6 September 2010 | 6 pages

Aurobindo Pharma (ARBN.BO)

Equity

Buy: Astra Deal – Another Revenue Stream

- **Leveraging its Strengths** — Aurobindo Pharma's (ARBP) deal with Astra is another instance of the company's ability to leverage its manufacturing & product development strength to gain from the growth opportunity in emerging markets. This is the company's second known deal with a large innovator company and, while financial details are not available, is another step towards achieving its vision of US$2bn (cUS$400-500m from partnerships) revenues by CY13 (FY14).
- **Deal for Emerging Markets** — ARBP has entered into a licensing & supply agreement (non exclusive) with Astra for emerging markets. The deal covers c25 oral solid & sterile products across c40 countries and is expandable in future. The structure is similar to its earlier arrangement with Pfizer – upfront licensing fees, followed by income from supplies once the products are launched. We believe supplies could commence towards the end of FY12.
- **Further Validation** — ARBP is now a key supplier to two large global companies that are highly focused on emerging markets – a clear validation of its product development capability and cost leadership. Moreover, these deals provide ARBP far superior access to the lucrative, emerging markets than it would have been able to achieve on its own.
- **Significant Operating Leverage** — In addition to the upfront licensing income, ARBP expects these partnerships to generate revenues of cUS$400-500m by FY14 (v/s cUS$45-50m in FY10). Incremental investment in capacity would be minimal and largely maintenance oriented. We thus expect these deals to provide significant leverage to improve margins as well as RoI, going forward.
- **Remains a High Conviction Buy** — Despite recent strength, we believe the stock remains attractive at c11xFY11E EPS – especially now that balance sheet concerns have receded and its capabilities have been validated by two leading global pharmacos. The large valuation gap (c40%) vis-à-vis the sector looks unwarranted and is likely to narrow. Buy for a TP of Rs1,340/sh.

Buy/Medium Risk	**1M**
Price (06 Sep 10)	Rs1,063.75
Target price	Rs1,340.00
Expected share price return	26.0%
Expected dividend yield	0.4%
Expected total return	**26.4%**
Market Cap	Rs61,933M
	US$1,332M

Price Performance (RIC: ARBN.BO, BB: ARBP IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2008A	1,900	28.10	-5.5	37.9	5.1	18.9	0.3
2009A	2,410	37.28	32.7	28.5	4.6	20.4	0.4
2010E	4,868	75.13	101.5	14.2	3.2	31.7	0.4
2011E	6,554	101.17	34.6	10.5	2.4	29.7	0.4
2012E	8,193	126.46	25.0	8.4	1.7	24.9	0.4

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Aurobindo Pharma

Company description

Aurobindo Pharma is an Indian pharma company targeting global generics. It has traditionally had a strong presence in the cephalosporin and ARV segments but has expanded its product basket recently. It is fully integrated and owns one of largest manufacturing bases (14 plants) and portfolios of products amongst Indian companies.

Investment strategy

We rate Aurobindo Pharma Buy/Medium Risk, given improving fundamentals and attractive valuations (c50% disc to the sector). We believe APL is much better placed to leverage its large backend infrastructure and product basket. A multiple-market supply deal with Pfizer and critical scale in its own operations in key markets would drive revenues. Rising capacity utilization and better product mix (higher share of formulations) would drive sustained margin expansion and drive 23% and 30% CAGRs (FY10-12E) in EBIDTA and PAT respectively. Moreover, rising cash generation and lower capex going forward will also enable APL to lower debt and alleviate balance sheet concerns.

Valuation

We value Aurobindo using a sum of the parts approach. Given that pharma is a growth sector, we use P/E as our primary method to value the base business of pharma companies. We value Aurobindo's core earnings on 14x 12m forward FDEPS - a 30% discount to the target multiple of 20x that we use for sector leaders such as Cipla and DRL. We believe that the discount is justified at this point, given the possibility of equity dilution (to redeem FCCBs in case they do not get converted), risk of an appreciating rupee (c20-25% net exposure) and higher customer concentration (the Pfizer deal). At 14x June '11E EPS we value Aurobindo's core business at Rs1250/sh. We also value Aurobindo's dossier licensing income at 5x. We believe the lower multiple captures the fact that this income stream may not be recurring, at current levels, over the longer term. At 5x June '11 estimates, we value Aurobindo's dossier licensing income at Rs90/sh. Cumulatively, we arrive at our target price of Rs1,340/sh.

Risks

We rate Aurobindo Medium Risk, in line with our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks that could impede the stock from reaching our target price include (1) Fresh equity dilution if FCCBs do not get converted; (2) Execution hiccups in the supply deal with Pfizer; (3) Currency Risk - an appreciating INR would be structurally negative.

Appendix A-1

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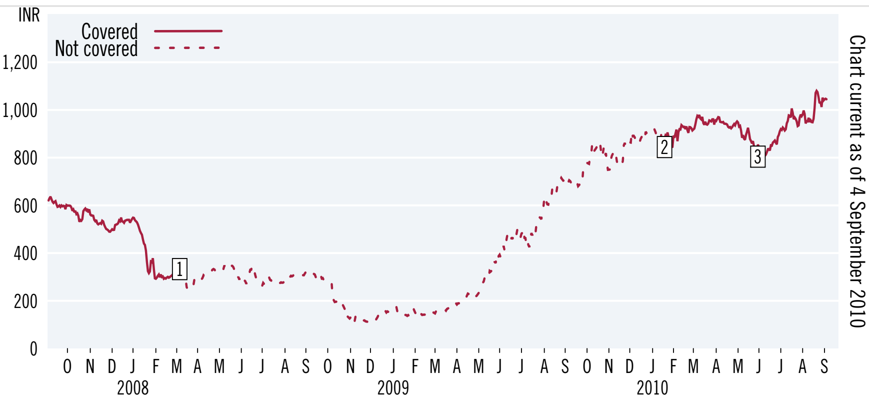
Aurobindo Pharma (ARBN.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Prashant Nair, CFA
Covered since January 19 2010



#	Date	Rating	Target Price	Closing Price
1	6-Mar-08	Coverage suspended		
2	19-Jan-10	*1M	*1,350.00	879.85
3	30-May-10	1M	*1,340.00	839.55

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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