Company Focus

18 September 2007 | 13 pages

United Phosphorus (UNPO.BO)

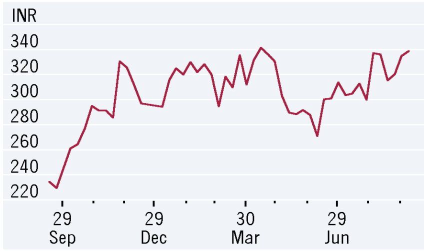
Target price change ☑

Buy: A Few Catalysts Down the Road

- **Raising target price to Rs460/share as we roll forward to 16x FY09E EPS** — We expect the street to focus on FY09 over the next few months as the Cerexagri restructuring benefits start reflecting in earnings. We also expect catalysts in the form of robust EPS growth and more colour on Advanta's (UPL's 49.9% associate company) efforts to capitalize on its exciting Nutrisun project.
- **Nutrisun: high potential** — Our meeting with the project head (Dr Alberto Leon) indicates that Nutrisun holds significant potential. It is a high stearic high oleic oil, positioned as having greater nutritional value & similar/better functionality than the oils currently being used in bakery products, ice-creams, frying, margarine, etc. Commercialisation is expected in late CY09/early CY10.
- **Arysta in play?** — Media reports (*Bloomberg*) say that UPL is bidding for Arysta, Japan. While UPL has not commented, we view Arysta as a good fit for UPL & integration, while challenging, should be manageable. However, we are wary on valuations, given that Arysta reportedly has multiple bidders.
- **Cerexagri integration on course** — UPL has finalized a redundancy plan for c22% of the French work force and decided to shut down 1 out of 4 sites in France – the work is being shifted to the other sites and its UK plant. We expect material improvement in margins to come through from 4QFY08.
- **Maintain Buy (1L)** — We find UPL attractive at 12.5x FY09E EPS, given our forecast 35% EPS CAGR (FY07-10E) and the option to participate in the potential upside if the Nutrisun project pans out as expected.

Buy/Low Risk	1L
Price (17 Sep 07)	Rs358.15
Target price	Rs460.00
from Rs380.00	
Expected share price return	28.4%
Expected dividend yield	0.3%
Expected total return	**28.8%**
Market Cap	Rs67,064M
	US$1,662M

Price Performance (RIC: UNPO.BO, BB: UNTP IN)



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	2,163	11.34	20.4	31.6	5.4	21.0	0.3
2007A	2,897	14.41	27.1	24.9	4.8	20.9	0.3
2008E	3,877	19.28	33.8	18.6	4.1	23.8	0.4
2009E	5,775	28.72	49.0	12.5	3.1	28.3	0.4
2010E	7,145	35.53	23.7	10.1	2.4	26.9	0.4

