DOMESTIC FORMULATIONS

Indigenous Cure

April 27, 2007

Edelweiss
Ideas create, values protect

Nimish Mehta
+91 22 2286 4295
nimish.mehta@edelcap.com

Amod Karanjikar
+91 22 2286 4429
amod.karanjikar@edelcap.com

Edelweiss Securities Pvt. Ltd.

Executive Summary

Structural changes consolidating the domestic formulations landscape

We expect the domestic formulations market to grow at a sustainable 13%-14% going forward which is almost double the growth rate of 6-9% p.a. seen in five year period upto CY05. We believe the low growth rate was primarily because of the highly fragmented nature of the industry (leading to severe price pressures) and poor healthcare infrastructure.

However, a slew of structural changes over the past 12–18 months including 1) implementation of stricter and uniform good manufacturing practices (GMP) in line with WHO GMP norms; 2) imposition of MRP-based excise duty (instead of the ex-factory cost-based one); and 3) migration of manufacturing base for most companies to excise free zones, is expected to reduce the level of fragmentation in the industry considerably. These changes are likely to reduce price undercutting and thus will lead to improved growth outlook for the industry.

Organized players to see higher growth

These structural changes are likely to deprive the smaller players of their low manufacturing cost advantage, thereby eventually driving higher consumption of branded products. In addition, pricing pressures are likely to ease, with reduction of price undercutting by smaller players. Both these factors will favour organised sector players with a strong brand franchise. This shift to organized players will happen largely in acute therapies as smaller players' concentration is higher there.

Ingredients in place for secular growth at a much higher level

The last date to comply with the new GMP norms was June 30, 2005; the new MRP-based excise was introduced in January 2005. Over the last two years, most of the organised players have therefore shifted their manufacturing facilities to excise free zones. The effect of this has already started showing in CY06 with overall industry value growth of 18% (against 8% in CY05) and volume growth of 17% (net price increase). Further, we estimate that the one time impact of diseases like *chicken gunya* and *dengue* in CY06 would not account for more than 2% of the total growth of 18%. CY06 also saw the rural market growing at 39%, underscoring the GDP-led growth in these under penetrated markets. ORG-IMS report of strong industry growth indicates robustness of the organised sector, as their survey covers the top 300 companies ranked by revenues.

We believe these factors will be assisted by improving macro economic fundamentals such as strong and sustainable GDP growth and higher disposable incomes. Hence, 13-14% annual growth looks extremely sustainable to us, at least for the next three years upto CY09.

Companies investing in sales force will benefit the most; Ipca and Torrent are our top picks

Our recommendations to play this theme are companies (1) where meaningful proportion of total sales is contributed by domestic formulations; (2) which have increased sales force or are increasing sales force to tap the incremental growth; (3) which have shifted their manufacturing base to excise free zones; and (4) with national brands and preferably, though not necessarily, focused on acute therapies.

Our top picks are Ipca and Torrent which meet most of the above criteria and also have attractive valuations. We reiterate **'BUY'** on Lupin and Nicholas Piramal – both of them have charted plans to grow in the rural markets. While Sun and Cipla have the advantage of size, we rate them **'ACCUMULATE'** and **'REDUCE'** respectively purely on premium valuations.

CONTENTS

COMPANIES

AT A GLANCE

Pharmaceuticals — At a glance

Company	Price (INR)	Shares O/S (mn nos)	Mkt cap (INR mn)	Reco		Financials (INR mn) Revenue	EBITDA	PAT	EPS (INR)	Growth (%) Revenue	EBITDA	PAT	PE	Valuation (x) EV/EBITDA	Mcap/ Rev.
Cipla	217	777	168,674	REDUCE	FY06	29,814	6,692	6,076	7.8	32	35	48	27.8	25.8	5.7
					FY07	35,787	8,227	6,608	8.5	20	23	9	25.5	19.9	4.7
					FY08E	42,299	8,975	7,344	9.4	18	9	11	23.0	18.0	4.0
Ipca	630	25	15,750	BUY	FY06	7,580	1,117	600	24.0	21	81	154	26.2	15.8	2.1
					FY07E	9,167	1,975	1,167	46.7	21	77	94	13.5	9.1	1.7
					FY08E	10,936	2,447	1,523	60.9	19	24	31	10.3	7.1	1.4
Lupin	697	88	61,663	BUY	FY06	16,061	2,283	1,827	23	38	80	117	30.6	24.5	3.8
					FY07E	19,972	3,147	2,312	26	24	38	27	26.7	19.4	3.1
					FY08E	25,080	4,285	3,324	38	26	36	44	18.6	14.1	2.5
Nicholas Piramal	251	209	52,449	BUY	FY06	15,944	2,096	1,210	5.8	22	24	(25)	43.3	26.3	3.3
					FY07	24,719	3,835	2,285	10.9	55	83	89	23.0	15.1	2.1
					FY08E	29,978	4,807	2,983	14.3	21	25	31	17.6	11.9	1.7
Sun Pharma	1,038	207	215,229	ACCUM.	FY06	16,380	4,917	5,730	31	38	18	45	39.6	39.9	13.1
					FY07E	20,849	6,835	7,862	38	27	39	37	27.4	28.8	10.3
					FY08E	24,568	8,687	9,344	45	18	27	19	23.0	21.8	8.8
Torrent Pharma	196	85	16,556	BUY	FY06	9,672	1,080	508	6.0	77	46	4	32.6	17.0	1.7
					FY07E	12,587	1,538	903	10.7	30	42	78	18.3	12.4	1.3
					FY08E	14,507	2,135	1,304	15.4	15	39	45	12.7	8.9	1.1

** June ending*

Price as on 8th November 2006

The Indian pharmaceutical market: Lower growth despite strong economy

Fragmentation kept the growth muted

The Indian pharmaceuticals market is characterised by the following features:

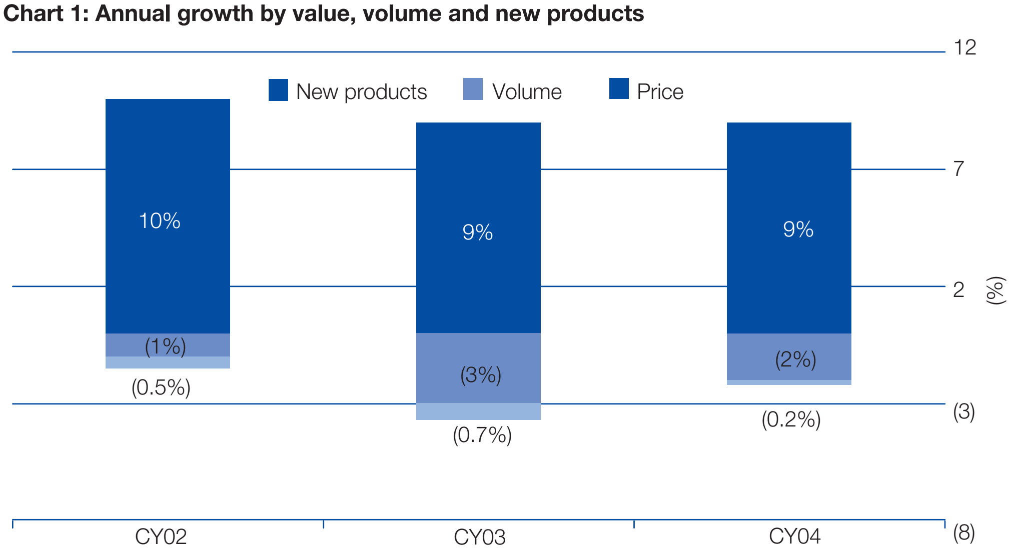
- Globally, thirteenth position in value and fourth in volume.
- Pharmaceuticals drug penetration at less than 50%.
- About 3000 manufacturing units with ~300 units in the hands of large organised players.
- Top ten companies capture 38% market share as against 80% in the US.
- Nearly, 70,000 brands marketed by various players.
- Overall growth of ~8% in the past four years, marked by decline in pricing of existing products.

1947-1970:- During this period, India produced few drugs and product patent was in force with MNCs (holding above 80% market share) selling most of the on-patent products in the country. Moreover, the prices of these on-patent drugs were among the highest globally. As a result, the healthcare penetration was extremely limited with a total market size of only INR 3,000 mn. This restricted the number of formulations manufacturers in the country, at ~2,257 in 1970.

1972-2005:- From 1972, the 'Indian Patent Act – 1970' came into force, which did not recognise product patents and granted only process patents. This enabled indigenous pharmaceutical players to reverse-engineer the products manufactured in other countries via a different process and sell them in India. With this, entry barriers reduced significantly and number of manufacturers increased (to ~20,053 in 2000), growing the number of new product launches in the market manifold. By 2005, the Indian players were able to increase their market share by almost 70%. Simultaneously, competition among the domestic players intensified, dragging the drug prices down considerably. Today, drug prices in India, are among the lowest in the world.

However, in spite of continuous volume growth, the value growth remains lower on account of price cuts.

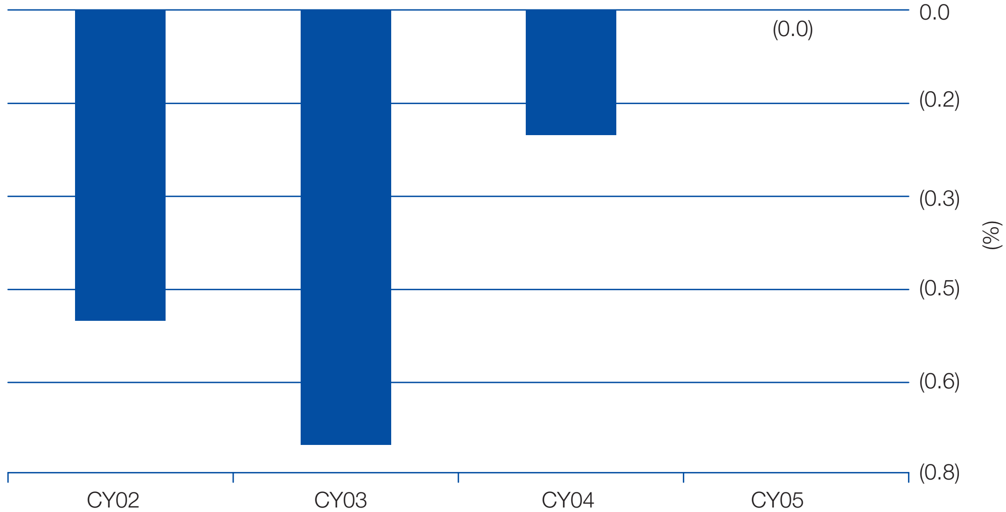
Chart 1: Annual growth by value, volume and new products



Source: ORG IMS

Consistent price reduction over the years has hampered the growth

Chart 2: Average price reduction annually

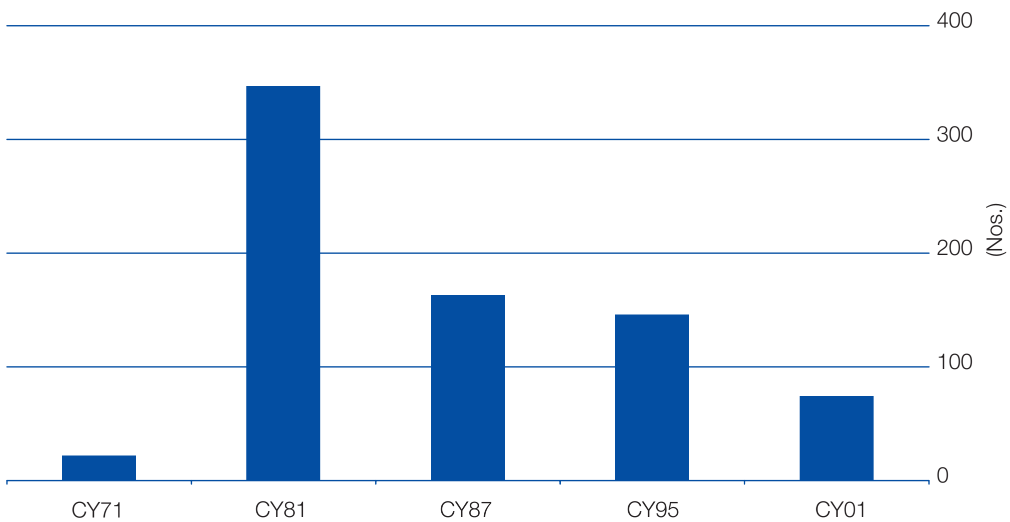


Source: ORG IMS

As shown in the graph above, the industry growth has remained ~8% in the past four years, largely driven by new product launches. The growth in value continues to be muted, in spite of the number of drugs under DPCO constantly reducing (from 347 in 1981 to 74 in 2001). This clearly reflects that the industry has been facing severe pricing pressure, purely on account of intense competition rather than government intervention.

Competition kept the prices low, though government mandated price control reduced

Chart 3: Number of drugs under DPCO



Source: CrisInfac

It is thus evident that rampant undercutting happens in the industry, hampering the overall growth. Even for products under price control, the market prices in some products tend to be lower than the stipulated ceiling (see the table below).

Drugs are sold at lower prices than even the DPCO ceiling

Table 1: Lower prices than DPCO ceiling

Drug name	Ceiling price as per DPCO	Actual prevailing market price	Difference (%)
Tetracycline 250 mg (10s)	8.2	7.9	(2.7)
Chloroquine 250mg (10s)	6.3	4.4	(31.0)
Ciprofloxacin 250mg (10s)	30.7	21.0	(31.5)
Rifampcin 150mg (4s)	7.2	4.9	(31.0)

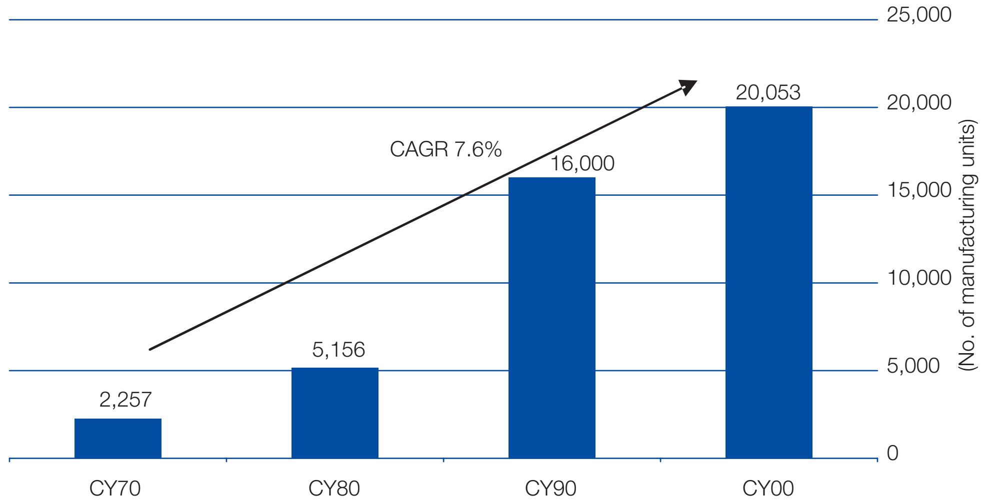
Source: Current Index of Medical Specialties India, Industry, Edelweiss research

Fragmentation: The biggest growth dampener

Although all the macro economic indicators have favoured robust industry growth, the domestic formulations market's growth profile remains muted, primarily due to fragmentation.

Number of manufacturing units increased manifold increasing fragmentation

Chart 4: Number of players



Source: OPPI

As shown in the graph above, the number of players in the industry has increased manifold over the years. While according to OPPI (Organization of Pharmaceutical Producers of India), the total no. of units is 20,000, which might include units for Ayurved, Unani, herbal, Siddha and naturaopathy medicine. However, there is no agency that has formally undertaken a survey to count the no. of pharmaceutical units.

However, a report by The Institute for Studies in Industrial Development (ISID, a national-level policy research organization in the public domain and is affiliated to the Indian Council of Social Science Research (ICSSR)) in Jan 2007, collated data from Annual Survey of Industries. This report mentions the total no. of units to be about 2872. However, out of that 91% were small manufacturing enterprises.

Small firms: low on investment but high on output

Table 2: Large number of manufacturing units

Characteristics	Small units	Large units	Total
No. of units (nos.)	2,623	249	2,872
% of total	*91.3*	*8.7*	*100.0*
Employment (nos.)	162,487	86,559	249,046
% of total	*65.2*	*34.8*	*100.0*
Net fixed investment (INR bn)	2.9	6.9	9.8
% of total	*29.6*	*70.4*	*100.0*
Total output (INR bn)	151.1	212.8	363.9
% of total	*41.5*	*58.5*	*100.0*
Net fixed investment per firm (Rs. mn)	1.1	27.7	3.4
Total output per firm (Rs. mn)	57.6	854.6	126.7
Total output / Net fixed investment	52.1	30.8	37.1

Source: Annual Survey of Industries, 2000 – 01, Mashelkar committee report

A small manufacturing enterprise (SME) is defined as an establishment where total investment is less than or equal to INR 10 mn. In other words, the extent of fragmentation remains the same in most of the datapoints.

As evident from the above table, a significant portion (42%) of pharmaceutical output is contributed by SMEs.

This extreme fragmentation has given birth to a number of small manufacturers/marketers focused at regional levels, with continuous product launches in their target markets, intensifying competition.

Large number of players has increased competition for every product leading to severe price undercutting

Table 3: Large no. of brands for one molecule

Molecule	No. of brands
Ciprofloxacin	101
Gatifloxacin	67
Cetrizine	83
Diclofenac	67
Rabeprazole	49
Atenelol	49
Glimeperide	40

Source: CIMS, Edelweiss research

This, in turn, has led to price undercutting among players, hitting the overall growth rate of the industry. Thus, Indian medicines are cheapest even in comparison with drug prices in developing countries like Brazil, China, and Malayasia.

Reasons for fragmentation

Poor regulatory standards for quality norms offer low entry barriers

Low quality products gave undue cost advantage to the smaller players

As evident from the table above, the average investment per small firm is drastically lower (INR 1.1 mn) than that of a larger unit (INR 27.7 mn). This is despite the fact that productivity in small plants is not at all hampered by their size, as reflected in their healthy output to net investment ratio. In fact, the value output per rupee invested in small plants is 69% higher compared with the larger units, though the large units enjoy numerous scale benefits (starting from purchase of raw materials to manufacturing efficiency).

This indicates that lesser investments in small units are a function of lack of investments in the overall manufacturing infrastructure (air conditioning, air control devices to check contamination, and effluent treatment plants). Small manufacturers resorted to mediocre manufacturing processes to achieve cost efficiency in an extremely competitive market. In the absence of apt regulatory standards for quality norms, they could easily get their sub-standard products approved (since product approval was a state affair).

As per the table below ~10% of the drugs are either spurious or sub-standard in quality. According to a WHO report, 35% of spurious drugs of the world are being produced in India.

Atleast 10% of products were found to be substandard/spurious

Table 4: Quality of drugs tested in India

Year	Tested	Substandard quality	Spurious	Sub-standard quality (%)	Spurious (%)	Total (%)
1995-96	32,770	3,490	100	10.7	0.3	10.7
1996-97	38,936	3,189	94	9.7	0.3	10.0
1997-98	32,936	2,979	157	9.1	0.5	9.6
1998-99	38,936	3,189	94	9.7	0.3	10.0
1999-00	35,570	3,666	115	11.2	0.4	11.5
2000-01	36,947	3,088	112	9.4	0.3	9.8
2001-02	38,824	3,458	96	10.6	0.3	10.9
2002-03	36,314	3,395	125	10.4	0.4	10.7
					Avg	10.4

Source: Mashelkar committee report November 2003

As per a presentation by CII to Mashelkar Committee on substandard drugs, following points came out:

- Revenue loss of over Rs.4000 Crores to industry;
- 2001 production of total drugs : 22,887 crores. 18% spurious=>4112 crores;
- Government supplies-majority fail quality test; and
- WHO statistics on spurious drugs – India leads with 35% of world production

It is worth noting that the above data on substandard drug is in comparison with India's good manufacturing practices (GMP) norms. However, India's GMP norms are themselves way below the global standards.

Thus, if we recalculate the extent of spurious and substandard drugs as per WHO norms, it would be much higher than 10%, as reported in the above table.

This is in sharp contrast with facts such as Indian companies have the highest number of USFDA approved plants (75) outside the US and Indian generic manufacturers are a dominant force in the global generics market. This, however, holds true in case of the large manufacturers.

In other words, it is the small and regional players who are responsible in substandard drug manufacturing, to efficiently compete against the larger manufacturers that comply with WHO GMP norms, enduring higher production costs.

This indicates that a lot of drug manufacturers, mostly smaller and regional players ply on a low manufacturing cost base.

Excise structure and trade margin favouring smaller players

Excise on ex-factory gave smaller players additional advantage

Till January 2005, excise was levied on the cost of production. This provided additional benefits to the low-cost manufacturers, thereby increasing the manufacturing cost gap between small and large manufacturers further. This gap will widen further, if small manufacturers continue to resort to under-invoicing that has been prevalent among them.

In other words, the difference between MRP and ex-factory costs is very high for small marketers (with own regional brands) in comparison with the organised players. This difference becomes multifold for small companies that sell unbranded generics. In such cases, the MRP can even be 4-7 times the ex-factory prices.

However, it is pertinent to note that small marketers/manufacturers pass on a portion of the differential between the ex-factory and MRP costs to the trade channels (in some cases including doctors), to encourage volume sales.

All these works to organised players' disadvantage, who pay excise on higher cost of production, which ultimately pushes the overall product cost.

Factors affecting growth in pharmaceutical market

Factor 1 – Increasing consolidation

While fragmentation has been primarily responsible for sluggish growth of the domestic pharmaceutical sector, consolidation is foreseen as its biggest growth driver. We believe several structural changes, of late, have triggered consolidation, as a result of which several small companies have become unviable. These changes include (1) stricter GMP norms, (2) change in basis of excise calculations, and (3) migration of manufacturing base to excise free zones.

Strict implementation of schedule M for GMP norms has increased costs for unorganised players which has lead to shifting or closing of several small manufacturing units

GMP norms becoming stricter

Based on the *Mashelkar* committee report in November 2003, the government made amendments to the Schedule M that defines the standard manufacturing practices, to bring it closer to WHO GMP norms.

This is a major step towards establishing quality standards and uniformity across manufacturing practices. The small manufacturers are however reluctant to adapt to the GMP norms because, it takes away from them the cost competitiveness that they enjoyed all this while. There has been a clear tendency among small firms under the Confederation of Indian Pharmaceutical Industry (CIPI) to delay implementation of Schedule M. Under their pressure, the government had extended the deadline for implementation of Schedule M from December 31, 2003 to December 31, 2004 and then to June 30, 2005.

While majority of the large units have already taken steps to bring in the manufacturing standards mandated by highly regulated markets like the US, Europe, and Australia, small firms are reluctant to do so, as it entails heavy investments in their resource starved units.

