Company In-Depth

29 August 2007 | 9 pages

# Cipla (CIPL.BO)

## Sell: Troubled Times Continue; Cutting Estimates and Target Price

Rating change ☐
Target price change ☑
Estimate change ☑

- Maintain Sell (3L) — as we believe that Cipla's valuations are still stretched given the low value addition in its business model, tepid earnings growth and falling capital efficiency. We cut our FY08-10E earnings estimates by 15-18% and forecast lacklustre earnings CAGR of 4% over FY07-10E. We also cut our target price by 14% to Rs165 and maintain Cipla as our top Sell in the sector.
- Multiple pressures on profitability — We expect sustained pressure on Cipla's profitability, given the negative impact of rupee appreciation on exports, higher cost of imports from China, rising staff cost & pricing pressure in key markets. Cipla's supply based model is particularly vulnerable, in our view, given the shift in bargaining power toward the larger and more consolidated set of buyers.
- Reducing estimates — We cut our estimates for FY08-10 in-line with Cipla's indication that sales growth would be subdued at 10-12% (our earlier estimate was 16%) and FY08 net profit would likely decline YoY. Our sales and net profit estimates are lower by 3-7% and 15-18% respectively over FY08-10.
- Capital efficiency under pressure — The declining profitability combined with aggressive capex plans (cRs9.5bn over FY08-09) and falling asset turnover reflects in rapidly falling capital efficieny ratios. We expect Cipla's RoAE and RoACE to decline from 25.6% and 27% in FY07 to 17.2% and 19.8% in FY10.
- What could change? — Cipla has supply agreements with 10 US companies for c124 products, some of which are patent challenges. Supplies during exclusivity would lead to a scale-up in sales and margins (a la 9mFY07). However, we note that such upsides are unsustainable and should not affect valuations materially.

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

| Sell/Low Risk | 3L |
|---|---|
| Price (29 Aug 07) | Rs169.75 |
| Target price | Rs165.00 |
| *from Rs191.00* | |
| Expected share price return | -2.8% |
| Expected dividend yield | 1.4% |
| **Expected total return** | **-1.4%** |
| Market Cap | Rs131,945M |
| | US$3,220M |

**Price Performance (RIC: CIPL.BO, BB: CIPLA IN)**


**Statistical Abstract**

| Year to 31 Mar | Net Profit (RsM) | Diluted EPS (Rs) | EPS growth (%) | P/E (x) | P/B (x) | ROE (%) | Yield (%) |
|---|---|---|---|---|---|---|---|
| 2006A | 6,076 | 8.11 | 48.4 | 20.9 | 6.4 | 34.4 | 1.2 |
| 2007A | 6,680 | 8.59 | 6.0 | 19.8 | 4.1 | 25.6 | 1.2 |
| 2008E | 6,163 | 7.93 | -7.7 | 21.4 | 3.6 | 17.9 | 1.4 |
| 2009E | 6,672 | 8.58 | 8.3 | 19.8 | 3.2 | 17.2 | 1.5 |
| 2010E | 7,476 | 9.62 | 12.0 | 17.7 | 2.9 | 17.2 | 1.6 |

