

Margin pressure; Outlook firm



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3Q miss on cost pressure; Revise forecasts & PO

IPCA's 3Q adj profits at Rs561mn declined 6% yoy on weak EBITDA margins, however forex gains aided 10% reported PAT growth. While revenue growth at 18% was in line with estimates, weaker margins (at 19.5%) led to flattish EBITDA growth. Domestic formulations grew at 12% (lack of tender biz.) while export formulations surged 33% YoY led by US, CIS. We revise our forecasts marginally (~3%) to factor in near term cost pressures, reducing our PO to Rs355 (at 15x FY12E, 15% discount to sector). US facility approval remains key upside trigger.

Margin pressure to persist for next 2-3 quarters

3Q margin decline of 331bps was largely due to recent fieldforce addition (1000 in last 3 qtrs) increasing promotion costs as well as surge in freight charges. While fieldforce would become productive from next quarter, we expect margins to stabilize at 21%+ levels after 2-3 quarters. Unabsorbed overheads of ~Rs250mn annually in Indore SEZ are likely to recede on start of UK shipments (1HFY12) & expect facility approval (by 2HFY12) as recent filings for PEPFAR has triggered compulsory visit in next 6 mths. Higher export tender wins may surprise on upside

Domestic momentum sustains, Formulation exports shine

Lack of tender business affected domestic formulations growth, adjusting for which the business grew ~17% (up 19% YTD). Exports surged 33% YoY driven by strong US, Russia and RoW markets. Tender business (exports) contributed Rs191mn in 3Q, expect further upside from new tender wins (~Rs400mn in 4Q). We remain confident of robust 18% revenue CAGR driven by strong domestic business (driven by strong fieldforce) & export business aided by pipeline.

Management call highlights

(a) Tender wins for Artimether+Lumefantrine may exceed Rs1bn for FY11 (Rs533mn YTD), (b) Forward hedges (60% of exports) at ~Rs48 per USD to protect losses from currency fluctuations. (c) To file 18 ANDAs in FY12, adding to current pipeline of 22 (11 approved), boosting US generics outlook.

Estimates (Mar)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	960	2,054	2,200	2,960	3,587
EPS	8.06	16.42	17.59	23.66	28.68
EPS Change (YoY)	-25.6%	103.7%	7.1%	34.5%	21.2%
Dividend / Share	2.58	2.80	3.00	3.25	3.25
Free Cash Flow / Share	8.84	3.72	8.68	12.74	20.87

Valuation (Mar)

	2009A	2010A	2011E	2012E	2013E
P/E	38.92x	19.10x	17.83x	13.26x	10.94x
Dividend Yield	0.823%	0.893%	0.957%	1.04%	1.04%
EV / EBITDA*	16.65x	13.36x	13.24x	9.58x	8.03x
Free Cash Flow Yield*	2.82%	1.19%	2.77%	4.06%	6.66%

* For full definitions of *iQmethod*SM measures, see page 6.

Stock Data

Price	Rs313.60
Price Objective	Rs355.00
Date Established	27-Jan-2011
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs214.40-Rs352.00
Mrkt Val / Shares Out (mn)	US\$858 / 125.1
Average Daily Volume	85,737
BofAML Ticker / Exchange	XBLAF / BSE
Bloomberg / Reuters	IPCA IN / IPCA.BO
ROE (2011E)	23.0%
Net Dbt to Eqty (Mar-2010A)	51.3%
Est. 5-Yr EPS / DPS Growth	24.0% / 15.0%
Free Float	53.8%

Key Changes

(Rs)	Previous	Current
Price Obj.	365.00	355.00
2011E EPS	18.03	17.59
2012E EPS	24.35	23.66
2013E EPS	29.22	28.68

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Refer to important disclosures on page 6 to 8. Analyst Certification on Page 4. Price Objective Basis/Risk on page 4. Link to Definitions on page 4. 11013455

iQprofileSM IPCA Labs

Key Income Statement Data (Mar)	2009A	2010A	2011E	2012E	2013E
(Rs Millions)					
Sales	12,926	15,666	17,967	21,680	25,761
Gross Profit	7,854	9,210	10,723	12,991	15,435
Sell General & Admin Expense	(4,714)	(5,331)	(6,672)	(7,519)	(8,909)
Operating Profit	2,256	2,838	2,800	4,037	4,851
Net Interest & Other Income	(1,073)	(176)	177	(179)	(168)
Associates	NA	NA	NA	NA	NA
Pretax Income	1,183	2,663	2,977	3,858	4,684
Tax (expense) / Benefit	(280)	(627)	(796)	(919)	(1,118)
Net Income (Adjusted)	960	2,054	2,200	2,960	3,587
Average Fully Diluted Shares Outstanding	125	125	125	125	125

