

## INDUSTRY PHARMA

CMP (as on 14 Dec 2017) Rs 2,311

Target Price Rs 2,400

Nifty 10,252

Sensex 33,247

## KEY STOCK DATA

Bloomberg DRRD IN

No. of Shares (mn) 166

MCap (Rs bn) / (\$ mn) 392 / 5,954

6m avg traded value (Rs mn) 1,733

## STOCK PERFORMANCE (%)

52 Week high / low Rs 3,204/1,901

3M 6M 12M

Absolute (%) 2.5 (13.4) (26.6)

Relative (%) (0.6) (20.1) (51.6)

## SHAREHOLDING PATTERN (%)

Promoters 26.8

FIs &amp; Local MFs 13.5

FPIs 29.7

Public &amp; Others 30.1

Source : BSE

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## Are the clouds parting?

Dr. Reddy's Laboratories (DRRD) received an EIR (Establishment Inspection Report) for its Bachupally (plant 3) formulations facility. This leaves DRRD with only the crucial Duvvada facility under significant regulatory action (Srikakulam API plant EIR expected after only 2 483 obs. in re-inspectiion). With ~50% of DRRD's top-line coming from the US business and the majority of this being sold from Bachupally, the risk of escalation to an import alert was a significant investor concern. This has now been eased.

While this news is positive, DRRD's recovery still hinges on the clearance of Duvvada in the next re-inspection. Mgt has indicated that a re-inspection is likely towards the end of 4QFY18. A large chunk of DRRD's lucrative pipeline has been filed from this facility, and as such, offsetting the pressure on the base business will be difficult without the products from Duvvada. There are a few good product opportunities for DRRD in the near to medium term, such as Nuvaring (launch in 4QFY18 likely), Suboxone (depends on litigation outcome) and Copaxone (CRL received). Factoring in these and the clearance of Duvvada in 2HFY19E, we foresee 10% revenue CAGR and 30% earnings CAGR over FY17-20E. With our SELL call dated July 28, 2017 being met, and regulatory relief from the EIR for Bachupally plant 3, we upgrade our rating from SELL to NEUTRAL with a revised TP of Rs 2,400 (16x Dec19E).

- **Bachupally crucial for existing business, Duvvada key to the future:** With this overhang cleared, DRRD can now focus on its Duvvada facility, on which the recovery of its US base business hinges. DRRD's

lucrative oncology pipeline, which we believe includes products like gAloxi, gAlimta, gGleevec, gFaslodex, gJevtana etc., is filed from this facility. DRRD will only be able to offset and grow above the price erosion with launches from this pipeline.

- **Suboxone opportunity impacted, Copaxone delayed:** Indivior has received approval for a once-a-month injectable, Sublocade, for the treatment of moderate to severe opioid use disorder. We believe that the increased convenience (once a month vs daily) is likely to play a significant role in patient compliance. Hence, Sublocade is likely to grab a good share of the market. With Teva also being FTF in Suboxone, the commercial opportunity for DRRD is thinning. We expect this product to be launched in FY20E (TAD in 4QFY18). W.r.t Copaxone, as expected by the mgt, there were some queries on the 20mg file, which will now need to be worked on. The TAD for the 40mg filing is in 1QFY19, which remains a key monitorable.
- **View and valuation:** At CMP, DRRD is trading at 19.7x FY19E and 14.3x FY20E, reasonable when compared to large-cap peers. However, the degree of dependence on Duvvada prompts us to maintain a NEUTRAL stance.

