

13 October 2010 (No. of pages: 18)

Strides Arcolab (STR IN)

6-mth rating: **1**

Target price: Rs587.00

Share price: Rs409.70 (12 Oct)

Pharmaceuticals & healthcare: India

Kartik A. Mehta(91) 22 6622 1012
kartik.mehta@in.daiwacm.com**Chaturya Tipnis**(91) 22 6622 1017
chaturya.tipnis@in.daiwacm.com

Initiation of coverage: playing the niche segment

Focused on specialised sterile products

Strides Arcolab (Strides) is engaged in the manufacture of a wide range of pharmaceutical products, including branded generics and sterile products. The company derived 27% of sales from the Specialty division for 2009. We forecast total sales and earnings to increase at CAGRs of 26% and 76%, respectively, from 2010-12 driven by a 55.2% CAGR in the specialty business for the period.

We initiate coverage with a **1 (Buy)** rating and six-month target price of Rs587 based on our SOTP valuation.

Increased filings and approvals in niche areas

Strides specialises in penicillins, penems, peptides, and oncology products, and also focuses on injectable products that face little price erosion following the expiry of their patents. The company has filed 99 abbreviated new drug applications (ANDA) in the US (72 in steriles and 27 in oncology), and has received 29 approvals in the steriles space in the US.

Pfizer and GSK deals validate foray into injectables

Pfizer (PFE US, US\$17.38, 3) and GlaxoSmithKline (GSK) (Not rated) have signed exclusive deals with Strides for products, pre-dominantly injectables (mainly in oncology), covering the US and other markets, respectively.

Reuters code STAR.NS

Market data

SENSEX Index		20,203.34
Market cap	(US\$m)	530.49
EV	(US\$m: 10E)	795.40
3-mth avg daily T/O	(US\$m)	2.33
Shares outstanding	(m)	58
Free float	(%)	70.0
Major shareholder	Arun Kumar & Group (30.0%)	
Exchange rate	Rs/US\$	44.668

Performance (%)*	1M	3M	6M
Absolute	(5.2)	(2.2)	21.3
Relative	(12.6)	(14.8)	8.2

Source: Daiwa

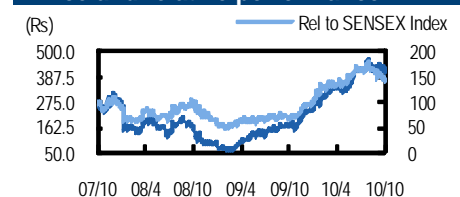
Note: *Relative to SENSEX Index

Investment indicators

		2010E	2011E	2012E
PER	(x)	13.4	9.1	6.8
PCFR	(x)	19.4	8.3	6.7
EV/EBITDA	(x)	9.5	7.5	5.7
PBR	(x)	1.7	1.4	1.1
Dividend yield	(%)	0.4	0.5	0.6
ROE	(%)	18.2	18.9	20.9
ROA	(%)	5.7	8.0	10.4
Net debt equity	(%)	64.4	45.3	26.7

Source: Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

Income summary

Year to 31 Dec	Revenue		EBITDA		Net profit		EPS		CFPS (Rs)	DPS (Rs)
	(Rs m)	(%)	(Rs m)	(%)	(Rs m)	(%)	(Rs)	(%)		
2008	10,203	37.1	696	n.a.	440	n.a.	7.943	n.a.	(7.221)	0.000
2009	13,048	27.9	1,957	181.1	612	39.1	11.046	39.1	47.459	1.500
2010E	17,139	31.4	3,723	90.2	2,022	230.5	30.579	176.8	21.119	1.500
2011E	20,588	20.1	4,535	21.8	2,991	47.9	45.225	47.9	49.069	2.000
2012E	25,926	25.9	5,586	23.2	3,990	33.4	60.339	33.4	60.915	2.500

Source: Company, Daiwa forecasts

IMPORTANT DISCLOSURES, INCLUDING ANY REQUIRED RESEARCH CERTIFICATIONS, ARE PROVIDED ON THE LAST TWO PAGES OF THIS REPORT.

Global Equity Research

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The three most important charts in this report ...

Strides: sales mix and EBITDA margin (%)

	2008	2009	2010E	2011E	2012E	CAGR 2010-12E
Total gross sales	100	100	100	100	100	26.2
Specialty	29	27	41	44	50	55.2
Non-specialty	71	73	59	56	50	11.0
EBITDA margin	6.8	15.0	21.7	22.0	21.5	

Source: Company

Note: Specialty includes milestones

Strides: ANDA filings

	2006		2007		2008		2009		YTD Sep 2010		Total	
	Filed	Approved	Filed	Approved	Filed	Approved	Filed	Approved	Filed	Approved	Filed	Approved
Sterile	19	-	8	1	19	13	24	3	2	12	72	29
Oncology					3		20		4		27	-
Patented					3		9			1	12	1
Matured	19	-	8	1	19	13	35	3	6	11	87	28

Source: Company

Strides: ANDA filings in US with partners

Date	API name	Type	Company	Dosage form/route	Strength
27-Sep-10	lidocaine hydrochloride	Final	Strides Arcolab	Injectable; injection	2%
03-Aug-10	ergocalciferol	Final	Strides Arcolab	Capsule; oral	1.25mg
30-Jul-10	rocuronium bromide	Final	Sagent Strides	Injectable; injection	10mg/ml-5ml and 10ml multi dose vials
28-Jul-10	sumatriptan succinate	Final	Sagent Strides	Injectable; subcutaneous	EQ 6mg base/ 0.5ml(EQ 12mg base/ ml)
10-Jun-10	mycophenolate mofetil	Final	Strides Arcolab	Capsule; oral	250mg
08-Jun-10	fosphenytoin sodium	Final	Strides Arcolab	Injectable; injection	EQ 50mg Phenytoin NA/ml
12-May-10	abacavir sulfate	Tentative	Strides Arcolab	Tablet; oral	300mg
12-May-10	bacitracin	Final	Sagent Strides	Injectable; injection	50,000MU
11-May-10	vecuronium bromide	Final	Akorn Strides	Injectable; injection	10mg/Vial; 20mg/Vial
21-Apr-10	adenosine	Final	Sagent Strides	Injectable; injection	3mg/ml
19-Apr-10	metoprolol tartrate	Final	Sagent Strides	Injectable; injection	1mg/ml
13-Apr-10	mesna	Final	Sagent Strides	Injectable; intravenous	100mg/ml
09-Apr-10	granisetron hydrochloride	Final	Sagent Strides	Injectable; injection	1mg/ml; EQ 4mg/base (EQ 1mg base/ml)
12-Feb-10	efavirenz	Tentative	Strides Arcolab	Tablet; oral	200mg
03-Feb-10	labetalol hydrochloride	Final	Sagent Strides	Injectable; injection	5mg/ml
22-Dec-09	lamivudine; nevirapine; zidovudine	Tentative	Strides Arcolab	Tablet; oral	150mg; 200mg; 300mg
14-Sep-09	haloperidol lactate	Final	Akorn Strides	Injectable; injection	EQ 5mg base/ml
06-Aug-09	lamivudine	Tentative	Strides Arcolab	Tablet; oral	150mg; 300mg
13-May-09	meloxicam	Final	Strides Arcolab	Tablet; oral	7.5mg; 15mg
24-Mar-09	azithromycin	Final	Sagent Strides	Injectable; injection	EQ 500 mg base/vial
30-Dec-08	vancomycin hydrochloride	Final	Akorn Strides	Injectable; injection	EQ 5gm base/vial
31-Oct-08	pamidronate disodium	Final	Akorn Strides	Injectable; injection	30mg/10ml; 90mg/10ml
29-Aug-08	dexamethasone sodium phosphate	Final	Akorn Strides	Injectable; injection	EQ 10mg Phosphate/ml
25-Jun-08	famotidine	Final	Akorn Strides	Injectable; injection	10mg/ml
22-May-08	rifampin	Final	Akorn Strides	Injectable; injection	600mg/Vial
13-May-08	flumazenil	Final	Akorn Strides	Injectable; injection	0.5mg/5ml; 1mg/10ml
23-Apr-08	ondansetron hydrochloride	Final	Akorn Strides	Injectable; injection	EQ 2mg base/ml
20-Mar-08	stavudine; lamivudine; nevirapine	Tentative	Strides Arcolab	Tablet; oral	30mg; 150mg; 200mg
18-Mar-08	fosphenytoin sodium	Final	Akorn Strides	Injectable; injection	EQ 50mg Phenytoin NA/ml
11-Mar-08	tobramycin sulfate	Final	Akorn Strides	Injectable; injection	EQ 43mg base/ml

