Indiabulls

RANBAXY LABORATORIES LTD
RESEARCH

EQUITY RESEARCH **June 21, 2007**

INITIATING COVERAGE

Share Data

Market Cap	Rs. 132.71 bn
Price	Rs. 356
BSE Sensex	14499.24
Reuters	RANB.BO
Bloomberg	RBXY IN
Avg. Volume (52 Week)	0.35 mn
52-Week High/Low	Rs. 445/305.5
Shares Outstanding	372.78 mn

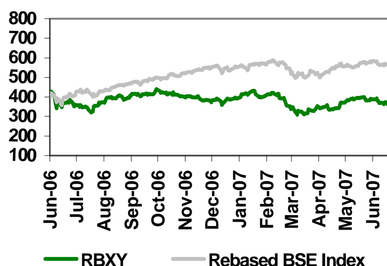
Valuation Ratios

Year to 31 March	2007E	2008E
EPS (Rs.)	15.8	18.6
+/- (%)	12.1%	17.6%
PER (x)	22.5x	19.2x
EV/ Sales (x)	2.4x	2.2x
EV/ EBITDA (x)	16.0x	13.7x

Shareholding Pattern (%)

Promoters	35
FIIs	16
Institutions	20
Public & Others	29

Relative Performance



Ranbaxy Laboratories Limited **Hold**

Maintaining momentum likely to be difficult

Ranbaxy is the largest Indian pharmaceutical company with a strong presence in formulations, APIs, generics and consumer health care products. Owing to a higher growth in several markets, new product launches, and contribution from recent acquisitions, the company witnessed a substantial rise in its revenues and profit margins in CY06. Over the next two to three years, while some one-time opportunities like obtaining 180 day market exclusivity (granted to the generic company that is first to file for approval and challenge an existing patent) could arise, the overall product pipeline of the company does not look encouraging. Due to limited opportunities and greater competition from the generics companies and Big Pharma, we expect the company to find it difficult to maintain momentum in the near future.

Key Figures

Year to March	CY04	CY05	CY06	CY07E	CY08E	CAGR (%)
(Figures in Rs mn, except per share data)						(CY07-08E)
Net Sales	54,512	52,816	61,434	70,491	77,540	12.3%
EBITDA	10,005	3,169	8,825	10,574	12,329	18.2%
Net Profit	7,011	2,642	5,154	5,940	6,779	14.7%
Margins(%)						
EBITDA	18.4%	6.0%	14.4%	15.0%	15.9%	
NPM	12.9%	5.0%	8.4%	8.4%	8.7%	
Per Share Data (Rs.)						
EPS	19.1	5.7	14.1	15.8	18.6	14.8%
PER (x)	18.6x	62.5x	25.3x	22.5x	19.2x	

- On the back of the recent appreciation in the Indian Rupee, limited upside potential from the market exclusivity of Pravastatin, and intense competition, we expect the company to achieve a net sales growth of 12.3% CAGR over CY06-08E.
- We expect the EBITDA and net profit margins to increase by 150bps and 30bps over CY06-08E due to the cost cutting initiatives taken by the company.
- At the current price of Rs. 356, the stock trades at a forward PE of 22.5x estimated CY07 earnings and 19.2x estimated CY08 earnings. With limited downside and possible upsides arising from one off events, we initiate coverage with a Hold rating with a target price of Rs 371.

Rationale

Limited upside expected from the launch of Pravastatin

Delay in launching Pravastatin 80mg, negates the potential upside from the marketing exclusivity rights

Pravastatin is the generic version of Bristol Myer Squibb's Pravachol. The USFDA recently granted approval to Ranbaxy to manufacture and market Pravastatin sodium tablets of strengths 10mg, 20mg, 40mg and 80mg with 180-day market exclusivity for the 80mg strength. Meanwhile, other firms had already received approval to launch the generic versions of the lower strength (10mg to 40mg) tablets. Because of the time-lag in launching the 80mg tablet, the company is not likely to benefit much from the market exclusivity rights as tablets of lower strengths are already available in the market.

Dependence on acquisitions could prove costly

Potential acquisitions likely to be quite expensive

The need to resort to inorganic growth has assumed greater significance in the global generics space. There has been a consolidation in the global generics space with Teva, Sandoz and Mylan, the top three generics firms in the world, carrying out significantly large acquisitions of late. Ranbaxy has also made several acquisitions in CY06 targeted towards strengthening its operations in Europe and Africa. Given Ranbaxy's goal of attaining $5bn of sales by 2010, it is looking at more acquisitions worldwide. However, as is evident from the recent acquisition of Merck's generic business by Mylan, valuations of the potential targets are likely to be expensive. Whereas there are synergies to be gained from these transactions, they are likely to have a constraining impact on the margins of the acquirer in the near term.

Margins under pressure in the generics space

Price wars in the generics space expected to erode margins

The generics segment in the top eight pharma markets is expected to witness double digit growth due to a number of key patent expiries over the next few years. Ranbaxy is well placed to ride the generics wave on the strength of a strong product pipeline, its distribution presence in key global markets and fully integrated operations.

However, Big Pharma has resorted to aggressive legal defence tactics, 'authorized generics' deals and development of combination products thereby limiting the manoeuvring space of the existing players in the generics space.

Going forward, price wars are inevitable which are expected to erode the margins of companies like Ranbaxy.

US FDA warning on the Paonta Sahib facility

Delay in ruling on Paonta Sahib facility to affect launch of new products

Ranbaxy received a USFDA warning regarding quality standards at its facility in Paonta Sahib. Consequently, the company suffered delays in launching a few products from this plant in the US markets. Though the company expects that the issue would be resolved and the facility would be operational soon, any further delay or a negative ruling by the USFDA could have an adverse effect on the company's future prospects.

