

PHARMACEUTICALS

Buoyant quarter, pricing policy an overhang

India Equity Research | Pharmaceuticals



We expect the pharma universe to continue its growth trajectory led by strong uptick in the US and emerging markets, while domestic growth could tone down due to delayed monsoon. Though margins are expected to remain steady QoQ, YoY they are likely to expand on back of higher realisations. Moreover, the recent appreciation of INR could reverse MTM forex losses for players such as Ranbaxy (RBXY), Glenmark (GNP) and Aurobindo (ARBP). We also expect one-off opportunities to benefit Sun (SUNP), Dr. Reddy's (DRRD) and Cipla. Among mid caps, IPCA and ARBP are expected to report better growth and earnings.

Recurring growth to sustain as one-offs icing on cake

We expect revenue growth of 29.5%YoY, in line with the previous quarter (30% YoY). While growth will be led by US and continued momentum in emerging markets, India could see lower growth momentum. High value one-time opportunities such as Tacrolimus for DRRD and Doxil for SUNP will also contribute to higher profitability. We estimate margin expansion of 225bpsYoY and EBITDA growth of 42.5%. PAT growth is estimated at 38% with some negative impact from increase in tax rate.

Sun Pharma, Dr. Reddy's and Cipla on firm footing

We expect SUNP, DRRD and Cipla to report strong earnings growth led by higher realisations, continued growth in branded generics and one-time high value launches in US. Cipla could also see favourable impact from accrual of milestone income from Meda. Lupin's growth in US generics to benefit from higher market share gain in Combivir and Geodon. RBXY's profits will have positive impact from exclusivity sales of Actos. GNP's revenue growth will remain strong; however, reported numbers are likely to face base effect from licensing income. Among mid caps, we expect QoQ margin improvement for ARBP from higher operating leverage in US, while IPCA is likely to also report strong momentum from higher anti-malaria exports.

Short-term favourable impact from MTM gains

Given the appreciation in currency (from USDINR 54 at end Q1FY13 to 52.9 end September 2012) reported earnings for GNP, RBXY and ARBP are likely to get a boost from reversal of MTM forex losses as these have higher foreign currency loans.

Valuations: Negative overhang from pricing policy

We are cautious as we foresee slower earnings growth during H2FY13 on a high base, which coupled with challenging regulatory environment and lower currency realisations (sequentially) could have negative bearing on valuations. We estimate a potential loss of INR20bn (2.5%-3% of domestic sales) from current pricing policy, which could rise to INR60mn if cost-based pricing model is adopted. The final policy outcome, if in favour of cost-based pricing, could potentially de-rate the sector. Hence, we continue to remain stock specific. **Lupin, Cadila and Glenmark are our preferred bets in large caps and IPCA in mid caps.**

