Company Focus

30 October 2007 | 12 pages

Glenmark Pharmaceuticals (GLEN.BO)

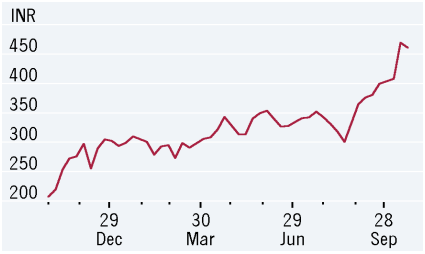
Target price change ☑

Buy: Another Deal! Raising Target Price to Rs575

- **Raising target price to Rs575** — as we factor in Rs95/share as option value for its R&D deal with Eli Lilly & roll forward our base business valuation to FY09E EPS. The deal with Eli Lilly validates our view that Glenmark is the best play on innovative R&D in Indian pharma. Maintain Glenmark as one of our top picks.
- **Another exciting deal** — Glenmark has licensed a portfolio of TRPV1 antagonist molecules (including GRC-6211) to Eli Lilly. Eli Lilly will develop, register & commercialize the molecule in N America, Europe and Japan, while Glenmark will retain rights for other countries and co-promote the drug in the US.
- **What does Glenmark get?** — Eli Lilly will bear all cost of further trials. Glenmark would receive US$45m upfront & further milestones up to US$305m (US$215m plus US$90m, if other indications are successfully developed). On successful launch, Glenmark would get royalties on sales. Based on 25% probability of launch, we add Rs95/share as option value for the deal to our TP.
- **More to come** — Glenmark has 5 more leads (3 NCEs, 2 NBEs) in its pipeline, of which 3 would enter the clinic in FY08 – potential licensing candidates & sources of option value. Glenmark expects to conclude one more deal in FY08.
- **Pipeline risks** — We also highlight risks associated with Glenmark's pipeline: a) despite a partial positive response from the USFDA on Oglemilast, we believe the fate of its deal with Forest would depend on the latter's hurdle rate; b) Merck KgaA's decision to discontinue diabetes research has brought in some uncertainty on the fate of the GRC-8200 deal.

Buy/Medium Risk	**1M**
Price (30 Oct 07)	Rs474.20
Target price	Rs575.00
from Rs427.00	
Expected share price return	21.3%
Expected dividend yield	0.1%
Expected total return	**21.4%**
Market Cap	Rs115,760M
	US$2,942M

Price Performance (RIC: GLEN.BO, BB: GNP IN)



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	864	3.22	-20.9	147.1	30.3	25.5	0.1
2007A	3,093	11.54	258.0	41.1	16.6	58.5	0.1
2008E	5,328	19.88	72.3	23.8	9.5	56.4	0.1
2009E	6,761	25.23	26.9	18.8	6.1	44.2	0.1
2010E	7,608	28.39	12.5	16.7	4.4	34.1	0.1

