

Dr Reddy's Labs

Industry **Pharmaceuticals**
Bloomberg **DRRD IN**
BSE CODE **500124**

Strong US performance and cost optimization initiative to drive margins going forward

RATING	BUY
CMP	2787
Price Target	3193
Potential Upside	15%

Rating Change	
Estimate Change	
Target Change	

Stock Info

52wk Range H/L	2,745/1,888
Mkt Capital (Rs Cr)	45484
Free float (%)	73%
Avg. Vol 1M (,000)	616
No. of Shares (Cr)	17
Promoters Pledged %	0%

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3QFY19 Result update

- ❑ Overall revenue grew by 1% YoY to Rs.3850 crores. The growth in India and Emerging market was offset by 15% decline in US sales on a YoY basis.
- ❑ Gross profit margin contracted by 339 bps YoY and 288 bps sequentially to 69.6% largely on account of price erosion in some of the key molecules in the US which was partly offset by favorable foreign exchange.
- ❑ EBITDA margin improved by 15 bps YoY to 20.8% on account of reduced other expenses. Other expenses has contracted by 9% to Rs.1079 crores largely due to the spend control on the back of cost optimization and productivity improvement initiatives.
- ❑ R&D expenditure for the quarter is Rs.367 crores, a decline of 21% YoY on account of time gap in development related activities coupled with productivity improvement measures.
- ❑ PAT grew by 65% YoY to Rs.500 crores led by increase in other income and reduced tax rate. The effective tax rate for the quarter is 16.4%.is 16.4%.

View and Valuation

PAT grew by 65% YoY to Rs.500 crores on the back of lower tax rate and increased other income this quarter. The management was able to maintain EBITDA margin at 20.8% with a slight improvement of 1% YoY on account of reduced other expenses and lower R&D expenses. US revenue de grew by 15% YoY to USD 209 million as there was a onetime contribution from Renvela in Q3FY18. Europe sequentially has grown by 1% on back of improvement in supplies and new launches in UK and Germany. Going forward, we expect traction from all the major market especially from Europe, Emerging market and US business. Emerging market will grow in the coming quarters as the company is foraying into new geographies, also new launches and volume uptick would contribute towards such growth. Europe was facing supply issues but the situation has stabilized now. Even in Proprietary products segment; we expect to see revenue growth on the back of DFN-02 launch in FY20. We assume US to deliver strong performance in FY20 based on specialty launch of NuvaRing and Copaxone. Based on cost optimization and productivity improvement initiatives being undertaken by the management we have increased our PAT estimates for FY19E and FY20E by 12% and 8% respectively. We maintain our BUY rating with a target price of Rs.3193 (24x FY20e EPS).

Key Risks to our rating and target

- ❑ Responses awaiting from USFDA for Duvvuda facility and Srikakulam facility.
- ❑ R&D expenditure
- ❑ Suboxone verdict from court

KEY FINANCIAL/VALUATIONS	FY16	FY17	FY18	FY19E	FY20E
Net Sales	15248	13866	13802	15012	16597
EBITDA	3585	2221	2351	3124	3605
EBIT	2646	1194	1274	2025	2489
PAT	2131	1041	947	1939	2207
EPS (Rs)	125	63	57	117	133
EPS growth (%)	-9%	-50%	-9%	105%	14%
ROE (%)	17%	8%	8%	14%	14%
ROCE (%)	19%	9%	8%	12%	13%
BV	737	740	758	849	958
P/B (X)	4.0	3.5	2.7	3.3	2.9
P/E (x)	23.4	40.9	36.5	23.8	21.0

