

## Company Flash

30 January 2009 | 7 pages

# Sun Pharmaceuticals (SUN.BO)

## Buy: Caraco 3Q – Is Protonix Upside Fading?

- Expectations to reset** — Caraco's 3Q results were below expectations primarily due to dip in Protonix sales & lower gross margins. While the miss appears high, we expect 2 factors to mitigate the impact: a) numbers will be healthier in INR terms; & b) Protonix was always considered a "one-time" upside. However, we also believe this could reset consensus expectations from the stock to more reasonable levels (IBES avg TP of Rs1433/sh is c.13% higher than our TP).
- Is the Protonix upside fading?** — Our analysis of the numbers & Caraco's guidance implies that the upside from "at risk" sales of Protonix may be coming to an end at least for this fiscal. We estimate that Protonix sales have dipped to c.US\$12m in 3Q from c.US\$125m in 1H. It is difficult to determine whether this is a mere quarterly blip or if Sun has reached its risk threshold. We await more details / colour on this in Sun's earnings call tomorrow.
- FDA update** — The FDA has acknowledged Caraco's response to the warning letter (for the Detroit facility) & will evaluate the corrective measures on its next inspection. We believe that Caraco is unlikely to receive approvals till the issue is cleared – manufactured product sales could thus decline going forward.
- What would lower Protonix mean for valuation?** — Our estimates include Protonix sales of US\$170m in FY09E & FY10E & our TP includes Rs31/sh as upside potential from this opportunity. If Sun were to sell no more Protonix, we believe it would impair the latter by c.Rs20/sh. At the same time, our earnings estimates for Sun's core biz could decline by 2-3% to factor in the lower cash generation. Even if the scenario were to play out, we believe these are unlikely to be material enough to change our fundamental view on the stock.

<b>Buy/Medium Risk</b>	<b>1M</b>
Price (30 Jan 09)	Rs1,083.10
Target price	Rs1,265.00
Expected share price return	16.8%
Expected dividend yield	2.0%
<b>Expected total return</b>	<b>18.8%</b>
Market Cap	Rs224,328M
	US\$4,600M

### Price Performance (RIC: SUN.BO, BB: SUNP IN)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	7,843	37.87	36.8	28.6	8.0	35.4	0.6
2008A	9,895	47.78	26.2	22.7	4.3	24.8	1.1
2009E	12,693	61.29	28.3	17.7	3.3	21.3	2.0
2010E	15,589	75.27	22.8	14.4	2.7	20.5	2.2
2011E	18,679	90.19	19.8	12.0	2.2	20.2	2.0

Source: Powered by dataCentral

### Prashant Nair, CFA<sup>1</sup>

 +91-22-6631-9855  
 prashant.nair@citi.com

### Akshay Rai<sup>1</sup>

akshay.rai@citi.com

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<sup>1</sup>Citigroup Global Markets India Private Limited

## Caraco – 3Q Snapshot

Figure 1. Caraco – 3QFY09 Earnings Summary (US\$ m, %)

Year Ended 31 Mar	3QFY08	3QFY09	% Ch YoY	2QFY09	% Ch QoQ	CIR Comments
<b>Net sales</b>	<b>81.9</b>	<b>55.7</b>	<b>(31.9)</b>	<b>122.2</b>	<b>(54.4)</b>	Revenues down YoY & sequentially on account of lower sales of pantoprazole and oxcarba
Cost of Goods Sold	58.6	39.8	(32.0)	100.2	(60.3)	
<b>Gross Profit</b>	<b>23.3</b>	<b>15.9</b>	<b>(31.7)</b>	<b>22.0</b>	<b>(27.7)</b>	Margin expansion QoQ on account of higher share of manufactured products which have higher margins
Gross margins (%)	28.4	28.5	9 bps	18.0	1,053 bps	
SG& A expenses	3.7	3.7	0.3	4.2	(11.8)	
R&D cost other	4.1	5.8	42.4	5.6	4.3	
<b>Operating Profit (ex affiliates R&amp;D cost)</b>	<b>15.5</b>	<b>6.3</b>	<b>(59.0)</b>	<b>12.2</b>	<b>(47.9)</b>	
<b>OPM (%)</b>	<b>18.9</b>	<b>11.4</b>	<b>-752 bps</b>	<b>10.0</b>	<b>142 bps</b>	
Net Other income (expense)	0.5	0.2	(71.6)	0.1	5.69	
Tax	(0.6)	1.4		3.9		
<b>Net Income</b>	<b>16.7</b>	<b>5.1</b>	<b>(69.5)</b>	<b>8.4</b>	<b>(39.6)</b>	
Net margins (%)	20.3	9.1	-1,122 bps	6.9	223 bps	
R&D cost to Sun Global -Non Cash	5.9	-	nm	-	nm	
<b>Reported Net income</b>	<b>10.8</b>	<b>5.1</b>	<b>(52.8)</b>	<b>8.4</b>	<b>(39.6)</b>	

