

Equities

15 November 2011 | 14 pages

Cipla (CIPL.BO)

Better Mix Drives 2Q Beat

- Best Ideas
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- **Better mix, forex gain aids 2Q beat** — Net profit came in c9% ahead of our estimate despite in line sales, as a better product mix and forex gain buoyed profitability. While part of this would even out over the full year, we believe the weaker INR and easing base effect would keep growth rates healthy in 2H. The froth is out of valuations after last year's underperformance last year and downside looks limited. Maintain Neutral.
- **Revenues in line, mix better** — Sales growth was in line at 11% YoY but mix improved, with India (+12%) and formulation exports (+13.2%) growing faster than API exports (-5.2%). Other operating income (+30.2%) was also buoyed by forex gain of Rs140m, leading to overall revenue growth of 11.1% in 2Q.
- **Margins better** — The better revenue mix along with lower input prices led to significantly better material cost – RM/Sales dipped 490bps to 41.1%. This helped offset the continued increase in staff cost (+36.3%: annual increments, headcount addition) and other expenses (+21.7%: overheads in new facilities). This led to 192bps YoY improvement in EBIDTA margin, which along with lower-than-expected depreciation, translated into 17.5% higher net income (c9% ahead of Citi estimate).
- **Revenue guidance maintained, capex remains heavy** — Cipla reiterated its 10-12% topline growth guidance for FY12 and indicated that margins would be in line with what it achieved in 1H. We expect the favorable mix effect on margin to normalize over the full year but believe that the weaker INR (vs. the US\$) would keep it buoyant. It also reiterated its FY12 capex guidance (cRs5-6bn) and indicated that a similar sum would be invested in FY13 as well.
- **Other takeaways** — a) No supplies of olanzapine to Teva (came as a surprise to us); b) Indore SEZ would take c3-4 years to scale up – till then would partially service demand shifted from other facilities; c) Positive on inhalers opportunity in the EU – expects more approvals over the next year; d) Forward contracts worth cUS\$190m outstanding – adequate to hedge net dollar exposure.

Neutral	2
Price (14 Nov 11)	Rs288.30
Target price	Rs310.00
Expected share price return	7.5%
Expected dividend yield	0.8%
Expected total return	8.3%
Market Cap	Rs231,482M US\$4,629M

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



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2010A	10,481	13.05	8.7	22.1	3.9	20.4	0.7
2011A	9,671	12.05	-7.7	23.9	3.5	15.4	0.7
2012E	11,227	13.98	16.1	20.6	3.1	15.8	1.0
2013E	13,753	17.13	22.5	16.8	2.7	17.1	1.0
2014E	16,286	20.28	18.4	14.2	2.3	17.6	1.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Mar	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	22.1	23.9	20.6	16.8	14.2
EV/EBITDA adjusted (x)	16.8	17.3	14.5	12.0	10.0
P/BV (x)	3.9	3.5	3.1	2.7	2.3
Dividend yield (%)	0.7	0.7	1.0	1.0	1.0
Per Share Data (Rs)					
EPS adjusted	13.05	12.05	13.98	17.13	20.28
EPS reported	13.48	12.05	13.98	17.13	20.28
BVPS	73.62	83.02	93.52	107.16	123.95
DPS	2.00	2.00	3.00	3.00	3.00
Profit & Loss (RsM)					
Net sales	56,250	63,218	71,355	80,897	92,266
Operating expenses	-43,985	-52,468	-58,561	-65,235	-73,545
EBIT	12,265	10,750	12,794	15,661	18,721
Net interest expense	-230	-173	-181	-51	-26
Non-operating/exceptionals	880	1,049	1,248	1,369	1,412
Pre-tax profit	12,916	11,625	13,861	16,979	20,107
Tax	-2,435	-1,954	-2,634	-3,226	-3,820
Extraord./Min.Int./Pref.div.	346	0	0	0	0
Reported net income	10,827	9,671	11,227	13,753	16,286
Adjusted earnings	10,481	9,671	11,227	13,753	16,286
Adjusted EBITDA	13,936	13,291	15,782	18,785	21,969
Growth Rates (%)					
Sales	7.0	12.4	12.9	13.4	14.1
EBIT adjusted	12.3	-12.4	19.0	22.4	19.5
EBITDA adjusted	12.0	-4.6	18.7	19.0	16.9
EPS adjusted	8.7	-7.7	16.1	22.5	18.4
Cash Flow (RsM)					
Operating cash flow	11,188	9,325	10,814	11,689	13,329
Depreciation/amortization	1,671	2,542	2,988	3,124	3,248
Net working capital	-1,310	-2,888	-3,401	-5,187	-6,205
Investing cash flow	-6,883	-12,889	-4,500	-4,500	-4,500
Capital expenditure	-5,219	-9,449	-4,500	-4,500	-4,500
Acquisitions/disposals	-1,664	-3,440	0	0	0
Financing cash flow	-4,210	3,377	-6,666	-3,477	-2,477
Borrowings	-9,352	5,668	-4,189	-1,000	0
Dividends paid	-1,873	-2,615	-2,802	-2,802	-2,802
Change in cash	95	-188	-353	3,713	6,352
Balance Sheet (RsM)					
Total assets	73,091	86,301	92,668	104,152	119,436
Cash & cash equivalent	3,085	6,914	6,236	9,624	15,651
Accounts receivable	15,666	14,908	17,736	20,108	22,933
Net fixed assets	26,954	33,799	35,311	36,688	37,940
Total liabilities	13,986	19,641	17,583	18,116	19,916
Accounts payable	9,980	9,581	10,713	11,577	12,694
Total Debt	51	5,719	1,530	530	530
Shareholders' funds	59,106	66,661	75,086	86,036	99,521
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	24.8	21.0	22.1	23.2	23.8
ROE adjusted	20.4	15.4	15.8	17.1	17.6
ROIC adjusted	17.7	14.0	14.5	16.4	18.0
Net debt to equity	-5.1	-1.8	-6.3	-10.6	-15.2
Total debt to capital	0.1	7.9	2.0	0.6	0.5

