Matrix Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,063	HDPH IN
	REUTERS CODE
S&P CNX: 2,663	MAXL.BO

Equity Shares (m)	153.6
52-Week Range	313/163
1,6,12 Rel. Perf. (%)	0/-3/-25
M.Cap. (Rs b)	32.0
M.Cap. (US$ b)	0.7

13 June 2006

Buy

Previous Recommendation: Buy

Rs209

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	11,586	1,358	8.8	9.0	23.6	3.4	25.3	13.8	3.7	32.3
03/07E	16,442	1,830	11.9	34.8	17.5	2.9	17.7	14.0	2.4	16.2
03/08E	18,440	2,286	14.9	24.9	14.0	2.4	18.8	16.6	2.1	13.4

Matrix' stand-alone performance for 4QFY06 was lower than expectation with sales growth of just 4.2% to Rs1.6b and EBITDA margins declining by 940bp to 13%. Key highlights of results and conference call includes:

- Net sales during 4QFY06 grew just by 4.2% YoY to Rs1.6b. Higher RM cost (at 56.3% of sales v/s 51.5% in 4QFY05) and higher R&D cost (up by 139% YoY) resulted in 940bp decline in EBITDA margins to 13%. However, higher other income (up by 95%) and tax write back (of Rs16m v/s tax expense of Rs78m in 4QFY05) boosted net profit growth to 7.3% to Rs307m.
- On consolidated basis, the company reported net sales of Rs3.9b and PAT of Rs372m for 4QFY06. For FY06, consolidated net sales stood at Rs11.6b and PAT at Rs2b, including a one-time other income of Rs634m (post-tax) mainly on account of profit on transfer of ARV facility to Astrix JV.
- Matrix plans to divest the medical supplies business of DocPharma (~Rs2.1b revenues) and use the proceeds and internal accruals to repay around US$100m of US$200m loan which it had taken to acquire DocPharma.
- Going forward, growth is expected to be driven by new product launches in the US market (10 new APIs) and in Belgium and Netherlands (8 product launches by DocPharma) in FY07 and increased traction in ARV business, resulting in revenue CAGR of 26% (FY06-08). We also expect part-benefits of manufacturing synergies with Docpharma to be visible in FY07E. Matrix is currently valued at 17.5x FY07E and 14x FY08E consolidated earnings. Maintain **Buy**.

QUARTERLY PERFORMANCE (STANDALONE) (Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Net Sales	**1,540**	**1,625**	**1,661**	**1,546**	**1,543**	**1,744**	**2,056**	**1,611**	**6,375**	**6,671**
YoY Change (%)	*28.2*	*20.5*	*21.1*	*9.9*	*0.2*	*7.3*	*23.8*	*4.2*	*20.3*	*4.6*
Total Expenditure	1,072	1,083	1,289	1,200	1,373	1,418	1,689	1,402	4,631	5,835
EBITDA	**468**	**541**	**372**	**346**	**170**	**326**	**367**	**209**	**1,744**	**836**
Margins (%)	*30.4*	*33.3*	*22.4*	*22.4*	*11.0*	*18.7*	*17.8*	*13.0*	*27.3*	*12.5*
Depreciation	34	36	44	58	54	55	59	55	191	223
Interest	12	49	9	8	11	17	26	28	63	82
Other Income	26	61	37	84	178	100	390	165	147	833
PBT before EO exp	**447**	**518**	**355**	**364**	**284**	**354**	**672**	**291**	**1,637**	**1,364**
EO Exp/(Inc)	0	0	0	0	0	0	-753	0	0	-753
PBT after EO Exp	**447**	**518**	**355**	**364**	**284**	**354**	**1,425**	**291**	**1,637**	**2,117**
Taxes	40	98	100	78	31	47	48	-16	317	293
Rate (%)	*8.9*	*18.9*	*28.1*	*21.4*	*10.9*	*13.4*	*7.1*	*-5.6*	*19.4*	*21.5*
Reported PAT	**407**	**420**	**256**	**286**	**253**	**307**	**1,377**	**307**	**1,320**	**1,824**
Adjusted PAT	**407**	**420**	**256**	**286**	**253**	**307**	**624**	**307**	**1,320**	**1,071**
YoY Change (%)	*32.7*	*30.8*	*-23.5*	*-25.5*	*-37.9*	*-26.9*	*438.8*	*7.3*	*5.9*	*38.2*
Margins (%)	*26.5*	*25.8*	*15.4*	*18.5*	*16.4*	*17.6*	*67.0*	*19.1*	*20.7*	*27.3*

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Decline in domestic sales restricts revenue growth

Net sales (stand-alone) during 4QFY06 grew just by 4.2% YoY to Rs1.6b, as domestic sales during the quarter declined by 65% to Rs321m. However, export sales grew by 103% YoY to Rs1.3b driven by higher ARV sales.

