Dr Reddy's Laboratories

Buy

DART — DOLAT ANALYSIS & RESEARCH THEMES — IN-DEPTH• PRECISE• ACTIONABLE

Result Update

US sales improved... key approvals shifted to 2HFY19E

As per our expectations, earnings started picking up from Q2FY18 onwards. Revenues came ahead of our expectations, as US sales were 12% QoQ higher at USD 252mn (vs USD 224mn QoQ) with gRenvela benefits. Higher SG&A expenses and one-offs adjustment in SG&A, forex and tax line impacted bottom line.

The status on key approvals have received more clarity with some extension of timeline than expected earlier. We believe that despite TAD on Nuvaring been shifted to July'18, we might expect some early approvals possibility as the patent expires in early Apr'18. Company announced a minor CRL on gSuboxone which is expected to be responded soon (3-4 weeks) and the approval closer to 2HFY19.The management also added approval is easier however, key is the litigation. gAloxi is also another opportunity around the corner (post Teva launch). gCopaxone has received a major CRL which will take nearly 4-5 months to responded and approval mostly shifts to end of FY19E.

The management has guided for improvement in the margins from these levels and indicated cost integration to accrue further benefits. In terms of compliance towards the several facilities, Company has responded to USFDA queries on Srikakulam facility post the concall with the agency. Duvadda to see re-inpsection in either 4QFY18/1QFY19.

Overall all we feel FY19E earnings to be stronger and should be a year for DRL where all compliance issues at plants being sorted. FY18-20E would be strong growth years for the company based on key assets approvals and more niche approvals coming by post clearance of plants.

Q3FY18 Financial Highlights - Sales stood at ₹ 38.1bn, growing 3% YoY. The fall of 2% in US generics and PSAI was supported by Propriety products (up 254% YoY). EBITDA margins contracted 265bps YoY to 20.9%. PAT stood at ₹ 3.3bn, declining 29% YoY.

Outlook and Valuation

DRL, in our view, continues to be one of the strongest entities having built up leads in the injectables, biosimilars and complex oral solids. Given the core strengths of the business in R&D, we believe the current under performance offers an opportunity to accumulate over time. We have a BUY rating on the stock with a 20x FY20E EPS rollover target price of ₹ 3,450.

We have revised our earning to from earlier expectations of full year impact of gNuvaring and gSuboxone to half year in FY19E. At the current market price of ₹ 2,504, the stock trades at 18x FY19E EPS of ₹ 137 and 15x FY20E EPS of ₹ 170.

Q3FY18 Result (₹ Mn)

Particulars	Q3FY18	Q3FY17	YoY (%)	Q2FY18	QoQ (%)
Net Sales	38,060	37,065	2.7	35,460	7.3
Gross profit	21,411	21,899	(2.2)	18,901	13.3
R&D	4,667	4,956	(5.8)	4,175	11.8
EBIT	4,696	5,602	(16.2)	3,694	27.1
Net Interest	936	133	603.8	68	1,276.5
PBT	5,632	5,735	(1.8)	3,762	49.7
Tax	2,601	1,221	113.0	1,027	153.3
Reported PAT	3,031	4,514	(32.9)	2,735	10.8
Adjusted PAT	3,344	4,701	(28.9)	2,849	17.4
			(bps)		(bps)
Gross Profit Margin (%)	56.3	59.1	(283)	53.3	295
Tax Rate (%)	46.2	21.3	2,489	27.3	1,888
NPM (%)	8.0	12.2	(421)	7.7	25

CMP	₹ 2,504
Target / Upside	₹ 3,450/38%
BSE Sensex	36,377
NSE Nifty	11,159
Scrip Details	
Equity / FV	₹ 852mn/₹ 5/-
Market Cap	₹ 415bn
	USD 6.4bn
52-week High/Low	₹ 3,175/1,902
Avg. Volume (no)	631,410
NSE Symbol	DRREDDY
Bloomberg Code	DRRD IN
Shareholding Pattern Dec'17(%)	
Promoters	26.8
MF/Banks/FIs	15.4
FIIs	43.9
Public / Others	13.9

Valuation (x)

