Company Focus

18 January 2008 | 9 pages

Nicholas Piramal India (NICH.BO)

Buy: Inline quarter; Expect Margins to Improve Further

- **Maintain Buy (1M)** —3Q results were strong, with margin improvement being much higher than anticipated. We expect this trend to continue on the back of aggressive restructuring in UK operations and help completely offset a shortfall in FY08 revenues vis-à-vis the guidance. We rate NPIL as the best Indian play on innovator CRAMS and reiterate it as our top pick in Indian pharma.
- **Inline 3Q** — A 13% YoY growth in sales translated into a 43% YoY growth in net profit on the back of a 237bps expansion in EBIDTA margins – excluding NCE R&D spend from both periods. NPIL appears well on course to achieving its FY08 guidance on EBIDTA margins (18.7%) and EPS (Rs17.5) despite a shortfall on the revenues front (set to end with 16% growth vs. 20% guidance).
- **Mixed trend in revenues** — While domestic revenues recovered (up 15% YoY) and pathlabs thrived (up 89% YoY), CMG sales grew at a tepid 7%, leading to overall topline growth of 13% YoY. The slow growth in CMG was partly seasonal and partly due to lower PDS sales out of Canada (on an appreciating Canadian dollar vs. the US$) as the restructuring process is also underway in UK.
- **Rapid improvement in profitability** — Restructuring of the UK CRAMS business and shifting more contracts to lower cost Indian facilities have led to higher EBIDTA margins, which is expected to cross 20% in FY09. NPIL's decision to materially reduce head count in UK should also aid profitability although there would be some VRS payment upfront (a large chunk to reflect in 4Q earnings).
- **NCE demerger catalyst** — NPIL has received the authenticated court order approving the demerger and expects to complete this listing process by May'08 – we expect this to act as a significant catalyst for the stock.

Buy/Medium Risk	**1M**
Price (18 Jan 08)	Rs330.35
Target price	Rs455.00
Expected share price return	37.7%
Expected dividend yield	1.2%
Expected total return	**38.9%**
Market Cap	Rs69,047M
	US$1,763M

Price Performance (RIC: NICH.BO, BB: NP IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	1,210	5.79	-31.6	57.1	7.2	16.6	0.9
2007A	2,256	10.80	86.5	30.6	6.6	22.5	1.1
2008E	3,638	17.40	61.2	19.0	6.1	33.4	1.2
2009E	4,675	22.37	28.5	14.8	4.6	35.6	1.4
2010E	5,749	27.50	23.0	12.0	3.5	33.4	1.5

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	57.1	30.6	19.0	14.8	12.0
EV/EBITDA adjusted (x)	34.9	20.2	13.7	11.3	9.3
P/BV (x)	7.2	6.6	6.1	4.6	3.5
Dividend yield (%)	0.9	1.1	1.2	1.4	1.5
Per Share Data (Rs)					
EPS adjusted	5.79	10.80	17.40	22.37	27.50
EPS reported	5.79	10.80	17.40	22.37	27.50
BVPS	45.98	50.14	54.14	71.38	93.18
DPS	3.00	3.50	4.00	4.50	5.00
Profit & Loss (RsM)					
Net sales	15,944	24,541	29,709	33,961	37,080
Operating expenses	-14,537	-21,703	-25,116	-28,277	-30,379
EBIT	**1,408**	**2,839**	**4,592**	**5,684**	**6,701**
Net interest expense	-173	-305	-425	-351	-160
Non-operating/exceptionals	97	-39	14	12	31
Pre-tax profit	**1,331**	**2,494**	**4,181**	**5,344**	**6,571**
Tax	-238	-389	-523	-668	-821
Extraord./Min.Int./Pref.div.	116	151	-21	-1	-1
Reported net income	**1,210**	**2,256**	**3,638**	**4,675**	**5,749**
Adjusted earnings	1,210	2,256	3,638	4,675	5,749
Adjusted EBITDA	2,096	3,657	5,541	6,635	7,704
Growth Rates (%)					
Sales	19.5	53.9	21.1	14.3	9.2
EBIT adjusted	-1.5	101.7	61.8	23.8	17.9
EBITDA adjusted	7.3	74.5	51.5	19.7	16.1
EPS adjusted	-31.6	86.5	61.2	28.5	23.0
Cash Flow (RsM)					
Operating cash flow	**1,579**	**2,395**	**4,165**	**5,228**	**6,526**
Depreciation/amortization	688	818	949	951	1,004
Net working capital	-367	-740	-1,063	-1,006	-685
Investing cash flow	**-2,510**	**-4,012**	**-1,969**	**-1,110**	**-957**
Capital expenditure	-2,248	-217	-1,528	-1,122	-988
Acquisitions/disposals	-60	-2,000	0	0	0
Financing cash flow	**1,734**	**1,164**	**-1,324**	**-4,174**	**-4,552**
Borrowings	-863	2,778	33	-3,101	-3,360
Dividends paid	-685	-1,491	-973	-1,072	-1,192
Change in cash	**802**	**-453**	**-78**	**-56**	**1,016**
Balance Sheet (RsM)					
Total assets	**18,464**	**23,018**	**25,831**	**27,861**	**30,202**
Cash & cash equivalent	953	506	427	371	1,388
Accounts receivable	2,429	3,673	4,847	5,633	6,148
Net fixed assets	10,418	12,238	11,918	12,090	12,075
Total liabilities	**8,290**	**12,151**	**14,510**	**12,937**	**10,720**
Accounts payable	3,277	4,551	5,308	6,067	6,622
Total Debt	3,114	6,392	6,850	4,100	900
Shareholders' funds	**10,174**	**10,867**	**11,321**	**14,925**	**19,483**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	13.1	14.9	18.7	19.5	20.8
ROE adjusted	16.6	22.5	33.4	35.6	33.4
ROIC adjusted	9.6	15.5	22.0	25.1	27.9
Net debt to equity	21.2	54.2	56.7	25.0	-2.5
Total debt to capital	23.4	37.0	37.7	21.6	4.4

