

SUN PHARMACEUTICALS INDUSTRIES

INR 1,064

*Taro Acquisition – Betting Big*

ACCUMULATE

Sun Pharma's Q407 results were largely in line with our estimates, except in terms of the other income.

Y-o-Y revenue growth, EBITDA, and net profit for the quarter were 34%, 59%, and 48% respectively. Domestic formulations registered a robust 43% Y-o-Y growth, while formulation exports grew 29%.

Sun Pharma announced the acquisition of Israel-based Taro Pharma at a value of USD 454 mn, indicating an EV/Sales of 1.5x. Taro has been facing competitive pressures in the US market and was close to bankruptcy at the time of acquisition. We believe it will be a challenging task for the management to turn this company around. It is uncertain whether Taro Pharma will be EPS accretive in FY08E.

Our outlook on Sun Pharma (excluding Taro) is positive with continued growth in its domestic formulations business and robust growth of the US generics segment. At CMP of INR 1,064, the stock trades at a PE of 25.7x on our FY08E earnings; we have still not accounted for Taro Pharma's financials. We maintain our 'ACCUMULATE' recommendation on the stock.

* **Taro acquisition – Betting Big**

In this quarter, Sun Pharma announced the acquisition of Israel-based Taro pharma at a total enterprise value of USD 454 mn. Taro Pharma's CY05 sale was USD 298 mn and net profit USD 5.7 mn, with more than 90% of the company's sales emanating from North America. This deal values Taro Pharma's equity at 230 mn, or USD 7.75 per share, which is at a 27% premium to its May 18, 2007 closing price of USD 6.10. Sun Pharma intends to refinance USD 224 mn in Taro Pharma's net debt and provide it interim financing to the extent of USD 45 mn.

Taro Pharma was to restate its financial statements for 2003 and 2004 as per the audit committee's mandate, as the committee had spotted errors in the company's charge-back estimates (from wholesalers) and actual inventory in the drug distribution chain. Further, Taro Pharma declared on March 20, 2007 its expectation of booking a substantial loss for the year ended December 31, 2006.

Financials

Year to March	Q4FY07	Q4FY06	% change	Q3FY07	% change	FY07	FY08E
Revenues (INR mn)	5,442	4,054	25.5	5,400	0.8	21,321	25,137
EBITDA (INR mn)	1,545	969	37.3	1,733	(12.2)	8,523	10,254
Net profit (INR mn)	2,121	1,429	48.4	1,989	6.2	8,600	10,618
EPS (INR)	10.2	6.9	48.4	9.6	6.2	41.5	51.2
P/E (x)						28.5	25.7
EV/EBITDA (x)						29.7	22.8

May 21, 2007

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Market Data

52-week range (INR) : 1,196 / 640
Share in issue (mn) : 186.7
M cap (INR bn/USD mn) : 198.7 / 4,847.0
Avg. Daily Vol. BSE/NSE ('000) : 243.2

Share Holding Pattern (%)

Promoters : 68.3
MFs, FIs & Banks : 4.8
FIs : 15.8
Others : 11.1

Moreover, two-thirds of Taro Pharma's U.S. products originate from Canadian factories and its manufacturing cost advantage has dissipated with the appreciation of the Canadian dollar. It is a small company that channels 40% of its sales through powerful wholesalers. Its principal customers have demanded unfavourable terms that have led to cash-flow problems and a recent revenue restatement.

Considering the aforementioned factors, we believe, while this acquisition will allow Sun Pharma to deploy its USD 350 mn productively, its turnaround may take a long time. We expect the acquired entity to become EPS accretive in FY09E.

