BST Research

Dr Reddy's Laboratories: A hidden gem in the emerging markets

Dmitry Krasotkin, CFA
Tel.: +7 916 492 4603
e-mail: info@bstresearchtoday.com

Sarthak Gera
Tel.: +91 93153 57443
e-mail: sarthak.gera97@gmail.com

Boris Maizel
Tel.: +7 925 193 2950
e-mail: info@bstresearchtoday.com

India Equity Research

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A threat of global recession looms over the global markets. Dr.Reddy's Laboratories, a growing Indian pharmaceutical company, might be an interesting opportunity for a conservative investor seeking both value and protection against adverse markets movements

- India is expected to become the third-largest consumer economy with its consumption tripling to US$4 trillion by 2025 as per a Boston Consulting Group (BCG) report.
- India's domestic pharmaceutical market is at US$ 42 billion in 2021 and likely to reach US$ 65 billion by 2024 and further expand to reach ~US$ 120-130 billion by 2030.
- Dr Reddy's is a growing pharma company with a sustainable revenue stream well diversified both geographically and product-wise with a strong exposure to domestic market.
- The company stock is currently trading at 14.5x ttm EV/EBITDA, which is 24% lower than the mean for its peers.
- We believe this discount is not justified given Dr Reddy's strong product line, good geographical diversification and a strong exposure to the growing Indian market.

Dr Reddy's Ticker:	DRREDDY.BO
Current share price, rupees	4 217
Market cap, billion rupees	690
EV	680
Revenue, ttm	217
EBITDA, ttm	47
Net profit, ttm	30
EV/Sales	3,1
EV/EBITDA	14,5
P/E	23,0
Dividend yield, %	0,6
PEG ratio (5-yr expected)	1,18
Target share price, 12m	**4 548**

Source: Yahoo!Finance, BST Research estimates

Dr. Reddy's Laboratories at a glance

Dr. Reddy's laboratories Ltd is one of India's largest pharmaceutical companies, with a wide range of products and services including generics, biosimilars, Active Pharmaceutical Ingredients (API) and Custom Pharmaceutical Services (CPS). The company was established in 1984 by Dr. Kallam Anji Reddy in the city of Hyderabad, Telangana, India, where it has its headquarters now. The company has almost 190 generics, 60 APIs and other biotechnology products. The company supplies generics and APIs all over the world, with USA, Europe and Asia as its major markets. Dr Reddy has 9 manufacturing units globally with 3 FDA approved in USA, 5 R&D centers and more than 40 sales and marketing offices all around the world. In a span of 38 years the company has become a global pharmaceutical conglomerate with its reach into new markets increasing per year. The company has expanded into emerging markets such as Romania, Commonwealth of Independent States (CIS), South Africa and Brazil.

Why invest in India?

India comes under the category of emerging markets, which is promising for high growth rates to come. In Asia, India has emerged as one of the fastest growing economies amongst other countries such as Bangladesh, Pakistan, Indonesia and Malaysia etc.

The business environment, aggressive vaccination drives and focus on industrial output has led to a strong trajectory of growth, with GDP estimates at 9% in the coming years.

The Union Budget 2022-2023 which was passed in February 2022 has put a lot of focus on infrastructural development. The Govt. has increased its Capex by 35% since last year which shows its commitment towards industrial growth.

According to the Indian Economic Survey 2021, the domestic market is expected to grow 3x in the next decade. India is expected to become the third-largest consumer economy with its consumption tripling to US$4 trillion by 2025 as per a Boston Consulting Group (BCG) report.

With such advances in growth rates and a focus on infrastructural and industrial output, the future of the country looks bright. Some macroeconomics parameters must be kept in mind while looking at the sustained growth of the Indian economy in the long run such as inflation, geopolitical unrest, commodity prices and pandemics. So far India has been able to battle these shocks and has displayed a tenacious growth trajectory.

Indian pharma as the largest global provider of generic drugs

India pharmaceutical industry is globally, the largest provider of generic drugs. The Indian pharma sector supplies over 50% of global demand for various vaccines, 40% of generic demand in the US and 25% of all medicine in the UK.

Globally, India ranks 3rd in terms of pharmaceutical production by volume and 14th by value. The domestic pharmaceutical industry includes a network of 3,000 drug companies and ~10,500 manufacturing units. The global demand for production is ever growing and India has the capacity to satisfy it as well.

