investor's eye

Index

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Tata Motors

Viewpoint

CARS conversion—an overhang

CMP: Rs273

What are CARS?

CARS are Zero Coupon Convertible Alternative Reference Securities issued by Tata Motors in July 2007 to raise $490 million from foreign bond holders. These bonds are due for redemption on June 12, 2012 and carry yield to maturity (YTM) of 131.82%.

CARS notification issued by Tata Motors dated February 16, 2012

Tata Motors has notified to all bondholders to convert CARS before June 12, 2012 into Tata Motors' ordinary shares. The conversion price is fixed at Rs181.43 per share. The bondholders also have an option to redeem these bonds at a predefined yield. Our scenario analysis throws odds in favour of the redemption.

Scenario 1: CARS conversion by bondholders

The conversion price as well as the rupee-dollar rate while estimating the bond conversion into equity shares has been fixed. The bondholders who may opt for conversion will get a conversion price of Rs181.4. The $473 million worth CARS will fetch a dollar-rupee rate of 40.6.

Impact on Tata Motors

The conversion of CARS by the bondholders will be hugely positive for the company as there will be no cash outflow. This would also bring down the automotive debt: equity ratio of the company, thereby strengthening the balance sheet. We estimate 3.9% equity dilution in Tata Motors' ordinary shares.

Returns to Tata Motors bondholders on conversion	
Zero coupon CARS (mn$) **(A)**	473.0
$ Conversion price assumed	40.6
CARS investment in Rs crore (quantum)	1,919.9
Conversion price Rs	181.4
Equity dilution (no. of shares in crore)	10.6
Current market price Rs	270.0
Assuming converted shares sold at CMP (Rs crore)	2,857.6
Shares sold converted into dollar **(B)**	583.2
Gain expected post-sales of converted shares (dollar) **(B-A)**	110.2
Returns to bondholders on their investment (%)	**23.3**

Scenario 2: CARS redeemed by the bondholders

The bond holders are entitled to a 131% YTM on their zero coupon CARS. There is no fixed dollar-rupee rate for the redemption. The redemption would take place at current currency rates.

Impact on Tata Motors

Tata Motors would face a double whammy as the company has to bear the impact of a sharp depreciation in the rupee at the time of redemption. Apart from the currency impact, the company would also see a significant increase in the refinancing cost. We estimate a 58% impact on Tata Motors at Rs49 (conversion rate of the dollar) if it redeems the bonds.

Impact of redemption on Tata Motors	
Pay-in	
Zero coupon CARS (mn$)	473.0
$ Conversion price assumed	40.6
CARS amount in Rs crore (quantum) **(A)**	1,919.9
Pay-out	
Zero coupon CARS (mn$)	473.0
$ Conversion price assumed	49.0
CARS amount in Rs crore (quantum)	2,317.7
131% YTM **(B)**	3,036.2
Impact **(B/A-1)** (%)	58.1

Probability of conversion low

We estimate a mere 23.3% return for bondholders in five years, assuming they sell the converted shares at Rs270 per share. The returns are much lower than 131%, five-year YTM return on the respective bonds. The conversion is highly unlikely at the current prices due to the lower relative return.

Conversion consideration only if market price improves above Rs287 per share

The bondholders are likely to get a 31% return on redemption. This is equivalent to Tata Motors' stock price at Rs286 per share at a rupee-dollar rate of 49. The bondholders would be enthused only if Tata Motors' stock price moves above Rs287.

Options for bondholders (redemption)	
Zero coupon CARS (mn$)	473.0
$ Conversion price assumed	49.0
CARS amount in Rs crore (quantum)	2,317.7
131% YTM	3,036.2
Gains in Rs crore	718.5
Returns to bondholders (%)	**31.0**
Stock price equivalent of bondholders redemption value	286.8

Conclusion

The conversion will be hugely positive for Tata Motors but redemption will have a severe impact on the company's cash flow. At the current prices, the bondholders are likely to opt for redemption unless they have a long-term equity interest in the company. Prima facie, our view is negative for the event but the same may reverse if the stock price appreciates sharply or the rupee appreciates to around Rs46 levels.

Sharekhan Limited, its analyst or dependant(s) of the analyst might be holding or having a postition in the companies mentioned in the article.

Valuation

Our FY2012 consolidated earnings per share (EPS) estimate stands at Rs36. The stock has traded between 8x and 9x one-year forward earnings in the past. Given the excellent performance of Land Rover, the company may continue to see long-term investment interest. However, the short-term overhang of CARS redemption would stay. We are positive on the stock with a long-term investment horizon.

Tata Motors (consolidated) (Rs cr)

Particulars	FY09	FY10	FY11	FY12E
Revenues	70,881.0	92,519.3	123,133.3	164,929.7
Growth (%)	*100.1*	*30.5*	*33.1*	*33.9*
EBIDTA margin (%)	2.6	8.8	13.7	13.7
PAT	-2166.0	2486.6	9,042.6	11,413.0
Growth (%)	*NA*	*-214.8*	*263.7*	*26.2*
FD EPS	-8.4	8.7	28.5	36.0
P/E (x)	-32.3	31.2	9.5	7.6
P/B (x)	11.8	9.5	4.5	2.9
RoE (%)	-36.5	30.3	47.2	38.1
RoCE (%)	0.3	13.3	22.6	23.8

