

In-line quarter. PAT excluding forex gain and VRS reversal at Rs2.9 bn were in line with our estimates. Sales, up 21%, were 7% higher than our estimate mainly due to higher PSAI segment sales with generics in line; however, we continue to see muted sales growth in 27% of business. Margin pressures remain and are likely to get accentuated in 2HFY12E due to sharp increase in R&D, lower DEP benefits. We expect muted base business EPS growth in FY2012E due to (1) lower margin, (2) pick-up in tax rate to 17% in FY2012E from 11%, (3) higher interest costs. However, we expect core EPS growth to be strong at 25% in FY2013E. We value DRL at (1) 20X base business EPS of Rs83 (2) Rs16 from limited competition US launches. Maintain REDUCE, PT at Rs1,660 (unchanged).

Company data and valuation summary

Dr Reddy's Laboratories

Stock data

52-week range (Rs) (high,low)	1,855-1,386
Market Cap. (Rs bn)	268.5

Shareholding pattern (%)

Promoters	25.6
FIs	43.8
MFs	6.5

Price performance (%)	1M	3M	12M
Absolute	6.3	(0.5)	(3.6)
Rel. to BSE-30	(0.5)	8.8	13.4

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	64.9	82.8	98.9
EPS growth (%)	932.5	27.5	19.4
P/E (X)	24.3	19.1	16.0
Sales (Rs bn)	74.7	95.9	110.7
Net profits (Rs bn)	11.0	14.1	16.8
EBITDA (Rs bn)	16.8	22.5	26.3
EV/EBITDA (X)	17.1	12.8	10.6
ROE (%)	24.8	27.1	25.8
Div. Yield (%)	0.7	0.8	0.9

Sales at Rs22.7 bn were up 21% yoy, 7% higher than our estimate due to higher PSAI sales

Sales grew 21% yoy to Rs22.7 bn, 7% higher than our estimate with generics segment sales in line with our estimate and PSAI beating our estimate. (1) India finished dosage (20% of sales) grew poorly for the 3rd quarter in a row with sales growth at 9%, in line with estimate, (2) USA, Russia (60% of sales) reported impressive growth, 3% higher than our estimate, however, (3) Germany+ RoW declined yoy and continue to witness pressure largely on account of (a) pricing decline in Germany and (b) acute inflation in Venezuela, DRL's main ROW market which is witnessing high inflation leading to devaluation of local currency. PSAI segment (26% of sales) sales growth was impressive at 29% despite import ban at Mexican facility driven by (1) lower base of last year, (2) turnaround in services business, (3) higher sales from API business.

EBITDA margin at 21.7%, down 100 bps yoy and 90 bps lower than our estimate

EBITDA margin adjusted for VRS reversal of Rs94 mn was at 21.7%, and missed our estimate by 90 bps. While gross margin at 53.8% was 30 bps higher than our estimate and up 40% yoy, mainly due to improvement in PSAI business, generics gross margin was lower by around 50 bps yoy. The sharp increase in SG&A and R&D led to lower margin—(1) SG&A expenses at Rs6 bn were up from Rs5.4 bn in 1QFY12 due to higher salary, freight costs (50% of SG&A is salary costs) and (2) R&D expenses grew 15% yoy, 14% higher than our estimates. Although EBIT was 4% higher than our estimate, forex income of Rs151 mn led to PAT being 8% higher than estimate.

We increase FY2012E PAT by 4%, FY2013E unchanged

We factor in base business sales growth of 25% in 2HFY12E versus 19% in 1HFY12. However, we expect base business margin to remain muted in 2HFY12E due to sharp increase in R&D leading to EBITDA margin of 21% in FY2012E versus 21.4% in 1HFY12. While reported PAT is up 15% in 1HFY12 excluding forex gain of Rs309 mn in 1HFY12 and forex loss of Rs274 mn in 1HFY11, PAT growth is 4% in 1HFY12. We expect base business EPS to grow by 2.5% in FY2012E.

