India | Health Care

11 January 2012

Cipla

Levers for earnings surprises

- We upgrade Cipla to Outperform from In-Line and raise price target to Rs400 (Rs315 earlier) given levers for earnings surprises and potential for valuation re-rating.
- Margin upside is visible, led by operating leverage benefits, improved product mix and higher contribution from developed markets.
- INR depreciation will benefit revenue and margin; sensitivity analysis shows margin expansion of 50-150bps for 5-15% INR depreciation.
- Potential generic Seretide launch in key EU markets in FY13 could add 4-5% upside to revenue.
- 12-month PT of Rs400 valuing Cipla at 20x P/E.

Margin upside potential. Margin upside in the short term is visible led by a) operating leverage benefits, b) product mix improvements and c) higher contribution from developed markets. Indore SEZ (20% of gross block, 8% of revenue) achieved break-even in 2Q FY12, as per our calculation, with potential to scale up to 15-20% of revenue at peak.

Poised to gain from currency weakness. Cipla's net US$ export exposure is ~22% of sales; our sensitivity analysis shows margin gains of 50-150bps for 5-15% INR devaluation, (4-12% upsides to our estimates). Operationally, the company's shorter duration forex hedges (2-3 months) and minimal debt place it favourably to ride the current INR weakness.

Potential generic Seretide launch in EU in FY13 next significant trigger. Cipla expects generic Seretide approval for some key EU markets in FY13. We currently model no such upside due to registration complexities (for product and device), but a potential approval for MDI adds US$50-70m (4-5% of revenue) to estimates on an annual basis.

Earnings growth = re-rating. Cipla's valuations over the past 4-5 years have de-rated, tracking the 12-13% CAGR earnings growth in FY08-11 (50% lower than FY03-08) and currently is 25-30% lower than peak valuations. Current upward trajectory (17% CAGR over FY11-14E) position the stock for a valuation re-rating given lower earnings volatility, healthy balance sheet, potential for improved ratios and a reasonable risk-reward ratio. We raise our 12 month PT to Rs400 valuing it at 20x (18x earlier), which is in-line with peers like Sun Pharma and Dr. Reddy's. Key risks include potential negative impact of DPCO outcomes.

OUTPERFORM (from IN-LINE)

PRICE (as at 11 January 2012)	PRICE TARGET
Rs340.55	**Rs400.00**

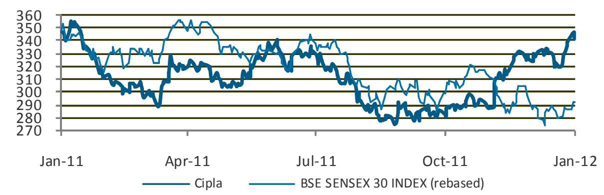
Bloomberg code	**Reuters code**
CIPLA IN	CIPL.BO
Market cap	**12 month range**
Rs273,428m (US$5,288m)	Rs274.50 - 354.60

EPS adj est change	2012E	-	2013E	12%

Year end: March	2011	2012E	2013E	2014E
Sales (Rsm)	63,145	68,721	78,469	88,812
EBITDA (Rsm)	13,276	15,711	18,766	21,840
EBIT (Rsm)	10,734	12,884	15,661	18,432
Pretax profit (Rsm)	11,625	13,969	16,471	19,242
Net profit adjusted (Rsm)	9,896	11,400	13,566	15,816
FCF (Rsm)	(429)	6,090	5,492	8,299
EPS adjusted (Rs)	12.32	14.20	16.90	19.70
DPS (Rs)	2.00	3.19	3.80	4.43
Book value/share (Rs)	83.03	93.49	105.94	120.45
EPS growth adj (%)	-3.1	15.2	19.0	16.6
DPS growth (%)	0.0	59.7	19.0	16.6
EBITDA margin (%)	21.0	22.9	23.9	24.6
EBIT margin (%)	17.0	18.7	20.0	20.8
Net margin adj (%)	15.7	16.6	17.3	17.8
Div payout (%)	16.2	22.5	22.5	22.5
Net gearing (%)	7.1	1.9	-2.1	-7.5
ROE (%)	15.7	16.1	16.9	17.4
ROCE (%)	15.4	15.8	17.1	17.9
EV/Sales (x)	4.2	4.0	3.5	3.0
EV/EBITDA (x)	20.1	17.5	14.5	12.2
PBR (x)	3.9	3.6	3.2	2.8
PER adj (x)	**26.8**	**24.0**	**20.2**	**17.3**
Dividend yield (%)	**0.6**	**0.9**	**1.1**	**1.3**

Source: Company, Standard Chartered Research estimates

Share price performance



Share price (%)	-1 mth	-3 mth	-12 mth
Ordinary shares	5	21	-2
Relative to Index	5	24	17
Relative to Sector	-	-	-
Major shareholder			Promoter (36.8%)
Free float			63%
Average turnover (US$)			8,475,329

