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BEYOND HOOPLA

Inhaler launch an incremental positive; no significant increase in earnings seen near term

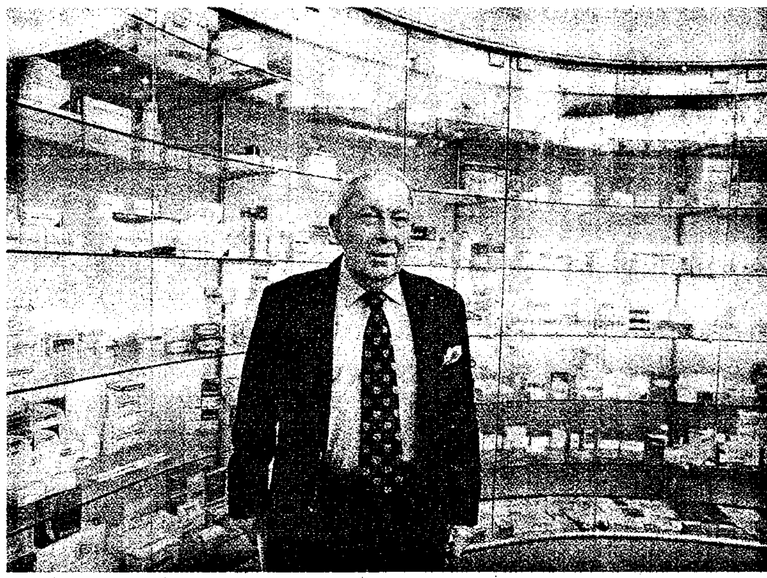
CIPLA
RATING: REDUCE▼

CIPLA's stock has increased 64% since 31 May 2014, vs the Sensex return of 11%. The stock trades at 35.7x FY15F (forecast) and 26x FY16F EPS (earnings per share) of ₹17.65 and ₹24.27 respectively, a 30-45% premium to peers. The valuation seems expensive as we see limited upside risk to earnings in the near term.

However, we don't expect revenue composition to change significantly, and a rise in R&D spend should result in limited Ebitda (earnings before interest, taxes, depreciation, and amortisation) margin expansion. We believe investors expectations from Cipla's inhaler franchise have risen after the recent launch of Seretide MDI in select EU markets. The approval is a positive development, but approvals for other high-value inhalers in the EU and the US still have significant regulatory challenges.

Even for Seretide MDI, we are cautious as: (i) generic penetration and substitutability of inhalers is likely to be lower and (ii) Glaxo may be aggressive on pricing. Our industry checks suggest that Cipla has priced Seretide MDI at 40% discount to the innovator in Germany, which is a small market. The discount could be higher for the UK, which is a much larger market. Further, the discount will likely increase with additional competition. We prefer Dr Reddy's, which is at a similar market cap and trades at 36%/25% discount to Cipla on FY15F/FY16F P/E.

Expectations around the inhaler franchise have increased: The launch of Seretide MDI in select EU markets this month was a catalyst for the stock price run-up, in our view. The launch was an incremental positive; however, we do not expect additional earnings upside from this segment. There is no visibility yet on approvals of additional high-value inhalers in Europe or the US currently. We highlight the following: (a) Cipla has an advantage by being the first generic entrant in the EU market with its Seretide MDI generic. We also appreciate that there will be pressure from payors to accept generics. However, unlike oral solids or injectables, there are challenges to market share gains.



Cipla chairman Yusuf Hamied: It won't be a cakewalk in EU market

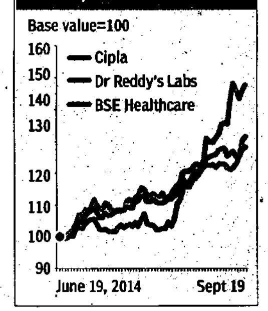
(i) Cipla's product has obtained regulatory approval in select EU markets based on in-vitro equivalence and pharmacokinetic (PK) studies. Cipla has not done clinical trials on patients to establish therapeutic equivalence.