REDUCE

OCTOBER 25, 2011

RESULT

Coverage view: **Cautious**

Price (Rs): **1,580**

Target price (Rs): **1,660**

BSE-30: **17,255**

QUICK NUMBERS

- Sales at Rs22.7 bn were up 21% yoy, 7% higher than our estimate due to higher PSAI sales
- EBITDA margin at 21.7%, down 100 bps yoy
- While reported PAT is up 15% in 1HFY12 excluding forex, PAT growth is 4%

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Key takeaways from conference call

- ▶ Margin pressure remains which we believe will result in lower EBITDA margin yoy on base business. We factor in EBITDA margin of 21% in FY2012E versus 21.4% reported in 1HFY12 due to
 - DEPB benefit income in FY2011 was Rs1.5 bn as per 20-F filing which is accounted in material costs. Due to revision of rates to 2.5-3% from 6% earlier, the impact at margin level due to loss of DEPB benefit will be Rs100-120 mn per quarter from 3QFY12E onwards.
 - R&D costs for FY2012E are likely to be between 7% and 7.5% versus 6.2% in 1HFY12 implying sharp ramp-up in costs in 2HFY12E.
 - SG&A spend was up 25% yoy, higher than sales growth of 20% in 1HFY12 and is likely to rise further with greater OTC spend coinciding with peak season in Russia. OTC sales are at 25% of overall Russia sales.
 - Gross margin in generics was lower qoq and yoy by 50-100 bps due to product mix (likely on account of poor India growth) and cost pressures and lower gross margin in Germany.
 - DRL has forward covers of US\$775 mn (40% of FY2012E sales) for next 18 months at rates of 45-47 implying limited gains from Rupee depreciation while costs in Rupee terms may continue to increase due to manpower and manufacturing costs in US, Mexico, and UK. We expect these realized losses to be accounted for in topline and expect no further forex gain in 2HFY12E. Forex gain of Rs309 mn was due to translational impact on assets and liabilities.
- ▶ PSAI segment growth seen this quarter is likely to sustain on account of customer lock-ins and wave of patent expiries, according to DRL. DRL gave a broad sales guidance of 15% for next two years. Despite FDA ban at Mexico facility, sales growth in US was strong as (1) services business has turned around, and (2) Naproxen (sales of US\$15 mn) is excluded from the ban. The Mexican facility has US\$30 mn exposure to US out of which half is from Naproxen. In 3 months' time, DRL will get back to FDA and upon satisfactory review of response, facility will be inspected.
- ▶ 2HFY12E is likely to witness stronger sales growth due to (1) new launches, (2) market share gains in US, (3) continuing growth in Russia + PSAI, and (4) higher sales from Bristol facility due to seasonality and Shevreport facilities. We factor in base business sales growth (excluding sales of Rs4.6 bn from exclusive launches in 2HFY12E) of 25% in 2HFY12E versus 19% in 1HFY12, accordingly.

Interim results—Dr Reddy's, March fiscal year-ends (Rs mn)

	2QFY12	2QFY12E	2QFY11	1QFY12	% change		
					2QFY12E	2QFY11	1QFY12
Net sales	22,679	21,277	18,704	19,784	7	21	15
Cost of revenues	10,473	9,894	8,718	9,228	6	20	13
R&D	1,459	1,277	1,270	1,197	14	15	22
SG&A	5,948	5,500	4,661	5,523	8	28	8
Other operating expenses/(income)	(215)	(200)	(218)	(186)			
EBITDA	5,014	4,806	4,273	4,022	4	17	25
EBITDA, %	22.1	22.6	22.8	20.3	(0.5)	(0.7)	1.8
Amortization	389	400	317	405	(3)	23	(4)
Depreciation	879	800	731	828	10	20	6
EBIT	3,746	3,606	3,225	2,789	4	16	34
EBIT, %	16.5	17.0	17.2	14.1	(0)	(1)	2
Profit in affiliate/forex gain/(loss)	189	4	(27)	179	4625	NM	6
Net Finance Income/ (Cost) excl forex c	(225)	(225)	(5)	(221)			
PBT	3,710	3,385	3,193	2,747	10	16	35
Tax	(631)	(542)	(327)	(120)			
PAT	3,079	2,844	2,866	2,627	8	7	17
PSAI	5,933	4,308	4,617	4,832	38	29	23
India	752	666	653	662	13	15	14
North America	1,068	271	814	842	294	31	27
Europe	2,303	1,708	1,551	1,693	35	48	36
Others	1,810	1,663	1,599	1,635	9	13	11
Generics	16,136	16,368	13,667	14,424	(1)	18	12
India	3,459	3,476	3,160	2,936	(0)	9	18
Russia & CIS	3,380	3,275	2,751	3,018	3	23	12
North America	6,287	6,099	4,416	5,756	3	42	9
Europe	2,117	2,335	2,366	1,917	(9)	(11)	10
Others	893	1,184	974	797	(25)	(8)	12
Others	610	600	420	528	2	45	16
Total	22,679	21,277	18,704	19,784	7	21	15

