Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Dr. Reddy's Laboratories Ltd

Upgrade to Buy; healthy product pipeline and business condition

Pharmaceuticals	Sharekhan code: DRREDDY
Reco/View: Buy ↑	CMP: Rs. 5,188 / Price Target: Rs. 5,963 ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Dr. Reddy's Laboratories Ltd.'s (Dr. Reddy's) stock is trading at an attractive valuation of ~18.1x/~17.1x its revised FY2024E/FY2025E EPS estimates, while offering strong ROE (~17.5%) and balance sheet proposition for the underlying business. Thus, we revise upwards the PT to Rs. 5,963 and upgrade the rating to BUY from Hold.
- Dr. Reddy's recently announced its foray into the trade generics business in India, which is expected to drive volume growth and overall revenue growth marginally higher over FY2023-FY2025E.
- Although the recent quarterly market share data for key existing products such as gRevlimid, gVascepa and gVasostrict point to a marginally weak outlook for the North American market, we believe gRevlimid will continue to be a key product until January 2026, as guided by management. This coupled with the acquired prescription portfolio of 45 products from Mayne Pharma should continue to drive North America's revenue at a ~8.2% CAGR over FY2023-FY2025E.
- The company's focus on 25-30 limited competition product launches, including for injectables for the North America market in FY24E and receipt of CAD9 million (Rs. 57 crore) of litigation settlement income from Janssen Group in Q1FY2024E should help it drive its earnings growth upwards, marginally though, by ~10.2% CAGR from ~9.1% CAGR envisaged earlier over FY2023-FY2025E.

Dr. Reddy's has had one of the fruitful years in FY2023 as it experienced ~46.4% y-o-y rise in adjusted net income to Rs. 4,083 crore, excluding unusual gains related to the sale of non-core brands worth Rs. 494 crore and impairments costs worth Rs. 70 crore. Reported PAT increased by ~106.5% y-o-y to Rs. 4,507 crore for the year. This can be attributed to decent growth in the U.S. and Europe, driven by high value product launches and traction in the base business. Additionally, cost-efficiency measures implemented during the year helped the company to enhance its profitability. Growth in U.S. revenue at ~35.8% y-o-y to Rs. 10,170 crore was driven by 25 new product launches, including Lenalidomide (gRevlimid), Sorafenib, and Pemetrexed Injection, partially offset by price erosion in key products such as Icosapent Ethyl Capsules (gVascepa) and Vasopressin (gVasostrict). At the same time, recent developments such as the company's newly announced foray into the trade generics business in India and receipt of a one-time litigation settlement income of CAD9 million (Rs. 56 crore) from Janssen Group in Q1FY2024 incite marginally upwards revision in earnings estimates for FY024E and FY2205E. We revise our revenue CAGR to ~6.8% from ~6.3% CAGR and earnings growth estimate to ~10.2% CAGR from ~9.1% CAGR over FY2023-FY2025E.

- **Trade generics business announcement to boost India's growth trajectory:** We believe the company's newly announced entry into the trade generics business in India will help it drive higher volumes for the market and improve its operating leverage, thereby driving higher profitability over the medium to long term.
- **Focus on complex generics and first-to-market products to drive profitable growth in North America over the short to long term:** Nearly ~58% of its pending filings with the USFDA are indicative of a strong product pipeline, largely comprising complex generics, with a large number of First to File (FTFs) and novel drugs, which are expected to drive profitable revenue growth for the U.S. market over the next 4-5 years. Moreover, the company's plans to launch 25-30 products in FY2024E and Mayne Pharma's acquired 45 prescription product portfolio should drive profitable growth in North America over short the medium term.
- **Market shares of products give a mixed signal but gRevlimid continues to be a key product:** Although competitive intensity in its key products such as gRevlimid, gVascepa, and gVasostrict indicate marginally subdued outlook for North America's revenue, we continue to believe gRevlimid will be the key product to drive profitable growth along with new product launches over FY2023-FY2025E.
- **Unusual income from litigation settlement to boost earnings marginally in FY2024E:** The company has received one-time settlement income of CAD9 million (Rs. 56 crore) from Janssen Group in Q1FY2024E in relation to a litigation around ANDS for a generic version of Zytiga (Abiraterone). We believe this coupled with its foray into the trade generic business in India would boost its earnings estimates for FY2024E and FY2025E marginally by ~3% and ~2%, respectively.

