

Company Results Review

24 July 2007 | 8 pages

Dr Reddy (REDY.BO)

Buy: Core Business Strength Shines Through

- Maintain Buy (1M)** — 1QFY08 results once again demonstrate the strengths in DRL's core business. We expect DRL's well diversified business and expanding pipeline of products/markets in each segment to drive sustained growth. Besides, its efforts in biosimilars and innovative R&D should throw up valuation and growth drivers beyond the traditional generics opportunity over the longer term.
- Ahead of expectations** — DRL's core PAT was ahead of our estimate (Rs1.8bn vs. Rs1.5bn); the only negative surprise being higher price erosion and shelf stock adjustment in ondansetron post exclusivity. Like-to-like sales growth of 10% YoY and strong gross margins 50.8% came through despite strong rupee appreciation, cost pressures in Betapharm and supply hiccups in the CCS business.
- Core business shines through** — 1Q sales and PAT came entirely from the core business, with no exclusivities / AG deals spiking up the numbers. Moreover, PAT was healthy despite sub par profitability in Betapharm and the Mexican CCS business – both factors that look set to be corrected over the next few quarters.
- Estimate upside potential** — Especially if further rupee appreciation is limited. Despite transient issues, 1Q recurring PAT (Rs1.8bn) is ahead of the average quarterly profit (Rs1.3bn) that DRL has to clock to achieve our FY08 estimate. Given that we are ahead of consensus, we expect an increase in street estimates.
- Other key points** — a) 11% sales growth in Betapharm (37% growth in pharmacy sales) belies concerns; b) lower court verdicts in rivastigmine and galantamine expected towards end CY07; and c) balaglitazone enters P-III trials; DRF-1042 receives orphan drug status from EMEA for osteocarcoma.

Buy/Medium Risk	1M
Price (23 Jul 07)	Rs667.10
Target price	Rs803.00
Expected share price return	20.4%
Expected dividend yield	0.6%
Expected total return	21.0%
Market Cap	Rs112,138M US\$2,789M

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



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	929	12.11	337.6	55.1	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	15.2	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)	55.1	12.0	19.3	15.2	13.0
EV/EBITDA adjusted (x)	172.7	6.8	10.3	8.0	6.7
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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Buy: Core Business Strength Shines Through

We maintain our Buy, Medium Risk (1M) rating on Dr Reddy's Laboratories as 1QFY08 results once again demonstrate the strengths in DRL's core business. We expect DRL's well diversified business and expanding pipeline of products/markets in each segment to drive sustained growth. Besides, its efforts in biosimilars and innovative R&D should throw up valuation and growth drivers beyond the traditional generics opportunity over the longer term.

1QFY08 – Core profit ahead of expectations

DRL's core PAT was ahead of our estimate (Rs1.8bn vs. Rs1.5bn); the only negative surprise being higher price erosion and shelf stock adjustment in ondansetron post exclusivity. In fact, like-to-like sales growth of 10% YoY and impressive gross margins of 50.8% came through despite strong rupee appreciation, cost pressures in Betapharm and supply hiccups in the CCS business. 1Q sales and PAT came entirely from the core business, with no exclusivities / AG deals spiking up the numbers. Moreover, PAT was healthy despite sub par profitability in Betapharm and the Mexican CCS business – both factors that are set to be corrected over the next few quarters.

Estimates have upside potential — especially if further rupee appreciation is limited. Despite transient issues, 1Q recurring PAT (Rs1.83bn) is well ahead of the average quarterly profit (Rs1.32bn) that DRL has to clock to achieve our FY08 estimate. We believe that this is comfortably achievable, given that there were transient issues that pulled down 1Q profits, which would be addressed over the next few quarters. Given that we are ahead of consensus, we expect street estimates to move up considerably.

