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Powered by the Sharekhan 3R Research Philosophy

Dr Reddy's Laboratories Ltd

Healthy growth prospects

Pharmaceuticals	Sharekhan code: DRREDDY	Company Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 4,915**	
Price Target: **Rs. 5,900**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

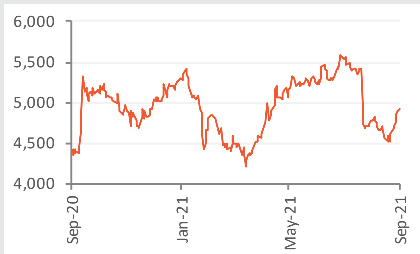
Company details

Market cap:	Rs. 81,774 cr
52-week high/low:	Rs. 5,613 / 4,136
NSE volume: (No of shares)	12.7 lakh
BSE code:	500124
NSE code:	DRREDDY
Free float: (No of shares)	12.2 cr

Shareholding (%)

Promoters	26.7
FII	43.2
DII	14.7
Others	15.3

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.7	-6.4	9.5	13.7
Relative to Sensex	-4.7	-18.3	-6.2	-38.3

Sharekhan Research, Bloomberg

Summary

- Dr Reddy's Laboratories Ltd (DRL) has entered in to a definitive agreement to sell its rights pertaining to an investigational cancer drug, resulting in cash in-flows of $40 mn, upon completion of deal. This would be followed by 2 milestone payments of $40mn and $70 mn.
- Focus on geographic expansion and OTC business to drive the India business growth. Opportunities from Covid products including vaccines to also add to the growth.
- A strong pipeline of new product launches in the US business to enable DRL reduce the impact of the price erosion and support growth.
- At the CMP the stock trades at 30.4x / 23.1x its FY22E / FY23E EPS. Basis the positives we re-iterate Buy recommendation on the stock with an unchanged PT of Rs 5900.

Dr. Reddy's Laboratories Limited (DRL) is expected to benefit from the definitive agreement entered in to sell its rights pertaining to an investigational cancer drug, E7777, leading to a $40 million cash inflows upon completion of deal, followed by two milestone payments. Growth from new products in the US business could enable DRL to reduce the impact of price erosion, and this coupled with strong growth prospects for India business including COVID-led opportunities, would be key growth drivers.

- **Definitive agreement to sell rights for investigational cancer drug to lead to cash in-flows:** DRL is expected to witness strong cash inflows of $40 million (~Rs. 300 crore) on completion of agreement to sell its rights in an investigational cancer drug. This would be followed by milestone payments of $40 million and $70 million related to Cutaneous T-Cell lymphoma (CTCL) indication and likely approval for other indications. The strong cash inflows bode well for DRL.
- **New product pipeline in the US to enable DRL reduce impact of price erosion:** DRL has launched four new products in the US and two new products in Canada in quarter ending June 2021. Also DRL is expected to launch the generic version of Lenalidomide in Canada soon. Moreover, DRL has a strong pipeline for the US, which would enable it to tide over the headwinds such as price erosion.
- **Strong prospects for India business:** DRL's India business is well placed to grow, backed by geographic expansion and focus on growing the over-the-counter (OTC) segment. Opportunities arising from COVID-19 vaccines are also expected to add to the overall growth. In addition to Sputnik V, DRL is working towards getting approval for Sputnik light in India.

Our Call

Valuation: Re-iterate Buy with an unchanged PT of Rs. 5,900: DRL's topline and PAT are expected to post 14% and 34.6% CAGR over FY2021-FY2023E, driven by strong growth prospects for India business and emerging opportunities from COVID-19 vaccines, while new product launches in the US would enable the company to reduce the impact of price erosion in the US and support growth. Strong cash in-flows expected from selling of rights in an investigational cancer drug bodes well for DRL. At CMP, stock trades at 30.4x/23.1x its FY022E/FY2023E EPS. Based on the above positives, we reiterate our Buy recommendation with an unchanged price target (PT) of Rs. 5,900.

Key risk

1) Adverse development on the regulatory front can impact earnings prospects; and 2) currency risks.

