

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.

Vivek Kumar

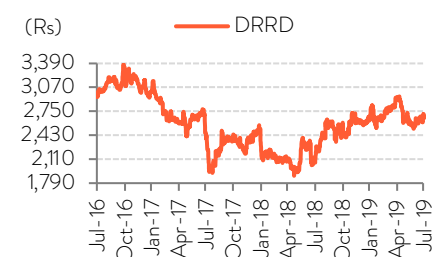
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Upgrade to ADD: The stock has performed in line with our expectations since we initiated coverage in Nov'18 (REDUCE, TP Rs 2710). We now upgrade our rating based on stabilising US base business, nearing monetisation of key assets (gNuvaring: Q4FY20 / 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.

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

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

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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.

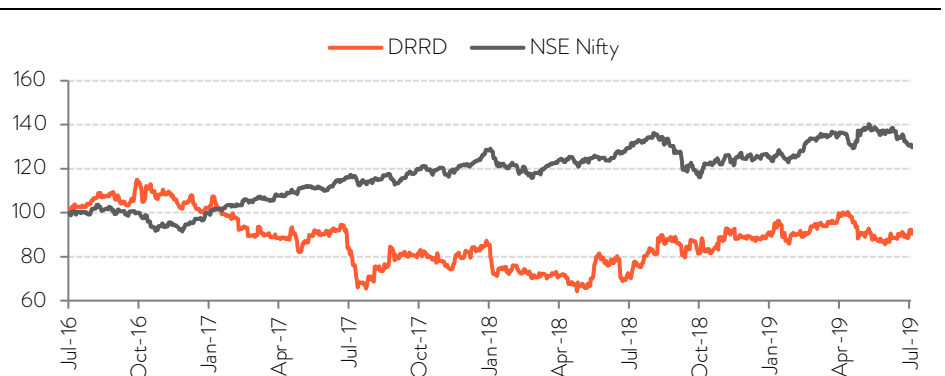
We roll forward to a Sep'20 target price of Rs 2,900 based on 11x EV/EBITDA (18.5x implied P/E) and see reasonable upside in the stock. Early Srikakulam API resolution, gRevlimid & gVimovo launches, and further cost saving in SGA are upside risks to our estimates.

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

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Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

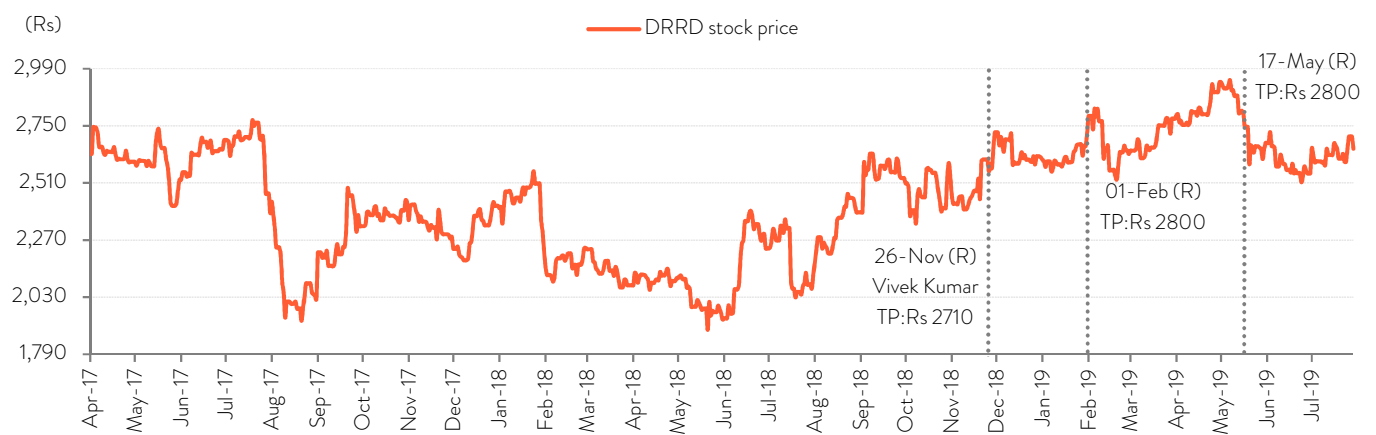
ADD – Expected return from >+5% to +15%

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)



B – Buy, A – Add, R – Reduce, S – Sell

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