Source: Powered by dataCentral

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

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	147.1	41.1	23.8	18.8	16.7
EV/EBITDA adjusted (x)	87.8	28.9	18.0	14.5	12.4
P/BV (x)	30.3	16.6	9.5	6.1	4.4
Dividend yield (%)	0.1	0.1	0.1	0.1	0.1
Per Share Data (Rs)					
EPS adjusted	3.22	11.54	19.88	25.23	28.39
EPS reported	3.22	11.54	19.88	25.23	28.39
BVPS	15.65	28.58	50.09	77.45	108.34
DPS	0.35	0.40	0.60	0.70	0.70
Profit & Loss (RsM)					
Net sales	7,020	12,220	17,259	21,082	24,621
Operating expenses	-5,880	-8,380	-11,019	-13,438	-16,015
EBIT	**1,140**	**3,840**	**6,240**	**7,644**	**8,606**
Net interest expense	-147	-384	-227	0	0
Non-operating/exceptionals	128	157	106	136	354
Pre-tax profit	**1,121**	**3,613**	**6,118**	**7,781**	**8,960**
Tax	-241	-513	-782	-1,012	-1,344
Extraord./Min.Int./Pref.div.	-16	-8	-8	-8	-8
Reported net income	**864**	**3,093**	**5,328**	**6,761**	**7,608**
Adjusted earnings	864	3,093	5,328	6,761	7,608
Adjusted EBITDA	1,372	4,263	6,801	8,270	9,297
Growth Rates (%)					
Sales	23.3	74.1	41.2	22.2	16.8
EBIT adjusted	-18.2	237.0	62.5	22.5	12.6
EBITDA adjusted	-11.9	210.7	59.5	21.6	12.4
EPS adjusted	-20.9	258.0	72.3	26.9	12.5
Cash Flow (RsM)					
Operating cash flow	**-268**	**932**	**4,466**	**4,861**	**6,125**
Depreciation/amortization	232	423	561	626	691
Net working capital	-1,657	-3,263	-1,815	-2,737	-2,451
Investing cash flow	**-2,568**	**-2,688**	**-1,535**	**-1,000**	**-1,000**
Capital expenditure	-2,553	-2,711	-1,535	-1,000	-1,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**2,505**	**1,891**	**-3,642**	**-2,472**	**-200**
Borrowings	2,886	2,088	-3,243	-2,273	0
Dividends paid	-205	-117	-172	-200	-200
Change in cash	**-331**	**136**	**-711**	**1,388**	**4,925**
Balance Sheet (RsM)					
Total assets	**13,416**	**19,346**	**22,759**	**28,176**	**36,780**
Cash & cash equivalent	1,056	1,058	346	1,734	6,659
Accounts receivable	3,816	5,712	7,615	9,884	11,866
Net fixed assets	5,805	8,104	9,078	9,452	9,761
Total liabilities	**9,502**	**12,482**	**10,731**	**9,579**	**10,767**
Accounts payable	1,719	2,329	3,664	4,582	5,502
Total Debt	7,354	9,367	6,124	3,852	3,852
Shareholders' funds	**3,915**	**6,864**	**12,028**	**18,597**	**26,013**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	19.5	34.9	39.4	39.2	37.8
ROE adjusted	25.5	58.5	56.4	44.2	34.1
ROIC adjusted	10.6	25.4	31.8	33.0	31.5
Net debt to equity	160.9	121.1	48.0	11.4	-10.8
Total debt to capital	65.3	57.7	33.7	17.2	12.9

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Another Deal; Raising Target Price to Rs575

Glenmark's deal with Eli Lilly for its pain compound (GRC-6211) further validates our view that Glenmark is the best play on innovative R&D in Indian pharma. With significant deals for 3 NCEs, more R&D assets in the pipeline and base business gaining momentum, we remain positive. We raise our target price by 35% to Rs575/share as we factor in Rs95/share as option value for its R&D deal with Eli Lilly & roll forward our base business valuation to FY09E earnings. We maintain our Buy/Medium Risk (1M) rating and reiterate Glenmark as one of our top picks in the sector.

Raising Target Price by 35%

We are raising our target price for Glenmark by 35% to Rs575/share, based on the following factors:

- **Option value for GRC-6211, following licensing deal with Eli Lilly**: We build in option value of Rs95/share for Glenmark's licensing deal with Eli Lilly. Glenmark has licensed a portfolio of TRPV1 antagonist molecules (including GRC-6211) to Eli Lilly for the markets of North America, Europe and Japan. Glenmark will receive an upfront payment of US$45m and total milestones up to US$305m if GRC-6211 is successfully commercialized for all indications. As with Oglemilast, we use a probability based cash flow valuation approach to arrive at a value for this deal. We assume that milestone payments would be spread out over the next five years and have built in reducing probabilities for receipt of each successive milestone and a 25% probability of launch in FY2013 with peak sales potential of US$4bn. This takes our valuation of Glenmark's validated R&D assets (Oglemilast, GRC-8200 & GRC-6211) to Rs268/share.

- **Base business valuation raised 17%**: We raise our base business valuation to Rs307/ share (from Rs263/ share earlier) – as we roll over our target multiple to March'09E (September'08E earlier) earnings. Glenmark's base (non R&D) business has gained significant traction, especially in the US, India & Latin America, and we remain positive on its future growth prospects.

These, along with marginal changes to our valuation of Oglemilast & GRC-8200 (on roll forward of our DCF values) lead to our revised target price of Rs575/share.

