

27 June 2012

Dr Reddy's Labs

Reasonable valuations; growth prospects intact; upgrade to Buy

Rating: **Buy**

Target Price: ₹1,900

Share Price: ₹1,600

Having corrected ~15% in the last two months, Dr Reddy's Labs now offers ~20% upside potential. We are optimistic of its business outlook and growth prospects, led by its US generics business, due to its product launches with limited competition and expected recovery in domestic formulations. We upgrade the stock from a Hold to a Buy, due to its reasonable valuations and our expectations of sustained strong performance in the medium term. However, we lower the price target to ₹1,900 (from ₹1,910 earlier) as approval for Lipitor has not come in.

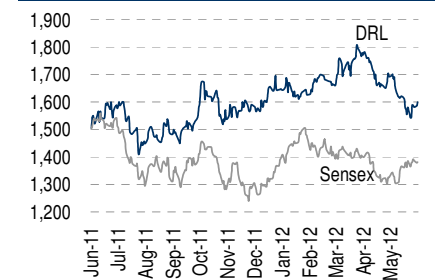
- Growth prospects in global generics unaffected.** In the medium term, Dr Reddy's Labs' (DRL) growth prospects are intact and we believe that the US would be a key growth driver, followed by Russia and India. Over FY12-14, we expect 20.9% CAGR in its US base business revenue, 19% in Russia and the CIS and 13% in domestic formulations.
- PSAI to grow steadily.** The pharma services and active ingredients (PSAI) sub-segment is likely to sustain a steady 10.3% CAGR over FY12-14, led by patent expiries in regulated markets. Growth in the PSAI segment is likely to be largely driven by the US and the EU.
- Raise estimates.** We raise our estimates of DSL's revenue 5-8% to factor in the higher growth in US generics and favourable currency shifts in FY13 (assuming ₹52/\$, from ₹50 earlier). However, we raise our net profit estimate for FY13 and FY14 just 2.3% and 0.9%, respectively, due to a higher tax rate and depreciation charge.
- Valuation.** Considering the strong growth outlook and reasonable valuations, we upgrade the stock from a Hold to a Buy, with a revised price target of ₹1,900 (earlier ₹1,910). The lower target is due to the removal of the Lipitor opportunity. **Risks:** Regulatory challenges and any delay/failure in monetising para-IV opportunities.

Key data	DRRD IN / REDY.BO
52-week high / low	₹1818 / ₹1387
Sensex / Nifty	17033 / 5165
3-m average volume	US\$8.9m
Market cap	₹269bn / US\$4.8bn
Shares outstanding	169.6m

Shareholding pattern (%)	Mar '12	Dec '11	Sep '11
Promoters	25.61	25.61	25.61
- of which, pledged	0	0	0
Free float	74.39	74.39	74.39
- Foreign institutions	27.42	27.15	26.32
- Domestic institutions	13.43	13.77	14.42
- Public	33.54	33.47	33.65

Estimates revision (%)	FY12e	FY13e	FY14e
Sales	-	8.2	5.2
EBITDA	-	8.9	4.2
EPS	-	2.3	0.9
Target multiple (x)	-	-	-

Relative price performance



Source: Bloomberg

Key financials (YE 31 March)	FY10	FY11	FY12e	FY13e	FY14e
Sales (₹m)	70,277	74,693	96,737	109,674	119,816
Net profit (₹m)	9,214	10,763	15,065	15,345	16,865
EPS (₹)	54.6	63.6	88.8	90.5	99.4
Growth (%)	4.1	16.8	40.0	1.9	9.9
PE (x)	29.3	25.1	18.0	17.7	16.1
EV/EBITDA (x)	18.4	18.4	12.5	11.5	10.3
PBV (x)	6.3	5.9	4.7	3.9	3.3
RoE (%)	21.7	24.2	29.1	24.2	22.3
RoCE (%)	15.8	17.4	19.6	17.6	18.5
Dividend yield (%)	0.7	0.8	1.1	1.1	1.2
Net gearing (%)	10.5	38.6	43.2	19.3	3.0

