



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
Updated Jan 08, 2022

31.35

High Risk

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

Source: Morningstar

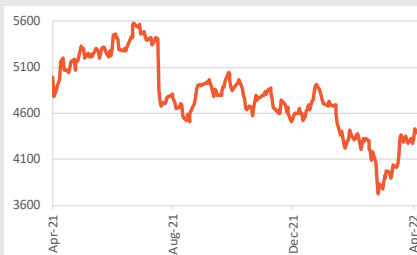
Company details

Market cap:	Rs. 72,508 cr
52-week high/low:	Rs. 5,614 / 3,655
NSE volume: (No of shares)	4.7 lakh
BSE code:	500124
NSE code:	DRREDDY
Free float: (No of shares)	12.2 cr

Shareholding (%)

Promoters	26.7
FII	28.4
DII	22.3
Others	22.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	9.6	-7.1	-11.2	-12.7
Relative to Sensex	4.2	-2.9	-8.4	-35.0

Sharekhan Research, Bloomberg

Dr. Reddy's Laboratories Ltd

Near-term concerns likely; long term growth prospects stay bright

Pharmaceuticals

Sharekhan code: DRREDDY

Reco/View: Buy



CMP: Rs. 4,373

Price Target: Rs. 5,550



Upgrade



Maintain



Downgrade

Summary

- We retain Buy recommendation on Dr Reddys Laboratories (DRL) with a revised PT of Rs 5,550
- DRL's India business is expected to stage a double digit growth going ahead backed by a pick up across pain and respiratory therapy while the other therapies are expected to sustain the growth momentum
- The performance of the US business is likely to be under stress in the near term due to sustained price erosion and slower product approvals. However over the long term, a strong product pipeline comprising limited competition products provides ample visibility on growth
- DRL's Q4FY22 performance is expected to be weak as higher cost pressures and elevated raw material prices could result in a OPM's declining on a yoy basis.

Dr. Reddy's Laboratories' (DRL's) India business is expected to stage a strong show backed by growth across chronic and acute therapies. DRL reported strong performance in therapies such as gastro/cardiac/derma/anti-infectives/anti-diabetes, while the pain and respiratory segment's performance is expected to pick up. US business' growth is likely to slow down in the near term due to slow product approvals and sustained price erosion, while a strong product pipeline provides long-term growth visibility. Geopolitical stress is expected to overweigh on DRL's Russia performance in the near term. Further, overall elevated cost pressures are expected to drag down operating profit margin (OPM) in Q4FY2022. Higher costs and elevated competitive pressures in the US are near-term challenges for DRL, but strong opportunities in India business and likely gradual pick-up in the PSAI segment are key positives.

- Strong product pipeline provides long term visibility for US; Near-term headwinds likely:** US revenue growth for 9MFY2022 has been slower at 3.6% y-o-y versus 9% in FY2021, largely due to price erosion, which could sustain in the near term at least. Further, the product approval momentum has slowed down with only 17 approvals received in FY2022 till date versus 34 in FY2021. Product pipeline is strong with 91 ANDA pending approvals and includes few Para IV and first-to-file products. It provides growth visibility over the medium to long term, while in the near term, price erosion and slower product approvals could slow down the momentum.
- Adverse currency headwinds to impact DRL's Russia business:** DRL's revenue from Russia accounts for ~10% of overall sales. A major chunk of sales from Russia region is from the OTC segment. While Russia sales in local currency have normalised, but depreciating Ruble against INR is likely to impact the region's performance. As the geopolitical situation is dynamic, we await further clarity to gauge the medium to long-term effect on the company's performance. That said, near-term performance is likely to be affected by adverse currency movements.
- India business to sustain double-digit growth trajectory:** India sales have been consistently outperforming IPM growth with 15.5% y-o-y growth in FY2021 and 29% growth in 9MFY2022. Going ahead, management expects the double-digit growth trajectory to sustain. In India, DRL is present across chronics and acute therapy and has outperformed the industry's growth. On MAT basis in therapy areas of gastro/cardiac/derma/anti-infective/anti-diabetes, the pain and respiratory segments have underperformed, which are now expected to pick up. This coupled with focus to expand the geographical reach is expected to drive performance of the India business.

