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PINC RESEARCH

Initiating coverage
Sector: Pharmaceuticals
BSE Sensex: 16,536

# Ipca Laboratories

HOLD
CMP Rs240
TP Rs262

Initiating Coverage

**October 12, 2011**


**Sushant Dalmia, CFA**
sushant.dalmia@pinc.co.in
+91-22-6618 6462

**Poonam Sanghavi**
poonam.sanghavi@pinc.co.in
+91-22-6618 6709


**We initiate coverage on Ipca Laboratories (Ipca) with a HOLD rating as the domestic formulation business faces stiff competition resulting into pressure on margins while the growth on the AMFm business could taper down in FY13E on back of rationalisation of co-payments to manufacturers. As a result, we expect net sales and recurring PAT to grow by 15.5% and 12.5% over FY11-13E. The stock has corrected by ~30% in the last three months and is trading at 12.6x FY12E and 10.5x FY13E recurring earnings. We have valued the company at 12x one year forward earnings and arrived at a Target Price of Rs262.**

## Domestic formulation business faces stiff competition

Ipca's domestic business has been under pressure on back of intense price competition, internal restructuring and attrition of field force. The company's key therapeutic segments namely Anti-malaria, Anti-infective and CNS have witnessed de-growth in the last few months. As a result, we now estimate Ipca's high-margin domestic formulation business to grow below industry average over FY11-13E as compared to out-performance seen in the last couple of years.

## Export growth depends on Indore SEZ approval

Ipca's export growth going ahead would be dependent on Indore SEZ approval by USFDA which has been pending for the last 30 months. Although we have factored in the approval for Q4FY12, any further delay would hamper the growth. Further AMFm, which contributed ~10% to sales in Q1FY12, could rationalise co-payments to manufacturers going ahead.

## VALUATIONS AND RECOMMENDATION

We value the stock at 12x one year forward earnings which is at a discount of 45% to large peers given the scale and the business-mix (high exposure to low-margin API segment and highly competitive domestic formulation acute therapeutic segment). We initiate coverage on the stock with a 'HOLD' rating and Target Price of Rs262. We believe any re-rating from here on would be driven by pick-up in the domestic formulation business.

## KEY FINANCIALS (Rs mn)

| | FY09 | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|---|
| Total Revenues | 12,925 | 15,668 | 18,989 | 22,208 | 25,307 |
| YoY Gr. (%) | 18.4 | 21.2 | 21.2 | 17.0 | 14.0 |
| Op. Profit | 2,651 | 3,337 | 3,761 | 3,990 | 4,849 |
| OPM (%) | 20.5 | 21.3 | 19.8 | 18.0 | 19.2 |
| Adj. Net Profit | 1,709 | 2,026 | 2,292 | 2,383 | 2,902 |
| YoY Gr. (%) | 44.1 | 18.5 | 13.1 | 4.0 | 21.8 |
| **KEYRATIO** | | | | | |
| Dil. EPS (Rs) | 13.7 | 16.2 | 18.2 | 19.0 | 22.8 |
| ROCE (%) | 22.2 | 24.6 | 22.7 | 20.4 | 21.7 |
| RoE (%) | 16.5 | 27.4 | 27.4 | 20.8 | 21.6 |
| PER (x) | 29.8 | 14.6 | 11.5 | 12.6 | 10.5 |
| EV/ Net Sales (x) | 2.7 | 2.2 | 1.9 | 1.6 | 1.4 |
| EV /EBDITA (x) | 13.3 | 10.5 | 9.7 | 9.3 | 7.8 |

## STOCK DATA

| | |
|---|---|
| Market cap | Rs30bn |
| Book Value per share | Rs98 |
| Shares O/S (F.V. Rs2) | 126mn |
| Free Float | 54% |
| Avg Trade Value (6 months) | Rs36mn |
| 52 week High/Low | 351/230 |
| Bloomberg Code | IPCA IN |
| Reuters Code | IPCA.BO |

## PERFORMANCE (%)

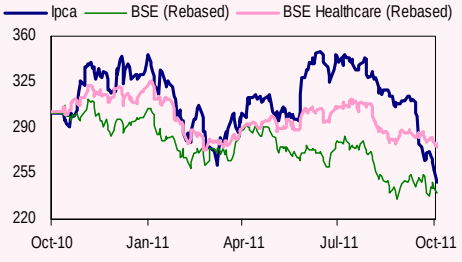
| | 1M | 3M | 12M |
|---|---|---|---|
| Absolute | (23.3) | (30.4) | (20.8) |
| Relative | (21.8) | (21.2) | (2.6) |

## TOP SHAREHOLDERS

| Name | % holding |
|---|---|
| HDFC Trustee Company | 8.6 |
| HDFC Standard Life Ins. | 4.2 |
| Sundaram MF | 2.8 |
| Carlson Fund | 2.0 |
| Franklin Templeton MF | 2.0 |

**As on June 30, 2011*

## RELATIVE PERFORMANCE

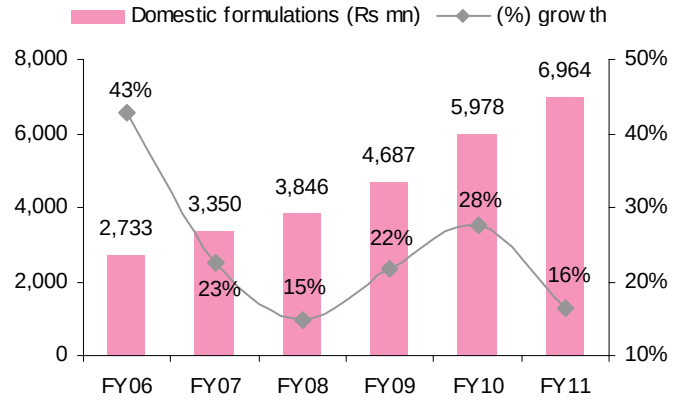


## Investment Rationale

### Domestic formulation business faces stiff competition

Ipca has been one of the fastest growing companies in the domestic formulation market clocking a CAGR of 20.6% higher than industry average of 14-15% over FY06-11. The segment now contributes 37% to the sales of the company. The higher than industry growth was driven by stupendous growth in both acute and chronic therapeutic segments. On the acute therapy front NSAID clocked CAGR of 36.6% while Anti-Malarial segment grew by 15.6% over FY06-11. The chronic therapeutic segment primarily CVS and Diabetes grew by 19.7% over the stated period. On back of robust growth in the past and to increase its penetration, Ipca aggressively expanded its field force by more than 30% in FY11 to 4,200MRs. The company also introduced 25 new products in FY11 primarily in the new therapeutic segments, namely urology and nephrology. Further, being in branded generic market, Ipca's margin on the segment is higher than its other business segments.

**Exhibit 1 - IPCA's domestic formulations trend**




*Source: Company, PINC Research*

**Exhibit 2 - Therapeutic segment breakup**

| (Rs mn) | FY11 | CAGR (FY06-11)% | Wt (%) |
|---|---|---|---|
| **Acute** | **4,527** | **20.2** | **65** |
| NSAID | 1,950 | 36.6 | 28 |
| Anti malarial | 1,184 | 15.6 | 17 |
| Anti bacterial | 557 | 7.8 | 8 |
| Gastro intestinal products | 418 | 11.2 | 6 |
| Cough preparations | 279 | 20.6 | 4 |
| Others | 139 | 11.2 | 2 |
| **Chronic** | **2,437** | **21.3** | **35** |
| Cardio & Anti diabetic | 1,880 | 19.7 | 27 |
| CNS & Dermatology | 557 | 27.7 | 8 |

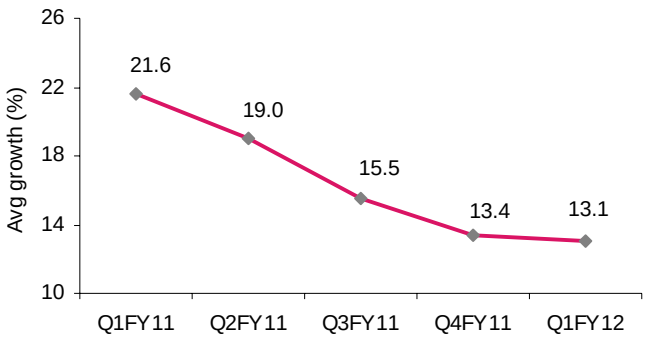
*Source: Company, PINC Research*

After witnessing a strong growth in the earlier years, the domestic formulation industry's overall growth rate has slipped from 17% in FY11 to 13-14% in the last six months on back of following:

- Intense price competition primarily in the acute segment where companies have become more aggressive. Strong volume discount has been offered to increase market share. Mankind, Intas, Pfizer and Aventis have become aggressive in the market in last few months.
- No breakdown of major epidemic during the year
- Chronic segment however is growing at a strong rate

Ipca, on the other hand, has not only been marred by increasing competition in the industry but also by internal restructuring and attrition of field force. Anti-Malaria segment, which contributes nearly 17% to the domestic formulation sales, has grown in a low single digit on back of extended monsoon season with its key brand Lariago de-growing in double-digits. Ipca does get majority of its anti-malaria sales in July-September months and as a result has lost sales to the tune of Rs300mn. Further, the company is also facing pressure on the Anti-infective and CNS segments which have also shown de-growth. The de-growth in these segments is primarily due to high attrition witnessed in the last six months. However, NSAID and Gastro segments continue to do well for the company.

