Company Report

Pharmaceuticals

February 17, 2006
ICICIdirect Code: SUVPHA

Suven Life Sciences

HOLD

Current Price Rs 153

Suven Life Sciences, a pioneer in Contract Research and Manufacturing Services (CRAMS), has successfully leveraged its R&D expertise and relationships with top MNC pharmaceutical firms by venturing into drug discovery and development support (DDDSS) and collaborative research partner (CRP) services. It also has its own drug discovery research program and is expected to file an IND (Investigational New Drug) for its lead molecule in the therapeutic area of central nervous system (CNS) in Q1FY08. We initiate coverage on the company with HOLD rating.

KEY TRIGGERS

- **Steady growth in base businesses**

  Suven's main businesses are CRAMS, DDDSS and clinical research. We expect these businesses to grow at a CAGR of 22% over FY06-08E to Rs 133.89 crore. The CRAMS model will continue to be the mainstay of the company. The company will leverage its business relationships with global life science majors. It is also forging new alliances with other players in the life sciences industry across the globe.

- **Big break expected from out-licensing of lead molecules**

  The company's focused R&D is in the therapeutic area of central nervous system (CNS). It has developed tremendous in-house R&D competencies and has in-house drug discovery research pipeline of 30 molecules. It is likely to file an investigational new drug (IND) application for its lead candidate for Alzheimer's disease in Q1FY08, which would trigger clinical trials. The company can be in for windfall gains if the molecule shows encouraging results in the clinical trials.

- **Robust clinical research order book**

  The company is sitting on an order book position of Rs 14 crore from CRO services. It expects to realize Rs 5 crore in FY07E, Rs 8 crore in FY08E and rest in FY09E. We expect further traction in the business going forward as the company leverages its competencies and infrastructure.

VALUATIONS

We expect that the company would report an EPS of Rs 4.01 in FY07E and Rs 5.34 in FY08E from its base businesses. However, in FY08E we expect significant gain in the form of a milestone payment from out-licensing deal for its lead molecule for Alzheimer's. We believe the company would be able to strike a deal between US$50-250 million. On the basis of the few out-licensing deals in the Indian pharma industry, we have simulated various deal sizes and the pay-offs. On a minimum deal size of US$50 million, the estimated EPS would flare up by around 54% to Rs 8.23. At the upper end of the deal size, the EPS would spike by 555% to Rs 35. The FY08E P/E would be in the range of 4.43x to 18.83x depending on the actual deal size.

Exhibit 1: Key Financials

(Rs Crore)

Year to March 31	FY05	FY06	FY07E	FY08E
Net Profit (Rs crore)	2.44	6.38	10.04	13.36
Shares in issue (in crore)	2.50	2.50	2.50	2.50
EPS (Rs)	0.98	2.55	4.01	5.34
% Growth	-53.90	161.64	57.30	33.12
P/E (x)	158.91	60.74	38.61	29.01
Price / Book (x)	4.77	4.30	3.97	3.57
EV/EBIDTA (x)	47.69	38.10	24.40	17.96
RoE (%)	3.00%	7.07%	10.25%	12.30%
RoCE (%)	6.01%	6.73%	9.48%	11.36%

Company Profile

Registered Office

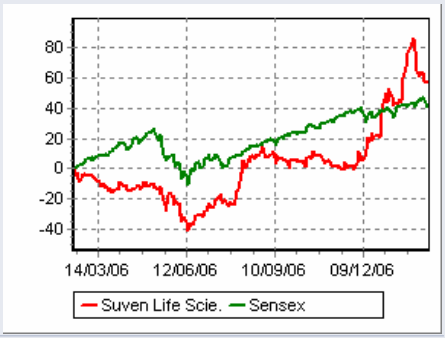
SDE Serene Chambers, Road No. 7, Banjara Hills, Hyderabad, Andhra Pradesh - 500034
Telephone No. 23541142, 23543311
Website: www.suven.com

Vice Chairman & CEO: **Venkateswarlu Jasti**
Business Group: **NA**

Shareholding Pattern as on 31/12/2006	
Major Holders	**%**
Promoters	61.7
Institutional Investors	18.67
Other Investors	9.47
General Public	10.16

Stock Data	
Market Cap (Rs crore)	432.14
Shares Outstanding (in crore)	2.5
52-week High (Rs)	183
52-week Low (Rs)	55
Avg. Volume	38052
Absolute Return 3 mth (%)	56.38
Absolute Return 12 mth (%)	52.96
Sensex Return 3 mth (%)	3.73
Sensex Return 12 mth (%)	38.53