Our Call

Upgrade to Buy with a revised PT of Rs. 5,963: Dr. Reddy's FY2023 performance was one of the best in recent times, driven by the launch of gRevlimid, wherein it had 180 days' exclusivity for two strengths until the end of Q4FY23. Although the recent quarterly market share data for key existing products such as gRevlimid, gVascepa and gVasostrict point toward a marginally weak outlook for the North American market, we believe gRevlimid will continue to remain a key product until January 2026 and the acquisition of 45 prescription products from Mayne Pharma and ~25-30 new complex product launches including injectables will continue to drive North America's revenue at an ~8.2% CAGR over FY2023-FY2025E. The company's recent foray in the trade generics business in India and receipt of settlement income of CAD9 million or Rs. 56 crore in Q1FY2024 bode well for boosting earnings growth marginally to a ~10.2% CAGR from ~9.1% CAGR before over FY2023-FY2025E. The stock is trading at an attractive valuation level of ~18.4x/~17.4x its FY2024E/FY2025E revised EPS estimates, while offering strong ROE (~17.5%) and balance sheet for the underlying business. We, therefore, revise upwards the PT to Rs. 5,963 and upgrade the rating to BUY from Hold.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23	FY24E	FY25E
Net sales	20514.4	23459.5	25907.8	26767.4
EBITDA Margin (%)	21.3	25.3	25.3	25.8
Adj. PAT	2788.2	4083.2	4689.5	4960.6
Adj. EPS (Rs)	168.0	246.0	281.8	298.1
PER (x)	30.9	21.1	18.4	17.4
EV/EBITDA (x)	15.7	11.0	9.4	9.1
ROCE (%)	16.1	19.7	16.2	14.8
RONW (%)	14.5	17.5	14.6	13.4

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 26.6
Updated Jun 08, 2023

Medium Risk

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

Source: Morningstar

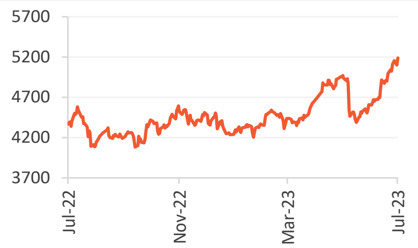
Company details

Market cap:	Rs. 74,467 cr
52-week high/low:	Rs. 5,205/3,997
NSE volume: (No of shares)	3.7 lakh
BSE code:	500124
NSE code:	DRREDDY
Free float: (No of shares)	12.2 cr

Shareholding (%)

