Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Dr. Reddy's Laboratories Ltd

Charting a sustainable growth trajectory

Pharmaceuticals	Sharekhan code: DRREDDY
Reco/View: Buy ↔	CMP: **Rs. 4,639** / Price Target: **Rs. 5,900** ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 36.60

Updated Oct 08, 2021

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

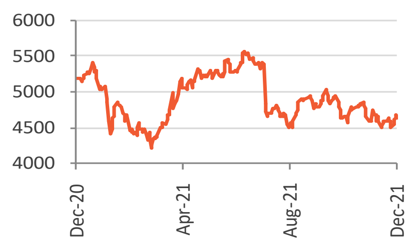
Company details

Market cap:	Rs. 77,199 cr
52-week high/low:	Rs. 5,614/4,136
NSE volume: (No of shares)	5.2 lakh
BSE code:	500124
NSE code:	DRREDDY
Free float: (No of shares)	12.2 cr

Shareholding (%)

Promoters	26.7
FII	28.8
DII	21.4
Others	23.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	0.8	-3.2	-12.1	-10.8
Relative to Sensex	2.9	1.7	-20.5	-32.5

Sharekhan Research, Bloomberg

Summary

- We re-iterate Buy recommendation on Dr Reddys Laboratories (DRL) with an unchanged PT of Rs 5900.
- With onset of new Omicron variant of Covid 19, demand for DRL's Covid drugs including Sputnik vaccines is likely to improve. USFDA's EUA for Molnupiravir could also likely have a positive rub off as DRL holds rights for Molnupiravir for India and other LMIC's.
- DRL is committed to resolving the USFDA observations for Duvvada formulations plant and is confident of submitting timely responses.
- Strong product pipeline, pick up in base business to drive US sales and enable DRL to tide over competitive pressures while new launches, expanding penetration and pick up in existing portfolio including Covid basket to drive India sales.

Dr. Reddy's Laboratories' (DRL) COVID-19 portfolio includes an array of drugs and sputnik V & Sputnik light vaccines. With the onset of the new Omicron variant, demand for these drugs/vaccines is likely to pick up. Moreover, USFDA's Emergency Use Authorization (EUA) for anti-COVID oral drug, Molnupiravir, points at likely approval from Indian regulators also, which bodes well for DRL as it has rights for Molnupiravor for India and LMICs. Moreover, DRL is committed to resolving eight observations received from the USFDA for Duvvada formulations plant and is confident of submitting timely responses. The approval of the facility is critical as the company has products filed from the site for US markets. Overall growth prospects across India and US geographies stay bright.

- **DRL confident of addressing Duvvada form 438; To submit replies in stipulated time lines:** DRL's Duvvada plant was inspected by the USFDA in October 2021 and the inspection ended with form 483 and eight observations with none pertaining to data integrity issues nor was there any repeat observation. Management is committed towards resolving these observations, which could take few months and intends to submit its responses in the stipulated time frame. Approval of the facility is critical as the company has products filed from the site in US markets.
- **Strengthening COVID-19 Portfolio:** DRL's COVID-19 portfolio includes an array of drugs including – Remdesivir, Avigan, 2-deoxy-D-glucose (2DG), Molnupiravir, and Sputnik vaccines. With the recent spike in COVID-19 cases due to the new variant Omicron, there is possibility of a pick up in demand for Sputnik V and Sputnik Light (as a booster dose). As per RDIF, Gameliya Institute is in the process of developing a new version of Sputnik to treat the new variant, and this could also have a positive rub-off effect on DRL. Further, USFDA has issued an EUA for anti-viral oral drug for Covid-19 – Molnupiravir, and this points at a possibility of approval by Indian regulators as well. DRL has Molnupiravir rights for India and certain low and middle income countries.
- **Healthy outlook for US; India business on a strong footing:** DRL's new product launch intensity in the US has been strong and going ahead is expected to remain healthy due to a strong product pipeline. This coupled with pick up in the base business could drive US sales and would enable to tide over competitive pressures. India business is also expected to stage strong growth, backed by expansion in rural areas, contribution from COVID-19 portfolio, growing OTC portfolio, and new launches. In addition, the company plans to leverage the digital platform for growing its brands, which is expected to improve profitability as well.