Sharekhan Special

Q3FY2012 Pharma earnings review

Key points

- **Pharma universe grows 29% in Q3FY2012:** Sharekhan's pharmaceutical (pharma) universe reported a 29.1% year-on-year (Y-o-Y) growth in net sales during Q3FY2012. The growth was mainly driven by the export of formulations which grew by 39% year on year (YoY) on a weaker currency and acquisition-led volume growth for a few. Excluding the contribution from the newly acquired entities the growth would have been at 16% YoY. Adjusted for the marked-to-market (MTM) foreign exchange (forex) losses and the extraordinary items, the net profit grew by 49% YoY, mainly driven by an improvement in the margins and better operating leverage. Revenues of players like Opto Circuits (up 46% YoY), Sun Pharma (up 34% YoY), Ipca Laboratories (Ipca; up 29% YoY) and Glenmark Pharma (up 37% YoY) were better than our expectations. Other players like Divi's Laboratories (Divi's; up 33.7% YoY), Cadila Healthcare (Cadila; up 21.9% YoY), Lupin (up 22.1% YoY) and Torrent Pharma (up 21.8% YoY) performed in line with our expectations.

- **Weaker rupee helps OPM but pinches bottom line:** The operating profit margin (OPM) of our pharma universe stood at 26.2% (up 362 basis points YoY) mainly due to favourable currency movement and a better operating performance by players like Sun Pharma (up 1,741 basis points YoY, due to the consolidation of Taro Pharma), Ipca (up 586 basis points YoY) and Lupin (up 390 basis points YoY). However, players like Glenmark Pharma (core operating profit down 420 basis points YoY), Divi's (core operating profit down 280 basis points YoY) and Cadila (core operating profit down 114 basis points YoY), mainly on a higher raw material cost and higher payments to foreign employees due to the rupee's depreciation. However, lower values of the rupee against major international currencies also resulted in huge MTM losses which eroded a substantial portion of the profits. During the quarter, our pharma universe collectively provided non-cash forex loss of Rs222 crore against forex gains of Rs39 crore in Q3FY2011. Players like Glenmark Pharma, which has substantial foreign liabilities, provided Rs102 crore of MTM forex losses, followed by Ipca with Rs40 crore, Lupin with Rs34 crore, Cadila with Rs31.7 crore and Torrent Pharma with Rs18 crore. Players like Divi's recorded forex gains of Rs8 crore during the quarter. However, since these are non-cash items, we expect a partial write-back in the subsequent quarter as the rupee has strengthened against the major international currencies.

Q3FY2012 results snapshot (Rs cr)

Company	Net sales			OPM (bps)			Adjusted PAT		
	Q3FY12	YoY %	QoQ %	Q3FY12	YoY	QoQ	Q3FY12	YoY %	QoQ %
Cadila Healthcare	1,383	21.9	13.4	18.9	-114	85	181	8.8	17.7
Divi's Lab	415	33.7	17.1	35.8	-281	13	115	12.8	8.0
Glenmark Pharma	1,031	37.3	-2.3	8.4	-232	-956	148	61.8	-45.7
Ipca Lab	602	29.0	-2.6	23.0	346	-171	104	62.3	-1.2
Lupin	1,792	22.1	8.9	21.3	393	445	270	20.4	39.0
Opto Circuits	611	46.4	8.8	28.0	-143	46	129	50.4	6.5
Sun Pharma	2,145	34.0	13.2	44.9	1741	355	668	90.9	11.8
Torrent Pharma	676	21.8	2.7	17.5	90	3	101	31.6	24.8
Total	**8,654**	**29.1**	**10.5**	**25.2**	**216**	**86**	**1,715**	**47.9**	**7.1**

* bps - Basis points

- **Universe's bottom line grows 26% YoY despite forex losses:** Despite the provisioning of MTM forex losses, the net profit of the pharma universe grew by 26% YoY, mainly driven by Sun Pharma, which reported a 90% Y-o-Y rise in its net profit due to the consolidation of Taro Pharma, Opto Circuits (up 31% YoY) and Divi's (up 20.6% YoY). However, the forex losses affected the net profit of Glenmark Pharma (down 58% YoY) and Cadila (down 7.9% YoY) during the quarter. The adjusted profit after tax (PAT; excluding the forex loss and extraordinary items) grew by 48% YoY for our universe.

- **We introduce estimates for FY2014:** Since we are closer to the end of FY2012 and the visibility of the revenues and earnings of our universe is better, we have introduced estimates for FY2014. On an average, our pharma universe is trading 14x and 12x FY2013E and FY2014E earnings. We have based our valuation on the average of the earnings for FY2013 and FY2014. We prefer Sun Pharma (an impressive performance of Taro Pharma and a better operating performance on a cash-rich balance sheet), Divi's (niche business segments and a clean balance sheet) and Ipca (a better operating performance on operationalisation of the Indore plants).

Without acquisitions pharma universe would have grown 16% YoY despite weaker currency

Our pharma universe reported a 29% Y-o-Y rise in net sales during Q3FY2012, mainly driven by acquisitions and favourable currencies that boosted the exports. During the quarter, Cadila included the revenue from the newly acquired Neshar Pharma, USA (estimated revenue Rs50 crore in Q3FY2012) Bremer Pharma, Germany (Q3FY2012 revenue at Rs10.7 crore) and Biochem Pharma, India (two weeks' revenue in Q3FY2012 at Rs10 crore). Besides, Lupin included the revenues from the newly acquired Irom Pharma, Japan (estimated revenues of Rs73 crore in Q3FY2012) while Sun Pharma included revenues from Taro Pharma, which was acquired in December 2010 (revenues at Rs741 crore in Q3FY2012 vs Rs170 crore in Q3FY2011). Excluding the sales from these acquisitions, the pharma universe would have grown by 16.3% YoY. The acquisitions and the weaker rupee also helped to report an impressive rise in exports, which grew by 33% during the quarter. It may be noted that the rupee depreciated by 13.3% against the dollar and by 12.6% against the euro during the quarter.