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2QFY12 Results Snapshot

Figure 1. Cipla – 2QFY12 Consolidated Income Statement (Rupees in Million, %)

Year to 31 March	2QFY11	2QFY12	% ch YoY	1QFY12	% Ch QoQ	CIRA Comments
Sales	15,886	17,581	10.7	15,738	11.7	Conclusion: Net income beats Citi estimate by c9% on better product mix & forex gains
Excise Duty	(87)	(263)	201.8	(235)	11.8	
Net Sales	15,799	17,318	9.6	15,503	11.7	Revenue growth in line but mix better, as formulation exports grow faster than expected
Other Operating Income	355	462	30.2	411	12.4	
Net Revenues	16,154	17,780	10.1	15,914	11.7	
Consumption of Raw Materials	7,487	7,117	(4.9)	6,682	6.5	RM/Sales sees big improvement – product mix, better realizations & Rs140m forex gain in other operating income – unlikely to sustain at current levels
% of Net sales	47.4	41.1	-630 bps	43.1	-201 bps	
Staff Cost	1,376	1,875	36.3	1,712	9.5	Staff cost higher on annual increments & headcount addition – to stabilize as a % of sales going forward
% of Net sales	8.7	10.8	212 bps	11.0	-22 bps	
Other Expenses	3,625	4,413	21.7	3,824	15.4	Tax rate continues to go up on expiry of EoU tax benefits
% of Net sales	22.9	25.5	253 bps	24.7	81 bps	
Total Expenditure	12,488	13,404	7.3	12,219	9.7	
Operating profits	3,666	4,376	19.4	3,695	18.4	
<i>OPM (%)</i>	22.7	24.6	192 bps	23.2	139 bps	
Interest	(3)	(24)	750.0	(43)	(44.0)	
Depreciation	(639)	(656)	2.7	(703)	(6.6)	
Other income	166	243	46.1	249	(2.2)	
PBT	3,190	3,939	23.5	3,199	23.1	
Tax	(560)	(850)	51.7	(666)	27.6	
<i>Tax rate (%)</i>	17.6	21.6	401 bps	20.8	76 bps	
Net Profit	2,630	3,090	17.5	2,533	22.0	
<i>Net margin (%)</i>	16.6	17.8	119 bps	16.3	150 bps	

Source: Company Reports and CIRA Estimates

Figure 2. Cipla – 2QFY12 Consolidated Revenue Break up (Rupees in Million, %)