India is at an important position in the global pharmaceuticals sector. India is home to some of the largest pharmaceutical companies in the world, which conduct business all over the world. The competition amongst them helps to keep prices and quality of pharmaceutical services in check and ensure efficiency in the same.

India's domestic pharmaceutical market is at US$ 42 billion in 2021 and likely to reach US$ 65 billion by 2024 and further expand to reach ~US$ 120-130 billion by 2030.

India's biotechnology industry is growing steadily and comprises of biopharmaceuticals, bio-services, bio-agriculture, bio-industry, and bioinformatics. The Indian biotechnology industry was valued at US$ 70.2 billion in 2020 and is expected to reach US$ 150 billion by 2025.

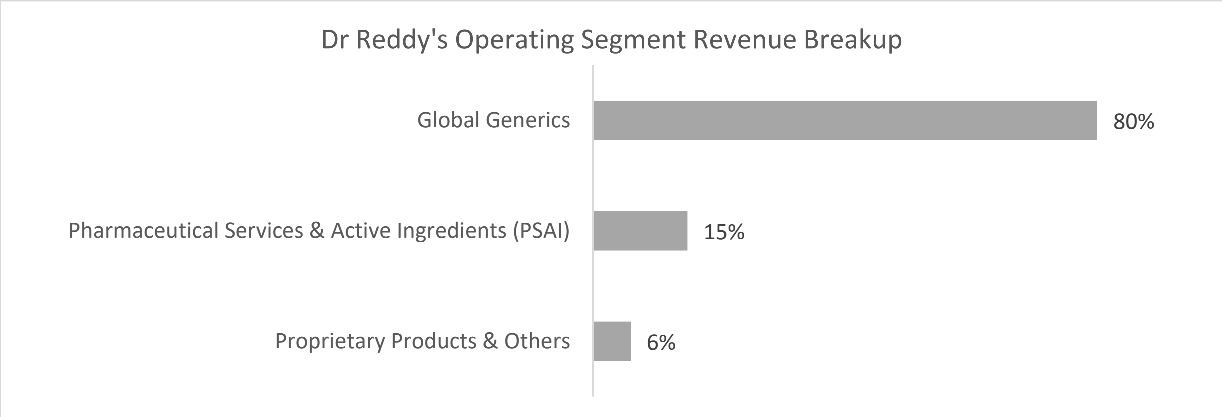
India's medical devices market stood at US$ 10.36 billion in FY20. The market is expected to increase at a CAGR of 37% from 2020 to 2025 to reach US$ 50 billion.

Dr. Reddy's Laboratories business overview

Dr. Reddy's Laboratories is a major Indian manufacturer of generic drugs.

Revenue Breakup

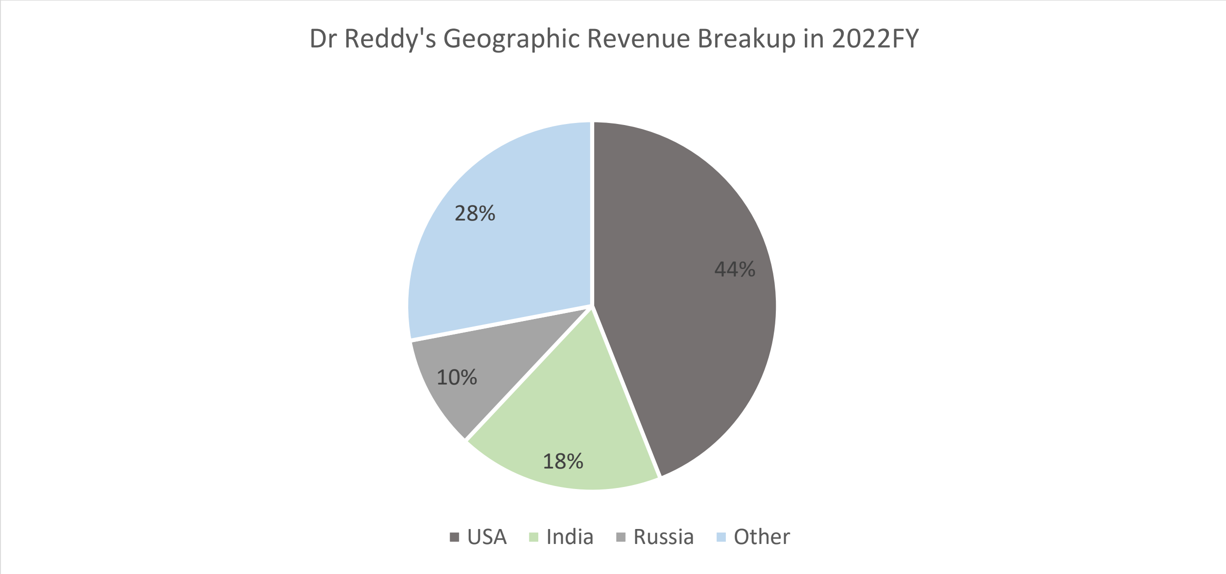
Global Generic Segment accounts for 80% of the revenues, owing to the diverse product placement in the American, European and emerging markets. Pharmaceutical Services & Active Ingredients (PSAI) contributed 15% to the revenues and is a sector with promising growth. Proprietary Products & Others accounted for 6% of the revenues.



