

Pharmaceuticals

Target price Rs1,271

Earnings revision

(%)	FY10E	FY11E
Sales	↓ 5.0	↓ 1.0
EBITDA	↑ 1.4	↑ 3.8
Net profit	↑ 37.9	↑ 39.0

Shareholding pattern

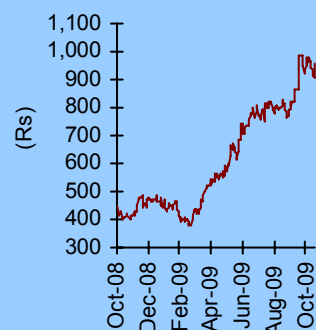
	Mar '09	Jun '09	Sep '09
Promoters	26.4	25.8	25.8
Institutional investors	42.3	45.1	43.8
MFs and UTI	6.8	6.3	7.2
Insurance Cos.	13.4	13.4	13.2
FII's	22.2	25.4	23.3
Others	31.3	29.1	30.3

Source: NSE

Target price revision

Rs1,271 from Rs1,150

Price chart



Rajesh Vora

rajesh.vora@icicisecurities.com

+91 22 6637 7508

INDIA

Dr. Reddy's Laboratories

BUY

Maintained

Rs960

Blockbuster performance

Reason for report: Q2FY10 results review and earnings revision

Dr. Reddy's Laboratories' (DRL) consolidated recurring net profits almost tripled to Rs2.4bn as per Indian GAAP. This was substantially ahead of our estimates, mainly owing to significantly lower-than-expected depreciation charge (given ₹209mn write-down with respect to betapharm intangibles), and higher-than-expected EBITDA margin and revenues (especially from North America). Led by better revenue mix, lower R&D costs and benefits of operating leverage, EBITDA margin expanded 432bps to 19.4%. Hence, we raise FY10E-11E EPS estimates 38-39% and increase fair value to Rs1,271. Launch of generic *Prilosec* OTC in Q3FY10 followed by the likely launch of generic *Arixtra* in the next 2-3 quarters would further boost earnings growth for the next couple of years. This combined with the likelihood of a big pharma buying stake in DRL could keep valuations high for some time. **BUY.**

- **Thumping Q2FY10 results.** Consolidated operating revenues grew 14% YoY to Rs18bn, as per the Indian GAAP. This was mainly powered by dosage form revenues in North America & Russia and PSAI revenues from Europe, which is impressive. Depreciation decreased 19% YoY to Rs994mn, mainly due to lower amortisation charge given ₹209mn write-down with respect to betapharm-related intangibles. This was vastly below our estimates. Interest costs crashed 74% YoY to Rs69mn due to lower interest rates and rising cash. Thus, consolidated recurring net profits spiked 177% YoY to Rs2.39bn, significantly ahead of our estimates.
- **Speculations of GSK plc buying stake boosted the stock price.** With recent speculations on GSK plc picking up 5% stake in DRL at an EV of ~US\$3.3bn, the stock price spiked ~15% within 10 days of the newsflow. While both the companies have denied such a move, we believe big pharma MNCs are desperate to rapidly scale-up their businesses in emerging markets through acquisitions; hence, we remain upbeat on the future prospects of such deals.
- **Reiterate BUY.** Buoyed by multi-year upside from two key products – generic *Prilosec* OTC (to be launched in Q3FY10) and generic *Arixtra* (launch in April '10) – and healthy growth in the base business, we expect DRL to post strong performance in the next two years. Given the EPS upgrade (due to better-than-expected H1FY10) as well as superiority over peers on the US FDA compliance front, we have raised our target price to Rs1,271/share from Rs1,150/share.

