

ADD

TP: Rs 3,350 | ▲ 5%

DR REDDY'S LABS

Pharmaceuticals

27 January 2020

Margin beat to sustain; TP raised to Rs 3,350

Strong cost control and operating leverage led to a Q3 EBITDA beat of 5%. Dr Reddy's (DDRD) maintained growth momentum across India (up 13% YoY), Russia (20%), CIS (29%) and ROW (11%) markets, while Europe (52%) surprised positively. Sustained cost savings are driving the surprise, per management, leading to a 3-13% increase in our FY21/FY22 EPS. Reported loss of Rs 5.7bn was fueled by an impairment charge of Rs 13.2bn. DRRD continues to target 25% margins and ROCE in coming years. We retain ADD; TP raised to Rs 3,350 (vs. Rs 2,960).

Vivek Kumar
 research@bobcaps.in

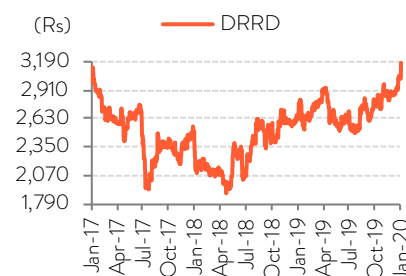
US miss and US\$ 156mn impairment charge on gNuvaring: US revenue was 5% below estimates at US\$ 225mn (up 10% QoQ led by deferred sales from Q2). DRRD launched 22 products in 9M and is on track for 30 launches in FY20 – management commented that while price erosion persists, the product mix has turned healthy. We expect US sales of US\$ 1.1bn by FY22 (10% CAGR over FY20, 5% ex-Copaxone, Nuvaring). DRRD has taken a US\$ 156mn charge on gNuvaring (83% of acquisition cost) due to generic competition, implying sharp reduction in FY21/FY22 amortisation cost (at least by Rs 7/sh p.a).

Ticker/Price	DDRD IN/Rs 3,189
Market cap	US\$ 7.4bn
Shares o/s	166mn
3M ADV	US\$ 25.2mn
52wk high/low	Rs 3,209/Rs 1,873
Promoter/FPI/DII	27%/27%/18%

Source: NSE

Q3 surprised positively on margins: Continued control over SG&A (up 7% YoY vs. 4% YoY in 9MFY20) and staff cost (up 3% YoY) led to 23.2% EBITDA margins (80bps beat). While the PSAI margin was close to historic highs of 31% (vs. avg. of 22%), the global generics margin expanded 270bps QoQ to 58.2%. Core EPS in Q3/9M was Rs 37/Rs 98 (ex-onetime income and 20% tax).

STOCK PERFORMANCE



Source: NSE

Earnings call takeaways: (1) Response on gNuvaring/Copaxone CRL likely in the near term. (2) Net carrying value on Nuvaring is US\$ 43.2mn. (3) More injectable launches expected in Europe. (4) Strong growth likely in Russia due to combination of both retail/B2B. (5) India business margins have further scope of improvement.

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	142,028	153,852	173,690	184,389	204,225
EBITDA (Rs mn)	22,869	31,333	41,629	41,255	47,244
Adj. net profit (Rs mn)	9,404	17,895	27,912	26,010	30,854
Adj. EPS (Rs)	56.7	107.8	168.1	156.7	185.9
Adj. EPS growth (%)	(20.1)	90.3	56.0	(6.8)	18.6
Adj. ROAE (%)	7.7	13.8	19.1	15.6	16.1
Adj. P/E (x)	56.3	29.6	19.0	20.4	17.2
EV/EBITDA (x)	23.7	17.9	13.2	13.1	10.9

Source: Company, BOBCAPS Research

BOB Capital Markets Ltd is a wholly owned subsidiary of Bank of Baroda

Important disclosures, including any required research certifications, are provided at the end of this report.



