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Stock Update | Result Update

Dr. Reddy's Laboratories Ltd

Weak Q4; Downgrade to Hold

Pharmaceuticals	Sharekhan code: DRREDDY
Reco/View: Hold ↓	CMP: Rs. 4,482	Price Target: Rs. 5,100 ↓

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- For Q4FY23, Dr. Reddy's Laboratories' (DRL's) profitability was augmented by proceeds from divestment of a few non-core brands amounting to Rs. 494.1 crore; this was included in reported revenue.
- Normalized net income rose ~27.9% y-o-y to ~ Rs. 550 crore, excluding brand divestment-related income, while reported net profits increased ~ 889.8% y-o-y to Rs. 960.1 crore in Q4FY23.
- Core EBITDA margins excluding other non-operating income and unusual gains and impairment costs fell by ~ 165 bps y-o-y to ~ 18.8% in Q4FY23. Reported EBITDA margins rose ~ 156 bps y-o-y to 25.1%.
- Stock trades at ~ 15.3x/14.3x its FY2024E/25E EPS estimates. We downgrade it to Hold from Buy with a revised PT of Rs. 5,100, using lower multiples than before to factor in uncertainty on impact of loss of exclusivity for gRevlimid's 2.5 and 20.0 mg strengths on the profitability, going forward.

Dr. Reddy's posted a ~ 10.7% y-o-y rise in normalized revenue to Rs. 5,821.1 crore (actual revenue reported was Rs. 6,315 crore) for Q4FY23, excluding sale of non-core brands to Eris Lifesciences, Torrent Pharma and JB Chemicals. Core revenue growth was driven by new product launches, an increase in volume of base business, and favorable forex movement. However, core revenues declined by 14.3% q-o-q due to ~ 17.2% q-o-q decline in the US revenue, ~ 30.0% q-o-q decline in India revenue and a 14.9% q-o-q decline in emerging markets revenue. We believe the India business actually rose by ~ 4.9% y-o-y to ~ Rs. 789.3 Cr, excluding income from divestment of brands. North America revenues clocked a strong 26.8% y-o-y growth to Rs. 2,532.1 crore, though. With core revenue growth sharply lagging growth in expenses, normalized EBITDA margins fell by ~ 165 bps y-o-y and by 11.42% points q-o-q to 18.8% for Q4FY23. Eventually, with a 127.9% y-o-y rise in taxes, the adjusted PAT fell by ~ 27.9% y-o-y to Rs. 520.0 Cr for Q4FY23. The PAT has been adjusted for impairments related to certain products and noncore brands' divesture income of ~ Rs. 494.1 crore.

Key positives

- Launched six products in Q4 and has 86 ANDAs pending for approval including 5 NDAs under 505(b)(2) route. In addition, out of these 86 filings, nearly 45 ANDA filings are Para IV filings and 18 have FTF status indicating a strong line-up of complex products. The company has launched 25 new products for FY23.
- The company has done over ~ 190 global generic filings and ~ 130 DMFs filed across the world in FY23.

Key negatives

- US revenue growth was affected by lower gRevlimid sales q-o-q and slower growth in the base business due to seasonality.
- Core EBITDA margins have declined to normalised levels of ~18.8%, which was witnessed before the launch of gRevlimid in Q2FY23 and Q3FY23.

Management Commentary

- Revenue growth was also augmented by divestment of a few non-core brands in India.
- The company envisages EBITDA margins of ~ 25.0% annually, going forward.
- Business momentum was strong across all businesses adjusted for COVID 19 sales in FY23.
- North America sales was driven by product launches such as gRevlimid etc. and an increase in market share for base products, which more than offset price erosions. The company launched 25 products in FY23 and expects the momentum to rise for it in FY24E.

Revision in estimates – The company's core revenue and earnings are expected to grow at ~ 6.3% rate and ~ 9.1% CAGR, respectively, over FY23-FY25E.

