Global Equity Research - India

Company Update

15 April 2010

Sector: Pharma

KARVY STOCK BROKING LIMITED

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Indoco Remedies (Rs389)

BUY
Target Price: Rs480

We recently met up with management of Indoco Remedies Ltd.(Indoco) to have a better understanding about the nature of tie-ups recently forged by the company (WATSON, ASPEN) and events (tender supply) panning out in the near future in its Export Formulations(EF) business. Indoco's Domestic Formulations (DF) space has also witnessed traction post the restructuring exercise. We upgrade FY11 earnings estimates and introduce FY12E estimates. We upgrade our rating on the stock from market performer to BUY.

Indoco's regulated market business has witnessed tender supply orders from Germany, South Africa & New Zealand for metformin and paracetamol tablets boosting its EF revenues. The company also stands to gain on the back of new dossier licensing and supply deal with Watson Inc. (WATSON) and Aspen Pharmacare (ASPEN) entered during Q4FY10. The WATSON deal for US market is expected to pan out from FY13 whereas supplies for ASPEN deal for emerging countries will start from FY12 onwards. The semi-regulated markets business will gain further traction on the back of tender supplies (Kenya). Indoco is in the process of building a dedicated facility for ophthalmic products catering exclusively to the regulated markets which it plans to enter by filing its own ANDA's. We expect the tender supply business and contract supply business to gain further traction going forward.

Domestic Formulations (DF) revenues has been gaining momentum post the restructuring exercise commenced during Q4FY09. Indoco currently markets 200 products (incl. line extensions) in the domestic formulations space focusing mainly on Anti-infectives, Respiratory and Dental which comprise atleast 60% of the total domestic formulation revenues. Indoco plans to launch two new divisions (EXTENT & INTEGRA) with 300 new medical representatives (MR). Although Indoco's focus categories will remain unchanged, the thrust will be to launch niche products which would command higher price realizations.

We upgrade our FY11 revenue estimates by 4.9% to Rs.4,743 mn on account of better revenue traction in the high margin DF space and uptake in the EF space. We have incorporated FY12 numbers and roll over our target price based on FY12 EPS. Improvement in revenue traction, EBITDA margins and strong earnings growth of 30% plus in FY11E and FY12E coupled with improving return ratios make the stock an attractive investment opportunity. We upgrade our rating on the stock from market performer to **BUY** with a price target of Rs480 based on 8x FY12E.

Indoco Remedies	
Bloomberg Code	INDR.IN
Market Cap(Rs bn)	4.78
Market Cap(US$ mn)	106.24
Shares Outstanding(mn)	12.29
52-week High/Low (Rs)	429/121
Major Shareholders (%)	
Promoters	61.02
FIIs	2.75
Banks/Fis/MFs/NRIs/corporates	9.15
Public	27.08

Y/E March Rs Mn	FY08	FY09	FY10E	FY11E	FY12E
Net Revenues	2,628	3,522	3,943	4,743	5,895
EBITDA	436	478	575	719	931
Net Profit	313	308	427	562	738
EPS(Rs)	33.9	25.1	34.7	45.7	60.1
EPS growth (%)	1.4	(26.1)	38.6	31.6	31.4
EBITDA margin(%)	16.6	13.6	14.6	15.2	15.8
PER(x)	11.5	15.5	11.2	8.5	6.5
EV/EBITDA (x)	11.4	10.6	8.3	6.9	5.4
P/S (x)	1.8	1.4	1.2	1.0	0.8
RoCE(x)	16.4	11.5	12.1	14.2	16.5
RoE(%)	17.1	11.6	14.5	16.9	19.3

Source: Company and Karvy Estimates *Indian GAAP Consolidated*

Export formulations

Indoco's Export Formulations (EF) business is multifaceted. The company sells dossiers, does contract manufacturing and supply of different molecules at decent margins, has tie-ups for select ANDA's and has now started filing their own ANDA's. Indoco's chemistry and formulations skill sets coupled with regulatory complied manufacturing capabilities has been gaining recognition from MNC's abroad. Indoco has also entered into a couple of deals with MNC's during Q4FY10. Although the initial revenues may not be substantial, we believe the beginning has been made and the pie will grow going ahead.

Regulated markets growth to be driven by UK, Germany...

Indoco's regulated market business comprises around 80% of the EF revenues. It consists of countries like US, UK, Germany, Eastern Europe, South Africa, Australia and New Zealand.

