Company Focus

7 March 2008 | 12 pages

Shasun Chemicals & Drugs (SHAS.BO)

Rating change ☑
Target price change ☑
Estimate change ☑

Buy: Dip Before a Rise

- **Set for a turnaround** — We believe that Shasun is set for better times going forward after facing several hiccups leading to a tough 1HFY08. The company has made significant progress in its nascent CRAMS foray, which along with a recovery in its legacy API business is likely to lead to strong growth in 2HFY08 and beyond.
- **Hiccups in 1HFY08** — Shasun faced a few setbacks in 2007 leading to a weak 1HFY08 – 12% growth in sales & reporting a loss at the net level. Besides the significant appreciation of the rupee vs. USD, which hit most pharma companies, Shasun was also hit by disruption of supplies in one of its key products (nizatidine) as well as upfront expenses for its formulations foray.
- **Expect better 2H; 3Q encouraging** — on 1) Significant ramp up in supplies under the take or pay agreement and 2) pickup in formulation sales vs. no corresponding increase in costs. 3Q FY08 performance has already shown a healthy recovery both in Indian and UK business.
- **Step jump in FY10** — We expect Shasun's earnings to recover in FY09 and FY10 as the UK operations achieve critical mass and the profitability improves. We forecast earnings (excluding the take or pay contract) to grow to Rs157m and Rs482m in FY09E and FY10E respectively from a loss of Rs75m in FY08E.
- **Maintain Buy** — In line with our reduced estimates, we cut our target price to Rs86/share (from Rs165) based on our revised FY09E earnings and using a higher discounting rate to value the "take or pay" contract.

Buy/High Risk	**1H**
from Buy/Medium Risk	
Price (05 Mar 08)	Rs54.70
Target price	Rs86.00
from Rs165.00	
Expected share price return	57.2%
Expected dividend yield	3.7%
Expected total return	**60.9%**
Market Cap	Rs2,639M
	US$66M

Price Performance (RIC: SHAS.BO, BB: SSCD IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	367	7.64	12.4	7.2	1.5	23.4	3.1
2007A	-30	-0.63	-108.3	nm	1.2	-1.5	3.1
2008E	262	5.43	958.5	10.1	1.1	11.2	3.7
2009E	157	3.25	-40.1	16.8	1.0	6.3	4.1
2010E	482	9.99	206.9	5.5	0.9	17.8	4.1

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	7.2	nm	10.1	16.8	5.5
EV/EBITDA adjusted (x)	5.0	14.2	5.6	6.6	4.1
P/BV (x)	1.5	1.2	1.1	1.0	0.9
Dividend yield (%)	3.1	3.1	3.7	4.1	4.1
Per Share Data (Rs)					
EPS adjusted	7.64	-0.63	5.43	3.25	9.99
EPS reported	7.64	10.91	6.71	4.11	9.99
BVPS	36.94	46.42	50.83	52.34	59.72
DPS	1.70	1.70	2.00	2.25	2.25
Profit & Loss (RsM)					
Net sales	3,640	7,719	8,995	9,138	10,004
Operating expenses	-3,176	-7,699	-8,478	-8,748	-9,148
EBIT	**464**	**20**	**517**	**390**	**856**
Net interest expense	-49	-90	-100	-112	-122
Non-operating/exceptionals	19	642	-5	-39	-96
Pre-tax profit	**433**	**572**	**413**	**239**	**638**
Tax	-66	-45	-89	-41	-156
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**367**	**526**	**324**	**198**	**482**
Adjusted earnings	367	-30	262	157	482
Adjusted EBITDA	696	279	829	758	1,280
Growth Rates (%)					
Sales	11.9	112.1	16.5	1.6	9.5
EBIT adjusted	9.9	-95.7	nm	-24.6	119.4
EBITDA adjusted	9.0	-59.9	196.9	-8.6	68.8
EPS adjusted	12.4	-108.3	958.5	-40.1	206.9
Cash Flow (RsM)					
Operating cash flow	**327**	**-43**	**656**	**574**	**881**
Depreciation/amortization	232	259	312	368	424
Net working capital	-325	-948	-17	-63	-147
Investing cash flow	**-316**	**-780**	**-700**	**-700**	**-700**
Capital expenditure	-271	-815	-700	-700	-700
Acquisitions/disposals	0	-55	0	0	0
Financing cash flow	**-89**	**914**	**-62**	**112**	**-198**
Borrowings	-98	1,125	149	350	50
Dividends paid	-78	-137	-111	-125	-125
Change in cash	**-77**	**92**	**-106**	**-13**	**-17**
Balance Sheet (RsM)					
Total assets	**3,513**	**6,318**	**6,894**	**7,365**	**7,967**
Cash & cash equivalent	59	137	30	17	1
Accounts receivable	760	1,882	2,032	2,067	2,262
Net fixed assets	1,770	2,348	2,798	3,172	3,448
Total liabilities	**1,736**	**4,080**	**4,443**	**4,842**	**5,087**
Accounts payable	626	1,861	2,032	2,067	2,262
Total Debt	795	1,920	2,069	2,419	2,469
Shareholders' funds	**1,777**	**2,238**	**2,450**	**2,523**	**2,879**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	19.1	3.6	9.2	8.3	12.8
ROE adjusted	23.4	-1.5	11.2	6.3	17.8
ROIC adjusted	15.4	-0.7	9.4	6.9	12.7
Net debt to equity	41.4	79.7	83.2	95.2	85.7
Total debt to capital	30.9	46.2	45.8	48.9	46.2