Source: Company

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: March	FY10	FY11	FY12e	FY13e	FY14e
Net revenues	70,277	74,693	96,737	109,674	119,816
Revenue growth (%)	1.2	6.3	29.5	13.4	9.2
- Op. expenses	55,170	59,032	72,996	84,987	93,291
EBIDTA	15,107	15,661	23,741	24,686	26,526
EBITDA margin (%)	21.5	21.0	24.5	22.5	22.1
- Interest expenses	372	362	690	692	442
- Depreciation	4,160	4,147	5,214	5,896	6,193
+ Other income	986	926	1,669	1,083	1,191
- Tax	985	1,403	4,204	3,836	4,216
Effective tax rate (%)	48	11	23	20	20
Reported PAT	1,068	11,040	14,262	15,345	16,865
+/- Extraordinary items	-9,508	365	-1,040	0	0
+/- Minority interest	0	0	0	0	0
Adjusted PAT	9,214	10,763	15,065	15,345	16,865
Adj. FDEPS (₹/share)	54.6	63.6	88.8	90.5	99.4
Adj. FDEPS growth (%)	4.1	16.8	40.0	1.9	9.9

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (₹m)

Year-end: March	FY10	FY11	FY12e	FY13e	FY14e
Share capital	844	846	848	848	848
Reserves & surplus	42,071	45,144	56,596	68,350	81,269
Net worth	42,915	45,990	57,444	69,198	82,117
Minority interest	0	0	0	0	0
Total Debt	14,656	23,503	32,210	22,210	12,210
Def. tax liab. (net)	2720	2022	1132	1132	1132
Capital employed	60,291	71,515	90,786	92,540	95,459
Net fixed assets	36,432	44,888	46,775	48,379	48,185
Investments	3,600	33	10,773	10,773	10,773
- of which, Liquid	3,574	0	0	0	0
Net working capital	13,675	20,865	25,859	24,551	26,750
Cash and bank balance	6,584	5,729	7,379	8,837	9,751
Capital deployed	60,291	71,515	90,786	92,540	95,459
Net debt	4498.0	17774.0	24831.0	13372.8	2458.7
WC days	50.9	49.8	72.3	77.4	72.5
Book value (₹/sh)	254	272	339	408	484

Source: Company, Anand Rathi Research

Fig 3 – Cash-flow statement (₹m)

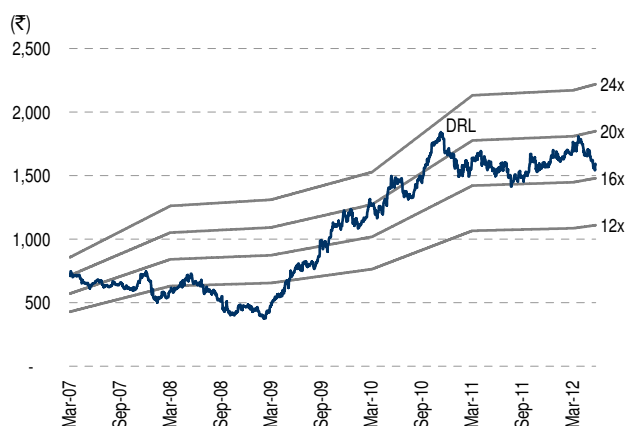
Year-end: March	FY10	FY11	FY12e	FY13e	FY14e
PAT	1,068	11,040	14,262	15,345	16,865
+ Non-cash items	12,683	2,744	2,050	2,060	1,977
Cash profit	13,751	13,784	16,312	17,405	18,842
- Incr./ (Decr.) in WC	(3,407)	6,534	4,909	(1,308)	2,198
Operating cash-flow	17,158	7,250	11,403	18,713	16,644
- Capex	4,456	9,000	8,450	7,500	6,000
Free cash-flow	12,702	(1,750)	2,953	11,213	10,644
- Dividend	2,217	2,583	2,709	3,591	3,946
+ Equity raised	0	0	0	0	0
+ Debt raised	(4,827)	8,847	8,707	(10,000)	(10,000)
- Investments	3,118	(3,564)	10,795	0	0
- Misc. items	1,552	8,933	(3,494)	(3,837)	(4,217)
Net cash-flow	988	(855)	1,650	1,458	914
+ Op. cash & bank bal.	5,596	6,584	5,729	7,379	8,837
Cl. cash & bank bal.	6,584	5,729	7,379	8,837	9,751