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3QFY19 Results

Financials	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19	YoY %	QoQ%	FY17	FY18	YoY %
Net Sales	3,834	3,554	3,737	3,818	3,865	0.8%	1.2%	14,196	14,281	0.6%
Other Income	43	45	50	128	102	137.9%	-20.2%	172	155	-9.5%
COGS	1,037	1,007	1,005	1,052	1,176	13.4%	11.8%	3,697	4,040	9.3%
Gross Margin	73%	72%	73%	72%	70%	-4.6%	-4.0%	74%	72%	-3.0%
Employee Cost	818	801	837	872	805	-1.6%	-7.7%	3,107	3,215	3.5%
Other Expen.	1,187	1,183	1,126	1,134	1,079	-9.1%	-4.9%	5,172	4,675	-9.6%
EBITDA	793	564	769	759	805	1.5%	6.0%	2,221	2,351	5.9%
EBITDA Mar.	21%	16%	21%	20%	21%	0.7%	4.7%	16%	16%	5.3%
Depreciation	272	276	279	279	290	6.9%	4.2%	1,027	1,077	4.9%
EBIT	521	287	490	481	514	-1%	7.0%	63	79	24.3%
Interest	17	18	20	21	24	40%	15.9%	63	79	24.3%
PBT	547	314	521	588	593	8.3%	0.7%	1,006	912	-9%
Exceptional										
Tax	253	49	53	81	101	-60.0%	25.3%	297	438	48%
PAT	294	265	468	507	500	70.1%	-1.4%	1,041	947	-9%
PAT Margin	8%	8%	13%	14%	13%	64.0%	-4.6%	7%	7%	-10%

Muted Revenue performance

DRREDDY Q3FY19 revenue was in line with our expectation. Revenue grew by 1% YoY as well as sequentially majorly driven by the growth in India and Emerging market offset by decline in the US sales.

Emerging market grew by 31% YoY primarily on account of new launches, volume uptick and traction in new markets. Russia grew by 22%, other CIS and Romania grew by 45% and ROW grew by 43% on a YoY basis. US sales for the quarter contracted by 15% on a YoY basis largely due to higher base previous year on account on Renvela sales, though sequentially it has increased by 1% on back of decent improvement in volume due to new launches namely Colesevalam, Dipyridamole, Aspirin XR, Sevelamer sachet, Sevelamer unit dose, and Omeprazole OTC tablets offset by the product specific price erosion.

India sales increased by 10% YoY on back of Repatha and Hervycta launch in the first half. The sequential sales growth of 3% in Europe was driven by improvement in supplies and new launches.

Reduced R&D and Other expense led to margin improvement

EBITDA margin improved by 15 bps YoY to 20.8% primarily due to the spend control on the back of cost optimization and productivity improvement initiatives. Lower R&D expenditure this quarter on account of time gap in development related activities also contributed towards such growth.

Higher other income and lower tax rate led to PAT improvement

Higher other income on back of sale of API manufacturing facility located at Jeedimetla, Hyderabad and lower tax rate primarily on account of reduction of the federal income tax rate from 35% to 21% in the US and claim of deduction of an item in the current quarter, which was previously disallowed for tax purpose, had led to a 65% YoY PAT growth to Rs.500 crores.

Concall Highlights

- In US, during the quarter, 10 new products were launched including limited competition products like Colesevalam, Dipyridamole, Aspirin XR, Sevelamer sachet, Sevelamer unit dose, and Omeprazole OTC tablets.
- Suboxone- DRRD is awaiting verdict from court.
- Management has guided for the launch of NuvaRing and gCopaxone in the first half of calendar FY19 and second half of calendar FY19 respectively.
- Europe - During the quarter, 2 products were launched in Germany and 4 products in the UK.

- For proprietary product business, management expects to file the NDA for DFN-15 by Q1FY20. Development on equal 7 for CTCL indication in the US is on track and management expects to file the DLA by Q1FY21.
- The Company recently received USFDA approval for intranasal sumatriptan DFN-02 (Specialty product) under the brand name Tosymra. Prelaunch activities are underway and the company is preparing for the launch in the next few months.
- The USFDA inspection took place in Duvvuda facility in 20th October 2018 concluding with 8 observations. The company has already responded and USFDA has raised few questions seeking clarification on few responses.
- For the Srikakulam API facility, the company has responded to all the queries raised by the USFDA and awaits the re-inspection of the facility by the USFDA.
- The management in an effort to optimize cost and improve the productivity in terms of manpower, SG&A, R&D and proper asset utilization has concluded the sale of the API Business manufacturing unit located at Jeedimetla, Hyderabad.
- Trade receivables as on 31st December 2018 were Rs.3730 crores. The reduction in Trade receivables was because the company has started factoring of receivables.
- Gross profit margin for GG and PSAI business segments were at 57.6% and 30.8% respectively.
- Free cash flow generated during this quarter was Rs.1512 crores which led to significant improvement in the net debt equity. The net debt equity was 0.13 as on 31st Dec 2018.
- Other income includes gain of Rs.42 crores on account of sale of the API Business manufacturing unit located at Jeedimetla, Hyderabad.
- Effective tax rate for the quarter is 16.4%. This lower rate is primarily on account of reduction of the federal income tax rate from 35% to 21% in the US and claim of deduction of an item in the current quarter, which was previously disallowed for tax purpose.
- Effective tax rate for the full year is expected to be around 15-17%.
- Capital expenditure is at 1.5 billion.

