

SUN PHARMACEUTICALS INDUSTRIES

INR 1,199



On an upswing, but Taro overhang persists

ACCUMULATE

We recently met the management of Sun Pharmaceuticals (Sun Pharma). Some key takeaways from the meeting are:

Sun Pharma's domestic formulations segment has performed well, delivering more than 20% growth in H1FY08. We have increased our growth assumptions for this segment to 22% for FY08 and ~ 17% for FY09. The company's US generics business has been showing Q-o-Q growth for the past few quarters. There are several one-time opportunities for the company like Oxcarbazapine, Pantaprazole, Venlafaxine, and Rivastigmine, which could add ~INR 45 per share. We have included revenues only for Oxcarbazapine in our numbers. The US business is expected to be the company's forte over the next couple of years with a CAGR of ~ 28% for FY07-09E.

Taro declared its CY06 and 9M07 figures, a recurring loss of USD 103 mn and a profit of USD 20 mn, respectively. This is a positive development for Sun Pharma, as Taro's acquisition could be EPS accretive for the company from first year onwards. This will give the payback period of ~ 5 years for Sun Pharma. Clarity on Taro acquisition is likely only by end of February or March 08. The uncertainty over Taro acquisition has been a major overhang on the stock over the past few months and we believe if Sun Pharma is able to acquire Taro in the next three months, it will provide a significant trigger to the stock price, especially after looking at Taro's better profitability. In other segments, we believe the company will be able to deliver growth of 30% over the next two years.

On the whole, Sun Pharma has demonstrated one of the strongest business fundamentals in a difficult sector over the past few years. It has given steady topline and bottomline growth of ~20% in the past. We believe the business drivers are in place to deliver these growth numbers over the next three years. Additional triggers in the stock are the one-time Para IV opportunities and completion of Taro acquisition. We are positive on the company's business, but at current valuations, the upsides could be limited. We believe, with the completion of Taro acquisition and new announcements on Para IV opportunities, the stock price is likely to make some significant gains. We have revised our earnings numbers upwards by 8% for FY08E and by 6% for FY09E. At CMP of INR 1,199, the stock is trading at 24.6x on FY08 and 20.6x on FY09 revised estimates. With one-time upsides of ~INR 45 per share and possibility of Taro acquisition trigger we are positive on the stock. We maintain our 'ACCUMULATE' recommendation.

Financials

Year to March	FY06	FY07	FY08E	FY09E
Revenues (INR mn)	16,380	21,321	27,047	31,051
Rev growth (%)	38.0	30.2	26.9	14.8
EBITDA (INR mn)	4,917	6,724	10,216	11,880
Net profit (INR mn)	5,733	7,843	10,124	12,058
Shares outstanding (mn)	185.7	207.3	207.3	207.3
EPS (INR)	30.9	37.8	48.8	58.2
EPS growth (%)	44.5	22.5	29.1	19.1
P/E (x)	38.8	31.7	24.6	20.6
EV/EBITDA (x)	46.0	36.6	22.7	18.8
ROE (%)	42.1	36.0	31.6	29.1

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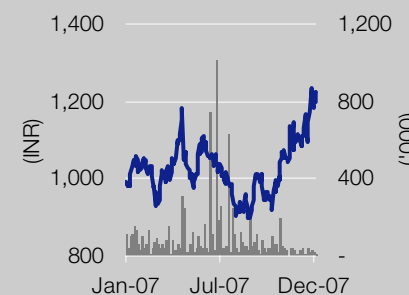
Reuters : SUN.BO
Bloomberg : SUNP IN

Market Data

52-week range (INR) : 1,265 / 886
Share in issue (mn) : 199.2
M cap (INR bn/USD mn) : 238.7 / 6,059.1
Avg. Daily Vol. BSE/NSE ('000) : 258.1

Share Holding Pattern (%)

