

## Company Flash

19 February 2008 | 8 pages

# Sun Pharmaceuticals (SUN.BO)

## Buy: Taro reports impressive CY07 results

- Impressive CY07** — Taro reported impressive preliminary CY07 results, with sales at US\$313m (up 70% YoY) & recurring net income at US\$29m (from a loss of US\$103m in CY06). 4QCY07 sales & recurring net income stood at US\$81m & US\$9m respectively. The smart improvement without any synergy benefits should put to rest concerns over Sun's ability to achieve its targeted payback period of 5.5 years on the deal.
- Truer picture on profitability** — The improvement in gross margins to 54% from 23% in CY06 underlines the fact that the low profitability & high net loss in CY06 were due to of one off events. R&D & SG&A spends declined by 19% & 15% respectively leading to OPM of 18% and we believe there could be further upside to these numbers once synergies with Sun begin to come through.
- NDA approval for Flo-Pred** — In January 2008, the US FDA approved Taro new drug application for Flo-Pred (prednisolone acetate oral suspension) equivalent to 5 mg/5 mL and 15 mg/5 mL prednisolone in Taro's patent-protected NonSpil liquid drug delivery system. Taro expects to launch the product in 3Q CY08 and company has indicated a target market of US\$55m for the product.
- Nearing closure** — Taro has indicated that it continues to work with Sun to conclude the merger agreement. We believe there is a good probability that the deal will go through, however have not included it in our estimates yet. While the deal could be dilutive in Yr 1, we expect a strong combined entity over the medium term, with a large product basket/pipeline, integrated operations & multiple synergies

<b>Buy/Low Risk</b>	<b>1L</b>
Price (19 Feb 08)	Rs1,124.70
Target price	Rs1,350.00
Expected share price return	20.0%
Expected dividend yield	1.0%
<b>Expected total return</b>	<b>21.0%</b>
Market Cap	Rs226,602M
	US\$5,721M

### Price Performance (RIC: SUN.BO, BB: SUNP IN)



### Statistical

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	5,733	27.68	35.7	40.6	14.4	41.4	0.5
2007A	7,843	37.87	36.8	29.7	8.3	35.4	0.6
2008E	11,971	57.80	52.6	19.5	6.1	36.2	1.2
2009E	14,008	67.64	17.0	16.6	4.7	32.0	1.4
2010E	15,788	76.23	12.7	14.8	3.7	28.1	1.6

Source: Powered by dataCentral

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## Taro reports impressive CY07 results

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### Net sales up 70% YoY in CY07

Low sales and gross margins in CY06 due to delayed product approvals, pricing pressure and efforts to reduce inventory with its customers

Gross Margins up to 54% compared to 23% in CY06 – a truer reflection of Taro's profitability

Lower R&D and SG&A expenses as a percentage of sales compared to previous years leading to operating margin of 18.1%

One-off expense of US\$12m in CY07 including professional fees related to Taro's investigations and its proposed transaction with Sun Pharmaceutical Industries Ltd

Extraordinary income of US\$4m due to sale of a parking lot in Ireland

Figure 1. Taro CY04-07 Financial Results Summary ('000 US\$, %)