Performance Chart



Raghvendra Kumar
raghvendra.kumar@icicidirect.com

ICICI Brokerage Services Limited,
2nd Floor, Stanrose House,
Appasaheb Marathe Road,
Prabhadevi, Mumbai - 400 025

COMPANY BACKGROUND

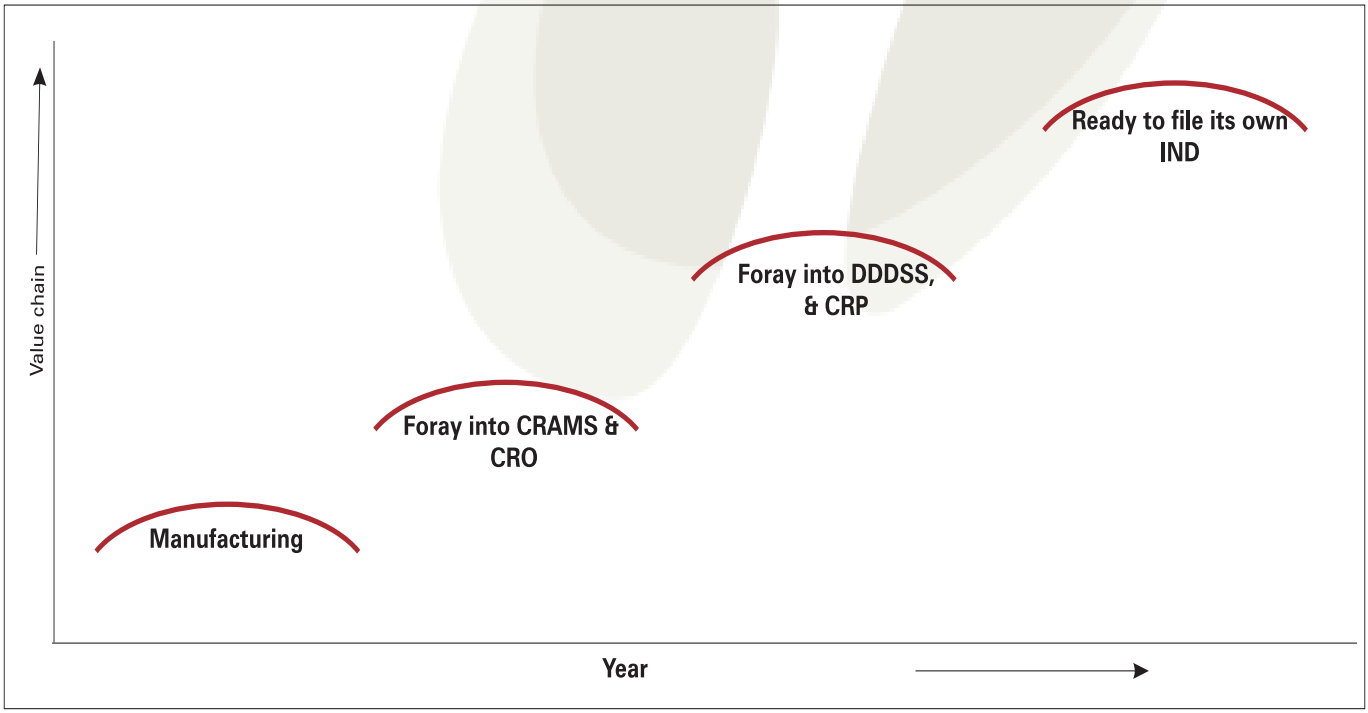
The company was incorporated in March 1989 as a private limited company. It was promoted by Mrs Sudha Rani Jasti and Mr Venkateswarlu Jasti. Mr Jasti is a pharmacist by training who migrated to the US in 1974 and returned to Hyderabad in 1988 after selling off the chain of six pharmacy stores in New Jersey. In March 1995, the company came out with a public issue to part-finance the company's project for the manufacture of bulk drugs and drug intermediates and meet long-term working capital requirements.

The company manufactures bulk drugs and drug intermediates — theophylline, caffeine, nitroso compound, cyanoacetic acid, etc. SPL has a sizeable export turnover through the export of drug intermediates to Germany, Switzerland, Israel, Europe, etc.

Suven has become a favourite R&D house for the world's leading Pharma companies like Abbott (US), Borregarrd (US/Norway), Du Pont (US), Hoechst (Germany), Kodak (US), Degussa (Germany), Fermion (Finland), Sochinaz (Switzerland), Imation/3M (US) and many others.