Source: Company, Anand Rathi Research

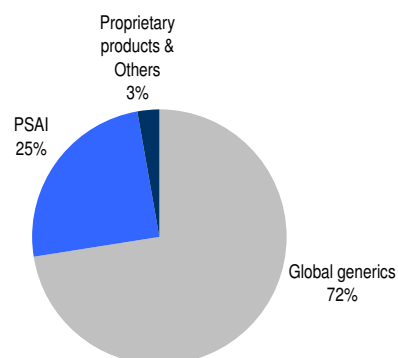
Fig 4 – Ratio analysis @ ₹1,600

Year-end: March	FY10	FY11	FY12e	FY13e	FY14e
P/E (x)	29.3	25.1	18.0	17.7	16.1
P/B (x)	6.3	5.9	4.7	3.9	3.3
EV/EBITDA (x)	18.4	18.4	12.5	11.5	10.3
RoE (%)	21.7	24.2	29.1	24.2	22.3
RoCE (%)	15.8	17.4	19.6	17.6	18.5
Dividend yield (%)	0.7	0.8	0.9	1.1	1.2
Dividend payout (%)	178.0	20.0	16.3	20.0	20.0
Asset turnover (x)	1.9	1.7	2.1	2.3	2.5
Net Debt/Equity (x)	0.1	0.4	0.4	0.2	0.0
Net debt/EBITDA (x)	0.3	1.1	1.0	0.5	0.1
Net debt/Op. CF (x)	0.3	2.5	2.2	0.7	0.1
Interest coverage (x)	29.4	31.8	26.9	27.2	46.0
P/CEPS (x)	20.2	18.2	13.4	12.8	11.8
EV/ sales (x)	4.0	3.9	3.1	2.6	2.3
M-cap/sales (x)	3.8	3.6	2.8	2.5	2.3

Source: Company, Anand Rathi Research

Fig 5 – Valuation chart (P/E)


Source: Bloomberg, Anand Rathi Research

Fig 6 – Revenue breakdown (FY13e)


Source: Anand Rathi Research

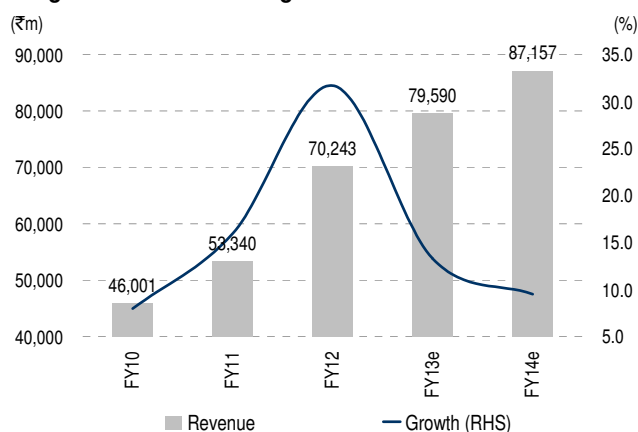
Sound valuations & growth prospects

Having corrected ~15% in the last two months, Dr Reddy's Labs now offers ~20% upside potential. We are optimistic of its business outlook and growth prospects, led by its US generics business, due to its product launches with limited competition and expected recovery in domestic formulations. We upgrade the stock from a Hold to a Buy, as we expect the strong performance to continue in the medium term and considering the reasonable valuations. However, we revise the price target to ₹1,900 (from ₹1,910 earlier) due to the removal of the Lipitor opportunity.

