Infinity.com Financial Securities Ltd
Small World, Infinite Opportunities

PINC RESEARCH

RESULT REVIEW

Q2FY2012 Review
Sector: Pharmaceuticals
BSE Sensex: 1 7,255

Dr Reddy's Laboratories

Maintain	SELL
CMP	Rs1,580
TP	Rs1.442

Margins disappoints, in spite of strong revenue growth

DRL reported strong revenue growth driven by US, Russia and PSAI segments. The growth on the low-margin PSAI front was a positive surprise. However, the high-margin domestic formulation segment continues to grow below the industry average. Further the EBIT margins, in spite of strong revenue growth, continue to disappoint on back of higher raw-material and employee cost, coupled with marketing expenses in Russia/CIS region.

We value DRL on a SOTP basis with a target price of Rs1,442, valuing the base business now at Rs1,379 (18x one year forward recurring earnings) and Rs63/share for P-IV/ limited competition opportunities. We maintain our SELL rating on the stock.

25 October 2011

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PSAI segment surprises on the positive side

DRL reported revenue of Rs22.7bn up 21.3% YoY which was ahead of our estimates driven by US, Russia and PSAI segments. US formulation segment continued with the strong performance clocking 42.4% YoY growth on back of product launches (Allegra D-24 OTC and generic Arixtra) and improvement of market share in existing products. Further, Russia & CIS segments also clocked robust growth of 22.9% YoY. The surprise came from the PSAI segment which grew by 28.5% YoY driven by new product launches in Europe. However, India formulation segment continues to disappoint with below industry average growth rate.

Pressure on EBIT still persists

DRL reported adjusted EBIT of 15.3%, inspite of stellar growth from the US business coupled with the surprise from the PSAI segment, impacted by higher raw-material cost and SG&A expenses. The increase in SG&A expenses continued for the second consecutive quarter on account of higher employee cost, marketing expenses in Russia and overhead cost at the acquired GSK facility.

VALUATIONS AND RECOMMENDATION

We value DRL on a SOTP basis with a target price of Rs1,442, valuing the base business now at Rs1,379 (18x one year forward recurring earnings) and Rs63/share for P-IV/ limited competition opportunities. The stock is trading at 24.1x FY12E and 19.7x FY13E recurring earnings. We maintain our SELL rating on the stock.

KEY FINANCIALS (Rs mn)

	FY09	FY10	FY11	FY12E	FY13E
Recurring Sales	60,979	67,046	69,974	80,704	92,620
YoY Gr. (%)	*34.2*	*9.9*	*4.4*	*15.3*	*14.8*
Recurring EBIT	5,197	8,296	9,721	12,464	15,450
Recurring EBIT (%)	8.5	12.4	13.9	15.4	16.7
Recurring Net Profit	1,242	9,728	8,714	11,103	13,586
YoY Gr.(%)	*(54.3)*	*683.1*	*(10.4)*	*27.4*	*22.4*

KEY RATIOS

	FY09	FY10	FY11	FY12E	FY13E
Dil. EPS (Rs)	-	6.3	65.3	93.7	101.1
ROCE (%)	(3.4)	2.4	14.4	18.3	17.6
RoE (%)	13.4	27.3	24.8	30.0	25.6
PER (x)	-	250.5	24.2	16.9	15.6
EV/ Net Sales (x)	4.4	4.0	3.8	3.3	2.8
EV /EBIDTA (x)	52.0	32.0	27.4	21.5	17.0

QUARTERLY SNAPSHOT (Rs mn)

	Quarter Ended		
	Mar-11	June-11	Sept-11
Net sales	20,170	19,784	22,679
YoY Gr. (%)	*22.8*	*17.5*	*21.3*
Op. Profit	2,318	2,551	3,345
OPM (%)	*13.1*	*13.2*	*15.3*
Adj.Net Profit	3,343	2,627	3,078
YoY Gr. (%)	*57.8*	*25.3*	*7.4*

