Company Results Review

22 October 2006 | 8 pages

Cipla (CIPL.BO)

In-line Quarter

- **In-line** — Cipla's 2QFY07 numbers were solid, although they came in marginally below our estimates. Strong revenue growth and higher other income were the key drivers for the 41% YoY net profit growth, even as EBIDTA margins were surprisingly lower by 99bp YoY.

- **Strong revenue growth continues** — Sales growth remained strong, in-line with expectations, as domestic sales grew 22% YoY and exports grew 37% YoY. Exports were driven by higher API sales (up 120% YoY) that, we believe, were partly due to exclusivity sales for its partners in the US. We expect robust revenues, although the rate of growth could taper off in 2HFY07.

- **Product mix hits margins** — EBIDTA margins were surprisingly lower by 99bp YoY, contrary to our expectations. RM/Sales increased by 249bp YoY and 106bp QoQ – the company indicated that this is largely due to product mix issues during the quarter. Higher other income (interest earned on proceeds of the recent GDR issue) and lower tax, however, propped up the bottom line.

- **Maintain Sell/Low Risk (3L)** — We believe Cipla's primarily supply-based model for regulated markets is low on value addition and could be at risk in light of the global consolidation process. Valuations, in our view, factor in most positives such as robust growth and wide global presence. The momentum in the stock is likely to taper off, as growth decelerates in 2H. Maintain Sell.

Sell/Low Risk	**3L**
Price (20 Oct 06)	Rs262.50
Target price	Rs170.00
Expected share price return	-35.2%
Expected dividend yield	1.1%
Expected total return	**-34.1%**
Market Cap	Rs204,039M
	US$4,512M

Price Performance (RIC: CIPL.BO, BB: CIPLA IN)

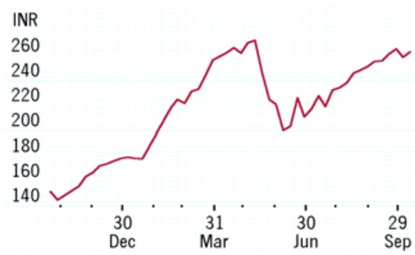

Figure 1. Statistical Abstract

Year to 31 March	Net Profit (Rsm)	EPS (Rs)	EPS Growth (%)	P/E (x)	ROAE (%)
FY04	2,956	3.9	19.3	66.6	25.3
FY05	4,096	5.5	38.6	48.0	29.1
FY06	6,001	8.0	46.5	32.8	34.3
FY07E	6,988	9.0	12.3	29.2	28.0
FY08E	8,407	10.8	20.3	24.3	25.3
FY09E	9,856	12.7	17.2	20.7	25.3

Source: Company Reports and Citigroup Investment Research

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See page 6 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	48.0	32.8	29.2	24.3	20.7
EV/EBITDA adjusted (x)	41.4	30.8	22.3	18.2	17.1
P/BV (x)	12.7	10.1	6.7	5.7	4.8
Dividend yield (%)	0.5	1.0	1.1	1.3	1.6
Per Share Data (Rs)					
EPS (adjusted)	5.46	8.00	8.99	10.82	12.68
EPS (reported)	5.46	8.00	8.99	10.82	12.68
BVPS	20.72	25.90	39.32	46.17	54.20
DPS	1.40	2.52	2.92	3.52	4.12
Profit & Loss (RsM)					
Net sales	22,545	29,857	34,856	41,354	48,663
Operating expenses	-18,143	-24,023	-26,782	-31,632	-37,229
EBIT	**4,402**	**5,834**	**8,074**	**9,722**	**11,434**
Net interest expense	-76	-114	-52	-20	-20
Non-operating/exceptionals	820	1,311	297	307	319
Pre-tax profit	**5,146**	**7,031**	**8,319**	**10,009**	**11,733**
Tax	-1,050	-1,030	-1,331	-1,601	-1,877
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**4,096**	**6,001**	**6,988**	**8,407**	**9,856**
Adjusted earnings	4,096	6,001	6,988	8,407	9,856
Adjusted EBIT	4,402	5,834	8,074	9,722	11,434
Growth Rates (%)					
EPS (adjusted)	38.6	46.5	12.3	20.3	17.2
EBIT (adjusted)	16.2	32.5	38.4	20.4	17.6
Sales	17.2	32.4	16.7	18.6	17.7
Cash Flow (RsM)					
Operating cash flow	**2,468**	**4,110**	**5,723**	**6,459**	**6,454**
Depreciation/amortization	550	830	953	1,073	0
Net working capital	-2,178	-2,721	-2,218	-3,021	-3,402
Investing cash flow	**-1,338**	**-2,046**	**-9,185**	**-2,578**	**-842**
Capital expenditure	-2,958	-1,650	-2,050	-2,000	0
Acquisitions/disposals	1,621	-396	-7,135	-578	-842
Financing cash flow	**-1,131**	**-2,064**	**3,462**	**-3,881**	**-4,805**
Borrowings	-155	50	-700	-800	0
Dividends paid	-1,199	-2,131	-2,561	-3,081	-3,612
Change in cash	**0**	**0**	**0**	**0**	**807**
Balance Sheet (RsM)					
Total assets	**26,161**	**32,607**	**44,555**	**50,833**	**59,200**
Cash & cash equivalent	337	764	7,936	8,558	9,454
Net fixed assets	8,449	9,269	10,366	11,293	13,293
Total liabilities	**10,624**	**13,194**	**13,993**	**14,944**	**17,067**
Debt	1,950	2,000	1,300	500	500
Shareholders' funds	**15,536**	**19,413**	**30,563**	**35,889**	**42,133**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	22.0	22.3	25.9	26.1	23.5
ROE adjusted	29.1	34.3	28.0	25.3	25.3
ROIC adjusted	21.2	24.3	29.1	30.3	30.4
Net debt to equity	10.4	6.4	-21.7	-22.5	-21.3
Total debt to capital	11.2	9.3	4.1	1.4	1.2

