Dr Reddy's Laboratories Ltd.

RESULT UPDATE

28th July, 2017

Dr Reddy's Laboratories Ltd.

Sharp fall in margins…..

CMP	Target	Potential Upside	Market Cap (INR Mn)	Recommendation	Sector
INR 2,478	**INR 2,523**	**1.8%**	**4,49,457**	**HOLD**	**Pharma**

Result highlights

•Dr Reddy's Labs reported Q1FY18 revenue of INR 33,332 mn which grew 1.98% Y-o-Y but degrew 7.13% Q-o-Q due to price erosion and channel consolidation in the US along with destocking of inventories due to GST in India. However, the company has witnessed a growing trend in the emerging market and Europe due to volume uptake and new product launches..

•EBITDA stood at INR 3232 mn and has witnessed sharp fall in margin which stood 9.9% in Q1 FY18 as against 16.9% in Q4 FY17. The higher R&D cost, employee cost and raw material cost has impacted the EBITDA margins. R&D for the quarter was INR 5100 mn which is 15.7% of total sales vs INR 4600 mn in Q4 2017 which was 13.1% of the total sales.

•PAT for the quarter came in at INR 666 mn with margins of 2% which has decreased drastically by 760 bps q-o-q and 277 bps y-o-y. The decrease in EBITDA along with spurt in interest and tax rate has affected the PAT margins adversely.

MARKET DATA

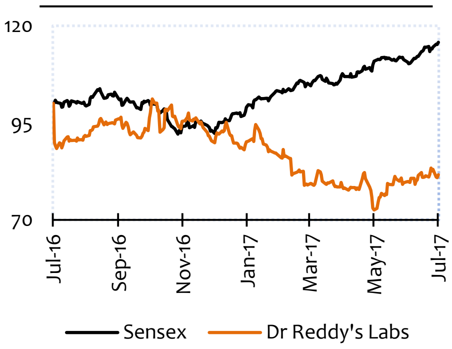
Shares outs (Mn)	166
EquityCap (INR Mn)	829
Mkt Cap (INR Mn)	449457
52 Wk H/L (INR)	3517/2382
Volume Avg (3m K)	355.6
Face Value (INR)	5
Bloomberg Code	DRRD IN

KEY FINANCIALS

INR Mn	FY15	FY16	FY17	FY18E	FY19E
Revenues	1,49,084	1,55,683	1,41,961	1,58,852	1,87,261
EBITDA	33,787	35,853	24,722	32,536	38,917
APAT	23,364	21,306	12,921	16,740	20,863
AEPS	137.1	124.9	77.9	101.0	125.8
P/E(x)	30.7	33.7	33.7	26.0	20.9
EV/EBITDA(X)	0.8	0.8	1.9	1.3	1.0
ROAE (%)	26.4	19.0	10.4	12.9	14.4

Source: Company, KRChoksey Research

SHARE PRICE PERFORMANCE



High cost and low revenues led to spurt in margins:

Dr Reddy's Laboratories Ltd. has delivered a weak performance in the quarter due to increasing costs and low revenues. The higher R&D cost have made a dent in the EBITDA. The company expects that the going forward the remediation cost would come down which will provide support to the margins. However, we expect that the company's two plants Srikakulam (API plant) and Duvvada (oncology injectables plant) are still under USFDA's radar, so the cost for remediation would still be there unless these plants don't receive an EIR(Establishment Inspection Report)

North America's business to see pressure : The US business of the company has witnessed intense pressure of price erosion, consolidation of channels and growing competition. North American revenues saw a declining trend, a de-growth of 4% Y-o-Y to INR 15 bn on account of increased competition in Valgancyclovir, Azacitidine and Decitabine along with discontinuation of the McNeil Business. But the decline was offset by contribution from the new launches such as doxorubicin, progesterone and bivalirudin Going forward , the company expects the price erosion to be in high double digit as the competition is getting more intense in the US.

