Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Dr. Reddy's Laboratories Ltd

Strong products' momentum in the US

Pharmaceuticals	Sharekhan code: DRREDDY
Reco/View: Buy ↔	CMP: Rs. 4,408 — Price Target: Rs. 5,460 ↔

↑ 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 31.24

Updated Oct 08, 2022

High Risk

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

Source: Morningstar

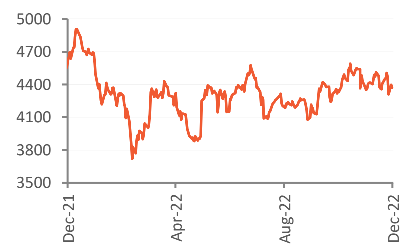
Company details

Market cap:	Rs. 73,371 cr
52-week high/low:	Rs. 4,931 / 3,654
NSE volume: (No of shares)	2.4 lakh
BSE code:	500124
NSE code:	DRREDDY
Free float: (No of shares)	12.2 cr

Shareholding (%)

Promoters	26.7
FII	36.3
DII	24.7
Others	12.3

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.2	2.3	4.7	-4.1
Relative to Sensex	2.4	-0.4	-11.6	-12.5

Sharekhan Research, Bloomberg

Summary

- We maintain our rating on Dr. Reddy's at Buy with a price target of Rs. 5,460, as we believe strong earnings growth prospects are intact for the company with equally strong market share gains visible in its newly launched blockbuster but limited quantity generic of Revlimid or Lenalidomide capsules in the US.
- Additionally, some of its existing products such as gVascepa and gSuboxone are proving to be the market leaders in the US, in each of the product categories, reinforcing our belief in its US segment's growth outlook.
- The company has 11-12 biosimilar products under trial. Tocilizumab biosimilar has recently completed stage I study successfully. Overall products in the US comprise 40% injectables and 15% complex products, which are high-value products. This should continue to drive US's profitable sales growth, partially offset by increased competition in injectables.
- As the company expects to launch 15-20 new products in the domestic market with a focus on 10 therapies, including anti-diabetic, oncology, cardiovascular (CVS), and gastrointestinal, India market should perform well in the short-medium term.

Dr. Reddy's US revenue base has been immensely benefited by the limited quantity and exclusive launch of gRevlimid for 2.5 mg and 20 mg strengths in the US in September 2022. The same will continue to help it grow profitably strong over the next 2 quarters and continue to gain from the sales of gRevlimid in a limited quantity until FY26. As a result, the gRevlimid launch also led to the highest total EBITDA and PBT for the company in Q2FY23. As per broking house's report, Dr. Reddy's has emerged as the largest generics player in gRevlimid with a market share of 18% for the week ended November 2022 with positive continuing trend in it in the US. The company continues to spend nearly 8% of the revenue on R&D over the last three quarters. The strong and complex product pipeline should help the company to drive the US segment's profitable sales growth; partially offset by increased competition in injectables.

- **Growth strong in the US due to launch of gRevlimid:** In Q2FY23, the company witnessed the US segment to benefit immensely from the limited quantity launch of gRevlimid (Lenalidomide capsules) besides other 6 product launches in the US. As per broking house's report, Dr. Reddy's has emerged as the largest generics player in gRevlimid with a market share of 18% for the week ended November 2022, with positive continuing trend in it in the US.
- **Product pipeline is strong, gives visibility over FY23E-FY25E:** As of Q2FY23, the company has 81 ANDA filings, pending for approval from the USFDA. Out of these, 3 are NDA filings under 505 (b)(2) route. Also, out of these 81 filings 42 are para IV filings and 22 have FTFs status. This indicates nearly 50% of the products pending for approval from the USFDA are complex products, indicating strong outlook for profitable US revenue growth over FY22-FY25E.
- **India market focus to aid growth:** As the company expects to launch 15-20 new products in the domestic market with focus on 10 therapies including anti-diabetic, oncology, Cardiovascular and Gastrointestinal, India market should perform well, going forward.

Our Call

Valuation: Dr. Reddy's is well placed to benefit from limited but exclusive launch of gRevlimid in specific strengths in the US, as of September 2022, in a profitable manner over the next 2 quarters and post that with competition until FY26, on a limited quantity basis. It is experiencing market leadership in some of its existing products in the US. We therefore maintain the CAGR earnings growth estimate at 33.0% over FY22-FY25E. At CMP, the stock trades at a relatively attractive valuation of 16.8x/14.4x its FY2024E/FY2025E EPS. We continue to value the company's shares at 17.7x while applying it on FY25E EPS. As such, we maintain the PT at Rs. 5,460 and the rating at BUY, as at the CMP, the stock indicates an upside potential of 24%.

