

## Company Flash

8 December 2007 | 7 pages

# Sun Pharmaceuticals (SUN.BO)

## Buy: Encouraging 9mCY07 Results from Taro

- Maintain Buy (1L)** — Taro's unaudited 9mCY07 results were better than we anticipated and should put to rest most of the concerns over Sun's ability to achieve its targeted payback period of 5.5 years on the deal. With improving visibility on its patent challenge pipeline, rapid growth across geographies and relatively lower currency risk vis-à-vis peers, we maintain our Buy (1L) rating.
- Taro: surprise profit in 9mCY07** — Taro reported unaudited CY06 and 9m07 results. While the former was below guidance, we are positively surprised by the US\$20m recurring PAT in 9m07 (c3.6x CY05 recurring PAT). CY06 was affected by lower sales due to delayed product approvals, pricing pressure and efforts to reduce inventory with its customers.
- CY06 appears an aberration** — A concern on Taro was lower sales (US\$180-200m vs. US\$298m in CY05) and net loss (US\$95-120m) guidance for CY06. While CY06 sales is in line with guidance (net loss is higher), the recovery in 9m07 should allay fears that Sun may have overpaid for Taro. Topline has recovered to CY05 levels despite price erosion, and profitability has improved on the back of lower SG&A & R&D costs – even without any synergy benefits.
- Clarity over closure in a few months** — Now that latest financials have been reported, we expect Taro to call a meeting of shareholders over the next few months to decide on Sun's offer. We believe there is a good probability that the deal will go through, however have not included it in our estimates yet. While the deal could be dilutive in Yr 1, we expect a strong combined entity, with a large product basket/pipeline, integrated operations and multiple synergies.

<b>Buy/Low Risk</b>	<b>1L</b>
Price (07 Dec 07)	Rs1,110.90
Target price	Rs1,150.00
Expected share price return	3.5%
Expected dividend yield	1.0%
<b>Expected total return</b>	<b>4.5%</b>
Market Cap	Rs223,410M
	US\$5,668M

### 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	27.48	34.7	40.4	14.3	41.4	0.5
2007A	7,843	37.60	36.8	29.5	8.2	35.4	0.6
2008E	9,808	47.02	25.1	23.6	6.4	30.4	1.0
2009E	11,688	56.03	19.2	19.8	5.0	28.4	1.2
2010E	14,048	67.34	20.2	16.5	4.0	27.0	1.5

Source: Powered by dataCentral

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## Encouraging 9mCY07 Results from Taro

We maintain our Buy/Low Risk (1L) rating on Sun Pharma as Taro's unaudited 9mCY07 results were better than we anticipated and should put to rest most of the concerns over Sun's ability to achieve its targeted payback period of 5.5 years on the deal. With improving visibility on its patent challenge pipeline, rapid growth across geographies and relatively lower currency risk vis-à-vis peers, we remain positive on the stock.

### Taro – surprise profit in 9m07; CY06 appears an aberration

Figure 1. Taro Pharmaceutical Industries Consolidated P&L (US\$ '000)