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)	31.6	24.9	18.6	12.5	10.1
EV/EBITDA adjusted (x)	15.1	13.3	10.9	7.9	6.4
P/BV (x)	5.4	4.8	4.1	3.1	2.4
Dividend yield (%)	0.3	0.3	0.4	0.4	0.4
Per Share Data (Rs)					
EPS adjusted	11.34	14.41	19.28	28.72	35.53
EPS reported	11.33	14.03	15.00	28.72	35.53
BVPS	66.92	74.33	87.84	115.07	149.12
DPS	1.00	1.20	1.40	1.40	1.40
Profit & Loss (RsM)					
Net sales	17,954	24,498	36,103	39,424	43,270
Operating expenses	-14,525	-20,483	-30,975	-32,187	-34,812
EBIT	**3,429**	**4,015**	**5,127**	**7,237**	**8,458**
Net interest expense	-988	-1,046	-1,116	-1,005	-973
Non-operating/exceptionals	66	135	-703	475	757
Pre-tax profit	**2,507**	**3,104**	**3,308**	**6,707**	**8,243**
Tax	-328	-525	-595	-1,341	-1,649
Extraord./Min.Int./Pref.div.	-18	241	304	410	551
Reported net income	**2,162**	**2,821**	**3,017**	**5,775**	**7,145**
Adjusted earnings	2,163	2,897	3,877	5,775	7,145
Adjusted EBITDA	4,831	5,671	7,043	9,243	10,501
Growth Rates (%)					
Sales	26.8	36.4	47.4	9.2	9.8
EBIT adjusted	36.2	17.1	27.7	41.1	16.9
EBITDA adjusted	38.2	17.4	24.2	31.2	13.6
EPS adjusted	20.4	27.1	33.8	49.0	23.7
Cash Flow (RsM)					
Operating cash flow	**1,767**	**8,820**	**3,107**	**5,724**	**6,865**
Depreciation/amortization	1,402	1,656	1,916	2,007	2,043
Net working capital	-1,969	4,424	-1,175	-1,172	-1,015
Investing cash flow	**-6,271**	**-12,394**	**-547**	**-386**	**-296**
Capital expenditure	-1,452	-4,350	-893	-861	-1,053
Acquisitions/disposals	-3,862	-6,986	0	0	0
Financing cash flow	**9,311**	**6,784**	**-2,361**	**-2,299**	**-299**
Borrowings	9,981	7,247	-2,062	-2,000	0
Dividends paid	-161	-454	-299	-299	-299
Change in cash	**4,807**	**3,210**	**200**	**3,040**	**6,271**
Balance Sheet (RsM)					
Total assets	**33,816**	**47,837**	**49,006**	**53,297**	**61,011**
Cash & cash equivalent	4,158	4,604	4,804	7,844	14,115
Accounts receivable	4,298	5,697	9,571	10,775	11,825
Net fixed assets	6,517	10,921	10,860	10,742	10,701
Total liabilities	**21,051**	**32,841**	**31,595**	**30,820**	**32,238**
Accounts payable	7,716	12,504	13,321	14,546	15,964
Total Debt	12,128	19,593	17,530	15,530	15,530
Shareholders' funds	**12,765**	**14,996**	**17,410**	**22,477**	**28,772**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	26.9	23.1	19.5	23.4	24.3
ROE adjusted	21.0	20.9	23.8	28.3	26.9
ROIC adjusted	18.2	15.0	16.9	21.8	25.2
Net debt to equity	62.4	99.9	73.1	34.2	4.9
Total debt to capital	48.7	56.6	50.2	40.9	35.1

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A Few Catalysts Down the Road

We maintain our Buy (1L) rating on UPL and raise our price target by 21% to Rs460/share, as we roll forward to 16x FY09E EPS. We expect the street to focus on FY09 over the next few months as the Cerexagri restructuring benefits start reflecting in earnings. We also expect catalysts in the form of robust EPS growth and more colour on Advanta's (UPL's 49.9% associate company) efforts to capitalize on its exciting Nutrisun project. We find the stock attractive at 12.5x FY09E earnings, given the robust 35% EPS CAGR (FY07-10E) and the opportunity to participate in the potential upside from Nutrisun if the project pans out as expected.

Raising Target Price to Rs460/share

As valuations roll forward to FY09, we expect the full upside from Cerexagri will be captured in the stock price

We raise our target price for UPL by 21% to Rs460/share as we roll forward to 16x FY09E earnings. We expect the street to focus on FY09 earnings over the next few months as management provides an update on the restructuring process at Cerexagri. The biggest talking point / cause for concern / optimism on UPL over the last 6-9 months has centred on the Cerexagri acquisition that the company concluded last year. The restructuring of Cerexagri's operations are on course, as planned, and we expect the first signs of material improvement in profitability to come through in 4QFY08 results. As valuations roll forward to FY09 earnings, we expect the full upside from the Cerexagri restructuring would get priced in, leading to significant upside from current levels.

Robust EPS growth, indications on improving profitability at Cerexagri and news flows on Advanta's Nutrisun project would act as catalysts in 2HFY08

Besides, we also expect catalysts in the form of robust EPS growth (we forecast 35% CAGR over FY07-10E) and further colour on the Nutrisun project being pursued by Advanta (an associate company in which UPL holds 49.9% stake). We expect some progress and news flows on the latter in the second half of FY08 that would bring the scale of the opportunity into the limelight. We believe that investing in UPL is a good way to play this high potential, albeit long term, opportunity.

Nutrisun – Exciting Opportunity

An innovative R&D based project

Nutrisun is the product of an R&D program (Sunsat) that Advanta has been running in collaboration with the CSIC and Unilever, as a part of its operations in Argentina. The program involved development of a hybrid sunflower seed that can provide a healthy oil alternative – for which CSIC provided the scientific inputs, while Unilever has the commercial rights for making margarine from the oil extracted from these seeds. Advanta has exclusive control of intellectual property in these seeds, plants, and oils.