**Exhibit 3 - Domestic industry growth trend (%)**




*Source: Industry reports, PINC Research*

**Exhibit 4 - Ipca's domestic sales growth YTD (%)**

| (Rsmn) | Ipca growth (%) | Industry growth (%) |
|---|---|---|
| Anti infective | (11.2) | 8.4 |
| Anti malarial | 1.5 | 3.4 |
| CNS | (8.5) | 13.4 |
| CVS | 11.5 | 17.8 |
| Dermatology | 14.2 | 12.6 |
| Diabetes | 19.8 | 23.4 |
| GI | 16.5 | 9.8 |
| Pain management | 30.8 | 12.3 |

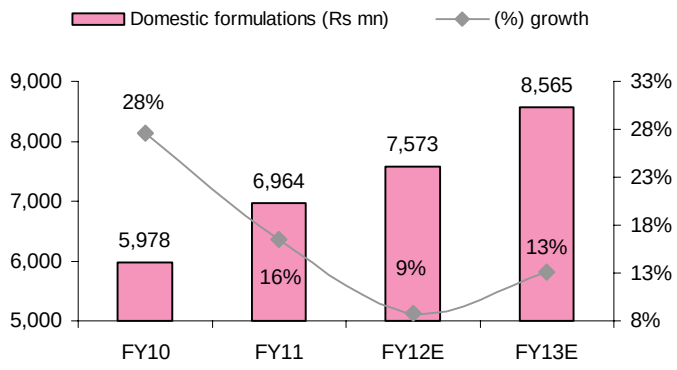
*Source: Industry reports, PINC Research*

In order to address the issue, Ipca has undertaken following restructuring exercise:

- The company has hived off its bigger brands such as Tenolol and Tenoric acid, which have been de-growing, to a separate division in order to increase promotion and enhance visibility.
- The company has also split the NSAID division into two viz; Rheumatoid Arthritis and Osteoarthritis. Ipca has also beefed up the sales force for the division.
- Post the 30% increase in field force in FY11, the company would now focus on improving productivity.

We now expect Ipca's high-margin domestic formulation business to grow below industry average as compared to out-performance witnessed in the last couple of years on back of high exposure to competitive acute therapy and the restructuring exercise. Overall, the company's domestic formulation sales is estimated to clock CAGR of 10.9% over FY11-13E with a pick-up in growth from FY13E onwards on back of improvement in sales force productivity and benefits flowing from restructuring exercise. The company has also lowered its domestic growth guidance to 10-12% from earlier 16-18% in FY12.

**Exhibit 5 - Domestic formulations trend**




*Source: Company, PINC Research*

**Exhibit 6 - Expected therapeutic segments growth rate**

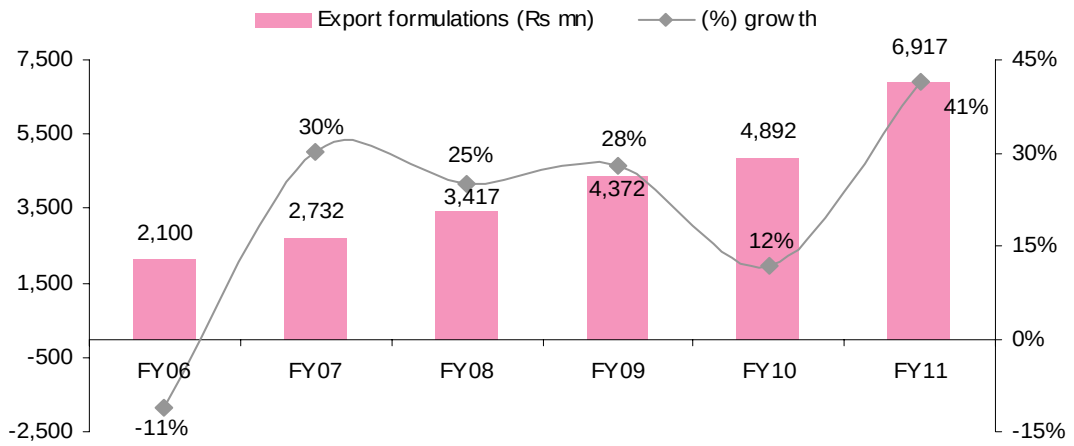
| Growth rate (%) | FY12E | FY13E |
|---|---|---|
| **Acute** | **9.1** | **12.1** |
| NSAID | 15.0 | 14.0 |
| Anti-malarial | 3.0 | 12.0 |
| Anti-bacterial | (5.0) | 5.0 |
| Gastro Intestinal Products | 12.0 | 10.0 |
| Cough Preparations | 12.0 | 12.0 |
| Others | 20.0 | 15.0 |
| **Chronic** | **8.1** | **15.0** |
| Cardio & Anti Diabetic | 12.0 | 15.0 |
| CNS & Dermatology | (5.0) | 15.0 |

*Source: Company, PINC Research*

## Export formulation growth depends on Indore SEZ approval

Ipca generates nearly 37% of the sales from the export formulation business. The segment has been the driver for Ipca and has clocked a CAGR of 26.9% over FY06-11 driven by US and Europe region. The company has been increasing its penetration in the regulated markets by expanding the list of generic drugs backed by its own API. In the emerging and semi-regulated markets, Ipca focuses on building brands in the CVS, CNS, NSAID, Anti-Malarial segments and tapping new geographies. The company has now become a key player in AMFm (Affordable Medicines Facility- malaria) contracts post the approval of finished dosage Artemether + Lumefantrine 20/120mg tablets combination (ACTs) in FY10.

**Exhibit 7 - Export formulations trend**

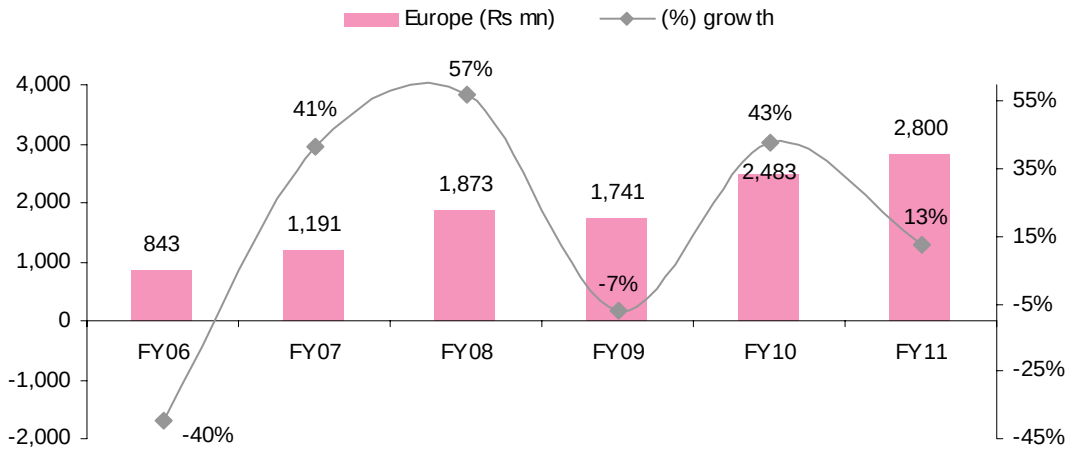



*Source: Company, PINC Research*

## Europe to grow at a slower pace

Europe, mainly comprising UK, is the largest market for Ipca and contributes 40.5% of the company's generic formulations sales. The company has stepped up the activity of registering products in the UK and other EU markets. It has submitted 54 dossiers for registration (25-30 are already marketed) and 42 dossiers are under development. Ipca is also working on registering the dossiers approved in UK for the other EU markets like Portugal, Denmark and Hungary. However, we expect the Europe region to clock 12.9% CAGR over FY11-13E to Rs3.6bn on back of slower product approvals and launches.

