

SUN PHARMACEUTICALS INDUSTRIES

INR 1,022

*US generics gaining momentum*

ACCUMULATE

Sun Pharma reported Q307 results which were in line with our estimates. Y-o-Y revenue grew by 24.4%; EBITDA by 17.5% and net profit by 35.8%. Revenue growth was led by US generics segment which increased by ~55% and domestic formulations which grew by 18.5%. Besides this, other income and negative tax were also significant contributor to the net profit growth.

While the EBITDA margin was in line with expectation, 55% growth in Caraco sales was above our expectation. Going forward, we expect the gross margin to improve due to better product mix in favour of domestic formulations. However, that will be compensated by higher R&D and litigation expenses resulting in flat EBITDA margin in FY08E & FY09E.

We are increasing our FY07E EPS estimates by 6.3% on the back of (1) better than expected Caraco sales (2) higher than expected other income. (3) Lower tax rates.

At CMP of INR 1022, the stock currently trades at a P/E of 29.1x and 27.5x on our FY07E and FY08E earnings, respectively. We maintain our 'ACCUMULATE' recommendation on the stock.

* **US generics: could show better performance going forward**

Caraco reported revenues of USD 31.3 mn, up 55% Y-o-Y and 13% Q-o-Q. Growth was driven by continuing sales of generic Ultracet, which seems to have shown good volume growth while taking a price-cut on Gabapentin. Sun launched one new product Phenytoin in Q3FY07. We believe Phenytoin (USD 180 mn branded revenues) could be an important opportunity as the competition for this product is expected to be limited. For the other products, the pricing in US markets remain extremely competitive hence the margins are expected to be muted. The company has filed quite a few Para IV products which are expected to increase the litigation expenses.

The company as of now has received 31 approvals and 7 tentative approvals. 61 more ANDAs await approval. With this pipeline expected to grow going forward the R&D expenses is also expected to increase significantly as was seen in this quarter (R&D expenses increased by ~ 86% Y-o-Y). We believe with some niche opportunities coming up for Sun pharma, it could drive the revenue growth but margins could be lower. We believe for FY07E the US generics business to will grow by ~ 37% and for FY08E it will grow by ~ 19%.

Financials

Year to March	Q3FY07	Q3FY06	% change	Q2FY07	% change	FY07E	FY08E
Revenues (INR mn)	5,400	4,343	24.4	5,362	0.7	20,849	23,924
EBITDA (INR mn)	1,733	1,476	17.5	1,708	1.5	6,835	7,865
Net profit (INR mn)	1,989	1,464	35.8	1,864	6.7	7,288	7,694
EPS (INR)	9.6	7.9	21.5	9.0	6.7	35.1	37.1
PE (x)						29.1	27.5
EV/EBITDA (x)						28.5	22.0

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Reuters : SUN.BO
Bloomberg : SUNP IN

Market Data

52-week range (INR) : 1,082 / 640
Share in issue (mn) : 186.7
M cap (INR bn/USD mn) : 190.9 / 4,316.0
Avg. Daily Vol. BSE/NSE ('000) : 235.0

Share Holding Pattern (%)

Promoters : 69.6
MFs, Fls & Banks : 3.9
Fls : 16.0
Others : 10.5

* **Domestic market formulations: Growth continues**

Domestic market formulations grew by 18.5% to INR 2,935 mn contributing ~ 52% of revenues. The company has seen good growth in its key therapeutic categories of CNS, CVS, Anti-diabetes and GI which contributes 71% of the domestic formulations. Sun Pharma's market share in the domestic formulations is now 3.2%. We believe the company will report 16.7% growth in domestic formulations in FY07E and 18% growth in FY08E.