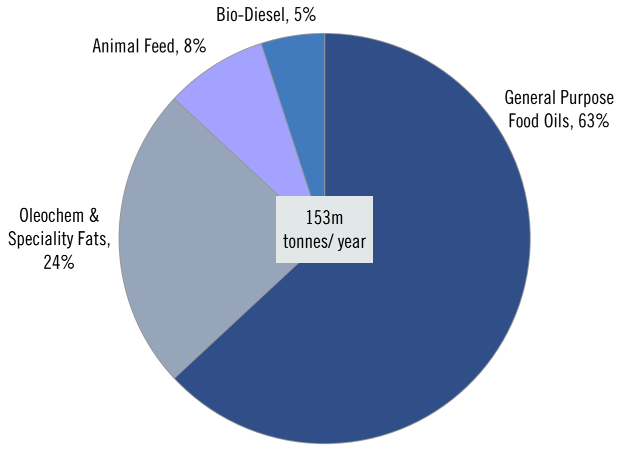
Moving up the value chain from seeds to oil

At the outset, Advanta intended to restrict itself to just the seeds part of the value chain. However, post acquisition by UPL, the company has decided to retain control over the value chain right up to the oil stage. The seed to oil value chain includes several processing steps such as grain production, crushing, refining & bleaching and fractionation, for which Advanta intends to tie-up with different players, while retaining control over the commercial rights to the processed oil – thus capturing a bigger share of the value created along the process.

Significant opportunity

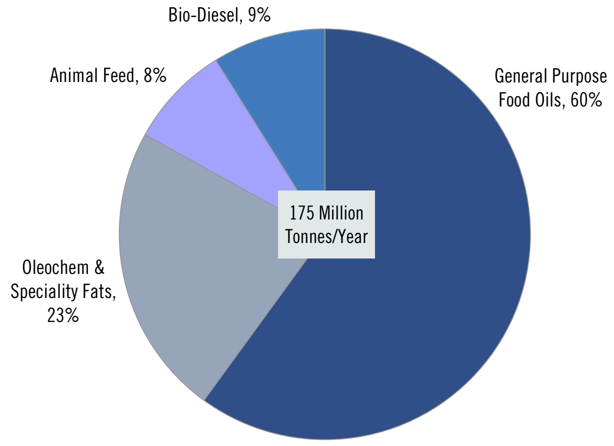
Our recent meeting with the Sunsat project head, Mr Alberto Leon, indicates that the opportunity could be quite significant for Advanta. As per the Oils & Fats International (OFI), the global market for edible oils is around 153m MT/ year and is expected to grow to around 175m MT/ year, of which around 60% comprise general purpose food oils.

Figure 1. Edible Oils & Fats – Current Applications (2007)



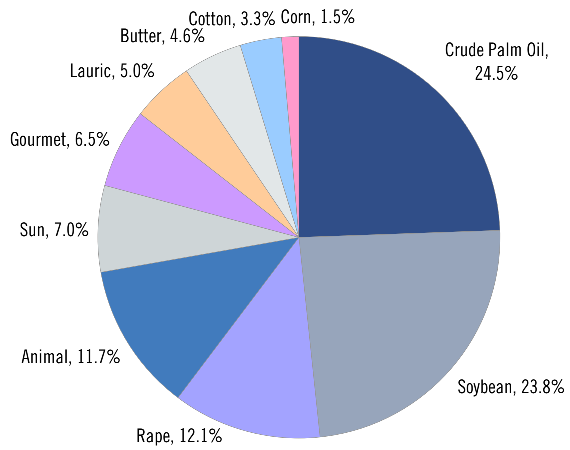
Source: Oils & Fats International

Figure 2. Edible Oils & Fats – Current Applications (2010)



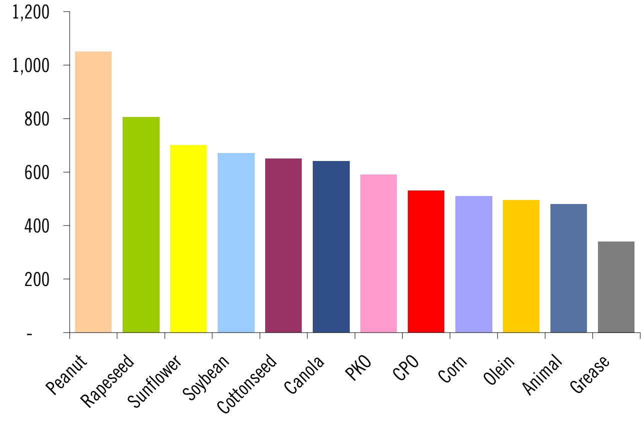
Source: Oils & Fats International

Figure 3. Global Application – Share of Different Oils



Source: Oils & Fats International

Figure 4. Edible Oils & Fats – Typical Prices (US$ / MT)