Suven's innovative research for intermediates of new chemical entities (new drugs) has focussed on theurepatic category like anti-cholesterol, anti-depressant, anti-AIDS, anti-hypertension, anti-convulsant and medical imaging.

Exhibit 2: Suven's business model



Source: Company

INVESTMENT RATIONAL

(I) Core businesses in fine fettle

Suven's main businesses are CRAMS, DDDSS and clinical research. We expect these businesses to grow at a CAGR of 22% over FY06-08E to Rs 133.89. The CRAMS model will continue to be the mainstay of the company. The company will leverage its business relationships with global life science majors. It is also forging new alliances with other players in the life sciences industry across the globe.

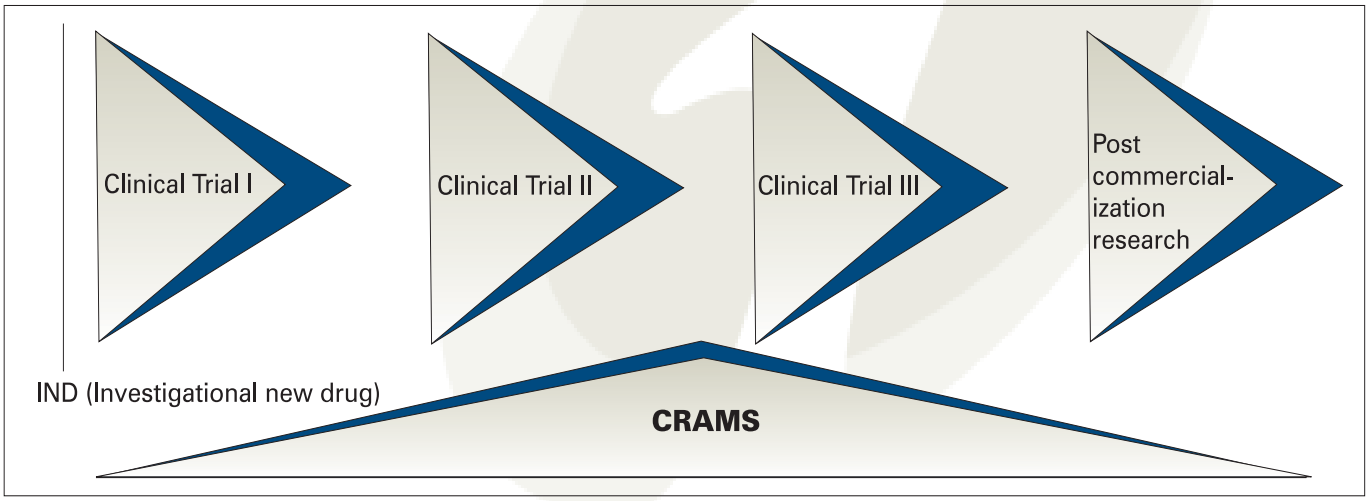
The company forayed into DDDSS in January 2005, coinciding with IP protection. Going forward, this segment of business is expected to become the key driver for the company's growth. Suven was amongst the first Indian companies to adopt this model and hopes to extract the first mover advantage. The company's clinical research, under which it provides services to global pharma MNCs like Eli Lilly, Pfizer, etc is also thriving.

CRAMS business to provide stability

The CRAMS business is expected to grow at a CAGR of over 19% over FY06-08E to Rs 112.69 crore. Under CRAMS, Suven works with the innovator company when the underlying molecule is in the clinical trial stages. Its customers include 18 global life sciences companies. It has executed over 300 CRAMS projects till date.

Currently, it is working on 52 molecules. Out of these, 26 molecules are undergoing phase I clinical trials, 21 are in phase II and 5 are in phase III. Contracts for phase I projects offer the highest margins in the range of 40 to 45%. Margins decline as the phase advances. After the molecule is commercialized, margins dip to 10 to 15%.