## Financial Summary

YE Mar (Rs bn)	FY17	FY18E	FY19E	FY20E
Net Sales	140,809	142,333	159,522	186,037
EBITDA	25,220	26,332	35,893	46,509
APAT	12,039	11,767	19,474	26,721
Adj. EPS (Rs/sh)	72.7	71.0	117.5	161.2
P/E (x)	31.8	32.5	19.7	14.3
RoE (%)	9.5	9.2	14.0	16.9

Source: Company, HDFC sec Inst Research

HDFC securities Institutional Research is also available on Bloomberg HSLB &lt;GO&gt; &amp; Thomson Reuters

*It is to be noted that the clearance of the Duvvada facility would lead to a re-rating in the multiple. Accordingly, we have presented a scenario analysis around the Duvvada inspection outcome. Our estimates assume facility clearance in late 2HFY19*

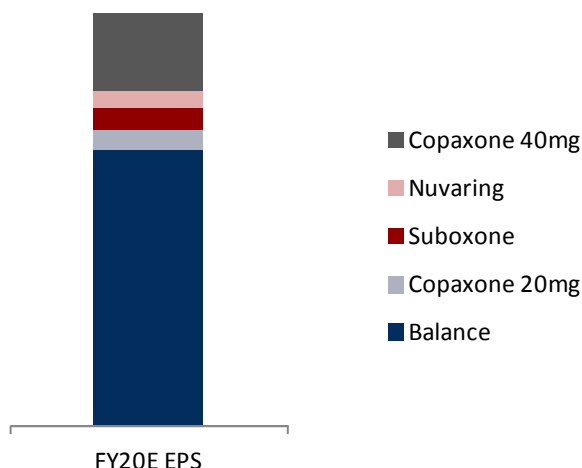
## Scenario analysis – Duvvada inspection

Duvvada inspection outcome	Multiple	Dec-19E EPS	TP on Dec-19E EPS	Upside/ (Downside)
No 483 observations and WL lifted (unlikely)	20x	150	3,005	30.0
Resolution in 2HFY19 (base case)	16x	150	2,400	3.9
Serious/repeat observations and possible import alert	15x	115	1,725	(25.3)

Source: Company, HDFC sec Inst Research

## Contribution from Nuvaring, Suboxone and Copxone

### 33% Of FY20E EPS Contingent On Blockbuster Launches



Source: Company, HDFC sec Inst Research

- **Nuvaring:** Nuvaring's patents expire in Apr-18, and as such, this is the most likely launch among the four key products for DRRD. With the TAD in 4QFY18, we expect DRRD to be in the first wave of generics.
- **Suboxone:** While the opportunity size will thin (assumed 50% shift to Sublocade), DRRD was the only generic with a favourable litigation outcome in the US courts. With the Appeals court decision likely in 2HFY19, we have factored in the launch in FY20E.
- **Copaxone 20mg and 40mg:** As foreseen by the mgt, there were queries from the FDA on the 10<sup>th</sup> Nov TAD for the 20mg file. With further generic entrants likely to follow quickly behind Natco/Mylan's launch, and considering the status of the files, we have assumed FY20E launch for DRRD and 70% market erosion by then for both 20 and 40mg.

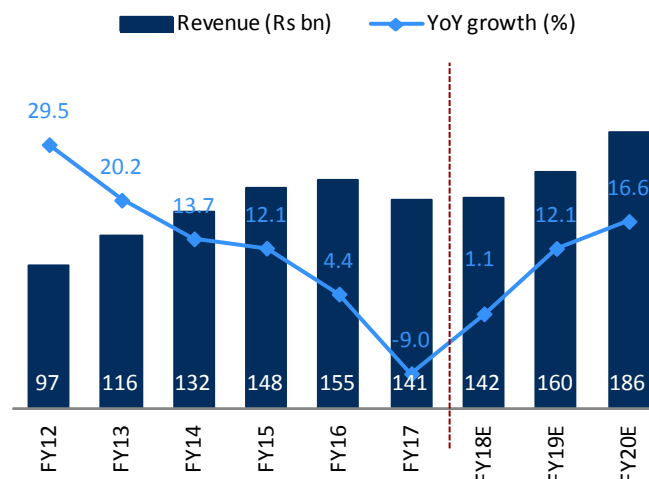
**Factoring in Duvvada's clearance in 2HFY19 and the launches of the four blockbuster products over the course of the next 2 years, we arrive at a forecasted 10% earnings CAGR over FY17-20E**