Europe and emerging markets aided the sales: Revenues from Europe increased 28% y-o-y to INR 2bn due to improvement in base business along with new product launches. The company expects that the emerging markets such as Brazil, China, Columbia etc will gain momentum and will help to aid the business in long run. The biosimilar commercialization in markets of Russia will help to stabilize the revenues. However, Russian markets is a tender business which makes it more volatile. We expect that revenues from these markets wouldn't be significant enough to offset the market share loss in the US which is largest market of Pharma.

Domestic business impacted due to GST destocking: The Domestic markets witnessed a steep fall ,degrowth of 10% Y-o-Y and 17.9% Q-o-Q to INR 4.7bn due to GST destocking and supply side disruptions. However, the company expects that the impact of GST will be subdued in the coming quarters. So, as full year the impact of q1fy18 due to GST will offset going forward.

MARKET INFO

SENSEX	32382
NIFTY	10021

SHARE HOLDING PATTERN (%)

Particulars	Jun 17	Mar 17	Dec 16
Promoters	26.78	26.79	26.79
FIIs	31.64	32.4	36.27
DIIs	11.74	10.56	8.19
Others	29.84	30.24	28.75
Total	100	100	100

10.2%

Revenue CAGR between FY 17 and FY 19E

99

No. Of ANDA

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Dr Reddy's Laboratories Ltd.

More time to capitalize R&D will offset the margins

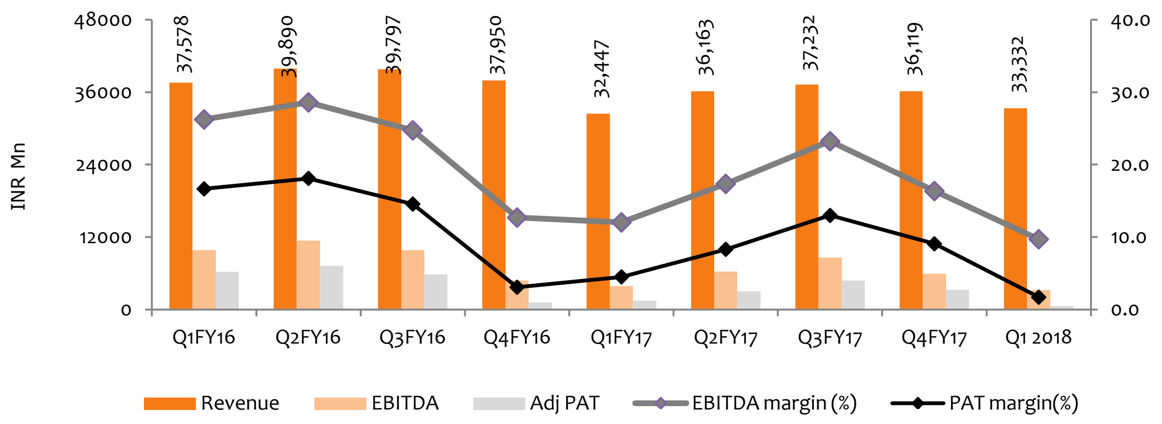
We expect FY18 will be a muted year for the company due to increase in price erosion in the US, consolidation of channels and delay in new product launches. FY18 will be more challenging for the company due to delay in plant remediation, intense competition in the US and entry of new players in the market. The low approvals and lack of meaningful launches will lead to weak margin growth. The company expects the R&D spend to capitalize in 2-3 years which will impact the profitability of the firm in coming years.

Dr Reddy's Laboratories Ltd has pipeline of 99ANDA and 2 NDA (New drug Abbreviations) pending approval with the US FDA out of which 59 are Para IV and 26 are first to file. Due to USFDA plant issue of Duvvada plant most of the complex generics (injectables) filed from Duvvada facility will see delay in launch. Key assets to watch are gAloxi, gCopaxone 20mg and 40mg, gSuboxone, gStrattera and gNuvaRing over FY18-20E with the foremost catalyst being the resolution of the Srikakulam facility and Duvvada faciltiy by the end of FY18E.