Exhibit 3: CRAMS model



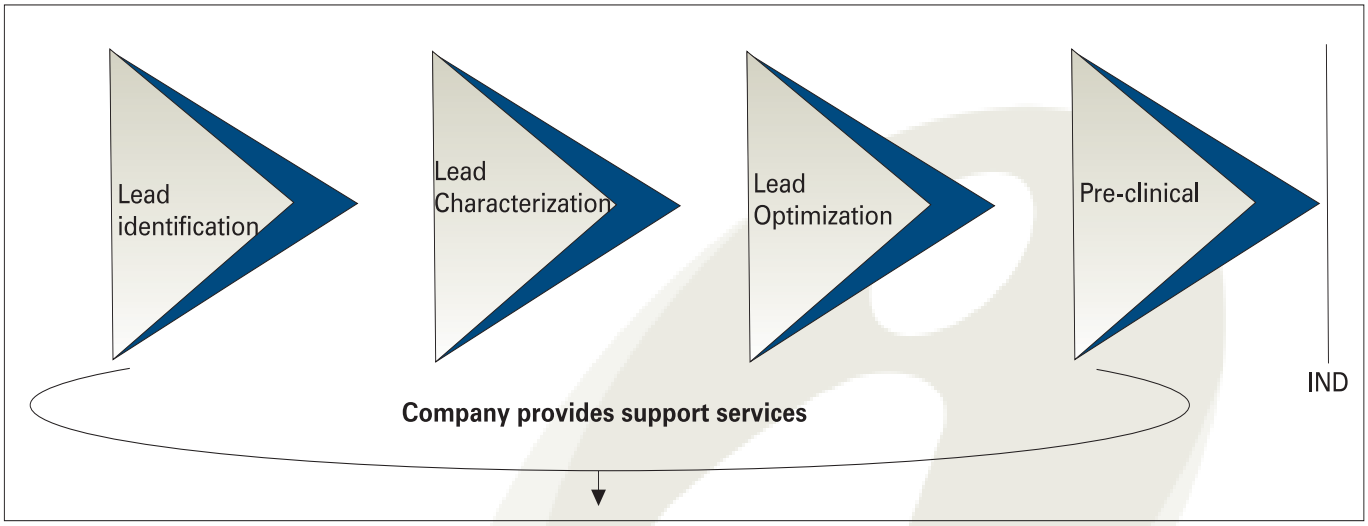
Source: Company, ICICIdirect Research

DDDSS business set to take-off

Suven's DDDSS business is still in the nascent stages and in FY06 generated Rs 4.56 crore, about 5% of total revenue. Here, Suven provides services to the innovator company when the molecule is in pre-clinical stage. Over FY06-087E, revenues from this business are likely to grow at a CAGR of 48% to Rs 10.03 crore. Going forward, we expected this business to contribute around 25% of total revenue.

We believe this segment will be the key driver for growth in the years to come. The company has invested in people, infrastructure, software and business processes in this area. The company plans to leverage the cost-effective India-based delivery model and evolve into a global clinical research enterprise.

Exhibit 4: DDSSS model

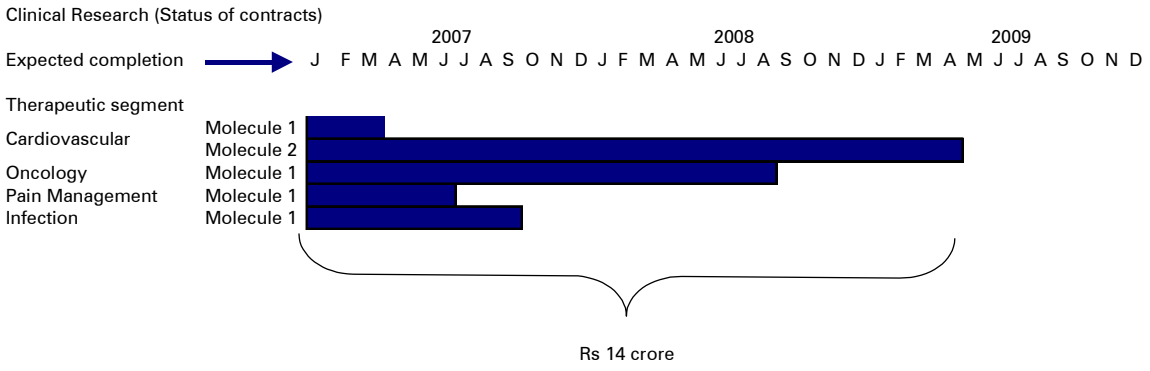


Source: Company, ICICIdirect Research

Thriving clinical research business

Currently, Suven has five live clinical research contracts to be executed in the period of two years. In FY07E, the company is likely to realize Rs 5 crore while in FY08E, revenue from the CRO services is likely to be in the range of Rs 8 crore. Under the CRO business, the company provides clinical research services to MNCs including Eli Lilly, Pfizer, etc. The profile of the different clinical research projects is shown in the exhibit below.

