

Company

21 July 2009 | 10 pages

Dr Reddy (REDY.BO)

 Equity

Buy : Mixed Bag; Long-Term Story Intact

- Some hiccups** — 1Q results were marginally below expectations & reflect headwinds in Russia & Germany that bear watching in the near term. However, its businesses in the US, India & other emerging markets have seen significant traction & allowed it to partially offset the former. We expect growth rates to pick up in 2H & recommend using any result-related weakness as a buying opportunity. DRL remains one of our top picks in Indian pharma.
- 1Q: mixed bag** — Core biz (excl Imitrex AG) grew just c7% YoY, despite robust growth (42% YoY) in US, due to headwinds in Russia (up 2% YoY) & Germany (down 36% YoY). Core biz gross margins appear to be higher by c200bps on cost saving & favorable currency. Higher amortization (recurring) & tax rate (quarterly skew) led to a 7% YoY decline in rec PAT (c6% below our estimate). Reported PAT grew 120% on high margin Imitrex AG sales (Rs2bn in 1QFY10).
- Update on key markets** — a) **US**: Omeprazole OTC launch by end 2QFY10 – Imitrex competition expected in mid Aug; b) **Russia**: bears watching – sales expected to pick up from 3Q; c) **Germany**: significant pricing pressure due to increased tender activity by insurance firms – fresh AOK tender for 94 products launched – supplies to commence in Jan'10 – bidding in Aug/Sept; d) **India**: plans to launch 2 biosimilars in FY10 – supply chain initiatives on track – signs of pickup in growth rates.
- Other earnings call takeaways** — a) FY10 guidance maintained; b) Some supplies to GSK in FY10 but will ramp up only over 12-18 months; c) SEZ land acquisition completed, expect construction to commence in the next few months; d) Integration of discovery services with Aurigine completed; e) R&D expense to be at c6% of sales in FY10.

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2007A	5,191	30.91	279.9	25.5	3.2	16.3	0.3
2008A	5,372	31.94	3.3	24.7	2.8	12.1	0.6
2009E	4,668	27.76	-13.1	28.4	3.2	10.6	0.6
2010E	7,410	44.06	58.7	17.9	2.7	16.4	0.7
2011E	9,572	56.92	29.2	13.9	2.3	17.9	0.8

Source: Powered by dataCentral

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

Buy/Medium Risk	1M
Price (21 Jul 09)	Rs789.55
Target price	Rs825.00
Expected share price return	4.5%
Expected dividend yield	0.7%
Expected total return	5.2%
Market Cap	Rs133,171M
	US\$2,767M

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



Prashant Nair, CFA

 +91-22-6631-9855
 prashant.nair@citi.com

 Akshay Rai
 akshay.rai@citi.com

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Mixed Bag

DRL's 1Q results were marginally below expectations & reflect headwinds in Russia & Germany that bear watching in the near term. However, its businesses in the US, India & other emerging markets have seen significant traction & allowed it to partially offset the former. We expect growth rates to pick up in 2H & recommend using any result-related weakness as a buying opportunity. DRL remains one of our top picks in Indian pharma.

1QFY10 Earnings Snapshot

DRL's 1QFY10 results were a mixed bag. Recurring net income of Rs1.38bn was c6% below our estimate. Good traction in the US, India & other emerging markets helped offset the impact of headwinds in Russia/CIS & Germany. Moreover, gross margins (excluding Imitrex AG sales) also improved by an impressive 200bps YoY on the back of favorable currency & cost reduction initiatives. Higher amortization (recurring) & tax rate (quarterly skew) led to a 7% YoY decline in recurring PAT. Reported PAT grew 120% YoY on high margin Imitrex AG sales (Rs2bn in 1QFY10).

FY10 guidance maintained

- 10% top-line growth and return ratios in the mid to high teens
- Expects strong growth in US & Indian markets to compensate for poor performance in Russia & Germany
- Expects revenues in Germany to be lower than FY09 level vs. flat sales indicated earlier
- US launch of fondaparinux not built into the guidance

Figure 1. 3QFY09 Consolidated Earnings Summary (Rs m, %)

