Equities

20 January 2011 | 9 pages

Biocon (BION.BO)

Licensing Income Drives Beat

- **Licensing Income Drives Beat** — Biocon's reported 3Q numbers were higher than our expectations (13% beat on EBIDTA and 9% beat on net income), almost entirely driven by higher licensing income (net of higher R&D spend) during the quarter. Other than this, the only surprise was subdued performance at Axicorp, which was offset by strong growth in Biopharma and a recovery in research services.

- **Biopharma drives topline** — Higher sales in Biopharma (+22% YoY; +15% QoQ) & higher licensing income (up 339% YoY – largely from Pfizer) led to good revenue growth (+15% YoY). Launch of tacrolimus earlier in FY11, continued growth in the India branded biz & a pick up in statins were the main factors aiding strong growth in Biopharma. Research services (+14%) also grew well following a pick up in fortunes at Syngene. However, the Axicorp biz (-15%YoY, -19% QoQ) in Germany was affected by compulsory rebates in the German market from this quarter.

- **Profitability aided by higher licensing Income** — EBIDTA margins improved 317bps YoY, primarily on the back of higher licensing income. R&D expenses were higher as well, with charges of cRs300m (related to insulin for Europe) that were capitalized earlier being expensed during the quarter. Net Profit growth (+22% YoY) was subdued due to unusually higher tax rate (c22% vs. 15%), which is expected to normalize over the full year.

- **Key Earnings Call Takeaways** — a) Encouraged by the oral insulin (IN 105) trial results and hopes to be able to shortlist a potential licensing partner in the next 6 months b) Revenues from India and other emerging markets under the insulins deal with Pfizer to commence in FY12; c) Plans to bolster immunosupressants pipeline with 3 new products (one filed, two under development for the US); d) Expects to launch reusable pen for insulin in mid-2011; e) Expects to file human insulin in Europe in mid CY12. Glargine trials for EU to also start in CY11

■ Company Update

Hold/Medium Risk	2M
Price (20 Jan 11)	Rs387.05
Target price	Rs480.00
Expected share price return	24.0%
Expected dividend yield	1.1%
Expected total return	**25.1%**
Market Cap	Rs77,410M
	US$1,708M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	2,231	11.15	3.3	34.7	5.1	14.9	0.8
2010A	2,933	14.66	31.5	26.4	4.4	17.9	0.9
2011E	3,367	16.84	14.8	23.0	3.9	17.9	1.1
2012E	3,984	19.92	18.3	19.4	3.4	18.6	1.3
2013E	4,796	23.98	20.4	16.1	3.0	19.6	1.5

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	34.7	26.4	23.0	19.4	16.1
EV/EBITDA adjusted (x)	24.1	16.8	14.3	12.4	10.4
P/BV (x)	5.1	4.4	3.9	3.4	3.0
Dividend yield (%)	0.8	0.9	1.1	1.3	1.5
Per Share Data (Rs)					
EPS adjusted	11.15	14.66	16.84	19.92	23.98
EPS reported	4.66	14.66	16.84	19.92	23.98
BVPS	75.54	87.89	99.80	113.90	130.86
DPS	3.00	3.50	4.21	4.98	5.99
Profit & Loss (RsM)					
Net sales	16,087	23,678	28,082	31,459	35,594
Operating expenses	-13,956	-20,365	-24,358	-27,142	-30,486
EBIT	**2,131**	**3,314**	**3,724**	**4,317**	**5,108**
Net interest expense	-177	-169	-153	-50	0
Non-operating/exceptionals	466	370	390	420	534
Pre-tax profit	**2,421**	**3,515**	**3,961**	**4,687**	**5,642**
Tax	-118	-487	-594	-703	-846
Extraord./Min.Int./Pref.div.	-1,371	-96	0	0	0
Reported net income	**931**	**2,933**	**3,367**	**3,984**	**4,796**
Adjusted earnings	2,231	2,933	3,367	3,984	4,796
Adjusted EBITDA	3,234	4,715	5,465	6,198	7,156
Growth Rates (%)					
Sales	52.7	47.2	18.6	12.0	13.1
EBIT adjusted	4.1	55.5	12.4	15.9	18.3
EBITDA adjusted	8.3	45.8	15.9	13.4	15.4
EPS adjusted	3.3	31.5	14.8	18.3	20.4
Cash Flow (RsM)					
Operating cash flow	**1,079**	**4,248**	**4,281**	**5,316**	**6,295**
Depreciation/amortization	1,103	1,401	1,741	1,881	2,047
Net working capital	-1,282	-345	-980	-599	-548
Investing cash flow	**-2,553**	**-2,578**	**-972**	**-2,000**	**-5,500**
Capital expenditure	-3,649	-2,015	-3,278	-2,000	-2,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**-574**	**-1,000**	**-3,621**	**-3,665**	**-1,403**
Borrowings	11	-298	-2,636	-2,500	0
Dividends paid	-585	-702	-985	-1,165	-1,403
Change in cash	**-2,047**	**670**	**-312**	**-349**	**-608**
Balance Sheet (RsM)					
Total assets	**25,436**	**29,361**	**30,630**	**32,274**	**37,273**
Cash & cash equivalent	118	1,399	1,321	1,379	1,321
Accounts receivable	3,667	4,461	5,353	5,997	6,785
Net fixed assets	12,205	12,408	13,167	13,286	13,239
Total liabilities	**10,081**	**11,444**	**10,331**	**9,157**	**10,763**
Accounts payable	3,570	4,909	5,752	6,402	7,176
Total Debt	5,239	5,136	2,500	0	0
Shareholders' funds	**15,355**	**17,916**	**20,299**	**23,117**	**26,510**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	20.1	19.9	19.5	19.7	20.1
ROE adjusted	14.9	17.9	17.9	18.6	19.6
ROIC adjusted	12.7	15.4	15.5	16.4	18.6
Net debt to equity	33.4	20.9	5.8	-6.0	-5.0
Total debt to capital	25.4	22.3	11.0	0.0	0.0

