MOTILAL OSWAL

Aurobindo Pharma

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,962	ARBP IN
	REUTERS CODE
S&P CNX: 3,744	ARBN.BO

Equity Shares (m)	53.3
52-Week Range	740/287
1,6,12 Rel. Perf. (%)	-7/-24/45
M.Cap. (Rs b)	32.4
M.Cap. (US$ b)	0.7

31 October 2006 — **Sell**

Previous Recommendation: Sell — Rs614

YEAR END*	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/06A	16,955	697	11.9	1,765.2	51.0	4.0	8.6	7.4	2.6	24.9
03/07E	21,784	2,174	31.8	166.1	19.2	3.2	21.3	10.6	2.0	12.1
03/08E	25,171	2,729	39.9	25.5	15.3	2.5	21.3	12.5	1.7	10.0

** Consolidated results*

2QFY07 results (standalone) were below our estimates with EBITDA margin expanding by merely 770bp to 14.4%, impacted by higher cost push. However, higher other income and lower tax boosted PAT to Rs546m. Key highlights:

- Revenues grew 50% YoY to Rs4.8b, driven by export sales (up 86% to Rs2.8b) on account of higher regulated market sales (US business up by 70% and EU up by 228%).
- EBITDA margins expanded 770bp to 14.4% reflecting improved product mix and some recovery in pen-G prices. Margin expansion would have been higher but for higher cost push in form of higher staff cost (up 54%) and other expenditure (up 51%).
- Higher other income (up 250% to Rs267m) from idle FCCB funds and lower taxes (tax rate of 9.8%) due to conversion of some units into EOUs boosted PAT to Rs546m (v/s Rs36m).
- The company continued its aggressive pace in filings for the regulated markets with 9 ANDAs and 14 DMFs filed during the quarter, taking the total to 69 ANDAs and 93 DMFs until date.
- We are revising our earnings estimate upwards for FY07E by 39.6% to Rs31.8 and for FY08E by 7.8% to Rs39.9, to factor in for higher ARV sales, improvement in prices of Pen-G based products, higher other income and lower tax.

Aurobindo is making some progress with its regulated market business, this coupled with stable ARV business and slight recovery of Pen G prices, gives some visibility to near term earnings. However, given its high leverage and modest return ratios, valuations at 24.4x FY07E and 16.1x FY08E earnings appear expensive. Maintain **Sell.**

STANDALONE QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales	**2,807**	**3,195**	**4,090**	**4,630**	**4,386**	**4,800**	**4,855**	**5,381**	**14,722**	**19,422**
YoY Change (%)	*-1.5*	*18.6*	*28.1*	*62.1*	*56.3*	*50.2*	*18.7*	*16.2*	*27.0*	*31.9*
Total Expenditure	2,576	2,980	3,508	3,915	3,727	4,109	4,054	4,385	12,979	16,275
EBITDA	**231**	**215**	**582**	**716**	**659**	**691**	**801**	**995**	**1,743**	**3,146**
Margins (%)	*8.2*	*6.7*	*14.2*	*15.5*	*15.0*	*14.4*	*16.5*	*18.5*	*11.8*	*16.2*
Depreciation	119	125	135	133	143	150	155	164	511	612
Interest	134	141	163	168	181	202	240	234	606	857
Other Income	36	76	80	112	171	267	175	161	304	774
PBT	**13**	**25**	**364**	**527**	**506**	**606**	**581**	**758**	**929**	**2,451**
Tax	2	4	32	55	7	48	103	135	93	292
Deferred Tax	-9	-15	70	113	137	12	0	0	159	149
Rate (%)	*-52.3*	*-44.4*	*28.0*	*31.9*	*28.5*	*9.8*	*17.8*	*17.8*	*27.1*	*18.0*
PAT	**20**	**36**	**262**	**375**	**362**	**546**	**478**	**624**	**694**	**2,010**
Adjusted PAT	**20**	**36**	**262**	**375**	**362**	**546**	**478**	**624**	**694**	**2,010**
YoY Change (%)	*-88.8*	*5.5*	*165.9*	*922.6*	*1,701.5*	*1,401.1*	*82.5*	*66.2*	*98.1*	*189.8*
Margins (%)	*0.7*	*1.1*	*6.4*	*8.1*	*8.3*	*11.4*	*9.8*	*11.6*	*4.7*	*10.3*

