Company Flash

30 April 2007 | 6 pages

Glaxosmithkline Pharmaceutical (GLAX.BO)

Sell: Good Story; Remains Well Priced

- Maintain Sell (3L) — as 1QCY07 results were lacklustre, with marginal 5% YoY growth in pharma sales. While EBITDA margins improved 134 bps YoY, we see signs of pressure on the staff cost front, which may subdue profitability. While GSK would benefit from the stricter IPR regime in India, we expect the uncertainties on this front and the real long-term nature of this upside to keep valuations capped over the medium term.

- Margin boost — GSK's sales mix has improved, with the sale of the animal health business last year, leading RM/Sales to fall 158 bps to 40.6%. However, while GSK was able to control SG&A cost, staff cost went up 8% YoY. We expect wage inflation to have a dampening impact on margins, which anyway appear to have topped out as the upside from restructuring wears out.

- Muted medium-term growth — The bigger question, however, concerns top-line growth – pharma sales grew by a mere 5% in 1Q, when most domestic players recorded double-digit growth, as GSK continue to lag behind in terms of new product launches. While patented launches would likely commence from end CY07 (more likely CY08) with Tykerb, we believe it will be a few years before patented launches are able to lead to a step-up in overall growth rates.

- Underperformance to continue — as we see very few triggers in the medium term and earnings growth would remain lacklustre. Despite sustained underperformance over the last few months, at valuations of 24.8x CY07E, we believe that the stock already builds in a fair amount of option value for the expected upside from product patents in India.

Sell/Low Risk	**3L**
Price (30 Apr 07)	Rs1,166.75
Target price	Rs1,143.00
Expected share price return	-2.0%
Expected dividend yield	2.6%
Expected total return	**0.5%**
Market Cap	Rs98,827M
	US$2,422M

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2004A	2,661	30.47	24.8	38.3	11.0	33.4	2.1
2005A	3,063	36.16	18.7	32.3	10.4	32.7	2.4
2006E	3,509	41.43	14.6	28.2	8.6	33.4	2.6
2007E	3,992	47.13	13.8	24.8	7.8	33.0	2.6
2008E	4,634	54.71	16.1	21.3	6.8	34.2	2.6

Source: Powered by dataCentral

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

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Good Story, but Well Priced

We maintain Sell, Low Risk (3L), as we see very few triggers in the medium term and earnings growth would remain lacklustre. 1QCY07 results were lacklustre, with marginal 5% YoY growth in pharma sales. While EBITDA margins improved 134 bps YoY, we see signs of pressure on the staff cost front, which may subdue profitability. GSK does stand to benefit from the stricter IPR regime in India; however, at 24.8x CY07E, we believe that the stock already builds in a fair amount of option value for this opportunity. Despite sustained underperformance over the last few months, we expect the various uncertainties over the patent regime and subdued medium-term growth to keep the upside capped in the medium term.

Figure 1. Earnings Summary (Rupees in Million, Percent)

Year Ended Dec	1QCY06	1QCY07	% Ch YoY	4QCY06	% Ch QoQ	CIR Comments
Gross Sales	4,569	4,580	0.2	3,489	31.3	
Excise Duty	(315)	(377)	19.6	(391)	-3.6	
Excise rate (%)	*6.9*	*8.2*	*133 bps*	*11.2*	*-298 bps*	
Net Sales	**4,254**	**4,203**	**-1.2**	**3,098**	**35.7**	Continuing business growth of 5%; YoY decline on account of divestment of animal health business
- Pharma	3,807	3,994	4.9	3,068	30.2	Muted growth of 5% YoY is disappointing, in context of the rapid growth in the industry
- Others	532	327	-38.6	305	7.0	Sale of the Animal heath products business
Total expenses	(2,843)	(2,753)	-3.2	(2,284)	20.5	
EBITDA	1,411	1,450	2.8	814	78.2	Improvement in margins on the back of better product mix (divestment of low margin animal health business and tight control over SG&A overheads. We see wage inflation as an issue going forward
EBITDA Margin (%)	*33.2*	*34.5*	*134 bps*	*26.3*	*823 bps*	
Interest	0.0	0.0	nm	0.0	nm	
Depreciation	(38)	(37)	-3.2	(41)	-11.2	Sale of Animal Health business and limited fresh investment in the business
Operating PBT	1,373	1,414	2.9	773	82.9	
Other income	222	272	22.4	299	-9.2	Higher Interest income (up 28%)
PBT	1,596	1,686	5.7	1,072	57.2	
Tax	(561)	(573)	2.0	(391)	46.6	
Tax rate (%)	*35.2*	*34.0*	*-121 bps*	*36.4*	*-247 bps*	100 bps decline in tax rate is a quarterly skew; we maintain our full year estimate at 35%
PAT Before EO Items	**1,034**	**1,113**	**7.6**	**682**	**63.3**	
Extraordinary (EO) Items	(22)	0	-100.0	(4)		
PAT after extra ordinaries	1,012	1,113	10.0	678	64.2	

Source: Company Reports and Citigroup Investment Research

Figure 2. Costs Breakup (Rupees In Million, Percent)

