investors eye

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Sharekhan Ltd
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Sun Pharmaceutical Industries

Ugly Duckling

Stock Update

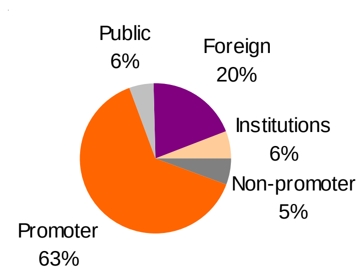
Cranbury warning unlikely to have much impact

Buy; CMP: Rs1,751

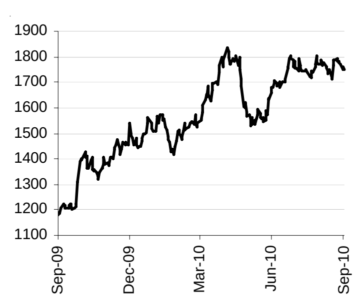
Company details

Price target:	Rs2,025
Market cap:	Rs3,605 cr
52 week high/low:	Rs1857/1122
NSE volume: (No of shares)	1.0 lakh
BSE code:	524715
NSE code:	SUNPHARMA
Sharekhan code:	SUNPHARMA
Free float: (No of shares)	11 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-0.4	5.9	14.5	48.0
Relative to Sensex	-1.1	-0.9	3.5	27.2

Event 1

The US Food and Drug Administration (USFDA) has issued a warning letter to Sun Pharmaceuticals (Sun) for manufacturing practice violations at its Cranbury facility in New Jersey. The warning letter has been issued as a follow-up to the inspection initiated by the USFDA in February 2010 and Sun's responses in May 2010. The USFDA has raised issues covering deficiencies in process controls, failure to inform the regulatory body on product quality defects and inadequate corrective measures. The warning letter specifically relates to four products: gemfibrozil tablets, nimodipine capsule, promethazine HCI and oxycodone HCI tablets. The regulator may withhold the approval of the pending new drug applications until the violations are corrected.

Products manufactured at Cranbury facility	US market size ($mn)	Usage
Gemfibrozil tablets	44.0	Anti-cholesterol (recently recall)
Promethazine Hydrochloride	50.0	Anti-histamine
Oxycodone HCI tablets	160.0	Analgesic (pain management)
Nimodipine capsule	36.0	Neurology (brain)

Impact

The decision is unlikely to have a significant impact on Sun's US operations, as the Cranbury plant manufactures only limited products, mainly four to five controlled substance drugs (drugs that come under the narcotics category). Further, Sun has maintained its revenue guidance of 18-20% for FY2011, indicating that the issue would not have any material financial implication. It has undertaken immediate corrective actions and intends to respond to the USFDA within 15 working days. We note that it can take about six to nine months to resolve the warning letter, as the USFDA will have to re-inspect the facility.

Valuation table (consolidated)

Particulars	FY2008	FY2009	FY2010	FY2011E	FY2012E
Net sales (Rs cr)	3356.5	4272.3	4102.8	4746.8	5404.6
PAT (Rs cr)	1486.9	1817.7	1351.1	1605.1	1763.6
Shares in issue (cr)	20.7	20.7	20.7	20.7	20.7
EPS (Rs)	71.8	87.8	65.2	77.5	85.1
PER (x)	24.3	19.9	26.8	22.5	20.5
EV/Ebidta (x)	22.5	18.1	24.4	21.0	18.1
Book value (Rs/share)	241.0	340.1	389.7	451.1	520.1
P/BV (x)	7.2	5.1	4.5	3.9	3.4
Mcap/sales	10.8	8.5	8.8	7.6	6.7
RoCE (%)	31.1	27.0	17.1	17.8	17.1
RoNW (%)	29.8	25.8	16.7	17.2	16.4

Event 2

Sun has received the USFDA's approval for its abbreviated new drug application (ANDA) to market a generic version of Strattera ®, atomoxetine hydrochloride capsules. Atomoxetine hydrochloride capsules are indicated for the management of attention deficit hyperactivity disorder in children aged six years and older, teens and adults. The annual sales in the USA for these strengths of branded and generic atomoxetine hydrochloride capsules are estimated at over $530 million. This is a shared exclusivity opportunity.