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Table 1: Earning estimates

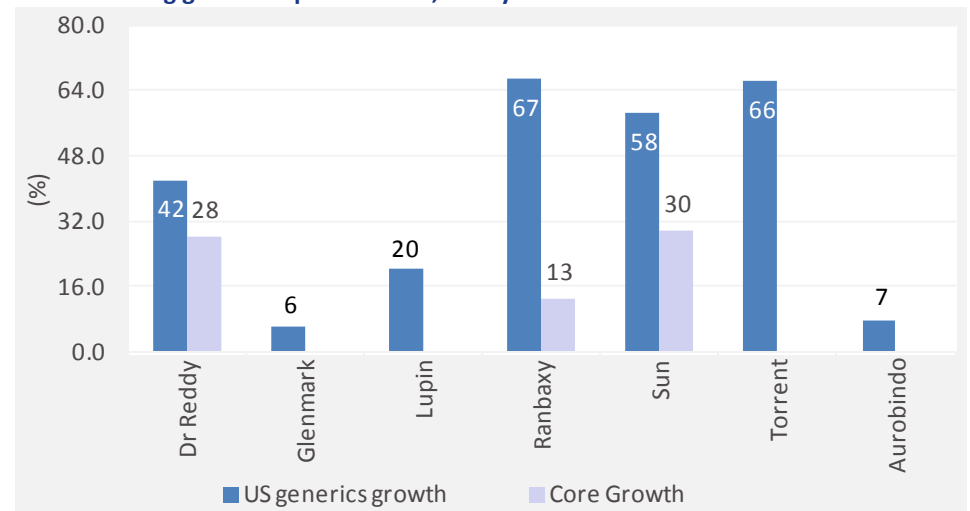
	Net Sales				EBITDA				EBITDA Margin (%)				PAT (adjusted)				Key data to watch out
	Y-o-Y (%)		Q-o-Q (%)		Y-o-Y (%)		Q-o-Q (%)		Y-o-Y (%)		Q-o-Q (%)		Y-o-Y (%)		Q-o-Q (%)		
	Q2FY13E	Recurring growth	Q-o-Q	(%)	Q2FY13E	Recurring growth	Q-o-Q	(%)	Q2FY13E	Core Margins	Y-o-Y (%)	Q-o-Q (%)	Q2FY13E	Recurring growth	Q-o-Q	(%)	
Large Cap	27,136	29.5	18.5	(15.9)	4,872	179.8	74.4	(4.7)	18.0	12.2	964.6	211.6	3,244	252.4	102.8	(4.8)	Core sales growth of 17% YoY; Expect recurring margins to improve from 9.2% in Q2CY12 to 11.8% in current quarter; One-time exclusivity sales from Actos to benefit consolidated level performance; Forex MTM loss not build in estimates
Dr. Reddy's	30,946	36.5	32.1	21.8	6,406	36.2	29.5	28.2	20.7	19.9	(4.5)	104.0	4,066	36.8	22.2	24.6	Expect strong set of numbers with 41% growth in global generics and 22% growth in PSAI business; We have build incremental USD25mm sales in Tacrolimus as Mylan has withdrawn product (DRRD has ramped up its market share to 45% from 16% in the product); Expect gross margins to remain stable QoQ, however we see strong sequential improvement in EBITDA margins from operating leverage
Cipla	21,531	21.1	13.4	10.0	6,328	44.6	20.7	17.2	29.4	26.2	477.8	181.9	4,644	55.8	33.0	21.6	Cipla to accrue USD10mm milestone income from Meda for recently approved Dymista drug; Export formulation sales are expected to ramp-up from Lexapro and Vancomycin; We expect domestic growth of 15%; Margins would remain strong from higher currency realizations YoY and incremental benefit of milestones
Sun Pharma	29,017	53.2	38.6	8.1	12,876	64.2	32.7	3.7	44.4	39.6	299.3	(191.6)	8,683	45.3	11.3	9.1	Momentum to remain strong in US from supply of Doxil (USD50mm sales estimated); Taro margins to decline QoQ, however YoY momentum is expected remain strong; Core margins (Ex-Taro and Doxil) is estimated to improve sequentially from higher mix of domestic sales
Lupin	22,605	27.5	24.4	0.3	4,620	12.1	2.8	1.0	20.4	19.2	(280.7)	13.4	2,864	4.7	(4.5)	2.1	Expect momentum to sustain from higher growth in US and continued market share gain in Combivir and Geodon
Cadila	15,825	28.0	28.0	2.2	3,412	27.7	27.7	(0.2)	21.6	21.6	(4.2)	(51.7)	2,107	14.7	14.7	3.5	Continued growth momentum and stable margins YoY; expect Hospira profitability to remain intact QoQ with no meaningful price erosion in docetaxel; We have not build in any MTM forex loss or gain in our estimates.
Large Cap	147,060	33.1	25.9	3.5	38,514	51.3	27.5	7.2	26.2	23.2	314.4	91.4	25,608	47.0	19.6	10.0	
Mid Cap	8,099	18.5	18.5	5.6	1,786	24.5	24.5	(1.2)	22.1	22.1	105.1	(151.0)	1,189	15.3	25.4	(0.8)	Growth to remain strong on back of US and Brazil. Domestic growth traction during quarter is critical (estimated at 13%); Margins to benefit from higher currency realization, however, expect to remain lower sequentially
IPCA	7,176	15.1	15.1	13.1	1,818	19.6	19.6	28.2	25.3	25.3	94.4	298.0	1,154	25.6	25.6	31.5	Sharp sequential growth in Anti-malaria tenders and ramp up in brand generics post-resolution of manufacturing issues; Margins to benefit from strong currency and better product mix; anti-malaria sales in domestic to remain subdued, however other business will maintain healthy growth; We expect improved outlook and guidance for FY13
Glennmark	11,607	9.9	23.8	11.5	2,381	(21.3)	29.3	8.2	20.5	20.5	(815.0)	(63.6)	1,515	(29.2)	36.8	20.6	Strong growth in core business; YoY sales and profitability impacted due to higher licensing income in corresponding quarter; Expect margins to remain stable qoq; We highlight that quarter is critical for in terms of execution on margins front
Aurobindo	13,664	27.1	27.1	12.5	1,924	67.8	67.8	37.7	14.1	14.1	342.0	257.2	828	122.3	122.3	116.5	Expect 9% sequential growth in constant currency led by new launches and ramp-up in existing products; Expect export margins to improve from 11% in Q1FY13 to 13% driven by higher capacity utilization; Strong currency realization to have positive impact on INR growth, while appreciating INR would lead to some reversal in MTM losses
Mid Cap	40,546	17.9	10.9	7,909	11.0	15.9	19.5	(122.8)	84.4	4,686	5.0	26.1					
Overall	187,606	29.5	5.0	46,423	42.5	8.6	24.7	82.3	30,294	38.4	11.2						
Recurring business	179,346	25.1	9.2	40,163	29.0	15.6	22.9	66.9	124.2	25,456	22.9	21.8					