	FY18E	FY19E	FY20E
P/E	39.4	18.3	14.7
EV/EBITDA	19.2	12.1	10.0
ROE	8.3	16.3	17.5
ROCE	9.9	15.9	18.0

Estimates (₹ mn)

	FY18E	FY19E	FY20E
Net Sales	137,145	169,101	189,345
EBITDA	24,106	37,606	45,033
PAT	10,538	22,649	28,214
EPS	63.6	136.6	170.2

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DOLAT CAPITAL

Quarterly Highlights

US FDA Inspections - During the quarter, the company received EIR at its Bachupally facility. The inspection was carried out from 19th – 28th Apr'17, resulting in Form 483 with 11 observations.

Regulatory Authority of German Inspection

- The re-inspection was carried about by Regulatory Authority of Germany last week.
- On 10th Aug'17, German authority had inspected Unit 2 and did not renew GMP compliance certificate.
- Post the recent re-inspection, the regulatory authority has withdrawn EU noncompliance status
- The company can now resume the supply of approved products form the facility.
- **Duvadda facility USFDA re-inspection** expected by **end of Q4FY18E.**

Global Generics

- Sales fell 1% YoY to ₹ 30.1bn as the all the segments but India fell during the quarter. The management has cited USD depreciation and lower EU generic contribution as the reasons for the poor performance.
- Gross margin stood at 56.3% during the quarter, contracting 283bps YoY and expanding 295bps QoQ.

North America

- Revenues dropped 3% YoY to ₹ 16.1bn in the US, attributing to pricing pressure, increased competition and USD depreciation.
- **New Launches in the US -** The company launched 3 products in the market viz. **gAlkeran** (melphalan, USD 107mn), **gCloral** (clofarabine, USD 53mn), and **gSurmontil** (trimipramine, USD 2mn).
- The company has a total of 99 pending ANDA filings with US FDA, of which 59 are Para IV (29 First to File status). Additionally, 3 NDAs are under 505(b)(2).
- The quarter saw strong sales from Sevelamer. However, with new entrants, the contribution would lower in subsequent quarters.

EM

- Sales was flat YoY at ₹ 5.9bn.
- Russian sales grew 9% YoY to ₹ 3.4bn driven by uptick in base business and new products. In constant currency, sales grew 5% YoY.
- Romania and other CIS countries showed decline of 2% YoY to ₹ 1bn.
- ROW sales fell 17% YoY to ₹ 1.5bn during the quarter.

Domestic

- Indian business grew 3% YoY to ₹ 6.1bn. Normalising for the GST, the growth is 11% YoY.
- Company expects to achieve growth of 10-15% in domestic space

EU

- Sales fell 7% YoY to ₹ 2bn due to higher price erosion in few key molecules and temporary supply disruptions.

Pharma Service and Active Ingredients (PSAI)

- PSAI sales grew 1% YoY at ₹ 5.4bn as the profits from ROW and India was offset by all other segments. ROW and India grew 25% and 53%, respectively.
- Gross margin stood at 19.1% during the quarter, contracting 302bps YoY and 48bps QoQ.
- DMFs filed during the quarter stood at 13 globally with 1 in US. Cumulatively, the company now has 791 DMF filings.

Proprietary products

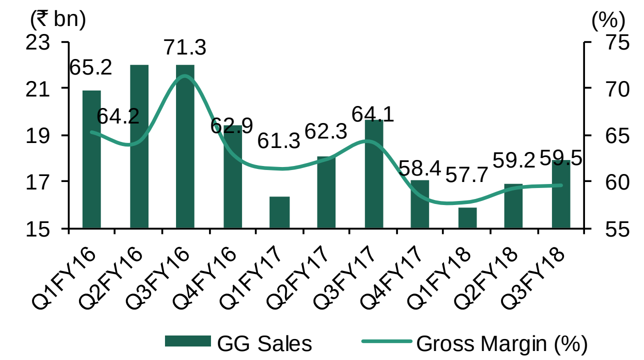
- Sales grew 145% YoY to ₹ 2.5bn.
- The company received USFDA approval of gImpyoz (Clobetasol propionate). With existing out licensing agreement with Encore Dermatology, this approval triggered milestone award of ₹ 1.3bn.
- The management guided NDA filing of DFN-02 Q1FY19E. It is a nasal sumatriptan for the treatment of migraine.

