Orchid Chemicals & Pharmaceuticals (ORCD.NS)

Rating change ☑
Estimate change ☑

Buy: Better Days Ahead

- **Target at Rs386** — Given the high visibility into its key product launches and its record of good market share in the US, we expect Orchid to record an EPS CAGR of 48% (FY07-10), which should raise valuations. We cut estimates to factor in a stronger INR, launch delays, higher interest cost and the latest equity dilution. Our target is unchanged as we roll forward to 16x FY09E EPS. (*From hereon, Chirag Dagli is the analyst with primary coverage of this stock.*)
- **Strong product visibility** — Orchid's investment in cephalosporins is bearing fruit and it has several key product opportunities like Cefipime, Cefdinir and Tazo-pip, giving strong visibility to earnings over the next 2 years. Early signs are encouraging, with 3Q FY08 sales, EBIDTA and PAT growth of 19%, 45% and 104%, buoyed by the launches of Cefepime and Cefdinir in the US.
- **Strength in sterile injectibles** — Orchid has a strong presence in sterile injectibles and has consistently garnered large market shares in the first wave of injectible cephalosporin launches in the US. Cefazolin, Ceftriaxone and Cefoxitin are cases in point where Orchid has managed to get approvals in time to leverage the distribution strength of its partners and gain large market shares in the first wave of generic launches.
- **Concerns priced in** — We believe concerns over its balance sheet and inconsistent delivery are fair but priced in at the current valuation of 10x FY09E EPS. We believe that any significant re-rating of the stock would however be contingent on these concerns being firmly addressed. We raise our risk rating to High to factor in Orchid's heavy dependence on Tazo-Pip.

Buy/High Risk	1H
from Buy/Low Risk	
Price (05 Mar 08)	Rs239.60
Target price	Rs386.00
Expected share price return	61.1%
Expected dividend yield	2.1%
Expected total return	**63.2%**
Market Cap	Rs15,669M
	US$390M

Price Performance (RIC: ORCD.NS, BB: OCP IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	573	7.87	-33.2	30.5	2.0	9.3	1.6
2007A	785	8.01	1.8	29.9	3.3	12.5	2.2
2008E	1,543	15.73	96.4	15.2	2.7	28.6	2.3
2009E	2,368	24.14	53.4	9.9	3.0	34.7	2.5
2010E	2,541	25.91	7.3	9.2	2.4	29.3	2.7

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	30.5	29.9	15.2	9.9	9.2
EV/EBITDA adjusted (x)	10.9	10.4	8.9	7.0	6.4
P/BV (x)	2.0	3.3	2.7	3.0	2.4
Dividend yield (%)	1.6	2.2	2.3	2.5	2.7
Per Share Data (Rs)					
EPS adjusted	7.87	8.01	15.73	24.14	25.91
EPS reported	7.87	8.01	15.73	24.14	25.91
BVPS	120.03	73.71	90.27	78.71	98.11
DPS	3.90	5.23	5.50	6.00	6.50
Profit & Loss (RsM)					
Net sales	9,366	9,638	12,088	14,917	15,914
Operating expenses	-7,850	-7,723	-9,512	-11,451	-12,437
EBIT	**1,516**	**1,915**	**2,576**	**3,466**	**3,477**
Net interest expense	-878	-993	-835	-752	-670
Non-operating/exceptionals	12	4	12	42	80
Pre-tax profit	**650**	**926**	**1,753**	**2,756**	**2,887**
Tax	-77	-140	-210	-389	-346
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**573**	**785**	**1,543**	**2,368**	**2,541**
Adjusted earnings	573	785	1,543	2,368	2,541
Adjusted EBITDA	2,375	2,766	3,526	4,489	4,558
Growth Rates (%)					
Sales	23.1	2.9	25.4	23.4	6.7
EBIT adjusted	15.6	26.3	34.5	34.6	0.3
EBITDA adjusted	21.8	16.5	27.5	27.3	1.5
EPS adjusted	-33.2	1.8	96.4	53.4	7.3
Cash Flow (RsM)					
Operating cash flow	**-1,127**	**-387**	**1,412**	**1,527**	**4,474**
Depreciation/amortization	858	851	950	1,023	1,081
Net working capital	-2,476	-1,868	-871	-1,475	1,199
Investing cash flow	**-1,829**	**-4,772**	**-1,500**	**-1,000**	**-1,000**
Capital expenditure	-1,830	-4,774	-1,500	-1,000	-1,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-1,162**	**-2,764**	**-1,947**	**-2,091**	**-2,058**
Borrowings	-769	-1,319	-750	-750	-750
Dividends paid	-156	-225	-362	-589	-638
Change in cash	**-4,118**	**-7,923**	**-2,035**	**-1,564**	**1,417**
Balance Sheet (RsM)					
Total assets	**21,685**	**28,910**	**30,381**	**31,116**	**34,228**
Cash & cash equivalent	163	1,189	171	75	2,789
Accounts receivable	3,486	3,832	4,747	5,032	5,402
Net fixed assets	12,606	16,584	17,134	17,111	17,031
Total liabilities	**13,929**	**24,059**	**24,440**	**23,396**	**24,605**
Accounts payable	2,383	6,259	7,268	6,585	8,197
Total Debt	10,450	16,488	15,738	14,988	14,238
Shareholders' funds	**7,756**	**4,851**	**5,941**	**7,720**	**9,624**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	25.4	28.7	29.2	30.1	28.6
ROE adjusted	9.3	12.5	28.6	34.7	29.3
ROIC adjusted	8.3	8.7	10.7	13.0	13.1
Net debt to equity	132.6	315.4	262.0	193.2	119.0
Total debt to capital	57.4	77.3	72.6	66.0	59.7

