Company In-Depth

7 March 2007 | 8 pages

Nicholas Piramal India (NICH.BO)

Buy: Deep Value; Raising Target Price to Rs300

Rating change ☐
Target price change ☑
Estimate change ☐

- **Prime pick on outsourcing** — We view NPIL as one of the best Indian picks on the global outsourcing opportunity, with its efforts on this front over the last 2-3 years now beginning to reflect positively in financials. We raise our target price by 18% to Rs300/share on rollover to March'08E earnings. At 13.5x FY08E earnings, we find the stock very attractive. Maintain Buy/Medium Risk (1M).
- **FY07: several steps forward** — After 2 years hit by transient issues in domestic formulations and delays in scale-up of outsourcing sales from India, NPIL has made good progress in FY07. Key positives include: a) emerging as a top 10 global CMO with acquisition of Pfizer's Morpeth facility; b) drug discovery deal with Eli Lilly; and c) faster-than-expected turnaround in Avecia.
- **Expect stronger FY08** — We expect the momentum to sustain in FY08 and forecast earnings growth of 41%, driven by the following factors: a) further improvement in Avecia's financials; b) full-year upside from the Morpeth acquisition; and c) commencement of further outsourcing revenues from India – viz. Fortune 500 company and hospitals products company.
- **Good earnings visibility** — NPIL's outsourcing business (contracts with annual sales of c.US$200m) and the stable nature of the business (long-term exclusive contracts with low risk of litigation/excess competition) ensure good earnings visibility relative to its peers, in our view. Its robust branded formulations business also helps smooth any initial lumpiness in outsourcing revenues.
- **Strong growth** — We expect revenue and earnings CAGRs of 23% and 53%, respectively, over FY06-09E, which would provide support to valuations.

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

Buy/Medium Risk	**1M**
Price (07 Mar 07)	Rs201.50
Target price	Rs300.00
from Rs255.00	
Expected share price return	48.9%
Expected dividend yield	2.0%
Expected total return	**50.9%**
Market Cap	Rs42,116M
	US$953M

Price Performance (RIC: NICH.BO, BB: NP IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	1,608	8.46	-18.7	23.8	7.7	35.6	1.4
2006A	1,211	5.79	-31.6	34.8	4.4	16.6	1.5
2007E	2,206	10.56	82.2	19.1	3.9	21.6	2.0
2008E	3,120	14.93	41.4	13.5	3.3	26.2	2.2
2009E	4,006	19.17	28.4	10.5	2.7	28.0	2.5

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	23.8	34.8	19.1	13.5	10.5
EV/EBITDA adjusted (x)	24.0	22.1	13.7	10.3	8.2
P/BV (x)	7.7	4.4	3.9	3.3	2.7
Dividend yield (%)	1.4	1.5	2.0	2.2	2.5
Per Share Data (Rs)					
EPS adjusted	8.46	5.79	10.56	14.93	19.17
EPS reported	8.46	5.79	10.56	14.93	19.17
BVPS	26.31	45.98	51.98	61.77	75.24
DPS	2.92	3.00	4.00	4.50	5.00
Profit & Loss (RsM)					
Net sales	13,342	15,944	22,278	26,287	29,718
Operating expenses	-11,912	-14,537	-19,765	-22,754	-25,333
EBIT	**1,430**	**1,408**	**2,513**	**3,533**	**4,386**
Net interest expense	-192	-173	-210	-222	-164
Non-operating/exceptionals	9	98	154	166	240
Pre-tax profit	**1,246**	**1,332**	**2,457**	**3,477**	**4,462**
Tax	-465	-238	-246	-348	-446
Extraord./Min.Int./Pref.div.	827	116	-5	-10	-10
Reported net income	**1,608**	**1,211**	**2,206**	**3,120**	**4,006**
Adjusted earnings	1,608	1,211	2,206	3,120	4,006
Adjusted EBITDA	1,954	2,096	3,392	4,529	5,407
Growth Rates (%)					
Sales	-5.5	19.5	39.7	18.0	13.1
EBIT adjusted	-42.3	-1.5	78.5	40.6	24.1
EBITDA adjusted	-35.0	7.3	61.8	33.5	19.4
EPS adjusted	-18.7	-31.6	82.2	41.4	28.4
Cash Flow (RsM)					
Operating cash flow	**2,754**	**1,757**	**2,221**	**3,410**	**4,587**
Depreciation/amortization	524	688	879	996	1,022
Net working capital	215	-87	-930	-803	-562
Investing cash flow	**-2,383**	**-2,193**	**-2,688**	**-633**	**-573**
Capital expenditure	-2,027	-2,248	-938	-633	-573
Acquisitions/disposals	0	-60	-2,000	0	0
Financing cash flow	**-564**	**2,031**	**-151**	**-2,322**	**-1,942**
Borrowings	107	-566	1,336	-1,250	-750
Dividends paid	-671	-685	-953	-1,072	-1,192
Change in cash	**-194**	**1,595**	**-618**	**454**	**2,072**
Balance Sheet (RsM)					
Total assets	**13,021**	**18,497**	**21,432**	**23,092**	**26,042**
Cash & cash equivalent	155	953	335	789	2,862
Accounts receivable	1,460	2,429	2,970	3,578	4,045
Net fixed assets	7,278	10,418	12,477	12,115	11,666
Total liabilities	**7,447**	**8,323**	**10,533**	**10,136**	**10,262**
Accounts payable	2,366	3,309	4,010	4,701	5,315
Total Debt	3,680	3,114	4,450	3,200	2,450
Shareholders' funds	**5,574**	**10,174**	**10,899**	**12,956**	**15,780**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.6	13.1	15.2	17.2	18.2
ROE adjusted	35.6	16.6	21.6	26.2	28.0
ROIC adjusted	9.9	9.6	14.6	18.4	22.3
Net debt to equity	63.2	21.2	37.8	18.6	-2.6
Total debt to capital	39.8	23.4	29.0	19.8	13.4