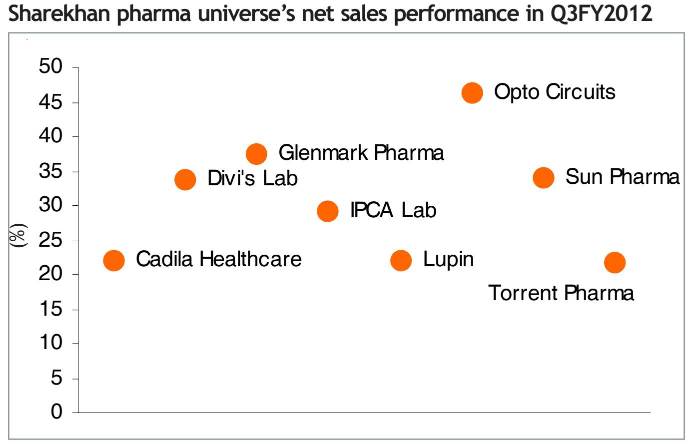
Revenue break-up (pharma universe)

Particulars	Q3 FY12	Q3 FY11	YoY %	Q2 FY12	QoQ %
Domestic formulations	2,329	2,093	11.3	2,406	-3.2
Exports formulations	4,208	3,017	39.5	3,625	16.1
Bulk drugs	900	834	8.0	858	5.0
Others*	1,216	753	61.6	1,055	15.3
Total	**8,655**	**6,697**	**29.2**	**7,943**	**9.0**

*Includes revenues from Opto Circuits, CRAMS business of Divi's and animal healthcare, OTC business of Cadila

In our universe, Opto Circuits topped with a 46.4% Y-o-Y rise in revenues (an acquisition-led growth) followed by Glenmark Pharma at 37.3% (on strong US sales), Sun Pharma at 34% YoY (on consolidation of Taro Pharma) and Divi's at 33.7% YoY (on strong traction in contract research and manufacturing services [CRAMS] business). Cadila was the weakest performer with a 21.9% Y-o-Y rise in the net sales during the quarter despite contributions from the three newly acquired entities.

Sharekhan pharma universe's net sales performance in Q3FY2012



Indian formulation business: Except Lupin none of players witnessed double-digit growth

In Q3FY2012 our pharma universe witnessed an 11.3% Y-o-Y rise in the Indian formulation business, which is better than the 9.7% growth achieved in Q3FY2011. However, on a Q-o-Q basis the pharma universe witnessed a 3.2%

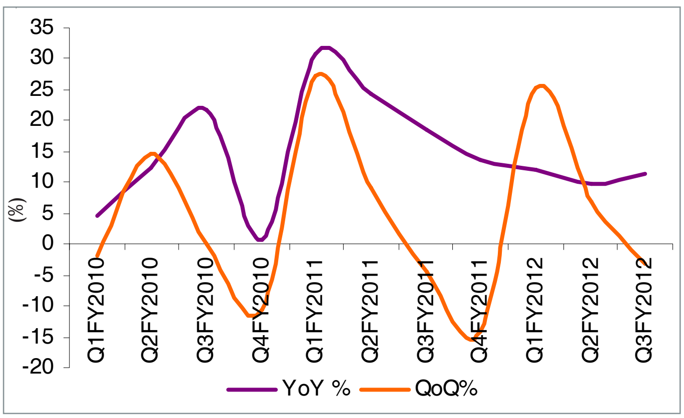
Trend in net sales (Y-o-Y growth in %)

Company	Q1FY10	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12
Cadila Healthcare	28.4	23.7	31.1	16.1	19.9	21.2	17.5	43.2	11.2	10.2	21.9
Divi's Lab	-23.8	-33.2	-30.2	-3.7	29.5	13.7	63.3	52.8	36.6	39.8	33.7
Glenmark Pharma	18.0	5.5	10.4	44.4	25.4	22.7	17.0	11.7	27.4	45.7	37.3
Ipca Lab	21.7	23.8	26.3	15.8	16.4	20.5	17.9	34.9	26.8	19.2	29.0
Lupin	25.9	22.7	30.5	23.1	20.9	26.0	16.9	17.6	17.6	17.1	22.1
Opto Circuits	29.9	17.8	21.8	56.9	26.7	29.6	62.5	44.7	78.4	69.6	46.4
Sun Pharma	-24.4	-7.5	11.2	-2.2	73.3	25.8	56.8	31.9	19.8	38.3	34.0
Torrent Pharma	22.4	16.2	10.3	13.8	12.8	21.4	19.5	9.2	16.7	19.2	21.8
Pharma universe	9.2	8.5	17.6	16.5	29.8	23.5	29.1	27.9	22.5	27.9	29.1

decline in the revenues. The growth in the domestic market was mainly led by Lupin, which recorded a 29.8% Y-o-Y rise in the sales of formulations in India. Except Lupin none of the players witnessed a double-digit growth during the quarter on an organic basis. Of late, the domestic formulation industry has witnessed a sluggish growth mainly due to slower offtake in acute segments and fewer new product launches.

