

# SUN PHARMACEUTICALS INDUSTRIES

Completed acquisition of Taro

## ■ Sun Pharma acquires controlling stake in Taro

Sun Pharma (SUNP) has acquired controlling stake in Taro, with the tendering of Taro promoters shares in SUNP's open offer for Taro shares. Post tendering of Taro promoter stake, SUNP now controls 48.7% stake in Taro, ex warrants, and voting rights of 65.8%. We estimate SUNP to have paid ~USD 37 mn for this stake, with a total acquisition value of USD 143mn.

## ■ Our view

We view this transaction as positive and a final closure on the long saga of Taro acquisition by SUNP. Taro's product portfolio of dermatology, topical and OTC products is complementary to SUNP's generic portfolio in the US and SUNP plans to leverage Taro's current manufacturing and R&D in Canada and Israel for new delivery systems. Taro's proprietary (branded) portfolio (including two NDAs) also provides a potential revenue stream for SUNP, with further upsides from NCE candidate T2000 (for essential tremor).

As per IFRS, we understand that SUNP would likely consolidate Taro to its accounts, despite holding only less than 50% stake in the company. Moreover, we are unclear on whether SUNP would exercise its option for 3.8 mn warrants at USD 6 per share, which would increase its stake to 53%.

As highlighted earlier, Taro's accounts for last two years are provisional and carry risk of restatement. However, on a provisional basis, annualizing H1CY10 Taro results, we estimate upsides of 4% and 7% to EPS in FY11 (six months) and FY12 respectively. We believe that there could be upsides to estimates, given possible potential for Taro margins to increase under SUNP management.

## ■ Outlook and valuations: Positive; maintain 'HOLD'

We maintain our "HOLD" rating on the stock, continuing to value core business earnings at 20x FY12E EPS (ex Taro) and assigning INR 20 per share to "one-off" non recurring sales. We would likely revisit our valuations for Taro (earlier INR 76 per share, valuing Taro at 1X CY09 sales for 100% stake) post more clarity on business outlook and potential accounting restatements in Taro, but highlight that we believe that Taro acquisition is a complementary acquisition with positive EPS impact on SUNP and has the potential for new revenue streams and operational efficiencies.

### Financials

Year to March	FY09	FY10	FY11E	FY12E
Revenues (INR mn)	41,833	40,066	48,189	52,503
Rev growth (%)	27.1	(4.2)	20.3	9.0
Operating profit (INR mn)	18,640	13,430	17,026	18,147
Net profit (INR mn)	18,177	13,511	16,213	18,370
Shares outstanding (mn)	207	207	207	207
EPS (INR)	64.7	46.5	68.6	83.8
EPS growth (%)	23.2	(28.1)	47.7	22.1
P/E (x)	29.9	41.5	28.1	23.0
EV/EBITDA (x)	19.8	27.3	21.0	19.0
ROE (%)	21.3	13.2	17.3	18.1

September 21, 2010

Reuters: SUN.BO Bloomberg: SUNP IN

### EDELWEISS 4D RATINGS

Absolute Rating	<b>HOLD</b>
Rating Relative to Sector	<b>Performer</b>
Risk Rating Relative to Sector	<b>Low</b>
Sector Relative to Market	<b>Equalweight</b>

Note:

Please refer last page of the report for rating explanation

### MARKET DATA

CMP	:	INR 1931
52-week range (INR)	:	1,947 / 1,185
Share in issue (mn)	:	207.1
M cap (INR bn/USD mn)	:	398 /8,704
Avg. Daily Vol. BSE/NSE ('000):	:	231.3

### SHARE HOLDING PATTERN (%)

Promoters*	:	63.7
MFs, FIs & Banks	:	6.0
FIIIs	:	19.5
Others	:	10.8
* Promoters pledged shares (% of share in issue)	:	0.4