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Deep Value; Raising Price Target by 18%

We view NPIL as one of the best Indian picks on the global outsourcing opportunity, with its efforts on this front over the last 2-3 years beginning to reflect positively in financials. We raise our price target by 18% to Rs300/share on rollover to March'08E earnings. At 13.5x FY08E earnings, we find the stock very attractive, especially given the 53% EPS CAGR over FY06-09E. We maintain our Buy/Medium Risk (1M) rating.

FY07 – Several Steps Forward

After 2 years hit by transient issues in domestic formulations and delays in scale-up of outsourcing sales from India, NPIL has made good progress in FY07. The key positives to emerge over the current fiscal include:

- Emergence as a top 10 global CMO: Five contracts with different global majors along with the acquisitions of Avecia (UK) and Pfizer's Morpeth facility have placed NPIL among the top 10 CMOs in the world with annualized revenues of US$200m from outsourcing contracts. The acquisition of Pfizer's facility along with an arrangement to manufacture some of Pfizer's products is particularly significant because there is no lead time for the revenues to start reflecting in NPIL's financials unlike most other outsourcing contracts.

- Ramp-up in Indian outsourcing revenues: With revenues from a couple of contracts out of India (AMO and Allergan) also beginning to flow through, the CMG business has finally achieved scale. With the contract with the Fortune 500 Company expected to commence in 4QFY07 and revenues from the hospital products company contract likely to start coming through from 2HFY08, we expect the growth momentum to continue.

- Recovery in Avecia on course: Avecia, which was acquired by NPIL in FY06, has been a drain on the company's profitability due to the high fixed costs in the business. The management had announced that it expects Avecia to break even by the end of FY07, implying some losses over the full year. We believe that the company may be a bit ahead of its expectations on this front. While NPIL does not disclose Avecia's revenues and profitability separately, it did mention that Avecia reported a marginal profit in 2QFY07, which came as a positive surprise to us.

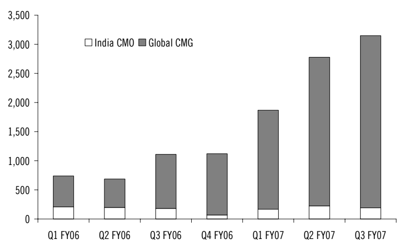
- Drug discovery deal with Eli Lilly: NPIL entered into a new drug discovery agreement with Eli Lilly to develop a select group of the latter's pre-clinical drug candidates in multiple therapeutic areas. To start with, Eli Lilly has licensed one molecule to NPIL in the metabolic disorder space, which 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 3 molecules in the clinic besides several others in the pre-clinical stage.

Figure 1. NPIL's CMG Business – Key Contracts

Contract	Rev (US$ m)	Commencement
AMO	25	FY06
Allergan	10-15	FY06
Fortune 500 Co	15-20	FY07
Astra Zeneca	NA	FY07-08
Hospital Products Co	12-15	FY08
Pfizer Animal Health	NA	FY07-08
Avecia (acquisition)	65	FY07
Pfizer (Morpeth)	64	FY07
Total	**200**	

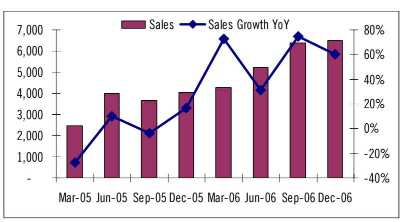
Source: NPIL; Citigroup Investment Research

Figure 2. CMG sales (Rs m) – Gaining Momentum



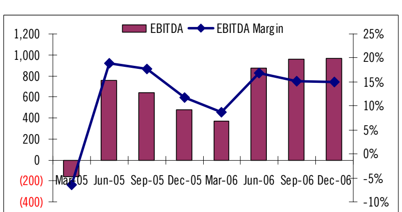
Source: Company Reports

Figure 3. Quarterly Sales Trend (Rs m; %)



Source: Company Reports

Figure 4. Quarterly EBIDTA Trend (Rs m; %)



