

Cipla

14 August 2017

Reuters: CIPL.NS; Bloomberg: CIPLA IN

Gross Margin Improvement Is A Positive Surprise

Cipla's revenues in 1QFY18 stood at Rs35,251mn, showing a decline of 4%/2% on YoY/QoQ basis, respectively. They were also 8%/9% below our/consensus estimate, respectively. Revenues from India were down 13% YoY on account of Goods and Services Tax or GST-related destocking. The US business, despite multiple product launches in the past few quarters, remained flat QoQ and posted YoY decline of 2%. The new launches merely offset the price erosion. Europe, emerging markets or EMs, API and ROW showed sequential decline of 15%/10%/20%/11%, respectively. On YoY basis, Europe and South Africa revenues were up 34%/21%, respectively. Despite a major miss on the top-line, net earnings were 22% above consensus estimate, driven by one-time gain (Rs1,170mn) from divestment of animal health subsidiary and 400bps improvement in gross margin on YoY basis. Excluding the one-time gain, net earnings were 7% below consensus estimate. The gross margin improvement of 400bps was the highlight of the quarter and the company stated that out of the 400bps improvement, 250bps is sustainable. The company attributed gross margin improvement to cost reduction initiatives and also improvement in product/geography mix. Net earnings were also aided by lower-than-normal spending on research and development or R&D during the quarter (6% of sales as against 8% which is the expected run-rate for the year). We believe a large part of cost savings have been realised by virtue of Cipla's decision to go slow on its biosimilar portfolio.

Cipla's earnings growth should gain traction from 3QFY18 onwards, as it expects three limited-competition (differentiated) launches beginning at the end of 2QFY18/early 3QFY18. One of these limited-competition launches is Sevelamer Carbonate (Renvela generic). We expect oseltamivir (gTamiflu), ambrisentan (gBosentan) and oral pellets of Kaletra to be the other limited-competition/differentiated launches during the year. Apart from these limited-competition launches, there will be seven other launches in the US which include generic versions of HIV drugs Viread (US\$591mn) and Sustiva (US\$900mn). Apart from Albuterol (Proventil generic – MDI inhaler) whose target action date is by end of FY18, other complex launches/filings that we believe Cipla can make in the near future will be Qvar generic (Beclomethasone Dipropionate MDI inhaler), Nasonex (Mometasone Furoate nasal spray) and Liposomal Amphotericin. In FY18, we expect US revenues to grow by around US\$80mn-US\$100mn. We have retained Buy rating on the stock with a target price of Rs684.

EBITDA performance: For the quarter, EBITDA stood at Rs6,465mn which was up 6%/28% on YoY/QoQ basis. It was below our/consensus estimates by 10%/4%, respectively. EBITDA growth was led by the decline in raw material costs of 14%/11% on YoY/QoQ basis, respectively. Gross margin stood at 67%, showing an improvement of 417bps/334bps on YoY/QoQ basis, respectively. The improvement in gross margin is steep and it will be good to understand if the same is sustainable. Staff costs were down 2% YoY and up 5% QoQ. Other expenses were sequentially down by 5% and up YoY by 5%.

Reported PAT: It stood at Rs4,088mn, which includes one-time income of Rs1,178.2mn on divestment of South Africa subsidiary. Excluding this, PAT stood at Rs3,121mn which was an 8% decline on YoY basis. This adjusted PAT was 7% below our/consensus estimate, respectively. Interest costs fell 17% on QoQ basis. Depreciation was sequentially down 66% (4QFY17 had witnessed the booking of an one-time charge under this account) and was up YoY by 5%.

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BUY

Sector: Pharmaceuticals

CMP: Rs541

Target Price: Rs684

Upside: 26%

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Key Data

Current Shares O/S (mn)	804.7
Mkt Cap (Rsbn/US\$bn)	437.5/6.8
52 Wk H / L (Rs)	622/479
Daily Vol. (3M NSE Avg.)	1,319,872

Price Performance (%)