BUSINESS BREAK UP (RS M)

	4Q FY06	4Q FY05	YOY GR (%)	3Q FY06	QOQ GR (%)
Exports	1,290	635	102.9	1,123	14.8
Contribution (%)	*80.1*	*41.1*		*54.6*	
Net domestic sales	321	910	-64.7	933	-65.6
Contribution (%)	*19.9*	*58.9*		*45.4*	
Net sales	**1,611**	**1,546**	**4.2**	**2,056**	**-21.7**

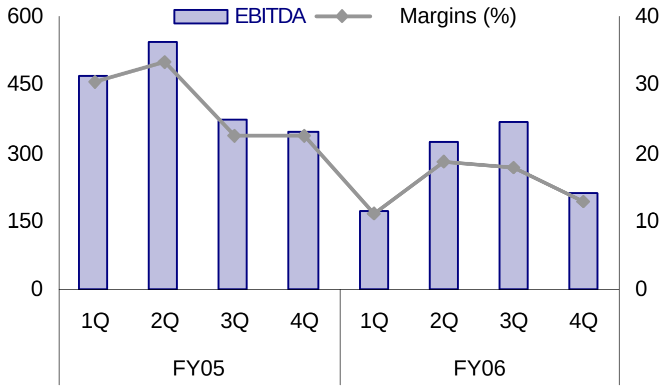
Source: Company/Motilal Oswal Securities

This is the first quarter of consolidation of all subsidiaries/ JVs. The consolidated net sales for 4QFY06 stood at Rs3.9b, where as for FY06 net sales were at Rs11.6b. DocPharma reported sales of EUR29.1m (approx. Rs1.55b) for the quarter recording a growth of 13.7%, while for FY06 (9M) DocPharma sales grew by 8.5% to EUR77.8m. Docpharma's performance was adversely impacted as only 2 of the proposed 10 products were launched by the company. Approvals for the remaining products have been delayed and launch is expected in H1FY07.

Higher RM cost and R&D expense impacts margins

EBITDA margins (stand-alone) declined by 940bp to 13% resulting in 40% decline in EBITDA to Rs209m. EBITDA margins were impacted by higher RM cost (at 56.3% of sales v/s 51.5% in 4QFY05) and higher R&D cost (up by 139% YoY). Matrix has booked an income of Rs66.2m (included in other income) as income from patent litigation settlement. This income stream is likely to continue in FY07E also. However, higher other income (up by 95%) and a tax write back (of Rs16m v/s tax expense of Rs78m in 4QFY05) boosted net profit growth to 7.3% to Rs307m. Although, the company has not given complete details, we believe that it would have recorded a profit of Rs752m (post tax Rs634m) on account transfer of ARV facility to Astrix JV. Adjusted for this one-time income, we estimate the consolidated PAT at Rs1,358m for FY06.

TREND IN EBITDA MARGINS



Source: Company/ Motilal Oswal Securities

On consolidated basis, EBITDA margins at 10.8%, were lower than stand-alone due to consolidation of acquired companies (Docpharma, FCC, MChem, Astrix JV) some of which, have lower margins. Consolidated performance was also impacted by Docpharma's up-front investments (not quantified) for entry into new markets like France and Italy.

Divesting medical supplies business of DocPharma

Matrix plans to divest Docpharma's medical supplies business (with annualized sales of about Rs2.14b) as it is a non-core business. The proceeds of the divestment coupled with internal accruals will be utilized for repayment of $100m of loan (of the total $200m) that the company had borrowed for funding the Docpharma acquisition. The divestment is likely to be completed over the next few months. The company had initially indicated raising funds through an overseas issue to repay this loan. We believe that if the divestment of the medical devices business goes through, the company may not dilute equity in the near future. We believe that this will be a positive development. Our estimates factor in divestment of medical supplies business in 2HFY07 and thereby lowering in interest expense due to repayment of US$100m loan.