Year Ending 31 December	2004	2005	2006	9m 2007	CIR Comments
<b>Sales</b>	<b>261,119</b>	<b>297,733</b>	<b>184,122</b>	<b>231,800</b>	Substantial drop in CY06 sales due to price erosion, delayed approval of new products & reducing inventory levels with customers
Cost of sales	119,749	128,690	141,938	105,998	
<b>Gross profit</b>	<b>141,370</b>	<b>169,043</b>	<b>42,184</b>	<b>125,802</b>	Price erosion offset by new products only in late fourth quarter causing gross margins to revert back to more robust levels in 9mCY07
<i>Gross Margins</i>	<i>54.1%</i>	<i>56.8%</i>	<i>22.9%</i>	<i>54.3%</i>	
Operating expenses					
Research and development	41,956	45,767	36,220	20,605	Sharp reduction as a % of sales in 9mCY07 is a positive surprise; we believe Sun will be able to sustain these levels going forward
<i>% of Sales</i>	<i>16%</i>	<i>15%</i>	<i>20%</i>	<i>9%</i>	
Selling, marketing, general and administrative	123,465	108,099	96,922	62,450	Adjusted for one time impairment charges; Sharp drop in sales saw SG&A/sales shoot up in CY06 before reverting to low levels in 9mCY07 – ability to sustain sub 30% levels needs to be watched
<i>% of Sales</i>	<i>47%</i>	<i>36%</i>	<i>53%</i>	<i>27%</i>	
Total Operating expenses	165,421	153,866	133,142	83,055	
<b>Operating income (loss)</b>	<b>(24,051)</b>	<b>15,177</b>	<b>(90,958)</b>	<b>42,747</b>	
<b>OPM</b>	<b>-9%</b>	<b>5%</b>	<b>-49%</b>	<b>18%</b>	
Financial expenses, net	4,832	7,893	13,404	18,800	
Other Income, net	-	-	-	520	
Income (loss) before income taxes	(28,883)	7,284	(104,362)	24,467	
Income taxes	2,606	1,617	(1,640)	4,229	
<i>Effective tax rate</i>	<i>-9%</i>	<i>22%</i>	<i>2%</i>	<i>17%</i>	
<b>Net Recurring Income (loss)</b>	<b>(31,489)</b>	<b>5,667</b>	<b>(102,722)</b>	<b>20,238</b>	<b>Strong recovery in 9mCY07 is a positive surprise and augurs well for Sun's expected payback from the transaction – if it goes through</b>
Extraordinary / One-time Items	-	-	38,000	10,000	- US\$ 38m in 2006 due to asset impairment - US\$ 10m in 2007 includes one-time charges and professional fees related to the restatement of 2003 and 2004 results, a related investigation & its proposed transaction with Sun Pharma
Extraordinary Income	-	-	-	4,000	Proceeds from the sale of a car park in Ireland
<b>Net income (loss)</b>	<b>(31,489)</b>	<b>5,667</b>	<b>(140,722)</b>	<b>14,238</b>	
Net income (loss) per share					
Basic earnings (loss) per ordinary share	(1.08)	0.19	(4.80)	0.43	
Diluted earnings (loss) per ordinary share	(1.08)	0.19	(4.77)	0.43	

Source: Company Reports, Citi Investment Research

Figure 2. Taro Pharmaceutical Industries Consolidated Balance Sheet (US\$ '000)

	2004	2005	2006*	9m 2007*	CIR Comments
<b>Assets</b>					
<b>Current Assets</b>					
Cash and cash equivalents	85,330	72,828	16,911	50,097	Fund infusion by Sun Pharma and improved financials
Restricted short-term bank deposits	6,598	6,859	152	41	
Marketable securities	13,300	-	-	-	
Accounts receivable					
Trade, net	48,651	52,954	43,687	65,369	
Other receivables and prepaid expenses	14,257	12,865	15,284	15,309	
Inventories	86,591	76,192	60,017	62,632	Inventory levels maintained despite strong growth in revenues
<b>Total Current Assets</b>	<b>254,727</b>	<b>221,698</b>	<b>136,051</b>	<b>193,448</b>	
Long-Term Receivables	20,239	19,527	23,390	26,967	
Property, Plant & Equipment, Net	241,966	269,419	226,980	216,570	
Other Assets	70,682	68,367	52,467	49,466	
<b>Total Assets</b>	<b>587,614</b>	<b>579,011</b>	<b>438,888</b>	<b>486,451</b>	
<b>Liabilities &amp; Shareholder's Equity</b>					
<b>Current Liabilities</b>					
Short Term Bank Credit	64,961	92,549	110,576	105,293	
Current Maturities of Long Term Liabilities	16,944	14,728	26,339	22,357	
Accounts Payable & Accrued Expenses	81,802	63,008	87,702	73,290	
<b>Total Current Liabilities</b>	<b>163,707</b>	<b>170,285</b>	<b>224,617</b>	<b>200,940</b>	
Long Term Liabilities	184,419	161,949	108,383	96,099	Expected to keep declining as debt pay downs continue
Deferred Taxes & Other Liabilities	9,018	9,912	7,517	7,427	
<b>Total Liabilities</b>	<b>357,144</b>	<b>342,146</b>	<b>340,517</b>	<b>304,466</b>	
Shareholder's Equity	230,470	236,865	98,371	181,985	Equity investment by Sun and return to profitability
<b>Total Liabilities &amp; Shareholder's Equity</b>	<b>587,614</b>	<b>579,011</b>	<b>438,888</b>	<b>486,451</b>	