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Better Days Ahead

We maintain our Buy rating on Orchid Chemicals with a High Risk rating and a target price of Rs386. With high visibility on key product launches over the next 2 years and its track record of getting good market share in the US, we forecast an earnings CAGR of 48% over FY07-10. Orchid's valuations have been at a discount to other 2nd line pharma stocks, due to legacy concerns related to its balance sheet and inconsistent delivery vis-à-vis expectations. We believe any significant re-rating in the stock would be contingent on these concerns being firmly addressed.

High visibility on product launches...

Figure 1. Key Growth Drivers

Year	Key Products
FY06	Ceftriaxone
FY07	Cefprozil, Cefazolin
FY08E	Cefdinir, Cefepime, Cefadroxyl, Cefixime, Cefuroxime axetil
FY09E	Tazo-Pip, EU Cephs, NPNC
FY10E	Penems, NPNC

Source: Company and Citi Investment Research

Orchid has invested significant money and time over the last 5-6 years to establish a presence in the US and Europe. These efforts have started bearing fruit over the past two years, and we have improved visibility of growth over the next 2 years on the back of significant product launches. Orchid's strength in the niche cephalosporin-based products, where competition and price erosion are relatively limited, would remain the key growth driver over FY08, while injectible penicillin, penems and NPNC (non penicillin non cephalosporin) would add to growth prospects over FY09E-10E. We believe there are some significant opportunities within these segments that could lead to a jump in Orchid's profitability if the company is able to maintain its record of gaining significant market share in its product launches.

The visibility of product approvals and launches over the next two years is good, with some significant launches in FY08 starting with Cefdinir and Cefepime that Orchid launched in 1H FY08. Growth in FY09E would be driven by Tazobactum-pippericillin and Ceph-based products in the EU markets

Figure 2. Cephalosporin-based Product Launches for the US/EU in FY08E and FY09E

	Market	Size (US$ m)	Partner	Expected Competition
1H FY08 – Already Launched				
Cefepime Injectible	US	165	Apotex	Only generic; management expects no competition through FY08
Cefadroxil (OS + Capsules)	US	26	McKesson	Ranbaxy, Sandoz, Teva, Lupin, Aurobindo already have approvals; no further approvals likely through FY08
Cefdinir (Tablet & Oral Suspension)	US	850	McKesson	Orchid, Lupin, Sandoz and Teva
2H FY08				
Cefuroxime Axetil (tabs) (Already launched)	US	39	Apotex	High competition; old product – Ranbaxy, Lupin, Sandoz, Teva, Wockhardt, Aurobindo have approvals
Tazo – Pip	US	220	Apotex	Globally, Sandoz & Orchid are the only generic companies with USFDA approved facilities for injectible penicillin; We do not expect any other competitor for 1-1.5 years post launch in the EU & US
Tazo – Pip	EU	228	Hospira	
Cefpodomine Proxetil	US	25	McKesson	We expect 2-3 players in the first wave of launch
1H FY09				
Cefuroxime Axetil (Oral Suspension)	US	28	McKesson	No generic approved yet; we believe this product could have high competition as in the case of tablets
Cephalexin capsules	EU	10	Actavis	High competition and small opportunity
Ceftriaxone	EU	320	Actavis	Expect 3-4 players in 1st phase of launch which might last for about a year like in the US
Cefazolin	EU	49	Actavis	We expect limited competition as was the case in the US; Hikma & Sandoz could be strong competitors
Ceftazidamine Sodium Injectibles	EU	43	Actavis	Niche opportunity; limited competition (2-3 players)
2H FY09				
Cefuroxime Axetil tablets	EU	158	Actavis	We expect competition from 6-7 players
Cefuroxime Sodium Injectible	EU	88	Actavis	Niche opportunity; Mature generic product in the US; Teva, Hikma, Abraxis, Marsam Pharm are the other players
Ceftiofur	US	75	Teva	

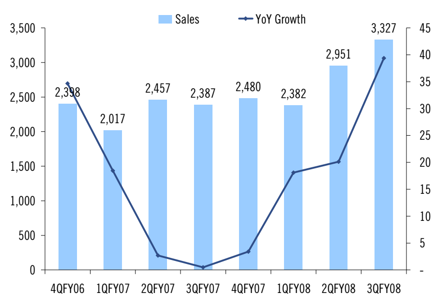
Source: Company Reports and Citi Investment Research

...reflected in strong 2Q and 3Q FY08 results

The potential upside from these niche product launches is reflected to some extent in Orchid's 2Q and 3Q FY08 results with revenues, EBIDTA and net profit witnessing an upward shift on a sequential basis. In 3Q FY08 revenues grew 40% yoy and 12% qoq. EBIDTA margins were under pressure due to the strong INR, down 300bps YoY. Overall 3Q FY08 net profit was up 88%. This was after 104% growth in 2Q FY08.

