Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

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 31.35
Updated Feb 08, 2022

High Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 70,887 cr
52-week high/low:	Rs. 5079 / 3655
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	-2.6	3.4	1.0	-10.0
Relative to Sensex	-9.6	4.6	1.6	-18.4

Sharekhan Research, Bloomberg

Dr. Reddy's Laboratories Ltd

Weak Q1; long-term growth levers intact

Pharmaceuticals	Sharekhan code: DRREDDY

Reco/View: Buy	↔	CMP: **Rs. 4,259**	Price Target: **Rs. 5,000**	↓

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Dr. Reddy's Laboratories' (DRL's) Q1FY23 operating performance reflected high cost pressures that dragged down adjusted operating margins. Results missed estimates and reflected several one-time items
- Higher costs and elevated competitive pressures in the US are near-term challenges for DRL, but a strong new product pipeline and growth in base business could help tide over pricing pressures, to certain extent
- Expected healthy growth in India business, gradual pick up in the PSAI segment and strong product pipeline in the US including limited competition / FTF products, are key positives.
- We retain our Buy recommendation on the stock with a revised PT of Rs 5,000.

Dr. Reddy's Laboratories'(DRL's) Q1FY23 operating performance reflected high cost pressures that dragged down adjusted operating margins. Results missed estimates and reflected several one-time items. Overall revenue growth moderated to a meagre 6% y-o-y, while adjusted PAT stood at Rs.625 crore, up 9% y-o-y and missed estimates. Other income included Rs 563.8 crore of one-time settlement income. Overall, higher costs and elevated competitive pressures in the US are near-term challenges for DRL, but a strong new product pipeline and growth in the base business could enable it to tide over pricing pressures. Expected double-digit growth in India business, gradual pick up in the PSAI segmentand strong product pipeline in the US including limited competition / FTF products, are key positives.

Key positives

- India Sales rose 26% y-o-y due to price increases and new product launches and also includes income from divesture of brands.
- Strong US product pipeline comprising 86 generic filings pending for approval with USFDA - 83 ANDAs and 3 NDAs under the 505(b)(2) route.

Key negatives

- US sales grew by just 2% y-o-y and declined 11% Q-o-Q due to sustained price erosion and elevated cost pressures which could stay going ahead.
- Gross margins declined by 210 bps y-o-y due to inflationary pressures and reflect an impact of adverse foreign exchange movement.

Management Commentary

- DRL is witnessing heightened competitive pressures in the US, leading to price erosion. Substantial product launch pipeline and growth in the base business could enable DRL to mitigate the risk. DRL has a strong product pipeline for the US including limited competition products / FTF's.
- DRL's India business is expected to stage a healthy growth for FY23 backed by product portfolio expansion and price increases and expanding geographical reach.
- DRL's Russia revenues declined by 9% y-o-y due to channel inventory normalization post stocking up in previous quarter. The management sees Russia business improving materially as the geopolitical pressures are easing gradually.

Revision in estimates – DRL's Q1FY23 operating performance was weak on the back of high cost pressures and adjusted operating margins declined. Hence, factoring this we have revised downward our earnings estimates by 12% and 9% for FY23E and FY24E.

Our Call

Valuation: Retain Buy with revised PT of Rs 5,000: Headwinds in the form of pricing pressures in the US business, and high input cost prices, which are expected to continue for DRL. However, given the ramp-up in new products, a strong product pipelineand growth in base business, the impact of price erosion is likely to be reduced. Further, growth in acquired products, focus on the OTC portfolio, and rural areas for growth could fuel India business growth. DRL's PSAI segment'sperformance too is expected to improve gradually. At CMP, the stock is trading at a P/E multiple of 24x/20x it's FY23E/FY24E EPS. While near-term cost pressures could affect the performance, DRL's long-term growth levers are intact. We retain our Buy recommendation on the stock with a revised PT of Rs 5,000.

