Company Focus

7 March 2008 | 7 pages

Cipla (CIPL.BO)

Sell: No Respite in Sight

- **Maintain Sell (3L) —** as the core business continues to be hit by rupee appreciation, stiff competition & adverse shift in product mix. We believe Cipla's supply-based model is vulnerable, given the shift in bargaining power towards the larger & more consolidated set of buyers.
- **Multiple pressures —** We expect continued pressure on profitability, given the strengthening rupee, higher cost of imports from China, rising staff costs & pricing pressure in key markets. We believe Cipla would find it difficult to grow revenues in excess of 15% in the absence of exclusivity supplies to partners. Moreover, with a large part of the growth coming from low-margin ARV sales to less regulated markets, we expect the pressure on margins to sustain.
- **Capital efficiency falling —** Declining profitability combined with aggressive capex plans (cRs9.5bn over FY08-09) & falling asset turnover reflects in rapidly falling capital efficiency ratios. We expect Cipla's RoAE and RoACE to decline from 25.6% & 27% in FY07 to 17.2% and 19.8% in FY10E
- **We expect multiple contraction** — Cipla's valuations are not attractive relative to the value add in the business. With growth rates tapering off & capital efficiency under pressure, we believe current multiples will not sustain. While exclusivity opportunities for its partners could provide the occasional surprise, we note that these are unsustainable & should not impact valuations materially.
- **Potential catalysts** — Cipla has supply agreements with 10 US companies for c124 products, some of which are patent challenges. Supplies during exclusivity would lead to a scale up in sales & margins (a la 9mFY07)

Sell/Low Risk	3L
Price (05 Mar 08)	Rs205.45
Target price	Rs181.00
Expected share price return	-11.9%
Expected dividend yield	1.1%
Expected total return	**-10.8%**
Market Cap	Rs159,695M US$3,971M

Price Performance (RIC: CIPL.BO, BB: CIPLA IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	6,076	8.11	48.4	25.3	7.8	34.4	1.0
2007A	6,680	8.59	6.0	23.9	4.9	25.6	1.0
2008E	6,730	8.66	0.7	23.7	4.3	19.4	1.1
2009E	7,018	9.03	4.3	22.8	3.8	17.7	1.1
2010E	7,795	10.03	11.1	20.5	3.4	17.4	1.2

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)	25.3	23.9	23.7	22.8	20.5
EV/EBITDA adjusted (x)	24.3	18.9	18.7	17.1	15.4
P/BV (x)	7.8	4.9	4.3	3.8	3.4
Dividend yield (%)	1.0	1.0	1.1	1.1	1.2
Per Share Data (Rs)					
EPS adjusted	8.11	8.59	8.66	9.03	10.03
EPS reported	8.11	8.59	8.66	9.03	10.03
BVPS	26.46	41.63	47.78	54.17	61.27
DPS	2.07	2.00	2.16	2.26	2.51
Profit & Loss (RsM)					
Net sales	29,753	35,620	41,133	45,954	51,732
Operating expenses	-23,862	-28,140	-33,910	-38,186	-43,177
EBIT	**5,891**	**7,480**	**7,223**	**7,768**	**8,555**
Net interest expense	-114	-70	-104	-88	-58
Non-operating/exceptionals	380	658	1,038	827	951
Pre-tax profit	**6,157**	**8,069**	**8,158**	**8,507**	**9,449**
Tax	-1,022	-1,400	-1,428	-1,489	-1,653
Extraord./Min.Int./Pref.div.	942	11	0	0	0
Reported net income	**6,076**	**6,680**	**6,730**	**7,018**	**7,795**
Adjusted earnings	6,076	6,680	6,730	7,018	7,795
Adjusted EBITDA	6,693	8,514	8,532	9,357	10,340
Growth Rates (%)					
Sales	32.0	19.7	15.5	11.7	12.6
EBIT adjusted	33.8	27.0	-3.4	7.5	10.1
EBITDA adjusted	35.1	27.2	0.2	9.7	10.5
EPS adjusted	48.4	6.0	0.7	4.3	11.1
Cash Flow (RsM)					
Operating cash flow	**2,743**	**2,621**	**4,781**	**8,696**	**4,837**
Depreciation/amortization	802	1,034	1,310	1,589	1,785
Net working capital	-4,135	-5,093	-3,259	89	-4,742
Investing cash flow	**-3,652**	**-5,146**	**-3,668**	**-6,321**	**-1,957**
Capital expenditure	-3,610	-4,192	-4,500	-5,000	-3,000
Acquisitions/disposals	-41	-954	832	-1,321	1,043
Financing cash flow	**1,850**	**3,166**	**-1,132**	**-3,540**	**-4,045**
Borrowings	2,777	-3,454	837	-323	-600
Dividends paid	-1,773	-1,819	-1,968	-2,053	-2,280
Change in cash	**942**	**641**	**-18**	**-1,165**	**-1,165**
Balance Sheet (RsM)					
Total assets	**34,583**	**44,137**	**51,079**	**56,298**	**62,930**
Cash & cash equivalent	669	2,493	846	2,166	1,124
Accounts receivable	8,760	10,288	11,677	13,121	15,069
Net fixed assets	11,436	14,613	17,803	21,214	22,429
Total liabilities	**14,751**	**11,775**	**13,936**	**14,189**	**15,306**
Accounts payable	8,132	7,130	8,162	8,534	9,947
Total Debt	4,689	1,236	2,073	1,750	1,150
Shareholders' funds	**19,833**	**32,363**	**37,143**	**42,108**	**47,623**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	22.5	23.9	20.7	20.4	20.0
ROE adjusted	34.4	25.6	19.4	17.7	17.4
ROIC adjusted	22.7	21.3	16.2	15.3	15.1
Net debt to equity	20.3	-3.9	3.3	-1.0	0.1
Total debt to capital	19.1	3.7	5.3	4.0	2.4

