Update

SECTOR: PHARMACEUTICALS

Cipla

STOCK INFO.	BLOOMBERG
BSE Sensex: 11,905	CIPLA IN
	REUTERS CODE
S&P CNX: 3,474	CIPL.BO

Equity Shares (m)	777.3
52-Week Range (Rs)	305/136
1,6,12 Rel. Perf. (%)	5/5/34
M.Cap. (Rs b)	203.1
M.Cap. (US$ b)	4.4

5 September 2006

Buy

Previous Recommendation: Buy

Rs261

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/06A	29,814	6,076	8.1	47.9	32.2	9.9	30.8	28.3	7.0	31.0
03/07E	36,696	7,244	9.3	14.8	28.0	6.1	21.8	23.9	5.3	21.3
03/08E	43,539	8,658	11.1	19.3	23.5	5.1	21.5	23.8	4.4	17.4

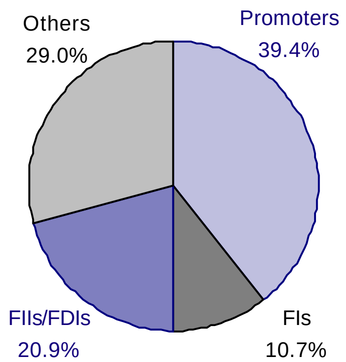
One of the strongest generics pipelines: Cipla has about 160 products in various stages of development. It has entered into partnerships for 125 products (only 17 have been commercialized till date) with 8 partners in the US alone. It has filed over 170 registrations in EU and over 4,000 formulations approvals in the emerging markets (incl South & Central America, the Middle East and Africa). Secondly, CFC-free inhalers could bring in long-term upsides, as Cipla is one of the very few generics companies in the world to have developed a whole range of such inhalers. Currently, the company has 9 such inhalers at various stages of regulatory submissions in EU.

Unique low-risk partnership model: Cipla has tied up with various generics companies (like Teva, Sandoz, Watson) for its generics products. As a policy, it remains only a supplier to the global generics companies. This has helped the company to de-risk its business model, as it does not directly get involved in patent challenges.

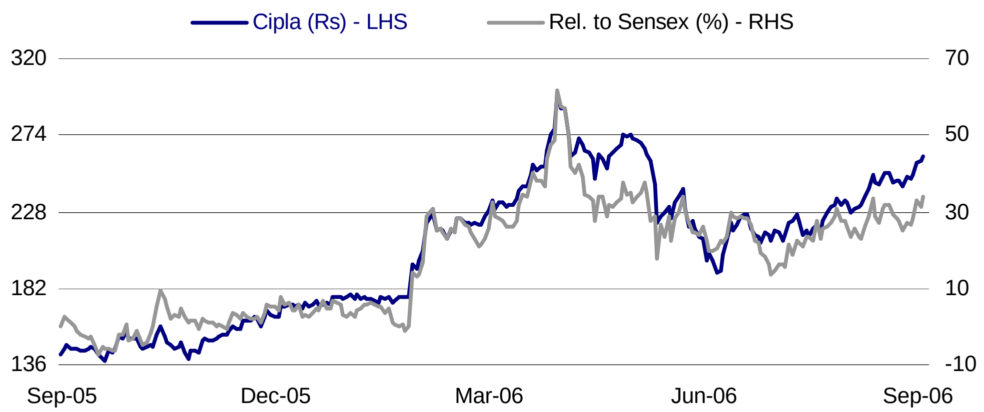
Strongly positioned for future growth: Cipla has incurred a capex of Rs7b in the last two years and has raised US$170m recently to part-fund future capex (about Rs6b). This indicates the management's confidence regarding the company's long-term future.

Good long-term potential; Buy: The management is undertaking significant capex of Rs13b during FY05-08 to upgrade and expand facilities, which we believe, implies good long-term potential. Valuations at 28x FY07E and 23.5x FY08E earnings do not fully reflect the potential of Cipla's generics pipeline. Our estimates do not include any uncertain upsides linked to patent challenges filed by Cipla's partners. We expect sales CAGR of 21% and PAT CAGR of 19% during FY06-08. Maintain **Buy**.