We expect the growth to pick up in the subsequent quarters as the newly added field force would contribute better. We expect Lupin to maintain the growth momentum while Cadila is expected to catch up on the contribution from Biochem Pharma. Ipca is expected to report better numbers from the domestic market as most of the restructuring of its sales division is over.

Domestic formulations (Q3FY2012 growth in %)



Domestic formulation (Y-o-Y growth in %)

Company	Q2 FY11	Q3 FY11	Q4 FY11	Q1 FY12	Q2 FY12	Q3 FY12
Cadila Healthcare*	18.6	16.6	22.4	4.9	0.7	10.6
Glenmark Pharma	21.5	29.7	-11.2	20.0	13.4	6.5
Ipca Lab	29.4	11.7	13.2	12.4	3.3	5.7
Lupin	15.6	16.2	26.7	17.1	22.2	29.8
Sun Pharma	36.1	20.2	14.6	11.9	9.9	4.4
Torrent Pharma	21.3	15.6	8.5	9.5	7.3	8.4
Pharma universe	24.3	18.4	13.7	12.0	9.7	11.3

*Excluding newly acquired Biochem Pharma, growth would be 8.2% YoY.

Favourable currency and acquisitions led the bumper growth; growth momentum to slow in subsequent quarters

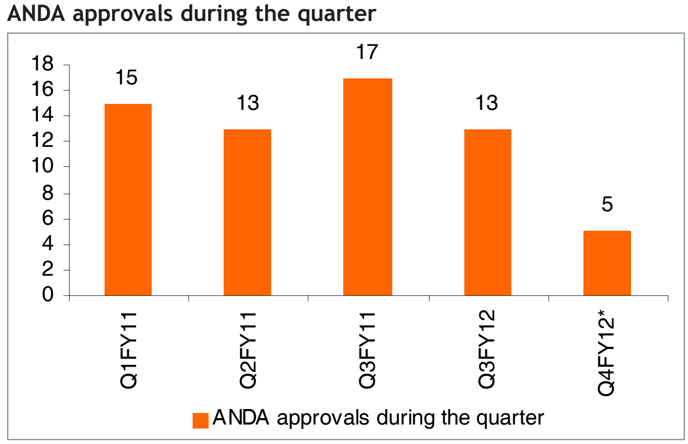
During Q3FY2012, our pharma universe reported a 39.3% Y-o-Y rise in exports, mainly contributed by favourable currency movement and acquisitions. The growth in exports was mainly led by Glenmark Pharma (up 65% YoY on key launches in US markets), Sun Pharma (up 53% YoY on contribution from Taro Pharma) and Opto Circuits (up 46% YoY on contribution from Cardiac Science).

The export growth would be slower for our universe in the subsequent quarters for two key reasons: (a) a stronger rupee and (b) a high base effect (the full quarter revenue of Taro Pharma for Sun Pharma and that of Cardiac Science for Opto Circuits).

We expect US market to see better traction on key launches

During the quarter, our pharma universe witnessed the approval of 13 abbreviated new drug application (ANDA) from the US Food and Drug Administration (USFDA), most of which accrued to Sun Pharma and Lupin. During January and February 2012, our universe has seen five ANDA approvals (three for Glenmark Pharma and two for Sun Pharma).

ANDA approvals during the quarter



Bulk drug business continues to be volatile, expect single-digit growth for most

During the quarter the bulk drug business reported an 8% Y-o-Y rise, mainly driven by Sun Pharma (up 32.8% YoY)

Key products to drive FY2012 revenues of Indian players

Brand name	Brand owner	Generic name	Patent expiry	Market opportunity	FTF opportunity	Others
Plavix	Sanofi	Clopidogrel bisulfate	May-12	$5.9bn	Apotex	Sun Pharma, DRL, Torrent, Teva
Seroquel	Astrazeneca	Quetiapine fumarate	Mar-12	$3.7bn	Teva	Accord, Handa Pharma
Lexapro	Forest	Escitalopram oxalate	Mar-12	$2.2bn	Teva/Dr Reddy's	Sun Pharma
Geodon	Pfizer	Ziprasidone hydrochloride	Mar-12	$864mn	Dr Reddy's/Lupin/Sandoz	NA
Stalevo	Orion	Carbidopa	Apr-12	$139mn	Sun Pharma, Wockhardt	NA
Viagra	Pfizer	Sildenafil citrate	Mar-12	$1bn	NA	NA
Singulair	Merck & Co.	Montelukast sodium	Aug-12	$3bn	Glenmark Pharma	NA

and Divi's (custom synthesis business up 33.7% YoY). The single-digit growth in the bulk drug can mainly be attributed to the higher captive consumptions by the integrated players. We expect the bulk drug business to maintain the single-digit growth in the subsequent quarters as well.