Source: Company, FactSet

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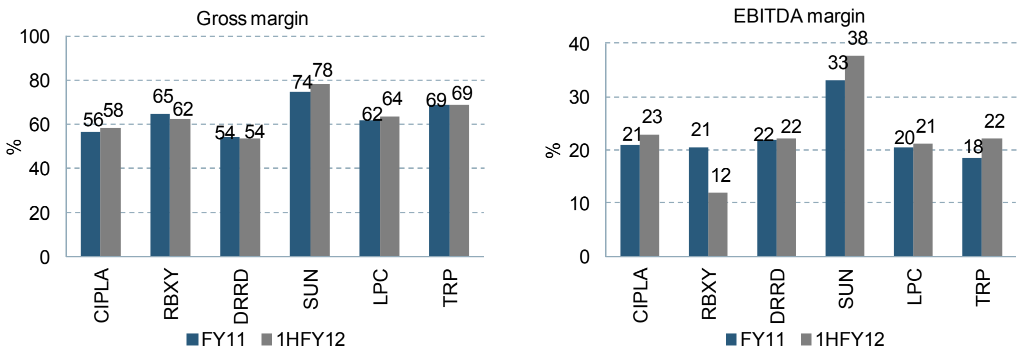
Investment argument

Margin upside visible in the short term

We believe Cipla has the potential to deliver further margin expansion surprises despite its partnership export model constraining overall margins in comparison to peers (~12% average discount to peers like Dr Reddy's, Ranbaxy and Sun Pharma, even after discounting for "limited competition" products), see Fig 1 below. Future margin performance will be buoyed by a) operating leverage benefits, b) improvement in product mix, c) higher contribution from developed markets and d) recent currency movements. We thus increase our overall margin assumptions by 20-50bps for FY13/14.

Fig 1 – Cipla has lower margins than most large cap peers



Source: Company, Standard Chartered Research

Large capacities being commercialized – potential for operating leverage

Cipla's EBITDA margin has improved 140bps (end 2Q FY12) to 23.7% from FY05 levels of 22.4%. Our analysis of this margin recovery shows that it has been led by improved gross margins. Gross margins have improved 300bps from FY10 to 2Q FY12 (and 500bps in the past six years). Fixed costs, in our analysis, has contributed 650bps negatively to overall margins, with overall fixed costs having grown at a 23% CAGR over FY05-11, against revenue growth of 19% during the same period (see Fig 2 below).

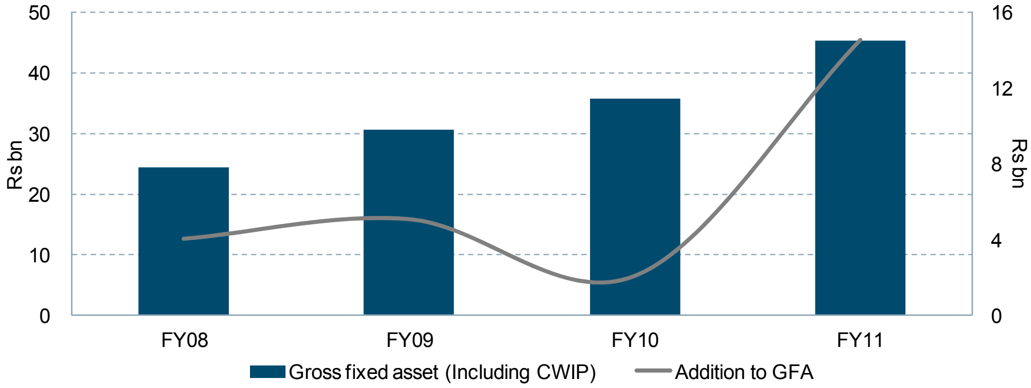
Fig 2 – Fixed costs have outpaced sales growth in the past six years

	FY05	FY11	CAGR (%)	Q1FY12	% yoy	Q2FY12	% yoy
Net sales (ex tech income)	21,813	61,303	18.8	15,676	7.0	17,563	10.0
Staff costs	1,166	4,895	27.0	1,712	24.0	1,875	36.0
Other fixed costs	5,380	17,504	21.7	3,824	24.0	4,413	17.0
Total fixed costs	6,546	22,399	22.8	5,537	24.0	6,288	22.0
EBITDA	5,054	13,276	17.5	3,457	-1.0	4,158	22.0
Gross margins (%)	51.4	56.5		57.4		59.5	
EBITDA margins (%)	22.4	21.0		22.0		23.7	

Source: Company, Standard Chartered Research

This sharp increase in fixed costs, in our view, is primarily due to the stepped up capex incurred by the company in the past few years. Total capex during FY08-11 was Rs26bn, increasing total gross fixed assets by 85% during the period. This included investments for formulations (Indore ~Rs9bn and Sikkim ~Rs3.1bn), APIs (Kurukumbh, Bangalore and Patalganga) and R&D facilities.