**Recovery in the US business will be the key driver of top-line growth, boosted by launches of Nuvaring, Suboxone and Copaxone**

**Earnings to outperform with 30% CAGR over the same period, with the EBITDA margin expanding ~700bps**

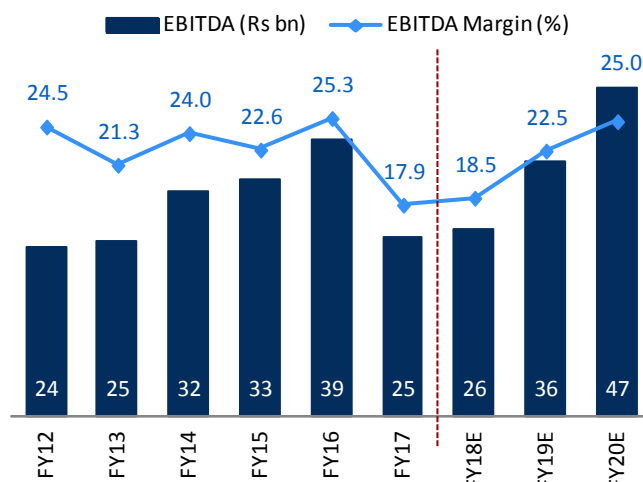
## DRRD In Charts

### Revenue: Expect 10% CAGR Over FY17-20E



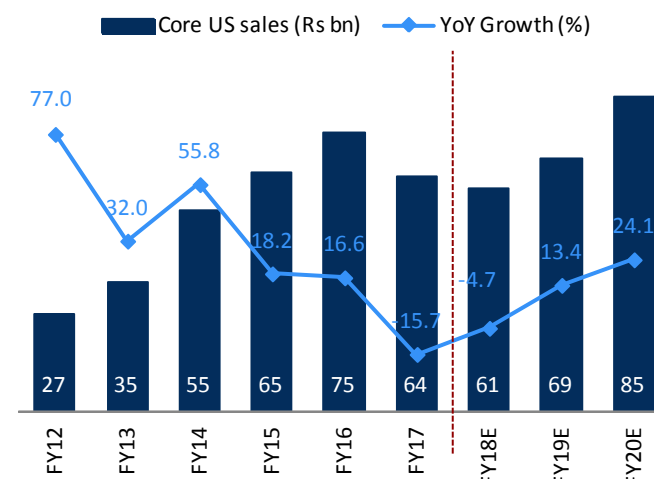
Source: Company, HDFC sec Inst Research

### EBITDA Margin: Significant Recovery Only In FY20E



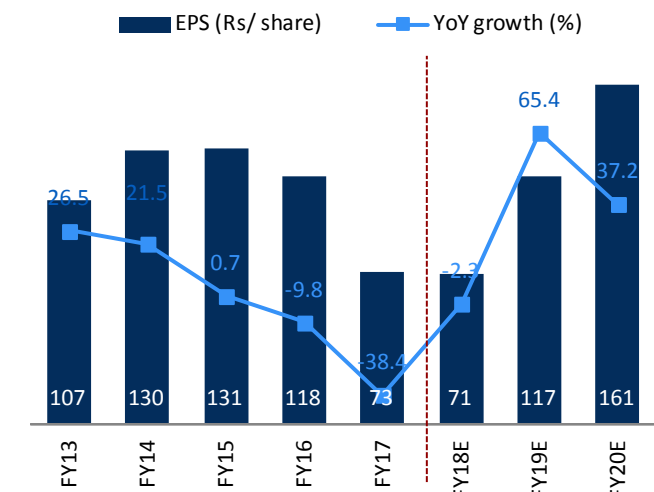
Source: Company, HDFC sec Inst Research

### Core US Sales To Recover With Duvvada Clearance



Source: Company, HDFC sec Inst Research

### EPS Growth: 30% CAGR Over FY17-20E, Significant Boost From Blockbuster Launches



Source: Company, HDFC sec Inst Research

## Peer Valuations

	Mcap (Rs bn)	CMP (Rs/sh)	Reco	TP	Adj EPS (Rs/sh)				P/E (x)				RoE (%)			
					FY17	FY18E	FY19E	FY20E	FY17	FY18E	FY19E	FY20E	FY17	FY18E	FY19E	FY20E
Sun Pharma	1,238	514	NEU	485	26.0	14.6	20.9	28.5	19.8	35.1	24.6	18.0	17.9	9.4	12.5	15.2
Cipla	474	590	NEU	630	12.5	21.2	27.6	35.2	47.2	27.8	21.4	16.8	8.4	12.8	14.7	16.3
Cadila Healthcare	420	410	BUY	540	14.5	12.6	19.2	25.9	28.2	32.5	21.4	15.8	23.5	16.9	21.6	24.0
<b>Dr Reddy's Labs</b>	<b>392</b>	<b>2,311</b>	<b>NEU</b>	<b>2,400</b>	<b>72.7</b>	<b>71.0</b>	<b>117.5</b>	<b>161.2</b>	<b>31.8</b>	<b>32.5</b>	<b>19.7</b>	<b>14.3</b>	<b>9.5</b>	<b>9.2</b>	<b>14.0</b>	<b>16.9</b>
