

# Dr Reddy's Laboratories (DRRD IN)

## Warning letter hits earning visibility

INDIA | PHARMACEUTICALS | Company Update

10 November 2015

### Warning letter for three facilities – a big negative surprise

DRRD received a warning letter from the USFDA for its two API facilities (Srikakulam in AP and Miryalaguda in Telangana) and for its oncology formulation unit at Duvvada in Visakhapatnam. The warning letters followed the inspection of these sites by the USFDA in November 2014, January 2015, and February 2015 respectively. While the Srikakulam unit had been under 483 since a year, the letters for Miryalaguda and Duvvada units are truly negative surprises.

### Concall highlights

- DRRD management is studying and evaluating the warning letter comprehensively and will respond to the USFDA within the mandated 15 days.
- Key issues behind the warning letter were documentation practices, laboratory-testing practices, incident reporting and management, hardware control, and other operating procedures. There were no critical observations relating to data integrity.
- The warning letter said that DRRD is verifying its corrective actions (taken to address USFDA observations) and its overall manufacturing procedures through a third party.
- DRRD management indicated that remedial actions based on the warning letter would be implemented across all its plant, including the problematic ones. Hence, it expects remedial action to take considerable time.
- DRRD will continue to rely on site-transfer applications for de-risking its near-term US pipeline. There are 4-5 important pending ANDAs from the Srikakulam unit.
- The Srikakulam API plant is the largest among the three plants with linkages for many of its US marketed drugs and future pipeline. DRRD plans to use its Miryalaguda API unit is for third-party API supply and the Duvvada formulation unit is relatively new with minimal revenue contribution. The plants under warning letter currently contribute about 10-12% of its consolidated sales.

**Valuation and view:** We know that the warning letter does not imply discontinuation of drugs supply to the US market. Considering the procedural nature of observations, we believe DRRD would resolve its facility issues amicably – this would protect itself from any import alert. So, we don't expect any major sales implication in FY16, but we see meaningful revenue impact in FY17 due to possible postponement of big-ticket approvals (Gleevec, Copaxone, Aloxi, Xeloda, Diprivan) to FY18. Additionally, we believe that the supply disturbance to other markets and unanticipated expenses in corrective actions in three sites, would hit DRRD's operational performance meaningfully.

Factoring these, we cut our FY16/17 earnings estimates by 9%/20% to Rs 154.1/159.5. An import alert (on failing to resolve facility issues quickly) would pose a risk to our estimates. Considering the ongoing regulatory issues around its three facilities, we see a de-rating in DRRD's valuation multiple. Hence, we cut our target multiple to 22x (from 24x earlier) and value DRRD at Rs 3,500 (from Rs 4,760 earlier), implying no near-term upside. We downgrade our recommendation to Neutral from BUY.

### Revision of estimates

(Rs Bn)	Old Est.			Revised Est.			% Revision		
	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E
Revenue	163.8	186.0	211.3	159.7	167.0	197.4	-2.5	-10.2	-6.6
EBITDA	43.7	50.8	58.3	40.2	42.2	53.1	-8.0	-16.8	-9.0
EBITDAM%	26.7	27.3	27.6	25.2	25.3	26.9			
Core PAT	28.9	33.7	38.8	26.2	27.1	34.8	-9.4	-19.5	-10.3
EPS	170.2	198.2	228.0	154.1	159.5	204.5	-9.4	-19.5	-10.3

### NEUTRAL (Downgrade)

CMP RS 3504

TARGET RS 3500 (0%)

### COMPANY DATA

O/S SHARES (MN) :	171
MARKET CAP (RSBN) :	619
MARKET CAP (USDBN) :	9.4
52 - WK HI/LO (RS) :	4383 / 3010
LIQUIDITY 3M (USDMN) :	29.9
PAR VALUE (RS) :	5

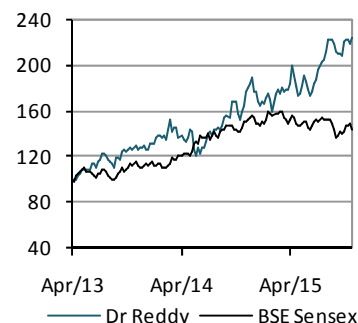
### SHARE HOLDING PATTERN, %

	Jun 15	Mar 15	Dec 14
PROMOTERS :	54.7	63.6	63.7
FII / NRI :	28.6	24.1	23.6
FI / MF :	7.8	4.5	4.8
NON PRO :	6.1	5.5	3.3
PUBLIC & OTHERS :	28.2	28.1	28.2

### PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-14.5	-15.0	11.6
REL TO BSE	-12.0	-7.8	17.5

### PRICE VS. SENSEX



Source: Phillip Capital India Research

### KEY FINANCIALS

Rs mn	FY16E	FY17E	FY18E
Net Sales	148,189	159,691	166,993
EBITDA	35,018	40,242	42,249
Net Profit	22,808	26,219	27,125
EPS, Rs	133.8	153.9	159.5
PER, x	26.2	22.8	22.0
EV/EBITDA, x	18.1	15.3	14.2
P/BV, x	5.4	4.4	3.7
ROE, %	19.9	19.3	16.9
Debt/Equity (%)	38.7	28.7	22.2

Source: PhillipCapital India Research Est.

