Company In-Depth

20 May 2007 | 10 pages

Dr Reddy (REDY.BO)

Buy: Solid Results; Concerns Overdone

Rating change ☐
Target price change ☐
Estimate change ☑

- **Strong quarter** — 4Q07 PAT beat our estimate by 62%, despite an impairment charge (Rs1.8bn) & disruption of German sales. Net of impairment, PAT was Rs5bn (consensus: Rs2bn). While partly driven by one-offs (higher ondansetron sales & rabeprazole API supply to Teva), core business also beat expectations.
- **Focus on the core** — Core sales (excl acquisitions & "one-offs") growth of 63% & 25% in 4Q and FY07, respectively, reflects DRL's progress in broad basing its business across segments and geographies. We expect this momentum to sustain going forward and forecast 13% CAGR in core revenues over FY07-10E.
- **What does Aciphex change?** — DRL's loss in the Aciphex litigation triggered the recent 7.5% fall in the stock. We believe that this is an overreaction, as the NPV of the opportunity was only cRs15/share in our view. The street exaggerates the impact of Para IV wins/losses on valuations, in our view – while positive for the business, these "one-offs" rarely act as more than trading triggers for the stock.
- **German concerns factored in** — We expect regulatory pressure on pricing to put pressure on the German business. DRL's renegotiated contract with Hexal, while allowing for earlier sourcing from India (leading to higher gross margins), will also involve higher upfront cost. Our estimates factor this in, as reflected by DRL's overall GM guidance of 50-52% (vs. our estimate: 50.7%) for FY08.
- **Maintain Buy (1M)** — DRL's well diversified business and expanding pipeline of products/markets in each segment would drive sustained growth. Besides, its efforts in biosimilars and new drug discovery R&D would throw up valuation & growth drivers beyond the traditional generics opportunity over the longer term.

See Appendix A-1 for Analyst Certification and important disclosures.

Buy/Medium Risk	1M
Price (18 May 07)	Rs665.75
Target price	Rs803.00
Expected share price return	20.6%
Expected dividend yield	0.6%
Expected total return	**21.2%**
Market Cap	Rs111,788M
	US$2,774M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	929	12.11	337.6	55.0	2.3	4.3	0.5
2007A	9,328	55.63	359.2	12.0	2.7	29.4	0.6
2008E	5,799	34.58	-37.8	19.3	2.4	13.3	0.7
2009E	7,376	43.99	27.2	15.1	2.1	15.0	0.7