Bulk drugs (Y-o-Y growth in %)

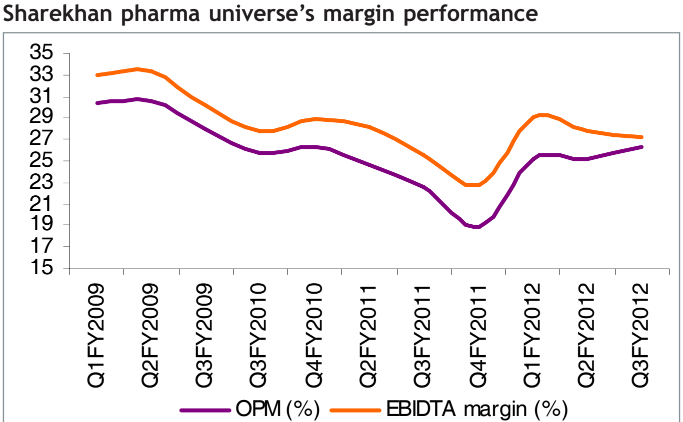
Company	Q2 FY11	Q3 FY11	Q4 FY11	Q1 FY12	Q2 FY12	Q3 FY12
Cadila Healthcare	-5.8	5.9	18.2	-24.9	-27.1	-12.4
Divi's Lab	13.7	63.3	52.8	36.6	39.8	33.7
Glenmark Pharma	30.4	-3.4	68.1	1.9	-1.2	11.5
Ipca Lab	-1.9	8.6	5.4	5.3	9.4	4.8
Lupin	0.4	18.8	42.6	12.0	1.3	-12.8
Sun Pharma	4.6	-18.1	0.2	4.1	6.0	32.8
Torrent Pharma	14.3	35.3	11.6	38.4	-1.3	2.6
Pharma universe	5.2	13.2	30.8	9.6	5.9	8.0

OPM improves on weaker rupee and better product mix

The OPM of the pharma universe jumped by 216 basis points YoY to 27.6% mainly due to favourable currency movement and a better operating performance in some cases. Prominent players among our universe were Sun Pharma, which witnessed a 1,740-basis-point Y-o-Y jump in its OPM on consolidation with Taro Pharma, and Lupin, which reported a 400-basis-point Y-o-Y rise in its margin on a better contribution from the high-margin Indian formulation business. The unavailability of exclusivity products affected the OPM of Glenmark Pharma (margin down 232 basis points YoY) while players like Divi's (margin down 280 basis points YoY) and Cadila (margin down 100 basis points YoY) witnessed higher employee and material costs respectively.

We expect better margins going forward for three key reasons: (a) a ramp-up in the newly commissioned facilities would result in lower overhead costs (in case of Torrent Pharma, Ipca and Cadila); (b) the key launches in the US markets would fetch better operating profits (in case of Glenmark Pharma, Lupin and Sun Pharma); and (c) better contribution from the newly added field force in the domestic market (Ipca and Cadila).

Sharekhan pharma universe's margin performance



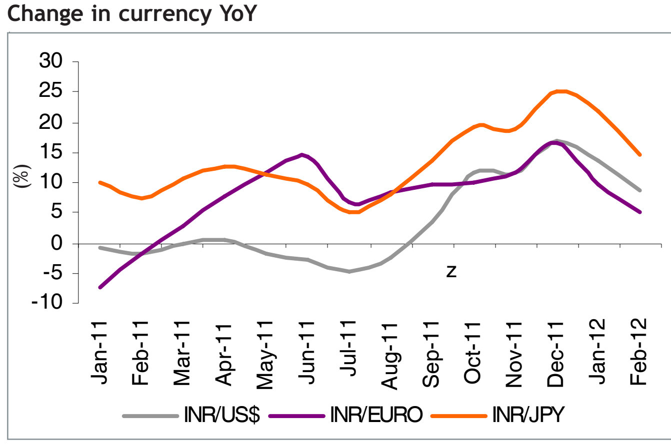
OPM %

Company	Q2 FY11	Q3 FY11	Q4 FY11	Q1 FY12	Q2 FY12	Q3 FY12
Cadila Healthcare	21.2	20.1	15.7	19.6	18.1	18.9
Divi's Lab	33.5	38.6	39.9	35.6	35.6	35.8
Glenmark Pharma	23.5	22.2	3.4	34.2	18.2	19.8
Ipca Lab	22.8	19.5	19.3	18.0	24.7	23.0
Lupin	19.2	17.3	17.8	17.5	16.8	21.3
Opto Circuits	31.9	29.4	12.1	27.5	27.5	28.0
Sun Pharma	34.1	27.5	30.3	33.5	41.4	44.9
Torrent Pharma	15.9	16.6	5.7	19.4	17.5	17.5
Pharma universe	24.6	22.6	18.8	25.3	25.2	27.6

Forex loss erodes profits for many, expect partial write-back in subsequent quarters

During the quarter, our pharma universe collectively provided non-cash forex loss of Rs222 crore against forex gains of Rs39 crore in Q3FY2011. Most of the provisions were related to the translation of foreign loans and forward contracts into hedge receivables. Players like Glenmark Pharma, which has substantial foreign liabilities, provided Rs102 crore of MTM forex losses, followed by Ipca with Rs40 crore, Lupin with Rs34 crore, Cadila with Rs31.7 crore and Torrent Pharma with Rs18 crore. Players like Divi's recorded forex gains of Rs8 crore during the quarter. However, these being non-cash items, we expect a partial write-back in the subsequent quarter as the rupee has strengthened against the major international currencies in February 2012.

Change in currency YoY



Weaker rupee and higher interest rate regime at home spike finance costs

During the quarter the interest cost of our pharma universe jumped by 32.6% YoY and 10% QoQ mainly due to higher interest payments on foreign loans due to the depreciating local currency and a spike in the interest rate at home amidst spiraling inflation. Interest cost during the quarter constituted 1.2% of the net sales as compared to 1.1% in Q3FY2011.