FIG 1 – QUARTERLY PERFORMANCE

(Rs mn)	Q3FY20	Q3FY19	YoY (%)	Q2FY20	QoQ (%)	Q3FY20E	Var (%)
Net Sales	43,838	38,500	13.9	48,009	(8.7)	43,228	1.4
EBITDA	10,188	8,156	24.9	14,080	(27.6)	9,684	5.2
Depreciation	3,085	3,108	-	3,339	-	3,339	-
EBIT	7,103	5,048	40.7	10,741	(33.9)	6,345	-
Interest	(419)	13	-	(231)	-	(100)	-
Other Income	228	681	-	135	-	400	-
PBT	7,750	5,716	35.6	11,107	(30.2)	6,845	13.2
Less: Taxation	423	953	-	(3,261)	-	2,190	-
Less: Minority Interest	(176)	(89)	-	(117)	-	0	-
Recurring PAT	7,503	4,852	54.6	14,485	(48.2)	4,654	61.2
Exceptional items	(13,200)	0	-	(3,560)	-	0	-
Reported PAT	(5,697)	4,852	(217.4)	10,925	(152.1)	4,654	(222.4)
Key Ratios (%)							
Gross Margin	54.1	53.9	-	57.5	-	54.0	-
EBITDA Margin	23.2	21.2	-	29.3	-	22.4	-
Tax / PBT	5.5	16.7	-	(29.4)	-	32.0	-
NPM	17.1	12.6	-	30.2	-	10.8	-
EPS (Rs)	44.0	28.5	-	85.0	-	27.3	-

Source: Company, BOBCAPS Research

FIG 2 – REVENUE MIX

(Rs mn)	Q3FY20	Q3FY19	YoY (%)	Q2FY20	QoQ (%)	Q3FY20E	Var (%)
Global Generics	35,927	31,347	14.6	32,816	9.5	35,205	2.1
North America	15,999	14,832	7.9	14,265	12.2	16,940	(5.6)
Europe	3,093	2,030	52.4	2,764	11.9	2,091	47.9
India	7,636	6,741	13.3	7,511	1.7	7,437	2.7
ROW	9,199	7,744	18.8	8,276	11.2	8,738	5.3
PSAI	6,906	5,937	16.3	7,107	(2.8)	6,531	5.7
Proprietary Products	(226)	577	(139.2)	60	(476.7)	692	(132.6)
Others	1,231	639	92.6	8,026	(84.7)	800	53.9
Net Sales	43,838	38,500	13.9	48,009	(8.7)	43,228	1.4

Source: Company, BOBCAPS Research

Valuation methodology

DRRD is trading at reasonable valuations of 20x FY21E EPS. With the nearing monetisation of key assets (Copaxone, Revlimid) and strong SG&A cost control (mere 3% increase in the last three years), we think the stock should hold strong even though upsides could be capped following the 10-12% rally in recent months.

We raise our FY20/FY21/FY22 EPS estimates by 19%/3%/13%. This is mainly led by a reduction in gNuvaring-related amortisation charge and other changes including: (1) expected delays in Copaxone upside from FY21 to FY22 following likely delay in approvals, and (2) reduction in Nuvaring sales expectations to US\$ 20mn from US\$ 30mn for FY22. Our EPS revision for FY20 is significantly higher due to a much lower effective tax (9MFY20 is tracking at zero due to DTA benefits). Our core EPS for FY20/FY21/FY22 is projected at Rs 130/Rs 157/Rs 170 (ex-Copaxone).

