Cipla Limited

Hold — Target Price: Rs 282

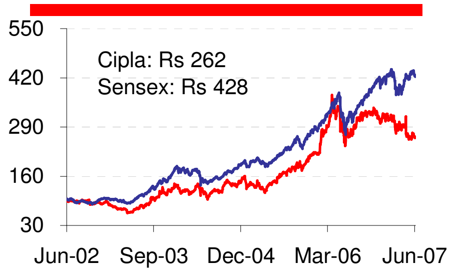
By this recommendation of HOLD, what we mean is that existing shareholders would be better off holding onto the stock from a FY10 perspective. However, if an investor would like to BUY this stock, then the upside from the current levels is about 35% point to point (over 11% on a compounded annual basis). Investors could take the investment decision based on this premise.

Market data

Current price	Rs 209 (BSE)
Market cap	Rs 162,435 m
Face value (Rs)	2.0
FY07 Div/share	Rs 3.0
NSE symbol	CIPLA
No of shares	777.2 m
Free float	60.6%
52 week H/L	Rs 275 / 194

Share price chart

Rs 100 invested is worth



Shareholding

Category	(%)
Promoters	39.4
Banks, MFs and FIs	11.4
FIIs	16.8
Indian public	25.3
Others	7.1
Total	100.0

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Investment Rationale

- **Low-risk global strategy:** Cipla's strategy for its generics business is to enter into bulk drug supply arrangements with companies well entrenched in the generic markets. These arrangements are typically to supply specialty bulk drugs. Cipla has entered into partnerships for 125 products with 8 companies in the US and a strategic alliance to develop over 50 generic products for the generics major Teva/Ivax. The company also has alliances with other US generics companies - Watson, Eon, Morton Grove, Pentech Pharma, Paddock, Akorn and Metpoint for a range of products. Besides this, the company has filed over 170 registrations in Europe, primarily for marketing formulations in the continent. The company thus, intends to enter specialty segments with a low-risk return approach ensuring relatively stable earnings flow.

- **Exports to drive growth:** Cipla is driving growth through increasing exports (over 170 countries worldwide) with the same having grown at a CAGR of 38% in last 6 years (till FY07). The contribution of exports to the topline has gone up to 50% in FY07 from 25% in FY01. Apart from developing markets, Cipla is also focusing on regulated markets for growth, wherein it supplies bulk drugs to global generic companies with whom it has tied up. Keeping in mind the huge generics potential in the coming couple of years and consequently, an increase in product approvals of its generic partners, we expect export revenues from the bulk drugs segment to grow at a CAGR of 30% between FY07 and FY10. The company's initiatives to tie up with new customers are also expected to drive the growth of bulk drug exports. In addition, Cipla's formulation exports grew by 26% YoY in FY07 and are expected to grow at a CAGR of 22% over the next three years. Formulations in anti-hypertensives, anti-AIDS, anti-asthma and anti-ulcerants therapeutic segments will be the growth drivers. Overall, we expect exports to grow at a CAGR of 24% between FY07 and FY10 to form 56% of revenues by FY10.

- **Anti-asthma and anti-HIV focus to augur well:** Cipla enjoys a near dominant position in the asthma segment (about 20% of sales). It is one of the few companies globally having the required technology to manufacture CFC-free inhalers. With CFC (Chlorofluorocarbons) inhalers to be compulsorily phased out by 2010, this segment is expected to see growth in the future. Cipla is targeting to market its CFC free inhalers in Europe, which is the biggest market for inhaler drugs. It has received approvals for 'Budesonide' inhalers from Germany and Portugal.

Besides this, 9 more additional inhaler products are at various stages of regulatory submission. The total market size for asthma inhalers in Europe has been estimated at US$ 2.5 bn.

