Dr. Reddy's Labs

SELL

INDUSTRY	PHARMA
CMP *(as on 27 Jul 2017)*	Rs 2,621
Target Price	Rs 2,275
Nifty	10,021
Sensex	32,383
KEY STOCK DATA	
Bloomberg	DRRD IN
No. of Shares (mn)	166
MCap (Rs bn) / ($ mn)	435/6,778
6m avg traded value (Rs mn)	784
STOCK PERFORMANCE (%)	
52 Week high / low	Rs 3,400/2,380

	3M	6M	12M
Absolute (%)	1.0	(12.5)	(12.0)
Relative (%)	(6.9)	(28.6)	(27.6)

SHAREHOLDING PATTERN (%)	
Promoters	26.8
FIs & Local MFs	11.7
FPIs	31.6
Public & Others	29.8

Source : BSE

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Misery continues

Dr. Reddy's Labs (DRRD) posted weak numbers, with the top-line growing only ~3% YoY in 1QFY18. This was led by a 3% decline in the US business and a 10% decline in domestic revenues. The EBITDA margin came in at 9.2%, sinking ~700bps QoQ, with the gross margin plummeting to 51.5% during the quarter. Incremental competition in the US continues to erode profits in the absence of new lucrative product launches. The impact of GST on the domestic business also contributed to the margin decline. PAT was Rs 591mn, down 53% YoY despite the low base.

With the ongoing regulatory issues and low visibility on significant launches in the near/medium term, we expect only ~10% CAGR in the US business, and 11% CAGR in the overall top-line over FY17-20E.

At CMP, the stock is trading at 34x FY18E/21.2x FY19E, expensive when compared to peers. We have further cut our FY18/19/20 estimates owing to the continuous and severe erosion in the base business. Till the time we have visibility on the resolution of the warning letter, which would spark a recovery in the US business, the outlook is bleak. Downgrade to SELL with a TP of Rs 2,275 (17x Jun19E).

- **US business:** Revenues were flat QoQ at ~US$ 231mn (vs est. of ~5% growth). This was primarily owing to the lack of new launches and increased competition in key products. Erosion in gValcyte and gVidaza was ~US$ 11mn QoQ. 1HFY18 is expected to continue to be soft, with no sizeable launches planned. This will likely heap further pressure on the base business. On the positive side, the gCopaxone 40mg filing is likely in the next two weeks. Also, gCopaxone 20mg TAD is on the horizon and gSubaxone and gNuvaring have TADs in 4QFY18.
- **Other highlights:** (1) Progress is being made in Duuvada, re-inspection required (no guidance on when this is likely), (2) Srikakulam WL impact is not significant, as many assets have been tech transferred, (3) Responses to the queries for the Bachupally plant have been submitted, (4) Future US rev. is dependent on injectables filed from own and partner sites, (5) Top 5 products now contribute only ~25% of US revenues.
- **Near-term outlook:** With no visibility on significant launches to offset base biz erosion, the outlook is soft.

Financial Summary

(Rs mn)	1QFY18	1QFY17	YoY (%)	4QFY17	QoQ (%)	FY17	FY18E	FY19E	FY20E
Net Sales	33,159	32,345	*2.5*	35,542	*(6.7)*	140,809	148,224	168,275	191,048
EBIT	3,058	3,773	*(19.0)*	5,834	*(47.6)*	25,220	27,421	37,862	47,762
APAT	591	1,263	*(53.2)*	3,125	*(81.1)*	12,039	12,791	20,465	27,392
Diluted adj. EPS (Rs)	3.5	7.4	*(53.2)*	18.4	*(81.1)*	72.7	77.2	123.4	165.2
P/E (x)						36.1	34.0	21.2	15.9
RoE (%)						9.5	10.0	14.5	17.0

Source: Company, HDFC sec Inst Research # Consolidated

Pricing pressures in the US continued to plague DRRD's top line, witnessing double-digit erosion YoY