Table 1: Revenue break-up

	Q3 2007	Q3 2006	% change	Q2 2007	% change
Domestic Formulations	2935	2476	18.5	2834	3.6
% of total sales	51.9	55.1		50.2	
Domestic API	227	187	21.4	278	(18.5)
% of total sales	4.0	4.2		4.9	
Other Domestic sales	6	0	NA	1	357.1
% of total sales					
Total Domestic Sales	3168	2662	19.0	3114	1.7
% of total sales	56.0	59.3		55.2	
Formulation to less regulated	487	371	31.2	522	(6.7)
% of total sales	8.6	8.3		9.3	
API to less regulated	556	525	5.9	726	(23.5)
% of total sales	9.8	11.7		12.9	
Other Export sales	7	0	NA	6	13.1
% of total sales					
Total less regulated mkt sales	1050	897	17.1	1255	(16.3)
% of total sales	18.6	20.0		22.2	
Formulation sales - Caraco	1440	930	54.8	1274	13.1
% of total sales	25.4	20.7		22.6	
TOTAL SALES	5658	4489	26.0	5642	0.3

Source: Company, Edelweiss research

* **Financials: No margin expansion, increased other income and lower tax rates to boost profits**

We believe with pricing pressure in the US generics market to continue, increased R&D expenditure due to increased filing and higher litigation costs as the company has filed a few Para IVs, the margins will be under pressure for Sun Pharma. However this will get compensated by an improved gross margin due to a favourable product mix in favour of domestic formulations.

The company now has ~ USD 500 mn of cash on its books, which is going to drive the other income upwards going forward. This quarter the company had negative effective tax rate. This was primarily on account of some losses (due to R&D expense in the recently acquired US businesses). We expect 5% tax rate in FY08E and FY09E once these R&D expenses start generating revenues.

* **R&D hive-off by March 07**

The company has said that it has received the necessary approvals for the de-merger of the innovative research business and the process of de-merger will be completed by March 2007. Of the total R&D expenses, 1/3rd of it is made on the innovative research. The company also announced that the NCE is now undergoing phase II trials in US. More data regarding the molecules in this division will be made public just before the de-merger takes place which will give us more clarity on valuing this entity.

* **Valuation**

We continue to believe that the stock trades at relatively expensive valuations and do not see a re-rating until there is further clarity on the demerger of its innovative research business. At CMP of INR 1022, the stock currently trades at a P/E of 29.1x and 27.5x on our FY07E and FY08E earnings, respectively. We maintain our '**ACCUMULATE**' recommendation.

Financial snapshot								(INR mn)
Year to March	Q3FY07	Q3FY06	Growth (%)	Q2FY07	Growth (%)	FY06	FY07E	FY08E
Total operating income	5,400	4,343	24.4	5,362	0.7	16,380	20,849	23,924
Gross sales	5,658	4,489	26.0	5,642	0.3	17,372	21,806	25,400
Domestic sales	3,168	2,662	19.0	3,114	1.7	10,414	12,094	14,056
Export sales	2,490	1,827	36.3	2,528	(1.5)	6,958	9,711	11,343
Less: Excise duty	257	242	6.4	280	(8.2)	1,003	957	1,476
Net sales	5,400	4,247	27.1	5,362	0.7	16,368	20,849	23,924
Total expenses	3,667	2,867	27.9	3,654	0.4	11,463	14,014	16,059
Cost of goods sold	1,694	1,243	36.3	1,712	(1.0)	5,295	6,542	7,097
Raw material cost (incl. adj. to stock)	1,557	1,137	36.9	1,579	(1.4)	4,872	6,009	6,597
Other manufacturing expenses	137	107	28.9	133	3.6	424	533	500
Gross profit	3,706	3,099	19.6	3,650	1.5	11,085	14,307	16,827
Other expenses	1,973	1,624	21.5	1,942	1.6	6,168	7,472	8,962
Salaries, wages, other payments	658	486	35.5	616	6.8	1,416	2,547	2,929
R&D	705	458	54.1	526	34.0	1,534	2,482	2,978
Other expenses	610	680	(10.4)	800	(23.8)	3,218	2,444	3,055
EBITDA	1,733	1,476	17.5	1,708	1.5	4,917	6,835	7,865
Other income (incl. interest income)	636	268	137.1	402	58.2	1,662	1,811	1,811
PBDIT	2,369	1,744	35.8	2,110	12.3	6,579	8,646	9,676
Depreciation	212	177	19.8	204	3.7	610	833	945
Interest	-	-	-	-	-	-	-	-
PBT	2,157	1,567	37.7	1,906	13.2	5,969	7,813	8,731
Tax (including deferred tax)	(29)	70	(140.8)	(22)	31.7	239	(49)	437
PAT	2,186	1,497	46.0	1,928	13.4	5,730	7,862	8,294
Minority interest	198	33	(705.8)	64	(3)	574	600	600
Net profit for eq	1,989	1,464	35.8	1,864	6.7	5,733	7,288	7,694
Equity capital (FV INR 5)	1,037	928		1,037		929	1,037	1,037
Dividend						1,167	1,378	1,590
Dividend per share (INR)						6	7	8
Number of shares (mn)	207	186		207		186	207	207
EPS (INR)	9.6	7.9	21.5	9.0	6.7	30.9	35.1	37.1
PE (x)						33.1	29.1	27.5
EV/EBITDA (x)						39.3	28.5	22.0
M. cap/Revenues (x)						11.6	10.2	8.9
as % of net revenues								
COGS	31.4	28.6		31.9		32.3	0.3	29.7
Excise	4.8	5.6		5.2		6.1	4.6	6.2
Salaries, wages, other payments	12.2	11.2		11.5		8.6	12.2	12.2
R&D	13.1	10.5		9.8		9.4	11.9	12.4
Other expenses	11.3	15.7		14.9		19.6	11.7	12.8
Other income	11.8	6.2		7.5		10.1	8.7	7.6
Total expenses	67.9	66.0		68.1		70.0	0.7	67.1
Depreciation	3.9	4.1		3.8		3.7	4.0	4.0
Gross profit	68.6	71.4		68.1		67.7	0.7	70.3
EBITDA	32.1	34.0		31.9		30.0	0.3	32.9
Net profit	36.8	33.7		34.8		35.0	0.3	32.2
Dividend payout						20.3	0.2	20.2
Tax rate (%)	(1.3)	4.5		(1.1)		4.0	(0.0)	5.0

