26 April 2009 | 13 pages

Ranbaxy (RANB.BO)

Downgrade to Sell (3H); Long Road Ahead

Rating change ☑
Target price change ☑
Estimate change ☑

- **Downgrade to Sell (3H)** — with a revised TP of Rs141/sh. Besides poorer than expected 1Q results & consequent reduction in estimates, we build in added conservatism into our valuation of Ranbaxy's FTF pipeline. Given the likely poor results in the medium term, high sensitivity to a volatile rupee & no clarity on how long the US impasse could last or how worse it could get, we believe the recent strength in the stock (up 31% since March) is a good exit opportunity.
- **Poor 1Q** — Results were affected by several factors with FDA issues in the US, adverse market conditions in EU & currency headwinds in emerging mkts taking a toll on sales & profitability. Sales declined 4% YoY, EBITDA margins slumped to 0.1% (12.6% in 4Q08) & it posted a recurring net loss of Rs263m.
- **A long road in the US** — US profitability has been significantly dented by higher overheads on expansion at Ohm Labs & fixed costs at Paonta & Dewas. With the AIP imposed on Paonta, we believe it could take quite some time for things to be set right. However, supplies from Dewas may resume if the FDA is satisfied with the steps taken at this plant. While most FTF cash flows appear secure, we believe this may be offset to some extent by any penalty/fine that may arise as part of any settlement/consent decree with the FDA.
- **Changing estimates & TP** — We believe that Ranbaxy's CY09 guidance includes Nexium API supplies to Astra. Excluding this, we expect sales of Rs67bn & recurring net loss of Rs2.5bn (vs. net profit of Rs4bn earlier) in CY09. We also cut our core business sales & recurring PAT estimates for CY10 by 14% & 108% respectively. Our new TP of Rs141/sh (from Rs241) builds in Rs58/sh for the core biz & Rs99/sh for the FTF opportunities. We also assign a negative value of Rs16/sh for the one-time forex loss that we estimate for CY09.

Sell/High Risk	**3H**
from Hold/High Risk	
Price (24 Apr 09)	Rs175.75
Target price	Rs141.00
from Rs241.00	
Expected share price return	-19.8%
Expected dividend yield	0.0%
Expected total return	**-19.8%**
Market Cap	Rs73,880M
	US$1,489M

Price Performance (RIC: RANB.BO, BB: RBXY IN)

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	4,243	10.61	43.9	16.6	2.7	16.9	4.8
2007A	3,634	9.08	-14.4	19.4	2.5	13.5	4.8
2008E	2,952	6.91	-23.9	25.4	1.2	6.4	1.7
2009E	-2,466	-5.77	-183.5	nm	1.3	-4.1	0.0
2010E	-426	-1.00	82.7	nm	1.1	-0.7	4.8

