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Glaxo SmithKline Pharma

Market Performer | **Rs 1,123** | **September 26, 2007**

New Products to Drive Growth...

We recently conducted a CEO Conference with Dr. Hasit Joshipura, Vice President-South Asia and Managing Director-India and Mr. Mehernosh Kapadia, Senior Executive Director of Glaxo SmithKline Pharmaceuticals (GSK) to discuss the future prospects of the company.

Key Figures

Y/e Dec	CY06	CY07E	CY08E	CY09E
Revenues (Rs m)	15,530	16,360	17,161	19,003
EBITDA (Rs m)	4,760	5,271	5,658	6,436
Margins (%)	*30.7*	*32.2*	*33.0*	*33.9*
PAT (Rs m)	5,456	6,196	4,714	5,384
EPS (Rs)	42.7	50.4	55.9	63.8
PER (x)	26.3	22.3	20.1	17.6
EV / E (x)	16.6	14.3	12.9	11.3
EV / Sales (x)	6.1	5.8	5.5	5.0
RoCE (%)	*52.8*	*47.7*	*44.0*	*44.4*
RoE (%)	*50.9*	*44.9*	*28.4*	*28.7*

The discussion started with a brief presentation on GSK followed by a question and answer session. Key Highlights of the presentation were:

- The company focuses on 35 Power Brands for organic growth and for in-licensing opportunities and brand acquisitions for inorganic growth. GSK has a strong portfolio of vaccines to be launched over next 2-3 years. The company has plans to launch the patented molecules of the parent company in India.

Category wise growth rate

(Rs m)

Y/e Dec	CY05	yoy gr. (%)	CY06	yoy gr. (%)
Priority Focus	3,930	*16.0*	4,500	*15.0*
Priority Others	4,200	*5.0*	4,650	*11.0*
Price Controlled	4,050	*1.0*	4,450	*10.0*
Vaccines	1,210	*15.0*	1,100	*(9.0)*
Total	**13,390**	*7.0*	**14,700**	*10.0*

As seen from the table, GSK sales grew by 10% in CY06. The Priority Focus and Priority Other segments contributed 31% and 32% respectively to the total revenues and grew by 15% and 11% respectively. The price-controlled products contributed 30% (GR 10%) and the vaccines contributed 7% (GR –9%) to the total revenues. De-growth in vaccines in CY06 was attributed to the supply issues at the parent company's end. GSK expects the price –controlled products to come down -- from 30% to 20% over the next 5 years.

(Stock price as on September 25, 2007)

Category wise sales in H1CY07 *(Rs m)*

Y/e Dec	H1 CY07	H1 CY06	*yoy gr. (%)*
Priority Focus	26,050	23,660	*10.1*
Priority Others	24,010	23,030	*4.3*
Price Controlled	23,910	23,670	*1.0*
Vaccines	4,660	4,820	*(3.3)*
Iodex	2,970	2,560	*16.0*
Total	**81,600**	**77,740**	*5.0*

For H1CY07, the overall sales growth was 5%. The priority focus brands have grown by 10% against the market growth rate of around 12%. The price-controlled products grew marginally by 1%. The decline in the growth rate of vaccines is attributed to the supply issues, as vaccines are imported from the parent company.

- GSK is looking for in-licensing opportunities as it has strong sales, marketing and distribution set up in the domestic market. The company has access to over 100,000 doctors and all major retailers in India.

Details of various products introduced by GSK under in-licensing

COMPANY	PRODUCT	INDICATIONS
Farchim	Cetzine	Anti-allergic
Farchim	Levocetirizine	Anti-allergic
Fujisawa	Cefizox	Antibiotic
Teva	Alpha D3	Vitamin D3
Ferronine	Albion	Novel chelated iron
Novartis	Terbenafine	Antifungal
Organon	Contraceptives	Oral contraceptives
Eisai	Parit	Antiulcerant

All the in-incensing deals are endorsed and supported by the parent company.