Fig 3 – Gross fixed asset increased by 85% over the past four years



Source: Company, Standard Chartered Research

Fig 4 – Capex additions have been higher in FY09 and FY11 as plants got commissioned

(Rs bn)	FY08	FY09	FY10	FY11
Incremental net sales	5.7	9.5	4.0	7.7
Incremental fixed cost	3.0	3.2	1.3	4.7
Incremental gross fixed asset	5.6	6.2	5.2	9.4

Source: Company, Standard Chartered Research

As shown in Fig 4 above, capex additions have not been uniform, with higher additions in FY09 and FY11, as plants have got commercialized. The recent spike in FY11 can largely be explained by acquisition of Meditab assets and commercialization of Indore SEZ in May '10.

We believe that Cipla's margins are poised to benefit significantly from higher operating leverage over the medium term, especially as the company moves to commercialize its large investments incurred over the past 4-5 years. To highlight, the Indore SEZ facility (20% of current gross block) has seen a steady sequential ramp up (see Fig 5 below) in revenue, with the plant now clocking revenue of ~Rs1.5bn quarterly (see Fig 5 below) and could contribute almost 10% of FY12 company revenue, as per our estimates. Conversely, the company is currently incurring ~Rs600-700m as fixed costs every quarter from this plant, which would see some scale benefits as the capacities are more efficiently utilized. As per our estimates, on a company gross margin of ~55%, the Indore SEZ would have broken even in 2Q FY12, and could contribute positively to margins from 3Q, with capacity scale-up providing upside benefits.

Fig 5 – We expect Indore SEZ to contribute ~10% of sales in FY12

	4QFY11	1QFY12	2QFY12	FY11	FY12E
Indore SEZ sales	600	1,400	1,500	1,000	7,000
% of total sales	3.4	8.8	8.4	1.6	10.0
Total sales	17,881	15,911	17,825	61,726	68,353

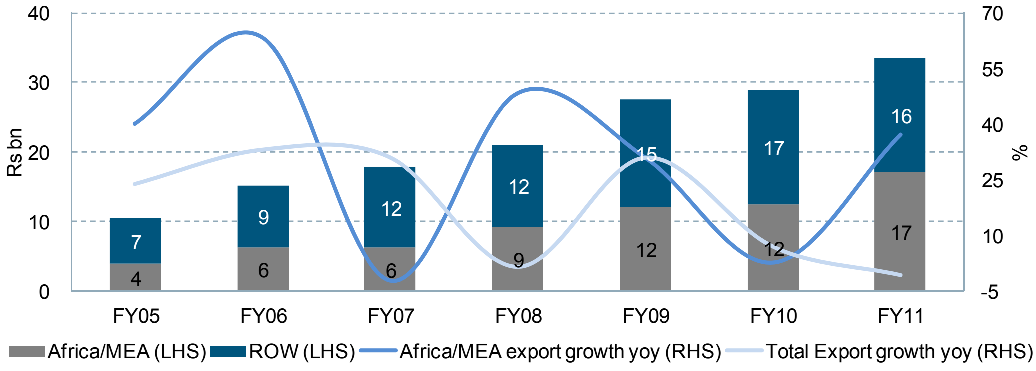
Source: Company, Standard Chartered Research Estimates

On a gross fixed asset turnover basis of 1.5-2x, we believe the Indore SEZ could ramp up sales to around Rs18-20bn at peak, in our view. However, predicting the timing of such a quantum jump in revenue is difficult and would be contingent on the plant getting mandatory key regulatory approvals, including USFDA approvals. According to the company, it expects to file for USFDA in FY13 and thus we would expect such approvals 12-18 months post such filings.

Product mix improvements

A second leg for margin support comes from the improved product mix. Cipla's recent export growth has been led by Africa/MEA, which contributed 56% of total incremental export growth in FY04-11. The bulk of exports in these markets comprise ART (anti-retroviral therapy) sales that are typically government contracts with high volume and low margins, marked by intense competition. Cipla has indicated that it has recently begun to focus on better profit realizations in its tender business, even at the expense of revenue.

Fig 6 – Export growth has been led by Africa/MEA geographies



Source: Company, Standard Chartered Research

We see developed market business gaining traction (currently 29% of exports, as per our estimates), as many of Cipla's existing partnership contracts (22 in US, 60 in EU) await commercialization. This should help overall profitability in the businesses, in our view.

Currency depreciation to help margins expand

We estimate Cipla has a net US$ export exposure ((Total exports less EU exports) – (Total Imports less estimated Forex fixed costs)) of ~22% of sales, which would imply that Cipla should be a net beneficiary of the current depreciation in the Indian currency, both in revenue and also in margins. Our sensitivity analysis shows that 5-15% depreciation in the INR would expand margins by 50-150bps (see Fig 7 below) from our current margin estimate of ~24% for FY13.