Market Cap	Rs133bn/US\$2.8bn
Reuters/Bloomberg	REDY.BO/DRRD IN
Shares Outstanding (mn)	168
52-week Range (Rs)	809/377
Free Float (%)	74.2
FII (%)	23.3
Daily Volume (US\$/'000)	9,300
Absolute Return 3m (%)	17.8
Absolute Return 12m (%)	115.8
Sensex Return 3m (%)	9.3
Sensex Return 12m (%)	93.2

Year to March	FY08	FY09	FY10E	FY11E
Revenue (Rs mn)	49,630	69,006	71,981	83,168
Net Income (Rs mn)	3,636	5,456	9,054	11,197
EPS (Rs)	21.7	32.5	54.0	66.8
% Chg YoY	(61.5)	50.0	66.0	23.7
P/E (x)	44.3	29.5	17.8	14.4
CEPS (Rs)	45.6	62.1	79.0	95.5
EV/E (x)	20.7	13.5	11.1	8.4
Dividend Yield (%)	0.5	0.8	0.8	0.9
RoCE (%)	6.7	11.2	16.2	18.0
RoE (%)	8.6	13.6	23.1	23.4

Earnings revision

Key reasons are:

- Significantly lower-than-expected depreciation due to lower amortisation charge on account of €209mn write-down in Q4FY09 with respect to betapharm acquisition related intangibles.
- Lower-than-expected interest costs due to rising cash levels and reduction in interest rate.
- Benefits from the cost savings programme (including R&D expenditure mainly due to reorganisation of the NCE model), with other expenditure being trimmed 280bps to 16.4% of revenues.

On the back of the aforementioned factors, we raise FY10E and FY11E EPS 38% and 39% respectively.

Table 1: Earnings revision

(Rs mn)

	FY10E			FY11E		
	Old	New	% chg	Old	New	% chg
Operating Income	75,732	71,981	(5.0)	83,974	83,168	(1.0)
EBITDA	15,173	15,388	1.4	19,190	19,919	3.8
PAT	6,568	9,054	37.9	8,057	11,197	39.0
EPS (Rs)	39.2	54.0	37.9	48.0	66.8	39.0

Source: I-Sec Research

With impressive H1FY10 results, we gain confidence on DRL's ability to deliver strong growth in the base business (which has been historically volatile) in the next two years; we have raised EPS estimates 38-39% for the next two years and lowered multiples from 25x for base business and 14x for first-to-files (FTFs), which we had used temporarily to justify the surging stock price. Our revised EPS for the base generics business is Rs51 – we have applied P/E of 22x to it, resulting in value of Rs1,121/share. Besides, we value two certain FTF generic versions of *Prilosec* OTC & *Arixtra* at Rs150/share at 10x present value of EPS, given the likelihood of multi-year upside. We, thus, arrive at a total target price of Rs1,271/share, implying a potential upside of 32% over the next 12-15 months.

Table 2: Q2FY10 results review (as per Indian GAAP consolidated)

(Rs mn, year ending March 31)

	Q2FY10	Q2FY09	YoY	H1FY10	H1FY09	% Chg (YoY)
Net Sales	18,004	15,759	14.2	35,792	30,572	17.1
Other op income	576	444	29.7	996	618	61.2
Total Operating Income	18,580	16,203	14.7	36,788	31,190	17.9
Total Expenditure	14,984	13,767	8.8	28,851	26,593	8.5
Raw Material	6,591	5,874	12.2	12,196	11,227	8.6
R&D expenses	952	986	-3.4	1,925	2,011	(4.3)
Personnel costs	2,806	2,437	15.1	5,846	4,837	20.9
Selling expenses	1,703	1,462	16.4	3,431	2,943	16.6
Other expenditure	2,932	3,008	-2.5	5,453	5,575	(2.2)
EBITDA	3,596	2,436	47.6	7,937	4,597	72.6
Other Income	292	93	215.4	478	582	(17.9)
Interest	69	263	-73.9	191	489	(60.9)
Depreciation	994	1,228	(19.0)	2,025	2,408	(15.9)
PBT	2,826	1,038	172.3	6,198	2,283	171.5
Tax	428	172	149.4	1,411	497	184.2
Reported PAT	2,398	866	176.8	4,787	1,786	168.0
Recurring PAT	2,398	866	176.8	4,787	1,786	168.0
EPS (Rs)	14.3	5.2	176.8	28.5	11	168.0
Ratios (%)						
EBITDA Margin	19.4	15.0	432.1	21.6	14.7	683.5
Net Profit Margin	13.3	5.5	782.1	13.4	5.8	753.2