Valuation (Consolidated) Rs cr

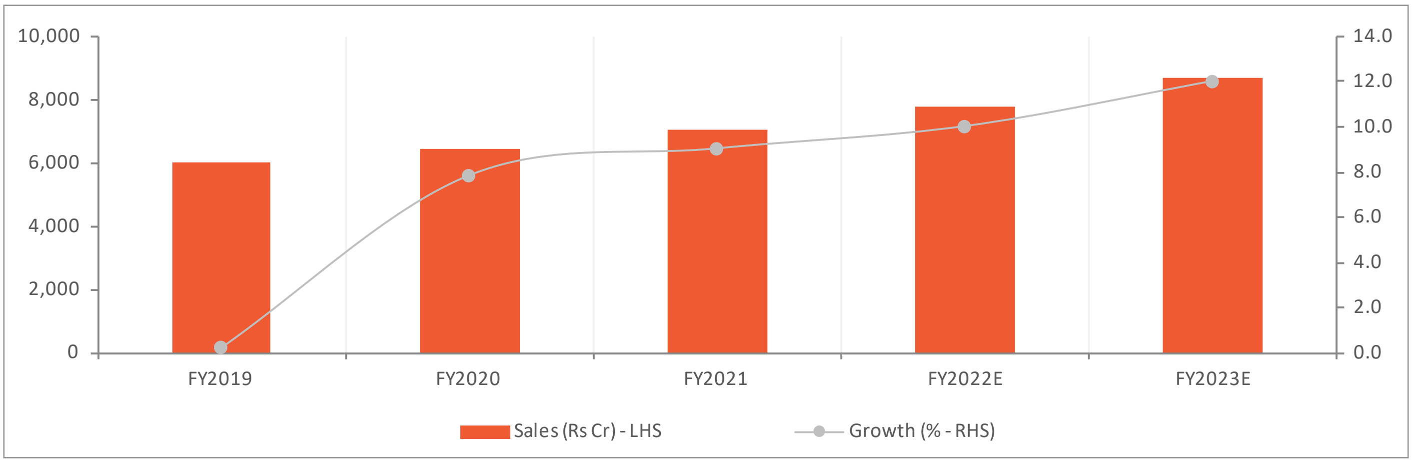
Particulars	FY2019	FY2020	FY2021	FY2022E	FY2023E
Net sales	14870.6	16357.4	18420.2	21110.4	23923.0
EBITDA	3189.8	4147.1	4546.7	4852.3	6070.2
EBITDA (%)	21.5	25.4	24.7	23.0	25.4
Adj PAT	1950.0	2026.0	1951.6	2687.9	3537.5
EPS (Rs)	117.5	122.0	117.6	161.9	213.1
PER (x)	41.8	40.3	41.8	30.4	23.1
EV/EBITDA (x)	23.4	16.9	16.6	15.4	11.8
P/BV (x)	5.8	5.2	4.6	4.3	3.8
RoCE (%)	11.5	7.4	12.7	15.1	18.6
RoNW (%)	13.9	13.0	11.1	14.1	16.6

Source: Company; Sharekhan estimates

Enters into a definitive agreement to sell its rights for cancer drug E7777: DRL has entered into a definitive agreement to sell all of its rights pertaining to E7777, which is an investigational cancer drug along with certain related assets. The consideration for the said deal stands at $40 million (around Rs. 300 crore) as an upfront payment on closing of the transaction. In addition to this, DRL is eligible to receive a milestone payment of up to $40 million pertaining to Cutaneous T-Cell lymphoma (CTCL) indication approval. Further, DRL is also eligible to receive another milestone payment of upto $70 million (around Rs. 525 crore) towards additional indication approvals. The company had acquired the global exclusive rights (excluding Asia and Japan) way back in March 2016. The definitive agreement would result in an immediate cash inflow amounting to $40 million, translating into around Rs. 300 crore on the closing of the transaction, while the two-stage milestone payments of $40 million and $70 million translate into cash inflow of around Rs. 800 crore, which is strong. Cash inflows could enable DRL to reduce its debt, which stands at around Rs. 2,944 crore as of FY2021.

