Company In-Depth

9 November 2006 | 11 pages

Glenmark Pharmaceuticals (GLEN.BO)

Buy: Raising Target on Better Base Business; Higher Option Value

Rating change ☐
Target price change ☑
Estimate change ☑

- **Raising target price by 40% to Rs635/share** — We factor in the improved outlook on the base business (raising FY07-09E estimates by 7-33%) and option value for its recent outlicensing deal with Merck KgaA. We continue to rate Glenmark as the best Indian player on innovative R&D.
- **R&D, key value driver** — Besides Oglemilast and GRC-8200, Glenmark has four other NCEs that are likely to enter the clinic in the next six months. We believe these offer further value-unlocking opportunities for Glenmark through licensing deals. Management expects to conclude another licensing deal in FY07. We expect each deal to add to the option value in the stock and spread failure risk.
- **Favorable risk-reward equation** — With significant deals for two NCEs, more R&D assets in the pipeline and the base business gaining traction, we remain positive on Glenmark. With the higher base business value, we believe that the R&D option value is only c25% of the stock price. We also note that key risk triggers appear some way off with catalysts remaining in the next six months.
- **Revising estimates** — Net profit forecasts rise 0.3-60% for FY07-09E on higher estimates for the base business (up 7-33%) and higher milestone payments in FY08 and FY09 following the Merck deal. Our FY07 net profit estimate remains largely unchanged as the upfront payment from Merck (Eur25m) would offset the delay in the milestone payment from Forest (US$30m).
- **Key risks** — relate to failure of one or both licensed molecules in the clinic. This would wipe off the option value built into the stock partially or fully.

Buy/High Risk	**1H**
Price (08 Nov 06)	Rs435.20
Target price	Rs635.00
from Rs455.00	
Expected share price return	45.9%
Expected dividend yield	0.2%
Expected total return	**46.1%**
Market Cap	Rs51,727M
	US$1,159M

Price Performance (RIC: GLEN.BO, BB: GNP IN)

See page 9 for Analyst Certification and important disclosures.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	1,063	8.16	133.3	53.4	16.8	40.3	0.2
2006A	872	6.48	-20.6	67.2	13.9	25.7	0.2
2007E	2,653	19.71	204.4	22.1	8.3	53.2	0.2
2008E	5,026	37.34	89.4	11.7	4.6	57.7	0.2
2009E	6,184	45.94	23.0	9.5	3.0	43.6	0.2

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	53.4	67.2	22.1	11.7	9.5
EV/EBITDA adjusted (x)	34.6	41.1	16.1	9.2	7.3
P/BV (x)	16.8	13.9	8.3	4.6	3.0
Dividend yield (%)	0.2	0.2	0.2	0.2	0.2
Per Share Data (Rs)					
EPS adjusted	8.16	6.48	19.71	37.34	45.94
EPS reported	8.16	6.48	19.71	37.34	45.94
BVPS	25.88	31.29	52.73	94.04	144.99
DPS	0.70	0.70	0.80	0.90	1.00
Profit & Loss (RsM)					
Net sales	5,694	7,020	11,579	16,656	20,245
Operating expenses	-4,300	-5,880	-8,343	-10,899	-13,381
EBIT	**1,393**	**1,140**	**3,236**	**5,757**	**6,863**
Net interest expense	-173	-147	-298	-125	0
Non-operating/exceptionals	52	128	121	154	254
Pre-tax profit	**1,273**	**1,121**	**3,059**	**5,786**	**7,117**
Tax	-202	-241	-398	-752	-925
Extraord./Min.Int./Pref.div.	-8	-8	-8	-8	-8
Reported net income	**1,063**	**872**	**2,653**	**5,026**	**6,184**
Adjusted earnings	1,063	872	2,653	5,026	6,184
Adjusted EBITDA	1,558	1,372	3,600	6,132	7,250
Growth Rates (%)					
Sales	62.8	23.3	65.0	43.8	21.5
EBIT adjusted	140.2	-18.2	184.0	77.9	19.2
EBITDA adjusted	125.4	-11.9	162.4	70.3	18.2
EPS adjusted	133.3	-20.6	204.4	89.4	23.0
Cash Flow (RsM)					
Operating cash flow	**-57**	**-519**	**694**	**2,581**	**3,595**
Depreciation/amortization	164	232	364	375	386
Net working capital	-1,279	-1,657	-2,311	-2,351	-2,243
Investing cash flow	**-1,906**	**-2,453**	**-500**	**-200**	**-200**
Capital expenditure	-1,904	-2,439	-500	-200	-200
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**2,966**	**2,505**	**-352**	**-1,983**	**-1,393**
Borrowings	3,137	2,886	62	-1,728	-1,250
Dividends paid	-96	-205	-116	-130	-143
Change in cash	**1,003**	**-467**	**-158**	**398**	**2,002**
Balance Sheet (RsM)					
Total assets	**9,076**	**13,416**	**16,990**	**21,198**	**27,023**
Cash & cash equivalent	1,273	1,056	1,295	2,446	5,373
Accounts receivable	2,376	3,816	5,622	7,523	9,338
Net fixed assets	3,503	5,805	5,941	5,766	5,580
Total liabilities	**5,806**	**9,502**	**10,530**	**9,834**	**9,610**
Accounts payable	1,120	1,719	2,606	3,488	4,329
Total Debt	4,375	7,354	7,416	5,688	4,438
Shareholders' funds	**3,270**	**3,915**	**6,460**	**11,364**	**17,413**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	27.4	19.5	31.1	36.8	35.8
ROE adjusted	40.3	25.7	53.2	57.7	43.6
ROIC adjusted	23.7	10.6	24.3	35.8	36.9
Net debt to equity	94.9	160.9	94.7	28.5	-5.4
Total debt to capital	57.2	65.3	53.4	33.4	20.3