Year to Mar 31	1Q FY09	1Q FY10	Ch YoY	4Q FY09	% Ch QoQ	CIRA Comments
Revenues	15,038	18,189	21.0	19,851	(8.4)	Recurring PAT c6% below estimate – largely on account of headwinds in Russia & Germany
Cost of revenues	7,544	8,017	6.3	9,081	(11.7)	
Gross Profit	7,494	10,172	35.7	10,770	(5.6)	Ex Imitrex AG, sales grew by 7% YoY in 1QFY10
Gross Margin (%)	49.8	55.9	609 bps	54.3	167 bps	We estimate base biz gross margins of c52% - Overall margins was buoyed by high margin Imitrex AG sales (Citi estimate: 85% GM)
S,G&A Expenses	4,708	5,420	15.1	4,951	9.5	
as a % of sales	31.3	29.8	-151 bps	24.9	486 bps	SG&A costs higher due to one-time costs on sales force exit at Betapharm & closure of Atlanta facility – excluding this S,G&A expenses grew 6% YoY
R&D Expenses	1,050	985	(6.2)	1,135	(13.2)	
as a % of sales	7.0	5.4	-157 bps	5.7	-30 bps	Amortisation costs higher due to amortisation of intangibles related to Beta brand which was not expensed earlier. This is recurring in nature.
Amortization Expenses	377	507	34.5	14,339	(96.5)	
Other operating exp/(inc)	241	(35)	(114.5)	(186)	(81.2)	Tax rate higher in 1QFY10 due to greater sales from US – FY10 tax rate guidance of c17%
Total Operating Expenses	6,376	6,877	7.9	20,239	(66.0)	One time expenses include €7.2m costs on exit of sales force at Betapharm and US\$1.5m costs related to closure of Atlanta facility
Operating Income	1,118	3,295	194.8	(9,469)	(134.8)	
Operating Margin (%)	7.4	18.1	1,068 bps	(47.7)	6,582 bps	Imitrex AG: Assumed 85% GM, 20% tax rate
Equity in Loss of Affiliates	-	(11)	nm	(14)	nm	
Forex Loss / (Gain)	(176)	84	(147.7)	400	(79.0)	
Other (Income) / Expenses	99	51	(48.5)	(318)	(116.0)	
PBT	1,195	3,171	165.4	(9,537)	(133.2)	
Tax	84	726	764.3	240	202.5	
Effective tax rate	7.0	22.9	1,586 bps	(2.5)	2,541 bps	
Reported Net Income	1,111	2,445	120.2	(9,777)	(125.0)	
One time expenses	365	355	nm	13,023	nm	
Upside from Imitrex AG (est)	-	1,421	nm	2,461	(42.2)	
Recurring Net Income	1,476	1,379	(6.6)	785	75.6	

Source: Citi Investment Research and Analysis

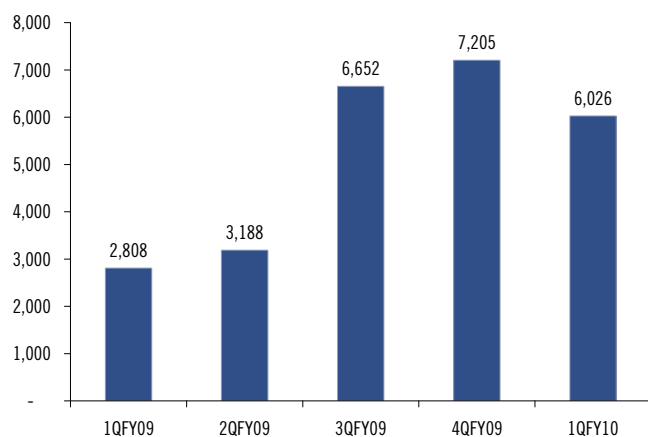
Figure 2. 3QFY09 Consolidated Revenue Breakup (Rs m, %)