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Inline 3Q; Expect Margins to Improve Further

We maintain our Buy/Medium Risk (1M) rating on Nicholas Piramal (NPIL), following strong 3Q results on the back of higher than anticipated margin expansion. We expect this trend to continue on the back of aggressive restructuring in UK operations and help completely offset a shortfall in FY08 revenues vis-à-vis the guidance. We rate NPIL as the best Indian play on innovator CRAMS and reiterate it as our top pick in Indian pharma. NPIL is likely to conclude the demerger and listing of its NCE R&D business by May 2008, which we believe should act as a significant catalyst for the stock.

Inline quarter; Margins beat expectations

A 13% YoY growth in sales translated into a 43% YoY growth in net profit on the back of a 237bps expansion in EBIDTA margins – excluding NCE R&D spend from both periods. NPIL appears well on course to achieving its FY08 guidance on EBIDTA margins (18.7%) and EPS (Rs17.5) despite a shortfall on the revenues front (set to end with 16% growth vs. 20% guidance).

3QFY08 results highlights

- **Revenues –** Consolidated revenues up 13% yoy at Rs7.3bn for the quarter driven by branded formulation sales and strong growth in PMS revenues. Branded formulations sales up 16% yoy driven by new product launches and sales of lifestyle products. NPIL launched 24 new products in 9mFY08, while lifestyle products accounted for 32% of the total branded formulation sales in same period.

- **Operating performance –** EBITDA margins (excluding the NCE R&D spend from both quarters) improved by 237 bps yoy. This was driven mainly by reduction in expenses due to faster than anticipated integration of overseas subsidiaries and shift of operations to Indian facilities. Net profit for the quarter was up 31% yoy at Rs728m.

- **Custom manufacturing –** CMG sales were up 7% yoy driven by a 15% increase in PMS revenues. Sales from contracts from Indian assets tripled at Rs554m as compared to Rs180m in 3QFY07. However, the PDS business, which is largely out of Canada, was hurt by the appreciation of the Canadian dollar vs. the US dollar – leading to a YoY decline of 27%. The Pathlabs business witnessed an 89% yoy increase with sales of Rs315m.

- **NCE R&D –** Phase I/II studies for the lead molecule P-276 have been completed in US and Canada. The dossier for Phase II studies will be submitted in early CY08. In 3QFY08, NPIL also entered a collaboration agreement with Merck & Co to develop new drugs for two targets selected by Merck.

- **NCE R&D demerger –** The demerger of the NCE R&D business is almost complete, with the Mumbai High Court having approved the process. NPIL has received the authenticated copy of the judgment from the court and, on receipt of a certified copy of the same (expected in a few days), would move forward on the same. It is confident of concluding this process by May 2008.