Cipla does hedging on a monthly basis for net exports (US$190m in 2Q FY12, covering 2-3 months of exports), which is relatively of a shorter duration compared to most of peers. Thus we expect the company to be an early beneficiary of the recent currency depreciation. Moreover, its balance sheet position is also healthy, with marginal impact due to minimal debt on books.

Fig 7 – Sensitivity analysis – Impact on margin due to INR depreciation for FY13 estimates

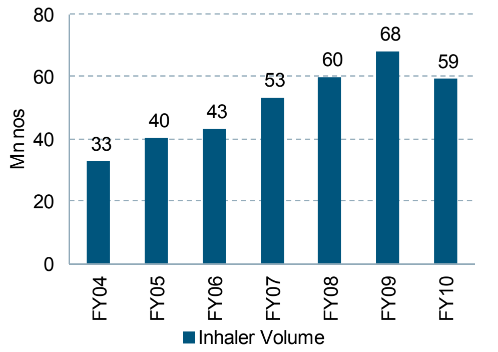
Currency depreciation	0%	5%	10%	15%
Sales	78,469	80,258	82,047	83,836
EBITDA	18,766	19,633	20,501	21,368
EBITDA margin (%)	23.9	24.5	25.0	25.5
Increase in margin from base case (bps)		**55**	**107**	**157**

Source: Company, Standard Chartered Research Estimates

Inhaler opportunity profitable, but regulatory challenges remain

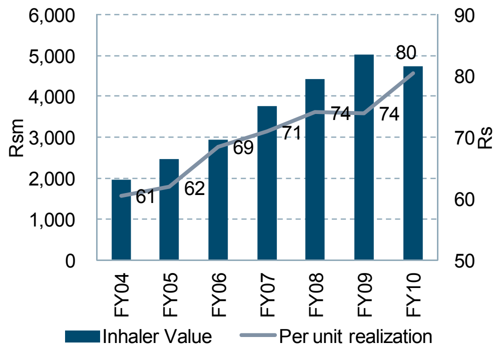
An important option value to Cipla will be the supply of inhalers to regulated markets, where Cipla currently has four approvals and at least six products in the pipeline. Cipla has a relatively attractive competitive position around inhalers, with an early mover advantage in the EU and a reasonably strong franchise in India. Inhalers contribute almost 15-20% of Cipla's total sales (similar share both in exports and domestic formulations). Cipla is the leader in the domestic market (estimated at ~55% market share in anti-asthmatic products and 70% market share in the inhaler market.) Fig 8 shows sales of inhalers/aerosols over the past seven years.

Fig 8 – Volume of aerosols have increased



Source: Company, Standard Chartered Research

Fig 9 – Value of sales have increased

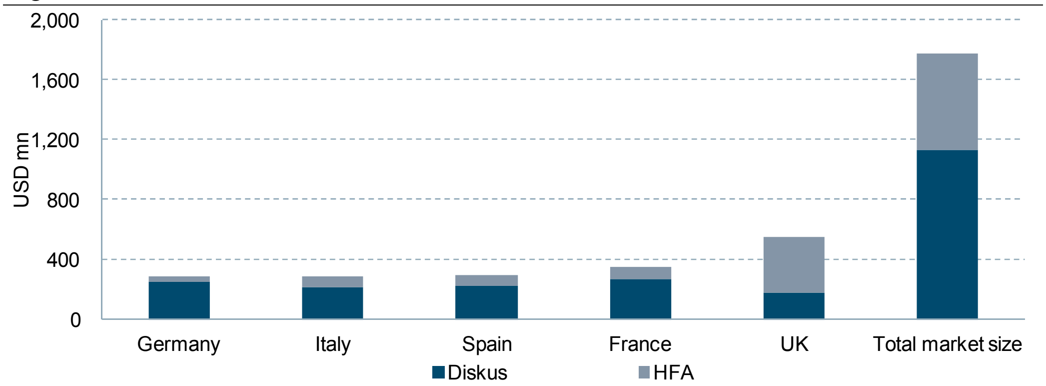


Source: Company, Standard Chartered Research

Regulated markets, including the US and the EU, offer the largest pie, with the EU itself representing Euro1.8bn of branded sales, in mono and combo therapies. It currently has approvals for some mono therapies including budesonide inhalers in Germany, Portgual and Spain, salmeterol inhalers in the UK, Germany, Poland and Ireland and beclomethasone in Portugal.

The next trigger for Cipla in inhalers would come from combination therapy approvals. According to the company, it is expecting approval for generic Seretide (fluticasone/salmeterol) in the EU next year, which would be a significant approval for the company, representing its first combination approval in these markets. The total Seretide market in the EU is ~US$1.8 bn, as shown in Fig 10 below, with ~65% of the market in DPI (dry powder inhalers) form.