- The parent company has a rich pipeline of vaccine products and plans to introduce the same through GSK in the domestic market during 2008-2010. These are as follows: Rotarix –rotavirus (Q2CY08), Cervarix-cervical cancer and Infanrix Hexa-infant mortality (both in 2008) and Synflorix-pneumonia (2010). With the introduction of these vaccines, GSK is likely to become a dominant player in the vaccines segment. Currently, there are no equivalent products in the domestic market and these will be the first of its kind.
- GSK has plans to launch the following new products in the domestic market in 2008-2009. These are: Tykerb –anticancer (2008), in-licensed CV drug (H1CY08), Allermist-allergic rhinitis and in-licensed critical care drug (both in 2009). These products are in the specialised segments and are unlikely to face major competition.
- The company receives good support from GSK, UK and conducts clinical trials for the parent company in India for 8-10% of global patient population. The revenue from this business is around Rs 300m in CY07.
- GSK has a country specific model and offers products across all therapeutic segments and at all price points. The company intends to grow at or ahead of market growth (12-14%) for the priority products. GSK intends to maintain the margin at the current levels. The operating margin for H1CY06 was 32.7% was one of the highest in the industry.
- GSK divested its fine chemicals business to Thermo Electron India Private Limited in H1CY07 and will receive Rs 2.4bn from its sales. This division had sales of Rs 970m and margin of 22%.

Questionnaire

Question: How do you foresee the growth rate for the domestic pharma market and for GSK products?

Response: The domestic pharma market is likely to grow at 12-14% and the growth rate is sustainable over the next few years. GSK expects its priority focus brands to grow by around 15%, priority other products by 10% and flat growth for the price –controlled products. The company expects a double-digit growth in the coming years arising from the new products introduction, in-licensing opportunities and existing products. Skincare and CVS are the high growth areas for the company.

Question: Can you share the therapeutic category wise sales composition for GSK?

Response: GSK has a healthy and well-diversified product portfolio. The same has been shown in the following chart:

GSK derives 20% of its revenues from anti-infective segment and 15% from vitamins and nutrients. Majority of the products in these two segments are in the price control. The company is the market leader in the dermatology segment and derives 12% of its revenues from this segment.

Question: GSK has good operating margins. Going further, how do you foresee the margins?

Response: GSK's current margins are healthy. The company hopes to retain these margins in future. The new products will have better margins than the existing products but the company will have to spend on the advertisement and promotion on the new products.

Question: Can you elaborate the supply issue of vaccines?

Response: Vaccine manufacturing is a complex business and globally GSK has very few manufacturing facilities. The spurt in the global demand for flu vaccine led to the shortage of other vaccines in CY06 and hence GSK's vaccine sales declined by 9% in CY06. The supply problem has eased out in CY07. With the GSK's two new vaccine manufacturing facilities coming up at Germany and US in CY08, the supply constraint is likely to ease out.

Question: In your opinion, what are the major growth drivers for the domestic pharma industry?

Response: The major growth driver will be the increase in healthcare expenditure-- from 0.9% to 2% of GDP. The increase in the health insurance due to the opening up of insurance sector, increase in life expectancy and the demand for the quality healthcare are the other growth drivers. The increase in the private hospitals is also likely to drive the future growth of the company.

Question: Is there a possibility for the parent company to source from India in a major way?

Response: GSK currently manufactures and supplies Betamethasone API to the parent company. However, this is not a major revenue earner for the company. Currently, there are no plans to export formulations to the parent company.

Question: Can you throw some light on the recent developments on DPCO front?

Response: There is a proposal to increase the number of price-controlled drugs from 74 to 354 under DPCO. The Group of Ministers (GoM) headed by Mr. Sharad Pawar met on 12th Septmber'07 and had a joint meeting with the industry associations and their representatives. The GoM is likely to forward their finding to the concerned ministry and the same will be placed in Lok Sabha for discussion. This is a time consuming exercise. In the worst-case scenario, the price controlled products for GSK may go up --from 30% to 50% resulting in a sharp decline in sales and profitability.

