Company Flash

26 April 2007 | 7 pages

Cipla (CIPL.BO)

Sell: Reality Bites

- **Maintain Sell (3L)** — as 4Q07 results came in below our "lowest-on-the-street" estimates. Exclusivity sales to partners in the US have buoyed profitability over the last few quarters, and the high base would be a challenge in future. Cipla's supply-based business model for regulated markets is also vulnerable, given the global consolidation trend. While spikes on "exclusivity sales" could continue, we believe such transient upsides should not have a high bearing on valuations.

- **Margin trouble** — was the main reason for poor 4Q results. While sales growth at 7% YoY was in-line, PAT declined 34% YoY. Gross margins declined 417bps YoY & 258bps QoQ to 45.2%, while EBIDTA margins declined 505bps YoY & 924bps QoQ to 15.7%. The absence of "exclusivity sales" to regulated markets and the higher share of ARV sales in 4Q led to the drop in gross margins, while EBIDTA margins were further affected by higher factory and general overheads.

- **What is the real picture?** — We believe that the 15% EBIDTA margins in 4Q do not reflect Cipla's true profitability, as several factors combined to keep it low. We also highlight that 9m EBIDTA margins of c.25% are also misleading. Besides product mix issues & spread of costs across quarters skewing quarterly margins, we believe that 9m margins were also buoyed by supply of products such as finasteride & sertraline for exclusivity sales in US.

- **Challenges persist** — High growth in low-margin ARVs & rising competition in India would pose margin challenges, in our view, while sales growth, barring exclusivities, would be subdued in 1H08 due to a high base. We are below consensus in our estimates and believe the stock is expensive at 23xFY08E EPS.

Sell/Low Risk	**3L**
Price (26 Apr 07)	Rs253.25
Target price	Rs170.00
Expected share price return	-32.9%
Expected dividend yield	1.2%
Expected total return	**-31.7%**
Market Cap	Rs196,849M
	US$4,844M

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	4,096	5.46	38.6	46.4	12.2	29.1	0.6
2006A	6,001	8.00	46.5	31.6	9.8	34.3	1.0
2007E	6,988	8.99	12.3	28.2	6.4	28.0	1.2
2008E	8,407	10.82	20.3	23.4	5.5	25.3	1.4
2009E	9,856	12.68	17.2	20.0	4.7	25.3	1.6

Source: Powered by dataCentral

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

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Reality Bites

We maintain Sell (3L) on Cipla, as 4Q07 results came in way below our "lowest on the street" estimates. We maintain that sales to partners for exclusivities in the US market have buoyed profitability over the last few quarters and the high base would be a challenge in future. Cipla's supply-based business model for regulated markets is also vulnerable, given the global consolidation process. While spikes due to "exclusivity sales" could continue, we believe these transient upsides should not have a high bearing on valuations. We remain below consensus in our earnings estimates and believe that the stock is expensive at 23.4x FY08E earnings

Figure 1. Earnings Summary (Rupees in Millions)