Promoters	26.7
FII	38.6
DII	23.1
Others	11.7

Price chart



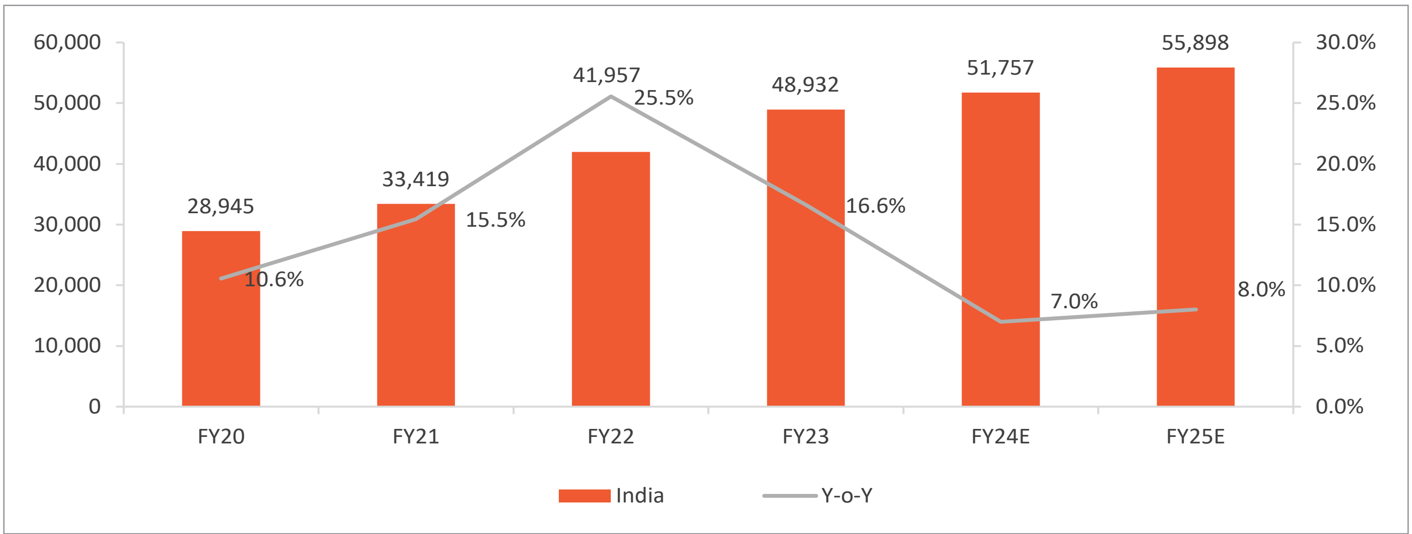
Price performance

(%)	1m	3m	6m	12m
Absolute	12.5	11.4	8.5	19.2
Relative to Sensex	7.9	0.6	0.5	-3.9

Sharekhan Research, Bloomberg

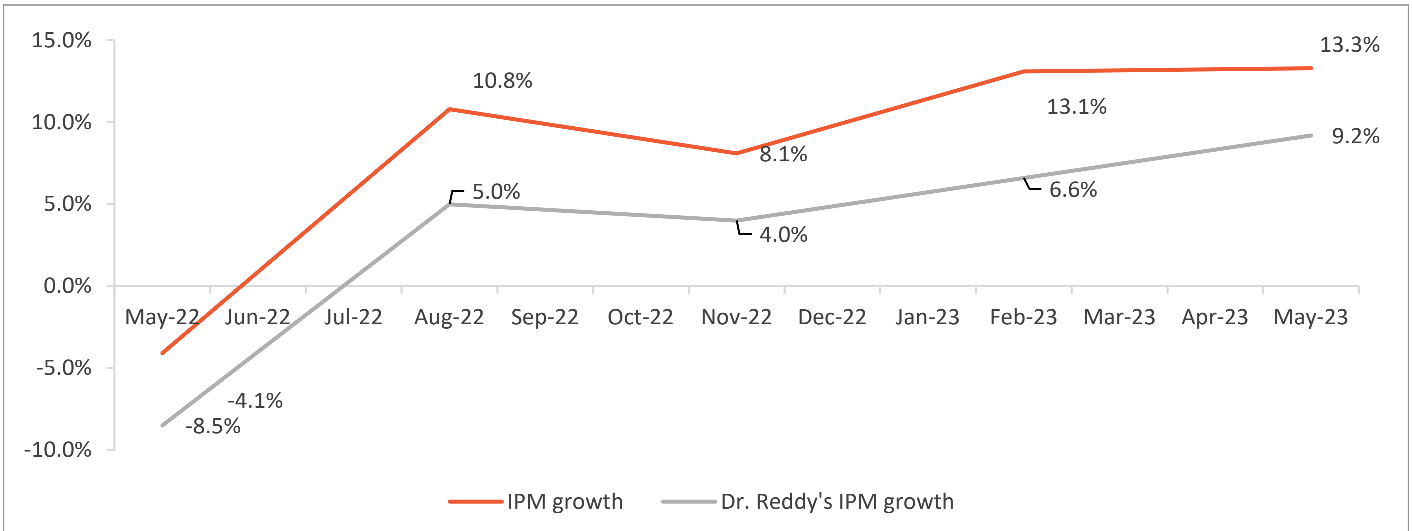
- **Announcement of its foray into the trade generics business to boost India's growth trajectory:** The company has been witnessing decent average growth of ~17% in the Indian market over FY2020-FY2023, which contributes ~20% to total revenue. The growth rate has reduced from ~25.5% in FY2022 to ~16.6% in FY2023. In FY2023, growth was largely driven by increased pricing of existing products, incremental revenue coming in from new product launches (9 new brands launched), and divestment of a few non-core brands in the year. However, on core growth basis, it was slower at ~2.5%, as Dr. Reddy's India segment underperformed the India Pharma Market's (IPM) growth at ~7.9% y-o-y for FY2023. As per IQVIA, this was on account of a decline in volumes. We believe the company's recently announced foray into the trade generics business in India, under the newly formed division called 'RGenX' (in June 23), bodes well to drive higher volumes and can help it to become the fifth largest pharma player in India from being the tenth player currently. As trade generics offer reduced investments and low profitability model with an ability to boost volumes, we believe the company should be able to achieve improved operating leverage and, thereby, drive profitability higher over the medium-long term. We revise upwards the CAGR for the segment's revenue to ~6.9% over FY2023-FY2025E vs. ~4.4% CAGR estimated earlier for the same period.

India Revenue in Rs. Cr.



