PRESS INFORMATION BUREAU
पत्र सूचना कार्यालय
GOVERNMENT OF INDIA
भारत सरकार

Financial Express, Delhi
Monday 24th February 2014, Page: 11
Width: 14.39 cms, Height: 25.40 cms, a4, Ref: pmin.2014-02-24.32.59

R&D to the fore

Higher operating expenses to curb margin improvement

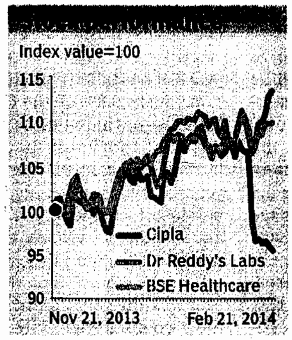
CIPLA

RATING: NEUTRAL ▼

Q3 miss significant: Cipla reported Q3 net profit at ₹2.8 bn (-16% year-on-year), 23% lower than HSBCe (estimates) of ₹3.7bn on the back of higher operating expenses. During the quarter, Cipla has consolidated Cipla Medpro South Africa for the full period. Net sales at ₹25.8 bn were broadly in-line, though export formulations were 7.5% above the estimates. Ebitda margins at 17.2% excluding other operating income were below expectations on the back of higher staff and R&D expenses (part of other expenses). Other income includes forex gain of ₹400m.

Operating costs creating a new base: Staff costs in quarter have increased 56% y-o-y to 15.8% to sales. Even after excluding the ₹160m Esop (employee stock option plan) contribution, costs are higher by 8%. Other expenses including R&D are up 36% y-o-y, 14% over estimates. The company has attributed this increase to recruitment of new talent (Sameer Goyal from GSK joins as country head-India) and an increase in R&D, which is now 4.5% to sales. Additionally, full consolidation of Cipla Medpro in the quarter has impacted margins.

Filings picking up, but launches are likely back-ended: Cipla is confident of greater efficiency and a large number of filings in future. As per the management, 60% of critical filings are on track. In the US, it filed 10 products in 9M (nine months) and received approval for six products (including gXopenex, $200m market, launch pending). It filed six products in the quarter; a total of



35 ANDAs (abbreviated new drug applications) are pending approval now. Of these 35, 17 ANDAs are under Cipla's name. We believe many of these product launches may be back-ended.

Valuation and risks: We downgrade Cipla to Neutral from OW (overweight) as we believe operating costs have a new higher base going forward on account of higher operating expenses related to increased focus on R&D and Medpro integration. Higher operating expenses will keep margin improvement under check. Also, we believe that key stock drivers like the launch of combination inhaler products in developed market is a bit far off for Cipla and the management's ongoing effort to increase process efficiency will take time to fructify.

We roll forward our target price to Dec-14 from Sep-14 and value Cipla at 20x (unchanged, in-line with the current sector average) Dec-15 EPS (earnings per share) of ₹22 to arrive at consolidated TP (target price) of ₹440 (from ₹477). A key upside risk is the reduction in costs and improvement in margins by Medpro. Downside risks include the continued delay in launches of high margin products (inhalers etc.) in bigger markets and further escalation of costs.

Respiratory franchise: Cipla has created a separate global respiratory business unit and added a centre of excellence (CoE). On the product launch part, Cipla has launched Duolin (levosalbutamol and ipratropium) in Croatia and looks to launch in other European countries. The company has begun to see positive traction from Seretide, which it had launched in Russia and in South Africa. In the US, Cipla has received approval for levosalbutamol ($200m market size with four potential players including Cipla) and carrying out discussion to check customer acceptance before launching it in the market. Cipla expects potential launch of combination inhaler in FY15 onwards.

Hedges: Cipla has $220m of foreign forward contracts outstanding which were booked at ₹55/USD rate and covers most of outstanding debtors. The company has booked forex gain of ₹400m in Q3.

R&D: Cipla has significantly ramped up R&D during Q3, which were 4.5% of sales. Cipla expect upward trend to continue and expects c5% of R&D as % total sales in FY14. Cipla has intensified filings across markets and currently 200 formulations development plans are underway. It has de-risked its product launch model and believes it has increased its efficiency by more than 30% to bring a product into market.

Capex: For Q3FY14, Cipla had capex of ₹900m and expects capex of ₹4bn for next year including rollover of ₹1.5bn capex from previous year.

New appointment: Cipla has appointed Dr Peter Mugyenyi as an independent director on the board. Dr Mugyenyi is recognised as one of the world's foremost specialists in the field of HIV/AIDS and he was credited for playing a major role in the formulation of US government programme, PEPFAR (President's Emergency Plan for AIDS relief) for HIV/AIDS treatment in Africa.

—HSBC

Change in estimates (after building in higher costs including R&D expense, and reduce technology incomes)

	New estimate			Old estimate		
₹ million	FY14e	FY15e	FY16e	FY14e	FY15e	FY16e
Sales	99,008	115,539	134,104	99,258	115,038	132,826
Ebitda*	20,434	24,302	28,514	23,285	26,921	31,025
Net profit	13,443	15,248	18,500	15,688	17,750	20,621
Adj. EPS (₹)	16.7	19.0	23.0	19.5	22.1	25.7

*inclusive of other operating income+technology income

Source: HSBC estimates

R&D