

Company Focus

24 October 2007 | 9 pages

Dr Reddy (REDDY.BO)

 Estimate change

Buy: Hiccups in Germany, CCS

- Some hiccups** — 2Q results were hit by disruption in Betapharm & Mexican CCS sales and exceptional items in SG&A – even as reported PAT was shored up by a Rs1.5bn tax write-back. Gross margin of c51% was, however, a positive surprise given the strong INR. We lower recurring PAT estimates over FY08-10E by 2-6% to build in these hiccups and stronger rupee appreciation.
- Multiple pressures in Germany** — Betapharm reported sales of Rs1.9bn (down 26% YoY & 10% QoQ) on supply constraints at Solutas & lower pricing. DRL has moved 20 products out of Solutas (6 transferred to India) – benefits to be visible in 2H. We believe that while the worst is behind in Germany, the market would remain a challenge & shoring up profitability would be a tough haul.
- Mixed trend in CCS** — The Mexican CCS business remained suppressed (down 56% YoY) due to lower demand even as supply constraints were resolved. On the other hand, the higher margin Indian CCS business has gained significant traction and is likely to witness a doubling of revenues in FY08. We expect CCS to remain one of the fastest growing, albeit small, businesses within DRL.
- Strength in Russia, US** — Russia and US generics were strong drivers, with YoY sales growth of 25% and 61% respectively. We expect these markets along with Indian formulations to remain key growth drivers.
- All in the price** — We believe most of the issues being faced by DRL are already factored into valuations, although the stock lacks visible triggers in the near term. We maintain our long-term Buy (1M) rating on the stock.

Buy/Medium Risk	1M
Price (24 Oct 07)	Rs629.95
Target price	Rs803.00
Expected share price return	27.5%
Expected dividend yield	0.6%
Expected total return	28.1%
Market Cap	Rs105,915M
	US\$2,676M

Price Performance (RIC: REDDY.BO, BB: DRRD IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	929	12.11	337.6	52.0	2.2	4.3	0.6
2007A	9,328	55.55	358.6	11.3	2.5	29.2	0.6
2008E	5,673	33.79	-39.2	18.6	2.3	12.9	0.7
2009E	7,066	42.08	24.5	15.0	2.0	14.3	0.7
2010E	8,137	48.46	15.2	13.0	1.8	14.5	0.7

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	52.0	11.3	18.6	15.0	13.0
EV/EBITDA adjusted (x)	161.9	6.0	10.8	8.2	6.7
P/BV (x)	2.2	2.5	2.3	2.0	1.8
Dividend yield (%)	0.6	0.6	0.7	0.7	0.7
Per Share Data (Rs)					
EPS adjusted	12.11	55.55	33.79	42.08	48.46
EPS reported	12.11	55.55	42.72	42.08	48.46
BVPS	290.40	247.62	276.23	313.14	356.42
DPS	3.50	4.00	4.50	4.50	4.50
Profit & Loss (RsM)					
Net sales	23,562	65,095	50,754	58,640	63,216
Operating expenses	-23,404	-54,528	-45,166	-50,861	-53,985
EBIT	158	10,567	5,589	7,779	9,231
Net interest expense	1,118	-3	819	400	400
Non-operating/exceptionals	-88	-63	-21	-60	-60
Pre-tax profit	1,188	10,501	6,387	8,119	9,571
Tax	-258	-1,177	-714	-1,056	-1,436
Extraord./Min.Int./Pref.div.	-1	4	1,500	2	2
Reported net income	929	9,328	7,173	7,066	8,137
Adjusted earnings	929	9,328	5,673	7,066	8,137
Adjusted EBITDA	578	13,908	7,050	9,079	10,531
Growth Rates (%)					
Sales	21.0	176.3	-22.0	15.5	7.8
EBIT adjusted	29.7	nm	-47.1	39.2	18.7
EBITDA adjusted	22.1	nm	-49.3	28.8	16.0
EPS adjusted	337.6	358.6	-39.2	24.5	15.2
Cash Flow (RsM)					
Operating cash flow	1,039	4,683	832	4,421	6,604
Depreciation/amortization	420	3,341	1,461	1,300	1,300
Net working capital	-1,873	-4,265	-6,341	-2,647	-1,536
Investing cash flow	-34,524	-4,102	-900	-900	-900
Capital expenditure	-1,873	-3,341	-900	-900	-900
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	27,211	6,279	-869	-869	-869
Borrowings	6,322	-3,066	0	0	0
Dividends paid	-436	-758	-869	-869	-869
Change in cash	-6,274	6,861	-937	2,652	4,835
Balance Sheet (RsM)					
Total assets	68,768	85,919	87,427	94,274	101,921
Cash & cash equivalent	5,334	18,603	16,166	18,818	23,653
Accounts receivable	4,802	7,519	9,386	10,844	11,691
Net fixed assets	9,086	12,428	13,328	14,228	15,128
Total liabilities	46,496	44,330	41,034	41,682	42,059
Accounts payable	3,639	4,755	4,172	4,820	5,196
Total Debt	30,995	24,754	22,041	22,041	22,041
Shareholders' funds	22,272	41,578	46,382	52,579	59,848
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	2.5	21.4	13.9	15.5	16.7
ROE adjusted	4.3	29.2	12.9	14.3	14.5
ROIC adjusted	-0.8	54.0	22.3	25.9	26.9
Net debt to equity	115.2	14.8	12.7	6.1	-2.7
Total debt to capital	58.2	37.3	32.2	29.5	26.9

