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Ajcon's Xpress idea: Dr. Reddy's Ltd. (DRRD: IN) - "BUY"

5th Jan, 2015

CMP: 3,146 | Target: Rs. 3,800 | Upside: 21% | Market Cap: Rs. 537 bn | FV: Rs. 5

About the Company

Dr. Reddy's Laboratories Ltd. is an integrated global pharmaceutical company engaged in three business viz., Pharmaceutical Services and Active Ingredients, Global Generics and Proprietary products. DRL offers a portfolio of products and services including APIs, custom pharmaceutical services, generics, biosimilars and differentiated formulations. Major therapeutic focus is on gastro – intestinal, cardiovascular, diabetology, oncology, pain management and anti – infective. Major markets include India, USA, Russia – CIS and Europe apart from other select geographies within Emerging markets. In FY14, nine new products were launched in North America. The major ones were (i) decitabine, a complex injectable to treat blood cell disorders including acute myeloid leukemia; (ii) azacitadine, also for blood cell and bone marrow cancer; (iii) zoledronic acid, to prevent osteoporosis; (iv) divalproex extended release, for treating seizures and epilepsy; and (v) donepezil 23 mg, to treat patients with dementia. These types of highly specialized medicines – be they in oral forms or in injectable dosages. During FY2014, Dr. Reddy's R&D expenses amounted to Rs. 12.4 bn – an increase of 62% over the previous year and amounting to 9.4% of sales. This is an essential ingredient for growth and the basis for the Company to create innovative medicines that meet unmet patient needs.

Top 10 products

North America	India	Russia
Decitabine Injection	Omez®	Nise®
OTC Omeprazole Mg	Omez-DSR®	Omez®
Azacitidine	Nise®	Ketorol®
Metoprolol	Stamlo®	Cetrine®
Zoledronic Acid (Reclast)	Reditux™	Ciprolet®
Fondaparinux	Stamlo Beta TM	Senade
Omeprazole DR	Razo™	Sirdalud
Tacrolimus	Razo-D®	Ibuclin®
Atorvastatin	Atocor™	Novigan®
OTC Fexo	Econorm®	Femibion

Source: Company, Ajcon Research

Q2FY15 result update

Dr Reddy's sales witnessed a yoy growth of 6.9% to touch Rs. 35.87bn in Q2FY15, in line with street estimates driven by 8% growth in North American formulations, 14% growth in Emerging markets and 14% growth in Indian markets. Revenues from the Global Generics segment stood at Rs. 28.9 bn, yoy growth of 9% while Revenues from the Pharmaceutical Services and Active Ingredients segment stood at Rs. 6.4 bn.



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EBITDA stood at Rs. 8.7 bn. EBITDA margin decreased by 245 bps on yoy basis to touch 22.7% and PAT decreased by 16.8% yoy basis to Rs. 5.74 bn in Q2FY15.

Segmental Analysis

Global Generics

Revenues stood at Rs. 28.9 bn, yoy growth of 9%, primarily driven by India, Rest of the world markets territory (primarily Venezuela) and North America.

- 1) Revenues from North America stood at Rs. 14.3 bn, yoy growth of 8%
 - a) Sustained performance of FY14 'limited competition' launches namely decitabine, azacitidine and divalproex sodium ER.
 - b) Progress on market share expansion of key molecules namely divalproex sodium ER, metoprolol succinate and ziprasidone.
 - c) 1 new product launched during the quarter
 - d) 2 ANDA filings during the quarter. Cumulatively, 72 ANDAs are pending for approval with the USFDA of which 45 are Para IVs, and we believe 11 to have 'First to File' status.
- 2) Revenues from Emerging Markets stood at Rs. 8.3 bn, yoy growth of 14%
 - a) Revenues from Russia at Rs. 4.1 bn, year on year decline of 11% primarily on account of the Rouble devaluation. In constant currency the growth is flat.
 - b) Emerging Markets Ex – Russia at Rs. 4.2 bn recorded year on year growth of 57% primarily driven by strong performance in Venezuela Market.
- 3) Revenues from India stood at Rs. 4.8 bn, yoy growth of 14% driven by healthy volume expansion in its focus brands, some of which are also listed under the NLEM portfolio.

Pharmaceutical Services and Active Ingredients (PSAI)

- a) Revenues from PSAI stood at Rs. 6.4 bn
- b) During the quarter 28 DMFs were filed globally, filed 3 in the US, 19 in the ROW and 6 in Europe. The cumulative number of DMF filings as on Sep. 30, 2014 stood at 703.

Key developments

The Company entered into an asset purchase agreement with Novartis Consumer Health Inc. to acquire the title and rights to Habitrol franchise (an over – the counter nicotine replacement therapy transdermal patch) and to market the product in the US territory. The agreement is subject to FTC review and the transfer of asset will happen post FTC clearance.

Impact of fall in oil prices and currency devaluation of Russian Rouble



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The steep fall in oil prices and subsequent currency devaluation of Russian Rouble and Venezuelan Bolivar will impact Dr. Reddy's FY16 sales and operating profits by 4-5 per cent.

While Russia accounts for about 12 per cent of sales, Venezuela contributes about 2-3 per cent to revenues. The impact on earnings would be lower due to potential price hikes undertaken and benefit of INR depreciation against the US dollar. US accounts for about 46 per cent of Dr Reddy's revenues.

Russia is one of the fastest growing markets for Dr Reddy's with annual revenue growth averaging 15 per cent between FY10-14 with FY14 revenues at US\$270 million (Rs. 1,620 crore). The market also happens to be one of the higher margin geographies with increasing proportion of over the counter medicines (the other segment is prescription sales), the share of which have doubled to 37 per cent over the last five years. The company could reduce the impact of currency by increasing the prices of the OTC products as these don't fall under price control. Dr. Reddy's has been benefitting from drug shortages especially in Venezuela in the September quarter with local players unable to import raw material due to lack of American currency as the Venezuelan currency has been depreciating. It was the sharp rise in sales to that country which helped Dr Reddy's rest of the world sales grow 95 per cent year on year. Apart from India, higher rest of the world sales were the only positive in an otherwise muted September quarter which saw a single digit gain in the US market and fall in revenues from the EU. The correction in rouble and latin American currencies completely overshadowed the company's announcement of the launch of generic version of anti-viral drug Valcyte in the US market. The product has sales of US\$440 million (Rs 2,800 crore) and is expected to add about US\$30 million-US\$40 million (Rs 250 crore) annually to the company's sales.

Outlook and Valuation

The company witnessed revenue CAGR of 17% over the period FY09-14 to touch 132.2 bn in FY14. Over the same period EBITDA witnessed a CAGR of 20% to Rs. 33.2 bn in FY14. PAT too registered an impressive CAGR of 111 percent to touch Rs. 21.5 bn in FY14. We believe that the company is well placed to tap the opportunity presented by US generics market and is strongly placed in domestic formulations business. With due consideration to factors like a) street expectation of revenue and PAT CAGR of 18% and 21% respectively over the period FY14-16E, b) management expectations of 6-8 launches in the US in 2HFY2015, which will drive growth, while Domestic and Russian businesses are likely to outpace industry growth going ahead on continued brand building efforts and new launches, c) Company planning to file its first NDA (novel product) in the US by FY2015, which is expected to get an approval in the next 12 months. At CMP, the stock trades at a P/E of 25x FY14 earnings. We recommend a "BUY" on the stock with a price target of Rs 3800 assuming a P/E of 20x FY16E earnings, an upside of 21%, over a period of 6 – 9 months.



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- b) Company holding: No**
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