Year to Mar 31	1Q FY09	1Q FY10	Ch YoY	4Q FY09	% Ch QoQ	CIRA Comments
Pharma Services & Active Ingredients	4,613	4,870	5.6	4,860	0.2	Growth driven by launch of new products including Gemcitabine, Montelukast, Sumatriptan & Levetiracetam as well as INR depreciation
- India	722	629	(12.9)	572	10.0	
- North America	1,085	995	(8.3)	833	19.4	
- Europe	1,080	1,371	26.9	2,153	(36.3)	
- ROW	1,726	1,875	8.6	1,302	44.0	
Global Generics	10,287	10,520	2.3	14,669	(28.3)	N.America sales up of 42% YoY, excluding Imitrex AG (21% in US\$ terms) on the back of 14% volume growth in existing products
Branded Generics	4,485	4,885	8.9	4,368	11.8	
- India	2,202	2,393	8.7	2,072	15.5	
- Russia	1,499	1,529	2.0	1,399	9.3	
- CIS	429	342	(20.3)	435	(21.4)	
- ROW	355	621	74.9	462	34.4	
Generics	5,802	8,134	40.2	10,301	(21.0)	India sales growth driven by growth in key brands (Omez, Nise, Razo)
- North America	2,808	6,026	114.6	7,205	(16.4)	Decline in Betapharm sales on account of destocking by the trade ahead of the AOK tender supplies & withdrawal of olanzapine
Authorized Generic	-	2,090	nm	3,619	(42.2)	
Continuing Business	2,808	3,936	40.2	3,586	9.8	
- Europe	2,994	2,108	(29.6)	3,096	(31.9)	
Betapharm, Germany	2,521	1,605	(36.3)	2,583	(37.9)	Tepid growth in Russia due to inventory holding correction at the trade level
Others	473	503	6.3	513	(1.9)	
Innovative Products	138	300	117.4	177	69.5	Base biz growth expected to pick up in the 2HFY10 with likely recovery in Russia and Omeprazole OTC launch in the US
Others	-	-	nm	145	nm	
Total revenues	15,038	18,189	21.0	19,851	(8.4)	
Continuing / Base Business	15,038	16,099	7.1	16,232	(0.8)	

Source: Citi Investment Research and Analysis

Update on Key Businesses

Figure 3. Generics Revenues – North America (Rs m)



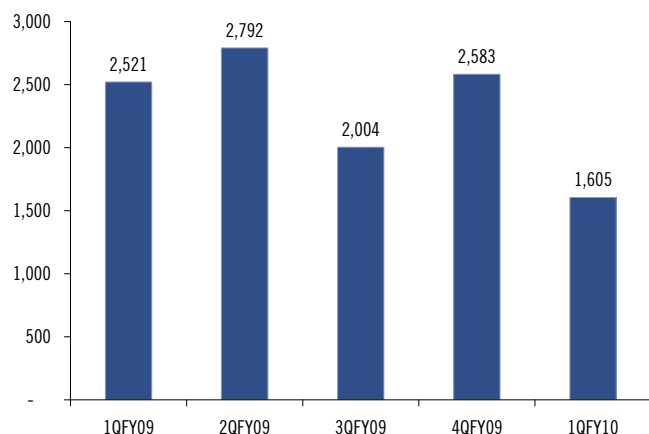
CIRA Comments

- 1QFY10 includes cUS\$43m (cRs2.1bn) from the AG sales of Imitrex (cUS\$73m and US\$70m in 3QFY09 & 4QFY09) – these sales will continue till mid August
- Market share of over 50% in generic Imitrex
- Excluding Imitrex, revenues grew by 42% YoY, driven by high volume growth in key products (21% in US\$ terms)
- Omeprazole OTC launch expected in Q2FY10. We expect this product to be a key growth driver in FY10
- Total 139 ANDAs filed in US with 67 pending approval – 28 are Para IVs and 16 FTFs

Source: Company Reports and Citi Investment Research and Analysis

Source: Company Reports and Citi Investment Research and Analysis

Figure 4. Generics Revenues – Germany (Betapharm) (Rs m)



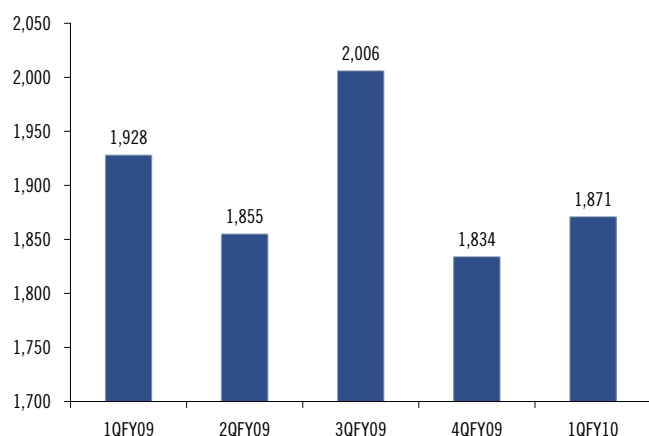
Source: Company Reports and Citi Investment Research and Analysis