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## Financials

### Income Statement

Y/E Mar, Rs mn	FY15	FY16e	FY17e	FY18e
<b>Net sales</b>	<b>148,189</b>	<b>159,691</b>	<b>166,993</b>	<b>197,357</b>
Growth, %	12	8	5	18
Total income	148,189	159,691	166,993	197,357
Raw material expenses	-62,786	-62,759	-65,628	-77,561
Other Operating expenses	-50,385	-56,690	-59,116	-66,707
<b>EBITDA (Core)</b>	<b>35,018</b>	<b>40,242</b>	<b>42,249</b>	<b>53,089</b>
Growth, %	7.3	14.9	5.0	25.7
Margin, %	23.6	25.2	25.3	26.9
Depreciation	-8,103	-8,351	-9,219	-10,035
<b>EBIT</b>	<b>26,915</b>	<b>31,891</b>	<b>33,031</b>	<b>43,054</b>
Growth, %	3.4	18.5	3.6	30.3
Margin, %	18.2	20.0	19.8	21.8
Interest paid	1,682	1,352	1,447	1,323
Non-recurring Items	-629	0	0	0
<b>Pre-tax profit</b>	<b>28,163</b>	<b>33,443</b>	<b>34,687</b>	<b>44,596</b>
Tax provided	-5,984	-7,224	-7,562	-9,811
<b>Profit after tax</b>	<b>22,179</b>	<b>26,219</b>	<b>27,125</b>	<b>34,785</b>
<b>Net Profit</b>	<b>22,179</b>	<b>26,219</b>	<b>27,125</b>	<b>34,785</b>
Growth, %	6.0	15.0	3.5	28.2
<b>Net Profit (adjusted)</b>	<b>22,808</b>	<b>26,219</b>	<b>27,125</b>	<b>34,785</b>
Unadj. shares (m)	170	170	170	170
Wtd avg shares (m)	170	170	170	170

### Balance Sheet

Y/E Mar, Rs mn	FY15	FY16e	FY17e	FY18e
Cash & bank	5,394	20,125	33,570	52,356
Debtors	40,755	39,923	41,748	49,339
Inventory	25,529	26,615	27,832	32,893
Other current assets	13,901	15,394	17,648	20,381
Total current assets	85,579	102,058	120,798	154,969
Investments	37,076	42,076	47,076	52,076
Gross fixed assets	116,073	127,827	140,049	152,882
Less: Depreciation	-57,672	-66,023	-75,242	-85,277
Add: Capital WIP	6,119	6,000	6,000	6,000
Net fixed assets	64,520	67,804	70,807	73,606
Non-current assets	1,795	1,795	1,795	1,795
<b>Total assets</b>	<b>194,762</b>	<b>218,946</b>	<b>245,169</b>	<b>286,669</b>
Current liabilities	10,660	13,308	13,916	16,446
Provisions	7,252	6,937	9,509	11,401
Total current liabilities	17,912	20,245	23,425	27,848
Non-current liabilities	65,548	63,126	60,830	64,751
Total liabilities	83,460	83,370	84,256	92,599
Paid-up capital	852	851	851	851
Reserves & surplus	110,450	134,724	160,062	193,219
Shareholders' equity	111,302	135,575	160,913	194,069
<b>Total equity &amp; liabilities</b>	<b>194,762</b>	<b>218,946</b>	<b>245,169</b>	<b>286,669</b>

