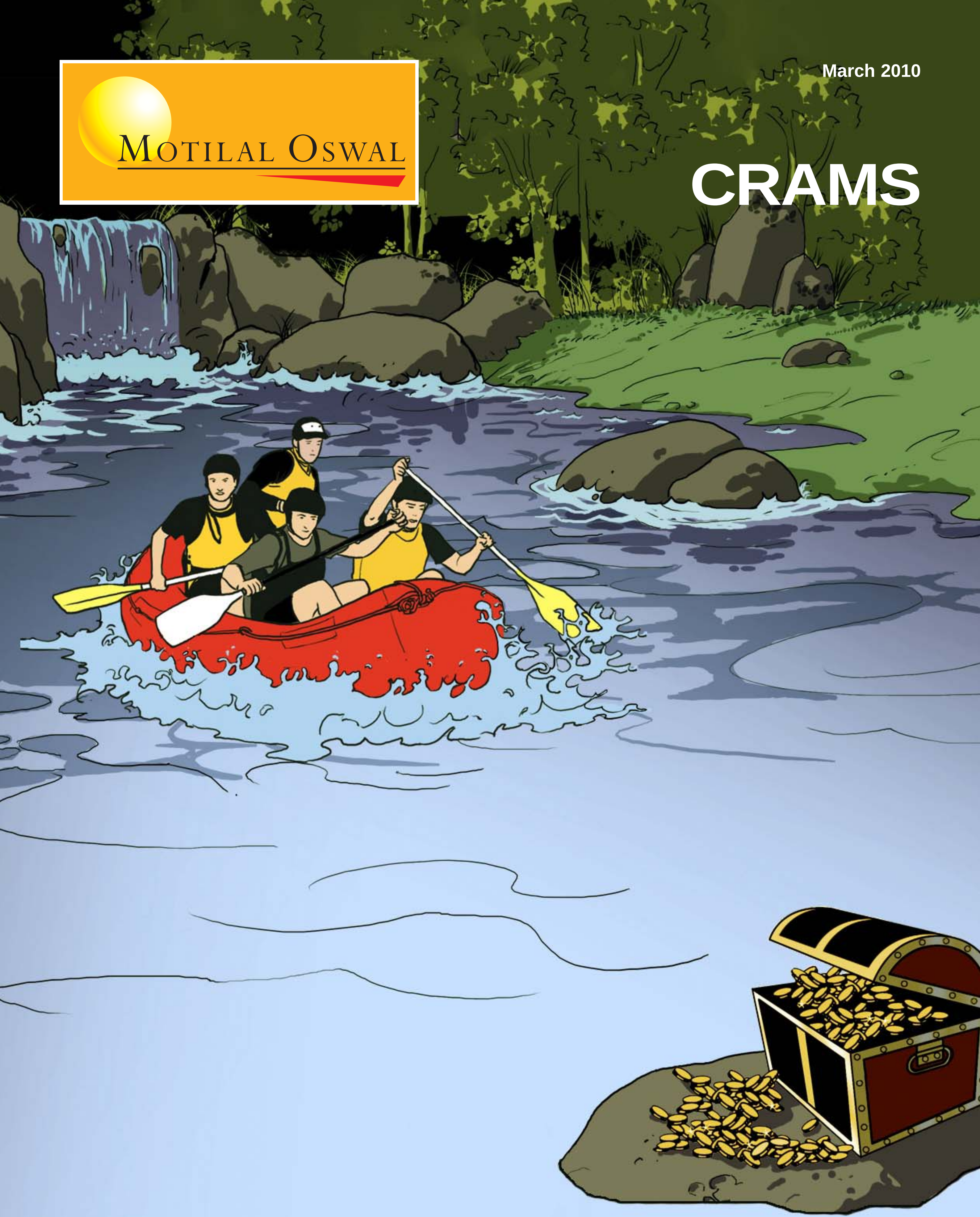

MOTILAL OSWAL

March 2010

CRAMS

In Calmer Waters

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Prices as of Thursday, March 4, 2010

Thematic Report

SECTOR: PHARMACEUTICALS

CRAMS

BSE Sensex: 16,972 S&P CNX: 5,080 8 March 2010

COMPANY NAME	PG.
Divi's Lab *(Buy, Rs650)*	25
Piramal Healthcare *(Buy, Rs415)*	35
Dishman Pharma *(Neutral, Rs208)*	51
Jubilant Organosys *(Neutral, Rs324)*	63

The Indian Contract Research and Manufacturing Services (CRAMS) companies are on the threshold of a significant opportunity given the expected increase in pace of outsourcing from India.

- **Inventory de-stocking coming to an end:** We expect the adverse impact of global inventory de-stocking (undertaken by customers) to correct gradually from FY11 onwards as the underlying demand for pharmaceutical products has remained intact despite the global slowdown. Most of the Indian CRAMS players have recently indicated that there will be increased trend towards outsourcing in FY11.

- **Macro environment favourable for increased outsourcing:** We expect a significant traction in the global outsourcing business given the low R&D productivity and intense pressure on the global innovators to generate growth. A large portion of this outsourcing business is likely to be sourced from Asia (mainly India and China).

- **Entry barriers are high:** Given the significant entry barriers in this business, we expect existing players to get a disproportionate share of the business.

- **India is on the threshold of a big opportunity:** India's market share in the global contract manufacturing business is likely to more than double to 7% in 2007-2012 while supply revenues will grow from US$800m to US$3b, giving rise to a significant opportunity for well-established CRAMS players.

- **Demonstrated skills for CRAMS:** We believe that some of the Indian companies have demonstrated strong chemistry and regulatory skills coupled with IPR compliance and low manufacturing costs — the prerequisites for building a successful CRAMS business.

- **Recommendations:** We reiterate our Buy rating on Divi's Labs (17% upside), Piramal Healthcare (19% upside). Consolidation of customer base and delayed paybacks from acquired companies, which were funded through leverage, are the key risks to our positive stance.

PHAMACEUTICALS - COMPARATIVE VALUATIONS

COMPANY	CMP (RS)	RECO	EPS (RS)			P/E (X)			EV/EBITDA (X)			ROE (%)		
	04.03.10		FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
Divis Labs	650	Buy	23.8	28.5	34.5	27.3	22.8	18.8	22.2	16.9	13.7	22.6	22.5	23.0
Piramal Healthcare	415	Buy	21.1	25.8	31.0	19.6	16.1	13.4	14.0	11.2	9.6	29.7	29.2	28.5
Dishman Pharma	208	Neutral	14.1	15.4	18.8	14.8	13.5	11.1	11.8	9.4	7.6	14.9	14.4	15.3
Jubilant Organosys	324	Neutral	20.7	18.6	31.7	15.7	17.4	10.2	10.6	8.7	7.6	27.3	26.3	24.8

Source: MOSL

Outsourcing to grow exponentially

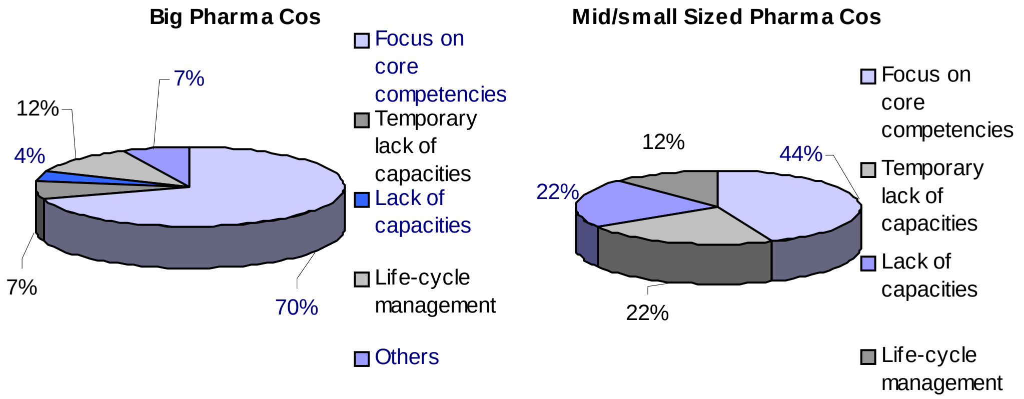
We expect significant traction in the global outsourcing business given the low R&D productivity and intense pressure on global innovators to generate growth. A large portion of this outsourcing business is likely to be sourced from Asia (mainly India and China). India is on the threshold of a big opportunity, with its market share in the global contract manufacturing business likely to more than double to 7% by 2012, indicating better prospects for well-established CRAMS players. We believe that some of the Indian companies have demonstrated strong chemistry and regulatory skills coupled with IPR compliance and low manufacturing costs — the prerequisites for building a successful CRAMS business.

Innovators focusing on core competencies

MNCs are re-focusing their resources to critical functions

Innovator pharmaceutical companies have started focusing on their core competencies (i.e. R&D and marketing), as they add the maximum value to the organization. A variety of factors have forced the MNCs to re-focus their resources to critical functions while defocusing from non-core (or less value adding) functions like manufacturing. A survey carried out by Contract Pharma has revealed the following as the key reasons for outsourcing:

KEY DRIVERS OF OUTSOURCING



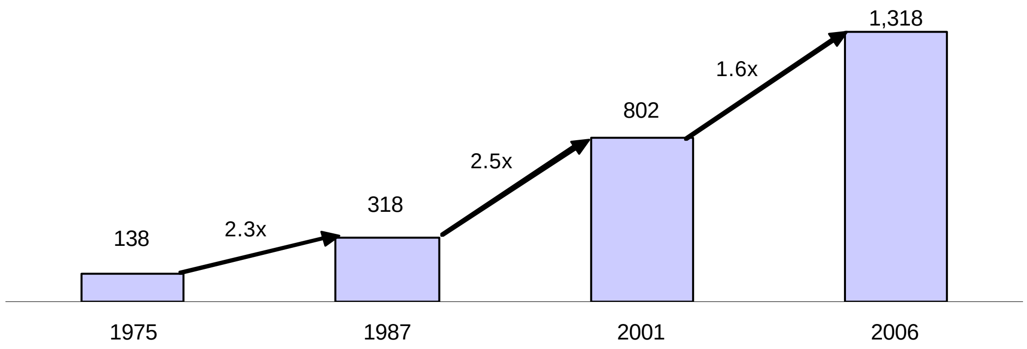
Source: Company/MOSL

New drug development is becoming extremely time-consuming…

New drug development often takes 10-12 years and US$1b-1.3b in development costs

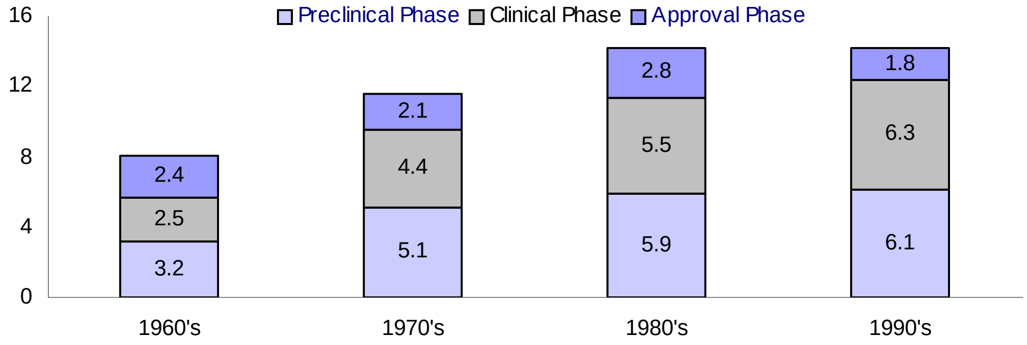
New drug development has become very time-consuming, taking 10-12 years and US$1b-1.3b in development costs (including costs of failures). Clinical trials alone take up 6-7 years of development time. Most of the easier-to-develop drugs have already been discovered and the pharmaceutical industry is entering a phase where it will have to work on more complex molecules. This has stretched the time required to successfully develop a new drug. Stringent regulatory requirements, in terms of data on clinical trails and associated paperwork, have also lengthened the time-line of new product development.

BURGEONING NEW DRUG DEVELOPMENT COST (US$M)



NEW DRUG DEVELOPMENT: TIME-FRAME IN YEARS

While approval time has declined, development is becoming more time consuming



Source: Industry/MOSL

…and the rate of new drug/molecule approvals has been declining…

No low-hanging fruits; therefore, very few drugs being approved by US-FDA

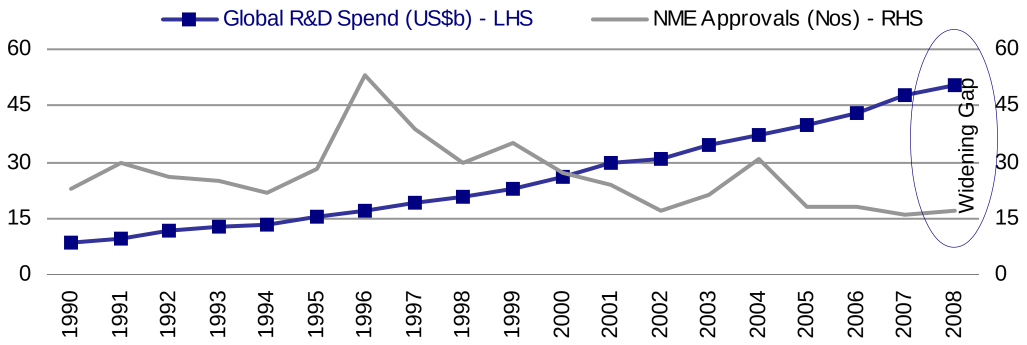
Very few new molecules are being approved by the US-FDA, which implies low R&D productivity for the MNCs. We believe that one of the reasons for the decline in approvals is that the easier-to-develop molecules have already been commercialized. The global pharmaceutical industry is now entering a phase where far more efforts will be required to invent a new molecule. This is because of greater complexity of target diseases, the longer and larger clinical trials required by regulators and the medical system's growing demand for more complex data about new drugs and their side-effects.

…leading to decline in R&D productivity

Despite reduced approval time, R&D productivity has declined

The combination of increased development time, decline in the rate of new approvals and higher development costs has resulted in a decline in R&D productivity of MNCs. This is despite reduced approval times.

DECLINING GLOBAL R&D PRODUCTIVITY



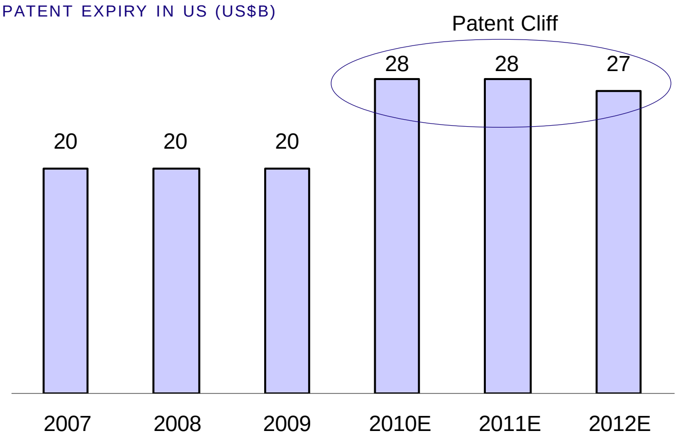
Source: US FDA, Phrma

Also, there is increasing competition from generics

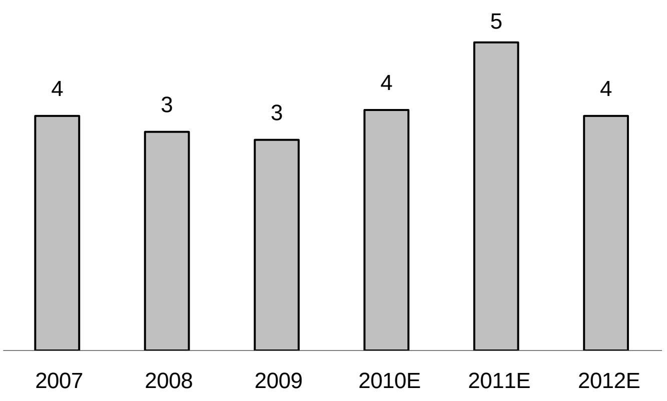
Generic competition is threatening existing MNC products…

Innovator pharmaceutical companies have experienced intense onslaught from the generic companies in the past few years. Large generic companies have challenged the patent holders very aggressively. Several blockbuster drugs have lost patent protection due to successful patent challenges and more are likely in coming years. In fact, most of the existing drugs are already facing generic competition or are facing patent challenges. This has put intense pressure on the revenues and profitability of the innovator companies.

PATENT EXPIRY IN US (US$B)



PATENT EXPIRY IN EUROPE (US$B)



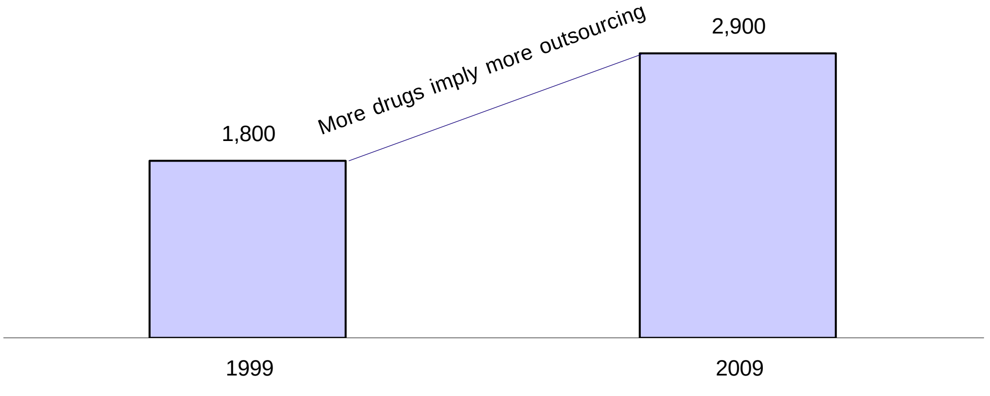
Source: Industry/MOSL

… leading to more drugs under development…

We observe that declining R&D productivity and increasing patent expiries, coupled with generic competition and fewer blockbuster drugs has led to a significant increase in the total number of drugs under development over the last ten years.

With significant rise in the number of drugs under development…

NUMBER OF DRUGS UNDER DEVELOPMENT



Source: Industry/MOSL

…outsourcing opportunities have increased considerably

… implying more outsourcing opportunities

More drugs under development would imply that MNCs would need to outsource more services and intermediates from cost-efficient regions (including India). Innovator companies have been forced to re-look the "expenditure" side of their operations and focus on their core activities of R&D and marketing due to:

1. Declining R&D productivity despite the increased expenditure on research and reduced regulatory approval times.
2. More complicated and time-consuming drug research, as the low hanging fruits (i.e. easy to invent drugs) have already been plucked.
3. Intense pressure on existing products due to generic competition.
4. More "me-too" drugs under development, which offer only incremental advantages over existing therapies. This has impacted the number of blockbuster drugs in the pipeline.

This is likely to force the innovator companies to look at effective cost management techniques. The first step in any cost reduction/management exercise is to outsource non-core activities from low-cost destinations/players. In our opinion, MNCs would look for the following factors while deciding on outsourcing partners:

1. Cost efficiency of the partner
2. Timely delivery of products/services
3. Chemistry skills of the partner
4. IPR compliance policy of the partner

A number of Indian companies have the pre-requisites for building a flourishing CRAMS business

WHAT DO MNC PHARMA COMPANIES THINK ABOUT OUTSOURCING?

AstraZeneca	■	Planning to outsource all its API manufacturing activities within ten years
	■	Aiming to become a pure research, development and marketing organization
	■	Looking to access China and India in a much more meaningful way
Pfizer	■	Aiming to outsource 30% of its manufacturing capabilities by 2010
	■	Thinks Asia is major outsourcing destination
GSK	■	Operational Excellence' program designed to achieve savings of •1b by 2010
	■	40% of these savings will come from manufacturing rationalization including outsourcing
Merck	■	Planning to outsource about 30% of the manufacturing
	■	Entered into a five-year master supply agreement with Patheon
BMS	■	Planning to divest/shut down manufacturing sites
	■	Aggressively outsource manufacturing of mature products
	■	Continue to use third-party suppliers for back-up production of newer drugs
Novo Nordisk	■	Planning to outsource about one-third of its global research and development activities to India
	■	Would invest heavily in India besides trebling headcount in the country from 600 to 2,000 by 2012
Takeda	■	Expects to raise the ratio of outsourced production to 80% of its overall output

Source: Companies/MOSL

Potential cost saving for innovators through outsourcing

Below, we have given an example to analyze the potential cost saving for the innovators through outsourcing. We have assumed the size of the drug at US$1b and API manufacturing cost at 5% of revenue.

GROSS MARGIN IMPROVEMENT FOR INNOVATOR (%)

		% COST SAVINGS				
		20%	30%	40%	50%	60%
% API manufacturing outsourced	50%	0.5	0.8	1.0	1.3	1.5
	60%	0.6	0.9	1.2	1.5	1.8
	70%	0.7	1.1	1.4	1.8	2.1
	80%	0.8	1.2	1.6	2.0	2.4
	90%	0.9	1.4	1.8	2.3	2.7
	100%	1.0	1.5	2.0	2.5	3.0

Source: Company/MOSL

REVENUE FOR CRAMS PLAYER (US$M)

		% COST SAVINGS				
		20%	30%	40%	50%	60%
% API manufacturing outsourced	50%	20.0	17.5	15.0	12.5	10.0
	60%	24.0	21.0	18.0	15.0	12.0
	70%	28.0	24.5	21.0	17.5	14.0
	80%	32.0	28.0	24.0	20.0	16.0
	90%	36.0	31.5	27.0	22.5	18.0
	100%	40.0	35.0	30.0	25.0	20.0

Source: Company/MOSL

Indian CRAMs companies capable of offering 40% cost savings

India on the threshold of a significant opportunity

Given the growth challenges faced by the global innovator companies, outsourcing is likely to grow exponentially in the coming years. We believe that India is on the threshold of a significant opportunity in the global outsourcing industry and has compelling advantages for attracting outsourcing business. We believe that, over the next decade, existing outsourcing players with high-cost operations in USA and Europe will gradually lose business to India due to the following advantages, which India offers:

- World-class quality at 30-40% lower cost.
- Proven chemistry and process innovation skills instilled by years of fierce competition in the domestic market.
- India has six times the number of trained chemists as the US, available at a tenth of the cost.
- India has up to 40% lower capital cost, resulting in lower initial capex on new facilities.
- Established regulatory skills - India has highest number of US-FDA approved facilities outside USA. Indian players account for 25-30% of the total DMFs filed with the US-FDA.
- The implementation of the WTO TRIPS-mandated product patents in India (w.e.f. 1 January 2005) is likely to give extra comfort to MNCs for outsourcing from India.

Contract manufacturing - the most scalable opportunity for Indian players

Though contract manufacturing is the most scalable opportunity for Indian players…

We believe that of the three broad outsourcing opportunities available to India - CCS, clinical trials and contract manufacturing, the most scalable business opportunity for Indian players would be contract manufacturing. This is because:

1. CCS would typically involve supply of material at gram or kilogram level, while contract manufacturing involves supplies in tons.
2. CCS supplies are linked to the success of the partner's R&D pipeline and are, hence, volatile. Contract manufacturing supplies, on the other hand, are linked to the success of a product post commercialization and can provide relatively stable revenues (since probability of success post commercialization is higher than that at the R&D level).

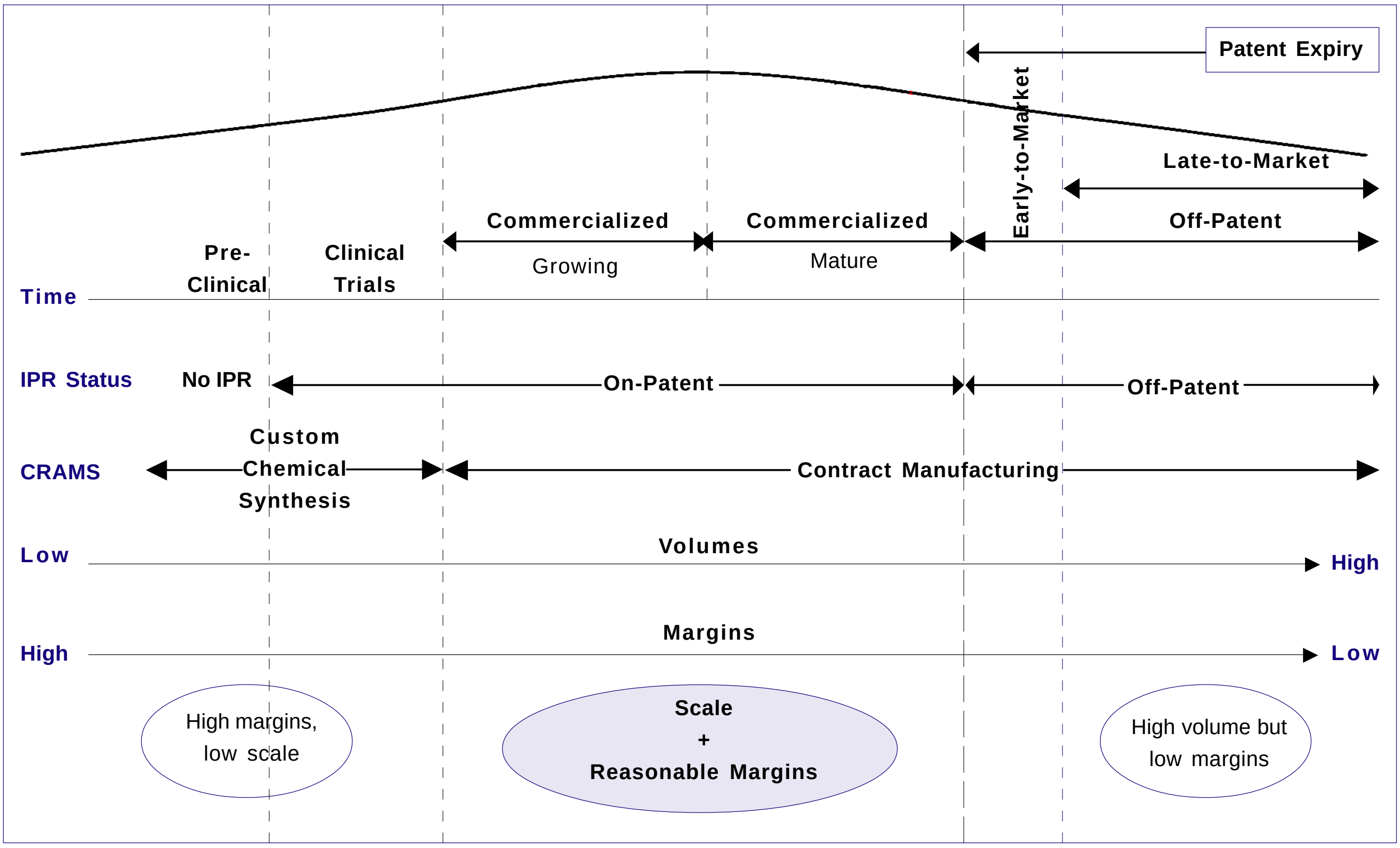
…we believe CCS skills are also important

However, we believe that CCS skills are important from the following perspective:

- CCS assignments give Indian players an opportunity to lock-in into MNC relationships very early in the product lifecycle. This augurs well for the partnership approach that lays the foundation of the outsourcing business.
- CCS projects demonstrate a company's ability in process innovation. CCS skills can help a company to graduate from only a 'supplier' to a 'preferred strategic partner'.

Hence, we believe that a proper mix of CCS and contract manufacturing projects is a prerequisite for success in the outsourcing space.

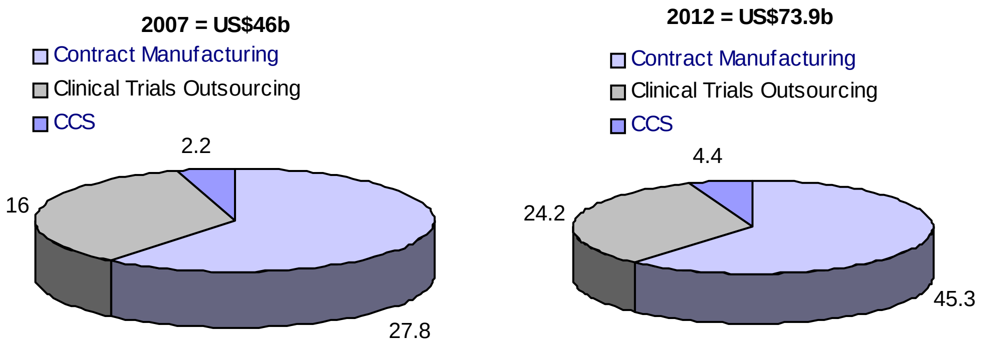
CRAMS VALUE CHAIN


Patent Expiry
Early-to-Market
Late-to-Market
Off-Patent
Commercialized
Growing
Commercialized
Mature
Pre-
Clinical
Clinical
Trials
Time
IPR Status
No IPR
On-Patent
Off-Patent
CRAMS
Custom
Chemical
Synthesis
Contract Manufacturing
Low
Volumes
High
High
Margins
Low
High margins,
low scale
Scale
+
Reasonable Margins
High volume but
low margins

Source: MOSL

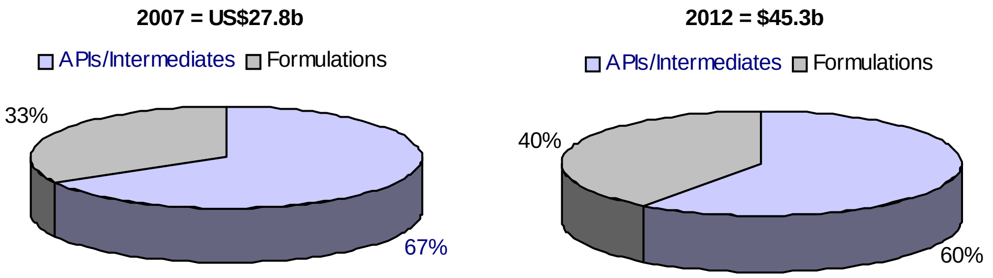
The global outsourcing market opportunity is expected to grow at 9.9% CAGR from US$46b in 2007 to US$73.9b by 2012. Of this, contract manufacturing (the most scalable opportunity) is expected to grow from US$27.8b to about US$45.3b by 2012, a CAGR of 10.3%.