Promoters : 66.3
MFs, Fls & Banks : 4.8
Fls : 17.0
Others : 11.9



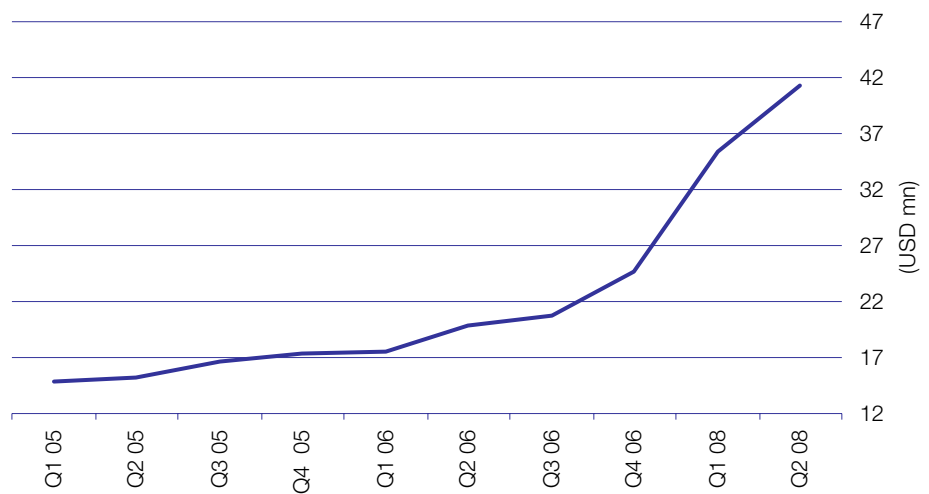
*** Domestic formulations: Growing strong**

Sun Pharma’s domestic formulations segment, which contributed ~ 54% to revenues (in Q2FY08), has grown at a robust rate of ~28% for H1FY08. Growth in the second half is expected to be much lower than in the first, but we expect total domestic revenues to grow by ~22% for FY08E and much lower at 17% for FY09E. With more than 70% revenues coming from the high growth, high margin chronic segments, this growth is expected to significantly boost margins as well.

*** US generics: Significant boost from one-time opportunities**

Sun Pharma’s US business is one of the best and profitable businesses amongst its peers. It has 87 ANDA awaiting approval; it has shown quarter-on-quarter growth for the past 10 quarters.

Chart 1: US generics revenues



Source: Company

The company has lined up various one-time opportunities which could act as significant triggers for the stock price going forward.

Oxcarbazapine: (Brand name Trileptal has branded revenues of ~ USD 640 mn) Sun Pharma has received 180 days exclusivity for Oxcarbazapine and there are three generic players in the market (Sun, Glenmark, and an AG). We believe this opportunity, worth ~ INR 3 per share for the company, is one of the first major Para IV opportunities paying off for Sun Pharma.

Pantoprazole: (Brand name Protonix has branded revenues of ~ USD 2,500 mn) The company has filed a Para IV and received approval for Pantoprazole. Teva also has FTF status and launched it at risk. As of now, Teva has stated that it is not going to sell the generic version of Protonix, and Teva and Wyeth will have discussions for an out of court settlement. Sun Pharma can also launch it at risk. As of now, it is not in discussions with Wyeth for an out of court settlement, but we believe, there is a possibility that Sun Pharma could also go in for an out of court settlement for Protonix. We believe this opportunity could add ~ INR 15 per share to the stock.

Venlafaxine: (Brand name Effexor XR has branded revenues of ~ USD 2,600 mn) Sun Pharma has 180 days exclusivity and the earliest launch will be in June 2008. This is a significant opportunity as the company has received a ‘will not sue’ covenant from Wyeth. We believe this opportunity will add ~ INR 26 per share to the stock.

Rivastigmine: (Brand name Exelon has branded revenues of ~ US 200 mn) Sun Pharma has entered into an out of court settlement with Novartis; the terms of the settlement have not yet been disclosed. There is a possibility that there will be two-three players in all who could share the upsides in this case. This opportunity could add ~ INR 3 per share to the stock.

