The Front Page

September 16, 2008

What's Inside: Strategy, IDFC (SELL), Glenmark Pharma (REDUCE), Events calendar

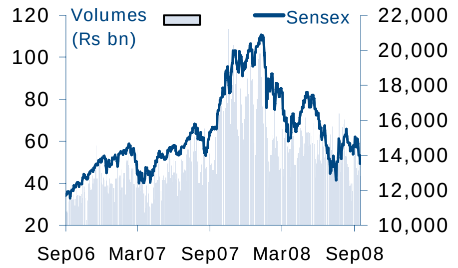
Market Front Page

Index Movements	Closing	% Chg	% YTD
Sensex	13,531	(3.4)	(33.3)
Nifty	4,073	(3.7)	(33.7)
BSE Smallcap	6,380	(4.9)	(52.2)
CNX Midcap	5,313	(4.3)	(42.3)
Nasdaq	2,180	(3.6)	(17.8)
DJIA	10,918	(4.4)	(17.7)
IBOV	48,416	(7.6)	(24.2)
FTSE	5,204	(3.9)	(19.4)
CAC	4,169	(3.8)	(25.7)
Turnover		US$m	% Chg
BSE		944	(13.3)
NSE		2,592	(4.1)
Derivatives (NSE)		13,319	6.0
FII F&O (US$m)		Index	Stocks
Net buying		122	130
Open interest		7,664	4,611
Chg in open int.		(81)	(263)
Equity Flows (US$m)	Latest	MTD	YTD
FII (12/9)	(212)	(877)	(8,134)
MF (12/9)	46	49	2,570

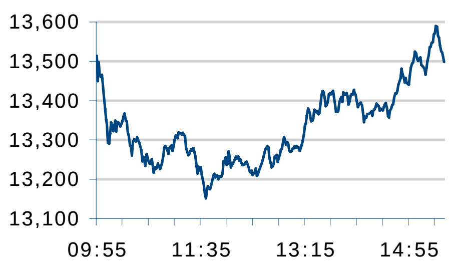
ADR/GDR (US$)	Latest	% Chg	% Prem
HDFC Bank	78.3	(10.5)	(0.1)
Reliance	83.7	0.1	2.1
Infosys	34.8	(6.6)	1.6
Satyam	18.1	(14.4)	12.8
Wipro	9.9	(6.9)	13.3
ICICI Bank	26.1	(12.5)	(4.2)
SBI	63.0	(4.5)	(2.6)
ITC	4.1	(1.7)	(1.2)
Commodities	Latest	%Chg	%YTD
Gold (US$/ounce)	776	(1.3)	(6.9)
Crude (US$/bl)	96	(5.4)	(0.3)
Aluminium (US$/MT)	2,567	(3.7)	6.6
Copper (US$/MT)	6,930	(2.7)	3.8
Forex Rates	Closing	% Chg	%YTD
Rs/US$	45.9	0.2	16.6
Rs/EUR	66.0	1.8	13.5
Rs/GBP	82.8	2.2	5.2
Bond Markets		Closing	bps Chg
10 yr bond		8.2	(8.0)
Interbank call		10.5	225.0

Charts Front Page

Sensex price volume



Sensex intraday



Corporate Front Page

- Government to initiate the process of merging State Bank of Indore and State Bank of Patiala with **SBI** (ET)
- **Satyam Computers** receives a SAP implementation contract in Oman (ET)
- **Reliance ADAG** proposes to set up a 12mtpa steel plant in Jharkhand (BL)
- **SBI** makes an advance tax payment Rs15.6bn, which is 50% higher YoY (DNA)
- **HCL Tech** plans to acquire 3-4 captive BPOs in BFSI space in the Asia-Pac region (BL)
- **Reliance Capital** is raising US$1bn from foreign investors for its PE foray (BS)
- **Gammon Infra** is considering a foray into urban infrastructure, airports and power transmission (BL)
- **Dr Reddy's** diabetic drug to enter clinical phase next month (BL)
- **Crompton Greaves** acquires US-based MSE Power Systems for US$16m (BL)
- The chief strategy officer of **Wipro**, Sudip Nandy, quits (BS)
- **Bharti Airtel** launches calling-card services in Singapore (ET)
- **Jet Airways** may take 24% in **GMR Group's** proposed aircraft MRO venture being set up at Rajiv Gandhi International Airport in Hyderabad (mint)
- **Educomp** bids for providing computer-aided education in about 8,000-9,000 government schools in UP, MP and Karnataka (ET)
- South Korean firm STX Shipbuilding won a US$376m bid to build four new ships for **SCI** (mint)
- A Dubai-based fund doubles its investment in **Sobha's** SPV in Bangalore (ET)
- **Mindtree** sets up a centre of excellence for its testing services (BL)

Market Front Page

Top Movers BSE 200

Top Gainers	Price (Rs)	Chg (%)	YTD (%)	Top Losers	Price (Rs)	Chg (%)	YTD (%)
HPCL	240	3.0	-35.0	Ansal Properties	78	-11.5	-81.6
Maruti Udyog	721	2.5	-27.5	IFCI	41	-11.2	-55.8
IOC	413	1.4	-48.0	Dish TV India	32	-11.2	-68.6
HDFC	2204	1.0	-23.4	NDTV	267	-10.9	-42.4
ACC Limited	597	0.9	-41.7	Reliance Capital	1084	-10.4	-58.1

Volume spurts

Company	CMP	M.Cap	Vol. (in '000)	10D A.Vol (in '000)	% Chg
United Spirits	1325	2,890	3,069	418	634
Asian Paints	1205	2,516	140	28	399
Shree Cement	551	418	66	18	258
Marico	58	769	1,538	490	214
CESC	284	773	422	143	195
Matrix Labs	136	456	55	19	187
Glenmark Pharma	602	3,275	1,023	378	171
Gateway Distr.	87	219	614	241	155
TCS	763	16,249	2,577	1,033	149
Pantaloon Retail	311	1,079	486	210	132

FII - FII trades

Scrip	12/9/2008			15/9/2008		
	Volume '000	Price	Prem %	Volume '000	Price	Prem %
Tata steel	1,100	529	0.5	692	502	1.0
Sbi	674	1,542	1.5	441	1,470	1.5
Obc	39	185	2.5	-	-	-
Union bank	47	157	5.0	115	142	4.5
Grasim	-	-	-	10	1,930	1.5
Pantaloon	17	406	19.0	-	-	-

Corporate Front Page

- **Raymond** launches *ColorPlus* brand of children's wear (BL)
- **Emami** raises price of its open offer for Zandu Pharma to Rs15,000/share (ET)
- Blackstone, Actis among PEs in race for acquiring more than 40% stake in **Usher Agro** (ET)
- **AllCargo** to form a SPV with shipping firms for Rs20bn port project (ET)
- **Jai Balaji Group** to start work on its Purulia project from November 2008 (DNA)

Economy Front Page

- Rupee closed at two-year low of Rs46.06 against the dollar (ET)
- Crude slips below US$96 per barrel but Government rules out any retail price cuts (ET)
- Foreign telecom companies cannot launch 3G services with 5MHz of spectrum, says DoT (ET)
- Government puts clinical research approvals on fast lane (ET)
- Railways to offer 5-6% freight rebate on caustic soda, caustic soda liquor and alumina (ET)
- Government appoints Ashok Chawla as economic affairs secretary in Ministry of Finance (DNA)

Insider Trading

Company	Name of Acquirer / Seller	Transaction Date	Buy /Sale	Quantity	Price (Rs)	Deal Size (Rs m)	Shares Transaction (%)	Holding after Transaction (%)
Bosch Chassis Systems India Ltd	Robert Bosch GmbH	10/09/2008	Buy	3,300,854	586.0	1,934	15.9	95.9
Geometric Ltd	Rakesh Jhunjhunwala	04/09/2008	Buy	250,000	66.0	17	0.4	9.0
Kohinoor Foods Ltd	Temptation Foods Ltd	09/09/2008	Buy	228,826	125.0	29	0.9	6.8
Kohinoor Foods Ltd	Temptation Foods Ltd	10/09/2008	Buy	100,000	125.0	13	0.4	7.1
Setco Automotive Ltd	Harish Sheth-HUF	10/09/2008	Sell	275,000	190.0	52	3.1	2.9
Setco Automotive Ltd	Setco Engineering Pvt Ltd	10/09/2008	Buy	275,000	190.0	52	3.1	44.6
Subex Ltd	Subash Menon	10/09/2008	Buy	115,000	108.0	12	0.3	5.0
Wires & Fabriks (SA) Ltd	W & F Securities P Ltd	12/09/2008	Buy	1,499,499	55.3	83	49.1	50.6
Yes Bank Ltd	Alok Gupta	08/09/2008	Buy	125,000	148.0	19	0.0	0.0

Deal Size worth more than Rs10m considered

BSE/ NSE - Bulk Deals

Company	Name of Acquirer / Seller	Transaction Date	Buy /Sale	Quantity	Price (Rs)	Deal Size (Rs m)
Ahmednagar F	Warhol Limited	15/09/2008	Buy	2,640,000	87.0	230
Ahmednagar F	Copthall Mauritius International Ltd	15/09/2008	Sell	447,258	87.0	39
Ahmednagar F	Citigroup Global Markets Mauritius Pvt Ltd	15/09/2008	Sell	2,182,310	87.0	190
Bartronics India Ltd	Grants Investments Ltd. A/C Gdr	15/09/2008	Sell	175,777	156.7	28
Diamon Cable	Merrill Lynch Capital Markets Espana S.A. S.V.	15/09/2008	Buy	125,000	260.0	32
K S Oils Ltd	Morgan Stanley Mauritius Company Ltd	15/09/2008	Buy	3,830,398	60.0	230
K S Oils Ltd	Morgan Stanley Mauritius Company Ltd	15/09/2008	Sell	4,347,873	60.0	261
Rolta India Ltd	Fidelity Funds - Emerging Markets Fund	15/09/2008	Sell	974,894	300.2	293
United Spirits Ltd	Deutsche Securities Mauritius Limited	15/09/2008	Buy	2,875,191	1256.6	3,613
United Spirits Ltd	Merrill Lynch Capital Markets Espana S.A. Svb	15/09/2008	Sell	2,705,695	1256.8	3,401

Corporate profitability – The impact of change in business and credit cycle

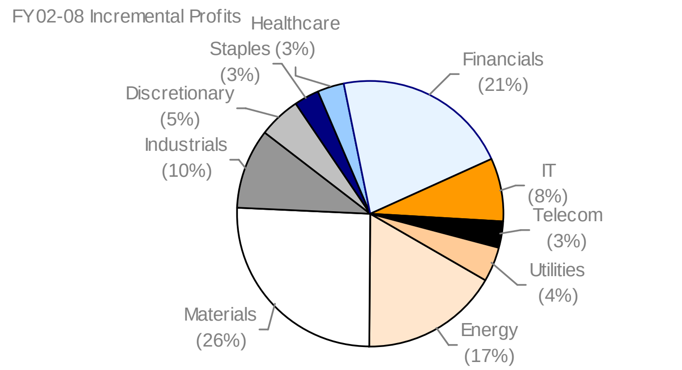
16 September 2008

A number of endogenous and exogenous factors resulted in a boom in business cycle in the past six years and those very tailwinds now seem to be turning into headwinds. The rise in commodity prices, bountiful availability of risk capital, credit acceleration led demand growth were some of the key causative drivers for the ebullience in the past six year's business cycle. In the backdrop of a benevolent cycle, between FY02-08, net profits of a universe of 926 companies rose by 33% Cagr, much faster than nominal GDP Cagr of 13%. Productivity gains, operating and financial leverage made the profit cycle sweeter. The unfolding scenario for the next 12-24 months looks very different though, as the business cycle seems to be reversing course. A disaggregation analysis of FY08-10 Nifty consensus earnings shows that analyst estimates still look optimistic, given the trend reversal in business cycle. With the narrowing of RoE-CoE spreads, the case for sustenance of valuations at current levels, look even tougher. The companies that are most at risk in terms of potential earnings downgrades are those with high gearing and high operating leverage.

- Led by a strong turnaround in business cycle, India's corporate profits rose at 20%pts above the nominal GDP Cagr in the FY02-08 period. Gross margins grew multi-fold, Ebidta grew faster than revenues, and net profits grew faster than Ebidta. Almost two-thirds of the profit growth came from just three sectors – materials, energy and financials. The boom in commodities and a benign credit cycle thus were major drivers for earnings accretion, and both of these factors, on the margin, are reversing course. Capital, the other fuel for balance sheet and profit expansion, is getting expensive and scarce. FX translation gains could now well turn out to be losses, and this will be an added factor weighing down reported profit growth.