R&D activity to be ramped up

Matrix plans a significant ramp-up in its generic pipeline in FY07E. It has filed 60 DMFs till date (only 10 have been commercialized) and plans to file another 30 in FY07E. It also expects to file about 30 ANDAs and EU dossiers in FY07E. We believe that the company will have one of the strongest DMF pipelines from India by end-FY07E. Strengthening of generic pipeline (both DMFs and ANDAs) will lead to increased R&D expenses. The company has guided R&D expenses at 5-6% of sales for FY07E.

Three pronged approach to growth

Matrix has identified three main drivers of business growth – Generic API (US business), Generic formulations (DocPharma) and Anti-AIDS drugs (ARV).

- **US generic API business gathering momentum:** Matrix already has around 60 DMF filings and plans to file another 30 in FY07E. Of the total DMF filings, only 10 have been commercialized till FY06. The company plans to launch another 10 APIs in US market in FY07E, doubling its existing product basket in US to 20 products. Key API launches proposed for the US include, Simvastatin, Pravastatin (both through Concord Biotech), Sertraline and 2 oncology products. Matrix has indicated launch of some APIs in the US (in FY07E) which, will face limited competition. Our estimates do not include upsides from such products as they may be linked to patent challenges.
- **DocPharma increasing momentum in product launches:** The management expects to launch around 8 products by DocPharma in Belgium and Netherlands, on back of expected approvals which got delayed in FY06. DocPharma's performance in FY06 (9M) was adversely impacted as only 2 of the proposed 10 products were launched by the company. Also, DocPharma would be able to benefit out of sourcing some of the products from Matrix, resulting in cost saving. However, the full benefit of shifting sourcing to India would be realized only in the long term as and when DocPharma is able to complete the 'site change' procedures.
- **ARV business gaining traction:** For Matrix, the ARV business is very attractive because of its relatively low asset intensity, higher volumes and limited competition. Although margins will be lower than in the generics and contract manufacturing businesses, revenues and profits are more sustainable and will help the company to grow in scale much faster. We expect the ARV business to grow by 50% in FY07E to about $90m led by increased off-take from its partners like Aspen, Ranbaxy and Cipla.

Emerging as a preferred outsourcing partner for global players

We believe that Matrix has the necessary attributes to execute its plans and emerge as a "*knowledge-based partner of choice*" for global pharmaceutical players. It has already demonstrated its strong chemistry and intellectual property (IP) capabilities through its success in Citalopram (in Europe) and its non-compete arrangement with an innovator company for another undisclosed product. This and its robust API pipeline have given it good visibility among global generic and innovator companies – its potential customers.

Besides, Matrix has used the inorganic route to integrate backward (into intermediates) and forward (into finished dosages). Apart from expanding its presence across the value chain, this also enhances the company's cost competitiveness. These attributes make Matrix one of the preferred outsourcing partners for global players. The management has stated that it would avoid confrontation with innovators as well as generic formulations players by refraining from entering the generic formulations market on its own. We, however, believe that Matrix's efforts to support para-IV generic filers would involve some conflict of interest with this strategy and would keenly watch how the company gets around this aspect going forward. Till the time this conflict is resolved, Matrix is unlikely to get contract manufacturing assignments for patented products from innovator pharmaceutical companies.

Valuation and view

We remain positive on Matrix and believe that it has the necessary attributes to emerge as a “knowledge based partner of choice” of global pharmaceutical companies. Matrix has used the inorganic route to integrate backward (into intermediates) and forward (into finished dosages). Going forward, growth is expected to be driven by new product launches in the US market (10 new APIs) and in Belgium and Netherlands (8 product launches by DocPharma) in FY07 and increased traction in ARV business, resulting in revenue CAGR of 26% (FY06-08). We also expect part-benefits of manufacturing synergies with Docpharma to be visible in FY07E. Matrix is currently valued at 17.5x FY07E and 14x FY08E consolidated earnings. We maintain **Buy** with a target price of Rs290 (~20xFY08E consolidated EPS).

Matrix Laboratories : an investment profile

Company description

Matrix is engaged in the manufacture of APIs and intermediates with exports accounting for around 77% of its revenue. Matrix's biggest success so far has been in developing a non-infringing process for Citalopram and supplying to several generic companies in Europe.

