Company Flash

31 January 2008 | 7 pages

Sun Pharmaceuticals (SUN.BO)

Buy: Oxcarba Exclusivity Boost; How Sustainable?

- **How much is sustainable?** — We believe Sun's strong 3Q (sales up 47%; PAT up 60%) was primarily due to exclusivity sales of oxcarba in the US, reflected in the step jump QoQ in Caraco's distributed sales. Despite the late October launch and modest market share, sales appear quite high, implying that there may have been some pipeline filling that could normalize over the current quarter. We await more clarity from the management during the earnings call. The rest of the business – especially domestic formulations – continued to show encouraging growth and profitability. Maintain Buy (1L).
- **Oxcarba boost** — Sun distributes oxcarba in the US through Caraco & the step jump in Caraco's distributed sales (US$50m in 3Q vs. US$13m in 1H) implies that it was the key driver in 3Q. However, Sun had only 15% of the market by end December – pointing to some likely pipeline filling. With more companies having entered the market and 90%+ price erosion, this may be unsustainable.
- **Protonix next** — Sun launched generic protonix as settlement talks between Teva & Wyeth fell through. With Teva having captured 58% of the market & Wyeth's AG, we believe Sun may not get a very high market share. But, it looks like it may enjoy an extended co-exclusivity (with Teva) as the only other known P-IV filer (Kudco) will not get approval before Dec'08/Jan'09 (30-month stay expiry). While Sandoz & DRL also have ANDAs, they have not been sued and it is not clear whether they have challenged the composition of matter patent.
- **Key questions for the earnings call** — a) What are oxcarba inventory levels & could there be chargebacks given the recent price erosion? b) When does Sun expect further competition in generic protonix? c) What is the view on possible launch of Effexor XR in 2HCY08?

Buy/Low Risk	1L
Price (30 Jan 08)	Rs1,154.50
Target price	Rs1,150.00
Expected share price return	-0.4%
Expected dividend yield	1.0%
Expected total return	**0.6%**
Market Cap	Rs232,606M US$5,919M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	5,733	27.48	34.7	42.0	14.8	41.4	0.5
2007A	7,843	37.60	36.8	30.7	8.6	35.4	0.6
2008E	9,808	47.02	25.1	24.6	6.6	30.4	1.0
2009E	11,688	56.03	19.2	20.6	5.2	28.4	1.2
2010E	14,048	67.34	20.2	17.1	4.2	27.0	1.4

Source: Powered by dataCentral

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

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Oxcarba Boost; How Sustainable

We maintain our Buy/ Low Risk (1L) rating on Sun Pharma, even as we await clarity from the management over sustainability of the strong 3QFY08 numbers. We believe Sun's strong 3Q (sales up 47%; PAT up 60%) was primarily due to exclusivity sales of oxcarba in the US, reflected in the step jump QoQ in Caraco's distributed sales. Despite the late October launch and modest market share, sales appear quite high, implying that there may have been some pipeline filling that could normalize over the current quarter. We await more clarity from the management during the earnings call. At the same time, the at risk launch of generic Protonix would likely enable Sun to report consistently strong growth over the next few quarters, irrespective of how oxcarbazepine sales and profitability pan out hereon.

3QFY08 Results – Key Tables

Sales growth driven by exclusivity sales of oxcarbazepine and strong domestic formulations growth

Margin expansion due to higher margins in oxcarbazepine exclusivity sales

Net interest income not comparable YoY as it includes undisclosed amount in marked to market forex gains in both years

Figure 1. Sun Pharmaceuticals – 3QFY08 Results Snapshot (Rupees in Millions; Percent)

Year to 31st March	3QFY07	3QFY08	*% Ch YoY*	2QFY08	*% Ch QoQ*
Sales	**5,658**	**8,309**	***46.9***	**6,945**	***19.6***
Excise duty	(395)	(407)	*3.0*	(480)	*(15.3)*
Effective rate	*7.0*	*4.9*	*-208 bps*	*6.9*	*-202 bps*
Net sales	**5,263**	**7,902**	***50.1***	**6,465**	***22.2***
Expenditure	(3,530)	(4,356)	*23.4*	(4,056)	*7.4*
EBITDA	**1,733**	**3,547**	***104.6***	**2,409**	***47.2***
EBITDA Margin	***32.9***	***44.9***	***1,195 bps***	***37.3***	***761 bps***
Depreciation	(212)	(245)	*15.8*	(230)	*6.6*
Net Interest & Other income	636	179	*(71.8)*	111	*61.4*
PBT	2,157	3,481	*61.3*	2,290	*52.0*
Tax	29	(116)	*nm*	(1)	*nm*
Tax Rate	*(1.3)*	*3.3*	*nm*	*0.0*	*nm*
PAT	2,186	3,365	*53.9*	2,289	*47.0*
Share of minority partner	(198)	(181)	*(8.3)*	(104)	*74.4*
Net profit	**1,989**	**3,184**	***60.1***	**2,186**	***45.7***
Net Margins	*37.8*	*40.3*	*250 bps*	*33.8*	*648 bps*