Impact

The exclusivity for the drug expires between September 2010 and July 2011 for different strengths. The USFDA has already granted the approval to Mylan, Actavis, and Sun while others like Glenmark Pharmaceuticals, Aurobindo Pharmaceuticals, Cadila Healthcare and Apotex have a tentative approval. The other players are expected to receive the final approval soon. However, Eli Lily has filed a preliminary injunction relating to the approval at the Federal Circuit Court and thus we do not expect the generic players to launch the drug at risk. With a shared co-exclusivity, we expect Sun to reap incremental earnings per share (EPS) of about Rs2 during the exclusivity period (subject to a favourable ruling, as we do not expect the company to launch the product at risk).

Valuation and view

As per the latest annual report, Sun has recently begun to build sales of the first few controlled substance ANDAs from its Cranbury facility. Although with limited financial implication, after Caraco Pharmaceuticals (yet to resolve matters with the USFDA) the issuance of the second warning letter is negative news for the company. We believe that a delay in resolution might affect the launch of controlled substance drugs in the USA. However, the product approval for Strattera implies that the product approvals from the other facilities would not be affected.

We expect Sun's strong domestic business, its niche US market (controlled release substances, hormones etc) and the improving visibility of its patent challenge pipeline to drive a steady growth in its business in the long term. The potential launch of the key products like Prandin and a clean chit from the USFDA should be re-rating factors going ahead. At the current market price of Rs1,745, Sun is valued at 22.5x FY2011E and 20.5x FY2012E fully diluted earnings. We maintain our Buy recommendation on the stock with a price target of Rs2,025.

The author doesn't hold any investment in any of the companies mentioned in the article.

Patels Airtemp India

Emerging Star

Stock Update

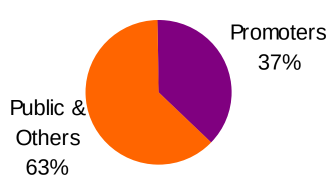
Robust operating performance

Buy; CMP: Rs97

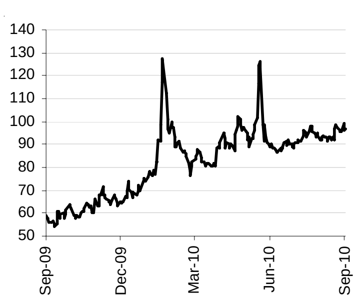
Company details

Price target:	Rs122
Market cap:	Rs49.2 cr
52 week high/low:	Rs132/54
BSE volume: (No of shares)	33,288
BSE code:	517417
Sharekhan code:	PATELAIR
Free float: (No of shares)	30 lakh

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4.8	9.3	19.9	76.5
Relative to Sensex	4.0	2.2	8.4	51.6

Key points

- Patels Airtemp's Q1FY2011 results showed top line having increased by 8.2% yoy to Rs16.6 crore. Conventionally, the first quarter is a sluggish quarter. The operating profit margin (OPM) improved by 430 basis points year on year (yoy) to 22.2% in Q1FY2011 from 17.9% in the corresponding quarter of last year. This was mainly due to increased manufacturing capacities, which reduced low-margin trading of goods, resulting in lower raw material cost as a percentage of sales. Consequently, the operating profit for the quarter rose by 28.2% to Rs3.5 crore.
- The interest cost increased to Rs0.5 crore on account of rising working capital borrowings for the quarter. Further, the depreciation charge also increased to Rs0.25 crore due to the capex undertaken earlier in Q4FY2010. The net profit came in at Rs1.8 crore, a 12.1% year-on-year (y-o-y) increase.
- Its order book improved to Rs68 crore from Rs61 crore in Q4FY2010. Order inflows worth Rs9 crore from GEA for Paradip Refinery Project helped boost the order book.
- The surge in investments in the oil and gas, power and refinery sectors will augur well for the company. Also, the company is optimistic about the opportunities in the nuclear power sector. The outlook for the fertiliser sector remains bright with huge investments lined up in the sector. We maintain our estimates for FY2011 and FY2012 in view of better execution in subsequent quarters. We expect the top line to grow at a compounded annual growth rate of 19% over FY2010-12 along with sustenance of margins at the FY2010 level.