Aurobindo Pharma	389	665	NEU	800	39.3	37.7	46.7	53.7	16.9	17.6	14.2	12.4	27.6	21.3	21.5	20.3
Lupin	383	853	BUY	1,125	56.9	36.7	46.6	66.0	15.0	23.3	18.3	12.9	20.9	11.8	13.6	17.0
Divi's Labs	282	1,061	NEU	1,100	39.9	35.9	46.5	53.1	26.6	29.6	22.8	20.0	22.0	16.8	19.4	19.8
Alkem Laboratories	250	2,090	BUY	2,100	74.6	52.2	87.6	107.5	28.0	40.0	23.9	19.4	21.9	13.0	19.0	20.1
Torrent Pharma	224	1,323	BUY	1,480	51.2	46.9	60.7	79.0	25.8	28.2	21.8	16.8	22.1	17.8	20.6	22.7
Glenmark	151	534	BUY	1,000	29.6	25.1	41.9	54.6	18.1	21.3	12.7	9.8	18.1	13.1	18.4	20.0
Jubilant Life Sciences	106	668	BUY	850	37.0	41.9	55.1	70.1	3.4	3.0	2.3	1.8	18.0	17.9	19.7	20.9
Alembic Pharma	99	525	NEU	555	21.4	21.1	24.7	31.1	24.6	24.8	21.3	16.9	23.0	19.5	19.6	21.0
Strides Shasun	70	781	BUY	1,200	34.0	35.0	51.6	67.5	23.0	22.4	15.2	11.6	13.1	11.7	16.0	18.2
Dishman Carbogen Amcis	48	300	BUY	410	9.0	11.8	16.7	22.9	33.3	25.5	18.0	13.1	3.0	3.9	5.3	6.9
Granules India	32	127	BUY	170	7.5	6.9	9.0	12.2	16.8	18.4	14.0	10.3	21.0	15.5	16.0	19.1

Source: HDFC sec Inst Research

## Change In Estimates (Consolidated)

Rs mn	Previous			New			% Chg		
	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E	FY18E	FY19E	FY20E
Net Sales	142,333	161,500	183,255	142,333	159,522	186,037	0.0	(1.2)	1.5
EBITDA	26,332	36,338	45,814	26,332	35,893	46,509	0.0	(1.2)	1.5
APAT	11,767	19,698	26,348	11,767	19,474	26,721	0.0	(1.1)	1.4