Company Description

Sun Pharma is a major player in domestic formulations market which contributes more than 50% of revenues. It concentrates on high growth lifestyle drugs segment like CVS, CNS, GI and Anti-diabetes segment. It has a strategy to enter the niche segments in India and in exports market as well. Sun entered in the US generics market through Caraco in which it has 63% stake. Over the last 2-3 years the company has built a strong pipeline of more than 60 ANDAs awaiting approvals. It has also grown inorganically by acquiring mostly stressed assets at cheap valuations. It has raised ~ USD 350 mn through FCCBs to pursue acquisition opportunities. Recently the company has announced that it will de-merge its innovative R&D business into a separate entity.

Investment Thesis

We believe the company will be able to deliver steady growth rate going forward because (1) its domestic business is expected to grow at a steady rate of 16-18%. (2) The US generics segment is expected to grow with strong pipeline and presence in some niche products. (3) De-merger of innovative R&D business could unlock some value but we believe more data is required for us to determine the exact value for the business.

Key Risks

The price cuts/controls in the domestic markets will negatively impact the company's growth.

Severe price erosion in the US generics market will drag the margins down.

Non-profitable acquisitions going forward and problems in integration of the acquired assets could have a negative impact on the company's balance sheet.

Financial Statements

Income statement					(INR Mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Income from operations	11,868	16,380	20,849	23,924	27,558
Gross sales	12,744	17,372	21,806	25,400	29,196
Less: Excise	891	1,003	957	1,476	1,638
Net sales	11,853	16,368	20,849	23,924	27,558
Total operating expenses	7,686	11,463	14,014	16,059	18,513
Materials cost	3,642	5,295	6,542	7,097	8,207
Employee cost	888	1,416	2,547	2,929	3,369
R&D cost	1,009	1,534	2,482	2,978	3,424
Other expenses	2,147	3,218	2,444	3,055	3,513
EBITDA	4,182	4,917	6,835	7,865	9,045
Other income	433	1,662	1,811	1,811	1,811
Depreciation and amortisation	406	610	833	945	992
Interest expense/(income)	-	-	-	-	-
Profit before tax	4,209	5,969	7,813	8,731	9,864
Provision for tax	205	239	(49)	437	493
PAT(post exceptionals & pre min. int.)	4,004	5,730	7,862	8,294	9,371
Minority interest & others	42	(3)	574	600	600
PAT (post excep.) for eq. shareholders	3,962	5,733	7,288	7,694	8,771