These are important triggers for the stock and are likely to add ~ INR 45 per share. These upsides are likely to be seen in the stock over the next two-three years. These opportunities indicate the pipeline of ANDAs that the company has been able to build over the past few years and possible upsides in future as well.

We are expecting a CAGR of 28% in the US generics business for FY07-09E.

* **Taro Pharma: Uncertainty an overhang on the stock**

Taro has declared its 2006 and 9M07 unaudited numbers. The company has reported a net profit of ~ USD 20 mn for the 9M07, this is on the back of loss of almost USD 102 mn for CY06. This turnaround has been achieved by reducing R&D costs by almost 1100bps as percentage to sales for 9M07 compared to CY06 and reduction in SG&A costs by 2600bps for 9M07 compared to CY06. These better-than-expected numbers at Taro indicate that Sun Pharma will be able to have a payback period of ~ 5 years. We have not included Taro's figures in our estimates, but with the good performance, we believe the acquisition will become EPS accretive much earlier than estimated.

At least 45 days will be required to call for the next shareholders meeting for approval of acquisition of Taro by Sun Pharma. So, in effect, any clarity on the acquisition will be possible only by end of February or March 2008. There is a possibility that clarity may not come through by February or March and a further delay of another 3 months is a possibility in the light of continued opposition from some Taro investors. This uncertainty has been a major overhang on the stock over the past few months and we believe if Sun Pharma is able to acquire Taro in the next three months, it will provide a significant trigger to the stock price, especially after looking at Taro's better profitability.

Table 1: Taro financials

	(In USD ' mns)					
Year to December	2,002	2,003	2,004	2,005	2006*	9M2007*
Sales, net	211.6	278.1	261.1	297.7	184.1	231.8
<i>% Change</i>		31.4	(6.1)	14.0		
Cost of sales	79.5	102.5	119.7	128.7	141.9	106.0
Gross profit	132.1	175.6	141.4	169.1	42.2	125.8
GPM (%)	62.4	63.2	54.1	56.8	22.9	54.3
Operating expenses:						
Research and development	26.4	40.6	42.0	45.8	36.2	20.6
<i>% Sales</i>	12.5	14.6	16.1	15.4	19.7	8.9
S,G&A costs	52.5	97.9	123.5	108.1	96.9	62.5
<i>% Sales</i>	24.8	35.2	47.3	36.3	52.6	26.9
Total operating expenses	78.9	138.5	165.4	153.9	133.1	83.1
Operating income (loss)	53.3	37.1	(24.1)	15.2	(91.0)	42.7
<i>% Sales</i>	25.2	13.3	(9.2)	5.1	(49.4)	18.4
Financial expenses	(0.2)	2.7	4.8	7.9	13.4	18.8
Other loss	0.1	(0.0)	0.0	0.0	0.0	(0.5)
Income (loss) before I-T	53.2	34.4	(28.9)	7.3	(104.4)	24.5
Income taxes	8.4	4.1	2.6	1.6	(1.6)	4.2
<i>Effective tax rate (%)</i>	15.8	11.9	(9.0)	22.2	1.6	17.3
Net Income (loss)	44.8	30.3	(31.5)	5.7	(102.7)	20.2
NPM (%)	21.2	10.9	(12.1)	1.9	(55.8)	8.7
Extraordinary items					38.0	6.0
Net income (loss) post exception	44.8	30.3	(31.5)	5.7	(140.7)	14.2
NPM (%)	21.2	10.9	(12.1)	1.9	(76.4)	6.1

Source: Company

Note: * Unaudited numbers

Table 2: Impact of Taro's acquisition on Sun Pharma

	USD mn
Cash Utilised for Taro Acquisition	454.0
Interest Income *	31.8
EPS from this income (INR)	6.1
Taro's CY08E PAT **	32.0
EPS from this income (INR)	6.2

Source: Company, Edelweiss research

Notes: * Assuming 7% interest income ** Annualising CY07 PAT for Taro and assuming 20% growth
Assuming INR/USD at 40

