Company Flash

1 February 2008 | 6 pages

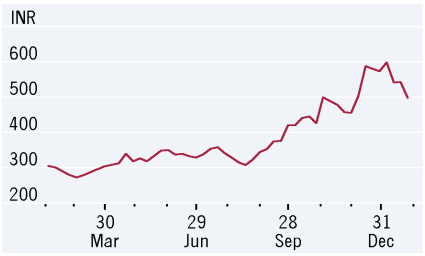
Glenmark Pharmaceuticals (GLEN.BO)

Buy: Termination of Merck deal – Not Unexpected, Not Negative

- **Not unexpected, Not negative** — Merck & Glenmark's decision to terminate their licensing deal on GRC-8200 (Melogliptin) is neither unexpected nor a big negative, in our view. We note that this is a function of Merck's decision to get out of diabetes R&D rather than anything specific to Melogliptin. We continue to rate Glenmark as one of the best Indian plays on innovative R&D & see any decline triggered by this news as an even more attractive buying opportunity.
- **No refund; no liability** — As per the settlement, Glenmark regains the global rights for Melogliptin & does not have to refund the upfront amount of US$25m it received from Merck. Besides, Merck would transfer all activities to Glenmark at no cost to the latter & also pay for completion of some ongoing activities.
- **Validation holds** — We believe that Merck's original decision to in-license Melogliptin validates the potential of the molecule & this does not change since the return of the molecule is more of an overall R&D strategy call. In fact Merck's initial interest in Melogliptin could help Glenmark in its effort to find another licensing partner (management expects to do this in CY2008).
- **Interesting trends in DPP-IVs** — There has been mixed news for the DPP-IV class of molecules in the recent past, especially after safety concerns over Avandia & other glitazones. While the EU approval for Novartis' Galvus (vildagliptin) & Takeda's alogliptin (both DPP-IV inhibitors) lead to greater optimism on this class, this also leaves Melogliptin as fourth or fifth in class

Buy/Medium Risk	**1M**
Price (01 Feb 08)	Rs503.15
Target price	Rs632.00
Expected share price return	25.6%
Expected dividend yield	0.2%
Expected total return	**25.8%**
Market Cap	Rs124,599M
	US$3,172M

Price Performance (RIC: GLEN.BO, BB: GNP IN)



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	864	3.22	-20.9	156.1	32.2	25.5	0.1
2007A	3,093	11.54	258.0	43.6	17.6	58.5	0.1
2008E	5,885	21.96	90.3	22.9	9.7	60.9	0.2
2009E	6,710	25.04	14.0	20.1	6.4	42.8	0.2
2010E	7,947	29.66	18.4	17.0	4.5	34.9	0.2

Source: Powered by dataCentral

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

Glenmark Pharmaceuticals

Company description

Glenmark Pharmaceuticals is a fully integrated research-based pharmaceutical company, with a business model spanning drug discovery research, APIs and formulations in the domestic and international markets. It operates in more than 65 countries, including the regulated markets of the US and Europe, with around 50% of its revenues coming from overseas markets. The company came into the limelight in September 2004 after it licensed out the US market rights of its first new chemical entity (NCE), GRC-3886, to Forest Laboratories.

Investment strategy

We have a Buy/Medium Risk (1M) rating on the stock with a target price of Rs632/share. Our positive outlook on the stock takes into consideration the following: a) R&D pipeline has broadened with seven molecules expected by the company to be in the clinic by end FY08; b) With three molecules licensed out, the R&D option value or value at risk is now spread across a larger number of molecules; c) the base business has witnessed significant traction, especially in the USA and Latin America. We also believe that the rapid scale up in the base business adds another catalyst for the stock apart from the option value being built in by its R&D effort (primarily Oglemilast, GRC-8200 & GRC-6211). The risk reward, we believe, remains in favor of investors. Although there are potential risk triggers (especially related to Oglemilast) that could lead to partial erosion of the option value, we believe that any such decline is a buying opportunity since Glenmark has a robust pipeline that would enable it to shore up the R&D value over time via new outlicensing deals.

Valuation

We use sum of the parts to value the stock, valuing the R&D deals and the base business separately. We believe probability-adjusted DCF is appropriate to calculate the option value from Oglemilast, GRC-6211 and GRC-8200 as it captures the reducing probability of success as the molecules progress on the clinical path. We have used the licensing deal with Forest Laboratories for the US market as a benchmark as well as a 13% discount rate (in-line with Glenmark's WACC) following our adjustment for the higher-risk income streams by probability of success. We arrive at a value of Rs125/share for Oglemilast. We use a similar approach for GRC-8200 and GRC-6211 arriving at a value of Rs47/share and Rs95/share respectively. We value Glenmark's base business (excluding R&D income) on P/E in view of the healthy growth expected in earnings. This takes the total valuation of the company to Rs632/share.

Risks

We rate Glenmark Medium Risk, even though its risk rating according to our quantitative model is Low, as we believe the element of R&D related option value built into the stock warrants a higher risk rating. The main downside risks

to our target price and estimates include: (1) Glenmark's efforts to build its own front-end in regulated markets could prove to be a drag on earnings if it is unable to effectively execute its plans; (2) growing competition, rapid price erosion and fragmented market share are risks that are inherent to the generics business; and (3) the failure of Oglemilast or GRC-8200 could lead to the R&D milestone payments getting taken off our estimates. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

Analyst Certification

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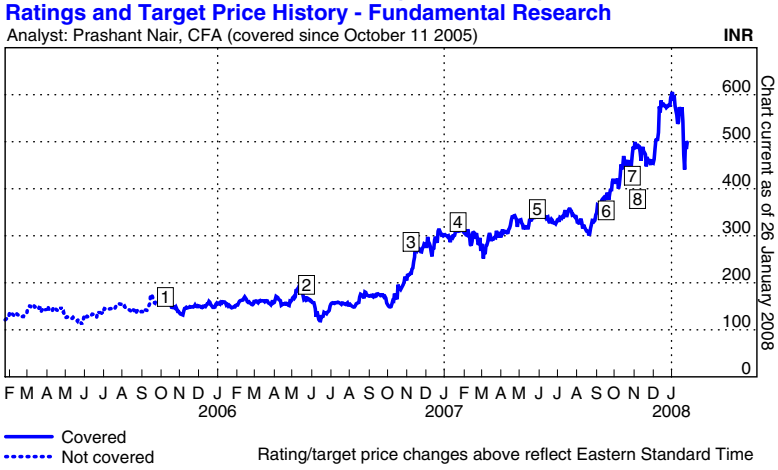
Glenmark Pharmaceuticals (GLEN.BO)

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	3H	152.50	162.75
2:	24 May 06	*1H	*227.50	163.05
3:	8 Nov 06	1H	*317.50	217.60
4:	23 Jan 07	*1M	*379.50	310.40
5:	30 May 07	1M	*427.00	336.58
6:	18 Sep 07	1M	427.00	380.55
7:	30 Oct 07	1M	*575.00	474.20
8:	7 Nov 07	1M	*632.00	486.45

*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

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% of companies in each rating category that are investment banking clients	52%	53%	40%

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