Source: Company Reports, Citi Investment Research

\*unaudited

## Sun Pharmaceuticals

### Company description

Sun Pharma is one of the fastest-growing companies in the domestic pharmaceutical market, growing at about 2x the industry rate. The company has followed a strategy of being the first to enter niche, high-growth segments (both organic and through acquisitions). The company has a presence in the CNS, pain management, ophthalmology, cardiovascular and respiratory segments. Sun is facing stiff competition in its traditional strongholds, but has managed to sustain growth and is focusing on new therapeutic areas. The company is looking to export its top formulation products to drive growth, and has set up marketing and distribution infrastructure in various markets. It is also filing for ANDA approvals through its US subsidiary Caraco.

### Investment strategy

We rate Sun Pharma as Buy/Low Risk (1L) with a target price of Rs1,150. The recent Taro acquisition, using idle funds on the balance sheet, should improve the company's global scale and reach as well as improve quality of earnings. Having taken a big step forward towards being bigger and more geographically spread out by acquiring Taro Pharma, we believe that Sun is now well placed to grow despite the challenges that keep coming in the way of global generics companies. Its strong base in India should continue to be a good driver of

growth and profitability as well as a source of cash flows, besides providing it with a cushion against an appreciating rupee.

## Valuation

Our target price of Rs1,150 is based on a sum-of-the-parts approach. We continue to 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 20x FY09E 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 Dr Reddy's and Cipla. Our estimates do not incorporate the Taro acquisition. However, we believe that it would be dilutive in the short term, i.e. FY08E, before being earnings neutral or mildly accretive in FY09E. As such, we believe that it is relevant to value Sun based on FY09E estimates as the earnings dilution phase is transient, and should not affect fair value. At 20x FY09E earnings, we arrive at a value of Rs1,136 /share for the base business. We also ascribe an option value of Rs14/share to Sun's patent challenge pipeline, using a 15% success rate on the company's patent challenges that are in the public domain.

## Risks

We rate Sun Pharma as Low Risk because of its steady growth and visible earnings stream. This is also consistent with our quantitative risk-rating system, which tracks 260-day historical share price volatility. The key 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. Upside risks to our target price include a faster-than-expected integration of the Taro acquisition and a win in any patent challenge.

# Appendix A-1

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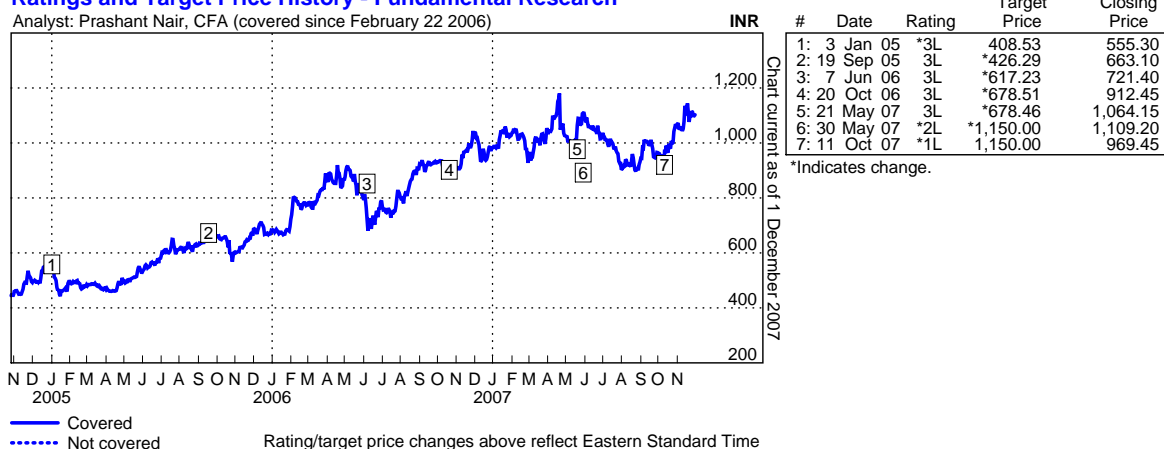
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Analyst: Prashant Nair, CFA (covered since February 22 2006)



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