Key investment arguments

- Has already demonstrated its strong chemistry and intellectual property (IP) capabilities
- Has necessary attributes to emerge as a "knowledge based partner of choice" of global pharmaceutical companies
- Vertical integration would give competitive advantage to endure price erosion in generics market
- Capability to target around 25% of the top 200 products in the world

Key investment risks

- Integration of various acquisitions/JV would be critical for future success
- Regulated markets being the key growth driver going forward, Matrix remains susceptible to factors like stiffer competition from Indian peers and approval delays.
- Support to Para IV filings could hamper its efforts to strike long term relationships with innovator companies.

Recent developments

- Plans to divest medical supplies business of DocPharma

Sector view

- Regulated markets would remain the key sales and profit drivers in the medium term
- FY06 to be year of consolidation in terms of profitability
- We are overweight on companies that are towards the end of the investment phase

Valuation and view

- Our consolidated earnings for FY07E and FY08E are Rs11.9 and Rs14.9 respectively
- Valuations at 17.5x FY07E and 14x FY08E consolidated EPS do not fully reflect growth potential of the company
- We maintain **Buy** with target price of Rs290

COMPARATIVE VALUATIONS

		MATRIX	AUROBINDO	BIOCON
P/E(x)	FY07E	17.5	23.3	15.0
	FY08E	14.0	15.1	12.5
P/BV(x)	FY07E	2.9	2.8	3.3
	FY08E	2.4	2.3	2.8
EV/Sales(x)	FY07E	2.4	1.7	3.4
	FY08E	2.1	1.5	2.8
EV/EBITDA(x)	FY07E	16.2	12.3	10.4
	FY08E	13.4	9.3	8.4

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	55.3	63.8	66.7
Domestic Institutions	3.6	2.8	0.8
FIIs/FDIs	20.3	16.9	8.5
Others	20.8	16.5	24.0

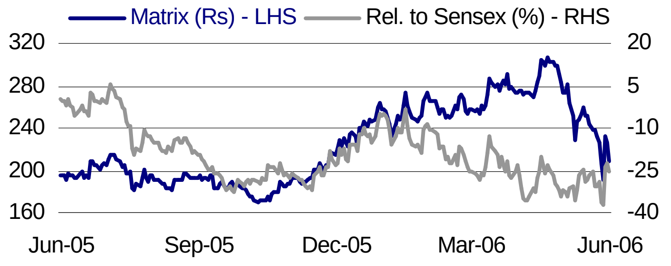
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	11.9	13.7	-13.2
FY08	14.9	18.2	-18.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
209	290	38.8	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (CONSOLIDATED)					(Rs Million)
Y/E MARCH	**2004**	**2005**	**2006**	**2007E**	**2008E**
Net Sales	**5,295**	**6,368**	**11,586**	**16,442**	**18,440**
Change (%)	*33.9*	*20.3*	*82.0*	*41.9*	*12.2*
Total Expenditure	3,628	4,660	10,270	14,035	15,533
EBITDA	**1,667**	**1,708**	**1,316**	**2,407**	**2,907**
Margin (%)	*31.5*	*26.8*	*11.4*	*14.6*	*15.8*
Depreciation	111	191	335	391	414
EBIT	**1,556**	**1,517**	**981**	**2,015**	**2,493**
Int. and Finance Charges	179	63	269	520	432
Other Income - Rec.	103	68	916	720	721
PBT before EO Expense	1,479	1,522	1,629	2,215	2,782
Extra Ordinary Exp./(Inc)	0	0	-753	0	0
PBT after EO Exp	1,479	1,522	2,382	2,215	2,782
Current Tax	117	408	376	177	223
Deferred Tax	116	-100	0	155	195
Tax Rate (%)	*15.8*	*20.2*	*15.8*	*15.0*	*15.0*
Minority Int/Share of loss	0	0	-14	-53	-79
Reported PAT	**1,246**	**1,215**	**1,992**	**1,830**	**2,286**
Adj PAT	**1,246**	**1,215**	**1,358**	**1,830**	**2,286**
Change (%)	*66.0*	*-2.5*	*11.8*	*34.8*	*24.9*
Margin (%)	*23.5*	*19.1*	*11.7*	*11.1*	*12.4*