Stiff competition in the domestic market

Stiff competition in the domestic markets to reduce cost advantage

The company faces stiff competition especially from Indian players and aggressive counter strategies by innovators. So far, Indian companies like Ranbaxy have depended on their low-cost and reverse engineering skills to fight in the generics market. But changes in India's patent regime and the entry of foreign players such as Teva Pharmaceuticals of Israel, etc have made the topography far more hostile. Though Indian companies have thrived on their cost-advantage benefit so far, this advantage is likely to diminish in future.

Key Risks

Better than expected returns from the Terapia acquisition could affect margins positively

Better than expected returns from Terapia could improve margins

Ranbaxy acquired a 96.7% stake in Terapia, which is the sixth largest generic company in Romania, with low cost operations and two manufacturing facilities. Terapia is an integrated player having its in-house R&D and clinical trial capabilities. Given its proximity to Russia and the CIS countries, Romania (where Terapia is located) could serve as a beachhead to both eastern and western Europe. Better than expected returns from Terapia, could affect margins positively.

Strong NCE pipeline could surprise on the upside

There have been instances in the past when companies have out-licensed drugs in Phase-I itself (DRL's co-partnering with Rheoscience on Balaglitazone). If Ranbaxy were to arrive at such an agreement with any other firm, it could attain significant milestone and royalty payments.

Positive developments on the generics

Pro generics development in the US will have positive impact

Several pro-generics initiatives are pending in the US Congress. Among these are bills prohibiting brand-name pharmaceutical companies from launching authorized generics until after the 180 day marketing exclusivity period. Another pending bill prohibits brand name companies from settling patent challenges by paying generics companies to delay the launch of generics. Positive developments on these fronts would have a significant effect on Ranbaxy's future prospects.

Price controls

The Indian government imposes price controls for specified pharma products under certain circumstances. Adverse changes in the DPCO (Drugs (Price Control) Order, 1995) list or in the span of price control can affect pricing, and hence, revenues.

Appreciation of rupee to affect exports realizations

9% appreciation in Rupee since January

The INR has appreciated by around 9% against the USD since the beginning of the year. Ranbaxy derives about three-fourths of its sales from exports. As almost 65% of its exports are dollar denominated, any further appreciation in the rupee would reduce the amount realized in rupee terms going forward.

Regulatory approvals

Ranbaxy continues to carry risks of competition, litigation, regulatory ad legislative reforms in its global generics business. The company's inability to obtain necessary regulatory approvals for its products or failure of a product at any stage may disturb its future revenue projections.

Outlook

The global pharma industry is estimated at $500 bn, of which generics account for about $40 bn. Big Pharma, or the top 10 global drug manufacturers, account for 50 per cent of the non-generic, or branded drugs market, but things are getting increasingly difficult for them. On the one hand, drug discovery costs are soaring (an estimated $1 bn is required to develop and market a new drug), while on the other hand, soaring healthcare cost, especially in the US, has consumers clamouring for cheaper generics.

Ranbaxy's management has given a guideline of 20% upside in sales and EBITDA margin of 16% for CY07. However, on the back of the recent appreciation in the Indian Rupee vis-à-vis the US Dollar, limited upside potential from the market exclusivity of Pravastatin and intense competition, we expect the company to achieve a net sales growth of 12.3% CAGR over CY06-08E.

We expect the EBITDA and net profit margins to increase by 150bps and 30bps over CY06-08E due to the cost cutting initiatives taken by the company.

At the current price of Rs. 356, the stock trades at a forward PE of 22.5x estimated CY07 earnings and 19.2x estimated CY08 earnings. With limited downside and possible upsides arising from one off events, we initiate coverage with a Hold rating with a target price of Rs 371.

Company Background

Ranbaxy is one of the largest Indian pharma companies and the ninth largest generic company in the world. It has presence in over 125 countries where it sells products through multiple channels. Its key markets are US, UK, Germany, Brazil and France and of late it has been increasing its focus on Russia and the CIS region. Exports formed over 70% of its revenues in 2006 with over 50% coming from the US and Europe.

Its manufacturing facilities are spread across nine countries. Their ranges of products cover a wide band of therapies. The company is headquartered in Gurgaon, India and employs about 11,000 people worldwide.

It concluded nine M&A transactions in CY06 amounting to $450mn.

- **Terapia** (Romania): Acquired a 96.7% stake from Advent International for $324mn. Combined with Ranbaxy's own operations in Romania, the Terapia acquisition creates Romania's largest generics firm
- **Ethimed** (Belgium), a generics company in Belgium and **Allen** (Italy), the unbranded generics business of GSK in Italy
- **Be-Tabs Pharma** (Proprietary) Ltd (South Africa), the fifth largest branded company in South Africa. South Africa is the largest pharma market in the Africa.
- **Mundogen** (Spain), which constituted the generics business of GSK in Spain
- **Zenotech Labs**: 6.94% stake for Rs 200mn to gain access to the high growth therapeutic segment of Oncology
- **Krebs Biochemicals**: 14.9% for Rs 89mn to gain access to low cost manufacturing of fermentation based products
- **Cardinal Drugs**: Its API based manufacturing facility, to augment the vertical integration strengths and expand existing manufacturing capacities
- **Senetek PLC**: To gain access to niche patented technologies such as disposable autoinjector technology for self-administration of parenteral drugs used in emergency conditions.

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