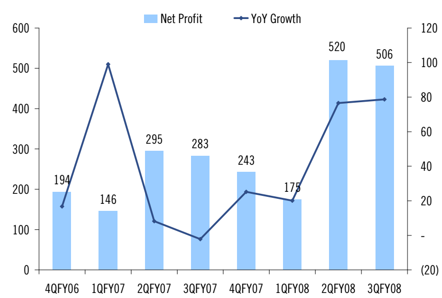
Two key product launches — cefipime injectibles and cefdinir — were the primary drivers of this growth. Both products were launched in the second quarter and the limited competition ensured low price erosion and reasonable market shares. We expect some easing in the forthcoming quarters as the launch would have involved some pipeline filling; however, we expect these products to remain strong growth drivers over the next 12-15 months.

Figure 3. Sales (Rs m), YoY growth (%)



Source: Company Reports and CIR

Figure 4. Net Profit (Rs m), YoY growth (%)



Source: Company Reports and CIR

Good record in sterile injectibles

Orchid has a strong presence in sterile injectibles and has consistently been in the first wave of injectible cephalosporin launches in the US market. Cefazolin, Ceftriaxone and Cefoxitin are cases in point where Orchid has managed to get approvals in time to enter the market in the first wave of generic launches and has garnered a large share of the market due to the distribution strength of its partners.

- Cefoxitin: Apart from Orchid, there is only one other generic company (Abraxis Pharma) in the market.
- Cefazolin: Orchid supplies the product not only to its partner (Apotex) but also to four other key players.
- Cefepime: Orchid launched the product in 1Q FY08, and is the only approved generic until date; management does not expect additional competition in FY08.
- Ceftriaxone – one of its first injectible launches in the US market: Orchid has been able to garner 20% market share (through its partner, Apotex) despite entering the market a few weeks after competitors such as Lupin and Sandoz.

Figure 5. Key Injectible Products

	Market Share (%)	No of Competitors
Ceftriaxone	20	12
Cefazolin	80	7
Cefoxitin	70	1
Cefepime	65	0

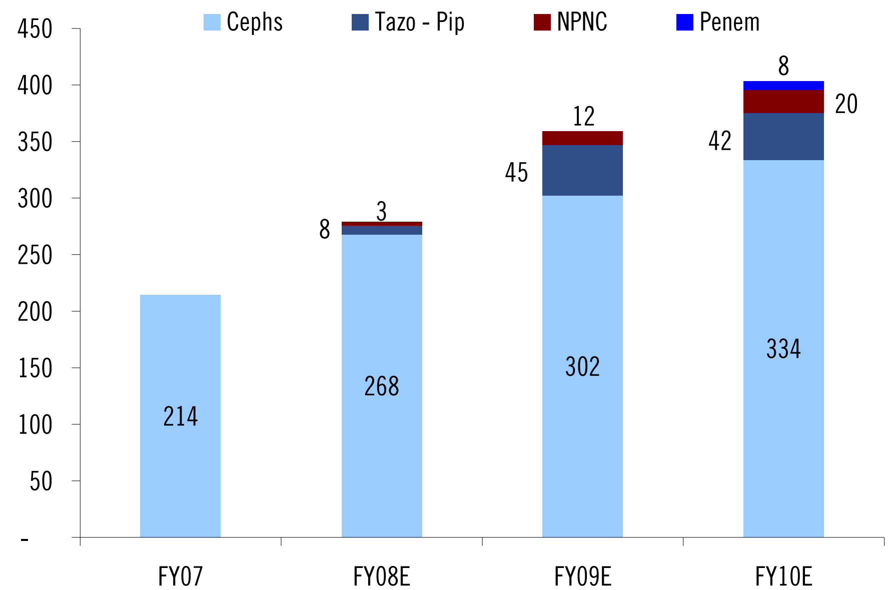
Source: Company

The strong traction in injectible cephalosporins has enabled Orchid to ramp up its US revenues significantly to US$55m in the second year of operations itself. With its strong pipeline, we believe Orchid is well placed to continue growing in regulated markets (the US and EU) at a rapid pace (57% CAGR over FY07-10E).

Growth beyond cephalosporins

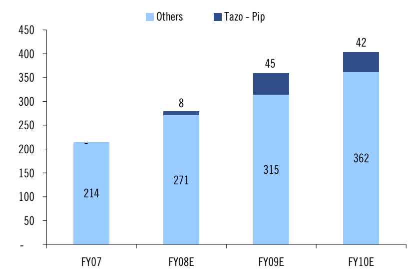
Orchid's growth in the US has been driven by cephalosporin-based products, especially injectibles. However, the company has a reasonably robust pipeline of niche non-cephalosporin-based products – viz. penicillin injectibles, penems and NPNC products, which would contribute to growth going forward. Orchid has largely completed the investment required for penicillin injectibles, penems and NPNC products, and we expect growth in FY09 and beyond to be driven by these segments.

