

Jan 27, 2012

ORCHID CHEMICALS & PHARMACEUTICALS LTD. **STRONG BUY**

Incorporated in 1992, **Orchid Chemicals & Pharmaceuticals Ltd.** (Orchid) is a leading pharmaceutical company headquartered in Chennai. The company is involved in development, manufacturing and marketing of diverse bulk activities, formulations and nutraceuticals. Orchid, which was established as an export-oriented unit (EOU), exports its product to more than 75 countries.

- ANDA filings and approvals count is poised to increase in the upcoming quarters supported by continuous efforts on product development. By the end of Q2 FY12, Orchid had 28 ANDA approvals, comprising of 11 in Cephalosporin and 17 in NPNC.
- Orchid has entered into several long-term supply contracts with large global players which pave its way to sustain robust bottom-line growth.
- Restructuring of business model to further help the company to register top-line growth. Orchid's operational performance continues to tread on a strong path after the transfer of injectable business to Hospira in FY11.
- The company has a natural hedge against currency fluctuation. Orchid has majority of its borrowing in FCCB. Depreciation of rupees will not impact the company much as more than 85% of the sales comes from exports and is billed in US dollar.
- In 2007, Orchid raised USD 175mn through FCCB which were to mature in five years. Though USD 58mn bonds have already been bought back or converted, USD 117mn is due in February 2012. The company has recently received approval to sanction USD 100mn by way of ECB from a consortium of Indian banks to redeem its outstanding FCCB.
- Orchid has a diversified presence with exports spanning across more than 75 countries. It is the largest manufacturer (exporter) of cephalosporin in India and is ranked among the top five cephalosporin producers in the world.

Based on a consolidated FY13 P/E and P/BV multiple of 6.6 and 1.8, the fair value for the company works out to be Rs 211

Financial Snapshot

Projections (Rs Mn)	FY07A	FY08A	FY09A	FY10A	FY11A	FY12E	FY13E
Revenue	2,516	4,681	8,185	10,776	15,856	22,090	27,389
Y-o-Y Growth %		86.1%	74.9%	31.6%	47.1%	39.3%	24.0%
EBITDA	853	1,523	2,843	3,561	4,765	6,047	7,422
Y-o-Y Growth %		78.6%	86.7%	25.2%	33.8%	26.9%	22.7%
Adj. PAT	733	1,331	2,132	2,644	3,607	4,689	5,963
Y-o-Y Growth %		81.7%	60.2%	24.0%	36.5%	30.0%	27.2%
EPS Rs	3.9	7.1	11.4	14.2	19.4	25.2	32.0
BVPS Rs	11.4	17.9	27.7	56.1	73.3	92.6	117.1
EBIDTA %	33.9%	32.5%	34.7%	33.0%	30.1%	27.4%	27.1%
NPM %	29.1%	28.4%	26.0%	24.5%	22.8%	21.2%	21.8%
ROE %	34.5%	39.8%	41.3%	25.3%	26.4%	27.2%	27.3%
PER x						8.2	6.4
P/B Ratio						2.2	1.8

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Recommendations	<= 1 year	1 - 2 yrs	2 - 5 yrs
Strong Buy			
Buy			
Hold			
Reduce			
Sell			

Strong Buy – Expected Returns > 20% p.a.

Buy – Expected Returns from 10 to 20% p.a.

Hold – Expected Returns from 0% to 10% p.a.

Reduce – Expected Returns from 0% to 10% p.a. with possible downside risk

Sell – Returns < 0%



STOCK DATA

BSE / NSE Code	524372 / ORCHIDCHEM
Bloomberg Code	OCP IN EQUITY
No. of Shares (Mn)	70
Sensex / Nifty	17,077.2 / 5,158.3

PRICE DATA

CMP Rs (25th Jan' 12)	167.4
Beta	1.42
Market Cap (Rs mn)	11,788
52 Week High-low	324.7 - 112.3
Average Daily Volume	558055

