



Dr Reddy's Labs

BSE Sensex
27,837

S&P CNX
8,423

CMP: INR3,613

TP: INR3,870 (+7%)

Buy



Stock Info

Bloomberg	DRRD IN
Equity Shares (m)	170.4
52-Week Range (INR)	3,809/2,266
1, 6, 12 Rel. Per (%)	1/6/41
M.Cap. (INR b)	615.6
M.Cap. (USD b)	9.6

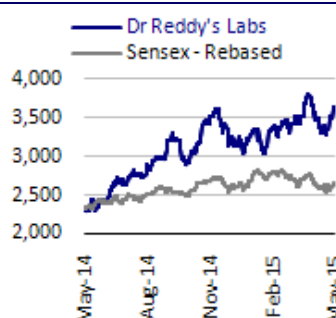
Financial Snapshot (INR Billion)

Y/E Mar	2015E	2016E	2017E
Sales	148.2	161.6	183.8
EBITDA	33.5	38.4	45.5
Net Profit	22.2	25.0	30.0
Adj. EPS (INR)	130.2	147.1	176.1
EPS Gr. (%)	4.5	13.0	19.7
BV/Sh. (INR)	653.3	778.1	928.4
RoE (%)	19.9	18.9	19.0
RoCE (%)	16.9	17.8	18.5
P/E (x)	27.8	24.6	20.5
P/BV (x)	5.5	4.6	3.9

Shareholding pattern (%)

As on	Mar-15	Dec-14	Mar-14
Promoter	25.5	25.5	25.5
DII	5.4	5.7	6.3
FII	55.8	55.9	52.3
Others	13.3	12.9	15.9

Stock Performance (1-year)



Specialty thrust to fortify long term outlook

Benefits of strategic R&D initiatives to fructify from FY18 onwards

Post attending Dr Reddy's (DRRD) Investor's Day, our confidence on DRRD's strong R&D capabilities and efforts towards building a sustainable research led business model was reaffirmed. Meaningful revenue traction and earning accretion from the showcased pipeline is likely to accrue from FY18 onwards, the strategic intent of shift towards Specialty pharma model was evident. We highlight the key takeaways from the event in this report.

R&D surge due to strong thrust on Proprietary/Biosimilar portfolio

DRRD leads the Indian pharma peers in terms of absolute R&D spend (USD280m, 12% of sales), 40% of which is directed towards Proprietary and Biosimilar projects (vs 15% in FY09). Generic R&D spend is largely directed towards building complex generic portfolio, whose share in US revenues has risen to 57% in FY15 (vs 29% in FY12). Ramp up in R&D spend has helped in strengthening product mix resulting in higher gross margin expansion (vs R&D increase). We expect R&D spend to persist at 11-12% of sales going forward.

Complex generics: Focus on injectables, topical and respiratory

Over 50% of pending ANDA pipeline consists of complex generics and this likely to increase going forward. Within injectables, the company is targeting long-acting variants with technology barriers like Liposomals, Microspheres, etc representing market opportunity worth USD7.5b. In a short span of time, DRRD has proven its execution success in Injectables space with revenues of USD250m (24% of US sales). DRRD has adopted partnership approach (25+ partners for 12+ dosage forms) for topical, inhaler and controlled substance products. This would help shorten gestation period and accelerate access to new technology platforms (where it lacks capabilities).

Proprietary products: Targeting unmet needs in derma, CNS space

Current portfolio consist of four derma brands, actively marketed to ~8,000 dermatologists in US by 54 sales representatives, generating USD36m sales in FY15 (USD12m in FY11). The pipeline focuses on NDDS based opportunities (approved API) to be filed through the 505 (b)(2) route. DRRD aims to scale USD400m revenues from Proprietary products by FY22, generating margins in excess of 40% (24% company average). With 3 novel applications (NDA) already filed in FY15, the company plans to file 2 NDA's annually over the next five years with each product likely to garner peak sales of USD100-300m.

