

Biocon

STOCK INFO.	BLOOMBERG
BSE SENSEX: 9,238	BIOS IN
	REUTERS CODE
S&P CNX: 2,809	BION.BO

18 January 2006

Buy
Previous Recommendation: Buy
Rs481

Equity Shares (m)	100.0
52-Week Range	538/392
1,6,12 Rel. Perf. (%)	-2/-19/-51
M.Cap. (Rs b)	48.1
M.Cap. (US\$ b)	1.1

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/05A	7,126	1,977	19.8	42.6	24.3	6.5	26.7	25.8	6.5	20.7
03/06E	7,754	1,750	17.5	-11.5	27.5	5.5	20.0	21.3	6.1	20.2
03/07E	9,744	2,373	23.7	35.6	20.3	4.5	22.4	23.1	4.7	15.2

Biocon's 3QFY06 results were slightly better than our expectations, driven by commencement of insulin sales to non-regulated markets. Key highlights include:

- Net consolidated sales grew by 12% to Rs1.99b while the bottom-line recorded a decline of 12.8% to Rs439m for the quarter.
- Biopharma sales increased 12% to Rs1.54b contributing 77% to overall revenues. Contract research services (including Syngene & Clinigene) recorded 50% growth to Rs270m led mainly by the ramp-up in Syngene's performance.
- EBITDA margins declined by 400bp to 29.6%, due to (a) pricing pressure in European statins market (b) higher investments in R&D and (c) increased staff costs.
- EBITDA margin erosion coupled with higher depreciation (up by 21%), lower other income (down by 63%) and higher tax provisioning (17.8% of PBT v/s 13% in 3QFY05), translated into net profit decline of 13% to Rs439m.

Biocon is currently valued at 20.3x FY07E earnings, which is not cheap. However, the insulin and the immunosuppressants portfolio may bring in long-term benefits. A significant expansion in statin volumes (post patent expiry) can lead to an upside in the short term. Maintain **Buy**.

CONSOLIDATED QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Sales	1,742	1,861	1,777	1,746	1,740	2,006	1,993	1,993	7,126	7,754
YoY Change (%)	62.2	24.0	27.8	20.8	-0.1	7.8	12.1	14.2	31.8	8.8
Total Expenditure	1,206	1,245	1,181	1,255	1,235	1,416	1,404	1,373	4,887	5,427
EBITDA	536	616	596	490	505	589	589	621	2,239	2,326
Margins (%)	30.8	33.1	33.6	28.1	29.0	29.4	29.6	31.1	31.4	30.0
Depreciation	46.0	47.3	61.5	68.7	71.1	73.8	74.6	175.9	223.4	395.4
Interest	7.0	5.7	5.4	2.5	2.8	1.5	3.8	5.2	20.3	13.3
Other Income	37.0	34.0	48.4	37.2	17.8	11.3	18.1	59.7	156.2	106.8
PBT	520	597	578	456	449	525	529	499	2,151	2,024
Tax	34	39	75	34	66	94	94	29	186	283
Rate (%)	6.5	6.5	13.0	7.4	14.8	17.9	17.8	5.8	8.6	14.0
Minority Interest	0	-4	0	-1	-5	-4	-4	0	-10	-13
PAT	486	562	503	424	387	435	439	470	1,975	1,754
YoY Change (%)	112.2	50.4	43.7	-2.3	-20.3	-22.6	-12.8	10.9	42.5	-11.2
Margins (%)	27.9	30.2	28.3	24.3	22.3	21.7	22.0	23.6	27.7	22.6

E: MOST Estimates

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Biopharma and contract research drives top-line growth

Consolidated revenues grew 12.1% YoY in 3QFY06, driven by 11.8% growth in Biopharma business and 50% growth in contract research. Growth in biopharmaceutical sales was primarily driven by commencement of insulin sales in unregulated markets. Also, statin prices in Europe have stabilized, resulting in easing of pressure on revenues sequentially. However, on a YoY basis, statin prices have been still lower.

