**Quantum Information Services Private Limited**
*Independent Investment Research*
03 June, 2006

# Aventis Pharma Limited

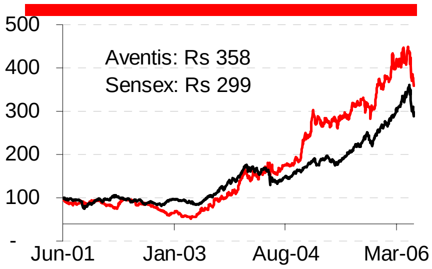
**Buy** **Target Price: Rs 2,138**

### Market data

| | |
|---|---|
| Current price | Rs 1,622 (BSE) |
| Market cap | Rs 37,206 m |
| Face value | Rs 10 |
| CY05 Div/share | Rs 16.0 |
| NSE symbol | AVENTIS |
| No of shares | 23.0 m |
| Free float | 39.6 % |
| 52 week H/L | Rs 2,140 / 1,230 |

### Share price chart


### Rs 100 invested is worth




### Shareholding

| Category | (%) |
|---|---|
| Promoters | 60.4% |
| FIIs | 12.9% |
| Public | 8.1% |
| MFs & UTI | 11.0% |
| Banks | 4.5% |
| Others | 3.1% |
| Total | 100.0% |

### Report prepared by

Quantum Information Services
www.equitymaster.com
info@equitymaster.com

### Investment Rationale

- **Aggressive in product launches:** Aventis has an aggressive strategy as far as new product launches are concerned. Contrary to the other MNC pharma companies, which have been relatively slower in launching new products in the Indian markets, Aventis has received active support from its parent for launching new products. This can be gauged by the fact that 6 out of the current top 15 products of the parent company have already been launched in India. Consequently, the company has a relatively younger product portfolio as compared to its MNC peers and commands leadership position in most segments in which it operates.

**Aventis India: 6 of the parent's top 15 drugs launched**

| Products | Therapeutic area | CY05 (YoY growth) | Parent's global sales (US$ m) |
|---|---|---|---|
| Clexane | Cardiovascular | 14% | 2,743 |
| Taxotere | Oncology | N.A | 2,060 |
| Allegra | Anti-histamine | N.A | 1,722 |
| Lantus | Diabetology (insulin) | 83% | 1,554 |
| Amaryl | Diabetology (oral) | 18% | 867 |
| Actonel | Osteoporosis | N.A | 466 |

Source: Sanofi-Aventis and Aventis India annual reports

- **Capitalising on parent's pipeline:** The company's parent Sanofi-Aventis has 127 molecules under development in the lifestyle category (CNS, oncology, cardiovascular, metabolic disorders) and vaccines, out of which 56 products are in Phase-II and Phase-III clinical trials stage. The parent's recent launches in the US markets include 'Ambien' (CNS) and three vaccines and possible launches include 'Acomplia' (obesity), which could translate into new product launches in the Indian markets as well, in the light of the new patent regime.

- **Strong presence in lifestyle segment:** The Indian pharmaceutical market, which has traditionally been focusing on the anti-infectives (acute therapy), has over the years seen a shift to the lifestyle (chronic therapy) segment on the back of increased urbanisation and change in lifestyles. This can be gauged by the fact that the chronic segment has witnessed around 10% YoY growth as opposed to the acute segment, which has been growing at a much lesser rate.

- Against this backdrop, Aventis India with its strong presence in the lifestyle segment of cardiovascular, anti-diabetics and oncology is most likely to benefit. To put things in perspective, in the anti-diabetes segment, its brands 'Amaryl' is the market leader having cornered a share of around 6%. In the cardiovascular segment, its brand 'Cardace' is the largest brand in the Indian market with a share of around 13%.

Moreover, the company's new launch, 'Lantus' (the world's first and only once a day insulin) clocked an impressive 83% YoY growth outpacing the Human Insulin market (18.7% YoY growth). Aventis has a strong presence in the vaccines market, which can be gauged by the fact that its brand 'Rabipur' commands around 69% share. This brand crossed the Rs 1 bn milestone in revenues in CY05 and is expected to contribute significantly to the company's revenues. We believe that these brands will continue to be the key growth drivers going forward. We, thus, expect Aventis' domestic revenues to grow at a CAGR of 13.3% over the next three years.