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Powered by: dataCentral

A dip before a rise

Shasun has corrected significantly since June 2007 on the back of the troubles with Nizatidine supplies and concerns on the strength in INR. However, the CRAMS business both in UK and India have been performing in-line with expectations and Shasun's transition from an API supplier to a CRAMS player appears on course. While, 1H performance has been below expectations, we believe that earnings will recover in 2HFY08 as formulation sales and supplies for the phase III molecule pickup. We maintain a Buy but raise our risk rating to High, from Medium, due to the execution risks. We cut our target price to Rs86/share on 15x March 09E earnings and DCF based value for the take or pay contract.

Set for a turnaround after hiccups

We believe that Shasun is set for better times going forward after facing several hiccups leading to a tough 1HFY08. The company has made significant progress in its nascent CRAMS foray, which along with a recovery in its legacy API business is likely to lead to strong growth in 2HFY08 and beyond.

Some Hiccups in 1HFY08

Shasun faced a few setbacks in 2007 leading to a weak 1HFY08 – 12% growth in sales and reporting a loss at the net level. Besides the significant appreciation of the rupee against the US dollar, which hit most pharma companies, Shasun was also hit by disruption of supplies in one of its key products (nizatidine) as well as upfront expenses for its formulations foray. We outline the key factors that led to the weakness below:

- **Nizatidine woes** – Shasun was the sole supplier of Nizatidine to Reliant Pharma, who had brought the global rights for the drug from the innovator, Eli Lilly. With 80% of the global market for the drug being in Japan, Shasun effectively supplied most of the API for nizatidine. Reliant has now got a second source approved for nizatidine API and opted not to renew the earlier contract with Shasun (due for renewal in June'07). While Shasun continues to supply nizatidine to Reliant, it now does so on an order to order basis rather than as a long term supplier. Moreover, it has to share this opportunity with the second source. Given that nizatidine was one of the most profitable products for Shasun, the lower volumes and pricing have taken a toll on financials – especially in 1HFY08, when volumes were lower pending the resolution of this issue between the two companies.

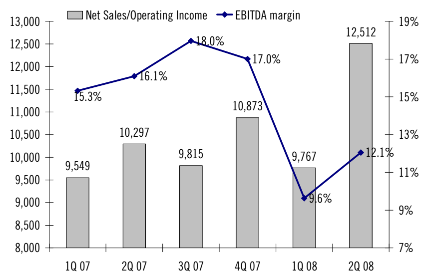
- **Rupee appreciation vis-à-vis the US dollar** – Shasun is an export oriented company and its exposure to foreign currency has increased after the acquisition of Rhodia's CCS business in the UK. Following the acquisition, international sales account for c80% of the company's overall revenues and more than 3/4th of international sales is dollar denominated. Consequently, the sharp c12% appreciation of the INR vs. the USD in 1HFY08 vs. 1HFY07 had an adverse impact on the company's profitability, especially given that it does not have much pricing power in its legacy API business. Shasun also does not have any dollar denominated costs that could act as a natural hedge against the appreciating rupee.

- **Upfront expenses on formulations foray** – Shasun's profitability in 1HFY08 was also affected by upfront costs (cRs 130 m) incurred on its nascent formulations, with very limited concomitant sales. We expect this to change from the end of FY08, as more products get approved and revenues pick up.

The above factors affected the profitability of the Indian operations, with EBIDTA margins declining to 11% in 1HFY08 from 19% in FY07 – it was particularly low at 9.6% in 1QFY08.