Figure 6. Orchid FY07 — FY10E Revenue Breakdown (US$ m)



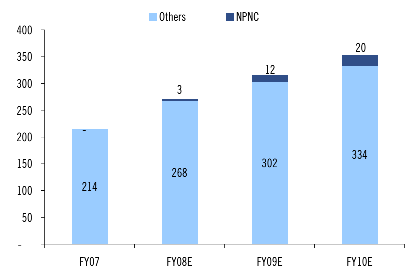
Source: Company Reports and Citi Investment Research estimates

Figure 7. Tazo-Pip Revenue Contribution (US$ m)



Source: Company Reports and CIR estimates

Figure 8. NPNC Revenue Contribution (US$ m)



Source: Company Reports and CIR estimates

Injectible penicillin: The Tazo-Pip opportunity

Tazobactam – Pipperacillin (Tazo-Pip) is the generic version of Zosyn, for which Wyeth holds the patent in regulated markets. Orchid filed the DMF for this product in July 2005 and tied up with Apotex for distribution in the US market. Subsequently, Wyeth's discontinued its original formulation and launched a new version with fresh patents. In response, the generic players viz. APP, Sandoz and Orchid filed a citizen's petition in February 2007 claiming that Wyeth is trying to unfairly extend the patent life. The generic companies have claimed that a drug can be withdrawn from the market only for safety or efficacy reasons and that Zosyn is a safe and effective drug that Wyeth had marketed for 13 years.

With the compound patent having expired in February 2007 in the US and most major non-US markets in July 2007, we believe that a generic launch of Zosyn is imminent in the US, Canada and EU markets. Wyeth has also in its recent filing to the SEC indicated a likely risk of genericisation of Tazo-Pip anytime now in the US. Zosyn recorded global sales of US$1.1bn in 2007. We build in 50% price erosion and the partner's market share of 35%, and forecast Tazo-Pip to add US$45m to Orchid's revenues in FY09E.

Non-penicillin, Non-cephalosporin (NPNC): Just the beginning

Orchid has stepped up its regulatory filing efforts for NPNC (non penicillin non cephalosporin) products in the US and EU markets. It has identified a list of 87 molecules in these markets and has already entered into partnerships for 20 products with combined current retail sales of US$20bn. Revenues have also commenced, with terbinafine and amlodipine besylate being launched in 1Q FY08. We expect momentum in filings and approvals to pick up going forward and believe that sales of NPNC products would drive growth over FY09-10.

We forecast revenues of US$12m and US$20m respectively in FY09E and FY10E without building any upside from any potential para IV opportunities.

Carbapenems: Another niche opportunity

Carbapenems are a class of beta-lactam antibiotics with a broad spectrum of antibacterial activity, and have a structure which renders them highly resistant to beta-lactamas. The chemistry involved in Carbapenems is similar to penicillin. Like cephs, these products also need dedicated facilities and have few players. Orchid expects to be a significant player in Carbapenems when it opens up in CY09.

Orchid expects to launch both products on patent expiry in FY10E; like in the case of cephs and tazo-pip, we expect these to be niche opportunities for the company, leading to higher revenues and profitability. As of now, we believe that Ranbaxy is the only other company from India that is setting up a facility for penems. However, we highlight that there is adequate time for patent expiry and other companies are likely to enter the fray over time. Orchid's advantage, in our view, lies in the fact that it has already entered into a marketing tie-up for these products with Mayne Pharma (now acquired by Hospira) – a strong player in the regulated markets which would enable it to capture a reasonable share of the market.

With limited generic competition as is the case with cephs, we expect the price erosion to be less than 50% in each of these products. We forecast revenues of US$8m in FY10E assuming a launch in 2H FY10E.

Legacy concerns/disappointments

Orchid's valuations have consistently been at a discount to other second-line pharma companies, largely on account of legacy disappointments / concerns – with most of these being related to the company's balance sheet and some related to inconsistent delivery vis-à-vis expectations. These factors have offset the company's efficient execution on the operating side of the business. We believe that any significant re-rating in the stock would be contingent on these concerns being firmly addressed.

We highlight where Orchid stands today vis-à-vis some of these issues:

- **Consistent equity dilution:** Orchid's recent US$200m FCCB issue in February 07 and the consequent 35% increase in the fully diluted share count have been perceived negatively by the market. While this was necessary in light of the highly leveraged balance sheet, the fact that this came within 15 months of a previous dilution (US$85m) led to a significant overhang on the sentiment for the stock. We would like to highlight that the capital raising was largely to correct the high leverage – an offshoot of the high capex involved in Orchid's key focus areas of injectible cephalosporins and penicillin products.

  After the last round of equity dilution, Orchid's debt equity has improved to a relatively healthy 0.66x. The company has also indicated that there is no major capex requirement going forward and free cash flow would be used to pay down debt further. As such, we believe that further dilution is unlikely in the medium term.

- **High debt equity:** Orchid's debt equity has been consistently high in the past, raising the possibility of equity dilution in order to correct the situation, especially if the business does not gain traction in line with expectations. For instance, just before its latest equity issue, the company's debt equity ratio was >1.5x. This is because of the front-ended nature of the investment made in the dedicated sterile cephalosporin, penicillin and penem facilities and ANDA filings that were largely funded by debt.

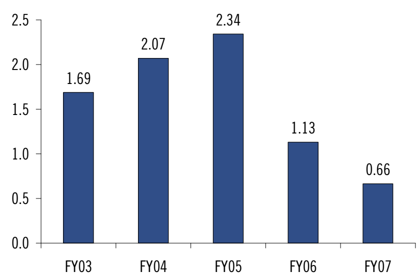
  However, after the recent dilution, Orchid's debt equity (treating FCCB as equity) has declined to 0.6x and with most of the cash generated likely to be used to further pay down debt, we expect this to decline further to 0.2x in FY10E. Since most of the investment in facilities is complete, we believe Orchid is nearing the end of its high capex phase and can meet all incremental requirements out of internal accruals. We factor in steady repayment of debt over the next 3 years as product approvals come through and the regulated markets business gains traction.