Biosimilars: Long term play, best positioned among Indian players

DRRD is likely to spend USD40m annually (unlikely to exceed) towards biosimilars R&D over the next five years. With four biosimilars already commercialized in Emerging markets (market opportunity worth USD3b), the company expects gradual scale-up on new market launches and portfolio

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expansion. The company is targeting revenues of USD150-200m by FY20 (25%+ margins) in Emerging markets. Partnership with Merck Serono (R&D sharing, co-commercialization rights) for Developed markets would help restrict R&D spend and have attractive risk reward targeting developmental pipeline worth USD37b (10 molecules under evaluation) as well as six projects underway (IND filed for two – Rituximab and Pegfilgrastim) worth USD25b market size. DRRD expects commercialization of US biosimilars from FY20 (royalty kicking in) anticipating annual profits of USD15-200m from biosimilar portfolio in US by FY25.

Valuations fair: Deep option value of R&D pipeline not factored in

DRRD stock trades at 24.6x FY16E and 20.5x FY17E, at 20% premium to its historic average. Significant investments in long gestation R&D projects with back-ended monetization prospects limit near-term earnings growth (forecast 16% EPS CAGR over FY15-17E). However, we are positive on medium term prospects and would recommend buying on dips strategy to play on (a) superior R&D capability with monitorable developmental milestones over medium term, (b) strong management team and corporate governance standards (80% independent directors, US listed, early IFRS adopter), (c) potential earnings surprises from complex and differentiated US portfolio (68 pending filings, 50% in niches). Key risks to our thesis: Adverse USFDA action on Srikakulam API facility (9 Form 483 observations), delays in regulatory approvals affecting key launches and currency fluctuation (mainly Russia/Venezuela exposure).

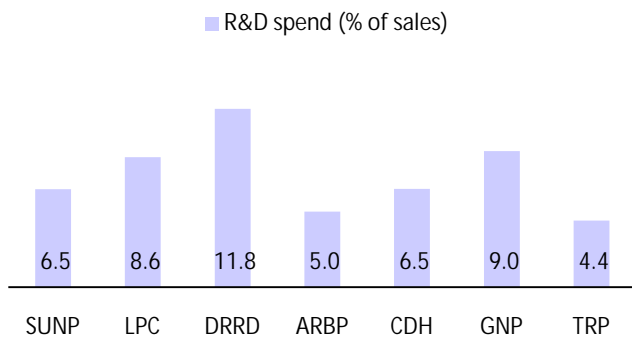
Exhibit 1: Valuation metrics

EXHIBIT 17: Valuation Metrics												
Company	CMP (INR)	Mkt Cap (USD b)	Rating	CAGR % (FY15E-17E)			P/E (x)			EV/ EBITDA (x)		
				Revenue	EBITDA	PAT	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E
Indian Generics (Large Caps)												
SUNP	966	38	Buy	17	17	23	34	28	22	22	19	15
LPC	1,722	13	Buy	16	20	18	32	28	23	22	18	15
DRRD	3,612	10	Buy	11	17	16	28	25	21	20	16	14
CIPLA	688	9	Neutral	17	27	38	46	32	24	25	19	15
Average				15	20	24	35	28	23	22	18	15
Indian Generics (Mid Caps)												
ARBP	1,391	7	Buy	16	23	26	27	21	17	18	15	12
CDH	1,755	6	Buy	20	24	25	30	24	19	21	16	13
GNP	907	4	Buy	21	23	21	32	26	21	19	15	12
IPCA	672	1	Neutral	21	24	23	26	19	15	14	11	9
TRP	1,250	3	Buy	16	24	31	31	25	20	23	16	13
ALPM	538	2	Buy	19	30	26	36	27	20	14	10	7
Average				19	25	25	30	24	19	18	14	11
CRAMS												
DIVI	1,780	4	Neutral	17	16	12	28	23	19	21	17	14
BIOS	448	1	Sell	24	33	34	22	20	18	14	12	10
Average				20	24	23	25	21	18	17	14	12
MNCs												
GLXO	3,201	4	Neutral	4	16	15	51	43	39	42	38	32
AVEN	3,197	1	Neutral	14	17	21	37	33	26	19	18	13
Average				9	16	18	44	38	32	31	28	23
Average (overall)				16	21	23	34	28	23	22	19	15

