

# Sun Pharmaceutical Industries

12 September 2014

Reuters: SUN.BO; Bloomberg: SUNP IN

## Surprise Audit Of Halol Unit By USFDA - Outcome Is Key

As per a report in the *Business Standard* newspaper dated 11 September 2014, the US Food and Drug Administration (USFDA) has undertaken a surprise audit of Sun Pharmaceutical Industries' (SPIL) Halol facility in Gujarat. While it will take a few days to know the outcome of the inspection, we believe it will remain a near-term overhang on SPIL after the recent import alert on its Karkhadi (Gujarat) facility over data integrity issues. Based on our interactions with SPIL's management, we believe the Halol facility is the largest, which supplies products to the US excluding Taro (as per our assessment, the facility contributed around 22%-25% to FY14 EBITDA) and, therefore, any negative outcome will significantly impact earnings. If the inspection is cleared successfully, then we believe it will significantly boost investors' confidence in SPIL's manufacturing capability. Since the inspection of Karkhadi unit, there have been three inspections by the USFDA, out of which SPIL has been given 483 on one audit (as per <http://fdazilla.com>, a website tracking USFDA regulatory actions). In our earlier interactions, SPIL's management had stated that an internal review of all facilities was undertaken after the Karkhadi import alert and that the focus was on strengthening the manufacturing practices across plants. We prefer a wait-and-watch strategy pending clarity on Halol unit inspection and have retained Accumulate rating on SPIL with a target price of Rs872, valuing the stock at 25x FY16E EPS of Rs34.9 (unchanged).

### USFDA's uninformed audit comes as a surprise, but not a bolt from the blue:

While the sudden and uninformed USFDA audit is surprising, it is not a bolt from the blue as after the Karkhadi import alert – because of data integrity issue – it was widely expected that SPIL's other facilities will also be subject to strict scrutiny by the USFDA. It may be recalled that in the warning letter issued for the Karkhadi unit, the USFDA had raised the issue of integrity of all data generated by the company. While the Karkhadi import alert had a negligible impact (<1% of sales), Halol is the largest facility supplying products to the US (excluding Taro) and had accounted for 22%-25% of FY14 EBITDA, as per our estimate. An adverse outcome can significantly impact earnings as well as SPIL's premium valuation. If SPIL clears the inspection successfully, then we believe it will significantly boost investors' confidence in SPIL's manufacturing capability. As per <http://fdazilla.com>, there have been three inspections by the USFDA since the Karkhadi inspection, out of which SPIL has been given 483 on one audit (the inspection was immediately after the Karkhadi audit). In our earlier interactions with the management, SPIL had stated that an internal review of all facilities was undertaken after the Karkhadi import alert and that the focus was on strengthening the manufacturing practices across its plants.

**Surprise USFDA audits may happen across the pharmaceuticals sector:** While the remaining facilities of companies which had experienced GMP (Good Manufacturing Practices) non-compliance problems are likely to be under the high-risk category, we believe the scope of USFDA surprise checks is likely to expand. In the past, companies were informed at least one-two months prior by the USFDA about its inspection, which gave them ample time to set things right. However, with the USFDA setting up an office in India, the frequency of its inspections has increased (often, without any notice), while the lead time has declined significantly, resulting in an increase in the number of GMP non-compliance cases.

## ACCUMULATE

**Sector:** Pharmaceuticals

**CMP:** Rs823

**Target Price:** Rs872

**Upside:** 6%

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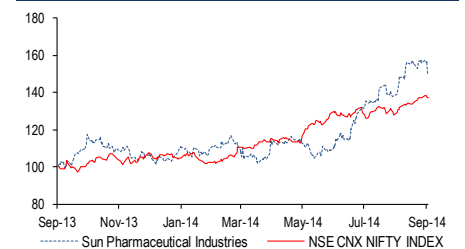
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### Key Data

Current Shares O/S (mn)	2,071.1
Mkt Cap (Rsbn/US\$bn)	1,703/28.0
52 Wk H / L (Rs)	878/536
Daily Vol. (3M NSE Avg.)	2,104,023