SHAREHOLDING PATTERN (JUNE 2006)



STOCK PERFORMANCE (1 YEAR)



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AGM highlights

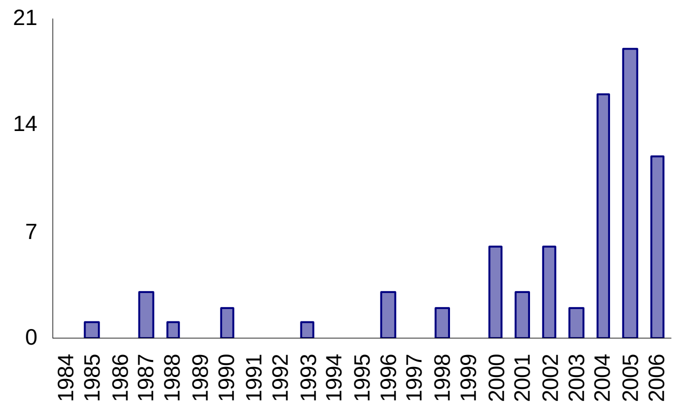
Key highlights from Cipla's AGM include:

- **Momentum in business continues:** Cipla's performance during the first five months of the current year continues to be impressive with an increase in sales in excess of 30%. Export continues to be mainstay of this growth which has improved by 48% over the corresponding period last year.
- **Guidance:** Management has guided 15-18% top-line growth for FY07E. We believe that this is conservative given the fact that it has already recorded 30% top-line growth for the Apr-Aug 2006 period. We are forecasting 23% sales growth for FY07E.
- **Aggressive capex plans:** Over the last couple of years, Cipla has invested around Rs7b in manufacturing assets. The company has made aggressive plans to expand its manufacturing capacities, particularly for the regulated markets. A new EOU at Patalganga, Maharashtra, for APIs and formulations got operational during the week. Over the next few years, the company plans to invest another Rs6b in setting up new facilities like:
  - EOU for manufacturing APIs and formulations at Kurkumbh, Pune
  - EOU for manufacturing APIs at Banglore
  - Formulations facility in SEZ in Goa
- **Strong generic pipeline** - In US, Cipla has entered into partnership for 125 projects with about 8 partners and about 90 products for the regulated EU markets. Furthermore, the company has filed over 80 DMFs in US and over 60 in EU. Cipla's partners have filed about 75 ANDAs till date and we expect this to increase to about 110 by Mar-07. Management has indicated about 6-7 more ANDA approvals by Mar-07. Only 17 products have been launched till date in the regulated markets implying that a majority of the filings are yet to be commercialized.
- **Acquisitions in nice segment:** In addition to aggressive capex plans, Cipla is also looking out for acquisition opportunities in niche business segments, not necessarily adding to sales, but intending to enhance and expand its newer business segments such as biotechnology.
- **In-licensing opportunities:** Cipla is open to in-license new drugs for domestic market. Cipla would be in-licensing new drugs in CVS, Oncology.
- **CFC-free Inhalers:** In addition to the approval of Budesonide inhalers in Germany and Portugal, Cipla has obtained regulatory approval for Salbutamol metered dose inhalers in Denmark. Further, nine additional inhaler products are in various stages of regulatory submission. Cipla is in process of initiating clinical trials on multi-dose dry-powder inhalers for the European market.
- **R&D efforts:** On the R&D front, Cipla is developing NDDS for existing and newer active drug substances. It has also developed a unique transdermal delivery system and has already launched a testosterone spray patch. It had developed a novel, dry powder inhaler device and is in process of launching another unique single action unit dose inhaler device.
- **Avesthagen collaboration:** Cipla has entered into a research agreement with Avesthagen for biopharmaceutical development program. The partnership will focus on a range of products in the area of autoimmune disorders and other categories such as CVS and oncology.
- **Global consolidation leads to dilution of partnerships –** Cipla indicated that the intense global consolidation has had some adverse impact on its partnerships (some products have been dropped) but at the same time has resulted in higher volumes (emanating from supplies to much larger players).