Source: Company, MOSL

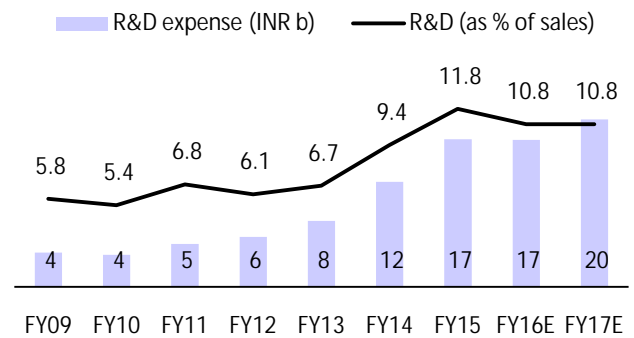
Story in charts

Exhibit 2: R&D expense highest among peers



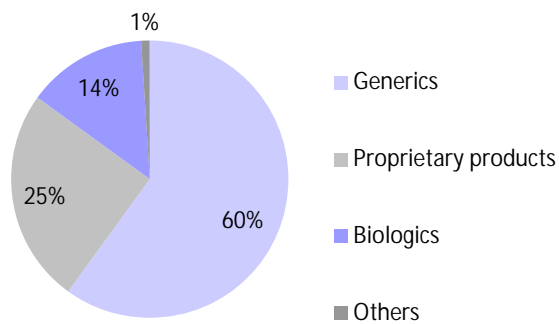
Source: Company, MOSL

Exhibit 3: DRRD - R&D expense likely to remain elevated



Source: Company, MOSL

Exhibit 4: R&D investment breakup (FY15)



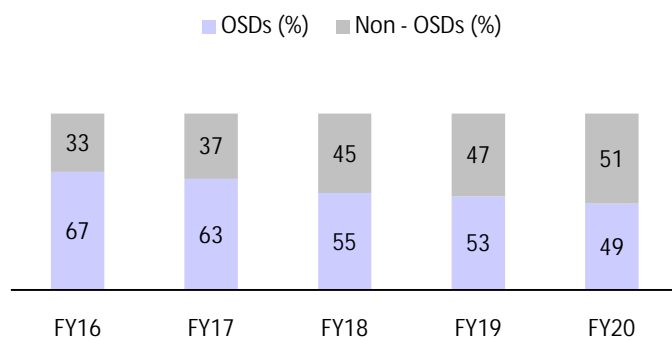
Source: Company, MOSL

Exhibit 5: Increase R&D staffs is significant

Division	FY10	FY15
Generics	1050	1066
Proprietary Products	66	160
Biologics	400	540
Aurigene	410	428

