Company Focus

7 March 2008 | 9 pages

Glaxosmithkline Pharmaceutical (GLAX.BO)

Target price change ☑

Sell: Still a Long Haul

- **Lower TP to Rs1,100** — as we cut our target multiple to 20x (from 25x) & roll over to March'09E earnings. While GSK would benefit from the stricter IPR regime in India, the uncertainties & delays on this front appear higher than we anticipated earlier. As such, given GSK's already large base, tangible upside to financials would reflect only over the very long term. In the interim, we expect earnings growth to remain tepid & high valuations are unlikely to sustain. (*From hereon, Chirag Dagli is the analyst with primary coverage of this stock*.)
- **A long haul** — Although GSK is set to launch its first product (Tykerb) with patent protection in mid CY08, it expects to launch only 5 patented products over CY08-10. Given that none of these are likely to clock sales in excess of Rs250-300m by the 3rd year, we expect a significant lag before patent protection results in any material step up in overall growth rates & profitability.
- **Uncertainties continue** — over patentability in India with several patents being challenged pre/post grant by Indian firms. Government intervention in pricing is another potential risk. It also remains to be seen how profitable the patented products are for GSK as most of them would be imported from the parent.
- **Tepid growth** — pharma sales & PBIT grew 7% & 12% respectively in CY07, while most peers clocked double digit growth, as GSK lagged behind in product launches. We expect a mere 13% CAGR in recurring PAT (CY07-09E) as margins have peaked & patented launches are unlikely to contribute materially.
- **Fairly priced** — At 21x CY08E EPS & 13% EPS CAGR over CY07-09E, we believe the stock builds in a fair amount of option value for the upside from patented launches & expect it to remain a laggard.

Sell/Low Risk	3L
Price (05 Mar 08)	Rs1,117.25
Target price	Rs1,100.00
from Rs1,273.00	
Expected share price return	-1.5%
Expected dividend yield	3.2%
Expected total return	**1.7%**
Market Cap	Rs94,634M
	US$2,353M

Price Performance (RIC: GLAX.BO, BB: GLXO IN)

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	3,063	36.16	18.7	30.9	10.0	32.7	2.5
2006A	3,617	42.71	18.1	26.2	7.9	33.8	2.8
2007E	4,002	47.25	10.6	23.6	7.9	33.3	3.2
2008E	4,499	53.12	12.4	21.0	8.2	38.2	4.8
2009E	5,122	60.47	13.8	18.5	8.7	45.9	5.4

Source: Powered by dataCentral

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

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	30.9	26.2	23.6	21.0	18.5
EV/EBITDA adjusted (x)	19.3	16.8	15.7	14.6	12.6
P/BV (x)	10.0	7.9	7.9	8.2	8.7
Dividend yield (%)	2.5	2.8	3.2	4.8	5.4
Per Share Data (Rs)					
EPS adjusted	36.16	42.71	47.25	53.12	60.47
EPS reported	59.28	64.41	63.53	53.12	60.47
BVPS	111.99	141.05	142.32	135.50	127.73
DPS	28.00	31.00	36.00	53.12	60.47
Profit & Loss (RsM)					
Net sales	14,995	15,754	15,972	17,059	19,296
Operating expenses	-10,723	-10,921	-10,887	-11,632	-12,994
EBIT	**4,271**	**4,833**	**5,085**	**5,427**	**6,302**
Net interest expense	-7	-7	0	0	0
Non-operating/exceptionals	515	734	1,032	1,442	1,518
Pre-tax profit	**4,779**	**5,560**	**6,116**	**6,869**	**7,820**
Tax	-1,716	-1,942	-2,115	-2,370	-2,698
Extraord./Min.Int./Pref.div.	1,958	1,838	1,379	0	0
Reported net income	**5,021**	**5,455**	**5,381**	**4,499**	**5,122**
Adjusted earnings	3,063	3,617	4,002	4,499	5,122
Adjusted EBITDA	4,429	4,992	5,247	5,589	6,464
Growth Rates (%)					
Sales	8.4	5.1	1.4	6.8	13.1
EBIT adjusted	14.6	13.2	5.2	6.7	16.1
EBITDA adjusted	13.5	12.7	5.1	6.5	15.7
EPS adjusted	18.7	18.1	10.6	12.4	13.8
Cash Flow (RsM)					
Operating cash flow	**6,111**	**4,812**	**6,152**	**6,009**	**5,692**
Depreciation/amortization	157	159	162	162	162
Net working capital	1,005	-354	609	1,348	408
Investing cash flow	**-3,417**	**-2,077**	**-823**	**-932**	**88**
Capital expenditure	-113	-338	-150	-150	-150
Acquisitions/disposals	-2,100	400	0	0	0
Financing cash flow	**-4,814**	**-3,001**	**-3,386**	**-5,078**	**-5,780**
Borrowings	-10	-7	55	0	0
Dividends paid	-2,704	-2,994	-3,441	-5,078	-5,780
Change in cash	**-2,120**	**-266**	**1,943**	**0**	**0**
Balance Sheet (RsM)					
Total assets	**15,016**	**17,661**	**17,816**	**18,843**	**19,135**
Cash & cash equivalent	9,606	11,744	12,418	13,199	12,961
Accounts receivable	674	604	688	734	829
Net fixed assets	969	945	933	921	910
Total liabilities	**5,530**	**5,714**	**5,760**	**7,366**	**8,316**
Accounts payable	2,576	2,477	2,691	2,847	3,174
Total Debt	49	55	0	0	0
Shareholders' funds	**9,486**	**11,947**	**12,055**	**11,477**	**10,819**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	29.5	31.7	32.8	32.8	33.5
ROE adjusted	32.7	33.8	33.3	38.2	45.9
ROIC adjusted	nm	nm	na	na	na
Net debt to equity	-100.8	-97.8	-103.0	-115.0	-119.8
Total debt to capital	0.5	0.5	0.0	0.0	0.0