### Cash Flow

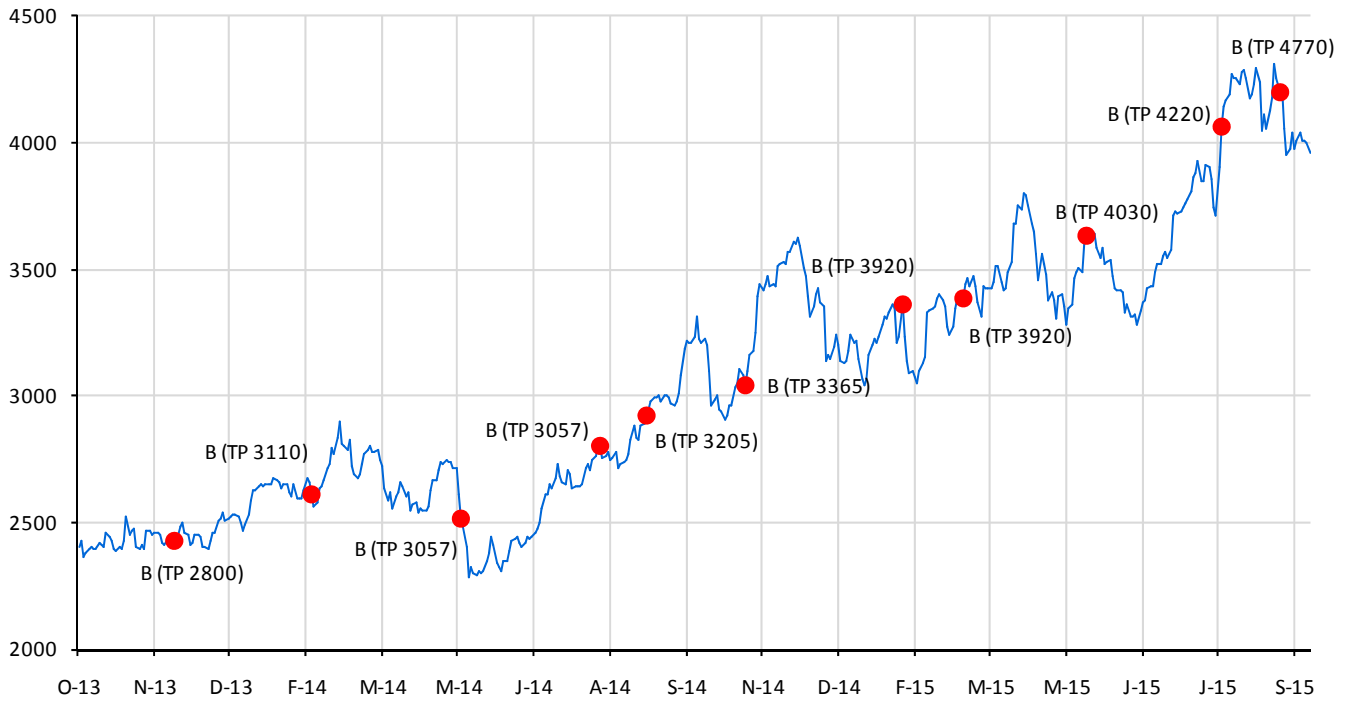
	FY15	FY16e	FY17e	FY18e
Pre-tax profit	28,163	33,443	34,687	44,596
Depreciation	8,103	8,351	9,219	10,035
Chg in working capital	-5,161	1,709	-1,996	-10,273
Total tax paid	-5,373	-5,922	-6,284	-8,361
Other operating activities	0	0	0	0
<b>Cash flow from operating activities</b>	<b>25,732</b>	<b>37,581</b>	<b>35,626</b>	<b>35,998</b>
Capital expenditure	-13,502	-11,635	-12,222	-12,833
Chg in investments	-11,993	-5,000	-5,000	-5,000
<b>Cash flow from investing activities</b>	<b>-25,300</b>	<b>-16,435</b>	<b>-17,012</b>	<b>-17,613</b>
Free cash flow	17,414	27,401	0	0
Equity raised/(repaid)	627	1,455	1,615	1,773
Debt raised/(repaid)	-1,616	-4,268	-3,172	2,251
<b>Cash flow from financing activities</b>	<b>-989</b>	<b>-2,813</b>	<b>-1,557</b>	<b>4,024</b>
Net chg in cash	-557	18,333	17,056	22,409

### Valuation Ratios

	FY15	FY16e	FY17e	FY18e
<b>Per Share data</b>				
EPS (INR)	133.8	153.9	159.5	204.5
Growth, %	6.0	15.0	3.5	28.2
Book NAV/share (INR)	653.2	795.6	944.3	1,138.9
FDEPS (INR)	133.8	153.9	159.5	204.5
CEPS (INR)	185.1	202.9	213.3	263.0
CFPS (INR)	152.8	219.4	207.8	210.0
<b>Return ratios</b>				
Return on assets (%)	11.6	12.3	11.3	12.8
Return on equity (%)	19.9	19.3	16.9	17.9
Return on capital employed (%)	16.9	17.8	16.4	18.2
<b>Turnover ratios</b>				
Asset turnover (x)	1.4	1.4	1.4	1.5
Sales/Total assets (x)	0.8	0.8	0.7	0.7
Sales/Net FA (x)	2.4	2.4	2.4	2.7
Working capital/Sales (x)	0.5	0.4	0.4	0.4
Receivable days	100.4	91.3	91.3	91.3
Working capital days	165.1	149.5	151.5	150.2
<b>Liquidity ratios</b>				
Current ratio (x)	6.5	6.2	6.7	7.2
Quick ratio (x)	4.6	4.6	5.2	5.7
Total debt/Equity (%)	38.7	28.7	22.2	19.5
Net debt/Equity (%)	33.9	13.8	1.3	(7.4)
<b>Valuation</b>				
PER (x)	26.2	22.8	22.0	21.0
PEG (x) - y-o-y growth	4.3	1.5	6.4	0.7
Price/Book (x)	5.4	4.4	3.7	3.8
EV/Net sales (x)	4.3	3.8	3.6	3.6
EV/EBITDA (x)	18.1	15.3	14.2	13.5
EV/EBIT (x)	23.6	19.3	18.1	16.6

Source: Company, PhillipCapital India Research Estimates

### Stock Price, Price Target and Rating History



### Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	$\geq +15\%$	Target price is equal to or more than 15% of current market price
NEUTRAL	$-15\% > \text{to} < +15\%$	Target price is less than +15% but more than -15%
SELL	$\leq -15\%$	Target price is less than or equal to -15%.

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