### One-Year Indexed Stock Performance



### Price Performance (%)

	1 M	6 M	1 Yr
Sun Pharma	7.6	41.7	46.5
Nifty Index	6.0	24.2	36.7

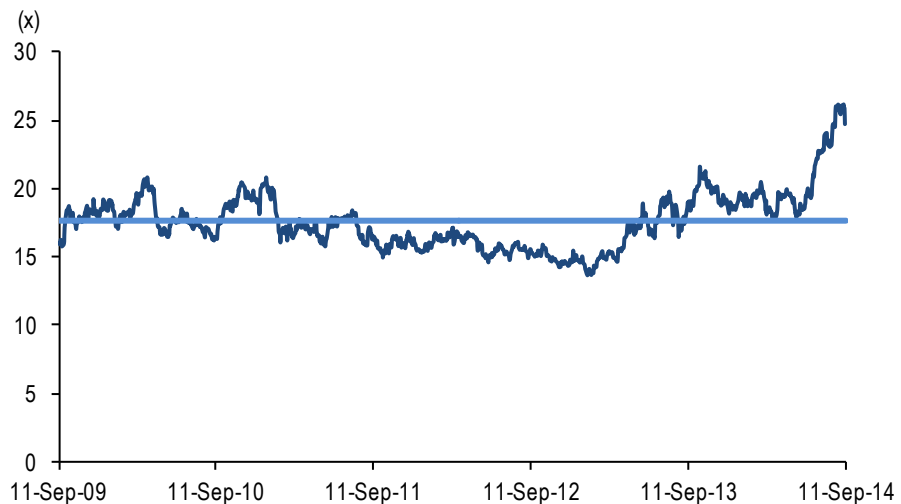
Source: Bloomberg

## Exhibit 1: Financial summary

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Revenue	112,999	160,804	189,987	217,299	254,614
YoY (%)	40.9	42.3	18.1	14.4	17.2
EBITDA	48,900	71,956	84,910	96,067	112,561
EBITDA (%)	43.3	44.7	44.7	44.2	44.2
Reported PAT	29,896	32,044	65,714	72,238	85,253
YoY (%)	12.5	7.2	105.1	9.9	18.0
Adjusted PAT	35,732	57,218	65,714	72,238	85,253
YoY (%)	34.4	60.1	14.8	9.9	18.0
Reported EPS	14.4	15.5	31.7	34.9	41.2
Adjusted EPS	17.3	27.6	31.7	34.9	41.2
RoE (%)	26.2	33.9	30.9	27.2	26.2
RoCE (%)	29.4	33.4	30.4	28.2	27.3
P/E (x)	47.6	29.7	25.9	23.5	19.9
EV/EBITDA (x)	34.0	22.9	19.0	16.3	13.5

Source: Company, Nirmal Bang Institutional Equities Research

## Exhibit 2: P/E ratio



Source: Company, Nirmal Bang Institutional Equities Research

## Financials

### Exhibit 3: Income statement

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Net sales	112,999	160,804	189,987	217,299	254,614
% growth	40.9	42.3	18.1	14.4	17.2
Raw material costs	(20,733)	(27,793)	(34,963)	(36,737)	(43,046)
Staff costs	(15,345)	(20,744)	(25,513)	(29,173)	(34,184)
R&D expenses	(6,249)	(9,862)	(12,473)	(14,263)	(16,712)
Other expenses	(21,771)	(30,448)	(32,128)	(41,059)	(48,111)
Total expenditure	(64,099)	(88,848)	(105,077)	(121,231)	(142,053)
EBITDA	48,900	71,956	84,910	96,067	112,561
% growth	52.6	47.1	18.0	13.1	17.2
EBITDA margin (%)	43.3	44.7	44.7	44.2	44.2
Other income	1,512	5,081	4,725	4,559	5,672
Interest costs	2,000	(442)	(500)	(600)	(700)
Depreciation	(3,362)	(4,094)	(5,102)	(5,597)	(6,092)
Profit before tax	49,050	72,501	84,033	94,429	111,441
% growth	46.1	47.8	15.9	12.4	18.0
Exceptional Items	(5,835.8)	(25,174.0)	-	-	-
Tax	(8,456)	(7,908)	(12,605)	(14,164)	(16,716)
Effective tax rate (%)	17.2	10.9	15.0	15.0	15.0
Net profit	34,759	39,420	71,428	80,265	94,725
% growth	14.2	13.4	81.2	12.4	18.0
Minority Interest	(4,863)	(7,375)	(5,714)	(8,026)	(9,473)
Reported net profit	29,896	32,044	65,714	72,238	85,253
% growth	12.5	7.2	105.1	9.9	18.0
Adjusted net profit	35,732	57,218	65,714	72,238	85,253
% growth	34.4	60.1	14.8	9.9	18.0

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 5: Balance Sheet

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
Equity	1,036	2,071	2,071	2,071	2,071
Reserves	148,862	185,935	235,772	290,557	355,213
Net worth	149,897	188,006	237,843	292,629	357,284
Short-term loans	50	50	50	50	50
Long-term loans	2,547	24,840	23,850	23,850	23,850
Total loans	2,597	24,890	23,900	23,900	23,900
Deferred tax liabilities/(assets)	(7,122)	(9,109)	(9,109)	(9,109)	(9,109)
Minority interest	16,351	19,212	24,926	32,953	42,425
<b>Liabilities</b>	<b>161,723</b>	<b>222,999</b>	<b>277,560</b>	<b>340,372</b>	<b>414,500</b>
Gross block	87,092	102,109	111,109	120,109	129,109
Depreciation	30,618	34,711	39,813	45,410	51,502
Net block	56,475	67,398	71,296	74,699	77,607
Capital work-in-progress	5,626	9,193	9,193	9,193	9,193
Long-term investments	23,021	26,765	33,885	41,005	48,125
Inventories	25,778	31,230	42,993	49,180	57,631
Debtors	27,108	22,004	45,211	51,717	60,605
Cash	40,587	75,901	114,453	154,259	202,032
Liquid Investments	1,095	1,095	1,095	1,095	1,095
Other current assets	19,947	47,377	33,269	38,056	44,596
Total current assets	114,515	177,608	237,021	294,307	365,960
Creditors	13,565	13,283	22,237	25,656	30,063
Other current liabilities	24,348	44,683	51,597	53,173	56,317
Total current liabilities	37,913	57,965	73,834	78,829	86,380
Net current assets	76,601	119,643	163,187	215,478	279,580
<b>Total assets</b>	<b>161,723</b>	<b>222,999</b>	<b>277,560</b>	<b>340,372</b>	<b>414,500</b>