YE December	2004	2005	2006	2007
<b>Net Sales</b>	<b>261,119</b>	<b>297,733</b>	<b>184,122</b>	<b>312,955</b>
Cost of sales.	119,749	128,690	141,938	144,470
Gross profit	141,370	169,043	42,184	168,485
<i>Gross Margins</i>	<i>54.1%</i>	<i>56.8%</i>	<i>22.9%</i>	<i>53.8%</i>
Operating expenses				
Research and development, net	41,956	45,767	36,220	29,302
<i>% of Sales</i>	<i>16.1%</i>	<i>15.4%</i>	<i>19.7%</i>	<i>9.4%</i>
SG&A	123,465	108,099	96,922	82,444
<i>% of Sales</i>	<i>47%</i>	<i>36%</i>	<i>53%</i>	<i>26%</i>
Total Operating expenses	165,421	153,866	133,142	111,746
<b>Operating income (loss)</b>	<b>(24,051)</b>	<b>15,177</b>	<b>(90,958)</b>	<b>56,739</b>
<b>Operating Margins</b>	<b>-9.2%</b>	<b>5.1%</b>	<b>-49.4%</b>	<b>18.1%</b>
Financial expenses (Net)	4,832	7,893	13,404	23,892
Other Income (Net)	-	-	-	1,243
Income (loss) before income taxes	(28,883)	7,284	(104,362)	34,090
Income taxes	2,606	1,617	(1,640)	4,951
<i>Effective tax rate</i>	<i>-9%</i>	<i>22%</i>	<i>2%</i>	<i>15%</i>
<b>Net recurring income (loss)</b>	<b>(31,489)</b>	<b>5,667</b>	<b>(102,722)</b>	<b>29,139</b>
Extraordinary Expense	-	-	38,000	12,000
Extraordinary Income	-	-	-	4,000
<b>Net income (loss)</b>	<b>(31,489)</b>	<b>5,667</b>	<b>(140,722)</b>	<b>21,139</b>
Basic net income (loss) per ordinary share	(1.08)	0.19	(4.80)	0.61
Diluted net income (loss) per ordinary share	(1.08)	0.19	(4.77)	0.60

Source: Company Reports and Citi Investment Research

Figure 2. Taro's 9MCY07 & 4QCY07 Unaudited Results Summary ('000 US\$, %)

YE December	9m 2007	4QCY07
<b>Net Sales</b>	<b>231,800</b>	<b>81,155</b>
Cost of sales.	105,998	38,472
Gross profit	125,802	42,683
<i>Gross Margins</i>	<i>54.3%</i>	<i>52.6%</i>
Operating expenses		
Research and development, net	20,605	8,697
<i>% of Sales</i>	<i>8.9%</i>	<i>10.7%</i>
Selling, marketing, general and administrative	62,450	19,994
<i>% of Sales</i>	<i>27%</i>	<i>25%</i>
Total Operating expenses	83,055	28,691
<b>Operating income (loss)</b>	<b>42,747</b>	<b>13,992</b>
<b>Operating Margins</b>	<b>18.4%</b>	<b>17.2%</b>
Financial expenses (Net)	18,800	5,092
Other Income (Net)	520	723
Income (loss) before income taxes	24,467	9,623
Income taxes	4,229	722
<i>Effective tax rate</i>	<i>17%</i>	<i>8%</i>
<b>Net recurring income (loss)</b>	<b>20,238</b>	<b>8,901</b>
Extraordinary Expense	10,000	2,000
Extraordinary Income	4,000	-
<b>Net income (loss)</b>	<b>14,238</b>	<b>6,901</b>
Basic net income (loss) per ordinary share	0.43	0.20
Diluted net income (loss) per ordinary share	0.43	0.20

Source: Company Reports and Citi Investment Research

## Sun Pharmaceuticals

### Company description

Sun Pharma is one of the fastest-growing companies in the domestic pharmaceutical market, growing at about 2x the industry rate. The company has followed a strategy of being the first to enter niche, high-growth segments (both organic and through acquisitions). The company has a presence in the CNS, pain management, ophthalmology, cardiovascular and respiratory segments. Sun is facing stiff competition in its traditional strongholds, but has managed to sustain growth and is focusing on new therapeutic areas. The company is looking to export its top formulation products to drive growth, and has set up marketing and distribution infrastructure in various markets. It is also filing for ANDA approvals through its US subsidiary Caraco and is close to concluding its second key acquisition in the US (Taro Pharma).

### Investment strategy

We rate Sun Pharma as Buy/Low Risk (1L). The recent Taro acquisition, using idle funds on the balance sheet, improves the company's global scale and reach as well as improving quality of earnings. Having taken a big step forward towards being bigger and more geographically spread out, we believe that Sun is now well placed to grow despite the challenges that keep coming in the way of global generics companies. Its strong base in India should continue to be a good driver of growth and profitability as well as a source of cash flows, besides providing it with a cushion against an appreciating rupee. At the same time, the growing visibility and success on its patent challenge pipeline improves cash flows as well as ability to gain traction with the trade.