**Exhibit 8 - Europe formulations trend**

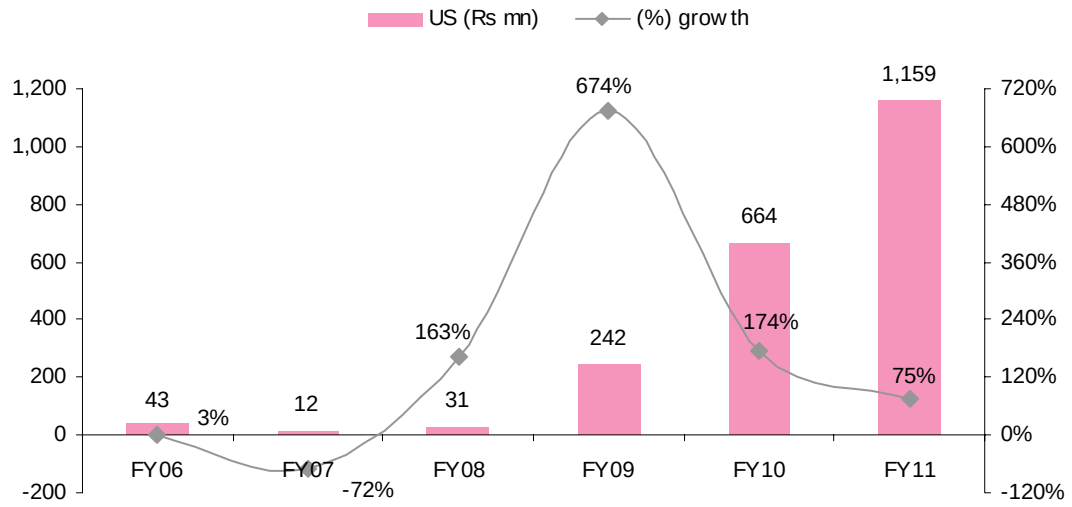



*Source: Company, PINC Research*

**US- Indore SEZ approval is the key**

Ipca has been a late entrant in the US market. In order to scale-up faster, it has followed partnership model in US. The company has entered into marketing deal with three companies including Ranbaxy whereby the company shares its operating profit (50%) with the marketing company. Ipca has filed for 22 ANDA's of which 12 are approved. Ipca plans to file 10-12 ANDA's every year for the next two-three years. The company has almost doubled its sales in last one year driven by product launches and improvement in market share. However, the company has been facing capacity constraints at the existing facility (Piparia) and is awaiting USFDA approval for its new SEZ facility at Indore for the last 30 months. US FDA has been short of resources and ANDA approval now takes > 30months from 25-30 months, a year back. The company is incurring cost to the tune of Rs250mn (including depreciation) on the facility without commensurate sales. We expect the approval to come by end of FY12 and estimate sales to the tune of Rs750mn in FY13E from the facility. As a result, we expect the region to clock a CAGR of 43.6% over FY11-13E to Rs2.4bn for the company.

**Exhibit 9 - US formulations trend**

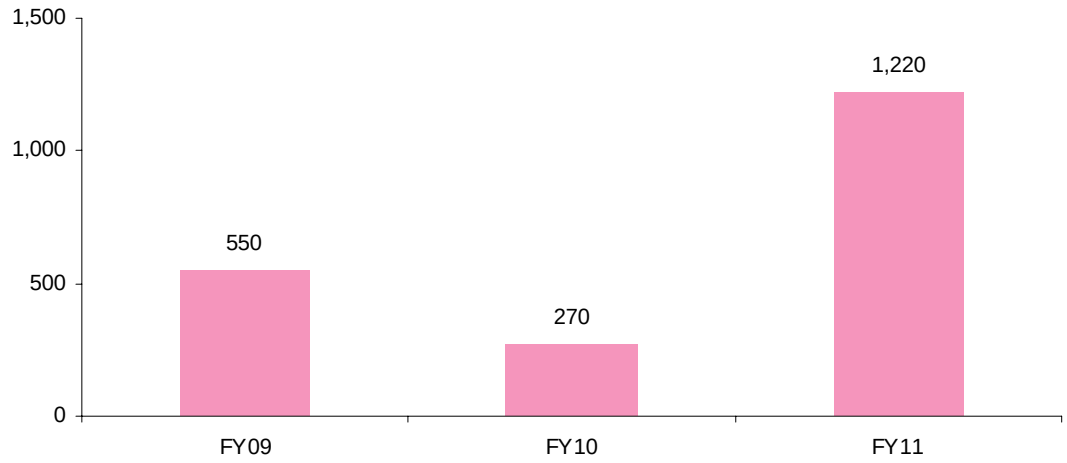



*Source: Company, PINC Research*

**AMFm could rationalise co-payments to manufacturers**

Ipca is one of the few pharma players, eligible to supply under the AMFm (Affordable Medicines Facility- malaria). AMFm is an innovative financing mechanism to expand access to affordable artemisinin-based combination therapies (ACTs) for malaria. AMFm is hosted and managed by the Global Fund to Fight AIDS, Tuberculosis and Malaria (The Global Fund). UNITAID, The Government of the United Kingdom and the Bill & Melinda Gates Foundation are the financiers. It's an USD216mn fund to provide subsidy on the ACT supply to African countries (refer Appendix A for more details on AMFm). Ipca won the WHO Pre-qualifications for finished dosage Artemether + Lumefantrine 20/120mg Tablets in Sept 2010. Post the prequalification in 2010, Ipca's institution business has gained traction in FY11 to Rs1.2bn, contributing 6.5% to the total sales of the company.

**Exhibit 10 - Export Institutional Sales (Rs mn)**




*Source: Company, PINC Research*

However, a recent survey report by Africa Fighting Malaria (AFM), a non-profit health advocacy group, published in September 2011(http://www.fightingmalaria.org/pdfs/amfmpolicypaper.pdf); highlighted that there were certain anomalies that surfaced with regards to the AMFm supply and demand:

- Although malaria is a childhood disease, 70% of the AMFm treatment orders are for adult doses.
- Zanzibar being a zero malaria transmission country has ordered for 240,000 AMFm ACT treatments.
- Three ACT manufacturers are also acting as first line buyers with potential conflict of interest (including Ipca Labs).
- Survey in West Africa also revealed that AMFm products are being sold even in non-AMFm countries. That indicates the threat of leakage of AMFm drugs.

The report has concluded that AMFm was pushed forward, too far, too fast and with too much money.

Further, as per 'A framework for rationing the AMFm phase 1 Co-payment fund' report dated Aug 2011, there has been a higher ACT uptake rate than anticipated, which would translate to faster co-payment fund depletion rate. This would consequently lead to increase in additional contribution requirements to the AMFm co-payment Fund to meet the updated demand for ACTs under the revised projections.

The recent meeting of the donors in July 2011 reached no decision on the additional contribution that any party would be willing to make to the AMFm co-payment fund. As of August 2011, the uncommitted fund stands at USD63mn. There are USD62mn pending copayment requests leading to a backlog. If all of these orders are approved without rationing then the original Phase I copayment Trust fund would get depleted before the end of CY12.

Besides, there has been supply issue of raw-material for Artemether leading to doubling of prices to USD600/kg. Nevertheless, the management is confident of achieving its guidance of Rs2.0-2.2bn in FY12 and strong traction in FY13E depending on the availability of the raw-material, Artemether. However, we would be cautious and thereby factor in Rs1.7bn in FY12E and Rs1.4bn in FY13E.

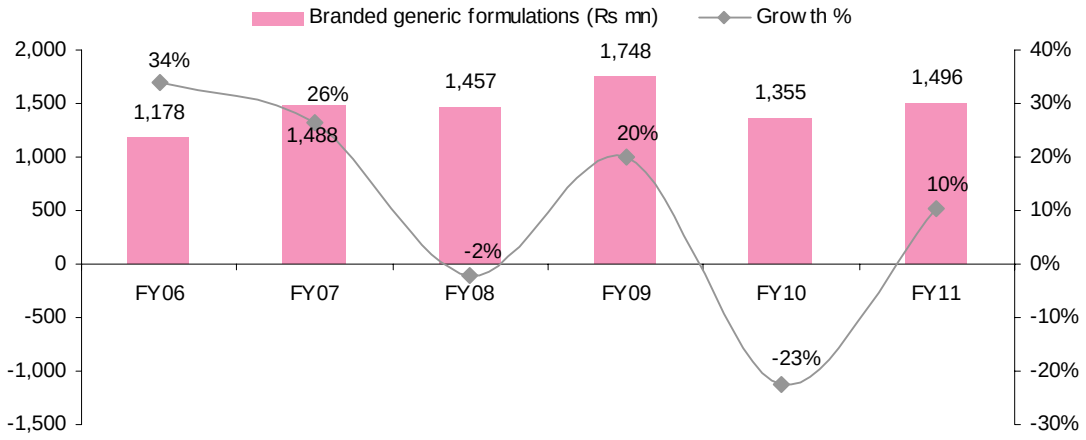
**Scaling up presence in other markets**

Ipca is also establishing its presence in Australia and New-Zealand by increasing the dossiers filing in the region. These regions currently contribute around 1% to the sales of the company. We expect a CAGR of 64.3% over FY11-13E on back of small base.

**Branded generic segment now on a strong footing**

Ipca has been introducing and promoting strong brands from the domestic market to other Emerging markets. Ipca's key markets include CIS, Africa and Asia. The company has been focusing on brand building in the CVS, NSAID, CNS, Anti-Malarial and Anti-Infective segments in these markets. The company registered a slower CAGR of 4.9% over FY2006-11 affected by adverse currency movement, change in dossier filing regulations and long working capital cycle in CIS in FY09-10. We expect the company to register a CAGR of 28.3% over FY2011-13E in these markets on the back of introduction of new products, expansion into new geographies, viz. South and Central America and Western African countries and strengthening of its field force.