Source: Oils & Fats International

Crude palm oil (CPO), canola & rapeseed oil and soyabean oil (especially in the USA) are the largest categories in this market, comprising around 61% of the total production, while oil extracted from sunflower, corn, cotton and other seeds make up the rest. These oils are used across multiple food applications such as bakery products, ice-creams, frying, margarine and fat spreads, cocoa butter equivalents, among others. **Even a small share of this global market at the prevailing price level would be significant from Advanta's point of view**.

Oils – trade off between functionality & health

Most stable fatty acids increase cardiovascular risk

However, there are certain health issues involved in using some of these oils. The manufacturing process for most foods demands stable / solid fats (i.e. fats with low susceptibility to oxidation and which match the condition of plastic or semi-plastic at room temperature). The traditional and main sources of these fats had been animal fats and tropical oils. Several studies had shown that these fats / oils are not healthy, due to the high level of bad saturated fatty acids (lauric, myristic & palmitic), which lead to a higher level of LDL (bad cholesterol) in the body and increases the risk of cardiovascular disease.

Figure 5. Saturated & Unsaturated Fatty Acids – Cardiovascular Risk

DOES IT INCREASE THE RISK OF HEART DISEASES?						
Lauric SATURATED	Myristic SATURATED	Palmitic SATURATED	Stearic SATURATED	Trans UNSATURATED	Oleic UNSATURATED	Linoleic UNSATURATED
YES	YES	YES	NO	YES	NO	NO
Saturated				Unsaturated		

Source: Company Reports and Citi Investment Research

Safe unsaturated fatty acids are not stable enough, unless partially hydrogenated – which, in turn, increases cardiovascular risk

On the other hand, vegetable oils that contain high levels of unsaturated fatty acids (oleic, linoleic & linolenic) are healthy because they increase the HDL (good cholesterol) and decrease the LDL. However, these are not stable enough and have to undergo a partial hydrogenation process to increase their oxidative stability and solidity. Hydrogenation however produces trans fatty acids (TFAs) or trans fats, which also lead to a higher level of LDL in the body. In fact some studies have also indicated that trans fats reduce the HDL levels – although there is no conclusive evidence to this effect.

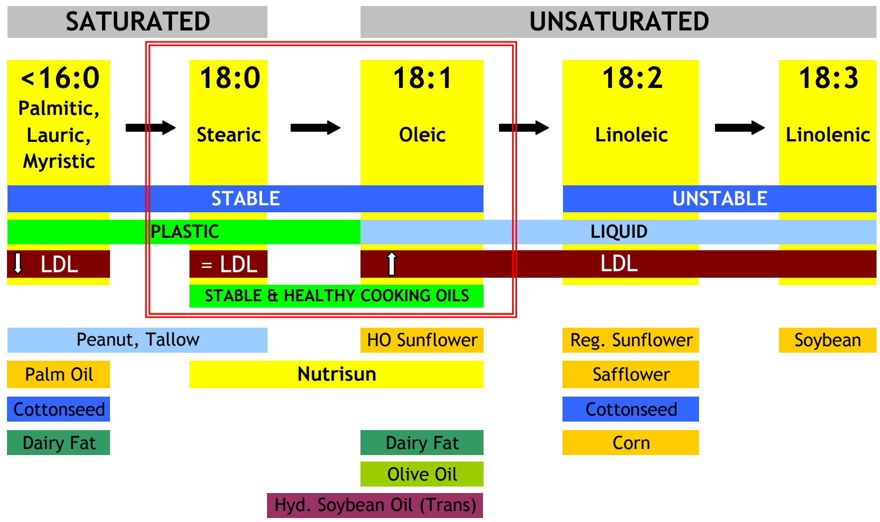
As per studies, Stearic acid is the only saturated fatty acid that is neutral on both LDL and HDL – thus offering a stable as well as healthy alternative.