Source: Company data, I-Sec Research

Table 3: Revenue mix (as per IFRS)

(Rs mn, year ending March 31)

	Q2FY10	Q2FY09	YoY	H1FY10	H1FY09	% Chg (YoY)
Generics	12,707	11,160	13.9	25,727	21,485	19.7
India	2,520	2,237	12.7	4,913	4,439	10.7
Global	10,187	8,923	14.2	20,814	17,046	22.1
North America	4,285	3,188	34.4	10,311	6,034	70.9
of which <i>Imitrex AG</i>	222	0		2,322	0	
Europe	2,849	3,184	(10.5)	4,958	6,046	(18.0)
Russia & CIS	2,347	1,855	26.5	4,218	3,783	11.5
Others	706	696	1.4	1,327	1,183	12.2
PSAI (Pharm Ser & API)	5,375	4,827	11.4	10,245	9,440	8.5
India	629	656	(4.1)	1,258	1,378	(8.7)
Global	4,746	4,171	13.8	8,987	8,062	11.5
North America	1,150	1,092	5.3	2,145	2,177	(1.5)
Europe	1,761	1,176	49.7	3,132	2,256	38.8
Others	1,835	1,903	(3.6)	3,710	3,629	2.2
Innovative Products	0	48	-	300	48	526
Others	0	116	-	0	215	-
Total	18,082	16,151	12.0	36,272	31,188	16.3

Source: Company data, I-Sec Research

Financial summary (Consolidated, as per Indian GAAP)

Table 4: Profit and Loss statement

(Rs mn, year ending Mar 31)

	FY08	FY09	FY10E	FY11E
Operating Income (Sales)	49,630	69,006	71,981	83,168
of which Exports	40,010	57,594	59,610	70,354
of which Domestic	9,620	11,412	12,371	12,814
Operating Expenses	41,241	55,986	56,592	63,249
EBITDA	8,389	13,020	15,388	19,919
% margins	15.6	17.6	19.7	22.3
Depreciation & Amortisation	4,019	4,977	4,210	4,841
Gross Interest	958	972	384	442
Other Income	1,292	993	951	1,046
Recurring PBT	4,704	8,064	11,746	15,682
Extraordinaries (Net)	745	(14,628)	0	0
Less: Taxes	1,077	2,608	2,691	4,485
- Current tax	1,235	2,788	2,891	4,695
- Deferred tax	(159)	(180)	(200)	(210)
Less: Minority Interest	(9)	0	0	0
Net Income (Reported)	4,381	(9,172)	9,054	11,197
Recurring Net Income	3,636	5,456	9,054	11,197

Source: Company data, I-Sec Research

Table 5: Balance sheet

(Rs mn, year ending Mar 31)

	FY08	FY09	FY10E	FY11E
Assets				
Total Current Assets	30,342	38,798	42,731	51,824
of which cash & cash eqv.	7,453	5,623	6,741	9,309
Total Current Liabilities & Provisions	11,508	17,112	16,506	18,096
Net Current Assets	18,834	21,686	26,225	33,728
Investments				
of which	4,821	523	600	800
Strategic/Group	57	0	0	0
Other Marketable	4,821	523	600	800
Net Fixed Assets	20,733	25,333	26,539	28,612
intangibles	26,640	12,936	11,460	9,999
Capital Work-in-Progress	2,678	4,296	4,296	4,296
Goodwill	21,071	8,233	6,614	4,995
Total Assets	65,459	55,775	59,978	68,135
Liabilities				
Borrowings	19,684	19,976	16,583	15,261
Deferred Tax Liability	806	538	338	128
Minority Interest	0	0	0	0
Equity Share Capital	841	841	841	841
Face Value per share (Rs)	5	5	5	5
Reserves & Surplus*	44,128	34,420	42,217	51,905
Less: Misc. Exp. #	0	0	0	0
Net Worth	44,969	35,261	43,058	52,746
Total Liabilities	65,459	55,775	59,978	68,135