Source: compiled by Daiwa

Executive summary

We initiate coverage with a 1 (*Buy*) rating

Strides manufactures a wide range of pharmaceutical products

Strides is engaged in the manufacture of a wide range of pharmaceutical products, including branded generics and sterile products. The company derived 27% of sales from the specialty segment for 2009 and 40% for 1H10. We forecast total sales and earnings to increase at CAGRs of 26% and 76%, respectively, from 2010-12. We initiate coverage with a 1 (*Buy*) rating and six-month target price of Rs587. We have used an SOTP methodology to value the stock (Rs307/share for the non-specialty business, Rs31/share for milestone revenue, Rs197/share for the existing Specialty division, and Rs52/share for the joint venture with Pfizer) based on our 2011 forecasts.

Strides: SOTP calculation of target price

Valuation	% of EPS	Multiple (x)	Method	Value (Rs)	Remarks
Non-specialty	19.2	16	PER -14-18x	307	Stable business, limited capex required, 14% EBITDA margin
Milestone	10.8	2	2x cash	31	US\$100m guided by the company, DCF for 2010, 2011, 2012, 35% margin, non-recurring
Specialty (non-Pfizer)	11.0	18	PER 16-20x	197	Sales rising, plant approved, 20-25% margin, 15x, base of 1.3bn for 1H10
Pfizer JV upside	4.3	12	PER 16 - 20 x	52	Facility and product approval pending; we do not expect 2011 to be a peak year for sales. 2012 will be the first full year of sales
Total				587	
Less: Pfizer JV upside				52	
TOTAL				536	Removing the upside of the Pfizer joint venture from the target price

Source: Daiwa forecasts

Increased filings in oncology therapy

Increased focus on oncology with 20 ANDA filings in 2009

Strides specialises in penicillins, penems, peptides, and oncology products, which usually face little price erosion after the patents expire. The company is increasingly focusing on injectables, which also face limited competition. It has filed 99 ANDAs in the US (72 for sterile products and 27 in oncology), and has received 29 approvals in the steriles space in the US. Strides also has submitted 22 filings in Europe. The company submitted 20 ANDA filings in the oncology space in 2009 compared with three in 2008.

One of the largest lyophilisation facilities in the world

The company's lyophilisation capacity is among the largest in the world

In our opinion, the oncology market represents an attractive opportunity for the generics players, as price erosion after patents expire (in the 60-70% range) is lower than for non-oncology drugs. According to industry estimates, the value of injectable oncology products due to go off-patent in 2015 is about US\$9bn. Currently, Strides's lyophilisation (freeze-drying) capacity is among the largest in the world.

Specialty business expected to drive future revenue growth

We forecast the specialty business to account for 50% of revenue by 2012

We forecast the specialty segment to be the core business going forward. We expect the high-margin Specialty division, which accounted for 27% of total 2009 revenue, to account for 50% of revenue by 2012. For 1H10, 40% of the Specialty division's revenue generated 70% of the EBITDA.

Increased partnerships and joint ventures strengthen competency

Global partnerships

Among other agreements, Strides has entered into deals with five of the top-10 international pharmaceutical companies, in Australia, South Africa, Europe, and the US. The company's partnerships include ones with Pfizer, GSK, Aspen Global (Not rated), Akorn (Not rated), Teva (Not rated), Novartis (Not rated), Apotex (Not rated), Martindale (Not listed), Sagent (Not listed), ICN (Not listed), Actavis (Not rated), and Sandoz (Not rated). These partnerships stem from the need for low-cost, reliable manufacturing facilities that have been approved in the injectables space to develop and register products in a large number of markets.

Company background

Established in 1990, Strides is a Bangalore-based company that develops and manufactures oral, semi-solid, and specialty injectables, including beta-lactum, cephalosporin, oncolytics and penems. Its capacities in lyophilisation, soft-gel capsules and sterile products are among the largest in the world. Including joint ventures and partnerships, Strides has 14 manufacturing facilities, and has a marketing presence in more than 75 countries in developed and emerging markets.

Strides Arcolab – financial summary

Profit and loss (Rs m)						Balance sheet (Rs m)					
Year to 31 Dec	2008	2009	2010E	2011E	2012E	As at 31 Dec	2008	2009	2010E	2011E	2012E
Specialty	3,272	3,625	6,715	9,035	13,040	Cash & short-term investment	570	912	5,233	787	1,490
Pharma	6,931	9,422	10,424	11,553	12,886	Inventory	1,731	2,334	2,488	2,986	3,757
Others	0	0	0	0	0	Accounts receivable	3,375	4,161	5,465	6,565	8,267
Total revenue	10,203	13,048	17,139	20,588	25,926	Other current assets	1,799	2,054	2,054	2,054	2,054
Other income	0	0	0	0	0	Total current assets	7,475	9,461	15,241	12,392	15,568
COGS	(5,240)	(7,008)	(7,446)	(9,012)	(11,473)	Fixed assets	6,385	9,319	9,758	10,635	11,437
SG&A	(645)	(668)	(2,098)	(2,688)	(3,695)	Goodwill & intangibles	5,905	10,094	10,094	10,094	10,094
Other op. expenses	(4,023)	(3,907)	(4,432)	(4,976)	(5,870)	Other non-current assets	3,464	3,414	3,414	3,414	3,414
EBIT	296	1,464	3,162	3,912	4,888	Total assets	23,230	32,287	38,506	36,534	40,512
Net-interest inc./(exp.)	(847)	(759)	(1,018)	(739)	(450)	Short-term debt	2,837	3,118	618	618	618
Assoc./forex/extraord./others	1,060	236	373	540	570	Accounts payable	3,599	5,057	5,316	6,379	8,027
Pre-tax profit	509	941	2,518	3,713	5,007	Other current liabilities	611	1,743	1,743	1,743	1,743
Tax	(108)	(216)	(338)	(557)	(851)	Total current liabilities	7,047	9,917	7,677	8,740	10,388
Min. int./pref. div./others	678	371	(301)	(165)	(165)	Long-term debt	10,674	11,942	13,863	7,972	6,481
Net profit (reported)	1,080	1,097	1,878	2,991	3,990	Other non-current liabilities	44	23	23	23	23
Net profit (adj.)	440	612	2,022	2,991	3,990	Total liabilities	17,766	21,883	21,563	16,735	16,893
EPS (reported) (Rs)	19.492	19.803	28.396	45.225	60.339	Share capital	401	402	578	578	578
EPS (adj.) (Rs)	7.943	11.046	30.579	45.225	60.339	Reserves/R.E./others	3,261	7,417	13,780	16,635	20,456
DPS (Rs)	0.000	1.500	1.500	2.000	2.500	Shareholders' equity	3,662	7,819	14,358	17,213	21,035
EBIT (adj.)	296	1,464	3,162	3,912	4,888	Minority interests	1,803	2,585	2,585	2,585	2,585
EBITDA (adj.)	696	1,957	3,723	4,535	5,586	Total equity & liabilities	23,230	32,287	38,506	36,534	40,512
						Net debt/(cash)	12,942	14,148	9,248	7,803	5,610

