

# Cipla

Rs324

**OUTPERFORMER**

## RESULT NOTE

**Mkt Cap: Rs260bn; US\$5.8bn**

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**Result** : Q3FY11

**Comment** : Below estimates due to sharp increase in overheads

**Last report** : 11 November 2010 (Price Rs332; Recommendation: Outperformer)

### Key financials

| As on 31 March | Net sales (Rs m) | Adj. net Profit (Rs m) | Adj. EPS (Rs) | % growth | PER (x) |
|----------------|------------------|------------------------|---------------|----------|---------|
| FY08           | 42,032           | 7,014                  | 8.7           | 5.7      | 37.2    |
| FY09           | 52,346           | 7,768                  | 9.7           | 11.1     | 33.5    |
| FY10           | 56,057           | 9,874                  | 12.3          | 27.1     | 26.4    |
| FY11E          | 62,058           | 10,454                 | 13.0          | 5.9      | 24.9    |
| FY12E          | 71,575           | 12,740                 | 15.8          | 21.9     | 20.4    |

Source: IDFC Securities Research

### Key highlights

- Cipla's Q3FY11 net profits declined by 20% yoy to Rs2.3bn, sharply below our estimate of Rs2.9bn, primarily due to lower operating margins (17.7%, v/s our estimate of 22%). While gross margins (53.7%; 20bp higher yoy) were healthy, overheads increased 32% yoy, largely due to commissioning of the Indore SEZ facility, which put pressure on margins. Net sales grew by 11.7% yoy to Rs15bn, below our estimate of Rs15.6bn.
- Domestic formulation sales grew by 11.3% yoy to Rs7.56bn (our estimate, Rs7.7bn), with the branded business clocking 11-12% yoy growth. The management remains hopeful of clocking higher double-digit growth.
- Export formulations grew by 11.7% yoy to Rs6.3bn (our estimate, Rs6.4bn), offsetting the impact of adverse forex movements (up to 4%). Domestic and export formulations contributed 48% and 42%, respectively, to consolidated sales for the quarter. API sales grew by 12.8% yoy to Rs1.4bn (our estimate, Rs1.2bn).
- EBITDA margins declined by 530bp yoy to 17.7%, sharply below our estimate of 22%. A confluence of factors (detailed below) contributed to the lower operating margins.
  - a) Higher employee costs due to an increase in manpower, particularly at the Indore SEZ.
  - b) Regrouping of contractual staff at the Goa facilities.
  - c) Annual increments.
  - d) Other expenditure increased mainly due to an increase in selling expenses and factory expenditure, in particular at the Indore SEZ, such as repairs & maintenance, power & fuel, stores & spares, etc.
- Other expenses (percentage of sales) increased by 307bp yoy to 26.9%.
- Cipla invested ~Rs8bn for setting up the Indore SEZ and recently received approvals from MHRA, WHO and South African and Australian regulatory bodies. This should enable Cipla to start utilizing this facility for these markets. The company expects Indore to contribute ~10% of sales by Q4FY12. However, this number looks aggressive to us.