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Hiccups in Germany, CCS

DRL's 2Q results were hit by disruption in Betapharm & Mexican CCS sales and exceptional items in SG&A – even as reported PAT was shored up by a Rs1.5bn tax write-back and gross margins surprised positively. We lower recurring PAT estimates over FY08-10E by 2-6% to build in these hiccups and stronger rupee appreciation. We believe that although the stock appears to lack catalysts in the near term, most negatives are already built into the price and downside from current levels appears limited. We maintain our long-term Buy (1M) rating on the stock.

2Q – a mixed bag

Figure 1. Consolidated Earnings Summary (Rupees in Million, Percent)

Year to Mar 31	2Q FY07	2Q FY08	%Ch YoY	1Q FY08	%Ch QoQ	CIR Comments
Revenues	20,039	12,670	(36.8)	12,166	4.1	4% YoY growth on a like to like basis – excluding unique opportunities in the previous year
Cost of revenues	11,751	6,170	(47.5)	5,914	4.3	
Gross Profit	8,288	6,500	(21.6)	6,252	4.0	YoY comparisons are meaningless – as authorized generics sales of last year were at very low gross margins
<i>Gross Margin (%)</i>	<i>41.4</i>	<i>51.3</i>	<i>994 bps</i>	<i>51.4</i>	<i>-9 bps</i>	
S,G&A Expenses	3,667	4,228	15.3	3,166	33.6	One-off items (related to Germany, legal costs) have pulled this up; likely to come down to sub 30% of sales by end of FY08
<i>as a % of sales</i>	<i>18.3</i>	<i>33.4</i>	<i>1,507 bps</i>	<i>26.0</i>	<i>735 bps</i>	
R&D Expenses	743	810	9.0	806	0.5	Includes US\$1.5m paid to Rheosciences on commencement of Phase 3 trials in Balaglitazone
<i>as a % of sales</i>	<i>3.7</i>	<i>6.4</i>	<i>269 bps</i>	<i>6.6</i>	<i>-23 bps</i>	
Amortization Expenses	402	410	2.0	351	16.8	
Forex Loss / (Gain)	(285)	(256)	nm	(285)	nm	Realised gains on forward contracts
Other operating expense/(income)	1	1	nm	1	nm	
Total Operating Expenses	4,528	5,193	14.7	4,039	28.6	
Operating Income	3,760	1,307	(65.2)	2,213	(41.0)	
<i>Operating Margin (%)</i>	<i>18.8</i>	<i>10.3</i>	<i>-845 bps</i>	<i>18.2</i>	<i>-788 bps</i>	
Equity in Loss of Affiliates	(21)	(3)	(83.8)	4	nm	
Other (Income) / Expenses	250	(113)	(145.1)	57	(297.9)	
PBT	3,531	1,423	(59.7)	2,152	(33.9)	
Tax	737	252	(65.8)	181	39.2	
<i>Effective tax rate</i>	<i>20.9</i>	<i>17.7</i>	<i>-316 bps</i>	<i>8.4</i>	<i>930 bps</i>	Full year guidance of 10-12%
Minority Interest	4	1	nm	(3)	nm	
Recurring Net Income	2,790	1,170	(58.1)	1,974	(40.7)	
One off expenses/ (Income)		(1,500)	nm		nm	Write back of deferred tax liability created in Betapharm due to the reduction in German tax rates
Reported Net Income	2,790	2,670	(4.3)	1,974	35.2	