Cash flow (Rs m)						Key ratios					
Year to 31 Dec	2008	2009	2010E	2011E	2012E	Year to 31 Dec	2008	2009	2010E	2011E	2012E
Profit before tax	509	941	2,518	3,713	5,007	Sales – YoY %	37.1	27.9	31.4	20.1	25.9
Depreciation and amortisation	401	493	561	623	698	EBITDA (adj.) – YoY %	n.a.	181.1	90.2	21.8	23.2
Tax paid	(168)	(237)	(338)	(557)	(851)	Net profit (adj.) – YoY %	n.a.	39.1	230.5	47.9	33.4
Change in working capital	(1,781)	946	(1,199)	(534)	(825)	EPS (adj.) – YoY %	n.a.	39.1	176.8	47.9	33.4
Other operational CF items	640	485	(144)	0	0	EBITDA margin % (adj.)	6.8	15.0	21.7	22.0	21.5
Cash flow from operations	(400)	2,629	1,397	3,245	4,028	EBIT margin % (adj.)	2.9	11.2	18.4	19.0	18.9
Capex	(1,443)	(3,426)	(1,000)	(1,500)	(1,500)	Net-profit margin % (adj.)	4.3	4.7	11.8	14.5	15.4
Net (acquisitions)/disposal	(3,445)	50	0	0	0	ROAE (%)	14.8	10.7	18.2	18.9	20.9
Other investing CF items	(378)	(4,188)	0	0	0	ROAA (%)	2.0	2.2	5.7	8.0	10.4
Cash flow from investing	(5,266)	(7,564)	(1,000)	(1,500)	(1,500)	ROCE (%)	1.7	6.6	11.1	13.1	16.5
Change in debt	246	1,549	(579)	(5,891)	(1,491)	ROIC (%)	2.5	10.0	20.1	21.9	24.3
Net share issues/(repurchases)	(144)	2	176	0	0	Net debt to equity (%)	353.5	180.9	64.4	45.3	26.7
Dividends paid	(5)	(71)	(102)	(135)	(169)	Effective tax rate (%)	21.2	22.9	13.4	15.0	17.0
Other financing CF items	4,221	3,798	4,429	(165)	(165)	Accounts receivable (days)	89.0	105.4	102.5	106.6	104.4
Cash flow from financing	4,318	5,278	3,924	(6,191)	(1,825)	Payables (days)	130.9	121.1	110.5	103.7	101.4
Forex effect/others	0	0	0	0	0	Net interest cover (x)	0.3	1.9	3.1	5.3	10.9
Change in cash	(1,348)	342	4,321	(4,446)	703	Net dividend payout (%)	0.0	7.6	5.3	4.4	4.1

Key assumptions						PER bands					
Year to 31 Dec	2008	2009	2010E	2011E	2012E	(Rs)					
Pharma sales growth YoY (%)	37.1	35.9	10.6	10.8	11.5						

Source: Company, Daiwa forecasts

A brief introduction to the business

A niche pharmaceutical player with a global footprint

Established in 1990, Strides is based in Bangalore (in the state of Karnataka) and develops and manufactures oral, semi-solid and specialty injectable products including beta-lactam, cephalosporin, oncolytics and penems. Its capacities in lyophilisation, soft-gel capsules and sterile products are among the largest in the world. Including joint ventures and partnerships, Strides has 14 manufacturing facilities – in India, Singapore, Brazil, Nigeria, Poland and Italy – and has a marketing presence in more than 75 countries in developed and emerging markets. Of the company's five facilities in Bangalore, three have been approved by the US Food and Drug Administration (FDA).

Different strategies for different markets

Strides: strategies adopted for different markets

Market	Remarks	Focus
India/Africa and other less-regulated markets	Sells through its own distribution network	More on non-specialty
Regulated markets	Partners or JVs, eg, Akorn, Sagent, Pfizer	Specialty focus includes injectables and oncology

Source: Company, Daiwa

Partnering with international companies by Strides has facilitated links with global organisations

Strides has partnered with global companies such as Pfizer, GSK, Aspen Global, Akorn, Teva, Novartis, Apotex, Martindale, Sagent, ICN, Actavis, and Sandoz. This facilitates partnerships with international organisations, ranging from the United Nations International Children's Education Fund, the US President's Emergency Plan for AIDS Relief, the United Nations Development Program, Global TB Drug Facility, and The Clinton Foundation to European to US pharmaceutical giants and even private labellers and distribution chains. In addition, the company undertakes contract research and manufacturing (CRAMS) for specialty chemicals. It has partnered with five of the top-10 international pharmaceutical companies, in Australia, South Africa, Europe, and the US.

A specialty-driven business model

We forecast sales for the Specialty division to increase at a CAGR of 55.2% for 2010-12

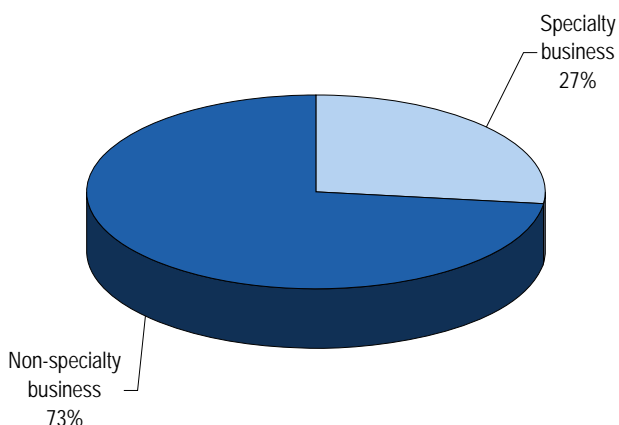
The company has two major divisions – Specialty, and Non-specialty (which includes pharmaceuticals and branded generics). We forecast Specialty sales to increase at a CAGR of 55.2% for 2010-12 driven by new product launches, milestone revenue, and the contribution from the Pfizer joint venture. The Non-specialty division accounted for 73% of total sales for 2009, with branded generics accounting for about 56% of the division's business for the year. In India, the marketing of branded generics is conducted through two units: *Grandix* (which covers all of India and has a sales force of more than 500 staff) and *Ray of Light* (which focuses on hospital specialty portfolio products). We forecast sales from the non-specialty business to increase at a CAGR of 11% for 2010-12. Other non-specialty business includes sales to Australasia, Africa and India.

Presence in Australasia through Ascent Pharma

Operations in five emerging markets

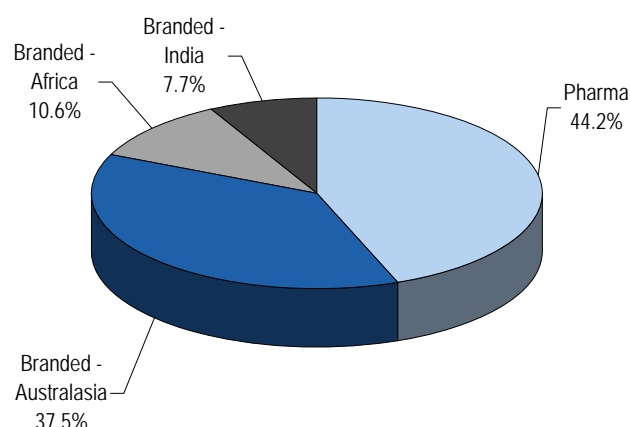
Among other agreements, Strides operates in the Australasia region through its listed generic pharmaceuticals and consumer-health company, in Australia and Singapore (Ascent Pharma Health [Not rated], in which it owns a 57.3% stake). This company has its manufacturing facility in Jurong, Singapore, and has operations in five emerging Southeast Asia markets.

