

Company

23 July 2010 | 9 pages

Biocon (BION.BO)

 Equity
 Target price change

Sell: No Surprises in 1Q; Margin Pressure Ahead

- No Surprises** — Biocon's 1Q results contained few surprises. Better revenues were offset by higher interest cost, leading to net income being marginally below our estimate. Good growth in biopharma is encouraging; however, margins were mainly buoyed by higher licensing income and are likely to dip as R&D spend increases going forward. We believe valuations are stretched and maintain Sell (3H), even as we raise TP marginally to Rs290 (roll over to Sept 11E EPS)
- Good Growth across Most Segments** — Biopharma (+31%) was buoyed by supply of tacrolimus API for the US and atorvastatin API to Europe as well as healthy growth (+28%) in Indian branded sales. Axicorp (+37%) continued to reflect the upside from recent tender wins while licensing income (Rs206m v/s Rs24m in 1QFY10) also aided the topline. However, research services (+13%) remained subdued and appears to have plateaued over the last few quarters.
- Margins Buoyed by Licensing Income** — EBIDTA margin remains under pressure. Excluding the sharply higher licensing income, EBIDTA margin dipped c277bps YoY despite high growth in most businesses and improving profitability (up to higher single digit range) in Axicorp. We believe this pressure will continue given the sharp increase in R&D spend expected going forward. Net income (+34% YoY) was marginally below our estimate.
- Key Earnings Call Takeaways** — a) Human insulin: received go ahead from German authorities for clinical trials – patient recruitment to start soon and launch possible by end CY12/CY13; b) Oral insulin – to start first trial under US IND (to look at the drug in type 1 diabetes) – awaiting data from type 1 & 2 diabetes trials before deciding how to position the product and commence licensing discussions; c) R&D spend to increase given these projects – to be cRs1.5bn in FY11 (v/s Rs784m in FY10); d) Restructuring research services biz to offer higher value added services – to entail some investment over next two quarters.

Sell/High Risk	3H
Price (23 Jul 10)	Rs324.75
Target price	Rs290.00
<i>from Rs285.00</i>	
Expected share price return	-10.7%
Expected dividend yield	1.0%
Expected total return	-9.7%
Market Cap	Rs64,950M
	US\$1,378M

Price Performance (RIC: BION.BO, BB: BIOS IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2008A	2,160	10.80	7.9	30.1	4.4	16.9	0.8
2009A	2,231	11.15	3.3	29.1	4.3	14.9	0.9
2010E	2,932	14.66	31.5	22.1	3.7	17.9	1.1
2011E	3,290	16.45	12.2	19.7	3.3	17.6	1.3
2012E	3,597	17.99	9.3	18.1	2.9	17.0	1.4

