

**ADD**

TP: Rs 2,960 | ▲ 7%

**DR REDDY'S LABS**

Pharmaceuticals

01 November 2019

## Multiple one-offs – US to recover from Q3

**Q2 headline EBITDA of Rs 14bn (Rs 8.5bn est.) had multiple one-time impacts: (1) licensing income of Rs 6.84bn net of cost, (2) sales hit in the US (\$10mn-15mn in our view) from Ranitidine recall & logistic issues, and (3) Rs 1bn in SG&A. Adj. EBITDA was a 3% miss. The 13% QoQ drop in US sales is transitional and should reverse from Q3. India growth at 9.4% YoY was lower than expected and ROW in line. Impairment charge of Rs 3.5bn and tax benefit of Rs 5.2bn were other one-offs driving PAT. Retain TP of Rs 2,960 on reasonable valuations.**

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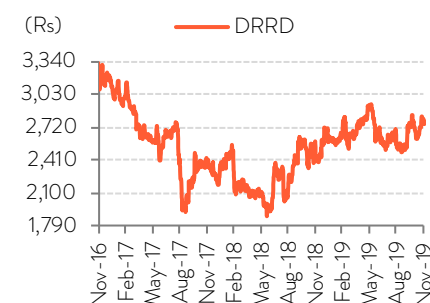
**US weak; expect recovery in Q3:** US sales fell 13% QoQ to US\$ 204mn. Ranitidine and base price erosion had a lower impact than disruption from logistic issues, and hence is transitional. Excluding this, US business was a tad lower than the Q1 base. Contribution in H2 should be higher (vs. H1 US\$ 437mn) given Dr Reddy's (DRRD) has planned +16 launches and benefits from gVigabatrin, Carboprost and Pregabalin should reflect (launched in late Jul'19).

Ticker/Price	DRRD IN/Rs 2,757
Market cap	US\$ 6.5bn
Shares o/s	166mn
3M ADV	US\$ 23.5mn
52wk high/low	Rs 2,964/Rs 1,873
Promoter/FPI/DII	27%/27%/18%

Source: NSE

**Cost control continues:** Core EBITDA margin was stable QoQ at 19% as the tight leash on expenses continues. Opex (staff, R&D, SG&A) was flat YoY and down 2% for H1. DRRD has guided for lower R&D in the US\$ 200mn-240mn range for FY20 (vs. US\$ 250mn+). We expect 22% margins in H2 as US launches deliver and PSAI margins hold steady. Core EPS for Q2/H1 is Rs 24/ Rs 46. We retain FY21/FY22 EPS factoring NuvaRing and Copaxone launches. Srikakulam API resolution, gRevlimid & gVimovo launches are upside risks.

## STOCK PERFORMANCE



Source: NSE

**Earnings call takeaways:** (1) Rs 3.5bn impairment charge relates to intangibles on 3 products: Ramelteon, Tobramycin, Imiquimod. (2) gNuvaring/Copaxone expect to submit response on CRL in the near term. (3) Srikakulam/CTO-6 reinspection expected soon. (4) Logistics disruption fixed; products already shipped in Oct'19.

## KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	142,028	153,852	176,350	192,842	204,855
EBITDA (Rs mn)	22,869	31,333	40,740	42,437	44,388
Adj. net profit (Rs mn)	9,404	17,895	23,531	25,326	27,277
Adj. EPS (Rs)	56.7	107.8	141.8	152.6	164.3
Adj. EPS growth (%)	(20.1)	90.3	31.5	7.6	7.7
Adj. ROAE (%)	7.7	13.8	15.6	14.5	13.8
Adj. P/E (x)	48.7	25.6	19.4	18.1	16.8
EV/EBITDA (x)	21.4	15.5	11.6	10.8	9.9

Source: Company, BOBCAPS Research

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**FIG 1 – QUARTERLY PERFORMANCE**

