MOTILAL OSWAL

Cipla

BSE SENSEX	S&P CNX
18,008	5,396
Bloomberg	CIPLA IN
Equity Shares (m)	802.9
52-Week Range (Rs)	381/299
1,6,12 Rel. Perf. (%)	-2/2/-7
M.Cap. (Rs b)	260.1
M.Cap. (US$ b)	5.7

Rs324 Buy

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GR. (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/10A	56,057	10,050	12.5	25.0	25.9	4.4	17.0	20.6	4.6	18.9
03/11E	61,368	9,597	12.0	-4.5	27.1	3.9	14.5	16.0	4.3	19.6
03/12E	70,266	12,010	15.0	24.9	21.7	3.5	16.0	17.7	3.7	16.0
03/13E	80,302	13,509	16.8	12.4	19.3	3.0	15.8	17.7	3.2	14.2

Cipla's 3QFY11 performance was below estimates. Key highlights are:

- Net revenues grew by 8%YoY to Rs15.54b (vs estimate of Rs15.96b), EBITDA declined by 21% to Rs3.18b (vs estimate of Rs3.57b) and PAT de-grew by 19.5% to Rs2.33b (vs estimate of Rs2.52b). Revenue growth was impacted due to lower domestic formulation sales (up 11.5% vs estimate of 14.7% growth) and lower growth for formulation exports (up 11.7% vs estimate of 15.3%).
- EBITDA declined by 21%YoY to Rs3.18b (vs estimate of Rs3.57b) while EBITDA margins contracted 760bps to 20.5% (vs estimate of 22.4%). EBITDA was impacted mainly due lower topline growth and increased expenses related to the Rs10b Indore SEZ which is not generating commensurate revenues as of now, pending regulatory approvals.
- PAT de-grew by 19.5%YoY to Rs2.33b (vs estimate of Rs2.52b) reflecting the muted operational performance but was partly boosted by higher than expected other income at Rs257m vs estimate of Rs168m.

We have revised our EPS estimates downwards by 6-7%each for FY11E, FY12E and FY13E. We believe that Cipla has one of the strongest generic pipelines amongst Indian companies. After a long delay, we believe Cipla's CFC-free inhaler pipeline is likely to gradually get commercialized in Europe and upsides from high-margin opportunities like Seretide can potentially come through over the next two years (our estimates do not include these upsides). Its large manufacturing infrastructure, strong chemistry skills and huge inhaler capacity make it a partner of choice for global MNCs that are ramping up their generics and emerging market presence. Temporary slow-down in overall growth, increased expenses to maintain the Indore SEZ without commensurate revenues and increasing working capital requirements remain our key concerns for the company. Maintain **Buy** with a target price of Rs370 (22x FY13E EPS).

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY10				FY11				FY10	FY11E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Revenues	**13,760**	**14,408**	**14,385**	**13,504**	**14,798**	**16,154**	**15,537**	**14,880**	**56,057**	**61,368**
YoY Change (%)	*14.0*	*6.4*	*7.2*	*1.5*	*7.5*	*12.1*	*8.0*	*10.2*	*7.1*	*9.5*
Total Expenditure	10,075	10,695	10,346	11,198	11,152	12,638	12,355	11,901	42,315	48,045
EBITDA	**3,685**	**3,713**	**4,039**	**2,305**	**3,646**	**3,516**	**3,182**	**2,979**	**13,742**	**13,323**
Margins (%)	*26.8*	*25.8*	*28.1*	*17.1*	*24.6*	*21.8*	*20.5*	*20.0*	*24.5*	*21.7*
Depreciation	458	478	457	278	548	639	653	670	1,671	2,510
Interest	105	84	44	-3	1.1	2.8	29.3	10.5	230	44
Other Income	-150	203	-62	478	28	316	257	192	469	793
Profit before Tax	**2,972**	**3,354**	**3,477**	**2,508**	**3,124**	**3,190**	**2,757**	**2,491**	**12,311**	**11,562**
Extra-Ord expense				-950					-950	0
PBT after EO expense	**2,972**	**3,354**	**3,477**	**3,458**	**3,124**	**3,190**	**2,757**	**2,491**	**13,261**	**11,562**
Tax	555	618	587	676	550	560	430	426	2,435	1,966
Rate (%)	*18.7*	*18.4*	*16.9*	*27.0*	*17.6*	*17.6*	*15.6*	*17.1*	*19.8*	*17.0*
Reported PAT	**2,417**	**2,737**	**2,890**	**2,782**	**2,574**	**2,630**	**2,327**	**2,065**	**10,826**	**9,597**
Adj PAT	**2,417**	**2,737**	**2,890**	**2,155**	**2,574**	**2,630**	**2,327**	**2,065**	**10,199**	**9,597**
YoY Change (%)	72.6	80.7	29.4	-17.7	*6.5*	*-3.9*	-19.5	*-4.2*	31.3	-5.9
Margins (%)	*17.6*	*19.0*	*20.1*	*16.0*	*17.4*	*16.3*	*15.0*	*13.9*	*18.2*	*15.6*