E: MOSt Estimates

Nimish Desai (Nimishdesai@MotilalOswal.com); Tel: +91 22 3982 5406/ Jinesh K Gandhi (Jinesh@MotilalOswal.com); Tel +91 22 3982 5416

Formulation and ARV sales drive revenue growth

During the quarter, revenues grew 50% YoY to Rs4.8b, driven by export sales (up by 86% to Rs2.8b) and stable growth in domestic business (up by 18% to Rs2b). Export sales were driven by higher regulated market sales with US business up by 70% to Rs761m and EU business up by 228% to Rs762m. Also, RoW business grew by 55% to Rs1.28b.

TREND IN MARKET MIX (RS M)

	2QFY07	2QFY06	YOY (%)	1QFY07	QOQ (%)
India Sales	1,998	1,689	18.3	1,871	6.8
Contribution (%)	*41.6*	*52.9*		*42.6*	
International Sales					
US	761	448	70.0	790	-3.7
Contribution (%)	*15.9*	*14.0*		*18.0*	
EU	762	232	228.0	579	31.6
Contribution (%)	*15.9*	*7.3*		*13.2*	
Africa/CIS/Asia	1279	825	55.0	355	260.3
Contribution (%)	*26.6*	*25.8*		*8.1*	
Total Internat. Sales	**2,802**	**1,505**	**86.2**	**2,517**	**11.3**
Contribution (%)	*58.4*	*47.1*		*57.4*	
Total	**4,800**	**3,194**	**50.3**	**4,388**	**9.4**

Source: Company/ Motilal Oswal Securities

Formulations business grew by 258% YoY to Rs1.3b, driven by exports to regulated markets (US & EU). Also, its SSP business grew by 51.2% (to Rs1.1b) and Cephalosporins business grew by 12.5% (to Rs1.44b), reflecting gradual improvement in Pen-G based products. Although ARV and other businesses grew merely 12.7% (to Rs912m), it is expected to gain momentum in forthcoming quarters based on commencement of supply to WHO and PEPFAR program.

TREND IN PRODUCT MIX (RS M)

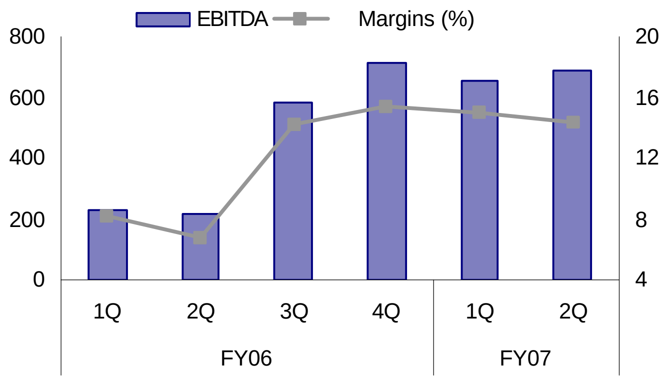
	2QFY07	2QFY06	YOY (%)	1QFY07	QOQ (%)
SSP	1104	730	51.2	1,031	7.1
Contribution (%)	*23.0*	*22.8*		*23.5*	
Cephalosporins	1440	1280	12.5	1,259	14.4
Contribution (%)	*30.0*	*40.1*		*28.7*	
ARV & Others	912	809	12.7	1,048	-13.0
Contribution (%)	*19.0*	*25.3*		*23.9*	
Formulations	1344	375	258.0	1,044	28.8
Contribution (%)	*28.0*	*11.8*		*23.8*	
Total	**4,800**	**3,195**	**50.2**	**4381**	**9.6**

Source: Company/ Motilal Oswal Securities

Cost push restricts margin expansion

EBITDA margins expanded by 770bp to 14.4% reflecting improved product mix and some recovery in pen-G prices. Margin expansion would have been higher but for higher cost push in the form of higher staff cost (up 54%) and other expenditure (up 51%). Despite the ramp-up in business and aggressive product filings, Aurobindo's fixed cost was almost flat, implying partial capitalization of R&D/ product development expenses. Hence, the reported EBITDA margins might have been inflated to that extent.