*Excluding revaluation reserves; # not-written off

Source: Company data, I-Sec Research

Table 8: Quarterly trend

(Rs mn, year ending Mar 31)

	Dec-08	Mar-09	Jun-09	Sep-09
Net sales	18,050	19,282	17,788	18,004
% growth (YoY)	52	53	20	14
EBITDA	3,465	4,957	4,341	3,596
Margin (%)	16.9	25.3	22.0	16.8
Other income	90	322	186	292
Extraordinaries (Net)	(493)	(14,649)	0	0
Net profit	1,592	2,078	2,389	2,398

Source: Company data, I-Sec Research

Table 6: Cashflow statement

(Rs mn, year ending Mar 31)

	FY08	FY09	FY10E	FY11E
Operating Cash flow	6,080	9,659	13,932	16,892
Working Capital Changes	(3,728)	(4,603)	(3,421)	(4,935)
Capital Commitments	(10,934)	(7,470)	(5,693)	(7,605)
Free Cash Flow	(8,583)	(2,413)	4,818	4,353
Cash flow from Investing Activities	1,292	993	951	1,046
Issue of Share Capital	1	0	0	0
Buyback of shares	0	0	0	0
Inc (Dec) in Borrowings	(5,223)	292	(3,394)	(1,321)
Dividend paid	(738)	(1,231)	(1,258)	(1,509)
Extraordinary Items	745	0	0	0
Chg. in Cash & Bank balance	(11,157)	(1,830)	1,118	2,568

Source: Company data, I-Sec Research

Table 7: Key ratios

(Year ending Mar 31)

	FY08	FY09	FY10E	FY11E
Per Share Data (Rs)				
EPS(Basic Recurring)	21.7	32.5	54.0	66.8
Diluted Recurring EPS	21.7	32.5	54.0	66.8
Recurring Cash EPS	45.6	62.1	79.0	95.5
Dividend per share (DPS)	4.4	7.3	7.5	9.0
Book Value per share (BV)	267.8	210.0	256.4	314.1
Growth Ratios (%)				
Operating Income	(23.8)	39.0	4.3	15.5
EBITDA	(49.3)	55.2	18.2	29.4
Recurring Net Income	(61.5)	50.0	66.0	23.7
Diluted Recurring EPS	(61.5)	50.0	66.0	23.7
Diluted Recurring CEPS	(42.1)	36.3	27.1	20.9
Valuation Ratios (x)				
P/E	44.3	29.5	17.8	14.4
P/CEPS	21.1	15.5	12.2	10.1
P/BV	3.6	4.6	3.7	3.1
EV / EBITDA	20.7	13.5	11.1	8.4
EV / Operating Income	3.5	2.5	2.4	2.0
EV / Operating FCF	73.7	34.7	16.3	14.0
Operating Ratio				
Raw Material/Sales (%)	36.5	34.8	33.1	29.7
SG&A/Sales (%)	25.9	27.0	25.2	26.0
Other Income / PBT (%)	27.5	12.3	8.1	6.7
Effective Tax Rate (%)	19.8	(39.7)	22.9	28.6
NWC / Total Assets (%)	17.4	28.8	32.5	35.8
Inventory Turnover (days)	189.1	187.6	226.7	259.8
Receivables (days)	52.6	55.9	76.7	74.8
Payables (days)	205.2	196.3	222.8	211.2
D/E Ratio (%)	45.6	58.2	39.3	29.2

Return/Profitability Ratio (%)

Recurring Net Income Margins	7.1	7.8	12.4	13.3
RoCE	6.7	11.2	16.2	18.0
RoNW	8.6	13.6	23.1	23.4
Dividend Payout Ratio	16.8	22.5	13.9	13.5
Dividend Yield	0.5	0.8	0.8	0.9
EBITDA Margins	15.6	17.6	19.7	22.3

Source: Company data, I-Sec Research

I-Sec investment ratings (all ratings relative to Sensex over next 12 months)

BUY: +10% outperformance; **HOLD:** -10% to +10% relative performance; **SELL:** +10% underperformance

ANALYST CERTIFICATION

We I, *Rajesh Vora, Grad. CWA, CFA* research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report. Analysts aren't registered as research analysts by FINRA and might not be an associated person of the ICICI Securities Inc.