Other key highlights

- The company entered into a settlement agreement with US DoJ related to packaging against a payout of ₹ 319mn.
- R&D expenses stood at ₹ 4.7bn (down 6% YoY), 12.3% of Q3FY18 sales. The management has guided focus on building complex generics, biosimilars and differentiated products pipeline/
- CAPEX stood at ₹ 2.2bn and Net Debt: Equity at 0.25x for the quarter.
- Tax Rate for FY18E to be between 23-25%.

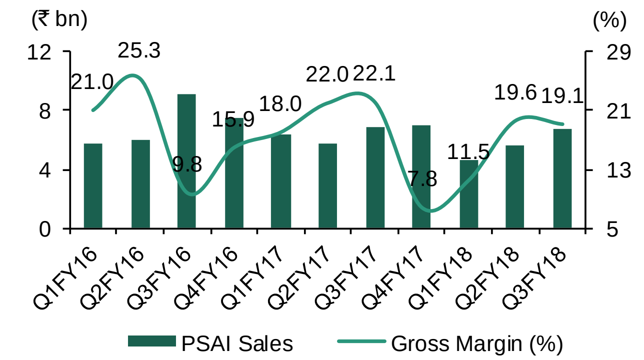
Product	Market size (USD mn)	Status	Comments
gNuvaRing	560	Queries answered. No litigation barrier	TAD in Jul'18. Launched expected by H2FY19E. Patent expire on 8th Apr'18.
gSuboxone	1100	Queries answered. Litigation fairly strong position	Expected by H2FY19E
gAloxi	625		Observing litigation closely - 505J
gCopaxone (20mg & 40 mg)	960	Received CRL	Approval mostly in FY19E end
g Kombiglyze XR	700	Acquired from TEVA	
g Tobi	350		
gQsymia	10		
g Zyclara	72		
g Rozerem	70		

Exhibit 1: Global Generics recovering with margin at 59.5%



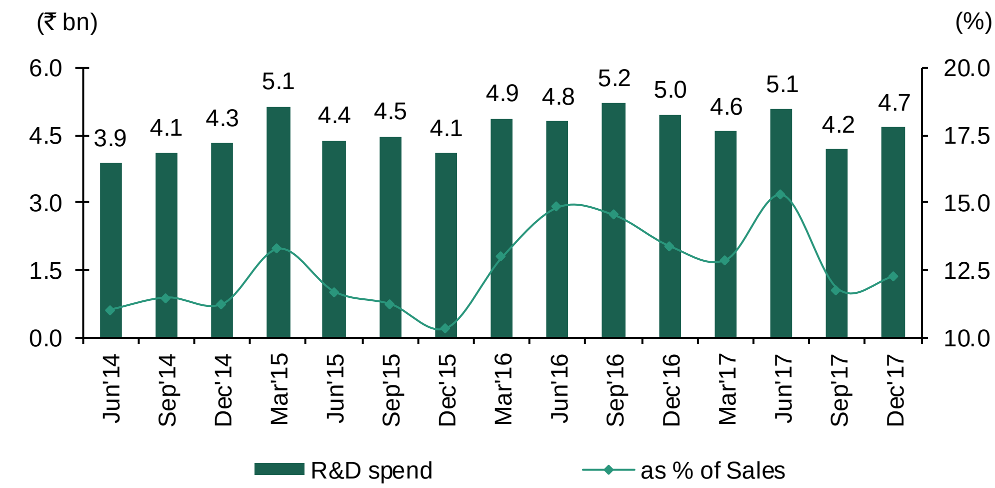
Source: DART, Company

Exhibit 2: PSAI gross margin at 19.1% in Q3FY18



Source: DART, Company

Exhibit 3: R&D expense stood ₹ 4.7bn in Q3FY18



Source: DART, Company

DART

Income Statement (₹ mn)