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Best Indian Player on R&D – Raising Target Price

We rate Glenmark as the best Indian player on innovative R&D. With significant deals for two NCEs, more R&D assets in the pipeline and the base business gaining momentum, we remain positive. We also note that key risk triggers appear some way off, while upside catalysts remain over the next six months. We raise our target price by 40% to Rs635/ share, as we factor in the improved outlook on the base business (raising FY07-09E estimates by 7-33%) and option value for its recent outlicensing deal with Merck KgaA. Maintain Buy/ High Risk (1H).

Raising Target Price by 40%

We are raising our target price for Glenmark by 40% to Rs635/ share, based on the following factors:

- **Base business valuation raised 45%**: We raise our base business valuation to Rs327/ share (from Rs226/ share earlier) – as we raise our estimates and roll over our target price to December '07E (June '07E earlier) earnings. Glenmark's base (non R&D) business has gained significant traction, especially in the US, India and Latin America, prompting the management to raise its guidance by c.38-39% over FY07-08. We have raised our estimates for this business by 7-33% over FY07-09E.

- **Option value for Merck KgaA deal**: We build in option value of Rs85/share for Glenmark's licensing deal with Merck KgaA. Glenmark recently licensed its DPP-IV inhibitor molecule (GRC-8200) to Merck for the markets of North America, Europe and Japan. Glenmark would receive an upfront sum of Eur25m and further payments on the molecule achieving certain milestones. As per the company, the sum total of these payments would amount to Eur190m. On successful launch, Glenmark would get royalties on sales and also supply the API to Merck for global requirements. As with Oglemilast, we use a probability based cash flow valuation approach to arrive at a value for this deal. We assume that milestone payments would be evenly spread out over the next five years and have built in reducing probabilities for receipt of each successive milestone and a 20% probability of launch in FY2013.

- **Adjusting Oglemilast value for potential delay**: in milestone payments and launch time line. The second milestone from Forest Laboratories, which was expected in FY07, is likely to spill over to FY08 and may lead to a slight delay in the expected date of launch. We build in this expected delay into our option value calculations, leading to a lower value of Rs223/ share (from Rs229/ share earlier).

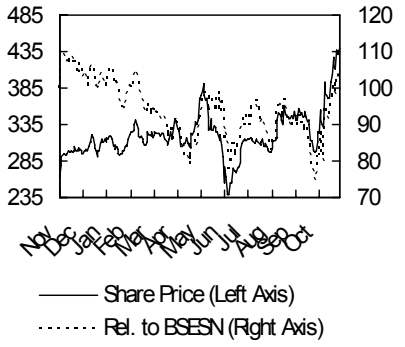
Cumulatively, we arrive at our revised target price of Rs635/share for Glenmark.