Figure 1. NPIL 3QFY08 Results Snapshot (Rupees in Millions; Percent)

Year Ended Mar 31	3QFY07	3QFY08	% ch YoY	2QFY08	% ch QoQ	CIR Comments
Net Sales	**6,495**	**7,323**	*12.8*	**7,646**	*(4.2)*	**Driven by domestic formulations and CMG sales from Indian facilities**
Expenditure (excl NCE R&D)	5,372	5,883	*9.5*	6,071	*(3.1)*	
EBIDTA (pre R&D)	**1,124**	**1,441**	***28.2***	**1,575**	***(8.5)***	**Margin expansion of 237bps yoy driven by cost savings due to faster than anticipated integration of overseas subsidiaries and lower R&D expenditure**
EBITDA Margins (%)	***17.3***	***19.7***	***237 bps***	***20.6***	***-93 bps***	
NCE R&D Spend	153	229	*49.7*	246	*(6.9)*	
EBITDA	971	1,212	*24.9*	1,329	*(8.8)*	
EBITDA Margins (%)	*14.9*	*16.5*	*160 bps*	*17.4*	*-84 bps*	
Interest	88	122	*38.9*	111	*9.5*	
Depreciation	222	269	*21.2*	263	*2.2*	
Other income	2	40	*nm*	-	*nm*	
PBT	663	861	*29.9*	955	*(9.8)*	
Tax	110	79	*(27.9)*	80	*(1.0)*	
Effective tax rate (%)	*16.5*	*9.2*	*-735 bps*	*8.3*	*81 bps*	
PAT	554	782	*41.3*	875	*(10.6)*	
Minority Interest	-	(1)	*nm*	0	*nm*	
Recurring Net Income	554	784	*41.5*	875	*(10.4)*	
Net Income (excl NCE R&D)	**706**	**1,013**	**43.4**	**1,121**	**(9.6)**	
One time items	2	(56)	*nm*	(27)	*nm*	Includes payments made under VRS schemes in overseas subsidiaries. Expect large one time expense in 4QFY08
Reported Net Income	**555**	**728**	***31.0***	**848**	***(14.2)***	

Source: Company Reports and Citi Investment Research

Figure 2. NPIL 3QFY08 Expenditure Breakup (Rupees in Millions; Percent)

Year Ended Mar 31	3QFY07	3QFY08	% ch YoY	2QFY08	% ch QoQ	CIR Comments
Raw materials consumed	2,387	2,869	*20.2*	2,932	*(2.1)*	
as a % of sales	*36.7*	*39.2*	*243 bps*	*38.3*	*83 bps*	
Staff Cost	1,120	1,198	*6.9*	1,322	*(9.4)*	Rationalisation of manpower at the UK facilities results in lower staff cost as a % of sales
as a % of sales	*17.2*	*16.4*	*-89 bps*	*17.3*	*-94 bps*	
R&D Spend	312	330	*5.7*	359	*(8.3)*	Includes Rs229m of NCE R&D spend
as a % of sales	*4.8*	*4.5*	*-30 bps*	*4.7*	*-20 bps*	
Other Expenditure	1,706	1,715	*0.5*	1,703	*0.7*	Lower as a % of sales due to integration of overseas subsidiaries and shift of operations to Indian facilities.
as a % of sales	*26.3*	*23.4*	*-285 bps*	*22.3*	*114 bps*	
Total Expenditure	**5,525**	**6,112**	***10.6***	**6,317**	***(3.2)***	
as a % of sales	***85.1***	***83.5***	***-160 bps***	***82.6***	***84 bps***	

Source: Company Reports and Citi Investment Research

Figure 3. NPIL 3QFY08 Sales Breakup (Rupees in Millions; Percent)

Year Ended Mar 31	3QFY07	3QFY08	% ch YoY	2QFY08	% ch QoQ	CIR Comments
India Sales	**3,479**	**4,089**	***17.5***	**4,418**	***(7.5)***	
Branded Formulations	2,918	3,372	*15.6*	3,543	*(4.8)*	Lifestyle products consists of 32% of total formulation sales in 9mFY08, New products account for 5% of 9m sales
CMO	225	247	*9.6*	286	*(13.7)*	
Path labs	167	315	*88.6*	312	*1.0*	Organic growth at 12%
Others	170	155	*(8.3)*	278	*(44.0)*	
Global Sales	**3,015**	**3,235**	***7.3***	**3,228**	***0.2***	
CMG	2,955	3,163	*7.0*	3,137	*0.8*	Growth driven by revenues from Indian facilities. Rs554m of CMG revenues from Indian facilities as compared to Rs180m in 3QFY07. PDS sales affected by sharp increase in Canadian Dollar against the US Dollar. OTC business grew by 30% yoy.
PDS	422	308	*(26.9)*	315	*(2.0)*	
PMS	1,919	2,208	*15.0*	2,222	*(0.7)*	
MMBB	614	647	*5.3*	599	*7.9*	
Others	60	72	*20.0*	91	*(20.9)*	
Total Net Sales	**6,495**	**7,323**	***12.8***	**7,646**	***(4.2)***	

Source: Company Reports and Citi Investment Research

Nicholas Piramal India

Company description

Nicholas Piramal (NPIL), the fourth-largest company in the Indian formulations market, is targeting the regulated pharmaceutical markets through custom manufacturing (CMG). The company has scaled up in the domestic market through both organic and inorganic initiatives, and is looking at doing the same in the overseas markets. Some initial CMG successes have been achieved in the form of six diverse contracts with innovator companies and two acquisitions in overseas markets.