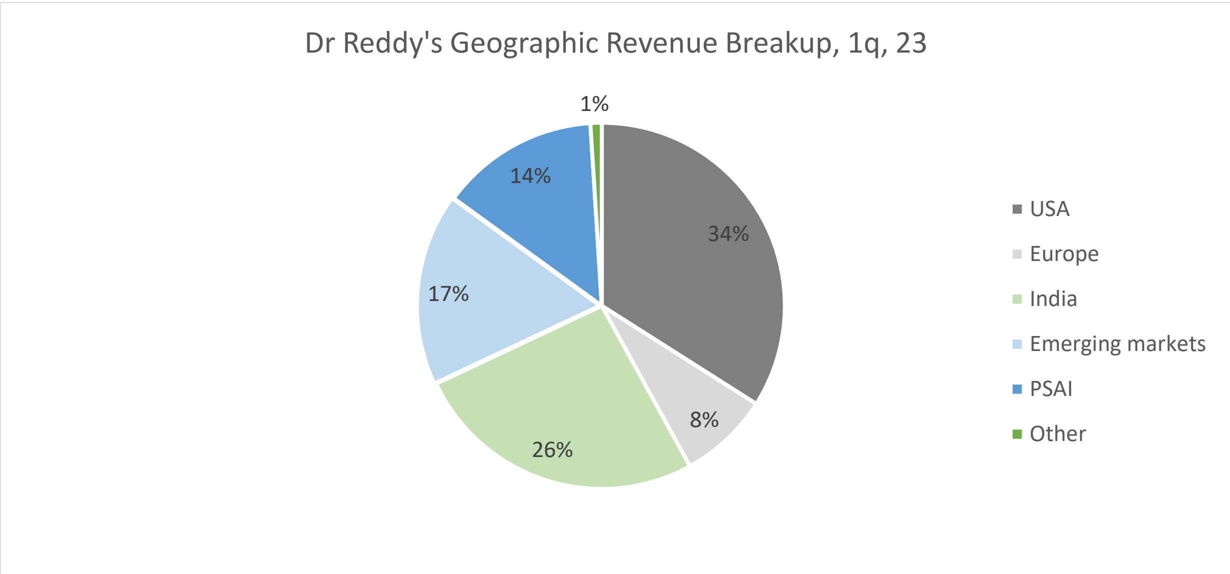
Source: Company reports

Geographic Revenue Breakup

In 2022FY (financial year that started on 1 April, 2021 and ended 31 March, 2022), USA stands as the largest contributor in revenues at 44% and is the largest market for generics, followed by Others (Europe, Emerging Markets) at 28%. India accounted for 18% and Russia for 10% of revenue in 2022FY. The revenue share of India is expected to grow in the coming years owing to the rising demand for generics and other pharmaceutical services.



But things have changed in Q1, 2023FY. The share of North America has decreased sharply, while the share of India has increased significantly. We believe this shows that the company has been able to leverage its domestic franchise and grow sales on the growing Indian market.



Revenues for Russia in Q1, 23FY were at Rs. 3.2 billion, down 9% y-o-y and down 53% from Q4, 22FY due to higher base in Q4 FY22 from brand divestment income and channel inventory normalization in the current quarter.