The regulated markets business of Indoco has been skewed towards countries like UK and Germany. Indoco's UK business which contributes more than 60% of the regulated markets revenues will continue to grow strongly on the back of contractual supplies whereas German business which contributes more than 20% will grow on the back of AOK supplies.

The tender business in regulated markets of Germany, South Africa (Metformin) and New Zealand (Paracetamol) will continue to show an uptake owing to company's plans to increase the number of product application in the second round of bidding. In Germany, Indoco plans to file for 5 products through its partners, for new AOK tenders (March, 2011 - March, 2013) (2 products filed in previous round and received approval for one). Similarly, for New Zealand and South Africa, Indoco is expected to see higher tender orders going forward.

We believe UK and Germany will continue to maintain their share of the regulated market business over the next 3 years.

WATSON deal and ophthalmic product portfolio to drive business in US region...

In February 2010, Indoco finalized a generic product development alliance with WATSON for seven sterile products (incl. ophthalmic products) having market size of US$679 mn. The deal includes a few patented products also. Indoco will provide API manufacturing, formulation development and manufacturing of the generic formulations whereas WATSON will file the Abbreviated New Drug Applications (ANDAs) for US FDA approval and will have rights to market, sell and distribute these products in the US pharmaceutical market. The filings have already begun and we are expecting the approvals to start coming in from FY13. We expect milestone payments for dossier development to come in during FY11 but we have not factored the same in our estimates.

The US business (mainly ophthalmic products) has been marginal owing to differences with its US partner Amneal Pharmaceuticals (Amneal). However, Indoco has firmed up plans to enter the US markets by filing its own ANDA's. Indoco has commissioned a dedicated ophthalmic facility catering exclusively for the regulated markets which is expected to come onstream in FY12. Indoco expects 30% of EF revenues to come from the new plant in FY12 which will increase to 35% in FY13.

Indoco's EF business

(in Rs. Mn)	FY09	FY10E	FY11E	FY12E
Regulated Markets	758	889	1,201	1,663
y-o-y (%)		17	35	38
% of total	80	82	81	78
Semi-Regulated markets	191	191	281	481
y-o-y (%)		0	47	71
% of total	20	18	19	22
TOTAL	948	1,080	1,482	2,144
y-o-y (%)		14	37	45

Source: Company, KSBL Research

ASPEN deal to drive growth in semi-regulated markets in the long term…

Indoco's semi-regulated markets business includes countries namely Latin America, Africa, South East Asia & Commonwealth of Independent States (CIS). Indoco has been marred by the payment related issues in these countries and is therefore keen to explore the tender business model and partnership model for further penetration in these geographies.

In March 2010, Indoco entered into an dossier licensing and supply deal with ASPEN for the supply of 7 opthalmic products to 30 emerging countries(incl. BRICS & other emerging countries & SA). ASPEN will start marketing and distributing these products immediately on obtaining the regulatory approvals. We expect Rs. 200 mn revenues coming from ASPEN in FY12. During Q3FY10, Indoco bagged a large tender from Kenya for a couple of products which will generate revenues of Rs.180 mn over a period of next 2 years. The supply for the same has started from February 2010.

EF revenues will be further boosted by the milestone payments from WATSON and ASPEN during FY11 and FY12 as dossier licensing income which has not been factored in.

With increased cost conscious attitude of MNC's, we believe companies like Indoco which have facilities adhering to global regulatory standards stand to benefit in the long run.

Domestic Formulations

Indoco's Domestic Formulations business (68% of 9MFY10 revenues) has been showing a turnaround post the inventory and debtor re-alignment exercise commenced during Q4FY09. It currently markets 200 products (incl. line extension) through 6 divisions in the domestic formulations space with a 1500 medical representatives (MR) strength.