Key Risks

1) Adverse development on the regulatory front including outcome of inspections can impact earnings prospects; 2) currency fluctuation risk

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Net sales	18420.2	20514.4	23652.2	25787.5
EBITDA	4546.7	4698.1	5225.6	6079.4
EBITDA (%)	24.7	22.9	22.1	23.6
Adj PAT	1951.6	2182.5	2943.8	3534.5
EPS (Rs)	117.6	131.5	177.3	212.9
PER (x)	36.2	32.4	24.0	20.0
EV/Ebidta (x)	14.3	13.3	12.1	9.8
RoCE (%)	12.7	11.4	14.9	16.6
RoNW (%)	11.1	11.4	14.1	15.2

Source: Company; Sharekhan estimates

Operating margins under pressure; results miss estimates: Q1FY23 operating performance reflected elevated cost pressures and the adjusted operating margins declined backed by higher costs. The results missed estimates. Overall revenue growth moderated to a meager 6% y-o-y backed by a 8% growth in the Global Generics to Rs 4432.4 crore. This was on the back of a strong 26% y-o-y growth in the India business while the US business grew by 2% y-o-y, attributable to the sustained competitive pressures leading to price erosion. The operating margins at 18% (excluding the other income) declined by 60 bps y-o-y on the back of a 210 bps y-o-y decline in the gross margins on a reported basis, which includes the impact of adverse foreign currency movements, which stood at 150 bps in the gross margins. Further the employee cost shot up 100 bps y-o-y basis which resulted in the OPM contraction. The other income for the quarter included Rs 563.8 crore of a one-time incomes relating to settlement of contingency claims relating to IndiviorInc and Indivior UK and Aquestive Therapeutics. Therefore, adjusting for one-time income,PAT stood at Rs.625 crore up 9% y-o-y and missed estimates. Reported PAT stood at Rs 1,189.1 crore.

Q1FY2023 Concall Highlights

- **PSAI segment revenues grow modest 4%, management expects gradual improvement:** The PSAI segment's revenue stood at Rs.7,090 crore, down 6% y-o-y, due to a high base in Q1FY22 with covid product sales, partly offset by new products launched and favorable forex rates.The sequential decline was primarily due to lower volumes of base business, partly offset by new product launches. Going ahead, the management sees cost pressures persisting in the near term, but it also sees a gradual recovery in the PSAI segment sales.

- **Strong product pipeline in the US bodes well:** US revenue for the quarter stood at Rs.1781.5 crore, translating into a meager 2% y-o-y growth, while sequentially the revenues have declined sharply by 11%, sequentially the decline in revenues could be attributable to the elevated pricing pressures and low volumes in select products as competition increased. The y-o-y growth can be attributable to y launch of new products and favorable forex rates, which was offset by price erosion in some key molecules. However, going ahead, management expects growth in the US business to be driven by new product launches largely which would be complemented by the pick-up in the base business. During Q1FY23 the company launched 7 new products in US -Ketorolac, OTC Nicotine Lozenges Original, Methylprednisolone Sodium Succinate, Pemetrexed Injection, Posaconazole Tabs and Sorafenib. (in Q4FY22, the company had launched 3 new products. For FY22 the company has launched 17 new products in the US, and going ahead the launch momentum is expected to sustain. In recent launches includinggRevlimid in June 2022, g Vascepa, (DRL has garnered a-double-digit market share in the US) are amongst the key launches recently in the US.In addition to this, the pipeline is healthy with 86 generic filings pending for approval with USFDA, which include 83 ANDAs and 3 NDAs under the 505(b)(2) route. Out of the pending ANDAs, 44 are Para IVs and 24 have 'First to File' status. Also the DRL has plans for complex injectable products in the US markets. Further, the base business in the US is gaining traction and is expected to pick up with the full effect 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 in FY23, which could enable the company to tide over the double digit pricing pressures in the US and provide ample growth visibility going ahead.