Result expectations during the quarter

We expect a robust revenue growth of 29.5%YoY for the pharma universe. Excluding the impact of one offs, recurring growth is also expected to remain strong at 25% YoY. This outperformance will be led by:

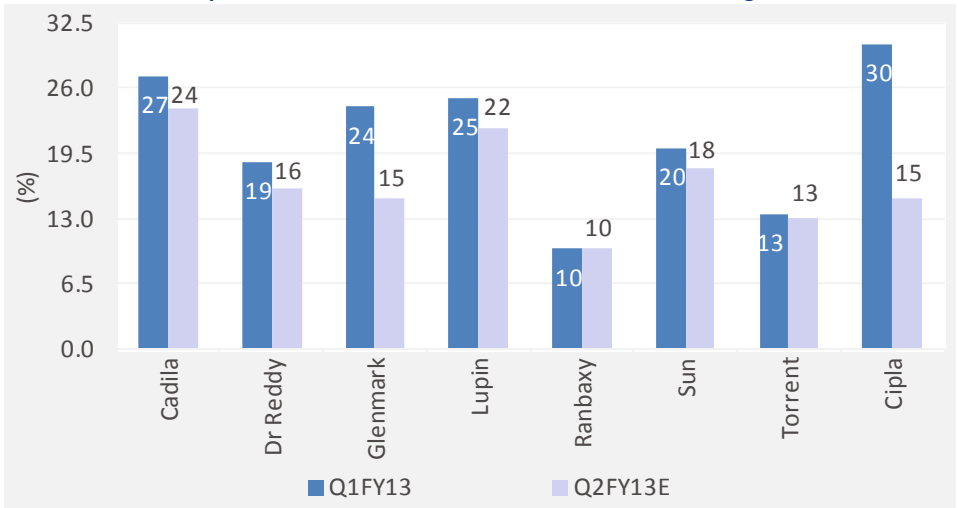
- Higher foreign currency realisations (20.4%YoY and 2%QoQ) as a large part of the earnings is being driven by export formulations.
- Continued growth momentum in US generics from higher market share traction and incremental new launches. Few players such as ARBP and Cadila received a slew of product approvals that will aid their growth momentum within the US in ensuing quarters.
- DRRD, SUNP and Cipla are also likely to benefit from one-time sales of a few high value launches such as Tacrolimus (benefit from short supply), Doxil and Lexapro/Vancomycin, respectively.
- Domestic growth, though at a moderate pace from previous quarter, will remain in mid-double digits for our universe.
- We estimate continued momentum in emerging markets of Russia, Brazil, Mexico and others.

