

Biocon

STOCK INFO.	BLOOMBERG
BSE SENSEX: 10,007	BIOS IN
	REUTERS CODE
S&P CNX: 2,933	BION.BO

19 July 2006

Buy
Previous Recommendation: Buy
Rs337

Equity Shares (m)	100.0
52-Week Range	538/306
1,6,12 Rel. Perf. (%)	-3/-36/-62
M.Cap. (Rs b)	33.7
M.Cap. (US\$ b)	0.7

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/06A	7,881	1,739	17.4	-12.0	19.4	3.8	19.6	19.9	4.3	14.7
03/07E	8,823	1,543	15.4	-11.3	21.8	3.3	15.3	16.5	3.8	14.2
03/08E	10,536	2,143	21.4	38.9	15.7	2.9	18.3	19.5	3.0	10.5

Biocon 1QFY07 results were below our estimates, with lower than expected margins at 25.5%, a decline of 350bp YoY.

Key highlights include:

- Net consolidated sales grew by 21.6% YoY to Rs2.1b (v/s estimate of Rs2b) while the PAT remained flat at Rs389m (v/s estimate of Rs428m). Sales growth was driven by 53% YoY growth in contract research fees (to Rs290m) and 19% YoY growth in Biopharma business to Rs1.6b. Enzymes business registered a growth of 10% to Rs220m.
- Weak statin prices YoY, higher investments in R&D and higher fixed expenses on new facilities were key factors impacting EBITDA margins. This coupled with higher depreciation (up by 54% YoY) translated in PBT decline of 5% YoY to Rs426m. However, lower tax provisioning (at 9.9% of PBT v/s 14.8% of PBT in 1QFY06) resulted in flat PAT to Rs389m.
- Biocon has entered into agreement with Bayer for marketing of insulin in Chinese market, which is expected to be launched in CY08. It has received approval to market BIOMAb (for treating head & neck cancers) from DCGI and plans to launch it in 2QFY07.
- We have revised our earnings downward by 18.5% for FY07E and 8.5% for FY08E to take into account a) higher R&D expense, b) higher investment in domestic formulation business and c) higher fixed expenses on new facility.
- While some of Biocon's initiatives look promising, as of now, the visibility of them is poor. Biocon is currently valued at 21.8x FY07E and 15.7x FY08E earnings. We believe that most of the negatives are already captured into the current valuations and that there is little downside to the stock from current levels. Maintain **Buy**.

CONSOLIDATED QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Net Sales	1,740	2,006	1,993	2,143	2,120	2,142	2,173	2,388	7,881	8,823
YoY Change (%)	-0.1	7.8	12.1	22.8	21.9	6.8	9.1	11.4	10.6	12.0
Total Expenditure	1,235	1,416	1,404	1,538	1,577	1,607	1,614	1,695	5,593	6,493
EBITDA	505	589	589	605	544	535	560	693	2,288	2,330
Margins (%)	29.0	29.4	29.6	28.2	25.6	25.0	25.7	29.0	29.0	26.4
Depreciation	71.1	73.8	74.6	76.9	109.7	150.0	170.0	173.0	296.5	602.7
Interest	2.8	1.5	3.8	9.4	16.7	15.0	16.0	11.7	17.5	59.4
Other Income	17.8	11.3	18.1	4.3	13.6	16.0	17.0	21.8	51.4	68.4
PBT	449	525	529	523	431	386	391	530	2,026	1,737
Tax	66	94	94	51	42	50	51	66	306	208
Rate (%)	14.8	17.9	17.8	9.8	9.8	13.0	13.0	12.4	15.1	12.0
Minority Interest	-5	-4	-4	-7	-5	-4	-4	-2	-20	-15
PAT	387	435	439	478	394	340	344	466	1,740	1,543
YoY Change (%)	-20.3	-22.6	-12.8	12.9	1.8	-22.0	-21.6	-2.7	-11.9	-11.3
Margins (%)	22.3	21.7	22.0	22.3	18.6	15.9	15.8	19.5	22.1	17.5

