Company Focus

18 January 2008 | 10 pages

# Ranbaxy (RANB.BO)

Estimate change

## Buy: Steady Quarter; Strong Guidance

- **Maintain Buy (1M)** — As Ranbaxy's strong guidance for CY08 indicates, it looks well set to continue the recovery process that commenced last year. A strong FTF pipeline, tie-ups to augment its product pipeline & leverage its strong front end and efforts to move to a more capital efficient model make us positive on Ranbaxy's short as well as long term prospects.
- **CY07: recovery amidst tough times** — Following a steady 4Q (sales up 7%; EBIDTA margins up 65bps), it ended up with 9% and 20% YoY growth in sales & operating PAT respectively. This came about despite multiple hurdles – viz. a stronger rupee, regulatory issues in Romania & growing competition – thus reflecting the benefits of Ranbaxy's restructuring & improved business model.
- **Strong guidance** — Ranbaxy guided to 18-20% growth in US$ sales, 17.5-18% EBIDTA margins & 20-25% growth in reported PAT. The latter is especially impressive as CY07 PAT was buoyed by net translation gains (not built into guidance) of Rs 1.56bn & US$47m from forward contracts (likely to be much lower in CY08). We forecast 36% YoY growth in Ranbaxy's CY08 operating PAT.
- **Monetizing P-IVs / FTFs** — Ranbaxy intends to shortly announce another FTF upside that would play out in 2H08. It has a target of 1 FTF launch / upside each year & has taken care of CY09 (Valtrex) & CY10 (Lipitor & Flomax). With this line up, we believe the street would build in some value for its FTF pipeline (18-20 products; cUS$17bn excluding Valtrex, Lipitor & Flomax)
- **Attractive** — Adjusted for NPVs of Valtrex, Tamsulosin & Lipitor exclusivities, Ranbaxy trades at 13.6x CY08E FDEPS, which is very attractive in our view.

| Buy/Medium Risk | 1M |
|---|---|
| Price (17 Jan 08) | Rs367.90 |
| Target price | Rs505.00 |
| Expected share price return | 37.3% |
| Expected dividend yield | 1.4% |
| **Expected total return** | **38.6%** |
| Market Cap | Rs137,283M |
| | US$3,505M |

**Price Performance (RIC: RANB.BO, BB: RBXY IN)**


**Statistical Abstract**

| Year to 31 Dec | Net Profit (RsM) | Diluted EPS (Rs) | EPS growth (%) | P/E (x) | P/B (x) | ROE (%) | Yield (%) |
|---|---|---|---|---|---|---|---|
| 2005A | 2,617 | 7.03 | -62.6 | 52.4 | 5.6 | 10.6 | 1.6 |
| 2006A | 5,103 | 12.76 | 81.7 | 28.8 | 5.7 | 20.3 | 2.3 |
| 2007E | 7,863 | 19.67 | 54.1 | 18.7 | 4.9 | 28.1 | 2.3 |
| 2008E | 8,704 | 21.77 | 10.7 | 16.9 | 4.2 | 26.7 | 2.4 |
| 2009E | 11,228 | 28.08 | 29.0 | 13.1 | 3.5 | 29.2 | 2.7 |