E: MOSL Estimates

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Lower formulation revenues and higher expenses for Indore SEZ impact performance

Net revenues grew by 8%YoY to Rs15.54b (vs estimate of Rs15.96b), EBITDA declined by 21% to Rs3.18b (vs estimate of Rs3.57b) and PAT de-grew by 19.5% to Rs2.33b (vs estimate of Rs2.52b).

Revenue growth was impacted due to lower domestic formulation sales (up 11.5% vs estimate of 14.7% growth) and lower growth for formulation exports (up 11.7% vs estimate of 15.3%). API exports grew by 13% to Rs1.38b (in-line with estimate) while Other Operating Income (OOI) de-grew by 44.6% to Rs523m (in-line with estimate).

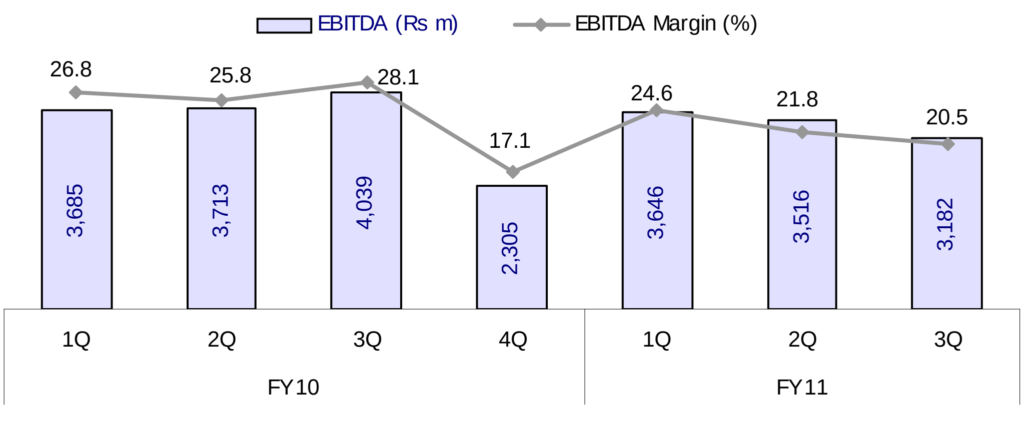
Sales mix (Rs m)

	3QFY11	3QFY10	YoY (%)	2QFY11	QoQ (%)
Domestic	7,340	6,592	11.3	7,564	(3.0)
% of Revenues	47	45		47	
Exports	7,818	6,987	11.9	8,322	(6.1)
% of Revenues	50	48		51	
Formulations	6,432	5,758	11.7	6,639	(3.1)
APIs	1,386	1,229	12.8	1,683	(17.6)
Other Operating Income	523	943	(44.6)	355	47.5
% of Revenues	3	6		2	
Total Gross Revenues	**15,681**	**14,522**	**8.0**	**16,241**	**-3.4**

Source: Company

EBITDA declined by 21%YoY to Rs3.18b (vs estimate of Rs3.57b) while EBITDA margins contracted 760bps to 20.5% (vs estimate of 22.4%). EBITDA was impacted mainly due lower topline growth and increased expenses related to the Rs10b Indore SEZ which is not generating revenues as of now, pending regulatory approvals.

