Company Focus

28 January 2008 | 7 pages

Dishman Pharmaceuticals & Chemicals (DISH.BO)

Buy: Soft 3Q but Outlook Remains Robust

- **3Q below expectations** — Dishman reported 3Q FY08 numbers with revenue up 18% YoY while margins declined 939bps to 20% due to losses at subsidiaries. As a result, recurring net income (excluding MTM gains on foreign currency debt) declined 12% to Rs216m. However, we continue to be positive on Dishman and believe that 3Q FY08 was a blip due to some one-off expenses.

- **Why are 3Q margins low?** — We highlight some one-offs in 3Q that dragged margins: 1) Some sales were postponed to Q4 FY08. We note this is not unusual in contract manufacturing. 2) Losses at Dishman's subsidiaries in Japan, the Netherlands and the Middle East – all of which are businesses in the nascent stage. Management expects these to be reversed in Q4. 3) Higher staff costs due to consolidation of the vitamins business and incentive payouts at Carbogen.

- **Strong pricing power** — Management indicated that it had taken c5% price increase in 3Q for some of its key products to mitigate some of the losses due to the appreciating INR. This is after having taken significant price increases for its quats in 2Q FY08. We note that the price increases will come with a lag. However, this indicates that Dishman has pricing power with its customers and is resilient to currency pressures over the longer term.

- **Maintain Buy (1M)** — with a TP of Rs372, as we continue to believe that Dishman is most leveraged to the exciting innovator CRAMS opportunity.

Buy/Medium Risk	**1M**
Price (25 Jan 08)	Rs326.95
Target price	Rs372.00
Expected share price return	13.8%
Expected dividend yield	0.5%
Expected total return	**14.3%**
Market Cap	Rs25,722M US$654M

Price Performance (RIC: DISH.BO, BB: DISH IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	522	6.46	57.2	50.6	12.0	31.3	0.2
2007A	928	11.47	77.7	28.5	7.5	36.8	0.3
2008E	1,168	14.44	25.9	22.6	5.1	28.9	0.4
2009E	1,585	19.59	35.7	16.7	3.8	26.5	0.5
2010E	1,815	22.44	14.5	14.6	3.0	23.1	0.5

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	50.6	28.5	22.6	16.7	14.6
EV/EBITDA adjusted (x)	42.2	25.5	15.4	12.0	9.7
P/BV (x)	12.0	7.5	5.1	3.8	3.0
Dividend yield (%)	0.2	0.3	0.4	0.5	0.5
Per Share Data (Rs)					
EPS adjusted	6.46	11.47	14.44	19.59	22.44
EPS reported	6.46	11.34	14.44	19.59	22.44
BVPS	27.30	43.42	63.95	86.92	107.26
DPS	0.70	1.00	1.21	1.57	1.79
Profit & Loss (RsM)					
Net sales	2,774	5,786	8,325	10,360	12,433
Operating expenses	-2,248	-4,896	-6,772	-8,336	-9,917
EBIT	**526**	**889**	**1,552**	**2,024**	**2,516**
Net interest expense	-102	-189	-372	-380	-288
Non-operating/exceptionals	135	260	68	51	51
Pre-tax profit	**559**	**960**	**1,248**	**1,695**	**2,279**
Tax	-31	-32	-75	-102	-456
Extraord./Min.Int./Pref.div.	-5	-11	-5	-8	-8
Reported net income	**522**	**917**	**1,168**	**1,585**	**1,815**
Adjusted earnings	522	928	1,168	1,585	1,815
Adjusted EBITDA	647	1,153	2,004	2,516	3,036
Growth Rates (%)					
Sales	48.8	108.5	43.9	24.5	20.0
EBIT adjusted	24.9	69.0	74.5	30.4	24.3
EBITDA adjusted	28.3	78.2	73.9	25.6	20.7
EPS adjusted	57.2	77.7	25.9	35.7	14.5
Cash Flow (RsM)					
Operating cash flow	**166**	**461**	**895**	**1,270**	**1,597**
Depreciation/amortization	121	263	452	492	520
Net working capital	-456	-835	-1,233	-1,360	-1,221
Investing cash flow	**-817**	**-4,176**	**-1,099**	**-765**	**-673**
Capital expenditure	-832	-1,010	-750	-400	-400
Acquisitions/disposals	0	-3,150	0	0	0
Financing cash flow	**1,923**	**2,752**	**1,101**	**-1,148**	**-1,470**
Borrowings	2,064	2,777	513	-1,671	-1,300
Dividends paid	-34	-55	-109	-148	-170
Change in cash	**1,272**	**-962**	**896**	**-643**	**-545**
Balance Sheet (RsM)					
Total assets	**5,944**	**11,594**	**14,796**	**15,895**	**17,261**
Cash & cash equivalent	1,352	355	1,252	609	63
Accounts receivable	863	1,252	2,664	3,315	3,979
Net fixed assets	2,124	6,030	6,328	6,236	6,116
Total liabilities	**4,070**	**8,425**	**9,866**	**8,850**	**8,563**
Accounts payable	473	656	1,457	1,865	2,300
Total Debt	3,255	5,609	6,123	4,452	3,152
Shareholders' funds	**1,874**	**3,169**	**4,929**	**7,045**	**8,698**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	23.3	19.9	24.1	24.3	24.4
ROE adjusted	31.3	36.8	28.9	26.5	23.1
ROIC adjusted	15.1	13.8	15.8	17.8	16.9
Net debt to equity	101.5	165.8	98.8	54.6	35.5
Total debt to capital	63.5	63.9	55.4	38.7	26.6