Exhibit 5: Strong order-book under clinical research



Source: Company, ICICIdirect Research

(II) CRP – a high-value new business segment

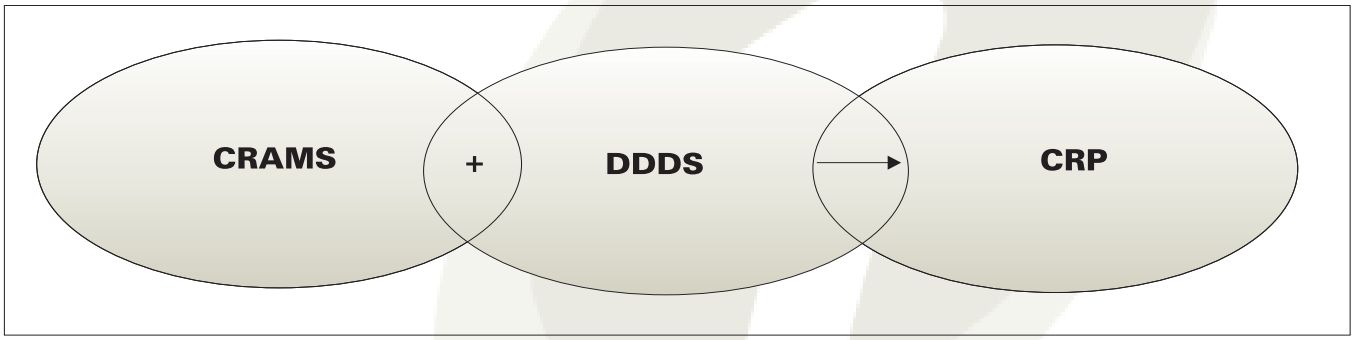
Suven's vision is to emerge as a leading player by providing the full spectrum of services in drug discovery, development, manufacturing and support services in collaboration with leading global life science players.

Under the collaborative research program (CRP), Suven works with innovator companies to develop drugs up to a certain level, after which the partner would take up the product for further development. During the development phases, it will receive milestones payments at different levels of development. When the partner company takes up the molecule for further investigation, two more revenue streams will open up for Suven. When the partner starts clinical research, Suven will get the CRAMS business and also CRO contracts. On successful commercialization of the molecule, it will get a royalty for marketing the product. Suven is the first Indian company to get into such collaborative research program.

The company has entered into an agreement with Eli Lilly to develop three drugs under central nervous system (CNS) within three years starting August 2006. While the maiden CRP project is likely to be revenue neutral, the company expects margin to improve going forward.

Currently, the company it has the capability to work on only two CRP projects. It is setting up a green-field research facility at cost of US$10 million. The project will be financed through an US$8 million loan from SBI and US$2 million from internal accruals. Once the facility is operational, the company would be able to handle up to 4 projects at a time.

Exhibit 6: Blend of old and new revenue sources



Source: Company, ICICIdirect Research

(III) Bonanza expected from out-licensing of lead molecule

Suven's focused R&D is in the therapeutic area of central nervous system (CNS). The company's research in this therapeutic area spans into various disease categories like Alzheimer's, Parkinson's, Dementia, Cognition, Bipolar disorder, etc. It is likely to file an IND application for its lead candidate for Alzheimer's disease in Q1FY08. Filing for the IND would trigger clinical trials on the molecule. The company can has kept the option open that it may out-license clinical trial process at any stage.

In the pharmaceutical industry, on an average out of 1,000 lead molecules from the research table, 350 enters phase I clinical trials. Further, only 60 enter phase II (A). The number is whittled down to 30 in phase II (B) trials and just 3 in clinical trial III. This way, only 1 or 2 molecules are commercialized. Hence as the molecule progress through clinical trials, the deal size increases. In case the molecule fails at any stage, then all the expenses incurred would be a sunk cost.

Globally, for CNS molecules, the deal size has been in the range of US$10 million to 100 million in the pre-clinical stage, with a success rate of 5%. When the molecule goes to phase II (A) clinical trials (proof of concept phase), the deal size increases to US$150 million to US$400 million.

Suven plans to do the initial trials on its own and it may out-license the molecule at a later stage in order to maximize the deal size and curtail its risk and expense. Looking at the past few out-licensing deals, we feel that the company would be able to strike a deal between US$50 to 200 million.