Cipla also has a strong presence in the anti-retroviral segment and is one of the key suppliers to the Clinton Foundation HIV/AIDS Initiative (CHAI) and the US President's Emergency Plan for AIDS Relief (PEPFAR). The United Nations has estimated that 36.1 m people worldwide have already been infected with HIV, with thousands being infected each day, indicating the growing threat of the disease. Out of these, only 6.5 m actually require treatment, of which only 1.3 m are being currently treated, indicating that there is scope to increase the treatment going forward. Another point to be noted is that around 95% of those having HIV are from the developing nations especially Africa.

Market share in ARV segment

Company	Market share (%)
Cipla	51
Aurobindo	21
Hetero	14
Emcure	5
Strides	5
Ranbaxy	4

Source: Cipla

Among the purchases made by the WHO and CHAI, around 69% are from Indian generic players namely, Cipla, Ranbaxy, Hetero, Aurobindo, Strides and Emcure. Among these, Cipla enjoys the highest market share at 51%. Thus, this segment is also expected to drive Cipla's growth going forward. Having said that, presence in the anti-retroviral segment will be more of a volume play, as the prices of these drugs will be much lower keeping in mind that they have to be affordable.

- **Domestic growth driver – High-end therapeutic segments:** While Cipla's focus areas on the domestic side remains the same as exports, the company has a track record of launching new products faster than any other of its competitor in the high value therapeutic segments. This gives Cipla a first mover advantage. It has also tied up with Avestha Gengraine Technologies, a Bangalore-based biotech company, to scale up its biotechnology folio in the long run. Domestic revenues grew by 17% in FY07 and we expect a 15% CAGR in the domestic formulations segment over the next three years.

Comparative Valuations

(FY07/CY06)	Cipla	Ranbaxy	Dr.Reddy's
Valuation metrics			
Current price (Rs)	209	374	633
Price to earnings (x)	21.1	27.3	11.0
Price to book value (x)	5.5	5.4	3.6
Price to sales (x)	3.9	2.3	1.7
Performance metrics			
EBIDTA margin (%)	20.0	14.2	25.4
Net margin (%)	19.4	8.3	14.8
Sales/GFA (x)	2.1	1.2	2.7
Return on equity (%)	26.9	19.7	32.8
Return on assets (%)	17.3	6.0	13.7

Investment Concerns

- **Research strategy unclear:** Cipla has filed a patent for NCE in the area of antihistamines and is working on new drug delivery systems (NDDS). In basic research, Cipla is working on the anti-asthmatic and anthelmintics (de-wormer) therapeutic segments. However, the company has refrained from disclosing the progress (clinical stage) of these molecules and it would be futile to judge its success in research at this stage. Also, the company significantly lags behind its peers Dr.Reddy's, Ranbaxy, Biocon and Glenmark in terms of a future R&D pipeline. While the effect of the same will not be felt in the medium term, its R&D lag will hurt the company considerably in the long-term.

- **Domestic dependence:** Competition in the domestic market is likely to become fierce in the coming years, as MNC's that have a presence in India launch their patented products in light of the new patent regime. This means that Cipla, which is among the top three companies in the domestic market in terms of market share, may witness a slowdown in product launches in the long-term. Besides this, the company also faces stiff competition from its domestic peers such as Ranbaxy, Nicholas Piramal and Sun Pharma in the domestic market.

- **NPPA blues:** The National Pharmaceutical Pricing Authority (NPPA) issued notice to the company for the recovery of over Rs 1.8 bn in arrears, which represented 50% of the amount allegedly overcharged in respect of some drugs till July 2003. This is in view of the fact that the Supreme Court had set aside the Mumbai High Court judgment, which had excluded certain drugs from the DPCO cover. Cipla has, subsequently, in April 2007, received demand notices for the entire 100% of the aforesaid amount along with interest aggregating to Rs 7.5 bn. This liability, if it materialises, could put pressure on the cash flows of the company going forward.

