Cadila Healthcare

Emerging Star

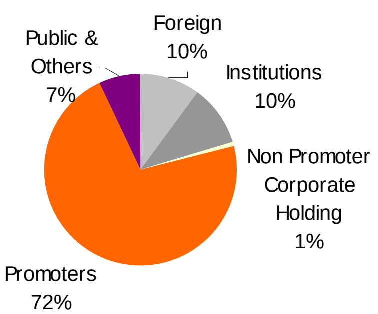
Just what the doctor ordered

Buy; CMP: Rs595

Company details

Price target:	Rs850
Market cap:	Rs3,737 cr
52 week high/low:	Rs621/423
NSE volume: (No of shares)	70,633
BSE code:	532321
NSE code:	CADILAHC
Sharekhan code:	CADILAHEAL
Free float: (No of shares)	1.7 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	15.3	21.5	9.7	22.7
Relative to Sensex	6.2	3.6	-14.9	-26.1

Key points

- **US generic business to grow exponentially:** Cadila Healthcare (Cadila) has made a big entry into the regulated markets of US formulations this year. In the coming years its revenues from the high-margin regulated markets are expected to increase exponentially. It has a strong research and product pipeline with 30 products expected to receive generic approval by FY2007.
- **Strong and steady domestic formulation business to provide a solid base:** Cadila is ranked number five in the domestic formulation business in India. It plans to introduce over 40 products in the Indian market in the next two years. We expect the formulation business to be a steady revenue source in the future, showing a higher-than-industry growth rate.
- **Key subsidiaries to start adding value:** Cadila has subsidiaries in France, the USA and Brazil, and these were making losses till this year. The French business, earlier expected to break even in FY2009, is now expected to do so even earlier, in FY2008. The US subsidiary is expected to earn good profits for Cadila from FY2007 onwards. We expect these subsidiaries to collectively make a profit of over Rs32 crore in FY2008 as compared with a loss of over Rs30 crore in FY2005.
- **Buy with a price target of Rs850:** A strong research-based, integrated pharma player, Cadila is now spreading its wings to the high-margin regulated markets. We expect its consolidated profit after tax (PAT) to grow from Rs117.9 crore in FY2005 to Rs293.8 crore in FY2008, at a 36% CAGR. Considering its strong growth prospects, we initiate our Buy recommendation on Cadila with a 12-month price target of Rs850, which is a 43% upside to the current market price of Rs595.

Company background

Cadila is amongst the top five companies in the Indian formulation space with a current market share of over 3.5%. Initially concentrating on formulations for the domestic market the company is now spreading its wings worldwide. Armed with a robust generic pipeline, Cadila is making its big entry into the regulated markets of the USA while continuously expanding its portfolio in Europe. Cadila operates in various geographies like the USA, France and Brazil through wholly owned subsidiaries.

Key financials (consolidated) Rs (cr)

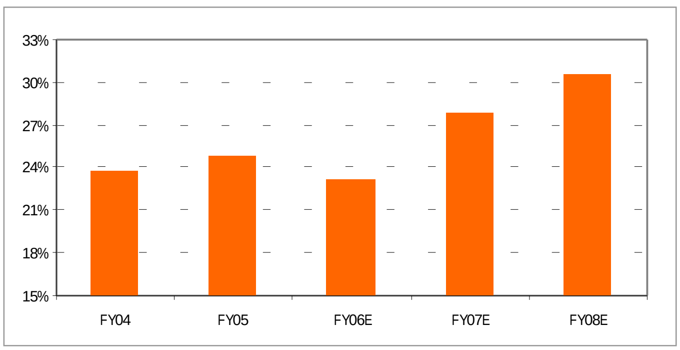
Particulars	FY2004	FY2005	FY2006E	FY2007E	FY2008E
Net sales	1,196.2	1,243.0	1,442.5	1,729.4	2,029.7
PAT	130.2	117.9	163.3	226.8	293.8
Shares in issue (cr)	6.3	6.3	6.3	6.3	6.3
EPS	20.7	18.8	26.0	36.1	46.8
PE	28.7	31.7	22.9	16.5	12.7
BV/ share	83.0	93.2	119.3	155.4	202.2
Price/BV	7.2	6.4	5.0	3.8	2.9
EV/EBITDA	15.9	17.0	13.5	10.5	8.6
Price/Sales	3.1	3.0	2.6	2.2	1.8
Mcap/EBITDR	11.7	12.2	9.8	7.7	6.5

Investment arguments

US generic business to grow exponentially

Cadila has made its big entry into the regulated markets of US formulations this year. In the coming years its revenues from the high-margin regulated markets are expected to increase exponentially. The company has a strong research and product pipeline with 30 products expected to receive generic approval by FY2007. The company is currently marketing four products and this number is expected to increase to over 16 in the next year and to over 25 in FY2008. These generic launches include a combination of some already off-patent drugs and some blockbuster drugs going off patent in the near future. The company has tied up with Mallinckrodt of the USA to market some of these drugs. Being the seventh largest US generic firm Mallinckrodt has a strong marketing network that, we believe, will benefit Cadila's product launches. We expect the revenues from the US business to increase from Rs45.7 crore in FY2006 to over Rs210 crore by FY2008, thereby boosting the company's growth.

