

Company Flash

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Cipla (CIPL.BO)

Tech Licensing Fees Boost 4Q

- 4Q beats expectations** — Cipla reported strong 4Q results, largely driven by higher-than-expected tech licensing fees. Pharma sales grew 14% YoY – domestic sales were up 16% YoY, while exports grew 11% YoY. EBITDA margins & PBT (excluding licensing income) expanded by 434 bps & 245 bps YoY respectively due to better product mix and a favorable currency.
- Technology fees boost** — Exports growth of 11% is disappointing given the currency boost. Revenues were propped up by Rs999m of tech know-how fees, which are sporadic milestone payments received in lieu of technology outlicensed to its partners. The sharp rise in these payments in 4Q is unlikely to be sustained at the same level across quarters.
- Tepid FY10 guidance** — Cipla's FY10 guidance of 10% sales & profit growth appears conservative, especially given that the Indian market is growing at a fast pace. Pricing pressure apart, exports could be hurt if Adcock Ingram acquires Cipla Medpro in South Africa. Cipla has mentioned that competition & sourcing issues may cost it some sales to SA (c7% of exports).
- Forex hedging positions reduced** — Cipla had a loss of Rs2.3bn in FY09 on forex forward contracts (Rs667m gain in FY08). The company indicated that it has trimmed these positions from US\$190m to cUS\$120m. As such, the impact of currency movement is likely to be much smaller in future.
- Maintain Sell (3M)** — At 18x FY10E EPS Cipla appears expensive relative to the value add in the business. On a structural basis, we believe that the potential shift in bargaining power to a larger and consolidated set of buyers would hurt over the longer term.

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	6,350	8.17	16.9	29.3	5.7	24.3	0.8
2008A	6,343	8.16	-0.1	29.3	5.0	18.1	0.8
2009E	8,916	11.47	40.6	20.9	4.4	22.3	0.9
2010E	9,902	12.74	11.1	18.8	3.8	21.6	1.3
2011E	10,901	14.02	10.1	17.1	3.3	20.5	1.5

Source: Powered by dataCentral

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

Sell/Medium Risk	3M
Price (24 Apr 09)	Rs239.35
Target price	Rs178.00
Expected share price return	-25.6%
Expected dividend yield	0.9%
Expected total return	-24.7%
Market Cap	Rs186,045M
	US\$3,750M

Price Performance (RIC: CIPL.BO, BB: CIPLA IN)



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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	29.3	29.3	20.9	18.8	17.1
EV/EBITDA adjusted (x)	22.7	21.8	16.4	14.6	13.3
P/BV (x)	5.7	5.0	4.4	3.8	3.3
Dividend yield (%)	0.8	0.8	0.9	1.3	1.5
Per Share Data (Rs)					
EPS adjusted	8.17	8.16	11.47	12.74	14.02
EPS reported	8.59	9.02	8.25	12.74	14.02
BVPS	41.63	48.31	54.49	63.50	73.43
DPS	2.00	2.00	2.18	3.18	3.51
Profit & Loss (RsM)					
Net sales	35,707	42,309	51,318	58,549	66,223
Operating expenses	-28,478	-35,000	-41,231	-47,188	-53,731
EBIT	7,229	7,309	10,087	11,362	12,492
Net interest expense	-70	-117	-318	-450	-468
Non-operating/exceptionals	590	521	721	737	801
Pre-tax profit	7,749	7,712	10,489	11,649	12,825
Tax	-1,400	-1,369	-1,573	-1,747	-1,924
Extraord./Min.Int./Pref.div.	328	667	-2,500	0	0
Reported net income	6,678	7,010	6,416	9,902	10,901
Adjusted earnings	6,350	6,343	8,916	9,902	10,901
Adjusted EBITDA	8,263	8,616	11,712	13,273	14,560
Growth Rates (%)					
Sales	20.0	18.5	21.3	14.1	13.1
EBIT adjusted	20.5	1.1	38.0	12.6	9.9
EBITDA adjusted	21.5	4.3	35.9	13.3	9.7
EPS adjusted	16.9	-0.1	40.6	11.1	10.1
Cash Flow (RsM)					
Operating cash flow	2,608	2,293	3,733	5,795	9,088
Depreciation/amortization	1,034	1,307	1,625	1,912	2,068
Net working capital	-5,103	-6,025	-4,308	-6,018	-3,880
Investing cash flow	-5,133	-5,390	-4,665	-6,200	-3,400
Capital expenditure	-4,192	-5,620	-5,000	-5,000	-2,500
Acquisitions/disposals	-941	231	335	-1,200	-900
Financing cash flow	3,166	2,751	-607	-760	-6,853
Borrowings	-3,454	4,570	2,544	3,301	-2,500
Dividends paid	-1,819	-1,819	-1,986	-2,896	-3,188
Change in cash	641	-346	-1,540	-1,165	-1,165
Balance Sheet (RsM)					
Total assets	44,135	57,326	66,874	78,922	86,889
Cash & cash equivalent	2,488	1,732	939	2,349	3,228
Accounts receivable	10,288	14,065	16,936	20,293	22,951
Net fixed assets	14,613	18,945	22,320	25,409	25,841
Total liabilities	11,775	19,774	24,518	29,560	29,814
Accounts payable	7,100	10,128	12,246	13,690	16,124
Total Debt	1,236	5,805	8,349	11,650	9,150
Shareholders' funds	32,360	37,552	42,356	49,362	57,075
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	23.1	20.4	22.8	22.7	22.0
ROE adjusted	24.3	18.1	22.3	21.6	20.5
ROIC adjusted	20.4	15.8	18.0	17.3	17.0
Net debt to equity	-3.9	10.8	17.5	18.8	10.4
Total debt to capital	3.7	13.4	16.5	19.1	13.8