Strides: sales mix 2009



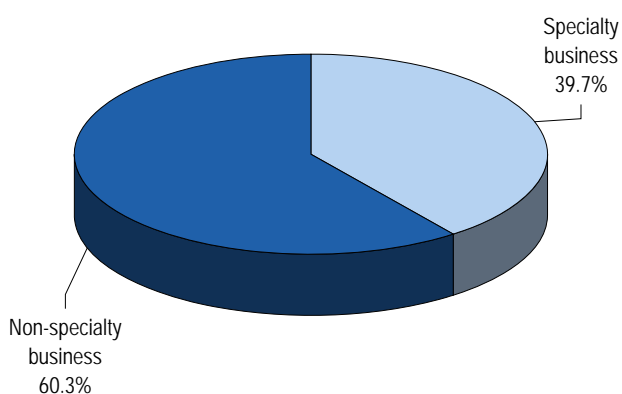
Source: Company, compiled by Daiwa

2009: business breakdown for the Non-specialty division



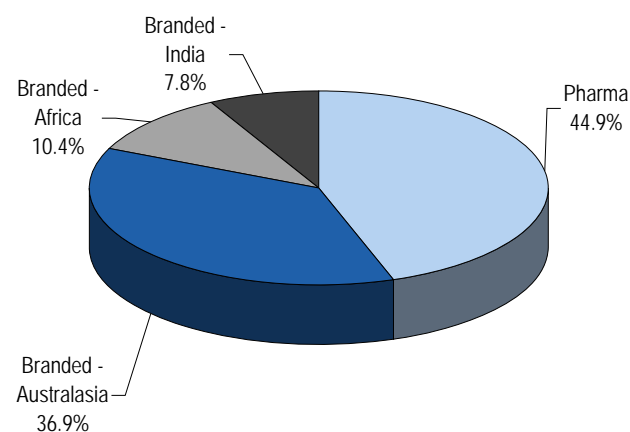
Source: Company, compiled by Daiwa

Strides: sales mix (1H10)



Source: Company, compiled by Daiwa

1H10: business breakdown of Non-specialty division



Source: Company, compiled by Daiwa

Filings skewed towards oncology therapy

An increasing number of filings for the Specialty division

Strides specialises in penicillins, penems, peptides, and oncology products, which usually face little price erosion after the patents expire. The company is increasingly focusing on injectables, which also face limited competition. It has filed 99 ANDAs in the US (72 for sterile products and 27 in oncology), and has received 29 approvals in the steriles space in the US. Also, Strides has submitted 22 filings in Europe. The company submitted 20 ANDA filings in the oncology space in 2009 compared with three in 2008. The 29 ANDAs approved in US market accounted for about US\$6.2bn of US sales for the year ended 31 December 2009 for the brand-name versions of these products, according to IMS Health data.

Strides: ANDA filings

	2006		2007		2008		2009		YTD Sep10		Total	
	Filed	Approved	Filed	Approved	Filed	Approved	Filed	Approved	Filed	Approved	Filed	Approved
Sterile	19	-	8	1	19	13	24	3	2	12	72	29
Oncology					3		20		4		27	-
Patented					3		9			1	12	1
Matured	19	-	8	1	19	13	35	3	6	11	87	28

Source: Company

Strides has one of the largest lyophilisation capacities in the world

In our opinion, the oncology market represents an attractive opportunity for generics players, as price erosion following the expiry of patents (in the 60-70% range) is lower than that for non-oncology drugs. According to industry estimates, the value of injectable oncology products due to go off-patent in 2015 is about US\$9bn. Currently, Strides has one of the largest lyophilisation capacities in the world.

Three commercialised products enjoy high market shares

Strides's three commercialised products, *Vancomycin*, *Azithromycin* and *Rifampicin*, have local market values (LMV) of about US\$157m, US\$28m and US\$8m, respectively, according to IMS Health data. These LMVs represent sales of Strides's products and other equivalent pharmaceutical products, either patented or generic, in the US for the year ended 31 December 2009. The products had market shares of 15% (*Vancomycin*), 18% (*Azithromycin*) and 52% (*Rifampicin*), for 1Q10 according to IMS Health.

Strides: ANDA filings in US with partners

Date	API name	Type	Company	Dosage form/route	Strength
27-Sep-10	lidocaine hydrochloride	Final	Strides Arcolab	Injectable; injection	2%
03-Aug-10	ergocalciferol	Final	Strides Arcolab	Capsule; oral	1.25mg
30-Jul-10	rocuronium bromide	Final	Sagent Strides	Injectable; injection	10mg/ml-5ml and 10ml multi dose vials
28-Jul-10	sumatriptan succinate	Final	Sagent Strides	Injectable; subcutaneous	EQ 6mg base/ 0.5ml(EQ 12mg base/ ml)
10-Jun-10	mycophenolate mofetil	Final	Strides Arcolab	Capsule; oral	250mg
08-Jun-10	fosphenytoin sodium	Final	Strides Arcolab	Injectable; injection	EQ 50mg Phenytoin NA/ml
12-May-10	abacavir sulfate	Tentative	Strides Arcolab	Tablet; oral	300mg
12-May-10	bacitracin	Final	Sagent Strides	Injectable; injection	50,000MU
11-May-10	vecuronium bromide	Final	Akorn Strides	Injectable; injection	10mg/Vial; 20mg/Vial
21-Apr-10	adenosine	Final	Sagent Strides	Injectable; injection	3mg/ml
19-Apr-10	metoprolol tartrate	Final	Sagent Strides	Injectable; injection	1mg/ml
13-Apr-10	mesna	Final	Sagent Strides	Injectable; intravenous	100mg/ml
09-Apr-10	granisetron hydrochloride	Final	Sagent Strides	Injectable; injection	1mg/ml; EQ 4mg/base (EQ 1mg base/ml)
12-Feb-10	efavirenz	Tentative	Strides Arcolab	Tablet; oral	200mg
03-Feb-10	labetalol hydrochloride	Final	Sagent Strides	Injectable; injection	5mg/ml
22-Dec-09	lamivudine; nevirapine; zidovudine	Tentative	Strides Arcolab	Tablet; oral	150mg; 200mg; 300mg
14-Sep-09	haloperidol lactate	Final	Akorn Strides	Injectable; injection	EQ 5mg base/ml
06-Aug-09	lamivudine	Tentative	Strides Arcolab	Tablet; oral	150mg; 300mg
13-May-09	meloxicam	Final	Strides Arcolab	Tablet; oral	7.5mg; 15mg
24-Mar-09	azithromycin	Final	Sagent Strides	Injectable; injection	EQ 500 mg base/vial
30-Dec-08	vancomycin hydrochloride	Final	Akorn Strides	Injectable; injection	EQ 5gm base/vial
31-Oct-08	pamidronate disodium	Final	Akorn Strides	Injectable; injection	30mg/10ml; 90mg/10ml
29-Aug-08	dexamethasone sodium phosphate	Final	Akorn Strides	Injectable; injection	EQ 10mg Phosphate/ml
25-Jun-08	famotidine	Final	Akorn Strides	Injectable; injection	10mg/ml
22-May-08	rifampin	Final	Akorn Strides	Injectable; injection	600mg/Vial
13-May-08	flumazenil	Final	Akorn Strides	Injectable; injection	0.5mg/5ml; 1mg/10ml
23-Apr-08	ondansetron hydrochloride	Final	Akorn Strides	Injectable; injection	EQ 2mg base/ml
20-Mar-08	stavudine; lamivudine; nevirapine	Tentative	Strides Arcolab	Tablet; oral	30mg; 150mg; 200mg
18-Mar-08	fosphenytoin sodium	Final	Akorn Strides	Injectable; injection	EQ 50mg Phenytoin NA/ml
11-Mar-08	tobramycin sulfate	Final	Akorn Strides	Injectable; injection	EQ 43mg base/ml

