Xpress idea: Cipla Ltd. – Good times to come- "BUY" 2nd Dec., 2016

CMP: 572| Target: Rs. 700| Upside: 22%| Market Cap: Rs. 460 bn|Face Value: Rs. 2

Stock price movement

Source: Moneycontrol website

Investment Rationale

Domestic leadership intact: Cipla continues to maintain its leadership in respiratory, paediatric and urology therapies. Legacy brands continue to perform well. As one of India's leading pharmaceutical companies, its commitment to provide modern patients. In FY16, despite pricing challenges and the impact of a weak monsoon, Cipla's domestic revenues for its prescription business grew by 16% compared to the industry growth of 14%, as per IMS Health data.

The India business contributed ~40% to overall Company revenues, with new products contributing 4.5% of total India business revenues. The prescription business accounted for 81% of India business revenues and market share for this segment currently stands at 5.3%. The Company grew faster than the market in Anti-infectives, Gastrointestinal and Urology. The respiratory business saw strong uptake with over 20% growth in the COPD portfolio. Cipla continues to focus on high-value opportunities to build out its specialty portfolio, through a mix of in-licensing and in-house innovation and development.

momentum in FY 2015-16 with 6 deals executed in oncology, respiratory and dermatology segments. The Company also initiated several high value innovation projects, of which a few are likely to be commercialized in FY 2016-17.

With the successful launch of Sofosbuvir in India for the treatment of Hepatitis-C, Cipla has expanded access to the drug with nearly 10,000 patients being treated under the brand name

Cipla continues to build out its Hepatitis franchise in order to improve access to breakthrough therapies for patients with HepCvir + Ledipasvir / Daclatasvir combinations.

Cipla also entered new areas through a partnership model – Cutisera in cosmetology, Nasovac S in vaccines and Reteplase in the Anti-Thrombolytic segment.

In the coming years, the domestic business will continue to focus on enhancing depth of portfolio in priority therapy areas, and increasing sales force productivity with the rollout of Customer Relationship Management (CRM) and Sales Force Automation (SFA) systems. Through this, Cipla aims to grow above market rate of growth and strengthen leadership position in priority therapy areas in the Indian market.

Striving to be focused player; exiting from difficult geographies: In the past six months, Cipla has exited 24 countries and brought down its presence abroad to 110 nations from about 135 earlier. Much of this has been achieved by Umang Vora, who took charge as managing director and chief executive officer (CEO) from September 1. He was elevated from the earlier role of chief operating officer. Vora aims to exit six more countries in the near future and there could be more on the cards.These moves are aimed at enabling the company to maintain focused and profitable growth. However, the phase of accelerated expansion into global markets did not start too long ago. Subhanu Saxena joined the company as CEO in February 2013, following the resignation of then joint managing director Amar Lulla in December 2010. Saxena, to strengthen presence in the “rest of the world" markets, entered into a series of acquisitions of distributions companies. It was a move to adopt the costly front-end model of business beyond the domestic market. It was opposite to what Lulla had practised under the partnership model for the company in foreign markets. Fast expansion into global markets saw the company’s return on capital employed dropping to 14.5 per cent at the end of 2015-16, from 24 per cent at the end of 2012-13. Profit margins, too, have declined. Certainly, the expansionist mode did not work, and hence the consolidation strategy under the new leadership of Vora is in play now.

Consolidating position globally and focus on key markets: In the past four years, the company invested in building front-end in various global markets, acquiring key assets such as Medpro in South Africa and building strong leadership positions in various emerging markets. Cipla acquired Medpro in 2013 for Rs 2,707 crore and followed up with the Rs 3,575-crore acquisitions of the US generic drug makers, InvaGen and Exelan. The Company’s focus will be to consolidate its position globally and focus on key markets. As part of the new strategy, Cipla intends to have front-end presence in “key markets" including India, the US and South Africa. In other markets, it intends to return to the old model of partnership. The Company holds a leadership position in several markets such as Uganda, Sri Lanka, Yemen and North Africa. Cipla’s business in partnership-led markets (B2B) saw a growth of 8% in FY 2015-16 over the previous year. The Company is proactively simplifying its businesses, rationalising markets where necessary, and focusing only on high-growth markets where it holds a leadership position.