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- The management said there would be a drag on operational margins until the Indore SEZ reaches optimal utilization, i.e. 1.5-2 years from now. During the quarter, expenses related to the Indore SEZ were Rs250m-300m and did not have commensurate revenue contribution. Adjusting for the aforesaid operating expenses, EBITDA margins for the quarter stood at 19.7%.
- Interest cost reduced to Rs29m in Q3FY11 due to repayment of short-term working capital loans.
- Depreciation cost grew by 43% yoy to Rs652m due to addition of fixed assets mainly on commissioning of the Indore SEZ. The management indicated that the entire cost incurred on Indore SEZ had been capitalized.
- Other operating income stood at Rs523m (our estimate, Rs600m) with contribution from technological know-how income at Rs151m. The company said the sharp yoy drop in technological know-how income is a result of a high base and a one-time payment in Q3FY10.
- The effective tax rate for the quarter stood at 16%, below our estimate of 19%.
- Overall, net profit declined by 20% yoy to Rs2.3bn, below our estimate of Rs2.8bn.
- Cipla continues to maintain its hedging policy of locking in a third of its export receivables and one-month forward sales under forward contracts. Cipla currently has ~US\$190m in forward contracts.
- Interestingly, the company indicated willingness to file/ market its own ANDAs/ dossiers in the US as well as other geographies. While it is a statement of intent at this point of time, this does mark a dramatic deviation from Cipla's policy of sticking to partners for managing the marketing its products across geographies. The management said it believed the company has the necessary R&D expertise and capabilities and would be willing to explore suitable opportunities for filing/ launching own products.
- Cipla remains highly positive on its inhaler business in the regulated markets. Cipla has begun to Seroflo in South African markets and expects to begin supplies for the Russian market over the next couple of quarters. It expects Seroflo to be a material revenue contributor given limited competition in the market. The company has indicated that the inhaler business accounts for 17% of its total sales and expects this to increase to 22-25% over the next few years.
- While Salbutamol and Budesonide are interesting generic opportunities in the EU given limited competition, combination inhalers (Seretide and Symbicort) account for >70% of the inhaler market and, therefore, are the drugs to target. Cipla estimates the EU market opportunity to be worth more than US\$1.8bn and hopes to address this over the next 2-3 years. Cipla is expecting regulatory approval for its first combination inhaler in key EU markets by FY12/13, which will open up a potentially large opportunity and would truly mark the effective initiation of regulated market opportunity for Cipla's inhaler business.
- The company indicated that post Lulla's departure from Cipla, the company is being managed by a board consisting of the promoters and Radhakrishnan supported by a very competent and experienced top and middle management team.
- The company indicated that it continues to pursue multiple MNC tie-ups and remains hopeful on closing some in the next few quarters.

#### □ Valuations and view

Cipla's Q3FY11 performance was sharply below estimates as the revenue growth miss was further exacerbated by a higher overheads cost base, primarily on account of commissioning of the Indore SEZ. Growth rates should pick up going forward as Cipla has begun to secure regulatory approvals from various overseas regulators, including UKMHRA. This, combined with the anticipated ramp-up in the inhaler business, should aid faster growth in profits. Despite the near-term challenges, Cipla remains one of our preferred business models in the industry with its diversified geographic footprint and strong R&D capabilities. This is amply reflected in the company's ability to maintain 17-19% ROCE despite intense capex over the past few years, which is yet to start delivering effectively. To adjust for the earnings disappointment we have lowered our FY11 and FY12 earnings estimates by 10% and 11% respectively. We maintain our Outperformer call with a 12-month price target of Rs365 (23x FY12E EPS). Developments on outsourcing opportunities with MNC pharma companies and visibility on regulated market inhaler launches should provide material upsides to our earnings estimates and would be rerating triggers.