Source: Kotak Institutional Equities estimates, Company

Break-up of profits (Rs mn)

	2011	2012E	2013E	2014E		2011	2012E	2013E	2014E
Net sales (Rs mn)					PAT (Rs mn)				
Base	74,692	91,308	103,447	122,303	Base	11,039	11,311	14,085	17,445
Exclusivity	—	4,611	7,290	513	Exclusivity	—	2,767	2,730	159
Total	74,692	95,919	110,737	122,816	Total	11,039	14,078	16,816	17,604
EBITDA adding back one-off exp. (Rs mn)					EPS before excep. (Rs)				
Base	16,814	19,052	22,349	27,029	Base	64.9	66.5	82.9	102.6
Exclusivity	—	3,459	3,910	231	Exclusivity	—	16.3	16.1	0.9
Total	16,814	22,510	26,260	27,260	Total	64.9	82.8	98.9	103.6
EBITDA, %					P/E (X)				
Base	22.5	20.9	21.6	22.1	Base	23.1	22.6	18.1	14.6
Exclusivity	—	75.0	53.6	45.0	Total	23.1	18.1	15.2	14.5
Total	22.5	23.5	23.7	22.2					

Source: Kotak Institutional Equities estimates, Company

Quarterly EBITDA margin profile

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Sales	18,190	18,369	17,297	16,424	16,832	18,704	18,985	20,173	19,784	22,679
Reported operating income	3,296	2,546	(5,945)	2,114	2,626	3,225	2,933	3,845	2,789	3,746
Reported EBIT margin	18	14	(34)	13	16	17	15	19	14	17
Non recurring charges	496	—	8,603	409	—	—	404	—	136	(94)
Depreciation	550	600	799	732	685	731	758	787	828	879
Amortisation	507	329	374	269	288	317	307	274	405	389
EBITDA excl one-time	4,849	3,475	3,831	3,524	3,599	4,273	4,402	4,906	4,158	4,920
Adjusted EBITDA margin	26.7	18.9	22.1	21.5	21.4	22.8	23.2	24.3	21.0	21.7
Company defined adj. EBITDA		3,793	3,636	3,507	3,417	4,248	4,000	4,700	4,300	5,109
Company defined adj. EBITDA, %		20.6	21.0	21.4	20.3	22.7	21.1	23.3	21.7	22.5

Source: Kotak Institutional Equities estimates, Company

Change in estimates (Rs mn)

	New estimates		Old estimates		% change	
	2012E	2013E	2012E	2013E	2012E	2013E
Net sales	95,919	110,737	91,542	108,469	5	2
Operating expenses						
Materials	(43,795)	(50,753)	(41,905)	(50,699)	5	—
Selling	(23,829)	(27,403)	(22,687)	(26,090)	5	5
R&D	(6,656)	(7,322)	(5,700)	(6,500)	17	13
Others	829	1,000	720	1,000	15	—
Total expenditure	(73,451)	(84,478)	(69,572)	(82,289)	6	3
EBITDA	22,468	26,260	21,970	26,180	2	—
Depreciation/amortisation	(4,901)	(5,300)	(4,833)	(5,300)	1	—
EBIT	17,567	20,960	17,137	20,880	3	—
Net finance cost	(1,100)	(800)	(1,100)	(800)	—	—
Other income	476	100	291	100	64	—
PBT	16,943	20,260	16,328	20,180	4	—
Tax	(2,866)	(3,444)	(2,730)	(3,431)	5	—
PAT	14,078	16,816	13,598	16,749	4	—