Source: Powered by dataCentral

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| Fiscal year end 31-Mar | 2006 | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| **Valuation Ratios** | | | | | |
| P/E adjusted (x) | 20.9 | 19.8 | 21.4 | 19.8 | 17.7 |
| EV/EBITDA adjusted (x) | 20.1 | 15.7 | 16.4 | 14.9 | 13.3 |
| P/BV (x) | 6.4 | 4.1 | 3.6 | 3.2 | 2.9 |
| Dividend yield (%) | 1.2 | 1.2 | 1.4 | 1.5 | 1.6 |
| **Per Share Data (Rs)** | | | | | |
| EPS adjusted | 8.11 | 8.59 | 7.93 | 8.58 | 9.62 |
| EPS reported | 8.11 | 8.59 | 7.93 | 8.58 | 9.62 |
| BVPS | 26.46 | 41.63 | 46.99 | 52.77 | 59.24 |
| DPS | 2.07 | 2.00 | 2.30 | 2.49 | 2.79 |
| **Profit & Loss (RsM)** | | | | | |
| Net sales | 29,753 | 35,620 | 39,726 | 44,822 | 50,668 |
| Operating expenses | -23,862 | -28,140 | -33,040 | -37,487 | -42,517 |
| **EBIT** | **5,891** | **7,480** | **6,686** | **7,334** | **8,151** |
| Net interest expense | -114 | -70 | -62 | -88 | -58 |
| Non-operating/exceptionals | 380 | 658 | 847 | 841 | 968 |
| **Pre-tax profit** | **6,157** | **8,069** | **7,471** | **8,088** | **9,061** |
| Tax | -1,022 | -1,400 | -1,307 | -1,415 | -1,586 |
| Extraord./Min.Int./Pref.div. | 942 | 11 | 0 | 0 | 0 |
| **Reported net income** | **6,076** | **6,680** | **6,163** | **6,672** | **7,476** |
| Adjusted earnings | 6,076 | 6,680 | 6,163 | 6,672 | 7,476 |
| Adjusted EBITDA | 6,693 | 8,514 | 7,995 | 8,923 | 9,936 |
| **Growth Rates (%)** | | | | | |
| Sales | 32.0 | 19.7 | 11.5 | 12.8 | 13.0 |
| EBIT adjusted | 33.8 | 27.0 | -10.6 | 9.7 | 11.1 |
| EBITDA adjusted | 35.1 | 27.2 | -6.1 | 11.6 | 11.3 |
| EPS adjusted | 48.4 | 6.0 | -7.7 | 8.3 | 12.0 |
| **Cash Flow (RsM)** | | | | | |
| **Operating cash flow** | **2,743** | **2,621** | **5,883** | **6,373** | **6,557** |
| Depreciation/amortization | 802 | 1,034 | 1,310 | 1,589 | 1,785 |
| Net working capital | -4,135 | -5,093 | -1,590 | -1,889 | -2,703 |
| **Investing cash flow** | **-3,652** | **-5,146** | **-3,886** | **-4,705** | **-3,513** |
| Capital expenditure | -3,610 | -4,192 | -4,500 | -5,000 | -3,000 |
| Acquisitions/disposals | -41 | -954 | 614 | 295 | -513 |
| **Financing cash flow** | **1,850** | **3,166** | **-2,015** | **-2,832** | **-4,209** |
| Borrowings | 2,777 | -3,454 | 0 | 514 | -600 |
| Dividends paid | -1,773 | -1,819 | -2,015 | -2,182 | -2,445 |
| **Change in cash** | **942** | **641** | **-18** | **-1,165** | **-1,165** |
| **Balance Sheet (RsM)** | | | | | |
| **Total assets** | **34,583** | **44,137** | **49,332** | **55,309** | **61,240** |
| Cash & cash equivalent | 669 | 2,493 | 1,064 | 770 | 1,282 |
| Accounts receivable | 8,760 | 10,288 | 10,945 | 13,257 | 14,367 |
| Net fixed assets | 11,436 | 14,613 | 17,803 | 21,214 | 22,429 |
| **Total liabilities** | **14,751** | **11,775** | **12,803** | **14,290** | **15,189** |
| Accounts payable | 8,132 | 7,130 | 7,985 | 8,707 | 9,898 |
| Total Debt | 4,689 | 1,236 | 1,236 | 1,750 | 1,150 |
| **Shareholders' funds** | **19,833** | **32,363** | **36,529** | **41,020** | **46,051** |
| **Profitability/Solvency Ratios (%)** | | | | | |
| EBITDA margin adjusted | 22.5 | 23.9 | 20.1 | 19.9 | 19.6 |
| ROE adjusted | 34.4 | 25.6 | 17.9 | 17.2 | 17.2 |
| ROIC adjusted | 22.7 | 21.3 | 15.4 | 14.6 | 14.6 |
| Net debt to equity | 20.3 | -3.9 | 0.5 | 2.4 | -0.3 |
| Total debt to capital | 19.1 | 3.7 | 3.3 | 4.1 | 2.4 |

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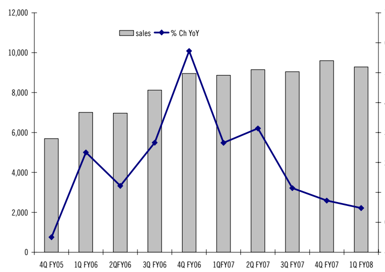
# Troubled times continue; Cutting estimates & target price

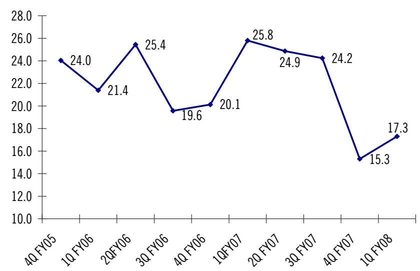
We maintain our Sell, Low Risk (3L) rating on Cipla, as we believe that valuations are still stretched given the low value addition in its business model, tepid earnings growth and falling capital efficiency. We cut our FY08-10E earnings estimates by 15-18% and forecast lacklustre earnings CAGR of 4% over FY07-10E. We also cut our target price by 14% to Rs165; Cipla remains our top Sell in the sector.