Exhibit: Sales and Sales Growth

Sales for the quarter grew by 1% YoY to Rs.3850 crores (vs our expectation of Rs.3895 crores)

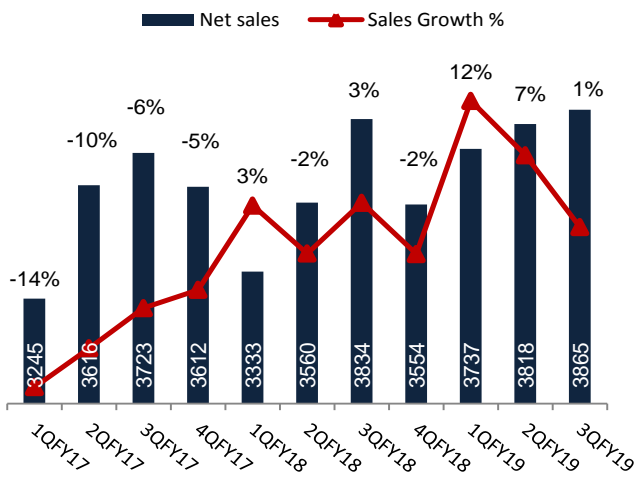


Exhibit: Gross and EBITDA margin

Gross margin contracted by 339 bps YoY to 70% on account of price erosion in key products in US.

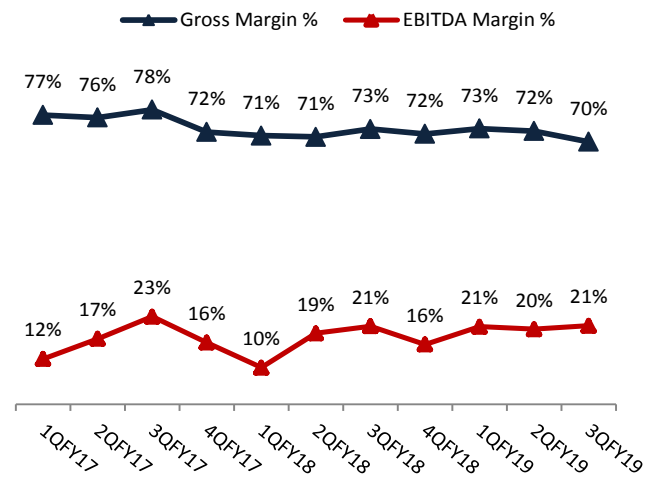


Exhibit: PAT and PAT margin

PAT has improved by 65% YoY to Rs.500 crores on account of lower tax rate and higher other income