Nutrisun – positioned as a healthy option

Nutrisun is a high stearic high oleic oil – providing safety as well as stability

Advanta's SUNSAT project is aimed at arriving at a healthy option – Nutrisun. Nutrisun is a high stearic high oleic oil, with the high stearic content providing the required stability without the adverse health issues thrown up by other saturated fatty acids present in regular oils. Nutrisun has properties tailored to meet the needs of various sectors of the food industry, such as healthy oil content, plasticity for margarine and spread production (without the need for partial hydrogenation), and stability.

Figure 6. Nutrisun – Positioned as a Stable & Healthy Oil



Source: Company

Some of the applications for which Nutrisun can prove to be a viable alternative include margarine (for which it already has a tie-up with Unilever, which has 60% global market share), cocoa butter equivalent (CBE), ice creams, bakery fats, biscuits, and crackers.

Figure 7. Nutrisun – Comparison with Alternatives

		How Nutrisun Compares On			
Businesses	**Current Usage**	**Functionality**	**Stability**	**Nutrition**	**Price**
CBE	Shea, Palm, Mid fraction, Illipe	=?	=	=	+++
CBR	Hydrogenated Oils	+	=	+++	=
CBS	PKO, Coconut Oil	=	=	+++	-
Ice-cream	Dairy Fat	=	++	++	++?
	HPKO, Coconut Oil	=	=	+++	-
Food service frying	HO Sunflower	=	++	=-	=
	Palm Olein	=	=	+++	-
Industrial Frying	HO Sunflower	=/+	++	=-	=
	Palm Olein	=	=	++	-
Margarines + Spreads	Palm, PKO, Rapeseed, Palm. Hydrogenated Soybean (PHS)	=	=	+++	-
Bakery Fats	PHS, Palm, Tallow	=	=	+++	-

Source: Company

Aiming for a launch in late CY09 / CY10

Production in India, Ukraine & Argentina; most of the initial sales to Europe

The program has an established proof of concept and is being scaled up for a potential launch in late CY09 or early CY10; however it could take a few years to achieve peak sales in this product. The company intends to produce the seeds in three countries – Argentina, Ukraine and India – to start with, and most of the initial production is expected to be supplied to Europe. Advanta may also look at production in the USA at a later date to service the US demand. It has already filed an application in Argentina while efforts are on to complete the filing in Europe as well. At the same time, it is also in the midst of talks with potential customers as well as partners (to carry out the processing from the seed stage to the oil stage).

Could turn out to be a very significant product for Advanta

Given the average level of pricing that currently prevails in the market for different oils, we believe that even if Advanta is able to get a small share in some of the applications, it would be a big opportunity for the company that could take it into a completely different scale of operations. However, how much value this would add to Advanta's (and in turn UPL's) financials and valuations would depend on how the upside is shared between Advanta and its potential partners along the processing chain.

An unpriced option embedded in UPL

We expect news flows on this front to come through over the next few months as Advanta moves ahead with its plans on this front. As UPL owns 49.9% stake in Advanta, we expect UPL to share in the potential upside on this front. Given the relatively long time lines to launch and achieve peak sales, we believe that it would be better to play this opportunity via UPL, as it is already trading at attractive valuations and has several other triggers that should allow it to absorb any delay / risk to the Nutrisun project.

Aiming for Arysta?

Acquisitions form a core component of UPL's growth strategy

There have been several media reports (Business Standard, CNBC, Bloomberg) of late, speculating about Arysta Lifesciences of Japan being on the block and UPL being one of the six bidders for the company. Management has not commented on the same; however, they have reiterated that UPL would continue to look at all available options to grow in the crop protection space.

We believe that acquisitions are a core component of UPL's growth strategy. As such, if Arysta is indeed on the block, we would not be surprised if UPL is one of the bidders for the asset. However, we believe that there would be multiple contenders and valuations may not be as attractive as some of the smaller acquisitions that UPL has made in the past. We profile Arysta and try to outline the likely synergies for UPL if it acquires the former.

Profiling Arysta

A large business

Arysta LifeScience is the world's largest privately held agrochemical company. The Tokyo-based company has a portfolio of more than 150 products and a presence in over 125 countries worldwide. Its businesses are divided into two key segments – **AgriScience**, which consists of crop protection products &

Lifescience, which includes pharmaceuticals, pharmaceutical additives, organic chemical intermediates and veterinary products. Arysta follows a toll manufacturing strategy and has partnerships with Japanese development companies.