CIRA Comments

- Revenues down 38% YoY on destocking ahead of the commencement of AOK tender supplies & withdrawal of olanzapine from the market
- Commenced supplies to AOK tender in 1QFY10
- Betapharm sales force reduced from 110 to 50. DRL incurred one time severance costs of €7.2m in 1QFY10
- Germany witnessing increased tender activities by other insurance companies. AOK tender for further 94 product in 2HCY09 – supplies expected to commence in Jan '10
- Headwinds in this market pose risk to FY10 guidance

Source: Company Reports and Citi Investment Research and Analysis

Figure 5. Generics Revenues – Russia & CIS (Rs m)



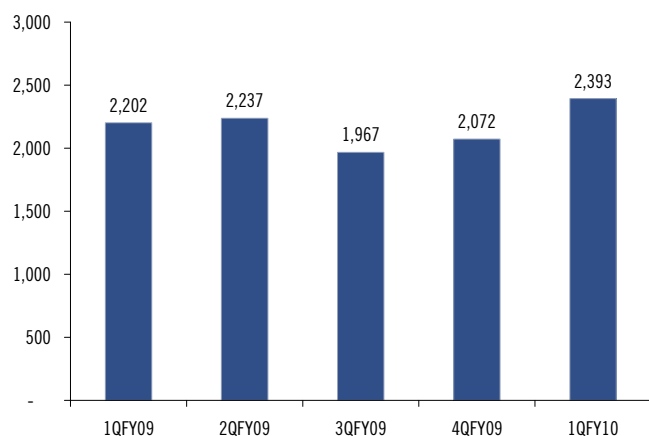
Source: Company Reports and Citi Investment Research and Analysis

CIRA Comments

- Revenues from Russia up 2% YoY on the back of strong performance of key brands – up 18% in Rouble terms
- Volumes in the Russian market have degrown YoY due to inventory holding correction at the trade level as well as lack of liquidity in the market
- Robust secondary sales growth trends – up 46% YoY in the months of April & May, ahead of industry growth rate of c34%
- Sales expected to improve from 3Q, which is a seasonally strong quarter

Source: Company Reports and Citi Investment Research and Analysis

Figure 6. Generics Revenues – India (Rs m)



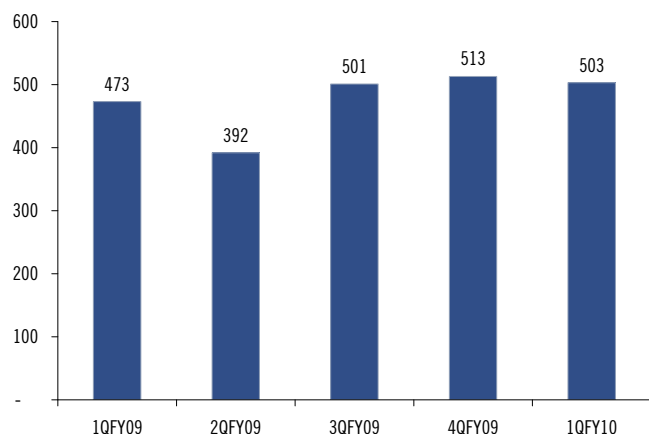
Source: Company Reports and Citi Investment Research and Analysis

CIRA Comments

- Revenues up 9% YoY driven by growth in sales of major brands (Omez, Nise & Razo)
- 14 new products launched during the quarter
- Robust secondary sales growth trends – up 11.4% YoY in the months of April & May, ahead of industry growth rate of c10%
- Changes implemented in supply chain progressing well

Source: Company Reports and Citi Investment Research and Analysis

Figure 7. Generics Revenues – Rest of Europe (Rs m)



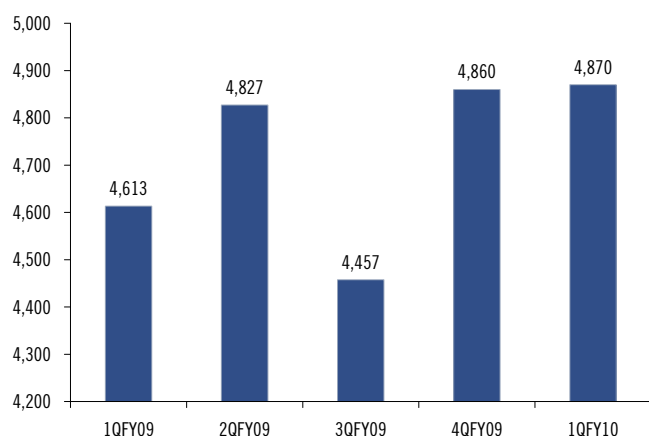
CIRA Comments

- Revenues up 6% YoY at Rs503m largely driven by 23% YoY increase in UK sales

Source: Company Reports and Citi Investment Research and Analysis

Source: Company Reports and Citi Investment Research and Analysis

Figure 8. PSAI Revenues (Rs m)