US base business erosion and GST impact were behind the decline in the gross margin

Lower gross margin and operating de-leverage resulted in the decline in the EBITDA margin

Quarterly Financials Snapshot (Consolidated)

Particulars (Rs mn)	1QFY18	1QFY17	YoY (%)	4QFY17	QoQ (%)
Net Sales	**33,159**	**32,345**	***2.5***	**35,542**	***(6.7)***
Material Expenses	16,062	14,167	*13.4*	17,360	*(7.5)*
SG&A Expenses	8,964	9,603	*(6.7)*	7,769	*15.4*
R&D Expenses	5,075	4,802	*5.7*	4,579	*10.8*
EBITDA	**3,058**	**3,773**	***(19.0)***	**5,834**	***(47.6)***
Depreciation	2,799	2,681		3,204	
EBIT	**259**	**1,092**	***(76.3)***	**2,630**	***(90.2)***
Other Income	194	96		505	
Net Finance Cost	(211)	(365)		(133)	
FX (Gains)/ Loss	(10)	(80)		181	
PBT	**674**	**1,633**	***(58.7)***	**3,087**	***(78.2)***
Tax	181	444		64	
Minority Interest	(98)	(74)		(102)	
RPAT	**591**	**1,263**	***(53.2)***	**3,125**	***(81.1)***
EO Items (Adj For Tax)	-	-		-	
APAT	**591**	**1,263**	***(53.2)***	**3,125**	***(81.1)***

Source: Company, HDFC sec Inst Research

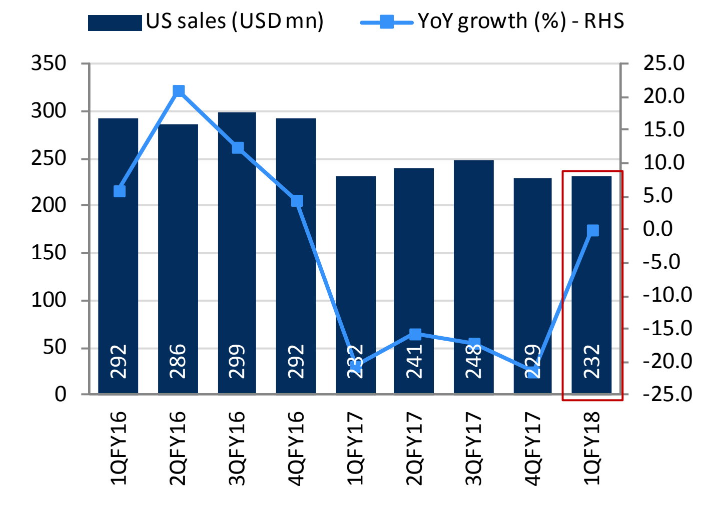
Margin Analysis

	1QFY18	1QFY17	YoY (bps)	4QFY17	QoQ (bps)
Material Expenses % Net Sales	48.4	43.8	*464*	48.8	*(40)*
SG&A Expenses % Net Sales	27.0	29.7	*(266)*	21.9	*517*
R&D Expenses % Net Sales	15.3	14.8	*46*	12.9	*242*
EBITDA Margin (%)	**9.2**	**11.7**	***(244)***	**16.4**	***(719)***
Tax Rate (%)	2.0	5.0	*(302)*	8.7	*(665)*
APAT Margin (%)	1.8	3.9	*(212)*	8.8	*(701)*

Source: Company, HDFC sec Inst Research

DRRD continues to see price erosion in the US base business (double digit YoY) and with no major product launches, US revenue growth remains subdued