Key Risks

1) Adverse regulatory developments including outcome of inspections can impact earnings prospects; 2) currency fluctuation risks.

Valuation (Consolidated) Rs cr

Particulars	FY2021	FY2022	FY2023E	FY2024E	FY2025E
Net sales	18,420.2	20,514.4	24,935.3	27,812.7	30,714.4
EBITDA Margin (%)	24.7	22.9	23.6	24.9	25.7
Adj. PAT	1,951.6	2,182.5	3,605.8	4,413.1	5,133.5
Adj. EPS (Rs)	117.6	131.5	217.2	265.9	309.2
PER (x)	37.9	33.9	20.5	16.8	14.4
EV/EBITDA (x)	15.0	14.0	11.5	9.7	7.8
ROCE (%)	12.7	11.4	19.1	20.5	21.0
RONW (%)	11.1	11.4	17.3	18.5	18.5

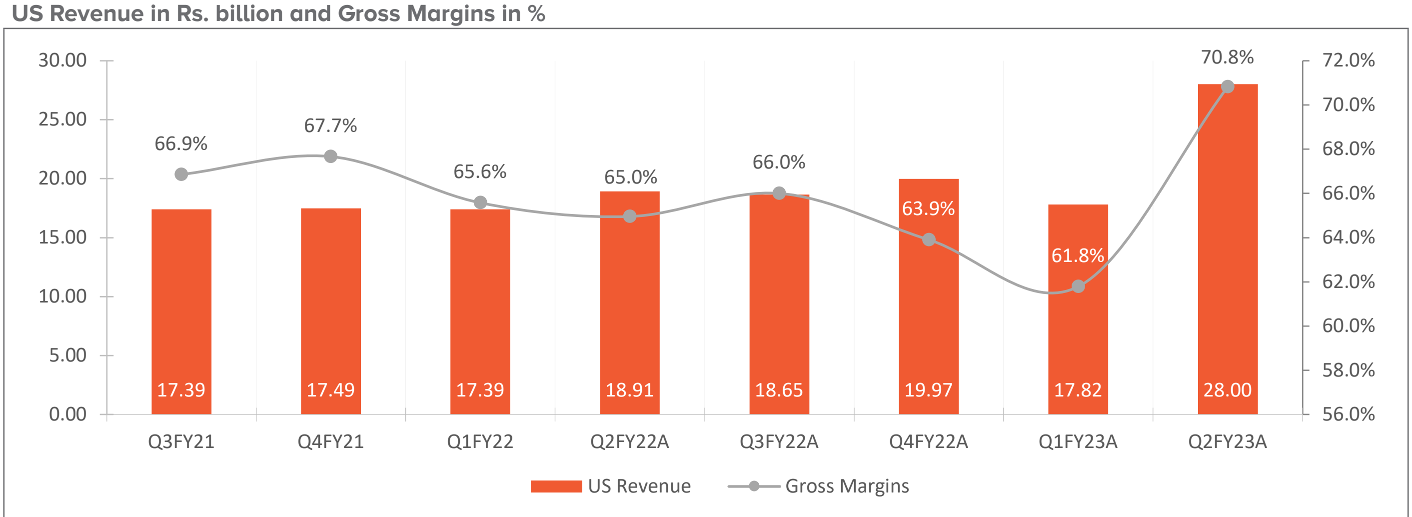
Source: Company; Sharekhan estimates

Growth strong in the US due to launch of gRevlimid: In Q2FY23, the company witnessed the US segment to benefit immensely from the limited quantity launch of gRevlimid (Lenalidomide capsules) besides other 6 product launches in the US. The US segment witnessed 48.1% YoY (+57.2% QoQ) rise in the US revenue to Rs. 2,800 Cr. vs. an average growth of 4.7% seen every quarter, in it, during Q3FY21-Q2FY23A. The gRevlimid launch also led to the highest total EBITDA and PBT for the company in Q2FY23. Lenalidomide was introduced in Q2FY23 (September 22) and was eligible for 180 days of generic drug exclusivity for 2.5 mg and 20 mg strengths. As a result, the company's gross profits margins also improved dramatically by 587 bps YoY (+903 bps QoQ) to 70.8% in Q2FY23. It is expected that the limited quantity sales of gRevlimid will continue for the remaining quarters of FY23 and on a non-exclusive basis until FY26. As per broking house's report, Dr. Reddy's has emerged as the largest generics player in gRevlimid with a market share of 18% for the week ended November 2022, with positive continuing trend in it in the US. In terms of its existing products, the company maintains the highest market share in gVascepa at 16% and second highest market share in gSuboxone, which is at 20% as of Q3CY22. In addition, the other 6 new products launched should lead to continuous growth in the US segment revenue over short – medium term.