In its 2020-21 FY Annual Report the company provided revenue growth forecasts for its key geographic markets:

Pharmaceutical Growth Forecast for Major Countries

Region	2016-2020 CAGR	2021-2025 CAGR
United States	4.2%	2%-5%
United Kingdom	5.3%	2.5%-5.5%
Other Developing	4.2%	2.5%-5.5%
Russia	10.8%	11%-14%

India	9.5%	7.5%-10.5%
Pharmerging	7.4%	7%-10%

(Source: Dr Reddy's Labs Annual Report 20-21)

This forecast is in line with the recent developments as demonstrated in the 1q, 23 sales breakup.

Key Geographic Markets Overview

India

The Indian segment has seen a revenue of Rs. 10.3 billion in the quarter and nine months ended December 31, 2021. There was a 7% growth in revenues year-on-year due to increase in sale price of existing products and revenues from newly launched products. This was slightly offset by the decrease in sales of covid related products. This can be attributed partly to the extensive vaccine coverage in the country and there is little to no substantial impact on consumer and investor sentiments.

The economic outlook for India is positive, considering a rapid growth in agricultural, manufacturing and services sector. The demand for generics is set to rise with the growing population in India and more focus by the government on healthcare sector.

The onset of covid has also led to a higher number of people being more conscious about their personal health and hygiene, which will have an overall positive impact on pharmaceutical sales.

India ranks third globally for pharmaceutical production by volume and exports to more than 200 countries. This figure is only set to rise in the future as India has joined the global race for being one of the top API producers. India's main market for pharmaceutical products is North America which is itself one of the largest global markets for pharmaceutical products.

USA

The revenue from North American segment stood at Rs 18.6 billion, 7% up year-on-year. This was due to increase in sales volume of the base business, new product launches and favorable forex rate. The North American segment might see higher price performance in the future due to the 88 ANDAs and 3 NDAs pending approval.

The expected launch of new product lines will boost revenue in the future. North America still stays as the world's largest marketplace for pharmaceutical products, indicating no signs of a lower demand. The market spending in pharmaceuticals is set to rise as it is predicted that Americans will spend approximately $635-$655 billion on medicine by 2023 which is an almost 29.6%-33.7% increase from 2019.

The general outlook for the North American segment is a positive one with sales expected to increase in the near future which was only hampered by the onset of covid.

Europe

The revenue from Europe segment stood at Rs. 4.1 billion which has declined by 2% year-on-year due to price erosion on some of the existing products. However, this was partially offset by traction in volume for baseline and existing products as well as introduction of new products.

Emerging Markets

The emerging markets segment was among the top performers reporting a 20 per cent jump for the 3d quarter of 2022FY with sales of Rs. 11.5 billion. Within emerging markets, the rest of the world segment saw sharp 46 per cent growth aided by product launches and higher sales volumes for the base business.

Revenues from other CIS countries and Romania market at Rs. 2.4 billion. Year-on-year growth of 11% driven by launch of new products, offset partially due to lower volumes in the base business. Revenues from Rest of World (RoW) territories at Rs. 4.4 billion. Year-on-year growth of 50% was driven by new product launches and higher sales volume in base business, offset partially by price erosion in some of their key products.

Going forward we should expect a significant decline in DrReddys' sales in Ukraine due to the ongoing military operations there. However, Ukraine is no more than 10% of total EM revenue, so the overall effect on EM sales will not be significant and is likely to be offset by growth in sales in other countries.

Russia

Dr Reddy's has a significant part of their revenue generated in Russia.

Starting from 2014, economic sanctions have been imposed and gradually expanded by the United States, the European Union and certain other countries against certain Russian individuals and legal entities. The imposition of sanctions has resulted in increased economic uncertainty including more volatile equity markets, a depreciation of the Russian Ruble, a reduction in both local and foreign direct investment inflows and a significant tightening in the availability of credit. As a result, certain Russian businesses may have difficulty accessing international equity and debt markets and may become increasingly dependent on government support for their operations.

In recent months, following the Russian Federation's launch of a special military operation in Ukraine, the United States, the European Union and certain other countries have imposed additional severe sanctions on certain major financial institutions and certain other entities and individuals in Russia. In addition, restrictions were imposed on the supply of various goods and services to Russian businesses. In response to the sanctions described above, the Russian government introduced certain currency control measures and the Russian Central Bank raised its key rate to 20%, which was subsequently lowered to 8.5%.