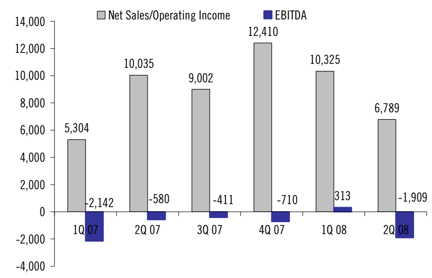
The UK operations fared well in 1QFY08 but recorded a loss at EBITDA level in 2QFY08 due to the lack of significant supplies for the take or pay contract. This was merely a seasonal issue and quite common in this business. We expect supplies for this contract to accelerate in 2HFY08, leading to a significant improvement going forward.

Figure 1. Shasun – India Operations Sales (Rs m, %)



Source: Company Reports

Figure 2. SPSL, UK (Rs m)



Source: CIR Estimates

Silver linings

However we have seen some improvement in 2QFY08, with margins in the Indian business improving to 12.1%, as Shasun gained some lost ground in nizatidine that helped offset some of the impact of the stronger INR. We expect this improvement to continue as contribution from formulations and CRAMS increases going forward. Besides, there has been significant progress on the qualitative front in Shasun's CRAMS business – both in India and UK – leading us to believe that the company is well on course in making the transition from an API supplier to a CRAMS player.

- **India CRAMS growing** – Revenues from India CRAMS grew by more than 100% YoY in 1H FY08. We expect the strong momentum in the business to continue going forward.

- **UK CRAMS on course** – Shasun's UK CRAMS operations (SPSL) have performed in line with our expectations with the volatility across quarters being in line with the lumpy nature of the business. SPSL's revenues grew 12% YoY in 1HFY08 despite minimal supplies under the take or pay agreement and postponement of some supplies in 2Q. Overall we estimate SPSL's revenues (excluding the take or pay contract) to grow at a CAGR of 13% over FY07-10E. Given the high fixed cost structure and high contribution margins of this business, we believe there is significant operating leverage that will play out as revenues grow, leading to material improvement in profitability.

- **Formulations filings are on track** – Shasun ANDAs filings under its partnerships with Glenmark and Actavis appear on track. While revenues have been marginal at this point (3 products have been launched), we expect a scale up in 2HFY08 and beyond. Given that the upfront costs are already reflecting in the P&L, this should lead to improved profitability as well.

We expect a healthy recovery in 2HFY08

We expect a healthy recovery in 2HFY08 performance on the back of:

- **Significant ramp up in supplies under the take or pay agreement**: The management has indicated supplies to the tune of GBP 7-8m for FY08. With sales of only GBP 1-2m being captured in 1H, revenues are set to scale up materially in 2HFY08.

- **Pick up in formulation sales** on product launches with no incremental costs given that most of the filing related expenses have been incurred till 1HFY08 (Rs130m). We expect formulation sales to pick up to Rs200m, Rs500m and Rs691m in 2HFY08, FY09 and FY10 respectively.

Figure 3. 3Q FY08 Earnings Snapshot

	3QFY07	3QFY08	% Ch YoY
Net Revenues	1,882	2,501	32.9
EBITDA	115	230	100.0
EBITDA Margins	6.1	9.2	309 bps
Recurring Net income	**20**	**106**	**440.5**
Negative Goodwill	97	13	(86.9)
Reported Net Income	116	119	2.3

Source: Citi Investment Research

3QFY08 has already shown a sharp recovery

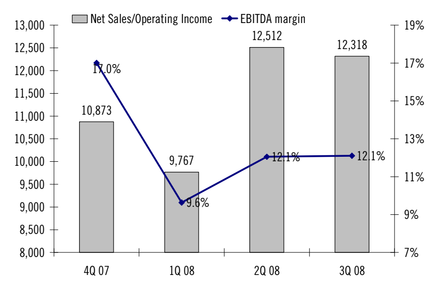
3QFY08 results for Shasun were encouraging with sales up 33% and recurring PAT (excluding gains from negative goodwill write back) up more than 435% to Rs106m. Overall EBITDA margins recovered from the lows of 2% 1HFY08 to 9.2% in 3QFY08. We believe the sharp improvement in 3Q over 1H was driven by easing INR, supplies for the phase 3 molecule, increased formulation sales without corresponding increase in costs.

