

# Sun Pharma

Margin rebound unlikely in the medium term

- ▶ **Costs for building generics portfolio and increasing exports to unregulated markets to sustain pressure on margins partly offset by interest income from a substantial war chest**
- ▶ **Awaiting details on innovative pipeline to value research business**
- ▶ **Lower earnings estimates by 3% for FY07 and 2% for FY08. Remain Neutral with notional target price of INR675/share**

## Sun Pharma in an investment phase

We believe that Sun Pharma is currently in an intense phase of investments towards broadening its generic portfolio in the US markets. The acquisition of manufacturing facilities in Hungary and the US as well as the facilities of bankrupt Able Laboratories was the beginning. Sun is now actively engaged in ramping up the pace of generic filings to utilise these facilities. Hence we expect generic R&D expenses to remain high (c10-11% of turnover) as Sun scales up its generic filings.

In addition, we also expect an increase in the proportion of relatively lower margin formulation export business which is also likely to compress margins for Sun Pharma. While we do not expect margins in formulation exports to unregulated markets to improve significantly, the current investments in generics would be earnings accretive only by FY09, when we expect Sun Pharma to have amongst the largest generic portfolios in the US amongst Indian generic companies. The proposed de-merger of the innovative research unit is unlikely to significantly offset a combination of increased generic R&D and greater proportion of business in unregulated markets.

Overall, although we remain positive on Sun Pharma's overall strategy of expanding into generics through acquisition and turn-around of distressed assets rather than through expensive acquisitions, we believe margin pressures to be sustained over the next 18 months.

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## Disclaimer & Disclosures.

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, that form part of it.

### Stock data

Current price	Reuters	Bloomberg equity	Bloomberg debt	Valuation range
INR 720.2	SUN BO	SUNP IN	SUNPIN	INR 641-709

Source: HSBC

## Await details of research pipeline

In our valuations for Sun Pharma, we have not factored in the research pipeline given the clarity which is awaited on various products under development, including Sun Pharma's new chemical entity (NCE) and its therapeutic target as well as the efficacy results of trials. Management states that the details are likely to be released later during FY07.

## Forecasts and valuations

- ▶ Considering Sun Pharma's steadily growing formulation export business, we increase our sales estimates by 7% for FY07e and by 6% for FY08e.
- ▶ With research and development outlay for generic market expected to remain high and added costs related to the acquired facilities, we cut our operating profit margin estimates by 8% for FY07 to 31%, and by 6% for FY08 to 32.6% for FY08.
- ▶ We believe that despite building a significant war chest of cUSD450mn, Sun Pharma is unlikely to easily commit to a big-ticket acquisition, given the management's preference of acquiring distressed assets. Hence we expect interest other income would support net margins and we lower our net income estimates only by 3% for FY07e and by 2% for FY08e.

### Change in forecasts

	FY07e	FY08e
Sales	7%	6%
Operating profit	-8%	-6%
Net income	-3%	-2%
EPS	-3%	-2%

Source: HSBC

## Valuations

Our PE-derived valuation range is unchanged at INR 641-709 with target PE of 15.4x FY08e earnings, in line with Sun Pharma's peer group. Our notional target price is the mid-point of our fair value range. We retain our Neutral rating on Sun Pharma. At the current price of INR720.2, Sun Pharma trades at a PE of 16.4x FY08e earnings.

## Key risks to our rating

- ▶ Sun Pharma has tasted its first Paragraph IV success in Ultracet. Going ahead, any legal success over its steadily growing Paragraph IV basket or a settlement with patent holder is an upside risk to our estimates.
- ▶ The new patent regime would constrain Sun Pharma's strategy of aggressive new product launches in the domestic market.
- ▶ Sun Pharma is also aggressively focussed on the export market where margins are lower than in the Indian domestic formulations business.

## Financials & valuation

### Financial statements

Year to	03/2005a	03/2006e	03/2007e	03/2008e
<b>Profit &amp; loss summary (INRm)</b>				
Revenue	11,433	15,931	20,644	24,728
EBITDA	4,167	4,975	6,410	8,053
Depreciation & amortisation	-406	-615	-793	-912
Operating profit/EBIT	3,761	4,360	5,618	7,142
Net interest	115	869	962	1,015
PBT	4,209	5,968	7,084	8,598
HSBC PBT	0	0	0	0
Taxation	-207	-239	-330	-450
Net profit	4,002	5,729	6,754	8,148
HSBC net profit	4,002	5,729	6,754	8,148

### Cash flow summary (INRm)

Cash flow from operations	2,813	4,713	5,579	7,688
Capex	-1,690	-1,657	-1,350	-1,450
Cash flow from investment	-6,410	-2,767	-1,900	-3,050
Dividends	-755	-1,627	-2,448	-4,092
Change in net debt	-1,483	-1,530	-3,573	-2,199
FCF equity	698	2,336	3,623	5,680

