investors eye

Index

- Stock Update >> Sun Pharmaceutical Industries
- Stock Update >> Allied Digital Services
- Sector Update >> Banking

Sharekhan Ltd
Lodha iThink Techno Campus, 10th Floor, Beta Building, Off. JVLR, Opp. Kanjurmarg Railway Station, Kanjurmarg (East), Mumbai – 400 042, Maharashtra.

Sun Pharmaceutical Industries

Ugly Duckling

Stock Update

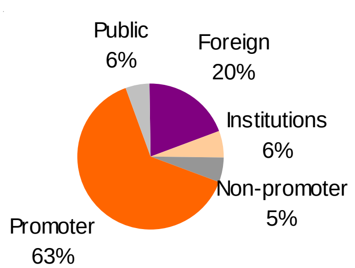
Price target revised to Rs2,090

Buy; CMP: Rs1,921

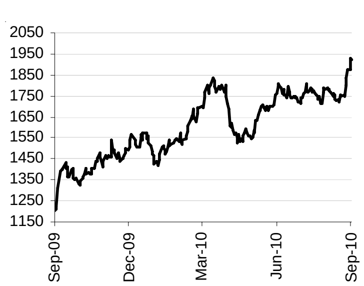
Company details

Price target:	Rs2,090
Market cap:	Rs39,767 cr
52 week high/low:	Rs1985/1187
NSE volume: (No of shares)	4.4 lakh
BSE code:	524715
NSE code:	SUNPHARMA
Sharekhan code:	SUNPHARMA
Free float: (No of shares)	7.5 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	8.6	10.9	14.6	62.6
Relative to Sensex	-0.2	-1.3	-0.4	34.2

Key points

- **Sun increases stake to 48.7% in Taro:** Based on the favourable ruling from the Israeli supreme court, Sun Pharmaceutical Industries (Sun) has completed the acquisition of a controlling stake in Israel based Taro Pharmaceuticals (Taro). Post tendering Taro's promoter's stake, Sun now controls 48.7% stake in Taro with voting rights of 65.8%. Sun would now have to shell out $36.7 million in order to acquire the controlling stake, with a total acquisition value of $139 million.
- **Taro acquisition synergistic:** With more than 100 abbreviated new drug application (ANDA) approvals (higher than Sun and Caraco combined till date), 29 pending approvals, and US$360 million in US revenues (CY2009 provisional numbers), Taro provides a strong base for Sun in the US market. Even at 100% stake, the acquisition is valued at 5.3x EV/EBITDA and 1.04x its CY2010E EV/sales which is very attractive in our view.
- **Taro valued at Rs94:** Assuming $58 million profit from Taro in CY2010E and Sun's 57.6% stake (with warrants), we value Taro at Rs94 (at a PE of 16x). Further the acquisition would contribute Rs5.87 to Sun's FY2012E earning per share (EPS) of Rs84.9, implying an upside of 7%.
- **Valuation and view:** We believe that Sun's management could potentially drive manufacturing and other operational efficiencies resulting in improvement in Taro's profitability from the current 12% net margins. At the current market price of Rs1,920, Sun is valued at 24.8x FY2011E and 22.6x FY2012E fully diluted earnings. We maintain our Buy recommendation on the stock with a revised price target of Rs2,090.

Sun acquires controlling stake in Taro

After receiving a favorable ruling from the Israeli supreme court, Sun has completed the acquisition of a controlling stake in Taro pursuant to the Option Agreement entered into in 2007 with Taro's controlling shareholders. Post tendering Taro's

Valuation table (consolidated)

Particular	FY2008	FY2009	FY2010	FY2011E	FY2012E
Net sales (Rs cr)	3356.5	4272.3	3904.0	4642.0	5268.1
PAT (Rs cr)	1486.9	1817.7	1351.1	1606.5	1757.8
Shares in issue (cr)	20.7	20.7	20.7	20.7	20.7
EPS (Rs)	71.8	87.8	65.2	77.6	84.9
PER (x)	26.7	21.9	29.4	24.8	22.6
EV/EBIDTA (x)	24.9	20.1	27.6	23.2	20.0
Book value (Rs/share)	241.0	340.1	378.0	462.8	531.6
P/BV (x)	8.0	5.6	5.1	4.1	3.6
Mcap/sales	11.8	9.3	10.2	8.6	7.5
RoCE (%)	31.1	27.0	17.7	17.3	16.5
RoNW (%)	29.8	25.8	17.3	16.8	16.0

promoter's stake, Sun now controls 48.7% stake in Taro with voting rights of 65.8%. Sun would now have to shell out $36.7 million in order to acquire the controlling stake, with a total acquisition value of $139 million.

