

Dr Reddy's Labs

BSE SENSEX	S&P CNX
40,165	11,891
Bloomberg	DRRD IN
Equity Shares (m)	166
M.Cap.(INRb)/(USD\$b)	457.5 / 6.5
52-Week Range (INR)	2965 / 2065
1, 6, 12 Rel. Per (%)	-2/-8/-5
12M Avg Val (INR M)	2123
Free float (%)	73.2

Financials & Valuations (INR b)

Y/E Mar	2019	2020E	2021E
Sales	152.1	166.5	181.1
EBITDA	29.5	32.8	38.8
Net Profit	17.5	17.8	21.0
Adj. EPS (INR)	105.2	107.2	126.2
EPS Gr. (%)	62.6	1.9	17.8
BV/Sh. (INR)	845	990	1,097
RoE (%)	13.1	11.7	12.1
RoCE (%)	8.9	11.3	10.6
P/E (x)	26.2	25.7	21.8
P/BV (x)	3.3	2.8	2.5

Estimate change



TP change



Rating change



CMP: INR2,755 TP: INR2,590 (-6%) Neutral

Ex-US trends favorable, cost-cut benefits visible

- PSAI/EM/EU drive growth:** Adjusting for one-time income of INR7.2b as license fee for two brands, sales increased 7.5% YoY to INR40.8b (our estimate: INR41.9b) in 2QFY20, led by PSAI (+18% YoY), EMs (+10% YoY) and Europe (+44% YoY), partly offset by muted growth in the US (flat YoY). For 1HFY20, sales/EBITDA increased 5% YoY to INR79b/INR15.7b, while PAT was down 12% YoY to INR8.5b.
- Cost measures offset adverse mix impact, drive margins:** Adjusting for the sale of brands and voluntary recall of Ranitidine from the US market, the gross margin shrank ~350bp YoY to 51.5%, mainly due to price erosion in the US base business and higher cost of revenue in PSAI. However, controlled SG&A expense (-290bp YoY), adjusting for impairment and one-offs, and lower R&D spend (-180bp YoY) drove 130bp YoY expansion in the EBITDA margin to 20.8% (our estimate: 20.0%). EBITDA thus came in line with our estimate at INR8.5b. Further, DRRD recognized deferred tax asset (INR5.2b) related to MAT credit. Adj. PAT declined 20% YoY to INR4b (in-line).
- Key concall takeaways:** (1) DRRD received complete response letter (CRL) from the USFDA on g-Nuvaring and g-Copaxone. It would file response for the same over the next few months. (2) Company expects USFDA inspection at CTO-6 in near future. (3) Adverse impact of nationwide recall of Ranitidine from the US is fully factored in 2Q. (4) While 2Q US sales were impacted by product recall and logistics issues, DRRD guided for normalization 3Q onward. (5) R&D spend guided at USD200-240m for FY20.
- Valuation view:** We cut our FY20/21 EPS estimate by 11%/3% to INR107/INR126 to factor in product recalls/associated expenses, deferred key approvals and the delayed pick-up in the gross margin. We continue valuing DRRD at 20x 12M forward earnings to arrive at a TP of INR2,590 (prior: INR2,620). DRRD has been progressing well in terms of revenue growth across markets, except the US, and cost reduction initiatives are also fructifying to an extent. However, we maintain our Neutral rating as the current valuation adequately factors in the aforementioned positives.

Tushar Manudhane – Research Analyst (Tushar.Manudhane@MotilalOswal.com);+91 022 6129 1536

Hitakshi Chandrani – Research Analyst (Hitakshi.Chandrani@motilalosal.com);+91 22 6129 1557

Investors are advised to refer through important disclosures made at the last page of the Research Report.