TREND IN EBITDA MARGINS



Source: Company/ Motilal Oswal Securities

Higher other income (up 250% to Rs267m) on idle FCCB funds and lower taxes (tax rate of 9.8%) due to conversion of some units into EoUs boosted PAT to Rs546m (v/s Rs36m).

Revising estimates

We are revising our earnings estimates upwards for FY07E by 39.6% to Rs31.8 and for FY08E 7.8% to Rs39.9, to factor in for higher ARV sales, improvement in prices of Pen-G based products, higher other income and lower tax rate.

REVISED FORECAST (RS M)

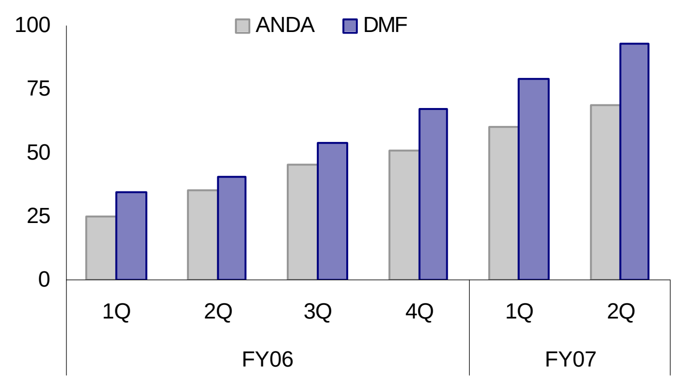
	FY07E			FY08E		
	REV	OLD	CHG (%)	REV	OLD	CHG (%)
Net Sales	21,784	20,484	6.3	25,171	23,488	7.2
Net Profit	2,174	1,557	39.6	2,729	2,533	7.8
EPS (Rs)	31.8	22.7	39.6	39.9	37.0	7.8

Source: Motilal Oswal Securities

Impetus on product filing continues

The company continued its aggressive pace in filings for the regulated markets with 9 ANDAs filed during the quarter, taking the total to 69 until date. It has also filed 93 DMFs until date with the US FDA - one of the strongest API pipelines from India. The company has a strong portfolio of anti-AIDS products approved by the US FDA (about 18 approvals) making it eligible to supply products to the African continent under the PEPFAR program of the US government.

TREND IN FILINGS IN US (CUMULATIVE)



Source: Company/ Motilal Oswal Securities

Huge approved manufacturing infrastructure

Aurobindo has huge manufacturing assets with approvals from major regulatory bodies already in place. Aurobindo has already invested around US$350m (over FY02-FY06) to set up such large manufacturing infrastructure. Also, the company has a manufacturing presence in China, where it manufactures intermediates/APIs for its SSPs and Cephlasporins business. Aurobindo has vertically integrated into intermediates, APIs and formulations for most of the products, resulting in cost competitiveness. Since Aurobindo has made upfront investment (without commensurate revenues) to build its manufacturing infrastructure, hence scaling up of its operations would be critical to improve profitability, else fixed overheads of these facilities would be drag on margins.

AUROBINDO'S FACILITY - REGULATORY APPROVALS IN PLACE

UNIT	CERTIFICATIONS
API	
Unit I	US FDA
Unit I A	US FDA
Unit VI A	Health Canada, US FDA (Pre approval over)
Unit VIII	US FDA, WHO
Unit XI	US FDA
Datong, China	cGMP
Formulations	
Unit III	US FDA, UK MHRA, WHO, Health Canada, MCC(SA), Brazil Anvisa
Unit VI B	US FDA, Health Canada, MCC(SA), Brazil Anvisa
Unit XII	US FDA, UK MHRA, Health Canada, Brazil Anvisa
Bio-equiv. centre	US FDA, WHO, Brazil Anvisa

Source: Company

Momentum in regulated market business to continue

Aurobindo's businesses in regulated markets of the US (up by 60%) and the EU (up by 122%) grew by 84% in 1HFY07, albeit on a lower base. Aurobindo has made further progress in its initiatives to tap regulated markets. The company has filed 14 DMFs and 9 ANDAs, taking total DMF filings to 93 and ANDAs to 69. Also, in other regulated markets, it filed for 52 API dossiers and 22 formulation dossiers, taking the total to 189 API and 106 formulation dossiers. Given its strong product pipeline, the company is in a position to leverage its pipeline to grow its regulated market business. However, Aurobindo is yet to demonstrate its ability to effectively distribute these products in the regulated markets. Also, being one of the late entrants in regulated markets, Aurobindo would be competing on price, thereby compromising on profitability.