GLOBAL OUTSOURCING OPPORTUNITY

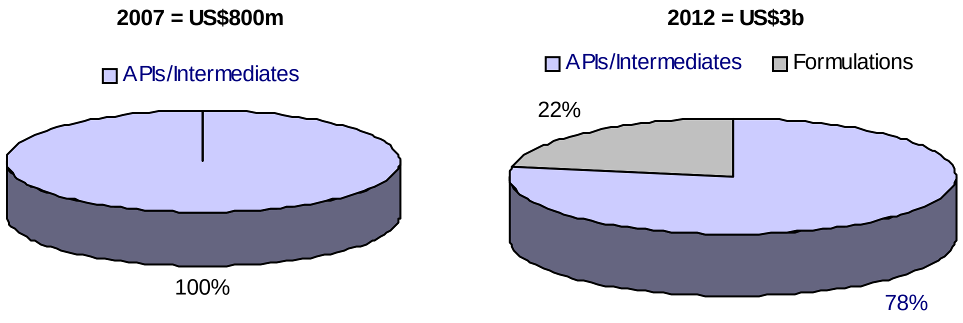


Source: Industry/MOSL

GLOBAL CONTRACT MANUFACTURING OPPORTUNITY



INDIA CONTRACT MANUFACTURING OPPORTUNITY



Source: Industry/MOSL

MNCs have been outsourcing APIs and intermediates, but formulations outsourcing from India is yet to take off

Innovator pharmaceutical companies have till date outsourced both APIs as well as intermediates from a few Indian companies. However, formulations outsourcing from India is yet to take off. No company from India supplies formulations to MNCs on a contract manufacturing basis (Piramal Healthcare has commenced supplies some time back). Since the Indian contract manufacturing segment is still evolving, it accounted for only US$800m (3% market share) of the global contract manufacturing industry in 2007. India's market share could more than double to 7% to US$3b by 2012.

China is not a threat yet

Despite lower labor costs, China is not a major threat to Indian CRAMS

China is a manufacturing powerhouse in sectors like Textiles, Metals and Commodities, where it derives significant cost advantage through economies of scale. By its very nature, pharmaceutical manufacturing is a batch-process industry, wherein economies of scale are relatively less important and do not result in significant cost advantage. Though China's labor costs may be less than India's, the latter enjoys a lead over China in critical determinants like chemistry skills, compliance to strict international regulatory norms, scientific skills, MNC comfort, etc. For instance, India has the largest number of US-FDA approved facilities outside USA, while China has very few such facilities. India accounts for 25-30% of global DMF filings while Chinese companies contribute a minuscule percentage. Hence, we do not expect China to be a major threat to India in the CRAMS space in the next five years despite having the advantage of lower labor costs.

CRAMS - INDIA V/S CHINA

PARAMETER	INDIA	CHINA
Manufacturing focus	Advanced Intermediates, APIs, Formulations	Bulk chemicals, Intermediates, Fermentation-based products
Chemistry skills for pharma products	Well developed	Moderately developed
Regulatory skills & compliance	Well established	Evolving
Labour costs	Cheap	Less than India
Scientific skills	Good	Moderate
US FDA approved facilities	> 100 - highest outside USA	Very few
DMFs filed	25-30% of global filings	Very few
Product basket offered	Broad	Narrow
MNC Outsourcing stance	Favorable	Favorable
MNC confidence for technology transfer	Moderate	Moderate
MNC relationships	Scaling up	Scaling up
IPR Protection	Product patent regime implemented in Jan-05 but still some grey areas	Product patent regime implemented long back but loosely implemented
Domestic pharmaceutical industry	Well developed	Moderately developed
Communication (English language)	Well established	Weak
Overall Infrastructure	Weak	Well developed

Source: MOSL

It's not just about 'labor arbitrage'

The India CRAMS opportunity will not be restricted to pure labor arbitrage

Although India's cost of manufacturing is significantly lower than that in developed markets, we believe that the India CRAMS opportunity will not be restricted to pure 'labor arbitrage'. This is also vindicated by the fact that despite enjoying lower labor costs than India, China has not evolved into a major outsourcing hub for pharmaceuticals. We believe the following are the prerequisites to emerge as a preferred outsourcing destination:

- Chemistry skills for pharma products
- Regulatory skills & compliance
- Low labor costs
- Scientific skills
- Timely delivery
- US-FDA approved facilities
- MNC relationships
- IPR compliance

Key factors that help win contracts

Time and quality: Time and quality are of extreme importance to the innovator companies. In R&D, time is very important to save on the limited patent life, and in manufacturing, it is a matter of reputation for innovator companies to market the drugs during the entire patented period. Also, high quality products are essential to win contracts. Due to the nature of pharmaceuticals, threat of product contamination or excess impurities is enough to scare the potential customer. Also, the drug quality has significant implication on the reputation of the innovator and financial liabilities of the company.

Availability of manufacturing capacity: Just as timeliness of supply is critical, sufficient capacity is key to the new business especially for contract manufacturing. Innovator companies generally request rapid turnaround time. Existing manufacturing capacity is critical for time-sensitive projects. However, where supply relationships already exist, the ability to plan for projected new capital needs can be jointly accomplished.

Reputation and track record: If the CRAMS player was the service provider for the innovator company in the past, and had delivered satisfactory services, the customer will most likely opt for the same CRAMS player for similar or new projects on the basis of the trust that has been built. Also, innovator companies will generally prefer big CROs and CMOs due to available infrastructure and service quality.

Array of services offered: Generally, innovators like to get maximum possible services from same contract research company due to ease in administration and effective communication regarding requirements. For example, if a company has synthesized a chemical, it might be a good choice for other services such as process chemistry too.

Reliability and flexibility: Suppliers should be reliable in terms of dedicated management team, financial stability, strong track record of supply, manufacturing, logistics, etc. Flexibility is also extremely important to innovators, as CMOs often collaborate with them to develop a new drug. In particular, the ability to adjust manufacturing schedules to meet deadlines, adjust manufacturing processes, and meet critical timelines is very important.

Scalability: Pharmaceutical customers prefer suppliers who have the ability to increase their scale of production, as products move from early stages to later stages of drug development. In general, this means suppliers should have ready availability of cGMP capacity as products pass through FDA hurdles, or the means to rapidly build additional capacity in conjunction with the anticipated product launch. In addition, it requires a scalable process used to manufacture the molecule. In other words, the contract manufacturer must develop a process that can effectively and affordably manufacture commercial quantities of the molecule. This ties closely to contract-manufacturing process chemistry skills. We believe that these skills are critical, yet very difficult to assess (other than increased contract wins).

Cost: Our discussions with various CRAMS players suggest that before the advent of Asia as the outsourcing destination, cost was not a major selection criterion, as the western CRAMS players had almost the same cost structure as innovators. Rather, it was the relationship and expertise which mattered. This is still true in the case of contract research work, where timeliness and proximity of the service provider is more important than cost. However, entry of Indian and Chinese companies in the space has changed the rules of the game and has made costing a major consideration for innovator companies, as the Asian CRAMS players can deliver the same quality as European players in a timely manner and at considerably lower cost due to structural advantages. Cost is of significant importance for awarding manufacturing contracts especially for products going off-patent.

A good beginning has already been made

Most innovator MNCs have already begun outsourcing from Indian players and it is only a matter of time before international CRAMS players also begin to show increasing interest in India. Given that there are high entry barriers to becoming a preferred vendor to innovator companies and switching cost for innovators is high, we expect the top-5 players from India to gain a disproportionate share of the business in the initial phase.

INDIA - MNC OUTSOURCING TILL DATE

COMPANY	OUTSOURCING FOCUS IN INDIA		
	CLINICAL TRIALS	MANUFACTURING	R&D
GSK	Yes	Yes	Yes
Eli Lilly	Yes	Yes	Yes
Aventis	Yes	Yes	Yes
Novartis	Yes	Yes	Yes
Abbott		Yes	Yes
Nycomed		Yes	
Pfizer	Yes	Yes	Yes
AstraZeneca	Yes	Yes	Yes
Solvay		Yes	
Roche	Yes		
Johnson and Johnson	Yes		
Merck	Yes	Yes	Yes
Amgen	Yes		
Eisai	Yes		
BMS	Yes	Yes	Yes
Wyeth		Yes	Yes

Note: Above information is based on disclosed projects. Details on CCS outsourcing are not available due to confidentiality clauses. *Source: Industry/MOSL*

INDIA - MAJOR CONTRACT MANUFACTURING DEALS SIGNED TILL DATE

COMPANY	MNC PARTNER	PRODUCT	NATURE OF PRODUCT	ON PATENT
Piramal Healthcare	AMO	Neutralizing tablets for lens care		N.A.
	Allergan	Levobunolol, Brimonidine	API	One product
	Fortune 500 company (name not disclosed)	Many products	Formulations	Likely
	AstraZeneca	Many products	APIs & Intermediates	Likely
	Global hospital products company (name not disclosed)	Many products	API	N.A.
	Pfizer	Veterinary	APIs/Formulations	Likely
Shasun Chemicals	GSK	Ranitidine	API	No
	Eli Lilly	Nizatidine, Cyclosorine	API	No
	Boots Plc	Ibuprofen	API	No
Divi's Labs	Abbott, Merck	N.A.	N.A.	N.A.
Dishman	Solvay	Eposartan Mesylate	API	Yes
		Fenofibrate	API	Yes
		Fluvoxamine	API	
		Mebeverine	API	
	AstraZeneca	Esomeprazole intermediates	Intermediates	Yes
	GSK	Some products	Intermediates	N.A.
Jubilant Organosys	Many MNCs	Many products	API/Intermediates	Some Products

Note: Above information is based on disclosed projects *Source: Companies/MOSL*

MNCs have started outsourcing from India

Innovators have begun outsourcing from India…

Most of the MNCs have commenced outsourcing from Indian players. However, most of the products being outsourced are off-patent products. It is only in the recent past that MNCs have shown a willingness to outsource patented products as well. We believe that the implementation of product patents in India will augur well for outsourcing of patented drugs in the long term.

International CRAMS players are likely to show increasing interest in India

…and international CRAMS players are also beginning to show an interest

Global contract manufacturing players like Lonza, DSM and Degussa are yet to establish any major presence/relationship in India (although some of them have recently set up chemistry labs in India). We believe that since India is still evolving as a contract manufacturing destination, it is not yet being perceived as a serious threat. Hence, these players have not established linkages with India. Incidentally, DSM has tied up with Lupin to source some Cephalosporins. Lonza expects India to become a serious player in the global CRAMS segment over the next five years. We expect increased interest levels in India from global players in the coming years.

As entry barriers are high for becoming a preferred vendor…

Becoming a preferred vendor entails significant entry barriers…

We believe that achieving a preferred vendor status entails high entry barriers, as it involves a partnership with the innovator pharmaceutical companies. Preferred vendors (numbering 1-2 per product) are allocated 50-75% of the outsourcing business while the remaining is distributed amongst temporary suppliers. A preferred vendor will typically get an opportunity to participate in outsourcing of a range of products and is likely to become a strategic partner for the innovator over a period of time.

Given the huge product portfolios of innovator pharmaceutical companies, preferred vendors are able to achieve reasonable scale of operations as the relationship matures. Due to their significant presence in generic markets (competing against MNCs), most of the Indian pharmaceutical companies are unlikely to gain the preferred vendor status (although they may get some outsourcing assignments). We believe that the following factors are most important from the Indian perspective:

1. Relationships with innovator companies
2. References from existing customers
3. Strict IPR compliance

Although cost of manufacturing, regulatory compliance, chemistry skills and having US-FDA approved facilities are also important, we believe that the above three factors will clearly separate potential preferred vendors from one-off suppliers. Also, it takes many years for a supplier to gain the innovator's comfort and confidence.

…and switching cost for innovators is high…

…and switching costs for innovators are high

Once the contract is signed, innovator companies generally do not like to switch the service provider as it is time-consuming to select a new service provider. (The innovator needs to evaluate the facilities and test the products delivered by the provider). Also, the innovator company has to reference the manufacturing partner and its production facility in its regulatory filings. When changing the supplier, the innovator has to submit a new set of regulatory documents, which takes 1-1.5 years, causing loss of time and revenue.

…top players would get disproportionate share of business, initially

Hence, the incumbent leaders would get a disproportionate share of the business

As MNCs increase their outsourcing requirements from India, the top 5 players from India are likely to gain a disproportionate share of the business in the initial phase as:

1. Most of the Indian pharmaceutical companies are currently focusing on generics and are unlikely to attract significant contract manufacturing business.
2. Potential entrants in the contract manufacturing business will have to face significant entry barriers in terms of time and resources required for developing MNC relationships.

We have identified the following players that are likely to benefit in the initial phase of increased outsourcing:

COMPANY	COMMENTS
Piramal Healthcare	Preferred vendor for AstraZeneca and another Fortune 500 company
Divi's Labs	Has strong relationship with Abbott. Supplies to top 10 pharma MNCs
Dishman	Has strong relationship with Solvay. Taking steps to expand relationship to more MNCs
Jubilant Organosys	Supplies intermediates to 7 of top 10 pharma MNCs
Shasun Chemicals	Preferred vendor for Eli Lilly

Source: MOSL

We believe that all these players have invested significant resources to develop MNC relationships and are likely to be key beneficiaries in the coming years as India attracts more outsourcing business from global pharmaceutical companies. We believe that all these players (combined) could account for about 75% of the total contract manufacturing business from India, resulting in potential combined CRAMS revenues of about US$3-4b for all these players in 2012.

Overseas acquisitions - a mixed experience

Most of the Indian CRAMS companies have resorted to acquisitions in Western Europe to gain access to customers and critical technologies/capabilities. While some of these acquisitions have been expensive, they have given the Indian companies an initial "foot through the door" entry into the global innovator customer segment. These acquisitions have also brought in access to some critical technologies related to high-potency manufacturing, biocatalysis and chiral chemistry.

KEY CRAMS ACQUISITIONS BY INDIAN COMPANIES

ACQUIRER	ACQUIRED COMPANY	COUNTRY	ACQUISITION DATE	COST OF ACQUISITION (US$M)	EV/SALES (X)	EV/EBITDA (X)
Dishman	Carbogen AMCIS	Switzerland	Apr-05	74.5	0.8	5.8
Dr. Reddy's	Roche's Mexico facility	Mexico	Dec-05	59.0	0.5	3.3
	Dow's UK facility	U.K.	May-07	Not disclosed but likely to be less than US$25m	N.A.	N.A.
Jubilant Organosys	Hollister Stier	USA	Apr-07	138.5	2.5	12.6
	Draxis	Canada	Apr-08	255.0	3.0	12.0
Piramal Healthcare	Avecia	U.K.	Dec-05	20.0	0.3	Negative EBITDA of US$8m
	Pfizer's Morpeth facility	U.K.	Jun-06	20.0**	0.3	1.7
Shasun	Rhodia's UK facility	U.K.	Apr-06	4.0	0.05	Negative EBITDA of US$8m

*** Acquisition cost assumed at US$20m*

Source: Companies/MOSL

Have these acquisitions delivered?

Indian CRAMS companies have had a mixed experience in international acquisitions

Indian CRAMS companies have had a mixed experience in international acquisitions. Some of the acquisitions have suffered from delayed pay-backs. This is mainly due to the inability of Indian companies to turn around loss-making units and, of late, a decline in overall business due to inventory de-stocking. Piramal Healthcare's acquisition of Avecia and Shasun's acquisition of Rhodia UK fall in this category. Piramal Healthcare (PHL) was forced to close down Avecia's Huddersfield facility while Shasun had to close down one of the Rhodia units.

At the same time, Dishman's acquisition of Carbogen AMCIS and PHL's Morpeth acquisition have delivered the desired results. Jubilant's acquisitions are of recent origin (last 2-3 years), but we do not rule out the risk of extended paybacks given the high cost of these acquisitions.

ACQUISITIONS - MIXED EXPERIENCE

COMPANY	ACQUISITION	REMARKS
Piramal Healthcare	Avecia Morpeth Facility	Delayed payback leading to closure of one of the units Has delivered desired results
Jubilant Organosys	Hollister Stier Draxis	Acquisitions done recently Hollister scaling up well
Dishman	Carbogen Amcis	Has delivered desired results, but currently suffering from lower business
Shasun	Rhodia UK	Delayed payback leading to closure of one of the units

Source: Companies/MOSL

Taking corrective action to reduce pay-back period of acquired companies

Post getting access to customer relationships through acquisitions in Western Europe/ USA, some of the Indian companies are now taking corrective action to reduce the pay-back of such acquisitions. A beginning has been made by Piramal Healthcare (PHL) and Shasun - each of them have closed of one of their units in UK. PHL has closed its Huddersfield facility while Shasun has announced the closure of its Annan facility. The existing contracts from these facilities have been shifted to other facilities and partly to their Indian facilities. Most of the Indian CRAMS players, excluding Divi's Labs, have acquired companies in Western Europe/USA.

Inventory de-stocking nearing completion; expect bounce-back in FY11

The global CRAMS industry has weathered the inventory de-stocking crisis

Over the last 4-5 quarters, the performance of the global CRAMS industry has suffered due to:

1. A severe round of inventory de-stocking undertaken by large innovator companies, leading to lower contract manufacturing revenues for CRAMS companies.
2. Post the credit crises of 2008, the mid-sized and small-sized research companies faced a liquidity crunch, resulting in a cut-down in many of the research projects undertaken by them. This has partly impacted custom synthesis contracts for the CRAMS players.

We expect a bounce-back in FY11

However, we believe that this is likely to reverse in FY11 due to the following:

1. **Pharma demand continues to grow:** The overall end-consumer demand for pharmaceutical products continues to grow steadily. Hence, inventory de-stocking will ultimately get aligned with demand post which the innovators will have to commence outsourcing again. We believe that this reversal is likely to be visible partly in FY11 and fully by FY12.
2. **Credit situation is gradually improving:** While the mid and small-sized research companies continue to face funding issues, we note that over the past few quarters the global credit situation is improving gradually. This will eventually open up the funding channels for these companies. While the custom synthesis business from such companies is currently under pressure, we expect a gradual improvement over the next two years.

GLOBAL CRAMS PLAYERS - RECENT OUTLOOK

COMPANY		RECENT COMMENTS/OUTLOOK
Lonza	■	Underlying demand in life science markets remains robust
	■	Customer supply chain optimization impact felt
	■	Increased trend towards outsourcing in Biopharma as well as in chemical APIs
	■	EBIT growth in the mid to high teens on average until 2013
Patheon	■	Demand for outsourced pharmaceutical development and commercial manufacturing services is expected to continue to grow
	■	Customer focus on cost reduction to be main driver of growth in outsourcing
Albany Molecular	■	Customers will be under pressure due to continuing political and regulatory pressure to reduce healthcare costs leading to increased outsourcing in the long-term
	■	In response to growing visibility, the company has started hiring at all non US operations
DSM	■	End-market less impacted by global recession
	■	CRAMS business in 2008 was relatively unaffected despite global slow-down
	■	Faces challenges in 2009 due to the loss of some of the larger custom manufacturing contracts

Source: Companies

GLOBAL CRAMS COMPANIES - RECENT PERFORMANCE

COMPANIES		FINANCIALS		COMMENT
Lonza	**CY08**	**CY09**	**% chg**	
Sales (CHF M)	2,937	2,690	-8.4	Lower demand across business segments.
				Life Science Ingredients felt the impact of de-stocking and weak end-user markets.
PAT (CHF M)	419	279	-33.4	Custom manufacturing affected by reduction in clinical research driven orders and customers reducing their inventory levels
Patheon	**FY08**	**FY09**	**% chg**	
Sales (US$ M)	717	655	-8.7	Decline was primarily due to lower overall demand for development, services due to general market conditions.
PAT (US$ M)	20	1	-95.1	
Albany Molecular	**CY08**	**CY09**	**% chg**	
Sales (US$ M)*	229.3	196.4	-14.4	Large Scale segment continues to be impacted by project delays
PAT (US$ M)	21	-17	-	Order reduction from largest customer due to their 2009 inventory reduction efforts impacted revenues.
DSM (Pharma business)	**9MCY08**	**9MCY09**	**% chg**	
Sales (Euro M)	647	526	-18.7	Activity level was under pressure due to low demand, delays in approvals and loss of large contracts
EBIT (Euro M)	59	16	-72.9	
Cambrex	**CY08**	**CY09**	**% chg**	
Sales (US$ M)	250	236	-5.6	The company has re-negotiated an extension of an important contract and made price concessions
PAT (US$ M)	8	10	31.7	Guides for flat revenue in CY10

Source: Companies/MOSL

Bet on companies that can deliver scale

Unlike generics, contract manufacturing offers stable revenue streams. Also, contrary to popular belief, contract manufacturing yields decent margins. However, the business has a long gestation period and significant front-ended capex is involved. We advocate investing in companies that can deliver scale through a large pipeline of manufacturing contracts and that have the resources to undertake the requisite front-ended capex for additional contracts.

Unlike generics, contract manufacturing offers stable revenue streams

Contract manufacturing offers stable revenues…

Contract manufacturing offers a very stable revenue stream once the supplies to the innovator commence. The contracts are usually valid for at least five years, with confirmed offtake from the partners. Hence, the contract manufacturer is generally assured of confirmed annual offtake on successful commencement of supplies.

Contrary to popular belief, contract manufacturing also yields decent margins

…and also yields decent margins

Although low cost forms the very basis of outsourcing, we believe that contract manufacturing is capable of delivering reasonable margins. Most of the contract manufacturing deals have been struck at 20-25% EBITDA margins. We believe that margins will vary from product-to-product and will also depend on whether the supplies are for on-patent or off-patent products. On-patent product supplies are likely to attract higher margins due to the better pricing power enjoyed by the MNC partner in its home market.

However, gestation periods are long…

CRAMS business has a long gestation period. As the Indian CRAMS industry is still evolving, potential customers take a long time to award contracts. Secondly, as a test case, the initial off take by the customer may not be very high. It should also be noted that post the announcement of the contract, it takes 18-24 months for the supplies to begin. This is due to the time-consuming registration process with various countries before which supplies cannot commence. Hence, investors should expect a time-gap between the signing of contracts and actual commencement of supplies.

…and significant front-ended capex is involved

Due to the very nature of the contract manufacturing assignments (valid for at least five years), the manufacturer's facilities are locked-in for the period of the contract. Hence, CRAMS players will have to undertake front-ended capex for signing new contracts, necessitating strong balance sheets.

'Black box' investment opportunity

One needs to take a long-term view on investing

Contract manufacturing assignments come with confidentiality clauses regarding disclosure of name of the partner, product details and delivery schedules. This result in very low visibility on a company's contract manufacturing pipeline as well as potential revenue streams and time-line of supplies linked to individual contracts. For investors, this leads to a 'black box' investment opportunity - investing for long periods (till contracts start delivering revenues), with little visibility.

Valuation and view

We believe that investors should take a long-term view on the CRAMS opportunity, as India is still evolving as a global contract manufacturing destination. Gestation periods are likely to be longer (till Indian players achieve critical mass) and at times will be accompanied by phases of faint visibility (due to the confidentiality attached to signing of contracts). However, we believe that the overall CRAMS opportunity is too large to ignore despite initial teething problems, which will be taken care of as Indian players strengthen their pipelines.

Our top picks are Divi's Labs and Piramal Healthcare

While the current valuations of leading players reflect part-upsides from announced contracts, it is just the tip of the iceberg. We forecast exponential growth in outsourcing from India over the next five years. We expect contract manufacturing alone to contribute about US$3b in revenues by 2012 as compared to about US$800m, in 2007. All leading players in India would reap the benefits of the favorable MNC stance towards outsourcing from India. Though most of the Indian CRAMS players have strengthened their contract pipelines significantly, many of these contracts are not in execution mode. This implies significant growth for such companies as these contracts start contributing to revenues. Our top picks in the CRAMS space include **Divi's Labs** and **Piramal Healthcare**.

PHAMACEUTICALS - COMPARATIVE VALUATIONS

COMPANY	CMP (RS)	RECO	EPS (RS)			P/E (X)			EV/EBITDA (X)			ROE (%)		
	04.03.10		FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E	FY10E	FY11E	FY12E
Divis Labs	650	Buy	23.8	28.5	34.5	27.3	22.8	18.8	22.2	16.9	13.7	22.6	22.5	23.0
Piramal Healthcare	415	Buy	21.1	25.8	31.0	19.6	16.1	13.4	14.0	11.2	9.6	29.7	29.2	28.5
Dishman Pharma	208	Neutral	14.1	15.4	18.8	14.8	13.5	11.1	11.8	9.4	7.6	14.9	14.4	15.3
Jubiliant Organosys	324	Neutral	20.7	18.6	31.7	15.7	17.4	10.2	10.6	8.7	7.6	27.3	26.3	24.8

Source: MOSL

Risks and concerns

Global M&A could impact contract research business

The global pharmaceutical industry is at the throes of significant consolidation with large mergers (to increase size and gain scale) and acquisition of smaller R&D companies (to strengthen R&D pipelines). We view large mergers like Pfizer-Wyeth, Merck-Schering and acquisition of small R&D companies as a risk to the global CRAMS industry, as consolidation amongst customers may lead to loss of business in the contract research space. In fact, consolidation has been the chief reason for the significant decline in fortunes of CRAMS players some years ago.

What Pfizer has to say about R&D rationalization post Wyeth merger

Pfizer told analysts it expects to reduce its workforce by 10%. It has already announced that it would slash 800 research positions this year, explaining that it was trimming staff in order to focus on the research that had the best chances of reaching the market.

INDIAN CRAMS COMPANIES' EXPOSURE TO CONTRACT RESEARCH

COMPANY	% OF REVENUE FROM CCS
Dishman	~25
Divi's Lab	NA
Piramal Healthcare	3-5
Jubilant	7

Source: Company/MOSL

Extended payback from acquired companies

Many Indian CRAMS players have resorted to inorganic initiatives to achieve scale, customer relationships and access to critical technologies. All these acquisitions have been in the high-cost developed markets. We believe that Indian acquirers could face the risk of extended paybacks on these acquisitions if they are unable to convince customers to shift part of manufacturing to India.

Impact of credit/liquidity crises

While we do not expect any direct impact on the performance of the large MNC pharmaceutical companies, some of the smaller research/biotech companies could face liquidity problems. We believe that exposure of Indian CRAMS players to such companies is negligible and hence do not expect a significant impact on them.

Adverse impact of inventory reductions by customers to gradually reverse from 4QFY10 onwards: Although the end-consumer demand for pharmaceutical products remains unaffected by the global economic slowdown, most of the global pharmaceutical companies have undertaken inventory reductions across markets for already commercialized products. This has resulted in reduced outsourcing from Indian CRAMS players. The inventory reduction commenced in 2HFY09 and we expect it to improve from 4QFY10 onwards as the underlying demand for pharmaceutical products has remained intact despite the global slowdown. Most of the global CRAMS players have recently reiterated that there will be increased trend towards outsourcing.

MNC tie-ups with generics players

Many innovators are trying to enter the generics business and some are expanding their presence in the generics space. MNCs like Pfizer and GSK have signed deals with Indian generics companies to source generic products. Also, Daiichi Sankyo of Japan bought majority stake in Ranbaxy, India's largest pharmaceutical company in 2008 to foray into generics. Going forward, the generics partners of these innovator companies could start doing CRAMS work as well for them.

MNC'S INTEREST IN GENERIC INDUSTRY

MNC	GENERIC COMPANY	TYPE OF SOURCING	REMARKS
Pfizer	Aurobindo	Generics	Generics for regulated markets and for semi-regulated markets
GSK	Dr Reddy's Lab	Generics	Generic for emerging markets
Pfizer	Strides Acrolab	Generics	Generic for US market
Pfizer	Claris Lifesciences	Generics	Generics for regulated markets
Aventis	Medley	Acquisition	Strong footprint in Latin American generic market
Daiichi	Ranbaxy	Acquisition	Strong footprint in Indian and US generic market. Also get access to emerging market.