MRP based excise has taken away the savings on excise from smaller players

Tax incentives and MRP-based excise

With the objective of providing impetus to industrialisation in the backward regions, the government has been adopting area-based tax holiday schemes. As a part of this strategy, specified areas in selected states like Himachal Pradesh, Uttaranchal, Sikkim, and Jammu and Kashmir have declared a number of tax incentives like ten-year excise holiday and full income-tax waiver for the specific years.

In August 2006, the excise free zone status for new units coming into production or taking up substantial expansion in specified areas of Himachal Pradesh, Uttaranchal, and Sikkim, has been extended up to March 30, 2010. Currently, the applicable excise duty is 16%.

This area-based tax holiday had created two groups of states – the tax exempt and non-tax exempt states. The impact of such a policy on small pharmaceutical manufacturers outside such tax free zones was strongly negative.

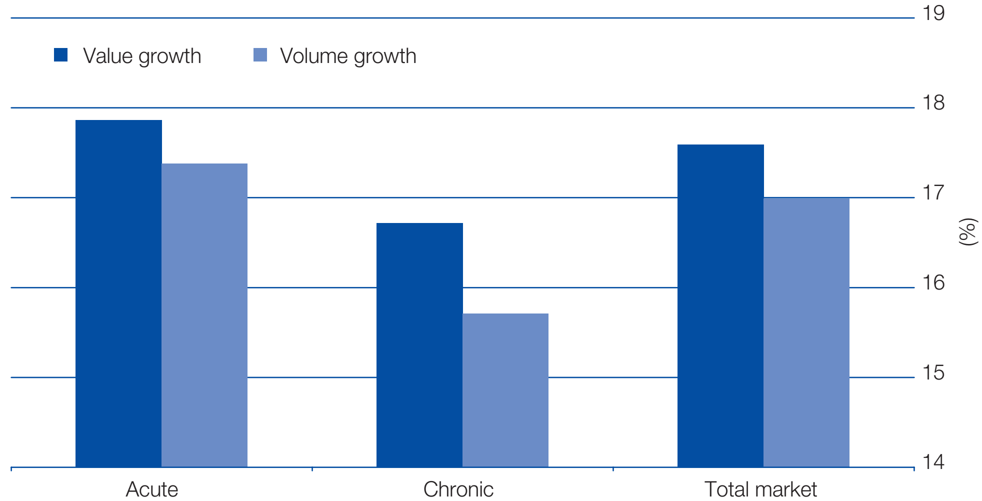
1,000 small pharma units have either migrated or shut down in Maharashtra in the past few years

Shift towards the organized players

Since all the factors favouring the unorganized players have turned against them, the market is shifting towards the organized players. Also with increased disposable income, is also expected to drive the growth for the branded organized players. This phenomenon is already underway which is reflected by the 18% growth for CY06 as reported by ORG. ORG captures sales for only the top 300 organized players. Since most of the unorganized players are in the non-urban market, we believe a part its growth of 39% (in non-urban areas) would be on account of shifting of significant revenues from the unorganized to the organized players. It is estimated that about 1000 small pharmaceutical units have either migrated or shut down in Maharashtra alone in the past few years (as per Pharmabiz). We expect this trend to accelerate going forward.

CY06 growth reflects changed scenario

Chart 5: Annual growth by acute & chronic therapy



Source: ORG IMS

This change is visible in higher growth in acute therapy

It is worth noting that fragmentation was hitting the acute therapy the highest as almost all the small players are focussed on that segment. With aforementioned structural changes, acute therapy segments are likely to benefit the most. This was partially visible in CY06 as the acute market has unusually grown faster than the chronic market after a long time. This would have had one time impact of diseases like chicken gunya and dengue, but we belive its contribution would not be more than 2% in the overall growth of 18% for the year.

It is also worth noting that unlike the past years, the value growth in acute therapy is higher than the volume growth. In addition, the rural market growth in CY06 has been a phenomenal 39% as against 21% in CY05 and 9% in CY04.

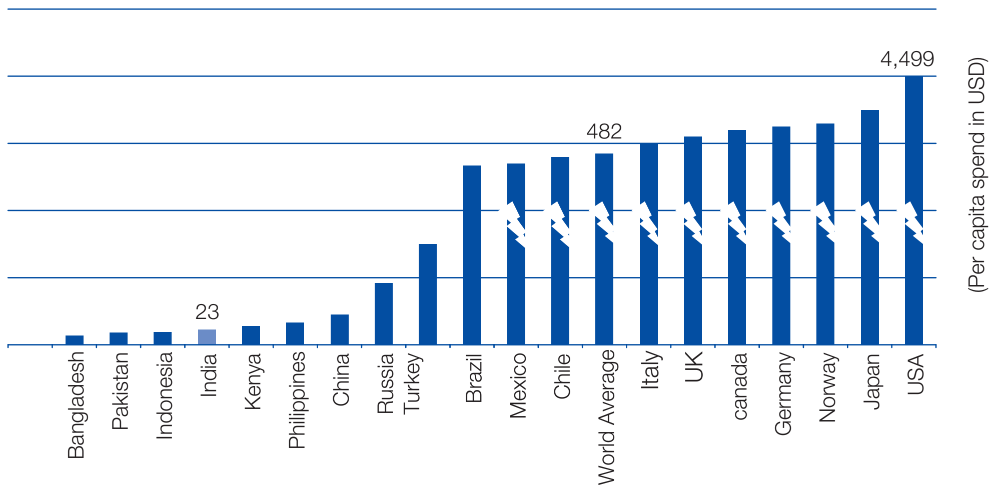
Factor 2: Macro factors indicate room for robust growth in the industry

Low penetration

Low penetration of healthcare infrasturcture leaves room for growth in the future

Historically, India's spending on healthcare has been one of the lowest in the world. Till date, the per capita expenditure on healthcare stands at USD 23, whereas the world average is at USD 482. A primary reason for this gap is that almost 70% of the Indian population resides in rural areas that do not have access to the modern medicines. We however believe that this gap is bound to reduce with increasing urbanization.

Chart 6: Healthcare spent by different countries



Source: CrisInfac

This low penetration is also evident from the low doctor coverage of all the major Pharmaceutical companies. (Total medical practitioners in India ~ 600,000)

Low doctor coverage by large companies indicate potential for branded players to grow

Table 5: Low Doctor coverage

Company	Doctor coverage (in thousands)	Sales Force	Domestic sales (FY07, in INR mn)
Cipla	450	3,000	17,720.0
Ranbaxy	225	2,200	12,506.5
Lupin	225	1,800	7,894.1
Torrent	225	2,400	6,675.9
Cadila	200	1,900	10,504.3
GSK	150	1,800	14,160.0
Ipca	150	2,000	3,693.0
Sun Pharma	125	2,000	11,203.0
Alembic	125	1,200	5,004.0
Dr Reddy's Labs	120	1,300	6,416.0

Source: Companies, Edelweiss research

Lack of healthcare penetration in India is also evident from the fact that - of the total global population bereft of essential medication, almost 38% is in India (68% of Indian population).

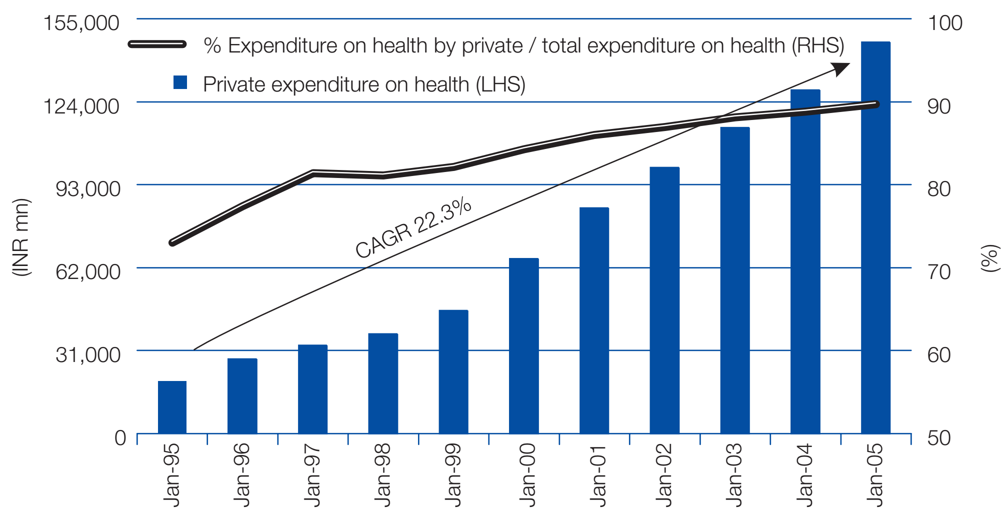
Table 6: Low percentage of population have access to essential medicines

WHO region	Number of countries	Total population (mn)	% of total	Estimated number, ranged ans perfentages of population: Population without access (mn)	Perce ntage of WHO regional population without access	Perfentage of world population without access
African	45	566	10	267 (200-334)	47 (35-59)	15 (11-19)
American	35	813	14	179 (134-224)	22 (16-27)	10 (8-12)
East Mediterranean	22	485	8	143 (107-179)	29 (22-36)	8 (6-10)
European	46	832	14	114 (85-142)	14 (10-17)	7 (5-9)
South-East Asia	9	486	8	127 (95-159)	26 (19-32)	7 (5-9)
India	1	998	17	649 (487-811)	65 (49-81)	38 (28-47)
West Pacific	26	380	7	55 (41-69)	14 (10-17)	3 (2-4)
China	1	1,274	22	191 (143-239)	15 (11-19)	11 (8-14)
Total all countries	183	5,834	100	1,725 (1,294 - 2,156)	30 (22-37)	100

Source: WHO

The government is however keen to improve this scenario, towards which, it has recommended in the draft pharma policy provision of necessary medicine in towns and villages.

Chart 7: Privarte expenditure on health



Source: CMIE

Government initiatives

Government's budgetary allocation for health increased by 22% in the latest budget

The government has introduced national rural health mission (NRHM), under which, basic healthcare amenities would be facilitated in the rural areas. The finance minister has consistently increased the budgetary allocation for health over the years. Even in Budget 2007-08, the allocation to health and family was increased 22% to INR 152,910 mn. All these steps are expected to bear fruits in the next 3-5 years and we are likely to see a significant increase in demand of pharmaceutical products from the government authorities.

Table 7: Healthcare spend by public and private sectors

Country	Healthcare as a percentage of GDP		
	Total	Public sector	Private sector
Indonesia	2.7	0.6	2.1
Philippines	3.4	1.6	1.8
Bangladesh	3.8	1.4	2.4
Pakistan	4.1	0.9	3.2
India	**4.9**	**0.9**	**4.0**
Turkey	5.0	3.6	1.4
China	5.3	1.9	3.4
Russia	5.3	3.8	1.5
Mexico	5.4	2.5	2.9
Chile	7.2	3.1	4.1
UK	7.3	5.9	1.4
Norway	7.8	6.6	1.2
Japan	7.8	6.0	1.8
Italy	8.1	6.0	2.1
Kenya	8.3	1.8	6.5
Brazil	8.3	3.4	4.9
Canada	9.1	6.6	2.5
World Average	9.3	5.4	3.9
Germany	10.6	8.0	2.6
USA	13.0	5.8	7.2

Source: Crisinfac

Government initiative is targetted at rural India where drug penetration is extremely low

Though the government expenditure on healthcare has been low, the total expenditure on healthcare has increased at a CAGR of 20% over the past ten years; private healthcare expenditure (contributing ~90% to total healthcare spend as in 2005) has increased by more than 22%. One of the primary reasons for this is increasing personal disposable income (by 12.8% over the past 10 years). We believe, this spend is expected to increase at a similar rate, going forward.

The government is also aiming at improving the healthcare infrastructure in the country to encourage industry growth and penetration.

Healthcare infrastructure

Poor healthcare infrastructure is all set to improve

Historically, the number of doctors and hospitals in India has been abysmally low compared with any other country because of its low literacy rates and poor healthcare infrastructure.

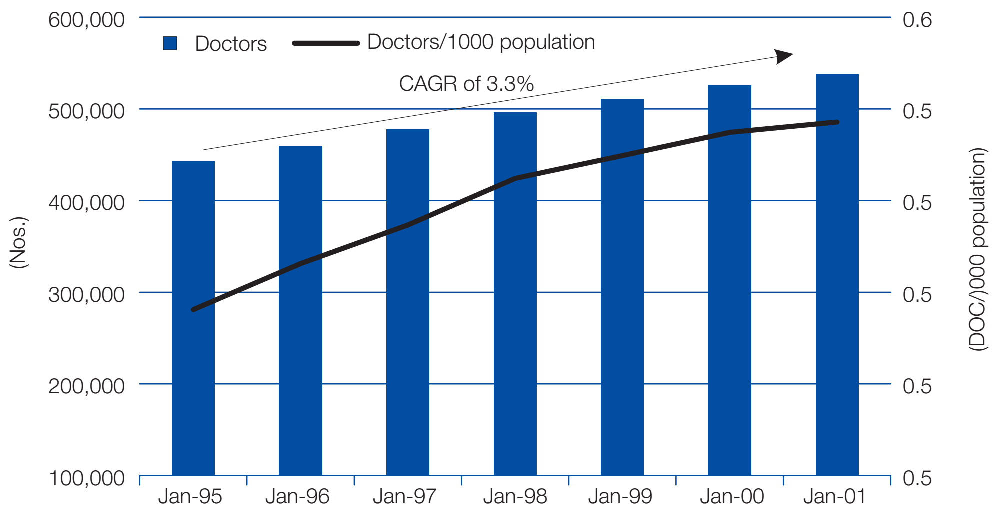
Table 8: India's healthcare infrastructure compares unfavourably with developing countries comparing Indian healthcare with other developing countries

	India	Developing countries	Developed countries
Life expentancy (years)	63	65	78
Infant mortality (deaths per 000 births)	70	59	6
Beds per 000 population (#)	1.5	4.3	7.4
Numbers per 000 population (#)	0.9	1.9	7.5

Source: Industry

This trend is however reversing now. With increasing literacy rates and awareness, better healthcare infrastructure is visible from the fact that the ratio of number of people per doctor is reducing and is expected to go down further. This increased penetration of healthcare infrastructure is bound to give a major boost to the overall healthcare sector.

Chart 8: Number of doctors in India



Source: CMIE

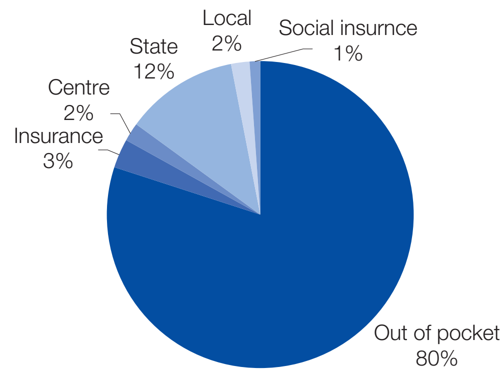
Moreover, medical insurance in India remains un-penetrated and with its bright growth prospects, this segment is likely to boost the healthcare spend significantly.

Healthcare insurance: Potential growth driver

The domestic healthcare insurance is currently at a nascent stage. As of now, only 3% of the healthcare costs are borne by the insurers in India and the same figure is at 80%+ for US. This trend is, however, set to change. As more and more medical expenses will be borne by the health insurance companies, consumers/patients will be ready to pay higher prices for their medicines. Consequently, pricing power of players would improve.

Health insurance has grown at a CAGR of 44% in the last four years

Chart 9: Breakup of medical costs borne by individuals in India



Source: Industry

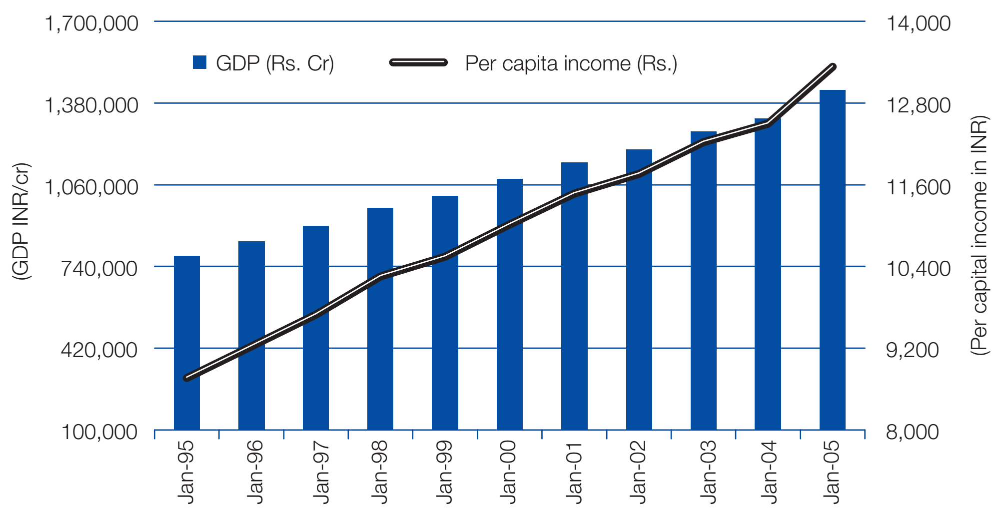
Health insurance industry has grown at a CAGR of 44% in the last four years which is expected to grow at a similar rate going forward which will give a major boost to the healthcare spend in the country.

Increasing GDP and disposable income to give added impetus to this growth

Increasing GDP and disposable income to fuel further growth

Growth in Pharma industry due to all the above mentioned factors is significantly supported by the fact that India's GDP has been increasing at a rate of 8%+ over the past three years. It is expected to continue this growth momentum for the next 3-5 years at least. The domestic disposable income and per capita income are also growing at similar rates. These factors are likely to have a direct positive impact on the healthcare spending over the next few years.

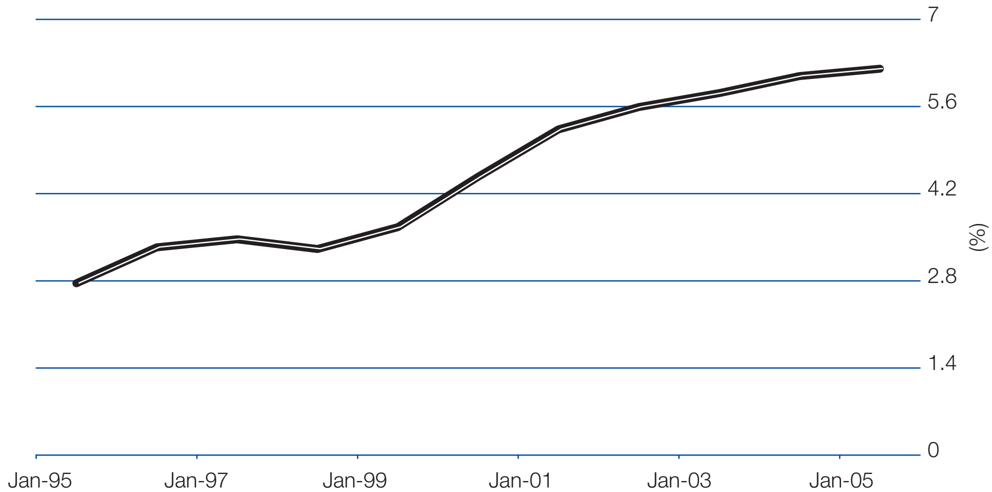
Chart 10: GDP and per capita income growth



Source: CMIE

We have observed that Indians' spending on health (as a percentage of their disposable income) is on a rise over the past few years. In 1995, only 2.8% of disposable income was spent on healthcare, whereas this figure increased to 6.2% in 2005. We believe this kind of trend will continue, going forward.

Chart 11: Percentage of personal spend on health to disposable income



Source: Edelweiss research

Over the last five years, we have observed that the Indian domestic formulations market grew 1.6 times (on an average) the growth in the GDP. This makes us believe that with Indian GDP expected to grow by more than 8% over the next two years, the Indian pharmaceuticals industry is poised to grow at 13-14% during the period.

Consistent growth in GDP to help the pharma industry to grow at 13%-14% over the next two years

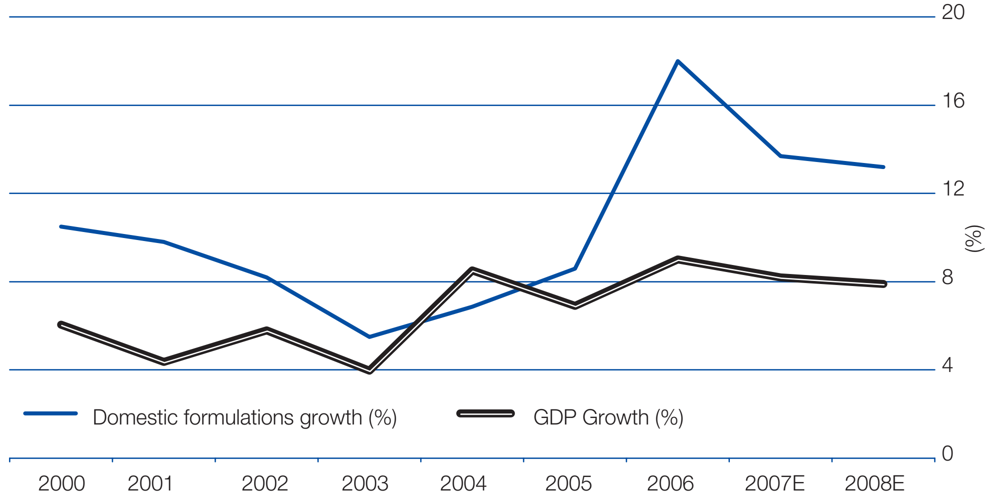
Table 9: Multiple of domestic formulations growth to GDP growth

Year	Domestic formulations Growth (%)	GDP Growth (%)	Multiple
2000	10.5	6.1	1.7
2001	9.8	4.4	2.2
2002	8.2	5.8	1.4
2003	5.5	4.0	1.4
2004	6.9	8.5	0.8
2005	8.6	6.9	1.2
2006	18.0	9.0	2.0
2007E	13.7	8.2	1.7
2008E	13.2	7.9	1.7

Source: Edelweiss research *Estimate using 1.67x multiple*

In summary we believe that (1) Thrust by the government to increase healthcare expenditure; (2) Better healthcare infrastructure and health insurance penetration and (3) Increased private spend on healthcare on account of increasing GDP and disposable income will drive spend on healthcare which indirectly will drive the domestic formulations market.

Chart 12: GDP growth and growth in domestic formulations market



Source: CMIE, Edelweiss research

India Equity Research | Pharmaceuticals | Company update

CIPLA

INR 217

Adjusting to reality

REDUCE

April 27, 2007

Nimish Mehta
+91-22-2286 4295
nimish.mehta@edelcap.com

Amod Karanjikar
+91-22-2286 4429
amod,karanjikar@edelcap.com

Domestic formulations to drive the show

Besides being the second-largest pharma company in the Indian market, Cipla has a robustly growing anti-infective franchise. With the highest number of sales force in India, Cipla is best positioned to capture growth in rural markets. Its other categories like anti-asthma and CVS too are reporting robust growth. We estimate Cipla to grow by 15% in FY08 in line with the estimated market growth despite higher base.