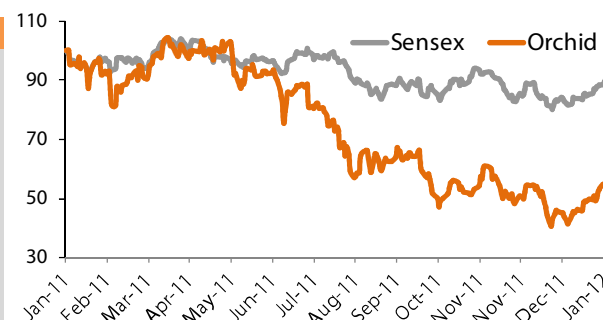
STOCK RETURN (%)

	30D	3M	6M	1Y
OCIL	19.8%	6.6%	-28.6%	-45.6%
Sensex	8.5%	-1.0%	-9.5%	-10.0%
Nifty	9.4%	-0.6%	-9.2%	-9.3%

SHARE HOLDING PATTERN (%)

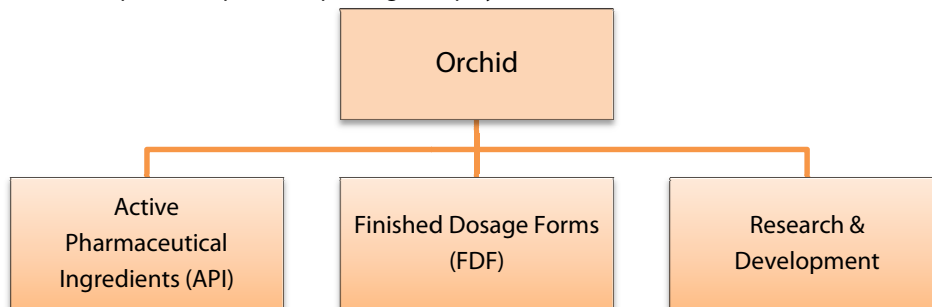
Promoter	32.4
Institution	15.9
Others	51.7
Total	100.0

1 Year Price Performance (Rel. to Sensex)



BUSINESS PROFILE

Orchid is one of the leading Indian specialty companies with strong capabilities in oral and injectable antibiotic APIs and niche generics. Established as an export-oriented unit (EOU), Orchid is a vertically integrated company spanning across the entire pharmaceutical value chain from discovery to delivery with established credentials in research, manufacturing and marketing. The company has presence across multi-therapeutic segments like anti-infectives (oral and sterile), anti-inflammatory, central nervous system (CNS), cardio vascular segment (CVS), nutraceuticals and other oral and sterile products and operates across more than 70 nations through front-end marketing, alliances and partnerships with reputed global players.

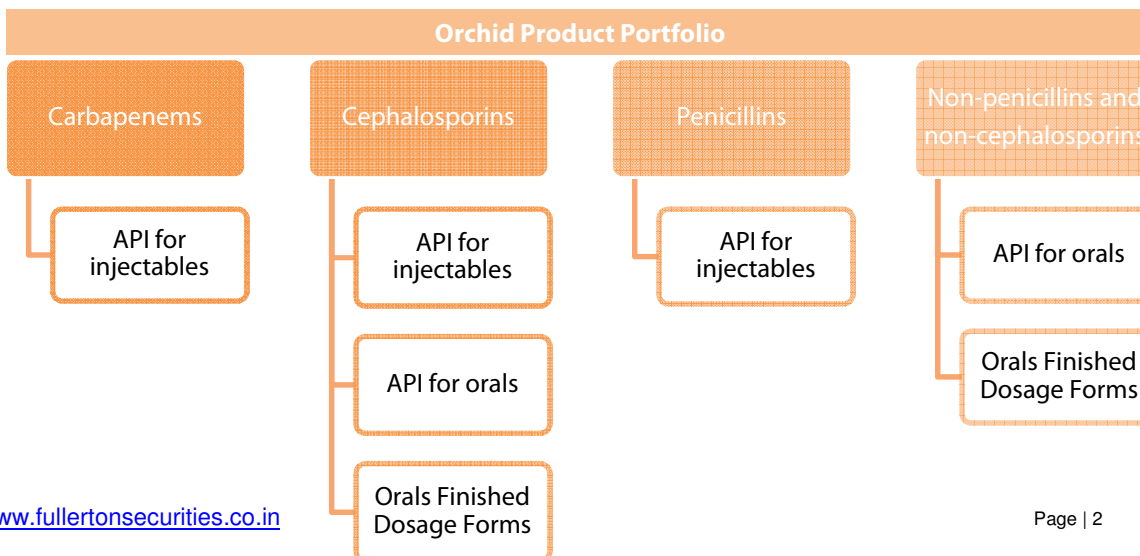


API: The company manufacture APIs for Cephalosporins (Injectables and Oral), Penicillins (Injectables) and Carbapenems (Injectables). Orchid sells the products with limited competition to global partners under long term supply agreements. It has three API plants located in Chennai, Aurangabad and China (joint venture).