Chart 1: Strong growth expected in US, led by blockbuster FTFs



Source: Company, Edelweiss research

Chart 2: Growth expectations in domestic market across the coverage universe



Source: Company, Edelweiss research

Table 2: Key launches in US during the quarter

Month	Molecule	Brand	Market Size (USD mn)	Generic player
Jul-12	Metformin Hydrochloride ER	Glucophage XR	230	Aurobindo
Jul-12	Zolpidem Tartrate	Ambien	NA	Cipla
Jul-12	Pregabalin	Lyrica	1,424	Lupin
Jul-12	Norgestimate and Ethinyl Estradiol	Ortho Tri-Cyclen	316	Lupin
Jul-12	Atorvastatin calcium	Lipitor	1,500	Dr. Reddy's
Jul-12	Entacapone	Comtan	80	Sun Pharma
Aug-12	Montelukast Sodium	Singulair	3,219	Aurobindo, Dr. Reddy's, Glenmark, Torrent Pharma
Aug-12	Metoprolol Succinate ER	Toprol-XL	450	Dr. Reddy's
Aug-12	Didanosine			Aurobindo
Aug-12	pioglitazone hydrochloride	Actos	2,500	Ranbaxy
Aug-12	Alfuzosin Hydrochloride	Uroxatral	NA	Aurobindo
Sep-12	Amlodipine Besylate / Benazepril HCL	Lotrel	500	Aurobindo
Sep-12	Escitalopram oxalate	Lexapro	2,700	Aurobindo, Cadila, Lupin, Torrent Pharma
Sep-12	Modafinil	Provigil	1,133	Aurobindo
Sep-12	Tramadol HCL / Acetaminophen	Ultracet	135	Cadila
Sep-12	Levofloxacin	Levaquin	NA	Cadila
Sep-12	Ethosuximide	Zarontin	NA	Cadila
Sep-12	Irbesartan	Avapro	642	Cadila, Dr. Reddy's
Sep-12	Rizatriptan Benzoate	Maxalt	378	Glenmark
Sep-12	Cetirizine HCL / Pseudoephedrine HCL	Zyrtec	NA	Sun Pharma
Sep-12	Amoxicillin	Amoxil	179	Dr. Reddy's

Source: Bloomberg, Company, Edelweiss research

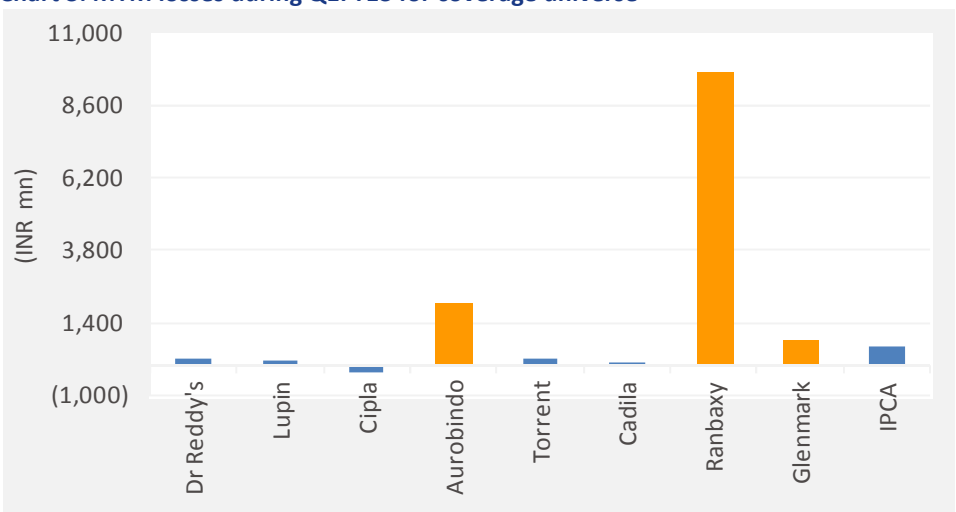
Reversal in forex losses from currency appreciation