Source: compiled by Daiwa

The largest soft-gel capacity in the world

Manufacturing facilities in numerous locations

Strides has 14 manufacturing facilities, in India, Singapore, Brazil, Nigeria, Poland and Italy, offering its customers/partners the advantage of choosing their preferred location to source products. The company's capacities for specialty, lyophilisation and soft-gel products are among the largest in the world. It also has the largest sterile facility in India. The India manufacturing facilities for the regulated markets have been approved by all the major regulatory bodies, such as the Medicines and Healthcare Products Regulatory Agency of the UK, the Therapeutic Goods Administration of Australia, the Medicines Control Council of South Africa, the UK's Medicines Control Agency, the Agencia Nacional de Vigilancia Sanitaria of Brazil, and the US FDA. Of the 14 manufacturing facilities, 12 are currently owned by Strides. In February 2010, the company entered into an agreement with Aspen Global, Cellofarm LTDA (Not listed), and Starsmore (Not listed) to acquire two more manufacturing facilities.

Strides: manufacturing plants

Plant details	Location	
Oral dosage (India)		
Facility I	Anekal Taluk	Bangalore
Facility II	Hosur	Tamil Nadu
Facility III	Thane	Maharashtra
Beta-lactams (India)	Bilekahalli	Bangalore
Cephalosporins (India)	Bilekahalli	Bangalore
Sterile products (India)		
Facility I	Bilekahalli	Bangalore
Facility II	Anekal Taluk	Bangalore
Penems	Campos dos Goytacazes	Brazil
Penicillins	Campos dos Goytacazes	Brazil
Onco Therapies Ltd (India)	Anekal Taluk	Bangalore
Strides Arcolab Polska Sp.Zo.o	Warszawa	Poland
Strides Vital Nigeria Ltd	Ikeja Lagos	Nigeria
Beltapharm SpA	Via Stelvio	Italy
Drugs Houses of Australia (Asia) Pte Ltd	Haw Par Tiger Balm Bld.	Singapore

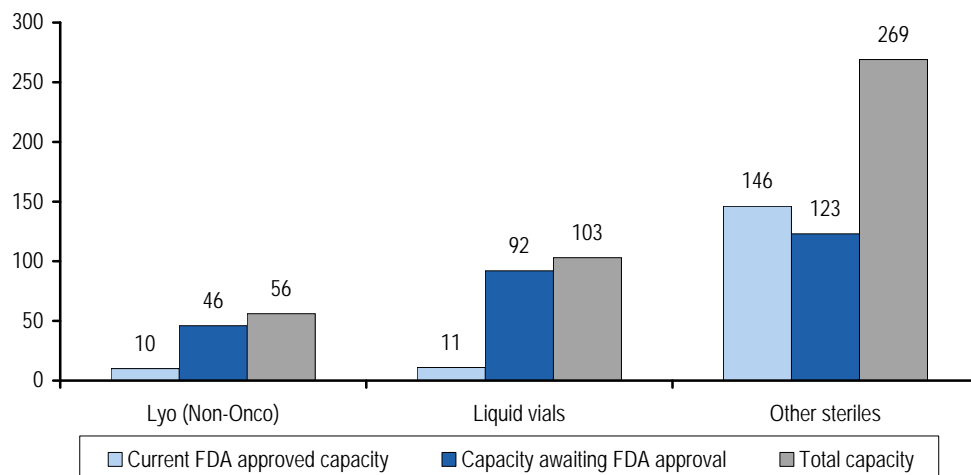
Source: Company

Four new plants likely to give the company access to developed markets

Large increases in capacity due to come online

The approval of currently pending filings from four new plants would give Strides greater access to developed markets. As can be seen from the following chart, lyophilisation capacity would increase by 5.6x, liquid-vial capacity would rise by 9.4x, and capacity for other sterile products would rise by 1.8x.

Strides: capacity (m units)



Source: Company

An increasing injectables footprint

Strengthening its position in the injectables area

Strides acquired Aspen Pharmacare Holdings's (Not rated) *Campos* facility in Brazil for a consideration of US\$75m, and this will become part of the specialty injectable business. The company has also acquired a 100% interest (from 50% previously) in its oncology joint venture with Aspen Global for a consideration of US\$117m.

Partnerships with five of the top-10 international pharmaceutical companies

Key deals/partnerships/joint ventures with innovators

Among other agreements, Strides has entered into deals with five of the top-10 international pharmaceutical companies, in Australia, South Africa, Europe, and the US. The company's partnerships include ones with Pfizer, GSK, Aspen Global, Akorn, Teva, Novartis, Apotex, Martindale, Sagent, ICN, Actavis, and Sandoz. These partnerships stem from the need for low-cost, reliable manufacturing facilities that have received approval in the injectables space to develop and register products in a large number of markets. Some of the partnerships include those with Pfizer for the licensing of specialty sterile injectables for the US market. Another agreement with Pfizer is to sell and promote the company's off-patent products in Australia. Strides has combined its oncology portfolio with Pfizer for the US market and with GSK and Aspen Pharmacare Holdings for emerging markets. The company continues to enter into such deals with international pharmaceutical companies.

Working with Pfizer on oncology products

Pfizer deal – exclusive to the US market

In January 2010, Strides entered into four licence and supply agreements with Pfizer to develop, manufacture and sell off-patent sterile injectables and oral products in the US market. The agreements expire on different dates in 2019, 2024, and 2025. We expect the first product to be launched in 1H11. In April 2010, the company extended the agreements to market up to 38 generic oncology products in countries in the EU, Australia, Korea, Japan, New Zealand and Canada, and will supply five additional niche sterile injectable products for the US market. US sales can start once the new plant in Bangalore is approved by the US FDA and product filings from this plant receive approval.

Strides-Aspen joint venture: in-licensing deal with GSK***OTL tie-up with GSK***

In July 2008, Onco Therapies (OTL), 100%-owned by Strides, entered into a licensing and supply agreement with GSK whereby OTL licenses intellectual property and supplies finished dosage form pharmaceuticals to GSK. The arrangement covers 95 countries, mainly emerging markets in Latin America, Eastern Europe, the Middle East, and the Asia-Pacific region. The products will be sourced by GSK and we expect them to be launched from 4Q10 onwards. OTL will recover its product-development costs from GSK and share the profit with GSK from the commercialisation of the products. The agreements have an exclusivity period of 10 years for each product.

Acquisition of outstanding stake in OTL

In 2009, Strides restructured its oncology arrangements with Aspen Global to acquire a 100% interest in the oncology joint ventures – OTL, and India and Onco Laboratories – for a consideration of US\$117m. As part of the arrangement, Strides will license the existing and future oncology products to Pharmicare Limited, an Aspen Group company, in certain territories.

Research includes a focus on a variety of dosage forms***A dedicated R&D facility in Bangalore***

Strides's R&D centre, Strides Technology and Research (STAR), is located in Bangalore, India, and has 350 scientists and researchers. The focus areas at STAR include clinical-supplies manufacturing, process development, analytical services, packaging development, and microbiological testing. STAR can work on a variety of dosage forms, including oncolytics, peptides, penems, suspension injection, tablets and soft-gel oncolytics, ophthalmic, and mini bags.