Particulars	Mar17	Mar18E	Mar19E	Mar20E
Net Sales	**140,809**	**137,145**	**169,101**	**189,345**
Growth(%)	*(9.0)*	*(2.6)*	*23.3*	*12.0*
Total Expenditure	**116,654**	**114,040**	**132,556**	**145,373**
Raw material consumed	54,522	55,679	65,953	72,621
Selling & Distribution exp	42,581	40,458	43,628	48,851
R&D expenses	19,551	17,902	22,976	23,901
Operating profit	**24,155**	**23,106**	**36,545**	**43,972**
Other operating income	1,065	1,000	1,062	1,062
EBIDTA (Excl. OI)	**25,220**	**24,106**	**37,606**	**45,033**
EBIDTA (Incl. OI)	**24,788**	**24,896**	**38,743**	**46,124**
Other Income	(432)	790	1,137	1,091
Interest	(1,587)	3,374	1,337	1,171
Depreciation	11,722	6,913	8,554	9,012
Profit Before Tax	**14,653**	**14,609**	**28,852**	**35,942**
Tax	2,614	4,071	6,203	7,727
Reported Net Profit	**12,039**	**10,538**	**22,649**	**28,214**
Adj Net Profit	**12,039**	**10,538**	**22,649**	**28,214**
Growth(%)	*(46.7)*	*(12.5)*	*114.9*	*24.6*

Balance Sheet (₹ mn)

Particulars	Mar17	Mar18E	Mar19E	Mar20E
Sources of Funds				
Equity Capital	829	829	829	829
Reserves	123,215	128,791	147,854	172,482
Net Worth	**124,044**	**129,620**	**148,683**	**173,311**
Secured Loans	5,646	5,340	5,233	5,129
Unsecured Loans	43,539	41,998	36,557	31,116
Loan Funds	**49,185**	**47,338**	**41,790**	**36,244**
Deferred Tax Liability	(7,789)	(7,610)	(7,855)	(8,108)
Total Capital Employed	**165,440**	**169,347**	**182,618**	**201,448**
Applications of Funds				
Net Block	**102,083**	**108,040**	**111,486**	**115,742**
Goodwill	3,754	3,754	3,754	3,754
Investments	21,110	25,996	27,553	33,903
Inventories	28,529	25,289	31,296	35,061
Sundry Debtors	38,065	36,332	44,962	50,372
Cash & current investment	3,866	(346)	(6,036)	(7,329)
Loans and Advances	262	267	273	278
Other current assets	13,159	14,164	15,506	16,980
sub total	**55,352**	**50,417**	**54,705**	**60,301**
Less : Current Liabilities & Provisions				
Current Liabilities	40,832	38,977	41,005	42,141
Provisions	4,556	5,172	5,172	5,172
sub total	45,388	44,149	46,177	47,313
Total Assets	**165,440**	**169,347**	**182,618**	**201,448**

E – Estimates

Cash Flow (₹ mn)

Particulars	Mar17	Mar18E	Mar19E	Mar20E
Profit before tax	**14,653**	**14,609**	**28,852**	**35,942**
Depreciation	11,722	6,913	8,554	9,012
Change in working capital	1,443	2,552	(13,978)	(9,537)
Total tax paid	(7,271)	(3,893)	(6,448)	(7,980)
Others	(806)	2,751	367	247
Cash flow from oper. (a)	**19,741**	**22,931**	**17,347**	**27,683**
Capital expenditure	(39,048)	(12,870)	(12,000)	(13,267)
Free cash flow	(19,307)	10,061	5,347	14,416
Change in investments	17,221	(4,886)	(1,557)	(6,350)
Others	(907)	576	921	872
Cash flow from inv. (b)	**(22,734)**	**(17,180)**	**(12,637)**	**(18,745)**
Equity raised/(repaid)	(15,266)	0	0	0
Debt raised/(repaid)	15,672	(1,847)	(5,548)	(5,546)
Dividend (incl. tax)	(3,523)	(3,523)	(3,523)	(3,523)
Others	5,055	(4,592)	(1,330)	(1,162)
Cash flow from fin. (c)	**1,938**	**(9,963)**	**(10,401)**	**(10,231)**
Net chg in cash (a+b+c)	**(1,055)**	**(4,212)**	**(5,690)**	**(1,293)**