Source: Company/MOSL

Companies

BSE Sensex: 16,972 S&P CNX: 5,080 8 March 2010

COMPANY NAME	PG.
Divi's Lab *(Buy, Rs650)*	25
Piramal Healthcare *(Buy, Rs415)*	35
Dishman Pharma *(Neutral, Rs208)*	51
Jubilant Organosys *(Neutral, Rs324)*	63

Divi's Laboratories

8 March 2010

Buy

Previous Recommendation: Buy

Rs650

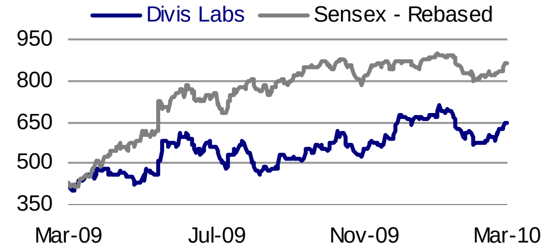
STOCK INFO.	BLOOMBERG
BSE Sensex: 16,972	DIVI IN
	REUTERS CODE
S&P CNX: 5,080	DIVI.BO

Y/E MARCH	2009	2010E	2011E	2012E
Net Sales (Rs m)	11,803	9,202	11,107	13,355
EBITDA (Rs m)	5,178	3,554	4,523	5,468
Adj. NP (Rs m)	4,166	3,087	3,692	4,471
EPS (Rs)	32.2	23.8	28.5	34.5
EPS Growth (%)	19.5	-25.9	19.6	21.1
BV/Share (Rs)	95.8	115.1	137.9	162.2
P/E (x)	20.2	27.3	22.8	18.8
P/BV (x)	6.8	5.6	4.7	4.0
EV/EBITDA (x)	16.3	22.2	16.9	13.7
EV/Sales (x)	7.2	8.6	6.9	5.6
RoE (%)	39.6	22.6	22.5	23.0
RoCE (%)	40.6	25.0	25.2	25.8

KEY FINANCIALS	
Shares Outstanding (m)	129.5
Market Cap. (Rs b)	84.2
Market Cap. (US$b)	1.8
Past 3 years Sales Growth (%)	45.8
Past 3 years NP Growth (%)	81.2
Dividend Payout (%)	10.9
Dividend Yield (%)	0.5

STOCK DATA	
52-W High/Low Range (Rs)	715/383
Major Shareholders (as of December 2009)	(%)
Promoter	52.9
Domestic Inst	14.4
Foreign	17.4
Others	15.3
Average Daily Turnover	
Volume ('000 shares)	453.2
Value (Rs million)	231.0
1/6/12 Month Rel. Performance (%)	2/17/-49
1/6/12 Month Abs. Performance (%)	5/26/52

STOCK PERFORMANCE (1 YEAR)



Most profitable company in Indian CRAMS space: Divi's Labs is the most profitable company in the Indian CRAMS space with EBITDA margin of 35-40%, backed by its strong chemistry skills and custom synthesis presence. It has the largest portfolio of highly profitable custom synthesis projects in India.

Strong relationships with innovators to drive growth: Divi's provides services to the top-10 global innovator pharmaceutical companies. A recovery in the global outsourcing business is widely expected, and we believe Divi's would be a key beneficiary of increased outsourcing from India. We expect Divi's CRAMS business to record 20% revenue CAGR over FY10-12.

Generic API business - a cash cow: Divi's Labs has a strong generic API business and enjoys worldwide leadership in some of its marketed products. This has helped the company to maintain higher profitability in this business unlike its peers. We expect this business to record 12.5% revenue CAGR over FY10-12.

Carotenoids - good long-term potential: Divi's is targeting the global synthetic carotenoids market by tying up with feed manufacturers. The global carotenoids market - including food, feed and pharmaceuticals - is estimated at about US$1b. Carotenoid supplies are expected to ramp-up to a ~US$25m business by FY12. We believe that this business holds good long-term potential for Divi's.

Strong track record gives confidence despite adverse FY10 performance: Divi's past financial performance has been par excellence, with high profitability. For the period FY01-09, it recorded 23% revenue and 33% EPS CAGR. However, FY10 performance was adversely impacted (26% EPS de-growth) due to customer inventory de-stocking. We believe that customers are likely to re-start outsourcing from Divi's from FY11. The management believes only in organic growth and has not diluted equity since listing. Further, the company is virtually debt-free.

Expect 20% earnings CAGR over FY10-12; Buy: Divi's will be a key beneficiary of increased outsourcing from India, leading to 20% earnings CAGR for FY10-12. We estimate RoCE and RoE of 20%+ for the next few years, led by traction in the high-margin CRAMS business and incremental contribution from the carotenoids business. The stock trades at 22.8x FY11E and 18.8x FY12E earnings. We re-iterate **Buy**, with a price target of Rs759 (22x FY12E EPS).

Frontrunner in Indian CRAMS sector

Divi's Labs services all the top-10 global innovator companies

Being an early entrant, Divi's Labs has become a key outsourcing partner for some of the largest innovator companies. It services all the top-10 global innovator companies. It has become a prominent player in providing custom synthesis services from India and collaborates with innovator companies all through the early drug development stage to the commercialization stage.

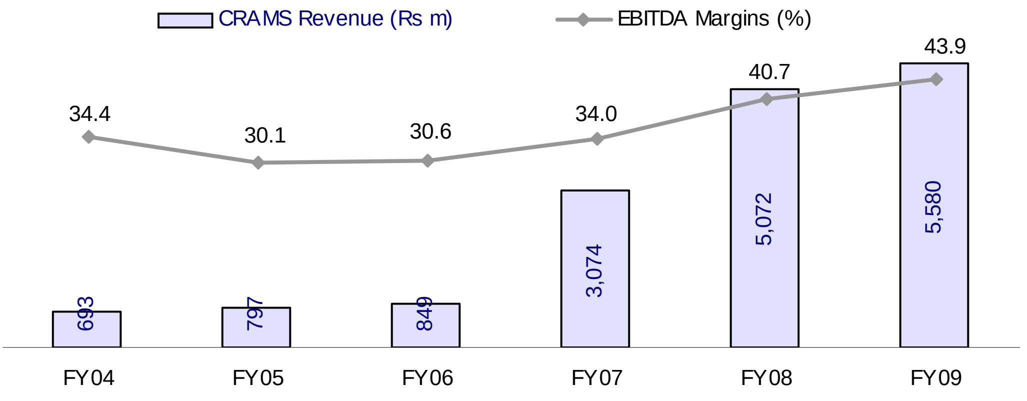
Custom synthesis - earning big bucks

CRAMS players offer a variety of services to innovators. The real value addition, however, is in the area of custom chemical synthesis, where the service provider is involved with the innovator company from the early stages of the drug lifecycle. It provides them process and synthetic chemistry services such as process design for new drug candidates, process optimization, product yield improvement, etc. These services entail significant cost savings for the innovators. Besides, outsourcing these activities gives the innovator an opportunity to focus on discovery research. While the custom synthesis business cannot scale up to a large revenue number (supplies are generally in a few kilograms), it offers an opportunity to lock-in with the customer from early development stage and generally leads to large contract manufacturing orders once the drug is successfully commercialized.

Divi's has developed significant capabilities in this space and has been able to provide services to the top-10 global innovator companies over the last few years. These capabilities are also evident from the 38% CAGR in its CRAMS business revenues (custom synthesis plus contract manufacturing) over FY04-10 and the significant ramp-up in EBITDA margins from 28% to 38.6%.

Divi's capabilities are evident from its 38% CAGR in its CRAMS business revenues over FY04-10 and the ramp up of its EBITDA margins from 28% to 38.6%

CRAMS REVENUE RAMP UP AND EBITDA MARGINS



Source: Company/MOSL

Large-scale manufacturing - logical extension of custom synthesis; a growth driver

Strong presence in custom synthesis gives Divi's Labs an opportunity to grab a share of commercial manufacturing of the drug, if approved by regulatory authorities. Generally, innovator drug companies prefer their custom synthesis partner as the manufacturing partner for various reasons:

- It is easier for the CRAMS player to develop large-scale synthesis of the molecule, as it has already worked on the drug candidate in the development stage.
- The working comfort and understanding between innovator and the CRAMS player

would have had already developed, which is extremely important given the confidentiality attached with the IPR of the drug.

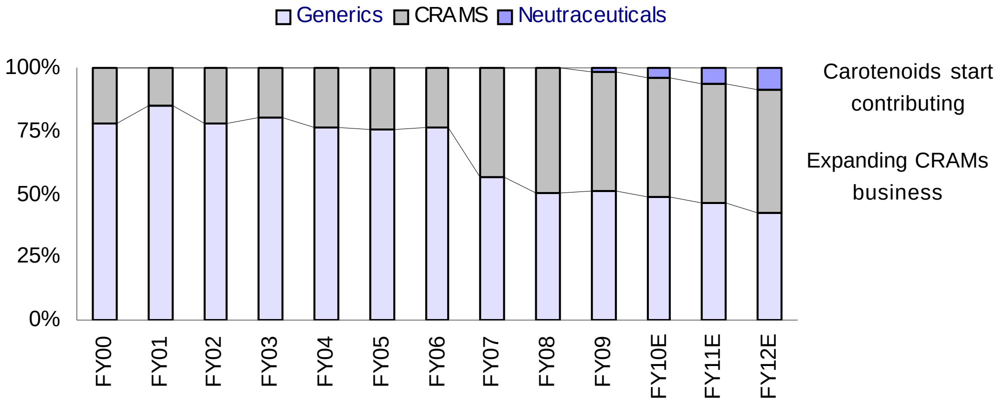
- It is difficult and time-consuming for the innovator to change manufacturing partner for various regulatory reasons.

Divi's has a sizable number of custom synthesis products; even if a few of these reach the market, it would give Divi's a significant revenue opportunity

We believe Divi's has a sizable pipeline of custom synthesis products though the company does not disclose the same due to confidentiality of research. Of these, even if a few drugs reach the market, it would give Divi's a significant revenue opportunity. Moreover, commercial manufacturing contracts are generally long term in nature, with high revenue visibility.

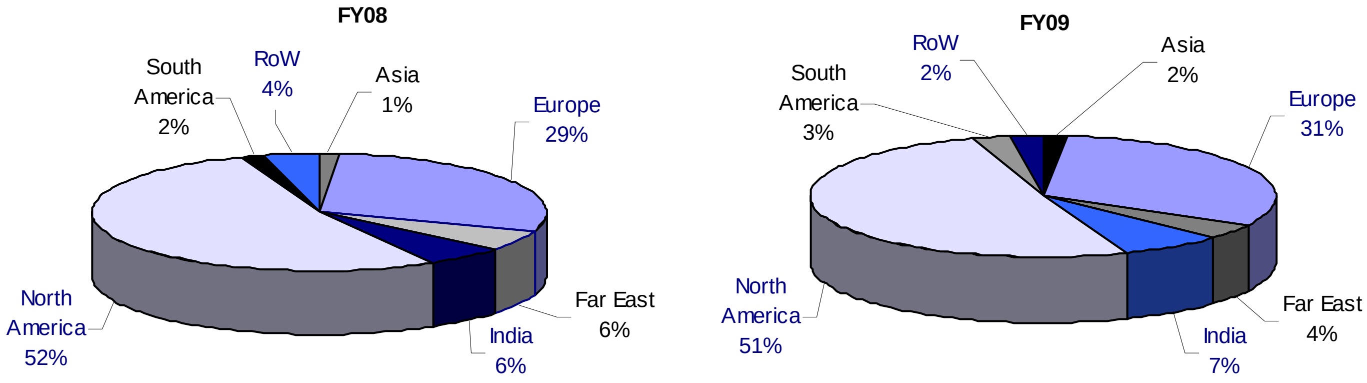
The traction in the CRAMS business is being led mainly by increased sourcing by the innovators (as products move from clinical trials into commercialization). Since the CRAMS business is linked to the progress of the NCE in the innovator's R&D pipeline, revenues from CRAMS supplies tend to be lumpy and unpredictable. These risks/uncertainties are an inherent part of the CRAMS business.

DIVI'S LABS: REVENUE MIX (%)



Source: Company/MOSL

DIVI'S LABS: GEOGRAPHICAL REVENUE MIX (%)



Source: Company/MOSL

Inventory de-stocking nearing completion; expect bounce-back in FY11

Divi's CRAMS business was adversely affected by the 2008 credit crisis and inventory de-stocking by large innovator companies...

Over the last 4-5 quarters, the performance of the global CRAMS industry has suffered due to:

1. A severe round of inventory de-stocking undertaken by large innovator companies, leading to lower contract manufacturing revenues for CRAMS companies.
2. Post the credit crises of 2008, the mid-sized and small-sized research companies faced a liquidity crunch, resulting in a cut-down in many of the research projects undertaken by them. This has partly impacted custom synthesis contracts for the CRAMS players.

... but in line with the global industry trend, the impact is likely to be reversed in FY11

In line with the global industry trend, Divi's CRAMS business was also adversely impacted. However, we believe that this is likely to reverse in FY11 due to the following:

1. **Pharma demand continues to grow:** The overall end-consumer demand for pharmaceutical products continues to grow steadily. Hence, inventory de-stocking will ultimately get aligned with demand post which the innovators will have to commence outsourcing again. We believe that this reversal is likely to be visible partly in FY11 and fully by FY12.
2. **Credit situation is gradually improving:** While the mid and small-sized research companies continue to face funding issues, we note that over the past few quarters the global credit situation is improving gradually. This will eventually open up the funding channels for these companies. While the custom synthesis business from such companies is currently under pressure, we expect a gradual improvement over the next two years.

Strong generic API business - a cash cow

Divi's has a strong cash flow business of generic API and intermediates, which contribute about half of its revenues

Divi's Labs has a strong cash flow business of generic API and intermediates that contributes ~50% of revenues. These products are supplied mainly to innovator generics companies (as a part of life-cycle management post patent expiry) and some leading generics companies. Divi's is a global leader in some APIs, including Naproxen, Dextromethorphan, Iopamidol, Diltiazem, Nabumetone, etc. These products have already been genericised and are growing at a steady 8-10% per annum. Since the pricing for these products has already stabilized, we expect steady growth of 8-10% for these products over the next few years.

Divi's is targeting a pipeline of 25-30 generic products going off-patent over the next 5-10 years. We believe that Divi's would be commercializing these products in a phased manner over the next few years. We expect this business to record 12.5% CAGR over FY10-12.

Global M&A transactions in the past coupled with closure of some of the innovators' facilities for these products has resulted in Divi's becoming a strong and dominant player globally for some of these products. By virtue of its strong presence, the company is able to command better pricing for these products, unlike normal generic APIs. Hence, this business continues to remain a cash cow for the company.

DIVI'S LABS: GLOBAL API FILINGS

COUNTRY	API FILINGS
USA	29
Europe	15
Canada	9
Korea	2
China	2
Japan	2

Source: Company/MOSL

DIVI'S LABS: PRODUCT-WISE GLOBAL API FILINGS

API	USA	EUROPE	CANADA	KOREA	CHINA	JAPAN
Dextromethorphan HBr	Y	Y	Y		Y	Y
Naproxen	Y	Y	Y			
Naproxen Sodium	Y	Y	Y			
Diltiazem HCl	Y	Y			Y	
Nabumetone	Y	Y		Y		
Levetiracetam	Y	Y	Y			
Phenylephrine HCl	Y	Y		Y		
Carbidopa	Y	Y	Y			
Levodopa	Y	Y				
Proguanil HCl	Y		Y			
Iopamidol	Y	Y				
Bupropion HCl	Y					
Niacin	Y					
Verapamil HCl	Y					
Fosphenytoin Sodium	Y					
Zolpidem Tartrate	Y	Y				Y
Risedronate Sodium	Y					
Tamsulosin HCl	Y		Y			
Gabapentin	Y	Y				
Desloratadine	Y					
Sibutramine HCl	Y	Y				
Quetiapine Fumarate	Y	Y				
Topiramate	Y					
Vigabatrin	Y					
Methyldopa	Y					
Loratadine	Y					
Ketoenamine	Y		Y			
Capecitabine	Y					
Venlafexine HCl	Y					
Rizatriptan Benzoate		Y	Y			

Data as of September 2009 *Source: Company/MOSL*

Inventory de-stocking also impacted API business in FY10

Divi's API business was also impacted by inventory de-stocking by customers in FY10. We believe that the key reasons for this adverse impact were:

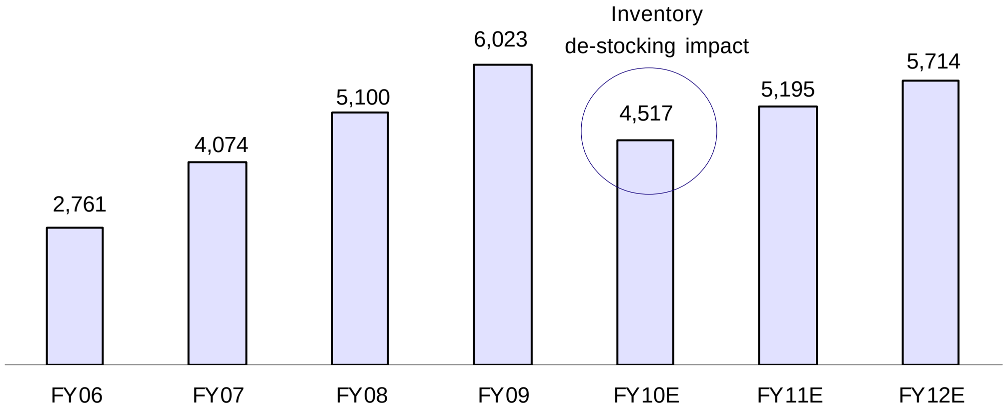
1. Innovator pharmaceutical companies were in an inventory reduction mode. To the extent of supplies to such companies, Divi's supplies were also impacted.
2. By virtue of its strong and dominant global presence in some of the APIs, Divi's had supplied large quantities of some of these APIs to its generic customers. Post the liquidity crunch in 2008, many customers resorted to conserving resources, thus reducing the working capital. This trend adversely impacted Divi's API supplies to such customers.

API supplies to generic customers are expected to gradually pick up from FY11 since most of the API inventory cuts are nearly complete

API supplies to pick up gradually from FY11 onwards

We believe that majority of the API inventories with customers are now aligned to the overall end-consumer demand and that the inventory reductions are near completion. We expect API supplies to generic customers to gradually pick up from FY11.

API REVENUE RAMP UP



Source: Company/MOSL

Carotenoids - could be a big opportunity…

Divi's is targeting the global synthetic carotenoids market, estimated at US$1b and growing at 10-15% a year

Divi's is targeting carotenoids as an additional growth driver in the coming years. It is targeting the global synthetic carotenoids market by tying up with feed manufacturers. The global carotenoids market - including food, feed and pharmaceuticals - is estimated at about US$1b. Europe accounts for almost half of this market and the US accounts for about 20%. Feed will continue to dominate carotenoids demand for the next few years. This business has high entry barriers because of complexities in manufacturing. Divi's Astaxantin product for the aquaculture market has been approved by some major customers.

An expanding carotenoids market is witnessing a face-off between synthetic and natural carotenoids, as customers become increasingly conscious about food content. With the diet of Europeans beginning to include greater amounts of fortified foods, the natural segment has begun to gain on the synthetic one. While cheaper synthetic imports from China and India are threatening the profits of European manufacturers, natural carotenoids are likely to generate greater revenues, as they are nearly four times more expensive than their synthetic equivalents. Increasing promotion of natural carotenoids and their growing demand in the developing dietary supplements market are driving demand in the natural segment, further.

…but ramp-up would be gradual

Divi's commissioned its carotenoids facility in June 2008; expects revenues of US$7m from carotenoids in FY10 and US$25m in FY12

Divi's has commissioned its carotenoids facility on 1 June 2008 and has identified six carotenoids like Beta-carotene, Lycopene, Astaxanthin, Apocarotenal, Lutein and Canthaxanthin as its key products in this segment. The company is targeting the US$1b global carotenoids market, which is estimated to grow at 10-15% per annum.

Divi's is expected to offer comparable quality carotenoids, but at a significantly lower price (due to the low cost of manufacturing). Currently, two players - DSM and BASF - which collectively command a market share of 90-95%, lead this market. We believe that it may not be easy for an unknown player like Divi's to gain significant market share (despite the cost advantage) in the short term.

The company has recruited experienced employees from DSM and BASF to drive its carotenoids business. During FY09, Divi's Lab started the supply of carotenoids in small quantities. This business reported revenues of Rs200m in FY09 and Rs260m in 9MFY10. Management has indicated that supplies are likely to ramp up significantly over the next two years (not quantified). We have forecast revenues of about US$7m from carotenoids in FY10, about US$15m in FY11 and US$25m for FY12.

Peptides and nucleotides - developing complex chemistry skills

Divi's develops intermediates and building blocks for peptides and nucleotides, which will find applications in new-generation, peptide-based drug research

Divi's Labs develops intermediates and building blocks for peptides and nucleotides, which will ultimately find applications in new-generation, peptide-based drug research. The peptide drug segment is an emerging area of drug discovery. Leading innovator companies involved in the research and manufacture of peptide-based drugs outsource peptide segments and protected amino acids, which, in turn, are synthesized to produce peptide drugs. It is this area that Divi's plans to exploit.

It has developed chemical synthesis capabilities for key intermediates and building blocks, which have already been approved by several users. It has commercialized some of these products and can now offer key starting materials or synthesized intermediates like DIBOC, FMOC and HOBT as well as subsequent intermediates like protected amino acids, which are building blocks. A significant number of drug therapies over the next 5-10 years would be based on peptides.

Divi's experience in peptide and nucleotide research would enable it to transfer and scale up any of the processes developed at the research centers

Another area that Divi's Labs has ventured into is nucleotides. Nucleotides and their related compounds are also important energy-carrying agents. They are incorporated into non-natural sequences and inserted into genes to elicit specific control over protein synthesis. Several nucleotide-based sequences are being developed to fight genetic diseases. Divi's Labs is currently focusing on nucleotide research. It is developing nucleotide building blocks at its research center and is developing the process for four major protected nucleotides. Besides, it is already manufacturing a couple of closely related chemicals commercially.

This experience would enable the company to transfer and scale up any of the processes developed at its research centers. Both peptides and nucleotides involve complex chemistry skills and are emerging areas in drug discovery. Most of the leading MNCs are working on them. Although they hold immense potential, the complexities involved also mean that the failure rate can be quite high. Hence, we have not included any major upsides from this segment in our estimates.

Divi's Laboratories 3QFY10: Below estimates; Inventory correction impact continues; cutting estimates; managment expects recovery from 4Q

- Divi's Labs reported 25.9% YoY de-growth in revenues to Rs1.96b (vs our est of Rs2.63b), EBITDA de-growth of 39% to Rs659m (vs est of Rs926m) and a 14.7% YoY de-growth in PAT to Rs678m (v/s our est of Rs747m).
- Topline growth was impacted by severe inventory corrections undertaken by customers. CRAMS business recorded 23% YoY de-growth and accounted for about 49% of revenues.

- Generic API business has declined 34% YoY and accounted for about 47% of overall revenues. Carotenoids contributed ~Rs80m to revenues accounting for 4% of revenues.
- The revenues would have been partially impacted by ~4.5% appreciation of INR v/s US$ since about 60% of Divi's revenues are US$-denominated.
- EBITDA declined 39% YoY to Rs659m (vs our estimate of Rs926m) while EBITDA margins at 33.6% were lower than our estimate of 35.2% primarily due to lower revenues and higher other expenditure.
- PAT declined by 14.7% YoY to Rs678m. Decline in PAT was restricted by Rs160m of forex gains vs Rs140m of forex losses in 3QFY09.

QUARTERLY PERFORMANCE (RS MILLION)

Y/E MARCH	FY09				FY10				FY09	FY10E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Op Revenue	**2,661**	**3,305**	**2,648**	**3,191**	**2,058**	**2,253**	**1,963**	**2,927**	**11,803**	**9,202**
YoY Change (%)	*16.7*	*36.3*	*-6.9*	*14.8*	*-22.6*	*-31.8*	*-25.9*	*-8.3*	*14.3*	*-22.0*
Total Expenditure	1,473	1,676	1,565	1,912	1,392	1,200	1,304	1,753	6,625	5,648
EBITDA	**1,188**	**1,629**	**1,083**	**1,279**	**667**	**1,053**	**659**	**1,175**	**5,178**	**3,554**
Margins (%)	*44.6*	*49.3*	*40.9*	*40.1*	*32.4*	*46.7*	*33.6*	*40.1*	*43.9*	*38.6*
Depreciation	107	119	123	129	129	131	133	144	479	536
Interest	20	18	16	18	8	30	18	18	72	74
Other Income	-38	0	-63	-44	143	55	262	64	-145	524
PBT before EO Income	**1,023**	**1,491**	**880**	**1,088**	**673**	**947**	**771**	**1,077**	**4,482**	**3,468**
EO Income	0	0	0	0	-540	0	0	0	0	-540
PBT after EO Income	**1,023**	**1,491**	**880**	**1,088**	**132**	**947**	**771**	**1,077**	**4,482**	**2,928**
Tax	42	101	59	64	87	83	104	108	266	381
Deferred Tax	16	26	26	-18	2	17	-11	-8	50	0
Rate (%)	*5.7*	*8.5*	*9.6*	*4.2*	*67.5*	*10.5*	*12.0*	*9.3*	*7.0*	*13.0*
Reported PAT	**965**	**1,364**	**795**	**1,042**	**43**	**848**	**678**	**977**	**4,166**	**2,546**
Adj PAT	**965**	**1,364**	**795**	**1,042**	**585**	**848**	**678**	**977**	**4,166**	**3,016**
YoY Change (%)	*43.4*	*49.5*	*-21.0*	*20.8*	*-39.4*	*-37.8*	*-14.7*	*-6.3*	*20.6*	*-27.6*
Margins (%)	*36.3*	*41.3*	*30.0*	*32.7*	*28.4*	*37.6*	*34.6*	*33.4*	*35.3*	*32.8*

E: MOSL Estimates

Management guides revenue de-growth in FY10; expects recovery in FY11

Although the management has guided topline de-growth in FY10, long-term prospects for outsourcing are bright

Divi's management has guided topline de-growth in FY10, reflecting the impact of inventory reductions by customers. It has indicated that the impact of inventory de-stocking is almost over and expects a gradual recovery from 4QFY10. CRAMS supplies (45-50% of revenues) are likely to gradually revert to normal levels from 4QFY10, as inventories and global demand get re-aligned, leading to recovery in topline in FY11. We note that there has not been any major adverse impact on demand for pharmaceutical products due to global economic slowdown. The long-term prospects for outsourcing remain bright.

Global M&As may lead to rationalization of R&D pipelines

Recently, the global pharmaceutical industry has witnessed the announcement of two large M&A deals - the acquisition of Wyeth by Pfizer, Schering Plough by Merck and Solvay's pharmaceutical business by Abbott. If this becomes a trend, it signals consolidation of customer base for CRAMS players like Divi's, which are strong in the custom chemical synthesis (CCS) segment and could potentially reduce the number of R&D projects under development.

Low forex hedges - company exposed to adverse currency rate movements

Currently, Divi's has very small outstanding forex hedges, exposing it to adverse movement in foreign currency exchange rates. About 60% of revenues are US$-denominated. The company is planning to take up fresh hedges in the near future. However, some of its CRAMS contracts have a clause of part protection against large currency swings - the partner compensates Divi's for large adverse currency movements.

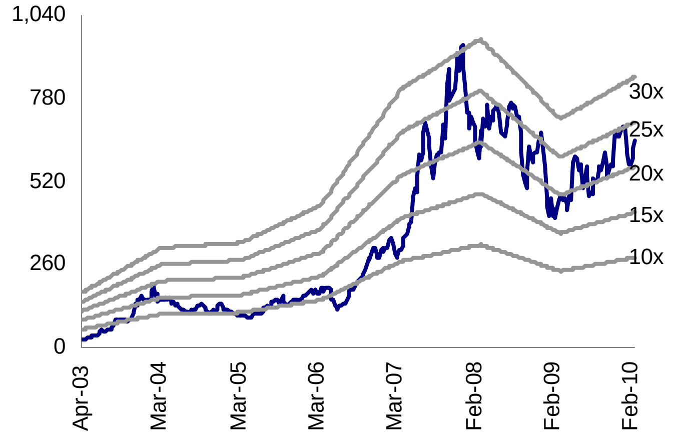
Valuation and outlook

Divi’s will be a key beneficiary of increased pharmaceutical outsourcing from India given its strong relationships with global innovators

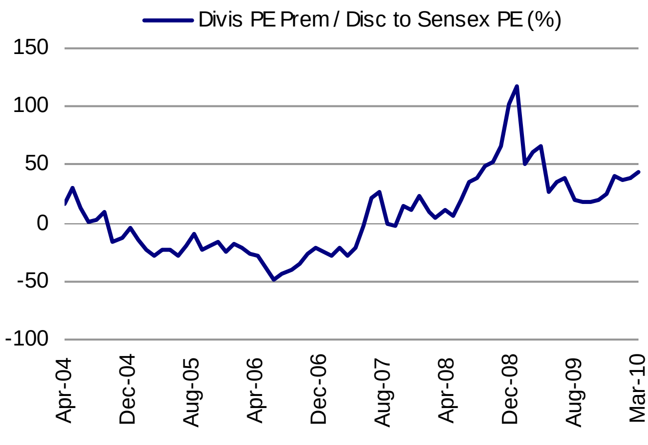
Divi's performance in the short-term will be adversely impacted as customers are reducing inventories. We note that near-term earnings visibility is contingent on innovator companies re-starting sourcing from CRAMS companies.