Earnings outlook

Sales mix and EBITDA margin

We forecast margins to remain at about 21-22% from 2010-12

The specialty business accounted for 27% of sales for 2009 and we forecast the division to account for 54% of the total for 2012. We forecast total gross sales to increase at a CAGR of 26.2% for 2010-12, with sales for the specialty business rising at a 55.2% CAGR for the period, and sales for the non-specialty business to rise at a 11% CAGR for 2010-12. We forecast the EBITDA margin to range from 21-22% over the period due to the rising contribution from the specialty business. The company's EBITDA margin has risen consistently over the past six quarters due to new-product launches and an increasing amount of licensing income.

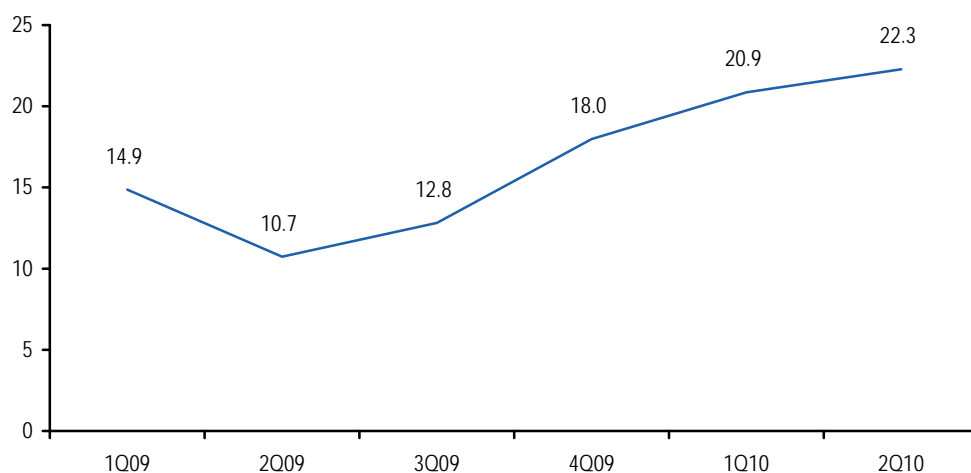
Strides: sales mix and EBITDA margin (%)

	2008	2009	2010E	2011E	2012E	CAGR 2010-12E
Total gross sales	100	100	100	100	100	26.2
Specialty	29	27	41	44	50	55.2
Non-specialty	71	73	59	56	50	11.0
EBITDA margin	6.8	15.0	21.7	22.0	21.5	

Source: Company

Note: Specialty includes milestones

Strides: EBITDA margin (%)



Source: Company, compiled by Daiwa

Specialty base sales increasing with more product launches

Even excluding milestones, we believe the recurring revenue base of the specialty business is increasing fairly strongly, in line with various product approvals and product launches with the company's partners. Assuming all the licensing income is received in the specialty business, and including sales from the Brazil facility acquired from Aspen Global, we calculate the base revenue of the specialty business was Rs1.3bn for 1H10.

Strides: 1H10 results at a glance (Rs m)

	1H10	1H09	% change
Net sales	8,280	5,940	39.4
EBITDA	1,792	755	137.2
Other income	372	86	333.0
PBIDT	2,164	841	157.3
Depreciation	308	217	42.0
Interest	623	375	66.1
PBT	1,233	249	394.6
Tax	159	75	111.4
Minority interests	(74)	(23)	n.m.
Adjusted PAT	1,000	152	559.4
Extraordinary income/(expenses)	(144)	371	n.m.
Reported PAT	856	523	63.8
EBITDA margin (%)	21.6	12.7	

Source: Company, compiled by Daiwa

What could go wrong?

Delays in approvals of products and plants

Delays in product and plant approvals

In our view, the biggest challenge for Strides is to get timely approval of its plants and products from various regulatory bodies. We believe that any delays would result in revenue being postponed from one period to another. Delays in approval would also lead to slower-than-expected gains in market share by its partners.

Balance sheet and cash flow

Internal accruals to fund future capex

Internal accruals should fund most of the future capex

We expect the company to undertake moderate amounts of capital expenditure over the next three years, and for this to be met mainly by internal accruals. Liabilities within the next one year include US\$115m to Aspen Global, mainly to be paid next year through US\$100m raised recently.

FCCBs worth US\$80m to be converted in June 2012

YTM on FCCB is 145.058%

Currently, US\$80m worth of foreign-currency convertible bonds (FCCB) are scheduled to be repaid in June 2012. The yield-to-maturity (YTM) on these is 145.058% of the principal amount.

Strides: FCCB position

Particulars	Year of issue	Size of the issue (US\$m)	Interest rate (%)	Converted (US\$m)	Bought back (US\$m)	Outstanding balance (US\$m)	Conversion price per share (Rs)	Due date
FCCB 08	2007-08	100	-	0	20	80	462	27-Jun-12

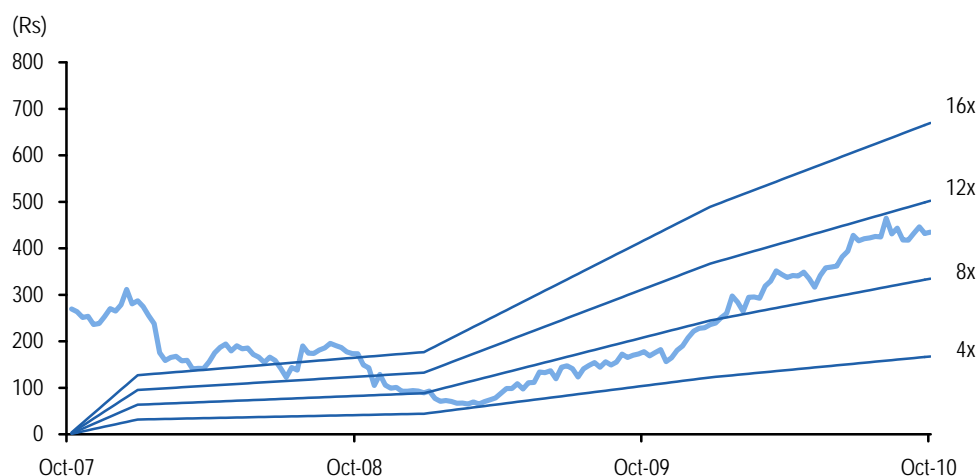
Source: Company, compiled by Daiwa

Valuation and target price

The stock has traded within a 4-16x PER band since October 2008

Over the past two years, the stock has traded within a PER band of 4-16x. We believe that the PER band will expand once the rate of approval increases and sales from new joint ventures start coming in. Incremental product launches in the injectable space in the regulated markets will lead to an improvement in the EBITDA margin, in our view. The announcement of the Pfizer joint venture, mainly for oncology injectables, has improved the PER band over the past one year. We believe there is too much focus by investors on the Pfizer joint venture, and that the base injectable business, which we expect to expand at a faster rate depending on approvals, is being ignored.

Strides: one-year forward PER bands



Source: Company, Bloomberg, Daiwa forecasts

Target price of Rs587, based on SOTP

We initiate coverage with a **1 (Buy)** rating and six-month target price of Rs587. We have used an SOTP methodology to value the stock (Rs307/share for the non-specialty business, Rs31/share for milestone revenue, Rs197/share for the existing Specialty division, and Rs52/share for the joint venture with Pfizer) based on our 2011 forecasts. Recent deals in the injectable space have been at about 4x sales, and based on this we estimate that on a replacement basis the value of the existing specialty business and Pfizer's business is about Rs444 /share.