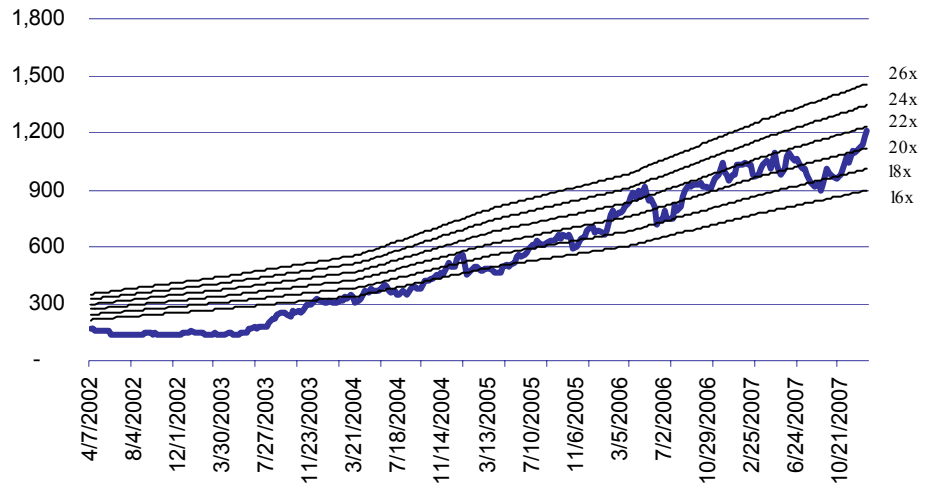
This signifies that the core EPS for Sun Pharma will go up significantly as the EPS lost from the utilization of cash will be made up by Taro's operating profits, which may result in the stock getting higher valuations on its core EPS.

* **Other segments: Steady growth likely to continue**

Sun Pharma's other revenues in semi-regulated markets are expected to grow at 30% over the next two years. Its APIs business, which can be lumpy over various quarters, is expected to grow at ~10% over the next two years. We believe its strong presence in semi-regulated markets may help the company record higher-than-expected growth rates in these markets. The company's entry in European markets in a phased manner over the next three-five years could be the next growth driver.

* Outlook and valuations: Positive; maintain 'ACCUMULATE'

Chart 2: One year forward P/E band



Source: Edelweiss research

Sun Pharma has demonstrated one of the strongest business fundamentals in a difficult sector over the past few years. It has given steady topline and bottomline growth of ~20% in the past. We believe the business drivers are in place to deliver these growth numbers over the next three years. We are positive on the company's business, but at current valuations, the upsides could be limited. We believe with completion of Taro acquisition and new announcements on Para IV opportunities, the stock price will see some significant gains. We have revised our earnings numbers upwards by 8% for FY08E and by 6% for FY09E. At CMP of INR 1,207, the stock is trading at 24.7x on FY08 and 20.8x on FY09 revised estimates. With one-time upsides of ~INR 45 per share and possibility of a trigger from completion of Taro acquisition, we are positive on the stock. We maintain our 'ACCUMULATE' recommendation.

Company Description

Sun Pharma is a major player in domestic formulations market which contributes more than 50% of revenues. It concentrates on high growth lifestyle drugs segment like CVS, CNS, GI and pain management. It has a strategy to enter the niche segments in India and in exports market as well. Sun entered in the US generics market through its subsidiary Caraco in which it owns a majority stake. Over the last 2-3 years the company has built a strong pipeline of more than 60 ANDAs awaiting approvals. It has also grown inorganically by acquiring mostly stressed assets at cheap valuations. It is in process of acquisition of Israel based generics firm Taro Pharma for USD 454 mn.

Investment Theme

We believe the company will be able to deliver steady growth rate going forward because (1) its domestic business is expected to grow at a steady rate of ~20%. (2) The US generics segment is expected to grow with strong pipeline and presence in some niche products. (3) Strong growth in the semi-regulated markets is also expected to have 30% CAGR over FY07-FY09E.