Source: Powered by dataCentral

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


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| Fiscal year end 31-Dec | 2005 | 2006 | 2007E | 2008E | 2009E |
|---|---|---|---|---|---|
| **Valuation Ratios** | | | | | |
| P/E adjusted (x) | 52.4 | 28.8 | 18.7 | 16.9 | 13.1 |
| EV/EBITDA adjusted (x) | 43.7 | 18.7 | 17.2 | 12.2 | 9.8 |
| P/BV (x) | 5.6 | 5.7 | 4.9 | 4.2 | 3.5 |
| Dividend yield (%) | 1.6 | 2.3 | 2.3 | 2.4 | 2.7 |
| **Per Share Data (Rs)** | | | | | |
| EPS adjusted | 7.03 | 12.76 | 19.67 | 21.77 | 28.08 |
| EPS reported | 7.03 | 12.76 | 19.67 | 21.77 | 28.08 |
| BVPS | 65.70 | 64.68 | 75.31 | 87.52 | 104.97 |
| DPS | 6.00 | 8.50 | 8.50 | 9.00 | 10.00 |
| **Profit & Loss (RsM)** | | | | | |
| Net sales | 53,131 | 61,382 | 69,427 | 78,045 | 90,542 |
| Operating expenses | -51,149 | -54,452 | -61,674 | -66,834 | -76,654 |
| **EBIT** | **1,982** | **6,930** | **7,753** | **11,211** | **13,888** |
| Net interest expense | -671 | -1,036 | -1,443 | -1,364 | -1,280 |
| Non-operating/exceptionals | 633 | 616 | 3,661 | 1,238 | 1,672 |
| **Pre-tax profit** | **1,944** | **6,510** | **9,971** | **11,085** | **14,281** |
| Tax | 698 | -1,357 | -2,070 | -2,328 | -2,999 |
| Extraord./Min.Int./Pref.div. | -25 | -50 | -38 | -53 | -53 |
| **Reported net income** | **2,617** | **5,103** | **7,863** | **8,704** | **11,228** |
| Adjusted earnings | 2,617 | 5,103 | 7,863 | 8,704 | 11,228 |
| Adjusted EBITDA | 3,427 | 8,773 | 9,981 | 13,916 | 16,911 |
| **Growth Rates (%)** | | | | | |
| Sales | -2.5 | 15.5 | 13.1 | 12.4 | 16.0 |
| EBIT adjusted | -77.4 | 249.6 | 11.9 | 44.6 | 23.9 |
| EBITDA adjusted | -65.7 | 156.0 | 13.8 | 39.4 | 21.5 |
| EPS adjusted | -62.6 | 81.7 | 54.1 | 10.7 | 29.0 |
| **Cash Flow (RsM)** | | | | | |
| **Operating cash flow** | **3,771** | **3,512** | **13,834** | **11,304** | **13,645** |
| Depreciation/amortization | 1,445 | 1,843 | 2,228 | 2,706 | 3,022 |
| Net working capital | -746 | -4,492 | 2,262 | -1,522 | -1,939 |
| **Investing cash flow** | **-8,381** | **-19,931** | **-8,349** | **-3,665** | **-7,764** |
| Capital expenditure | -9,275 | -4,358 | -4,763 | -2,435 | -3,275 |
| Acquisitions/disposals | 712 | -15,803 | -3,512 | -270 | -3,451 |
| **Financing cash flow** | **7,460** | **15,128** | **-7,085** | **-7,289** | **-5,530** |
| Borrowings | 11,622 | 19,544 | -2,030 | -2,100 | 0 |
| Dividends paid | -3,612 | -3,611 | -3,612 | -3,825 | -4,250 |
| **Change in cash** | **2,851** | **-1,291** | **-1,600** | **351** | **351** |
| **Balance Sheet (RsM)** | | | | | |
| **Total assets** | **59,687** | **84,001** | **88,573** | **95,705** | **107,101** |
| Cash & cash equivalent | 2,430 | 2,951 | 1,000 | 1,000 | 1,000 |
| Accounts receivable | 11,404 | 15,716 | 14,264 | 16,791 | 19,526 |
| Net fixed assets | 26,187 | 42,534 | 45,421 | 45,502 | 46,106 |
| **Total liabilities** | **35,051** | **57,808** | **58,091** | **60,290** | **64,653** |
| Accounts payable | 7,714 | 8,128 | 8,323 | 10,925 | 12,704 |
| Total Debt | 20,043 | 39,556 | 37,526 | 35,426 | 35,426 |
| **Shareholders' funds** | **24,636** | **26,193** | **30,482** | **35,415** | **42,447** |
| **Profitability/Solvency Ratios (%)** | | | | | |
| EBITDA margin adjusted | 6.4 | 14.3 | 14.4 | 17.8 | 18.7 |
| ROE adjusted | 10.6 | 20.3 | 28.1 | 26.7 | 29.2 |
| ROIC adjusted | 6.8 | 10.2 | 8.8 | 13.4 | 15.8 |
| Net debt to equity | 71.5 | 139.8 | 119.8 | 97.2 | 81.1 |
| Total debt to capital | 44.9 | 60.2 | 55.2 | 50.0 | 45.5 |

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# Steady Quarter; Strong Guidance

