Company Flash

24 August 2007 | 6 pages

Cipla (CIPL.BO)

Sell: No Respite in Sight

- Lower profit in FY08 — Cipla indicated that its PAT may be lower in FY08 due to rupee appreciation, higher cost of imports from China and pricing pressures. Accordingly, we are reviewing our estimates and expect the Street to do the same. Although the stock has declined considerably, it remains expensive and Cipla remains our top Sell in the sector.

- High capex Phase — Cipla plans to incur capex of around Rs9.5bn over FY08-09 primarily on its facilities in Sikkim, Goa and Indore. With profitability under pressure we expect this to take a heavy toll on return ratios.

- Other key takeaways — a) Guidance of 10-12% sales growth and lower profits in FY08; b) tie up for 125 products across 10 partners in the US/ 94 ANDAs filed and expects to file 20-25 in FY08; c) Cipla is looking for reasonable acquisitions in niche/new business segments d) Cipla has a forex cover of US$300m which has been marked to market at the end of 1Q.

- Maintain Sell (3L) — Despite recent underperformance, as we believe that valuations are still not attractive relative to the value add in the business. We believe that Cipla's supply-based model in regulated markets is at significant risk due to global consolidation, while it is also vulnerable to rising competition in India. With growth rates tapering, we believe current high multiples are not sustainable.

Sell/Low Risk	3L
Price (24 Aug 07)	Rs170.95
Target price	Rs191.00
Expected share price return	11.7%
Expected dividend yield	1.7%
Expected total return	13.4%
Market Cap	Rs132,878M US$3,248M

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	6,076	8.11	48.4	21.1	6.5	34.4	1.2
2007A	6,608	8.50	4.9	20.1	4.3	26.1	1.6
2008E	7,220	9.29	9.3	18.4	3.8	21.8	1.8
2009E	8,097	10.42	12.2	16.4	3.3	21.4	2.0
2010E	9,074	11.67	12.1	14.6	2.9	20.9	2.2

Source: Powered by dataCentral

Prashant Nair, CFA[1]
+91-22-6631-9855
prashant.nair@citi.com

Chirag Dagli[1]
+91-22-6631-9874
chirag.dagli@citi.com

Akshay Rai[1]
akshay.rai@citi.com

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

[1]Citigroup Global Markets India Private Limited

Cipla

Company description

Cipla is a leading pharmaceutical company in India with a strong and profitable business model. The company has a well-diversified portfolio, without any overdependence on a particular segment. It has developed a strong presence in the export market — both in developed and developing countries — and has products registered in more than 140 countries. Furthermore, it has been at the forefront in reverse engineering the latest drugs and active pharmaceutical ingredients. The company has focused its R&D efforts on profitable projects, and tied up with the local players in various markets to de-risk its business model. However, the company lags its peers in discovery-led research. Cipla's business model also represents a low-risk model with the commensurate returns also being moderate.

Investment thesis

We rate Cipla Sell (3L) with a target price of Rs191/share. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, Cipla could face an increasingly uncertain global environment, if the current consolidation process gathers momentum. Its partners, which appear inherently tied up because of their weak product capabilities, may get acquired and the acquirers may not want to source drugs from Cipla. We think Cipla's business model lacks significant value addition, both in terms of innovative research as well as control over the front end in the US and European generics markets. We believe that any re-rating will be contingent on the company making fresh forays into these areas and / or getting acquired at a significant premium. Since the pricing pressure has not been waning in the US or Europe, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players. Cipla, as one of the weaker parts of the supply chain, will bear the brunt, in our view.

Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs191 is based on 20x June 08E earnings. Historically, the stock has traded at 15-30x forward earnings. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector, justified by the lower value addition to the business (lack of its own front-end in the regulated markets and ownership of IPR), with few signs of this changing. Our target multiple for Cipla's base business is at a 10% discount to the multiple (20x) that we use for its peers such as Ranbaxy, Dr Reddy's and Sun Pharma. However, while we value the latter's patent challenge opportunities separately from the base business, we are unable to do the same for Cipla, given the lack of information on its tie-ups with different partners. Hence, we apply a higher multiple of 20x to base business earnings to factor in any potential "one-off" upsides that may come through from time to time.

Risks

We rate Cipla as Low Risk, as the company has a steadily growing base business and has a visible earning stream. The ongoing dispute regarding alleged overcharging for seven drugs in the domestic market could result in significant cash outflow as well as could impact future profitability. Global consolidation is a risk to the company's supply based model. The new drug policy, if implemented in the current form could also hurt earnings. Key upside risks to our rating and target price include: a) the company doing better operationally than forecast; b) any move to front-end in target markets could give further support to current high valuations; c) any exclusivity for its partners could also sustain the growth momentum beyond our expectations.

Appendix A-1

Analyst Certification

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

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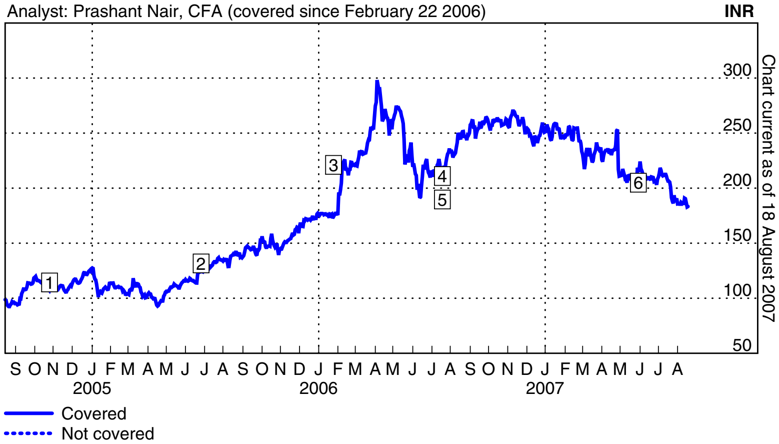
Cipla (CIPL.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	26 Oct 04	3L	*96.00	106.92
2:	27 Jun 05	3L	*116.00	124.12
3:	25 Jan 06	3L	*65.60	174.06
4:	19 Jul 06	3L	*170.00	212.45
5:	19 Jul 06	3L	170.00	212.45
6:	30 May 07	3L	*191.00	214.75

*Indicates change.

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