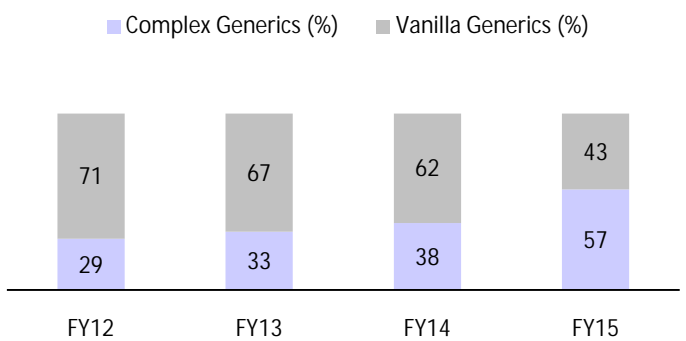
Source: Company, MOSL

Exhibit 6: Targeting high margin Non OSD form. going ahead



Source: Company, MOSL

Exhibit 7: Break-up of US portfolio

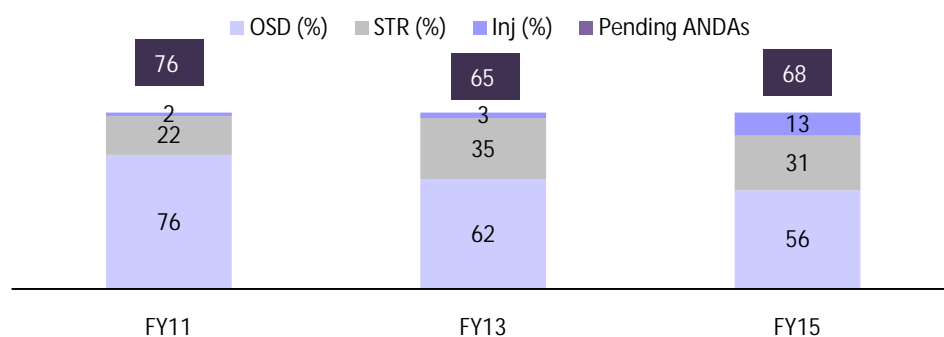


Source: Company, MOSL

Exhibit 8: Future pipeline is diversified across various complex platforms

Complex Generics	Under pipeline	Future products	Mkt Size (USD b)	Comments
Microspheres	2	2	2.5	Full Integration of Octoplus synergies with Global injectable platform
Liposomals	2	1	1	Two near term filings i.e. One each in FY16 and FY17
Particulate Systems	2	2	2	Early POC (proof of concept) work through academic partnerships
Ready to use	4	Multiple	3.1	Four near terms filings, working on 505b(2) approach on a large number of candidates
Derma	7	> 5	3.5	Filed Three ANDAs in FY15
Transdermals	3	1	1.9	Two patches filed till date, Acquisition of Habitrol
Soft gels	3	3	1	Commercialized Isotretinoin in US both as a branded and generic product
Respiratory	3	2	3	Launched Levalbuterol

Source: Company, MOSL

Exhibit 9: Complex generic forms constituting higher share incrementally

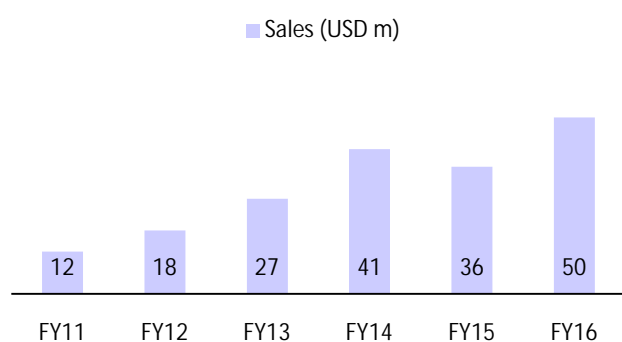
Source: Company, MOSL

Exhibit 10: Biologics in FY20 (and FY25)

Product Portfolio	<ul style="list-style-type: none"> • 6 existing products; > 50 filings across 14 major countries • 5 new products in clinical development • 5 new products in early development
FY20 Business Profile	<ul style="list-style-type: none"> • Emerging Markets Revenue: \$150Mn – \$ 200Mn • Developed Markets Profits/Royalties expected to Kick-in • EBITDA margin post R&D: > 25 %
FY25 Business Profile	<ul style="list-style-type: none"> • Emerging Markets Revenue: \$300Mn – \$400Mn • Developed Markets Profits: ~ \$150 – 200Mn • EBITDA margin post R&D: > 35 %

Source: Company, MOSL

Exhibit 11: Proprietary business scaling up



Source: Company, MOSL

Exhibit 12: DRRD is targeting underserved segments in Derma and CNS (proprietary products)

Segments	No of Patients (mn)	DRRD's target
Acne	40-50	2-4 m
Psoriasis	7.5	> 1.5m
Actinic Keratosis	58	0.8-1m
Rosacea	16	0.8-1m
Migraine	30	2-4m
Parkinson's	1	150-250k
Epilepsy	1.7	250-500k