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Quarterly Perf. - IFRS

(INR M)

Y/E March	FY19				FY20E				FY19	FY20E	Estimates	
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE			2QE	% Var
Sales	37,207	37,978	38,500	38,366	38,435	40,809	42,403	44,866	1,52,051	1,66,513	41,946	-2.7
YoY Change (%)	12.2	7.1	1.2	8.5	3.3	7.5	10.1	16.9	7.1	9.5	10.4	
Total Expenditure	29,632	30,575	30,344	31,968	31,168	32,328	34,346	35,867	1,22,518	1,33,710	33,557	
EBITDA	7,575	7,403	8,156	6,398	7,267	8,481	8,057	8,998	29,533	32,803	8,389	1.1
Margins (%)	20.4	19.5	21.2	16.7	18.9	20.8	19.0	20.1	19.4	19.7	20.0	
Amortization	3,110	2,998	3,108	3,183	3,082	3,339	3,200	3,200	12,400	12,821	3,150	
Interest	0	0	0	0	0	1	2	3	1	2	1	
Other Income	542	1,375	757	2,636	4,315	483	291	265	5,310	5,354	7,266	
One-off income/(expense)						2,039				2,039		
Profit before Tax	5,007	5,780	5,805	5,851	8,500	7,663	5,146	6,060	22,442	27,368	12,504	-38.7
Tax	446	742	953	1,507	1,872	-3,261	1,030	907	3,648	547	2,876	
Rate (%)	8.9	12.8	16.4	25.8	22.0	-42.6	20.0	15.0	16.3	2.0	23.0	
Reported PAT	4,561	5,038	4,852	4,344	6,628	10,924	4,116	5,153	18,794	26,821	9,628	
Minority Interest	0	0	0	0	0	0	0	0	0	0	0	
Adjusted PAT	4,561	5,038	4,852	3,008	4,444	4,042	4,118	5,193	17,459	17,797	4,143	-2.4
YoY Change (%)	671.7	76.8	13.5	-0.5	-2.6	-19.8	-15.1	72.7	62.6	1.9	-17.8	
Margins (%)	12.3	13.3	12.6	7.8	11.6	9.9	9.7	11.6	11.5	10.7	9.9	

Business highlights

Global generic sales increased 7% YoY to INR33b, led by growth of 9% YoY in India (INR7.5b), 10% YoY in emerging markets (INR8.3b) and 44% YoY in Europe (INR2.8b). US sales remained muted at INR14.3b.

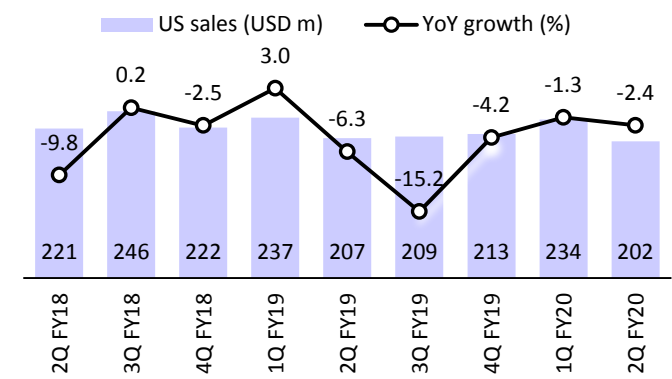
PSAI business grew at a robust rate of 18% YoY to INR7.1b, led by increased volumes in the existing business.

During the quarter, DRRD received one-time license fee for selling US and select territory rights for three brands (Zembrace, Symtouch, Tosymratm) to Upsher-Smith Laboratories, driving overall proprietary products revenue.

Price erosion/recalls offset incremental business from new launches

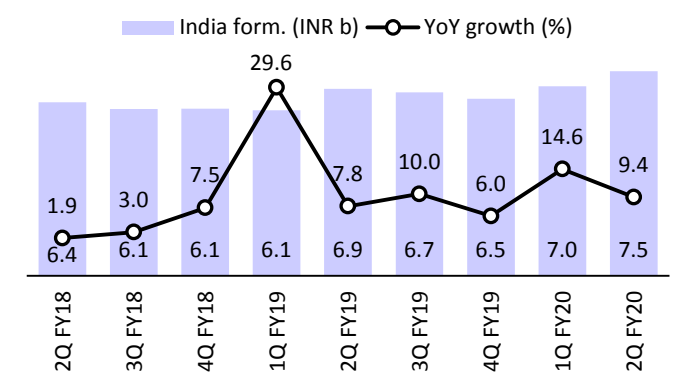
2QFY20 was the fifth consecutive quarter of a YoY dip in revenue in the US business. This segment continues to be affected by price erosion because of intensifying competition in key molecules and low volumes. The situation has worsened on account of voluntary recall of Ranitidine and supply issues during the quarter. DRRD launched eight products in 2QFY20. It has 99 ANDAs pending for approval as of Sep'19, with 55 being Para IVs (31 being FTFs).