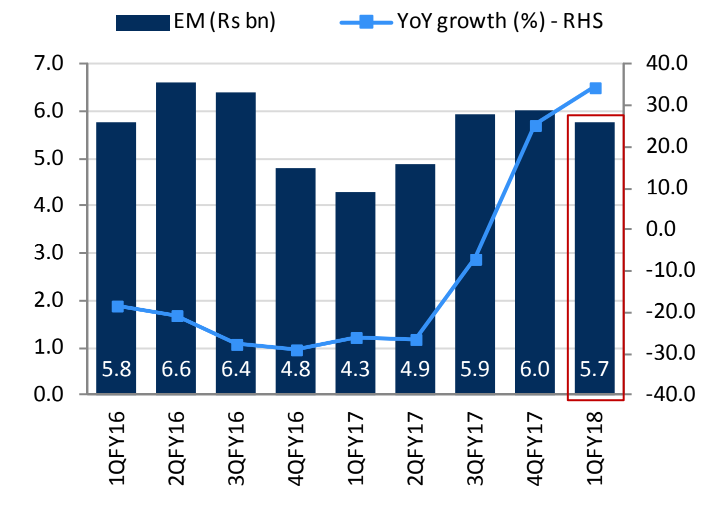
US Formulations



Source: Company, HDFC sec Inst Research

EM business saw good progress, led by 48% (reporting currency) growth in the Russia business

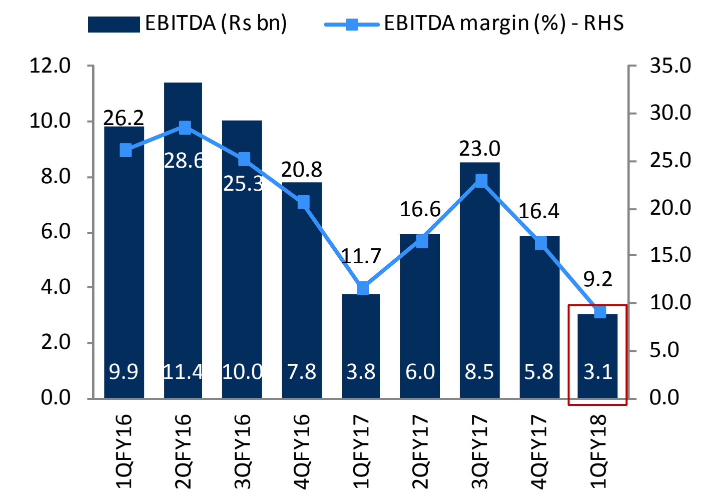
Emerging Markets Growth Trajectory



Source: Company, HDFC sec Inst Research

EBITDA margin decline was led by the drop in the gross margin

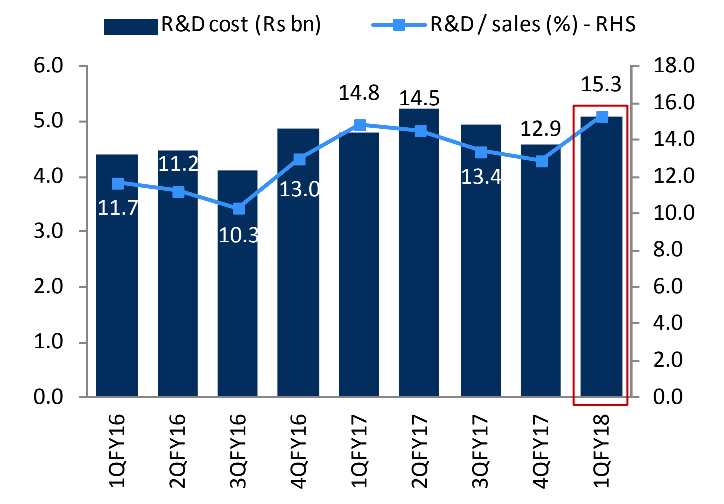
EBITDA Margin: Sharp Decline



Source: Company, HDFC sec Inst Research

R&D expenses came in at 15.3% of sales, ~130bps higher than expectations

R&D: Trending Upwards



Source: Company, HDFC sec Inst Research

Domestic revenue declined ~10% in 1QFY18 on the back of pre-GST channel de-stocking