Finished Dosage Forms: This segment manufactures oral FDFs for Cephalosporins and NPNCs across multiple therapeutic areas in three formulation sites in Chennai. All the manufacturing facilities of the company are in compliance with cGMP, cGLP, ISO and OHSAS guidelines and are approved by global regulatory authorities such as US FDA, UK MHRA, EDQM, PMDA, DMA, MCC and TGA. The company has presence across regulated (US, Europe, Japan) and emerging markets (CIS, China, Middle East, India, etc.) through own front end presence and alliances with partners such as Hospira, AlvoGen and a leading Japanese innovator.

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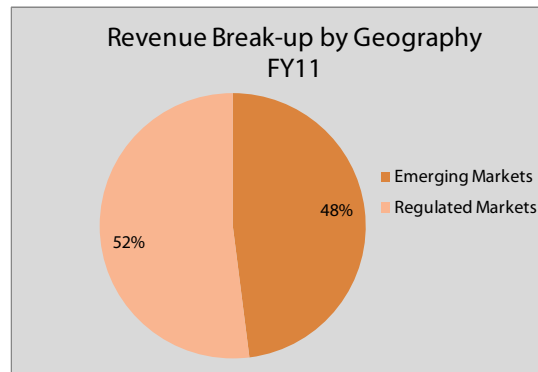
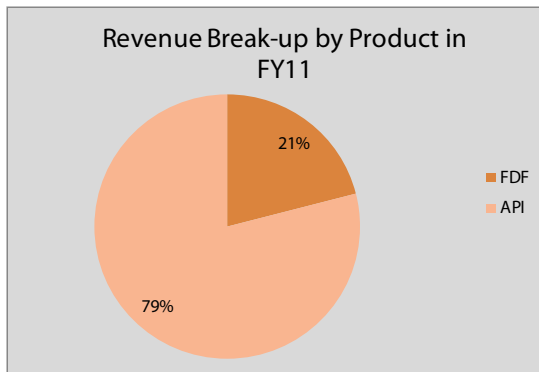
BUSINESS PROFILE (Contd.)

Research and Development: Orchid's research and development activities are divided into core areas of process research, pharmaceutical research, novel drug delivery systems, new drug discovery and biotechnology.

- The process research is focused on non-infringing processes for patenting and regulated market entry.
- Pharmaceutical research covers antibiotics and nonantibiotics, with specific departments for domestic markets, emerging generic markets and regulated generic markets, as well as a specialised veterinary product development programmes.
- The novel drug delivery systems research focuses on the development of novel methods for drug delivery.
- New drug discovery research focuses on development of new molecular entities and conducts pre-clinical and analytical testing of these molecules. Research is mainly focused on the therapeutic areas of anti-diabetes, anti-inflammatory, anti-infectives, oncology and clotting disorders.
- Biotechnology research focuses on molecular biology and bio-chemical engineering.

The company's long-term strategy for drug discovery is to validate compounds through pre-clinical testing and Phase I human clinical and proof-of-concept studies.

The process research is focused on non-infringing processes for patenting and regulated market entry



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Regulatory filings

- Orchid's cumulative DMF filings by the end of Q2FY13 stood at 86 (27 in Cephalosporin, 46 in NPNC, 2 in Betalactam and 11 in Carbapenems)
- Cumulative certificate of suitability for the European markets stood at 21 (14 in Cephalosporin, 6 in NPNC and 1 in Betalactam)
- Cumulative ANDA filings stood at 43, which includes 8 Para IV First-To-File (13 in Cephalosporin and 30 in NPNC)
- Cumulative marketing authorizations for the European markets stood at 25 (13 in Cephalosporin and 12 in NPNC)

ANDA approvals stood at 28, which includes 6 tentative approvals by the end of Q2FY12

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- Cumulative marketing authorizations approvals for the European markets stood at 21 (9 in Cephalosporin and 12 in NPNC)



FCCB ISSUE RESOLVED & SWOT ANALYSIS

Orchid has recently received approval from a consortium of Indian banks to raise USD 100mn through external commercial borrowings (ECB) in order to redeem USD 117mn of FCCB which is due in February 2012. The remaining USD 17mn will be paid from the company's internal accruals in dollars.