## Quarterly results

| Particulars (Rs m)     | Q1FY10        | Q2FY10        | Q3FY10        | Q4FY10        | Q1FY11        | Q2FY11        | Q3FY11        | Comments                                       |
|------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|--|
| <b>Net Sales</b>       | <b>13,253</b> | <b>13,712</b> | <b>13,442</b> | <b>13,175</b> | <b>14,274</b> | <b>15,799</b> | <b>15,014</b> | Net sales below estimates (at Rs15.6bn)        |
| Operating Expenses     | 10,075        | 10,695        | 10,346        | 10,967        | 11,152        | 12,627        | 12,355        |  |
| Cost of Sales          | 6,067         | 6,396         | 6,248         | 6,108         | 6,702         | 7,486         | 6,958         |  |
| Other Expenses         | 4,009         | 4,300         | 4,099         | 4,859         | 4,449         | 5,141         | 5,397         | Higher other expenses drag margins down        |
| <b>EBITDA</b>          | <b>3,177</b>  | <b>3,016</b>  | <b>3,095</b>  | <b>2,208</b>  | <b>3,122</b>  | <b>3,172</b>  | <b>2,659</b>  |  |
| EBITDA (%)             | 24.0          | 22.0          | 23.0          | 16.8          | 21.9          | 20.1          | 17.7          | EBITDA margins below estimates (at 22%)        |
| Tech know-how          | 257           | 508           | 703           | 136           | 159           | 120           | 151           |  |
| Other Non-Op           | 251           | 209           | 241           | 437           | 365           | 235           | 372           |  |
| Forex losses           | -270          | 75            | -240          | -200          | -140          | 140           |               |  |
| Other Income           | 120           | 128           | 178           | 451           | 168           | 166           | 257           |  |
| Total Other Income     | 358           | 920           | 882           | 823           | 551           | 661           | 780           |  |
| Depreciation           | 458           | 478           | 457           | 495           | 548           | 639           | 653           |  |
| Interest               | 105           | 84            | 44            | 5             | 1             | 3             | 29            |  |
| <b>PBT</b>             | <b>2,972</b>  | <b>3,375</b>  | <b>3,477</b>  | <b>2,531</b>  | <b>3,124</b>  | <b>3,191</b>  | <b>2,757</b>  |  |
| Extraordinary          | -             | -             | -             | 950           | -             | -             | -             |  |
| Provision for Taxation | 555           | 618           | 587           | 726           | 550           | 560           | 430           | Tax rates (at 16%) below our estimates (at 19) |
| <b>PAT</b>             | <b>2,417</b>  | <b>2,757</b>  | <b>2,890</b>  | <b>2,755</b>  | <b>2,574</b>  | <b>2,631</b>  | <b>2,327</b>  |  |
| Adjusted PAT           | 2,417         | 2,757         | 2,890         | 2,090         | 2,574         | 2,631         | 2,327         | Net profits were below estimates               |
| Effective tax rates    | 19            | 18            | 17            | -9            | 18            | 18            | 16            |  |
| <b>yoy growth</b>      |               |               |               |               |               |               |               |  |
| Net Sales              | 9.80          | 1.20          | 0.20          | 6.70          | 7.70          | 15.20         | 11.70         |  |
| EBITDA                 | 17.70         | (4.40)        | (8.60)        | (3.00)        | (1.70)        | 5.10          | (14.10)       |  |
| Net Profit             | 37.00         | 35.40         | 29.40         | 8.90          | 6.50          | (4.60)        | (19.50)       |  |
| Adjusted Profit        | 37.00         | 35.40         | 29.40         | (17.40)       | 6.50          | (4.60)        | (19.50)       |  |

Source: Company

## Sales break up

| Particulars (Rs m)          | Q3FY11        | Q3FY10        | % change    | 9MFY11        | 9MFY10        | % change    |
|-----------------------------|---------------|---------------|-------------|---------------|---------------|-------------|
| Domestic                    | 7,340         | 6,592         | 11.3        | 21,655        | 19,425        | 11.5        |
| Exports - Formulations      | 6,432         | 5,758         | 11.7        | 19,328        | 17,048        | 13.4        |
| Exports - API's & Others    | 1,386         | 1,229         | 12.8        | 4,470         | 4,339         | 3.0         |
| <b>Total Exports</b>        | <b>7,818</b>  | <b>6,987</b>  | <b>11.9</b> | <b>23,798</b> | <b>21,387</b> | <b>11.3</b> |
| % of exports to total sales | 51.6          | 51.5          |             | 52.4          | 52.4          |             |
| <b>Total Sales</b>          | <b>15,158</b> | <b>13,579</b> | <b>11.6</b> | <b>45,454</b> | <b>40,812</b> | <b>11.4</b> |

Source: Company

## Other operating income breakup

| Particulars (Rs m)       | Q3FY11       | Q3FY10       | % change      | 9MFY11        | 9MFY10        | % change      |
|--------------------------|--------------|--------------|---------------|---------------|---------------|---------------|
| Technology know how/fees | 151.4        | 702.7        | (78.5)        | 42.99         | 146.74        | (70.7)        |
| Others                   | 371.7        | 240.7        | 54.4          | 97.17         | 67.98         | 42.9          |
| <b>Total</b>             | <b>523.1</b> | <b>943.4</b> | <b>(44.6)</b> | <b>140.16</b> | <b>214.72</b> | <b>(34.7)</b> |

Source: Company

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