These developments resulted in an increased volatility in the financial markets and a significant increase in the level of economic uncertainty in the Russian business environment.

However, even though all these economic and political woes may have a negative effect on DrReddys' business environment in Russia as a whole, their sales in the country are unlikely to suffer much in the long-term as the generic drugs the company sells are priced in a low-to-middle pricing range, and with consumers switching from higher priced Western companies' drugs to lower priced substitutes, DrReddys is well positioned to benefit from this substitution effect. There are also some Western companies that declared their intention to scale down their operations in Russia and freeze all further investments in the country. This again may well play into DrReddys' hands as the company may take over the niches vacated by competitors.

We look positively at the DrReddys' position in the Russian market and believe that even despite the on-going crisis situation there, the company is well-positioned to further grow sales in this market in the long-term, although in the short-term we might expect some increased volatility in sales in Russia.

Valuation Considerations

The company demonstrates revenue growth at CAGR of 5% in the last 6 years, however, in the last 5 years this growth has been more impressive at 8% CAGR.

For our DCF valuation of Dr Reddy's stock we used a number of assumptions.

Revenue

Revenue FY2016-FY2022

Particulars, in million rupees	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY2021	FY 2022E
Revenue Model							
Global Generics							
North America	75 445	63 601	59 822	59 957	64 659	70 494	75 429
Europe	7 732	7 606	8 217	7 873	11 707	15 404	17 098
India	21 293	23 131	23 322	26 179	28 946	33 419	38 432
Russia	10 600	11 500	12 600	15 300	16 900	15 800	18 170
Emerging Markets	12 992	9 571	10 053	13 594	15 911	19 297	24 121
Total GG Revenue	**128 062**	**115 409**	**114 014**	**122 903**	**138 123**	**154 414**	**173 250**
Total GG Revenue Growth		*-10%*	*-1%*	*8%*	*12%*	*12%*	*12%*
PSAI							
Total PSAI	**22 379**	**21 277**	**21 992**	**24 140**	**25 747**	**31 982**	**32 500**
PP&Others	4 267	4 123	6 022	6 808	10 730	3 326	3 559
Total Revenue	**154 708**	**140 809**	**142 028**	**153 851**	**174 600**	**189 722**	**209 309**
Total revenue growth, %		*-9%*	*1%*	*8%*	*13%*	*9%*	*10%*

Historical financials are provided in the table below:

Particulars, in million rupees	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY2021	FY 2022E
Total Revenue	**154 708**	**140 809**	**142 028**	**153 851**	**174 600**	**189 722**	**209 309**
Total revenue growth, %		*-9%*	*1%*	*8%*	*13%*	*9%*	*10%*
Cost of Reveues (COGS)	62 427	62 453	65 724	70 421	80 591	86 645	100 551
Gross Profit	**92 281**	**78 356**	**76 304**	**83 430**	**94 009**	**103 077**	**108 758**
Gross Profit Margin (%)	*60%*	*56%*	*54%*	*54%*	*54%*	*54%*	*52%*
Expenses (SG&A)	45 702	46 372	46 910	48 890	50 129	54 650	62 081
R&D Expenses	17 834	19 551	18 265	15 607	15 410	16 541	17 482
Impairment of non-current assets	0	0	0	0	16 767	8 588	7 562
Other Income (net)	-874	-1 065	-788	-1 955	-4 290	-982	-2 761
Total Operating Expenses	**62 662**	**64 858**	**64 387**	**62 542**	**78 016**	**78 797**	**84 364**
Operating Profit	**29 619**	**13 498**	**11 917**	**20 888**	**15 993**	**24 280**	**24 394**
Finance Income (Net)	2 708	-806	-2 080	-1 117	-1 478	-1 653	-2 119
Net Result of Investees	-229	-349	-344	-438	-561	-480	703
Profit Before Tax(PBT)	**27 140**	**14 653**	**14 341**	**22 443**	**18 032**	**26 413**	**25 810**
Tax Expenses	7 127	2 614	4 535	3 648	-1 466	9 175	8 730
% of PBT	26%	18%	32%	16%	-8%	35%	34%
Net Profit	**20 013**	**12 039**	**9 806**	**18 795**	**19 498**	**17 238**	**17 080**