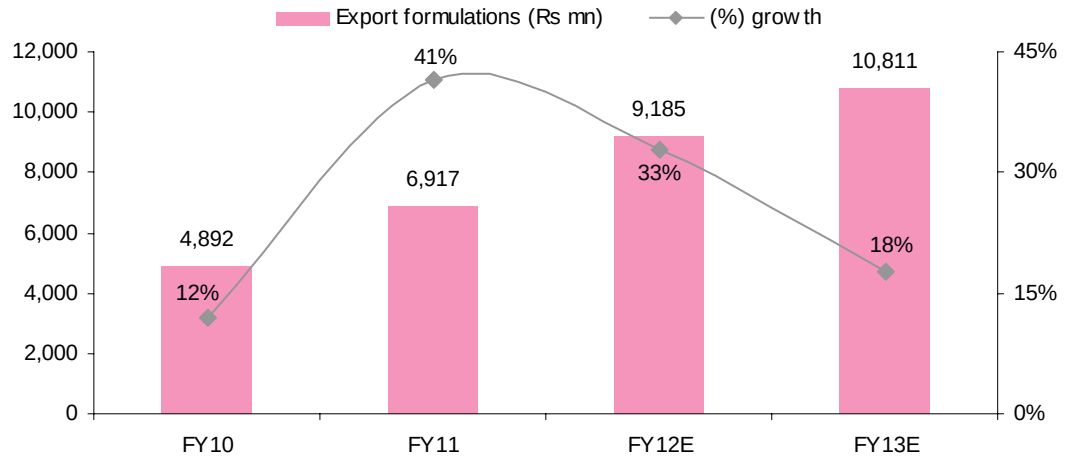
**Exhibit 11 - Branded Generic Formulations trend**




*Source: Company, PINC Research*

Overall, we expect the export formulation sales to grow by 25.0% over FY11-13E to Rs10.8bn driven by US (dependent on USFDA approval of Indore SEZ facility) and branded generic segment.

**Exhibit 12 - Export formulations**

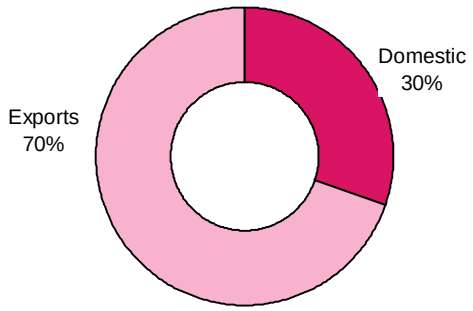



*Source: Company, PINC Research*

**API- supporting formulation growth**

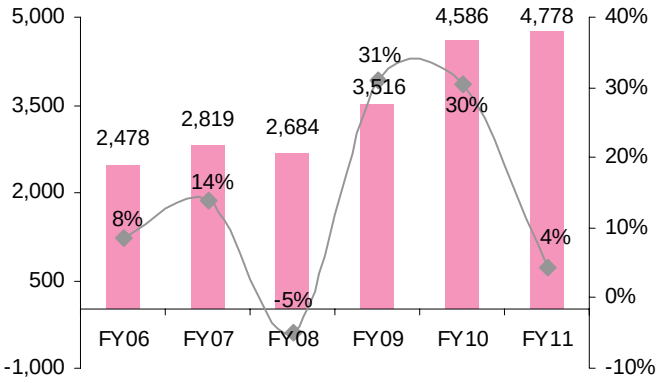
Ipca is an established low-cost producer of select APIs including Atenolol, Furosemide, Chloroquine Phosphate, Losartan, Hydrochlorothiazide, Metoclopramide HCl, Hydroxychloroquine Sulphate, Pyrantel Pamoate, Propranolol HCl, Metoprolol Succinate, Metoprolol Tartrate and it is seeking to be a dominant player in the formulations based on these selected APIs. Ipca has scaled up to 95 API's from 40 in FY2003, which has significantly enhanced its level of vertical integration in its formulation business. This strategy will enable Ipca to be cost effective in tough generic markets like the US and UK. Further, many global pharma companies have also been sourcing their API (off-patent) requirements from Ipca. Ipca also plans to establish itself as a partner of choice in the above-mentioned APIs. The low-margin API business contributed around 25% of Ipca's total sales for FY11. API business has clocked a CAGR of 14.0% over FY06-11 which is lower than other business segments as company has been incrementally using API for internal consumption and has also started facing capacity constraint off-late. In order to address the capacity constraint, Ipca is building 3 API facilities in Ratlam of which atleast 2 are expected to contribute by end of FY12.

**Exhibit 13 - API geographical sales break-up**




*Source: Company, PINC Research*

**Exhibit 14 - API trend**




*Source: Company, PINC Research*

## Financial Overview

### Growth trajectory to slow down

Ipca clocked net sales CAGR of 20.0% during FY06-11 to Rs18.8bn led by growth across domestic as well as export formulations segment. The domestic segment which contributes ~45% to the total sales grew by 19.3% over FY06-11, while exports clocked CAGR of 20.6% over the stated period. Domestic segment growth was led by both acute and chronic therapy. While on the export front, growth was led by Europe and the scaling up of business in US. Similarly the company also increased the proportion of formulation segment from 67% in FY06 to 74% in FY11.

**Exhibit 15 - Sales trend**

| Segments (Rs mn) | FY06 | FY07 | FY08 | FY09 | FY10 | FY11 | FY12E | FY13E | CAGR 2011-13E |
|---|---|---|---|---|---|---|---|---|---|
| Domestic formulations | 2,913 | 3,530 | 4,326 | 4,766 | 5,978 | 6,964 | 7,573 | 8,565 | 10.9% |
| Domestic API | 559 | 707 | 741 | 1,083 | 1,416 | 1,443 | 1,515 | 1,667 | 7.5% |
| **TOTAL DOMESTIC SALES** | 3,472 | 4,237 | 5,067 | 5,849 | 7,395 | 8,407 | 9,089 | 10,232 | 10.3% |
| Export formulations | 2,100 | 2,732 | 3,417 | 4,372 | 4,892 | 6,917 | 9,185 | 10,811 | 25.0% |
| Export API | 1,919 | 2,113 | 1,943 | 2,432 | 3,169 | 3,335 | 3,586 | 3,887 | 8.0% |
| **TOTAL EXPORT SALES** | 4,018 | 4,845 | 5,360 | 6,804 | 8,061 | 10,252 | 12,771 | 14,698 | 19.7% |
| **Subsidiary sales** | 67 | 201 | 85 | 183 | 140 | 166 | 170 | 173 | 2.0% |
| **Net Sales** | **7,557** | **9,283** | **10,512** | **12,836** | **15,596** | **18,825** | **22,029** | **25,103** | **15.5%** |

*Source: Company, PINC Research*

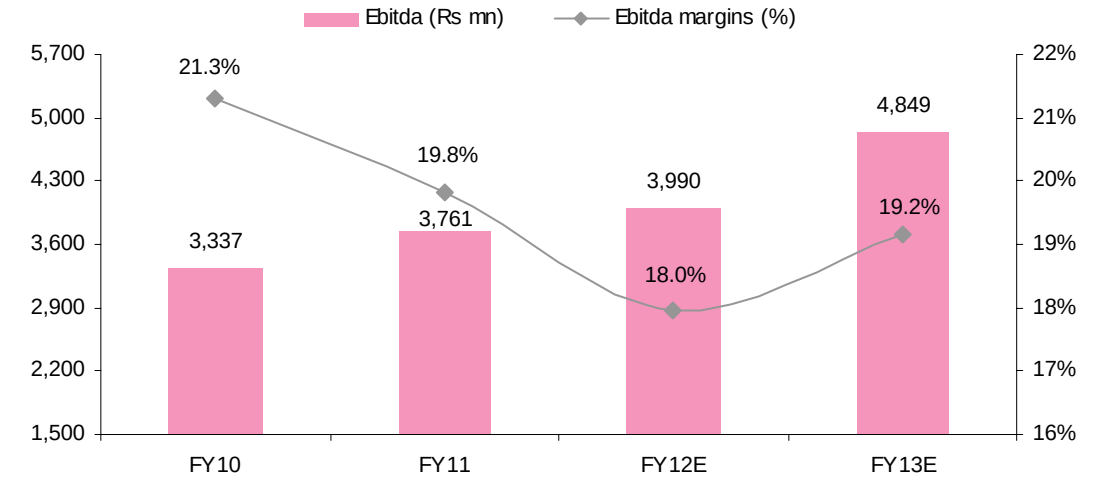
For FY12E, we have estimated growth of 17.0% YoY which is below the company's guidance of 18-20% on back of lower domestic formulation sales growth and lower AMFm institutional sales. On the domestic front, the acute therapy is expected to grow by 9.1% YoY while the chronic segment is expected at 8.1% YoY. Further, on the export formulation front, we estimate Europe sales to grow by 13.7% YoY on back of volume growth and favourable currency movement. In addition, US formulation is expected to grow by 31.5% YoY on back of improvement in market share of existing launched products. While the export branded formulations segment is expected to grow by strong 35.5% YoY driven by CIS region. On the API front, we estimate sales to grow by 6.8% YoY as two units at Ratlam would become operational in H2FY12 and start contributing to the sales.

For FY13E, we expect the net sales to grow by 14.0% YoY as domestic formulation segment is expected to revive post the restructuring done in FY12 and growth on the export front to come from Indore SEZ. However, we are factoring de-growth of 18.2% to Rs1.4bn on the AMFm segment. We estimate domestic formulation to clock a growth of 13.1% on back of improving sales force productivity. On the domestic front, the acute therapy is expected to grow by 12.1% YoY while the chronic segment is expected at to grow at 15.0% yoy. Further, on the export formulation front, growth would be at 17.7% YoY driven by US region. We expect the Indore SEZ to get USFDA clearance by Q4FY12 and scale up production by H2FY13E. Europe is estimated to grow by 12.2% YoY while the branded generic segment is expected to clock a growth of 21.5% YoY. On the API front we expect sales to grow by 8.9% YoY as all the three units at Ratlam would be fully operational.