EBITDA and margin trend



Source: Company

PAT de-grew by 19.5%YoY to Rs2.33b (vs estimate of Rs2.52b) reflecting the muted operational performance but was partly boosted by higher than expected other income at Rs257m vs estimate of Rs168m.

Incurring significant expenses on Indore SEZ - commensurate revenues to ramp-up gradually

Cipla has invested significantly in setting up new facilities in the past 2-3 years. One of its large investments has been in the Rs10b Indore SEZ which was commissioned in 1QFY11. This is one of the largest investments in an SEZ in the pharmaceutical industry as of today.

The company is currently incurring expenses of ~Rs250-300m per quarter on this SEZ without commensurate revenues pending regulatory approvals. We believe that the company is facing a temporary mismatch between timing of such expenses and commensurate revenue stream from this large investment.

Management has indicated that the regulatory authorities from UK, Australia and South Africa have recently inspected this facility and hence expects exports to these markets to ramp-up up gradually in the coming quarters. US FDA inspection is yet to take place. It has also indicated that it expects this SEZ to contribute about 10-12% of overall sales by end of FY12. This is one of key reasons impacting Cipla's operational performance.

Continues to be under-hedged, although not a concern as of now

Management continues with its policy of hedging net exposure on monthly basis. Current forex hedges are at US$190m (down from $230m as of Sep-10), which we believe will be inadequate if the INR were to appreciate significantly against the US$. We believe that Cipla is currently under-hedged given its annual net exposure of ~US$300m plus some exposure to the Euro. As of now this may not be a concern since the INR is unlikely to appreciate significantly in the short-term.

Potential MNC contracts can upgrade earnings - negotiations are on - but a delayed opportunity

Cipla has, in the past, indicated that it is negotiating with MNCs like Pfizer, GSK, and Boehringer for long-term supply agreements. Generally, such deals span across many products and multiple markets. These potential contracts are likely to raise earnings for FY12/13 (as of now not included in our estimates).

We believe Cipla is strongly positioned to emerge as key supplier of generic products to global MNCs due to large manufacturing infrastructure, strong chemistry skills and large capacity for inhalers. However we also note that these negotiations have been on for many quarters with no major deal announcement as yet.

CFC-free Inhalers remain key long-term trigger

Launch of CFC-free inhalers in EU & US remains as a key long-term trigger for the company. The company is developing 8 different inhalers and has the 3rd largest inhaler manufacturing capacity globally.

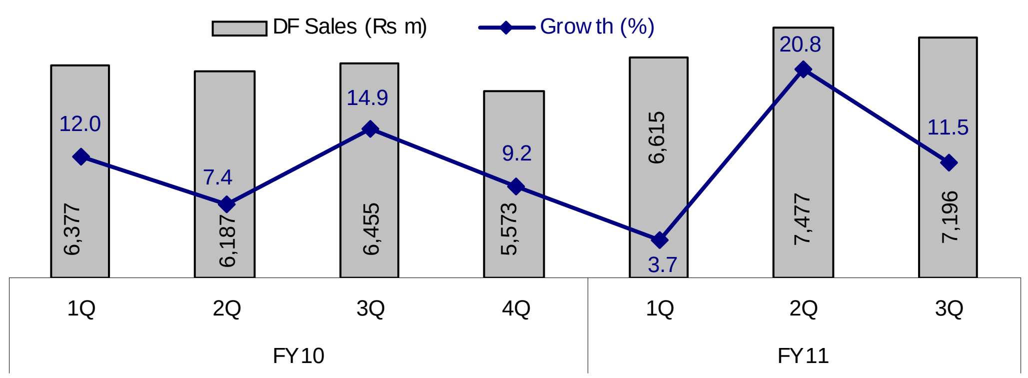
It has already commercialized some of its inhalers in UK, Germany, Spain and Portugal. While launch of these inhalers remains as a key trigger in the long-term, as of now the visibility on the launch time-lines is poor. Management expects its full range of 8 inhalers to be commercialized in Europe over the next 2-3 years and expects a total of 3-6 players for each product in this category implying that this will be a low-competition, high-margin opportunity.