Key Cash Flow Statement Data

Net Income	960	2,054	2,200	2,960	3,587
Depreciation & Amortization	397	467	536	572	649
Change in Working Capital	(736)	(1,664)	(537)	(1,353)	(1,635)
Deferred Taxation Charge	78	142	156	159	163
Other Adjustments, Net	1,276	727	523	1,005	1,198
Cash Flow from Operations	1,974	1,726	2,879	3,344	3,962
Capital Expenditure	(869)	(1,261)	(1,792)	(1,750)	(1,351)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	(316)	86	250	44	(269)
Cash Flow from Investing	(1,185)	(1,174)	(1,543)	(1,706)	(1,620)
Shares Issue / (Repurchase)	(1)	0	0	0	0
Cost of Dividends Paid	(323)	(350)	(375)	(407)	(407)
Cash Flow from Financing	(769)	(558)	(1,150)	(1,517)	(1,701)
Free Cash Flow	1,105	466	1,086	1,594	2,611
Net Debt	4,486	4,437	4,077	3,923	3,253
Change in Net Debt	1,050	(49)	(361)	(154)	(671)

Key Balance Sheet Data

Property, Plant & Equipment	5,768	6,379	7,843	9,020	9,721
Other Non-Current Assets	556	708	251	207	477
Trade Receivables	3,391	3,880	4,459	5,441	6,466
Cash & Equivalents	113	108	294	414	1,054
Other Current Assets	3,893	5,004	5,292	6,387	7,591
Total Assets	13,722	16,078	18,139	21,470	25,310
Long-Term Debt	4,599	4,545	4,371	4,337	4,307
Other Non-Current Liabilities	651	793	872	960	1,055
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	2,162	2,097	2,428	3,152	3,746
Total Liabilities	7,412	7,435	7,671	8,449	9,109
Total Equity	6,309	8,643	10,468	13,021	16,201
Total Equity & Liabilities	13,722	16,078	18,139	21,470	25,310

iQmethodSM - Bus Performance*

Return On Capital Employed	16.0%	17.0%	13.8%	18.1%	18.5%
Return On Equity	15.7%	27.5%	23.0%	25.2%	24.5%
Operating Margin	17.6%	18.2%	15.7%	18.7%	18.9%
EBITDA Margin	20.5%	21.1%	18.6%	21.3%	21.4%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	2.1x	0.8x	1.3x	1.1x	1.1x
Asset Replacement Ratio	2.2x	2.7x	3.3x	3.1x	2.1x
Tax Rate (Reported)	23.7%	23.6%	26.7%	23.8%	23.9%
Net Debt-to-Equity Ratio	71.1%	51.3%	38.9%	30.1%	20.1%
Interest Cover	6.0x	10.8x	10.9x	16.9x	18.7x

Key Metrics

* For full definitions of iQmethodSM measures, see page 6.

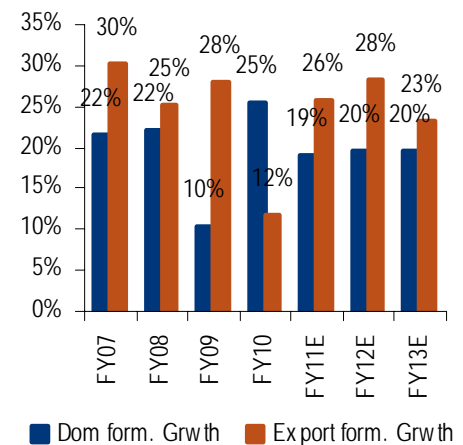
Company Description

Mumbai based IPCA Labs is a fully integrated pharmaceuticals company with a diversified revenue mix (53% exports). With a product portfolio of 150+ formulations across therapies, IPCA is leader in anti-malarials and Rheumatoid-Arthritis segments in domestic market. Leveraging its strength in API, IPCA has been successful in its export formulations strategy, with recent entry into lucrative US generic market.

Investment Thesis

We are positive on IPCA's steady growth prospects, given export formulations poised for a stronger growth trajectory. We expect robust 20% EPS growth over the next two years driven by 19% revenue growth. Focus on chronic segments, strong backward integration and rich product pipeline would be key growth drivers. Given the stocks significant discount to sector average, we view IPCA as an attractive value play and expect valuations to move close to the sector average over the next 12 months.