GRC-6211 – third molecule licensed out

GRC-6211 is the third NCE that Glenmark has licensed out to a global pharma company (Eli Lilly). We believe this is a significant deal for Glenmark and have ascribed an option value of Rs95/share for the same in our target price.

Another significant deal

Glenmark has entered into another significant NCE R&D agreement with a global major (Eli Lilly). Under the terms of the agreement, Eli Lilly will acquire the rights to a portfolio of transient receptor potential vanilloid sub-family 1 (TRPV1) antagonist molecules, including a clinical compound, GRC-6211. GRC-6211 is currently in early clinical Phase II development as a potential next-generation treatment for various pain conditions, including osteoarthritic

pain, dental & neuropathic pain and urinary incontinence. Glenmark had completed Phase I clinical trials for GRC-6211 on 72 healthy human subjects using single and multiple doses – and claims that the results were positive. It had initiated a Phase IIA proof of concept study for dental pain in Europe (scheduled for completion in December 2007) and had plans to initiate two large Phase II studies for neuropathic pain and osteoarthritis. Glenmark had indicated in the past that, if successful, GRC-6211 could be the third or fourth in class – Merck and GSK have a molecule each in Phase II while Pfizer has one in the pre-clinical stage.

Creates significant value for Glenmark

As part of the deal, Eli Lilly will develop, register & commercialize the molecule in North America, Europe & Japan, while Glenmark will retain rights for other countries and co-promote the drug in the US. Eli Lilly will bear all cost of further development. Glenmark would receive US$45m as upfront payment and further payments in potential development and sales milestones for the initial indication. Besides, it also stands to receive additional milestones of US$90m if other indications are successfully developed. In addition to the pre-launch receipts, Glenmark also stands to receive royalties on sales if GRC-6211 is successfully commercialized.

We value the deal at Rs95/share

We have arrived at the option value from this deal by using a probability based cash flow valuation approach. We have assumed that the milestone payments are spread out in a back ended manner over the next five years (upto CY12 / FY13), with reducing probabilities for receipt of each successive milestone. Besides, we assume a 25% probability of launch in FY13, peak sales of US$4bn (to be achieved within 5 years of launch), patent expiry in CY26 and 16% royalties on sales. We have used a 13% discount rate in our model (in-line with Glenmark's WACC), as we have already adjusted the higher risk income streams by probability of success. Based on our calculations, we arrive at a value of Rs95/ share for the deal.

Pipeline update – things that bear watching

We highlight a couple of developments on Glenmark's two other outlicensed molecules – Oglemilast and GRC-8200 – that we believe bear close watching over the next few months.

- **On Oglemilast**, Glenmark and its partner (Forest Laboratories) have received a "partial positive" response from the US FDA that allows them to commence large-scale proof of concept (phase IIb) studies in COPD. As per Glenmark, this is positive for the development path of the molecule. However, we also note that Forest indicated in its recent conference call that they have posed some additional questions to the FDA that would help them define the long-term development program for Oglemilast – on which, they expect a response in around two to three months. Forest also mentioned that it intends to discuss the optimal path forward for the program with Glenmark. While this means that Oglemilast is good to start Phase IIb trials (and, thus trigger a further milestone payment to Glenmark), Forest may wait for the

additional response from the US FDA before it makes its next move. In the unlikely event of Forest withdrawing from the program, we believe that the option value on Oglemilast could be impaired to a large extent. We have built in Rs125/share (c25% of current stock price) as option value for Oglemilast. On the other hand, if the FDA response is positive, we believe that the option value would expand further since the probability of launch (we currently build in 20%) would go up further.

- **On GRC-8200**: Merck KgaA (Glenmark's licensing partner) has recently announced its decision to discontinue diabetes research. It intends to look at partnerships for existing projects in this field. As such, the status of this arrangement is currently hazy. We believe that there could be two potential outcomes – a) Merck sub-licenses the molecule to another player and the deal continues on existing / new terms; b) Merck returns the molecule to Glenmark, who can then seek another licensing partner. We are not overtly concerned on this front – in either scenario – since the issue has nothing to do with the quality of GRC-8200. In fact, we believe that Merck's original decision to in-license GRC-8200 has already validated the molecule and would help Glenmark in its effort to seek another licensing partner. As such, irrespective of the course of action adopted by Merck, we do not expect any significant impairment of option value on this molecule.