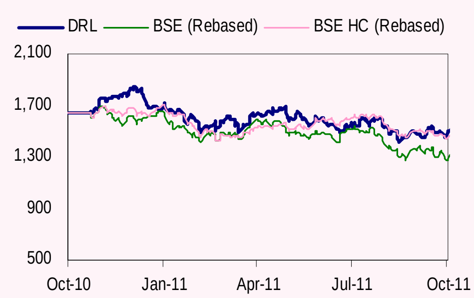
STOCK DATA

Market cap	Rs267bn
Book Value per share	Rs351
Shares O/S (F.V. Rs5)	169mn
Free Float	74.4%
Avg. Trade Value (6 months)	Rs560mn
52 week High/Low	Rs1,855/1,387
Bloomberg Code	DRRD IN
Reuters Code	REDY.BO

PERFORMANCE (%)

	1M	3M	12M
Absolute	6.3	0.1	(4.4)
Relative	(0.5)	7.4	12.1

RELATIVE PERFORMANCE



Key call takeaways

1) US: a) DRL expects revenue growth in H2FY12 to be better than H1FY12 on back of product launches and improvement in market share in existing products b) The company has garnered market share of 32% in Tacrolimus, 20% each in Lansoprazole and Omeprazole and 10% in generic Arixtra c) Two plants underwent successful USFDA inspection including Vizag.

2) Gross margins for global generic business stood at 63% down by 50-60bps YoY on back of higher raw material cost while PSAI segment gross margins came in at 28%, up 600bps YoY driven by new product launches.

3) Domestic: a) September month IMS growth for DRL stood at 14%; this is in-line with company's expectation. b) The company expects recovery in H2FY12.

4) PSAI a) Strong growth on back of new product launches in Europe b) DRL expects the growth momentum on the revenue front to continue.

5) Europe a) Germany tender business continues to face pricing pressure.

6) Withdrawal of DEPB scheme to impact profitability by 100-120mn per quarter.

7) Capex of USD73mn in H1FY12.

8) Tax rate for FY12 to be in range of 18-20%.

9) R&D spend in H2FY12 to higher than H1FY12.

10) Guidance of USD2.7bn on the revenue front remains intact.

Exhibit 1 - Earnings Summary (Rs mn)

Year to Mar 31	Q2FY11	Q2FY12	% Ch YoY	Q1FY12	% Ch QoQ	H1FY11	H1FY12	% Ch YoY	PINC Comments
Recurring revenues	17,943	21,820	21.6	19,256	13.3	34,110	41,076	20.4	Driven by US, Russia and PSAI segment.
Unique products	761	859	12.8	528	62.7	1,425	1,387	(2.7)	
Total revenues	18,704	22,679	21.3	19,784	14.6	35,535	42,463	19.5	
Cost of revenues	8,718	10,473	20.1	9,228	13.5	16,635	19,701	18.4	
Gross Profit	9,986	12,206	22.2	10,556	15.6	18,900	22,762	20.4	Margins expand by 43 bps YoY.
Gross Margin (%)	*53.4*	*53.8*	*43 bps*	*53.4*	*46 bps*	*53.2*	*53.6*	*42 bps*	
SG&A Expenses	5,392	6,827	26.6	6,351	7.5	10,586	13,178	24.5	Higher freight costs, Annual increments across businesses, increased marketing spend in Russia and overhead costs at the acquired GSK facility.
as a % of recurring sales	*30.1*	*31.3*	*124 bps*	*33.0*	*(169) bps*	*31.0*	*32.1*	*105 bps*	
R&D Expenses	1,270	1,459	14.9	1,197	21.9	2,263	2,656	17.4	
as a % of recurring sales	*7.1*	*6.7*	*(39) bps*	*6.2*	*47 bps*	*6.6*	*6.5*	*(17) bps*	
Amortization Expenses	317	389	22.7	405	(4.0)	605	794	31.2	
Other operating expense/(income)	(218)	(215)	nm	(186)	nm	(404)	(401)	nm	
Total Operating Expenses	6,761	8,460	25.1	7,767	8.9	13,050	16,227	24.3	
EBIT	3,225	3,746	16.2	2,789	34.3	5,850	6,535	11.7	
EBIT Margin (%)	*17.2*	*16.5*	*(72) bps*	*14.1*	*242 bps*	*16.5*	*15.4*	*(107) bps*	
Recurring EBIT	2,743	3,345	22.0	2,551	31.1	4,932	5,991	21.5	
Recurring EBIT (%)	*15.3*	*15.3*	*4 bps*	*13.2*	*208 bps*	*14.5*	*14.6*	*12 bps*	Adjusted for VRS expenses.
Net interest expenses/(Income)	35.0	50.0	42.9	46.0	8.7	212.0	96.0	nm	Includes net forex gain of Rs151mn and profit on sale of investments of Rs25mn.
Equity in Loss of Affiliates	(3)	(13)	nm	(4)	nm	(8)	(17)	nm	
Other Income / (Expenses)	-	-		-		-	-		
PBT	3,193	3,709	16.2	2,747	35.0	5,646	6,456	14.3	
Tax	327	631	93.0	120	425.8	684	751	9.8	
Effective tax rate	*10.2*	*17.0*	*677 bps*	*4.4*	*1,264 bps*	*12.1*	*11.6*	*-*	
Minority Interest	-	-	nm	-	nm	-	-	nm	
Reported Net Income	2,866	3,078	7.4	2,627	17.2	4,962	5,705	15.0	
One off expenses/ (Income)	-	-	nm	-	nm	-	-	nm	
Recurring Net Income	2,866	3,078	7.4	2,627	17.2	4,962	5,705	15.0	Adjusting for one time expenses and tax normalizing.