Source: Company, Sharekhan Research

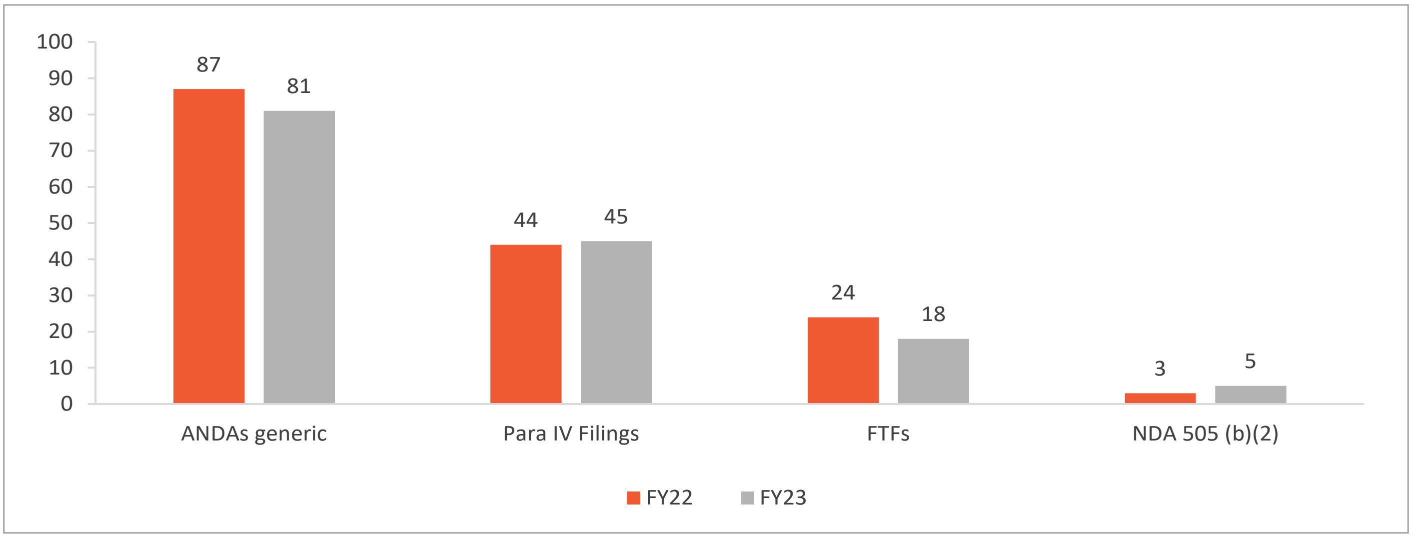
IPM growth vs. Dr. Reddy's IPM growth



Source: Sharekhan Research; IQVIA

- **Focus on complex generics or first-to-market products to drive profitable growth in the U.S. market:** The company has 86 ANDA filings pending for approval by the USFDA as of FY2023, of this 45 are Para IV filings (out of these, 18 have likely FTF status). Additionally, the company has five NDAs awaiting approval under the 505(b)(2) route. Nearly ~58% of its pending filings are indicative of a strong pipeline, largely comprising complex generics, with a large number of FTFs and novel drugs, which are expected to drive profitable revenue growth over the next 4-5 years. On the other hand, the company plans to launch nearly 25-30 products in FY2024, including injectables, and has acquired Mayne Pharma's prescription product portfolio, including 45 already commercialised products, 4 products in the pipeline, and 40 approved but not marketed products (including a few generic products for women's health such as hormonal vaginal ring and a birth control pill and a cardiovascular product) for the U.S. market for USD93 million in cash (Rs. 763 crore and completed in April 2023), which should drive growth in the U.S. over the short to medium term.

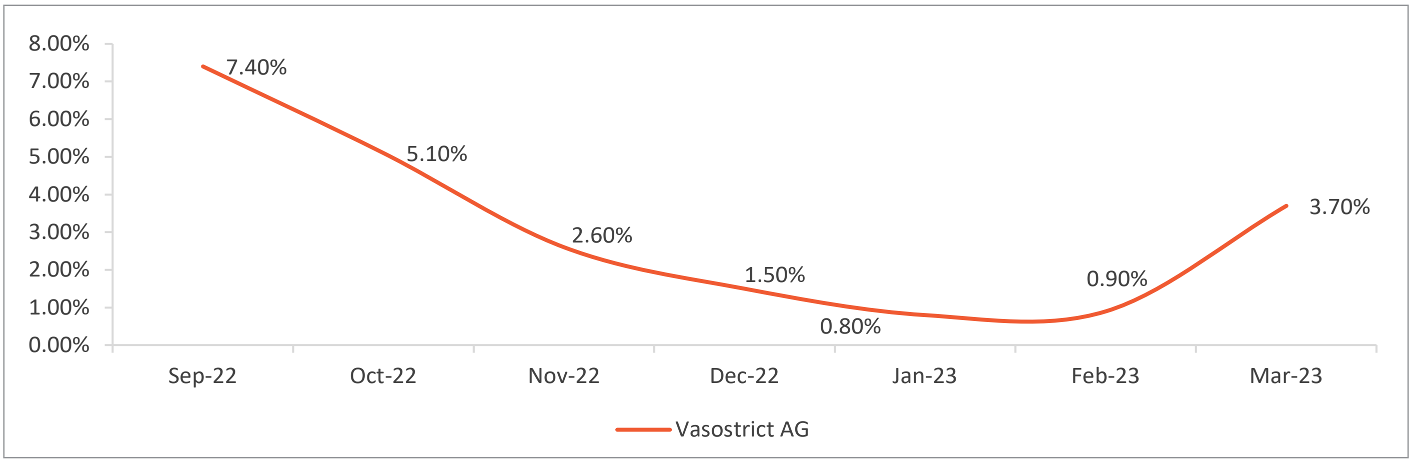
Pending USFDA approvals - Product pipeline



*Sharekhan research; Company; *Is a part of Para IV filings; ** Is a part of ANDAs generic*