More in the bush – falling R&D risk?

Besides the three licensed molecules, Glenmark has several other molecules that are expected to enter clinical trials over the next few months. We believe that these are outlicensing candidates as well, and could create significant value for the company and investors.

Figure 1. Growing & Diversified R&D Pipeline

Compound (Partner)	Target	Primary indications	Status
Own			
GRC 3886 (Forest)	PDE 4	Asthma, COPD	Phase II
GRC 8200 (Merck KgaA)	DPP IV	Diabetes (Type II)	Phase II
GRC 6211 (Eli Lilly)	VR 1	Osteo Arthritis, Migraine, Incontinence, Asthma	Phase II
GRC 10693	CB 2	Neuropathic pain, Osteoarthritis and other inflammatory pain	Phase I by CY07 end
GRC 10801	CB 1	Obesity	Phase I by end FY08
GRC 4039	PDE 4	Rheumatic Arthritis, Inflamation	Phase I by CY07 end
Tie-up with Dyax			
3 anti-bodies	Unknown	Unknown	First NBE to enter clinic in 2009
Chromos			
CHR-1103	Monoclonal anti body	Multiple Sclerosis; Rheumatic Arthritis, Inflamation Bowel disease	Pre clinical
CHR-1201	Monoclonal anti body	Acute Thrombosis	Pre clinical
Napo			
Crofelemer	Chronic Diarrhoea	Chronic Diarrhoea	Phase II

Source: Company Reports and Citi Investment Research

As the above table shows, Glenmark's pipeline is made up of multiple compounds of different classes, most of them aimed at different targets in areas of large unmet therapeutic need. With such a fast-growing and well-diversified pipeline as well as cash flow from milestones, we believe that at a business level Glenmark has de-risked its R&D to a large extent.

Revisiting Glenmark's R&D Strategy

We revisit Glenmark's R&D strategy – a source of significant value creation for the company. Glenmark has had an aggressive focus on drug discovery research over the last five years. It initiated NCE (new chemical entity) research in 2001, focusing on four key areas – asthma, diabetes/obesity, inflammatory conditions and CNS. Despite a much smaller R&D budget, Glenmark has surpassed its larger Indian peers in terms of delivery. In our opinion, the management's focused approach to this high-risk activity and its ability to extract maximum value from its intellectual assets set Glenmark apart from other Indian companies in the drug discovery space.

The following factors have been key to its success in R&D:

- **Working on areas of high unmet need**: Choice of chronic segments like diabetes, asthma and obesity with high potential RoI; however, with a clear focus on lower risk analogue research. Each of these are areas of large unmet clinical need, and hence, considerable interest among innovator companies.
- **Aggressive partnering strategy**: Intention to seek out licensing partners beyond pre-clinical / Phase I stage to mitigate risk of failure and optimize upsides from early stage success.
- **Ability to negotiate excellent terms with its out-licensing partners**: The company's first big success in NCE research came in the form of landmark licensing deals with Forest Laboratories (US market) and Teijin Pharma (Japanese market) for its anti-asthma / COPD compound – GRC-3886, now named *Oglemilast*. This was followed by a deal with Merck KgaA for GRC-8200 (a DPP-IV inhibitor for anti-diabetes) and the recent deal with Eli Lilly for GRC-6211 (VR1 agonist for pain indications).

The result has been four significant outsourcing deals across three molecules and a pipeline of several other molecules on the verge of entering the clinic. We believe that the successful & high profile outlicensing deals have validated Glenmark's R&D capabilities and improved its visibility globally – factors that would help in striking similar deals as well, in our view.

Glenmark Pharmaceuticals

Company description

Glenmark Pharmaceuticals is a fully integrated research-based pharmaceutical company, with a business model spanning drug discovery research, APIs and formulations in the domestic and international markets. It operates in more

than 65 countries, including the regulated markets of the US and Europe, with around 50% of its revenues coming from overseas markets. The company came into the limelight in September 2004 after it licensed out the US market rights of its first new chemical entity (NCE), GRC-3886, to Forest Laboratories.