Background

Cipla is the third largest pharma company in the domestic retail market (ORG survey) and has presence in formulations and bulk drugs manufacturing. All the bulk drug manufacturing facilities of the company have been approved by the US FDA and the formulation facilities have been approved by the Medicine Control Agency (UK), the Medicine Control Council (South Africa), the Therapeutic Goods Administration (Australia) and other international agencies. On the exports front, the company has strategic alliance with major generic manufacturers such as Watson, Mylan, Barr and Ivax for supply of bulk drugs. It has a very wide product range in the domestic market, which includes antibiotics, anti-bacterial, anti-asthmatics, anti-inflammatory, antiretroviral, anti-cancer and cardiovascular. The company also concentrates on developing specialty bulk drugs for export markets.

Industry Prospects

The global pharma market grew by 7% in 2006 to reach US$ 643 bn (Source: IMS). The North American market grew by 8% constituting 48% of the global sales in 2006. Growth was fuelled by additional healthcare benefits, increased utilisation of generics within new therapy classes and launch of new drugs targeted at specific diseases, namely cancer and diabetes. The size of the Indian pharmaceutical market in CY06 was Rs 249 bn and grew by 13% YoY (Source: Pfizer annual report). While MNC pharma companies grew at 9%, their domestic counterparts registered a much stronger growth of 14% YoY. Growth was led by both the acute and the chronic therapy segments and an increasing demand for medicines from the rural and semi-urban population. As per the Pfizer annual report, the India pharma market is expected to grow at a CAGR of 13.6% for the period 2006-2010, driven by chronic (cardiovascular, diabetes etc.) and niche specialty (oncology etc.) segments. The product patent came into force in India with effect from January 1, 2005, which will result in the introduction of patented drugs into the country and possibly, higher growth rates for the MNC pharma companies in the long term.

Risk Matrix

	High Risk	Medium Risk	Low Risk
Rating	(1 to 3)	(4 to 6)	(7 to 10)
Sector	High	Medium	Low
Sales (US$ m)	< 500	501 - 1,000	> 1,000
Current Ratio (x)	< 1	1 – 2	> 2
Debt to Equity Ratio (x)	> 1	0.5 - 1	< 0.5
Long term EPS growth (%)	< 10	10 - 20	> 20
Dividend Payout (%)	< 15	15 - 25	> 25
Promoter holding (%)	< 25	25 - 40	> 40
FII Holding (%)	> 25	10 - 25	< 10
Liquidity (Nos. '000)	< 100	100 - 200	> 200
Margin of Safety (%)	< 3	3 - 6	> 6
Final Rating	**< 30**	**30 - 60**	**> 60**

Sector: While the fundamental factors driving the generics industry continue to remain strong, the same is bogged down by intense competition and severe price erosion. In comparison, contract manufacturing, wherein companies are partnering with global generic majors to capitalise on the generics opportunity in the future has proven to be a relatively stable business model. That said, the revenue potential depends on the generic partners' success in garnering ANDA approvals. Based on this, we have assigned a medium risk rating of 4 to the sector.

Sales: Cipla generated average revenues to the tune of Rs 24 bn (US$ 539 m) in the last five years. We believe that companies, as they grow larger in size, are better equipped to face market pressure and competition than their smaller peers. Based on our parameters, we assign a medium risk rating of 4 to the stock.

Current ratio: Cipla's average current ratio during the period FY03 to FY07 has been 2.3 times, indicating the company's ability to pay up short-term obligations. A ratio under 1 suggests that the company is unable, at that point, to pay off its obligations, if they came due. We assign a low-risk rating of 8 to the stock.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Considering Cipla's debt to equity ratio of 0.1, we have assigned a low-risk rating of 10 to the stock.

Long term EPS growth: We expect Cipla's net profit to grow by around 18% CAGR during the period FY07-FY10 (growth of 26% during FY01-FY06). Based on a normal scenario, we consider a compounded growth of over 20% in net profits in the last 5 years as healthy for a company. As such, the rating assigned to the stock on this factor is 8.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. Cipla's average payout ratio was around 29% in the last five years, which is healthy. We have assigned a low risk rating of 7.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of March 2007, the promoter holding in Cipla stood at over 39%, which is reasonably healthy. We have, thus, assigned a medium risk rating of 6 to the stock.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. FII holding in the company currently stands at just over 16%, which is within the limits of our comfort. Therefore, we assign a medium risk rating of 5 to the stock.