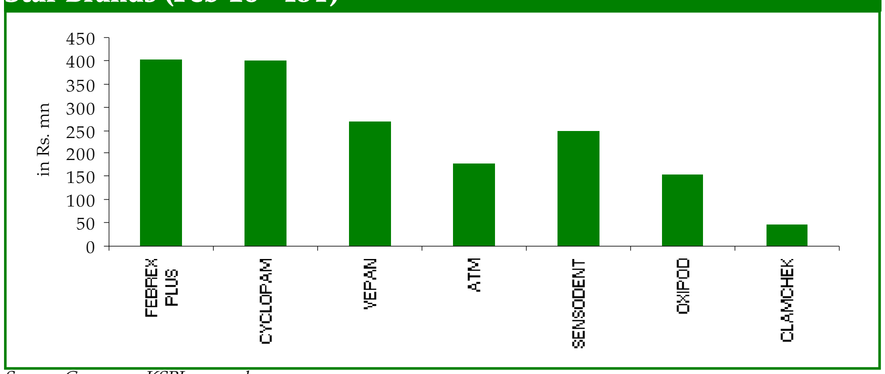
Main therapy areas		Contribution (in Rs.)	
Respiratory & Anti-allergy	24%		
Anti-infective	21%	5 brands	200 mn +
Dental	16%	5 brands	100-200 mn
Alimentary Systems	11%	16 brands	30-100 mn

Source: Company, KSBL research

From, the above it can be seen that 45% of the domestic formulation revenues of Indoco come from Respiratory and Anti-allergy (RI) and Anti-infectives (AI) products. Indoco has significant number of products in the revenue range of Rs.30-100 mn. Going forward, the company will launch niche, high realization products in its main therapy areas namely RI and AI. The company's endeavour will be to scale up a product launch to a Rs.30 mn brand in a span of 2 years for it to be profitable.

Indoco's top 5 brands are growing above the average domestic formulation market growth rate except Vepan (DPCO product).

Star Brands (Feb'10 - YoY)



Source: Company, KSBL research

STAR Brands (Feb'09-Feb'10)	(Growth %)
FEBREX PLUS	26
CYCLOPAM	33
VEPAN	-5
ATM	29
SENSODENT	22
OXIPOD	92
CLAMCHEK	218

Source: Company, KSBL Research

The company's intention to grow OXIPOD and CLAMCHECK as displayed by the strong growth rates clocked by them during last year.

Indoco plans to launch two new divisions namely EXTENT and INTEGRA focusing on two therapy areas namely Respiratory (RI) and Gastrointestinal (GI) products. Initially, the new divisions will focus on selling in 4 southern states and then it will be launched on a pan-India basis. Indoco plans to hire 300 new MR's for the same. During FY11, Indoco plans to launch 50 new products (10 each from new divisions, 5 each from old divisions). We believe the above initiatives will enable the company to grow by 14% y-o-y during FY11 and 15% y-o-y during FY12 in the domestic formulations space.

Working capital update

The company has set an ambitious target of reducing its working capital post the restructuring exercise. We have factored debtor days to reduce from 80 days in FY10 to 70 days in FY11. The inventory days will come down from 73 days in FY10 to 60 days in FY11. On creditor days the company's policy is to pay on time and hence save the interest cost in the domestic space. The result has been reduction in creditor days to 65 days in FY10. The same will be maintained going forward.

Views & Valuation

We upgrade our FY11 revenue estimates by 4.9% to Rs.4,743 mn on account of better revenue traction in the high margin DF space and uptake in the EF space. We have incorporated FY12 numbers and roll over our target price based on FY12 EPS. Improvement in revenue traction, EBITDA margins and strong earnings growth of 30% plus in FY11E and FY12E coupled with improving return ratios make the stock an attractive investment opportunity. We upgrade our rating on the stock from market performer to BUY with a price target of Rs480 based on 8x FY12E.

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Profit & loss statement

(Rs mn)	FY2008	FY2009	FY2010E	FY2011E	FY2012E
Domestic sales	2,117	2,508	2,739	3,112	3,566
Exports	602	1,003	1,168	1,584	2,261
Net Sales	2,627	3,506	3,908	4,696	5,827
% growth	(19.4)	33.5	11.4	20.2	24.1
Opearting Income	2	16	35	47	68
Total Revenues	2,628	3,522	3,943	4,743	5,895
Raw Material	1,127	1,496	1,668	2,019	2,535
Staff	323	479	559	670	804
R&D Exps	72	92	99	129	160
Others Exps	668	974	1,038	1,202	1,460
Miscellaneous Expenditure	2	3	3	4	5
Total Expenditure	2,192	3,044	3,367	4,025	4,964
EBITDA	436	478	575	719	931
% growth	(25.1)	9.6	20.4	24.9	29.5
EBITDA margin (%)	16.6	13.6	14.6	15.2	15.8
Other income	10	17	2	28	23
Interest	36	58	30	38	38
Gross Profit	410	437	547	709	916
% growth	(24.9)	6.5	25.2	29.7	29.2
Depreciation	78	112	120	147	176
Profit Before Tax	332	325	427	562	740
% growth	(27.1)	(2.2)	31.4	31.7	31.6
Tax	19	17	0	0	0
Effective tax rate (%)	5.9	5.2	0.00	0.00	0.00
Net Profit	313	308	427	562	740
% growth	(23.9)	(1.5)	38.6	31.6	31.4
Extraordinaries	(5)	6	0	0	0
Reported Net Profit	308	314	427	562	740
% growth	(26.8)	2.2	35.8	31.6	31.4
EPS (Rs)	33.9	25.1	34.7	45.7	60.1
% growth	1	(26)	39	32	31
DPS (Rs)	5	5	7	9	12
Payout (%)	22	24	24	23	22