Source: Powered by dataCentral

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

[1]Citigroup Global Markets India Private Limited

Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	16.6	19.4	25.4	nm	nm
EV/EBITDA adjusted (x)	11.6	11.9	15.9	nm	21.1
P/BV (x)	2.7	2.5	1.2	1.3	1.1
Dividend yield (%)	4.8	4.8	1.7	0.0	4.8
Per Share Data (Rs)					
EPS adjusted	10.61	9.08	6.91	-5.77	-1.00
EPS reported	12.76	19.53	-21.40	-16.96	32.69
BVPS	64.68	70.05	150.57	134.37	156.65
DPS	8.50	8.50	3.00	0.00	8.50
Profit & Loss (RsM)					
Net sales	61,316	69,895	71,174	69,655	98,979
Operating expenses	-54,452	-62,859	-67,662	-70,798	-80,852
EBIT	**6,864**	**7,036**	**3,512**	**-1,143**	**18,127**
Net interest expense	-1,036	-1,412	-1,886	-1,890	-1,890
Non-operating/exceptionals	683	4,434	-16,377	-8,515	1,230
Pre-tax profit	**6,510**	**10,058**	**-14,751**	**-11,548**	**17,467**
Tax	-1,357	-2,119	5,605	4,302	-3,498
Extraord./Min.Int./Pref.div.	-50	-124	0	0	0
Reported net income	**5,103**	**7,815**	**-9,146**	**-7,246**	**13,969**
Adjusted earnings	4,243	3,634	2,952	-2,466	-426
Adjusted EBITDA	8,707	9,219	6,168	-12	4,242
Growth Rates (%)					
Sales	15.4	14.0	1.8	-2.1	42.1
EBIT adjusted	246.3	2.5	-50.1	-181.9	139.9
EBITDA adjusted	154.1	5.9	-33.1	-100.2	nm
EPS adjusted	43.9	-14.4	-23.9	-183.5	82.7
Cash Flow (RsM)					
Operating cash flow	**3,512**	**12,063**	**-17,327**	**-800**	**29,400**
Depreciation/amortization	1,843	2,183	2,656	2,864	3,095
Net working capital	-4,492	802	-12,723	1,691	10,446
Investing cash flow	**-19,931**	**-4,364**	**-25,881**	**2,643**	**-21,682**
Capital expenditure	-4,358	-5,227	-5,774	-7,211	-5,974
Acquisitions/disposals	-15,803	639	-21,597	11,000	-15,000
Financing cash flow	**15,128**	**-392**	**28,513**	**-1,890**	**-6,140**
Borrowings	19,544	4,333	-3,990	0	0
Dividends paid	-3,611	-3,642	-1,500	0	-4,250
Change in cash	**-1,291**	**7,308**	**-14,694**	**-48**	**1,578**
Balance Sheet (RsM)					
Total assets	**84,322**	**92,782**	**116,816**	**108,715**	**132,133**
Cash & cash equivalent	2,951	4,379	748	1,026	2,404
Accounts receivable	15,716	14,931	17,807	15,934	17,528
Net fixed assets	42,534	45,619	48,737	53,084	55,963
Total liabilities	**58,129**	**64,178**	**51,905**	**50,725**	**64,623**
Accounts payable	8,450	8,615	9,972	8,923	9,815
Total Debt	39,556	41,416	37,426	37,426	37,426
Shareholders' funds	**26,193**	**28,604**	**64,911**	**57,990**	**67,509**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.2	13.2	8.7	0.0	4.3
ROE adjusted	16.9	13.5	6.4	-4.1	-0.7
ROIC adjusted	10.1	7.6	12.5	1.7	-2.9
Net debt to equity	139.8	129.5	56.5	62.8	51.9
Total debt to capital	60.2	59.1	36.6	39.2	35.7

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Powered by: dataCentral

Downgrade to Sell; Long Road Ahead

We downgrade Ranbaxy to Sell, High Risk (3H) from Hold, High Risk (2H) earlier with a revised TP of Rs141/sh. Besides poorer than expected 1Q results & consequent reduction in estimates, we build in added conservatism into our valuation of Ranbaxy's FTF pipeline. Given the likely poor results in the medium term, high sensitivity to a volatile rupee & no clarity on how long the US impasse could last or how worse it could get, we believe the recent strength in the stock (up 31% since March) is a good exit opportunity.

Downgrade to Sell; TP of Rs141/share

We downgrade Ranbaxy from Hold, High Risk (2H) to Sell, High Risk (3H) with a revised target price of Rs141/share. Besides the sharp upmove in the stock over the last two months (up 31% since March), our downgrade is driven by the following factors:

Sharp reduction in estimates

Post the 1QCY09 performance and the subsequent management guidance for CY09 we make the following revisions to our estimates

Figure 1. Earnings Revision

	CY09E	CY10E
Revenues (Rs)		
New	69,655	98,979
Old	88,541	114,733
Change (%)	*-21%*	*-14%*
EBITDA (Rs)		
New	1,721	21,222
Old	12,445	27,110
Change (%)	*-86%*	*-22%*
Recurring PAT (Rs)		
New	(2,466)	(426)
Old	4,046	5,679
Change (%)	*-161%*	*-108%*

Source: Citi Investment Research and Analysis

- **Revenues**: We reduce our CY09 & CY10E revenue estimates by 21% & 14% respectively. This is primarily on the back of lower sales from Europe & CIS as well as a delay in commencement of supplies of Nexium API to AstraZeneca. We have also cut our US revenue estimates further to factor in the products (simvastatin, pravastatin & loratadine) affected by the AIP on Paonta Sahib.

