9 December 2008 | 108 pages

Indian Pharma Capsule

Healthcare Check – Defensive Value

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- **What's in the report?** — High ownership levels & valuations have somewhat abated and the sector's defensive fundamentals should once again be reflected in superior stock performance, in our view. In this edition of the *Indian Pharma Capsule*, we revisit our view on the sector as well as fine tune-our estimates & valuations in line with the changed macro & market environments.
- **Are there risks to defensive growth?** — While we reiterate the defensive nature of Indian pharma in a worsening global macro environment, we highlight companies that are vulnerable to 3 key fundamental risks *viz*: a) rising cost of capital & how it affects future growth plans; b) fallout of potential financial instability in emerging markets; & c) a volatile rupee & its impact on operating as well as financial health.
- **Focus on B/S & capital efficiency** — With the cost of capital rising & credit tight, we examine balance sheet strength & capital efficiency to identify the companies with greater resilience to rising funding costs. We also deconstruct RoEs by using Dupont analysis to highlight companies where leverage has magnified returns. GSK, Sun & Lupin appear best placed in terms of B/S strength & capital efficiency while Jubilant & Dishman appear most vulnerable.
- **Reviewing valuation framework** — We shift our entire coverage universe to a lower valuation range in line with the broader market and reflective of the current tough environment. We lower target P/E for sector leaders to 14x (20x earlier) & build in higher discounts for companies with subdued return ratios & lower liquidity. Among our key changes, GSK Pharma is upgraded to Buy and Ranbaxy to Hold, while Cadila is downgraded to Sell (as a valuation call).

Indian Pharma: Top Buys & Sells

	RIC	MCap	Price	Rating		Target Price		P/E (x)		ROE (%)	
		US$mn	5-Dec	Old	New	Old	New	FY09E	FY10E	FY09E	FY10E
Top Buys											
GSK India	GLAX.BO	1,956	1,150	3L	1L	1,100	1,300	21.5	17.7	32.5	37.6
Lupin	LUPN.BO	979	589	1M	1M	938	823	11.5	9.6	31.0	29.2
Piramal	PIRA.BO	892	212	1M	1M	469	345	9.9	8.3	36.8	34.1
Sun Pharma	SUN.BO	4,197	1,009	1M	1M	1,659	1,265	16.5	13.4	21.3	20.5
Top Sells											
Biocon	BION.BO	386	96	3H	3H	122	93	9.9	9.1	12.4	12.1
Cipla	CIPL.BO	2,866	184	3L	3M	200	152	18.4	16.7	19.5	19.1

Source: CIR Estimates; Note: FY09E/10E is to March 09E/10E, but is to Dec. 08E/09E for GSK Pharma

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

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Health Check – How Defensive Is the Sector?

With global growth slowing & major earnings downgrades expected across sectors, we believe Indian pharma remains a relatively safe haven – particularly after the sharp dip in valuations over the last 3-4 months. However, while reiterating the defensive nature of the sector, we highlight 3 key fundamental risks *viz:* a) rising cost of capital & how it affects future growth plans; b) fallout of potential financial instability in emerging markets & c) a volatile rupee & its impact on operating as well as financial health. We evaluate these in detail & highlight the vulnerable & safe companies.

Reiterating defensive nature of the business

With global growth slowing & major earnings downgrades expected across sectors, we believe Indian pharma remains a relatively safe haven. In our last edition (July 2008) of the Indian Pharma Capsule *(Taking Stock; Assessing Key Risks)*, we had adopted a cautious stance on the sector given the significant increase in ownership levels & higher valuations. Since then, while the sector has continued to outperform the broader market, stock prices have corrected significantly and are at much less demanding valuations.

Fundamentally defensive

Indian Pharma's attractive value proposition – lower cost & good quality

- **Generics – lower cost for consumers, insurance companies & / or governments**
- **CRAMS – lower cost & more capital efficient solutions for innovator companies**
- **Innovative R&D – filling pipeline gaps for Big Pharma at lower cost**

We do not expect Indian pharma companies to be affected much by global slowdown fears. Firstly, drugs are among the consumption categories least affected by any slowdown. Secondly, and more importantly, Indian Pharma's value proposition has largely been that of lowering cost without compromising quality. Generics companies offer lower cost drugs, thus reducing expenditure for consumers, insurance companies &/or governments, while innovator CRAMS companies offer lower costs & more capital efficient solutions in manufacturing and research for innovator companies. Even those Indian companies engaged in innovative R&D are largely focusing on filling in the gaps in pipelines of global majors at a lower cost. Given that the overall demand itself is likely to remain steady, any prolonged slowdown should only increase the attractiveness of the value proposition that Indian pharma offers.

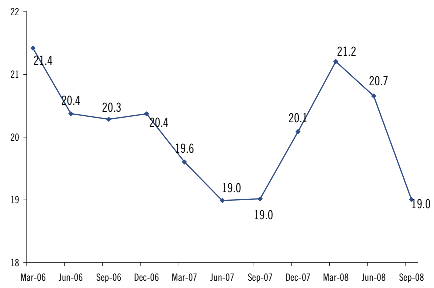
High ownership levels & valuations have corrected

Over the last 3-4 months, while the sector has continued to outperform, individual stocks have corrected & sector P/E has declined materially. This was partly due to company specific issues & partly driven by the fall in the broad market. Moreover, the relative P/E for the sector vis-à-vis the Sensex has also come down from c1.4x to c1.2x. We believe this is a good time to take a re-look at the sector – in the context of the changed price points / valuations as well as the changes in the business environment across the world.

Figure 1. Indian Pharma – P/E Bands (1 year)

Source: Citi Investment Research

Figure 2. Indian Pharma – FII Shareholding (%)



Source: Citi Investment Research

Are there risks to defensive growth?

However, while we reiterate the defensive nature of the sector in a worsening global macro environment, we highlight 3 key fundamental risks *viz*: a) rising cost of capital & how it affects future growth plans; b) fallout of potential financial instability in emerging markets & c) a volatile rupee & its impact on operating as well as financial health.

Risk #1: Rising cost of capital

In an environment where cost of capital is rising & credit is tight, we examine balance sheet & capital efficiency for our coverage universe. This exercise highlights those in more defensive positions and hence with greater resilience to rising funding costs. We also deconstruct every company's RoE by using Dupont Analysis to highlight those companies where leverage has magnified returns as we believe that capital efficiency, more than growth, would be the key driver of valuations going forward.

Figure 3. Indian Pharma – Debt Metrics (FY09E)

Net Debt / (Cash) (Rs bn)	67.8
Net Debt/Equity (x)	0.18
Net Debt/EBITDA (x)	0.70
Interest Coverage (EBITDA)	14.1x

Source: Citi Investment Research

In our view, the Indian pharma sector is comfortable, at an aggregate level, with respect to the financial leverage & is likely to generate adequate cash to handle capex requirements over the next 2-3 years. While there could be some increase in interest cost, as short-term debt is rolled over or refinanced, we believe this is manageable. We have incorporated this into our estimates for companies in our coverage universe.

Figure 4. Indian Pharma – Capex plans (Rs m, x)

	Operating CF (FY09-11E)	Capex (FY09-11E)	Net D/E
Apollo	7,065	(7,750)	0.16
Biocon	5,554	(7,531)	0.21
Cadila	11,109	(5,100)	0.61
Cipla	17,171	(12,500)	0.20
Dishman	6,080	(4,280)	0.95
Dr. Reddy's	10,914	(15,000)	0.35
Fortis	3,721	(4,900)	0.29
Glenmark	20,953	(8,530)	0.33
GSK India	17,457	(450)	(1.08)
Jubilant	12,249	(25,160)	2.07
Lupin	14,553	(4,500)	0.35
Piramal	17,619	(5,660)	0.59
Ranbaxy	37,737	(18,872)	0.16
Sun Pharma	54,110	(7,058)	(0.45)

Source: Citi Investment Research

At the same time, there are some companies that are more vulnerable than others in terms of high financial leverage, where any execution hiccup leading to lower cash flow generation could hurt growth plans. We also believe that valuations of companies with poor capital efficiency / return ratios would come under pressure in a rising cost of capital environment. *Within our coverage universe, we believe Jubilant & Dishman are vulnerable on the financial leverage front while companies such as DRL, Ranbaxy, Biocon, Apollo & Fortis are most vulnerable to be de-rated on account of poor capital efficiency*. We reflect these in our valuations & ratings for these stocks.

M&A strategy – a tale of have & have nots

Sun, Ranbaxy & Biocon appear well placed

We expect balance sheet strength to play a key role in the M&A space. Historically, Indian companies have been very aggressive in pursuing inorganic options, especially in the international markets. However, the tightness in credit availability & weakness in capital markets are likely to lead to a more sedate approach on this front. On the other hand, valuations of many assets – especially in the generics segment – have come down significantly over the last few months. We believe this throws up an opportunity for those companies that have sizeable cash balances or very low leverage to capitalize on any distressed asset sales that the current crisis may trigger. *The companies that appear best placed on this front in our coverage universe include Sun Pharma, Biocon & Ranbaxy.*

Risk #2: Financial instability in emerging markets

With the macro environment deteriorating globally, we look at risks associated with emerging markets such as Russia / CIS, Latin America, South Africa etc, which have been key growth markets for Indian pharma companies. This is particularly relevant for generics companies as the innovator CRAMS companies are largely focused on customers in Western Europe & North America while the Indian hospital companies are primarily India focused.

We do not expect much slowdown in primary demand …

Emerging markets have been a source of high growth & superior margins for Indian generics companies. However, many of these economies have been hit hard by the global financial crisis & this is likely to impact the pharma business as well to some extent. We do not expect any major impact on primary demand as we believe that there is still room for penetration of healthcare & western medicine to increase in these countries.

… but are concerned about risks at the wholesale level – viz. destocking and / or longer working capital cycles …

However, we are concerned about risks at the wholesale level, particularly the ability of wholesalers to meet payment obligations on time given the shortage of credit & excess stock held in the distribution system. We believe this could lead to some destocking by the trade, impacting near term revenue growth, and / or delayed payment terms, which would have an adverse impact on working capital cycles & cash flows in the form of higher and / or some bad receivables.

… & impact of cross currency fluctuations

We believe another factor that bears watching with respect to the emerging markets is cross currency risk. Most Indian companies invoice in either US$ or Euro. Consequently, a depreciation of the local currency leads to higher prices, putting downward pressure on demand, especially if local competitors hold pricing. If the local currencies in emerging markets continue to weaken significantly, we believe it could force Indian exporters to reduce prices in order to offset or contain the impact on demand.

We have toned down our growth estimates for these markets & assumed longer working capital cycles

Our interaction with managements of Indian companies indicates that they have not felt the stress till now. Indian companies have typically been conservative & deal with only the top distributors in each market and thus will be among the last to be hit, if at all. Most companies therefore appear sanguine about these risks at this point. However, we believe it is prudent to tone down growth expectations & account for higher working capital cycles in these markets until there is further clarity on the situation in these economies. This is reflected in our revised estimates. *Within our coverage universe, the companies that are most exposed on this front include DRL, Glenmark, Ranbaxy & Cipla.*

Risk #3: Currency Risk – a depreciating rupee

Indian pharma companies are primarily exposed to the US dollar & Euro as far as their international sales are concerned. As exporters, they benefit on rupee depreciation & lose out on rupee appreciation. However, many Indian companies also import a large part of their raw material requirements & have expenses associated with overseas operations, bringing the net exposure down to some extent. In our view, companies who have a pure supply-based model or provide services only from Indian facilities would be most susceptible (in a positive or negative manner) to currency changes.

Figure 5. Net Exports (% of FY08/CY07 sales)

Company	Net Exports
Biocon	76%
Cadila Healthcare	23%
Cipla	37%
Dishman	66%
Dr. Reddy's	62%
Glenmark Pharma	69%
Jubilant Organosys	47%
Lupin	33%
Orchid	71%
Piramal Healthcare	36%
Ranbaxy	72%
Sun Pharma	67%
Wockhardt Ltd	48%

Source: Citi Investment Research

Recent rupee depreciation should help at the operating level …

The Indian rupee depreciated against the US dollar in FY09 after a sustained period of appreciation – it depreciated by around 27% v/s the dollar and around 10% v/s the Euro YTD. YoY comparisons, at the operating level, would thus be favorable for all pharma exporters over the next few quarters. We have already seen this in the numbers of companies in the first two quarters of FY09.

Figure 6. 1HFY09 Forex impact (Rs m)

	Recurring PAT	Forex Loss
Biocon	1,000	600
Cadila Healthcare	1,846	245
Cipla	4,348	2,325
Dishman	781	475
Dr. Reddy's	2,531	120
Glenmark	2,040	(420)
Jubilant	2,318	2,818
Orchid	464	1,314
Piramal H/C	2,045	494
Ranbaxy*	3,361	5,846
Wockhardt Ltd*	2,613	1,293

Source: Citi Investment Research *9MCY08

… but currency hedges have led to exaggerated short-term losses

At the same time, most Indian exporters have taken sizeable currency hedges in the form of forward contracts (largely in the Rs41-42/$ range) and have taken mark-to-market or realized losses on these contracts. Several companies also have foreign currency debt, on which they have booked translation losses.

We are not unduly worried on this front as: a) most of these losses are notional & would be reversed if the INR changes course; b) these act as natural hedges for the companies' net forex inflows – however, while the positive impact on topline & margins only comes through over the year, the entire impact on the forex debt / forward contracts reflects in one or two quarters. Over a period of time, this would be cancelled out by a commensurate benefit on companies' foreign currency inflows. Besides, in the case of translation losses on forex debt, the underlying liabilities also act as a natural hedge to the companies' operations & benefit in times of unfavorable currency movements, thus providing some stability to the overall business.

Overall, we expect most Indian pharma companies to benefit from currency depreciation despite the near-term losses on forward contracts & translation. *Key beneficiaries include Sun Pharma, Cipla & Biocon.*

Valuations & Key Ratings

We shift our entire coverage universe to a lower valuation range in line with lower valuations for the broader market. Besides, in the current tough environment, we focus more on balance sheet strength, capital efficiency & differentiation along with liquidity while arriving at our target multiples. We lower target P/E for sector leaders to 14x (20x earlier) & build in higher discounts for companies with subdued return ratios & lower liquidity.

Consequently, we upgrade GSK Pharma to Buy (1L), which joins Sun (1M), Lupin (1M) & Piramal (1M) as a top pick. We also upgrade Ranbaxy to Hold (2H) & downgrade Cadila to Sell (3H) besides changing target prices across the board. Cipla (3M) & Biocon (3H) remain our top sells.

Shifting the valuation range lower

We shift our coverage universe to a lower valuation range... albeit with a higher defensive premium to the broad market

We have been valuing the sector at a premium to the broader market given its superior earnings growth & defensive nature of the business. We believe these factors have become more important in the current environment and argue for a higher defensive premium (50% v/s the 30-40% that we have been using in the past) vis-à-vis the broader market. However, valuations of the broader market have declined considerably, and this needs to be built into pharma sector valuations as well. We therefore shift our entire coverage universe to a lower valuation range in line with lower valuations for the broader market.

We use higher discounts for companies with subdued return ratios & lower liquidity

Besides, in the current tough macro environment, we shift focus away from earnings growth & focus more on balance sheet strength, capital efficiency & differentiation along with relative liquidity while arriving at our target multiples. In sum, we lower target P/E for sector leaders to 14x (20x earlier) and build in higher discounts for companies with subdued return ratios & lower liquidity.

Top picks – Sun Pharma, Lupin, Piramal, GSK

- **Sun Pharma (1M)**: Sun's track record of delivering consistent & robust growth while maintaining strong profitability & return ratios makes it the best Indian generics play. Its strong B/S, presence in solid markets & high cash generation would hold it in good stead in the current uncertain environment. While the warning letter for Caraco & "at risk" launches have increased the risk in the business, we believe this is factored in valuations. **Buy for a TP of Rs1,265/sh**.

- **Lupin (1M)**: Lupin continues to demonstrate excellent execution in difficult markets. It has made good progress in its efforts to move up the value chain in terms of product (APIs to formulations) & markets (less regulated to regulated) aided by some accretive acquisitions in key markets. With a strong B/S, robust cash flows & healthy capital efficiency, it is well placed to ride out the tough credit environment without compromising on growth. **Buy for a TP of Rs823/sh**.

- **Piramal Healthcare (1M)**: We rate NPIL as the best play on innovator CRAMS in Indian pharma. Strong traction in outsourcing, steady cash flows from the Indian formulations biz along with superior profitability & return ratios make it one of the better options in the sector in our view. **Buy for a TP of Rs345/sh**.

- **GSK Pharma (1L)**: GSK is an excellent defensive play, with a strong Indian biz, robust B/S, superior return ratios & c4.3% dividend yield. GSK appears largely insulated from the economic slowdown & would also be a key beneficiary of the stronger IPR regime in India over the long term – allowing it to sustain premium valuations in an uncertain environment. **Upgrade to Buy for a TP of Rs1,300/sh**.

Other rating changes & recommendations

- **Ranbaxy – Upgrade to Hold**: post the c51% fall in the stock triggered by the import alert on Paonta/Dewas. Despite a sharp cut in estimates (33-36% over CY09-10E), adjusted for NPV of unaffected exclusivities, the stock trades at c7xCY09E EPS & c0.54xCY09E sales, which we believe prices in most negatives. While there are still some uncertain issues, which prevent us from being more constructive on the stock, risk & reward appear to be more balanced at this point. **Hold for a TP of Rs241/sh**.

- **Cadila – Downgrade to Sell**: Our downgrade is purely a valuation call as we shift our entire coverage universe to a lower valuation range, yielding a new TP of Rs231/sh which is below the current stock price. In the current tough environment, we believe that the stock will be unable to command higher valuations given the relative lack of differentiation, subdued return ratios & no visibility on any major catalyst. **Sell for a TP of Rs231/sh**.

- We change target prices across all other stocks in our coverage universe as we shift the sector to a lower valuation band (see details in table below).

- We drop coverage of Orchid Chemicals & Wockhardt.

Figure 7. Indian Pharma: Snapshot of Changes in Rating & Target Price

		Old		New		
	RIC	CIR Rating	Target Price	CIR Rating	Target Price	*% Change*
Apollo Hospitals	APLH.BO	1M	582	1M	457	*-21%*
Biocon	BION.BO	3H	122	3H	93	*-24%*
Cadila Healthcare	CADI.BO	1M	383	3M	231	*-40%*
Cipla	CIPL.BO	3L	200	3M	152	*-24%*
Dishman	DISH.BO	1H	390	1H	189	*-52%*
Dr. Reddy's	REDY.BO	2M	739	2M	535	*-28%*
Fortis	FOHE.BO	3H	60	3H	59	*-2%*
Glenmark Pharma	GLEN.BO	1M	770	1H	467	*-39%*
GSK India	GLAX.BO	3L	1,100	1L	1,300	*18%*
Jubilant Organosys	JUBO.BO	1M	473	1H	211	*-55%*
Lupin	LUPN.BO	1M	938	1M	823	*-12%*
Piramal Healthcare	PIRA.BO	1M	469	1M	345	*-26%*
Ranbaxy	RANB.BO	3H	373	2H	241	*-35%*
Sun Pharma	SUN.BO	1M	1,659	1M	1,265	*-24%*

Source: Citi Investment Research

Figure 8. CIR Indian Healthcare - Statistical Abstract

			Mkt cap	Share price	Target	P/E (x)		EV/EBITDA (x)		EV/Sales (x)		Div. Yield (%)		
Company Name	**RIC Code**	**Rating**	**(US$m)**	**5-Dec-08**	**price**	**FY09E**	**FY10E**	**FY09E**	**FY10E**	**FY09E**	**FY10E**	**FY09E**	**FY10E**	**ETR**
Generic Pharma														
Biocon	BION.BO	3H	386	96	93	9.9	9.1	5.5	5.6	1.0	1.0	2.0%	2.2%	-1%
Cadila Healthcare	CADI.BO	3M	659	261	231	10.5	9.8	6.9	5.9	1.4	1.2	1.5%	1.5%	-10%
Cipla	CIPL.BO	3M	2,866	184	152	18.4	16.7	13.6	12.2	2.9	2.7	1.0%	1.5%	-16%
Dr Reddy	REDY.BO	2M	1,608	475	535	14.0	11.1	10.1	9.9	1.4	1.4	0.9%	0.9%	13%
Glenmark	GLEN.BO	1H	1,575	313	467	10.5	8.1	8.3	6.4	3.2	2.4	0.3%	0.3%	49%
Lupin	LUPN.BO	1M	967	582	823	11.4	9.5	8.7	7.4	1.6	1.4	1.7%	1.7%	43%
Ranbaxy*	RANB.BO	2H	1,762	209	241	50.2	22.0	10.6	7.3	1.3	1.0	1.4%	2.6%	17%
Sun Pharma	SUN.BO	1M	4,197	1,009	1,265	16.5	13.4	9.6	8.4	4.6	3.8	2.1%	2.4%	27%
Innovator CRAMS														
Dishman	DISH.BO	1H	204	126	189	6.7	5.8	6.4	5.6	1.5	1.3	1.5%	1.7%	52%
Jubilant	JUBO.BO	1H	356	120	211	5.0	4.4	4.4	5.4	0.9	1.1	1.7%	1.7%	78%
Piramal HC	PIRA.BO	1M	892	212	345	9.9	8.3	7.5	6.4	1.5	1.3	2.1%	2.4%	65%
Hospitals														
Apollo Hospitals	APLH.BO	1M	468	387	457	17.6	15.3	8.8	7.5	1.5	1.3	2.3%	2.6%	20%
Fortis Healthcare	FOHE.BO	3H	290	64	59	178.8	46.3	18.0	11.2	2.7	2.0	0.0%	0.0%	-7%
MNC Pharma														
GSK Pharma*	GLAX.BO	1L	1,956	1,150	1,300	21.5	17.7	14.1	12.1	4.9	4.2	3.5%	4.3%	17%

Source: Citi Investment Research estimates *Equates to year end Dec'08E & Dec'09E for these companies

Balance Sheet & Capital Efficiency

In an environment where cost of capital is rising & credit is tight, we examine balance sheet & capital efficiency for our coverage universe. This exercise highlights those in more defensive positions and hence with greater resilience to rising funding costs. We also deconstruct every company's RoE by using Dupont Analysis to highlight those companies where leverage has magnified returns. We believe that companies such as GSK Pharma, Sun Pharma & Cipla, who generate decent RoEs despite low financial leverage are relatively better off in a tightening credit environment vis-à-vis companies such as Jubilant & Dishman, who's RoEs are healthy but significantly driven by high financial leverage.

Well placed in aggregate

In our view, the Indian pharma sector is comfortable, at an aggregate level, with respect to the financial leverage & is likely to generate adequate cash to handle capex requirements over the next 2-3 years.

Profit margins & asset turnover have been improving over the last 2-3 years, leading to a steady trend in return ratios despite declining leverage. While there could be some increase in interest cost & dip in return on equity, as short-term debt is rolled over or refinanced, we believe this is manageable.

Figure 9. Indian Pharma – Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**25%**	**19%**	**13%**	**17%**	**16%**	**16%**	**18%**
PBIT Margin	**20%**	**17%**	**15%**	**19%**	**19%**	**19%**	**20%**
EBITDA Margin	21%	19%	16%	20%	21%	21%	22%
Depreciation/Sales	3%	3%	3%	3%	4%	3%	3%
Total Asset Turnover (Sales/CE)	**1.24**	**1.08**	**0.84**	**0.89**	**0.84**	**0.85**	**0.89**
Sales/Fixed Assets	2.46	2.11	1.38	1.57	1.45	1.55	1.67
Sales/Net Current Assets	2.97	3.34	3.15	2.64	2.71	2.89	2.89
Inventory Days	70	82	85	76	79	78	77
Debtor Days	64	70	76	75	84	85	84
Investments/Capital Employed	7%	17%	12%	9%	11%	16%	16%
Return on Equity (ROE)	**27%**	**22%**	**18%**	**22%**	**20%**	**18%**	**18%**
Net Margin	15%	13%	12%	15%	15%	15%	15%
Total Asset Turnover	1.24	1.08	0.84	0.89	0.84	0.85	0.89
Leverage (CE/Equity)	1.4	1.5	1.8	1.7	1.5	1.4	1.3

Source: Company data, Citi Investment Research estimates

Figure 10. Indian Pharma - Debt Metrics (CY08E/FY09E)

	RIC	Market Cap (US$ m)	Net Debt / (cash) (Rs m)	Net Debt to Equity (x)	Net Debt to EBITDA (x)	Interest Coverage (EBITDA)
Apollo Hospitals	APLH.BO	468	2,145	0.16	0.90	8.5x
Biocon	BION.BO	386	3,409	0.21	1.11	16.9x
Cadila Healthcare	CADI.BO	659	8,126	0.61	1.40	8.2x
Cipla	CIPL.BO	2,866	8,406	0.20	0.78	43.6x
Dishman	DISH.BO	204	6,914	0.95	2.73	5.6x
Dr. Reddy's	REDY.BO	1,608	18,370	0.35	2.13	na
Fortis Healthcare	FOHE.BO	290	3,995	0.29	4.06	2.0x
Glenmark Pharma	GLEN.BO	1,575	7,509	0.33	0.98	14.9x
GSK India	GLAX.BO	1,956	(15,410)	(1.08)	(2.65)	na
Jubilant Organosys	JUBO.BO	356	34,295	2.07	4.55	9.2x
Lupin	LUPN.BO	967	6,964	0.35	1.05	11.9x
Piramal HC	PIRA.BO	892	7,911	0.59	1.19	12.5x
Ranbaxy	RANB.BO	1,762	10,120	0.16	1.14	4.2x
Sun Pharma	SUN.BO	4,197	(30,219)	(0.45)	(1.52)	na
Sector Average			**67,808**	**0.18**	**0.70**	**14.1x**

Source: Company data, Citi Investment Research estimates

Who has leveraged up returns?

At the same time, there are some companies that are more vulnerable than others in terms of high financial leverage, where any execution hiccup leading to lower cash flow generation could hurt growth plans & future returns.

We run the Dupont Analysis on our coverage universe to break down RoEs into three components; asset turnover, net profit margin and financial leverage, with the aim of highlighting those companies where leverage has magnified returns. With the credit environment worsening and the consequent increase in cost of external capital, we believe these companies are likely to find it difficult to sustain return ratios at current levels going forward and are more susceptible to a de-rating.

Figure 11. Indian Pharma – RoE deconstruction

	M Cap	RoE				Profit Margin (%)				Asset Turnover (x)				Financial Leverage			
	(US$ m)	FY07	FY08	FY09E	FY10E	FY07	FY08	FY09E	FY10E	FY07	FY08	FY09E	FY10E	FY07	FY08	FY09E	FY10E
Apollo Hospitals	468	8%	6%	9%	10%	6%	7%	8%	8%	0.79	0.64	0.73	0.80	1.6x	1.5x	1.4x	1.5x
Biocon	386	18%	14%	12%	12%	20%	20%	11%	10%	0.76	0.59	0.82	0.99	1.2x	1.2x	1.2x	1.2x
Cadila	659	28%	24%	26%	23%	13%	11%	12%	11%	1.28	1.14	1.24	1.27	1.7x	1.9x	1.7x	1.6x
Cipla	2,866	20%	17%	19%	18%	18%	15%	16%	15%	1.03	0.94	0.97	0.94	1.1x	1.2x	1.2x	1.3x
Dishman	204	29%	21%	21%	20%	16%	15%	14%	14%	0.65	0.64	0.76	0.78	2.8x	2.2x	2.0x	1.8x
Dr. Reddy's	1,608	27%	10%	11%	12%	17%	9%	9%	11%	0.97	0.76	0.91	0.87	1.6x	1.4x	1.4x	1.3x
Fortis HC	290	-17%	-3%	1%	2%	-19%	-7%	1%	3%	0.44	0.28	0.36	0.47	2.0x	1.3x	1.3x	1.4x
Glenmark	1,575	27%	27%	24%	25%	17%	24%	23%	26%	0.64	0.67	0.78	0.82	2.5x	1.7x	1.4x	1.2x
GSK India	1,956	30%	29%	32%	37%	23%	25%	27%	29%	1.36	1.34	1.23	1.29	1.0x	0.9x	1.0x	1.0x
Jubilant	356	17%	23%	26%	24%	9%	12%	11%	11%	0.67	0.71	0.75	0.82	3.0x	2.8x	3.1x	2.7x
Lupin	967	16%	21%	23%	22%	10%	13%	13%	13%	1.09	1.03	1.32	1.40	1.4x	1.6x	1.4x	1.2x
Piramal HC	892	21%	34%	33%	30%	9%	13%	13%	14%	1.35	1.51	1.52	1.48	1.7x	1.7x	1.7x	1.5x
Ranbaxy	1,762	19%	21%	4%	7%	8%	8%	3%	5%	0.93	1.00	0.70	0.85	2.5x	2.5x	1.6x	1.5x
Sun Pharma	4,197	30%	30%	30%	26%	39%	46%	48%	47%	0.54	0.63	0.61	0.56	1.4x	1.0x	1.0x	1.0x
Sector Average		**22%**	**20%**	**18%**	**18%**	**15%**	**15%**	**15%**	**15%**	**0.89**	**0.84**	**0.85**	**0.89**	**1.7x**	**1.5x**	**1.4x**	**1.3x**

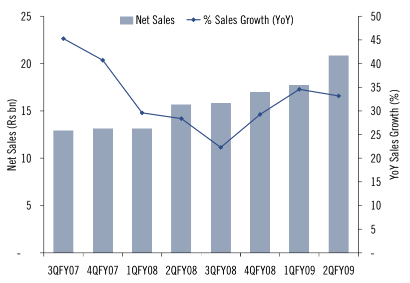
Source: Company data, Citi Investment Research estimates

We believe that companies such as GSK Pharma, Sun Pharma & Cipla, who generate decent RoEs despite low financial leverage are relatively better off in a tightening credit environment vis-à-vis companies such as Jubilant & Dishman, who’s RoEs are healthy but almost entirely driven by high financial leverage.

Key Segments – Recent Trends

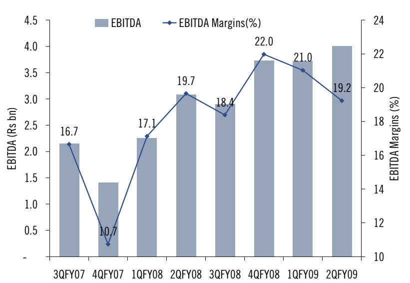
We present an update on the innovator CRAMS, global generics & healthcare delivery segments in India and highlight some of the current issues being faced by companies operating in these areas. Piramal H/C, Sun Pharma & Apollo Hospitals are our preferred plays on each segment respectively.

Figure 12. Innovator CRAMS: Sales (Rs bn, %)



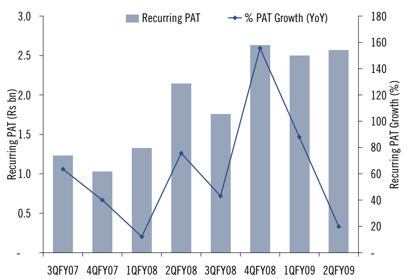
Source: Company Reports and CIR Estimates

Figure 13. Innovator CRAMS: EBIDTA (Rs bn, %)



Source: Company Reports and CIR Estimates

Figure 14. Innovator CRAMS – PAT (Rs bn, %)



Source: Company Reports and CIR Estimates

Innovator CRAMS – looking to sweat assets

We continue to rate innovator CRAMS as the best opportunity within the Indian pharma sector. Most companies in this space have seen a scale change – both in terms of revenues as well as number of contracts and relationships.

The tight capital environment test

Outsourcing, especially of manufacturing services, essentially involved shifting capital cost from the customer (Innovator company) to the supplier (CRAMS company). In fact, we believe that more than the reduction in COGS, it is better capital efficiency that would prompt more innovator companies to outsource more. Moreover, CRAMS companies need to first set up the physical infrastructure before they can bag contracts, which then could take as long as 12-24 months to generate revenues & cash flows.

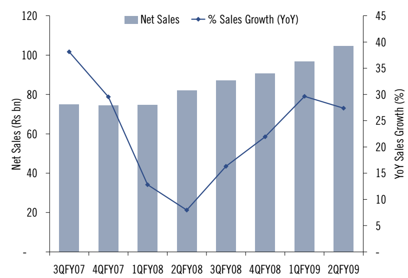
The innovator CRAMS model is thus inherently capital intensive and, hence, likely to be under more pressure in an environment where availability & cost of capital is tight. We have traditionally favored a non pure CRAMS play such as Piramal Healthcare over its counterparts such as Jubilant & Dishman, primarily because of its ability to generate steady cash flows from its branded formulations business in India – thus reducing its dependence on external capital. We believe this factor becomes even more important in the current environment.

The other side of the equation relates to the financial health of the customers. Companies with customers such as VC funded biotech / small molecule companies are likely to be affected if the latter see funding dry up. We have already seen WuXi decide to discontinue its biologics manufacturing business due to losses on account of cancelled/delayed projects from its 20 small biotech clients. On the other hand, companies that are focused on large or medium sized pharma companies are unlikely to face a similar slowdown. We believe that most Indian companies are well placed on this front although Piramal Healthcare could face some slowdown in its Torcan business in Canada that deals primarily with biotech companies.

Will terrorism affect outsourcing flow to India?

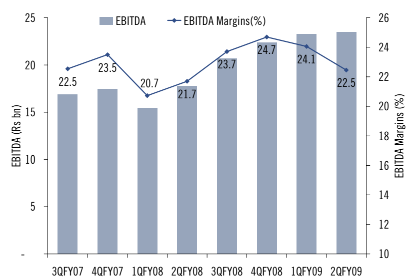
There have been some concerns among investors in the recent past as to whether the recent terrorist attacks in Mumbai affect India's attractiveness as an outsourcing destination. We believe it is too early to call. Our interaction with some of the Indian companies engaged in outsourcing indicates that, so far, there is no sign of any such slowdown or reluctance on the part of potential customers. There have been some visits that have been cancelled in the aftermath of the attacks and if this continues for a while, some contracts may be delayed. Barring that, there is unlikely to be any major impact on business. However, we do believe that if such incidents continue at regular intervals, it could hinder business to some extent as innovators would be loathe to put any part of their supply chain at risk.

Figure 15. Indian Generics – Sales (Rs bn, %)



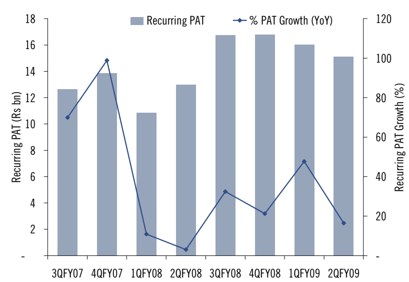
Source: Company Reports and CIR Estimates

Figure 16. Indian Generics – EBIDTA (Rs bn, %)



Source: Company Reports and CIR Estimates

Figure 17. Indian Generics – PAT (Rs bn, %)



Source: Company Reports and CIR Estimates

Generics: challenges & opportunities

Exposure to multiple markets

Indian generic companies operate in multiple markets across the world. While the rising penetration of generics in most markets would remain a structural driver over the medium to long term, the short term is likely to throw up challenges given the tightening credit situation in key markets.

India: The Indian market appears largely insulated from the tight credit environment at this point. Our interactions with companies in our coverage universe indicate that there is no evidence of de-stocking by the trade as yet. We expect revenue growth to sustain in the low teens, with the sector leaders growing faster than the market. The robust profitability & free cash flows generated in the Indian market would hold the companies in good stead in the current environment.

Developed markets: Sales to the regulated markets (US & W.Europe) would be aided by the weak INR (down 27% YoY vis-à-vis the US$ & c10% YoY vis-à-vis the Euro). Most companies have ramped up their filings in these markets and we expect a steady stream of approvals over the next few years. We expect a push towards greater genericisation, especially in the US markets post the recent elections. At the same time, pricing pressure & a slower pace of US FDA approvals would continue to weigh on the industry's fortunes for some time. A similar trend is likely in most west European markets & Japan, as the focus shifts to low cost healthcare. Germany is a classic case, where the regulatory framework has led to a shift in purchasing decision making from

Emerging markets: such as Russia/CIS, Latin America, Australia/NZ, South Africa etc also hold good potential over the medium to long term in our view. However, many of these economies have been hit hard by the global financial crisis and this is likely to have an impact on the pharma business as well to some extent. This could reflect in the form of destocking by the trade or pressure on working capital in the form of higher and / or some bad receivables. Indian companies have typically been conservative and deal with only the top distributors in each market. Most companies are therefore sanguine about the situation at this point; however, we believe it is prudent to tone down growth expectations & account for higher working capital cycles in these markets until there is further clarity on the situation in these economies.