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 4: Cash flow

Y/E March (Rsmn)	FY13	FY14	FY15E	FY16E	FY17E
EBIT	45,538	67,862	79,808	90,470	106,469
Inc./(dec.) in working capital	(11,115)	(27,027)	(13,127)	(14,061)	(19,473)
<b>Cash flow from operations</b>	<b>34,423</b>	<b>40,835</b>	<b>66,681</b>	<b>76,409</b>	<b>86,996</b>
Other income	1,512	5,081	4,725	4,559	5,672
Depreciation	3,362	4,094	5,102	5,597	6,092
Interest paid (-)	2,000	(442)	(500)	(600)	(700)
Tax paid (-)	(8,456)	(7,908)	(12,605)	(14,164)	(16,716)
Dividends paid (-)	(6,419)	(11,160)	(7,742)	(15,876)	(17,453)
Exceptional items	(5,836)	(25,174)	-	-	-
<b>Net cash from operations</b>	<b>20,586</b>	<b>5,327</b>	<b>55,661</b>	<b>55,924</b>	<b>63,891</b>
Capital expenditure (-)	(24,785)	(18,584)	(9,000)	(9,000)	(9,000)
<b>Net cash after capex</b>	<b>(4,199)</b>	<b>(13,257)</b>	<b>46,661</b>	<b>46,924</b>	<b>54,891</b>
Inc./(dec.) in short-term borrowing	(370)	-	-	-	-
Inc./(dec.) in long-term borrowing	(241)	22,293	(990)	-	-
Inc./(dec.) in preference capital	-	-	-	-	-
Inc./(dec.) in borrowings	(610)	22,293	(990)	-	-
(Inc./(dec.) in investments	(1,987)	(3,745)	(7,120)	(7,120)	(7,120)
Equity issue/(buyback)	-	1,036	-	-	-
<b>Cash from financial activities</b>	<b>(2,597)</b>	<b>19,584</b>	<b>(8,110)</b>	<b>(7,120)</b>	<b>(7,120)</b>
Others	7,903	-	-	-	-
Opening cash	33,672	40,587	75,901	114,453	154,259
Closing cash	40,587	75,901	114,453	154,259	202,032
Change in cash	6,915	35,314	38,551	39,806	47,773

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 6: Key ratios

Y/E March	FY13	FY14	FY15E	FY16E	FY17E
<b>Per share (Rs)</b>					
Reported EPS	14.4	15.5	31.7	34.9	41.2
Adjusted EPS	17.3	27.6	31.7	34.9	41.2
DPS	5.0	3.1	6.3	7.0	8.2
BV/share	72.4	90.8	114.8	141.3	172.5
Dividend payout (%)	22.6	24.2	24.2	24.2	24.2
<b>Performance ratios (%)</b>					
RoE	26.2	33.9	30.9	27.2	26.2
RoCE	29.4	33.4	30.4	28.2	27.3
<b>Valuation ratios (x)</b>					
P/E	47.6	29.7	25.9	23.5	19.9
P/BV	11.3	9.0	7.1	5.8	4.8
EV/net sales	14.7	10.3	8.5	7.2	6.0
EV/EBITDA	34.0	22.9	19.0	16.3	13.5
<b>Efficiency ratios</b>					
Asset turnover (x)	1.0	1.1	1.0	0.9	0.9
Working capital/sales (x)	0.5	0.5	0.5	0.5	0.5
Receivable days	88	50	87	87	87
Inventory days	83	71	83	83	83
Payable days	77	77	77	77	77

Source: Company, Nirmal Bang Institutional Equities Research

## Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
1 November 2011	Hold	503	513
15 November 2011	Hold	510	532
12 January 2012	Buy	519	592
14 February 2012	Buy	552	635
19 March 2012	Hold	545	596
16 April 2012	Hold	579	596
31 May 2012	Hold	566	596
13 August 2012	Sell	675	638
4 October 2012	Sell	698	638
19 October 2012	Sell	700	638
9 November 2012	Sell	694	651
7 January 2013	Sell	735	651
11 January 2013	Hold	746	768
29 May 2013	Hold	996	1,037
13 June 2013	Hold	981	1,005
21 June 2013	Hold	968	1,005
12 August 2013*	Buy	507	589
18 November 2013*	Hold	608	684
7 January 2014*	Buy	588	684
14 February 2014*	Buy	615	708
11 April 2014*	Buy	616	708
2 June 2014*	Buy	608	735
10 July 2014*	Accumulate	722	735
14 August 2014	Accumulate	800	872

\*Post 1:1 bonus share issue

## Disclaimer

### Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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