Our Call

Valuation: Reiterate Buy with an unchanged PT of Rs. 5,900: Strong growth prospects for India business, opportunities from COVID-led portfolio, including vaccines, a sturdy product pipeline, and expected growth in the existing portfolio in the US would likely enable DRL to tide over pricing pressures in the US and provide ample growth visibility. The recent USFDA EUA for anti-COVID drug, Molnupiravir, could have a possible positive rub-off for DRL as well. At the CMP, the stock is trading at a P/E multiple of 28x/22.1x its FY2022E/FY2023E EPS; and over the past six months, the stock price has corrected by ~17%, which provides a good opportunity. We reiterate our Buy recommendation on the stock with an unchanged PT of Rs. 5,900.

Key Risks

1) Adverse development on the regulatory front can impact earnings prospects; 2) higher competitive pressures in US markets; and 3) currency risk.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Net sales	18420.2	21469.8	24355.8	26610.0
EBITDA	4546.7	4933.5	6007.9	6719.8
EBITDA (%)	24.7	23.0	24.7	25.3
Adj. PAT	1951.6	2748.4	3491.1	3974.6
EPS (Rs.)	117.6	165.6	210.3	239.4
PER (x)	39.5	28.0	22.1	19.4
EV/EBIDTA (x)	15.6	14.3	11.7	9.8
P/BV (x)	4.4	4.0	3.6	3.2
RoCE (%)	12.7	15.5	18.3	18.7
RoNW (%)	11.1	14.4	16.4	16.4

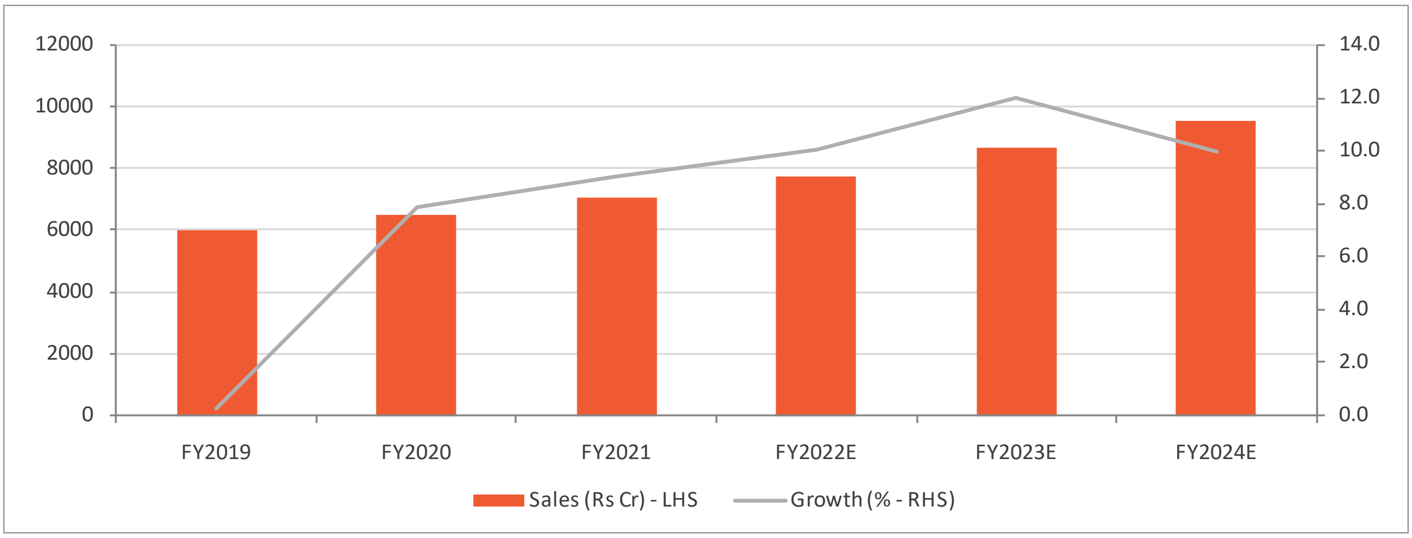
Source: Company; Sharekhan estimates

Management confident of addressing Duvvada form 438; To submit replies in stipulated time lines: Over the past 2-3 years, DRL's Duvvada formulations (sterile manufacturing) plant was inspected twice by the USFDA and was issued form 483 with eight observations and two observations. Further, in February 2020, the plant was classified as a VAI and was issued an EIR. However, USFDA conducted a re-inspection of the plant in October 2021, and the inspection ended with form 483 with eight observations. The USFDA has flagged off procedural as well as quality-control issues at the formulations plant, while there are no repeat observations and no data integrity issues as well. Management is committed towards resolving the observations, which could take few months and intends to submit its responses in the stipulated time frame. As the observations are procedural in nature, it is likely that the same could be resolved and is unlikely to be escalated further.