Figure 1. Consolidated Earnings Summary (Rupees in Million, Percent)

Year to Mar 31	1Q FY07	1Q FY08	% Ch YoY	4Q FY07	% Ch QoQ	CIR Comments
Revenues	14,049	12,018	(14.5)	15,573	(22.8)	Decline due to high AG sales in 1QFY07; like to like growth of c10% is also depressed due to rupee appreciation
Cost of revenues	7,960	5,914	(25.7)	5,818	1.7	
Gross Profit	6,089	6,104	0.2	9,755	(37.4)	Higher margins in APIs; Lower margins on AG products in 1QFY07; in line with the company's overall guidance for FY08
<i>Gross Margin (%)</i>	<i>43.3</i>	<i>50.8</i>	<i>745 bps</i>	<i>62.6</i>	<i>-1,185 bps</i>	
S,G&A Expenses	3,346	3,166	(5.4)	3,433	(7.8)	YoY decline is largely a function of lower sales in 1QFY08 due to absence of high AG sales in the US market
<i>as a % of sales</i>	<i>23.8</i>	<i>26.3</i>	<i>253 bps</i>	<i>22.0</i>	<i>430 bps</i>	
R&D Expenses	533	806	51.2	852	(5.4)	
<i>as a % of sales</i>	<i>3.8</i>	<i>6.7</i>	<i>291 bps</i>	<i>5.5</i>	<i>124 bps</i>	
Amortization Expenses	388	351	(9.5)	2,221	(84.2)	
Forex Loss / (Gain)	74	(285)	nm	74	nm	No significant translation gains; largely realised gains
Other operating expense/(income)	(70)	1	nm	(70)	nm	
Total Operating Expenses	4,271	4,039	(5.4)	6,510	(38.0)	
Operating Income	1,818	2,065	13.6	3,245	(36.4)	
<i>Operating Margin (%)</i>	<i>12.9</i>	<i>17.2</i>	<i>424 bps</i>	<i>20.8</i>	<i>-366 bps</i>	
Equity in Loss of Affiliates	15	4	(73.3)	29	nm	
Other (Income) / Expenses	197	57	(71.1)	(297)	(119.2)	Includes US\$2.7m charge on prepayment of loan
PBT	1,606	2,004	24.8	3,513	(43.0)	
Tax	208	181	(13.0)	260	(30.4)	
<i>Effective tax rate</i>	<i>13.0</i>	<i>9.0</i>	<i>-392 bps</i>	<i>7.4</i>	<i>163 bps</i>	
Minority Interest	-	(3)	nm	1	nm	
Recurring Net Income	1,398	1,826	30.6	3,252	(43.9)	Net profit of Rs1.83bn without any material contribution from ondansetron is a big positive surprise

Source: Company Reports and Citigroup Investment Research

Figure 2. Consolidated Sales Breakup (Rupees in Million, Percent)