Our Call

Valuation – Retain Buy with a revised PT of Rs. 5,550: DRL faces headwinds in the form of continued pricing pressures in the US business. This coupled with delayed product approvals could slow down US sales growth in the near term, while a strong product pipeline provides long-term visibility. Geopolitical stress is likely to overweigh on DRL's Russia's performance, while India business is expected to sustain double-digit growth trajectory. Albeit, Q4FY2022 performance is likely to be weak, given the elevated cost pressures leading to expected margin contraction. At the CMP, the stock is trading at a P/E multiple of 27.1x/20.2x/17.7x its FY2022E/FY2023E/FY2024E EPS. With the stock price correcting ~12% in the past five months, valuations are now turning reasonable. We retain our Buy recommendation with a revised PT of Rs. 5,550.

Key Risks

- Adverse development on the regulatory front, including outcome of inspections, can impact earnings prospects; and
- currency fluctuation risks.

Valuation (Consolidated)

Rs cr

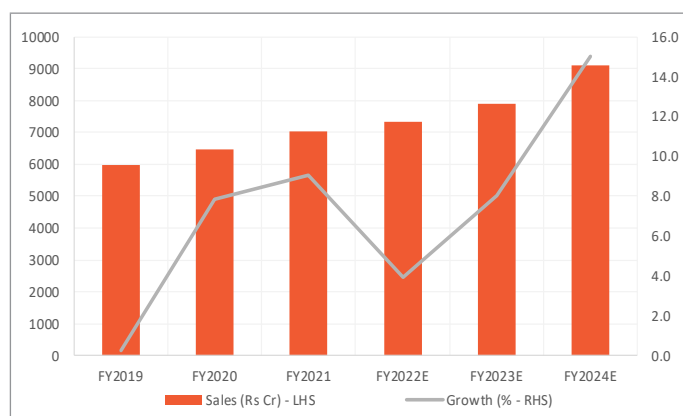
Particulars	FY2020	FY2021	FY2022E	FY2023E	FY2024E
Net sales	16357.4	18420.2	21038.9	23859.3	26455.8
EBITDA	4147.1	4546.7	4625.7	5887.3	6681.4
EBITDA (%)	25.4	24.7	22.0	24.7	25.3
Adj PAT	2026.0	1951.6	2682.0	3588.5	4090.7
EPS (Rs)	122.0	117.6	161.6	216.2	246.4
PER (x)	35.8	37.2	27.1	20.2	17.7
EV/Ebitda (x)	15.0	14.7	13.9	10.9	9.0
P/BV (x)	4.7	4.1	3.8	3.4	3.0
RoCE (%)	7.4	12.7	14.3	18.0	18.8
RoNW (%)	13.0	11.1	14.0	16.9	16.9

Source: Company; Sharekhan estimates

Strong product pipeline provides long-term visibility for US business; Near-term headwinds likely:

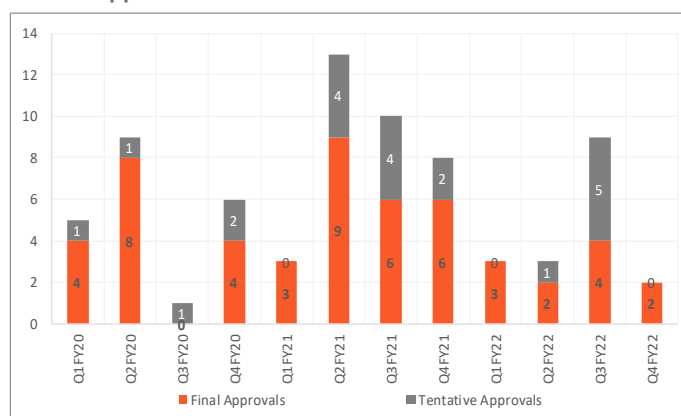
DRL's revenue growth from the US business has moderated for 9MFY2022 with sales at Rs. 5,494 crore up by 3.6% y-o-y as compared to strong 9% growth reported for FY2021. Moderation in growth can be attributed to the steep price erosion in the generics in US markets and the same is expected to stay at least in the near term. In addition to this, the product approval momentum has also slowed down with only 17 approvals received in FY2022 till date versus 34 in FY2021. Going ahead, management expects growth in the US business to be driven by new product launches largely, which would be complemented by pick up in the base business. During the previous three quarters, the company has launched four new products each and these are likely to ramp up gradually. gVascepa, which has been a sizeable launch for the company, has garnered a market share of ~11%. In addition to this, product pipeline is strong with 91 ANDAs pending approval and includes few Para IV and first-to-file products. It provides growth visibility over the medium to long term, while in the near term, price erosion and slower product approvals could slow down the growth momentum.