Source: HDFC sec Inst Research

## Income Statement (Consolidated)

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
<b>Net Revenues</b>	<b>154,708</b>	<b>140,809</b>	<b>142,333</b>	<b>159,522</b>	<b>186,037</b>
<b>Growth (%)</b>	<b>4.4</b>	<b>-9.0</b>	<b>1.1</b>	<b>12.1</b>	<b>16.6</b>
Material Expenses	62,427	62,453	64,050	67,797	76,275
SG&A Expenses	35,359	33,585	33,448	35,095	39,998
R&D Expenses	17,834	19,551	18,503	20,738	23,255
<b>EBITDA</b>	<b>39,088</b>	<b>25,220</b>	<b>26,332</b>	<b>35,893</b>	<b>46,509</b>
<b>EBITDA Margin (%)</b>	<b>25.3</b>	<b>17.9</b>	<b>18.5</b>	<b>22.5</b>	<b>25.0</b>
<b>EBITDA Growth (%)</b>	<b>16.8</b>	<b>-35.5</b>	<b>4.4</b>	<b>36.3</b>	<b>29.6</b>
Depreciation	10,343	11,722	12,098	12,443	14,139
<b>EBIT</b>	<b>28,745</b>	<b>13,498</b>	<b>14,233</b>	<b>23,450</b>	<b>32,371</b>
Net finance expense (Including EO Items)	1,834	(806)	(768)	(1,522)	(2,011)
<b>PBT</b>	<b>26,911</b>	<b>14,304</b>	<b>15,001</b>	<b>24,971</b>	<b>34,382</b>
Tax (Incl Deferred)	7,127	2,614	3,515	5,817	7,981
Minority Interest	229	349	280	320	320
<b>RPAT</b>	<b>20,013</b>	<b>12,039</b>	<b>11,767</b>	<b>19,474</b>	<b>26,721</b>
<b>APAT</b>	<b>20,013</b>	<b>12,039</b>	<b>11,767</b>	<b>19,474</b>	<b>26,721</b>
<b>APAT Growth (%)</b>	<b>(9.8)</b>	<b>(39.8)</b>	<b>(2.3)</b>	<b>65.5</b>	<b>37.2</b>
<b>Adjusted EPS (Rs)</b>	<b>117.9</b>	<b>72.7</b>	<b>71.0</b>	<b>117.5</b>	<b>161.2</b>

Source: Company, HDFC sec Inst Research

## Balance Sheet (Consolidated)

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
<b>SOURCES OF FUNDS</b>					
Share Capital - Equity	853	828	828	828	828
Reserves	127,483	123,215	131,002	146,497	168,840
<b>Total Shareholders Funds</b>	<b>128,336</b>	<b>124,043</b>	<b>131,830</b>	<b>147,325</b>	<b>169,668</b>
Long Term Debt	10,685	5,449	2,839	2,339	1,839
Short Term Debt	22,828	43,736	44,486	46,006	47,526
<b>Total Debt</b>	<b>33,513</b>	<b>49,185</b>	<b>47,325</b>	<b>48,345</b>	<b>49,365</b>
<b>Net Deferred Taxes</b>	<b>(4,230)</b>	<b>(4,376)</b>	<b>(4,376)</b>	<b>(4,376)</b>	<b>(4,376)</b>
<b>Other Non-current Liabilities &amp; Provns</b>	<b>3,216</b>	<b>4,124</b>	<b>2,920</b>	<b>2,920</b>	<b>2,920</b>
<b>TOTAL SOURCES OF FUNDS</b>	<b>160,835</b>	<b>172,976</b>	<b>177,699</b>	<b>194,214</b>	<b>217,577</b>
<b>APPLICATION OF FUNDS</b>					
Net Block	46,411	50,660	55,719	59,157	62,663
CWIP	7,550	6,500	5,500	6,500	5,250
Intangible assets	24,644	48,677	52,678	56,178	59,178
Investments	1,309	1,603	1,603	1,603	1,603
Other Non-current Assets	3,051	6,220	2,900	3,000	3,000
<b>Total Non-current Assets</b>	<b>82,965</b>	<b>113,660</b>	<b>118,400</b>	<b>126,438</b>	<b>131,694</b>
<b>Cash &amp; Equivalents</b>	<b>40,130</b>	<b>18,398</b>	<b>11,252</b>	<b>13,865</b>	<b>22,917</b>
Inventories	25,578	28,529	29,783	31,526	35,468
Debtors	41,306	38,271	35,053	39,287	45,817
Other Current Assets	12,674	15,383	15,395	17,285	20,202
<b>Total Current Assets</b>	<b>79,558</b>	<b>82,183</b>	<b>80,231</b>	<b>88,098</b>	<b>101,487</b>
Creditors	12,300	13,417	12,238	12,954	14,574
Other Current Liabilities & Provns	29,518	27,847	19,947	21,234	23,947
<b>Total Current Liabilities</b>	<b>41,818</b>	<b>41,264</b>	<b>32,185</b>	<b>34,188</b>	<b>38,521</b>
<b>Net Current Assets</b>	<b>37,740</b>	<b>40,919</b>	<b>48,046</b>	<b>53,910</b>	<b>62,967</b>
<b>TOTAL APPLICATION OF FUNDS</b>	<b>160,835</b>	<b>172,977</b>	<b>177,699</b>	<b>194,214</b>	<b>217,577</b>