Fig 10 – DPIs form almost 65% of the market for Seretide in the EU



Source: Standard Chartered Research

We believe that Cipla would most likely be targeting approvals in the MDI (metered dose inhalers) segment in the first phase, which is approximately one-third of the available opportunity in the EU, with the key market of the UK contributing almost 55% of the MDI market in Seretide. We believe that Cipla has a partnership with Neolabs for generic Seretide in the UK. While the basic patent on the combination had expired in Sep '10, Seretide is covered by a Supplementary Protection Certificate (SPC) extending patent protection until Sep '13. Neolab has filed to invalidate the combination patent in key markets like Germany and the UK.

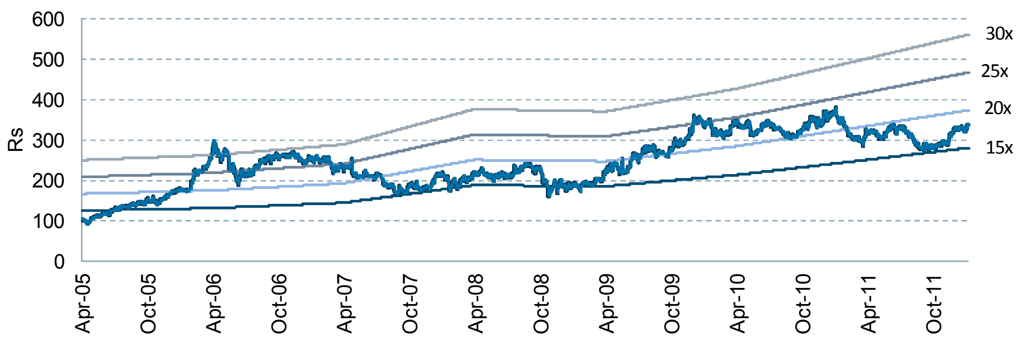
In the US market, Cipla is currently developing a fluticasone/azelastine nasal spray combination for Meda, which is currently in Phase III trials. This arrangement has also been extended for other key markets like the EU, Brazil, Australia and Japan and could lead to US$5m on registration in each country and up to US$10m on attainment of certain milestones. Meda has filed for USFDA approval in April 2011 with a PDUFA data set for May 2012, and is also expected to file for Europe approvals shortly.

We have not built in a separate revenue stream for upside from such approvals, despite the Seretide opportunity being a fairly lucrative one for the company, with possibly only 2-3 other generic players. The registration process is fairly complex, including data from separate trials and device level complexities. Assuming a 20-25% market share with 30-40% price erosion, the total market for generic Seretide in MDIs in the EU could represent almost US$70-80m with the UK itself offering a market of US$50m for the company, as per our estimates. We have also not built in separate upside from revenue or milestone on account of Meda in our estimates, where there is a potential for milestone incomes in the next few quarters.

Valuation

Cipla's valuations have been volatile, but have generally trended lower in the past five years. From a peak valuation of 28-30x, the stock saw a significant de-rating, with lows of 13-15x in 2008 and current 18x. This de-rating tracked the underwhelming operations of the company, as profit growth halved to 12-13% CAGR over FY08-11 from the historical 23-24% CAGR over FY03-FY08.

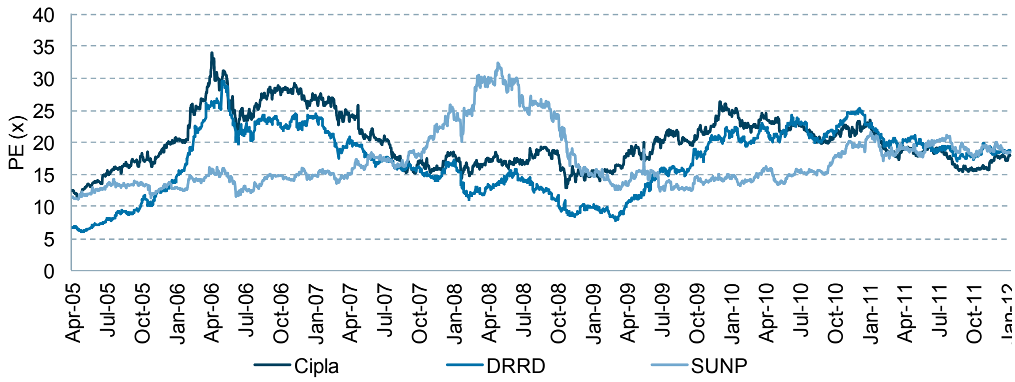
Fig 11 – Cipla: PE band



Source: Company, Bloomberg, Standard Chartered Research Estimates

On a relative basis, the stock has underperformed its larger peers (see Fig 12 below). From a historical premium of 20-25% to peers, the stock's de-rating saw it trade at a discount to its larger peers in 1H FY12.