	1 M	6 M	1 Yr
Cipla	1.0	(6.2)	3.8
Nifty Index	(0.7)	10.5	13.1

Source: Bloomberg

Y/E March (Rsmn)	1QFY17	4QFY17	1QFY18	YoY (%)	QoQ(%)
Net revenues	35,561	34,870	34,323	(3.5)	(1.6)
Other operating income	939	950	927	(1.3)	(2.3)
Total revenues	36,500	35,820	35,251	(3.4)	(1.6)
Total raw material costs	13,705	13,155	11,767	(14.1)	(10.6)
% of revenues	37.5	36.7	33.4	(82bps)	(334bps)
Staff costs	6,866	6,389	6,729	(2.0)	5.3
% of revenues	19.3	18.3	19.6	30bps	128bps
Other expenses	9,818	11,214	10,290	4.8	(8.2)
% of revenues	27.6	32.2	30.0	237bps	(218bps)
EBITDA	6,112	5,062	6,465	5.8	27.7
EBITDA margin (%)	16.7	14.1	18.3	159bps	421bps
Other income	252	228	336*	33.2	47.3
Interest costs	315	334	279	(11.5)	(16.6)
Depreciation	2,038	6,322	2,134	4.7	(66.2)
PBT	4,011	(1,366)	4,387	9.4	(421.3)
Tax	553	(757)	1,097	98.4	(244.9)
Tax rate (%)	13.8	55.4	25.0	1,122 bps	(3,043bps)
Share of profit and minority interest	(67.60)	(9.30)	(169.60)	150.9	1,723.7
Reported PAT	3,391	(618)	3,121*	(8.0)	-

*Other income excludes one-off income from divestment of South African subsidiary amounting to Rs1,178.2mn which has been excluded and tax adjusted to that extent. If this amount is included, other income and PAT would have been Rs1,514mn/ Rs4,088mn, respectively. : Source: Company, Nirmal Bang Institutional Equities Research

Earnings call commentary

Gross margin: During the quarter, company witnessed 400bps improvement in gross margin YoY. According to the company, 250bps improvement is sustainable while 150bps is not. The improvement is driven by the rise in geographic/product mix/ pricing improvement and ongoing cost optimization programmes. European business is now profitable.

ANDA launches: Expects to launch 10 new products in the US during the remaining part of the year and also continues to give guidance of one differentiated launch per quarter.

Domestic business: There are still pockets (UP and Bihar) which are yet to normalise post GST-led disruption. A partial recovery was witnessed in the domestic business in July 2017.

R&D spending: It stood at 6% of sales during the quarter and for the full year it is expected to be around 8% of sales. The company aims to restrict R&D spending to 9% of sales at any point in time in future.

Mid-teen growth: This is likely over the next three quarters.

ANDA filings: The company has 96 ANDAs pending for approval, of which 68 are fully owned by Cipla, 11 are partnered and 17 are filed under the PEPFAR scheme.

South Africa business: It grew 10.3% in South Africa as against market growth of 9.3%.

Sereflo performance in the UK: It is below the company's expectation as GlaxoSmithKline or GSK is aggressively protecting its brand share. Based on our market understanding, GSK is offering bundled discounts to pharmacies on Advair DPI and MDI sales which kills the cost benefit it receives from discounted prices on generic Advair MDI. Sereflo market share in the UK is still in low single-digit.

Renvela generic: Cipla gave guidance that it is preparing for a launch, but did not give the approval timeline. We believe Cipla can potentially launch this product by the end of this quarter.

Price erosion in the US: Cipla is looking at high single-digit to low double-digit price erosion in the US. According to the company, generic drug pricing in the US follows a commodity cycle and it touches a low before it bounces back as players start exiting. It is generally a two-year period during which players begin to exit and prices start moving upwards. Companies in the US have begun to experience the pain of low prices.

Exhibit 1: Actual versus NBIE estimate and Bloomberg consensus estimate

(Rsmn)	Actual	NBIE estimate	Var.(%)	Cons.estimate	Var.(%)
Sales	35,251	38,525	(8.5)	38,859	(9.3)
EBITDA	6,465	7,187	(10.1)	6,714	(3.7)
EBITDA margin (%)	18	19	(32bps)	17	106bps
Reported PAT	*3,121	3,369	(7.4)	3352	(6.9)

Note: Other income excludes the one-off income from divestment of South African subsidiary amounting to Rs1,172.8mn which has been excluded and tax adjusted to that extent. If this amount is included, other income and PAT would have been Rs1,514mn/ Rs4,088mn, respectively.