Contract research services (including Syngene & Clinigene) recorded 50% growth to Rs270m, led mainly by the ramp-up in Syngene's performance. Commissioning of new facilities and addition of new clients has resulted in a significant growth in Syngene's operations.

However, enzymes continued with decline in sales, with 18% YoY decline. The company continued using the fermentation facility for statins, due to capacity constraints, resulting in lower enzyme production. However, once the new facility starts operation by 1QFY07, enzymes business should revert to the normal growth phase.

TREND IN PRODUCT MIX (RS M)

	3Q FY06	3Q FY05	GR (YOY)	2Q FY06	GR (QOQ)
Sales Trend					
Bio-Pharmaceuticals	1,543	1,377	12.0	1,558	-1.0
% of Sales	77.4	77.5		76.8	
Enzymes	180	220	-18.2	240	-24.9
% of Sales	9.0	12.4		11.8	
Contract Research Fees	270	180	50.0	230	17.2
% of Sales	13.6	10.1		11.4	
Total	1,993	1,777	12.1	2,028	-1.8

Source: Company/Motilal Oswal Securities

Europe statin prices stabilizing

The statins business in Europe witnessed stable prices after many quarters of severe competitive pressures, which was the main reason for the company's poor performance earlier. Biocon expects to commence simvastatin supplies to USA from 4QFY06 onward. The company has invested significantly (approximately Rs4.5b) in new capacities to exploit the opening of the simvastatin and pravastatin market

in USA. The company maintains that despite the large number of filings for statins in USA, many players may not receive US FDA approvals in time, leading to relatively higher statin prices in the initial months. It expects about 7-8 players to enter the market on day one. We however, believe that competition in statins is here to stay and that higher statin prices may not be sustainable in the long term. However, a significant volume expansion in the statins market could positively surprise us.

Will supply statins to innovators also

Biocon, through its alliance partners, has tied up with some of the innovator companies for supply of statins for the latter's combination products. Supplies may begin in CY07 subject to a favorable approval from the regulatory authorities for the innovator's products. This is likely to bring in incremental benefits for Biocon from FY08 onward.

Higher R&D spend and forex loss impacts margins

EBITDA margins declined by 400bp to 29.6% due to: (a) pricing pressure in European statins market; (b) higher investments in R&D; (c) increased staff costs (up by 22% YoY); and (d) forex loss of Rs18m (v/s gain of Rs64m in 3QFY05). EBITDA margin erosion coupled with higher depreciation (up by 21%), lower other income (down by 63%) and higher tax provisioning (17.8% of PBT v/s 13% in 3QFY05), translated into a net profit decline of 13% to Rs439m. The company has not made any provisions for its equity and debt exposures in Nobex Corporation (USA). The latter has recently filed for bankruptcy in USA. Biocon has indicated that irrespective of Nobex's fate, its rights to the oral insulin drug for the Indian subcontinent will not be adversely impacted. In fact, Biocon is expected to be one of the bidders for taking complete control of Nobex.

Building future growth engines – visibility still poor

While statins represent a large medium-term growth opportunity for Biocon, the cash flows generated from this business would enable Biocon to build strengths in other biopharmaceutical products (immunosuppressants and anti-

diabetes) as well as its own drug discovery and contract research efforts. The company's efforts to launch human insulin in India and in unregulated markets as well as a supply tie-up with Bristol Myers Squibb (for the latter's NDDS version) are also likely to scale up over the next couple of years.

The company has also made considerable progress in research, with the knowledge gained through its custom and clinical research activities aiding its own efforts to develop non-infringing processes. Biocon also has its own R&D program focusing on improving efficiencies and developing new biological entities (NBEs). The company expects to launch its monoclonal antibody for treating head and neck cancers in FY07 in India. However, although progress on any of these fronts could lead to higher growth and a re-rating, the visibility on these is still poor.

Capacity expansion benefits likely visible in FY07

Biocon's new statins facility is likely to be fully commissioned by 1QFY07. The US patents on simvastatin and pravastatin will expire in CY06 and hence the full benefits of the expanded capacity are likely to accrue only in FY07. In the intermediate period, we expect the company's new facilities to cater to markets in the EU.