The company mentioned that depreciation of domestic currency will not impact it much as 85% of its sales is exports and is billed in US dollar. This is a natural hedge for the company against currency fluctuations. ECB borrowing is a positive development for Orchid because there were some apprehensions that they would not be able to service the debt due to fall in contribution from injectibles business.

India's low per capita expenditure on health is expected to correct to the high global average

Description	2012 Bonds
FCCB Issue Value	USD 175mn
Conversion till date	Nil
Redemption value (%) of the book value	142.77%
FCCB bought back	USD 57.578mn
FCCB outstanding	USD 117.422mn

Strength	Weakness
<ul style="list-style-type: none"> - Strong end-to-end capabilities with presence across the entire value chain of APIs and formulations - Global presence in over 70 countries - Five state of the art API and formulations manufacturing facilities with approvals from leading agencies - Strong track record of regulatory filings and approvals - Successful ECB borrowing to redeem FCCB 	<ul style="list-style-type: none"> - Orchid is focused only on niche products - Decline in revenue contribution from Generic injectable formulations business (Hospira deal) - Increase in raw material and wage inflation impacted bottomlines - Sales generated by new approvals witnessed declining trends over the last few years despite an increase in R&D budgets
Opportunity	Threat
<ul style="list-style-type: none"> - Total addressable market size of USD 75 – 80 bn - India's low per capita expenditure on health is expected to correct to the global average - Branded drugs going off-patent in the near future are likely to create a huge market for generic drugs - Rising income levels, increasing affordability, gradual penetration of health insurance and rise in chronic diseases will drive domestic formulation market growth - To reduce R&D spending, US companies are outsourcing their R&D to low-cost destinations 	<ul style="list-style-type: none"> - Delay or rejection of product approval - Unfavorable government policies - Rise in addressable market size and per capita spending might attract new players - Increase in working capital or CAPEX requirement then estimated - Failing to renew regulatory approvals of plants

Delay or rejection of product approval is a threat for the company

Strong end-to-end capabilities with presence across the entire value chain of APIs and formulations



BUSINESS PERFORMANCE AND RISKS

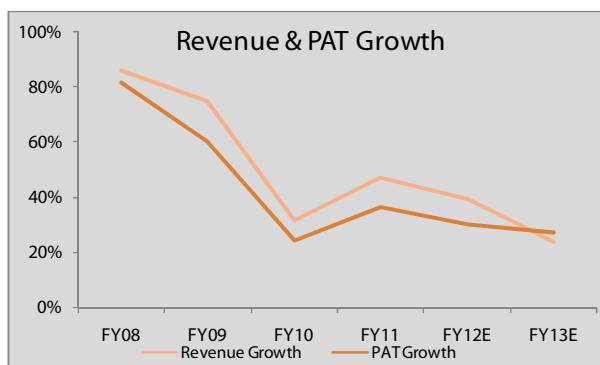
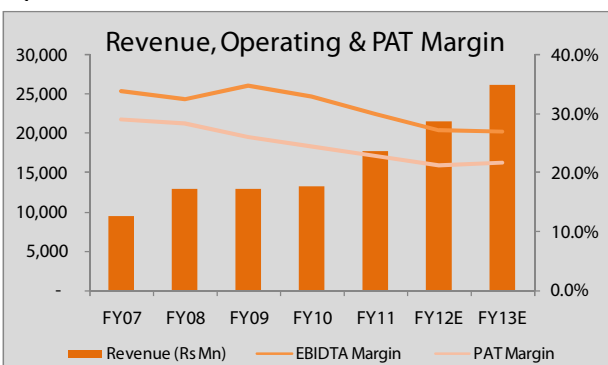
For the quarter ended Q2FY12, on a consolidated level, Orchid reported net sales of Rs 4,587.5mn, up 17.8% Y-o-Y. Long-term contracts with reputed MNCs accounted for ~40% of the top line, with the Hospira contract alone accounting for ~22% of revenue. In the FDF segment, cumulative ANDA filings for the US market stood at 43, which include eight Para IV FTF filings. The break-up of total ANDAs filed is 13 in the cephalosporins space and 30 in the NPNC space. In the EU region, the cumulative count of Marketing Authorizations (MAs) filed stood at 25. The break-up of the total MA filings is 13 in the cephalosporin space and 12 in the NPNC space.