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Soft 3Q but Outlook remains Robust

Dishman reported 3Q FY08 numbers with revenue up 18% YoY while margins declined 939bps to 20% due to losses at subsidiaries and high staff costs. As a result, recurring net income (excluding MTM gains on foreign currency debt) declined 12% to Rs216m. We continue to be positive on Dishman and believe that 3Q FY08 was a blip due to some one-off expenses. Dishman remains most leveraged to the exciting innovator CRAMS opportunity, and we believe Dishman's business model is resilient to a strong INR environment.

Figure 1. 3Q FY08 Earnings Summary (Rs in million, percent)

	3Q FY07	3Q FY08	YoY ch (%)	2Q FY08	QoQ Ch (%)	CIR Comments
Sales	1,736	2,066	19.0	1,866	10.7	Muted growth partly due to shifting of orders in 4Q and due to the currency; Management indicated that they have managed to take price increases; however price increases happen with a lag
Other Operating Income	34	21	(39.0)	56	(62.8)	DEPB benefits, recoveries
Net revenues	**1,771**	**2,087**	**17.9**	**1,922**	**8.6**	
RM Costs	696	771	10.7	663	16.2	Gross margins improve due to higher price realizations
as a % of Revenues	39.3	36.9	-238 bps	34.5	243 bps	
Staff Cost	185	547	195.5	462	18.5	Higher Staff costs due to the consolidation effect of Vitamin business and bonus payouts at Subsidiaries
as a % of Revenues	10.5	26.2	1,577 bps	24.0	220 bps	
Other Expenses	367	349	(4.9)	335	4.0	Losses at subsidiaries in Japan, Netherlands and middle east lead to sharp increase
as a % of Revenues	20.7	16.7	-400 bps	17.4	-73 bps	
Total Expenditure	1,248	1,667	33.6	1,461	14.1	
EBITDA	**522**	**419**	**(19.7)**	**461**	**(9.1)**	EBITDA growth muted
EBIDTA Margins (%)	*29.5*	*20.1*	*-939 bps*	*24.0*	*-390 bps*	Margins decline despite gross margin improvement due to one off expenses
Interest	72	77	6.8	72	7.1	
Depreciation	156	104	(33.2)	111	(6.1)	
PBT	294	239	(19.0)	279	(14.4)	
Tax	50	22	(56.2)	32	(31.8)	Overall guidance of effective tax rate at 5% for FY09
Tax Rate	*17.1*	*9.2*	*-785 bps*	*11.6*	*-235 bps*	
PAT	244	217	(11.3)	246	(12.2)	
Minority Interest	(0)	1	(608.7)	(0)	(417.2)	
Net Income	**244**	**216**	**(11.7)**	**247**	**(12.6)**	
MTM gains	na	104	nm	35	199.0	
Reported Net Income	244	320	30.9	282	13.6	