Investment strategy

We rate NPIL Buy/Medium Risk (1M) with a target price of Rs455/share. We believe NPIL is one of the best plays on custom manufacturing and the branded formulations market in India. Among the Indian mid-tier companies, NPIL has a unique approach to the domestic and export markets. Leveraging its manufacturing capabilities and relationships with global majors, the company has positioned itself as a 'partner of choice' for innovator companies across the product life cycle and value chain. On the domestic front, it has focused on building brands and strengthening its marketing and distribution network, making it less dependent than its peers on new product launches for growth. The move to demerge its NCE R&D unit would also add significant value for shareholders over the next 6-9 months, in our view. We are comfortable with valuations at current levels and expect significant upside potential as earnings momentum should continue in FY08 and beyond.

Valuation

We value NPIL on a sum of parts basis - valuing its core business on a P/E basis and the holding in the demerged NCE R&D entity, based on book value.

Our fair value of Rs448/share is based on 20x March '09E earnings. This is at a premium to our target multiple for mid-sized pharma companies and in-line with our target multiple for sector leaders. We believe NPIL deserves a higher multiple given the nature of its CMG business and possible upside from inorganic initiatives. Revenue visibility and sustainability are high in the CMG business: these are long-term exclusive contracts with innovators with no risk of litigation-related delays and competitive pressures. However, given the 18-24 month time lag between doing a deal and commencement of revenues, the full upside is not captured in one-year forward earnings. As such, we believe it deserves a higher valuation multiple.

We assign a value to the holding in NPRC on the basis of NPRC's current book value. NPRC has a book value of Rs74.3 and each NPIL shareholder will get 1 share in NPRC for every 10 shares held in NPIL. As such, we assign a value of

Rs7/share (1/10th of the book value) for the R&D company in our target price for NPIL. We believe this is conservative, but refrain from assigning a higher value for the R&D business at the moment as we await some third party validation of NPIL's R&D effort (in the form of a licensing deal / investment by a strategic partner).

Risks

We rate Nicholas Medium Risk in contrast with our quantitative risk-rating system's Low risk to account for the integration-related issues of the Avecia and Morpeth acquisitions. The main downside risks to our target price are: 1) While custom manufacturing should drive NPIL's revenues and profitability, any slip-up in executing the contracts would be a big negative; 2) A break-up of any major association could have a short-term impact on revenues and earnings; and 3) Any unfavorable trend in growth or pricing could have an adverse impact on the company's financials. The main upside risks to our target price are: 1) If NPIL bags new contracts that have a shorter lead time, it could have a positive impact on our estimates and target price; and 2) NPIL continues to scout for acquisitions, which could add further to its strengths in target businesses and our estimates.

Appendix A-1

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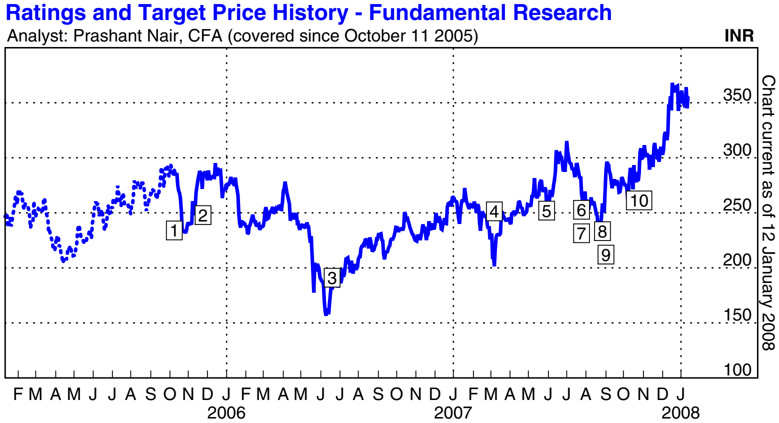
Nicholas Piramal India (NICH.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since October 11 2005)



#	Date	Rating	Target Price	Closing Price
1:	10 Oct 05	2L	318.00	288.60
2:	24 Nov 05	2L	*286.00	286.60
3:	20 Jun 06	*1M	*255.00	180.40
4:	7 Mar 07	1M	*300.00	201.50
5:	30 May 07	1M	*330.00	254.30
6:	25 Jul 07	1M	*345.00	267.20
7:	25 Jul 07	1M	*330.00	267.20
8:	28 Aug 07	1M	*345.00	258.55
9:	2 Sep 07	1M	*395.00	288.20
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*Indicates change.

Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

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