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3QFY11 Results Snapshot

Figure 1. 3QFY11 Financial Snapshot (Rs m; %)

Year to 31st March	3QFY10	3QFY11	% ch YoY	2QFY11	% ch QoQ
Biopharma	2,895	3,540	*22.3*	3,078	*15.0*
Axicorp	2,587	2,184	*(15.6)*	2,698	*(19.1)*
Licensing Income	175	768	*338.9*	231	*232.5*
Research Services	694	789	*13.7*	781	*1.0*
Total Operational Income	**6,351**	**7,281**	***14.6***	**6,788**	***7.3***
RM Costs	3,710	3,842	*3.6*	3,998	*(3.9)*
as a % of sales	*58.4*	*52.8*	*-565 bps*	*58.9*	*-613 bps*
Staff costs	599	758	*26.5*	707	*7.2*
as a % of sales	*9.4*	*10.4*	*98 bps*	*10.4*	*0 bps*
Others	604	447	*(26.0)*	450	*(0.7)*
as a % of sales	*9.5*	*6.1*	*-337 bps*	*6.6*	*-49 bps*
R&D	171	550	*221.6*	197	*179.2*
as a % of sales	*2.7*	*7.6*	*486 bps*	*2.9*	*465 bps*
Total Expenditure	5,084	5,597	*10.1*	5,352	*4.6*
EBITDA	**1,267**	**1,684**	***32.9***	**1,436**	***17.2***
EBIDTA Margin	*19.9*	*23.1*	*317 bps*	*21.2*	*197 bps*
EBIDTA Margin (ex license inc)	*17.7*	*14.1*	*-362 bps*	*18.4*	*-432 bps*
Depreciation	360	406	*12.7*	391	*3.8*
Interest	27	66	*143.0*	65	*0.9*
Other Income	64	96	*50.0*	89	*7.9*
PBT	**944**	**1,308**	***38.6***	**1,069**	***22.4***
Taxes	112	291	*159.8*	156	*87.0*
Effective tax rate	*11.9*	*22.2*	*1,038 bps*	*14.6*	*769 bps*
PAT	**832**	**1,017**	***22.3***	**913**	***11.4***
Minority Interest/Other	24	10	*(58.8)*	22	*(54.8)*
Net Income	**808**	**1,007**	***24.7***	**892**	***13.0***

CIRA Comments

Conclusion: **3Q better than expected on higher licensing income (From Pfizer). Otherwise inline.**

Revenue growth driven by Biopharma – Axicorp disappoints on compulsory rebates (16%) introduced during the quarter in Germany

EBIDTA margin improvement mainly due to higher Biopharma sales and higher licensing income; dragged down by Axicorp