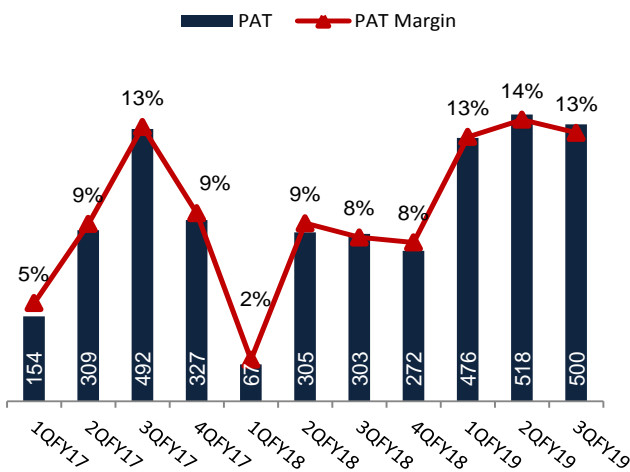


Exhibit: R&D cost and R&D as a % of sales

R&D expenditure for the quarter were Rs.367 crores

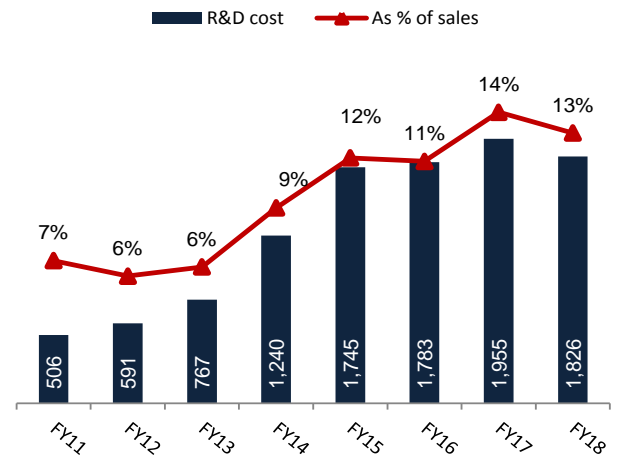


Exhibit: COGS and Other expenses

Other expenses has declined by 9% YoY on account cost optimization and productivity improvement initiatives.

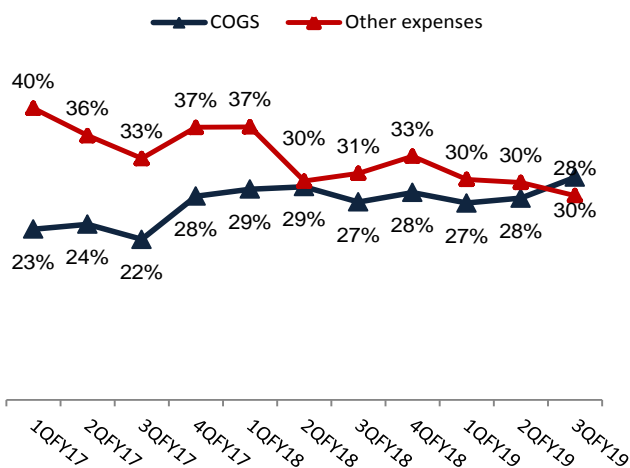
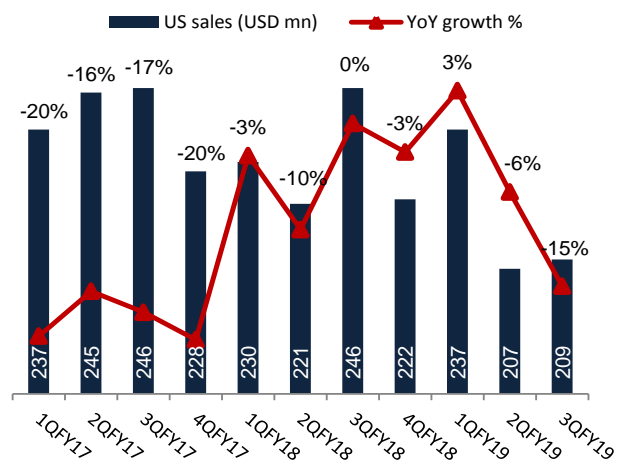


Exhibit: US sales and YoY growth

US sales contracted by 15% YoY to USD 209 million though sequentially has improved by 1%.



Operational Details

Geography	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
<i>North America</i>	1660	1535	1495	1432	1607	1449	1590	1427	1483
<i>Europe</i>	215	207	208	242	201	171	202	192	203
<i>India</i>	595	571	469	637	613	614	607	686	674
<i>Emerging Markets</i>	595	601	575	551	590	550	664	749	774
<i>PSAI</i>	540	540	465	565	544	625	541	603	594
<i>Proprietary products and</i>	103	100	105	119	252	126	116	141	122