Exhibit 1: US sales growth remains muted



Source: MOFSL, Company

Exhibit 2: India business grew at 9% YoY



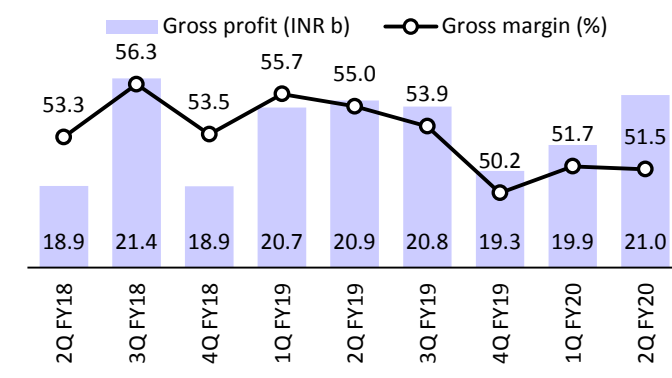
Source: MOFSL, Company

ROW sales drive growth in EM

New launches and volume traction in existing products led to 10% YoY growth in EM sales to INR8.3b. Revenue in Russia stood at INR4.1b, up 8% YoY, led by volume growth and better realization in a few products. CIS and Romania sales grew at a better rate of 16% YoY for the quarter. RoW grew at 11% to INR2.5b on the back of new products and volume traction in existing products.

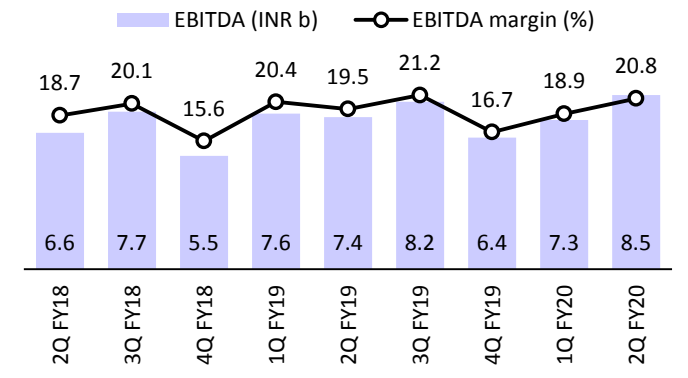
Europe business drives overall growth: Europe sales increased by a strong 44% YoY to INR2.8b on account of improved performance of the base business and better off-take of new launches.

Exhibit 3: Gross margin shrank 350bp YoY



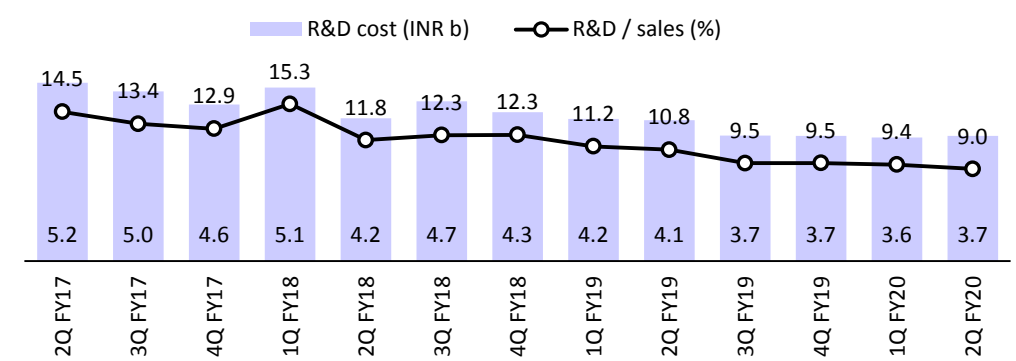
Source: Company, MOFSL

Exhibit 4: EBITDA margin expanded ~130bp YoY



Source: Company, MOFSL

Exhibit 5: Gradual downtrend in R&D expense (as % of sales)