**Figure 1. Sales & Change YoY (Rs M, %)**




Source: Company Reports and CIR

**Figure 2. EBITDA Margins (%)**




Source: Company Reports and CIR

## Multiple pressures

We believe that Cipla is facing multiple pressures on its business that would continue to affect its profitability, growth and capital efficiency. Earnings growth continues to decelerate and return ratios are declining. Given the growing competition from smaller Indian companies, especially in the API supply space, we do not see things improving soon.

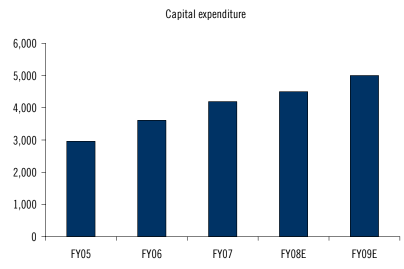
### Two consecutive quarters of sharp margin erosion; set to continue

The pressure on profitability comes from multiple sources. While the sharp rupee appreciation has a negative impact on exports (51% of Cipla's FY08 revenues), the opposite positive impact on imports has been offset to some extent by the abolition of export incentives in China. Cipla imports a reasonably large part of its requirements from China, where prices have gone up to account for the withdrawal of these incentives. At the same time, the rising cost of living in India has also led to upward pressure on staff cost. Over and above all these factors, the management has also indicated that pricing pressure is significant in key markets, especially the US.

We believe that Cipla's supply based model is particularly vulnerable on the pricing front, given the shift in bargaining power toward the larger & more consolidated set of buyers. Consequently Cipla has reported 482 bps and 851 bps YoY reduction in EBIDTA margins in 4QFY07 and 1QFY08 respectively.

We believe that the 15% EBIDTA margin in 4QFY07 does not reflect Cipla's true profitability, as several factors combined to keep it low. We, however, also highlight that 9mFY07 EBIDTA margin of c.25% is also misleading. Besides product mix issues and spread of costs across quarters skewing quarterly margins, we believe that 9mFY07 margins were also buoyed by supply of products such as finasteride & sertraline for exclusivity sales in US. With exclusivity supplies running out and margin pressures increasing, we now expect at least another two quarters of YoY decline in margins and net profit for Cipla. Overall, we expect EBIDTA margins to decline from 23.9% in FY07 to 20.1% in FY08, 19.9% in FY09E and 19.6% in FY10E.

**Figure 3. Capex (Rs m)**




Source: Company Reports and CIR

**Figure 4. Earnings Revision**

| Year to | Old | New | Chg (%) |
|---|---|---|---|
| **Revenue (Rs m)** | | | |
| 2008E | 41,026 | 39,726 | (3.2) |
| 2009E | 47,460 | 44,822 | (5.6) |
| 2010E | 54,681 | 50,668 | (7.3) |
| **EPS (Rs)** | | | |
| 2008E | 9.3 | 7.93 | (14.6) |
| 2009E | 10.4 | 8.58 | (17.6) |
| 2010E | 11.67 | 9.62 | (17.6) |

Source: Company Reports and CIR

## High capex continues unabated

After having spent c.Rs7.8bn over the last two years on capex, Cipla announced another ambitious capex programme of Rs9.5bn over FY08-09 primarily on its facilities in Sikkim, Goa and Indore. This is higher than our estimate of Rs6bn over the next two years. We have adjusted our capex estimates upwards accordingly. With profitability under pressure, we expect this to take a heavy toll on return ratios.

## Cutting estimates again

We lower our earnings estimates for Cipla, following very disappointing 1QFY08 results and management's comments at the recent AGM. We believe that Cipla's margins will continue to trend down, as the share of lower margin ARV sales goes up and sales to regulated markets feel the pinch of lower pricing and rupee appreciation. Accordingly, we reduce our FY08 and FY09 earnings estimates by 15% and 18% respectively. We forecast a tepid 4% CAGR in earnings over FY07-10E.

## What could change?

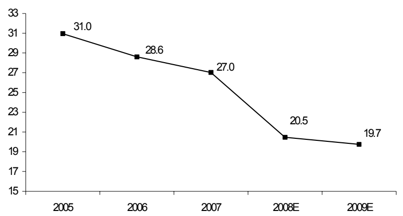
Our estimates do not include any upside from API/formulation supplies for any uncertain patent challenge wins – consistent with our approach for all pharma companies. Two opportunities that could play out in future include Flonase with Watson (Watson indicated in an earlier conference all that Flonase approval coming through in 3QCY07 is a "wish") and Lexapro (with Teva/Ivax; generics lost the case in the lower court). While a launch of either of these products would represent an upside to our estimates, they would be "one-off" unsustainable upsides – and, hence, should not matter much to valuations in our view.