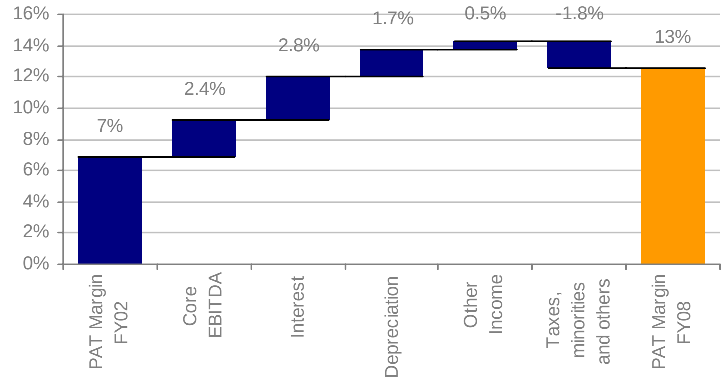
- Consensus is forecasting FY08-10 net profit Cagr of 20% for the widely tracked Nifty index. Of the incremental growth, 49% is expected to come from the materials and energy sectors. Even adjusted for large capacity additions in refining and natural gas production, we believe that the aggregate estimates are not factoring in the change underway in business and credit cycle. The earnings of the lesser tracked mid-small cap companies would be at even greater risk, if history is any guide, given their higher operating and financial leverage to changes in cycles. From a portfolio perspective, we believe that the high risk zones are companies with high gearing, high operating leverage and stocks with high back-ended growth.

Sectoral breakdown of incremental profits growth



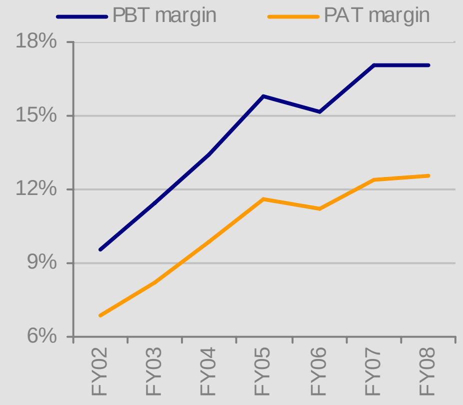
Source: Capitaline, IIFL Research

Lower interest expense biggest contributor to margin expansion



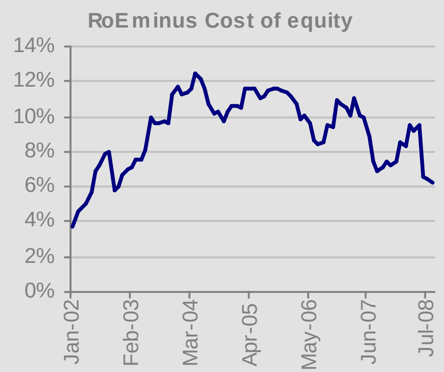
Source: Capitaline, IIFL Research

Margins (ex financials) – At the peak?



Source: Capitaline, IIFL Research.

RoE minus CoE - narrowing



Source: MSCI, Bloomberg. Calculated as MSCI India RoE (PB *multiplied* by PE) minus FIMMDA 5yr AAA bond yield *plus*300bps

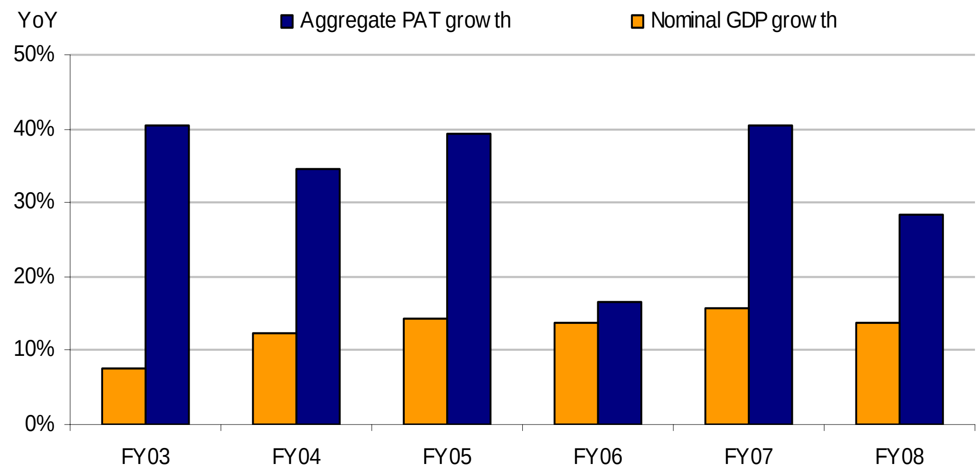
Nemkumar
nemkumar@iiflcap.com
(91 22) 6620 6630

Ashutosh Datar
ashutosh.datar@iiflcap.com
(91 22) 6620 6642

India's business cycle started to boom sometime around 2003. The upswing in the cycle was led by a multiplicity of factors, key ones being a synchronized global growth leading to a favourable demand environment, moderation in cost of capital and abundant availability of risk capital, commodity price and asset price inflation, acceleration in credit to GDP ratios, and a catch-up phase in capacity creation to cater to the rising demand, fuelling the investment cycle.

In order to assess the impact of the benevolent business cycle on the corporate profitability, we decided to cull out the financial data points for 926 companies, for which data series was available for the period from FY02-08. We had to exclude some large cap listings like RCom, from this exercise due to non-availability of data prior to the listing date (DLF, NTPC, TCS are however included due to data availability). We also excluded the large acquisition of Corus and public sector oil marketing companies—IOC, BPCL and HPCL—to make the comparisons more meaningful. Notwithstanding these exclusions, the universe is diverse enough to draw conclusions that we have attempted to draw, for this exercise.

Figure 1: Corporate profits grew at 20%pt more pa than Nominal GDP over past 6-yrs



Source: Capitaline, IIFL Research
Note: Includes all companies with market cap currently move than Rs1bn and which have reported financial result history beginning FY02. Considers standalone results for Tata Steel. Excludes HPCL, BPCL and IOC.

Between FY02-08, India's nominal GDP grew by 13% Cagr. The topline growth for this universe (ex financials) grew by 22% Cagr, Ebidta grew by 24% Cagr, and net profits by 34% Cagr. Ebidta thus grew faster than revenues and net profits grew faster than Ebidta. This can be explained by productivity gains (as companies downsized labour and improved processes in the 1998-02 downturn), operating and financial leverage, and higher non-operating income on cash raised from dilutions. Large translation gains on FX liabilities, led by the appreciating trend in rupee till March-08, further helped to boost non-operating income. In particular, for commodity companies like RIL and Tata Steel, the operating leverage in a cyclical boom was understandably large enough to push up the profits several times over.

Figure 2: Large swings in profits over FY02-08

Company	Sector	FY02 Profit	FY08 Profit	Profit change
Reliance Inds.	Energy	33	195	162
O N G C	Energy	62	199	137
S A I L	Materials	-17	75	92
DLF Ltd	Financials	0	78	78
Bharti Airtel	Telecom	-1	64	65
St Bk of India	Financials	35	90	55
Tata Steel	Materials	2	47	45
Hind.Zinc	Materials	1	44	43
Sterlite Inds.	Materials	1	44	43
TCS	IT	11	50	39

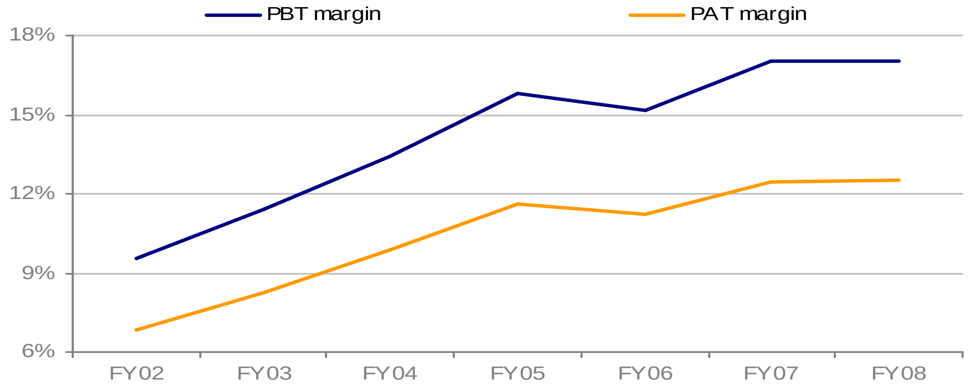
Source: Capitaline, IIFL Research

Figure 3: FY02-08 - EBITDA growth faster than revenues, PAT faster than EBITDA

Ex financials and excluding HPCL, BPCL and IOC	FY02-08 Cagr
Net Sales	22%
EBITDA	24%
Interest	4%
Depreciation	15%
Other income	25%
PAT	34%

Source: Capitaline, IIFL Research
Note: Includes all companies with market cap currently move than Rs1bn and which have reported financial result history beginning FY02. Considers standalone results for Tata Steel. Excludes HPCL, BPCL and IOC.

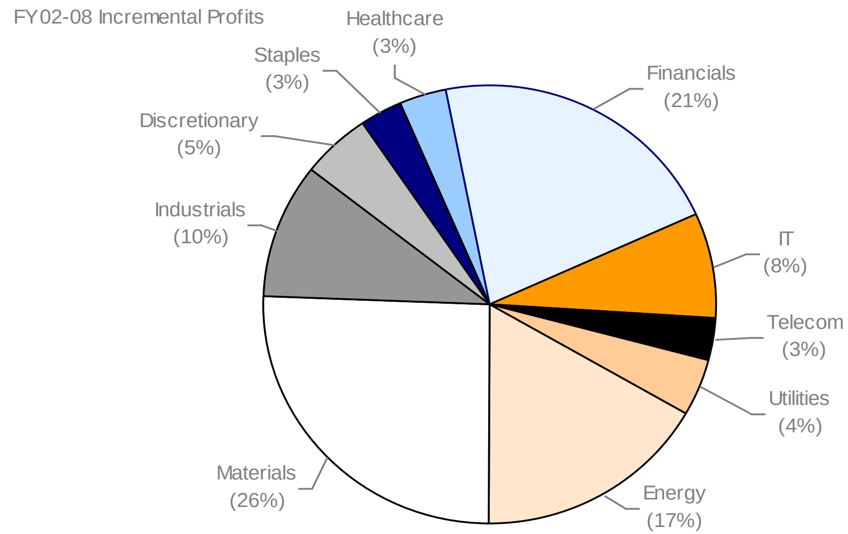
Figure 4: Profit margins – are they at their peaks?



Source: Capitaline, IIFL Research

A sectoral disaggregation of the earnings Cagr is given in Figure 3. For this universe, 64% of the incremental earnings growth came from just three sectors, i.e. materials (metals, chemicals, cement), energy (oil, gas, petrochems), and financials. The sector with the slowest earnings growth was utilities with 15% earnings Cagr. That 42% of the net profit expansion came from global cyclicals like metals, refining, oil and petrochems goes on to suggest that Indian companies, on a net basis, did benefit from the rise in global commodity prices. Till very recently, the commodity user industries had the pricing power to absorb these cost increases and still grow profits, if not margins. The business cycle was benevolent and powerful enough to lift all boats, though the global and domestic cyclicals understandably were relatively better off.

Figure 5: Sectoral breakdown of FY02-08 incremental profits growth



Source: Capitaline, IIFL Research
Note: Includes all companies with market cap currently move than Rs1bn and which have reported financial result history beginning FY02. Considers standalone results for Tata Steel. Excludes HPCL, BPCL and IOC.