- **EBITDA**: Our EBITDA estimates are lower by 86% & 22% in CY09 & CY10 respectively. This is largely on account of higher than anticipated overheads due to expansion at its facility in New Jersey and fixed costs of keeping the plants at Paonta & Dewas operational despite no revenues. These estimates include upside from API supplies to AstraZeneca for Nexium in CY09 as well as exclusivity launch of Flomax (Tamsulosin) in CY10. Excluding these upsides, we expect CY09 EBITDA to be negative.

- **Recurring PAT**: We expect Ranbaxy to report a recurring loss of Rs2.5bn in CY09 – excluding any forex hit as well as the upside from API supplies to AstraZeneca. We have also cut our CY10 recurring PAT estimate by 94% to Rs385m. However, after expensing interest on its FCCBs, even CY10 recurring net income would be negative to the tune of Rs426m.

Greater conservatism on its FTF opportunities

We maintain our view that most of Ranbaxy's large patent challenge / FTF opportunities appear safe. Based on our current understanding, we believe that a change of site is unlikely to be construed as a withdrawal of an ANDA – which could trigger forfeiture of exclusivity. Even in the case of post MMA filings (such as Nexium, Valtrex, Flomax & Caduet), where there is a requirement to get tentative approval within 30 months so as to not forfeit exclusivity, Ranbaxy has received tentative approval for every product other than Caduet. While it has not yet received tentative approval on Lipitor, this was a pre MMA filing & is not subject to the "tentative approval within 30 months" condition.

We, however, also acknowledge that we have not seen any precedent of the AIP being invoked against a large company with FTF opportunities. In this context, it is difficult to predict with 100% certainty how the FDA may look at the entire situation. Moreover, there is also a possibility that some part of the cash flows accruing from such settlements would have to be used to pay for any penalty that the FDA may impose on the company as part of any consent decree or settlement of the issue. As such, we take a hair cut of 25% on our valuation for Ranbaxy's unique opportunities – leading to a fresh value of Rs99/share from Rs137/share earlier.

New target price of Rs141/share

- **Core biz at Rs58/sh**: We now value Ranbaxy's core business at Rs58/share (vs. Rs104/share earlier). With the company going into the red at the net profit level, we switch to EV/Sales in order to value the core business. We use an EV/Sales multiple of 0.7x (the lowest multiple that Ranbaxy has ever traded at over the last 7 years). Based on 0.7x CY09E core sales, we arrive at a value of Rs58/share for the core business

- **Valuing FTFs at Rs99/sh**: We reduce our valuation of Ranbaxy's FTF pipeline from Rs137/share to Rs99/share as we take a hair cut of 25% on our original valuation to account for any unforeseen risks on account of the AIP or potential penalty that may be imposed on the company by the FDA

- We also assign a negative value of Rs16/share for the MTM losses that we expect Ranbaxy to take on its ineffective hedges over the next two years. We believe this is fair as we remove these losses while arriving at our valuation for the core business.

Cumulatively, we arrive at a target price of Rs141/share for the stock.

Key conference call takeaways

- **CY09 guidance**: Ranbaxy has guided to topline of Rs70bn (US$1.4bn) and a loss of Rs8bn (US$150m) at the PAT level for CY09. Barring any adverse movement in the currency rates the company expects to break even at the PAT level over the next three quarters. Emerging markets are likely to be the key growth drivers given the loss of revenues from US and de-growth in revenues from Europe. It mentioned that it has not included Valtrex exclusivity in this guidance. However, we believe that API supplies to AstraZeneca under its Nexium settlement is part of this guidance.

- **Update on US biz**: Ranbaxy is in dialogue with the FDA to resolve the issues involved at its plants. FDA inspection of Paonta and Dewas facilities is likely to take place during the year. Ranbaxy believes that supply from Dewas facilities could start again if FDA finds the plants GMP compliant post the inspection. The company is also expanding its facility at Ohm Labs in the US to serve the US market better. While these are steps in the right direction we believe resolution of the issues involved will be a slow and long drawn out process. Any substantial recovery in the near to medium term looks unlikely.