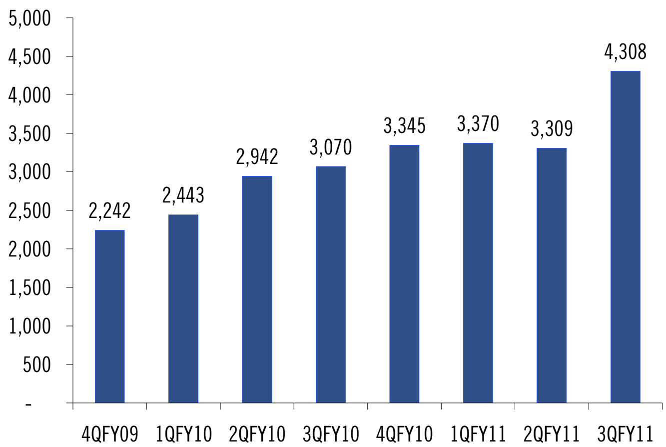
EBITDA margin (ex-licensing) seems depressed owing to higher R&D expense (capitalized items expensed during the quarter); Adjusting for higher R&D expenses (Rs 350m), margin is similar to 3QFY10

Tax rate higher than the 15% guidance for FY11 owing to one time internal transfer of IP

Source: Company Reports and CIRA Estimates

Snapshot of Key Businesses

Figure 2. Biopharma (ex Axicorp) Revenues (Rs m)



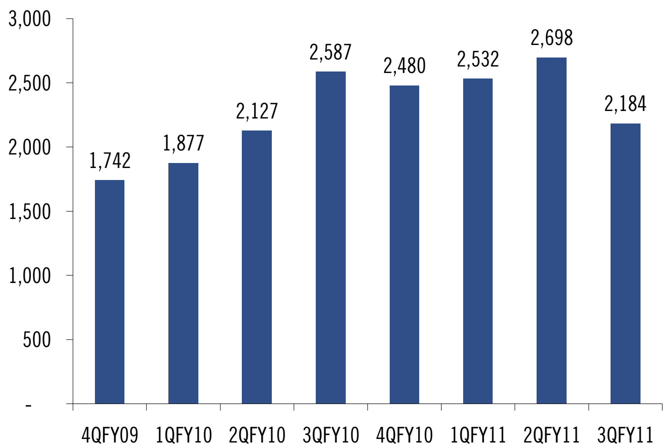
Source: Citi Investment Research and Analysis

CIRA Comments

- 3Q revenues include Rs768m of licensing income, largely from Pfizer – v/s Rs231m in 2QFY10
- Milestone payments from Mylan expected to continue for the next few quarters while cash flows from Pfizer to also be recognized in the P&L over a period of 4-5 yrs
- Immunosuppresants (esp Tacrolimus) and Statins biz continue to do well
- Branded formulations in India grew by c32% YoY – New division launched in 2Q have started contributing to the growth

Source: Citi Investment Research and Analysis estimates

Figure 3. Axicorp Revenues (Rs m)



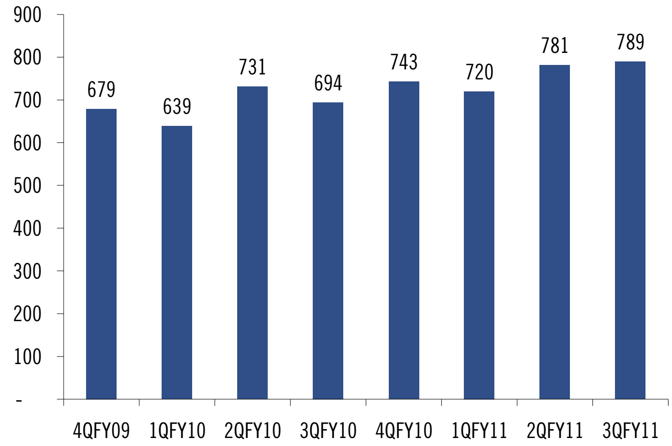
Source: Citi Investment Research and Analysis

CIRA Comments

- Axicorp revenues declined 16% YoY and 19% QoQ primarily due to government imposed price cuts in the tune of 16%
- EBITDA margins at 4% for the quarter dragged down the overall margins
- Company expects the challenges to continue in the coming quarters and is not factoring in any growth

Source: Citi Investment Research and Analysis estimates

Figure 4. Contract Research Revenues (Rs m)