E: MOST Estimates

Bio-Pharma and Contract research continues to drive top-line growth

Consolidated revenues grew 22% YoY in 1QFY07, driven by 19% growth in Bio-Pharma business and 53% growth in contract research. Growth in bio-pharmaceutical sales was primarily driven by sales of insulin in unregulated markets. Although, statin prices in Europe have stabilized sequentially, however, on YoY basis statin prices were lower. Contract Research services (including Syngene & Clinigene) recorded 71% growth to Rs290m led mainly by the ramp-up in Syngene's performance. Commissioning of new facilities and addition of new clients has resulted in a significant growth in Syngene's operations. Sequentially, contract research revenues have declined by 10% as the company executed a large contract in 4QFY06.

SALES TREND (RS.M)

	1QFY07	1QFY06	GR(YOY)	4QFY06	GR(QOQ)
Bio-Pharma.	1,610	1,350	19	1,570	2.5
% of sales	75.9	77.6		73.3	
Enzymes	220	200	10	250	-12.0
% of sales	10.4	11.5		11.7	
Cont. Research Fees	290	190	53	323	-10.2
% of sales	13.7	10.9		15.1	
Total	2,120	1,740	21.9	2,143	-1.1

Source: Company/ Motilal Oswal Securities

Enzymes grew by 10% YoY, after subdued performance in FY06 as the company was able to free up extra capacity for enzymes due to the commissioning of new Statins facility. We believe that the enzymes business should revert back to normal growth phase. We expect enzymes business to grow at 26% YoY in FY07E, on low base of FY06.

Lower statin prices and higher R&D restricts margin expansion

Continued pricing pressure in European statins market, higher investments in R&D (up by 50% YoY to Rs60m), higher fixed expenses on new facilities, setting of oncology division (to market BIOMAb) and forex loss (of Rs30m) impacted EBITDA margins. This coupled with higher depreciation (up by 54% YoY) translated in PBT decline of 5% YoY to Rs426m. However, lower tax provisioning (at 9.9% of PBT v/s 14.8% of PBT in 1QFY06) resulted in flat PAT to Rs389m.

Europe statin prices stabilizing, but US supplies delayed

The statins business in Europe witnessed stable prices (on sequential comparison) after many quarters of severe competitive pressures, which was the main reason for the company's poor performance in the past. Commercial supplies of Simvastatin and Pravastatin API to the US have been delayed due to grant of 180-day exclusivity, which has delayed sourcing by Biocon's partners.

We expect Biocon's Pravastatin supplies to commence from Sep'06 while Simvastatin supplies are expected to commence in Dec'06. Biocon has invested significantly (approximately Rs.4.5bn) in new statin capacities to exploit the opening of the Simvastatin and Pravastatin market in USA (with combined market size of about \$6.5b). We believe that the grant of 180-day exclusivity to some of the generic companies for both these products has diluted the Statin opportunity for Biocon. We do not expect Biocon's partners to garner significant market share as even after the expiry of the 180-day exclusivity, the incumbent generic players will continue to command a reasonable market share. This is likely to increase the pay-back period for Biocon as far as its investments in the Statins space is concerned.

For the US market, Biocon expects to garner around 40% of market share in Pravastatin and Simvastatin as there would be limited competition in API supplies (expects 3 more players post expiry of the 180-day exclusivity). We believe that competition is likely to be severe for both these products and hence have forecasted lower market share for Biocon (Simvastatin 25% and Pravastatin 15%).

Will supply statins to innovators also

Biocon, through its alliance partners, has tied up with some of the innovator companies for supply of statins for the latter's combination products. Supplies may begin in CY07 subject to a favourable approval from the regulatory authorities for the innovator's products. This is likely to bring in incremental benefits for Biocon from FY08 onwards.

Building future growth engines – visibility still poor

Biocon is in the process of building future growth engines to reduce its dependence on Statins. Biocon is building strengths in other biopharmaceutical products (immunosuppressants and anti-diabetes) as well as its own drug discovery and contract research efforts. The company's efforts to launch human insulin in India and in unregulated markets as well as a supply tie up with Bristol Myers Squibb (for the latter's NDDS version) are also likely to scale up over the next couple of years.