Figure 18. Indian Generics – Geographical revenue break up (% of total sales)

	Cadila	Cipla	DRL	Glenmark	Lupin	Ranbaxy	Sun Ph	Wockhardt
India	61	46	21	30	49	20	55	29
North America	13	14	24	43	37	33	39	10
Europe	12	12	25	2	3	22	-	53
Asia (Japan, Middle East, Australasia)	N/A	5	N/A	N/A	7	7	N/A	N/A
Russia/CIS	N/A	N/A	11	12	N/A	5	2	N/A
RoW (LatAm, Africa)	14	23	19	13	5	12	4	7

Source: Company Reports and Citi Investment Research

US FDA inspections & warnings – is there a trend?

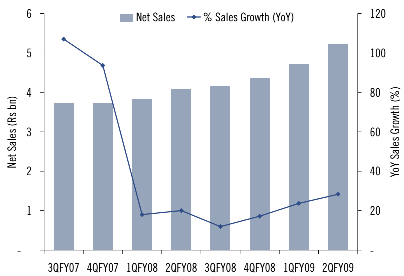
One of the concerns in the minds of investors with respect to Indian generics is whether the US FDA has become more stringent with Indian companies. This has been triggered by three separate incidents in quick succession viz. a) an import alert on products from Ranbaxy's plants (Dewas & Paonta Sahib); b) warning letter to Caraco (subsidiary of Sun Pharma) for its plant in Detroit; c) some inspectional observations (483s) issued to Lupin for its plant in Mandideep.

We do believe that the level of scrutiny by the FDA appears to have increased after the heparin incident in China and the flak that it received for the same. This along with the fact that the FDA has now set up an office in India could lead to more frequent and surprise inspections. However, we do not see any reason, as yet, to view this as a trend specific to Indian companies or expect this to be an impediment to growth for the industry as a whole.

Healthcare – ability to fund expansion is key

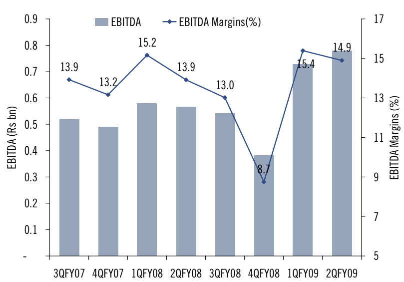
We remain positive on the Indian healthcare industry on the back of changing demographics & disease profiles along with the scope to increase penetration in the country. However, this is now tempered by multiple pressures viz. the deteriorating macro environment, rising cost of capital & adverse trend in income levels. We expect capital constraints to hit expansion plans of corporate hospitals at the aggregate level although the two listed hospitals that we cover – Apollo & Fortis – appear better placed on this front.

Figure 19. Indian Hospitals – Sales (Rs bn, %)



Source: Company Reports and CIR Estimates

Figure 20. Indian Hospitals – EBIDTA (Rs bn, %)



Source: Company Reports and CIR Estimates

Are there risks to growth?

We believe that growth for the Indian hospitals sector can be affected by factors on the supply or demand side – more so the former.

Supply side – will funding be a constraint?

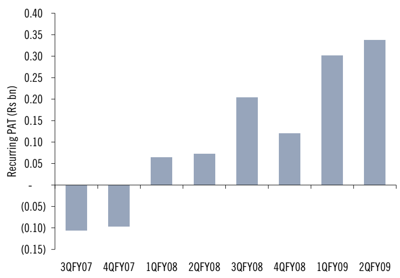
The private healthcare sector in India is at a fairly nascent stage with most companies in the midst of an investment phase, trying to rapidly scale up to desired levels. We thus expect the sector to be hit hard by the tightening credit conditions, as companies find it difficult to raise fresh capital. This could lead to deferment of expansion plans in the near term unless funding is already tied up. Moreover, the higher cost of capital would also affect NPVs / IRRs of individual hospitals, potentially triggering a relook at the viability of some of the planned projects. On the other hand, these companies should get some relief from the declining real estate cost / rentals, given that cost of land can account for as much as 50% of the upfront capital cost for a hospital.

We however highlight that both companies in our coverage universe – Apollo Hospitals & Fortis Healthcare – appear well placed with respect to their funding requirements at least over the next 1-2 years. Both companies have robust balance sheets with comfortable net debt/equity ratios (0.2x & 0.3x for Apollo & Fortis respectively) which provide them some flexibility to leverage up, albeit at a higher cost than earlier.

Demand side – falling income levels could hurt

Most of the spending on healthcare in India is out of pocket with only a small part of the population having some access to healthcare insurance of any kind. As such, rising income levels was a key driver for the organised hospitals companies over the last few years as it allowed them to ramp up occupancies despite their services being priced at a premium. With income levels likely to fall going forward, this may change. While we still do not see any major issue with ramping up occupancy levels (given the high level of underinvestment in the sector), it may be a challenge for companies to take price increases on a consistent basis.

Figure 21. Indian Hospitals – PAT (Rs bn, %)



Source: Company Reports and CIR Estimates

The other indirect impact of falling income levels could be postponement of certain projects. For instance, Fortis Healthcare has entered into several MoUs with real estate majors, among them DLF and Ansal, to build hospitals in the vicinity of planned townships. However, with income levels declining, the viability of some of these townships may itself be under a cloud – implying postponement of plans to set up hospitals to service them.

These factors make it even more critical for expansion projects to be completed on time, in our view.

Valuations – execution & capital efficiency are key

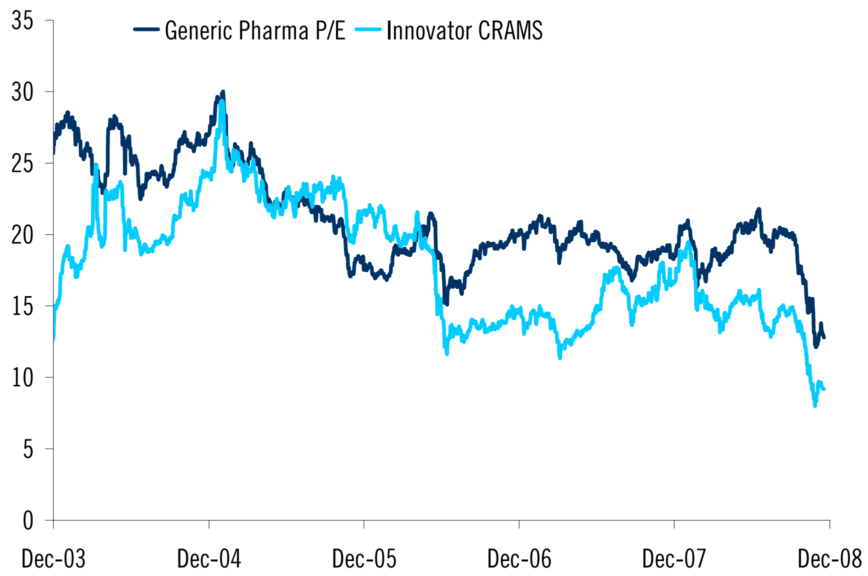
Given the sudden tightness in money supply, we expect valuations of hospital stocks to be affected. The street will focus more on efficient execution of already funded planned projects & ability to improve capital efficiency. Moreover, both listed hospital companies are relatively small in terms of market capitalisation & suffer from low liquidity. This is likely to be another factor that weighs on valuations. We factor these into valuations by lowering our target EV/EBIDTA multiple for Apollo & Fortis to 10x from 12x earlier. Apollo remains our preferred play in this space at these levels.

Indian Pharma – Valuations Snapshot

After a strong re-rating in Indian CRAMS over CY02-06, which was followed by a sharp de-rating, the gap between Indian generics and Indian CRAMS has been gradually declining.

The recent underperformance has been on account of the higher leverage of the Indian CRAMS companies, which has been a concern area for the street in the tight credit environment

Figure 22. P/E Trend – Indian CRAMS vs. Indian Generics (5 years)



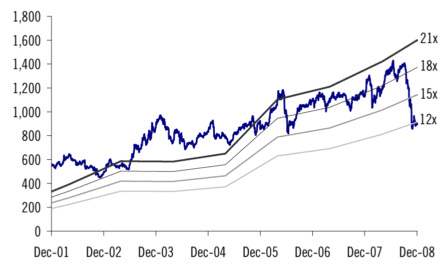
Source: Citi Investment Research

After being on an uptrend for most part of the year, the sector P/E has corrected sharply over the last two months – touching its lowest point in many years

Figure 23. Indian Pharma – P/E band (1 year)

Source: Citi Investment Research

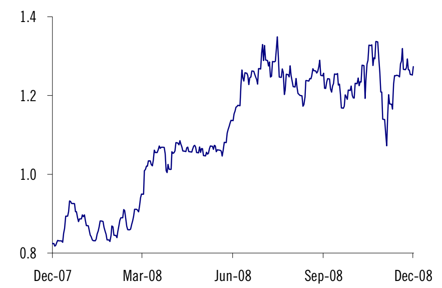
Figure 24. Indian Pharma – P/E band (7 year)



Source: Citi Investment Research

After a significant de-rating over the last few years, the pharma sector P/E has moved back to a reasonable premium to the Sensex P/E over the last year – we expect this defensive premium to expand further

Figure 25. Indian Pharma P/E vs. Sensex (1 year)



Source: Citi Investment Research

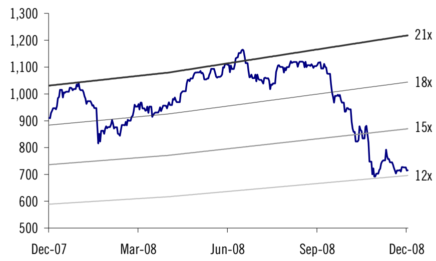
Figure 26. Indian Pharma P/E vs. Sensex (7 year)

Source: Citi Investment Research

Indian generic pharma companies have witnessed a steady decline in multiples given low growth expectations and increased competition in the generics space.

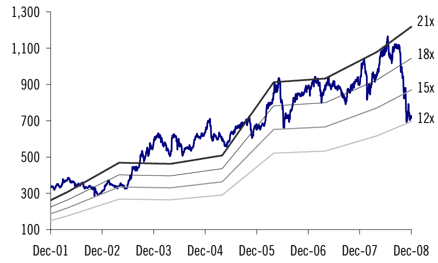
A re-rating does not appear to be on the cards. Key triggers include progress on biogenerics, authorized generics ban.

Figure 27. Generic Pharma – P/E bands (1 year)



Source: Citi Investment Research

Figure 28. Generic Pharma – P/E bands (6 year)

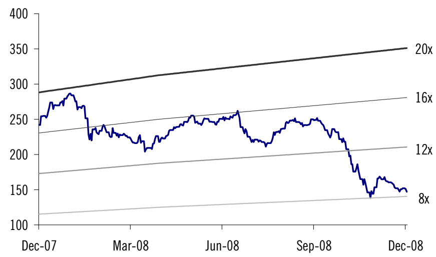


Source: Citi Investment Research

Innovator CRAMS multiples have dipped over the last few months on worries over leveraged balance sheets of some companies.

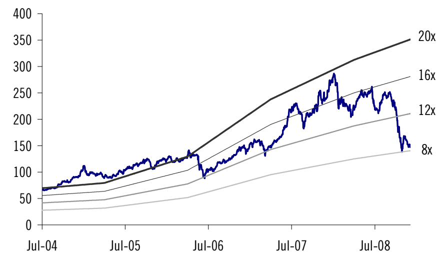
We expect P/Es to move back to higher levels on higher earnings & good traction in deal flows

Figure 29. Innovator CRAMS – P/E bands (1 year)



Source: Citi Investment Research

Figure 30. Innovator CRAMS – P/E bands (5 year)

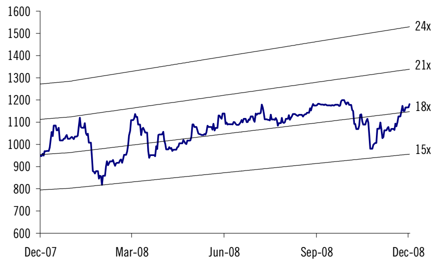


Source: Citi Investment Research

MNC Pharma P/E (includes only GSK Pharma) multiples had risen after introduction of product patents in January 2005 as the option value of the patented products opportunity was built into these stocks.

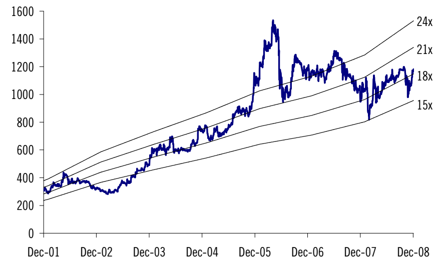
Recently multiples have been range bound between18-21x, and the stock has held on. Given its strong balance sheet and steady business, we expect this trend to continue.

Figure 31. MNC Pharma – P/E bands (1 year)



Source: Citi Investment Research

Figure 32. MNC Pharma – P/E bands



Source: Citi Investment Research

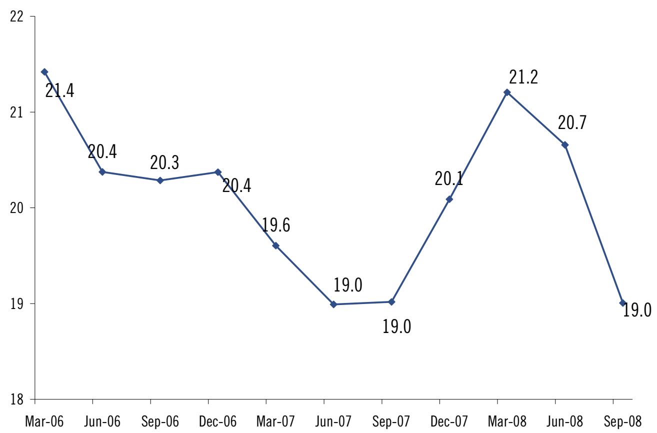
Indian Pharma – Ownership Tracker

Figure 33. Indian Pharma – Institutional Shareholding

	FII Holding				Mutual Funds Holding			
	31-Dec-07	31-Mar-08	30-Jun-08	30-Sep-08	31-Dec-07	31-Mar-08	30-Jun-08	30-Sep-08
Aurobindo Pharma	27%	25%	24%	25%	9%	8%	8%	8%
Biocon	8%	8%	7%	8%	11%	11%	10%	10%
Cadila Health	5%	5%	5%	5%	16%	16%	16%	16%
Cipla	21%	23%	22%	20%	13%	13%	14%	16%
Dishman Pharm.	9%	12%	13%	14%	21%	21%	18%	16%
Divi's Lab	18%	17%	17%	16%	13%	14%	14%	15%
Dr Reddy's Labs.	28%	27%	26%	24%	17%	19%	21%	21%
Glaxosmithkline	16%	15%	15%	15%	16%	16%	17%	17%
Glenmark Pharma	27%	29%	30%	31%	4%	4%	4%	3%
Lupin	22%	26%	17%	16%	14%	10%	20%	21%
Opto Circuits(I)	34%	35%	35%	33%	4%	5%	5%	4%
Orchid Chemicals	34%	23%	17%	17%	17%	19%	17%	17%
Piramal Healthca	23%	24%	25%	25%	9%	9%	8%	8%
Ranbaxy Labs.	17%	21%	20%	9%	25%	23%	23%	12%
Sun Pharma.	19%	22%	21%	21%	5%	5%	5%	5%
Wockhardt	4%	4%	3%	3%	10%	10%	10%	10%

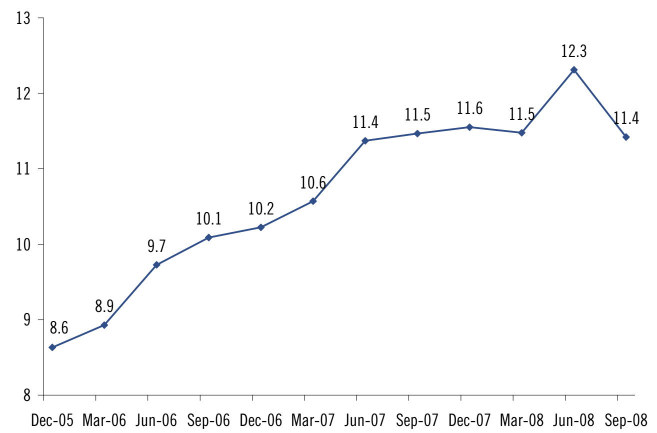
Source: Capitaline

Figure 34. Indian Pharma – FII Shareholding (%)



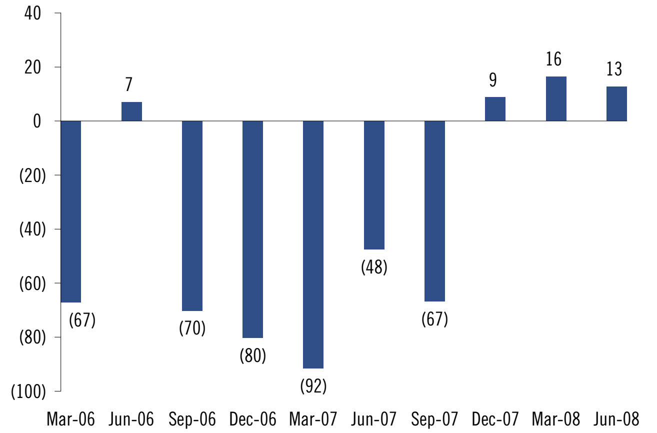
Source: Citi Investment Research

Figure 35. Indian Pharma – Mutual Funds Shareholding (%)



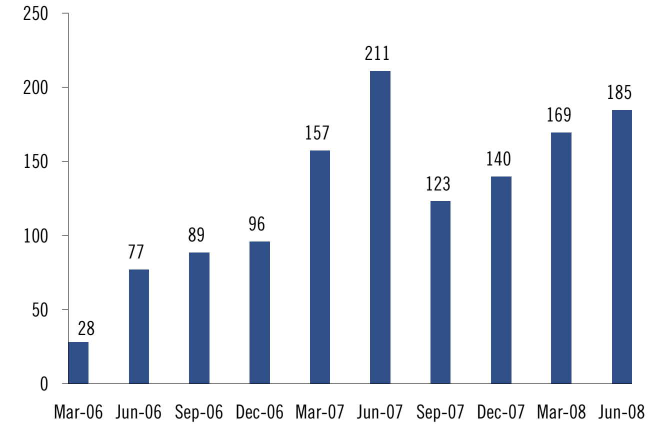
Source: Citi Investment Research

Figure 36. Indian Pharma – FII Overweight(Underweight) vs. MSCI



Source: Citi Investment Research

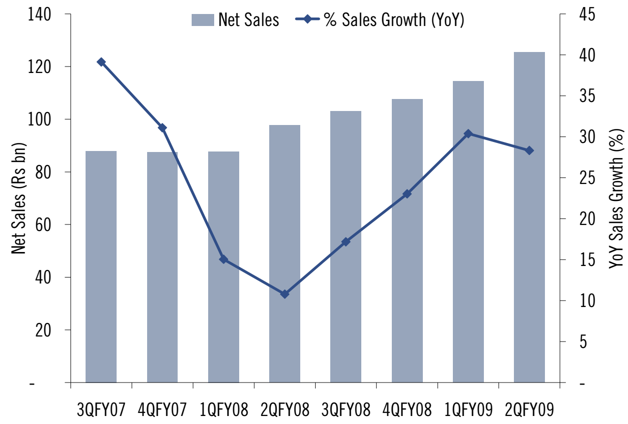
Figure 37. Indian Pharma – MF Overweight(Underweight) vs. NIFTY



Source: Citi Investment Research

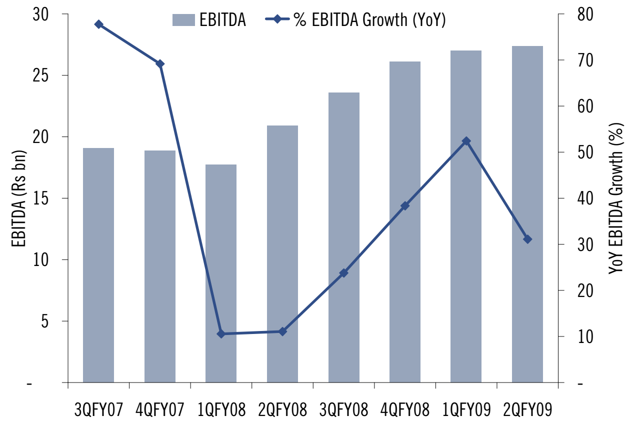
Indian Pharma – Key Indicators

Figure 38. CIR Pharma Universe – Quarterly Sales & YoY Growth (Rs bn, %)



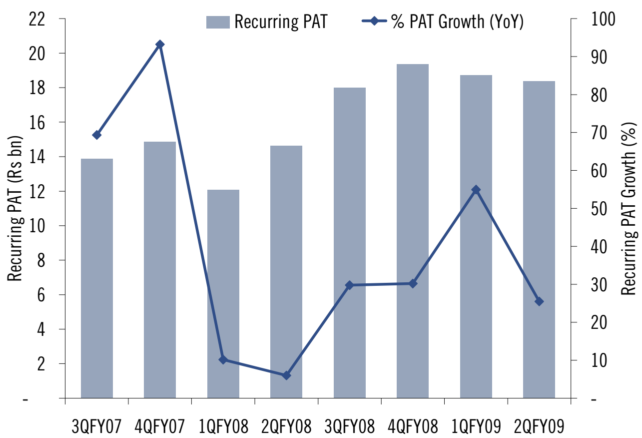
Source: Citi Investment Research

Figure 39. CIR Pharma Universe – Quarterly EBITDA & YoY Growth (Rs bn, %)



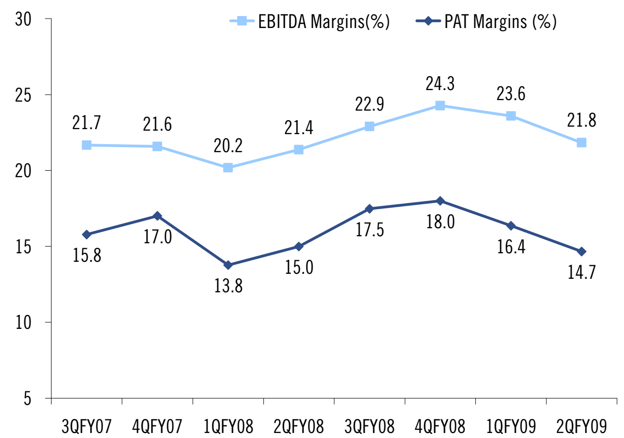
Source: Citi Investment Research

Figure 40. CIR Pharma Universe –Quarterly Net Profit, YoY Growth (Rs bn, %)



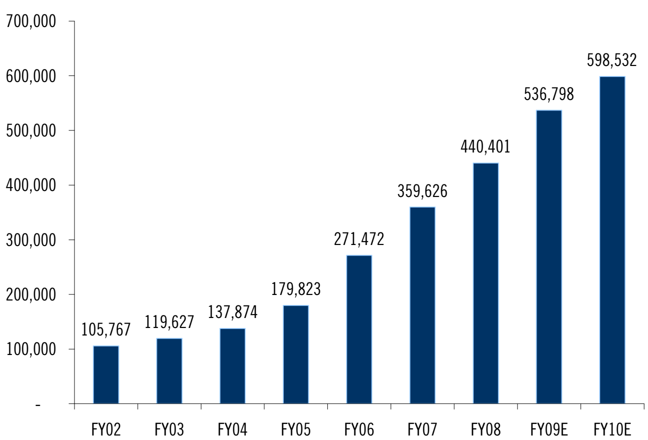
Source: Citi Investment Research

Figure 41. CIR Pharma Universe – Quarterly Margin Trends (%)



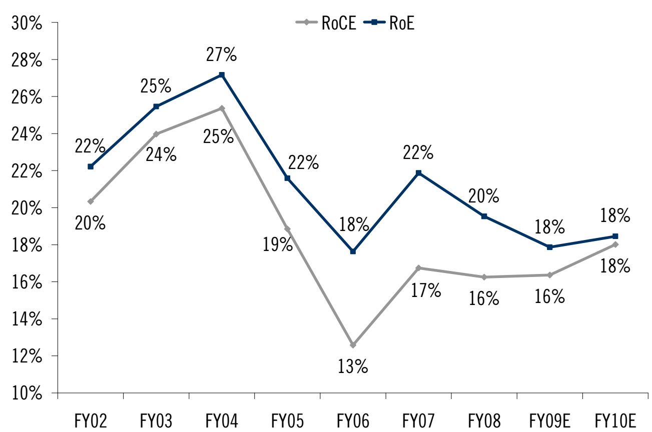
Source: Citi Investment Research

Figure 42. CIR Pharma Universe –Capital Employed (Rs m)



Source: Citi Investment Research

Figure 43. CIR Pharma Universe – Return Ratios (%)



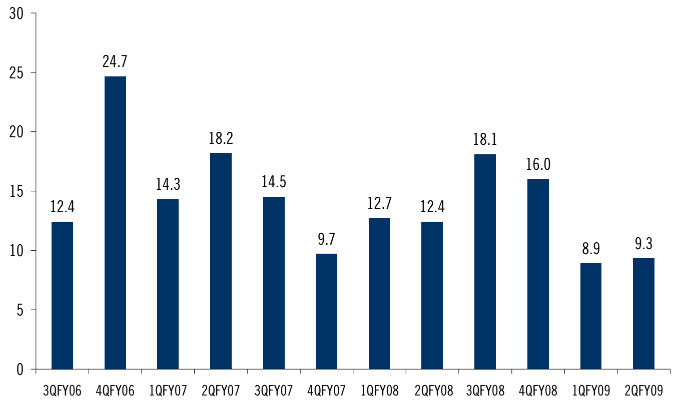
Source: Citi Investment Research

Figure 44. Indian Pharmaceuticals – Top ten companies by market share*

	Last month		Last 12 Mths	
	Market Share	*% Growth YoY*	Market Share	*% Growth YoY*
Cipla	5.1	*7.6*	5.3	*0.2*
Ranbaxy	5.2	*16.8*	5.1	*14.5*
GlaxoSmithKline	4.3	*(3.0)*	4.6	*5.7*
Nicholas Piramal	3.7	*2.3*	3.7	*(1.9)*
Zydus Cadila	3.5	*(2.8)*	3.7	*14.3*
Sun Pharma	3.5	*16.9*	3.4	*18.9*
Alkem	3.0	*0.3*	3.2	*18.3*
Lupin	2.7	*13.0*	2.7	*25.2*
Dr.Reddy's Lab	2.3	*2.7*	2.3	*11.9*
Abbot	2.4	*11.8*	2.3	*22.5*

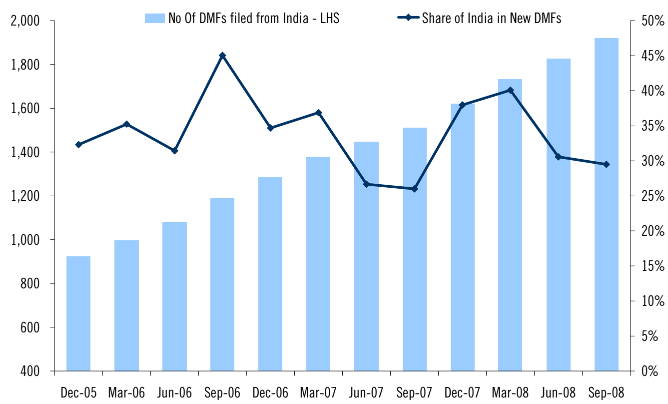
Source: Citi Investment Research **as of May 2008*

Figure 45. Indian Pharmaceuticals Market YoY Growth (%)



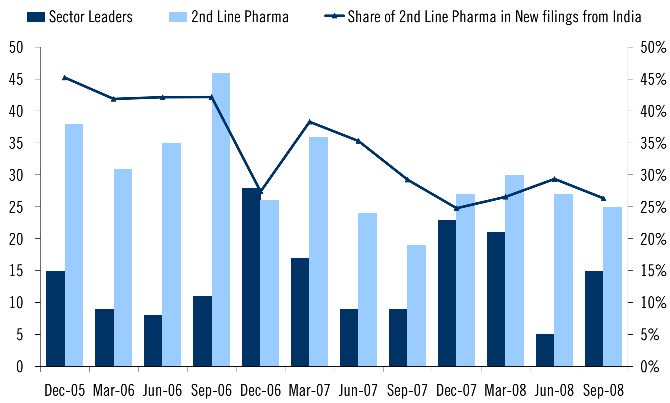
Source: ORG IMS, CRIS INFAC

Figure 46. Indian DMF filings (by quarter)



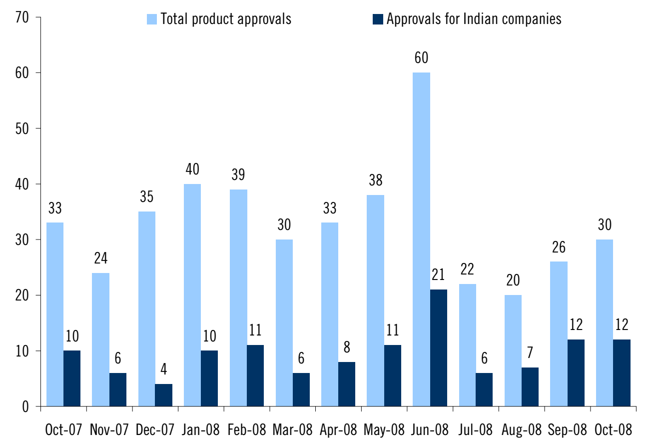
Source: Citi Investment Research

Figure 47. Indian DMF filings (by quarter) – Sector Leaders vs. 2nd line Co



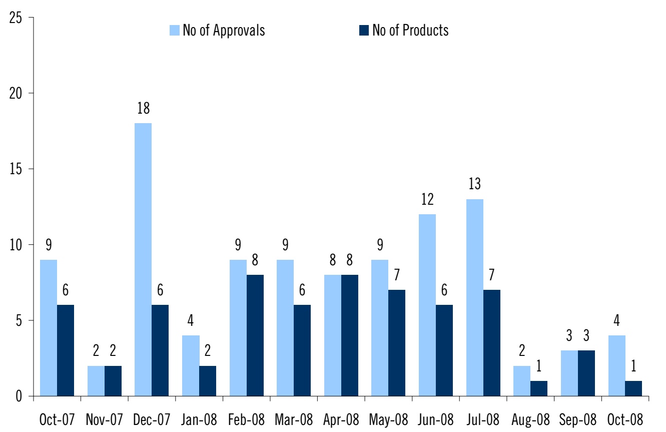
Source: Citi Investment Research

Figure 48. US ANDA Approvals



Source: Citi Investment Research

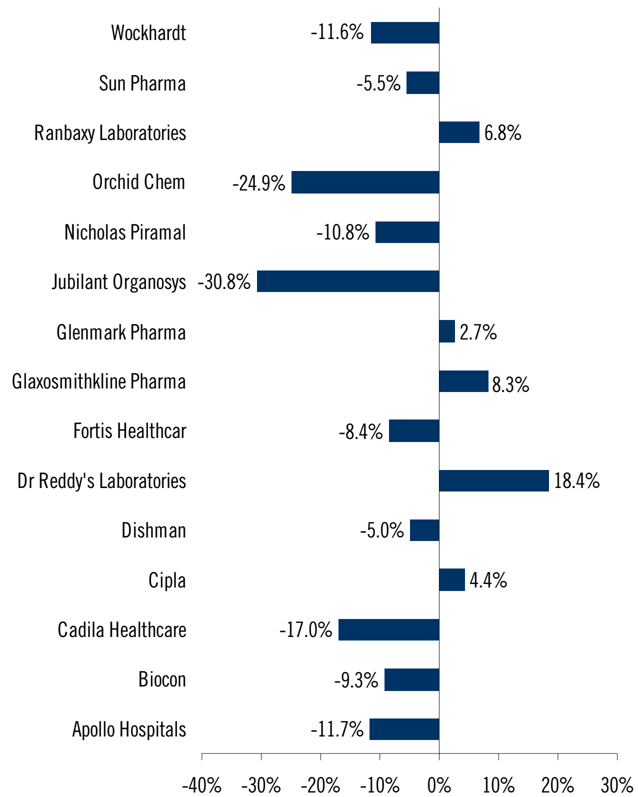
Figure 49. US ANDA Approvals for First Time Generics



Source: Company Reports

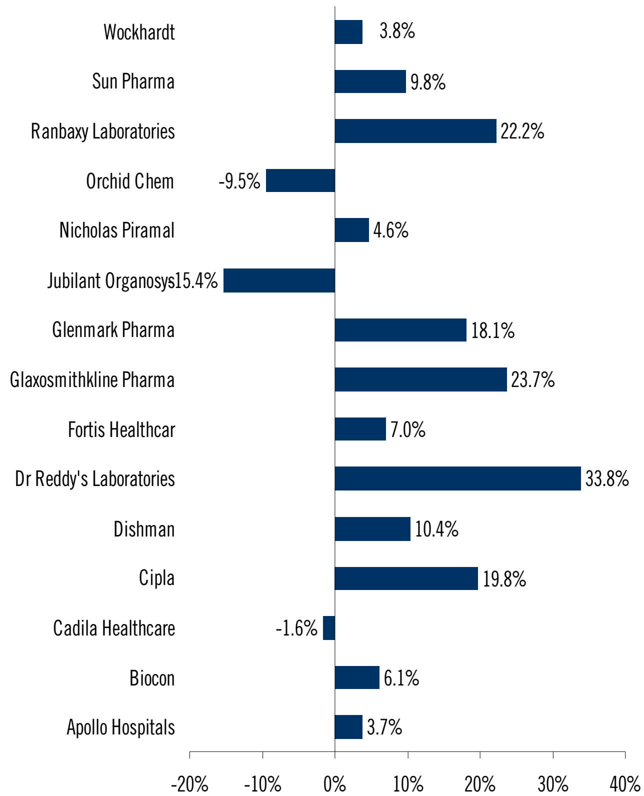
Indian Pharma – Taking Stock

Figure 50. Absolute Performance – Nov 2008 (%)



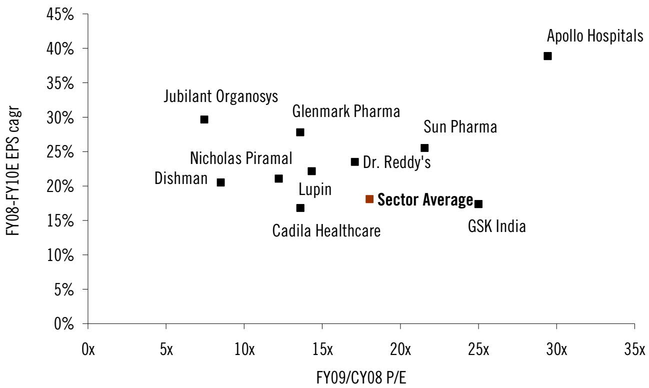
Source: Citi Investment Research

Figure 51. Relative Performance – Nov 2008 (%)



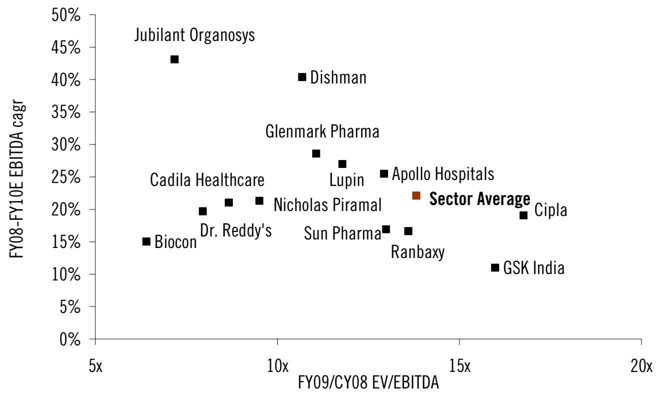
Source: Citi Investment Research

Figure 52. Indian Pharma – FY09 P/E vs. EPS CAGR (%)



Source: Citi Investment Research

Figure 53. Indian Pharma – FY09 EV/EBITDA vs. EBITDA CAGR (%)