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Material cost	30.7	32.3	31.4	29.7	29.8
Employee cost	7.5	8.6	12.2	12.2	12.2
Other expenses	18.1	19.6	11.7	12.8	12.7
Depreciation	3.4	3.7	4.0	4.0	3.6
Interest expenditure	-	-	-	-	-
EBITDA margins	35.2	30.0	32.8	32.9	32.8
Net profit margins	33.4	35.0	35.0	32.2	31.8

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	20.6	38.0	27.3	14.7	15.2
EBITDA	5.9	17.6	39.0	15.1	15.0
Net profit	20.6	44.7	27.1	5.6	14.0
EPS	(39.7)	44.5	13.9	5.6	14.0

Cash flow statement					(INR Mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Cash flow from operations	4,233	5,029	8,578	9,725	10,419
Cash for working capital	(658)	(2,146)	(1,420)	(975)	(1,396)
Net operating cash flow	3,575	2,883	7,158	8,750	9,023
Net purchase of fixed assets	(1,623)	(3,387)	(1,000)	(692)	(727)
Net purchase of investments	(4,729)	4,166	-	-	-
Net cash flow from investing	(6,352)	779	(1,000)	(692)	(727)
Proceeds from equity capital	(141)	(793)	14,586	(1,378)	(1,590)
Proceeds from LTB/STB	13,781	645	(15,753)	(1,000)	(1,000)
Net cash flow from financing	13,640	(148)	(1,166)	(2,378)	(2,590)
Free cash flow	1,952	(504)	6,158	8,057	8,296

Balance sheet					(INR Mn)
As on 31st March	FY05	FY06	FY07E	FY08E	FY09E
Shareholders funds	11,307	15,902	37,564	43,668	50,636
Capital	942	943	1,051	1,051	1,051
Reserves & surplus	10,366	14,959	36,513	42,617	49,586
Borrowings	18,230	18,745	2,992	1,992	992
Secured loans	217	356	356	356	356
Unsecured loans	18,014	18,389	2,636	1,636	636
Deferred tax liability (net)	896	1,053	1,053	1,053	1,053
Minority interest	161	332	332	332	332
Sources of funds	30,595	36,031	41,941	47,045	53,013
Gross block	9,344	12,849	13,849	14,541	15,268
Depreciation	2,087	3,779	4,612	5,558	6,550
Net block	7,257	9,070	9,236	8,984	8,718
Capital work in progress	493	414	414	414	414
Investments	6,485	3,541	3,541	3,541	3,541
Inventories	3,173	5,117	6,322	6,858	7,931
Sundry debtors	2,511	3,609	4,593	5,271	6,072
Cash and bank balances	11,809	15,323	20,314	25,994	31,699
Loans and advances	1,392	2,237	2,237	2,237	2,237
Other current assets	62	234			
Total current assets	18,946	26,520	33,467	40,360	47,939
Current liabilities	1,741	2,279	2,814	3,053	3,530
Provisions	845	1,236	1,329	2,027	2,296
Total current liabilities and provisions	2,587	3,515	4,143	5,079	5,826
Net current assets	16,360	23,006	29,324	35,281	42,113
Uses of funds	30,595	36,031	42,515	48,219	54,786
Book value per share (BV)	61	86	181	211	244

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROE (%)	35.0	36.1	19.4	17.6	17.3
ROCE (%)	13.8	16.6	18.6	18.6	18.6
Inventory days	318.0	352.7	352.7	352.7	352.7
Debtors days	77.2	80.4	80.4	80.4	80.4
Fixed assets T/o (x)	1.4	1.5	1.6	1.7	1.8
Debt/equity	1.6	1.2	0.1	0.0	0.0

Valuations parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS, post exceptional (INR)	21.4	30.9	35.1	37.1	42.3
Y-o-Y growth (%)	(39.7)	44.5	13.9	5.6	14.0
CEPS (INR)	23.5	34.2	39.2	41.7	47.1
PE (x)	47.9	33.1	29.1	27.5	24.2
Price/BV(x)	16.8	11.9	5.6	4.9	4.2
EV/Sales (x)	16.5	11.8	9.3	7.9	6.6
EV/EBITDA (x)	46.9	39.3	28.5	23.9	20.0

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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