Company Focus

7 March 2008 | 9 pages

Dr Reddy (REDY.BO)

Downgrade to Hold: Growth Pangs

Change in opinion ☑
Rating change ☑
Target price change ☑

- **Downgrade to Hold** — We downgrade Dr Reddy's from Buy to Hold as we reduce our target price by 11% to Rs642/share. Our target price cut stems from a lower multiple (18x v/s 20x earlier) to value its core business (due to near term uncertainties in Germany) & lower option value for Perlecan. Although long term initiatives hold promise, the German concerns would act as an overhang on valuations in the near term, in our view.
- **Mixed outlook** — We expect DRL's well diversified business & expanding pipeline of products/markets in each segment to drive sustained growth over the long term. Besides, its efforts in biosimilars & innovative R&D would throw up valuation & growth drivers beyond the traditional generics opportunity. However, over the next few quarters, we expect the pain in German operations to continue and suppress overall earnings growth.
- **Concerns in Germany** — DRL took a big write-off (Rs2.4bn) of intangibles related to Betapharm in 3QFY08. Although it has made good progress in shifting production to low cost Indian facilities, the regulatory pressure on pricing & growing bargaining power of insurance companies show no signs of easing in the near term and should keep profitability under pressure.
- **Cut TP to Rs642/share** — We cut our target P/E on the base business to 18x (from 20x) due to the near term uncertainty on earnings & return ratios – especially on concerns in Germany. We also shift to a more conservative valuation of its P-IV pipeline (down 15% to Rs27) & stake in Perlecan Pharma (down 35% to Rs26), as we raise our discounting rate to factor in the higher risk premium for equities.

Hold/Medium Risk	**2M**
from Buy/Medium Risk	
Price (05 Mar 08)	Rs579.90
Target price	Rs642.00
from Rs725.00	
Expected share price return	10.7%
Expected dividend yield	0.7%
Expected total return	**11.4%**
Market Cap	Rs97,523M
	US$2,425M

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	47.9	2.0	4.3	0.6
2007A	9,328	55.55	358.6	10.4	2.3	29.2	0.7
2008E	4,195	24.99	-55.0	23.2	2.2	9.7	0.8
2009E	5,786	34.46	37.9	16.8	2.0	12.2	0.8
2010E	7,032	41.88	21.5	13.8	1.7	13.3	0.8

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	47.9	10.4	23.2	16.8	13.8
EV/EBITDA adjusted (x)	147.4	5.4	10.7	8.9	7.1
P/BV (x)	2.0	2.3	2.2	2.0	1.7
Dividend yield (%)	0.6	0.7	0.8	0.8	0.8
Per Share Data (Rs)					
EPS adjusted	12.11	55.55	24.99	34.46	41.88
EPS reported	12.11	55.55	25.83	34.46	41.88
BVPS	290.40	247.62	267.43	296.71	333.42
DPS	3.50	4.00	4.50	4.50	4.50
Profit & Loss (RsM)					
Net sales	23,562	65,095	49,509	57,844	62,114
Operating expenses	-23,404	-54,528	-47,006	-51,494	-54,183
EBIT	**158**	**10,567**	**2,504**	**6,350**	**7,931**
Net interest expense	1,118	-3	832	400	400
Non-operating/exceptionals	-88	-63	-8	-60	-60
Pre-tax profit	**1,188**	**10,501**	**3,328**	**6,690**	**8,271**
Tax	-258	-1,177	865	-906	-1,241
Extraord./Min.Int./Pref.div.	-1	4	143	2	2
Reported net income	**929**	**9,328**	**4,336**	**5,786**	**7,032**
Adjusted earnings	929	9,328	4,195	5,786	7,032
Adjusted EBITDA	578	13,908	6,355	7,650	9,231
Growth Rates (%)					
Sales	21.0	176.3	-23.9	16.8	7.4
EBIT adjusted	29.7	nm	-76.3	153.6	24.9
EBITDA adjusted	22.1	nm	-54.3	20.4	20.7
EPS adjusted	337.6	358.6	-55.0	37.9	21.5
Cash Flow (RsM)					
Operating cash flow	**1,039**	**4,683**	**-1,585**	**2,991**	**5,601**
Depreciation/amortization	420	3,341	3,851	1,300	1,300
Net working capital	-1,873	-4,265	-5,923	-2,797	-1,433
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**	**-3,354**	**1,222**	**3,832**
Balance Sheet (RsM)					
Total assets	**68,768**	**85,919**	**85,849**	**91,453**	**97,970**
Cash & cash equivalent	5,334	18,603	15,108	16,330	20,162
Accounts receivable	4,802	7,519	9,156	10,697	11,487
Net fixed assets	9,086	12,428	13,328	14,228	15,128
Total liabilities	**46,496**	**44,330**	**40,932**	**41,617**	**41,968**
Accounts payable	3,639	4,755	4,069	4,754	5,105
Total Debt	30,995	24,754	22,041	22,041	22,041
Shareholders' funds	**22,272**	**41,578**	**44,905**	**49,822**	**55,985**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	2.5	21.4	12.8	13.2	14.9
ROE adjusted	4.3	29.2	9.7	12.2	13.3
ROIC adjusted	-0.8	54.0	15.5	21.3	23.4
Net debt to equity	115.2	14.8	15.4	11.5	3.4
Total debt to capital	58.2	37.3	32.9	30.7	28.2

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Growth Pangs; Downgrade to Hold

We downgrade Dr Reddy's from Buy to Hold as we reduce our target price by 11% to Rs642/share. Our target price cut stems from a lower multiple (18x v/s 20x earlier) to value its core business (due to near term uncertainties in Germany) & lower option value for Perlecan. Although long term initiatives hold promise, the German concerns would act as an overhang on valuations in the near term in our view.