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In-Line Quarter; Margin Decline Surprising

Cipla's 2Q numbers were solid, although they came in marginally below our estimates. Strong revenue growth and higher other income were the key drivers for the 41% YoY net profit growth, even as EBIDTA margins were surprisingly lower. We believe Cipla's primarily supply-based model for regulated markets is low on value addition and could be at risk in light of the global consolidation process. Valuations, in our view, factor in most positives such as robust growth and wide global presence. We expect the recent underperformance in the stock to continue, as growth decelerates in 2H. Maintain Sell/Low Risk (3L).

Figure 2. 2QFY07 Earnings Summary (Rupees in Million, percent)

Year to 31 March	2QFY06	2QFY07	Change YoY	1QFY07	Change QoQ	CIR Comments
Sales	6,968	9,153	31.4	8,869	3.2	
Excise Duty	(251)	(192)	(23.6)	(233)	(17.9)	
Excise duty rate	*3.6*	*2.1*	*-150 bps*	*2.6*	*-54 bps*	
Net Sales	**6,717**	**8,961**	**33.4**	**8,636**	**3.8**	Strong growth in domestic sales and API exports
Expenditure	(4,944)	(6,685)	35.2	(6,347)	5.3	
Operating profits	**1,773**	**2,276**	**28.4**	**2,289**	**(0.6)**	
OPM (%)	*26.4*	*25.4*	*-99 bps*	*26.5*	*-110 bps*	Higher fixed costs and adverse product mix affect EBIDTA margins despite excise duty savings; we believe this is a quarterly aberration
Interest	(17)	(16)	(7.7)	(28)	(44.1)	
Depreciation	(215)	(245)	14.0	(260)	(5.8)	Expected to increase going forward, as aggressive capex plans are rolled out
Other income	15	190	1,141.2	220	(13.5)	Interest income earned on recent GDR proceeds
PBT	**1,556**	**2,205**	**41.7**	**2,220**	**(0.7)**	
Tax	(330)	(403)	22.0	(516)	(22.0)	Tax savings due to Baddi and recently set up plant in EoU at Patalganga
Tax rate (%)	21.2	18.3	*-296 bps*	23.2	*-499 bps*	
Net profit	**1,226**	**1,803**	**47.0**	**1,704**	**5.8**	
Net margin (%)	*18.3*	*20.1*	*187 bps*	*19.2*	*90 bps*	

Source: Company Reports and Citigroup Investment Research

Figure 3. 2QFY07 Cost Breakup (Rupees in Million, percent)

Year to 31 March	2QFY06	2QFY07	Change YoY	1QFY07	Change QoQ	CIR Comments
Net Sales	6,717	8,961	33.4	8,636	3.8	
Consumption of Raw Materials	2,911	4,106	41.1	3,865	6.2	Adverse product mix led to rise in RM/Sales ratio
% of Net sales	*43.3*	*45.8*	*249 bps*	*45*	*106 bps*	
Staff Cost	303	439	44.5	513	(14.5)	Higher wage bill due to salary hike as well as increase in head count
% of Net sales	*4.5*	*4.9*	*38 bps*	*6*	*-105 bps*	
Other Expenses	1,730	2,140	23.7	1,969	8.7	
% of Net sales	*25.8*	*23.9*	*-187 bps*	*23*	*109 bps*	
Total Expenditure	4,944	6,685	35.2	6,347	5.3	
% of Net sales	*73.6*	*74.6*	*99 bps*	*73*	*110 bps*	