2010E	8,605	51.32	16.7	13.0	1.9	15.2	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)	55.0	12.0	19.3	15.1	13.0
EV/EBITDA adjusted (x)	172.1	6.8	10.2	8.0	6.6
P/BV (x)	2.3	2.7	2.4	2.1	1.9
Dividend yield (%)	0.5	0.6	0.7	0.7	0.7
Per Share Data (Rs)					
EPS adjusted	12.11	55.63	34.58	43.99	51.32
EPS reported	12.11	55.63	34.58	43.99	51.32
BVPS	290.40	245.33	274.73	313.54	359.68
DPS	3.50	4.00	4.50	4.50	4.50
Profit & Loss (RsM)					
Net sales	23,562	65,095	53,938	61,212	66,129
Operating expenses	-23,404	-54,528	-46,809	-52,237	-55,708
EBIT	**158**	**10,567**	**7,128**	**8,975**	**10,421**
Net interest expense	1,118	-3	-350	-240	-240
Non-operating/exceptionals	-88	-63	-40	-60	-60
Pre-tax profit	**1,188**	**10,501**	**6,738**	**8,675**	**10,121**
Tax	-258	-1,177	-943	-1,301	-1,518
Extraord./Min.Int./Pref.div.	-1	4	4	2	2
Reported net income	**929**	**9,328**	**5,799**	**7,376**	**8,605**
Adjusted earnings	929	9,328	5,799	7,376	8,605
Adjusted EBITDA	578	13,908	8,528	10,275	11,721
Growth Rates (%)					
Sales	21.0	176.3	-17.1	13.5	8.0
EBIT adjusted	29.7	nm	-32.5	25.9	16.1
EBITDA adjusted	22.1	nm	-38.7	20.5	14.1
EPS adjusted	337.6	359.2	-37.8	27.2	16.7
Cash Flow (RsM)					
Operating cash flow	**1,039**	**-7,926**	**7,023**	**4,937**	**6,957**
Depreciation/amortization	420	3,341	1,400	1,300	1,300
Net working capital	-1,873	-17,258	1,220	-2,441	-1,650
Investing cash flow	**-34,524**	**-1,200**	**-900**	**-900**	**-900**
Capital expenditure	-1,873	-1,200	-900	-900	-900
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**27,211**	**9,539**	**-868**	**-868**	**-868**
Borrowings	6,322	0	0	0	0
Dividends paid	-436	-757	-868	-868	-868
Change in cash	**-6,274**	**413**	**5,255**	**3,169**	**5,189**
Balance Sheet (RsM)					
Total assets	**68,768**	**82,617**	**84,736**	**91,844**	**99,987**
Cash & cash equivalent	5,334	5,746	11,002	14,171	19,360
Accounts receivable	4,802	11,592	9,975	11,320	12,229
Net fixed assets	9,086	10,286	11,186	12,086	12,986
Total liabilities	**46,496**	**41,475**	**38,658**	**39,256**	**39,660**
Accounts payable	3,639	5,350	4,433	5,031	5,435
Total Debt	30,995	24,263	22,363	22,363	22,363
Shareholders' funds	**22,272**	**41,139**	**46,070**	**52,578**	**60,315**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	2.5	21.4	15.8	16.8	17.7
ROE adjusted	4.3	29.4	13.3	15.0	15.2
ROIC adjusted	-0.8	44.7	24.0	29.1	30.4
Net debt to equity	115.2	45.0	24.7	15.6	5.0
Total debt to capital	58.2	37.1	32.7	29.8	27.0