Raising Estimates by 0.3-60% over FY07-09E

We have raised our net profit estimates for Glenmark's overall business by 0.3-60% over FY07-09E – based on the following adjustments:

- **Raising base business (excluding R&D milestones) net profit estimates by 7%-33% over FY07-09E**. We build in higher formulation sales in the USA and India as well as higher profitability in the Indian business. We also highlight

Figure 1. Stock Performance



Source: source here

Figure 2. Price Performance

(%)	3M	6M	12M
Absolute	47.3	29.3	67.1
Rel. to .BSESN	21.1	21.4	4.2

Source: Type source here

Figure 3. Earnings Revision

	FY07E	FY08E	FY09E
Revenues (Rs m)			
Old	11,593	13,920	16,936
New	11,579	16,656	20,245
% Change	(0.1)	19.7	19.5
EPS (Rs)			
Old	19.7	23.4	29.2
New	19.7	37.3	45.9
% Change	0.3	59.8	57.3

Source: CIR Estimates

- that our revised estimates for the base business are slightly lower than Glenmark's recently revised guidance, as we choose to build in a buffer for product launch delays and / or any aggressive pricing pressure – both of which are factors that cannot be ruled out in the generics environment

- Building in higher milestone payments for FY08 and FY09 – The recent deal with Merck KgaA brings in an additional source of R&D related cash flows. For FY07, the upfront payment expected from Merck (Eur25m) would offset the delay in milestone payment from Forest Laboratories (US$30m). In FY08 and FY09, we expect milestone payments from Merck to add to the R&D related cash flows for Glenmark. We have built in milestone payments of Eur25m and Eur30m in our estimates for FY08 and FY09, respectively

R&D Update – Adding Option Value

We revisit Glenmark's R&D strategy – a source of significant value creation for the company. Glenmark has had an aggressive focus on drug discovery research over the last five years. It initiated NCE (new chemical entity) research in 2001, focusing on four key areas – asthma, diabetes/obesity, inflammatory conditions and CNS. Despite a much smaller R&D budget, Glenmark has surpassed its larger Indian peers in terms of delivery. In our opinion, the management's focused approach to this high-risk activity and its ability to extract maximum value from its intellectual assets set Glenmark apart from other Indian companies in the drug discovery space.

The following factors have been key to its success in R&D:

- Choice of chronic segments like diabetes, asthma and obesity, with high potential RoI; however with a clear focus on lower risk analogue research.

- Intention to seek out licensing partners beyond pre-clinical / Phase I stage to mitigate risk of failure and optimize upsides from early stage success.

- Ability to negotiate excellent terms with its out-licensing partners: The company's first big success in NCE research came in the form of landmark licensing deals with Forest Laboratories (US market) and Teijin Pharma (Japanese market) for its anti-asthma / COPD compound – GRC-3886, now named *Oglemilast*. This was followed by the recent deal with Merck for GRC-8200 (a DPP-IV inhibitor).

The result has been three significant outsourcing deals across two molecules and a pipeline of four more molecules on the verge of entering the clinic. We believe that the successful and high profile outlicensing deals have validated Glenmark's R&D capabilities and improved its visibility globally – factors that we believe would help in striking similar deals as well.

GRC-8200 – second molecule licensed out

GRC-8200 is the second NCE molecule that Glenmark has licensed out to a global pharma company (Merck KgaA). GRC 8200 is a novel, oral DPPIV inhibitor in development for type 2 diabetes. It is currently in Phase II clinical trials in South Africa and India. Phase I studies were conducted by Parexel in the UK and were designed to study the safety and bioavailability of GRC 8200 in humans using single and multiple oral doses on 88 healthy volunteers.

According to the company, the compound was very well tolerated by the subjects at all dosage levels and there were no significant adverse events reported. Glenmark believes that, if successfully launched, GRC-8200 could be the fourth or fifth in class to reach the market. In our estimates for arriving at the option value for GRC-8200, we have assumed peak sales of US$900m for the product in key markets of USA, Europe and Japan.

Merck KgaA deal creates value

Glenmark has licensed GRC-8200 to Merck KGaA. As part of the deal, Merck will develop, register and commercialize the molecule in North America, Europe and Japan, while Glenmark will retain rights for India and share the rights for other markets with Merck. Merck would bear the costs of all ongoing studies. Glenmark would receive an upfront sum of Eur25m and further payments on the molecule achieving certain milestones. As per the company, the sum total of these payments would amount to Eur190m. On successful launch, Glenmark would get royalties on sales and also supply the API to Merck for global requirements.

We value the deal at Rs84/share

We have arrived at the option value from this deal by using a probability based cash flow valuation approach. We have assumed that the milestone payments are spread out over the next five years, with reducing probabilities for receipt of each successive milestone. Besides, we assume a 15% probability of launch in FY10 and 15% royalties on sales and API supplies beyond FY10. We have used a 13% discount rate in our model (in-line with Glenmark's WACC), as we have already adjusted the higher risk income streams by probability of success. Based on our calculations, we arrive at a value of Rs84/ share for this deal.

What's up with Oglemilast?