The company is also likely to come up with a 2nd IND filing in about 10-12 months from its own discovery research pipeline of 30 molecules.

RISKS & CONCERNS

❑ The company is focusing its R&D activities in the therapeutic area of CNS. However, global pharma MNCs already possess many of the lead molecules in this segment. This may impact the payoffs in the event of an out-licensing deal.

❑ The company is involved in both discovery research in CNS segment and at the same time engaged in CRPs with pharma majors in the same space. This might distract the company from spotting new business opportunities. To look after the risk the company is diversifying into other therapeutic segment in CRP by putting up two R&D facilities.

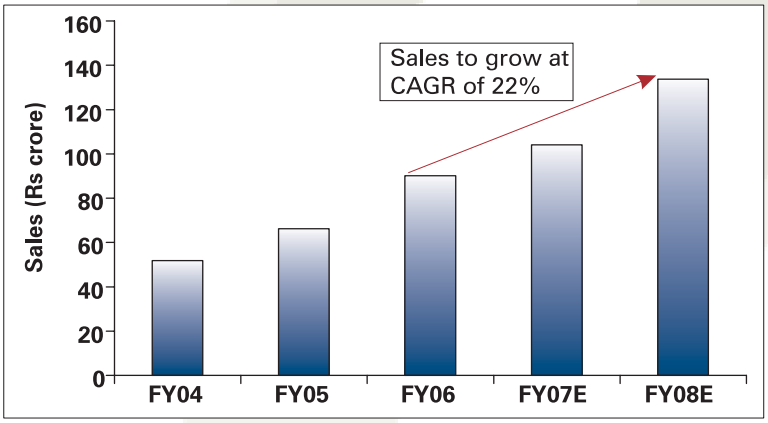
❑ We have not factored in any pay-off from out-licensing deals in our earnings estimate. The stock is overvalued on the base business. Our entire valuation depends upon the pay-off from the out-licensing deal. Also, it is very difficult to speculate on the deal size. It totally depends on the probability of commercialization of the molecule, and at the stage at which it is being out-licensed.

FINANCIALS

Core business to grow at comfortable pace

Consolidated revenues are likely to grow at a CAGR 22% over FY06-08E to Rs 133.89 crore on the back of higher contribution from new businesses and traction in CRAMS projects. Revenues from DDDSS and clinical research are likely grow at a CAGR of around 48% over FY06-08E to Rs 10.03 crore, while the CRAMS business is likely to grow at a CAGR of 18% to Rs 112.69 crore.

Exhibit 7: Steady growth in sales

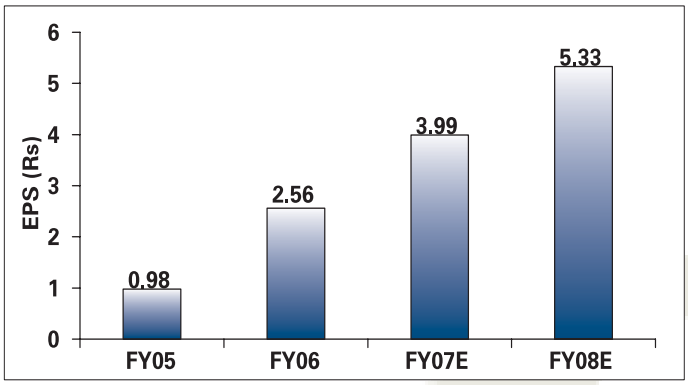


Source: Company, ICICI direct Research

Margins to expand

New businesses and increase in number of CRAMS projects are likely to expand EBIDTA margins by 697 bps over FY06-08E to 19.67%. Net margins, however, are expected to rise at a slower pace to 9.95% from 7.02%, a rise of 292 basis points, due to higher interest and depreciation charges.

Exhibit 09: Higher traction in margins

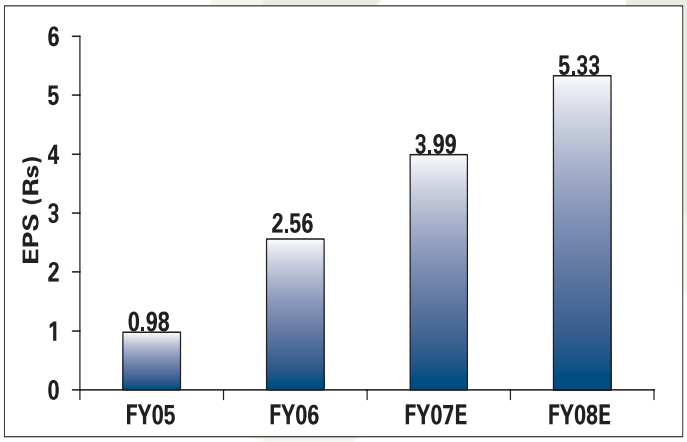


Source: Company, ICICI Direct Research

Healthy EPS growth

EPS is likely to grow at a healthy rate of 44.52% to Rs 5.34 (face value Rs 2) on account of a 697 bps operating margin expansion and 22% growth in sales revenue.