Further Sun also holds warrants due for conversion, which will increase its stake to 57.6% in the company with voting rights of 69% leading the total investment to $161.7 million.

After Israeli court's decision

Particulars	No of shares (mn)	Investment ($mn)	% of shares	Voting power (%)
Sun's current stake	14.22	102.24	36.0	24
Warrants	3.79	22.73	9.6	4
Promoters stake	4.74	36.74	12.0	41
Sun's total stake post acquisition	**22.75**	**161.70**	**57.6**	**69**

Scale benefits from Taro acquisition

By the acquisition, Sun intends to build on Taro's expertise in dermatology, pediatrics and over-the-counter products. Also, it plans to exploit the distribution strength of Taro in USA, Canada, the UK and Israel. Taro receives approximately 75% of its revenues from the US market (approximately 60% of its revenues come from the dermatology portfolio) and has about 100 ANDAs approved with 29 pending for approval. With Taro's acquisition, Sun will also get access to a strong research and development (R&D) team of approximately 170 scientists specialised in complex generics as well as highly modern manufacturing capacities.

Taro has already achieved revenues worth $187 million in H1CY2010 with bottom line of $29 million and an EBITDA margin of 19-20%. As of June 30, 2010, Taro has a net debt of $23 million with cash equivalent of $187 million. We believe that Taro would provide a good strategic fit and significantly boost Sun's therapeutic portfolio due to its presence in derma products in the US.

Acquisition at attractive valuations

Particulars	%	$mn
Sun's current stake in taro	57.60	161.70
Assuming Sun acquires remaining stake	42.40	204.75
Total acquisition	100.00	366.45
Taro's net debt		23.00
EV of Taro deal		389.45
Taro's CY10E sales		374.00
EV/Sales for CY2010E (x)		1.04
Taro's EBITDA for CY2010E		74.00
EV/EBITDA (x)		5.26

Assuming that Sun would buy all the remaining ordinary shares at the current market price of $12.2, Sun would have to give out Rs204.8 crore for the remaining 42.4% stake. Calculating the total net debt value, the acquisition stands at 5.3x EV/EBITDA and 1.04x its CY2010E EV/sales which is very attractive in our view.

The acquisition is EPS accretive

Sun's acquisition of promoters' stake and warrant conversion would lead to an outlay of $59.5 million while its stake would reach to 57.6%. Assuming $58 million profit from Taro in CY2010E and Sun's 57.6% stake (with warrants), we value Taro at Rs94 (at a PE of 16x). Given the fact that Taro's audited figures are available till CY2007, we assume that the figures reported are correct for our calculations.

Sun's current stake in Taro (%)	36.00
Post acquisition (%)	57.60
Taro's CY10E PAT ($mn)	58.00
Contribution to Sun's PAT ($mn)	33.41
Total acquisition cost ($mn)	70.15
Legal costs (10%)	7.01
Net contribution to Sun's PAT ($mn)	26.39
Incremental EPS (Rs)	5.87
Low margin business hence multiple of 16x	93.84
Sun's target price (ex-Taro)	1994.41
New target price	**2088.26**

Valuation and view

With more than 100 ANDA approvals (higher than Sun and Caraco combined till date) and US$360 million in US revenues (CY2009 provisional numbers), Taro provides a strong base for Sun in the US market in our view. We believe that Sun's management could potentially drive manufacturing and other operational efficiencies resulting in improvement in Taro's profitability from the current 12% net margins. Further the acquisition would contribute Rs5.87 to Sun's FY2012E EPS of Rs84.9, implying an upside of 7%.

We expect Sun's strong domestic business, its niche US market (controlled release substances, hormones etc) and the improving visibility of its patent challenge pipeline to drive a steady growth in its business in the long term. The potential launch of the key products like Prandin and a clean chit from the US Food and Drug Administration (USFDA) should be re-rating factors going ahead. At the current market price of Rs1,920, Sun is valued at 24.8x FY2011E and 22.6x FY2012E fully diluted earnings. We maintain our Buy recommendation on the stock with a revised price target of Rs2,090.

