Dr Reddy's: Supported by traction in limited competition products

Sales growth in North America was helped by healthy market share for the generic version of Vascepa

Representative image

Highlights

- *US business helped by recent launches, which offsets pricing erosion*
- *Sputnik V opportunity fades for domestic market, but holds potential for export market*
- *Investment in digitisation and brands to cap operating margin improvement*
- *Strong product launch pipeline and opportunity in EMs to support growth*

While **Dr Reddy's Laboratories** (CMP: Rs 4,219; Market Cap: Rs 70,205 crore) continues to face price erosion challenges, traction in limited competition products supports growth.

However, as the risk of the pandemic is fading, investors need to evaluate any pharma investment devoid of COVID-related opportunities. Most of the pre-COVID challenges, including USFDA scrutiny and pricing erosion in developed markets, are back.

Among the positive triggers is a lean balance sheet, which helps the company to look for M&A deals. In this context, its investment in a health-tech platform would be a key watch. Through this platform, the company plans to give end-to-end solutions related to healthcare. This may encompass pharmacy, diagnostics etc. Capital allocation decisions will be a short- to medium-term watch.

EMs help offset pricing weakness

Dr Reddy's Q3FY22 sales grew by 8 percent year on year (YoY), aided by emerging markets (EMs), but partially offset by pricing erosion in the US and European markets.

In case of EMs (21 percent of Q3 sales), strong traction in the Rest of the World (RoW) and product launches aided topline growth.

The India business (19 percent of sales) grew by a mediocre 7 percent, helped by pricing, but offset by decrease in volumes for COVID-related products.

Sales growth in North America (35 percent of sales) was 7 percent. **But this appeared remarkable, considering the double-digit pricing erosion in the base business. This was helped by healthy market share for the generic version of Vascepa, which commands about 11-12 percent market share.**

Vascepa is used in treating patients with high triglyceride levels.

Q3FY22 financials

Consolidated Income Statement

Particulars	Q3 FY22 ($)	Q3 FY22 (Rs.)	Q3 FY21 ($)	Q3 FY21 (Rs.)	YoY Gr %	Q2 FY22 ($)	Q2 FY22 (Rs.)	QoQ Gr %
Revenues	715	53,197	663	49,296	8	775	57,632	(8)
Cost of Revenues	330	24,585	306	22,758	8	361	26,846	(8)
Gross Profit	385	28,612	357	26,538	8	414	30,786	(7)
Operating Expenses								
Selling, General & Administrative expenses	207	15,411	193	14,387	7	214	15,951	(3)
Research and Development expenses	56	4,159	55	4,108	1	60	4,463	(7)
Impairment of non-current assets	1	47	80	5,972	(99)	-	-	-
Other operating income	(3)	(240)	(2)	(128)	88	(23)	(1743)	(86)
Results from operating activities	124	9,235	30	2,199	320	163	12,115	(24)
Net finance income	(4)	(289)	(7)	(493)	(41)	(4)	(319)	(9)
Share of profit of equity accounted investees	(2)	(185)	(2)	(151)	23	(3)	(247)	(25)
Profit before Income Tax	131	9,709	38	2,843	242	170	12,681	(23)
Income Tax	36	2,644	36	2645	(0)	37	2,761	(4)
Profit for the period	95	7,065	3	198	3468	133	9,920	(29)

Revenue Mix by Segment

Segment	Q3 FY22 (Rs.)	Q3 FY21 (Rs.)	YoY Gr %	Q2 FY22 (Rs.)	QoQ Gr %
Global Generics	44,508	40,751	9	47,431	(6)
North America	18,645	17,394	7	18,909	(1)
Europe	4,058	4,143	(2)	4,135	(2)
India	10,266	9,591	7	11,402	(10)
Emerging Markets	11,539	9,623	20	12,985	(11)
Pharmaceutical Services and Active Ingredients (PSAI)	7,271	7,009	4	8,372	(13)
Proprietary Products & Others	1,418	1,536	(8)	1,829	(22)
Total	53,197	49,296	8	57,632	(8)

Source: Dr Reddy's

Coming to margins, EBITDA margins improved to 22.6 percent (+120 bps) due to a better product mix, partially offset by higher employee cost.