Product pipeline is strong, gives visibility over FY23E-FY25E: As of Q2FY23, the company has 81 ANDA filings, pending for approval from the USFDA. Out of these, 3 are NDA filings under 505 (b)(2) route. Also, out of these 81 filings 42 are para IV filings and 22 have FTFs status. This indicates nearly 50% of the products pending for approval from the USFDA are complex products, indicating strong outlook for profitable US revenue growth over FY22-FY25E. The company has plans to file 20-25 products p.a., which can offset any impact of competitive pressures in the base business, in the US. The company continues to spend nearly 8% of the revenue on R&D over the last three quarters. The company has 11-12 biosimilar products under trial. Recently, its under trial Tocilizumab biosimilar (RLD: Roche's Actemra) which is used for treating rheumatoid arthritis in adults, has reached an important milestone with completion of the phase I study. Overall products in the US comprise of 40% being injectables and 15% being complex products, which are high value products. This should continue to drive US' profitable sales growth; partially offset by increased competition in injectables.

India market focus to aid growth: The company has been seeing a subdued performance in the domestic business due to having a higher share of the acute therapy offerings. Nevertheless, as the company expects to launch 15-20 new products in the domestic market with focus on 10 therapies including anti-diabetic, oncology, Cardiovascular and Gastrointestinal, India market should perform well, going forward.

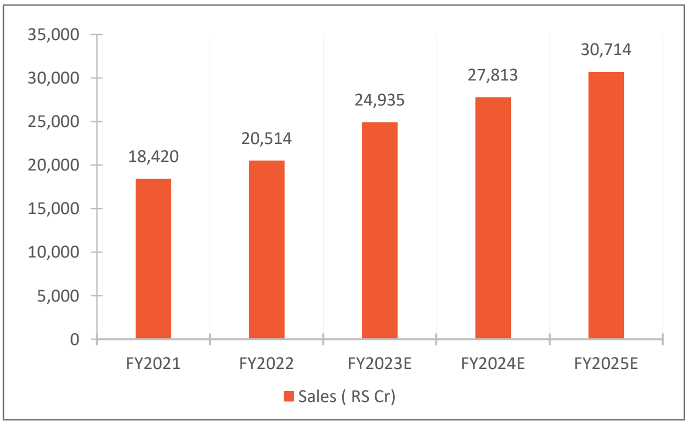
US Revenue in Rs. billion and Gross Margins in %



Source: Sharekhan Research

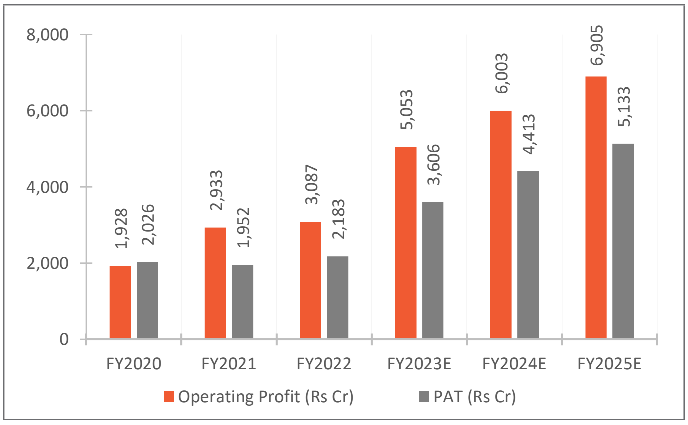
Financials in charts

Sales Trends (Rs Cr)