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Still A Long Haul

We maintain our Sell, Low Risk (3L) rating on the stock despite the significant underperformance over the last year. We reduce our target price to Rs1,100/share as we cut our target multiple to 20x (from 25x) & roll over to March'09E earnings. While GSK would benefit from the stricter IPR regime in India, the uncertainties & delays on this front appear higher than we anticipated earlier. As such, given GSK's already large base, tangible upside to financials would reflect only over the very long term. In the interim, we expect earnings growth to remain tepid & high valuations are unlikely to sustain.

Reducing Price Target to Rs1,100/share

We reduce our price target to Rs1,100/share as we cut our target multiple to 20x from 25x earlier and roll forward to March '09E earnings. We believe a lower multiple is warranted on account of the following factors:

- **Uncertainties in the patented opportunity** – The upside from the introduction of product patents in India is playing out slower than we anticipated earlier. Indian companies have opposed patent grants vigorously and we expect this to continue. The instance of Cipla launching a generic version of Tarceva "at risk" without even going through the pre or post patent opposition route reflects the kind of hurdles that MNC Pharma companies could likely face going forward. Given that these products are not blockbusters in India, the cost of litigation may not seem as negligible in the overall scheme of things for these companies as it is for their parents in the more regulated markets.

- **Limited upside in the medium term** – GSK outlined its plans to launch patented products in India at its recent analyst meet. It is set to launch its first product with patent protection (Tykerb) in mid CY08. While this is positive for sentiment and shows its intent to treat India as one of its key markets, the pipeline is not very exciting. The company expects to launch only five patented products (2 of them inlicensed) over the next three years. We do not expect any of these products to clock revenues in excess of Rs250-300m in the third year of launch – implying that sales from products with patent protection would remain quite low over the medium term. As such, we expect a significant lag before patent protection results in any material step up in overall growth rates & profitability

In this context, we believe that a P/E multiple of 20x is fair given the company's tepid earnings CAGR of 13% over CY07-09E, dividend yield of c3% and to build in some option value for the back ended upside from introduction of product patents in India.

Glaxosmithkline Pharmaceutical

Company description

SKB Pharmaceutical (India) was merged with Glaxo India in 2001 to become Glaxo SmithKline Pharmaceuticals following the merger of their parents in 2000. Post-merger, GSK Pharmaceuticals is the largest pharmaceutical company in India. The company sells branded formulations in almost all product categories, mainly anti-infective, pain management and vitamins. However, a large part of the company's portfolio is under DPCO coverage, limiting sales and profitability growth. The merged entity has been carrying out a restructuring exercise and has evolved a strategy to grow profits ahead of sales and to maintain market leadership. The company is looking to achieve these by rationalizing its product portfolio, controlling costs and reducing business.