Going forward, for FY12, the company has stated revenue guidance of ~USD 500mn, 25% Y-o-Y growth. The expected OPM stands at 24%, with EPS of Rs 30 on current equity. Factors that would lead to this growth include full year impact of carbapenem approvals, which the company received in FY11, additional approvals expected for carbapenems in FY12 and overall growth across different business segments, led by balance sheet deleveraging, which the company undertook in FY11.

During Q2FY12, Orchid's OPM expanded by 1.1% to 21.3%. The rise in operating profit was on account of muted rise in other expenses, which dipped by 6.8% Y-o-Y during the quarter. The company's reported net profit of Rs 207.3mn was up 19.6% on a Y-o-Y basis, mainly on account of higher interest expenses. Interest expenses during the quarter rose by 58.4% Y-o-Y.

For the quarter ended Q2FY12, on a consolidated level, Orchid reported net sales of Rs 4,587.5mn, up 17.8% Y-o-Y

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Peers

We are comparing Orchid chemicals with another firm into similar line of business Glaxo SmithKline. In terms of operational efficiency; Orchid chemical has performed at par with its peer. However R&D expenses as a % of sales for Orchid chemicals stood 0.5% which overtook that of GSK which reported around 0.4%. We therefore believe that higher R&D mix is likely to result in improved top line performance of the firm. In addition, the better R&D mix is likely to drive revenue from its outsourced business as well.

Orchid filed cumulative US DMFs of 83 till Q2FY12

Peer Group Comparison (Rs mn)						
Companies	Net sales	EBITDA	EBITDA (%)	N/P (%)	P/E	P/ BV (x)
Orchid chemicals	17817	2929	16%	9%	7.8	1.1
GlaxoSmithKline	23061	3470	15%	13%	30.9	8.5

* FY11 figures

VALUATION

We expect Orchid's revenues to grow at a CAGR of 31.4% over FY11-13 to Rs 27.4bn. We further estimate that PAT would grow at a CAGR of 28.6% over the same period to Rs 6.0bn in FY13 from Rs 3.6bn in FY11. The company was trading at a 2 year forward P/E multiple of 5.7x in FY10 and 7.2x in FY11. Even the 2 year forward P/BV multiple were in 1.5x and 1.9x in FY10 and FY11 respectively.

We believe that Orchid is likely to see strong growth across emerging and developed markets on the back of increase in ANDA approvals, several long-term supply contracts with large global players, restructuring of business model, diversified presence across 75 countries etc. We believe that the company's 2 year forward P/E and P/BV multiples would be at 6.6x and 1.8x by FY13 respectively.

Based on a consolidated FY13 P/E and P/BV multiple of 6.6 and 1.8, the fair value for the company works out to Rs 211.

We recommend a '**STRONG BUY**' rating on the stock.

Orchid's revenues to grow at a CAGR of 31.4% over FY11-13

The company was trading at a 2 year forward P/E multiple of 5.7x in FY10 and 7.2x in FY11

Based on a consolidated FY13 P/E and P/BV multiple of 6.5 and 1.8, the fair value for the company works out to be Rs 211