Valuations & Views: We believe that the warning letters to its facilities will lead to slow traction of new launches and approvals. This will offset the revenues along with growing competition in the US. The low revenues coupled with high R&D will impact the margins. Going ahead, we believe the topline to deliver a Y-o-Y growth of 6% with sales at INR 150,872 mn in FY18 and EBITDA at INR 25,353 with margins at 17.2%.

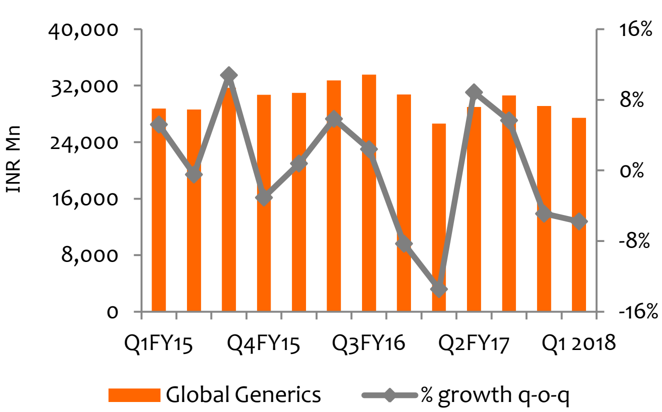
At CMP of INR 2,478 the stock is trading at EPS of INR 77.9 in FY17 and we project EPS of INR 78.8 in FY19E . We recommend **"HOLD"** rating on the stock and value the stock at 32x, its FY19E EPS and arrive at a target price of **INR 2,523** indicating **1.8%** upside from CMP.

The total revenues of the business has declined over the quarters…..



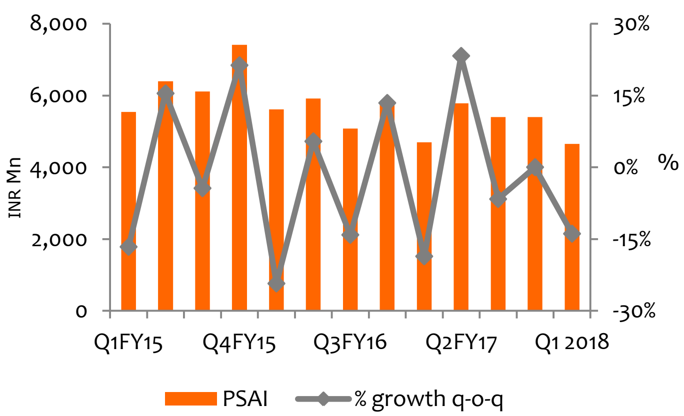
Source: Company, KRChoksey Research

Along with the global generics business…..



Source: Company, KRChoksey Research

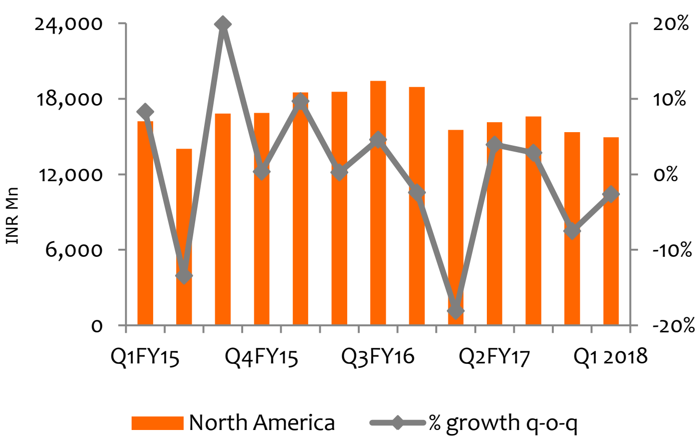
and PSAI segment.