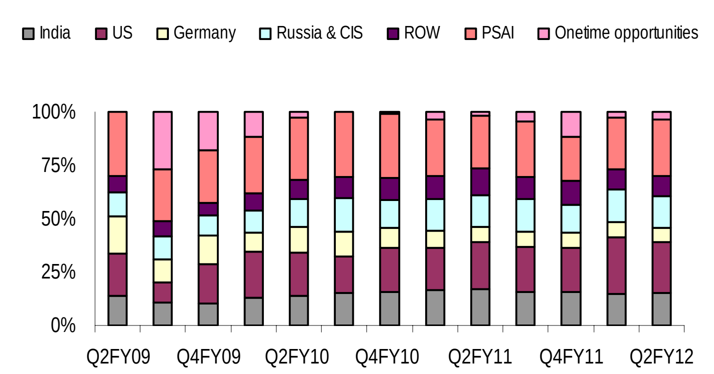
Source: Company, PINC Research

Exhibit 2 - Revenue Break-up (Rs mn)

Year to Mar 31	Q2FY11	Q2FY12	% Ch YoY	Q1FY12	% Ch QoQ	H1FY11	H1FY12	% Ch YoY	PINC Comments
Generics	6,782	8,404	23.9	7,673	9.5	12,616	16,077	27.4	
North America	4,416	6,287	42.4	5,756	9.2	8,313	12,043	44.9	Led by new product launches (Allegra D-24 OTC and generic Arixtra) including limited competition products and market share improvement.
Europe	2,366	2,117	(10.5)	1,917	10.4	4,303	4,034	(6.3)	De-growth on back of price erosions in Germany.
Branded Formulations	6,885	7,732	12.3	6,751	14.5	12,969	14,483	11.7	
India	3,160	3,459	9.5	2,936	17.8	5,938	6,395	7.7	
Russia & Other CIS	2,751	3,380	22.9	3,018	12.0	5,303	6,398	20.6	Driven by OTC segment and prescription sales growth.
RoW	974	893	(8.3)	797	12.0	1,728	1,690	(2.2)	
PSAI	4,617	5,933	28.5	4,832	22.8	9,116	10,765	18.1	Driven by improvement in the customer order status of the contract manufacturing segment.
North America	814	1,068	31.2	842	26.8	1,651	1,910	15.7	
Europe	1,551	2,303	48.5	1,693	36.0	3,106	3,996	28.7	Led by new product launches.
India	653	752	15.2	662	13.6	1,286	1,414	10.0	
RoW	1,599	1,810	13.2	1,635	10.7	3,073	3,445	12.1	
Others	420	610	45.2	528	15.5	835	1,138	36.3	
Total Revenues	18,704	22,679	21.3	19,784	14.6	35,535	42,463	19.5	