Operating performances will remain robust owing to higher growth in sales and margin expansion (2235bps YoY; core margins are estimated to expand 67bps YoY). While off late the USD/INR has appreciated (5% by end September from end June), average realisations remain strong. The average USD/INR realisation is 55.1 for Q2FY13, which is 20.4% higher than corresponding quarter (Q2FY12). Even on sequential basis, average realisations are higher by

2.5%. We thus believe that margins are likely to remain steady and continue to benefit; however, going forward as the currency appreciates, average realisations may decline. Thus, companies that have open hedge positions such as SUNP and Cipla could face negative impact of the same. Other players that have hedged their exports at average rate of USD/INR 51-52 will continue to gain benefit of higher realisation for the balance fiscal.

Moreover, given the appreciation of INR by quarter range (from USD/INR54 on June 30, 2012, to USD/ INR52.9 on September 30, 2012) reported earnings growth for players such as GNP, RBXY and ARBP is likely to get a boost from reversal of MTM forex losses as these have higher foreign currency borrowings. On other hand companies that have higher receivables such as Cadila, could see some MTM loss on currency appreciation. We have build MTM gain for ARBP (INR1.14bn), GNP (INR300mn) and IPCA (INR324mn). We also expect benefit from reversal of losses for RBXY; however, we have not build the same in our estimates.

Chart 3: MTM losses during Q1FY13 for coverage universe



Source: Company, Edelweiss research

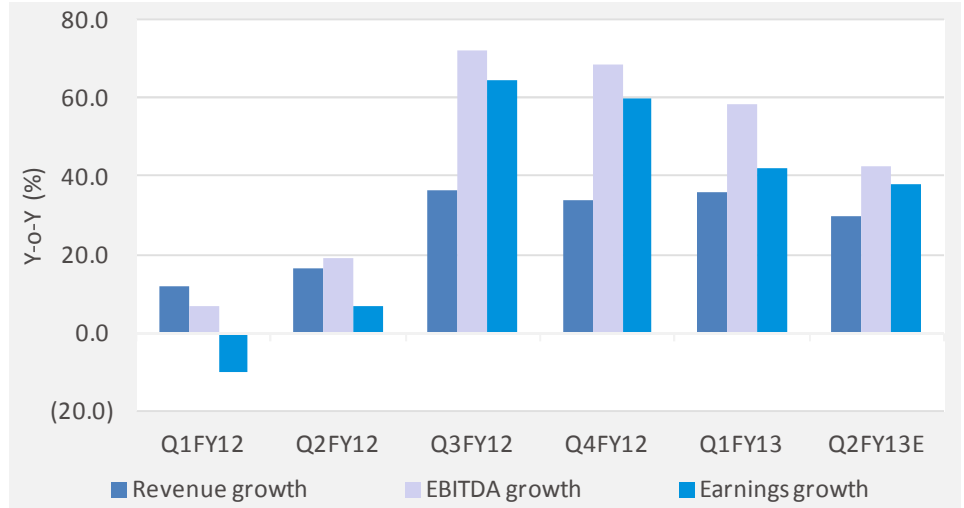
Valuations: Regulatory risks an overhang

We foresee a slowdown in earnings growth during H2FY13 on high base as shown in chart 4. This, coupled with challenging regulatory environment and lower currency realisations (sequentially), could have negative bearing on valuations. During the quarter, the pharma universe has been trading in the 17.5-18.0x one-year forward earnings range, lower than the peak of 20-22x. We continue to remain cautious as the risk-return could turn unfavourable from pricing policy outcome, currency appreciation and lower earnings for a few players in balance fiscal (on a higher base).