Figure 6: Sector wise Earnings Cagr

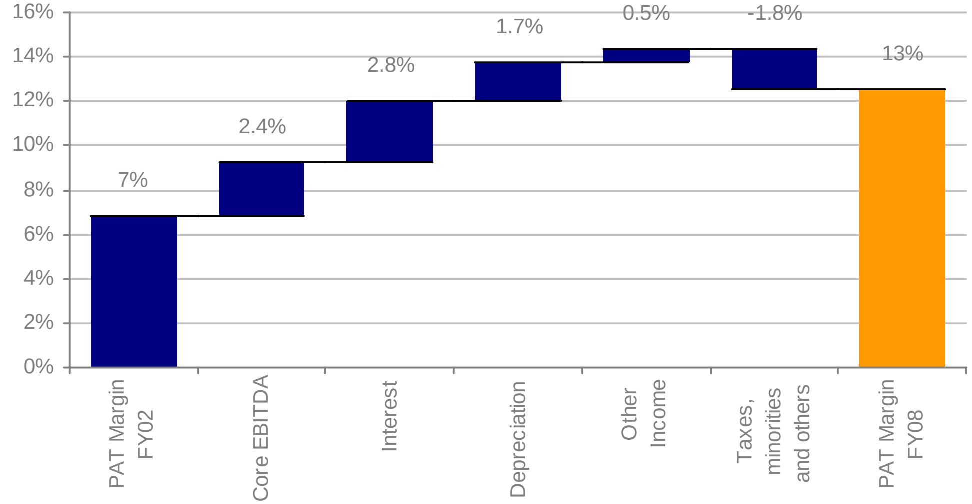
Sectoral profit growth	FY02-08 PAT Cagr
Energy	29.8%
Materials	177.5%
Industrials	43.6%
Consumer Discretionary	38.7%
Consumer Staples	17.2%
Health care	26.6%
Financials	28.8%
Information Technology	28.4%
Telecommunication Services	25.6%
Utilities	15.1%
Total	33.0%
Total ex Materials	27.9%

Source: Capitaline, IIFL Research
Note: Includes all companies with market cap currently move than Rs1bn and which have reported financial result history beginning FY02. Considers standalone results for Tata Steel. Excludes HPCL, BPCL and IOC.

Aggregate net profit margins as % of sales for this universe (ex financials) rose from 7% in FY02 to 13% in FY08. A growth disaggregation of net profit margins shows that 2.4%pts of margin expansion came from Ebidta, 2.8%pts came from savings in interest costs, 1.7%pts from lower depreciation charge, 0.5%pts due to increase in other income while taxes, minorities and others dragged down margins by 1.8%pts.

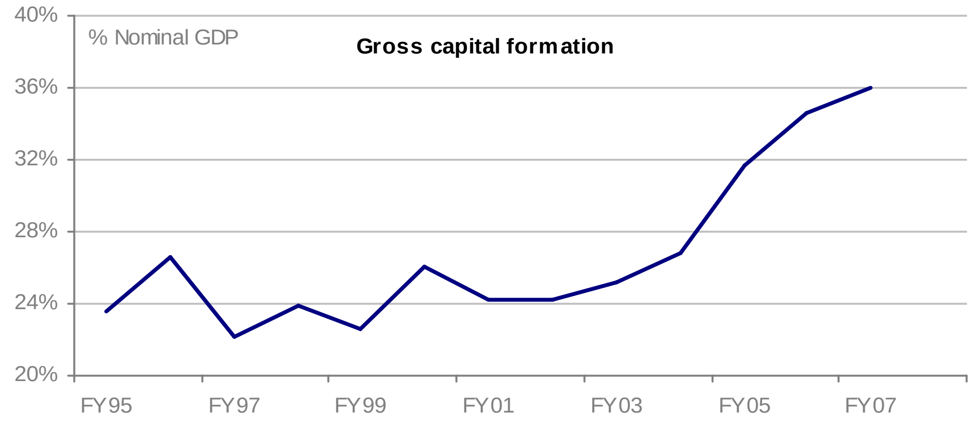
The ensuing virtuous cycle from better profitability, resulted in strong growth in capital formation in the private sector (from 5.4% of GDP in FY02, to 14.5% in FY07) and that in turn was a part contributor to the strong growth in India's GCF.

Figure 7: Lower interest expense (% sales)—biggest contributor to margin expansion



Source: Capitaline, IIFL Research
Note: Includes all companies with market cap currently move than Rs1bn and which have reported financial result history beginning FY02. Considers standalone results for Tata Steel. Excludes HPCL, BPCL and IOC.

Figure 8: Gross capital formation grew at a Cagr of 22% between FY02-07



Source: CSO

In the above backdrop, let's visualize the scenario that seems to be unfolding over the next 12-24 months. As compared to the past six years, the following elements are undergoing a reversal in trend or if not, at least a deceleration in growth of varying degrees:

- The tailwind of strong global growth seems to be behind us, even as domestic growth rates are decelerating for several reasons
- Commodity prices are softening and in the current environment, it is fair to assume that they are likely to remain subdued for some time to come. Profit margins of commodity producers will come off, in some cases materially, in the coming quarters.
- Risk capital has become scarce and cost of capital for Indian companies is almost back to the levels seen in the latter part of the last decade. Interest rates may remain sticky, even if inflation comes off, for other reasons.
- Credit growth is slowing, due to the diktat of RBI as well in-house risk management needs of banks, and the consequent impact of slowdown in credit growth is now gradually seeping into the economy

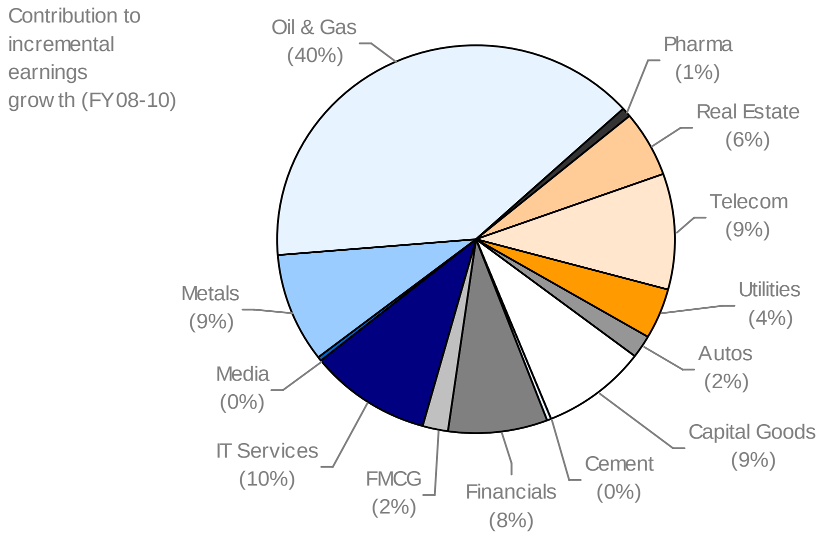
- The trend of continued rupee appreciation that resulted in large translation gains has at least temporarily reversed
- Asset prices are deflating, negatively impacting earnings of sectors like real estate
- In addition, there is limited scope for any more productivity gains. Any more such gains can come only from improvement in quality of infrastructure (like availability of reliable power at cheaper rates) but that will come in trickles.

Selectively, industries like cement, autos and refining have added (or are adding over the next 12 months) large capacities, the commissioning of which is coinciding with a demand slowdown. The risk of operating leverage, working in the reverse, is therefore rising, in our view.

What will happen to corporate profit growth in the new context of a not-so-benevolent business cycle? Can corporate earnings growth be slower than nominal GDP growth in the next 2 years? Are analysts factoring in the changes in business cycle in their earnings?

To answer these questions, we looked at the more widely tracked Nifty basket. Consensus is forecasting 19% earnings growth for FY09 and 21% for FY10. It is true that 22% of the incremental growth in earnings in FY09 and 38% in FY10 is coming from RIL and RPL, led by large capacity additions in natural gas production, refining and petrochemicals. Nonetheless, these estimates still seem to be at risk. Over the past few months, anecdotal evidence suggests that the quality of balance sheets have deteriorated, gearing levels have risen and pricing power is waning across industries. The risk of any slippage in project execution, at least for RIL and RPL are not priced in, at all. The case for valuation multiples sustaining at current levels, in the face of likely downgrades, looks tough.

Figure 9: Incremental consensus Nifty earnings growth (FY08-10)



Source: Bloomberg, IIFL Research

Figure 10: Consensus Nifty and Nifty sector earnings growth

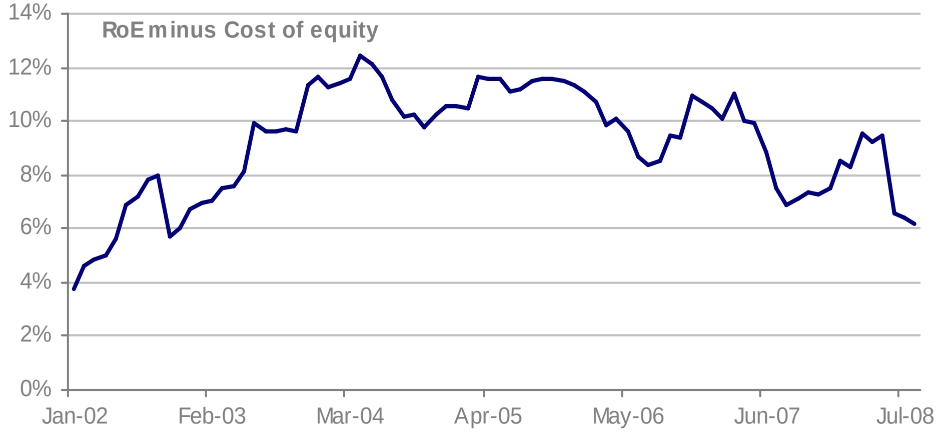
Consensus Nifty Sector earnings growth	Cagr FY08-10	Contribution to incremental earnings growth (FY08-10)
Auto & Auto Ancillaries	11.8%	2.0%
Capital Goods	32.5%	8.6%
Cement	-2.8%	-0.4%
Financials	14.5%	7.9%
FMCG	13.9%	2.2%
IT Services	19.4%	9.9%
Media	22.8%	0.3%
Metals	13.2%	9.2%
Oil & Gas	29.2%	40.1%
Pharma	9.2%	0.8%
Real Estate	18.4%	5.6%
Telecom	22.1%	9.5%
Utilities	12.9%	4.2%
Nifty	19.8%	100.0%
Nifty ex RIL and RPL	15.4%	69.0%
RIL and RPL	57.8%	31.0%

Source: Bloomberg, IIFL Research

When credit cycles worsen the way they have in the past 6-8 months, they leave an uneven impact on corporate earnings. In general, the smaller companies tend to suffer more than their larger peers, given their inability to borrow at more competitive rates and their relatively higher leverage (both operating and financial) to changes in business cycle. It is only appropriate to assume that the earnings of lesser tracked mid-cap and smaller companies are at greater risk, when business cycles reverse course. That they benefited more when the cycle turned benign in 2003, is a story that's well known and well documented.

It's even tougher, if one were to look at the shrinking gap between RoE and CoE. When the bull rally began in 2003-04, the widening gap between RoE and CoE was used as a justifiable argument for re-rating of Indian equities. The situation is converse now, with CoE having moved up and remaining stubbornly high, even as RoEs are coming off.

Figure 11: RoE minus CoE gap is narrowing



Source: MSCI, Bloomberg. Calculated as MSCI India RoE (PB *multiplied* by PE) minus FIMMDA 5yr AAA bond yield *plus*300bps

From a portfolio perspective, high-risk zones are companies with high gearing (or those having large funding gaps), companies with high operating leverage and stocks whose valuations are predominantly linked to growth. With capital preservation being the dominant theme in the near-term, the risk-reward is much more favourable to own stocks that are relatively cheap and those with relatively higher degree of earnings predictability. In a deteriorating business cycle and credit cycle environment, the challenge would lie in avoiding stocks that run the risk of big earning cuts; and the factors that will drive these cuts, as always in most cases, will be due to reasons beyond management's control.

IDFC – SELL

IDFC IN	Rs82	Banking	16 Sep 2008	Visit Note

Cap on leveraging

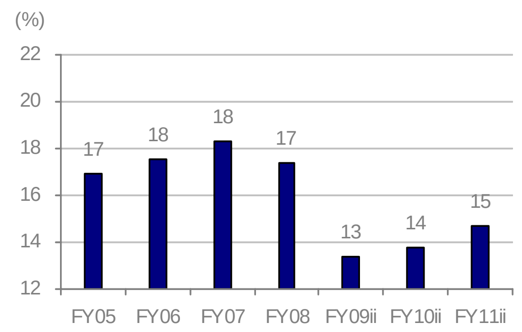
Our recent meeting with IDFC management inclines us to believe that there is a marked slowdown in the core project lending business, caused by a combination of demand slowdown and the need to conserve capital. The company is unable to leverage more than 5x (versus 7x earlier), so as to retain its "AAA" rating. A slowdown in the low-RoE project lending is not negative per se, as long as it does not adversely affect other income streams. But that remains to be seen. IDFC's management plans to raise US$250m in new equity before end of this fiscal and this would translate to ~9% dilution. The silver lining is the AMC business, whose AuM the company reckons will reach US$2.3bn by end-FY09. We expect IDFC's earnings CAGR to decelerate to 14% over FY08-10 from 29% over FY06-08. SELL.