Epidemic market: Looking for increased funding

The anti-AIDS market is looking forward to the opening up of a big tender by the South African government. Cipla's PEPFAR approvals too have grown to eight and the company continues to focus on more approvals. Also, Cipla recently entered into an agreement with a non–profit organization to manufacture and supply artemisinin-based combination products for malaria. While, this may not earn any immediate benefits, this is a definite positive as the incidence of bacterial resistant malaria increases exponentially.

Margin reduction in Q4 FY07 – reflects one time impact of exclusivity

In Q2 and Q3 months FY07, Cipla supplied sertraline under 180-day exclusivity to Teva boosting sales and margin. However, in Q4 EBITDA margin came down by 924 bps sequentially due to (1) expiry of 180-day exclusivity of sertraline and (2) high growth of low margin anti-AIDS products. While Q2 and Q3 EBITDA margins were higher than the normalized margin, Q4 EBITDA margin of 15.7% is much lower than the sustainable margin. We believe EBITDA margin of 21-22% is sustainable and thus have revised our earnings forecast downwards.

Valuation: Price still needs to adjust to the corrected margin

While we have high faith in the business fundamentals of Cipla, and see a sustainable growth on a yearly basis, we believe the market's expectation has run far too ahead. Despite Cipla's correction of 15%+ after the announcement of the Q4 result, we believe the valuations are still rich at a PE of 23x on our FY08E earnings. The management has guided for a weak margin scenario for the next two quarters which will continue to have pressure on the stock price. We thus reiterate our **'REDUCE'** recommendation on the stock.

Reuters	:	CIPL.BO
Bloomberg	:	CIPLA IN

Market Data

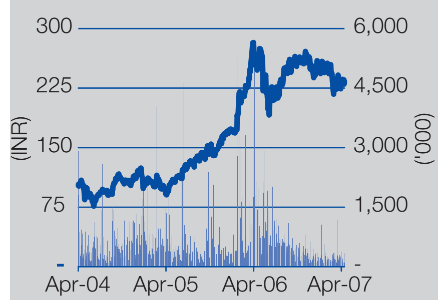
52-week range (INR)	:	280 / 178
Share in issue (mn)	:	777.5
M cap (INR bn/USD mn)	:	168.7 / 4,116.1
Avg. Daily Vol. BSE/NSE ('000)	:	1,766

Share Holding Pattern (%)

Promoters	:	39.4
MFs, FIs & Banks	:	11.4
FIIs	:	16.8
Others	:	32.5

Financials

Year to March	FY06	FY07	FY08E	FY09E
Revenues (INR mn)	29,814	35,787	42,299	50,286
Rev growth (%)	*32.2*	*20.0*	*18.2*	*18.9*
EBITDA (INR mn)	6,692	8,227	8,975	10,806
Net profit (INR mn)	6,076	6,608	7,344	8,775
Shares outstanding (mn)	777.3	777.3	777.3	777.3
EPS (INR)	7.8	8.5	9.4	11.3
EPS growth (%)	*43.2*	*8.7*	*11.1*	*19.5*
P/E (x)	27.8	25.5	23.0	19.2
EV/EBITDA (x)	25.8	19.9	18.0	14.7
ROE (%)	30.6	20.9	20.5	21.6

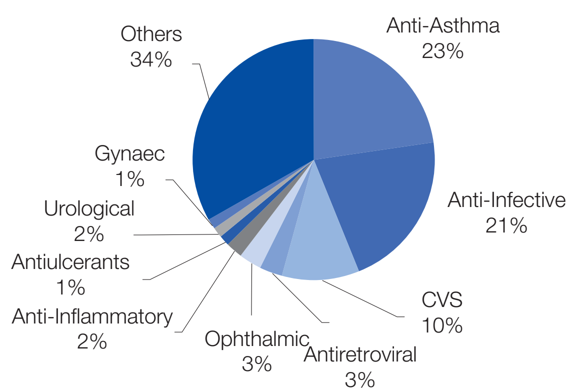


Investment Rationale

Domestic formulations: Growing rapidly despite a high base

Cipla's domestic formulations business has always outperformed market growth by a wide margin despite its heavy presence in the acute therapy segment (~25% of domestic sales). This is due to: (1) high rate of new launches; (2) industry's best sales force productivity (~0.5 mn per month per person) with the biggest sales force of 3,000 people; (3) wide coverage of about ~0.45 mn doctors out of ~0.6 mn registered in India; and (4) creating strong brands with 18 brands in the top 300 (GSK has the highest with 23 brands).

Chart 1: Therapeutic breakup



Source: Company

All these inherent benefits will help Cipla capture the rapid growth in rural markets. Cipla may increase its sales force further to capture the incremental sales.

It is important to note that Cipla's doctor coverage is much higher than rest of industry players, indicating that it is already present in areas which very few branded players have penetrated. As majority growth is coming from these neglected areas, we believe Cipla will benefit the most with its existing presence.

Cipla's top three performing therapeutic areas are: (1) Anti infectives; (2) Anti asthma; and (3) Cardio vasculars.

Anti infectives

In the anti-infectives category, Cipla holds ~6.3% of the domestic market share, which represents approximately 20.3% of the total pharmaceutical market in India according to ORG IMS. Cipla has ~100 products in the anti-infectives category and has introduced 27 products over the past three years according to ORG IMS. Ciplox, Norflox, Novamox, and Novaclox are key brands in this category and were ranked among the top 100 pharmaceutical brands in India in 2005, according to ORG IMS.

In addition to acute therapies, Cipla's growth remains high in asthma, cardio vasculars, and AIDS medications. In asthma and AIDS medication, the company dominates the market with a share of 55% and 74%, respectively.

Anti asthmatics

In the anti-asthmatic category, Cipla held 54.5% share of the domestic market in 2005, according to ORG IMS, with sales of inhalation therapy products constituting almost 80.9% of total sales of inhalation therapy products in India. Cipla has 45 products in the anti-asthmatics category and the company has introduced 10 new products in the past three years. Four of the key brands in the anti-asthmatic category—Asthlin, Seroflo, Aerocort, and Foracort—were ranked among the top 100 pharmaceutical brands in India in 2005, according to ORG IMS.

Cardio vascular

The cardio vascular category forming approximately 5.8% of the pharmaceutical market in India is a highly fragmented market with less than 10% share held by any individual company according to ORG IMS. Cipla holds 5.8% share of the Indian cardiac pharmaceutical market and has 55 products including 14 products introduced over the past three years, according to ORG IMS.

We expect Cipla to grow by 15% in FY08E (in line with our estimate of market growth of 14%) and FY09E each.

Epidemics market: High growth expected from anti-AIDS market

Cipla's current revenue from anti-retrovirals (ARV) formulations is above USD 100 mn. Out of this, ~90% comes from exports to mainly Africa. Cipla, off late, has increased its filings in PEPFAR and now has eight approvals in place. Till now, Cipla's ARV revenues have largely come from WHO tenders and direct sales to national governments and have been negligible from PEPFAR. We believe with these approvals in place, its PEPFAR revenues too will start pouring in.

Table 1: ARV approvals

Company	WHO approvals	PEPFAR approvals
Aurobindo	12	12
Cipla	13	8
Ranbaxy	11	3
Strides Arcolabs	5	4
Aspen Pharma	5	1
Hetero	4	Nil
Matrix	Nil	1

Source: Companies, Edelweiss research

Besides tender-based sales, Cipla sells products in South Africa through its marketing alliance Cipla-Medpro. While Cipla-Medpro markets a range of therapeutic products, majority of the revenues are generated from ARVs. In CY05, Cipla-Medpro registered sales of INR 2.3 bn. FY08E (CY07) will likely see a robust increase in Cipla-Medpro revenues as the South African government will be tendering an ARV order worth USD 450 mn. Cipla-Medpro was the only company, other than innovators and Aspen Pharmaceuticals, to have received an order when this tender was floated the last time.

We expect Cipla to gain about USD 30 mn from this order in FY08E and thus expect the total sales of ARV from Cipla to touch USD 165 mn in FY08E.

Malaria initiative: Besides AIDS, Cipla has recently entered the high end anti-malarial drug market through WHO. The company has entered into a development and supply agreement with Drugs for Neglected Diseases Initiative (DNDi), a global non-profit organisation, for a new anti-malarial combination drug. The drug, a new fixed dose combination of artesunate and mefloquine, will be manufactured by Cipla using a technology developed by DNDi.

It is worth noting that anti-malarial drugs are the third largest selling therapy class among Cipla's export formulations, presumably to Africa. The tender business of regular anti-malarial medicines like chloroquine phosphate is a very low margin business. However, off late, malaria deaths due to drug resistant falciparum have increased. And, in response to this widespread resistance, WHO now recommends Artemisinin-based combination therapy (ACT). Cipla's recent agreement with DNDi is for an ACT medication that generates much higher margins than usual malaria products. We expect Cipla's anti-malaria sales to increase from USD 12 mn in FY06 to USD 18 mn in FY08E.

US generics: No exclusivity-based revenues, but a great pipeline to unfold

Cipla had supplied sertraline to Teva under the 180-day exclusivity period in Q2 and Q3 FY07.

Because of the one-time effect of sertraline exclusivity, Q4 margins were much lower than the 9 months margins. While FY08E, margin will be lower than FY07, we believe US sales will still show growth despite the high base in FY07E. This is because of Cipla's war chest of DMF filings (~150 pending) that will unfold over the coming years. We thus believe that it will not be difficult for Cipla to grow from the FY07E API base (higher due to sertraline exclusivity). We expect Cipla's API sales to grow by 15% in FY07E.

It is worth noting that Cipla had an agreement to supply finasteride to erstwhile Ivax (now acquired by Teva) under 180-day exclusivity. However, this was the supply of formulations and not API and thus does not impact API sales. Also, finasteride is a small product (patented size of USD 350) in comparison to sertraline (patented size of USD 2 bn) and thus its base impact is almost negligible.

CFC-free Inhalers: Increasing approvals

In FY07, Cipla received approvals for CFC-free inhalers from Denmark. It is already marketing these CFC free inhalers in Germany and Portugal and the company is now expecting approvals from rest of the European nations. The market for inhalers in Europe is USD 2 bn (including CFC and CFC-free products) and offers a unique opportunity in specialty products. Cipla's total export inhaler sale in FY06 was ~USD 30 mn; we expect it to reach USD 50 mn in FY08E (CAGR of 29%), which may prove conservative if rest of the approvals start coming through. Cipla has filed about nine CFC-free inhalers in various European countries, out of which it is currently marketing only one inhaler in Germany, Portugal, and Denmark. The approval time for CFC-free inhalers remains high (about 2-2.5 years). However, Cipla has filed most of these inhalers in early FY06 and thus we can expect approvals in FY08 resulting in significant gains for Cipla. Our current estimate includes increase of Budesonide sales in Germany and full year impact of its launches in Denmark.

The CFC-free inhalers market for generics in the US will open up in FY09 and thus offer a long term opportunity for Cipla.

Financial Outlook

Cipla's EBITDA margin (23%) in FY07 is higher on account of higher sales to regulated markets. Going forward, regulated markets sales are likely to continue to grow, though we expect domestic formulations and anti-AIDS markets to grow faster. Anti AIDS sales generates much lower margins in comparison to other businesses. This might partly get compensated by higher growth in inhaler sales, we believe Cipla's overall EBITDA margin will stabilize at 21-22%. We expect the company's overall sales to grow by 19% in FY08E and FY09E each..

The tax rate in FY06 was low at 14.5% due to benefits accruing from Goa and Baddi facilities in case of formulations and Kurkumbh and Bangalore EOUs in case of APIs. However, in Q1FY07, the tax benefit from Goa ended as the five-year tax holiday ended and the effective tax rate thus shot up to 23%. However, in Q3FY07, Cipla commenced production from a new EOU facility at Patalganga, which will result in reduction in the tax rate. We thus expect an effective tax rate of 16.5% in FY08E and 17% in FY09E.

Cipla incurred INR 2.5 bn capex in FY07 and will have maintenance capex in FY08E and FY09E. Thus the increase in depreciation will be marginal from FY07E through F09E. We also expect Cipla to become debt free in FY08 and thus do not estimate any interest expense in FY08 and FY09. All these will translate into a steady net margin of ~18% for Cipla.

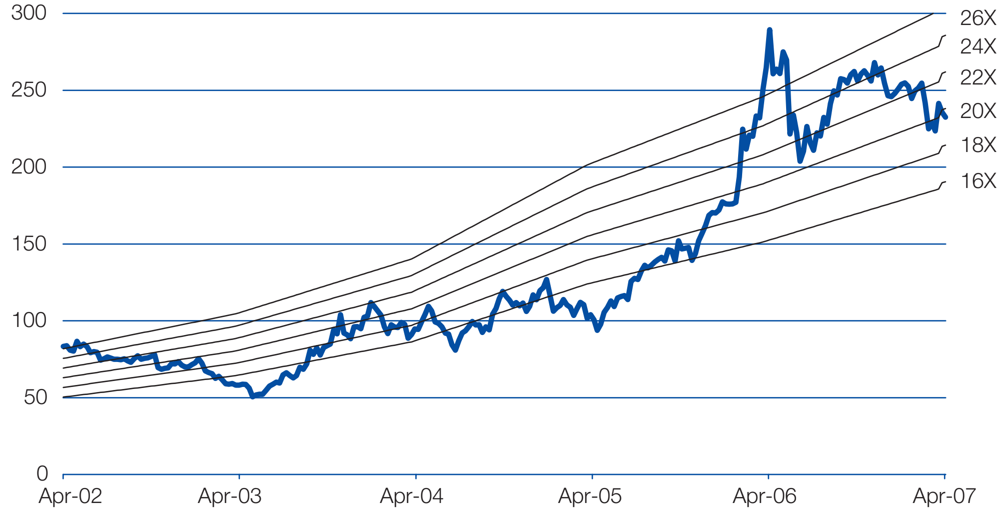
Valuation

We believe Cipla is fundamentally the strongest pharma company in India with: (1) a fully diversified business model; (2) scalable presence and high end opportunities right from epidemics to specialty products like inhalers. This ensures growth with overall decent margins; and (3) consistent organic growth in top line as well as bottom line for the past 12 years, consequently with ROCE at ~25%.

However, the margin expectation for Cipa ran very high owing to the FY07 EBITDA margin of 25% which is positively impacted by 180 day exclusivity period products. Adjusting the financials to a normalized 21-22% EBITDA margin offers modest growth of 11% in FY08 (on a high FY07 base).

We thus believe a P/E of 23x on our FY08E earnings with an EPS CAGR of 15% from FY07 through FY09E makes the stock look expensive at current valuation. We thus retain our **'REDUCE'** recommendation on the stock.

Chart 2: 1-yr forward P/E band



Source: Edelweiss research

Key Risks

NPPA's penalty on Cipla: In a case of product overcharging, NPPA's penalty on Cipla totals up to INR 7.4 bn including interest. The Mumbai High Court had given a judgement in favour of Cipla. However, on an appeal filed by the government, the Supreme Court has remanded the matter to the Bombay High Court for further and more detailed examination in the light of the principles laid down by the Supreme Court. The Supreme Court had also permitted the government to recover 50% of the amount that they had claimed was overcharged. However, the government had sent notices to the company demanding an aggregate of INR 7.4 bn in respect of the said drugs, which according to them is 100% of the amount allegedly overcharged by the company till July 2003. Subsequently, in separate proceedings the Allahabad High Court had ruled that the prices fixed by the government in respect of the said drugs were illegal and void. On an appeal filed by the government against this ruling, the Supreme Court has stayed the judgment of the Allahabad High Court. Further, the Supreme Court has directed that no coercive action shall be taken against the company till the appeal is finally decided.

A positive development for Cipla can provide sentimental boost to the stock price.

Avian Flu pandemic: Cipla has developed generic Tamiflu – the only medication for Avian Flu. Currently the disease is found rarely found; however, there is a strong chance that it might turn into a pandemic. If it becomes a pandemic – Cipla will benefit the most as it is the only generic company in the world to have reverse engineered this product. In that case, the earnings estimate can change significantly upwards.

Financial Statements

Income statement (INR mn)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Income from operations	22,545	29,814	35,787	42,299	50,286
Gross sales	23,276	30,197	35,330	42,382	50,115
Less: Excise	1,464	1,223	884	1,423	1,169
Net sales	21,813	28,974	34,447	40,959	48,946
Other operating income	732	839	1,340	1,340	1,340
Total operating expenses	17,592	23,121	27,560	33,324	39,479
Materials cost	10,947	14,116	17,280	21,410	25,813
Employee cost	1,166	1,508	1,843	2,211	2,654
Other expenses	5,479	7,498	8,437	9,702	11,013
EBITDA	4,953	6,692	8,227	8,975	10,806
Depreciation and amortisation	552	802	1,041	1,093	1,147
Interest	76	114	70	0	0
Other income	820	1,322	891	913	913
Profit before tax	5,145	7,098	8,008	8,796	10,572
Provision for tax	1,050	1,022	1,400	1,451	1,797
PAT	4,095	6,076	6,608	7,344	8,775

Common size metrics as % of net revenues

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Material cost	48.6	47.3	48.3	50.6	51.3
Employee cost	5.2	5.1	5.1	5.2	5.3
Other expenses	24.3	25.1	23.6	22.9	21.9
Depreciation	2.4	2.7	2.9	2.6	2.3
Interest expenditure	0.3	0.4	0.2	0.0	0.0
EBITDA margins	22.0	22.4	23.0	21.2	21.5
Net profit margins	18.2	20.4	18.5	17.4	17.5

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Revenues	17.2	32.2	20.0	18.2	18.9
EBITDA	18.1	35.1	22.9	9.1	20.4
Net profit	33.5	48.4	8.7	11.1	19.5
EPS	33.5	43.2	8.7	11.1	19.5

Cash flow statement (INR mn)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Cash flow from operations	4,040	6,757	8,098	8,488	10,268
Cash for working capital	(2,040)	(3,986)	(2,448)	(2,846)	(3,341)
Net operating cash flow	2,000	2,772	5,650	5,642	6,927
Net purchase of fixed assets	(2,961)	(3,891)	(2,500)	(808)	(849)
Net purchase of investments	2,298	(1)	-	-	-
Net cash flow from investing	(663)	(3,892)	(2,500)	(808)	(849)
Proceeds from equity capital	(1,017)	(1,197)	5,845	(2,393)	(3,100)
Proceeds from LTB/STB	(229)	2,650	(3,569)	(1,120)	-
Net cash flow from financing	(1,246)	1,454	2,276	(3,513)	(3,100)
Free cash flow	**1,337**	**(1,121)**	**3,150**	**4,834**	**6,078**

Balance sheet (INR mn)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Shareholders funds	15,537	19,833	31,665	35,909	40,696
Capital	600	600	1,555	1,555	1,556
Reserves & surplus	14,937	19,233	30,110	34,354	39,141
Borrowings	1,912	4,689	1,120	0	0
Secured loans	412	513	513	0	0
Unsecured loans	1,500	4,176	607	0	0
Deferred tax liability (net)	889	980	980	980	980
Sources of funds	**18,338**	**25,501**	**33,765**	**36,888**	**41,676**
Gross block	9,867	13,667	16,167	16,975	17,824
Depreciation	2,478	3,101	4,141	5,234	6,382
Net block	7,389	10,566	12,025	11,741	11,442
Capital work in progress	1,060	870	870	870	870
Investments	**183**	**224**	**224**	**224**	**224**
Inventories	7,457	9,570	11,715	14,515	17,500
Sundry debtors	5,873	8,760	10,515	12,428	14,775
Cash and bank balances	112	445	5,871	7,192	10,170
Loans and advances	3,913	4,015	4,015	4,015	4,015
Other current assets	135	134	134	134	134
Total current assets	17,490	22,923	32,249	38,284	46,593
Current liabilities	4,945	6,359	7,811	9,678	11,669
Provisions	2,840	2,723	3,793	4,553	5,785
Total current liabilities and provisions	7,784	9,082	11,604	14,231	17,454
Net current assets	9,706	13,841	20,645	24,053	29,140
Uses of funds	**18,338**	**25,501**	**33,765**	**36,888**	**41,676**
Book value per share (INR)	21	26	41	46	52

Ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
ROE (%)	26.4	30.6	20.9	20.5	21.6
ROCE (%)	28.5	28.3	23.9	23.8	25.4
Inventory days	249	247	247	247	247
Debtors days	95	107	107.2	107	107
Fixed assets T/o (x)	2.3	2.2	2.2	2.5	2.8
Debt/equity	0.1	0.2	0.0	0.0	0.0

Valuation parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS, post exeptionals(INR.)	5.5	7.8	8.5	9.4	11.3
Y-o-Y growth (%)	*33.5*	*43.2*	*8.7*	*11.1*	*19.5*
CEPS (INR)	6.2	8.8	9.8	10.9	12.8
P/E (x)	39.7	27.8	25.5	23.0	19.2
Price/BV(x)	10.5	8.5	5.3	4.7	4.1
EV/Sales (x)	7.3	5.8	4.6	3.8	3.2
EV/EBITDA (x)	33.2	25.8	19.9	18.0	14.7

THIS PAGE IS INTENTIONALLY LEFT BLANK

IPCA

INR 630

Surging ahead

BUY

Edelweiss
Ideas create, values protect

April 27, 2007

Nimish Mehta
+91-22-2286 4295
nimish.mehta@edelcap.com

Amod Karanjikar
+91-22-2286 4429
amod,karanjikar@edelcap.com

Domestic formulations growth on strong brand franchise

We believe Ipca is among the best-positioned to capture the domestic formulations industry growth with strong brands. Ipca's future growth in domestic formulations will come from (1) strong brands in acute therapy with focus on general practitioners, (2) focus on rural markets with increased doctor coverage, and (3) increased focus on specialty markets, where it has limited presence currently. Ipca has already identified its growth areas and is rightfully working at increasing its sales force from 1500 in FY06 to 2500 by FY08E end. This makes us confident about the company implementing its growth strategies effectively in future. We believe Ipca's domestic formulation will grow at a CAGR of 18% between FY07E to FY09E.

Branded formulations for less regulated market looking up

Ipca's early efforts to establish presence in the branded formulation segment of the less-regulated countries, especially CIS countries, are now bearing fruits. Healthcare spending in these economies has increased on the back of their robust economy growth; Russian pharmaceutical market grew by 35% in CY06 and continues showing momentum. In addition to promoting its brands in these countries through increased sales force, Ipca is now entering newer geographies. All these will lead to a CAGR of 35% during FY07-09E.

Generic business – US to contribute and UK to recover

Ipca has diversified its products offering creating a basket of 21 products, ever since its lead products in the UK suffered severe price erosion. Ipca is also entering the US generics market gradually through an alliance with Ranbaxy. In addition, it is also expanding into other geographies like Australia and South Africa. This will help their sales from regulated generics to double by FY09.