Forex (gains)/loss

Company	Q1FY10	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12
Cadila Healthcare	1.41	2.53	-3.83	1.11	9.15	-1.88	0.62	-16	0.00	51.00	31.7
Divi's Lab	0	0	0	0	0	0	0	0	0	0	-8
Glenmark Pharma	0	0	0	0	-9	-12	-18	-26	-9	85	102
Ipca Lab	-6	1	2	-2	0	-29	-11	-3	0	27	40
Lupin	0	0	0	0	0	0	0	0	0	0	34
Opto Circuits	-0.4	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	-4.9	5.1	4.2
Sun Pharma	0	0	0	0	0	0	0	0	0	0	0
Torrent Pharma	0	0	0	0	0	0	0	0	0	-19	18
Pharma universe	-5	3	-2	-1	0	-43	-29	-45	-14	149	222

Interest costs as % of net sales

Company	Q1FY10	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12
Cadila Healthcare	2.6	2.3	2.2	1.9	2.1	1.6	1.7	1.6	1.0	2.1	2.0
Divi's Lab	0.4	1.3	0.9	-0.9	0.1	0.2	0.2	0.1	0.1	0.2	0.0
Glenmark Pharma	8.1	7.7	5.7	5.3	5.4	4.3	4.0	7.4	4.7	2.8	3.5
Ipca Lab	2.1	1.6	1.3	1.6	1.2	1.2	1.2	3.0	1.6	1.9	1.8
Lupin	1.0	0.8	0.9	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.5
Opto Circuits	5.8	4.1	2.8	2.1	1.8	1.9	2.1	2.4	2.1	2.5	2.7
Sun Pharma	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Torrent Pharma	0.6	1.3	0.6	1.0	0.5	0.6	0.6	0.6	0.7	0.4	0.0
Total	**2.2**	**2.0**	**1.7**	**1.4**	**1.4**	**1.2**	**1.1**	**1.7**	**1.1**	**1.1**	**1.2**

Depreciation costs as % of net sales

Company	Q1FY10	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12	Q2FY12	Q3FY12
Cadila Healthcare	3.4	3.4	3.5	4.9	3.0	2.8	2.9	2.7	3.0	3.1	3.4
Divi's Lab	6.3	5.9	7.0	3.9	5.0	5.2	4.4	2.8	3.9	4.3	3.9
Glenmark Pharma	5.7	6.1	5.7	2.4	3.4	4.7	4.6	0.4	3.0	2.3	2.2
Ipca Lab	3.1	2.7	3.0	3.2	3.1	2.6	3.0	3.0	2.9	2.8	3.0
Lupin	2.1	2.2	2.9	3.2	3.1	3.1	2.8	3.1	3.1	3.2	3.2
Opto Circuits	1.9	2.7	2.5	3.0	3.1	3.5	3.7	3.1	2.9	1.9	2.3
Sun Pharma	4.8	3.5	3.5	3.8	2.9	2.6	5.0	3.3	4.0	3.5	3.6
Torrent Pharma	2.4	2.8	2.6	4.3	2.7	2.8	2.9	3.4	3.3	3.1	2.9
Total	**3.5**	**3.4**	**3.6**	**3.6**	**3.1**	**3.2**	**3.7**	**2.8**	**3.3**	**3.1**	**3.2**

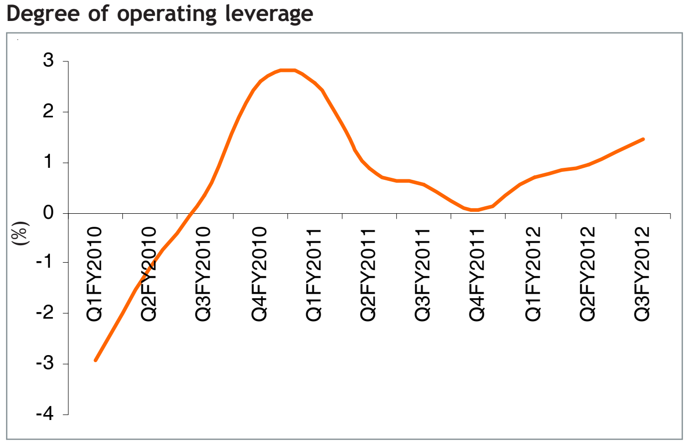
Capex phase is over for most players, better operating leverage ahead

During the quarter the depreciation cost of our pharma universe rose by 9.7% YoY, which is better than the increase of 29% and 24% YoY seen in Q1FY2012 and Q2FY2012 respectively. As most of the players in our universe are done with their major expansion programmes, we may see better operating leverage ahead.

Expect better operating leverage ahead

During the quarter the degree of operating leverage for our pharma universe stood at 1.4x as compared to 0.7x and 1x in Q1FY2012 and Q2FY2012 respectively. That shows a better operating performance on expanded assets. Historically, operating leverage has been higher in case of first to file (FTF) opportunities, which give extraordinary margins.