- **Impact of FDA issues on Para IV settlements**: Ranbaxy does not expect the ongoing FDA issues to impact its settlements of Para IV litigations. It is currently in the process of filing for site transfer for Valtrex (Valacyclovir). While upside from Valtrex has not been included in the guidance the company believes the probability of launch of the product remains high. The company also indicated that Nexium API supplies are likely to begin in the latter half of CY09.

- **Restructuring European biz**: Ranbaxy is looking to restructure its business in the region with a higher emphasis on profitability. The management indicated that the company has been scaling back operations in these markets following the sustained pricing pressures. It has reduced a large part of its fixed costs/overheads in UK & Germany.

- **Forex Hedges**: Ranbaxy has incurred a MTM loss of Rs9.2bn on account of re-valuation of ineffective hedges. The company indicated that it has an outstanding position of US$1.4bn of ineffective hedges. These positions are spread over the next 8 years and a large part of the losses are likely to be back ended.

1QCY09 results snapshot

Figure 2. . Ranbaxy – 1QCY09 Consolidated Earnings Summary (Rs m, %)

Year to 31st December	1QCY08	1QCY09	*% Ch YoY*	4QCY08	*% Ch QoQ*
Gross Sales	16,231	15,584	*(4.0)*	19,096	*(18.4)*
Excise Duty	94	36	*(61.7)*	47	*(23.4)*
Net sales	16,137	15,548	*(3.6)*	19,049	*(18.4)*
Other Operating Income	739	223	*(69.8)*	933	*(76.1)*
Total Net revenues	**16,876**	**15,771**	***(6.5)***	**19,982**	***(21.1)***
Cost of sales	8,516	9,115	*7.0*	10,178	*(10.4)*
Gross Profit	8,360	6,656	*(20.4)*	9,804	*(32.1)*
Gross margins (%)	*49.5*	*42.2*	*-733 bps*	*49.1*	*-686 bps*
SG&A	4,998	5,554	*11.1*	6,013	*(7.6)*
as a % of sales	*31.0*	*35.7*	*475 bps*	*31.6*	*416 bps*
R&D	920	1,079	*17.3*	1,264	*(14.6)*
as a % of sales	*5.7*	*6.9*	*124 bps*	*6.6*	*30 bps*
EBITDA	**2,442**	**23**	***(99.0)***	**2,527**	***(99.1)***
EBITDA Margin (%)	**14.5**	***0.1***	***-1,432 bps***	***12.6***	***-1,250 bps***
Depreciation & Amortization	621	639	*2.9*	720	*(11.3)*
Interest Cost	384	246	*(35.9)*	442	*(44.3)*
Other Income	85	457	*437.6*	546	*(16.3)*
PBT	1,522	(405)	*(126.6)*	1,911	*(121.2)*
Tax	318	(142)	*(144.6)*	778	*(118.2)*
Tax Rate	*20.9*	*35.0*	*1,414 bps*	*40.7*	*-568 bps*
Recurring Net Income	**1,204**	**(263)**	***(121.8)***	**1,133**	***(123.2)***
Translation Gain / (Loss) - assets	110	(845)	*(868.2)*	(3,612)	*(76.6)*
Translation (Gain)/Loss - liabilities	798	1,273	*59.5*	1,920	*(33.7)*
Exceptionals	895	(9,188)	*(1,126.6)*	(7,843)	*17.1*
Total Exceptional Items	207	(11,306)	*(5,561.8)*	(13,375)	*(15.5)*
Tax Impact	43	(3,959)	*(9,260.7)*	(5,444)	*(27.3)*
Exceptional items (net of tax)	164	(7,347)	*(4,585.7)*	(7,931)	*(7.4)*
Reported Net Income	**1,368**	**(7,610)**	***(656.3)***	**(6,798)**	***11.9***

CIR Comments

Recurring PAT below expectations – results affected by US FDA issues in US, adverse market conditions in Europe and economic crisis & cross currency headwinds in emerging markets

Margins impacted by overheads on Paonta & Dewas – not supplying to US currently due to import alert by the FDA

Other income higher YoY due to cash from Daiichi coming in at the end of CY08

Tax credits on losses booked on forex hedges

Forex losses – Realised losses of Rs845m; Unrealized MTM loss on FCCBs of Rs1273m & MTM loss on hedging contracts of Rs9188m