Source: Company, HDFC sec Inst Research

## Cash Flow

Year ending March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Reported PBT	27,140	14,653	15,281	25,291	34,702
Non-operating & EO items	(795)	583	-	-	-
Interest expenses (net)	1,834	(806)	(768)	(1,522)	(2,011)
Depreciation	10,343	11,722	12,098	12,443	14,139
Working Capital Change	7,242	(5,673)	(5,011)	(5,964)	(9,056)
Tax Paid	(6,898)	(5,461)	(3,440)	(5,732)	(7,896)
<b>OPERATING CASH FLOW ( a )</b>	<b>38,866</b>	<b>15,018</b>	<b>18,161</b>	<b>24,516</b>	<b>29,877</b>
Capex	(24,428)	(38,954)	(20,158)	(20,381)	(19,394)
Free cash flow (FCF)	14,438	(23,936)	(1,998)	4,135	10,483
Investments	(487)	20,470	4,678	(1,036)	(1,063)
<b>INVESTING CASH FLOW ( b )</b>	<b>(24,915)</b>	<b>(18,484)</b>	<b>(15,480)</b>	<b>(21,417)</b>	<b>(20,457)</b>
Debt Issuance/(Repaid)	(9,613)	15,672	(1,860)	1,020	1,020
Interest expenses (net)	(1,834)	806	768	1,522	2,011
FCFE	2,505	13,012	1,588	5,641	12,451
Share Capital Issuance	1,001	(12,353)	-	398	597
Others	-	2,265	(75)	(85)	(85)
Dividend	(3,979)	(3,979)	(3,979)	(4,377)	(4,974)
<b>FINANCING CASH FLOW ( c )</b>	<b>(14,425)</b>	<b>2,411</b>	<b>(5,146)</b>	<b>(1,523)</b>	<b>(1,431)</b>
<b>NET CASH FLOW (a+b+c)</b>	<b>(474)</b>	<b>(1,055)</b>	<b>(2,466)</b>	<b>1,577</b>	<b>7,989</b>
<b>Closing Cash &amp; Equivalents</b>	<b>4,921</b>	<b>3,866</b>	<b>1,400</b>	<b>2,975</b>	<b>10,964</b>