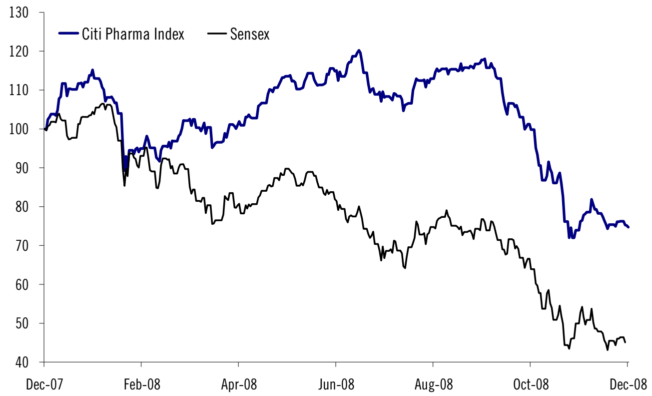
Source: Citi Investment Research

Figure 54. India Pharmaceutical and Healthcare Sectors – Stock Performances (Rs, Million shares)

	RIC	Price	Average Volume		Absolute Performance					Performance relative to Sensex				
	code	03 Dec 08	1- week	12m trailing	1week	1m	3m	6m	12m	1week	1m	3m	6m	12m
Apollo Hospitals	APLH.BO	359	0.06	0.09	-4.6%	-11.7%	-31.1%	-26.4%	-26.9%	-1.5%	3.7%	10.8%	17.2%	28.3%
Biocon	BION.BO	92	0.19	0.32	-6.1%	-9.3%	-54.1%	-60.1%	-67.9%	-3.0%	6.1%	-12.2%	-16.5%	-12.6%
Cadila Healthcare	CADI.BO	225	0.00	0.04	-0.3%	-17.0%	-33.1%	-22.9%	-21.7%	2.8%	-1.6%	8.8%	20.8%	33.5%
Cipla	CIPL.BO	183	1.63	1.61	-5.5%	4.4%	-23.1%	-11.5%	-0.7%	-2.4%	19.8%	18.7%	32.1%	54.5%
Dishman	DISH.BO	124	0.11	0.08	-9.8%	-5.0%	-60.9%	-60.6%	-54.4%	-6.7%	10.4%	-19.0%	-17.0%	0.8%
Dr Reddy's Laboratories	REDY.BO	478	0.85	0.48	12.6%	18.4%	-19.3%	-28.7%	-27.4%	15.7%	33.8%	22.6%	14.9%	27.8%
Fortis Healthcare	FOHE.BO	60	0.11	0.84	-1.6%	-8.4%	-20.1%	-17.3%	-28.9%	1.5%	7.0%	21.7%	26.3%	26.3%
Glaxosmithkline Pharma	GLAX.BO	1,190	0.04	0.06	3.5%	8.3%	0.7%	9.2%	25.3%	6.6%	23.7%	42.5%	52.9%	80.6%
Glenmark Pharma	GLEN.BO	317	0.45	0.54	-2.2%	2.7%	-52.2%	-51.3%	-31.5%	0.8%	18.1%	-10.3%	-7.7%	23.7%
Jubilant Organosys	JUBO.BO	115	0.07	0.09	-9.8%	-30.8%	-67.5%	-66.2%	-61.6%	-6.7%	-15.4%	-25.6%	-22.6%	-6.4%
Piramal Healthcare*	PIRA.BO	217	0.04	0.25	2.9%	-10.8%	-34.8%	-41.4%	-29.4%	6.0%	4.6%	7.1%	2.2%	25.8%
Orchid Chem & Pharma	ORCD.NS	81	0.52	5.34	-1.6%	-24.9%	-68.1%	-64.8%	-67.7%	1.5%	-9.5%	-26.2%	-21.2%	-12.5%
Ranbaxy Laboratories	RANB.BO	203	1.49	3.47	-4.7%	6.8%	-58.6%	-60.8%	-47.6%	-1.6%	22.2%	-16.7%	-17.2%	7.6%
Sun Pharma	SUN.BO	1,045	0.53	0.34	-5.4%	-5.5%	-31.7%	-23.8%	-3.6%	-2.3%	9.8%	10.1%	19.8%	51.7%
Wockhardt	WCKH.BO	95	0.04	0.13	2.7%	-11.6%	-52.9%	-64.2%	-75.9%	5.8%	3.8%	-11.0%	-20.6%	-20.7%

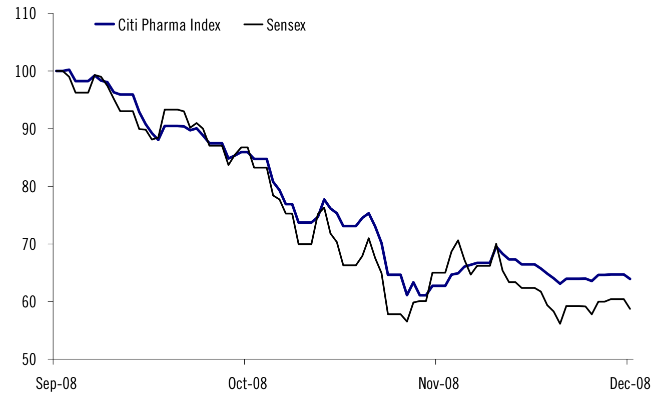
Source: Citi Investment Research estimates; *Absolute & relative performance change does not reflect the demerger of the R&D entity into Piramal Lifesciences

Figure 55. Indian Pharma Performance Relative to Sensex – last 12 months



Source: Citi Investment Research

Figure 56. Indian Pharma Performance Relative to Sensex –last 3 months



Source: Citi Investment Research

Global Valuation Maps

Figure 57. Global Generics Valuation Map

	RIC	CIR Rating	Price 05-Dec-08	MarketCap (US$ m)	PE CY08	PE CY09	EPS CAGR CY07-09E	EV/Sales CY08	EV/Sales CY09	Stock Performance 2006	Stock Performance 2007	Stock Performance YTD 2008
US Generics												
Barr Labs	BRL.N	NR	64	6,992	22.4	17.5	12%	n/a	n/a	-20%	6%	20%
Mylan Lab	MYL.N	NR	9	2,864	15.4	9.9	-16%	n/a	n/a	0%	-30%	-33%
Watson Pharma	WPI.N	NR	23	2,385	12.1	11.8	22%	n/a	n/a	-20%	4%	-16%
Teva	TEVA.O	NR	42	34,500	15.4	14.3	13%	n/a	n/a	-28%	50%	-9%
Weighted Average					**16.3**	**14.4**	**12%**	**-**	**-**	**-24%**	**36%**	**-6%**
Indian Pharma												
Biocon	BION.BO	3H	96	386	9.2	8.9	-28%	1.2	1.0	-25%	56%	-67%
Cadila Healthcare	CADI.BO	3M	261	659	9.5	8.6	17%	1.3	1.1	43%	-10%	-17%
Cipla	CIPL.BO	3M	184	2,866	19.3	17.1	15%	3.1	2.7	41%	-15%	-14%
Dr. Reddy's	REDY.BO	2M	475	1,608	14.7	11.8	4%	0.9	0.9	66%	-9%	-35%
Glenmark Pharma	GLEN.BO	1H	313	1,575	11.2	8.7	33%	3.4	2.6	91%	98%	-47%
Lupin	LUPN.BO	1M	582	967	12.0	9.9	24%	1.7	1.5	60%	4%	-8%
Ranbaxy	RANB.BO	2H	209	1,762	48.9	21.5	-14%	1.4	1.0	8%	9%	-51%
Sun Pharma	SUN.BO	1M	1,009	4,197	18.0	14.5	26%	5.0	4.0	44%	41%	-17%
Weighted Average					**19.6**	**13.9**	**15%**	**3.0**	**2.4**	**45%**	**22%**	**-27%**
European Generics												
Egis	EGIS.BU	3M	10,460	397	7.3	7.3	17%	0.6	0.5	17%	-28%	-44%
Gedeon Richter	GDRB.BU	1M	28,250	2,568	13.6	11.8	14%	1.9	1.7	13%	-4%	-32%
Zentiva N.V.	ZNTVsp.PR	2M	1,055	1,999	22.0	21.0	9%	3.1	2.7	12%	-23%	9%
Novo Nordisk A/S	NOVOb.CO	2M	294	26,538	20.5	18.2	11%	4.0	3.6	33%	42%	-12%
Krka	KRKG.LJ	1L	53	2,398	10.6	10.2	12%	2.3	2.1	83%	59%	-57%
Weighted Average					**19.2**	**11.2**	**11%**	**3.6**	**3.2**	**33%**	**35%**	**-16%**

Source: Citi Investment Research estimates; IBES estimates for non-rated (NR) companies

Figure 58. Global Innovator CRAMS Valuation Map

	RIC Code	CIR Rating	Price 05-Dec-08	M Cap (US$ m)	P/E CY08	P/E CY09	EPS -CAGR CY07-09E	EV/Sales CY08	EV/Sales CY09	Stock Performance 2006	Stock Performance 2007	Stock Performance YTD 2008
Asian CRAMS												
Dishman	DISH.BO	1H	126	204	7.0	5.9	22%	1.6	1.4	31%	49%	-66%
Divi's Laboratories	DIVI.BO	NR	1,226	1,594	17.1	13.1	35%	n/a	n/a	100%	206%	-34%
Jubilant	JUBO.BO	1H	120	356	5.2	4.3	19%	1.2	1.1	12%	43%	-65%
Piramal Healthcare	PIRA.BO	1M	212	892	10.4	8.4	33%	1.6	1.4	-3%	35%	-41%
Wuxi PharmaTech	WX.N	2H	5	300	9.3	8.1	15%	0.8	1.0	n/a	n/a	-83%
Weighted Average					**12.7**	**10.0**	**30%**	**0.7**	**0.7**	**50%**	**114%**	**-46%**
Global CRAMS												
Albany Molecular Research Inc	AMRI.OQ	NR	9	284	17.9	21.0	32%	n/a	n/a	-13%	36%	-37%
Cambrex	CBM.N	NR	3	93	8.4	7.9	-8%	n/a	n/a	21%	-63%	-62%
Charles River Lab	CRL.N	NR	22	1,455	7.8	7.6	5%	n/a	n/a	2%	52%	-67%
Clariant	CLN.VX	3H	7	1,263	5.1	10.3	-43%	0.4	0.3	-4%	-42%	-36%
Covance	CVD.N	NR	35	2,234	11.8	10.5	16%	n/a	n/a	21%	47%	-59%
DSM	DSMN.AS	2M	16	3,652	4.1	6.2	-6%	0.3	0.3	8%	-14%	-51%
Lonza	LONN.VX	2H	90	3,787	13.9	13.5	7%	2.0	1.7	31%	30%	-35%
Parexel	PRXL.OQ	NR	8	433	8.7	7.4	21%	n/a	n/a	43%	67%	-68%
Patheon	PTI.TO	NR	1	75	(4.6)	4.1	n/a	n/a	n/a	-10%	-38%	-66%
Rhodia SA	RHA.PA	NR	5	594	3.1	2.9	15%	n/a	n/a	46%	-17%	-83%
Weighted Average					**9.9**	**10.2**	**5%**	**0.5**	**0.5**	**15%**	**17%**	**-48%**

Source: Citi Investment Research estimates; IBES estimates for non-rated (NR) companies

Figure 59. Global Hospitals Valuation Map

	RIC Code	CIR Rating	Price 5-Dec-08	Market Cap US$m	P/E CY07/ FY08	P/E CY08E/ FY09E	P/E CY09E/ FY10E	EV/EBITDA CY07/ FY08	EV/EBITDA CY08E/ FY09E	EV/EBITDA CY09E/ FY10E	EPS CAGR ('07-09E)	EBITDA CAGR ('07-09E)
Global Hospitals												
Parkway	PARM.SI	3L	1.1	846	10.4	12.7	15.0	7.2	10.7	14.1	-16.6%	-28.4%
Tenet Healthcare Corp	THC.N	3S	1.4	678	(15.3)	(20.2)	(10.8)	7.3	7.2	6.9	19.4%	3.3%
Health Management Associates Inc	HMA.N	2S	1.7	408	2.9	4.3	5.7	6.1	5.6	5.9	-27.9%	1.2%
LifePoint Hospitals Inc	LPNT.O	2H	19.8	1,058	9.1	7.9	8.7	5.7	5.6	5.7	2.0%	0.3%
Community Health Systems Inc	CYH.N	2H	13.5	1,260	7.2	6.2	6.0	10.5	6.7	6.3	9.5%	29.2%
Bumrungrad Hospital	BH.BK	NR	17.2	351	7.8	11.6	12.2	17.4	6.2	6.7	-20.1%	60.6%
Bangkok Dusit Medical Services	BGH.BK	NR	13.9	474	13.4	9.7	8.9	18.4	4.8	4.9	22.4%	93.8%
Bangkok Chain Hospital	KH.BK	NR	6.0	160	12.0	9.6	8.9	9.8	4.9	5.5	16.0%	33.5%
Indian Hospitals												
Apollo Hospitals	APLH.BO	1M	387.2	468	38.5	30.0	22.4	17.3	15.1	12.4	31.1%	18.3%
Fortis Healthcare	FOHE.BO	3H	63.7	290	nm	nm	nm	38.9	49.2	19.8	nm	40.3%
Weighted Average					**7.9**	**6.5**	**7.5**	**11.4**	**9.5**	**8.3**		**17.9%**

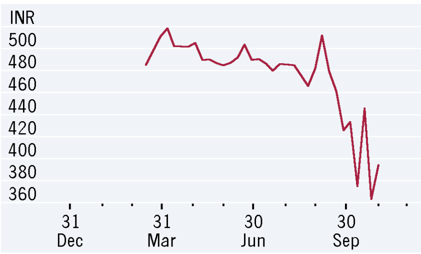
Source: Citi Investment Research estimates; IBES estimates for non-rated (NR) companies

Companies

Apollo Hospitals (APLH.BO)

Buy/Medium Risk	**1M**
Price (05 Dec 08)	Rs387.15
Target price	Rs457.00
from Rs582.00	
Expected share price return	18.0%
Expected dividend yield	2.3%
Expected total return	**20.3%**
Market Cap	Rs23,320M
	US$468M

Price Performance (RIC: APLH.BO, BB: APHS IN)



Buy: Best Play on Indian Healthcare; TP Cut to Rs457

- **Cutting TP to Rs457** — as we lower our EV/EBIDTA multiple to 10x (from 13x earlier). Besides the downward shift in market multiples, this is driven by the fact that Apollo is still in an investment phase and thus remains vulnerable in the current environment. A lower multiple factors in the risk of growth tapering off in case rising cost of capital leads to any deferment of expansion plans.

- **Remains preferred play** — We remain positive on the long-term prospects of Indian healthcare. Apollo is our preferred play, given its scale, national footprint and presence in multiple disease/delivery segments. Its exposure to retail pharmacies & healthcare BPO would also act as a support to valuations.

- **Balance sheet & capital efficiency** — Apollo's balance sheet is sound with conservative net debt/equity of 0.3x, implying reasonable ability to fund future projects. Return ratios are, however, depressed (sub 10%) at the reported level due to the losses in retail pharmacies and the fact that its hospitals business remains in an investment phase.

- **Key catalysts** — We do not see any major catalysts (other than earnings announcements) in the near term for Apollo given the limited news flows in this space. Over the longer term, unlocking of value in its retail pharmacies and healthcare services BPO could aid valuations – although the probability of either happening in the foreseeable future is remote in our view.

- **Key risks** — a) Rising cost of capital could hurt earnings given its capex plans; b) inability to scale up retail pharmacy sales would drag EBDITA – we forecast breakeven in FY10: further delay would hurt estimates; c) currency volatility could affect profitability of its healthcare BPO associate – Apollo Healthstreet.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	671	12.99	7.4	29.8	2.7	9.8	1.3
2008A	771	13.14	1.2	29.5	1.7	7.5	1.4
2009E	1,291	22.00	67.4	17.6	1.7	9.7	2.3
2010E	1,488	25.35	15.2	15.3	1.6	10.5	2.6
2011E	1,751	29.83	17.7	13.0	1.5	11.7	3.1

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	29.8	29.5	17.6	15.3	13.0
EV/EBITDA adjusted (x)	16.3	12.9	9.7	8.2	7.0
P/BV (x)	2.7	1.7	1.7	1.6	1.5
Dividend yield (%)	1.3	1.4	2.3	2.6	3.1
Per Share Data (Rs)					
EPS adjusted	12.99	13.14	22.00	25.35	29.83
EPS reported	18.99	13.14	22.00	25.35	29.83
BVPS	145.88	221.35	233.42	247.34	263.71
DPS	5.00	5.26	8.80	10.14	11.93
Profit & Loss (RsM)					
Net sales	9,495	12,148	14,287	17,295	21,042
Operating expenses	-8,354	-10,829	-12,451	-15,018	-18,179
EBIT	**1,140**	**1,319**	**1,836**	**2,277**	**2,862**
Net interest expense	-270	-382	-281	-443	-622
Non-operating/exceptionals	436	170	310	320	311
Pre-tax profit	**1,306**	**1,106**	**1,866**	**2,154**	**2,551**
Tax	-326	-374	-593	-684	-819
Extraord./Min.Int./Pref.div.	0	39	18	18	18
Reported net income	**981**	**771**	**1,291**	**1,488**	**1,751**
Adjusted earnings	671	771	1,291	1,488	1,751
Adjusted EBITDA	1,548	1,859	2,392	2,927	3,606
Growth Rates (%)					
Sales	25.0	27.9	17.6	21.1	21.7
EBIT adjusted	24.7	15.7	39.2	24.0	25.7
EBITDA adjusted	19.7	20.1	28.7	22.4	23.2
EPS adjusted	7.4	1.2	67.4	15.2	17.7
Cash Flow (RsM)					
Operating cash flow	**1,175**	**-439**	**3,052**	**1,825**	**2,187**
Depreciation/amortization	408	540	556	650	744
Net working capital	-142	-1,420	1,481	-36	-32
Investing cash flow	**-2,133**	**-6,247**	**-2,550**	**-2,600**	**-2,600**
Capital expenditure	-1,566	-2,236	-2,550	-2,600	-2,600
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**980**	**6,891**	**-1,520**	**1,033**	**310**
Borrowings	751	1,743	-178	1,188	945
Dividends paid	-298	-348	-582	-671	-790
Change in cash	**22**	**205**	**-1,018**	**259**	**-103**
Balance Sheet (RsM)					
Total assets	**14,450**	**22,351**	**22,934**	**25,550**	**28,249**
Cash & cash equivalent	2,009	4,869	3,809	3,865	3,962
Accounts receivable	1,089	1,423	1,566	1,801	2,133
Net fixed assets	7,816	9,541	11,535	13,485	15,341
Total liabilities	**6,575**	**9,022**	**8,915**	**10,732**	**12,489**
Accounts payable	1,556	1,810	2,153	2,606	3,171
Total Debt	3,579	5,322	5,144	6,332	7,277
Shareholders' funds	**7,875**	**13,329**	**14,019**	**14,817**	**15,760**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.3	15.3	16.7	16.9	17.1
ROE adjusted	9.8	7.5	9.7	10.5	11.7
ROIC adjusted	8.8	8.2	9.1	10.4	11.7
Net debt to equity	19.9	3.4	9.5	16.6	21.0
Total debt to capital	31.2	28.5	26.8	29.9	31.6

For further data queries on Citi's full coverage universe please contact CIR Data Services Asia Pacific at CIRDataServicesAsiaPacific@citi.com or +852-2501-2791

Powered by: dataCentral

Best Play on Indian H/C; Cut TP to Rs457

We remain positive on the long-term prospects of the Indian healthcare sector. Apollo is our preferred play, given its scale, national footprint and presence in multiple disease/delivery segments. Its exposure to retail pharmacies and healthcare BPO services would also act as a support to valuations. We, however, lower our target price to Rs457/share as we lower our target EV/EBIDTA multiple to 10x (from 13x earlier) in order to factor in the downward shift in overall market multiples as well as the risk to growth in a rising cost of capital environment.

Revising estimates and target price

We marginally lower our FY10 estimates of EBIDTA and EPS by 4% and 5%, respectively, as we factor in: a) higher interest cost in the backdrop of a rising cost of capital environment and b) slower ramp-up in revenues and profitability for the retail pharmacy business. We also introduce FY11 estimates and forecast 20% and 25% CAGRs in revenues and EBIDTA over FY08-11E.

Figure 1. Earnings Revision

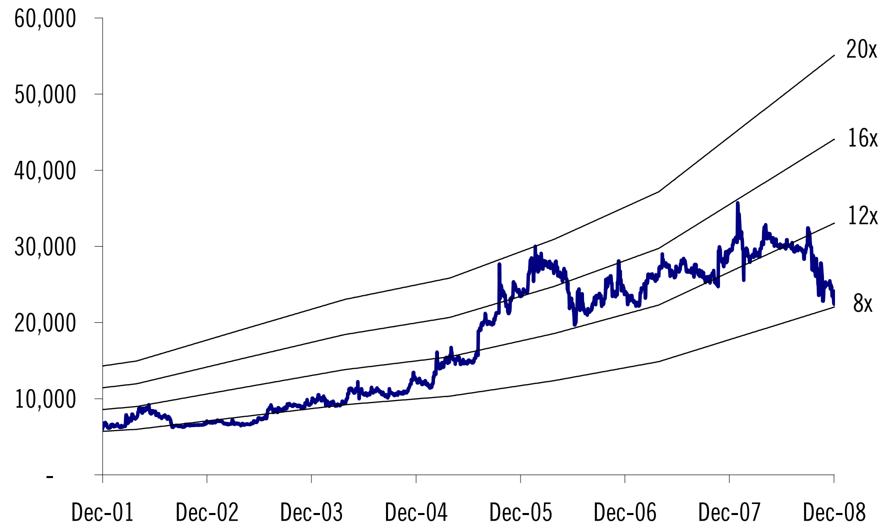
	FY09E	FY10E
Revenues (Rs m)		
New	14,287	17,295
Old	14,287	17,198
Change (%)	0%	1%
EBITDA (Rs m)		
New	2,392	2,927
Old	2,392	3,060
Change (%)	0%	-4%
Net Profit (Rs)		
New	1,291	1,488
Old	1,291	1,567
Change (%)	0%	-5%

Source: Citi Investment Research estimates

Lowering price target to Rs457 – remains a Buy

We cut our target price to Rs457/share as we use a lower target EV/EBITDA multiple – 10x vs. 13x earlier. This is partly due to the downward shift in overall market valuations. However, we also believe that hospital companies remain vulnerable in the current high cost of capital environment. The lower multiple factors in the risk of growth tapering off in case rising cost of capital leads to any deferment of expansion plans.

Figure 2. Apollo Hospitals Ltd. – EV/EBITDA band chart (Rs m)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	1,281
Net Debt/Equity (x)	0.10
Net Debt/EBITDA (x)	0.69
Interest Coverage (EBITDA)	4.9x

Source: Citi Investment Research estimates

Despite being in a capital intensive industry, Apollo's balance sheet is sound with conservative net debt/equity of 0.3x, implying reasonable ability to fund future projects. Funds sourced via the private placement of equity with Apax Partners has strengthened the balance sheet and ensured that there will be no pressing need to slow expansion plans at least for the next two years.

Return ratios are, however, depressed (sub 10%) at the reported level due to the losses in retail pharmacies and the fact that its hospitals business remains in an investment phase. Apollo's investments in other businesses such as healthcare services BPO and health insurance also pull down its return ratios. Low capital efficiency at the reported level is common across hospital companies in India because the industry is in the nascent stage. We are not unduly worried as we believe that at most, efficiently run individual tertiary care hospitals generate 20%+ RoI.

Falling profitability, on account of losses in retail pharmacies and lower asset turnover, due to sizeable investments, have led to significant erosion in return ratios over the last few years

Apollo has been very efficient in consistently improving its fixed asset turnover – implying quick ramp-up in occupancies and pricing in the core hospitals business

Investments/CE represents Apollo's investment in associates and other businesses. This has been a key drain on return ratios; any progress in unlocking value or improving profitability in these businesses would drive improvement

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**12%**	**13%**	**10%**	**10%**	**8%**	**11%**	**12%**
PBIT Margin	**14%**	**13%**	**13%**	**13%**	**13%**	**15%**	**15%**
EBITDA Margin	18%	17%	17%	16%	15%	17%	17%
Depreciation/Sales	5%	5%	5%	4%	4%	4%	4%
Total Asset Turnover (Sales/CE)	**0.88**	**0.97**	**0.77**	**0.79**	**0.64**	**0.73**	**0.80**
Sales/Fixed Assets	1.12	1.30	1.13	1.18	1.24	1.21	1.26
Sales/Net Current Assets	6.25	5.72	4.93	5.65	3.92	8.82	10.45
Inventory Days	24	22	23	23	26	25	24
Debtor Days	51	51	43	42	43	40	38
Investments/Capital Employed	7%	8%	17%	19%	32%	32%	29%
Return on Equity (ROE)	**13%**	**14%**	**9%**	**8%**	**6%**	**9%**	**10%**
Net Margin	5%	6%	7%	6%	7%	8%	8%
Total Asset Turnover	0.88	0.97	0.77	0.79	0.64	0.73	0.80
Leverage (CE/Equity)	2.7	2.3	1.6	1.6	1.5	1.4	1.5

Source: Company data, Citi Investment Research estimates

Apollo Hospitals

Company description

Apollo Hospitals is an integrated healthcare company in India's private sector, with the largest hospital network in Asia. The group and its subsidiaries own 16 hospitals, and it operates 24 hospitals. These hospitals are owned either by joint ventures and associated companies or operated under contracts as franchise hospitals or under consultancy contracts across the Afro-Asian region, with more than 5,000 operational beds. It has a network of more than 2,000 doctors (including more than 1,300 "fee-for-service" doctors), around 2,000 nurses and 1,000 paramedical personnel on its payroll. It also operates a network of primary-care clinics, a medical back-office operation, a health-insurance company and a healthcare staffing company that provides nurses to the UK, the US and other countries. Its retail pharmacy business is one of the largest in India, with a network of 750 outlets.

Investment strategy

We rate Apollo Hospitals Buy/Medium Risk. We are positive on the Indian healthcare delivery market and believe that Apollo is one of the best plays on the burgeoning healthcare opportunity in India. It appears poised to benefit from healthcare opportunities in India, driven by both domestic and international patients, and is ahead of most of its competitors on scale, brand recognition and service offerings. It has an integrated business model that, in addition to hospitals, includes clinics, diagnostic services, pharmacies, telemedicine, and healthcare education and training. The company, which dominates the tertiary-care segment, is pursuing a strategy of expanding its presence in secondary- and tertiary-care markets: secondary hospitals can offer 25-30% higher returns than tertiary hospitals. We expect Apollo's new hospitals and improvements in asset utilization to drive a 20% revenue CAGR and 25% in EBIDTA over FY08-11E.

Valuation

Our target price for Apollo is Rs457/share. While there are few listed comparables in the domestic market, the company has a reasonable and well-diversified global peer group. Some of these are much bigger than Apollo, but we see healthcare growth opportunities as greater in India than in developed markets given the country's current low expenditure and health care penetration. Notionally, P/E and EV/EBITDA relative to earnings growth would seem to be ideal tools to value Apollo, given the high predictability and stability of earnings streams in the healthcare services industry. Yet we believe that this method may not be optimal, since high interest and depreciation charges incurred upfront would lead to earnings not fully reflecting operating performance. We therefore use EV/EBIDTA v/s EBIDTA CAGR as our primary methodology to value Apollo Hospitals. We reduce our target multiple to 10x from 13x earlier to factor in the risk of growth tapering off in case rising cost of capital leads to any deferment of expansion plans – this is towards the lower end of the stock's EV/EBIDTA trading band of 6-20x over the past two to three years.

Risks

We rate Apollo Hospitals Medium Risk based on our quantitative risk-rating system. Main downside risks to our target price and estimates are: 1) Rising cost of capital could hurt earnings given its capex plans; 2) inability to scale up retail pharmacy sales would drag EBDITA – we forecast break-even in FY10: further delay would hurt estimates; 3) currency volatility could affect profitability of its healthcare BPO associate – Apollo Healthstreet.

Biocon (BION.BO)

Sell/High Risk	3H
Price (05 Dec 08)	Rs96.05
Target price	Rs93.00
from Rs122.00	
Expected share price return	-3.2%
Expected dividend yield	2.0%
Expected total return	**-1.2%**
Market Cap	Rs19,210M
	US$386M

Price Performance (RIC: BION.BO, BB: BIOS IN)

Sell: Vulnerable Business Model; TP Cut to Rs93

- **Cutting TP to Rs93 from Rs122** — We reduce our target PE multiple to 9x from 12x. We believe Biocon's business model remains vulnerable and expect the recent string of disappointing results, poor capital efficiency & uncertainty over the tacrolimus opportunity to continue weighing on valuations. Maintain Sell.

- **Vulnerable business model** — The high sensitivity of Biocon’s earnings to delayed launches (tacrolimus recently & the statins earlier) – a common occurrence in generics – shows that its model remains vulnerable despite efforts to build new growth drivers through R&D & foray into formulations. With the research services business also witnessing sustained pressure on margins, growth & return ratios are likely to remain subdued going forward as well.

- **Balance sheet & capital efficiency** — Biocon has net cash of cRs300m and should remain virtually debt free even after its aggressive capex program over next 2-3 years. However, declining profitability (especially in research services) & falling asset turnover have put immense pressure on capital efficiency (RoCE of c12% in FY09E). We expect return ratios to remain subdued going forward.

- **Key catalysts** — a) Licensing deals for oral insulin or T1h molecules; b) Progress in biosimilars legislation in the US and/or any approvals from the EU; c) On tacrolimus, if its partners are able to litigate and secure early entry into the US, it would be positive for valuations and sentiment.

- **Key risks** — a) Disruption in research services (17% of sales & 18% of EBIDTA in FY08) or any delay in scale up of the BMS contract would hurt as it is the most profitable business in Biocon’s mix; b) Failure of its oral insulin or T1h compounds; c) Any fresh bout of pricing pressure in statins (c30% of sales).

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	2,003	10.01	15.1	9.6	1.8	20.5	1.6
2008A	2,160	10.80	7.9	8.9	1.3	16.9	2.6
2009E	1,947	9.73	-9.9	9.9	1.2	12.4	2.0
2010E	2,113	10.56	8.5	9.1	1.0	12.1	2.2
2011E	2,254	11.27	6.7	8.5	1.0	11.8	2.3

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	9.6	8.9	9.9	9.1	8.5
EV/EBITDA adjusted (x)	7.1	6.4	6.5	5.7	5.2
P/BV (x)	1.8	1.3	1.2	1.0	1.0
Dividend yield (%)	1.6	2.6	2.0	2.2	2.3
Per Share Data (Rs)					
EPS adjusted	10.01	10.80	9.73	10.56	11.27
EPS reported	10.01	23.20	7.34	11.44	11.27
BVPS	53.43	74.21	82.52	91.50	100.13
DPS	1.50	2.50	1.95	2.11	2.25
Profit & Loss (RsM)					
Net sales	9,857	10,538	16,767	21,866	23,592
Operating expenses	-7,689	-8,491	-14,964	-19,315	-20,930
EBIT	**2,169**	**2,047**	**1,803**	**2,551**	**2,662**
Net interest expense	-98	-102	-183	-235	-152
Non-operating/exceptionals	39	279	450	180	175
Pre-tax profit	**2,110**	**2,224**	**2,070**	**2,496**	**2,685**
Tax	-169	-129	-166	-312	-336
Extraord./Min.Int./Pref.div.	62	2,544	-435	104	-96
Reported net income	**2,003**	**4,639**	**1,469**	**2,288**	**2,254**
Adjusted earnings	2,003	2,160	1,947	2,113	2,254
Adjusted EBITDA	2,834	2,986	3,084	3,951	4,169
Growth Rates (%)					
Sales	24.9	6.9	59.1	30.4	7.9
EBIT adjusted	8.3	-5.6	-11.9	41.5	4.3
EBITDA adjusted	23.3	5.4	3.3	28.1	5.5
EPS adjusted	15.1	7.9	-9.9	8.5	6.7
Cash Flow (RsM)					
Operating cash flow	**1,511**	**2,608**	**-733**	**2,725**	**3,562**
Depreciation/amortization	665	939	1,281	1,401	1,508
Net working capital	-1,252	172	-3,624	-1,271	-446
Investing cash flow	**-1,912**	**-6,281**	**-383**	**-1,800**	**-1,100**
Capital expenditure	-1,905	-2,325	-4,631	-1,800	-1,100
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**515**	**-431**	**544**	**-894**	**-2,477**
Borrowings	800	-80	999	-400	-1,950
Dividends paid	-285	-351	-456	-494	-527
Change in cash	**114**	**-4,105**	**-572**	**30**	**-15**
Balance Sheet (RsM)					
Total assets	**15,743**	**20,789**	**24,324**	**26,933**	**27,339**
Cash & cash equivalent	87	96	98	97	148
Accounts receivable	3,065	2,591	5,468	6,537	7,053
Net fixed assets	9,145	10,419	13,588	13,987	13,580
Total liabilities	**5,065**	**6,021**	**7,934**	**8,678**	**7,262**
Accounts payable	2,324	2,300	3,179	3,921	4,141
Total Debt	1,868	2,551	3,550	3,150	1,200
Shareholders' funds	**10,678**	**14,768**	**16,389**	**18,255**	**20,077**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	28.8	28.3	18.4	18.1	17.7
ROE adjusted	20.5	16.9	12.4	12.1	11.8
ROIC adjusted	18.0	14.6	9.6	10.4	10.3
Net debt to equity	16.7	16.6	21.1	16.7	5.2
Total debt to capital	14.9	14.7	17.8	14.7	5.6

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Powered by: dataCentral

Vulnerable Business Model; Cut TP to Rs93

We cut our target price on Biocon to Rs93/share as we reduce our target PE multiple to 9x from 12x earlier. We believe Biocon's business model remains vulnerable and expect the recent string of disappointing results, poor capital efficiency and uncertainty over the tacrolimus opportunity to continue weighing on valuations. Maintain Sell/High Risk (3H).

Lowering target price to Rs93/share

We cut our target price on Biocon to Rs93/share (9x Dec'09E earnings) from Rs122/share (12x Sept'09E earnings) earlier. While we have shifted the valuation range for our entire coverage universe down in line with the changed market environment, we continue to value Biocon at a discount to most of its generic peers such as Lupin, Glenmark and Cadila. This is primarily due to its lower earnings CAGR (5% over FY09-11E) and return ratios (c12%). We also believe that the higher vulnerability of Biocon's business model to pricing pressure and delayed product launches / scale-up would continue to keep the stock's multiples on the lower side.

Figure 1. Biocon Ltd – P/E band chart (Rs)

Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Figure 2. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	3,409
Net Debt/Equity (x)	0.21
Net Debt/EBITDA (x)	1.11
Interest Coverage (EBITDA)	16.9x

Source: Citi Investment Research estimates

Biocon had net cash of cRs300m in Sept'08 and should remain virtually debt free even after its aggressive capex program over the next 2-3 years. Although it would have to raise marginal debt in order to service its capex plans, it is very comfortably placed in terms of interest coverage at c17x EBIDTA (FY09E).

However, we believe declining profitability (especially in research services) and falling asset turnover have put immense pressure on capital efficiency (RoCE of c12% in FY09E). We expect return ratios to remain subdued going forward.

Falling profitability & asset turnover have led to significant erosion in return ratios over the last few years

Recent acquisition of Axicorp would drive asset turnover higher but given the very low margins, we do not expect any material change in return on capital

Figure 3. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**25%**	**26%**	**20%**	**17%**	**13%**	**11%**	**12%**
PBIT Margin	**30%**	**30%**	**26%**	**22%**	**22%**	**13%**	**12%**
EBITDA Margin	33%	31%	29%	29%	28%	18%	18%
Depreciation/Sales	3%	3%	4%	7%	9%	8%	6%
Total Asset Turnover (Sales/CE)	**0.84**	**0.85**	**0.77**	**0.76**	**0.59**	**0.82**	**0.99**
Sales/Fixed Assets	2.46	1.23	0.95	1.02	0.99	1.19	1.51
Sales/Net Current Assets	1.34	25.41	7.98	3.87	4.50	2.81	3.02
Inventory Days	58	38	51	60	62	70	70
Debtor Days	80	93	103	114	90	119	109
Investments /Capital Employed	3%	28%	10%	6%	27%	2%	2%
Return on Equity (ROE)	**25%**	**27%**	**19%**	**18%**	**14%**	**12%**	**12%**
Net Margin	26%	28%	22%	20%	20%	11%	10%
Total Asset Turnover	0.84	0.85	0.77	0.76	0.59	0.82	0.99
Leverage (CE/Equity)	1.15	1.14	1.16	1.22	1.20	1.24	1.21

Source: Company reports, Citi Investment Research estimates

Biocon

Company description

Biocon is an integrated biotechnology company in India that encompasses all three critical stages of drug development - drug discovery, development, and manufacturing and commercialization of biopharmaceuticals and enzymes. With more than 25 years of expertise in fermentation technology, the company has built strong capabilities in high-growth segments like statins, immunosuppressants and anti-diabetes. While statins form the major part of its current business, Biocon is aggressively pursuing the biogenerics opportunity in regulated markets and is also making investments in drug discovery research to build a future pipeline.