Source: Citi Investment Research and Analysis

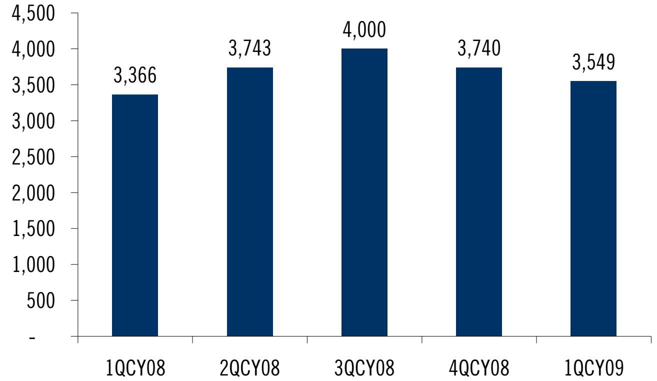
Figure 3. Ranbaxy – 1Q CY09 Consolidated Revenue Distribution (Rs m)

	1QCY08	1QCY09	% Ch YoY	4QCY08	% Ch QoQ
India	3,366	3,549	*5.4*	3,740	*(5.1)*
Europe	3,291	2,831	*(14.0)*	3,268	*(13.4)*
Asia Pacific & CIS	1,978	1,996	*0.9*	2,688	*(25.8)*
RoW	2,058	2,039	*(1.0)*	2,580	*(21.0)*
North America	4,352	4,040	*(7.2)*	5,080	*(20.5)*
Total Dosage	**15,047**	**14,456**	***(3.9)***	**17,356**	***(16.7)***
API	1,183	1,128	*(4.6)*	1,379	*(18.2)*
Total Sales	**16,230**	**15,584**	***(4.0)***	**18,735**	***(16.8)***

Source: Citi Investment Research and Analysis

Update on key businesses

Figure 4. India Formulation Sales (US$ m)



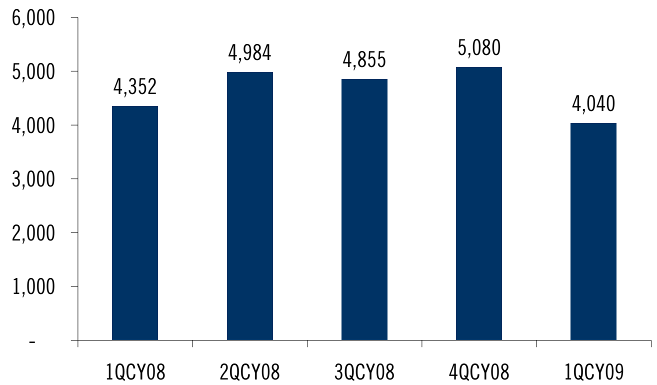
Source: Citi Investment Research and Analysis

CIRA Comments

- Sales up 9% YoY – includes one time sales of Rs739m for supply of ARVs to National Aids Control Organisation
- Launched Omlesartan (in-licensed from Daiichi) during the quarter – co marketing agreement with GSK
- Ranked no.2 in the domestic market with a market share of 4.8%; market leader in the anti-infective segment with a 11% market share
- 5 brands in the top 30 brands in the country

Source: Company Reports and Citi Investment Research and Analysis

Figure 5. North America Formulation Sales (US$ m)



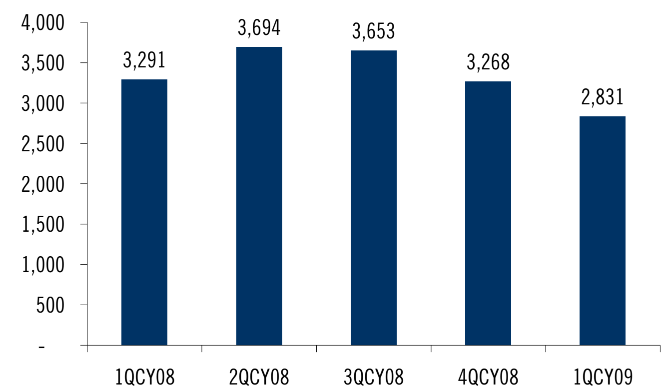
Source: Citi Investment Research and Analysis