Strengthening COVID-19 portfolio augurs well: DRL's COVID-19 portfolio includes an array of drugs including – Remdesivir, Avigan, 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 but subsequently struggled to ramp up the second dose, thus losing out on the vaccine opportunity in India. However, the company has now received approval from the Government to export the doses of Sputnik and it is evaluating the opportunity for Sputnik Light (which is the first dose of Sputnik V) as a booster dose as well as for adolescent population. With the recent spike in the COVID-19 cases due to the new variant Omicron, there is possibility of an improvement in demand for Sputnik V or Sputnik Light (as a booster dose). As per RDIF, Gameliya Institute is in the process of developing a new version of Sputnik to treat the new variant and this could have a positive rub-off effect on DRL as well. Further, the USFDA has issued a EUA for the anti-viral oral drug for COVID-19 – Molnupiravir and DRL has Molnupiravoir rights for India as well as other low and middle income countries (LMICs). Following the EUA from USFDA, the probability of regulatory approval for India is also quite high and, if approved by regulators, it could open up substantial growth opportunities. Collectively, a strong COVID-19 portfolio augurs well from a growth perspective.

New products and growth in the base business to enable DRL tide over pricing pressures in North America business: DRL's US revenue for 1HFY2022 stood at Rs. 3,630 crore, translating into 2% y-o-y growth, driven by growth in the existing portfolio and new product launches, which enabled to offset the impact of price erosion. 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 past two quarters, DRL launched four new products, including – Chlordiazepoxide Hydrochloride + Clidinium Bromide Capsules in the US and Lenalidomide capsules, Ertape'ilem injection and Dasatinib tablets in Canada in addition to four new products in the US and Canada launched prior to the above, which include gVascepa, which is a major launch offering a substantial addressable market size. Over the months of November and December, DRL has launched Ephedrine sulphate injection, Valsartan tablets, and Venlaflexine ER tablets (150 mg and 225mg) in US markets with an addressable market size of $67.5mn, $150 mn, and $51 mn, respectively, which is a healthy market share. In addition to this, the USFDA has also approved DRL's ANDA, which is a generic of Nuvaring. Despite DRL being a third generic player in the space and overall the fourth player, the product offers a substantial addressable market size. In addition to this, the pipeline is healthy with 93 generic filings pending for approval with USFDA, which include 90 ANDAs and 3 NDAs under the 505(b)(2) route as of September 2021. Out of the pending ANDAs, 46 are Para IVs and 23 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 recent launches expected to be reflected in the coming quarters. Overall, new product launch intensity has been strong; and going ahead, the product launch intensity is likely to be healthy, which could enable the company to tide over pricing pressures in the US and provide ample growth visibility going ahead.