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	30.1	29.1	22.1	19.7	18.1
EV/EBITDA adjusted (x)	21.7	20.2	14.1	12.0	10.8
P/BV (x)	4.4	4.3	3.7	3.3	2.9
Dividend yield (%)	0.8	0.9	1.1	1.3	1.4
Per Share Data (Rs)					
EPS adjusted	10.80	11.15	14.66	16.45	17.99
EPS reported	23.20	4.66	14.66	16.45	17.99
BVPS	74.21	75.54	87.89	99.53	112.26
DPS	2.50	3.00	3.50	4.11	4.50
Profit & Loss (RsM)					
Net sales	10,538	16,087	23,678	26,984	29,321
Operating expenses	-8,491	-13,956	-20,365	-23,318	-25,289
EBIT	2,047	2,131	3,313	3,666	4,032
Net interest expense	-102	-177	-169	-153	-50
Non-operating/exceptionals	279	466	370	357	250
Pre-tax profit	2,224	2,421	3,515	3,871	4,232
Tax	-129	-118	-487	-581	-635
Extraord./Min.Int./Pref.div.	2,544	-1,371	-96	0	0
Reported net income	4,639	931	2,932	3,290	3,597
Adjusted earnings	2,160	2,231	2,932	3,290	3,597
Adjusted EBITDA	2,986	3,234	4,715	5,411	5,884
Growth Rates (%)					
Sales	6.9	52.7	47.2	14.0	8.7
EBIT adjusted	-5.6	4.1	55.5	10.7	10.0
EBITDA adjusted	5.4	8.3	45.8	14.8	8.7
EPS adjusted	7.9	3.3	31.5	12.2	9.3
Cash Flow (RsM)					
Operating cash flow	2,609	1,079	4,248	4,439	5,033
Depreciation/amortization	939	1,103	1,401	1,745	1,852
Net working capital	173	-1,282	-345	-749	-466
Investing cash flow	-6,281	-2,553	-2,578	806	-1,500
Capital expenditure	-2,325	-3,649	-2,015	-2,500	-1,500
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	-361	-574	-1,000	-3,599	-3,552
Borrowings	-10	11	-298	-2,636	-2,500
Dividends paid	-351	-585	-702	-962	-1,052
Change in cash	-4,033	-2,047	670	1,646	-19
Balance Sheet (RsM)					
Total assets	20,789	25,436	29,361	30,223	31,247
Cash & cash equivalent	96	118	1,399	3,270	3,614
Accounts receivable	2,591	3,667	4,461	5,144	5,590
Net fixed assets	10,419	12,205	12,408	13,164	12,812
Total liabilities	6,021	10,081	11,444	9,978	8,457
Accounts payable	2,300	3,570	4,909	5,428	5,855
Total Debt	2,551	5,239	5,136	2,500	0
Shareholders' funds	14,768	15,355	17,916	20,244	22,789
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	28.3	20.1	19.9	20.1	20.1
ROE adjusted	16.9	14.9	17.9	17.6	17.0
ROIC adjusted	14.6	12.7	15.4	15.7	16.5
Net debt to equity	16.6	33.4	20.9	-3.8	-15.9
Total debt to capital	14.7	25.4	22.3	11.0	0.0

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1QFY11 Results Snapshot

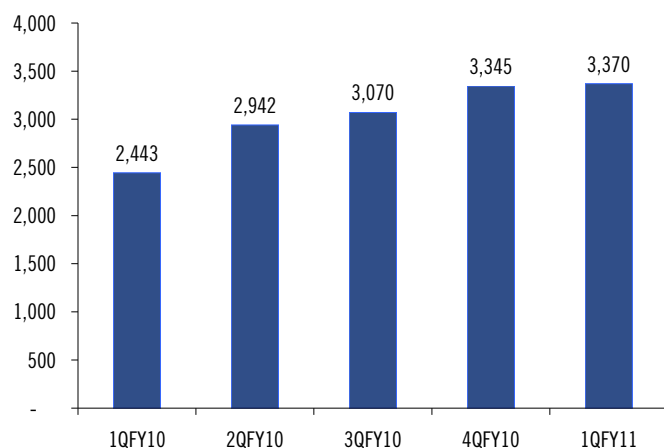
Figure 1. Biocon – 1QFY11 Earnings Summary (Rs m, %)

Year to 31st March	1QFY10	1QFY11	% ch YoY	4QFY10	% ch QoQ	CIRA Comments
Biopharma	2,419	3,164	30.8	3,139	0.8	Conclusion: Numbers largely in line. PAT slightly lower despite better revenues due to higher-than-expected interest cost
Axicorp	1,877	2,532	34.9	2,480	2.1	
Licensing Income	24	206	758.3	206	-	
Contract Research Services	639	720	12.7	743	(3.1)	
Total Operational Income	4,959	6,622	33.5	6,568	0.8	While topline growth is buoyant across segments (mainly driven by commencement of tacrolimus supplies and atorva API launch in Europe), margins appear largely buoyed by higher licensing income
RM Costs	2,891	4,033	39.5	3,976	1.4	
as a % of sales	58.3	60.9	261 bps	60.5	37 bps	
Staff costs	525	695	32.4	604	15.1	
as a % of sales	10.6	10.5	-9 bps	9.2	130 bps	
Others	330	369	11.8	492	(25.0)	
as a % of sales	6.7	5.6	-108 bps	7.5	-192 bps	
R&D	201	212	5.5	192	10.4	
as a % of sales	4.1	3.2	-85 bps	2.9	28 bps	
Total Expenditure	3,947	5,309	34.5	5,264	0.9	
EBITDA	1,012	1,313	29.7	1,304	0.7	EBIDTA margins, excluding licensing income, have dipped c277bps YoY, despite tight control over overheads
EBITDA Margin (%)	20.4	19.8	-58 bps	19.9	-3 bps	
EBITDA Margin (%) (ex licensing inc)	20.0	17.3	-277 bps	17.3	0 bps	R&D spend to go up materially over the next few quarters – likely to be to the tune of cRs1.5bn in FY11 – most of it to be expensed
Depreciation	324	375	15.7	367	2.2	
Interest	57	70	22.8	33	112.1	
Other Income	94	95	1.1	88	8.0	
PBT	725	963	32.8	992	(2.9)	
Taxes	137	164	19.7	144	13.9	
Effective tax rate (%)	18.9	17.0	-187 bps	14.5	251 bps	
PAT	588	799	35.9	848	(5.8)	
Minority Interest/Others	13	31	138.5	42	(26.2)	
Recurring PAT	575	768	33.6	806	(4.7)	