Investment strategy

We have a Sell/High Risk rating on Biocon in view of the nascent nature of longer-term growth initiatives. Despite several initiatives being taken by the company to emerge as a biotechnology major, Biocon remains primarily an API player with high exposure to the statins segment. Unlike other Indian companies, Biocon does not have the requisite breadth in its product portfolio to overcome the pressure on statins and delays in biogenerics launches. The setbacks on pravastatin and simvastatin in the US in CY06 & tacrolimus in CY08 reflect the high sensitivity of Biocon's earnings to a delayed launch and are an indication of the vulnerability of the company's business model. Overall, we expect a 5% CAGR in net profit for Biocon over FY09-11E, even after factoring in the full impact of statin sales in the US market and aggressive ramp-up in research services as well as insulin and BioMAb sales. Valuations appear expensive relative to the growth outlook and the vulnerability of earnings in the near to medium term.

Valuation

Our target price of Rs93 (Rs122 earlier) for Biocon is based on 9x Dec'09E (v/s 12x Sept '09E earlier) earnings – this is at a discount to our target range for most generic pharma companies in our coverage universe such as Lupin, Glenmark and Cadila. This is due to Biocon's lower earnings CAGR (5% over FY09-11E) and return ratios (c12%). We also believe that the higher vulnerability of Biocon's business model to pricing pressure and delayed product launches /scale-up would continue to keep the stock's multiples on the lower side.

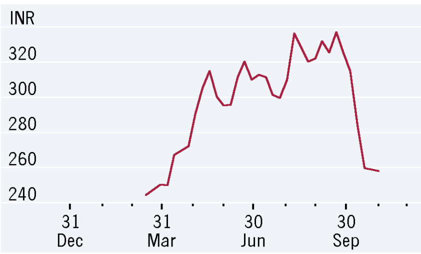
Risks

Our risk rating for Biocon is High Risk, factoring in the current volatility in markets. Our quants-based rating system, which tracks 260-day historical share price volatility, suggests Medium Risk. The main downside risks to our target price and estimates include: 1) Disruption in research services (17% of sales and 18% of EBIDTA in FY08) or any delay in scale up of the BMS contract would hurt as it is the most profitable business in Biocon's mix; 2) failure of its oral insulin or T1h compounds; 3) any fresh bout of pricing pressure in statins (c30% of sales). The main upside risks to our target price and estimates include: 1) licensing deals for oral insulin or T1h molecules; 2) progress in biosimilars legislation in the US and/or any approvals from the EU; 3) On Tacrolimus, if its partners are able to litigate and secure early entry into the US, it would be positive for valuations and sentiment.

Cadila Healthcare (CADI.BO)

Sell/Medium Risk	**3M**
from Buy/Medium Risk	
Price (05 Dec 08)	Rs261.35
Target price	Rs231.00
from Rs383.00	
Expected share price return	-11.6%
Expected dividend yield	1.5%
Expected total return	**-10.1%**
Market Cap	Rs32,829M
	US$659M

Price Performance (RIC: CADI.BO, BB: CDH IN)



Downgrade to Sell: TP Cut to Rs231

- **Downgrade to Sell** — This is a valuation call, as we shift our coverage universe to a lower valuation band and focus on balance sheet and capital efficiency. We cut our target P/E for Cadila to 9x, yielding a TP of Rs231. Given the lack of differentiation and no major catalyst in sight, we believe the stock will be unable to command higher valuations as multiples contract across the board.

- **Cut TP to Rs231** — as we use a lower target P/E of 9x (16x earlier) – c35% discount to the sector leaders, yielding a base business valuation of Rs205. We believe this is justified, given the low differentiation in the business, smaller scale & relatively illiquid nature of the stock. We also value the Nycomed JV at Rs10/share and the entitlement to Carnation shares at Rs16/share.

- **Balance sheet & capital efficiency** — Cadila net D/E is comfortable at 0.5x & should hold it in good stead going forward. Capital efficiency is, however, subdued, reflecting the competitive nature of the business. Reported RoCE & RoE are misleading, being buoyed by the Nycomed JV – a highly profitable, but finite, business. Excluding this, RoCE is subdued at c14% for FY09E, although we expect this to improve over the next 2-3 years on better asset T/O.

- **Key catalysts** — a) Faster than expected scale-up in the Hospira JV – commercialization in 2HFY09; b) commencement of new API supplies to Nycomed as part of the Zydus Nycomed JV.

- **Key risks** — a) Greater than expected erosion in Zydus Nycomed would impair margins; b) inability to scale up the Hospira JV (oncology) to be negative, being one of the few niche areas it is present in; c) high exposure to India makes it vulnerable to any significant widening of the price control net.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	2,327	18.53	52.7	14.1	3.8	29.7	1.3
2008A	2,467	19.64	6.0	13.3	3.1	25.6	1.5
2009E	3,390	24.84	26.5	10.5	2.7	28.3	1.5
2010E	3,657	26.79	7.9	9.8	2.2	24.7	1.5
2011E	3,969	29.07	8.5	9.0	1.8	22.1	1.5

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	14.1	13.3	10.5	9.8	9.0
EV/EBITDA adjusted (x)	9.8	8.5	7.1	6.0	5.3
P/BV (x)	3.8	3.1	2.7	2.2	1.8
Dividend yield (%)	1.3	1.5	1.5	1.5	1.5
Per Share Data (Rs)					
EPS adjusted	18.53	19.64	24.84	26.79	29.07
EPS reported	18.53	19.64	24.84	26.79	29.07
BVPS	68.91	84.57	97.87	119.48	143.37
DPS	3.50	4.00	4.00	4.00	4.00
Profit & Loss (RsM)					
Net sales	18,547	23,245	28,918	33,377	37,056
Operating expenses	-15,590	-19,616	-24,152	-27,779	-30,935
EBIT	**2,957**	**3,629**	**4,767**	**5,598**	**6,121**
Net interest expense	-234	-444	-708	-1,035	-1,139
Non-operating/exceptionals	5	-60	58	56	48
Pre-tax profit	**2,728**	**3,125**	**4,116**	**4,619**	**5,030**
Tax	-324	-613	-617	-831	-905
Extraord./Min.Int./Pref.div.	-77	-45	-109	-130	-156
Reported net income	**2,327**	**2,467**	**3,390**	**3,657**	**3,969**
Adjusted earnings	2,327	2,467	3,390	3,657	3,969
Adjusted EBITDA	3,780	4,598	5,810	6,737	7,395
Growth Rates (%)					
Sales	24.9	25.3	24.4	15.4	11.0
EBIT adjusted	40.9	22.7	31.3	17.4	9.3
EBITDA adjusted	31.4	21.6	26.4	15.9	9.8
EPS adjusted	52.7	6.0	26.5	7.9	8.5
Cash Flow (RsM)					
Operating cash flow	**2,196**	**1,609**	**2,761**	**3,843**	**4,505**
Depreciation/amortization	823	969	1,044	1,139	1,274
Net working capital	-763	-2,167	-1,781	-1,083	-894
Investing cash flow	**-1,674**	**-4,918**	**-1,500**	**-1,700**	**-1,900**
Capital expenditure	-1,876	-4,927	-1,500	-1,700	-1,900
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-295**	**3,001**	**-654**	**-708**	**-708**
Borrowings	103	3,842	0	0	0
Dividends paid	-398	-841	-708	-708	-708
Change in cash	**227**	**-308**	**608**	**1,435**	**1,897**
Balance Sheet (RsM)					
Total assets	**19,915**	**25,478**	**29,547**	**33,594**	**37,808**
Cash & cash equivalent	990	926	1,534	2,969	4,865
Accounts receivable	2,784	3,555	4,627	5,340	5,929
Net fixed assets	9,783	14,001	14,457	15,018	15,644
Total liabilities	**11,118**	**14,662**	**15,886**	**16,854**	**17,652**
Accounts payable	4,588	4,138	5,147	5,941	6,596
Total Debt	4,535	8,377	8,377	8,377	8,377
Shareholders' funds	**8,797**	**10,816**	**13,661**	**16,740**	**20,156**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	20.4	19.8	20.1	20.2	20.0
ROE adjusted	29.7	25.6	28.3	24.7	22.1
ROIC adjusted	20.2	17.6	19.4	20.3	20.6
Net debt to equity	40.3	68.9	50.1	32.3	17.4
Total debt to capital	34.0	43.6	38.0	33.4	29.4

For further data queries on Citi's full coverage universe please contact CIR Data Services Asia Pacific at CIRDataServicesAsiaPacific@citi.com or +852-2501-2791

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Cut TP to Rs231; Downgrade to Sell

We downgrade Cadila to Sell/Medium Risk (3M) from Buy/Medium Risk (1M) earlier. This is a valuation call, as we shift our coverage universe to a lower valuation band and focus on balance sheet and capital efficiency. We cut our target P/E for Cadila to 9x, yielding a TP of Rs231. Given the lack of differentiation and no major catalyst in sight, we believe the stock will be unable to command higher valuations as multiples contract across the board.

Downgrade to Sell; What has changed?

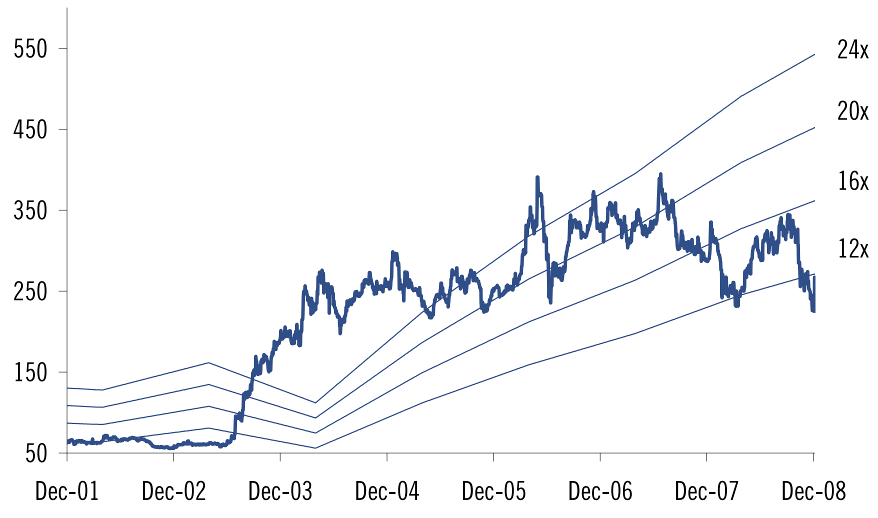
Our downgrade is purely a valuation call based on our revised target price (Rs231/share), which is below the current price.

- **Shifting to a lower multiple (9x vs. 16x earlier)**: We are shifting our entire coverage universe to a lower valuation range in line with the reduction in valuations for the overall market. Besides, in the current tough environment, we are focusing more on balance sheet strength, capital efficiency and differentiation along with liquidity while arriving at our target multiples. Thus, while we lower our target P/E for sector leaders to 14x (from 20x earlier), we also build in a higher valuation discount for companies with subdued return ratios and lower liquidity. We reduce our target P/E for Cadila to 9x from 16x earlier – this represents c35% discount to our target P/E for sector leaders.

- **Lower estimates**: While we raise our FY09 earnings estimate by 11% to factor in higher revenues from the Nycomed JV, we lower our FY10-11E EPS estimates by 2-8% to factor in higher interest cost and potential erosion in the Nycomed business in FY11, as Protonix is fully genericised. This also contributes to our lower target price and Sell rating.

- **Target price of Rs231/share**: At 9x Dec'09E earnings, we value Cadila's base business at Rs205/share. We also value the Nycomed JV at Rs10/share and the entitlement to Carnation shares at Rs16/share, yielding a cumulative target price of Rs231/share, which is below the current share price.

Figure 1. Cadila – P/E band chart (Rs)



Source: Citi Investment Research

Revising estimates

- We raise our revenue estimates for FY09-11E by 3-4% to factor in the following:
  - Weaker INR assumptions – we now use INR47/US$ for FY09E, INR48/US$ for FY10E & INR46/US$ in FY11E
  - Higher sales from the joint venture with Nycomed in FY09 &FY10
  - Lower growth estimates for emerging markets such as Brazil to factor in a potential scenario where distributors and / or companies adopt a more cautious stance given the worsening credit conditions and increasing currency risk
- We, however, incorporate higher interest cost and trim operating margin assumptions for FY10-11, leading to our EPS estimates being lower for FY10 & FY11 by 2% and 8%, respectively.
- Our EPS estimate for FY09 is higher by 11% due to the higher proportion of Zydus Nycomed sales in the top line.

Figure 2. Earnings Revision

	FY09E	F10E	FY11E
Revenue (Rs m)			
New	28,918	33,377	37,056
Old	27,820	32,072	35,862
Change (%)	*4%*	*4%*	*3%*
EPS (Rs)			
New	24.8	26.8	29.1
Old	22.4	27.4	31.7
Change (%)	*11%*	*-2%*	*-8%*

Source: Citi Investment Research estimates

Balance Sheet & Capital Efficiency

Cadila net D/E is comfortable at 0.5x and should hold it in good stead going forward. However, we expect this to increase to around 0.6x by FY09E end to service its capex requirements. Rising interest rates would have some impact on profitability, especially given that debt level is increasing – we have reflected this in our estimates.

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	8,126
Net Debt/Equity (x)	0.61
Net Debt/EBITDA (x)	1.40
Interest Coverage (EBITDA)	8.2x

Source: Citi Investment Research estimates

Capital efficiency has been subdued, reflecting the competitive nature of the business. Reported RoCE and RoE are misleading, being buoyed by the Nycomed JV – a highly profitable, but finite, business. Excluding this, RoCE is subdued at c14% for FY09E, although we expect this to improve over the next 2-3 years on better asset T/O.

Reported RoCE buoyed by the highly profitable Zydus Nycomed JV – which is a finite business

Excluding this, Cadila lags behind its peers both in terms of asset T/O as well as profitability – which, we believe, reflects the lack of differentiation in its generics business

RoE has been magnified by leverage to some extent; as cost of debt goes up, we expect this to shrink to some extent – albeit, not materially

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**18%**	**16%**	**17%**	**20%**	**18%**	**21%**	**21%**
PBIT Margin	**15%**	**14%**	**14%**	**16%**	**16%**	**17%**	**17%**
EBITDA Margin	19%	19%	19%	20%	20%	20%	20%
Depreciation/Sales	6%	6%	5%	4%	4%	4%	3%
Total Asset Turnover (Sales/CE)	**1.13**	**1.19**	**1.19**	**1.28**	**1.14**	**1.24**	**1.27**
Sales/Fixed Assets	1.54	1.62	1.78	1.90	1.66	2.00	2.22
Sales/Net Current Assets	5.12	5.49	4.26	4.19	3.77	3.38	3.01
Inventory Days	54	63	61	77	74	77	77
Debtor Days	61	35	49	55	56	58	58
Investments/Capital Employed	5%	4%	6%	2%	1%	1%	1%
Return on Equity (ROE)	**27%**	**22%**	**23%**	**28%**	**24%**	**26%**	**23%**
Net Margin	12%	10%	11%	13%	11%	12%	11%
Total Asset Turnover	1.13	1.19	1.19	1.28	1.14	1.24	1.27
Leverage (CE/Equity)	2.0	1.8	1.8	1.7	1.9	1.7	1.6

Source: Company data, Citi Investment Research estimates

Cadila Healthcare

Company description

Cadila Healthcare (Zydus Cadila) is an offshoot of the Cadila group, founded in 1952. It split into Cadila Pharma and Cadila Healthcare in 1995. A leading participant in the Indian market, Cadila consolidated its position with the acquisition of Recon Healthcare (1999) and German Remedies (2001). For the overseas markets, it has adopted a combination of the contract manufacturing and generics strategy. As part of its generics strategy, it acquired Alpharma's arm in France in 2003, and also started filing its own ANDAs and DMFs in the US market. On the contract manufacturing front, it has a profitable JV with Altana, and has recently entered into a series of other smaller contracts.

Investment strategy

We rate Cadila Healthcare as Sell/Medium Risk, downgraded from Buy/ Medium Risk earlier. Our downgrade is purely a valuation call based on our revised target price (Rs231/share), which is below the current price. We are shifting our entire coverage universe to a lower valuation range in line with the reduction in valuations for the overall market. Besides, in the current tough environment, we are focusing more on balance sheet strength, capital efficiency & differentiation along with liquidity while arriving at our target multiples. We value Cadila at 9x 12m forward earnings, which is at a 35% discount to sector leaders. Given the lack of differentiation, subdued return ratios & no major catalyst in sight, we believe the stock will be unable to command higher valuations at this point.

Valuation

Our sum-of-parts target price for Cadila is Rs231 (Rs383 earlier) and is derived using a DCF model for the Zydus Nycomed JV, P/E relative to growth for the rest of the business & a market price based valuation for the Carnation shares that Cadila shareholders would receive as a part of the restructuring process.

In valuing Cadila's non-Altana business at Rs205/share (Rs352/share earlier), we use 9x 12-month (16x earlier) forward earnings - a 35% discount to sector leaders and towards the lower end of our target multiples for our mid-cap universe. The discount reflects the pressure on Cadila's return ratios post the genericisation of Protonix. At 9x Dec’09E earnings, we derive a value of Rs205/share for the core business.

We value the Zydus Nycomed (formerly Zydus Altana) JV on DCF given that we expect this business to witness sharp erosion when Protonix goes off patent. We use a three-stage DCF model with explicit forecasts to FY10, beyond which we assume a 95% decline in cash flows (on patent expiry) for one year and 5% terminal growth. Based on the above assumptions and a 15% discount rate, we value Cadila's stake in the JV at Rs10/share.

We also add a value of Rs16/share (Rs20/share earlier) to account for the Carnation shares that Cadila shareholders would receive as part of the restructuring process. This is based on Carnation’s current price of Rs60/share (v/s Rs76/share earlier).

Risks

We have a Medium Risk rating for Cadila as accorded by our quantitative risk-rating system. The main downside risks to our target price include: 1) Greater-than-anticipated price erosion / competition in the US; and 2) Break-up of any of its alliances. The main upside risks to our target price include: 1) Cadila may be able to bag sizable contract manufacturing deals; 2) Any value accretive acquisition by the company in Europe; 3) faster than expected scale up in the Hospira JV.

Cipla (CIPL.BO)

Sell/Medium Risk	**3M**
from Sell/Low Risk	
Price (05 Dec 08)	Rs183.60
Target price	Rs152.00
from Rs200.00	
Expected share price return	-17.2%
Expected dividend yield	1.5%
Expected total return	**-15.7%**
Market Cap	Rs142,711M
	US$2,866M

Price Performance (RIC: CIPL.BO, BB: CIPLA IN)

Sell: Expensive; TP Cut to Rs152/share

- **Maintain Sell** — with a revised target price of Rs152 as we cut our target multiple to 14x (from 20x earlier) in line with the lower valuation range in broader markets. We believe Cipla's business would remain under strain barring the odd upside from exclusivity supplies – this reflects in our EPS estimate for FY10, which is c12% below consensus.
- **We expect multiple correction** — We believe Cipla's supply-based model is vulnerable, given the shift in bargaining power towards a larger & consolidated set of buyers. With growth rates subdued (14% EPS CAGR over FY0E-11E) & capital efficiency under pressure, we believe current multiples will not sustain.
- **Balance sheet & capital efficiency —** Cipla's balance sheet is robust with a low net debt/equity of 0.2x. We believe operating cash flows & marginal increase in debt would suffice to fund capex plans of cRs10bn over FY09-10, thus keeping it virtually debt free. Return ratios have, however, declined to sub 20% levels from above 30% in FY05 due to falling asset T/O & margins. We expect them to remain subdued going forward as well and to weigh on valuations.
- **Key catalysts** — a) The depreciating INR will boost the top line & should help offset the pressure on margins; b) exclusivity opportunities for its partners could provide the occasional surprise, boosting revenues & margins. We note that these are unsustainable & should not affect valuations materially.
- **Key risks** — a) Supply-based model makes it vulnerable to pricing pressure as bargaining power shifts to larger & fewer buyers; b) relatively higher exposure to India (46% of sales) leaves it exposed to any widening of the price control net; c) Rising losses on forward cover positions could affect sentiment.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	6,350	8.17	16.9	22.5	4.4	24.3	1.1
2008A	6,343	8.16	-0.1	22.5	3.8	18.1	1.1
2009E	7,739	9.96	22.0	18.4	3.4	19.5	1.0
2010E	8,562	11.02	10.6	16.7	3.0	19.1	1.5
2011E	9,402	12.10	9.8	15.2	2.6	18.4	1.6

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	22.5	22.5	18.4	16.7	15.2
EV/EBITDA adjusted (x)	17.4	16.7	13.7	12.4	11.3
P/BV (x)	4.4	3.8	3.4	3.0	2.6
Dividend yield (%)	1.1	1.1	1.0	1.5	1.6
Per Share Data (Rs)					
EPS adjusted	8.17	8.16	9.96	11.02	12.10
EPS reported	8.59	9.02	7.65	11.02	12.10
BVPS	41.63	48.31	53.72	61.52	70.07
DPS	2.00	2.00	1.91	2.75	3.02
Profit & Loss (RsM)					
Net sales	35,707	42,309	49,858	56,433	63,563
Operating expenses	-28,478	-35,000	-40,673	-46,130	-52,267
EBIT	**7,229**	**7,309**	**9,186**	**10,304**	**11,296**
Net interest expense	-70	-117	-248	-387	-383
Non-operating/exceptionals	590	521	386	399	414
Pre-tax profit	**7,749**	**7,712**	**9,324**	**10,316**	**11,327**
Tax	-1,400	-1,369	-1,585	-1,754	-1,926
Extraord./Min.Int./Pref.div.	328	667	-1,792	0	0
Reported net income	**6,678**	**7,010**	**5,947**	**8,562**	**9,402**
Adjusted earnings	6,350	6,343	7,739	8,562	9,402
Adjusted EBITDA	8,263	8,616	10,810	12,215	13,364
Growth Rates (%)					
Sales	20.0	18.5	17.8	13.2	12.6
EBIT adjusted	20.5	1.1	25.7	12.2	9.6
EBITDA adjusted	21.5	4.3	25.5	13.0	9.4
EPS adjusted	16.9	-0.1	22.0	10.6	9.8
Cash Flow (RsM)					
Operating cash flow	**2,608**	**2,293**	**4,195**	**4,837**	**8,138**
Depreciation/amortization	1,034	1,307	1,625	1,912	2,068
Net working capital	-5,103	-6,025	-3,376	-5,636	-3,332
Investing cash flow	**-5,133**	**-5,390**	**-5,000**	**-5,000**	**-2,500**
Capital expenditure	-4,192	-5,620	-5,000	-5,000	-2,500
Acquisitions/disposals	-941	231	0	0	0
Financing cash flow	**3,166**	**2,751**	**-360**	**-1,002**	**-6,803**
Borrowings	-3,454	4,570	2,544	2,667	-2,888
Dividends paid	-1,819	-1,819	-1,739	-2,504	-2,750
Change in cash	**641**	**-346**	**-1,165**	**-1,165**	**-1,165**
Balance Sheet (RsM)					
Total assets	**44,135**	**57,326**	**66,206**	**76,251**	**82,880**
Cash & cash equivalent	2,488	1,732	1,435	1,435	1,435
Accounts receivable	10,288	14,065	16,480	19,591	22,066
Net fixed assets	14,613	18,945	22,320	25,409	25,841
Total liabilities	**11,775**	**19,774**	**24,447**	**28,434**	**28,411**
Accounts payable	7,100	10,128	12,102	13,124	15,665
Total Debt	1,236	5,805	8,349	11,016	8,128
Shareholders' funds	**32,360**	**37,552**	**41,759**	**47,817**	**54,469**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	23.1	20.4	21.7	21.6	21.0
ROE adjusted	24.3	18.1	19.5	19.1	18.4
ROIC adjusted	20.4	15.8	16.3	15.7	15.4
Net debt to equity	-3.9	10.8	16.6	20.0	12.3
Total debt to capital	3.7	13.4	16.7	18.7	13.0

For further data queries on Citi's full coverage universe please contact CIR Data Services Asia Pacific at CIRDataServicesAsiaPacific@citi.com or +852-2501-2791

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Expensive; Cut TP to Rs152/share

We maintain our Sell rating on Cipla with a revised target price of Rs152 as we cut our target multiple to 14x (from 20x earlier) in line with the lower valuation range in broader markets. We believe Cipla's business would remain under strain barring the odd upside from exclusivity supplies. In our view, Cipla's supply-based model is vulnerable, given the shift in bargaining power towards a larger & consolidated set of buyers. With growth rates subdued (14% EPS CAGR over FY0E-11E) & capital efficiency under pressure, we believe current multiples will not sustain.

Revising estimates & target price

We raise our FY09-10E revenue & earnings estimates marginally by 4% and 4-7% respectively. This is almost entirely due to the weaker INR forecasts – Rs47/ US$ in FY09E and Rs48/US$ in FY10E

Figure 1. Earnings Revision

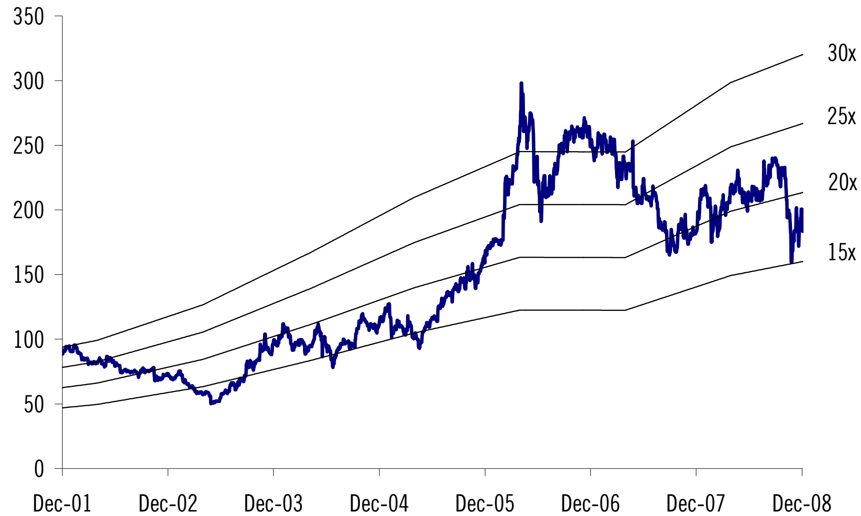
	FY09E	F10E
Revenue (Rs m)		
New	49,858	56,433
Old	48,020	54,010
Change (%)	*4%*	*4%*
EPS (Rs)		
New	10.0	11.0
Old	9.3	10.6
Change (%)	*7%*	*4%*

Source: Citi Investment Research

Cutting target price to Rs152/share

We cut our target price on Cipla to Rs152/share from Rs200/share earlier, as we move to a lower target P/E multiple of 14x from 20x earlier. This reduction is in line with the lower valuation range that we use for our entire coverage universe following the changed market environment & lower market multiple.

Figure 2. Cipla – P/E band chart (Rs)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	8,906
Net Debt/Equity (x)	0.21
Net Debt/EBITDA (x)	0.82
Interest Coverage (EBITDA)	43.6x

Source: Citi Investment Research

Cipla's balance sheet is robust with a low net debt/equity of 0.2x. We believe operating cash flows & marginal increase in debt would suffice to fund capex plans of cRs10bn over FY09-10, thus keeping it virtually debt free.

Despite relatively stable margins across the years, Cipla's return ratios have declined considerably

Lower asset turnover – on fixed assets & working capital – reflect the lower value addition & growing competition / pricing pressure in its business

Return ratios have, however, declined to sub 20% levels from above 30% in FY05 due to falling asset T/O & margins. We expect them to remain subdued going forward as well and to weigh on valuations.

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**27%**	**29%**	**25%**	**23%**	**17%**	**19%**	**18%**
PBIT Margin	**22%**	**23%**	**21%**	**22%**	**19%**	**19%**	**19%**
EBITDA Margin	22%	22%	23%	23%	20%	22%	22%
Depreciation/Sales	2%	2%	3%	3%	3%	3%	3%
Total Asset Turnover (Sales/CE)	**1.25**	**1.23**	**1.17**	**1.03**	**0.94**	**0.97**	**0.94**
Sales/Fixed Assets	3.19	2.67	2.60	2.44	2.23	2.23	2.22
Sales/Net Current Assets	2.54	2.32	2.15	1.88	1.69	1.76	1.66
Inventory Days	108	121	117	100	97	96	99
Debtor Days	95	95	107	105	121	121	127
Investments/Capital Employed	12%	1%	1%	3%	2%	2%	2%
Return on Equity (ROE)	**25%**	**27%**	**26%**	**20%**	**17%**	**19%**	**18%**
Net Margin	16%	18%	18%	18%	15%	16%	15%
Total Asset Turnover	1.25	1.23	1.17	1.03	0.94	0.97	0.94
Leverage (CE/Equity)	1.2	1.2	1.3	1.1	1.2	1.2	1.3

Source: Citi Investment Research

Cipla

Company description

Cipla is a leading pharma company in India with a strong and profitable business model. The company has a well-diversified portfolio, without any overdependence on a particular segment. It has developed a strong presence in the export market — both in developed and developing countries — and has products registered in more than 140 countries. Furthermore, it has been at the forefront in reverse engineering the latest drugs and active pharmaceutical ingredients. The company has focused its R&D efforts on profitable projects, and tied up with the local players in various markets to de-risk its business model. However, the company lags its peers in discovery-led research. Cipla's business model also represents a low-risk model with the commensurate returns also being moderate.

Investment strategy

We rate Cipla Sell (3M) with a target price of Rs152/share. We believe current valuations are still not attractive enough relative to the value add for the business. In addition, Cipla could face an increasingly uncertain global environment, if the current consolidation process gathers momentum. Its partners, which appear inherently tied up because of their weak product capabilities, may get acquired and the acquirers may not want to source drugs from Cipla. We think Cipla's business model lacks significant value addition, both in terms of innovative research as well as control over the front end in the US and European generics markets. We believe that any re-rating will be contingent on the company making fresh forays into these areas and / or getting acquired at a significant premium. Since the pricing pressure has not been waning in the US or Europe, we believe profitability will remain under pressure and volume growth could be lower as the overall pie is being split among several players. Cipla, being one of the weaker parts of the supply chain, will bear the brunt, in our view.

Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs152 (Rs200 earlier) is based on 14x Dec'09E (v/s 20xSept'09E earlier) earnings. The lower multiple is in line with our change in multiples for our entire coverage universe. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector such as Sun Pharma & Glenmark, justified by the lower value addition to the business (lack of its own front-end in the regulated markets and ownership of IPR). There are few signs of this changing. However, while we value the latter's patent challenge opportunities separately from the base business, we are unable to do the same for Cipla, given the lack of information on its tie-ups with different partners. Hence, we apply the same multiple (14x) as we do for Sun & Glenmark to Cipla's base business earnings to factor in any potential "one-off" upsides that may come through from time to time.

Risks

We change our risk rating on Cipla from Low to Medium in line with what our quantitative risk-rating system suggests. The ongoing dispute regarding alleged overcharging for seven drugs in the domestic market could result in significant cash outflow as well as could impact future profitability. Global consolidation is also a risk to the company's supply based model. The new drug policy, if implemented in the current form could also hurt earnings. Key upside risks to our rating and target price include: a) the company doing better operationally than forecast; b) any move to front-end in target markets could give further support to current high valuations; c) any exclusivity for its partners could also sustain the growth momentum beyond our expectations.

Dishman Pharmaceuticals & Chemicals (DISH.BO)

Buy: Cut TP to Rs189; Remain Positive on Business

Buy/High Risk	**1H**
Price (05 Dec 08)	Rs123.60
Target price	Rs189.00
from Rs390.00	
Expected share price return	52.9%
Expected dividend yield	1.5%
Expected total return	**54.4%**
Market Cap	Rs9,974M
	US$200M

Price Performance (RIC: DISH.BO, BB: DISH IN)

- **Maintain Buy but cut TP to Rs189** — We believe Dishman, being a pure play on innovator CRAMS, will benefit from the burgeoning outsourcing opportunity. However, we reduce our target price to Rs189 as we use a significantly lower target P/E of 9x (19x earlier). Besides lower valuations in the broad market, our new multiple reflects a higher discount for the higher execution risk, inferior return ratios & lower market cap/liquidity in Dishman.

- **Balance sheet & capital efficiency** — Dishman is one of the few vulnerable pharma companies on the balance sheet front, with debt of cRs7bn & D/E of c1x. While the leverage boosts RoE to c23%, RoCE remains low at c16%. With some of the debt redeemable in Aug'09, we believe Dishman is vulnerable to rising interest cost. However, with most of its capex already completed, it would be able to use cash flows to gradually reduce debt going forward.

- **Key catalysts** — a) Contract with Astra for 14 APIs likely to be finalized by Jan '09 & could add cUS$25m to top line; b) New contract wins from Japan (in talks with several players) & US (stepped up sales initiatives); c) commercial launch of any molecule for which Dishman is providing contract research services.