Disclosures:

ICICI Securities Limited (ICICI Securities) and its affiliates are a full-service, integrated investment banking, investment management and brokerage and financing group. We along with affiliates are leading underwriter of securities and participate in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationship with a significant percentage of companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. ICICI Securities generally prohibits its analysts, persons reporting to analysts and their dependent family members from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover.

The information and opinions in this report have been prepared by ICICI Securities and are subject to change without any notice. The report and information contained herein is strictly confidential and meant solely for the selected recipient and may not be altered in any way, transmitted to, copied or distributed, in part or in whole, to any other person or to the media or reproduced in any form, without prior written consent of ICICI Securities. While we would endeavour to update the information herein on reasonable basis, ICICI Securities, its subsidiaries and associated companies, their directors and employees ("ICICI Securities and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance or other reasons that may prevent ICICI Securities from doing so. Non-rated securities indicate that rating on a particular security has been suspended temporarily and such suspension is in compliance with applicable regulations and/or ICICI Securities policies, in circumstances where ICICI Securities is acting in an advisory capacity to this company, or in certain other circumstances.

This report is based on information obtained from public sources and sources believed to be reliable, but no independent verification has been made nor is its accuracy or completeness guaranteed. This report and information herein is solely for informational purpose and may not be used or considered as an offer document or solicitation of offer to buy or sell or subscribe for securities or other financial instruments. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. ICICI Securities will not treat recipients as customers by virtue of their receiving this report. Nothing in this report constitutes investment, legal, accounting and tax advice or a representation that any investment or strategy is suitable or appropriate to your specific circumstances. The securities discussed and opinions expressed in this report may not be suitable for all investors, who must make their own investment decisions, based on their own investment objectives, financial positions and needs of specific recipient. This may not be taken in substitution for the exercise of independent judgement by any recipient. The recipient should independently evaluate the investment risks. The value and return of investment may vary because of changes in interest rates, foreign exchange rates or any other reason. ICICI Securities and affiliates accept no liabilities for any loss or damage of any kind arising out of the use of this report. Past performance is not necessarily a guide to future performance. Actual results may differ materially from those set forth in projections. Forward-looking statements are not predictions and may be subject to change without notice.

ICICI Securities and its affiliates might have managed or co-managed a public offering for the subject company in the preceding twelve months. ICICI Securities and affiliates might have received compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for services in respect of public offerings, corporate finance, investment banking or other advisory services in a merger or specific transaction. ICICI Securities and affiliates expect to receive compensation from the companies mentioned in the report within a period of three months following the date of publication of the research report for services in respect of public offerings, corporate finance, investment banking or other advisory services in a merger or specific transaction. It is confirmed that *Rajesh Vora, Grad. CWA, CFA* research analysts and the authors of this report have not received any compensation from the companies mentioned in the report in the preceding twelve months. Our research professionals are paid in part based on the profitability of ICICI Securities, which include earnings from Investment Banking and other business.

ICICI Securities or its affiliates collectively do not own 1% or more of the equity securities of the Company mentioned in the report as of the last day of the month preceding the publication of the research report.

It is confirmed that *Rajesh Vora, Grad. CWA, CFA* research analysts and the authors of this report or any of their family members does not serve as an officer, director or advisory board member of the companies mentioned in the report.

ICICI Securities may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report. ICICI Securities and affiliates may act upon or make use of information contained in the report prior to the publication thereof.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject ICICI Securities and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.