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Industry

Sun Pharma

Formulations at the core

Robust fundamentals and good long-term growth prospects justify premium valuation for the stock

HOLD

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Sound business fundamentals and robust growth, facilitated by a focussed management, have helped Sun Pharma command a 23 per cent premium valuation (on a price-to-earnings basis) over the BSE Healthcare index.

At its current price of Rs 616, the stock trades at 22.3 times one year forward earnings. This leaves little room for meaningful upside in the near term. But, considering the company's good growth prospects over a two-three year time frame, investors can continue to hold the stock. Also, one can use any dip in the stock price from these levels as a buying opportunity.

Sun is predominantly into manufacturing of formulations, constituting 93 per cent of the company's revenues; the remaining 7 per cent being active pharma ingredient (API) sales. US formulation sales, including Taro, account for 43 per cent of the total revenue; domestic formulation forms 36 per cent and contribution from the world (RoW) markets is 14 per cent.

The company's overall revenue grew 40 per cent to Rs 8012 crore in FY12, driven by strong domestic growth, consolidation of Taro for over two quarters and steady growth in the other international markets. The management expects to grow revenue by 18-20 per cent in the current fiscal.

CORE STRENGTH

Sun is the third largest player in the domestic market with a 4.7 per cent share. Thanks to its strong portfolio of drugs for cronic ailments, the company's domestic formulations business has grown at an impressive pace of around 20 per cent a year over FY07-12.

Chronic therapies constitute over 70 per cent of the company's domestic revenue. Sun is the leader in key chronic therapies, namely neuropsychiatry (27 per cent of domestic revenue) and cardiology (19 per cent of domestic revenue) and ranks among the top five in the anti-diabetes segment (14 per cent of domestic revenue).

The company launched 22 products last fiscal. To strengthen its presence in the anti-diabetes segnent, Sun has partnered with Merck Sharpe Dohme (MSD) to co-market the latter's two anti-diabetes molecules sold under Sun's brand names, Istavel and Istamet. The domestic formulations' revenue for FY-12 stood at Rs 2915 crore, posting impressive growth of 22.5 per cent.

Rational product selection, basket approach (presence in all key molecules in respective therapy segments), coupled with concerted brand-building strategy, have helped Sun consistently outpace market growth. The management is confident of sustaining ahead-of-the-market growth in the current fiscal as well.

BOOSTER TO US PERFORMANCE

Sun's US business has grown at a striking 22 per cent over the period 2007-12 on the back of a healthy portfolio consisting of over 170 products. Exclusive products such as pantoprazole have further helped the company's growth pace in the US market.

Due to short supply of J&J's Doxil (anti-cancer drug), Sun has been granted permission to temporarily supply Lipodox to the US market. This helped Sun's revenue and profit growth in the fourth quarter of FY12. Since J&J is expected to resume full supply only by the end of this year, the opportunity for Sun may extend beyond the current quarter.

Taro, in which Sun holds 66 per cent stake, has further strengthened the company's presence in the US. With strong presence in the dermatology segment, Taro complements Sun's portfolio. The company derives over 80 per cent of the revenue from the US market.

Though product concentration remains a risk in the near term, Taro has stepped up investment in research and development (R&D) to diversify the portfolio. It has increased its quarterly spend on R&D by $2 million since its acquisition by Sun.

Taro's revenue grew 35 per cent in Q4FY12 to about Rs 708 crore ($145 million).

Conscious efforts by Taro to reduce costs and price increase on specific products helped it improve operating margins from 34.9 per cent to 48.8 per cent over the past four quarters.

The management is cautious about the sustainability of the current growth rate and operating margins. But given its healthy pipeline, benefits from new product launches should help the company's growth.

Sun has a strong cumulative ANDA filing pipeline of 397 products, out of which 147 are pending approval. Approval of exclusive products such as Prandin (anti-diabetic drug for which Sun is likely to enjoy six-month exclusivity through its subsidiary Caraco), in addition to other generic products, will drive the company's US revenue.

Sun also has presence in 40 less regulated branded generic markets such as Brazil, Mexico and CIS countries. This market grew at a healthy 24 per cent posting revenues of Rs 799 crore (excluding Taro's RoW business).

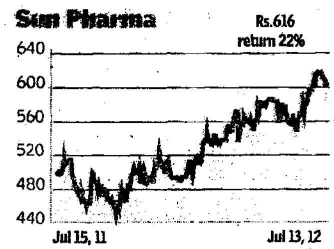
HIGHER TAX OUTGO

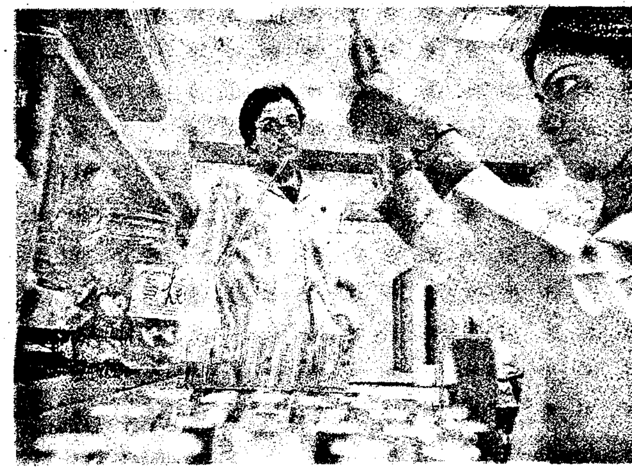
Sun's manufacturing facilities at Sikkim and Baddi, which cater to the domestic market, are held by partnership fi
Sun Pharma Sikkim and Sun Phar
dustries. With the introduction of
nate minimum tax on partnerships
tax rate is expected to increase fro
per cent in FY12 to 18-19 per cent
current year. This will likely moder
net profit margin for the company,
stood at 37.1 per cent in FY12.

The penalty payable to Wye
launch of generic protonix ahead
resolution of the litigation rema
over hang on the stock. Though
has submitted an expert report cl
damage of $960 million (Rs 5280
Sun believes that the claim is exagg
and untenable.

WHY HOLD

- Premium valuations
- Profit may moderate due to higher tax outgo
- Strong long-term growth outlook





Sun Pharma's product launches to support growth.