As is evident, 3QFY08 showed a sharp improvement – both for the India Business and the UK business

In India, margins & revenues have recovered from the 1Q Lows

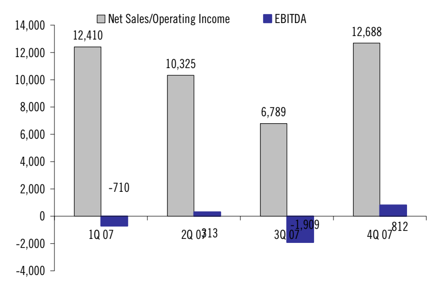
In UK operations, revenues in 3Q have recovered on the back of supplies for the take or pay contract

Figure 4. India Operations Sales (Rs m, %)



Source: Citi Investment Research

Figure 5. SPSL, UK (Rs m)



Source: Citi Investment Research

Step Jump in Earnings in FY09E and FY10E

We expect Shasun's earnings to recover in FY09 and FY10 as the UK operations achieve critical mass and the profitability improves. We forecast earnings (excluding the take or pay contract) to grow to Rs183m and Rs520m in FY09E and FY10E respectively from a loss of Rs68m in FY08E.

Figure 6. Shasun – Consolidated Financial analysis

	FY07	FY08E	FY09E	FY10E	FY07-10E cagr	CIR Comments
USD estimates	45.3	40.2	38.0	36.0	-7.4%	In line with our economist estimates
GBP estimates	85.6	82.6	82.7	78.9	-2.7%	
Revenues	**7,719**	**8,995**	**9,138**	**10,004**	**9.0%**	
- Legacy Business (APIs, Formulations, India CRAMS etc.)	4,185	4,667	4,990	5,532	9.7%	Growth driven by formulation sales and CRAMS; While the base API business muted
- SPSL, UK (Continuing Business)	3,363	3,667	4,148	4,472	10.0%	Muted growth due to currency appreciation in GHP
- Take or Pay contract	171	661	0	0		We have taken only the assured off take in our estimates
EBITDA	**279**	**829**	**758**	**1,280**	**66.1%**	Improving margins on the UK operations
- Legacy Business (APIs, Formulations, India CRAMS etc.)	805	654	709	815	0.4%	Margins decline in FY08E and then onto recover
- SPSL, UK (Continuing Business)	**-637**	**-255**	**49**	**465**		Sharp improvement in the profitability as it achieves critical mass of revenue since a large part of the expenditure is fixed in nature
- Take or Pay contract	111	430	0	0		
Adjusted Net Profit	**-30**	**262**	**157**	**482**		
Shasun + SPSL,UK (excluding take or pay contract)	-133	-75	157	482		Sharp improvement in the profitability of the UK operations as the revenue growth leads to operating leverage; Steady performance for the Indian operations
Take or pay contract	103	337	0	0		
Release of negative Goodwill for the acquisition of Rhodia's CCS unit	557	62	41	0		
Reported Net income	526	324	198	482	**-2.9%**	Reported PAT declines in FY09E because we have not assumed any supplies for the take or pay contract beyond FY08

Source: Company, Citi Investment Research

Figure 7. Earnings Revision (Rs M)

	FY08E	FY09E
Revenues		
Old	9,612	10,009
New	8,995	9,138
% Change	(6.42)	(8.70)
Reported Net Income		
Old	691	657
New	324	198
% Change	(53.2)	(69.8)

Source: CIR estimates

Revising Target Price to Rs86/share

We reduce our reported earnings forecast by 53-70% on the back of the negative developments on Nizatidine (a key high margin product) and stronger than expected INR appreciation. We remain positive on the CRAMS business of Shasun and forecast a step jump in earnings in FY10E.

However we believe that near term earnings will be dependant on supplies under the take or pay contract and legacy API supplies – which are inherently lumpy; especially the latter, where the company does not have much pricing power either. We raise our risk rating to High (from Medium earlier) in order to factor in the execution challenges for a company of Shasun's scale in this lumpy business.

We are revising our target price to Rs86/share (from Rs165/share earlier) based on our revised March' 09E earnings (vs. June 08E earnings earlier) and a higher discounting rate used for valuing the "take or pay" contract.

Key Risks to the Story

- **Sharper currency appreciation / volatility –** While the management has taken steps to mitigate the loss, we believe a volatile movement in the currency, as witnessed in the recent past, will have an adverse impact on Shasun's earnings.

- **Dependence on the take or pay contract supplies –** Our estimates factor in assured supplies in FY08 under the take or pay contract and no supplies in FY09 for the same. Any competitive pressure on the molecule (from other molecules in the pipeline) or regulatory delays in the development / launch process could adversely impact Shasun's supplies and our valuation of the opportunity.

- **Quarterly volatility in earnings –** Shasun is heavily dependent on some products in the India API business while the CRAMS business (in India and UK) is inherently lumpy in nature. This could lead to some volatility in Shasun's earnings and profitability across quarters.