Figure 9. Capital Raising by Orchid

	Amount (US$ m)	Instrument
Feb-07	175.0	FCCBs
Dec-05	42.5	FCCBs
Dec-05	42.5	GDRs
2002	20.0	Placement with IFC
1999	40.0	Placement with Schroeders

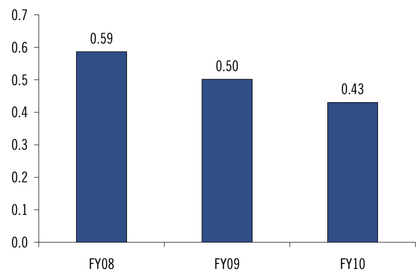
Source: Company Reports

Figure 10. Debt Equity - FY03-07 (x)



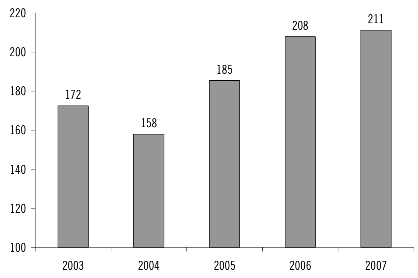
Source: Company and Citi Investment Research

Figure 11. Debt Equity – FY08-10E (x)



Source: Company and CIR estimates

Figure 12. Working Capital Cycle (No of Days)



Source: Company Reports

- **Working capital management:** Orchid has had a significantly high working capital cycle, largely due to high inventory and debtor days. Barring FY04, overall working capital cycle has been close to or in excess of 200 days, which is much higher than most of its peers. As per the company, this is largely due to high sales to the less regulated markets. However, Orchid has been trying to address the situation by reducing the inventory and debtor days substantially. We expect the growing share of regulated market sales to help in this effort, although things have not improved much over the last two years. At the same time, Orchid has taken steps to reduce inventory and credit period in the less regulated markets as well. We have already seen evidence in 1Q and 2Q FY08. However, given the track record of the company, we prefer to watch this trend continuing for some more time before building in any significant improvement in our estimates.

- **High capex, low asset turn and lower return ratios:** Historically, Orchid's RoCEs / RoEs have been on the lower side despite robust EBIDTA margins relative to its peers. This is primarily on account of the significantly high and front ended capex incurred by the company to execute its plans of tapping the regulated markets. We highlight that Orchid was primarily an API manufacturer targeting the less regulated markets until three years back. As such, its strategy to target the regulated markets through the formulations route entailed setting up facilities at least a couple of years before the first product could be launched. Moreover, given that Orchid did not have a formulations franchise in the less regulated markets, these facilities did not generate revenues for a while. This led to lower asset turnover and, given that the expansion was largely debt funded, lower net margins as well. In fact, even now, Orchid is generating revenues from only one of the four distinct product opportunities that it has built capacity for.

As approvals come through, return ratios should improve since Orchid is towards the end of its capex cycle

Figure 13. Return Ratios (FY04-10E)

	2004	2005	2006	2007	2008E	2009E	2010E
Net Profit Margin	5.1%	8.0%	6.1%	8.1%	12.6%	15.9%	15.6%
Asset Turnover	0.59	0.54	0.54	0.47	0.54	0.64	0.64
Assets/Equity (including FCCBs in Equity)	2.88	3.21	2.54	1.85	1.62	1.53	1.45
RoAE	8.6%	13.9%	8.5%	7.0%	10.9%	15.5%	14.5%
RoACE	7.9%	9.8%	7.8%	7.9%	10.0%	12.9%	12.4%

Source: Company Reports and Citigroup Investment Research estimates

With substantial investment having already been made, we expect incremental capex to be minimal going forward. As more product approvals and revenues come through, we expect margins to pick up and asset turnover to improve, in turn leading to better return ratios. However, we highlight that Orchid has disappointed on this front in the past (with capex ahead of guidance) and valuations are likely to improve only after the improvement is actually visible on the balance sheet.

Deconstructing Orchid's return ratios

We attempt to deconstruct Orchid's RoCE in line with its various product lines in a bid to evaluate how much room there could be for improvement going forward. We break the company's business in four distinct segments – viz. 1) Cephalosporins 2) Penicillin based injectibles 3) Non Ceph, non Penicillin (NPNC) and 4) Penems – and look at the metrics for each business separately.

While Orchid has largely completed the required investment in facilities as well as filings for each segment, revenues have started coming in only from cephalosporin-based products. The other three buckets have not yet contributed to earnings even as the investment reflects in the balance sheet and hence the lower return ratios. We believe that as the other 3 segments start contributing to profits, margins and asset turns will improve thereby improving return ratios.