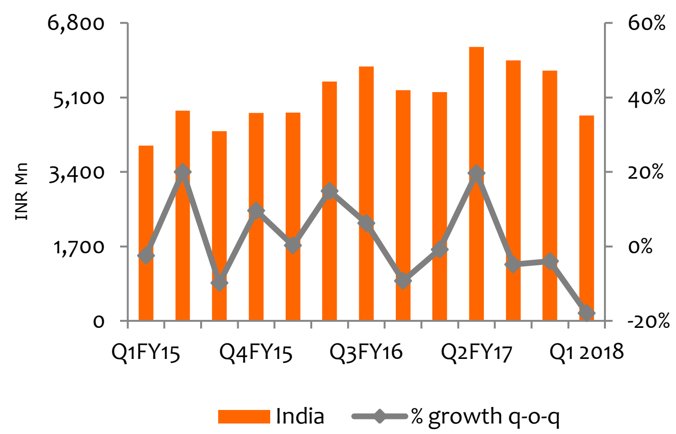
Source: Company, KRChoksey Research

Dr Reddy’s Laboratories Ltd.

The revenues loss from North America and India….

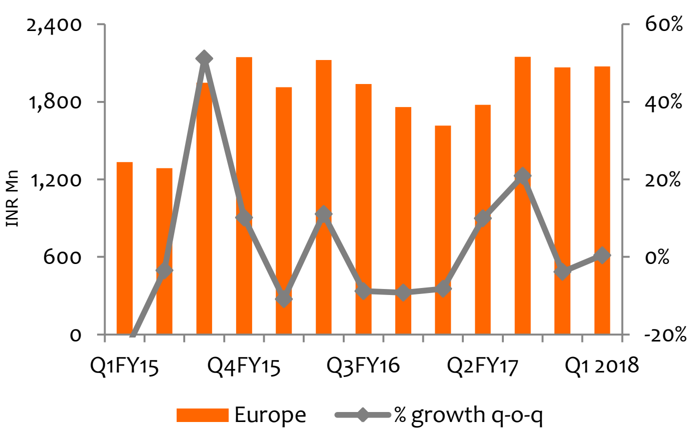


Source: Company, KRChoksey Research



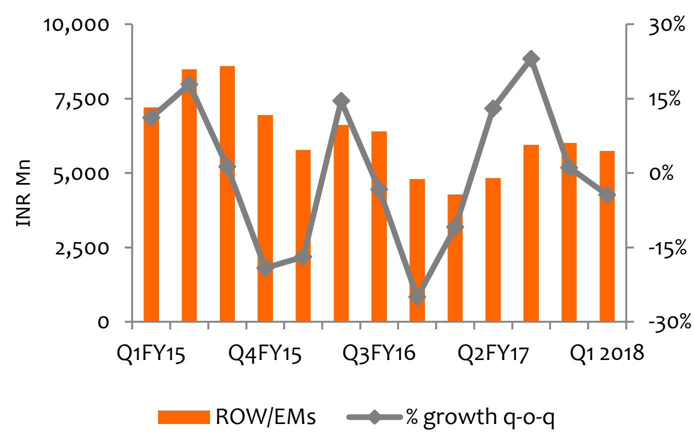
Source: Company, KRChoksey Research

was offset by market penetration in Europe….



