

ADD

TP: Rs 2,900 | ▲ 9%

DR REDDY'S LABS

| Pharmaceuticals

| 29 July 2019

Adj. EBITDA in line; upgrade to ADD on reasonable valuations

Q1 reported 18% EBITDA miss impacted by one-offs in gross margins (PSAI & inventory write-offs in US totaling US\$20mn, in my view), while adj. EBITDA was in line. Management expects PSAI weakness to reverse in coming quarters. Gross margins in the global generics rose 170bps QoQ (from lows of 55.9%), led by a better US and India mix. We roll over to a Sep'20 TP of Rs 2,900 (from Rs 2,800) and upgrade to ADD (from REDUCE) on reasonable valuations. DRRD continues to expect >30 launches in the US & cost savings in FY20.

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Upgrade to ADD: The stock has performed in line with our expectations since we initiated coverage in Nov'18 (REDUCE, TP Rs 2710). We now upgrade our rating based on stabilising US base business, nearing monetisation of key assets (gNuvaring: Q4FY20 / Copaxone: Q1FY21), and cost control in SGA. This together fuels a ~5% increase in FY21 EPS while we cut our FY20 estimate by 2% due to the risk of inventory write-off in the US. We roll over to a Sep'20 TP of Rs 2,900 and see reasonable upside in the stock. Early Srikakulam API resolution and gRevlimid & gVimovo launches are upside risks to our estimates.

Good scale-up in US sales; India grew 14% YoY: DRRD clocked US\$ 234mn in US sales, up 10% QoQ, led by Daptomycin injectable, Isotretinoin relaunch and Suboxone. The company's FY20 launch target of >30 ANDAs is on track with ramp-up likely in H2 led by gNuvaring. We expect gross margins to head up from Q2 with normalising PSAI sales and lower inventory write-offs vs. Q1.

Key earnings call takeaways: (1) R&D spend to stay within US\$ 250mn-300mn range. (2) gNuvaring – goal date due in coming weeks; expect additional queries from USFDA. (3) Srikakulam/CTO-6 reinspection expected soon. (4) Other income includes Revlimid settlement income of Rs 3.5bn. (5) DRRD has 10% market share in gSuboxone.

KEY FINANCIALS

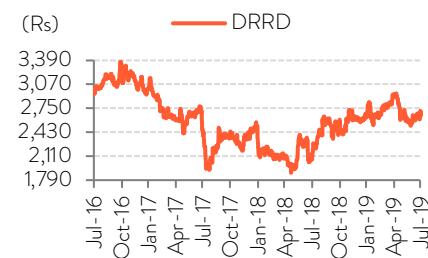
| Y/E 31 Mar | FY18A | FY19A | FY20E | FY21E | FY22E |
|-------------------------|--------|--------|--------|--------|--------|
| Adj. net profit (Rs mn) | 9,404 | 17,895 | 21,010 | 25,171 | 27,249 |
| Adj. EPS (Rs) | 56.7 | 107.8 | 126.6 | 151.6 | 164.2 |
| Adj. EPS growth (%) | (20.1) | 90.3 | 17.4 | 19.8 | 8.3 |
| Adj. ROAE (%) | 7.7 | 13.8 | 14.3 | 15.0 | 14.4 |
| Adj. P/E (x) | 46.8 | 24.6 | 21.0 | 17.5 | 16.2 |
| EV/EBITDA (x) | 20.6 | 15.0 | 12.0 | 10.5 | 9.5 |

Source: Company, BOBCAPS Research

| | |
|------------------|-------------------|
| Ticker/Price | DRRD IN/Rs 2,654 |
| Market cap | US\$ 6.4bn |
| Shares o/s | 166mn |
| 3M ADV | US\$ 25.9mn |
| 52wk high/low | Rs 2,964/Rs 1,873 |
| Promoter/FPI/DII | 27%/27%/18% |