New products enable DRL tide over pricing pressures in North America business: DRL's US business has been confronting headwinds in the form of a steep price erosion, which has substantially slowed down the company's revenue growth in the quarter ending June 2021. However, going ahead, management expects growth in the US business to be driven by new product launches and growth in the base business. During the June ending quarter, DRL has launched four new products – Sapropterin Dihydrochloride powder, Albendazole tablets, Ertapenem injection, Icosapent Ethyl Capsules (gVascepa) in the US and two new products in Canada. Moreover, recently Canada has approved DRL's generic version of Lenalidomide, which is indicated for the treatment of patients with transfusion-dependent anemia as well as for the treatment of multiple myeloma patients. The company is looking to launch the drug in Canada markets soon. Of the above new products, gVascepa is a major launch offering a substantial addressable market size. In addition to this, the pipeline is healthy with 90 generic filings pending for approval with USFDA, which includes 90 ANDAs and 3 NDAs under the 505 (b)(2) route. Out of the pending ANDAs, 47 are Para IVs and 24 have 'First to File' status. Further, the base business in the US is gaining traction and is expected to pick up with the full impact of the recent launches expected to be reflected in the coming quarters. Overall, new product launch intensity has been strong; and going ahead, the company's product launch intensity is likely to be healthy, which could enable DRL to tide over pricing pressures in US markets, which constitute around 37% of FY2021 overall sales.