Long term generic pipeline is exciting

Biocon has already received US FDA acceptance for its pravastatin, simvastatin, lovastatin and pioglitazone manufacturing facilities. This acceptance will permit Biocon to access the US\$6b market scheduled to go off patent in the US in CY06. We believe that this development has long term positive implications for Biocon. The company is already selling pravastatin and simvastatin in Europe and commands a market share of about 20% and 40% respectively. However, it should be noted that competition in the US statins market will be severe as a large number of generic players are expected to enter the market post patent expiry.

The company is building its pipeline of immunosuppressants and has filed DMFs for mycophenolate mofetil and

Tacrolimus. We believe that immunosuppressants will be key growth drivers for the company in the long term (beyond FY07).

Specialty pipeline is also being strengthened

Biocon expects to enter the specialty segment of the pharmaceutical market by developing proprietary products based on its developmental efforts with monoclonal Antibodies (Mab). Its JV with a Cuban organization focuses on developing products using Mab. It is currently working on developing Mab for the immunosuppressant, arthritis and cancer segments. The JV has a pipeline of three Mab and three anti-cancer vaccines.

Insulin can be a very big long term opportunity

Biocon has signed a non-exclusive agreement with BMS for supply of r-Human Insulin for the latter's NDDS insulin. This is a 9-year deal with commercial supplies to BMS expected to commence after two years. Biocon has already supplied sample quantities of insulin to BMS. It has also filed a DMF for Insulin with the US FDA.

Biocon is also simultaneously targeting launch of generic insulin in regulated markets in the long term. It has already filed a DMF for insulin with the US FDA and expects to introduce the product in the US market through the 505(b)(2) route. The company will have to conduct limited clinical trials for this product. We believe that the regulatory environment for biotech products (like insulin) is gradually becoming favourable for generic companies. Regulators in both, Europe and USA, have indicated their willingness to frame detailed guidelines for approving generic biotech products.

The company has launched generic insulin in about 8 non-regulated markets till date and has about 25 registrations pending in other non-regulated markets. It has already launched its insulin in the domestic market under the "Insugen" brand. We do not expect Biocon to garner a significant market share in the domestic insulin market in the short term since leading players like Novo Nordisk and

Eli Lilly are well entrenched in the market. However, export of insulin to non-regulated markets will bring in long-term benefits to the company.

The global insulin market is currently worth US\$4b-5b and can be a very big opportunity for generic suppliers like Biocon post 2006.

Syngene's operations are being ramped up

Syngene's new research facility has been inaugurated on 21 October 2004 and we expect a significant ramp-up in Syngene's operations (albeit on a lower base). New client additions as well as ramp-up from existing clients, is likely to result in an improved performance for Syngene in the coming years. Syngene has 6 of the top 10 global pharmaceutical companies as its clients. Syngene has a

scientist strength of about 500 working for various MNCs. It expects to almost double its headcount over the next 12 months in anticipation of increased outsourcing business from the innovator companies.

Valuation and view

Biocon is expected to go through a rough phase over the next 12 months, as increased competition and the rising costs of building an innovation-oriented business is likely to strain the profitability. Biocon is currently valued at 20.3x FY07E earnings, which is not cheap. However, the insulin and the immunosuppressants portfolio may result in long term benefits. A significant expansion in statin volumes (post patent expiry) can lead to an upside in the short term. Maintain **Buy** with a price target of Rs520.

Biocon: an investment profile

Company description

Biocon is an integrated biotechnology company. With over 25 years of expertise in fermentation technology, it has built a strong presence in lucrative high growth segments like statins, immuno-suppressants and anti-diabetics.

Key investment arguments

- ✍ Strong expertise in fermentation process, decision to stay out of formulations in regulated markets make it best positioned to capitalize on statins opportunity.
- ✍ Healthy growth and cash flows to enable scale up of initiatives that would drive growth post 2007.