BALANCE SHEET (CONSOLIDATED)					(Rs Million)
Y/E MARCH	**2004**	**2005**	**2006E**	**2007E**	**2008E**
Equity Share Capital	127	299	307	307	307
Total Reserves	1,655	5,941	9,211	10,831	12,841
Net Worth	**1,782**	**6,240**	**9,518**	**11,138**	**13,148**
Minority Interest	0	0	1,634	1,672	1,721
Deferred liabilities	276	175	363	518	713
Total Loans	2,075	461	11,250	7,200	7,200
Capital Employed	**4,132**	**6,876**	**22,765**	**20,528**	**22,782**
Gross Block	3,091	4,323	8,648	9,648	9,898
Less: Accum. Deprn.	837	999	2,162	2,553	2,967
Net Fixed Assets	**2,254**	**3,324**	**6,486**	**7,095**	**6,931**
Capital WIP	416	388	500	250	150
Goodwill	0	0	8,790	8,790	8,790
Investments	31	1,595	1,595	31	1,431
Curr. Assets	**2,816**	**4,426**	**10,574**	**11,405**	**13,186**
Inventory	1,251	1,710	3,765	4,439	5,348
Account Receivables	942	1,367	3,650	4,357	4,887
Cash and Bank Balance	36	88	842	307	370
Loans & Advances	587	1,261	2,317	2,302	2,582
Curr. Liability & Prov.	**1,384**	**2,856**	**5,180**	**7,043**	**7,706**
Account Payables	1,084	2,046	3,360	4,933	5,071
Provisions	300	810	1,820	2,111	2,635
Net Current Assets	**1,432**	**1,570**	**5,394**	**4,362**	**5,480**
Appl. of Funds	**4,132**	**6,876**	**22,765**	**20,528**	**22,782**

RATIOS (CONSOLIDATED)					
Y/E MARCH	**2004**	**2005**	**2006E**	**2007E**	**2008E**
Basic (Rs)					
EPS	**9.8**	**8.1**	**8.8**	**11.9**	**14.9**
Cash EPS	10.7	9.4	15.1	14.5	17.6
BV/Share	14.0	41.7	62.0	72.5	85.6
DPS	0.2	1.2	1.2	1.5	2.0
Payout (%)	13.7	16.9	10.5	14.4	15.5
Valuation (x)					
P/E		25.7	23.6	17.5	14.0
Cash P/E		22.2	13.8	14.4	11.9
P/BV		5.0	3.4	2.9	2.4
EV/Sales		5.1	3.7	2.4	2.1
EV/EBITDA		19.0	32.3	16.2	13.4
Dividend Yield (%)		0.6	0.6	0.7	1.0
Return Ratios (%)					
RoE	89.1	30.3	25.3	17.7	18.8
RoCE	53.7	30.0	13.8	14.0	16.6
Working Capital Ratios					
Debtor (Days)	65	78	115	97	97
Creditor (Days)	172	236	181	192	180
Inventory (Days)	86	98	119	99	106
Working Capital Turnover (I	96	85	143	90	101
Leverage Ratio (x)					
Current Ratio	2.0	1.5	2.0	1.6	1.7
Debt/Equity	1.2	0.1	1.4	0.8	0.6

CASH FLOW STATEMENT (CONSOLIDATED)					(Rs Million)
Y/E MARCH	**2004**	**2005**	**2006E**	**2007E**	**2008E**
Oper. Profit/(Loss) before T	1,667	1,708	1,316	2,407	2,907
Interest/Dividends Recd.	103	68	916	720	721
Direct Taxes Paid	-117	-408	-188	-177	-223
(Inc)/Dec in WC	-565	-87	-3,070	497	-1,055
CF from Operations	**1,087**	**1,281**	**-1,025**	**3,446**	**2,350**
EO Expense / (Income)	0	0	-753	0	0
CF from Operating incl	**1,087**	**1,281**	**-272**	**3,446**	**2,350**
(inc)/dec in FA	-1,270	-1,232	-3,610	-750	-150
(Pur)/Sale of Investments	3	-1,564	0	1,564	-1,400
CF from Investments	**-1,267**	**-2,796**	**-3,610**	**814**	**-1,550**
Issue of Shares	-309	3,448	1,482	0	0
Inc/(Dec) in Debt	768	-1,614	10,789	-4,050	0
Interest Paid	-179	-63	-269	-520	-432
Dividend Paid	-171	-205	-210	-264	-355
Others	20	0	-7,157	38	49
CF from Fin. Activity	**129**	**1,566**	**4,636**	**-4,795**	**-737**
Inc/Dec of Cash	**-51**	**52**	**754**	**-535**	**63**
Add: Beginning Balance	87	36	88	842	307
Closing Balance	**36**	**88**	**842**	**307**	**370**

E: MOSt Estimates

N O T E S

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Disclosure of Interest Statement	Matrix Laboratories
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