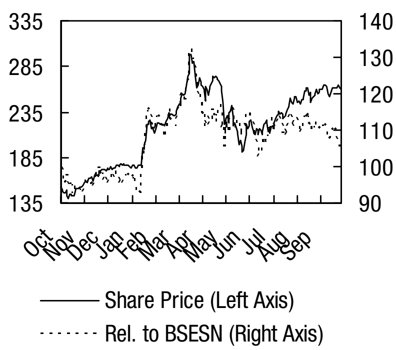
Source: Company Reports and Citigroup Investment Research

Figure 4. 2QFY07 Sales Breakup (Rupees in Million, percent)

Year to 31 March	2QFY06	2QFY07	Change YoY	1QFY07	Change QoQ	CIR Comments
Domestic	**3,636**	**4,444**	**22.2**	**4,729**	**(6.0)**	Led by all round growth across anti-asthmatics, anti-aids, cardiovascular and anti-biotic / bacterials segments
% of Net sales	*52.2*	*48.6*	*-362 bps*	*53.3*	*-476 bps*	
Exports	**3,206**	**4,397**	**37.2**	**3,938**	**11.7**	Led by growth in anti-retrovirals, anti-asthmatics, anti-depressants and cardiovascular segments
% of Net sales	*46.0*	*48.0*	*204 bps*	*44.4*	*364 bps*	
Formulations	2,480	2,800	12.9	3,187	(12.1)	
APIs	725	1,597	120.2	752	112.5	We believe this includes supplies for some exclusivity sales for partners in the US market
Other operating income	127	311	146.1	202	53.9	
% of Net sales	*1.8*	*3.4*	*159 bps*	*2.3*	*112 bps*	
Sales	6,968	9,153	31.4	8,869	3.2	

Source: Company Reports and Citigroup Investment Research

Figure 5. Price Performance



Source: Data Central

Figure 6. Stock performance

(%)	3M	6M	12M
Absolute	22.6	(3.0)	70.3
Rel. to .BSESN	(3.6)	(9.3)	6.7

Source: Data Central

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 Rs170. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, the risks posed to the business from the current global consolidation could have an impact on the company's future growth prospects. 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. Even if Cipla does not lose too much business, we believe that pricing could come under pressure as the bargaining power in the market shifts towards the customers. We think Cipla's business model lacks significant value addition, both in terms of innovative research as well as forward integrating into 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 in the US and European markets has not been waning, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players.

Valuation

Cipla is a steadily growing company and therefore we use P/E as the base valuation tool for the company. Our target price of Rs170 is based on 18x June '07E 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). There are few signs of this changing. Our target multiple for Cipla is therefore at a 10% discount to the multiple we use for its peers such as Ranbaxy, Dr Reddy's and Wockhardt. Besides, we believe Cipla could trade at 14-16x EV/EBITDA. Using 15x June 07E EV/EBITDA, which is at a significant premium to the Sensex but in line with some of the second-line pharmaceutical companies, we get a value of about Rs191/share.

Risks

We rate Cipla 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 risks to our Sell 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.

Analyst Certification Appendix A-1

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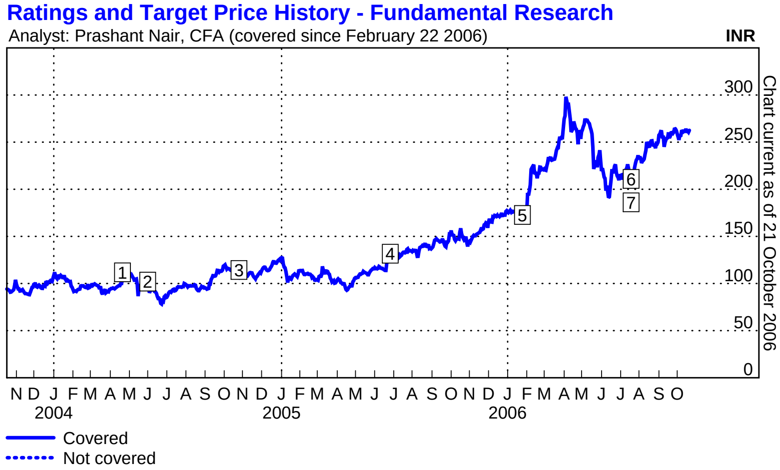
Cipla (CIPL.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	21 Apr 04	3L	*88.00	104.81
2:	1 Jun 04	3L	88.00	95.58
3:	26 Oct 04	3L	*96.00	106.92
4:	27 Jun 05	3L	*116.00	124.12
5:	25 Jan 06	3L	*65.60	174.06
6:	19 Jul 06	3L	*170.00	212.45
7:	19 Jul 06	3L	170.00	212.45

*Indicates change.

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