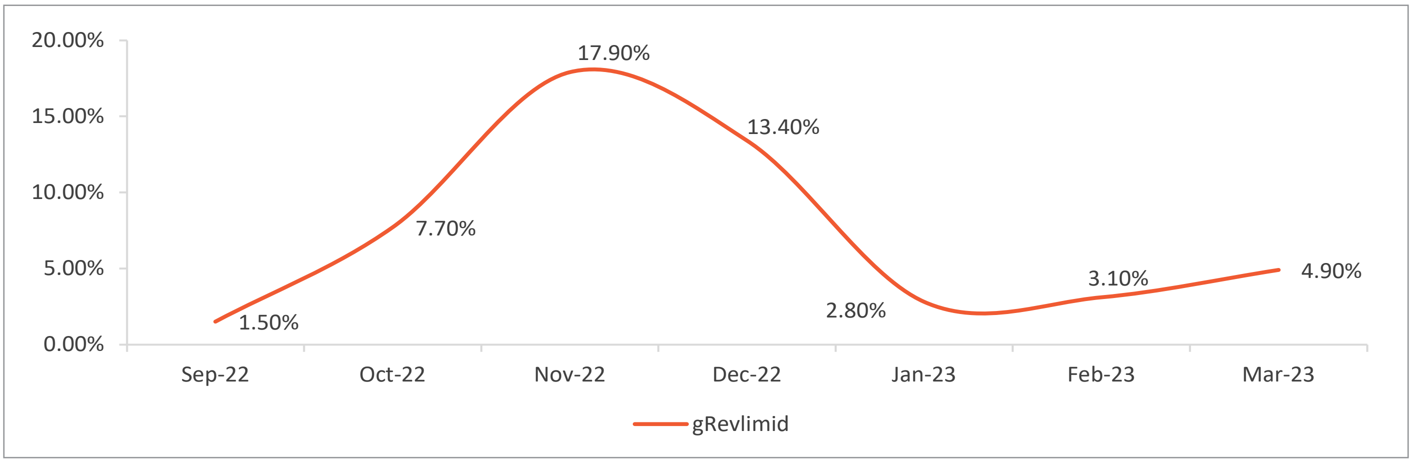
- **Launch of gRevlimid led to strong growth in North America's sales in FY2023 and is expected to continue to drive it until FY2026:** In FY2023, the company witnessed ~35.8% y-o-y rise in revenue for the U.S. market to Rs. 10,170 crore (~41% of the total revenue), driven by new product launches such as lenalidomide (gRevlimid), sorafenib (gNexavar), and pemetrexed injection (gAlimta), increased volumes for certain products such as Icosapent ethyl (gVascepa) and daptomycin, and partially offset by pricing pressure in the base business (~8% pricing erosion). However, the company has seen a downward trend q-o-q in the market share for gRevlimid to ~4% in Q4FY2023 from ~13% in Q3FY2023, as it has lost exclusivity on two strengths of gRevlimid by the end of Q4FY2023. Nevertheless, it can be noted that for March 2023, Dr. Reddy's market share for gRevlimid increased to ~4.9% in March 2023 vs. ~3.1% in February 2023 and ~1.5% in September 2022. We believe gRevlimid will continue to remain a key product for the U.S. market until the settlement agreement ending in January 2026. We expect the base business to continue to witness price erosion due to competitive intensity in the U.S. market.