Source: Company, MOSL

Exhibit 13: Key Programs in Dermatology Pipeline

Preclinical	Phase 1	Phase 2a	Phase 2b	Phase 3/BE	Filed
DFD-01: Psoriasis					
DFD-09: Rosacea					
DFD-10: Acne					
DFD-06: Psoriasis					
DFD-03: Acne					
DFD-05: NGW*					
DFD-04: Rosacea					
DFD-07: AK					
DFD-08: AK					

Source: Company, MOSL

Exhibit 14: Key Programs in Neurology Pipeline

Preclinical	Phase 1	Phase 2a	Phase 2b	Phase 3/BE	Filed
DFN-11: Migraine					
DFN-02: Migraine					
DFN-15: Migraine					
DFN-10: Migraine					
DFN-14: Migraine					
DFN-19: Migraine					
Epilepsy: 4 preclinical programs					
Parkinson's: 4 preclinical programs					

Source: Company, MOSL

Valuation and view

Successful monetization of several niche products (gDacogen, gVidaza) has helped DRRD achieve a formidable base for FY15. With fewer new launches in US and concerns on Russian market, FY16 would be a year of consolidation for DRRD. However, we expect upside from US portfolio and healthy domestic growth to result in 16% EPS CAGR over FY15-17E to be driven by 11% revenue growth and cumulative 220bp operating margin expansion.

Our TP of INR3,870 implies 7% upside from current levels. We value DRRD at 22x FY17E EPS, at par with sector average (one-year forward P/E) and at discount to large peers due to:

- n Relatively slower earnings growth of 16% CAGR (vs 23% for large peers)
- n Potential overhang of currency depreciation/demand outlook in key emerging markets (21% of sales)
- n Healthy Balance Sheet (D/E: 0.4x) and return ratios (RoE at 20%)

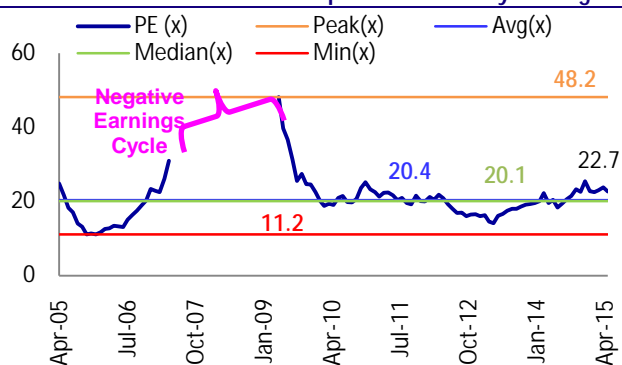
Key catalysts to drive stock's performance over the medium term are:

- n Stabilisation of emerging market economies/currency, mainly Russia/CIS (12% of sales)
- n Clearance of Form 483 issues at Srikakulam API facility
- n Launch of key products like gCopaxone, gNexium, etc

Key risks to our investment thesis:

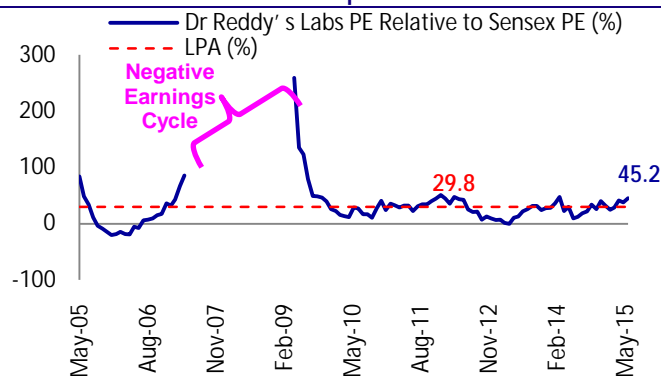
- n Regulatory delays affecting key US launches,
- n Adverse outcome of pending FDA issues (API facility)
- n Further depreciation of Russian currency. Every 10% depreciation of Ruble hereon (vs USD) leads to 2% downgrade in EPS estimate (annualized).