Source: Citi Investment Research

Dishman Pharmaceuticals & Chemicals

Company Description

Dishman commenced operations in 1989 as a Quats manufacturer and has since transformed itself to focus on intermediates/ API manufacturing – with a specific focus on innovator CRAMS. Dishman ventured into CRAMS with a contract to manufacture eprosartan mesylate for Solvay for the European market. Since then, Dishman has entered into contracts with various other pharma companies including GSK, AstraZeneca and Nippon Gosai. In 2006, Dishman acquired Carbogen Amcis from Solutia. With this, Dishman has the complete CRAMS basket for innovator pharma companies from building blocks to the commercialization stage.

Investment strategy

We have a Buy/Medium Risk rating on Dishman. We believe that Dishman is the Indian pharma company most leveraged to the innovator CRAMS opportunity – especially post the acquisition of Carbogen Amcis – with c78% of its revenues coming from this segment. Over the past two years, Dishman has grown in scale as well as diversified its customer and revenue bases. With synergies from the Carbogen Amcis acquisition expected to play out over the next 1-2 years and with rapid growth in its Indian business, we expect Dishman to report a 25% CAGR in earnings over FY07-10E.

Valuation

Given that Pharma is a growth sector, we use P/E as our primary method to value the base business of every company. At the same time, since many pharma companies have some unique opportunities that could play out, we ascribe a separate value for these. For Dishman, we use a target P/E multiple of 19x, which is at a 5% discount to our target multiple for Nicholas Piramal, which is the leader in the innovator CRAMS segment, in our view. We believe that a 5% discount is justified given Dishman's relatively smaller size as well as the smaller pipeline but higher exposure to CRAMS.

In its limited trading history of less than 3 years, Dishman has traded in a band of 13-26x 1-year forward earnings. Our target multiple of 19x is within this band and in line with the median/average multiple of 19x. Using a 19x multiple on FY09 FDEPS, we arrive at a target price of Rs372/share.

Risks

Regulatory risks - Delays in the execution of various contracts due to delays in regulatory approvals or any adverse outcome at the customer end could impact Dishman's revenues and profitability, especially given that Dishman has to build the facilities upfront. Generally, the time lag between entering into a contract and commencement of revenues is around 2-3 years.

Lumpy business - CRAMS revenues tend to be lumpy across quarters and hence the quarterly performance of the company might be volatile.

These risks could impede the stock from achieving our price target.

Appendix A-1

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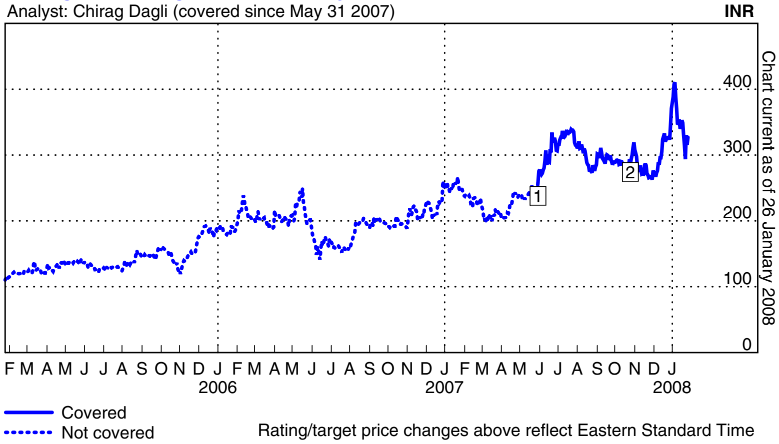

#	Date	Rating	Target Price	Closing Price
1:	30 May 07	1M	313.00	258.00
2:	25 Oct 07	1M	*372.00	287.00

*Indicates change.

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