Respiratory market to add profits in Cipla’s kitty: Over the last 40 years, Cipla has invested in three dedicated manufacturing sites for Respiratory. The Company manufactures four major dosage forms i.e. metered dose inhalers (pMDIs), dry powder inhalers (DPIs), nasal sprays and nebulisers in addition to a range of inhalation devices. In FY16, the Company was amongst the largest manufacturers of pMDIs with capacity to produce over 100 million inhalers. In addition, the Company has built a team of world-class specialists across Manufacturing, Quality Control, Quality Assurance, Supply-Chain who continue to collaborate seamlessly across functions. Cipla Respiratory has unique end-to-end capability covering the value chain from API, formulation, device development and manufacturing to doctor and patient initiatives.

In India, Cipla Respiratory has played a pioneering role in driving the conversion of patients from oral to inhaled therapy for the treatment of Respiratory disease. This year, the Company further strengthened and adapted where necessary its pioneering "BreatheFree" patient awareness and education programs across key markets outside India such as South Africa and Sri Lanka.

Cipla Respiratory has grown to almost ~US$ 400 mn, accounting for ~25% of the company's revenues. Despite aggressive competition, the Company remains focused to retain leadership in serving patients diseases across the world.

With the global respiratory market expected to grow to US$50 billion by 2018 from current US$36 billion, Cipla would be able to generate about US$500 million in net profit over the next 5-7 years from its respiratory portfolio

New launches to drive growth: Leveraging the front-end in the US market, the company plans to launch 10-15 products. It has a target of filing 20-25 ANDAs (Abbreviated New Drug Applications) in the current financial year for drugs going off-patent. The Company expects the execution of the InvaGen pipeline and continued approvals in Cipla DTM (direct-to-market) to ramp up the US revenue to about $500 million by FY18, which should help improve base business margin over FY18-19.

In the next five to seven years, the US is going to see drugs in broad categories of respiratory, HIV, immuno medications and oncology, go off-patent.

The company has huge proven capabilities in respiratory and HIV drugs where it sees opportunity with drugs going off-patent in the US. Oncology is the third area where the company claims to be well-versed with to capitalise on the coming opportunity in the world's largest market for pharmaceutical products.

Cipla reported 18 per cent of its Rs crore revenue in the quarter ended September from North America. Domestic rivals Lupin earns over 40-45 per cent of revenue from the US market. While there is potential for Cipla to ramp up the revenue share of the US market in the short to medium term, analysts don't sound confident.

While management expects US business to see strong growth led by four-five limited competition (drugs) over the next 12 months, the challenges for the business have risen significantly and we remain cautious. "Cipla is, in our view, significantly late to the market, which will limit the overall potential of the business.

Decent Q2FY17 result

The Company witnessed a topline growth of 15.3 percent on yoy basis to touch Rs. 37510 mn in Q2FY17. However, sequentially topline remained flat.

EBITDA registered a jump of whopping 295 percent on yoy basis to Rs. 6,807 mn. On qoq basis, EBITDA grew by 11.4 percent. OPM increased by 1,286 bps on yoy basis to 18.1 percent which outperformed our expectations.

The Company posted PAT of Rs. 3,271 mn as against loss in Q2FY16. On qoq basis, PAT witnessed a growth of 4.2 percent. PAT margin stood at 8.7 percent.

Valuation & Recommendation

At CMP, the stock is trading at a P/E of 31x FY16 EPS. We recommend a “BUY” on the stock with a price target of Rs. 700 (assign a discounted multiple of 28x at street estimated FY18 EPS of Rs. 25) an upside of 22%, over a period of 3 months.

Recommendation parameters for fundamental reports:

Buy – Absolute return of 20% and above

Accumulate – Absolute return between 15% and above

Book profits: On achieving the price target given in the research report for a particular Company or on a occurrence of a specific event leading to change in fundamentals of the Company recommended

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