Financial Analysis and Projections

Particulars (Rs Mn)	FY07A	FY08A	FY09A	FY10A	FY11A	FY12E	FY13E
Net Revenue	2,516	4,681	8,185	10,776	15,856	22,090	27,389
Other Income	37	171	288	-76	316	120	120
Total Income	2,583	4,882	8,602	10,691	16,582	22,262	27,616
Operating Expenditure	1,730	3,359	5,759	7,131	11,817	16,215	20,195
Depreciation	24	63	138	278	508	565	651
EBIT	829	1,460	2,705	3,283	4,257	5,482	6,771
EBIT Margin (%)	32.9%	31.2%	33.0%	30.5%	26.8%	24.8%	24.7%
Interest	74	109	537	382	321	458	391
Profit Before Tax	755	1,352	2,168	2,901	3,936	5,024	6,380
Less: Tax	22	38	75	296	251	336	416
Adj. Profit After Tax	733	1,331	2,132	2,644	3,607	4,689	5,963
PAT Margin (%)	29.1%	28.4%	26.0%	24.5%	22.8%	21.2%	21.8%
ROE (%)	34.5%	39.8%	41.3%	25.3%	26.4%	27.2%	27.3%
EPS (Rs)	3.9	7.1	11.4	14.2	19.4	25.2	32.0
BVPS (Rs)	11.4	17.9	27.7	56.1	73.3	92.6	117.1
Valuation Ratios (x)						FY12E	FY13E
P/E						8.2	6.4
P/B						2.2	1.8

Ratio Analysis

Ratios (x)	FY07A	FY08A	FY09A	FY10A	FY11A	FY12E	FY13E
Current Ratio	3.0	2.7	2.7	3.2	2.6	2.8	2.6
Cash Ratio	0.4	0.4	0.2	0.4	0.3	0.5	0.3
Debt-Equity	0.3	0.3	1.0	0.2	0.7	0.6	0.4
Debt-Capital	0.2	0.2	0.5	0.2	0.4	0.4	0.3
Sales / Assets	0.9	1.1	0.8	0.8	0.7	0.8	0.9
Assets / Equity	1.3	1.3	2.1	1.2	1.7	1.6	1.4
Interest Coverage Ratio	11.2	13.4	5.0	8.6	13.3	12.0	17.3



Balance Sheet

Particulars (Rs Mn)	FY07A	FY08A	FY09A	FY10A	FY11A	FY12E	FY13E
Sources of Funds	2,848	4,442	10,682	12,923	22,965	28,290	30,985
Equity Capital	616	942	1,615	1,829	1,864	1,864	1,864
Equity Share Warrants	0	40	0	246	0	0	0
Reserves & Surplus	1,509	2,364	3,551	8,383	11,805	15,397	19,966
Shareholders funds	2,125	3,346	5,166	10,458	13,669	17,261	21,830
Loan funds	645	1,012	5,379	2,328	8,844	10,444	8,444
Minority Interest	73	80	134	135	219	352	477
Net DTL	5	5	3	2	234	234	234
Application of funds	2,848	4,442	10,682	12,923	22,965	28,290	30,985
Net Block	797	987	4,355	5,095	10,702	10,882	12,216
Capital WIP	12	17	172	262	252	280	308
Investments	3	3	3	3	0	0	0
Current Assets	3,044	5,075	9,843	10,885	19,272	26,413	29,635
Inventories	1,055	1,456	2,305	2,212	4,325	6,026	7,471
Debtors	1,187	2,376	4,060	4,396	6,784	9,232	11,583
Cash & bank balances	385	686	913	1,223	2,342	4,304	3,030
Loans & advances	417	558	2,565	3,054	5,821	6,852	7,551
Current Liabilities & Provisions	1,010	1,901	3,709	3,381	7,328	9,366	11,254
Net Current Assets	2,034	3,174	6,134	7,505	11,944	17,048	18,380
Miscellaneous Expenditure	2	262	18	59	68	81	81

Cash Flow Statement

Particulars (Rs Mn)	FY07A	FY08A	FY09A	FY10A	FY11A	FY12E	FY13E
Cash Flow from Operations	-88	403	1,152	1,781	1,306	2,262	4,023
Net Profit before tax & extraordinary items	764	1,371	2,203	2,932	3,924	4,689	5,963
Adjustments for non-cash & non-operating items	97	163	977	238	941	1,051	1,083
Adjustments for WC changes	-918	-1,074	-1,918	-1,060	-3,321	-3,142	-2,607
Cash Taxes	-21	-38	-75	-296	-251	-336	-416
Others / Extra-ordinary items	-10	-20	-35	-32	12	0	0
Cash Flow from Investing	-304	-498	-4,175	-1,159	-5,962	-346	-1,511
Net Investment in GFA	-192	-265	-3,518	-1,032	-2,129	-400	-1,550
Net Investment	232	-5	-155	-89	-15	-66	-81
Investment income	-343	-228	-502	-38	-3,817	120	120
Cash Flow from Financing	675	397	3,250	-313	5,774	46	-3,786
Net proceeds from debt	-130	367	4,367	-3,051	6,516	1,600	-2,000
Net proceeds from equity	1,080	419	215	4,246	809	0	0
Dividend paid	-129	-320	-755	-959	-985	-1,096	-1,394
Interest paid	-74	-109	-537	-382	-321	-458	-391
Others	-72	40	-40	-166	-246	0	0
Beginning Cash & Cash Equivalents	102	385	686	913	1,223	2,342	4,304
Net inc / (dec) in cash	283	301	228	310	1,119	1,962	-1,274
Ending Cash & Cash Equivalents	385	686	913	1,223	2,342	4,304	3,030