Well spread geographically

The AgriScience business has an established product line of over 60 products. The business manages its sales, marketing and distribution activities across different geographies through three key subsidiaries: Arysta LifeScience North America (serving NAFTA, Australia and New Zealand); Arysta LifeScience Europe, Africa & Middle East; and Arysta LifeScience South America, while the Japanese market is served by its AgroFrontier division. Arysta has been aggressive on the inorganic front to drive growth; it has completed four acquisitions since January 2006 with the latest being the acquisition of Grupo Bioquímico Mexicano, S.A. de C.V. (GBM) in Sep 2007. The company employs around 2,300 people, of which around 1,800 employees are a part of the AgriScience business.

However, it comes with some unrelated lines of business as well

The LifeScience unit operates in three core lines of business: 1) Healthcare including pharmaceuticals, pharmaceutical additives, cosmetic materials and health food; 2) Organic chemical intermediates including production and supply of aromatic, heterocyclic and modified compounds; and 3) Veterinary products including veterinary medicines and feed additives.

What would Arysta add for UPL?

Scale & geographical expansion, would form the major upsides for UPL, in our view

- **Scale** – Arysta had revenues of around US$1bn in CY06 – a large part of this comes from generic crop protection, but it also has proprietary products, pharma products and some trading income. UPL+Arysta (generics) would rank as the second largest generic crop protection company in the world – just behind MA Industries (erstwhile Makhteshim Agan). The higher scale would be beneficial to UPL in many ways, providing it a better visibility with distributors, greater cash flows to make registrations and grow further and an enhanced capacity to absorb re-registration costs.
- **Geographical synergies** – Arysta would make UPL much stronger in two key geographies – Japan & South/Latin America – than it is currently. We believe that these are very important markets, especially South America, given that global farming could shift out to such markets from EU and US, if farm subsidies are phased out.
- **Product synergies** – UPL is fairly well mapped out in terms of broad product categories. While there would obviously be products in each category that are complementary, it is difficult to get a proper sense of this aspect as neither company shares a detailed product break up. One area of potential upside would be earlier entry into markets – for instance neither UPL nor Arysta is likely to have mapped out all their products across all markets, leading to some synergies at an individual market level.

Backward integration into India is another potential area of upside

- **Manufacturing synergies** – Arysta does not have any manufacturing capabilities for technicals (active ingredients) although it has formulation lines. So, clearly, backward integration into UPL's Indian facilities is a distinct possibility – although it would be a gradual process, in our view.

In general, crop-protection companies that lack backward integration and low-cost advantages have EBITDA margins of less than 25%. UPL could potentially add some value and bring margins closer to its own EBIDTA margin (25%), as it is currently doing in Cerexagri's case.

Can UPL pull it off?

Challenging but possible

If UPL has bid for Arysta, it would clearly be the largest acquisition that it has attempted (that we know of). We do not see integration as a major issue. While there would be challenges given Arysta's size and vast scope of operations and will require a lot of top management time, we believe that UPL has the ability to get it done.

Cerexagri integration will not come in the way, in our view

The obvious question that comes up is whether UPL would be able to handle any fresh acquisition given that it is still in the process of integrating Cerexagri. We however do not expect Cerexagri to be a major stumbling block here due to two reasons:

- Cerexagri's integration is going forward as envisaged by the management. We believe it is only the street that got too optimistic on timelines to start with, leading to a disappointment post 4Q
- While full financial impact of the Cerexagri restructuring will only reflect in FY09, management would have completed most of the process by the end of this year. Post that, we believe it is only a matter of waiting for the quarterly seasonality in operations to play out and profitability should improve on its own

Fund raising plan – a precursor?

UPL has taken board approval to raise fresh funds by way of a preferential allotment of 31m warrants to promoters and up to US$500m by a fresh issue of equity / equity linked instruments.

A good fit for the business, but we expect bidding to be aggressive – whether a deal is possible at good valuations is the key question

UPL's track record of walking away from deals unless the payback period is less than 4 years provides comfort

Overall, we believe that Arysta would be a very good fit for UPL's business, if it is able to pull it off. The big risk we anticipate is on the valuations front. If reports that multiple players are interested in buying the business are correct, UPL's bid may prove aggressive. This could push valuations beyond the range at which transactions have been struck in this industry. While UPL, with its low-cost India advantage, should be able to achieve a reasonable payback even at a higher acquisition price, we would still be concerned if the price paid is too aggressive. UPL's past track record on this front, however, has been very good – it has pulled out from any transaction where the likely payback is higher than 4 years.