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Tech Licensing Fees, Weak INR boosts 4Q

Cipla reported strong 4Q results, largely driven by higher-than-expected tech licensing fees. Pharma sales grew 14% YoY – domestic sales were up 16% YoY, while exports growth of 11% YoY was disappointing given the currency boost. EBITDA margins & PBT (excluding licensing income) expanded by 434 bps & 245 bps YoY respectively due to better product mix & a favorable currency. At 18x FY10E EPS Cipla appears expensive relative to the value add in the business. On a structural basis, we believe that the potential shift in bargaining power to a larger & consolidated set of buyers would hurt over the longer term. Maintain Sell (3M).

4Q & FY09 results snapshot

Figure 1. Cipla – 4Q&FY09 Earnings Summary (Rs in million, %)

Year to 31 March	4QFY08	4QFY09	% Ch YoY	FY08	FY09	% Ch YoY	CIRA Comments
Sales	11,023	12,487	13.3	40,886	50,337	23.1	PAT above expectations, driven by higher than expected technology licensing income
Excise Duty	(207)	(135)	(34.7)	(907)	(610)	(32.7)	
Excise duty rate (%)	1.9	1.1	-79 bps	2.2	1.2	-101 bps	
Net Sales	10,816	12,352	14.2	39,979	49,727	24.4	
Other Operating Income	405	1,316	225.1	2,206	2,979	35.0	Revenues buoyed by tech know-how fees (up 286% YoY) & weak INR
Net Revenues	11,221	13,667	21.8	42,185	52,706	24.9	
Raw Material Expense	5,700	5,665	(0.6)	20,600	23,497	14.1	Margin expansion on the back of favorable currency, improved product mix & significantly higher tech know-how income
% of Net sales	52.7	45.9	-683 bps	51.5	47.3	-427 bps	
Staff Cost	730	779	6.6	2,555	3,181	24.5	
% of Net sales	6.8	6.3	-45 bps	6.4	6.4	1 bps	
Other Expenses	2,764	3,632	31.4	10,417	13,195	26.7	
% of Net sales	25.6	29.4	385 bps	26.1	26.5	48 bps	
Expenditure	9,194	10,076	9.6	33,571	39,873	18.8	
EBITDA	2,027	3,592	77.2	8,614	12,832	49.0	Higher depreciation costs on account of capacity expansions over the past year
EBITDA Margin (%)	18.1	26.3	821 bps	20.4	24.3	393 bps	
OPM (%) - ex Tech Income	16.1	20.5	434 bps	17.4	21.1	364 bps	
Interest	(46)	(133)	191.0	(117)	(335)	186.9	Interest costs up on account of debt raised to fund capex plans as well as tighter credit environment
Depreciation	(367)	(557)	51.8	(1,307)	(1,757)	34.4	
Other income	157	155	(1.4)	527	678	28.8	
PBT	1,771	3,057	72.6	7,717	11,419	48.0	
PBT Margin (%)	15.8	22.4	658 bps	18.3	21.7	337 bps	Forex losses of INR2.3bn in FY09 on forward contracts vs. gains of INR667m in FY08 – likely to be much smaller going forward as Cipla has trimmed its forward contract positions
PBT Margin (%) - ex Tech Inc	13.8	16.2	245 bps	15.2	18.3	305 bps	
Tax	(199)	(442)	122.4	(1,260)	(1,785)	41.6	
Tax rate (%)	11.2	14.5	324 bps	16.3	15.6	-70 bps	
Recurring Net Profit	1,573	2,615	66.3	6,456	9,634	49.2	
Forex Gain/(Loss)	250	(100)	(140.0)	667	(2,318)	(447.5)	
Forex Gain/(Loss) net of tax	222	(86)	(138.5)	558	(1,956)	(450.4)	
Reported Net profit	1,795	2,529	40.9	7,014	7,678	9.5	