The company gradually progressing on the research front, with the knowledge gained through its custom and clinical research activities coming in handy in its own efforts to develop non-infringing processes. Biocon also has its own R&D program focusing on improving efficiencies and developing new biological entities (NBEs). The company expects to launch its monoclonal antibody for treating head and neck cancers by 2QFY07 in India. However, although progress on any of these fronts could lead to higher growth and a re-rating, the visibility on these is still poor.

Long-term generic pipeline is exciting

The company is building its pipeline of immunosuppressants and has filed DMFs for Mycophenolate Mofetil and Tacrolimus. We believe that immunosuppressant's will be one of the key growth drivers for the company in the long-term (beyond FY08). We believe that this segment is likely to witness relatively less competition due to the technological entry barriers. Launch of bio-generics could be another exciting opportunity in the long-term, although, currently the visibility on this opportunity is poor.

Specialty pipeline is also being strengthened

Biocon expects to enter the specialty segment of the pharmaceutical market by developing proprietary products based on its developmental efforts with Monoclonal Antibodies (Mab). Its JV with a Cuban organization focuses on developing products using Mab. It is currently working on developing Mab for the immunosuppressant, arthritis and

cancer segments. The JV has a pipeline of three Mab and three anti-cancer vaccines.

Launching BIOMAb in 2QFY07

Biocon expects to launch BIOMAb EGFR (its head & neck cancer product) in 2QFY07 as it has already received marketing approval for Indian markets, from DCGI. The company would be marketing this product through a field-force of 30 Medical Representatives targeting 400 oncologists (200 in Phase I and 200 in Phase II). Around 34% of the cancer patients suffer from head and neck cancer in India. It also expects to get approval for other cancer indications in the next 24 months.

Insulin can be a very big long-term opportunity

Biocon is targeting launch of generic insulin in regulated markets in the long-term. It has already filed a DMF for insulin with the US FDA and expects to introduce the product in the US market through the 505(b)(2) route. The company will have to conduct limited clinical trials for this product. We believe that the regulatory environment for biotech products (like insulin) is gradually becoming favourable for generic companies. Regulators in both, Europe and USA, have indicated their willingness to frame detailed guidelines for approving generic biotech products. In fact, the European authorities (EMEA) have already issued broad guidelines to be followed for approval of bio-generics.

The management indicated that it is looking at licensing insulin in regulated markets of US & EU. It has already started registration process of insulin in EU and will soon start clinical trials in consultation with EMEA and its partners. We believe that launch of bio-generic Insulin is at least 18-24 months away.

Agreement with Bayer for Insulin in China

Biocon has signed agreement with Bayer to market Insugen (Biocon's human insulin) in China. Bayer would have exclusive marketing rights of Insugen for Chinese market. Biocon expects Insugen's launch in China in CY08. Bayer

also has option to expand the marketing rights to other countries in Asia Pacific. Biocon has received some upfront (bonus) payment, which it would be accounting on pro-rata basis over the 10 year period (life of the contract). The Chinese insulin market is around US\$100m, dominated by Novo Nordisk (~65% MS) and Eli Lilly (~35% MS). As per the agreement, all the registration process/cost would be incurred by Bayer.

Biocon has already filed its Insulin application in 22 non-regulated markets and expects approvals to come through gradually in FY07E. It has recently commenced supplies to one of these markets.

Biocon has also entered into a non-exclusive agreement with BMS for supply of r-Human Insulin for the latter's NDDS insulin. This is a 9-year deal with commercial supplies to BMS expected to commence after two years. Biocon has already supplied sample quantities of Insulin to BMS. It has also filed a DMF for Insulin with the US FDA.

The global insulin market is currently worth \$ 4-5bn and can be a very big opportunity for generic suppliers like Biocon as very few generic players are prepared for exploiting this opportunity (particularly in regulated markets).