Anti-retrovirals: a sustainable volume play

The ARV opportunity is sizeable and largely an unmet one. Around 48m patients are infected with the HIV virus, of which around 90% are not treated. Moreover, an additional 3m people are infected each year. The demand for ARV drugs is thus expected to grow at a strong rate as initiatives, from sponsors like WHO, PEPFAR, the Clinton Foundation and Medicins sans Frontier, to increase access to low-cost drugs, gather momentum. This has resulted in a growth opportunity for low-cost manufacturers such as Aurobindo and other Indian companies.

The ARV business opportunity in the non-regulated markets (including Africa) is primarily driven by Western funding and a relaxation in IPR regulations. We believe that there is a huge unmet demand for ARVs in these markets. Most of the business is likely to be routed through WHO floated tenders resulting in long-term supply contracts at fixed prices. Hence, once full-fledged supplies commence (expected in FY07), it is likely to result in stable revenue streams for all the suppliers.

While we believe that ARVs would be a high-volume and low-margin business, we do not expect EBITDA margins to be substantially lower. We expect minimum sustainable EBITDA margins of about 15% for the ARV business, given low competition in this segment.

One of the strongest pipelines in ARV segment

During 1HFY07, Aurobindo's revenue from ARV and other business witnessed significant growth of 38% (to Rs1.96b). Aurobindo has geared up in the ARV segment as it has already received 18 approvals under the PEPFAR program, including 3 NDA approvals. Also, its products are also included in WHO's pre-qualification list. The company has made considerable progress in ARV business under the PEPFAR program, as it has one of the strongest pipelines in this segment. It is well positioned to benefit from increased funding towards anti-aids treatment. Aurobindo would be competing against players like Aspen (SA), Cipla, Ranbaxy etc. Although Aurobindo would be competitively well positioned due to its presence in manufacturing of APIs as well as formulations across most ARVs, its ability to garner orders based on tenders would determine upside arising out of this opportunity.

Valuation and view

Aurobindo's profitability in FY06 was under considerable pressure, impacted by lower Pen-G prices, higher fixed costs for R&D and regulatory filings. At the same time, rising debt and capex levels also tempered overall profitability and return metrics.

However, with significant scale up in regulated market revenues, coupled with lower dependence on its legacy pen-G based products (~53% of sales in 1HFY07 v/s 64.3% in 1HFY06) and a gradual improvement in prices of Pen-G based products, is expected to boost EBITDA margins going forward.

Aurobindo's initiatives for regulated markets, as reflected in the strong product pipeline, would result in continued momentum in regulated business. This coupled with one of the strongest product pipeline in the ARV segment would drive earnings growth in the near-to-medium term. However, given its high leverage and modest return ratios, valuations at 24.4x FY07E and 16.1x FY08E EPS (consolidated fully diluted) appear expensive. It should be noted that earnings may be boosted due to the company's policy of part-capitalization of R&D/product development expenses, particularly in the light of significantly higher number of product filings for regulated markets. Maintain **Sell** with our target price of Rs557.

Aurobindo Pharma: an investment profile

Company description

Aurobindo Pharma is primarily an API supplier with a small presence in formulations as well. The company's product portfolio is spread over six major product areas encompassing antibiotics, anti-retrovirals, CVS, CNS, gastroenterologicals, and anti-allergics) with around 65 APIs in non-antibiotics and over 55 APIs in the antibiotic segment. Aurobindo has always been focused on exports (supplies to over 100 countries) and is now focusing on increasing the share of formulation sales to the regulated markets.