Strong generics pipeline

Cipla has one of the strongest generic pipelines in India with about 160 products at various stages of development. Cipla has entered into partnerships for 125 products with number of partners in US. Cipla's partners will have filed about 110 ANDAs cumulatively (35 in FY07E) with the US FDA by Mar-07. We expect this pipeline to start generating revenues from FY07E onwards. While more clarity on these products will emerge over a period of time, we believe that this is one of the strongest generic pipelines amongst Indian companies. It is currently selling about 9 products in the US market and expects 5 new launches in FY07E. Supplies linked to Para-IV filings will remain uncertain till resolution of patent litigations and hence are excluded from our estimates. We have, however, included upsides from supply of generic Sertraline API to Ivax (Teva) and supply of Finasteride and Fluticasone formulations to the US market in our estimates for FY07E. These products together are likely to contribute about Rs1.0/share to our FY07E EPS.

CIPLA – DMF FILINGS (Y/E MARCH)



Source: USFDA

Partnering with global generics players: a low risk strategy

Cipla follows a low-risk strategy through its partnership model for the regulated generics market. Cipla has tied up with various generic companies (in USA & EU) for supplying about 160 products over the next few years. This has helped the company spread its risks associated with the generic markets. We believe that the company has also attempted to spread risks across product categories like plain vanilla generics, patent challenges and first to files. It should be noted that Cipla, as a policy, does not get directly involved in patent challenges and remains only a supplier to the generic company filing the patent challenge. Hence, the company does not carry any litigation risks linked to patent challenges. To sum up, we believe that Cipla follows a de-risked strategy for the generic markets.

Multiple opportunities for generic Seretide

Cipla has entered into a tie-up with Neolab (UK) for supplying a combination of Salmeterol and Fluticasone Propionate (useful for asthma treatment). GSK is the innovator of the drug and sells it under the *Seretide/Advair* brand. Neolab has challenged GSK's patent expiring in 2013. This patent relates to the combination of Salmeterol and Fluticasone Propionate. The patent expiry date of 2013 includes supplementary protection certificate (SPC). Individual patents on Salmeterol and Fluticasone Propionate have expired in 2005. Other patents on Seretide include the Diskus device patent expiring in 2011 and the CFC-free MDI patent expiring in 2012, which have not been challenged.

The London Court has given its ruling in favor of generics companies (this ruling applies only to UK). GSK has appealed against this ruling. We believe that GSK's data exclusivity (valid till 2008) will prevent any generics entry unless generics companies conduct their own limited clinical trials for the product. We believe that Cipla/Neolab have already commenced clinical trials for this product and hence a commercial launch may be possible in UK before 2008 (provided the London Court ruling is upheld in the higher court). The UK market for Seretide is estimated at US$240m while global sales are estimated at about US$4b, with USA accounting for 55% of the sales. We believe that Cipla will try to address the US opportunity, also (through its partners). GSK's US patents on the product expire in August 2008, 2010 and 2011. It also holds data exclusivity on the product expiring on 21 April 2007. It should be noted that we have not included any upsides from Seretide in our estimates since it is linked to the successful outcome of a patent challenge.

Anti-AIDS products represent a high-volume opportunity

The anti-retroviral (ARV) opportunity is a sizeable and largely unmet one. Around 48m patients globally are infected with the HIV virus, of which around 90% are not treated. The African sub-continent houses 40-50% of AIDS patients. Almost 3m people are infected with the AIDS virus each year. The demand for ARV drugs is expected to grow at a fast pace, as initiatives from sponsors like WHO, PEPFAR, the Clinton Foundation and Medicins sans Frontier to increase access to low-cost drugs gather momentum. These programs were mainly initiated to make ARV drugs more affordable to the population of the least-developed countries – particularly the African sub-continent, which is facing a public health emergency. Cipla has been at the forefront of the battle against AIDS and in making ARV drugs more affordable. The company has significantly reduced the prices of its ARV drugs both in the domestic and the international markets.

Cipla is one of the leading players in the anti-AIDS market and is likely to participate in the US government's PEPFAR program for supplying low-priced ARVs to under-developed nations facing a healthcare emergency (like the African subcontinent). The company expects to register its own ARV drugs with the US-FDA over the next 12 months to enable it to participate in the US government's PEPFAR program. This fund initiative has made it mandatory for suppliers to register their drugs with the US-FDA to qualify as a supplier. It should be noted that although Cipla is late in getting its products registered with the US-FDA, its joint venture with Medpro Pharmaceutica – known as Cipla Medpro – is one of leading generic companies in South Africa. Cipla supplies various drugs to Medpro, including ARVs.