- **India business to stage double-digit growth:** DRL's India business has reported a healthy 26% y-o-y growth to Rs1333 crore. Sequentially as well, growth stood at 38% backed by divestment of a few non-core brands, revenue contribution from the products acquired / in licensed, new products contribution and growth in the base business. The y-o-y growth could also be attributable to divestment of a few non-core brands, revenue contribution from the products acquired / in-licensed growth in base business and new products contribution. DRL expects India business to grow at a healthy pace due to investments towards expansion in rural areas, growing the OTC portfolio, price increases and new launches.

- **Europe:** DRL's revenue from Europe stood at Rs.414 crore, growing 4% y-o-y, but declining 7% QoQ. The growth on a y-o-y basislaunch of new products and scale up of base business, which was partly offset by price erosion in some molecules and adverse forex rates. The sequential decline is on account of price erosion which has had a adverse impact on volumes.

- **Emerging Markets:** Revenue from the segment stood at Rs.902.8 crore, a decline of 1% y-o-y and drop of 25% q-o-q.

- Revenue from Russia declined by 9% y-o-y due to channel inventory normalization post stocking up in Q4 FY22, which was partly offset with launch of new products. Revenues from CIS countries and Romania grew by 33% y-o-y, driven by volume traction in base business, favorable price benefits and launch of new products. The rest of world markets declined b y 6% y-o-y due to primarily on account of higher base in Q1 FY22 due to covid product sales and price decline in current quarter, partly offset by new product launches.
- **EBITDA margin outlook:** DRL has retained its target of 25% EBITDA margin and expects this to be driven by a favourable mix, leveraging digital platform, and possible market share gains in branded products. Further, the company expects the US business to grow in single digits while the non-US business is expected to stage a double-digit growth.

Results Rs cr

Particulars	Q1FY23	Q1FY22	YoY %	Q4FY22	QoQ %
Revenues	5232.9	4945.1	5.8	5474.9	-4.4
Operating profit	941.2	918.3	2.5	1192.9	-21.1
Other income	290.1	107.9	168.9	121.9	138.0
EBIDTA	1231.3	1026.2	20.0	1314.8	-6.4
Interest	34.7	19.3	79.8	31.5	10.2
Depreciation	301.8	467.7	-35.5	293.0	3.0
PBT	894.8	539.2	65.9	990.3	-9.6
Tax	279.0	175.4	59.1	161.9	72.3
Reported PAT	1189.1	380.4	212.6	97.0	1125.9
Adjusted PAT	625.3	573.4	9.1	838.9	-25.5
Margins			**BPS**		**BPS**
OPM (%)	18.0	18.6	-58.4	21.8	-380.2
Tax Rate (%)	31.2	32.5	-135.0	16.3	1483.2

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 mostdeveloped 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 the 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 andbiosimilars) and commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for pharmaceutical companies.