Revenue gr. %	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
<i>North America</i>	3%	-8%	-3%	-4%	12%	-10%	10%	-10%	4%
<i>Europe</i>	21%	-4%	0%	17%	-17%	-15%	18%	-5%	6%
<i>India</i>	-5%	-4%	-18%	36%	-4%	0%	-1%	13%	-2%
<i>Emerging Markets</i>	23%	1%	-4%	-4%	7%	-7%	21%	13%	3%
<i>PSAI</i>	-7%	0%	-14%	22%	-4%	15%	-13%	11%	-2%
<i>Proprietary products and</i>	-5%	-2%	5%	13%	112%	-50%	-8%	22%	-14%

Revenue mix%	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
<i>North America</i>	45%	43%	45%	40%	42%	41%	43%	38%	39%
<i>Europe</i>	6%	6%	6%	7%	5%	5%	5%	5%	5%
<i>India</i>	16%	16%	14%	18%	16%	17%	16%	18%	18%
<i>Emerging Markets</i>	16%	17%	17%	16%	16%	16%	18%	20%	20%
<i>PSAI</i>	15%	15%	14%	16%	14%	18%	15%	16%	15%
<i>Proprietary products and</i>	3%	3%	3%	3%	7%	4%	3%	4%	3%

Financial Details

Balance Sheet

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
Share Capital	85	85	85	85	83	83	83	83
Reserves	6,284	7,780	9,768	12,485	12,179	12,489	14,001	15,808
Networth	6,369	7,865	9,853	12,570	12,262	12,572	14,084	15,891
Debt	3,165	4,136	3,617	3,340	4,908	5,065	5,546	5,546
Other Non Current Liab	193	299	492	399	590	570	594	626
Total Capital Employed	9,534	12,001	13,470	15,910	17,170	17,637	19,630	21,437
Net Fixed Assets (incl CWIP)	4,616	5,280	5,906	7,335	10,255	10,439	10,556	10,639
Non Current Investments	0	0	146	330	683	465	488	488
Other Non Current Assets	344	424	670	925	1,195	1,142	1,179	1,191
Non Current Assets	4,961	5,704	6,721	8,590	12,133	12,046	12,222	12,318
Inventory	2,171	2,419	2,570	2,558	2,853	2,909	3,318	3,609
Debtors	3,180	3,325	4,101	4,125	3,799	4,053	3,801	4,135
Cash & Bank	2,017	2,301	1,872	492	387	264	2,288	3,677
Other Current Assets	1,159	2,281	3,333	4,619	2,646	3,273	3,403	3,538
Current Assets	8,527	10,326	11,877	11,794	9,684	10,498	12,810	14,959
Creditors	966	893	867	907	1,057	1,335	1,624	1,767
Provisions	674	816	1,144	529	513	439	469	509
Other Current Liabilities	2,120	2,021	2,624	2,640	2,488	2,564	2,716	2,939
Curr Liabilities	3,760	3,730	4,636	4,075	4,057	4,338	4,809	5,214
Net Current Assets	4,767	6,596	7,241	7,719	5,626	6,161	8,001	9,745
Total Assets	13,487	16,030	18,598	20,384	21,817	22,544	25,033	27,278

Income Statement

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
Revenue from Operation	11,896	13,415	15,023	15,568	14,196	14,281	15,335	16,675
Change (%)	21%	13%	12%	4%	-9%	1%	7%	9%
EBITDA	2,720	3,251	3,494	3,585	2,221	2,351	3,124	3,605
Change (%)	12%	20%	7%	3%	-38%	6%	33%	15%
Margin (%)	23%	24%	23%	23%	16%	16%	20%	0%
Depr & Amor.	550	648	760	939	1,027	1,077	1,099	1,116
EBIT	2,169	2,603	2,734	2,646	1,194	1,274	2,025	2,489
Int. & other fin. Cost	100	127	108	83	63	79	86	86
Other Income	150	170	274	295	172	155	364	356
EBT	2,219	2,646	2,900	2,859	1,302	1,350	2,303	2,759
Exp Item	54	-	-	-	-	-	-	-
Tax	638	683	563	751	297	438	391	552
Minority Int & P/L share of Ass.	-	-	-	23	35	34	28	-
Reported PAT	1,527	1,963	2,336	2,108	1,006	912	1,911	2,207
Adjusted PAT	1,527	1,963	2,336	2,131	1,041	947	1,939	2,207
Change (%)	17%	29%	19%	-9%	-51%	-9%	105%	14%
Margin(%)	13%	15%	16%	14%	7%	7%	13%	0%