Source: Company, MOFSL

Considerable one-off income in revenue/cost of revenue/SGA section

During the quarter, DRRD received one-time income of INR7.2b on account of selling US and select territory rights for three brands. Cost of revenue was impacted largely by one-time income and Ranitidine recall from the US market. SGA was impacted by impairment recognition (INR3.6b) against Ramelteon, Tobramycin and Imiquimod products along with certain additional one-offs (~INR1b) which are partially related to the sale of neuro brands. The company also recognized deferred tax assets (related to MAT) amounting to INR5.2b.

Operating metrics**Exhibit 6: Operating Metrics**

	FY17			FY18				FY19				FY20	
	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q
Revenue Mix (%)													
US	45.0	44.8	43.2	45.1	40.4	42.2	41.0	42.7	37.6	38.5	37.3	42.5	35.0
India	17.4	16.0	16.1	14.1	18.0	16.1	17.4	16.3	18.1	17.5	16.2	18.1	18.4
Europe	5.0	5.8	5.8	6.3	6.8	5.3	4.8	5.4	5.0	5.3	4.8	6.3	6.8
Russia	9.9	11.1	12.8	13.3	11.6	11.6	10.5	13.4	13.7	14.3	12.0	13.5	14.2
Others	3.6	5.0	4.1	4.1	4.0	3.9	5.1	4.4	6.0	5.8	5.3	5.5	6.1
PSAI	16.1	14.6	15.2	14.0	15.9	14.3	17.7	14.5	15.9	15.4	16.9	11.8	17.4
Innovative products	3.0	2.8	2.8	3.2	3.4	6.6	3.6	3.1	3.7	3.2	7.5	2.4	2.1
Revenue Growth (%)	-10.1	-6.6	-5.4	2.5	-1.1	2.7	-0.5	12.2	7.1	1.2	13.4	3.3	7.5
US	-13.1	-14.5	-19.0	-3.7	-11.3	-3.1	-5.6	6.4	-0.4	-7.7	3.2	2.6	0.0
India	14.4	2.4	8.4	-10.3	1.9	3.0	7.5	29.6	7.8	10.0	6.0	14.6	9.4
Europe	-16.4	10.9	17.5	28.5	36.5	-6.6	-17.2	-2.8	-21.0	1.2	11.7	19.2	44.3
Russia	-9.8	-2.0	-2.0	47.8	16.0	-2.0	-2.0	13.6	26.8	-2.0	-2.0	-1.0	0.0
Others	-51.9	-23.0	-23.0	3.6	8.2	-18.8	24.5	22.0	63.0	49.6	17.8	27.8	9.1
PSAI	-2.3	6.3	-6.3	-0.9	-2.2	0.7	15.7	16.3	6.6	9.2	8.2	-16.1	17.9
Innovative products	-10.5	-1.2	-1.9	3.7	10.2	145.3	25.8	10.4	18.9	-51.7	139.1	-21.3	-39.0
Cost of sales (%)	83.2	77.0	83.6	90.8	81.3	79.9	84.4	79.6	80.5	78.8	83.3	81.1	79.2
Raw material	44.0	40.9	48.8	48.4	46.7	43.7	46.5	44.3	45.0	46.1	49.8	48.3	48.5
SG&A	24.7	22.7	21.9	27.0	22.8	23.8	25.6	24.2	24.7	23.2	24.0	23.4	21.8
R&D cost	14.5	13.4	12.9	15.3	11.8	12.3	12.3	11.2	10.8	9.5	9.5	9.4	9.0
Tax Rate	23.1	20.6	2.0	23.4	26.5	43.8	19.4	8.9	12.8	16.4	25.8	22.0	-42.5
Margins (%)													
Gross Margins	56.0	59.1	51.2	51.6	53.3	56.3	53.5	55.7	55.0	53.9	50.2	51.7	51.5
EBITDA Margins	16.8	23.0	16.4	9.2	18.7	20.1	15.6	20.4	19.5	21.2	16.7	18.9	20.8
EBIT Margins	8.7	15.1	7.4	0.8	10.4	12.3	7.0	12.0	11.6	13.1	8.4	10.9	12.6
PAT margins	9.0	12.7	8.8	1.8	8.0	11.2	8.5	12.3	13.3	12.6	11.3	11.6	9.9