Key investment risks

- ✍ Fall in prices of Simvastatin and Pravastatin would result in lower profitability for Biocon.
- ✍ Operating at full capacity; any delay in capacity expansion or stabilizing production at the new plant would result in loss of a big market opportunity.
- ✍ Atorvastatin going off-patent earlier than expected would result in cannibalization of other statins, resulting in lower profitability for Biocon.

Recent developments

- ✍ Nil

Valuation and view

- ✍ Revenues and earnings CAGR of 16% and 14%, respectively, expected over FY05-08.
- ✍ The stock trades at 20.3x FY07E earnings, which now factor in a fair share of the negatives.
- ✍ Reiterate **Buy** with a price target of Rs520.

Sector view

- ✍ Regulated markets to remain the key sales and profit drivers in the medium term. Europe to emerge as the next growth driver.
- ✍ FY05 and FY06 to be years of consolidation in terms of profitability, as companies divert efficiency gains to seeding regulated market and R&D initiatives.
- ✍ We are overweight on companies that are towards the end of the investment phase.

COMPARATIVE VALUATIONS

		BIOCON	CIPLA	DRL
P/E (x)	FY06E	27.5	27.7	37.9
	FY07E	20.3	19.8	30.8
P/BV(x)	FY06E	5.5	6.9	3.4
	FY07E	4.5	5.5	3.1
EV/Sales (x)	FY06E	6.1	4.8	3.3
	FY07E	4.7	3.8	2.7
EV/EBITDA (x)	FY06E	20.2	20.1	38.3
	FY07E	15.2	15.0	27.6

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	63.9	65.3	65.3
Domestic Institutions	1.2	2.0	1.0
FII's/FDIs	9.7	4.8	2.9
Others	25.2	27.9	30.8

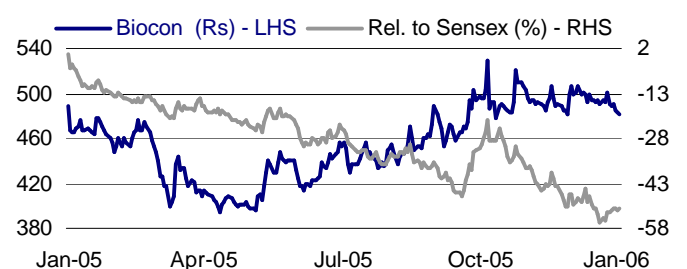
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	17.5	22.9	-23.6
FY07	23.7	31.8	-25.5

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
481	520	8.2	Buy

STOCK PERFORMANCE (1 YEAR)



CONSOLIDATE INCOME STATEMENT						(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E						
Exports	3,008	2,733	3,880	5,240	5,492						
Net Domestic Sales	2,011	3,730	2,977	3,421	4,217						
Net Sales	5,019	6,464	6,856	8,661	9,708						
Contract Research Fees	388	662	897	1,083	1,329						
Net Income	5,406	7,126	7,754	9,744	11,038						
Change (%)	92.0	318	8.8	25.7	13.3						
Total Expenditure	3,623	4,886	5,427	6,758	7,602						
EBITDA	1,783	2,240	2,326	2,987	3,436						
Change (%)	146.1	25.6	3.9	28.4	15.0						
Margin (%)	33.0	314	30.0	30.7	311						
Depreciation	163	223	395	555	537						
Int. and Finance Charges	16	20	13	12	11						
Other Income - Rec.	13	156	107	200	277						
PBT	1,617	2,152	2,024	2,620	3,165						
Tax	230	186	283	262	288						
Tax Rate (%)	14.2	8.6	14.0	10.0	9.1						
Minority Interest	0.0	-10.4	-8.9	-5.0	-20.0						
Reported PAT	1,386	1,977	1,750	2,373	2,897						
Change (%)	218.6	418	-115	35.4	22.0						
Margin (%)	25.6	27.6	22.5	24.2	26.1						