(Rs mn)	Q2FY20	Q2FY19	YoY (%)	Q1FY20	QoQ (%)	Q2FY20E	Var (%)
<b>Net Sales</b>	<b>48,009</b>	<b>37,978</b>	<b>26.4</b>	<b>38,435</b>	<b>24.9</b>	<b>43,216</b>	<b>11.1</b>
<b>EBITDA</b>	<b>14,080</b>	<b>7,403</b>	<b>90.2</b>	<b>7,267</b>	<b>93.8</b>	<b>8,488</b>	<b>65.9</b>
Depreciation	3,339	2,998	-	3,082	-	3,082	-
<b>EBIT</b>	<b>10,741</b>	<b>4,405</b>	<b>143.8</b>	<b>4,185</b>	<b>156.7</b>	<b>5,406</b>	<b>-</b>
Interest	(231)	(625)	-	(393)	-	(100)	-
Other Income	135	641	-	3,759	-	400	-
<b>PBT</b>	<b>11,107</b>	<b>5,671</b>	<b>95.9</b>	<b>8,337</b>	<b>33.2</b>	<b>5,906</b>	<b>88.1</b>
Less: Taxation	(3,261)	742	-	1,872	-	1,358	-
Less: Minority Interest	(117)	(109)	-	(163)	-	0	-
<b>Recurring PAT</b>	<b>14,485</b>	<b>5,038</b>	<b>187.5</b>	<b>6,628</b>	<b>118.5</b>	<b>4,548</b>	<b>218.5</b>
Exceptional items	(3,560)	0	-	0	-	0	-
<b>Reported PAT</b>	<b>10,925</b>	<b>5,038</b>	<b>116.9</b>	<b>6,628</b>	<b>64.8</b>	<b>4,548</b>	<b>140.2</b>
<b>Key Ratios (%)</b>							
Gross Margin	57.5	55.0	-	51.7	-	52.0	-
EBITDA Margin	29.3	19.5	-	18.9	-	19.6	-
Tax / PBT	(29.4)	13.1	-	22.5	-	23.0	-
NPM	30.2	13.3	-	17.2	-	10.5	-
<b>EPS (Rs)</b>	<b>85.0</b>	<b>29.6</b>	<b>-</b>	<b>38.9</b>	<b>-</b>	<b>26.7</b>	<b>-</b>

Source: Company, BOBCAPS Research

**FIG 2 – REVENUE MIX**

(Rs mn)	Q2FY20	Q2FY19	YoY (%)	Q1FY20	QoQ (%)	Q2FY20E	Var (%)
Global generics	32,816	30,536	7.5	32,982	(0.5)	35,022	(6.3)
North America	14,265	14,265	0.0	16,322	(12.6)	16,590	(14.0)
Europe	2,764	1,915	44.3	2,404	15.0	1,972	40.1
India	7,511	6,864	9.4	6,960	7.9	8,004	(6.2)
ROW	8,276	7,492	10.5	7,296	13.4	8,456	(2.1)
PSAI	7,107	6,029	17.9	4,539	56.6	6,632	7.2
Proprietary Products	60	301	(80.1)	102	(41.2)	361	(83.4)
Others	8,026	1,112	621.8	812	888.4	1,200	568.8
<b>Net Sales</b>	<b>48,009</b>	<b>37,978</b>	<b>26.4</b>	<b>38,435</b>	<b>24.9</b>	<b>43,216</b>	<b>11.1</b>

Source: Company, BOBCAPS Research

## Valuation methodology

DRRD is trading at reasonable valuations of 17.8x FY21E EPS. With the nearing monetisation of key assets (gNuvaring and Copaxone in Q1FY21), reduction in proprietary business losses, and cost control in SG&A (which has increased 3% in the last three years), we think the stocks offers reasonable upside although the risk-reward will be more favourable at Rs 2,500-2,600 levels.

We increase our FY20 EPS estimate by 12% to factor in one-time licensing income of US\$ 70mn, while retaining FY21/FY22 estimates given management commentary of a recovery in US business from Q3 onwards. Our revised EPS for FY20/FY21/FY22 stands at Rs 142/Rs 153/Rs 164. We expect a 15% CAGR on core EPS over FY20-FY22.