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Powered by: dataCentral

Solid Results; Concerns Overdone

DRL's 4Q07 PAT beat our estimate by 62%, despite an impairment charge (Rs1.8bn) & disruption of German sales. Net of impairment, PAT was Rs5bn (consensus: Rs2bn). While partly driven by one-offs (higher ondansetron sales & rabeprazole API supply to Teva), core business also beat expectations. We believe that recent concerns over the Aciphex litigation loss and pricing pressure in Germany are overdone. We have lowered our earnings estimates for FY08E and FY09E by 10.8% and 4.4% to factor in the preponement of ondansetron sales in FY07, rupee appreciation and pricing pressure in the German market. The lower FY08 estimates do not change our target valuation, as we value such unsustainable "exclusivity" upsides only on a cash flow basis.

In our view, DRL's well diversified business and expanding pipeline of products/markets in each segment would drive sustained growth. Besides, its efforts in biosimilars and new drug discovery R&D would throw up valuation & growth drivers beyond the traditional generics opportunity over the longer term. Maintain Buy, Medium Risk (1M).

Figure 1. Earnings Summary (Rupees In Million, Percent)

Year to Mar 31	4Q FY06	4Q FY07	% Ch YoY	3Q FY07	% Ch QoQ	FY06	FY07	% Ch YoY	CIR Comments
Revenues	**6,932**	**15,573**	**124.7**	**15,434**	**0.9**	**24,267**	**65,095**	**168.2**	**Strong growth in core business (c25% in FY07 & 63% in 4QFY07) as well as multiple "one-off" upsides and two acquisitions**
Cost of revenues	4,037	5,818	44.1	8,690	(33.0)	12,417	34,219	175.6	
Gross Profit	**2,895**	**9,755**	**237.0**	**6,744**	**44.6**	**11,850**	**30,876**	**160.6**	**FY07 gross margins lower due to the high share of lower margin AG sales**
Gross Margin (%)	*41.8*	*62.6*	*2,088 bps*	*43.7*	*1,894 bps*	*48.8*	*47.4*	*-140 bps*	
S,G&A Expenses	2,292	3,433	49.8	3,604	(4.7)	8,029	14,051	75.0	Excluding exclusivities, SG&A expenses at 30% of sales
as a % of sales	33.1	22.0	-1,102 bps	23.4	-131 bps	33.1	21.6	-1,150 bps	
R&D Expenses	678	852	25.7	676	26.0	2,153	2,463	14.4	Likely to remain in the 7-8% of sales range
as a % of sales	9.8	5.5	-431 bps	4.4	109 bps	8.9	3.8	-509 bps	
Amortization Expenses	162	451	178.4	330	36.7	420	1,571	274.0	Higher due to acquisitions
Forex Loss / (Gain)	19	(205)	nm	49	nm	126	(137)	nm	
Other operating expense/(income)	4	25	nm	(21)	nm	(320)	(67)	nm	
Total Operating Expenses	3,155	4,556	44.4	4,638	(1.8)	10,408	17,881	71.8	
Operating Income	**(260)**	**5,199**	**(2,099.6)**	**2,106**	**146.9**	**1,442**	**12,995**	**801.2**	
Operating Margin (%)	*(3.8)*	*33.4*	*3,714 bps*	*13.6*	*1,974 bps*	*5.9*	*20.0*	*1,402 bps*	
Equity in Loss of Affiliates	49	29	(40.8)	12	nm	88	63	(28.4)	
Other (Income) / Expenses	(12)	(113)	841.7	241	(146.9)	(534)	661	(223.8)	
PBT	(297)	5,283	(1,878.8)	1,853	185.1	1,888	12,271	549.9	
Tax	(61)	260	(526.2)	(27)	(1,063.0)	258	1,177	356.2	
Effective tax rate	*20.5*	*4.9*	*-1,562 bps*	*(1.5)*	*638 bps*	*13.7*	*9.6*	*-407 bps*	
Minority Interest	1	1	nm	-	nm	-	(4)	nm	
Recurring Net Income	**(237)**	**5,022**	**nm**	**1,880**	**167.1**	**1,630**	**11,098**	**580.9**	**Expect a decline in FY08, as one-offs go away**
One off expenses/ (Income)	-	1,770	nm	-	nm		1,770	nm	Impairment charge for Betapharm (US$35m) and Trigenesis (US$6m)
Reported Net Income	(237)	3,252	(1,472.2)	1,880	73.0	1,630	9,328	472.3	

Source: Company Reports and Citigroup Investment Research

Figure 2. Comprehensive Sales Summary & Breakdown (Rupees In Million, Percent)