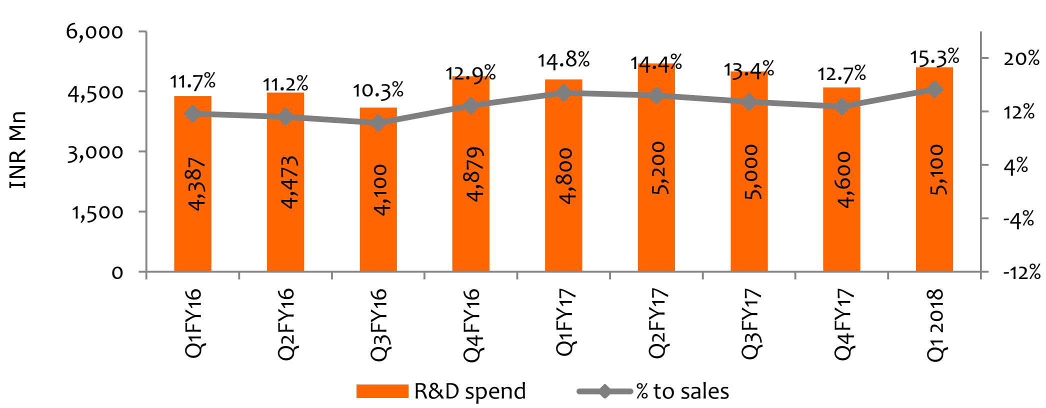
Source: Company, KRChoksey Research

and growing market share of emerging countries



Source: Company, KRChoksey Research

The R&D spend by the company has increased over the quarters



Source: Company, KRChoksey Research

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Dr Reddy's Laboratories Ltd.

Q1FY18 Result Snapshot

Exhibit 1 Consolidated Result Update (INR Mn)

INR Mn	Q1FY18	Q4FY17	Q1FY17	QoQ (%)	YoY (%)
Revenues	33,332	36,119	32,447	-7.7%	2.7%
Expenditure	30,100	30,214	28,545	-0.4%	5.4%
Materials Consumed	9,347	8,400	9,357	11.3%	-0.1%
Increase/ decrease in stock	245.0	1652.0	-1793.0	-85.2%	-113.7%
Staff cost	8073	6711	8050	20.3%	0.3%
Selling expenses	3264	2972	3268	9.8%	-0.1%
Other expenses	9171	10479	9663	-12.5%	-5.1%
EBITDA	3232	5905	3902	-45.3%	-17.2%
EBITDA margin (%)	10%	16%	12%	-67bps	432bps
Depreciation	2592	2543	2436	1.9%	6.4%
EBIT	640	3362	1466	-81.0%	-56.3%
Other Income	380	205	670	85.4%	-43.3%
Finance exp/(income)	215	196	148	9.7%	45.3%
PBT	805	3371	1988	-76.1%	-59.5%
Tax	237	97	526	144.3%	-54.9%
Effective tax rate (%)	29.4	2.9	26.5	923.2%	11.3%
Adj. PAT	568	3274	1462	-82.7%	-61.1%
Share of profit/loss of equity accounted affiliate	98	102	73	-3.9%	34.2%
PAT	666	3376	1535	-80.3%	-56.6%
PAT margin (%)	2%	9%	5%	-73bps	-273bps
EPS	4.0	20.4	9.3	-80.3%	-56.7%

Source: Company, KRChoksey Research

Key Con-call Highlights:

•Management expects that there will be high double digit price erosion in the US which will impact the revenues. The pricing pressure in the US and competition from McKesson and Walmart is going to affect the business adversely.

•The company will maintain its R&D spend to 15.1% in order to grow and fund its ongoing clinical trials. The capitalization of R&D will take 2-3 years to provide returns.

•The USFDA has insepcted its key plants ; Srikakulam and Duvvada for which the company has responded. Due to this the PSAI and the high margins drugs from the Duvvada facility will be affected. The company is working on strengthening its manufacturing plant for smooth functioning of its activities in the future.

•The company has launched gdoxil,gvytorin, progesterone and gAngiomax in Q1 FY2018 which are doing well and are aiding to the revenues.

•The company is facing price erosion on its US base portfolio which consists of gDacogen, gValcyte and gVidaza.

•The company plans to expand its geographical reach by tapping the emerging markets of China, Columbia, Brazil etc with the main focus on US will help the company to sustain

•Dr Reddy's Laboratories Ltd (DRL) has a patent litigation going on for Aloxi 505 (b2) filing which has a verdict after 8 weeks from June 2017.