Growth prospects intact in global generics

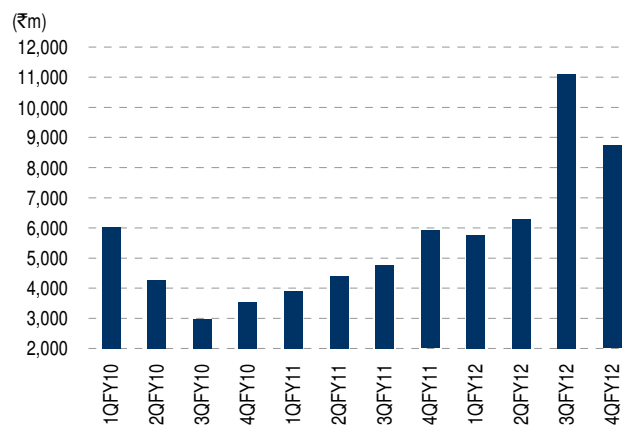
Growth prospects for DRL are unaffected in the medium term and we believe that the US would be the key growth driver, followed by India and Russia. We expect 20.9% CAGR in its US base business revenue over FY12-14, 19% in its Russian and CIS business revenue and 13% in its domestic formulations revenue. Management has maintained its revenue guidance of US\$2.7bn in FY13, one-third of it to come from US generics. Our estimates, at US\$2.1bn revenue, are below management guidance, with US generics amounting to US\$683m. We expect global generics revenue to register 11.4% CAGR over FY12-14.

Fig 7 – Global generics revenue and growth trend



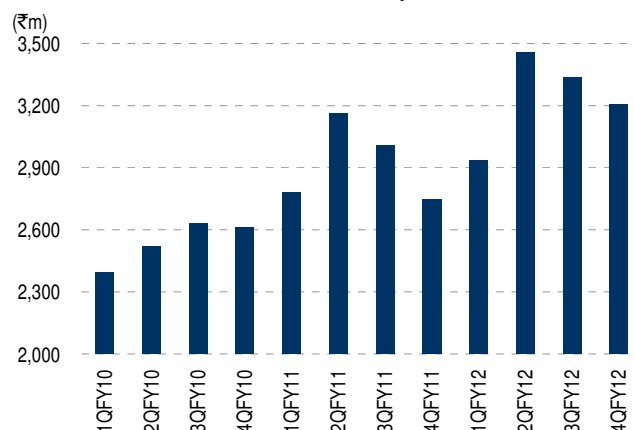
Source: Company, Anand Rathi Research

The global generics sub-segment grew 31.7% in FY12 to ₹70bn, led by robust 68% growth in US generics and 22.1% increase in Russia and the CIS. The company launched 16 products in the US during the quarter, including limited competition opportunities such as fondaparinux, olanzapine, ziprasidone and fexofenadine pseudoephedrine D24 OTC. It has gained ~15% market share in lansoprazole OTC and ~17% in fondaparinux. We believe traction will be strong in US generics for the next couple of years, as the para-IV products pipeline is strong and the products are to be launched in the next 2-3 years.

Fig 8 – US: Quarterly revenue trend

Source: Company

After four quarters of single-digit growth in DRL's domestic brand-named formulations, compared to 13-14% industry growth, DRL reported 16.7% growth in 4QFY12. It guided to growth for the next two years in line with the industry growth rate of ~14%. The company launched 23 products during FY12 and we expect growth to revive in the coming quarters, led by product launches and sales restructuring. We expect 13% CAGR in domestic formulation revenue over FY12-14.