Exhibit 15: DRRD trades at 11% premium to 10 year avg. PE



Source: Company, MOSL

Exhibit 16: DRRD trades at 45% premium to Sensex PE



Source: Company, MOSL

Financials and valuations

Income Statement						(INR Million)		
Y/E March	2010	2011	2012	2013	2014	2015E	2016E	2017E
Net Sales	70,277	74,693	96,738	116,266	132,171	148,189	161,631	183,833
Change (%)	1.2	6.3	29.5	20.2	13.7	12.1	9.1	13.7
Other Income	1,058	1,118	1,669	3,634	2,411	2,871	1,880	2,110
Total Expenditure	56,075	59,033	72,996	91,503	100,472	114,717	123,244	138,334
EBITDA	14,202	15,660	23,742	24,763	31,699	33,472	38,387	45,499
Change (%)	-6.0	10.3	51.6	4.3	28.0	5.6	14.7	18.5
Margin (%)	20.2	21.0	24.5	21.3	24.0	22.6	23.8	24.8
Depreciation & Amort.	12,763	4,147	6,254	6,237	7,085	8,103	8,566	9,743
EBIT	1,439	11,513	17,488	18,526	24,614	25,369	29,821	35,755
Net Interest Exp	372	189		118	79	77	413	413
Forex (Gains)/Losses	72	0	0	365	329	0	0	0
PBT after EO Expense	2,053	12,442	19,157	21,677	26,616	28,163	31,287	37,452
Tax	985	1,403	4,204	4,900	5,093	5,984	6,257	7,490
Tax Rate (%)	48.0	11.3	21.9	22.6	19.1	21.2	20.0	20.0
Reported PAT	1,068	11,039	14,953	16,777	21,524	22,179	25,030	29,962
Adjusted Net Profit	1,068	11,099	12,428	13,682	21,188	22,179	25,030	29,962
Change (%)	-120.7	939.2	12.0	10.1	54.9	4.7	12.9	19.7
Margin (%)	1.5	14.9	12.8	11.8	16.0	15.0	15.5	16.3

Balance Sheet						(INR Million)		
Y/E March	2010	2011	2012	2013	2014	2015E	2016E	2017E
Equity Share Capital	840	846	848	849	851	852	851	851
Reserves	42,075	45,144	56,596	72,256	89,950	110,450	131,500	157,069
Net Worth	42,915	45,990	57,444	73,105	90,801	111,302	132,351	157,920
Loans	14,656	23,503	32,210	36,678	44,742	43,126	41,347	41,347
Deferred Liabilities/Tax	1,438	87	-833	-1,669	-3,310	-4,013	-4,013	-4,013
Capital Employed	59,009	69,580	88,821	108,114	132,233	150,414	169,685	195,254
Gross Block	29,679	38,359	44,064	52,958	63,444	71,712	83,049	94,387
Less: Accum. Deprn.	12,087	14,714	18,086	21,213	25,695	30,297	35,572	41,453
Net Fixed Assets	22,459	29,642	33,246	37,814	44,424	48,090	54,152	59,608
Investments	4,153	622	11,558	18,131	26,384	38,872	20,819	20,819
Goodwill/Intangibles	13,973	15,246	13,529	14,021	14,697	16,430	12,266	12,266
Curr. Assets	38,463	47,560	59,179	68,751	78,664	85,579	113,350	137,233
Inventory	13,371	16,059	19,352	21,600	23,992	25,529	28,184	31,628
Account Receivables	11,960	17,615	25,339	31,972	33,037	40,755	39,806	45,274
Cash and Bank Balance	6,584	5,729	7,379	5,136	8,451	5,394	29,196	41,947
Others	6,548	8,157	7,109	10,043	13,184	13,901	16,163	18,383
Curr. Liability & Prov.	20,039	23,490	28,691	30,603	31,936	38,556	30,902	34,672
Account Payables	9,322	8,480	9,502	11,862	10,503	10,660	11,581	12,996
Other Current Liabilities	10,717	15,010	19,189	18,741	21,433	27,896	19,321	21,676
Net Current Assets	18,424	24,070	30,488	38,148	46,728	47,023	82,448	102,561
Appl. of Funds	59,009	69,580	88,821	108,114	132,233	150,414	169,685	195,254