CIRA Comments

- Revenue down 7% YoY in INR terms & 26% YoY in US$
- US sales of US$68m – severely impacted by FDA issues
- US sales include cUS$2m of exclusivity sales of Imitrex. Sales affected due to presence of AG launch by DRL
- Canada sales up 57% YoY to Rs639m
- 4 product approvals from the US FDA during the quarter – all from the facility at Ohm labs
- Expansion of Ohm Labs facilities in progress

Source: Company Reports and Citi Investment Research and Analysis

Figure 6. Europe Formulation Sales (US$ m)



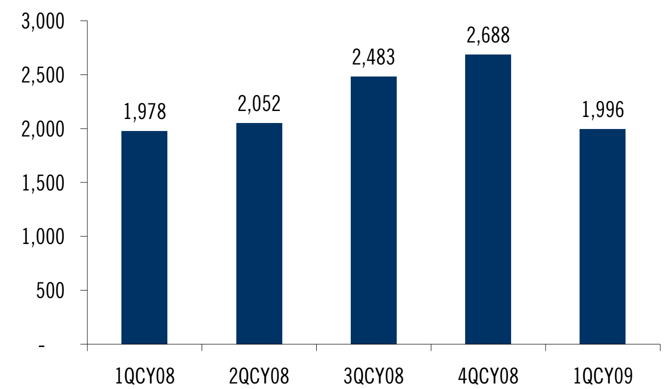
Source: Citi Investment Research and Analysis

CIRA Comments

- Multiple concerns across markets – Revenues down 14% YoY
- Romania sales down 8% YoY mainly on account of currency devaluation and uncertain regulatory environment; Ranbaxy remains the largest generic player in this market
- YoY de-growth of 8% in UK, France & Germany due to currency depreciation (UK) & adverse regulatory conditions (Germany)
- 6 product approvals & 4 launches during the quarter

Source: Company Reports and Citi Investment Research and Analysis

Figure 7. Asia Pac & CIS Formulation Sales (US$ m)



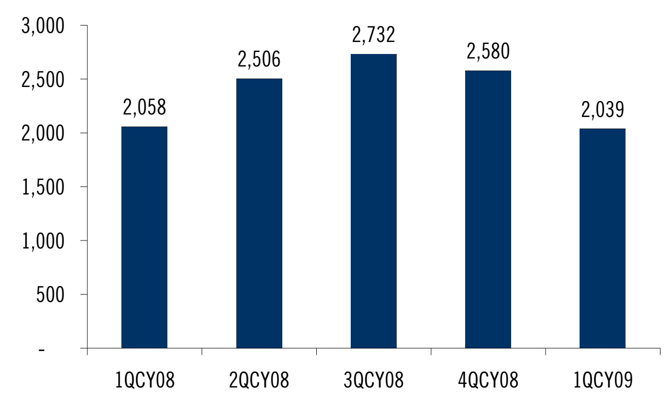
Source: Citi Investment Research and Analysis

CIRA Comments

- CIS revenues down 8% YoY – Sales affected by economic crisis and the resulting currency devaluation in the region
- Russia sales up 25%YoY on a constant currency basis
- Asia Pacific revenues of US$22m up 9% YoY

Source: Company Reports and Citi Investment Research and Analysis

Figure 8. RoW (LatAm & Africa) Formulation Sales (US$ m)



Source: Citi Investment Research and Analysis

CIRA Comments

- Revenues from Brazil down 8% YoY with revenues of US$7m – affected by cross currency movements
- Ranbaxy is currently ranked 6th in the generics market in Brazil with a market share of 4%
- Revenue growth in all markets other than Mexico & Brazil
- Revenues from Africa up 8% YoY at US$26m including US$14m from South Africa (up 58% YoY) & US$5m from Nigeria (up 15% YoY)

Source: Company Reports and Citi Investment Research

Ranbaxy

Company description

Ranbaxy is a leading Indian pharmaceutical company with a strong export business complementing its domestic business. It has a vision of becoming a leading generics pharmaceutical company in the global market and, in the long term, a research-led pharmaceutical company. The company already has a presence in several countries, and has developed a complex business model, perhaps the first of its kind in a developing country.