**We maintain our Buy (1M) rating on Ranbaxy, as the company's strong guidance for CY08 indicates that it is well set to continue the recovery process that commenced last year. A strong FTF pipeline, tie-ups to augment its product pipeline & leverage its strong front end and efforts to move to a more capital efficient model make us positive on Ranbaxy's short as well as long term prospects. We have raised our earnings estimates for CY08 & CY09 by 2.5% and 2.9% respectively to account for the strong guidance. Adjusted for NPVs of Valtrex, Tamsulosin & Lipitor exclusivities, Ranbaxy trades at 13.6xCY08E FDEPS, which is very attractive in our view.**

## Steady Quarter

**Figure 1. Ranbaxy 4Q & CY07 Earnings Summary**

| Year to 31st December | 4Q CY06 | 4Q CY07 | % Ch YoY | 3QCY07 | % Ch QoQ | CY06 | CY07 | % Ch YoY | CIR Comments |
|---|---|---|---|---|---|---|---|---|---|
| Sales | 17,077 | 17,951 | *5.1* | 16,520 | *8.7* | 60,652 | 66,353 | *9.4* | |
| Excise Duty | 102 | 106 | *3.9* | 106 | - | 482 | 449 | *(6.8)* | |
| **Net sales** | **16,975** | **17,845** | ***5.1*** | **16,414** | ***8.7*** | **60,170** | **65,904** | ***9.5*** | **20% growth in dollar terms – in line with guidance** |
| Other Operating Income | 794 | 1,178 | *48.4* | 1,316 | *(10.5)* | 1,179 | 3,523 | *198.8* | Mainly driven by gains on forward cover contracts |
| **Total Net revenues** | **17,769** | **19,023** | ***7.1*** | **17,730** | ***7.3*** | **61,350** | **69,427** | ***13.2*** | |
| Cost of sales | 9,131 | 9,653 | *5.7* | 8,702 | *10.9* | 31,046 | 35,731 | *15.1* | |
| **Gross Profit** | **8,638** | **9,370** | ***8.5*** | **9,028** | ***3.8*** | **30,304** | **33,696** | ***11.2*** | **Rupee appreciation and high base effect of simva exclusivity hurts gross margins YoY** |
| ***Gross margins*** | ***48.6*** | ***49.3*** | ***64 bps*** | ***50.9*** | ***-166 bps*** | ***49.4*** | ***48.5*** | ***-86 bps*** | |
| SG&A | 4,749 | 5,008 | *5.5* | 5,091 | *(1.6)* | 17,608 | 19,476 | *10.6* | |
| *as a % of sales* | *28.0* | *28.1* | *9 bps* | *31.0* | *-295 bps* | *29.3* | *29.6* | *29 bps* | |
| R&D | 1,224 | 1,385 | *13.2* | 1,106 | *25.2* | 3,955 | 4,239 | *7.2* | R&D spend to be under US$100m in CY08 post demerger of NDDR business |
| *as a % of sales* | *7.2* | *7.8* | *55 bps* | *6.7* | *102 bps* | *6.6* | *6.4* | *-14 bps* | |
| **EBITDA** | **2,665** | **2,977** | ***11.7*** | **2,831** | ***5.2*** | **8,740** | **9,981** | ***14.2*** | **Ability to maintain margins despite sharp rupee appreciation is a positive; Core EBIDTA margin (excluding translation loss of 16.5% in CY07)** |
| ***EBITDA Margin (%)*** | ***15.0*** | ***15.6*** | ***65 bps*** | ***16.0*** | ***-32 bps*** | ***14.2*** | ***14.4*** | ***13 bps*** | |
| Depreciation/Amortization | 531 | 493 | *(7.2)* | 613 | *(19.6)* | 1,843 | 2,228 | *20.9* | |
| Interest Cost | 247 | 385 | *55.9* | 394 | *(2.3)* | 1,036 | 1,443 | *39.3* | |
| Forex (Gain)/Loss | (460) | (109) | *nm* | (487) | *(78)* | (85) | (3,169) | *nm* | MTM gains on forex debt; not sustainable |
| Other Income | 24 | 87 | *262.5* | 56 | *55.4* | 564 | 225 | *(60.1)* | |
| PBT | 2,371 | 2,295 | *(3.2)* | 2,367 | *(3.0)* | 6,510 | 9,704 | *49.1* | |
| Tax | 512 | 461 | *(10.0)* | 516 | *(10.7)* | 1,357 | 2,070 | *52.5* | |
| *Tax Rate* | *21.6* | *20.1* | *-151 bps* | *21.8* | *-171 bps* | *20.8* | *21.3* | *49 bps* | |
| PAT | 1,859 | 1,834 | *(1.3)* | 1,851 | *(0.9)* | 5,153 | 7,634 | *48.1* | |
| Minorities | 26 | - | *(100.0)* | - | *nm* | 50 | 38 | *(24.3)* | |
| **Recurring Net Income** | **1,833** | **1,834** | ***0.1*** | **1,851** | ***(0.9)*** | **5,103** | **7,596** | ***48.8*** | |
| Exceptionals | - | 44 | *nm* | 223 | *nm* | - | 267 | *nm* | Includes Rs235m from sale of land and building and Rs191m of provision towards compensation of termination of a supply arrangement for a key molecule |
| **Reported PAT** | **1,833** | **1,878** | ***2.5*** | **2,074** | ***(9.5)*** | **5,153** | **7,901** | ***53.5*** | |