Through its partner - Neo Labs - Cipla has filed for regulatory approval of a generic Seretide Inhaler (GSK's US$6.5b global brand with US$250m sales in the UK) in Sep-08 in UK, post expiry of GSK's data exclusivity. We expect this approval to come through in CY11. Our estimates do not include the upsides from these supplies.

Needs to improve growth traction in the domestic formulations business

Cipla is a dominant player in the domestic formulations market and enjoys the no. 2 ranking in the industry. This business contributes 45-50% of Cipla's overall revenues and is a key earnings driver for the company. However, for the past few quarters, Cipla has not been able to record strong growth in this business due to high base and increasing competition. To counter this management is expanding the sales force and has increased the marketing and promotional spend. We believe that it is imperative for Cipla to drive strong growth as it is a key determinant of its overall growth and valuations.

Cipla: Domestic Formulation (DF) performance



Source: Company

Cutting estimates

Based on the lower than expected 3QFY11 results, we have revised our EPS estimates downwards by 6-7%each for FY11E, FY12E and FY13E. We expect EPS of Rs12 for FY11E (down 4.5% YoY), Rs 15 for FY12E (up 25% on low base) and Rs16.8 for FY13E (up 12.4% YoY). Our estimates do not include any upsides from the expected ramp-up from the Indore SEZ.

Valuation and view

We believe that Cipla has one of the strongest generic pipelines amongst Indian companies. After a long delay, we believe Cipla's CFC-free inhaler pipeline is likely to gradually get commercialized in Europe and upsides from high-margin opportunities like Seretide can potentially come through over the next 2-years (our estimates do not include these upsides).

Its large manufacturing infrastructure, strong chemistry skills and huge inhaler capacity make it a partner of choice for global MNCs that are ramping up their generics and emerging market presence. This coupled with its low-risk strategy and one of the strongest capex in the company's history (currently under utilized) should ensure good long-term potential.Temporary slow-down in overall growth, increased expenses to maintain the Indore SEZ without commensurate revenues and increasing working capital requirements remain our key concerns for the company.

We remain positive on Cipla's long-term prospects (especially on upsides from MNC contracts and commercialization of CFC-inhalers). We note that Cipla management has officially confirmed that it is negotiating supply contracts with Pfizer, although Cipla is taking a long-time to consummate the deal. As and when details of such contracts are made public, we expect an upgrade in earnings to take into account the upsides from such contracts. Maintain **Buy** with a target price of Rs370 (22x FY13E EPS).

Cipla: an investment profile

Company description

Cipla is the largest player in the domestic formulations market and has a presence across most therapeutic areas. The company also has robust exports to several markets including US, Europe, South Africa, Australia and the Middle East. Cipla's strategy for regulated markets (Europe and US) exports is built around supply tie-ups with global players.

Key investment arguments

- Supply agreements with 22 US players for 118 products to drive growth in the medium term, as partners scale up filings and patents expire - adding to the exports momentum.
- Commencement of exports of CFC free inhalers to Europe will be a key positive; Cipla has the third largest capacity of inhalers in the world and could be a key beneficiary of the unfolding opportunity in the long-term.
- Potential MNC contracts are likely to raise earnings for FY12/13

Recent developments

- Nil.

Key investment risks

- NPPA liability of Rs.12b (if it materializes) could result in a significant one-time cash outflow.
- The new pharmaceutical policy (proposed) has raised uncertainties regarding pricing of drugs in India. Further clarity on this is awaited.
- Consolidation in the global generic space can have an adverse impact on the upside from the partnership model adopted by the company.

Valuation and view

- Revenue and EPS CAGR of 13% and 10% respectively expected over FY10-13.
- One of the strongest generic pipelines coupled with de-risked strategy and large under-utilized capacities should bring in long-term benefits.
- **Buy** with a target price of Rs370 (22x FY13E EPS).

Sector view

- Emerging markets would remain the key sales and profit drivers in the medium term. Japan is expected to emerge as the next growth driver, particularly for companies with a direct marketing presence.
- We are overweight on companies that are towards the end of the investment phase, with benefits expected to start coming in from the next fiscal.