Source: Citi Investment Research and Analysis

Figure 2. Cipla – 4Q&FY09 revenue breakup (Rs in million, %)

YE 31 March	4Q FY08	4Q FY09	% Ch YoY	FY08	FY09	% Ch YoY	CIR Comments
Domestic	4,525	5,245	15.9	19,868	22,793	14.7	Strong performance in Indian market – Cipla remains the leader in this segment & is growing faster than the market rate
% of Total Revenues	39.6	38.0	-160 bps	46.1	42.8	-336 bps	
Formulations	4,730	5,553	17.4	15,537	21,725	39.8	
APIs	1,769	1,689	(4.5)	5,481	5,819	6.2	
Exports	6,498	7,242	11.4	21,017	27,544	31.1	Growth aided by a weak INR; Improved product mix with higher proportion of formulation exports
% of Total Revenues	56.9	52.5	-439 bps	48.8	51.7	289 bps	
Tech know/how fees	259	999	285.7	1,534	2,197	43.2	
Others	146	317	117.4	672	782	16.4	Higher than expected Tech know-how fees
Other operating income	405	1,316	225.1	2,206	2,979	35.0	
% of Total Revenues	3.5	9.5	599 bps	5.1	5.6	47 bps	
Total Revenues	11,428	13,802	20.8	43,091	53,315	23.7	

Source: Citi Investment Research and Analysis

Cipla

Company description

Cipla is a leading pharma 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.

Investment strategy

We rate Cipla Sell (3M) with a target price of Rs178/share. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, Cipla could face an increasingly uncertain global environment, if the current 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 control over the front end in 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 has not been waning in the US or Europe, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players. Cipla, being one of the weaker parts of the supply chain, will bear the brunt, in our view.

Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs178 is based on 14x Mar'10E earnings. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector such as Sun Pharma & Glenmark, 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. However, while we value the latter's patent challenge opportunities separately from the base business, we are unable to do the same for Cipla, given the lack of information on its tie-ups with different partners. Hence, we apply the same multiple (14x) as we do for Sun & Glenmark to Cipla's base business earnings to factor in any potential "one-off" upsides that may come through from time to time.

Risks

We maintain a Medium Risk rating on Cipla, which is in line with what our quantitative risk-rating system suggests. 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 also a risk to the company's supply based model. The new drug policy, if implemented in the current form could also hurt earnings. Key upside 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

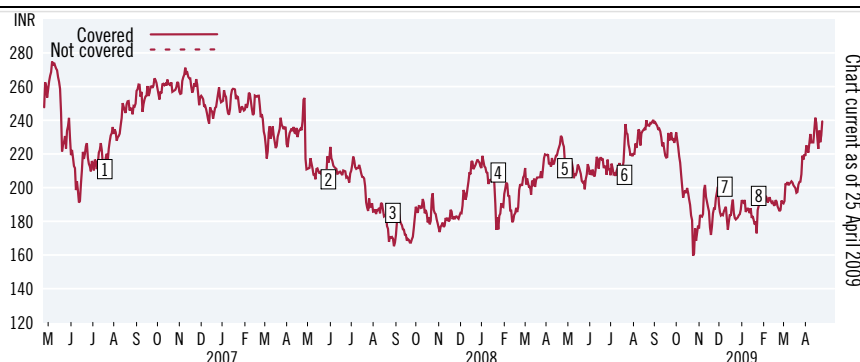


Chart current as of 25 April 2009

	Date	Rating	Target Price	Closing Price
1	19-Jul-06	3L	*170.00	212.45
2	30-May-07	3L	*191.00	214.75
3	29-Aug-07	3L	*165.00	169.75

	Date	Rating	Target Price	Closing Price
4	24-Jan-08	3L	*181.00	175.20
5	27-Apr-08	3L	*193.00	224.30
6	21-Jul-08	3L	*200.00	226.45

	Date	Rating	Target Price	Closing Price
7	9-Dec-08	*3M	*152.00	185.95
8	26-Jan-09	3M	*178.00	186.65

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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