Strides: SOTP calculation of target price

Valuation	% of EPS	Multiple (x)	Method	Value (Rs)	Remarks
Non-specialty	19.2	16	PER -14-18x	307	Stable business, limited capex required, 14% EBITDA margin
Milestone	10.8	2	2x cash	31	US\$100m guided by the company, DCF for 2010, 2011, 2012, 35% margin, non-recurring
Specialty (non-Pfizer)	11.0	18	PER 16-20x	197	Sales rising, plant approved, 20-25% margin, 15x, base of 1.3bn for 1H10
Pfizer JV upside	4.3	12	PER 16 - 20 x	52	Facility and product approval pending; we do not expect 2011 to be a peak year for sales. 2012 will be the first full year of sales
Total				587	
Less: Pfizer JV upside				52	
TOTAL				536	Removing the upside of the Pfizer joint venture from the target price

Source: Daiwa forecasts

Recent deals in the oncology space have been at over 4x sales**Recent deals in the injectables space**

Year	Acquirer	Target	Deal size	Remarks
2010	Mylan	Bioniche(US)	About US\$550m	About 4x sales
2009	Hospira	Orchid (India)	About US\$400m	About 4x sales
2009	Novartis	Ebewe (Austria)	About US\$1.2bn	About 4x sales

Source: Company, Daiwa

Strides: comparison with replacement value

Details	Rs m	Remarks
Replacement value of specialty business	16,081	4x sales
Replacement value of Pfizer JV	13,265	2x 2012 sales, full year for Pfizer JV, value increases as product and plant are approved
Total value	29,346	
Value per share	444	
Upside from value in our target price, factoring in the replacement value for the specialty business	195	33%

Source: Daiwa forecasts

Downside risks

We see delays in product and plant approvals as the major downside risks to our recommendation. We also see uncertainty over the utilisation of the cash on the company's books and the prospects for the global CRAMS business as risks.

Delays in product and plant approvals**Disclaimer**

Daiwa Capital Markets India Limited and/or its affiliates has an investment banking services client relationship with Strides Arcolab during the past twelve months; and has received compensation from Strides Arcolab for investment banking services in the past twelve months.

DAIWA'S ASIA PACIFIC RESEARCH DIRECTORY

Hong Kong

Regional Research Head; Pan Asia Research	Nagahisa MIYABE	(852) 2848 4971	nagahisa.miyabe@hk.daiwacm.com
Regional Research Co-head	Craig IRVINE	(852) 2848 4485	craig.irvine@hk.daiwacm.com
Macro Economy (Hong Kong, China)	Kevin LAI	(852) 2848 4926	kevin.lai@hk.daiwacm.com
Strategy (Regional)	Colin BRADBURY (Regional Chief Strategist)	(852) 2848 4983	colin.bradbury@hk.daiwacm.com
Strategy (Regional)	Mun Hon THAM	(852) 2848 4426	munhon.tham@hk.daiwacm.com
Property Developers (Hong Kong)	Jonas KAN (Head of Hong Kong Research; Regional Property Co-ordinator; Co-head of Hong Kong and China Property)	(852) 2848 4439	jonas.kan@hk.daiwacm.com
All Industries (China); Pan Asia Research	Hongxia ZHU	(852) 2848 4460	hongxia.zhu@hk.daiwacm.com
Automobiles (China)	Ricon XIA	(852) 2848 4923	ricon.xia@hk.daiwacm.com
Banking (Hong Kong, China)	Grace WU (Head of Hong Kong and China Banking)	(852) 2532 4383	grace.wu@hk.daiwacm.com
Banking (Hong Kong, China)	Sophia HUO	(852) 2532 4381	sophia.huo@hk.daiwacm.com
Banking (Hong Kong, China)	Queenie POON	(852) 2532 4380	queenie.poon@hk.daiwacm.com
Capital Goods – Electrical Equipment and Machinery (China)	Ole HUI	(852) 2848 4468	ole.hui@hk.daiwacm.com
Consumer/Retail (Hong Kong, China)	Peter CHU	(852) 2848 4430	peter.chu@hk.daiwacm.com
Consumer/Retail (China)	Nicolas WANG	(852) 2848 4963	nicolas.wang@hk.daiwacm.com
Hotels, Restaurants and Leisure – Casinos and Gaming (Hong Kong); Capital Goods – Conglomerate (Hong Kong)	Gavin HO	(852) 2532 4384	gavin.ho@hk.daiwacm.com
IT/Electronics – Semiconductor and Solar (Regional, Taiwan, Singapore, Hong Kong and China)	Pranab Kumar SARMAH (Regional Head of IT/Electronics)	(852) 2848 4441	pranab.sarmah@hk.daiwacm.com
IT/Electronics (Regional)	Eric CHEN (Co-head of Regional IT/Electronics)	(852) 2773 8702	eric.chen@hk.daiwacm.com
IT/Electronics – Tech IT Services (Hong Kong, China)	Joseph HO	(852) 2848 4443	joseph.ho@hk.daiwacm.com
Materials/Energy (Regional)	Alexander LATZER (Regional Head of Materials)	(852) 2848 4463	alexander.latzer@hk.daiwacm.com
Materials (China)	Felix LAM	(852) 2532 4341	felix.lam@hk.daiwacm.com
Oil & Gas (China, Korea)	Andrew CHAN	(852) 2848 4964	andrew.chan@hk.daiwacm.com
Property Developers (Hong Kong, China)	Danny BAO (Head of Hong Kong and China Property)	(852) 2848 4471	danny.bao@hk.daiwacm.com
Property (Hong Kong, China)	Yannis KUO	(852) 2773 8735	yannis.kuo@hk.daiwacm.com
Small/Medium Cap (Regional)	Mark CHANG (Regional Head of Small/Medium Cap)	(852) 2773 8729	mark.chang@hk.daiwacm.com
Small/Medium Cap (Regional)	John CHOI	(852) 2773 8730	john.choi@hk.daiwacm.com
Telecommunications (Regional, Greater China and SG)	Marvin LO (Regional Head of Telecommunications)	(852) 2848 4465	marvin.lo@hk.daiwacm.com
Transportation – Aviation and Expressway (Hong Kong, China, Singapore)	Kelvin LAU	(852) 2848 4467	kelvin.lau@hk.daiwacm.com
Transportation (Hong Kong, China)	Edwin LEE	(852) 2532 4349	edwin.lee@hk.daiwacm.com
Utilities; Capital Goods - Electrical Equipment (Hong Kong, China)	Dave DAI	(852) 2848 4068	dave.dai@hk.daiwacm.com
Custom Products Group	Philip LO	(852) 2773 8714	philip.lo@hk.daiwacm.com
Custom Products Group	Jibo MA	(852) 2848 4489	jibo.ma@hk.daiwacm.com

South Korea

Strategy; Banking/Finance	Chang H LEE (Head of Research)	(82) 2 787 9177	chlee@kr.daiwacm.com
Automobiles; Shipbuilding; Steel	Sung Yop CHUNG	(82) 2 787 9157	sychung@kr.daiwacm.com
Banking/Finance	Anderson CHA	(82) 2 787 9185	anderson.cha@kr.daiwacm.com
Capital Goods (Construction and Machinery)	Mike OH	(82) 2 787 9179	mike.oh@kr.daiwacm.com
Consumer/Retail	Sang Hee PARK	(82) 2 787 9165	sanghee.park@kr.daiwacm.com
IT/Electronics (Tech Hardware and Memory)	Jae H LEE	(82) 2 787 9173	jhlee@kr.daiwacm.com
IT/Electronics	Steve OH	(82) 2 787 9195	steve.oh@kr.daiwacm.com
Materials (Chemicals)	Daniel LEE	(82) 2 787 9121	daniel.lee@kr.daiwacm.com
Pan Asia Research; Small/Medium Caps	Yumi KIM	(82) 2 787 9838	yumi.kim@kr.daiwacm.com
Pan Asia Research	Hirokazu MIYAGI	(82) 2 787 9801	hirokazu.miyagi@kr.daiwacm.com
Telecommunications; Software (Internet/On-line Game)	Thomas Y KWON	(82) 2 787 9181	yskwon@kr.daiwacm.com