Year to 31 March	4Q FY06	4Q FY07	% Ch YoY	3Q FY07	% Ch QoQ	FY06	FY07	% Ch YoY	CIR Comments
Sales	8,762	9,291	6.0	8,532	8.9	30,209	35,330	17.0	Absence of "exclusivity sales" to regulated market partners subdues YoY growth in 4Q
Excise Duty	(250)	(219)	(12.5)	(240)	(8.6)	(1,195)	(884)	(26.1)	
Excise (% of sales)	*2.9*	*2.4*	*-50 bps*	*2.8*	*-45 bps*	*4.0*	*2.5*	*-146 bps*	Savings from the shift to Baddi
Net Sales	8,511	9,071	6.6	8,292	9.4	29,014	34,447	18.7	
Other Operating Income	195	313	60.8	513	(39.0)	843	1,340	58.9	Growth on account of higher technology fees from partners
Net Revenues	**8,706**	**9,385**	**7.8**	**8,805**	**6.6**	**29,857**	**35,787**	**19.9**	**High base effect subdues growth in 4Q**
Expenditure	(6,903)	(7,915)	14.7	(6,613)	19.7	(23,193)	(27,560)	18.8	Higher factory and general overheads have been partially offset by flat staff cost YoY in 4Q
EBIDTA	**1,803**	**1,470**	**(18.5)**	**2,193**	**(33.0)**	**6,664**	**8,227**	**23.5**	**Adverse shift in product mix (higher ARV sales; lower regulated market sales) and higher fixed overheads drive margins down in 4Q. FY07 margins may be more representative of real profitability**
EBIDTA Margin (%)	*20.7*	*15.7*	*-505 bps*	*24.9*	*-924 bps*	*22.3*	*23.0*	*67 bps*	
Interest	(33)	(13)	(60.8)	(13)	(2.3)	(114)	(70)	(39.1)	Repayment of short term borrowings
Depreciation	(250)	(261)	4.3	(275)	(5.2)	(830)	(1,041)	25.4	
Other income	468	221	(52.8)	261	(15.6)	1,311	891	(32.0)	Lower due to non recurring insurance claim of Rs200m in 4QFY06
PBT	1,988	1,417	(28.7)	2,166	(34.6)	7,031	8,008	13.9	
Tax	(80)	(160)	99.4	(322)	(50.5)	(1,030)	(1,400)	35.9	
Tax rate (%)	*4.0*	*11.3*	*723 bps*	*14.9*	*-361 bps*	*14.6*	*17.5*	*283 bps*	
Net profit	**1,908**	**1,257**	**(34.1)**	**1,844**	**(31.8)**	**6,001**	**6,608**	**10.1**	**Lower than consensus estimates (source: Bloomberg) by 36% in 4Q**
Net margin (%)	*22.4*	*13.9*	*-855 bps*	*22.2*	*-838 bps*	*20.7*	*19.2*	*-150 bps*	

Source: Citigroup Investment Research

Figure 2. Revenue Break-Up (Rupees in Millions)

Year to 31 March	4Q FY06	4Q FY07	% Ch YoY	3Q FY07	% Ch QoQ	FY06	FY07	% Ch YoY	CIR Comments
Domestic	3,495	3,997	14.4	4,353	(8.2)	15,027	17,523	16.6	Steady growth continues
% of Total Revenues	*39.0*	*41.6*	*260 bps*	*48.1*	*-651 bps*	*48.4*	*47.8*	*-61 bps*	
Exports	**5,266**	**5,293**	**0.5**	**4,179**	**26.7**	**15,182**	**17,807**	**17.3**	High base effect hits 4Q growth
% of Total Revenues	*58.8*	*55.1*	*-368 bps*	*46.2*	*892 bps*	*48.9*	*48.6*	*-33 bps*	
Formulations	3,320	3,879	16.8	3,197	21.3	10,315	13,062	26.6	4Q growth driven by strong growth in ARVs
APIs	**1,946**	**1,415**	**(27.3)**	**982**	**44.1**	**4,868**	**4,745**	**(2.5)**	High base in 4Q FY06 due to supplies for partners' "exclusivity sales" in regulated markets
Sales	8,762	9,291	6.0	8,532	8.9	30,209	35,330	17.0	
Other operating income	195	313	60.8	513	(39.0)	843	1,340	58.9	Primarily driven by technology know-how fees
% of Total Revenues	*2.2*	*3.3*	*109 bps*	*5.7*	*-241 bps*	*2.7*	*3.7*	*94 bps*	
Total Revenues	**8,956**	**9,604**	**7.2**	**9,045**	**6.2**	**31,052**	**36,671**	**18.1**	