Core lending business to slow down… We expect IDFC's core project finance business to slow down considerably from current levels (42% YoY in 1QFY09), mainly because of its need to conserve capital and partly because of delays in new infrastructure projects. Consequently, we estimate loan growth at 20% CAGR over FY08-10 compared to 40% CAGR in the last two years. Infrastructure loan approvals have dipped sharply in recent months.

…but will this affect other businesses? It remains to be seen if this slowdown will hurt the company's other income streams such as advisory, investment banking fees and principal investments. In the past, the company maintained that project lending is important for garnering other related businesses and it even considered acquiring a commercial bank to get access to retail deposits.

Cap on leveraging is a structural negative: IDFC has the highest Tier-I CAR of 17.7% in its peer group. However, this needs to be raised to a minimum of 20% to satisfy rating agencies and retain its AAA rating. An equity issuance of US$250m is planned in the current year, and this should be enough for the next two years. But this would entail slower asset growth of below 20% during this period, compared to 53% CAGR in the past two years. Inability to leverage will likely cap IDFC's peak ROE at not more than 15%, compared with 19% before the last round of capital raising in July 2007.

ROE trends



Source: Company, IIFL Research

Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Op income (Rs m)	7,158	13,236	15,515	19,157	22,744
Net profit (Rs m)	5,039	7,422	8,610	10,670	12,659
EPS (Rs)	4.5	5.8	6.1	7.6	9.0
Growth (%)	28.6	29.9	5.4	23.8	18.6
PER (x)	18.3	14.1	13.4	10.8	9.1
Dividend yield (%)	1.1	1.3	1.3	1.6	2.2
Price/Book (x)	**3.1**	**1.9**	**1.6**	**1.4**	**1.3**
ROA (%)	3.4	3.2	2.9	3.1	3.1
ROE (%)	18.3	17.4	13.3	13.8	14.7
CAR (%)	20.4	22.2	25.4	24.6	23.7

Price as at close of business on 15 Sept 2008

12-mth Target price (Rs) 78 (-5%)

Market cap (US$ m)	**2,326**
52Wk High/Low (Rs)	235/81
Diluted o/s shares (m)	1295
Daily volume (US$ m)	27.8
Dividend yield FY08ii (%)	1.3
Free float (%)	77.9

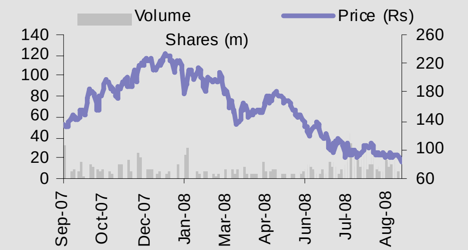
Shareholding pattern (%)

GOI / IDBI	22.1
FIIs	43.9
Domestic MF/Insurance cos	24.5
Others	9.5

Price performance (%)

	1M	3M	1Y
IDFC	-14.3	-37.7	-36.8
Rel. to Sensex	-6.2	-26.8	-23.5
HDFC	-3.7	3.5	-0.8
SBI	2.4	11.6	-4.3
Power Finance	-4.0	5.8	-35.6

Stock movement

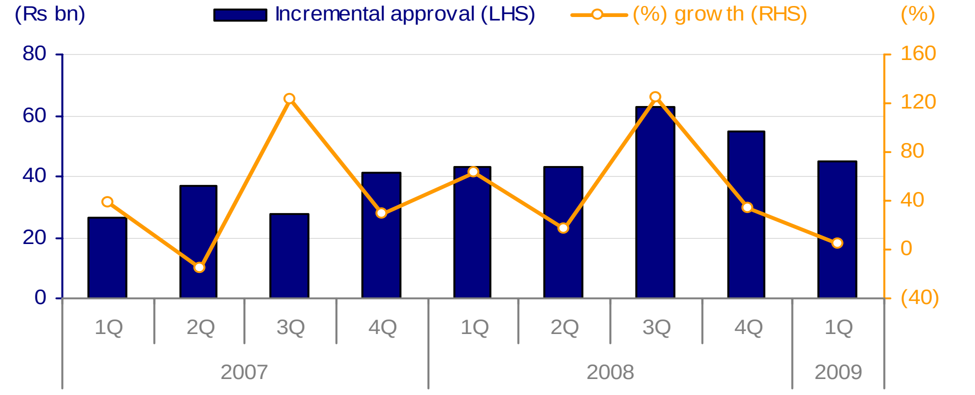


Prabodh Agrawal
prabodh@iiflcap.com
(65) 6511 6161

Parthapratim Gupta
parthapratim@iiflcap.com
(91 22) 6620 6652

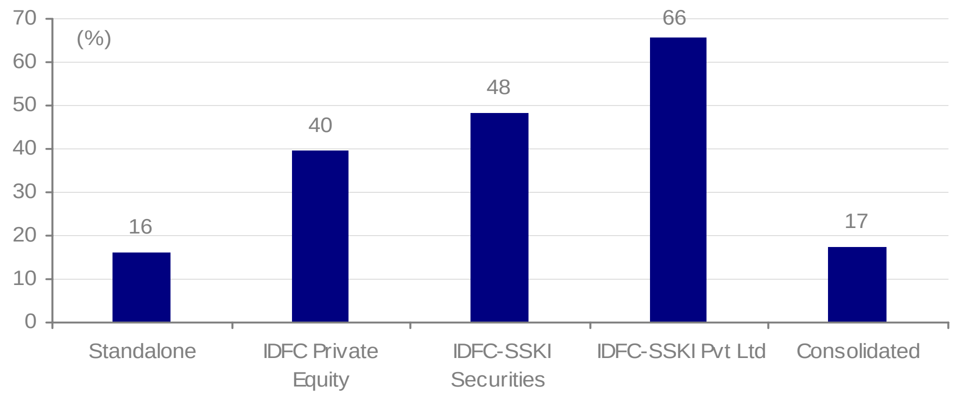
Cap on leveraging

Figure 1: Loan approvals – beginning to slow down



Source: Company, IIFL Research

Figure 2: ROE break-up (FY08) – RoE remains low for core lending business

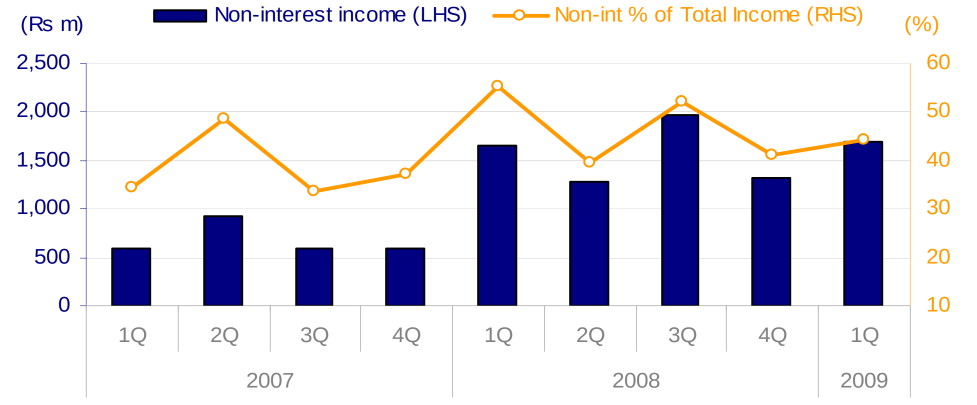


Source: Company, IIFL Research

Equity issuance of US$250m in FY09: IDFC has received shareholders' approval to raise up to US$750m in a combination of Tier-I and Tier-II capital. However, equity issuance is likely to be limited to US$250m. Assuming new equity issue of US$250m at Rs95/share, this would be dilutive by 9%. Shareholders' funds would expand by 20%, driving down current-year ROE to 13.3% from the 15.2% estimated earlier.

Income from capital markets and principal investments slowing down too: Decline in gains from principal investments (down 18% YoY in 1QFY09) and investment banking fees (down 28% YoY) were on expected lines. While the company still has Rs2.5bn of unrealised gains on its investments, we believe it would be increasingly difficult to book these gains. On the investment banking side, IDFC successfully completed a QIP (Gammon Infra) and IPO (KSK Energy) in 1QFY09. Absent more such deals going forward, this income stream will likely decline. We have assumed a 30% decline in principal gains and a 25% decline in investment banking fees in FY09. Advisory fees, though not affected by capital market conditions, would also see a slowdown, with growth in disbursements tapering off. We estimate fee income from advisory fees will grow by a slower 12.5% in FY09 and by 10% in FY10.

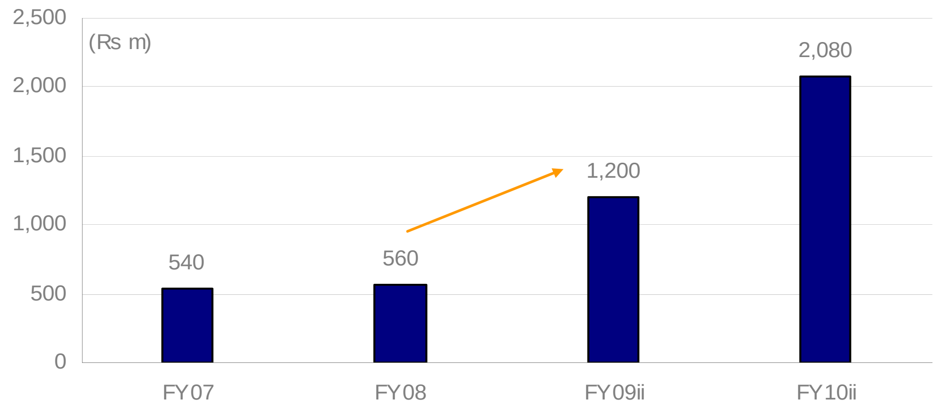
Figure 3: Non-interest income growth declining



Source: Company, IIFL Research

AuM mobilisation is on track: A silver lining is the AMC business, whose AuM we estimate will reach US$2.35bn by end-FY09, as guided earlier. IDFC has already raised US$500m as the first tranche of its infrastructure fund launched with Citigroup. For the second tranche of US$500m to be launched soon, it has firm commitments of US$380m. For its third PE fund of US$700m, it has received firm commitments and is awaiting RBI approval. IDFC earns fees on total fund size from the first date of close. Hence, we expect fees from asset management to more than double in FY09 to Rs 1.2bn and grow by a further 73% to Rs2bn in FY10.

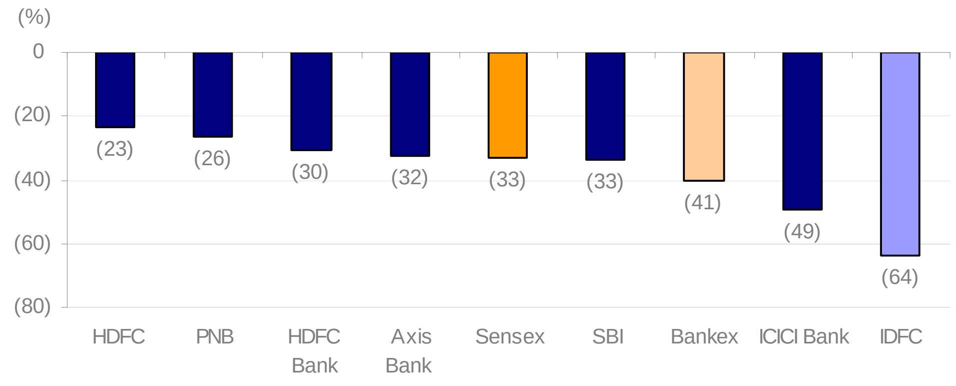
Figure 4: AMC fees expected to double in FY09



Source: Company, IIFL Research

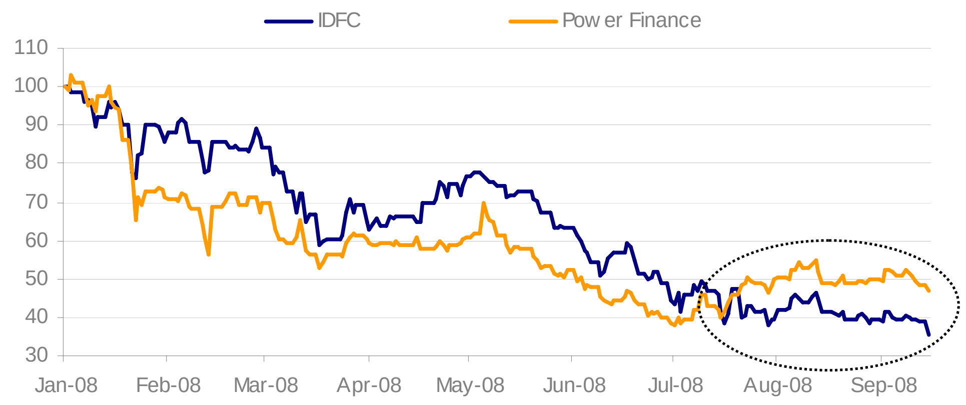
No major deterioration in asset quality: IDFC has exposure to about 300 projects and none has been restructured so far. Management believes that some ongoing projects may get delayed by 18-24 months but are unlikely to be shelved. However, financial closure of new projects may be prolonged in the current environment. Net NPLs remain zero and the company has stepped up loan-loss provisioning (from 0.5% to 1.0%) on some risky exposure.