* **US generics - Ramping up fast**

Sun Pharma's received its first ANDA approval for its acquired sites (in Ohio) this year, keeping momentum up for the US business. Between Sun Pharma and Caraco, 34 ANDAs are now approved as against 22 at the end of 2006. Total of 16 ANDAs have been filed during the fourth quarter, 8 each from Sun Pharma and Caraco. With this, 77 ANDAs await USFDA approval including 7 tentative approvals (6 from Sun Pharma and 1 from Caraco). Notable approvals during the year include final approval for generics *phenytoin*, *nimodipine*, and *gabapentin*, which have already been launched and a tentative approval for *amifostine* for injection (Para IV filing).

Caraco recently announced Q4 sales of USD 32.7 mn, up 32% from USD 24.7 mn for Q4 FY06. For FY07, sales reached USD 117 mn, growing 41% over last year. Caraco recorded a net income of USD 26.9 mn for FY 07, despite a competitive market.

We expect litigation expenses to rise, as the company increases its Para IV filings and the legal proceedings on *exelon* and *protonix* continue. For FY08E, we expect the US generics business to show a 30% growth.

* **Domestic market formulations - Growing consistently**

Sun Pharma's domestic market formulations grew at a robust 43%, as the company changed its incentive structure for the field force to normalise sales across quarters. Thus, this higher growth is unlikely to be sustainable, though there is a possibility of a high double digit growth.

Sun Pharma's domestic formulations business continues to grow on the back of: (1) new launches in the high value chronic ailment therapies segment that constitutes 71% of the revenues from the domestic market, (2) launch of technically complex products manufactured by very few domestic players, and (3) improved distribution channels across the country. We believe this growth momentum in the domestic market is sustainable, given the company's presence in a niche segment and expect the business to grow by 15% for FY08E.

* **Valuation and Outlook**

Sun Pharma's overall performance depends largely on the integration and turnaround of Taro Pharma. Since the acquisition looks like a challenging turnaround target in the near term, the company's performance might take a beating. However, the management has not disclosed any further information about the acquisition and thus we have not factored that into our estimates. On the longer term, we remain confident about Sun Pharma's ability to turnaround Taro Pharma. At CMP of INR 1064, the stock trades at a PE of 25.7x on our FY08E earnings, looking richly valued. We retain our '**ACCUMULATE**' recommendation on the stock.

Financial snapshot								(INR mn)
Year to March	Q4FY07	Q4FY06	Growth (%)	Q3FY07	Growth (%)	FY06	FY07	FY08E
Total operating income	5,442	4,054	34.2	5,400	0.8	16,380	21,321	25,137
Gross sales	5,725	4,288	33.5	5,658	1.2	17,372	22,373	26,654
Domestic sales	3,265	2,278	43.4	3,168	3.1	10,414	12,686	14,443
Export sales	2,459	2,010	22.4	2,490	(1.2)	6,958	9,687	12,211
Less: Excise duty	283	234	21.1	257	9.9	1,003	1,052	1,517
Net sales	5,442	4,054	34.2	5,400	0.8	16,368	21,321	25,137
Total expenses	3,897	3,085	26.3	3,667	6.3	11,463	14,523	16,614
Cost of goods sold	1,483	1,349	9.9	1,694	(12.5)	5,295	6,441	7,541
Raw mat. cost (incl. adj. to stock)	1,355	1,261	7.4	1,557	(13.0)	4,872	5,912	7,041
Other manufacturing expenses	129	89	45.4	137	(6.3)	424	528	500
Gross profit	3,959	2,705	46.4	3,706	6.8	11,085	14,880	17,596
Other expenses	2,414	1,735	39.1	1,973	22.3	6,168	8,082	9,073
Salaries, wages, other payments	664	517	28.6	658	1.0	1,416	2,558	2,941
R&D	716	510	40.4	705	1.4	1,534	2,547	2,514
Other expenses	1,034	709	45.7	610	69.5	3,218	2,978	3,618
EBITDA	1,545	969	59.4	1,733	(10.9)	4,917	6,798	8,523
Other income (incl. interest income)	942	697	35.2	636	48.2	1,662	2,253	2,106
PBDIT	2,487	1,666	49.3	2,369	5.0	6,579	9,051	10,629
Depreciation	201	189	6.5	212	(5.0)	610	818	945
PBT	2,286	1,477	54.7	2,157	6.0	5,969	8,233	9,684
Tax (including deferred tax)	(18)	113	(115.8)	(29)	(37.6)	239	(67)	484
PAT	2,304	1,364	68.9	2,186	5.4	5,730	8,300	9,200
Minority interest	183	(65)	181.5	198		(3)	559	600
Net profit for eq	2,121	1,429	48.4	1,989	6.7	5,733	7,741	8,600
Equity capital (FV INR 5)	1,037	1,037		1,037		929	1,037	1,037
Dividend						1,167	1,378	1,590
Dividend per share (INR)						6	7	8
Number of shares (mn)	207	207		207		186	207	207
EPS (INR)	10.2	6.9	48.4	9.6	6.7	30.9	37.3	41.5
P/E (x)						34.5	28.5	25.7
EV/EBITDA (x)						40.9	29.7	22.8
M. cap/Revenues (x)						12.1	10.3	8.8
as % of net revenues								
COGS	27.3	33.3		31.4		32.3	30.2	30.0
Excise	5.2	5.8		4.8		6.1	4.9	6.0
Salaries, wages, other payments	12.2	12.7		12.2		8.6	12.0	11.7
R&D	13.1	12.6		13.1		9.4	11.9	10.0
Other expenses	19.0	17.5		11.3		19.6	14.0	14.4
Other income	17.3	17.2		11.8		10.1	10.6	8.4
Gross profit	72.7	66.7		68.6		67.7	69.8	70.0
EBITDA	28.4	23.9		32.1		30.0	31.9	33.9
Net profit	39.0	35.2		36.8		35.0	36.3	34.2
Tax rate	(0.8)	7.7		(1.3)		4.0	(0.8)	5.0