US business sales trends



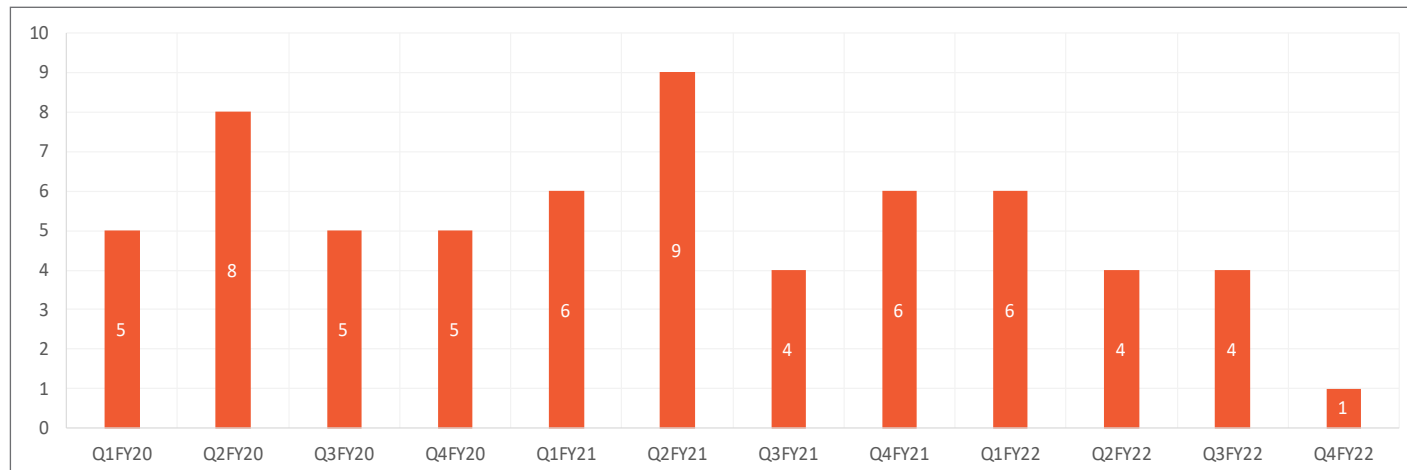
Source: Company, Sharekhan Research

USFDA approval trends



Source: Company, Sharekhan Research

ANDA's Launched in the US



Source: Sharekhan Research

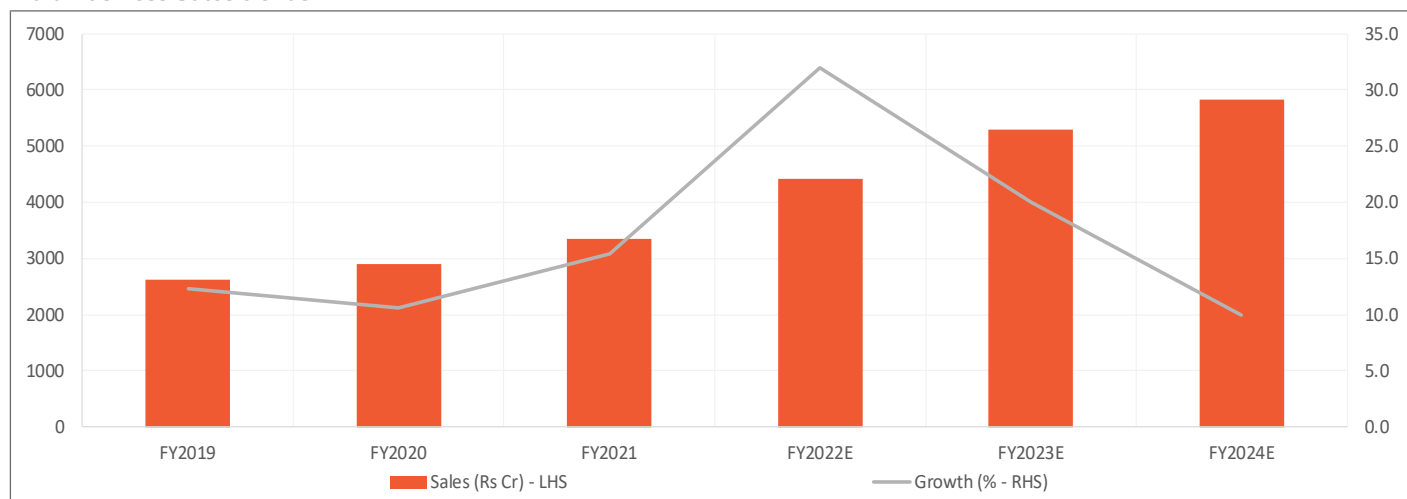
Adverse currency headwinds to impact DRL's Russia's performance in the near term:

DRL's revenue from Russia accounts for ~10% of overall sales. A major chunk of sales from the Russian region is from the OTC segment, which constituted around 45% of Russian sales. While Russia's sales, on a constant currency basis, are normalising, but depreciating Ruble against the INR (depreciated by ~20% in a little over the past one month) is likely to impact performance from the geography. As the geopolitical situation is an evolving one, we await further clarity to gauge the medium to long-term impact on the company's performance. That said, the near-term performance is likely to reflect the impact of adverse currency movements and could exert pressure on the overall Russian market's performance of DRL.

India business expected to sustain double-digit growth trajectory:

DRL's India business sales have been consistently outperforming IPM growth, which is reflected in 15.5% y-o-y growth reported in FY2021 and 29% growth in 9MFY2022. Strong growth in 9MFY2022 is despite reducing share of Covid-19 products. In the Indian markets, the company is present across therapies with chronics accounting for 45% of overall sales, while the balance is from acute therapies. On MAT basis, considering a span of four years, the company has outperformed in therapy areas of gastro/cardiac/derma/anti-infective/anti-diabetes, while the pain and respiratory segments have underperformed. However, in the past six months, the pain and respiratory segments have picked up and reported strong growth. On overall basis, India business is expected to sustain its double-digit growth. Moreover, investments towards expansion in rural areas, growing OTC portfolio, and new launches would add to growth. In addition, the company plans to leverage the digital tech platform for growing its brands, which is expected to improve profitability as well. Further, industry reports suggest double-digit growth for IPM in FY2023 along with the expected price increase, all of which bodes well from a growth perspective.