Valuation and outlook

With the entire branded formulations (domestic and international) segment looking up atstrong growth, we believe Ipca's outlook remains robust, as: (1) branded formulations constitute 60% of total growth and (2) branded formulations earns highest margin among all its business lines. At CMP of INR 630, the stock trades at an attractive PE of 10.3x and an EV/EBITDA of 7.1x on FY08E earnings. We recommend a '**BUY'** on the stock.

Reuters	:	IPCA.BO
Bloomberg	:	IPCA IN

Market Data

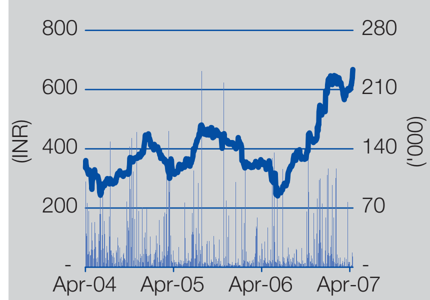
52-week range (INR)	:	675 / 235
Share in issue (mn)	:	25.0
M cap (INR bn/USD mn)	:	15.8 / 384.2
Avg. Daily Vol. BSE/NSE ('000)	:	24.0

Share Holding Pattern (%)

Promoters	:	52.2
MFs, FIs & Banks	:	21.2
FIIs	:	7.5
Others	:	19.1

Financials

Year to December	FY06	FY07E	FY08E	FY09E
Revenues (INR mn)	7,580	9,167	10,936	13,450
Rev growth (%)	*12.0*	*20.9*	*19.3*	*23.0*
EBITDA (INR mn)	1,117	1,975	2,447	3,096
Net profit (INR mn)	600	1,167	1,523	2,063
Shares outstanding (mn)	25.0	25.0	25.0	25.1
EPS (INR)	24.0	46.7	60.9	82.2
EPS growth (%)	*(19.0)*	*94.4*	*30.5*	*34.9*
P/E (x)	26.2	13.5	10.3	7.7
EV/EBITDA (x)	15.8	9.1	7.1	5.3



Investment Rationale

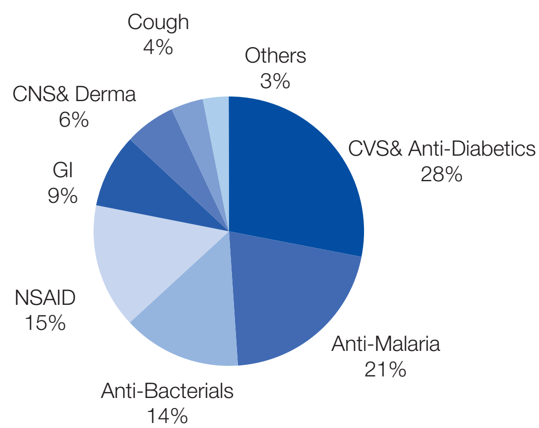
Domestic formulations – looking forward to sustainable and robust growth

In FY06 and FY07E, Ipca's domestic formulation business grew 38% and 27% respectively, mainly because of:(1) new product introductions in lifestyle diseases segment and (2) increased focus per brand, by creation of more divisions for the existing products.

Going forward, Ipca will continue to introduce new products in the lifestyle diseases segment that currently forms ~35% of total sales. At the same time, Ipca is also focusing on expanding its acute therapy brand franchise in the rural markets.

Ipca has also expanded sales force from 1500 in FY06 to 2000 in FY07 and is planning to further increase it to 2500 in FY08E. This will help their doctor coverage to expand from 0.1 mn currently to 0.15 mn by the end of FY08E. It is worth noting that industry growth is likely to primarily happen due to increased penetration, as pharmaceuticals remain the most under-penetrated market with less than 50% of penetration currently. Thus, increased sales force and increased doctor coverage will bring in substantial growth.

Chart 1: Therapeutic breakup



Source: Company

Besides these, Ipca is also focusing on innovative combinations to funnel growth. For instance, in FY06, Ipca launched a novel injectible antibiotic under brands *sultax* and *keftragard*. In November 2006, Ipca launched the combination of *artemether* and *lumefantrine* (equivalent of branded *coartem* of Novartis), to treat the rising cases of drug resistant malaria. In both these instances, Ipca is the first to launch the product in the Indian market, giving them significant lead. Currently, Ipca is working on 11 such clinical trials and has already identified 16 new products with bioequivalence studies.

All of the above reasons offer us comfort of Ipca achieving a CAGR of 18%, despite growing by 30% in the last two years.

Branded formulations in less-regulated markets – reaping fruits of early entry

Over the past few years Russia's economy has grown strongly, driven by rising crude prices. This has led to higher spending on healthcare, resulting in higher revenues for pharmaceutical companies. Apart from this, the Russian government also runs a reimbursement programme (DLO programme), which purchases medicines from pharmaceutical companies for free distribution among pensioners, invalids, infants, and pregnant women. The Russian pharmaceutical market is therefore witnessing an unprecedented growth of 35%. Besides, some of the African economies that are dependant on oil (like Nigeria) too are growing well.

Ipca has entered these markets well in advance and currently has a sales force of about 370 people in these markets. Out of these, CIS accounts for the largest chunk with a sales force of 270 and 60% of sales from branded formulations in less regulated markets.

Sales will further ramp up due to:

- Increased penetration in existing markets by expansion in business lines, institutions, and distributors. Further expansion through additional field force.
- Geographical expansion in South America and Francophone countries.
- Introduction of new brands; nearly 50 existing developed products are identified for registration and brand launch across all continents.

Generics business – UK recovering

Europe formulations account for 17% of total sales, with primary contribution from *paracetamol*. FY06 saw some severe price erosions in *paracetamol* due to increased competition. Though the prices have stabilised now, they are unlikely to come back to the original level in the near term. However, Ipca has launched several new products in FY07 and has filed 30-35 dossiers. These additional launches have helped Ipca recover its sales to FY05 level, after it was hit in FY06.

Ipca's recovery is led by diversification through increased product launches. It launched six products each in FY06 and FY07. It has now registered ~35 dossiers and is also diversifying into other European markets with the same dossiers.

We believe diversification can lead to UK business recovery, though it may not add greatly to the bottomline. However, an improvement in the UK business can impact the overall margin positively. FY07 reflects almost half year impact of the UK turnaround.

US generics and API

Currently, Ipca sells 23 APIs in the US market. Its API business is expected to grow as the company increases product base tie ups. It is also developing process patent for new products, targeting supplying through product tie-ups, and gaining the upsides from these novel processes. Ipca has already got its process patent approved for *losartan*.

In addition to the US API business, Ipca has tied up with several Indian generic companies like Ranbaxy to supply APIs for its US generics. It expects these sales to grow rapidly.

Ipca has now planned to enter the finished dosage generic market of US and has already filed five ANDAs. It is expecting USFDA approval for its formulations facility by the end of FY08E. Till then, it has allied with Ranbaxy to file ANDAs. According to the arrangement between the two, Ipca will supply the API for the approved ANDA under this alliance and will also share profits, once it is marketed. It has already received two approvals viz. *furosemide* and *atenolol*. After Ipca's formulation facility is USFDA approved, Ipca will own the ANDAs and will sell finished dosage, with Ranbaxy being the marketing partner. Till the facility is approved, Ipca is targeting to launch six new products through Ranbaxy.

We have not factored in any income out of its profit sharing arrangement with Ranbaxy, though we have factored the growth in API supply for these products. We expect total API sales to grow by 11% in FY08E.

Financial Outlook

We believe Ipca's sales growth will be 19% and 23% in FY08E and FY09E respectively. FY07E EBITDA margin is likely to be at 21.5%, with partial positive impact of: (1) excise savings, as Ipca moves its formulation manufacturing for domestic market to excise free zones and (2) recovery in the UK business for about six months. Both these factors will have their full year impact, resulting into an EBITDA improvement of 80bps in FY08E.

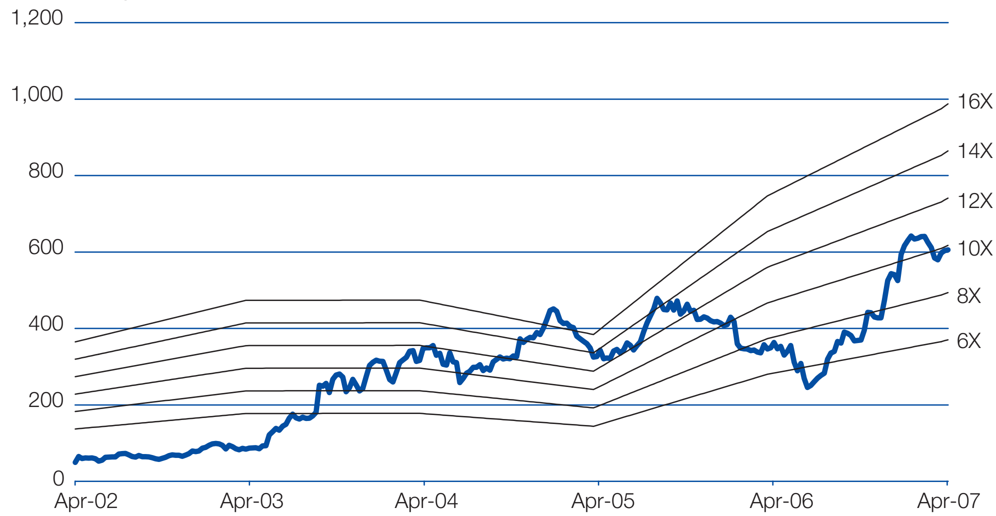
However, we expect net margin to improve by 125bps in FY08E due to better financial and operating leverage. We expect debt to reduce from INR 2.5 bn in FY07 to INR 2.0 bn in FY08E.

With majority capex of INR 600 mn incurred in FY07, we do not expect any major capex in FY08E and FY09E and thus expect depreciation to increase very modestly.

Valuation – attractive on all parameters

Ipca's PE has always remained at the lower end in comparison with its peers. However, this has tracked the poor profitability growth record of no growth during FY03-06. Now, as we look forward to a sustainable growth in EPS (CAGR of 33% from FY07E through FY09E), we believe, PE also would get re-rated upwards. With an ROE of 28% and a growth of 33%, we believe Ipca is attractively valued at a PE of 10.3x and an EV/EBITDA of 7.1x on our FY08E earnings. We initiate coverage on Ipca with a **'BUY'** rating.

Chart 2: 1-yr forward P/E band



Source: Edelweiss research

Key Risks

Government mandated price control: Currently, 74 drugs are under government regulated price control; the government is contemplating to expand that this list to 356 drugs. While most of the other related ministries have opposed this move, the ministry of chemicals and fertilizer is in favour of an expanded price cut. If this happens, all the companies with a focus on branded formulations, including Ipca, will be under serious trouble.

Foreign Exchange risk: Since exports account for more than 50% of sales, appreciation in the Indian rupee would impact Ipca's profitability negatively. However, this is a potential risk only if the INR appreciates over a longer term, since Ipca has already covered its forex exposure through forward contracts for the near-term..

Interest rate risk: Currently Ipca's interest expense is 11% of EBITDA, with a debt of INR 2.5 bn. We have already factored in a higher interest rate for Ipca in our estimates; however, any increase from our estimates of a 10% interest rate will dent the company's profitability, though to only some extent, as Ipca is likely to reduce its debt through internal cash generation.

Financial Statements

Income statement (INR mn)

Year to December	FY04	FY05	FY06E	FY07E	FY08E
Income from operations	6,770	7,580	9,167	10,936	13,450
Gross sales	7,214	8,142	9,673	11,541	14,130
Less: Excise	475	585	526	625	701
Net sales	6,739	7,557	9,147	10,916	13,430
Other operating income	31	23	20	20	20
Total operating expenses	5,595	6,463	7,192	8,489	10,354
Materials cost	2,872	3,494	3,849	4,585	5,640
Employee cost	897	1,024	1,196	1,405	1,714
Other expenses	1,825	1,945	2,147	2,499	2,999
EBITDA	1,175	1,117	1,975	2,447	3,096
Other income	77	20	47	22	22
Depreciation and amortisation	192	249	290	295	299
Interest	111	144	215	197	141
Extraordinary items [expenses/(gain)]	30	-	-	-	-
Profit before tax	979	745	1,518	1,978	2,679
Provision for tax	238	145	351	455	616
PAT (post exc. & pre min. interests)	741	600	1,167	1,523	2,063
PAT (inc. exceptionals)	741	600	1,166.6	1,522.9	2,062.8
Shares outstanding (mn)	25.0	25.0	25.0	25.0	25.1
Dividend per share (INR)	5.5	5.5	9.3	12.2	16.5
Dividend payout (%)	18.6	22.9	20.0	20.0	20.0

Common size metrics as % of net revenues

Year to December	FY04	FY05	FY06E	FY07E	FY08E
Material cost	42.4	46.1	42.0	41.9	41.9
Employee cost	13.2	13.5	13.0	12.8	12.7
Other expenses	27.0	25.7	23.4	22.9	22.3
EBITDA margins	17.4	14.7	21.5	22.4	23.0
Net profit margins	10.9	7.9	12.7	13.9	15.3

Growth metrics (%)

Year to December	FY04	FY05	FY06E	FY07E	FY08E
Revenues	11.2	12.0	20.9	19.3	23.0
EBITDA	8.1	(5.0)	76.8	23.9	26.5
Net profit	0.2	(19.0)	94.4	30.5	35.5
EPS	0.2	(19.0)	94.4	30.5	34.9

Cash flow statement (INR mn)

Year to December	FY04	FY05	FY06E	FY07E	FY08E
Cash flow from operations	1,021	1,069	1,456	1,818	2,362
Cash for working capital	(443)	143	(821)	(540)	(732)
Net operating cash flow	578	1,212	635	1,278	1,629
Net purchase of fixed assets	(1,168)	(770)	(600)	(350)	(351)
Net purchase of investments	18	25	-	-	-
Net cash flow from investing	(1,150)	(745)	(600)	(350)	(351)
Proceeds from equity capital	-	-	(233)	(305)	(413)
Proceeds from LTB/STB	561	(462)	500	(500)	(564)
Net cash flow from financing	561	(462)	267	(805)	(976)
Free cash flow	**(590)**	**442**	**35**	**928**	**1,278**

Balance sheet (INR mn)

Year ended 31st December	FY04	FY05	FY06E	FY07E	FY08E
Shareholders funds	3,260	3,703	4,610	5,786	7,379
Capital	250	250	250	250	250
Reserves & surplus	3,010	3,453	4,360	5,536	7,129
Borrowings	2,207	1,969	2,469	1,969	1,405
Secured loans	2,198	1,732	2,232	1,732	1,168
Unsecured loans	9	237	237	237	237
Deferred tax liability (net)	429	479	479	479	479
Sources of funds	**5,897**	**6,151**	**7,558**	**8,234**	**9,264**
Gross block	3,842	4,546	5,146	5,496	5,847
Depreciation	889	1,099	1,389	1,684	1,983
Net block	2,952	3,447	3,758	3,813	3,865
Capital work in progress	282	297	297	297	297
Investments	28	36	36	36	36
Inventories	1,792	1,872	2,194	2,613	3,215
Sundry debtors	1,519	1,377	2,418	2,885	3,533
Cash and bank balances	50	55	329	410	657
Loans and advances	245	274	274	274	274
Total current assets	3,606	3,577	5,215	6,182	7,679
Current liabilities	857	1,074	1,099	1,261	1,493
Provisions	115	131	649	834	1,118
Total current liabilities and provisions	971	1,205	1,748	2,094	2,611
Net current assets	2,634	2,372	3,467	4,088	5,068
Others	1	-	-	-	-
Uses of funds	**5,897**	**6,153**	**7,558**	**8,234**	**9,266**
Book value per share (INR)	130	148	184	231	294

Ratios

Year to December	FY04	FY05	FY06E	FY07E	FY08E
ROE (%)	25.6	17.2	28.1	29.3	31.3
ROCE (%)	21.3	14.7	25.3	27.5	32.2
Inventory days	211	191	193	191	189
Debtors days	78	70	76	89	87
Fixed assets T/o (x)	2.0	1.8	1.9	2.1	2.4
Debt/equity	0.7	0.5	0.5	0.3	0.2

Valuation parameters

Year to December	FY04	FY05	FY06E	FY07E	FY08E
EPS, inc. exceptionals (INR)	29.6	24.0	46.7	60.9	82.2
Y-o-Y growth (%)	*0.2*	*(19.0)*	*94.4*	*30.5*	*34.9*
CEPS (INR)	37.3	34.0	58.2	72.7	94.1
P/E (x)	21.3	26.2	13.5	10.3	7.7
Price/BV(x)	4.8	4.3	3.4	2.7	2.1
EV/Sales (x)	2.6	2.3	2.0	1.6	1.2
EV/EBITDA (x)	15.2	15.8	9.1	7.1	5.3

LUPIN

INR 697

Growth momentum to continue **BUY**

April 27, 2007

Nimish Mehta
+91-22-2286 4295
nimish.mehta@edelcap.com

Amod Karanjikar
+91-22-2286 4429
amod,karanjikar@edelcap.com

Domestic formulations to maintain double-digit growth

The domestic formulations market, accounting for 40% of total sales, continues to grow at a consistent rate of 24-26%. We believe this kind of growth momentum is expected to continue on account of the company's: (1) increased focus on lifestyle diseases, (2) entry into new therapeutic areas like oncology, ophthalmology, and gynecology, and (3) better penetration in rural areas. We believe these efforts are likely to translate into a 32% growth in domestic formulations in FY07E and ~18% and ~10% in FY08E and FY09E, respectively.

US generics: Strong pipeline building

With ten ANDA approvals in place, Lupin is currently generating USD 60 mn annually from the US generics market; it is among the only five companies in India generating annual US generic sales of more than USD 50 mn. We believe Lupin's US generics approach to have an excellent mix of large but 'me-too' products, offering scale, and niche products with limited competition, offer attractive margins. It is the only Indian company to have a profitable branded generic franchise in the US. With the launch of *cefdinir* (patented size of USD 350 mn), where Lupin is the only company with an ANDA approval, we expect Lupin to more than double US generics revenues in FY08E.

Less-regulated market to grow on the back of anti-TB sales

The ROW formulations sales grew robustly (100%+) in the first half of this fiscal, mainly because of the increased global TB tender business; TB is fast increasing on the back of increased incidence of AIDS, especially in the African markets. With increased funding from global donor agencies, Lupin is set to reap higher sales from this business. With TB being associated with AIDS, the US too is likely to see incidences of TB, which were otherwise absent. We have not factored this opportunity fully but believe this can offer great positive surprise for Lupin, going forward.

Financial outlook

We draw comfort from Lupin's fully diversified business model, with all business divisions growing robustly. With an EPS CAGR of 27% (FY07-09) and ROCE of 19%, Lupin's outlook remains robust. At CMP of INR 697, the stock trades at a PE of 18.6 x on FY08E earnings, offering potential upside. We reiterate our **'BUY'** recommendation on the stock.

Financials

Year to March	FY06	FY07E	FY08E	FY09E
Revenues (INR mn)	16,061	19,972	25,080	28,791
Rev growth (%)	*38.3*	*24.3*	*25.6*	*14.8*
EBITDA (INR mn)	2,283	3,147	4,285	4,769
Net profit (INR mn)	1,827	2,312	3,324	3,702
Shares outstanding (mn)	80.3	88.5	88.5	88.5
EPS (INR)	22.8	26.1	37.6	41.8
EPS growth (%)	*116.6*	*14.8*	*43.7*	*11.4*
P/E (x)	30.6	26.7	18.6	16.7
EV/EBITDA (x)	24.5	19.4	14.1	12.4
ROE (%)	28.4	30.3	34.1	30.3

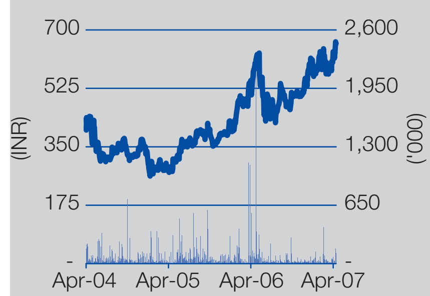
Reuters	:	LUPN.BO
Bloomberg	:	LPC IN

Market Data

52-week range (INR)	:	1,275 / 460
Share in issue (mn)	:	80.3
M cap (INR bn/USD mn)	:	56.0 / 1,365.4
Avg. Daily Vol. BSE/NSE ('000)	:	131.5

Share Holding Pattern (%)

Promoters	:	52.4
MFs, FIs & Banks	:	11.4
FIIs	:	13.6
Others	:	22.6



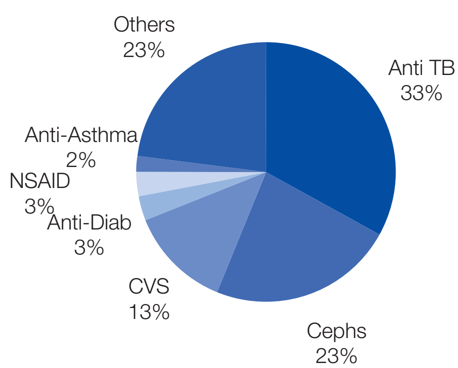
Investment Rationale

Domestic Formulations: Maintaining leadership in existing segments and entering new segments

Lupin has evolved from being a major TB player in the past to one with growing presence in several segments, mainly lifestyle (cardiovascular and diabetes), through aggressive product launches. The company's new products in the lifestyle segment contribute 20% to the total branded sales.

In the acute therapy, Lupin continues to maintain its leadership in the anti-TB and *cephalosporin* market, with eight brands in the top 300 category. The company is also targeting expansion in the under-covered geographies, towards which it launched 'lupinova', focused on promoting growth in the rural markets. With a strong brand franchise in anti-infectives, pain management, and gastrointestinal (40% of domestic formulations sales), we believe Lupin's efforts in the rural market are likely to give it huge potential upsides.

Chart 1: Therapeutic breakup



Source: Company

Having grown by 20%+ for the past five quarters consecutively, we expect Lupin to grow further, at 18%, on the back of its following strategies:

- Strengthening the field force and improving their skill sets by scientific methods; Lupin currently has a field force of 1800, with sales force productivity of INR 0.37 mn per month per person, which is at the higher end in the pharma industry.
- Continued focus on rural markets by establishing distribution channels, building a locally trained sales force, and keeping rural medical practitioners updated with developments in the specified medical field.
- Maintaining and strengthening undisputed leadership in the anti-TB segment.

Regulated market generics: Strong pipeline for FY08

Lupin has a strong pipeline of products, slated to be launched over the next two years. In 9MFY07, Lupin's US generics business grew 47%, despite a high base effect due to the launch of *ceftriaxone* in FY06, demonstrating the strength of Lupin's US generics strategy.