### PRICE PERFORMANCE (%)

	Stock	Nifty	EW Pharma Index
1 month	8.6	8.6	7.0
3 months	10.9	12.2	5.6
12 months	62.6	20.8	53.9

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**Table 1: Taro acquisition to add 4-7% upsides to our FY11-12 estimates**

	SUNP	Taro	Adj. for other income	Proforma FY11E	% upside
Revenue	48,189	8,615		56,804	17.9
EBITDA	17,026	1,695		18,721	10.0
Margin (%)	35.3	19.7		55	
Reported PAT	16,213	1,349	(43)	17,519	8.1
Less: Minority interest in Taro				(674)	
Profit after minority interest	16,213			16,844	3.9
Shares o/s	207.1			207.1	
EPS dil	78.3			81.3	3.9

	SUNP	Taro	Adj. for other income	Proforma FY12E	% upside
Revenue	52,503	17,229		69,732	32.8
EBITDA	18,147	3,391		21,537	18.7
Margin (%)	35	19.7		54	
Reported PAT	18,270	2,698	(112)	20,855	14.2
Less: Minority interest in Taro				(1,349)	
Profit after minority interest	18,270			19,507	6.8
Shares o/s	207.1			207.1	
EPS dil	88.2			94.2	6.8

Source: Edelweiss research

Note: USD/INR rate of 46 assumed; Assuming 50% stake in Taro for consolidating financials

**Table 2: SUNP has invested USD 143 mn for a 48.7% stake in Taro**

Date	Event	No. of shares	Per share value (USD)	Total transaction value
18-May-07	As per merger agreement	3.8	6.00	23
19-May-07	As per merger agreement	3.0	6.00	18
02-Aug-07	Conversion of warrant 1	3.0	6.00	18
Jul-07	Open market	0.1		
19-Feb-08	Brandes	3.7	10.30	38
23-Jun-08	Harel Insurance Co	0.8	9.50	8
21-Sep-10	Under option agreement	4.9	7.75	38
<b>Total</b>		<b>19.3</b>		<b>143</b>
<b>% of total Taro shareholding</b>		<b>48.7</b>		

Source: Edelweiss research

Note: USD/INR rate of 46 assumed

**Table 3: SUNP has the option of increasing its stake by exercising warrants**

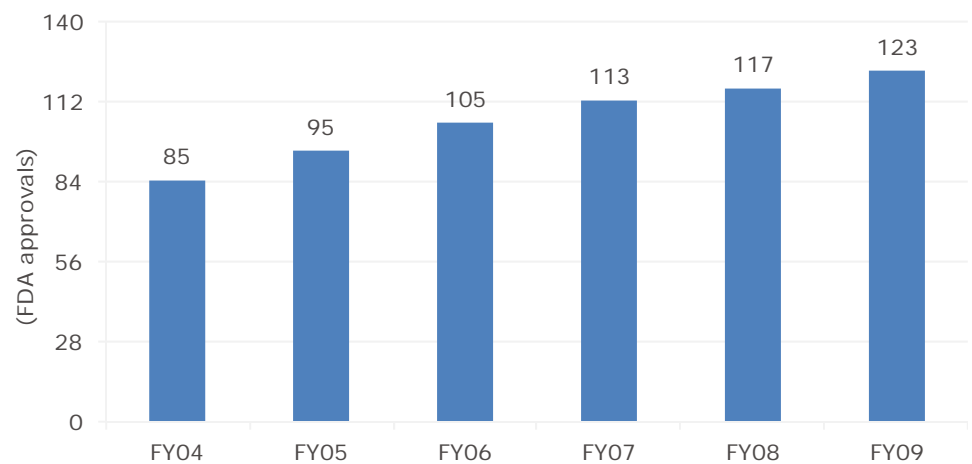
	(mn)
No. of shares in May (pre acquisition)	36.5
Add: Conversion of warrants 1	3.0
Sun option to convert warrant 2	3.8
Total no. of shares	43.3
<b>Potential no. of shares acquired by Sun</b>	
Total acquired (pre tender offer)	14.4
Add: shares acquired under option agreement	4.9
Total shares acquired (as on Sept 2010)	19.2
Add: Option for warrant 2	3.8
Total no. of shares	23.0
<b>% stake in Taro post tender offer</b>	<b>48.7</b>
<b>% stake if warrant 2 is exercised</b>	<b>53.2</b>

