our target price of Rs140 for Biocon is based on 12x June 2010E earnings, at a 25% discount to our target range for most generic pharma companies in our coverage universe such as Lupin, Glenmark and Cadila. This is due to Biocon's lower earnings CAGR (5% over FY09-11E) and return ratios (c.12%). We also believe that the higher vulnerability of Biocon's business model to pricing pressure and delayed product launches /scale-up would continue to keep the stock's multiples on the lower side.

Risks

Our risk rating for Biocon is High Risk, factoring in the current volatility in markets. Our quants-based rating system, which tracks 260-day historical share price volatility, suggests Medium Risk. The main upside risks to our target price and estimates include: 1) licensing deals for oral insulin or T1h molecules; 2) progress in biosimilars legislation in the US & / or any approvals from the EU; 3) On Tacrolimus, if its partners are able to litigate and secure early entry into the US, it would be positive for valuations and sentiment.

Appendix A-1

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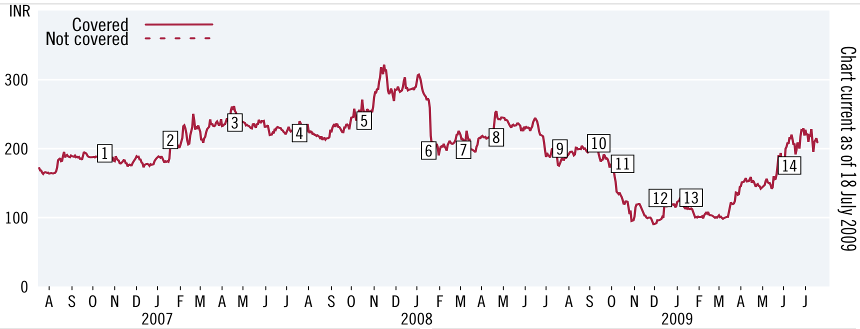
Biocon (BION.BO)

Ratings and Target Price History
Fundamental Research
Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	18-Oct-06	3L	*197.50	191.05
2	18-Jan-07	3L	*210.50	205.13
3	19-Apr-07	3L	*217.50	254.58
4	19-Jul-07	3L	*232.50	239.88
5	18-Oct-07	3L	*252.50	252.65
6	17-Jan-08	3L	*250.50	270.30
7	6-Mar-08	*3M	*218.00	214.08
8	22-Apr-08	3M	*228.00	254.43
9	21-Jul-08	*3H	*199.50	178.50
10	12-Sep-08	3H	*200.00	191.95
11	16-Oct-08	3H	*122.00	125.90
12	9-Dec-08	3H	*93.00	96.30
13	21-Jan-09	3H	*104.00	113.35
14	9-Jun-09	3H	*140.00	216.55

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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