### Valuation

Our revised target price of Rs1,350 is based on a sum-of-the-parts approach. We continue to value Sun's base business using a P/E vs. earnings CAGR approach and ascribe an option value for its patent challenge pipeline. We value Sun's base business at 22x FY09E earnings. With a steadily growing profit line, we believe P/E is the best method to value Sun Pharma. We value frontline pharma stocks at a premium of around 40% to the broad market, due to the intellectual property built into the business models, faster growth as well as the potential to deliver positive earnings surprises. This works out to a multiple of 20x that we use for Sun Pharma as well as its peers such as Dr Reddy's and Cipla. However, since we do not include a few upsides (Effexor XR, Taro acquisition) into our estimates at this point in time, we use a higher multiple of 22x to capture this value. At 22x FY09E earnings, we arrive at a value of Rs1,300 /share for the base business. We also ascribe an option value of Rs50/share to Sun's patent challenge pipeline – the higher value is on account of the success achieved by Sun in monetizing three patent challenges (Trileptal, Protonix, Exelon), which we value on an NPV basis, and the growing number of patent challenges in the public domain.

## **Risks**

We rate Sun Pharma as Low Risk because of its steady growth and visible earnings stream. This is also consistent with our quantitative risk-rating system, which tracks 260-day historical share price volatility. The key risks to our target price are: (1) Price deterioration in any of its key markets; (2) Inability to close / effectively integrate the Taro acquisition and exploit synergies could keep earnings depressed for longer than we have anticipated; (3) A stronger IPR law in India could lead to a gradual slowdown in growth rates for the Indian market; (4) damages to be paid in case it loses the litigation on Protonix with Wyeth. Upside risks to our target price include a faster-than-expected integration of the Taro acquisition and a win in any patent challenge.

# Appendix A-1

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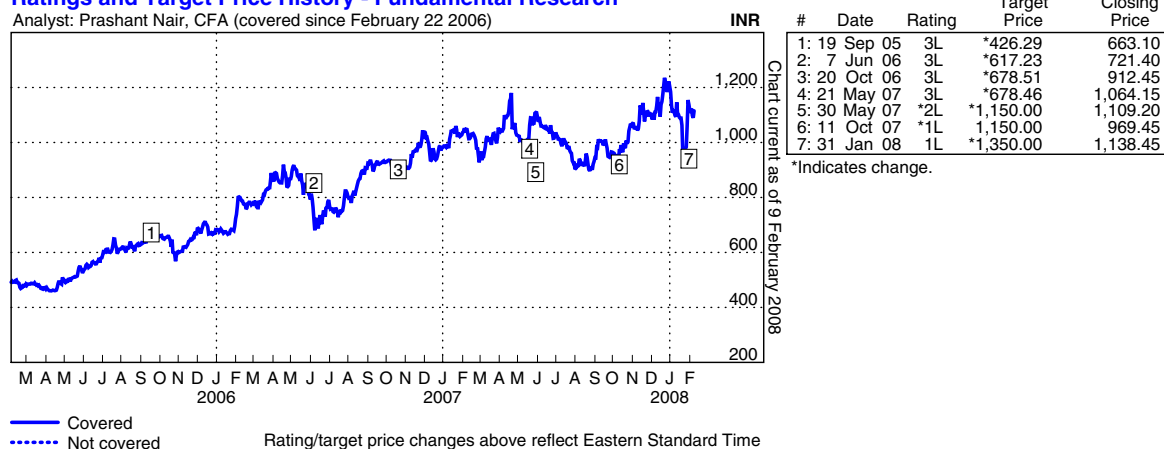
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Analyst: Prashant Nair, CFA (covered since February 22 2006)



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