Key Risks

The price cuts/controls in the domestic markets will negatively impact the company's growth.

Severe price erosion in the US generics market will drag the margins down.

Integration issues with Taro could hurt the margins for the company.

Non-profitable acquisitions going forward and problems in integration of the acquired assets could have a negative impact on the company's balance sheet.

Financial Statements

Income statement					(INR Mn)
Year to March	FY05	FY06	FY07	FY08E	FY09E
Income from operations	11,868	16,380	21,321	27,047	31,051
Gross sales	12,744	17,372	22,373	28,651	32,911
Less: Excise	891	1,003	1,052	1,603	1,861
Net sales	11,853	16,368	21,321	27,047	31,051
Other operating income	15	12	-	-	-
Total operating expenses	7,686	11,463	14,597	16,831	19,171
Materials cost	3,642	5,295	6,296	8,220	9,275
Employee cost	888	1,416	1,989	2,287	2,631
R&D cost	1,009	1,534	2,440	2,705	3,105
Other expenses	2,147	3,218	3,873	3,618	4,161
EBITDA	4,182	4,917	6,724	10,216	11,880
Other income	433	1,662	2,425	1,819	2,205
Depreciation and amortisation	406	610	813	1,037	1,102
Profit before tax	4,209	5,969	8,335	10,999	12,982
Provision for tax	205	239	(67)	275	325
PAT(post excep. & pre min. interests)	4,004	5,730	8,402	10,724	12,658
Minority interest & others	42	(3)	559	600	600
PAT (post excep.) for eq. shareholders	3,962	5,733	7,843	10,124	12,058

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07	FY08E	FY09E
Material cost	30.7	32.3	29.5	30.4	29.9
Employee cost	7.5	8.6	9.3	8.5	8.5
Other expenses	18.1	19.6	18.2	13.4	13.4
Depreciation	3.4	3.7	3.8	3.8	3.5
EBITDA margins	35.2	30.0	31.5	37.8	38.3
Net profit margins	33.4	35.0	36.8	37.4	38.8

Growth metrics (%)

Year to March	FY05	FY06	FY07	FY08E	FY09E
Revenues	(2.1)	38.0	30.2	26.9	14.8
EBITDA	(32.8)	17.6	36.7	51.9	16.3
Net profit	(28.8)	44.7	36.8	29.1	19.1
EPS	(64.4)	44.5	22.5	29.1	19.1

Cash flow statement					(INR Mn)
Year to March	FY05	FY06	FY07	FY08E	FY09E
Cash flow from operations	4,233	5,029	9,080	12,102	13,808
Cash for working capital	(658)	(2,146)	(4,202)	2,906	(1,120)
Net operating cash flow	3,575	2,883	4,878	15,008	12,689
Net purchase of fixed assets	(1,623)	(3,387)	(2,294)	(806)	(1,000)
Net purchase of investments	(4,729)	4,166	998	-	-
Net cash flow from investing	(6,352)	779	(1,296)	(806)	(1,000)
Proceeds from equity capital	(141)	(793)	14,516	(1,308)	(1,590)
Proceeds from LTB/STB	13,781	645	(7,601)	(1,000)	(1,000)
Net cash flow from financing	13,640	(148)	6,915	(2,308)	(2,590)
Free cash flow	1,952	(504)	2,584	14,202	11,689