Aggressive plans to invest in domestic formulations business – may impact margins

Biocon is planning to give significant thrust to its domestic formulations business which would be having two niche products in form of human insulin and BIOMAb. The company intends to double its field force from 135 MRs to 265 MRs, which would help to get into new territories. The company intends to double its current market share of 10% in human insulin in next two years. Although Biocon would be investing resources in domestic formulations form current year onwards, the pursuant benefits would be reflected in next 9-12 months, thereby impacting margins in FY07.

Commenced Phase-I trials on oral insulin

Also, Biocon has commenced Phase-I clinical trials for its oral insulin molecule IN105. Biocon had recently acquired this molecule from Nobex. The Phase-I studies are expected to be completed by 3QFY07 and would be used to support IND filings with international regulatory authorities.

Contract research operations are being ramped up

Syngene's operations are growing at a robust pace led by commissioning of new facilities and ramp-up of the customer base. The company is targeting a further expansion of its contract research facilities at a capex of Rs500m. New client additions as well as ramp-up from existing clients, is likely to result in an improved performance for Syngene in the coming years. Syngene has 6 of the top 10 global pharmaceutical companies as its clients. Syngene has scientist strength of more than 500 working on various MNC projects.

Biocon's CRO subsidiary, Clinigene is also expected to commence operations from a new 65,000 sq. ft. facility in FY07E and hence will witness a rapid growth in revenues, albeit on a lower base. Between Syngene and Clinigene, about 150 new employees were added in FY06 and a similar number will be further added in FY07E taking the overall strength to about 750.

Capex

Biocon has guided a consolidated capex of about Rs1.1b for FY07E with Rs500m each for Biocon and Syngene. The company has already incurred a significant capex of about Rs6.0b in the last two years for setting up new Statins and biologics facility as well as capacity ramp-up for Syngene.

Revising estimates downwards

We have revised our earnings downward by 18.4% for FY07E and 8.4% for FY08E to take into account (a) higher R&D expense, (b) higher investment in domestic formulation business and (c) higher fixed expenses on new facility.

REVISED FORECAST (RS M)

	FY07E			FY08E		
	REV	OLD	CHG (%)	REV	OLD	CHG (%)
Net Sales	8,823	8,829	-0.1	10,536	10,572	-0.3
Net Profit	1,543	1,894	-18.4	2,143	2,342	-8.4
EPS (Rs)	15.4	18.9	-18.4	21.4	23.4	-8.4

Source: Motilal Oswal Securities

Valuation and view

We believe that the US Statins opportunity for Biocon has been diluted due to the grant of 180-day exclusivity to some of the generic companies, thus delaying the sourcing by Biocon's partners. We do not expect Biocon's partners to garner significant market share as even after the expiry of the 180-day exclusivity, the incumbent generic player will continue to command a reasonable market share. This is likely to increase the pay-back period for Biocon as far as its investments in the Statins space is concerned.

Supply of Insulin to non-regulated markets will be a key growth driver in the short-to-medium term. Biocon is targeting 22 non-regulated markets for Insulin supplies and is likely to receive regulatory approval from some of these markets in FY07E.

Biocon's initiatives in the immunosuppressant's and biogenerics space as well as its NCE program (including oral Insulin and monoclonal anti-body) will be key determinants of long-term success.

Sales growth for FY07E will be led mainly by Statin supplies to the US (post the 180-day expiry), improvement in the Enzyme business and a ramp-up in operations at Syngene and Clinigene.

Biocon's subsidiary Clinigene (engaged in clinical trials) will be moving operations to a new 65,000sq. ft. facility to expand its operations. We expect a significant ramp-up in Clinigene's performance over the next few years, albeit on a low base.

We have revised our earnings downward by 18.5% for FY07E and 8.5% for FY08E to take into account (a) higher R&D expense, (b) higher investment in domestic formulation business and (c) higher fixed expenses on new facility.

While some of Biocon's initiatives look promising, as of now, the visibility of them is poor. Biocon is currently valued at 21.8x FY07E and 15.7x FY08E earnings. We believe that most of the negatives are already captured into the current valuations and that there is little downside to the stock from current levels. Maintain **Buy**.

