

PHARMACEUTICALS Q1 RESULTS PREVIEW

Expect robust revenues

Core margins likely to remain steady sequentially

WE EXPECT a robust 32% year-on-year revenue growth for the pharma universe. This outperformance will be led by (i) higher foreign currency realisations as a large part of the earnings is being driven by export formulations, (ii) new launches in the US, including generic Combivir, Plavix, Serquel, Zipsadone, Olanzapine, Fortament, Ocs (oral contraceptives), among others, (iii) continued benefit from one-off exclusivity sales of Zipsadone (Lupin and Dr Reddy's), Lupitor (Ranbaxy) and Doxil (Sun Pharma). Excluding the impact of these one-offs, recurring growth is expected to remain strong at 28% YoY for the universe, (iv) strong growth in domestic business, specifically higher traction in anti-infectives and other acute therapies, and (v) continued momentum in emerging markets of Russia, Brazil, Mexico and others.

The pharma universe may sustain its strong growth trajectory with core margins likely to remain steady sequentially. We see pressure on earnings due to mark-to-market (MTM) foreign exchange losses and higher tax rates. Within geographies, we see a strong surge in the US market from limited competition launches and continued exclusivity sales of Zipsadone/Lupitor. We also expect a firm traction for Sun Pharma, Lupin, Dr. Reddy's Laboratories and Cipla among large caps, and Glenmark in the mid-cap space. Aurbindo Pharma should also report improved margins.

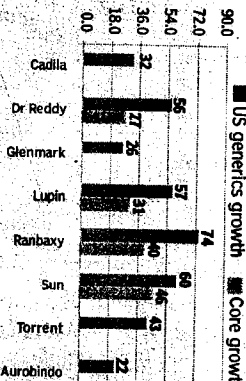
Valuations: Regulatory risks an overhang. We foresee a slowdown in earnings growth which coupled with challenging regulatory environment could potentially de-rate the sector. Historically, pharma multiples have tracked earnings growth and over the last three months, multiples of the large cap pharma universe have come off from 20x to 18.5x. We remain cautious and prefer companies with a strong pipeline besides those which offer a differentiated portfolio to sustain growth beyond FY12. Lupin, Cadila and Glenmark are our preferred bets. Lupin and Glenmark have a robust pipeline in the US as well as a differentiated model which renders a strong earnings visibility. Moreover, valuations based on price earnings-to-growth (PEG) do not appear to be stretched. We, thus, see a visible narrowing of the gap with the peer group.

Higher tax, interest costs and forex losses to impact earnings growth. Operating performances will remain robust owing to higher growth in sales and margin expansion. However, the reported earnings growth is likely to get impacted from higher foreign exchange losses due to an increase in MTM losses on foreign currency borrowings for various coverage companies. We expect high MTM losses for Aurbindo (₹2.35 bn), Cadila (₹1.44 bn), Ranbaxy (₹6.5 bn), Glenmark (₹1.6 bn) and Lupin (₹800 m).

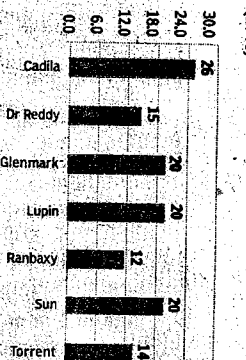
Adjusted for these losses, earnings growth at 25% YoY are impacted by higher tax rate (Cadila, Lupin and Sun Pharma) due to the loss of SEZ benefits, minimum alternate taxes (MAT) applicability to partnership entities and higher sales from first-to-file status. (FTFs). With the applicability of schedule VI, in the event of a MTM foreign exchange loss on borrowings, these companies would need to restate the difference in interest costs of India and foreign currency borrowings (6% to 10%) as notional costs in profit & loss (P&L). **Sun Pharma, Lupin and Dr Reddy's on a firm footing.** We expect Sun Pharma, Lupin and Dr Reddy's to report strong earnings growth led by higher realisations and niche product launches in the US. Lupin's growth in the US generics is estimated at 90% YoY led by launches such as Combivir, Nor-QD (OC) and Fortament. We believe Sun Pharma would grow from the ramp-up of Doxil and constant benefits from price increases.

In Taro although we see a sequential margin pressure for Taro. Cipla will reap greater benefits from the supply of Lexapro formulations to Taro and rupee depreciation. Glenmark's core revenue

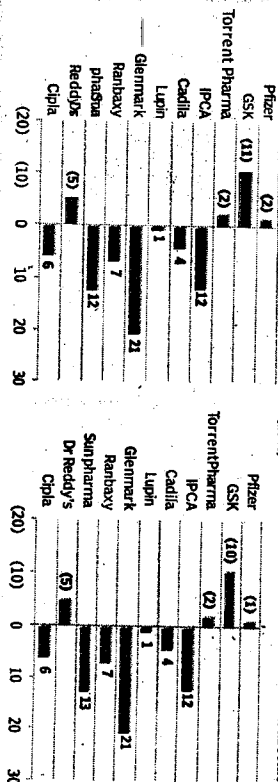
Strong growth expected in US, led by blockbuster FTFs



Growth expectations in domestic market across the coverage universe



Performance within sector (Relative to Sensex and Absolute)



Source: Bloomberg, Edelweiss research

growth would remain strong with margins firming up on back of niche launches in the US. Aurbindo Pharma's margin might see a marginal improvement q-o-q though YoY, it would be subdued