Source: NSE

STOCK PERFORMANCE



Source: NSE



FIG 1 – QUARTERLY PERFORMANCE

| (Rs mn) | Q1FY20 | Q1FY19 | YoY (%) | Q4FY19 | QoQ (%) | Q1FY20E | Var (%) |
|-------------------------|---------------|---------------|--------------|---------------|---------------|---------------|---------------|
| Net Sales | 38,435 | 37,207 | 3.3 | 40,166 | (4.3) | 40,385 | (4.8) |
| EBITDA | 7,267 | 7,575 | (4.1) | 8,198 | (11.4) | 8,817 | (17.6) |
| Depreciation | 3,082 | 3,110 | - | 3,183 | - | 3,325 | - |
| EBIT | 4,185 | 4,465 | (6.3) | 5,015 | (16.6) | 5,492 | - |
| Interest | (393) | (156) | - | (349) | - | (100) | - |
| Other Income | 3,759 | 303 | - | 330 | - | 400 | - |
| PBT | 8,337 | 4,924 | 69.3 | 5,694 | 46.4 | 5,992 | 39.1 |
| Less: Taxation | 1,872 | 446 | - | 1,507 | - | 1,378 | - |
| Less: Minority Interest | (163) | (83) | - | (157) | - | 0 | - |
| Recurring PAT | 6,628 | 4,561 | 45.3 | 4,344 | 52.6 | 4,614 | 43.6 |
| Exceptional items | 0 | 0 | - | 0 | - | 0 | - |
| Reported PAT | 6,628 | 4,561 | 45.3 | 4,344 | 52.6 | 4,614 | 43.6 |
| Key Ratios (%) | | | | | | | |
| Gross Margin | 51.7 | 55.7 | - | 52.4 | - | 54.0 | - |
| EBITDA Margin | 18.9 | 20.4 | - | 20.4 | - | 21.8 | - |
| Tax / PBT | 22.5 | 9.1 | - | 26.5 | - | 23.0 | - |
| NPM | 17.2 | 12.3 | - | 10.8 | - | 11.4 | - |
| EPS (Rs) | 38.9 | 26.8 | - | 25.5 | - | 27.1 | - |

Source: Company, BOBCAPS Research

FIG 2 – REVENUE MIX

| (Rs mn) | Q1FY20 | Q1FY19 | YoY (%) | Q4FY19 | QoQ (%) | Q1FY20E | Var (%) |
|----------------------|---------------|---------------|------------|---------------|--------------|---------------|--------------|
| Global generics | 32,982 | 30,643 | 7.6 | 30,384 | 8.6 | 32,880 | 0.3 |
| North America | 16,322 | 15,903 | 2.6 | 14,957 | 9.1 | 16,617 | (1.8) |
| Europe | 2,404 | 2,016 | 19.2 | 1,912 | 25.7 | 2,076 | 15.8 |
| India | 6,960 | 6,074 | 14.6 | 6,505 | 7.0 | 6,505 | 7.0 |
| ROW | 7,296 | 6,650 | 9.7 | 7,010 | 4.1 | 7,682 | (5.0) |
| PSAI | 4,539 | 5,409 | (16.1) | 6,765 | (32.9) | 5,950 | (23.7) |
| Proprietary Products | 102 | 462 | (77.9) | 323 | (68.4) | 554 | (81.6) |
| Others | 812 | 700 | 16.0 | 2,694 | (69.9) | 1,000 | (18.8) |
| Net Sales | 38,435 | 37,214 | 3.3 | 40,166 | (4.3) | 40,385 | (4.8) |

Source: Company, BOBCAPS Research

Valuation methodology

DRRD has undergone 9-10 months of time correction since our initiation of Nov'18 (REDUCE, TP Rs 2710) and is trading at reasonable valuations of 21x FY20E/17.5x FY21E EPS. Given this and nearing monetisation of key assets (gNuvaring: Q4FY20 / Copaxone: Q1FY21), reduction in proprietary business losses by US\$ 25mn annually with the recent divestments in five derma products, and cost control in SGA (which grew 3% in the last three years), we think the stocks offers reasonable upside although the risk-reward will be more favourable at ~Rs 2,500 levels. Upgrade from REDUCE to ADD.

We increase our FY21 EPS estimate by 5% while cutting FY20 EPS by 2% due to possible risk of inventory write-off in the US, as highlighted by management during the Q1 call. Our revised core EPS for FY20 and FY21 stands at Rs 127 and Rs 152 respectively.

We roll forward to a Sep'20 target price of Rs 2,900 based on 11x EV/EBITDA (18.5x implied P/E) and see reasonable upside in the stock. Early Srikakulam API resolution, gRevlimid & gVimovo launches, and further cost saving in SGA are upside risks to our estimates.

FIG 3 – REVISED ESTIMATES

| (Rs mn) | Revised | | Old | | Change (%) | |
|-------------------|---------|---------|---------|---------|------------|-------|
| | FY20E | FY21E | FY20E | FY21E | FY20E | FY21E |
| Sales | 173,191 | 193,428 | 179,905 | 196,172 | (3.7) | (1.4) |
| EBITDA | 37,832 | 42,615 | 38,972 | 41,710 | (2.9) | 2.2 |
| EBITDA margin (%) | 21.8 | 22.0 | 21.7 | 21.3 | 18bps | 77bps |
| EPS (Rs) | 127 | 152 | 129 | 145 | (1.7) | 4.9 |