Comparative valuations

		Cipla	DRL	Ranbaxy
P/E (x)	FY11E	27.1	24.4	13.3
	FY12E	21.7	21.7	42.4
P/BV (x)	FY11E	3.9	5.4	3.0
	FY12E	3.5	5.3	2.7
EV/Sales (x)	FY11E	4.3	3.8	2.6
	FY12E	3.7	3.5	2.8
EV/EBITDA (x)	FY11E	19.6	23.1	13.0
	FY12E	16.0	22.4	26.4

Shareholding Pattern (%)

	Dec-10	Sep-10	Dec-09
Promoter	36.8	36.8	38.1
Domestic Inst	18.3	17.5	16.9
Foreign	19.3	20.3	20.5
Others	25.7	25.5	24.5

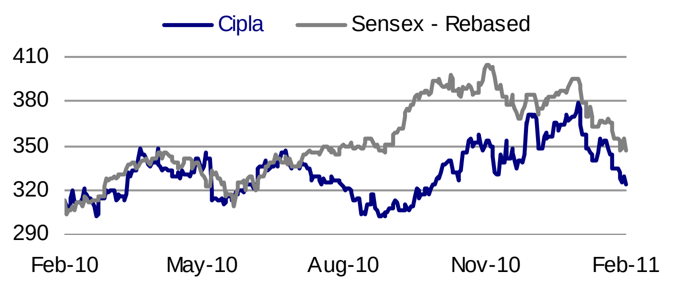
EPS: MOSL forecast v/s consensus (Rs)

	MOSL Forecast	Consensus Forecast	Variation (%)
FY11	12.0	14.0	-14.8
FY12	15.0	16.4	-8.9

Target Price and Recommendation

Current Price (Rs)	Target Price (Rs)	Upside (%)	Reco.
324	370	14.2	Buy

Stock performance (1 year)



Financials and Valuation

INCOME STATEMENT					(Rs Million)
Y/E MARCH	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Gross Sales	**50,216**	**54,117**	**59,952**	**68,814**	**78,822**
Change (%)	*22.8*	*7.8*	*10.8*	*14.8*	*14.5*
Exports	27,430	29,004	32,077	37,593	43,542
Net Domestic Sales	22,176	24,592	27,383	30,669	34,656
Other Operating Income	2,737	2,462	1,909	2,004	2,104
Net Income	**52,343**	**56,057**	**61,368**	**70,266**	**80,302**
Change (%)	*24.5*	*7.1*	*9.5*	*14.5*	*14.3*
Total Expenditure	40,124	42,315	48,045	53,907	62,068
EBITDA	**12,219**	**13,742**	**13,323**	**16,359**	**18,234**
Margin (%)	*23.3*	*24.5*	*21.7*	*23.3*	*22.7*
Depreciation	1,518	1,671	2,510	2,848	3,026
Int. and Finance Charges	329	230	44	86	86
Other Income - Rec.	-1,359	469	793	872	960
PBT before EO Items	**9,013**	**12,311**	**11,562**	**14,297**	**16,082**
Extra Ordinary Expense	0	-950	0	0	0
PBT but after EO Exp.	**9,013**	**13,261**	**11,562**	**14,297**	**16,082**
Tax	1,245	2,435	1,966	2,288	2,573
Tax Rate (%)	*13.8*	*18.4*	*17.0*	*16.0*	*16.0*
Reported PAT	**7,768**	**10,826**	**9,597**	**12,010**	**13,509**
Adj PAT	**7,768**	**10,050**	**9,597**	**12,010**	**13,509**
Change (%)	*10.7*	*29.4*	*-4.5*	*25.1*	*12.5*
Margin (%)	*14.8*	*17.9*	*15.6*	*17.1*	*16.8*