Source: Company Reports and Citi Investment Research

## Strong Guidance

Ranbaxy's CY08 guidance came in as a positive surprise, especially in the rising rupee environment. Key components of the guidance include:

- Revenue growth (dollar terms) of 18-20% - we expect growth in rupee terms to be lower on account of continued appreciation in the rupee
- EBIDTA margins of 17.5-18% (post demerger of NCE R&D business) – with R&D spend expected to slip under US$100m

- Net profit (reported) growth of 20-25% - this would largely come from the core business & include some upside on account of sale of certain assets.

### Net profit guidance is particularly impressive

Ranbaxy's CY07 reported net profit includes Rs 2230m by way of net translation gains and US$47m by way of forward cover gains – both of which are unlikely to sustain at similar levels in CY08. Besides, Ranbaxy has not included any translation gain / loss on currency or potential first to file / settlement in the guidance. As such, a 20-25% growth on reported PAT implies a significant growth in core profits even if we were to exclude any upside from asset sales.

**Figure 2. Key Data**

| | 2007 | 2008E | % Ch | CIR Comments |
|---|---|---|---|---|
| **Recurring Net Income** | **6,062** | **8,242** | ***36%*** | **Does not include any forex gains or losses on translation** |
| Net Translation Impact (net of tax) | 1,561 | 462 | *-70%* | This is not a part of Ranbaxy's overall net profit guidance. Sharp appreciation of the rupee v/s the US$ led to high gains in CY07; we expect this to fall off substantially in CY08 |
| Extraordinary Items (post tax) | 240 | - | *nm* | |
| **Reported PAT** | **7,863** | **8,704** | ***11%*** | **We have not forecast any gains on sale of assets that the management has incorporated into its guidance** |
| Company Guidance | 7,863 | 9,4 36-9,839 | *20-25%* | To come largely from the core business and would also include some gain from sale of assets. Does not include any FTF / settlement upside nor any impact of forex gains / losses on translation |

Source: Company Reports and Citi Investment Research

We have raised our net profit estimates for CY08-09 by 2.5-2.9% and forecast 36% growth in Ranbaxy's core net profit in CY08. Our estimates currently do not include any upside from the Valtrex settlement or the expected FTF opportunity in 2HCY08.