India Business Sales trends



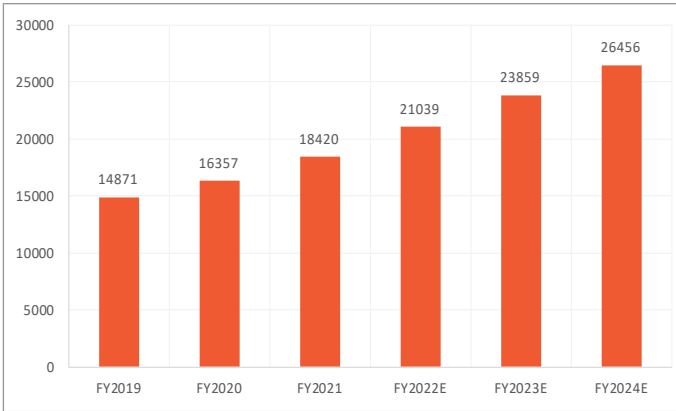
Source: Sharekhan Research

Management expects gradual improvement for the PSAI segment:

The PSAI segment's revenue for 9MFY2022 stood at Rs. 2,318 crore, down 1% y-o-y after strong 24% y-o-y growth in FY2021 pointing at the elevated base. The decline could be attributed to lower share of Covid-19 products. Going ahead, management expects an uptick in the PSAI segment, backed by new product launches lined up by the customers over the next two years as well as an expected uptick in the base business. However, high base and lower share of Covid-19 products could moderate growth in the near term.

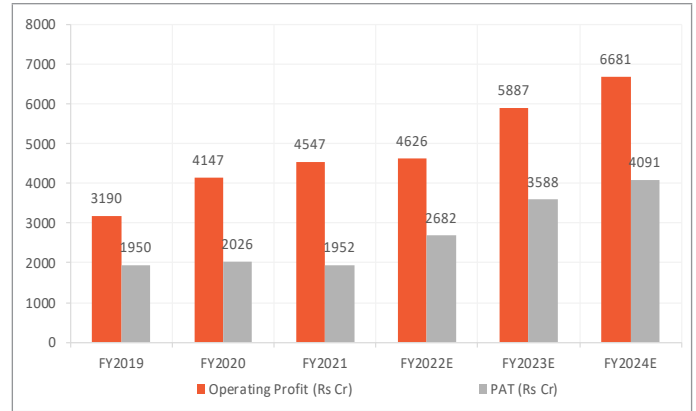
Financials in charts

Sales Trends (Rs Cr)



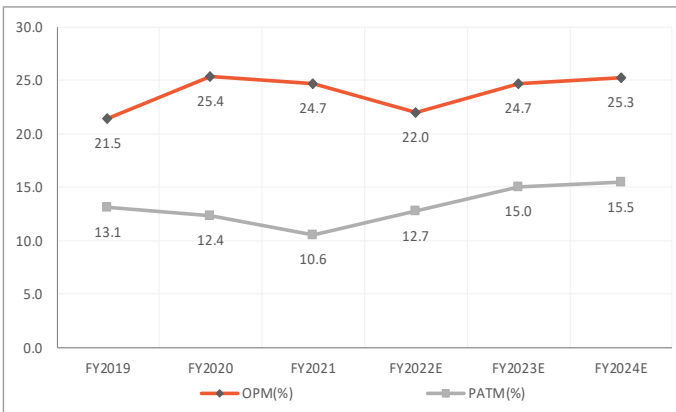
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