Source: Company Reports and Citi Investment Research

Sharp decline in expenses as a percentage of sales as revenues were boosted by high margin exclusivity sales of oxcarbazepine

Figure 2. Sun Pharmaceuticals – 3QFY08 Expenditure Breakup (Rupees in Millions; Percent)

Year to 31st March	3QFY07	3QFY08	% Ch YoY	2QFY08	% Ch QoQ
Total Raw Material	1,557	1,779	14.3	1,800	(1.1)
% of Sales	*29.6*	*22.5*	*-706 bps*	*27.8*	*-532 bps*
Employee Expenses	658	764	16.1	750	1.8
% of Sales	*12.5*	*9.7*	*-284 bps*	*11.6*	*-194 bps*
R&D spend	705	805	14.1	671	19.9
% of Sales	*13.4*	*10.2*	*-322 bps*	*10.4*	*-20 bps*
Other Expenses	610	1,008	65.3	835	20.8
% of Sales	*11.6*	*12.8*	*117 bps*	*12.9*	*-15 bps*
Total Expenditure	**3,530**	**4,356**	**23.4**	**4,056**	**7.4**
% of Sales	***67.1***	***55.1***	***-1,195 bps***	***62.7***	***-761 bps***

Source: Company Reports and Citi Investment Research

Exports formulation growth driven by oxcarbazepine exclusivity sales

Strong growth in domestic formulations business

De-growth in bulk drug sales due to greater captive consumption reflected in high growth rates in formulation sales

Figure 3. Sun Pharmaceuticals – 3QFY08 Sales Breakup (Rupees in Millions; Percent)

Year to 31st March	3QFY07	3QFY08	*% Ch YoY*	2QFY08	*% Ch QoQ*
Total Sales	**5,658**	**8,309**	***46.9***	**6,945**	***19.6***
Domestic	**3,168**	**3,937**	***24.3***	**3,933**	***0.1***
% of Sales	*56.0%*	*47.4%*		*56.6%*	
Formulation	2,935	3,758	*28.0*	3,720	*1.0*
Bulk	227	177	*(22.1)*	211	*(16.1)*
Others	6	2	*(65.6)*	2	*(4.3)*
Exports	**2,490**	**4,372**	***75.6***	**3,013**	***45.1***
% of Sales	*44.0%*	*52.6%*		*43.4%*	
Formulation	1,927	3,902	*102.5*	2,478	*57.4*
Bulk	556	466	*(16.2)*	529	*(12.0)*
Others	7	5	*(30.4)*	6	*(12.7)*

Source: Company Reports and Citi Investment Research

Lower margins due to increased sales of distributed products, mainly oxcarbazepine

Distributed products accounted for 61% of total revenues in 3QFY08 at US$ 49.6m compared to 3% of total revenues in 3QFY07 – sharp sequential increase – up to US$50m in 3Q vs. US$13m in 1H, largely driven by oxcarbazapine sales in our view

Gross margins on distributed products at 15-16% significantly lower compared to 49% for manufactured products in 9mFY08

Figure 4. Caraco – 3QFY08 Results Snapshot (US $ in Millions; Percent)