Cipla Medpro's ownership change will not impact supplies

Cipla's supply of drugs to South Africa and its neighboring regions will not be derailed by South African drug company Enaleni Pharmaceuticals' decision to buy Cipla Medpro for Rand1.2b (about Rs8.2b). Cipla does not have an equity participation in Cipla Medpro; it is only a marketing alliance for the region. It has an existing 10-year exclusive distribution agreement with Cipla Medpro and this will now be shifted to the new company.

CFC-free inhalers – good long-term potential

Cipla is in the process of developing nine anti-asthma inhalers using non-CFC propellants. It has already developed few CFC-free inhalers including Budesonide, Formeterol, Salbutamol, and combination of Budesonide and Formeterol. It has initiated the process of registering these inhalers in major markets in Europe. However, the company may have to conduct clinical trials for obtaining registrations, implying that the launch of most of these inhalers is still some time away. Our estimates do not include the upsides from CFC-free inhalers expect for the Budesonide inhaler, which Cipla has already launched in Germany and Portugal.

EU regulations are aimed at encouraging CFC-free inhalers

Although the Montreal Protocol (on phasing out CFC based products) has set 2010 as the deadline for complete eradication of CFC inhalers, its current regulations are aimed at encouraging CFC-free inhalers. The regulations require a complete shift from CFC to non-CFC inhalers subject to the two conditions mentioned below:

1) At least two CFC-free alternatives are available on the market
2) The CFC-free inhalers have undergone a post-marketing surveillance of at least 12 months

The above conditions reflect a clear focus on a total phase-out of CFC inhalers much before the 2010 deadline.

Shift to CFC-free inhalers to open up a large market

The total market size for asthma inhalers in the EU is estimated at US$2.5b. This includes both CFC and CFC-free products, with the former accounting for a major chunk of the market. The gradual shift to CFC-free products is expected to open up a huge market for the manufacturers of these products over the next five years.

Multinationals have already introduced CFC-free inhalers…

As a consequence of the 2010 deadline and a favorable regulatory environment, multinational companies (the patent holders) have already started introducing CFC-free inhalers in various European markets. The shift of prescriptions in favor of CFC-free products has already commenced.

...but there is good long-term potential for players like Cipla

We believe that export of CFC-free inhalers to Europe can contribute significantly to Cipla's revenues in the long-term, as we expect limited competition. The company has done significant work on developing these inhalers over the past few years. It has launched its Budesonide asthma inhaler in Germany in FY05 through three generics companies, although it lost the first mover advantage to an Italian company. It has also received approval for Budesonide inhaler in Portugal and is awaiting regulatory approval in Spain. Cipla has a total of 9 CFC-free inhalers under various stages of regulatory submissions, which will be launched over the next few years.

However, patent infringement issues cannot be ruled out

Cipla believes that it has developed non-infringing inhalers for Budesonide and Formeterol. We do not rule out patent litigation (between Cipla's partners and the innovators) in case of the remaining 9 CFC-free inhalers being developed by Cipla. For instance, AstraZeneca has patents for the Budesonide-Formeterol combination in a few countries in Europe. Given the huge opportunity that the CFC-free inhaler market offers, we believe that the patent holders (multinational companies) will be extremely aggressive in protecting their IPRs and preventing entry of cheaper generic versions.

Significant capex for future growth

Cipla has undertaken significant capex for setting up facilities to drive future growth. The company has already incurred a capex of about Rs7b in the last two years on expanding and upgrading its existing facilities as well as on setting up new facilities in excise-exempt zones like Baddi. It plans to further expand its facilities for which it has recently raised about US$170m through a GDR issue (@Rs274 per share). The company has raised these funds for financing future capex (Rs6b) for its facilities at Goa, Patalganga, etc. Incremental capex at Goa is likely to enjoy fiscal incentives regarding excise duty, income tax and sales tax. We believe that such a significant capex is an indication of the management's confidence regarding the long-term future of the company.