Source: MOFSL, Company

Valuation and view

We cut our FY20/21 EPS estimate by 11%/3% to INR107/INR126 to factor in product recalls/associated expenses, deferred key approvals and the delayed pick-up in the gross margin. We continue valuing DRRD at 20x 12M forward earnings to arrive at a TP of INR2,590 (prior: INR2,620). DRRD has been progressing well in terms of revenue growth across markets, except the US, and cost reduction initiatives are beginning to fructify. However, we maintain our **Neutral** rating as the current valuation adequately factors in the aforementioned positives.

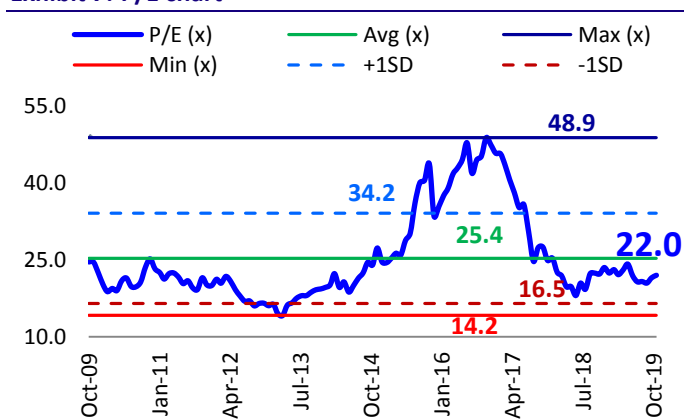
Key catalysts to drive stock's performance over the medium term:

- Growth in EM economies/currency, mainly Russia/CIS (12% of sales).
- Successful outcome of the likely re-inspection at its Srikakulam API site.
- Launch of key products like gNuvaring and gCopaxone.

Key risks to our investment thesis:

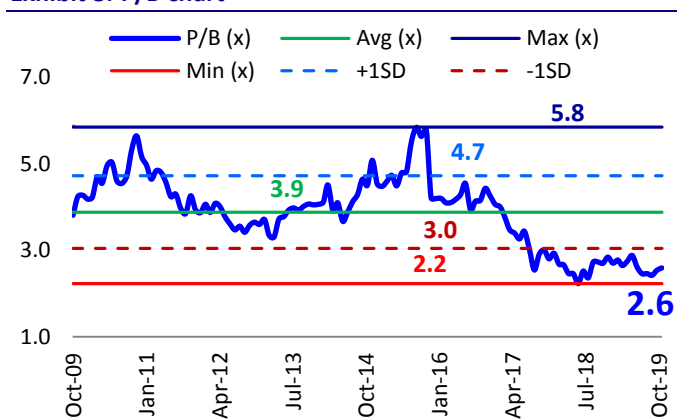
- Regulatory delays affecting key US launches.
- Delay in clearance for pending FDA issues (API facility).
- Further depreciation of the Russian currency.