### Pressure on EBITDA margins

We expect Ipca to witness margin pressure in FY12 as the high-margin domestic formulation growth slows down on back of intensive competition coupled with restructuring exercise undertaken by the company. However, this would be cushioned by the export formulation segment which would be partially benefited by favourable currency movement. As a result, the company is estimated to report EBITDA margins of 18.0% which is expected to contract by 184bps YoY. In FY13E however, the margins are expected to improve by 120bps primarily on back of improvement in the domestic formulation segment and commercialisation of Indore SEZ.

**Exhibit 16 - EBITDA trend**

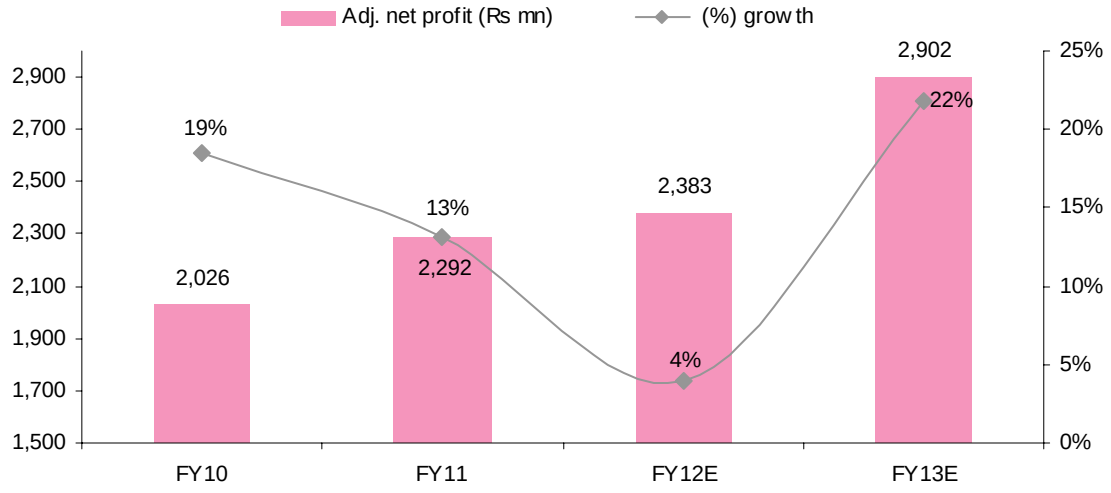



*Source: Company, PINC Research*

**Net Profit to grow at 12.5% CAGR over FY11-13E**

The net profit registered a CAGR of 33.7% during FY06-11 led by the growth across the formulations segment and margin expansion. However, over FY11-13E we expect Ipca to post a CAGR of 12.5% excluding forex gain/loss. This would be driven by sales CAGR of 15.5% over FY11-13E. Interest cost is expected to rise by 18.3% over FY11-13E as we expect debt levels to move up. While depreciation is likely to show a CAGR of 12.5% over the stated period, as the company commercialise production at Sikkim and 3 API units at Ratlam. On the tax front, we expect Ipca to be MAT paying company for FY12E and FY13E also.

**Exhibit 17 - Adjusted PAT trend**




*Source: Company, PINC Research*

**Capex on API infrastructure**

Ipca in the last three years has undertaken capex to the tune of Rs4.2bn to build formulation facility at Indore SEZ and Sikkim in addition to maintenance capex. Post the building of formulation capacity and in order to increase the backward integration the company plans to expand its API infrastructure at Ratlam and build a new API facility at Baroda. Going ahead, Ipca plans to incur capex to the tune of Rs2.2-2.5bn each over the next two years inclusive of the maintenance capex.

**Exhibit 18 - Capacity Utilisation**

| Capacity Utilisation | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| API | 91.4% | 100.2% | 90.1% | 73.5% | 87.1% |
| Tablets & capsules | 83.3% | 79.8% | 69.6% | 69.5% | 77.7% |

*Source: Company, PINC Research*

**Recent Acquisitions miniscule in nature**

Ipca recently acquired Onyx Research and Tonira Pharma. The acquisitions are relatively miniscule in nature and are expected to contribute ~2% to Ipca's sales in FY12E.

Onyx Research Chemicals (Onyx) specialises in pre-clinical and clinical trials. Custom synthesis and Process Development are the main services rendered by Onyx research. The company had sales to the tune of GBP3.9mn (~1% of Ipca's FY12E sales) and EBITDA margins of 17% for FY11. Ipca acquired Onyx at about 1.2x Price/Sales.

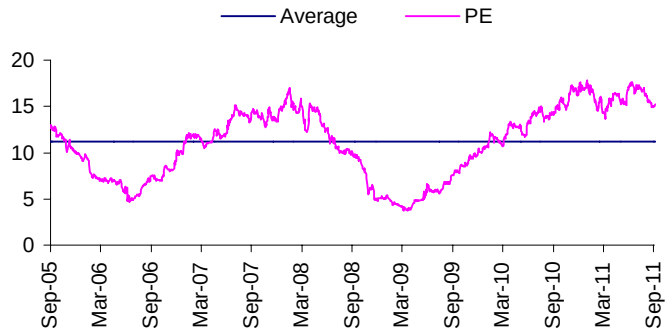
Ipca also increased its stake in Tonira Pharma, an API player, from 37% to 100% by merging Tonira with itself. Under the merger agreement, Ipca would issue 6 shares for every 100 shares of Tonira valuing the company at 0.4x Price/Sales. Tonira reported net sales of Rs300mn (~1% of Ipca's FY12E sales) with EBITDA margins of 13% in FY11. The rationale is to source API from Tonira for the generic formulation business and get access to Japanese market.

Further, as per media reports, Ipca is scouting for acquisition in Indonesia and has earmarked USD20mn for the overseas acquisition.

## Outlook & Valuation

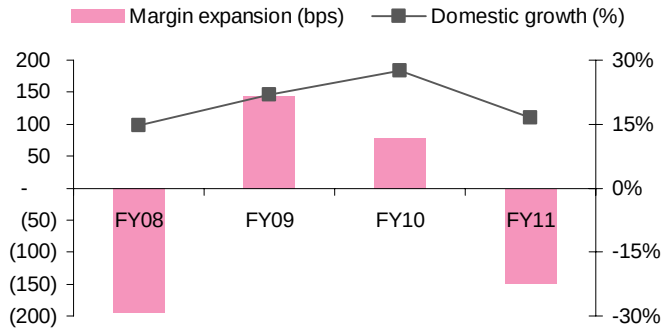
Ipca in the last five years has grown at a higher than industry average driven by both domestic and export formulation segment. The stock has traded in range of 4-18x with an average of 11x. The re-rating in last two years was driven primarily by strong growth from the domestic formulation business which also led to expansion in operating margins.

**Exhibit 19 - PE Chart (x)**




*Source: Company, PINC Research*

**Exhibit 20 - Domestic growth and margin expansion**

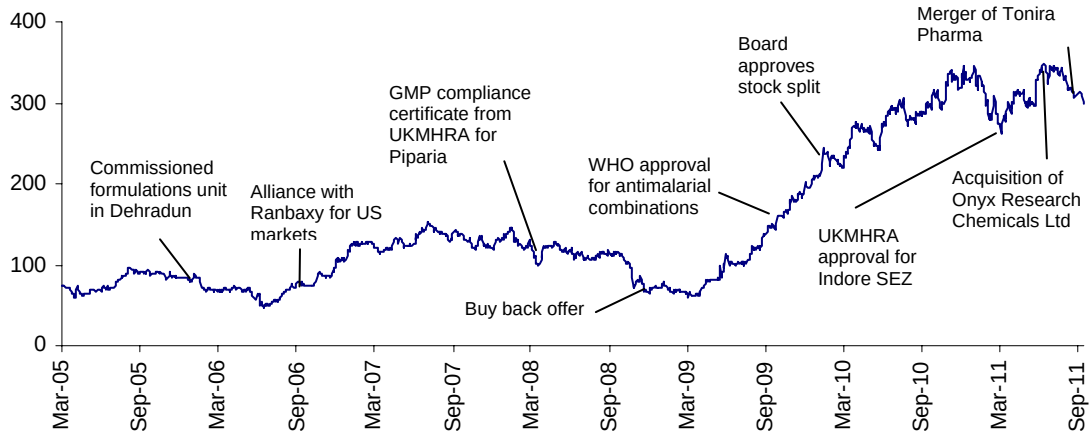



*Source: Company, PINC Research*

Going ahead the high-margin domestic formulation segment is expected to be under pressure on back of intense price competition in the acute segment which contributes nearly 65% to the domestic sales and restructuring exercise undertaken by the company. On the export front, growth is expected to be driven by the Indore SEZ which depends on USFDA approval and would take atleast 6 months post the approval to break-even.

In the last 3 months, the stock has corrected by ~30% owing to pressure in domestic business and delay in the Indore SEZ approval. The stock is currently trading at 12.6x FY12E and 10.5x FY13E earnings. We value the stock at 12x one year forward earnings which is at a discount of 45% to large peers given the scale and business-mix (exposure to low-margin API segment and highly competitive acute therapeutic segment). We initiate coverage on the stock with a Hold rating and a Target Price of Rs262. We believe any re-rating from here on would be primarily be driven by pick-up in the domestic formulation business.