Figure 5: YTD performance – IDFC vis-à-vis peers



Source: Bloomberg, IIFL Research

Figure 6: IDFC relative performance (YTD) vis-à-vis Power Finance Corporation



Source: Bloomberg, IIFL Research

Financial summary

Sharp deceleration in fee income growth

Cost-to-income ratio set to rise

EPS CAGR of 14% over FY08-10ii

Loan growth to moderate

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Interest income	13,043	21,885	28,775	33,783	40,369
Interest expense	8,555	14,829	19,164	22,090	26,286
Net interest income	**4,488**	**7,056**	**9,612**	**11,693**	**14,083**
Fee Income	1,340	4,020	4,391	5,801	6,748
Others	1,330	2,160	1,512	1,663	1,913
Non-interest income	**2,670**	**6,180**	**5,903**	**7,464**	**8,661**
Total op income	**7,158**	**13,236**	**15,515**	**19,157**	**22,744**
Employee cost	480	1,677	2,138	2,619	3,182
Other operating expenses	341	855	1,140	1,376	1,525
Total op expenses	**821**	**2,532**	**3,278**	**3,995**	**4,707**
Op profit pre prov	**6,337**	**10,705**	**12,237**	**15,162**	**18,037**
Provisions	175	700	719	899	1,123
Profit before tax	**6,162**	**10,004**	**11,518**	**14,263**	**16,914**
Taxes	1,241	2,480	2,879	3,566	4,228
Minorities and other	118	102	28	27	26
Net profit	**5,039**	**7,422**	**8,610**	**10,670**	**12,659**

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Net loans & advances	139,184	199,051	238,861	285,439	338,245
Cash & equivalents	10,800	18,081	16,886	14,618	14,056
Other int-earning assets	23,903	52,257	59,217	68,586	80,926
Total int-earning assets	**173,888**	**269,391**	**314,967**	**368,647**	**433,233**
Fixed assets	490	3,850	565	650	747
Other assets	9,463	16,172	20,976	27,751	34,127
Total assets	**183,841**	**289,413**	**336,509**	**397,048**	**468,107**
Other int-bearing liabs	149,028	223,277	248,735	295,364	352,062
Total int-bearing liabs	**149,029**	**223,279**	**248,738**	**295,368**	**352,067**
Other non-int-bearing liabs	5,335	10,201	14,282	19,995	24,993
Total liabilities	**154,365**	**233,480**	**263,019**	**315,363**	**377,060**
Net worth	**29,476**	**55,933**	**73,489**	**81,686**	**91,047**
Total liabs & equity	**183,841**	**289,413**	**336,509**	**397,049**	**468,108**

Source: Company data, IIFL Research

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Balance Sheet Structure Ratios (%)					
Loans / Borrowings	93.4	89.1	96.0	96.6	96.1
Loan Growth	38.0	43.0	20.0	19.5	18.5
Growth in Borrowings	58.9	49.8	11.4	18.7	19.2
Growth in Total Assets	49.4	56.4	15.4	17.0	17.5
Profitability Ratios (%)					
Net Interest Margin	3.0	3.2	3.3	3.4	3.5
Return on Average Assets	3.4	3.2	2.9	3.1	3.1
Return on Average Equity	18.3	17.4	13.3	13.8	14.7
Non-Int Inc as % of Tot Inc	37.3	46.7	38.0	39.0	38.1
Net Profit Growth	29.0	47.3	16.0	23.9	18.6
FDEPS Growth	28.6	29.9	5.4	23.8	18.6
Efficiency Ratios (%)					
Cost to Income Ratio	11.5	19.1	21.1	20.9	20.7
Salaries as % of Non-Int Costs	58.4	66.2	65.2	65.6	67.6
Credit Quality Ratios (%)					
Gross NPLs as % of loans	0.2	0.2	0.3	0.3	0.3
NPL coverage ratio	284.3	105.6	81.9	92.0	129.3
Total prov as % avg loans	0.1	0.2	0.2	0.3	0.3
Net NPLs as % of net loans	0.0	0.0	0.0	0.0	0.0
Capital Adequacy Ratios (%)					
Total CAR	20.4	22.2	25.4	24.6	23.7
Tier I capital ratio	16.1	19.5	22.5	21.8	21.0
Key earnings drivers (%)					
Loan growth	38.0	43.0	20.0	19.5	18.5
Net interest margin	3.0	3.2	3.3	3.4	3.5
Net int income growth	57.8	57.2	36.2	21.7	20.4
Core fee income growth	40.3	200.0	9.2	32.1	16.3
Non-int inc as % of total	37.3	46.7	38.0	39.0	38.1
Operating costs growth	50.6	208.2	29.5	21.9	17.8
Cost/income ratio	11.5	19.1	21.1	20.9	20.7
Gross NPAs as % of loans	0.2	0.2	0.3	0.3	0.3
Total prov as % of loans	1.4	1.5	1.5	1.7	1.9
Tax rate	20.1	24.8	25.0	25.0	25.0

Source: Company data, IIFL Research

Net interest margins to improve

ROE declining due to equity dilution

Asset quality remains comfortable

Higher Tier I as per rating agency requirements

Glenmark Pharma – REDUCE

GNP IN	Rs602	Pharmaceuticals	16 Sep 2008	Initiating coverage

Falling short of expectations

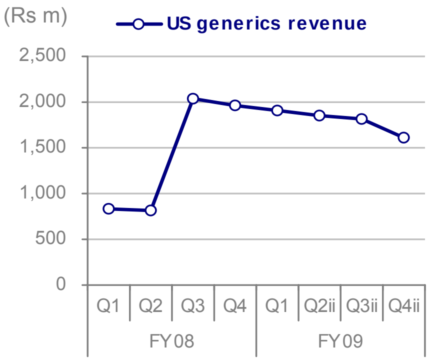
Glenmark is richly valued at current levels because there is little upside to current consensus expectations and several downside risks to it, in our view. The major risks are: 1) potential waning of US generic Trileptal revenue (which formed nearly 23% of the company's 1QFY09 revenue); 2) erosion of business in other geographies over the last couple of quarters and limited visibility in the quarters ahead; and 3) potential delays in launch of oglemilast, GRC 6211 and melogliptin. We initiate coverage with a price target of Rs596. REDUCE.

Limited visibility across geographies: Nearly half of Glenmark's US revenue in 1QFY09 came from generic Trileptal. Revenue from this product is likely to decline in the next few months, leading to an overall slowdown in US revenues. Growth in the Indian market is slowing down to mid- to low teens and we see no organic triggers to accelerate growth. Revenue from Latin America declined by more than 30% YoY in each of the last two quarters. Sales to other semi-regulated markets also declined 11% YoY in 1QFY09 after a slow 8.6% growth in FY08.

Upside from pipeline seems difficult at this stage: Licensing revenues may continue to flow in from Glenmark's R&D pipeline, but major upsides are unlikely, in our view. Oglemilast belongs to a failed class of molecules—PDE IV inhibitors—and the development partner Forest Labs seems to have low focus on it. Glenmark's latest guidance of regulated market launch by 2011 is too optimistic, in our view. A first-rung global pharma company may have reservations in picking up melogliptin, which has been dropped by Merck KGaA. Unpredictability of licensing revenue adds to the risk.

Limited upside to consensus: Our FY09-11 earnings estimates are 13-26% below current consensus estimates. Our price target of Rs596 is 20x FY10ii core earnings, in line with the multiples we apply to other large Indian pharma companies. Low visibility on outlicensing revenues and volatility in generic business growth are the major risks to our estimates.

Fall in generic Trileptal revenue can affect US growth rates



Source: Company, IIFL Research

Financial summary

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenues (Rs m)	12,185	19,812	23,233	27,074	33,389
EBITDA Margins (%)	35%	41%	39%	39%	39%
Pre-Exceptional PAT (Rs m)	3,093	6,321	6,894	7,852	9,980
Reported PAT (Rs m)	3,093	6,321	6,894	7,852	9,980
EPS (Rs)	11.6	25.0	27.0	30.6	38.9
Growth (%)	260.7	115.9	8.0	13.7	26.8
PER (x)	**52.1**	**24.1**	**22.3**	**19.6**	**15.5**
ROE (%)	45.1	41.6	30.8	25.9	24.3
Debt/Equity (x)	1.4	0.7	0.5	0.3	0.2
EV/EBITDA (x)	39.5	20.0	17.9	15.2	12.2
Price/Book (x)	23.5	10.0	6.9	5.1	3.8

Price as at close of business on 15 September 2008

12-mth Target price (Rs) 596 (-1%)

Market cap (US$ m)	**3,267**
52Wk High/Low (Rs)	736/351
Diluted o/s shares (m)	250
Daily volume (US$ m)	6.3
Dividend yield FY08 (%)	0.1
Free float (%)	47.9

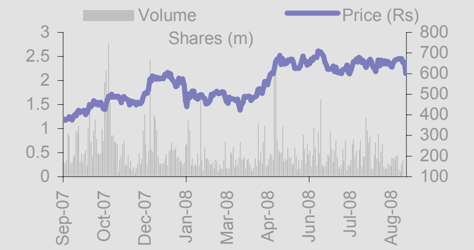
Shareholding pattern (%)

Promoters	52.1
FIIs	28.9
Domestic MFs/Insurance cos	4.0
Others	15.0

Price performance (%)

	1M	3M	1Y
Glenmark Pharmaceuticals	-9.6	-15.3	60.5
Rel. to Sensex	-1.5	-4.4	73.8
Ranbaxy Lab	-15.9	-25.9	1.5
Dr Reddy's Lab	-4.7	-22.9	-12.3
Sun Pharma	1.3	-0.1	47.6

Stock movement

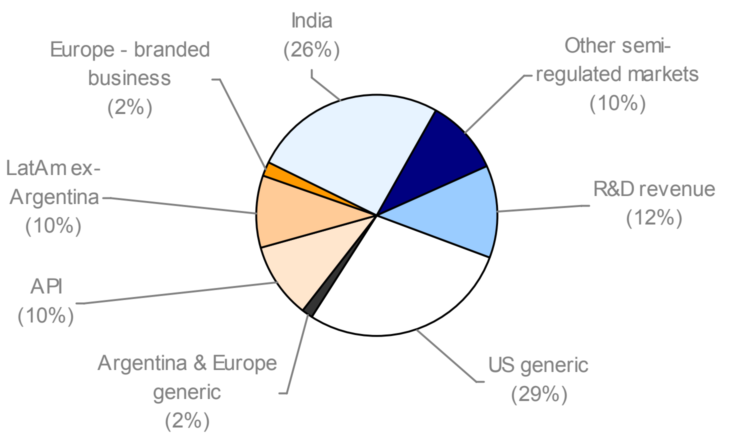


Dr Bino Pathiparampil
bino@iiflcap.com
(91 22) 6620 6648

Risks to boom time

Glenmark has grown rapidly over the last couple of years on the back of entry into new markets, a couple of large out-licensing deals in the R&D pipeline and the generic Trileptal exclusivity opportunity. While growth from new product launches across markets should continue, we believe there are some near-term risks to overall growth expectations. A gradual decline in sales of generic Trileptal may affect US generics revenues and failure of out-licensed molecules could dry up milestone payments. Recent volatility from other geographies adds to our concern.