Taiwan

Head of Research; Pan Asia Research	Hirokazu MITSUDA	(886) 2 2758 8754	h.mitsuda@daiwacm-cathay.com.tw
Co-head of Research; Strategy	Alex YANG	(886) 2 2345 3660	alex.yang@daiwacm-cathay.com.tw
Consumer/Retail	Yoshihiko KAWASHIMA	(886) 2 8780 5987	y.kawashima@daiwacm-cathay.com.tw
IT/Technology Hardware (PC)	Calvin HUANG	(886) 2 2758 8805	calvin.huang@daiwacm-cathay.com.tw
IT/Technology Hardware; Software (Small/Medium Caps)	Christine WANG	(886) 2 8788 1531	christine.wang@daiwacm-cathay.com.tw
IT/Technology Hardware (Panels)	Chris LIN	(886) 2 8788 1614	chris.lin@daiwacm-cathay.com.tw
IT/Technology Hardware (PC Components)	Jenny SHIH	(886) 2 8780 1326	jenny.shih@daiwacm-cathay.com.tw
IT/Technology Hardware; Pan Asia Research	Mitsuharu WATANABE	(886) 2 2758 9437	m.watanabe@daiwacm-cathay.com.tw
Materials; Small/Medium Caps	Albert HSU	(886) 2 8786 2212	albert.hsu@daiwacm-cathay.com.tw

India

Head of India Equities Strategy	Jaideep GOSWAMI	(91) 22 6622 1010	jaideep.goswami@in.daiwacm.com
Strategy; Banking/Finance	Punit SRIVASTAVA (Deputy Head of Research)	(91) 22 6622 1013	punit.srivastava@in.daiwacm.com
All Industries; Pan Asia Research	Fumio YOKOMICHI	(91) 22 6622 1003	fumio.yokomichi@in.daiwacm.com
Automobiles	Hitesh GOEL	(91) 22 6622 1060	hitesh.goel@in.daiwacm.com
Capital Goods; Utilities	Jonas BHUTTA	(91) 22 6622 1008	jonas.bhutta@in.daiwacm.com
Materials	Vishal CHANDAK	(91) 22 6622 1006	vishal.chandak@in.daiwacm.com
Oil & Gas; Construction; Small/Medium Caps	Atul RASTOGI	(91) 22 6622 1020	atul.rastogi@in.daiwacm.com
Pharmaceuticals and Healthcare; Consumer	Kartik A. MEHTA	(91) 22 6622 1012	kartik.mehta@in.daiwacm.com
Real Estate	Amit AGARWAL	(91) 22 6622 1063	amit.agarwal@in.daiwacm.com
Software (Tech IT Services)	R. RAVI	(91) 22 6622 1014	ravi.r@in.daiwacm.com

Singapore

Head of Research; Pan Asia Research	Tatsuya TORIKOSHI	(65) 6321 3050	tatsuya.torikoshi@sg.daiwacm.com
Macro Economy (Regional)	Prasenjit K BASU (Chief Economist, Asia Ex-JP)	(65) 6321 3069	p-k.basu@sg.daiwacm.com
Quantitative Research	Deep KAPUR (Global Director of Quantitative Research)	(65) 6321 3079	deep.kapur@sg.daiwacm.com
Quantitative Research	Josh CHERIAN	(65) 6499 6549	josh.cherian@sg.daiwacm.com
Quantitative Research	Suzanne HO	(65) 6499 6545	suzanne.ho@sg.daiwacm.com
Banking; Property and REITs	David LUM (Regional Head of Banking/Finance)	(65) 6329 2102	david.lum@sg.daiwacm.com
Conglomerates; Soft Commodities; Energy; Small/Medium Caps	Chris SANDA	(65) 6321 3085	chris.sanda@sg.daiwacm.com
Oil and Gas; Utilities (Southeast Asia)	Adrian LOH	(65) 6499 6548	adrian.loh@sg.daiwacm.com
Telecommunications (Southeast Asia & India)	Ramakrishna MARUVADA (Head of SE Asia & India Telecommunications)	(65) 6499 6543	ramakrishna.maruvada@sg.daiwacm.com

Australia

Banking/Diversified Financials	Johan VANDERLUGT	(61) 3 9916 1335	johan.vanderlugt@au.daiwacm.com
Resources/Mining/Petroleum	David BRENNAN	(61) 3 9916 1323	david.brennan@au.daiwacm.com

Japan

Industrials (Regional); Pan Asia Research	Taiki KAJI	(81) 3 5555 7174	taiki.kaji@jp.daiwacm.com
Industrials (Regional); Pan Asia Research	Daijiro HATA	(81) 3 5555 7178	daijiro.hata@jp.daiwacm.com

DAIWA SECURITIES GROUP INC

<i>OFFICE / BRANCH / AFFILIATE</i>	<i>ADDRESS</i>	<i>TEL</i>	<i>FAX</i>
HEAD OFFICE	Gran Tokyo North Tower, 1-9-1, Marunouchi, Chiyoda-ku, Tokyo, 100-6753	(03) 5555 3111	(03) 5555 0661
Daiwa Securities Trust Company	One Evertrust Plaza, Jersey City, NJ 07302, U.S.A.	(1) 201 333 7300	(1) 201 333 7726
Daiwa Securities Trust and Banking (Europe) PLC (Head Office)	5 King William Street, London EC4N 7JB, United Kingdom	(44) 207 320 8000	(44) 207 410 0129
Daiwa Securities Trust and Banking (Europe) PLC (Dublin Branch)	Level 3, Block 5, Harcourt Centre, Harcourt Road, Dublin 2, Ireland	(353) 1 603 9900	(353) 1 478 3469

DAIWA CAPITAL MARKETS LIMITED

<i>OFFICE / BRANCH / AFFILIATE</i>	<i>ADDRESS</i>	<i>TEL</i>	<i>FAX</i>
HEAD OFFICE	Gran Tokyo North Tower, 1-9-1, Marunouchi, Chiyoda-ku, Tokyo, 100-6753	(03) 5555 3111	(03) 5555 0661
Daiwa Capital Markets America Inc	Financial Square, 32 Old Slip, New York, NY10005, U.S.A.	(1) 212 612 7000	(1) 212 612 7100
Daiwa Capital Markets Europe Limited	5 King William Street, London EC4N 7AX, United Kingdom	(44) 20 7597 8000	(44) 20 7597 8600
Daiwa Capital Markets Europe Limited, Frankfurt Branch	Trianon Building, Mainzer Landstrasse 16, 60325 Frankfurt am Main, Federal Republic of Germany	(49) 69 717 080	(49) 69 723 340
Daiwa Capital Markets Europe Limited, Paris Branch	127, Avenue des Champs-Élysées, 75008 Paris, France	(33) 1 56 262 200	(33) 1 47 550 808
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HEAD OFFICE	15-6, Fuyuki, Koto-ku, Tokyo, 135-8460, Japan	(81) 3 5620 5100	(81) 3 5620 5603
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