Outlook

Steady US business traction due to the growth in limited competition products helped Dr Reddy's to overcome pricing erosion. In recent times, the company launched Vascepa, which addresses a market of at least $400 million. Here, it competes with Amarin, Hikma, and Apcotex.

The management mentions that it has secured the relevant API for the next few quarters, making it relatively immune to supply-chain challenges.

Also, the company expects to gain more market share from the innovator for Suboxone, a prescription drug used to treat opioid addiction. Here, the company holds more than 20 percent market share.

In the field **of biologics**, **Rituximab**, to treat leukemia, is undergoing phase 3 trials. In addition, there are three more bio-similars undergoing clinical trials.

Further, the expected launch of oncology drug Revlimid by FY23 also adds to medium-term prospects.

Along with Rituximab, Revlimid is going to be a global product as the company plans to launch it in Canada and Europe.

Overall, the prospects in the US market are supported by a robust product pipeline. There are 91 pending filings, of which 45 are 'Para IV'. Twenty four filings are expected to have 'first to file' status.

'Para IV' filing is made when a company intends to sell the innovator's drug before its patent expiry. It files an additional document called Para IV with the USFDA to get the approval. A first-to-file ANDA is eligible for 180-day exclusivity for sales. In general, approvals under Para IV and the 'first to file' status should help in having a better market share and margins.

Among non-US markets, we remain positive on the growing opportunity in China. According to the earlier management guidance on filing 25 products in FY22 and FY23 in the Chinese market, the company has filed more than 15 products.

While the management sees no impact of the recent Ukraine-Russia spat on business, it remains a key geo-political event to track.

As regards the COVID opportunity, which is largely on the export front, the company remains hopeful of some traction for Sputnik Light, given the demand for booster doses and lower vaccination coverage in many countries. Further, the company is in a better set-up to benefit from the demand for Molnupiravir, for which it relies on in-house facilities to manufacture APIs.

Nevertheless, in the larger scheme of things, due to the competition from other anti-COVID pills, this opportunity doesn't appear to be material enough.

On the regulatory front, the company has submitted response with respect to the USFDA observations for the Vizag plant and is awaiting feedback. This inspection was triggered by a product filing.

As far as margins are concerned, the management guides that the EBITDA margins should improve on account of the full-value realisation of the recent product launches in the US.

Having said that, we believe aspirational EBITDA margin target of 25 percent will take some time due to the need for recurring investments (digitisation, brand- building exercise and elevated R&D) in the medium term.

As far as valuation is concerned, given the recent correction and downward tweak in our estimates, the stock is trading at 12.3x FY23e EV/EBITDA, close to the median multiple for the sector.

While the growth story has moderated due to pricing erosion, a steady traction in limited competition products and strong presence in EMs make the stock an accumulation candidate on declines.

EARNINGS PROJECTIONS

	FY19	FY20	FY21	FY22e	FY23e
Sales	15,205	16,740	18,883	21,716	24,973
EBITDA	2,911	3,534	4,389	4,778	5,744
EBITDA margin	19.1%	21.1%	23.2%	22.0%	23.0%
Profit before tax	2,244	2,575	3,420	3,723	4,477
Net profit	1,880	1,950	1,916	2,755	3,313
EPS (Rs)	113	118	115	166	199
P/E (x)	37.2	35.9	36.6	25.4	21.2
EV/Ebitda (x)	24.3	20.0	16.1	14.8	12.3

(in Rs crore), Source: Dr Reddy's, Moneycontrol Research

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FIRST PUBLISHED: JAN 31, 2022 11:23 AM