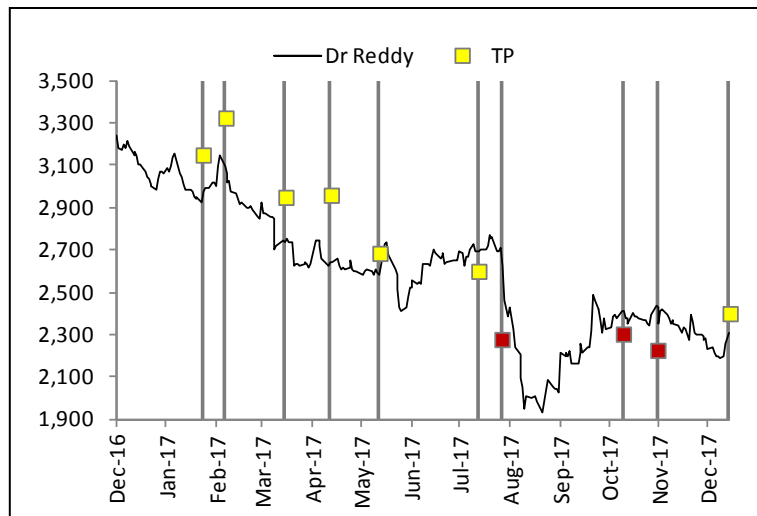
Source: Company, HDFC sec Inst Research

## Key Ratios

	FY16	FY17	FY18E	FY19E	FY20E
<b>PROFITABILITY (%)</b>					
GPM	59.6	55.6	55.0	57.5	59.0
EBITDA Margin	25.3	17.9	18.5	22.5	25.0
APAT Margin	12.9	8.5	8.3	12.2	14.4
RoE	16.7	9.5	9.2	14.0	16.9
RoIC (or Core RoCE)	18.8	8.4	7.1	10.7	13.6
RoCE	12.9	7.6	6.9	10.7	13.2
<b>EFFICIENCY</b>					
Tax Rate (%)	26.5	18.3	23.4	23.3	23.2
Fixed Asset Turnover (x)	1.9	1.5	1.4	1.4	1.5
Inventory (days)	60.3	74.0	76.4	72.1	69.6
Debtors (days)	97.5	99.2	89.9	89.9	89.9
Other Current Assets (days)	29.9	39.9	39.5	39.6	39.6
Payables (days)	29.0	34.8	31.4	29.6	28.6
Other Current Liab & Provns (days)	69.6	72.2	51.2	48.6	47.0
Cash Conversion Cycle (days)	89.0	106.1	123.2	123.4	123.5
Debt/EBITDA (x)	0.9	2.0	1.8	1.3	1.1
Net D/E (x)	(0.1)	0.2	0.3	0.2	0.2
<b>PER SHARE DATA (Rs)</b>					
EPS	117.9	72.7	71.0	117.5	161.2
Dividend	20.0	20.0	20.0	22.0	25.0
Book Value	755.8	748.6	795.5	888.6	1,023.3
<b>VALUATION</b>					
P/E (x)	19.6	31.8	32.5	19.7	14.3
P/BV (x)	3.1	3.1	2.9	2.6	2.3
EV/EBITDA (x)	9.9	16.4	15.9	11.6	8.8
EV/Revenues (x)	2.5	2.9	2.9	2.6	2.2
OCF/EV (%)	9.7	4.0	4.6	6.3	7.9
FCF/EV (%)	3.4	(5.4)	(0.2)	1.5	3.2
FCFE/Mkt Cap (%)	0.6	3.4	0.4	1.5	3.3
Dividend Yield (%)	0.9	0.9	0.9	1.0	1.1

Source: Company, HDFC sec Inst Research

## RECOMMENDATION HISTORY



Date	CMP	Reco	Target
23-Jan-17	2,940	NEU	3,150
6-Feb-17	3,145	NEU	3,325
15-Mar-17	2,716	NEU	2,950
12-Apr-17	2,645	NEU	2,960
15-May-17	2,585	NEU	2,685
12-Jul-17	2,690	NEU	2,600
28-Jul-17	2,621	SELL	2,275
10-Oct-17	2,409	SELL	2,300
1-Nov-17	2,428	SELL	2,220
14-Dec-17	2,311	NEU	2,400

### Rating Definitions

- BUY : Where the stock is expected to deliver more than 10% returns over the next 12 month period
- NEUTRAL : Where the stock is expected to deliver (-)10% to 10% returns over the next 12 month period
- SELL : Where the stock is expected to deliver less than (-)10% returns over the next 12 month period



**Disclosure:**

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**Any holding in stock –No**

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