However, we remain positive on the prospects of pharmaceutical outsourcing from India, given the unique combination of low cost and chemistry skills that India offers. We expect Divi's to be a key beneficiary of the increased pharmaceutical outsourcing from India given its strong relationships with global innovator pharmaceutical companies.

P/E BAND



RELATIVE P/E TO SENSEX



Source: MOSL

Strong track record gives confidence despite adverse FY10 performance

Divi's past financial performance has been par excellence, with high profitability. For the period FY01-09, it recorded 23% revenue and 33% EPS CAGR. However, FY10 performance was adversely impacted (26% EPS de-growth) due to customer inventory de-stocking. We believe that customers are likely to re-start outsourcing from Divi's from FY11. The management believes only in organic growth and has not diluted equity since listing. Further, the company is virtually debt-free.

Expect 20% earnings CAGR over FY10-12; Buy

Expect earnings CAGR of 20% over FY10-12

We expect Divi's to be a key beneficiary of increased outsourcing from India, leading to 20% earnings CAGR for FY10-12. We estimate RoCE and RoE of 20%+ for the next few years, led by traction in the high-margin CRAMS business and incremental contribution from the carotenoids business. The stock currently trades at 22.8x FY11E and 18.8x FY12E earnings. We re-iterate **Buy**, with a price target of Rs759 (22x FY12E earnings) - an upside of 17%.

Financials and Valuation

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Net Sales	**10,328**	**11,803**	**9,202**	**11,107**	**13,355**
Change (%)	*42.6*	*14.3*	*-22.0*	*20.7*	*20.2*
Total Expenditure	6,127	6,625	5,648	6,585	7,887
% of Sales	*59.3*	*56.1*	*61.4*	*59.3*	*59.1*
EBITDA	**4,201**	**5,178**	**3,554**	**4,523**	**5,468**
Margin (%)	*40.7*	*43.9*	*38.6*	*40.7*	*40.9*
Depreciation	357	479	536	588	671
EBIT	**3,845**	**4,700**	**3,018**	**3,934**	**4,798**
Int. and Finance Charges	102	72	74	47	47
Other Income - Rec.	32	-145	524	307	330
PBT after EO Expense	**3,775**	**4,482**	**3,468**	**4,195**	**5,081**
Current Tax	194	266	381	503	610
Deferred Tax	105	50	0	0	0
Tax Rate (%)	*7.9*	*7.0*	*11.0*	*12.0*	*12.0*
Reported PAT	**3,476**	**4,166**	**3,087**	**3,692**	**4,471**
PAT Adj for EO Items	**3,476**	**4,166**	**3,087**	**3,692**	**4,471**
Change (%)	*81.1*	*19.9*	*-25.9*	*19.6*	*21.1*
Margin (%)	*33.7*	*35.3*	*33.5*	*33.2*	*33.5*

BALANCE SHEET (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Equity Share Capital	258	259	259	259	259
Total Reserves	8,356	12,155	14,649	17,603	20,746
Net Worth	**8,614**	**12,414**	**14,908**	**17,862**	**21,005**
Deferred liabilities	383	432	432	432	432
Total Loans	861	526	476	476	476
Capital Employed	**9,857**	**13,372**	**15,816**	**18,770**	**21,913**
Gross Block	6,422	7,828	8,107	8,807	10,307
Less: Accum. Deprn.	1,451	1,929	2,526	3,114	3,785
Net Fixed Assets	**4,971**	**5,899**	**5,581**	**5,693**	**6,522**
Capital WIP	631	195	250	251	251
Investments	556	1,718	600	600	600
Curr. Assets	**5,630**	**7,671**	**11,175**	**14,570**	**17,799**
Inventory	2,814	4,213	3,313	3,999	4,941
Account Receivables	2,095	2,660	1,564	1,888	2,404
Cash and Bank Balance	142	148	5,746	8,016	9,652
Loans & Advances	579	650	552	666	801
Curr. Liability & Prov.	**1,930**	**2,110**	**1,789**	**2,344**	**3,259**
Account Payables	1,564	1,621	1,288	1,555	1,870
Provisions	366	489	501	789	1,389
Net Current Assets	**3,700**	**5,561**	**9,385**	**12,226**	**14,540**
Appl. of Funds	**9,857**	**13,372**	**15,816**	**18,770**	**21,913**

E: MOSL Estimates

RATIOS

Y/E MARCH	2008	2009	2010E	2011E	2012E
Basic (Rs)					
EPS	**26.9**	**32.2**	**23.8**	**28.5**	**34.5**
Cash EPS	29.7	35.9	28.0	33.0	39.7
BV/Share	66.7	95.8	115.1	137.9	162.2
DPS	2.0	3.0	3.1	4.9	8.8
Payout (%)	8.7	10.9	15.0	20.0	29.7
Valuation (x)					
P/E	24.1	20.2	27.3	22.8	18.8
Cash P/E	21.9	18.1	23.2	19.7	16.4
P/BV	9.7	6.8	5.6	4.7	4.0
EV/Sales	8.2	7.2	8.6	6.9	5.6
EV/EBITDA	20.2	16.3	22.2	16.9	13.7
Dividend Yield (%)	0.3	0.5	0.5	0.7	1.3
Return Ratios (%)					
RoE	49.5	39.6	22.6	22.5	23.0
RoCE	47.2	40.6	25.0	25.2	25.8
Working Capital Ratios					
Fixed Asset Turnover (x)	2.4	2.2	1.6	2.0	2.2
Debtor (Days)	74	82	63	64	67
Inventory (Days)	99	130	131	131	135
Working Cap. T/O (Days)	126	167	144	138	134
Leverage Ratio (x)					
Current Ratio	2.9	3.6	6.2	6.2	5.5
Debt/Equity	0.1	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
OPt/(Loss) bef. Tax	4,201	5,178	3,554	4,523	5,468
Interest/Dividends Recd.	32	-145	524	307	330
Direct Taxes Paid	-194	-266	-381	-503	-610
(Inc)/Dec in WC	-675	-1,855	1,773	-570	-678
CF from Operations	**3,365**	**2,912**	**5,470**	**3,757**	**4,510**
CF fr. Op. incl EO Exp.	**3,365**	**2,912**	**5,470**	**3,757**	**4,510**
(inc)/dec in FA	-1,764	-971	-273	-701	-1,500
(Pur)/Sale of Invest.	-550	-1,162	1,118	0	0
CF from Invest.	**-2,314**	**-2,133**	**845**	**-701**	**-1,500**
Issue of Shares	20	89	-129	0	0
Inc/(Dec) in Debt	-679	-334	-50	0	0
Interest Paid	-102	-72	-74	-47	-47
Dividend Paid	-302	-456	-463	-738	-1,328
Others	-18	0	0	0	0
CF from Fin. Activity	**-1,081**	**-773**	**-717**	**-785**	**-1,375**
Inc/Dec of Cash	**-30**	**6**	**5,598**	**2,271**	**1,636**
Add: Beginning Balance	172	142	148	5,746	8,016
Closing Balance	**142**	**148**	**5,746**	**8,016**	**9,652**

Piramal Healthcare

8 March 2010

Buy

Previous Recommendation: Buy

Rs415

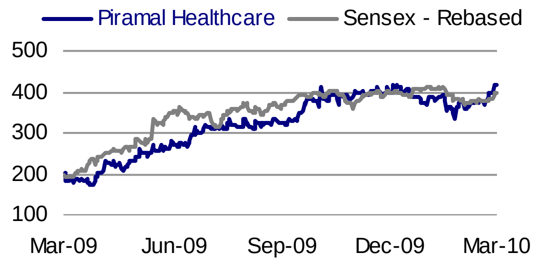
STOCK INFO. BSE Sensex: 16,972	BLOOMBERG PIHC IN
S&P CNX: 5,080	REUTERS CODE NICH.BO

Y/E MARCH	2009	2010E	2011E	2012E
Net Sales (Rs m)	32,448	36,839	42,492	48,178
EBITDA (Rs m)	6,272	7,029	8,766	10,117
NP (Rs m)	3,580	4,416	5,399	6,474
EPS (Rs)	17.1	21.1	25.8	31.0
EPS Growth (%)	-1.7	23.3	22.3	19.9
BV/Share (Rs)	63.0	79.2	98.0	119.6
P/E (x)	24.2	19.6	16.1	13.4
P/BV (x)	6.6	5.2	4.2	3.5
EV/EBITDA (x)	15.8	14.0	11.2	9.6
EV/Sales (x)	3.1	2.7	2.3	2.0
RoE (%)	29.7	29.7	29.2	28.5
RoCE (%)	21.0	20.0	22.6	23.3

KEY FINANCIALS	
Shares Outstanding (m)	209.0
Market Cap. (Rs b)	86.7
Market Cap. (US$b)	1.9
Past 3 years Sales Growth (%)	27.0
Past 3 years NP Growth (%)	41.3
Dividend Payout (%)	32.2
Dividend Yield (%)	1.0

STOCK DATA	
52-W High/Low Range (Rs)	441/171
Major Shareholders (as of December 2009)	(%)
Promoter	49.4
Domestic Inst	8.8
Foreign	25.4
Others	16.5
Average Daily Turnover	
Volume ('000 shares)	333.2
Value (Rs million)	91.0
1/6/12 Month Rel. Performance (%)	8/19/10
1/6/12 Month Abs. Performance (%)	12/28/111

STOCK PERFORMANCE (1 YEAR)



CRAMS potential intact despite short-term hiccups: Post the severe inventory de-stocking during the last five quarters, we expect Piramal Healthcare (PHL) to witness a gradual recovery in its CRAMS revenues from FY11. We expect the company's CRAMS business to record 16% CAGR over FY10-12, with its Indian CRAMS facilities recording 20% revenue CAGR, led by ramp-up in existing contracts, execution of new contracts and shift in manufacturing of some products from its UK facilities to India. We expect its UK CRAMS facilities to record a more modest 12% revenue CAGR, but with improved profitability.

Fourth largest payer in domestic formulations, its most profitable business: PHL has emerged as the fourth largest player in the domestic formulations business, on the back of organic and inorganic growth initiatives. It has been consistently outperforming industry growth over the past several quarters. We expect this business to record 15% revenue CAGR over FY10-12, led by increasing field force and geographical penetration, and the growing proportion of chronic segment.

Expect improved profitability for anesthetics business: The global inhalation anesthetics business opportunity is pegged at US$1b and PHL has established its presence in all key segments on the back of the Minrad acquisition in March 2009. While we expect 10% revenue CAGR for this business over FY10-12, profitability should improve significantly.

Expect 21% earnings CAGR; Buy: PHL is likely to benefit from the expected increase in outsourcing from India. Its domestic formulations business continues to grow strongly, with attractive profitability even on a high base. FY11 is likely to be a turning point for PHL, given the expected recovery in the CRAMS business and improving profitability of its anesthetics portfolio. We expect 21% EPS CAGR over FY10-12, with sustained RoE of 25-30%. PHL is currently valued at 16.1x FY11E and 13.4x FY12E earnings. We believe that valuations do not fully reflect the recovery in the CRAMS business and rapidly growing domestic formulations business. We reiterate **Buy** with a price target of Rs496 (16x FY12E earnings), an upside of 19%.

CRAMS business - good upside potential

Piramal Healthcare is one of the leading CRAMS players from India and one of the largest contract manufacturers for Pfizer

PHL is one of the leading CRAMS players from India. It has been able to establish good relations with some of the top 10 global innovator pharmaceutical companies and is currently one of the largest contract manufacturers for Pfizer. The company is also gradually developing capabilities in the custom chemical synthesis (CCS) segment to address the entire CRAMS value-chain.

Inventory de-stocking nearing completion; expect bounce-back in FY11

Over the past 4-5 quarters, the performance of the global CRAMS industry has suffered due to:

1. A severe round of inventory de-stocking undertaken by large innovator companies, leading to lower contract manufacturing revenues for CRAMS companies.
2. Post the credit crises of 2008, the mid-sized and small-sized research companies faced a liquidity crunch, resulting in a cut-down in many of the research projects undertaken by them. This has partly impacted custom synthesis contracts for the CRAMS players.

PHL is gradually developing capabilities in the custom chemical synthesis to address the entire CRAMS value chain

In line with the global industry trend, PHL's CRAMS business was also adversely impacted. However we believe that this is likely to reverse in FY11 due to the following:

1. **Demand for pharmaceutical products continues to grow:** The overall end-consumer demand for pharmaceutical products continues to grow steadily. Hence, inventory de-stocking will ultimately get aligned with demand post, and the innovators will have to commence outsourcing again. We believe that this reversal is likely to be visible partly in FY11 and fully by FY12.
2. **Credit situation is gradually improving:** While the mid and small-sized research companies continue to face funding issues, we note that over the past few quarters, the global credit situation is improving gradually. This will eventually open up the funding channels for these companies. Hence, while the custom synthesis business from such companies is currently under pressure, we expect a gradual improvement over the next two years.

PHL's CRAMS business was adversely impacted but a rebound is expected in FY11

Like all other CRAMS companies, PHL's CRAMS business faced strong headwinds in FY10 due to the global inventory de-stocking undertaken by customers beginning 3QFY09. The de-stocking started in 3QFY09, which affected the demand from CRAMS companies for last year.

For 9MFY10, PHL's CRAMS business de-grew by 12% YoY to Rs6.7b. The business was down despite 28% YoY growth in CRAMS revenues from Indian manufacturing facilities. CRAMS revenues from manufacturing facilities outside India fell 29% YoY partially due to closure of the Huddersfield facility in UK, which contributed GBP19m to revenues in FY09. We expect recovery in this business starting FY11, as overall demand for pharmaceutical products has not been affected globally.

Demonstrated strengths in contract manufacturing - management has disclosed six contracts till date

PHL has till date disclosed details on six of the eleven CRAMS contracts - one each with AstraZeneca, AMO, a global hospital product company (not named), Allergan, a Fortune-500 company (not named) and Pfizer. We believe that the formulations contract with the

Fortune-500 company and the API/intermediates contract with AstraZeneca hold very good potential. We give below the key highlights of all these contracts:

PHL has signed 11 CRAMS contracts

1. **AstraZeneca contract holds significant long-term potential - developmental supplies have commenced**

   In November 2005, PHL signed a development and know-how agreement with AstraZeneca AB (Sweden). The agreement involves collaboration between the two parties for development of processes for the manufacture of intermediates and APIs to be supplied to AstraZeneca. On successful product development, the two partners will further negotiate the terms of the agreement for supply of products by PHL.

PHL's deal with AstraZeneca involves collaboration on development of processes for the manufacture of intermediates and APIs and is expected to be a long-term positive for PHL

   PHL will have to achieve certain milestones (including successful product development) before being eligible for supplying commercial quantities of intermediates and APIs to AstraZeneca. Though the conversion of this agreement into a contract manufacturing assignment will be contingent on PHL achieving these milestones, we believe that this is a long-term positive for PHL. An association with a leading innovator company like AstraZeneca is likely to bring in long-term benefits. We also believe that the agreement will cover a basket of products belonging to AstraZeneca. As of now, the company has not indicated any separate capex requirements for this agreement, but we do not rule out product-specific capex when the contract manufacturing is actually taken up. In fact, PHL has a ready US-FDA approved facility at Hyderabad, which could be utilized for servicing these contracts.

   Value-added deal: Typically, contract manufacturing entails transfer of technology/know-how by the innovator to its partner, while the latter just carries out the manufacturing. This is one of the very few agreements, where the partner (i.e. PHL) will be developing the processes for manufacture of the products. Hence, we expect this to be a much more value-added agreement as compared to the normal contract manufacturing assignments. On the other hand, it will also test PHL's capabilities of product development and process improvement.

2. **Agreement with Fortune-500 company - commercial supplies have commenced**

PHL's agreement with a Fortune-500 company for manufacture and supply of various pharmaceutical products could expand and revenue streams started from mid-FY07

   This agreement signed in November 2004 is for the manufacture and supply of various pharmaceutical products to a leading pharmaceutical company (name not disclosed) for sale in the US market. The agreement is for an initial period of five years, renewable thereafter for an additional period of three years. On expiry of the renewed period of three years, the agreement may be renewed on a year-to-year basis. The products would be manufactured at PHL's Pithampur unit.

   PHL would initially supply a select group of pharmaceutical products, which is likely to expand over the length of the agreement. It has not disclosed the size of this contract and whether it is for an on-patent or off-patent molecule. Revenue streams from the contract have commenced from mid-FY07. We believe that PHL's partner for this contract is a fairly large innovator company (since it belongs to the Fortune 500 list). This implies that the contract size could expand significantly over a period of time, subject to PHL's ability to successfully execute such contracts.

PHL's 10-year manufacturing and supply agreement with a global hospital products company provides for addition of more products and supplies to the customer have begun

3. **Agreement with global hospital products company - supplies have begun**
   In November 2005, PHL signed a long-term manufacturing and supply agreement with a global hospital products company (name not disclosed). The agreement is for an initial term of ten years, followed by yearly renewals. This agreement represents an exclusive partnering arrangement between the two companies for certain global markets. The agreement provides for addition of further products under the arrangement.

   PHL manufactures these products at its USFDA-approved facilities at Digwal (AP). Supplies to the customer have already commenced.

4. **Agreement with Allergan Inc, USA - supplies have commenced**
   In November 2004, PHL entered into an agreement with Allergan Inc (USA) for the manufacture of two high-value anti-Glaucoma APIs. PHL will cater to Allergan's worldwide requirements of Levobunolol (used in Betagan formulation) and Brimonidine (used in Alphagan and Alphagan-P formulation).

PHL's multi-purpose, US FDA-approved Hyderabad plant produces high value anti-Glaucoma APIs fro Allergan Inc, USA

   The agreement is valid till October 2011. DMFs have already been filed for both products - DMF for Levobunolol was filed in October 2003 while that for Brimonidine was filed in August 2004. US-FDA approvals for both the products have been granted and supplies have commenced from FY06. These products are being manufactured at PHL's multi-purpose plant near Hyderabad. This plant typically caters to high margin, low volume products.

5. **Agreement with AMO - supplies have commenced**
   PHL has commenced commercial shipments to AMO (PHL's first contract manufacturing assignment) from July 2005. Shipments were delayed by about six months due to excess inventory with AMO since the latter was in the process of switching over from its current supplier to PHL.

PHL's contract manufacturing and R&D services agreement with Pfizer will offer process development and scale-up services to Pfizer's animal health unit

6. **Contract with Pfizer for supply of veterinary product - developmental supplies have commenced**
   In December 2005, PHL entered into a long-term contract manufacturing and related R&D services agreement with Pfizer International LLC. Key highlights of the agreement:
   - PHL will provide process development and scale-up services to Pfizer's Animal Health Division from its facilities in India. The agreement is valid for a period of seven years, and is renewable thereafter.
   - We believe that the revenues from this contract are likely to come through only after PHL completes the process development and scale-up. It will also be required to file the product with international regulatory authorities.

CRAMS revenues from India ramping up

Custom manufacturing (CMG) revenues from Indian facilities have started ramping up, led by execution of new contracts (only 6-7 out of 11 contracts are currently in execution) and shift in manufacturing of some products from the company's UK facilities to India. For 9MFY10, CMG revenues from Indian facilities grew by 28% to Rs2.9b accounting for 44% of total CRAMS revenues. We expect PHL to record 20% CAGR for CRAMS supplies from India over FY10-12, led by:

1. Ramp-up in existing contracts
2. Commencement of supplies under new contracts
3. Shift of manufacturing from UK operations to India

PHL is expected to post 20% CAGR for CRAMS supplies from India over FY10-12

Mixed experience with CRAMS acquisitions outside India

As a part of its effort to get access to new customers and to critical technologies, PHL has made two acquisitions in the CRAMS segment in UK - Pfizer's Morpeth facility and Avecia. While the company is reaping the benefits of the Morpeth acquisition, the expected turnaround at Avecia was delayed, extending the payback from this acquisition.

PHL: CRAMS ACQUISITIONS

COMPANY	MONTH/YEAR	COST	SALES	ACQUISITION PARAMETERS	
				EV/SALES	EV/EBITDA
Avecia (UK)	Dec-05	GBP 11.8m	GBP 36m	0.3	EBITDA Loss
Pfizer's UK unit (Morpeth)	Jun-06	US$25-30m**	US$ 80m	0.3	2.5

*** - Estimated*

Source: Company/MOSL

Renewal of Pfizer contracts - PHL one of the largest partners for Pfizer

PHL acquired Pfizer's Morpeth facility and Avecia in the UK and is trying to win contracts from MNCs besides Pfizer

PHL is one of the largest contract manufacturers for Pfizer. It has fully renewed the Pfizer contract at Morpeth (UK) and has also added a few new products. Manufacturing of some of these contracts is being shifted to PHL's Indian facilities. This would have a positive impact on profitability, with benefits likely to be shared by the two partners.

PHL is also in the process of reducing its dependence on Pfizer for improving capacity utilization at Morpeth by trying to win more contracts from other MNCs. A beginning has been made, as it has been able to enter into supply arrangements for clinical quantities for some drugs. While we do not expect such clinical supplies to add significantly to PHL's topline and profits in the short term (these will be low-volume, high margin supplies), they strengthen relationships with the customer from the drug development stage, and hold good long-term prospects.

Turnaround at Avecia delayed, leading to restructuring of operations

PHL renewed the Pfizer contract at Morpeth and added new products, the manufacture of some of which is being shifted to India, which would have a positive impact on profitability

PHL's acquisition of Avecia did not deliver the desired benefits due to:

1. Lack of new contracts
2. Customer inventory de-stocking, leading to lower outsourcing

In 4QFY09, PHL announced the closure of the Huddersfield (UK) facility (acquired in December 2005 as part of Avecia operations) as a part of the ongoing restructuring at the UK operations. This facility contributed about GBP19m to FY09 revenues, with single-digit EBITDA margin. All the existing customer contracts were shifted to PHL's India facilities or to its other UK sites, depending on customer preference.

Three CCS products in advanced phase-III trials

PHL's CCS pipeline includes three products (not named) undergoing advanced phase-III trials at the customer's end and which could be launched over the next two years. PHL is likely to be the primary source for supplying API for these products. While the timeline for the launch of these products is uncertain, a successful launch by the partner can potentially boost EBITDA margin, as these products are likely to enjoy patent protection.

PHL: CRAMS PIPELINE

BUSINESS	CONTRACT RESEARCH (PDS)					CONTRACT MFG (PMS)		
SEGMENT	PRE-CLINICAL	PHASE-I	PHASE-II	PHASE-III	TOTAL	LAUNCHED	LAUNCHED	TOTAL
YEAR						(< 5 YEARS)	(> 5 YEARS)	
2006	8	23	42	9	82	9	16	25
2007	11	26	44	12	93	12	39	51
2008	12	29	64	18	123	12	45	57
2009	14	57	81	19	171	14	54	68

Source: Company/MOSL

Long term growth potential for CRAMS remains intact

PHL will be a key beneficiary of increased outsourcing to India due to its size, scale and relationships with innovator companies

We believe that India can provide significant advantages in the CRAMS business due to a variety of factors like:

- Low cost manufacturing
- Good chemistry skills
- Good regulatory expertise in product filing, registrations, etc.
- Most of the top innovators are likely to increase the proportion of outsourcing to Asia (India & China) in the coming years.

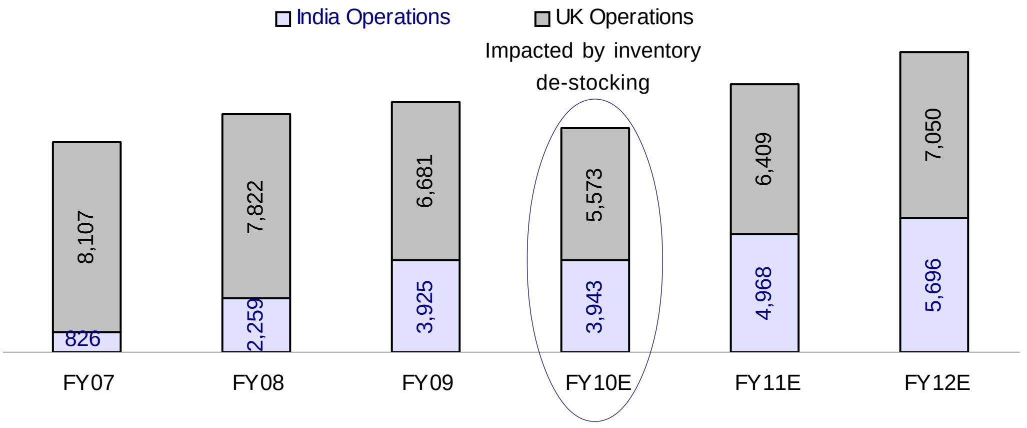
We believe that PHL will be a key beneficiary of the increased outsourcing to India due to its size, scale, and relationships with innovator companies. It has signed about 11 contract manufacturing agreements over the past few years, of which 6-7 are currently in execution. Some other contracts are likely to be commercialized over the next two years.

PHL has signed 11 contracts, of which 6-7 are in execution and some are likely to be commercialized over the next two years

We expect PHL's CRAMS business to record 16% CAGR over FY10-12 with its Indian CRAMS facilities recording 20% revenue CAGR, led by ramp-up in existing contracts, execution of new contracts and shift in manufacturing of some products from the company's UK facilities to India. The UK CRAMS facilities are likely to record a more modest 12% revenue CAGR, but with improved profitability.

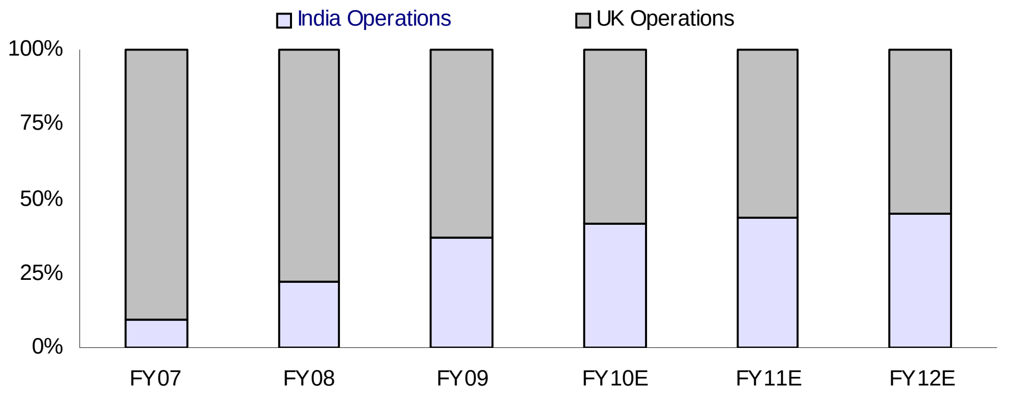
India ramping up, but UK operations to record moderate growth

PHL: CRAMS REVENUE RAMP-UP (RS M)



Source: Company/MOSL

PHL: CRAMS REVENUE DISTRIBUTION



Source: Company/MOSL

Fourth largest player in domestic formulations, its most profitable business

PHL is the fourth largest player in the domestic formulations business due to its organic and inorganic growth initiatives

PHL has emerged as the fourth largest player in the domestic formulations business on the back of organic and inorganic growth initiatives. It has been consistently outperforming industry growth over the past several quarters.

We expect this business to record 15% revenue CAGR over FY10-12, led by increasing field force and geographical penetration, and the growing proportion of chronic segment. This is PHL's most profitable business and remains an important cash-flow generator.

Domestic formulation industry likely to report strong growth

The domestic formulations industry is set to grow to US$20b by 2015 from the current size of US$8b - a CAGR of 14%. Many factors will drive the growth, including:

- Rising disposable income
- Rising number of middle-class households
- Expansion of healthcare infrastructure
- Higher penetration of health insurance
- Rising prevalence of chronic diseases
- Adaptation of product patent

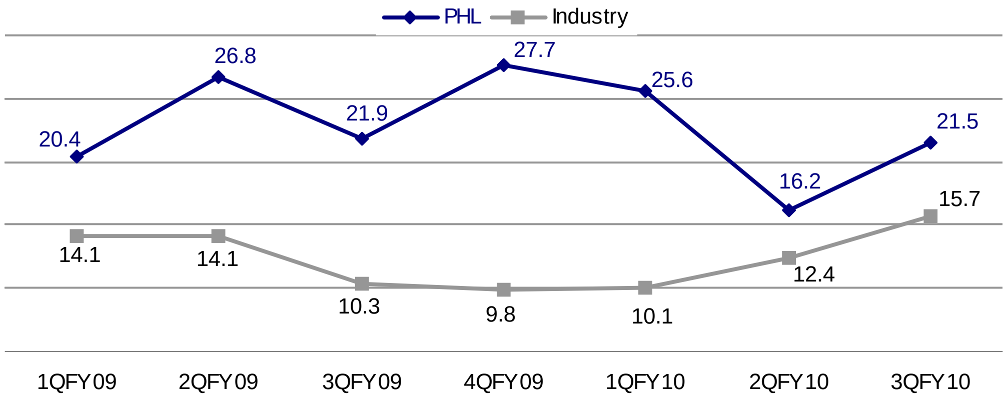
Also, with change in lifestyles, the share of the chronic disease segment is rising, thereby improving the profitability of players that have strong presence in the segment. We believe that with coverage of 10 therapeutic areas and a field force of about 4,000 people, PHL is well-placed to take advantage of this growth opportunity.