Russia business grew 31% YoY in constant currency terms

New product launches are driving sales in Europe, with momentum likely to continue

DRRD now has 99 filings pending (97 ANDAs, 2 NDAs), of which 59 are Para IV opportunities and 26 FTFs

Segmental Quarterly Performance

(Rs mn)	1QFY18	1QFY17	YoY (%)	4QFY17	QoQ (%)
Domestic formulations	4,687	5,223	*(10.3)*	5,711	*(17.9)*
US Generics	14,946	15,523	*(3.7)*	15,349	*(2.6)*
Russia +CIS	4,347	2,977	*46.0*	4,135	*5.1*
ROW	1,400	1,300	*7.7*	1,877	*(25.4)*
Europe	2,075	1,615	*28.5*	2,066	*0.4*
PSAI	4,651	4,692	*(0.9)*	5,401	*(13.9)*
Others	1,053	1,015	*3.7*	1,003	*5.0*
Total	**33,159**	**32,345**	***2.5***	**35,542**	***(6.7)***

Source: Company, HDFC sec Inst Research

Assumptions

(Rs mn)	FY17	FY18E	FY19E	FY20E
Domestic Formulations	23,131	24,750	27,720	31,047
Growth (%)	*8.6*	*7.0*	*12.0*	*12.0*
US Formulations	63,601	64,289	74,994	87,550
Growth (%)	*(15.7)*	*1.1*	*16.7*	*16.7*
Russia/CIS	14,425	16,684	18,860	21,152
Growth (%)	*1.8*	*15.7*	*13.0*	*12.2*
ROW (inc. Venezuela)	6,646	7,038	8,282	9,669
Growth (%)	*(29.5)*	*5.9*	*17.7*	*16.7*
Europe	7,606	8,201	9,231	10,308
Growth (%)	*(1.6)*	*7.8*	*12.6*	*11.7*
API and Others	21,277	22,726	24,199	25,835
Growth (%)	*(4.9)*	*6.8*	*6.5*	*6.8*
Proprietary Products	4,123	4,535	4,989	5,488
Growth (%)	*(3.4)*	*10.0*	*10.0*	*10.0*
Total	**140,809**	**148,224**	**168,275**	**191,048**
Growth (%)	***-9.0***	***5.3***	***13.5***	***13.5***

Source: HDFC sec Inst Research

Peer Valuations

	Mcap (Rs bn)	CMP (Rs/sh)	Reco	TP	Adj EPS (Rs/sh)				P/E (x)				RoE (%)			
					FY17	FY18E	FY19E	FY20E	FY17	FY18E	FY19E	FY20E	FY17	FY18E	FY19E	FY20E
Sun Pharma	1,376	572	NEU	650	26.0	23.5	30.5	35.8	22.0	24.4	18.8	16.0	17.9	14.5	16.4	16.8
Cadila Healthcare	554	540	BUY	600	14.5	15.3	19.7	26.4	37.2	35.3	27.4	20.5	23.5	20.1	21.1	23.3
Lupin	499	1,110	BUY	1,800	59.4	57.6	78.4	94.1	18.7	19.3	14.2	11.7	21.8	17.9	20.7	20.7
Cipla	457	569	NEU	495	15.7	18.1	23.5	28.7	36.3	31.4	24.2	19.8	10.5	11.1	13.0	14.0
Dr Reddy's	**435**	**2,621**	**SELL**	**2,275**	**72.7**	**77.2**	**123.4**	**165.2**	**36.1**	**34.0**	**21.2**	**15.9**	**9.5**	**10.0**	**14.5**	**17.0**
Aurobindo	432	739	BUY	760	39.3	41.2	44.8	52.1	17.9	16.1	14.2	14.2	27.6	23.0	20.4	18.8
Alkem Laboratories	219	1,830	NEU	2,050	74.6	72.1	92.8	114.7	24.5	25.4	19.7	16.0	21.9	17.9	19.9	21.0
Torrent Pharma	215	1,269	BUY	1,470	51.2	48.9	68.5	88.2	24.8	26.0	18.5	14.4	22.1	17.7	21.4	23.2
Glenmark	202	716	BUY	1,035	29.6	32.0	47.5	57.8	24.2	22.4	15.1	12.4	18.1	16.4	20.0	20.0
Divis Labs	175	660	NEU	680	39.9	33.2	41.1	47.0	16.5	19.3	15.5	13.6	22.0	15.6	17.4	17.9
Alembic Pharma	102	543	BUY	635	21.4	23.6	29.7	37.8	25.4	23.0	18.3	14.4	23.0	21.5	22.7	23.9
Granules India	31	137	BUY	195	7.2	8.5	11.4	14.2	19.1	16.2	12.0	9.7	21.0	19.7	22.2	23.1