## Lowering target price to Rs165/share

Target price of Rs165/share

We lower our target price to Rs165/share on rollover to 20x Sept'08E revised earnings. We believe that Cipla's base business should receive a lower multiple (10% discount) vis-à-vis its other peers such as Ranbaxy, Dr Reddy's and Sun Pharma, given the lower value add in its business. However, while we value the latter's patent challenge opportunities separately from the base business, we are unable to do the same for Cipla, given the lack of information on its tie-ups with different partners. Hence, we apply a higher multiple of 20x to base business earnings to factor in any potential "one-off" upsides that may come through from time to time.

Figure 5. ROCE (FY05 – FY09E,%)




Source: Company Reports and CIR

## We remain negative

We believe that Cipla's business model is low on value addition, given its reluctance to invest in the front end in target markets, as well as on new drug discovery research. While this would keep profitability up in the near term, it would affect the longer-term growth outlook adversely in our view. We thus argue for a valuation discount for Cipla vis-à-vis other sector leaders.

At the same time, Cipla's supply-based model for regulated markets is at risk due to global consolidation, in our view. With global buyers becoming bigger and Indian companies failing to consolidate among themselves, we believe that Cipla could be affected by lower bargaining power, if not total loss of business. The partial loss of the sertraline upside to DRL last year (FY07) is a key case in point. We believe similar losses cannot be ruled out going forward.

We thus believe that challenges persist for Cipla, with earnings likely to witness a YoY decline in FY08 – especially significant in 2Q and 3Q of FY08. The high growth in low margin ARVs & rising competition in India would pose margin challenges, in our view, while sales growth would remain subdued due to a high base. At the same time, the higher than expected capex planned over the next two years would put immense pressure on capital efficiency as well. While spikes on "exclusivity sales" cannot be ruled out, we believe such transient upsides should not have a high bearing on valuations.

## Cipla

### Company description

Cipla is a leading pharmaceutical company in India with a strong and profitable business model. The company has a well-diversified portfolio, without any overdependence on a particular segment. It has developed a strong presence in the export market — both in developed and developing countries — and has products registered in more than 140 countries. Furthermore, it has been at the forefront in reverse engineering the latest drugs and active pharmaceutical ingredients. The company has focused its R&D efforts on profitable projects, and tied up with the local players in various markets to de-risk its business model. However, the company lags its peers in discovery-led research. Cipla's business model also represents a low-risk model with the commensurate returns also being moderate.

### Investment thesis

We rate Cipla Sell (3L) with a target price of Rs165/share. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, Cipla could face an increasingly uncertain global environment, if the current consolidation process gathers momentum. Its partners, which appear inherently tied up because of their weak product capabilities, may get acquired and the acquirers may not want to source drugs from Cipla. We think Cipla's business model lacks significant value addition, both in terms of innovative research as well as control over the front end in the US and European generics markets. We believe that any re-rating will be contingent on the company making fresh forays into these areas and / or getting acquired at a significant premium. Since the pricing pressure has not been waning in the US or Europe, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players. Cipla, being one of the weaker parts of the supply chain, will bear the brunt, in our view.

## Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs165 (Rs191 earlier) is based on 20x Sept'08E (20x June 08E earlier) earnings. Historically, the stock has traded at 15-30x forward earnings. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector, justified by the lower value addition to the business (lack of its own front-end in the regulated markets and ownership of IPR). There are few signs of this changing. Our target multiple for Cipla's base business is therefore at a 10% discount to the multiple (20x) that we use for its peers such as Ranbaxy, Dr Reddy's and Sun Pharma. However, while we value the latter's patent challenge opportunities separately from the base business, we are unable to do the same for Cipla, given the lack of information on its tie-ups with different partners. Hence, we apply a higher multiple of 20x to base business earnings to factor in any potential "one-off" upsides that may come through from time to time.

## Risks

We rate Cipla as Low Risk, as the company has a steadily growing base business and has a visible earning stream. The ongoing dispute regarding alleged overcharging for seven drugs in the domestic market could result in significant cash outflow as well as could impact future profitability. Global consolidation is a risk to the company's supply based model. The new drug policy, if implemented in the current form could also hurt earnings. Key upside risks to our rating and target price include: a) the company doing better operationally than forecast; b) any move to front-end in target markets could give further support to current high valuations; c) any exclusivity for its partners could also sustain the growth momentum beyond our expectations.

# Appendix A-1

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| # | Date | Rating | Target Price | Closing Price |
|---|---|---|---|---|
| 1: | 26 Oct 04 | 3L | *96.00 | 106.92 |
| 2: | 27 Jun 05 | 3L | *116.00 | 124.12 |
| 3: | 25 Jan 06 | 3L | *65.60 | 174.06 |
| 4: | 19 Jul 06 | 3L | *170.00 | 212.45 |
| 5: | 19 Jul 06 | 3L | 170.00 | 212.45 |
| 6: | 30 May 07 | 3L | *191.00 | 214.75 |

*Indicates change.

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|---|---|---|---|
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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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