Year to 31 March	2QFY11	2QFY12	% ch YoY	1QFY12	% Ch QoQ	CIRA Comments
India Sales	7,564	8,470	12.0	7,436	13.9	Growth remains subdued; unbranded generics (c15% of sales) growing faster
<i>% of Total Revenues</i>	46.6	46.9	37 bps	46.0	90 bps	
Formulations	6,639	7,516	13.2	6,589	14.1	Higher than expected – mix also better; limited impact of weaker INR
APIs	1,683	1,595	(5.2)	1,713	(6.9)	
International Sales	8,322	9,111	9.5	8,302	9.7	Benefit of weak INR vs. the US\$ to reflect in 2H
<i>% of Total Revenues</i>	51.2	50.5	-75 bps	51.4	-91 bps	
Sales	15,886	17,581	10.7	15,738	11.7	
Tech know/how fees	235	78	(66.9)	98	(20.9)	Continues to decline in line with recent trends Includes forex gain of cRs140m
Others	120	384	221.0	313	22.9	
Other operating income	355	462	30.2	411	12.4	
<i>% of Total Revenues</i>	2.2	2.6	38 bps	2.5	2 bps	
Total Revenues	16,241	18,043	11.1	16,149	11.7	

Source: Company Reports and CIRA Estimates

Research Best Ideas Update

Relative Call – Adding Lupin and Glaxosmithkline Pharma, Extending Dr Reddy and Cipla.

Summary – We name Lupin a Most Preferred stock and Glaxosmithkline Pharma a Least Preferred stock relative to our fundamental analyst coverage for the next three months.

Furthermore, we extend our relative call on Dr Reddy as a Most Preferred stock and Cipla as a Least Preferred stock relative to our fundamental analyst coverage for the next three months. Our last call was made on 02 Sep 2011.

Rationale - Extending earlier calls

Cipla

Catalyst and Thesis - Valuations look rich, and a subdued earnings trend could continue for another quarter before growth rates recover.

Glaxosmithkline Pharmaceutical

Catalyst and Thesis - Valuations look expensive. Likely to be hit hard if proposed DPCO 2011 is implemented. Limited upside.

Lupin

Catalyst and Thesis - Attractive valuations (c.15x FY13E), triggers available in the form of several niche product opportunities that will play out for the next 6-9 months.

Dr Reddy

Catalyst and Thesis - Valuations look attractive after the stock's recent underperformance against the BSE Sensex. Potential near-term catalysts include upside from generic Arixtra (fondaparinux) and Zyprexa (olanzapine).

Cipla

Company description

Cipla is a leading Indian pharma company with more than 50% of exports and product registrations in over 180 countries. It has a well-diversified portfolio across therapies including anti-asthma, anti-inflammatory, cardiac, anti-retroviral, anti-cancer, eye/ear preparations, dermatology, anti-ulcerant, anti-malaria and critical care. It is one of the leading players globally in respiratory care, with experience in developing complex technologies in inhalation therapy. It has a strong branded biz in India and is among the top-2 players in the highly fragmented Indian Pharma market. To de-risk its business model, it has tied up with several partners for overseas markets.

Investment strategy

We rate Cipla Neutral (2) with a TP of Rs310. The stock has underperformed significantly over the last year, taking most of the froth out of valuations. The sharp depreciation in the INR (v/s the US\$) over the last few weeks should also help its sizeable exports business. These make us less negative on the stock than we were earlier. However, Cipla remains our least favored business among the sector leaders. We believe it could be vulnerable, given its lack of control over the front end in the US and EU generics markets. In an industry susceptible to pricing pressure, Cipla, being one of the weaker parts of the supply chain, could bear the brunt in our view - reflected in its deteriorating return ratios. This prevents us from getting more constructive on the stock till valuations de-rate further.

Valuation

Cipla is a steadily growing company, thus we use P/E as the base valuation tool for the company. Our target price of Rs310 is based on 20x Sep 12E earnings. Although Cipla is an Indian pharma major, we believe it should trade at a marginal discount to peers in the sector such as DRL, 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 (20x) as we do for the sector leaders such as DRL to Cipla's base business earnings to factor in any potential "one-off" upside that may come through from time to time.