- **Exports scenario:** Aventis' exports largely comprise of exports to Russia (up 26% YoY in CY05) and the CIS countries and sourcing (up 55% YoY) from its parent. Exports clocked a 12% YoY growth in CY05 and will continue to boost the topline going forward. We have factored in a 13% CAGR in exports in the next 3 years, which translates to around 28% of total revenues by CY08. Aventis' Ankleshwar plant has been approved by the US FDA and is being used as a base to further strengthen exports. The company has already commenced exports of 'Glibenclamide' (Daonil) to European countries and 'Articaine Hydrochloride' (dental anaesthetic) to Germany. This is likely to result in higher revenues for the company going forward.

## Investment Concerns

- **Lurking competition:** Although Aventis has been successful in commanding premium prices for its products on account of the strong brand image enjoyed by the company with the medical community, stiff competition from other domestic brands and low priced generic products is a cause of concern. For example, despite the fact that Aventis is a market leader in the cardiovascular and anti-diabetic segment, it is facing fierce competition in these segments, which is likely to continue going forward.

- **Likely pressure on margins:** In order to ensure premium prices for their brands, Aventis is likely to incur huge advertising and promotion expenditure for conducting conferences, research and awareness campaigns. Although necessary for ensuring a smooth launch of products, going forward, this could put pressure on the margins of the company. Also, the scope to reduce expenses on the raw material and employee front is likely to diminish going forward. We expect operating margins to reduce marginally from 27.7% in CY05 to around 27.3% in CY08.

## Comparative Valuation

| (CY06E) | Aventis | GSK Pharma | Pfizer |
|---|---|---|---|
| Valuation metrics** | | | |
| Current price (Rs) | 1,622 | 1,116 | 840 |
| Price to earnings (x) | 21.4 | 26.4 | 26.3 |
| Price to book value (x) | 5.7 | 8.2 | 6.5 |
| Price to sales (x) | 4.0 | 5.5 | 3.5 |
| EV/EBIDTA (x) | 13.1 | 17.6 | 13.6 |
| **Performance metrics (CY06E)** | | | |
| EBIDTA margin (%) | 27.6% | 28.7% | 24.0% |
| Net margin (%) | 18.9% | 20.7% | 13.4% |
| Sales/NFA (x) | 6.7 | 18.5 | 8.9 |
| Return on equity (%) | 26.9% | 31.2% | 24.7% |
| Return on assets (%) | 21.4% | 17.7% | 17.2% |

** Valuations are based on CY06E numbers

## Background

Aventis Pharma, the 50% subsidiary of Aventis SA, France, is the second largest pharma MNC in India with a turnover of over Rs 8.0 bn (CY05). It is the seventh largest domestic player with a market share of 2.8%. Aventis has relatively few but very strong brands in the country. An indicator in this regard is the fact that the top ten brands account for around 76% of domestic sales and continue to show healthy growth. Domestic sales constituted 72% of total sales in 2005 and exports constituted the remaining 28%. Over the years, it has progressively transformed itself into a company catering to the chronic (diabetes, cardio vascular) and critical-care therapeutic segments. Apart from catering to the Indian markets, the company supplies bulk drugs to its parent. Recently, the parent merged with another France based pharma company, Sanofi, thus making it part of one of the largest pharma conglomerates in the world.

## Industry Prospects

The global pharma market grew by 7% in 2005 to reach US$ 602 bn (Source: IMS). Growth in North America, which accounts for almost half of the global market, lagged at 5.2%. The size of the Indian pharmaceutical market in CY05 was Rs 220 bn and grew by 5.3% YoY (Source: Pfizer annual report). While MNC pharma companies grew at 4%, their domestic counterparts clocked a 5.8% growth. India's per capita health expenditure at US$ 20 is very low as compared to China (US$ 33), Brazil (US$ 309) and Malaysia (US$ 81) (Source: World Bank). However, with growing health awareness coupled with the growth of the health insurance schemes, the per capita health expenditure is bound to rise.