Balance sheet					(INR Mn)
As on 31st March	FY05	FY06	FY07	FY08E	FY09E
Shareholders funds	11,307	15,902	27,728	36,332	46,587
Capital	942	943	981	1,051	1,051
Reserves & surplus	10,366	14,959	26,747	35,281	45,537
Borrowings	18,230	18,745	11,144	10,144	9,144
Secured loans	217	356	395	395	395
Unsecured loans	18,014	18,389	10,749	9,749	8,749
Deferred tax liability (net)	896	1,053	895	895	895
Minority interest	161	332	438	438	438
Sources of funds	30,595	36,031	40,205	47,809	57,064
Gross block	9,344	12,849	14,949	15,949	16,949
Depreciation	2,087	3,779	4,738	5,774	6,876
Net block	7,257	9,070	10,211	10,175	10,073
Capital work in progress	493	414	608	414	414
Investments	6,485	3,541	2,543	2,543	2,543
Inventories	3,173	5,117	6,645	6,435	7,260
Sundry debtors	2,511	3,609	6,789	5,052	5,800
Cash and bank balances	11,809	15,323	13,802	26,327	34,826
Loans and advances	1,392	2,237	2,264	2,264	2,264
Other current assets	62	234	389		
Total current assets	18,946	26,520	29,889	40,078	50,151
Current liabilities	1,741	2,279	2,966	3,536	3,989
Provisions	845	1,236	80	1,865	2,127
Total current liabilities and provisions	2,587	3,515	3,046	5,401	6,116
Net current assets	16,360	23,006	26,843	34,677	44,034
Uses of funds	30,595	36,031	40,205	47,809	57,064
Book value per share (BV)	61	86	134	175	225

Ratios

Year to March	FY05	FY06	FY07	FY08E	FY09E
ROE (%)	40.7	42.1	36.0	31.6	29.1
ROCE (%)	12.6	15.7	18.9	21.0	22.8
Inventory days	286.4	285.7	285.7	285.7	285.7
Debtors days	73.2	68.2	68.2	68.2	68.2
Fixed assets T/o (x)	1.4	1.5	1.5	1.8	1.9
Debt/equity	1.6	1.2	0.4	0.3	0.2

Valuations parameters

Year to March	FY05	FY06	FY07	FY08E	FY09E
EPS, post exceptional (INR)	21.4	30.9	37.8	48.8	58.2
Y-o-Y growth (%)	(64.4)	44.5	22.5	29.1	19.1
CEPS (INR)	23.5	34.2	41.7	53.8	63.5
P/E (x)	56.1	38.8	31.7	24.6	20.6
Price/BV(x)	19.7	14.0	9.0	6.8	5.3
EV/Sales (x)	19.3	13.8	11.5	8.6	7.2
EV/EBITDA (x)	54.7	46.0	36.6	22.7	18.8

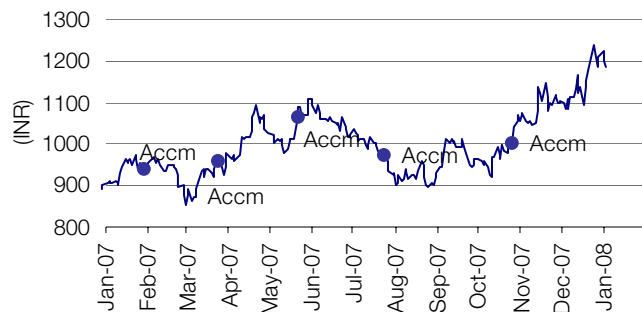
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Coverage group(s) of stocks by primary analyst(s): Pharmaceuticals:

Aurobindo Pharma, Cadila Healthcare, Cipla, Dishman Pharmaceuticals and Chemicals, Dr.Reddy's Laboratories, Glaxosmithkline Pharmaceuticals, Glenmark, Ipca Laboratories, Jubilant Organosys, Lupin, Nicholas Piramal India, Ranbaxy Laboratories, Sun Pharmaceuticals Industries, Torrent Pharmaceuticals and United Phosphorus.

Sun Pharmaceuticals Industries



Recent Research

Date	Company	Title	Price (INR)	Recos
01-Nov-07	Jubilant Organosys	Value in store; Visit Note	306	Buy
14-Dec-07	Pharma	Fact Sheet		
26-Nov-07	Biocon	Some more wait; Initiating Coverage	563	Accu.
20-Nov-07	Pharma	Fact Sheet		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	107	45	18	3	193

* 13 stocks under review / 7 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	104	69	20

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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