What has changed?

Our downgrade stems from the following factors:

- **Uncertainty persists on Germany**: While we believe that DRL's acquisition of Betapharm in Germany is a right move over the long term from the strategic perspective, it has been caught on the wrong foot by the significant changes in regulations and market dynamics. Although these concerns are not new, the impact of these on the company's earnings power appears to be much higher than we had anticipated earlier.

  In 3QFY08, DRL took another big write-off (Rs2.4bn) of intangibles related to Betapharm (the first one being a Rs1.8bn charge taken in 4QFY07). Although supply constraints under its sourcing contract with Solutas is a thing of the past and DRL has made good progress in shifting production to low cost Indian facilities (4 products already being supplied out of India), the benefits are being offset by the higher rebates being demanded by insurance companies. With another round of price cuts expected around April 2008 and the bargaining power of insurance companies unlikely to ease, we believe it would take time for the company to strike a balance between the need to have a sales force on the ground and the profitability of the business.

  Overall, we believe that as the business transforms to a generic generic market from a branded generics one, earnings would no longer command the same multiple that it used to in the past.

- **Some duress in Perlecan Pharma**: We have been building in some option value for DRL's holding in Perlecan Pharma. However, Perlecan has faced some setbacks on its R&D portfolio. The data on RUS-3108 has thrown up safety concerns and the molecule appears likely to be dropped. At the same time, the company has also taken DRL-10945 out of the purview of Perlecan Pharma, given the higher risk profile of the compound in light of recent indications from the FDA. This leaves only two molecules in Perlecan Pharma (v/s 4 earlier) and implies a lower value for the firm. We have made appropriate changes to our valuation for DRL's stake in Perlecan – reducing it to Rs26/share from Rs35/share earlier.

Reducing Target Price to Rs642/share

We lower our target price by 11% to Rs642/share on the back of the following factors:

- We cut our target P/E on the base business to 18x (from 20x) due to the near term uncertainty on earnings & return ratios – especially on concerns in Germany. We now value the core business at Rs589/share (down 12% from Rs659/share earlier)

- We also shift to a more conservative valuation of its P-IV pipeline (down 15% to Rs27) & stake in Perlecan Pharma (down 35% to Rs26), as we account for the setbacks faced in the latter and factor in the raise our discounting rate to factor in the higher risk premium for equities.

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 Hold/Medium Risk. The company has evolved a business model that is 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 makes DRL one of the best companies in the Indian pharma industry, 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. However, our positive view is tempered by DRL being caught on the wrong foot with its acquisition of Betapharm in Germany, given significant changes in regulations and market dynamics. Although these concerns are not new, the impact on the DRL's earnings power appears to be much higher than we had originally anticipated.

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 seems justified given that the sector is IPR driven and has the potential for significant earnings growth. However, we value Dr.Reddy's at a 10% discount due to the near term uncertainty on earnings & return ratios – especially on concerns in Germany. At 18x March '09E earnings, we value DRL's base business at Rs589/ share. We value DRL's Para IV pipeline and drug discovery efforts separately at Rs27/share. For patent challenges, we use a success probability of 25% and a discounted cash flow (discount factor 15%) for the opportunities being targeted over the next few years. We value DRL's new drug discovery efforts in Perlecan Pharma at Rs26/share to account for the setback in one of the four molecules under development. Together, these values give us a target price of Rs642.

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. 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 stock-price volatility; and (3) R&D success rates are low. Upside risks include: (1) better than expected performance in Germany either due to lower pricing pressure or higher savings on sourcing from India could lead to an upside to our earnings estimates and target price; (2) any success achieved in either its NCE R&D program or any of its patent challenges could act as a positive catalyst

Appendix A-1

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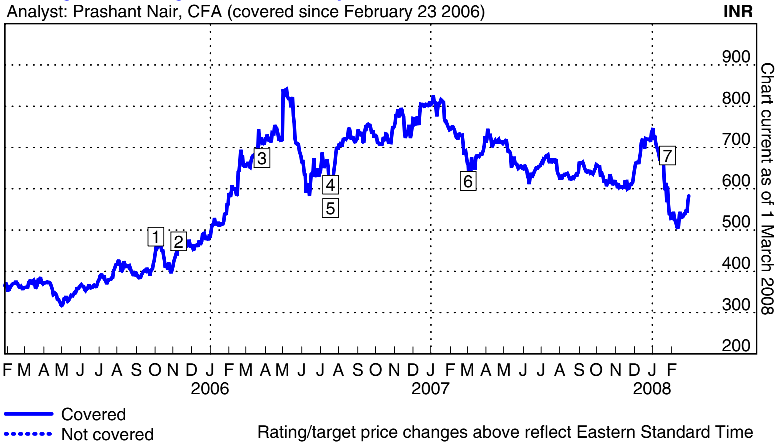
Dr. Reddy's (REDY.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	4 Oct 05	1L	*534.00	455.65
2:	10 Nov 05	1L	*593.50	457.27
3:	28 Mar 06	*3M	*758.00	711.20
4:	19 Jul 06	*1M	*778.50	610.00
5:	19 Jul 06	1M	778.50	610.00
6:	2 Mar 07	1M	*803.00	660.60
7:	25 Jan 08	1M	*725.00	605.40

*Indicates change.

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