Fig 12 – Cipla has come-off from its historical premium to peers, is now trading at par



Source: Company, Bloomberg, Standard Chartered Research Estimates

We believe that Cipla has the potential to surprise positively on earnings, given the above discussed levers for margin surprises. While margin upside is more visible in the short term (currency, operating leverage), the company could see significant upgrades if it secures approvals for generic Seretide in some of the key markets in the EU. As highlighted earlier, the company is expecting at least one market approval next year in the EU in generic Seretide and we estimate full year sales of at least US$70-80m from the MDI segment alone, assuming approvals across all key markets in the EU. This would represent 4-5% upside to our FY13 revenue estimates.

Given its valuation history of valuation premium, lower earnings volatility, potential for improved return ratios and healthy balance sheet, this would set the stage for valuations to also re-rate, in our view. Moreover, the earnings trajectory is also expected to improve significantly, with projected earnings CAGR of 17% over FY11-14E in our forecast period. This would be supported by option value in inhalers (especially combos and potential for the company to execute a large strategic contract in this segment). Moreover, the stock also scores favourably on a risk adjusted basis, given the lower revenue growth built in consensus (and our estimates) and lowered risk of negative surprises.

We thus set a new PT of Rs400 (Rs 315 earlier) and upgrade the stock to Outperform, basing our PT on 20x (18x earlier). We have marginally increased our margin estimates by 20-50bps in FY13-14E to factor in short-term currency movements.

Income statement (Rsm)					
Year end: Mar	2010	2011	2012E	2013E	2014E
Sales	56,057	63,145	68,721	78,469	88,812
Gross profit	31,527	35,674	40,339	45,904	51,955
SG&A	(16,471)	(21,173)	(23,525)	(25,924)	(28,745)
Other income	0	0	0	0	0
Other expenses	(1,261)	(1,226)	(1,103)	(1,213)	(1,371)
EBIT	**12,125**	**10,734**	**12,884**	**15,661**	**18,432**
Net interest	186	891	1,085	810	810
Associates	0	0	0	0	0
Other non operational	0	0	0	0	0
Exceptional items	950	0	0	0	0
Pretax profit	**13,261**	**11,625**	**13,969**	**16,471**	**19,242**
Taxation	(2,435)	(1,952)	(2,794)	(3,129)	(3,656)
Minority interests	0	224	225	225	230
Exceptional items after tax	0	(1)	0	0	0
Net profit	**10,826**	**9,896**	**11,400**	**13,566**	**15,816**
Net profit adj	**10,050**	**9,896**	**11,400**	**13,566**	**15,816**
EBITDA	**13,795**	**13,276**	**15,711**	**18,766**	**21,840**
EPS (Rs)	13.70	12.32	14.20	16.90	19.70
EPS adj (Rs)	12.72	12.32	14.20	16.90	19.70
DPS (Rs)	2.00	2.00	3.19	3.80	4.43
Avg fully diluted shares (m)	790	803	803	803	803

Cash flow statement (Rsm)					
Year end: Mar	2010	2011	2012E	2013E	2014E
EBIT	12,125	10,734	12,884	15,661	18,432
Depreciation & amortisation	1,671	2,542	2,827	3,106	3,408
Net interest	186	891	1,085	810	810
Tax paid	(2,285)	(2,320)	(2,794)	(3,566)	(4,175)
Changes in working capital	(1,310)	(2,889)	(2,912)	(5,519)	(5,176)
Others	950	0	0	0	0
Cash flow from operations	**11,337**	**8,957**	**11,090**	**10,492**	**13,299**
Capex	(5,037)	(9,386)	(5,000)	(5,000)	(5,000)
Acquisitions	(1,664)	(3,440)	0	0	0
Disposals	0	224	225	225	230
Others	0	0	0	0	0
Cash flow from investing	**(6,700)**	**(12,602)**	**(4,775)**	**(4,775)**	**(4,770)**
Dividends	(1,873)	(1,973)	(3,001)	(2,565)	(3,052)
Issue of shares	6,656	293	0	0	0
Change in debt	(9,352)	5,668	0	0	0
Other financing cash flow	0	0	0	0	0
Cash flow from financing	**(4,568)**	**3,988**	**(3,001)**	**(2,565)**	**(3,052)**
Change in cash	**69**	**344**	**3,314**	**3,152**	**5,477**
Exchange rate effect	0	0	0	0	0
Free cash flow	**6,300**	**(429)**	**6,090**	**5,492**	**8,299**