Biocon: an investment profile

Company description

Biocon is an integrated biotechnology company encompassing all the three critical stages of drug development. With over 25 years of expertise in fermentation technology, the company has built a strong presence in lucrative high-growth segments like statins, immuno-suppressants and anti-diabetes.

Key investment arguments

- Strong expertise in the complex fermentation process make it the best positioned to capitalize on the lucrative statins opportunity.
- Human insulin, immuno-suppressants and contract research to be the key long-term growth drivers.

Key investment risks

- Higher than estimated fall in prices of *Simvastatin* and *Pravastatin* post-generic launch would result in lower profitability for Biocon.
- Delay in capacity expansion or stabilizing production at the new plant would result in the loss of a big opportunity.
- Atorvastatin* going off-patent earlier than expected would result in it cannibalizing franchise of other statins as it is more cost effective, resulting in lower profitability.

COMPARATIVE VALUATIONS

		BIOCON	CIPLA	DRL
P/E(x)	FY07E	21.8	22.7	31.6
	FY08E	15.7	19.0	20.1
P/BV(x)	FY07E	3.3	4.9	3.8
	FY08E	2.9	4.1	3.3
EV/Sales(x)	FY07E	3.6	4.2	3.0
	FY08E	2.9	3.5	2.5
EV/EBITDA(x)	FY07E	13.4	16.9	26.9
	FY08E	9.9	13.9	18.4

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	60.9	63.9	65.3
Domestic Institutions	2.5	1.2	0.8
FII's/FDIs	12.6	9.7	3.2
Others	24.0	25.2	30.7

Recent developments

- Acquired IP assets (incl. oral insulin and oral BNP program) of Nobex for US\$5m

Valuation and view

- We believe that most of the negatives are already captured into the current valuations and that there is little downside to the stock from current levels.
- The stock trades at 21.8x FY07E and 15.7x FY08 earnings, which now factor in a fair share of the negatives. Maintain Buy with target price of Rs430.

Sector view

- Regulated markets to remain the key sales and profit drivers in the medium term. Europe to emerge as the next growth driver, particularly for companies with a direct marketing presence.
- We are overweight on companies that are towards the end of the investment phase, with benefits expected to start coming in from the next fiscal.

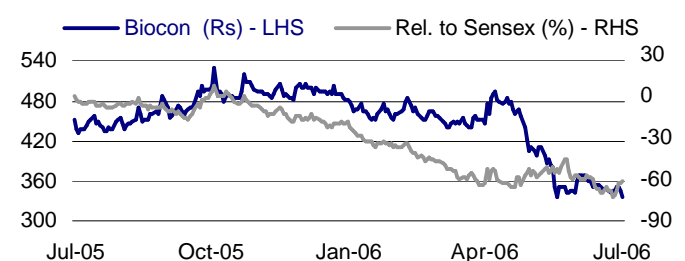
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	15.4	21.6	-28.5
FY08	21.4	26.3	-18.7

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
337	430	27.6	Buy

STOCK PERFORMANCE (1 YEAR)



CONSOLIDATE INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Exports	3,008	3,753	3,584	3,757	4,561
Net Domestic Sales	2,011	2,711	3,291	3,543	4,154
Net Sales	5,019	6,464	6,875	7,301	8,716
Contract Research Fees	388	662	1,006	1,522	1,820
Net Income	5,406	7,126	7,881	8,823	10,536
Change (%)	92.0	318	10.6	2.0	19.4
Total Expenditure	3,623	4,887	5,593	6,493	7,502
EBITDA	1,783	2,239	2,288	2,330	3,034
Change (%)	146.1	25.6	2.2	18	30.2
Margin (%)	33.0	314	29.0	26.4	28.8
Depreciation	163	223	297	603	668
Int. and Finance Charges	16	20	18	59	37
Other Income - Rec.	13	156	51	68	84
PBT	1,617	2,151	2,025	1,737	2,413
Tax	230	186	306	208	290
Tax Rate (%)	14.2	8.6	5.1	2.0	2.0
Minority Interest	0.0	-10.4	-19.7	-15.0	-20.0
Reported PAT	1,386	1,976	1,739	1,543	2,143
Change (%)	218.6	417	-2.5	-11.1	38.9
Margin (%)	25.6	27.6	21.8	17.3	20.2