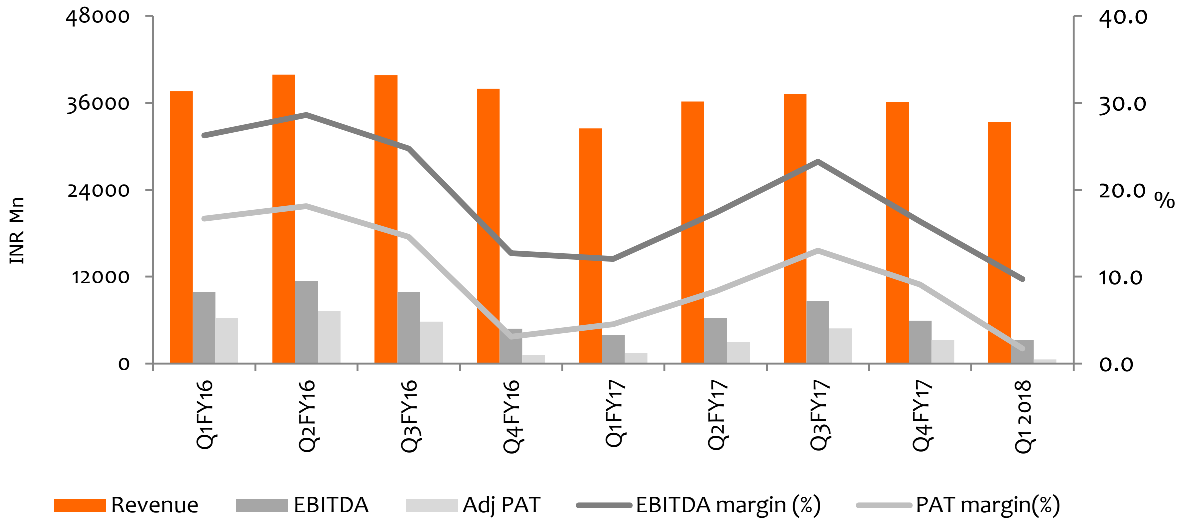
•The company is working on cost reduction and it expects to save aproox INR 100 crores in a year. Going ahead, the company believes that the remediation cost would go down.

Dr Reddy's Laboratories Ltd.

Exhibit 2 - Segment wise revenues

INR Mn	Q1FY18	Q4FY17	Q1FY17	QoQ (%)	YoY (%)
Global Generics	27,455	29,138	26,638	-5.8	3.1
North America	14,946	15,349	15,523	-2.6	-3.7
Europe	2,075	2,066	1,615	0.4	28.5
India	4,687	5,711	5,223	-17.9	-10.3
Emerging Markets	5,747	6,012	4,277	-4.4	34.4
PSAI	4,651	5,401	4,692	-13.9	-0.9
North America	797	532	643	49.8	24.0
Europe	911	2,539	1,947	-64.1	-53.2
India	1,388	395	372	251.4	273.1
ROW	1,555	1,935	1,730	-19.6	-10.1
Proprietary Products	1,053	1,003	1,015	5.0	3.7
Total	33,159	35,542	32,345	-6.7	2.5

Source: Company, KRChoksey Research



Source: Company, KRChoksey Research

Dr Reddy's Laboratories Ltd.