Shasun Chemicals & Drugs

Company Description

Shasun started as an API manufacturer of Ibuprofen and is among the largest API players in Ibuprofen in the world today. Subsequently, it added Nizatidine and Ranitidine to its portfolio. Realizing India's potential in CRAMS, Shasun started focusing on this segment. However it was the acquisition of the CCS business of Rhodia that took Shasun in a different orbit in the custom chemical synthesis business. After the acquisition, Ibuprofen, Nizatidine and Ranitidine contribute c45% of total revenue vs. 85% in FY06

Investment strategy

We rate Shasun Chemicals a Buy/High Risk (1H) with a target price of Rs86/share. Shasun has made good progress in its effort to transition from a pure API supplier to a serious player in innovator CRAMS. Its high dependence on three mature APIs, which was the key reason for low valuations, has come down significantly post the acquisition of Rhodia's CCS business in CY06. The acquisition provides scale, a wider product basket and a significant leg up in the innovator CRAMS space through new relationships and running contracts. Shasun has also ventured into formulations through tie-ups with Glenmark and Actavis. We expect the stock to be re-rated over the next 12-18 months, as the benefits of integration reflect in financials.

Valuation

Given that Pharma is a growth sector, we use P/E as our primary method to value the base business of every company. For Shasun's base business, we use a P/E multiple of 15x one year forward earnings. We believe that with the acquisition of Rhodia's CCS unit and foray in formulations, Shasun revenue mix will continue to improve, reducing its dependence on the legacy API business. This should, in our view, lead to a re-rating over the next 18 months. As such, we argue for a 25% premium to its historical P/E range over the last 4 years of 11-12x and arrive at a target multiple of 15x. We note that this is at a 25% discount to our target multiple for the largest CRAMS player in India, Nicholas Piramal. Accordingly, we arrive at a fair value of Rs47/share.

For Shasun's contract for the phase III molecule that could be launched by end CY10, we use a probability adjusted NPV method to arrive at a valuation of Rs39/share, given the uncertainty built into this arrangement. Hence we arrive at our sum-of-parts based target price of Rs86 (Rs47 for the base business and Rs39 for the take or pay contract).

Risks

We rate Shasun Chemicals as High Risk vs. the Medium Risk assigned by our quantitative risk rating system because we recognise the execution risks in CRAMS relative to Shasun's size and the lumpy nature of the business.

Key downside risks to our estimates and target price include:
1) slower-than-expected turnaround of SPSL's business in UK could have adverse impact on our estimates. 2) A significant part of revenue is from exports (dollar denominated). It does not, however, have significant imports to neutralize the impact of strong INR. If the rupee appreciation is higher than we anticipate, the losses may be higher; 3) failure of the molecule for which Shasun has a take or pay contract would knock off around Rs39/share from our target price; 4) contract manufacturing tends to be lumpy across quarters and hence quarterly results may be volatile 5) Shasun's business is dependant on regulatory approvals received by its customers. Any delay or adverse outcome on its customers' projects could have significant impact on Shasun

Key upside risks to our target price include 1) any potential launch from Shasun's phase III pipeline 2) A weakening INR could boost Shasun's margins for the India business.

Appendix A-1

Analyst Certification

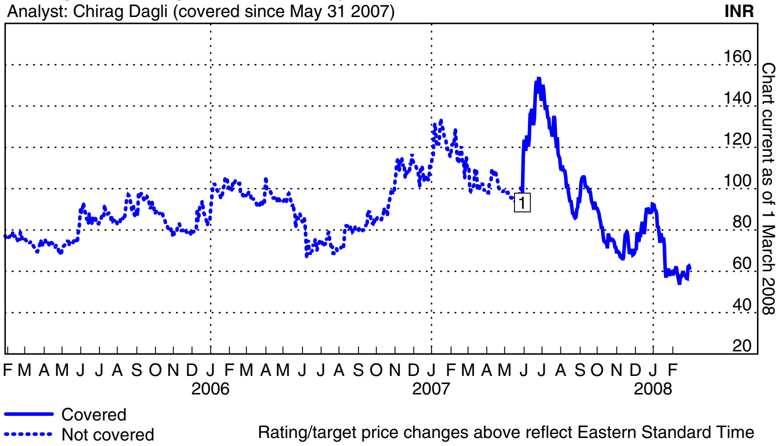
Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst 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

Shasun Chemicals & Drugs (SHAS.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Chirag Dagli (covered since May 31 2007)



#	Date	Rating	Target Price	Closing Price
1:	30 May 07	1M	165.00	96.80

*Indicates change.

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Citi Investment Research Global Fundamental Coverage (3421)	50%	37%	12%
% of companies in each rating category that are investment banking clients	52%	53%	40%

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