Export business as % of total sales



Source: Sharekhan Research

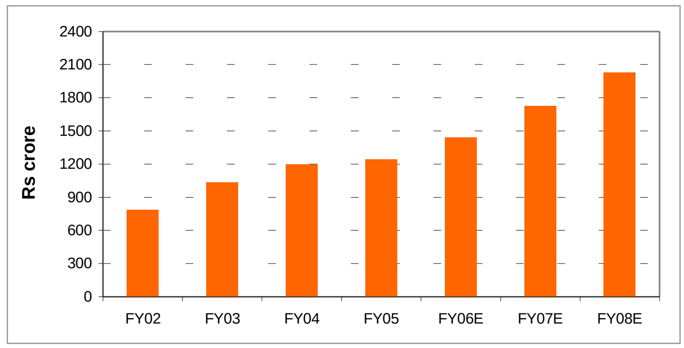
Strong and steady domestic formulation business to provide a solid base

Cadila is ranked number five in the domestic formulation business in the country, controlling a market share of over 3.5%. The company has an extensive sales force and a good marketing reach. It plans to introduce over 40 products in the Indian market in the next two years which, we believe, will fuel the domestic formulation growth. The company has chalked out its growth strategy and will focus on niche areas like women healthcare and gastrointestinals apart from its significant presence in the areas of high growth such as cardio vascular and consumer products. The company has recently picked up a 15% stake in Carnation Nutra-Analogue Foods that sells the largest brand of margarine, ie Nutralite, in India. The company enjoys a gross margin of close to 65% in the domestic formulation business which is at the higher end of the industry. We expect the formulation business to be a steady revenue source for the company in the future, showing a higher-than-industry growth rate.

Key subsidiaries to start adding value

Cadila has subsidiaries in France, the USA and Brazil, and these were making losses till this year. On a consolidated basis these losses were over Rs30 crore and hence resulted in the consolidated PAT being significantly lesser than the stand-alone PAT. The French business, earlier expected to break even in FY2009, is now expected to break even in FY2008. This early break-even is due to the launch of a wide range of products (76) from Cadila's pipeline. Cadila is shifting both its filing and manufacturing bases for the French operations to India, thus bumping up the margins due to the low cost advantage. Also the company has made a deal with one of the buying groups representing over 2,000 retailers in France to market its products in the fast growing French market.

Consolidated net sales



Source: Sharekhan Research

Apart from the French subsidiary, the US subsidiary, which was initially making losses, is expected to provide substantial profits to the company from FY2007 onwards. Also the Brazilian business that was losing money is expected break even this year due to a host of new products being launched in this region. As a result the company seems to be beginning a new phase in its earnings where the profit-making subsidiaries will have a positive impact on the bottom line. We expect the French, US and Brazilian subsidiaries to collectively make a profit of over Rs32 crore in FY2008 as compared with a loss of over Rs30 crore in FY2005.

Altana joint venture to provide a stable revenue source

Cadila has a 50:50 joint venture with Altana to manufacture two intermediates for Pantaprazole (going off patent in 2009). This is a highly profitable venture providing a net profit margin of close to 65%. The company has recently increased the production capacity of this joint venture and we expect this venture to provide stable revenues till FY2010. We also expect the company's dependence on this joint venture to decrease in the future because of sound, profit-making business operations of its subsidiaries around the globe.

