

## Company Focus

17 January 2008 | 8 pages

# Biocon (BION.BO)

 Target price change   
 Estimate change 

## Sell: Another Disappointing Quarter

- Poor 3Q** — with loss of momentum in revenues, sharp erosion in margins and lower PAT despite higher other income. While the stock appears to gain favor with investors from time to time on the back of potential listing of its research services biz and upside on R&D, the core business remains vulnerable. We reduce our EPS estimates for FY08-10 by 3-1% and maintain Sell (3L).
- Revenue momentum hit** — Biocon's revenues declined 4% YoY in 3Q, primarily due to the sale of its enzymes business. However, continuing business growth was also tepid at 2%. Research services degrew 24% YoY; while this is due to a quarterly skew in licensing fees, it puts the high growth in 1H in the right context. Biopharma continued to disappoint growing 11% YoY & declining 13% QoQ, as it felt the pinch of a rising rupee and the lack of product launches.
- Margins under pressure** — EBIDTA margins declined 665bps despite the sale of the low margin enzymes business, hit by rupee appreciation and increase in fixed costs. Although gross margins improved by 303bps YoY (on lower outsourcing), it declined by 291bps QoQ due to rupee appreciation.
- Key conference call takeaways** — a) Syngene to be listed in India in FY09; b) oral BNP project on hold – write-off of Rs220m taken; c) potential launch of oral insulin in India in 2010; d) strategic tie-up to invest cUS\$10m in IATRICA as part of a co-development deal.
- Limited sustainable upside** — While there are potential catalysts over the long term, we do not see any respite on the problems related to its core business in the near term. Maintain Sell (3L) with a slightly lower target price of Rs501.

<b>Sell/Low Risk</b>	<b>3L</b>
Price (17 Jan 08)	Rs540.60
Target price	Rs501.00
	<i>from Rs505.00</i>
Expected share price return	-7.3%
Expected dividend yield	0.6%
<b>Expected total return</b>	<b>-6.7%</b>
Market Cap	Rs54,060M
	US\$1,380M

### Price Performance (RIC: BION.BO, BB: BIOS IN)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	1,778	17.78	-9.7	30.4	6.1	21.8	0.5
2007A	2,003	20.03	12.6	27.0	5.1	20.5	0.6
2008E	2,181	21.81	8.9	24.8	3.6	17.0	0.6
2009E	2,945	29.45	35.0	18.4	3.1	18.1	0.8
2010E	3,643	36.43	23.7	14.8	2.6	19.0	1.0