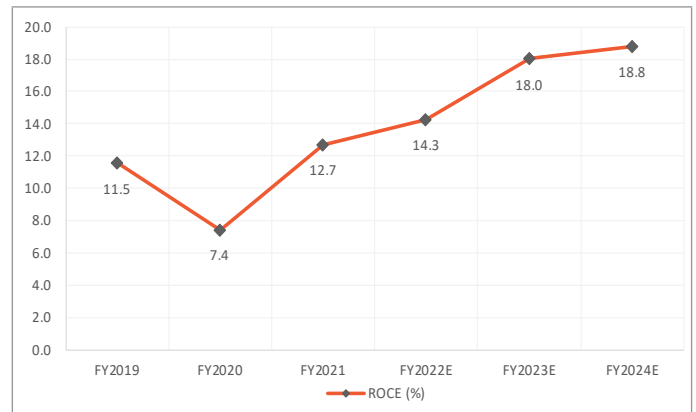
Source: Company, Sharekhan Research

Margins to improve



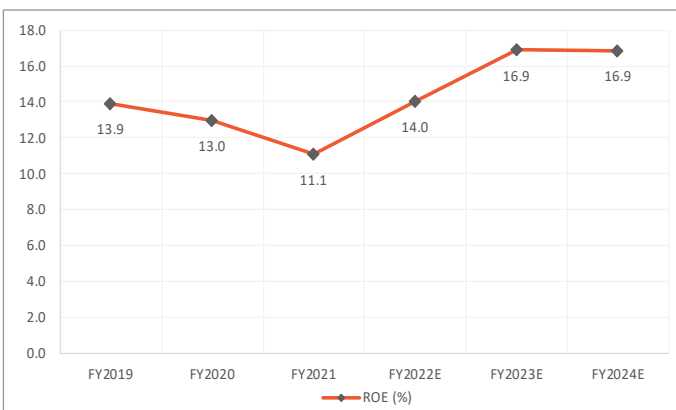
Source: Company, Sharekhan Research

ROCE (%)



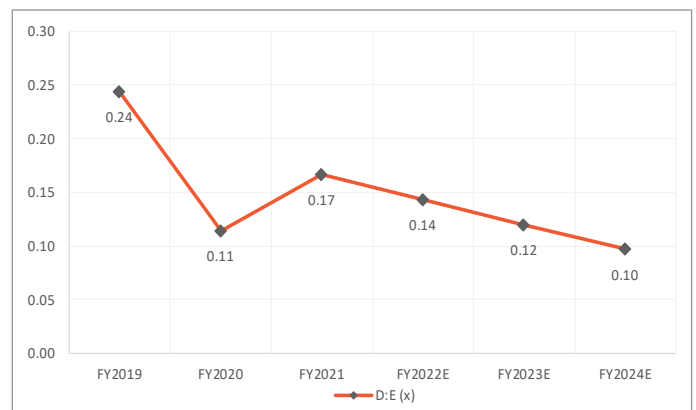
Source: Company, Sharekhan Research

ROE (%)



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 –** 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, though over the long term. 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 Light. However, the PSAI segment's performance is expected to be soft in the near term with a likely gradual improvement.

■ **Valuation – Retain Buy with a revised PT of Rs. 5,550:** DRL is witnessing headwinds in the form of pricing pressures in the US business, which are expected to continue at least in the near term. DRL has a strong product pipeline, which includes few limited competition/first-to-file products, which could unfold going ahead. However, elevated pricing pressures and slower product approvals are likely to slow down the growth momentum for the US business in the near term. Geopolitical stress in Russia has led to Ruble depreciating against INR. This is likely to exert pressures on Russian performance. On the other hand, India business backed by improvement across therapy areas and pick up in pain/respiratory therapy areas is expected to sustain double-digit growth. Albeit, given the elevated cost pressures and higher raw-material prices, OPM for Q4 is expected to contract and Q4FY22 is likely to be a weak quarter. At the CMP, the stock is trading at a P/E multiple of 27.1x/20.2x/17.7x its FY2022E/FY2023E/FY2024E EPS. With the stock price correcting ~12% in the past five months, valuations are now turning reasonable. However, cost headwinds, adverse currency movements, and slower growth in the US could outweigh near-term performance, but long-term growth levers are intact. We retain our Buy recommendation with a revised PT of Rs. 5,550.

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	4,357.0	16.6	72,508.0	37.1	27.0	20.2	14.7	13.8	10.9	11.1	14.0	16.9
Aurobindo	682.0	58.6	39,961.0	16.2	13.6	10.9	7.2	7.2	5.3	12.8	12.6	13.9
Gland Pharma	3221	16.3	52921	52.8	41.8	33.3	34.5	27.1	21.2	16.9	17.7	18.3

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 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, Sputnik V offers 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) 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

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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 deteriorating 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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