Source: Company Reports and CIRA Estimates

Key Segment Updates

Figure 2. Biopharma (ex Axicorp) Revenues (Rs m)



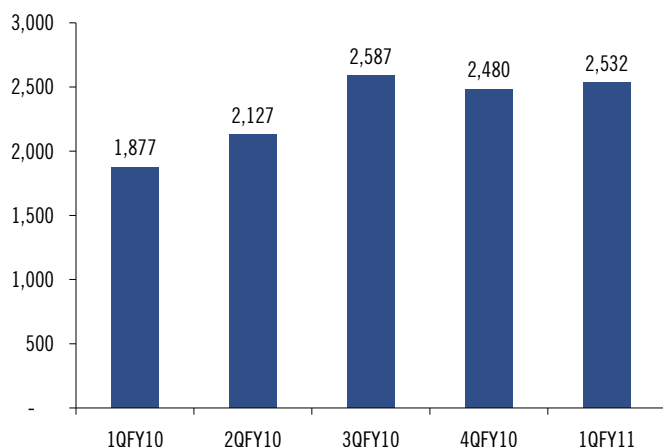
Source: Company Reports

CIRA Comments

- 1Q revenues include Rs206m of licensing income, largely from Mylan – v/s Rs24m in 1QFY10
- Milestone payments from Mylan expected to continue for the next few quarters
- Tacrolimus API supplies to customers has begun – partnered with 2 out of the 3 players in the market and 6-7 files awaiting approval
- Supply of atorvastatin API supplies to Europe has begun (in Spain) – has added to growth rates
- Branded formulations in India grew by c28% YoY

Source: Company Reports

Figure 3. Axicorp (Rs m)



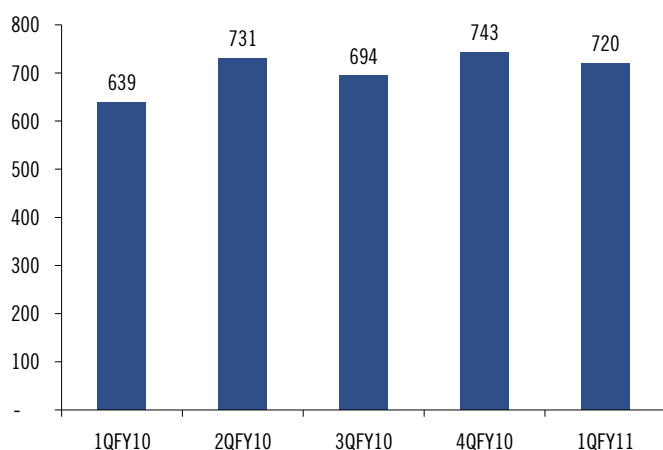
Source: Company Reports

CIRA Comments

- Strong growth in sales continues on account of tender wins in Germany
- Axicorp has won tenders for several generic products from AOK, BKK and DAK
- Margins up (in higher single digit range) on the back of improved sourcing arrangements and restructuring of sales force – Biocon expects current margins to be sustainable

Source: Company Reports

Figure 4. Contract Research Revenues (Rs m)



Source: Company Reports

CIRA Comments

- Contract research revenues appear to be stagnating at the cRs700m range over the last few quarters
- Change of strategy – especially at the Clinigene level – to start offering more value-added services – will involve some additional spend over the next one to two quarters – benefits to start coming in towards end of FY11

Source: Company Reports

Biocon

Company description

Biocon is an integrated biotech company that encompasses all three critical stages of drug development - drug discovery, development, and manufacturing and commercialization of biopharmaceuticals. It is also engaged in contract research services. With more than 25 years of expertise in fermentation technology, the company has built strong capabilities in high-growth segments like statins, immunosuppressants and anti-diabetics. While statins form the major part of its current business, Biocon is aggressively pursuing the biosimilars opportunity in regulated markets and is also making investments in drug discovery research to build a future pipeline.