Vasostrict AG Market share



Source: Company, Sharekhan Research

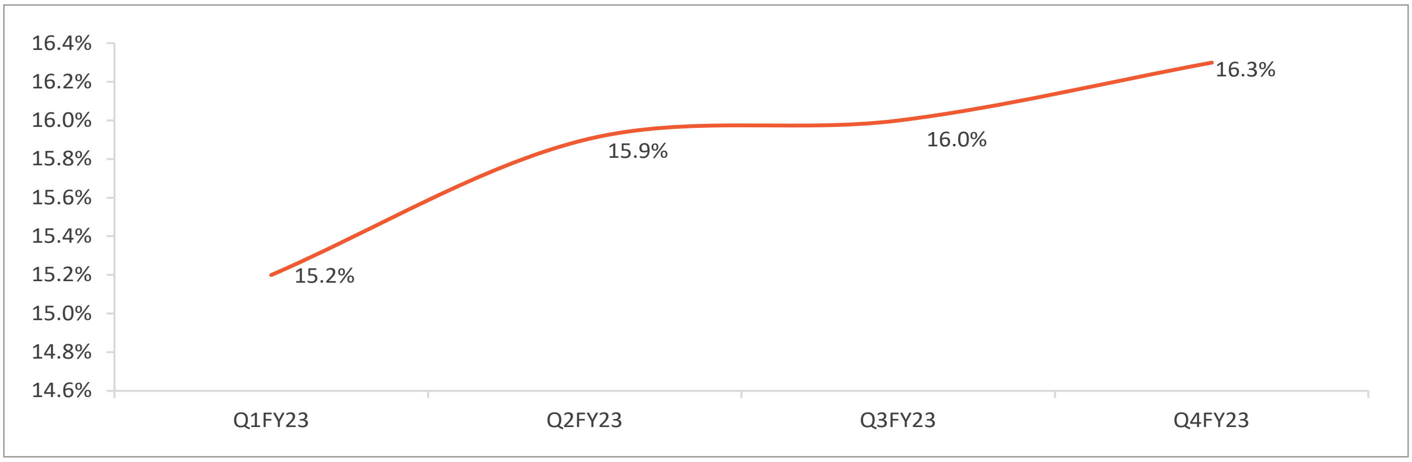
gRevlimid's Market share



Source: Company, Sharekhan Research

- **Products' market shares give mixed signal but gRevlimid continues to be a key product:** Dr. Reddy's is expected to witness competitive pressure in gVascepa with the entry of Zydus Life in the product in April 2023; whereas as of Q4FY2023, it has had a stable market share q-o-q at ~16.3%. For VasostrictAG, the company has seen reduction in market share from ~11.0% in Q2FY2023 to ~2.0% in Q4FY2023; however, it improved from ~0.9% in February 2023 to ~3.7% in March 2023. We believe gRevlimid will be the key product besides others, which can continue to drive profitable growth for the North American market over FY2023-FY2025E, while the product pipeline comprising complex generics and novel drug filings will support and drive higher profitable growth from FY2025E-FY2026E.

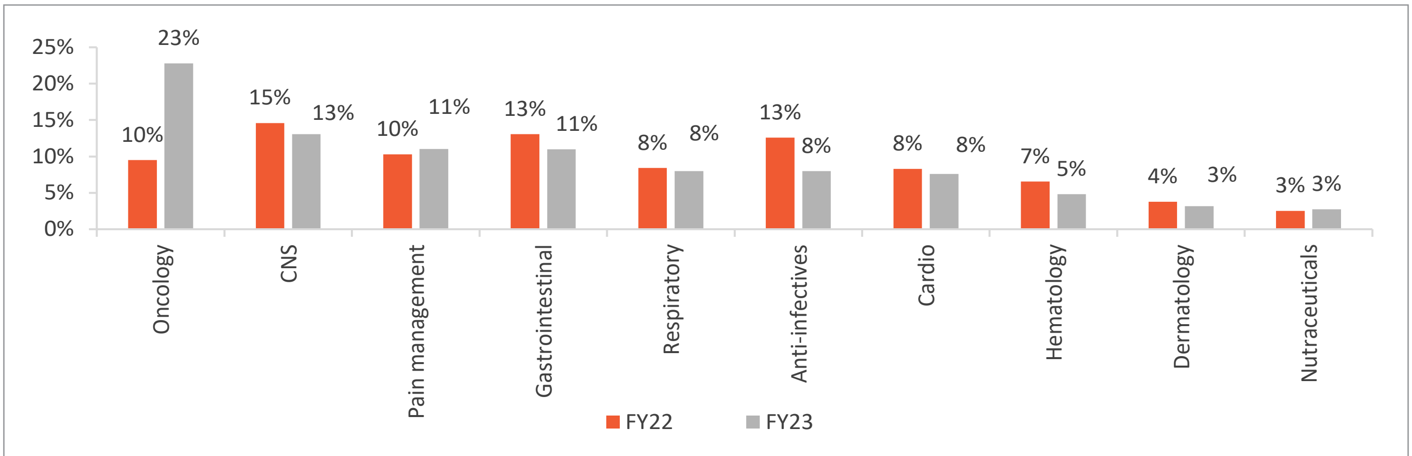
gRevlimid's Market share



Source: Company, Sharekhan Research

- **Unusual income from litigation settlement to boost earnings marginally in FY2024:** The company has received a one-time settlement income of CAD9 million (Rs. 56 crore) from Janssen Group in Q1FY2024E in relation to a litigation around an ANDS for a generic version of Zytiga (Abiraterone). We believe this coupled with foray into India trade generic business is expected to boost earnings estimates marginally for FY2024E and FY2025E by ~3%/~2%, respectively.
- **Strong FY2023 performance:** The company experienced ~46.4% y-o-y rise in adjusted net income to Rs. 4,083 crore, excluding unusual items related to gains from the sale of brands worth Rs. 494 crore and impairments worth Rs. 70 crore. Reported PAT increased by ~106.5% y-o-y to Rs. 4,507 crore for the year. This can be attributed to decent growth in the U.S. and Europe, which was driven by high-value product launches and traction in the base business. Additionally, cost-efficiency measures implemented during the year helped the company to enhance its profitability. Growth in U.S. revenue at ~35.8% y-o-y to Rs. 10,170 crore was driven by 25 new product launches, including Lenalidomide (gRevlimid), Sorafenib, and Pemetrexed Injection, partially offset by price erosion in key products such as Icosapent Ethyl Capsules (gVascepa) and Vasopressin (gVasostrict). Adjusted total revenue increased at ~14.4% y-o-y to Rs. 23,460 crore for FY2023. This was driven by a ~35.8% y-o-y rise in North America's revenue to Rs. 10,170 crore. As a result, the company's operating margin improved by ~390 bps y-o-y to ~25.3%. Gross margin expanded by ~340 bps y-o-y to ~68% and R&D spend and promotional expenses declined y-o-y as a percentage of revenue, which we believe is due to strong operating efficiencies.