Figure 14. Growth Drivers

Source: Citi Investment Research estimates

Figure 15. Segmental Breakdown of Fixed Assets (all figures are approximates)

Parameters	Cephs	NPNC	Betalactams	Carbapenems	Company	CIR Comments
Fixed Assets base (US$ m)	250	50	50	50	400	With Orchid towards the end of the capex cycle, incremental investment will be minimal
Current Revenues (US$ m)	250	0	0	0	250	While investment is almost complete for all four segments, revenues have started coming through only from cephs (c2/3rd of the current gross block)
Likely Peak Revenues (US$ m)	300	100	50-60	50-60	500-520	
Likely asset Turns at peak (X)	1-1.2x	2.0x	1.0x-1.2x	1.0x-1.2x	1.2-1.3x	With no contribution from the other 3 segments, overall asset T/O is low; however, should improve to 1-1.5x over time
Likely EBITDA margins (%)	30-35%	20%	30-35%	30-35%	25-30%	These segments enjoy high margins due to limited competition, which leads to lower price erosion and high market share
CIR Comments	Lower asset T/O due to lower realizations in less regulated markets; Regulated market sales commenced in FY06	Will drive growth in FY08/FY09E	Will drive growth in FY09E; Tazo-Pip is the key product opportunity in this segment	Will drive growth in FY10E; so far only Ranbaxy and Orchid appear geared to tap this segment; more competitors could come in by patent expiry	Only Cephs contribute to revenues, although capex is largely complete for all four segments	Over the next 2-3 years, as each segment starts contributing to revenues and achieves peak revenues, we expect an improvement in asset turnover which will in turn reflect in healthier return ratios for the company

Source: Company and Citi Investment Research estimates

Revising estimates and target price

We are revising our estimates to factor in a stronger rupee, delays in a few key product launches, higher interest cost and the latest equity dilution. However, our target price remains unchanged as we roll forward to 16x FY09E earnings.

Figure 16. Earnings Revision

	FY08E	FY09E	CIR Comments
Revenue (Rs M)			
New	12,088	14,917	Largely on the back of stronger INR (Rs40.2,38, 36 for FY08E, FY09 and FY10E respectively). Also factoring in some delays in product launches – viz. ceftiofur, tazo-pip in the US as well as EU product launches
Old	13,648	15,654	
% Change	*(11.4)*	*(4.7)*	
EBITDA margins (%)			
New	29.2	30.1	Largely on the back of the stronger rupee assumptions, partially mitigated in FY09 by Tazo
Old	30.7	28.9	
% Change	*-153bps*	*119bps*	
Adjusted Net Profit (Rs M)			
New	1,543	2,368	Significantly higher interest costs (as postponement of revenues and profits from key products led to lower repayment of debt) and lower other income
Old	2,424	2,749	
% Change	*(36.3)*	*(13.9)*	
FD EPS (Rs)			
New	15.7	24.14	Factoring in dilution on account of the recent FCCB issue (US$175m)
Old	33.3	37.7	
% Change	*(52.9)*	*(35.8)*	

Source: Citi Investment Research estimates

Favorable risk-reward

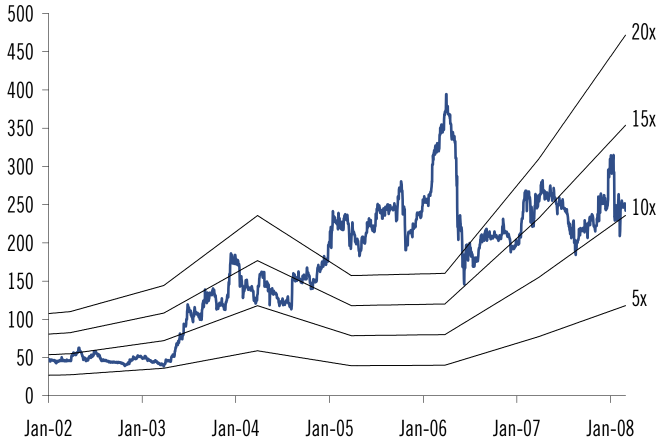
Orchid's stock performance has been lackluster in the last 2 years on the back of some of the concerns highlighted earlier in the report. Besides, the company has not delivered in line with investor expectations. However, given the strong visibility on product launches over FY08 and FY09 and the relative discount in valuations vis-à-vis peers, we believe that the risk reward is in favour of investors. We believe that balance sheet concerns are already built into the price and the valuation at 15x FY08E FD EPS ignores the change in the business scale witnessed in 2Q and 3Q FY08. With a strong earnings CAGR of 48% over FY07-10, we believe Orchid is a good medium-term investment, with strong growth in each successive quarter likely to act as catalysts.

Figure 17. Orchid Stock Performance

	Abs	Rel to Sensex	Rel to CIR Pharma
1 Month	4%	16%	-4%
3 Month	-4%	15%	-6%
6 Month	15%	10%	9%
9 Month	-3%	-17%	-7%
12 Months	5%	-18%	-9%