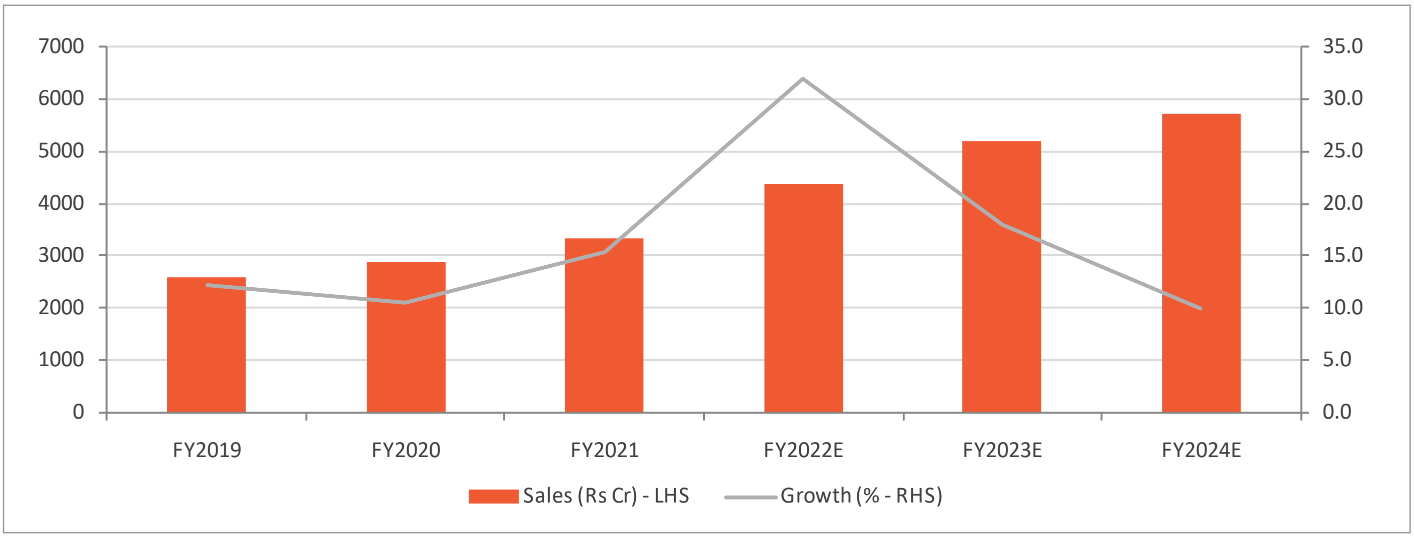
US Business sales trends



Source: Company, Sharekhan Research

India business on a strong growth footing: DRL's India business has reported a stellar performance for 1HFY2022 with revenue at Rs. 2,200 crore, up substantially by 43% y-o-y, thus comfortably outpacing the industry's growth. Growth was driven by increasing volumes in existing products, growth in COVID-19 portfolio, and increased sales price of few select drugs. DRL expects India business to grow at a healthy pace due to investments towards expansion in rural areas, contribution from COVID-19 portfolio, growing the OTC portfolio, and new launches. 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.