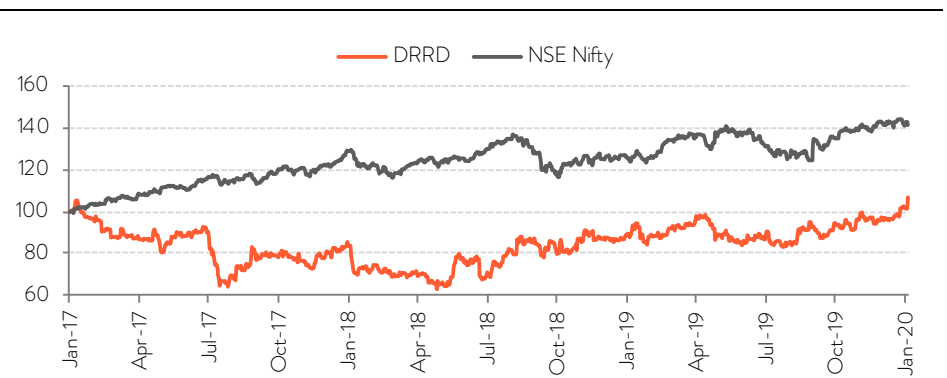
This together with inclusion of the Revlimid upside (Rs 200/sh NPV basis) and EV/EBITDA roll forward (to Mar'22 from Sep'21 earnings) drive revision in our target price to Rs 3,350 (from Rs 2,960). Our TP is based on 12x EV/EBITDA (19.5x implied P/E) and offers reasonable upside. Early Srikakulam API resolution, gVimovo launch, and further SG&A cost savings 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	173.7	184.4	204.2	176.4	192.8	204.9	(1.5)	(4.4)	(0.3)
EBITDA	41.6	41.3	47.2	40.7	42.4	44.4	2.2	(2.8)	6.4
EBITDA margin (%)	24.0	22.4	23.1	23.1	22.0	21.7	87bps	37bps	147bps
EPS (Rs)	168	157	186	142	153	164	18.6	2.7	13.1

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
Total revenue	142,028	153,852	173,690	184,389	204,225
EBITDA	22,869	31,333	41,629	41,255	47,244
Depreciation	11,740	12,399	12,760	12,605	13,670
EBIT	11,129	18,934	28,869	28,650	33,575
Net interest income/(expenses)	(788)	(889)	(960)	(960)	(960)
Other income/(expenses)	3,598	3,498	3,104	5,655	7,455
Exceptional items	0	0	0	0	0
EBT	13,939	21,543	31,013	33,346	40,070
Income taxes	4,535	3,648	3,101	7,336	9,216
Extraordinary items	402	901	(4,500)	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	9,806	18,796	23,412	26,010	30,854
Adjustments	402	901	(4,500)	0	0
Adjusted net profit	9,404	17,895	27,912	26,010	30,854

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	16,052	14,553	16,655	17,681	19,583
Other current liabilities	26,248	27,219	31,264	33,190	36,760
Provisions	3,785	4,218	4,762	5,055	5,599
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	155,026	176,885	203,589
Shareholders' fund	123,534	136,594	155,856	177,715	204,419
Total liabilities and equities	220,174	220,965	246,918	272,023	304,743
Cash and cash eq.	2,638	2,228	9,143	48,615	71,990
Accounts receivables	40,617	39,869	47,586	50,518	55,952
Inventories	29,089	33,579	35,690	37,888	41,964
Other current assets	18,368	17,061	27,790	29,502	32,676
Investments	22,983	25,871	25,871	25,871	25,871
Net fixed assets	49,941	49,363	48,603	37,999	36,329
CWIP	7,928	4,725	4,725	4,725	4,725
Intangible assets	48,610	48,269	47,509	36,905	35,235
Deferred tax assets, net	0	0	0	0	0
Other assets	0	0	0	0	0
Total assets	220,174	220,965	246,918	272,023	304,743

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	21,546	31,195	36,171	38,614	44,523
Interest expenses	788	889	960	960	960
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(4,407)	(2,530)	(13,866)	(3,596)	(6,668)
Other operating cash flows	0	0	0	0	0
Cash flow from operations	17,927	29,554	23,265	35,977	38,815
Capital expenditures	(13,167)	(4,574)	(12,000)	(2,000)	(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)	(2,000)	(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	10,605	1,670
Cash flow from financing	(4,115)	(22,502)	(4,350)	5,495	(3,440)
Changes in cash and cash eq.	(1,228)	(410)	6,915	39,472	23,375
Closing cash and cash eq.	2,638	2,228	9,143	48,615	71,990

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	59.1	113.2	141.0	156.7	185.9
Adjusted EPS	56.7	107.8	168.1	156.7	185.9
Dividend per share	20.0	25.0	25.0	25.0	25.0
Book value per share	744.2	822.9	938.9	1,070.6	1,231.4