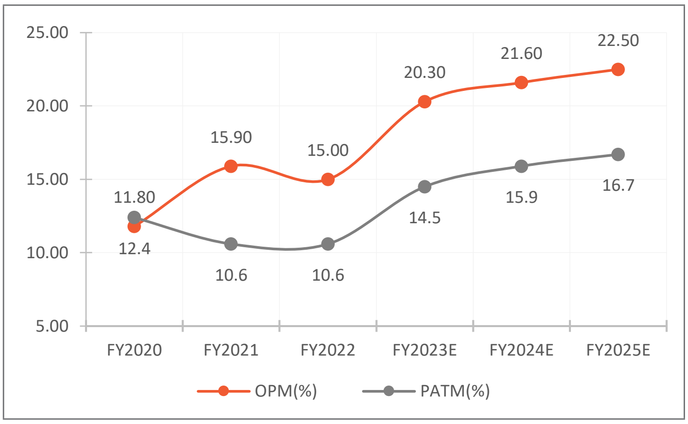
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



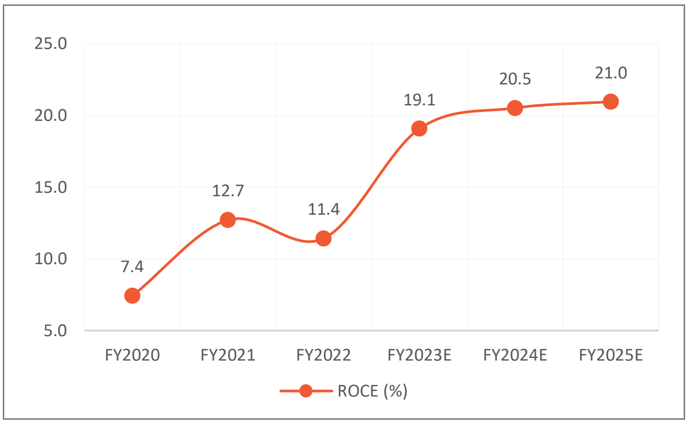
Source: Company, Sharekhan Research

Operating Margin - PAT Margins



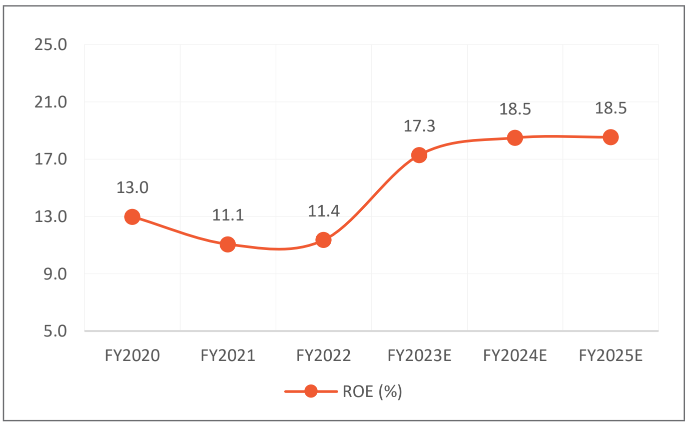
Source: Company, Sharekhan Research

ROCE (%)



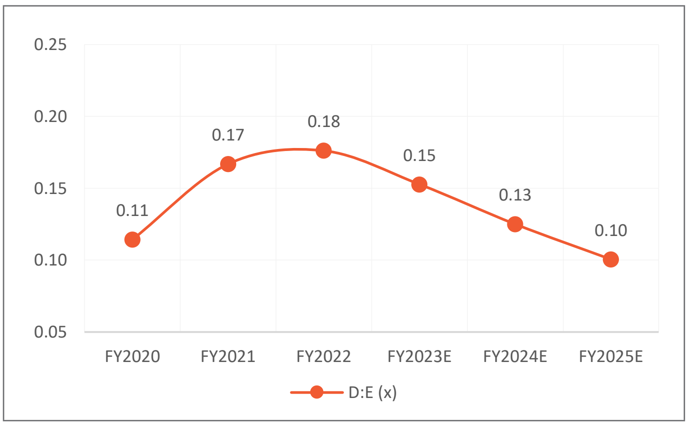
Source: Company, Sharekhan Research

ROE (%)



Source: Company, Sharekhan Research

Debt : Equity (x)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Multiple growth engines ahead

The Indian Pharma market (IPM) is growing with increased consumer spend and awareness. Additionally, Indian pharmaceutical players with large market share in IPM and a strong pipeline of speciality products will help them gain market share in the US and thereby partially offset any impact of competitive pricing pressure in the US. Moreover, other factors such as faster product approvals and resolutions by the USFDA regards to plant observations and 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, biosimilars and injectables) and commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for Indian pharma companies.