Result table

Particulars	Q1FY2011	Q1FY2010	% yoy chg
Net sales	**16.6**	**15.3**	**8.2**
Total expenditure	13.1	12.6	3.9
Operating profit	**3.5**	**2.7**	**28.2**
Other income	0.0	0.0	22.0
EBIDTA	3.5	2.8	28.2
Interest	0.5	0.2	169.4
PBDT	3.0	2.6	17.5
Depreciation	0.3	0.2	33.1
PBT	**2.8**	**2.4**	**16.2**
Tax	1.0	0.8	24.2
PAT	**1.8**	**1.6**	**12.1**
Margins (%)			
OPM	21.2	17.9	
PATM	10.6	10.2	
Tax rate	36.6	34.3	

- At the current market price, the stock is available at 4x FY2012E earnings. Given its low debt equity ratio of 0.2:1, dividend yield of 2%, and healthy return on net worth of 28.7%, the valuations appear quite attractive. We maintain our Buy recommendation on the stock.

The author doesn't hold any investment in any of the companies mentioned in the article.

Valuation table

Particulars	FY08	FY09	FY10	FY11E	FY12E
Net sales (Rs crore)	53.9	68.4	72.2	85.4	102.6
% yoy chg	*32*	*27.0*	*5.5*	*18*	*20*
Net profit (Rs crore)	5.2	7.1	8.7	9.9	12.4
EPS (Rs)	10.3	14.1	17.1	19.5	24.4
% yoy chg	*105.3*	*37.0*	*21.5*	*13.6*	*25.5*
PER (x)	9.4	6.9	5.7	5.0	4.0
P/B (x)	3.0	2.2	1.6	1.3	1.0
EV/EBIDTA (x)	5.9	3.9	3.0	2.3	1.6
RoCE (%)	46.3	48.8	46.8	41.2	40.0
RoNW (%)	31.5	31.5	28.7	25.3	24.7

Pantaloon Retail India

Viewpoint

Home business break-even is the key

CMP: Rs466

Pantaloon Retail has declared its results for Q4FY2010. But the results of the core retail business include those of Home Solution Retail India Ltd (HSRIL) that was merged with the company during the quarter and hence are not comparable on a year-on-year (y-o-y) basis. On a like-to-like basis, the core retail business (ie ex-HSRIL) saw a growth of 30.3%, ahead of our expectation. The same-store sales growth momentum was very robust with the value retailing segment recording a growth of 11.5% and the lifestyle retailing segment registering an increase of 19.4%, surpassing our expectation of 11% and 12% growth respectively.

- The operating profit (ex-HSRIL) came in at Rs221 crore, in line with our expectation of Rs228 crore, while the margin at 10.2% was 80 basis points lower than our estimate of 11%.

Quarterly core operating performance Rs (cr)

Particulars	Q4FY10	Q4FY09	% yoy
Sales & operating income	2166.0	1662.7	30.3
Operating profit	221.4	183.3	20.8
Operating profit margin (%)	10.2	11.0	

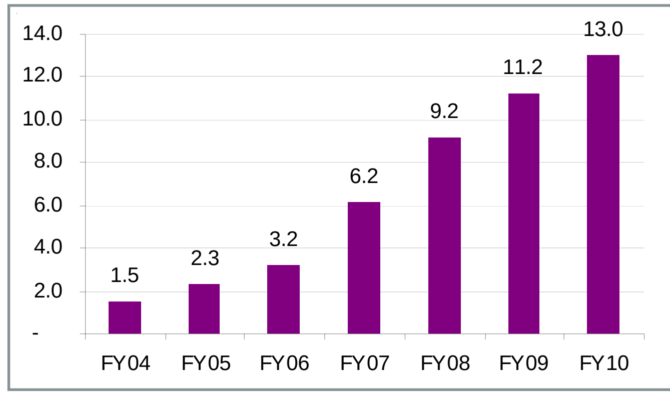
- The home solutions business, which was a 66.67% subsidiary of Pantaloon Retail till FY2009, has now been merged into Pantaloon Retail. For Q4FY2010, the segment reported a top line of Rs332 crore and a loss of Rs8.8 crore at the profit before tax (PBT) level.

- The reported net profit for the quarter came in at Rs99 crore (up 182% year on year [yoy]) while the adjusted profit (adjusted for other income on account of the sale of three subsidiaries) came in at Rs72 crore during Q4FY2010.