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	30.4	27.0	24.8	18.4	14.8
EV/EBITDA adjusted (x)	23.1	19.4	18.4	13.6	11.2
P/BV (x)	6.1	5.1	3.6	3.1	2.6
Dividend yield (%)	0.5	0.6	0.6	0.8	1.0
<b>Per Share Data (Rs)</b>					
EPS adjusted	17.78	20.03	21.81	29.45	36.43
EPS reported	17.78	20.03	46.51	31.03	38.00
BVPS	88.81	106.86	149.67	175.70	207.53
DPS	2.50	3.00	3.27	4.42	5.46
<b>Profit &amp; Loss (RsM)</b>					
Net sales	7,919	9,857	10,654	13,159	15,194
Operating expenses	-5,889	-7,688	-8,647	-10,256	-11,632
<b>EBIT</b>	<b>2,030</b>	<b>2,169</b>	<b>2,007</b>	<b>2,904</b>	<b>3,563</b>
Net interest expense	-18	-98	-104	-83	-35
Non-operating/exceptionals	51	38	371	391	445
<b>Pre-tax profit</b>	<b>2,064</b>	<b>2,110</b>	<b>2,274</b>	<b>3,212</b>	<b>3,973</b>
Tax	-306	-169	-136	-193	-238
Extraord./Min.Int./Pref.div.	20	62	2,513	83	66
<b>Reported net income</b>	<b>1,778</b>	<b>2,003</b>	<b>4,651</b>	<b>3,103</b>	<b>3,800</b>
Adjusted earnings	1,778	2,003	2,181	2,945	3,643
Adjusted EBITDA	2,326	2,835	2,947	3,860	4,582
<b>Growth Rates (%)</b>					
Sales	11.2	24.5	8.1	23.5	15.5
EBIT adjusted	1.1	6.9	-7.5	44.7	22.7
EBITDA adjusted	4.2	21.9	3.9	31.0	18.7
EPS adjusted	-9.7	12.6	8.9	35.0	23.7
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>769</b>	<b>1,482</b>	<b>5,419</b>	<b>3,703</b>	<b>4,503</b>
Depreciation/amortization	297	665	940	956	1,019
Net working capital	-1,265	-1,281	-232	-512	-443
<b>Investing cash flow</b>	<b>-888</b>	<b>-1,991</b>	<b>-5,010</b>	<b>-2,800</b>	<b>-2,850</b>
Capital expenditure	-2,284	-1,905	-2,750	-2,500	-1,800
Acquisitions/disposals	0	0	0	0	0
<b>Financing cash flow</b>	<b>-227</b>	<b>515</b>	<b>-638</b>	<b>-950</b>	<b>-1,768</b>
Borrowings	0	800	-268	-450	-1,150
Dividends paid	-227	-285	-370	-500	-618
<b>Change in cash</b>	<b>-347</b>	<b>6</b>	<b>-229</b>	<b>-46</b>	<b>-115</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>12,874</b>	<b>15,744</b>	<b>19,931</b>	<b>22,873</b>	<b>25,612</b>
Cash & cash equivalent	20	87	63	60	66
Accounts receivable	2,237	3,065	3,347	4,135	4,774
Net fixed assets	8,270	9,145	10,956	12,499	13,280
<b>Total liabilities</b>	<b>3,960</b>	<b>5,065</b>	<b>5,016</b>	<b>5,280</b>	<b>4,745</b>
Accounts payable	2,184	2,324	2,456	2,899	3,220
Total Debt	1,050	1,868	1,600	1,150	0
<b>Shareholders' funds</b>	<b>8,913</b>	<b>10,678</b>	<b>14,915</b>	<b>17,593</b>	<b>20,867</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	29.4	28.8	27.7	29.3	30.2
ROE adjusted	21.8	20.5	17.0	18.1	19.0
ROIC adjusted	21.5	18.0	13.9	17.5	19.3
Net debt to equity	11.6	16.7	10.3	6.2	-0.3
Total debt to capital	10.5	14.9	9.7	6.1	0.0

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## Another disappointing quarter

Biocon reported another disappointing quarter, with a loss of momentum in revenues, sharp erosion in margins & lower PAT despite higher other income. While the stock appears to gain favor with investors from time to time on the back of potential listing of its research services biz and upside on R&D, the core business remains vulnerable. We reduce our EPS estimates for FY08-10 by 3-1%. While there are potential catalysts over the long term, we do not see any respite on the problems related to its core business in the near term. We maintain Sell (3L) with a slightly lower price target of Rs501/share.

## Revenue momentum halts; margins decline

Figure 1. Biocon 3QFY08 Earnings Summary

Year to 31st March	3QFY07	3QFY08	% ch YoY	2QFY08	% ch QoQ	CIR Comments
Biopharma	1,690	1,880	11.2	2,162	(13.0)	
Enzymes	210	60	(71.4)	190	(68.4)	
Contract Research Services	570	430	(24.6)	440	(2.3)	
<b>Total Operational Income</b>	<b>2,470</b>	<b>2,370</b>	<b>(4.0)</b>	<b>2,792</b>	<b>(15.1)</b>	<b>YoY decline due to sale of enzymes business and lower contract services revenue</b>
RM Costs	1,210	1,177	(2.8)	1,358	(13.4)	YoY decline due to lower outsourcing; however, QoQ decline reflects the impact of rupee appreciation and pricing pressure
<i>as a % of Bio Pharma sales</i>	<i>63.7</i>	<i>60.6</i>	<i>-303 bps</i>	<i>57.7</i>	<i>291 bps</i>	
Staff costs	250	286	14.5	296	(3.4)	
R&D	130	120	(7.7)	220	(45.5)	
Others	100	197	96.5	111	77.0	
Total Expenditure	1,690	1,779	5.3	1,985	(10.4)	
<b>EBITDA</b>	<b>780</b>	<b>591</b>	<b>(24.3)</b>	<b>807</b>	<b>(26.8)</b>	<b>Margins hit by rupee appreciation and higher other expenses</b>
<b>EBITDA Margins</b>	<b>31.6</b>	<b>24.9</b>	<b>-665 bps</b>	<b>28.9</b>	<b>-397 bps</b>	
Depreciation	180	240	33.3	234	2.7	
Interest	20	26	29.0	27	(3.4)	
Other Income	0	211	nm	19	nm	Includes Rs70m from treasury returns; Rs100m as part of a staggered consideration on sale of enzymes business to Novozyme
<b>PBT</b>	<b>580</b>	<b>536</b>	<b>(7.6)</b>	<b>566</b>	<b>(5.3)</b>	
Taxes	40	17	(56.5)	38	(53.6)	
<i>Effective tax rate</i>	<i>6.9</i>	<i>3.2</i>	<i>-365 bps</i>	<i>6.6</i>	<i>-338 bps</i>	
PAT	540	518	(4.0)	528	(1.8)	
Minority Interest/Other	-20	-12	(38.5)	-14	(9.6)	
<b>Recurring Net income</b>	<b>560</b>	<b>531</b>	<b>(5.2)</b>	<b>542</b>	<b>(2.0)</b>	
Extraordinary Items (Net of Tax)	-	2,385	nm	-	nm	Consists of gain of Rs2539m from sale of enzymes business and Rs154m loss due to write-off of cost of IP for Oral BNP product
Reported Net Income	560	2,915	420.6	542	438.3	