BALANCE SHEET					(Rs Million)
Y/E MARCH	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Equity Share Capital	1,555	1,606	1,606	1,606	1,606
Reserves	41,863	57,410	64,608	73,615	83,747
Revaluation Reserves	90	90	90	90	90
Net Worth	**43,508**	**59,106**	**66,303**	**75,311**	**85,442**
Loans	9,402	51	4,320	4,320	4,320
Deferred Liabilities	1642	1792	1907	1650	1489
Capital Employed	**54,551**	**60,948**	**72,530**	**81,280**	**91,251**
Gross Block	26,933	28,973	34,973	40,973	45,473
Less: Accum. Deprn.	7,008	8,861	11,371	14,219	17,244
Net Fixed Assets	**19,925**	**20,112**	**23,602**	**26,754**	**28,228**
Capital WIP	3,663	6,842	6,842	6,842	6,842
Investments	813	2,464	5,595	5,595	5,595
Curr. Assets	**44,196**	**43,673**	**49,423**	**57,816**	**68,512**
Inventory	13,983	15,126	16,290	19,263	22,067
Account Receivables	18,372	15,666	17,247	20,738	23,755
Cash and Bank Balance	530	621	3,327	3,045	5,716
Others	11,311	12,260	12,559	14,769	16,975
Curr. Liability & Prov.	**14,046**	**12,144**	**12,931**	**15,726**	**17,927**
Account Payables	14,046	12,144	12,931	15,726	17,927
Net Current Assets	**30,150**	**31,530**	**36,491**	**42,089**	**50,585**
Appl. of Funds	**54,551**	**60,948**	**72,530**	**81,280**	**91,251**

E: MOSL Estimates

RATIOS					
Y/E MARCH	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Basic (Rs)					
EPS	**10.0**	**12.5**	**12.0**	**15.0**	**16.8**
Cash EPS	11.9	14.6	15.1	18.5	20.6
BV/Share	55.9	73.5	82.5	93.7	106.3
DPS	4.0	4.7	5.1	6.4	7.2
Payout (%)	23.4	19.8	25.0	25.0	25.0
Valuation (x)					
P/E	32.4	25.9	27.1	21.7	19.3
PEG (x)	3.0	0.9	-6.0	0.9	1.5
Cash P/E	27.1	22.2	21.5	17.5	15.7
P/BV	5.8	4.4	3.9	3.5	3.0
EV/Sales	5.1	4.6	4.3	3.7	3.2
EV/EBITDA	22.0	18.9	19.6	16.0	14.2
Dividend Yield (%)	1.2	1.4	1.6	2.0	2.2
Return Ratios (%)					
RoE	17.9	17.0	14.5	16.0	15.8
RoCE	17.1	20.6	16.0	17.7	17.7
Working Capital Ratios					
Fixed Asset Turnover (x)	2.9	2.8	2.8	2.8	2.9
Debtor (Days)	128	102	103	108	108
Inventory (Days)	98	98	97	100	100
Working Capital (Days)	207	201	197	203	204
Leverage Ratio (x)					
Current Ratio	3.1	3.6	3.8	3.7	3.8
Debt/Equity	0.2	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Op. Profit/(Loss) before Ta	12,219	13,742	13,323	16,359	18,234
Interest/Dividends Recd.	-1,359	469	793	872	960
Direct Taxes Paid	-1,095	-2,285	-1,850	-2,545	-2,734
(Inc)/Dec in WC	-5,851	-1,289	-2,256	-5,880	-5,826
CF from Operations	**3,914**	**10,637**	**10,010**	**8,807**	**10,634**
EO expense	0	-950	0	0	0
CF from Oper. incl EO	**3,914**	**11,587**	**10,010**	**8,807**	**10,634**
(inc)/dec in FA	-6,161	-5,037	-6,000	-6,000	-4,500
(Pur)/Sale of Investments	134	-1,651	-3,131	0	0
CF from Investments	**-6,027**	**-6,688**	**-9,131**	**-6,000**	**-4,500**
Issue of Shares	0	6,912	0	0	0
Inc/(Dec) in Debt	3,998	-9,352	4,269	0	0
Interest Paid	-329	-230	-44	-86	-86
Dividend Paid	-1,819	-2,139	-2,399	-3,002	-3,377
CF from Fin. Activity	**1,850**	**-4,809**	**1,826**	**-3,089**	**-3,464**
Inc/Dec of Cash	**-263**	**91**	**2,706**	**-282**	**2,671**
Add: Beginning Balance	793	530	621	3,327	3,045
Closing Balance	**530**	**621**	**3,327**	**3,045**	**5,716**

N O T E S

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Disclosure of Interest Statement	Cipla
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No