Exhibit 10: EPS to grow at steady clip



Source: Company, ICICI Direct Research

VALUATIONS

We expect that the company to report an EPS of Rs 4.01 in FY07E and Rs 5.34 in FY08E from its core businesses of CRAMS, DDDSS and CRO. However, in FY08E we expect a significant gain in the form of a milestone payment (we have not considered any inflow from the deal in our earnings model) on signing of out-licensing deal for its Alzheimer's disease lead molecule.

Looking at the few out-licensing deals that have taken place, we believe that the company would be able to strike a deal between US$50 – 250 million. In November 2006, Glenmark out-licensed its molecule GRC8200 where it will receive a success-related milestone payment totaling euros 190 million (including euros 25 million up-front).

We have simulated various deal sizes and their respective payoffs. Assuming the up-front payment of 5% of the deal size, the estimated EPS of the company for FY08 would flare up by around 54% to Rs 8.23 at the minimum deal size of US$50mn. At the upper end of the deal size, the EPS would spike by 555% to Rs 35. Hence the FY08E PE would be in the range of 4.43 to 18.83 depending on the actual deal size.

Exhibit 11: Incremental EPS growth following the expected deal

Out-licensing Deal size	$0mn	$50mn	$100mn	$150mn	$250mn	$350mn	$400mn
EPS '08 (Assuming of 5% of deal size)	5.34	8.23	12.05	15.88	23.53	31.18	35.00
Incremental EPS		2.89	3.83	3.83	7.65	7.65	3.83
PE	29.01	18.83	12.86	9.76	6.59	4.97	4.43
EV to EBIDTA	17.96	12.94	9.76	7.83	5.61	4.38	3.94

Source: ICICI Direct Research

We have simulated different deal size ranging from US$50mn to US$400mn in dollar terms that may accrue to the company on account of out-licensing of the molecule and the payoff there from. We have assumed that 5% of the deal size would accrue to the company up front while the rest would come in as it moves ahead in the clinical trials. In clinical phase I trial 10% would accrue to the company while 15% would accrue in phase II (A), 20% in phase II (B) and the rest would accrue to it in phase III trials and on commercialization. We have discounted the pay offs at the cost of capital (9.68%) to find out the present value of the cash flows from the out-licensing of the molecule.

Exhibit 12: Implied valuation of NCE business

(Rs Crore)

Market cap	387.5
Value of CRAMS (20x FY08E EPS)	267.19
Implied valuation of NCE business	120.31

Source: ICICI Direct Research

Exhibit 13: Upside resulting in different scenarios

Deal size (US$, million)	Present value(Rs crore)	Upside (Rs crore)	Upside (Rs/share)
50	136.64	16.33	6.53
100	273.28	152.97	61.19
150	409.92	289.61	115.84
250	683.20	562.89	225.15
350	956.48	836.17	334.47
400	1093.12	972.81	389.12

Source: ICICI Direct Research

FINANCIAL SUMMARY (Consolidated)

Profit and Loss Account

(Rs Crore)

(Year-end March 31)	FY05	FY06	FY07E	FY08E
Gross Sales	66.24	90.11	104.12	133.89
% Growth	28.00%	36.04%	15.54%	28.59%
Op Profit	8.54	10.79	17.29	24.85
% Growth	-5.43%	26.35%	60.25%	43.75%
Other Income	1.55	0.81	0.99	0.32
Depreciation	3.23	3.46	5.06	5.35
EBIT	6.86	8.14	13.22	19.83
Interest	0.82	1.65	2.29	5.27
Profit before Tax	6.04	6.49	10.94	14.56
% Growth	0.34%	7.48%	68.54%	33.36%
Taxation	3.60	0.11	0.90	1.20
Tax as % of PBT	59.62	1.69	8.25	8.25
Net Profit	2.44	6.38	10.04	13.36
% Change YoY	-54%	162%	57%	33%
Shares O/S	2.50	2.50	2.50	2.50
EPS (Rs)	0.98	2.55	4.01	5.34
CEPS (Rs)	2.27	3.94	6.04	7.48
DPS	1	1	1	1