Source: Company data, BST Research estimates

Forecast

Particulars, in million rupees	FY 2023	FY 2024	FY 2025	FY 2026
Revenue Model				
Global Generics				
North America	78 446	81 584	84 847	88 241
Europe	17 782	18 494	19 233	20 003
India	43 428	49 074	55 453	62 662
Russia	17 751	18 994	20 323	21 746
Emerging Markets	26 630	30 624	35 218	40 501
% Revenue Growth Russia				
Total GG Revenue	184 037	198 769	215 075	233 152
Total GG Revenue Growth	*8%*	*8%*	*8%*	*8%*
Total PSAI	**34 775**	**37 209**	**39 814**	**42 601**
PP&Others	3 808	4 074	4 360	4 665
Total Revenue	**222 620**	**240 053**	**259 249**	**280 418**
Total revenue growth, %	*8%*	*8%*	*8%*	*8%*
Cost of Reveues (COGS)	111 310	115 225	121 847	128 992
Gross Profit	**111 310**	**124 827**	**137 402**	**151 426**
Gross Profit Margin (%)	*50%*	*52%*	*53%*	*54%*
Expenses (SG&A)	66 427	71 077	76 052	81 376
R&D Expenses	18 706	20 015	21 416	22 915
Impairment of non-current assets	5 000	5 000	5 000	5 000
Other Income (net)	-2 500	-2 500	-2 500	-2 500
Total Operating Expenses	**87 632**	**93 592**	**99 968**	**106 791**
Operating Profit	**23 678**	**31 236**	**37 434**	**44 635**
Finance Income (Net)	-2 000	-2 000	-2 000	-2 000
Net Result of Investees	600	600	600	600
Profit Before Tax(PBT)	**25 078**	**32 636**	**38 834**	**46 035**
Tax Expenses	8 777	11 422	13 592	16 112
% of PBT	35%	35%	35%	35%
Net Profit	**16 301**	**21 213**	**25 242**	**29 923**

Revenue

The company reported y-o-y revenue growth of 8% for GG segment in the quarter ended 30 June 2022. We assume that on average it will be able to grow its revenues at the above rate in the period 2023FY-2026FY.

Specific geography revenue growth assumptions are as follows: North America – 4%, Europe – 4%, India – 13%, Russia – 7%, Emerging Markets – 15%. We believe that in line with the current trends most growth will come from the domestic market and other emerging markets.

SG&A

A 7% growth rate has been taken for SG&A as we predict the expenses to go up in the coming years owing to the company's plans to increase its generics base in the USA, Europe, Russia and India, which will increase expenditure in general.

Gross profit margins

The gross profit margin for 2022-2026 has been taken between 50%-54%. This is based on an average of gross profit margins from 2016-2021 which is 55%. The gross profit margins used for 2022-2023 are conservative owing to the rising inflation kept in mind and the general macroeconomic conditions which may affect the company. However, considering inflationary pressure to ease out and macroeconomic factors to stabilize after 2023, the margins considered are ascending.

R&D Expenses

R&D expenses as a % of Revenues from 2016-2022 are declining dropping from 14% - 8%, however we expect to see a rise in the R&D expenditure in the coming years owing to the company's investments in new generics, PP and other services. R&D expenditure for a pharmaceutical company is an indication towards future growth prospects as it provides long term benefits.

The company has one of the highest R&D expenses as a % of Revenue among all its major peers by at least 4-5x. This is a highly positive indication for the company to be ahead of its peers in the coming years. R&D being above peer average also indicates higher margins for the company including higher gross profit margins.

Particulars, in million rupees	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026
DCF Valuation					
EBITDA		**40 178**	**47 736**	**53 934**	**61 135**
Tax Expense		-8 777	-11 422	-13 592	-16 112
Change in Net Working Capital		7 481	-4 792	-6 345	-6 992
Capex		-20 000	**-16**	**-15**	**-14**
Free Cah Flow		**18 881**	**15 521**	**18 997**	**24 031**
Termial Value (EBITDA*EVEBITDA Multiple)					917 023
Discount Period		0,5	1,5	2,5	3,5
Discount Rate Coefficient (1/(1+discount rate*)^Discount Period)		0,95	0,86	0,77	0,69
Discounted Free Cash Flow		17 921	13 272	14 634	16 678
Discounted Terimal Value					636 429
Enterprise Value (EV)	698 934				
Net Debt- (Short Term Debt+Long term debt current portion+long term debt)-Cash and Cash Equivalents	18 993				
Equity Value (EV-Net Debt)	679 941				
No. of Shares Outstanding (Million)	166				
Price per Share	**4 097**				
Target price, rupees	**4 548**				

*We used 11% as our discount rate (WACC) for our model.