Source: HDFC sec Inst Research

Change In Estimates (Consolidated)

Rs mn	Previous			New			*% Chg*		
	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	*FY18E*	*FY19E*	*FY20E*
Net Sales	151,552	172,439	200,096	148,224	168,275	191,048	*(2.2)*	*(2.4)*	*(4.5)*
EBITDA	34,857	40,523	50,024	27,421	37,862	47,762	*(21.3)*	*(6.6)*	*(4.5)*
APAT	18,549	22,264	28,604	12,791	20,465	27,392	*(31.0)*	*(8.1)*	*(4.2)*

Source: HDFC sec Inst Research

Income Statement (Consolidated)

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Net Revenues	**154,708**	**140,809**	**148,224**	**168,275**	**191,048**
Growth (%)	***4.4***	***-9.0***	***5.3***	***13.5***	***13.5***
Material Expenses	62,427	62,453	66,701	71,517	78,330
SG&A Expenses	35,359	33,585	34,092	37,021	41,075
R&D Expenses	17,834	19,551	20,010	21,876	23,881
EBITDA	**39,088**	**25,220**	**27,421**	**37,862**	**47,762**
EBITDA Margin (%)	***25.3***	***17.9***	***18.5***	***22.5***	***25.0***
EBITDA Growth (%)	***16.8***	***-35.5***	***8.7***	***38.1***	***26.1***
Depreciation	10,343	11,722	11,858	13,125	14,520
EBIT	**28,745**	**13,498**	**15,564**	**24,736**	**33,242**
Net finance expense (Including EO Items)	1,834	(806)	(768)	(1,522)	(2,011)
PBT	**26,911**	**14,304**	**16,332**	**26,258**	**35,254**
Tax (Incl Deferred)	7,127	2,614	3,821	6,113	8,182
Minority Interest	229	349	280	320	320
RPAT	**20,013**	**12,039**	**12,791**	**20,465**	**27,392**
APAT	**20,013**	**12,039**	**12,791**	**20,465**	**27,392**
APAT Growth (%)	***(9.8)***	***(39.8)***	***6.2***	***60.0***	***33.8***
Adjusted EPS (Rs)	**117.9**	**72.7**	**77.2**	**123.4**	**165.2**

Source: Company, HDFC sec Inst Research

Balance Sheet (Consolidated)