Exhibit 3: Income Statement

INR Mn	FY15	FY16	FY17	FY18E	FY19E
Revenues	**1,49,084**	**1,55,683**	**1,41,961**	**1,50,872**	**1,72,389**
Op. Expenses	1,15,297	1,19,830	1,17,239	1,25,519	1,43,592
EBITDA	**33,787**	**35,853**	**24,722**	**25,353**	**28,797**
Other Income	3,890	2,950	1,715	1,717	1,722
Depreciation	7,599	9,389	10,266	11,307	12,283
EBIT	**30,078**	**29,414**	**16,171**	**15,763**	**18,236**
Interest	1,082	826	634	1,205	1,262
Ex. ordinary	0	0	0	0	0
Sh. of Associates	0	0	0	0	0
PBT	**28,996**	**28,588**	**15,537**	**14,557**	**16,974**
Tax	5,632	7,511	2,965	3,348	3,904
PAT	**23,364**	**21,077**	**12,572**	**11,209**	**13,070**
Adj PAT	**23,364**	**21,306**	**12,921**	**11,209**	**13,070**

Source: Company, KRChoksey Research

Exhibit 4: Balance Sheet

INR Mn	FY15	FY16	FY17	FY18E	FY19E
Equity Share Capital	852	853	829	829	829
Reserves & Surplus	97,679	1,24,845	1,21,792	1,29,685	1,39,440
Total Shareholders Fund	**98,531**	**1,25,698**	**1,22,621**	**1,30,514**	**1,40,269**
Minority Interest	0	0	0	0	0
Non- current liabilties	23,753	8,767	4,561	4,884	5,219
Long term Borrowings	21,284	10,685	5,449	5,558	5,669
Deferred tax liabilities	-1,043	-5,368	-5,164	-5,164	-5,164
Other LT liabilties & prov	3,512	3,450	4,276	4,490	4,714
Current Liabilities	61,244	63,471	84,199	89,004	95,340
Short-term borrowings	21,857	22,718	43,626	45,807	48,098
Trade payables	8,673	9,068	10,569	11,692	14,162
Other cur liabilities & Prov	30,714	31,685	30,004	31,504	33,079
Total Liabilities	**1,83,528**	**1,97,936**	**2,11,381**	**2,24,402**	**2,40,828**
Assets					
Non- current Assets	64,761	79,996	1,14,544	1,17,153	1,16,892
Fixed assets	59,060	73,352	1,02,552	1,04,999	1,04,575
Non-current investments	1,456	3,297	6,826	6,894	6,963
Long-term loans & adv	4,181	2,559	4,127	4,210	4,294
Other non-current assets	64	788	1,039	1,049	1,060
Current assets	1,18,767	1,17,940	96,837	1,07,249	1,23,936
Current investments	21,022	35,210	14,535	14,680	14,827
Trade receivables	41,012	41,250	37,986	40,913	47,404
Inventories	25,699	25,579	28,528	30,588	35,422
Cash & bank balances	18,724	4,921	3,865	8,575	12,044
Short-term loans & adv	10,747	9,648	10,491	11,061	12,807
Other current assets	1,563	1,332	1,432	1,432	1,432
Total Assets	**1,83,528**	**1,97,936**	**2,11,381**	**2,24,402**	**2,40,828**

Source: Company, KRChoksey Research

Dr Reddy's Laboratories Ltd.

Exhibit 5 FY17: Cash flow statement

INR Mn	FY15	FY16	FY17	FY18E	FY19E
PBT	**28996**	**28588**	**15537**	**14557**	**16974**
Depreciation	7599	9389	10266	11307	12283
Interest Exp	1082	826	634	1205	1262
Others	7859	862	6027	0	0
CF before W.cap	45536	39665	32464	27070	30519
Inc/dec in W.cap	-14837	-25	-5250	-2934	-9025
Op CF after W.cap	30699	39640	27214	24137	21493
Less Taxes	-5464	-7014	-5770	-3348	-3904
Net CF From Operations	**25235**	**32626**	**21444**	**20788**	**17589**
Inc/(dec) in F.A + CWIP	-15143	-14732	-40887	-13755	-11859
(Pur)/sale of Investments	-9619	991	21872	-214	-216
others	2115	-6653	611	521	528
CF from Invst Activities	**-22647**	**-20394**	**-18404**	**-13447**	**-11546**
Loan Raised/(repaid)	-750	-11980	16314	1085	1140
Equity Raised	5	1	-15693	0	0
Dividend	-3587	-5022	-4313	-3316	-3316
Others	0	0	87	0	0
CF from Fin Activities	**-4332**	**-17001**	**-3605**	**-2231**	**-2176**
Net inc /(dec) in cash	**-1744**	**-4769**	**-565**	**5110**	**3867**
Exchange rate changes on cash	0	4295	-491	-400	-398
Op. bal of cash	**20468**	**5395**	**4921**	**3865**	**8575**
Cl. balance of cash	**18724**	**4921**	**3865**	**8575**	**12044**