PHL continues to report double-digit growth

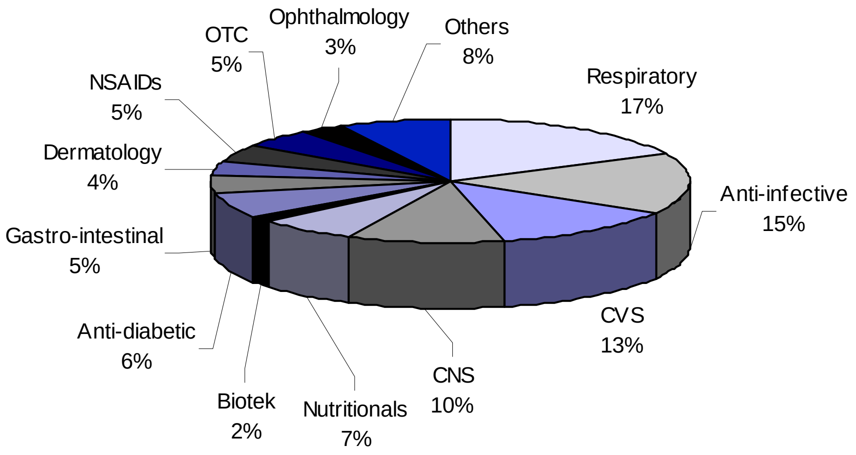
The domestic formulations industry is set to grow to US$20b by 2015 from US$8b, a CAGR of 14%

PHL underperformed the industry in FY08 due to non-availability of Codeine, a key input for its Rs1.3b Phensedyl brand. Since then, it has consistently delivered strong growth in the domestic formulations business, outperforming the industry. We believe that PHL will continue to maintain this growth momentum in the coming years on the back of a strong field force, therapeutic expansion and new product introductions.

PHL: DOMESTIC FORMULATION GROWTH TREND (%)



PHL: DOMESTIC FORMULATIONS - THERAPEUTIC BREAK-UP (FY09)



Source: Company/MOSL

Outperforming industry in major therapeutic segments

PHL has outperformed the industry growth rate in major therapeutic areas like respiratory, anti-infectives, CNS. The company has maintained its market share in almost all the therapy segments it has a presence in.

PHL: PERFORMANCE V/S INDUSTRY (% GROWTH RATE)

THERAPEUTIC SEGMENT	PHL	INDUSTRY**
Respiratory	21.2	18.5
Anti-infective	39.6	14.1
CVS	14.3	18.4
CNS	22.9	19.9
Anti-diabetic	25.0	21.1
Gastro-intestinal	15.8	17.6
Dermatology	17.4	20.8
Overall	**22.8**	**17.0**

*** Trailing 12 months ended Dec-09*

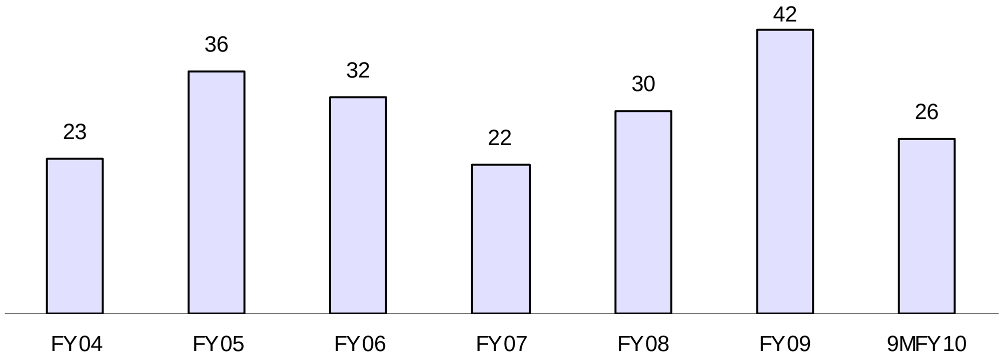
Source: Company/MOSL

New introduction-led growth

PHL has consistently introduced new products in various therapy areas. We see this as one of the major drivers of its strong performance in the last two years. The company has aggressively launched new products in the market over the past few years. Currently, *PHL's introduction of new products has been a major driver of its strong performance over the past two years*

new products contribute 8.3% to total domestic formulations revenue v/s 5.2% in FY07. We believe that new launches currently account for ~50% of the domestic formulations growth. PHL continues to launch new products aggressively, which would be a key growth driver in the coming years.

PHL: DOMESTIC FORMULATIONS - NUMBER OF NEW LAUNCHES



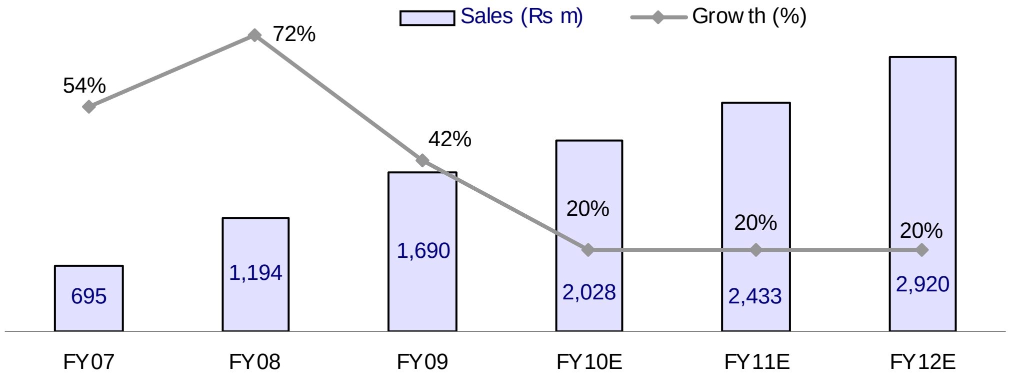
Source: Company/MOSL

Pathology laboratories - in growth phase

PHL has been developing a presence in the pathological laboratories business through mergers and acquisitions

PHL has been growing its presence in the pathology laboratories business through mergers and acquisitions. This business currently accounts for about 5% of its total revenues. The company's revenues from the business have grown more than 3x in the last three years, albeit on a lower base and partly boosted by large number of small-sized acquisitions. We believe that the business is promising, looking at various demographic factors leading to massive increase in spending on healthcare in urban as well as rural areas. Besides, only three other players - Ranbaxy SRL, Apollo and Metropolis - have presence at a national level. Though a capital intensive business, operating margins are attractive.

PHL: RAMP-UP OF PATHOLOGY LABORATORIES BUSINESS



Source: Company/MOSL

Global critical care business - becoming a bigger player

PHL is one of only three companies in the world to have a presence across product segments in the US$1b inhalation anesthetics business

PHL is one of the only three companies globally to have a presence across product segments in the US$1b inhalation anesthetics (IA) business. It has built this business through the inorganic route commencing with the acquisition of Rhodia's IA business a few years ago. PHL propelled itself into the top-3 league through the acquisition of Minrad (USA) in December 2008 along with RxElite (its distributor) for ~US$62m.

Minrad acquisition - propels PHL into largest segments of IA

The acquisition of Minrad has enabled PHL to add two of the largest IA products to its portfolio

The acquisition of Minrad has enabled PHL to add two of the largest IA products - Sevoflurane and Desflurane to its portfolio of older IA products (acquired from Rhodia). These two products constitute 92% value share of the inhalation anesthetics market, with Sevoflurane commanding the largest share of 72% with market size of US$750m.

PHL paid a consideration of US$62m for the acquisition of Minrad and RxElite (the distribution company for IA gases in the US). At the time of acquisition, Minrad had annual revenues of US$23m for the nine months ended September 2008, with losses of US$15m at EBITDA level. However, in 9MFY10, the management has been able to turn around the company, with US$33m in revenues and 6-7% EBITDA margins.

Litigation to delay Desflurane launch

Desflurane is the second largest product in the IA market and has a market size of US$200m, with the US contributing to the majority of the revenues. Desflurane is the most expensive inhalation anesthetic and enjoys the highest margins in the segment. Baxter, the innovator of Desflurane, is the only player in the regulated market, since it is a niche, difficult to manufacture product.

PHL (Minrad) filed Desflurane Para-IV ANDA in December 2008, following which the innovator company Baxter sued it in January 2009. Minrad is the only generic company that has filed ANDA for this product. So, we expect very limited competition, and hence, higher margins for this product post the generic launch by PHL. The patent on this product expires in July 2011. PHL's launch is contingent on a successful outcome of the court litigation.

PHL to leverage capacity utilization and cost reductions

PHL will be able to turn Minrad around by leveraging its worldwide distribution network in the IA business and low cost manufacturing

We believe that PHL will be able to turn Minrad around by leveraging its worldwide distribution network in the IA business and low cost manufacturing. PHL has integrated the distribution channels and has reduced the combined field force by 30%.

Production at Minrad has increased and EBITDA margins are back in positive territory (6-7% margins). The expected recovery in Minrad operations has been delayed by 1-2 quarters due to the delay in commissioning of vaporizers at the customer's premises.

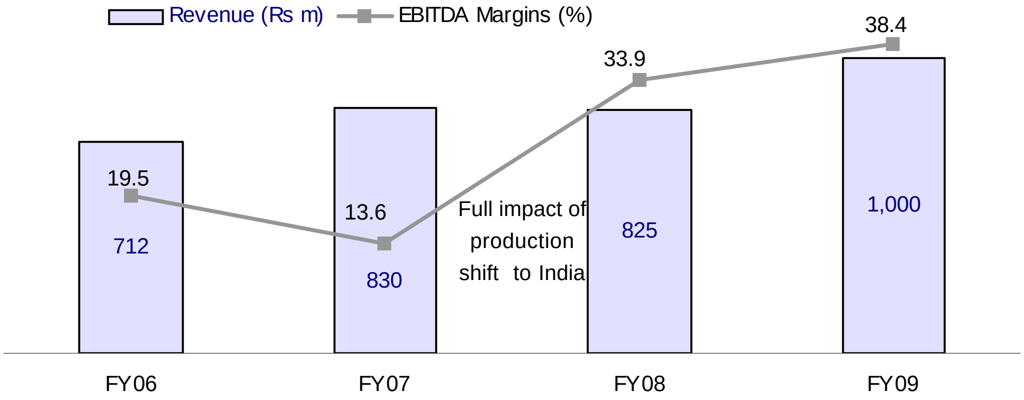
PHL has improved the price realization of Sevoflurane by 7%. It will further increase margins by increasing the volume and capacity utilization at its US manufacturing location and improving the yield. The company has signed two large contracts, one for Sevoflurane and Isoflurane, and other with a veterinary distributor for Isoflurane. Further, it is in the process of filing dossiers in various European markets for Sevoflurane and getting it registered. We believe that PHL is likely to witness revenue and profitability ramp-up in this business starting FY11.

PHL has good track record in IA business

PHL entered the global critical care business with the acquisition of the Halothane business of ICI Pharma in India in 2002 and the acquisition of Rhodia's inhalation anesthetics business in 2004. These acquisitions enabled PHL to enter the global markets of Halothane and Isoflurane. Since then, PHL has successfully integrated Rhodia IA, growing this business at 14% CAGR over FY06-09. It has significantly improved the profitability of this business by shifting production to its low-cost Indian facility. It has achieved EBITDA margin improvement from 19.5% to 38.4% over FY06-09.

PHL has no plans to shift Minrad's production to India but we believe PHL will be able to achieve peak EBITDA margins of 20-25% for Minrad operations over the next two years

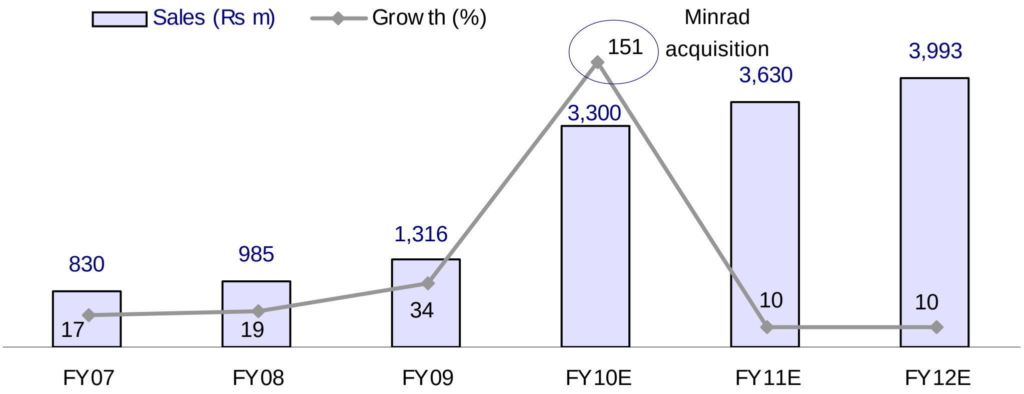
PHL - IA BUSINESS (EX-MINRAD) PERFORMANCE IMPROVEMENT



Source: Company/MOSL

While this is very impressive, we do not expect a similar improvement in Minrad's operations since PHL does not have any plans to shift Minrad's production to its Indian facilities in the short-to-medium term. We believe that PHL will be able to achieve peak EBITDA margins of 20-25% for Minrad operations over the next two years.

PHL - INHALATION ANESTHETIC BUSINESS RAMP UP



Source: Company/MOSL

Financials - 3QFY10 performance disappointing; expect improvement in FY11

Although PHL's 3QFY10 performance was below our estimate, we expect improvement in FY11

PHL's 3QFY10 numbers were lower than we had estimated due to disappointing CRAMS and GGC business performance:

- Topline grew 9.6% YoY to Rs9.1b v/s our estimate of Rs9.8b and EBITDA grew 14% YoY to Rs1.77b v/s our estimate of Rs1.95b. Adjusted PAT increased 127% YoY to Rs1.36b v/s our estimate of Rs1.2b, boosted by tax write-back of Rs204m.
- Excluding the Minrad acquisition (Rs490m sales), organic topline growth was just 3.7%. This was despite a strong 21.5% growth for domestic formulations (55% of

sales). CRAMS business (23% of sales) de-grew 18.4%, adversely impacting overall revenues.

- EBITDA grew 14% YoY to Rs1.77b but was below our estimate of Rs1.9b mainly due to lower topline growth. EBITDA margin at 19.5% was in line with our estimate.
- A tax write-back of Rs205m helped the company to report 127% PAT growth to Rs1.36b (v/s our estimate of Rs1.2b). The management indicated that the tax write-back was a one-off event related to deferred tax assets in its international CRAMS business and is unlikely to recur in the coming quarters.

QUARTERLY PERFORMANCE (RS MILLION)

Y/E MARCH	FY09				FY10				FY09	FY10E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Sales	**7,083**	**8,893**	**8,283**	**8,189**	**8,215**	**10,000**	**9,077**	**9,546**	**32,448**	**36,839**
YoY Change (%)	*16.5*	*17.5*	*13.1*	*5.5*	*16.0*	*12.5*	*9.6*	*16.6*	*12.9*	*13.5*
Total Expenditure	5,680	7,066	6,728	6,702	6,658	8,226	7,303	7,622	26,176	29,810
EBITDA	**1,403**	**1,827**	**1,555**	**1,487**	**1,557**	**1,774**	**1,774**	**1,924**	**6,272**	**7,029**
Margins (%)	*19.8*	*20.5*	*18.8*	*18.2*	*19.0*	*17.7*	*19.5*	*20.2*	*19.3*	*19.1*
Depreciation	270	288	295	343	385	375	434	435	1,196	1,629
Interest	120	170	261	286	254	254	217	230	838	954
Other Income	-207	-408	-309	540	45	15	33	37	-384	130
PBT before EO Expense	**806**	**960**	**691**	**1,397**	**963**	**1,160**	**1,157**	**1,296**	**3,854**	**4,576**
Extra-Ord Expense	41	96	0	310	0	4	0	0	446	4
PBT after EO Expense	**766**	**864**	**691**	**1,087**	**963**	**1,157**	**1,157**	**1,296**	**3,408**	**4,572**
Tax	87	114	72	118	113	94	-204	364	391	366
Deferred Tax	0	0	0	-171	0	0	0	-206	-171	-206
Rate (%)	*11.3*	*13.2*	*10.4*	*-4.9*	*11.7*	*8.1*	*-17.7*	*12.2*	*6.4*	*3.5*
PAT	**679**	**750**	**619**	**1,140**	**851**	**1,063**	**1,361**	**1,138**	**3,188**	**4,412**
Less: Minority Interest	-2	17	20	-10	0	0	-1	2	26	0
Reported PAT	**681**	**733**	**599**	**1,150**	**851**	**1,063**	**1,362**	**1,136**	**3,163**	**4,412**
Adj PAT	**717**	**816**	**599**	**1,078**	**851**	**1,066**	**1,362**	**1,136**	**3,580**	**4,416**
YoY Change (%)	*19.8*	*-21.0*	*-36.3*	*13.8*	*18.7*	*30.6*	*127.5*	*5.4*	*-1.7*	*23.3*

E: MOSL Estimates

GUIDANCE FOR FY10E

	GUIDANCE		
PARAMETER	REVISED	PREVIOUS	REMARKS
Sales Growth (%)	13-15	16-17	For Apr-Dec'09 growth was 12.3%. We forecast FY10 growth at 13.5%
Sales Growth -	18-20	14-16	For Apr-Dec'09 growth was 20.7%. We expect domestic formulations FY10 growth at 19%
CRAMS Business (Rs b)	9.5	10.0	For Apr-Dec'09 sales were Rs6.69b. We expect FY10 sales at Rs9.5b
Critical Care Revenues (Rs b)	3.3	4.5	Recorded Rs2.39b in sales for Apr-Dec'09. Revenues to ramp-up in coming quarters as capacity utilization improves at Minrad
Overall EBITDA Margins (%)	20	21-22	Boosted by 6-8% improvement in margins for CRAMS business due to closure of UK facility. Apr-Dec'09 EBITDA margins were at 18.7%. We forecast FY10 EBITDA margins at 19.1%
Capex (Rs b)	1.3	1.8	Capex for FY09 was Rs1.9b. Apr-Dec'09 capex was Rs995.3m.
D/E target for 31-Mar-2010	0.7x	0.7x	FY09 D/E was 1x which has improved marginally to 0.8x by Dec-09.
EPS (Rs)	23.5-24	23.5-24	FY09 EPS was Rs17.1. We expect FY10E EPS at Rs21.1

Note - Guidance excludes exceptional charge and forex losses/gains *Source: Company*

Management downgrades revenue, EBITDA margin guidance for FY10

The management has reiterated its EPS guidance mainly due to savings on interest, depreciation and tax

The management has downgraded its revenue and EBITDA margin guidance for FY10 due to delayed recovery in both the CRAMS and GCC businesses. However, it has reiterated its EPS guidance mainly due to savings on interest, depreciation and tax.

FY11 to be an important year for PHL

We believe that FY11 will be a critical year for PHL, as all its three major businesses are likely to show improvement. Key factors that will lead to improved performance are:

- Expected recovery in CRAMS business, which has suffered in FY10 due to inventory de-stocking by customers
- Continued buoyancy in the highly profitable domestic formulations business on a high base
- Improvement in profitability for the Minrad acquisition in the US, led by ramp-up in capacity utilization and benefits from cost reductions

Expect 14-15% revenue CAGR over FY10-12

We expect PHL to record 14.4% revenue CAGR over FY10-12, led by:

- A 20% CAGR each for CRAMS supplies from India and pathology laboratories business
- Domestic formulations CAGR of 15-16%

PHL is expected to post 14.4% revenue CAGR over FY10-12 led by growth in CRAMS supplies, the pathology laboratories business and domestic formulations

REVENUE MODEL (RS M)

	FY07	FY08	FY09	FY10E	FY11E	FY12E	CAGR % (FY10-12)
Healthcare Solutions	11,742	12,913	16,049	19,098	22,154	25,477	15.5
Pharma Solutions	8,933	10,081	10,606	9,516	11,377	12,746	15.7
India	826	2,259	3,925	3,943	4,968	5,696	20.2
International	8,107	7,822	6,681	5,573	6,409	7,050	12.5
Pathlabs	695	1,194	1,690	2,028	2,433	2,920	20.0
Global Critical Care	0	985	1,316	3,300	3,630	3,993	10.0
Others	3,350	3,555	2,787	2,898	2,898	3,042	2.5
Total	**24,719**	**28,728**	**32,448**	**36,839**	**42,492**	**48,178**	**14.4**
Growth (%)		*16.2*	*12.9*	*13.5*	*15.3*	*13.4*	

Source: Company/MOSL

Valuation and outlook

We believe that PHL will be a key beneficiary of increased outsourcing from India due to:

- Strong MNC relations that the company enjoys
- Access to low-cost manufacturing
- IPR compliant business policies
- Expanding capabilities in contract research
- Favorable stance from MNCs towards outsourcing from India

We expect 16% CAGR for PHL's CRAMS revenue over FY10-12. A steady double-digit growth for the domestic formulations business (49% of total revenues for FY09) with good profitability and potential debt reduction also augur well.

EBITDA margins to expand by 200bp over FY10-12

We expect a 200bp expansion in PHL's EBITDA margins, led by:

- Recovery in CRAMS business beginning FY11
- Improving profitability in Minrad operations
- Continued momentum in the highly profitable domestic formulations business

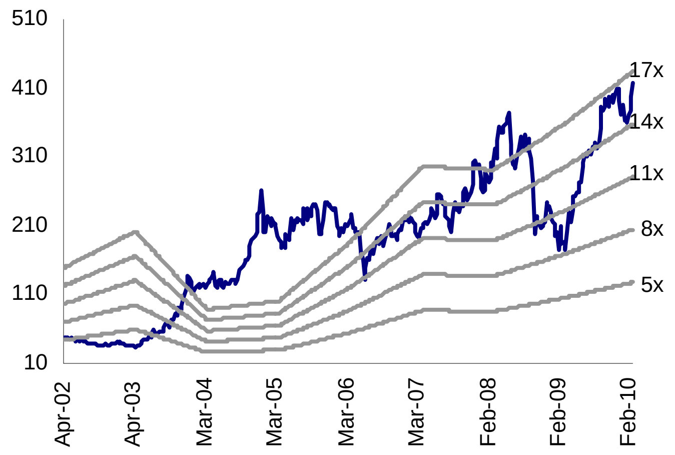
We note that it is imperative for PHL to improve EBITDA margins for its GCC business to achieve its guidance of 20% for FY10. We estimate EBITDA margins at 19.1% for FY10 based on 9MFY10 performance.

Expect 21% earnings CAGR; Buy

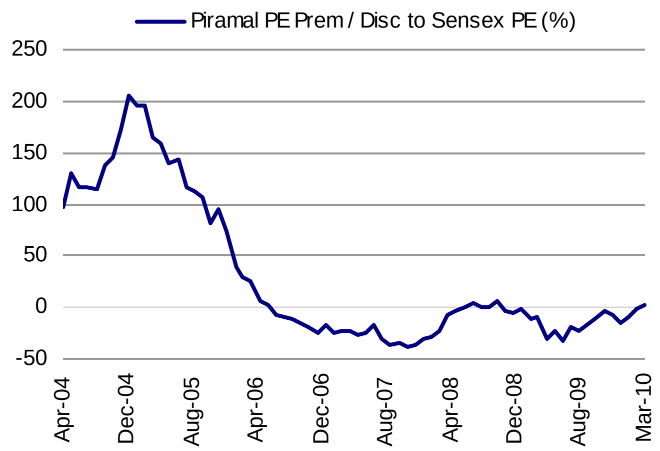
FY11 is likely to be a turning point for PHL due to the expected recovery of the CRAMS business and improving profitability of its anesthetics portfolio

FY11 is likely to be a turning point for PHL, given the expected recovery in the CRAMS business and improving profitability of its anesthetics portfolio. We expect 21% EPS CAGR over FY10-12 and estimate EPS at Rs21.1 for FY10 (up 23.3%), Rs25.8 for FY11 (up 22.3%), and Rs31 (up 19.9%), with sustained RoE of 25-30%. The stock trades at 16.1x FY11E and 13.4x FY12E earnings. We believe that valuations do not fully reflect the expected recovery in the CRAMS business and rapidly growing domestic formulations business. We reiterate **Buy** with a price target of Rs496 (16x FY12E earnings), an upside of 19%.

P/E BANDS



RELATIVE P/E TO SENSEX



Source: MOSL

Key risks

Global M&A activity may impact CCS pipeline

The global pharmaceutical industry has recently witnessed large M&A transactions - Pfizer's acquisition of Wyeth, Merck acquiring Schering Plough and Abbott acquiring Solvay's pharmaceutical business. If such large deals force other global companies (like GSK, Novartis, etc) to also acquire mid-sized players, this could signal a consolidation of customer base. One of the key areas for cost cutting in such mergers could be rationalization of R&D pipelines, which could lead to some projects being dropped. This could impact the CCS pipelines of CRAMS players like PHL.

New drug policy still remains uncertain

The biggest risk to our positive stance on PHL could be the implementation of the pharmaceutical policy

We believe that the biggest risk to our positive stance on PHL could be the implementation of the new pharmaceutical policy. The new policy proposes to significantly increase the span of control by bringing in additional 354 drugs under price control. Recent proposals by the Chemicals Ministry also include placing a cap on price of newly launched products. This could impact the profitability of PHL's domestic business. The industry has taken strong objection to the proposed policy and we believe that the policy is unlikely to be implemented in the current form. Given the strong opposition from the industry, the government has formed a Group on Ministers (GoM), which would give final recommendations to the government regarding the new pharmaceutical policy. However, the uncertainty related to this will remain till the government finally notifies the new pharmaceutical policy.

Financials and Valuation

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Net Sales	**28,728**	**32,448**	**36,839**	**42,492**	**48,178**
Change (%)	*18.7*	*12.9*	*13.5*	*15.3*	*13.4*
Total Expenditure	23,311	26,176	29,810	33,725	38,062
EBITDA	**5,418**	**6,272**	**7,029**	**8,766**	**10,117**
Margin (%)	*18.9*	*19.3*	*19.1*	*20.6*	*21.0*
Depreciation	947	1,196	1,629	1,860	2,022
Int. and Finance Charges	463	838	954	1,005	1,005
Other Income - Rec.	61	-384	130	120	132
PBT before EO Exp.	**4,068**	**3,854**	**4,576**	**6,022**	**7,222**
EO (Inc)/Exp	339	446	4	0	0
PBT after EO Expense	**3,729**	**3,408**	**4,572**	**6,022**	**7,222**
Tax	377	219	160	623	747
Tax Rate (%)	*10.1*	*6.4*	*3.5*	*10.4*	*10.4*
Reported PAT	**3,352**	**3,188**	**4,412**	**5,399**	**6,474**
PAT Adj for EO Items	**3,657**	**3,605**	**4,416**	**5,399**	**6,474**
Change (%)	*57.6*	*-1.4*	*22.5*	*22.3*	*19.9*
Margin (%)	*12.7*	*11.1*	*12.0*	*12.7*	*13.4*
Less: Mionrity Int. & Others	14	26	0	0	0
Adj Net Profit	**3,643**	**3,580**	**4,416**	**5,399**	**6,474**

BALANCE SHEET (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Equity Share Capital	418	418	418	418	418
Reserves	10,508	12,753	16,125	20,057	24,575
Net Worth	**10,926**	**13,171**	**16,543**	**20,475**	**24,993**
Minority Interest	49	74	74	74	74
Deferred Liabilities	897	726	726	726	726
Total Loans	7,163	13,391	12,060	13,060	12,060
Capital Employed	**19,035**	**27,361**	**29,403**	**34,335**	**37,853**
Gross Block	16,987	26,059	27,359	29,859	32,359
Less: Accum. Deprn.	4,983	6,595	7,409	8,339	9,350
Net Fixed Assets	**12,005**	**19,464**	**19,950**	**21,520**	**23,009**
Capital WIP	581	927	500	500	500
Investments	653	278	278	278	278
Curr. Assets	**11,695**	**14,908**	**15,076**	**19,076**	**21,810**
Inventory	4,033	4,834	4,912	5,311	6,022
Account Receivables	4,457	4,866	5,250	6,887	7,809
Cash and Bank Balance	551	946	622	1,478	1,532
Others	2,654	4,262	4,292	5,400	6,447
Curr. Liability & Prov.	**5,898**	**8,215**	**6,400**	**7,040**	**7,744**
Account Payables	4,676	6,307	5,000	5,500	6,050
Provisions	1,222	1,909	1,400	1,540	1,694
Net Current Assets	**5,797**	**6,692**	**8,676**	**12,036**	**14,066**
Appl. of Funds	**19,035**	**27,362**	**29,404**	**34,334**	**37,853**

E: MOSL Estimates

RATIOS

Y/E MARCH	2008	2009	2010E	2011E	2012E
Basic (Rs)					
EPS	**17.4**	**17.1**	**21.1**	**25.8**	**31.0**
Cash EPS	22.0	22.8	28.9	34.7	40.7
BV/Share	52.3	63.0	79.2	98.0	119.6
DPS	4.2	4.2	5.0	6.0	8.0
Payout (%)	31.2	32.2	27.7	27.2	30.2
Valuation (x)					
P/E	23.8	24.2	19.6	16.1	13.4
Cash P/E	18.9	18.2	14.3	12.0	10.2
P/BV	7.9	6.6	5.2	4.2	3.5
EV/Sales	3.2	3.1	2.7	2.3	2.0
EV/EBITDA	17.2	15.8	14.0	11.2	9.6
Dividend Yield (%)	1.0	1.0	1.2	1.4	1.9
Return Ratios (%)					
RoE	34.0	29.7	29.7	29.2	28.5
RoCE	25.6	21.0	20.0	22.6	23.3
Working Capital Ratios					
Fixed Asset Turnover (x)	2.4	2.1	1.9	2.0	2.2
Debtor (Days)	57	55	52	59	59
Inventory (Days)	51	54	49	46	46
Working Capital (Days)	74	75	86	103	107
Leverage Ratio (x)					
Current Ratio	2.0	1.8	2.4	2.7	2.8
Debt/Equity	0.7	1.0	0.7	0.6	0.5

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
OP/(Loss) before Tax	**5,418**	**6,272**	**7,029**	**8,766**	**10,117**
Interest/Dividends Recd.	61	-384	130	120	132
Direct Taxes Paid	-373	-391	-160	-623	-747
(Inc)/Dec in WC	-125	-501	-2,307	-2,504	-1,975
CF from Operations	**4,981**	**4,996**	**4,692**	**5,759**	**7,526**
EO Expense/(income)	339	446	4	0	0
CF fr. Op. incl EO Exp.	**4,641**	**4,550**	**4,689**	**5,759**	**7,526**
(Inc)/Dec in FA	-1,295	-9,001	-1,688	-3,430	-3,511
(Pur)/Sale of Invest.	-365	374	0	0	0
CF from Invest.	**-1,660**	**-8,627**	**-1,688**	**-3,430**	**-3,511**
Change in Net Worth	-384	0	183	0	0
Inc/(Dec) in Debt	-1,045	6,337	-1,331	1,000	-1,000
Interest Paid	-463	-838	-954	-1,005	-1,005
Dividend Paid	-1,045	-1,027	-1,223	-1,467	-1,956
CF from Fin. Activity	**-2,936**	**4,472**	**-3,325**	**-1,472**	**-3,961**
Inc/Dec of Cash	**45**	**395**	**-324**	**857**	**54**
Add: Beginning Balance	506	551	946	622	1,478
Closing Balance	**550**	**946**	**622**	**1,478**	**1,531**

Dishman Pharma

8 March 2010

Neutral

Re-initiate Coverage

Rs208

Set to benefit from increased outsourcing from India: We expect Dishman Pharma (DPL) to benefit from the expected increase in pharmaceutical outsourcing from India over the next few years. Ramp-up in supplies to Solvay (now Abbott) coupled with addition of new customers and commissioning of the new HIPO facility will be the key growth drivers. We forecast a topline CAGR of 19% for DPL over FY10-12.