Question: GSK scores better than other local companies in case of in-licensing opportunities. Can you elaborate on the same?

Response: GSK has a very good track record in the domestic pharma market. The company has a strong presence in dermatology. GSK has a well trained and large field force and an efficient distribution network. The company is close to finalising two in-licensing deals (of which one is patentable). The company is likely to maintain the margins at the current level despite higher ASP expenditure.

Question: Can you throw some light on the new products introduction in India? Will it be through the listed company or through 100% subsidiary?

Response: All new products will be introduced through the listed company. The 100% subsidiary is involved in the manufacture of vaccines at Nashik and has a Horlicks manufacturing facility at Sonepat.

Question: How do you foresee the effect of Novartis' Gleevac case on the other patented products?

Response: The Gleevac case of Novartis is relevant to the products, which have incremental innovation. GSK's parented products will be first in the class and there is no incremental innovation involved. The vaccines and in-licensing products are not based on incremental innovation and hence are not likely to face problems in their approval.

Question: Can you elaborate on the prospects of parent company's pipeline of products in India?

Response: GSK parent company has a product in thrombolytic segment, which is currently undergoing Phase III clinical trials. The commercialisation of this product can become a big opportunity for the company, as there is no competing product in this category currently.

Question: Can you throw some light on the pricing strategy for the new products?

Response: The company's pricing strategy for the new products will be dependent on the therapeutic area. GSK, UK has a country specific pricing policy.

Question: How much of the sales will be contributed by patented products in future?

Response: The patented products will not be more than 9-10% of the overall revenues by 2010. GSK will have to make additional investment in promoting these products in the domestic market.

Question: The parent company is outsourcing clinical trail work from India. What are the future prospects of this business?

Response: GSK carries out clinical trials in India for the parent company, covering 8-10% of the global patient population. This business is likely to generate revenues of Rs 300m in FY08 and the charges are on cost+ basis. However, the margin of this business is lower than the overall company margin.

Question: GSK has substantial cash in its books. What are the plans to deploy this cash?

Response: The company has currently substantial cash in its books and will receive Rs 2.4bn from the sale of fine chemicals division in H2CY07. GSK is looking at brand acquisition in the domestic market. Alternatively, it will distribute cash to the shareholders or may go for a buy back of shares. However, the parent company has no plans to de-list the company.

Question: Can you throw some light on the capex plan for the next two years?

Response: GSK has adequate manufacturing facility and has no plans for immediate expansion. The company is likely to incur normal capex of Rs 200-250m per annum on routine capex and balancing equipments.

Financials

We have re-worked our financials based on the recent sale of fine chemicals business for Rs 2.4bn. We expect GSK to report 7% CAGR in net sales over next 3 years. The lower sales growth in CY07 and CY08 is attributed to the divestment of animal healthcare (AHC) business in CY06 and the sale of fine chemicals business in CY07.

We expect the operating margin to improve from 30.7% in CY06 to 32.2% in CY07 and further improve to 33.0% in CY08. The margin expansion is likely to come from the divestment of the above-mentioned businesses. We expect the operating margin to improve further to 33.9% in CY09, as the company will have only pharma business.

We expect GSK's net profit (before EO) items to grow by 14% CAGR over next 3 years due to the improvement in the operating margins.

We have revised our estimates downwards by 3% and 6% for CY07 and CY08 respectively in view of the divestment of fine chemicals business. Our revised EPS estimates for CY07 and CY08 are Rs 50.4 and Rs 55.9 respectively (against our earlier estimates of Rs 52.0 and Rs 59.7).

GSK occupies the leading position in the domestic pharma market. However, it is likely to have lower sales growth in CY07 and CY08 due to the divestment of its AHC and Fine chemicals businesses. The sales growth is likely to pick up from CY09 onwards due to the in-licensing opportunities and the introduction of new products. The company's net profit is likely to grow by 14% CAGR over next three years.