Source: Company Reports and Citi Investment Research

## Key Earnings Call Takeaways

- Biocon intends to list its contract research services arm, Syngene, in FY09. The board has, in principle, agreed to go ahead with the listing in India to start with. Syngene has total revenues of Rs1.6bn in FY08E and EBIDTA and PAT margins of c35% and c25% respectively. It is a capital-intensive business with total capital employed of Rs4.5bn by end FY08E.
- Biocon has written off Rs220m of its intangible assets during the quarter, representing the capitalization on account of its oral BNP molecule. This followed recent reports about safety concerns on and declining sales of Nesoritide (J&J's BNP molecule). The net write-off post tax is Rs 154m. However, it expects its oral insulin molecule to commence Phase II studies in India shortly and aims to launch the product in India in 2010. Biocon could also look for an outlicensing deal on this molecule for some markets.

- Biocon has entered into a strategic partnership with IATRICa, a biotechnology start-up in Maryland, USA, to co-develop an exclusive new class of immuno-conjugates for targeted immuno therapy of cancers and infectious diseases. Biocon will make an equity investment in IATRICa. The candidates for development will be based on IATRICa's technology platform that enables development of a diverse spectrum of immuno-conjugates that are capable of activating potent targeted immune responses against various tumors or pathogens. The total investment – over time – would be in the range of US\$10m toward acquiring a 30% stake in IATRICa, and Biocon would consider the option of raising its investment in future.

## Reducing earnings & target price

We reduce our earnings estimates over FY08-10E by 3-1% and reduce our target price to Rs501/share (from Rs505/share earlier) – as we roll forward to 17x March'09E (vs. Sept'08E earlier) earnings.

**Figure 2. Earnings Revision**

YE March	FY08E	FY09E	FY10E
<b>EBITDA</b>			
Old	3,165	4,008	4,749
New	2,947	3,860	4,582
<i>% Change</i>	<i>(6.9)</i>	<i>(3.7)</i>	<i>(3.5)</i>
<b>Recurring Profit</b>			
Old	2,250	2,974	3,681
New	2,181	2,945	3,643
<i>% Change</i>	<i>(3.1)</i>	<i>(1.0)</i>	<i>(1.1)</i>
<b>FD EPS</b>			
Old	22.50	29.74	36.81
New	21.81	29.45	36.43
<i>% Change</i>	<i>(3.1)</i>	<i>(1.0)</i>	<i>(1.1)</i>

Source: Company Reports and Citi Investment Research

## Biocon

### Company description

Biocon is an integrated biotechnology company encompassing all three critical stages of drug development – drug discovery, development, and manufacturing and commercialization of biopharmaceuticals and enzymes. With more than 25 years of expertise in fermentation technology, the company has built strong capabilities in high-growth segments like statins, immunosuppressants and anti-diabetes. While statins form the major part of its current business, Biocon is aggressively pursuing the biogenerics opportunity in regulated markets and is also making investments in drug discovery research to build a future pipeline.