We expect the company to launch *cefdinir* in Q2FY08, which is likely to be among its major products, with a branded size of about USD 700 mn. As of now, Lupin and Sandoz are the only generic players to have received approval, and we believe there could be two other generic players on day one to launch *cefdinir*, apart from Lupin. Hence, the competition is likely to be limited, which could translate into significant margins for the company. We expect Lupin to have revenues of ~INR 1,400 mn from *cefdinir* in FY08E. There could be a possible upside to these estimates, if less than four generic players launch *cefdinir* on day one. The company is also aggressively filing for more ANDAs with a proper mix of PIIIs and PIVs.

Lupin's branded generics venture—*suprax*—continues to do well; the company was even able to affect some price hikes for *suprax* in the previous quarter. The company plans to launch two new line extensions for *suprax* in next few quarters, which can further boost its revenues from the regulated markets. We have estimated revenues of USD 140 mn and USD 190 mn in FY08 and FY09, respectively, from the regulated markets.

Global TB tender: Business based on established strength

The ROW formulations sales grew robustly (100%+) in the first half of this fiscal, mainly because of the increased global TB tender business; TB is fast increasing on the back of increased incidence of AIDS, especially in the African markets. With increased funding from global donor agencies, Lupin is set to reap higher sales from this tender-based business. The company reiterated its optimism on this opportunity, though it did not mention about the current sales from this business. With TB being associated with AIDS, US too is likely to see incidences of TB, which were otherwise absent. We have not factored in this opportunity fully in our estimates, but believe that it can offer great positive surprise for Lupin going forward.

Financial Outlook

We expect Lupin's EBITDA margin to improve by 130bps in FY08E on the back of: (1) full year impact of excise duty benefit and (2) launch of *cefdinir*, where we expect Lupin to generate 80% operating margin. Lupin invested ~INR 1.5 bn in FY07E and will invest about INR 850 mn over the next two years. As a result, depreciation expense (as a percentage of sales) will reduce, resulting into a net profit margin improvement by 170bps in FY08E over FY07E. Consequently, Lupin's ROCE is set to increase to 23.3% in FY08E from 18.8% in FY07E.

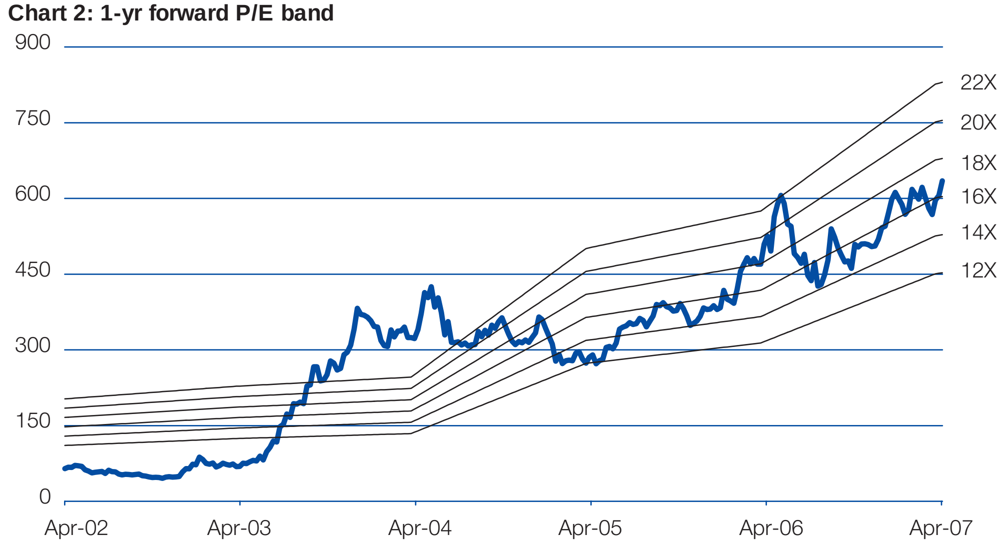
We expect EPS CAGR of 27% from FY07 through FY09E on a fully diluted basis. Lupin still has about USD 100 mn in cash raised via FCCB issue. The money is earmarked for pediatric brand acquisition in the US and/or a plant acquisition in Europe. We believe a brand acquisition in the US will be very positive, as Lupin's operating leverage is high due to an already enrolled sales force for its brand *suprax*.

It is also imperative to note that we have still not anticipated any robust growth from the tender business of anti-TB, which can offer great surprises going forward as funding for these neglected diseases increases.

Valuations – attractive for a long term and diversified growth story

We have always argued for Lupin's re-rating which we believe has partly happened. However, with 27% EPS CAGR and a PE of 18.6x over FY08E earnings, the stock still is trading at a PEG of 0.7. The stock is attractive, particularly given its ROE of 30%. Although, currently Lupin is rated among the second tier companies, we believe, with its focused US strategy and robust growth in branded franchises it will soon be positioned with the likes of Ranbaxy and Dr Reddy's. We reiterate our **'BUY'** rating on Lupin.

Chart 2: 1-yr forward P/E band



Source: Edelweiss research

Key Risks

Dependence on Cefdinir: Our current estimates assume 25% of FY08E EBITDA from cefdinir. Lupin has sought a declaratory judgement on the same the hearing is likely to happen any time now. If Lupin does not get a declaratory judgement, there is strong possibility that Abbott (the innovator of Cefdinir) will sue Lupin just as it has sued other generic companies. In that case, Lupin's launch can get delayed well beyond FY 08 and thus will risk our estimates of FY08E.

Government mandated price control: Currently, 74 drugs are under government regulated price control and government is contemplating to expand that list to 356 drugs. While most of the other related ministries have opposed this move, the minister of Chemicals and Fertilizer is in favour of an expanded price cuts. If this happens all the companies with a focus on branded formulations including Lupin will be under severe trouble.

Foreign Exchange risk: ~46% of sale is contributed by export sales and appreciation in the Indian Rupee would impact Lupin's profitability negatively.

Financial Statements

Income statement (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Income from operations	11,611	16,061	19,972	25,080	28,791
Gross sales	12,123	16,610	20,616	26,100	29,913
Less: Excise	511	549	725	1,020	1,122
Net sales	11,611	16,061	19,891	25,080	28,791
Other operating income	-	-	81	-	-
Total operating expenses	10,341	13,778	16,825	20,795	24,022
Materials cost	5,684	7,568	9,117	11,401	13,388
Employee cost	1,257	1,557	1,907	2,384	2,860
R&D cost	798	986	1,268	1,994	2,015
Other expenses	2,602	3,667	4,532	5,016	5,758
EBITDA	1,270	2,283	3,147	4,285	4,769
Depreciation and amortisation	332	404	451	459	482
Interest	273	303	366	223	223
Other income	188	725	636	450	450
Profit before tax	853	2,302	2,965	4,053	4,515
Provision for tax	9	475	653	730	813
PAT (inc. exc. & pre min. interests)	844	1,827	2,312	3,324	3,702
PAT (inc. exc.) for equity shareholders	844	1,827	2,312	3,324	3,702

Common size metrics as % of net revenues

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Material cost	49.0	47.1	45.8	45.5	46.5
Employee cost	10.8	9.7	9.6	9.5	9.9
Other expenses	22.4	22.8	22.8	20.0	20.0
Depreciation	2.9	2.5	2.3	1.8	1.7
Interest expenditure	2.4	1.9	1.8	0.9	0.8
EBITDA margins	10.9	14.2	15.8	17.1	16.6
Net profit margins	7.3	11.4	11.6	13.3	12.9

Growth metrics (%)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Revenues	3.7	38.3	24.3	25.6	14.8
EBITDA	(45.9)	79.8	37.8	36.2	11.3
Net profit	(13.1)	116.6	26.5	43.7	11.4
EPS	(13.1)	116.6	14.8	43.7	11.4

Cash flow statement (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Cash flow from operations	1,345.4	2,558	2,986	3,859	4,267
Cash for working capital	(94.8)	(1,421)	(516)	(1,472)	(1,454)
Net operating cash (outflow) / inflow	1,251	1,137	2,470	2,387	2,813
Net (purchase) / sale of fixed assets	(1,283)	(820)	(1,548)	(350)	(500)
Net (purchase) / sale of investments	1	53	-	-	-
Net cash (outflow) / inflow from inv.	(1,282)	(767)	(1,548)	(350)	(500)
Proceeds from equity capital	(294.5)	4,076	(298)	(1,119)	(1,221)
Proceeds from LTB/STB	353	(66)	22	(1,500)	-
Net cash (outflow) / inflow from fin.	58.5	4,011	(276)	(2,619)	(1,221)
Free cash flow	**(32)**	**317**	**922**	**2,037**	**2,313**

Balance sheet (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Shareholders funds	5,005	10,901	12,094	14,197	16,678
Capital	401	401	803	803	803
Reserves & surplus	4,604	6,038	6,830	8,932	11,413
Other term liabilities		4,462	4,462	4,462	4,462
Borrowings	4,406	4,665	4,687	3,187	3,187
Secured loans	3,806	4,287	4,287	2,787	2,787
Unsecured loans	600	378	400	400	400
Deferred tax liability (net)	934	956	956	956	956
Sources of funds	**10,346**	**16,522**	**17,737**	**18,339**	**20,820**
Gross block	7,149	8,351	9,851	10,201	10,701
Depreciation	1,559	1,927	2,377	2,836	3,318
Net block	5,589	6,424	7,473	7,364	7,383
Capital work in progress	698	252	300	300	300
Investments	94	95	95	95	95
Inventories	2,481	3,103	3,801	5,065	6,498
Sundry debtors	2,354	3,484	4,332	5,440	6,245
Cash and bank balances	178	4,558	5,205	4,623	5,714
Loans and advances	1,726	2,329	1,900	1900	1900
Total current assets	6,739	13,474	15,238	17,028	20,358
Current liabilities	2,374	2,995	3,597	4,498	5,282
Provisions	400	728	1,772	1,951	2,034
Total current liabilities and provisions	2,774	3,723	5,369	6,449	7,315
Net current assets	3,965	9,751	9,869	10,580	13,042
Uses of funds	**10,346**	**16,522**	**17,737**	**18,339**	**20,820**
Book value per share (INR)	62	80	86	110	138

Ratios

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
ROE (%)	16.9	28.4	30.3	34.1	30.3
ROCE (%)	10.9	15.8	18.8	23.3	22.8
Inventory days	159	150	152	162	177
Debtors days	74	79	79	79	79
Fixed assets T/o (x)	1.6	1.9	2.0	2.5	2.7
Debt/equity	0.9	0.7	0.6	0.3	0.3

Valuation parameters

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
EPS, inc. exeptionals (INR)	10.5	22.8	26.1	37.6	41.8
Y-o-Y growth (%)	*(13.1)*	*116.6*	*14.8*	*43.7*	*11.4*
CEPS (INR)	14.6	27.8	31.2	42.7	47.3
P/E (x)	66.3	30.6	26.7	18.6	16.7
Price/BV(x)	11.2	8.7	8.1	6.3	5.0
EV/Sales (x)	5.2	3.5	3.1	2.4	2.1
EV/EBITDA (x)	47.4	24.5	19.4	14.1	12.4

THIS PAGE IS INTENTIONALLY LEFT BLANK

NICHOLAS PIRAMAL

INR 251

Domestic formulations back on track

BUY

April 27, 2007

Nimish Mehta
+91-22-2286 4295
nimish.mehta@edelcap.com

Amod Karanjikar
+91-22-2286 4429
amod,karanjikar@edelcap.com

Domestic formulations – Investing in future growth

Nicholas Piramal (NPIL), being fourth largest player in the domestic pharmaceutical market, is poised to be a major beneficiary of the secular growth expected in branded formulations. The company is taking several steps to enter the mass market in un-tapped urban markets and largely ignored rural areas. We have increased our growth estimates for the company in this segment to 10% for FY09E, signifying a CAGR of 10% from FY07-FY09E.

CRAMS - Inorganic growth paying off

The acquisition of Avecia and Morpeth has given NPIL access to innovator companies for contract manufacturing of patented products and the necessary scale to attract more clients. We believe, these businesses would start contributing significantly to NPIL's profitability FY08E onwards. In addition to the acquired assets, NPIL's own CRAMS deals will start contributing to its revenues FY08E onwards, beginning with the fortune 500 contract (in addition to the contracts for AMO and Allergan). We believe the company's new deal with Eli Lilly, for contract research, is a major development and successful completion of this contract could provide it a significant upside. We expect NPIL's CRAMS segment to post a CAGR of ~27% over FY07-FY09E.

Financial outlook – Increased EPS estimates for FY09E

We have increased our revenue estimate for FY09E, to reflect NPIL's strong growth in the domestic formulations market. We thereby increase our EPS estimate for FY09E by 8% to INR 18.1. Over FY07-FY09E, we expect the company's revenues and EBITDA to grow at 15.8% and 22.5% CAGR respectively. Its ROE and ROCE are also estimated to improve to 24.8% and 20.5% in FY09E from 12.6% and 10.2% in FY06, respectively.

Valuation – Reiterate our 'BUY' recommendation

We believe that NPIL is all set to reap the benefits of its investments in the CRAMS space over the past 2-3 years. In addition, the company's increased focus in domestic formulations puts it in a sweet spot to see a CAGR of 31.6% in EPS from FY07-FY09E. At CMP of INR 251, the stock trades at a P/E of 17.8x and 13.9x on FY08E and FY09E earnings. On EV/EBITDA basis, it trades at 11.9x and 9.7x times its FY08E and FY09E estimates respectively. We consider the stock attractively priced and reiterate our **'BUY'** recommendation.

Reuters	:	NICH.BO
Bloomberg	:	NP IN

Market Data

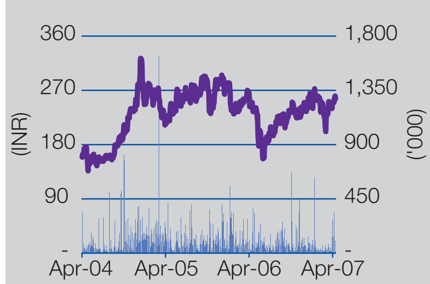
52-week range (INR)	:	284 / 150
Share in issue (mn)	:	209.0
M cap (INR bn/USD mn)	:	52.5 / 1,279.8
Avg. Daily Vol. BSE/NSE ('000)	:	210.1

Share Holding Pattern (%)

Promoters	:	50.1
MFs, FIs & Banks	:	7.3
FIIs	:	14.4
Others	:	28.2

Financials

Year to March	FY06	FY07	FY08E	FY09E
Revenues (INR mn)	15,944	24,719	29,978	33,160
Rev growth (%)	*21.9*	*55.0*	*21.3*	*10.6*
EBITDA (INR mn)	2,096	3,835	4,807	5,740
Net profit (INR mn)	1,206	2,283	2,947	3,780
Shares outstanding (mn)	209.0	209.0	209.0	209.0
EPS (INR)	5.8	10.4	14.1	18.1
EPS growth (%)	*(31.8)*	*80.8*	*35.1*	*28.3*
P/E (x)	43.5	24.1	17.8	13.9
EV/EBITDA (x)	26.3	15.1	11.9	9.7
ROE (%)	12.6	20.7	22.8	24.8



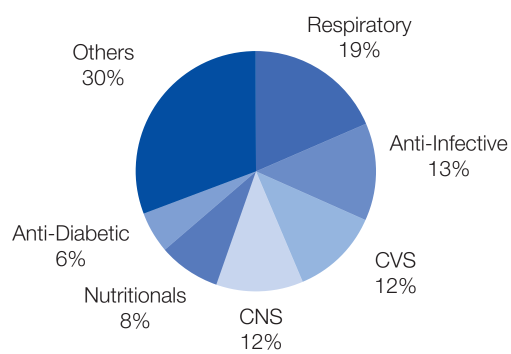
Investment Rationale

Increasing focus on domestic formulations

NPIL ranks amongst the top four companies in the domestic formulations market (domestic formulations contributed 49% to revenues in FY07), deriving 19% revenues from the respiratory segment (driven by *phensedyl*) and 24% from CVS and CNS segments. In the past, the company faced certain issues regarding sale of *phensedyl*, but now it has successfully overcome these challenges and is planning new initiatives.

As of now, NPIL is present in only 40% molecules in the market, but it intends to expand its presence significantly with new product launches. Currently, the company has ~2,600 medical representatives in its 12 divisions.

Chart 1: Therapeutic breakup



Source: Company

We believe NPIL is among the major branded companies to have identified the huge potential of the largely un-tapped semi-urban and rural markets. It has recently announced a new initiative to target the mass market with a focus on general practitioners. Focus therapy areas will be anti-infective, pain, anti-fungal, and cough and cold segments. It has already launched operations in 12 states with a field force of 400 people, covering 50,000 general practitioners. The company has a target to take this number to 800 people in a year's time. This could be one of the most important strategies undertaken by NPIL, since mass market is considered to have immense growth potential and is estimated to grow at a much higher rate than the industry average. The company is investing ~INR 250 – 300 mn in FY07E towards this initiative. Though such an investment is expected to affect the company's profitability marginally in the near term, it will fuel the company's growth in the long run.

NPIL has also entered into several marketing tie-ups with some of the major international pharmaceutical companies. We believe this type of in-licensing strategy would be crucial for almost all the domestic pharma companies, especially post product patent regime. Some of NPIL's marketing tie-ups are listed below:

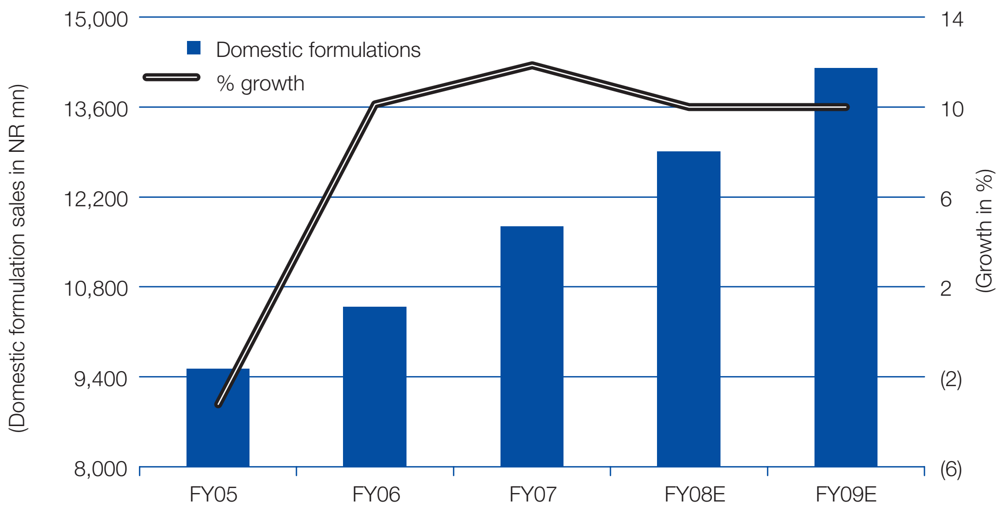
Table 1: Marketing tie-ups

Sr. No.		Partner	Product	Therapeutic Area
1	Chiese Farmaceutici	Curosurf	Boitech- Lung surfactant	Nov-03
2	Biogen Idec	Avonex	Boitech- multiple sclerosis	Nov-03
3	Pierre Fabre	Various products	Dermatology	
4	Genzyme Corporation	*Synvisc Viscose supplementation*	*Osteoarthritis*	*Aug-04*
5	*Ethypharm*	*Technology for paracetamol flash tablets*	*Pain relief/Pediatric*	*Aug-04*
6	*Eli Lilly**	*Dobutrex*	*CVS*	*Jul-04*

Source: Company, Edelweiss research ** Brand acquisition*

We believe, the company will be able to deliver a CAGR of 10% in domestic formulations from FY07-FY09E, primarily because of (1) new product introductions across categories, (2) improved penetration through the mass market initiatives, and (3) in-licensing agreements with MNCs.

Chart 2: Growth in domestic formulations



Source: Company, Edelweiss research

Avecia and Morpeth - Inorganic growth paying off

NPIL has become one of the top 10 custom manufacturing players in the world with revenues of more than USD 200 mn, primarily achieved through acquisitions of Avecia and Morpeth. Avecia acquisition was NPIL's first major acquisition in the contract manufacturing space and gave the company necessary scale and base to move up the value chain in the CRAMS space. This acquisition also provided NPIL some high technology platforms, which the company will use to provide value-added services to the innovators.

When NPIL acquired Avecia in October 2005, it had revenues of about GBP 54 mn and EBITDA losses of 12%. NPIL however intends to turnaround Avecia in the near term and is undertaking several projects to scale up commercialisation in this acquired entity, to absorb overheads. The company is also considering to source raw materials from India and trying to move manufacturing of low-end intermediates to the country. We believe, all these initiatives will ensure better profitability for Avecia, going forward. Though Avecia has just turned around in4QFY07, it is expected to begin contributing to NPIL's profits FY08E onwards.

NPIL acquired the UK-based Morepath, Pfizer's manufacturing facility, in June 2006. This acquisition has been extremely profitable, making NPIL the largest custom manufacturer for Pfizer. Morpeth is a sourcing hub for certain Pfizer products to the US, EU, and Japan. At the time of this acquisition, NPIL entered into a supply agreement with Pfizer till 2011, which could add up to total revenues of ~USD 350 mn. From this facility, Pfizer has already launched four patented products since 2000. This facility is currently working at capacity utilisation of ~50%. Since NPIL could also use this facility for contracts from other innovators, we believe there is scope for significant margin improvement. Morepath acquisition not only offers NPIL an opportunity to ramp up its business, but also proves the company's credentials of successfully working with major global innovator companies. We believe this acquisition has also helped NPIL to neutralise the impact from the loss-making Avecia.

Both these acquisitions offer NPIL scope of cross-selling various contract manufacturing services to other customers. We believe there is an immediate opportunity of winning contracts from Avecia's customers for the Morpeth facility. There is also a strong likelihood of Avecia's current customers offering low-end manufacturing contracts to NPIL's India facility.

Further, NPIL has already taken approval from its board to raise USD 1.5 bn for further acquisitions in the international markets, clearly signifying its keen interest in pursuing inorganic growth. The company has set itself a target of achieving revenues of USD 500 mn from CRAMS by 2010. We believe these inorganic opportunities could give NPIL significant upsides, going forward.