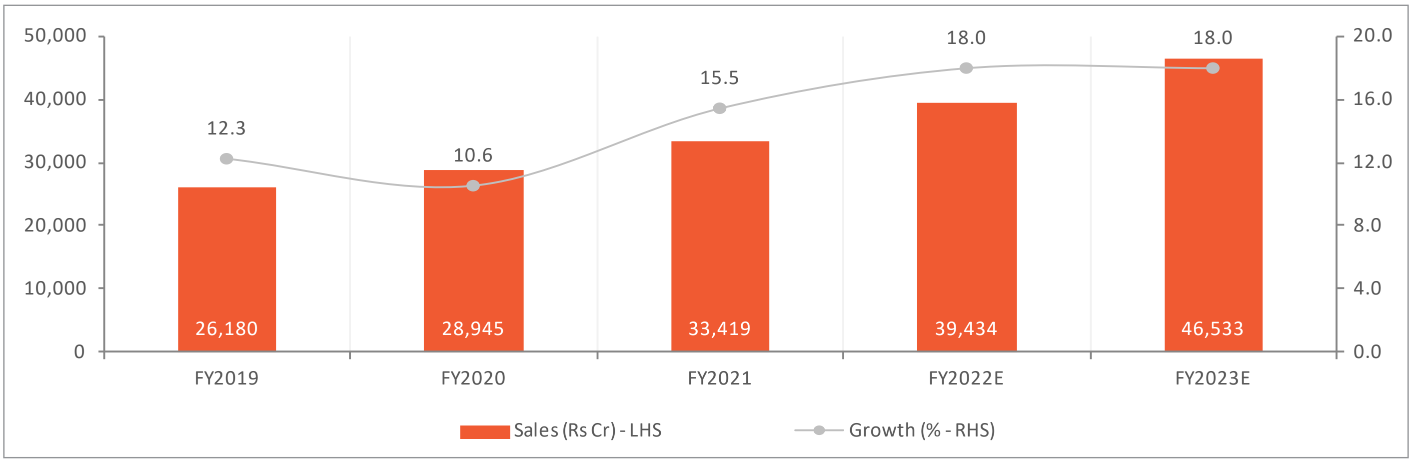
US Business - Revenue and Growth Trends



Source: Company; Sharekhan research

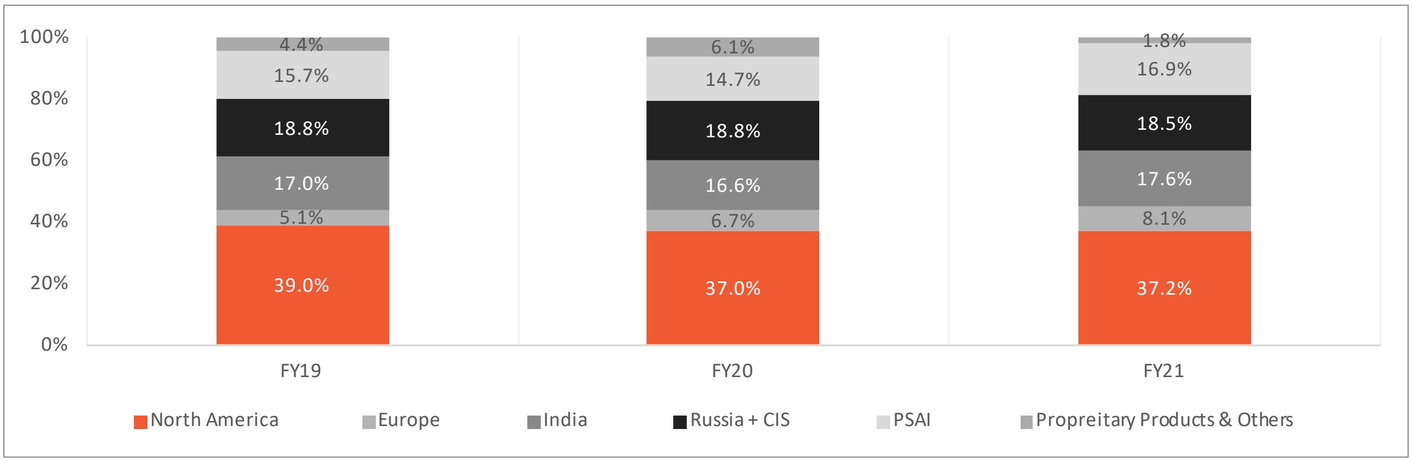
Strengthening COVID-19 portfolio, strong traction in India business augurs well: DRL's COVID-19 portfolio includes an array of drugs, including – Remdesivir, Avigan/Favipiravir, 2-deoxy-D-glucose (2DG) – developed in collaboration with DRDO, Molnupiravir and other COVID-19 drugs such as Barcitinib. DRL Launched Sputnik V vaccine in India in May 2021 and is now working with six CMOs in India to ramp-up production. DRL is also working on Sputnik Light, for which the company intends to leverage phase III trials in Russia for India approval. Further, DRL has launched Avigan in India and few of the other markets and it is in clinical stages for Molnupiravir. In addition to COVID portfolio, DRL's India business is well placed to grow. DRL expects India business to grow at a healthy pace due to investments towards expansion in rural areas and growing OTC portfolio. In addition, the company plans to leverage the digital platform for growing its brands, which is expected to improve profitability as well. Further, industry reports suggest double-digit growth for IPM in FY2022, which is also expected to have a positive rub-off effect on DRL's India business; and this bodes well from a growth perspective.