Exhibit 7: P/E chart



Source: Company, MOFSL

Exhibit 8: P/B chart



Source: Company, MOFSL

Financials and Valuations

Income Statement							(INR m)	
Y/E March	FY14	FY15	FY16	FY17	FY18	FY19	FY20E	FY21E
Net Sales	1,32,171	1,48,189	1,54,708	1,40,809	1,42,028	1,52,051	1,66,513	1,81,124
Change (%)	13.7	12.1	4.4	-9.0	0.9	7.1	9.5	8.8
Total Expenditure	1,00,472	1,14,717	1,15,620	1,16,654	1,19,137	1,22,518	1,33,710	1,42,364
EBITDA	31,699	33,472	39,088	24,155	22,891	29,533	32,803	38,761
Change (%)	28.0	5.6	16.8	-38.2	-5.2	29.0	11.1	18.2
Margin (%)	24.0	22.6	25.3	17.2	16.1	19.4	19.7	21.4
Depreciation & Amort.	7,085	8,103	10,343	11,722	11,762	12,400	12,821	13,584
EBIT	24,614	25,369	28,745	12,433	11,129	17,133	19,982	25,176
Net Interest Exp	79	77	334	0	817	1,163	407	448
PBT & EO Expense	26,616	28,163	27,140	14,653	14,341	22,443	27,374	26,528
Change (%)	22.8	5.8	-3.6	-46.0	-2.1	56.5	22.0	-3.1
PBT after EO Expense	26,616	28,163	27,140	14,653	14,341	22,443	27,374	26,528
Tax	5,093	5,984	7,127	2,614	4,535	3,648	547	5,571
Tax Rate (%)	19.1	21.2	26.3	17.8	31.6	16.3	2.0	21.0
Minority Interest	0	0	0	0	0	0	0	0
Reported PAT	21,524	22,179	20,013	12,039	9,806	18,795	26,817	20,957
Adjusted Net Profit	21,188	22,179	22,577	12,039	10,736	17,459	17,797	20,957
Change (%)	54.9	4.7	1.8	-46.7	-10.8	62.6	1.9	17.8
Margin (%)	16.0	15.0	14.6	8.5	7.6	11.5	10.7	11.6

Balance Sheet							(INR m)	
Y/E March	FY14	FY15	FY16	FY17	FY18	FY19	FY20E	FY21E
Equity Share Capital	851	852	853	829	830	830	830	830
Reserves	89,950	1,10,450	1,24,845	1,21,792	1,24,886	1,39,406	1,63,452	1,81,285
Net Worth	90,801	1,11,302	1,25,698	1,22,621	1,25,716	1,40,236	1,64,282	1,82,115
Loans	44,742	43,126	33,403	49,075	50,651	34,125	24,125	19,125
Deferred Liabilities/Tax	-3,310	-4,013	-5,368	-5,164	-3,455	-3,844	-3,844	-3,844
Capital Employed	1,32,233	1,50,414	1,53,733	1,66,532	1,72,912	1,70,517	1,84,563	1,97,396
Gross Block	52,958	72,011	81,635	92,605	99,286	1,15,805	1,23,213	1,31,075
Less: Accum. Deprn.	21,213	30,040	35,505	42,324	49,553	61,953	74,774	74,774
Net Fixed Assets	37,814	48,090	52,756	56,376	57,411	53,852	48,438	56,301
Investments	26,384	38,871	41,854	26,317	28,935	30,769	30,769	30,769
Goodwill/Intangibles	14,697	16,430	20,596	46,176	46,974	47,393	47,393	47,393
Curr. Assets	78,664	85,580	82,730	82,512	86,718	88,325	1,07,785	1,11,210
Inventory	23,992	25,529	25,579	28,528	29,089	33,579	37,940	36,721
Account Receivables	33,037	40,755	41,250	38,196	40,696	39,982	46,004	46,418
Cash and Bank Balance	8,451	5,394	4,921	3,865	2,638	2,228	10,520	13,580
Others	13,184	13,901	10,980	11,923	14,295	12,536	13,321	14,490
Curr. Liability & Prov.	31,936	38,556	44,203	44,849	47,126	49,822	52,722	51,278
Account Payables	10,503	10,660	9,068	10,569	13,345	13,671	15,590	15,089
Other Current Liabilities	21,433	27,896	35,135	34,280	33,781	36,151	37,132	36,189
Net Current Assets	46,728	47,024	38,527	37,663	39,592	38,503	55,063	59,932
Appl. of Funds	1,25,623	1,50,414	1,53,733	1,66,532	1,72,912	1,70,517	1,84,563	1,97,396