Source: Kotak Institutional Equities estimates, Company

Profit and loss statement, March fiscal year-ends, 2009-2014E

	2009	2010	2011	2012E	2013E	2014E
Net sales	69,440	70,276	74,692	95,919	110,737	122,816
Operating expenses						
Materials	(32,941)	(33,937)	(34,430)	(43,795)	(50,753)	(58,213)
Selling	(17,206)	(17,147)	(19,138)	(23,829)	(27,403)	(30,144)
R& D	(4,037)	(3,793)	(5,060)	(6,656)	(7,322)	(8,200)
Others	(14,277)	(9,232)	711	829	1,000	1,000
Total expenditure	(68,461)	(64,109)	(57,917)	(73,451)	(84,478)	(95,557)
EBITDA	979	6,167	16,775	22,468	26,260	27,260
Depreciation/amortisation	(3,814)	(4,160)	(4,147)	(4,901)	(5,300)	(5,750)
EBIT	(2,835)	2,007	12,628	17,567	20,960	21,510
Net finance cost	(1,034)	(372)	(305)	(1,100)	(800)	(400)
Other income	(128)	417	119	476	100	100
PBT	(3,997)	2,052	12,442	16,943	20,260	21,210
Tax	(1,172)	(985)	(1,403)	(2,866)	(3,444)	(3,606)
PAT	(5,169)	1,067	11,039	14,078	16,816	17,604

Source: Kotak Institutional Equities estimates, Company

Balance sheet statement, March fiscal year-ends, 2009-2014E

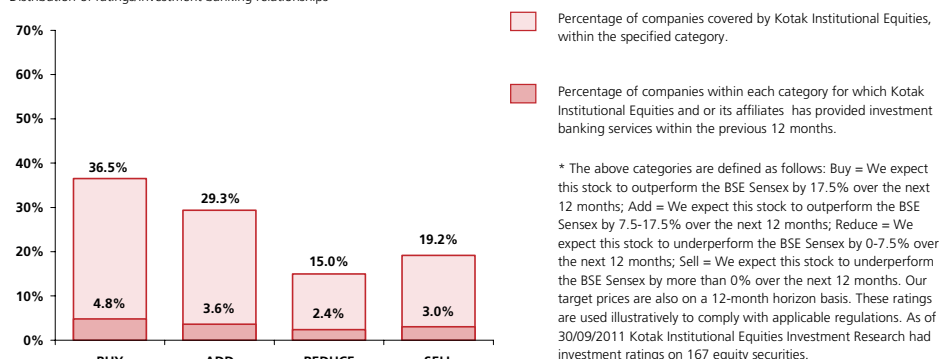
	2009	2010	2011	2012E	2013E	2014E
Equity						
Share capital	842	844	846	846	846	846
Share premium	20,204	20,429	20,683	20,683	20,683	20,683
Other reserves	20,999	21,642	24,461	36,339	50,786	65,852
Net worth	42,045	42,915	45,990	57,868	72,315	87,381
Short term loans	5,892	5,604	18,289	22,172	12,675	8,550
Long term loans	13,633	9,091	5,283	5,283	5,283	256
Debt	19,525	14,695	23,572	27,455	17,958	8,806
Trade creditors	5,987	9,322	8,480	9,000	10,000	10,000
Provisions	3,110	2,565	2,586	2,586	2,586	2,586
Other current liabilities	8,455	8,113	12,355	12,355	12,355	12,355
Current liabilities	17,552	20,000	23,421	23,941	24,941	24,941
Defered tax liabilities	3,411	1,438	87	87	87	87
Total sources of funds	82,533	79,048	93,070	109,351	115,301	121,215
Assets						
Inventories	13,226	13,371	16,059	23,021	24,362	28,248
Sundry debtors	14,592	11,960	17,615	22,061	25,470	28,248
Other debtors	5,066	6,548	8,157	8,157	8,157	8,157
Cash/cash equivalents	6,126	10,184	5,762	8,533	8,033	8,033
Current assets	39,010	42,063	47,593	61,772	66,022	72,686
Gross block	26,491	29,679	38,359	47,159	54,159	59,159
Less: Accumulated depreciation	9,888	12,087	14,714	18,021	21,621	25,621
Net fixed assets	16,603	17,592	23,645	29,138	32,538	33,538
Intangible assets incl goodwill	22,179	13,973	15,246	15,852	14,152	12,402
Capital -WIP	4,279	4,867	5,997	2,000	2,000	2,000
Other non current assets	462	553	589	589	589	589
Total uses of funds	82,533	79,048	93,070	109,351	115,301	121,215
Free cash flow						
Operating cash flow, excl. working capital		3,725	14,165	17,903	20,997	21,853
Working capital		3,554	(6,948)	(10,888)	(3,750)	(6,664)
Capital expenditure		(3,776)	(9,810)	(4,803)	(7,000)	(5,000)
Investments						
Free cash flow		3,503	(2,593)	2,212	10,247	10,189

Source: Kotak Institutional Equities estimates, Company

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As of September 30, 2011

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