Contract manufacturing from Indian business – Revenues beginning to flow in

In FY06, there were some delays in revenue flow from few India-based CRAMS deals. Now, the company is however back on track and has begun receiving revenues from the AMO deal for ophthalmic solution FY06 onwards. This contract has potential to yield revenues of ~USD 15 mn by FY07E. Additionally, the Allergan deal for two APIs (*Levebunolol* and *Brimonidine*) has also started contributing to the overall revenues. The revenues from the fortune 500 contract are also expected to start contributing significantly to NPIL's total revenues from 1QFY08. (The company has guided for peak revenues of USD 30 mn from both these contracts)

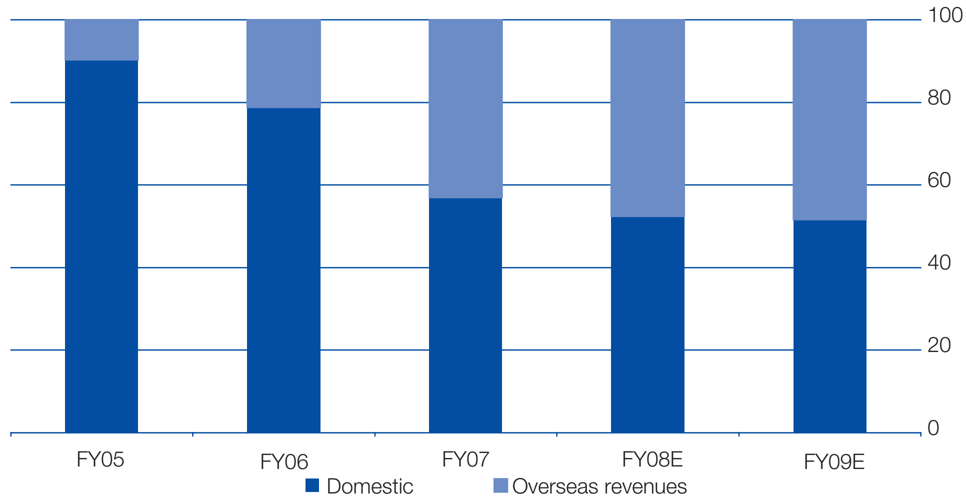
NPIL has recently entered into a deal with Eli Lilly for clinical development of one of Lilly's NCE. NPIL would develop the compound from preclinical stage till completion of Phase II trials and will bear all the developmental costs. In return, NPIL will receive milestone-based payments totaling to USD 100 mn. The company would receive the first milestone in FY09E. We believe this is a major development for NPIL because (1) partnering with a global company will open up avenues for alliances with other global players as well, (2) NPIL will be able to cross-sell its contract manufacturing services to Eli Lilly, and (3) this alliance will help NPIL gain experience in doing clinical development for a big pharma company; such an experience will help NPIL grow up the value chain of drug discovery without any exposure to R&D-related risks.

Such deals confirm our faith that the company is moving in the right direction towards being one of the leading CRAMS players, partnering the innovator at every stage of the product lifecycle. We believe all these initiatives will ensure revenue CAGR of ~27% from CRAMS space from FY07-FY09E.

Financial Outlook

For NPIL, the overseas revenues are expected to post a CAGR of 23% from FY07-FY09E. With domestic formulations growing at CAGR of 10%, the contribution of overseas revenues is expected to go up to 48% by FY09E from ~80% in FY06.

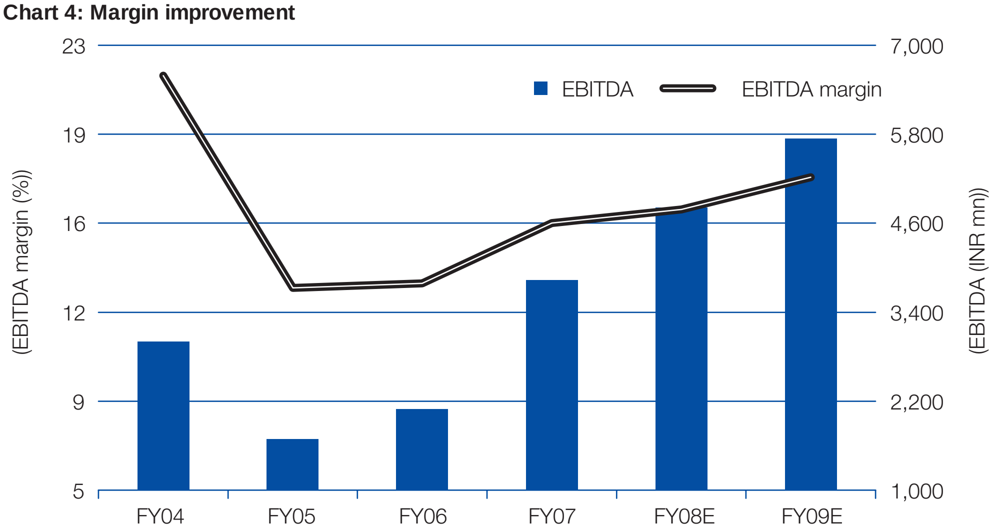
Chart 3: Contribution from overseas revenues



Source: Company, Edelweiss research

An increased contribution from overseas revenues is primarily driven by acquisitions. Since these acquired entities had relatively low margins, NPIL's overall EBITDA margins have declined significantly in FY06. However, as these entities are gradually integrated to the company's business gradually, its margins are estimated to improve from 15.5% in FY07 to ~17.3% in FY09E.

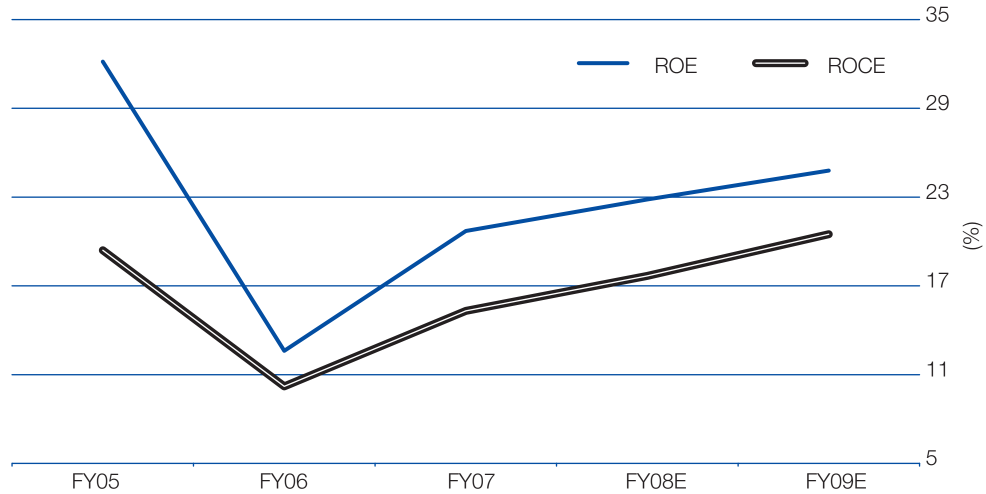
Chart 4: Margin improvement



Source: Company, Edelweiss research

We believe this would directly reflect in much better return ratios for NPIL. The ROEs would improve from 12.6% in FY06 to 24.8% in FY09E and ROCE is expected to improve from 10.2% in FY06 to 20.5% in FY09E.

Chart 5: Improving return ratios



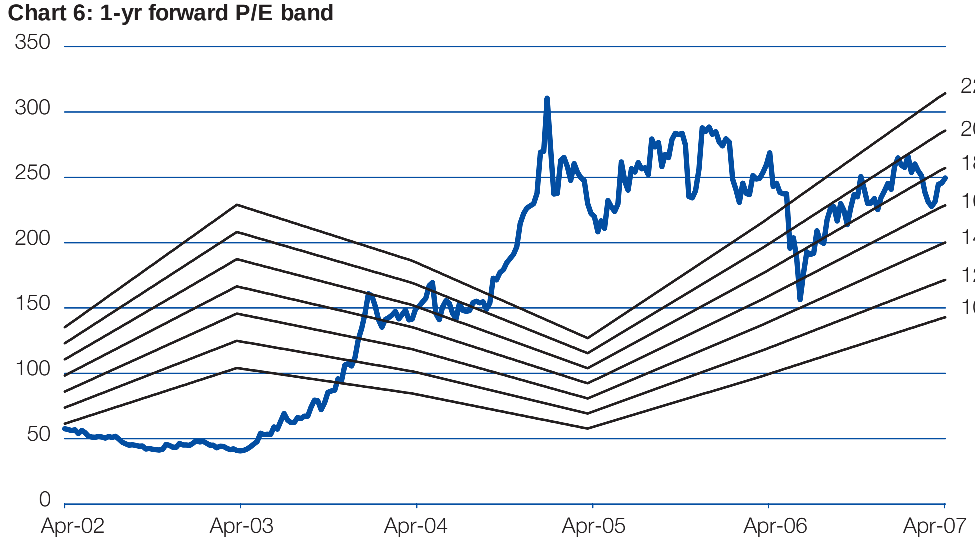
Source: Company, Edelweiss research

Valuations

We believe NPIL's business model has strengthened after the acquisition of Avecia and Morepeth leading to higher probability of its winning new contracts. Its deal with Eli Lilly reinforces its strategy of partnering the innovator at every stage of product lifecycle. In addition, the initiative on the domestic formulations is a welcome development. We are increasing our EPS estimate for FY09E by 8%. Because of its improved strategic positioning in CRAMS, there is a strong chance of Nicholas Piramal earning expanded contracts from existing customers of Avecia. Thus, there is a strong possibility of NPIL beating our current estimates that are based on the existing contracts only.

At CMP of 251 the stock trades at 17.8x and 13.8x FY08E and FY09E earnings respectively. On EV/EBITDA basis the stock is trading at 11.4x and 9.1x its FY08E and FY09E estimates respectively. We believe at these levels the stock is attractively priced.We thus retain our **'BUY'** recommendation.

Chart 6: 1-yr forward P/E band



Source: Edelweiss research

Key Risks

Risks to the CRAMS business

The CRAMS business involves long gestation period and potential customers take long time to award contracts. Supplies begin only after 18–24 months of signing the contract.

NPIL has made considerable investments in the CMO business and currently earns revenues of over USD 200 mn from it. Most of the deals are for a period five years or more, renewable there after. We estimate contract manufacturing to contribute 28% of total revenues in FY07. Any termination of contracts, slow down in demand for the product from the customer, or inefficient execution of contracts could result in downside to our estimates.

Government mandated price control: Currently, 74 drugs are under government regulated price control and government is contemplating to expand that list to 356 drugs. While most of the other related ministries have opposed this move, the minister of Chemicals and Fertilizer is in favour of an expanded price cuts. If this happens all the companies with a focus on branded formulations including Nicholas Piramal will be under severe trouble.

Foreign Exchange risk: ~40% of sale is contributed by export sales and appreciation in the Indian Rupee would impact Nicholas Piramal's profitability negatively.

Financial Statements

Income statement (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Income from operations	13,082	15,944	24,719	29,978	33,160
Gross sales	13,723	16,904	25,721	30,606	33,845
Less: Excise	641	960	1,001	628	684
Net sales	13,082	15,944	24,719	29,978	33,160
Other operating income	-	-	-	1	-
Total operating expenses	11,388	13,849	20,885	25,170	27,420
Materials cost	5,588	6,668	8,791	10,642	11,440
Employee cost	1,549	1,928	4,200	5,040	5,544
R&D cost	495	775	1,265	1,700	2,040
Other expenses	3,755	4,477	6,629	7,788	8,396
EBITDA	1,694	2,096	3,835	4,807	5,740
Other income	334	249	4	-	-
Depreciation and amortisation	524	688	818	928	1,006
Interest	192	173	305	371	242
Extraordinary items [expenses/(gain)]	(796)	35	145	-	1
Profit before tax	2,108	1,448	2,571	3,508	4,492
Provision for tax	465	238	389	526	674
PAT (inc. exc. & pre min. interests)	1,643	1,210	2,182	2,982	3,818
Minority interest & others	3	4	1	3	4
Pre. dividend, including tax thereon	32	-	-	32	33
PAT (inc. exc.) for eq. shareholders	1,608	1,206	2,181	2,947	3,780
PAT (inc. exc.) for equity shareholders	1,608	1,206	2,181	2,947	3,780
Shares outstanding (mn)	190.0	209.0	209.0	209.0	209.0
Dividend per share (INR)	3.0	3.0	3.5	4.5	6.0

Common size metrics as % of net revenues

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Material cost	42.7	41.8	35.6	35.5	34.5
Employee cost	11.8	12.1	17.0	16.8	16.7
Other expenses	28.7	28.1	26.8	26.0	25.3
Depreciation	4.0	4.3	3.3	3.1	3.0
Interest expenditure	1.5	1.1	1.2	1.2	0.7
EBITDA margins	12.9	13.1	15.5	16.0	17.3
Net profit margins	12.3	7.6	9.2	9.8	11.4

Growth metrics (%)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Revenues	(7.3)	21.9	55.0	21.3	10.6
EBITDA	(43.7)	23.7	83.0	25.4	19.4
Net profit	(18.7)	(25.0)	89.2	29.1	28.3
EPS	(18.7)	(31.8)	80.8	35.1	28.3

Balance sheet (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Shareholders funds	5,533	10,144	11,477	13,353	15,704
Capital (incl. equity and pr. capital)	914	952	836	836	836
Reserves & surplus	4,620	9,192	10,642	12,518	14,869
Borrowings	3,680	3,114	4,951	4,951	3,451
Secured loans	3,095	2,718	4,554	4,554	3,054
Unsecured loans	585	397	397	397	397
Deferred tax liability (net)	596	836	932	932	932
Minority interest	41	30			
Sources of funds	**9,850**	**14,124**	**17,360**	**19,235**	**20,086**
Gross block	8,026	12,601	15,701	17,801	19,301
Depreciation	1,799	3,951	4,769	5,697	6,702
Net block	6,227	8,650	10,932	12,104	12,598
Capital work in progress	1,052	1,768	1,768	1,768	1,768
Investments	37	287	287	287	287
Inventories	2,705	2,812	4,510	5,368	5,936
Sundry debtors	1,460	2,429	3,735	4,444	4,914
Cash and bank balances	155	922	107	570	791
Loans and advances	1,272	1,535	1,535	1,535	1,535
Other current assets	63	67	67	67	67
Total current assets	5,656	7,764	9,953	11,984	13,243
Current liabilities	2,317	3,310	4,360	5,277	5,673
Provisions	804	1,035	1,223	1,631	2,137
Total current liabilities and provisions	3,121	4,345	5,582	6,908	7,810
Net current assets	2,535	3,419	4,371	5,076	5,433
Uses of funds	**9,850**	**14,124**	**17,357**	**19,235**	**20,086**
Book value per share (INR)	29	49	54	67	68

Cash flow statement (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Cash flow from operations	2,674	1,952	3,080	4,045	4,967
Cash for working capital	(79)	(408)	(1,954)	(648)	(642)
Net operating fash flow	2,595	1,544	1,127	3,397	4,325
Net purchase of fixed assets	(1,959)	(2,214)	(3,100)	(2,100)	(1,500)
Net purchase of investments	20	(297)	96	-	-
Net cash flow from investing	(1,940)	(2,511)	(3,004)	(2,100)	(1,500)
Proceeds from equity capital	(671)	2596.9	(743)	(834)	(1,104)
Proceeds from LTB/STB	(83)	(863)	1,806	-	(1,500)
Net cash flow from financing	(754)	1,734	1,063	(834)	(2,604)
Free cash flow	**656**	**(967)**	**(1,877)**	**1,297**	**2,825**

Ratios

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
ROE (%)	32.2	12.6	20.7	22.8	24.8
ROCE (%)	19.4	10.2	15.3	17.7	20.5
Inventory days	74	64	64	64	64
Debtors days	40	55	53	53	53
Fixed assets T/o (x)	1.8	1.5	1.7	1.8	1.8
Debt/equity	0.8	0.4	0.5	0.4	0.3

Valuation parameters

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
EPS, inc. exceptionals (INR)	8.5	5.8	10.4	14.1	18.1
Y-o-Y growth (%)	*(18.7)*	*(31.8)*	*80.8*	*35.1*	*28.3*
CEPS (INR)	11.2	9.1	14.3	18.5	22.9
P/E (x)	29.7	43.5	24.1	17.8	13.9
Price/BV(x)	8.6	5.2	4.6	3.8	3.7
EV/Sales (x)	4.0	3.5	2.3	1.9	1.7
EV/EBITDA (x)	30.5	26.3	15.1	11.9	9.7

India Equity Research | Pharmaceuticals | Company update

SUN PHARMACEUTICALS INDUSTRIES

INR 1,038

Edelweiss
Ideas create, values protect

Consistent performer

ACCUMULATE

April 27, 2007

Nimish Mehta
+91-22-2286 4295
nimish.mehta@edelcap.com

Amod Karanjikar
+91-22-2286 4429
amod,karanjikar@edelcap.com

Domestic formulations: High growth phase

Domestic formulations, which contribute ~ 51% to Sun Pharma's (Sun) total revenues, have grown robustly at a CAGR of ~ 29% over FY04-06. This was primarily driven by significant presence (~47% revenues from CVS and CNS) in high growth lifestyle related products. We believe continued focus on these lifestyle related products and new product introductions will ensure a CAGR of 15% over FY07E-09E in this segment.

US generics: Impressive ramp up

Sun's US generics business is expected to contribute ~ 24% of revenues in FY07E. Sun, along with Caraco, has ramped up the US business significantly, which is evident from the fact that pending ANDA approvals have increased from 26 in Q306 to 61 in Q307. Sun's revenues from US generics have steadily increased at a CAGR of 28% over FY04-06. We are increasing our revenue estimates for FY08 and FY09 by 13% and 15%, respectively. With an increased filing pace and Caraco's tie ups with other companies, we believe US generics is likely to have a CAGR of 31% over FY06-09E.

Demerger of R&D entity: Margin accretive

The company has announced demerger of its R&D entity Sun Pharmaceuticals Advanced Research Centre (SPARC) and it will be listed separately on exchanges. This entity includes all the IP assets of the innovative R&D within Sun Pharma. We have valued this entity at INR 43.1. We believe this step will be margin accretive for Sun Pharma and once this entity gets listed, we believe the unlocking of this value will be a positive trigger for the stock.

Financial outlook and valuations

Sun has managed to maintain high EBITDA margins (30% plus) in competitive markets over the past few years. We believe the company will be able to maintain similar margins going forward (helped by reduction in R&D costs). The ROCEs are expected to go up from 15.3% in FY06 to 21.4% in FY09E. We are increasing our EPS estimates for FY08 and FY09 by 14% and 23%, respectively (On account of higher US revenues, higher other income & reduction in R&D costs). We expect the EPS to grow at a CAGR of 21.5% over FY07E-09E. At the CMP of INR 1,038 the stock trades at 24.6x and 20.0x its FY08 and FY09 estimates, respectively. We maintain our **'ACCUMULATE'** recommendation.

Financials

Year to March	FY06	FY07E	FY08E	FY09E
Revenues (INR mn)	16,380	20,849	24,568	29,043
Rev growth (%)	*38.0*	*27.3*	*17.8*	*18.2*
EBITDA (INR mn)	4,917	6,835	8,687	10,436
Net profit (INR mn)	5,733	7,288	8,744	10,775
Shares outstanding (mn)	185.7	207.3	207.3	207.3
EPS (INR)	30.9	35.1	42.2	52.0
EPS growth (%)	*44.5*	*13.9*	*20.0*	*23.2*
P/E (x)	33.6	29.5	24.6	20.0
EV/EBITDA (x)	39.9	28.8	21.8	17.4
ROE (%)	42.1	27.3	21.3	21.9

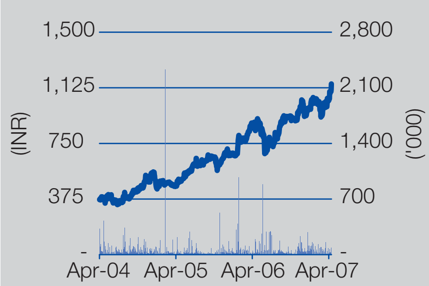
Reuters	:	SUN.BO
Bloomberg	:	SUNP IN

Market Data

52-week range (INR)	:	1,115 / 640
Share in issue (mn)	:	186.7
M cap (INR bn/USD mn)	:	193.8/4,727.9
Avg. Daily Vol. BSE/NSE ('000)	:	231.5

Share Holding Pattern (%)

Promoters	:	69.6
MFs, FIs & Banks	:	3.9
FIIs	:	16.0
Others	:	10.5

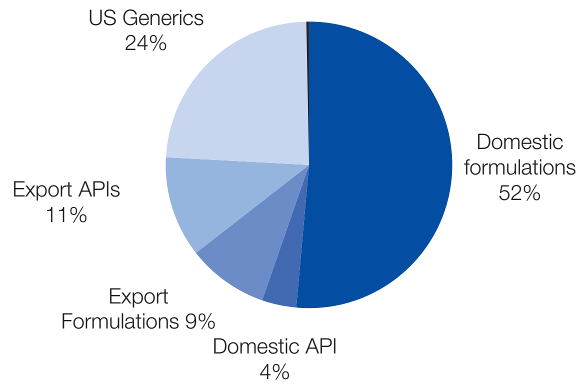


Investment Rationale

Domestic formulations: High growth phase

Domestic formulations, which contribute ~ 51% to Sun's total revenues, have grown robustly at a CAGR of ~ 29% over FY04-06.

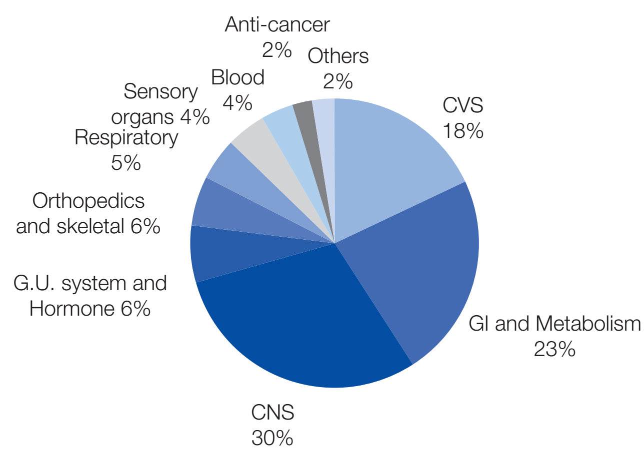
Chart 1: Revenue break up for FY07E



Source: Edelweiss research

The company focuses on lifestyle related disease like CVS, CNS, GI, and metabolism, which have consistently had a higher growth rate than the total domestic formulations market.