Revenue share therapywise to Global Generics

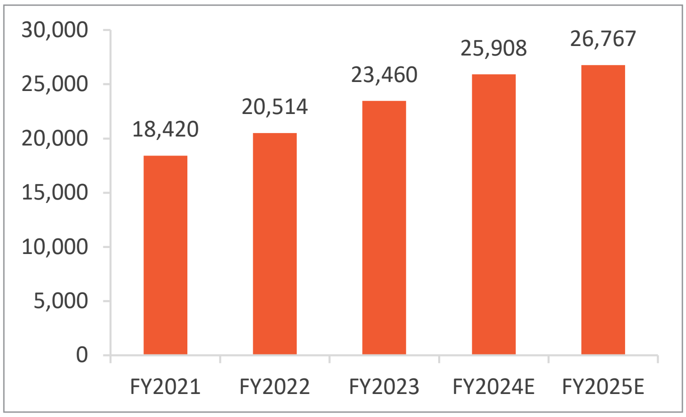


Source: Company, Sharekhan Research

- **Robust balance sheet to fuel its growth plans:** The company's debt to equity stood at a comfortable level of ~0.06x, while its cash balance, including short-term investments, stood at Rs. 6,180 crore as of FY2023. The company spent on enhancing capacity for multiple products at its API Srikakulam plant (SEZ) located at Andhra Pradesh, India, and incurred additional capex for enhancing its oncology formulations' injectables facility at Srikakulam Plant 11, Andhra Pradesh, India, which was established in FY2022. The company has capital work in progress worth Rs. 996 crore and capital investment commitment of Rs. 834 crore as of FY2023 for the expansion of its manufacturing and research facilities located in India and Mexico, which will be to enhance capacity of its formulation injectable facility at Srikakulam, Andhra Pradesh, India, and new capacity at its Biologics facility at Hyderabad, Telangana, India. The company believes it should be able to finance its expansion plans through internal accruals, while most of these plans are likely to be over by FY2024E and FY2025E, thereby paving way for stronger profitable growth over the medium to long term.

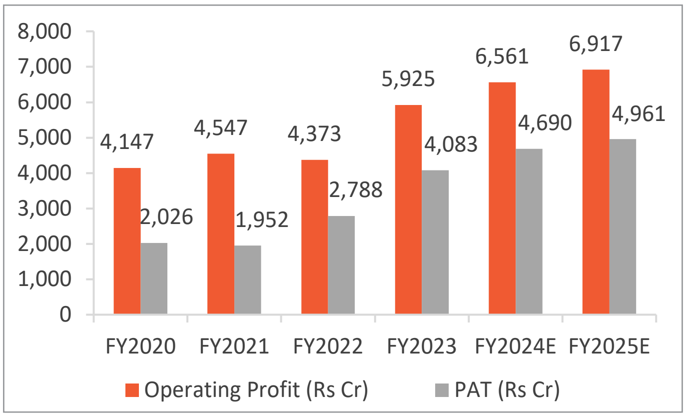
Financials in charts

Sales Trends Rs Cr



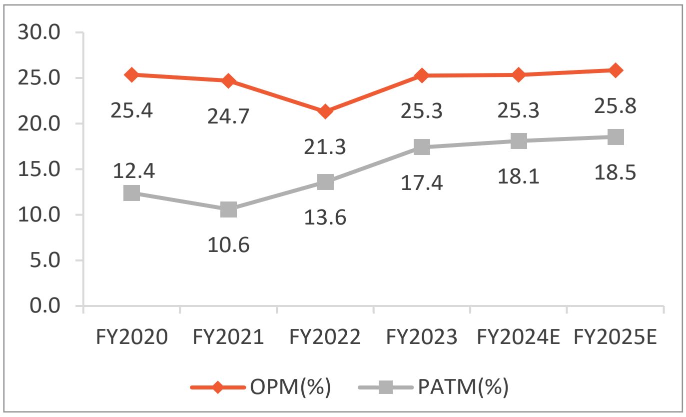
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