India business - Revenue and Growth Trends



Source: Company; Sharekhan research

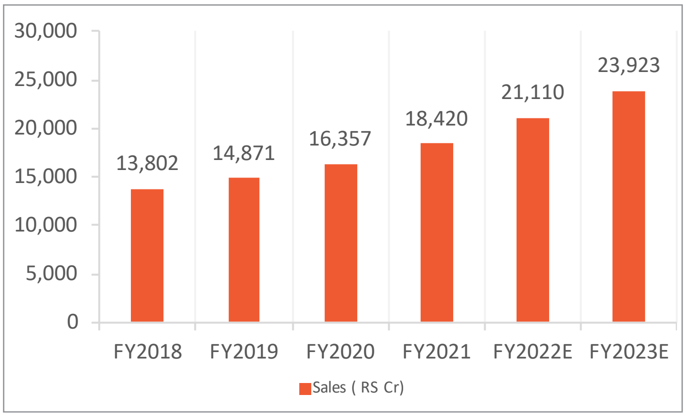
DRL - Revenue Mix



Source: Company; Sharekhan research

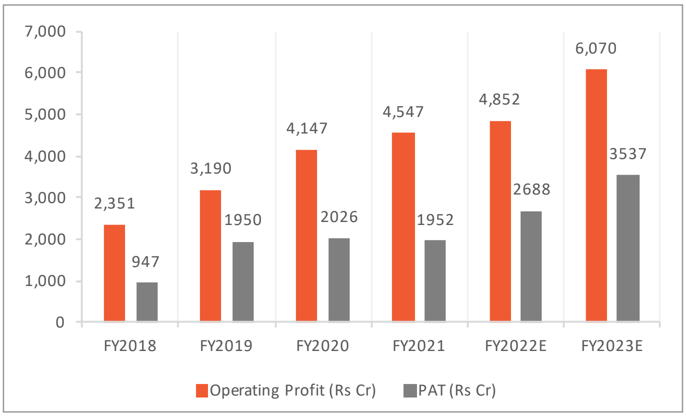
Financials in charts

Sales Trends Rs Cr



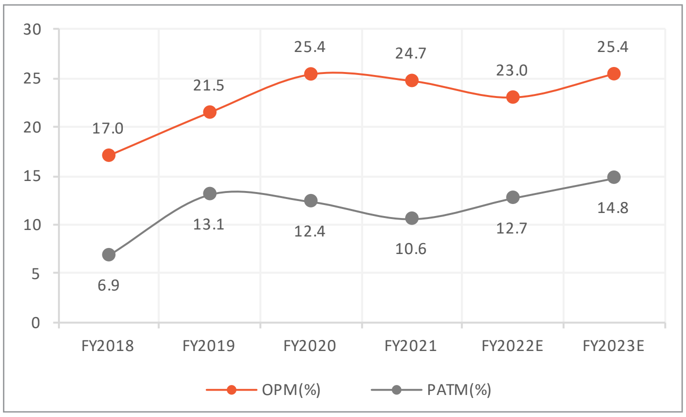
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



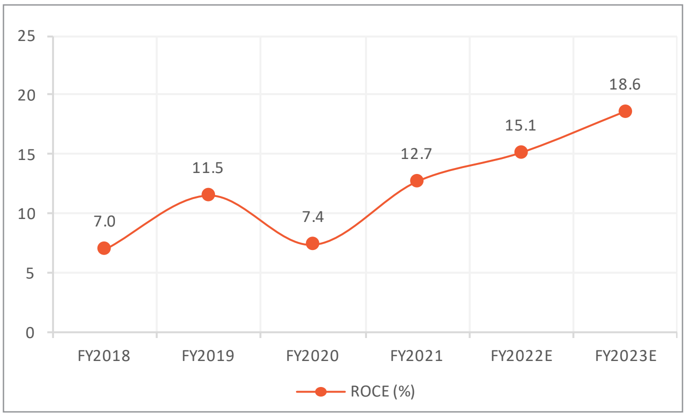
Source: Company, Sharekhan Research

OPM's to improve



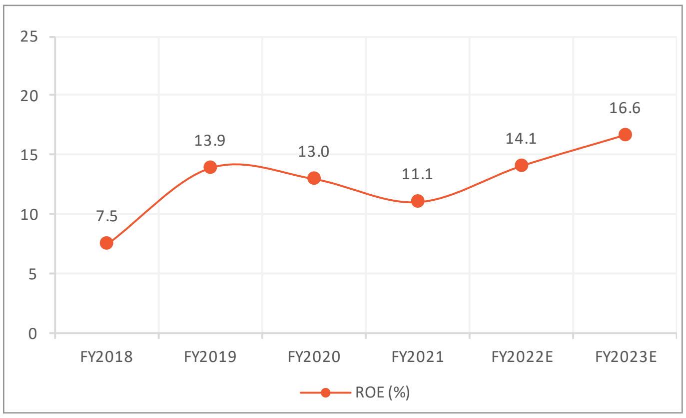
Source: Company, Sharekhan Research

ROCE (%)



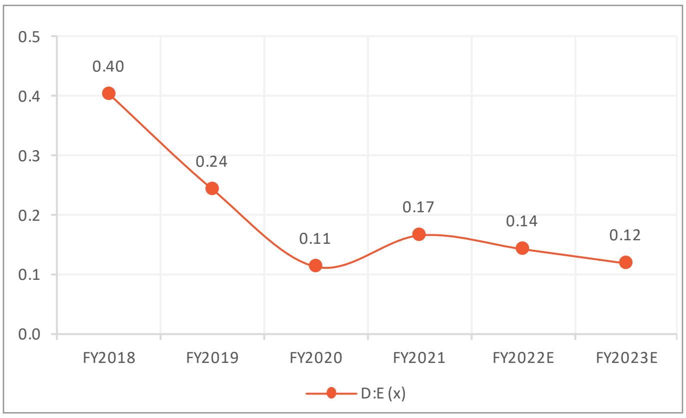
Source: Company, Sharekhan Research

Return ratios (ROE) to improve



Source: Company, Sharekhan Research

Debt : Equity (x)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Growth momentum to improve

Pharmaceutical companies are better placed to harness opportunities and report healthy growth going ahead. Indian companies are among the most competitive ones globally and hold a sizeable market share in most developed as well as other markets. Moreover, other factors such as easing of pricing pressures (especially in the US generics market), rise in product approvals and plant resolutions by the USFDA coupled with strong growth prospects in domestic markets and emerging opportunities in the API space would be key growth drivers. This would be complemented by strong capabilities developed by Indian companies (leading to a shift towards complex molecules and biosimilars) and commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for pharmaceutical companies.