We, thus, prefer companies with a strong pipeline and differentiated portfolio. **Lupin, Cadila and GNP are our preferred bets.** Lupin and GNP have a robust pipeline in the US as well as a differentiated model which renders strong earnings visibility. Moreover, valuations based on PEG (price earnings to growth) do not appear to be stretched. We are positive on **SUNP**, although current valuations do not leave much upside.

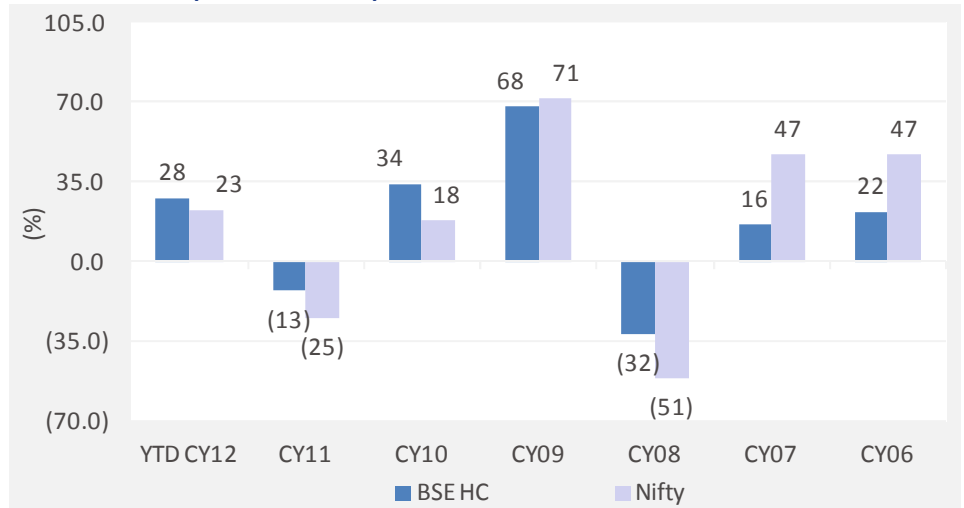
Among mid caps, we prefer IPCA, where we estimate strong upside to Street earnings from better growth visibility and margin traction in US, India and anti-malaria exports.

