

Company Flash

4 November 2008 | 7 pages

Sun Pharmaceuticals (SUN.BO)

Buy: Warning Letter for Caraco a Negative Surprise

- Negative surprise** — Caraco's announcement that it has received a warning letter from the US FDA is a negative surprise, particularly given Sun's track record of flawless execution. While the immediate impact is manageable, if the issue is not resolved soon, it could put revenues from this facility and future growth rates at risk. We expect this issue to weigh on stock valuations.
- FDA issues warning letter** — Caraco has received a warning letter from the US FDA for its manufacturing facility at Detroit. It had received a 483 notice for the plant in June'08 following an inspection in May'08. The FDA cites inadequate & untimely investigation by Caraco's quality control unit in regard to certain incidents as one of the observations leading to the warning letter.
- Could affect fresh approvals** — Caraco has received 7 ANDA approvals after the 483 notice was issued in June. At end of 2QFY09, Caraco had 23 ANDAs (for 19 products) & 1 NDA pending approval. The FDA may hold further approvals till the issues in the warning letter are resolved. While this is a setback & could lead to slower growth, this is partially compensated by the fact that ANDAs are increasingly being filed from Sun's facilities.
- Worst case** — If the issues outlined in the warning letter are not resolved, the FDA could stop sales from the Detroit facility. Sales of manufactured products from Caraco accounted amounted to US\$125m in FY08 & US\$64m in 1HFY09 – we estimate this to be c17% of Sun's recurring sales in FY09. Gross margins are in the range of 48-50% – implying gross profit of cUS\$60m (Rs13/share) in FY09, which could be at risk if the worst case scenario materializes.

Buy/Medium Risk	1M
Price (03 Nov 08)	Rs1,106.25
Target price	Rs1,659.00
Expected share price return	50.0%
Expected dividend yield	1.0%
Expected total return	51.0%
Market Cap	Rs229,123M
	US\$4,723M

Price Performance (RIC: SUN.BO, BB: SUNP IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	5,733	27.68	35.7	40.0	14.1	41.4	0.5
2007A	7,843	37.87	36.8	29.2	8.1	35.4	0.6
2008E	14,869	71.80	89.6	15.4	5.7	43.5	1.5
2009E	19,827	95.74	33.3	11.6	4.1	41.2	2.0
2010E	26,863	129.71	35.5	8.5	2.9	40.1	2.7

Source: Powered by dataCentral

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

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Sun Pharmaceuticals

Company description

Sun Pharma is growing at twice the rate of the domestic pharmaceutical market. Its strategy is to enter niche, high-growth segments (organic and through acquisitions). It has a presence in the CNS, pain management, ophthalmology, cardiovascular and respiratory segments. Sun is facing stiff competition in its traditional strongholds, but has sustained growth and is focusing on new therapeutic areas. It intends to export its top products to drive growth, and set up marketing and distribution infrastructure in various markets. It is also filing for ANDA approvals through its US subsidiary Caraco and looking to conclude its second key acquisition in the US (Taro Pharma).

Investment strategy

We rate Sun Pharma Buy/Medium Risk (1M) with a target price of Rs1,659. We believe that Sun is well placed to grow despite challenges that stand in the way of global generics companies. Its strong base in India should remain a good driver of growth and profitability and a source of cash flows, besides providing it with a cushion against an appreciating rupee. At the same time, the growing visibility and success on its patent challenge pipeline improves cash flows as well as its ability to gain traction with the trade.

Valuation

Our target price of Rs1,659 is based on a sum-of-the-parts approach. We value Sun's base business using a P/E vs. earnings CAGR approach and ascribe an option value for its patent challenge pipeline. We value Sun's base business at 22x Sept '09E earnings. With a steadily growing profit line, we believe P/E is the best method to value Sun Pharma. We value frontline pharma stocks at a premium of around 40% to the broad market, due to the intellectual property built into the business models, faster growth as well as the potential to deliver positive earnings surprises. This works out to a multiple of 20x that we use for Sun Pharma as well as its peers such as Glenmark and Cipla. However, we believe that Sun Pharma deserves a premium to the sector given its consistent track record, high profitability as well as return ratios. We value Sun at a 10% premium to other frontline generic stocks. At 22x Sept 09E earnings, we arrive at a value of Rs1,554 /share for the base business. We also ascribe an option value of Rs105/share to Sun's patent challenge pipeline to reflect Sun's success in monetizing three patent challenges (Trileptal, Protonix, Ethyol) and the Effexor-XR opportunity, which we value on an NPV basis, and the growing number of patent challenges in the public domain.

Risks

Our risk rating on Sun Pharma is Medium Risk as we factor in the uncertainties on Taro and Effexor-XR, although our quant-based rating system suggests Low Risk. The key downside risks to our target price are: (1) Price deterioration in any of its key markets; (2) Inability to close / effectively integrate the Taro acquisition and exploit synergies could keep earnings depressed for longer

than we have anticipated; (3) A stronger IPR law in India could lead to a gradual slowdown in growth rates for the Indian market; (4) damages to be paid in case it loses the litigation on Protonix with Wyeth; (5) longer than expected delays in FDA approval for Effexor-XR. Upside risks to our target price include a faster-than-expected completion and integration of the Taro acquisition and a win in any patent challenge.

Appendix A-1

Analyst Certification

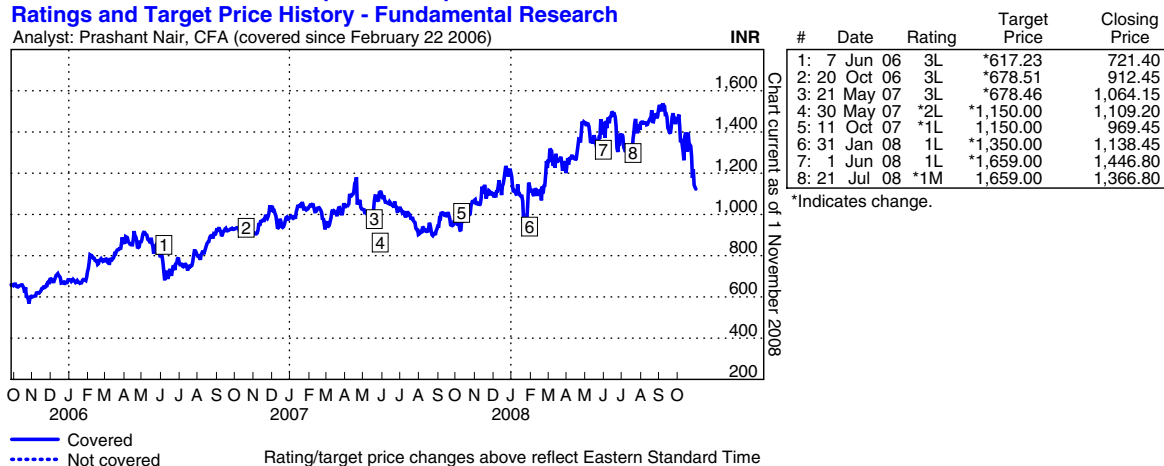
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Sun Pharmaceuticals (SUN.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since February 22 2006)



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