Risks

The key downside risks to our target price and rating include: a) Inability to scale up utilization levels at the Indore SEZ, as planned; b) Any significant slowdown in the Indian market (accounts for c45% of sales); c) If any of its partners gets acquired / is part of a merger, it may lose out on some of the earlier contracted business. The key upside risks to our target price and rating include: a) the company doing better operationally than forecast, due to gains from rupee depreciation; b) any move to front-end in target markets could give further support to valuations; c) any exclusivity for its partners could also sustain growth beyond our expectations.

Dr Reddy

Valuation

Our Rs1,835 target price for DRL is based on a sum-of-the-parts valuation approach. We use a target multiple of 20x to value DRL's core earnings. This is in line with its historical trading range. At 20x Sep'12E earnings, we value DRL's base business at Rs1,760. We continue to value DRL's Para IV pipeline separately at Rs75, based on a probability adjusted DCF valuation. We use a range of probabilities from 25% to 90%, based on individual product dynamics, and a discount factor of 12.5% for the opportunities being targeted over the next few years.

Risks

Key downside risks to our target price include: (1) Lower than expected market share in fondaparinux (Arixtra) or the Allegra OTC franchise in the US could entail downward revision of estimates; (2) Continued sluggishness in the Indian market (c17% of sales); (3) Stiffer competition / regulatory pressure on pricing in Russia/CIS.

(REDY.BO; Rs1,641.95; 1)

Glaxosmithkline Pharmaceutical

Valuation

Our target price of Rs2,200 for GSK Pharma is based on 25x Dec 2012E 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, with a median of c23x over the last five years. GSK launched its first patented product in India two years back and has announced plans to launch a few more over the next two years. While we expect greater clarity on the implementation of the IPR regime over the next few years, we believe that the upside on this front for most companies is likely to be limited in the near to medium term. As such, we believe that 25x is a suitable fair-value multiple.

Risks

The key upside risks to our hypothesis include: a) Higher than expected product launches - esp. from the patented basket & vaccines; b) Any accretive acquisitions, given the sizeable cash balance (cUS\$450m+) on its books. The key downside risks to our hypothesis include: a) Slowdown in Indian market growth, given that GSK operates entirely in this market and is among the top 5 companies; b) Further price control related regulations in India, given more than 20% of the current revenues are from price controlled products. Any of these risk factors could cause the shares to deviate from our target price.

(GLAX.BO; Rs2,020.40; 2)

Lupin

Valuation

Given that pharma is a growth sector, we use P/E as our primary method to value the base business of pharma companies. Lupin has historically (last six to seven years) traded in a band of 10-34x one-year forward earnings. We value Lupin at 20x 12m forward earnings, in line with the sector leaders such as Cipla and Dr Reddy's, due to its leadership in key markets/products & robust financial metrics. At 20x Dec12E recurring FDEPS, we arrive at a target price of Rs565.

Risks

Key risks to our target price include: 1) Earlier than expected generic competition in Suprax; 2) INR appreciation would hurt, given its exposure to global markets; 3) Reasonable exposure to the domestic formulations market (c31% of sales) leaves Lupin vulnerable to any significant widening of the price control net or slow down in industry growth. 4) Inability to effectively scale up the Kyowa operations or Antara sales.

(LUPN.BO; Rs466.60; 1)

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's 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 report.

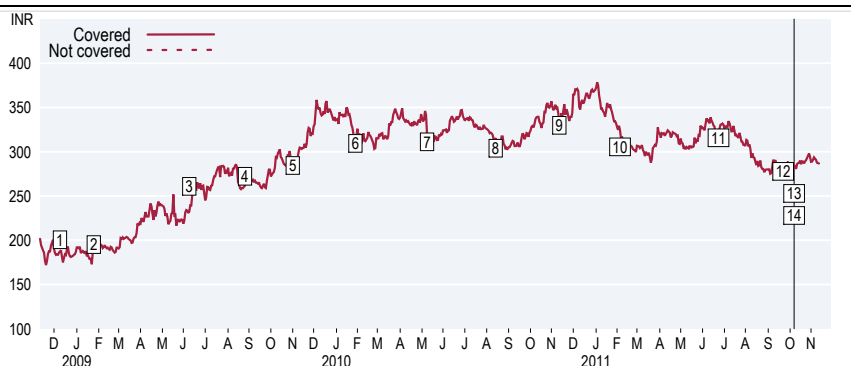
IMPORTANT DISCLOSURES

Cipla (CIPL.BO)