Source: Company, Citi Investment Research

Figure 2. Caraco – 3QFY09 revenue break up (Citi Estimates) (Rs in m, %)

	3QFY08	3QFY09	% Ch YoY	2QFY09	% Ch QoQ	CIR Comments
<b>Manufactured Products</b>	<b>32.3</b>	<b>29.5</b>	<b>(8.5)</b>	<b>32.3</b>	<b>(8.6)</b>	Sales of manufactured products appear to have dipped QoQ – as fresh product approvals are on hold due to FDA issues at its Detroit plant
Gross Profit	15.8	13.3	(16.2)	15.5	(14.3)	
Gross Margins (%)	49.1	45.0	-412 bps	48.0	-300 bps	
<b>Distributed Products</b>	<b>49.6</b>	<b>26.2</b>	<b>(47.2)</b>	<b>89.9</b>	<b>(70.8)</b>	GM on manufactured products declined QoQ on customer mix issues & pricing pressure – Caraco expects to achieve FY08 GM levels for the year as a whole
Gross Profit	7.4	2.6	(64.8)	6.5	(59.7)	
Gross Margins (%)	15.0	10.0	-500 bps	7.2	277 bps	
<b>Para IV products</b>	<b>14.6</b>	<b>11.6</b>	<b>(20.2)</b>	<b>67.6</b>	<b>(82.8)</b>	Distributed product sales lower YoY due to lower oxcarba sales (exclusive in 3Q08) - QoQ decline due to lower sales of pantoprazole ("at-risk" launch)
Gross Profit	1.2	0.6	(50.1)	3.4	(82.8)	
Gross Margins (%)	8.0	5.0	-300 bps	5.0	0 bps	
<b>Non Para IV products</b>	<b>35.0</b>	<b>14.6</b>	<b>(58.4)</b>	<b>22.3</b>	<b>(34.7)</b>	
Gross Profit	6.3	2.0	(67.5)	3.1	(34.7)	
Gross Margins (%)	17.9	14.0	-392 bps	14.0	0 bps	
<b>Total Sales</b>	<b>81.9</b>	<b>55.7</b>	<b>(31.9)</b>	<b>122.2</b>	<b>(54.4)</b>	
Gross Profit	23.3	15.9	(31.7)	22.0	(27.7)	
Gross Margins (%)	28.4	28.5	9 bps	18.0	1,053 bps	

Source: Company, Citi Investment Research

## Sun Pharmaceuticals

### Company description

Sun Pharma is one of the fastest-growing companies in India's domestic pharmaceutical market, growing at about 2x the industry rate. The company has followed a strategy of being the first to enter niche, high-growth segments (both organic and through acquisitions). The company has a presence in the CNS, pain management, ophthalmology, cardiovascular and respiratory segments. Sun is facing stiff competition in its traditional strongholds, but has managed to sustain growth and is focusing on new therapeutic areas. The company is looking to export its top formulation products to drive growth, and has set up marketing and distribution infrastructure in various markets. It is also filing for ANDA approvals through its US subsidiary Caraco and is looking to conclude its second key acquisition in the US (Taro Pharma).