Our Call

View: Downgrade to Hold with a revised PT of Rs. 5,100: The company clocked in a decent growth in normalized revenue in Q4FY23 led by strong growth in key markets. We expect it to clock in ~ 6.3% and ~ 9.1% CAGR rise in revenue and net income, respectively, over FY23-FY25E. At CMP, the stock trades at ~ 15.3x/14.3x it's FY24E/FY25E. We downgrade it to HOLD with a revised PT of Rs. 5,100 though. We value it at a lower multiple than before and downgrade it to HOLD to factor in the uncertainty surrounding impact of gRevlimid on its profitability, going forward, given loss of exclusivity on 2.5 and 20.0 mg strengths of it by the end of Q4FY23. However, we also continue to believe that the company has authority to sell all strengths of gRevlimid in the US until January 2026 at a stepped up pre-decided proportions and at an unlimited quantity post that, which can help it sustain the US sales growth, besides due to other new product launches; partially offset by increased competitive intensity for the US and India base business over short-medium term.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY2022	FY2023E	FY2024E	FY2025E
Net sales	20514.4	23459.5	25810.0	26509.4
EBITDA (%)	21.3	25.3	25.3	25.8
Adj. PAT	2788.1	4083.1	4567.0	4860.5
Adj. EPS (Rs)	168.0	246.0	275.1	292.8
PER (x)	25.0	17.1	15.3	14.3
EV/Ebitda (x)	14.2	9.1	10.2	8.3
RoCE (%)	13.6	18.7	18.1	16.9
RoNW (%)	14.5	17.5	16.9	15.8

Source: Company; Sharekhan estimates

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 26.60

Updated May 05, 2023

Medium Risk

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

Source: Morningstar

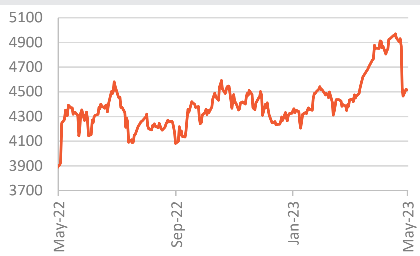
Company details

Market cap:	Rs. 74,467 cr
52-week high/low:	Rs. 4,989/ 3,829
NSE volume: (No of shares)	2.3 lakh
BSE code:	500124
NSE code:	DRREDDY
Free float: (No of shares)	12.2 cr

Shareholding (%)

Promoters	26.7
FII	37.8
DII	23.4
Others	12.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-7.6	-0.6	1.8	14.8
Relative to Sensex	-10.4	-1.6	2.1	1.5

Sharekhan Research, Bloomberg

Q4FY2023 Concall Highlights

- **Outlook:** DRL has been focusing on strengthening core businesses while investing in businesses of the future. The focus has also been on driving manufacturing excellence and product pipeline strengthening. The company envisages EBITDA margins of ~ 25.0% annually, going forward. Effective tax rate was ~27.6% for Q4FY23. ETR is expected to be 24-25% p.a.
- **Q4FY23 revenues:** Revenue growth was also augmented by divestment of a few non-core brands in India. The growth in revenue was also driven by new product launches, partly offset by price erosion. North America sales was driven by product launches such as gRevlimid, etc and an increase in market share for base products, which more than offset price erosions. The company launched 25 products in FY23 and expects momentum to rise for it in FY24E. The company has done over ~ 195 global generic filings and 130 DMFs filed across the world in FY23. Progressing well on biosimilar products development.
- **Profitability:** Gross margins for global generics and PSAI segments stood at 61.7% and 25.2%, respectively in Q4FY23. It increased y-o-y due to favorable product mix and forex changes, partially offset by price erosions especially in the US and Europe. The business momentum was strong across all businesses adjusted for COVID-19 sales in FY23.
- **Capex, R&D and FCF:** Capex was Rs. 1130 Cr in FY23 and it was at Rs. 260 Cr for Q4FY23. R&D spend was Rs. 540 Cr or 8.5% of revenue.

Results Rs cr

Particulars	Q4FY23	Q4FY22	YoY %	Q3FY23	QoQ %
Revenues	5,821.1	5,258.5	10.7	6,789.8	-14.3
Expenditure	4,727.3	4,183.7	13.0	4,738.8	-0.2
EBITDA	1,093.8	1,074.8	1.8	2,051.0	-46.7
Depreciation	315.5	293.0	7.7	323.7	-2.5
EBIT	778.3	781.8	-0.4	1,727.3	-54.9
Interest	35.4	31.5	12.4	41.8	-15.3
Other income	138.5	121.9	13.6	58.7	135.9
PBT	881.4	872.2	1.1	1,744.2	-49.5
Tax	369.0	161.9	127.9	393.8	-6.3
Adjusted PAT	520.0	720.8	-27.9	1,356.4	-61.7
Exceptional items	440.1	-623.8	NM	-112.5	NM
Reported PAT	960.1	97.0	889.8	1,243.9	-22.8
Margins			**BPS**		**BPS**
GPM (%)	82.3	67.0	1525	66.1	1621
EBITDA (%)	18.8	20.4	-165	30.2	-1142
Adj PAT (%)	8.9	13.7	-477	20.0	-1104
Tax Rate (%)	41.9	18.6	2330	22.6	1929