Key investment argument

- Improving market mix in favor of regulated markets and from APIs to formulations, would improve growth rates and profitability over the long term.
- Improving product profile (shift from low-value to high-value APIs) in India and other unregulated markets would also improve profitability levels.
- Well placed to benefit from the ARV opportunity, given its very strong product pipeline.

Recent development

- Raised US$200m through a FCCB issue convertible at Rs1,014 (US$150m) and at Rs665 (US$50m).

Key investment risks

- Highly leveraged - consolidated debt estimated at Rs22b (excl US$200m FCCB in 1QFY07) in FY06.
- Being a late entrant, its ability to garner market share in the regulated market, compromising on margins would be the key challenge.
- Core business (Pen-G based APIs) is commoditized and hence unpredictable.

Valuation and view

- Valuations at 24.4x FY07E and 16.1x FY08E EPS (consolidated fully diluted) appear expensive, given its high leverage and modest return ratios.
- Maintain **Sell** with a target price of Rs557.

Sector view

- Regulated markets would remain the key sales and profit drivers in the medium term. Europe is expected to emerge as the next growth driver, particularly for companies with a direct marketing presence.
- We are overweight on companies that are towards the end of the investment phase, with benefits expected to start coming in from the next fiscal.

COMPARATIVE VALUATIONS

		AUROBINDO	LUPIN	WOCKHARDT
P/E(x)	FY07E	24.4	15.0	14.5
	FY08E	16.1	12.2	11.2
P/BV(x)	FY07E	3.3	4.2	3.8
	FY08E	2.7	3.3	3.0
EV/Sales(x)	FY07E	2.1	1.9	2.8
	FY08E	1.8	1.6	2.3
EV/EBITDA(x)	FY07E	14.0	11.4	12.4
	FY08E	9.7	9.1	9.1

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoter	55.4	55.8	55.8
Domestic Inst	6.5	6.4	8.8
Foreign	31.4	31.5	24.7
Others	6.6	6.3	10.7

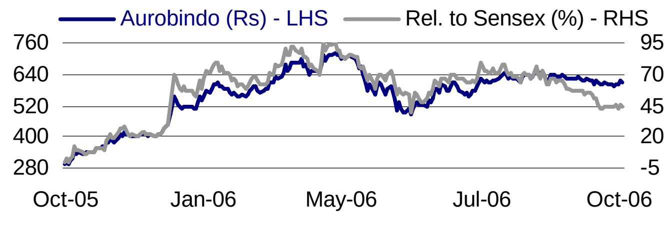
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	31.8	27.6	15.0
FY08	39.9	41.2	-3.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
609	557	-8.5	Sell

STOCK PERFORMANCE (1 YEAR)



CONSOLIDATED INCOME STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	**14,167**	**16,955**	**21,784**	**25,171**	**28,846**
Change (%)	*-3.3*	*19.7*	*28.5*	*15.6*	*14.6*
Total Expenditure	12,905	15,180	18,164	20,897	23,768
EBITDA	**1,262**	**1,775**	**3,620**	**4,274**	**5,078**
Margin (%)	*8.9*	*10.5*	*16.6*	*17.0*	*17.6*
Depreciation	647	721	844	957	992
Int. and Finance Charges	499	691	902	780	490
Other Income - Rec.	51	622	860	895	850
Profit before Taxes	**167**	**985**	**2,734**	**3,431**	**4,446**
Tax	130	274	492	618	800
Tax Rate (%)	*78.0*	*27.8*	*18.0*	*18.0*	*18.0*
Reported PAT	**37**	**711**	**2,242**	**2,814**	**3,646**
Change (%)	*-96.6*	*1,832.4*	*215.2*	*25.5*	*29.6*
Margin (%)	*0*	*4*	*10*	*11*	*13*
Minority Interest	4	14	67	84	109
Net Profits	**32**	**697**	**2,174**	**2,729**	**3,537**