## Investment strategy

We maintain a Sell/Low Risk (3L) rating on Biocon with a target price of Rs501 (down from Rs505 earlier) in view of the nascent nature of longer-term growth initiatives. Despite several initiatives being taken by the company to emerge as a biotechnology major, Biocon remains primarily an API player with high exposure to the statins segment. While initial expectations of high growth from the statins opportunity in Europe and the US have been belied owing to stiff competition and pricing pressure, there is still no clarity on when the biogenerics opportunity would open up in these markets. Unlike other Indian companies, Biocon still does not have the requisite breadth in its product portfolio to overcome the pressure on statins and delays in biogenerics launches. The setbacks on pravastatin and simvastatin in the US in CY06 reflect the high sensitivity of Biocon's earnings to a delayed launch and are an indication of the vulnerability of the company's business model. We believe a similar trend may emerge in case simvastatin prices decline significantly in the US and/or if ramp-up in some of its new products is slower than expected. Overall, we expect a 24% CAGR in net profit for Biocon over FY07-10E, even after factoring in the full impact of statin sales in the US market and aggressive ramp-up in research services as well as insulin and BIOMAB sales. Valuations appear expensive relative to the growth outlook and the vulnerability of earnings in the near to medium term.

## Valuation

We value Biocon on a P/E basis given that its earnings profile is normalized and unlikely to change materially in the medium term. Our target price of Rs501 (down from Rs501 earlier) is based on 17x March 2009E (vs. 17x Sept 2008E earlier) earnings, which is in-line with our target range for mid-sized pharma companies (such as Aurobindo, Cadila and Jubilant). Biocon's earnings FY07-10E CAGR at 24% is among the lowest in our coverage universe; however, we still give it a multiple in-line with other mid-sized pharma companies to factor in any positive surprise from its partnership-based R&D initiatives and recent product launches. While earnings growth has turned positive in FY07, after a disappointing FY06, the higher vulnerability of Biocon's business model to pricing pressure and delayed product launches /scale-up leads us to refrain from assigning a higher multiple.

## Risks

We rate Biocon Low Risk according to our quantitative risk-rating system. The main downside risks to our target price and estimates include: (1) greater than expected erosion in prices of statins in Europe and the US; and (2) inability to deliver on promises to outlicense R&D molecules within the next 12 months. The main upside risks to our target price and estimates include: (1) higher than expected market share or volume growth in simvastatin; (2) any upside from Biocon's R&D initiatives, which we have not incorporated into our estimates and (3) earlier than expected upside from biogenerics in regulated markets.

# Appendix A-1

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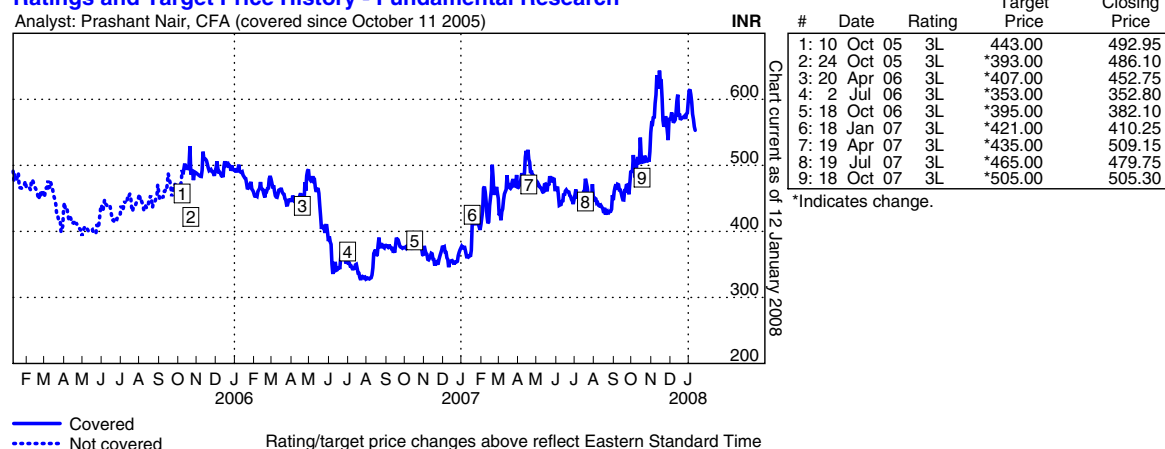
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Analyst: Prashant Nair, CFA (covered since October 11 2005)



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