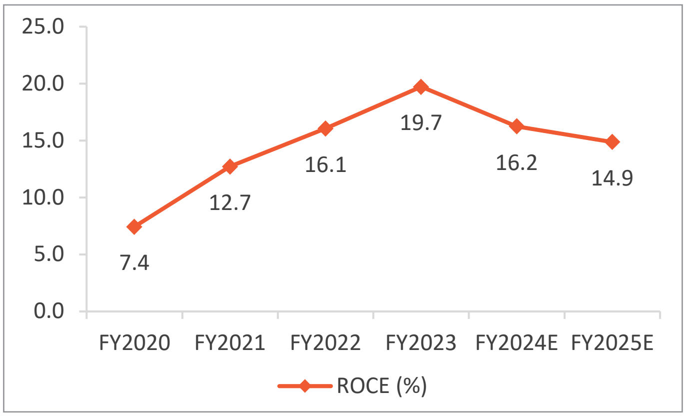
Source: Company, Sharekhan Research

Operating Margin - PAT Margins



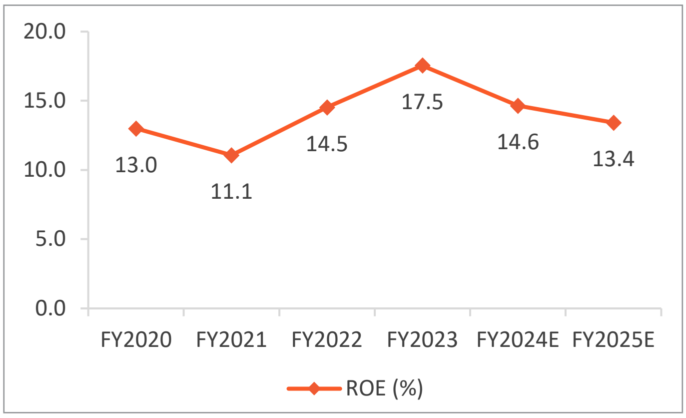
Source: Company, Sharekhan Research

ROCE (%)



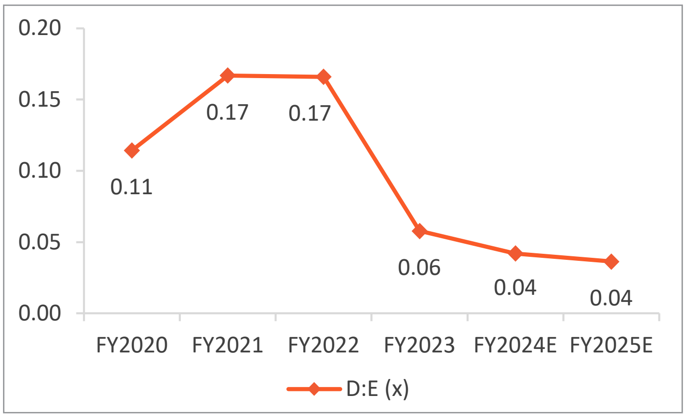
Source: Company, Sharekhan Research

Return ratios (ROE) to improve



Source: Company, Sharekhan Research

Debt : Equity (x)



Source: Company, Sharekhan Research

Outlook and Valuation

■ **Sector view - Regulatory concerns and pricing erosion prove a hurdle over the short to medium term**

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

■ **Company outlook - Inorganic growth opportunity drive growth**

DRL has a global presence, especially in the formulations segment. Globally, the company is present in most markets with the U.S. and India accounting for ~41% and ~20%, respectively, of overall sales. In addition, 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 strong geographical diversification, performance is expected to gather pace, backed by geographical expansion. A strong product pipeline in the U.S. generics and specialty business would fuel U.S. 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.

■ **Valuation - Upgrade to Buy with a revised PT of Rs. 5,963**

Dr. Reddy's FY2023 performance was one of the best in recent times, driven by the launch of gRevlimid, wherein it had 180 days' exclusivity for two strengths until the end of Q4FY23. Although the recent quarterly market share data for key existing products such as gRevlimid, gVascepa and gVasostrict point toward a marginally weak outlook for the North American market, we believe gRevlimid will continue to remain a key product until January 2026 and the acquisition of 45 prescription products from Mayne Pharma and 25-30 new and complex product launches including injectables will continue to drive North America's revenue at an ~8.2% CAGR over FY2023-FY2025E. The company's recent foray in the trade generics business in India and receipt of settlement income of CAD9 million or Rs. 56 crore in Q1FY2024 bode well for boosting earnings growth marginally to a ~10.2% CAGR from ~9.1% CAGR before over FY2023-FY2025E. The stock is trading at an attractive valuation level of ~18.4x/~17.4x its FY2024E/FY2025E revised EPS estimates, while offering strong ROE (~17.5%) and balance sheet for the underlying business. We, therefore, revise upwards the PT to Rs. 5,963 and upgrade the rating to BUY from Hold.

Peer Comparison

Companies	CMP (Rs/ Share)	O/S Shares (Crs)	MCAP (Rs Cr)	P/E (x)			EV / EBITDA (x)			RoE (%)		
				FY23	FY24E	FY25E	FY23	FY24E	FY25E	FY23	FY24E	FY25E
Dr Reddy's	5,188.0	16.6	86,362.9	21.1	18.4	17.4	11.0	9.4	9.1	17.5	14.6	13.4
Sun Pharma	1,048.8	239.9	2,51,642.3	28.7	27.0	24.5	21.8	19.9	17.4	14.8	14.1	14.0
Biocon	262.6	120.1	31,521.8	41.8	23.6	16.4	36.5	6.9	16.2	3.4	4.8	6.5

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 ~41% and 20%, 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.

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: BSE; Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp India	15.16
2	JP Morgan Chase	10.62
3	BlackRock Inc	2.65
4	First State Investments ICVC	2.51
5	Vanguard Group Inc.	2.28
6	ICICI Prudential Life Insurance	2.22
7	Republic of Singapore	1.86
8	NPS Trust UTI	1.80
9	Kuwait Investment Authority	1.66
10	Aditya Birla Sun Life AMC	1.47

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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