Source: Edelweiss research

**Table 4: Financial outflow for remaining shares**

	No of shares (mn)	Per share price (USD)	Amount invested (USD mn)
Current stake	14.4		105
Tender	4.9	7.8	38
Cash outflow post tender	19.3		143
Option for Warrant 2	3.8	6.0	23
Total cash outflow	23.1		165

Source: Edelweiss research

**Chart 1: Cumulative ANDA approvals of TARO**

Source: Edelweiss research

**Financial snapshot – Taro**
**(USD mn)**

	Q2CY10	Q2CY09	% chg	Q1CY10	% chg	CY07	CY08	CY09
Net sales	98	97	1.2	89	9.7	320	337	360
Cost of sales	41	39	6.2	38	8.9	133	147	155
Gross profit	57	58	(2.2)	51	10.3	186	189	206
<i>Gross margin (%)</i>	<i>57.8</i>	<i>59.8</i>		<i>57.5</i>		<i>58.3</i>	<i>56.3</i>	<i>57.0</i>
Research and Development	9	10	(4.6)	9	1.5	30	36	35
Selling, general and admin	28	28	(0.2)	25	8.9	97	99	104
Total operating expense	37	37	(1.3)	34	6.9	127	134	139
Operating income	20	21	(3.7)	17	17.1	59	55	66
<i>Operating margin (%)</i>	<i>20.3</i>	<i>21.3</i>		<i>19.0</i>		<i>18.5</i>	<i>16.4</i>	<i>18.4</i>
Financial expenses	2	2	30.3	1	91.1	23	18	9
Other income	4	(6)	(177.1)	(4)	(214.7)	4	19	(8)
Profit before tax	22	13	66.3	12	83.2	41	56	49
Taxes	3	1	353.1	2	90.1	6	12	5
Net Income (loss)	19	12	51.8	10	82.2	34	44	44
EPS								
- Basic	0.5	0.3		0.3		1.0	1.1	1.1
- Diluted	0.5	0.3		0.3		1.0	1.1	1.1

Balance sheet	Q2CY10	CY09
Cash	86	113
Debtors	99	94
Total assets	520	508
Payables	109	102
Debt	144	158
Networth	256	238
Total liabilities	520	508
Net debt / (cash)	58	45

### ■ Company Description

Promoted by Mr. Dilip S Shanghvi, a first generation entrepreneur, SUNP is India's 4th largest pharmaceutical company. It is also one of the fastest growing Indian pharmaceutical companies with revenue and profit growth of 26% CAGR and 30% CAGR over FY05/10 respectively. It also has one of the highest margins amongst its domestic peers. SUNP has a significant presence in the domestic formulation market and the US generic market. Indian domestic formulations sales, at INR 18 bn in FY10, constitute almost 45% of sales. With over 2,500 medical reps, SUNP has a market share of 3.7% and is a top 5 player in the Indian domestic market. It has been consistently ranked #1 across leading therapeutic categories like psychiatry, neurology and CVs.

### ■ Investment Theme

SUNP's core earnings from base business are expected to grow at CAGR of 34% in FY10-FY12E, led by strength in domestic business, export formulations (ex-caraco) and incremental sales from new products in US generics space. The earnings growth is also impacted from the lower base due to USFDA issues in Caraco, disproportionately impacting sales and earnings in FY10. While we do not build in early resumption in Caraco manufacturing sites, a favorable outcome will be potentially accretive by ~USD 50-60 mn to sales for FY11-12. One-off exclusivities (~16% of FY10 gross sales) would contribute NPV of ~20 per share to the base business value. Taro acquisition has been delayed due to pending litigation with promoter for an extended period. In-lieu of the recent favorable developments, we have factored in upsides from potential Taro acquisition in our valuation.