As far as the therapeutic segments are concerned, though the acute segment enjoys a larger chunk of the domestic market (about 73%), it has been growing by a marginal 5%. As against this, the chronic segment, which has been growing at a faster pace of around 10%, has increased its share to 27% of the market. As per IMS, the India pharma market is expected to grow at a CAGR of 9.5% for the period 2004-2009 driven by chronic (cardiovascular, diabetes etc.) and niche specialty (oncology etc.) segments. The product patent came into force in India with effect from January 1, 2005, which will result in the introduction of patented drugs into the country and possibly, higher growth rates for the MNC pharma companies in the long term.

## Risk Analysis

**Sector:** The domestic pharma industry is expected to grow at a rate of around 9% over the next three years largely driven by growth in the chronic therapy and specialty segments. In light of the product patent regime in the country, continuous flow of new product launches will be determined by R&D efforts of companies. Besides this, the industry is fragmented and highly competitive with the top player enjoying around 6% market share. Based on these factors, we have assigned a medium risk rating of 5 to the stock.

**Sales:** Aventis generated average revenues to the tune of Rs 6.7 bn (US$ 149 m) in the last five years. We, thus, assign a high risk rating of 1 to the stock.

**Current ratio:** Aventis' average current ratio during the period CY01 to CY05 has been 2.5 times, indicating the company's ability to pay up short-term obligations. A ratio under 1 suggests that the company is unable, at that point, to pay off its obligations if they came due. We assign a low-risk rating of 8 to the stock.

**Debt to equity ratio:** A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Considering Aventis' debt to equity ratio of 0.1, we have assigned a low risk rating of 10 to the stock.

**Long term EPS growth:** We expect the company's net profit to grow by around 16% CAGR during the period CY05-CY08 (growth of 21% during CY01-CY05). Based on a normal scenario, we consider a compounded growth of over 20% in net profits in the last 5 years as healthy for a company. As such, the rating assigned to the stock on this factor is 7.

**Dividend payout:** A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. Aventis' average payout ratio was a healthy 31% in the last 5 years. Thus, we have assigned a low risk rating of 8.

**Promoter holding:** A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of March 2006, the promoter holding in Aventis stood at 60%, which is healthy. We have assigned a low risk rating of 9 to the stock.

**FII holding:** We believe that FII holding of greater than 25% can lead to high volatility in the stock price. FII holding in the company stood at around 12.9%, which is comfortably within the limits. Therefore, the rating assigned is 4.

**Liquidity:** The past five-year average daily volume of the stock is in the range of 10,300 shares. This is on the lower side and therefore, the impact cost to acquire a large chunk will be high. The rating assigned is 1.

**Margin of safety:** This is to determine the value of the stock relative to its price and the returns over a risk free rate. Margin of safety of a stock lies in its earning power, which is calculated as - EPS divided by Market price (reciprocal of P/E). Considering Aventis' P/E of 25.7 times its CY05 earnings, the earning power is 4%. Thus, the rating assigned is 4.

**Considering the above parameters, the total ranking assigned to the company is 57. This makes the stock a medium-risk investment from a long-term perspective.**

## Risk Matrix

| | High Risk | Medium Risk | Low Risk |
|---|---|---|---|
| Rating | (1 to 3) | (4 to 6) | (7 to 10) |
| Sector | High | Medium | Low |
| Sales (US$ m) | < 500 | 501 - 1,000 | > 1,000 |
| Current Ratio (x) | < 1 | 1 - 2 | > 2 |
| Debt to equity ratio (x) | > 1 | 0.5 - 1 | < 1 |
| Long term EPS growth (%) | < 10 | 10 - 20 | > 20 |
| Dividend Payout (%) | < 15 | 15 - 25 | > 25 |
| Promoter holding (%) | < 25 | 25 - 40 | > 40 |
| FII holding (%) | > 25 | 10 - 25 | < 10 |
| Liquidity (Nos. '000) | < 100 | 100 - 200 | > 200 |
| Margin of Safety (%) | < 3 | 4 - 6 | > 6 |
| Final Rating | < 30 | 30 - 60 | > 60 |

## Valuations

We had recommended a BUY on Aventis Pharma in October 2005 at Rs 1,370 with a target price of Rs 2,178. The stock has nearly breached our price target and is currently lying at the lower end of our valuation band, implying attractive valuations. At the current price of Rs 1,622, the stock is trading at a price to earnings multiple of 19.0 times our estimated CY07 earnings. We, thus re-iterate a BUY on the stock with a price target of Rs 2,138 from a two-year perspective. Our preferred plays among MNC pharma majors are Aventis, Glaxo and Pfizer from a two to three year perspective.