Chart 1: Robust formulations growth outlook



Source: BofA Merrill Lynch Global Research estimates, Company

Stock Data

Price to Book Value 3.7x

3QFY11 Result analysis

Table 1: IPCA Labs: Quarterly results, March fiscal year ends

Year to Mar (Rs mn)	Dec-09	Sep-10	Dec-10	YoY	QoQ	Comments
Formulations						
Domestic	1,589	2,219	1,775	12%	-20%	Domestic growth driven by key therapy segments like CVs (up 26%), Pain Mgmt (up 27%), CNS. Anti-malarial sales reverts to strong growth (19%), leading to strong surprise. Adjusting for decline in tender sales, business grew at robust 17% YoY (19% YTD). Export sales driven by strong 42% growth in generics business while branded formulations grew at healthy 21%. Impact of rupee appreciation affected growth.
Export	1,257	1,751	1,671	33%	-5%	
Total formulations	2,847	3,970	3,446	21%	-13%	
API						
Domestic	338	408	322	-5%	-21%	API sales affected due to higher captive usage. Rupee appreciation further affected realisations
Exports	755	764	865	15%	13%	
Total API	1,092	1,173	1,187	9%	1%	
Others	18	40	30	69%	-25%	
Net Revenues	3957	5183	4664	18%	-10%	
Cost of raw materials	1,604	2,044	1,912	19%	-6%	Gross margins declined 46bps YoY, margin gains restricted due to weaker domestic formulations contribution
<i>% of Net Sales</i>	<i>40.5%</i>	<i>39.4%</i>	<i>41.0%</i>	<i>46bps</i>	<i>155bps</i>	
Staff costs	541	700	649	20%	-7%	Steep rise in staff cost factor inclusion of ~1000 fieldforce in last 3 quarters
<i>% of Net Sales</i>	<i>13.7%</i>	<i>13.5%</i>	<i>13.9%</i>	<i>25bps</i>	<i>42bps</i>	
SG&A expenses	909	1,259	1,193	31%	-5%	Partly reflect fixed overheads being incurred at Indore SEZ, not contributing to any revenues. Increase in freight and marketing overheads also led to cost pressures
<i>% of Net Sales</i>	<i>23.0%</i>	<i>24.3%</i>	<i>25.6%</i>	<i>261bps</i>	<i>128bps</i>	
Total expenditure	3,054	4,003	3,754	23%	-6%	
EBITDA	903	1180	910	1%	-23%	EBITDA margins declined by 331bps YoY largely due to high overheads due to fieldforce expansion as well as freight costs
EBITDA margin (%) (core)	22.8%	22.8%	19.5%	(331bps)	(326bps)	
Other income	9	8	4	-62%	-53%	
Forex gains/ (losses)	(17)	288	112	-779%	-61%	Forex gains relate to forward hedges only.
Interest	53	62	56	6%	-10%	Total debt remained at same levels as 2Q, however some repricing led to sequential decline
Depreciation	119	137	142	19%	4%	
Pre-tax profits	724	1,277	828	14%	-35%	Sharp increase driven by forex gains, adjusting for which PBT is down 3% YoY
Tax	141	337	188	33%	-44%	Tax rates to remain at ~22% going forward
Net profits (w/o minority)	583	940	640	10%	-32%	Profit miss due to weak EBITDA margins
Adjusted PAT (core business)	595	744	561	-6%	-25%	Profits fell 15% below estimates on weak margins

Source: Company Data, BofA Merrill Lynch Global Research

Comparative valuations

Table 2: Indian Pharma coverage valuation comparables

Stock	BofAML		CMP	Mkt Cap	P/E (x)		EPS CAGR		EV/EBITDA (x)		RoE (%)		EV/Sales (x)				
	Ticker	BofAML Opinion			Rs	US\$mn	FY11E	FY12E	10-12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E		
Ranbaxy^	XIZZF	Neutral	564	5323	38.1x	19.6x	83%	24.9x	13.2x	29%	29%	3.5x	2.9x				
Cipla	N.A.	Not rated	343	6089	24.4x	20.8x	10%	18.3x	15.7x	18%	18%	4.4x	3.8x				
Sun Pharma	N.A.	Not rated	474	10781	27.7x	23.7x	24%	18.5x	15.8x	20%	19%	8.3x	6.7x				
Dr Reddys	DRYBF	Buy	1579	5,902	25.9x	18.0x	39%	17.5x	12.9x	26%	34%	3.4x	2.6x				
Lupin	LPMCF	Buy	467	4,608	24.5x	18.6x	28%	17.8x	13.7x	29%	30%	3.6x	3.0x				
Large cap generics average								25.6x	20.3x	25%		18.0x	14.5x	23%	25%	4.9x	4.0x
Cadila	CDLHF	Buy	840	3,802	24.9x	19.1x	29%	17.2x	13.7x	35%	34%	4.1x	3.3x				
Divis	XXQPF	Buy	631	1,848	17.6x	14.6x	19%	17.4x	12.9x	21%	24%	6.9x	5.4x				
Glenmark	XVQWF	Buy	325	1,941	16.5x	14.8x	29%	10.8x	9.8x	11%	16%	3.2x	2.6x				
Biocon	BCLTF	Buy	366	1,615	18.8x	13.6x	36%	11.3x	8.7x	20%	23%	2.5x	2.1x				
GSK Pharma^	GXOLF	Underperform	2270	4,248	31.0x	27.2x	15%	21.0x	18.1x	29%	29%	7.5x	6.4x				
IPCA	XBLAF	Buy	314	870	17.8x	13.3x	21%	13.3x	9.7x	23%	25%	2.5x	2.1x				
India Pharma sector average (ex-Ranbaxy)								22.9x	18.4x	25%		16.3x	13.1x	23%	25%	4.6x	3.8x

Source: BofA Merrill Lynch Global Research. ^ - Dec- ending, Bloomberg. For Dec ending companies, comparable data adjusted for Mar- ending. Consensus estimates are used where stock is not covered by BofAML.