Chart 4: Growth momentum likely to slowdown in H2FY13 on higher base



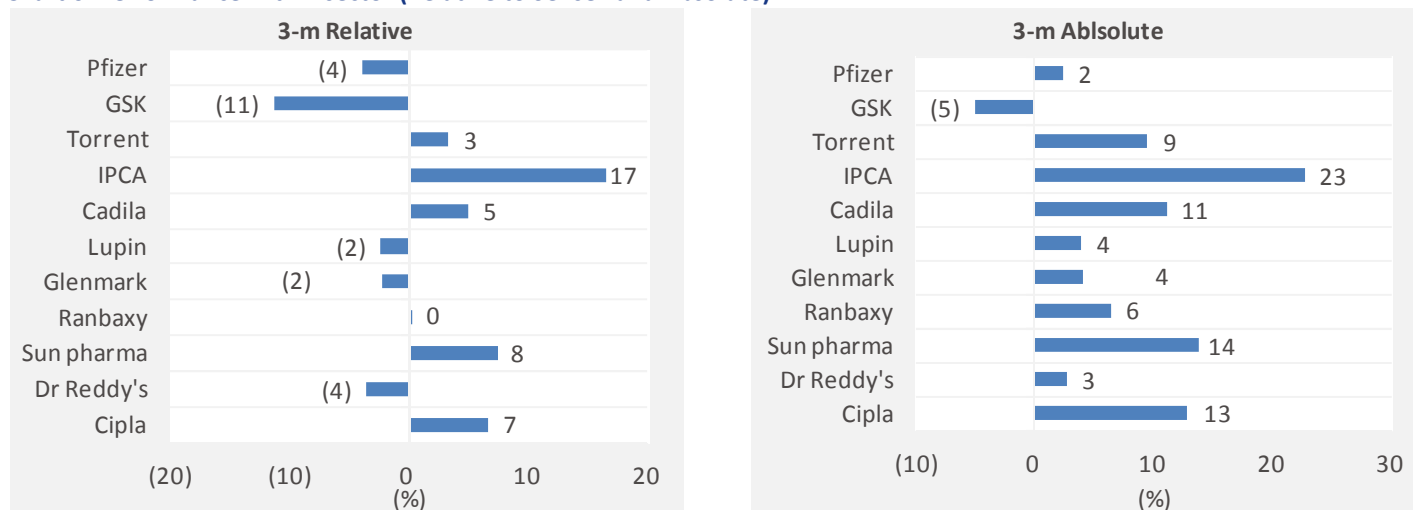
Source: Company, Edelweiss research

Chart 5: Relative performance of pharma to Sensex



Source: Bloomberg, Edelweiss research

Chart 6: Performance within sector (Relative to Sensex and Absolute)



Source: Bloomberg, Edelweiss research

Table 3: Valuation and recommendation snapshot

(INR mn)

	Price	Core EPS (INR)		P/E (x)		EV/EBITDA (x)		ROAE (%)	
	INR	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Sun Pharma	709	26.6	30.3	26.0	22.8	14.2	14.7	26.2	21.3
Cipla	367	18.5	20.6	19.9	17.9	13.3	11.7	18.1	17.7
Ranbaxy	528	14.3	19.5	32.8	24.1	9.5	13.1	52.0	25.6
Cadila	831	38.2	47.6	21.8	17.5	14.2	11.6	27.1	27.1
Dr. Reddy's	1,696	89.0	98.1	18.6	16.9	10.7	9.6	26.6	23.4
Lupin	566	26.3	33.0	21.5	17.2	13.7	11.0	25.9	26.8
Large Cap				23.4	19.4	12.6	11.9		
Glenmark	403	19.9	24.6	18.7	15.2	13.0	10.9	23.4	22.5
Torrent pharma	688	49.5	59.0	13.9	11.7	9.0	7.4	31.0	29.5
IPCA	456	32.8	41.6	13.9	11.0	9.0	7.2	28.4	30.9
Aurobindo	143	11.9	17.0	12.1	8.4	8.5	6.3	13.7	17.0
Unichem	175	13.9	16.9	12.6	10.4	7.5	6.5	26.5	26.5
Mid cap				14.7	11.6	9.9	8.0		
Overall				19.9	16.2	11.5	10.3		

Source: Edelweiss research

Note: *EPS represents core business excl NPV and other one-offs

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Coverage group(s) of stocks by primary analyst(s): Pharmaceuticals

Apollo Hospitals Enterprise, Aurobindo Pharma, Cadila Healthcare, Cipla, Dr.Reddys Laboratories, Glenmark Pharmaceuticals, Lupin, Ranbaxy Laboratories, Sun Pharmaceuticals Industries, Torrent Pharmaceuticals

Recent Research

Date	Company	Title	Price (INR)	Recos
05-Oct-12	Pharma	Supreme Court order advocates cost base pricing; <i>Sector Update</i>		
03-Oct-12	Dr. Reddy's Lab	Strong momentum in ensuing quarters; <i>Visit Note</i>	1,646	Hold
03-Oct-12	Aurobindo Pharma	Better growth visibility; <i>Visit Note</i>	144	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	113	53	19	186
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	114	58	14	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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