- **Key risks** — a) Any deferment of outsourcing contracts by partners in the wake of the recent terrorist attacks in Mumbai could affect earnings & valuations; b) any patent challenge on eprosartan mesylate as supplies for this product make up c16% of sales; c) inability to curb losses in its new subsidiaries could hit estimates; & d) higher exposure to international sales (75% of sales) leave it more vulnerable to long-term rupee appreciation.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	928	11.47	77.6	10.8	2.8	36.8	0.9
2008A	1,215	15.02	31.0	8.2	1.7	27.3	0.8
2009E	1,515	18.72	24.7	6.6	1.4	23.3	1.5
2010E	1,765	21.81	16.5	5.7	1.1	21.9	1.8
2011E	2,029	25.08	15.0	4.9	0.9	20.9	2.0

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	10.8	8.2	6.6	5.7	4.9
EV/EBITDA adjusted (x)	11.8	10.5	6.6	5.7	5.1
P/BV (x)	2.8	1.7	1.4	1.1	0.9
Dividend yield (%)	0.9	0.8	1.5	1.8	2.0
Per Share Data (Rs)					
EPS adjusted	11.47	15.02	18.72	21.81	25.08
EPS reported	11.34	14.80	18.72	21.81	25.08
BVPS	43.83	71.89	89.92	109.19	131.33
DPS	1.06	1.01	1.87	2.18	2.51
Profit & Loss (RsM)					
Net sales	5,786	8,031	10,796	12,784	14,181
Operating expenses	-4,898	-6,974	-8,849	-10,464	-11,591
EBIT	**888**	**1,057**	**1,947**	**2,320**	**2,589**
Net interest expense	-189	-339	-456	-552	-538
Non-operating/exceptionals	260	511	201	204	215
Pre-tax profit	**959**	**1,228**	**1,692**	**1,972**	**2,267**
Tax	-32	-13	-178	-207	-238
Extraord./Min.Int./Pref.div.	-9	-18	0	0	0
Reported net income	**917**	**1,197**	**1,515**	**1,765**	**2,029**
Adjusted earnings	928	1,215	1,515	1,765	2,029
Adjusted EBITDA	1,151	1,529	2,535	3,013	3,375
Growth Rates (%)					
Sales	108.5	38.8	34.4	18.4	10.9
EBIT adjusted	68.8	19.0	84.2	19.2	11.6
EBITDA adjusted	78.0	32.8	65.8	18.9	12.0
EPS adjusted	77.6	31.0	24.7	16.5	15.0
Cash Flow (RsM)					
Operating cash flow	**460**	**501**	**1,504**	**1,805**	**2,771**
Depreciation/amortization	263	472	588	693	786
Net working capital	-835	-1,386	-1,131	-1,282	-662
Investing cash flow	**-4,176**	**-2,532**	**-2,004**	**-2,018**	**-1,694**
Capital expenditure	-1,010	-2,694	-1,580	-1,500	-1,200
Acquisitions/disposals	-3,150	0	0	0	0
Financing cash flow	**2,752**	**2,053**	**204**	**194**	**-987**
Borrowings	2,777	1,938	172	400	-750
Dividends paid	-55	-89	-177	-206	-237
Change in cash	**-963**	**22**	**-297**	**-20**	**90**
Balance Sheet (RsM)					
Total assets	**11,594**	**14,930**	**17,614**	**19,784**	**21,194**
Cash & cash equivalent	355	371	74	54	145
Accounts receivable	1,252	2,042	2,375	2,685	2,836
Net fixed assets	5,943	8,168	9,160	9,966	10,380
Total liabilities	**8,429**	**9,201**	**10,339**	**10,950**	**10,569**
Accounts payable	656	603	1,619	1,662	1,843
Total Debt	5,609	6,580	6,752	7,152	6,402
Shareholders' funds	**3,165**	**5,728**	**7,275**	**8,833**	**10,625**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	19.9	19.0	23.5	23.6	23.8
ROE adjusted	36.8	27.3	23.3	21.9	20.9
ROIC adjusted	13.7	9.8	13.0	13.5	13.6
Net debt to equity	166.0	108.4	91.8	80.3	58.9
Total debt to capital	63.9	53.5	48.1	44.7	37.6

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Powered by: dataCentral

Cut TP to Rs189; Remain Positive

We believe Dishman, being a pure play on innovator CRAMS, will benefit from the burgeoning outsourcing opportunity. However, we reduce our target price to Rs189 as we use a significantly lower target P/E of 9x (19x earlier). Besides lower valuations in the broad market, our new multiple reflects a higher discount for the higher execution risk, inferior return ratios & lower market cap/liquidity in Dishman. Maintain Buy/High Risk (1H)

Revising estimates & target price

Figure 1. Earnings Revision

	FY09E	F10E
Revenue (Rs m)		
New	10,796	12,784
Old	10,385	12,128
Change (%)	4%	5%
EPS (Rs)		
New	18.7	21.8
Old	18.6	22.4
Change (%)	1%	-3%

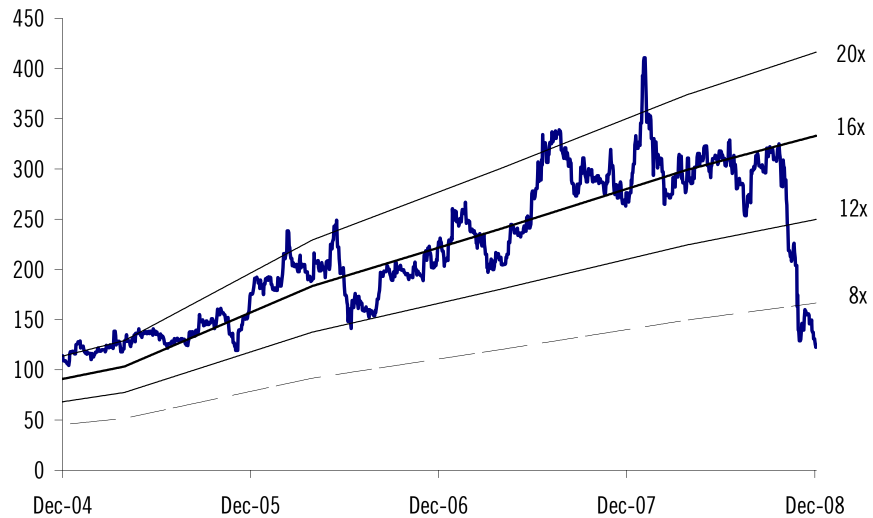
Source: Citi Investment Research

- We raise our FY09-10E revenue estimates by 4-5% as we factor in the weaker INR into our estimates. We now use INR47/US$ for FY09E and INR48/US$ for FY10E.
- We also factor in higher interest cost given the rising cost of capital, some refinancing requirements starting August 2009 and the high debt on Dishman's balance sheet.
- Consequently, our recurring net profit & EPS estimates are higher by 1% in FY09 and lower by 3% in FY10.
- We also introduce FY11 estimates and forecast FY08-11E revenue & recurring EPS CAGRs of 21% and 19% respectively.

Cutting target price to Rs189/share

We reduce our target price on Dishman significantly to Rs189/share from Rs390/share as we move to a target P/E multiple of 9x from 19x earlier. While this is partly on the back of an overall downward shift in sector multiples, we also use a much higher discount for Dishman to the sector leaders (who we value at 14x). This is on account of its higher leverage (and therefore susceptibility to rising cost of capital), smaller size (consequently higher execution risk) and lower market cap/liquidity. At 9x Dec '09 EPS, we arrive at a value of Rs189/share for the company.

Figure 2. Dishman – P/E band chart (Rs)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	6,989
Net Debt/Equity (x)	0.96
Net Debt/EBITDA (x)	2.76
Interest Coverage (EBITDA)	5.6x

Source: Citi Investment Research

Dishman is one of the few vulnerable pharma companies on the balance sheet front, with debt of cRs7bn and D/E of c1x. Of this around Rs5bn is foreign currency debt, while the rest is rupee denominated working capital loans. With some of the debt redeemable in Aug'09, we believe Dishman is vulnerable to rising interest cost. However, with most of its capex already completed & reasonable cash flows from operations, we believe it would be able to gradually reduce debt going forward.

While the leverage boosts RoE to c23%, RoCE remains low at c16%. Dishman has been in an investment phase as it builds capacity in the CMG business. Revenues have not yet started scaling up at the same pace, which has led to deterioration in RoCE despite some improvement in profitability. We expect this trend to change to some extent over the next few years, as it has seen some traction in terms of new contracts – Astra's recent decision to outsource 14 APIs from Dishman being one of them.

Despite reasonably steady profitability in the past, Dishman's return ratios have been affected by falling asset T/O

Some improvement over FY07-08 in terms of fixed assets & working capital turnover have offset the negative impact of lower profitability

Dishman has leveraged up returns (RoE) in the past & could be hurt more than its peers in a rising interest cost scenario

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**20%**	**17%**	**13%**	**13%**	**13%**	**15%**	**15%**
PBIT Margin	**22%**	**24%**	**24%**	**20%**	**20%**	**20%**	**20%**
EBITDA Margin	25%	27%	23%	20%	19%	23%	24%
Depreciation/Sales	5%	4%	4%	5%	6%	5%	5%
Total Asset Turnover (Sales/CE)	**0.95**	**0.70**	**0.54**	**0.65**	**0.64**	**0.76**	**0.78**
Sales/Fixed Assets	1.50	1.37	1.31	0.96	0.96	1.16	1.26
Sales/Net Current Assets	2.57	1.45	0.95	2.08	1.95	2.18	2.06
Inventory Days	127	159	142	188	139	142	142
Debtor Days	67	131	114	79	93	80	77
Investments/Capital Employed	0%	0%	1%	2%	0%	0%	0%
Return on Equity (ROE)	**31%**	**23%**	**28%**	**29%**	**21%**	**21%**	**20%**
Net Margin	12%	18%	19%	16%	15%	14%	14%
Total Asset Turnover	0.95	0.70	0.54	0.65	0.64	0.76	0.78
Leverage (CE/Equity)	2.7	1.8	2.7	2.8	2.2	2.0	1.8

Source: Citi Investment Research

Dishman Pharmaceuticals & Chemicals

Company description

Dishman commenced operations in 1989 as a Quats manufacturer and has since transformed itself to focus on intermediates/ API manufacturing – with a specific focus on innovator CRAMS. Dishman ventured into CRAMS with a contract to manufacture eprosartan mesylate for Solvay for the European market. Since then, Dishman has entered into contracts with various other pharma companies including GSK, AstraZeneca and Nippon Gosai. In 2006, Dishman acquired Carbogen Amcis from Solutia. With this, Dishman has the complete CRAMS basket for innovator pharma companies from building blocks to the commercialization stage.

Investment strategy

We have a Buy/High Risk (1H) rating on Dishman. We believe that Dishman is the Indian pharma company most leveraged to the innovator CRAMS opportunity - especially post the acquisition of Carbogen Amcis - with c75% of its revenues coming from this segment. Over the past two years, Dishman has grown in scale as well as diversified its customer and revenue bases. With synergies from the Carbogen Amcis acquisition expected to play out over the next 1-2 years and with rapid growth in its Indian business, we expect Dishman to report a 19% CAGR in recurring earnings over FY08-11E.

Valuation

Given that Pharma is a growth sector, we use P/E as our primary method to value the base business of every company. At the same time, since many pharma companies have some unique opportunities that could play out, we ascribe a separate value for these. For Dishman, we use a target P/E multiple of 9x (v/s 19x earlier), which is at a 35% (v/s 5% earlier) discount to our target multiple for Piramal Healthcare, which is the leader in the innovator CRAMS segment. We believe that a higher discount is now justified given Dishman's relatively smaller size & pipeline, higher leverage, inferior return ratios & lower market cap/liquidity. In its limited trading history of less than 5 years, Dishman has traded in a band of 6-26x 1-year forward earnings. Our target P/E of 9x is towards the lower end of this band given the higher risk aversion on the street. At 9x Dec '09E EPS we value Dishman at Rs189/share.

Risks

Our risk rating for Dishman is High Risk, as reflected in our quantitative risk-rating system, which tracks 260-day historical share price volatility. The high risk rating is to account for the greater uncertainty in the underlying market and consequent volatility in smaller cap stocks.

Regulatory risks - Delays in the execution of various contracts due to delays in regulatory approvals or any adverse outcome at the customer end could impact Dishman's revenues and profitability, especially given that Dishman has to build the facilities upfront. Generally, the time lag between entering into a contract and commencement of revenues is around 2-3 years.

Lumpy business - CRAMS revenues tend to be lumpy across quarters and hence the quarterly performance of the company might be volatile.

These risks could impede the stock from achieving our price target.

Dr Reddy (REDY.BO)

Hold/Medium Risk	**2M**
Price (05 Dec 08)	Rs475.45
Target price	Rs535.00
from Rs739.00	
Expected share price return	12.5%
Expected dividend yield	0.9%
Expected total return	**13.5%**
Market Cap	Rs80,076M
	US$1,608M

Price Performance (RIC: REDY.BO, BB: DRRD IN)

Hold: We Remain Cautious; TP Cut to Rs535

- **Maintain Hold** — with a lower TP of Rs535. Despite the optimism on initial results of the AOK tender, we are cautious on the structural changes in Germany (could remain a drag on return ratios) and its exposure to Russia/CIS. While there are longer-term drivers such as biosimilars, patent challenges, etc., we believe the near- to medium-term outlook remains hazy.

- **Cut TP to Rs535** — as we cut FY09-11E EPS by 7-4% & use a lower P/E of 13x (18x earlier) for its base business. We value DRL at a c10% discount to other sector leaders, primarily due to its inferior return ratios & the uncertainty in the German market. We also remove the value ascribed to Perlecan (Rs10) & Balaglitazone (Rs7) from our TP & increase option value for its P-IV pipeline to Rs23 (from Rs21) to factor in the higher upside from Imitrex.

- **Balance sheet & capital efficiency** — DRL's low net D/E of 0.3x implies good ability to fund future projects. However, return ratios remain depressed (sub 10% RoCE) due to the expensive Betapharm acquisition and troubled times in Germany. We do not see this changing materially over the next 2-3 years and expect it to remain a drag on valuations.

- **Key catalysts** — a) Settlement of Allegra patent challenge with Sanofi; b) Favorable pricing terms and/or volumes in the AOK tender; c) Development of a regulatory pathway for biosimlars in US/EU; and d) Higher than expected upside from Imitrex AG due to Ranbaxy's inability to launch on time.

- **Key risks** — a) Germany (c15% of sales) remains an area of uncertainty; weak pricing could offset benefits of sourcing from India; b) Exposure to Russia/CIS (c8% of sales) exposes it to potential slowdown in growth & credit issues.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	11,099	66.10	712.5	7.2	1.9	34.8	0.8
2008A	4,714	28.03	-57.6	17.0	1.7	10.6	0.9
2009E	5,708	33.94	21.1	14.0	1.5	11.5	0.9
2010E	7,191	42.76	26.0	11.1	1.4	13.1	0.9
2011E	8,322	49.48	15.7	9.6	1.2	13.5	1.2

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	7.2	17.0	14.0	11.1	9.6
EV/EBITDA adjusted (x)	4.2	7.9	6.6	6.3	5.5
P/BV (x)	1.9	1.7	1.5	1.4	1.2
Dividend yield (%)	0.8	0.9	0.9	0.9	1.2
Per Share Data (Rs)					
EPS adjusted	66.10	28.03	33.94	42.76	49.48
EPS reported	55.56	24.70	33.94	42.76	49.48
BVPS	247.62	279.87	308.64	346.22	389.38
DPS	4.00	4.50	4.50	4.50	5.50
Profit & Loss (RsM)					
Net sales	65,096	50,005	64,166	67,560	74,929
Operating expenses	-54,528	-47,599	-57,202	-59,468	-65,506
EBIT	**10,568**	**2,406**	**6,964**	**8,093**	**9,423**
Net interest expense	-3	748	-205	360	360
Non-operating/exceptionals	-63	2	1	-2	-2
Pre-tax profit	**10,502**	**3,156**	**6,760**	**8,451**	**9,781**
Tax	-1,177	989	-1,056	-1,268	-1,467
Extraord./Min.Int./Pref.div.	4	9	4	8	8
Reported net income	**9,329**	**4,154**	**5,708**	**7,191**	**8,322**
Adjusted earnings	11,099	4,714	5,708	7,191	8,322
Adjusted EBITDA	13,909	6,592	8,613	9,443	10,623
Growth Rates (%)					
Sales	168.3	-23.2	28.3	5.3	10.9
EBIT adjusted	nm	-77.2	189.4	16.2	16.4
EBITDA adjusted	984.1	-52.6	30.7	9.6	12.5
EPS adjusted	712.5	-57.6	21.1	26.0	15.7
Cash Flow (RsM)					
Operating cash flow	**8,825**	**3,651**	**832**	**4,695**	**5,387**
Depreciation/amortization	3,341	4,186	1,649	1,350	1,200
Net working capital	-4,265	-2,628	-4,880	-2,504	-2,943
Investing cash flow	**-4,102**	**-7,161**	**-7,000**	**-4,000**	**-4,000**
Capital expenditure	-3,341	-4,338	-7,000	-4,000	-4,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**6,279**	**-5,748**	**-870**	**-870**	**-1,064**
Borrowings	-3,066	-5,007	0	0	0
Dividends paid	-758	-870	-870	-870	-1,064
Change in cash	**11,002**	**-9,258**	**-7,038**	**-175**	**323**
Balance Sheet (RsM)					
Total assets	**85,919**	**85,445**	**90,167**	**95,396**	**102,768**
Cash & cash equivalent	18,588	7,421	383	208	531
Accounts receivable	7,519	6,823	8,790	9,255	10,264
Net fixed assets	12,428	16,765	23,765	27,765	31,765
Total liabilities	**44,330**	**38,378**	**38,259**	**37,159**	**37,265**
Accounts payable	4,755	5,410	6,153	5,553	6,159
Total Debt	24,754	19,542	18,679	18,179	17,679
Shareholders' funds	**41,578**	**47,067**	**51,905**	**58,225**	**65,484**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	21.4	13.2	13.4	14.0	14.2
ROE adjusted	34.8	10.6	11.5	13.1	13.5
ROIC adjusted	54.0	14.7	18.5	16.8	17.0
Net debt to equity	14.8	25.8	35.2	30.9	26.2
Total debt to capital	37.3	29.3	26.5	23.8	21.3

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We Remain Cautious; Cut TP to Rs535

We maintain our Hold/Medium Risk (2M) rating on DRL, with a lower TP of Rs535. Despite the optimism on initial results of the AOK tender, we are cautious on the structural changes in Germany (could remain a drag on return ratios) and its exposure to the Russia/CIS markets. While there are longer-term drivers such as biosimilars, patent challenges, etc., we believe the near- to medium-term outlook remains hazy.

Revising estimates & target price

- We raise our revenue estimates for FY09 by 5% but lower them for FY10-11E by 2-4%. Our revised assumptions factor in the following:
  - Weaker INR assumptions – we now use INR47/US$ for FY09E, INR48/US$ for FY10E & INR46/US$ in FY11E
  - Lower growth estimates for emerging markets such as Russia/CIS to factor in a potential scenario where distributors/companies adopt a more cautious stance given the tightness in credit & currency risk
  - Lower sales (Euro terms) in Germany; however, this is largely offset by weaker INR/Euro assumptions
  - Higher sales of Imitrex AG in the US, following Ranbaxy's inability to launch its version on time
- We lower our profitability estimates for Betapharm (reducing gross margins to c43-45% from c50-52% earlier). This is also largely offset by the upside from a weaker rupee.
- Net of all these, we reduce our EPS estimates by 7%, 1% and 4% for FY09, FY10 & FY11 respectively.

Figure 1. Earnings Revision

	FY09E	F10E	FY11E
Revenue			
New	64,166	67,560	74,929
Old	61,271	68,679	77,772
Change (%)	*5%*	*-2%*	*-4%*
EPS			
New	33.9	42.8	49.5
Old	36.4	43.2	51.6
Change (%)	*-7%*	*-1%*	*-4%*

Source: Citi Investment Research estimates

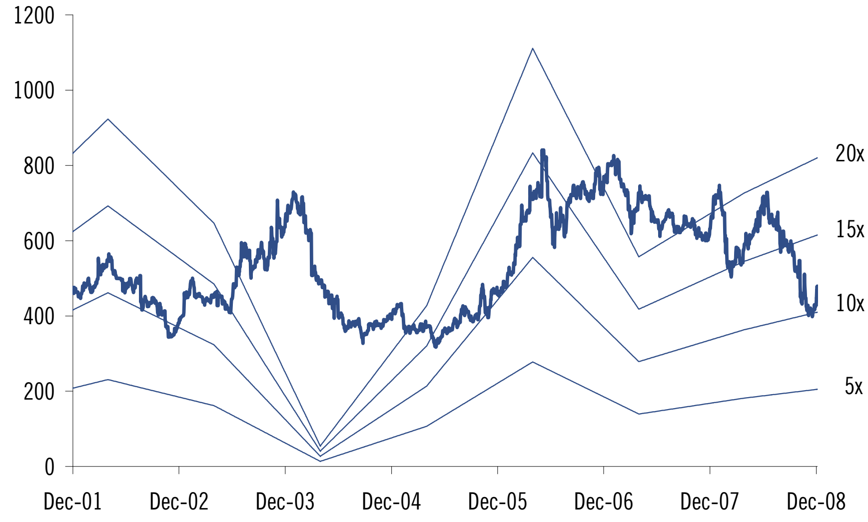
Reducing target price to Rs535/share

We lower our target price to Rs535/share from Rs739/share earlier, primarily on the back of our revised earnings estimates as well as a lower multiple for its core business.

We reduce our target P/E multiple for Reddy's base business to 13x from 18x earlier. We value DRL at a c10% discount to other sector leaders, primarily due to its inferior return ratios & the uncertainty in the German market. At 13x Dec '09 EPS we arrive at a value of Rs511/share for the base business.

We also remove the value ascribed to Perlecan (Rs10) & Balaglitazone (Rs7) from our TP & increase option value for its P-IV pipeline to Rs23 (up from Rs21) to factor in the higher potential upside from Imitrex.

Figure 2. Dr.Reddy's Labs – P/E bands (Rs)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

DRL's low net D/E of 0.3x implies good ability to fund future projects and / or acquisitions. It has a foreign currency denominated loan (Eur210m) on Betapharm, which is long term in nature while rupee loans are largely for working capital. At the same time, it also had cash of Rs5.1bn as at end Sep'08.

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	18,370
Net Debt/Equity (x)	0.35
Net Debt/EBITDA (x)	2.13

Source: Citi Investment Research estimates

However, return ratios remain depressed (sub 10% RoCE) due to the expensive Betapharm acquisition & troubled times in Germany. We do not see this changing materially over the next 2-3 years and expect it to remain a drag on valuations.

Sharp erosion in margins & asset turnover take a heavy toll on return ratios

FY07 numbers inflated by high share of exclusivity /AG supplies in top line

Expensive acquisition of Betapharm & subsequent problems in the German market are the root cause of poor capital efficiency

We expect return ratios to remain subdued over the next few years

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**12%**	**1%**	**3%**	**18%**	**8%**	**10%**	**11%**
PBIT Margin	**13%**	**1%**	**7%**	**19%**	**10%**	**11%**	**13%**
EBITDA Margin	11%	2%	5%	21%	13%	13%	14%
Depreciation/Sales	2%	2%	2%	2%	4%	3%	2%
Total Asset Turnover (Sales/CE)	**0.91**	**0.90**	**0.49**	**0.97**	**0.76**	**0.91**	**0.87**
Sales/Fixed Assets	1.88	1.81	0.50	1.35	0.90	1.03	1.02
Sales/Net Current Assets	1.81	1.81	18.04	3.44	4.77	7.72	6.35
Inventory Days	55	66	104	42	81	81	81
Debtor Days	68	67	72	42	50	50	50
Investments/Capital Employed	1%	1%	0%	0%	0%	0%	0%
Return on Equity (ROE)	**12%**	**1%**	**6%**	**27%**	**10%**	**11%**	**12%**
Net Margin	13%	1%	6%	17%	9%	9%	11%
Total Asset Turnover	0.91	0.90	0.49	0.97	0.76	0.91	0.87
Leverage (CE/Equity)	1.0	1.0	2.2	1.6	1.4	1.4	1.3

Source: Company data, Citi Investment Research estimates

Dr Reddy

Company description

DRL is a leading pharma company in India, with one of the best R&D pipelines. It focuses on value addition by increasing the share of branded formulations and generics exports to regulated markets. After starting as a bulk-drugs player in 1984, it has moved up the value chain and is aiming to become an innovator company. In generics, it is trying to increase the share of sales from regulated markets to boost overall profitability. As part of its inorganic growth strategy, it acquired Betapharm in Germany and is looking at smaller deals going forward.

Investment strategy

We rate DRL Hold/Medium Risk. The company has evolved a business model that is among the best placed to tackle the changing dynamics of the industry. Near-term growth drivers and investment for the longer-term sustainability of growth makes DRL one of the best Indian pharma companies, in our view. At the same time, DRL's presence in patent challenges and drug discovery implies the potential for positive surprises to earnings and valuations. However, our positive view is tempered by DRL being caught on the wrong foot with its acquisition of Betapharm in Germany, given significant changes in regulations and market dynamics. Although these concerns are not new, the impact on the DRL's earnings power appears to be much higher than we had originally anticipated.

Valuation

Our target price for DRL is Rs535 (Rs739 earlier), which is based on a sum-of-the-parts valuation approach. We use a target multiple of 14x (20x earlier) to value sector leaders, which is at a premium of about 50% (40% earlier) to the broad market and seems justified given that the sector is IPR driven and has the potential for significant earnings growth despite the economic slowdown. However, we value DRL at a 10% discount to sector leaders due to the near-term uncertainty on earnings and return ratios – especially on concerns in Germany. At 13xDec'09E (18xSept'09E earlier) earnings, we value DRL's base business at Rs511 (Rs701 earlier). We value DRL's Para IV pipeline separately at Rs23 – this is up from Rs21 earlier due to the higher potential upside from Imitrex AG. For this, we use a success probability of 25% & a discounted cash flow (discount factor 15%) for the opportunities being targeted over the next few years. We have taken out the values that we used to ascribe to DRL's NCE assets (Perlecan Pharma & Balaglitazone – Rs17/share) due to setbacks on these fronts.

Risks

We rate DRL Medium Risk, which is in line with our quant based risk rating system. Downside risks to our target price include: (1) DRL's ramp-up in sales and distribution in the US entails large investments; (2) Patent challenges are win-lose situations and often cause stock-price volatility; (3) R&D success rates are low. Upside risks include: (1) better-than-expected performance in Germany either due to lower pricing pressure or higher savings on sourcing from India could lead to upside to our earnings estimates and target price; (2) any success achieved in either its NCE R&D program or any of its patent challenges could act as a positive catalyst.

Fortis Healthcare (FOHE.BO)

Sell/High Risk	**3H**
Price (05 Dec 08)	Rs63.70
Target price	Rs59.00
from Rs60.00	
Expected share price return	-7.4%
Expected dividend yield	0.0%
Expected total return	**-7.4%**
Market Cap	Rs14,439M
	US$290M

Price Performance (RIC: FOHE.BO, BB: FORH IN)

Maintain Sell: Cautious on Execution

- **Cutting TP to Rs59 on 10x EV/EBIDTA (v/s 12x earlier)** — Besides the downward shift in market multiples, this lower fair-value multiple is driven by Fortis still being in an investment phase and thus remaining vulnerable in the current environment. Growth is at risk of tapering off if rising cost of capital leads to any deferment of expansion plans.

- **Maintain Sell (3H)** — While we remain positive on Fortis' long-term prospects, given its presence in a high growth industry, we believe that upside from current levels remains limited. There are positive signs in the business, especially on the Escorts front. However, given the aggressive expansion plan on a relatively smaller base, we believe execution risk is higher in Fortis.

- **Balance sheet & capital efficiency** — Fortis has a sound balance sheet with net debt/equity of 0.3x, implying good ability to fund projects. Return ratios, however, are very low (RoCE of 2.4% in FY09E), owing to the investment phase and the high price paid for Escorts. While these would improve going forward, we do not expect return ratios to touch double digit levels even by FY11E.

- **Key catalysts** — a) Escorts Delhi has seen an encouraging turnaround in 1H09 (occupancy up to 69%; EBIDTA margins at 13%) and would continue to drive healthy sequential growth in EBIDTA; b) Difficult credit environment may open the doors for more acquisitions, which could act as a catalyst, if accretive.

- **Key risks** — a) Rising cost of capital is likely to put pressure on profitability given the company's aggressive capex plans; b) With the decision to go slow on tie-ups with real estate firms, medium term growth depends on 2 key projects: Shalimar Bagh & Gurgaon – execution delays would be a drag on valuations.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	-963	-5.63	-96.1	-11.3	3.0	-27.9	0.0
2008A	-376	-1.66	70.5	nm	1.3	-5.0	0.0
2009E	81	0.36	121.5	178.8	1.3	0.7	0.0
2010E	312	1.38	286.5	46.3	1.2	2.7	0.0
2011E	767	3.38	145.5	18.8	1.2	6.3	0.0

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	-11.3	nm	178.8	46.3	18.8
EV/EBITDA adjusted (x)	37.4	94.0	18.9	11.9	8.2
P/BV (x)	3.0	1.3	1.3	1.2	1.2
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	-5.63	-1.66	0.36	1.38	3.38
EPS reported	-5.92	-2.45	0.64	1.38	3.38
BVPS	21.55	49.60	50.24	51.61	55.00
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net sales	5,194	5,071	6,566	9,040	11,276
Operating expenses	-5,477	-5,331	-6,123	-8,071	-9,643
EBIT	**-283**	**-260**	**444**	**969**	**1,634**
Net interest expense	-660	-555	-498	-598	-643
Non-operating/exceptionals	10	230	284	125	175
Pre-tax profit	**-933**	**-584**	**229**	**496**	**1,166**
Tax	-73	-16	-50	-149	-350
Extraord./Min.Int./Pref.div.	-7	45	-35	-35	-49
Reported net income	**-1,013**	**-555**	**145**	**312**	**767**
Adjusted earnings	-963	-376	81	312	767
Adjusted EBITDA	555	209	985	1,619	2,409
Growth Rates (%)					
Sales	77.6	-2.4	29.5	37.7	24.7
EBIT adjusted	-29.5	8.1	270.9	118.3	68.7
EBITDA adjusted	139.8	-62.4	372.3	64.3	48.8
EPS adjusted	-96.1	70.5	121.5	286.5	145.5
Cash Flow (RsM)					
Operating cash flow	**331**	**121**	**1,060**	**927**	**1,734**
Depreciation/amortization	838	468	542	650	776
Net working capital	-91	-101	312	-183	-160
Investing cash flow	**-675**	**-2,008**	**-1,500**	**-1,700**	**-1,700**
Capital expenditure	-717	-1,119	-1,500	-1,700	-1,700
Acquisitions/disposals	-10	0	0	0	0
Financing cash flow	**441**	**1,885**	**463**	**763**	**-66**
Borrowings	-422	-2,261	463	763	-66
Dividends paid	0	0	0	0	0
Change in cash	**96**	**-2**	**23**	**-10**	**-32**
Balance Sheet (RsM)					
Total assets	**11,449**	**16,997**	**18,089**	**20,040**	**21,582**
Cash & cash equivalent	307	161	160	150	150
Accounts receivable	918	959	1,313	1,718	2,030
Net fixed assets	5,085	9,533	10,492	11,541	12,466
Total liabilities	**7,568**	**5,539**	**6,475**	**8,079**	**8,773**
Accounts payable	1,065	1,247	1,720	2,561	3,321
Total Debt	5,922	3,755	4,217	4,980	4,914
Shareholders' funds	**3,881**	**11,458**	**11,614**	**11,961**	**12,809**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	10.7	4.1	15.0	17.9	21.4
ROE adjusted	-27.9	-5.0	0.7	2.7	6.3
ROIC adjusted	-3.6	-2.2	2.5	5.0	7.4
Net debt to equity	144.7	31.4	34.9	40.4	37.2
Total debt to capital	60.4	24.7	26.6	29.4	27.7

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Powered by: dataCentral

Cautious on Execution; Maintain Sell

We maintain our Sell (3H) rating on Fortis with a target price of Rs59/share. While we remain positive on Fortis' long-term prospects, given its presence in a high growth industry, we believe that upside from current levels remains limited. There are positive signs in the business, especially on the Escorts front. However, given the aggressive expansion plan on a relatively smaller base, we believe execution risk is higher in Fortis.

Revising estimates & target price

Figure 1. Earnings Revision

	FY09E	FY10E
Revenues (Rs m)		
New	6,566	9,040
Old	8,090	10,506
Change (%)	*-19%*	*-14%*
EBITDA (Rs m)		
New	985	1,619
Old	1,089	1,692
Change (%)	*-10%*	*-4%*
EPS (Rs)		
New	0.4	1.4
Old	(1.4)	0.2
Change (%)	*nm*	*nm*

Source: Citi Investment Research estimates

We revise our estimates for FY09 and FY10 on the back of following factors

- **Revenues**: Our new FY09-10 revenue estimates are lower by 14-19% due to reclassification of Malar Hospitals as an associate company (earlier built into our estimates as a subsidiary) and the delay in commencement of operations in the Navi Mumbai hospital. The former is merely an accounting issue as the contribution from this hospital will now reflect as "share of profit from associate" above the net income line

- **EBIDTA**: Despite a similar adjustment at the EBIDTA level, we reduce our FY09-10 EBITDA estimates by a lower degree (4-10%). This is because of the faster than expected turnaround in the Escorts Delhi hospital witnessed in 1H09. We now build this into our FY09 and FY10 estimates.

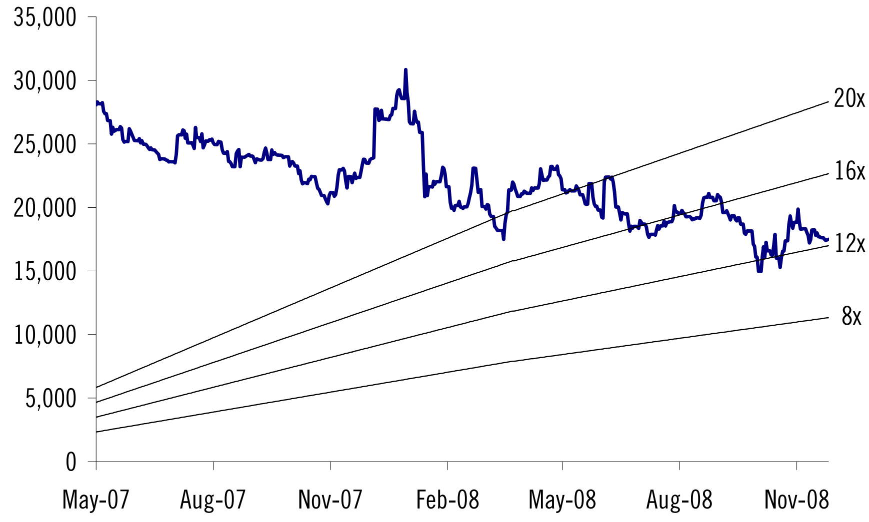
- **Net Profit**: We raise our FY09-10 net profit estimates significantly. A large part of this is because of the change in accounting treatment of goodwill by the company – it now tests for impairment rather than writing it off over a fixed period. This, again, is an accounting change that does not affect the business or our valuations. We also raise interest costs to factor in the higher cost of capital in the current environment. If one ignores the change in accounting treatment for goodwill, our net profit estimates would remain largely unchanged.

- We also introduce FY11 estimates and forecast CAGRs of 31% and 56% in sales and EBIDTA over FY09-11E

Reducing target price to Rs59/share

We cut our target EV/EBITDA multiple to 10x (from 12x earlier). Besides the downward shift in market multiples, this is driven by the fact that Fortis is still in an aggressive investment phase & thus remains vulnerable in the current high cost of capital environment. The lower multiple factors in the risk of growth tapering off in case rising cost of capital leads to any deferment of expansion plans. At 10x FY10E EBITDA, we arrive at a target price of Rs59/share.

Figure 2. Fortis – EV/EBITDA Band (Rs m)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Fortis has a sound balance sheet with net debt/equity of 0.3x, implying good ability to fund projects. The company is still in the process of deploying the funds raised during its IPO. There are expectations that the founders, who recently sold their stake in Ranbaxy, would infuse more funds into the business. However, there is no clarity on how this infusion would happen.

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	3,995
Net Debt/Equity (x)	0.29
Net Debt/EBITDA (x)	4.06
Interest Coverage (EBITDA)	2.0x

Source: Citi Investment Research estimates

Return ratios, however, are very low (RoCE of 2.4% in FY09E), due to the investment phase and the high price paid for Escorts. While these would improve going forward, we do not expect return ratios to touch double digit levels even by FY11E.

Fortis is still in its investment phase and is expected to report a profit for the first time in FY09. As such, its return on capital is likely to remain in the 3 -5% range in the near term.

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**-11%**	**1%**	**-1%**	**-2%**	**1%**	**3%**	**5%**
PBIT Margin	**-18%**	**1%**	**-5%**	**-5%**	**4%**	**10%**	**12%**
EBITDA Margin	-10%	-10%	8%	11%	4%	15%	18%
Depreciation/Sales	14%	12%	15%	16%	9%	8%	7%
Total Asset Turnover (Sales/CE)	**0.58**	**0.63**	**0.28**	**0.44**	**0.28**	**0.36**	**0.47**
Sales/Fixed Assets	0.50	0.60	0.29	0.47	0.31	0.39	0.51
Sales/Net Current Assets	(3.46)	(14.30)	5.63	6.90	3.51	5.80	6.93
Inventory Days	9	11	13	8	9	8	8
Debtor Days	7	31	85	65	69	73	69
Investments/Capital Employed	0%	0%	0%	0%	2%	2%	2%
Return on Equity (ROE)	**-77%**	**-28%**	**-11%**	**-17%**	**-3%**	**1%**	**2%**
Net Margin	-34%	-8%	-17%	-19%	-7%	1%	3%
Total Asset Turnover	0.58	0.63	0.28	0.44	0.28	0.36	0.47
Leverage (CE/Equity)	3.9	5.2	2.4	2.0	1.3	1.3	1.4

Source: Company data, Citi Investment Research estimates

Fortis Healthcare

Company description

Fortis was set up and is owned by the founders of India's largest pharmaceutical company, Ranbaxy Laboratories. Fortis went public in May 07. It is a professionally managed company with a fairly broad management team, headed by Mr. Shivinder Singh (founder shareholder and Managing Director).

Investment strategy

We rate Fortis as Sell/High Risk with a target price of Rs59/share. While Fortis looks well placed to gain from the growing market for healthcare delivery services in India over the longer term, we believe its medium-term outlook depends on how soon it is able to turn around the operations at Escorts, Delhi. This hospital has gone through some pain in the recent past due to the exit of Dr Naresh Trehan and the associated negative publicity, leading to lower occupancies and margins. While we believe that the recovery in the Delhi hospital's revenues and profitability is only a matter of time (some signs being visible in 3QFY08), we believe it could remain a drag on growth and valuations over the next few quarters.