Investment strategy

We rate Ranbaxy Sell/High Risk (downgrade from Hold/High Risk) with a target price of Rs141 (Rs241 earlier). We believe that the US FDA's move to block imports and new approvals from Ranbaxy's Paonta and Dewas facilities could significantly hit the US business and overall profitability. Besides poorer than expected 1Q results & consequent reduction in estimates, we build in added conservatism into our valuation of Ranbaxy's FTF pipeline. Given the likely poor results in the medium term, high sensitivity to a volatile rupee & no clarity on how long the US impasse could last or how worse it could get, we believe the recent strength in the stock (up 31% since March) is a good exit opportunity.

Valuation

While we normally value most Indian pharma stocks using the P/E vs. earnings CAGR methodology, we now switch to EV/Sales to value Ranbaxy's core business given that it has gone into the red at the bottom line level. We also add an additional value for the company's impressive patent challenge pipeline. We value the core generics business (excluding exclusivity upsides) at 0.7x 12-month forward sales, which is the lowest multiple it has traded at over the last 7-8 years. We believe this low multiple is warranted given the uncertainty in its business following issues with the US FDA. At 0.7xMarch09E recurring sales, we arrive at a value of Rs58/sh (Rs104/sh earlier) for the base generics business. We value the company's patent challenge pipeline at Rs137/share using a probability-adjusted NPV approach and applying a discount rate of 20%. However, we take a haircut of 25% on this number to account for any unforeseen risks on account of the AIP or potential penalty that may be imposed on the company by the FDA. We also assign a negative value of Rs16/share for the MTM losses that we expect Ranbaxy to take on its ineffective hedges over the next two years. Cumulatively, we arrive at a fair value of Rs141/share.

Risks

We rate Ranbaxy High Risk. The High Risk rating is to account for the added risk to the US operations following the stand-off with the US FDA. Our quant-based rating system, which tracks 260-day historical share price volatility, suggests Medium Risk. The key upside risks to our call include: 1) Earlier than expected resolution of the US FDA issues; 2) Lower than expected impact on US sales and profitability due to the ban on products from two facilities; 3) Any fresh settlement / patent challenge win in the US could boost sentiment for the stock. The key downside risks include: a) Price cuts in Romania (c8% and c20% of sales & EBIDTA); b) Early triggering of its exclusivity in Nexium, impairing its deal with Astra: each year knocks cRs8/sh off NPV; c) Spillover of FDA issues to other plants.

Appendix A-1

Analyst Certification

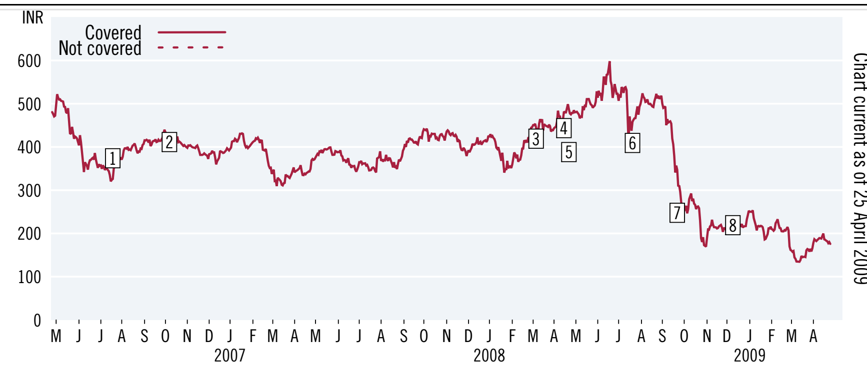
Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Ranbaxy (RANB.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	19-Jul-06	*1M	*402.00	325.90
2	6-Oct-06	1M	*505.00	422.35
3	6-Mar-08	1M	*545.00	453.60
4	15-Apr-08	1M	*595.00	481.80
5	22-Apr-08	1M	*620.00	487.15
6	21-Jul-08	*1H	*604.00	458.20
7	21-Sep-08	*3H	*373.00	356.85
8	9-Dec-08	*2H	*241.00	213.05

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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