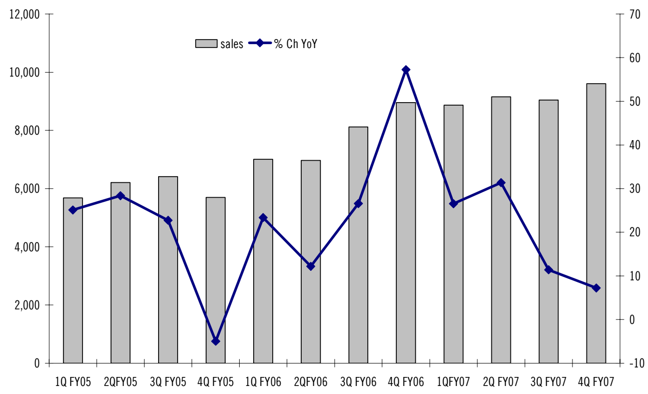
Source: Citigroup Investment Research

Figure 3. Cost Break-Up (Rupees in Millions)

Year to 31 March	4Q FY06	4Q FY07	% Ch YoY	3Q FY07	% Ch QoQ	FY06	FY07	% Ch YoY	CIR Comments
Net Sales	8,511	9,071	6.6	8,292	9.4	29,014	34,447	18.7	
Raw Materials	4,313	4,975	15.4	4,334	14.8	14,244	17,280	21.3	Change in revenue mix in favour of ARVs and lower API sales to regulated markets
% of Net sales	*50.7*	*54.8*	*417 bps*	*52.3*	*258 bps*	*49.1*	*50.2*	*107 bps*	
Staff Cost	426	433	1.8	458	(5.4)	1,473	1,843	25.1	Decline QoQ is surprising; may rise again in forthcoming quarters
% of Net sales	*5.0*	*4.8*	*-22 bps*	*5.5*	*-74 bps*	*5.1*	*5.4*	*27 bps*	
Other Expenses	2,165	2,507	15.8	1,821	37.6	7,477	8,437	12.8	Higher factory (power & fuel, stores & spares, repairs) and general (selling expenses, professional fees)
% of Net sales	*25.4*	*27.6*	*220 bps*	*22.0*	*567 bps*	*25.8*	*24.5*	*-128 bps*	
Total Expenditure	**6,903**	**7,915**	**14.7**	**6,613**	**19.7**	**23,193**	**27,560**	**18.8**	
% of Net sales	*81.1*	*87.3*	*615 bps*	*79.7*	*750 bps*	*79.9*	*80.0*	*7 bps*	4Q is excessively skewed to the higher side just as the first 3 quarters were excessively skewed to the lower side

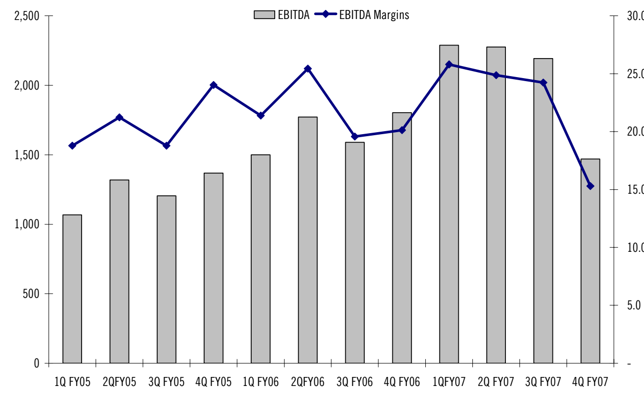
Source: Citigroup Investment Research

Figure 4. Sales and % Change YoY (Rupees in Million, Percent)



Source: Company Reports and Citigroup Investment Research

Figure 5. EBITDA and EBITDA margin (Rupees in Million, Percent)



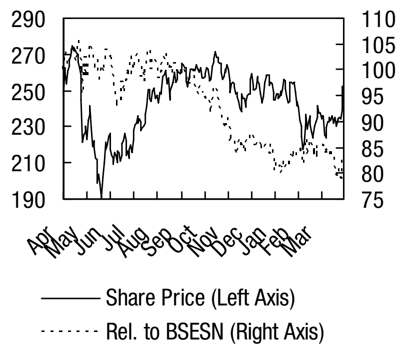
Source: Company Reports and Citigroup Investment Research

Cipla

Company description

Cipla is a leading pharmaceutical company in India with a strong and profitable business model. The company has a well-diversified portfolio, without any overdependence on a particular segment. It has developed a strong presence in the export market — both in developed and developing countries — and has products registered in more than 140 countries. Furthermore, it has been at the forefront in reverse engineering the latest drugs and active pharmaceutical ingredients. The company has focused its R&D efforts on profitable projects, and tied up with the local players in various markets to de-risk its business model. However, the company lags its peers in discovery-led research. Cipla's business model also represents a low-risk model with the commensurate returns also being moderate.