## Investment strategy

We rate Sun Pharma as Buy/Medium Risk (1M), with a target price of Rs1,265. We believe that Sun is well placed to grow despite the challenges that keep coming in the way of global generics companies. Its strong base in India should continue to be a good driver of growth and profitability as well as a source of cash flows, besides providing it with a cushion against an appreciating rupee. At the same time, the growing visibility and success on its patent challenge pipeline improves cash flows as well as its ability to gain traction with the trade.

## Valuation

Our target price of Rs1,265 is based on a sum-of-the-parts approach, valuing its base business using a P/E approach and ascribing an option value for its patent challenge pipeline. We value frontline pharma stocks at a premium of around 50% to the broad market, due to the intellectual property built into the business models, faster growth as well as the potential to deliver positive earnings surprises. This works out to a multiple of 14x that we use for most sector leaders such as Glenmark, Cipla & Piramal Healthcare. However, we believe that Sun deserves a premium to these stocks, given its consistent track record, high profitability and return ratios as well as the potential upside from the deployment of idle cash in the business. We therefore value Sun at a 20% premium to other frontline generic stocks - at 17x Dec'09E earnings, we value the core business at Rs1,220/share. We also ascribe an option value of Rs45/share to Sun's patent challenge pipeline - the value reflects the success achieved by Sun in monetizing three patent challenges (Trileptal, Protonix, Ethyol) and the growing number of patent challenges in the public domain.

## Risks

Our risk rating on Sun Pharma is Medium Risk as we factor in the uncertainties on Taro; this is also in line with our quant-based rating system. The key downside risks to our target price are: (1) Warning letter by the FDA for Caraco's Detroit plant may prevent further approvals from the plant till the issues in letter are resolved; (2) Inability to close / effectively integrate the Taro acquisition and exploit synergies could keep earnings depressed for longer than we have anticipated; (3) A stronger IPR law in India could lead to a gradual slowdown in growth rates for the Indian market; (4) Damages to be paid in case it loses the litigation on Protonix with Wyeth. Upside risks to our target price include a faster-than-expected completion and integration of the Taro acquisition and a win in any patent challenge.

# Appendix A-1

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Analyst: Prashant Nair, CFA

Covered since February 22 2006

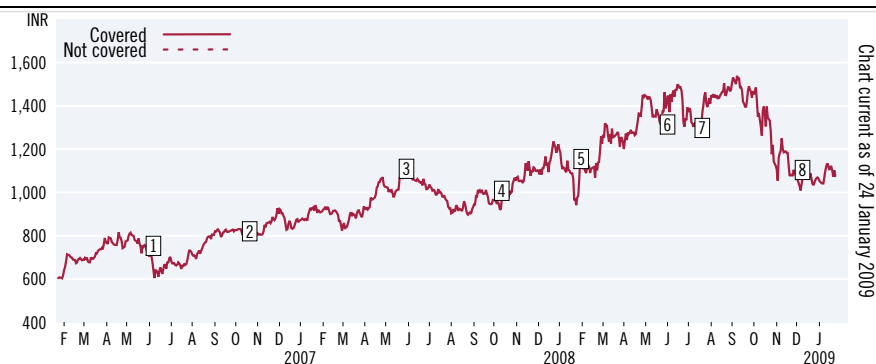


Chart current as of 24 January 2009

	Date	Rating	Target Price	Closing Price
1	7-Jun-06	3L	*617.18	640.63
2	20-Oct-06	3L	*678.46	810.28
3	30-May-07	*2L	*1,150.00	1,109.20

	Date	Rating	Target Price	Closing Price
4	11-Oct-07	*1L	1,150.00	969.45
5	31-Jan-08	1L	*1,350.00	1,138.45
6	1-Jun-08	1L	*1,659.00	1,402.90

	Date	Rating	Target Price	Closing Price
7	21-Jul-08	*1M	1,659.00	1,366.80
8	9-Dec-08	1M	*1,265.00	1,036.15

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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## Sun Pharmaceuticals (SUN.BO)

30 January 2009

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