Source: Company, BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

- **US approval delays:** Delays in niche product opportunities (gCopaxone, gNuvaring, gRevlimid)
- **Weakness in EM currencies**
- **Import alert risk:** Escalation of the import alert risk at API site (Srikakulam)

FINANCIALS

Income Statement

| Y/E 31 Mar (Rs mn) | FY18A | FY19A | FY20E | FY21E | FY22E |
|--------------------------------|----------------|----------------|----------------|----------------|----------------|
| Total revenue | 142,028 | 153,852 | 173,191 | 193,428 | 206,818 |
| EBITDA | 22,869 | 31,333 | 37,832 | 42,615 | 45,101 |
| EBIT | 11,129 | 18,934 | 25,072 | 29,075 | 30,781 |
| Net interest income/(expenses) | (788) | (889) | (960) | (960) | (960) |
| Other income/(expenses) | 3,598 | 3,498 | 3,173 | 4,575 | 5,567 |
| Exceptional items | 0 | 0 | 0 | 0 | 0 |
| EBT | 13,939 | 21,543 | 27,286 | 32,690 | 35,388 |
| Income taxes | 4,535 | 3,648 | 6,276 | 7,519 | 8,139 |
| Extraordinary items | 402 | 901 | 3,500 | 0 | 0 |
| Min. int./Inc. from associates | 0 | 0 | 0 | 0 | 0 |
| Reported net profit | 9,806 | 18,796 | 24,510 | 25,171 | 27,249 |
| Adjustments | 402 | 901 | 3,500 | 0 | 0 |
| Adjusted net profit | 9,404 | 17,895 | 21,010 | 25,171 | 27,249 |

Balance Sheet

| Y/E 31 Mar (Rs mn) | FY18A | FY19A | FY20E | FY21E | FY22E |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|
| Accounts payables | 16,052 | 14,553 | 16,607 | 18,548 | 19,832 |
| Other current liabilities | 26,248 | 27,219 | 31,174 | 34,817 | 37,227 |
| Provisions | 3,785 | 4,218 | 4,748 | 5,303 | 5,670 |
| Debt funds | 50,555 | 38,381 | 38,381 | 38,381 | 38,381 |
| Other liabilities | 0 | 0 | 0 | 0 | 0 |
| Equity capital | 830 | 830 | 830 | 830 | 830 |
| Reserves & surplus | 122,704 | 135,764 | 156,124 | 177,145 | 200,244 |
| Shareholders' fund | 123,534 | 136,594 | 156,954 | 177,975 | 201,074 |
| Total liabilities and equities | 220,174 | 220,965 | 247,865 | 275,024 | 302,184 |
| Cash and cash eq. | 2,638 | 2,228 | 10,409 | 27,706 | 50,944 |
| Accounts receivables | 40,617 | 39,869 | 47,450 | 52,994 | 56,662 |
| Inventories | 29,089 | 33,579 | 35,587 | 39,746 | 42,497 |
| Other current assets | 18,368 | 17,061 | 27,711 | 30,949 | 33,091 |
| Investments | 22,983 | 25,871 | 25,871 | 25,871 | 25,871 |
| Net fixed assets | 49,941 | 49,363 | 48,603 | 47,064 | 44,744 |
| CWIP | 7,928 | 4,725 | 4,725 | 4,725 | 4,725 |
| Intangible assets | 48,610 | 48,269 | 47,509 | 45,970 | 43,650 |
| Deferred tax assets, net | 0 | 0 | 0 | 0 | 0 |
| Other assets | 0 | 0 | 0 | 0 | 0 |
| Total assets | 220,174 | 220,965 | 247,865 | 275,024 | 302,184 |

Source: Company, BOBCAPS Research

Cash Flows

| Y/E 31 Mar (Rs mn) | FY18A | FY19A | FY20E | FY21E | FY22E |
|-------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Net income + Depreciation | 21,546 | 31,195 | 37,270 | 38,711 | 41,569 |
| Interest expenses | 788 | 889 | 960 | 960 | 960 |
| Non-cash adjustments | 0 | 0 | 0 | 0 | 0 |
| Changes in working capital | (4,407) | (2,530) | (13,698) | (6,803) | (4,501) |
| Other operating cash flows | 0 | 0 | 0 | 0 | 0 |
| Cash flow from operations | 17,927 | 29,554 | 24,531 | 32,868 | 38,028 |
| Capital expenditures | (13,167) | (4,574) | (12,000) | (12,000) | (12,000) |
| Change in investments | (1,873) | (2,888) | 0 | 0 | 0 |
| Other investing cash flows | 0 | 0 | 0 | 0 | 0 |
| Cash flow from investing | (15,040) | (7,462) | (12,000) | (12,000) | (12,000) |
| Equities issued/Others | 1 | 0 | 0 | 0 | 0 |
| Debt raised/repaid | 1,567 | (12,174) | 0 | 0 | 0 |
| Interest expenses | (788) | (889) | (960) | (960) | (960) |
| Dividends paid | (3,992) | (4,150) | (4,150) | (4,150) | (4,150) |
| Other financing cash flows | (903) | (5,289) | 760 | 1,540 | 2,320 |
| Cash flow from financing | (4,115) | (22,502) | (4,350) | (3,570) | (2,790) |
| Changes in cash and cash eq. | (1,228) | (410) | 8,181 | 17,298 | 23,238 |
| Closing cash and cash eq. | 2,638 | 2,228 | 10,409 | 27,706 | 50,944 |