## Update on key markets

**Figure 3. Ranbaxy 4Q & CY07 Revenue Distribution**

| | 4Q CY06 | 4Q CY07 | *% Ch YoY* | 3QCY07 | *% Ch QoQ* | CY06 | CY07 | *% Ch YoY* | CIR Comments |
|---|---|---|---|---|---|---|---|---|---|
| **Dosages** | | | | | | | | | |
| India | 71 | 92 | *29.6* | 97 | *(5.2)* | 275 | 354 | 28.8 | 11% growth in rupee terms is the true picture |
| Europe, CIS and Africa | 136 | 174 | *27.9* | 135 | *28.9* | 420 | 579 | 38.0 | Led by UK, France and Romania |
| Asia Pac & Middle East | 19 | 26 | *36.8* | 20 | *30.0* | 89 | 94 | 5.6 | |
| Latin America | 16 | 20 | *25.0* | 18 | *11.1* | 49 | 64 | 30.8 | |
| North America | 114 | 113 | *(0.9)* | 109 | *3.7* | 392 | 415 | 6.0 | Base business grew 19% YoY in CY07 |
| **Total Dosage** | **356** | **425** | ***19.4*** | **379** | ***12.1*** | **1,225** | **1,507** | **23.0** | |
| API | 26 | 27 | *3.8* | 26 | *3.8* | 115 | 100 | *(12.4)* | |
| **Total Sales** | **382** | **452** | ***18.3*** | **405** | ***11.6*** | **1,339** | **1,607** | ***20.1*** | |
| INR | 44.8 | 39.9 | *(10.8)* | 40.6 | *(1.6)* | 45.3 | 41.3 | *(8.9)* | |

Source: Company Reports and Citi Investment Research

### North America

- **US** – Revenues of US$ 386m for CY08 and US$ 104m for 4QCY08. The business recorded 19% growth yoy for CY07 and 8% yoy growth for 4Q (excluding first to file opportunities); branded business growth was driven by the dermatology portfolio acquired from BMS and robust performance of the company's flagship brand, Sotret

- **Canada** – Revenues of US$29m for the year and US$ 9m for the quarter up 148% and 62% yoy respectively.

### Europe

- **Romania** – Revenues of US$120m for the year and US$ 32m for the quarter up 21% and 23% yoy respectively. Post integration of Terapia in 2006 the company has garnered the largest market share in the generics segment in the region. Revenue growth in this market was hampered to some extent in CY07 due to the postponement of the pricing and reimbursement system that prompted distributors and wholesalers to delay their purchases. With the system expected to be put in place by February 2008, growth momentum is likely to pick up once again in CY08.

- **Germany** – Revenues at US$49m were up 69% yoy for the year. For the quarter the company recorded a yoy increase of 170% with sales of US$16m. In 2007 the company managed to win 11 products in the AOK tender and plans to participate aggressively in the upcoming tenders for 2008 and 2009

- **UK** – Sales were up 36% yoy at US$ 47m for CY07. For the quarter sales at US$ 12m grew by 22% yoy. Branded business growth was driven by inhaler products sales which grew by 27% during the year.

- **Rest of Europe** – Annual sales were up 20% at US$74m. Quarterly sales grew by 6% at US$20m. Sales in Italy and Portugal grew by over 60% yoy while Spain recorded an 11% increase.

### Asia & CIS

- **India** – Overall business grew by 22% yoy with revenues of US$ 301m. For the quarter sales grew by 30% yoy at US$ 76m. However, the growth in dollar terms is a misnomer, as it gets inflated on conversion in a rising rupee environment. The real picture is reflected in the 11% YoY growth in rupee terms

- **CIS** – Sales in Russia was at US$52m up 17% yoy while Ukraine recorded a 28% yoy increase with sales of US$ 38m. Sales were mainly driven by key brands such as Ketanov and Faringospet in Russia and Ketanov and Cifran in Ukraine

### Rest of the World

- Brazil recorded a 44% yoy growth with sales of US$ 39m for CY07. Sales in Rest of Latin America increase 18% yoy.

# Ranbaxy

## Company description

Ranbaxy is a leading domestic pharmaceutical company with a strong export business complementing the domestic business. It has a vision of becoming a leading generics pharmaceutical company in the global market and, in the long term, a research-led pharmaceutical company. The company already has a presence in several countries, and has developed a complex business model, perhaps the first of its kind from a developing country. Over the past few years, Ranbaxy has grown rapidly and established itself firmly as a leading generics company globally. While the core pharmaceutical business is growing, the company has also invested in R&D. The company also has a strong chemicals and animal healthcare business in India.