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Cipla

Company description

Cipla is a leading pharmaceutical company in India with a strong and profitable business model. The company has a well-diversified portfolio, without any overdependence on a particular segment. It has developed a strong presence in the export market — both in developed and developing countries — and has products registered in more than 140 countries. Furthermore, it has been at the forefront in reverse engineering the latest drugs and active pharmaceutical ingredients. The company has focused its R&D efforts on profitable projects, and tied up with the local players in various markets to de-risk its business model. However, the company lags its peers in discovery-led research. Cipla's business model also represents a low-risk model with the commensurate returns also being moderate.

Investment strategy

We rate Cipla Sell (3L) with a target price of Rs181/share. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, Cipla could face an increasingly uncertain global environment, if the current consolidation process gathers momentum. Its partners, which appear inherently tied up because of their weak product capabilities, may get acquired and the acquirers may not want to source drugs from Cipla. We think Cipla's business model lacks significant value addition, both in terms of innovative research as well as control over the front end in the US and European generics markets. We believe that any re-rating will be contingent on the company making fresh forays into these areas and / or getting acquired at a significant premium. Since the pricing pressure has not been waning in the US or Europe, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players. Cipla, being one of the weaker parts of the supply chain, will bear the brunt, in our view.

Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs181 is based on 20x March 09E earnings. Historically, the stock has traded at 15-30x forward earnings. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector, justified by the lower value addition to the business (lack of its own front-end in the regulated markets and ownership of IPR). There are few signs of this changing. Our target multiple for Cipla's base business is therefore at a 10% discount to the multiple (20x) that we use for its peers such as Ranbaxy, Dr Reddy's and Sun Pharma. However, while we value the latter's patent challenge opportunities separately from the base business, we are unable to do the same for Cipla, given the lack of information on its tie-ups with different partners. Hence, we apply a higher multiple of 20x to base business earnings to factor in any potential "one-off" upsides that may come through from time to time.

Risks

We rate Cipla as Low Risk, as the company has a steadily growing base business and has a visible earning stream. The ongoing dispute regarding alleged overcharging for seven drugs in the domestic market could result in significant cash outflow as well as could impact future profitability. Global consolidation is a risk to the company's supply based model. The new drug policy, if implemented in the current form could also hurt earnings. Key upside risks to our rating and target price include: a) the company doing better operationally than forecast; b) any move to front-end in target markets could give further support to current high valuations; c) any exclusivity for its partners could also sustain the growth momentum beyond our expectations.

Appendix A-1

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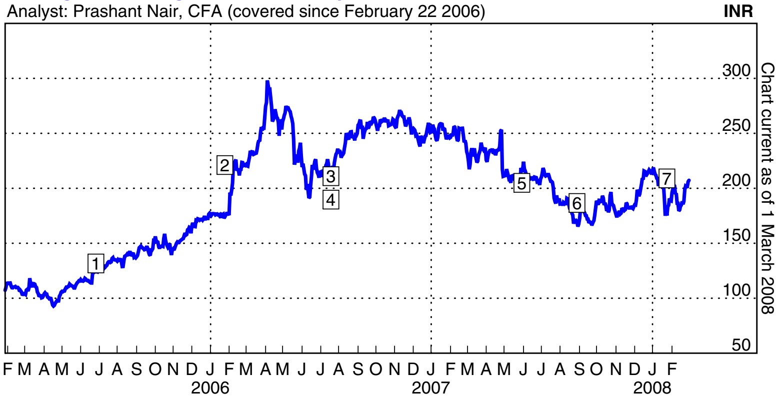
Cipla (CIPL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since February 22 2006)



#	Date	Rating	Target Price	Closing Price
1:	27 Jun 05	3L	*116.00	124.12
2:	25 Jan 06	3L	*65.60	174.06
3:	19 Jul 06	3L	*170.00	212.45
4:	19 Jul 06	3L	170.00	212.45
5:	30 May 07	3L	*191.00	214.75
6:	29 Aug 07	3L	*165.00	169.75
7:	24 Jan 08	3L	*181.00	175.20

*Indicates change.

Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

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