There have been concerns on the street related to Glenmark's lead molecule (Oglemilast), which has been licensed out to Forest Laboratories (for the US) and Teijin Pharma (for Japan). The concerns largely stem from the delay in commencement of full-scale Phase II trials on the molecule, which in turn has postponed the expected milestone payment of US$30m from Forest Laboratories. In our view, while there clearly is a delay vis-à-vis the originally expected timeline, the concerns are overdone. Both Forest and Glenmark have indicated that two phase II trials are already under way for "exercise induced asthma" and "antigen challenge" – enrollment has been completed for the first study and top-line results are likely by November 2006. Phase II trials for COPD have been delayed to CY07 due to additional non clinical data requested by the US FDA. While this may delay triggering of the milestone payment, we do not believe this does not indicate any higher risk of failure of the molecule. Significantly, Glenmark also indicated in its recent analyst meet that it may still get the next milestone payment from Forest in FY07, despite including it in FY08 guidance. We, however, think this is unlikely in light of Forest's recent guidance – where it indicated that a large part of milestone payments would get postponed to FY08.

More in the bush – Robust Pipeline

Besides the two licensed molecules, Glenmark has four other molecules that are expected to enter clinical trials over FY07/1QFY08. We believe that these are

outlicensing candidates as well, and could create significant value for the company and investors.

Figure 4. Glenmark's R&D Pipeline

Compound	Target	Primary indications	Status	Target Launch
GRC 3886	PDE 4	Asthma, COPD	Phase II	2009/10
GRC 8200	DPP IV	Diabetes (Type II)	Phase II	2010
GRC 6211	VR 1	Osteoarthritis, Migraine, Incontinence, Asthma	Phase I in Nov, 06	2011
GRC 10693	CB 2	Neuropathic pain, Osteoarthritis and other inflammatory pain	Phase I in Jan, 07	2012
GRC 10801	CB 1	Obesity	Phase I in Q4 FY07	2011
GRC 4039	PDE 4	Rheumatic Arthritis, Inflammation	Phase I in Q1 FY08	2012

Source: Company Reports

Base Business – Scaling up Rapidly

Glenmark's base business – especially formulations sales in India and the US – has been gaining traction and has scaled up faster than our expectations. This is reflected not only in improved revenues but also higher profitability on this business. In its recent analyst meet, the company raised its guidance.

USA – Good Progress

Figure 5. US ANDA Filings Rollout

	Mar'06 Actual	Current	Mar'07 Target
Marketed	6	10	18-22
Pending Approval	19	25	38-40
Total Filings	20	35	56-62

Source: Company Reports

We believe that Glenmark has adopted a smart strategy to target the US markets, and the benefits are now visible. Having set up its own front end in the market, the company is now focusing on rapidly strengthening its product basket through a combination of own filings as well as through various partnerships. We believe this is a smart move by the company to fast-track the scale-up of its US business by leveraging its front-end infrastructure. It now has 25 filings pending approval and 38-40 filings by FY07 end. This would make its US pipeline one of the most impressive among its peers, translating into US revenues of US$34m, US$51m and US$76m in FY07E, FY08E and FY09E, respectively (up from US$14m in FY06.

Europe – Inorganic Route

Most of the Glenmark's efforts in the regulated markets have been focused on the US market. The company's level of preparedness to tap the EU market is therefore relatively low, and it is looking to fill this gap through acquisitions. In its recent analyst meet, the company indicated that it is evaluating small targets (revenues in the Eur8-12m range) in this region and may conclude a deal before the end of FY07.

Latin America – Initiatives Paying Off

Glenmark has also made good progress in Latin American markets as well, with its past acquisitions (Laboratories Klinger, Servycal) and own registration initiatives beginning to pay off. The company has expanded its field force and has also commenced commercial operations in 10 countries, including Brazil and Argentina. It has filed 38 dossiers and received approval to market 8 products. The company intends to continue filing registrations at a rapid pace and expand the number of products in the market. The higher scale as well as growing share of revenues from products originating out of India would also lead

to improved profitability, in our view. Glenmark recorded Latin American sales of Rs470m in 1HFY07; we expect the company to clock Latin American sales of Rs1.5b, Rs2b and Rs2.4b in FY07E, FY08E and FY09E, respectively, (up from Rs759m in FY06).

India – Rapid Growth

India has been another very good market for Glenmark in 1HFY07, with sales growing 15% YoY to Rs 1,970m – on the back of a pickup in overall market growth rate, aggressive product introductions by Glenmark and an expansion in its field force. We expect India to remain a steady growth market for Glenmark, with profitability of its operations expected to go up on the back of the company's efforts to improve field force productivity, reduce supply chain cost and shift a large part of its production to Baddi for tax benefits.