## Valuation table

| (Rs m) | CY05 | CY06E | CY07E | CY08E |
|---|---|---|---|---|
| Total revenues | 8,078 | 9,221 | 10,353 | 11,728 |
| Net profit | 1,450 | 1,746 | 1,967 | 2,285 |
| EPS (Rs) | 63.0 | 75.9 | 85.5 | 99.4 |
| Price to earnings (x) | 25.7 | 21.4 | 19.0 | 16.3 |
| Price to sales (x) | 4.6 | 4.0 | 3.6 | 3.2 |

## Performance over the years…

| (Rs m) | CY02 | CY03 | CY04 | CY05 |
|---|---|---|---|---|
| Promoter holding (%) | 60.4% | 60.4% | 60.4% | 60.4% |
| Net sales (Rs m) | 6,157 | 6,516 | 7,350 | 8,078 |
| EBIDTA margin (%) | 15.8% | 21.5% | 29.2% | 27.7% |
| Net profit (Rs m) | 612 | 987 | 1,485 | 1,450 |
| Net profit margin (%) | 9.9% | 15.1% | 20.2% | 17.9% |
| Debt to equity (x) | 0.07 | 0.05 | 0.05 | - |
| Return on equity (%) | 22.7% | 30.7% | 35.2% | 27.7% |
| Div per share (Rs) | 16.0 | 16.0 | 16.0 | 16.0 |

## Financials at a glance

| (Rs m) | CY05 | CY06E | CY07E | CY08E |
|---|---|---|---|---|
| Sales | 8,078 | 9,221 | 10,353 | 11,728 |
| *Sales growth (%)* | *9.9%* | *14.2%* | *12.3%* | *13.3%* |
| Operating profit | 2,240 | 2,545 | 2,816 | 3,202 |
| *Operating profit margin (%)* | *27.7%* | *27.6%* | *27.2%* | *27.3%* |
| Net profit | 1,450 | 1,746 | 1,967 | 2,285 |
| *Net profit margin (%)* | *17.9%* | *18.9%* | *19.0%* | *19.5%* |
| | | | | |
| **Balance Sheet** | | | | |
| Net fixed assets | 1,418 | 1,374 | 1,333 | 1,284 |
| Investments | 53 | 53 | 53 | 53 |
| Current assets | 5,477 | 6,735 | 8,402 | 10,339 |
| **Total assets** | **6,948** | **8,161** | **9,788** | **11,676** |
| | | | | |
| Current liabilities | 1,710 | 1,669 | 1,884 | 2,132 |
| Net worth | 5,238 | 6,492 | 7,904 | 9,545 |
| Total liabilities | 6,948 | 8,161 | 9,788 | 11,676 |

## Sector Statistics

| Sales (Rs m) | | Market cap. (Rs m) | | EBDITA margin (%) | | Net profit margin (%) | | Return on NW (%) | |
|---|---|---|---|---|---|---|---|---|---|
| Cipla | 29,857 | Cipla | 165,750 | GSK Pharma | 29.1% | GSK Pharma | 33.4% | GSK Pharma | 53.2% |
| GSK Pharma | 15,185 | GSK Pharma | 94,525 | **Aventis** | **27.7%** | Novartis | 20.5% | Novartis | 31.9% |
| **Aventis** | **8,078** | **Aventis** | **37,306** | Cipla | 22.3% | Cipla | 20.1% | Cipla | 30.8% |
| Pfizer | 6,253 | Pfizer | 25,032 | Pfizer | 21.2% | **Aventis** | **17.9%** | **Aventis** | **27.7%** |
| Novartis | 5,259 | Novartis | 15,392 | Novartis | 16.4% | Pfizer | 10.9% | Pfizer | 20.1% |

**Important Notice:** Quantum Information Services Pvt. Limited (Equitymaster) is an Independent Equity Research Company.

**Disclosure:** The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.