Company Flash

28 August 2007 | 7 pages

Nicholas Piramal India (NICH.BO)

Buy: Proposed R&D Demerger Could Unlock Value

- Proposed NCE R&D demerger — NPIL's board is set to meet on 31 Aug 2007 to consider a proposal to demerge its NCE research unit into a separate entity. We expect this move to unlock value and act as a catalyst for the stock. We maintain our Buy/Medium Risk (1M) rating on India's leading innovator CRAMS play.
- Growing R&D focus — NPIL's focus on NCE R&D has been rising and it is working on 13 NCEs (3 in the clinic). R&D/sales was up from 1.2% in FY03 to 5.2% in FY07 (66% CAGR) and is set to rise to 5.7% in FY08E. We estimate that c50-67% of R&D spend is on NCE R&D. NPIL has also incurred material capex on this front and has entered into a co-development deal with Eli Lilly.
- Positive — NPIL has not shared specifics about the scheme yet. However, we believe it would be positive if it is in the form of a demerger with the NCE R&D unit being transferred to a NewCo and listed separately. This protects NPIL's core business from the high cost and risk of NCE R&D. It allows NPIL to seek other funding options in the R&D company without diluting the base business.
- Unlocking value — Our first-cut calculations indicate that a demerger would raise our FY09E and FY10E EPS 12-16% and 11-15% respectively. Besides, the street has treated NPIL's NCE R&D as a cost, thereby reducing the company's overall valuation. On demerger, if the NewCo is listed, we expect the Street to assign some value to this as well, thus unlocking value for shareholders.
- Case study: Sun Pharma — After a similar demerger, Sun's demerged R&D unit (SPRC.BO) is separately listed with a market capitalisation of cUS$365m, despite no revenues or licensing / partnership deals.

Buy/Medium Risk	1M
Price (28 Aug 07)	Rs259.10
Target price	Rs345.00
Expected share price return	33.2%
Expected dividend yield	1.5%
Expected total return	34.7%
Market Cap	Rs54,155M
	US$1,324M

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	1,211	5.79	-31.6	44.7	5.6	16.6	1.2
2007A	2,149	10.28	77.5	25.2	5.1	21.3	1.4
2008E	3,124	14.95	45.4	17.3	4.3	26.8	1.5
2009E	4,019	19.23	28.6	13.5	3.5	28.3	1.7
2010E	5,024	24.04	25.0	10.8	2.8	28.5	1.9

Source: Powered by dataCentral

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

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Proposed R&D Demerger Could Unlock Value

NPIL's board will consider a proposal to demerge its NCE unit into a separate entity. If the scheme is in the form of a demerger and separate listing of the NewCo, it would protect NPIL's core business from the high cost and risk of NCE R&D, while also allowing it to seek other funding options in the R&D company without diluting the base business. Our calculations indicate that a demerger would raise our FY09 and FY10 EPS estimates by 12-16% and 11-15%, respectively. We expect this move to unlock value and act as a catalyst for the stock and maintain our Buy/Medium Risk (1M) rating on India's leading innovator CRAMS play.

NCE R&D has been an ignored aspect of NPIL's business.

The lead candidate (P276) is already in clinical trials – in India as well as abroad. It recently got US FDA approval for the IND and clinical trials are expected to commence in the USA shortly

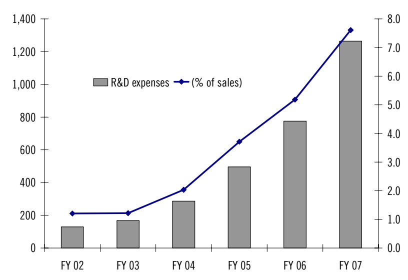
A recent co-development deal with Eli Lilly for the latter's molecules also validates NPIL's capabilities in clinical development

Figure 1. NCE Research Pipeline — Seeing Significant Traction

Therapeutic	Target	Compound	Stage
Oncology	CDK-4	P-276	Phase II
Inflammation	TNF-a	Sphira	Phase II
Anti-Infective	Dermato-phytes	Hespiderm	Phase II
Oncology	Bcl-2	NPB-001-05	Late Pre Clinical
Oncology	CDK-4	P-1446	Pre Clinical
Oncology	HIF-a	NA	Pre Clinical
Oncology	General	Microbial Leads	Pre Clinical
Inflammation	TNF-a	P-979	Pre Clinical
Inflammation	TNF-a	Back-ups	Pre Clinical
Inflammation	NSAID	P-1539	Pre Clinical
Diabetes	NA	NA	Pre Clinical
Diabetes	Non PPAR	P-1736	Pre Clinical
Anti-Infective	MRSA/VRE	PM-181104	Pre Clinical

Source: Company Reports

Figure 2. NPIL – R&D Spend (Rs m, %)



Source: Company Reports

Drug discovery deal with Eli Lilly

NPIL entered into a new drug discovery agreement with Eli Lilly to develop a select group of the latter's pre-clinical drug candidates in multiple therapeutic areas. To start with, Eli Lilly has licensed one molecule to NPIL in the metabolic disorder space, which would act as a prototype for the following molecules. The management has indicated that NPIL could receive milestone payments up to US$100m on successful completion of phase I and II trials by NPIL and on registration and launch by Eli Lilly. It would also be entitled to royalties on sales and commercial rights for certain markets. While the financial upside from the deal would be minimal, if at all, over the next two years, we believe that the deal validates NPIL's R&D capabilities. This is pertinent, given that NPIL's own drug discovery pipeline has expanded to encompass three molecules in the clinic besides several others in the pre-clinical stage.