### ■ Key Risks

**Rupee appreciation:** Rapid rupee appreciation could impact our sales estimate, especially on international revenues which are currently based on a currency estimate of USD/INR of INR 44.5 and INR 43 for FY11E and FY12E respectively.

**Domestic sales growth faster than expected:** We expect SUNP's domestic formulation sales to grow at 16-18% in FY11-12E (after adjusting for INR 2 bn of channel sales in FY10). Any uptick from these estimates could have a positive impact on margins and estimates for base business.

**Regulatory issues:** Regulatory issues including product approval delays, unfavorable litigation outcomes and potential future adverse inspections from USFDA are structural negatives for SUNP.

## Financial Statements

### Income statement

(INR mn)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Income from operations	32,909	41,833	40,066	48,189	52,503
Gross revenues	34,606	43,751	40,762	49,023	53,411
Less: Excise	1,696	1,917	696	833	908
Net revenues	32,909	41,833	40,066	48,189	52,503
Total operating expenses	17,398	23,194	26,635	31,164	34,357
Materials cost	7,222	8,556	10,214	12,192	13,388
Employee cost	2,331	3,401	4,822	5,304	5,729
R&D cost	2,725	3,099	2,470	3,012	3,675
Selling, admin and general expenses	5,120	8,138	9,129	10,656	11,565
Operating Income	15,511	18,640	13,430	17,026	18,147
Depreciation and amortisation	969	1,233	1,533	1,699	1,848
EBIT	14,543	17,407	11,897	15,326	16,299
Interest expense/(income)	(1,146)	(1,277)	(1,139)	(953)	(1,800)
Other income	305	808	915	1,100	1,600
Profit before tax	15,994	19,492	13,951	17,379	19,699
Provision for tax	485	712	679	1,217	1,379
Core Profit	10,873	13,397	9,627	14,218	17,360
Profit after tax	15,509	18,780	13,470	16,163	18,320
Minority interest & others	640	603	(41)	(50)	(50)
Profit after minority interest	14,869	18,177	13,511	16,213	18,370
Equity shares outstanding (mn)	207	207	207	207	207
EPS (INR) Adjusted	71.8	87.8	64.3	78.3	88.2
Diluted shares (mn)	207	207	207	207	207
Recurring EPS (INR) fully diluted	52.5	64.7	46.5	68.6	83.8
CEPS (INR)	54.1	67.7	54.1	77.1	93.0
Dividend per share (INR)	10.5	13.8	11.1	13.3	15.0
Dividend payout (%)	14.6	15.7	17.2	16.9	17.0

### Common size metrics- as % of net revenues

Year to March	FY08	FY09	FY10	FY11E	FY12E
Cost of revenues	21.9	20.5	25.5	25.3	25.5
Selling, admin and general expenses	15.6	19.5	22.8	22.1	22.0
R & D cost	8.3	7.4	6.2	6.3	7.0
Total operating expenses	52.9	55.4	66.5	64.7	65.4
Depreciation and Amortisation	2.9	2.9	3.8	3.5	3.5
Interest expenditure	(3.5)	(3.1)	(2.8)	(2.0)	(3.4)
EBITDA margins	47.1	44.6	33.5	35.3	34.6
Net profit margins	33.0	32.0	24.0	29.5	33.1

### Growth metrics (%)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	58.0	27.1	(4.2)	20.3	9.0
EBITDA	130.8	20.2	(27.9)	26.8	6.6
Net profit	29.4	23.2	(28.1)	47.7	22.1
PBT	91.9	21.9	(28.4)	24.6	13.3
EPS	34.9	23.2	(28.1)	47.7	22.1