Source: Company, KRChoksey Research

Exhibit 6 FY17: Ratio Analysis

Particulars	FY15	FY16	FY17	FY18E	FY19E
EPS	137.1	124.9	77.9	67.6	78.8
CEPS	181.7	179.9	139.8	135.8	152.9
BVPS	578.2	736.8	739.6	787.2	846.0
DPS	20.0	20.0	20.4	20.0	20.0
Payout (%)	14.6	16.0	26.2	29.6	25.4
Valuation (x)					
P/E	30.7	33.7	33.7	36.7	31.4
P/BV	7.3	5.7	3.6	3.1	2.9
EV/EBITDA	0.8	0.8	1.9	1.8	1.5
Dividend Yield (%)	0.5	0.5	0.8	0.8	0.8
Return ratio (%)					
EBIDTA Margin	23.0	23.5	17.8	17.2	17.1
PAT Margin	15.7	13.7	9.1	7.4	7.6
ROAE	26.4	19.0	10.4	8.9	9.7
ROACE	19.2	17.1	8.5	7.7	8.5
Leverage Ratios (x)					
Long Term D/E	0.2	0.1	0.0	0.0	0.0
Net Debt/Equity	0.2	0.2	0.4	0.3	0.3
Debt/EBITDA	1.3	0.9	2.0	2.0	1.9
Interest Coverage	24.2	32.0	22.8	11.7	13.1
Current ratio	2.5	2.0	2.0	2.1	2.3
Growth Ratios (%)					
Income growth	12.3	4.4	-8.8	6.3	14.3
EBITDA growth	8.4	6.1	-31.0	2.6	13.6
PAT growth	19.0	-8.8	-39.4	-13.2	16.6
Turnover Ratios					
F.A Turnover x	1.2	1.0	0.9	0.9	0.9
Inventory Days	62	61	71	73	71
Debtors Days	92	98	104	98	96
Payable days	28	27	31	32	33

Source: Company, KRChoksey Research

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Dr Reddy's Laboratories Ltd.

Dr Reddy's Laboratories Ltd.			
Date	CMP (INR)	TP (INR)	Recommendation
28-Jul-17	2,478	2,523	HOLD
06-Feb-17	3,095	3,523	ACCUMULATE
26-Oct-16	3,200	3,523	ACCUMULATE
27-Jul-16	2,964	3,366	ACCUMULATE
13-May-16	2,974	3,726	BUY
10-Feb-16	2,960	3,610	BUY
30-Oct-15	4,214	4,793	ACCUMULATE
31-July-15	3,908	4,203	ACCUMULATE
08-May-15	3,711	3,957	ACCUMULATE
13-May-15	3,469	3,957	ACCUMULATE
09-April-15	3,678	3,900	ACCUMULATE
30-Jan-15	3,362	3,722	ACCUMULATE
30-Oct-14	3,053	3,485	ACCUMULATE
08-Oct-14	3,204	3,515	ACCUMULATE

Rating Legend	
Our Rating	Upside
Buy	More than 15%
Accumulate	5% - 15%
Hold	0 – 5%
Reduce	-5% – 0
Sell	Less than -5%

I, Vaibhav Chowdhry (B.Com, MBA), research analyst, & Dhara Patwa (BBA,MBA), research associate, author and the name subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect my views about the subject issuer(s) or securities. I also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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