Source: Company, Sharekhan Research

Segment/region wise performance Rs cr

Segment	Q4FY23	Q4FY22	y-o-y %	Q3FY23	q-o-q %
Global Generics	**4,931.6**	**4,395.3**	**12.2**	**5,924.1**	**-16.8**
- North America	2,532.1	1,997.1	26.8	3,056.7	-17.2
- Europe	496.0	444.4	11.6	430.3	15.3
- India	789.3*	752.5*	4.9	1,127.4*	-30.0
- Emerging Markets	1,114.2	1,201.3	-7.3	1,309.7	-14.9
API	**778.7**	**755.7**	**3.0**	**775.8**	**0.4**
Others	92.4	69.3	33.3	70.1	31.8
Total	**5,802.7***	**5,220.3**	**11.2**	**6,770.0**	**-14.3**
Reported revenue	**6,296.8**	**5,436.7**	**15.8**	**6,770.0**	**-14.3**

*Source: company; Sharekhan Research; * Adjusted for divested brands related income*

Outlook and Valuation

■ Sector View – Regulatory concerns and pricing erosion prove a hurdle over short – medium term

Over the years, Indian pharmaceutical companies have established themselves as dependable source for global pharma companies. The confluence of other factors, including a focus on specialty/complex products in addition to emerging opportunities in the API space, would be key growth drivers over the long term. However, ongoing USFDA plant inspections and a few companies being issued Form 483s with observations point to apparent regulatory concerns. We believe that in the near term, based on the headwinds that may drag the performance, especially in the API and CDMO space and for large pharmaceutical players seeing USFDA OAI or WL status on their facilities, we have a Neutral view on the sector.

■ Company Outlook – To see slower growth in sales and earnings

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. A 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. The company's exclusivity to gRevlimid's 2.5 mg and 20 mg strengths are to get over by the end of Q4FY23. Hence, we believe that it will see slower revenue growth and earnings over FY23-FY25E.

■ Valuation – Downgrade to Hold with a revised PT of Rs. 5,100

The company clocked in a decent growth in normalized revenue in Q4FY23 led by strong growth in key markets. We expect it to clock in ~ 6.3% and ~ 9.1% CAGR rise in revenue and net income, respectively, over FY23-FY25E. At CMP, the stock trades at ~ 15.3x/14.3x it's FY24E/FY25E. We downgrade it to HOLD with a revised PT of Rs. 5,100 though. We value it at a lower multiple than before and downgrade it to HOLD to factor in the uncertainty surrounding impact of gRevlimid on its profitability, going forward, given loss of exclusivity on 2.5 and 20.0 mg strengths of it by the end of Q4FY23. However, we also continue to believe that the company has authority to sell all strengths of gRevlimid in the US until January 2026 at a stepped up pre-decided proportions and at an unlimited quantity post that, which can help it sustain the US sales growth, besides due to other new product launches; partially offset by increased competitive intensity for the US and India base business over short-medium term.

Peer valuation

Companies	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV/EBIDTA (x)			RoE (%)		
				FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Dr Reddy's	4,481.5	16.6	74,602.0	17.1	15.3	14.3	9.1	10.2	8.3	17.5	16.9	15.8
Sun Pharma	936.0	239.9	2,24,565.8	27.4	22.3	18.4	17.7	14.1	11.3	14.7	15.5	15.9

Source: Company, Sharekhan estimates

About the 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. However, loss of exclusivity on gRevlimid's 2.5 and 20 mg strengths besides competitive intensity in the US and India business will lead to decline in earnings over short – medium term at high single digits.

Key Risks

- Adverse regulatory changes can impact earnings prospects.
- 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: BSE; Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp India	15.2
2	JP Morgan Chase	10.6
3	BlackRock Inc	2.7
4	First State Investments ICVC	2.5
5	Vanguard Group Inc.	2.3
6	ICICI Prudential Life Insurance	2.2
7	Republic of Singapore	1.9
8	NPS Trust UTI	1.8
9	Kuwait Investment Authority	1.7
10	Aditya Birla Sun Life AMC	1.5

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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