Financial Details

Key Ratios

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
ROE	24%	25%	24%	17%	8%	8%	14%	14%
ROCE	28%	26%	24%	19%	9%	8%	12%	13%
Asset Turnover	3	3	3	2	1	1	2	2
Debtor Days	99	91	100	97	98	104	91	91
Inv Days	68	66	63	60	74	75	79	79
Payable Days	30	25	21	21	27	34	39	39
Int Coverage	18	22	21	25	32	19	16	23
P/E	19	21	24	23	41	36	24	21
Price / Book Value	4	5	6	4	3	3	3	3
EV/EBITDA	10	13	16	14	19	16	15	13
FCF per Share	37	52	58	156	56	53	125	113
Div Yield	1%	1%	1%	1%	1%	1%	1%	1%

Cash Flow Statement

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18	FY19E	FY20E
PBT	2,165	2,646	2,900	2,675	1,554	1,350	2,303	2,759
(inc)/Dec in Working Capital	(1,294)	(1,005)	(1,484)	(18)	(525)	(897)	171	(335)
Non Cash Op Exp	550	648	760	971	1,027	1,077	1,099	1,116
Int Paid (+)	100	127	108	82	63	79	86	86
Tax Paid	(555)	(714)	(546)	(710)	(577)	(276)	(391)	(552)
others	412	269	786	1,047	603	469	-	-
CF from Op. Activities	1,378	1,970	2,524	4,048	2,144	1,803	3,268	3,074
(inc)/Dec in FA & CWIP	(756)	(1,083)	(1,532)	(1,388)	(1,223)	(929)	(1,198)	(1,200)
Free Cashflow	622	887	992	2,660	922	874	2,070	1,874
(Pur)/Sale of Inv	(1,156)	(2,509)	(3,701)	(5,516)	(4,972)	(6,829)	-	-
others	466	1,898	2,967	4,962	4,354	6,270	(40)	-
CF from Inv. Activities	(1,446)	(1,694)	(2,265)	(1,942)	(1,840)	(1,488)	(1,239)	(1,200)
inc/(dec) in NW					(1,569)			
inc/(dec) in Debt	240	390	34	(1,199)	1,631	88	481	-
Int. Paid	(126)	(116)	(109)	(92)	(92)	(133)	(86)	(86)
Div Paid (inc tax)	(272)	(298)	(359)	(411)	(339)	(399)	(399)	(399)
others	0	0	1	0	-	-	-	-
CF from Fin. Activities	(157)	(24)	(433)	(1,701)	(369)	(444)	(5)	(485)
Inc(Dec) in Cash	(225)	251	(174)	405	(65)	(129)	2,025	1,389
Add: Opening Balance	746	611	757	154	443	384	264	2,288
Closing Balance	520	862	583	559	378	254	2,288	3,677

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Analyst's ownership of the stocks mentioned in the Report	NIL
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Registration Details of Group entities: G. Raj & Company Consultants Ltd (G RAJ)-BSE Broker INZ260010731; NSDL DP: IN-DP-NSDL-371-2014 || Narnolia Commerze Limited (Formerly Microsec Commerze Ltd.)-MCX/NCDEX Commodities Broker: INZ000051636 || NarnoliaVeloX Advisory Ltd.- SEBI Registered PMS: INP000005109 || Eastwind Capital Advisors Pvt Ltd. (EASTWIND)-SEBI Registered Investment Adviser: INA300005439 || Narnolia Insurance Brokers Limited (Formerly Microsec Insurance Brokers Ltd.)-IRDA Licensed Direct Insurance Broker (Life & Non-Life) Certificate No. 134, License No. DB046/02 || Narnolia Securities Ltd. (NSL)-AMFI Registered Mutual Fund distributor: ARN 20558, PFRDA NPS POP: 27092018 || Narnolia Capital Advisors Pvt. Ltd. - RBI Registered NBFC:B.05.02568.

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