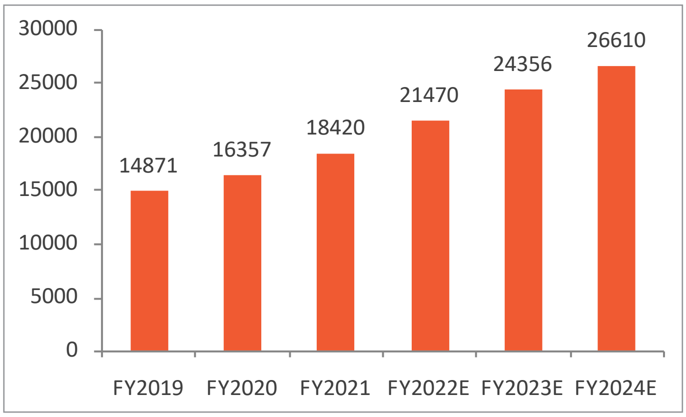
India Business Sales Trends



Source: Company, Sharekhan Research

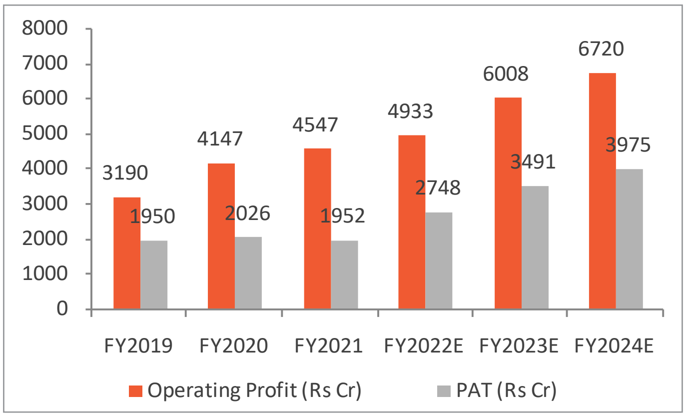
Financials in charts

Sales Trends Rs Cr



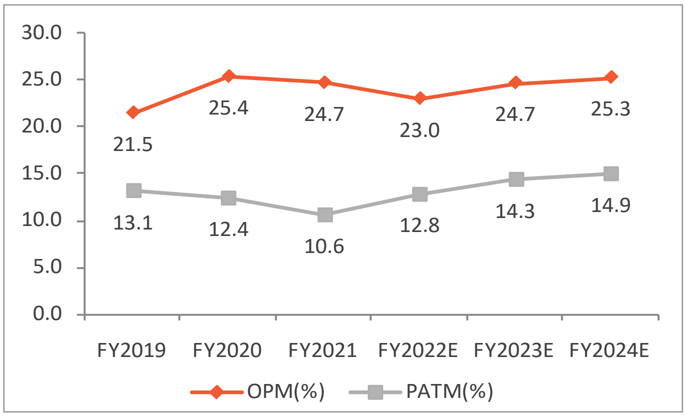
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



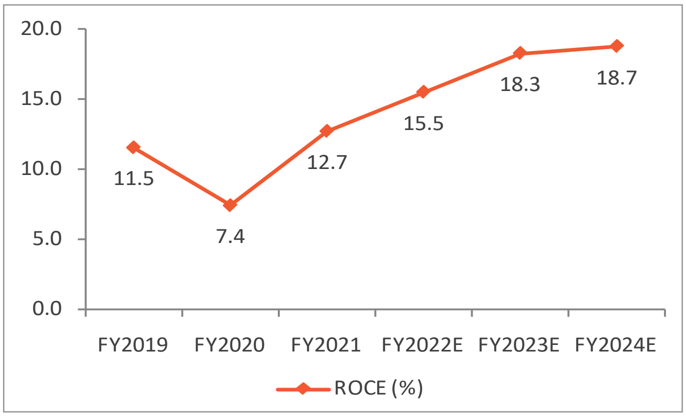
Source: Company, Sharekhan Research

OPM's to improve



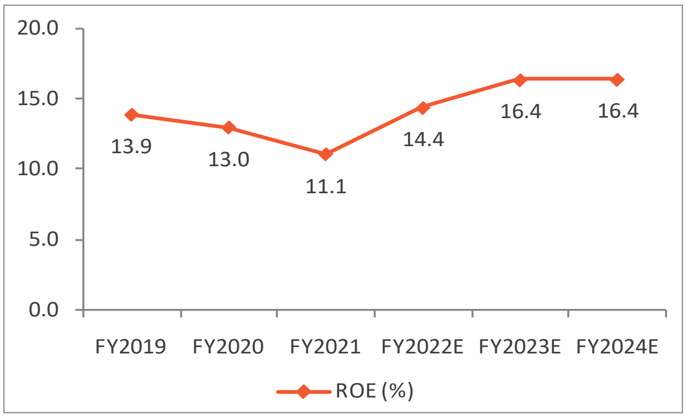
Source: Company, Sharekhan Research

ROCE (%)



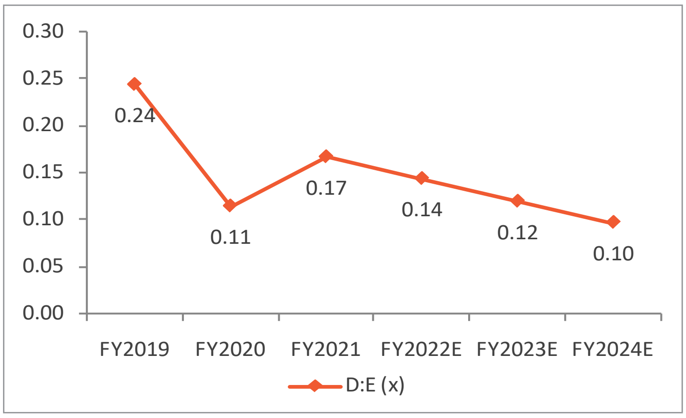
Source: Company, Sharekhan Research

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.