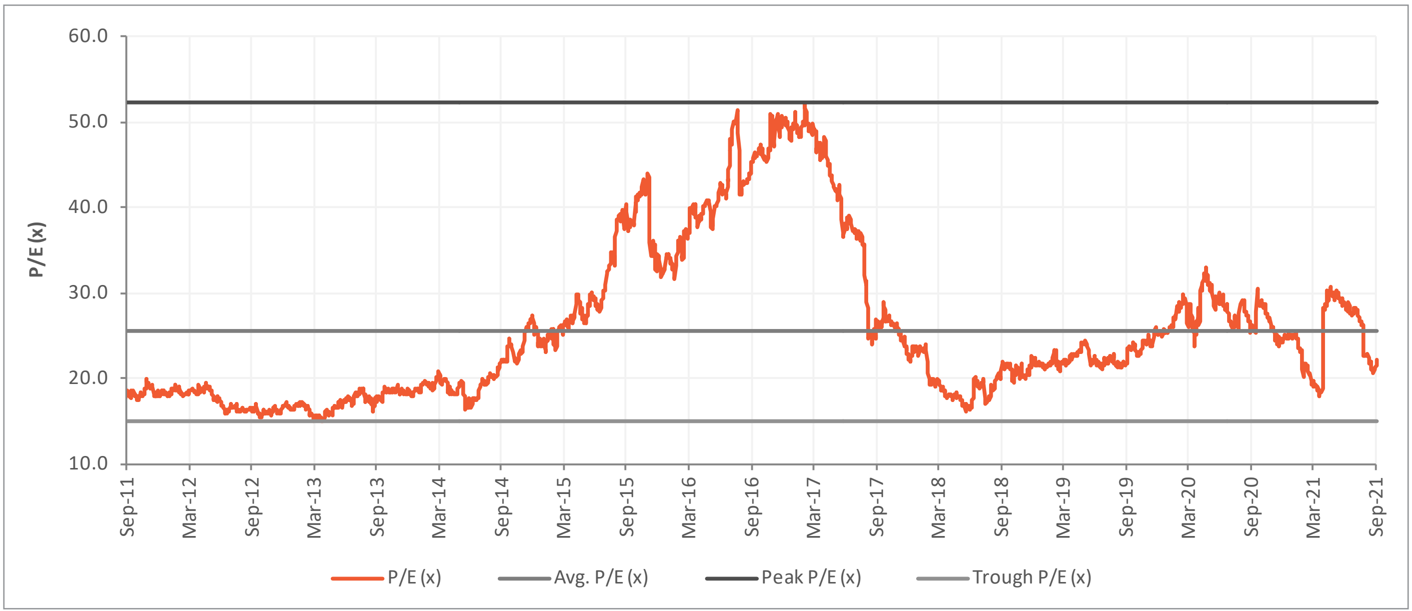
■ Company Outlook – Long-term growth levers intact

DRL is one of the leading pharmaceutical companies globally with higher presence in the formulations segments and a backward integration for select APIs. Globally, the company is present in most markets with US and India accounting for ~37% and ~17%, respectively, of overall sales. A confluence of cost-control as well as productivity improvement measures, synergies through partnerships, strong execution, and product-specific opportunities would be key growth drivers. Moreover, with the base business diversifying, performance is expected to improve. A strong product pipeline in the US generics business and improvement in the existing business would fuel US sales growth. On the other hand, revival in acute therapies and expected traction in the acquired portfolio coupled with efforts to expand geographically and leverage the digital platform to grow brands would be key drivers for India business. Moreover, COVID-19 related opportunities, including COVID-19 vaccine Sputnik V, offer a sizeable growth opportunity going ahead, as the company looks to tap export markets for Sputnik V. In addition to Sputnik-V, DRL is working on Sputnik Light and this also offers a sizeable growth potential. However, the PSAI segment's performance is expected to fluctuate in the near term, given volume and pricing pressures.