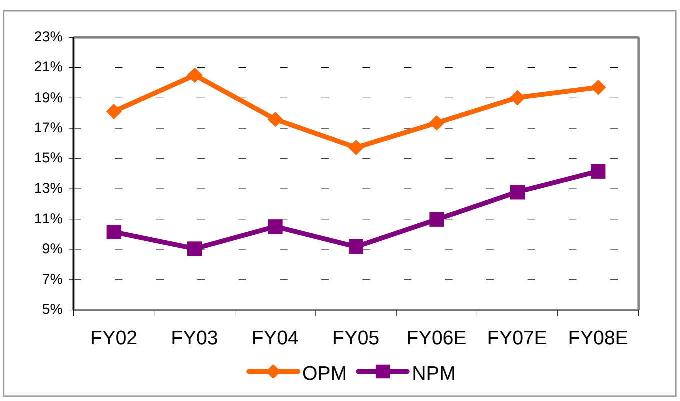
Contract manufacturing revenues and Mayne joint venture to provide long-term growth

Cadila has signed 11 contract-manufacturing deals for both patented as well as off-patent drugs. As of now these revenues contribute only US$2.5 million to the total revenues but in the future the contribution of these revenues is expected to be as high as US$24 million. We expect the contract manufacturing business to be one of the key revenue generators in the long term. The company has started a joint venture with Mayne to manufacture and market oncology drugs in the regulated markets. We expect revenues from this venture to start from 2008 onwards. This joint venture is expected to yield profits as big as the Altana joint venture and we remain strongly positive about this prospect.

Moving into the profit-making phase

Cadila has successfully moved from a consolidation phase over the last three years to a profit-making phase. The breaking even of its subsidiaries and the development of a strong US generic pipeline indicate that it has made the requisite investment to become a major player in the international pharma space. Cadila has one of the strongest generic pipelines in the industry, with over 30 products of diverse therapeutic segments, such as cardio vascular, anti-diabetics and anti-depressants, expected to receive approval by FY2008 and cater to a market size of over US$17 billion in the USA. It is also expected to carry out 12-15 launches per year over the next two years. We believe that this is the start of the phase in which Cadila will reap the benefits of its investments. We also believe that the company has prudently used its resources and will continue to do so in the future.

Margins



Source: Sharekhan Research

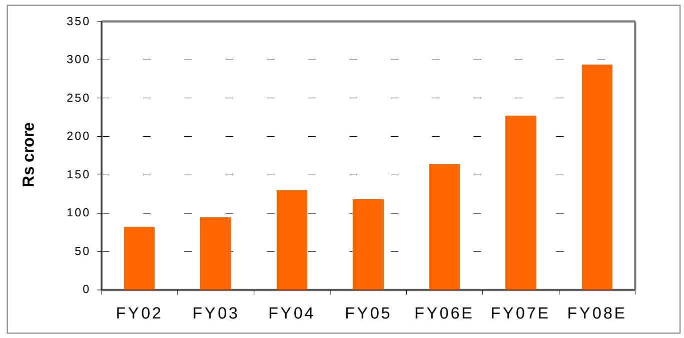
Operating margins to move upwards from 17.4% in FY2006 to 19.7% in FY2008

The US business is a high-margin business. Greater contribution from this business is expected to improve the net profit margins. Cadila has set up a new plant at Baddi. This plant enjoys tax and excise benefits that will further improve the margins. Finally the breaking even of the various subsidiaries will put the icing on the cake. We believe that the total effect of these initiatives will result in the operating profit margin improving from 17.4% in FY2006 to 19.7% in FY2008.

PAT to increase at a CAGR of 36% from FY2005 to FY2008

We believe that the impact of the various initiatives taken up by the company will reflect well on both the bottom line and the top line. We expect the consolidated PAT to increase from Rs117.9 crore in FY2005 to Rs293.8 crore in FY2008, registering a compounded annual growth of 36%. We also expect the return on capital employed to improve from 16.9% in FY2005 to 21.3% in FY2008.

Consolidated PAT

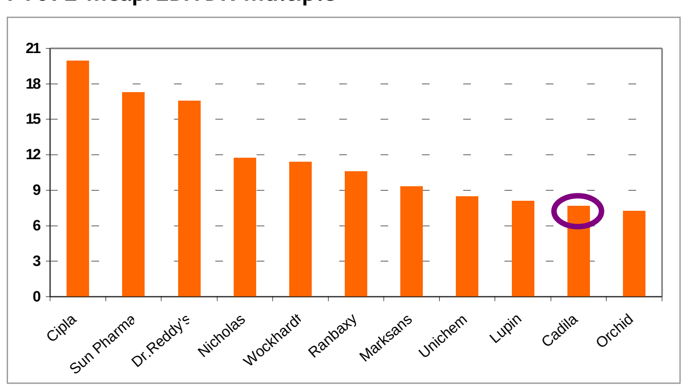


Source: Sharekhan Research

Valuations

Cadila is a research-based generic company with one of the strongest pipelines in the industry and it is now penetrating deeper into the regulated markets of the USA and Europe. Considering these facts we believe that the company is grossly under valued. When compared with its peers like Wockhardt and Orchid Chemicals we believe that Cadila (trading at 12.7x FY2008 earnings) is trading at a huge discount.