Year to Mar 31	4Q FY06	4Q FY07	Ch YoY	3QFY07	Ch QoQ	FY06	FY07	Ch YoY	CIR Comments
APIs	**2,090**	**3,891**	**86.2**	**2,729**	**42.6**	**8,238**	**11,827**	**43.6**	**Management expects to grow on the high FY07 base, on the back of its vast pipeline**
- India	546	467	(14.5)	482	(3.1)	2296	2075	(9.6)	Significant price decline in quinolones
- North America	450	646	43.6	527	22.6	1655	2030	22.7	Naproxen and Sertraline drive growth
- Europe	337	599	77.7	515	16.3	1421	2089	47.0	Sertraline, Finastride, Losartan and Ramipril drive growth
- ROW	757	2,179	187.8	1205	80.8	2866	5633	96.5	Rabeprazole & Sertraline (to Teva) and Clopidogrel drive growth in FY07; Strong Q4 growth is a one off due to rabeprazole supplies in anticipation of a positive litigation outcome
Branded Formulations	**2,079**	**2,743**	**31.9**	**3,183**	**(13.8)**	**9,926**	**12,319**	**24.1**	**The most profitable business for DRL, the robust growth here is expected to continue**
- India	1,270	1,479	16.5	1577	(6.2)	5526	6415	16.1	Back on the growth path thru enhanced focus – more product launches, deeper penetration
- Russia	382	691	80.9	950	(27.3)	2583	3494	35.3	Foray into hospitals & OTC segments (now 25% of revenues); double digit growth in FY08 in what is DRL's most profitable market
- CIS	147	252	71.4	321	(21.5)	827	1118	35.2	Ukraine, Kazakhstan were the key driver
- Central/Eastern Europe	79	51	(35.4)	119	(57.1)	259	377	45.6	Romania drives growth
- ROW	201	270	34.3	216	25.0	731	915	25.2	Growth across major market of Venezuela, S Africa and Myanmar
Generics	1,560	6,693	328.9	7,683	(12.9)	4,056	33,224	719.1	Strongest year in a while – besides exclusivities, acquisitions & AG deals, core business records excellent growth as well
- North America	500	5,585	1,016.2	4,631	20.6	1,600	23,600	nm	
Simvastatin + Finasteride (AG+own)	0	1,261	nm	3,385	(62.7)	0	15,800	nm	Strong revenues in 4Q even after complete genericisation of the market
Fexofenadine	0	611	nm	479	27.6	0	2400	nm	
Ondansetron	0	2680	nm	220	nm	0	2900	nm	180 day exclusivity – we believe there is a reasonable level of inventory in the pipeline
Other Formulations	500	1,033	106.5	767	34.7	1,600	2,500	56.3	10 product launches in the US drive growth in FY07; 69 ANDAs pending approval of which DRL believes it is FTF in 18 (brand sales: US$10bn)
- Europe	1,060	1,108	4.5	3,052	(63.7)	2,456	9,624	291.9	
Betapharm, Germany	705	788	11.8	2,664	(70.4)	705	8,004	1,035.3	Low 4Q sales due to supply problems with Hexal; now resolved and sales back to normal
UK	309	262	(15.2)	357	(26.6)	1700	1500	(11.8)	Decline despite volume growth due to pricing pressure in omeprazole and amlodipine
Others	46	58	26.1	31	87.1	51	120	135.3	Spain has been the key driver
Custom Chemical Business	**1,032**	**1,945**	**88.5**	**1,568**	**24.0**	**1,327**	**6,600**	**397.4**	
- Mexican Acquisition	805	1,525	89.4	1197	27.4	805	5397	570.4	Full year consolidation effect for FY07 drives the strong growth
- Continuing business	227	420	85.0	371	13.2	522	1203	130.5	Strong momentum on the back of growth in customer as well as product portfolio
Critical care & biotechnology	164	194	18.1	204	(4.9)	691	824	19.2	Steady growth
Others	6	107	1,683.3	67	59.7	29	301	937.9	
Total revenues	**6,932**	**15,573**	**124.7**	**15,434**	**0.9**	**24,267**	**65,095**	**168.2**	
Continuing Business (Excluding Acquisitions, Authorized generics, Fexofinadine, Ondansetron)	**5,422**	**9,969**	**83.9**	**7,489**	**33.1**	**22,757**	**30,594**	**34.4**	**Includes sertraline (partly not sustainable) & rabeprazole (not sustainable) API supplies to Teva – we estimate combined unsustainable sales of RsRs2.4bn for FY07 – even excluding this, core business growth is robust at 25% YoY**
% of sales	**78.2**	**64.0**		**37.4**		**93.8**	**47.0**		
Acquisitions	1,510	2,313	53.2	3,861	(40.1)	1,510	13,401	787.5	
% of sales	*21.8*	*14.9*		*19.3*		*6.2*	*20.6*		
Authorized generics	-	-	nm	3,385	nm	-	15,800	nm	AG sales of simva 5mg in 4Q; however, it is difficult to estimate the quantum
% of sales	*0.0*	*0.0*		*21.9*		*0.0*	*24.3*		
One time opportunities (Fexofinadine, Ondansetron)	0	3,291	nm	699	370.8	0	5,300	nm	Ranbaxy and Mylan have received tentative approvals for Fexofenadine – opportunity likely to shrink in FY08
% of sales	*0.0*	*21.1*		*4.5*		*0.0*	*8.1*		