Balance sheet (Rsm)					
Year end: Mar	2010	2011	2012E	2013E	2014E
Cash	621	1,010	4,324	7,476	12,953
Short term investments	0	0	0	0	0
Accounts receivable	15,666	14,908	16,945	19,348	21,899
Inventory	15,126	19,062	20,710	23,648	26,765
Other current assets	12,260	11,619	12,781	14,059	14,762
Total current assets	**43,673**	**46,599**	**54,761**	**64,532**	**76,379**
PP&E	26,954	33,799	35,972	37,866	39,458
Intangible assets	0	0	0	0	0
Associates and JVs	0	0	0	0	0
Other long term assets	2,464	5,904	5,904	5,904	5,904
Total long term assets	**29,418**	**39,703**	**41,876**	**43,770**	**45,362**
Total assets	**73,091**	**86,302**	**96,637**	**108,302**	**121,742**
Short term debt	0	0	0	0	0
Accounts payable	9,980	9,581	10,382	11,482	12,677
Other current liabilities	0	0	0	0	0
Total current liabilities	**9,980**	**9,581**	**10,382**	**11,482**	**12,677**
Long term debt	51	5,719	5,719	5,719	5,719
Convertible bonds	0	0	0	0	0
Deferred tax	1,792	2,131	2,131	2,131	2,131
Other long term liabilities	2,164	2,210	3,345	3,915	4,507
Total long term liabilities	**4,006**	**10,060**	**11,195**	**11,765**	**12,357**
Total liabilities	**13,986**	**19,641**	**21,576**	**23,247**	**25,034**
Shareholders' funds	59,106	66,661	75,061	85,056	96,708
Minority interests	0	0	0	0	0
Total equity	**59,106**	**66,661**	**75,061**	**85,056**	**96,708**
Total liabilities and equity	**73,091**	**86,302**	**96,637**	**108,302**	**121,742**
Net debt (cash)	(570)	4,708	1,394	(1,758)	(7,235)
Year end shares (m)	803	803	803	803	803

Financial ratios and other					
Year end: Mar	2010	2011	2012E	2013E	2014E
Operating ratios					
EBITDA margin (%)	24.6	21.0	22.9	23.9	24.6
EBIT margin (%)	21.6	17.0	18.7	20.0	20.8
Net margin adj (%)	17.9	15.7	16.6	17.3	17.8
Effective tax rate (%)	18.4	16.8	20.0	19.0	19.0
Sales growth (%)	7.1	12.6	8.8	14.2	13.2
Net income growth (%)	40.4	-8.6	15.2	19.0	16.6
EPS growth (%)	38.1	-10.0	15.2	19.0	16.6
EPS growth adj (%)	28.2	-3.1	15.2	19.0	16.6
DPS growth (%)	0.0	0.0	59.7	19.0	16.6
Efficiency ratios					
ROE (%)	21.1	15.7	16.1	16.9	17.4
ROCE (%)	19.9	15.4	15.8	17.1	17.9
Asset turnover (x)	0.8	0.8	0.8	0.8	0.8
Op cash / EBIT (x)	0.9	0.8	0.9	0.7	0.7
Depreciation / CAPEX (x)	0.3	0.3	0.6	0.6	0.7
Inventory days	216.6	227.1	255.7	248.6	249.6
Accounts receivable days	111.3	88.4	84.6	84.4	84.8
Accounts payable days	149.6	129.9	128.4	122.5	119.6
Leverage ratios					
Net gearing (%)	-1.0	7.1	1.9	-2.1	-7.5
Debt/capital (%)	0.1	7.5	6.6	5.9	5.2
Interest cover (x)	122.6	67.2	112.0	391.5	460.8
Debt/EBITDA (x)	0.3	0.2	0.4	0.3	0.3
Current ratio (x)	4.4	4.9	5.3	5.6	6.0
Valuation					
EV/Sales (x)	4.1	4.2	4.0	3.5	3.0
EV/EBITDA (x)	16.7	20.1	17.5	14.5	12.2
EV/EBIT (x)	19.0	24.9	21.3	17.3	14.4
PER (x)	20.9	26.8	24.0	20.2	17.3
PER adj (x)	22.5	26.8	24.0	20.2	17.3
PBR (x)	4.5	3.9	3.6	3.2	2.8
Dividend yield (%)	0.7	0.6	0.9	1.1	1.3