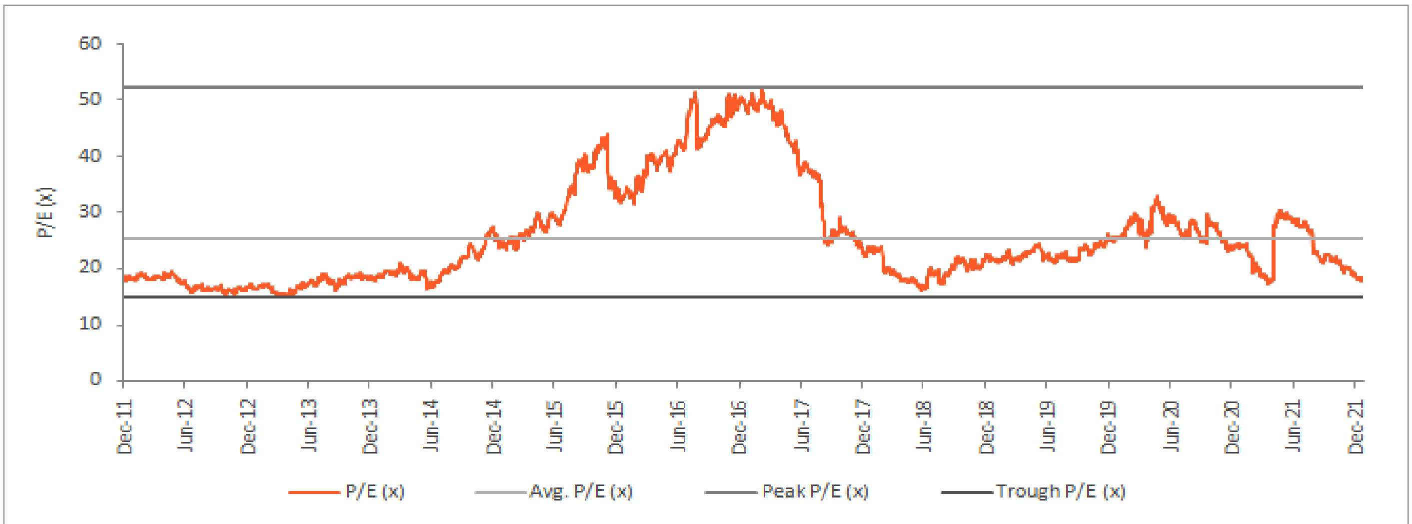
■ Company outlook - On the growth path

DRL is one of the leading pharmaceutical companies globally with higher presence in the formulations segment and 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 gather pace, backed by geographical expansion. A strong product pipeline in the US generics business and improvement in the existing business would fuel US sales. On the other hand, likely 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 vaccines) offer a sizeable growth opportunity going ahead, as the company looks to tap export markets for Sputnik V/Sputnik Light. However, the PSAI segment's performance is expected to fluctuate in the near term, given volume and pricing pressures.

■ Valuation - Reiterate Buy with an unchanged PT of Rs. 5,900

DRL's Duvvada plant, inspected in October 2021, had received Form 483 with eight observations, with no data integrity issues. Moreover, observations are largely procedural in nature and management seems confident of resolving the same. Further, the company has a strong product pipeline for the US; and this coupled with ramp up in new products and pick up in the base business would drive US sales and enable to reduce the impact of high competitive pressures in US markets. Further, growth in acquired products, focus on the 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. With the onset of the new variant, demand for vaccines is likely to increase given the possibility of a booster shot being evaluated. Moreover, EUA for antiviral oral COVID-19 drug – Molnupiravir by USFDA points at a higher possibility of approval by Indian regulators as well. DRL has rights for Monupiravir for India and other LMIC and if approved would add to DRL's topline. At the CMP, the stock is trading at a P/E multiple of 28x/22.1x its FY2022E/FY2023E EPS; and over the past six months, the stock price has corrected by ~17%, which provides a good opportunity. 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

Companies	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV / EBITDA (x)			RoE (%)		
				FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
Dr Reddy's	4,639.0	16.6	77,199.0	39.5	28.0	22.1	15.6	14.3	11.7	11.1	14.4	16.4
Aurobindo	708.2	58.6	41,496.0	16.8	12.3	10.7	7.5	6.7	5.3	12.8	14.3	14.4
Gland Pharma	3893	16.3	63958	63.8	49.2	31.8	42.1	32.8	21.0	16.9	18.1	22.0

Source: Company, Sharekhan Research

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 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 COVID-19 vaccine Sputnik V, offer a sizeable growth opportunity going ahead as the company looks to tap export markets for Sputnik V.

Key Risks

1) Adverse regulatory changes can impact earnings prospects.

2) Higher Competitive pressures in the US markets

3) 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

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

Sharekhan

by BNP PARIBAS

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Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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