CIRA Comments

- Revenues up 6% YoY at Rs4.9bn. DRL expects double-digit growth rates for the rest of FY10
- Growth driven by launch of new products including Gemcitabine, Montelukast, Sumatriptan & Levetiracetam
- EU & RoW markets account for most of the growth. Sales from India and US declined YoY
- Order book up 27% YoY.
- 4 DMFs filed during the quarter; 355 DMF filings till date

Source: Company Reports and Citi Investment Research and Analysis

Source: Company Reports and Citi Investment Research and Analysis

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. The company has evolved a business model that appears among the best placed to tackle the changing dynamics of the industry. Near-term growth drivers and investment for the longer-term

sustainability of growth make DRL one of the best Indian pharma companies, in our view. At the same time, DRL's presence in patent challenges and drug discovery implies the potential for positive surprises to earnings and valuations. While DRL has been caught on the wrong foot with its acquisition of Betapharm in Germany, given significant changes in regulations and market dynamics, its impact on the DRL's earnings power appears to be diminishing (c10% of FY11E gross profits vs. c17% of FY08 gross profits).

Valuation

Our target price for DRL is Rs825, which is based on a sum-of-the-parts valuation approach. We use a target multiple of 16x to value sector leaders, which is at a premium of about 5% to the broad market and seems justified given that the sector is IPR driven and has the potential for significant earnings growth despite the economic slowdown. We value DRL inline with other sector leaders with Russia faring better than our expectations and return ratios set to improve materially in FY10E. At 16x Jun 10E earnings, we value DRL's base business at Rs760. We value DRL's Para IV pipeline separately at Rs65 - including a Rs11 from Imitrex AG sales in FY10E. For the rest of the pipeline, we use a success probability of 35% and a discounted cash flow (discount factor 12.5%) for the opportunities being targeted over the next few years. Cumulatively, we arrive at a target price of Rs825.

Risks

We rate DRL Medium Risk, which is in line with our quant-based risk rating system. Downside risks to our target price include: (1) DRL's ramp-up in sales and distribution in the US entails large investments; (2) Patent challenges are win-lose situations and often cause stock-price volatility; and (3) R&D success rates are low.

Appendix A-1

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Dr Reddy (REDY.BO)

Ratings and Target Price History Fundamental Research

Analyst: Prashant Nair, CFA

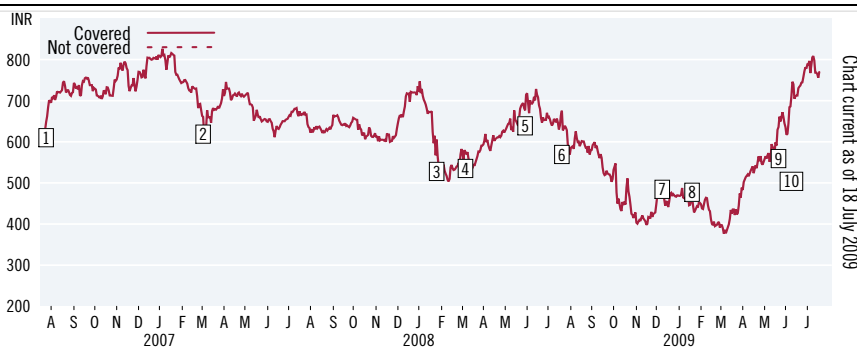


Chart current as of 18 July 2009

	Date	Rating	Target Price	Closing Price
1	19-Jul-06	*1M	*778.50	610.00
2	2-Mar-07	1M	*803.00	660.60
3	25-Jan-08	1M	*725.00	605.40
4	6-Mar-08	*2M	*642.00	579.90

* Indicates change

	Date	Rating	Target Price	Closing Price
5	29-May-08	*2L	*708.00	676.45
6	21-Jul-08	*2M	*739.00	675.65
7	9-Dec-08	2M	*535.00	481.20
8	20-Jan-09	2M	*547.00	467.90

	Date	Rating	Target Price	Closing Price
9	21-May-09	2M	*700.00	635.75
10	9-Jun-09	*1M	*825.00	711.40

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2009

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Dr Reddy (REDY.BO)

21 July 2009

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