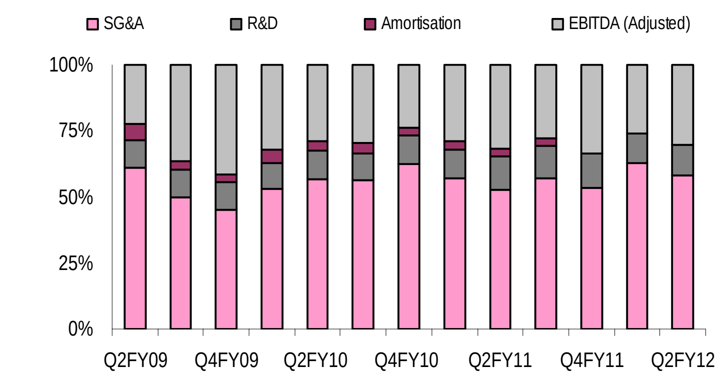
Source: PINC Research, Company

Exhibit 3 - Revenue Classification (%)



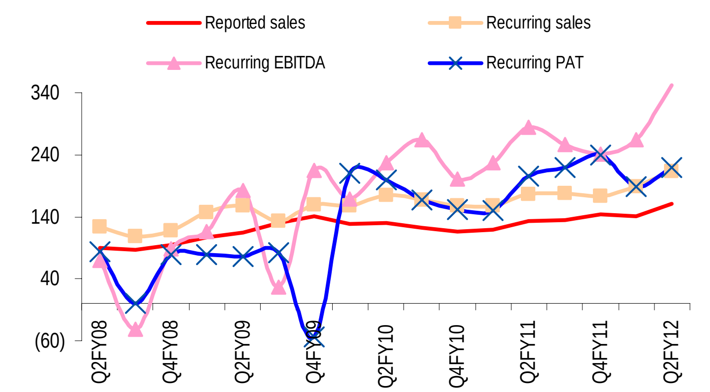
Source: PINC Research, Company

Exhibit 4 - Key Expenses and EBITDA



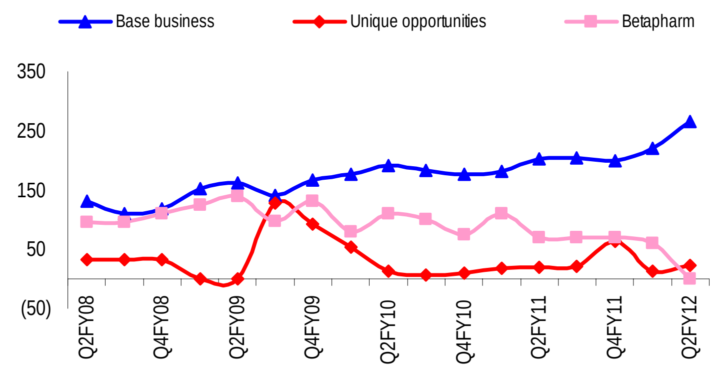
Source: PINC Research, Company

Exhibit 5 - Indexing of Key Financials



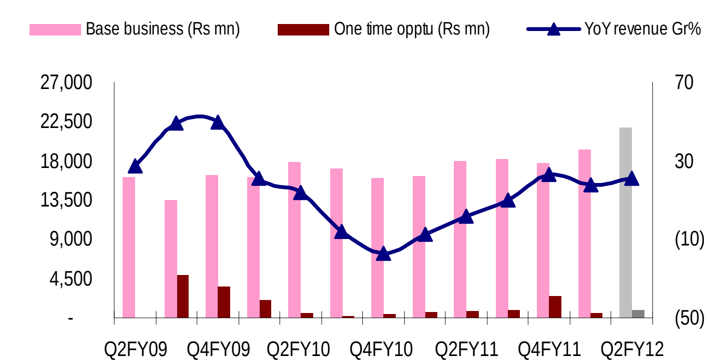
Source: PINC Research, Company

Exhibit 6 - Indexing of Revenue Mix



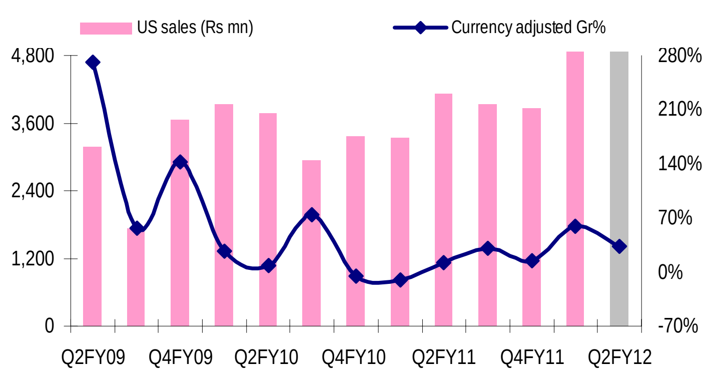
Source: PINC Research, Company

Exhibit 7 - Base Business and One time Opportunity



Source: PINC Research, Company

Exhibit 8 - US Recurring Sales Performance



Source: PINC Research, Company

Year Ended March (Figures in Rs mn based in IFRS)

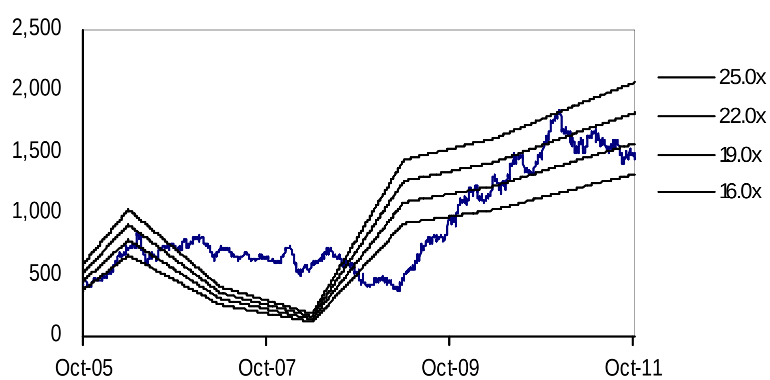
Income Statement	FY09	FY10	FY11	FY12E	FY13E