Allied Digital Services

Emerging Star

Stock Update

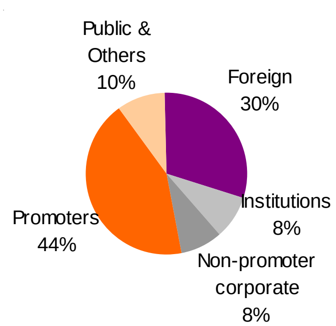
Intel investment to strengthen position in RIMS

Buy; CMP: Rs235

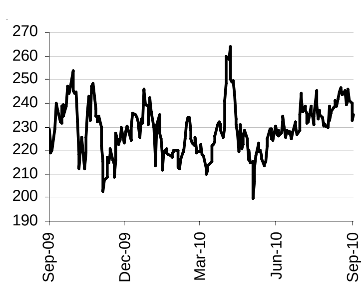
Company details

Price target:	Rs326
Market cap:	Rs1,093 cr
52 week high/low:	Rs270/195
NSE volume: (No of shares)	1.5 lakh
BSE code:	532875
NSE code:	ADSL
Sharekhan code:	ADSL
Free float: (No of shares)	2.6 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.7	1.9	6.5	4.1
Relative to Sensex	-5.7	-9.3	-7.4	-14.1

We spoke to Basit Shaikh, general manager-Finance of Allied Digital Services Ltd (ADSL), to discuss the recent announcement of the company's plan to raise funds from Intel Capital Corporation. We present the key takeaways from our interaction.

Issue of warrants to Intel Capital Corporation

ADSL has announced that it has obtained the approval of its board of directors for the issue of warrants on a preferential basis to Intel Capital Corporation for an amount not exceeding Rs32 crore. The warrants would be issued at a maximum price of Rs240 per warrant but would be dependent on the price as calculated by the Securities and Exchange Board of India's rules (not lower than the higher of the average price of the weekly high and the low of the closing prices quoted on the stock exchange over the last six months or in the last two weeks preceding the relevant date, whichever is higher). However, the issue would take at least two to three months as the approval of the shareholders would be taken by a postal ballot and the nod of the Foreign Investment Promotion Board (FIPB) will also be required.

At the price of Rs240 per share, the issue would lead to an offering of 13.33 lakh shares leading to a 2.9% dilution in the current equity of Rs23.25 crore (4.65 crore shares).

Strategic investment by Intel Capital

Intel Capital is the global investment arm of Intel Corporation. The company makes and manages investments in support of Intel Corporation's strategic objectives. As per the management, the investment is not a financial investment but more of a strategic investment which would help both the companies in the remote infrastructure management services (RIMS) space.

ADSL has already tied up with Intel Corporation to promote the latter's high "Intel V Pro" technology to leverage the same to deliver remote services to large enterprises. The technology delivers remote manageability, security and energy efficient performance for desktops and netbook personal computers.

Valuation table (consolidated)

Particulars	FY2008	FY2009	FY2010	FY2011E	FY2012E
Net sales (Rs cr)	297.4	552.1	697.5	907.5	1134.4
Adj. net profit (Rs cr)	43.6	74.5	107.8	142.1	170.6
No of shares (in cr)	3.5	3.6	4.6	4.7	4.7
EPS (Rs)	12.6	20.6	23.2	30.2	36.3
% y-o-y chg	*40.3*	*63.2*	*12.8*	*30.3*	*20.0*
PER (x)	18.7	11.4	10.1	7.8	6.5
Price/BV (x)	4.6	2.7	1.6	1.4	1.1
RoCE (%)	47.3	29.9	22.5	21.5	22.7
RoNW (%)	36.3	30.9	21.7	19.2	19.1

Earlier, the company had forged an alliance with Lenovo to provide remote services to Lenovo clients.

Valuation and view

The current announcement is another step taken by the company towards strengthening its position in the remote infrastructure space. The strategic investment by Intel Capital Corporation shows the confidence of Intel Corporation in the RIMS capabilities and business model of the company. The issue of warrants would lead to a 2.9% dilution in the equity capital of the company on a future date when the warrants shall be converted into shares.

We remain positive on the long-term sustainability of the company's business model, with incremental revenues coming from the high-margin RIMS business. We maintain our Buy recommendation on the stock with a price target of Rs326. At our price target the stock will be valued at 9x FY2012E earnings.