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Key financials

Y/E March (Rsmn)	FY15	FY16	FY17	FY18E	FY19E
Net sales	1,13,454	1,37,901	1,46,302	1,69,490	1,94,539
EBITDA	21,617	24,797	24,758	35,885	45,237
Net profit	12,542	13,954	10,424	21,768	27,814
EPS (Rs)	15	17	13	27	34
EPS growth (%)	(15.0)	17.2	(25.2)	107.3	28.2
EBITDA margin (%)	19.1	18.0	16.9	21.2	23.3
PER (x)	38	32	43	21	16
P/BV (x)	4.2	3.9	3.6	3.1	2.6
EV/EBITDA (x)	21.2	19.8	19.5	13.0	9.9
RoCE (%)	16.6	16.5	8.5	16.4	18.8
RoE (%)	11.8	12.1	8.3	14.9	16.1

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Revenue summary

(Rsmn)	1QFY17	4QFY17	1QFY18	YoY (%)	QoQ (%)
India	14,590	11,940	12,710	(12.9)	6.4
South Africa	4,030	4,670	4,880	21.1	4.5
US	6,570	6,460	6,460	(1.7)	0.0
Europe	1,180	1,850	1,580	33.9	(14.6)
Emerging markets	7,590	8,130	7,310	(3.7)	(10.1)
API	1,310	1,630	1,300	(0.8)	(20.2)
Rest of the world	1,230	1,140	1,010	(17.9)	(11.4)
Total	36,500	35,820	35,250	(3.4)	(1.6)

Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 4: Income statement

Y/E March (Rsmn)	FY15	FY16	FY17	FY18E	FY19E
Net sales	1,13,454	1,37,901	1,46,302	1,69,490	1,94,539
% growth	11.5	21.5	6.1	15.8	14.8
Raw material costs	41,897	50,899	53,171	59,759	68,940
Staff costs	19,677	24,340	26,338	28,393	31,112
R&D expenses	7,140	10,415	11,249	13,844	16,212
Other expenditure	23,123	27,450	30,787	31,610	33,038
Total expenditure	91,837	1,13,104	1,21,545	1,33,605	1,49,303
EBITDA	21,617	24,797	24,758	35,885	45,237
% growth	1.3	14.7	(0.2)	44.9	26.1
EBITDA margin (%)	19.1	18.0	16.9	21.2	23.3
Other income	1,656	2,082	2,287	2,500	2,500
Interest costs	1,683	2,066	1,594	1,434	1,191
Gross profit	71,557	87,002	93,131	1,09,731	1,25,599
% growth	13.6	21.6	7.0	17.8	14.5
Depreciation	5,047	7,542	13,229	9,000	9,700
Profit before tax	16,543	17,270	12,222	27,951	36,746
% growth	(12)	4	(29)	129	31
Tax	4,000	3,316	1,798	6,182	8,931
Effective tax rate (%)	24.2	19.2	14.7	22.1	24.3
Net profit before MI & Associates	12,542	13,954	10,424	21,768	27,814
Share of MI and associates	(735)	(120)	(70)	(300)	(300)
Net Profit	11,808	13,834	10,354	21,468	27,514
% growth	(11.5)	11.3	(25.3)	108.8	27.8
EPS (Rs)	15	17	13	27	34.2

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Balance sheet

Y/E March (Rsmn)	FY15	FY16	FY17	FY18E	FY19E
Equity	1,606	1,607	1,609	1,609	1,609
Reserves	1,04,969	1,13,555	1,23,645	1,41,686	1,65,947
Net worth	1,06,575	1,15,162	1,25,254	1,43,295	1,67,556
Minority interest	3,317	3,501	4,382	4,382	4,382
Net deferred tax liabilities	3,073	9,757	7,569	7,569	7,569
Short-term loans	13,925	49,697	4,672	5,272	6,076
Long-term loans	3,093	2,219	36,454	32,808	29,527
Other non-current liabilities	2,796	2,882	2,792	2,792	2,792
Liabilities	1,32,778	1,83,218	1,81,124	1,96,119	2,17,903
Net block	46,506	53,469	57,297	57,797	59,297
Intangible assets and goodwill	26,612	60,833	54,271	54,271	54,271
Other non-current assets	7,772	8,567	10,595	10,595	10,595
Inventories	37,806	38,081	34,853	39,171	45,189
Debtors	19,282	23,563	24,974	28,336	32,612
Cash	5,643	8,714	6,242	16,280	30,606
Other current assets	12,851	18,055	21,301	21,301	21,301
Total current assets	75,582	88,412	87,370	1,05,088	1,29,708
Creditors	14,610	14,758	15,711	17,658	20,371
Other current liabilities	9,083	13,306	12,697	13,973	15,596
Total current liabilities	23,693	28,064	28,408	31,631	35,967
Net current assets	51,889	60,349	58,962	73,457	93,741
Total assets	1,32,778	1,83,218	1,81,124	1,96,119	2,17,903