**Balance sheet****(INR mn)**

As on 31st March	FY08	FY09E	FY10	FY11E	FY12E
Equity capital	1,036	1,036	1,036	1,036	1,036
Reserves & surplus	48,879	69,414	74,695	87,748	102,537
Common shareholders equity	49,915	70,449	75,731	88,784	103,572
Total shareholders funds	49,915	70,449	75,731	88,784	103,572
Secured loans	368	364	364	364	364
Unsecured loans	1,068	1,425	1,425	1,425	1,425
Borrowings	1,436	1,789	1,789	1,789	1,789
Deferred tax liability (net)	92	(679)	(679)	(679)	(679)
Minority interest	1,886	1,970	1,970	1,970	1,970
<b>Sources of funds</b>	<b>53,328</b>	<b>73,530</b>	<b>78,811</b>	<b>91,864</b>	<b>106,653</b>
Gross block	15,960	21,476	24,747	26,747	29,247
Depreciation	5,607	6,851	8,384	10,083	11,931
Net block	10,354	14,625	16,363	16,664	17,316
Capital work in progress	686	1,571	-	-	-
Intangible assets & Goodwill	1,729	3,253	3,253	3,253	3,253
Investments	6,565	18,595	18,595	18,595	18,595
Inventories	7,728	9,757	10,180	12,542	13,665
Sundry debtors	14,177	8,811	12,120	13,203	14,384
Cash and bank balances	13,382	16,690	18,085	28,202	40,529
Loans and advances	4,762	6,983	7,333	7,699	8,084
Other current assets	320	441	441	441	441
Total current assets	40,368	42,683	48,159	62,088	77,104
Current liabilities	3,722	3,767	4,826	5,477	5,936
Provisions	2,651	3,431	2,733	3,259	3,681
Total current liabilities and provisions	6,373	7,198	7,559	8,736	9,616
Net current assets	33,995	35,485	40,600	53,352	67,488
<b>Uses of funds</b>	<b>53,328</b>	<b>73,530</b>	<b>78,811</b>	<b>91,864</b>	<b>106,653</b>
Book value per share ( INR)	241	340	366	429	500

**Free cash flow****(INR mn)**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	14,869	18,177	13,511	16,213	18,370
Depreciation	969	1,233	1,533	1,699	1,848
Others	(967)	(649)	(41)	(50)	(50)
Gross cash flow	14,871	18,762	15,003	17,862	20,168
Less: Changes in WC	(7,572)	1,818	(3,720)	(2,635)	(1,809)
Operating cash flow	7,299	20,580	11,283	15,228	18,358
Less: Capex	(1,886)	(6,390)	(1,700)	(2,000)	(2,500)
Free cash flow	5,413	14,190	9,583	13,228	15,858

**Cash flow metrics**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating cash flow	7,299	20,580	11,283	15,228	18,358
Financing cash flow	6,429	12,432	(8,188)	(3,110)	(3,532)
Investing cash flow	(7,973)	(21,468)	(1,700)	(2,000)	(2,500)
Net cash flow	5,755	11,544	1,394	10,118	12,327
Capex	(1,886)	(6,390)	(1,700)	(2,000)	(2,500)
Dividends paid	(2,547)	(3,215)	(2,633)	(3,160)	(3,582)

**Profitability and liquidity ratios**

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	26.4	21.3	13.2	17.3	18.1
ROACE (%)	34.5	34.2	20.7	23.0	20.2
Inventory days	363	373	356	340	357
Debtors days	116	100	95	96	96
Payable days	169	160	154	154	156
Cash conversion cycles	310	313	298	282	298
Current ratio	6.3	5.9	6.4	7.1	8.0
Debt/ EBITDA	0.1	0.1	0.1	0.1	0.1