Investment strategy

We have a Buy/Medium Risk (1M) rating on the stock with a target price of Rs575/share. Our positive outlook on the stock takes into consideration the following: a) R&D pipeline has broadened with seven molecules expected by the company to be in the clinic by end FY08; b) With three molecules licensed out, the R&D option value or value at risk is now spread across a larger number of molecules; c) the base business has witnessed significant traction, especially in the USA and Latin America. We also believe that the rapid scale-up in the base business adds another catalyst for the stock apart from the option value being built in by its R&D effort (primarily Oglemilast, GRC-8200 & GRC-6211). The risk reward, we believe, remains in favor of investors. Although there are potential risk triggers (especially related to Oglemilast) that could lead to partial erosion of the option value, we believe that any such decline is a buying opportunity since Glenmark has a robust pipeline that would enable it to shore up the R&D value over time via new outlicensing deals.

Valuation

We use sum of the parts to value the stock, valuing the R&D deals and the base business separately. We believe probability-adjusted DCF is appropriate to calculate the option value from Oglemilast, GRC-6211 and GRC-8200 as it captures the reducing probability of success as the molecules progress on the clinical path. We have used the licensing deal with Forest Laboratories for the US market as a benchmark as well as a 13% discount rate (in-line with Glenmark's WACC) following our adjustment for the higher-risk income streams by probability of success. We arrive at a value of Rs125/share for Oglemilast. We use a similar approach for GRC-8200 and GRC-6211 arriving at a value of Rs47/share and Rs95/share respectively. We value Glenmark's base business (excluding R&D income) on P/E in view of the healthy growth expected in earnings. Our valuation is based on 20x forward earnings, which is at a premium to the range that we use for other mid-sized pharma companies. We believe Glenmark deserves a premium given its higher value addition in its business and the ability to execute and leverage its assets. Based on 20x March 09E earnings, we value Glenmark's base business at Rs307/share. This takes the total valuation of the company to Rs575/share.

Risks

We rate Glenmark Medium Risk, even though its risk rating according to our quantitative model is Low, as we believe the element of R&D related option value built into the stock warrants a higher risk rating. The main downside risks to our target price and estimates include: (1) Glenmark's efforts to build its own front-end in regulated markets could prove to be a drag on earnings if it is unable to effectively execute its plans; (2) growing competition, rapid price erosion and fragmented market share are risks that are inherent to the generics business; and (3) potential failure of any of the R&D deals could lead to the R&D milestone payments getting taken off our estimates. If any of these factors

has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

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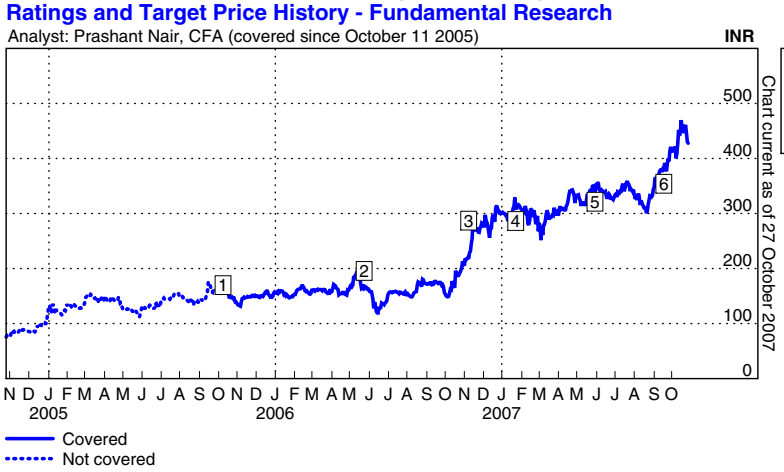
IMPORTANT DISCLOSURES

Glenmark Pharmaceuticals (GLEN.BO)
Ratings and Target Price History - Fundamental Research
Analyst: Prashant Nair, CFA (covered since October 11 2005)



#	Date	Rating	Target Price	Closing Price
1:	10 Oct 05	3H	152.50	162.75
2:	24 May 06	*1H	*227.50	163.05
3:	8 Nov 06	1H	*317.50	217.60
4:	23 Jan 07	*1M	*379.50	310.40
5:	30 May 07	1M	*427.00	336.58
6:	18 Sep 07	1M	427.00	380.55

*Indicates change.

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% of companies in each rating category that are investment banking clients	53%	55%	42%

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