Ratings and Target Price History

Fundamental Research

Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	9-Dec-08	*3M	*152.00	185.95
2	26-Jan-09	3M	*178.00	186.65
3	9-Jun-09	3M	*210.00	232.50
4	26-Aug-09	3M	*225.00	261.80
5	1-Nov-09	3M	*270.00	287.75

	Date	Rating	Target Price	Closing Price
6	28-Jan-10	3M	*280.00	318.95
7	9-May-10	3M	*290.00	341.80
8	13-Aug-10	3M	*300.00	315.45
9	11-Nov-10	3M	*320.00	331.90
10	4-Feb-11	3M	*300.00	324.20

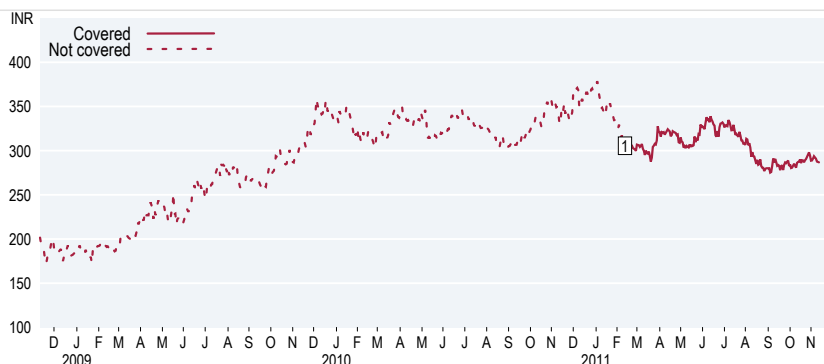
	Date	Rating	Target Price	Closing Price
11	23-Jun-11	3M	*330.00	315.80
12	22-Sep-11	3M	*310.00	278.05
13	7-Oct-11	Stock rating system changed		
14	7-Oct-11	*2	310.00	285.20

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Cipla (CIPL.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	312.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Glaxosmithkline Pharmaceutical (GLAX.BO)
Ratings and Target Price History
Fundamental Research

Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	9-Dec-08	*1L	*1,300.00	1,149.75
2	24-Feb-09	1L	*1,336.00	1,181.25
3	9-Jun-09	1L	*1,372.00	1,248.85
4	4-Aug-09	*3L	*1,360.00	1,387.15
5	30-Oct-09	3L	*1,400.00	1,578.30

* Indicates change

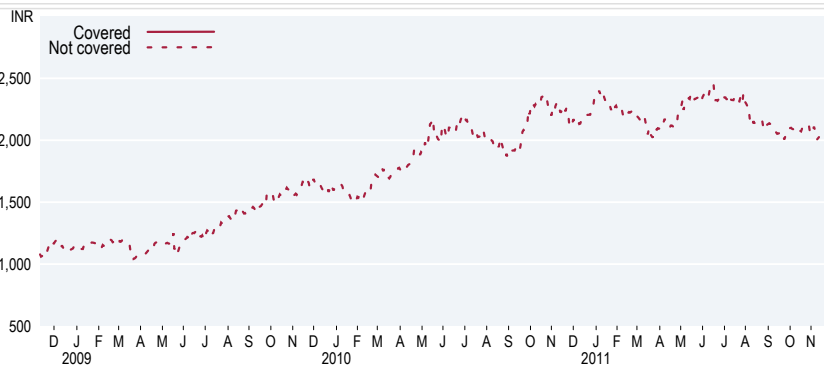
	Date	Rating	Target Price	Closing Price
6	19-Feb-10	3L	*1,550.00	1,649.65
7	2-Jul-10	3L	*1,820.00	2,162.15
8	26-Jul-10	3L	*1,880.00	2,062.70
9	28-Oct-10	3L	*2,030.00	2,261.85
10	29-Mar-11	3L	*2,100.00	2,085.30

	Date	Rating	Target Price	Closing Price
11	23-Jun-11	3L	*2,170.00	2,329.10
12	7-Oct-11	Stock rating system changed		
13	7-Oct-11	*2	2,170.00	2,086.45
14	6-Nov-11	2	*2,200.00	2,109.55

Rating/target price changes above reflect Eastern Standard Time

Glaxosmithkline Pharmaceutical (GLAX.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Prashant Nair, CFA