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

Banking

Sector Update

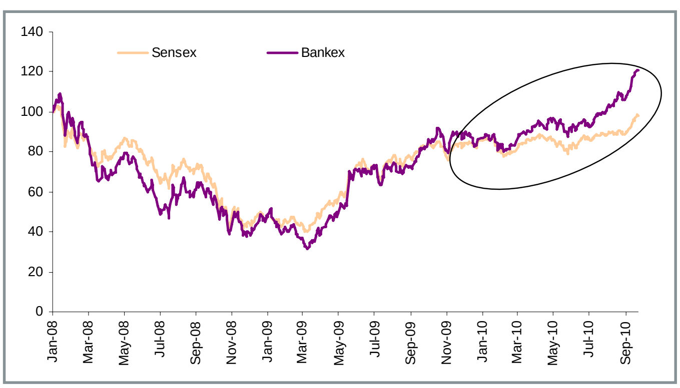
Time to be selective

The banking sector has been a darling of investors in recent months, as evidenced by a strong outperformance compared to the benchmark indices. The optimism (up to this point) is backed by a positive earnings surprise in recent times and a significant improvement in the macro environment. However, as valuations in general have turned rather ripe, we are turning selective on banking stocks. Having said that, we remain structurally positive on the domestic banking sector from a long-term perspective.

Strong outperformance

During CY2010 the Indian banking stocks have outperformed the market significantly, with the BSE Bankex expanding by 37.4% as compared to the 13.3% increase in the Sensex. The key factors that drove this performance include: (1) attractive valuations, (2) easing of asset quality risk, (3) a strong recovery in the economy, and (4) expectations of a higher earnings growth. Apart from earnings upgrades, an increase in valuations too are responsible for the sector's outperformance. However valuations for most banks still remain below their previous peaks.

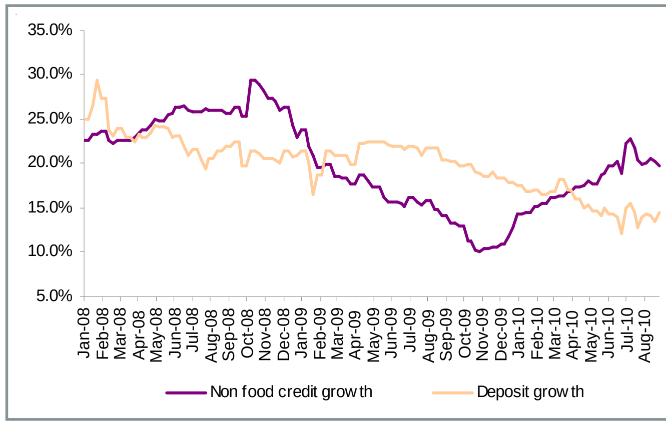
Bankex vs Sensex



Credit growth: Challenges ahead

Thanks to the smart economic recovery, the credit growth has revived smartly (touching a growth of 22.8% in July 2010). However, the credit growth has moderated since then to 19.8% year on year (YoY) as on August 27, 2010. While the strong economic recovery should translate into a healthy credit demand ahead, how much of the incremental demand comes to the banking sector is of key importance. Clearly, there are two major risks to the banking credit growth: (1) corporates moving to the short-term commercial paper market for working capital needs and (2) increasing demand for external commercial borrowings (ECBs) and foreign currency convertible bonds (FCCBs). In fact, State Bank of India (SBI) has already revised its credit growth target downwards to 18% (from 21% earlier).

Trend in credit and deposit growth



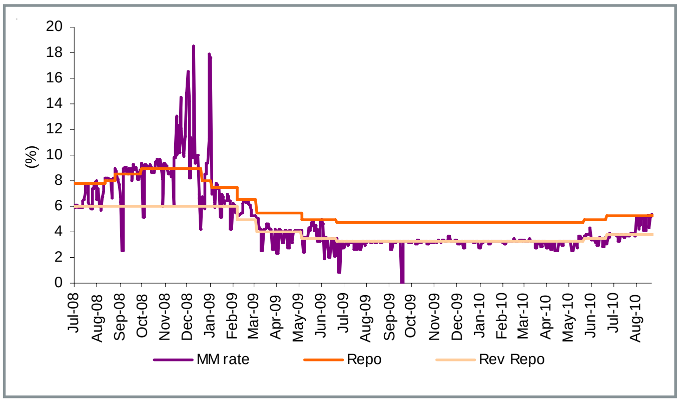
Deposit growth: Yet to revive meaningfully

As against the strong revival in credit growth since December 2009, the deposit growth has lagged significantly and is yet to revive meaningfully. This along with the reversal in monetary stance of the Reserve Bank of India (RBI) has led to a tight liquidity situation with banks now in borrowing mode at the repo window. What's more, the banks have been forced to hike the deposit rates in order to raise lending resources. Further hikes in term deposit rates might be on cards in order to revive deposit growth. Naturally, credit growth target of 20%+ for banks under our coverage implies pressure on the margins as banks would have to push the deposit growth to approximately 20%.