Per Share

| Y/E 31 Mar (Rs) | FY18A | FY19A | FY20E | FY21E | FY22E |
|----------------------|-------|-------|-------|---------|---------|
| Reported EPS | 59.1 | 113.2 | 147.7 | 151.6 | 164.2 |
| Adjusted EPS | 56.7 | 107.8 | 126.6 | 151.6 | 164.2 |
| Dividend per share | 20.0 | 25.0 | 25.0 | 25.0 | 25.0 |
| Book value per share | 744.2 | 822.9 | 945.5 | 1,072.1 | 1,211.3 |

Valuations Ratios

| Y/E 31 Mar (x) | FY18A | FY19A | FY20E | FY21E | FY22E |
|----------------|-------|-------|-------|-------|-------|
| EV/Sales | 3.3 | 3.1 | 2.6 | 2.3 | 2.1 |
| EV/EBITDA | 20.6 | 15.0 | 12.0 | 10.5 | 9.5 |
| Adjusted P/E | 46.8 | 24.6 | 21.0 | 17.5 | 16.2 |
| P/BV | 3.6 | 3.2 | 2.8 | 2.5 | 2.2 |

DuPont Analysis

| Y/E 31 Mar (%) | FY18A | FY19A | FY20E | FY21E | FY22E |
|---------------------------------|-------|-------|-------|-------|-------|
| Tax burden (Net profit/PBT) | 67.5 | 83.1 | 77.0 | 77.0 | 77.0 |
| Interest burden (PBT/EBIT) | 125.2 | 113.8 | 108.8 | 112.4 | 115.0 |
| EBIT margin (EBIT/Revenue) | 7.8 | 12.3 | 14.5 | 15.0 | 14.9 |
| Asset turnover (Revenue/Avg TA) | 20.7 | 22.0 | 23.4 | 23.5 | 22.7 |
| Leverage (Avg TA/Avg Equity) | 1.4 | 1.3 | 1.3 | 1.2 | 1.2 |
| Adjusted ROAE | 7.7 | 13.8 | 14.3 | 15.0 | 14.4 |

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

| Y/E 31 Mar | FY18A | FY19A | FY20E | FY21E | FY22E |
|--|--------|-------|-------|-------|-------|
| YoY growth (%) | | | | | |
| Revenue | 0.9 | 8.3 | 12.6 | 11.7 | 6.9 |
| EBITDA | (5.3) | 37.0 | 20.7 | 12.6 | 5.8 |
| Adjusted EPS | (20.1) | 90.3 | 17.4 | 19.8 | 8.3 |
| Profitability & Return ratios (%) | | | | | |
| EBITDA margin | 16.1 | 20.4 | 21.8 | 22.0 | 21.8 |
| EBIT margin | 7.8 | 12.3 | 14.5 | 15.0 | 14.9 |
| Adjusted profit margin | 6.6 | 11.6 | 12.1 | 13.0 | 13.2 |
| Adjusted ROAE | 7.7 | 13.8 | 14.3 | 15.0 | 14.4 |
| ROCE | 8.6 | 12.9 | 15.3 | 16.3 | 15.9 |
| Working capital days (days) | | | | | |
| Receivables | 104 | 95 | 100 | 100 | 100 |
| Inventory | 75 | 80 | 75 | 75 | 75 |
| Payables | 41 | 35 | 35 | 35 | 35 |
| Ratios (x) | | | | | |
| Gross asset turnover | 0.8 | 0.8 | 0.9 | 0.9 | 0.9 |
| Current ratio | 2.0 | 2.0 | 2.3 | 2.6 | 2.9 |
| Net interest coverage ratio | 14.1 | 21.3 | 26.1 | 30.3 | 32.1 |
| Adjusted debt/equity | 0.3 | 0.1 | 0.1 | 0.1 | 0.1 |

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: DR REDDY'S LABS (DRRD IN)



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