Year Ended 31 Mar	3QFY07	3QFY08	*% Ch YoY*	2QFY08	*% Ch QoQ*
Net sales	**31.3**	**81.9**	***161.9***	**41.4**	***97.9***
Cost of Goods Sold	16.1	58.6	*263.2*	23.3	*151.0*
Gross Profit	15.1	23.3	*53.9*	18.0	*29.2*
Gross margins (%)	*48.4*	*28.4*	*-1,996 bps*	*43.6*	*-1,512 bps*
SG& A expenses	2.6	3.7	*43.0*	3.0	*22.7*
R&D cost other	2.7	4.1	*49.5*	5.1	*(19.9)*
Operating Profit (ex affiliates R&D cost)	**9.8**	**15.5**	***58.0***	**9.9**	***56.7***
OPM (%)	**31.3**	**18.9**	***-1,243 bps***	**23.9**	***-498 bps***
Net Other income (expense)	0.3	0.5	*99.2*	0.4	*26.41*
Tax	-	(0.6)		0.2	
Net Income	**10.1**	**16.7**	***65.5***	**10.1**	***65.5***
Net margins (%)	*32.2*	*20.3*	*-1,184 bps*	*24.3*	*-398 bps*
R&D cost to Sun Global -Non Cash	-	5.9	*nm*	5.4	*8.1*
Total R& D	2.7	10.0	*264.6*	10.5	*(5.5)*
Reported Net income	**10.1**	**10.8**	***7.1***	**4.6**	***133.1***

Source: Company Reports and Citi Investment Research

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.

Investment strategy

We rate Sun Pharma as Buy/Low Risk (1L), with a target price of Rs1,150. The recent Taro acquisition, using idle funds on the balance sheet, improves the company's global scale and reach as well as improving quality of earnings. Having taken a big step forward towards being bigger and more geographically spread out, we believe that Sun is now 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.

Valuation

Our target price of Rs1,150 is based on a sum-of-the-parts approach. We continue to value Sun's base business using a P/E vs. earnings CAGR approach and ascribe an option value for its patent challenge pipeline. We value Sun's base business at 20x FY09E earnings. With a steadily growing profit line, we believe P/E is the best method to value Sun Pharma. We value frontline pharma stocks at a premium of around 40% 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 20x that we use for Sun Pharma as well as its peers such as Dr Reddy's and Cipla. Our estimates do not incorporate the Taro acquisition. However, we believe that it would be dilutive in the short term, i.e. FY08E, before being earnings neutral or mildly accretive in FY09E. As such, we believe that it is relevant to value Sun based on FY09E estimates as the earnings dilution phase is transient, and should not affect fair value. At 20x FY09E earnings, we arrive at a value of Rs1,136 /share for the base business. We also ascribe an option value of Rs14/share to Sun's patent challenge pipeline, using a 15% success rate on the company's patent challenges that are in the public domain.

Risks

We rate Sun Pharma as Low Risk because of its steady growth and visible earnings stream. This is also consistent with our quantitative risk-rating system, which tracks 260-day historical share price volatility. The key risks to our target price are: (1) Price deterioration in any of its key markets; (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. Upside risks to our target price include a faster-than-expected integration of the Taro acquisition and a win in any patent challenge.

Appendix A-1

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Sun Pharmaceuticals (SUN.BO)

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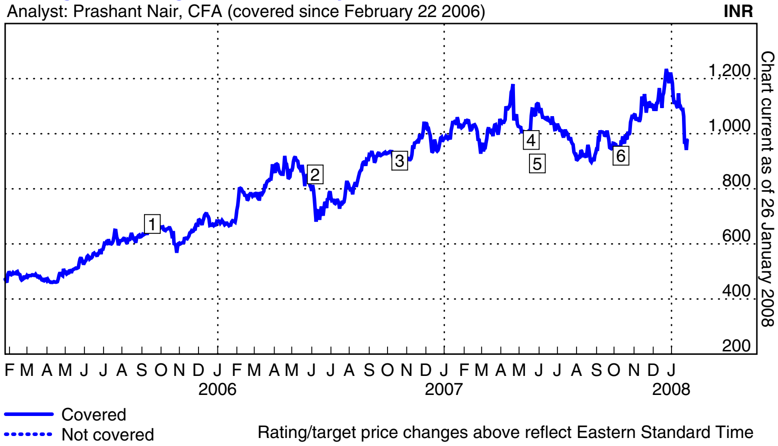
Analyst: Prashant Nair, CFA (covered since February 22 2006)



#	Date	Rating	Target Price	Closing Price
1:	19 Sep 05	3L	*426.29	663.10
2:	7 Jun 06	3L	*617.23	721.40
3:	20 Oct 06	3L	*678.51	912.45
4:	21 May 07	3L	*678.46	1,064.15
5:	30 May 07	*2L	*1,150.00	1,109.20
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