Strengthening MNC relationships augur well: DPL's focus on establishing relationships with new customers and reducing its dependence on Solvay has begun bearing fruits. It has signed supply contracts with AstraZeneca and is in advanced discussions with large companies like GSK, Novartis, and J&J for outsourcing deals.

Carbogen AMCIS offers an edge: Carbogen AMCIS has enabled DPL to establish a presence across the CRAMS value chain on the back of its strong contract research capabilities apart from giving access to its high potency manufacturing facility. Further, it has given DPL a ready base of clients.

Reduced early phase R&D activity and de-stocking impacting performance: Like many of its CRAMs peers, DPL has been suffering from de-stocking of inventory carried out by its large customers and declining demand from Carbogen AMCIS customers due to unavailability of funding. We believe that DPL's CRAMS business would revert to the growth path in FY11 while Carbogen AMCIS' performance will improve only in FY12.

Expect 15.6% earnings CAGR: The macro environment for the CRAMS business remains favorable given India's inherent cost advantages and chemistry skills. We believe that DPL will benefit from increased outsourcing from India, given its strengthening MNC relations. However, the adverse business environment for Carbogen will continue to impact earnings in FY10-11. We expect DPL to record a CAGR of 19% in revenues, 24% in EBITDA and 15.6% in EPS over FY10-12, led mainly by its Indian CRAMS operations. Earnings growth will be tempered down by higher depreciation and taxes, and lower other income. The stock currently trades at 13.5x FY11E and 11.1x FY12E earnings. RoE will continue to be at 15% till new facilities and CRAMS contracts ramp up. We re-initiate coverage, with a **Neutral** rating and a price target of Rs225 (12x FY12E earnings) - a 8% upside.

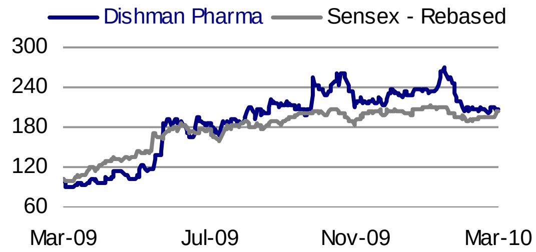
STOCK INFO.	BLOOMBERG
BSE Sensex: 16,972	DISH IN
	REUTERS CODE
S&P CNX: 5,080	DISH.BO

Y/E MARCH	2009	2010E	2011E	2012E
Net Sales (Rs m)	10,624	9,072	10,728	12,867
EBITDA (Rs m)	2,615	2,006	2,484	3,101
Adj. NP (Rs m)	1,463	1,142	1,255	1,526
EPS (Rs)	18.0	14.1	15.4	18.8
EPS Growth (%)	20.4	-21.9	9.9	21.5
BV/Share (Rs)	88.5	101.3	114.9	131.6
P/E (x)	11.6	14.8	13.5	11.1
P/BV (x)	2.3	2.1	1.8	1.6
EV/EBITDA (x)	9.1	11.8	9.4	7.6
EV/Sales (x)	2.2	2.6	2.2	1.8
RoE (%)	22.7	14.9	14.4	15.3
RoCE (%)	15.2	10.8	11.0	12.5

KEY FINANCIALS	
Shares Outstanding (m)	81.3
Market Cap. (Rs b)	16.9
Market Cap. (US$b)	0.4
Past 3 years Sales Growth (%)	56.5
Past 3 years NP Growth (%)	41.8
Dividend Payout (%)	7.7
Dividend Yield (%)	0.6

STOCK DATA	
52-W High/Low Range (Rs)	275/87
Major Shareholders (as of December 2009)	(%)
Promoter	60.8
Domestic Inst	12.5
Foreign	11.3
Others	15.4
Average Daily Turnover	
Volume ('000 shares)	254.2
Value (Rs million)	50.9
1/6/12 Month Rel. Performance (%)	-9/-10/5
1/6/12 Month Abs. Performance (%)	-5/-1/106

STOCK PERFORMANCE (1 YEAR)



Strengthening MNC relationships

Dishman Pharma (DPL) is preparing itself to reap the benefits of increased outsourcing from India. Over the past few years, the company has established itself as a key vendor for Solvay (now Abbott), with a gradual ramp-up in supplies of Eprosartan Mesylate (EM) and addition of more products. It is now is the process of developing and expanding relationships with new customers like AstraZeneca, GSK, Novartis, etc.

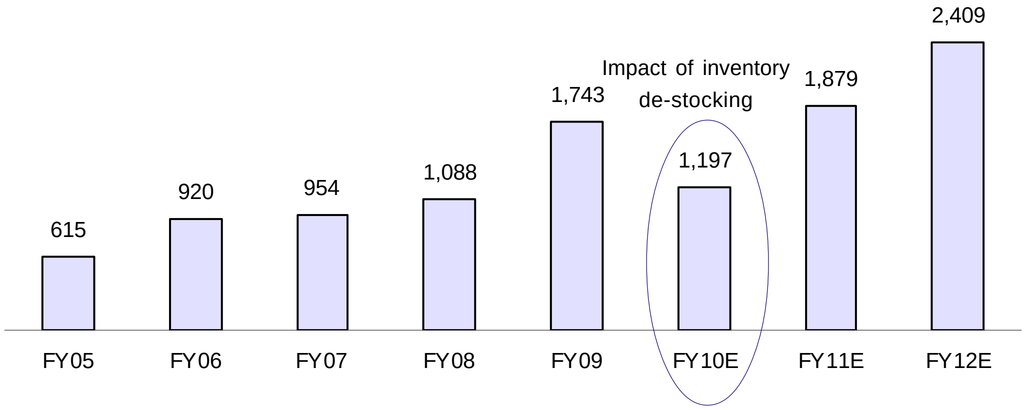
Strong relationship with Solvay - early mover advantage

DPL was one of the few companies to recognize the opportunity in the CRAMS segment as early as the late nineties. Since then, it has transformed itself from a chemicals manufacturer to an API manufacturer and a partner of choice for innovators. We believe that given the nature of the CRAMS business, which requires many years to establish relationships with innovator companies and has large entry barriers, DPL has made a good beginning by establishing a strong relationship with Solvay.

DPL entered the CRAMS business with a contract from Solvay in 2001

The agreement with Solvay marked DPL's entry into the CRAMS business in 2001. Initially, Solvay sourced small quantities of APIs of EM and three intermediates from DPL, which has now gradually increased to over 60% of Solvay's EM requirement. We believe that there is no risk to this revenue stream until 2013, when the EM patent expires in Europe. The increased quantity indicates Solvay's confidence in DPL's ability to supply quality products on time, and on its IPR policies. Though Solvay contributes less than 20% to DPL's total revenues, the relationship has helped DPL in gaining critical experience and capabilities in the CRAMS segment. This will help the company to garner business from other big innovator companies.

DPL: RAMP-UP IN SOLVAY SUPPLIES (RS M)



Source: Company/MOSL

It has signed more contracts with Solvay for Fenofibrate, Mebeverine and Fluvoxamine

Three more product contracts to start contributing: Recently, DPL has signed more contracts with Solvay for supplying API/intermediates for its three commercialized products. These products are Fenofibrate, Mebeverine and Fluvoxamine. While Mebeverine and Fluvoxamine will not be very big opportunities for DPL, we believe that Fenofibrate supplies to Europe could turn out to be a good opportunity since Solvay is likely to outsource 100% of its API requirement to DPL. Fenofibrate is a ~Euro500m product for Solvay in Europe, and we believe that the 100% API manufacturing for this product can contribute meaningful revenues and profits to DPL in the coming years. We estimate fenofibrate supplies to Europe to contribute about Rs1b in revenues by FY14.

Fenofibrate US opportunity will not be significant due to imminent generic competition: Fenofibrate (Tricor) has revenues of US$1.3b in the US and is marketed by Abbott. Teva and Impax have filed Para-IV ANDA for this product and Teva has already settled the patent dispute with Abbott and is likely to launch the generic version after March 2011. We anticipate the market size of the product and Abbott's market share to go down substantially, post generic launches. This in turn will imply a much smaller opportunity for DPL for Fenofibrate supplies in the US.

POST GENERIC LAUNCH (US$M)

Branded Sales	1,337
Price Erosion (%)	80
Genericized Mkt Size	267
Abbott's Mkt Share (%)	10
Revenue for Abbott	27
Gross Margins (%)	50
COGS	13
Cost of API	7
Revenue to Dishman (Rs m)	297
% of Current Revenues	3

Source: Company/MOSL

Further, the acquisition of Solvay's pharmaceutical business by Abbott has raised some questions about the potential continuation of these contracts (as they were signed prior to the acquisition). However, DPL's management has indicated that the acquisition will not have any negative impact on business. The management has indicated that it is also in talks with Abbott for couple of new deals.

Developing new relationships with other large innovator companies

DPL's focus on establishing relationships with new customers and reducing its dependence on Solvay has started bearing fruits. It has signed supply contracts with AstraZeneca and is in advanced discussions with large companies like GSK, Novartis, and Johnson & Johnson for potential outsourcing deals.

Besides Solvay, DPL has signed contracts with AstraZeneca…

AstraZeneca - set to become a big customer in the long-term: DPL is likely to emerge as one of the preferred vendors for AstraZeneca. We believe that given AstraZeneca's plans of completely exiting API manufacturing in next 10 years, it could translate into a significant opportunity for DPL.

ASTRAZENECA API OUTSOURCING - POTENTIAL UPSIDES

AstraZeneca's current revenues (US$ b)	33		
COGS (%)	10		
COGS (US$ b)	3.3		
Cost of APIs (US$ b)	1.8		
Outsourced products (% of total) - assumed	80		
Total Outsourcing opportunity @30% cost savings (US$ b)	1.0		
Upside for Dishman Pharma	**Low Case**	**Moderate Case**	**High Case**
Dishman's contribution to AstraZeneca's outsourcing (%)	5	10	15
Sales (US$ m)	51	102	152
Rs/US$ - assuming scale-up by FY14	42	42	42
Sales (Rs m)	2,134	4,269	6,403
PAT Margin (%) - assumed	15	15	15
PAT (Rs m)	320	640	960
Incremental EPS (Rs/sh)	**3.9**	**7.8**	**11.8**

Source: MOSL

Dishman has recently signed an agreement with AstraZeneca for contract manufacturing of 14 APIs (mix of on-patent and off-patent drugs). Dishman has earlier indicated that, in next two to three years, AstraZeneca will become a big customer.

….and is in discussions with GSK, Merck, Eli Lilly and Novartis

Other big customers - looking beyond: In order to reduce its dependence on Solvay, DPL is in discussions with many large innovator companies like GSK, Merck, Eli Lilly, and Novartis for contract manufacturing opportunities. It is also aggressively discussing with many Japanese pharmaceutical companies for potential out-licensing deals.

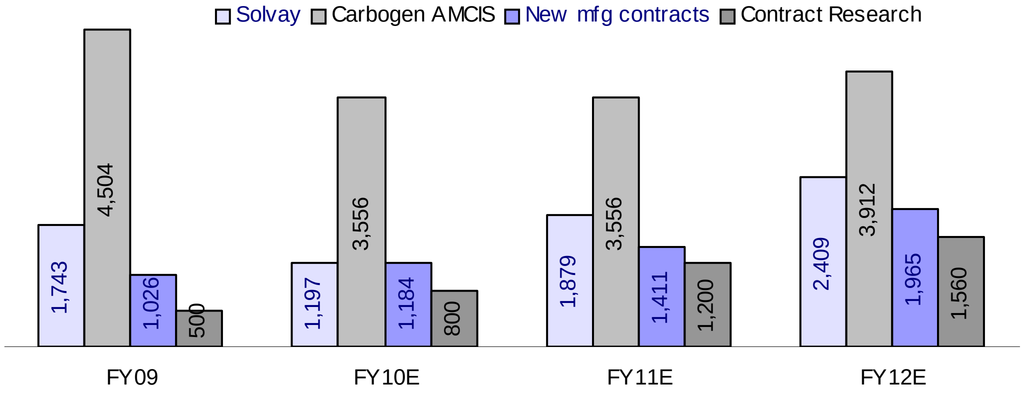
DPL: SNAPSHOT OF MNC RELATIONSHIPS

COMPANY	RELATIONSHIP	COMMENT
Solvay (now Abbott)	Supply of Eprosartan Mesylate and intermediates. Recently signed contract for 3 more products.	Largest customer with contribution of 24% to FY11 CRAMS revenue
AstraZeneca	Signed contract for 14 API/Intermediates	Likely to become as large customer over next few years
Takeda	CCS supplies	Intermediate for a new Phase III drug
Boehringer Ingelheim	Relationship yet to scale-up. Details not disclosed	
GSK	Relationship yet to scale-up. Details not disclosed	
J&J	Relationship yet to scale-up. Details not disclosed	
Novartis	Relationship yet to scale-up. Details not disclosed	
Merck	Relationship yet to scale-up. Details not disclosed	
Nippon	Relationship yet to scale-up. Details not disclosed	
Pharmacin	Relationship yet to scale-up. Details not disclosed	

Source: Company/MOSL

DPL: CRAMS BUSINESS RAMP-UP (RS M)

Except Carbogen AMCIS, all other CRAMS businesses to ramp up



Source: Company/MOSL

Capabilities across value chain

DPL has a presence across the CRAMS value chain and can cater to all the requirements of customers. It has a successful track record of being IPR-compliant, which we believe is the pre-requisite for gaining the trust and confidence of the innovator partner. It is building a new facility for manufacturing high potency APIs - the only one of its kind in India - at an estimated US$25m, which we believe augurs well for future growth.

Ability to offer complete range of CRAMS services

DPL has a presence across the CRAMS value chain

DPL has a presence across the CRAMS value chain and can cater to all the requirements of customers. Apart from providing large-scale manufacturing services from its low-cost Indian operations, DPL is also in a position to meet the contract research requirements of its clients through Carbogen AMCIS, and through its India based contract research operations.

DPL: SNAPSHOT OF CRAMS PRODUCT/SERVICE OFFERING

	CONTRACT MANUFACTURING	CONTRACT RESEARCH	REMARKS
India Operations	Strong capabilities	Scaling up	Needs to expand contract manufacturing relationship with other MNCs
Carbogen AMCIS	Strong capabilities in high potency products	Strong capabilities	Contract research business affected due to reduction in demand from small and mid sized pharma and Biotech customers

Source: MOSL

Track record of IPR compliance

DPL has a successful track record of being IPR-compliant, which we believe is the pre-requisite for gaining the trust and confidence of the innovator partner. This is especially relevant for CRAMS services for on-patent products.

Expanding infrastructure to drive future growth

The CRAMS business requires front-ended investments in creating infrastructure facilities and has a gestation period of 18-24 months post the capex for product registrations/site change filings, etc. DPL is in the process of setting up a high-potency (HIPO) unit and is expanding its existing API facilities in India. It has also invested in setting up a small unit in China.

DPL: RECENT CAPEX

FACILITIES	PURPOSE	INVESTMENT (RS M)	LIKELY COMMERCIALIZATION	PEAK REVENUES EXPECTED (RS M)
High Potency oncology API manufacturing facility in India	To cater to demand from CA customers for high commercial quantities	~1,000	1QFY11	~3,000
China Facility	To diversify manufacturing base	~450	2HFY11	~900
2 API manufacturing units in India	To cater to Fenofibrate and other contracts	~1,500	NA	NA

Source: Company/MOSL

High potency capability augurs well

It is building a new facility for manufacturing high potency APIs, the only one of its kind in India

DPL is building a new facility for manufacturing high potency APIs - the only one of its kind in India - at an estimated capex of US$25m. This facility is set up with the expertise of the Carbogen AMCIS (CA) team and is likely to be 4-5x the size of the existing AMCIS facility. DPL plans to shift a part of the AMCIS manufacturing to this new facility. Many of AMCIS customers have given their consent to this shift of manufacturing since the Indian facility will still be handled by the CA team. This is likely to free-up AMCIS capacities (fully booked as of now) to take up fresh contracts.

Globally, pharmaceutical research trends are shifting in the direction of developing more receptor-specific drugs to improve drug efficacy. Typical examples include drugs in the oncology and hormone related segments. It is estimated that 25-30% of the NCEs in various stages of development can be categorized in the 'Highly Potent' category. This figure is likely to increase significantly over the next 4-5 years to about 50%, as more drugs are added to this category.

Further, in-house investment for high potency drugs proves uneconomic for innovators as, high potency drugs are likely to need high containment environment for manufacturing, implying higher capital cost for such drugs. However, the highly concentrated nature of the drug necessitates low volume requirements (a few kilograms only for clinical quantities), making in-house investment uneconomic for innovators. The need of innovators to access high potency capability opens up a significant opportunity for CRAMS players, in whom the former can take recourse.

Access to a high potency facility is imperative for CRAMS players to service their clients

Second, small/mid-sized pharmaceutical and biotech companies are likely to gain traction in the NCE research space due to their focused approach and specific technical skills. Given their size and availability of resources, these companies are unlikely to invest in high potency manufacturing units, giving rise to compulsory outsourcing of such activity. Hence, having access to a high potency facility has become imperative for CRAMS players to service their clients.

CRAMS - Carbogen AMCIS acquisition gives an edge

DPL acquired Carbogen AMCIS, a Swiss CRAMS company in FY07

DPL's US$75m acquisition of Carbogen AMCIS (CA), a Swiss CRAMS company, in FY07 has given it strategic benefits:

- DPL got a ready set of clients from CA. In the CRAMS business, having a long-term relationship with innovator companies is of prime importance and acquiring a new customer is a time-consuming exercise. This acquisition has helped DPL to develop working relationships with many innovator companies.
- DPL enhanced its offerings in contract research by offering many services of CA to its existing customers. CA brought to the table a whole set of new technologies, mainly manufacturing of high-potency substances such as cytotoxic oncology drugs.
- With the help of the facilities at both Carbogen and AMCIS, DPL will be able to offer the complete range of services (from pre-clinical to commercialization stage) for high potency drugs. While Carbogen has the capability to meet a customer's requirement for the pre-clinical to Phase-II trials stage, AMCIS has the capability to scale up the manufacturing process from Phase-III to the commercialization stage. We believe that CA currently has many customers for whom it has undertaken high potency drug development (details undisclosed); this augurs well for DPL.
- Through its India-based low-cost facilities coupled with CA's capabilities, DPL is now in a position to offer services across the CRAMS value chain, with the added benefit of access to low-cost manufacturing.

CA is currently facing strong headwinds

Carbogen AMCIS' business has recently been impacted adversely

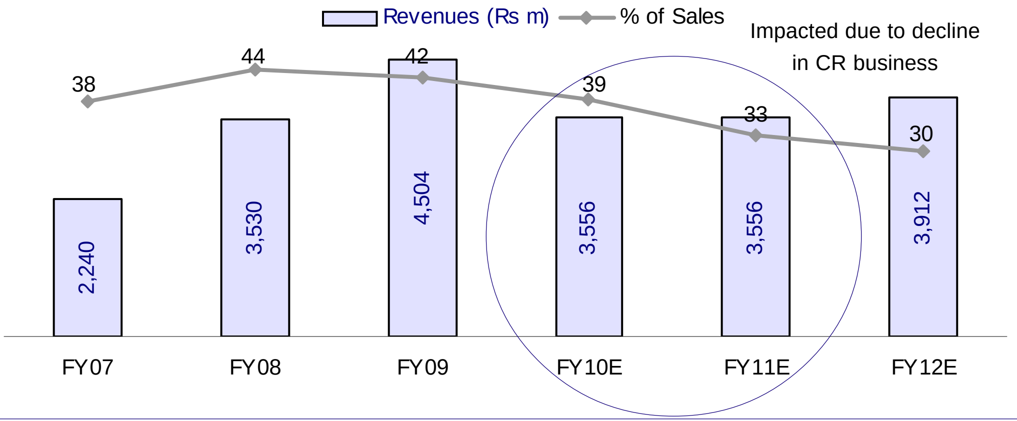
Carbogen AMCIS' business has recently been adversely impacted due to:

- Unavailability of funding to many of its small pharma/biotech customers
- De-growth in one-off businesses, primarily from US customers
- Inventory de-stocking undertaken by some of the large customers
- Innovator companies withdrawing some of their early research projects

Further, recently DPL has removed the CEO of Carbogen AMCIS, Mr Gollens Stepler, and retrenched ~50 people from the total employee base of 385.

In 9MFY10, revenues from Carbogen AMCIS dropped 11% YoY and EBITDA margins declined to ~10% in 3QFY10. In light of the recent developments and financial performance, we believe that the situation at Carbogen AMCIS will take some time to improve. Further, the management has also indicated that the adverse impact is likely to continue for another 2-3 quarters. We expect Carbogen AMCIS to report 21% YoY de-growth in FY10 and flat revenues for FY11, with recovery likely in FY12. Management has guided for 10% YoY growth for Carbogen AMCIS in FY11.

CARBOGEN AMCIS: REVENUE TREND



Source: Company/MOSL

Inventory de-stocking nearing completion; expect bounce-back in FY11

Over the last 4-5 quarters, the performance of the global CRAMS industry has suffered due to:

1. A severe round of inventory de-stocking undertaken by large innovator companies, leading to lower contract manufacturing revenues for CRAMS companies.
2. Post the credit crises of 2008, the mid-sized and small-sized research companies faced a liquidity crunch, resulting in a cut-down in many of the research projects undertaken by them. This has partly impacted custom synthesis contracts for the CRAMS players.

In-line with the global industry trend, DPL's CRAMS business was also adversely impacted. However, we believe that this is likely to reverse in FY11 due to:

However, we expect a bounce-back in FY11

1. **Pharma demand continues to grow:** The overall end-consumer demand for pharmaceutical products continues to grow steadily. Inventory de-stocking will ultimately get aligned with demand, post which the innovators will have to commence outsourcing again. We believe that this reversal is likely to be visible partly in FY11 and fully by FY12.
2. **Credit situation is gradually improving:** While the mid and small-sized research companies continue to face funding issues, we note that over the past few quarters, the global credit situation is improving gradually. This will eventually open up the funding channels for these companies. Hence, while the custom synthesis business from such companies is currently under pressure, we expect a gradual improvement over the next two years.

Like all other CRAMS companies, DPL's CRAMS business faced some headwinds in FY10 due to the global inventory de-stocking undertaken by customers. The de-stocking started in 3QFY09 and impacted demand for CRAMS companies.

For 9MFY10, DPL's overall CRAMS business de-grew by 11% YoY to Rs4.9b. The business was down due to a 60% YoY de-growth in Solvay supplies (from Indian manufacturing facilities) to Rs630m while CA revenues fell 11% YoY to Rs2.74b due to reasons discussed above. New contract revenues (including contract research) have grown by 80% (on a low base) to Rs1.54b.

DPL: IMPACT ON CRAMS SUPPLIES

	9MFY10	9MFY09	CHANGE (%)
Revenue (Rs m)			
Solvay	630	1,563	(59.7)
Other Manufacturing & Research Contracts	1,539	856	79.9
Carbogen AMCIS	2,738	3,085	(11.2)
Total CRAMS	**4,907**	**5,504**	**(10.8)**

Source: Company

Other businesses

QUATS - low margin cyclical business

DPL produces a broad basket of QUATS, which is used as a catalyst to transfer a reactant from one phase to another. QUATS is a commoditized business and earns low margins. The revenue contribution of this business has declined from 60% in FY05 to ~12%. Though the contribution of this business is currently meaningful to DPL's revenues, it is unlikely to be a focus area for the company, going forward. DPL is not planning to invest further capital in this business. In 9MFY10, revenue from the QUATS business has dropped 40% due to sharp fall in the prices. We expect a nominal annual growth of 5% for this business, going forward.

Vitamin-D business - remains a stable profit contributor

DPL acquired Solvay's vitamin-D business in July 2007 for •12m (including working capital of •7.5m), valuing the business at 1x FY07 revenues and 2x FY07 EBIT. Since acquisition, this business has reported steady growth and healthy profitability for DPL. The company has reported a growth of 13% YoY in revenues from this business to Rs925m in 9MFY10.

DPL is in the process of expanding this business. Recently, it inaugurated a large vitamin-D analogue facility in Netherlands, with 3x existing capacity. It has developed three more vitamin-D analogues and expects good growth, going forward.

3QFY10 performance has been disappointing

DPL's 3QFY10 performance has been disappointing

DPL reported disappointing 3QFY10 results, with revenue decline of 21% YoY to Rs2.2b and PAT decline of 19% YoY to Rs321m, primarily due to the impact of de-stocking and poor performance of its subsidiary, Carbogen AMCIS.

- CRAMS revenue declined 16% YoY to Rs1.6b (72% contribution to revenues) mainly due to a 41% YoY drop in the revenues of Carbogen AMCIS to Rs670m. Revenues declined primarily due to loss of early stage and preclinical business from small pharma and biotech companies, impacted by unavailability of funding.

- CRAMS revenues ex-Carbogen grew 21% YoY to Rs938m. Lower supplies to Solvay (not quantified) were compensated by contract research business from other customers. The MM business declined 33% YoY to Rs616m, led by a fall of 48% YoY in the QUATS segment due to lower volumes and price declines.

- EBITDA declined by 18% YoY to Rs513m while EBITDA margin contracted 70bp YoY to 23.1% due to a ~900bp reduction in the margins of Carbogen AMCIS to ~10% and an appreciating rupee. PAT fell 19% YoY to Rs321m and was partially boosted by lower depreciation and interest cost.

QUARTERLY PERFORMANCE (CONSOLIDATED) (RS MILLION)

Y/E MARCH	FY09				FY10				FY09	FY10E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Sales	**2,359**	**2,520**	**2,820**	**2,925**	**2,277**	**2,174**	**2,223**	**2,397**	**10,624**	**9,072**
YoY Change (%)	*40.4*	*35.1*	*36.5*	*20.9*	*-3.5*	*-13.7*	*-21.2*	*-18.0*	*32.3*	*-14.6*
Total Expenditure	1,696	2,022	2,102	2,189	1,745	1,677	1,710	1,935	8,009	7,066
EBITDA	**663**	**498**	**717**	**736**	**532**	**498**	**513**	**463**	**2,615**	**2,006**
Margins (%)	*28.1*	*19.8*	*25.4*	*25.2*	*23.4*	*22.9*	*23.1*	*19.3*	*24.6*	*22.1*
Depreciation	144	139	170	175	145	174	141	179	629	639
Interest	93	87	101	178	104	99	85	98	459	386
Other Income	-141	-235	51	373	155	59	32	43	48	288
PBT after EO Income	**277**	**37**	**497**	**756**	**438**	**284**	**319**	**228**	**1,575**	**1,269**
Tax	3	17	31	-6	9	25	30	24	45	89
Deferred Tax	5	-10	69	3	37	14	-32	19	66	38
Rate (%)	*2.7*	*20.0*	*20.1*	*-0.4*	*10.5*	*14.0*	*-0.6*	*18.8*	*7.1*	*10.0*
Adj PAT	**277**	**30**	**397**	**759**	**392**	**244**	**321**	**185**	**1,463**	**1,142**
YoY Change (%)	*29.5*	*-89.5*	*24.0*	*90.1*	*41.5*	*725.7*	*-19.3*	*-75.6*	*20.4*	*-21.9*
Margins (%)	*11.7*	*1.2*	*14.1*	*25.9*	*17.2*	*11.2*	*14.4*	*7.7*	*13.8*	*12.6*

E: MOSL Estimates

Guides revenue and PAT decline in FY10; FY11 topline growth of 20-25%

In light of the adverse impact on CA's recent performance, the management has guided 5-11% decline in revenues to Rs9.5b-10b and 11-14% drop in PAT to Rs1.25b-1.3b for FY10. However, it expects revenues to grow 20-25% in FY11. We have estimated revenues of Rs9.1b and PAT of Rs1.14b for FY10. The company has guided capex of Rs1.25b for each of FY10 and FY11 each and tax rate at ~10%. Further, the management expects significant revenue ramp up beginning FY12.