Rate cycle likely to pause

After raising the interest rates for the fifth time this year and returning to "neutral policy rate level", the Street expects the RBI to pause for a while before further monetary actions. We share the Street's view considering certain domestic issues (moderating industrial production, easing inflation and tight liquidity) along with the rising possibility of a double dip in developed economies. With the rate upcycle most likely to be delayed than expected earlier and liquidity remaining tight, we expect the net interest margins (NIMs) to come under pressure in the near term.

Trend in key policy rates



Near-term pressure on NIMs

With tight liquidity situation and narrowing policy rate corridor, the monetary tightening measures have started trickling down to banks' cost of funds (as borne out by the Q2FY2011 earnings season). In line, there is an increasing consensus among banks to hike the lending rates in H2FY2011, though moderating credit demand may limit the extent of the rate hike. Consequently, we believe that the NIM is likely to be under pressure in the near term with a limited upside even when the lending rates are hiked.

Asset quality concerns: Down but not out

On the asset quality front, there has been a distinct easing in concerns as the Indian economy continues to go strong despite an opposite trend in the developed world. Of course, this easing of concerns has been one of the major reasons for the optimism with regard the Indian banking sector. Having said that, we believe that investors should be cautious in the near term as the complete colour of the restructured assets will come out in the current and the next quarter. What's more, from a long-term perspective as well, prudence should be exercised as a major part of the incremental lending has gone towards the infrastructure sector (especially power).

H2FY2011 earnings: Healthy growth but moderation on cards

Collectively, all the above factors imply that the earnings growth rate during H2FY2011 is likely to be muted compared to the H1FY2011 growth. The key reason for this will be a stable to marginally higher NIM vs the last year's NIM, as the H2FY2010 NIMs were higher than the H1FY2010 NIMs. In addition, the treasury performance of banks too is likely to be muted in H2FY2011 as the bond yields have firmed up. This along with our belief that the asset quality concerns are not entirely behind us leads us to believe that the earnings growth is likely to moderate in H2FY2011.

Valuations not cheap anymore

The valuations of banking stocks are still below the exuberant previous peaks, though not significantly so. However, the current valuations are not cheap either. The valuations appear ripe especially considering the moderation in the earnings growth rate in the H2FY2011.

Valuation table

Banks	Current P/ABV	Average P/ABV*	High P/ABV*
Allahabad Bank	1.6	1.1	1.9
Andhra Bank	1.6	1.3	2.1
Corporation Bank	1.4	1.2	2.2
BOB	2.0	1.2	2.0
PNB	2.1	1.5	2.1
Federal Bank	1.3	1.0	1.5
SBI	3.1	2.0	3.3
UBI	2.0	1.5	2.3
ICICI Bank	2.4	2.1	3.3
Axis Bank	3.4	2.7	4.5
HDFC Bank	4.7	3.8	5.5
HDFC	1.5	1.3	1.8
IDBI	1.3	1.1	2.0

* Since April 2004

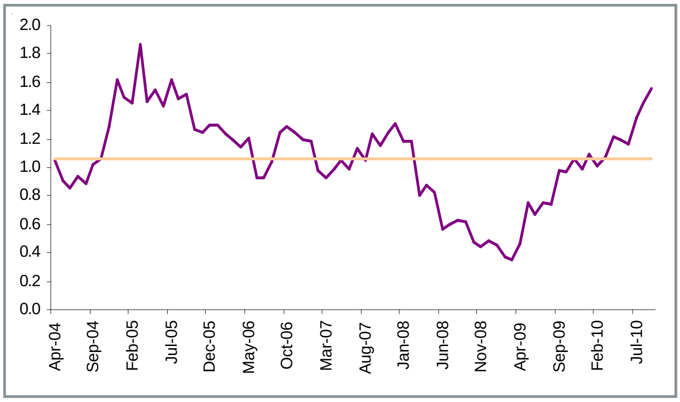
Turning selective

Considering our views, as discussed above, we advise investors to turn selective while investing in banking stocks. With the macro blanket play on the banking sector largely over in our view, we recommend banking stocks offering relatively better returns based on company-specific improvement over the medium term. We present now a summary of our recommendations.