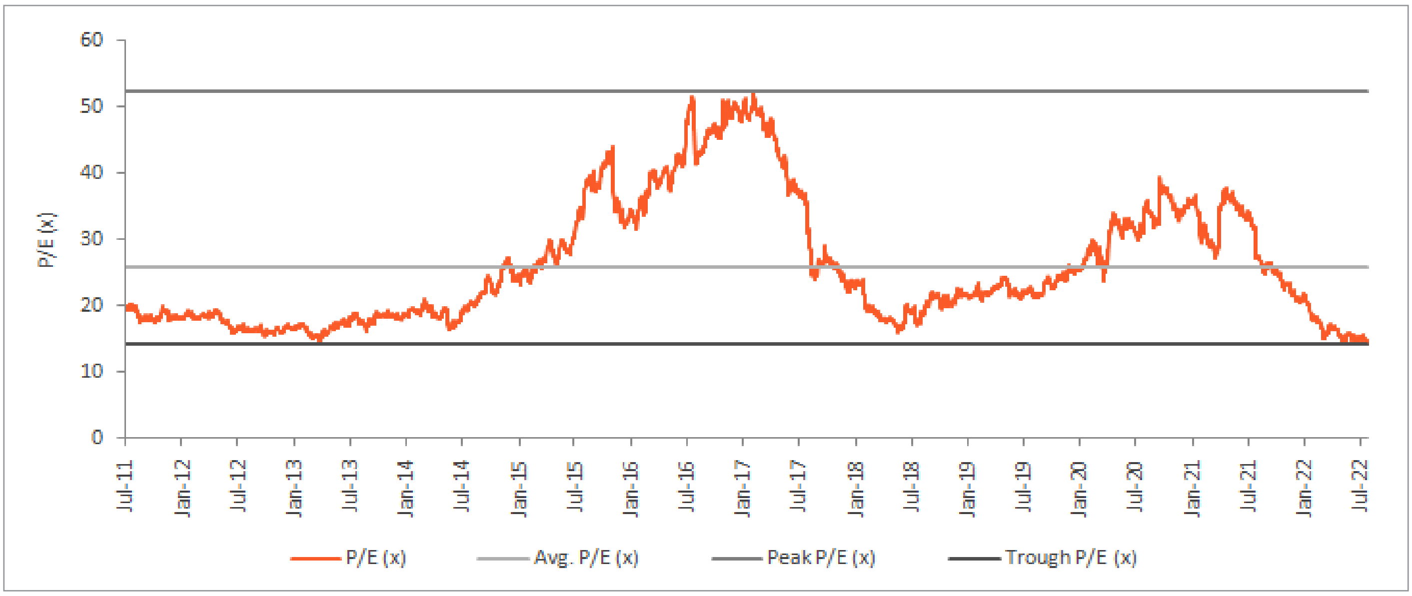
■ Company outlook - Outlines two-pronged growth strategy

DRL has a global presence, especially in the formulations segment. Globally, the company is present in most markets with US and India accounting for ~35% and 20%, respectively, of overall sales. Also, the management has charted out key focus areas for growth over the near term (under Horizon 1) and over the long term (under Horizon 2) which would propel growth going ahead. A confluence of costcontroland productivity improvement measures, synergies through partnerships, market and product portfolio expansion, strong executionand product-specific opportunities would be key growth drivers. Moreover, with the base business diversifying, performance is expected to gather pace, backed by geographical expansion. Strong product pipeline in the US generics business and improvement in the existing business would fuel US sales. On the other hand, a likely traction in acute therapies and acquired portfolio coupled with efforts to expand geographically and leverage the digital platform to grow brands would be key drivers for the Indian business. However, the PSAI segment's performance is expected to be soft in the near term with a likely gradual improvement.

■ Valuation - Retain Buy with revised PT of Rs 5000

Headwinds in the form of pricing pressures in the US business, and also elevated input cost prices, are expected to continue for DRL. However, given the ramp-up in new products, a strong product pipeline, and growth in the base business, the effect of price erosion is likely to be reduced. Further, growth in acquired products, focus on the over-the-counter (OTC) portfolio, and ruralareas for growth could fuel India business growth. DRL's PSAI segments performance too is expected to improve gradually. Factoring in a weak Q1FY23 operating performance, where results missed estimates and the management commentary suggested sustained cost pressures, we have lowered our earnings estimates by 12% and 9% for FY23E and FY24E. At CMP, the stock is trading at a P/E multiple of 24x/20x it's FY23E/FY24E EPS. While near-term cost pressures could affect the performance, DRL'slong-term growth levers are intact. We retain our Buy recommendation on the stock with a revised PT of Rs. 5,000.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Companies	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV / EBITDA (x)			RoE (%)		
				FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
Dr Reddy's	4,259	16.6	70,887	32.4	24.0	20.0	13.3	12.1	9.8	11.4	14.1	15.2
Sun Pharma	895	239.9	214,675	27.4	25.8	22.8	20.3	16.2	13.4	16.3	14.9	14.6
Biocon	307	120.0	36,822	48.6	29.0	18.7	21.1	15.2	10.2	9.0	13.2	17.1

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 customizedmodels 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

- Adverse regulatory changes can impact earnings prospects.
- 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

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