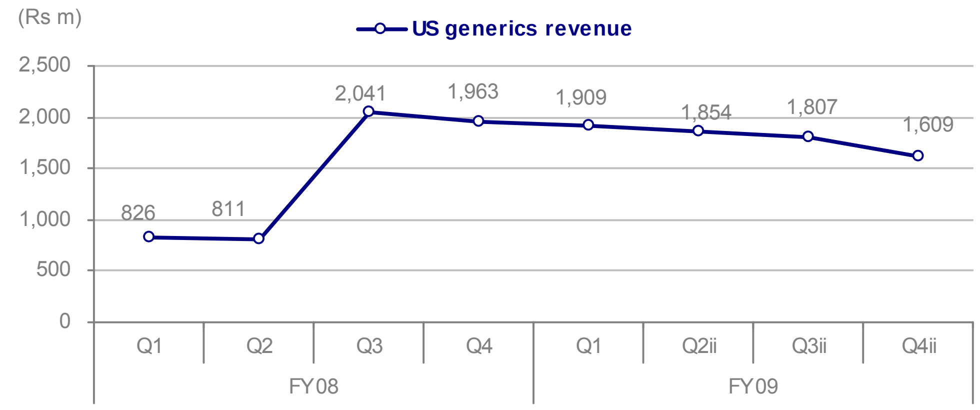
Figure 1: India and US generics contributed most to Glenmark topline in FY08



Source: Company

Erosion of generic Trileptal sales may be difficult to compensate for:
In the first two quarters of FY08, Glenmark's US generics revenue was around Rs800m. In 3QFY08, it shot up to Rs2041m, on the back of generic Trileptal exclusivity, which continued into 4QFY08. Based on interaction with company sources, we understand that the Trileptal upside continued into 1QFY09 as well, though the exclusivity period had expired. In 1QFY09, generic Trileptal contributed about US$25m to the topline. It is difficult to understand the dynamics in the generics Trileptal market since the companies involved do not disclose specific sales numbers and third-party sources are not completely reliable. However, we believe that this revenue stream is at risk of erosion, as price falls and competition increases over the next few months. Currently, there are seven players with FDA approval to sell generic versions of Trileptal. While growth from other products and new launches could compensate partly for loss of revenue from Trileptal, we feel that overall, US generics revenues may see QoQ declines, going forward.

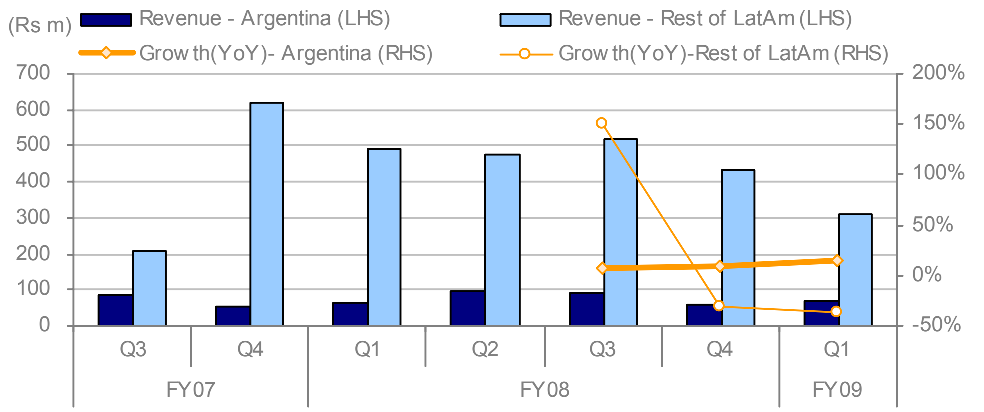
Figure 2: Waning generic Trileptal revenues pose risk to US revenue growth



Source: Company, IIFL Research

Latin America – low visibility on growth
Glenmark's Latin American operations showed good growth in the last couple of years and contributed about 11% of the total revenue in FY08. However, we are concerned about the significant volatility in sales over the last couple of quarters. Latin America, excluding Argentina, declined by over 30% YoY in each of the last two reported quarters. The company attributed the drop in revenue to its failure to obtain some hospital contracts, but there is little visibility on regaining the lost business. Argentina operations grew only 17% in FY08, despite the low base.

Figure 3: Volatile revenues in Latin America

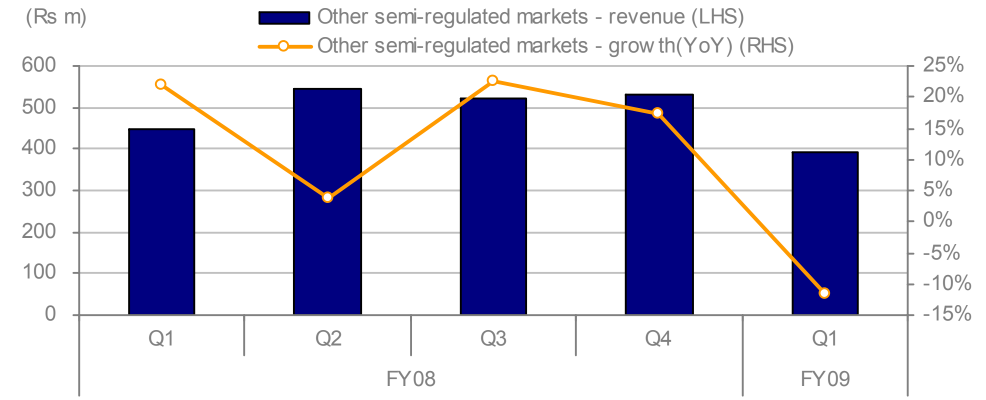


Source: Company, IIFL Research

Other semi-regulated markets slowing down

Glenmark's performance in the semi-regulated markets other than India and Latin America has been very volatile. This segment grew 78% in FY07, but only 8.6% in FY08, and declined 12% (YoY) in 1QFY09. Although Glenmark is aggressively entering new geographies, it will be several quarters before they start contributing meaningfully to growth. We believe the company is unable to maintain the initial growth momentum in the newly entered markets, as competition becomes tougher and incremental penetration becomes more difficult beyond certain levels.

Figure 4: Volatility in other semi-regulated markets

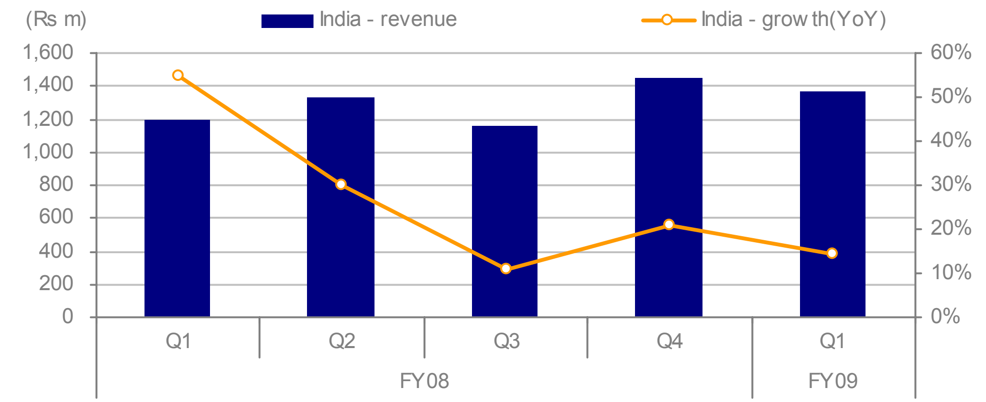


Source: Company, IIFL Research

India business growth slowing to market growth rate

Glenmark's India business is also slowing down significantly to more sustainable levels of mid-teen growth rates, slightly better than the overall market growth rate. After the 30% rise in FY08, the company has projected only 15-16% growth in the Indian market in FY09, and we see no organic triggers to accelerate growth.

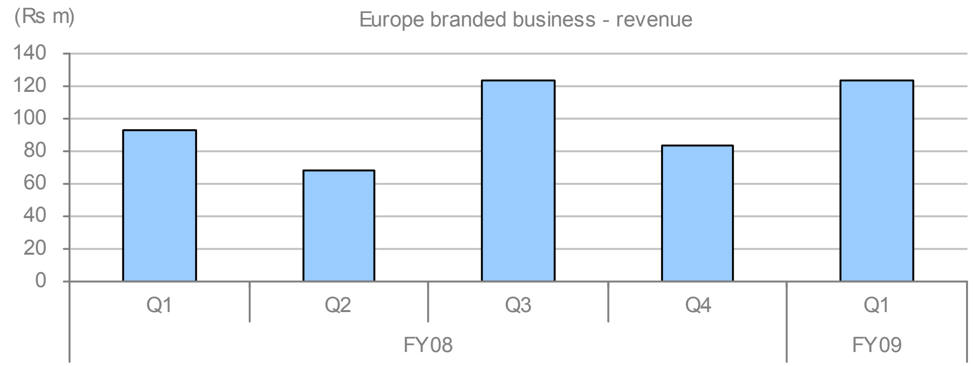
Figure 5: India growth slowing to mid-low teens



Source: Company, IIFL Research

Europe – low base, low visibility on growth
The branded-formulations business in Europe contributed only about 2% of Glenmark's total revenue in FY08. While the company projects a growth rate of over 100%, we believe it can come only through acquisition of brands and hence may not be sustainable. In 1QFY09, it grew only 33% YoY, which we believe is the best rate of organic sustainable growth.

Figure 6: Europe – low base



Source: Company, IIFL Research

NCE pipeline – stretched expectations

Glenmark's drug-discovery research initiatives with successful outlicensing deals have brought it into the spotlight. The company has so far clinched three major deals: oglemilast deal with Forest Labs, melogliptin deal with Merck KGaA, and TRPV1 antagonist deal with Eli Lilly. These deals are testament to the company's R&D capabilities and indicate significant potential of the pipeline to continue earning more revenue from early outlicensing deals as licence fees and milestone payments. However, based on a detailed analysis of publicly available information on the pipeline, we feel that the market expectations from the R&D pipeline are a bit stretched.

Solid phase II data is still some time away: We believe that most of Glenmark's R&D value lies in the company's ability to generate licensing revenues by churning out early-stage molecules rather than in already-outlicensed molecules. We do not ascribe any significant option value for any of the already-outlicensed molecules, since published efficacy data in sufficiently-large proof-of-concept phase II clinical studies is at least a year away. In our view, until proof-of-concept phase II clinical data is available, assigning option value to molecules is highly risky; even if such value were to be assigned, it would be very low, given the high discount rates to be used to compensate for the risk. In the specific case of Glenmark, we are not very optimistic about the success of oglemilast, and GRC 6211 is still very early in the drug development process. We also believe that the target launch dates released by the company are too aggressive and are likely to get extended for most of the pipeline molecules, at least for the regulated markets.

Oglemilast – yet to deliver

PDE 4 inhibitors – losing sheen: Oglemilast belongs to a class of molecules called phosphodiesterase (PDE) inhibitors - subclass, PDE4 inhibitors. They can potentially be anti-inflammatory drugs that can reduce distress in respiratory diseases such as asthma and chronic obstructive pulmonary disease (COPD). A preliminary search through academic compilations shows that there was significant scientific interest in PDE4 inhibitors in the late 1990s and the early 2000s, peaking in 2002-04. Around the same time, there were 3-4 molecules belonging to the class undergoing phase II studies and were considered promising drug candidates. Since 2005, however, hardly any papers have been published on PDE4 inhibitors. At the peak of the PDE4 enthusiasm in the pharmaceutical world, Glenmark managed to out-license its molecule oglemilast to Forest Laboratories—a significant achievement.

All PDE IV inhibitors (except oglemilast) have been abandoned: Further phase II clinical studies on PDE IV inhibitors did not yield results commensurate to the promise they held. Ibudilast is the only PDE inhibitor (it is non-selective) in clinical use in respiratory diseases, and was approved in Japan in 1989. That it was not accepted globally demonstrates that it was not clinically superior to other regular therapies for the disease. GSK, after years of lag and waning focus, announced termination of cilomilast (Ariflo) development in its 2007 annual report. The company did this in spite of an 'approvable' letter from the US FDA, issued in 2003 despite a recommendation to the contrary by the FDA advisory panel. Tetomilast, which was under development by Otsuka Pharmaceutical, entered phase II clinical studies in early 2000s. There is hardly any recent public update on the molecule in COPD, suggesting a quiet termination of its development. Further, Otsuka tried developing the molecule for autoimmune diseases like ulcerative colitis. Though it showed some promise in animal studies, it failed in clinical studies—two studies in active ulcerative colitis and Crohn's disease had to be terminated for lack of efficacy. Three other studies, all started in 2003-04, have been completed, but no further studies or regulatory submissions have been made, suggesting failure of meeting end points in the study.