Valuation and view

Cipla is currently valued at 28x FY07E and 23.5x FY08E earnings. Generic supplies to partners in regulated markets remain long-term triggers. Cipla has tied up with various generic companies for supplying more than 160 products over the next few years. While more clarity on these products will emerge over a period of time, we believe that this is one of the strongest generic pipelines amongst Indian companies. This coupled with the company's low-risk strategy should ensure good long-term potential.

A consistent performer

Cipla has been a consistent performer over the past six years, with sales CAGR of 27% and PAT CAGR of 28%. Unlike some of its peers, it has never recorded de-growth in profits in the last six years. We believe that the company's de-risked strategy has helped it in consistently growing the bottomline. It should be noted that Cipla recorded this performance totally through organic growth (it has never resorted to acquisitions) and without any equity dilution.

It has recently raised US$170m through a GDR issue, resulting in an equity dilution of about 3.5%. This is the only equity issue by the company since the rights issue in 1992. This has also resulted in the company recording better RoE and RoCE vis-a-vis its peers like Ranbaxy and Dr. Reddy's Labs. We believe that Cipla has one of the best track records of profit growth in the Indian pharmaceutical sector.

We expect Cipla's bottom-line to record sustainable 19% growth for both FY07 and FY08 to Rs7.25b and Rs8.7b, respectively. Our estimates do not include upsides from patent challenges filed by Cipla's partners due to the uncertainties linked with patent litigations.

Although, the global consolidation in the generics market has had some adverse impact on the number of products which Cipla can supply, it has also resulted in Cipla's tie-ups with leading generic companies like Teva, Sandoz and Watson. These companies typically command higher market shares in the generic markets given their distribution clout. Although, apprehensions have arisen about the sustainability of Cipla's product sourcing arrangement with Ivax (post the latter's acquisition by Teva), we do not expect any major alterations in the sourcing arrangement.

Key risks

- Cipla has not yet made provisions for the NPPA demand of Rs1.8b. The matter is in litigation with the Supreme Court. It should be noted that the total liability (raised by the NPPA's demand) is about Rs3.6b, of which NPPA is demanding 50% as of now. The total liability roughly equals 50% of our FY07 profit estimate of Rs7.3b.
- The global generics space is witnessing significant consolidation as larger generics companies try to gain scale through inorganic initiatives. The intense pricing pressure in regulated markets has accentuated the need for consolidation. Cipla has clearly indicated that it intends to remain as a supplier of generic products (the partnership model) and is unlikely to have a front-end in the regulated markets. This implies that it will have to rely completely on its partners for its supplies to the regulated markets. This raises uncertainties on the sustainability of the partnership arrangement in the event of Cipla's partners been taken over by other large generics companies.

INCOME STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Net Income	**19,230**	**22,545**	**29,814**	**36,696**	**43,539**
Change (%)	*31.7*	*17.2*	*32.2*	*23.1*	*18.6*
Total Expenditure	15,038	17,592	23,121	27,585	32,553
EBITDA	**4,192**	**4,953**	**6,692**	**9,111**	**10,986**
Margin (%)	*21.8*	*22.0*	*22.4*	*24.8*	*25.2*
Depreciation	403	551	802	951	1,105
Int. and Finance Charges	104	76	114	96	84
Other Income - Rec.	356	820	1,322	360	270
PBT before EO Items	**4,041**	**5,146**	**7,098**	**8,423**	**10,067**
Extra Ordinary Expense	207	0	0	0	0
PBT but after EO Exp.	**3,833**	**5,146**	**7,098**	**8,423**	**10,067**
Tax	878	1,050	1,022	1,179	1,409
Tax Rate (%)	*19.0*	*20.4*	*14.4*	*14.0*	*14.0*
Reported PAT	**2,956**	**4,096**	**6,076**	**7,244**	**8,658**
Adj PAT	**3,274**	**4,096**	**6,076**	**7,244**	**8,658**
Change (%)	*32.2*	*25.1*	*48.3*	*19.2*	*19.5*
Margin (%)	*17.0*	*18.2*	*20.4*	*19.7*	*19.9*