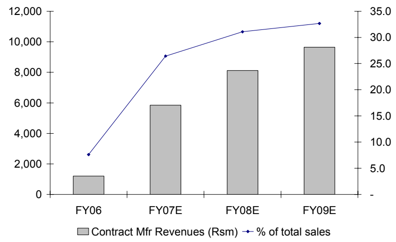
Source: Company Reports

Stronger FY08 Ahead

We believe that NPIL has consolidated its business over the last few quarters, while growing earnings and revenues off a low base. We expect the momentum to sustain in FY08 and forecast earnings growth of 41% on the higher base (82% earnings growth in FY07). This, we believe, would be driven by the following factors:

- Further improvement in Avecia's financials – We expect EBIDTA margins to scale up from break-even levels in FY07 to around 10-12% in FY08.
- Full year upside from the Morpeth acquisition – In FY07, revenues were recognized only for around 9 months.
- Commencement of further outsourcing revenues from India – viz. supplies to the Fortune 500 Company (expected to commence in March 2007 and scale up in FY08) and the hospitals products company (expected to commence in 2HFY08).
- Improvement in domestic formulations growth rates – The pickup in the growth rates for branded formulations in India would also stand NPIL in good stead, since it is the fourth-largest company in this market. Branded formulation sales in India accounts for about 56% of NPIL's consolidated revenues, and a robust trend in this business would help smooth any lumpiness of revenues in the outsourcing business.

Figure 5. Rising Share of CMG sales (Rs m; %)



Source: NPIL; Citigroup Investment Research

Raising Target Price to Rs300/share

We are raising our target price for NPIL by 18% to Rs300/share on rollover to 20x March'08E earnings (from 20x June'07E earnings earlier). This represents an upside of 49% from current levels.

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.

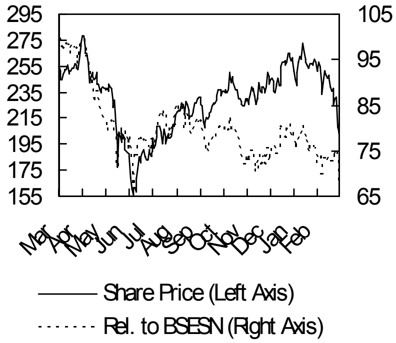
Investment thesis

We retain our Buy, Medium Risk (1M) rating on NPIL with a target price of Rs300/share (up from Rs255/share earlier). We believe NPIL is one of the best picks 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, the company has focused on building brands and strengthening its marketing and distribution network, making it less dependent relative to its peers on new product launches for growth. We are very comfortable with valuations at current levels and expect significant upside potential as earnings momentum continues in 4QFY07 and beyond.

Valuation

We value NPIL's stock on a P/E basis given the company's 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 multiple 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 the 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 Rs300/share (Rs255/share earlier) is based on 20x March'08E (v/s 20x June'07E earlier) 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 the stock deserves a higher valuation multiple.

Figure 6. Price Performance



Source: Powered by dataCentral

Figure 7. Stock Performance

(%)	3M	6M	12M
Absolute	(17.7)	(10.6)	(19.8)
Rel. to .BSESN	(8.6)	(15.8)	(31.6)

Source: Powered by dataCentral

Risk

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 and the higher volatility on the bourses (especially in mid and small caps).

The main downside risks to our target price include: (1) While custom manufacturing is expected to drive NPIL's revenues and profitability, any slip-up in execution of 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 include: (1) If NPIL bags new contracts, which have a lower 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

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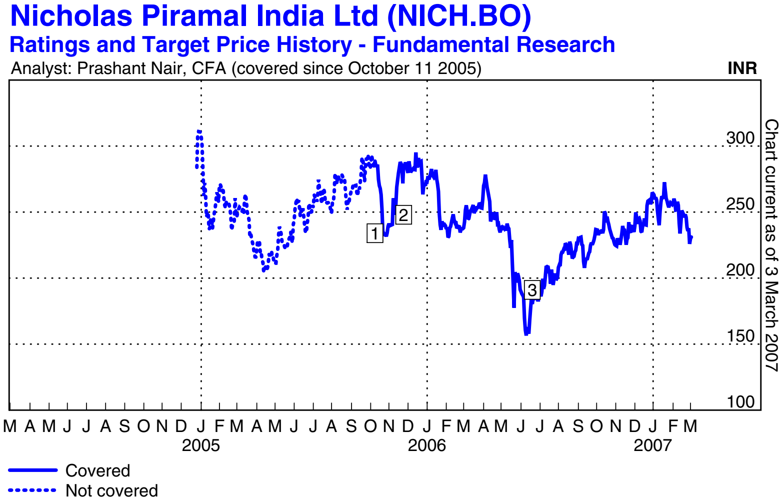

#	Date	Rating	Target Price	Closing Price
1:	10 Oct 05	2L	318.00	288.60
2:	24 Nov 05	2L	*286.00	286.60
3:	20 Jun 06	*1M	*255.00	180.40

*Indicates change.

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% of companies in each rating category that are investment banking clients	48%	50%	39%

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