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Lupin (LUPN.BO)
Ratings and Target Price History
Fundamental Research

Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	9-Dec-08	1M	*164.60	111.40
2	29-Jan-09	1M	*178.80	112.23
3	9-Jun-09	1M	*213.00	167.80
4	29-Sep-09	1M	*283.00	227.96

	Date	Rating	Target Price	Closing Price
5	20-Jan-10	1M	*340.00	284.82
6	9-May-10	*1L	*420.00	359.42
7	17-Oct-10	1L	*500.00	425.80
8	23-Jun-11	1L	*525.00	430.15

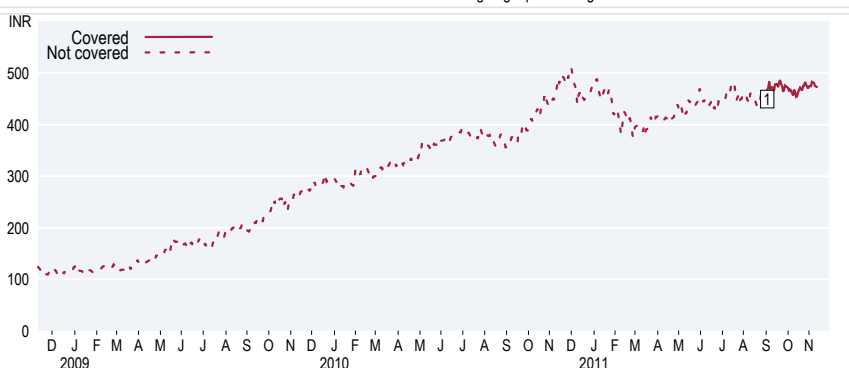
	Date	Rating	Target Price	Closing Price
9	22-Sep-11	1L	*565.00	478.20
10	7-Oct-11	Stock rating system changed		
11	7-Oct-11	*1	565.00	461.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Lupin (LUPN.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	2-Sep-11	*ADD MP	-	467.60

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Dr Reddy (REDY.BO)
Ratings and Target Price History
Fundamental Research

Analyst: Prashant Nair, CFA



	Date	Rating	Target Price	Closing Price
1	9-Dec-08	2M	*535.00	481.20
2	20-Jan-09	2M	*547.00	467.90
3	21-May-09	2M	*700.00	635.75
4	9-Jun-09	*1M	*825.00	711.40

	Date	Rating	Target Price	Closing Price
5	7-Oct-09	1M	*1,180.00	948.25
6	10-May-10	*2M	*1,350.00	1,220.40
7	25-Oct-10	2M	*1,810.00	1,638.10
8	27-Jan-11	*1L	1,810.00	1,552.40

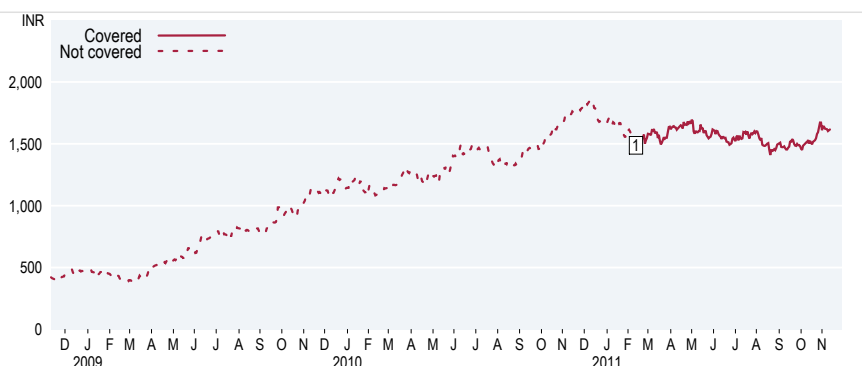
	Date	Rating	Target Price	Closing Price
9	16-May-11	1L	*1,895.00	1,619.25
10	23-Jun-11	1L	*1,835.00	1,492.25
11	7-Oct-11	Stock rating system changed		
12	7-Oct-11	*1	1,835.00	1,500.75

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Dr Reddy (REDY.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Prashant Nair, CFA



Date	Rating	Target Price	Closing Price
11-Feb-11	*ADD MP	-	1,495.05

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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