At the CMP of Rs 1,123, the stock trades at 22.3x CY07 and 20.1x CY08 earnings respectively. We have revised our rating from **OUTPERFOREMER** to **MARKET PERFORMER** for the scrip due to lower growth.

Income Statement *(Rs m)*

Y/e Dec	CY06	CY07E	CY08E	CY09E
Net Sales	**15,530**	**16,360**	**17,161**	**19,003**
Operating Expenses	10,770	11,089	11,503	12,567
(Inc) / Dec in stock	(125)	(30)	(37)	(58)
Material Cost	6,371	6,590	6,860	7,580
(% of sales)	*40.2*	*40.1*	*39.8*	*39.6*
Staff Cost	1,537	1,641	1,675	1,816
(% of sales)	*9.9*	*10.0*	*9.8*	*9.6*
Other Mfg. Exp.	1,037	1,015	1,058	1,142
(% of sales)	*6.7*	*6.2*	*6.2*	*6.0*
Selling & Admin Exps	1,951	1,873	1,947	2,087
(% of sales)	*12.6*	*11.4*	*11.3*	*11.0*
Operating Profit	**4,760**	**5,271**	**5,658**	**6,436**
Operating Margin (%)	*30.7*	*32.2*	*33.0*	*33.9*
Other Income	958	1,395	1,741	1,974
EBIDTA	**5,719**	**6,666**	**7,399**	**8,410**
EBIDTA Margin (%)	*36.8*	*40.7*	*43.1*	*44.3*
Depreciation	159	161	179	190
EBIT	**5,560**	**6,505**	**7,220**	**8,221**
EBIT Margin (%)	*35.8*	*39.8*	*42.1*	*43.3*
Interest	-	-	-	-
Profit Before Tax	**5,560**	**6,505**	**7,220**	**8,221**
Tax Provision	1,942	2,239	2,482	2,817
Eff. Tax Rate (%)	*34.9*	*34.4*	*34.4*	*34.3*
PAT before EO	**3,618**	**4,266**	**4,739**	**5,404**
Extraordinary Items	1,838	1,930	(25)	(20)
Net Profit	**5,456**	**6,196**	**4,714**	**5,384**

Balance Sheet *(Rs m)*

Y/e Dec	CY06	CY07E	CY08E	CY09E
SOURCES OF FUNDS :				
Equity Share Capital	847	847	847	847
Reserves & Surplus	11,101	14,810	16,738	19,136
Networth	11,948	15,657	17,585	19,983
Avg Networth	10,717	13,803	16,621	18,784
Total Debt	55	60	65	70
Avg Debt	52	58	63	68
Deferred Tax Liability	(246)	(301)	(361)	(426)
Capital Employed	**11,757**	**15,416**	**17,289**	**19,627**
APPLICATION OF FUNDS :				
Gross Block	2,536	2,736	2,986	3,248
Avg Gross Block	2,534	2,636	2,861	3,117
Less: Accum. Depreciation	1,678	1,839	2,018	2,207
Net Block	858	897	968	1,041
Capital Work in Progress	87	80	90	95
Investments	11,394	14,988	16,683	19,125
Current Assets, Loans & Adv.	5,077	4,785	5,551	5,792
Inventories	2,410	2,315	2,850	2,940
Sundry Debtors	604	680	785	850
Cash and Bank Balance	350	388	431	444
Other current assets	270	250	265	280
Loans and Advances	1,442	1,152	1,220	1,278
Less: Current Liab. & Prov.	5,659	5,333	6,004	6,426
Current Liabilities	2,477	2,596	2,953	3,161
Provisions	3,182	2,737	3,051	3,266
Net Current Assets	(582)	(549)	(453)	(634)
Capital Deployed	**11,757**	**15,416**	**17,289**	**19,626**