**Exhibit 21 - Price Performance (Rs)**




*Source: Company, PINC Research*

Our estimates are lower than consensus on the PAT front by 16-17% over FY12-13E as we expect margins of the company to be under pressure post the slower growth rate expected on the domestic formulation front. Further, we have factored in higher interest cost and lower other income for FY12-13E.

**Exhibit 22 - Consensus estimates**

| | PINC Estimates | | Bloomberg Consensus | | Var (%) | |
|---|---|---|---|---|---|---|
| | FY12E | FY13E | FY12E | FY13E | FY12E | FY13E |
| Sales (Rs mn) | 22,029 | 25,103 | 22,096 | 25,987 | (0.3) | (3.4) |
| EBITDA (%) | 18.0 | 19.2 | 20.1 | 20.8 | (10.6) | (7.9) |
| Net Profit (Rs mn) | 2,383 | 2,902 | 2,813 | 3,447 | (15.3) | (15.8) |

*Source: Company, Bloomberg, PINC Research*

**Exhibit 23 - Comparative valuations**

| Company | CMP | Mkt cap | PE (x) | | EV/EBITDA(x) | | EV/Sales(x) | | ROE(%) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (Rs) | (Rs bn) | FY12E | FY13E | FY12E | FY13E | FY12E | FY13E | FY12E | FY13E |
| Ipca | 240 | 30.1 | 12.6 | 10.5 | 9.3 | 7.8 | 1.6 | 1.4 | 20.8 | 21.6 |
| Indoco | 393 | 4.8 | 8.2 | 6.8 | 6.2 | 5.0 | 1.0 | 0.8 | 15.4 | 16.6 |
| Torrent | 545 | 46.1 | 13.9 | 11.4 | 9.9 | 8.3 | 1.8 | 1.6 | 28.5 | 27.6 |
| Unichem | 136 | 12.2 | 12.3 | 9.0 | 7.7 | 5.9 | 1.3 | 1.1 | 15.2 | 19.5 |

*Source: Bloomberg, PINC Research*

**Key Upside Risks**

- **Pick-up in domestic business**: We have estimated the domestic formulation business to clock a CAGR of 10.9% over FY11-13E with growth picking up from FY13E onwards. However, higher than expected growth on the domestic front driven by breakdown of an epidemic could pose an upside risk to our estimates.

- **Continuation of AMFm funding:** Based on the recent survey report by AFM we expect funding of the AMFm to be under pressure especially from FY13E onwards when the funds are likely to get exhausted. But, in case the Global funds decide to continue with the current rate of funding and expand the number of countries under the scheme then it would be positive for Ipca as we have built in sales of Rs1.4bn in FY13E.

- **Higher than expected rupee depreciation:** Ipca derives nearly 55% of the sales from the export segment. We have estimated rupee to be at 46/USD and 45/USD respectively in FY12E and FY13E. Any further depreciation of the rupee would be positive for the company.

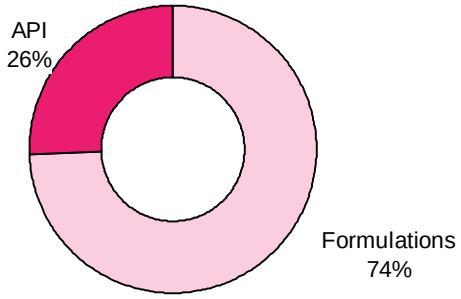
**Key Downside Risks**

- **Delay in Indore SEZ approval**: We expect Indore SEZ approval to come by Q4FY12, Ipca is incurring Rs250mn expense (including depreciation) without any commensurate revenue. So any delay in approval will adversely affect our estimates. We estimate US region for the company to grow 56.8% YoY in FY13 driven by Indore SEZ which in turn will also lead to margin expansions.

## Company background

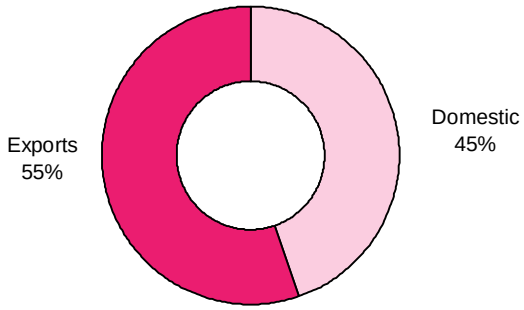
Ipca Laboratories Limited (Ipca) was incorporated in 1949 under the name of 'The Indian Pharmaceutical Combine Association Limited, which was changed to Ipca Laboratories Limited in 1993. It is a fully integrated company producing branded and generic formulations, APIs and intermediates. Ipca has a strong footing in the domestic markets across various therapeutic segments standing as one of the leaders in antimalarials and rheumatoid arthritis in the Indian market. On the export front, it caters to around 110 countries. Ipca has eleven manufacturing facilities across India of which eight are for formulations and three for APIs. Ipca is one of the world's largest manufacturers of atenolol (anti-hypertensive), chloroquine phosphate (anti-malarial), eurosemide (diuretic) and pyrantel salts (anthelmintic). The company is gradually shifting towards the chronic segment therapeutics, reducing its dependency on selected therapeutic segments.

**Exhibit 24 - Segmental Sales breakup**




*Source: Company, PINC Research*

**Exhibit 25 - Geographical Sales breakup**




*Source: Company, PINC Research*

**Management Profile:**

**R S Hugar: Chairman:**
Mr. Hugar is a Postgraduate in Econometrics from Pune University with an experience of 35 years in banking & finance. He was associated in various capacities with Bank of Maharashtra, Chairman and Managing Director of Corporation Bank and Global Trust Bank. He was the Director of Institute of Banking Personnel Selection.

**Premchand Godha: Managing Director:**
Mr. Godha is a Chartered Accountant and was in professional practice for five years before joining Ipca. He is the Director on the Board since 1975 and the Managing Director of the company since 1983. He has played a vital role in the growth of the company and bringing it to the forefront of Indian Pharmaceutical industry.

**Mr. A. K. Jain: Joint Managing Director:**
Mr. A. K. Jain is a qualified Chartered Accountant and a Science Graduate and is employed with the company since 1980. He was initially appointed as a Director of the Company and then re-designated as Joint Managing Director in 2010. He brings with him over 3 decades of experience in the pharmaceutical industry in the field of Finance, Accounts, Information Technology, Legal, R&D, General Administration, etc.

**Pranay Godha: Executive Director:**
Mr. Pranay Godha is a Management graduate with nearly 12 years experience in pharma sales and marketing and operations.

**Prashant Godha: Executive Director:**
Mr. Prashant Godha is a graduate in commerce with nearly 12 years experience in pharma marketing and general management.

**Exhibit 26 - Manufacturing facilities**

| Facility | Dosage Form | Approvals |
|---|---|---|
| **Formulations:** | | |
| Athal (Silvassa) | Tablets / Capsules | UKMHRA, TGA Australia, MCC-South Africa, HPB Canada, WHO Geneva |
| Ratlam (MP) | Tablets, Liquids & Injectables | MCC- South Africa |
| Kandla (Gujarat) | Betalactum-tabs, capsules & dry syrups | UK MHRA, TGA Australia, MCC-South Africa |
| Piparia | Tablets | USFDA, UKMHRA, TGA, AUSTRALIA, HPFB, CANADA |
| Silvassa | Tablets/Capsules | UK MHRA, USFDA, TGA-Australia, HPB Canada |
| Dehradun (Uttaranchal) | Tablets/Capsules | WHO GMP |
| Indore (SEZ) | Tablets/Capsules | UKMHRA |
| Sikkim | Tablets/Capsules | Domestic Market |
| **API:** | | |
| Ratlam (MP) | | USFDA, TGA Australia, EDQM, Danish Regulatory Authority, |
| | | PMDA-Japan, WHO-Geneva |
| Indore (MP) | | WHO-GMP |
| Aurangabad (Mah) | | WHO-GMP |

*Source: Company, PINC Research*

## Appendix A

**1) What is AMFm (Affordable Medicines facility- Malaria)?**
AMFm was inspired by a landmark report, “Saving Lives, Buying Time”, published in 2004 by a Committee of the Institutes of Medicine (IOM) of the National Academy of Sciences, USA.

AMFm is an innovative financing mechanism to expand access to affordable artemisinin-based combination therapies (ACTs) for malaria. It aims at enabling countries to increase the provision of affordable ACTs through the public, private not-for-profit and private for-profit sectors. By increasing access to ACTs and displacing artemisinin monotherapies from the market, the AMFm also seeks to delay resistance to the API, artemisinin.

AMFm is hosted and managed by the Global Fund to Fight AIDS, Tuberculosis and Malaria (the Global Fund). UNITAID, the Government of the United Kingdom and the Bill & Melinda Gates Foundation are the financiers of USD216mn AMFm co-payment fund to be used for the global subsidy. In addition, the Global Fund will spend about USD127mn on country-level activities to support the effective implementation of AMFm. The technical support would be provided by members of the Roll Back Malaria (RBM) Partnership.