Important Ratios

Particulars	Mar17	Mar18E	Mar19E	Mar20E
(A) Measures of Performance (%)				
EBIDTA Margin (excl. O.I.)	17.8	17.4	22.1	23.7
Interest / Sales	(1.1)	2.5	0.8	0.6
Tax/PBT	17.8	27.9	21.5	21.5
Net Profit Margin	8.5	7.7	13.4	14.9
(B) As Percentage of Net Sales				
Raw material consumed	38.7	40.6	39.0	38.4
Selling & Distribution exp	30.2	29.5	25.8	25.8
R&D expenses	13.9	13.1	13.6	12.6
(C) Measures of Financial Status				
Debt / Equity (x)	0.4	0.4	0.3	0.2
Interest Coverage (x)	(0.1)	0.1	0.0	0.0
Average Cost Of Debt (%)	(3.2)	7.1	3.2	3.2
Debtors Period (days)	98.7	96.7	97.0	97.1
Closing stock (days)	74.0	67.3	67.6	67.6
Inventory Turnover (x)	4.9	5.4	5.4	5.4
Fixed Assets Turnover (x)	1.6	1.3	1.5	1.7
WC Turnover (x)	0.1	0.1	0.2	0.2
(D) Measures of Investment				
EPS (₹)	72.6	63.6	136.6	170.2
CEPS (₹)	143.3	105.3	188.2	224.5
DPS (₹)	21.3	21.3	21.3	21.3
Dividend Payout (%)	29.3	33.4	15.6	12.5
Profit Ploughback (%)	70.7	66.6	84.4	87.5
Book Value (₹)	748.2	781.8	896.8	1,045.3
RoANW (%)	9.5	8.3	16.3	17.5
RoACE (%)	7.6	9.9	15.9	18.0
(E) Valuation Ratios				
CMP (₹)	2,504	2,504	2,504	2,504
P/E (x)	34.5	39.4	18.3	14.7
Market Cap. (₹ mn)	415,163	415,163	415,163	415,163
MCap/ Sales (x)	2.9	3.0	2.5	2.2
EV (₹ Mn)	464,086	462,233	456,680	451,129
EV/Sales (x)	3.3	3.4	2.7	2.4
EV/EBDITA (x)	18.4	19.2	12.1	10.0
P/BV (x)	3.3	3.2	2.8	2.4
FCFE Yield (%)	(0.9)	2.0	(0.0)	2.1
Dividend Yield (%)	0.8	0.8	0.8	0.8

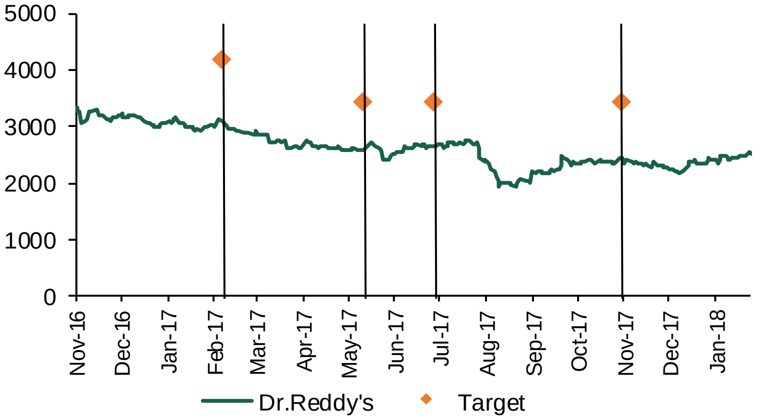
E – Estimates

DART RATING MATRIX

Total Return Expectation (12 Months)

Buy	**> 20%**
Accumulate	**10 to 20%**
Reduce	**0 to 10%**
Sell	**< 0%**

Rating and Target Price History



Month	Rating	TP (₹)	Price (₹)
Feb-17	Buy	4,200	3,095
May-17	Buy	3,450	2,585
Jul-17	Buy	3,450	2,436
Oct-17	Buy	3,450	2,431

** As on Recommendation Date*

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