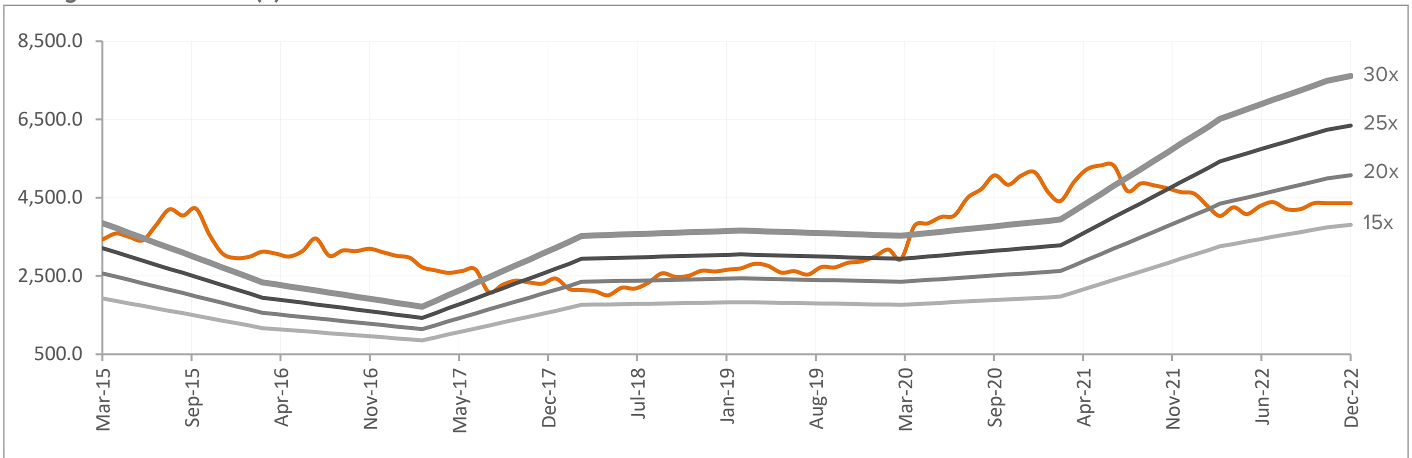
■ Company Outlook – Outlines two-pronged growth strategy

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. In addition, 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. A confluence of cost control and productivity improvement measures, synergies through partnerships, market and product portfolio expansion, 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. 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. 5,460

Dr. Reddy's is well placed to benefit from limited but exclusive launch of gRevlimid in specific strengths in the US, as of September 2022, in a profitable manner over the next 2 quarters and post that with competition until FY26, on a limited quantity basis. It is experiencing market leadership in some of its existing products in the US. We therefore maintain the CAGR earnings growth estimate at 33.0% over FY22-FY25E. At CMP, the stock trades at a relatively attractive valuation of 16.8x/14.4x its FY2024E/FY2025E EPS. We continue to value the company's shares at 17.7x while applying it on FY25E EPS. As such, we maintain the PT at Rs. 5,460 and the rating at BUY, as at the CMP, the stock indicates an upside potential of 24%.

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	4,461.0	16.6	74,260.8	33.9	20.5	16.8	14.0	11.5	9.7	11.4	17.3	18.5
Sun Pharma	989.8	239.9	2,37,474.2	30.3	27.5	23.2	22.5	18.0	14.7	16.3	15.4	15.6
Biocon	272.7	120.1	32,734.4	43.2	25.7	16.6	18.9	13.6	9.0	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 customized 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) Currency risk.

Additional Data

Key management personnel

K Satish Reddy	Chairman
Erez Israeli	Chief Executive Officer
Parag Agarwal	Chief Financial Officer
K Randhir Singh	Company Secretary & Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	APS Trust	20.63%
2	Life Insurance Corporation of India	15.16%
3	JP Morgan Chase & Co.	10.62%
4	BlackRock Inc.	2.63%
5	First State Investments ICVC	2.51%
6	SBI Funds Management Ltd.	2.47%
7	Vanguard Group Inc.	2.30%
8	ICICI Prudential Life Insurance Co. Ltd.	2.22%
9	Republic of Singapore	1.86%
10	NPS Trust A/C	1.80%

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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