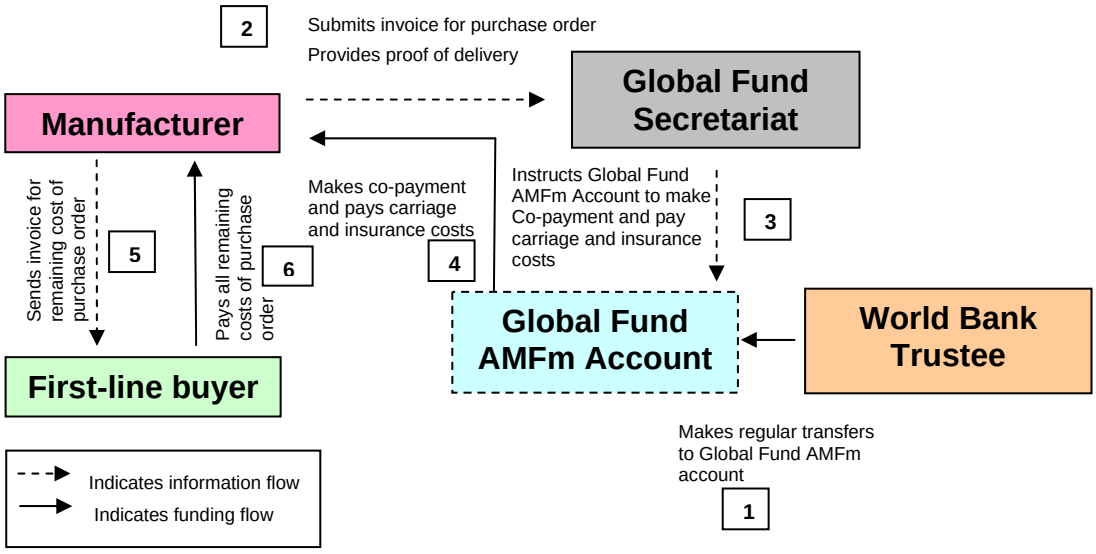
The objective of the AMFm is to ensure that people suffering from malaria have access to inexpensive, effective antimalarial treatment, in the form of ACTs. The AMFm promotes the use of effective antimalarials and drive out ineffective medicines from the market by reducing consumer prices to an affordable level through price negotiations and a buyer co-payment and ensuring safe and effective scale-up of ACT use by introducing in-country supporting interventions. By increasing access to ACTs and displacing artemisinin monotherapies from the market, the AMFm also seeks to delay resistance to the active pharmaceutical ingredient, artemisinin. By increasing access to ACTs, the AMFm represents one component of a comprehensive response to malaria

The Global Fund has negotiated with drug manufacturers to reduce the price of ACTs, with the condition that sale prices must be the same for both public and private sector first-line buyers. The Global Fund would pay a proportion of this reduced price (a buyer co-payment) directly to manufacturers to further lower the cost to eligible first-line buyers of ACTs purchased from the manufacturers. This means that first-line buyers only pay the remainder of the sales price for the ACTs.

First-line buyers for AMFm include buyers from the public, private not-for-profit and for-profit sectors who purchase ACTs directly from the manufacturer, or procurement agents buying on their behalf. First-line buyers are expected to pass on the highest possible proportion of this price benefit so that patients are able to buy ACTs across the public, private not-for-profit and for-profit sectors at a price lower than artemisinin monotherapies and competitive with that of less-effective anti-malaria drugs, such as CQ and SP.

The six pharmaceutical companies that meet the Global Fund’s quality criteria for supplying ACTs to first-line buyers under the AMFm include Novartis and Sanofi Aventis. Amongst the domestic, Ipca, Cipla and Ajanta Pharma are approved suppliers. From China, Guilin and from Uganda, Quality Chemicals Industries are also included. Further, Ipca, Guilin and Quality Chemicals Industries also qualify as the first line buyers.

**Payment flow for Co-Paid ACTs**




*Source: The Global Fund*

**2) What are ACTs?**

Artemisinin-based combination therapies (ACTs) combine artemisinin with another anti-malarial drug and are currently the most effective form of treatment for malaria. The WHO specifically recommends ACTs as first-line treatment for uncomplicated P. falciparum malaria. However, ACTs account for only one in five anti-malarial treatments taken and are provided almost entirely by the public sector. Over 60% of patients' access anti-malarial treatment through the private sector, where ACTs make up only 5% of treatments provided.

ACTs are 10-40 times more expensive when sold as OTC compared to the older drugs which have actually lost the effectiveness as the malarial parasite has developed resistance against it. However, due to the higher prices of ACTs, many of the patients are still opting for cheaper alternatives of cure.

**3) Phase I of AMFm?**

In November 2008, the Global Fund Board approved the first phase of AMFm. The Board decided that AMFm should be launched in a small group of countries, to enable lessons to be learned before a potential global roll-out of AMFm. The Board also agreed that AMFm Phase 1 will be assessed through an independent evaluation. AMFm Phase 1 is being implemented in eight countries namely Cambodia, Ghana, Kenya, Madagascar, Niger, Nigeria, Tanzania (mainland and Zanzibar) and Uganda. These are accounting for almost 80% of the total global ACT production capacity. The first co-paid ACTs arrived in Ghana and Kenya in August 2010. AMFm co-paid ACTs have also been delivered to Madagascar, Niger, Nigeria, Tanzania and Uganda. Orders have been placed for all AMFm Phase 1 countries, with the exception of Cambodia, for which there is currently no eligible ACT. To support the scale-up of ACTs under AMFm, countries that have signed host grant amendments with the Global Fund have begun to implement new or expanded supporting interventions.

**4) How long will AMFm Phase 1 operate for?**

AMFm Phase 1 will operate until the end of 2012 and will be reviewed through an independent evaluation. The Global Fund Board will consider the results of the evaluation and determine whether to expand, accelerate, modify, terminate or suspend AMFm. It is expected that the Board will make this decision in late 2012.

Year Ended March (Figures in Rs mn)

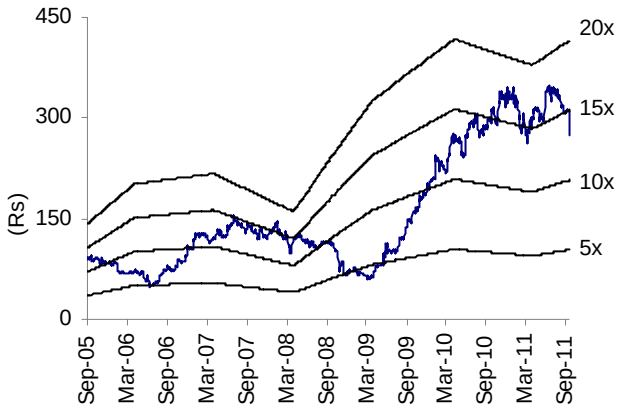
| Income Statement | FY09 | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|---|
| **Net sales** | 12,836 | 15,596 | 18,825 | 22,029 | 25,103 |
| Other operating income | 88 | 72 | 163 | 179 | 205 |
| **Total Revenues** | 12,925 | 15,668 | 18,989 | 22,208 | 25,307 |
| Growth (%) | 18.4 | 21.2 | 21.2 | 17.0 | 14.0 |
| **EBITDA** | 2,651 | 3,337 | 3,761 | 3,990 | 4,849 |
| Growth (%) | 27.4 | 25.9 | 12.7 | 6.1 | 21.5 |
| Depreciation | 397 | 467 | 558 | 593 | 706 |
| Other Income | 6 | 89 | 83 | 51 | 51 |
| **EBIT** | 2,261 | 2,959 | 3,287 | 3,447 | 4,193 |
| Interest Paid | 318 | 329 | 314 | 411 | 439 |
| PBT (before E/o items) | 1,943 | 2,629 | 2,973 | 3,037 | 3,754 |
| Tax Provision | 233 | 627 | 784 | 654 | 852 |
| E/o (income)/loss | 704 | (52) | (440) | - | - |
| **Net Profit** | 1,006 | 2,054 | 2,628 | 2,383 | 2,902 |
| Adjusted Net Profit | 1,709 | 2,026 | 2,292 | 2,383 | 2,902 |
| Growth (%) | 44.1 | 18.5 | 13.1 | 4.0 | 21.8 |
| **Diluted EPS (Rs)** | 13.7 | 16.2 | 18.2 | 19.0 | 22.8 |

| Cash Flow Statement | FY09 | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|---|
| PBT | 1,183 | 2,663 | 3,412 | 3,037 | 3,754 |
| Depreciation | 397 | 467 | 558 | 593 | 706 |
| Total Tax Paid | (224) | (459) | (644) | (547) | (676) |
| Chg in working capital | (876) | (985) | (984) | (672) | (1,338) |
| Other operating activities | 1,050 | 226 | (207) | - | - |
| **Cash flow from oper (a)** | 1,530 | 1,913 | 2,135 | 2,411 | 2,447 |
| Capital Expenditure | (898) | (1,341) | (1,962) | (2,198) | (2,199) |
| Chg in investments | - | - | - | - | - |
| Other investing activities | - | - | - | - | - |
| **Cash flow from inv.(b)** | (898) | (1,341) | (1,962) | (2,198) | (2,199) |
| **Free cash flow (a+b)** | 631 | 572 | 173 | 213 | 248 |
| Equity raised/(repaid) | (46) | 0 | 22 | - | - |
| Debt raised/(repaid) | 261 | (70) | 539 | 333 | 433 |
| Dividend (incl. Tax) | (336) | (379) | (439) | (558) | (679) |
| Other activities | (491) | (129) | (300) | - | - |
| **Cash flow from fin. (c)** | (612) | (577) | (177) | (225) | (246) |
| **Net chg in cash (a+b+c)** | 19 | (5) | (4) | (11) | 2 |