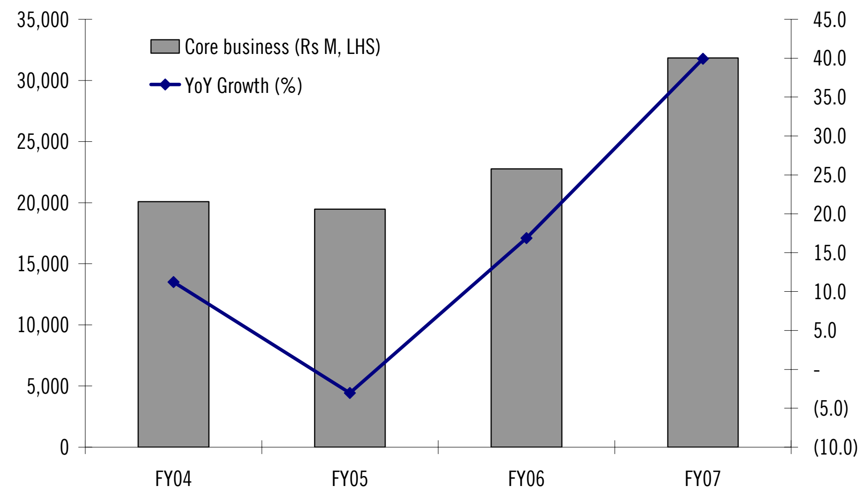
Source: Company; Citigroup Investment Research

FY07 – Core Business Trends

DRL's FY07 numbers are clouded by too many moving parts – exclusivities, acquisitions, authorized generic deals. In the midst of these, we believe the positive trends in the core business are not visible. We highlight the key trends in the base business below – the common theme running across the charts is the robust growth that the company has recorded in most target markets.

Growth in core business (excluding acquisitions, exclusivities and AG deals) has been very robust over the last four years; however it moved up to a different zone in FY07.

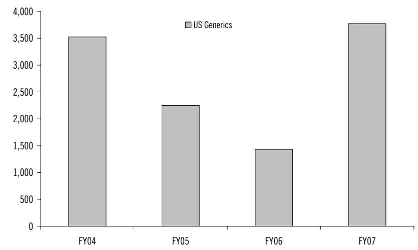
Figure 3. Core Revenues (Excluding acquisitions, exclusivities, AG deals)



Source: Company Reports

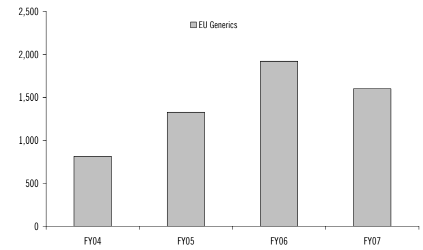
US generics (excluding all exclusivities) have bounced back, with a pickup in filings and new product introductions. Europe (excluding Betapharm) has grown rapidly over FY04-06, but witnessed a slight slowdown in FY07

Figure 4. US Generics (Rupees in Millions)



Source: Company

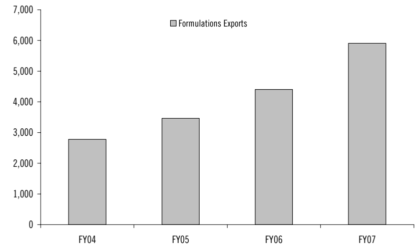
Figure 5. EU Generics (Rupees in Millions)



Source: Company

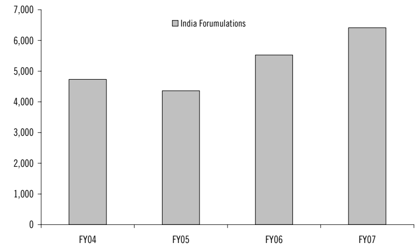
Russia has been the main driver for international branded formulation sales, while India has recovered on the back of new product launches, a more focused approach and greater penetration through an expanded field force

Figure 6. Branded Formulation Exports (Rs Mn)



Source: Company

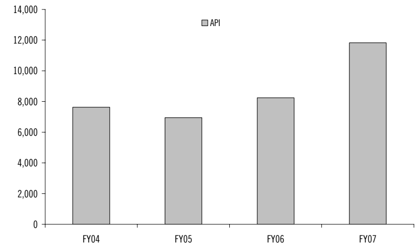
Figure 7. India Formulations (Rs Mn)