Financials and Valuations

Ratios

Y/E March	FY14	FY15	FY16	FY17	FY18	FY19	FY20E	FY21E
EPS	124.6	130.2	132.3	72.6	64.7	105.2	107.2	126.2
Cash EPS	166.2	177.7	193.0	143.3	135.5	179.9	184.4	208.1
BV/Share	533.8	653.2	736.8	739.6	757.3	844.8	989.6	1,097.1
DPS	18.0	20.0	17.6	10.9	20.0	15.8	16.1	18.9
Payout (%)	16.6	17.9	17.6	17.6	40.7	16.3	11.6	17.6
Valuation (x)								
P/E	22.1	21.2	20.8	37.9	42.6	26.2	25.7	21.8
PEG (x)	0.4	4.5	12	NA	-4	0	13.3	1.2
P/BV	5.2	4.2	3.7	3.7	3.6	3.3	2.8	2.5
EV/Sales	3.5	3.1	2.9	3.4	3.3	3.0	2.6	2.4
EV/EBITDA	14.7	13.6	11.3	19.7	20.8	15.5	13.4	11.1
Dividend Yield (%)	0.7	0.7	0.6	0.4	0.7	0.6	0.6	0.7
Return Ratios (%)								
ROIC	23.6	20.9	21.2	8.9	5.8	10.8	14.4	13.9
RoE	25.9	21.9	19.1	9.7	8.6	13.1	11.7	12.1
RoCE	16.6	14.2	14.1	6.4	4.8	8.9	11.3	10.6
Working Capital Ratios								
Fixed Asset Turnover (x)	2.7	2.4	2.0	1.6	1.5	1.4	1.4	1.4
Debtor (Days)	91	91	97	103	101	97	94	93
Inventory (Days)	66	61	60	70	74	75	78	75
Leverage Ratio								
Debt/Equity (x)	0.5	0.4	0.3	0.4	0.4	0.2	0.1	0.1

Cash Flow Statement

(INR m)

Y/E March	FY14	FY15	FY16	FY17	FY18	FY19	FY20E	FY21E
Op. Profit/(Loss) before Tax	26,616	28,163	27,140	14,653	14,341	22,443	27,374	26,528
Depreciation	7,085	8,103	10,343	11,722	11,762	12,400	12,821	13,584
Interest/Dividends Recd.	-2,082	-2,871	1,271	-2,220	-4,029	-6,473	2,050	-1,200
Direct Taxes Paid	-5,093	-5,984	-7,127	-2,614	-4,535	-3,648	-547	-5,571
(Inc)/Dec in WC	-5,265	-3,353	8,024	-192	-3,156	679	-8,268	-1,809
CF from Operating incl EO Expense	21,262	24,059	39,651	21,349	14,383	25,401	33,430	31,533
(inc)/dec in FA	-14,041	-13,502	-21,550	-40,922	-13,595	-9,260	-7,408	-7,863
Free Cash Flow	7,221	10,557	18,101	-19,573	788	16,141	26,023	23,670
(Pur)/Sale of Investments	-6,501	-9,617	-1,880	17,757	1,411	4,639	0	0
CF from Investments	-20,542	-23,118	-23,430	-23,165	-12,184	-4,621	-7,408	-7,863
Change in net worth	-247	2,302	-2,104	-13,003	-2,719	-1,211	352	555
(Inc)/Dec in Debt	8,064	-1,617	-9,723	15,672	1,576	-16,526	-10,000	-5,000
Other Items	-1,641	-703	-1,355	204	1,709	-389	-4,960	-12,486
Dividend Paid	-3,581	-3,979	-3,512	-2,113	-3,992	-3,064	-3,123	-3,678
CF from Fin. Activity	2,595	-3,997	-16,694	760	-3,426	-21,190	-17,731	-20,609
Inc/Dec of Cash	3,315	-3,057	-473	-1,056	-1,227	-410	8,292	3,061
Add: Beginning Balance	5,136	8,451	5,394	4,921	3,865	2,638	2,228	10,520
Closing Balance	8,451	5,394	4,921	3,865	2,638	2,228	10,520	13,581

NOTES

Explanation of Investment Rating	
Investment Rating	Expected return (over 12-month)
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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