Investment strategy

We rate GSK Pharma Sell/Low Risk (3L) with a target price of Rs1,100/share (v/s Rs1,273/share earlier). The stock has declined considerably over the last year as high valuations corrected to more reasonable levels. We believe that current multiple remains high despite the optimism over product patents in India. While near-term opportunities that could get exclusivity in India are few, we believe the company will benefit from CY08 onwards. However, we need to see government clarification on several issues relating to the product patent regime. The government has to make sure that a proper infrastructure and legal framework exists to address contentious legal issues. In the interim, the company has been strengthening its marketing and distribution setup. On the product front, the company's strategy is premised on focusing on its top 30 products, which are growing fast and are not under price control. These 30 products enjoy margins that are thrice that of the price-controlled products, which has led to an overall improvement in profitability. We expect steady profitability trends. If India adheres to the patent regime in earnest, we believe the company could also gain from outsourcing work from its parent for clinical trials to be conducted in India. The parent could also invest in creating research-based assets in India. However, it needs to be seen how these would be structured - whether in the listed entity, in the 100% subsidiary or through a profit-sharing agreement.

Valuation

Our target price of Rs1,100/share (Rs1,273/share earlier) is based on 20x March'09E (v/s 25x June'08E earlier) earnings. Given its steady earnings growth, we believe P/E is best suited to value GSK Pharma. GSK has traded at 20-60x in the past six to seven years. We were using a multiple of 25x earlier to value the stock on account of the visibility over the company's intent to launch patented products and to build in some option value for the patented opportunity. However, over the last year, we have seen a delay in launch of patented products as well as higher uncertainty over the issue of patentability in India. While we expect things to get clearer over the next 1-3 years, we believe that the upside on this front is likely to be limited in the medium term. As such, we believe valuing GSK at the lower end of its historic P/E range is appropriate and use a multiple of 20x.

Risks

We rate GSK Pharma as Low Risk in view of the company's profitable and growing business base in India. This is consistent with our quantitative risk-rating system. The upside risks to our rating include:

a) earlier-than-expected benefits from patented launches; we expect the first launch in CY08E; however, material benefits to start coming through only beyond CY10. b) Significant benefits from relaxation of price control norms.

GSK has around 30% of its revenues coming from price controlled products and if this goes down, profitability could improve considerably. Any sustainable recovery in the Indian market growth rate could lead to faster-than-expected growth in GSK's revenues and profits.

Appendix A-1

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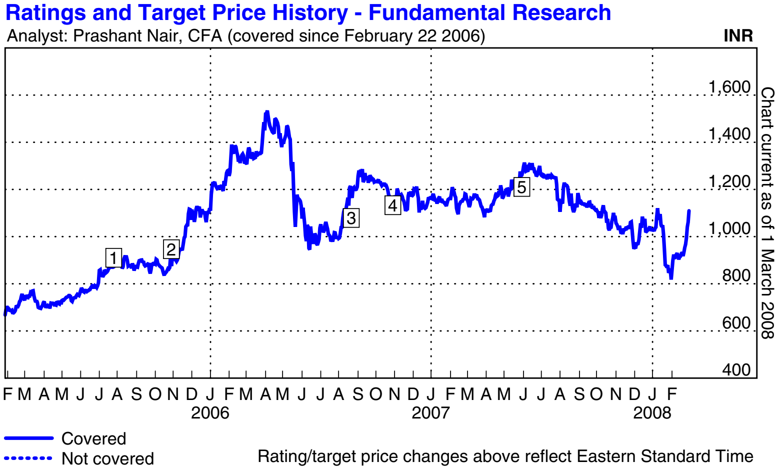
Glaxosmithkline Pharmaceutical (GLAX.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	26 Jul 05	*3L	*822.00	871.75
2:	28 Oct 05	3L	*857.00	875.05
3:	22 Aug 06	3L	*1,107.00	1,178.80
4:	30 Oct 06	3L	*1,143.00	1,133.10
5:	30 May 07	3L	*1,273.00	1,261.00

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% of companies in each rating category that are investment banking clients	52%	53%	40%

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