Management has guided decline in revenue and PAT in FY10, but expects 20-25% revenue growth in FY11

GUIDANCE FOR FY11E

PARAMETER	GUIDANCE	REMARKS
Overall Sales Growth (%)	20	We forecast FY11 growth at 18% due to flat revenue at CA. Company expects FY10 revenue at Rs9.5-10b. We estimate FY10 revenues at Rs9.1b due to slowdown in revenues at CA
Revenue from Solvay (Rs b)	1.8	Resumption of EM supplies along with Fenofibrate and 2 more product supplies will drive the growth. FY10 Revenue is expected at Rs1.2b
Carbogen AMCIS Revenue Growth (%)	10	We estimate revenues to remain flat because of subdued performance for contract research business to continue till 2QFY11. Company expects revenues of CHF 80-85m for FY10 where as our revenue expectation for FY10 is CHF 79m
Contract Research Revenue (Rs b)	1.2	FY10 contract research revenues are expected at Rs800m implying 50% growth for FY11
Overall EBITDA Margins (%)	24-25	We estimate EBITDA margins to stay flat at 23.2% (ex- one time charge incurred at CA in FY10) due to pressure on CA's profitability which will be partially offset by employee cost savings of CHF 8m at CA FY11 onwards. We expect FY10 EBITDA margins at 22.1%. Company includes Other Income in EBITDA guidance
Carbogen EBITDA Margins (%)	18	Company expects FY10 EBITDA margins at 12% due to sharp fall in contract research business
Capex (Rs b)	1.25-1.5	2 new API units are coming up at Bavla. FY10 capex is estimated at Rs1.25b
D/E	1x	We estimate FY10 D/E at 1x. Company to raise additional Rs750b through NCDs to part-fund capex
PAT Growth (%)	20	We expect PAT growth of 9.9% for FY11. Company expects FY10 PAT at Rs1.25-1.3b while we estimate it at Rs1.14b

Source: Company/MOSL

SALES MIX (RS M)

	FY08	FY09	FY10E	FY11E	FY12E
CRAMS	6,016	7,774	6,737	8,046	9,845
Dishman	2,486	3,270	3,181	4,490	5,934
Carbogen AMCIS	3,530	4,504	3,556	3,556	3,912
MM	2,015	2,850	2,334	2,682	3,022
Vitamin-D	330	1,097	1,239	1,338	1,445
QUATs	1,685	1,753	1,095	1,344	1,577
Total	**8,031**	**10,624**	**9,072**	**10,728**	**12,867**

Source: Company/MOSL

Valuation and outlook

The key factors that we believe will determine DPL's future valuations include:

1. Scale up in the Solvay contract (Fenofibrates and EM)
2. Successful expansion of customer base (AstraZeneca, GSK, etc) to de-risk dependence on Solvay
3. Successful ramp-up of HIPO facility

From merely a supplier of chemicals, DPL has transformed into a supplier of APIs and intermediates

Over the past few years, the company has transitioned from being merely a supplier of chemicals (mainly QUATS, an ammonium compound, and intermediates) to a supplier of APIs and intermediates.

It has been able to achieve this capability by (1) signing up for a higher number of API supply contracts and, (2) via acquisition of Carbogen AMCIS (CA). This acquisition has transformed DPL's business mix and has filled a large gap in its CRAMS offering.

We estimate 15-16% earnings CAGR over FY10-12

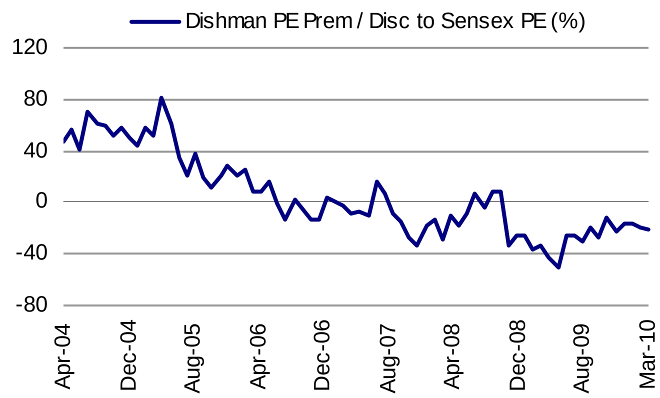
We estimate 15-16% earnings CAGR over FY10-12. While supplies to new customers will scale up over the next two years, this will be tempered down by loss of business at CA (contributes ~40% to overall revenues) and increase in depreciation and interest expenses due to two new manufacturing facilities coming on stream.

The macro environment for the CRAMS business remains favorable given India's inherent cost advantages and chemistry skills. We believe that DPL will benefit from increased outsourcing from India, given its strengthening MNC relations. However, the adverse business environment for Carbogen will continue to impact earnings in FY10-11.

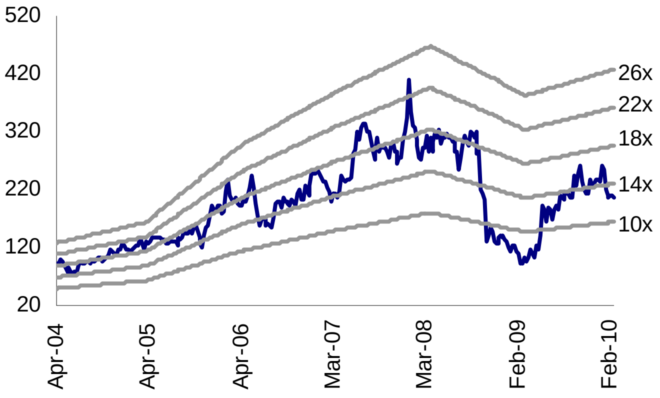
Re-initiating coverage with Neutral

We expect DPL to record a CAGR of 19% in revenues, 24% in EBITDA and 15.6% in EPS over FY10-12, led mainly by its Indian CRAMS operations. Earnings growth will be adversely impacted due to higher depreciation and taxes, and lower other income. The stock currently trades at 13.4x FY11E and 11.1x FY12E earnings. RoE will continue to be at 15% till new facilities and CRAMS contracts ramp up. We re-initiate coverage, with a **Neutral** rating and a price target of Rs225 (12x FY12E earnings) - a 8% upside.

P/E BANDS



RELATIVE P/E TO SENSEX P/E BAND



Source: MOSL

Key risks

Consolidation: The global pharmaceutical industry is at the throes of significant consolidation with large mergers (to increase size and gain scale) like Pfizer-Wyeth, Abbott's acquisition of Solvay's pharma business, etc and acquisition of smaller R&D companies (to strengthen R&D pipelines). We view this as a risk to the global CRAMS industry, as consolidation amongst customers may lead to loss of business. In fact, consolidation has been the chief reason for the significant decline in fortunes of CRAMS players some years ago.

Execution risks in CRAMS business and inability to fully utilize large capacities of acquired companies: One of the key risks is execution of large contracts. The reputation and subsequent business for CRAMS companies largely depend upon execution of the contracts in terms of quality, timeliness, supply chain management. Any failure in these aspects may lead to loss of further business. Also, the CRAMS business requires front-ended investments. Hence, there is risk of capacities remaining idle for a long time, which may bring down profitability and return ratios of the company.

Financials and Valuation

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Net Sales	**8,031**	**10,624**	**9,072**	**10,728**	**12,867**
Change (%)	*38.8*	*32.3*	*-14.6*	*18.3*	*19.9*
Total Expenditure	6,502	8,009	7,066	8,244	9,766
% of Sales	*81.0*	*75.4*	*77.9*	*76.8*	*75.9*
EBITDA	**1,529**	**2,615**	**2,006**	**2,484**	**3,101**
Margin (%)	*19.0*	*24.6*	*22.1*	*23.2*	*24.1*
Depreciation	472	629	639	810	889
EBIT	**1,057**	**1,985**	**1,367**	**1,673**	**2,212**
Int. and Finance Charges	305	459	386	449	498
Other Income - Rec.	477	48	288	170	60
PBT	**1,228**	**1,575**	**1,269**	**1,395**	**1,774**
Current Tax	70	45	89	98	177
Deferred Tax	-57	66	38	42	71
Tax Rate (%)	*1.1*	*7.1*	*10.0*	*10.0*	*14.0*
Reported PAT	**1,215**	**1,463**	**1,142**	**1,255**	**1,526**
PAT Adj for EO Items	**1,215**	**1,463**	**1,142**	**1,255**	**1,526**
Change (%)	*31.0*	*20.4*	*-21.9*	*9.9*	*21.5*
Margin (%)	*15.1*	*13.8*	*12.6*	*11.7*	*11.9*

BALANCE SHEET (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Equity Share Capital	159	161	161	161	161
Fully Diluted Equity Capital	163	163	163	163	163
Total Reserves	5,575	6,981	8,010	9,114	10,457
Net Worth	**5,735**	**7,143**	**8,171**	**9,276**	**10,618**
Deferred Liabilities	149	208	246	288	288
Total Loans	6,580	7,237	8,036	8,160	8,297
Capital Employed	**12,464**	**14,588**	**16,454**	**17,724**	**19,203**
Gross Block	6,443	7,979	9,279	10,529	11,529
Less: Accum. Deprn.	1,118	1,953	2,591	3,402	3,402
Net Fixed Assets	**5,325**	**6,027**	**6,688**	**7,128**	**8,128**
Capital WIP	1,485	2,227	2,227	2,227	2,227
Investments	13	14	14	14	14
Goodwill	1,520	1,754	1,754	1,754	1,754
Curr. Assets	**6,587**	**6,850**	**7,796**	**8,963**	**9,907**
Inventory	3,047	3,040	2,903	3,218	3,603
Account Receivables	2,042	1,494	1,542	1,931	2,445
Cash and Bank Balance	371	452	1,355	1,668	1,672
Loans & Advances	1,127	1,865	1,996	2,146	2,187
Curr. Liability & Prov.	**2,472**	**2,284**	**2,026**	**2,362**	**2,827**
Account Payables	1,959	1,588	1,361	1,609	1,930
Provisions	513	696	665	753	897
Net Current Assets	**4,115**	**4,566**	**5,770**	**6,601**	**7,080**
Appl. of Funds	**12,464**	**14,588**	**16,454**	**17,724**	**19,203**

E: MOSL Estimates

RATIOS

Y/E MARCH	2008	2009	2010E	2011E	2012E
Basic (Rs)					
EPS (fully diluted)	**15.0**	**18.0**	**14.1**	**15.4**	**18.8**
Cash EPS (fully diluted)	20.8	25.7	21.9	25.4	29.7
BV/Share	71.9	88.5	101.3	114.9	131.6
DPS	1.0	1.2	1.2	1.6	1.9
Payout (%)	7.8	7.7	10.0	12.0	12.0
Valuation (x)					
P/E (fully diluted)	13.9	11.6	14.8	13.5	11.1
Cash P/E (fully diluted)	10.0	8.1	9.5	8.2	7.0
P/BV	2.9	2.3	2.1	1.8	1.6
EV/Sales	2.9	2.2	2.6	2.2	1.8
EV/EBITDA	15.1	9.1	11.8	9.4	7.6
Dividend Yield (%)	0.5	0.6	0.6	0.8	0.9
Return Ratios (%)					
RoE	27.3	22.7	14.9	14.4	15.3
RoCE	14.5	15.2	10.8	11.0	12.5
Working Capital Ratios					
Fixed Asset Turnover (x)	1.7	1.9	1.4	1.6	1.7
Debtor (Days)	92	51	61	65	69
Inventory (Days)	139	104	117	110	102
Working Cap. T/O (Days)	170	141	178	168	153
Leverage Ratio (x)					
Current Ratio	2.7	3.0	3.8	3.8	3.5
Debt/Equity	1.1	1.0	1.0	0.9	0.8

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
OP/(Loss) before Tax	1,529	2,615	2,006	2,484	3,101
Interest/Dividends Recd.	477	48	288	170	60
Direct Taxes Paid	-70	-45	-89	-98	-177
(Inc)/Dec in WC	-1,382	-371	-301	-517	-475
CF from Operations	**553**	**2,246**	**1,904**	**2,039**	**2,508**
CF fr. Oper. incl EO Exp.	**553**	**2,246**	**1,904**	**2,039**	**2,508**
(inc)/dec in FA	-2,718	-2,514	-1,300	-1,250	-1,000
(Pur)/Sale of Invest	127	-1	0	0	0
CF from Invest.	**-2,591**	**-2,514**	**-1,300**	**-1,250**	**-1,000**
Issue of Shares	15	2	0	0	0
(Inc)/Dec in Debt	970	657	799	124	137
Interest Paid	-305	-459	-386	-449	-498
Dividend Paid	-94	-113	-114	-151	-183
Others	1,468	261	0	0	-960
CF from Fin. Activity	**2,053**	**348**	**299**	**-475**	**-1,504**
Inc/Dec of Cash	**16**	**81**	**903**	**313**	**4**
Add: Beginning Balance	355	371	452	1,355	1,668
Closing Balance	**371**	**451**	**1,355**	**1,668**	**1,672**

Jubilant Organosys

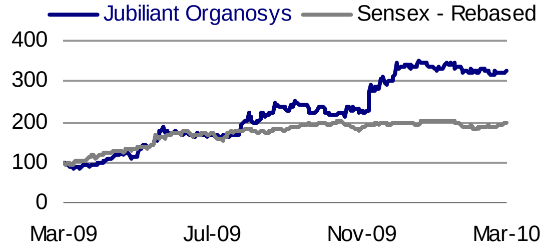
STOCK INFO.	BLOOMBERG
BSE Sensex: 16,972	JOL IN
	REUTERS CODE
S&P CNX: 5,080	JUBO.BO

Y/E MARCH	2009	2010E	2011E	2012E
Net Sales (Rs m)	35,180	37,687	43,134	48,803
EBITDA (Rs m)	6,766	7,669	9,038	10,385
Adj. NP (Rs m)	2,832	3,048	2,739	4,684
EPS (Rs)	19.2	20.7	18.6	31.7
EPS Growth (%)	-27.2	7.6	-10.1	71.0
BV/Share (Rs)	85.9	106.0	129.2	140.5
P/E (x)	16.9	15.7	17.4	10.2
P/BV (x)	3.8	3.1	2.5	2.3
EV/EBITDA (x)	12.2	10.6	8.7	7.6
EV/Sales (x)	2.4	2.2	1.8	1.6
RoE (%)	18.6	27.3	26.3	24.8
RoCE (%)	8.2	12.2	13.4	14.9

KEY FINANCIALS	
Shares Outstanding (m)	147.5
Market Cap. (Rs b)	47.8
Market Cap. (US$b)	1.0
Past 3 years Sales Growth (%)	32.9
Past 3 years NP Growth (%)	29.7
Dividend Payout (%)	9.2
Dividend Yield (%)	0.5

STOCK DATA	
52-W High/Low Range (Rs)	365/85
Major Shareholders (as of December 2009)	(%)
Promoter	50.8
Domestic Inst	2.0
Foreign	26.0
Others	21.2
Average Daily Turnover	
Volume ('000 shares)	279.1
Value (Rs million)	58.3
1/6/12 Month Rel. Performance (%)	-3/27/131
1/6/12 Month Abs. Performance (%)	1/36/232

STOCK PERFORMANCE (1 YEAR)



8 March 2010

Neutral

Previous Recommendation: Buy

Rs324

Well positioned to exploit CRAMS opportunity: Jubilant is one of the few CRAMS companies in India that can offer end-to-end services to its customers. Further, its presence in the niche area of contract manufacturing of sterile products gives it an edge. We believe that Jubilant is well placed to exploit the increasing outsourcing from India.

Inventory de-stocking coming to an end; to witness growth FY11 onwards: Like most of the CRAMS companies worldwide, Jubilant's FY10 CRAMS performance has been impacted by customer inventory de-stocking and tight liquidity. However, we believe that the situation is likely to reverse in FY11, with inventory de-stocking getting over and growing end-consumer demand for pharmaceutical products.

Acquisitions give an edge, but payback periods could be extended: Jubilant's acquisition of Hollister Stier in June 2007 and Draxis Healthcare in May 2008 have given it a strong presence in the sterile and non-sterile contract manufacturing space in North America. However, we believe that the consideration paid by Jubilant for these acquisitions was high (particularly the US$255m paid for Draxis) and the payback periods could be extended.

Focus on core business imperative: Apart from CRAMS, Jubilant is also present in various other businesses like generics, agri-products, performance polymers, industrial chemicals, etc. We believe that it needs to focus on its core business of CRAMS. Recently, Jubilant has decided to de-merge its agri and performance polymer business, and list it separately. This is a positive step, in our opinion.

High debt, FCCB redemption remains an overhang: We believe that outstanding FCCBs worth US192m (US$271m including YTM) which are due to redemption in 2010-11 are unlikely to get converted into equity. The redemption will need to be partly funded by incremental debt and/or equity. Overall D/E of over 2x for FY10E is on the higher side, making it imperative to raise equity funding.

Expect 24% earnings CAGR: We believe that Jubilant will benefit from the increased outsourcing from India, given its relationships with global pharmaceutical and agrochemical players. We estimate 14% revenue and 13% EPS CAGR over FY10-12 on reported basis. Adjusted EPS is likely to record 24% CAGR. FCCB redemption, high debt and lower return ratios will remain an overhang. We downgrade our recommendation to **Neutral**, with a target price of Rs350.

Well-placed to exploit CRAMS opportunity

Jubilant Organosys is well placed to benefit from the expected increase in outsourcing from India. It has a strong presence in contract manufacturing and is gradually strengthening its presence in the contract research segment. Its presence in the niche area of contract manufacturing of sterile products also gives it an edge.

An early entrant in the CRAMS space…

An early entrant: Jubilant is an early entrant in the CRAMS business, which gives it an edge, as the business has a long gestation period. Over the years, the company has transformed itself from a mere chemicals manufacturer to a full-fledged CRAMS player. Jubilant is likely to benefit more than the recent entrants, as this business requires many years to establish relationships with innovator companies and has large entry barriers.

…with presence in the niche area of sterile products…

Offers sterile injectables contract manufacturing services: Jubilant has established its presence in the niche and high entry barrier segment of sterile contract manufacturing through the Hollister and Draxis acquisitions in North America. It is now the largest Indian CRAMS company in the injectables space.

…and the ability to offer one-stop services

Presence across value chain makes it a partner of choice: Jubilant has established its presence across the CRAMS business value chain. It provides contract research services to its customers through its three subsidiaries - Jubilant Biosys, Jubilant Chemsys and Clinsys Clinical Research. Further, Jubilant has a presence in the custom synthesis and API manufacturing segments. It is also present in the dosage form manufacturing segment through acquisitions. Due to its presence across the value chain, Jubilant is able to offer one-stop services to innovator companies. Hence, it could emerge as a partner of choice for innovator pharmaceutical companies, going forward.

Well placed to leverage strong customer relationships

To benefit from strong customer relationships: Jubilant has strong relationships with various pharmaceutical and agrochemicals companies. It has been one of the largest suppliers of various intermediates and chemicals like Pyridines to these companies for several years. We believe that Jubilant is well-placed to leverage these long-standing relationships with MNCs to grow its CRAMS business.

Advantageously located manufacturing facilities: Jubilant has a geographically diversified manufacturing base. Through the acquisition of Draxis and Hollister Stier, it has established manufacturing facilities in North America. This is likely to give Jubilant an advantage, as innovators prefer proximity to the contract manufacturer in case of formulation contracts. Further, Jubilant can offer large scale API and intermediates from low cost destinations like India.

Acquisitions give edge, critical capabilities and customers, but are expensive

Jubilant has expanded its presence in the CRAMS and pharmaceutical segments largely through various acquisitions in India and overseas. It has entered APIs, generic dosages, specialty pharma, sterile CMO, and the clinical trials space through the inorganic route. Some of its acquisitions have given Jubilant critical capabilities and customers.

JUBILANT: DETAILS OF ACQUISITIONS

YEAR	ACQUIRED COMPANY	SEGMENT	COUNTRY	CONSIDERATION	EV/EBITDA (X)	RATIONALE
Sep-02	API business of Max India	API	India	~Rs690m	-	Natural extension of company's specialty chemical business
Apr-04	PSI	Generics	Belgium	~Rs750m	6.0	Establish presence in Pharma business in Europe
Jul-05	Trinity Lab	Generics	US	US$20m	-	To enter US generic business
Oct-05	Target Research Associates	Clinical Research	US	US$33.5m	-	To enter CRO space
Apr-07	Hollister Stier	CMO	US	US$180.5m	12.6	To enter fast growing contract injectables manufacturing segment
Apr-08	Draxis Health	CMO	Canada	US$255m	12.0	Entry into radiopharmaceutical market and To consolidate position in sterile and non-sterile CM business
May-08	Specialty Molecules	Pyridines	India	Rs200m	-	To strengthen global leadership position in Pyridine derivatives segment

Source: Company/MOSL

Hollister-Stier acquisition - gives access to sterile capabilities, important customers

Gained access to sterile capabilities through acquisition of Hollister-Stier…

Hollister has a presence in both the CRAMS and the generics space in the US. It is a leading contract manufacturer of sterile injectable vials and lyophilized products in the US. It is also one of the world's top producers of allergenic extracts and has about 38 customers spread across the innovator and generic pharmaceutical space. The injectables space has relatively higher entry barriers in the form of complex manufacturing processes, stringent regulatory compliance and higher capital investments.

Jubilant acquired Hollister-Stier for US$180.5m (US$122.5m in cash plus capex funding of US$58m) in April 2007, funded by a combination of existing cash and debt. The deal valued Hollister at 2.5x CY06 sales and 12.6x CY06 EBITDA.

At the time of acquisition, Hollister was in the process of trebling its steriles capacity from 48m vials to 120m vials. The acquisition was completed in 4QFY08. We expect a significant ramp-up in Hollister's capacity utilization in the coming years, as a significant part of the capacity has already been booked by customers.

Draxis acquisition - gives access to radiopharmaceuticals, important customers

Draxis has a presence in radiopharmaceuticals, CRAMS and generics. About 33% of its revenues come from the high-margin radiopharmaceuticals segment. The acquisition marks Jubilant's entry into the radiopharmaceuticals business. Draxis' operations are based in Canada, with majority of its revenues coming from its US-based customers. Jubilant funded this acquisition through a combination of cash available and debt.

…and to radiopharmaceuticals through Draxis acquisition

At 12x CY08 EV/EBITDA and 7.6x CY09 EV/EBITDA (net of cash), we believe that it was an expensive acquisition and might have an extended payback period.

Before its acquisition by Jubilant, Draxis reported revenues of US$79m (down 8%) for CY07, normalized EBITDA of US$10m (down 41%) and PAT of US$1.6m (down 86%). Performance was adversely impacted by appreciation of the Canadian dollar against the US dollar. Lower sales of sterile contract manufacturing products, shortages of medical isotopes, temporary suspension of production at one customer, and loss of Anipryl deferred revenues also impacted performance. Most of these have been corrected, but shortage of medical isotopes continues to impact Draxis' performance.

Some acquisitions have been made in unrelated areas

We believe the Draxis acquisition is in an unrelated area

Hollister and Draxis are the biggest acquisitions in Jubilant's history and have resulted in a significant increase in debt. The acquisition of Hollister gives Jubilant a strong presence in contract manufacturing of injectables (a high-margin opportunity), with ready demand. The Draxis acquisition gives Jubilant a strong presence in the radiopharma business, but is an unrelated diversification. The customers for the radiopharma business include diagnostic and imaging companies, and not pharmaceutical companies. Also, Jubilant does not have any in-house strength in the manufacture of radiopharma products. Shortage of radioactive isotopes continues to adversely impact Draxis' radiopharma business due to non-availability of adequate quantities of raw material.

Contract research - scaling up

Jubilant offers contract research services through its three subsidiaries

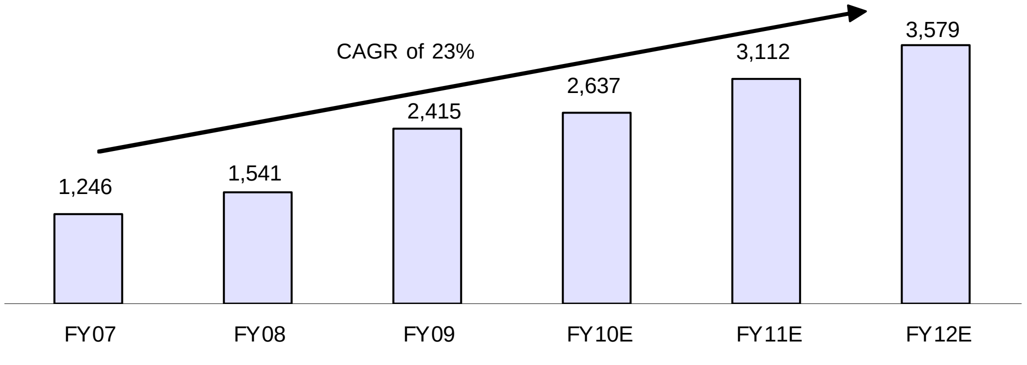
Jubilant offers knowledge based and informatics solutions for chemistry-based drug discovery and development services ranging from early-stage lead discovery and optimization to pre-clinical and clinical studies. Its contract research services are offered through various subsidiaries, namely:

1. **Jubilant Biosys:** It provides bio/chemo informatics databases for target identification and lead generation to discovery pharmaceutical and biotech companies. The company is working on projects for customers like Eli Lilly, Forest Labs, AstraZeneca and Amgen, and is likely to witness a ramp-up in business, as new contracts come into execution.

2. **Jubilant Chemsys:** A 100% subsidiary, Jubilant Chemsys offers custom chemical synthesis (CCS) services to global pharmaceutical and biotech companies on molecule deliverable and FTE basis.

3. **Clinsys Clinical Research:** Jubilant Clinsys, a 100% subsidiary, conducts bioavailability, bioequivalence, pharmacokinetic, phase-I studies and project management, monitoring and data management for clinical phase II-IV studies. It has a 54-bed facility spread over nearly 35,000 square feet in Noida. It also has a presence in the US, providing services to leading global pharmaceutical and biotech companies.

JUBILANT: RAMP-UP IN CONTRACT RESEARCH REVENUES (RS M)



Source: Company/MOSL

CRAMS business - expect 18% CAGR

We expect CRAMS business revenues to grow at 18% CAGR over FY09-12

We estimate 18% CAGR in Jubilant's CRAMS business revenues over FY09-12, led mainly by a recovery in the Proprietary Products and Drug Discovery business (beginning from FY11), and continued growth momentum in the sterile contract manufacturing business.

JUBILANT: CRAMS RAMP-UP

REVENUES (RS M)	FY07	FY08	FY09	FY10E	FY11E	FY12E
Proprietary Products & Exclusive Synthesis	5,558	8,387	10,262	10,262	12,314	14,408
Growth (%)			*22.4*	*0.0*	*20.0*	*17.0*
API	1,488	1,867	2,550	2,448	2,815	3,153
Growth (%)			*36.6*	*-4.0*	*15.0*	*12.0*
CMO of Sterile & Non-sterile Products	0	2,050	4,895	6,021	7,225	8,526
Growth (%)			*138.8*	*23.0*	*20.0*	*18.0*
Contract Research (DDDS)	1,246	1,541	2,415	2,637	3,112	3,579
Growth (%)			*56.7*	*9.2*	*18.0*	*15.0*
Total CRAMS	**8,292**	**13,845**	**20,122**	**21,368**	**25,466**	**29,665**
Growth (%)			*45.3*	*6.2*	*19.2*	*16.5*
Total CRAMS (excl APIs)	**6,804**	**11,978**	**17,572**	**18,920**	**22,651**	**26,512**
Growth (%)			*46.7*	*7.7*	*19.7*	*17.0*

Note: Company classifies generic API supplies under CRAMS *Source: Company/MOSL*

Inventory de-stocking impacted CRAMS business in FY10

Inventory de-stocking had impacted the CRAMS business in FY10…

Jubilant's API business was impacted by inventory de-stocking by customers in FY10. Its contract research business also suffered. We believe that the key reasons for this adverse impact were:

- Innovator pharmaceutical companies were in an inventory reduction mode. To the extent of supplies to such companies, Jubilant's supplies were also impacted.
- Tight liquidity also affected the mid-sized and small-sized research companies, resulting in a cut-down in many of the research projects undertaken by them. This partly impacted custom synthesis contracts for the CRAMS players.