Glenmark Pharmaceuticals

Company description

Glenmark Pharmaceuticals is a fully integrated research-based pharmaceutical company, with a business model spanning drug discovery research, APIs and formulations in the domestic and international markets. It operates in more than 65 countries, including the regulated markets of the US and Europe, with around 50% of its revenues coming from overseas markets. The company came into the limelight in September 2004 after it licensed out the US market rights of its first new chemical entity (NCE), GRC-3886, to Forest Laboratories.

Investment thesis

We have a Buy/High Risk (1H) rating on the stock with a target price of Rs635 (up from Rs455 earlier). Our outlook on the stock takes into consideration the following: a) R&D pipeline has broadened with six molecules expected to be in the clinic by end-FY07; b) With a second molecule licensed out, the R&D option value or value at risk is now spread across two molecules; c) the base business has witnessed greater traction, especially in the US and Latin America; d) potential risk triggers are still some way off, while nearer-term catalysts exist. We believe that with the faster than expected scale-up in the base business, the option value built into the stock for its R&D efforts (primarily Oglemilast & GRC-8200) is now at only c25% of the stock price. The risk reward, we believe, is thus in favor of investors, especially as the potential risk triggers that could lead to partial or full erosion of the option value appear some way off, while there remain potential upside catalysts over the next six months.

Valuation

We use sum of the parts to value the stock, valuing the R&D deals and the base business separately. We believe probability-adjusted DCF is appropriate to calculate the option value from Oglemilast and GRC-8200. We have used the licensing deal with Forest Laboratories for the US market as a benchmark as well as a 13% discount rate (in-line with Glenmark's WACC) following our adjustment for the higher-risk income streams by probability of success. We arrive at a value of Rs223/share for Oglemilast (down from Rs229/share earlier due to a delay in receipt of milestone payments). We use a similar approach for GRC-8200 and arrive at a value of Rs85/share. We value Glenmark's base business (excluding R&D income) on P/E in view of the healthy growth expected

in earnings. Our valuation is based on 20x December 2007E (20x June 2007E earlier) earnings, which is at a premium to the range that we use for other mid-sized pharma companies. We believe Glenmark deserves a premium given its higher value addition in its business and the ability to execute and leverage its assets. Based on 20x December 2007E earnings, we value Glenmark's base business at Rs327/share (up from Rs226/ share earlier). This takes the total valuation of the company to Rs635/share (up from Rs455/share earlier).

Risk

We rate Glenmark as High Risk based on our quantitative risk-rating system. The main downside risks to our target price and estimates include: (1) Glenmark's efforts to build its own front-end in regulated markets could prove to be a drag on earnings if it is unable to effectively execute its plans; (2) growing competition, rapid price erosion and fragmented market share are risks that are inherent to the generics business; and (3) the failure of Oglemilast could lead to the milestone payments getting taken off our estimates. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Analyst Certification Appendix A-1

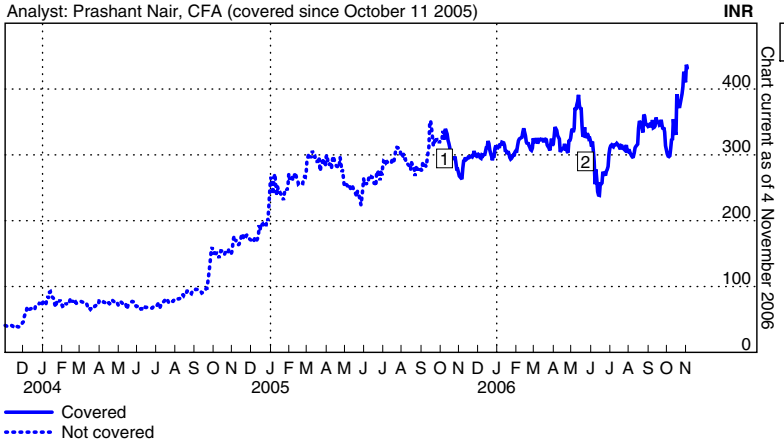
I, Prashant Nair, CFA, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Glenmark Pharmaceuticals Ltd (GLEN.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since October 11 2005)



#	Date	Rating	Target Price	Closing Price
1:	10 Oct 05	3H	305.00	325.50
2:	24 May 06	*1H	*455.00	326.10

*Indicates change.

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% of companies in each rating category that are investment banking clients	52%	65%	38%

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