## Investment strategy

We rate Ranbaxy Buy/Medium Risk (1M) with a target price of Rs505. We believe the stock price now factors in most negatives - viz. difficult global market dynamics, manufacturing related issues with the FDA, slowdown in product approvals, and loss of the Pravastatin 80mg opportunity. Moreover, we believe that these negatives and the declining stock price mask the positive steps that Ranbaxy has been taking since the beginning of CY06 to effect a turnaround in its fortunes. Benefits of its restructuring initiatives were visible in 1QCY06 operating profit margins, the EU foray has gained momentum with a series of acquisitions and revenues should scale up faster once the manufacturing issues are resolved. In the interim, we expect strong earnings momentum driven by exclusivity launch of Simvastatin 80mg to provide support to stock valuations and restrict downside.

## Valuation

We prefer to value Ranbaxy using EV/Sales methodology to reflect a much fairer value of Ranbaxy's business today. We believe that Ranbaxy's current cost structure and profitability are not normalized. Its cost structure is highly fixed-cost oriented and is a legacy of the heady days of very high profitability in global generics. We believe this is being corrected now, and the benefits of the aggressive cost reduction initiatives have started coming through in the financials in CY06. With its presence across multiple geographies and wide basket of products, we believe the business is not fairly valued at 2.5x sales - this is primarily on account of profitability being under par. A large part of the costs are discretionary and related to pipeline building measures for future growth, which do not contribute to revenues in the near term. Our fair value multiple of 3x Sept 07 EV/Sales is at a discount to its peers such as Cipla and Sun and towards the lower end of the company's EV/Sales range of 2-4.6x over the past five years. Because the company is still emerging from a period of poor sales growth and sub-optimal profitability, we will wait for growth to return before considering applying a higher multiple. At 3x Sept 07 EV/Sales, our target price is Rs505.

## Risks

We rate Ranbaxy Medium Risk based on our quantitative risk-rating system. The key upside risks to our target price include: (1) New ANDA approvals above the expected three to four per quarter; (2) Upside from simvastatin 80mg being higher than we expected (3) News on the NCE development program; and (5) Any new paragraph IV challenges. The key downside risks that could impede the stock from reaching our target price: (1) Intensifying pricing pressure in the US and European markets; (2) The company paying high multiples to acquire more businesses in Europe and USA; and (3) Inability to resolve the manufacturing issues with the US FDA by the end of the current fiscal.

# Appendix A-1

## Analyst Certification

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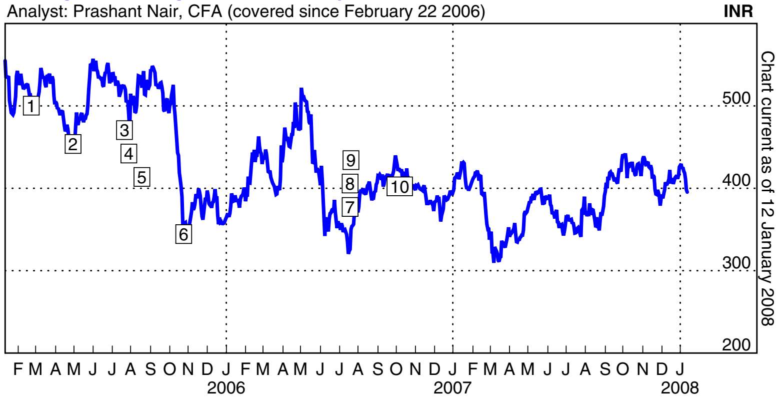
**Ranbaxy (RANB.BO)**
**Ratings and Target Price History - Fundamental Research**
Analyst: Prashant Nair, CFA (covered since February 22 2006)




| # | Date | Rating | Target Price | Closing Price |
|---|---|---|---|---|
| 1: | 22 Feb 05 | 3M | *467.50 | 506.55 |
| 2: | 29 Apr 05 | 3M | *422.50 | 456.42 |
| 3: | 21 Jul 05 | 3M | *407.50 | 522.97 |
| 4: | 28 Jul 05 | 3M | 407.50 | NA |
| 5: | 18 Aug 05 | 3M | *385.00 | 522.05 |
| 6: | 25 Oct 05 | 3M | *363.00 | 344.40 |
| 7: | 19 Jul 06 | *1M | *402.00 | 325.90 |
| 8: | 19 Jul 06 | 1M | 402.00 | 325.90 |
| 9: | 20 Jul 06 | 1M | 402.00 | 349.90 |
| 10: | 6 Oct 06 | 1M | *505.00 | 422.35 |

*Indicates change.

Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

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

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