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 Caraco in which it has 63% 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 has raised ~ USD 350 mn through FCCBs to pursue acquisition opportunities. Recently the company has announced that it will de-merge its innovative R&D business into a separate entity.

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 12%-15%. (2) The US generics segment is expected to grow with strong pipeline and presence in some niche products. (3) De-merger of innovative R&D business could unlock some value but we believe more data is required for us to determine the exact value for the business.

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.

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	25,137	29,708	
Gross sales	12,744	17,372	22,373	26,654	31,439	
Less: Excise	891	1,003	1,052	1,517	1,730	
Net sales	11,853	16,368	21,321	25,137	29,708	
Total operating expenses	7,686	11,463	14,523	16,614	19,454	
Materials cost	3,642	5,295	6,441	7,541	8,940	
Employee cost	888	1,416	2,558	2,941	3,382	
R&D cost	1,009	1,534	2,547	2,514	2,971	
Other expenses	2,147	3,218	2,978	3,618	4,161	
EBITDA	4,182	4,917	6,798	8,523	10,254	
Other income	433	1,662	2,253	2,106	2,547	
Depreciation and amortisation	406	610	818	945	992	
Profit before tax	4,209	5,969	8,233	9,684	11,808	
Provision for tax	205	239	(67)	484	590	
PAT(post exce. & pre minority int.)	4,004	5,730	8,300	9,200	11,218	
Minority interest & others	42	(3)	559	600	600	
PAT (post exce.) for equity shareholders.	3,962	5,733	7,741	8,600	10,618	

Common size metrics- as % of net revenues

Year to March	FY05	FY06	FY07	FY08E	FY09E
Material cost	30.7	32.3	30.2	30.0	30.1
Employee cost	7.5	8.6	12.0	11.7	11.4
Other expenses	18.1	19.6	14.0	14.4	14.0
Depreciation	3.4	3.7	3.8	3.8	3.3
EBITDA margins	35.2	30.0	31.9	33.9	34.5
Net profit margins	33.4	35.0	36.3	34.2	35.7

Growth metrics (%)