■ Valuation – Re-iterate Buy with an unchanged PT of Rs. 5,900

DRL is witnessing headwinds in the form of pricing pressures in the US business, which is expected to continue. However, given ramp-up in new products, a strong product pipeline, and growth in base business, the impact of price erosion is likely to be reduced. Further, growth in acquired products, focus on OTC portfolio, and rural areas for growth coupled with leveraging the digital platform would fuel India business growth. This would also be complemented by a strengthening portfolio of COVID-related products, including the vaccine. Further, the definitive agreement entered to sell the rights in an investigational cancer drug – E7777, is expected to result in upfront cash inflow of around $40 million (Rs. 300 crore) on the completion of the deal. Going ahead, a two-stage milestone payment totaling to ~Rs. 800 crore is on the cards. A strong cash inflow augurs well and would enable the company to reduce its debts. At the CMP, the stock is trading at a P/E multiple of 30.4x/23.1x its FY2022E/FY2023E EPS. We reiterate our Buy recommendation on the stock with an unchanged PT of Rs. 5,900.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV/EBIDTA (x)			RoE (%)		
				FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
Dr Reddy's	4,915	16.6	81,774	41.8	30.4	23.1	16.6	15.4	11.8	11.1	14.1	16.6
Sun Pharma	784	239.9	1,88,055	27.7	26.6	22.9	22.0	18.0	15.0	14.6	13.3	13.6
Cadila	557	102.4	57,001	24.9	25.0	20.3	18.5	15.3	12.6	17.6	15.6	16.6

Source: Company, Sharekhan estimates

About company

DRL is one of the leading pharmaceutical companies present across most markets globally. With respect to segments, global generics (generic formulations) is one of the key segments accounting for around 79% of the company's overall revenue. Under global generics, the company offers more than 400 high-quality generic drugs, keeping costs reasonable by leveraging its integrated operations. Generic formulations include tablets, capsules, injectables, and topical creams across major therapeutic areas of gastrointestinal ailments, cardiovascular disease, pain management, oncology, anti-infective, pediatrics, and dermatology. DRL is also present in APIs. The company is one of the leading manufacturers of API and partners with several leading generic formulator companies world over. DRL, through the API business, focuses on innovation-led affordability, which offers customers access to the most complex active ingredients, while maintaining a consistent global quality standard. The proprietary business is the third business segment and accounts for around 6% of the company's overall sales. The proprietary products business focuses on developing differentiated formulations, which significantly enhance benefits in terms of efficacy, ease of use, and the resolution of unmet patient needs. DRL's wholly owned subsidiary – Aurigene Discovery is a clinical stage biotech company committed to bringing novel therapeutics for the treatment of cancer and inflammation. The company has a fully integrated drug discovery and development infrastructure from hit generation to clinical development. Aurigene Discovery has pioneered customised models of drug discovery and development collaborations with large and mid-size pharmaceutical companies.

Investment theme

DRL is one of the leading pharmaceutical companies globally with higher presence in the formulations segments and backward integration for select APIs. Globally, the company is present in most markets with the US and India accounting for ~37% and 17%, respectively, of overall sales. The company has a healthy compliance track record, which augurs well. DRL is at an inflection point, wherein performance is expected to improve remarkably. A confluence of cost control as well as productivity improvement measures, synergies through partnerships, strong execution, and product-specific opportunities would be key growth drivers for the company. Moreover, with the diversification of its base business, performance is expected to gather pace, backed by geographical expansion. A strong product pipeline in the US generic business would fuel US sales. On the other hand, a likely revival in acute therapies and expected traction in the acquired portfolio would be key drivers for India business. Moreover, COVID-related opportunities, including the COVID-19 vaccine Sputnik V, offer a sizeable growth opportunity going ahead as the company also looks to tap export markets for Sputnik V.

Key Risks

1) Adverse regulatory changes can impact earnings prospects.

2) Currency risk.

Additional Data

Key management personnel

Mr. K Satish Reddy	Chairman
Mr. G V Prasad	Co Chairman and Managing Director
Mr. EREZ ISRAELI	Chief Executive Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	BlackRock Inc	4.34
2	Life Insurance Corp of India	4.22
3	First State Investments ICVC	3.65
4	First Sentier Global Umbrella Fund	3.05
5	SBI Funds Management Pvt Ltd	2.38
6	Axis Asset Management Co Ltd/India	1.79
7	ICICI Prudential Life Insurance Co	1.57
8	Aditya Birla Sun Life Asset Manage	1.42
9	Vanguard Group Inc/The	1.36
10	DSP Investment Managers Pvt Ltd	1.19

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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