Based on our past discussions with management, we believe that NCE R&D accounts for c50-66% of overall R&D spend

Tax shield is adjusted for the 150% weighted tax deduction that Indian companies get for R&D

Figure 3. Potential Accretion on NCE R&D Demerger – First-Cut Calculations

(Rs m)	FY09E		FY10E		CIR Comment
(A) Overall R&D Spend	2,057	2,057	2,397	2,397	CIR estimates
(B) Share of NCE R&D spend	*50%*	*67%*	*50%*	*67%*	CIR assumptions
(C) NCE R&D Spend	1,028	1,378	1,198	1,606	(A x B)
(D) Tax shield on NCE R&D	525	703	611	819	@34% on 150% of NCE R&D spend
(E) Net saving on demerger	**504**	**675**	**587**	**787**	**(C – D)**
(F) Current Net Profit	4,276	4,276	5,332	5,332	CIR estimates
(G) Net Profit post demerger	4,780	4,952	5,920	6,119	(F + E)
(H) Accretion	**12%**	**16%**	**11%**	**15%**	

Source: Citigroup Investment Research

Nicholas Piramal India

Company description

Nicholas Piramal (NPIL), the fourth-largest company in the Indian formulations market, is targeting the regulated pharmaceutical markets through custom manufacturing (CMG). The company has scaled up in the domestic market through both organic and inorganic initiatives, and is looking at doing the same in the overseas markets. Some initial CMG successes have been achieved in the form of six diverse contracts with innovator companies and two acquisitions in overseas markets.

Investment thesis

We rate NPIL Buy/Medium Risk (1M) with a target price of Rs345. We believe NPIL is one of the best plays on custom manufacturing and the branded formulations market in India. Among the Indian mid-tier companies, NPIL has a unique approach to the domestic and export markets. Leveraging its manufacturing capabilities and relationships with global majors, the company has positioned itself as a 'partner of choice' for innovator companies across the product life cycle and value chain. On the domestic front, it has focused on building brands and strengthening its marketing and distribution network, making it less dependent than its peers on new product launches for growth. We are comfortable with valuations at current levels and expect significant upside potential as earnings momentum continues in FY08 and beyond.

Valuation

We value NPIL's stock on a P/E basis given its earnings growth outlook. As pharmaceuticals is a growth sector, we use P/E in relation to earnings growth as our principal valuation methodology for a company's base business while applying a relative premium/discount for different companies. We use a target P/E of 20x to value sector leaders, which is at a premium of about 40% to the broader market. This is justified, in our view, because the sector is intellectual property-driven and has potential to spring earnings triggers that could lead to significant growth opportunities in the future. We broadly value mid-sized Pharma stocks at a 10-20% discount range (16-18x) to sector leaders. Our target price of Rs345/share is based on 20x Sept '08E earnings. This is at a premium to our target multiple for mid-sized pharma companies and in-line with our target multiple for sector leaders. We believe NPIL deserves a higher multiple given the nature of its CMG business and possible upside from inorganic initiatives. Revenue visibility and sustainability are high in the CMG business: these are long-term exclusive contracts with innovators with no risk of litigation-related delays and competitive pressures. However, given the 18-24 month time lag between doing a deal and commencement of revenues, the full upside is not captured in one-year forward earnings. As such, we believe it deserves a higher valuation multiple.

Risks

We rate Nicholas Medium risk in contrast with our quantitative risk-rating system's Low Risk to account for the integration-related issues of the Avecia and Morpeth acquisitions. The main downside risks to our target price are: 1) While custom manufacturing should drive NPIL's revenues and profitability, any slip-up in executing the contracts would be a big negative. 2) A break-up of any major association could have a short-term impact on revenues and earnings. 3) Any unfavorable trend in growth or pricing could have an adverse impact on the company's financials. The main upside risks to our target price are: 1) If NPIL bags new contracts that have a shorter lead time, it could have a positive impact on our estimates and target price; and 2) NPIL continues to scout for acquisitions, which could add further to its strengths in target businesses and our estimates.

Appendix A-1

Analyst Certification

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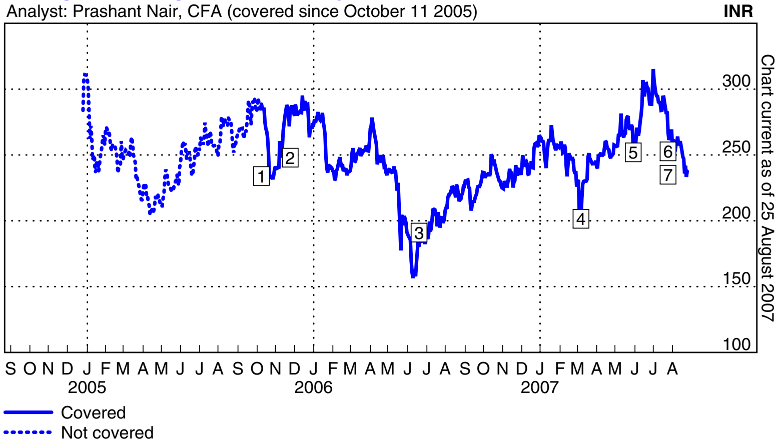
Nicholas Piramal India (NICH.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since October 11 2005)



#	Date	Rating	Target Price	Closing Price
1:	10 Oct 05	2L	318.00	288.60
2:	24 Nov 05	2L	*286.00	286.60
3:	20 Jun 06	*1M	*255.00	180.40
4:	7 Mar 07	1M	*300.00	201.50
5:	30 May 07	1M	*330.00	254.30
6:	25 Jul 07	1M	*345.00	267.20
7:	25 Jul 07	1M	*330.00	267.20

*Indicates change.

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