### Balance sheet summary (INRm)

Intangible fixed assets	0	0	0	0
Tangible fixed assets	6,213	7,255	7,812	8,350
Current assets	25,386	28,873	32,403	36,240
Cash & others	18,248	19,602	20,871	23,071
Total assets	31,644	36,223	40,360	44,786
Operating liabilities	1,758	2,383	2,785	2,939
Gross debt	18,230	18,054	15,750	15,750
Net debt	-18	-1,548	-5,121	-7,321
Shareholders funds	9,931	14,000	19,834	23,863
Invested capital	11,592	14,144	16,558	18,581

### Ratio, growth and per share analysis

Year to	03/2005a	03/2006e	03/2007e	03/2008e
<b>Y-o-y % change</b>				
Revenue	21.1	39.3	29.6	19.8
EBITDA	6.0	19.4	28.9	25.6
Operating profit	3.1	15.9	28.8	27.1
PBT	10.4	41.8	18.7	21.4
HSBC EPS	16.2	43.1	17.9	20.6

### Ratios (%)

Revenue/IC (x)	1.1	1.2	1.3	1.4
ROIC	33.9	32.5	34.9	38.5
ROE	48.3	47.9	39.9	37.3
ROA	17.7	16.9	17.6	19.1
EBITDA margin	36.4	31.2	31.1	32.6
Operating profit margin	32.9	27.4	27.2	28.9
EBITDA/net interest (x)				
Net debt/equity	-0.2	-11.1	-25.8	-30.7
Net debt/EBITDA (x)	0.0	-0.3	-0.8	-0.9

### Per share data (INR)

EPS Rep (fully diluted)	21.57	30.88	36.41	43.92
HSBC EPS	21.57	30.88	36.41	43.92
DPS	3.79	8.41	12.73	21.47
NAV	53.53	75.47	106.91	128.64

### Valuation data

Year to	03/2005a	03/2006e	03/2007e	03/2008e
EV/sales	11.7	8.3	6.2	5.1
EV/EBITDA	32.1	26.6	20.0	15.7
EV/IC	11.5	9.3	7.8	6.8
PE*	33.4	23.3	19.8	16.4
P/NAV	13.5	9.5	6.7	5.6
FCF yield (%)	0.5	1.7	2.7	4.3
Dividend yield (%)	0.5	1.2	1.8	3.0

Note: \* = Based on HSBC EPS

### Issuer information

Share price (INR)	720.20	Country	India
Reuters (Equity)	SUN.BO	Bloomberg (Equity)	SUNP IN
		Bloomberg (Debt)	SUNPIN
Market cap (INRm)	133,764	Enterprise value (INRm)	132120
No of shares (m)	186	Free float (%)	28.1
Analyst	Jatin Kotian	Contact details	91 22 2268 1638

Note: price at close of 12 Jun 2006

# Disclosure appendix

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## Rating definitions for long-term investment opportunities

### **Stock (vs Global sector universe of companies under coverage by sector team)**

- ▶ Overweight (Buy)
- ▶ Neutral (Hold)
- ▶ Underweight (Sell)

HSBC assigns ratings to its stocks in this sector on the following basis:

For companies covered on a sector basis, we apply a ratings structure which ranks the stocks according to their notional target price vs current market price and then categorises (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price is defined as the mid-point of the analysts' valuation for a stock.

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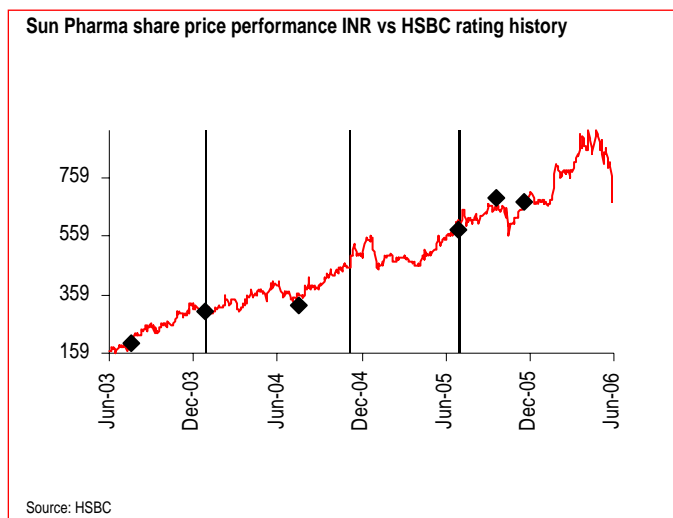
From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

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<b>Overweight/Buy</b>	42%	(37% of these provided with Investment Banking Services)
<b>Neutral/Hold</b>	41%	(36% of these provided with Investment Banking Services)
<b>Underweight/Sell</b>	17%	(32% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities



Rating & price target history		
From	To	Date
Add	Hold	07 January 2004
Hold	N/R	15 November 2004
N/R	Neutral	08 July 2005
Target price		Date
	Value	
Price 1	190.00	28 July 2003
Price 2	300.00	07 January 2004
Price 3	325.00	26 July 2004
Price 4	N/R	15 November 2004
Price 5	580.00	08 July 2005
Price 6	688.00	29 September 2005
Price 7	675.00	29 November 2005

Source: HSBC

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