Chart 2: Therapeutic breakup

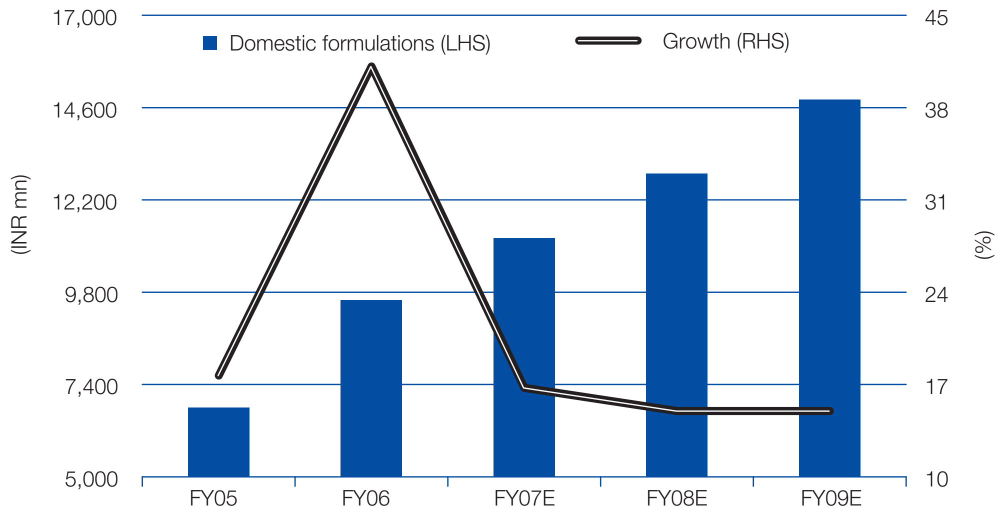


Source: Company

Sun is ranked amongst the top 3 in the seven of the 12 therapeutic segments. The company has a field force of ~2,000 across 17 different divisions. The company has introduced 32 new products during FY06 and it plans to focus on new product introductions and therapeutic areas by introducing newer divisions. One of the key differentiators for Sun has been the introduction of difficult to manufacture or new drug delivery systems based products in the market. In FY06, 11 such products were introduced in the market. The company has launched these novel products in semi-regulated markets and has plans to introduce them in US markets over the next two-three years.

We believe the company will be able to deliver a CAGR of 15% over FY07E-09E in domestic formulations. This primarily will be driven by: (1) increased focus in lifestyle related disease; (2) new product introductions; and (3) better focus on new segments by introducing newer divisions.

Chart 3: Sustainable growth in domestic formulations

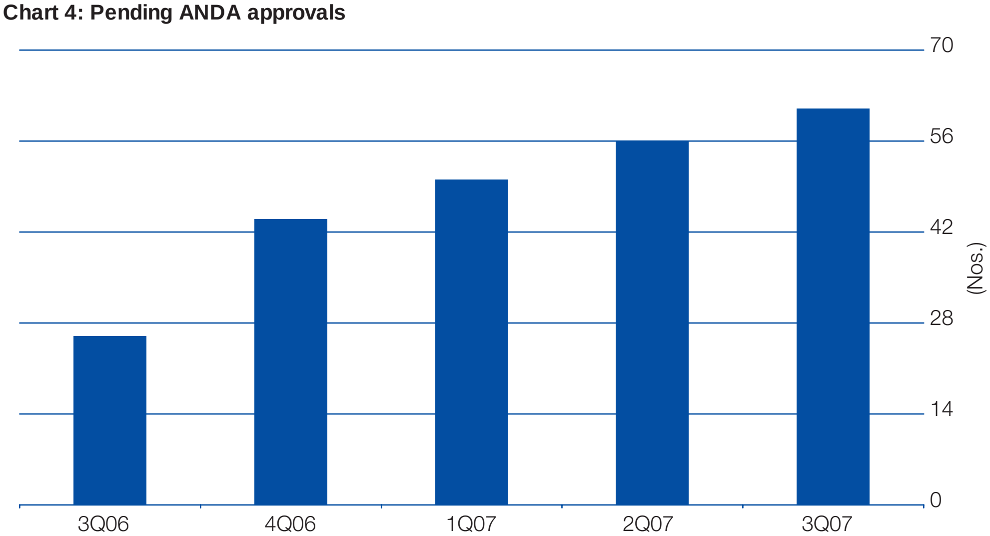


Source: Company, Edelweiss research

US generics: Impressive ramp up

Sun, along with Caraco, has been aggressive in its US generics business. This business has grown at a CAGR of 28% over FY04-06, driven by new product launches and addition of new customers. The company has had impressive ramp up in filings in the US, which is evident from the fact that the number of ANDAs awaiting approval have increased from 26 in 3Q06 to 61 in 3Q07. As of 3Q07, Sun has 31 approvals and seven tentative approvals.

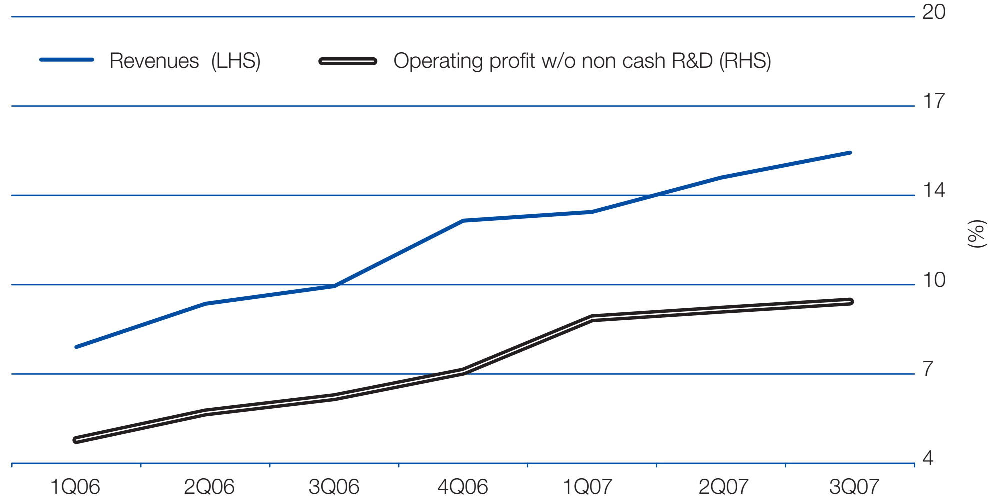
Chart 4: Pending ANDA approvals



Source: Company

The growth in US revenues has been consistent over the past few quarters. We believe this business is more profitable than for some of its competitors as is visible from its gross margins which have averaged at above 50% over the previous two years.

Chart 5: Consistent growth in US market



Source: Company

Sun also had first of its Para IV wins in the case of Ultracet in December 2005. In other Para IV challenges, the company has received tentative approvals for Amifostine (brand - Ethyol, innovator – Medimmune, branded revenues – USD 95 mn) and Rivastigmine (brand - Exelon, innovator – Novartis, branded revenues – USD 175 mn). The 30 month stay has already expired in both the cases. We believe such opportunities will be recurring in nature for Sun and there could be some upsides from these opportunities for the company in the future.

We believe all these initiatives will lead to a CAGR of 26.4% over FY07E-09E in the US generics market. This will be driven by increased product launches and rising customer base.

Demerger of R&D entity: Margin accretive

Sun has recently announced its NCE and NDDS pipeline in the R&D entity SPARC. This entity will be separately listed by June 2007. We have valued this demerged entity in our report *"A specialty company at best"* dated March 23, 2007, at INR 43.1. The company has stated that it will disclose some more details about the financials of SPARC just before listing. We believe this demerger will help in reducing the R&D costs for Sun Pharma and transfer R&D upside possibilities to SPARC. We believe SPARC will have significant triggers based on news flow related to out-licensing deals.

Financial Outlook

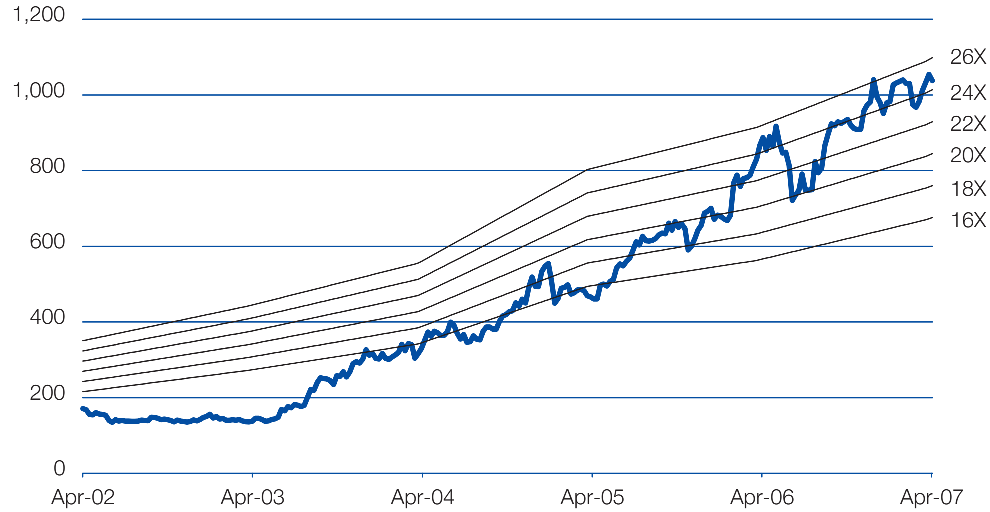
Sun has the best margins in the industry and we believe the company will be able to maintain this high profitability going forward. Margins are expected to improve primarily on account of reduction in R&D costs (due to spin off of SPARC) from 30% in FY06 to ~ 35% in FY09E. On account of better profitability, the ROCEs are expected to increase from 16.6% in FY06 to 21.2% in FY09E.

Revenues are expected to grow at a CAGR of 18% from FY07E-09E; PAT is expected to have a CAGR of ~21% from FY07E-09E. The company has ~ USD 500 mn cash on its books, which could be used for acquisitions.

Valuations

Historically, Sun has always traded at significant premium to the sector. We expect this premium to continue due to high contribution form branded business, higher profitable growth in US markets resulting in high EBITDA margins. At CMP of INR 1,038, the stock is trading at P/E of 24.6x and 20.0x FY08E and FY09E earnings, respectively. On EV/EBITDA basis, it is trading at 21.8x and 17.4x its FY08E and FY09E, respectively. We maintain our **'ACCUMULATE'** recommendation on the stock.

Chart 6: 1-yr forward P/E band



Source: Edelweiss research

Key Risks

Government mandated price control: Currently, 74 drugs are under government regulated price control and the government is contemplating expanding that list to 356 drugs. While most of the other related ministries have opposed this move, the minister of chemicals and fertilizers is in favour of expanded price cuts. If this happens, all the companies with a focus on branded formulations, including Sun, will be in trouble.

Foreign exchange risk: ~40% of Sun's sales are contributed by exports and appreciation in the Indian rupee will impact Sun's profitability negatively.

Severe price erosion in the US generics market: Caraco contributes 24% of total sales of Sun Pharma. The continuing pricing pressure in the US generics market exposes Caraco to that risk. While we have assumed conservative estimates, a worse-than-expected pricing scenario may put our estimates at risk.

Integration of acquired companies: Non-profitable acquisitions going forward and integration problems of acquired assets could have a negative impact on the company's balance sheet.

Financial Statements

Income statement (INR mn)

Year to March	FY04	FY05	FY06E	FY07E	FY08E
Income from operations	11,868	16,380	20,849	24,568	29,043
Gross sales	12,744	17,372	21,806	26,014	30,692
Less: Excise	891	1,003	957	1,445	1,648
Net sales	11,853	16,368	20,849	24,568	29,043
Total operating expenses	7,686	11,463	14,014	15,881	18,607
Materials cost	3,642	5,295	6,542	7,440	8,821
Employee cost	888	1,416	2,547	2,929	3,369
R&D cost	1,009	1,534	2,482	2,457	2,904
Other expenses	2,147	3,218	2,444	3,055	3,513
EBITDA	4,182	4,917	6,835	8,687	10,436
Other income	433	1,662	1,811	2,094	2,530
Depreciation and amortisation	406	610	833	945	992
Profit before tax	4,209	5,969	7,813	9,836	11,974
Provision for tax	205	239	(49)	492	599
PAT (post exc. & pre min. interests)	4,004	5,730	7,862	9,344	11,375
Minority interest & others	42	(3)	574	600	600
PAT (post exc.) for eq. shareholders	3,962	5,733	7,288	8,744	10,775

Common size metrics as % of net revenues

Year to March	FY04	FY05	FY06E	FY07E	FY08E
Material cost	30.7	32.3	31.4	30.3	30.4
Employee cost	7.5	8.6	12.2	11.9	11.6
Other expenses	18.1	19.6	11.7	12.4	12.1
Depreciation	3.4	3.7	4.0	3.8	3.4
EBITDA margins	35.2	30.0	32.8	35.4	35.9
Net profit margins	33.4	35.0	35.0	35.6	37.1

Growth metrics (%)

Year to March	FY04	FY05	FY06E	FY07E	FY08E
Revenues	(2.1)	38.0	27.3	17.8	18.2
EBITDA	(32.8)	17.6	39.0	27.1	20.1
Net profit	(28.8)	44.7	27.1	20.0	23.2
EPS	(64.4)	44.5	13.9	20.0	23.2

Cash flow statement (INR mn)

Year to March	FY04	FY05	FY06E	FY07E	FY08E
Cash flow from operations	4,233	5,029	8,578	10,830	12,474
Cash for working capital	(658)	(2,146)	480	(1,012)	(1,323)
Net operating cash flow	3,575	2,883	9,058	9,818	11,151
Net purchase of fixed assets	(1,623)	(3,387)	(1,000)	(692)	(727)
Net purchase of investments	(4,729)	4,166	-	-	-
Net cash flow from investing	(6,352)	779	(1,000)	(692)	(727)
Proceeds from equity capital	(141)	(793)	14,586	(1,378)	(1,590)
Proceeds from LTB/STB	13,781	645	(15,753)	(1,000)	(1,000)
Net cash flow from financing	13,640	(148)	(1,166)	(2,378)	(2,590)
Free cash flow	1,952	(504)	8,058	9,126	10,424

Balance sheet (INR mn)

Year to March	FY04	FY05	FY06E	FY07E	FY08E
Shareholders funds	11,307	15,902	37,564	44,718	53,691
Capital	942	943	1,051	1,051	1,051
Reserves & surplus	10,366	14,959	36,513	43,667	52,640
Borrowings	18,230	18,745	2,992	1,992	992
Secured loans	217	356	356	356	356
Unsecured loans	18,014	18,389	2,636	1,636	636
Deferred tax liability (net)	896	1,053	1,053	1,053	1,053
Minority interest	161	332	332	332	332
Sources of funds	**30,595**	**36,031**	**41,941**	**48,095**	**56,068**
Gross block	9,344	12,849	13,849	14,541	15,268
Depreciation	2,087	3,779	4,612	5,558	6,550
Net block	7,257	9,070	9,236	8,984	8,718
Capital work in progress	493	414	414	414	414
Investments	6,485	3,541	3,541	3,541	3,541
Inventories	3,173	5,117	5,121	5,824	6,905
Sundry debtors	2,511	3,609	3,894	4,589	5,425
Cash and bank balances	11,809	15,323	21,640	27,788	35,023
Loans and advances	1,392	2,237	2,237	2,237	2,237
Other current assets	62	234			
Total current assets	18,946	26,520	32,893	40,439	49,590
Current liabilities	1,741	2,279	2,814	3,200	3,794
Provisions	845	1,236	1,329	2,082	2,401
Total current liabilities and provisions	2,587	3,515	4,143	5,282	6,195
Net current assets	16,360	23,006	28,750	35,156	43,395
Uses of funds	**30,595**	**36,031**	**41,941**	**48,095**	**56,068**
Book value per share (BV)(INR)	61	86	181	216	259

Ratios

Year to March	FY04	FY05	FY06E	FY07E	FY08E
ROE (%)	40.7	42.1	27.3	21.3	21.9
ROCE (%)	12.6	15.3	17.4	18.9	21.4
Inventory days	286	286	286	286	286
Debtors days	73	68	68	68	68
Fixed assets T/o (x)	1.4	1.5	1.6	1.7	1.9
Debt/equity	1.6	1.2	0.1	0.0	0.0

Valuation parameters

Year to March	FY04	FY05	FY06E	FY07E	FY08E
EPS, post exeptionals (INR)	21.4	30.9	35.1	42.2	52.0
Y-o-Y growth (%)	*(64.4)*	*44.5*	*13.9*	*20.0*	*23.2*
CEPS (INR)	23.5	34.2	39.2	46.7	56.8
P/E (x)	48.6	33.6	29.5	24.6	20.0
Price/BV(x)	17.0	12.1	5.7	4.8	4.0
EV/Sales (x)	16.8	12.0	9.4	7.7	6.2
EV/EBITDA (x)	47.6	39.9	28.8	21.8	17.4

TORRENT PHARMACEUTICALS

INR 196

Turning around

BUY

Edelweiss
Ideas create, values protect

Domestic Formulations – Delivering profitable growth

Domestic formulation which constitutes 42% of the total sales (in FY06) has grown by ~47% for 9 months ending Dec 06. We believe this segment can easily grow at a rate of 20% for FY08E and FY09E. This segment is the most profitable business for the company and hence as this segment grows by 20%, Torrent's margins are expected improve.

Heumann acquisition expected to turnaround by FY09E

Torrent acquired Heumann Pharma, - the German generic pharma company of Pfizer, US in June 2005 which is still making losses. The company is in process of transfer of manufacturing of certain products to India as the manufacturing agreement with Pfizer is ending on December 2007. The company has already started the product transfer activity and by beginning of 2008 most of the major products are expected to be transferred to Indian facilities. As a result, the margins are expected to improve and we believe that Heumann pharma will be able to break even by FY09E.

Latin America and Russia & CIS region– consolidating position

Torrent's Brazil and Russian operations were incurring losses till FY06 but in from 3QFY07 these operations have started making significant profits. We believe the company has passed the investment phase in this segment and is expected to deliver much better performance from FY08E onwards. New product introductions and expansion in the neighboring countries is expected to drive ~20% growth for FY08E and FY09E.

Valuation and future outlook

Torrent is well poised to reap benefits from the investments it has made over the past 2 years. We believe so because (1)its acquired business in Germany (Heumann) (contributing ~20% of revenues) is expected to break even by FY09E, (2) the domestic market is expected to show significant growth (~20% for FY08E and FY09E) and (3) the Brazil and Russian operations (Which were making losses till FY06) are expected to show improvement in margins. With these improvements the revenues and PAT are expected to grow by 16% CAGR and 42% CAGR over FY07E-FY09E respectively. At CMP INR 196, the stock trades at a PE of 12.7x and 9.0x on FY08E and FY09E respectively. We belive the stock is attractively priced at these levels. We initiate the coverage with a **'BUY'** recommendation.

Financials

Year to March	FY06	FY07E	FY08E	FY09E
Revenues (INR mn)	9,672	12,587	14,507	16,850
Rev growth (%)	*76.6*	*30.1*	*15.3*	*16.2*
EBITDA (INR mn)	1,080	1,538	2,135	2,829
Net profit (INR mn)	508	903	1,304	1,831
Shares outstanding (mn)	84.6	84.6	84.6	84.6
EPS (INR)	6.0	10.7	15.4	21.6
EPS growth (%)	*4.3*	*77.5*	*44.5*	*40.4*
P/E (x)	32.6	18.3	12.7	9.0
EV/EBITDA (x)	17.0	12.4	8.9	6.7
ROE (%)	15.3	23.8	28.3	31.1

April 27, 2007

Nimish Mehta
+91-22-2286 4295
nimish.mehta@edelcap.com

Amod Karanjikar
+91-22-2286 4429
amod,karanjikar@edelcap.com

Reuters	:	TORP.BO
Bloomberg	:	TRP IN

Market Data

52-week range (INR)	:	337 / 158
Share in issue (mn)	:	21.2
M cap (INR bn/USD mn)	:	4.1 / 101.2
Avg. Daily Vol. BSE/NSE ('000)	:	55.6

Share Holding Pattern (%)

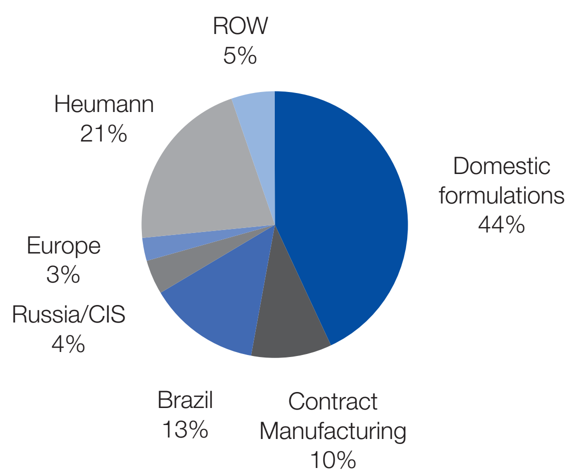
Promoters	:	74.1
MFs, FIs & Banks	:	5.9
FIIs	:	11.8
Others	:	8.2

Investment Rationale

Domestic Formulations – Delivering profitable growth

Domestic branded formulation has been the most important segment for Torrent Pharmaceuticals over the years.It contributed ~ 42% of total revenues FY06.

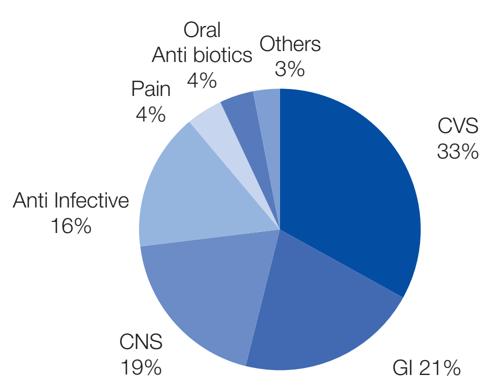
Chart 1: Revenue break-up for FY07E



Source: Company, Edelweiss research

The company focuses on the lifestyle based diseases like CVS and CNS contributing more than 50% of the total domestic formulations revenues, which is growing at much faster rate than the total market.

Chart 2: Therapeutic breakup



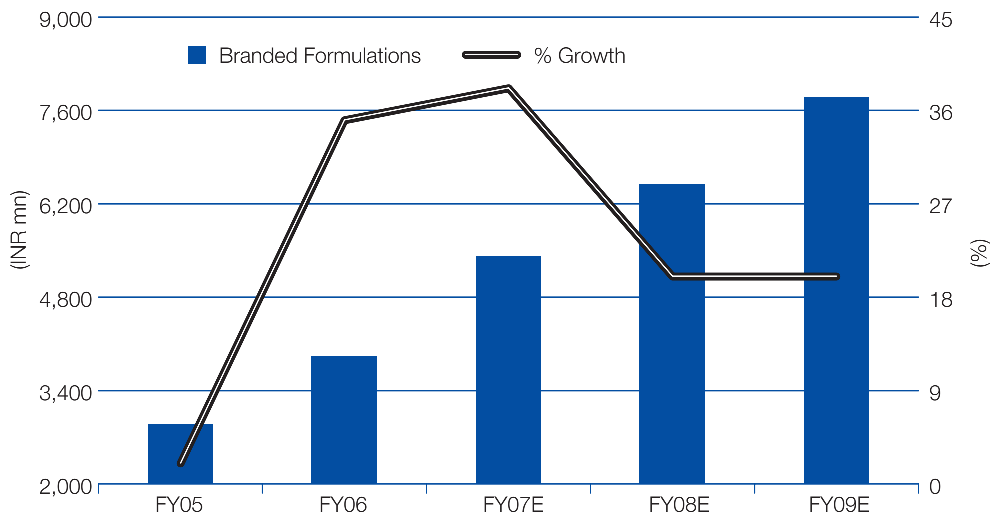
Source: Company

The company decided to expand its field force in 2005 when it was ~1200. Today Torrent's field force stands at 2400 people marketing their products through 11 divisions, 8 focusing on lifestyle products (Omega, Psycan, Delta, Azuca, Mind, Neuron, Axon and Sensa) 2 focusing in acute therapy (Prima and Alfa) and 1 focusing on orthopedic (Vista). These MRs cover ~ 0.2-0.25 mn doctors across the country and they have plans to increase this coverage in the future. (Registered medical practitioners in India are ~ 0.6 mn).The company has also entered in an in-licensing agreement with Tasly from China to exclusively market their traditional Chinese drug, cardio-tonic pill in India. The company is on the look out for similar such tie-ups and would give a major boost to the company's growth especially since the product patent regime is in place in India.