(ii) Patients and doctors are sticky with innovator brands for complex products like inhalers.

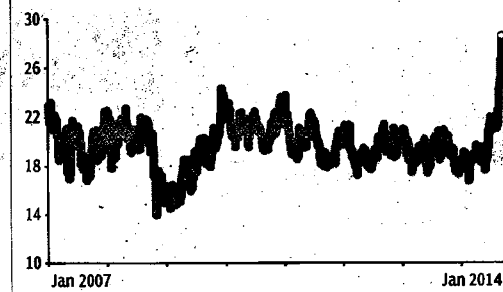
(iii) The innovator, in this case Glaxo, may react aggressively with pricing to retain market share, as has been the experience in the past. Our industry checks suggest that Cipla has priced its product at a 40% discount to the brand price in Germany. Cipla is the only generic player in that market. So, the discounts can be larger for bigger markets like the UK.

(b) US approval pathway is more difficult. Based on the draft guidelines released by the USFDA, for Albuterol MDI and Advair DPI, the generic companies have to establish not only in-vitro equivalence with the innovator product but also have to establish complete equivalence through PK studies and have to carry limited clinical trials on patients to establish therapeutic equivalence. For Seretide MDI in Europe, Cipla had established in-vitro equivalence. However, Cipla's product is not 100% bio-equivalent based on PK studies. As well, Cipla was not required by the regulators to conduct clinical trials. Thus, hurdles for the US market are significantly higher. We don't expect any meaningful US approval over the next three years.

Stock performance



Cipla one-year forward P/E multiple has expanded significantly



Cipla's valuation significantly ahead of peers

	Rating	P/E FY15F	P/E FY16F	P/E FY17F	PAT CAGR FY15-17F	ROE FY17F
Sun Pharma	Neutral	26.0	21.4	17.8	21%	26%
Dr Reddy	Buy	22.6	19.4	15.2	22%	23%
Lupin	Buy	29.3	25.7	21.5	17%	25%
Glenmark	Buy	21.0	16.8	8.9	54%	34%
Cadila	Buy	23.8	15.5	11.8	42%	34%
Cipla	Reduce	35.7	26.0	22.9	25%	16%

Source: Bloomberg, Nomura estimates, Pricing as of 15 Sep 2014

Limited leverage: The second market expectation is on Ebitda margin expansion as operating leverage kicks in. We focus on two cost items: (i) employee costs and (ii) R&D and legal costs. These overhead costs tend to rise as companies build the front-end and invest in development of the pipeline. We compare the costs for Cipla, Lupin and Dr Reddy's, which have current market caps in a similar range (Cipla: ₹505 bn; Dr Reddy's: ₹506 bn; Lupin: ₹634 bn). Over the last five years, employee costs have significantly increased for Cipla (more than 4x over the last four years alone), and are now ahead of Lupin. However, employee costs are still 37% lower than Dr Reddy's. We expect employee spending to grow only marginally below the top line and hence do not anticipate any significant operating leverage to play out.

Valuations moved ahead of peers: Cipla is trading at 36x FY15F and 26x FY16F. Cipla is trading at 28.6x one-year forward EPS of ₹21.43 (consensus), a significant premium to the historical average and peers. The rich valuation can either be attributable to (i) market expectations of a significant increase in earnings near term, and/or (ii) longer-term prospects beyond FY17F. As discussed, we do not look for any significant increase in earnings in the near term. We expect Cipla's business mix to change gradually and hence we do not anticipate a substantial increase in gross margins. Employee expense growth after the 42% CAGR (compound annual growth rate) over the last five years is likely to moderate and present some operating leverage. However, that can be negated by a rise in R&D spend. The company's intent to invest into complex generics, including inhalers, in the US is a positive. However, that intent is not unique, as peers have equally strong aspirations.

Our FY15/16F EPS are 5%/0% below consensus. Our 12-month target price at ₹569 is based on 22x one-year forward EPS of ₹25.8.

—Nomura