Source: Company Reports and Citi Investment Research

Figure 2. Consolidated Sales Breakup (Rupees in Million, Percent)

Year to Mar 31	2Q FY07	2Q FY08	%Ch YoY	1Q FY08	%Ch QoQ	CIR Comments
APIs	2,906	3,240	11.5	2,617	23.8	Steady growth across most markets
India	502	703	40.0	535	31.4	
North America	437	640	46.5	498	28.5	
Europe	536	595	11.0	536	11.0	
ROW	1,431	1,302	(9.0)	1,048	24.2	
Branded Formulations	3,283	3,816	16.2	4,051	(5.8)	
India	1,891	2,054	8.6	2,022	1.6	Growth slowing down due to limited new launches in recent months
Russia	783	980	25.2	1,243	(21.2)	Growth driven by strong demand plus traction in OTC & hospitals segment
CIS	241	322	33.6	423	(23.9)	
Central/Eastern Europe	105	109	3.8	114	(4.4)	
ROW	263	351	33.5	249	41.0	
Generics	12,113	4,392	(63.7)	4,247	3.4	
North America	9,082	2,053	(77.4)	1,785	15.0	
Authorized Generics	7,808	0	nm	0	nm	Finasteride & Simvastatin during exclusivity period in FY07
Fexofenadine - limited competition	807	586	(27.4)	517	13.3	Sharp increase in market share (to 46%) offset by lower pricing
Other Formulations	467	1,467	214.1	1,268	15.7	Simvastatin, ondansetron & other new launches aid growth
Europe	3,031	2,339	(22.8)	2,462	(5.0)	
Betapharm, Germany	2,554	1,900	(25.6)	2,100	(9.5)	Pressure on pricing brought about by policy changes plus volumes affected by supply constraints (with Solutas)
UK	455	439	(3.5)	327	34.3	
Others	22	0	nm	35	nm	
Custom Chemical Business	1,668	1,160	(30.5)	1,017	14.1	
Mexico	1,434	632	(55.9)	830	(23.9)	Initial disruption of this business due to unavailability of a key ingredient solved; however softening of naproxen demand has hit revenues – will continue to be a drag for the rest of FY08
India	234	528	125.6	187	182.4	Strong traction – expects to double revenues in FY08
Others	69	62	(10.1)	86	(27.9)	
Total revenues	20,039	12,670	(36.8)	12,018	5.4	
Continuing Business (Excluding Authorized generics, Ondansetron)	12,231	12,670	3.6	12,018	5.4	

Source: Company Reports and Citi Investment Research

Figure 3. Earnings Revision

	Previous	New	Change (%)
Revenue			
2008E	53,938	50,754	(5.9)
2009E	61,212	58,640	(4.2)
2010E	66,129	63,216	(4.4)
EPS			
2008E	34.6	33.8	(2.3)
2009E	44.0	42.1	(4.3)
2010E	51.3	48.5	(5.6)

Source: Citi Investment Research

Earnings Revision

We are revising our estimates downwards to factor in: a) lower revenues in Germany and the Mexican CCS business and b) stronger rupee appreciation.

Consequently, we are lowering our revenue and recurring net profit estimates by 6-4% and 2-6% over FY08-10E. Our reported net profit estimate for FY08E is higher by 24% to account for the tax write-back of Rs1.5bn taken in 2Q.