Source: Company, Standard Chartered Research estimates

Disclosures appendix

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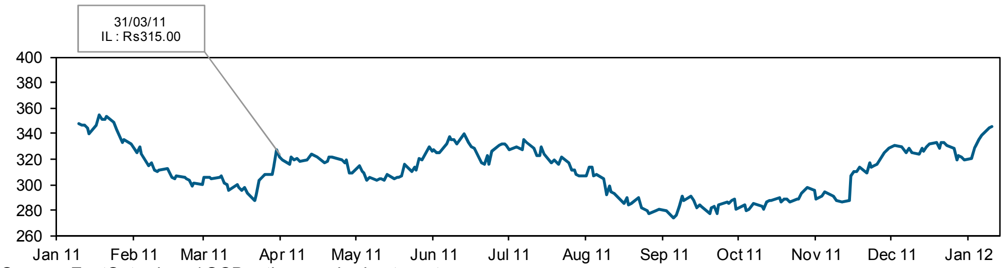
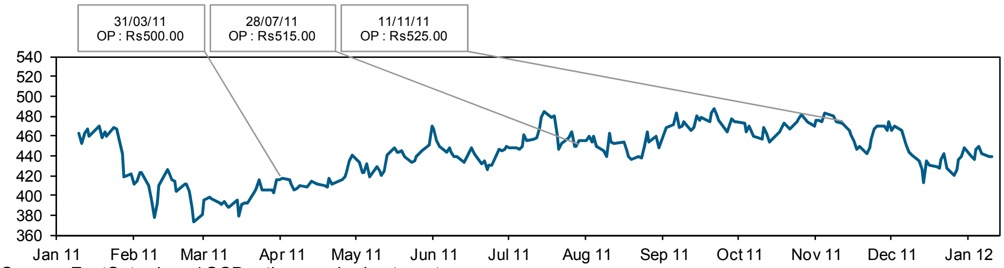
Cipla Ltd.



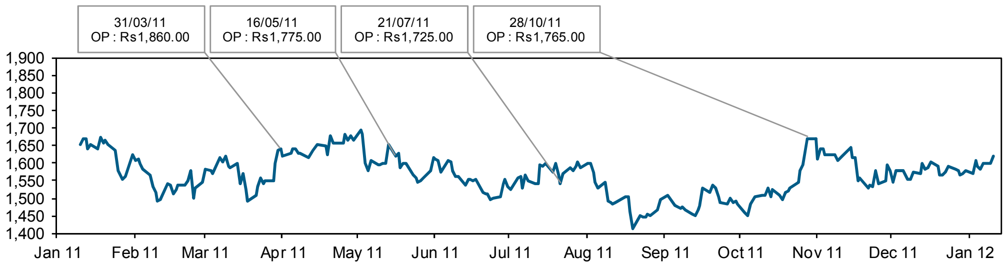
Source: FactSet prices / SCB ratings and price targets

Lupin Ltd.



Source: FactSet prices / SCB ratings and price targets

Dr. Reddy's Laboratories Ltd.



Source: FactSet prices / SCB ratings and price targets

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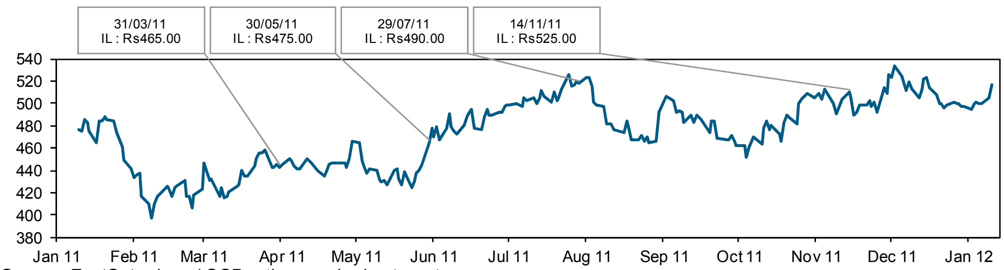
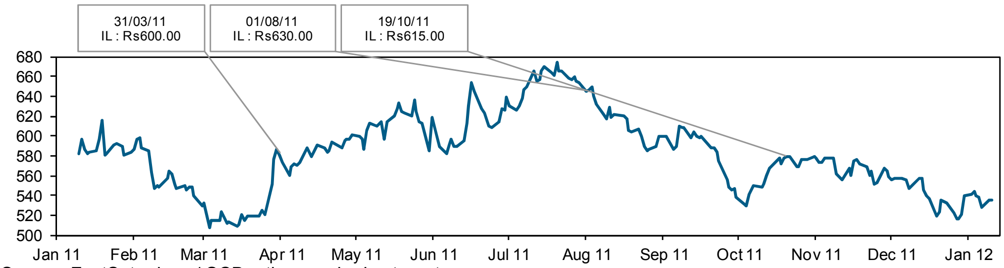


Source: FactSet prices / SCB ratings and price targets

Torrent Pharmaceuticals Ltd.



Source: FactSet prices / SCB ratings and price targets

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	% of covered companies currently assigned this rating	% of companies assigned this rating with which SCB has provided investment banking services over the past 12 months
OUTPERFORM	57.0%	9.6%
IN-LINE	31.1%	9.7%
UNDERPERFORM	11.9%	12.7%

Research Recommendation

Terminology	Definitions
OUTPERFORM (OP)	The total return on the security is expected to outperform the relevant market index by 5% or more over the next 12 months
IN-LINE (IL)	The total return on the security is not expected to outperform or underperform the relevant market index by 5% or more over the next 12 months
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SCB uses an investment horizon of 12 months for its price targets.

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