Liquidity: The past five-year average daily volume of the stock is in the range of 524,000 shares, which is on the higher side and is healthy. The rating assigned is 10.

Margin of safety: This is to determine the value of the stock relative to its price and the returns over a risk free rate. Margin of safety of a stock lies in its earning power, which is calculated as - EPS divided by Market price (reciprocal of P/E). Considering Cipla's P/E of 24.6 times its trailing 12-months earnings, the earning power is 4.1%. This is much lower when compared with the risk-free interest rate of 8.1% (10-year G-Sec yield). Thus, the rating assigned is 1.

Considering the above parameters, the total ranking assigned to the company is 63. This makes the stock a low-risk investment from a long-term perspective.

Valuations

We had recommended a 'Sell' on Cipla in September 2006 at Rs 257. The stock since then has fallen by around 18%. At that point, stretched valuations were the basic premise for our call. Having said that, while we have had to downgrade our numbers for FY07, we are positive about the company's growth prospects going forward. Thus, after the steep decline in the stock price, we believe that the valuations at the current level look reasonable.

We continue to remain enthused about the company's low risk strategy of partnering with global generic players to not only capitalise on the generics potential in the coming years but also to ensure a stable revenue stream. While the company will continue to outperform the growth in the domestic pharma market, exports will still play a larger role in bolstering Cipla's performance going forward.

At the current price of Rs 209, the stock is trading at a price to earnings multiple of 14.8 times our estimated FY10 earnings. We thus recommend a HOLD* on the stock with a target price of Rs 282 from a FY10 perspective.

Valuation Table

(Rs m)	FY07UA	FY08E	FY09E	FY10E
Revenue (Rs m)	34,381	41,970	50,041	58,922
PAT (Rs m)	6,676	7,704	9,462	10,977
EPS (Rs)	8.6	9.9	12.2	14.1
Price to earnings (x)	24.3	21.1	17.2	14.8
Price to sales (x)	4.7	3.9	3.2	2.8
Price to BV (x)	6.5	5.5	4.6	3.8

BV= Book Value

Financials at a Glance

(Rs m)	FY07UA	FY08E	FY09E	FY10E
Sales	34,381	41,970	50,041	58,922
Sales growth (%)	*18.7%*	*22.1%*	*19.2%*	*17.7%*
Operating profit	6,886	8,520	10,709	12,609
Operating profit margin (%)	*20.0%*	*20.3%*	*21.4%*	*21.4%*
Net profit	6,676	7,704	9,462	10,977
Net profit margin (%)	*19.4%*	*18.4%*	*18.9%*	*18.6%*
Balance Sheet				
Current assets	26,232	31,427	38,752	47,773
Fixed assets	12,025	13,830	14,976	15,761
Investments	224	224	224	224
Total Assets	**38,482**	**45,482**	**53,952**	**63,758**
Current liabilities	11,346	13,850	16,514	19,444
Net worth	24,833	29,409	35,296	42,251
Loan funds	1,323	1,243	1,163	1,083
Other Liabilities	980	980	980	980
Total liabilities	**38,482**	**45,482**	**53,952**	**63,758**

Sector Statistics

Sales (Rs m)		Market cap. (Rs m)		EBITDA margin (%)		Net profit margin (%)		Return on NW (%)	
Dr.Reddy's	64,346	Sun Pharma	203,070	Sun Pharma	31.9	Sun Pharma	36.3	Dr.Reddy's	32.8
Ranbaxy	61,325	Cipla	162,435	Dr.Reddy's	25.7	Cipla	19.8	Cipla	26.9
Cipla	34,381	Ranbaxy	139,278	Cipla	23.0	Dr.Reddy's	15.0	Sun Pharma	21.9
Sun Pharma	21,321	Dr.Reddy's	106,197	Ranbaxy	14.2	Ranbaxy	8.3	Ranbaxy	19.7

Based on FY07/CY06 numbers

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Disclosure: The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.