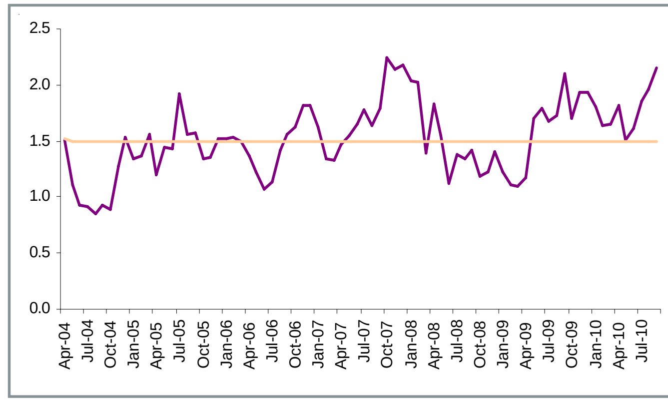
Summary

Company	Old		New	
	Reco	Target	Reco	Target
ICICI Bank	Buy	1,243	Buy	1,243
HDFC Bank	Hold	2,205	Hold	2,578
Axis Bank	Buy	1,560	Hold	1,560
State Bank of India	Buy	3,115	Hold	3,321
Punjab National Bank	Buy	1,224	Buy	1,505
Union Bank	Buy	385	Hold	420
Bank of India	Buy	504	Hold	535
Bank of Baroda	Buy	935	Buy	960
Corporation Bank	Buy	640	Buy	790
Andhra Bank	Buy	169	Hold	172
Federal Bank	Buy	387	Buy	433
IDBI	Buy	151	Buy	163
Allahabad Bank	Buy	210	Hold	237
HDFC	Hold	671	Hold	752
TFCI	Buy	38	Book Profit	38