Traded peer multiples valuation

Peer analysis is provided in the table below:

in billion Rupees

Company	Ticker	Mcap	Net Debt	EV	Key Financials, ttm				Multiples, ttm		
					Sales, ttm	EBITDA, ttm	EBITDA, % Sales	NetProfit	EV/Sales	EV/EBITDA	PE
Aurobindo Pharma	AURPHA	333	-13	320	234	43	18%	26	1,4	7,4	12,8
Biocon	BIOCON	370	31	401	85	20	24%	7	4,7	20,1	55,8
Zydus Lifesciences	CADHEA	350	7	357	152	33	22%	22	2,3	10,8	15,9
Cipla	CIPLA	834	-35	799	217	44	20%	25	3,7	18,2	33,4
Ipca Laboratories	IPCLAB	257	-5	252	159	12	8%	-21	1,6	21,0	-12,2
Lupin	LUPIN	300	20	320	161	27	17%	-5	2,0	11,9	-54,6
Sun Pharma	SUNPHA	2 200	-24	2 080	397	102	26%	39	5,2	20,4	56,4
Torrent Pharma	TORPHA	526	35	561	87	24	28%	8	6,4	23,4	65,8
Average							**20%**		**3,4**	**16,6**	**21,7**
Mean							**21%**		**3,0**	**19,1**	**24,6**
Dr Reddy's	DREDDY.NS	690	-10	680	217	47	22%	30	3,1	14,5	22,7

Source: Yahoo!Finance

Dr Reddy’s looks undervalued relative to its peers especially based on EV/EBITDA multiple.

Investment conclusion

Decision – BUY/HOLD

We expect the company to grow in the coming years. The recent future might test the tenacity of the company considering high inflationary pressure globally and macroeconomic conditions could bottleneck supply flows. However, the company has robust capex and growth plans, with new product launches almost every year globally. The COVID-19 pandemic and its following impact has changed the way the company functions and has been a learning experience. We expect the company to cope well in the turbulent months.

We assume the target price for the company for next year to be Rs. 4,548 or in the range of Rs 4,100 – Rs 4,500.

Disclaimer

This is not an investment recommendation.

Certain statements in this presentation are forward-looking statements within the meaning of the U.S. federal securities laws and are intended to be covered by the safe harbors created thereby.

Those forward-looking statements include, but are not limited to:

- management’s assessment of the Company’s future results, including revenue, net profit(loss), profit(loss) per share, dividends, investments, capital structure, margins and other operating and financial results;
- forecasts of the present value of future cash flows and related factors;
- the Company’s plans, goals and tasks relating, among other things, to its products and services development;
- the Company’s expectations with respect to improving its corporate governance practices;
- the Company’s market position – as anticipated;
- economic outlook and industry trends;

- the Company's expectations as to the sector regulation and assessment of impact of regulatory initiatives on the Company's activity;
- assumptions and prerequisites under the statements.

Such forward-looking statements are subject to risks, uncertainties and other factors, which could cause actual results to differ materially from those expressed or implied by these forward-looking statements.

These risks include the risk of changes in political, economic and social conditions in Russia as well as changes in global economic environment, the risks relating to changes in industry regulation and the Russian legislation, the risk of changes in the Company's operations and business prospects, the competition and other risks.

For a more detailed discussion of these and other factors, see the Company's Annual Report and other public filings.

This information is not an individual investment recommendation, and the financial instruments or transactions mentioned in it may not necessarily correspond to your investment profile and investment goals (expectations). Determining whether a financial instrument or transaction matches your interests, investment goals, investment horizon and level of acceptable risk is your task. BST Research is not responsible for possible losses in the event of transactions or investments in financial instruments mentioned in this information, and does not recommend using this information as the only source of information when making an investment decision.