CONSOLIDATED BALANCE SHEET						(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E						
Equity Share Capital	500	500	500	500	500						
Revaluation Reserves	16	16	14	13	11						
Other Reserves	5,113	6,889	8,243	10,080	12,321						
Net Worth	5,629	7,405	8,758	10,592	12,832						
Loans	647	763	465	435	435						
Minority Interest	0	9	0	-15	-35						
Deferred liabilities	177	234	322	404	493						
Capital Employed	6,453	8,412	9,545	11,416	13,725						
Gross Block	2,146	3,300	7,644	8,644	9,394						
Less: Accum. Deprn.	538	763	1,150	1,707	2,246						
Net Fixed Assets	1,607	2,537	6,494	6,937	7,148						
Capital WIP	586	3,245	750	500	500						
Investments	221	2,350	1,394	2,856	5,002						
Curr. Assets	5,441	2,768	2,951	3,650	3,968						
Inventory	857	738	1,036	1,264	1,434						
Account Receivables	1,188	1,824	1,660	2,066	2,340						
Cash and Bank Balance	3,169	34	89	115	130						
Loans & Advances	227	171	166	205	64						
Curr. Liability & Prov.	1,403	2,487	2,044	2,527	2,893						
Account Payables	1,252	2,152	1,566	1,892	2,129						
Provisions	152	335	479	635	764						
Net Current Assets	4,038	280	907	1,122	1,075						
Appl. of Funds	6,453	8,412	9,545	11,416	13,725						

E: MOS Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Basic (Rs) EPS	13.9	19.8	17.5	23.7	29.0
Cash EPS	15.5	22.0	21.5	29.3	34.3
BV/Share	56.1	73.9	87.4	105.8	128.2
DPS	1.0	1.9	3.5	4.7	5.8
Payout (%)	8.1	10.7	22.6	22.6	22.6
Valuation (x)					
P/E		24.3	27.5	20.3	16.6
Cash P/E		21.8	22.4	16.4	14.0
P/BV		6.5	5.5	4.5	3.7
EV/Sales		6.5	6.1	4.7	3.9
EV/EBITDA		20.7	20.2	15.2	12.6
Dividend Yield (%)		0.4	0.7	1.0	1.2
Return Ratios (%)					
RoE	24.6	26.7	20.0	22.4	22.6
RoCE	25.3	25.8	21.3	23.1	23.1
Working Capital Ratios					
Asset Turnover (x)	0.8	0.8	0.8	0.9	0.8
Debtor (Days)	80	93	78	77	77
Inventory (Days)	58	38	49	47	47
Working Capital (Days)	59	13	38	38	31
Leverage Ratio (x)					
Current ratio	3.9	1.1	1.4	1.4	1.4
Debt/Equity	0.1	0.1	0.1	0.0	0.0

CONSOLIDATED CASH FLOW STATEMENT						(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E						
Oper. Profit/(Loss) before	1,783	2,240	2,326	2,987	3,436						
Interest/Dividends Recd.	13	156	107	200	277						
Direct Taxes Paid	-197	-128	-195	-181	-199						
(Inc)/Dec in WC	-215	623	-572	-190	62						
CF from Operations	1,384	2,890	1,666	2,816	3,577						
(Incr)/Dec in FA	-917	-3,812	-1,858	-748	-748						
(Pur)/Sale of Investments	-171	-2,128	956	-1,462	-2,146						
CF from investments	-1,089	-5,940	-902	-2,211	-2,894						
Issue of Shares	3,015	-6	-9	-15	-20						
(Inc)/Dec in Debt	-39	155	-300	-32	-2						
Interest Paid	-16	-20	-13	-12	-11						
Dividend Paid	-113	-212	-396	-537	-655						
CF from Fin. Activity	2,848	-84	-718	-595	-688						
Inc/Dec of Cash	3,143	-3,134	46	11	-5						
Add: Beginning Balance	26	3,169	34	89	115						
Closing Balance	3,169	36	80	100	110						

E: MOS Estimates

N O T E S



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Disclosure of Interest Statement

- | | Biocon |
|--|---------------|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |

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