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
SOURCES OF FUNDS					
Share Capital - Equity	853	828	828	828	828
Reserves	127,483	123,216	132,027	148,513	171,926
Total Shareholders Funds	**128,336**	**124,044**	**132,855**	**149,341**	**172,754**
Long Term Debt	10,685	10,398	7,898	7,398	6,898
Short Term Debt	22,828	38,677	39,427	40,947	42,467
Total Debt	**33,513**	**49,075**	**47,325**	**48,345**	**49,365**
Net Deferred Taxes	**(4,230)**	**(4,376)**	**(4,376)**	**(4,376)**	**(4,376)**
Other Non-current Liabilities & Provns	**3,216**	**2,012**	**2,012**	**2,012**	**2,012**
TOTAL SOURCES OF FUNDS	**160,835**	**170,755**	**177,816**	**195,322**	**219,755**
APPLICATION OF FUNDS					
Net Block	46,411	50,660	55,719	59,046	25,978
CWIP	7,550	6,500	5,250	5,250	7,268
Intangible assets	24,644	47,368	47,369	47,369	47,369
Investments	1,309	1,309	1,309	1,309	1,309
Other Non-current Assets	3,051	3,100	2,900	3,000	3,000
Total Non-current Assets	**82,965**	**108,937**	**112,547**	**115,974**	**84,924**
Cash & Equivalents	**40,130**	**17,729**	**15,121**	**22,357**	**70,064**
Inventories	25,578	28,529	31,016	33,255	36,423
Debtors	41,306	38,065	36,504	41,443	47,051
Other Current Assets	12,674	13,906	16,130	18,335	20,840
Total Current Assets	**79,558**	**80,500**	**83,650**	**93,033**	**104,314**
Creditors	12,300	13,417	12,745	13,665	14,967
Other Current Liabilities & Provns	29,518	22,995	20,757	22,378	24,581
Total Current Liabilities	**41,818**	**36,412**	**33,501**	**36,043**	**39,548**
Net Current Assets	**37,740**	**44,088**	**50,148**	**56,991**	**64,767**
TOTAL APPLICATION OF FUNDS	**160,835**	**170,755**	**177,816**	**195,322**	**219,754**

Source: Company, HDFC sec Inst Research

Cash Flow

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Reported PBT	27,140	14,653	16,612	26,578	35,574
Non-operating & EO items	(795)	583	-	-	-
Interest expenses	334	-	482	478	489
Depreciation	10,343	11,722	11,858	13,125	14,520
Working Capital Change	7,242	(7,748)	(5,860)	(6,942)	(7,776)
Tax Paid	(6,898)	(2,564)	(3,746)	(6,028)	(8,097)
OPERATING CASH FLOW (a)	**37,366**	**16,646**	**19,346**	**27,212**	**34,709**
Capex	(24,428)	(37,645)	(15,668)	(16,453)	16,531
Free cash flow (FCF)	*12,938*	*(20,999)*	*3,678*	*10,759*	*51,240*
Investments	(487)	21,000	-	-	-
Non-operating Income	-	-	-	-	-
INVESTING CASH FLOW (b)	**(24,915)**	**(16,645)**	**(15,668)**	**(16,453)**	**16,531**
Debt Issuance/(Repaid)	(9,613)	15,562	(1,750)	1,020	1,020
Interest Expenses	(334)	-	(482)	(478)	(489)
FCFE	*2,505*	*15,563*	*1,446*	*11,301*	*51,771*
Share Capital Issuance	1,001	(12,352)	-	-	-
Others	-	(632)	(75)	(85)	(85)
Dividend	(3,979)	(3,979)	(3,979)	(3,979)	(3,979)
FINANCING CASH FLOW (c)	**(12,925)**	**(1,401)**	**(6,286)**	**(3,523)**	**(3,533)**
NET CASH FLOW (a+b+c)	**(474)**	**(1,400)**	**(2,609)**	**7,236**	**47,707**
Closing Cash & Equivalents	**4,921**	**3,521**	**912**	**8,148**	**55,855**