Balance Sheet

(Rs Crore)

(Year-end March 31)	FY05	FY06	FY07E	FY08E
Cash	2.54	1.31	6.98	18.09
Trade Receivables	18.62	14.99	20.82	26.78
Loans & Advances	10.63	14.34	14.35	14.35
Inventory- Other	19.31	22.74	31.44	39.64
Investments	7.09	4.09	0.00	0.00
Net Block	74.13	82.79	91.73	106.39
Capital Work-in-progress	3.31	2.67	0.00	0.00
Total Asset	114.21	121.00	139.22	174.55
Current Liabilities & Provisions	21.51	21.99	26.10	30.69
Secured Loans	19.80	23.65	34.35	58.82
Unsecured Loans	0.00	0.00	0.00	0.00
Deffered Tax Liability	13.23	7.15	7.15	7.15
Equity Share Capital	5.00	5.00	5.00	5.00
Reserves & Surplus	76.18	85.20	92.72	103.58
Total	114.21	121.00	139.22	174.55

Cash Flow Statement

(Rs Crore)

(Year-end March 31)	FY05	FY06	FY07E	FY08E
Profit after Tax	2.44	6.38	10.02	13.36
Misc exp w/o	0.03	0.02	0.06	0.00
Dividend Paid	-2.50	-2.50	-2.50	-2.50
Depn	3.23	3.46	5.06	5.35
Provision for deffered tax	3.07	-6.08	0.00	0.00
Cash Flow before WC Changes	6.26	1.28	12.64	16.21
Net Increase in Current Liabilities	5.08	0.48	4.11	4.58
Net Increase in Current Assets	15.68	3.51	14.55	14.15
Cash Flow after WC Changes	-4.34	-1.74	2.20	6.64
Purchase of Fixed Assets	12.19	11.48	11.33	20.00
(Increase) / Decrease in Investment	-8.21	-3.00	-4.09	0.00
Increase / (Decrease) in Loan Funds	-0.78	3.85	10.70	24.47
Inrease / (Decrease) in Equity Capital	-0.44	5.14	0.00	0.00
Op bal Cash & Cash equivalents	12.08	2.54	1.31	6.98
Closing Cash/ Cash Equivalent	2.54	1.31	6.98	18.09

Ratios

(Year-end March 31)	Mar ' 05	Mar ' 06	Mar ' 07E	Mar '08E
EPS (Rs)	0.98	2.55	4.01	5.34
Cash EPS (Rs)	2.27	3.94	6.03	7.48
Book Value (Rs)	32.47	36.08	39.09	43.43
Operating Profit Per Share (Rs)	3.42	4.32	7.18	9.94
Operating Margin (%)	13.76	12.69	18.26	19.67
Gross Profit Margin (%)	13.99	11.04	15.34	14.87
Net Profit Margin (%)	3.60	7.02	9.59	9.95
RONW (%)	3.00	7.07	10.25	12.30
ROCE (%)	6.01	6.73	9.48	11.36
Debt Equity (x)	0.24	0.26	0.35	0.54
Fixed Assets Turnover Ratio (x)	0.89	1.09	1.13	1.26
Enterprise Value	407.30	411.15	421.85	446.32
EV/Sales (x)	6.40	4.67	4.13	3.38
EV/EBIDTA (x)	47.69	38.10	23.51	17.96
Sales to Equity (x)	13.25	18.02	20.82	26.78
Market Cap	387.50	387.50	387.50	387.50
Market Cap to sales (x)	5.85	4.30	3.72	2.89

RATING RATIONALE

ICICIdirect endeavours to provide objective opinions and ecommendations. ICICIdirect assigns ratings to its stocks according to their notional target price vs current market price and then categorises them as Outperformer, Performer, Hold, and Underperformer. The performance horizon is 2 years unless specified and the notional target price is defined as the analysts' valuation for a stock.

Outperformer: 20% or more;
Performer: Between 10% and 20%;
Hold: ±10% return;
Underperformer: -10% or more.

Harendra Kumar **Head - Research and Content** harendra.kumar@icicidirect.com

ICICIdirect Research Desk
ICICI Brokerage Services Limited,
2nd Floor, Stanrose House,
Appasaheb Marathe Road,
Prabhadevi, Mumbai - 400 025
research@icicidirect.com

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