Price objective basis & risk

IPCA Labs (XBLAF)

Our PO of Rs355 is based on 15x FY12E EPS of Rs23.9. Our target multiple is at a 15% discount to Indian pharma peers trading at c18x FY12E. Our PO is pegged at the upper end of its historical 1-yr forward P/E band as we believe re-rating is justified on robust earnings growth outlook (20% earnings growth) and improving business mix. Higher upside from Artemether-Lumefantrine tender (WHO) and earlier than expected USFDA approval for Indore SEZ may provide upside triggers.

Downside risks: (a) International generics pricing pressure (b) regulatory delays and (c) foreign exchange fluctuation.

Link to Definitions

Healthcare

Click [here](#) for definitions of commonly used terms.

Analyst Certification

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27 January 2011

India - Healthcare Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	BIOCON LTD	BCLTF	BIOS IN	Arvind Bothra
	CADILA HEALTHCAR	CDLHF	CDH IN	Arvind Bothra
	Divi's Lab	XXQPF	DIVI IN	Arvind Bothra
	Dr Reddy's Lab	DRYBF	DRRD IN	S.Arun
	Dr Reddys Lab-A	RDY	RDY US	S.Arun
	Glenmark Pharm	XVQWF	GNP IN	Arvind Bothra
	IPCA Labs	XBLAF	IPCA IN	Arvind Bothra
	Lupin Limited	LPMCF	LPC IN	S.Arun
NEUTRAL				
	Ranbaxy Laboratories Limited	XIZZF	RBXY IN	S.Arun
UNDERPERFORM				
	GSK India	GXOLF	GLXO IN	Arvind Bothra
	Piramal Healthcare Ltd	XNIGF	PIHC IN	Arvind Bothra

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations - Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	$\text{Net Debt} = \text{Total Debt, Less Cash \& Equivalents}$	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations - Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

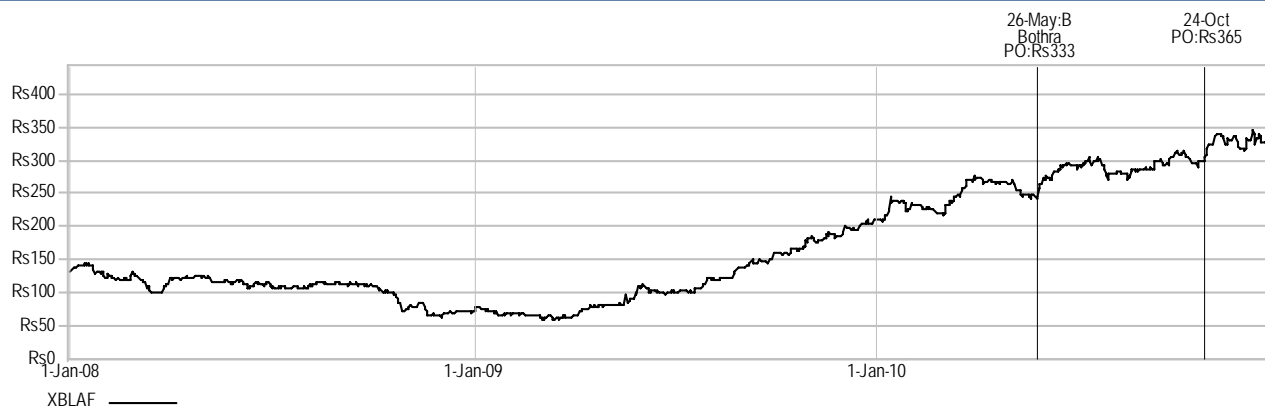
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Important Disclosures

XBLAF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of December 31, 2010 or such later date as indicated.

Investment Rating Distribution: Health Care Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	127	54.51%	Buy	54	46.15%
Neutral	57	24.46%	Neutral	32	58.18%
Sell	49	21.03%	Sell	17	34.69%

Investment Rating Distribution: Global Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2011	53.86%	Buy	874	48.31%
Neutral	925	24.77%	Neutral	444	52.30%
Sell	798	21.37%	Sell	276	36.75%

* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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