United Phosphorus

Company description

UPL is the only Indian play on the global generics opportunity in crop protection products. It has focused on the generics opportunity in the regulated markets of the US and Europe, and has achieved success over the past decade. Apart from fully integrated manufacturing facilities, UPL also has strong distribution infrastructure across its targeted markets. UPL's growth strategy is built around filing its own registrations and acquiring tail-end brands of global majors in regulated markets. With c.80% of its revenue coming from global markets and a strong direct presence in the targeted markets, UPL has emerged as the third-largest generics company in the world.

Investment strategy

We rate the stock Buy/Low Risk (1L), with a revised target price of Rs460/share (Rs380/share earlier). UPL is the only Indian play on the global crop protection market, with around 80% of revenue coming from global markets. The global crop protection market looks attractive and is highly consolidated, with limited generics penetration, due to the high entry barriers that generate pricing discipline. UPL has reached critical scale in the regulated markets of the EU and US through a series of acquisitions over the past two to three years. We believe that UPL's growing free cash flows give it the ability to step up growth initiatives - both organic and inorganic. We expect this to lead to a pickup in the rate of growth and forecast FY07-10E revenue and net profit CAGRs of 21% and 35%, respectively.

Valuation

The generics crop protection segment is likely to witness healthy growth, with leading companies such as UPL expected to be among the key beneficiaries. We therefore believe that P/E vs. earnings CAGR or EV/EBIDTA vs. EBIDTA CAGR is the correct metrics to value companies such as UPL. Our target price is based on 16x P/E, which is within its trading range of 9-21x since January 2004, when the stock got re-listed post the reverse merger with its subsidiary (Search Chem). Our price target of Rs460/share is based on 16x FY09E (16x Sept'08E earlier) earnings. We believe that FY09 estimates reflect the true earnings power of UPL, especially in the acquired Cerexagri business, as margins scale up to sustainable levels on the back of the restructuring efforts being undertaken by the company.

Risks

We rate UPL Low Risk according to our quantitative risk-rating system. The main downside risks to our target price and estimates include: (1) Cut in farm subsidies in regulated markets; (2) Inability to effectively integrate one of its acquisitions - slower than expected ramp up in Cerexagri's profitability; (3) shift in acreage to corn (8-9% of US sales) from cotton (15-18% of US sales), provided this cannot be made up by higher supplies to other parts of the world (4) Poor monsoons in India.

Appendix A-1

Analyst Certification

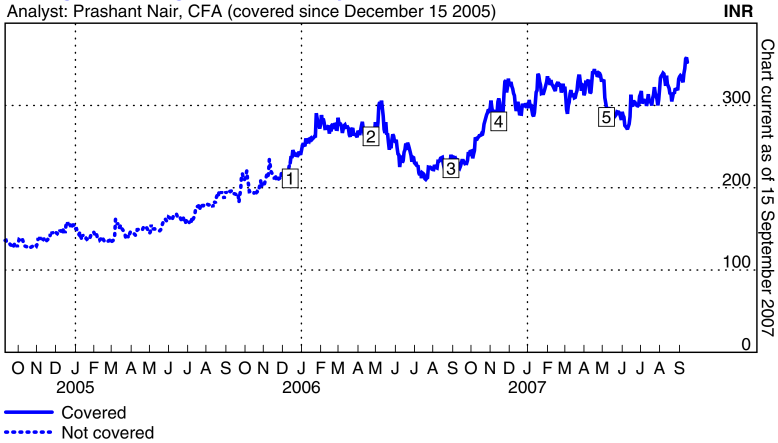
Each research analyst(s), strategist(s) or research associate(s) responsible for the preparation and content of this research report hereby certifies that, with respect to each issuer or security that the research analyst, strategist or research associate covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) strategist(s) or research associate(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, strategist or research associate in this research report.

IMPORTANT DISCLOSURES

United Phosphorus (UNPO.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since December 15 2005)



#	Date	Rating	Target Price	Closing Price
1:	14 Dec 05	1L	297.00	230.05
2:	24 Apr 06	1L	*317.00	269.10
3:	30 Aug 06	1L	*343.00	240.15
4:	15 Nov 06	1L	*383.00	308.55
5:	8 May 07	1L	*380.00	297.20

*Indicates change.

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