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Cash flow

Y/E March (Rsmn)	FY15	FY16	FY17	FY18E	FY19E
EBIT	18,225	19,337	13,816	29,385	38,037
(Inc./dec. in working capital)	(8,015)	(5,388)	(1,085)	(4,827)	(5,959)
Cash flow from operations	10,210	13,948	12,730	24,558	32,078
Other income	(1,656)	(2,082)	(2,287)	(2,500)	(2,500)
Other Expenses	(46)	6,685	(2,188)	-	-
Depreciation	5,047	7,542	13,229	9,000	9,700
Tax paid (-)	(4,000)	(3,316)	(1,798)	(6,182)	(8,931)
Net cash from operations	9,555	22,777	19,687	24,875	30,347
Capital expenditure (-)	(8,522)	(48,727)	(10,494)	(9,500)	(11,200)
Net cash after capex	1,033	(25,950)	9,193	15,375	19,147
Other investment activities	2,013	1,287	950	2,500	2,500
Cash from financial activities	839	27,734	(12,615)	(5,436)	(4,770)
Opening cash balance	1,758	5,643	8,714	6,242	18,682
Closing cash balance	5,643	8,714	6,242	18,682	35,558
Change in cash balance	3,885	3,071	(2,472)	12,440	16,877

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Key ratios

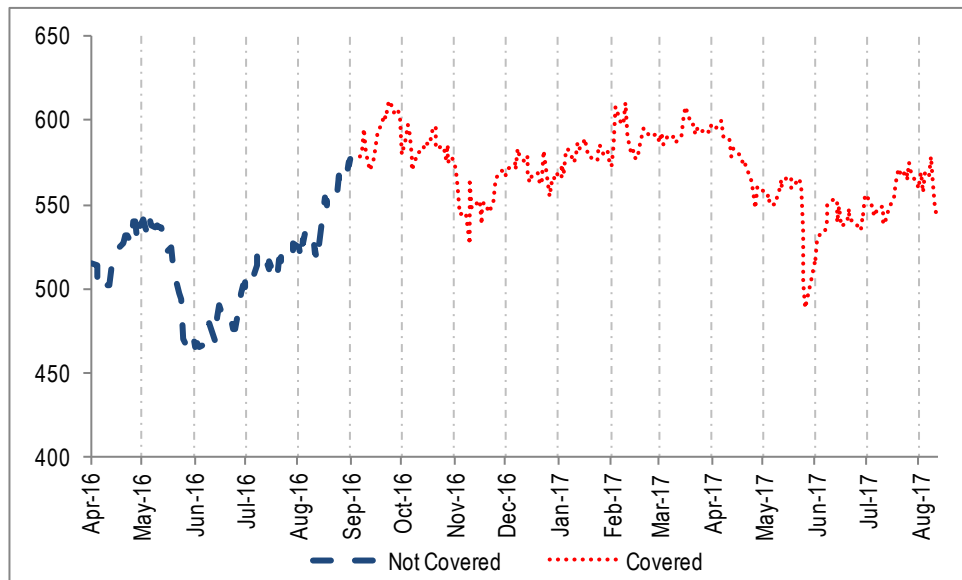
Y/E March	FY15	FY16	FY17	FY18E	FY19E
Profitability & return ratios					
EBITDA margin (%)	19.1	18.0	16.9	21.2	23.3
EBIT margin (%)	16.1	14.0	9.4	17.3	19.6
Net profit margin (%)	11.1	10.1	7.1	12.8	14.3
RoE (%)	11.8	12.1	8.3	14.9	16.1
RoCE (%)	16.6	16.5	8.5	16.4	18.8
Working capital & liquidity ratios					
Receivables (days)	56.6	55.9	59.7	57.2	57.5
Inventory (days)	286.8	268.4	246.9	223.0	220.3
Payables (days)	104.9	103.9	103.1	100.5	99.3
Current ratio (x)	3.2	3.2	3.1	3.4	3.7
Quick ratio (x)	1.6	1.8	1.8	2.2	2.5
Valuation ratios					
EV/sales (x)	4.0	3.6	3.3	2.8	2.3
EV/EBITDA (x)	21.2	19.8	19.5	13.0	9.9
P/E (x)	37.9	32.3	43.2	20.8	16.2
P/BV (x)	4.2	3.9	3.6	3.1	2.6

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price	Target price (Rs)
9 February 2017	Buy	560	700
6 September 2016	Buy	577	700
10 November 2016	Buy	566	700
26 December 2016	Buy	582	700
9 February 2017	Buy	603	700
26 May 2017	Buy	504	684

Rating track graph



Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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