Year to Mar 31	1Q FY07	1Q FY08	% Ch YoY	4Q FY07	% Ch QoQ	CIR Comments
APIs	2,309	2,617	13.3	3,884	(32.6)	Overall growth driven by ROW market; better product mix improved gross margins to 35%
- India	625	535	(14.4)	467	14.6	Volume declines in key products, lumpy business across quarters
- North America	420	498	18.6	646	(22.9)	New launches drive growth; dollar growth of 33%
- Europe	440	536	21.8	598	(10.4)	Driven by key products like Montelukast and Escitalopram
- ROW	824	1,048	27.2	2,173	(51.8)	Growth across all key markets; dollar growth of 53%
Branded Formulations	3,527	4,051	14.9	2,554	58.6	India, Russia and CIS drive growth, although appreciating rupee drags down the growth rates in the latter two regions
- India	1,742	2,022	16.1	1,353	49.4	7 new launches in the quarter; growth witnessed in key brands such as Nise, Omez, Stamlo, Beta, Atacor and Razo
- Russia	1,117	1,243	11.3	668	86.1	Growth in key brands such as Nise, Ciprolet and Keterol; rupee appreciation has restricted growth, since sales are dollar denominated – dollar sales growth of 29%
- CIS	339	423	24.8	233	81.5	Strong growth off a low base; driven by Ukraine and Kazakhstan; dollar growth of 43% YoY
- Central/Eastern Europe	106	114	7.5	52	119.2	
- ROW	223	249	11.7	248	0.4	
Generics	6,737	4,247	(37.0)	6,673	(36.4)	Like to like growth of 17% YoY; drop due to high AG sales in 1QFY07
- North America	4,321	1,785	(58.7)	5,558	(67.9)	Like to like growth of 56% YoY; drop due to high AG sales in 1QFY07
- Authorized Generics	3,346	203	(93.9)	1,261	(83.9)	
- Fexofenadine	503	517	2.8	611	(15.4)	Market share increases to 25% and helps offset price decline
- Ondansetron	0	66	nm	2680	(97.5)	Shelf stock adjustment due to severe price erosion post exclusivity
- Other Formulations	472	999	111.7	1,006	(0.7)	Continuous set of product launches drives YoY growth
- Europe	2,416	2,462	1.9	1,115	120.8	
- Betapharm, Germany	1,900	2,100	10.5	788	166.5	Management is cautiously optimistic about this growth; 37% growth in pharmacy volumes
- UK	426	327	(23.2)	262	24.8	Price erosion takes its toll
- Others	90	35	(61.1)	65	(46.2)	
Custom Chemical Business	1,418	1,017	(28.3)	1,945	(47.7)	Hit by supply constraints at its Mexico facility; Indian business doubles
- Mexican facility	1,200	830	(30.8)	1,525	(45.6)	Decline due to supply constraints of key raw material resulting in customer back orders; Things back on course, but recovering lost sales would be difficult
- Indian business	218	187	(14.2)	420	(55.5)	Strong outlook; Management looks to double revenues for FY08
Others	58	86	48.3	500	(82.8)	
Total revenues	14,049	12,018	(14.5)	15,556	(22.7)	Like to Like growth of c10%
Continuing Business (Excluding Authorized generics, Ondansetron)	10,703	11,749	9.8	11,615	1.2	Growth rate is lower due to the aggressive rupee appreciation witnessed over the last few months
% of sales	76.2	97.8		74.7		
Authorized generics	3,346	203	(93.9)	1,261	(83.9)	Only finasteride is being sold as an authorized generic now
% of sales	23.8	1.7		8.1		

Source: Company Reports and Citigroup Investment Research

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 (1M) with a target price of Rs803. 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 March'08E 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. Together, these values gives 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) R&D success rates are low.

Appendix A-1

Analyst Certification

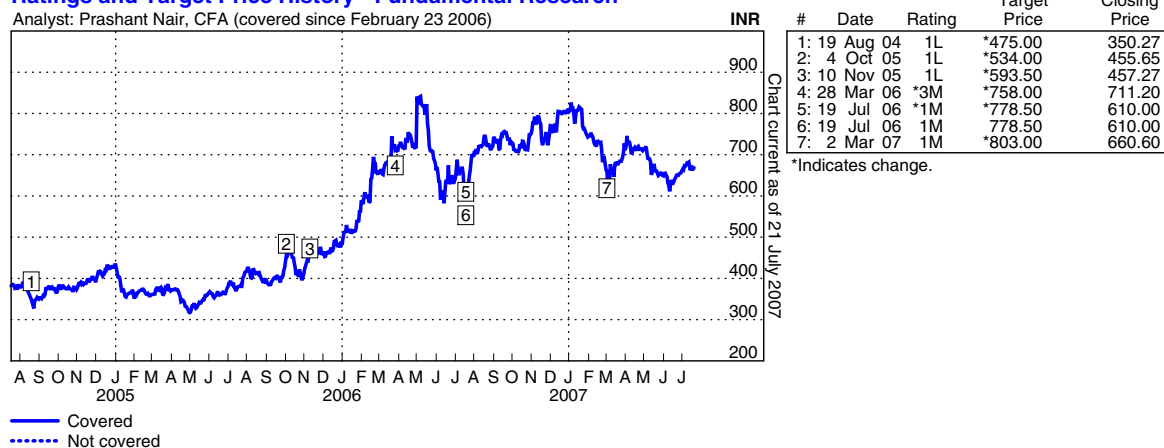
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Dr. Reddy's (REDY.BO)

Ratings and Target Price History - Fundamental Research

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



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Data current as of 19 July 2007

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