Figure 6. Price performance



Source: Powered by dataCentral

Investment thesis

We rate Cipla Sell (3L) with a target price of Rs170. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, the risks posed to the business from the current global consolidation could have an impact on the company's future growth prospects. Cipla could face an increasingly uncertain global environment if the current slow consolidation process gathers momentum. Its partners, which appear inherently tied up because of their weak product capabilities, may get acquired and the acquirers may not want to source drugs from Cipla. We think Cipla's business model lacks significant value addition, both in terms of innovative research as well as forward integrating into the US and European generics markets. We believe that any re-rating will be contingent on the company making fresh forays into these areas and/or getting acquired at a significant premium. Since the pricing pressure in the US and European markets has not been waning, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players.

Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs170 is based on 18x forward earnings. Historically, the stock has traded at 15-30x forward earnings. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector, justified by the lower value addition to the business (lack of its own front-end in the regulated markets and ownership of IPR). There are few signs of this changing. Our target multiple for Cipla is therefore at a 10% discount to the multiple we use for its peers such as Ranbaxy, Dr Reddy's and Sun Pharma.

Figure 7. Stock Performance

(%)	3M	6M	12M
Absolute	3.5	(1.9)	(3.5)
Rel. to .BSESN	3.9	(12.4)	(19.1)

Source: Powered by dataCentral

Risks

We rate Cipla as Low Risk, as the company has a steadily growing base business and has a visible earning stream. The ongoing dispute regarding alleged overcharging for seven drugs in the domestic market could result in significant cash outflow as well as could impact future profitability. Global consolidation is a risk to the company's supply based model. The new drug policy, if implemented in the current form could also hurt earnings. Key risks to our rating and target price include a) the company doing better operationally than forecast; b) any move to front end in target markets could give further support to current high valuations; c) any exclusivity for its partners could also sustain the growth momentum beyond our expectations.

Appendix A-1

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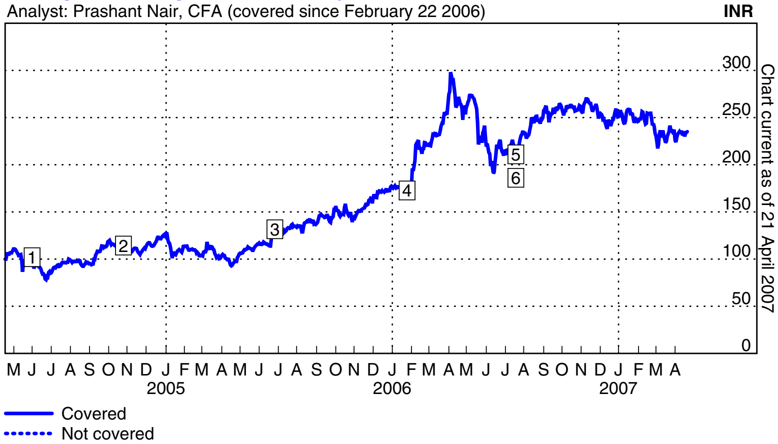
Cipla (CIPL.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	1 Jun 04	3L	88.00	95.58
2:	26 Oct 04	3L	*96.00	106.92
3:	27 Jun 05	3L	*116.00	124.12
4:	25 Jan 06	3L	*65.60	174.06
5:	19 Jul 06	3L	*170.00	212.45
6:	19 Jul 06	3L	170.00	212.45

*Indicates change.

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