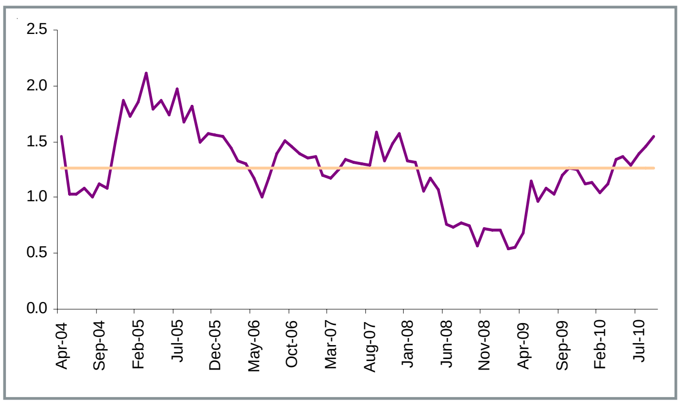
Allahabad Bank



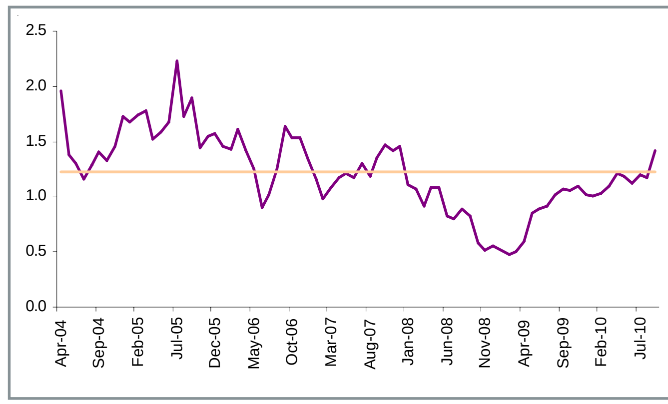
Bank of India



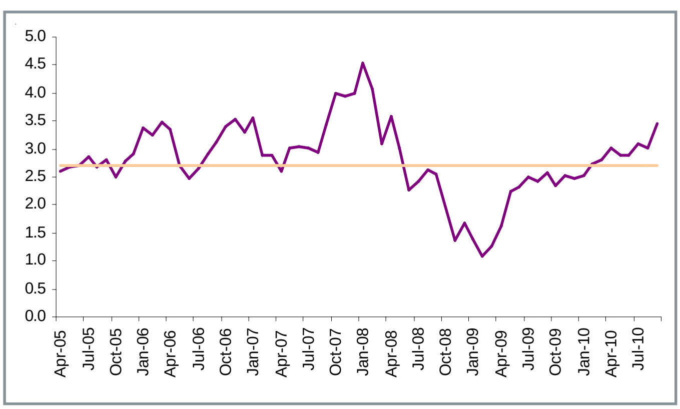
Andhra Bank



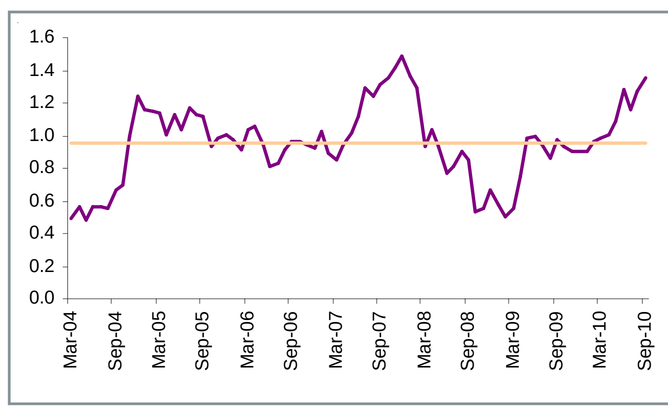
Corporation Bank



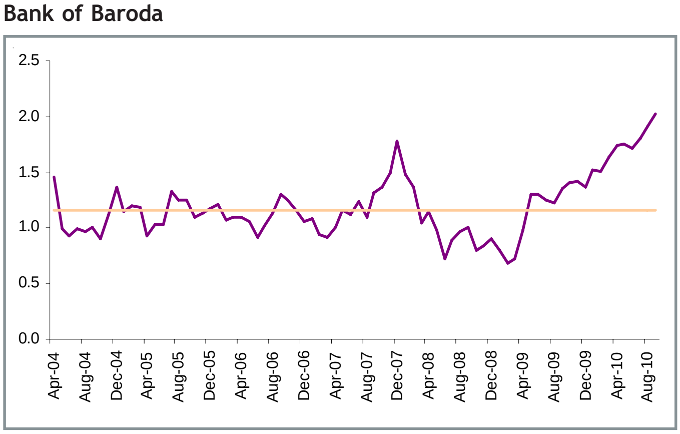
Axis Bank



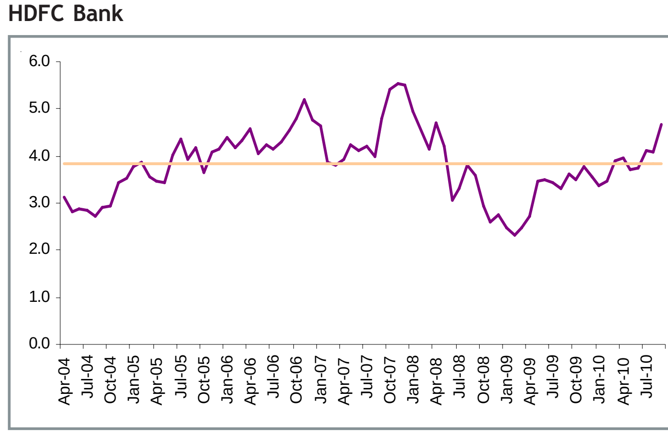
Federal Bank



Bank of Baroda

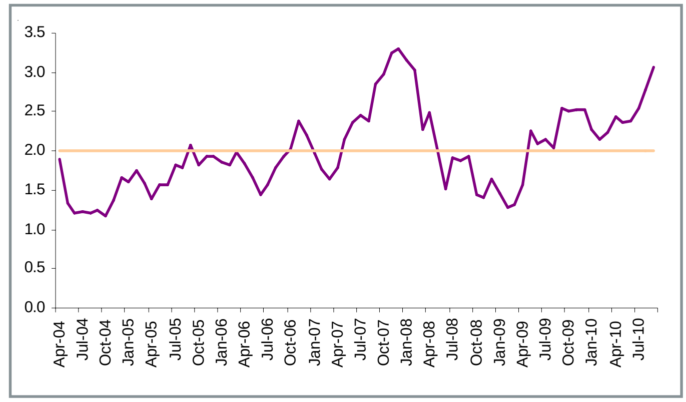


HDFC Bank



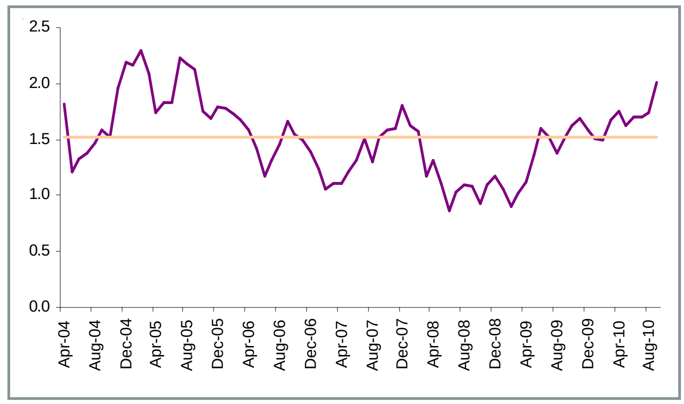
ICICI Bank

State Bank of India

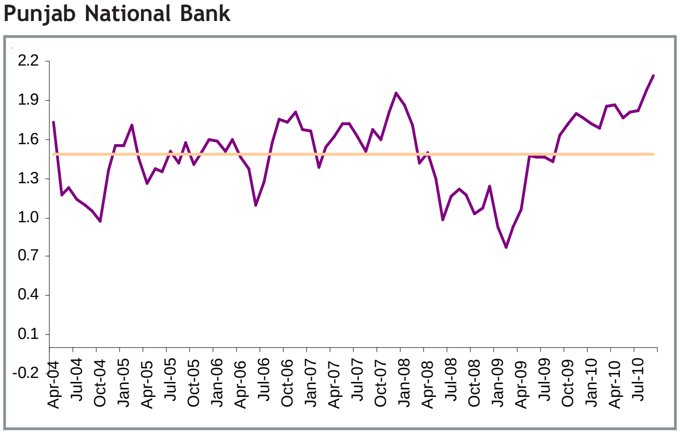


IDBI Bank

Union Bank of India



Punjab National Bank



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

Sharekhan Stock Ideas

Evergreen

- Housing Development Finance Corporation
- HDFC Bank
- Infosys Technologies
- Larsen & Toubro
- Reliance Industries
- Tata Consultancy Services

Apple Green

- Aditya Birla Nuvo
- Apollo Tyres
- Bajaj Auto
- Bajaj Finserv
- Bajaj Holdings & Investment
- Bank of Baroda
- Bank of India
- Bharat Electronics
- Bharat Heavy Electricals
- Bharti Airtel
- Corporation Bank
- Crompton Greaves
- Glenmark Pharmaceuticals
- Godrej Consumer Products
- Grasim Industries
- HCL Technologies
- Hindustan Unilever
- ICICI Bank
- Indian Hotels Company
- ITC
- Mahindra & Mahindra
- Marico
- Maruti Suzuki India
- Lupin