Balance sheet

(Rs mn)	FY2008	FY2009	FY2010E	FY2011E	FY2012E
Equity	123	123	123	123	123
Reserves	2,415	2,660	2,986	3,419	3,992
Networth	2,538	2,783	3,109	3,542	4,114
Short-term Loans	187	401	205	205	230
Long-term Loans	156	154	444	454	434
Total Loans	343	556	649	659	664
Deferred tax Liability	219	230	230	230	230
Liabilities	3,100	3,569	3,989	4,431	5,009
Gross Block	2,190	2,343	2,706	3,467	3,948
Depreciation	474	584	704	850	1,026
Net Block	1,716	1,759	2,002	2,617	2,922
Capital work-in-progress	18	163	100	139	158
Investments	0	0	0	0	0
Inventories	443	525	535	523	644
Debtors	1,078	1,003	889	901	1,118
Cash	161	290	634	471	436
Other Current assets	309	415	473	554	688
Total Current assets	1,991	2,233	2,531	2,449	2,886
Creditors	356	327	297	360	451
Other current liabilities	270	260	347	414	505
Total current liabilities	626	587	644	774	957
Net current assets	1,365	1,646	1,886	1,675	1,929
Total Assets	3,100	3,569	3,989	4,431	5,009

Ratios

(Rs mn)	FY2008	FY2009	FY2010E	FY2011E	FY2012E
EV/ EBDITA	11.4	10.6	8.3	6.9	5.4
ROE (%)	17.1	11.6	14.5	16.9	19.3
ROCE (%)	16.4	11.5	12.1	14.2	16.5
PE (x)	11.5	15.5	11.2	8.5	6.5
P/S (x)	1.8	1.4	1.2	1.0	0.8
P/BV (x)	1.9	1.7	1.5	1.3	1.2
Debt/Equity (x)	0.1	0.2	0.2	0.2	0.2

Cash flow

(Rs mn)	FY2008	FY2009	FY2010E	FY2011E	FY2012E
EBIT	358	366	456	572	755
(Inc.)/Dec in working capital	(159)	(152)	104	48	(288)
Cash flow from operations	200	215	560	620	466
Other income	10	17	2	28	23
Depreciation	78	112	120	147	176
Interest paid (-)	(36)	(58)	(30)	(38)	(38)
Deferred Tax liability	12	11	0	0	0
Tax paid (-)	(19)	(20)	0	(1)	(2)
Dividends paid (-)	(72)	(75)	(101)	(129)	(165)
Miscellaneous Exp	1	3	0	0	0
Extraordinaries	(5)	6	0	0	0
Net cash from operations	168	209	550	627	461
Capital Expenditure (-)	(125)	(299)	(300)	(800)	(500)
Free Cash Flow	44	(90)	250	(173)	(39)
Inc./(Dec.) in ST borrowing	40	214	(196)	0	25
Inc./(dec.) in LT borrowing	(53)	(1)	290	10	(20)
Inc./(dec.) in borrowings	(13)	213	94	10	5
(Inc.)/Dec. in Investments	0.0	(0.2)	0.0	0.0	0.0
Cash from Financial Activities	(13)	213	94	10	5
Others	(24)	6	0		
Opening cash	154	161	290	634	471
Closing cash	161	290	634	471	436
Change in Cash	7	129	344	(163)	(34)

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Stock Ratings		Absolute Returns	Stock Ratings		Absolute Returns
Buy	:	> 25%	Market Performer	:	0 - 15%
Out Performer	:	16 - 25%	Under Performer	:	< 0%
Sell	:	<(25%)			

Disclaimer

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