Investment strategy

We have a Sell/High Risk (3H) rating on Biocon in view of the nascent nature of longer-term growth initiatives. Despite several initiatives being taken by the company to emerge as a biotech major, Biocon remains primarily an API player with high exposure to the statins segment. Unlike other Indian companies, Biocon does not have the requisite breadth in its product portfolio to overcome the pressure on statins and delays in biogenerics launches. The setbacks on pravastatin and simvastatin in the US in CY06 and tacrolimus in CY08 reflect the high sensitivity of Biocon's earnings to a delayed launch and are an indication of the vulnerability of the company's business model. Overall, we expect an 11% CAGR in net profit for Biocon over FY10-12E, with higher spend on R&D offsetting revenue growth. Valuations appear expensive relative to the growth outlook and the vulnerability of earnings in the near to medium term.

Valuation

Our target price of Rs290 (up from Rs285 earlier) for Biocon is based on 17x Sept 11E earnings, at a 15% discount to our target range for leading generic pharma companies in our coverage universe, such as Dr.Reddy's. This is due to Biocon's lower earnings CAGR (11% over FY10-12E) and return ratios (c17%). We also believe that the higher vulnerability of Biocon's business model to pricing pressure and delayed product launches /scale-up would continue to keep the stock's multiples on the lower side. Since pharma is a growth sector, we prefer to use P/E v/s EPS CAGR as our primary valuation methodology for the base business of pharma companies.

Risks

Our risk rating for Biocon is High Risk as against the Low Risk rating suggested by our quant based rating system, given the risk from rupee appreciation and current high valuations that leave limited room for execution errors. The main upside risks that could prevent the stock from attaining our target price and estimates include: 1) licensing deals for oral insulin or T1h molecules; 2) progress in biosimilars efforts in the US & / or EU; 3) On Tacrolimus, faster-than-expected scale-up in partners' market share in the US would be positive for valuations and sentiment.

Appendix A-1

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Analyst: Prashant Nair, CFA

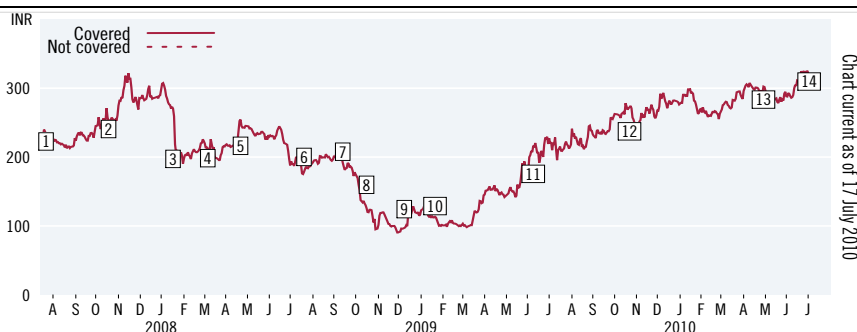


Chart current as of 17 July 2010

	Date	Rating	Target Price	Closing Price
1	19-Jul-07	3L	*232.50	239.88
2	18-Oct-07	3L	*252.50	252.65
3	17-Jan-08	3L	*250.50	270.30
4	6-Mar-08	*3M	*218.00	214.08
5	22-Apr-08	3M	*228.00	254.43

	Date	Rating	Target Price	Closing Price
6	21-Jul-08	*3H	*199.50	178.50
7	12-Sep-08	3H	*200.00	191.95
8	16-Oct-08	3H	*122.00	125.90
9	9-Dec-08	3H	*93.00	96.30
10	21-Jan-09	3H	*104.00	113.35

	Date	Rating	Target Price	Closing Price
11	9-Jun-09	3H	*140.00	216.55
12	22-Oct-09	3H	*200.00	272.20
13	29-Apr-10	3H	*250.00	302.40
14	2-Jul-10	3H	*285.00	316.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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