However, we believe that the situation is likely to reverse in FY11 due to:

…but we expect a bounce-back in FY11

- We believe that majority of the inventories with customers are now aligned to the overall end-consumer demand and that the inventory reductions are near to completion. We expect supplies to gradually pick up from FY11.
- Over the past few quarters, the global credit situation is improving gradually. This will eventually open up the funding channels for mid-sized and small pharmaceutical companies. Hence, while the custom synthesis business from such companies is, as of now, under pressure, we expect a gradual improvement over the next two years.

Focus on core business imperative

Apart from CRAMS, Jubilant is also present in various other businesses. It derives ~40% of its revenues from businesses other than CRAMS and API manufacturing. We present below an overview of its various businesses.

JUBILANT: OVERVIEW OF VARIOUS BUSINESS SEGMENTS

BUSINESS SEGMENTS	DESCRIPTION
CRAMS Business Segments	
Proprietary Products and Exclusive Synthesis	Pyridines and its derivatives used as building block for many drugs and agrochemicals, Exclusive Synthesis, Intermediates
API	Generic APIs
CMO of sterile injectables & non-sterile products	Contract manufacturing of sterile injectables and non-sterile products
Drug discovery and development services	Biology, Chemistry and Clinical research
Other Business Segments	
Pharmaceutical product segment	
Specialty Pharmaceuticals	Radiopharmaceuticals and Allergenic extracts
Generics	Generics in regulated markets
Life Science Chemicals	
Acetyls	Acetyls used in Textile, Pharma, Agrochemicals, Paints, Adhesive, Packaging industries
Specialty Gases	CO2 used in Food and Beverage industry, Horticulture and Agriculture Industry, ETO used in sterilization of medical equipments etc
Nutrition Ingredients	Makes Vitamins B3, B4, Enzymes used in Feed, Food, Pharma and Personal care industry
Healthcare	Hospitals
Agri Products	
SSP	Fertilizers
Agro chemicals	Crop nutrition, Crop protection chemicals
Performance Polymers	
Consumer Products	Woodworking solutions, Footwear adhesives etc
Application Polymers	Used in Construction chemicals, Paints, Textile industry
Food Polymers	Food industry particularly used in Bubble Gums
Latex Business	Used in Tyre and Conveyor belt industry

Source: Company/MOSL

We believe that Jubilant needs to have a focused business approach. Currently, it is one of the largest players in various chemical segments. Businesses like agri-products and performance polymers are non-related and have different economics. Further, apart from having presence in the chemicals industry, Jubilant is present in both the CRAMS and generic segments in the pharmaceuticals business. It has recently forayed into hospitals (although the investment required for this will be small). We believe that businesses like hospitals and generic dosage form do not fit in Jubilant's overall business profile as a CRAMS player.

De-merger of APP business to enhance focus

Has announced the de-merger of agri-products and performance polymers business

Recently, Jubilant has announced a de-merger of its agri-products and performance polymers (APP) business into a separate listed entity to enhance focus on the pharma and life sciences segments. This is a good step considering that both businesses require different approach and enjoy different economics. Even within the pharma and life sciences segment, Jubilant should focus on CRAMS and related businesses rather than having presence in entirely different business segments like hospitals and generics.

APP is a commodity business, with low margins. It reported 28% decline in the revenues in 9MFY10 on account of lower commodity prices globally, lower volumes, reduction in prices of fertilizers and product rationalization in application polymer business.

3QFY10 performance review

Jubilant's 3QFY10 operational performance was better than we had expected.

Highlights

- Topline grew by a moderate 5.7% YoY to Rs9.6b (v/s our estimate of Rs10.3b) impacted by 31% YoY decline in the agri and performance polymer (APP) revenues to Rs1b. The fall in APP revenues was primarily due to 51% YoY decline in fertilizer business revenues.
- Pharma and life sciences products and services (PLSPS) business reported revenue growth of 13% YoY to Rs8.6b (89% of overall revenues). Growth in PLSPS business was primarily led by the CMO and life science chemical segments, which grew 22% YoY to Rs1.7b and 24% YoY to Rs1.6b, respectively, on the back of new contracts and improved market conditions.
- EBITDA grew 60% YoY to Rs2.3b and was higher than our estimate of Rs1.9b. EBITDA margin expanded 790bp to 23.4% - higher than our estimate of 18.6% due to low base, better revenue mix and 61% YoY drop in SG&A expenses due to operational forex gains of Rs250m.
- Jubilant has changed its depreciation policy, resulting in lower depreciation charge of Rs313m for the quarter v/s Rs434 for 3QFY09, which has partly boosted PAT.
- PAT was Rs1b (v/s our estimate of Rs1.2b). PAT was lower than our estimate despite better operational performance due to Rs440m MTM forex losses.

QUARTERLY PERFORMANCE (RS MILLION)

Y/E MARCH	FY09				FY10				FY09	FY10E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Net Sales	**8,266**	**9,405**	**9,096**	**8,412**	**8,964**	**9,331**	**9,615**	**9,774**	**35,180**	**37,684**
YoY Change (%)	*53.1*	*52.1*	*41.8*	*22.1*	*8.4*	*-0.8*	*5.7*	*16.2*	*41.3*	*7.1*
Total Expenditure	6,608	7,632	7,686	6,488	7,342	7,480	7,364	8,052	28,414	30,237
EBITDA	**1,658**	**1,773**	**1,411**	**1,924**	**1,622**	**1,851**	**2,251**	**1,722**	**6,766**	**7,447**
Margins (%)	*20.1*	*18.8*	*15.5*	*22.9*	*18.1*	*19.8*	*23.4*	*17.6*	*19.2*	*19.8*
Depreciation	337	411	434	451	308	308	313	335	1,632	1,263
Interest	138	221	324	388	407	363	390	389	1,070	1,549
Other Income	-1,002	-1,671	-1,161	2,202	341	-512	-280	551	-1,631	100
PBT before EO Expense	**182**	**-530**	**-508**	**3,287**	**1,248**	**668**	**1,268**	**1,550**	**2,432**	**4,734**
Extra-Ord Expense	0	0	110	-644	0	0	0	0	-534	0
PBT after EO Expense	**182**	**-530**	**-618**	**3,931**	**1,248**	**668**	**1,268**	**1,550**	**2,966**	**4,734**
Tax	61	166	283	-243	223	240	225	211	267	899
Rate (%)	*33.6*	*-31.3*	*-45.7*	*-6.2*	*17.9*	*35.9*	*17.8*	*13.6*	*9.0*	*19.0*
PAT	**121**	**-696**	**-901**	**4,174**	**1,024**	**428**	**1,043**	**1,338**	**2,699**	**3,834**
Minority Interest	-7	-69	-25	-33	-13	1	35	-13	-133	10
Adjusted PAT	**128**	**-627**	**-715**	**3,523**	**1,037**	**427**	**1,008**	**1,352**	**2,346**	**3,824**
YoY Change (%)	*-91.1*	*-157.0*	*-178.5*	*528.1*	*712.9*			*-61.6*	*-41.2*	*63.0*
Margins (%)	*1.5*	*-6.7*	*-7.9*	*41.9*	*11.6*	*4.6*	*10.5*	*13.8*	*6.7*	*10.1*

E: MOSL Estimates; Quarterly numbers for FY09 do not add up to full-year numbers due to change in forex accounting policy (AS-11)

Large forex losses incurred in FY09

Jubilant incurred forex losses to the tune of Rs7b in FY09. These were primarily on account of restatement of foreign currency loans. Jubilant opted for revised AS11 to report these losses in the balance sheet. Accordingly, it capitalized exchange difference amounting to Rs1,131m to the cost of fixed assets and the balance amount of Rs2,751m to the 'foreign currency monetary item translation difference account' during the year.

FY10 guidance difficult to achieve

The management has indicated that the earlier EBITDA guidance of Rs8.75-9b may be adversely impacted by 5%YoY for FY10E. Given the 9MFY10 EBITDA of Rs5.7b (up 18%), we think that the guidance would be difficult to achieve. We estimate EBITDA of Rs7.7b for FY10E (EBITDA margin of 20.3% versus 20.5% reported for 9MFY10). Management has not given any revenue guidance post 3QFY10 results (earlier revenue guidance was at 15% for FY10). We are estimating revenue growth of 7%YoY for FY10 (9MFY10 revenue growth was 4.3%YoY)

JUBILANT: REVENUE MODEL

REVENUES (RS M)	FY08	FY09	FY10E	FY11E	FY12E	CAGR %
						(FY10-12)
Proprietary Products & Exclusive Synthesis	8,387	10,262	10,262	12,314	14,408	18.5
Growth (%)		*22.4*	*0.0*	*20.0*	*17.0*	
API	1,867	2,550	2,448	2,815	3,153	13.5
Growth (%)		*36.6*	*-4.0*	*15.0*	*12.0*	
CMO of sterile & non-sterile products	2,050	4,895	6,021	7,225	8,526	19.0
Growth (%)		*138.8*	*23.0*	*20.0*	*18.0*	
Contract Research (DDDS)	1,541	2,415	2,637	3,112	3,579	16.5
Growth (%)		*56.7*	*9.2*	*18.0*	*15.0*	
Total CRAMS	**13,845**	**20,122**	**21,368**	**25,466**	**29,665**	**17.8**
Growth (%)		*45.3*	*6.2*	*19.2*	*16.5*	
Speciality Pharmaceuticals	766	1,925	2,233	2,568	2,876	13.5
Growth (%)		*151.3*	*16.0*	*15.0*	*12.0*	
Generics	675	1,133	1,484	1,781	2,102	19.0
Growth (%)		*67.9*	*31.0*	*20.0*	*18.0*	
Total Pharmaceuticals Products	**1,441**	**3,058**	**3,717**	**4,349**	**4,978**	**15.7**
Growth (%)		*112.2*	*21.6*	*17.0*	*14.5*	
Acetyls	5,651	5,804	6,123	6,429	6,751	5.0
Growth (%)		*2.7*	*5.5*	*5.0*	*5.0*	
Specialty Gases	163	161	164	172	181	5.0
Growth (%)			*2.0*	*5.0*	*5.0*	
Life Science Chemicals	**5,814**	**5,965**	**6,287**	**6,602**	**6,932**	**5.0**
Growth (%)		*2.6*	*5.4*	*5.0*	*5.0*	
Nutrition Ingredients			**1,960**	**2,117**	**2,371**	**10.0**
Growth (%)				*8.0*	*12.0*	
Healthcare (Hospitals)	**17**	**57**	**80**	**112**	**145**	**34.9**
Growth (%)		*235.3*	*40.0*	*40.0*	*30.0*	
Total PLSP	**21,117**	**29,202**	**33,413**	**38,646**	**44,091**	**14.9**
Growth (%)		*38.3*	*14.4*	*15.7*	*14.1*	
Total Agri and Performance Polymers	**3,770**	**5,978**	**4,274**	**4,488**	**4,712**	**5.0**
Growth (%)		*58.6*	*-28.5*	*5.0*	*5.0*	
Total Revenues	**24,887**	**35,180**	**37,687**	**43,134**	**48,803**	**13.8**
Growth (%)		*41.4*	*7.1*	*14.5*	*13.1*	

Source: Company/MOSL

High debt, FCCB redemption remains an overhang

Jubilant had raised US$310m in FCCBs in 2005/2006 to fund acquisitions and capex. Of these, FCCBs worth US$192m (US$271m incl YTM) are due for redemption in phases in May 2010 and May 2011. We believe that these are unlikely to get converted into equity. The redemption will need to be partly funded by incremental debt and/or equity. Overall D/E of over 2x for FY10E is on the higher side, making it imperative to raise equity. The company has proposed to raise Rs15b through an equity offering in the near future.

FCCB overhang - sensitivity analysis

High debt, FCCB redemption remains an overhang

Jubilant had raised total US$310m in 2005/2006 through the issue of FCCBs, of which US$57m worth of FCCBs have been converted while the company has bought back FCCBs worth US$61m. Part of the outstanding FCCBs is due for redemption in May 2010 while the remaining is to be redeemed in May 2011.

JUBILANT: FCCB REDEMPTION (US$ M)

	TOTAL ISSUED	CON-VERTED	BOUGHT BACK	OUT-STANDING	REDEMPTION DATE	CONVERSION PRICE (RS/SH)	TOTAL OUTFLOW IF NOT CONVERTED (INCL YTM)
FCCB-1	35	34.7	0		May-09	163.64	
FCCB-2	75	22.3	3	49.7	May-10	273.06	68.8
FCCB-3	200	0	57.9	142.1	May-11	413.45	202.4
Total	**310**	**57**	**60.9**	**192.1**			**271.2**

Source: Company/MOSL

We have assumed full redemption of these FCCBs since, as of now, it seems unlikely that the outstanding FCCBS will get converted. The company will have to pay ~Rs12.5b including YTM to bond holders, which will be part funded by internal accruals and external financing (mainly equity).

JUBILANT: EPS SENSITIVITY TO FCCB CONVERSION/REDEMPTION (RS M)

	REDEMPTION		CONVERSION	
	FY11E	FY12E	FY11E	FY12E
EBITDA	9,038	10,385	9,038	10,385
Recurrent PAT	4,558	4,939	4,527	5,505
Provision for FCCB YTM	2,245	316	0	0
Adjusted PAT	2,739	4,684	4,527	5,505
Equity	148	148	155	171
Net Worth	19,056	20,728	22,089	33,444
Debt	38,744	31,869	33,294	22,757
D/E (x)	1.6	1.5	1.4	0.6
EPS (Rs)	18.6	31.7	26.5	32.2

Source: Company/MOSL

Plans to raise Rs15b through equity

The management has approved raising of Rs15b through equity/equity-linked instruments to strengthen the capital structure and to pursue future growth opportunities in the PLSPS business. We believe that part of the funds is likely to be utilized for de-leveraging the balance sheet.

Valuation and view

The macro environment for the CRAMS business remains favorable, given India's inherent cost advantages and chemistry skills. We believe that Jubilant will benefit from the increased outsourcing from India, given its relationships with global pharmaceutical and agrochemical players.

However, slowdown in some of the CRAMS products, declining realizations and product rationalization (for the chemicals business) continue to impact Jubilant's topline growth. Since we expect the global inventory de-stocking to be over by FY10, we expect a recovery in Jubilant's CRAMS business from FY11.

Expect 24% EPS CAGR

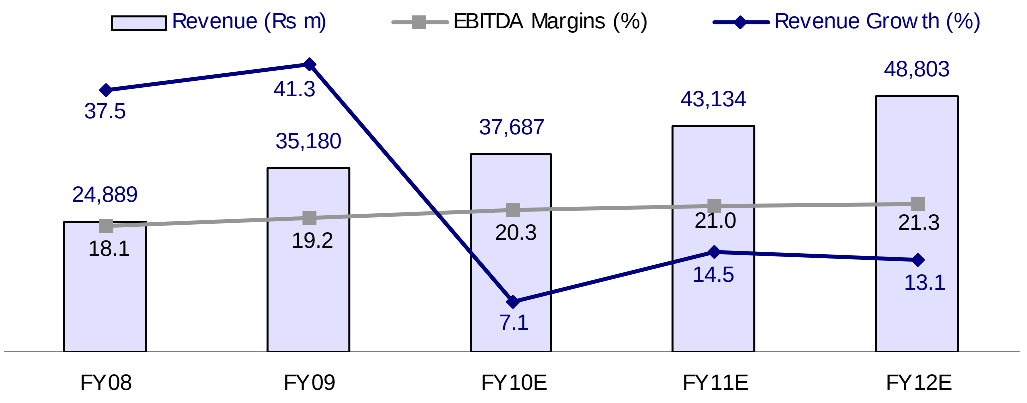
Management's FY10 guidance will be tough to achieve, in our opinion

We believe that the management's EBITDA guidance of Rs8.3b for FY10 will be tough to achieve and forecast Rs7.67b EBITDA for FY10. We estimate 14% revenue and 13% EPS CAGR over FY10-12 on reported basis. Adjusted EPS is likely to record 24% CAGR. FCCB redemption, high debt and lower return ratios will remain an overhang.

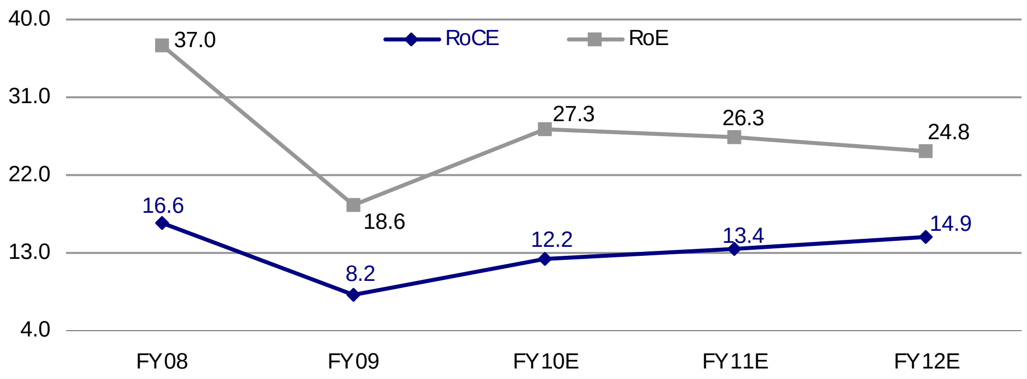
Downgrading recommendation to Neutral

The stock currently quotes at 17.4x FY11E and 10.2x FY12E EPS. Net D/E as of December 2009 is high at 1.7x, with US$271m of FCCBs coming up for redemption in 2010/11. We believe that the stock price will remain muted till clarity emerges on debt reduction and redemption of US$271m FCCBs (including YTM). We downgrade our recommendation to **Neutral**, with a target price of Rs350 (11x FY12E EPS).

TREND IN REVENUE, EBITDA AND EPS

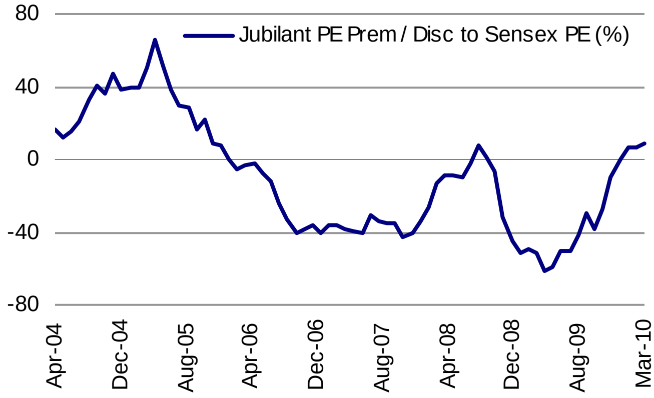


TREND IN ROE, ROCE

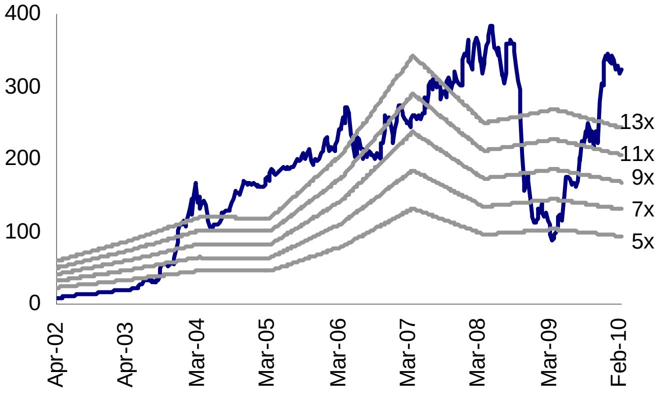


Source: MOSL

P/E BANDS



RELATIVE P/E TO SENSEX P/E



Source: MOSL

Key risks

Ability to maintain global customer relationships: Jubilant's ability to maintain its strong relationships with global clients and build on them is critical for continued success. Any slip-ups on this front (particularly on delivery of obligations) could lead to loss of business and a negative image among other potential customers.

Execution risks in CRAMS business and inability to fully utilize large capacities of acquired companies: One of the key risks is execution of large contracts. The reputation and the subsequent business for CRAMS companies largely depend upon its execution of the contracts in terms of quality, timeliness, and supply chain management. Any failure in these aspects may lead to loss of further business. Also, CRAMS business requires front-ended investments. Hence, there is risk of capacities remaining idle for a long time, which may bring down profitability and return ratios.

Financials and Valuation

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Net Sales	**24,889**	**35,180**	**37,687**	**43,134**	**48,803**
Change (%)	*37.5*	*41.3*	*7.1*	*14.5*	*13.1*
EBITDA	**4,507**	**6,766**	**7,669**	**9,038**	**10,385**
Margin (%)	18.1	19.2	20.3	21.0	21.3
Depreciation	1,039	1,632	1,263	2,078	2,228
EBIT	**3,468**	**5,133**	**6,406**	**6,960**	**8,157**
Int. and Finance Charges	337	1,070	1,550	1,734	2,100
Other Income - Rec.	1,430	-1,631	-81	413	54
PBT before EO Exp.	**4,561**	**2,432**	**4,776**	**5,639**	**6,110**
EO Expense/(Income)	129	-534	0	0	0
PBT after EO Expense	**4,432**	**2,966**	**4,776**	**5,639**	**6,110**
Current Tax	585	394	907	1,071	1,161
Deferred Tax	-12	-127	0	0	0
Tax Rate (%)	*12.9*	*9.0*	*19.0*	*19.0*	*19.0*
PAT	**3,860**	**2,699**	**3,868**	**4,568**	**4,949**
Less: Minority Interest	-16	-133	10	10	10
Adj Net Profit	**3,988**	**2,346**	**3,858**	**4,558**	**4,939**
Change (%)	*74.9*	*-41.2*	*64.5*	*18.1*	*8.4*
Margin (%)	*16.0*	*6.7*	*10.2*	*10.6*	*10.1*
Provision for FCCB red	0	0	1,000	2,245	316
Adjusted PAT	**3,876**	**2,832**	**3,048**	**2,739**	**4,684**

BALANCE SHEET (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
Equity Share Capital	147	148	148	148	148
Fully Diluted Share Capital	147	148	148	148	148
Total Reserves	12,415	12,528	15,493	18,908	20,580
Net Worth	**12,562**	**12,675**	**15,640**	**19,056**	**20,728**
Minority Interest	214	320	330	340	350
Deferred Liabilities	1302	1151	1151	1151	1151
Total Loans	21,085	38,781	36,413	38,744	31,869
Capital Employed	**35,163**	**52,927**	**53,533**	**59,290**	**54,097**
Gross Block	18,661	30,638	33,138	36,138	38,138
Less: Accum. Deprn.	5,835	9,033	10,296	12,374	14,602
Net Fixed Assets	**12,826**	**21,605**	**22,842**	**23,764**	**23,536**
Capital WIP	4,847	5,031	5,031	5,031	5,031
Goodwill	6,298	15,845	15,845	15,845	15,845
Investments	456	2,714	2,714	714	714
Curr. Assets	**17,398**	**19,672**	**19,929**	**27,712**	**23,449**
Inventory	4,350	5,956	6,281	7,189	8,134
Account Receivables	4,258	5,044	5,653	6,830	8,134
Cash and Equivalents	5,238	3,817	2,761	7,942	1,081
Loans & Advances	3,553	4,855	5,234	5,751	6,100
Curr. Liability & Prov.	**6,679**	**11,943**	**12,828**	**13,775**	**14,477**
Account Payables	3,718	7,365	7,328	8,148	8,812
Provisions	2,961	4,579	5,500	5,627	5,666
Net Current Assets	**10,719**	**7,729**	**7,102**	**13,937**	**8,972**
Misc Expenditure	16	3	0	0	0
Appl. of Funds	**35,163**	**52,927**	**53,533**	**59,290**	**54,097**

E: MOSL Estimates

RATIOS

Y/E MARCH	2008	2009	2010E	2011E	2012E
Basic (Rs)					
EPS	**26.4**	**19.2**	**20.7**	**18.6**	**31.7**
Cash EPS	34.2	27.0	34.7	45.0	48.6
BV/Share	85.3	85.9	106.0	129.2	140.5
DPS	1.5	1.5	1.9	2.6	2.9
Payout (%)	6.6	9.2	8.5	10.0	10.0
Valuation (x)					
P/E	12.3	16.9	15.7	17.4	10.2
Cash P/E	9.5	12.0	9.3	7.2	6.7
P/BV	3.8	3.8	3.1	2.5	2.3
EV/Sales	2.6	2.4	2.2	1.8	1.6
EV/EBITDA	14.1	12.2	10.6	8.7	7.6
Dividend Yield (%)	0.5	0.5	0.6	0.8	0.9
Return Ratios (%)					
RoE	37.0	18.6	27.3	26.3	24.8
RoCE	16.6	8.2	12.2	13.4	14.9
Working Capital Ratios					
Fixed Asset Turnover (x)	2.2	2.0	1.7	1.9	2.1
Debtor (Days)	62	52	55	58	61
Inventory (Days)	64	62	61	61	61
Working Cap. T/O (Days)	157	80	69	118	67
Leverage Ratio (x)					
Current Ratio	2.6	1.6	1.6	2.0	1.6
Net Debt/Equity	1.3	2.8	2.2	1.6	1.5

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2008	2009	2010E	2011E	2012E
OP/(Loss) before Tax	4,507	6,766	7,669	9,038	10,385
Interest/Dividends Recd.	1,430	-1,631	-81	413	54
Direct Taxes Paid	-573	-267	-907	-1,071	-1,161
(Inc)/Dec in WC	-1,824	1,569	-429	-1,654	-1,896
CF fr Op. incl EO Exp.	**3,412**	**6,970**	**6,252**	**6,726**	**7,382**
(inc)/dec in FA	-10,374	-20,143	-2,500	-3,000	-2,000
(Pur)/Sale of Invest.	-418	-2,257	0	2,000	0
CF from Invest.	**-10,792**	**-22,400**	**-2,500**	**-1,000**	**-2,000**
Change in Net Worth	-38	-2,205	-562	-686	-2,773
Inc/(Dec) in Debt	4,501	17,545	-2,368	2,331	-6,875
Interest Paid	-337	-1,070	-1,550	-1,734	-2,100
Dividend Paid	-257	-261	-328	-456	-494
CF from Fin. Activity	**3,869**	**14,008**	**-4,808**	**-545**	**-12,243**
Inc/Dec of Cash	**-3,512**	**-1,421**	**-1,056**	**5,181**	**-6,861**
Add: Beginning Balance	8,749	5,238	3,817	2,761	7,942
Closing Balance	**5,238**	**3,817**	**2,761**	**7,942**	**1,081**

NOTES

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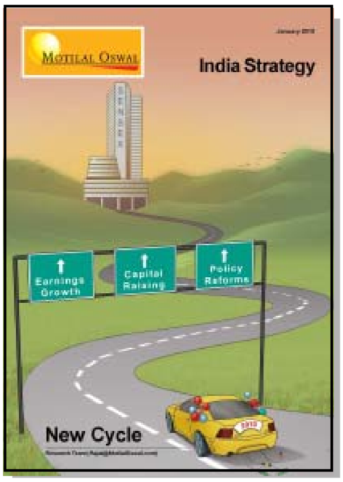
Metals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Capital Raising
Policy Reforms
2010
New Cycle

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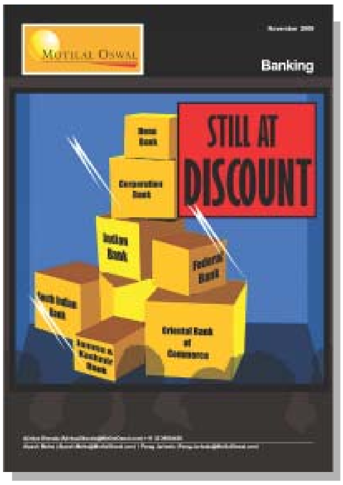
Dashboard
The Monthly Auto Update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STILL AT DISCOUNT
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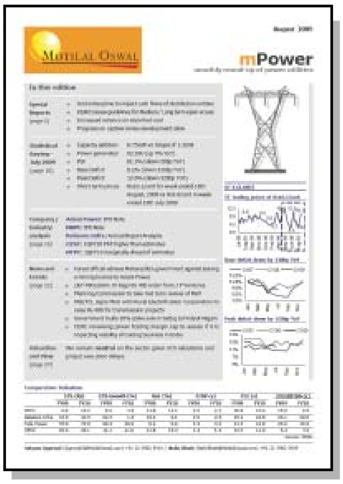
Corporation Bank
Indian Bank
Federal Bank
South Indian Bank
Oriental Bank of Commerce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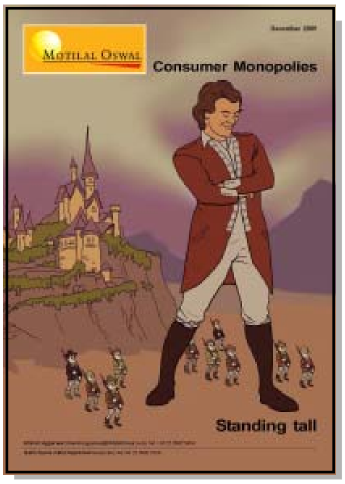
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1. Analyst ownership of the stock	No	No	No	No
2. Group/Directors ownership of the stock	No	No	No	No
3. Broking relationship with company covered	No	No	No	No
4. Investment Banking relationship with company covered	No	No	No	No

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