Results table Rs (cr)

Particulars	Q4FY10	Q4FY09	% yoy
Sales and operating income	2,498	1,663	50.2
Operating profit	217	183	18.4
Operating profit margin (%)	8.7	11.0	
EBITDA	292	183	59.3
EBITDA margin (%)	11.7	11.0	
Interest	97	91	6.7
Depreciation	58	39	49.4
PBT	137	53	156.1
Tax	39	19	107.8
PAT	99	35	182.2

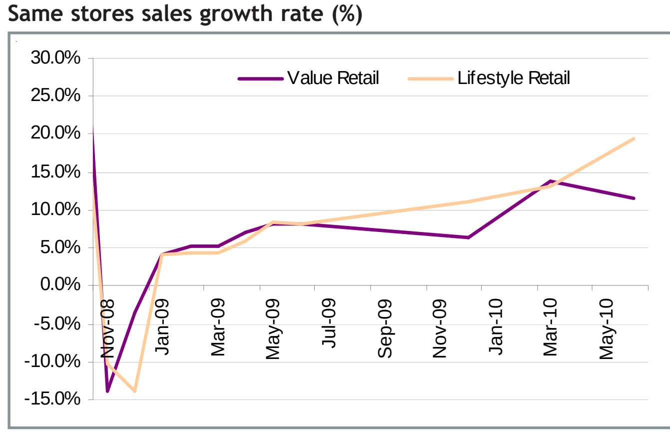
Total retail space (million sq ft)



Calibrated expansion, but quality growth

On the core retail front (that is the retail business including HSRIL), the company ended the year with an aggregate retail space of 13.0 million square feet, adding 1.8 million square feet for the year (lower than its last three years' average of 3 million square feet). Going forward, the management aims to grow the core business in a calibrated manner, adding 2.5-3 million square feet annually. But it has emphasised that having gained a reasonable scale the company would now focus more on efficiency.

Same stores sales growth rate (%)



Thrust on capital efficiency

During the year, the management undertook various efforts to streamline the supply chain process, improve inventory turns and the fill rates in the stores. These efforts include warehouse consolidation, rationalisation of stock keeping units (SKUs) and mechanisation and automation of various processes. The results of these efforts were visible in the form of improved fill rates (from 70% in FY2009 to 90% in FY2010), a reduction in inventory holding days (from 107 days in FY2009 to 93 days in FY2010). Also, with imparting efficiency on the inventory and supply chain side of the business, the management also focused on deleveraging the balance sheet as a result of which the debt level of the company came down from Rs3,200 crore in FY2009 to Rs2,900 crore. The debt-equity ratio improved from 1.2x in FY2009 to 0.9x in FY2010.

HSRIL profitability holds the key

HSRIL retails home improvement products, and home furnishing and electronics through its two formats: Home Town and Ezone. Currently, the company has ten Home Town stores across the country and 36 Ezone stores. For the year HSRIL clocked a revenue of Rs1,000 crore with a PBT loss of Rs88 crore. The management believes this to be a high-growth segment for the company and expects capital efficiency and volume to be the key drivers of the business' profitability. So it is working towards the same. The Home Town format is positive on a store earnings before interest, tax, depreciation and amortisation (EBITDA) level while the low-margin, high-volume electronics business (Ezone) is bleeding heavily. We believe that profitability of this venture is a key monitorable for Pantaloon Retail and any positive traction in the same (in terms of growth, efficiency) would be the key re-rating factor for the company.

Business restructuring process on track

During the year the company undertook a restructuring exercise to build Pantaloon Retail as a pure retail play by separating the other non-core and ancillary businesses. The significant part of the exercise involves demerging the financial services business (that holds 55% stake in Future Capital Holdings, its stake in Future Generali) from the core business and is expected to get completed by the current financial year. We believe that completion of this process would free investments and thus enhance the returns from the core retail business.

Valuation and view

We expect the company to register a top line compounded annual growth rate (CAGR) of 24.2% over FY2010-12, backed by same-store sales growth of 10%, 10% and 12% in the value, lifestyle and home categories respectively coupled with space expansion at the rate of 2 million square feet per year. Though the top line growth is expected to be robust, the margins and earnings would falter on account of the high operating expenses of the home retail segment. The demerger of the financial services business/induction of a strategic investor in Future Value Retail and the economics of the home retail format are the key factors to watch out for that would provide triggers to the stock.

The author doesn't hold any investment in any of the companies mentioned in the article.

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Housing Development Finance Corporation
HDFC Bank
Infosys Technologies
Larsen & Toubro
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
Apollo Tyres
Bajaj Auto
Bajaj Finserv
Bajaj Holdings & Investment
Bank of Baroda
Bank of India
Bharat Electronics
Bharat Heavy Electricals
Bharti Airtel
Corporation Bank
Crompton Greaves
Glenmark Pharmaceuticals
Godrej Consumer Products
Grasim Industries
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Patels Airtemp India
Thermax
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Ugly Duckling

BASF India
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