We believe going forward domestic formulations business would grow by 20% primarily driven by (1) new product introductions in lifestyle related diseases, (2) Increased penetration and focus via the newer marketing divisions and (3) marketing tie-ups (in-licensing deals) with some international companies.

On account of the above-mentioned initiatives the contribution from domestic formulations is expected to go up to 46% by FY09E (from 43% in FY06). (This increase would be on account of 20% growth for the next 2 years for domestic formulations, and other segments growing by 11.7% and 13% for FY08E and Fy09E respectively). The domestic business has grown by 17.3% CAGR over FY04-FY06. In FY07E this rate is expected to more than double to ~ 38.2%. Over FY07E-FY09E, this segment is expected to grow at a CAGR of 20%.

Chart 3: Branded formulations



Source: Company, Edelweiss research

Increased contribution from domestic formulations is expected to improve the margins for Torrent as well, since branded business is the most profitable for the company. As on FY07E domestic formulations is expected to contribute ~ 109% of the company's operating profit (Other segments are loss making). Even as the other segments start making profits, domestic formulations will still contribute ~ 76% of EBIT in FY09E.

Heumann acquisition expected to turnaround by FY09E

Torrent acquired Heumann Pharma in June 2005. It was Pfizer Group Company based in Germany, engaged in marketing of generics in Germany. When it was acquired the company had revenues of EUR 50 mn (USD 65 mn) per year but it was making losses. The company has ~ 130 products in the market.

Heumann was having EBIT margin of ~ -2% in FY06, but it the losses have gone up to -10% in 9 months FY07. (In 3Q07 EBIT margin was -7%). The main reason for these increased losses was that the German generic market has been under severe pressure and it has already faced price reduction of over 25% in the last 12 months. This has accentuated the losses in Heumann Pharma.

While we expect Heumann to continue facing pricing pressure, break even will be achieved by shifting production base to India. Currently Heumann is sourcing products from Pfizer's plant (earlier a part of Heumann) as per their initial agreement that will end in Dec 2007.

This will help Torrent to transfer manufacturing most of its important products to India by 2008.This is expected to improve the margins significantly for Torrent. The company has target of transferring products which contribute ~40%-45% of revenues to India by 2008 which would save ~ 3%-6% of margin on EBIT level. The company is also looking at introducing some new products in the German market in future. We believe these initiatives will ensure that the company's German operations would break-even by FY09E.

Latin America and Russia & CIS region– consolidating position

Torrent has ~ 20 products in the Brazilian market as of now. The company plans to introduce 4-6 new products every year. The company has a field force of ~ 225 in Brazil.

Until FY06, Torrent was expanding its reach across Brazil and thus was incurring upfront expenditure on incremental sales force. This resulted in Torrent incurring operational losses in Brazil. Now as Torrent has covered all the regions of Brazil, its operational performance too has improved in FY07.

Moreover, for Torrent the gross margin is much better in Brazil than in India, but the marketing costs are much higher. With increased number of products and revenues, the high operating leverage could kick in giving the company higher EBITDA margin as well.

The Brazilian operations which contribute ~ 13% of revenues have been making losses till FY06 (EBIT loss of ~ 2%).With these newer products introduced the margins have improved and it has touched 4% on EBIT level for 9 months FY07 (17% EBIT margin in 3Q07). The company plans to expand the geographies to Mexico and other LatAm countries. We believe this geographical expansion and general good economic growth in Brazil will help this segment to grow by 20% in the next 2 years.

Even in the Russian market the company has grown significantly over the past two years. It was making losses but in 3Q07 the company has made significant profits. We believe that the company would start making significant profits from FY08E onwards in this region. In Russia and CIS countries Torrent has entered in tie-up with Dr. Reddy's (DRL) for marketing some of its products. It has recently entered in an agreement with DRL to exclusively commercialize two products Listril and Listril plus (Both CVS products) in Russia and other CIS countries. Earlier the two companies had entered in a similar agreement for "Domstal O" (In GI segment). We believe that Torrent would be able to gain significant advantage from DRL's marketing presence in Russia. We believe that Torrent would be able to achieve 20% growth in the next two years driven by new product introductions and good economic growth (as these economies are based on Oil and Gas) in the Russian economy.

Other geographies performing steadily

Europe (excluding Heumann) contributes ~3% of sales. In FY07 there were severe pricing pressures in certain products like Lamotrigine (which contributes more than 50% of European revenues). In addition to this the company did not introduce new products during this year. As a result, this business was making losses in 3Q07. But in FY08E, onwards the company has plans to introduce 3-5 new products and increase the number going forward.

The ROW market is also growing significantly for Torrent showing a growth rate of 30%+ for the last two years. The company is getting aggressive in new product introductions in various countries of South East Asia, Africa, Middle East etc. As a result the costs have gone significantly on account of registrations and new filings. Hence this segment is expected to make some losses. But as the company stabilizes its operations in the next year we expect this geography to start contributing to the profits from FY08E onwards.

In the US market the company has filed 4 ANDAs and 3 DMFs and has plans to file 6-7 ANDAs per year in the next 2-3 years. It has already received approvals for 2 ANDAs already i.e for Sertraline and Metformin. It has not yet decided on it's front end strategy. So we believe, it will take at least 2-3 years before this business stabilizes and starts contributing significantly to the company's profitability.

Research and Development – could provide some upsides

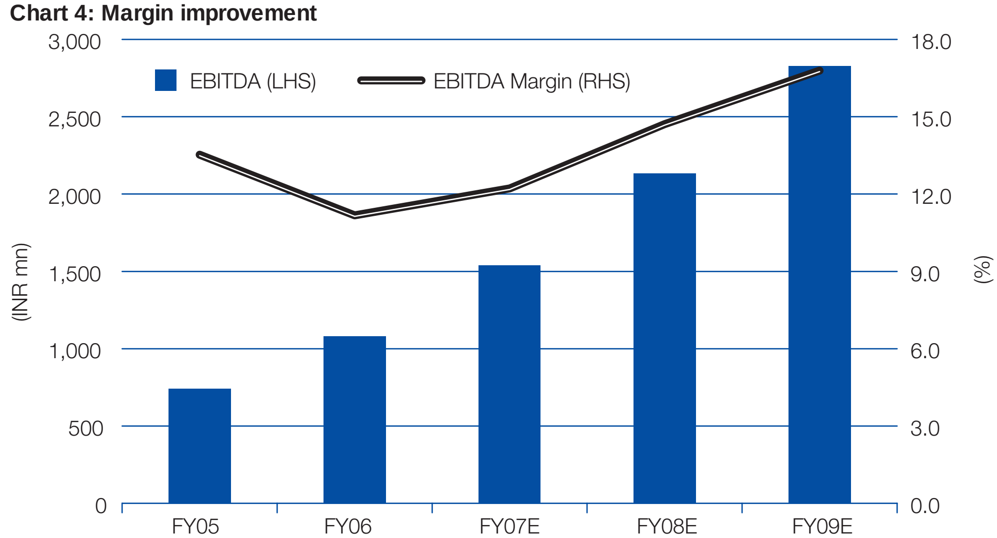
Torrent has a R&D team of about 560 scientists involved in drug discovery and generic research. It has set up an R&D center with an investment of ~ USD 40 mn. Currently it has 7 discovery projects in the pipeline, 3 are in diabetes, 2 in anti-obesity and 1 in CVS and CNS. Torrent has consistently invested in its R&D efforts. It spends ~ 5% of revenues on recurring R&D expenses. The company has had a record of successful tie-ups with global pharma majors.

In 2002 Torrent had entered in an out-licensing deal with Novartis. This deal was for the cardiovascular compound (AGE breaker). This had given Torrent an income of USD 3 mn.But it has been discontinued and even Torrent is not taking that compound forward. In February 2005, Torrent entered into a research collaboration with AstraZeneca for an anti hypertension product which is into preclinical stage right now. Under this agreement, Torrent and AZN will fund the project and success based milestones will be paid to Torrent.

Financial Outlook

Torrent's profitability had taken a major hit after its acquisition of Heumann, (which contributes more than 20% of total revenues) as it was a loss-making unit. Its other businesses like Brazil and Russia were also making losses till 1H07. From 3Q07 onwards all the businesses except Heumann are making significant profits. Transfer of manufacturing of most of the important products to India will improve margins at Heumann as well. As a result we believe there will be significant margins expansion and we expect the EBITDA margins to expand from 11.2% in FY06 to 16.8% in FY09E. In this period we would see revenue CAGR of 15.7% and EBITDA is expected to grow at a CAGR of 35.6%.

Chart 4: Margin improvement

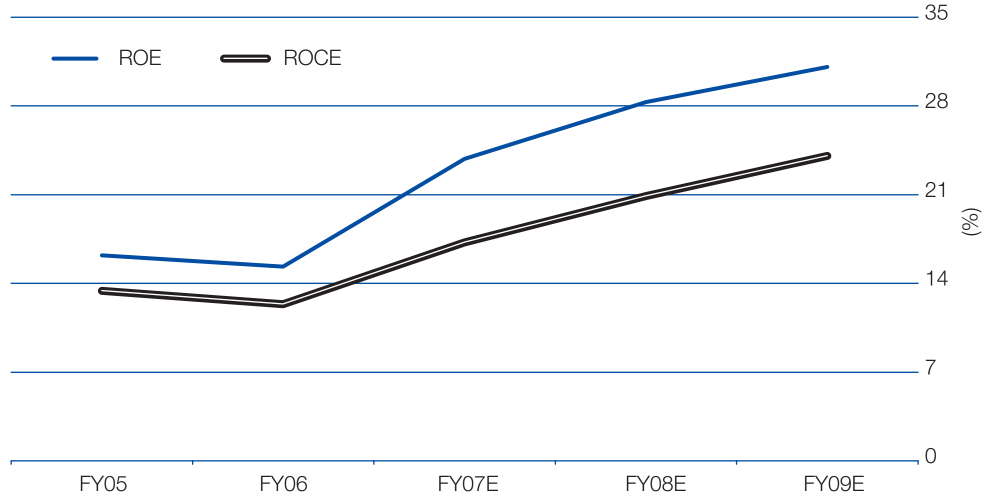


Source: Company, Edelweiss research

The overall profitability for the company is driven by domestic formulation, which is the most profitable business.We believe in FY07E, the domestic formulations will contribute almost 107% of the total EBIT for the company. This contribution is expected to be ~ 75% even in FY09E. This makes us believe that any delay in turnaround time for Heumann or any slight margin reduction in other business is not likely to hit the overall profitability of the company significantly.

On account of this margin expansion we believe that the return ratios would also see a major boost. The ROEs are expected to improve from 15.3% in FY06 to 31% in FY09E and the ROCEs are expected to improve from 12.4% in FY06 to 24.2% in FY09E.

Chart 5: Significant improvement in return ratios

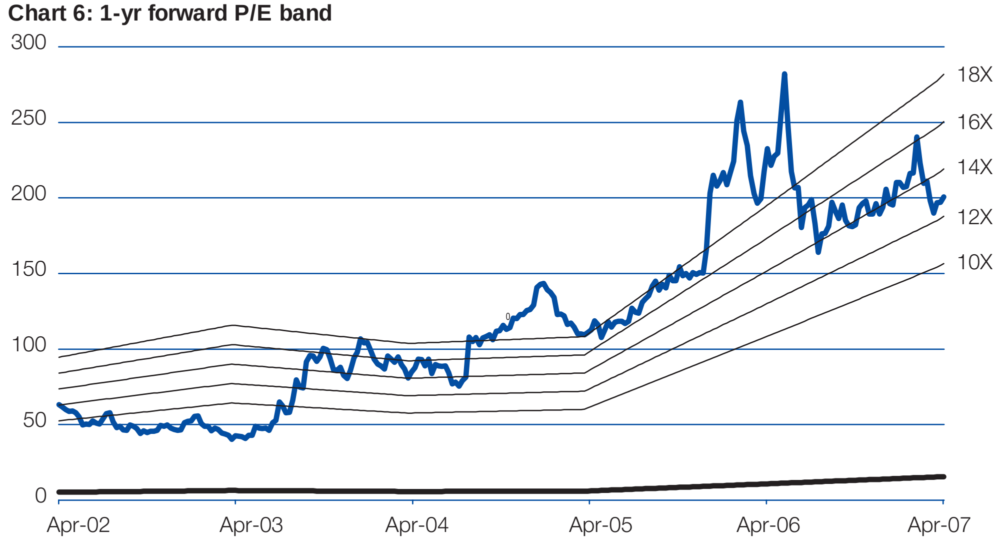


Source: Company, Edelweiss research

Valuation

The stock of Torrent has not performed over the past year. We believe this was primarily on account of the uncertainties related to the German market and execution of strategies to turnaround its loss making subsidiaries. We believe that the company is at an inflection point and most of its investments are set to pay off in the next 2-3 years. This would be visible in the improved profitability and much better return ratios. As a result we could see some significant multiple expansion for the stock. At CMP of INR 196, the stock trades at a PE of 12.7x on FY08E and 9.0x on FY09E earnings. On EV/EBITDA basis it trades at 8.9x and 6.7x on FY08E and FY09E estimates. We believe with visible increased profitability in all its business the stock is attractively priced and we initiate coverage with a **'BUY'** recommendation.

Chart 6: 1-yr forward P/E band



Source: Edelweiss research

Key Risks

Competitive situation in Germany: The German generic market is still in turmoil as further price cuts are likely to be announced. The competitive situation thus remains very uncertain and it is difficult to predict how it will unfold as some of the industry majors continue to cut product prices aggressively. We have estimated a 5% growth in topline for Heumann in FY08E (9 mths FY 07 sales have shown a growth of 12% despite price cuts) which seems conservative. However, if the situation is worse than expected, then it will have risks to our estimates as Heumann contributes ~20% to Torrent's total sales.

Government mandated price control: Currently, 74 drugs are under government regulated price control and government is contemplating to expand that list to 356 drugs. While most of the other related ministries have opposed this move, the minister of Chemicals and Fertilizer is in favour of an expanded price cuts. If this happens all the companies with a focus on branded formulations including Torrent will be under severe trouble.

Foreign Exchange risk: ~47% of sale is contributed by international markets and appreciation in the Indian Rupee would impact Torrent's profitability negatively.

Acquisition of Merck Generics: There are rumors that Torrent might acquire Merck generics. We believe if Torrent invests in this deal, it will be a major challenge for the company to manage its balance sheet and to integrate the acquired assets.

Financial Statements

Income statement (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Income from operations	5,478	9,672	12,587	14,507	16,850
Total operating expenses	4,737	8,591	11,049	12,372	14,021
Materials cost	1,777	3,422	4,377	4,820	5,509
Employee cost	872	1,798	2,337	2,641	2,971
R&D cost	505	564	685	725	843
Selling, admin and general expenses	734	1,319	1,715	2,058	2,305
Other expenses	848	1,488	1,934	2,128	2,393
EBITDA	741	1,080	1,538	2,135	2,829
Depreciation and amortisation	187	255	315	375	432
Interest	27	61	174	238	256
Other income	42	13	13	13	13
Extraordinary items [expenses/(gain)]	-	81	-	-	-
Profit before tax	569	696	1,062	1,534	2,154
Provision for tax	81	188	159	230	323
PAT(inc. exc. & pre min. interests)	488	508	903	1,304	1,831
PAT (inc. exc.) for equity shareholders	488	508	903	1,304	1,831
Shares outstanding	84.6	84.6	84.6	84.6	84.6
Dividend per share	2.3	2.5	3.0	3.0	3.0
Dividend payout (%)	39.5	41.6	28.1	19.5	13.9

Common size metrics as % of net revenues

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Material cost	32.4	35.4	34.8	33.2	32.7
Employee cost	15.9	18.6	18.6	18.2	17.6
Other expenses	15.5	15.4	15.4	14.7	14.2
Depreciation	3.4	2.6	2.5	2.6	2.6
Interest expenditure	0.5	0.6	1.4	1.6	1.5
EBITDA margins	13.5	11.2	12.2	14.7	16.8
Net profit margins	8.9	5.3	7.2	9.0	10.9

Growth metrics (%)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Revenues	19.2	76.6	30.1	15.3	16.2
EBITDA	(19.4)	45.8	42.4	38.8	32.5
Net profit	(10.5)	4.3	77.5	44.5	40.4
EPS	(55.2)	4.3	77.5	44.5	40.4

Balance sheet (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Shareholders funds	3,155	3,479	4,097	5,118	6,665
Capital	212	423	423	423	423
Reserves & surplus	2,944	3,056	3,674	4,695	6,242
Borrowings	2,124	2,654	3,154	3,654	3,654
Secured loans	1,827	2,561	3,061	3,561	3,561
Unsecured loans	297	93	93	93	93
Deferred tax liability (net)	378	478	478	478	478
Sources of funds	**5,657**	**6,611**	**7,730**	**9,250**	**10,798**
Gross block	3,246	4,836	5,670	6,829	7,578
Depreciation	1,034	1,165	1,480	1,855	2,287
Net block	2,212	3,672	4,190	4,975	5,291
Capital work in progress	771	387	387	387	387
Investments	1,472	2	2	2	2
Inventories	1,483	2,253	2,724	2,828	4,008
Sundry debtors	629	1,725	2,068	2,304	2,774
Cash and bank balances	107	850	590	1,296	1,235
Loans and advances	375	387	629	725	843
Other current assets	58	143	252	290	337
Total current assets	2,652	5,358	6,263	7,443	9,197
Current liabilities	1,193	2,459	2,608	2,976	3,406
Provisions	256	349	503	580	674
Total current liabilities and provisions	1,449	2,808	3,112	3,556	4,080
Net current assets	1,203	2,550	3,151	3,887	5,118
Uses of funds	**5,657**	**6,611**	**7,730**	**9,250**	**10,798**
Book value per share (INR)	37	41	48	60	79

Cash flow statement (INR mn)

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
Cash flow from operations	668	865	1,295	1,832	2,524
Cash for working capital	(416)	(697)	(1,015)	(107)	(1,385)
Net operating cash (outflow) / inflow	252	168	280	1,725	1,139
Net (purchase) / sale of fixed assets	(959)	(1,207)	(834)	(1,160)	(749)
Net (purchase) / sale of investments	(1,195)	1,470	-	-	-
Net cash (outflow) / inflow from inv.	(2,153)	263	(834)	(1,160)	(749)
Proceeds from equity capital	(191)	212	-	-	-
Proceeds from LTB/STB	2,063	531	500	500	-
Net cash (outflow) / inflow from fin.	1,872	742	500	500	-
Free cash flow	**(1,901)**	**431**	**(554)**	**566**	**390**

Ratios

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
ROE (%)	16.2	15.3	23.8	28.3	31.1
ROCE (%)	13.4	12.4	17.2	20.9	24.0
Inventory days	252	199	208	210	226
Debtors days	37	46	55	55	55
Fixed assets T/o (x)	1.7	2.0	2.2	2.1	2.2
Debt/equity	0.7	0.8	0.8	0.7	0.5

Valuation parameters

Year to March	FY05	FY06E	FY07E	FY08E	FY09E
EPS, inc. exeptionals (INR)	5.8	6.0	10.7	15.4	21.6
Y-o-Y growth (%)	*(55.2)*	*4.3*	*77.5*	*44.5*	*40.4*
CEPS (INR)	8.0	9.0	14.4	19.8	26.7
P/E (x)	33.9	32.6	18.3	12.7	9.0
Price/BV(x)	5.2	4.8	4.0	3.2	2.5
EV/Sales (x)	3.4	1.9	1.5	1.3	1.1
EV/EBITDA (x)	25.1	17.0	12.4	8.9	6.7

Edelweiss Securities
14th Floor, Express Towers,
Nariman Point, Mumbai – 400 021
Board: +91 22 2286 4400
Email*: research@edelcap.com*

Edelweiss
Ideas create, values protect

Naresh Kothari - 22864246	Head, Institutional Equities
Vikas Khemani - 22864206	Head, Institutional Equities

INDIA RESEARCH			SECTOR
Shriram Iyer	-	2286 4256	Head – Research
Gautam Roy	-	2286 4305	Airlines, Textile
Ashutosh Goel	-	2286 4287	Automobiles, Auto Components
Vishal Goyal, CFA	-	2286 4370	Banking & Finance
Revathi Myneni	-	2286 4413	Cement
Sumeet Budhraja	-	2286 4430	FMCG
Harish Sharma	-	2286 4307	Infrastructure, Auto Components, Mid Caps
Priyanko Panja	-	2286 4300	Infrastructure, Engineering, Telecom
Hitesh Zaveri	-	2286 4424	Information Technology
Parul Inamdar	-	2286 4355	Information Technology
Priyank Singhal	-	2286 4302	Media, Retail
Prakash Kapadia	-	4097 9843	Mid Caps
Niraj Mansingka	-	2286 4304	Oil & Gas, Petrochemicals
Nimish Mehta	-	2286 4295	Pharmaceuticals, Agrochemicals
Manika Premsingh	-	4019 4847	Economist
Sunil Jain	-	2286 4308	Alternative & Quantitative
Yogesh Radke	-	2286 4328	Alternative & Quantitative

INSTITUTIONAL SALES		
Nischal Maheshwari	-	2286 4205
Rajesh Makharia	-	2286 4202
Shabnam Kapur	-	2286 4394
Balakumar V	-	(044) 4263 8283
Ashish Agrawal	-	2286 4301
Nikhil Garg	-	2286 4282
Swati Khemani	-	2286 4266
Neha Shahra	-	2286 4276
Priya Ramchandran	-	2286 4389
Anubhav Kanodia	-	2286 4361
Tushar Mahajan	-	2286 4439
Harsh Biyani	-	2286 4419
Nirmal Ajmera	-	2286 4258
Ankit Doshi	-	2286 4671
Dipesh Shah	-	2286 4434

Email addresses: firstname.lastname@edelcap.com **e.g.** naresh.kothari@edelcap.com *unless otherwise specified*

RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	**Reduce**	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	**Sell**	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	**Trading Sell**	Expected to depreciate more than 10% over a 45-day period

Edelweiss
Ideas create, values protect

Edelweiss Securities, 14th Floor, Express Towers, Nariman Point, Mumbai 400 021
Tel: +91 22 2286 4400. Email: research@edelcap.com