**Operating ratios (x)**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Total asset turnover	0.7	0.7	0.5	0.6	0.5
Fixed asset turnover	3.3	3.3	2.6	2.9	3.1
Equity turnover	0.8	0.7	0.5	0.6	0.5

**Du pont analysis**

Year to March	FY08	FY09	FY10	FY11E	FY12E
NP margin (%)	31.1	30.6	24.1	29.6	33.2
Total assets turnover	0.7	0.7	0.5	0.6	0.5
Leverage multiplier	1.2	1.1	1.0	1.0	1.0
ROAE (%)	26.4	21.3	13.2	17.3	18.1

**Valuation parameters**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	52.5	64.7	46.5	68.6	83.8
EPS Y-o-Y growth (%)	34.9	23.2	(28.1)	47.7	22.1
CEPS (INR)	54.1	67.7	54.1	77.1	93.0
Diluted PE (x)	36.8	29.9	41.5	28.1	23.0
Price/BV(x)	8.0	5.7	5.3	4.5	3.9
EV/Sales (x)	11.6	8.8	9.2	7.4	6.6
EV/EBITDA (x)	24.7	19.8	27.3	21.0	19.0
Dividend yield (%)	0.5	0.7	0.6	0.7	0.8
Basic Shares O/S	207.1	207.1	207.1	207.1	207.1
Basic EPS	52.5	64.7	46.5	68.6	83.8
Basic P/E	36.8	29.9	41.5	28.1	23.0





## RATING & INTERPRETATION

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Aurobindo Pharma	BUY	SO	H	Cipla	REDUCE	SU	L
Dr.Reddys Laboratories	HOLD	SO	M	Lupin	BUY	SO	M
Piramal Healthcare	BUY	SU	H	Sun Pharmaceuticals Industries	HOLD	SP	L
Torrent Pharmaceuticals	BUY	SO	H				

### ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

### RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

### RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

### SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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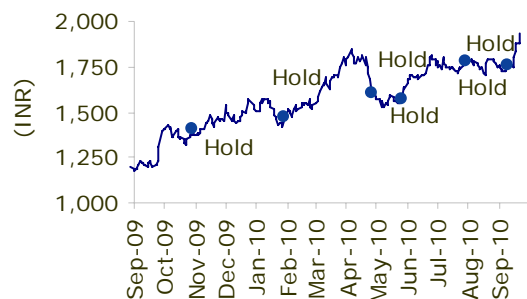
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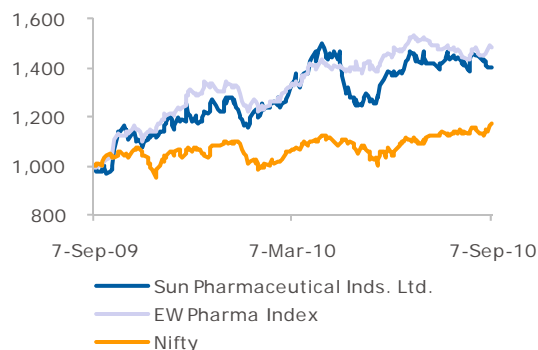
## Coverage group(s) of stocks by primary analyst(s): Pharmaceuticals

Aurobindo Pharma, Cipla, Dr.Reddys Laboratories, Lupin, Piramal Healthcare, Sun Pharmaceuticals Industries, Torrent Pharmaceuticals

### Sun Pharmaceuticals Industries



### EW Indices



### Distribution of Ratings / Market Cap

#### Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	116	45	12	176
* 3 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	110	53	13	

### Recent Research

Date	Company	Title	Price (INR)	Recos
08-Sep-10	Sun Pharmaceuticals	Likely denouement in Taro saga; Event Update	1723	Hold
02-Sep-10	Shasun Pharmaceuticals	Interesting times ahead; Visit Note	81	Not Rated
26-Aug-10	Apollo Hospitals	Strong play on domestic healthcare; Visit Note	812	Not Rated

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