Dr Reddy

Company description

DRL is a leading pharma company in India, with one of the best R&D pipelines. It focuses on value addition by increasing the share of branded formulations and generics exports to regulated markets. After starting as a bulk-drugs player in 1984, it has moved up the value chain and is aiming to become an innovator company. In generics, it is trying to increase the share of sales from regulated markets to boost overall profitability. As part of its inorganic growth strategy, it acquired Betapharm in Germany and is looking at smaller deals going forward.

Investment strategy

We rate DRL Buy/Medium Risk with a target price of Rs803 / share. We believe the company has evolved a business model that is among the best placed to tackle the changing dynamics of the industry. A right mix of near term growth drivers and investment for longer term sustainability of growth make DRL one of the best plays in the Indian pharma industry, in our view. Over the last few quarters, a slew of one time opportunities and inorganic initiatives have masked strong growth in the core base business. We expect this to become visible over the next few quarters and provide support to valuations. At the same time, DRL's presence in patent challenges and drug discovery implies the potential for positive surprises to earnings and valuations.

Valuation

Valuing DRL is a challenge as it has a high exposure to patent challenges and NCE research, where costs are front ended and returns likely to come through in future. As such, a pure P/E based approach would be insufficient and we use sum-of-the-parts valuation approach. We use a target multiple of 20x to value sector leaders, which is at a premium of about 40% to the broad market and is justified given that the sector is IPR driven and has the potential for significant earnings growth. At 20x March'08E earnings, we value DRL's base business at Rs703/ share. We value DRL's Para IV pipeline and drug discovery efforts separately at Rs31/share. For patent challenges we use a success probability of 20% and a discounted cash flow (discount factor 15%) for the opportunities being targeted over the next few years. We maintain Rs68/share value for DRL's new drug discovery efforts. Together, these values give us a target price of Rs803.

Risks

We rate the DRL Medium Risk in recognition of the steady growth of the base business and the longer-term potential for cash flows from research-based opportunities. The downside risks to our target price include: (1) DRL's ramp-up in sales and distribution in the US market entails large investments; (2) Patent challenges are win-lose situations and often cause volatile stock price movements; and (3) R&D success rates are low.

Appendix A-1

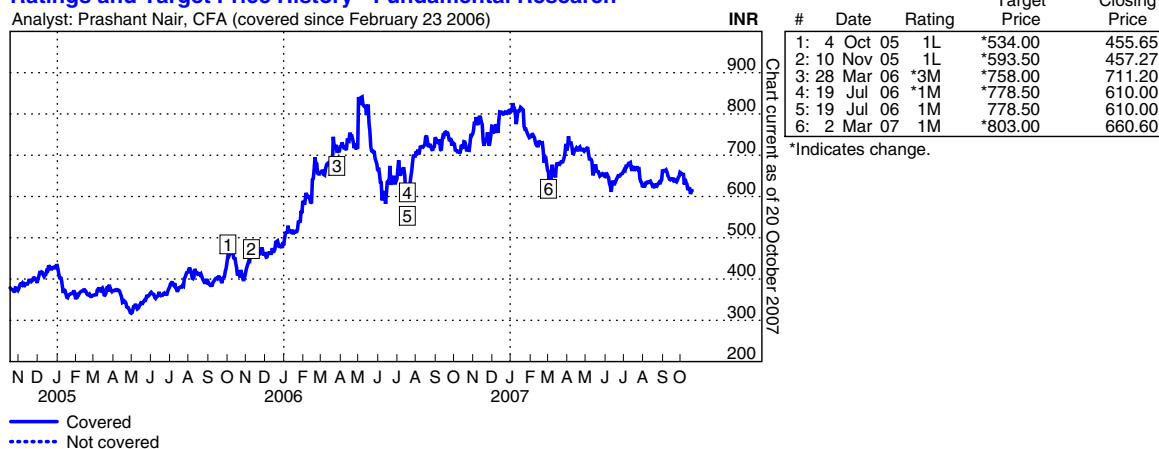
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Analyst: Prashant Nair, CFA (covered since February 23 2006)



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