Source: Citi Investment Research and Analysis

CIRA Comments

- Contract research revenues grew at 14% YoY basis primarily due to Syngene
- Syngene grew 21% YoY in top line and showed 3% improvement in EBITDA margins
- Restructuring and introduction of value added services have started positively impacting performance
- Listing of Syngene further pushed out to FY13

Source: Citi Investment Research and Analysis estimates

Biocon

Valuation

We have a target price of Rs480 for Biocon, based on an SOTP valuation. We value Biocon’s base business at Rs360/share – based on 18x March ‘12E EPS (v/s 17x Sept ‘11E earlier), at a 10% discount to our target range for leading generic pharma companies in our coverage universe, such as Dr.Reddy's & Lupin. We believe the discount is warranted given Biocon's relatively narrow product basket in APIs & lower growth. Since pharma is a growth sector, we prefer to use P/E v/s EPS CAGR as our primary valuation methodology for the base business of pharma companies. We also ascribe a value of Rs120/share to the insulins deal with Pfizer – based on an NPV of expected cash flows (upfront & milestone payments, capex & development cost as well as payments linked to Pfizer’s sales). We build in explicit forecasts till FY20, following which we use a terminal growth rate of -2%. We assume gradual increase in market share for Pfizer and that Biocon makes c15% on Pfizer’s sales. Given the back-ended nature of cash inflows and uncertainty over timelines & assumptions, we use a relatively higher discounting rate (15%) in our analysis.

Risks

Our risk rating for Biocon is Medium Risk as against the Low Risk rating suggested by our quant based rating system, given the risk from rupee appreciation and scope for delays / execution issues. The main downside risks include: 1) slower-than-expected ramp-up in the insulins deal with Pfizer; 2) Setback on the oral insulin project could hurt sentiment; 3) Sustained appreciation in the rupee could hurt revenues & profitability, especially in the research services biz. Key upside risks include: 1) licensing deals for oral insulin or T1h molecules; 2) faster-than-expected progress in biosimilars efforts in the US & / or EU; 3) Swift turnaround in the research services biz.

Appendix A-1

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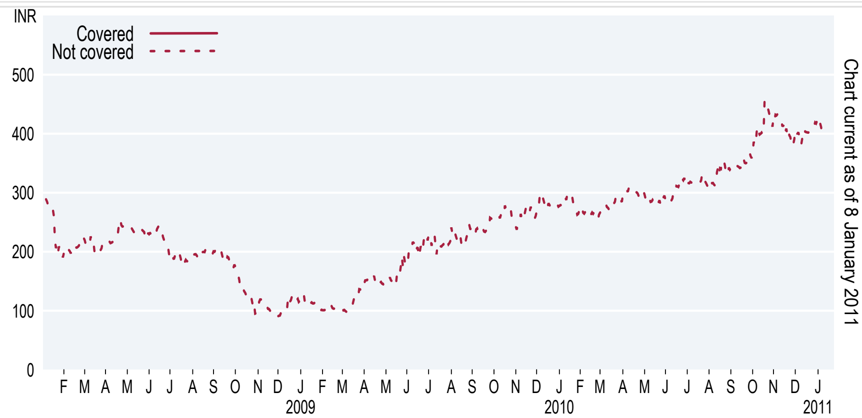
Biocon (BION.BO)
Ratings and Target Price History
Fundamental Research
Analyst: Prashant Nair, CFA

	Date	Rating	Target Price	Closing Price
1	17-Jan-08	3L	*250.50	270.30
2	6-Mar-08	*3M	*218.00	214.08
3	22-Apr-08	3M	*228.00	254.43
4	21-Jul-08	*3H	*199.50	178.50
5	12-Sep-08	3H	*200.00	191.95
6	16-Oct-08	3H	*122.00	125.90
7	9-Dec-08	3H	*93.00	96.30
8	21-Jan-09	3H	*104.00	113.35
9	9-Jun-09	3H	*140.00	216.55
10	22-Oct-09	3H	*200.00	272.20
11	29-Apr-10	3H	*250.00	302.40
12	2-Jul-10	3H	*285.00	316.30
13	23-Jul-10	3H	*290.00	320.85
14	25-Oct-10	*2M	*480.00	439.20

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Biocon (BION.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)
Analyst: Prashant Nair, CFA



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12 Month Rating ***Relative Rating***

Data current as of 31 Dec 2010	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
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