BALANCE SHEET					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Equity Share Capital	600	600	600	1,555	1,555
Reserves	11,939	14,836	19,140	31,742	38,628
Revaluation Reserves	102	101	93	93	93
Net Worth	**12,641**	**15,536**	**19,833**	**33,390**	**40,276**
Loans	2,106	1,912	4,689	1,302	1,502
Deferred Liabilities	659	889	980	895	795
Capital Employed	**15,406**	**18,338**	**25,501**	**35,587**	**42,573**
Gross Block	7,408	9,867	13,667	14,667	16,667
Less: Accum. Deprn.	1,932	2,478	3,101	4,052	5,157
Net Fixed Assets	**5,476**	**7,389**	**10,566**	**10,615**	**11,510**
Capital WIP	560	1,060	870	450	500
Investments	1,804	183	224	1,266	1,266
Curr. Assets	**14,362**	**17,491**	**22,923**	**34,573**	**42,922**
Inventory	5,689	7,457	9,570	11,271	13,398
Account Receivables	4,982	5,873	8,760	7,659	9,122
Cash and Bank Balance	62	112	445	10,097	13,766
Others	3,628	4,049	4,148	5,546	6,636
Curr. Liability & Prov.	**6,796**	**7,785**	**9,082**	**11,317**	**13,624**
Account Payables	6,796	7,785	9,082	11,317	13,624
Net Current Assets	**7,566**	**9,706**	**13,841**	**23,256**	**29,297**
Appl. of Funds	**15,406**	**18,338**	**25,501**	**35,587**	**42,573**

E: MOSt Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	**4.4**	**5.5**	**8.1**	**9.3**	**11.1**
Cash EPS	4.9	6.2	9.2	10.5	12.6
BV/Share	16.7	20.6	26.3	42.8	51.7
DPS	1.2	1.4	0.8	3.0	4.0
Payout (%)	34.3	29.3	29.2	18.3	20.5
Valuation (x)					
P/E		47.8	32.2	28.0	23.5
Cash P/E		42.1	28.5	24.8	20.8
P/BV		12.7	9.9	6.1	5.1
EV/Sales		9.1	7.0	5.3	4.4
EV/EBITDA		41.4	31.0	21.3	17.4
Dividend Yield (%)		0.5	0.3	1.1	1.5
Return Ratios (%)					
RoE	26.1	26.5	30.8	21.8	21.5
RoCE	26.9	28.5	28.3	23.9	23.8
Working Capital Ratios					
Asset Turnover (x)	1.2	1.2	1.2	1.0	1.0
Debtor (Days)	95	95	107	76	76
Inventory (Days)	108	121	117	112	112
Working Capital (Days)	144	157	169	231	246
Leverage Ratio (x)					
Current Ratio	2.1	2.2	2.5	3.1	3.2
Debt/Equity	0.2	0.1	0.2	0.0	0.0

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2004	2005	2006	2007E	2008E
Op. Profit/(Loss) before Tax	4,192	4,953	6,692	9,111	10,986
Interest/Dividends Recd.	356	820	1,322	360	270
Direct Taxes Paid	-780	-820	-932	-1,263	-1,510
(Inc)/Dec in WC	-690	-2,090	-3,802	237	-2,373
CF from Operations	**3,077**	**2,863**	**3,280**	**8,444**	**7,374**
(inc)/dec in FA	-2,440	-2,964	-3,789	-580	-2,050
(Pur)/Sale of Investments	-538	1,621	-41	-1,042	0
CF from Investments	**-2,977**	**-1,343**	**-3,831**	**-1,622**	**-2,050**
(Inc)/Dec in Debt	1,158	-194	2,777	-3,387	200
Interest Paid	-104	-76	-114	-96	-84
Dividend Paid	-1,015	-1,199	-1,773	-1,329	-1,771
CF from Fin. Activity	**39**	**-1,470**	**883**	**2,830**	**-1,655**
Inc/Dec of Cash	**-69**	**50**	**333**	**9,653**	**3,668**
Add: Beginning Balance	131	62	112	445	10,097
Closing Balance	**62**	**112**	**445**	**10,097**	**13,766**

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Disclosure of Interest Statement	**Cipla**
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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