Recurring Net Sales	60,979	67,046	69,974	80,704	92,620
Growth (%)	*34.2*	*9.9*	*4.4*	*15.3*	*14.8*
Unique Opportunities	8,461	3,230	4,719	10,388	9,911
Reported Net Sales	69,440	70,276	74,693	91,093	102,530
Growth (%)	*38.9*	*1.2*	*6.3*	*22.0*	*12.6*
Recurring EBIT	5,197	8,296	9,721	12,464	15,450
Growth (%)	*30.2*	*59.6*	*17.2*	*28.2*	*24.0*
Other Income	1,186	3	189	32	40
Equity loss of affiliates	24	48	3	-	-
Reported EBIT	(4,065)	2,052	12,444	18,429	19,897
Tax Provision	(1,173)	(985)	(1,403)	(2,580)	(2,786)
Reported Net Profit*	(5,238)	1,067	11,041	15,849	17,112
E/o income/(loss)	11,218	10,513	-	-	-
Recurring Net Profit	1,242	9,728	8,714	11,103	13,586
Growth (%)	*(54.3)*	*683.1*	*(10.4)*	*27.4*	*22.4*
Reported EPS (Rs) *	-	6.3	65.3	93.7	101.1
EPS Growth (%)	-	-	-	*43.6*	*8.0*
* including unique opportunities					