Valuation

We have a price target for Fortis of Rs59/share. We prefer to use EV/EBIDTA versus EBIDTA CAGR as the primary method to value Fortis. We believe that hospital companies in India would have a predictable and steady revenue stream, given high unmet demand and low but growing penetration of organized healthcare. Fortis has only one directly comparable company listed on the Indian market - Apollo Hospitals. We previously have valued Fortis at a slight discount to Apollo due to the higher risks, especially on the Escorts acquisition. We also used to value the Escorts hospital separately because it was in the midst of a turnaround. However, with these risks now mitigated to a large extent and Escorts operations back to normalised levels, we believe that it is fair to value both hospitals at similar multiples and in a similar manner. We therefore value Fortis at 10xFY10E EBIDTA, which is the same EV/EBIDTA multiple that we use for Apollo, which is set at the lower end of the latter's EV/EBITDA trading band of 6-20x over the past 2-3 years.

Risks

Our risk rating for Fortis is High Risk, factoring in the recent volatility in markets and therefore overriding the Medium Risk rating suggested by our quants-based rating system, which tracks 260-day historical share price volatility. Key upside risks to our rating and target price include: (1) If occupancy rates in Escorts increase much faster than expected, the company could beat our earnings estimates; (2) Any significant acquisition, if accretive, could change the outlook for the stock; (3) Any progress on Fortis' plan to unlock value in its land holding could also trigger an upward move in the stock.

Glaxosmithkline Pharmaceutical (GLAX.BO)

Buy/Low Risk	**1L**
from Sell/Low Risk	
Price (05 Dec 08)	Rs1,150.05
Target price	Rs1,300.00
from Rs1,100.00	
Expected share price return	13.0%
Expected dividend yield	4.3%
Expected total return	**17.3%**
Market Cap	Rs97,413M
	US$1,956M

Price Performance (RIC: GLAX.BO, BB: GLXO IN)

Upgrade to Buy; TP of Rs1,300

- **Upgrade to Buy (1L)** — A strong Indian business, robust balance sheet & superior return ratios make GSK an excellent defensive play, in our view. The company appears largely insulated from the economic slowdown & would also be a key beneficiary of a stronger IPR regime over the long term – allowing it to sustain premium valuations. Our higher TP of Rs1,300 is based on revised estimates (CY08-10E EPS up 1-9%) & roll over to Dec'09E earnings.

- **Steady & getting better** — Besides enhancing focus on pharma by exiting the animal health & fine chem businesses, GSK is focusing on higher margin priority products – with benefits visible in margins & rising cash levels. It has also started launching patented & inlicensed products & intends to focus on select branded generics as well. We expect these initiatives to drive revenue growth up to industry levels over next 2 years & above industry rates beyond.

- **Balance sheet & capital efficiency** — With US$300m cash & negative WC, GSK has the best balance sheet in the sector. Capex is negligible & return ratios (RoCE: 50%; RoE: 30-40%) are well above industry averages, giving it the flexibility to raise dividends, buy back shares or make accretive acquisitions.

- **Key catalysts** — a) Launch of patented / inlicensed products – launched Tykerb earlier in CY08 & plans to launch 5 more over next 2 years; b) Any decision to buy back shares / raise dividend payout.

- **Key risks** — a) Widening of the price control net in India would hurt significantly given GSK's almost complete dependence on this market; b) Delays in launching patented products/ setbacks in the parent's R&D pipeline; c) Ineffective implementation of the patent law in India.

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	3,617	42.70	18.1	26.9	8.2	33.8	2.7
2007A	3,997	47.19	10.5	24.4	7.2	31.3	3.1
2008E	4,535	53.54	13.4	21.5	6.8	32.5	3.5
2009E	5,507	65.01	21.4	17.7	6.5	37.6	4.3
2010E	6,116	72.20	11.1	15.9	6.1	39.5	4.8

Source: Powered by dataCentral

Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	26.9	24.4	21.5	17.7	15.9
EV/EBITDA adjusted (x)	17.2	15.5	14.2	12.2	10.6
P/BV (x)	8.2	7.2	6.8	6.5	6.1
Dividend yield (%)	2.7	3.1	3.5	4.3	4.8
Per Share Data (Rs)					
EPS adjusted	42.70	47.19	53.54	65.01	72.20
EPS reported	64.40	63.48	53.54	65.01	72.20
BVPS	141.05	160.67	168.29	177.54	187.82
DPS	31.00	36.00	40.69	49.41	54.87
Profit & Loss (RsM)					
Net sales	15,827	16,224	16,801	18,994	21,251
Operating expenses	-10,928	-10,961	-11,153	-12,472	-13,887
EBIT	**4,898**	**5,263**	**5,648**	**6,522**	**7,364**
Net interest expense	0	0	0	0	0
Non-operating/exceptionals	661	848	1,223	1,821	1,902
Pre-tax profit	**5,560**	**6,112**	**6,871**	**8,343**	**9,266**
Tax	-1,942	-2,115	-2,336	-2,837	-3,150
Extraord./Min.Int./Pref.div.	1,838	1,379	0	0	0
Reported net income	**5,455**	**5,377**	**4,535**	**5,507**	**6,116**
Adjusted earnings	3,617	3,997	4,535	5,507	6,116
Adjusted EBITDA	5,057	5,425	5,810	6,684	7,526
Growth Rates (%)					
Sales	5.5	2.5	3.6	13.1	11.9
EBIT adjusted	14.7	7.4	7.3	15.5	12.9
EBITDA adjusted	14.2	7.3	7.1	15.0	12.6
EPS adjusted	18.1	10.5	13.4	21.4	11.1
Cash Flow (RsM)					
Operating cash flow	**4,812**	**6,997**	**4,624**	**6,249**	**6,584**
Depreciation/amortization	159	162	162	162	162
Net working capital	-354	1,459	-73	581	306
Investing cash flow	**-2,077**	**-3,237**	**-677**	**-1,526**	**-1,337**
Capital expenditure	-338	-98	-150	-150	-150
Acquisitions/disposals	400	0	0	0	1
Financing cash flow	**-3,001**	**-3,570**	**-3,832**	**-4,723**	**-5,244**
Borrowings	-7	-2	58	0	0
Dividends paid	-2,994	-3,568	-3,889	-4,723	-5,245
Change in cash	**-266**	**190**	**115**	**0**	**3**
Balance Sheet (RsM)					
Total assets	**17,661**	**20,040**	**20,253**	**22,057**	**23,681**
Cash & cash equivalent	11,744	14,883	15,410	16,786	17,974
Accounts receivable	604	378	356	401	447
Net fixed assets	945	929	917	906	894
Total liabilities	**5,714**	**6,431**	**5,999**	**7,019**	**7,772**
Accounts payable	2,477	2,448	2,552	2,834	3,124
Total Debt	55	58	0	0	0
Shareholders' funds	**11,947**	**13,609**	**14,255**	**15,038**	**15,909**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	32.0	33.4	34.6	35.2	35.4
ROE adjusted	33.8	31.3	32.5	37.6	39.5
ROIC adjusted	nm	na	na	na	na
Net debt to equity	-97.8	-108.9	-108.1	-111.6	-113.0
Total debt to capital	0.5	0.4	0.0	0.0	0.0

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Upgrade to Buy; TP of Rs1,300/share

We upgrade GSK Pharma to Buy/Low Risk from Sell/Low Risk with a TP of Rs1,300. We believe GSK is as an excellent defensive play, given its strong Indian business, robust balance sheet & superior return ratios. GSK appears largely insulated from the economic slowdown & would also be a key beneficiary of a stronger IPR regime over the long term – allowing it to sustain premium valuations in an uncertain environment. Our higher TP is based on revised estimates (CY08-10E EPS up 1-9%) & roll over to Dec'09E earnings.

Upgrading to Buy

We upgrade GSK Pharma to a Buy/Low Risk (from Sell/Low Risk) with a target price of Rs1,300/share. We believe GSK is an excellent defensive play & a good place to hide in the current uncertain environment, given its strong Indian business, robust balance sheet & superior return ratios. The company appears largely insulated from the economic slowdown & financial crisis and would also be a key beneficiary of a stronger IPR regime in India over the long term. We believe the increase in uncertainty on multiple fronts – fundamental as well as technical – calls for a higher defensive premium for GSK vis-à-vis the rest of the sector. This is also reflected in our revised rating on the stock.

Steady show & getting better

Besides enhancing focus on pharma by exiting the animal health & fine chem businesses, GSK Pharma has been focused on higher margin priority products over the last several years. The benefits are visible in its EBIDTA margins as well as rising cash levels.

Having consolidated its existing business, the company has now started launching patented products from its parent's pipeline in the Indian market in a bid to capitalise on the stronger IPR regime in India post 2005. Besides, it is also increasing the number of inlicensed products in its portfolio and also intends to look at appropriate branded generics as a focus area for the Indian market going forward. It launched Tykerb in the Indian market in 1HCY08 and expects to launch 5 more products over the next two years.

We expect these initiatives to drive a higher rate of growth in revenues going forward. GSK expects to grow in the region of c9-10% over the next two years before moving up to the 10-12% (in line with industry) range over the following two years. Beyond that, as patented launches grow in number and value terms, revenue growth is likely to be in excess of industry growth.

Strong balance sheet & capital efficiency

With US$300m cash & negative WC, GSK has the best balance sheet in the sector. Besides, investment in fixed assets is also on the lower side given that it outsources c50% of its manufacturing requirements and also imports quite a few products from its parent. This along with negative working capital has translated into a much higher asset turnover relative to its Indian peers.

Figure 1. Debt Metrics

Net Debt / (Cash) (Rs m)	(15,410)
Net Debt/Equity (x)	(1.08)
Net Debt/EBITDA (x)	(2.65)

Source: Citi Investment Research estimates

With virtually no incremental capex & improving margins, GSK's return ratios have been improving steadily – its RoCE of c50% & RoE of c30-40% are well above the industry average. We believe GSK's strong balance sheet gives it an edge in terms of its ability to pursue accretive acquisitions as the Indian market consolidates or to reward its shareholders by increasing dividend payout and / or giving it the flexibility to raise dividend, buy back shares or make accretive acquisitions as appropriate. We believe these factors call for premium valuations in the current environment.

Glaxo's return ratios have been steadily improving on the back of improved profitability as it continues to focus on the core pharma business & higher margin priority products

Free cash on books is higher than total capital employed due to very small fixed asset base & negative working capital

Very high quality of RoE & profitability given that it is unleveraged & after paying full tax

Figure 2. Capital Efficiency Meter – Breakdown of Return Ratios

	CY03	CY04	CY05	CY06	CY07	CY08E	CY09E
Return on Cap Employed (ROCE)	**47%**	**48%**	**53%**	**48%**	**50%**	**50%**	**57%**
PBIT Margin	**26%**	**30%**	**32%**	**35%**	**38%**	**41%**	**44%**
EBITDA Margin	23%	28%	30%	32%	33%	35%	35%
Depreciation/Sales	2%	1%	1%	1%	1%	1%	1%
Total Asset Turnover (Sales/CE)	**1.79**	**1.60**	**1.66**	**1.36**	**1.34**	**1.23**	**1.29**
Sales/Fixed Assets	11.00	15.12	15.47	16.75	17.46	18.31	20.97
Sales/Net Current Assets	10.67	(385.62)	(14.41)	(23.05)	(7.56)	(8.11)	(7.16)
Inventory Days	67	60	53	56	46	44	43
Debtor Days	22	20	16	14	8	8	8
Investments/Capital Employed	**67%**	**90%**	**101%**	**98%**	**110%**	**108%**	**112%**
Return on Equity (ROE)	**27%**	**29%**	**32%**	**30%**	**29%**	**32%**	**37%**
Net Margin	17%	19%	20%	23%	25%	27%	29%
Total Asset Turnover	1.79	1.60	1.66	1.36	1.34	1.23	1.29
Leverage (Capital Employed/Equity)	0.9	0.9	1.0	1.0	0.9	1.0	1.0

Source: Company data, Citi Investment Research estimates

Raising estimates & target price

We raise our CY08-10E revenue estimates by 1-3% as we build in launches of patented and in-licensed products over the next two years. We also raise our earnings estimates by 1-9% over CY08-10E as we expect a) margin expansion as Glaxo continues to focus on its priority products & benefits of scale keep coming in & b) higher interest income on its large cash reserves as the tightening credit conditions drive yields higher.

Figure 3. Earnings Revision

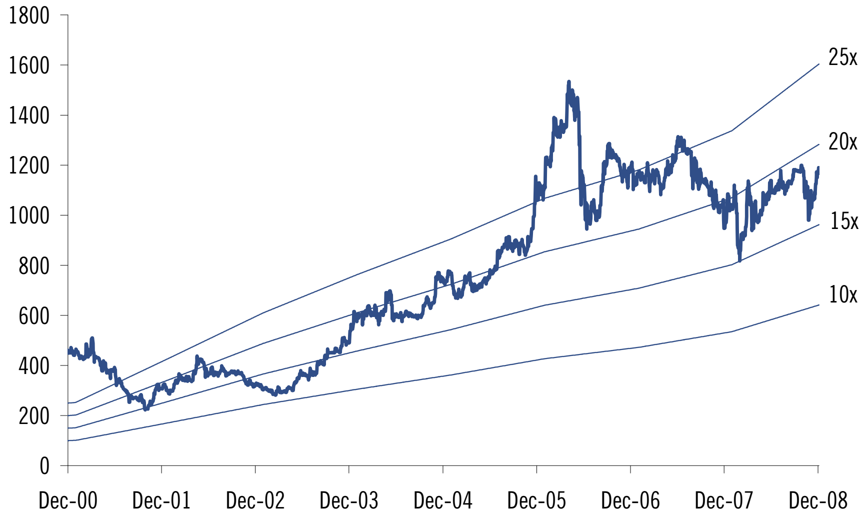
	CY08E	CY09E	CY10E
Revenue (Rs m)			
New	16,801	18,994	21,251
Old	16,599	18,781	20,569
Change (%)	*1%*	*1%*	*3%*
EPS (Rs)			
New	53.5	65.0	72.2
Old	53.1	60.5	65.4
Change (%)	*1%*	*7%*	*10%*

Source: Citi Investment Research estimates

Raising target price to Rs1,300/share

We raise our target price to Rs1,300/share from Rs1,100/share earlier. Our higher target price is based on our revised earnings estimates & roll over to 20xDec'09E earnings from 20xMarch'09E earnings earlier. This along with a healthy dividend yield of c4.3% makes it an attractive & safe investment, in our view.

Figure 4. GSK Pharma – P/E Band Chart (Rs)



Source: Citi Investment Research

Glaxosmithkline Pharmaceutical

Company description

SKB Pharmaceutical (India) was merged with Glaxo India in 2001 to become Glaxosmithkline Pharmaceutical following the merger of their parents in 2000. Post-merger, GSK Pharmaceutical 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 strategy

We rate GSK Pharma Buy/Low Risk as against Sell/Low Risk earlier. We believe GSK would be a key beneficiary from the stricter IPR regime in India, and despite some uncertainties and delays on this front, we expect a steady set of launches over the next two years. Moreover, given the concerns over economic growth and credit availability, we believe that GSK stands out as a safe haven. Its strong Indian business, robust balance sheet (cash of cUS$300m) & superior return ratios would hold it in good stead as also its healthy dividend yield of c4.2%. GSK appears largely insulated from the economic slowdown & would also be a key beneficiary of a stronger IPR regime over the long term – allowing it to sustain premium valuations in an uncertain environment.

Valuation

Our target price for GSK Pharma of Rs1,300/share (Rs1,100/share earlier) is based on 20x Dec'09E (20xMarch'09E earlier) earnings. Given its steady earnings growth, we believe P/E is best suited to value GSK Pharma. GSK has traded at 15-60x in the past 7-8 years. Over the past year, GSK has launched its first patented product and announced plans to launch 5 more over the next two years. While we expect greater clarity on the implementation of the IPR regime over the next 1-3 years, we believe that the upside on this front for most companies is likely to be limited in the medium term. As such, we believe valuing GSK at the lower end of its historic P/E range is appropriate at present; hence, the use of a target multiple of 20x that is towards the lower end of the trading band in recent years.

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 downside risks to our rating include: a) Delay in patented launches / setbacks in parent's pipeline; we expect 5 launches over the next two years; however, material benefits may come through only beyond CY10/11. b) Any further widening of the price control net. GSK has around 28% of its revenues coming from price-controlled products and if this goes up, profitability could be impacted considerably. c) Any sustained slowdown in the Indian market growth rate would hurt materially given GSK's almost complete dependence on this market.

Glenmark Pharmaceuticals (GLEN.BO)

Buy/High Risk	**1H**
from Buy/Medium Risk	
Price (05 Dec 08)	Rs318.00
Target price	Rs467.00
from Rs770.00	
Expected share price return	46.9%
Expected dividend yield	0.3%
Expected total return	**47.2%**
Market Cap	Rs79,655M
	US$1,599M

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

Buy: Pipeline for Free; TP Cut to Rs467

- **Maintain Buy (now at High Risk)** — We believe Glenmark is trading at a discount to the fair value of its core business and that its R&D pipeline is available for free. While the suspension of clinical trials for GRC-6211 is a setback, the impact on the stock price looks to be overdone. Glenmark offers both India's best innovative play & a quality generics business, in our view.

- **Cut TP to Rs467 (from Rs770)** — We value the base business at Rs365 as we reduce our fair-value P/E to 14x (20x earlier) inline with the rest of the sector. We also reduce the option value for R&D to Rs102, as we remove GRC-6211 from the valuation & use a higher discount rate (20% v/s 15% earlier) for the rest of the validated molecules.

- **Balance sheet & capital efficiency** — Glenmark's B/S remains strong with net D/E of 0.5x although high working capital remains a matter of concern. Cash flows from its base business would help fund current capex plans & repay debt or pursue inorganic options. Return ratios are also above sector average, with RoCE & RoE >25% for the base business (c35-40% including R&D).

- **Key catalysts** — a) Outlicensing deals for any of the molecules in the clinic – guidance of 2 deals by end FY09; b) settlements/ wins on FTFs (Tarka, Zetia being the key ones) & c) acquisitions in key markets & listing/value unlocking of its generics arm although the latter appears difficult in the near term.

- **Key risks** — a) If Oglemilast/ Melogliptin fails in clinical trials, fair value could be materially impaired (R&D is c22% of our TP); b) inability to meet milestone / deal guidance could hit sentiment; c) financial crisis in emerging markets such as Russia/ LatAm (c35% of core biz) could hurt growth &/or receivables.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	3,093	11.54	258.0	27.6	11.1	58.5	0.1
2008A	6,321	23.59	104.4	13.5	5.2	57.4	0.2
2009E	8,001	29.86	26.6	10.7	3.5	42.0	0.3
2010E	10,324	38.53	29.0	8.3	2.4	37.0	0.3
2011E	11,121	41.50	7.7	7.7	1.8	29.0	0.3

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	27.6	13.5	10.7	8.3	7.7
EV/EBITDA adjusted (x)	20.4	11.0	8.4	6.4	5.6
P/BV (x)	11.1	5.2	3.5	2.4	1.8
Dividend yield (%)	0.1	0.2	0.3	0.3	0.3
Per Share Data (Rs)					
EPS adjusted	11.54	23.59	29.86	38.53	41.50
EPS reported	11.54	23.59	29.86	38.53	41.50
BVPS	28.58	61.03	92.02	132.36	175.90
DPS	0.40	0.69	1.00	1.00	1.00
Profit & Loss (RsM)					
Net sales	12,220	19,757	27,434	34,860	38,996
Operating expenses	-8,380	-12,469	-17,951	-22,793	-26,065
EBIT	**3,840**	**7,288**	**9,483**	**12,068**	**12,931**
Net interest expense	-384	-632	-515	-220	0
Non-operating/exceptionals	157	458	72	19	152
Pre-tax profit	**3,613**	**7,115**	**9,040**	**11,867**	**13,083**
Tax	-513	-794	-1,040	-1,543	-1,962
Extraord./Min.Int./Pref.div.	-8	0	0	0	0
Reported net income	**3,093**	**6,321**	**8,001**	**10,324**	**11,121**
Adjusted earnings	3,093	6,321	8,001	10,324	11,121
Adjusted EBITDA	4,263	8,005	10,418	13,238	14,315
Growth Rates (%)					
Sales	74.1	61.7	38.9	27.1	11.9
EBIT adjusted	237.0	89.8	30.1	27.3	7.2
EBITDA adjusted	210.7	87.8	30.1	27.1	8.1
EPS adjusted	258.0	104.4	26.6	29.0	7.7
Cash Flow (RsM)					
Operating cash flow	**932**	**3,718**	**4,737**	**6,586**	**9,630**
Depreciation/amortization	423	717	935	1,170	1,384
Net working capital	-3,263	-3,846	-4,922	-5,436	-3,267
Investing cash flow	**-2,688**	**-5,099**	**-2,115**	**-3,360**	**-3,055**
Capital expenditure	-2,711	-5,174	-2,115	-3,360	-3,055
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**1,891**	**1,785**	**-3,831**	**-3,457**	**-2,491**
Borrowings	2,088	692	-3,026	-2,946	-2,200
Dividends paid	-117	-201	-291	-291	-291
Change in cash	**136**	**404**	**-1,210**	**-231**	**4,084**
Balance Sheet (RsM)					
Total assets	**19,346**	**29,256**	**35,472**	**44,191**	**54,047**
Cash & cash equivalent	1,058	1,565	355	124	4,208
Accounts receivable	5,660	8,069	11,612	15,459	17,726
Net fixed assets	8,104	12,557	13,738	15,927	17,598
Total liabilities	**12,482**	**14,062**	**12,569**	**11,255**	**10,281**
Accounts payable	2,323	3,030	4,354	5,679	6,512
Total Debt	9,367	9,909	6,884	3,937	1,737
Shareholders' funds	**6,864**	**15,194**	**22,903**	**32,936**	**43,766**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	34.9	40.5	38.0	38.0	36.7
ROE adjusted	58.5	57.4	42.0	37.0	29.0
ROIC adjusted	25.4	32.3	30.7	30.6	27.0
Net debt to equity	121.1	54.9	28.5	11.6	-5.6
Total debt to capital	57.7	39.5	23.1	10.7	3.8

For further data queries on Citi's full coverage universe please contact CIR Data Services Asia Pacific at CIRDataServicesAsiaPacific@citi.com or +852-2501-2791

Powered by: dataCentral

Pipeline for Free; Cut TP to Rs467

We maintain our Buy rating on Glenmark even as we lower our target price to Rs467/share & revise our risk rating to High. We believe Glenmark is trading at a discount to the fair value of its core business & that its R&D pipeline is available free. While the suspension of clinical trials for GRC-6211 is a setback, we believe the impact on the stock is overdone & offers an opportunity. We continue to rate Glenmark as a good combination of India's best innovative play & a quality generics business.

Revising estimates & target price

Figure 1. Earnings Revision

	FY09E	F10E
Revenue (Rs m)		
New	27,434	34,860
Old	26,457	35,058
Change (%)	*4%*	*-1%*
EPS (Rs)		
New	29.9	38.5
Old	30.7	40.6
Change (%)	*-3%*	*-5%*

Source: Citi Investment Research estimates

- We revise our revenue estimates to factor in two opposite factors:
  - Weaker INR estimates: we now use INR/US$ of 47, 48 & 46 for FY09, FY10 & FY11 estimates respectively &
  - Slower growth in emerging markets such as Russia/ CIS, LatAm to factor in any slowdown in these markets at the trade level following the ongoing financial crisis.

  Consequently, we raise our revenue estimate for FY09 by 4% & lower FY10 estimate by 1%.

- We factor in higher interest cost in FY10E on the back of higher working capital (increase in debtor days in emerging markets) & cost of capital.

- We factor in higher capex (cUS$114m over FY09-10E v/s US$75m earlier), leading to higher depreciation

Consequently, we reduce our FY09-10 recurring net profit estimates by 3-5%. We also incorporate FY11 estimates & forecast FY08-11E sales & recurring earnings CAGRs of 28% & 32% respectively in the base (non R&D) business.

Cut TP to Rs467/share

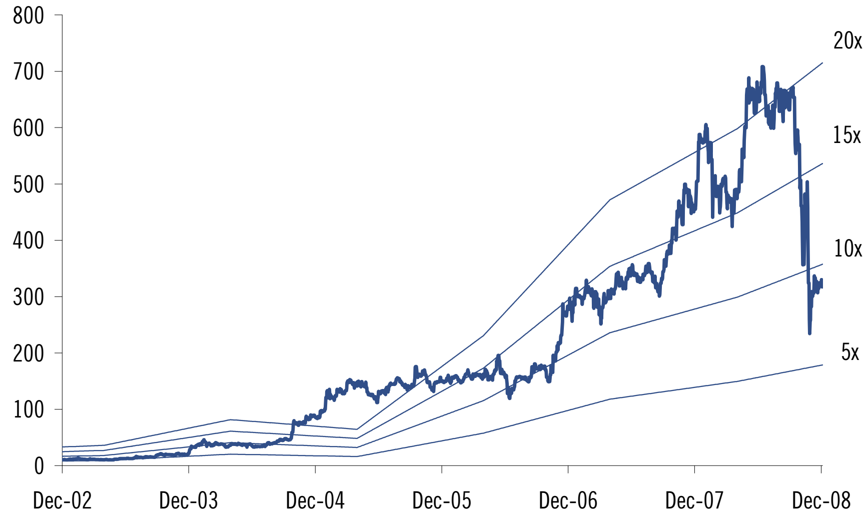
We also lower our target price on the stock to Rs467/share:

- We reduce our target P/E multiple for Glenmark's base business to 14x from 20x earlier inline with the changes for the rest of the sector. At 14x Dec '09E EPS we arrive at a value of Rs365/share for the non R&D business.

- We raise the discount rate for our probability adjusted DCF valuation of the R&D efforts to 20% from 15% earlier to factor in the higher risk premium in capital markets. We also take out the value of GRC-6211 following Eli Lilly's decision to suspend clinical trials. Accordingly we ascribe a value of Rs102/share for the R&D pipeline, with Oglemilast (GRC-3886) valued at Rs82/share & Melogliptin (GRC-8200) at Rs20/share. We continue with our approach of only valuing validated molecules.

We also change the risk rating on Glenmark to High Risk (from Medium Risk earlier), in line with our quantitative risk rating model.

Figure 2. Glenmark – P/E Band Chart (Rs)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Glenmark's B/S remains strong with net D/E of 0.5x, which we expect to further reduce to c0.3x by Mar '09. High working capital, however, remains a matter of concern. Cash flows from its base business would help fund current capex plans & repay debt or pursue inorganic options.

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	7,509
Net Debt/Equity (x)	0.33
Net Debt/EBITDA (x)	0.98
Interest Coverage (EBITDA)	14.9x

Source: Citi Investment Research estimates

Return ratios are also above sector averages, with RoCE & RoE >25% for the base business (c35-40% including R&D). We see room for further improvement given that Glenmark has been in the midst of an aggressive capex programme and revenues are likely to scale up over the next two to three years. Any reduction in working capital cycle will also aid expansion in return ratios

Glenmark's return on capital has gradually improved from its low in FY05 with both asset utilisation & profitability improving materially

Working capital cycle is higher than most peers due to the 2H skew in sales – leaving good room for improvement. However, this may come under some more strain in the near term, given the tight credit environment in emerging markets

RoE has improved despite declining leverage – a good sign

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**23%**	**11%**	**11%**	**18%**	**23%**	**25%**	**28%**
PBIT Margin	**25%**	**18%**	**19%**	**28%**	**35%**	**33%**	**34%**
EBITDA Margin	22%	16%	18%	28%	34%	32%	33%
Depreciation/Sales	3%	3%	3%	4%	4%	4%	4%
Total Asset Turnover (Sales/CE)	**0.94**	**0.60**	**0.58**	**0.64**	**0.67**	**0.78**	**0.82**
Sales/Fixed Assets	2.01	1.37	1.16	1.34	1.38	1.76	1.98
Sales/Net Current Assets	1.90	1.12	1.19	1.25	1.30	1.42	1.42
Inventory Days	86	91	85	91	84	84	84
Debtor Days	136	180	206	191	170	175	179
Investments/Capital Employed	4%	2%	2%	1%	1%	1%	0%
Return on Equity (ROE)	**21%**	**9%**	**18%**	**27%**	**27%**	**24%**	**25%**
Net Margin	14%	6%	10%	17%	24%	23%	26%
Total Asset Turnover	0.94	0.60	0.58	0.64	0.67	0.78	0.82
Leverage (CE/Equity)	1.6	2.4	3.0	2.5	1.7	1.4	1.2

Source: Company data, Citi Investment Research estimates

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/High Risk rating on Glenmark Pharmaceuticals. Our positive outlook on the stock is based on: a) The R&D pipeline has broadened, with the company expecting seven molecules to be in the clinic by end FY09; b) With two validated molecules in the clinic, the R&D option value or value at risk is now spread across a larger number of molecules; c) The base business has achieved significant traction, especially in the US & 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 (Oglemilast & GRC-8200). Although there are potential risk triggers (especially related to the licensed molecule) that could lead to partial erosion of the option value, we believe the risk-reward remains in favor of investors.

Valuation

Our target price for Glenmark Pharmaceuticals of Rs467 (v/s Rs770 earlier) is derived by 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 20% (v/s 15% earlier) discount rate. We believe a higher discount rate is justified given the lower risk appetite in the market. We also adjust for the higher-risk income streams by probability of success. Accordingly, we arrive at a value of Rs82 (v/s Rs113 earlier) for Oglemilast. We use a similar approach for Melogliptin (GRC-8200) and arrive at a value of Rs20 (Rs32 earlier). We value Glenmark's non-R&D business based on 14x (20x earlier) forward earnings, which we use for leading companies in the sector such as Cipla & Piramal H/C. We believe Glenmark deserves a premium to other mid-tier companies, given the higher value addition in its business, better balance sheet & capital efficiency & its proven ability to leverage its assets. At 14xDec'09E (20xJune'09E earlier) earnings, we arrive at a value of Rs365/share (Rs537/share earlier) for the base business.

Risks

We rate Glenmark High Risk (Medium Risk earlier) as suggested by our quantitative risk-rating model. 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 execution is lacking; (2) growing competition, rapid price erosion and fragmented market share are risks that are inherent to the generics business; and (3) the failure of any molecule in its pipeline could lead to the R&D milestone payments being removed from our estimates & option value being impaired.

Jubilant Organosys (JUBO.BO)

Buy/High Risk	**1H**
from Buy/Medium Risk	
Price (05 Dec 08)	Rs120.95
Target price	Rs211.00
from Rs473.00	
Expected share price return	74.5%
Expected dividend yield	1.7%
Expected total return	**76.1%**
Market Cap	Rs17,845M
	US$358M

Price Performance (RIC: JUBO.BO, BB: JOL IN)

Maintain Buy, Though High Leverage Will Drag; TP Cut to Rs211

- **Maintain Buy (now at High Risk)** — Although we acknowledge high leverage, potential increase in finance costs on refinancing FCCBs & an overall reduction in sector valuations, we continue to rate Jubilant among the better CRAMS plays, given its fully integrated presence across the pharma & chemicals value chain. And while leverage is high, we believe it is manageable given Jubilant's high growth & cash flows.

- **TP cut to Rs211 (from Rs473)** — We use lower fair-value multiples to derive values of Rs189/sh for the PLSPS & Rs23/sh for the IPP businesses. While this is partly due to the overall market-driven reduction in sector valuations, we also use a higher discount vis-à-vis Piramal H/C to value Jubilant's PLSPS business to build in the latter's higher leverage & lower return ratios & liquidity.

- **Balance sheet & capital efficiency** — Jubilant's RoE of c30% is buoyed by high leverage (net D/E: 2x) & non expensing of interest on FCCBs, while RoCE is low at c10%. With most debt being long term in nature (3-5 yrs) & robust operating CF, Jubilant appears well placed to reduce leverage. Any execution hiccups & lower earnings may however require a compromise on capex & growth plans.

- **Key catalysts** — a) launch of generic Sestemibi expected in 4QFY09; b) milestones from any of its several R&D tie-ups (with Eli-Lilly, Amgen, Forest)

- **Key risks** — a) Higher molasses prices could hurt margins: molasses & alcohol account for c13-15% of sales; b) while margins have been high in the IPP biz (37% of sales; 33% of PBIT), this is a commodity business & prices / volumes could decline & hurt profitability; c) inability to meet targets on the recently acquired Draxis could hurt given the high valuation of the deal.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	1,622	8.93	10.1	13.5	1.9	18.8	1.0
2008A	2,965	16.33	82.8	7.4	1.4	27.5	1.2
2009E	4,357	24.00	46.9	5.0	1.1	29.9	1.7
2010E	4,985	27.45	14.4	4.4	0.8	26.4	1.7
2011E	6,115	33.68	22.7	3.6	0.7	25.4	1.7

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	13.5	7.4	5.0	4.4	3.6
EV/EBITDA adjusted (x)	10.5	7.2	5.9	5.8	4.9
P/BV (x)	1.9	1.4	1.1	0.8	0.7
Dividend yield (%)	1.0	1.2	1.7	1.7	1.7
Per Share Data (Rs)					
EPS adjusted	8.93	16.33	24.00	27.45	33.68
EPS reported	8.93	22.06	16.10	30.48	36.71
BVPS	62.75	85.37	112.74	144.37	183.70
DPS	1.25	1.49	2.00	2.00	2.00
Profit & Loss (RsM)					
Net sales	18,097	24,889	38,743	47,075	54,095
Operating expenses	-16,184	-21,421	-32,873	-40,130	-45,882
EBIT	**1,913**	**3,468**	**5,870**	**6,946**	**8,213**
Net interest expense	-195	-337	-821	-1,256	-1,213
Non-operating/exceptionals	576	1,430	-1,131	902	954
Pre-tax profit	**2,295**	**4,561**	**3,917**	**6,592**	**7,954**
Tax	-712	-573	-963	-1,027	-1,259
Extraord./Min.Int./Pref.div.	39	16	-30	-30	-30
Reported net income	**1,622**	**4,005**	**2,924**	**5,535**	**6,665**
Adjusted earnings	1,622	2,965	4,357	4,985	6,115
Adjusted EBITDA	2,536	4,507	7,532	9,231	10,696
Growth Rates (%)					
Sales	20.7	37.5	55.7	21.5	14.9
EBIT adjusted	15.4	81.3	69.3	18.3	18.2
EBITDA adjusted	16.8	77.7	67.1	22.6	15.9
EPS adjusted	10.1	82.8	46.9	14.4	22.7
Cash Flow (RsM)					
Operating cash flow	**1,210**	**2,444**	**-312**	**5,324**	**7,236**
Depreciation/amortization	623	1,039	1,662	2,285	2,484
Net working capital	-886	-1,851	-5,410	-3,009	-2,535
Investing cash flow	**-3,675**	**-11,394**	**-17,160**	**-5,000**	**-3,000**
Capital expenditure	-3,674	-5,135	-17,160	-5,000	-3,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**9,630**	**5,928**	**11,304**	**839**	**-3,099**
Borrowings	9,831	6,123	11,639	1,174	-2,764
Dividends paid	-203	-209	-335	-335	-335
Change in cash	**7,165**	**-3,021**	**-6,168**	**1,163**	**1,137**
Balance Sheet (RsM)					
Total assets	**32,329**	**41,825**	**60,338**	**67,948**	**72,659**
Cash & cash equivalent	8,749	5,238	503	1,116	1,704
Accounts receivable	2,948	4,258	6,995	8,500	9,767
Net fixed assets	14,636	23,971	39,469	42,184	42,700
Total liabilities	**23,134**	**29,066**	**43,526**	**46,457**	**45,358**
Accounts payable	2,918	3,718	5,919	7,192	8,264
Total Debt	16,526	21,085	32,723	33,898	31,134
Shareholders' funds	**9,195**	**12,759**	**16,811**	**21,491**	**27,301**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.0	18.1	19.4	19.6	19.8
ROE adjusted	18.8	27.5	29.9	26.4	25.4
ROIC adjusted	6.5	10.9	11.4	10.5	11.5
Net debt to equity	84.6	124.2	191.7	152.5	107.8
Total debt to capital	64.3	62.3	66.1	61.2	53.3

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High Leverage Will Drag

We maintain our Buy rating on Jubilant, even as we cut TP to Rs211 & revise risk rating to High as we factor in its high leverage, potential increase in finance cost on refinancing FCCBs & overall reduction in sector valuations. We however continue to rate Jubilant among the better CRAMS plays, given its fully integrated presence across the pharma & chemicals value chain. We also believe that the while leverage is high, it is manageable given Jubilant's high growth & cash flows.