CONSOLIDATED BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Equity Share Capital	500	500	500	500	500
Revaluation Reserves	16	14	13	11	9
Other Reserves	5,113	6,891	8,368	9,562	11,221
Net Worth	5,629	7,405	8,881	10,073	11,730
Loans	647	763	1,050	435	435
Minority Interest	0	9	32	17	-3
Deferred liabilities	177	234	297	340	400
Capital Employed	6,453	8,412	10,261	10,866	12,562
Gross Block	2,146	3,300	4,070	10,142	11,392
Less: Accum. Deprn.	538	763	1,061	1,754	2,424
Net Fixed Assets	1,607	2,537	3,010	8,388	8,968
Capital WIP	586	3,245	5,260	500	500
Investments	221	2,350	1,002	885	2,024
Curr. Assets	5,441	2,768	3,601	3,324	3,820
Inventory	857	738	1,105	1,161	1,377
Account Receivables	1,188	1,824	2,237	1,870	2,233
Cash and Bank Balance	3,169	34	20	104	124
Loans & Advances	227	171	239	188	85
Curr. Liability & Prov.	1,403	2,487	2,613	2,231	2,750
Account Payables	1,252	2,115	2,184	1,700	2,061
Provisions	152	373	429	531	689
Net Current Assets	4,038	280	989	1,093	1,070
Appl. of Funds	6,453	8,412	10,261	10,866	12,562

E: M OSt Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Basic (Rs) EPS	13.9	19.8	17.4	15.4	21.4
Cash EPS	15.5	22.0	20.4	21.5	28.1
BV/Share	56.1	73.9	88.7	100.6	117.2
DPS	10	2.0	2.5	3.1	4.3
Payout (%)	8.1	11.5	16.4	22.6	22.6
Valuation (x)					
P/E		17.0	19.4	21.8	15.7
Cash P/E		15.3	16.5	15.7	12.0
P/BV		4.6	3.8	3.3	2.9
EV/Sales		4.5	4.3	3.8	3.0
EV/EBITDA		14.3	14.7	14.2	10.5
Dividend Yield (%)		0.6	0.7	0.9	1.3
Return Ratios (%)					
RoE	24.6	26.7	19.6	15.3	18.3
RoCE	25.3	25.8	19.9	16.5	19.5
Working Capital Ratios					
Asset Turnover (x)	0.8	0.8	0.8	0.8	0.8
Debtor (Days)	80	93	104	77	77
Inventory (Days)	58	38	51	48	48
Working Capital (Days)	59	13	45	41	33
Leverage Ratio (x)					
Current ratio	3.9	1.1	1.4	1.5	1.4
Debt/Equity	0.1	0.1	0.1	0.0	0.0

CONSOLIDATED CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Oper. Profit/(Loss) before	1,783	2,239	2,288	2,330	3,034
Interest/Dividends Recd.	13	156	51	68	84
Direct Taxes Paid	-197	-128	-243	-165	-230
(Inc)/Dec in WC	-215	623	-722	-20	43
CF from Operations	1,384	2,889	1,374	2,213	2,931
(Incr)/Dec in FA	-917	-3,812	-2,785	-1,221	-1,248
(Pur)/Sale of Investments	-171	-2,128	1,347	117	-1,139
CF from investments	-1,089	-5,940	-1,437	-1,103	-2,387
Issue of Shares	3,015	28	21	-2	-2
(Inc)/Dec in Debt	-39	136	330	-615	0
Interest Paid	-16	-20	-18	-59	-37
Dividend Paid	-113	-228	-285	-349	-485
CF from Fin. Activity	2,848	-84	49	-1,026	-523
Inc/Dec of Cash	3,143	-3,135	-14	84	20
Add: Beginning Balance	26	3,169	34	20	104
Closing Balance	3,169	34	20	104	124

E: M OSt Estimates



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Disclosure of Interest Statement

	Biocon
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.