CONSOLIDATED BALANCE SHEET					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Equity Share Capital	254	266	266	266	266
Fully Diluted Share Capital	*254*	*292*	*342*	*342*	*342*
Reserves	6,879	7,882	9,966	12,574	15,958
Net Worth	**7,132**	**8,149**	**10,232**	**12,840**	**16,225**
Minority Interest	12	24	92	176	285
Loans	10,340	13,731	23,206	19,633	17,633
Deferred liabilities	613	726	808	911	1,044
Capital Employed	**18,098**	**22,629**	**34,337**	**33,559**	**35,187**
Gross Block	10,727	13,562	15,062	16,062	17,562
Less: Accum. Deprn.	2,144	2,724	3,568	4,526	5,518
Net Fixed Assets	**8,583**	**10,838**	**11,493**	**11,536**	**12,044**
Capital WIP	2,525	1,497	500	500	500
Investments	2	3	3	3	3
Goodwill	0	0	0	0	0
Curr. Assets	**10,187**	**14,557**	**26,140**	**25,910**	**27,670**
Inventory	3,755	4,718	5,371	6,207	7,113
Account Receivables	4,533	5,822	7,162	8,275	9,484
Cash and Bank Balance	594	2,019	11,816	9,359	8,703
Others	1,305	1,997	1,790	2,069	2,371
Curr. Liability & Prov.	**3,200**	**4,265**	**3,799**	**4,389**	**5,030**
Account Payables	3,045	4,090	3,581	4,138	4,742
Provisions	155	175	218	252	288
Net Current Assets	**6,987**	**10,292**	**22,341**	**21,520**	**22,640**
Appl. of Funds	**18,098**	**22,629**	**34,337**	**33,559**	**35,187**

E: MOSt Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS (Fully Diluted)	**0.6**	**11.9**	**31.8**	**39.9**	**51.7**
Cash EPS (Fully Diluted)	13.4	24.3	44.1	53.9	66.1
BV/Share	140.5	153.0	192.1	241.1	304.6
DPS	0.5	0.8	0.8	1.0	1.3
Payout (%)	78.0	12.8	4.1	4.3	4.2
Valuation (x)					
P/E (Fully Diluted)	951.5	51.0	19.2	15.3	11.8
P/BV	4.3	4.0	3.2	2.5	2.0
EV/Sales	3.0	2.6	2.0	1.7	1.4
EV/EBITDA	33.4	24.9	12.1	10.0	8.1
Dividend Yield (%)	0.1	0.1	0.1	0.2	0.2
Return Ratios (%)					
RoE	0.5	8.6	21.3	21.3	21.8
RoCE	3.7	7.4	10.6	12.5	14.0
Working Capital Ratios					
Asset Turnover (x)	0.8	0.7	0.6	0.8	0.8
Debtor (Days)	117	125	120	120	120
Inventory (Day)	97	102	90	90	90
Leverage Ratio					
Debt/Equity (x)	1.4	1.7	2.3	1.5	1.1

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Oper. Profit/(Loss) before Ta	1,262	1,775	3,620	4,274	5,078
Interest/Dividends Recd.	51	622	860	895	850
Direct Taxes Paid	-39	-161	-410	-515	-667
(Inc)/Dec in WC	-83	-1,879	-2,253	-1,637	-1,776
CF from Operations	**1,191**	**357**	**1,817**	**3,018**	**3,486**
CF from Operating incl	**1,191**	**357**	**1,817**	**3,018**	**3,486**
(inc)/dec in FA	-2,743	-1,948	-503	-1,000	-1,500
(Pur)/Sale of Investments	54	0	0	0	0
CF from investments	**-2,689**	**-1,948**	**-503**	**-1,000**	**-1,500**
Issue of Shares	-113	408	0	0	0
Inc/(Dec) in Debt	2,110	3,390	9,476	-3,574	-2,000
Interest Paid	-499	-691	-902	-780	-490
Dividend Paid	-29	-91	-91	-121	-152
CF from Fin. Activity	**1,469**	**3,016**	**8,482**	**-4,475**	**-2,642**
Inc/Dec of Cash	**-29**	**1,425**	**9,797**	**-2,458**	**-656**
Add: Beginning Balance	623	594	2,019	11,816	9,359
Closing Balance	**594**	**2,019**	**11,816**	**9,359**	**8,703**

NOTES

For more copies or other information, contact
Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari
Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

Disclosure of Interest Statement	Aurobindo Pharma
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No