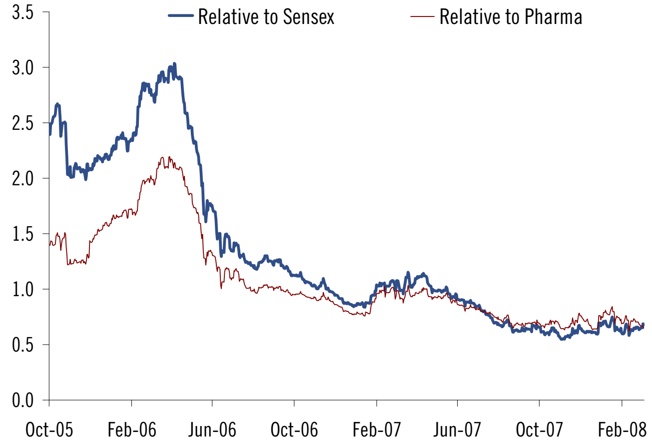
Source: Powered by dataCentral

Figure 18. One-Year Forward P/E Bands



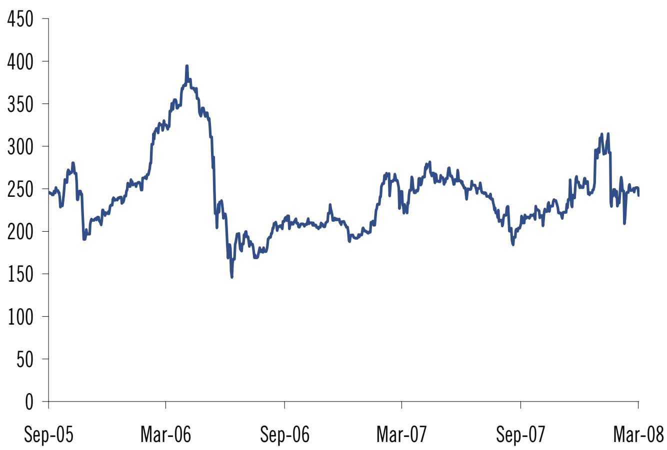
Source: Citi Investment Research

Figure 19. Orchid P/E Relative to Sensex and CIR Pharma Universe



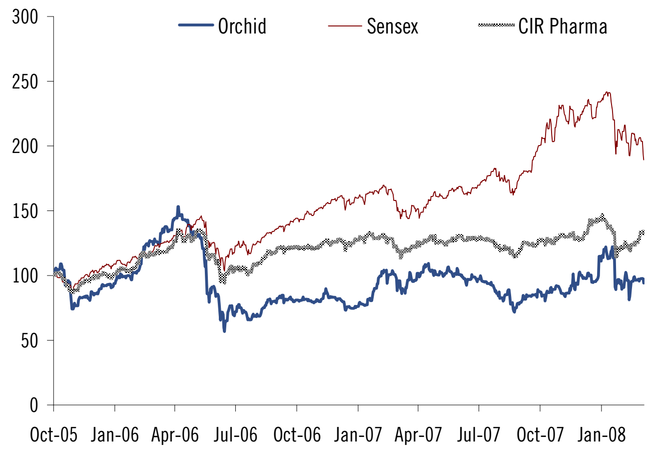
Source: Citi Investment Research

Figure 20. Absolute Share Price Performance



Source: Citi Investment Research

Figure 21. Relative Share Price Performance (1st Oct '05 based to 100)



Source: Citi Investment Research

Re-visiting the Orchid Story

A leading player in the niche antibiotics segments

The key factor differentiating Orchid's business from the overall sector is its presence in antibiotics (cephalosporins, penicillins, carbapenems), within which, it has a niche focus on high-end products such as sterile injectibles. The entry barriers in this space are higher than for most other segments, as it requires investment in dedicated facilities and there are several process patent issues (read: complex chemistry) surrounding these products.

We believe that these factors would limit the overall number of players operating in this segment. We believe that the company is following a similar philosophy for its NPNC products, focusing on complex-to-make drugs where circumventing patents could be difficult and competition limited. We also like the fact that as a late entrant into the market, the company is not building a distribution model from scratch in the overseas markets. Rather, it is developing fairly strong partnerships that should complement its manufacturing and chemistry skills.

Widening therapeutic focus beyond cephalosporins . . .

Orchid has predominantly been a cephalosporins player and is among the leading manufacturers of cephalosporins with a presence in all four generations of ceph drugs. With an annual capacity of 1050 MT, it accounts for 15% of the global capacity.

Over the last few years however, Orchid has focused on widening its therapeutic focus beyond the cephalosporins space in a bid to de-risk its portfolio and sustain growth. It has built a presence in other antibiotics such as betalactums, monobactums and carbapenems. Besides, it is also in the process of building capabilities in non-antibiotic therapeutic areas such as CNS, CVS, gastro intestinal, pain management and osteoporosis. The broader therapeutic focus would not only de-risk Orchid's API business in a highly competitive environment, but also enhance its ability to develop the formulations business in regulated and less-regulated markets.

Strong partnerships for the front-end

Orchid has adopted a partnership model for its regulated markets foray, and has already finalized tie-ups with global players for various products in the US and EU markets.

Figure 22. Orchid — Marketing Partnerships in Regulated Markets

Partner	Product	Markets
Apotex	Sterile cephs	US, Canada
McKesson	Oral cephs	US
Par Pharma	NPNC	US
IVX Animal Health	Ceftiofur	US, Canada, Mexico
Stada	NPNC	US
Actavis	NPNC	US, EU

Source: Company Reports

Under each agreement, Orchid would be responsible for product development and regulatory filings, while the global partner would handle the marketing and distribution in the target market. Some of the key common features across agreements include:

- The ownership of the ANDA and all associated IPR will remain with Orchid.
- The agreements are exclusive both ways, subject to the marketing partner being able to deliver on agreed commitments. These could be related to various parameters such as market share, volume off-take, and value sales.
- Profit on generics sales will be shared between the partners. Orchid has either an equal or higher share of profit in all products that agreements have been entered into until date.

- The partners will compensate Orchid for all development and filings costs by way of milestone payments over the course of the filings. They will also share the legal costs and risks, if any, on these products. However, these payments could come with a lag compared to the time incurred. Orchid is capitalizing the expenses and only writing off these filing expenses over a period of five years from the commercialization of the opportunity.