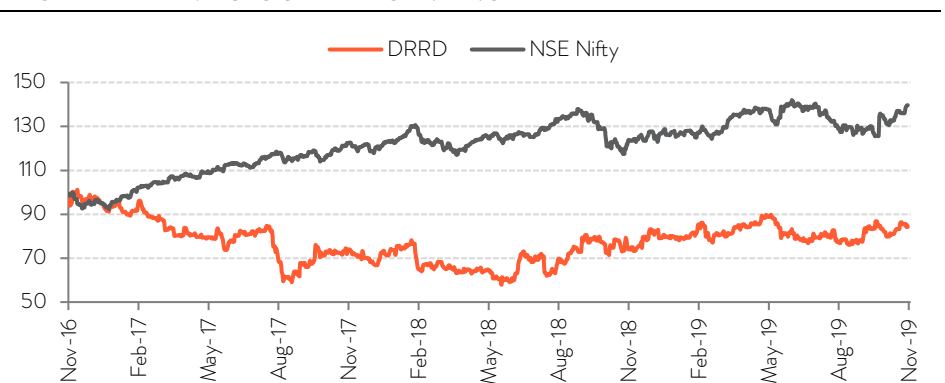
We retain our Sep'20 target price of Rs 2,960 based on 11x EV/EBITDA (18.5x implied P/E) and see reasonable upside in the stock. Early Srikakulam API resolution, gRevlimid & gVimovo launches, and further cost saving in SG&A are upside risks to our estimates.

**FIG 3 – REVISED ESTIMATES**

(Rs bn)	New			Old			Change (%)		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Sales	176.4	192.8	204.9	173.2	193.4	206.8	1.8	(0.3)	(0.9)
EBITDA	40.7	42.4	44.4	37.8	42.6	45.1	7.7	(0.4)	(1.6)
EBITDA margin (%)	23.1	22.0	21.7	21.8	22.0	21.8	130bps	1bps	(14bps)
EPS (Rs)	142	153	164	127	152	164	11.6	0.6	0.1

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
<b>Total revenue</b>	<b>142,028</b>	<b>153,852</b>	<b>176,350</b>	<b>192,842</b>	<b>204,855</b>
EBITDA	22,869	31,333	40,740	42,437	44,388
Depreciation	11,740	12,399	12,760	13,540	14,320
EBIT	11,129	18,934	27,980	28,898	30,069
Net interest income/(expenses)	(788)	(889)	(960)	(960)	(960)
Other income/(expenses)	3,598	3,498	3,539	5,385	6,315
Exceptional items	0	0	0	0	0
EBT	13,939	21,543	30,560	33,323	35,425
Income taxes	4,535	3,648	7,029	7,998	8,148
Extraordinary items	402	901	8,700	0	0
Min. int./Inc. from associates	0	0	0	0	0
<b>Reported net profit</b>	<b>9,806</b>	<b>18,796</b>	<b>32,231</b>	<b>25,326</b>	<b>27,277</b>
Adjustments	402	901	8,700	0	0
<b>Adjusted net profit</b>	<b>9,404</b>	<b>17,895</b>	<b>23,531</b>	<b>25,326</b>	<b>27,277</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	16,052	14,553	16,910	18,492	19,644
Other current liabilities	26,248	27,219	31,743	34,712	36,874
Provisions	3,785	4,218	4,835	5,287	5,616
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	163,845	185,021	208,148
Shareholders' fund	123,534	136,594	164,675	185,851	208,978
<b>Total liabilities and equities</b>	<b>220,174</b>	<b>220,965</b>	<b>256,545</b>	<b>282,722</b>	<b>309,493</b>
Cash and cash eq.	2,638	2,228	17,068	35,779	59,507
Accounts receivables	40,617	39,869	48,315	52,833	56,125
Inventories	29,089	33,579	36,236	39,625	42,093
Other current assets	18,368	17,061	28,216	30,855	32,777
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
<b>Total assets</b>	<b>220,174</b>	<b>220,965</b>	<b>256,545</b>	<b>282,722</b>	<b>309,493</b>

Source: Company, BOBCAPS Research

**Cash Flows**

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	21,546	31,195	44,991	38,865	41,596
Interest expenses	788	889	960	960	960
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(4,407)	(2,530)	(14,760)	(5,544)	(4,038)
Other operating cash flows	0	0	0	0	0
<b>Cash flow from operations</b>	<b>17,927</b>	<b>29,554</b>	<b>31,190</b>	<b>34,281</b>	<b>38,518</b>
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
<b>Cash flow from investing</b>	<b>(15,040)</b>	<b>(7,462)</b>	<b>(12,000)</b>	<b>(12,000)</b>	<b>(12,000)</b>
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
<b>Cash flow from financing</b>	<b>(4,115)</b>	<b>(22,502)</b>	<b>(4,350)</b>	<b>(3,570)</b>	<b>(2,790)</b>
<b>Changes in cash and cash eq.</b>	<b>(1,228)</b>	<b>(410)</b>	<b>14,840</b>	<b>18,711</b>	<b>23,728</b>
<b>Closing cash and cash eq.</b>	<b>2,638</b>	<b>2,228</b>	<b>17,068</b>	<b>35,779</b>	<b>59,507</b>