Pfizer terminated its development of tofemilast in 2006, based on failure in two phase II trials in COPD and asthma. Pfizer also had a drug development agreement with Altana of Germany for roflumilast (Daxas). However, after unacceptable phase III results, Pfizer terminated the agreement in 2005. Altana challenged Pfizer's contention on the drug and went ahead with a European marketing authorisation application (MAA), but had to withdraw it within months. Though Altana said it will continue the development, the molecule died a silent death in its pipeline. A year-2000 investor presentation from Bayer talks volumes about BAY 198004, a PDE4 inhibitor for asthma and COPD, with a launch target of 2004. But development of the molecule was terminated in 2001 after dismal phase II results. Given such a poor record for the class of molecules, it is difficult to assume that oglemilast can overcome all the problems and reach market. If the company does manage to commercialise the molecule, it would be a major success—but this remains a high-risk prospect, and we would rather not ascribe value to it until we've seen favourable data from a sufficiently large phase II study.

Figure 7: The story of PDE IV inhibitors

	1989	2000	2001	2002	2003	2004	2005	2006	2007	2008
Ibudilast	Approved in Japan									
Cilomilast (Ariflo)		Undergoing late stage trials under GSK			FDA approvable letter	GSK Silent on further development			Officially terminated	
Tetomilast		In phase II development by Otsuka			New studies in ulcerative colitis			All studies ended / terminated	No further studies / regulatory submission - silent death	
Tofemilast		Pfizer does phase II trials in COPD						Officially terminated development		
Roflumilast (Daxas)		Altana and Pfizer take it through phase II and III trials					Pfizer terminates deal after poor phase III data; Altana submitted EU application but soon withdrew		No more appears in Altana pipeline - silent death	
BAY 198004		Bayer presentation talks volumes on its potential	Terminated after poor phase II results							
Oglemilast						Glenmark partners with Forest Labs	No efficacy data coming out in 3 years; runs into problems with FDA on safety issues			Forest pays a milestone to Glenmark. Next data expected only in late 2009.

Source: Company, IIFL Research

Forest's low focus on oglemilast: We do not have enough information in the public domain to judge oglemilast's relative merit against other molecules in the class. Even assuming that oglemilast is superior, we feel that the molecule is not progressing fast enough in Forest's pipeline. It was outlicensed in September 2004 and completed phase I studies in January 2005. Nearly four years on, it is still in a dose-ranging phase II study, according to Forest Labs's clinical trial website (forestclinicaltrials.com). Forest Labs's investor presentations and reports are broadly silent on oglemilast, except that the name appears in the pipeline chart. In contrast, focus and active effort are visible in the case of other molecules. A case in point is RGH-188 (from Gedeon Richter (Hungary), which was in-licensed after oglemilast has already completed one phase IIb study and is in other phase IIb studies. Aclidinium, in COPD, recently completed phase III studies (with worse-than-expected results). Both are prominently highlighted in company presentations. In contrast, oglemilast finds only a minor mention in the form 10K filed with the SEC, which says that results of the current dose-ranging study are expected in 2HCY09. Even publications from analysts who cover Forest Labs hardly speak about oglemilast. Also, the second phase II study in asthma is going to be done in India by Glenmark, and not by Forest in the US. The undue delay and the lack of prominence suggest that oglemilast is currently not a focus product in Forest's pipeline.

Guidance on launch date is too aggressive: Even ignoring all our concerns and assuming that oglemilast is progressing well on the development course, we feel that regulated market launch in 2011, as guided by Glenmark, is too aggressive. Forest's 10K SEC filing indicates that the dose-ranging study results are expected not before 2HCY09. A March 2008 Forest Labs investor presentation, in which oglemilast is not listed among the IIb molecules, suggests that the current one may not be the last required phase II trial for the molecule. For an idea on how complex development of PDE4 in COPD can be, an October 2004 investor update from Altana says that roflumilast had gone through 16 clinical trials involving 4,400 patients by then and they would do 10 more clinical trials involving an additional 4,100 patients before filing for approval. Even if we optimistically assume that oglemilast will need only two more studies after the current one, a US market launch is highly unlikely before 2014.

If results from the current study come in 2HCY09, a phase IIb/IIIa study can be started in mid-CY10. Data from that trial can be expected by mid-CY11. Then the pivotal registration trial (typically a large one) can start by end-CY11 and data may be out by early CY13. Typically, data compilation and NDA preparation takes about six months, so submission is likely in mid-2013 at the earliest. FDA has a standard 10-month review period, which means approval can come in 1HCY14—if the data is good and straightforward.

Melogliptin – validated target; but market potential may suffer

Melogliptin belongs to a class of molecules called dipeptidyl peptidase—IV (DPP-IV) inhibitors. This class is one of the latest entrants to the diabetes mellitus therapeutics market. Sitagliptin (Januvia) from Merck was approved by US FDA in October 2006 and by EMEA in March 2007. Vildagliptin (Galvus) from Novartis was approved by EMEA in September 2007, but FDA asked for further data, leading to delay of approval in the US. Apart from sitagliptin and vildagliptin, two more molecules of the class are under FDA scrutiny. Alogliptin from Takeda has a PDUFA date (date by which FDA is obliged to respond to the company on its NDA submission) of October 2008. Saxagliptin from Bristol Myers Squibb and Astra Zeneca has a PDUFA date on or before 31 March 2009.

Merck exit a dampener: Glenmark outlicensed melogliptin in October 2006 to Merck KGaA. Merck initiated a phase II study of the molecule, but decided to terminate further developmental activities on the molecule and returned it to Glenmark in February 2008. While this decision by Merck clearly relates to the company's decision to move away from diabetes as a therapeutic area, it also suggests that it does not consider melogliptin to be significantly superior to the other DPP-IV inhibitors. We believe that Merck's decision was prompted by its reluctance to pay any more milestones to Glenmark before assessing the molecule's potential in a proof-of-concept phase IIb clinical study. Absence of other major diabetes candidates in Merck's pipeline thus led to melogliptin being given back for free and the company exiting diabetes research. Interestingly, an April 2008 investor presentation from Merck KGaA still featured a phase II anti-diabetic molecule in the company's pipeline, while melogliptin had been removed.

Further outlicensing may not come easy: There is hardly any safety or efficacy data on melogliptin in the public domain to assess its true potential. However, in all likelihood, it would broadly be in the range of other molecules in its class—either marginally superior or marginally inferior. This absence of proof-of-concept data may come in the way of further outlicensing of the molecule, given the background of dropping by Merck KGaA. Glenmark has initiated a phase II study of melogliptin in India and expects data from this study by mid-CY09. In our view, however, dropping of the molecule by Merck and consequent delay to market may make it less attractive to global pharma giants. In all probability, there will be at least four DPP-IV inhibitors (listed above), and possibly more already established in the regulated markets by 2013, when we believe melogliptin might be launched. We are still not ruling out further licensing out of the molecule to a smaller innovator pharma company, though it is likely only in FY10, after the data from the phase II study becomes available.

Best-case value is US$161m: The peak sales for Januvia franchise (Januvia and Janumet) are estimated at US$3bn-3.5bn. Late entry to the market, competition from other classes of drugs and promotion by a smaller pharma company could mean that peak sales of melogliptin could be well below that. Even assuming US$2.5bn peak sales, we estimate that the value of melogliptin as a molecule to Glenmark is less than US$161m, or Rs28 per share.

TRPV1 antagonists – promising, but too early in development

TRPV1 (transient receptor potential vanilloid 1 or vanilloid receptor 1) is a receptor, mostly expressed in sensory nerves in the human body. Activation of the channel results in the sensation of pain, neurogenic inflammation, smooth muscle contraction and cough. Hence 'down regulation' (tempering the activity) of these receptors can potentially be used to treat these conditions.

Glenmark has a portfolio of TRPV1 receptor antagonist molecules, on which regulated-market rights were sold to Eli Lilly for an upfront payment of US$45m, in addition to any potential additional developmental and commercial milestone payments. However, development of these molecules is still in such early stages that there is not enough data for to assess their market potential. The most advanced among these molecules is GRC 6211, but even that has been through only one phase I study so far. As per the Eli Lilly deal, Glenmark could earn milestone payments on any molecule from the portfolio for any indication, but royalty on sales and co-promotion rights for US are applicable on the lead molecule, GRC 6211.

Guidance on timelines is aggressive: Although we consider the TRPV1 portfolio as a promising novel therapeutic approach, it is very early in development and has multiple hurdles to go through before its potential becomes evident. It is a novel approach and the concept has not been proven clinically by any company for any molecule in the class. This means the course of development will be more laborious, with multiple phase II studies and safety studies, and the risk of failure is relatively higher. Hence, we feel that Glenmark's projection of a potential 2012 launch is aggressive for the regulated markets.

Figure 8: Best-case value of melogliptin is Rs28 per share

		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Sales (US$ m)		100	450	1,000	1,500	2,000	2,500	2,250	2,000	1,500	1,000	500	250
Glenmark's royalty + margin on API	20%	20	90	200	300	400	500	450	400	300	200	100	50
Present value	35%	4.46	14.87	24.47	27.19	26.86	24.87	16.58	10.92	6.06	2.99	1.11	0.41
Total present value		**160.79**											

Source: Company, IIFL Research

Merck started working with Neurogen on a similar portfolio of TRPV1 receptor antagonists as early as 2003. After five years, it is yet to prove the concept clinically. The lead molecule, MK-2295, is still in phase II proof-of-concept studies and Merck has indicated that it is only a proof-of-concept molecule and the one that is likely to go all way into phase III development and commercial launch could be a different one (still pre-clinical). Although MK-2295 was initially developed for pain indication, it is currently being studied for cough. Similar twists and turns are likely in the Glenmark-Lilly partnership as well, and it is improbable if not impossible that Lilly can speed through all the procedures significantly faster than Merck. Almost a year from out-licensing, Lilly is yet to initiate a phase II study on GRC 6211.

GSK's comparable has been shelved: SB705498, GSK's TRPV1 receptor antagonist molecule seems to have been discontinued. The molecule no longer appears in GSK's pipeline and 'www.clinicaltrials.gov' shows that a study of the molecule in migraine, started in January 2006, was terminated on account of lack of efficacy.

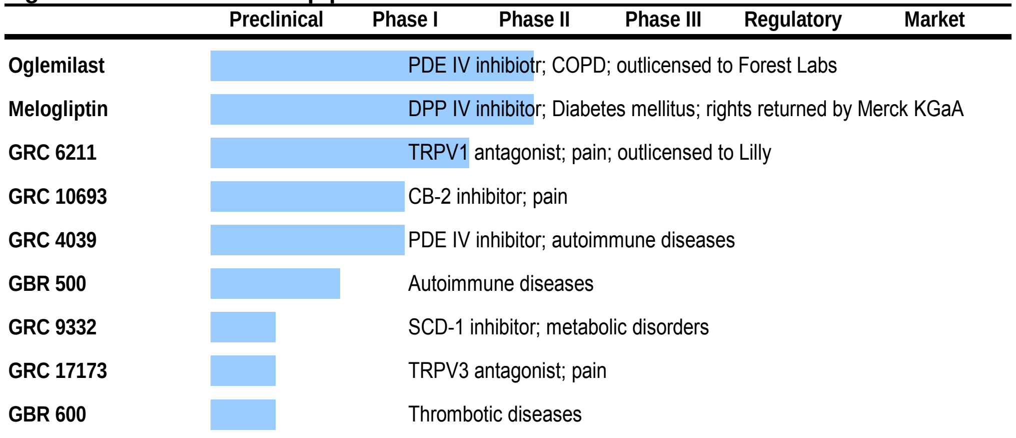
Small in value at this stage: A set of molecules, at so early a stage in development cannot command a big value. Neurogen is trading on NASDAQ at a market cap of less than US$30m. Given the recent validation by Lilly, the value of Glenmark's TRPV1 antagonist portfolio could be more, but we do not think it would be above US$50m-60m.