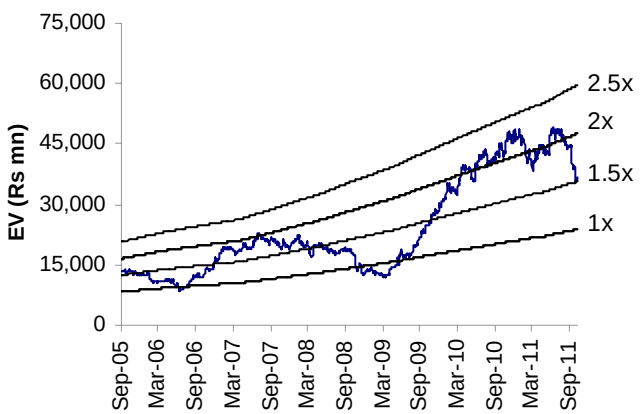
| Balance Sheet | FY09 | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|---|
| Equity Share Capital | 250 | 250 | 251 | 251 | 254 |
| Reserves & surplus | 6,064 | 8,398 | 10,265 | 12,090 | 14,313 |
| **Shareholders' funds** | 6,314 | 8,649 | 10,516 | 12,341 | 14,567 |
| Minorities interests | (4) | (6) | (7) | (7) | (7) |
| Total Debt | 4,599 | 4,545 | 5,308 | 5,641 | 6,074 |
| **Capital Employed** | 10,909 | 13,188 | 15,818 | 17,976 | 20,635 |
| Net fixed assets | 5,912 | 6,761 | 8,124 | 9,729 | 11,224 |
| Cash & Cash Eq. | 113 | 108 | 104 | 92 | 94 |
| Net Other current assets | 5,123 | 6,787 | 7,989 | 8,661 | 9,999 |
| Investments | 412 | 325 | 408 | 408 | 408 |
| Net Deferred tax Assets | (651) | (793) | (807) | (915) | (1,091) |
| **Total Assets** | 10,909 | 13,188 | 15,818 | 17,976 | 20,635 |

| Key Ratios | FY09 | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|---|
| OPM (%) | 20.5 | 21.3 | 19.8 | 18.0 | 19.2 |
| Net Margin (%) | 13.3 | 13.0 | 12.2 | 10.8 | 11.6 |
| Div. Yield (%) | 0.9 | 1.2 | 1.3 | 1.6 | 1.9 |
| Net debt/Equity (x) | 0.6 | 0.5 | 0.5 | 0.4 | 0.4 |
| Net Working Capital (days) | 145 | 158 | 154 | 142 | 144 |
| ROCE (%) | 22.2 | 24.6 | 22.7 | 20.4 | 21.7 |
| RoE (%) | 16.5 | 27.4 | 27.4 | 20.8 | 21.6 |
| EV/Net Sales (x) | 2.7 | 2.2 | 1.9 | 1.6 | 1.4 |
| EV/EBITDA (x) | 13.3 | 10.5 | 9.7 | 9.3 | 7.8 |
| PER (x) | 29.8 | 14.6 | 11.5 | 12.6 | 10.5 |
| PCE (x) | 21.4 | 11.9 | 9.5 | 10.1 | 8.5 |
| Price/Book (x) | 4.7 | 3.5 | 2.9 | 2.4 | 2.1 |

**1 year forward P/E band**




**1 year forward EV/Sales band**



PINC RESEARCH

# T E A M

## EQUITY DESK

| | | | |
|---|---|---|---|
| Sadanand Raje | Head - Institutional Sales<br>Technical Analyst | *sadanand.raje@pinc.co.in* | 91-22-6618 6366 |

## RESEARCH

| | | | |
|---|---|---|---|
| Vineet Hetamasaria, CFA | **Head of Research,** *Auto, Cement* | *vineet.hetamasaria@pinc.co.in* | 91-22-6618 6388 |
| Nikhil Deshpande | *Auto, Auto Ancillary, Cement* | *nikhil.deshpande@pinc.co.in* | 91-22-6618 6339 |
| Tasmai Merchant | *Auto, Auto Ancillary, Cement* | *tasmai.merchant@pinc.co.in* | 91-22-6618 6377 |
| Vinod Nair | *Construction, Power, Capital Goods* | *vinod.nair@pinc.co.in* | 91-22-6618 6379 |
| Ankit Babel | *Capital Goods, Engineering* | *ankit.b@pinc.co.in* | 91-22-6618 6551 |
| Hitul Gutka | *Power* | *hitul.gutka@pinc.co.in* | 91-22-6618 6410 |
| Subramaniam Yadav | *Construction* | *subramaniam.yadav@pinc.co.in* | 91-22-6618 6371 |
| Madhura Joshi | *Power* | *madhura.joshi@pinc.co.in* | 91-22-6618 6395 |
| Satish Mishra | *Fertiliser, Natural Gas* | *satish.mishra@pinc.co.in* | 91-22-6618 6488 |
| Urvashi Biyani | *Fertiliser, Natural Gas* | *urvashi.biyani@pinc.co.in* | 91-22-6618 6334 |
| Naveen Trivedi | *FMCG* | *naveent@pinc.co.in* | 91-22-6618 6384 |
| Rohit Kumar Anand | *IT Services* | *rohit.anand@pinc.co.in* | 91-22-6618 6372 |
| Namrata Sharma | *Media* | *namrata.sharma@pinc.co.in* | 91-22-6618 6412 |
| Sakshee Chhabra | *Media* | *sakshee.chhabra@pinc.co.in* | 91-22-6618 6516 |
| Bikash Bhalotia | *Metals, Mining* | *bikash.bhalotia@pinc.co.in* | 91-22-6618 6387 |
| Harleen Babber | *Metals, Mining* | *harleen.babber@pinc.co.in* | 91-22-6618 6389 |
| Dipti Vijaywargi | *Metals, Mining* | *dipti.vijaywargi @pinc.co.in* | 91-22-6618 6393 |
| Sushant Dalmia, CFA | *Pharma* | *sushant.dalmia@pinc.co.in* | 91-22-6618 6462 |
| Poonam Sanghavi | *Pharma* | *poonam.sanghavi@pinc.co.in* | 91-22-6618 6709 |
| Suman Memani | *Real Estate, Mid caps* | *suman.memani@pinc.co.in* | 91-22-6618 6479 |
| Abhishek Kumar | *Real Estate, Mid caps* | *abhishek.kumar@pinc.co.in* | 91-22-6618 6398 |
| C Krishnamurthy | *Technical Analyst* | *krishnamurthy.c@pinc.co.in* | 91-22-6618 6747 |

## SALES

| | | | |
|---|---|---|---|
| Rajeev Gupta | *Equities* | *rajeev.gupta@pinc.co.in* | 91-22-6618 6486 |
| Ankur Varman | *Equities* | *ankur.varman@pinc.co.in* | 91-22-6618 6380 |
| Himanshu Varia | *Equities* | *himanshu.varia@pinc.co.in* | 91-22-6618 6342 |
| Shailesh Kadam | *Derivatives* | *shaileshk@pinc.co.in* | 91-22-6618 6349 |
| Ganesh Gokhale | *Derivatives* | *ganeshg@pinc.co.in* | 91-22-6618 6347 |

## DEALING

| | | | |
|---|---|---|---|
| Mehul Desai | *Head - Sales Trading* | *mehul.desai@pinc.co.in* | 91-22-6618 6303 |
| Naresh Panjnani | *Co-Head - Sales Trading* | *naresh.panjnani@pinc.co.in* | 91-22-6618 6333 |
| Amar Margaje | | *amar.margaje@pinc.co.in* | 91-22-6618 6327 |
| Ashok Savla | | *ashok.savla@pinc.co.in* | 91-22-6618 6321 |
| Sajjid Lala | | *sajjid.lala@pinc.co.in* | 91-22-6618 6337 |
| Raju Bhavsar | | *rajub@pinc.co.in* | 91-22-6618 6322 |
| Kinjal Mehta | | *kinjal.mehta@pinc.co.in* | 91-22-6618 6333 |
| Chandani Bhatia | | *chandani.bhatia@pinc.co.in* | 91-22-6618 6324 |
| Hasmukh D. Prajapati | | *hasmukhp@pinc.co.in* | 91-22-6618 6325 |
| Kamlesh Purohit | | *kamlesh.purohit@pinc.co.in* | 91-22-6618 6357 |

## SINGAPORE DESK

| | | | |
|---|---|---|---|
| Amul Shah | | *amul.shah@sg.pinc.co.in* | 65-6327 0626 |

## DIRECTORS

| | | | |
|---|---|---|---|
| Gaurang Gandhi | | *gaurangg@pinc.co.in* | 91-22-6618 6400 |
| Hemang Gandhi | | *hemangg@pinc.co.in* | 91-22-6618 6400 |
| Ketan Gandhi | | *ketang@pinc.co.in* | 91-22-6618 6400 |

## COMPLIANCE

| | | | |
|---|---|---|---|
| Rakesh Bhatia | Head Compliance | *rakeshb@pinc.co.in* | 91-22-6618 6400 |

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