In our opinion, these partnerships are positive from Orchid's perspective and differentiate it from most of its peers. These not only validate Orchid's infrastructure and product development capabilities, but also improve the probability of success in the regulated markets. It would have taken a long time for Orchid to establish its own distribution set up in the regulated markets, which could have resulted in some missed initial opportunities. The partnerships with established generic companies provide Orchid with an immediate vehicle to tap the markets. At the same time, the funding of product development and filing expenditures will match the timing of costs and revenues (with a small initial gap) and we estimate will enable Orchid to scale up its long term growth initiatives without taking a hit on near-term profitability. Although we maintain that a profit share model would remain vulnerable versus competing against a fully integrated model, the former appears to be the best fit for Orchid, given the company's competencies.

The strength in Orchid's business model is visible in the fact that Orchid now supplies Oral Cephs directly to Mckesson (leading distributor) for the US market after Par Pharma (its original partner for Oral Cephs in the US) has had some financial difficulties. In fact, supplying directly to Mckesson has improved Orchid's profit sharing.

Orchid Chemicals

Company Description

Orchid is a leading participant in the global cephalosporin market, with a 15% share of the global API capacity. Orchid has a presence in APIs and formulations, and has also ventured into NDDS and NDD research. It employs more than 3,000 people across plants, research centers and offices, and exports to more than 75 countries. More than 80% of its revenue comes from exports of API and formulations.

Investment strategy

We rate Orchid Buy/High Risk. Orchid's fully integrated status makes it one of the lowest-cost players in India. Cephalosporins is a niche segment, where competition and pricing pressures are limited owing to high entry barriers — high upfront capital commitment and complex chemistry. Orchid is in the midst of a transition in its business model, which should drive up value addition and profitability — from APIs to formulations, from less-regulated to regulated markets and beyond cephalosporins to other therapeutic categories. Marketing tie-ups with global players lend greater credibility to Orchid's efforts and improve the probability of success, in addition to easing pressure on earnings via upfront funding of regulatory costs. It has already launched four products in the US. Other attractive product opportunities such as Cefuroxime Axetil, Ceftiofur and Tazo-Pip are in sight in the US. We expect these, along with interest cost savings, to drive earnings at a FY07-10E CAGR of 48%.

Valuation

We value Orchid on P/E, as we expect its earnings to normalize over the next two years; trailing ratios, though, would be skewed due to the company's depressed financials in the past. We use a target P/E of 20x to value sector leaders — a premium of about 40% to the broad market. This is justified, in our view, as the pharma sector is intellectual-property-driven, and has the potential to spring earnings surprises. We broadly value mid-sized pharma stocks at a 10-20% discount range (16-18x) to the sector leaders to account for the difference in scale, potential execution issues in their efforts to go global and lower liquidity. Our target multiple for Orchid is 16x FY09E EPS, giving us a target price of Rs386. Our target multiple is within Orchid's historical five-year P/E band of 7-19x. We continue to use a lower-end multiple than peers to value Orchid, despite superior earnings growth, due to factors such as lower return ratios, lower capital efficiency and high debt equity. We await management action on improving working capital cycle and lower debt equity.

Risks

We rate Orchid High Risk given its high dependence on Tazo-Pip for growth in FY09. Based on our quantitative risk-rating system, which tracks 260-day historical share price volatility, the stock would have been Low Risk. The risks that could prevent the stock from reaching our target price include: (1) product/profit concentration risk due to the high share of cephalosporin drugs in its revenues; (2) competition from other generic companies, Indian and global; and (3) partnership issues. The main upside risks include: (1) revenues from the NPNC (non-penicillin non-cephalosporin) segment, which are not factored in our estimates; and (2) tamer competition in key products like Tazo-Pip.

Appendix A-1

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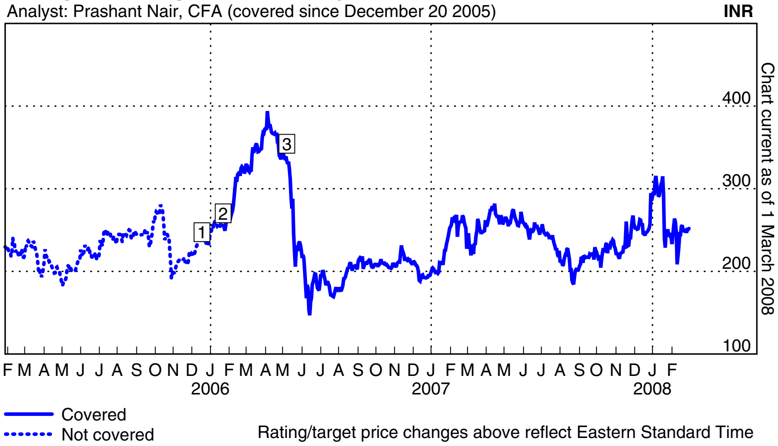
IMPORTANT DISCLOSURES

Orchid Chemicals & Pharmaceuticals (ORCD.NS)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since December 20 2005)



#	Date	Rating	Target Price	Closing Price
1:	19 Dec 05		-	236.95
2:	22 Jan 06	*1M	*355.00	255.60
3:	8 May 06	*1L	*386.00	333.35

*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

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