Financials and valuations

Ratios

Y/E March	2010	2011	2012	2013	2014	2015E	2016E	2017E
Basic (INR)								
EPS	6.4	65.6	73.3	80.6	124.6	130.2	147.1	176.1
Cash EPS	82.4	90.1	110.2	117.3	166.2	177.7	197.5	233.4
BV/Share	255.6	271.8	338.7	430.5	533.8	653.3	778.1	928.4
DPS	11.3	11.2	13.7	13.8	18.0	20.0	22.1	26.4
Payout (%)	207.4	20.2	18.2	16.3	16.6	17.9	17.6	17.6

Valuation (x)

P/E				44.8	29.0	27.8	24.6	20.5
Cash P/E				30.8	21.7	20.3	18.3	15.5
P/BV				8.4	6.8	5.5	4.6	3.9
EV/Sales				5.4	4.7	4.1	3.8	3.2
EV/EBITDA				25.4	19.7	18.4	15.8	13.1
Dividend Yield (%)				0.4	0.5	0.6	0.6	0.7

Return Ratios (%)

RoE	2.5	24.1	21.6	18.7	23.3	19.9	18.9	19.0
RoCE	3.1	16.8	19.7	17.2	18.7	16.9	17.8	18.5

Working Capital Ratios

Fixed Asset Turnover (x)	2.5	2.2	2.3	2.4	2.3	2.2	2.1	2.1
Debtor (Days)	62	86	96	100	91	100	90	90
Inventory (Days)	69	78	73	68	66	63	64	63
Working Capital (Days)	61	90	87	104	106	103	120	120

Leverage Ratio

Current Ratio (x)	1.9	2.0	2.1	2.2	2.5	2.2	3.7	4.0
Debt/Equity (x)	0.3	0.5	0.6	0.5	0.5	0.4	0.3	0.3

Cash Flow Statement

(INR Million)

Y/E March	2010	2011	2012	2013	2014	2015E	2016E	2017E
Op. Profit/(Loss) before Tax	14,202	15,660	23,742	24,763	31,699	33,472	38,387	45,499
Interest/Dividends Recd.	614	929	1,669	3,151	2,003	2,793	1,467	1,697
Direct Taxes Paid	-985	-1,403	-4,204	-4,900	-5,093	-5,984	-6,257	-7,490
(Inc)/Dec in WC	3,450	-6,501	-4,768	-9,903	-5,265	-3,352	-11,623	-7,362
CF from Operations	17,281	8,685	16,439	13,111	23,344	26,930	21,973	32,343
(inc)/dec in FA	-6,134	-12,603	-8,141	-11,297	-14,371	-13,502	-10,465	-15,199
Free Cash Flow	11,147	-3,918	8,298	1,814	8,973	13,428	11,508	17,143
(Pur)/Sale of Investments	-3,161	3,531	-10,936	-6,573	-8,253	-12,487	18,052	0
CF from Investments	-9,295	-9,072	-19,077	-17,870	-22,624	-25,989	7,587	-15,199
Change in net worth	2,019	-5,740	-780	1,620	-247	2,302	412	865
(Inc)/Dec in Debt	-4,827	8,847	8,707	4,468	8,064	-1,617	-1,779	0
Other Items	-1,974	-1,351	-920	-836	-1,640	-704	0	0
Dividend Paid	-2,216	-2,224	-2,719	-2,736	-3,581	-3,979	-4,393	-5,258
CF from Fin. Activity	-6,998	-468	4,288	2,516	2,596	-3,998	-5,759	-4,393
Inc/Dec of Cash	988	-855	1,650	-2,243	3,315	-3,057	23,801	12,751
Add: Beginning Balance	5,596	6,584	5,729	7,379	5,136	8,451	5,394	29,196
Closing Balance	6,584	5,729	7,379	5,136	8,451	5,394	29,196	41,947

NOTES

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