Cash Flow Statement	FY09	FY10	FY11	FY12E	FY13E
Net Income	(5,238)	1,067	11,041	15,849	17,112
Depreciation	3,814	4,160	-	-	-
Total Tax Paid	(1,619)	(1,846)	-	-	-
Chg in working capital	(8,459)	(1,572)	(11,236)	(2,373)	(3,544)
Other operating activities	15,790	11,238	5,991	(4,289)	(2,000)
Cash flow from oper (a)	4,288	13,047	5,796	9,188	11,567
Capital Expenditure	(4,680)	(4,222)	(8,456)	(7,900)	(4,900)
Chg in investments	4,294	(3,009)	3,567	-	-
Other investing activities	(3,086)	233	-	-	-
Cash flow from inv.(b)	(3,472)	(6,998)	(4,889)	(7,900)	(4,900)
Free cash flow (a+b)	816	6,049	907	1,288	6,667
Equity raised/(repaid)	5	17	256	-	-
Debt raised/(repaid)	(662)	(3,562)	(114)	-	-
Change in Minority Int	-	(80)	-	-	-
Dividend (incl. Tax)	(738)	(1,233)	(1,904)	(2,335)	(2,530)
Other financing activities	(1,246)	(203)	-	-	-
Cash flow from fin. (c)	(2,641)	(5,061)	(1,762)	(2,335)	(2,530)
Net chg in cash (a+b+c)	(1,825)	988	(855)	(1,047)	4,138

Balance Sheet	FY09	FY10	FY11	FY12E	FY13E
Equity Share Capital	842	844	846	846	846
Reserves & surplus	41,203	42,071	45,144	58,658	73,240
Shareholders' funds	42,045	42,915	45,990	59,504	74,086
Minorities interests	-	-	-	-	-
Total Debt	10,524	5,673	5,978	5,978	5,978
Capital Employed	52,569	48,588	51,968	65,482	80,064
Net fixed assets	43,061	36,432	44,888	52,788	57,688
Cash & Cash Eq.	5,596	6,584	5,729	4,682	8,819
Net Other current assets	8,320	7,982	3,060	9,722	15,266
Investments	262	310	313	313	313
Net Deferred tax Assets	(4,670)	(2,720)	(2,022)	(2,022)	(2,022)
Total Assets	52,569	48,588	51,968	65,482	80,064

Key Ratios	FY09	FY10	FY11	FY12E	FY13E
Recurring OPM (%)	8.5	12.4	13.9	15.4	16.7
Net Margin (%)	2.0	14.5	12.5	13.8	14.7
Div. Yield (%)	0.4	0.7	0.7	0.8	0.8
Net debt/Equity (x)	0.1	(0.1)	(0.0)	0.0	(0.0)
Net Working Capital (days)	43	40	14	38	53
ROCE (%)	(3.4)	2.4	14.4	18.3	17.6
RoE (%)	13.4	27.3	24.8	30.0	25.6
EV/Net Sales (x)	4.4	4.0	3.8	3.3	2.8
EV/EBITDA (x)	52.0	32.0	27.4	21.5	17.0
PER (x)	-	250.5	24.2	16.9	15.6
PCE (x)	96.8	23.8	30.7	24.1	19.7
Price/Book (x)	6.3	6.2	5.8	4.5	3.6

P/E Band



Key Assumption	FY10	FY11	FY12E	FY13E
Recurring business (% chng YoY)	9.9	4.4	15.3	14.8
One time opportunities (Rs m)	3,230	4,719	10,388	9,911
Gross Margins on base business (%)	50.7	53.4	53.7	53.8
OPMs (Ex-Onetime) (%)	12.4	13.9	15.4	16.7
Recurring EPS (Rs)	57.6	51.5	65.6	80.3
Recurring EPS growth (%)	680.8	(10.6)	27.4	22.4

PINC RESEARCH

T E A M

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