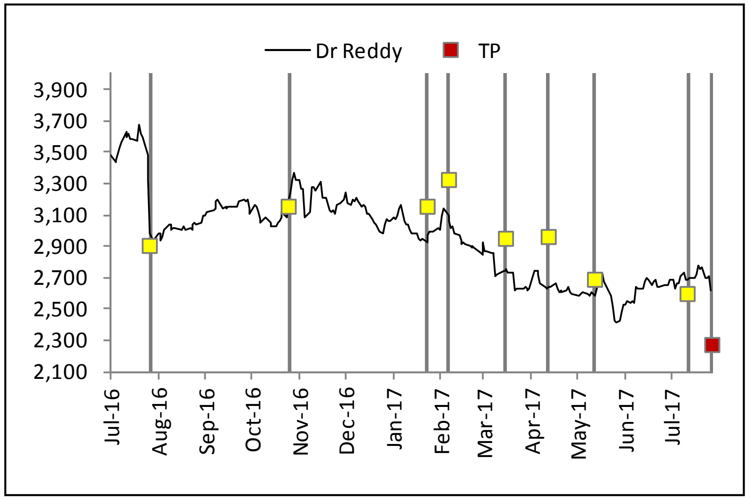
Source: Company, HDFC sec Inst Research

Key Ratios

	FY16	FY17	FY18E	FY19E	FY20E
PROFITABILITY (%)					
GPM	59.6	55.6	55.0	57.5	59.0
EBITDA Margin	25.3	17.9	18.5	22.5	25.0
APAT Margin	12.9	8.5	8.6	12.2	14.3
RoE	16.7	9.5	10.0	14.5	17.0
RoIC (or Core RoCE)	18.8	8.3	7.8	11.6	16.3
RoCE	12.9	7.2	7.5	11.1	13.3
EFFICIENCY					
Tax Rate (%)	26.5	18.3	23.4	23.3	23.2
Fixed Asset Turnover (x)	1.9	1.5	1.4	1.5	4.3
Inventory (days)	*60.3*	*74.0*	*76.4*	*72.1*	*69.6*
Debtors (days)	*97.5*	*98.7*	*89.9*	*89.9*	*89.9*
Other Current Assets (days)	*29.9*	*36.0*	*39.7*	*39.8*	*39.8*
Payables (days)	*29.0*	*34.8*	*31.4*	*29.6*	*28.6*
Other Current Liab & Provns (days)	*69.6*	*59.6*	*51.1*	*48.5*	*47.0*
Cash Conversion Cycle (days)	*89.0*	*114.3*	*123.5*	*123.6*	*123.7*
Debt/EBITDA (x)	0.9	1.9	1.7	1.3	1.0
Net D/E (x)	(0.1)	0.2	0.2	0.2	(0.1)
PER SHARE DATA (Rs)					
EPS	117.9	72.7	77.2	123.4	165.2
Dividend	20.0	20.0	20.0	20.0	20.0
Book Value	755.8	748.6	801.7	900.7	1,041.9
VALUATION					
P/E (x)	22.2	36.1	34.0	21.2	15.9
P/BV (x)	3.5	3.5	3.3	2.9	2.5
EV/EBITDA (x)	11.2	18.4	17.0	12.1	8.7
EV/Revenues (x)	2.8	3.3	3.1	2.7	2.2
OCF/EV (%)	8.5	3.6	4.2	5.9	8.4
FCF/EV (%)	3.0	(4.5)	0.8	2.3	12.4
FCFE/Mkt Cap (%)	0.6	3.6	0.3	2.6	11.9
Dividend Yield (%)	0.8	0.8	0.8	0.8	0.8

Source: Company, HDFC sec Inst Research

RECOMMENDATION HISTORY



Date	CMP	Reco	Target
27-Jul-16	2,980	NEU	2,900
26-Oct-16	3,201	NEU	3,150
23-Jan-17	2,940	NEU	3,150
6-Feb-17	3,145	NEU	3,325
15-Mar-17	2,716	NEU	2,950
12-Apr-17	2,645	NEU	2,960
15-May-17	2,585	NEU	2,685
12-Jul-17	2,690	NEU	2,600
28-Jul-17	2,621	SELL	2,275

Rating Definitions

BUY : Where the stock is expected to deliver more than 10% returns over the next 12 month period

NEUTRAL : Where the stock is expected to deliver (-)10% to 10% returns over the next 12 month period

SELL : Where the stock is expected to deliver less than (-)10% returns over the next 12 month period

Disclosure:

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