- Piramal Healthcare (Nicholas Piramal India)
- Punj Lloyd
- Sintex Industries
- State Bank of India
- Tata Global Beverages (Tata Tea)
- Wipro

Cannonball

- Allahabad Bank
- Andhra Bank
- IDBI Bank
- Madras Cements
- Phillips Carbon Black
- Shree Cement

Emerging Star

- 3i Infotech
- Allied Digital Services
- Axis Bank (UTI Bank)
- Cadila Healthcare
- Emco
- Greaves Cotton
- IL&FS Transportation Networks
- IRB Infrastructure Developers
- Max India
- Opto Circuits India
- Patels Airtemp India
- Thermax
- Zydus Wellness

Ugly Duckling

- Ashok Leyland
- BASF India
- Deepak Fertilisers & Petrochemicals Corporation
- Federal Bank
- Gayatri Projects
- Genus Power Infrastructures
- India Cements
- Ipca Laboratories
- ISMT
- Jaiprakash Associates
- JB Chemicals & Pharmaceuticals
- Orbit Corporation
- Pratibha Industries
- Provogue India
- Punjab National Bank
- Ratnamani Metals and Tubes
- Selan Exploration Technology
- Shiv-Vani Oil & Gas Exploration Services
- Subros
- Sun Pharmaceutical Industries
- Sunil Hitech Engineers
- Torrent Pharmaceuticals
- UltraTech Cement
- Union Bank of India
- United Phosphorus
- V-Guard Industries
- Zensar Technologies

Vulture's Pick

- Mahindra Lifespace Developers
- Orient Paper and Industries
- Tata Chemicals
- Unity Infraprojects