FY07E mcap/EBITDR multiple



Source: Sharekhan Research

We believe that for a strong research-based company like Cadila the market capitalisation (mcap)/earnings before interest, tax, depreciation and research (EBITDR) ratio is a good measure of valuation since it compares the efficiency of the base operations. Even on this parameter we find that Cadila is trading at a huge discount (53%) to the sector. Keeping in mind the strong formulation base of Cadila and its rapidly growing US generic business, we believe that assigning a valuation of 18x FY2008 to the company would be fair. Hence we put forth a 12-month price target of Rs850 on Cadila.

A strong research-based, integrated pharma player, Cadila is now spreading its wings to the high-margin regulated markets. With all its growth prospects intact and developing well, we believe that Cadila will yield excellent results in the future. Considering all this, we initiate our Buy recommendation on Cadila with a 12-month price target of Rs850, which is a 43% upside to the current market price of Rs595.

Financials

Key financials (consolidated) Rs (cr)

Particulars	FY04	FY05	FY06E	FY07E	FY08E
Net sales	1,196.2	1,243.0	1,442.5	1,729.4	2,029.7
PAT	130.2	117.9	163.3	226.8	293.8
Shares in issue (cr)	6.3	6.3	6.3	6.3	6.3
EPS	20.7	18.8	26.0	36.1	46.8
PE	28.7	31.7	22.9	16.5	12.7
Cash EPS	32.1	30.2	38.5	50.7	62.8
Cash PE	18.6	19.7	15.4	11.7	9.5
BV/ share	83.0	93.2	119.3	155.4	202.2
Price/BV	7.2	6.4	5.0	3.8	2.9
EV/EBITDA	15.9	17.0	13.5	10.5	8.6
Price/Sales	3.1	3.0	2.6	2.2	1.8
Mcap/EBITDR	11.7	12.2	9.8	7.7	6.5

Profit and loss account (consolidated) Rs (cr)

Particulars	FY04	FY05	FY06E	FY07E	FY08E
Sales turnover	1,277.3	1,305.1	1,505.3	1,803.0	2,114.1
Excise duty	81.1	62.1	62.9	73.5	84.5
Net sales	1,196.2	1,243.0	1,442.5	1,729.4	2,029.7
Other income	44.9	41.1	44.1	46.3	45.7
Total income	1,241.1	1,284.1	1,486.6	1,775.8	2,075.4
Total expenditure	985.8	1,047.6	1,192.1	1,400.6	1,630.1
Operating profit	210.4	195.4	250.4	328.9	399.6
EBITDA	255.3	236.5	294.5	375.2	445.3
Interest	32.6	27.8	19.1	19.5	18.2
Depreciation	71.2	71.6	78.6	91.7	100.6
Profit before tax	151.5	137.1	186.1	259.0	326.5
Total tax	21.3	19.2	22.8	32.2	32.7
Net profit	130.2	117.9	163.3	226.8	293.8

Balance sheet (consolidated) Rs (cr)

Particulars	FY04	FY05	FY06E	FY07E	FY08E
Sources of funds					
Share capital	31.4	31.4	31.4	31.4	31.4
Reserves total	505	562	725.3	952.1	1245.9
Shareholders funds	536.4	593.4	756.7	983.5	1277.3
Secured loans	372.5	299.1	319.1	269.1	239.1
Unsecured loans	65.1	84.2	94.2	99.2	104.2
Total debt	437.6	383.3	413.3	368.3	343.3
Total liabilities	974	976.7	1,170.0	1,351.8	1,620.6
Application of funds					
Net block	732.8	748.1	762.0	830.3	909.7
CWIP	41.5	42.5	160	180	260
Investments	47.9	46.7	48	50	52
Cash and bank	56	61.2	116.5	129.7	180.8
Total current assets	498.7	499.2	583.2	682.6	811.6
Total current liabilities	265	266.6	298.5	319.5	351.0
Net current assets	233.7	232.6	284.7	363.1	460.6
Net deferred tax	-97.2	-101.0	-92.5	-79.5	-69.5
Total assets	974	976.7	1,170.0	1,351.8	1,620.6

Key ratios (%)

Particulars	FY04	FY05	FY06E	FY07E	FY08E
OPM (%)	17.6	15.7	17.4	19.0	19.7
NPM (%)	10.5	9.2	11.0	12.8	14.2
RoCE (%)	18.9	16.9	18.5	21.0	21.3
RoNW (%)	24.3	19.9	21.6	23.1	23.0
Debt: Equity	0.82	0.65	0.55	0.37	0.27

The author doesn't hold any investment in any of the companies mentioned in the article.