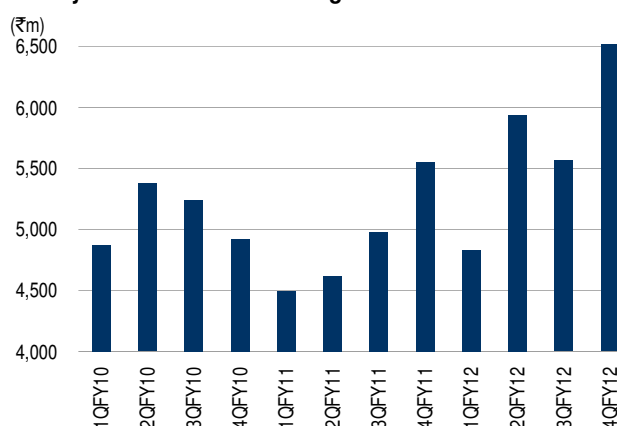
Fig 9 – Domestic formulations have been under pressure

Source: Company

Steady growth to continue in PSAI

The Pharmaceutical Services and Active Ingredients (PSAI) sub-segment recovered from negative growth in FY11 and grew by a strong 21.2% in FY12. The growth was driven across all geographical areas. We expect growth in the PSAI segment in FY13, at 13.3%, to be robust, and then to slow down to 7.6% in FY14. We believe that, in the longer term, this segment would grow at a steady 5-10%.

Fig 10 – Quarterly revenue trend: PSAI segment



Source: Company

Revising estimates

We tweak our estimates to factor in the delayed approval regarding Lipitor, the higher base of US sales and the dollar appreciation. Overall, we raise our revenue estimates for FY13 by 8.8% and for FY14 by 6.7%. However, we raise our net profit estimate for FY13 and FY14 by just 2.3% and 0.9%, respectively, due to a higher tax rate and depreciation charge.

Fig 11 – Change in estimates

₹m	FY13e			FY14e		
	Old	New	% chg	Old	New	% chg
Revenue	100,800	109,675	8.8	112,255	119,817	6.7
EBITDA	22,669	24,686	8.9	25,455	26,526	4.2
PAT	14,994	15,345	2.3	16,721	16,865	0.9
EPS	88.4	90.5	2.3	98.6	99.5	0.9

Source: Anand Rathi Research.

Valuation

The stock trades at 17.7x FY13e and 16.1x FY14e earnings. We raise our price target to ₹1,900 (from ₹1,910 earlier) as, in absence of approvals, we remove the Lipitor opportunity factor from our target price. Our target is based on 20x one-year-forward revised earnings. We upgrade the stock from a Hold to a Buy.

Risk

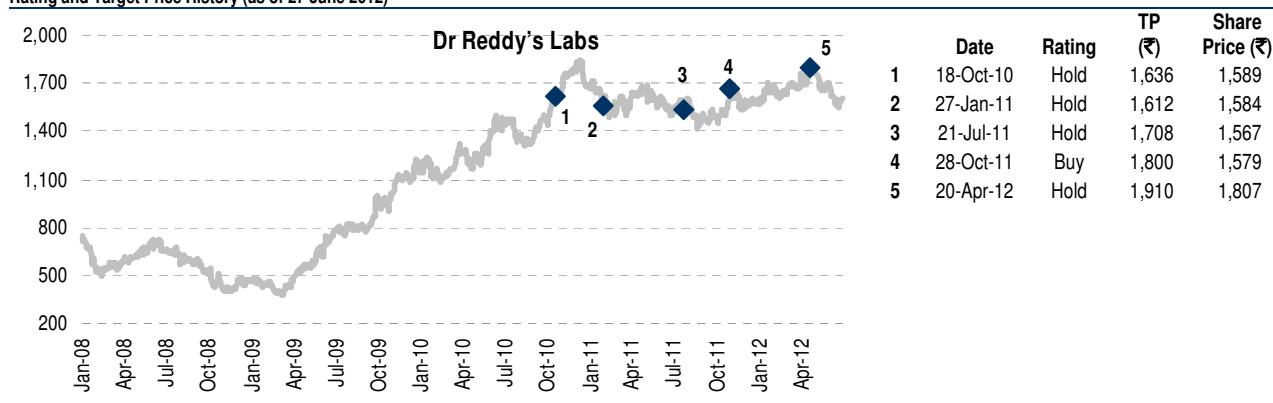
Regulatory challenges and any delay/failure in monetizing para-IV opportunities.

Appendix 1

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% who are investment banking clients	6%	6%	0%

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