Degree of operating leverage



Tax rate jumps for many, expect a slight decline in subsequent quarters

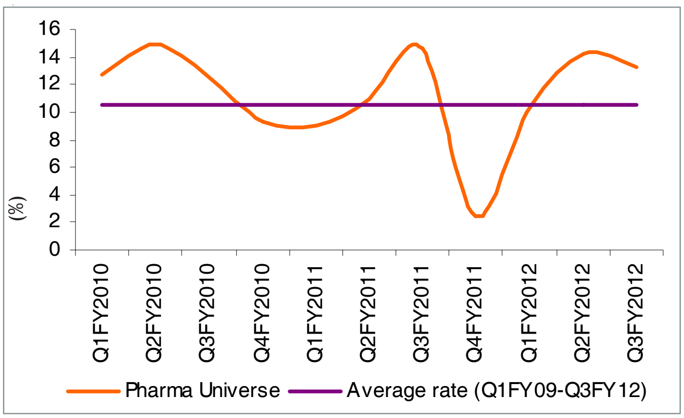
During the quarter the effective tax rate stood at 13.3% for our pharma universe as compared with 14.7% in Q3FY2011. However, companies like Ipca, Lupin and Divi's witnessed a spike in their effective tax rate mainly due to the cessation of the tax benefits on the export-oriented units (Divi's and Lupin) and a lower contribution from the tax-exempted units (Indore special economic zone [SEZ] for Ipca). However, most of other players witnessed a slightly lower tax rate.

The effective tax rate should ease in the subsequent quarters for Divi's (on a higher contribution from the DSN SEZ at Vishakhapatnam) and Ipca (on higher capacity utilisation of the Indore SEZ post-USFDA approvals).

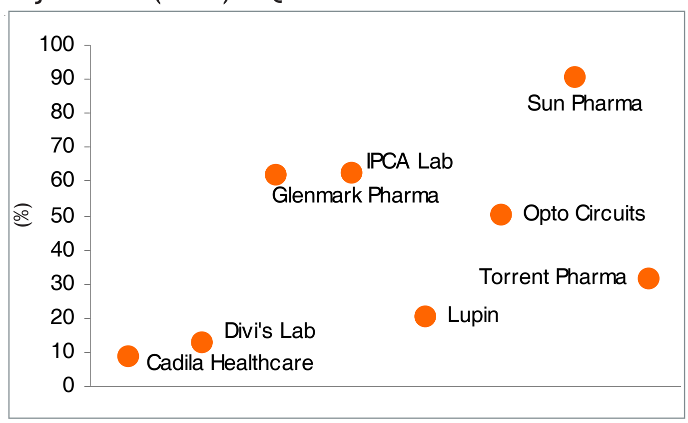
Pharma universe registers a net profit growth of 26%, despite forex MTM loss impact

Despite the provisioning of MTM forex losses, the net profit of our pharma universe grew by 26% YoY, mainly driven by Sun Pharma, which reported a 90% Y-o-Y rise in its net profit due to the consolidation of Taro Pharma, Opto Circuits (up 31% YoY), and Divi's (up 20.6% YoY). However, the forex losses affected the net profit of Glenmark Pharma (down 58% YoY) and Cadila (down 7.9% YoY) during the quarter. The adjusted PAT (excluding the forex loss and extraordinary items) grew by 48% YoY for our universe.

Effective tax rate



Adjusted PAT (YoY %) in Q3FY2012



Q3FY2012 results snapshot

	Q3FY12 performance	Surprises	Action
Cadila Healthcare	Broadly in line	Substantially lower than expected revenue from the emerging markets, Europe and Zydus Wellness	Revenue and earnings estimates revised downward for FY2012 and FY2013 respectively. Introduced FY2014 estimates.
Divi's Lab	In line with expectation	A sharp rise in the effective tax rate	Marginally reduced earnings estimates for FY2012 and FY2013. Introduced FY2014 estimates.
Glenmark Pharma	Better than expected but for for forex loss	A sharp decline in the core OPM	Maintain revenue and earnings estimates for FY2012 and FY2013. Introduced FY2014 estimates.
Ipca Lab	Better than expected	A 312% Y-o-Y jump in tender-based institutional business	Earnings estimates got revised by 14% and 7% for FY2012 and FY2013 respectively. Introduced FY2014 estimates.
Lupin	In line with expectations but higher tax rate	A sharp jump in the effective tax rate	Earnings estimates have been revised downward by 3.6% and 3.7% for FY2012 and FY2013 respectively. Introduced FY2014 estimates.
Opto Circuits	Better than expected	Better than expected revenues from newly acquired Cardiac Science (CSX); OPM declined sharply	Maintained earnings estimates for FY2012 and FY2013. Introduced FY2014 estimates.
Sun Pharma	Better than expected	Impressive performance of Taro Pharma	Introduced estimates for FY2014.
Torrent Pharma	In line with expectations	A 71% Y-o-Y rise in the US business; a 240-basis-point Y-o-Y improvement in OPM	Toned up earnings estimates for FY2012 and FY2013. Introduced estimates for FY2014.