Board of Directors

Director Name	Current Position	Description
Shri K Raghavendra Rao	Chairman & Managing Director	Shri K Raghavendra Rao has a Bachelors Degree in Commerce from Andhra University and a Post-Graduate Diploma in Management from IIM-Ahmedabad. He is also a member of The Institute of Cost & Works Accountants of India and The Institute of Company Secretaries of India. He is the Founder and Chairman and Managing Director of Orchid. Prior to establishing Orchid, he was associated with leading organisations in India in various capacities. He was singularly responsible for developing a multi-business conglomerate in the Gulf, which included the region's first ever bulk drugs plant.
Shri S Krishnan	Executive Director - Finance	Shri S Krishnan has been associated with Orchid for around a decade and has been heading the finance function in the last few years. He has a rich and diversified experience of over 24 years in the field of finance and Accounts. He possesses a degree in Bachelor of Science from the University of Madras and is also a member of the Institute of Chartered Accountants of India and the Institute of Company secretaries of India. Shri S Krishnan in addition to his executive responsibilities as a Board member also holds the current role of Chief Financial Officer of the company.
Shri T A Ganesh	Nominee Director, IDBI	Shri T A Ganesh joined the Industrial Development Bank of India Ltd. in 1978 at Mumbai. Worked in various departments of IDBI both operations and administration at Mumbai, Delhi, Chennai, Coimbatore and presently at Mumbai Mr. Ganesh is the DGM and Head-Retail Assets Operations at the Central Processing Unit of the Bank at Mumbai. He holds a degree in Commerce and Law together with an MBA.
Shri Deepak Vaidya	Independent Director	Shri Deepak Vaidya holds a commerce degree from the University of Mumbai and is a fellow member of the Institute of Chartered Accountants, England and Wales. He has been on the Board of Orchid since 1999 and is also a member of the Audit Committee and Remuneration Committee.
Shri R Sankaran	Independent Director	Shri R Sankaran has a rich and diversified experience in the area of financial services and business consulting spanning over 40 years across a wide set of areas in the Capital Markets, Corporate Finance, Institutional Relationships, Government & Regulatory Management, Corporate Sector and Policy Influencing Public Forums. Shri Sankaran holds a Masters Degree in Economics and Diploma in Business Management and Financial Management from Bombay University.
Shri Bharat D. Shah	Independent Director	Shri Bharat D. Shah is one of the founder members of HDFC Bank. He has served in various organisations such as Pyrene Company Limited, Bradma India Limited, Technova, Thomas Cook, Citibank and had been an Investment Advisor for Union Bank of Switzerland, Singapore. He is presently the Chairman of HDFC Securities Limited. Shri Bharat Shah is a B.Sc graduate from the Bombay University and holds a Higher National Diploma in Applied Chemistry from London University.
Prof. Bala V. Balachandran	Independent Director	Prof. Bala V. Balachandran is a PhD in Industrial Administration and an MBA from Carnegie Mellon University. He is also a Certified Public Accountant, Certified Management Accountant and Certified Internal Auditor. Currently, he is involved with the Ministry of Corporate Affairs in setting up of the Indian Institute of Corporate Affairs. He is the Founder & Dean of Great Lakes Institute of Management and also the Founder & President of Mumbai Business School in India. Additionally, he is Executive Professor & Strategy Advisor to the Dean, Bauer College, University of Houston and J. L. Kellogg's Distinguished Professor (Emeritus in service) of Accounting and Information Management, Northwestern University in USA. He was awarded the Padma Shri in 2001.

