

Stock Update

SEBI Investigation outcome an overhang; Downgrade to Hold

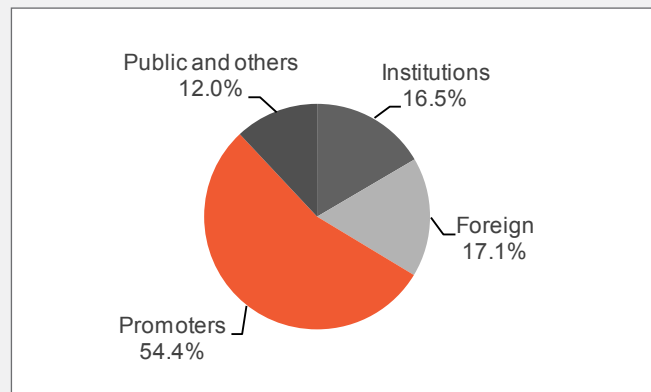
Sun Pharmaceutical Industries

Reco: Hold | CMP: Rs443

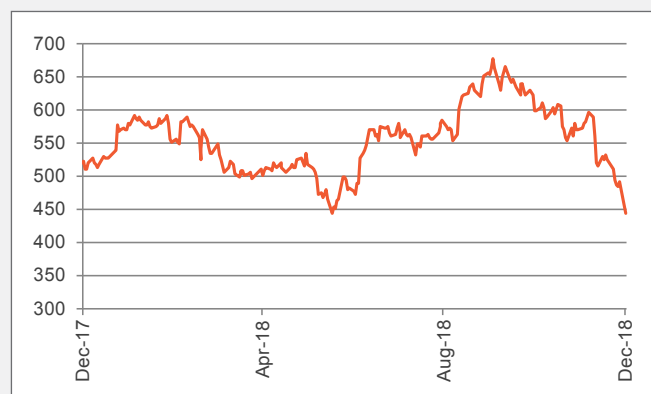
Company details

Price target:	Rs525
Market cap:	Rs106,289 cr
52-week high/low:	Rs679/435
NSE volume: (No of shares)	66.7 lakh
BSE code:	524715
NSE code:	SUNPHARMA
Sharekhan code:	SUNPHARMA
Free float: (No of shares)	109 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-20.4	-30.4	-5.7	-13.1
Relative to Sensex	-23.1	-26.6	-9.0	-22.3

Key points

- ♦ **SEBI investigation remains hangover:** Sun Pharma continues to remain surrounded by issues, the recent one being a whistle blower case filed with SEBI. This issue coupled with earlier reported business challenges has led to sharp de-rating. Though the company has still not received any communication from SEBI, the lack of information on the whistleblower case alleging irregularities at the company and uncertainty related to the outcome of reopening of insider trading case will continue to remain as a hangover on the stock.
- ♦ **Related party structure raises concerns among investors:** The domestic formulations business of Sun Pharma is routed via Aditya Medisales Limited (AML), which became a related party in FY2018 due to shareholding consolidation; it was not a related party prior to that. The company disclosed financials of Aditya Medisales for FY2018 and said that the current structure was implemented as it resulted in tax saving before GST implementation. The company is in the process of discussing various options and is open to changing the distribution arrangement with AML if investor concerns remain. The options include Sun Pharma taking over the distribution business or acquiring AML at a cost.
- ♦ **Increased loans and advances:** As per FY2018 annual report, loans and advances to employees stood at Rs. 2,200 crore. Management has said that the loan was given in the normal course of business, at arm's length and at market rates, to a pharma business, but refrained from divulging further details. However, management said that the loan was for a duration of two to two-and-a-half-years and has the potential to be reversed.
- ♦ **Downgrade to Hold with downward revised PT of Rs. 525:** Taking cues from management's commentary, we feel such corporate governance issues cropping up in Sun Pharma are not good news for valuations. Moreover, there continues to be an uncertainty related to the outcome of SEBI investigation. Hence, we downgrade our recommendation to Hold with downward revised price target (PT) of Rs. 525 (valuing the stock at 16x its FY2021E earnings vs. earlier 21x).
- ♦ **Key downside/upside risks:** Any delay in product launches or change in pharma policy or regulations in the U.S. can impact our earnings estimates adversely. Better-than-expected pick up in Ilumya and competition failing to take-off in Absorica pose upside risk to earnings.

Valuation	Rs cr			
Particulars	FY2018	FY2019E	FY2020E	FY2021E
Net sales	26489.5	30641.0	36619.6	44203.3
Adj. PAT	3112.1	4180.0	6209.9	7936.8
Shares in issue (cr)	239.9	239.9	239.9	239.9
EPS (Rs.)	13.0	17.4	25.9	33.1
PER (x)	34.7	25.8	17.4	13.6
EV/Ebitda (x)	28.6	22.5	15.9	11.5
Book value (Rs/share)	158.8	173.9	197.4	228.2
P/BV (x)	4.2	3.8	3.4	2.9
Mcap/sales	6.0	5.2	4.3	3.6
ROCE (%)	9.3	11.1	14.8	18.1
RONW (%)	8.2	10.0	13.1	14.5

Other Concall Highlights:

- ♦ The audit firm - Valia and Timbadia were the auditors to 16 of Sun Pharma's 66 subsidiaries (which accounts for 0.6% of the group's consolidated revenue in 2017-2018). Management clarified that the company did not engage large global audit firms due to the small size of its subsidiaries. Sun Pharma may look to hire new audit firms to improve investor confidence.
- ♦ Lakshdeep Investments and Finance, a company owned by Sudhir Valia, is not classified as the promoter of Sun Pharma, but it is classified as non-promoter entity on legal advice received years ago. Even if Lakshdeep Investments is classified as a promoter, there will be no change in promoter shareholding. Sun Pharma is looking to seek revised legal opinion on the matter.
- ♦ Jermyn Capital was the banker to some of Sun Pharma's fund-raising plans between 2004 and 2007. As per management's clarification, JPMorgan was the lead manager and sole book runner, while Jermyn Capital was the co-manager to overseas borrowings. Sun Pharma's management did not say anything about Jermyn Capital's links with Ketan Parekh and Dharmesh Doshi.
- ♦ Sun Pharma had lent money to four individuals without any security or collateral in 1995-1996; the amount of funds lent was small and has been fully recovered. The appeals tribunal in 2002 ruled in favour of the four individuals after being investigated by SEBI.
- ♦ Management also clarified that Sun Pharma was not involved in any insider trading issue on the Ranbaxy deal. There was a minor technical issue relating to trading window closure norms. The case was settled with SEBI without admission of guilt and the matter was closed.
- ♦ On Natco Pharma investment, management said that the transaction has been disclosed to the exchanges when transaction happened and Mr. Sanghvi still continues to own shares. On Orange Mauritius Investments, Mr. Sanghvi said he is not aware from whom he purchased the shares.
- ♦ Query related to tax rate was addressed saying that the effective tax rate is now in mid-teens (16-18%). A lower tax rate is a result of operations in tax-free zones. Management had guided many times in the past quarters that its tax rate will gradually inch up in the coming years as tax benefits expire.

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