Revising estimates & target price

Figure 1. Earnings Revision

	FY09E	F10E	FY11E
Revenue (Rs m)			
New	38,743	47,075	54,095
Old	37,286	44,747	51,194
Change (%)	4%	5%	6%
EPS (Rs)			
New	24.0	27.4	33.7
Old	22.9	28.5	34.7
Change (%)	5%	-4%	-3%

Source: Citi Investment Research estimates

We raise our FY09-11E revenue estimates by 4-6% on the back of weaker INR assumptions (we now factor in INR/$ assumptions of 47, 48 & 46 for FY09, FY10 & FY11 respectively). While this translates into higher recurring earnings for FY09E (up 5%), we reduce our recurring earnings estimates for FY10E & FY11E by 4% & 3% respectively as we build in higher interest costs & temper growth rates & profitability in the IPP business.

Cutting target price to Rs211/share

We cut our target price to Rs211/share as we use lower multiples for both businesses (PLSPS & IPP). While this is partly due to the overall reduction in sector valuations (market environment driven), we also use a higher discount vis-à-vis Piramal H/C to value Jubilant's PLSPS business to build in the latter's higher leverage & lower return ratios & liquidity.

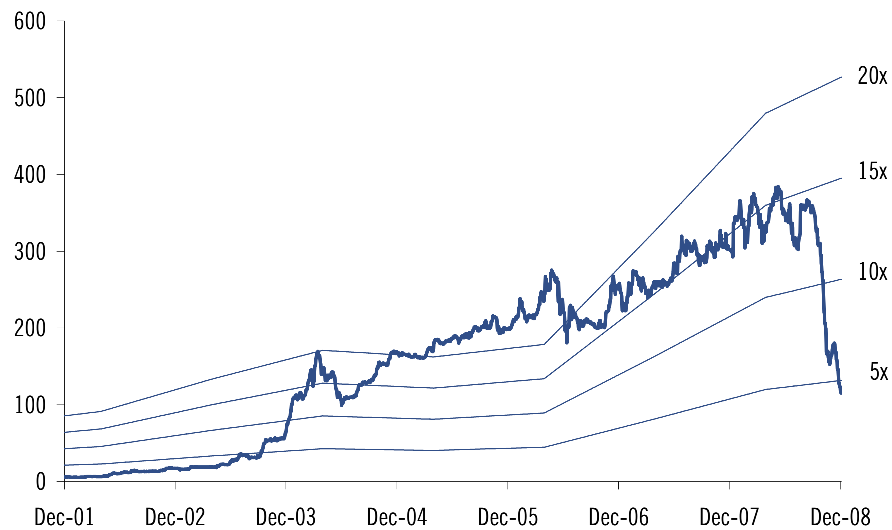
We have changed our valuation methodology from EV/EBIDTA to P/E, now that Jubilant has deployed all its idle cash in the business. Our new target price of Rs211/share includes the following parts:

- We ascribe a value of Rs189/share to Jubilant's Pharma & Life Sciences (PLSPS) business at 9x Dec '09E EPS. Our target multiple is at a 40% discount to the target multiple used for Piramal Healthcare which is our top pick in the space. We believe this discount is justified given Jubilant's higher leverage & lower return ratios & liquidity.

- We value Jubilant's Industrial Products (IPP) business at Rs23/share based on 4x Dec '09E EPS. We believe the lower multiple is justified given that this is a commodity business with lower operating margins (c12-14%) & growth rates vis-à-vis Jubilant's pharma business. Moreover, this business is more vulnerable in times of an economic slowdown.

We also revise the risk rating on Jubilant to High Risk (from Medium earlier) on account of its high leverage & lower liquidity.

Figure 2. Jubilant Organosys – P/E Band Chart (Rs)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	34,295
Net Debt/Equity (x)	2.07
Net Debt/EBITDA (x)	4.55
Interest Coverage (EBITDA)	9.2x

Source: Citi Investment Research estimates

Jubilant's B/S is highly leveraged with net debt / equity of c2x, with forex debt (including out of the money FCCBs) of cRs29bn & rupee of cRs3bn. We expect this to go up by cRs2-3bn by the end of FY09. On the positive side, most of the debt is locked in for the long term (3-5 yrs) at very low cost (effective cost of forex debt is c6% & c9-10% for the rupee debt).

Thus, with robust cash flows from operations & growing profits, the high leverage appears manageable. However, any execution hiccups & lower earnings may require a compromise on capex & growth plans. RoE of c30% is buoyed by high leverage (net D/E of 2x) & non expensing of interest on FCCBs, while RoCE is low at c10%.

Low RoCE primarily driven by aggressive capex – organic & inorganic

While profitability has improved, falling asset turnover & higher working capital cycle have been a drag

Jubilant has significantly leveraged up on returns (RoE) & this would be hit if interest cost goes up significantly or there is a material reduction in leverage

Non expensing of interest on FCCB bonds also inflates reported RoEs

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**19%**	**18%**	**11%**	**9%**	**11%**	**12%**	**13%**
PBIT Margin	**15%**	**15%**	**12%**	**14%**	**16%**	**16%**	**16%**
EBITDA Margin	18%	18%	14%	14%	18%	19%	20%
Depreciation/Sales	4%	3%	3%	3%	4%	4%	5%
Total Asset Turnover (Sales/CE)	**1.21**	**1.21**	**0.90**	**0.67**	**0.71**	**0.75**	**0.82**
Sales/Fixed Assets	1.73	1.61	1.30	1.24	1.04	0.98	1.12
Sales/Net Current Assets	4.02	4.87	2.92	1.45	2.32	3.40	3.13
Inventory Days	56	60	76	71	64	66	66
Debtor Days	60	55	60	59	62	66	66
Investments/Capital Employed	0%	0%	0%	0%	1%	1%	1%
Return on Equity (ROE)	**38%**	**22%**	**16%**	**17%**	**23%**	**26%**	**24%**
Net Margin	9%	10%	9%	9%	12%	11%	11%
Total Asset Turnover	1.21	1.21	0.90	0.67	0.71	0.75	0.82
Leverage (CE/Equity)	3.4	1.9	2.0	3.0	2.8	3.1	2.7

Source: Company data, Citi Investment Research estimates

Jubilant Organosys

Company description

Jubilant Organosys is the largest specialty chemicals company in India, with a high degree of vertical integration, and global scale and reach in almost all its key products. The company has established itself as a serious player right from fine chemicals to advanced intermediates and APIs. More recently, it has forayed into formulations and regulatory services through acquisitions in Belgium (PSI n.v. and PSI supply) and the US (Trigyn Laboratories). It has set up wholly owned subsidiaries to tap into the high-potential areas of bioinformatics, medicinal chemistry services and clinical services.

Investment strategy

We rate Jubilant Buy/High Risk (1H) with a target price of Rs211. Jubilant is among the top Indian pharma outsourcing plays under our coverage. It is a story of continuous forward integration with a business model that spans pharma & life sciences (P&LS), industrial chemicals and performance chemicals. Jubilant's strong presence in acetyls and pyridines builds a high degree of integration into its business and allows it to offer services across the value chain. Besides a natural cost advantage, this allows the company to leverage its customer relationships in strong areas to scale up new businesses, thus providing an edge in an increasingly competitive industry. Jubilant's P&LS business is in the midst of a high growth phase. We expect the share of this business to increase from 61% in FY08 to 78% in FY11E. This would not only raise profitability levels but also improve earnings quality by reducing Jubilant's exposure to the more volatile non-P&LS businesses.

Valuation

We use sum-of-the-parts to value Jubilant in view of the diversified nature of its business and earnings streams. We value both businesses using the P/E methodology (EV/EBITDA earlier) but apply different target multiples to each business given the difference in their growth and operating parameters. We arrive at a one-year target price of Rs211 based on the following factors.

We ascribe a value of Rs189/share to Jubilant's Pharma & Life Sciences (PLSPS) business at 9x Dec '09E EPS. Our target multiple is at a 40% discount to the target multiple used for Piramal Healthcare which is our top pick in the space. We believe this discount is justified given Jubilant's higher leverage & lower return ratios & liquidity.

We value Jubilant's Industrial Products (IPP) business at Rs23/share based on 4x Dec '09E EPS. We believe the lower multiple is justified given that this is a commodity business with lower operating margins (c12-14%) & growth rates vis-à-vis Jubilant's pharma business. Moreover, this business is more vulnerable in times of an economic slowdown.

Risks

Our risk rating for Jubilant is High, factoring in the volatility in the markets and overriding our quants-based Medium Risk rating. The main downside risks to our target price and estimates include: (1) Any delay in filing / launch or a litigation loss would affect the timing and quantum of revenues and profits; (2) Inability to integrate and exploit the synergies with its acquired subsidiaries could hurt profitability; and (3) Increases in molasses prices. The main upside risks to our target price include: (1) A significant value accretive acquisition could lead to upside to our estimates; and (2) Pyridine prices could firm up in the medium term.

Lupin (LUPN.BO)

Buy/Medium Risk	**1M**
Price (05 Dec 08)	Rs589.05
Target price	Rs823.00
from Rs938.00	
Expected share price return	39.7%
Expected dividend yield	1.7%
Expected total return	**41.4%**
Market Cap	Rs48,768M
	US$979M

Price Performance (RIC: LUPN.BO, BB: LPC IN)

Buy: Multiple Growth Engines

- **Maintain Buy (1M)** — Lupin continues to demonstrate excellent execution in difficult markets. It has made good progress in its efforts to move up the value chain in terms of product (APIs to formulations) & markets (less regulated to regulated) aided by some accretive acquisitions in key markets. We maintain Lupin as one of our top picks with a new target price of Rs823 (from Rs938).

- **Cut TP to Rs823** — We reduce our target P/E to 14x (from 18x), as we shift our coverage universe to a lower valuation band. We value Lupin at the upper end of sector valuations given its niche, less commoditized business, multiple growth engines & superior return ratios. Our new TP also reflects our higher EPS estimates (up 7% & 9% for FY09E & FY10E respectively).

- **Balance sheet & capital efficiency** — Lupin has a robust B/S. Net D/E is low at 0.3x & most debt is working capital related. It is also the only company with FCCBs (US$70m; redeemable in 2011) that are in the money. It has been able to improve return ratios (RoE & RoCE of c25%+ in FY09E) over the last 3 years on the back of improving asset T/O & profitability.

- **Key catalysts** — a) Product approvals in Europe would lead to material improvement in financials; b) we are above consensus on earnings – expect Street to catch up over 2HFY09; c) potential wins in AOK tenders in Germany.

- **Key risks** — a) 483s received at Mandideep are trivial as per management but could escalate if Lupin is unable to resolve the issues; b) Generic competition in Suprax (c5% of sales & 16% of PBT) – possible in FY10; c) Reasonable exposure to domestic formulations (34% of sales) leaves it vulnerable to price control changes; d) Inability to effectively integrate the Kyowa acquisition.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	2,353	29.28	25.9	20.1	5.4	31.4	0.8
2008A	3,640	41.10	40.4	14.3	3.8	33.8	1.7
2009E	4,524	51.07	24.3	11.5	3.0	31.0	1.7
2010E	5,432	61.32	20.1	9.6	2.3	29.2	1.7
2011E	6,252	70.58	15.1	8.3	1.9	26.6	1.7

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	20.1	14.3	11.5	9.6	8.3
EV/EBITDA adjusted (x)	17.7	11.8	9.0	7.5	6.4
P/BV (x)	5.4	3.8	3.0	2.3	1.9
Dividend yield (%)	0.8	1.7	1.7	1.7	1.7
Per Share Data (Rs)					
EPS adjusted	29.28	41.10	51.07	61.32	70.58
EPS reported	37.76	46.09	48.54	61.32	70.58
BVPS	108.70	155.91	199.24	253.64	318.03
DPS	5.00	10.07	10.07	10.07	10.07
Profit & Loss (RsM)					
Net sales	20,137	27,064	36,157	40,756	44,667
Operating expenses	-17,555	-22,886	-30,419	-33,956	-37,121
EBIT	**2,582**	**4,178**	**5,738**	**6,801**	**7,546**
Net interest expense	-372	-374	-558	-419	-166
Non-operating/exceptionals	1,865	1,598	522	826	923
Pre-tax profit	**4,075**	**5,402**	**5,702**	**7,208**	**8,302**
Tax	-1,039	-1,318	-1,391	-1,759	-2,026
Extraord./Min.Int./Pref.div.	-1	-1	-11	-17	-25
Reported net income	**3,035**	**4,083**	**4,300**	**5,432**	**6,252**
Adjusted earnings	2,353	3,640	4,524	5,432	6,252
Adjusted EBITDA	3,048	4,825	6,631	7,780	8,611
Growth Rates (%)					
Sales	18.8	34.4	33.6	12.7	9.6
EBIT adjusted	29.0	61.8	37.3	18.5	11.0
EBITDA adjusted	26.5	58.3	37.4	17.3	10.7
EPS adjusted	25.9	40.4	24.3	20.1	15.1
Cash Flow (RsM)					
Operating cash flow	**1,779**	**2,585**	**2,435**	**5,521**	**6,598**
Depreciation/amortization	466	647	893	979	1,065
Net working capital	-2,021	-2,589	-3,029	-1,327	-911
Investing cash flow	**-1,516**	**-4,918**	**-1,500**	**-1,500**	**-1,500**
Capital expenditure	-1,771	-2,345	-1,500	-1,500	-1,500
Acquisitions/disposals	0	-2,720	0	0	0
Financing cash flow	**-1,108**	**820**	**-3,898**	**-4,021**	**-4,107**
Borrowings	-456	1,626	-2,374	-2,635	-2,974
Dividends paid	-298	-477	-967	-967	-967
Change in cash	**-844**	**-1,513**	**-2,963**	**0**	**991**
Balance Sheet (RsM)					
Total assets	**22,629**	**33,497**	**35,249**	**37,930**	**40,982**
Cash & cash equivalent	3,845	2,742	300	300	1,291
Accounts receivable	4,039	7,439	9,611	10,834	11,256
Net fixed assets	7,971	11,125	11,732	12,253	12,688
Total liabilities	**13,896**	**20,606**	**18,789**	**16,988**	**14,731**
Accounts payable	3,472	5,961	6,472	7,228	7,903
Total Debt	8,648	12,029	9,655	7,020	4,047
Shareholders' funds	**8,733**	**12,891**	**16,460**	**20,942**	**26,251**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	15.1	17.8	18.3	19.1	19.3
ROE adjusted	31.4	33.8	31.0	29.2	26.6
ROIC adjusted	11.3	14.3	16.4	17.2	17.8
Net debt to equity	55.0	72.0	56.8	32.1	10.5
Total debt to capital	49.8	48.3	37.0	25.1	13.4

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Multiple Growth Engines

We maintain our Buy/Medium Risk (1M) rating on Lupin, as it continues to demonstrate excellent execution in difficult markets. It has made good progress in its efforts to move up the value chain in terms of product (APIs to formulations) & markets (less regulated to regulated) aided by some accretive acquisitions in key markets. We maintain Lupin as one of our top picks with a revised target price of Rs823/share.

Revising estimates & target price

Figure 1. Earnings Revision

	FY09E	FY10E	FY11E
Revenue (Rs m)			
New	36,157	40,756	44,667
Old	33,802	37,144	41,222
Change (%)	7%	10%	8%
EPS (Rs m)			
New	51.1	61.3	70.6
Old	47.8	56.5	67.9
Change (%)	7%	9%	4%

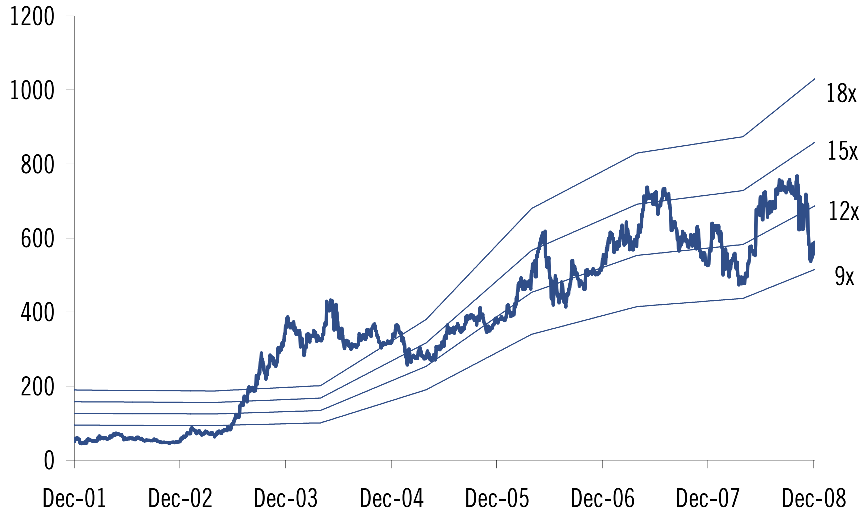
Source: Citi Investment Research estimates

- We raise our FY09-11E revenue estimates by 7-10% to build in the following:
  - Weaker INR estimates: we now use INR47/US$ for FY09E, INR48/US$ for FY10E & INR46/US$ in FY11E.
  - Lupin's co-promotion deal with Forest for Aerochamber Plus in the US branded market – we incorporate revenues of US$8m, US$15m & US$15m in FY09E, FY10E & FY11E respectively
  - Its recent acquisitions of Hormosan Pharma in Germany & Pharma Dynamics in South Africa.
- Increase in earnings over FY09-11E is marginally lower at 7%, 9% & 4% respectively as we incorporate higher interest cost & factor in an increase in dollar costs given the weaker currency forecasts

Cut target price to Rs823/share

We reduce our target price on Lupin to Rs823/share (from Rs938/share earlier) as we move to a lower target P/E of 14x (v/s 18x earlier). This is in line with our move to shift our entire coverage universe to a lower valuation band in the changed market environment. We continue to value Lupin towards the upper end of the sector valuation range, given its superior return ratios, healthy balance sheet & multiple growth engines.

Figure 2. Lupin – P/E Band Chart (Rs)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	6,964
Net Debt/Equity (x)	0.35
Net Debt/EBITDA (x)	1.05
Interest Coverage (EBITDA)	11.9x

Source: Citi Investment Research estimates

Improving return ratios largely driven by improving profitability

Trend expected to sustain despite margins topping out as asset turnover improves with growing scale in most target markets – especially EU & Japan

Despite steadily deleveraging the balance sheet & investing in the business, RoE has improved on the back of higher profitability

Lupin has a robust balance sheet. Debt/Equity is low at 0.35x & most debt is for working capital purposes. It is also the only company in our universe with FCCBs (US$70m; redeemable in 2011) that are in the money.

Return ratios have improved significantly over the last three years on the back of improving asset T/O & profitability. In fact, despite a reduction in financial leverage, Lupin has been able to improve RoE over the last two years due to material improvement in profitability.

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**27%**	**12%**	**17%**	**19%**	**20%**	**24%**	**26%**
PBIT Margin	**21%**	**10%**	**16%**	**17%**	**19%**	**18%**	**19%**
EBITDA Margin	19%	11%	14%	15%	18%	18%	19%
Depreciation/Sales	2%	3%	2%	2%	2%	2%	2%
Total Asset Turnover (Sales/CE)	**1.32**	**1.21**	**1.03**	**1.09**	**1.03**	**1.32**	**1.40**
Sales/Fixed Assets	2.26	1.99	2.52	2.53	2.08	2.66	2.89
Sales/Net Current Assets	3.20	3.11	1.75	1.93	2.06	2.64	2.71
Inventory Days	69	76	74	78	106	91	87
Debtor Days	68	74	67	73	100	97	97
Investments/Capital Employed	0%	0%	0%	0%	0%	0%	0%
Return on Equity (ROE)	**34%**	**20%**	**18%**	**16%**	**21%**	**23%**	**22%**
Net Margin	12%	8%	11%	10%	13%	13%	13%
Total Asset Turnover	1.32	1.21	1.03	1.09	1.03	1.32	1.40
Leverage (CE/Equity)	2.1	2.1	1.5	1.4	1.6	1.4	1.2

Source: Company data, Citi Investment Research estimates

Lupin

Company description

Lupin is a mid-sized pharma company actively targeting the generics opportunity in regulated markets. Historically very strong in the anti-TB segment (where it is the global leader), it has over the years built up expertise in fermentation-based products and segments like cephalosporins, prils and statins. Over the last few years, it has emerged as a fully integrated company, with manufacturing capabilities in APIs and formulations and a direct marketing presence in the target markets including the US, Europe and Japan (through the acquisition of Kyowa).

Investment strategy

We rate Lupin Buy/Medium Risk with a price target of Rs823. Lupin fits well within our prescription for growth in a troubled generics industry, given its differentiated business & improving profitability. It has made good progress in its efforts to move up the value chain in terms of product (from APIs to formulations) & markets (from less regulated to regulated markets). With robust growth in rec. earnings (20% CAGR over FY08-11E), healthy capital efficiency & attractive valuations, Lupin is one of our top picks in the sector.

Valuation

Given that pharma is a growth sector, we use P/E as our primary method to value the base business of pharma companies. Using a 14x multiple on December 09E recurring FDEPS, we arrive at a target price of Rs823. Lupin has historically (last five years) traded in a band of 10-34x one-year forward earnings. Our target multiple of 14x is at the lower this band. It is at a premium to the median/average multiples for the stock in its recent trading history (last 3 years) as we believe that the visibility on the business has improved and the Street is likely to reward this.

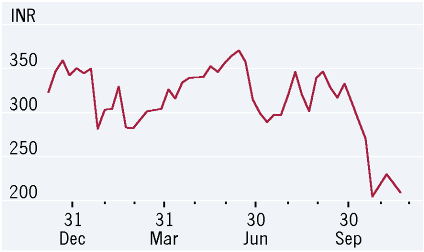
Risks

We rate Lupin Medium Risk, based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks to achieving our target price include: 1) Generic competition in *Suprax* (c5% & 16% of sales & PBT): This is possible in either FY10 or FY11. Two other players (both Indian companies) have filed DMFs for cefixime and either one or both companies could prove to be competitors. 2) The recent 483s received from the US FDA for the Mandideep facility could escalate in case Lupin is unable to respond satisfactorily to the issues raised. 3) Reasonable exposure to the domestic formulations market (34% of sales) leaves Lupin vulnerable to any significant widening of the price control net. 4) Inability to effectively integrate the Kyowa acquisition could take a heavy toll on profitability as well as return ratios.

Piramal Healthcare (PIRA.BO)

Buy/Medium Risk	**1M**
Price (05 Dec 08)	Rs212.45
Target price	Rs345.00
from Rs469.00	
Expected share price return	62.4%
Expected dividend yield	2.1%
Expected total return	**64.5%**
Market Cap	Rs44,405M
	US$892M

Price Performance (RIC: PIRA.BO, BB: PIHC IN)



Buy: Best Play on Innovator CRAMS; TP Cut to Rs345

- **Maintain Buy (1M)** — PIHC is the best play on innovator CRAMS in Indian pharma. Strong traction in outsourcing, steady cash flows from the Indian formulations biz along with superior profitability & return ratios make it one of the better options in the sector, in our view. However, we cut our TP to Rs345.

- **Cut TP to Rs345 (from Rs469)** — We use a target P/E of 14x (20x earlier) as we shift our entire coverage universe to a lower valuation band in the changed market environment. We value PIHC at the upper end of sector valuations given its leadership in innovator CRAMS & superior capital efficiency. The lower TP also reflects our 2-6% lower recurring EPS estimates on higher interest cost.

- **Balance sheet & capital efficiency** — PIHC's return ratios (RoCE & RoE of c25% & c34% respectively) are among the best in the sector & hold room for further improvement as the company sweats its CMG assets going forward. Leverage is comfortable as well – most debt is long term in nature & net D/E of 1x is set to decline materially (0.6x & 0.4x by end FY09E & FY10E respectively) as it is through with its investment phase.

- **Key catalysts** — a) PIHC has 6 contracts for Ph-3 NCEs (1 in Morpeth, 5 in India), 2 of which could hit the market in FY10, leading to material scale up in volumes; b) Earnings announcements: 2H results to be much stronger than 1H; c) Further progress in shifting work to higher margin Indian facilities.

- **Key risks** — a) Phensydyl, a key brand (c4% of sales; c9% of EBIDTA), could be hit if codeine supplies are disrupted; b) Exposure to the Indian market (45% of sales) leaves it vulnerable to any widening of the price control net; c) Any delay/ disruption in contracts due to recent terrorist attacks.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	2,256	10.80	86.5	19.7	4.2	22.5	1.6
2008A	3,661	17.52	62.3	12.1	4.1	34.2	2.0
2009E	4,492	21.49	22.7	9.9	3.3	36.8	2.1
2010E	5,367	25.68	19.5	8.3	2.5	34.1	2.4
2011E	7,067	33.81	31.7	6.3	1.9	33.8	2.6

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	19.7	12.1	9.9	8.3	6.3
EV/EBITDA adjusted (x)	13.5	9.4	7.8	6.4	4.9
P/BV (x)	4.2	4.1	3.3	2.5	1.9
Dividend yield (%)	1.6	2.0	2.1	2.4	2.6
Per Share Data (Rs)					
EPS adjusted	10.80	17.52	21.49	25.68	33.81
EPS reported	10.80	15.90	17.54	26.83	34.96
BVPS	50.14	52.28	64.69	85.81	114.50
DPS	3.50	4.20	4.50	5.00	5.50
Profit & Loss (RsM)					
Net sales	24,541	28,728	34,210	39,501	46,051
Operating expenses	-21,703	-24,259	-28,764	-32,888	-37,810
EBIT	**2,838**	**4,470**	**5,446**	**6,614**	**8,241**
Net interest expense	-305	-463	-534	-686	-663
Non-operating/exceptionals	-39	-279	-746	203	485
Pre-tax profit	**2,494**	**3,728**	**4,167**	**6,131**	**8,063**
Tax	-389	-377	-500	-765	-996
Extraord./Min.Int./Pref.div.	151	-29	0	240	240
Reported net income	**2,256**	**3,322**	**3,667**	**5,607**	**7,307**
Adjusted earnings	2,256	3,661	4,492	5,367	7,067
Adjusted EBITDA	3,657	5,417	6,671	7,972	9,649
Growth Rates (%)					
Sales	53.9	17.1	19.1	15.5	16.6
EBIT adjusted	101.7	57.5	21.8	21.4	24.6
EBITDA adjusted	74.5	48.1	23.2	19.5	21.0
EPS adjusted	86.5	62.3	22.7	19.5	31.7
Cash Flow (RsM)					
Operating cash flow	**2,395**	**3,359**	**3,388**	**6,507**	**7,724**
Depreciation/amortization	818	947	1,225	1,358	1,408
Net working capital	-877	-1,474	-2,166	-1,259	-1,583
Investing cash flow	**-4,012**	**-2,809**	**-2,580**	**-1,297**	**-1,015**
Capital expenditure	-217	-2,307	-2,660	-1,500	-1,500
Acquisitions/disposals	-2,000	0	0	0	0
Financing cash flow	**1,164**	**-560**	**-902**	**-2,377**	**-1,974**
Borrowings	2,778	-77	170	-1,186	-663
Dividends paid	-1,491	-140	-1,072	-1,192	-1,311
Change in cash	**-453**	**-960**	**-94**	**2,833**	**4,735**
Balance Sheet (RsM)					
Total assets	**23,018**	**24,932**	**29,367**	**34,538**	**42,086**
Cash & cash equivalent	506	551	457	3,290	8,025
Accounts receivable	3,673	4,457	6,040	6,971	8,125
Net fixed assets	12,238	12,585	14,020	14,162	14,254
Total liabilities	**12,151**	**13,958**	**15,799**	**16,554**	**18,106**
Accounts payable	4,551	4,676	5,426	6,264	7,300
Total Debt	6,392	7,163	7,867	7,367	7,367
Shareholders' funds	**10,867**	**10,975**	**13,569**	**17,984**	**23,980**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.9	18.9	19.5	20.2	21.0
ROE adjusted	22.5	34.2	36.8	34.1	33.8
ROIC adjusted	15.5	22.3	23.6	24.8	28.7
Net debt to equity	54.2	60.3	54.6	22.7	-2.7
Total debt to capital	37.0	39.5	36.7	29.1	23.5

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Powered by: dataCentral

Best Play on Innovator CRAMS

We maintain our Buy,/Medium Risk (1M) rating on Piramal Healthcare (PIHC) as we continue to rate it as the best play on innovator CRAMS in Indian pharma. Strong traction in outsourcing, steady cash flows from the Indian formulations biz along with superior profitability & return ratios make it one of the better options in the sector, in our view. We however reduce our TP to Rs345/share, as we shift our entire universe to a lower valuation band in the changed market environment.

Revising estimates & target price

- We raise our FY09-10E revenue estimates by 3-10% as we factor the weaker INR into our estimates. We now use INR47/US$ for FY09E, INR48/US$ for FY10E & INR46/US$ in FY11E.
- The effect on the EBIDTA level is much lower given that PIHC's net dollar exposure is only c12%. We also build in higher interest costs given the current tightness in credit.
- Consequently, our recurring EPS estimates for FY09-11E are lower by 2-5%.

Figure 1. Earnings Revision

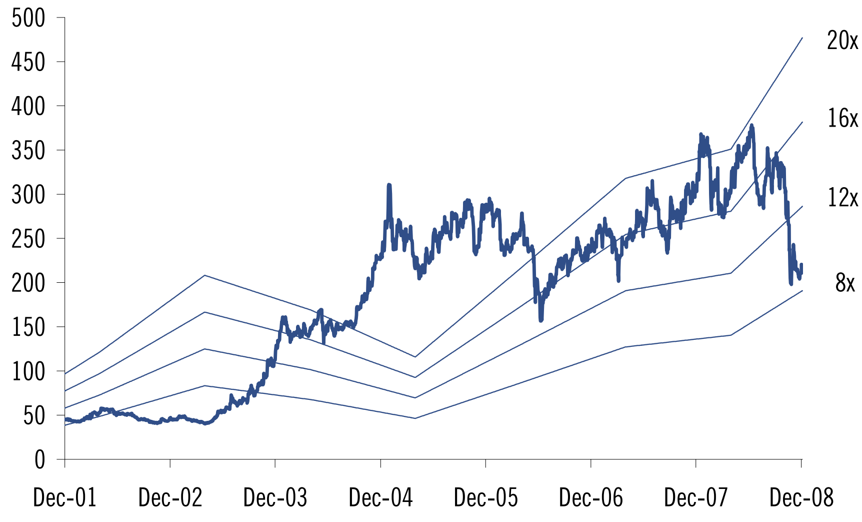
	FY09E	F10E	FY11E
Revenues (Rs m)			
New	34,210	39,501	46,051
Old	33,259	37,108	41,859
Change (%)	*3%*	*6%*	*10%*
Recurring PAT (Rs m)			
New	4,492	5,367	7,067
Old	4,610	5,667	7,191
Change (%)	*-3%*	*-5%*	*-2%*

Source: Citi Investment Research estimates

Cut target price to Rs345/share

We reduce our target P/E multiple for PIHC to 14x from 20x earlier. This is in line with our move to shift our entire coverage universe to a lower valuation band in the changed market environment. We continue to value PIHC towards the upper end of the sector valuation range in line with other sector leaders such as Cipla & Glenmark. We believe this is justified given its leadership in innovator CRAMS & superior capital efficiency. At 14x Dec '09E EPS we value PIHC at Rs345/share.

Figure 2. Piramal Healthcare – P/E Band Chart (Rs)



Source: Citi Investment Research

Balance Sheet & Capital Efficiency

Figure 3. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	7,911
Net Debt/Equity (x)	0.59
Net Debt/EBITDA (x)	1.19
Interest Coverage (EBITDA)	12.5x

Source: Citi Investment Research estimates

PIHC's leverage is comfortable. Of the total debt of Rs12bn at end of 1HFY09, rupee debt was Rs6.6bn & forex debt was cRs5.6bn. Most of the rupee debt was short term in nature; however, PIHC has just raised cRs3bn via a long term debenture in order to avoid any major escalation in interest costs going forward. On the other hand, less than 40% of the forex debt is short term (PCFC credit) while the rest mature over 2012-15. With growing cash flows & limited capex, we expect total debt as well as net debt / equity is set to decline materially (0.6x & 0.4x by end FY09E & FY10E respectively) going forward.

The company's return ratios (RoCE & RoE of c25% & c34% respectively) are among the best in the sector. Its highly profitable & steadily growing branded formulations business in India contributes significantly to return ratios at this point while return ratios in the CMG business are still in the 13-15% range. We see further room for improvement as PIHC sweats its CMG assets & improves revenues as well as profitability over the next few years.

Return ratios have benefited from rising profitability as well as better turnover on assets (fixed & current)

Buying distressed (Avecia) or sub-optimal (Morpeth) assets at low valuations & turning them around has helped

While margins may not rise much going forward, asset T/O would keep improving & drive capital efficiency

Financial leverage has boosted RoE to some extent in the past and we expect some reduction going forward – although it would remain healthy at 30%+ levels

Figure 4. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**30%**	**15%**	**11%**	**16%**	**24%**	**25%**	**25%**
PBIT Margin	**18%**	**11%**	**10%**	**12%**	**16%**	**16%**	**17%**
EBITDA Margin	21%	15%	13%	15%	19%	20%	20%
Depreciation/Sales	4%	4%	4%	3%	3%	4%	3%
Total Asset Turnover (Sales/CE)	**1.65**	**1.35**	**1.13**	**1.35**	**1.51**	**1.52**	**1.48**
Sales/Fixed Assets	2.49	1.83	1.53	2.01	2.28	2.44	2.79
Sales/Net Current Assets	4.96	5.26	4.66	4.36	4.96	4.35	3.30
Inventory Days	50	75	64	65	51	52	52
Debtor Days	47	40	56	55	57	64	64
Investments/Capital Employed	1%	0%	2%	2%	3%	3%	2%
Return on Equity (ROE)	**56%**	**17%**	**12%**	**21%**	**34%**	**33%**	**30%**
Net Margin	16%	6%	7%	9%	13%	13%	14%
Total Asset Turnover	1.65	1.35	1.13	1.35	1.51	1.52	1.48
Leverage (CE/Equity)	2.1	2.0	1.5	1.7	1.7	1.7	1.5

Source: Company data, Citi Investment Research estimates

Piramal Healthcare

Company description

Piramal Healthcare (PIHC), 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 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 strategy

We rate PIHC Buy/Medium Risk. We believe PHIC is one of the best plays on custom manufacturing and the branded formulations market in India. Among the Indian mid-tier companies, PHIC 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, it has focused on building brands and strengthening its marketing and distribution network, making it less dependent than its peers on new product launches for growth.

Valuation

Our target price for PHIC of Rs345/share (v/s Rs469/share earlier) is based on 14x Dec'09E (v/s 20x June'09E earlier) earnings. This is at a premium to our target multiple for mid-sized Indian pharma companies and in-line with our target multiple for sector leaders. We believe PHIC deserves a higher multiple given its leadership in innovator CRAMS & superior return ratios. Revenue visibility & sustainability are high in the CRAMS business: these are long-term exclusive contracts with innovators with no risk of litigation-related delays and competitive pressures – these would continue to boost valuations in an environment where outsourcing as a theme is gaining traction.

Risks

We rate PHIC Medium Risk, as opposed to the High Risk suggested by our quantitative risk-rating system. While the latter is based on the stock price performance, we believe the risk in the business is much lower, particularly given the steady stream of cash flows from its domestic operations & limited investment required going forward. The main downside risks to our target price are: 1) While custom manufacturing should drive PHIC's revenues and profitability, any slip-up in executing 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 are: 1) If PHIC bags new contracts that have a shorter lead time, it could have a positive impact on our estimates and target price. 2) PHIC continues to scout for acquisitions, which could add further to its strengths in target businesses and our estimates.