Others in the pipeline can bring licensing revenue

Other molecules in Glenmark's pipeline are in early stages of development. There could be some licensing revenue from the early pipeline, every year. We feel that the CB-2 inhibitor for pain, GRC 10693, and GBR 500, the biological molecule for inflammatory diseases, are the best-placed for the next out-licensing deal. GRC 4039, another PDE IV inhibitor being developed for autoimmune diseases, has already entered a phase I trial. However, as discussed earlier, the low interest in PDE IV inhibitors in the pharmaceutical world may make it difficult to find a strong partner for the molecule. The large number of targets being studied for autoimmune diseases globally and the failure of Otsuka's tetomilast in ulcerative colitis will probably make the situation tougher. We do not see any major licensing deal happening for GRC 9332, GRC 17173 and GBR 600 in the current financial year, given their early stage – if at all it happens, the up front payment may not be big.

Each of Glenmark's pipeline molecules individually has limited value at this stage; however, the pipeline as a whole and the research competence developed by Glenmark has some value attached to it. This value stems from the ability to generate revenue from outlicensing deals on molecules in the pipeline. Overall, we estimate US$50m, US$55m and US$65m as the potential outlicensing-related revenue in FY09, FY10 and FY11 respectively.

Figure 9: Glenmark's R&D pipeline



Source: Company reports, IIFL Research

Valuation

Glenmark's generics business (including branded generics and generic generics) has a different risk-return profile compared to its drug discovery business. As such, the drug discovery business is best valued separately. However, since the company does not clearly delineate the expenses and investments, we have valued the operations on a consolidated basis to arrive at our target price, though we have tried to independently assess the value of the R&D pipeline.

US$350m-500m standalone value of the pipeline: We have tried to arrive at a rough estimate of the range in which a pipeline similar to that of Glenmark could be valued at. Since there are few listed Indian companies engaged solely in drug discovery, and since there is hardly any clinical data available on the pipelines of listed Indian drug-discovery companies, we have used a large set of comparable companies from the US to arrive at a broad valuation range. We believe that this is a fair comparison, since the risk profile and potential target markets for all these drugs discovery companies essentially remain the same. Given below is a near-comprehensive list of listed US companies engaged solely in small-molecule drug-discovery operations.

Figure 10: Comparable US drug-discovery companies

Ticker	Company	Mkt cap (US$ m)	Therapeutic area
AUXL	Auxilium Pharmaceuticals Inc	1,660	Endocrine/urology
INCY	Incyte Corp.	918	HIV/diabetes/oncology/inflammation
RIGL	Rigel Pharmaceuticals Inc	809	Cancer, autoimmune disease
ALTH	Allos Therapeutics Inc	734	Cancer
CVTX	CV Therapeutics Inc	685	Cardiovascular disease
GTXI	GTX Inc	631	Cancer, endocrinology
VVUS	Vivus Inc	495	Sexual function; obesity
IDIX	Idenix Pharmaceuticals Inc	469	Hepatitis B, C; HIV
ARNA	Arena Pharmaceuticals Inc	467	Obesity, insomnia, diabetes
PTIE	Pain Therapeutics Inc	415	Pain, cancer
ARRY	Array Biopharma Inc	384	Cancer and inflammatory disease
IDP	Idera Pharmaceuticals Inc	313	Cancer, HIV
LGND	Ligand Pharmaceuticals Inc	298	Thrombocytopenia
LXRX	Lexicon Pharmaceuticals Inc	261	Cognitive Disorders; irritable bowel syndrome
CYPB	Cypress Biosciences	256	Fibromyalgia syndrome
CYTK	Cytokinetics Inc	215	Heart failure; cancer
ARIA	Ariad Pharmaceutical	211	Cancer
NBIX	Neurocrine Biosciences Inc	204	Neurology and endocrine disease
MSHL	Marshall Edwards Inc	198	Cancer
ADLR	Adolor Corp.	150	Pain
ARQL	Arqule Inc	148	Cancer
PARD	Poniard Pharmaceuticals Inc	147	Cancer
BCRX	Biocryst Pharmaceutical	129	Cancer/autoimmune/infectious disease
CRXX	Combinatorx Inc	119	Inflammatory diseases
RPRX	Repros Therapeutics Inc	110	Reproductive endocrinology
AVGN	Avigen Inc	103	Pain / muscle spasm
BNVI	Bionovo Inc	103	Female reproductive endocrinology; cancer
LJPC	La Jolla Pharmaceutical	103	Autoimmune disease
SUPG	Supergen Inc	102	Cancer
TRMS	Trimeris Inc	90	Anti-virals
ACAD	Acadia Pharmaceuticals Inc	88	CNS
EPIX	Epix Pharmaceuticals Inc	76	MRI imaging, Alzheimer's, cardiovascular
PCOP	Pharmacopeia Inc	76	COPD; RA; Cancer; Metabolic; Infection
DCGN	Decode Genetics Inc	75	Heart attack/ thrombosis/ asthma /vascular disease/ inflammation/pain
MBRX	Metabasis Therapeutics Inc	60	Metabolic; viral hepatitis; liver cancer
CYTR	Cytrx Corp.	45	ALS & Diabetes
TELK	Telik Inc	38	Cancer
PANC	Panacos Pharmaceuticals Inc	31	HIV
NRGN	Neurogen Corp.	28	Insomnia; Obesity; Diabetes
MEMY	Memory Pharmaceuticals Corp.	27	CNS
KERX	Keryx Biopharmaceuticals Inc	18	Renal; cancer

Source: Bloomberg, IIFL Research

The larger companies have proven products and good clinical data: The largest company in terms of market cap, Auxilium Pharmaceuticals, already has a drug in the market (Testim), with annualised revenue in excess of US$400m. It also has a regulatory stage drug candidate with blockbuster potential (>US$1bn revenue)—Xiaflex, which has had unquestionable phase III data in Dupuytren's contracture and good proof-of-concept phase II data in Peyronie's disease. None of Glenmark's molecules have so far reached proof–of-concept stage. Further, Auxilium has full rights to its drugs in the US market and is capturing the full value of the success of its products, while Glenmark will have to be satisfied with a small portion of the full value, on account of early partnering.

The second company, Incyte Corp, has a large pipeline with several molecules across different therapeutic areas in phase II that have shown good results in proof-of-concept studies. INCB18424 has shown good efficacy in myelofibrosis and rheumatoid arthritis. The recently-presented rheumatoid arthritis data showed ACR20/50/70/90 response rates (a measure of improvement in the disease) comparable to the best therapies available in the market. Other phase II molecules with some promising efficacy data include INCB13739 in type 2 diabetes, INCB7839 in multiple solid cancers and INCB9471 in HIV infection.

Clinical proof is the value driver: Regal Pharmaceuticals had excellent phase II data comparable to the best therapies available in rheumatoid arthritis. Allos Therapeutics has a cancer drug proven in phase II studies and is currently under phase III registration trial for T-cell lymphoma. The same drug is being investigated for multiple haematological malignancies and solid tumours. CV Therapeutics has two products in the market and more in phase II and III. GTX Inc has one marketed product, two in advanced phase III and two in phase IIb. What clearly emerges is that it is the presence of good proof-of-concept clinical data that determines the value of a pipeline. None of Glenmark's molecules have published proof-of-concept clinical efficacy data. The nearest to efficacy data is melogliptin, and this is probably the only molecule that can be ascribed some value of its own. In comparison with the pipelines of the above listed companies and their valuations, we estimate that the best-case standalone value of Glenmark's pipeline should fall in the range of US$350m-500m.

However, Glenmark's focus on early licensing revenue rather than successful development of the molecules and the cash cushion from the generics business make it a rather unique case. Hence, as mentioned earlier, we are doing our valuation on all the operations together on a consolidated basis, to arrive at our target price.

Richly valued: In our view, Glenmark shares are richly valued at current levels. Our price target of Rs596 is 20x FY10ii core earnings estimate. The applied PE is in line with the PE we have used to value comparable large Indian pharma companies. Major risks to our estimates are low visibility of outlicensing revenues and volatility in generic business growth.

Risks

Glenmark has an ongoing active geographical expansion programme, and deals/partnerships/small acquisitions can cause significant deviations from our projections.

Deals in the drug-development space are unpredictable and depend on several factors specific to potential buyers. Our analysis and estimates are based on a general understanding of the drug-discovery space. It is possible that some big pharma companies have different views or information that may prove our contention wrong. In that case, Glenmark may get a better deal than we expect.

Given Glenmark's low scale of operations in several markets, one or more major contracts can significantly add to revenues and impart better growth than we project.

Financial summary

As the business base increases, revenue growth rates may cool off

Glenmark is yet to be free cash flow positive due to the high working capital and R&D related capex

Income statement summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue	12,185	19,812	23,233	27,074	33,389
EBITDA	4,283	8,048	9,080	10,630	13,028
EBIT	**3,860**	**7,331**	**8,168**	**9,400**	**11,503**
Interest income	151	494	289	240	480
Interest expense	398	710	654	717	643
Profit before tax	**3,613**	**7,115**	**7,804**	**8,923**	**11,341**
Taxes	513	794	910	1,071	1,361
Minorities and other	8	0	0	0	0
Net profit	**3,093**	**6,321**	**6,894**	**7,852**	**9,980**

Cashflow summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Profit before tax	3,613	7,115	7,804	8,923	11,341
Depr. & amortization	423	717	911	1,230	1,524
Tax paid	277	885	910	1,071	1,361
Working capital Δ	-3,263	-3,846	-3,670	-2,696	-4,313
Other operating items	436	617	365	477	163
Operating cashflow	932	3,718	4,501	6,864	7,354
Capital expenditure	-2,712	-5,176	-5,000	-5,000	-5,000
Free cash flow	**-1,780**	**-1,459**	**-499**	**1,864**	**2,354**
Equity raised	311	2,002	2	1	2
Investments	0	-1	0	0	0
Debt financing/disposal	2,088	695	788	-930	-1,881
Dividends paid	-117	-201	-205	-206	-207
Other items	-511	-632	-365	-477	-163
Net change in cash	**-8**	**404**	**-278**	**251**	**105**

Source: Company data, IIFL Research

The debt situation may improve gradually as FCCBs get converted and business consolidates

Balance sheet summary (Rs m)

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Cash & equivalents	1,245	1,753	1,475	1,726	1,831
Sundry debtors	5,712	8,069	11,161	13,081	16,198
Inventories - trade	2,697	4,007	5,475	6,417	7,946
Other current assets	1,588	2,869	3,159	3,702	4,584
Fixed assets	**8,104**	**12,557**	**16,646**	**20,416**	**23,891**
Total assets	**19,346**	**29,256**	**37,916**	**45,342**	**54,450**
Sundry creditors	2,395	3,207	4,388	5,097	6,312
Long-term debt/CBs	9,367	9,909	10,161	8,972	6,154
Other long-term liabs	720	946	946	946	946
Minorities/other equity	0	15	15	15	15
Net worth	**6,864**	**15,179**	**22,407**	**30,313**	**41,024**
Total liabs & equity	**19,346**	**29,256**	**37,916**	**45,342**	**54,450**

Revenue growth rate may come down sharply

Margins to remain steady; but sensitive to out-licensing revenue

Ratio analysis

Y/e 31 Mar	FY07A	FY08A	FY09ii	FY10ii	FY11ii
Revenue growth (%)	74.7	62.6	17.3	16.5	23.3
Op Ebitda growth (%)	206.8	87.9	12.8	17.1	22.6
Op Ebit growth (%)	231.7	89.9	11.4	15.1	22.4
Op Ebitda margin (%)	35.1	40.6	39.1	39.3	39.0
Op Ebit margin (%)	31.7	37.0	35.2	34.7	34.5
Net profit margin (%)	25.4	31.9	29.7	29.0	29.9
Dividend payout (%)	3.1	2.7	2.5	2.2	1.8
Tax rate (%)	14.2	11.2	11.7	12.0	12.0
Net debt/equity (%)	118.3	53.7	45.3	29.6	15.0
Net debt/op Ebitda (x)	1.9	1.0	1.1	0.8	0.5
Return on equity (%)	45.1	41.6	30.8	25.9	24.3

Source: Company data, IIFL Research

Events calendar – September 2008

Monday	Tuesday	Wednesday	Thursday	Friday	Saturday
1 Jul Imports ↑ 48% July Exports ↑ 31%	2	3	4 WPI for 23 Aug — 12.3%	5	6
8	9	10 SAIL–10	11 WPI for 30 Aug — 12.1%	12 July IIP ↑ 7.1%	13
15	16	17	18 WPI for 6 Sep	19	20
22	23	24	25 WPI for 13 Sep	26	27
29	30 1QFY09 BoP	HDFC – 17 Oct			

Blue: Economic data, Orange: AGM

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.