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	3.8	3.6	3.2	2.9	2.5
EV/EBITDA	23.7	17.9	13.2	13.1	10.9
Adjusted P/E	56.3	29.6	19.0	20.4	17.2
P/BV	4.3	3.9	3.4	3.0	2.6

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	67.5	83.1	90.0	78.0	77.0
Interest burden (PBT/EBIT)	125.2	113.8	107.4	116.4	119.3
EBIT margin (EBIT/Revenue)	7.8	12.3	16.6	15.5	16.4
Asset turnover (Revenue/Avg TA)	20.7	22.0	23.5	22.5	22.3
Leverage (Avg TA/Avg Equity)	1.4	1.3	1.3	1.2	1.2
Adjusted ROAE	7.7	13.8	19.1	15.6	16.1

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	12.9	6.2	10.8
EBITDA	(5.3)	37.0	32.9	(0.9)	14.5
Adjusted EPS	(20.1)	90.3	56.0	(6.8)	18.6
Profitability & Return ratios (%)					
EBITDA margin	16.1	20.4	24.0	22.4	23.1
EBIT margin	7.8	12.3	16.6	15.5	16.4
Adjusted profit margin	6.6	11.6	16.1	14.1	15.1
Adjusted ROAE	7.7	13.8	19.1	15.6	16.1
ROCE	8.6	12.9	17.3	16.7	17.9
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	3.0	3.3
Net interest coverage ratio	14.1	21.3	30.1	29.9	35.0
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%

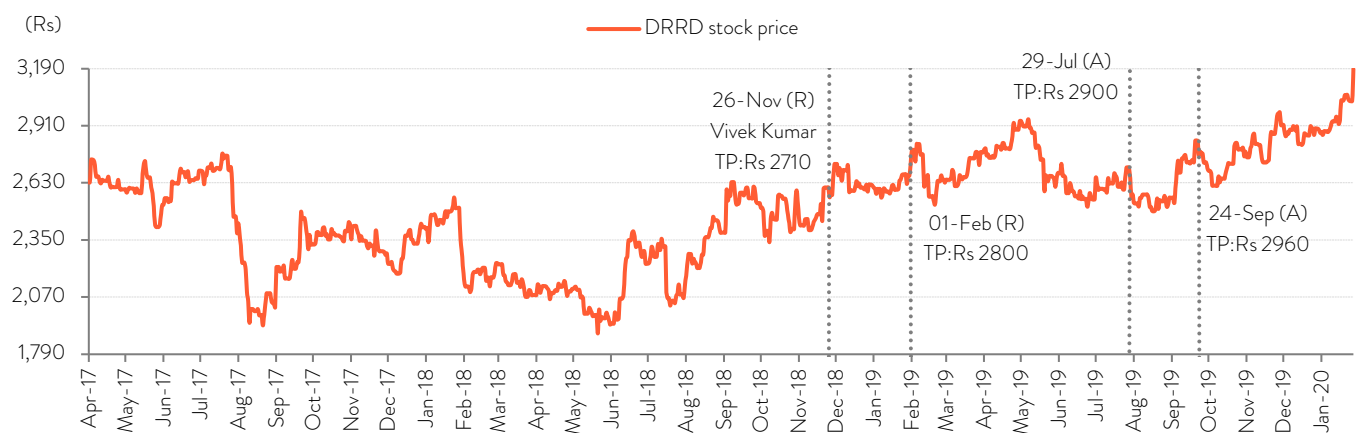
ADD – Expected return from >+5% to +15%

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)



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

Rating distribution

As of 31 December 2019, out of 83 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 50 have BUY ratings, 18 are rated ADD, 9 are rated REDUCE and 6 are rated SELL. None of these companies have been investment banking clients in the last 12 months.

Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

General disclaimers

BOBCAPS is engaged in the business of Institutional Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance and wealth management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2020. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations

expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities — that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have “long” or “short” positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may act as market makers or assume an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company in the past 12 months. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.