Year Ended Dec	1QCY06	1QCY07	% Ch YoY	4QCY06	% Ch QoQ	CIR Comments
Net Sales	4,254	4,203	-1.2	3,098	35.7	
Material Cost	1,777	1,689	-4.9	1,211	39.4	Gross margins improve on the back of better product mix and sale of the low margin Animal heath business
% of Sales	*41.8*	*40.2*	*-158 bps*	*39.1*	*109 bps*	
Staff Cost	371	402	8.1	353	13.9	Higher staff cost due to scale up of the clinical research activities
% of Sales	*8.7*	*9.6*	*82 bps*	*11.4*	*-183 bps*	
Other Expenses	720	679	-5.7	747	-9.0	
% of Sales	*16.9*	*16.2*	*-76 bps*	*24.1*	*-794 bps*	
Recovery of expenses	(25)	(17)	-31.9	(27)	-36.5	
Total expenses	2,843	2,753	-3.2	2,284	20.5	
% of Sales	*66.8*	*65.5*	*-134 bps*	*73.7*	*-823 bps*	

Source: Company Reports and Citigroup Investment Research

GlaxoSmithKline Pharmaceutical

Company description

SKB Pharmaceutical (India) was merged with Glaxo India in 2001 to become Glaxo SmithKline Pharmaceuticals following the merger of their parents in 2000.

Post-merger, GSK Pharmaceuticals is the largest pharmaceutical company in India. The company sells branded formulations in almost all product categories, mainly anti-infective, pain management and vitamins. However, a large part of the company's portfolio is under DPCO coverage, limiting sales and profitability growth. The merged entity has been carrying out a restructuring exercise and has evolved a strategy to grow profits ahead of sales and to maintain market leadership. The company is looking to achieve these by rationalizing its product portfolio, controlling costs and reducing business.

Investment thesis

We rate GSK Pharma as Sell/Low Risk (3L) with a target price of Rs1,143 per share. The stock has already witnessed a re-rating with India adopting product patents. While near-term opportunities that could get exclusivity in India are few, we believe the company will benefit from CY08 onwards. However, we need to see government clarification on several issues relating to the product patent regime. The government has to make sure that a proper infrastructure and legal framework exists to address contentious legal issues. In the interim, the company has been strengthening its marketing and distribution setup. On the product front, the company's strategy is premised on focusing on its top 30 products, which are growing fast and are not under price control. These 30 products enjoy margins that are thrice that of the price-controlled products, which has led to an overall improvement in profitability. We expect steady profitability trends. If India adheres to the patent regime in earnest, we believe the company could also gain from outsourcing work from its parent for clinical trials to be conducted in India. The parent could also invest in creating research-based assets in India. However, it needs to be seen how these would be structured - whether in the listed entity, in the 100% subsidiary or through a profit-sharing agreement.

Valuation

Our target price of Rs1,143 is based on 25x forward earnings. Given its steady earnings growth, we believe P/E is best suited to value GSK Pharma. GSK has traded between 20-60x in the past six to seven years. With greater visibility on the company's plans to launch patented products, we believe that the stock should trade at 25x to build in some option value for the patented opportunity. On EV/EBITDA, we expect GSK to trade at 15-16x forward EBITDA, again toward the lower end of its historical trading band. At 16x EV/EBIDTA, we value the stock at Rs1,159/share.

Risks

We rate GSK Pharma as Low Risk in view of the company's profitable and growing business base in India. This is consistent with our quantitative risk-rating system. The upside risks to our rating include:
a) earlier-than-expected benefits from patented launches; we expect the first launch in CY08E and material benefits to start coming through only from CY09/CY10. b) Significant benefits from relaxation of price control norms. GSK has around 30% of its revenues coming from price controlled products and if this goes down, profitability could improve considerably. Any sustainable recovery in the Indian market growth rate could lead to faster-than-expected growth in GSK's revenues and profits. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

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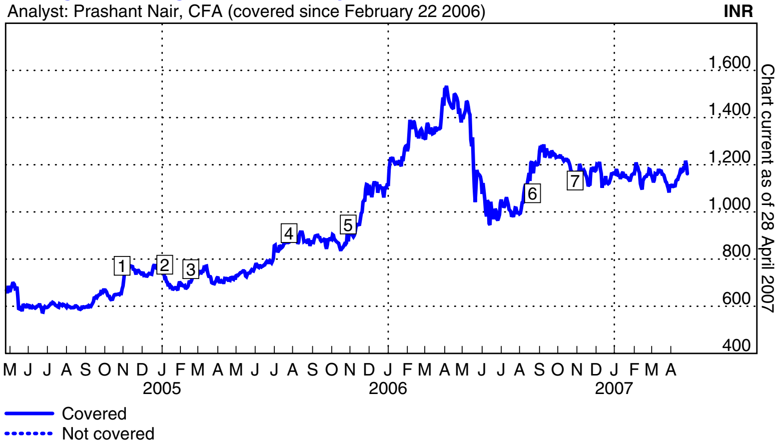
Glaxosmithkline Pharmaceutical (GLAX.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since February 22 2006)



#	Date	Rating	Target Price	Closing Price
1:	29 Oct 04	2L	*700.00	673.45
2:	6 Jan 05	2L	*790.00	718.70
3:	17 Feb 05	2L	*770.00	703.20
4:	26 Jul 05	*3L	*822.00	871.75
5:	28 Oct 05	3L	*857.00	875.05
6:	22 Aug 06	3L	*1,107.00	1,178.80
7:	30 Oct 06	3L	*1,143.00	1,133.10

*Indicates change.

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