Source: Company

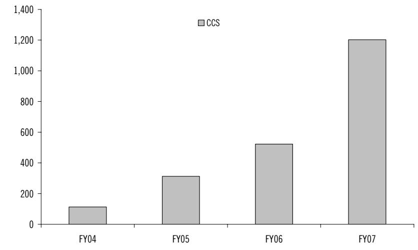
DRL's ability to make at least one high profile launch across any of its key markets have led to smart improvement in API revenues, while the CCS business has grown both organically as well as through the acquisition of Roche's facility in Mexico

Figure 8. API Revenue (Rupees in Millions)



Source: Company

Figure 9. Custom Chemical Synthesis



Source: Company

Revising Estimates

We revise our estimates for FY08 and FY09 down by 10.8% and 4.4%, respectively. We highlight that the decline in FY08 profit is on account of the lower exclusivity (one-off) sales of ondansetron booked during the year, as this has been shifted forward to 4QFY07. Our target valuation is based on sustainable earnings, and hence, this does not change our target valuation. We also introduce FY10 estimates. The revision is based on the following factors:

- Rupee appreciation – as we build in a more aggressive currency appreciation trend, following the trend witnessed over the last few months. This is the main reason for the lower estimates in FY09.
- Preponement of ondansetron exclusivity revenues – DRL booked higher exclusivity sales of ondansetron in 4QFY07; implying that the revenues booked in 1QFY08 during the exclusivity period would be lower. We have made this adjustment into our FY08 estimates. We highlight that this does not change our valuation for the stock, as these exclusivity profits are "one-off" in nature and we do not apply a multiple to these earnings.
- Betapharm – We have taken a slightly more conservative stance on revenues and gross margins for Betapharm, following the recent changes in the market dynamics. DRL highlighted in the call that they intend to move the manufacturing of top 10 products to India. If this happens fast, our numbers could move up again.

Figure 10. Earnings revision

31-Mar	Old	New	Change (%)
Revenue			
2008E	54,524	53,938	(1.1)
2009E	62,597	61,212	(2.2)
EPS			
2008E	38.8	34.6	(10.8)
2009E	46.0	44.0	(4.4)

Source: Citigroup Investment Research

Our target price remains unchanged as we roll over to June'08E earnings.

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 thesis

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 June'08E (v/s March'08E earlier) 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 via Perlecan Pharma. 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) The pricing pressure on Betapharm could be more acute and longer term than we have built in currently.

Appendix A-1

Analyst Certification

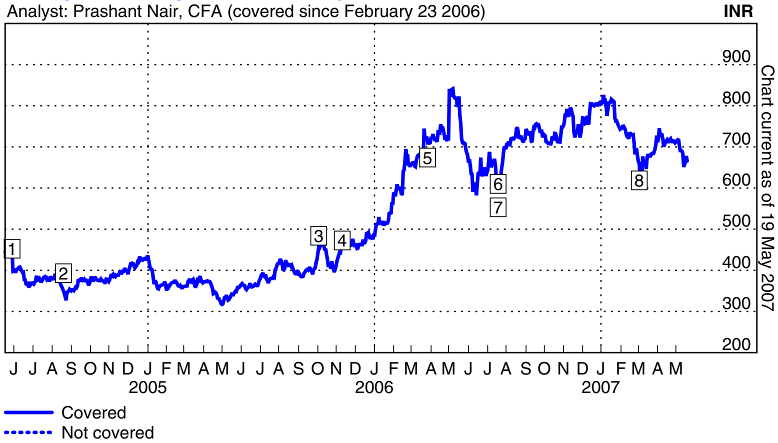
I, Prashant Nair, CFA, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Dr. Reddy's (REDY.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	25 May 04	*1L	500.00	437.77
2:	19 Aug 04	1L	*475.00	350.27
3:	4 Oct 05	1L	*534.00	455.65
4:	10 Nov 05	1L	*593.50	457.27
5:	28 Mar 06	*3M	*758.00	711.20
6:	19 Jul 06	*1M	*778.50	610.00
7:	19 Jul 06	1M	778.50	610.00
8:	2 Mar 07	1M	*803.00	660.60

*Indicates change.

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