**Per Share**

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	59.1	113.2	194.2	152.6	164.3
Adjusted EPS	56.7	107.8	141.8	152.6	164.3
Dividend per share	20.0	25.0	25.0	25.0	25.0
Book value per share	744.2	822.9	992.0	1,119.6	1,258.9

**Valuations Ratios**

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	3.4	3.2	2.7	2.4	2.1
EV/EBITDA	21.4	15.5	11.6	10.8	9.9
Adjusted P/E	48.7	25.6	19.4	18.1	16.8
P/BV	3.7	3.4	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	76.0	77.0
Interest burden (PBT/EBIT)	125.2	113.8	109.2	115.3	117.8
EBIT margin (EBIT/Revenue)	7.8	12.3	15.9	15.0	14.7
Asset turnover (Revenue/Avg TA)	20.7	22.0	23.3	22.6	21.7
Leverage (Avg TA/Avg Equity)	1.4	1.3	1.3	1.2	1.2
Adjusted ROAE	7.7	13.8	15.6	14.5	13.8

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

**Ratio Analysis**

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
<b>YoY growth (%)</b>					
Revenue	0.9	8.3	14.6	9.4	6.2
EBITDA	(5.3)	37.0	30.0	4.2	4.6
Adjusted EPS	(20.1)	90.3	31.5	7.6	7.7
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	16.1	20.4	23.1	22.0	21.7
EBIT margin	7.8	12.3	15.9	15.0	14.7
Adjusted profit margin	6.6	11.6	13.3	13.1	13.3
Adjusted ROAE	7.7	13.8	15.6	14.5	13.8
ROCE	8.6	12.9	16.7	16.0	15.4
<b>Working capital days (days)</b>					
Receivables	104	95	100	100	100
Inventory	75	80	75	75	75
Payables	41	35	35	35	35
<b>Ratios (x)</b>					
Gross asset turnover	0.8	0.8	0.9	0.9	0.9
Current ratio	2.0	2.0	2.4	2.7	3.1
Net interest coverage ratio	14.1	21.3	29.2	30.1	31.3
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%

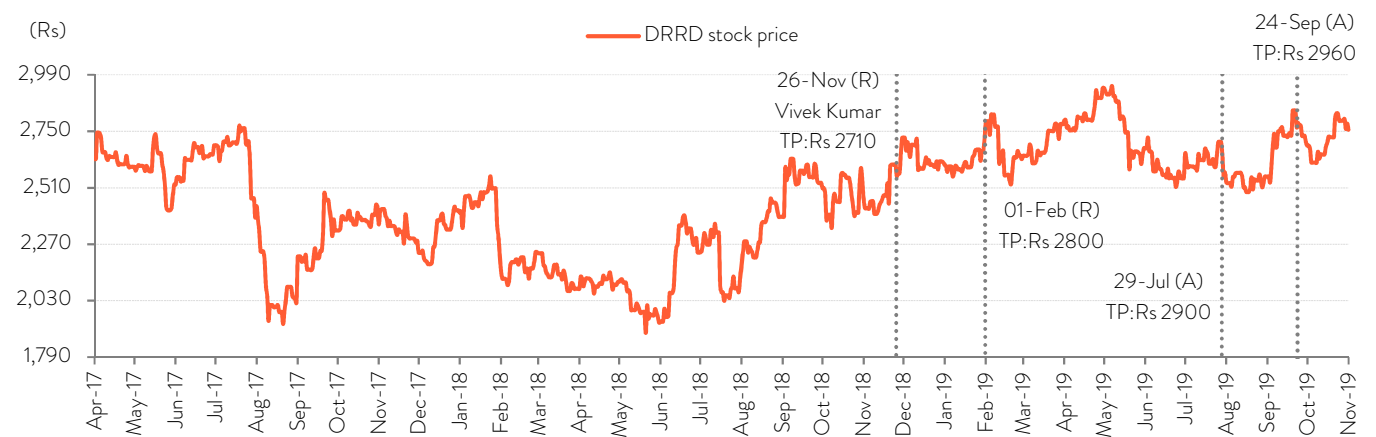
**ADD** – Expected return from >+5% to +15%

**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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