Ranbaxy (RANB.BO)

Hold/High Risk	**2H**
from Sell/High Risk	
Price (05 Dec 08)	Rs208.75
Target price	Rs241.00
from Rs373.00	
Expected share price return	15.4%
Expected dividend yield	1.4%
Expected total return	**16.9%**
Market Cap	Rs87,752M
	US$1,762M

Price Performance (RIC: RANB.BO, BB: RBXY IN)

Upgrade to Hold; TP Cut to Rs241/share

- **Upgrade to Hold (2H)** — This is a valuation call post the c51% fall in the stock triggered by the import alert on Paonta/Dewas. Despite a sharp cut in estimates (42-47% over CY09-10E), adjusted for NPV of unaffected exclusivities, the stock trades at c7xCY09E EPS & c0.5xCY09E sales, which we believe prices in most negatives. We cut our TP to Rs241/sh as we use a lower target P/E (11x v/s 16x) for the base biz & higher discount rate for NPV of unique opportunities

- **Why not a Buy?** — Some key uncertainties remain viz. a) how soon will the FDA issue be resolved? b) can it recover lost share if it gets back in the market (& how soon)? c) what direction will Daiichi drive the business in? We do not see clarity emerging soon & barring rapid resolution of FDA issues, these would weigh on valuations. We would get more constructive if there is more clarity on either resolution of FDA issues or progress on alternative sourcing options.

- **Balance sheet & capital efficiency** — Daiichi's cash infusion has strengthened balance sheet, lowering net D/E to c0.2x. Cash flows from settlements over CY09-14E will also add to financial muscle. However, return ratios have taken a big hit (RoCE of 7% & RoE of 4% in CY08E) due to lower margins & asset T/O post its troubles with the FDA. We expect this to remain a drag on valuations.

- **Key catalysts** — a) resolution of FDA issues: Ranbaxy has filed its response but road ahead is uncertain; b) successful switch/ outsourcing of key products hit by the import alert; c) clarity on specific steps to exploit synergies with Daiichi.

- **Key risks** — a) price cuts in Romania (c8% & c20% of sales & EBIDTA); b) early triggering of its exclusivity in Nexium, impairing its deal with Astra: each year knocks cRs8/sh off NPV; c) spillover of FDA issues to other plants.

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	4,243	10.61	43.9	19.7	3.2	16.9	4.1
2007A	5,126	12.81	20.7	16.3	3.0	19.0	4.1
2008E	1,777	4.16	-67.5	50.2	1.3	3.7	1.4
2009E	4,046	9.47	127.8	22.0	1.2	5.8	2.6
2010E	5,679	13.29	40.4	15.7	1.0	7.2	4.1

Source: Powered by dataCentral

Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	19.7	16.3	50.2	22.0	15.7
EV/EBITDA adjusted (x)	13.2	13.5	12.3	10.3	8.3
P/BV (x)	3.2	3.0	1.3	1.2	1.0
Dividend yield (%)	4.1	4.1	1.4	2.6	4.1
Per Share Data (Rs)					
EPS adjusted	10.61	12.81	4.16	9.47	13.29
EPS reported	12.76	19.35	-6.67	18.34	48.85
BVPS	64.68	70.05	156.75	167.58	203.60
DPS	8.50	8.50	3.00	5.50	8.50
Profit & Loss (RsM)					
Net sales	61,316	69,822	74,023	88,541	114,733
Operating expenses	-54,452	-62,859	-67,816	-78,960	-90,716
EBIT	**6,864**	**6,964**	**6,207**	**9,581**	**24,017**
Net interest expense	-1,036	-1,412	-2,099	-1,575	-1,103
Non-operating/exceptionals	683	4,434	-7,950	2,025	3,450
Pre-tax profit	**6,510**	**9,985**	**-3,842**	**10,031**	**26,364**
Tax	-1,357	-2,119	1,114	-2,072	-5,367
Extraord./Min.Int./Pref.div.	-50	-124	-124	-124	-124
Reported net income	**5,103**	**7,743**	**-2,852**	**7,835**	**20,874**
Adjusted earnings	4,243	5,126	1,777	4,046	5,679
Adjusted EBITDA	8,707	9,147	8,844	8,977	10,129
Growth Rates (%)					
Sales	15.4	13.9	6.0	19.6	29.6
EBIT adjusted	246.3	1.5	-10.9	-1.5	15.1
EBITDA adjusted	154.1	5.1	-3.3	1.5	12.8
EPS adjusted	43.9	20.7	-67.5	127.8	40.4
Cash Flow (RsM)					
Operating cash flow	**3,512**	**11,991**	**-6,382**	**15,038**	**29,082**
Depreciation/amortization	1,843	2,183	2,637	2,864	3,093
Net working capital	-4,492	802	-8,390	2,640	3,889
Investing cash flow	**-19,931**	**-4,364**	**-30,883**	**-4,718**	**-19,568**
Capital expenditure	-4,358	-5,227	-5,774	-7,174	-5,924
Acquisitions/disposals	-15,803	639	-26,597	3,000	-13,000
Financing cash flow	**15,128**	**-392**	**28,300**	**-10,325**	**-8,352**
Borrowings	19,544	4,333	-3,990	-6,000	-3,000
Dividends paid	-3,611	-3,642	-1,500	-2,750	-4,250
Change in cash	**-1,291**	**7,235**	**-8,965**	**-6**	**1,162**
Balance Sheet (RsM)					
Total assets	**84,322**	**92,782**	**123,929**	**128,751**	**148,024**
Cash & cash equivalent	2,951	4,379	2,828	2,364	2,292
Accounts receivable	15,716	14,931	17,813	19,447	20,191
Net fixed assets	42,534	45,619	48,756	53,066	55,897
Total liabilities	**58,129**	**64,178**	**56,250**	**56,321**	**60,079**
Accounts payable	8,450	8,615	9,975	10,890	11,972
Total Debt	39,556	41,416	37,426	31,426	28,426
Shareholders' funds	**26,193**	**28,604**	**67,679**	**72,430**	**87,945**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.2	13.1	11.9	10.1	8.8
ROE adjusted	16.9	19.0	3.7	5.8	7.2
ROIC adjusted	10.1	7.5	10.3	5.2	2.1
Net debt to equity	139.8	129.5	51.1	40.1	29.7
Total debt to capital	60.2	59.1	35.6	30.3	24.4

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Upgrade to Hold; TP of Rs241/share

We upgrade Ranbaxy to Hold,/High Risk (2H) with a target price of Rs241/share. This is a valuation call post the 51% fall in the stock triggered by FDA issues with its Paonta & Dewas facilities. Despite a sharp cut in estimates (42-47% over CY09-10E), adjusted for NPV of unaffected exclusivities, the stock trades at c7xCY09E EPS & c0.5xCY09E sales, which we believe prices in most negatives. We cut our TP to Rs241/sh as we use a lower target P/E (11x v/s 16x) for the base biz & higher discount rate for NPV of unique opportunities.

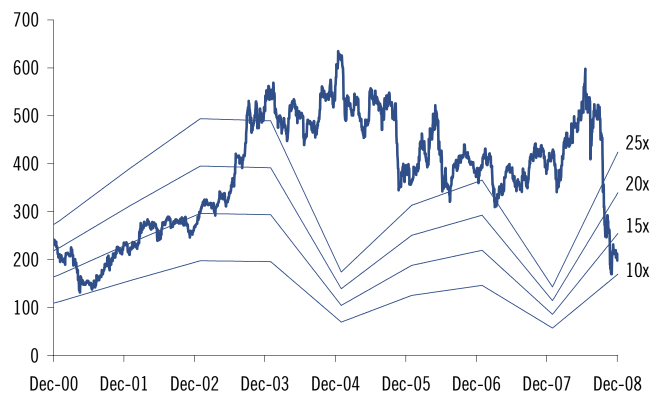
Upgrade to Hold; TP of Rs241/share

We upgrade Ranbaxy to a Hold/High Risk (from Sell/High Risk earlier), albeit with a lower target price of Rs241/share. We believe that post the sharp decline in the stock on the back of the import alert issued by the US FDA, valuations appear to build in most foreseeable negatives. While there are still some uncertain issues, which prevent us from being more constructive on the stock, risk & reward appear to be more balanced at this point.

Valuations have corrected substantially

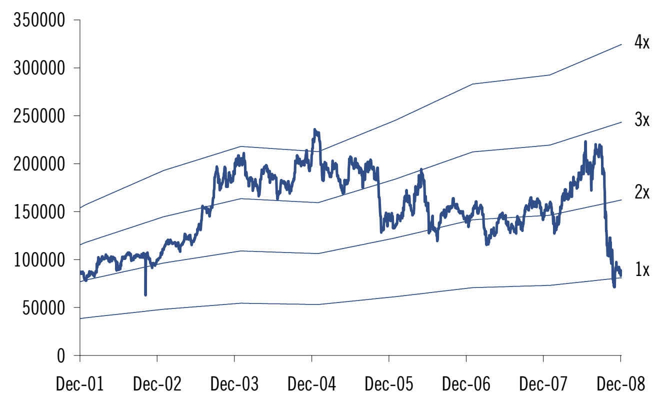
The Ranbaxy stock has declined by a sharp 51% in just over two months on the back of the import alert issued by the US FDA on two of its facilities. Following this decline, despite a sharp cut in our estimates (42-47% over CY09-10E), valuations have come off almost to all time lows. On adjusting for the NPV of unaffected settlements / exclusivities in the US market, the stock trades at c7xCY09E recurring earnings & EV/Sales (base biz) of c0.5xCY09E.

Figure 1. Ranbaxy – P/E Band Chart (Rs)



Source: Citi Investment Research

Figure 2. Ranbaxy – EV/Sales Band Chart (Rs m)



Source: Citi Investment Research

What could positively surprise?

The biggest positive surprise for the stock would be any progress on resolving the problems in the US market. Ranbaxy has already filed its response to the US FDA's warning letter with the agency & hopes for a speedy resolution. We are not sure how long this will take. At the very least, it will involve a re-inspection and the entire process could drag on for a while.

However, Ranbaxy has indicated that it is also in the process of looking at alternative options to ensure continuity in its US operations. It is seeking other sources for some of the key products that were being manufactured in the two plants. This could involve either of a) shift of manufacturing to some of its other plants in New Jersey, Goa or Toansa – this would involve change of site filings; b) source products from other manufacturers with US FDA approved plants – for instance, this is the option that Ranbaxy is evaluating for Storet & c) acquisition of US FDA approved manufacturing facilities on the back of its stronger balance sheet & the sharp erosion in valuations globally. If the company is able to execute one or more of these strategies, it could contain the negative impact on the US business to some extent.

Finally, with Daiichi having concluded the deal to acquire Ranbaxy, we could see some more clarity on specific steps to exploit synergies between the two businesses. These could be in the form of Ranbaxy providing contract manufacturing & research services to Daiichi or agreements to distribute Daiichi's products in different markets. While it would take some time for the benefits from these initiatives to reflect in financials, any clarity on specific measures would provide a support to valuations in our view.

Value of patent settlements

Figure 3. Key Para IV products – API filings

Para IV products	DMF filing	NPV (Rs/sh)
Lipitor	Toansa	56.3
Flomax	Toansa	15.0
Nexium	Toansa	47.2
Prilosec	Toansa	0.2

Source: Citi Investment Research

While the core business is definitely facing tough times, we believe that most of Ranbaxy's unique opportunities – in the form of patent challenge settlements – appear safe. Besides Imitrex & Valtrex, which were filed from the affected facilities, all other opportunities (Nexium, Flomax, Lipitor and Caduet) either appear to be filed from unaffected facilities or are far enough out in terms of time for Ranbaxy to execute alternative sourcing options. The Street appears to be ignoring the value of these opportunities (we put it at Rs137/share), which while understandable given the negative sentiment for the stock, is fundamentally incorrect. As such, while this may not act as a positive catalyst in the near to medium term, it is likely to provide support to valuations.

Why not a Buy?

Despite the lower valuations & some possible upsides, we believe that certain key uncertainties remain viz. a) How soon will the US FDA issue be resolved? b) Even if the issue is resolved or alternative sourcing arrangements are secured, can it recover lost share if it gets back in the market (& how soon)? c) What direction will Daiichi drive the business in? Will there be any transition related pain? There is also the possibility that despite being very conservative, we may have underestimated the impact of the import ban on estimates. We do not see clarity emerging on any of these issues in the near term and, barring rapid resolution of the FDA issue, these would weigh on valuations.

As such, we believe that the risk reward equation is more balanced than favourable at this point. We would look to get more constructive if there is more clarity on either the resolution of the issues at Paonta & Dewas or any tangible progress on alternate sourcing options.

Cutting target price to Rs241/share

We reduce our target price on Ranbaxy to Rs241/share from Rs373/share earlier. We reduce our target P/E for the base business to 11x (from 16x) – a 20% discount to the P/E that we use for sector leaders. Despite the sharp cut in our earnings estimates & the fact that CY09E earnings are not normalized, we believe that the discount is warranted given the uncertainties in the US business and the general risk aversion among investors. At 11xCY09E recurring earnings, we arrive at a fair value of Rs104/share for Ranbaxy's base business. We continue to value Ranbaxy's patent settlement upsides that appear unaffected by the import ban on an NPV basis – at Rs137/share.

Earnings Revision

Figure 4. Earnings Revision

	CY08E	CY09E	CY10E
Revenue (Rs m)			
New	74,023	88,541	114,733
Old	75,657	85,503	111,779
Change (%)	*-2%*	*4%*	*3%*
Net Profit (Rs m)			
New	1,777	4,046	5,679
Old	5,586	7,648	9,731
Change (%)	*-68%*	*-47%*	*-42%*

Source: Citi Investment Research estimates

- We revise our revenue estimates on the back of following factors:
  - Weaker INR estimates: we now use INR/US$ of 44, 48 & 47 for CY08, CY09 & CY10 estimates respectively
  - Lower revenues from US - we forecast a 7%-24% YoY decline in revenues ($ terms) over CY08-09E
  - Slower growth in emerging markets such as Africa, CIS & LatAm to factor in effect of the tight credit environment & potential trade level destocking

Despite the latter two negatives, the sharply lower INR assumptions lead to 3-4% higher revenue estimates over CY09-10E.

- We however lower our recurring net profit estimates for CY09-10E by 42-47% on the back of following factors:
  - Lower gross & operating margins on account of the higher loss of sales assumed in the US
  - Higher interest cost on the back of higher working capital (increase in debtor days in emerging markets) & cost of capital. We also expense the interest on the FCCBs given that they are far out of the money
  - CY08 net profit is lower by 56% to factor in the currency hedging losses incurred by Ranbaxy (primarily in 3Q)

Balance Sheet & Capital Efficiency

Figure 5. Debt Metrics (CY08E)

Net Debt / (Cash) (Rs m)	10,120
Net Debt/Equity (x)	0.16
Net Debt/EBITDA (x)	1.14
Interest Coverage (EBITDA)	4.2x

Source: Citi Investment Research estimates

Daiichi's cash infusion has strengthened Ranbaxy's balance sheet significantly, lowering net D/E to c0.2x & net debt of cUS$200-250m. We expect cash flows from settlements over CY09-14E to also add to the company's financial muscle. Overall, we believe that Ranbaxy is well placed to make further investments or pursue inorganic opportunities going forward.

However, return ratios have taken a big hit. We expect RoCE & RoE to decline to 6% & 4% respectively in CY08E due to lower margins & asset T/O post its troubles with the FDA. Even in the past, Ranbaxy's aggressive investment across markets & falling asset T/O due to increasing pricing pressure & competition have taken a toll on return ratios. We expect this to remain a drag on valuations in the medium term.

Impact of growing competition & pricing pressure clearly visible in the form of lower asset T/O & margins

Recent troubles with the US FDA cuts short a recovery in margins & will hurt return ratios

Improvement in CY09 is primarily on the back of commencement of Nexium API supplies to Astra

Balance sheet has however improved – with the infusion of cash by Daiichi – as reflected in the high share of investments in the balance sheet

As leverage drops, we see RoE coming under pressure

Figure 6. Capital Efficiency Meter – Breakdown of Return Ratios

	CY03	CY04	CY05	CY06	CY07	CY08E	CY09E
Return on Cap Employed (ROCE)	**36%**	**28%**	**6%**	**11%**	**12%**	**6%**	**11%**
PBIT Margin	**21%**	**18%**	**5%**	**12%**	**12%**	**9%**	**13%**
EBITDA Margin	22%	18%	6%	14%	13%	12%	14%
Depreciation/Sales	2%	2%	3%	3%	3%	4%	3%
Total Asset Turnover (Sales/CE)	**1.75**	**1.61**	**1.19**	**0.93**	**1.00**	**0.70**	**0.85**
Sales/Fixed Assets	4.37	3.00	2.03	1.44	1.53	1.52	1.67
Sales/Net Current Assets	2.94	3.53	2.90	2.68	3.17	2.71	3.57
Inventory Days	72	96	94	96	86	88	80
Debtor Days	57	76	78	94	78	88	80
Investments/Capital Employed	1%	1%	0%	1%	3%	28%	25%
Return on Equity (ROE)	**34%**	**29%**	**11%**	**19%**	**21%**	**4%**	**7%**
Net Margin	15%	13%	5%	8%	8%	3%	5%
Total Asset Turnover	1.75	1.61	1.19	0.93	1.00	0.70	0.85
Leverage (CE/Equity)	1.3	1.3	1.8	2.5	2.5	1.6	1.5

Source: Company data, Citi Investment Research estimates

Ranbaxy

Company description

Ranbaxy is a leading domestic pharmaceutical company with a strong export business complementing its domestic business. It has a vision of becoming a leading generics pharmaceutical company in the global market and, in the long term, a research-led pharmaceutical company. The company already has a presence in several countries, and has developed a complex business model, perhaps the first of its kind in a developing country. Over the past few years, Ranbaxy has grown rapidly and established itself firmly as a leading generics company globally. While the core pharmaceutical business is growing, it has also invested in R&D. The company also has a strong chemicals and animal healthcare business in India.

Investment strategy

We rate Ranbaxy Hold/High Risk (Sell/High Risk earlier) with a target price of Rs241. We believe that the US FDA's move to block imports & new approvals from Ranbaxy's Paonta & Dewas facilities could significantly hit the US business & overall profitability. However, post the sharp decline in the stock on the back of the aforesaid event, valuations appear to build in most foreseeable negatives. While there are still some uncertain issues, which prevent us from being more constructive on the stock at this point, we believe the risk-reward equation appears more balanced at this point.

Valuation

We value Ranbaxy shares using the P/E vs. earnings CAGR methodology to value its core business, as we do in the case of most stocks in the Indian pharmaceutical sector. We also add an additional value for the company's impressive patent challenge pipeline.

We value the core generics business (excluding exclusivity upsides) at 11x (v/s 16x earlier) 12-month forward earnings, at a 20% discount to frontline pharma companies in order to factor in the added uncertainty in its business following the issues with the US FDA. At 11x Dec09E recurring EPS, we arrive at a value of Rs104/share for the base generics business. We value the company's patent challenge pipeline using a probability-adjusted NPV approach. We increase this value to Rs137/share from Rs126/share earlier. Although we now use a higher discount rate (20% v/s 15% earlier), we use a lower share count (as we now treat FCCBs as debt) leading to the slightly higher value. We have not included some of the nearer-term opportunities (Imitrex, Valtrex) in our valuation to account for any delay due to the US FDA action. Cumulatively, we arrive at a fair value of Rs241/share (v/s Rs373/share earlier).

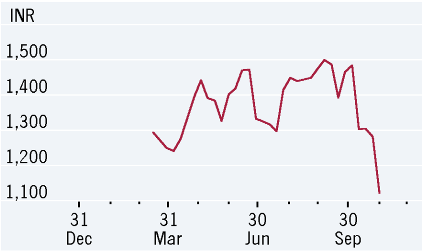
Risks

We rate Ranbaxy High Risk. The High Risk rating is to account for the added risk to the US operations following the stand-off with the US FDA. Our quants-based rating system, which tracks 260-day historical share price volatility, suggests Medium Risk. The key downside risks to our call include: a) price cuts in Romania (c8% & c20% of sales & EBIDTA); b) Early triggering of its exclusivity in Nexium, impairing its deal with Astra: each year knocks cRs8/sh off NPV; c) spill over of FDA issues to other plants. The key upside risks to our call include: 1) Earlier than expected resolution of the US FDA issues; 2) Lower than expected impact on US sales and profitability due to the ban on products from two facilities; 3) Any fresh settlement / patent challenge win in the US could boost sentiment for the stock.

Sun Pharmaceuticals (SUN.BO)

Buy/Medium Risk	**1M**
Price (05 Dec 08)	Rs1,009.10
Target price	Rs1,265.00
from Rs1,659.00	
Expected share price return	25.4%
Expected dividend yield	2.1%
Expected total return	**27.5%**
Market Cap	Rs209,001M
	US$4,197M

Price Performance (RIC: SUN.BO, BB: SUNP IN)



Buy: Solid Play; TP Cut to Rs1,265

- **Solid play** — Sun's track record of delivering consistent & robust growth while maintaining strong profitability & return ratios makes it the best Indian play in the generics space. Its strong balance sheet, rapid growth in solid markets & high cash generation should hold it in good stead in the current uncertain environment. Maintain Buy (1M) with a lower TP of Rs1,265.

- **TP cut to Rs1,265 (from Rs1,659)** — We lower our target P/E for the core biz to 17x from 22x, for a value of Rs1,220. The premium to other sector leaders is justified, we believe, given a superior track record, capital efficiency & B/S strength. We remove Effexor-XR from our option value for Sun's P-IV pipeline, post the USFDA's negative ruling, bringing it down to Rs45 (Rs105 earlier).

- **Balance sheet & capital efficiency** — Sun has a very strong B/S (net cash of US$550m), which along with its strong cash generation, is a great asset as it would allow Sun to pursue inorganic opportunities at a time when there has been significant erosion in generic valuations. Despite significant cash on books (45% of capital employed), RoCE is healthy at c22%.

- **Key catalysts** — a) Favourable ruling on Taro acquisition (Israeli SC hearing from Dec 8,'08); b) Resolution of issues raised in the FDA warning letter for Caraco's Detroit plant; c) Any settlements / wins on its Para-IV pipeline.

- **Key risks** — a) Warning letter by the FDA for Caraco's Detroit plant may prevent further approvals from the plant till the issues in the letter are resolved; b) Unfavourable ruling in the Protonix patent litigations could lead to material damages; c) Further setbacks on Taro front including unfavorable judgment in litigations or an inability to effectively integrate post acquisition.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	7,843	37.87	36.8	26.6	7.4	35.4	0.7
2008A	9,895	47.78	26.2	21.1	4.0	24.8	1.2
2009E	12,693	61.29	28.3	16.5	3.1	21.3	2.1
2010E	15,589	75.27	22.8	13.4	2.5	20.5	2.4
2011E	18,679	90.19	19.8	11.2	2.1	20.2	2.1

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	26.6	21.1	16.5	13.4	11.2
EV/EBITDA adjusted (x)	30.6	12.7	9.3	8.1	9.1
P/BV (x)	7.4	4.0	3.1	2.5	2.1
Dividend yield (%)	0.7	1.2	2.1	2.4	2.1
Per Share Data (Rs)					
EPS adjusted	37.87	47.78	61.29	75.27	90.19
EPS reported	37.87	71.80	91.62	102.20	90.19
BVPS	135.93	250.12	324.72	408.23	483.31
DPS	7.01	11.72	21.49	24.06	21.63
Profit & Loss (RsM)					
Net sales	21,340	33,571	41,310	47,207	45,459
Operating expenses	-15,414	-19,022	-22,591	-27,283	-29,354
EBIT	**5,926**	**14,549**	**18,719**	**19,924**	**16,105**
Net interest expense	0	0	323	323	323
Non-operating/exceptionals	2,408	1,445	2,013	3,209	4,255
Pre-tax profit	**8,334**	**15,994**	**21,054**	**23,455**	**20,682**
Tax	67	-485	-1,120	-1,137	-620
Extraord./Min.Int./Pref.div.	-559	-640	-960	-1,152	-1,383
Reported net income	**7,843**	**14,869**	**18,974**	**21,166**	**18,679**
Adjusted earnings	7,843	9,895	12,693	15,589	18,679
Adjusted EBITDA	6,739	15,517	19,863	21,214	17,528
Growth Rates (%)					
Sales	30.3	57.3	23.1	14.3	-3.7
EBIT adjusted	33.0	145.5	28.7	6.4	-19.2
EBITDA adjusted	33.0	130.2	28.0	6.8	-17.4
EPS adjusted	36.8	26.2	28.3	22.8	19.8
Cash Flow (RsM)					
Operating cash flow	**3,298**	**8,266**	**16,919**	**20,563**	**16,628**
Depreciation/amortization	813	969	1,144	1,290	1,423
Net working capital	-5,358	-7,572	-3,198	-1,893	-3,474
Investing cash flow	**-1,105**	**-5,809**	**-25,121**	**-16,686**	**-13,386**
Capital expenditure	-2,103	-1,787	-1,686	-2,686	-2,686
Acquisitions/disposals	998	-4,022	-23,435	-14,000	-10,700
Financing cash flow	**6,081**	**7,106**	**-3,049**	**-5,022**	**-4,513**
Borrowings	7,603	9,722	1,436	0	0
Dividends paid	-1,483	-2,547	-4,485	-5,022	-4,514
Change in cash	**8,275**	**9,563**	**-11,251**	**-1,144**	**-1,271**
Balance Sheet (RsM)					
Total assets	**43,250**	**59,701**	**71,836**	**90,007**	**106,605**
Cash & cash equivalent	14,106	18,284	28,556	42,564	53,374
Accounts receivable	6,789	14,177	12,738	13,317	15,533
Net fixed assets	10,122	11,040	11,582	12,978	14,241
Total liabilities	**15,085**	**7,901**	**4,587**	**5,462**	**6,511**
Accounts payable	2,966	3,722	4,390	5,265	6,314
Total Debt	11,144	1,436	0	0	0
Shareholders' funds	**28,166**	**51,800**	**67,249**	**84,545**	**100,093**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	31.6	46.2	48.1	44.9	38.6
ROE adjusted	35.4	24.8	21.3	20.5	20.2
ROIC adjusted	29.2	49.1	49.9	48.5	36.2
Net debt to equity	-10.5	-32.5	-42.5	-50.3	-53.3
Total debt to capital	28.3	2.7	0.0	0.0	0.0

For further data queries on Citi's full coverage universe please contact CIR Data Services Asia Pacific at CIRDataServicesAsiaPacific@citi.com or +852-2501-2791

Powered by: dataCentral

Solid Play; Cut TP to Rs1,265

Sun's track record of delivering consistent & robust growth while maintaining strong profitability & return ratios makes it the best Indian play in the generics space. Its strong balance sheet, rapid growth in solid markets & high cash generation would hold it in good stead in the current uncertain environment. Maintain Buy, albeit with a lower TP of Rs1,265, as we move to a lower multiple for the core business & take Effexor-XR out of our option value calculations.

Revising estimates & target price

- We revise our revenue estimates on the back of the following factors:
  - Weaker INR estimates: we now use INR/US$ of 47, 48 & 46 for FY09, FY10 & FY11 estimates respectively
  - Lower growth in Caraco, post the warning letter for its Detroit plant
  - Removal of Effexor XR from estimates; this is the main reason for the 10% decline in FY10 estimates.
- We reduce our FY09-10 recurring net profit estimates by 2-4% on account of higher depreciation costs.
- We also incorporate FY11 estimates & forecast FY08-11E recurring sales & earnings CAGRs of 19% & 23% respectively.

Figure 1. Earnings Revision

	FY09E	FY10E
Revenue (Rs m)		
New	41,310	47,207
Old	41,441	52,382
Change (%)	*0%*	*-10%*
Recurring EPS (Rs)		
New	61.3	75.3
Old	62.7	78.6
Change (%)	*-2%*	*-4%*

Source: Citi Investment Research estimates

Highlighting core & reported estimates

We highlight the components of our estimates for Sun Pharma – by breaking down its income statement into one of the core business and another from unique opportunities (exclusivity sales in Trileptal, Protonix & Ethyol). We assign a multiple only to core earnings while we build in a separate value for the upside from patent wins / settlements.

Figure 2. Sun Pharma – Core business & unique opportunities estimates

	FY08	FY09E	FY10E	FY11E
Core Business Revenues	27,279	33,086	38,951	45,459
Unique opportunities Revenues	6,292	8,223	8,256	-
Total Revenues (Rs m)	**33,571**	**41,310**	**47,207**	**45,459**
Core Business EBITDA	10,281	12,884	15,022	17,528
Contribution from Unique opportunities	5,236	6,979	6,192	-
Total EBITDA (Rs m)	**15,517**	**19,863**	**21,214**	**17,528**
Core Business EPS	47.8	61.3	75.3	90.2
Upside from exclusivities	24.0	30.3	26.9	-
Reported EPS (Rs)	**71.8**	**91.6**	**102.2**	**90.2**

Source: Company data, Citi Investment Research estimates

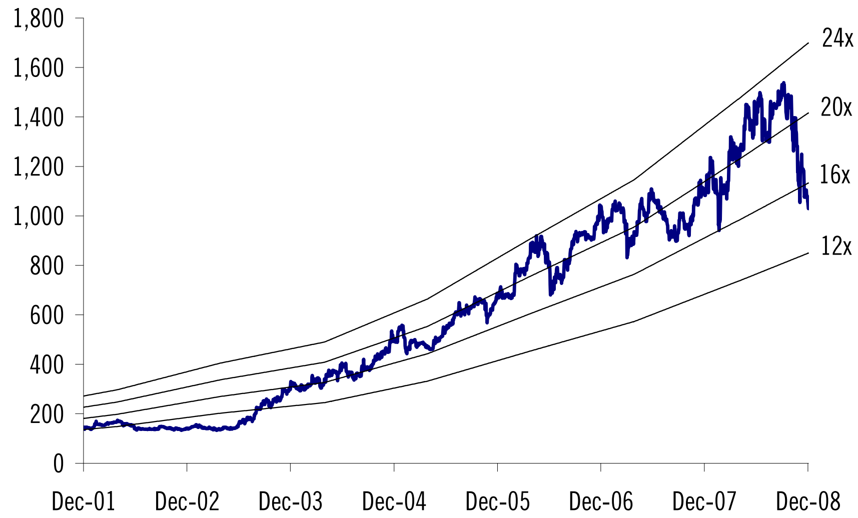
Cut TP to Rs1,265/share

We also lower our target price for Sun Pharma to Rs1,265 / share on the back of the following factors

- **Core business**: We reduce our target P/E multiple for Sun's base business to 17x from 22x earlier. This is in line with our move to shift our entire coverage universe to a lower valuation band in the changed market environment. Our valuation for Sun is at a 20% premium to other frontline generics stocks such Cipla & Glenmark. We believe this premium is justified given Sun's superior track record, capital efficiency & B/S strength as also the potential upside to earnings when it is able to deploy its sizeable cash in the business. At 17x Dec '09E EPS, we arrive at a value of Rs1,220/share for the core business (excluding exclusivities).

- **Unique opportunities**: We ascribe a value of Rs45/share to Sun's patent challenge pipeline – down from Rs105/share earlier. We remove Effexor XR (Rs60/share) from our earlier calculations post FDA's ruling upholding Osmotica's citizen's petition. We believe this opportunity may no longer be relevant for Sun from the near to medium term perspective although the company is still looking at its options. This value primarily reflects the NPV of future cash flows from Protonix & Ethyol.

Figure 3. Sun Pharma – P/E Band Chart (Rs)



Source: Citi Investment Research

Figure 4. Debt Metrics (FY09E)

Net Debt / (Cash) (Rs m)	(30,219)
Net Debt/Equity (x)	(0.45)
Net Debt/EBITDA (x)	(1.52)

Source: Citi Investment Research estimates

Balance Sheet & Capital Efficiency

Sun has a very strong balance sheet (net cash of US$550m), which along with its strong cash generation, is a great asset as it would allow Sun to pursue inorganic opportunities at a time when there has been significant erosion in generic valuations. Despite significant cash on books (45% of capital employed), RoCE is healthy at c22% on stripping out exclusivity upsides.

Return ratios – especially RoCE – are depressed despite improving profitability & fixed asset turnover due to high amount of idle cash on its books

Return ratios & margins for FY08-10E are buoyed by exclusivity sales – however, even excluding these, RoCE is healthy at 22%

As idle cash is deployed in the business, we expect further improvement

Conclusion of Taro acquisition may depress overall profitability & return ratios to start with before turning accretive over the longer term

Figure 5. Capital Efficiency Meter – Breakdown of Return Ratios

	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Return on Cap Employed (ROCE)	**31%**	**14%**	**17%**	**21%**	**30%**	**31%**	**28%**
PBIT Margin	**39%**	**35%**	**36%**	**39%**	**48%**	**51%**	**50%**
EBITDA Margin	40%	35%	31%	32%	46%	48%	45%
Depreciation/Sales	3%	3%	4%	4%	3%	3%	3%
Total Asset Turnover (Sales/CE)	**0.80**	**0.40**	**0.47**	**0.54**	**0.63**	**0.61**	**0.56**
Sales/Fixed Assets	1.51	1.53	1.73	1.97	2.63	3.10	3.21
Sales/Net Current Assets	2.92	3.04	2.38	1.72	1.62	1.73	1.83
Inventory Days	94	98	114	114	84	88	90
Debtor Days	83	77	80	116	154	113	103
Investments/Capital Employed	20%	61%	53%	41%	37%	45%	52%
Return on Equity (ROE)	**43%**	**35%**	**35%**	**30%**	**30%**	**30%**	**26%**
Net Margin	35%	34%	34%	39%	46%	48%	47%
Total Asset Turnover	0.80	0.40	0.47	0.54	0.63	0.61	0.56
Leverage (CE/Equity)	1.5	2.6	2.2	1.4	1.0	1.0	1.0

Source: Company data, Citi Investment Research estimates

Sun Pharmaceuticals

Company description

Sun Pharma is one of the fastest-growing companies in the domestic pharmaceutical market, growing at about 2x the industry rate. The company has followed a strategy of being the first to enter niche, high-growth segments (both organic and through acquisitions). The company has a presence in the CNS, pain management, ophthalmology, cardiovascular and respiratory segments. Sun is facing stiff competition in its traditional strongholds, but has managed to sustain growth and is focusing on new therapeutic areas. The company is looking to export its top formulation products to drive growth, and has set up marketing and distribution infrastructure in various markets. It is also filing for ANDA approvals through its US subsidiary Caraco and is looking to conclude its second key acquisition in the US (Taro Pharma).

Investment strategy

We rate Sun Pharma as Buy/Medium Risk (1M), with a target price of Rs1,265. We believe that Sun is well placed to grow despite the challenges that keep coming in the way of global generics companies. Its strong base in India should continue to be a good driver of growth and profitability as well as a source of cash flows, besides providing it with a cushion against an appreciating rupee. At the same time, the growing visibility and success on its patent challenge pipeline improves cash flows as well as its ability to gain traction with the trade.

Valuation

Our target price of Rs1,265 is based on a sum-of-the-parts approach, valuing its base business using a P/E approach and ascribing an option value for its patent challenge pipeline. We value frontline pharma stocks at a premium of around 50% to the broad market, due to the intellectual property built into the business models, faster growth as well as the potential to deliver positive earnings surprises. This works out to a multiple of 14x that we use for most sector leaders such as Glenmark, Cipla & Piramal Healthcare. However, we believe that Sun deserves a premium to these stocks, given its consistent track record, high profitability and return rations as well as the potential upside from the deployment of idle cash in the business. We therefore value Sun at a 20% premium to other frontline generic stocks – at 17x Dec'09E earnings, we value the core business at Rs1,220/share . We also ascribe an option value of Rs45/share to Sun's patent challenge pipeline – the value reflects the success achieved by Sun in monetizing three patent challenges (Trileptal, Protonix, Ethyol) and the growing number of patent challenges in the public domain.

Risks

Our risk rating on Sun Pharma is Medium Risk as we factor in the uncertainties on Taro; this is also in line with our quant-based rating system. The key downside risks to our target price are: (1) Warning letter by the FDA for Caraco's Detroit plant may prevent further approvals from the plant till the issues in letter are resolved; (2) Inability to close / effectively integrate the Taro acquisition and exploit synergies could keep earnings depressed for longer than we have anticipated; (3) A stronger IPR law in India could lead to a gradual slowdown in growth rates for the Indian market; (4) Damages to be paid in case it loses the litigation on Protonix with Wyeth. Upside risks to our target price include a faster-than-expected completion and integration of the Taro acquisition and a win in any patent challenge.

Appendix A-1

Analyst Certification

Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

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Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following as investment banking client(s): Apollo Hospitals, Barr Pharmaceuticals Inc, Fortis Healthcare, Glaxosmithkline Pharmaceutical, Glenmark Pharmaceuticals, Mylan Inc, Orchid Chemicals & Pharmaceuticals, Ranbaxy, Dr Reddy.

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