Year to March	FY05	FY06	FY07	FY08E	FY09E
Revenues	(2.1)	38.0	30.2	17.9	18.2
EBITDA	(32.8)	17.6	38.2	25.4	20.3
Net profit	(28.8)	44.7	35.0	11.1	23.5
EPS	(64.4)	44.5	21.0	11.1	23.5

Cash flow statement						(INR mn)
Year to March	FY05	FY06	FY07	FY08E	FY09E	
Cash flow from operations	4,233	5,029	8,983	10,696	12,315	
Cash for working capital	(658)	(2,146)	428	(1,101)	(1,347)	
Net operating cash flow	3,575	2,883	9,410	9,595	10,968	
Net purchase of fixed assets	(1,623)	(3,387)	(1,000)	(692)	(727)	
Net purchase of investments	(4,729)	4,166	-	-	-	
Net cash flow from investing	(6,352)	779	(1,000)	(692)	(727)	
Proceeds from equity capital	(141)	(793)	14,586	(1,378)	(1,590)	
Proceeds from LTB/STB	13,781	645	(15,753)	(1,000)	(1,000)	
Net cash flow from financing	13,640	(148)	(1,166)	(2,378)	(2,590)	
Free cash flow	1,952	(504)	8,410	8,903	10,241	

Balance sheet					(INR mn)
As on 31st March	FY05	FY06	FY07	FY08E	FY09E
Shareholders funds	11,307	15,902	38,017	45,026	53,842
Capital	942	943	1,051	1,051	1,051
Reserves & surplus	10,366	14,959	36,966	43,976	52,791
Borrowings	18,230	18,745	2,992	1,992	992
Secured loans	217	356	356	356	356
Unsecured loans	18,014	18,389	2,636	1,636	636
Deferred tax liability (net)	896	1,053	1,053	1,053	1,053
Minority interest	161	332	332	332	332
Sources of funds	30,595	36,031	42,394	48,403	56,219
Gross block	9,344	12,849	13,849	14,541	15,268
Depreciation	2,087	3,779	4,597	5,542	6,535
Net block	7,257	9,070	9,252	8,999	8,734
Capital work in progress	493	414	414	414	414
Investments	6,485	3,541	3,541	3,541	3,541
Inventories	3,173	5,117	5,042	5,903	6,998
Sundry debtors	2,511	3,609	3,983	4,696	5,549
Cash and bank balances	11,809	15,323	21,993	27,917	34,969
Loans and advances	1,392	2,237	2,237	2,237	2,237
Other current assets	62	234			
Total current assets	18,946	26,520	33,254	40,753	49,753
Current liabilities	1,741	2,279	2,770	3,244	3,845
Provisions	845	1,236	1,311	2,074	2,393
Total current liabilities and provisions	2,587	3,515	4,082	5,318	6,238
Net current assets	16,360	23,006	29,172	35,434	43,515
Uses of funds	30,595	36,031	42,379	48,389	56,204
Book value per share (BV) (INR)	61	86	183	217	260

Ratios

Year to March	FY05	FY06	FY07	FY08E	FY09E
ROE (%)	40.7	42.1	28.7	20.7	21.5
ROCE (%)	12.6	15.2	18.1	18.5	21.0
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	1.6	1.8	2.0
Debt/equity	1.6	1.2	0.1	0.0	0.0

Valuations parameters

Year to March	FY05	FY06	FY07	FY08E	FY09E
EPS, post exceptional (INR)	21.4	30.9	37.3	41.5	51.2
Y-o-Y growth (%)	(64.4)	44.5	21.0	11.1	23.5
CEPS (INR)	23.5	34.2	41.3	46.0	56.0
P/E (x)	49.8	34.5	28.5	25.7	20.8
Price/BV (x)	17.5	12.4	5.8	4.9	4.1
EV/Sales (x)	17.2	12.3	9.5	7.7	6.3
EV/EBITDA (x)	48.7	40.9	29.7	22.8	18.2

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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