Key growth drivers for Indian players

Cadila Healthcare	Strong business model, Baddi plants to help ramp up US sales, strong in vaccines (poor Q3FY2012 affected price). Expect acquisition-led growth in subsequent quarters.
Divi's Lab	CRAMS is likely to pick up, new SEZ facility to help ramp up production and bring down effective tax rate. Clean balance sheet and strong cash to weigh high on valuation.
Glenmark Pharma	The SOTP valuation includes Rs64 from the research pipeline; strong product pipeline in the USA including multiple FTF opportunities.
IPCA Lab	Focus on brands, WTO tender sales and scaling of Indore facility are main triggers. USFDA approvals of Indore plants would help ramp up sales in the USA.
Lupin	Branded business is facing competition, oral contraceptives and opthalmic products are focus area. Impressive growth in the domestic market and Japan is a strong factor. Expect small to mid-sized acquisitions in the emerging markets.
Opto Circuits	An acquisition-led growth in FY2012; FY2013 would be slower. Entry into the US market in the invasive segments would be a key driver (not started yet).
Sun Pharma	Consolidation of Taro Pharma would help post a stronger performance. The negative outcome on Protonix litigation and rejection of the offer price to acquire 100% stake in Taro Pharma would be sentiment dampener. The strong business model, focus on niche segments and cash-rich balance sheet would continue to help valuations.
Torrent Pharma	A pick-up in the CRAMS business, scaling up at the Sikkim plants and contribution from the newly added field force are main triggers; strong RoE and RoCE expected.

We have fine-tuned our estimates for key players

Getting cues from the nine months' results and our interaction with the management of the pharma companies under our coverage we have revised our estimates and price targets in some cases. We have also introduced our estimates for FY2014 on better visibility of revenues and profits.

Outlook

We deduce three key trends from the M9FY2012 performance of the key players in the pharma industry: (a) the domestic market has shown a pick-up; (b) even without FTF, players have shown a better operating performance; and (c) having completed major expansion programmes their focus has now shifted to strengthening of the bottom line. We expect better traction in the CRAMS business as well on better offtake by the key multinationals. The infusion of new technologies and the rising awareness towards diagnosis are set to lead the growth of the medical equipment industry (Opto Circuits).

Valuation and recommendations

We have introduced estimates for FY2014 and have based our valuations on the FY2014 earnings estimates. As a result, our price targets stand revised with one-year forward looking perspective. On an average, our pharma universe is trading 14x and 12x FY2013E and FY2014E earnings. We take the average of the earnings for FY2013 and FY2014 to set the price target of the key players in our coverage.

- **Cadila Healthcare (Buy; price target Rs818):** The stock is currently trading 15x and 12x FY2013 and FY2014 estimated earnings. We set a price target of Rs818, which implies 16x average earnings over FY2013-14E.
- **Divi's Laboratories (Buy; price target Rs1,122):** The stock is currently trading 16x and 13x FY2013 and FY2014 estimated earnings. Our price target implies 22x average earnings for FY2013E and FY2014E.
- **Glenmark Pharma (Buy; price target Rs400):** The stock is currently trading at 15x and 12x its core business earnings for FY2013E and FY2014E. Our price target includes Rs64 from the research pipelines and Rs336 from the core business (16x average earnings from the core business for FY2013 and FY2014).
- **Ipca Laboratories (Buy; price target Rs436):** The stock is currently trading at 11x and 9x FY2013E and FY2014E earnings. Our price target implies 13x average earnings for FY2013 and FY2014.
- **Lupin (Buy; price target Rs597):** The stock is trading 18x and 15x FY2013 and FY2014E earnings. Our price target implies 20x average earnings for FY2013E and FY2014E.
- **Opto Circuits (Buy; price target Rs393):** The stock is currently trading at 9x and 7x FY2013 and FY2014 estimated earnings. We value the stock at 12x average earnings for FY2013 and FY2014.
- **Sun Pharma (Buy; price target Rs692):** The stock is currently trading at 21x and 18x FY2013 and FY2014 estimated earnings. Our price target implies 24x average earnings for FY2013 and FY2014.
- **Torrent Pharma (Buy; price target Rs779):** The company is trading at 11x and 9x FY2013 and FY2014 estimated earnings. Our price target implies 14x average earnings for FY2013 and FY2014.

Valuations

Company	Net sales (Rs cr)			EPS (Rs)			P/E (x)			RoCE (%)			RoE (%)		
	FY12E	FY13E	FY14E	FY12E	FY13E	FY14E	FY12E	FY13E	FY14E	FY12E	FY13E	FY14E	FY12E	FY13E	FY14E
Cadila Healthcare	5,347	5,855	6,637	37.7	45.9	56.4	18.3	15.0	12.2	20.8	21.4	23.0	27.8	26.1	24.9
Divi's Lab	1,621	1,964	2,367	36.5	46.2	55.8	19.6	15.5	12.8	28.9	30.9	31.7	23.4	25.6	26.1
Glenmark Pharma	3,959	4,402	5,197	27.1	22.9	27.1	11.4	13.5	11.4	18.6	15.3	16.1	22.1	15.8	15.7
Ipca Lab	2,385	2,774	3,185	26.0	29.4	37.6	12.7	11.2	8.8	25.8	24.2	26.2	26.8	24.2	24.8
Lupin	6,775	8,163	9,533	21.4	26.4	33.3	22.0	17.9	14.2	21.3	21.8	22.8	22.4	21.4	21.1
Opto Circuits	2,270	2,623	3,042	25.0	29.5	36.0	10.5	8.9	7.3	19.8	19.9	21.0	28.9	26.7	25.5
Sun Pharma	7,973	8,778	9,805	23.5	26.2	30.1	23.4	20.9	18.2	25.6	23.0	22.0	21.1	19.2	18.2
Torrent Pharma	2,547	2,960	3,441	40.1	49.2	62.2	13.7	11.2	8.9	25.9	26.3	28.5	29.1	27.9	27.6
Average							***16.5***	***14.3***	***11.7***	***23.3***	***22.8***	***23.9***	***25.2***	***23.4***	***23.0***

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